Bullish thoughts

Our base case is that next year will be a year of normalisation

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Over the past year the market has been flat. But it has provided both bulls and bears reasons to be happy. We saw the fastest correction in history of 40 per cent between February and March on the back of the corona virus. The bulls came back equally strongly with a 60 per cent rally from the lows in the next six months. Where do we go now? We always evaluate three parameters to see where we are in the market cycle.

First, where are we in the earnings cycle? Clearly, we are at the low point of the earnings cycle (and this is ignoring the corona virus). Over the past 10 years earnings have grown at a CAGR of 6 per cent which is clearly a low phase. The previous low phase was between FY98 and FY03 when earnings grew at a CAGR of 4.5 per cent. In the phase after that from FY03 to FY08, earnings grew at a CAGR of 25 per cent. Earnings are likely to rebound sharply next year from the low of the current year. However, we think even beyond that earnings can grow at a CAGR of 12-15 per cent for a few years.

Secondly, where are we in the valuation cycle? Valuations are not cheap at these levels. On a price to earnings ratio, markets are trading at 10-15 per cent over long term averages. While earnings-based valuations in such uncertain times have their challenges, on a price to book value markets look relatively better, trading at 2.5x just below long-term averages. Other valuations parameters like earnings yield to bond yield also show valuations in neutral territory. Overall, we think market returns will mirror earnings growth with valuations being at the higher end of fair value.

Third, where are we in the equity performance cycle? We tend to look at the three-year trailing return that equities generate to look at where we are in the cycle. Here, the good news is that equities had provided lower returns than fixed deposits over the past few years.

Given this backdrop, where do we see equities over the next year? Our base case is that next year will be a year of normalisation. We think by the middle of 2021, the virus fear will have eased, either because the virus burns itself out or more likely because we get a vaccine to help prevent its spread. This will provide greater comfort for a recovery in the economy and earnings, and drive a positive return in equities.

Apart from comfort on overall markets, we think the vaccine will trigger a sectoral shift from the 'lockdown plays' to the 'unlocking sector plays'. Some of the economy plays that have been laggards in this rally will probably come back into focus. We would recommend a barbell approach currently. On one side, we would continue to be positive on pharma in spite of the sharp rally since it is coming off a few years of low margins and under-performance. Post its recent under-performance, we like telecom. On the other side of the barbell, we would recommend cement and auto ancillary stocks as early plays on a revival in the economy. As we get more certain of the virus containment, we would add to commercial vehicles, both through the OEMs as well as the ancillary companies as well as some capital good names. We would also like select high quality financial names, though the overall sector would continue to be under the stress of bad loans.

Yet, near term, there are a couple of events that could lead to a pullback in equities and provide a better buying opportunity. The first is the result of the USA Presidential elections. The market is worried about a Biden victory given that it may mean higher taxes and downgrade in earnings estimates. We are less worried since history shows that the first-year post election is generally good for markets irrespective of a Democrat or Republican President. The nightmare scenario is not who wins the election but whether the transition of power is a smooth process or ends up in courts, especially given the likelihood of a large number of mail-in ballots. The last time we had the court finally resolving the elections, the market fell eight per cent in the five weeks between the elections and the winner being declared.

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The second is the sharp resurgence of the corona virus in Europe and the consequent lockdown that is being implemented. The only comforting factor is that Europe's second wave started in mid-July and the case fatality rate (deaths per 100 infections) has been far lower compared with the period before. This could be because of a better understanding of the virus and management of cases with the experience acquired over months. ♦

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