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KNOW THE NOW

A CHANGE IN LEADERSHIP

MARCH 10, 2021

Dear Clients

Sir Isaac Newton was one of the smartest people to ever live, but after he lost money in the markets he famously exclaimed *“I can calculate the motions of the heavenly bodies but not the madness of the people in the markets".* The markets have challenged everyone in this last one year, first with their dramatic fall, then the vicious recovery and then the unexpected continuous upside, leaving many investors waiting for that elusive correction to enter. And just when the bears seemed to be getting a hold in late Jan'21, the budget came along, and markets were buoyed by the pro-growth outlook. A healthy dose of fear continues to fester, however our Chief Investment Strategist calls it, **The Bull Market in Fear**.

In our Feb'21 issue of **Know the Now: The Promise of Spring,** Sunil Sharma wrote that the Budget day was a turning point and asked that you look at valuations carefully (without the worst ever two quarters of 2020) and in Feb'21 we saw NIFTY go up 5.5%, the small cap Index was up 14.7% and the midcap index was up 13.5%.

Many investors had just about skewed portfolios to very good quality, large cap, well run and many would argue high valuation companies, only to scratch their heads as they saw their relative under performance in comparison to the broader markets. For a long time, Indian investors had believed that the only way to make outsized returns in the stock markets was to buy mid and small cap companies and/or managed portfolios. It is only since April 2018 when mid and small cap valuations and other factors such as the Mutual Fund reclassification caught up, that we saw a shift towards large cap, high quality stocks that showed out-performance over broader markets over the last 2-3 years. PMS strategies such as Coffee Can as an example saw significant out-performance over their peers. In the current edition of **Know the Now: A Change in Leadership**, we discuss the rotation that is underway, across capitalisation, sector and valuation.

How does an investor respond to this rotation, can you time your moves between market caps and styles and sectors - both entries and exits, or is it a better plan to create a diverse portfolio of stocks and/or managed accounts (MFs / PMS and AIFs with different styles). The decision is ultimately yours, but we believe it’s best to have a disciplined approach and stay the course of your investment plan, instead of chasing the flavour of the month. As Graham described it *"Indeed, the investors chief problem and even his worst enemy - is likely to be himself".*

Enjoy the read, and Happy Investing.

Amrita Farmahan
Chief Executive Officer

A Change in Leadership

Summary

- Rotations are underway across capitalization, sector and valuation. We discuss implications and strategy
- Is it time to be concerned about rising inflation, rising U.S. interest rates? We discuss the risks and outlook

March 2021

Sunil A. Sharma
Chief Investment Strategist

Meaningful Rotations Underway

Over the past year, there has been a dominant preference for large caps amongst investors. In the counter-intuitive world of investing, consensus opinion can often be a reliable contrarian signal.

Software and technology stocks holdings are being painfully unwound in the U.S. Domestically, large cap leaders in the consumer space, FMCG and Pharma are witnessing a rotation and a meaningful period of underperformance.

Budget Euphoria and Tilting towards Growth

As we wrote in "The Promise of Spring" last month, Budget day was **a turning point**. Small and mid-caps had been tracking large caps closely until January. Since budget day, investors clearly have been buoyed by the pro-growth budget, and responded by bidding up small and mid-caps. The small cap index was +14.7% in February, mid-caps rose +13.5%, while the Nifty rose a paltry 5.5% in comparison.

Strong Momentum in Forward 12 Mo EPS Upgrades

One reason for the market momentum is EPS revisions that have soared in recent weeks. (chart on next page). The six month change in forward 12 month earnings for mid-caps are improving at the highest rate in 15 years. Small caps are getting upgraded at the highest rate in six years. The Nifty 50 EPS revisions are the strongest in years as well.

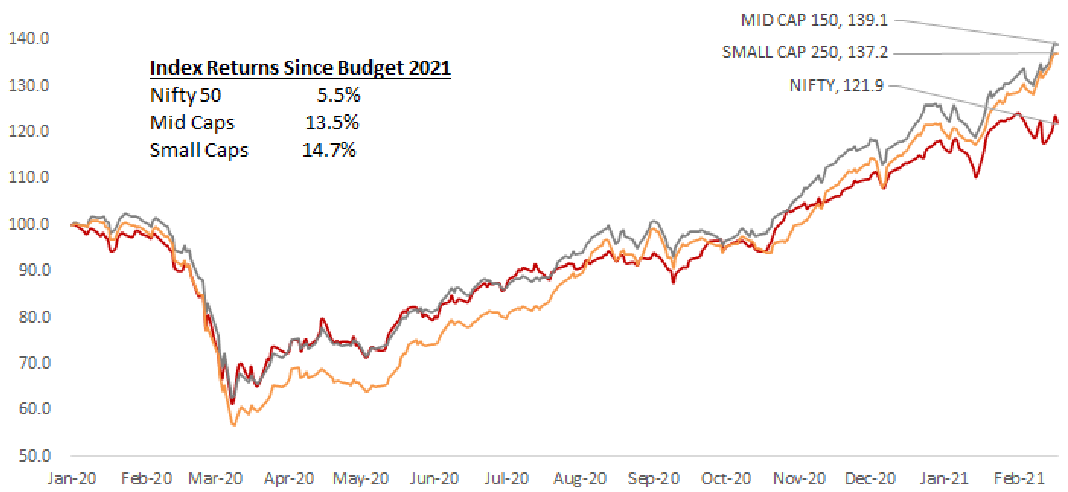
FMCG & Pharma are Underperforming Meaningfully

Six month returns illustrate the degree of underperformance we are witnessing in quality large FMCG and Pharma. Both sectors are underperforming the Nifty 50 by roughly 23-24% over the past 6 months. With FMCG forming a core part of many portfolios, the pain trade is alive and well. More on this later.

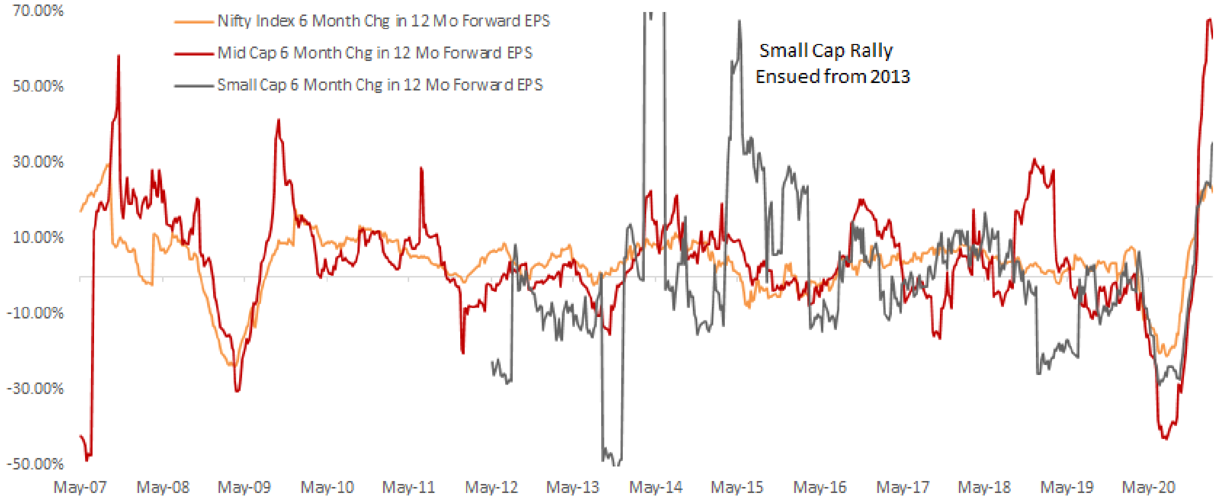
FMCG and Pharma – Pandemic Favorites – Are Out…
…Banks, PSUs, Metals, Realty are In

India	1 Month	3 Month	6 Month
NSE Nifty 50 Index	-1.2%	11.5%	32.0%
Nifty Auto	-4.9%	13.2%	33.4%
Nifty Bank	-2.1%	16.4%	54.9%
Nifty India Consumption	-3.4%	4.8%	16.9%
Nifty FMCG	-3.2%	1.6%	8.2%
Nifty IT	-2.6%	11.5%	37.1%
Nifty Media	-0.4%	7.4%	8.0%
Nifty Metal	8.9%	23.9%	62.8%
Nifty Energy	10.0%	14.5%	26.7%
Nifty Pharma	-6.0%	-1.7%	9.9%
Nifty PSU Bank	3.8%	26.0%	62.8%
Nifty PSE	8.5%	19.2%	32.9%
Nifty Realty	2.7%	25.6%	67.0%

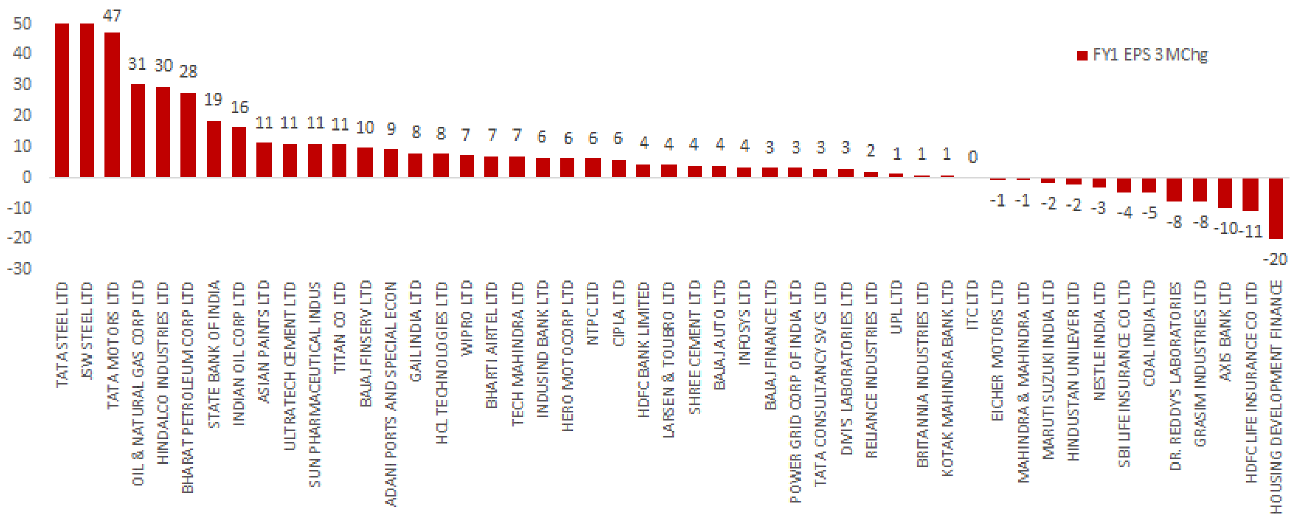
Post Budget, Small Caps are +14.7% and Mid-Caps +13.5% Vs the Nifty 50 at 5.5%...
… Large Cap High Valuation Stocks Are Underperforming



Mid-Caps are Witnessing the Highest Positive Earnings Momentum in 15 Years… …Small Caps are Witnessing the Strongest Earnings Momentum Since 2015



Save a Handful of Stocks, the Nifty 50 is Witnessing Impressive FY1 EPS Estimate Revisions

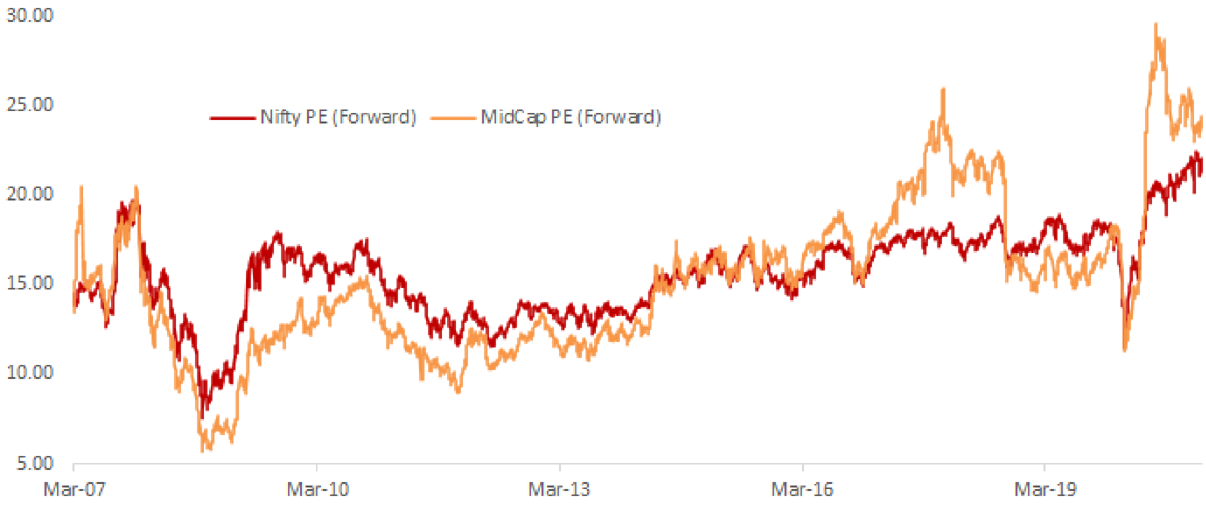


Mid and Small Caps Have Outperformed the Nifty 50 by 8% and 10% YTD Respectively… …And the Broader Market is Now Outperforming the Nifty 50 Over All 2-Year Periods

India	1 Week	1 Month	3 Month	YTD	6 Month	Trough	Peak	1 Year	2 Year	3 Year
S&P BSE SENSEX Index	1.7%	-0.3%	11.3%	7.1%	31.7%	97.0%	22.0%	43.5%	18.1%	15.3%
NSE Nifty 50 Index	1.5%	0.2%	12.3%	8.2%	32.1%	98.9%	22.5%	44.8%	17.1%	13.9%
NIFTY Midcap 100	0.3%	5.4%	18.5%	15.9%	44.1%	119.8%	36.9%	54.6%	17.9%	8.6%
NIFTY Smallcap 100	0.8%	7.8%	23.6%	18.3%	48.3%	148.5%	36.0%	62.1%	14.9%	1.6%
NSE Nifty 100 Index	1.2%	0.5%	12.0%	8.2%	31.6%	97.5%	22.3%	44.1%	16.5%	13.0%
NSE Nifty 200 Index	1.1%	1.1%	12.8%	9.1%	33.0%	100.0%	23.9%	45.3%	16.7%	12.5%
NSE Nifty 500 Index	1.1%	1.7%	13.6%	9.9%	34.0%	102.8%	25.6%	46.7%	17.2%	12.0%

Data as of Mar 10, 2021. Returns are absolute for 1 Year and under, **CAGR for above 1 Year periods.**
Source: Bloomberg, NSE.

The Valuation Spread Between Mid & Large Cap Valuation Has Also Compressed…
…Strengthening the Case for Mid and Lower Cap Growth Exposure



Source: Bloomberg, NSE

Rising Yields in the U.S., Rising Commodity Prices, Inflation in the Pipeline…

There have been a number of sharp moves across asset classes in recent weeks, and each, theoretically, has the potential to disrupt the fragile recovery. U.S. treasury **bond yields have spiked**. **Copper** prices have risen dramatically, as have **industrial spot** prices. Some of these moves can be attributed to Biden's **$1.9T stimulus** plan closing in on approval.

If this weren't enough, **crude oil** prices have been rising steadily, and add on top of that the government's own goal on spurring a recovery by raising subsidies on petrol and diesel.

Copper, Treasury and Crude

While we're certainly witnessing a global economic recovery, it is most certainly **not in danger of overheating**; rather, it is one that can be classified as tentative. The parabolic nature of the up moves in all three asset classes **is more likely due to speculative re-positioning** in *expectation* of Inflation.

Bond Market will Drive Fed Action

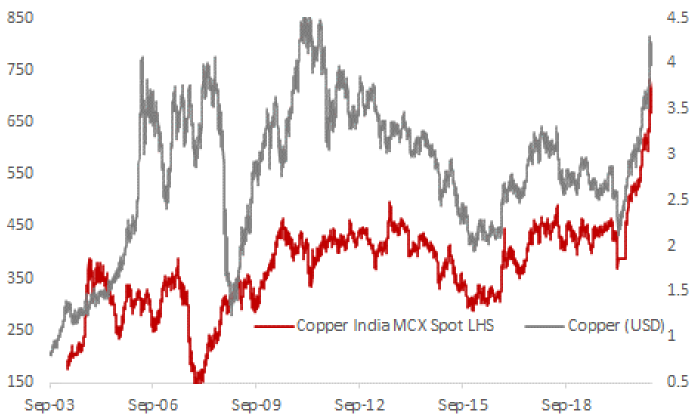
Ultimately, the U.S. bond market is being keenly monitored by the U.S. central bank, which has clearly demonstrated it will go to any length to preserve the current economic status quo. Should things worsen, expect a new acronym to go along with operation Twist, Tarp etc.

Crude Oil Offsets

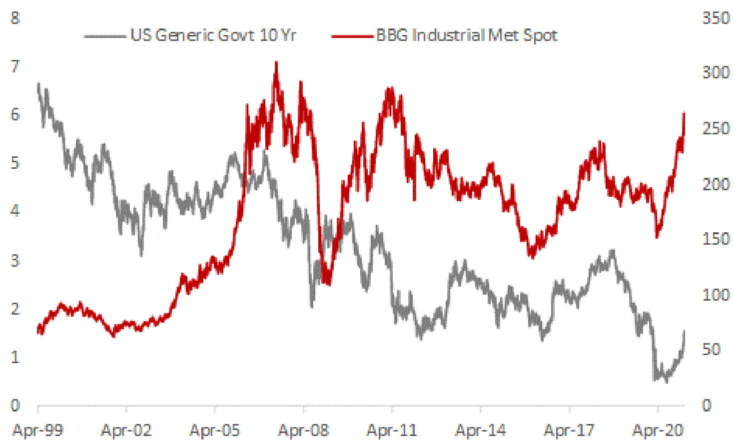
Crude oil prices have been rising steadily, and the subsidies on petrol and diesel *will* impede our recovery. However, work from home will lead to an attendant drop off in petrol and diesel usage. Secondly, crude prices have been stagnant for a decade.

The dramatic rise in domestic copper prices is a concern, but we expect will ultimately self-correct to demand equilibrium.

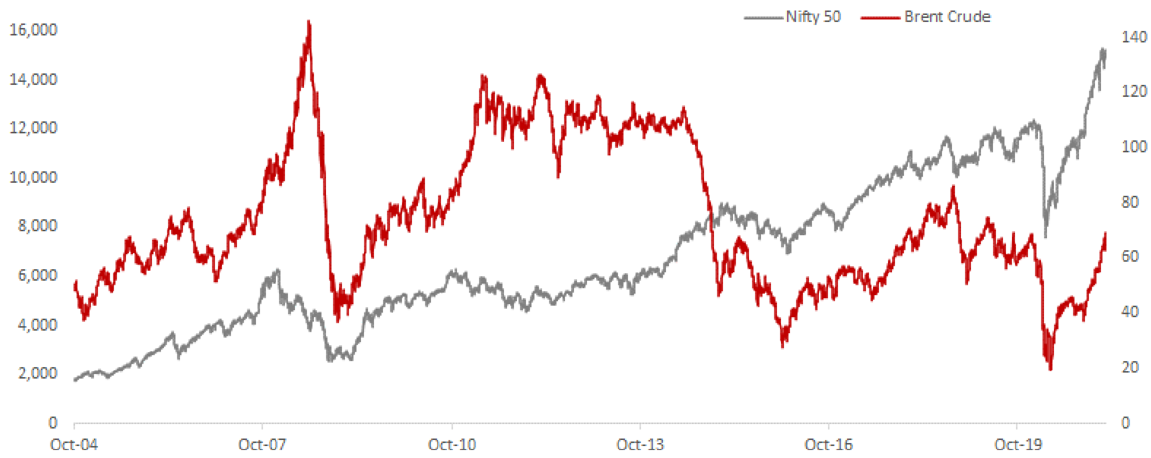
Copper Prices Have Skyrocketed…



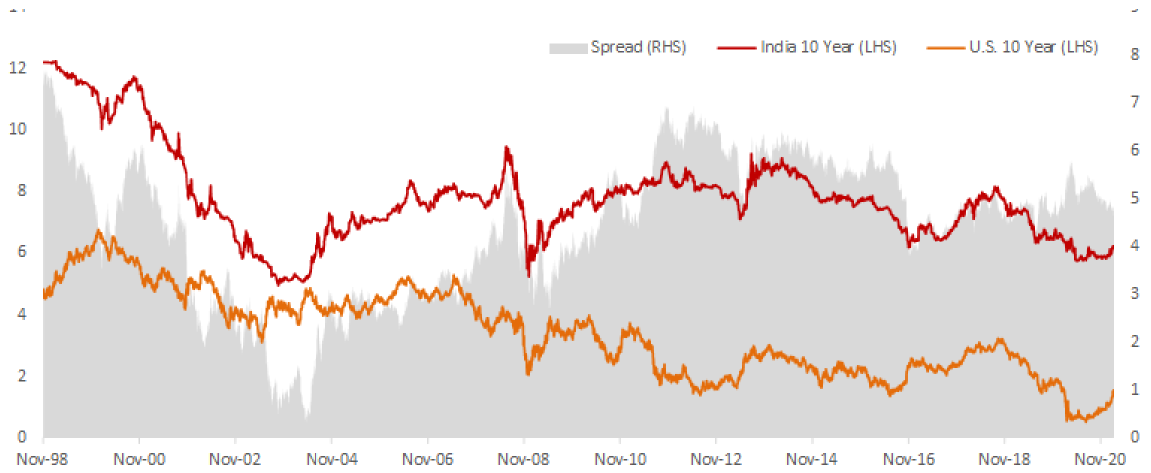
…So Have U.S. Treasury Bond & Industrial Metals Prices



A Move Above $80 is Generally Our Warning Signal for Crude Oil Where Economic Activity Is Impacted…
…While Long Term Crude Prices Have Stagnated, Subsidies Will Act as a Headwind



The Rise in Treasury Yields is Typical for This Stage in the Cycle…
…But U.S. Rate Movements Have a Tenuous Correlation with Domestic Bond Yields



Outlook

Last month we spoke about the Promise of Spring. Since the Budget, the **Nifty is up 5.5%. Mid caps are up 13.5%**. Small caps are up 14.7%.

The Bull Market in Fear

Still, fear remains fairly high these days. Despite a record-breaking rally, and robust economic and earnings data, investors remain on edge. There remains a fair amount of disbelief, which ultimately and counter-intuitively, is healthy for the market.

Imported Volatility

In the past decade, we've suffered through Greece, PIGS, Italy, INR depreciation, China debt, trade war, demonetization, GST, IL&FS and covid. Notably, **the Nifty has tripled from 5500 levels in those ten years**.

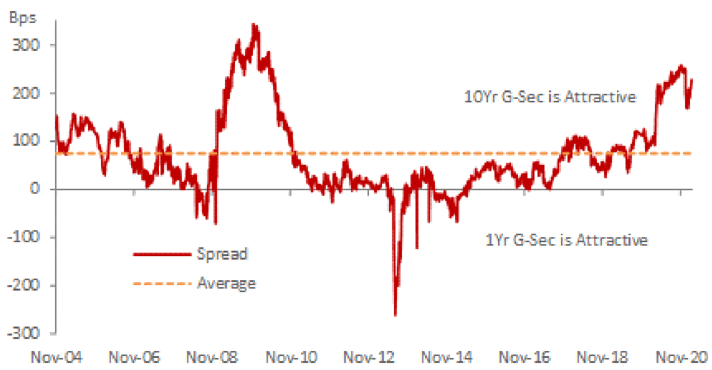
Time and again, global pressures and concerns roil our markets, and economy. The worry du jour is inflation and rising rates. **The rapid rise in prices is not demand driven; rather it appears speculative** in nature, and we expect counter balancing forces to restore equilibrium.

The Economy is Improving

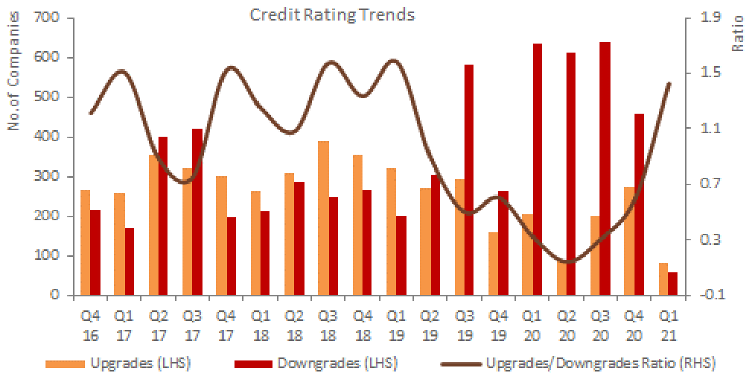
PMI data suggests an improving economy. **Analyst revisions** suggest strong optimism on earnings. **Productivity** has risen, thanks to cost cutting. Covid unleashed an impressive improvement in margins. India's **imports** have risen strongly for a third straight month, signaling rising consumer demand. Rising **savings rates** suggest the consumer balance sheet remains healthy.

India's coordinated policy response, robust recovery from Covid-19 and a stable rupee bode well for continued stability and growth.

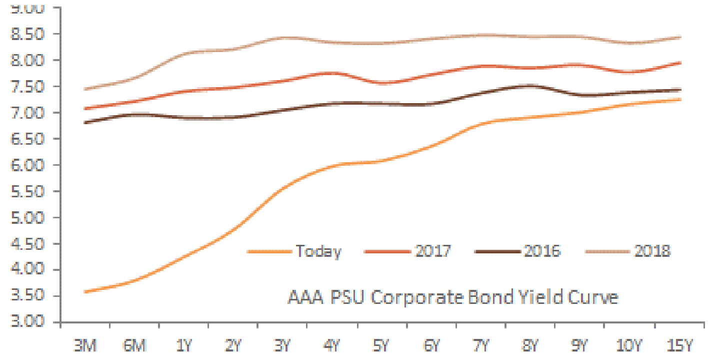
A Steepening Yield Curve is a Healthy Sign



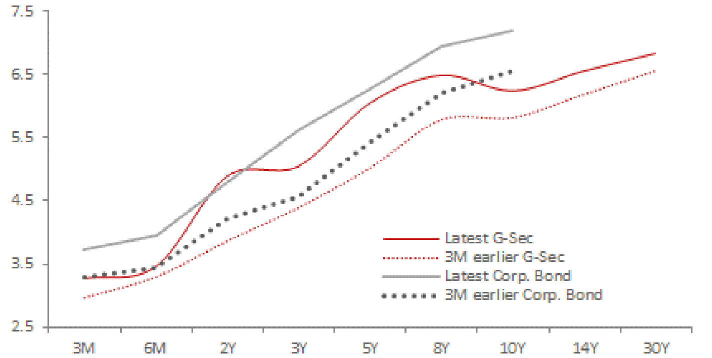
The Upgrade / Downgrade Cycle Has Reversed Up



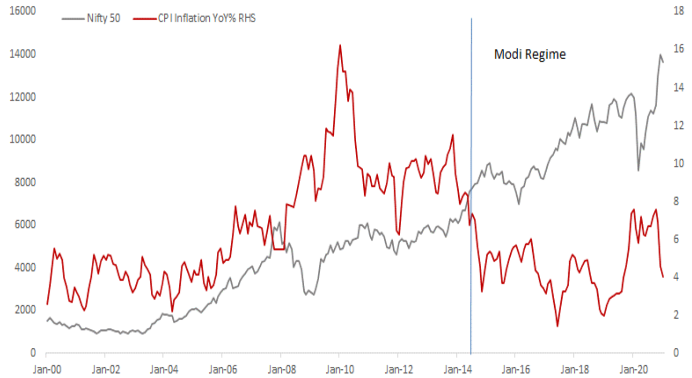
The Term Structure Is the Healthiest in Years



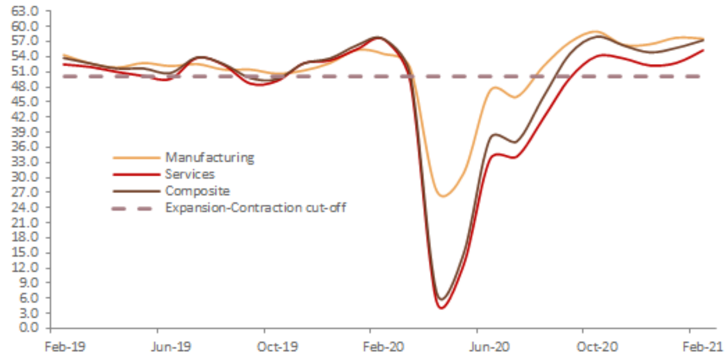
The Recent Rise in Yields is Not Yet Significant



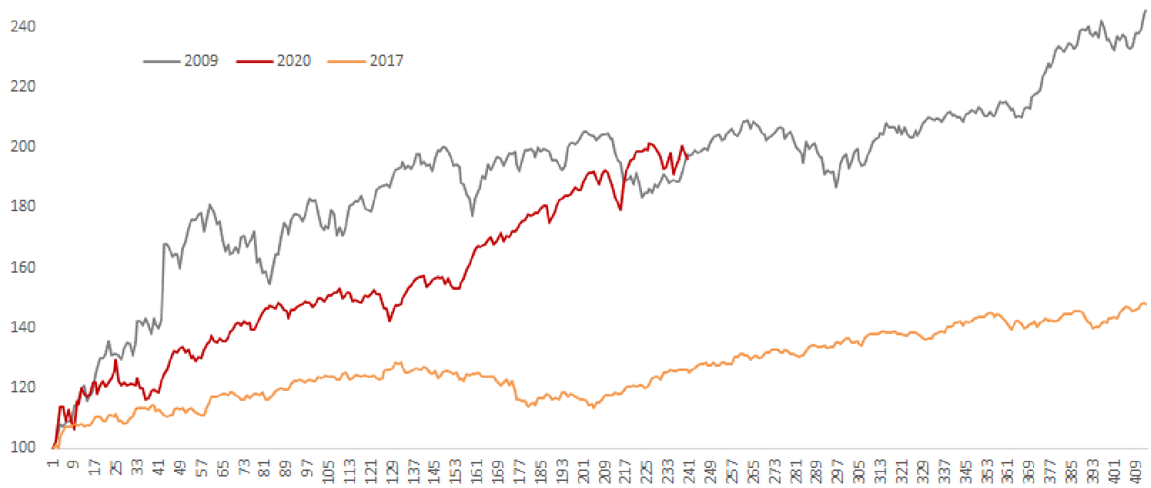
CPI is Trending Lower (Red Line)



While Services & Manufacturing are Soaring



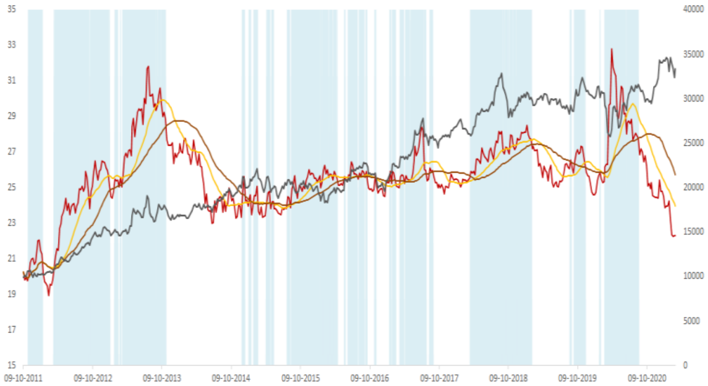
The Rally Continues to Track 2009, with Identical Returns to the 2009 Recovery, To Date



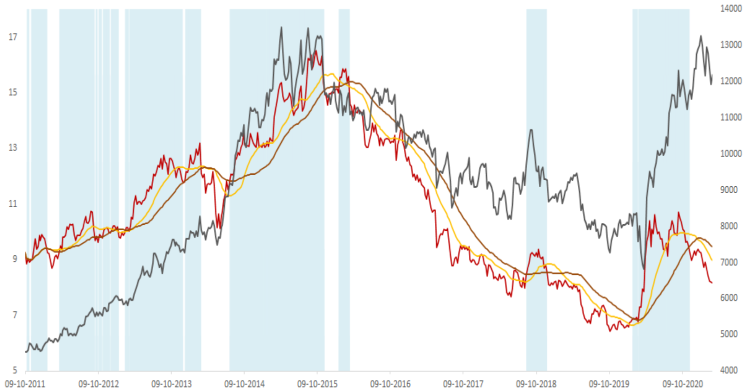
Source: Bloomberg, NSE

Outlook (Continued…)

FMCG Underweight Remains



Pharma Moves to Underweight



Challenges Persist

Challenges still persist, primarily the impact of a massive $1.9T stimulus, the threat of high fuel costs sparking inflation, the government's debt financing, rising rates and credit stress uncertainty, to name but a few concerns.

Strong Earnings and Revisions

But **powerful growth forces are also at play**. The market is delivering on the promise of earnings growth. Strong earnings momentum, easy year on year comparisons, rising eps revisions, and valuations that aren't as egregious as one may be led to believe lend us reasons to stay optimistic.

Powerful Forces Are Driving the Economy Forward

It is the job of the strategist – and fund manager - to **discern the most powerful forces driving the market**. Today, those forces are pro-growth fiscal and monetary policy, abundant capital, low rates, structural reforms, a $1.9T stimulus that looks like it will pass, strong demographic factors, rising services and manufacturing activity, rising **import activity**, strong profitability, a strengthening domestic manufacturing base and a **healthy consumer** balance sheet with rising savings.

Rally Continues to Track 2009

A genuine case can be made that we have amongst **the best fundamentals today in at least a decade**. On the models we track, the selling in Jan 2021 was surprisingly much higher than March 2020. Yet the market is a scant 2.0% off all-time highs. Should **a correction occur, we'd be buyers**. In other words, we would raise our tactical exposure to equities.

Positioning for Rotation

The market appears to be **rotating away from high valuation,** and sectors that traditionally underperform at this stage of the recovery. This too, is healthy and not unexpected.

Market prognosticators have posited about rapidly rising **inflation** for years now, and what we've gotten is a deflationary world, characterized by constantly declining prices for technology and services. Equities and real estate can be classically effective hedges against inflation. So can Gold, which is slumbering, incidentally. The situation bears watching.

Sector: With the market **rotation away from Consumer Staples, Health Care,** we're **focusing on Industrials** and **Consumer Discretionary** to benefit from increased government, consumer and private sector spending. While a case can be made for infra, metals, PSEs; it's advisable to tread carefully. These sectors require constant vigilance.

Secondly, in the search for growth, the choice is cyclicals, value, or smaller cap. Our preference is to **tilt portfolios to increased exposure to mid cap and multi cap.**.

The **promise of spring remains in view**. Fear, disbelief, and the short-term speculative fervor of crowds should not sway one from staying committed to long term wealth creation using sound tactical rotation, and asset allocation principles.

Author

Sunil A. Sharma is the Chief Investment Strategist and Equity Portfolio Manager at Ambit Global Private Client. Mr. Sharma has 11 years in India and 18 years on Wall Street, New York, as an Equity Portfolio Manager & Senior Strategist at Lehman Brothers, Senior Analyst at Morgan Stanley Asset Management, and Analyst at Alliance Capital. Mr. Sharma has run a large cap PMS and multi cap PMS since 2016, consistently ranking in the top decile or better.

Investment Outlook

Asset Allocation Relative to Strategic

Asset	Underweight	Strategic	Overweight	Comments
Equity				Slight Overweight above Strategic
Large				Strategic Weight in Large caps
Mid				
Small				
Thematic / Sector				Overweight Industrials, Consumer Discretionary Underweight Pharma, FMCG
Long / Short				Growth with Capital Preservation
Value / Growth				Favour Growth
Fixed Income				Favour Accrual currently in 2-5 year segment
Duration				Prefer Hold To Maturity (HTM) up to 3 -5 years
Credit				Well researched and selective high quality credits
Gold				Has not reacted to inflation expectations and unlikely to outperform as recovery unfolds

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

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