NETRA

# Early Signals Through Charts

Nov 2023

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# Cyclicality, Valuations & Gold

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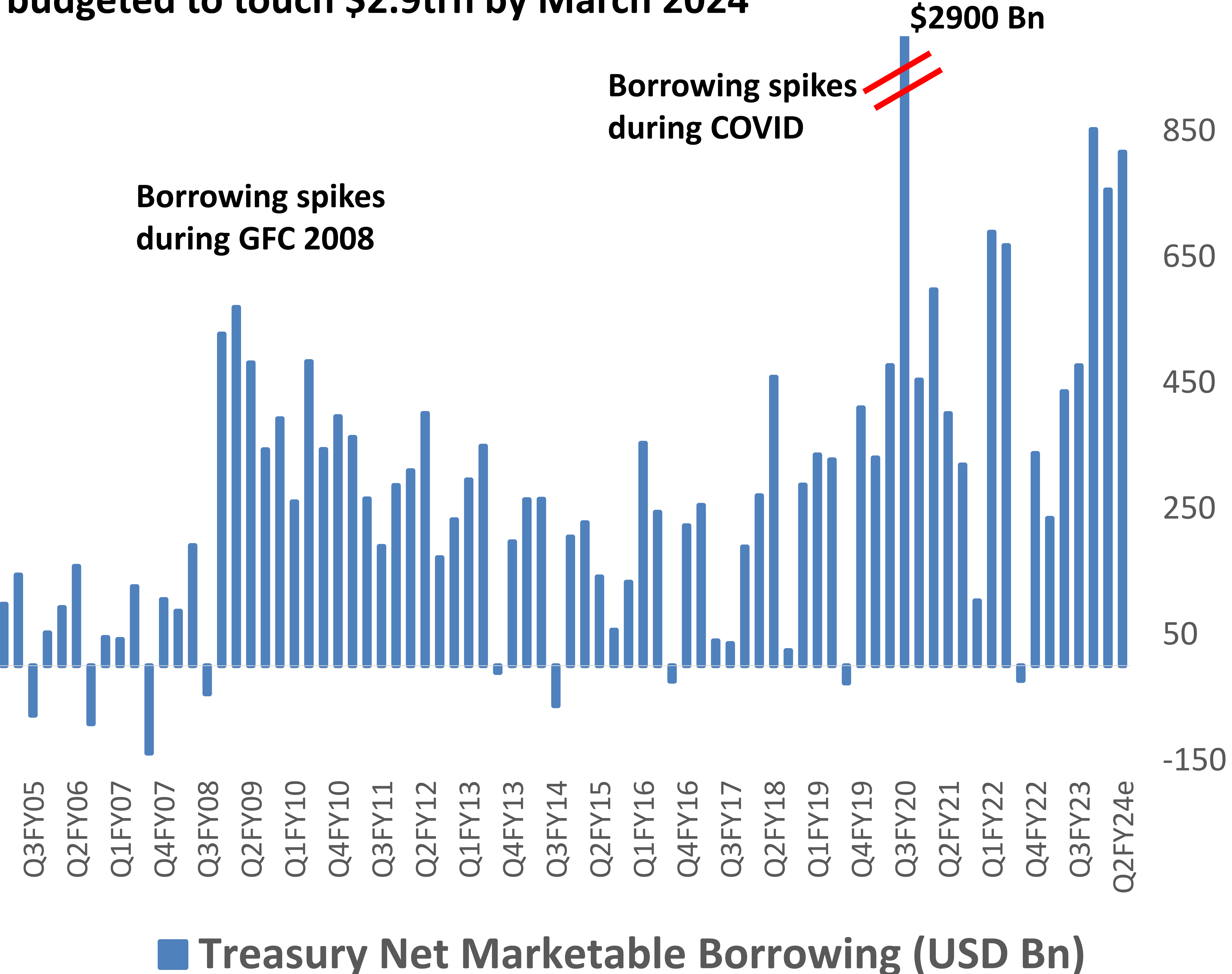
# US Treasury will borrow $1.6trn from Oct’23 to Mar’24. Where does it spend this money?

**Borrowing by US Treasury in trailing 4 qtrs Is budgeted to touch $2.9trn by March 2024**

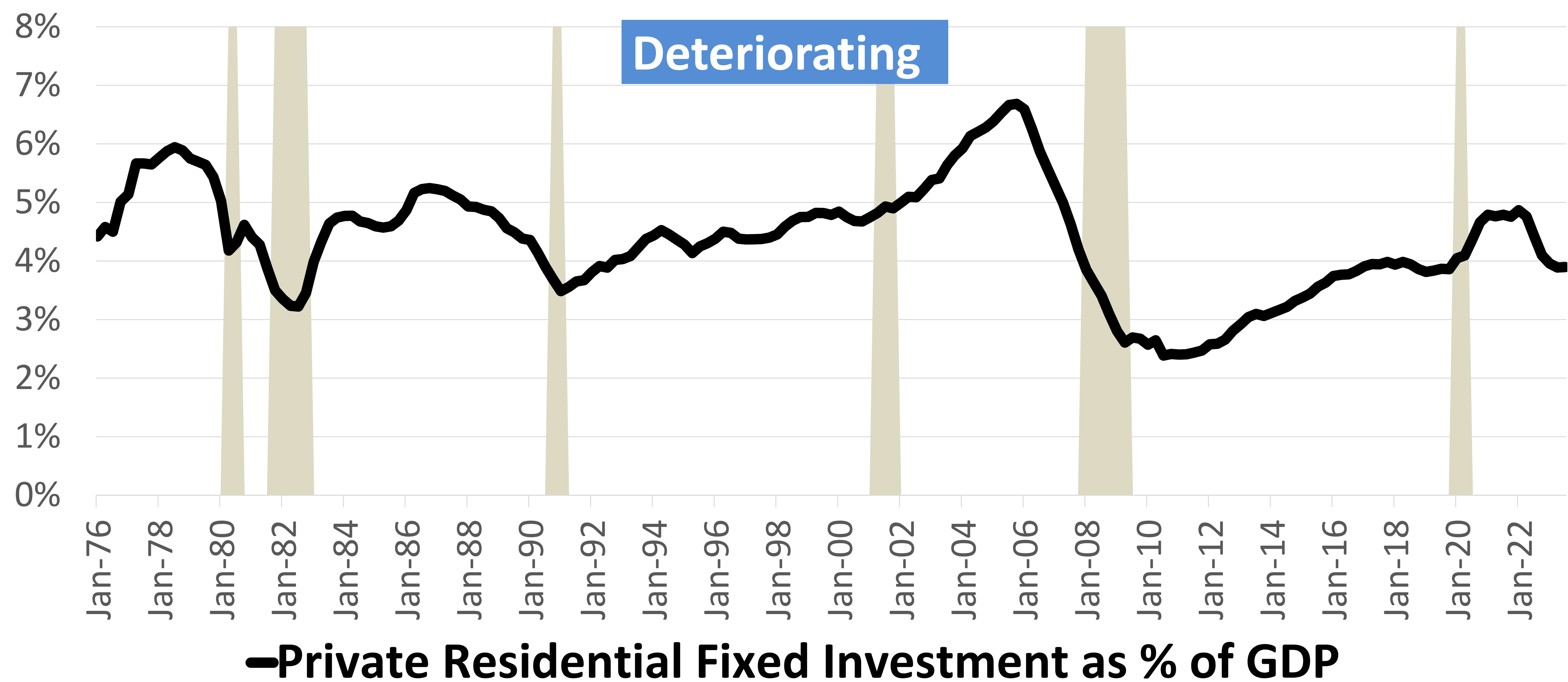


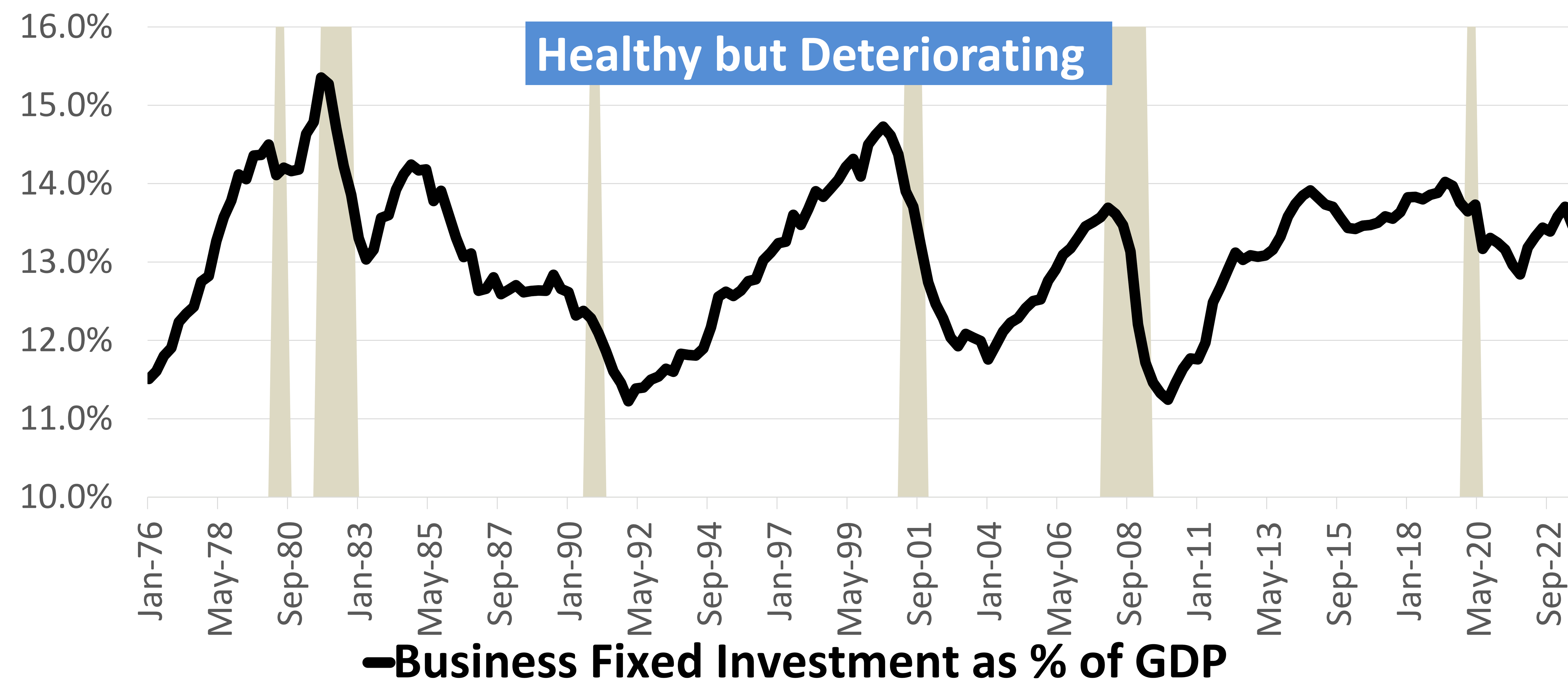

**Of the $9.1trn spending, nearly three-fourth is non-developmental**

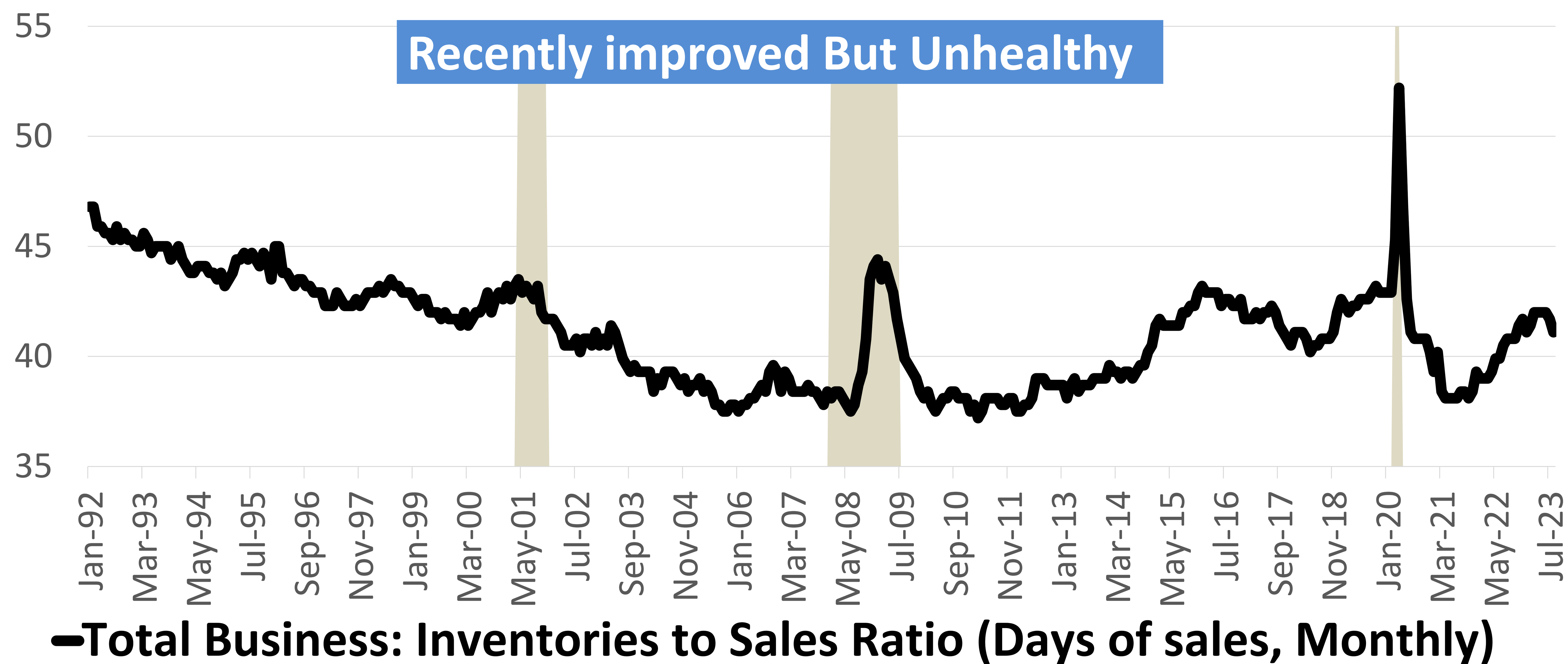
| FY 2023 YTD Spending by Budget Function | Percent of Total |
|---|---|
| Medicare | 16.2% |
| Social Security | 15.8% |
| National Defense | 14.0% |
| Health | 11.9% |
| **Net Interest** (Was 6% during mid of last decade) | **10.0%** |
| Income Security | 9.2% |
| General Government | 5.9% |
| Veterans Benefits & Services | 3.5% |
| Education, Training, Employment, & Social Services | 3.1% |
| Others | 10.4% |

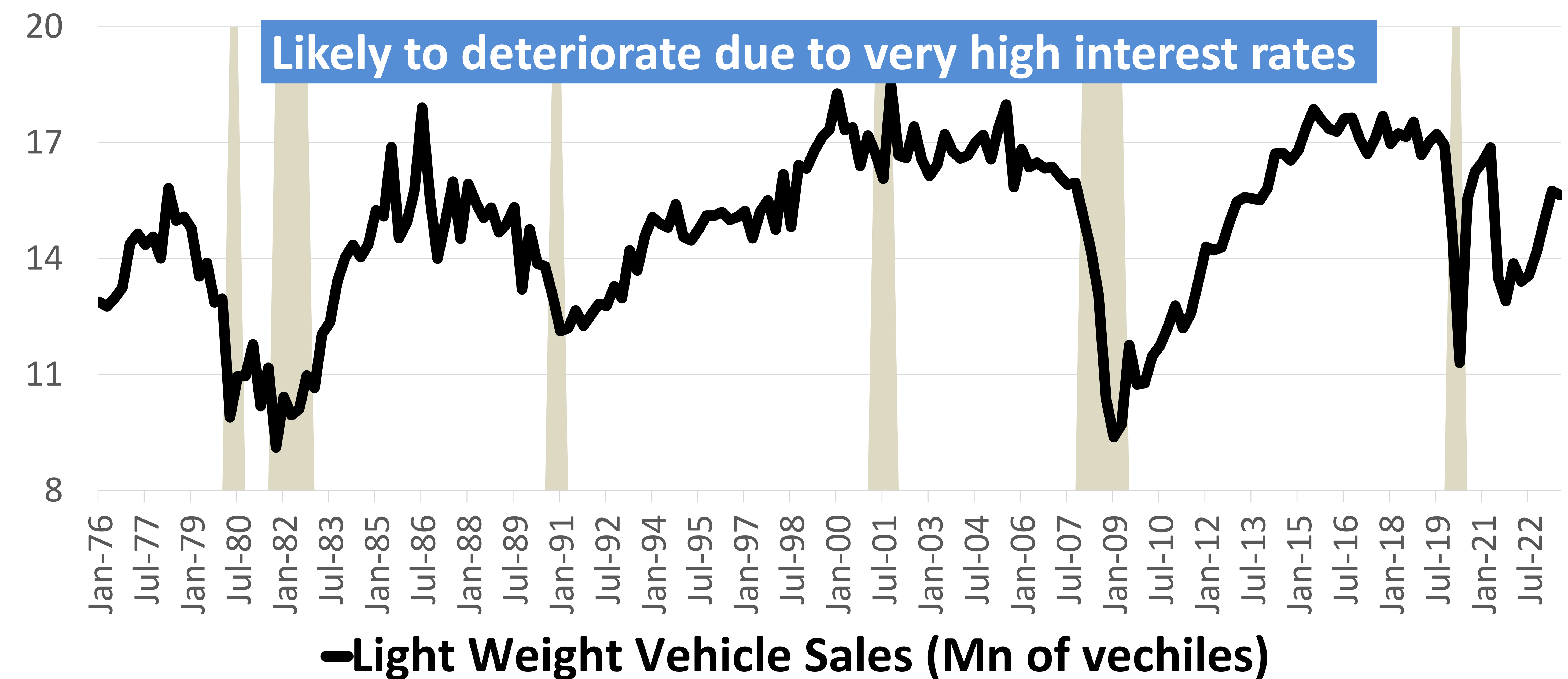
Source: US Department Of The Treasury, DSP; Data as on Oct 2023

# The Big Four cyclical indicators for the US economy

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Source: FRED, DSP; Data as on Oct 2023

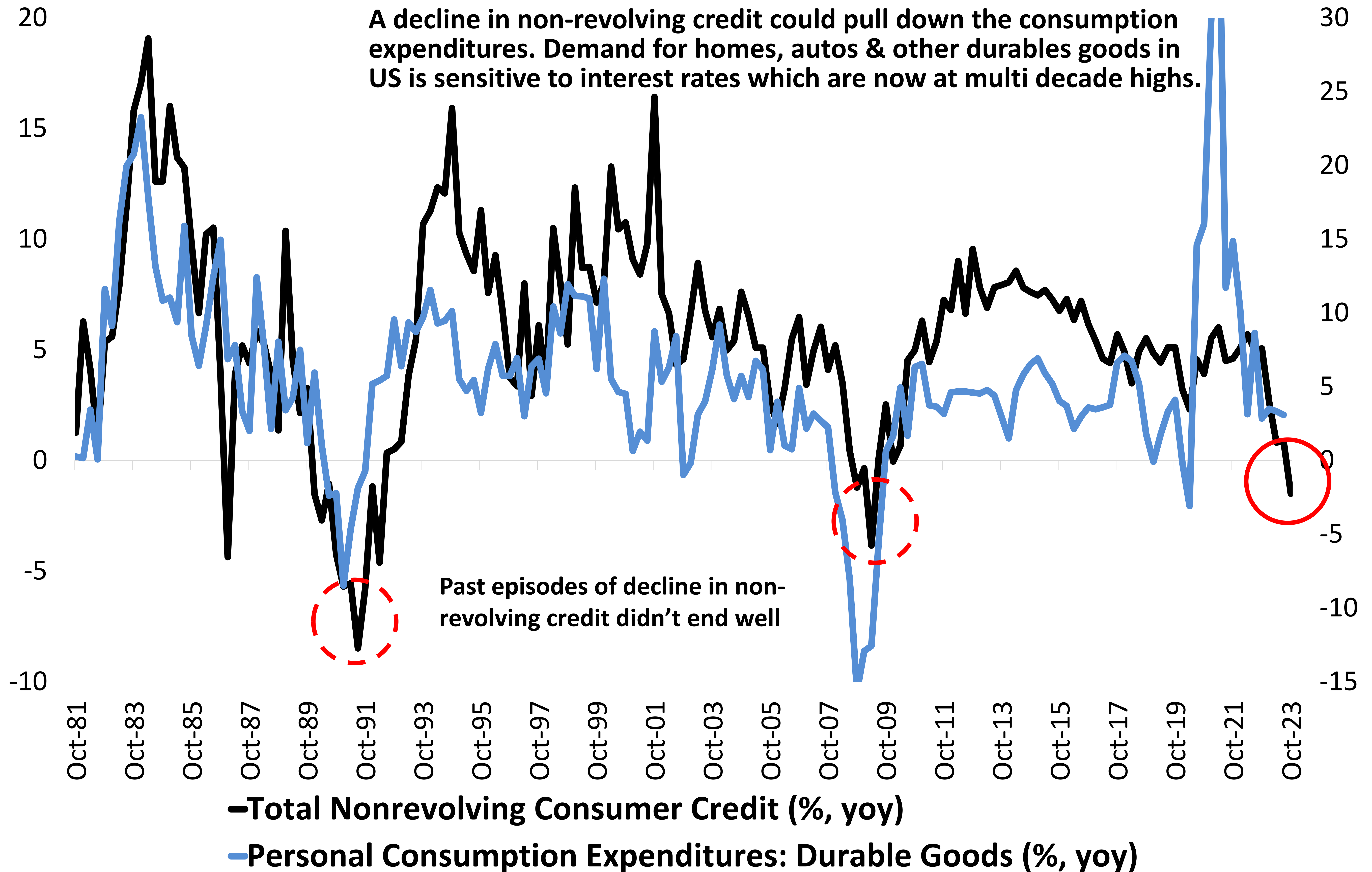
# Credit Offtake signals caution for the US Economy

Non-revolving credit is a type of loan with a fixed amount & set repayment schedule, such as an installment loan, where the balance cannot be re-borrowed once it's paid down. For instance a traditional auto loan, where you borrow a specific amount to purchase a car & repay it in fixed installments over a set period.

The non-revolving credit in the US is now contracting on a year on year basis. This means consumers are borrowing & spending less on big-ticket items like cars & education, which can impact economic growth negatively, as consumer consumption is a significant driver of the economy.

According to historical data, there has been a decline in non-revolving credit prior to most US recessions since 1960. Although it is not a sufficient condition to predict a recession, it is one of the factors which can cause economic slowdown.

This is a sign of caution for US economic growth & therefore for global growth.

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Source: FRED, Bloomberg, DSP; Data as on Oct 2023

# S&P 500 Index – Valuation Journal

| Valuation Measure | 25 Yr Avg | Last reading | Over or Under valued |
|---|---|---|---|
| Forward Price to Earnings (P/E) | 16.7 | 17.8 | 1.1 |
| Shiller's P/E | 27.7x | 29x | 1.3 |
| Dividend Yield | 1.98% | 1.70% | -0.3% |
| Price to Book | 3.1x | 3.6x | 0.5 |
| Price to Cash Flow | 11.3x | 13.5x | 2.2 |
| Earnings Yield minus Bond Yield | 0.33% | -0.80% | 1.13% |

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Source: Bloomberg, Factset, DSP; Data as on Oct 2023

# From 'TINA' to 'RINA'

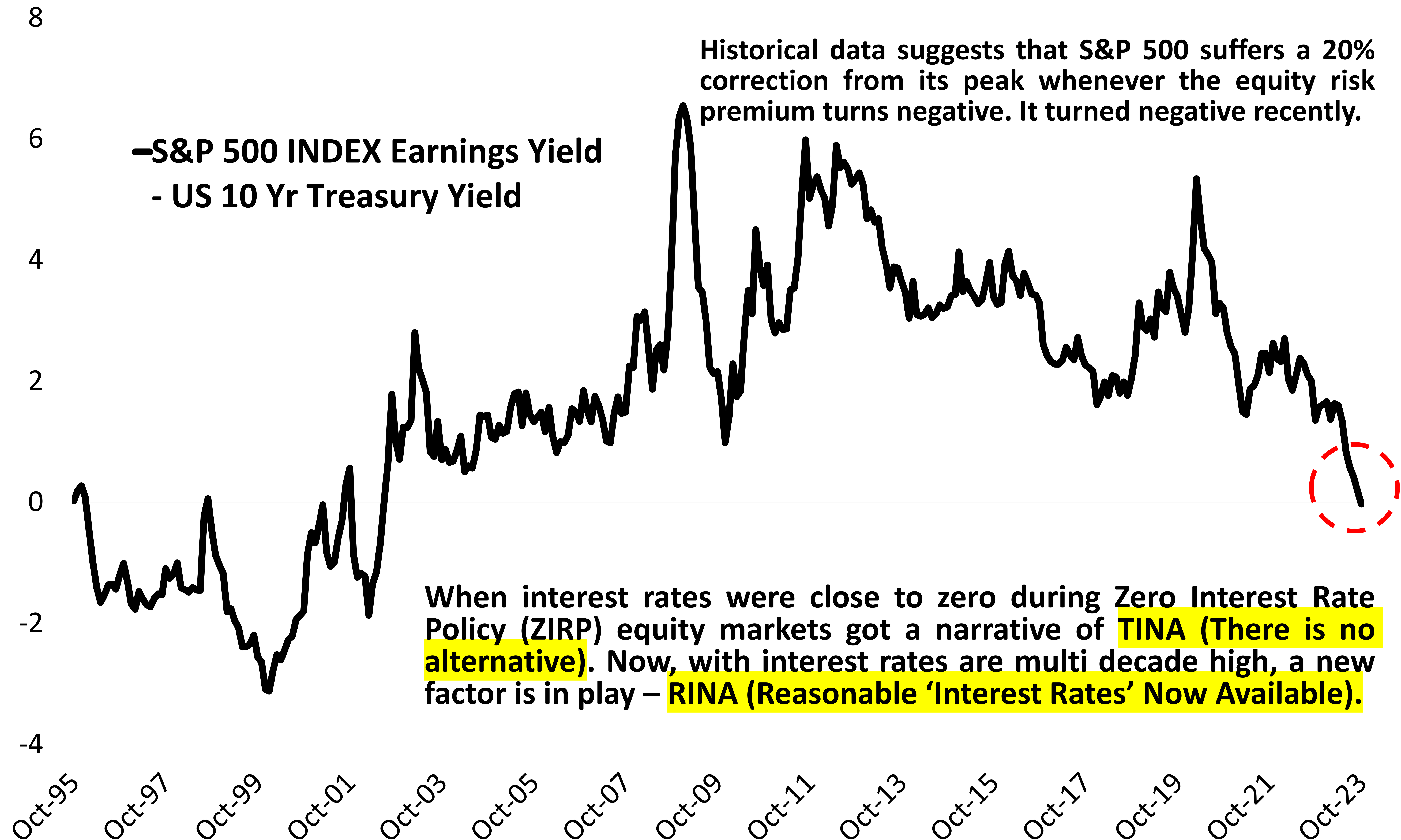
*Equity risk premium: Earnings yield minus (-) bond yield helps investors assess the relative attractiveness of investing in the stock market (S&P 500) compared to safer investments like US Treasury bonds.*

*S&P 500 Index Earnings Yield: This is the earnings per share (EPS) of the companies in the S&P 500 divided by the current price of the index. It represents the earnings return you could expect from investing in the S&P 500.*

*US 10-Year Treasury Yield: This is the yield (interest rate) on 10-year US Treasury bonds, which are considered low-risk investments.*

A positive equity risk premium suggests that investing in stocks is potentially more lucrative than investing in safer Treasury bonds, as it indicates that stocks are offering a higher return compared to the risk-free rate.

Historically, S&P 500 suffered a 20% correction from its peak whenever the equity risk premium turned negative. It has turned negative recently.

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Source: Bloomberg, DSP; Data as on Oct 2023

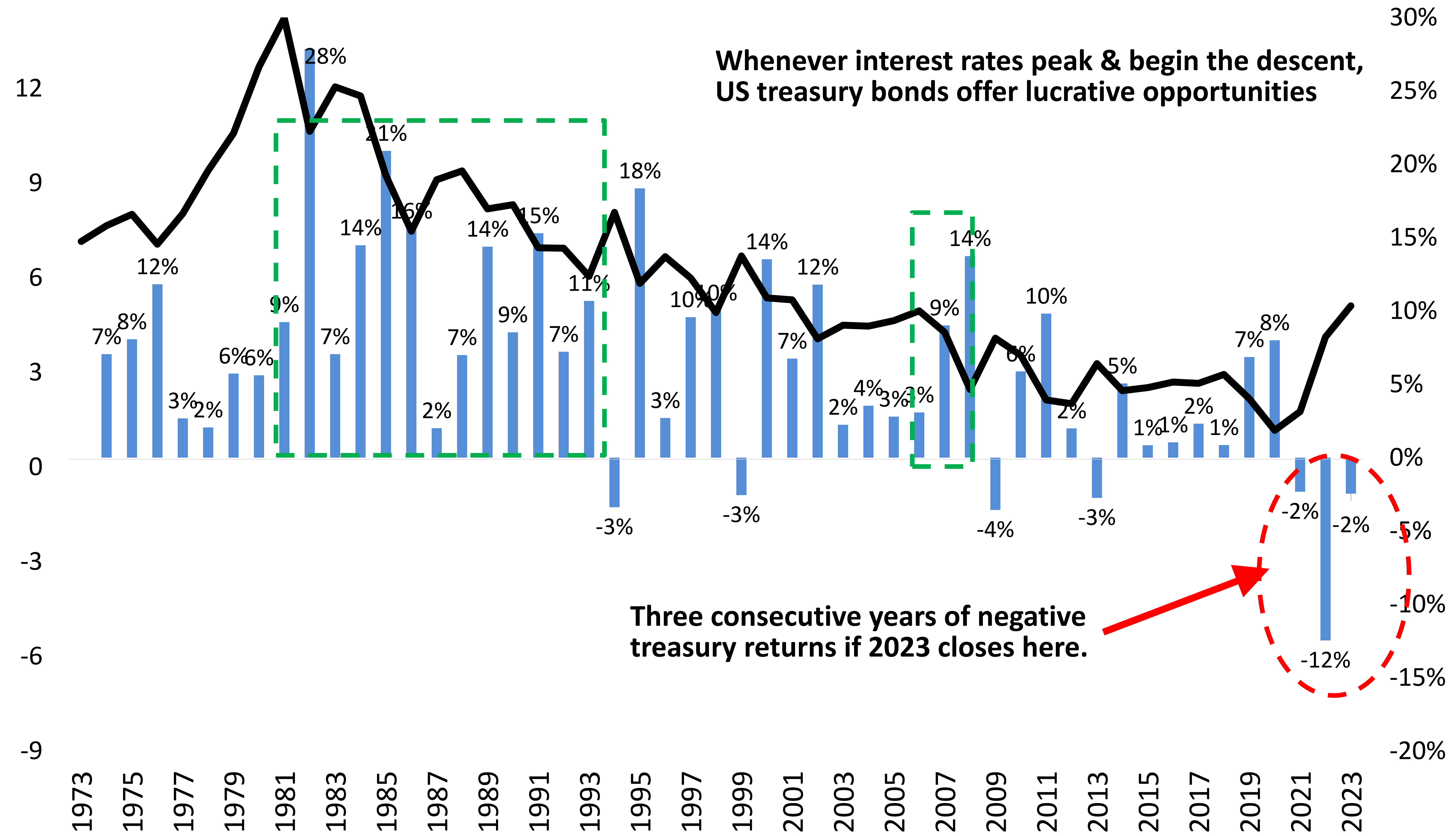
# US Long Bonds – An opportunity in Duration

2023 YTD is the first time in last 5 decades that US Treasury Bonds will deliver negative returns for three consecutive years.

This is a reflection of rapid interest rate hikes & increase in bond yields which have plummeted bond prices over the last 10 quarters. Historically, whenever interest rates peak & begin the descent, US treasury bonds offer lucrative opportunities. The idea is to get the duration right in such cycles.

Economic data suggests that growth in US may slow over the next few quarters. A slowing growth coupled with a likely end to US Fed's interest rate hike cycle can offer an excellent opportunity for investors. But this strategy would have to be tactical for Indian investors due to taxation inefficiencies.

A likely lowering of bond yields would also coincide with weakness in economic activity. This will be an indication of a drag on corporate profitability & therefore poor equity returns for some time.

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Source: Bloomberg, DSP; Data as on Oct 2023

# India's Economic Growth Momentum Is Normalizing

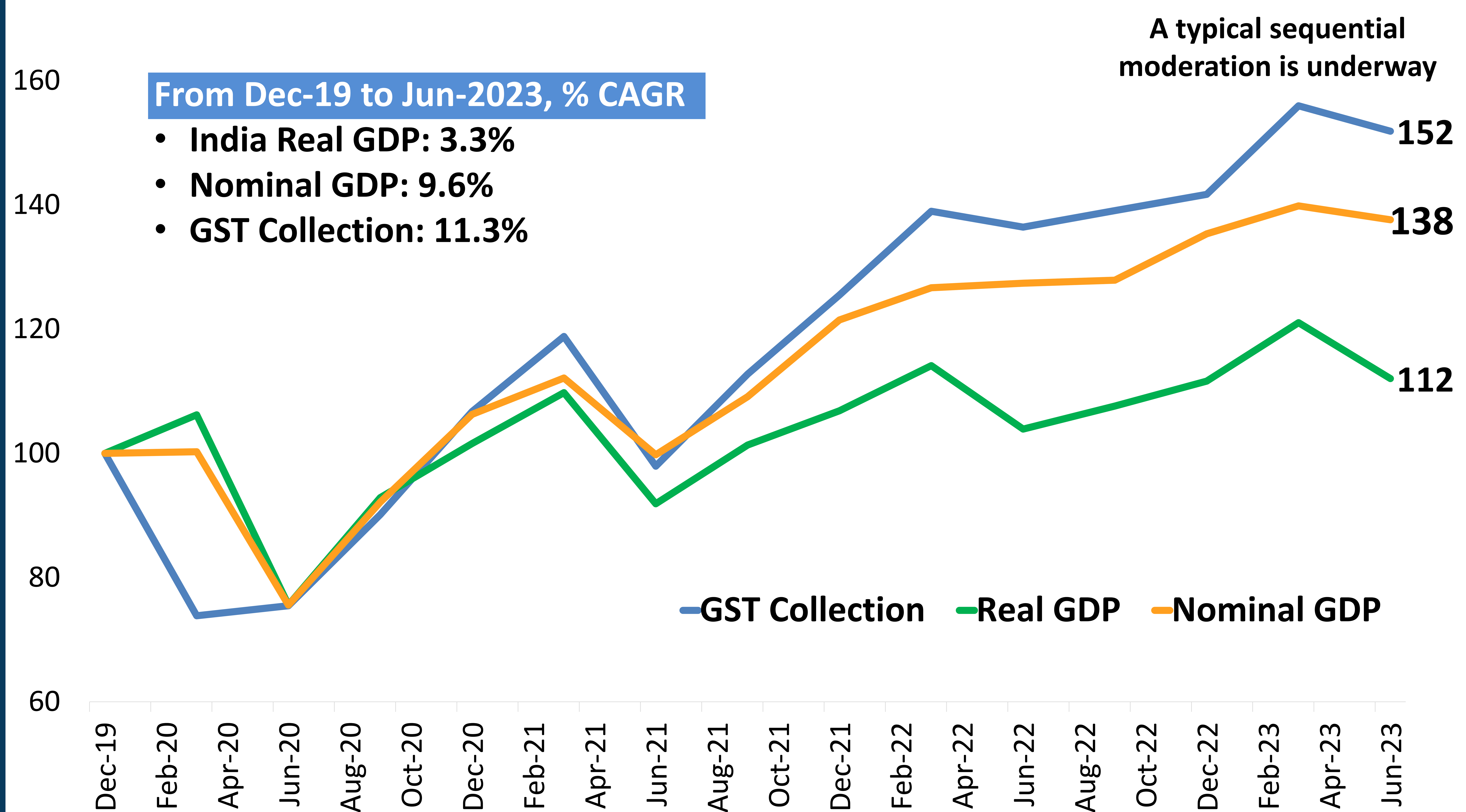
India's real GDP has grown by 12% on an absolute basis from Dec 2019 to Jun 2023, at a 3.3% CAGR.

The growth in nominal GDP & GST collections have been exceedingly healthy. This is in line with topline growth trends across the economy. All the headline numbers like Tax collection, Corporate Sales, Non-Oil imports, Transaction values & nominal wage increases, have grown sharply after the COVID bust.

Take the case of Corporate sales growth which has grown at a CAGR of 12% since the Dec-19 quarter. Corporate India during this period did massive costs savings & enjoyed low raw material costs thereby witnessing tremendous profitability & EPS growth.

As things stand today, the economic growth is now normalizing. India's core inflation is now at 4.6% which is typical of a disinflationary cycle.

If India's economic growth normalizes, corporate India will find it hard to continue its stellar sales & profit growth.

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Source: CMIE, DSP; Data as on Oct 2023

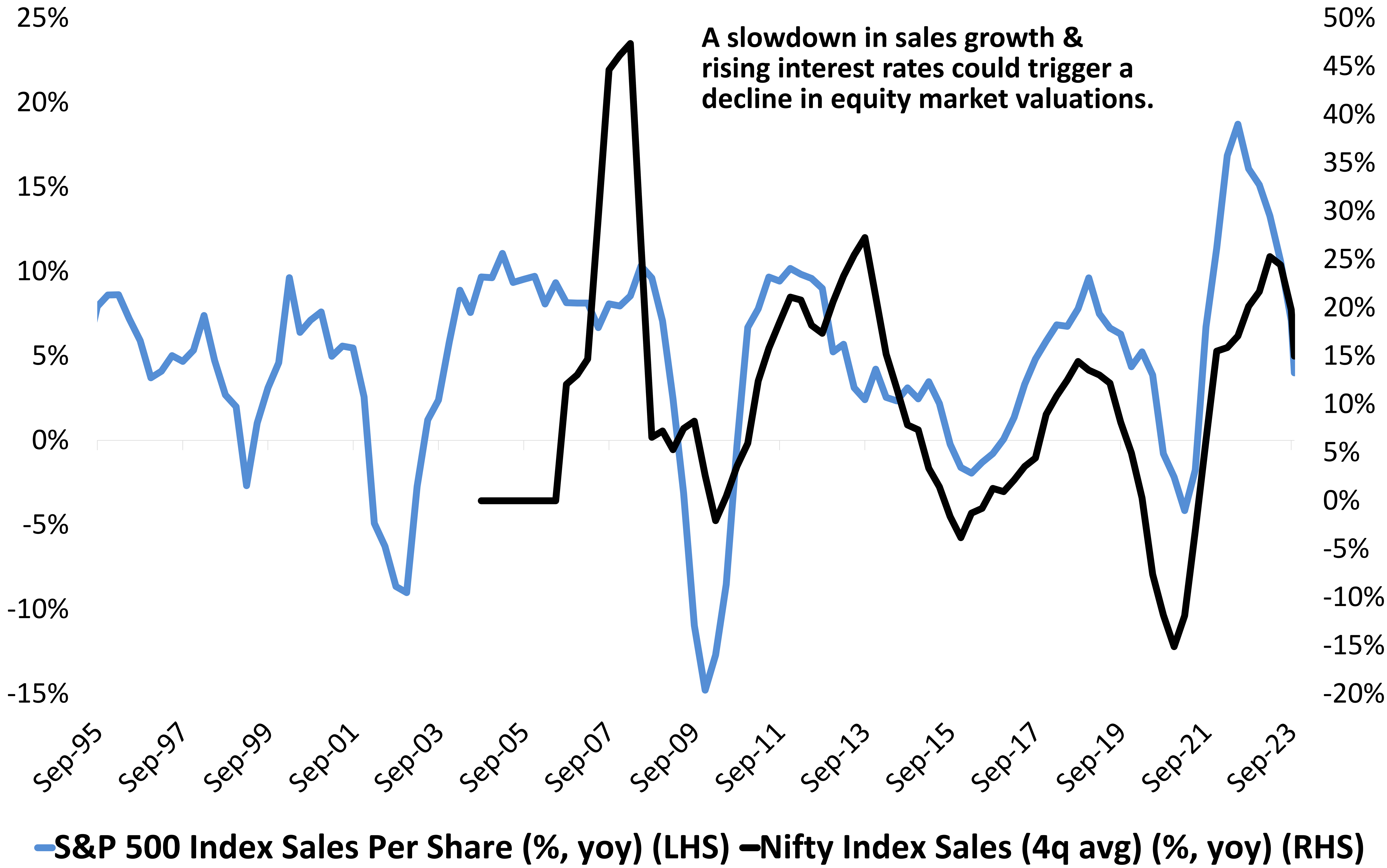
# Sales Growth Is Slowing; Can Hurt Profitability & Valuations

Corporate profits are driven by topline (sales) growth, margin expansions & investment efficiencies. All 3 are getting undone gradually.

We have seen how inflation has been gradually declining globally & now the delayed impact of elevated interest rates is beginning to show up in consumer demand & growth.

This is likely to take the shape of a decline in sales growth for corporates, not just in India, but globally. A decline in sales growth can exert negative pressure on a company's profitability by reducing its top-line revenue, squeezing profit margins, & challenging its ability to capitalize on economies of scale.

The edifice of a global equity rally post pandemic has been built on a strong earnings growth & a large valuation (PE ratio) multiple expansion. A slower sales growth & high interest rate combination can lead to a de-rating across equity markets.

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Source: Bloomberg, DSP; Data as on Oct 2023

# What would you pay for Earnings growth?

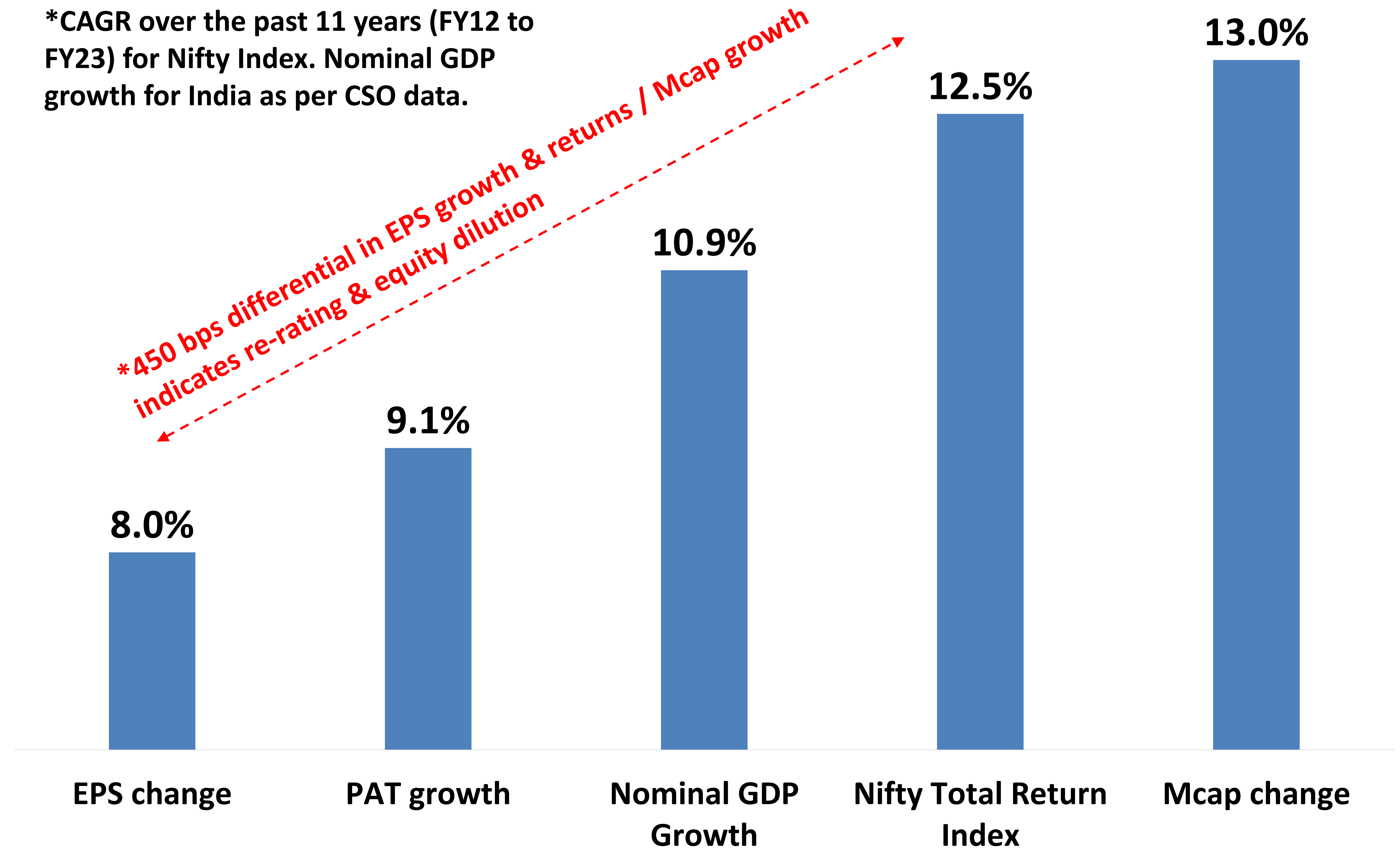
Over the past 11 years, India has delivered excellent returns. A large part of equity returns is explained by re-rating of valuation multiples. When a stock's valuation multiple is re-rated upwards, it indicates that investors are willing to pay a higher price for each unit of earnings or other fundamental metrics, reflecting increased confidence in the future prospects.

However, history shows that if starting (purchase) valuations are high, forward returns tend to be lower.

After a stellar re-rating of valuation multiples the rally in Indian stocks is now entirely dependent on earnings growth.

If Nifty falls below 18,000 levels it will likely approach its upper band of average valuations zone based on current trailing earnings.

**Question is, would you pay 22x trailing earnings (PE ratio) for 10%-12% earnings growth?**

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Source: Bloomberg, DSP; Data as on Oct 2023

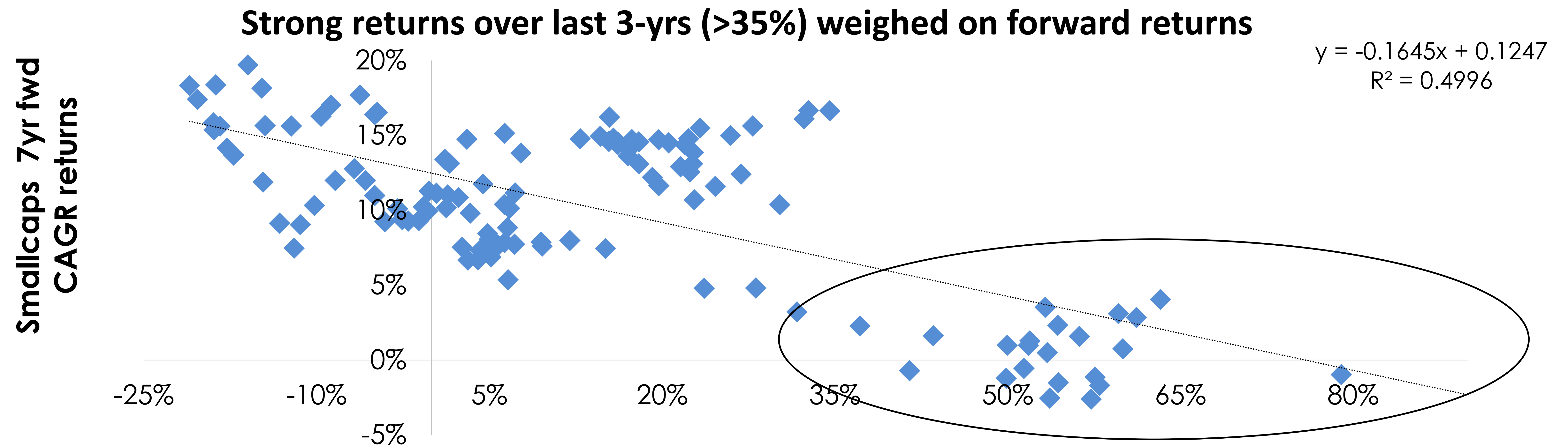
# Small & Midcap Base Rates Are Key To Watch

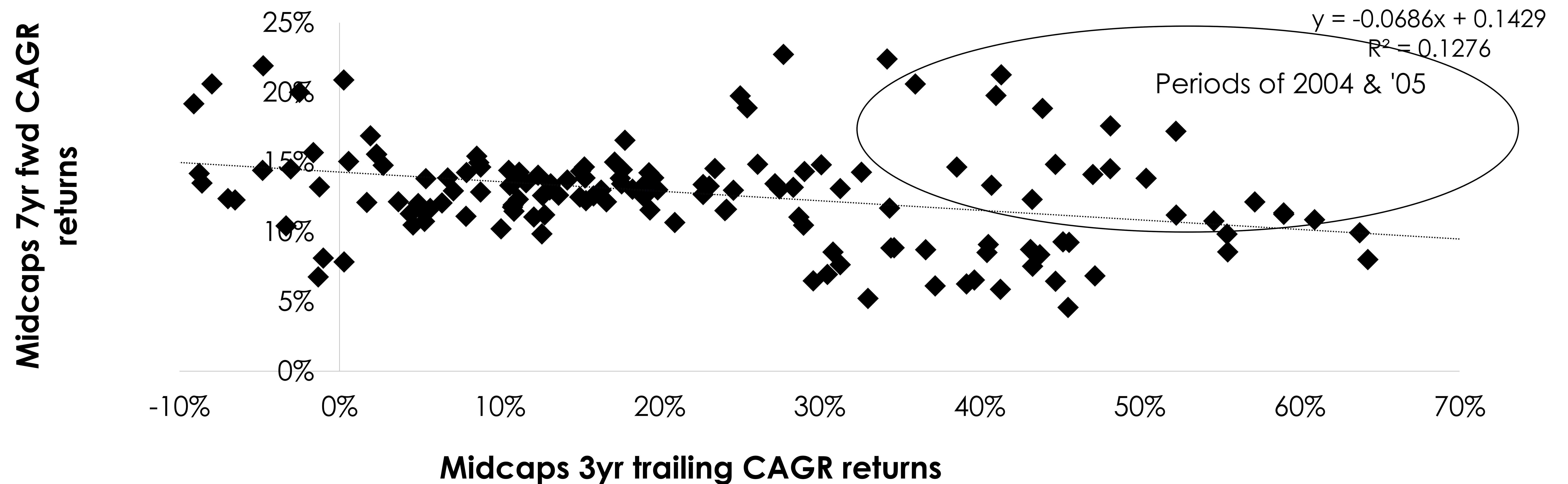
*"Base rates" - mean of "10-yr" returns (CAGR) delivered by Nifty (or the index) over 2005-2023.*

When small-caps delivered returns far above base rates (>35%) over 3 years, the next 7-yr forward returns were abysmal (<5% CAGR). For mid-caps, it appears mixed with a period of sustained outperformance & muted returns.

The 7-yr forward return CAGR exceeding 15% for mid-caps even after a 2-sigma move are associated with isolated periods of 2004-05 when EPS growth was exceptional. But the current frothy mid-cap valuations are backed by not an extraordinary PAT growth distribution & hence mid-cap returns may also be muted.

**Conclusion: Small & Midcaps need to undergo price or time correction, or both to once again become attractive for investors.**

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*Source: DSP, Ace Equity, Ambit Capital Research, BSE Smallcap & Nifty Midcap100 is used as reference*

# Valuations across markets

*Trailing Twelve Month Price to Earnings Ratio*

**India among the most expensive markets globally.**

Price/ Earning (axis: -2, 3, 8, 13, 18, 23, 28)

| Market | Price/ Earning |
|---|---|
| Brazil | 8 |
| China (HK Listed) | 9 |
| Hong Kong | 10 |
| UK | 11 |
| Eurozone | 12 |
| France | 12 |
| South Africa | 12 |
| Philippines | 13 |
| China Shenzen | 13 |
| Asia Ex-Japan | 13 |
| China Mainland | 14 |
| Mexico | 15 |
| Canada | 15 |
| Vietnam | 15 |
| Australia | 15 |
| Malaysia | 16 |
| Indonesia | 16 |
| Korea | 17 |
| Taiwan | 19 |
| US-S&P 500 | 21 |
| India | 21.6 |
| Japan | 25 |
| Argentina | 26 |

*Based on trailing financial year*

**The most expensive markets which aren't the most profitable are vulnerable to global growth at this time.**

Return on Equity (axis: 4, 8, 12, 16, 20)

| Market | Return on Equity |
|---|---|
| Brazil | 19 |
| China (HK Listed) | 10 |
| Hong Kong | 10 |
| UK | 15 |
| Eurozone | 14 |
| France | 12 |
| South Africa | 13 |
| Philippines | 11 |
| China Shenzen | 12 |
| Asia Ex-Japan | 11 |
| China Mainland | 9 |
| Mexico | 16 |
| Canada | 11 |
| Vietnam | 12 |
| Australia | 12 |
| Malaysia | 10 |
| Indonesia | 11 |
| Korea | 5 |
| Taiwan | 11 |
| US-S&P 500 | 18 |
| India | 13 |
| Japan | 10 |
| Argentina | 11 |

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Source: Bloomberg, Factset, DSP; Data as on Oct 2023

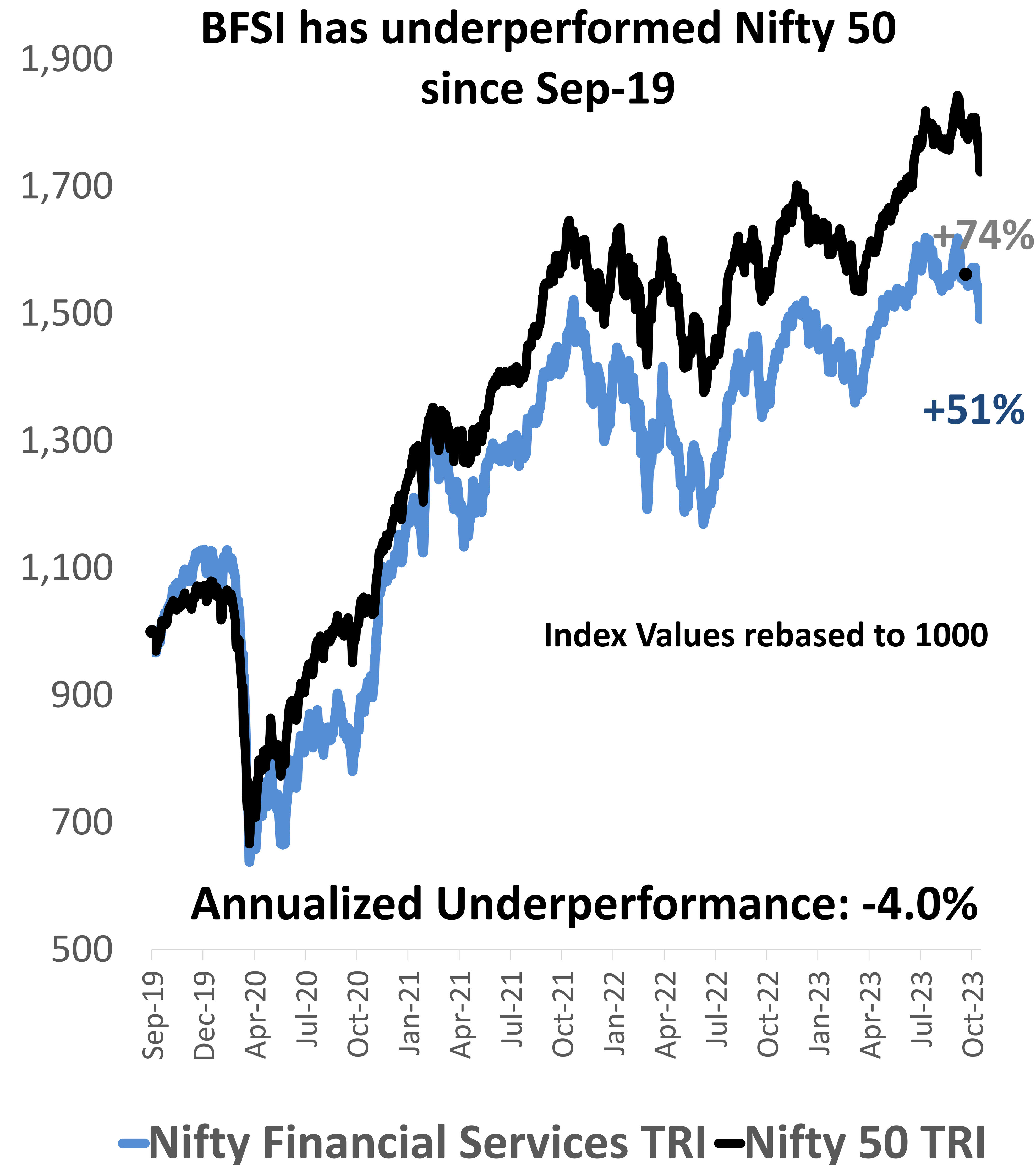
# BFSI Remains One Of The Most Attractive Bets. A 'Buy-on-dips'

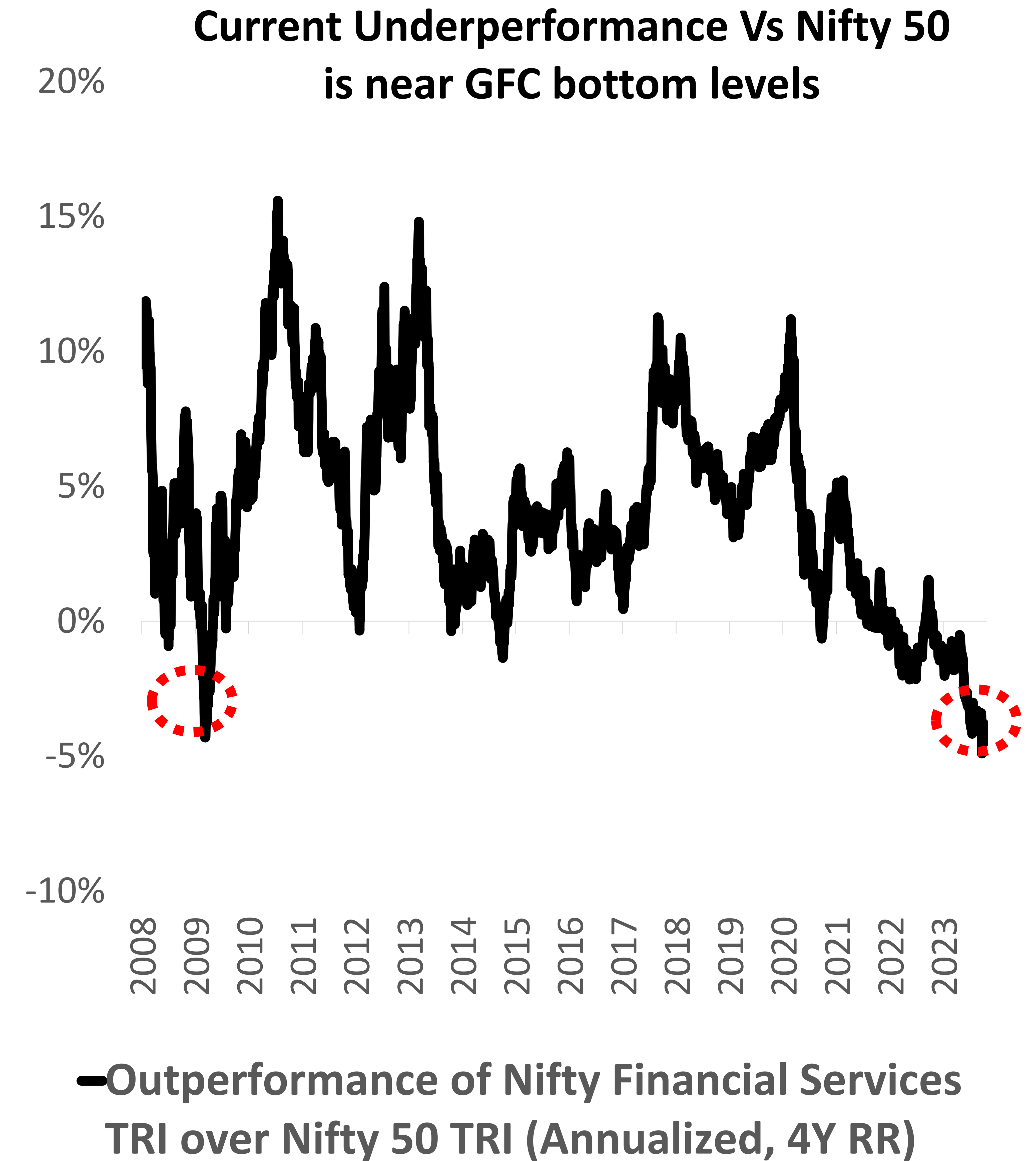
Since pre-covid level, the BFSI sector has underperformed broader markets by **-4%.** Such massive underperformance was last seen during Global Financial Crisis which may be justified due to many financial institutions collapsing globally.

Currently though, Banking & NBFCs have many positives which include but are not limited to

- NPA ratios at 8 year lows
- High Capital Adequacy Ratio
- Stronger Balance sheet
- Reasonable Valuations vs Nifty 50
- High Credit & Deposit growth

Apart from Banking & NBFC, there are other segments in BFSI which are emerging & growing at a fast pace like Insurance, AMC, Broking, Fin-Tech etc.

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Source: NSE, DSP; Data as on Oct 2023

# Gold Mining Equities Continue To Trade At Relatively Attractive Levels

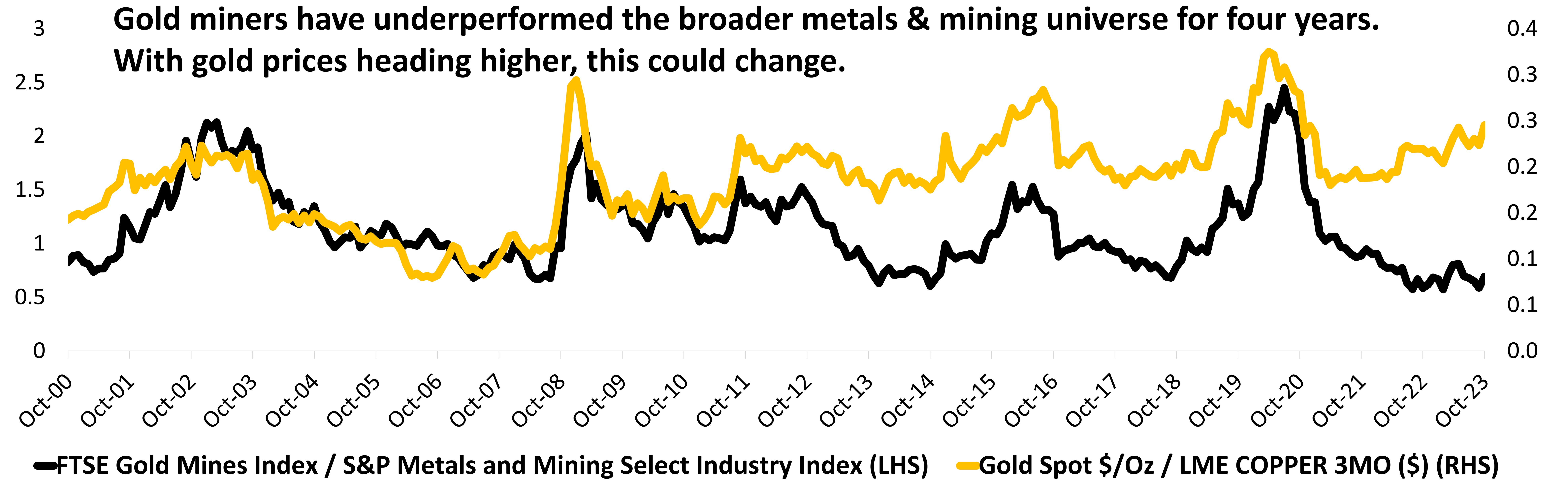
Gold has started to outperform Copper by a significant margin. Historically, the period in which Gold outperforms Copper, Gold mining equities also outperform the broader metals & mining equities.

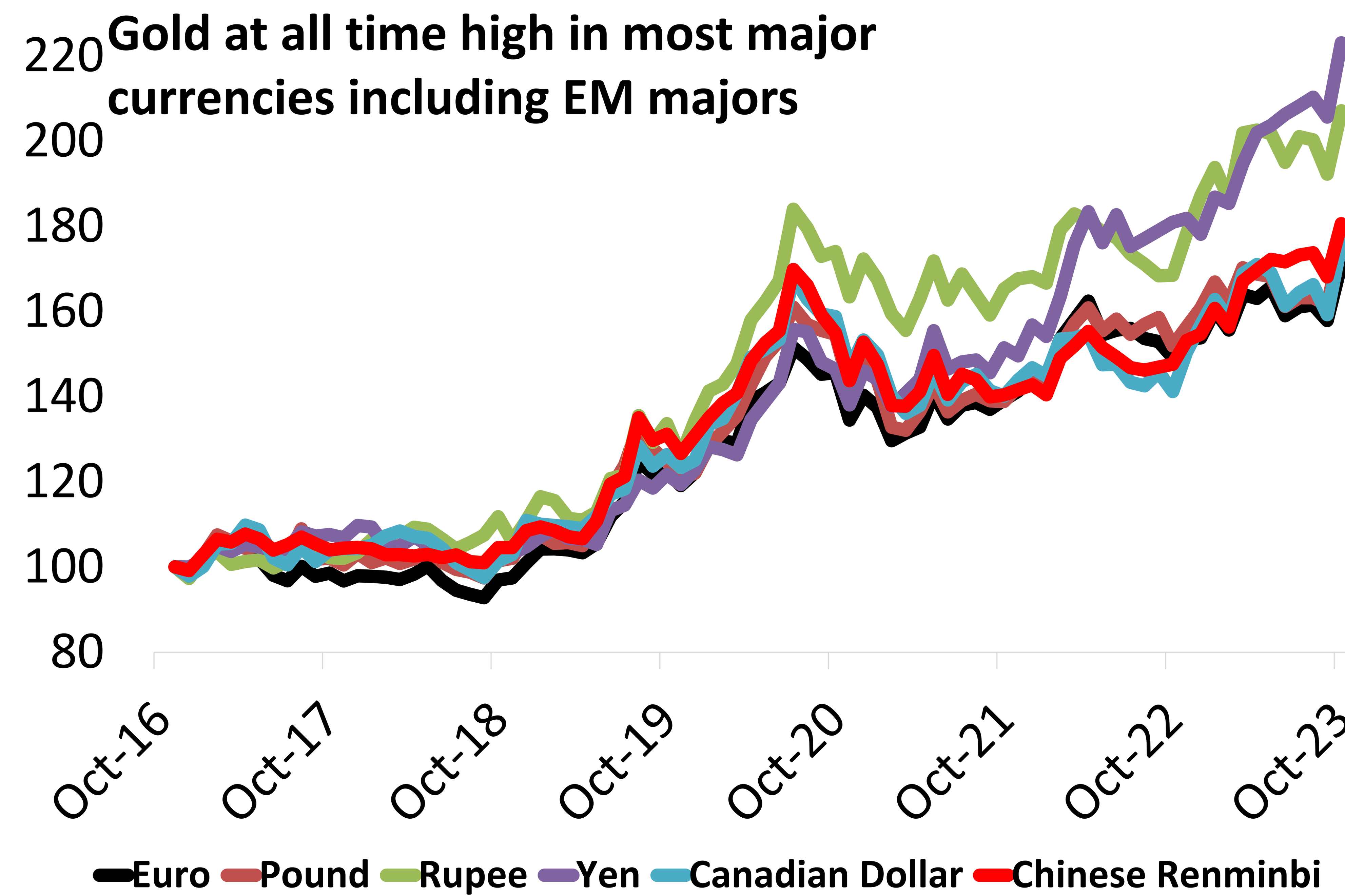
Currently, Gold mining equities are at relatively one of the most attractive levels vs the broader metals & mining equities.

Factors which help gold miners outperform include rising gold prices, weaker USD, low Net Debt & stable costs. At this time, gold miners have a number of tailwinds but the sector has been de-rated for lack of earnings momentum.

A new bull market in Gold prices can trigger a re-rating & earnings visibility for gold miners. Is there a new gold bull market on the horizon?

**A sidenote: Gold bull markets & gold miner outperformance has historically coincided with turmoil in broader equity markets.**



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Source: Bloomberg, DSP; Data as on Oct 2023

# The absence of evidence ≠ evidence of absence

Just because the equity markets have delivered 13% CAGR over the last 25 years, doesn’t mean it will deliver returns in a similar manner

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