Market Snapshot

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Background

Since the end of the COVID-19 pandemic, both the global and Indian stock markets have experienced one of the most significant bull markets in history. This surge has been driven by the return of earnings momentum in favour of companies and an overoptimistic outlook on future earnings, which has been factored into share prices. There has been a substantial increase in market participation, with many investors believing that the market can only yield positive returns. Notably, among the top 500 companies listed by the Association of Mutual Funds in India (AMFI), only 10% have posted negative returns post-COVID, making it challenging for investors to incur losses. The majority of this bull market has been bolstered by mid-cap and small-cap stocks.

Just a couple of more facts on how this bull market has been for us:

1. More than 2/3rd of all small cap stocks have become multibaggers
2. More than half of all the Midcap stocks have become Multibaggers
3. Top 20 performers gave returns at a CAGR of 76%, on average. This means tripling every other year.

It was not just the prices which have run up, this time it was also backed by earnings. There are many companies which also became an Earnings multibagger. Since Covid a significant portion of companies in sectors such as Commodities, Energy, and Utilities have exhibited robust earnings growth which suggests a favourable environment for cyclical companies. However, major sectors including consumer discretionary, IT, and FMCG have experienced subdued earnings growth—a departure from the norm during periods of robust market performance. The prevalence of a bull market driven by cyclical companies introduces a degree of apprehension, as such markets are inherently prone to correction.

India has never seen a steady increase like this ever before, the no of months where nifty has not declined by 5% or more is at 52 months which means that Nifty has not closed below 5% for the last 52 months, the previous peak was 38 months which was made in 2015. This story is repeated across all the other indices be it Midcap, Smallcap or the broader index Nifty 500.

This dream run is also being shown by the Market cap to GDP ratio (141%) which is well above its long-term averages (83%).

In times like these where anything opposite to the market trend feels like an opportunity being missed, but when the data starts to show the reversals in trend then a learned investor shouldn't ignore it. While the Market cap to GDP is touching highs, the Profit to GDP of those same companies is reverting back to its long-term averages particularly the mid-caps.

Financial Statements

When we talk about the profitability and Balance sheet strength of the companies which are essentially the backbone of their price performance. A company's profit growth is based on 2 major parameters. One is Revenue growth, and the other is Margin expansion. The revenue of NSE 500 (ex-financials) which grew by 10% CAGR in last 5 years is now moderating to a mere 2% YoY. This concerns us that the Topline growth of the companies are deteriorating. The other leg which is the margins, are seen expanding as the commodities prices have been stabilised. The balance sheet of the companies are strengthened as many companies have reduced a substantial amount of their debt thanks to the healthy cash flow which are being generated is being used here and also to do additional capital expenditure.

Valuations

The valuations have been the need of the hour, where everyone is riding the optimism in the markets, but we are particularly searching for Margin of safety as it is which is something not very easily available now. If we take a look at the sectoral valuations then we'll realise that among all the sectors, Banking and Financial Services (ex-PSU Banks) is the only sector where the companies are trading below its 5 years and 10 years average. Among all the other sectors Private bank is the only sector where the last 5-year CAGR of Operating Profit is higher than the 5-year CAGR of its Market cap. Within BSE 200, Banking and Financial Services is the only sector where most of the FY25 earnings upgrades are seen. If we take a look at the overall market, then within the BSE All market cap index which consists of 1220 stocks almost 50% of stocks are trading above 40 price to earnings multiple whereas only few stocks are trading below 20 times earnings multiple.

Someone might say that earnings multiple may not be the best way to look at all companies as different sectors are traded at different multiples. So, if we take a look at their book values then also the argument is not much different. Within the Mid and smallcap segment, 3/4th of the companies are trading above 3 times its book value. This number was totally opposite 5 years back when almost 3/4th of the companies were trading below 3 times its book value.

Finding Opportunities
In times where anything seems possible, it makes it more difficult for anyone to find any margin of safety as everything looks so expensive that a basic question kicks in our mind which is

'Is it really worth paying that much?'

As highlighted above that Banking and Financial Services (ex-PSU Banks) is one sector which has valuation comfort which is being paired with one of the strongest balance sheet periods in their history. Banks are currently at their all-time low NPA, and the profitability ratios (like ROA & ROE) are at their historic highs.

Consumer staples is one other sector which is seeing recovery in their revenue growth because of volume growth coming in from rural areas. Recent optimism of acceleration in consumption which is driven by expectations of the government implementing social welfare schemes, may improve the demand conditions for all consumer companies.

Apart from this there are a few pockets of Healthcare and Auto & auto ancillary where some opportunities lie.

Oulook
For such a frothy market to participate in we believe large caps are the space to look at. The valuations of large caps are much better than that of Mid and small caps. Also, their Market cap weight in overall market is lower than what it was 5 years back although their profit contribution is still higher. These large cap companies have much higher Free cash flow than the overall market which makes these companies as a hiding place in case a market correction happens. Also, historically large caps have a lower drawdown than the Mid & Small cap. The Attractive parts of the markets are Banking & Financial services, Healthcare, Auto and Auto Ancillary and a few bottoms up opportunities in Consumer Staples could offer better entry valuations.

Gold has seen a huge drop on the day of Budget making it a lucrative asset to purchase now.

How the investors should participate
Investors are advised to allocate their money in multi-asset strategies as diversification across asset class is the need of the hour. Multi asset provides a much smoother journey and similar return profile over longer term. Investors are also advised to use SIP route for staggered investments and focusing more on the market where margin of safety lies.

Our analysis shows that if an investor allocates their funds equally between a Multi Asset fund and a Multicap fund, rebalancing annually, they would have outperformed the Nifty 500 index (Broader Equity) over the long term on a three-year rolling returns basis. This strategy not only delivered higher returns but also resulted in significantly lower drawdowns and reduced volatility. This means that investors can adopt a more relaxed approach, allowing their portfolio to grow steadily with less risk.

Rolling Return Statistics - 3 years

+ Edit Range

	Rolling Returns				Rolling Returns Distribution (% of times)				
Funds and benchmarks	Min.	Med.	Max.	STD Dev.	< 0 %	0 - 8 %	8 - 12 %	12 - 20 %	> 20 %
• NIFTY 500 TRI	-9.5	12.9	38.3	7.85	7.0	20.8	15.5	39.9	16.7
• Mix 1	-0.65	13.47	34.13	5.95	1.0	20.6	22.1	47.0	9.4

(Mix 1 is the equal weighted portfolio of Multi asset model and NIFTY500 MULTICAP 50:25:25 TRI. Rebalanced annually)

Apart from this, investors can also allocate some part of their money in the largest stocks of the Nifty 50 index which are the top 10 stocks of India, as they are currently being traded at much attractive valuations for stocks which have higher ROEs than the market. Their recent underperformance with respect to market has made them a more lucrative option to go for. Currently the market cap contribution of top 10 stocks in the total market cap is at its all time low. Also, whenever 3-year historical alpha of Top 10 stocks vs Nifty 50 or Nifty 500 is negative, then the forward alpha for Top 10 stocks have always been positive. Currently the 3-year historic alpha is negative, so it can be the right time to invest in Top 10 stocks. Meaning that this may be the right time to concentrate on concentration. It also provides a diversified portfolio for something which only has 10 stocks.

Economy
The recent budget announcements were eagerly anticipated, and they delivered significant news. The government has revised the fiscal deficit estimate for FY25 to 4.9%, down from the 5.1% projected in the interim budget. This 20 basis points reduction indicates that the government has utilized the RBI dividend to reduce the deficit rather than increase expenditure. The capital expenditure remains unchanged from the interim budget, set at Rs. 11.1 trillion, which is expected to provide strong support to sectors like infrastructure and allied activities.

There have been some adjustments within the ministries concerning the allocation of this expenditure. The most notable change is in the Defence sector, where the allocation has been reduced from Rs. 6.2 trillion in the interim budget to Rs. 4.5 trillion. Additionally, provisions of Rs. 1.52 trillion for agriculture and allied sectors and Rs. 2.66 trillion for rural development have been made, benefiting FMCG companies with a significant presence in rural India.

The government's focus on job creation, through employment-linked incentives and credit guarantees for MSMEs, further strengthens the overall ecosystem. Government emphasized on the Central Government's significant investments in the past and committed to maintaining robust fiscal support for infrastructure over the next five years, balancing this with other priorities and fiscal consolidation.

Currently, the manufacturing and service PMI are stagnating but remain strong as private sector activity increases. India's trade deficit has narrowed to $21 billion, driven by a greater sequential decline in imports than exports, aided by easing oil prices. Consumer sentiment remains strong, well above the FY24 average.

However, inflation in food prices is a growing concern. In June, the inflation rate for vegetable prices contributed a significant 1.8% to the overall CPI basket, which inflated by 5.1% year-on-year, breaking a six-month disinflationary trend. Controlling inflation has become a primary objective for the government.