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Book profits in largecaps: D-Street on new highs, but ‘wow’ factor is missing

Mazhar Mohammad

The mysterious ways in which Mr. Market operates are once again into play as Dalal Street continued to hit new highs, but on the back of decelerating fundamentals.

This dichotomy between the real economy and consistent new highs for markets at regular intervals has become an enigma not only to economists but also to seasoned market professionals.

Surprisingly, multiple parameters related to economic growth are heading towards southern direction against the stock markets which are consistently hitting new highs.

Right from IIP data, consumption numbers, investment figures to corporate profits everything is pointing towards a slowdown in the economy.

Surprisingly, corporate earnings that are very closely tracked by market participants and can be considered as a key component to move the market has been heading south.

The earnings ratio plummeted below the lows of the year 2002 as corporate profits to GDP ratio for FY 2018 stands at 2.7 whereas low recorded in 2002 was 2.90.

Moreover, since 2015, this ratio remained stagnant between 2.7-3.0, suggesting muted growth and some stability in earnings. But, during this period, the stock markets continued to witness substantial gains.

By looking at such a low level, some among the fundamental fraternity is making an assumption that bull markets will not end at such a low level of corporate profits to GDP ratio.

It is true that, in the past, this ratio from the lows of the year 2002 gained multifold in the next five years, ushering in one of the best bull markets, before topping out at 7.20 in the year 2007 where the bull market ended.

However, in 2002 when this ratio hit such a low level, stock markets were still in the bear phase and were almost trading at the lowest levels.

Moreover, during this period, the world economy between 2000 – 2007 stepped into a growth phase which was aided by liquidity taps opened by several central bankers to cope with multiple crisis like Y2k, the collapse of mighty hedge fund Long Term Capital Management in 1998 or East Asian crisis of 1997 – 1999.

Unlike then now liquidity taps from central bankers are getting tightened, and the majority of world markets are at lifetime highs without any earnings justification.

Even if we argue that the market is a forward-looking animal and, hence, factoring in future growth, it may not itself get converted into substantial raise in the index to a large extent. The reason is that the majority of large-cap stocks are trading at higher earnings multiple. If earnings do not catch up, the bubble in them shall get pricked sooner than later.

Hence, in the absence of earnings recovery in the near future, the threat of expensive largecaps leading the next leg of downfall can’t be overruled.

Are markets really disconnected from the real economy?

Often, we are hearing from different quarters that there is a clear cut disconnect between the markets and the real economy.

This observation may be partly true when we only look at the main index like Sensex/Nifty but the broader market is clearly reflecting the pain of the real economy.

Even in the Nifty stocks, only a handful of names are hitting highs and 20 out of 50 stocks are 30 percent down from their respective lifetime highs which is significant for a large-cap counter.

Besides the Nifty500 index, which more or less moves in line with the Nifty, is surprisingly lagging behind the Nifty and is yet to hit new lifetime highs. On the other hand, the mid- and small-cap 100 indices are yet to show any concrete signs of bottoming out.

Both the indices hit a corrective swing low only in August and rallied from their respective lows by just 15 percent, unlike the Nifty which bottomed out in October 2018.

Another important observation is that the broader market appears to be in a larger-degree correction of its entire rally from the lows of 2013, the origin of this long-term bull market.

Interestingly, the NiftySmallCap-100 index retraced 62 percent of its entire rally from the lows of the year 2013 to the lifetime high witnessed in the year 2018 whereas the Midcap100 index retraced 45 percent of its entire rally.

The Nifty500 index retraced 38.2 percent whereas Nifty50 retraced only 23 percent. Despite the main index, Nifty50, is showing less retracement of only 23 percent, the carnage is clearly visible even in this space as 40 percent of Nifty50 components shaved off something between 30 – 60 percent which is significant enough for an index stock.

Technical Trends – What lies ahead for the market?

Albeit Nifty50 is making new lifetime highs, the long-term charts since 2018 have been unfolding with overlapping legs suggesting markets are in a complex corrective phase.

Moreover, the critical resistance for this market is placed around 12,350. Hence, unless the market registers a breakout and consistently trades above 12,400, a substantial up move shall not be expected in 2020.

On such a breakout, our best-case target for 2020 shall remain in the zone of 13,300 – 13,500.

But, based on our long-term trend projections, we presume that one more leg on the downside in the Nifty50 index is pending, which shall facilitate a better investment opportunity.

At this juncture, it seems prudent for investors to go for at least part profit booking (more than 50 percent of holding) in expensive largecaps where earnings multiples are 50 plus and reallocate those funds into those pockets where value is emerging.

(The author is Chief Strategist – Technical Research & Trading Advisory, Chartviewindia.in)