

Quadrant II - Notes

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Module Name: Introduction to Fundamental Analysis, Economic Analysis

Module No: 10

(b) Approaches to Equity Analysis

Equity analysis is the area that focuses on stock selection based on scientific methods. Broadly speaking there are two schools of thought to stock selection, These are fundamental analysis and technical analysis. In reality, however, investors and analysts apply both methods to select stocks.

Introduction to Fundamental Analysis

- Fundamental analysis is the study of underlying factors that impact securities prices.
- Fundamental analysis is a combination of economic, industry and company analyses to obtain a stock's current fair value and predict its future value.
- This kind of fundamental analysis is also known as 'top-down approach'. This is also called EIC (economy, industry and company) analysis.

Characteristics of Fundamental Analysis

Application of EIC Framework : Fundamental analysis emphasizes on three important levels of analysis to determine a stock value. These are - Economic analysis, Industry analysis and Company analysis, popularly known as EIC framework.

Determination of Intrinsic worth : Fundamental analysis enables investors to determine the intrinsic value or true worth of a company's share based on core factors that impact company's business and financial performance.

Based on real information : Fundamental analysis is based on real quantitative and qualitative information about economy, industry and company that is obtained from number of sources and analysed to compute the intrinsic worth of a share.

Economic Analysis

Economic analysis is a study of the general economic factors that go into an evaluation of a security's. The stock market is an integral part of the economy. An analysis of the macroeconomic environment is essential to understand the behaviour of stock prices. The commonly analysed macroeconomic factors are as follows.

- Gross domestic product (GDP)
- Savings and investment
- Inflation
- Interest rates
- Budget and fiscal deficit

- Tax structure
- Balance of payments
- Foreign direct investment
- Investment by foreign institutional investors (FIIs)
- International economic conditions
- Business cycles and investor psychology
- Monsoon and agriculture
- Infrastructure facilities
- Demographic factors

Gross Domestic Product (GDP)

- The growth rate of GDP points out the prospects for the industrial sector and the return investors can expect from an investment in shares. A decline in the GDP indicates a potential economic slowdown. A high GDP growth rate is advantageous to the stock market.

$$\text{GDP} = \text{Consumption} + \text{Investment} + \text{Exports} - \text{Imports}$$

- **Savings and Investment**

It is obvious that growth requires investment, which in turn, requires a considerable amount of domestic Growth in savings naturally leads to more investments. High capital investment means possibility of more production, more demand and supply, better prices in the future and consequently, higher business positive outlook for the stock market.

- **Inflation**

If there is inflation, the stock market is adversely affected. The price of stock is related to the performance of the company. Inflation typically results in the following:

- High raw material cost
- Non-availability of cheap credit due to rise in interest rates
- Low earnings

- **Interest Rates**

Interest Rates have a direct impact on the economy. The base rate of banks affects the cost of borrowed funds. The base rate is the minimum rate of interest at which banks lend to anyone. It is the floor rate below which the RBI will not allow banks to lend.

A increase in lending rates affects negatively firms which depend on banks for their working capital and growth requirements.

- **Budget and Fiscal Deficit**

The budget draft provides a detailed account of government revenues and expenditures. A deficit budget may lead to a high rate of inflation and adversely affect the cost of production. A surplus budget may result in deflation. A balanced budget is highly favourable to the stock market.

If capital expenditure in total expenditure is high and a deficit occurs, it is a healthy sign.

- **Tax Structure**

Concessions and incentives given to a particular industry encourage investment in that particular industry. The finance minister introduced tax exemptions for stock market investment in the Union Budget (2012-13) to attract retail investors to the stock market. The scheme, named the Rajiv Gandhi's ELSS Scheme, will allow 50 per cent tax deductions for those whose annual income is below ₹ 10 lakh and who invest up to 50,000 in stocks subject to a three-year lock in.

➤ **Balance of payments**

The balance of payments is the record of a country's money receipts from abroad and payments to foreign countries. The difference between receipts and payments may be a surplus or a deficit. Balance of payments is a measure of the strength of the rupee on the external account.

The volatility of the foreign exchange rate affects the investment of the foreign institutional investors in the Indian stock market. A favourable balance of payments has a positive effect on the stock market.

➤ **Foreign Direct Investment**

FDI help in the upgrading of technology, skills, and managerial capabilities and bring much needed capital into the economy. They also help in providing employment opportunities. Inflow of capital helps the economy grow and has a positive impact on the stock market.

Under the FDI policy, FDI up to 100 per cent is allowed under the automatic route in most sectors/ activities, except a few, where sectoral equity/entry route restrictions apply.

➤ **Investment by foreign institutional investors (FIIs)**

FIIs are considered to be the main drivers of the stock market. Outflows of FII investments affect the stock Market negatively.

Considering the importance of FII investments, in January 2012, the government announced its decision allow qualified foreign investors (QFIS) to invest directly in the Indian equity market.

➤ **International Economic Conditions**

Worldwide economies are not independent but interdependent. The boom or depression in one country affect other countries and the stock market.

➤ **Business cycles and investor psychology**

The business cycle contains four phases with distinct features, namely, boom, recession, depression and recovery. During a boom, economic activity is at its peak, and the growth of industry and GDP are prominent.

➤ **Monsoon and Agriculture**

In spite of technological advancements, Indian agriculture still depends heavily on the monsoon. Good monsoon are a boon for agriculture, Agriculture is directly and indirectly linked to many industries. For example, the sugar, cotton, textile, and food processing industries depend upon agriculture for raw materials. A favourable Monsoon leads to higher demand for these inputs, a bumper crop, and more disposable income in rural areas. This leads to buoyancy in the stock market.

➤ **Infrastructure facilities**

Good infrastructure facilities affect the stock market favourably. Infrastructure facilities are essential for the growth of the industrial and agricultural sectors. A wide communications network is a must for the growth of the economy. Regular supply of energy without any power cuts will enhance production. The banking and financial sectors should also be strong enough to provide adequate support to industry and agriculture. In India, even though infrastructure facilities have been developed, they are not enough.

➤ **Demographic factors**

Demographic data provide details about the population by age, occupation, literacy, and geographic location. This is needed to forecast the demand for consumer goods. The population by age indicates the availability of a skilled workforce. The cheap labour force in India has encouraged many multinationals to launch their ventures. Indian labour is cheaper compared to its Western counterpart. Population, by providing employees and demand for products, affects industry and the stock market.