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THE SINE CURVE: WINDS OF CHANGE - PART 2

NEWSLETTER • JULY '24

"THE HISTORY OF MARKETS IS ONE OF OVERREACTION ON BOTH SIDES" - PETER BERNSTEIN.

"THE FACT IS THAT STRATEGIES WHICH PERFORM BADLY IN CERTAIN MARKET CONDITIONS CAN WORK SURPRISINGLY WELL IN OTHERS" - PETER BERNSTEIN.

The June **'Winds of Change'** impacted Ambit 365 adversely. The month's top performers were IT, private banks, and consumer companies, sectors we have been short on for the last eight months. The worst performers were industrials and PSUs, sectors in which we have been positive. While we recalibrated the long book quickly- and recovered well, the short book just kept hurting us through the month. We lost 2% in June; short book attribution was more than -3%. **Since its inception (6th October '23), the NAV is up 12.7%, and we are on track for our indicated annual performance.**

In the last newsletter, 'Winds of Change,' we wrote about the possibility of cycle rotation and our introspection. While the real reasons for a cycle rotation may differ, we often need a catalyst. The weaker-than-expected performance of the ruling government in India in the June elections was a significant factor that forced people to think about whether the economy (and hence the stock performances) was becoming a little lopsided. The expectation that Government policies will try to address the weak rural and semi-urban demand issues is strong. The trigger also forced the market attention to relative valuations between the underperforming and the outperforming sectors. We believe there are solid arguments for mean-reversion here, and we will show a few charts in this note to support this.

We see three major trend reversals underway. **1. Rural demand/ FMCG upturn** - growth is expected to improve to 8-10%, as indicated by companies, compared to 3-4% earlier. **2. The IT sector is bottoming out,** as indicated by an uptick in net hiring numbers. **3. PSU Banks consolidation** - after three years of outperformance over private banks- as the valuation gap has narrowed to - for example, HDFCB/SBI price-to-book ratio (TTM) has narrowed to 1.5x from 5x three years ago.

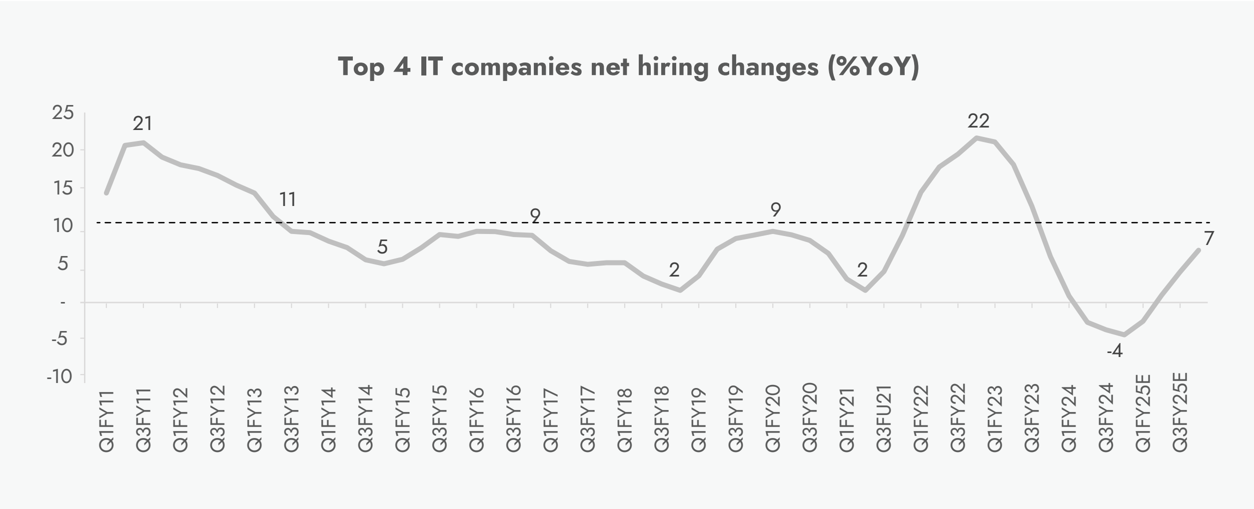
Table 1: FMCG companies related commentaries

Companies	Management commentary for Q1FY25
Marico	The company expects consolidated revenue growth to trend upwards during the year, driven by an improving trajectory in domestic volume growth and higher realizations.
Dabur	The company expects mid to high single-digit volume growth and talked of improvement in rural demand trend.
GCPL	India's business growth was broad-based, with volume growth in double-digits.

Source: Company's press release

As per Kantar, rural staples volume growth of 5.8% in the March quarter exceeded the urban volume growth of 4.7% - for the first time in four quarters. Industry players expect the trend to gather pace.

Chart 1: IT companies' net hiring trend is changing



Source: TCS, Infosys, HCL Tech & Wipro financials & Investec Research

The Sine curve of relative valuations: We present four interesting relative valuation charts to show how extreme these may have come, preparing a solid ground for mean reversion. We compare the PE ratio of three large-cap companies from the underperforming sectors with ABB. We chose ABB - as the most bullish representative of capex cycle optimism. a) HUL is the largest consumer company, and the volume growth deceleration has been the sharpest. Volume growth has declined from 7% in Mar'19 to 2% in Mar'24. b) Infosys, which has been underperforming the Nifty and IT peers, and c) Dr Reddy's - valuations have been under pressure despite a strong revival in US generics. Last, we compare the PB of HDFC Bank to SBI to illustrate how valuation convergence has occurred.

Chart 2: TTM P/BV (x) - HDFC Bank / SBI

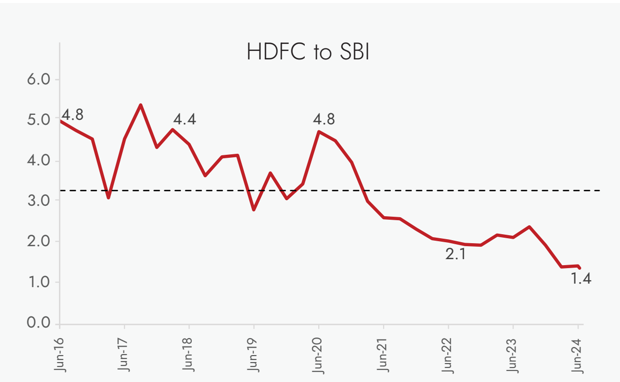
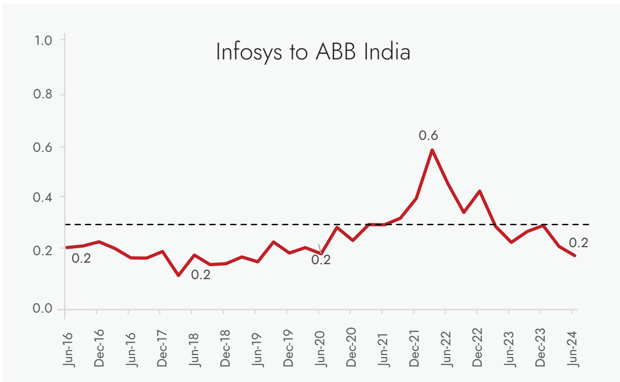


Chart 3: TTM P/E (x) - Infosys / ABB India



Source: Bloomberg

Chart 4: TTM P/E (x) - HUL / ABB India

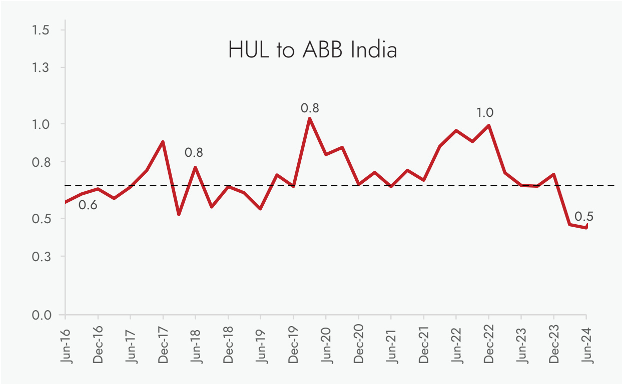
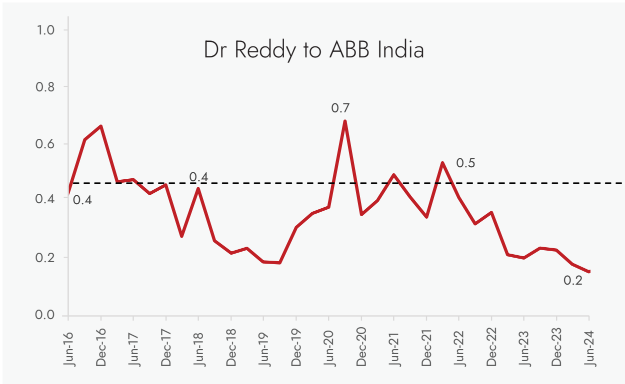


Chart 5: TTM P/E (x) - Dr Reddy / ABB India



Source: Bloomberg

OUTLOOK: VALUATION SENSITIVE VS. VALUATION AGNOSTIC

Why now? Why has the market suddenly become valuation sensitive as compared to valuation agnostic? As Peter Bernstein said, markets over-exceed on both sides, and different strategies need a (sometimes just a little) environmental change. This is why rotation always needs a catalyst- a little shock. The election results can be that event that has shifted focus. This is what COVID-19 did on a much larger scale. PSUs- pre-Covid- were trading at low single-digit trailing PE and below book value for almost two years. In some ways, the government policies to address the COVID-19 impact were favorable to beaten-down capex, industrials, and PSUs, and the cycle rotated. The election results have shifted the focus to the margin of safety, which many out-of-favor sectors offer.

Ambit 365 is now aligned with the changed winds. We are long FMCG (Nestle, thinking of adding more names), private banks (ICICI, we bought and booked profits in HDFC), IT services (Infosys, Techm, Wipro. We booked handsome gains in Persistent), and pharmaceuticals (Divis, Dr Reddy's and Lupin). We have shorts on names with steep relative valuations, like ABB, BAF, and Titan. Whether this is just a mean-reversion rotation or something larger still needs to be considered. The rotation is underway- the Sine Curve is on the move!

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