

Things to do at 10,000

Murphy's Law says, "Everything that can go wrong, will go wrong." Financial market participants are learning it the hard way.

Volatility and risk premiums have zoomed across asset classes while liquidity seems to have completely evaporated. Banks are scrambling for capital, deposits and trust but investors are scared. They are not looking at alternatives other than money under mattresses and gold in safe vaults.

As I mentioned in a recent note (You ain't seen nothing yet, Sept. 30, 08), that we are entering a period of long painful correction in global economy and markets and that Asia and other emerging markets like us would not be immune from the after-shocks. Our economy was a big beneficiary of global liquidity boom and as liquidity and credit conditions tighten significantly, we will face the negative fallout as well. Nobody dares to talk about de-coupling theory now! We enjoyed the fruits of globalization and now as the world faces severe challenges, we can't be immune. Given lower dependence on exports and high domestic savings, we should have been less affected by the global crisis. However, the fact is that we also made couple of mistakes at macro and micro levels and markets are always ruthless in punishing.

Where do we go from here

Financial markets are strange animals. In other markets, demand for a commodity goes up when price is down and vice-versa. But the same rational human beings behave differently in financial markets. In January this year, when the Sensex was at 21,000 investors were queuing up to put money in markets and now when Sensex is at close to 10,000 buyers are on strike.

One must not forget that the long term fundamentals of Indian economy remain absolutely intact. Favourable demographics and changing social and cultural fabric, large investment in infrastructure, opportunities in manufacturing, rising disposable income and consumption levels have been some of the key themes driving markets over the last few years. Most of these 'stories' are very much intact.

Till few months back, markets were pricing in all the possible positives with the economy and individual companies while ignoring any risk. But now the fear has overtaken greed and we are trying to price in every possible bad news. Undoubtedly, corporate earnings growth will take a hit but what we need to assess is how much of it is already in the price. One of the biggest risks for our markets was rising inflation and interest rates. That risk has substantially receded.

Let's talk about liquidity flows into equity markets. Mutual funds that got record inflows when markets peaked are now getting net redemptions. Insurance companies are also seeing deceleration in growth in premium income. But I have a strong view that large and sustained flow of money into equity market from domestic households can be expected

over the long run. Year to date, FIIs have sold almost \$10 billion worth of equities and considering the risk aversion and liquidity crunch some more outflows can be expected. But in a world where anemic growth is the best case scenario in most of the economies, India is likely to surprise positively. With a 50% correction in equity valuations and 20% depreciation in currency, global investors will look at our markets positively once the risk aversion decreases. India's higher capital productivity (ROE), longevity and visibility of growth prospects, better corporate governance, excellent market infrastructure, robust regulatory environment and variety of investment themes make India a unique value proposition.

What to watch: Key risks going forward

Key risks for the market would be further deterioration in global environment. Our problems get compounded due to high fiscal and current account deficit that constrain policy flexibility. Sentiments will play a big role as we have witnessed that loss of faith and trust can bring down mightiest financial institutions. Further large scale selling from foreign investors can create more panic. Investors would also watch out for political developments. Major correction in commodity prices would have positive macro impact through lower inflation and interest rates, however, they negatively impact earnings of commodity producers which still contribute significantly to Sensex profits (absolute terms).

Returns from stock market can be attributed to three sources, dividend yield, earnings growth and PE expansion. Sensex dividend yield is around 2% and a further increase in dividend yield through substantial increase in dividend payout is unlikely. From a historical perspective, market PE is below mean. PE expansion is unlikely to happen anytime soon given the current environment. However, I believe that at some point of time the market PE will expand to 16-18 unless we throw some major negative surprise on political and policy front. Over a very long period, aggregate corporate profits should grow at the rate of GDP growth. Putting all three together, one can expect return of 18-20% p.a. from owning equities over a 5-year time frame. Since, returns from equities don't come in a linear manner, taking a call on market could prove costly for long-term investors.

As I said, the broad market could be termed as fairly valued if not undervalued, beta itself should give decent returns. There is plenty of opportunity for alpha generation as well, in a market that is in complete disarray.

Both bond and equity markets are throwing interesting opportunities due to dislocations in global markets and investors should take advantage.

History suggests that the darkest hour always precedes the dawn. This time would be no different.

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