Nippon India Mutual Fund, MF/022/95/1

Connecting the Dots – Is Mean Reversion on the Cards for Indian Equities?

Indian equities saw a sharp re-rating post the COVID-19 pandemic, driven by a combination of liquidity, improving macroeconomic fundamentals and robust earnings growth across segments and sectors. The re-rating was sharper in small and midcap segment, and few select niche themes, with both NIFTY Midcap 150 index and NIFTY Small Cap 250 index delivering 29.7% and 31.2% respectively between Mar'2020 to Sep'24. Strong domestic inflows, supportive policy measures and growing retail participation further reinforced investor confidence, pushing valuations to elevated levels across the market spectrum.

From Re-rating to Consolidation - Since September 2024, however, markets have undergone price and time correction amid slowing domestic growth, global trade uncertainties and other evolving macro factors. Between Sep'24 to June'26 NIFTY50, NIFTY Midcap 150 and NIFTY Small cap 250 index have delivered -8.9%, 1.8% and -2.2% respectively. While the headline numbers show modest correction over the past two years, the correction was deeper in select mid and small cap stocks. Out of 461 stocks, 282 (61%) stocks are still below their Sep'24 peak. Further, 162 (35%) stocks are down by 20% or more. This broad-based correction might have helped remove excesses that had built up in select pockets of the market and has potentially improved the overall risk reward proposition for medium to long-term investors.

Returns of NIFTY 500 companies between Sep'24 peak to 8th July'26

Return Range	Number of Stocks	% of Observations
more than 50% returns	51	11%
more than 40 % returns	64	14%
more than 30% returns	82	18%
more than 20% returns	105	23%
more than 10% returns	135	29%
Positive Returns	**179**	**39%**
Negative Returns	**282**	**61%**
more than 10% correction	227	49%
more than 20% correction	162	35%
more than 30% correction	113	25%
more than 40% correction	71	15%
more than 50% correction	32	7%

Note: The number of stocks is 461 instead of 500 as 39 stocks were listed after Sept'24.

% of Observations is number of stocks divided by 461 for each return range

Looking back for Clues

History offers valuable perspective in such phases. Historically, periods when the Nifty has traded below 1-year forward P/E of 19x, markets have rebounded over the next 12 months.

Based on historical data, the Nifty 50 has traded below a 19x forward P/E on 22 occasions in the last 10 years. Most of these instances occurred after periods of muted market performance, with the preceding 12 month returns either being negative or in the low single digits.

History suggests that such valuations have often created attractive entry points. In the 12 months following these sub 19x valuation periods, the Nifty 50 delivered average returns of 34% (median: 27%), while the broader Nifty 500 has generated average returns of 41% (median: 37%).

Date	Nifty-50 P/E (x)	12-month retrun from event date*	
		Nifty-50 YoY Return (%)	Nifty-500 YoY Return (%)
Mar-16	18.0	19%	24%
Apr-16	18.2	19%	25%
May-16	18.8	18%	23%
Nov-16	18.5	24%	29%
Dec-16	18.3	29%	36%
Mar-20	15.8	71%	76%
Apr-20	17.7	48%	54%
May-20	16.7	63%	69%
Jun-20	17.5	53%	59%
Jul-20	18.3	42%	51%
Aug-20	18.4	50%	55%
Sep-20	17.7	57%	61%
Oct-20	17.9	52%	57%
Jun-22	18.4	22%	23%
Sep-22	18.9	15%	17%
Dec-22	19.0	20%	26%
Jan-23	18.2	23%	33%
Feb-23	17.6	27%	38%
Mar-23	17.3	29%	39%
Apr-23	18.0	25%	38%
May-23	18.5	22%	34%
Oct-23	18.9	27%	35%
Average		**34%**	**41%**
Median		**27%**	**37%**

*Event date is date when 1-year forward PE was below 19

With Indian markets going through a price and time correction over the past 21-months, Nifty 50 is now trading at 18.6x on 1-year forward P/E basis. This comes against a subdued return backdrop, with Nifty 50 down 5% YoY and the Nifty 500 broadly flat over the past year.

Markets tend to rebound after a consolidation phase

Another historical observation is that prolonged periods of time correction are often followed by phases of reasonable market performance. Based on historical analysis for the last 15 years, NIFTY 50 has delivered flat returns (-2% to 2%) on multiple instances. Few instances are shown below, as can be seen from the table below, the next 1-, 2-, 3- and 5-year returns have been reasonable.

From Date	To Date	2-Year Return	1-Year Return from 'To Date'	2-Year Return from 'To Date'	3-Year Return from 'To Date'	5-Year Return from 'To Date'
Dec-09	Dec-11	-2%	19%	12%	20%	11%
May-10	May-12	0%	15%	13%	16%	12%
Mar-11	Feb-13	2%	10%	25%	7%	13%
Oct-14	Oct-16	2%	20%	9%	11%	15%
Mar-15	Mar-17	0%	17%	10%	8%	13%
Mar-18	Mar-20	1%	44%	25%	19%	17%
Oct-21	Oct-23	2%	28%	17%		

Conclusion - While valuations alone are not sufficient to predict market performance, historical data suggests that periods of valuation normalization have often been followed by attractive medium-to-long-term returns. The combination of reasonable starting valuations and sustained earnings growth has potentially been a key ingredient for wealth creation across market cycles.

Looking ahead, earnings growth may remain the primary driver of market returns. While India's structural growth prospects remain compelling, investors should remain cognizant of risks arising from geopolitical developments and potential moderation in corporate profitability. On balance, the correction over the last 2 years may have improved the risk reward proposition, creating a potentially favorable environment for long-term investors.

All Sources: Bloomberg