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KNOW THE NOW
Shifting Winds

AUGUST 26, 2020

PREFACE

Rob Dobelli, in his best seller *The Art of Thinking Clearly*, systematically chronicled the cognitive errors and biases in decision making. He says ***"the more recent the information the better we remember it. This occurs because our short term memory drawer contains very little extra space. When a new piece of information gets filed, an older piece of information is discarded to make space."***

In a recent portfolio review with one of our favourite clients, we were discussing markets and how to position the equity portfolio going ahead. The mood around the zoom call was very positive and as we optimistically contemplated the future, I played party pooper by reminding everyone of how we were feeling in Mar'20 when blood pressures were peaking more so by the daily bloodbath in the equity markets rather than the "real" risk of the coronavirus and its impact in the real world.

That was then, just a few months ago, things seem to have changed, and in this edition of **"Know the Now: Shifting Winds"** our Chief Investment Strategist, Sunil Sharma talks about all that's changed. And let's admit it there have been significant unexpected shifts not just in the violent recovery of the markets on the back of the unprecedented liquidity infused by the Fed and central banks (refer Know the Now: Liquidity Gush, May'20), but also in the composition of the recovery with mid caps and small caps beating large and mega cap stocks (again pause and think about the noise around valuation concern on quality large cap before the pandemic, is it the mid/small catch up that was expected 6- 9 months ago?). Old favourites (banking and financials) have been trounced and new flavours of the season (pharma, healthcare and IT) have emerged.

Even the market participants have shifted - the 'retail investor' who was all but forgotten has led the charge in this recovery. Our friends at **Zerodha,** the fastest growing new age brokerage tell us that they have opened more than 1 million new accounts in the last few months, and the average age of their clients has dropped from 33 to 29 in just a few months...now whether these 'investors' know what they are doing or not, and how it will end (will it end in tears as it almost always does) only time will tell.

Going back to the recency bias: the recent recovery of the markets and the ensuing optimistic expectations of the future, is that a bias? or as the bulls would argue is it the still recent memory of the carnage in Mar/ Apr'20 (that's keeping many investors waiting on the side) a bias? Who knows? Isaac Newton had reportedly exclaimed when asked about the directions of stock markets ***"I can calculate the motions of the heavenly bodies but not the madness of the people in the markets."***

Our advice? It's not wise to bet against the Fed but it's also foolish to ignore the fundamentals (they always catch up). A calibrated and nuanced approach, keeping in mind your overall asset allocation and portfolio composition is needed, as they say, **God is always in the details.**

Happy reading!

Amrita Farmahan

CEO, Ambit Global Private Client

Global Private Client

Shifting Winds – Tracking the Rally

Sunil Sharma
Chief Investment Strategist
Ambit Global Private Client

Executive Summary

- **The Market Appears to Be Following the 2009 Recovery Pathway…**

The March 2009 recovery appears to be a template that markets are following. The 2020 rally bears similarities to 2009 in terms of a deep financial crisis and a massive stimulus response.

- **Retail Speculators are the New Market Kings**

With almost 4 million new accounts created this year, and new money being deployed into the markets, the retail buyer has become large enough to drive incremental price action.

- **Market Cap Leadership Has Shifted**

Just when investors solemnly swore to never own small and mid caps, mega caps and large caps are underperforming mid and small caps. Cap leadership has shifted.

- **The Portfolio Sectoral Construct Is Shifting**

For years, financials have dominated investor portfolios topping out at allocations as high as 45% last year. Price action suggests that the portfolio construct in place for years may need to be reconsidered.

- **Global Monetary Policy Regime is Shifting**

Developed economy rates are likely stuck at near zero for the foreseeable future. The monetary policy paradigm is shifting from interest rate management to stimulus and asset price management. Action in currency and rate markets, inflation should be kept on the radar.

- **Fundamentals – Do They Matter Today?**

With the omnipotent U.S. central bank dominating financial markets and economic cycles, equity markets and valuations have exploded higher. How does fundamental analysis fit in? Is this time different?

- **Investment Strategy**

With inflation rising, investing today requires a nuanced approach, one that achieves the dual objective of inflation beating real returns and capital protection. That remains our primary focus and we share our advisory portfolio performance.

Markets Appear to Be Following the 2009 Recovery Template

2009 Vs 2020

The 2020 recovery is **similar to 2009** in that both were born out of massive quantitative easing and fiscal stimulus. Markets essentially bottomed in Oct 2008 on the Fed's stimulus package announcement, similar to March 2020. The 2009 recovery remains the only recovery that was sharper than 2020 at the six month mark – up 82%, versus 47% for the current recovery.

The Market Bottomed in March 2009 on massive Fed / ECB stimulus and a 82% Recovery Ensued … An Eventual Peak came 18 Months Later

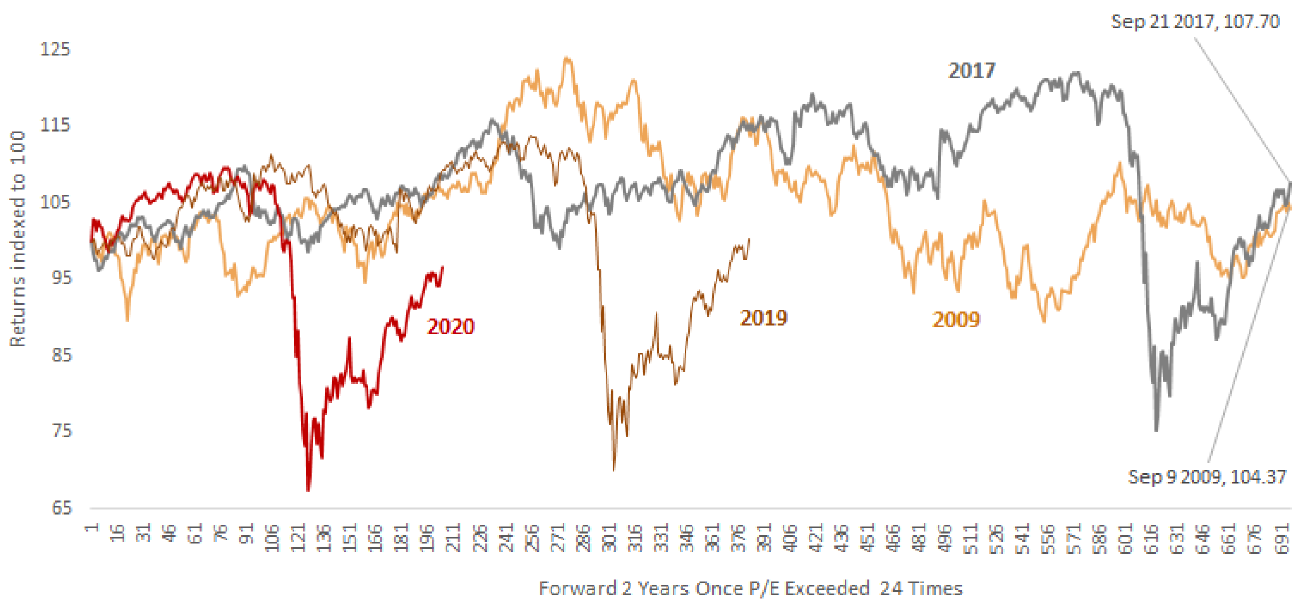
The 2009 Recovery Template Suggests Markets Can Tread Higher

The March 2009 recovery **did not peak until October 2010**, an 18 month recovery cycle. That suggests our **current recovery, in only its fifth month, could have further to go**.

Valuations Then and Now

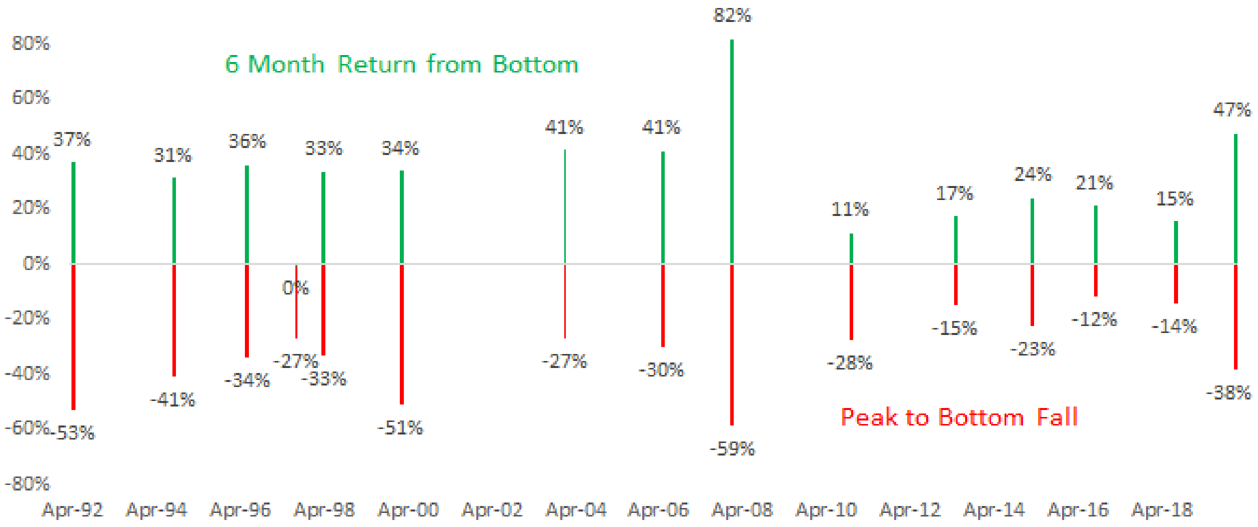
Around October 2009, Nifty valuations exceeded 24 times trailing earnings. Similarly, our market breached the 24 P/E mark a few weeks back. **The 2009 recovery remained unfazed with high valuations in 2009-10** and it took the **crisis in Greece**/Europe to lead to a bear market.

There Have Been 4 Instances When the Nifty PE Has Exceeded 24 in the Past Two Decades…
…The 2009 Rally Was One Such, and the Market Continued Rising For Months Despite High Valuations



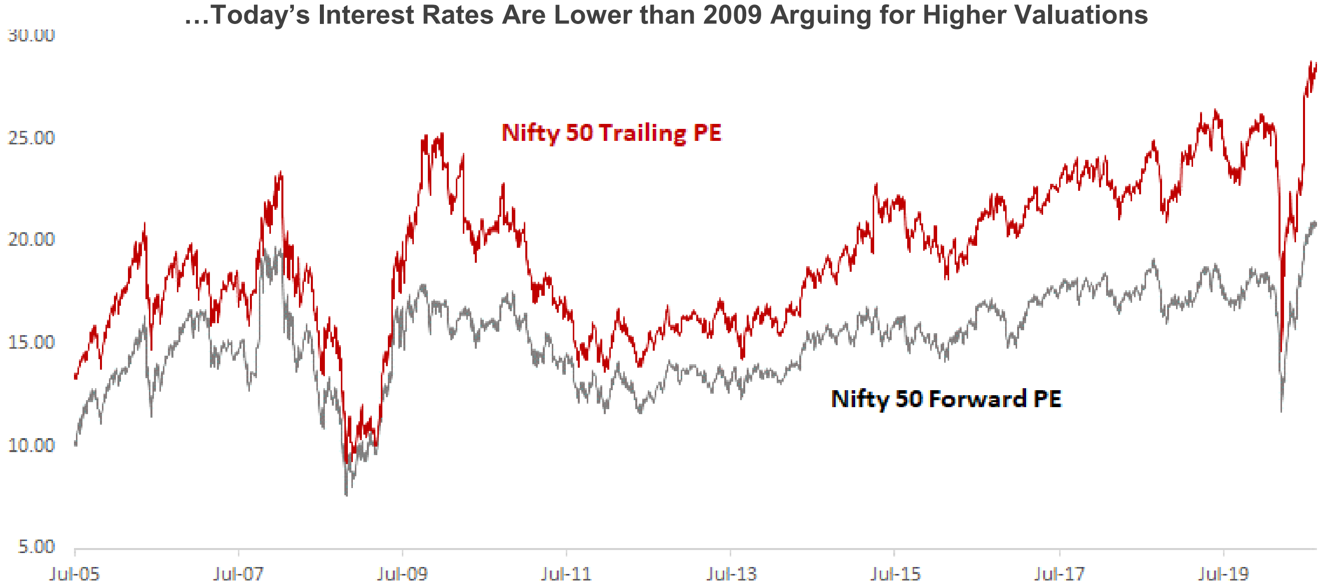
Source: Bloomberg, NSE.

6 Months Into a Recovery, the Current Nifty Rally of 47% is Not Without Precedent and Exceeded by the 2009 Rally*

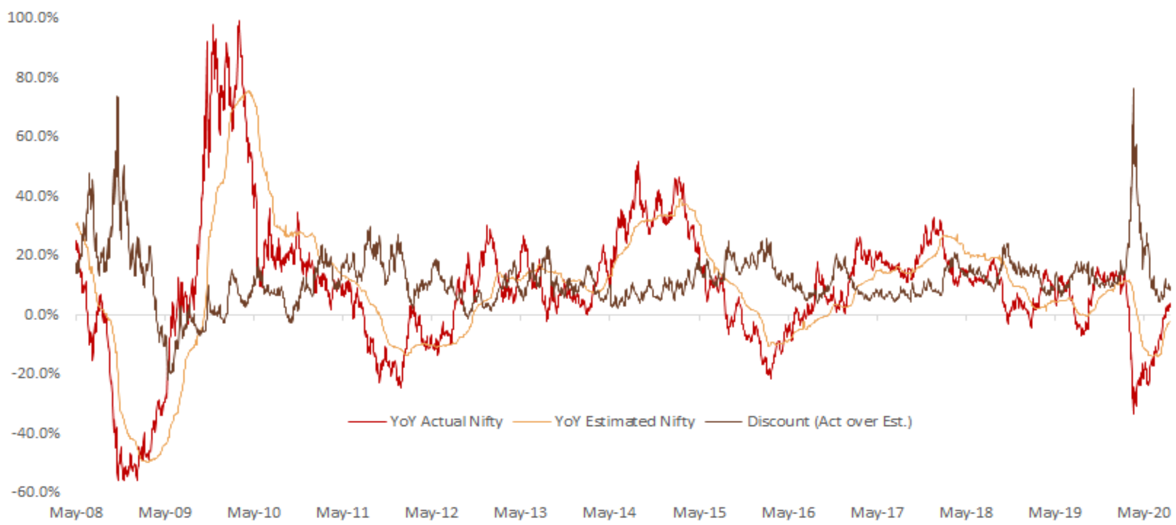


* Current rally data is through August 15, 2020

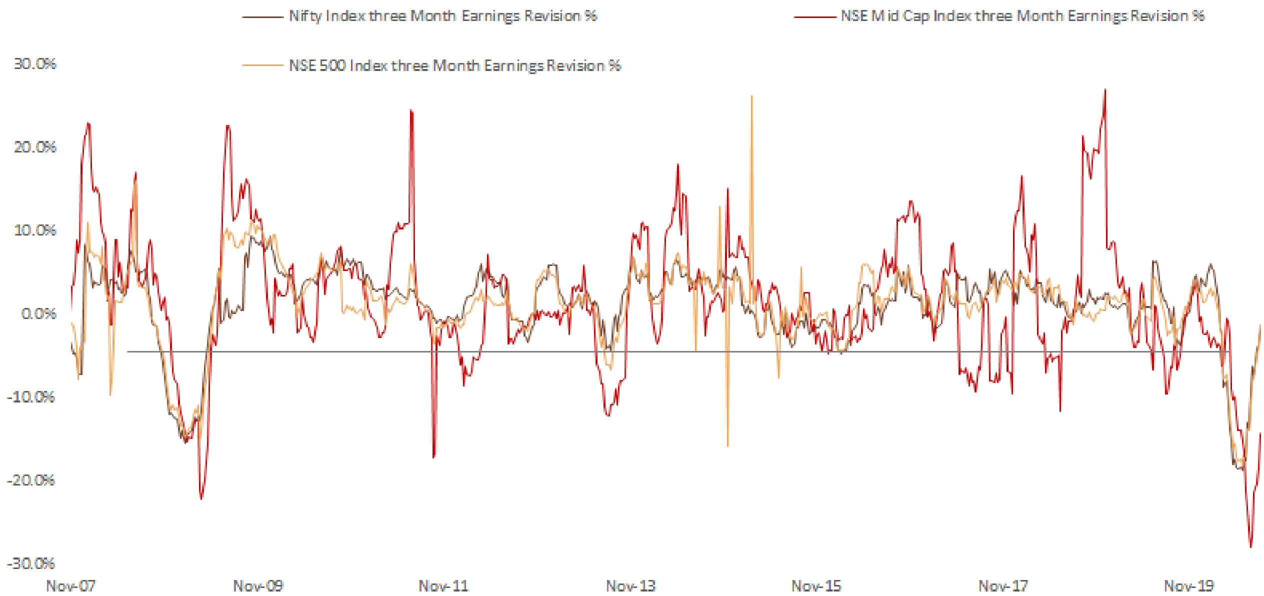
The Trailing P/E in 2009-10 Stayed Elevated for Over a Year…
…Today's Interest Rates Are Lower than 2009 Arguing for Higher Valuations



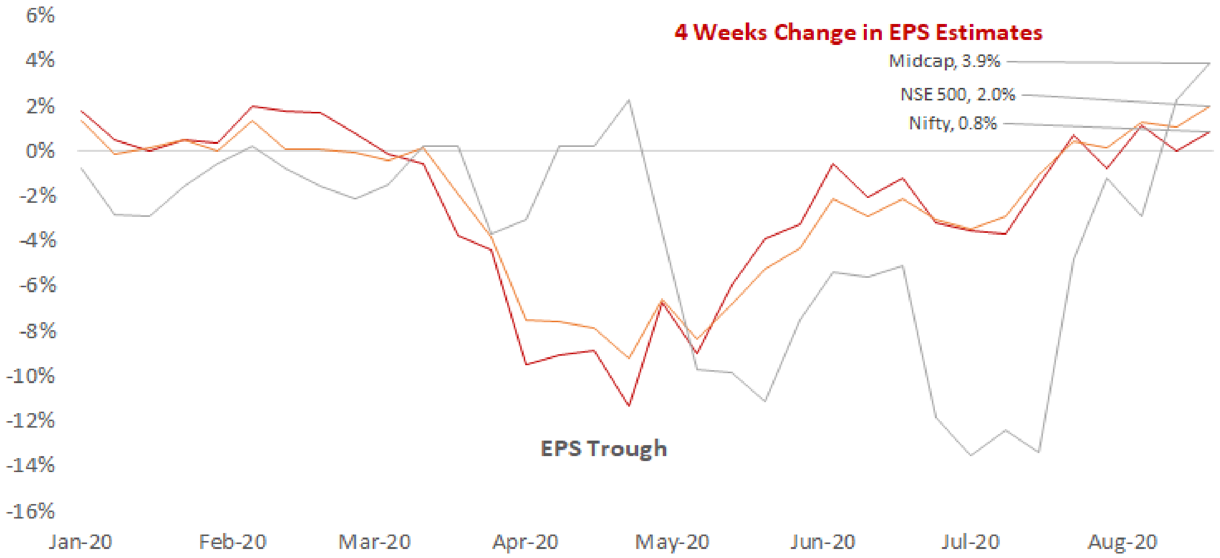
As in 2009, Expect Analyst Estimates for Nifty Price Targets to Rise Before a Peak…
…And Nifty YoY Price Comparisons to Keep Improving, As They Did in 2009



**3 Month Earnings Revisions Look to Be V Shaped, Similar to 2009…
… For the Nifty, NSE 500 and Mid Caps**



EPS Estimates Troughed in May and July for Midcaps, Revisions Turned Positive in late July



Source: Bloomberg, NSE.

Earnings Revisions Turned Positive in Late July
Adding further validation to the recovery theme, three month revisions are trending higher in a V shape very similar to 2009. EPS revisions were slashed in the past two quarters and the road to recovery is clearly evident in improving earnings expectations.

EPS Revisions are Trending Higher, as in 2009

The path for the markets likely remains higher from here. We've learnt over the years, though, that it's **dangerous to be committed to a view**. So while that's our base case, there remain risks that can manifest. Therefore, we **strongly suggest a contingency plan as part of the portfolio strategy** to account for alternative scenarios. Buy and hold has delivered dismal returns to investors. We believe it's time investors move to more relevant and nuanced investment strategies.

All Hail the New King – The Retail Investor

Rise in Robinhood Traders is a Trend Being Seen in the US, China and India
Robinhood and similar brokerages have encouraged the participation of the retail investor and have led to a surge in volumes. Work from home, job losses are key reasons.

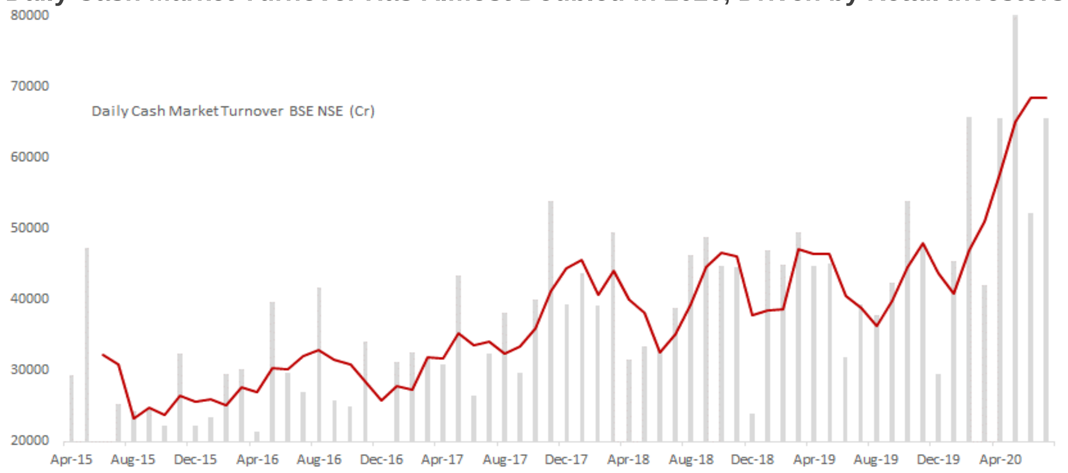
SEBI Data Shows 3.9 Million New Retail Accounts Have Been Created This Year
Cash segment volumes for retail investors have risen to a decade high of nearly 70%. Daily cash market turnover for the BSE and NSE has almost doubled this year, from an average of 30k to 40k crores the last few years to 50k to 70k crores.

Incidentally, FI Flows are Back in July and August
FI flows have also returned to the Indian market. While retail appears to be dabbling in unsound investments in highly indebted, leveraged companies, and penny stocks, FI flows have been driving quality growth stocks higher.

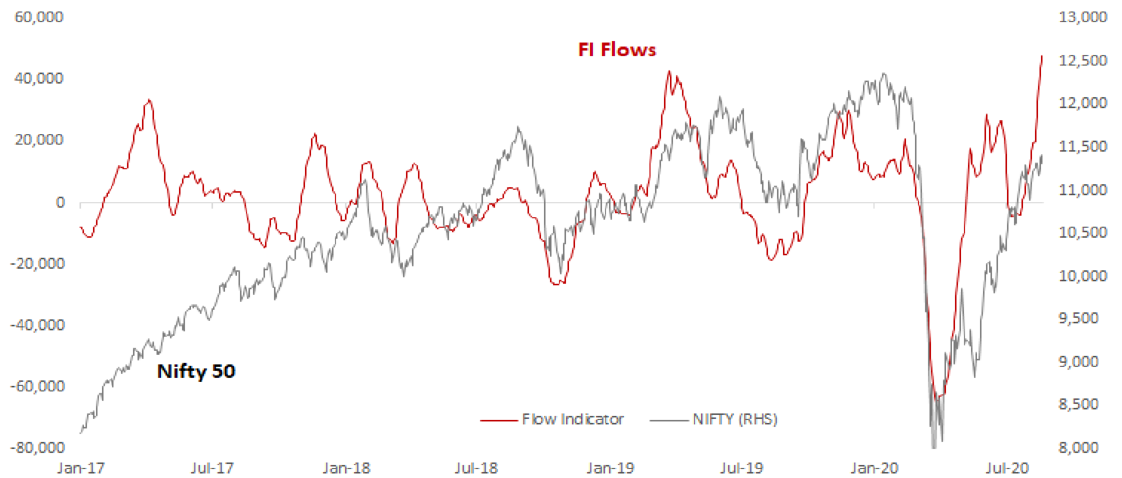
Incidentally, Recency Bias & Confirmation Bias May Be at Play Here for Parts of the Market
While retail is romping and FIs have joined in of late, **a fair share of investors remain on the sidelines**. A similar trend was evident in 2009-10. Our minds give higher probability to recent events, and fears of a repeat remain embedded in many investor's psyches….

***Anecdotal Price Action Suggests** that Retail is Purchasing Highly Debted, Loss Making Companies, Penny Stocks…History is Clear on the Ultimate Outcome*

Daily Cash Market Turnover Has Almost Doubled in 2020, Driven by Retail Investors



FI Flows Have Picked Up of Late, Creating a Powerful Foreign & Retail Buying Combination…



A Cap Shift is Underway… and Mid and Small Are Roaring

Mega and Large Caps Are Underperforming…
While Mid Caps and Small Caps are Outperforming

Decile	Market Cap (in millions)	1 Month	3 Month	YTD	1 Year
Top 10% by Market Cap	18,49,210.5	4.8	20.8	-1.5	9.7
80th - 90th Percentile	3,87,279.6	2.9	26.1	1.6	**27.5**
70th - 80th Percentile	2,12,841.7	3.7	26.7	**6.1**	**22.0**
60th - 70th Percentile	1,40,712.7	1.4	25.3	-5.9	9.2
50th - 60th Percentile	92,237.3	8.7	30.7	**6.0**	**30.3**
40th - 50th Percentile	62,260.1	4.5	28.0	2.5	**20.7**
30th - 40th Percentile	43,945.0	10.3	35.4	**5.7**	16.3
20th - 30th Percentile	33,275.5	4.3	32.8	0.1	0.2
10th - 20th Percentile	23,527.9	3.8	29.5	-19.1	-11.4
Bottom 10% by Market Cap	14,002.4	-3.4	19.9	-28.4	-25.8
Total CNX 500	2,85,386.5	4.1	27.5	-3.3	9.7

Mid and Small Caps are Outperforming the Nifty Across All Time Frames Since March…
IT, Pharma and Specialty Chemicals are Trouncing Consumption, FMCG and Private Banks

	Nifty 50	Junior Nifty	Mid Cap	Small Cap	Info Tech	Pharma	Average	Consumption	FMCG	Pvt Banks	Average
1 Week	-0.3%	0.7%	1.7%	2.0%	0.1%	2.7%	1.4%	-0.5%	-0.8%	-0.8%	-0.8%
2 Week	0.9%	2.3%	5.9%	7.2%	-0.3%	4.4%	2.1%	1.7%	1.2%	-0.4%	0.4%
1 Month	2.5%	4.0%	7.5%	10.7%	7.1%	11.2%	9.1%	1.6%	-0.6%	-1.9%	-1.3%
3 Month	22.3%	17.8%	26.1%	36.4%	36.6%	-1.5%	17.6%	16.5%	15.9%	14.7%	15.3%
Trough March	29.1%	33.6%	39.3%	50.5%	43.4%	70.9%	57.1%	26.2%	21.4%	10.2%	15.8%

Note: Weekly series, Trough is March 22nd in the table as opposed to March 23rd

Source: Bloomberg, NSE. Data as of August 10, 2020

*Shifts Underway in **Mega** and **Large Cap Under Performance…***

*…**New Leadership** is Pharma and Info Technology*

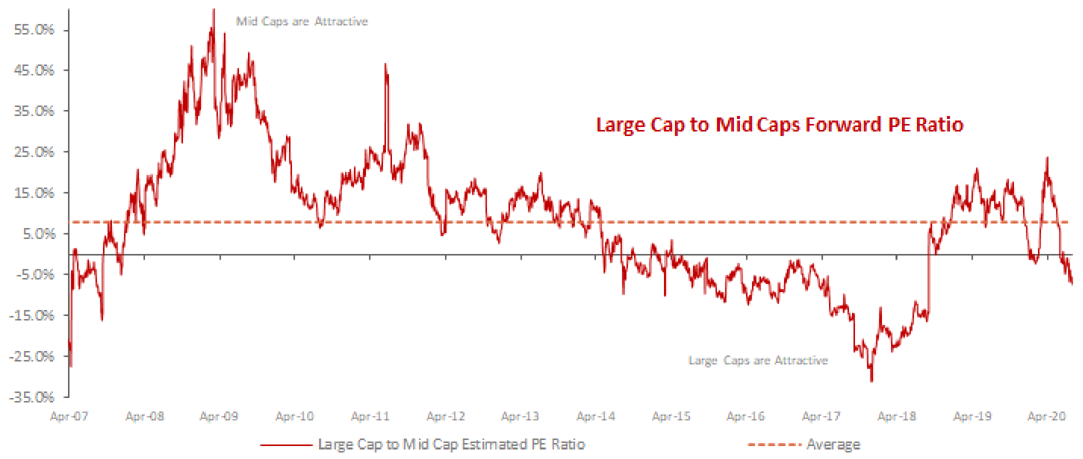
Mega Caps are Lagging, While Mid and Small Caps Are Outperforming
Stocks in the middle percentiles by market cap, i.e. midcaps and small caps, have been outperforming mega caps and large caps. Adjust mega cap performance for the heroic run by Reliance Industries, and the spread between large and smaller caps widens further.

Portfolios with a skew towards multi cap or smaller cap are doing especially well in the past few weeks. Valuations are cheaper, and growth is easier to come by, selectively, in quality mid and small caps. **Adding / increasing exposure to multi cap has delivered meaningful alpha. Adept multi-cap managers that run concentrated portfolios** is our strongly preferred means of adding exposure to smaller cap.

Health Care and Info Technology are the New Leadership Sectors
Leadership in the new cycle has emerged and it is Health care and Information Technology.

Paradigm Shift: Are the days of Large Cap and Financials Dominance Behind Us?
Both cap and sector shifts have **significant implications for investment portfolios**. The **vast preponderance of portfolios we have reviewed of PMS and MFs** - were structured around large overweights in private banks and financials.

The Catch Up Move on Valuations in Mid Caps Appears to be Already Over…
…However, A Trend Change Favoring Midcaps Outperforming Remains in Place



Markets are Rallying While Financials are Lagging…What Does That Tell Us?

Sector	1 Month	3 Month	YTD	1 Year	% from 52 Week High	Trough Ret %
Communication Services	2.2	36.7	1.6	7.6	-35.5	72.2
Consumer Discretionary	1.7	26.2	-12.0	4.2	-30.6	42.8
Consumer Staples	3.3	26.0	0.3	12.2	-20.0	55.5
Energy	2.5	15.7	-17.9	-11.1	-34.4	43.7
Financials	-0.0	24.1	-23.8	-12.9	-38.5	40.5
Health Care	**19.7**	**34.4**	**44.0**	**60.4**	**-9.8**	83.5
Industrials	-1.4	22.1	-11.4	-2.8	-32.6	42.8
Information Technology	**19.8**	**49.9**	**14.4**	**18.7**	**-15.4**	88.6
Materials	6.4	31.6	6.5	21.8	-20.7	62.6
Real Estate	-2.8	13.8	-34.1	-29.1	-47.1	17.4
Utilities	-5.1	15.6	-6.9	28.1	-27.0	37.5
CNX 500	4.1	27.5	-3.3	9.7	-27.6	53.2

Financials Are Lagging on Almost All 1 Year Periods
The most meaningful period is the YTD period. YTD, Financials are down 23.8% while the CNX 500 is down 3.3%. Over the past year, Financials are down 12.9% while the CNX 500 is up 9.7%.

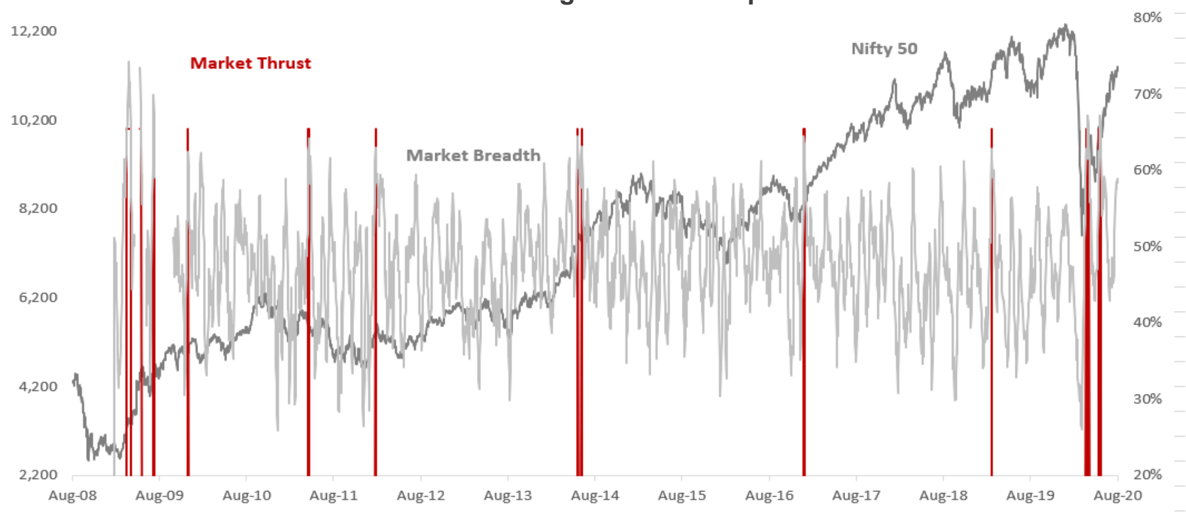
A Massive Divergence in the Market's Message and Financials
The market recovery has been driven by health care and IT. Both health care and IT are driven by sectoral trends – health/Covid and digital transformation. Financials meanwhile, are critical for a consumption economy, and are likely to struggle for the remainder of this year at minimum. The follow on question: **can the domestic economy recover with a weakened financial sector**?

The Portfolio Construct that Has Worked for Years May Need to be Reconsidered

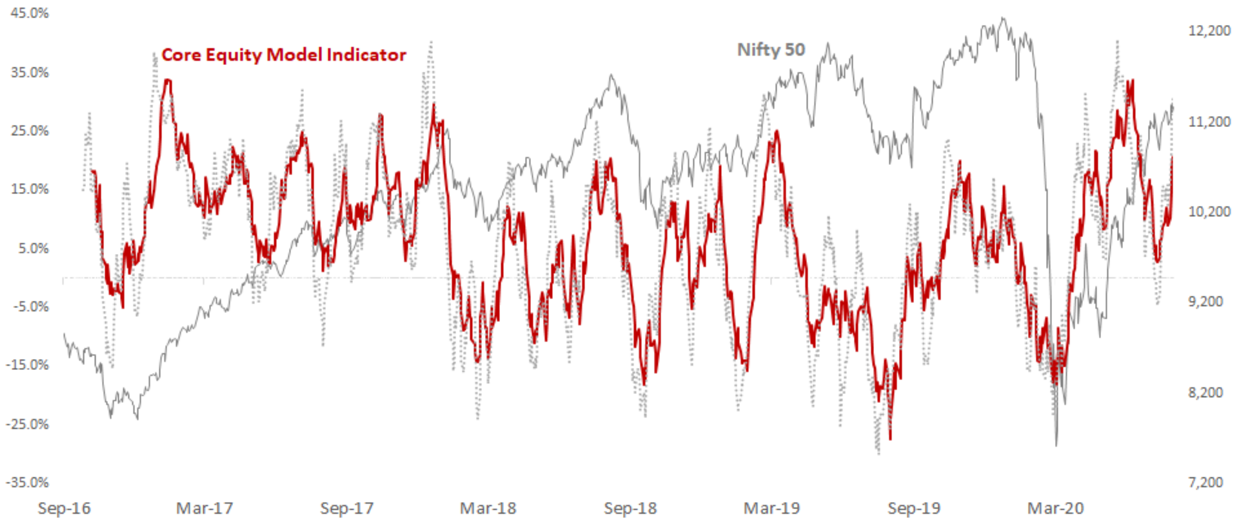
Shift in Paradigm to Non Consumption Themes
Yet another paradigm shift is underway with important implications for investor portfolios, with a shift to Health Care, IT, Specialty Chemicals and Ecommerce exposure.

The Market's Technicals Remain Healthy, Similar to 2009

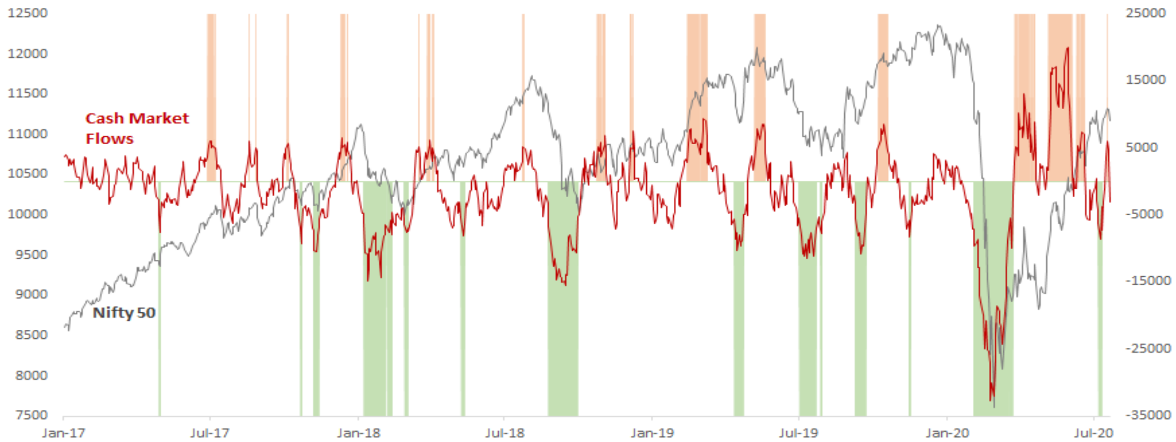
The Market's Breadth Remains Healthy and Thrust Remains Strong… … Following the 2009 Script



Our Core Equity Model Suggests Market Demand Remains Healthy, But…



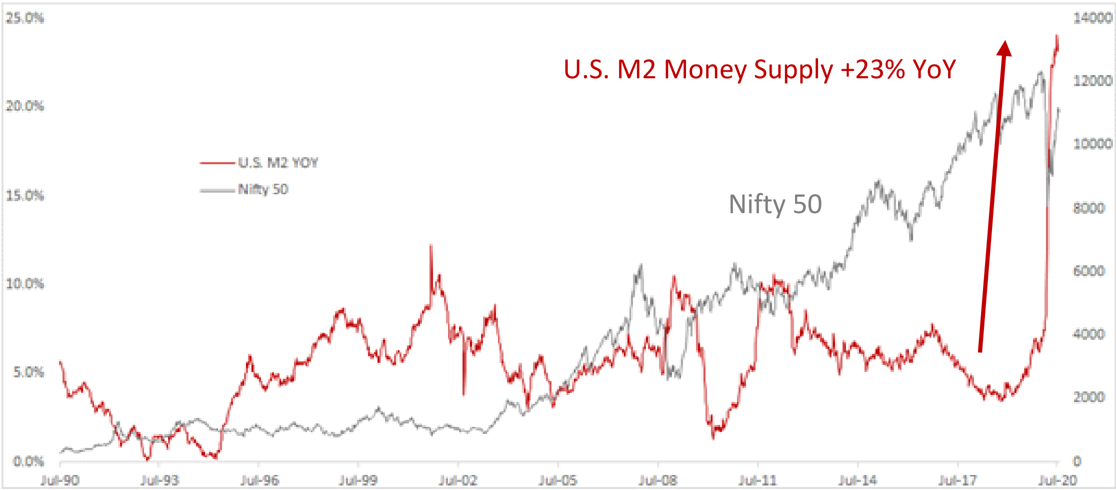
Our Flow Indicator Confirms the Rally is in Healthy Shape



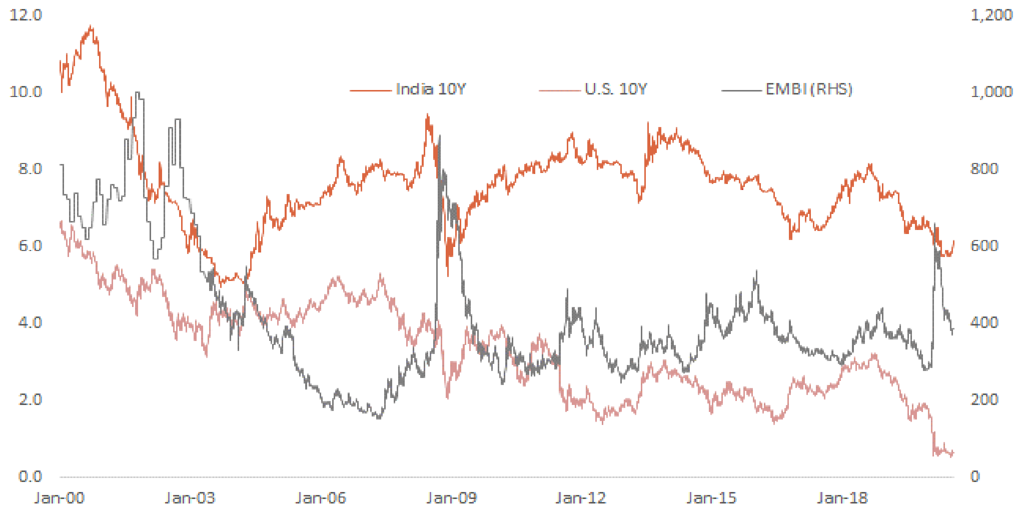
Source: Bloomberg, NSE

Global Macro Policy – A Shift from Rate Policy to Stimulus and Asset Price Management

M2 Money Supply Has Exploded Higher +23% YoY



U.S. 10 Year Yields Have Begun to Tick Up and the U.S. Dollar is Weakening



A Key Juncture for the Dollar, Watch For Trend Change…
…The 1990s Were the U.S. Dominance, Emerging Markets Dominated the 2000s…Time for Change?

Source: Bloomberg, NSE

The Fed's Mandate Has Shifted - to Massive Stimulus and Managing Asset Prices
The largest central bank's mandate has shifted to massive stimulus in the trillions, alongside managing financial asset prices, maintaining order in bond markets, currencies and managing *any* risk bubbling above the surface.

Interest Rate Based Monetary Policy Is Giving Way to MMT, Massive Stimulus and Direct Transfers
For decades, the primary monetary policy tool has been interest rate driven, generally inflation targeting. Central banks tightened during periods of economy overheating and loosened during downturns. That tool has been blunted and the prospect of seeing higher interest rates in the U.S. in the near future remain remote.

In its place, we are now essentially living an experiment… call it MMT, stimulus spending, asset price support, one that will have implications for developed and emerging markets alike in the months and years to come.

The First Signals Will Manifest via Currency Volatility, Inflation and Rate Volatility
Signs of worry are rising in the U.S. Dollar and the recent tick up in the 10 year. Granted both are small moves, but worthy of watching. It's likely that lack of confidence via capital outflows, or worries about inflation, or a lack of trust in the Fed's game plan will manifest in rates and currency.

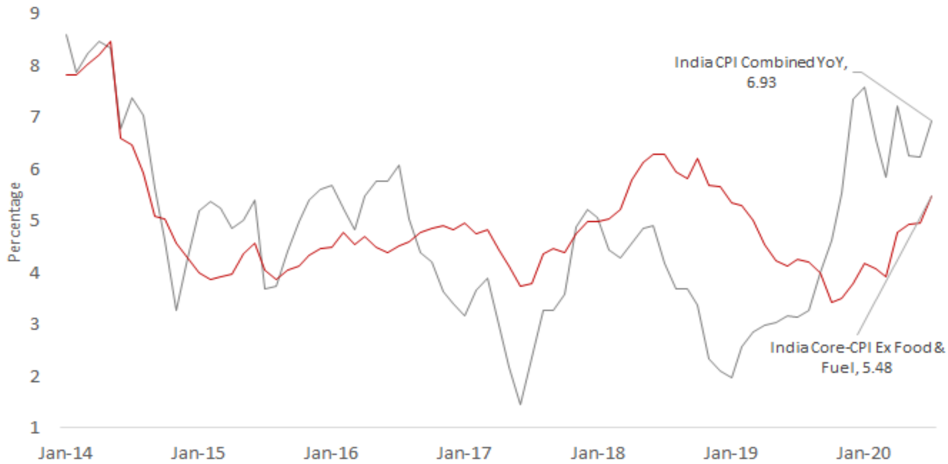
The Fed Has Shifted to Asset Price Management and MMT / Stimulus…

Look for Impacts in Currency, and Rate Markets

Investment Strategy & Outlook

The Fed Model Is Inching Towards Favoring Bonds…
…But We Note It Did the Same in 2009-10, So Valuations Could Continue to Stay Elevated

Rising Inflation Will Force Investors to Seek Inflation Protection…
…The Hurdle Rate for Positive <u>Real</u> Returns Now Rises to 7%!



Source: Bloomberg, NSE

Bearish Considerations

Valuations Are at All Time Highs

Valuations are at all time highs. We're in a recovery phase where valuations typically don't matter. The Fed has clearly signaled supporting equity prices and buying equities is a part of their mandate.

Relative Equity-Bond Yield Model Approaching Expensive Levels

As demonstrated, the yield on equities is declining relative to bonds. However, as witnessed in 2009, this did not derail the recovery then and unlikely to do so today.

High Fuel Prices, Rising Inflation Amidst Slow Growth

The tick up in inflation in our judgement is a result of high fuel prices, supply chain disruptions, reduced movement and availability of goods and services. **Higher inflation remains a key concern**.

The Bearish Case is Built Around…

…High Valuations, Inflation, Possible Financial Stress, Speculative Excesses in Retail Investors

Financial Stress & Tight Credit
Opacity still remains on what lurks in bank balance sheets. Significant stress could be coming forth in weaker parts of the system. MFI, personal loans, corporate loans, lower rated commercial real estate, residential real estate look vulnerable. With credit conditions tight and financials in fire-fighting mode, generating growth is likely to be a challenge.

Speculative Excess in Retail Investors
Inexperienced investors appear to have been pushing the market higher. There is a historical precedent on retail investor positioning. Time will tell if history repeats, however, this trend can keep driving prices higher.

Global Monetary Regime Shift
The shift to massive stimulus and a massive rise in money supply brings uncertainties. Currency markets are showing the first signs of concern with weakness in the U.S. dollar, and U.S. 10 year bond yields inching up.

Bullish Considerations

The Fed & Liquidity Remain All Powerful Forces
The most powerful force in the market remains the U.S. central bank, willing to go to any lengths, stating its intent in ensuring asset prices remain high, the Fed remains the buyer of last resort.

The Bullish Case is Simpler….It's on Fed Liquidity, Retail Flows, Receding Corona Concerns, and a Road to Recovery with the Worst Behind Us

Corona Virus Concerns Largely Factored In
Clearly the levels of fear associated with coronavirus have declined, positivity rates are improving, mortality rates are improving. Soon a vaccine will be available. The core reason for the global recession has been addressed and the road to recovery has begun.

The Worst is Behind Us
The government clearly appears ready to step in and support PSU banks, MSMEs and much has already been done. The worst looks to be behind us and systemic risks have receded.

Shifting Consumer and Investor Perceptions Towards Bullish
There has been a marked improvement in sentiment amongst institutional investors and consumers of late.

Outlook

Capital Preservation
We were the only wealth manager that we are aware of that issued a public call to protect portfolios at levels of 10,600 and 9900 in March 2020. (Know the Now – The Pendulum shifts to fear, March 6th and Know the Now – What to do now…in the midst of the fastest bear market ever, March 13th).

Capital Appreciation
Since then, we've launched our Equity Advisory services (CALIBER) in April 2020, our advisory portfolios are handsomely outperforming the market and delivering absolute returns. Our **best performing portfolio - the earliest advisory portfolio launched in April 22nd - is up 42% since Apr 22nd, versus the Nifty at 24.8%.** Our model portfolio is outperforming the benchmark by 7-8%. We've achieved **strong returns while mitigating risk**.

Base Case

Our base case is that **the market is likely to plod higher from here**, following the 2009 framework.

However, given the **excesses we are witnessing in liquidity and retail behavior**, **we are invested with a contingency plan.**

Our portfolio will take advantage of volatility should it occur. Therefore, **our portfolios are positioned to benefit from dual scenarios.**

The rally is likely to continue on the back of continued Fed support, continued flows, improving economic fundamentals and improving earnings. High valuations will not play a headwind for some time to come, and it is more likely that the problems emanate elsewhere.

A Nuanced Approach

We continue to believe the 2009 pathway is unfolding. However, **committing to a single forecast or opinion is a sub optimal strategy** given where we are on valuations and risks. Did anyone forecast the corona virus late last year?

Therefore, **a nuanced approach is necessary**, one that starts with asset allocation obviously, but then **factors market risks while positioning for returns**.

With Rising Inflation, Real Returns Take On Meaningful Importance
Fixed deposits, cash, arbitrage funds and liquid funds are delivering negative real returns.

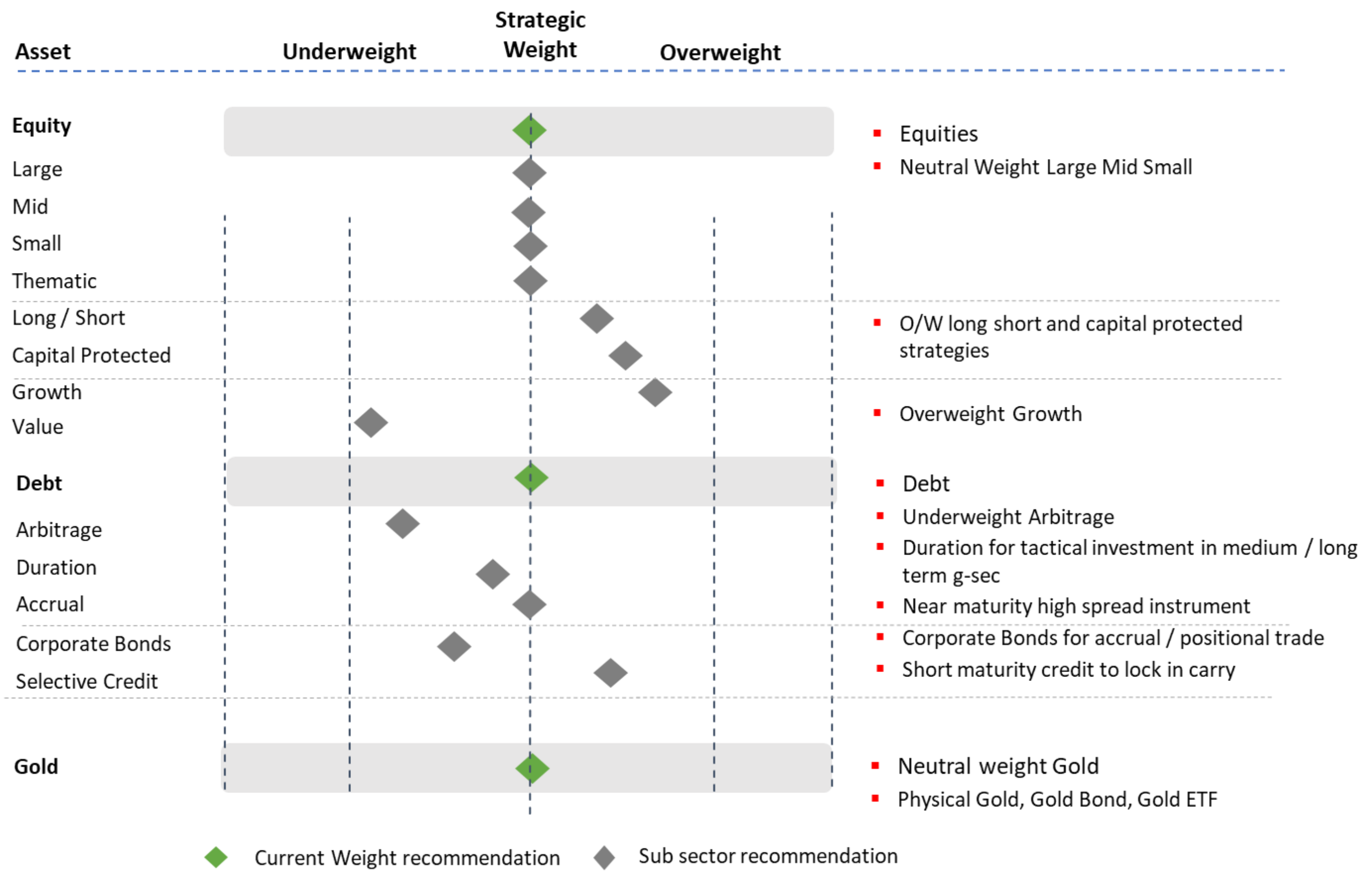
We complement our bedrock principles on asset allocation with **tactical strategies, proprietary strategies, income generation strategies, risk management, and special situation** strategies.

Adept multi-cap managers with proven track records and managers that run **absolute return**, **long-short** strategies, manage **concentrated portfolios**, are **nimble on sectoral and cap** positioning and focused on **capital protection** remain our preferred means of adding exposure.

Some say that it is impossible to time the markets. Maybe. But there are better options than buy and hold today. Buy and hold has largely delivered dismal returns to investors. We believe it’s essential investors consider the risks of such strategies, and move to more relevant and nuanced investment strategies.

Significant returns remain available today via such **specialized strategies and products**.

Asset Allocation Relative to Strategic



Sources: All sources unless otherwise noted are Bloomberg, NSE.

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