Impact Consultancy Private Limited

Mockingbird

The Big Picture

16th July 2015

Hush, little baby, don't say a word, Mama's gonna buy you a mockingbird,
If that mockingbird don't sing, Mama's gonna buy you a diamond ring
If that diamond turns brass, Mama's gonna buy you a dog named Rover,
If that dog named Rover don't bark …

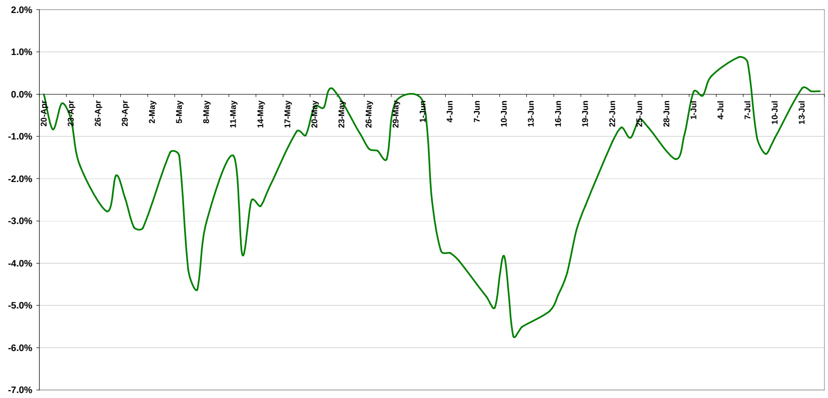
Overview

The Indian equity markets (Nifty-50) have been oscillating in a narrow 500 point range for the last three months, still uncertain of the way forward. But global events have been anything but quiet – the Chinese equity markets crashed 32% in barely a month, before they recovered a bit. The continuing drama of the Greek crisis played to a much higher tempo before an agreement was found. And finally what would be historic and positive, Iran and major world powers reached a nuclear deal which would lift sanctions on Iran and increase the supply of oil in an already over-supplied market.

Going forward, the risks to the markets still remain high. Although one of the problem, Greece's exit from the Eurozone, has been averted (although there is still a very small likelihood that it may not), there are still three big worries:

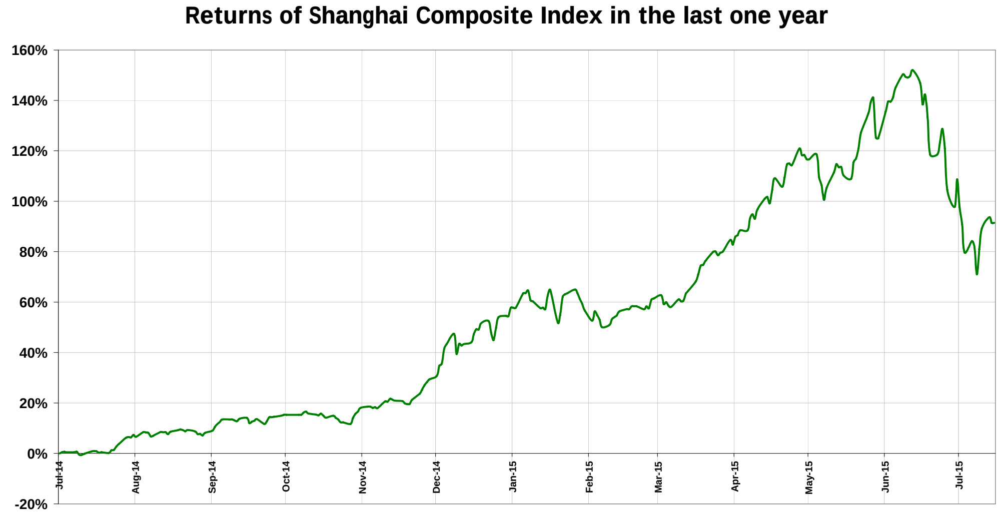
- China has been one of the economic powerhouses driving global growth and any mishap there could trip up markets
- The likelihood of the US Federal Reserve increasing rates by September-2015 remains high and that will impact global liquidity
- Indian markets continue to be at the top end of the valuation spectrum and the results for the first quarter of 2015-16 will be below the mark.

Nifty returns in the last 3 months



The Brass Ring

The Chinese equity markets rose an astounding 150% over the last one year before crashing 30% from the top – to be fair, there are still up about 90%. By any yardstick this is a classic (and giant) asset bubble in an economy that is decelerating and is comparable to the credit-crisis crash of 2008. The panicky Chinese government has instituted some bizarre measures such as banning trading in about half the stocks, banning short-selling, blocking cash sales and worst of all increasing the leverage in the market by cutting margins and allowing a wider range of collaterals.



Past experience shows that such artificial measures to prop up markets never work and the consequent crash is usually worse than the initial one – a good example is the US markets in 2008 when they rose marginally when short-selling was banned and then fell by another 25%.

There are particularly worrying factors about this Chinese crisis. Firstly, China is the world's second largest economy after the US, and contributed to 38% of global growth last year. Also, it has trade and investment linkages everywhere – any mishaps here will impact everyone. A Chinese slowdown could push global economic growth below 2% for the first time since 2008.

Secondly, this not the first time that the Chinese authorities have tried to inflate markets and hence drive consumption through the wealth effect. Post the credit crisis of 2008, massive investments were made in infrastructure which only created excess capacity and the now infamous 'ghost townships'. There were then the bubbles in commodities (which has hence fizzled) and Real estate (where there are still millions of new and empty apartments). This stock market bubble is probably the last gambit – like Real estate, the stock markets are highly leveraged and any further crash could really pull the economy down the tube causing a massive credit crisis, fall in consumption and worse still foment civil unrest.

From a technical point of view, the likelihood of a second crash, especially when all the curbs are removed, seems very high. Another fall of 20-30% seems well in range.

A dog named Rover

After a nervous few weeks where markets fretted over the possible exit of Greece from the Eurozone, a deal was struck which would keep Greece solvent (sort of) and within the Eurozone. But beyond the niceties of what has been called a "typically European agreement", Greece has been humiliatingly forced to accept conditions that are worse than what the Greek people rejected in a referendum.

The fact is that Greece's debt of $360 billion for the size of its economy is simply not sustainable. What is sustainable is if either Greece defaults on at least half that amount or its creditors waive half the debt. The austerity measures put in place by the IMF and the EU on Greece in 2010 have not worked – the economy has contracted by 25%, far more the costs saved – IMF economists themselves have admitted to that. A recent IMF study said that either Greece would need a 30-year grace period or deep upfront haircuts on its existing loans.

So the logic for even more punitive austerity and spending cuts could only be to squeeze as much from Greece while ignoring the huge human costs involved. Economist Joseph Stiglitz recently wrote "I can think of no depression, ever, that has been so deliberate and had such catastrophic consequences".

This is not the first time that Germany has threatened to throw Greece out of the Eurozone – it was done before in 2012. Germany's vindictiveness in forcing Greece to accept conditions that will deepen the ongoing recession and worsen poverty (and as some speculate, force a regime change) is patently apalling. German magazine *Der Spiegel* even compared Chancellor Angela Merkel to German Emperor Wilhelm II who led Europe into the First World War.

This current deal will not solve any of Greece's or Europe's problems. 'Grexit' will be back on the table before you know it and will then look extremely likely. A Greek government which won elections on an anti-austerity plank (and a referendum to boot) is not likely to carry this forward for too long. And more ominously, the recent acrimony between members will damage the union meant to foster integration and will eventually diverge from the current paradigm based on German dominance and intransigence. Those fissures among Euro members will have a far more devastating impact on the euro experiment and consequently the global markets.

Outlook

It is tough to be bullish when there are two significant structural problems at hand and two more Damocles swords hanging. The impending rate hikes by the US Federal Reserve (expected to start by September 2015) will turn the wheel back on the giant monetary easing in place since 2008 and which has contributed to much of the global asset inflation.

Closer to home, there are still no signs of a meaningful economic recovery, corporate earnings are still likely to be bad (our expectation for 1st quarter of 2015-16 is -4% y-o-y) and the Nifty Price/Earnings ratio is at 23.43x (against a long-term average of 19.75x and an estimated top of 23.94x). So, any rallies are likely to be short-lived and the risk of a deep correction remains.

Despite a deal on Greece, that problem/crisis will resurface soon enough and keep roiling the markets often enough. But China is the most worrying prospect – if the stock market continues to fall deep and a credit crisis ensues, not only would the quantum of damage be huge, it could spread very far very fast – much like the US credit crisis of 2008.

At least the one thing to genuinely look forward to would be Harper Lee's sequel to "To kill a Mockingbird".

Happy Investing.

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