Our Views

Market valuations – Predicting the Unpredictable

The world is facing seemingly unending headwinds from the pandemic spread. As everyone knows, the resultant economic contraction is making the markets volatile. Several considerations such as the length of the health crisis, economic implications of the lockdown, the shape of the recovery (U,V,W,L) and the global scenario make the market valuations unpredictable.

The Indian equity markets and the global indices corrected significantly in March 2020. Compared to February, the Nifty declined 38% in March. Even though the market has since moved on a recovery path, it is still at a 21% lower compared to February. To predict highs and lows of the markets in a situation where you have never experienced something like that before, you cannot say you know how it's going to turn out. Also, the use of averages from the past events can be misleading in predicting the future trend. However, trends from the past market's dislocation can guide us on the broad direction. Looking at data for last 20 years, we see two blocks of period with significant market dislocations – first in 2002, post the tech bubble and the Sep 11 incidence; and second in 2008, post the Global Financial Crisis (GFC). The market trends in these two periods on various parameters do give us meaningful insights to ponder upon.

The **Market Cap to GDP ratio** over the last 20 years in India has been an average of 70%. Post GFC, this ratio has been at ~74% on an average. During the two major dislocation periods, the market cap to GDP ratio had gone down significantly. In the year 2002, Indian market cap to GDP was 42% and in 2008 it was 52%. In both the situations, this ratio had stepped down by almost 50% compared to the earlier year's trends. At present, the market cap to GDP ratio in India is app 59% compared to 78% in 2019. With the 5-7% predicted contraction in FY21 GDP – a first in our lifetime – this ratio will only go up if the market does not correct itself from the current levels.

Looking at **Price to Earnings ratio** over the last 20 years, the Indian markets have traded at an average of ~20 multiple of its earnings. The current earnings multiple, even in these uncertain times, is still at 23 times. Comparatively, the US markets which has traded at around 24 times earnings in the last 20 years, is presently trading at 22 times. Again, if this parameter is an indicator, and given that the corporate earnings are expected to contract, the markets should correct.

The analysis of overall **contribution of the corporate earnings in the GDP** also throws a very interesting picture of the last 20 years. In India corporate earnings is ~4.4% of GDP whereas in the US its ~8.8%. The current earnings to GDP is almost at an all-time low of 2.5%. Based on this too, the current market levels should correct.

No one can succeed in predicting things that are heavily influenced by randomness and otherwise inconsistent. However, based on all the above past trends, and as we start getting answers to many questions, the market should correct itself at least by 10-15% from the present levels. History has shown that markets usually rebound within 6-9 months post sharp corrections, the situation this time has grown grimmer. While the markets were quick to recover post GFC 2008 – market cap to GDP moved from 52% in 2008 to 95% in 2010 – the ongoing pandemic with no set timelines might pose difficulties in a sharp recovery. The economic impact is expected to spill over till FY22 for which the estimates of GDP have been cut significantly.

"**No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future.**" Ian E. Wilson (former Chairman of GE)

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