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THE ALPHA DETERMINANTS OF FUTURE

(Return of CPG)

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NIFTY MID CAP 100 can touch 60K (DOUBLE) while NIFTY SMALL CAP 100 has the potential to touch 30K (TREBLE), in about 5 years

In my last article “Amidst The Ongoing Correction” which was released on 13 May 2022, I had taken out my frustration on “feelings of world coming to an end type of situation for the whole investors’ and traders’ fraternity whenever there is a sharp and deep correction in the stock markets”. The result is here in front of us **again,** that why we should have bought into that correction as well. This also proves my point again that why we need to look at the bigger picture and not just be myopic. If we think like an economist then will we be able to make money from investment in stock markets? The answer is emphatic “no”. This is not because economists do not have the ability to predict the future economic scenario. They have to deal with their own set of complexity in the forecasting. However, as far as stock market investments are concerned, current economic indicators are lagged in nature. Stock markets try to bake in three months to three years economic performance of the country or the globe, now. Therefore, it is said that stock markets never look into the rear-view mirror. They always look through the wind screen and be ready for the opportunities and challenges coming in the future.

Now, coming to the stock markets, the globe is gasping to breathe fresh air and Indian equities are outperforming the global stock markets. Indian equities have become the blue-eyed boy of Foreign Institutional Investors’ (FIIs) once again. More importantly, the “Broader markets” are performing better than the” Narrow market” in India. By the way, this is not mere by chance. Look at the last decade and recollect why Mid & Small Cap stocks became the victim in the second half of the last decade. I would attribute that to the “Absence of required corporate profit growth” which is the most important factor for the valuation of companies to sustain. Corporate world and Indian economy had to deal with many factors such as Demonetisation & IL&FS event etc. While the Indian economy and corporate world looked to be overcoming from these challenges in early 2020, India and the world were badly struck by Covid19 which brought global economies on to their knees.

As the world including India tries to overcome the perils of Covid19, we have to face increasing level of Geopolitical uncertainties. Amidst all the negatives, there one big positive on which I want to focus on currently and which is the premise of this article i.e., "Corporate Profit Growth".

As per the latest data, the Corporate Profit Growth (CPG) to GDP ratio is about 4.30% for India, which is about a decade high. If the CPG is sustained in future too, then it will keep one important factor under control i.e., Trailing and Forward PE. As long as companies are adding expected EPS, the valuation may not be a concern as it will always remain within the tolerable limit.

There is one more factor which could endorse a higher economic growth for India i.e., Credit Growth. The credit growth has increased from about 5-6% last year to about 15% as per the latest data released. Moderately high Credit growth propels CPG as well. This could be one more factor supporting the sustained CPG in future. A 15% credit growth may look very high and may be even concerning to a few. When we look into more detail, it will not look very concerning because the 15% credit growth is taking place at a lower base and therefore, it should not be considered as a cause of concern for higher inflation in future. Apart from this, RBI is also monitoring to keep the credit growth under watch and around the desired level in a way that it is supportive for the economy as well as not letting it to cause higher inflation.

Now, if the future of Indian equities looks promising (at least to me), then how do we position ourselves. And that's the crux of the question. The analysis says that developed economies have saddled themselves with debt during Covid19 and due to that, inflation has come haunting them. India is also witnessing higher inflation, however, that is controllable because Indian Central Bank (RBI) did not print money breathlessly. Government of India (GoI) and RBI supported the people and the economy with a mix of cash and kind as per the need assessed. This controlled the sloshing of money in the Indian economy which could have led to an uncontrollable inflation.

Because of the above situation, it is possible that the future and could be even this decade, may belong to the emerging economies with India being on top of the mind for all global investors. This may, in turn, lead to emerging markets equities outperforming developed market equities. Now, within emerging markets, India carries the second spot in terms of weight after China. India's weight in emerging market economies have been increasing consistently. There is another murmur going on that South Korea could move out of the emerging market index to enter the developed market index. This would further increase the weight of India in emerging market index and therefore, attracting more flow of capital.

So, up till here, filters shortlist Indian equities as best destination in the times to come. When we look into more detail, it seems that Mid & Small Cap indices could outperform Large Cap (Narrow Market) over a time frame of 3-5 years. As it is said, a picture speaks more than the thousand words can convey, so I take help from the below charts and tables to explain where do I see Nifty Mid Cap 100 and Nifty Small Cap 100 over 3-5 years and why.

NIFTY MID CAP 100 (Index)

Nifty Mid Cap 100 had risen about 3 times from the low of about 3,300 in July 2005 to the high of 9,781.70 in January 2008. This was the time period when the rise in index was also accompanied by the CPG. During this time frame Nifty rose by about 3 times. After this, the Nifty Mid Cap 100 index had fallen from the top of 9,781.70, made in January 2008 to the bottom of 2,930.75, made in March 2009. This was a massive 70% fall from the top. During the same period Nifty corrected by about 65%. It took Nifty Mid Cap 100 about 6 years to clear the top made in January 2008. Finally, this top was cleared in May 2014. This top was cleared against the expectation of the potential revival in corporate profitability, post the BJP took the reins of country. This expectation, however, was not met due to many unfavourable circumstances arising in between. As a result, investors lost the patience and finally, the index formed an intermediate top of about 21,840 in January 2018. The correction in the index was accentuated due to the arrival of Covid19. In this correction Nifty Mid Cap 100 made a bottom around 10,750 in March 2020, alike many other indices. This had resulted in the correction of

about 50% from the top of 21,840. The index indicated a breakout on 04 November 2020 from the downward sloping trendline. After this breakout, there was no looking back for this index and it recently even tested the 4.23 times retracement of the fall from 9,781.70 to 2,930.75 i.e., 31,951.60 in October 2021. The important point to note is that a major part of the rise took place while corporate profitability was on the rise.

NIFTY MID CAP 100 (Index)

After completing this one full cycle, the Nifty Mid Cap 100 started to correct and travelled close to the 38.20% retracement of the rise from the low of 10,750 to the high of 31,950.60 i.e., 24,651. In fact, the index returned little early after making a low of 25,048. It was difficult to conclude whether the index has completed the correction until a potential breakout was observed from the falling trendline on 05 August 2022. Though the breakout looks formidable enough, the confirmation of it will depend upon whether Nifty Mid Cap 100 is able to cross and sustain above the high of 31,950.60. If it does, then there is a possibility of a new trend starting for the index.

Further, the rise from 10,750 to 31,950.60 also looks like Wave 1 for which the Corrective Wave 2 also seems to have got completed after the index potentially indicated a breakout on 05 August 2022. As mentioned, the confirmation will take place only if the index is able to surpass and sustain above 31,950.60.

Given the recent results of corporate and world's view towards Indian equities, it is highly likely that Nifty Mid Cap 100 index will test 2.618 times retracement of about 40,000. In case the CPG continues, then it is possible that the index will test the 4.236 times retracement of about 58K. Further, in a stretched case scenario, it is possible that the index will try to test about 60K.

The above theory gets negated in short to medium term if the index is not able to sustain above the 38.20% retracement of about 24,650. In that case, it is possible that a larger correction could take place even towards 20K before the next leg of Bull Run begins.

Nifty Mid Cap 100 index had performed extremely well during the Bull Run of 2004-2007. This was also the era where CPG was strong. The index returned more than 3 times in this 3-4 years' time frame. Given the past performance of the Nifty Mid Cap 100 index and the conducive environment of GDP growth and CPG in India, I expect that the index may repeat the history once more and would try to surpass 4.236 times retracement even this time to complete the cycle to kiss 60K or thereabout. If this happens then the index has the ability to about DOUBLE from the current level. Also, if CPG is not derailed, then this target could be achieved in about 3-4 years i.e., either by FY2026 or CY2026.

NIFTY SMALL CAP 100 (Index)

Nifty Small Cap Index rose by about 4.75 times from the low of about 1,270, made in January 2005 to the high of about 6,048, made in January 2008. This was an outperformance to Nifty

Mid Cap 100 index by about 1.75 times. Nifty Small Cap 100 index fell by about 78% in between January 2008 to March 2009 from a high of about 6,048 to a low of about 1,362. Contrary to Nifty Mid Cap 100 index, Nifty Small Cap 100 index has just tested the 1.618 times retracement of this fall and is about to test the 2.618 times retracement. While Nifty Mid Cap 100 index cleared the top made in March 2009 in May 2014, Nifty Small Cap 100 index did it in January 2017 i.e., with a lag of about 2.5 years.

NIFTY SMALL CAP 100 (Index)

The above phenomenon helps us make two important inferences.

1. Small Cap index performs with a lag to Mid Cap index.
2. Small Cap index does better than Mid Cap index in the times of consistent CPG.

Alike Nifty Mid Cap 100 index, Nifty Small Cap 100 index could also try to head towards the 4.236 times retracement of about 21K (Retracement of the fall from the high of about 6,048, touched in January 2008 to the low of about 1,362, made in March 2009). If we take into account the outperformance which was witnessed during the CPG period of 2005-2008, it is possible that Nifty Small Cap index could outperform Nifty Mid Cap index once more and could head towards the 4.236 times retracement of 30K or thereabout (Retracement of the fall from the high of 9,656.55, touched in January 2018 to the low of about 3,203, made in March 2019 i.e., Covid19 low).

Small Cap index outperforms Mid Cap index with a lag. The lag could span from about a year to 3 years depending upon the circumstances. While Nifty Small Cap 100 index could double towards 20K in line with Nifty Mid Cap 100 index by either FY2026 or CY2026, the outperformance may start once the Nifty Mid Cap 100 index completes the cycle of 4.236 times rise. On these lines, in case the CPG continues for 5 years or thereabout, Nifty Small Cap 100 index even has the potential to treble from the current levels and head towards 30K in about 5 years.

NIFTY

For the similar time frame discussed above, Nifty is yet to achieve the cycle target of about 20-21K. I had covered this projection in my report **"Kaizen Nifty – The New Generation Nifty @ 20,500"** on 27 November 2020. I had given this projection for FY24 or FY25, however, given the momentum that Nifty has gained and support from FII buying, it is possible that the 20-21K cycle target of Nifty could be achieved by FY2023 itself. Post that, depending upon the fundamentals, Nifty may begin the next cycle which could take it towards 35K. I have covered this in my report **"Kaizen Nifty @ 35,000"** released on 01 December 2021.

Let's now compare the return of Nifty, Nifty Mid Cap 100 and Nifty Small Cap 100 from the bottom made in October 2008 and March 2009 respectively to the recently made high in October 2021 and January 2022. Also, we will try to relate this with the behaviour in terms time during breakout points. Apart from this, we will try to capture the long-term behaviour of these indices against each other.

	Nifty	Nifty Mid Cap 100	Nifty Small Cap 100
High	6357.10	9781.70	6048
Month & Year	Jan-08	Jan-08	Jan-08
Low	2252.75	2930.75	1362.5
Month & Year	Oct-08	Mar-09	Mar-09
Cleared Jan-08 High In	Mar-14	May-14	Jan-17
Recent All Time High	18604.50	33243.50	12047.50
Month & Year	Oct-21	Oct-21	Jan-22
Return From Low to Recent All Time High	8.25 X	12 X	8.85 X

The above-mentioned table and the charts help us make few important inferences.

1. The presence of CPG is absolutely necessary for a sustained performance of the broader market.
2. There can be hope rally in anticipation of CPG, however, if CPG does not arrive, valuations catch up with the reality and corrections take place. Further, the correction will be more intense in the broader market. We have seen this phenomenon in between 2014-2018 where disparity corrected itself and it took many years for CPG to lift Mid & Small Cap stocks again.
3. Small Cap index performs with a lag to Mid Cap index.
4. Small Cap index does better than Mid Cap index in the times consistent CPG.
5. Mid Cap stocks may behave in line with Large Cap stocks in short to medium term, however, over the longer term, their outperformance to the large cap stocks is clearly visible.
6. Rally/Correction begins with Large Cap in anticipation of the cycle. Mid Cap stocks also catch up with the similar move with minor lag; however, the outperformance does take place over the longer term when the anticipated event actually plays out.
7. Small Cap are the last in queue to catch up, however, they catch really well only when the event plays out. In case the event does not play out, they are the first to fizzle and most to get battered. One of the reasons for this could be limited liquidity in Small Cap stocks leading to larger impact cost.
8. Small Cap index/stocks outperform Mid Cap index and Large Cap index with a wide margin during the era of CPG.
9. The presence of CPG is absolutely necessary for a longer term sustained uptrend in stock markets followed by the outperformance of smaller indices over the big boys.
10. The arrival of double-digit credit growth and sustenance boosts the CPG.

As we could be in the era of sustained economic and corporate profit growth (CPG) led by structural reforms, it is possible that Indian stock markets would see multiple cycles of upside. This could make Nifty to pass on the baton to Mid & Small Cap stocks over a period of time

Note - I have captured about 15 years of data in this analysis due to the limited availability of data. Therefore, we will be able to read one complete cycle of CPG and then try to extrapolate for the projections.

As I am taking this call for a long-term, I also need to call out few events which could work as dampeners and could delay the timeline.

1. General Election in India in 2024
2. Global Geopolitical Events (Unfavourable)
3. Loss of Traction in CPG
4. Loss of Traction in GDP of India
5. Deviation of the world from China + 1 policy
6. Advent of natural calamity such as Pandemic/Epidemic
7. Unfavourable Government Policy Decisions
8. Domestic Inflation getting out of control
9. Populist measures of GOI ahead of General Election
10. Global economies facing deep recession for long

The journey to 60K for Nifty Mid Cap 100 and to 30K in Nifty Small Cap 100 will not be a straight line. It will be filled with undulations and the corrections including deep corrections should only be treated as opportunities to buy.

Therefore, if one is looking to generate ALPHA in cash market then, apart from Large Cap Stocks a decent chunk must be allocated to **QUALITY** Mid & Small cap stocks as and these will function as **"The Alpha Determinants"** of the overall portfolio**.**

The reason I write the reports like "Kaizen Nifty – The New Generation Nifty @ 20,500" or "Kaizen Nifty @ 35,000" or "The Alpha Determinants of Future" is because when you refer to these reports in future and look back, it will help reaffirm the concept of Wealth Creation via long term investment and why we should be focusing on building the ability to look at the bigger picture to be able to create wealth over a period of time, conserve it and grow further.

P. S. – I wanted to write and release this report at the fag end of CY21 itself; however, I wanted to wait and ensure that there is a fair degree of certainty of sustained Credit growth and CPG in the economy. This is because unless relevant fundamentals are in place, the projections

cannot be made with desired accuracy. This again emanates from my theory of **GEDETEF.** In this particular analysis, the "DE" component is not required.

GE – General Economy 3-5 years hence
DE – Derivatives Data
TE – Technical Analysis
F – Fundamental Analysis

Cheers!!!

Happy Investing!!!

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