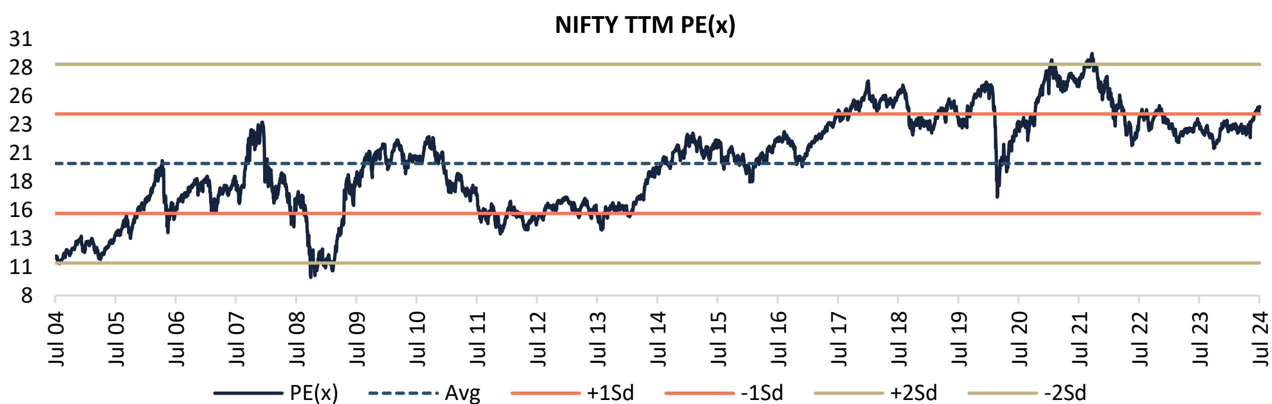
Nifty @ 25000 – Has the market become complacent?

This is a question that was apt anytime over the last year or so when the market has been hitting a new high regularly. The answer could have been on the affirmative side every time and yet the market has shown resilience along with strength. It has to be said that there is no new data point @ 25000 which makes the market more vulnerable than before.

To begin with, we have no clear basis for calling a top to the ongoing bull run right now. The post Covid economic recovery in India has been robust to say the least. Apart from beating consensus expectations for most part, several macro indicators have been showing continued strength. The economic growth has spawned earnings growth and that has kept the market well supported. The following chart is revealing.



Source: IIFL Securities, Ace Equity, Spark Fund Research

The market multiple peaked three years back in 2021. The market is now over 34% higher, while the multiple is now around 16% lower. The earnings growth has stayed resilient.

There is nothing to suggest that the economic growth needs to stall on its tracks. Even if the GDP slows down a notch or two, a 7%+ growth will be a stand-out number in a growth-starved world. That sort of growth is more likely to sustain over the next few years. Credit conditions have been benign. The outlook for bank NPAs is looking stable and the regulatory interventions have been timely and calibrated. Fiscal consolidation is on track. We are seeing a well-rounded growth in the economy after Covid. For now, the macro is flashing green.

The market has been discounting these developments along the way and there is nothing that warrants us to say that we are at the end of the road. Yet the question assumes significance at this stage. Is the market complacent?

The answer to this is a resounding YES. This does not mean that we are done with the rally. That question is hard to answer. That said, there are some red flags – or at best the light is flashing amber.

Returns above trend

The returns of the Nifty 50 going past the pre-covid high in January 2020 stand at 16.6% CAGR. Other indices also show a similar trend. Let us see how this has materially changed the longer-term return trend.

CAGR (%)	Jan 20, 2020	5-Yr	10-Yr	20-Yr
NIFTY 50	17.1	17.5	12.4	14.6
NSE MIDCAP 100	30.0	29.9	18.5	18.2
BSE SMALLCAP 500	34.1	34.2	18.7	18.1

Note: Return as on July 31, 2024
Source: Ace Equity, Spark Fund Research

The returns after Covid have had the impact of lifting the longer-term trend returns. Investors have now begun to take this for granted. The above-trend earnings growth post Covid has been buoyed by robust contribution from the more cyclical pockets in the market. These include PSU banks, capital goods/infra names and other deep cyclicals. Many of these companies had a terrible decade before Covid. A combination of factors led to the comeback in earnings for these. While their outlook remains benign for now, they cannot be expected to do the heavy lifting for long. Meanwhile, the erstwhile leaders have seen no improvement in earnings growth overall. There is a live risk of the trend returns pulling back when earnings growth starts to moderate or decelerate. The market seems to be in blissful denial.

What the valuation numbers hide

Headline valuations have always hidden as much as they have revealed.

In FY20, just before Covid, the market valuations were said to be reasonable based on headline numbers. At that point, the private banks, consumer centric stocks and other asset light businesses were trading way above trend valuations. The same was camouflaged by cheap multiples in PSU banks and other B2B names. Today, the valuations at the headline level still appear to be below peak (the chart above shows that) but the dispersion of valuations has narrowed.

Company	TTM PE(x) As on 30-07-2021	TTM PE(x) As on 31-07-2024
Asian Paints	81.3	58.2
Hindustan Unilever	66.9	61.5
Mahindra & Mahindra	49.5	34.4
Tata Consultancy Services	34.0	33.8
Infosys	33.6	29.1
Reliance Industries	28.6	29.6
ICICI Bank	26.0	20.2
HDFC Bank	24.5	18.9
Larsen & Toubro	18.1	39.3
State Bank of India	16.9	12.8
NTPC	8.6	19.6
Tata Motors	NM	12.2

Note: Standalone earnings for Banks, Mahindra & Mahindra
Source: Ace Equity, Spark Fund Research

No sector or market segment is at valuations that seem to provide a margin of safety. Yet we hear strategists citing that Nifty is not far above mean valuations even as most of their key stock picks are nowhere near those valuation levels.

In short, the mean of the Nifty valuations has lifted because of momentum in recent years and stocks that investors and funds want to own are way above this level. The advice is – look beyond

the index. When you do so, the picture is even more alarming. Valuation charts have been twisted to suit the narrative and investors need to take note.

The TINA factor

The attractiveness of equities as an asset class is supposedly buttressed by the lack of alternatives. The returns from bonds barely cover headline inflation on a post-tax basis. Real estate has not been the force it once was, and the liquidity is not great. The bull case for equities is that if fixed income and real estate do not even offset inflation, why should people with surplus capital consider them?

There is a sense of entitlement being implied here. Investors with surplus capital have made a resolution for themselves that come what may, they deserve to beat inflation using armchair investing. Equity risk premium seems to have been abolished in a virtual echo chamber that seems to resonate with a view that short term volatility apart, equities can only go up.

In a free market, somebody's desire or compulsion to beat inflation cannot be the reason for assets to bend to that will for an indefinite amount of time. History is replete with instances where such apparent Goldilocks settings have unravelled. Japan in the 1980s looked like a fairy-tale that would never end. The unwinding was not pleasant, and the hangover was devastating.

Shifting goal posts in analysis

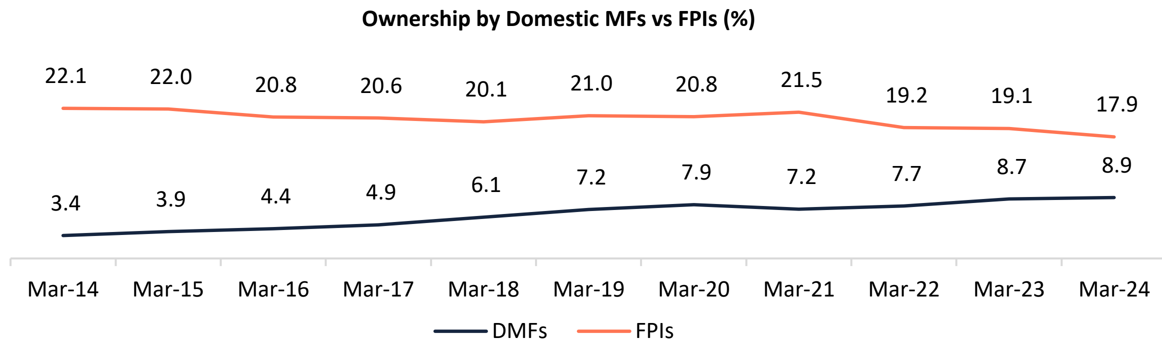
Professional analysts and fund managers have been shifting the goal post to justify the India story in a classic syndrome of tail wagging the dog.

Earlier, we had valuation discussions that centred around current year forward earnings, reflecting the position that equities discount the future. Then it went to 12 month forward earnings. Two-year forward earnings are now par for the course. Never mind that the forecasting error for even shorter periods has gone up given uncertainties in the global macro and other tricky moving parts. Further, quarterly beats are enough for justifying price performance even when the beat is against a low-balled consensus. Take the example of Infosys. It revised its guidance a few weeks back and has been on a roll because the outlook has supposedly improved (We don't own Infosys at present though we are invested in other IT services names). The company has changed its guidance in four out of the last five quarters even on low numbers. This time around, the upward revision has not taken the growth to even mid-single digits. Doesn't matter. A beat is a beat, and everyone is supposed to celebrate that with buying. Infosys is still a solid company with healthy cash flows et al. When you move to small/midcaps, the scenario gets far worse. For many companies where the PE ratio is considered too high, EV/EBTDA is quietly used in price forecasts. What was once a PE ratio kind of multiple is now an EV/EBITDA multiple. There is often a justification that PE is bad measure when it is on the higher side and inconvenient for a bullish view.

We can see the tail wagging the dog furiously. Every so-called expert is either looking the other way or muttering some diplomatic mumbo jumbo. While everyone has a right to be wrong (that includes us), we are better off calling out facts.

The coming of age of the Indian retail investor

This is one of the biggest indicators of complacency in equities. The spin is that the DIIs have been buying what FIIs have been selling and look at how well the markets have done.



Source: ICICI Securities, Spark Fund Research

The argument is that the domestic SIP flow acts as a buffer against any fall in stocks. After all, this is really long-term money from the Indian middle-class saver. If liquidity could have held up markets forever, bear markets would never happen. Nor would anyone remain poor as central banks can very well create as much liquidity as is needed to manufacture prosperity.

The TINA factor and the domestic liquidity can turn on a dime. We highlight the need to be cognizant on this even as we ourselves are cautious but constructive on the market. Fence is a good place to sit on in these times.

What next?

If the question is on whether complacency levels are an immediate signal that the markets would sell off, the answer to that is – NO ONE KNOWS. It is a fair call to make that the more we go down the road that we are going, the more the risks would keep building up. The end game would then be hugely unpleasant. While we lack the clairvoyance to forecast the exact shape of things to come, it is a good idea to remember that equities are a risky asset class. Somewhat riskier than is currently assumed by Indian stock investors. Within this, the small/midcaps tend to have built in risks which only become apparent when it is too late to notice. While the Indian growth story is intact, linear extrapolation of how that growth would impact stocks is a notion that needs to be examined. The trigger point for a possible pull-back may come from some unexpected quarters. Ipso facto, be ready to expect the unexpected.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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