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6 Jan 2015

A Rational Analysis of the Sensex for the Year ended December 2015:

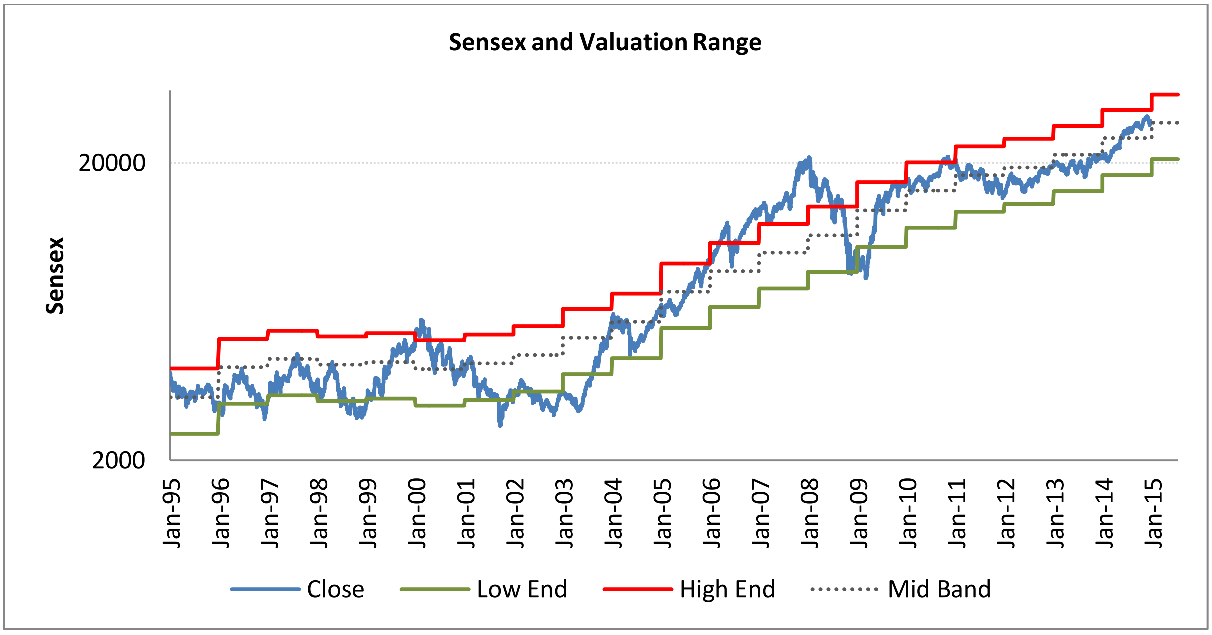
Post the May elections it is our belief that the SENSEX has been moving up primarily on *hope of*: 1. revival in the economy and earnings AND 2. Implementation of reforms by the new government. We had suggested in the last note that the SENSEX is unlikely to move substantially above our mid-band of 24,500 for December 2014 unless there is a strong recovery in earnings. Earnings momentum has not improved (discussed later) and other than diesel deregulation, in our opinion there haven't so far been any significant reforms that could jumpstart the investment cycle (of businesses). But the hope driven rally persists, even though earnings did not come through, with the market's focus now shifting towards hope of reforms to flow through in the 2015 Budget and the possibility of rate cuts after March 2015.

Fundamental Valuation:

Using our various valuation approaches we estimate the Fundamental Value of the Sensex for Calendar year 2015 as follows:

Sensex Valuation	LOW	HIGH
Historical	21,028	33,345
DCF	20,414	34,185
+1/-1 SD PE Band	20,741	35,394
Average	**20,728**	**34,308**

Sensex Valuation range for CY 2015: **21,000 – 34,000.**



We have observed that SENSEX tends to trade close to the High End (red line) of the valuation band only when supported by strong earnings growth. If strong earnings momentum is absent, the SENSEX should trade closer to the Mid-band of the valuation range (grey dotted line) and if earnings momentum is negative, Sensex would trade below mid-band and could go as low as the Lower end (green line) of the valuation range. This has certainly been the historical experience of the last decade.

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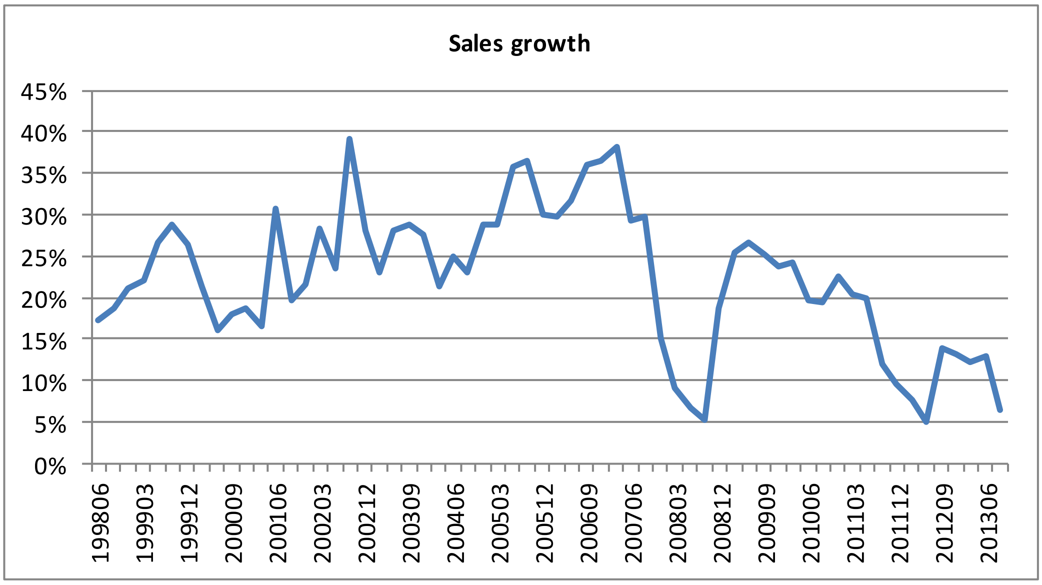
Currently we are certainly not in the best earnings momentum period as seen by the sales growth numbers of current constituent companies. Earnings momentum has in fact slowed down as compared to earlier quarters.



Source: ACE Equity. For Financial stocks NII growth used.

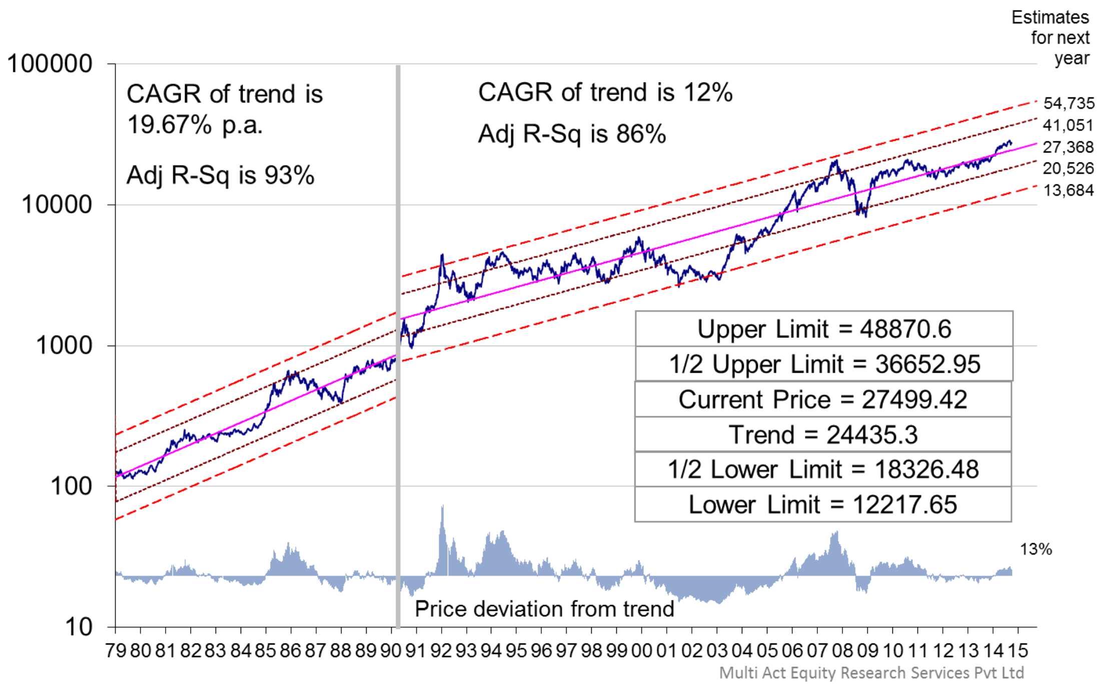
Market participants are currently factoring in a cyclical recovery and thus basing their assumptions on such a recovery. We feel that as long as we don't see a revival in the earnings momentum (as seen in the past), the current rally continues to be one driven by sentiment and "hope".
Thus we continue to hold on to our estimate of the market's "fair value" as the mid-band of our valuation range. For CY15 our mid-band stands at **27,500**.

Technical Analysis:

Technically SENSEX is looking strong with a continuing Setup 1 (Strong Buy Signal). Currently Sensex is in uncharted territory and has broken out after 6 years from the 2008 peak (~21000). This earlier peak could act as support in the medium to long run.

Quantitative Analysis:

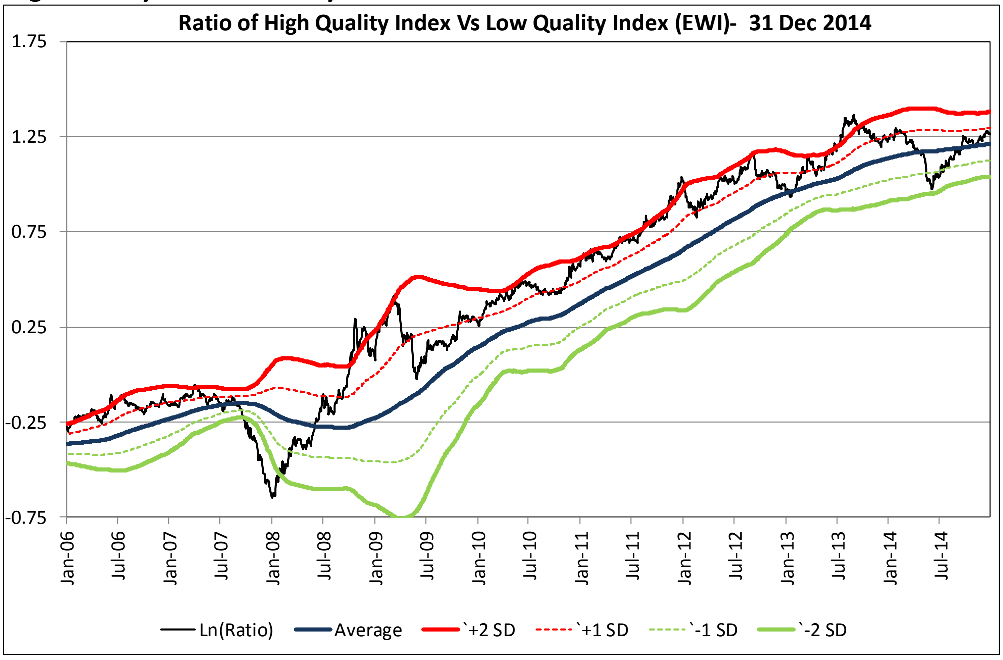
SENSEX Index Price from 1979 to 31 Dec 2014



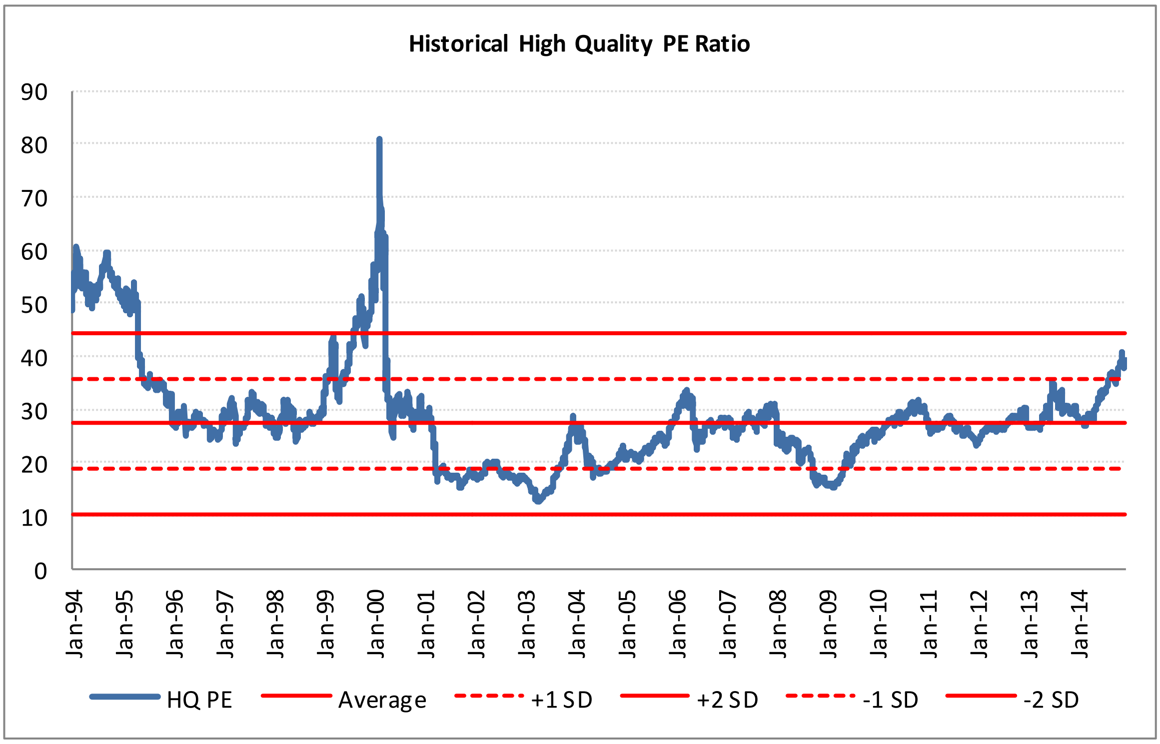
Our Trend Analysis suggests that the trend level of the Sensex for next year runs to~27,400 (Dec 2015). As stated in our earlier Sensex Rational analysis note, Sensex moving to the half upper limit is not impossible. Strong sentiment, fund inflows and strong earnings momentum can drive Sensex to the half upper limit (and in an "irrational" market even beyond). But based on current earnings momentum we feel the odds are against that happening. We therefore consider the SENSEX to be trading closer to trend considering both domestic and global macro situation. Thus based on quantitative trend analysis, the probability of flat or negative prospective return is high over the next year assuming Sensex moves back to trend.

Behavioral Analysis:

High Quality vs Low Quality Index:



The high quality (HQ) vs low quality (LQ) ratio had come down sharply post the election results hinting that risk appetite had increased sharply (as market participants chased LQ stocks as compared to HQ). But the ratio has since corrected back.This time though it does not signal that risk aversion has crept back in. If one looks at the individual indices a different point emerges instead, the low quality index has consolidated but there has been a further sharp rally in the High quality stocks, which has led to the correction in the HQ vs LQ ratio. As can be seen in the chart below, Multi-Act High Quality index is currently trading at ~40x PE ratio, which is the highest it has touched in the recent past (including the highs reached in 2006-8).



From April 2002, Weighted average trailing PE of High Quality index constituents has been used. Prior to April 2002, simple average of HQ trailing annual PE of available constituents has been used. Thus prior to April 2002, the PE is more of a representative PE than actual HQ index PE.

Thus the point to understand here is that, the correction in HQ vs LQ ratio is not on account of correction in the Low Quality space (risk aversion), but on account of overvaluation in the HQ space (appetite for "valuation risk"). Thus on an overall basis the sentiment indicators might not be ringing alarm bells, but on closer look, risk appetite seems to be certainly high and is more focused in the HQ space where market participants seem to be oblivious to *valuation risk*. But as seen in the past (1994-95 & 1999-2000), such overvaluation can persist and even expand further in an irrational market. Thus while we would be reluctant to call a peak in the HQ space, we are certainly in risky zone from valuation point of view.

Prospective Return of Constituents:
Based on our rational analysis framework (fundamental, technical, quantitative & behavioral) we arrive at best case and worst case prospective return estimate for individual stocks. Using the Sensex constituent and their weights we can arrive at the prospective return for the Sensex as well. Based on the prospective return of individual constituents, the best upside case for Sensex seems to be ~7% (or 29,800) while the worst case downside is estimated at -18% (or ~22,700) with average estimate of -5.7% (or 26,300).

Conclusion: On a Rational Analysis of the Sensex we would conclude that market is most likely to consolidate around **27,500** which is the mid-band of our valuation range and is also close to the end of year estimate of our trend (27,400) of the Sensex quantitative analysis. This is slightly higher than the average estimate (26,300) that we have arrived based on individual constituents prospective return. Thus from a fundamental (SENSEX valuation range) and Quantitative (Sensex Trend) analysis, the prospective return of the Sensex for CY15 from the current level is zero. We feel 21,000 would now be a good technical support on the downside. Our interpretation of the behavioural analysis is not ringing alarm bells at the broad level, but increasing risk appetite is clearly visible through High Quality overvaluation. The upside risk to our thesis of 34,000 on the SENSEX would play out if unexpectedly earnings momentum were to pick up strongly and this is also supported by decisive reforms by the government.

Regards

Rohan Samant
Assistant Portfolio Manager

Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited

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