

Title: The Formula One and Markets**Region: India Date: 05th August 2010 No of Pages: 2**

In my early college going days I used to be fascinated by the stock markets movements. Especially by the sense that prevailed even in the chaos in the erstwhile “Ring” or the trading pit of the Bombay Stock Exchange. I always used to wonder apart from that chaos, what moves the stock market indices to higher or lower levels. The most straight forward answer I used to get is the “Valuations”. And I did learn later that the most common measure used for stock market valuation is the Price to Earnings Ratio (henceforth PER). This ratio is nothing but the value of a stock index such as NIFTY Index, divided by the earnings per share of the companies constituting the NIFTY index (henceforth EPS). Thus the PER is the number of times its earnings that the buyer of a stock or index is willing to pay.

One can thus derive the value of index by simply multiplying the EPS by the PER. The PER can be on historical EPS or a forward looking (analyst’s community forecasts) EPS value of the Index constituents. So the two factors that influence the value of market indices the most are the EPS and PER. The market direction will be decided by either PER or EPS going up or down or the interplay between them.

Do markets become expensive only because of a sharp rise in the index? Or if markets fall drastically, have the markets become very cheap only due to the fall? The answer to both the questions are NO. It depends on what is driving the markets fall or rise. Whether it’s only the PER or EPS or a combination of both that are driving the markets. Table I below offers a simple Rule of Thumb for market valuations with reference to changes in EPS & PER. Not every fall or rise in PER makes the markets cheaper or expensive.

Table I: The Interplay & Misalignments between EPS, PER, and Markets

EPS (Forecast)	PER	Likely Changes in Index Value	Valuations	Remarks
Lower	Same	Lower	Expensive	Index lower but Expensive
Lower	Higher	Higher	Expensive	
Lower	Lower	Lower	Fair	Index lower but not Cheap
Higher	Same	Higher	Cheap	Index higher but Cheap
Higher	Higher	Higher	Fair	Index higher but not Expensive
Higher	Lower	Lower	Cheap	
Same	Higher	Higher	Expensive	
Same	Lower	Lower	Cheap	

Source: Delta Global Partners Research

Let’s try and account for the market movements in the last one year? Is it the PER expansion or EPS upgrades or both that explain the movements? Please refer to the Table II below.

In the last one year the NIFTY Index returned around 16%. *The market returns were almost entirely driven by the rise in or the expansion of PER (+17%)*. The huge amount of Net FII investments of Rs 88,118 crs in the last one year is also one of the prime reason for the PER expansions. The consensus EPS estimates for FY11 were in fact revised lower by 1%. We all know that in the long run the Economic Growth and the Corporate earnings (EPS) growth should drive the index values and not only the standalone PER expansions.

Usually a PER expansion leads an earnings one. If the stock market rallies are driven solely by PER expansions, the same should be followed by an Earnings or EPS expansions, to make the rally sustainable by bringing the PER lower. In other words the Earnings or EPS growth should catch up with the PER expansions. In case the EPS growth does not catch up there would be

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realignment in the market index value, on the lower side.

Table II: What drives the markets?

Period	NIFTY PER on Consensus FY 11 EPS estimates (in times)	NIFTY Consensus FY 11 EPS estimates (in Rs)	NIFTY Index	YOY change in Net FII investments (Rs in crs)	YOY change in Net Domestic Mutual Funds investments (Rs in crs)
31-Jul-09	15.0	310.0	4,636		
31-Jul-10	17.6	306.0	5,368		
YOY change	2.6	-4.0	732	88,118	(22,244)
YOY change in %	17%	-1%	16%		

Source: Delta Global Partners Research, IDFC-SSKI, www.moneycontrol.com

To conclude earnings growth needs to catch up to match the PER expansions. Any disappointment vis a vis the expectations would be negative for the markets. Stock market rallies driven only by PER expansions especially liquidity driven, don't last forever. Rapid standalone PER expansions are like the driver of a Formula One racing car, who usually drives it at a breakneck speed. And the Earnings or EPS growth are like the fuel held in the car. To travel longer distances the car will need refueling more often. Even the best of car drivers with the most powerful cars can cover only limited distances without refueling.

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