Impact Consultancy Private Limited

That Coyote moment

The Big Picture

10th September 2015

Overview

Just like in the old cartoons where the coyote runs off the cliff, is suspended for a while and then discovers gravity, global equity markets which were largely benign through 2015 crashed quite rapidly in the last one month. The Impact-Global-Index which hit its high in on May-2015 fell 15% from the top and the Nifty-50 fell 16% from its high in March-2015.

In this Market Outlook, we will review all that we have written about through this year, how they have panned out and possibly how the immediate future might look like.

The Impact-Risk Index

Market Outlook of March-2015:
"…with the likelihood of the Federal Reserve increasing rates before expected, the risk of a global correction is also increasing. In fact, The Impact-Risk-Index at 83, is now at a five-year high, and the risk-reward ratio does not favor continuing long positions."

The Impact-Risk-Index, which is derived from our proprietary methodology and based on fundamental and technical parameters, has always been an accurate measure of the inherent risk in the markets and especially of key turning points at the extremes. The Impact-Risk-Index crossed the danger-mark of 80 in March-2015 which also coincided with the market top. With the consequent correction, the index is down to around 60 and markets tend to bottom out in the 20-40 range – which suggests that this correction may not be done.

From May-2014 (when the new NDA government came to power) to March-2015 (when the RBI cut rates), while the Nifty-50 rose by 25%, Earnings-per-Share (EPS) for the index rose by barely 3%. Furthermore, with the EPS falling by 4% after that and Return-on-Capital (ROCE) falling to a 10-year low of 14.6%, this pushed the market risk levels to unsustainable levels.

Going forward, in the absence of any improvement in market fundamentals, risk levels will be persistently on the higher side unless price levels fall significantly. We expect corporate earnings to show an improvement only in the 3rd quarter of FY 2015-16 – which means the good news will start trickling in around January-2016.

Impact-Risk-Index

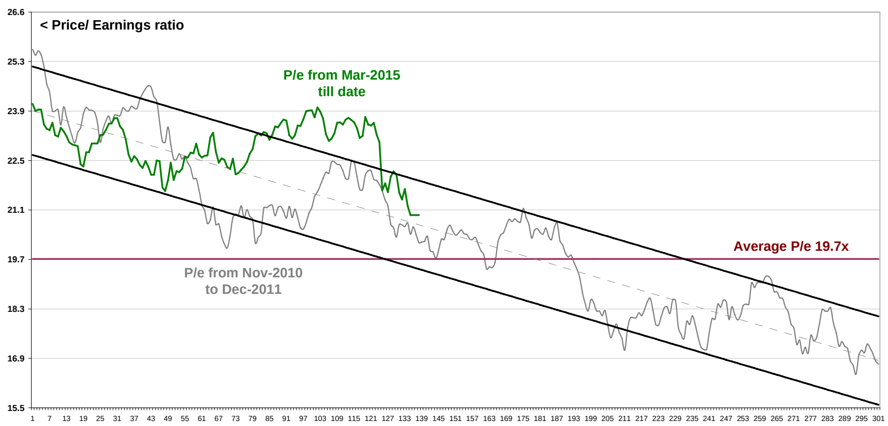
The Valuation Problem

<u>Market Outlook of May-2015:</u>
Indian equity markets continue to be a vulnerable position. The lack of an economic turnaround and consequently the deterioration in corporate earnings coupled with the reversal in sentiment will put a cap on any significant upside gains. Despite the correction, Price/Earnings multiple (P/e) continues to be over 22 - a move towards the long-term average of 19.7x would mean that Nifty could fall by another 11% (to 7318) – that will be the persistent risk.

<u>Market Outlook of July-2015:</u>
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.

We had written several times in the past that Indian equity markets were over-valued. The 5.6% fall in the Nifty EPS over the last one year actually made the valuation problem worse. Even with this correction, the Nifty Price/Earnings ratio has fallen from 24.06x to 20.94x – still well above the fair value of 19.70x. The fair value of Nifty now stands at 7100. The current correction's resemblance to the bear market of 2011 continues to be uncanny. If the market does overshoot and reaches the correction levels that it had hit at the bottom of 2011 bear market, then the equivalent level for Nifty now would be 6600!

P/e ratio comparison with 2011



Chinese checkers

Market Outlook of July-2015:
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 … of 20-30% seems well in range. 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.

Much has changed in two months with respect to the Chinese equity crash – from being a peripheral problem, the correction in the Chinese markets has prompted a Yuan devaluation of about 4%, fears of slower growth and steep corrections in all other global equity markets. A CNBC survey of global CFOs now shows that China is the biggest risk to businesses.

The Yuan devaluation which is probably aimed to improving export competitiveness after multiple attempts to boost domestic consumption have failed (including the now failed stock market bubble), will lead to slower growth in the global economy and specifically in the Asia-Pacific region.

In the July-2015 outlook, we had predicted that another fall of 20-30% seems well in range – it has fallen 19% since then and it does seem that the correction is still not done. At this point, through the course of 2015, it does appear to us that the correction in the Chinese equity markets is likely to continue. With a rapidly falling stock markets and the housing market having fallen 6.4%, there is a likelihood of a further 6% devaluation in the Yuan in an attempt to boost the economy – and we don't expect the GDP growth rate to cross 7%. All this adds up to persistent headwinds for the global economy and equity markets through this year.

Outlook
Market Outlook of August-2015:
Given that any upside moves will be capped by valuation barriers … our sense is that the next significant move will be on the downside. Fundamentally, Nifty-50's fair value is around 7200, about 15% lower from here.

The correction from obviously over-valued levels has predictably happened and market movements from hereon tend to be more difficult to predict. Notwithstanding any counter-trend rallies, which are very likely in the short-term, it does appear that we are firmly in a bear market which could last through this year and the Indian equity market is likely to go down further. Furthermore, there is potentially the Fed rate hike in mid-September, which could be the biggest game-changer of all.

Happy Investing.

Sashank Vipparthi
sashank@idika.com

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