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# Are US Equities in a sweet spot:

## Does an appreciated INR makes it sweeter for Indian Investors?

Enhance Safety, Enhance Returns

# Are US Equities in a sweet spot: Does an appreciated INR makes it sweeter for Indian Investors?

## US markets present several well-known companies with popular products across multiple sectors

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*"One can start with a 5% to 10% allocation to US markets and take it up to 20-30% depending on the suitability to their investment goals and risk profile"*

Indian investors are attracted to the US markets because of the presence of well-known companies with popular products. However, the dilemma is whether these companies present the right investment opportunity, especially, currently? Or does the US market as a whole present an investment opportunity? What about companies which are lesser known in India? Maybe those present a better opportunity?

*"It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts."*

***Sherlock Holmes***

***"A Scandal in Bohemia", Arthur Conan Doyle***

A scientific approach to the question of capital allocation requires collecting the required data before forming an opinion as to the relative attractiveness of a different asset classes.

US markets present several well-known companies with popular products across multiple sectors as shown in Exhibit 1 below.


Exhibit 1: US Market products and services. Source: OmniScience Research

## Investigating the US Economic Fundamentals

Fundamentally, the US economy is on a strong footing. Despite, Covid-19-related disruption, the US nominal GDP dropped by barely -1.2%. The 2021 nominal GDP growth is expected to be around 6% 2022 around 5.3% and 2023 around 4%.

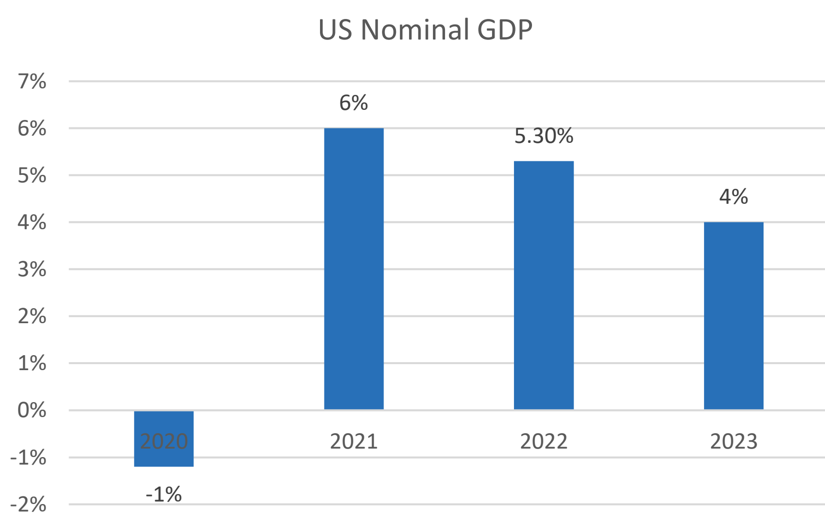


Exhibit 2: US Nominal GDP Projections. Source: OmniScience Research | Federal Reserve, Summary of Economic Projections Dec. 16, 2020 (link).

The Unemployment rate at the end of 2020 was 6.7% and is expected to be 5% in 2021, 4.2% in 2022, and 3.7% in 2023.

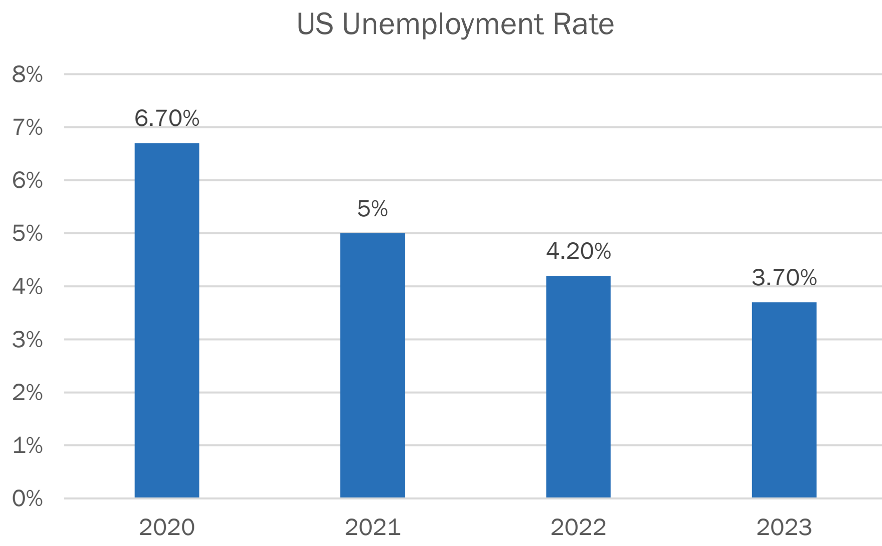


Exhibit 3: US unemployment rate Projections. Source: OmniScience Research | Federal Reserve, Summary of Economic Projections Dec. 16, 2020

Inflation at the end of 2020 was 1.4% and is expected to be in the range of 1.8%-2% during 2021-2023.

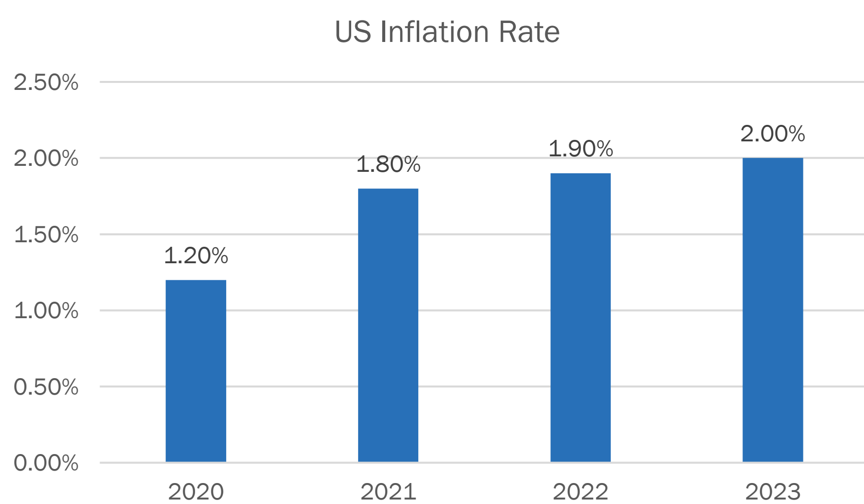


Exhibit 4: US Inflation rate Projections. Source: OmniScience Research | Federal Reserve, Summary of Economic Projections Dec. 16, 2020

Nominal GDP above 4% growth rate, i.e., nearly $1 Trillion addition to GDP every year for the next several years, combined with reducing unemployment rate dropping towards the *natural unemployment rate* around 4% and inflation rate sustaining at around 2% is considered ideal for the US economy.

All these fundamental data point to a robust and healthy economy which has fully recovered from the Covid-19 disruption and is well on its way to utilize the fiscal and monetary stimulus programs towards a strong economic growth with increasing employment.

Now that we have established that according to the most authentic data available at this time, the US economy is on strong fundamentals for the next several years, it is likely that the US-listed companies would also have strong revenue and earnings growth. In fact, the US economic growth would be a result of the revenue and earnings growth of the US companies.

Given that the fundamental growth of US companies over the next several years has a strong likelihood, the most important question to focus on is: *Are the valuations appropriate?*

## Investigating the US Bond Market Data

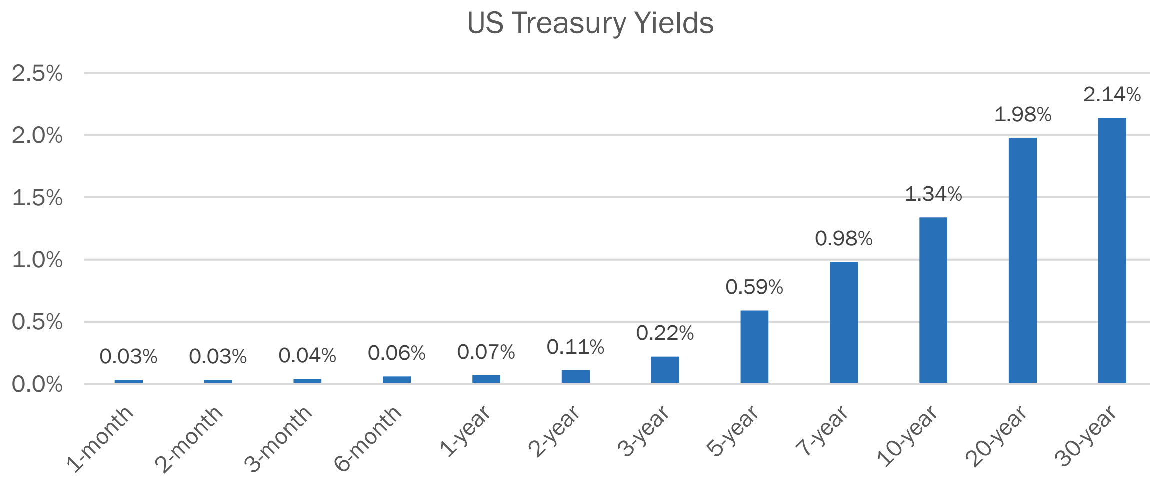


Exhibit 5: US Treasury Yields. Source: OmniScience Research | Treasure.gov as of 19th Feb 2021.

| | US Treasury Yields | US Treasury PE Ratio |
|---|---|---|
| 1-month | 0.03% | 3333 |
| 2-month | 0.03% | 3333 |
| 3-month | 0.04% | 2500 |
| 6-month | 0.06% | 1667 |
| 1-year | 0.07% | 1429 |
| 2-year | 0.11% | 909 |
| 3-year | 0.22% | 455 |
| 5-year | 0.59% | 169 |
| 7-year | 0.98% | 102 |
| 10-year | 1.34% | 75 |
| 20-year | 1.98% | 51 |
| 30-year | 2.14% | 47 |

Exhibit 6: US Treasury Yields and PE Ratio. Source: OmniScience Research | Treasure.gov as of 19th Feb 2021.

The US Treasury yields show that even for the 30-year bonds, the expected returns are 2.14% if held to maturity. This translates to a PE ratio of 47. 10-year bonds are yielding 1.34% with a PE ratio of 75.

## Investigating the US Stock Market Valuations

To understand how the stock market is currently being priced by Mr. Market—the collective version of all investors—we look at the ratios of different indexes. S&P 500 represents the US large-caps, S&P 400, the mid-caps, and S&P 600, the small-caps. S&P 1500 Information Technology index represents all the companies within the composite universe of large, mid, and small caps which are from the Information Technology sector. S&P 600 Information Technology index represents the small cap companies which are from the information technology sector.

What we observe is that the large-caps are at a slight premium to the mid and smallcaps. All the broad indexes are in the range of 20-22 PE. The S&P 1500 Info Tech index is at a premium with a PE of nearly 27. The S&P 600 Info Tech is at a slight premium with PE of 22.

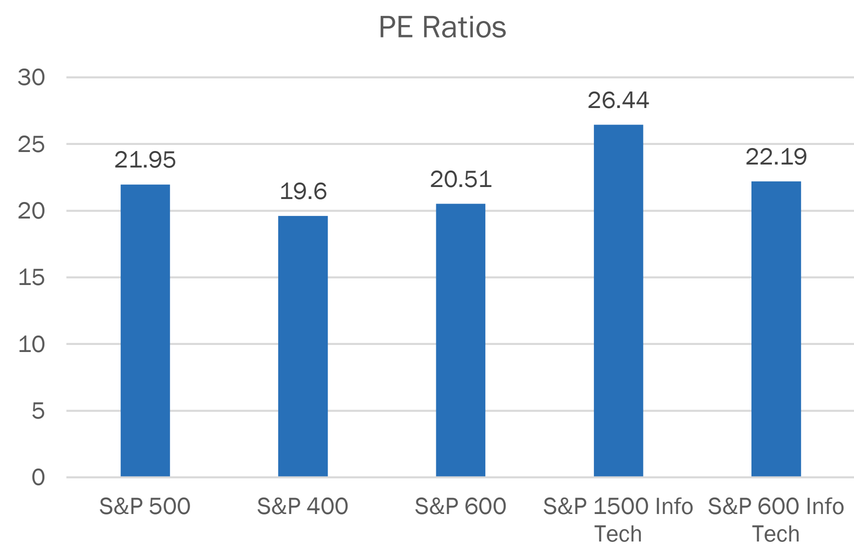


Exhibit 7: US market P/E Ratios. Source: OmniScience Research | S&P Global Indices, Fact sheets Jan 29, 2021

| Index | PE (Projected) | (Projected Earnings) Yield |
|---|---|---|
| S&P 500 | 21.95 | 4.6% |
| S&P 400 | 19.6 | 5.1% |
| S&P 600 | 20.51 | 4.9% |
| S&P 1500 Info Tech | 26.44 | 3.8% |
| S&P 600 Info Tech | 22.19 | 4.5% |

Exhibit 8: US market projected P/E Ratios and yields. Source: OmniScience Research | S&P Global Indices, Fact sheets Jan 29, 2021

Estimates show that nearly 90% of the earnings is paid out as dividends and buybacks. (Source: Data from Ashwath Damodaran http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html)

Based on this, we estimate that the pay-out yield or free cash flow yield to equity holders is as shown below:

| Index | Pay-out Yield |
|---|---|
| S&P 500 | 4.1% |
| S&P 400 | 4.6% |
| S&P 600 | 4.4% |
| S&P 1500 Info Tech | 3.4% |
| S&P 600 Info Tech | 4.1% |

Exhibit 9: US market Pay-out yields. Source: OmniScience Capital Research

The expected return would involve a growth factor. The US nominal GDP is expected to grow at 4-6% in the next few years and continue at 4% over the long-term. The S&P 500 companies have nearly 50% revenue from rest of the globe. The global nominal GDP is expected to be 8.5% for 2021 and 7.2% for 2022 (assuming an inflation rate of 3%). (Source: https://www.imf.org/en/Publications/WEO/Issues/2021/01/26/2021-world-economic-outlook-update)

Accounting for this, the expected growth rate for S&P 500 companies is around 5.5%-6%. This tallies well with the analyst estimates in Damodaran's data which is around 5.4%.

## Expected Return Estimates for an Investor in the US markets today

*Disclaimer: Any calculations or estimations of Expected Returns cannot be assumed to be a prediction about the actual returns in the future. These are estimates based on the particular methodology and the data being used which incorporates known information at this point of time. Future can have numerous unexpected events which cannot be accounted for today. See detailed disclaimer at omnisciencecapital.com/disclaimer*

If the companies remain profitable with free cash flows, the investor in the US markets would get the pay-out yield as shown in the table above. Further, the additional returns would come from the growth rate of these companies. The sum of the pay-out yield and expected growth rate is an estimate of the total expected return. There is one more factor which will impact the actual holding period returns. This is the yield at the time of selling. If the yields at the time of selling are higher, i.e. the PE ratios are lower, then the total returns for the investor will be lower. Similarly, if the ending yields are lower that is the PE ratios are higher, then the total returns would be higher still.

Based on this, the expected returns for an investor in S&P 500 is 4.1%+5.4% = 9.5%.

Even for a purely domestic revenue growth of 4% this translates to an 8.1% return for S&P 500.

Let us factor in the ending PE ratio or yields as well.

Expected Returns of S&P 500 in USD

However, if the interest rates go higher eventually and if the ending PE ratio is lower, say around 19 ten years later, i.e., an earnings yield of 5.2%, the total return from growth will be 3.87%. Adding, the pay-out yield of 4.1% will give a total annualized return as nearly 8% for a global revenue company and 2.49%+4.1% =6.59% for a domestic revenue company.

Expected Returns of S&P 500 in INR

All the above are USD-based estimates. For INR-based estimates one can add the INR depreciation rate over the long term. This would be around 2-3% or so. Over the past 10 years, the INR has depreciated at the rate of 4.9% per annum. *This means that the S&P 500 could return around 8.6% to 12.9% in INR terms* (assuming the lower bound of S&P 500 USD returns and the 2% INR depreciation rate and the upper bound of S&P 500 USD returns and the 4.9% INR depreciation rates).

Near term growth rate data is much more optimistic that our assumptions above

According to Yardeni Research[1], based on data from Thomson Reuters I/B/E/S, S&P 500 earnings are expected to grow at 24.4% in Calendar Year 2021 followed by 15.4% in CY2022. Even being sceptical about forecasts, the forecasts are quite positive and high.

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1 https://www.yardeni.com/pub/performancesapearningsrevenues.pdf

## What have the actual returns of S&P 500 and Sensex 30 been in the past?

The actual returns from S&P 500 and S&P BSE Dollex 30 are shown in the table below. The data shows clearly that the S&P 500 has delivered significantly higher returns in USD terms compared to Dollex 30, which is the USD version of Sensex 30.

| Index/Returns (USD) | 1-year | 3-year | 5-year | 10-year |
|---|---|---|---|---|
| S&P 500 (USD) | 17.25% | 11.7% | 16.16% | 13.5% |
| S&P BSE Dollex 30 (USD) | 12.53% | 5.19% | 13.04% | 6.22% |

Exhibit 10: Benchmark returns in USD. Source: OmniScience Research | S&P Global Indices, Fact sheets Jan 29, 2021

We also show the INR version of the same data. This, too, shows that the S&P 500 returns have been nearly 18-19% CAGR over the last 10-years. The excess returns above Sensex 30 have been significantly high over all the periods.

| Index/Returns (INR) | 1-year | 3-year | 5-year | 10-year |
|---|---|---|---|---|
| S&P 500 | 19.88% | 16.93% | 17.85% | 18.88% |
| S&P BSE Sensex 30 | 15.05 % | 10.07% | 14.67% | 11.25% |

Exhibit 11: Benchmark returns in INR. Source: OmniScience Research | S&P Global Indices, Fact sheets Jan 29, 2021

## How correlated are the US and Indian equities?

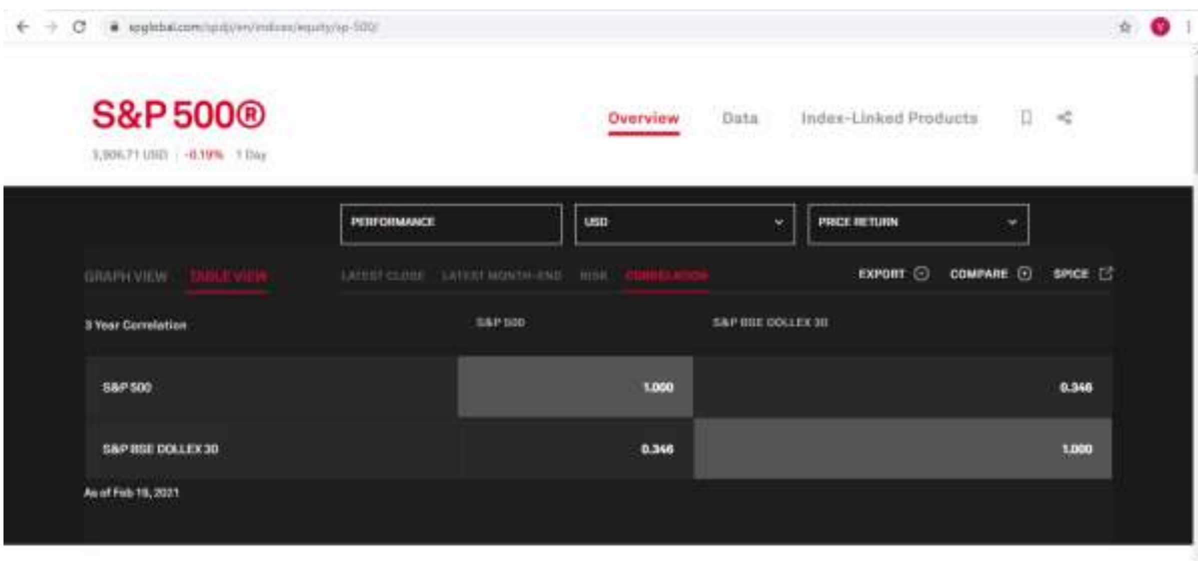


Exhibit 12: 3 Year correlation between S&P 500 & S&P BSE Dollex 30. Source: OmniScience Research | https://www.spglobal.com/spdji/en/indices/equity/sp-500/

The data shows that the correlation between the S&P 500 and Dollex 30 is 0.346 which is fairly low. This means that adding S&P 500 to an Indian portfolio could add diversification benefits and lower the portfolio volatility.

## Why should an investor add US equities to their portfolio?

While it is clear from the above data and analytics that US equities are likely to deliver satisfactory returns, the core idea behind the allocation towards them is asset allocation and diversification. Adding just the US equities to your portfolio should provide exposure to the global economy, including developed and emerging markets, multiple sectors, especially disruptive technologies, and an uncorrelated market return.

Currency diversification helps significantly since Indian market crashes are typically accompanied by FII outflows (mostly caused by FII outflows) and hence the INR depreciates against the USD. In this scenario, the US portfolio will outperform the Indian portfolio in INR terms. This makes the total portfolio much more stable.

Thus, adding the US equities to the Indian portfolio not only is likely to enhance the total portfolio returns, but also reduce the portfolio volatility. Further, there is true diversification on a fundamental basis in terms of exposure to the economies of the rest of the World and an allocation in a hard currency like the USD.

## US Market Valuations vs. Indian Market Valuations

| Market Capitalization | US Index | US market PE ratio (Projected) | Indian Market PE Ratio (Projected) | Indian Index |
|---|---|---|---|---|
| Large-cap | S&P 500 | 21.95 | 28.21 | S&P BSE Sensex |
| Mid-cap | S&P 400 | 19.6 | 31.76 | S&P BSE Midcap |
| Small-cap | S&P 600 | 20.51 | 23.13 | S&P BSE Smallcap |

Exhibit 13: Benchmark returns. Source: OmniScience Research | S&P Global Indices, Fact sheets Jan 29, 2021

From the above it can be seen that the PE ratios for the Indian markets are relatively higher compared to the US markets. This might be justified to some extent given the higher expected growth rates of Indian companies. However, one should be clear that the above are projected PE ratios, so they do incorporate the expected earnings growth one year forward.

In any case, it can be safely concluded that the US markets are available at a relatively better valuations than Indian markets.

## OmniScience Capital US Strategies

OmniScience Capital offers two main US strategies, viz. Omni Supreme and Omni AIoT.

Omni Supreme is a multi-cap (or flexi-cap based on SEBI's recent definition) strategy based on the Scientific Investing framework. Scientific Investing framework reduces fundamental risk while attempting to enhance expected returns. Omni Supreme is a curated portfolio, typically, consisting of 20-30 stocks, primarily, from the top 1500 US stocks represented by S&P 1500. There is a roughly equal allocation to the stocks, and they are reviewed and realigned on a quarterly and annual basis if there is a significant change in fundamentals or valuations.

Omni AIoT (Artificial Intelligence and Internet of Things) is a portfolio selected from a proprietary universe of nearly 180 US-listed equities which are working on Artificial Intelligence, Internet of Things, 5G, Cyber Security, Blockchain, Augmented Reality/Virtual Reality, Big Data, Analytics, Cloud or other related technologies. From this universe, using the Scientific Investing Framework, which modifies the financial statements to account for intangible asset creation, a curated portfolio of 15-20 stocks is created. This portfolio is reviewed and realigned on quarterly and annual basis.

The current Price to Cash Flow of Omni Supreme is around 11.9 as compared to S&P 1500 which is at 16. Similarly, the Omni AIoT is at a PCF of 17.6 compared to Nasdaq 100 which is at 23.1.

*We think an investor should allocate to both the Omni Supreme to gain exposure to the general economy and also to Omni AIoT to get exposure to the disruptive technologies which are likely to dominate the future of the US and global economy.*

## Investing now allows Indian investors to benefit from the elevated INR vs the USD

Currently, the USD INR rate is 72.51. The USD INR 27-1-2022 futures contract is being traded at 75.945. This is around a 5% return just from currency point of view.

It would make sense to take advantage of the elevated INR levels and remit money abroad for investing purposes. NRIs remit money to Indian when the INR is at a depreciated temporarily level so that they get more Rupees for their Dollars. Similarly, Indian investors should consider remitting money abroad when the INR is at an elevated level to get more Dollars for their Rupees.

Of course, the allocation to a global asset class would depend on the risk-return profile of any asset class at that point of time. We have clearly demonstrated the relative and absolute attractiveness of US equities at this point of time.

*However, this is not investment advice. Each individual investor should analyse their financial goals, investment objectives, risk tolerance and capacity, liquidity requirements, investment horizon and the expected risk-return profile of an asset class before investing. They should, ideally, consult a financial planner for this purpose. This document CANNOT be used as a substitute for detailed financial planning.*

## Actionable Ideas

We would like to point out that from a long-term perspective the US Indexes are slightly on the higher side in terms of their PE ratios, which is justified given the low interest rate environment. However, as the interest rates normalize over a 10-year holding period there could be some derating which also we have accounted for. However, under such a scenario it is better to allocate to a carefully selected, actively managed portfolio as compared to an ETF. Of course, one must be careful that the active portfolio is not even more vulnerable to a derating over the long-term. Under this scenario we trust the Scientific Investing process to deliver the optimal active portfolios, which are Omni Supreme US and Omni AIoT US.

An investor should go through a full financial planning exercise. If they have a 5+ year investment horizon and the risk tolerance for equities as well as forex rates, then one should estimate an appropriate allocation for US equities in their portfolio. Probably, one can start with a 5% to 10% allocation and take it up to 20-30% depending on their comfort level and suitability to their investment goals and risk profile.

## OmniInsight

*"Most market participants chase alpha but get risks, while one could chase safety and get alpha"*

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## Global Investment Focus

OmniScience's vision is to provide global investors with global opportunities via SuperNormal Portfolios for US, India and Transformative Technologies. Our Omni Supreme US and AIoT investment strategies help clients take exposure to US markets. Read more…

## Scientific Investing

Scientific Investing creates a SuperNormal Portfolio designed to survive and thrive through uncertainties, delivering optimal "Return on Safety". Read more…

## Investment Platform

Investors can explore and invest in OmniScience strategies on omniscience.smallcase.com

**Dr. Vikas V. Gupta**
CEO & Chief Investment Strategist

- Founder of OmniScience Capital & Inventor of Scientific Investing concept
- At an earlier firm he incubated the global equity vertical with US SEC license. The firm won international awards and rankings
  Former Professor/faculty at IIT Kharagpur & University of California and B.Tech (IIT Bombay), Masters and Doctorate, Columbia University, NY
- Columnist at Seeking Alpha, Mint, Moneycontrol, Economic Times

**Ashwini Kr. Shami**
EVP & Portfolio Manager

- Co-founder OmniScience Capital & leads advisory services and manages US, India & Technology portfolios
- At an earlier firm he set up one of the first Indian US SEC registered global money managers on the Interactive Brokers platform
- Previously worked at Goldman Sachs covering US and International stocks
- B.Tech and M.Tech from IIT Bombay; MBA from IIM Lucknow and Toulouse Business School, France.

**Varun Sood**
VP Quantitative Research

- Co-founder OmniScience Capital & heads investment research
- At a previous asset management firm, he developed 12 global strategies for US, UK & EU
- Earlier, at ING, Trefis and Masan group he covered US and International markets
- B.Tech from IIT Roorkee and earned his MBA from IIM Bangalore and EDHEC School of Business, France.

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