Trust Line

BizNotes

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For Private Circulation

CELEBRATING 20 YEARS of RESEARCH EXCELLENCE

MONTHLY VIEW

FROM THE FUND MANAGER DESK

Is the market turning stock-specific in broader space amid growing SEBI strictures?

The pressing question that is on the top of investors' mind: Will the recent turmoil in small and midcaps, caused by increasing SEBI oversight and regulatory overhang, morph into a manic price correction in the broader space? Or will it be another transient stumble that will subside soon? First, a bit of context on the recent correction, before we dive deeper into those questions. When the year began, there were no signs of any stalling for the stellar run for small caps. The one way run that started in April'23, continued its bullish course well into mid-March until it hit the wall of SEBI strictures. The blow came in the form of stress test prescriptions from SEBI for the small and mid-cap mutual funds, besides the sudden coordinated actions from RBI-SEBI in stemming the flows into the primary markets. This coming on the top of an unusually strong comment from the regulator on the market level, calling it a froth in the small-cap space, set off a sharp slump in the small and midcap segment. This resulted in the small-cap index crashing by over 14% from the highs it touched in Feb, before making a marginal recovery in the subsequent trading sessions. The index is still down by nearly 8% from the peak even after this recovery, reflecting the nervousness in the broader space.

Now, the key question that the investors are grappling with is, is this the beginning of another bear cycle in the small and mid-cap markets as happened in 2018? Investors are rightly worried as there is an eerie similarity to the 2018 downcycle. The small cap index was up by over 58% in 2017 when the sharp slide started in 2018. The situation is not far different now with the index up by over 47% in the previous year 2023. Valuation multiples are at a historical high across the market segments. But the similarities stop there. In 2018, the market was staring at the prospect of interest rate tightening cycle and was worried about the consequent macro risk events like the IL&FS crisis and balance sheet issues in the banking sector in general.

If one goes back and looks at all past downcycles, one will realize that in addition to expensive valuation, one needs other key ingredients either in the form of macro risk events or a hawkish interest rate environment

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for sharp price corrections in the broader space. One would find this common pattern across all the down cycles. Do we find such a pattern now? Yes, valuations are indeed expensive across the market segment compared to historical levels. Is that alone sufficient for a sharp price correction?

In the current context, two key ingredients that are critical for sharp price corrections are missing in that pattern. Global macro looks resilient with the recessionary risks in the developed world receding convincingly. With the Fed set for multiple interest rate cuts this year, interest rate outlook is far more benign now. In such a situation, sharp price correction looks more and more unlikely. Having said that, given the expensive multiples in which the broader space is trading, markets are likely to get into a consolidation phase with actions shifting to bottom-up stock-specific arena, as further upside at the index level may be limited. If one is on the right stock at the right price, it is still possible to eke out decent returns in this emerging scenario of range-bound markets in the small and mid-cap space as the markets are likely to reward stock-specific actions.

There is another compelling reason why we believe that the markets will turn stock-specific. It stems primarily from the nature of current economic expansion which is led by investments. The current cycle of expansion looks strikingly similar to the FY03-07 cycle that was propelled by private capex.

In that cycle, the investment to GDP ratio rose from 27% in FY03 to 39% in FY08 which was close to peak. Investment to GDP then hovered around those levels until it peaked in FY2011. It suffered a decade of decline over the subsequent years to hit a low of 28% in FY2021. From that low, it has now bounced back to over 34% in FY24. As per the consensus estimates, this ratio is likely to move up to over 36% by FY27. This sharp rise in the investment ratio is likely to be the defining nature of the current expansion.

Currently the investments are led by public capex. As has been highlighted in many forums, Govt's capex has moved from around 1.6% of GDP a few years back to 3.4% of GDP now (as per FY25 interim budget). Now, it is time for the baton to shift to private investments. With corporate profits as a percent of GDP moving from a trough of 1.1% FY2020 to 5.3% in FY23, it is a question of time before the corporates start loosening their purse strings for capex. Early signs are already there for everyone to see in terms of greenfield capacities being put up by India Inc in steel, cement, renewables, ports and airports. As the capex cycle extends, the impact will trickle down by lag effect to consumption that has been currently under pressure.

Overall, given this benign macro-outlook, this is not an easy market for investors who are waiting on the fence for sharp price correction. It

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doesn't look like this will get any easier in the coming weeks and months. Yes, the recent correction in the small-mid cap space has taken some froth away from the valuations, but expecting sharper price correction may only lead to a major disappointment to investors. Of course, the disclaimer is, if there is a surprise in the upcoming election outcome, scenario could be significantly different for the markets' direction. Assuming there is no surprise on that, investors may not have much choice but to look at SIPs or look at AIF or PMS funds which will invest in a phased and cautious manner using the cool-off, wobble or consolidation that is likely to be the nature of the current market direction, instead of waiting endlessly for a sharp price correction in the broader markets!

Happy Value Investing!!

ArunaGiri N.

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CORPORATE NEWS

- **Tata Motors** Group has signed a facilitation Memorandum of Understanding (MoU) with the Government of Tamil Nadu to explore setting-up of a vehicle manufacturing facility in the state. The MoU envisages an investment of ~Rs 9,000 crores over 5-years and can potentially create up to 5,000 jobs (direct and indirect).
- **Prataap Snacks Ltd** announced that it started a commercial production unit at Samba in Jammu and Kashmir. The unit will produce namkeen snacks, fried namkeen pellets, and other snacks including popcorn, according to an exchange filing. The unit has a production capacity of 10,000 metric tonne per annum.
- **Castrol,** India's leading lubricant brand, has teamed up with KTM, a premium motorcycle brand. Castrol POWER1, the company's performance lubricant will be powering the upcoming second season of its much-awaited KTM Cup 2024 as the official Performance Partner. This association is strategically aligned with the brand's increasing focus on driving and strengthening performance motorsports in India. KTM Cup is India's largest Racing Championship that attracts participation from all over the country.
- Reserve Bank conducts special audits for **IIFL Finance Ltd** and **JM Financial Ltd**, addressing regulatory breaches like gold loan deviations and IPO financing issues. Auditors to be appointed by April 12, 2024. Certain bank branches open for government transactions on March 31.
- **TCS** signs 7-year deal to transform global IT infrastructure for Ramboll. TCS will also deliver services to manage Ramboll's cloud and data centers, application development and maintenance, cyber security and digital workplace.
- **Aditya Birla Sun Life AMC** promoters to sell up to 11.47% stake via OFS. Aditya Birla Capital and Sun Life (India) AMC Investments have granted approval, for the sale of a maximum of 2.01 crore shares of Aditya Birla Sun Life AMC.
- **Zydus** launches anti-cancer generic drug Olaparib in India. The drug will target specific genetic mutations prevalent in certain types of cancers, paving the way for a more tailored and effective treatment approach, the company said in a stock exchange filing.

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MACRO NEWS

- **S&P Global** Market Intelligence revises India's FY25 growth upwards to 6.8%. The government expects the economy to grow 7.6% in FY24. India's growth numbers released last month showed that the economy expanded 8.2% in the year's first three quarters.
- **Government** allows urea imports by state-owned fertiliser companies till March' 25. The Directorate General of Foreign Trade (DGFT) in a notification, said that import of urea (for agriculture purpose) on government account shall be allowed either by designated state trading enterprises (STE) itself, or other entities authorised by the fertilizers department.
- Mobile phone manufacturing in value terms jumped 21-fold to Rs 4.1 lakh crore in India in the last 10 years as government policy measures like PLI played a critical role in attracting global players to boost local production, industry body **India Cellular and Electronics Association** (ICEA) said in a statement. India now produces 97% of its total mobile phone demand locally and 30% of the total production in financial year 2024 is meant for export, ICEA said.
- The state-run **Oil Marketing Companies** (OMCs) announced a nationwide price reduction of Rs 2 per litre for petrol and diesel.

FUNDS FLOW DATA

Data as on 27th Mar 2024

FUNDS FLOW DATA (Rs in Cr)		
Category	**MTD**	**YTD**
FII	31,056	6,851
DII	53,620	1,05,743
Total	**84,676**	**1,12,594**

DEBT & FOREX MARKET

Data as on 27th Mar 2024

DEBT / FOREX MARKET			
Category	**Day**	**1 Month**	**3 Months**
10 Yr Yield	7.07	7.07	7.21
Re / US $	83.29	82.88	83.26

MARKET VIEW

Uneasy Calm!

The best way to understand the current market set-up is to split the current calendar year performance, esp. in broader small and mid-cap space into two segments, one till Feb end and the other relating to March performance. The undertone was bullish for the broader markets in the Ist segment with the small-cap index returning about 6% for the two months. This is on top of the stellar run it had in the calendar year 2023, in which it had moved up sharply by a stunning 47%. That adds up to over 55% returns since the beginning of Jan'23. Of course, the regulator must have felt concerned about the unstoppable bull run in the small caps. This is where we come to the second segment of the market performance, which is to do with March. Right in the middle of March, SEBI's concern got expressed in the form of its prescriptions for stress test for small and mid-cap mutual funds, besides its chief's unusually outspoken "froth" comment on the small-caps space. Following this, fearing unfavorable outcome from the tests, investors and traders pressed the panic button on fears of margin calls and forced selling, triggering a precipitous fall in the broader space. At one point, the small-cap index fell as much as 14 to 15% from the all-time highs it hit in the month of Feb. While the index recovered partially post the publishing of stress test results, it is still hovering at the level where it began at the start of the year.

Ironically, amidst this turbulence in the broader segment, India attracted the highest FII flows for the month of March amongst Asian peers. With over 3.7 Bn dollars equity flows from FPIs (as on 27th March), March turned out to be one of the strongest month for FII flows. March also marked a notable increase in flows from the DIIs, with the net investments reaching the highest level since March 2020. So far, the month has received inflows of Rs 53K Cr+ from DIIs. This resilience in both the FII and DII flows amidst the turbulence in small and mid-cap space reflects growing traction in the larger universe.

While the markets are edgy in the broader space, given the prospect of the three rate-cuts by Fed this year and given the benign macro-outlook, sharper price corrections look unlikely, though long drawn time correction with a marked consolidation or range bound movements in the broader space cannot be ruled out. In such a scenario, investors are advised to take a bottom-up approach as the broader markets are likely to turn into more stock-specific ones from a momentum driven one that we witnessed since early April last year.

Value Extracts

- In this section of the newsletter, we attach an extract/write-up that we believe can add value to the readers from the ***"VALUE INVESTMENT"*** point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article from Business Standard titled ***"The Magnificent 7"*** by ***"Akash Prakash".***

"Any contrarian knows that just as a grim present is usually precursor to a better future, a rosy present may be precursor to a bleaker tomorrow".

- Seth Klarman

The Magnificent 7

The current level of concentration of tech giants in US markets is unprecedented. Could this be a bubble in the making?

The Magnificent Seven is the new acronym everyone is talking about in global equity markets. They are the seven largest companies by market capitalisation in the US (Microsoft, Apple, Nvidia, Amazon, Alphabet, Meta, Tesla) and have been on a tear over the past few years. These companies have seemingly been the driving force behind the markets, and their earnings, most recently Nvidia's, drive market sentiment. Rarely have so few stocks been so important for global equities.

If we look at relative performance, the reason for the hype is obvious. Over the last nine years, the Mag Seven stocks have surged more than 18 times, compared to less than three times for the S & P 500. As these seven stocks have gained greater prominence, the US stock market has become increasingly concentrated. Today, the top decile of stocks in the US account for more than 75 per cent of total market capitalisation. The only other time we have seen this level of concentration was at the bubble peaks of 2000 and 1929. Worryingly, in both the prior periods, this ratio eventually mean-reverted to 60per cent. Since 1926, the median ratio of concentration for the US has been 63 per cent.

If we look at the top five stocks, at 25 per cent of the S&P 500, this ratio is back to the peak of the Nifty 50 era of the late 1960s. Even the top 10 stocks, constituting 34 per cent of the S & P 500, have never been a bigger part of the market than today. Driven by the Mag Seven, concentration, whichever way you cut it, has never been higher.

VALUE EXTRACTS

When we look at the absolute values of these stocks, one starts to realise why this concentration has occurred. Taken together, the Mag Seven stocks, with a market capitalisation of $13 trillion, would be on their own the second-largest stock market in the world, larger than China and more than double the third-largest market, Japan. The single largest stock, Microsoft, at a market capitalisation of over $3 trillion, would on its own be the fifth-largest market in the world (just after India). Today, Microsoft and Apple individually have market capitalisation greater than the UK stock market. The scale and absolute size of this magnitude are unprecedented in my experience.

Even on the basis of profits, we are in a different world. Taking trailing 12 months' profits, the Mag Seven have a total net profit of $361 billion - almost equal to the total profits of corporate Japan and half the profit so fall the companies listed in China.

Their profits on an absolute basis are more than double the profits of all the companies listed in India ($151 billion: Source DB). Apple alone over the last 12 months, delivered a net profit of $101 billion, 70 per cent of the profitability of all listed Indian corporations (source: DB). Combined, Apple and Microsoft deliver 20 per cent more profit than all the listed companies in India. I don't think we have ever seen a phenomenon of companies with market capitalisation and profitability equal to large countries before.

However, does this scale and concentration on its own imply that we are in a bubble? First of all, while the current concentration is as high as the US has ever seen, it is not an outlier from a global perspective. All other global markets are far more concentrated. Most have a ratio of top 10 stocks over 50 per cent, and many have single stocks at over 25 per cent, compared to 8 per cent for the US. The size and profitability of these platform companies is also due to their network effects, global penetration and the inability of regulators until recently to rein them in. How do you compete against a company spending more than $30 billion a year each in terms of capex and research and design (R&D), as all the global platform stocks do? And how does one compete against Nvidia, which has the software/hardware integration, head start in graphics processing units (GPUs), and has locked much of TSMC's leading edge Fab capacity?

These competitive advantages get only further enhanced in the world of artificial intelligence (AI). The cost of compute for training and inference and the need for data ensure that only two or three global companies will dominate the development of large language models.

Either regulatory action or an innovator's inability to adapt business models to AI may be the only way these stocks lose their clout. However, while it is tempting to look at the size of the seven companies, their concentration, relative performance and the valuation of the US, jumping to the conclusion that we are in a bubble may be too hasty a judgement.

If we look at other indicators on sentiment, initial public offering, new investor numbers and margin debt levels, we are in a bull market, but not a bubble. Similarly, retail trading activity and flows into equities are not at bubble levels either. There remains a wall of worry around the US markets, and, in my opinion, we have not yet reached euphoria. Long term bull markets typically end with euphoria. It may come, as we are about to enter an interest rate easing cycle, with markets at all-time highs!

The hype around AI continues to build and will overshoot. Falling rates and easing liquidity can supercharge the AI hype further. AI provides the unquantifiable technological disruption narrative, which when combined with liquidity/leverage and sentiment, can drive markets into a bubble.

What is clear is that long-term returns from here for the US are likely to be muted. Valuations are not useful for short-term market timing as markets can overshoot and stay expensive for years. However, valuations remain the best possible predictor of long-term returns.

In the US, initial starting point valuations explain more than 80 per cent of the subsequent 10-year returns. Based on research done by BofA,

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at current valuation levels, one should not expect more than low-single digit returns from US equities over the coming decade. This comes at a time when the fiscal outlook and debt dynamics in the US has never been worse and the dollar looks set to enter a long-term cycle of depreciation. The US has had an incredible 15 years of both absolute and relative performance, and currently represents 62 per cent of global market capitalisation. It was higher than this in the mid-1960s, when there was no China and emerging markets. This relative performance dominance will reverse at some stage. The US cannot outperform forever.

While markets in the US may continue to rise in the short term, the conditions for an eventual blow-off are visible. Irrespective of this, the long term outlook for US equities is mediocre. This interplay between the short-term and long-term outlook for US equities is a delicate balance all allocators will have to strike. To the extent allocators recognise the long-term dynamic and move money overseas, India will benefit.

- Article by Akash Prakash

DISCLAIMER:

About TrustLine

At TrustLine, we run a specialized PMS / AIF fund for exclusive set of high net-worth clients (long only value based fund). We are a company with a single mission-to deliver superior long-term returns to our clients. We are managing over Rs. 1000+ crores of AUM for over 600+ highly satisfied clients. We are now one of the top 50 discretionary alternate asset managers(listed equities) in the country.

Over the years we, at TrustLine, have gained rich domain expertise by focusing and specializing in Portfolio Management Services (PMS) / Alternative Investment Fund (AIF). Unlike our competition, we are a unique firm focused only on Asset Management Services (PMS / AIF). This sets us apart and gives us a competitive advantage in the Fund Management space. At TrustLine we believe, the quality of “Research” is fundamental to delivering out-sized returns. When research is complemented by contrarian investment approach, the rewards can be dis-proportional. This forms the foundation of our investment choices and stock selection in our core PMS & AIF business. Our disciplined practice of this “Value Investment” principle has enabled us to deliver superior risk adjusted returns with significant out-performance over bench-mark indices.

With a client retention rate in excess of 95%+, we have grown as an organization through strong references, primarily driven by solid track record of building wealth across good and bad market cycles, through focused and disciplined approach to investing.

TrustLine products include:

- *Intrinsic* **Deep Alpha fund (AIF)**
- *Intrinsic* **Deep Value fund (PMS)**
- *Intrinsic* Floater **(Arbitrage fund)**

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TrustLine Holdings (P) Ltd
6/13, 3rd Floor, Equinox Building, Eastern Wing, North Avenue, Kesava Perumalpuram,
R.A. Puram, Chennai - 600 028.
Tel: 044 – 42083877, Email: pms@trustlineindia.com, aif@trustlineindia.com
www.trustlineindia.com
