"Do not dwell in the past, do not dream of the future, simply be in the present", Gautam Buddha had thus advised about life.

"Dwell in the past and learn from it, imagine the future and ignore the present" would be an apt, though a rather contrary adaptation of this for the stock markets.

The Past - What can we learn from it?

A simple study of the stock markets in India over last few decades throws up four key lessons.

These are

Lesson number 1

Over the long term, stock market indices in India have grown around the same rate as the nominal GDP (GDP Growth + Inflation) of India. **This implies that when in any extended period of, say 10 years, indices grow less than nominal GDP, they tend to make up in the future by delivering higher returns.**

The table below summarizes the returns of the SENSEX in those 10 year periods (since its inception in 1979), when the returns were less than 7% CAGR (approximately half of long term nominal GDP growth rate of 12-16%), and the returns of Sensex for the next 10 years.

As on	Sensex Returns CAGR (%)	
	Previous 10 Years	Next 10 Years
Dec 2001	5.5	16.8
Dec 2002	2.6	19.1
Dec 2003	5.7	13.7
Dec 2004	5.3	15.3
Dec 2016	6.8	?
Sep 2017	6.1	?

Source: Publicly available information

[Refer to the disclaimer at the end of this note]

It is interesting to note that thus far every 10-year period of below 7% CAGR of returns by Sensex was followed by a period in which Sensex delivered 14-19% CAGR over the next 10 years.

Interestingly, we are at such an instance again, as CAGR of Sensex in last 10 years is just 6.1%

Lesson number 2

This one is really simple. It suggests that Stock markets are volatile year to year and are hard to forecast in the short term.

The table below summarizes the 1 year return distribution of Sensex since its inception in 1979.

Calendar year returns of Sensex since 1979 (%)	Number of years
less than -30	1
between -15 and -30	6
between -15 and +15	10
between +15 and +30	9
more than +30	12
Total	38

[Refer to the disclaimer at the end of this note]

The wide variation in the annual Sensex returns clearly brings out the futility of attempts to forecast short term movements in stock markets.

And this applies to experts as well!

The table below gives for each year since 2005, the value of the Sensex at the beginning of the year, the 12 month forecast of the Sensex at the beginning of each year (as per Bloomberg consensus), the actual Sensex at the end of each year and finally the variation between the forecast and the actual.

Year	SENSEX at beginning of year	12M forward Bloomberg consensus Target of SENSEX	SENSEX Actual 12M later	Variation (%)
2006	9,859	9,745	13,787	41
2007	14,267	14,330	20,287	42
2008	20,301	20,853	9,647	-54
2009	9,903	12,139	17,465	44
2010	16,356	17,346	20,509	18
2011	18,022	21,784	15,455	-29
2012	17,301	19,236	19,427	1
2013	19,581	20,039	21,171	6
2014	21,140	21,754	27,499	26
2015	27,508	30,406	26,118	-14
2016	26,161	30,368	26,626	-12
2017	28,142	30,703	?	?

Source: Bloomberg, # Note: 12-month price target based on aggregation of underlying index member price targets. Calculated by summing the Consensus Target Price, times number of shares in the index for each member, divided by the index divisor.

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The wide variations between the actuals and forecasts, particularly in years when the Sensex was not range bound suggests once again, that the markets are not amenable to near term forecasts, even by experts.

In a lighter vein, probably only those who can correctly forecast the outcome of a toss of coin, can forecast one year returns of markets!

Lesson number 3

This lesson deals with sector rotation and suggests that there is a time and place for virtually every sector in the markets. Few sectors are perpetually good or bad investments. Market preferences periodically change as can be seen from the table below:

Period	Best performing sectors	stocks up (x) times	Worst performing sectors	stocks up (x) times	SENSEX up (x) times
1995-2000	IT	**96 - 97**	Auto, Cement, Capital Goods, Corporate Banks, Metals	**0.3 - 1.0**	**1.3**
2001-2007	Capital Goods, Refineries, Corporate & Retail Banks	**8 - 32**	FMCG, IT	**1 - 4**	**5.1**
2008-2015	Pharma, FMCG, Auto	**3 - 15**	Metals, Capital Goods, Refineries, Corporate Banks	**0.3 - 1.1**	**1.3**
2016 - YTD	Metals, Retail Banks	**1.4 - 2.8**	Pharma, IT	**0.6 - 1.0**	**1.2**

Source: Bloomberg

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It is clear from the table above that markets are fickle and their loyalties change i.e., between 1995 - 2000, IT was the preferred sector and markets shunned capital goods, banks, metals etc. This changed and between 2001- 2007 while IT sharply under-performed, capital goods, metals, banks etc were the best performing sectors. A similar role reversal was experienced when pharma, FMCG etc. that were out of favour around 2007, delivered the best returns between 2008-2015 and the erstwhile favourites - capital goods, metals etc. under-performed significantly in this period.

It is evident that repeatedly, sectors that were popular at one point of time fell out of favour and sectors that were considered untouchables became market darlings.

Lesson number 4

This is probably the most difficult lesson, certainly to practice, if not to understand. The lesson here is, that irrespective of what the majority in the market thinks or feels, the markets in the long term are perfect and are driven entirely by logic and rationale and nothing else.

example 1: IT that was wildly popular in 1999 and enjoyed a nearly 100% fan following, underperformed massively over the next few years. On the other hand, a uniform dislike for banks, capex, metals around 1999-2000 could not prevent these sectors from delivering 5-30 times returns over next several years.

Time	Most preferred sectors	stocks up (x) times 2001-2007	Least preferred sectors	stocks up (x) times 2001-2007
2000	IT	1 - 3	Cement, Capital Goods, Banks etc.	6 - 32

Source: Bloomberg

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example 2: Pre Lehman in 2007, the majority opinion favoured infra, capital goods, real estate etc. while FMCG, pharma etc. were out of favour. As things turned out, FMCG, pharma became the best performing sectors while infra, capital goods, real estate destroyed large amounts of wealth (refer table below).

Time	Most preferred sectors	stocks up (x) times 2008-2015	Least preferred sectors	stocks up (x) times 2008-2015
2007	Capital Goods, Real Estate, Infra	0.1 - 0.9	FMCG, Pharma	3 - 15

Source: Bloomberg

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example 3: More recently, oil marketing companies, that were shunned almost uniformly few years back when they were bearing subsidies, are up between 5-10x since.

Source: Bloomberg

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These examples and several more remind one of the memorable words of Benjamin Graham, **"You are neither right nor wrong because other people agree with you. You are right because your facts are right and your reasoning is right".**

Before moving away from the past and coming to the present, a brief recap of the key learnings presented is apt. These are:

- Stock markets are volatile in the short term and it is hard to forecast short term movements
- Stock markets in India are growing in line with nominal GDP growth over longer periods i.e., 12-16% CAGR
- Best performing and worst performing sectors tend to change every few years
- Unlike elections, where the majority opinion always wins, in stock markets, majority can be wrong if its logic or rationale is incorrect.

[Refer to the disclaimer at the end of this note]

The Present – Optically challenging

If one reads the headlines over the last few months, the impression one gets is that the economy is passing through challenging times - GDP growth is slow, earnings growth is low and is not supportive of markets.

As the tables below suggest, observations about slower GDP growth in last two quarters and weak earnings growth are indeed correct.

	GDP growth for the Quarter ended						
(YoY growth %)	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Real GDP	7.2	9.1	7.9	7.5	7.0	6.1	5.7

Source: CEIC, Kotak Institutional Equities

	YoY Growth in earnings for the Quarter ended									
YoY growth (%)	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
SENSEX Earnings	-10.9	1.8	-2.4	1.6	7.5	-1.4	5.1	0.8	10.1	-1.5

Source: Kotak Institutional Equities

However, the comment by many that markets are expensive etc., is not borne out by P/E multiples as the following table clearly suggests.

Sensex valuations

PE for	FY17	FY18E	FY19E	FY20E
as on Sep 30	22.2	21.8	17.3	14.7

Source: Kotak Institutional Equities, E- Estimated

More on this later.

The Future - looking beyond the obvious

Sometimes, what is visible is incorrect and what is invisible is correct. The situation is somewhat similar today.

1. GDP growth - sharp improvement ahead

GDP Growth has indeed slowed down in last few quarters. However, this is, in all probability driven by demonetisation and GST, two very significant reforms that have caused temporary disruption in the normal functioning of the economy. However, as things normalise, growth rates are expected to recover smartly over the next few quarters. Monthly data for July, August and September for several parameters (refer table below) already points in that direction.

	Quarter ended					Month ended		
YoY growth (%)	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Jul-17	Aug-17	Sep-17
Auto volumes – passenger (domestic)	9	15	-1	5	-1	11	12	12
Autos volumes - goods (domestic)	16	-7	-3	6	-22	9	29	29
Steel production	4	16	13	13	6	12	2	6
Power generation	10	3	6	4	5	6	8	5
Rail cargo volume	0	-3	1	4	4	6	8	6
Airline passengers	18	22	22	18	17	13	16	16
Non-oil non gems & jewellery exports	-4	-3	5	18	10	5	18	Na
IIP (Quarterly average)	7	5	4	3	2	1	4	Na

Note: Figures indicate yoy growth unless otherwise indicated; Passenger vehicles include MUVs;

Source: UBS, IDFC, Company data, JPC, CMIE, CEIC, SIAM, Central Electricity Authority, CapEx, Haver, Datastream, naukri.com, CSO, RBI, Bloomberg

It is evident that in the quarters around demonetisation (Dec 16) and GST (Jun 17) various parameters like auto volumes (both passenger & goods) did experience a sharp slowdown. The data for July, August and September is however very encouraging. Auto volumes, power generation, rail cargo are all showing good improvement in growth rates.

The medium term outlook for the economy is even more encouraging. This view is driven by a likely acceleration in infra capex, affordable housing and a revival in private capex. As per recent news flow, there are reasons to be optimistic about revival of private capex in the not too distant future primarily led by metals sector.

One more important point that needs to be explained is the low growth in mature categories. As a country and society progresses, certain categories of goods become increasingly affordable and penetration therefore increases. After reaching a certain level of penetration these categories witness natural fall in growth rates. For example: Salt which is highly penetrated is unlikely to grow at healthy rates. Certain consumer staple categories like soap, shampoo, toothpaste etc. have become affordable and are thus well penetrated in India, resulting in slower growth. As income levels rise, consumers move to more expensive or discretionary products in the same category. This explains the faster growth of motor cycles compared to bicycles in last two decades and the faster growth in 4 wheelers compared to 2 wheelers currently; this also explains the faster growth of air travel compared to rail travel and so on so forth. Slow growth in mature categories should therefore not be attributed to economic slowdown and is not a cause for concern. It is in fact a cause for celebration as it suggests that the masses are able to afford that category or are moving to better substitutes.

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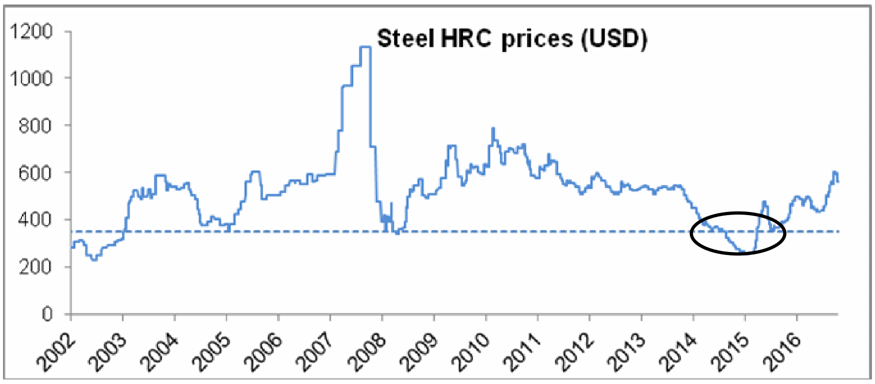
2. Earnings recovery is imminent

Expectations in financial markets move much faster than the real world. It typically takes two years to build a house, one year to renovate it, but we expect the economy growth to surge, NPAs to resolve, earnings to recover and much more in few quarters. Unfortunately, to bring about changes in the real world and more so in a large and complex country like India takes longer. Besides the environment is not static and sometimes while you fix one problem, another one crops up. Take for instance the fall in steel prices to near 15 year lows in 2015 unexpectedly. This set back not just the steel sector but also the banks by a few years.



Source: Bloomberg, HRC- Hot Rolled Coil

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The earnings disappointment in recent past has been weak mainly due to the sharp fall in profits of sectors like steel, engineering & capex and corporate banks. This however, is all set to change.

With the sharp recovery in steel and other metal prices as the above chart indicates, with the peaking of provisioning costs in banks and with a slow but steady improvement in infra capex, earnings recovery is underway and it should become increasingly evident with each passing quarter.

The last quarter's results are already pointing in that direction. In the table below it can be seen that corporate banks and metals that witnessed a fall in profits in Q1FY17 have reported decent profit growth in the Q1FY18 albeit on a low base. The biggest disappointment in earnings this year in Q1FY18 was in fact in pharmaceuticals!

Net profit growth of the Nifty-50 Index across sectors		
Sector	**Q1FY17**	**Q1FY18**
Autos	-25	-25
Corporate Banks & Financials	**-47**	**20**
Retail Banks & Financials	33	13
Cement	47	14
FMCG	10	6

Oil & Gas, Petchem	13	-30
Capital Goods	46	46
Metals & Mining	**-12**	**35**
Pharmaceuticals	**13**	**-56**
Technology	9	-1
Utilities	17	12
Others	13	-17
NIFTY-50 Index	0.6	-8.4
NIFTY-50 Index excluding Tata Motors and OMC's	1.7	3.8

Source: Kotak Institutional Equities

Further, barring the large hedging losses in Tata Motors (profit down ~90% YoY) and the inventory losses in OMCs (profit down ~70% YoY) which clearly are adventitious, earnings grew by 4% (vs de-growth of ~8% as reported).

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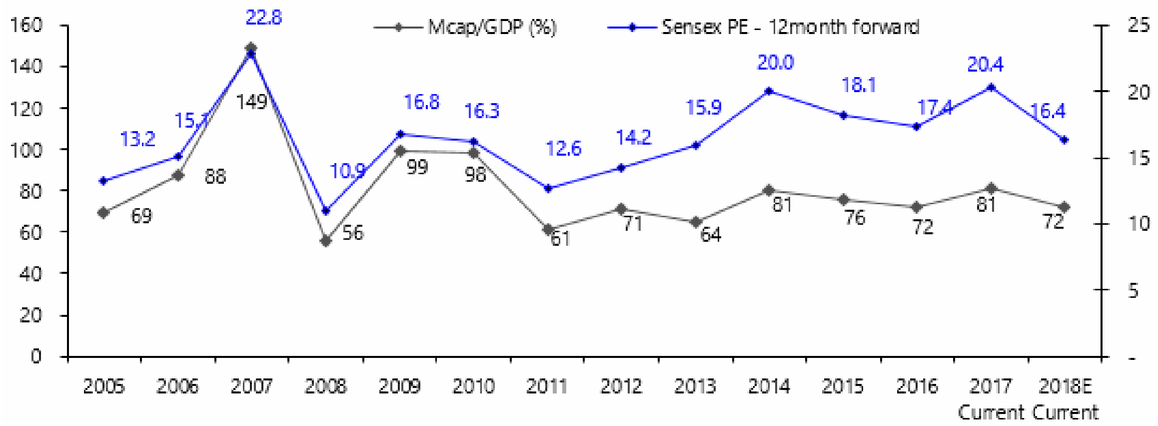
3. Promising markets

As highlighted in the beginning of this note, index has trailed nominal GDP growth by ~8% p.a. for last 10 years (SENSEX CAGR of ~6% vs Nominal GDP growth at a CAGR of ~14%). As a result, India's market cap to GDP on CY18 is ~72%, which is low (see chart below). This will be lower still for next year.

India market cap to GDP ratio, calendar year-ends 2005-18 (%)



Source: World Bank, Kotak Insitutional Equities, updated till 29th September, 2017
Note :
a) From 2005-16, S&P BSE SENSEX PE is based on 12 month forward estimated EPS
a) For 2017 and 2018, we have calculated S&P BSE SENSEX PE based on estimates as of Mar 18 and Mar 19 end and used market cap as of September 29, 2017

[Refer to the disclaimer at the end of this note]

Even in terms of p/e, markets are reasonably valued. In fact, as earnings growth improves, the p/e's should look more reasonable and move lower.

4. New sectors should lead earnings growth over next few years

The table below gives the profits growth sector wise for last few years and the estimates for the same for the next few.

	PAT CAGR % (March 12 to March 16)	PAT CAGR % (March 16 to March 19E)
Autos	6.9	12.8
Capital goods	-22	36.2
FMCG	11.7	11.8
Cement	-2.0	21.5
Corporate Banks & Financials	-15.8	36.4
Retail Banks & Financials	20.5	19.2
Healthcare	20.1	4.9
Metals & Mining	-12.5	39.2
Oil & Gas, Petchem	4.2	12.5
Utilities	11.6	9.6
Technology	18.1	6.5
Others	21.0	-6.4

Source: CLSA, based on CLSA coverage universe, E- CLSA estimates

It is interesting to note that there is a significant divergence in the profit growth across sectors between the past and estimates for the future. For instance: profits for capital goods de-grew by 22% CAGR between March 12 and March 16, are expected to grow at a CAGR of 36% between March 16 and March 19. Similarly, healthcare, where profits grew by 20% CAGR between March 12 and March 16 are likely to grow by only 5% CAGR between March 16 and March 19. This divergence in profits between the past and future opens up prospects for new sectors to gain leadership in the markets going forward.

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Conclusion

India is an economy that has delivered secular growth in the past and is likely to deliver continued growth for many years to come.

The last few years have witnessed a spate of reforms that have improved the macroeconomic fundamentals of the country and future growth prospects. Two important reforms viz., demonetisation and GST while being very beneficial over the medium to long term have adversely impacted growth in last few quarters. This slowdown in growth should not be extrapolated into the future and in fact there are reasons to believe that the economy should bounce back strongly in next few quarters.

Profitability in general and specifically for some sectors is cyclical.

As explained earlier, profitability in few sectors has been weak over last few years and this has hurt aggregate profit growth. This again should not be extrapolated into the future and in fact there are factors that suggest profit growth over next few years should be strong. Lower interest rates, peaking NPA's and higher metal prices etc. should aid this.

Equity markets have lagged nominal GDP by 8% CAGR over last 10 years and are consequently at attractive market cap to GDP ratio. In p/e terms, markets are trading near 17x FY19(e) and 15x FY20(e), which are reasonable, especially given the low interest rates.

In view of the above, there is merit in increasing allocation to equities or in staying invested as the case may be (for those with a medium to long term view and in line with individual risk appetite).

Successful investing needs more patience than intelligence. The track record of a few mutual fund schemes over decades and the experience of those investors who have stayed invested in these funds for long periods amply demonstrates this.

Let me end this long note once again with a thought attributed to Gautam Buddha.

“If the direction is right, all you need to do is to keep walking"

Hopefully, even the most ardent critic of economy or of stock markets, will agree that the direction is indeed right.

October 2017

Note; Sensex- S&P BSE SENSEX; Nifty 50- NIFTY 50

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