Understanding Markets for Wealth Creation

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India experienced its first stock market boom and bust in the second half of the nineteenth century, brought about by the civil war in the US. The civil war caused a cotton supply shortage in the US which consequently increased demand for Indian cotton. Indian merchants who benefitted from the rise in cotton prices started investing in stock markets causing stock prices to skyrocket, some up to ten times, within a matter of months. Investors were not restricted to groups of suave businessmen, but also included officers, clerks, editors, and even sweepers. Essentially, anyone who had money to spare was investing in the stock market. New companies were being floated and their shares offered for sale just to capitalise on the investment craze that had caught on among the people. Even as government officials warned against this frenzied buying, investors paid no heed. Like all things, this frenzy too came to an end. The civil war in the US ended in 1865 and with it, the uncertainty over the supply of cotton from the US receded along with the demand for Indian cotton. This led to a fall in cotton prices which caused the stock market to crash as investors scrambled to retrieve their investments.

Even though the markets have come a long way since investor behavior has remained the same. Investors enter the financial markets when the going is good, but exit in a panic when things turn quite bleak without understanding that this is the nature of the market. Read on…

Since the Sensex came into existence in 1979, the country has seen many setbacks and crisis, but the markets have survived the unfavouring events affecting the economy. There was also a spate of international events such as the Asian financial crisis of 1997, the 9/11 terrorist attacks, the Iraq war, the London terror attacks, the Global Financial Crisis, the Arab Spring, Syrian Civil War, Brexit, trade wars and others. In the four decades from 1979 to now, the BSE Sensex has moved from 124 to a staggering value of 40,000 today. That translates to a return CAGR of 16%, in spite of everything, even without counting dividends. Add dividends and that number could possibly be a couple of percentage points higher.

Over the last 28 years, since the liberalisation of the economy,

nominal GDP has grown over 13%, corporate profits have grown around 14% and market capitalisation has grown at around 15%. The corporate sector has seen its profitability grow more or less in line with the GDP growth and market capitalisation has also broadly been in line too. Investors could also have made returns in line with the growth in the economy and markets had they just stayed invested rather than being driven by greed and fear. Greed typically gets exhibited when markets are on their way up, and fear during a downturn, eventually leading to investors buying high and selling low. These emotions, in turn, are largely governed by the noise created by the media around relatively less relevant events from a longer-term standpoint as also the pull of peer performance and several such behavioral biases.

Tracking media articles and reports for an understanding of financial markets could be beneficial but investors often consider these as advisory pieces thereby making short-term decisions in a panic that could be harmful in the long-run. Investors ignore vital factors that indicate growth in the economy and are wholly fixated on the movements in the financial markets. For taking an informed view on the equity market, investors should focus on key factors viz macros, corporate profits, valuations, and liquidity. Macro-economic indicators such as inflation, interest rates, consumption growth, investment activity, etc provide key indications on the health of the economy which in turn affects corporate profitability.

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Like the economy, corporate earnings themselves move in cycles in the short term even as they typically trend higher in the long run, and analysing where in the cycle we are can be of immense help in taking an educated guess on prospective returns. The third factor, i.e., valuations are important as they allow one to gauge to what extent are earnings already priced in. And finally, liquidity is the catalyst that often allows the disconnects, if any, between the health of the economy, state of corporate profits and valuations to correct and get these efficiently reflected in stock prices.

In the current macro-economic scenario, a widespread slowdown in economic activity appears to be dampening investor sentiment. While some of the key macro-parameters such as inflation, external account, and fiscal situation look stable and net FDI inflows have seen a sharp jump to US$ 18.3 bn during April-July FY20; there have been reservations on growth for some time. A slowdown in the economic activity has been visible with a serious slump in consumption as reflected in sales of automobiles, FMCG, air travel, textiles, and other discretionary products. Further, the weakness in employment and household income prospects combined with the reduced risk appetite of lenders is also affecting growth. Additionally, challenges in the NBFC sector are also at play. These domestic factors have come to the fore at a time when the US-China trade conflict is leading to generalised moderation in global growth (and hence, export demand). Understandably, the investment cycle has stayed weak, with both consumption and export demand slowing.

While the macroeconomic stays sluggish, corporate profits have been even weaker. On several cyclical measures of corporate performance such as return on equity, profit margins, and corporate profits as a proportion of GDP, we are at multi-year troughs, very similar to the levels seen at the beginning of this century. The same is true for economic growth, both real, which had dipped below 5% and nominal which was in single digits, at the turn of this century, very similar to the situation today. The stage, therefore, appears set for a new cycle to begin. A reversion may be in order helped by tax cuts and falling real rates. Yet for a meaningful reversion, a new investment cycle is needed, which could be triggered by the 17% tax rate for new manufacturing provided policy and regulatory realignment

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Markets being forward-looking, investors have started accounting for this turnaround. FPI and DII flows have turned positive. Globally, a vast majority of central banks have been easing monetary policies in the wake of slowing growth. While the Bank of Japan and European Central Bank are already experimenting with negative interest rates, the US Fed is expanding its balance sheet again. At a time when investment opportunities are scarce globally and money is abundant, India can be an oasis of hope for foreign capital if the government stays intent on structural reform.

With respect to the bond market, the RBI has been maintaining an accommodative stance with a focus to revive growth. Contained inflation estimates, along with domestic and external headwinds to growth provide a positive backdrop to the bond markets from a fundamental perspective. This along with an elevated term premium should keep a ceiling on bond yields. Within corporate debt, there is polarisation in favour of top quality credits and spreads for other names are quite attractive. An economic revival can change this eventually, but in the near term, financial sector stress remains the big elephant in the room. A resolution on that front including measures to revive real estate stays a key monitorable for both equity and bond markets.

Amidst the current environment, we should not lose sight of our structural strengths. Given India's 4Ds – Democracy, Demographics, Demand, and Digitalisation, there is high growth potential in the Indian economy. Key reforms announced by the government such as the implementation of the Goods and Services Tax, the Insolvency and Bankruptcy Code, the Real Estate Regulation

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Act, a new monetary policy framework and e-auction of natural resources are steps in the right direction.

These reforms will lead to some key structural changes. The parallel economy comprising the unorganised sector will see a gradual shift to the mainstream economy. When that happens, tax to GDP ratio in the economy will go up, resulting in higher revenue for the government which could be invested to improve social and physical infrastructure.

Such measures as also the conversion of various business approvals/ declaration processes online have helped to enhance India's rank in World Bank's Ease of Doing business (from 142 in 2014 to 77 in 2018). The government's push towards the adaption of digitisation across sectors and its emphasis on financial inclusion will gradually lead to a higher allocation of savings to financial assets over physical investments.

Even though the global and domestic environment looks hazy, it is precisely at these points that one should not lose sight of the long-term picture. Current challenges are surely big but not insurmountable. Investors should follow disciplined investing through prudent asset allocation for long-term wealth creation. ■