Market Outlook for the rest of the CY2018

March 19, 2018

Nifty (10195.15):

The index has once again come very close to its 200-day MAs in 10-days-time. First, it was on Mar 07 when it almost tested the 200-day Simple MA; the intraday low that day was 10141 while the MA was at 10131—a wafer thin margin of just 10 points. It again did the same on last Friday when the intraday low touched 10180 while the same MA was at 10161. The near-testing of the important MA like the 200-day one in such quick succession is something we should not miss out, for it suggests an impending weakness of a serious nature where we might see much greater damage going forward. Unless, you see the index bouncing back from the current levels of sub-10200 range to above 10500 again and staying there we are in for a prolong downward pressure on stock prices. Thus, our immediate goalpost for a worthwhile recovery would be a sustained campaign above 10500.

However, this market outlook is not meant for focusing on the current week's price movement in the indices. We are undertaking this exercise to really try and make out probable scenarios during the CY2018. To do that, we would first look at the possible scenarios then from there to plausible outcomes finally graduating to probable price movements in the market.

While it is entirely possible that you see some cyclical recovery happening at the earnings front this year. There are some indications like the pick-up in IIP numbers and other parameters pointing towards at least some economic growth happening. However, consider this: even if the earnings go up from here there the scope for PE expansion is much less likely despite a fall of around 10% from the top of the Nifty level of 11171 . The current PE ratio of the Nifty as at Mar 16, 2018, is 24.87—it has come down from the peak of 27.81 on Jan 23. It has been found that whenever the Nifty PE ratio went beyond 22, its three-year returns turn negative, and while investing the further you go up on the PE scale the greater is the damage. Historically, the index generates substantial 3-year returns ranging from 21.18% (PE 20 – 22) to 152.10% when it is less than 14. Thus, to generate positive returns, the PE should fall further by 12 – 20% from the current levels. This means that even if earnings were to grow from here it won't translate into higher stock prices. The best that can happen would be stock prices remaining flat and PE compression takes place in the wake of higher earnings. However, the foregoing is just the best possible scenario. But does this sound plausible let alone being probable—I have several reasons to doubt.

First, the headwinds may come in the form of rising bond yields—7.563% (Indian 10-year GSec as per Bloomberg) as on last count at Mar 16, 2018. However, bond yields are expected to rise in line with the global trends and we could well see the important 8%-mark getting breached. Already, in the car loan market and in bank deposits, interest rates have already moved up by more than 1%ge point. Rising bond yield means interest rates are hardening up and this translates into lower PE for stocks. It is very simple in that it means for the same price of a bond you are going to get higher interest earnings. Now, if this is the trend in the debt market, you can rest assured risk-taking equity investors too would seek more returns for their money. Thus, there could be higher earnings, but it would just show up as PE readjustment but not higher stock prices. The rupee is also weakening—currently at 65.03 to the US dollar; we are forecasting a slide down to retest levels between 68 and 69 over the course of the current year.

Coupled with this would come in the global scenario where it is expected to show a probable fall in the Dow Jones index and things here could get murkier by the day considering possibilities for a trade war between the US and other partners. The global headwinds would sure to affect us negatively.

The probable assembly elections in three important states could well pose problems for the equity market for the outcome of not just the assembly polls but the next Parliamentary poll verdict is highly unlikely to be anything but certain—the return of the ruling party is not beyond doubt. This uncertainty would also lead to a fall in stock prices.

We are also not immune from global headwinds—if there were to be a melt down in the Dow over the next few months, it would have a cascading effect even on emerging markets including India. The Trump administration in the US seems to be hell-bent on initiating a trade war. It is about to impose stiff import tariff on 130 goods from China, and President Trump is determined to see drastic lowering of US$ 375 billion trade deficit with China. This attitude of the US administration would surely pave the way of an eventual trade war since the US is now moving towards an analogous situation with Europe and other exporters to the country. India is already affected in some measure. This trade war like situation would lead to a global correction in equity prices, and India would also be affected by that. Some foreign analysts have already commented upon relatively higher valuation of our markets compared to other emerging markets offering similar investment opportunities—the FIIs have been selling in our markets on most occasions in CY2018.

There is another problem lurking around the corner: while people are thinking that the due to LTCG re-imposition from FY2019, the profit booking led fall would taper off by the month end but for the differential between the short-term capital gains tax of 15% and the LTCG being 10%, there would be far less inclination to hold stocks for long-term. Who wants to hold a risky asset where a little extra payment can lock in gains? Probably, this would result in much higher volatility going forward.

Another striking similarity with the year 2008 is the success of the IPOs so far in raising huge capital from the market. This year, so far, we have seen about Rs 82000 crore worth of fund raising through the primary market by companies. It is the highest mobilization so far in any year surpassing the previous peak of just below Rs 40000 crore in 2008. This is very significant in that the IPOs by companies takes away money from the financial market to put that in to real ecoomy while mutual funds getting money in SIPs and through new fund offerings (NFO) bring money to the secondary market. Thus, it would be another source of pressure for the secondary market to seek lower levels in absence of adequate funds supporting it in times of distress.

To cut a long story short, the headwinds are far more powerful and there are quite a few of them already operating compared to the lone tailwind of recovery prospects in earnings growth. Even that can’t be taken for granted since in a scenario where interest rates are—most likely—headed upwards.

We tend to think that circa 2018 is going to be a year of correction. And this correction is going to be not a short-term affair but a sustained one where the indices would seek much lower levels before buying happens in a big way. The fact that it is a correction in wake of a liquidity fueled boom, and it might be a longer duration one. All liquidity fueled booms end up in some financial scam—like the PNB scam this time, Harshad Mehta “Bank Receipts” scam in 1992, Ketan Parekh channeling money from a Cooperative Bank and the then Global Trust Bank in 2000. In 2008, this happened in the US where such easy liquidity flowed from the banks to the real estate sector, and in turn affected not just the US market but almost the entire world.

Another problem that is likely to emerge as a side effect of any bank scam would be a liquidity crunch after the bank scam becomes public. As the regulators and authorities clamp down heavily after the horses have bolted the doors, the credit flow—at least, for some time—gets choked. Already, due to measures taken by the RBI like halting LoUs have pushed up costs for exporters. The good, the bad and the ugly of the gems and jewelry sector is feeling the heat of acute funds crunch. On top of that the recent notification of mandatory submission of passport details for promoters for any loan taken from banks and financial institutions amounting to Rs 50 crore or more might act as a deterrent for many genuine and well-meaning industrialists and businessmen; it is an atmosphere of fear and retribution on both sides—the lenders and the borrowers. In such situations, expect very few projects to come up especially any long gestation projects where profits may take a long time to come and in any adverse economic environments like a recession or any growth hampering scenarios such loans could easily turn NPAs and hence such projects would willy-nilly be shelved.

One striking fact is that each time our market suffered a bank or a financial scam, the indices retraced more than 50% from their top. In 1992, the 4500+ Sensex peak in April that year bottomed out at 1980 in the first half of 1993, in 2000, the Nifty peaked at 1818 and it bottomed out at 850, in 2008 the Nifty peaked at 6357 and it bottomed out at 2253 later the same year in October but took another six months to consolidate to finally embark on a bull run from early March 2009. These are very bad portents for our market. Each time such a peak happened it took a minimum of four quarters to six quarters to bottom out. This is even true for the intermediate peaks in 2010 and 2015.

Given the above concerns, our outlook for the market from here is quite negative: we expect the Nifty to scale down significantly even from the current levels of just above the 10000-mark. And we tend to believe that it would also last four to five quarters for a minimum. This time the peak happened on Jan 29 at 11171. Thus, roughly we can expect the market to bottom out in the first or the second quarter of the CY2019. We expect at least a probable retest of Dec 26, 2016, Nifty low of 7893.80 or it could just bottom out from around the 8000-mark. However, this flies against the more than 50%-drop in the index values from the preceding top in downturns following a bank scam, and to that extent it is quite optimistic. We are banking on the fact that our very long-term uptrend is still intact, and it would not violate the low of 6825.80 low recorded on Feb 29, 2016 which culminated the downtrend that began from the peak of 9119.20 on March 04, 2015—this remains a very significant bottom in the overall major uptrend in our equity market. If it gets taken out decisively then all hell might break loose.

Now, the question is what should we do from here? Our suggestion is to pare equity exposure wherever possible especially where you have purchased stocks at a relatively high valuation. Is there any hiding place currently? Yes, at lower levels—on any significant market dip—you can buy technology stocks for they are likely to outperform the market, they could buck the downtrend. However, they would also show a lot of volatility because of the genuine fear of melt down from higher levels where even the technology stocks could seek lower levels temporarily. Thus, buying technology is in order yet seek only significant dips in them to buy. Apart from that select fundamentally well performing FMCG and consumer stocks could also give you good opportunity in these troubled market conditions. In all these sectors and elsewhere, avoid concept stocks for they are bull market plays only. Concept stocks depend on stories and narratives of prospects, which people don't fall for in a market dominated by negative sentiments.

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