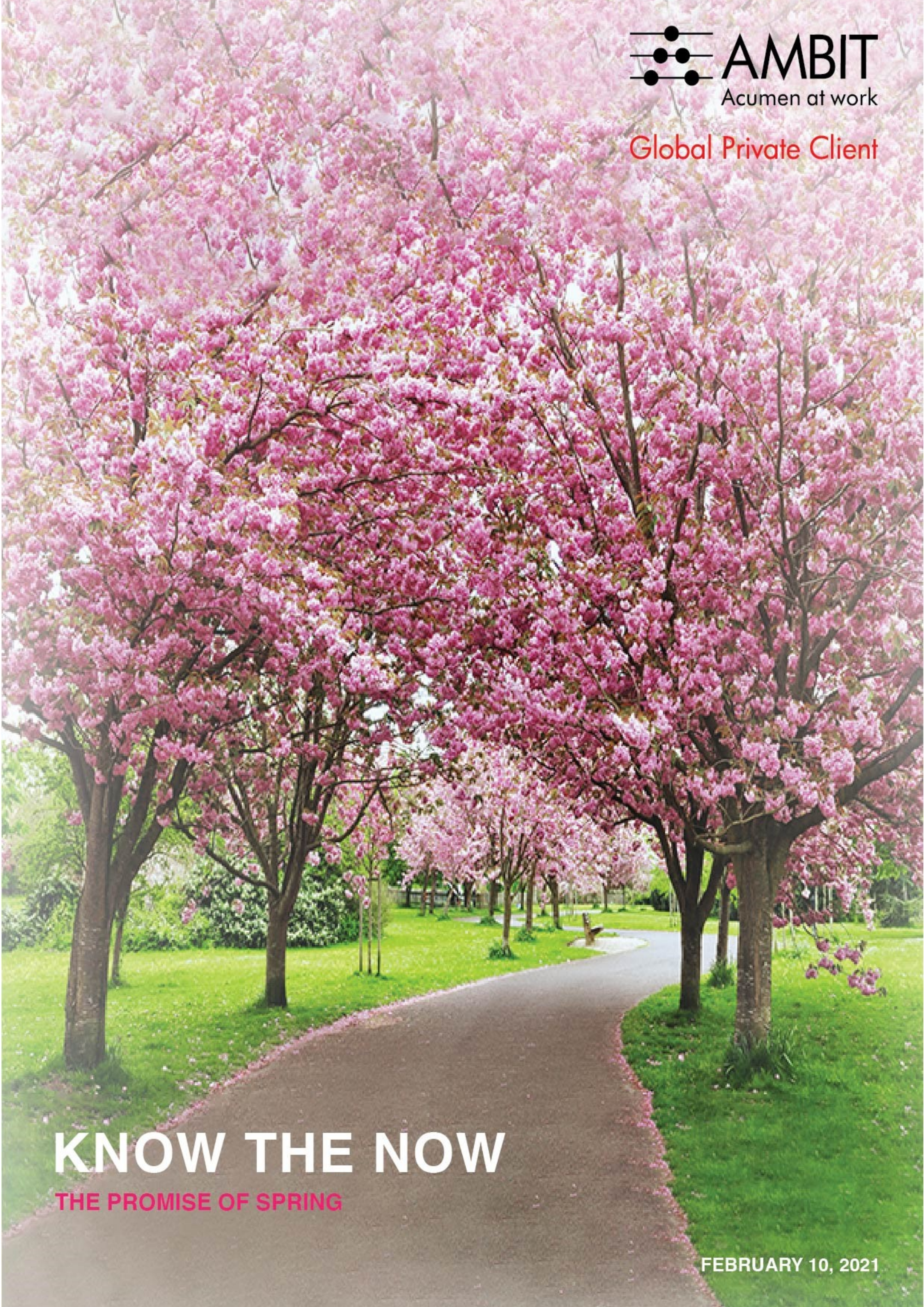


AMBIT

Acumen at work

Global Private Client

KNOW THE NOW

THE PROMISE OF SPRING

FEBRUARY 10, 2021

In our last edition of **Know the Now : Seeing the Light at the End of the Tunnel**, **Nov'20** our Chief Investment Strategist argued that it may *not* be prudent to look at headline valuation numbers of NIFTY and arrive at a conclusion that the markets are frothy. We put forward the case to enhance equity exposures with the following reasoning –

- With news of multiple vaccines coming out, the countdown to normalcy had begun.
- With US elections throwing a Biden victory, there will be return to stability in US policies and markets love stability.
- Be it the rise of the millennial retail investor or the FIIs, we have been making a case to not underestimate the impact of liquidity released by central banks globally (**The Liquidity Gush, May'20**). The famed retail investors who grabbed headlines with the game of the short squeeze have become a meaningful participant that professional managers can ignore only at their own peril.
- Low interest rates and rising inflation, make cash a negative yield asset and owning equities remains imperative to generate real returns.

In this edition of **Know the Now : The Promise of Spring**, Sunil deep dives into the current markets and argues that the NIFTY valuation numbers have to be normalized for the extraordinary two quarters of March and June' 20 and when you do that, the **run rate valuations** at 23-24 times are not **AS** expensive, and with NIFTY profits up 23.7% in Dec '20 (year on year) there seems more headway going ahead.

The reason I started with our Nov '20 piece is because many of you, our astute clients will say that now that markets have gone up, everyone is positive, and all news is good. Just wanted to remind you that we have been saying it for a few months through our notes and also in the ET Global Markets Summit in Jan'21, where we had an opportunity to participate. (refer link – Day 3: https://youtu.be/QuLfhj6RhuI).

The fact is, that the markets are always forward looking and the markets are almost always right. And this time they have been on point – be it the crash in 12 trading days when life as we knew it came to a standstill and a vicious recovery as markets realized that this was a one off, and the world at large will come out of it. The markets are ahead…they have priced the earnings recovery and the growth from pre-Covid19 levels. And with the pro-growth budget, signaling that the government seems ready to play ball, ***the promise of spring*** is in the air.

Making money is never easy, definitely not in the markets. It's a behavior game, we spend an inordinate amount of time trying to get the timing right, feel bad on missing the upside and not selling before a crash. Our report evaluates what if you perfected the *Art of Bad timing* and kept buying at peaks, how badly off would you be …you may be surprised at the findings.

Call us, there is lots to do and the answer as always lies in the details.

Happy Reading and Happier Investing!

Amrita Farmahan
Chief Executive Officer

AMBIT
Acumen at work

The Promise of Spring

Summary

- Review the rhetoric on high valuations versus reality
- We update quarterly earnings trends and the big picture post Budget
- Provide perspective on a question that many investors today are grappling with, i.e., should I deploy into equities?

February 2021

Sunil A. Sharma
Chief Investment Strategist

A Deeper Dive into Current Valuations

"What If" is a useful phrase that should belong in every investor's vocabulary. Oftentimes, it reinforces our knowledge, and other times, it leads us to meaningful insights. Let's get started.

What If current trailing P/Es are overstating reality by a wide margin?

Accounting standards are clear that one-time extra-ordinary items should be adjusted for in computing ongoing operating earnings.

March and June 2020 were extraordinary in every sense, with economic activity shutdown, and any logical analysis of trailing earnings in 2021 should **adjust for the extraordinary environment** we were in last spring and summer.

We do that by normalizing earnings for these two quarters, and end up with a **trailing P/E for the market that is at 23-24 times**. Conservatively assuming some growth next year brings valuations further lower, below 23 times. That's hardly expensive given decadal low interest rates and declining inflation.

Our Yield Gap Model Also Suggests Valuations are Fair

We favor the yield gap model on relative equity versus bond yields as a meaningful tool for relative valuation analysis (chart on page 4), and this indicator also suggests that valuations for equities remain in a reasonable range. This is one of the few times we prefer forward earnings yield, because it's likely closer to reality than the trailing eps based yield.

Nifty 50 Well Positioned to Deliver Strong EPS growth

As things stand in the current quarter, the Nifty 50 profits are up an **impressive 23.7% y-o-y**. Clearly, companies are benefitting from cost controls and operating and net leverage.

Further, historical drags on Nifty EPS growth – telecom, PSU banks, PSEs and some cyclicals – are all witnessing core issues being addressed.

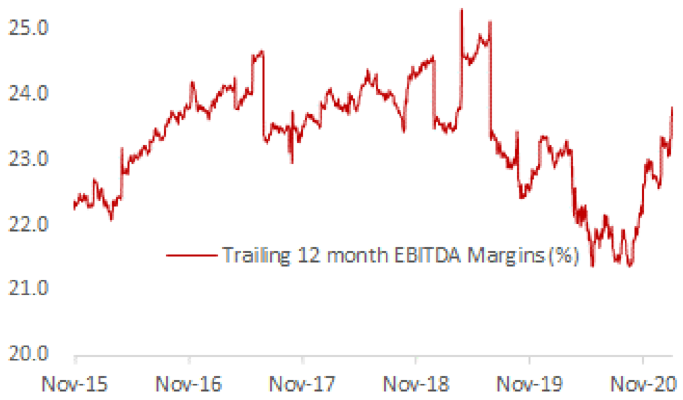
Key sectors that were struggling the past 2-3 years such as Pharma and Autos are also resurgent. IT has re-invented itself. Materials and Metals are rising. The budget was a game changer. There is a strong case that we may be entering a period of exceptional earnings growth.

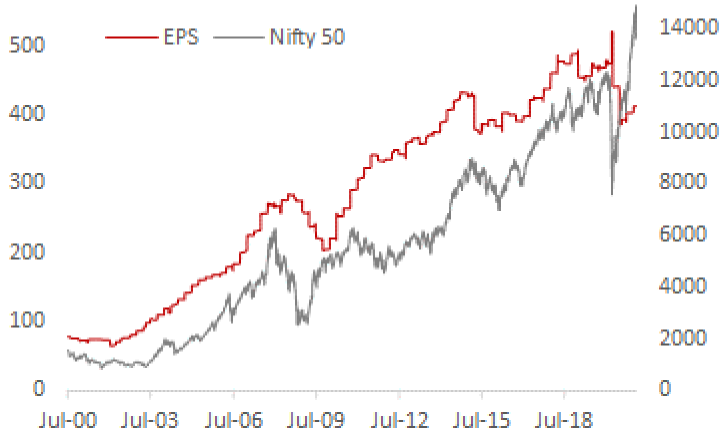
The Market's P/E Falls Dramatically from 37.9 Times to 25.1 Times If We Normalize for Shutdowns Last Year…
…For the Nifty 50, the Normalized P/E Falls to 26.5 Times

	Trailing P/S	P/S Normalized (Sep-Dec)	P/S Normalized (Dec Qtr)	Trailing P/E	P/E Normalized (Sep-Dec)	P/E Normalized (Dec)	Market Capitalization	% of Market
Consumer Discretionary	2.5	1.5	1.3	-254.0	23.2	21.4	9,59,625.0	7%
Consumer Staples	9.2	6.5	6.2	67.3	58.1	54.2	12,01,050.5	8%
Communication Services	3.8	2.7	2.6	-20.0	102.0	48.3	4,29,650.7	3%
Financials	3.6	2.7	2.6	29.7	23.8	23.2	45,10,321.0	31%
Health Care	5.7	4.1	4.0	36.3	27.0	28.0	5,95,543.4	4%
Industrials	3.3	2.2	2.0	43.2	29.6	35.4	8,32,519.2	6%
Information Technology	6.9	5.1	5.0	30.1	28.2	26.2	26,15,406.9	18%
Energy	1.9	1.3	1.2	27.6	18.4	18.3	14,18,176.6	10%
Materials	3.1	2.1	2.0	29.0	18.7	14.5	14,52,251.7	10%
Real Estate	19.3	11.1	8.9	-143.1	65.8	44.0	1,41,608.9	1%
Utilities	2.6	1.9	1.9	24.3	16.9	21.2	3,93,681.8	3%
Total Market	**3.6**	**2.5**	**2.4**	**37.9**	**25.1**	**23.7**	**1,45,49,835.6**	**100%**

Source: Bloomberg, NSE. Our Universe is NSE stocks with a market capitalization > 1000 Cr.

Nifty 50 EPS and EBITDA Margins Were Impacted Severely in the March & June Quarter 2020…
…Margins Are Now Back to Historical Averages; So Are Earnings, It's Just Not Reflected in Trailing 4 Quarter EPS





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The Nifty 50 Has Delivered 23.7% YoY Profit Growth This Quarter To Date…
…And Impressive 11.2% Net Margins

	Sales Growth YoY	Sales Growth Seq Q/Q%	Operating Profit Growth YoY	Operating Profit Q/Q%	Net Profits YoY%	Net Profit Q/Q%	Operating Margin	Net Margin
Information Technology	6.0%	4.4%	20.0%	8.3%	15.9%	16.6%	27.8%	19.7%
Health Care	12.0%	2.4%	80.7%	-7.7%	262.0%	-19.1%	22.0%	13.9%
Materials	16.6%	13.5%	65.0%	28.1%	156.8%	46.7%	26.4%	12.9%
Financials	13.5%	7.6%	-18.3%	-6.4%	5.7%	9.7%	26.0%	12.6%
Industrials	-1.8%	14.7%	-0.9%	14.0%	4.9%	-55.3%	17.0%	6.9%
Utilities	4.0%	-0.7%	8.0%	2.7%	15.4%	9.6%	31.8%	13.7%
Consumer Staples	20.6%	4.3%	17.2%	1.4%	19.1%	-1.9%	24.3%	15.9%
Energy	-20.7%	13.9%	4.8%	7.6%	21.9%	12.0%	14.3%	7.9%
Consumer Discretionary	10.0%	32.6%	46.4%	64.4%	37.6%	134.5%	14.8%	6.5%
Communication Services	20.8%	2.8%	28.0%	2.0%	-182.4%	-211.8%	44.6%	3.2%
Real Estate	nm	nm	nm	nm	nm	nm	nm	nm
Nifty 50	**0.9%**	**11.5%**	**4.1%**	**5.8%**	**23.7%**	**14.8%**	**22.1%**	**11.2%**

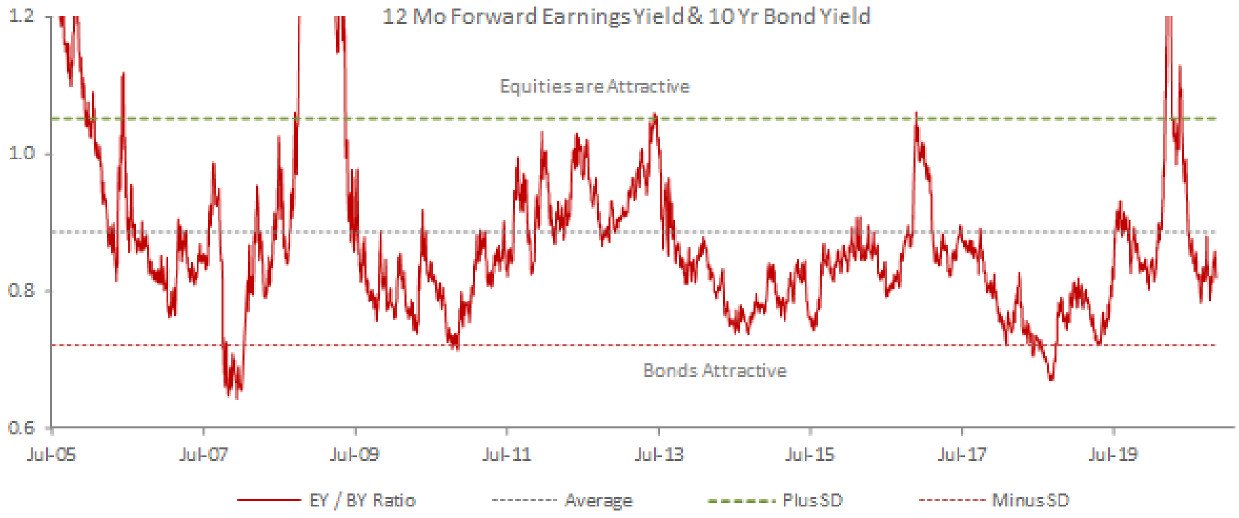
The Broader Market Has Delivered Top Line Growth of 3.7% YoY
With Super-normal Profit Growth Driven by Health Care, Materials and Utilities

	Sales Growth YoY	Sales Growth Seq Q/Q%	Operating Profit Growth YoY	Operating Profit Q/Q%	Net Profits YoY%	Net Profit Q/Q%	Operating Margin	Net Margin
Information Technology	6.1%	4.9%	21.2%	8.5%	17.3%	17.2%	26.9%	19.0%
Health Care	13.2%	2.9%	54.4%	-2.2%	261.1%	-7.3%	22.6%	14.3%
Materials	13.3%	11.0%	68.2%	31.2%	149.8%	81.3%	26.6%	13.4%
Financials	17.8%	7.4%	-8.4%	-9.7%	39.4%	4.8%	32.1%	11.2%
Industrials	-1.8%	18.5%	10.1%	23.3%	20.8%	-28.1%	14.7%	5.7%
Utilities	4.0%	-3.3%	8.1%	-14.7%	168.5%	-33.7%	30.5%	9.1%
Consumer Staples	11.0%	9.7%	19.6%	10.6%	25.3%	15.3%	17.4%	11.5%
Energy	-18.7%	18.4%	6.9%	3.2%	23.9%	0.3%	11.6%	6.3%
Consumer Discretionary	10.4%	28.2%	39.4%	56.2%	42.8%	18.7%	14.5%	6.3%
Communication Services	10.5%	7.2%	20.5%	6.0%	-1962.4%	-2006.4%	37.5%	5.4%
Real Estate	-3.5%	67.2%	47.6%	82.1%	13.6%	197.8%	27.2%	20.3%
Total Market	**3.7%**	**12.2%**	**10.4%**	**3.6%**	**49.5%**	**12.8%**	**23.0%**	**10.1%**

Source: Bloomberg, NSE

Notes on Profits: Health Care's profit growth is driven by exceptional numbers from Lupin, Sun Pharma and Cipla. Materials gains are driven by Jindal Steel, Asian Paints, SAIL, Shree Cements, Tata Steel BSL, while Utilities shine due to JP Power, Adani Power, and NTPC.

The Fed Model Suggests Valuations for Equities (Forward) are Fairly Priced Relative to Bonds



Source: Bloomberg, NSE. Our Universe is NSE stocks with a market capitalization > 1000 Cr.

Key Paradigm Shifts Are Underway

A Powerful Shift in Fiscal Policy

For years, the Modi regime focused on fiscal discipline and adhering to a fiscal deficit around 3.5%. With Covid distress, the government has rightly chosen to step forward with a proposed large increase in spending. Rightly so, as the fundamental responsibility of government is to step forward and spend during times of economic duress. That is the need of the hour, and a powerful shift in mindset.

What If…the **trifecta of fiscal policy, monetary stimulus and structural reforms is the juggernaut that propels India's growth** back above 8%?

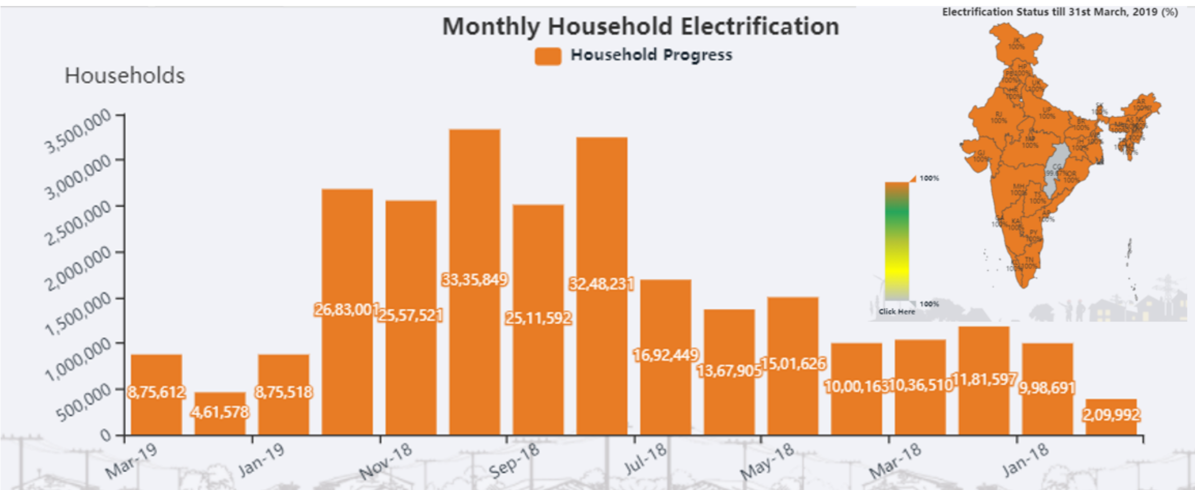
The Multiplier Benefits of Rural Electrification

India has achieved 100% electrification. Setting aside what that really means, our takeaway is that millions of rural consumers now have access to light, internet, appliances, information, and opportunity.

The successful drive to provide electricity access to all villages and households is a game changer.

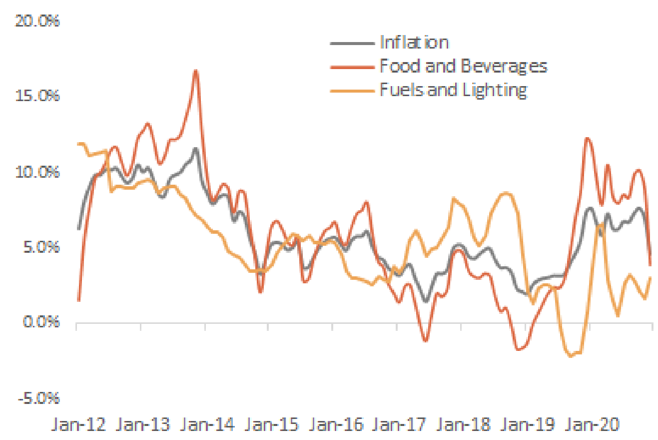
What If…structural reforms are the reason we're witnessing the sustained and surprising **strength in rural demand**?

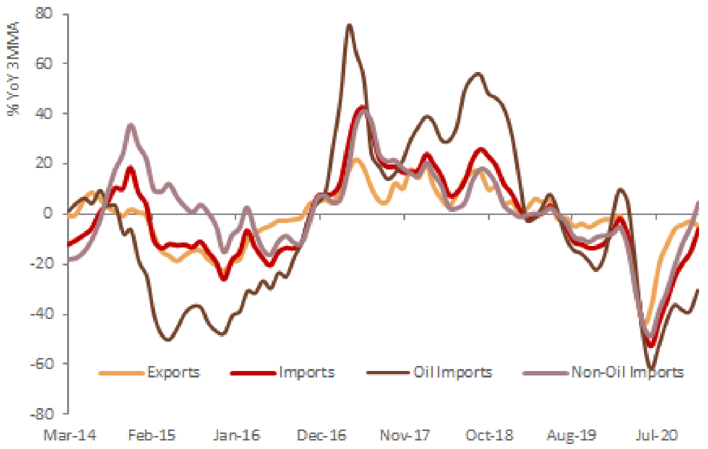
The Benefits of Rural Electrification Could be Under-appreciated



Source: Saubhagya.gov

Headline Inflation, Food Inflation Appear to Have Peaked…
…And Import Export Activity is Also Fast Approaching Normal





Source: Bloomberg

An Impressive List of Structural Reforms…
Change Occurs Slowly and Then All of a Sudden…

We borrow from Ernest Hemingway's law of change, but the idea is worth considering.

Over the past 7 years, the Modi government has achieved a plethora of meaningful reforms:

- Consistent massive investments in highway **infrastructure**, a key pillar for growth, leading to reduced transit time, reduced wastage, improved productivity
- The **divestiture** and consolidation of PSU Banks and reduction in stressed assets
- **Bankruptcy reform** and restructuring - Big NPA's like Essar Steel, Essar Oil, Monnet Ispat, Ruchi Soya, Alok Inds, Bhushan steel, Lanco Infra, DHFL have seen resolution and many are in the process.
- GST e-way bills reducing transit times
- The **PLI** scheme, combined with lower corporate tax rates for new factories, and import duty arbitrage for finished goods
- The **India Stack**, now a globally admired payments infrastructure with last mile connectivity, and **Aadhaar**, allowing for direct payments to the poor's bank accounts, minimizing leakage
- Rising tax collections and **tax participation**
- Reforms towards an **organized, white economy**

Declining Cost of Capital

We've witnessed a meaningful decline in the cost of funds, for private and public sector banks, which is finally transmitting to lower home loan rates and corporate rates. The benefits of lower cost of capital will flow through the system leading to higher affordability, higher profits and ROI.

It appears likely that the **cost of capital will remain low** for the next decade. Therefore, valuations are likely to remain high.

Never Let a Crisis Go to Waste

What if IL&FS, demonetization, GST, China trade war and Covid were the crises we needed to **cleanse the economy** of the albatross' that impeded growth - bad loans, black money, unorganized sector activity, credit crisis – and India is now positioned for a runway of growth this decade?

Global Recovery

We generally focus on the U.S., which drives global activity. The long end of the U.S. yield curve is rising, typical of recovery. Manufacturing and Services activity is robust. U.S. corporate sentiment is at a cycle high. High yield spreads are declining. New orders are averaging a 6% growth rate. The leading economic indicator continues to progress towards normal. Biden's $1.9 trillion surplus will provide additional support to the U.S. economy and global liquidity.

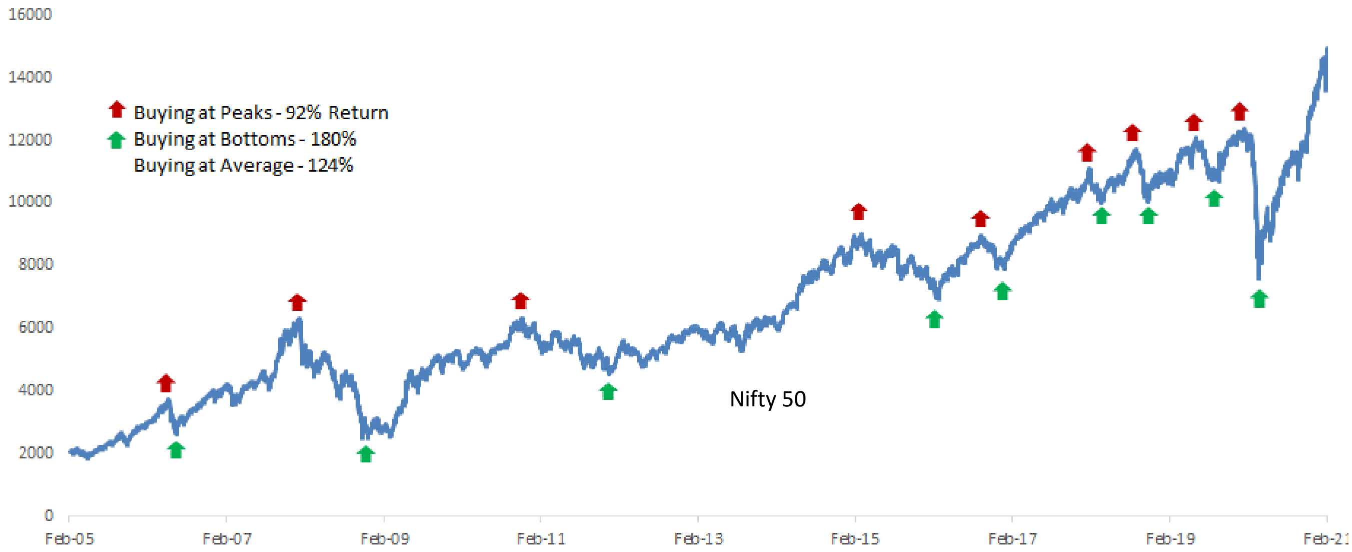
Geopolitical Realignment

Companies are **de-risking China** exposure, and India will be a clear beneficiary. Our government has acted quickly, and as a result, global leaders such as Apple, Tesla, Ikea are planning or setting up **manufacturing in India**. Many are bound to follow.

What If…the pain of the past few years has helped cleanse the system and we can now genuinely ponder the possibility of a **super cycle of growth in India**. .

Investing is a Behavior Game… the Case for Investing with Perfect Bad Timing

What If an Investor Perfected the Art of Bad Timing, and Buying at the Market Peak?



Buying the Market Peak Does Surprisingly Fine Relative to the Average Timer…

Peak Trough Cycle	Bought the Peak	Current	Return	CAGR %	Bought at Mid Point	Return	CAGR %	Bought the Bottom	Return	CAGR %
May-06	3,635	14,934	310.8%	10.1%	3,134	376.5%	11.2%	2,633	467.2%	12.5%
Jan-08	6,288	14,934	137.5%	6.8%	4,420	237.9%	9.7%	2,553	484.9%	14.4%
Nov-10	6,238	14,934	139.4%	8.9%	5,391	177.0%	10.4%	4,544	228.6%	12.3%
Mar-15	8,937	14,934	67.1%	9.0%	7,962	87.6%	11.2%	6,987	113.7%	13.7%
Sep-16	8,953	14,934	66.8%	12.3%	8,430	77.1%	13.8%	7,908	88.8%	15.5%
Feb-18	11,084	14,934	34.7%	10.4%	10,541	41.7%	12.2%	9,998	49.4%	14.2%
Sep-18	11,582	14,934	28.9%	11.0%	10,806	38.2%	14.2%	10,030	48.9%	17.8%
Jun-19	12,089	14,934	23.5%	13.4%	11,397	31.0%	17.4%	10,705	39.5%	21.8%
Jan-20	12,330	14,934	21.1%	19.6%	9,970	49.8%	46.0%	7,610	96.2%	87.9%

Buying at Market Peaks

We now come to the most important aspect of **investing, which is behavior**. We won't be too far off if we state that most portfolio returns in 2020 were primarily determined by actions taken in March 2020. Everything that followed was a reaction, the dice was set in March.

As we demonstrate in the table above, **an investor that bought the peak of the market** every time going back to 2005, a ridiculous assumption, still handily beat bonds, beat inflation and **earned a reasonable double-digit return**, and much higher if they bought quality growth.

The **fear of buying the top is fairly mis-placed if one extends the investment horizon**.

To paraphrase Peter Lynch:

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

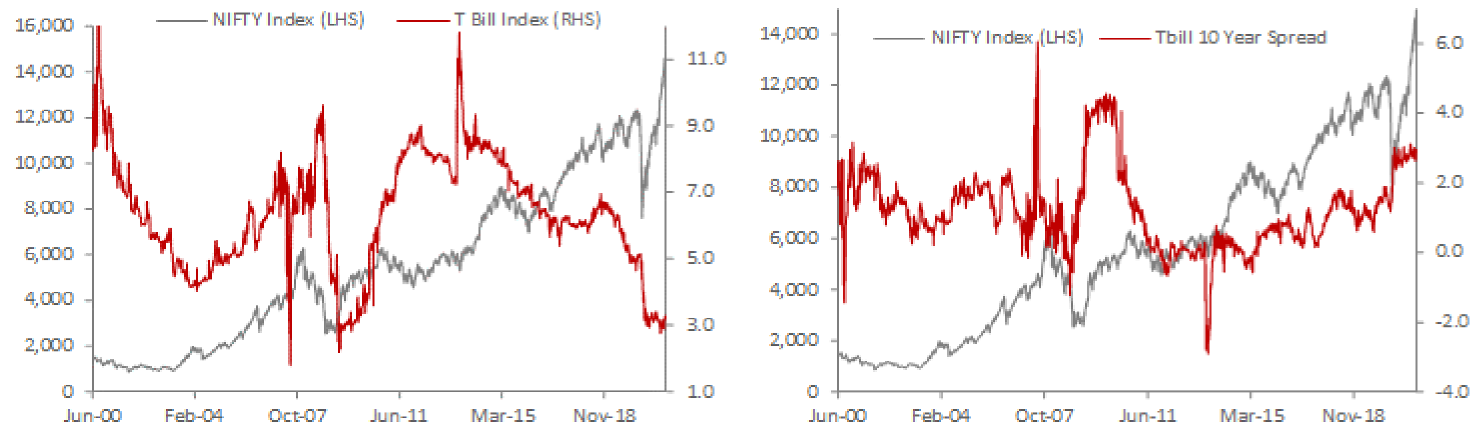
An Optimist Outlook is a Necessary Precondition

Time and again, it's been demonstrated that the necessity of an optimistic outlook is a pre-requisite for successful equity investing. Each sell off in the past few years confirms that the bullish investor consistently fares better.

Buying Recent Market Peaks

Even returns from market peaks in 2018, 2019 and 2020 have yielded positive returns, reinforcing the fact that India is a growth economy and the trajectory of the market is ultimately always higher.

A Flat 1 Year, and Rising 1-10 Spread Indicative of Ongoing Economic Recovery



Source: Bloomberg

Outlook

Budget Addresses Doubts on Growth Trajectory

Any doubts that the earnings and economic recovery in the third quarter are a catch-up from prior quarters, were addressed by the Budget.

Government spending has already picked up prior to the announcement, and with the revival of consumer and business confidence, and covid 19 vaccines demonstrating effectiveness, we think **consumer demand will witness a strong recovery**.

Wealth Effect from Equities

While wealth effects are certainly stronger from real estate activity, we expect investors with equity portfolios will be feeling confident and willing to step forward and spend. Wealth effects from rising equity values could deliver the largest boost to consumer demand in 15 years.

The Retail Cult of Equity

The retail investor has won and put the FIs and institutions in their place. We attribute this to **the democratization of investment knowledge**. Maybe this is a new retail investor that is better informed and equipped to achieve success in markets. In that case, the trend towards **financialization** has a long runway.

The Repetitive Loop of Global Volatility

The repetitive loop created by global events and the central bank leads to volatility that has nothing to do with the fundamentals of India. It should be expected, and taken advantage of. That's what the retail investor has done of late.

Consensus Bullishness Not a Concern

One thing we have always done and will continue to do in our investment writings is to raise the relevant issues in an unbiased manner and address them head on. In the process, we hope to end up with an objective view of the markets.

The naysayers think a **bubble** is upon us. These same naysayers – particularly an illustrious asset manager in the U.S. – have been calling for a bubble since S&P 500 was at 1800. Any investor heeding his advice has given up 100% gains in the market.

The naysayers were also active in 2010 and much of the previous decade. With all clear on the domestic economic front, it's important to **focus on the positives** that lie ahead for India.

While the consensus is bullish, we don't think that the consensus is fully invested, and there is cash on the sidelines.

Rally Continues to Track 2009

We have stated since last summer that this rally will follow the model of the 2009 recovery. As we've outlined, **valuations are not as big a concern** as the consensus believes.

The **budget** unleashed a fiscal policy push that will drive growth, alongside supportive monetary policy and strong reform driven agenda.

Super-cycle of Growth Ahead for India

Long term secular trends appear to be underway in infra, real estate, technology, pharma, specialty chemicals, financials, agriculture and online ecommerce that will create a virtuous cycle of growth.

The Indian economy looks well positioned to enter a super-cycle of growth over this decade. Investors would do well to build exposure for long term wealth creation.

Sectoral and Style Preferences

Sectoral positioning across the board looks the strongest it has been in years. The pillars of the Indian economy – Consumer, Financials, Information Technology, Pharma, Automobiles – are each resurgent. Real estate appears to be witnessing a recovery for the first time in years.

The details on sectors and cap are no longer as essential as is **building strategic asset allocation exposure weights to quality managers, quality portfolios, across cap sizes**.

There may be challenges and volatility along the way; however, the fundamentals of India relative to ROW are undeniably attractive, and investors would do well to focus on a long-term investment horizon, utilizing volatility along the way to deploy additional capital, or deploying in a regular and gradual manner.

Ambit Wealth Caliber Equity PMS Launch

We are delighted to announce the launch of our Ambit Wealth portfolio management platform. This marks a meaningful step forward in our journey towards building a best in class proposition for our clients, featuring global best practices tailored to individual client objectives.

We launch Caliber Equity, a long only PMS this month. We launched the Caliber Equity Advisory in April 2020. Our model advisory portfolio in that time has delivered **a 71.4% return, outperforming the Nifty 50 by 21.0%.**

In an environment where many fund managers have struggled to beat the index, we continue to deliver significant alpha using our proven multi-disciplinary, proprietary investment framework.

Caliber Long Equity Advisory

	Q2 CY20	Q3 CY20	Q4 CY20	Jan-21	Inception (Abs. Ret. %)
Caliber	16.0%	22.7%	23.2%	-2.3%	71.4%
Nifty 50	12.1%	9.2%	24.3%	-1.2%	50.4%
+/-	3.9%	13.5%	-1.1%	-1.1%	21.0%

Note: Caliber advisory return based on actual and model portfolio launched on **April 22, 2020**. Data as of Jan 31, 2021. Details available upon request.

Author

Sunil A. Sharma is the Chief Investment Strategist and Equity Portfolio Manager for the Caliber PMS 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.

Asset Allocation Relative to Strategic

- **Equity**
- Slightly Overweight Large Mid Small

- Overweight Long Short and Capital Preservation strategies

- Overweight Growth

- **Fixed Income**
- Underweight Arbitrage
- Duration for tactical investment in medium / long term G-Sec
- Near maturity high spread instrument
- Corporate Bonds for accrual / positional trade
- Short maturity credit to lock in carry

- **Gold**
- Slightly Underweight Gold
- Physical Gold, Gold Bond, Gold ETF

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

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