Greetings!

Bull with a stealthy gait

We have been in a bull market. The shortest bear market in history began and ended in March 2020. One characteristic of the market for the last few years has been that it has chosen to chart its own course other than finding a new high on a regular basis which is a mathematical corollary once a new high is reached and prices go up. For instance, the market has been regularly rebasing the mean on valuations. It has been defying or at least deferring mean reversion. On a more granular level, the market has been more than kind to certain types of business models in the sense that for those, earnings misses have been given a wide rope. For others, there has been instant and severe punishment. Companies with debt have been viewed with a pound of salt even though debt has never been cheaper. And I am not referring to companies with unsustainable gearing.

New age businesses have been commanding valuations which are at a clear disconnect to operating cash flows. We acknowledge the fallacy of force-fitting conventional valuation metrics to these business models. That said, cash flows and profits matter at some time and if that time is too far off, the uncertainty needs to be factored in as well. High valuations are being set in the unlisted space by so-called marquee investors (no doubt with a formidable record in creating wealth but often times with limited vintage). Unlike in the past bull markets, the valuations for IPOs are being dictated by the deal prices in the unlisted market. There is an issue in transparency in that market. That is an inherent limitation of that domain. Investors need to be aware of this. In the listed markets, price discovery is more seamless and is no doubt a more transparent process. In an earlier era, the public markets drove the basis for IPO valuations. Not anymore. The unlisted market is driving price discovery now. We are in this unchartered territory and it is useful to mind our steps.

Some takeaways from the new order of things (not validated yet but largely accepted by the consensus view) have been:

1. Change is a constant
2. Valuations are relative
3. The word Bubble is best avoided as you are sure to look less than smart after using it
4. Good managements can perform magic. Trust them to boost the market cap come what may
5. Lower interest rates are here to stay because it is someone else's compulsion

If the above situation should be analytically viewed as stable, fair and not accident prone, the one addition I may have to add to the list is that we should not bother with risk as the same would stand abolished. With humility, I demur. These are times when questions should be asked. By the way, all the five points listed above have some merit. But if questions are not asked or are answered with condescension, there is trouble ahead.

We are not bearish on equities and let us be clear about that. In April and since then, we have made several arguments on why the glass is half full. The glass is still half full. But the water is getting murky. It is time to tread with caution.

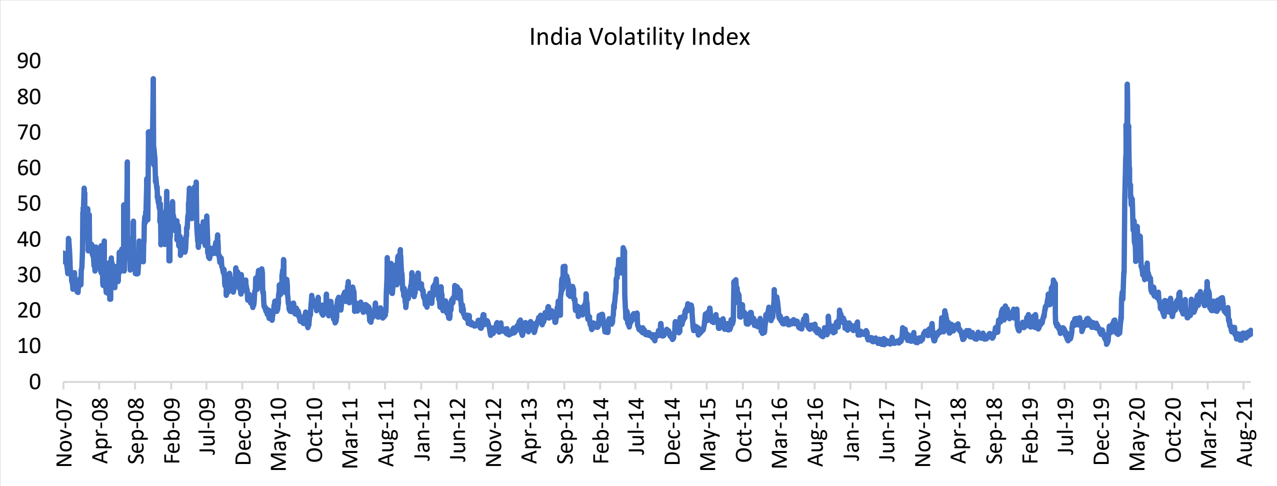
This bull market has cantered along with a majestic gait and has conquered all along its way. It has been stealthy in the sense that a lot of people seem to have been left out. Free markets don't promise salvation to all and stock market is even more particular about rewarding winners and none else. Let us highlight one characteristic of this bull market which has been in evidence for some years even before the current run. Which is that the market has been an excellent judge of which companies to allocate its largesse to. In the previous bull runs, all boats were lifted with the tide so to speak. This time around, a select few have dominated the proceedings and those few have been usually the best in class. This may be one reason for the strength and stickiness of this bull run. On qualitative assessment, and even on several quantitative parameters, no one can find fault with the movers & shakers in this bull market. Wheat has been well separated from the chaff.

But then the seeds of trouble are coded into the recipe for success that has been dishing out more than a sumptuous meal. The market has not used any sense of proportion in dishing out the fruits of success. If you don't pay the right price for what you invest with your own big bucks, you might pay a heavy price later. At some point, all good things come to a pause if not an end. Are we at a crossroad?

We can't be sure but let us look at some indicators that are flashing amber.

Complacency

There is a near universal consensus that little can go wrong with equities. The deal flows and IPO pipelines reflect that optimism. Most commentaries you come across talk about caution that sounds like a statutory disclaimer. No one dares to talk down equities. After all, you might look stupid soon thereafter. Let us look at the VIX, a measure of volatility and the state of mind of the investors when they go to sleep at night.

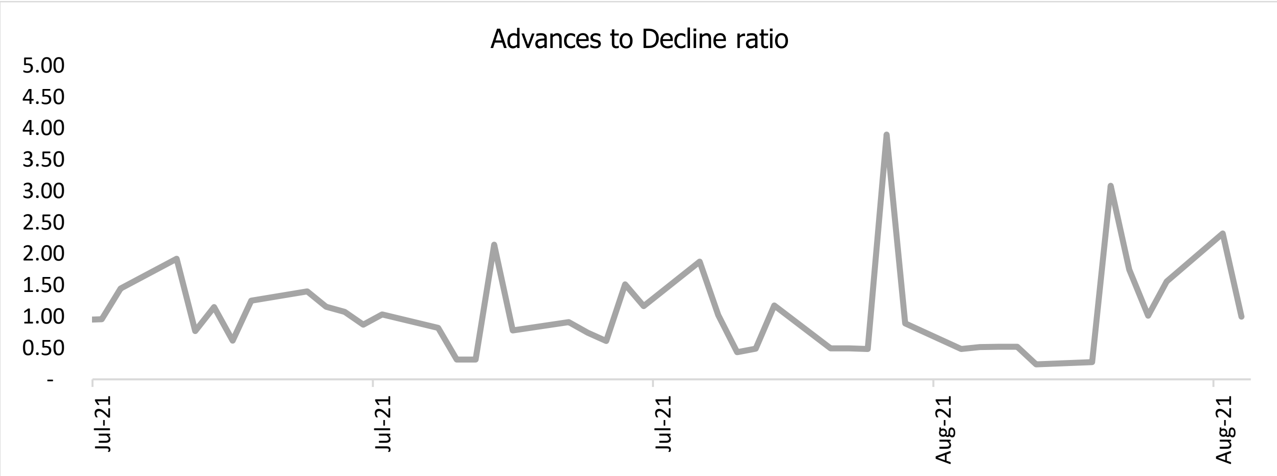


Source: Bloomberg, Spark Fund Research

The photo is clear. Either we are looking at a world devoid of all trouble going forward. Or else investors are in a nice siesta.

Narrowing market breadth

Look at the advance-decline ratio in India



Source: Bloomberg, Spark Fund Research

Though the chart is not showing a clear trend (unlikely in a unidirectional market that is going up), the ratio has been well below 1 on many days in recent weeks. For a market at a new high, signs of narrowing of breadth are signs of self-doubt.

Further, we note that the top ten contributors make up two-third of the Nifty performance quarter-to-date. In August, the top five contributed to half the run-up in Nifty. Participation from a narrowing set of stocks is an early sign of waning market strength though this metric needs further monitoring to see how it evolves.

Participant hesitancy

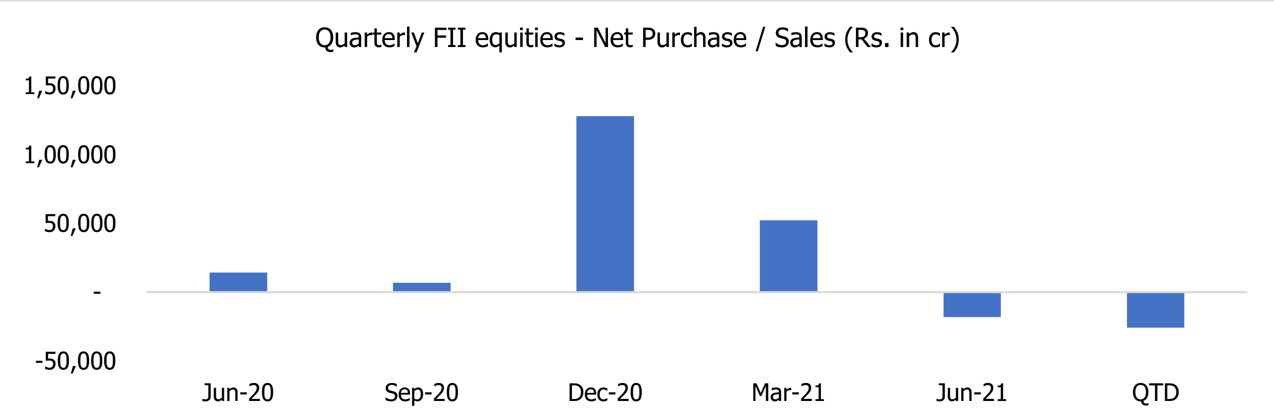
There have been some signs of strain in the IPO market. The below are 5 out of the 14 IPOs that listed after June 30 that are trading below offer price.

S.No.	Issuer Company	Issue Price	Current Price	Price move
1	Nuvoco Vistas Corporation Ltd	570.0	556.2	-2.4%
2	CarTrade Tech Limited	1,618.0	1,488.5	-8.0%
3	Krsnaa Diagnostics Limited	954.0	952.4	-0.2%
4	Windlas Biotech Limited	460.0	390.9	-15.0%
5	Glenmark Life Sciences Limited	720.0	691.1	-4.0%

Source: Media sources, Bloomberg, Spark Fund Research

With a much larger IPO pipeline ahead, supply of paper and IPOs pricing are likely headwinds for the market. This could be a speed-breaker for the market.

Let us look at foreign investors flows next.



Source: Moneycontrol, Spark Fund Research

FPIs are on the selling side at least for now. It is hard to read too much into this as the FPI universe is not all cut off the same cloth. The quantum of selling is not yet worrisome and the domestic institutions have more than made up. However, this calls for some caution as foreign investors have been price makers in the Indian market.

The dependency on the Fed

The US Fed has been viewed as the healer of last resorts by wounded bulls for a long while now. It is now sacrilege to look at it otherwise. Maybe, the Fed is itself brushing up its mandate. That only seems to state that it is a lender of last resort. Maybe the Fed will want to let the market find its own feet which is what free markets are supposed to be all about. Maybe the inflation scare is instilling the urge to normalise policy. Maybe the brave new world will be forced to test its bravery without being able to shoot off the shoulders of the Fed. Useful to be aware of these possibilities.

Expanding valuations

Yes, the valuations are relative. The thesis of high valuations has not been a showstopper. However, here is a fact. When prices go up by several tens of percentage points in a period of a few months, there is no way the fundamentals can keep up. Whatever be the valuation metric used or the model behind the same. Valuations have expanded and the theory of relativity can be extended till such time as there is a rude awakening. At some point, smart money will leave the room (ostensibly) for a break and will stay out for longer than others can hold on.

Company	FY21 PE* (x) on 31 -Aug-2020	FY22E PE* (x) on 31-Aug-2021
Hindustan Unilever Ltd	62.2	69.2
Bajaj Finance Ltd	5.7	8.6
Tata Steel Ltd	6.5	5.2
Reliance Industries Ltd	27.7	26.5
HDFC Bank Ltd	2.9	3.8
ICICI Bank Ltd	1.7	2.3
Infosys Ltd	20.4	32.7
Asian Paints Ltd	58.0	83.3

**P/B for financial sector companies;*
Source: Bloomberg, Spark Fund Research

The glass may still be half full but glasses are made of breakable material

All the above are points that exemplify the behavioural aspects of the market. In isolation, no single point would count for much but taken together, these may be revealing a few areas of stress in the internals of the market. We remain confident of the improving fundamentals for the Indian economy. We remain constructive on the earnings cycle and growth prospects. For much of the last decade, the market kept going up against earnings that broadly refused to show up. Upgrades are coming through now. It will not be out of character for the market to get into corrections when the news on earnings is all good and getting better. If behavioural factors are holding sway on the market like never before, volatility in the same is a risk which models won't bring out. The Achilles heel of this market could also be lying tucked away in its strongest hand.

Warm regards,

P Krishnan (CIO) and Team Spark Fund
