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IN AN ELECTION YEAR, CUT THROUGH THE NOISE AND FOCUS ON THE FUNDAMENTALS

POWER POINT

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Whether the general elections impact markets over a longer term or not, it certainly makes an interesting topic of discussion in the months before the run up to the elections. The first half of 2019 would be swarmed by political news and equations that could probably shape the fortunes of the next government at the centre. What investors fear is the market volatility that could crop up due to any unexpected election result and if this should make them more conservative, focusing on debt in the run up to election. The state elections that concluded in December 2018 were considered by many as a semi-final for the upcoming general elections. With the BJP losing the elections in three key states (Rajasthan, Chhattisgarh and Madhya Pradesh), many investors have started formulating a trend that could emerge in the 2019 general elections.

Having said that, in the last six elections since 1998, these three states haven't had a conclusive bearing on the following general elections. A party crossing the winning line during the state election does not necessarily repeat the performance at the centre. Also, the general observation is that the voting pattern during state elections and the centre elections has seen variance in the same constituencies.

Another aspect that is worth pondering over is the market reaction up to four months prior to the general election date and four months hence. Empirical evidence seen in the Indian equities across the five general elections (since 1996-2014) is that the market trend generally is not altered due to election results over an extended time period.

While we do agree that the impact might be felt for a few trading days prior and post the election (maximum up to 10 days), investors should not really be worried and stick to their asset allocations as they enter elections.

While trends of a bullish movement have always played out over an eight-month period, the opportunity that investors have is to take a call on the slope of the trend. A continuation of policies from the same government should result in more momentum while new policies from a different combination of parties would keep the trend volatile.

What should matter more to investors while making decision of whether to invest into equities or not would depend on how the market valuations and earnings outlook look like in the time horizon they wish to stay invested. Over the last 20 years, market returns have been primarily influenced by the price-to-earnings (P/E) levels and expected earnings growth. With this perspective in mind, event-based investment would not matter much for long term investors.

> **India's macro stability and prospects of higher earnings growth remain intact for FY20**

It is time to cut through the noise and focus only on the fundamentals that determine market trends over longer periods. If one looks at the Nifty 50 index price CAGR and EPS CAGR since FY01 through FY18, one can infer that EPS growth and market returns are significantly correlated. Here, we have broadly bucketed the data into two phases—pre and post FY2008. The market CAGR over both the phases is closely mirroring the EPS CAGR over same periods. Between FY01 and FY08, the price CAGR reported a 22% return on an EPS CAGR of 21%. While between FY08 and FY18, the price CAGR surged to 7.5% on a 5.5% EPS CAGR.

Recent 'trust deficit' in the markets seems to have stalled runaway market rally and is reflecting in slowing down of domestic MF flows. Global uncertainties (trade war, crude and emerging market flows), geopolitical tensions in the subcontinent and uncertain domestic political scenario continues until May 2019. However, India's relative macro stability and prospects of higher earnings growth remain intact for FY20 and beyond. The analysis provides comfort that with expected earnings recovery, market performance is a matter of time.

Despite this empirical evidence, we would base our recommendations and portfolio advice contingent on investors' risk tolerance, viz. aggressive, balanced and cautious. Aggressive investors with a two-year plus investment time frame could look at building a purely equity portfolio from now until elections. A more measured investor, with a similar time frame, can look at passive strategies in their core equity portfolio. As for the cautious investor or for those who want to wait it out until elections are out of the way, products that offer minimum fixed return could work the best. Whatever the result, there are interesting strategies to participate on the upside though an aggressive to measured framework of investments is recommended.

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