

Irrational Exuberance

August 14, 2009

Stock Market Scenario

The upturn in global markets since mid of March has fueled the belief that economic recovery is around the corner. Many markets have gone up substantially. Indian equity markets have almost doubled from its lows and others have also not done too badly. Almost all economic data has been projected a green shoot, reflecting the greenery of impending economic recovery. We doubt that this is the case. Our view is that while economy may not be experiencing any further downturn, robust recovery remain far off. The rich valuations of Indian stock markets are therefore not quite justified. A similar case can be made for US markets.

Below we list down some reasons for our negative stance of large Indian companies:

- Rich valuations (especially in terms of dividend): Indian market valuation in terms of dividend yields continues to be close to all time lows. The dividend yield is around 1.1%. Historically, this is a low figure for Indian markets. It could either mean that earnings are going to increase at a fast pace (leading to increase in dividends) or markets are expensive. From recent results it seems unlikely that the earnings are going to increase at a fast pace. The earnings have fallen by 5% despite the changes in accounting to take care of currency depreciation. Among global markets again India has the lowest dividend yield. Most markets have dividend yields which are significantly higher (40-100%). The price earnings ratio is itself over 20 and builds in an expectation of significant profit growth. All the valuation indicators show an expensive market.
- Falling earnings: The earnings of corporate sector have shown a declining trend over last 12 months. In the latest quarterly results, the decline was slow but additionally there was decline in revenue. So the arrest in decline comes on back of cost cutting, rather than revival of demand. This does not augur too well for future. At the same time, a PE ratio of more than 20 for Nifty reflects a certain optimism for future earnings which is not being reflected in reality.
- Change in accounting: In March Government of India allowed companies to change their accounting methods to account for losses on foreign currency loans. So losses on loans are being capitalized rather than shown as expenses. This has significantly increased the profits of companies. There are two problems here. One, these companies were happy to book profits on these loans when rupee had appreciated against the dollar. The losses should have been treated similarly. Two, these losses may turn out very real as these companies may find the global markets closed when these loans mature and rupee dollar at a similar level.
- Dependence on FIIs: The upsurge in stock market has been on back of \$ 5 bn inflow in the market from FIIs. The FII inflow itself has been on back of strong global markets (read US).

This inflow can reverse easily causing the market to fall. Below we also list the reasons we feel that the global markets face uncertain future.

- Stream of IPOs: As is expected in any bull run, a number of companies line to raise capital. We have already seen good response for companies (Adani Power, NHPC) which had significantly over priced their issue prices. This beginning of last part of bull run. In the end high prices will cure high prices by absorbing the liquidity and causing a fall.

Reasons for weak US (global) markets:

- Lower than expected earnings: Despite all the talks about green shoots the corporate earnings seasons has not turned out to be a good one. The reported earnings have seen a fall of 25%, compared to an expectation of increase of 6.8%. Corporate earnings are not exactly reflecting a healthy picture.
- Insolvent US banking: The number of banks that have collapsed in last 6 weeks is more than 30. Some of the larger banks have been saved from closure only due to lack of options for the regulators. The amount of capital loss that FDIC faces is on an average more than 20% of the assets. This is reflective of the overall insolvency of the banking system, where large banks have been saved only because of government support. Solvency for European banking system is also an issue.
- Wave of defaults: Wave of defaults still lie ahead for the financial system. The larger among them are loans on commercial properties and residential mortgage based ARM. Even foreclosures are still increasing. Some of the larger global banks have indicated that problems will persist till 2011. Fannie Mae has already seen its capital wiped out and losses are still coming on its loans. As fresh wave of defaults continue to hit markets will eventually go down.
- De leveraging: US face a situation where amount of debt available for consumers will continue to fall. This will lead to further fall in consumption. Under such a scenario it will difficult for corporate earnings to grow. Rather corporate earnings can fall for extended period of time. That can lead to sell off in market.

Overall the markets in India are too optimistic. This optimism may last for a while but will eventually lead disappointment. It is quite likely that there will be significant loss of capital for people putting money in big companies. Investors should try to preserve the capital.