NETRA

Early Signals Through Charts

Dec 2023

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Small Caps, India Growth & Ideas

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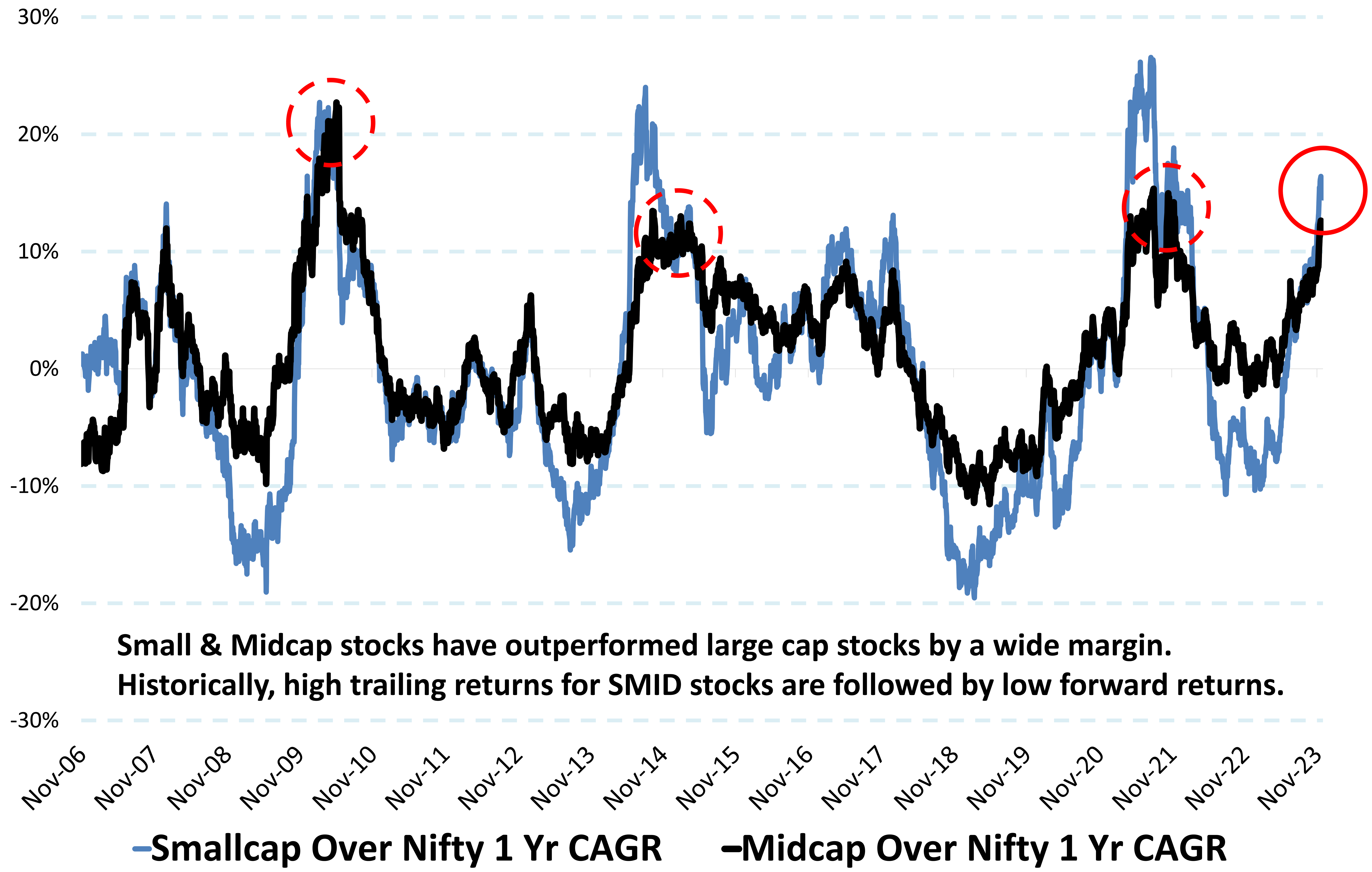
SMID Performance Has Reached Cyclical Extremes

Small & Midcap (SMID) stocks have outperformed Nifty over the last 11 months. The outperformance versus Nifty is about to hit the cyclical historical peaks.

Historically, Small & Midcap stocks enter a period of outperformance once they reverse from deep phases of underperformance, and perform poorly when they have high trailing outperformance. Currently, SMID stocks are not only trading with massive outperformance but are also more expensive on a trailing basis.

Based on trailing 12M P/E ratio, as per Bloomberg:
Nifty Index is trading at 21.8x
Nifty Midcap 100 Index is at 31x
Nifty Smallcap 100 Index is at 23.5x

This opens the room for relative underperformance for SMID stocks.



Source: Bloomberg, DSP; Data as on Nov 2023

How To Invest In Small Caps Now?

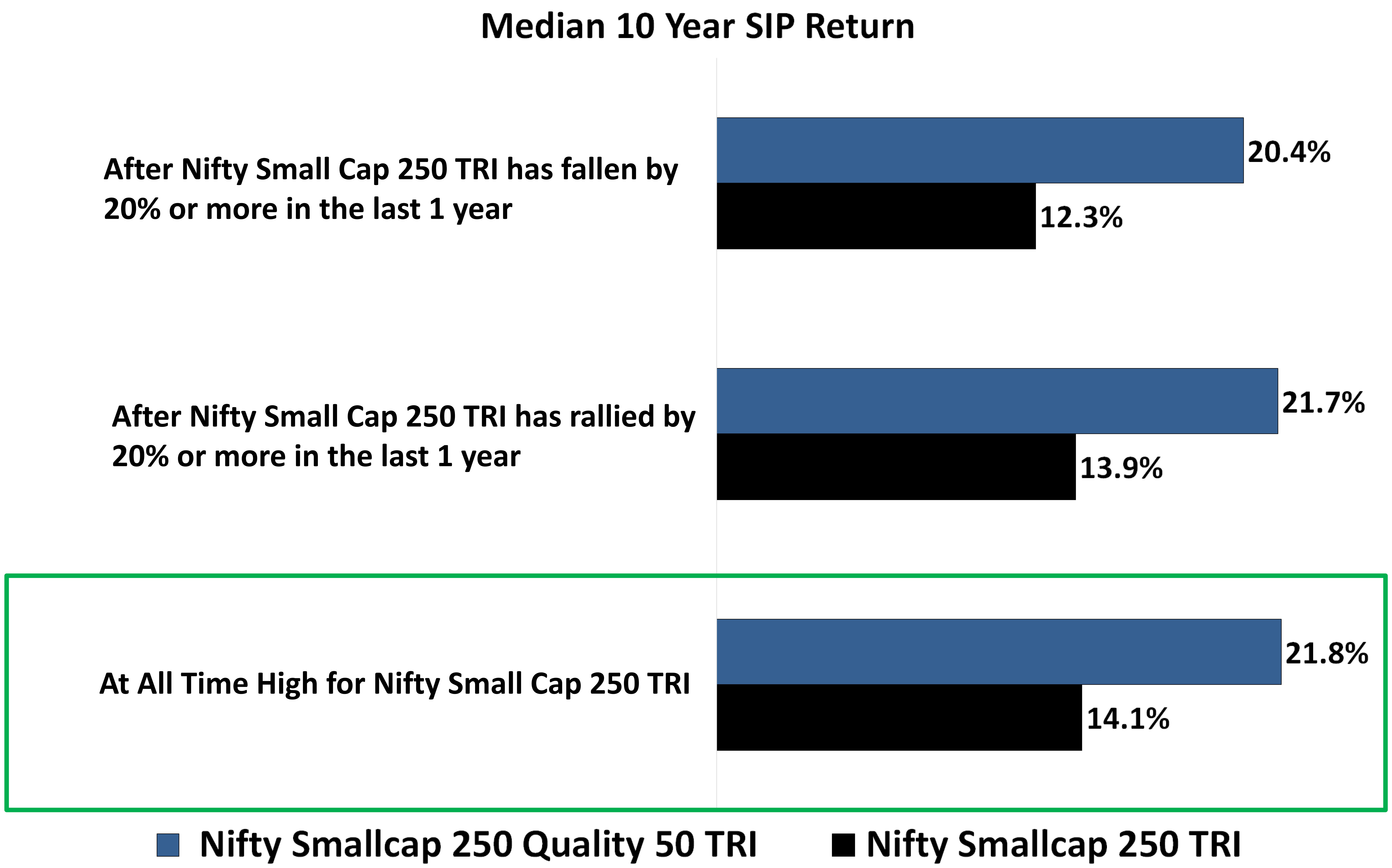
Starting a SIP at market highs, gives better behavior nudge. Initial units acquired at high prices will generate low return in short term causing one to lower expectations of returns and to stay invested for longer period.

Starting a SIP at market highs fare better because

1. Whenever markets fall from peaks you start to accumulate more units (falling NAVs).
2. These higher units will get the benefit of rising NAVs when market rises again.
3. Wealth = more units x higher NAV

Long term SIP in Quality Index has given similar returns irrespective of market being at peak or lows and considerably better returns compared to Broader Index. When markets are expensive, focus on quality is needed even more.

When Smallcaps are at all time high, the right things to do, is to start a SIP. It's better than not doing anything.



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Source: Bloomberg, DSP; Data as on Nov 2023

Why Quality In Small Caps Is Essential?

Smaller firms can present a greater risk to investors looking for capital preservation. Historical data shows that a set of smallcap stocks with subpar fundamentals were 8 times more likely to cause a permanent loss of capital to investors versus stocks from the Quality bucket.

Quality is defined as companies with better ROEs, lower debt and lower variability of earnings.

In fact, the Nifty Smallcap 250 Quality 50 Index has differentiated quality metrices. When a basket of 'Quality universe' firms is compared to the broader universe 'ex of quality' the quality firms have nearly double the ROEs and less than 2/3rd debt.

In Numbers: 20% ROEs for quality vs 11% for rest of the universe, 0.4x Debt to equity ratio for quality vs 1.4x for the rest of the universe.

Hence, Quality matters.

	Nifty Smallcap Universe	
	Quality Index Universe (222 stocks)	**Broader Universe ex of Quality (515 stocks)**
Firms that became largecaps	2%	1%
Firms that became midcaps	10%	8%
Firms that eroded wealth / capital loss	*8 times more firms in the broader small-cap stocks universe have eroded capital for investors compared to the quality small-cap universe* 2%	16%

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Source: NSE, DSP; Data as on Nov 2023

Data taken for NSE Smallcap 250 Index & NSE Smallcap 250 Quality 50 Index.
Wealth erosion = Bankruptcy / delisting or a 80% erosion in market cap in rolling 5 year period.

How Fast Has India Actually Grown In The Past?

India's GDP has grown at 7.3% on average over the long term. Following the 1991 liberalization, the average increased to 7.5%.

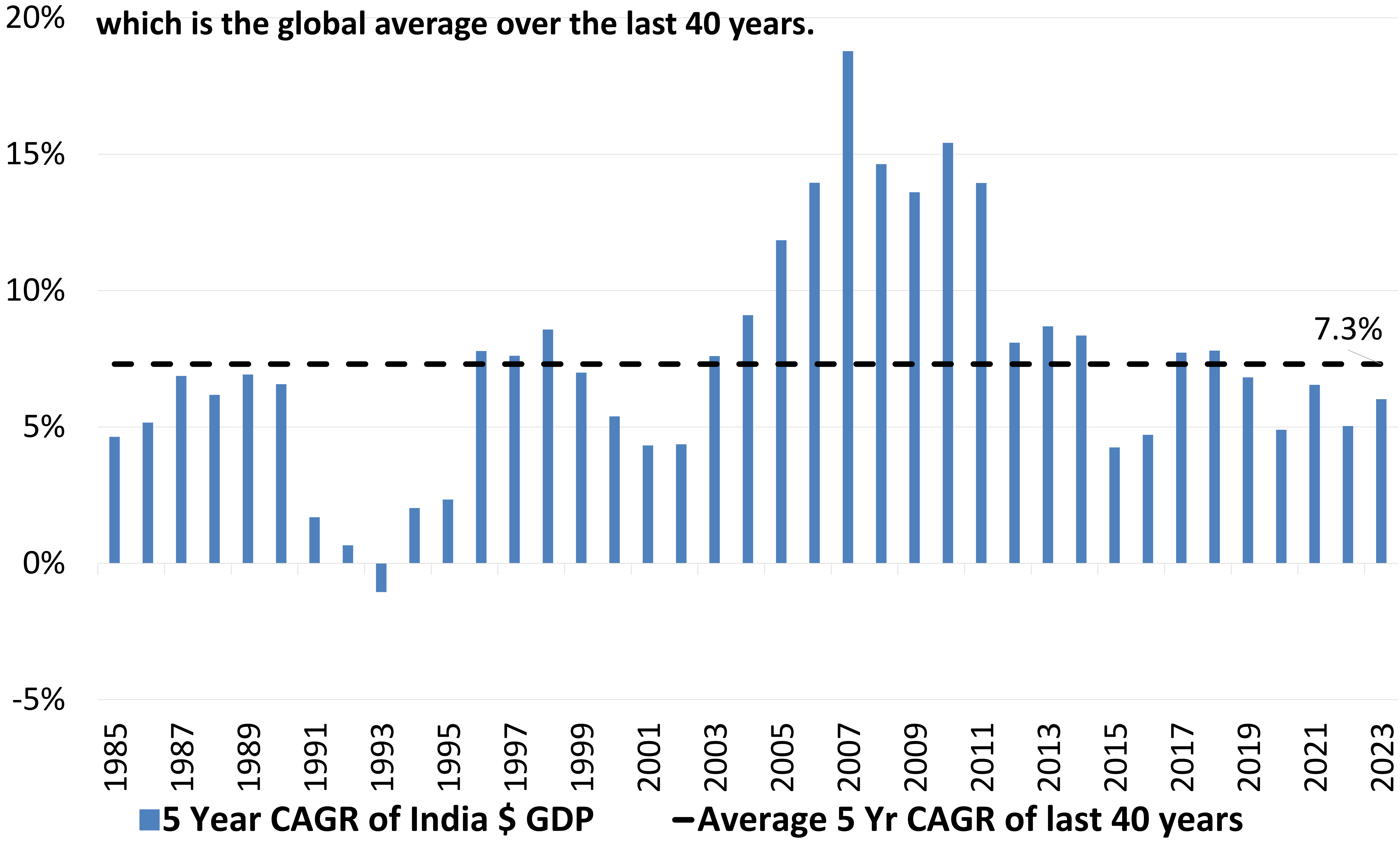
With a 7.2% CAGR, the data series doubles in 10 years. This implies that India's current GDP which is at ~$3.5 trn, could grow to $7trn by 2032, based on historical extrapolation. Similar projections suggest no new upward or downward surprises, which is unforecastable.

The past includes the best phase for economic growth (2003 to 2011) when India's growth was 13.2% on average. However, the world GDP was also growing at 7.6% during this phase, exceeding its long period average of 5.5%. This provides two crucial insights:

1. India's GDP gets a significant boost when the world is doing well. More conducive conditions globally, establish tailwinds for Indian economy to do well.
2. India's base has shifted considerably. It is easier to achieve a growth rate of 7% or more when the base is smaller, with a large population and global tailwinds.

A fractured global growth picture is a headwind for India's growth. Decoupling is still a story.

The go-go years of 2003 to 2011 saw India's $GDP growth at an average of 13.2%. If this period of global growth spurt is removed, the long term growth rate for India falls to 5.5% which is the global average over the last 40 years.



Source: IMF, DSP; Data as on Nov 2023

Can India Benefit From A China Growth Slowdown And Attract FDI?

Global FDI Is Scared & Scarce.

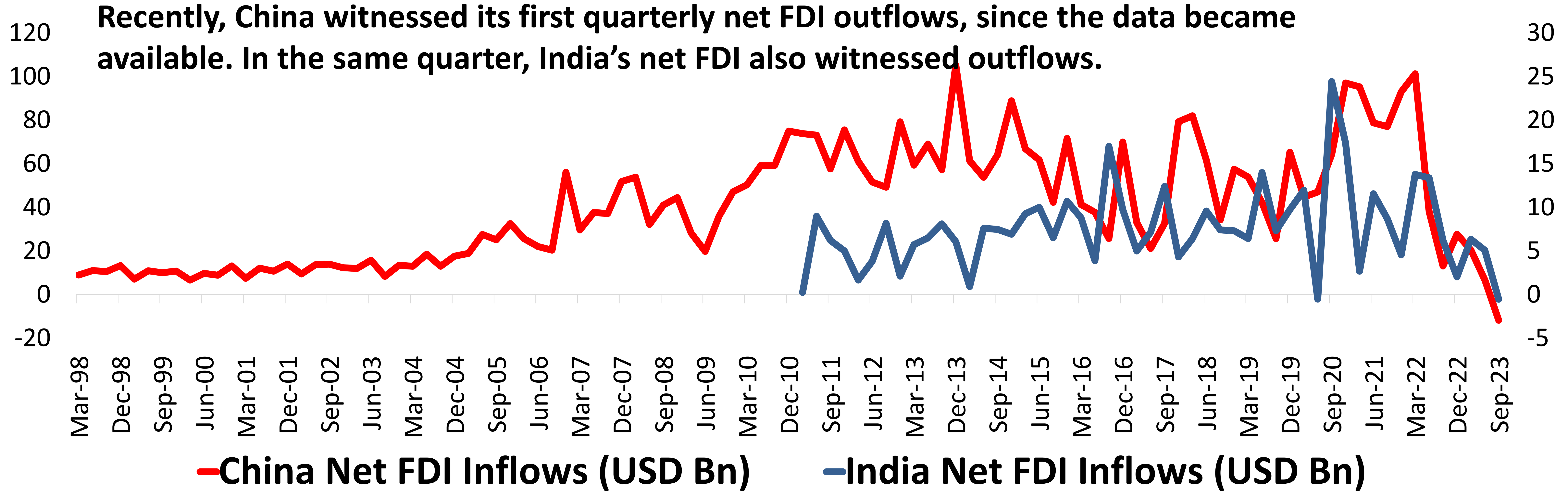
Net FDI into China fell (quarterly outflows of $11Bn) in Sep 2023 for the first time since data became available (1998).

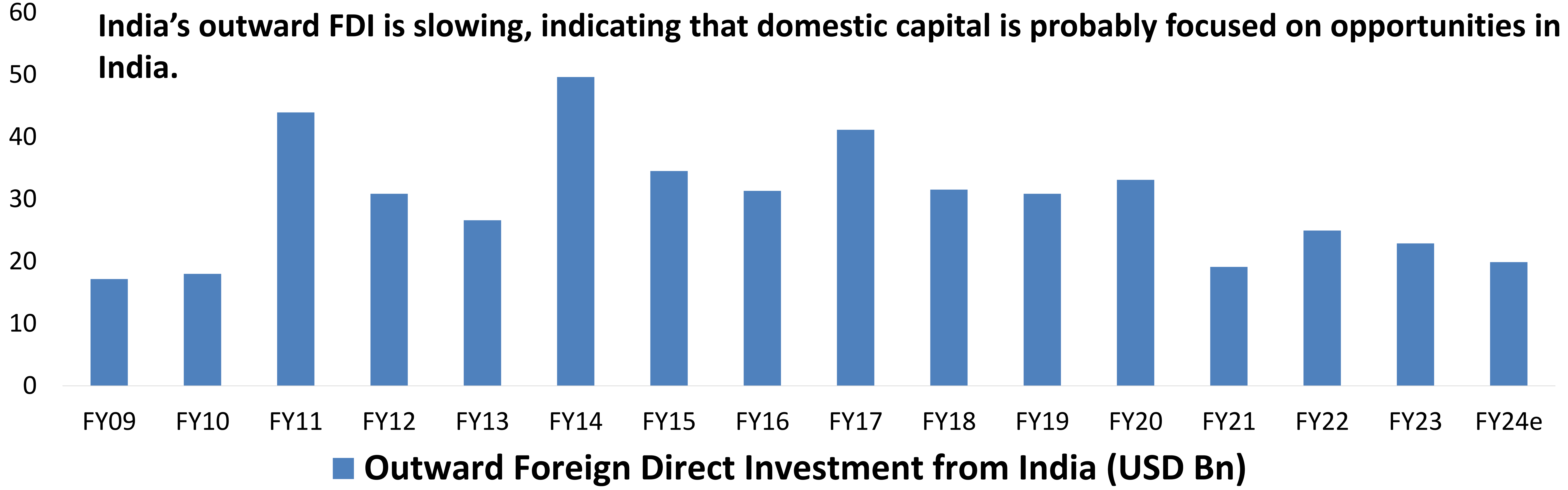
Net FDI into India in Sep quarter also fell (outflow of $537Mn). This marks the 2nd quarterly outflow since data became available in India in 2012 (the first was in Jun'20 quarter).

The narrative that India is benefitting from a Chinese slowdown by attracting foreign investments is yet to show up in numbers. All EMs sail in the same boat, but the flows vary based on individual country circumstances. Foreign capital is becoming scared and scarce.

In fact, over the last two years, cumulative FPI portfolio flows (the hot money flowing into the stock markets) has seen outflows from both India and China.

This also suggests that India benefits when the global economy is going well and is hurt by global a growth slowdown.





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Source: Bloomberg, DSP; Data as on Nov 2023

Global Growth Is Becoming Challenging, India Is A Bright Spot But Slowing

Manufacturing PMI	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23
Global	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.6	49.5	48.7	48.6	49.0	49.2	48.8
Emerging Market	51.7	50.8	50.2	49.4	49.8	49.7	49.8	49.9	51.6	50.7	50.5	51.4	51.1	50.2	51.4	50.9	50.1
Developed Market	52.5	51.3	50.2	50.1	48.8	47.8	47.3	48	48.1	48.4	48.5	47.6	46.3	47.1	46.8	47.4	47.5
US	52.7	52.2	51.5	52	50.4	47.7	46.2	46.9	47.3	49.2	50.2	48.4	46.3	49	47.9	49.8	50
Eurozone	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5	47.3	45.8	44.8	43.4	42.7	43.5	43.4	43.1
UK	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47	49.3	47.9	47.8	47.1	46.5	45.3	43	44.3	44.8
India	53.9	56.4	56.2	55.1	55.3	55.7	57.8	55.4	55.3	56.4	57.2	58.7	57.8	57.7	58.6	57.5	55.5
China	51.7	50.4	49.5	48.1	49.2	49.4	49	49.2	51.6	50	49.5	50.9	50.5	49.2	51	50.6	49.5
Japan	52.7	52.1	51.5	50.8	50.7	49	48.9	48.9	47.7	49.2	49.5	50.6	49.8	49.6	49.6	48.5	48.7
European Union	51.6	49.3	49.1	48.1	46.1	46.7	47.5	48.6	48.3	47.3	45.8	44.9	43.4	42.7	43.4	43.4	43.2
Germany	52	49.3	49.1	47.8	45.1	46.2	47.1	47.3	46.3	44.7	44.5	43.2	40.6	38.8	39.1	39.6	40.8
France	51.4	49.5	50.6	47.7	47.2	48.3	49.2	50.5	47.4	47.3	45.6	45.7	46	45.1	46	44.2	42.8
Taiwan	49.8	44.6	42.7	42.2	41.5	41.6	44.6	44.3	49	48.6	47.1	44.3	44.8	44.1	44.3	46.4	47.6
South Korea	51.3	49.8	47.6	47.3	48.2	49	48.2	48.5	48.5	47.6	48.1	48.4	47.8	49.4	48.9	49.9	49.8
Australia	56.2	55.7	53.8	53.5	52.7	51.3	50.2	50	50.5	49.1	48	48.4	48.2	49.6	49.6	48.7	48.2
Malaysia	50.4	50.6	50.3	49.1	48.7	47.9	47.8	46.5	48.4	48.8	48.8	47.8	47.7	47.8	47.8	46.8	46.8
Vietnam	54	51.2	52.7	52.5	50.6	47.4	46.4	47.4	51.2	47.7	46.7	45.3	46.2	48.7	50.5	49.7	49.6
Phillipines	53.8	50.8	51.2	52.9	52.6	52.7	53.1	53.5	52.7	52.5	51.4	52.2	50.9	51.9	49.7	50.6	52.4
Brazil	54.1	54	51.9	51.1	50.8	44.3	44.2	47.5	49.2	47	44.3	47.1	46.6	47.8	50.1	49	48.6
HongKong	52.4	52.3	51.2	48	49.3	48.7	49.6	51.2	53.9	53.5	52.4	50.6	50.3	49.4	49.8	49.6	48.9
Singapore	57.5	58	56	57.5	57.7	56.2	49.1	51.2	49.6	52.6	55.3	54.5	54.1	51.3	53.6	54.2	53.7
Indonesia	50.2	51.3	51.7	53.7	51.8	50.3	50.9	51.3	51.2	51.9	52.7	50.3	52.5	53.3	53.9	52.3	51.5

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Source: Anitha Rangan, Equirus Securities, DSP; Data as on Nov 2023

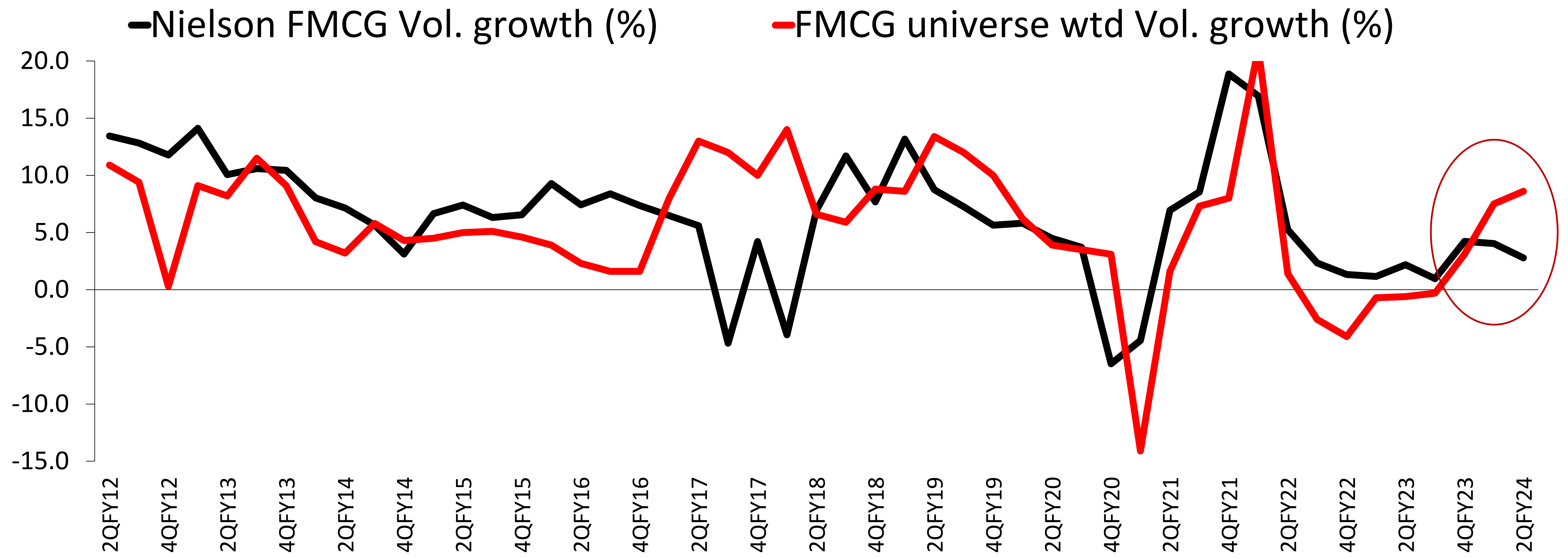
Is The Unorganized & Rural Economy Making A Comeback?

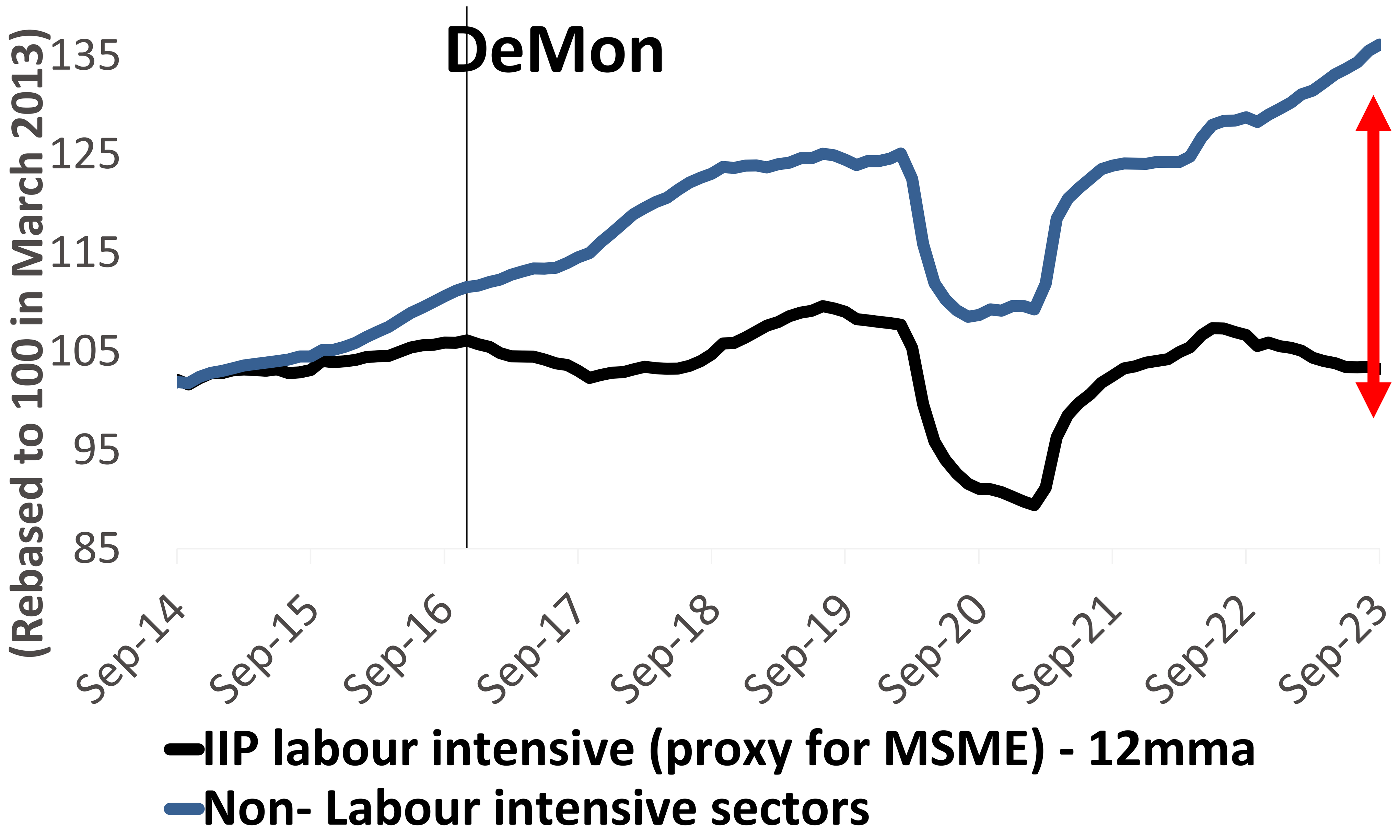
India's post COVID recovery has been patchy. The rural and especially the unorganized sector has been under consistent pressure either through COVID shock, lack of employment recovery or due to high inflation in 2022 and Q1CY23.

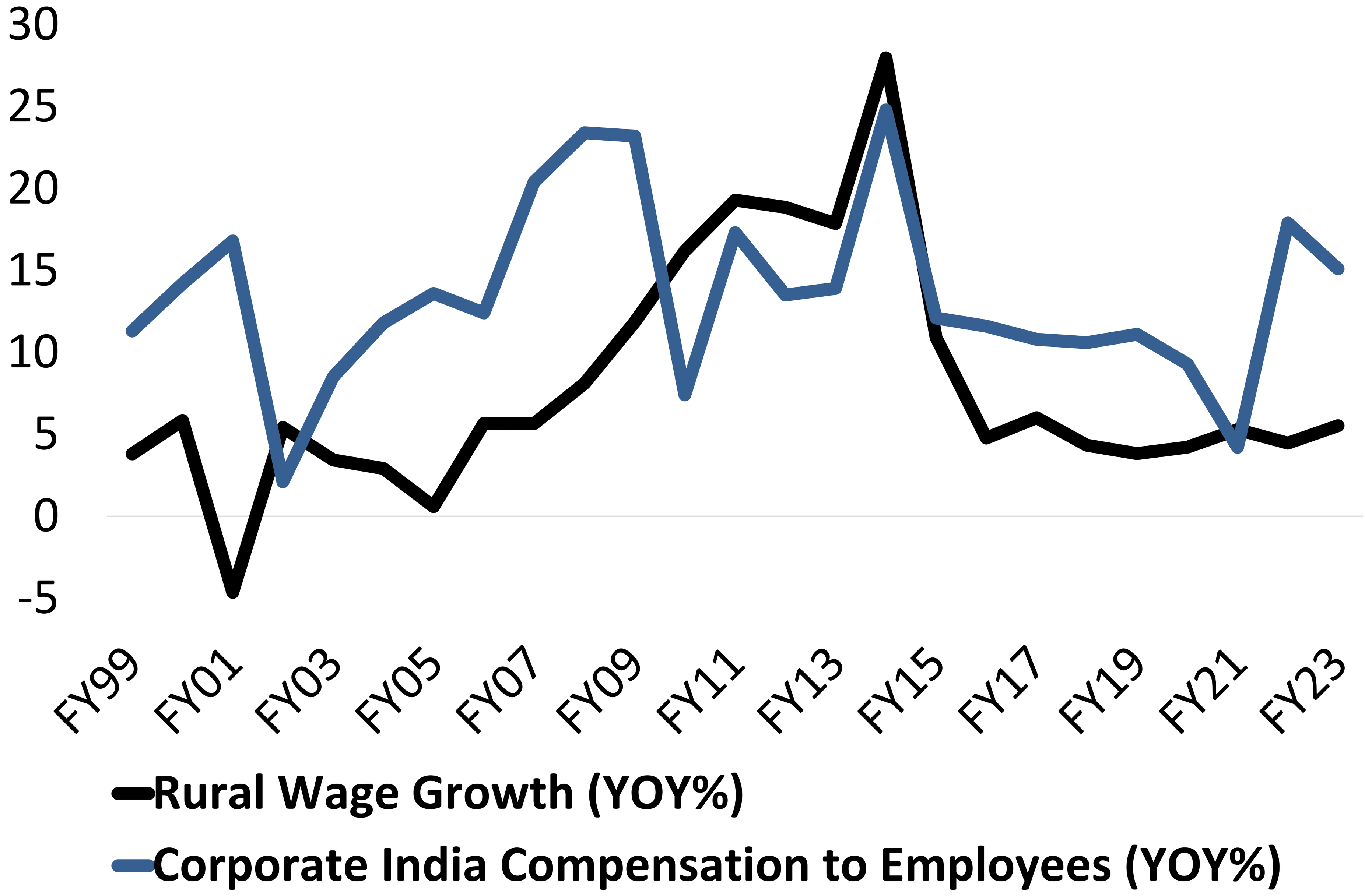
However, some firms have begun to highlight a comeback from smaller and unorganized sections. DSP Transcript discusses this in greater details *(Link to the report)*

The economic data is yet to show this recovery that firms have begun to talk about. The industrial production proxy for MSME (the labour intensive, and mostly unorganized space) is yet to show a meaningful recovery.

Listed FMCG universe has started to report an increase in volume growth, and the commentary is also supportive of a recovery. If hard data obliges, this could be the beginning of a steady trend and has implications for FMCG, automobiles and other proxy plays.







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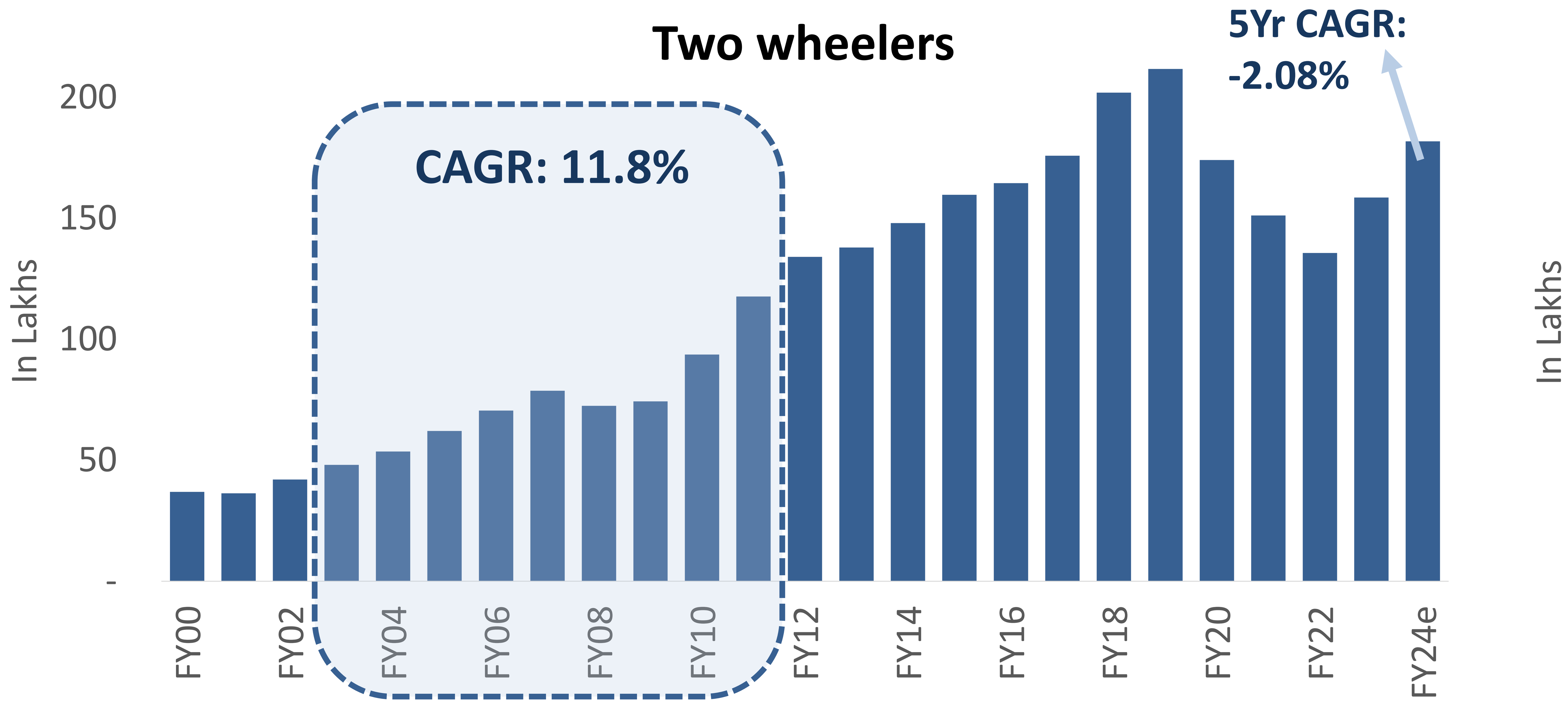
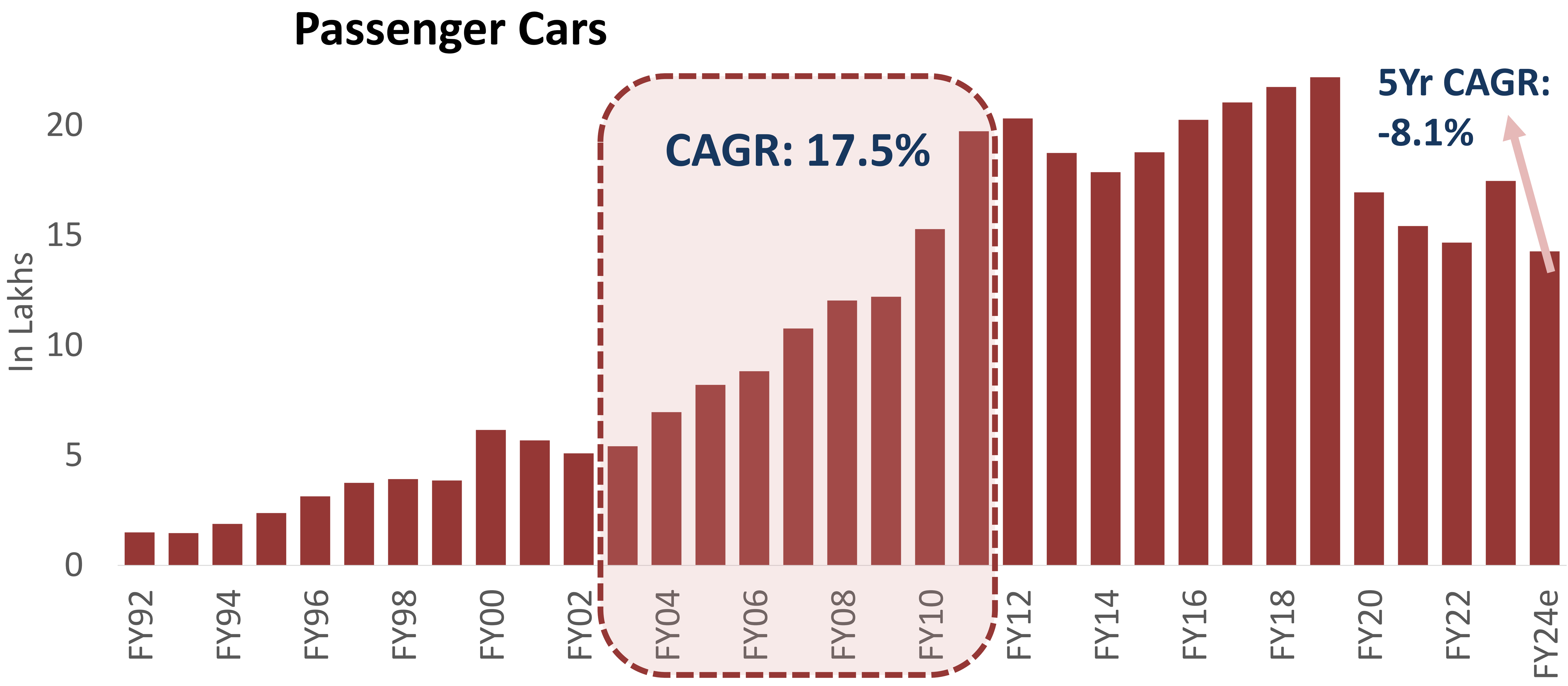
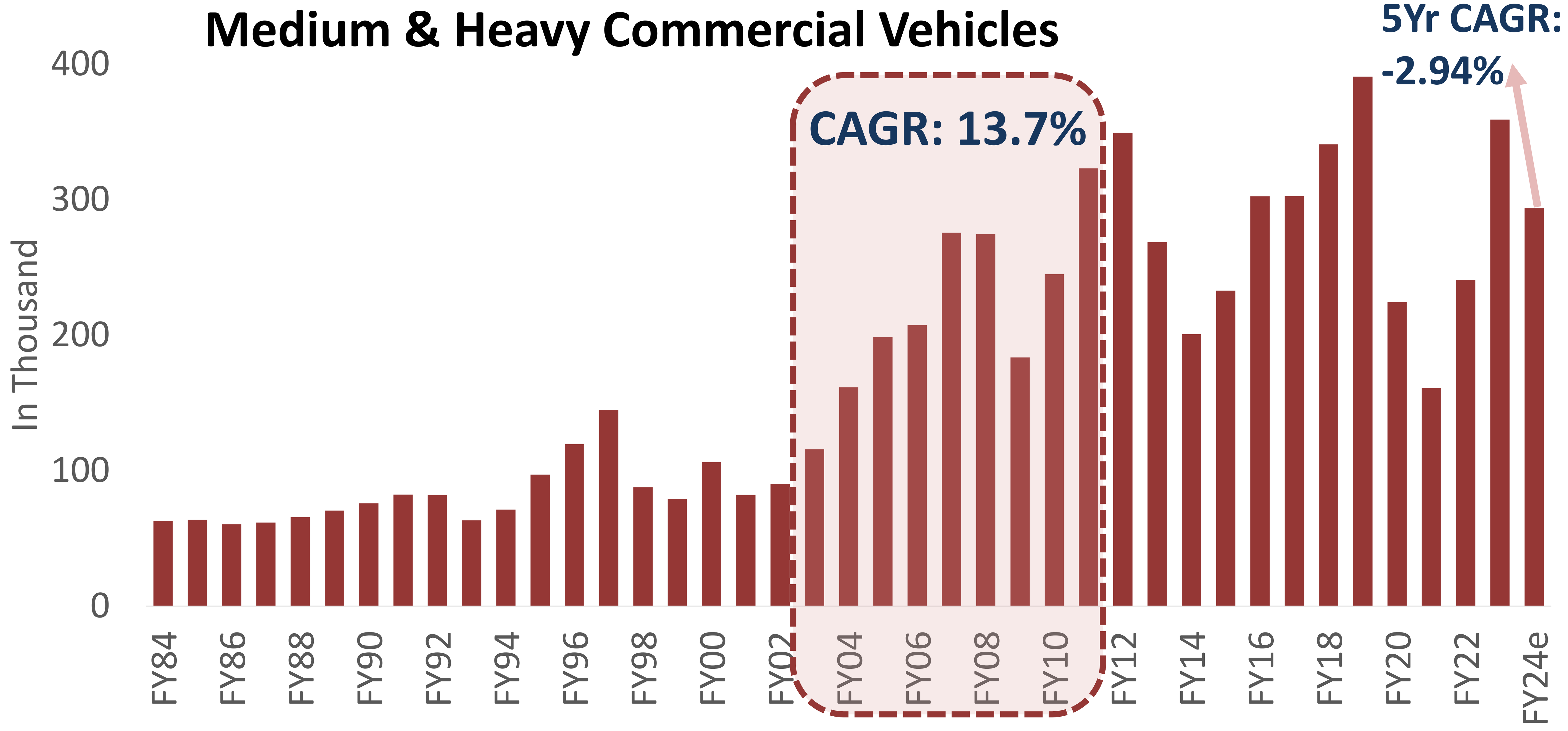
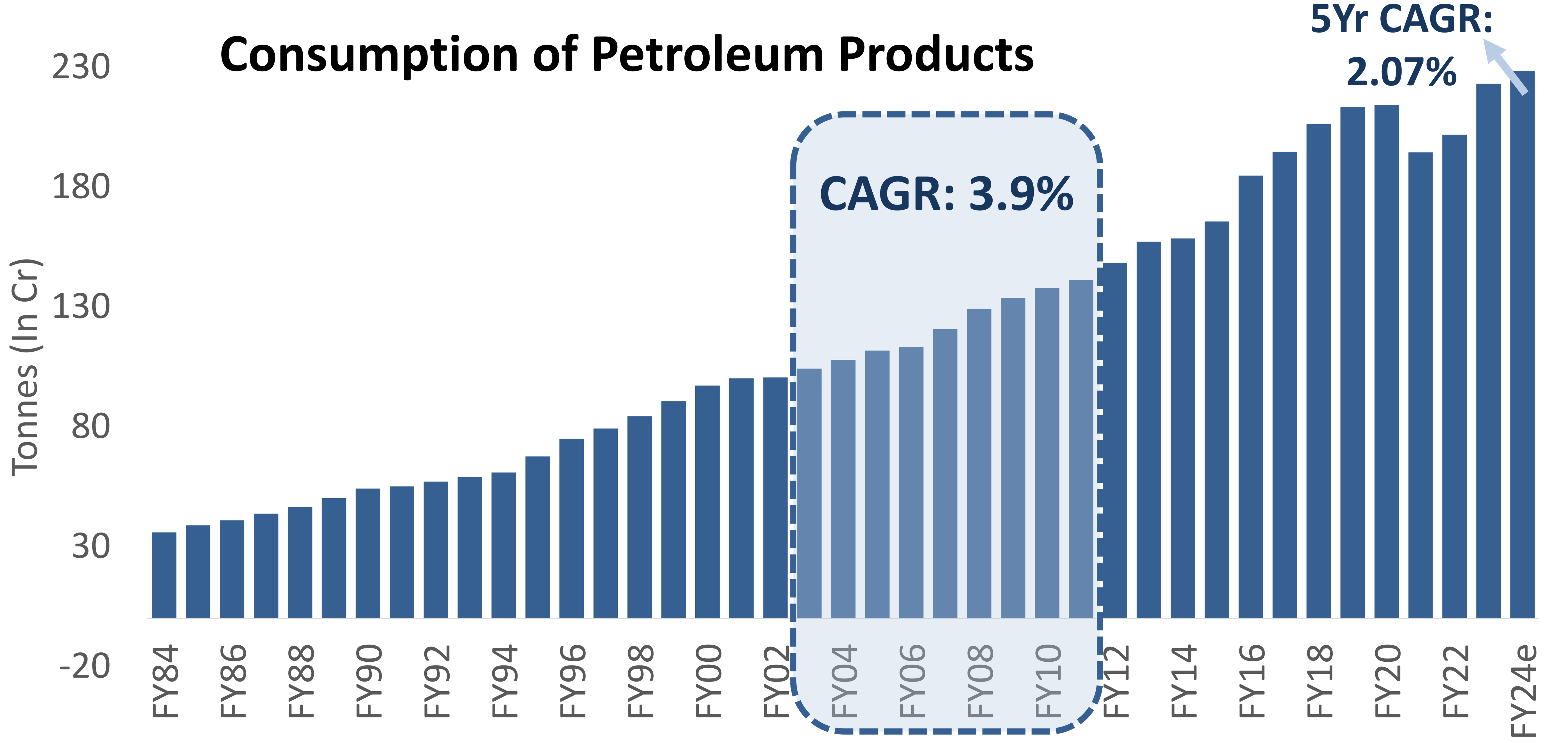
Source: Bloomberg, DSP; Data as on Nov 2023

Key Consumption Sectors' Growth Yet to Recapture the 'Best Period' Levels









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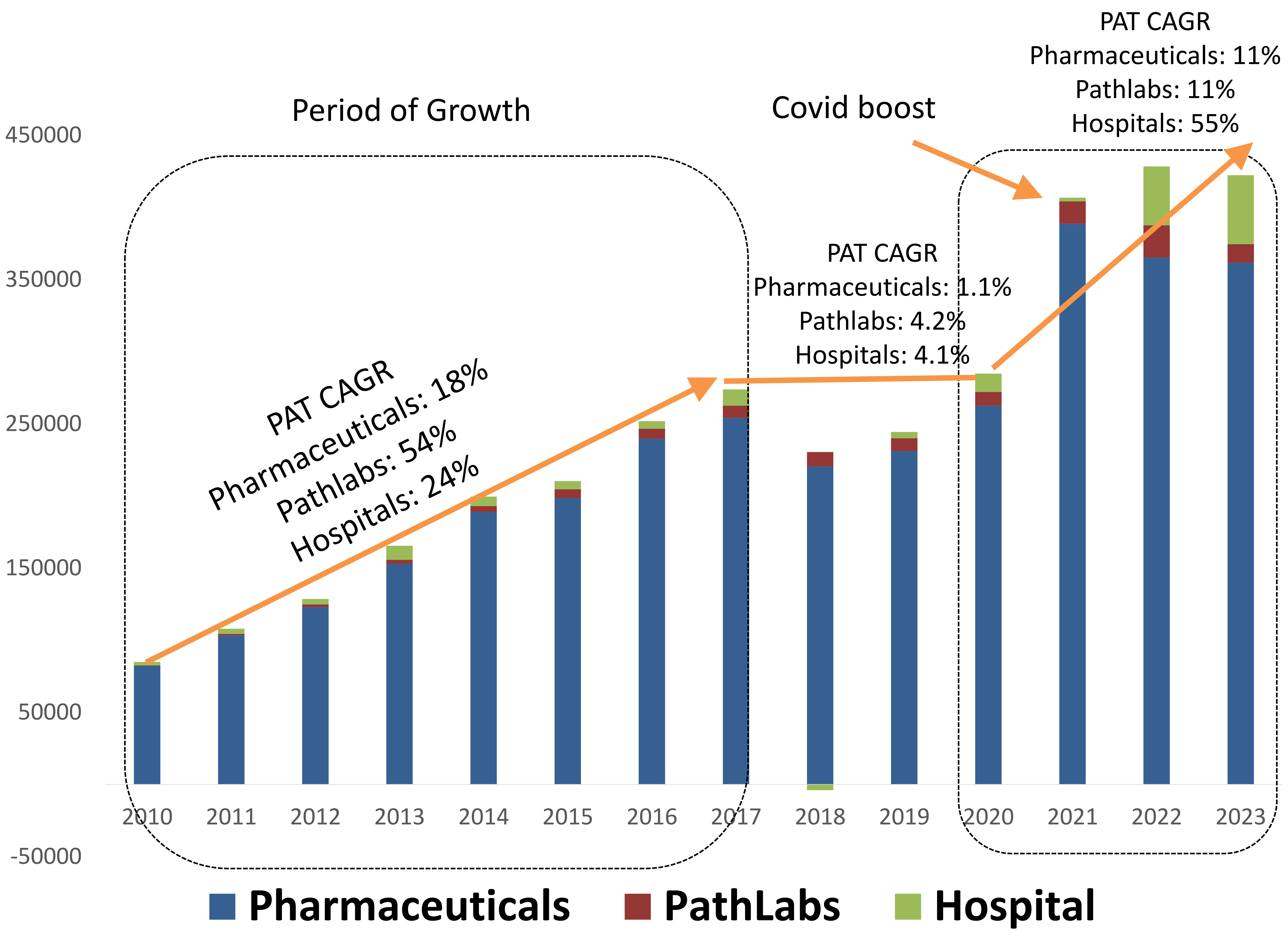
Source: CMIE, DSP; Data as on Nov 2023; ***FY24 are annualized numbers as estimates based October YTD***

Prescribing A Healthy Recovery: Healthcare Sector Doses Up Optimism

In recent years, the Healthcare sector has exhibited a notable divergence in performance. Unlike the robust growth observed in the years leading up to 2018, companies within the sector, apart from hospitals, have struggled to demonstrate substantial Profit After Tax (PAT) growth. Notably, pharmaceutical companies have witnessed a decline in their PAT growth trajectory, experiencing a notable reduction in from 18% CAGR pre-2018 to a more modest 6% post-2018 to 2023. This has begun to improve now.

Hospitals have emerged as a bright spot in the Healthcare landscape, demonstrating commendable PAT growth over the same period. The frothy valuations for this segment are also normalizing.

The uptick in profitability for the US Generics Pharma firms is discernible through the optimization of raw material and overhead costs, coupled with an expansion in revenue. The resultant reduction in costs not only contributes to enhanced profitability but also serves to bolster overall profit margins within the pharmaceutical sector.



Profit After Tax (PAT) growth for Pharma, Pathlabs and Hospital sector stocks

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Source: Investec, Bloomberg, Data as on Oct 2023

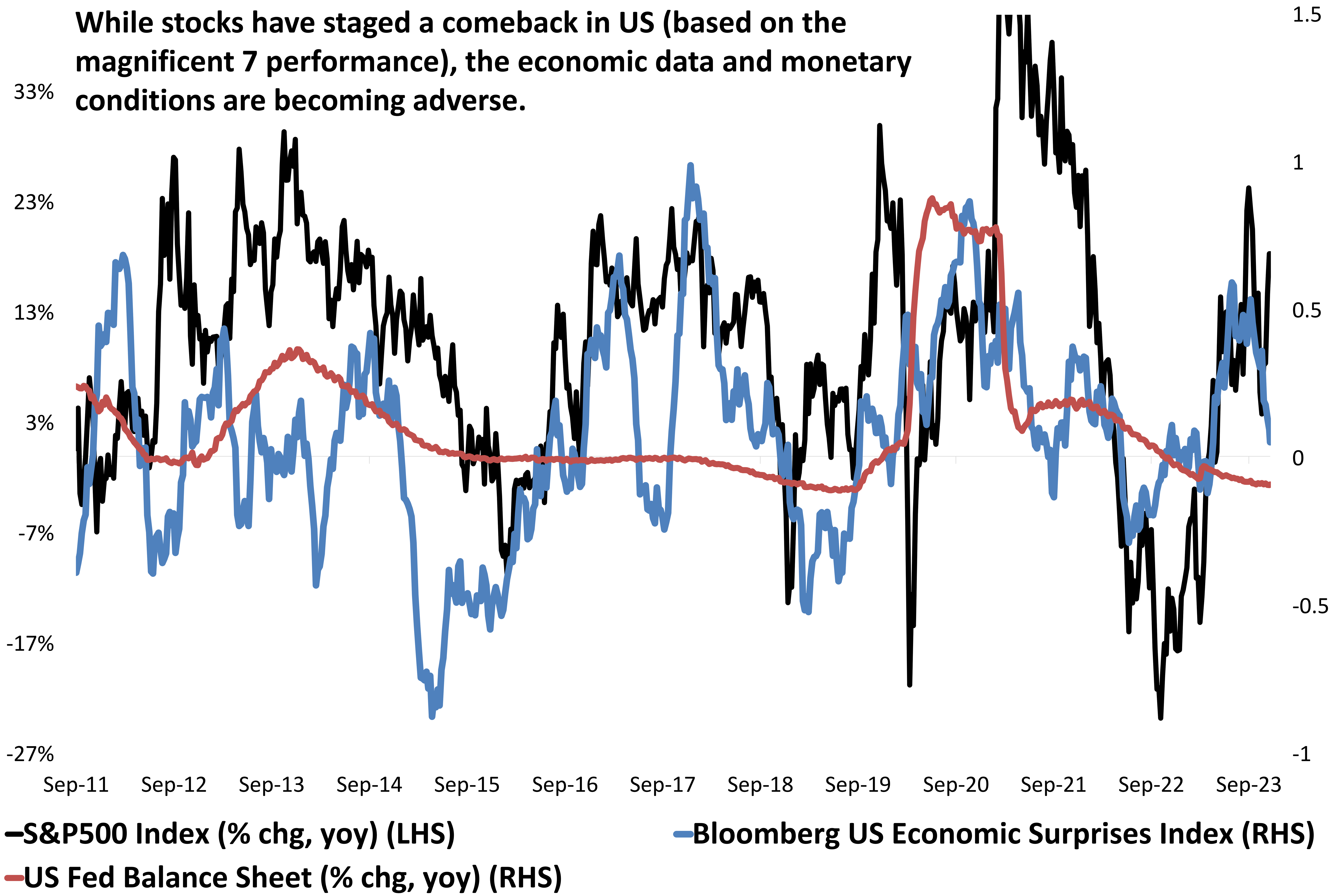
US Equity Returns Diverge From US Economic Data, Fed's Quantitative Tightening

Stock prices have continued to rise even as economic data disappoints and the Fed has begun to reduce its balance sheet meaningfully.

One possibility is that investors are betting on a soft landing for the economy, meaning that inflation will come down without causing a recession. This would be good news for corporate profits and stock prices.

The divergence between US equity returns and US economic data is a notable trend. In the past stock market returns have not been able to withstand a slower economic growth trajectory.

This is for the first time in many years that economic growth in US is slowing and at the same time the US Fed is tightening monetary conditions. Usually, the Central banks and Governments act counter cyclically to bolster growth during slowdown. This paints a sober picture for US equities. Stay cautious.



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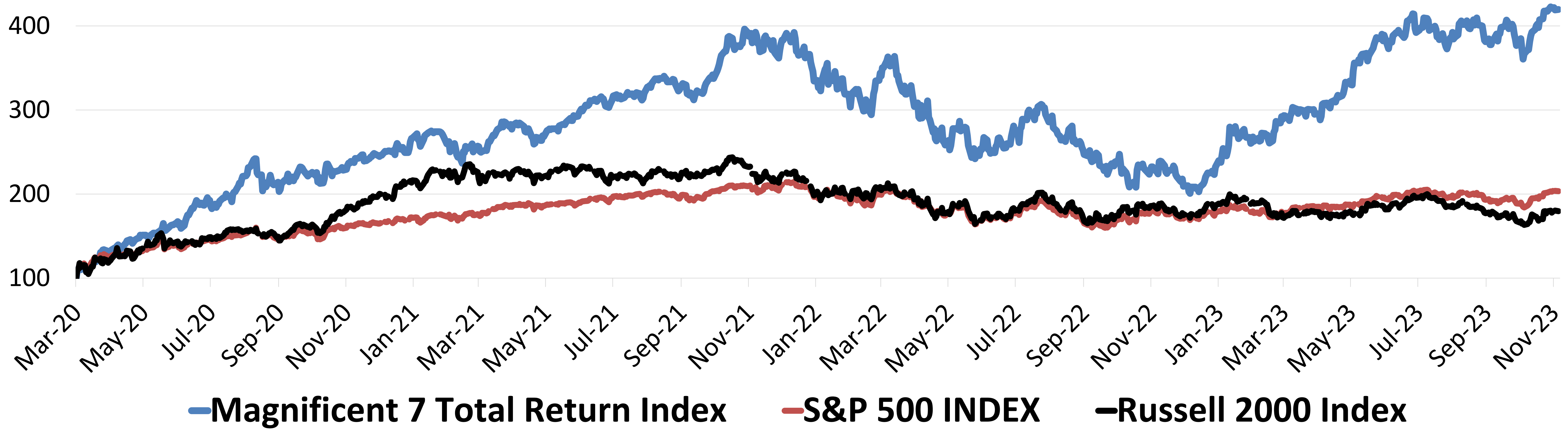
Source: Bloomberg, DSP; Data as on Nov 2023

The Tale of Two Markets

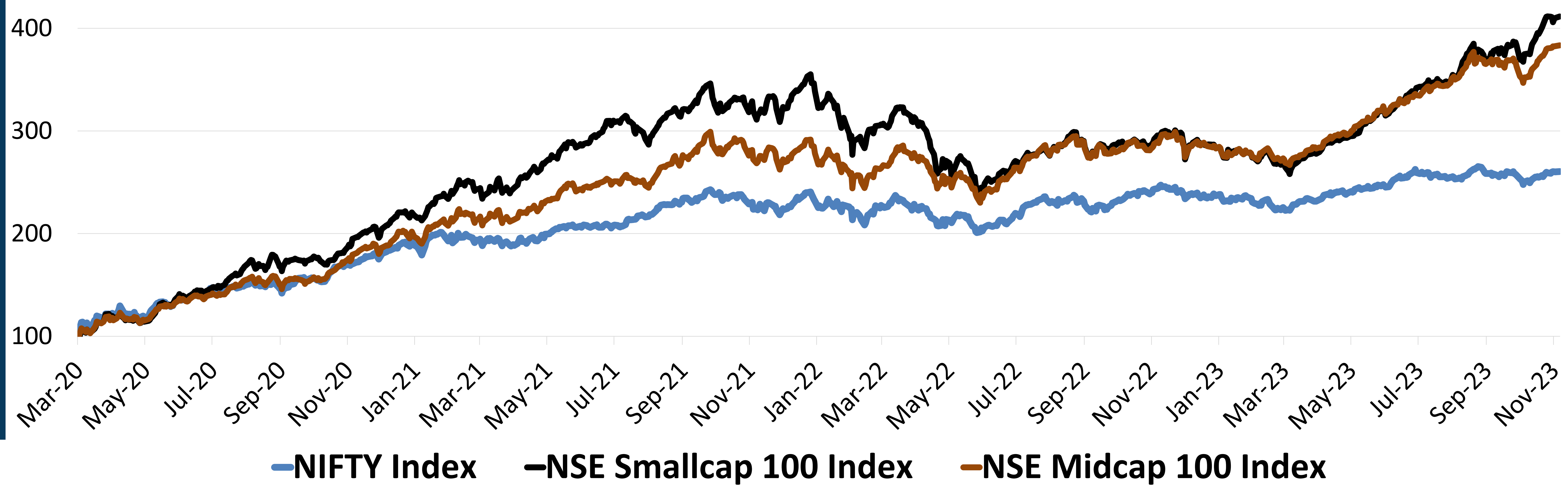
Is US, the stock market has become increasingly concentrated in the hands of a few large companies, with the top 7 firms accounting for a substantial portion of the overall market capitalization. The magnificent seven are: Apple, Microsoft, Amazon, Alphabet, Meta Platforms, Nvidia and Tesla. In spite of a deterioration in growth the US equity market has been held up by a select universe of blue-chip names. The broader small and midcap stocks have been languishing at multi month lows. This is an unhealthy condition for the market especially when broader market has lack of support from economic growth.

In India, the situation is opposite. The broader small and midcap stocks have outperformed the Largecaps by a huge margin. This has been aided by a revival in the broader economy and health prospects for earnings growth across market caps. This risk to the rally in India is contingent on the growth outlook which is closely linked with corporate earnings growth in the current cycle. The possibility that a growth normalization can impact performance of wider universe is high. Hence, be conservative.

A top heavy market. Performance driven entirely by top 7 firms and other larger companies.



A broad based rally with less participation from largecap & quality names, especially in last 2 years.



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Source: Bloomberg, DSP; Data as on Nov 2023

More Than 40% of World Population Accounting for 42% of GDP Will Vote in 2024

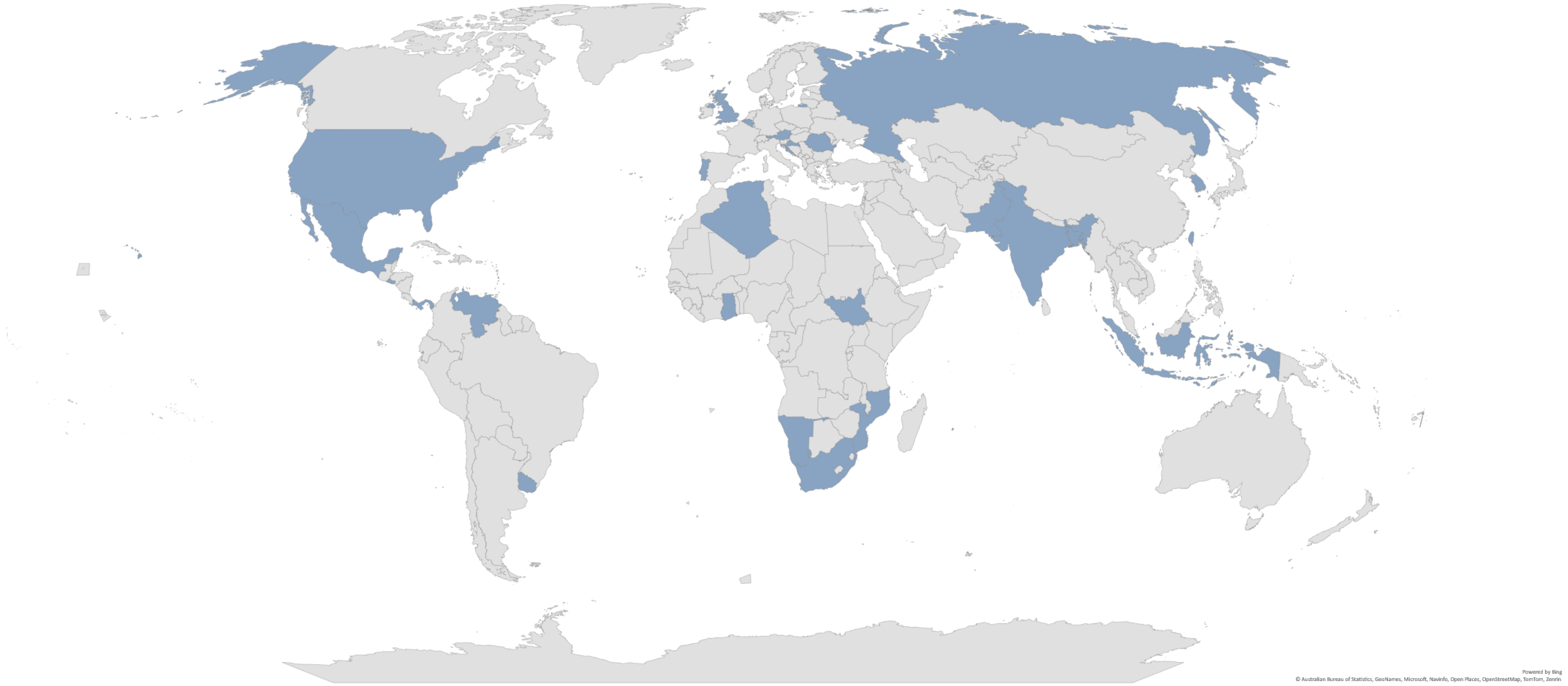
In the long term, political change makes a big difference to the economic policy and business environment of a country.

As investors, we have no expertise to project trends or winners, or to assign any probability of what policy changes can occur in case of political continuity or changes. In short, we have no idea about the outcome of any elections.

However, national elections have been a source of extreme volatility and market moves in the past. At present, the VIX (volatility indices) across US, EU, India, China and many other major markets are low. In fact US VIX and India VIX are at levels not seen since pre-covid times. Nifty Index options Implied volatility has been trading at levels that we have not seen since pre-GFC era.

This is a sign of complacency and also an opportunity to use PUT Options for hedging exposure to equity markets for the upcoming news and event driven year.

List of countries where legislative elections will be held in 2024



2024 Elections

	Total	Global share
Number of countries	40	21%
Population	3.2 billion	41
GDP	$44.2 trillion	42

Source: Bloomberg Economics based on IMF forecasts
Figures exclude elections for the European Parliament

Source: Bloomberg, DSP; Data as on Nov 2023

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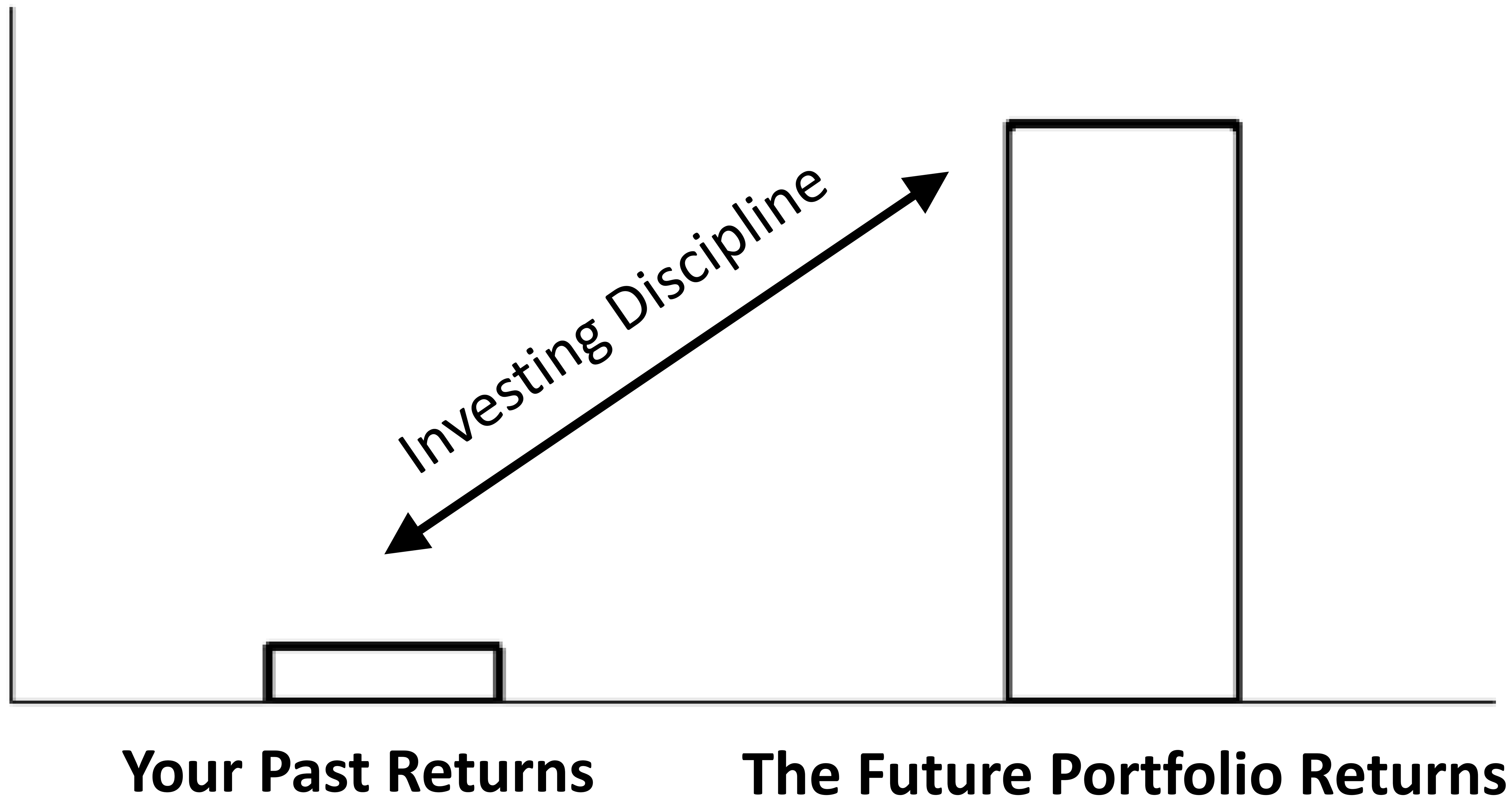
The Future Is Unknown But Malleable

Discipline is the distance between a mediocre past and a glorious future.



"The future is malleable, and to see it, you just have to listen to history and have a grand enough vision.

- Salome Gluecksohn Waelsch

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