

Value beckons on the marketplace

The stage is being set for a regime of low growth & declining inflation to take hold. This may not make for a strong bull market but should be broadly supportive of equities with value strategies coming back into vogue, says **Ruchir Sharma**.

AT a time when it's easy to despair about the persistent bear market regime, the line by Antoine Lavoisier, the father of modern chemistry, is rather instructive: "Nothing is lost, everything is transformed." The history of markets too suggests that no regime lasts forever and merely evolves over time.

The high-growth, low-inflation bull market from 2003 to '07 gave way to a stagflation-induced bear market late last year. Now it seems we are entering a low-growth and declining-inflation regime, which may not lead to a strong bull market rally but should be broadly supportive of equities, with plenty of value-oriented investment opportunities around.

Despite all the gloom about how this time it is different, as the credit-crisis led downturn is not just of the garden-variety, the fact is global equities are currently tracking a typical market cycle. A 20% peak-to-trough decline in the US market and a 30% fall in emerging markets are representative of an average bear market.

In the typical cycle, growth and momentum stocks usually do well at the latter stages of an economic expansion and commodities in particular keep outperforming until economic activity cracks decisively. A resulting fall in commodity prices then takes the heat off inflation and ends the monetary tightening phase, which in turn signals the bottom of a bear market and a new beginning.

Value strategies usually perform well during the early stages of a market recovery, while growth and momentum stocks lag considerably, staying out of vogue for a long time. Over the past couple of years, paying attention to valuation metrics yielded poor results as money kept chasing momentum strategies. The momentum bubble started to burst late last year with the Chinese and Indian equity markets de-rating on the back of inflation concerns. However, instead of disappearing, momentum money got concentrated in the commodity complex, stretching the relative outperformance of commodity stocks to levels never before seen in history.



While Chinese equity investors for much of this year have been questioning the sustainability of the economy's growth path in the face of a commodity-led inflation surge, commodity traders have been virtually manic about the demand growth in China. The disconnect between sentiment in commodity-importing equity markets such as China and the commodity trading pits could obviously not carry on. In fact, there are many such disparities still widely present in the marketplace, which make for some compelling long-term investment opportunities. History shows that as value factors start gaining ascendancy, reversion-to-mean strategies perform well.

For one, it's amazing to see that in the emerging market universe, consumer stocks account for less than 10% of total market capitalisation while commodity stocks comprise more than 35%. Such a large gap is irrational as the source of growth for both consumer and commodity-related stocks is theoretically the same — the so-called insatiable demand of the emerging market consumer. The last time a sector represented such a large portion of

the total emerging market capitalisation was in early 2000 when tech and telecom companies comprised nearly 40%.

WITH commodity related stories on one side, almost everything else is cheaply available. For instance, Turkey's stock market is a mere 25% of its economy, smaller in value than leading global oil companies. Similarly, the stock markets of many oil-consuming countries are so badly crushed that they no longer capture the size of their economies.

These gaps are bound to close as investors begin to focus more on value characteristics. To be sure, the commodity bulls counter that many stocks in that sector are hardly expensive as they are trading at low price-to-earnings, or P/E, ratios. The problem with this argument is that the P/E ratios based on forward earnings are currently misleading as earnings estimates are predicated on high commodity price forecasts. If commodity prices revert to their marginal cost of production, these stocks are far from cheap. Furthermore, on many long-term valuation metrics such as price-to-book, or P/B ratios and free cash flow,

commodity stocks are already expensive, partly because they are spending a major part of their earnings on increasing supply.

Focusing on P/E ratios turned out to be a fatal mistake for many investors in US financial and home-building stocks. P/E ratios of those stocks never got to seemingly high levels as the earnings estimates were inflated due to a mispricing of the underlying assets, with the cost of credit being artificially low. P/E ratios are a much too simple and often useless analytical tool in both bull and bear markets. They underestimate the rerating potential of stocks in an environment of falling interest rates and rising growth, and in bear markets they make stocks look falsely cheap as earnings growth is consistently overestimated.

More stable valuation metrics from P/B ratios to dividend yields or even raw market capitalisation data are better in identifying value propositions at this stage of the cycle. Stocks in the consumer discretionary and the financials space are indeed showing up as interesting value plays while commodity stocks are stacked up on the wrong side of the valuation tables.

Equity markets are currently in a transition phase where the last vestiges of the high growth regime, i.e., commodity stocks, are losing momentum and yet the confidence is lacking to bid up the value plays in the form of consumer and financial stocks. And, as is often the case at major turning points, volatility in some of the commodity prices such as oil is very high and after having seen oil prices go vertical many market participants are still scared of betting on an extended oil price decline.

Forming tops and bottoms is a complex and time-intensive process. Equity investors want some evidence of a turnaround in the inflation numbers and want to see a further taming of the oil beast before jumping in to buy. In the weeks ahead, such favourable news is likely to materialise. Even then, investors will rely on low valuations for support and favour sectors on that basis. The key lesson from history is that there is always some game to play in the marketplace as all is never lost and the game just transforms over time.