MARKET STRATEGY

PRICE TRAP

Investors' optimism despite expensive valuations has a tenuous basis

THE rapid appreciation in prices of several stocks in the past week has further reduced the appeal of the Indian market. It is increasingly difficult to find ideas with decent absolute upside without looking at FY19. Low global yields have already led to mispricing in several sectors. It seems investors are sanguine despite expensive valuations for somewhat tenuous reasons of (i) comfort (stock prices have been high for some time) and (ii) compulsion (other asset classes offer equally low yields).

We hope that central banks' policies will work out eventually but evidence is low

Global equity markets have shrugged off the negative development of 'Brexit' due to hopes of further monetary accommodation. Central banks' policies have been insufficient to revive global economy given limited transmission of higher asset prices to consumption or investment. Global GDP growth and earnings growth have continued to disappoint. On the other hand, low global yields have distorted the perception of risk and return. The idea of constant negative economic news being positive for the markets (more monetary accommodation) sounds rather preposterous. We do not know how long this charade will last.

We hope that China will manage its issues but we don't know for sure

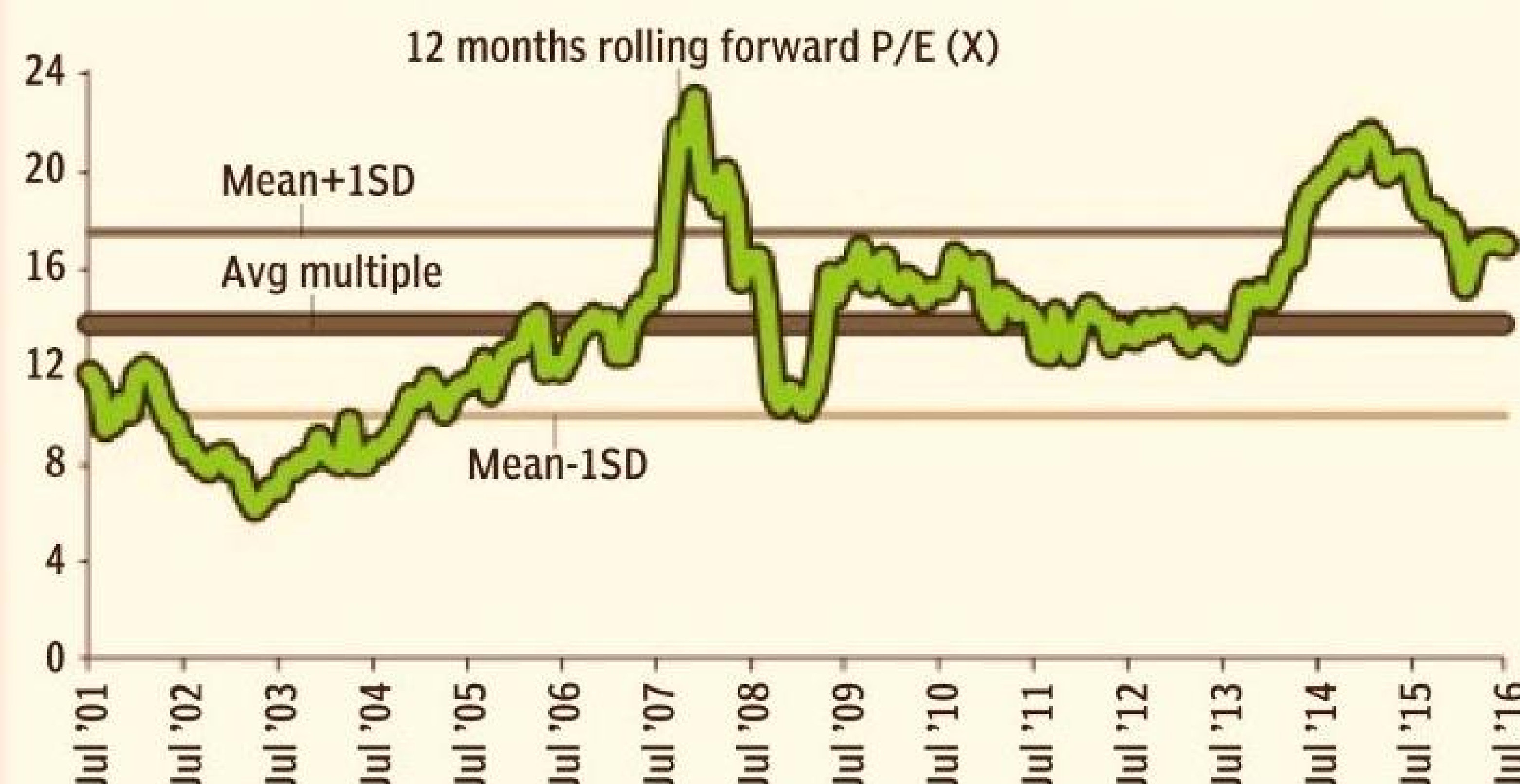
Currency and equity markets are hopeful about China's growth and debt issues and seem to have enough faith in the ability of the Chinese government to manage its challenges. The Chinese economy is showing signs of slow deterioration but the government is using its economic might to engineer a 'planned' slowdown. Any loss of this 'faith' or depreciation in the CNY may hurt sentiments for EM markets significantly.

We hope earnings will grow strongly but Street is already forecasting strong growth

The Street is confident about the government's reforms translating into economic and earnings recovery. We are positive on consumption-led economic recovery but do not expect any great acceleration—weak private sector investment and high banking system NPLs will continue to be a drag. Our strong earnings growth for FY17 simply reflects normalisation of earnings in several sectors and stocks from the low base of FY16. However, downside risks to earnings in certain sectors have increased post 'Brexit'. Domestic economic data is still mixed but will hopefully pick up post good monsoons and 7CPC payouts. FY18 earnings are largely predicated on strong domestic and moderate global economic recovery and they matter more since the street is already focusing on FY18 earnings.

Full valuation for Nifty-50 Index; last peak reflects earnings estimates that never transpired

12 month rolling forward PE of Nifty-50 Index, March fiscal year-ends, 2001-16 (X)



Notes: (a) We use actual EPS (12-month forward basis) for computing P/E for historical period
Source: Kotak Institutional Equities estimates

We expect strong earnings growth in FY2017 on low base of FY2016

Break-up of net profits of the Nifty-50 Index across sectors, March fiscal year-ends, 2015-17E

	Net profits (₹ bn)			Contribution (%)			Incremental profits 2017e	
	2015	2016	2017e	2015	2016	2017e	(₹ bn)	(%)
Automobiles	286	282	367	11	10	12	84	19
Tata Motors	142	110	161	5	4	5	51	11
Banking	582	502	637	22	19	20	135	30
PSU banks	165	46	124	6	2	4	79	18
Private banks	417	456	513	15	17	16	56	13
Cement	59	62	90	2	2	3	29	6
Consumers	148	155	178	5	6	6	23	5
Energy	501	545	526	19	20	17	(18)	(4)
ONGC	189	173	136	7	6	4	(38)	(8)
Reliance Industries	227	274	286	8	10	9	12	3
Industrials	47	36	51	2	1	2	15	3
Infrastructure	23	29	31	1	1	1	2	0
Media	8	9	12	0	0	0	3	1
Metals & Mining	158	125	187	6	5	6	62	14
Coal India	137	143	155	5	5	5	11	3
Pharmaceuticals	123	135	163	5	5	5	29	6
Technology	505	553	622	19	20	20	70	16
Telecom	112	102	104	4	4	3	2	0
Utilities	149	170	185	6	6	6	15	3
Nifty-50 Index	**2,701**	**2,703**	**3,152**	**100**	**100**	**100**	**449**	**100**
Nifty-50 change (%)	**0.7**	**0.1**	**16.6**	—	—	—	—	—
Nifty-50 ex-energy chg (%)	**4.1**	**(1.9)**	**21.6**	—	—	—	—	—
Nifty-50 EPS (FF)	**398**	**381**	**450**	—	—	—	—	—

Source: Kotak Institutional Equities estimates

We are hopeful about valuations holding up but that's just hope; valuations are rich

The Indian market's valuations have gone to uncomfortable levels on an overall basis and lofty levels for several sectors. At such elevated valuations, it would be critical for earnings to surprise positively or at least meet with street expectations. Otherwise, there will be a sickening realisation 6-9 months later that valuations were actually even richer. Our earnings growth estimates are certainly not conservative at about 19% for FY16-18e. Meanwhile, the few pockets of value (versus price) have also started to disappear with 10-15% appreciation in stock prices of downstream oil and regulated utilities over the past 2-3 weeks. Rural stocks and NBFCs have had a stupendous run over the past few weeks and we have had to gradually remove them from our recommended large-cap and mid-cap portfolios.

Model Portfolio changes—happy with boring stocks for now

In our large-cap portfolio, we remove Bajaj Finserv and allocate 200 bps to SBI. We also remove Ashok Leyland (200 bps) and allocate 100 bps each to HDFC (700 bps) and TTMT (600 bps). We are quite astounded by the huge surge in stock prices of NBFCs and their current rich valuations and have removed several of them (Bajaj Finserv, Bharat Financial Inclusion, Cholamandalam, Max, MMFS and SHTF) from our large-cap and mid-cap portfolios over the past two months. Until about two months back, most investors had had a fair amount of concerns about the long-term business models and short-term NPLs of NBFCs. Even as the NPL situation has improved, the investment case of lower borrowing costs through lower interest rate has weakened over this period.

Our large-cap portfolio is dominated by autos and private banks/NBFCs, which comprise 50% of the portfolio. We see both as good plays on our consumption-led economic recovery theme and in particular, autos will also benefit from (i) 7CPC payouts and (ii) GST implementation as the current indirect tax rates on automobiles are significantly higher than the likely GST rate of 17-18%. The rest of the stocks in the model portfolio are largely defensives but not the traditional consumer staples, which we find terribly expensive. In our mid-cap portfolio, we remove Dalmia Bharat Cement given the stock's 33% performance over the past one month.

—Kotak Institutional Equities