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Bull or bubble: What is brewing in global financial markets, including Sensex?

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Global financial markets once again surprised investors as well as economic pundits as they recouped almost all the losses witnessed due to the COVID-19 pandemic.

Some indices like NASDAQ COMPOSITE went on to make new lifetime highs, whereas Brazilian Bovespa from Emerging Markets segment outperformed with gains of 67 percent from the panic lows of 61690 registered in last March.

Meanwhile, Dow and DAX registered a little over 50 percent gains whereas Indian Nifty and CAC appreciated around 45 percent from their respective March lows.

Among the developed world FTSE remained an underperformer as it gained only 32 percent whereas from emerging markets space Shanghai Composite which is the epicenter of all this crisis recorded gains of just 30 percent from March lows.

Economists and Financial Market experts, who anchor their opinions based on economic principles were taken aback by this kind of strong performance whereas Contrarian investors who followed in the footsteps of Baron Rothschild, an 18th century British Nobleman and a member of Rothschild Banking Family who said “Time to buy is when there is blood in the street”, ended up with a Cheshire smile after three months.

Rothschild is believed to have amassed a fortune by buying in the market crash during the Battle of Waterloo.

This kind of recovery shall baffle every one equally as it is really sharp and in the midst of zero fundamental developments since March across the world.

Though there is no consensus on what is a bubble it is generally accepted that in Financial Assets bubbles will form when the underlying valuations of the asset class fail to justify the astronomical market prices prevailing for a prolonged period.

It seems jumbo stimulus packages announced by the global central bankers seems to be the sole reason which resulted in this rally.

Now, undoubtedly the major worry should be the fact that institutions like IMF and World Bank were forecasting slowdown and recession for the near future even before COVID–19 pandemic broke out.

In such a scenario, economic recovery process shall get accelerated on the downside making the forthcoming recessions one of the worst and ideally financial markets should also be remained subdued and atleast consolidate after the corrections but surprisingly they are heading higher and on the verge of making new lifetime highs after recovering all the post COVID losses.

Even hypothetically if we assume that markets are forward-looking animals and try to factor in future earnings growth then NASDAQ already multiplied itself by 8.3 times from the year 2009 lows of 1265 to a recent high of 10824.

S&P500 rallied by 5 times from the year 2009 lows of 666 to a high of 3393 registered in March 2020. During the famous dotcom bubble of modern financial history in the late 1990s, NASDAQ traded at a historical PE of 84.

While in late 1990s investors were betting on fast-growing innovations in tech space whereas today their focus is on FANG stocks –

Facebook, Amazon, Netflix, and the likes of Google. However, today’s Nasdaq fundamentals seem to be relatively stronger when compared to the erstwhile darlings of the 1990s like CISCO, DELL, MICROSOFT, and Intel which led to a bubble and subsequent crash of around 80 percent from the top.

Then it took almost 15 years to regain the tech bubble high of 5132 for Nasdaq Composite registered in the year 2000. Though valuations of NASDAQ are not as expensive as witnessed in late 1990s today NASDAQ is into 10 years of a bull market and delivered 8 times return from 2009 lows when future earnings for the world economy are looking obscure.

Back in India economic fundamentals started deteriorating since the year 2015 for a long time but the market was heading in opposite direction to what real economy was suggesting and Nifty50 almost doubled from the year 2016 lows of 6825 to a recent high of 12400 levels.

In the last 10 years i.e. from the lows of 2252, registered in the year 2008, it almost delivered close to 6 times returns. After this kind of rally, history valuation metrics of Sensex were hinting at a possible major correction going forward as revealed by the following table unless earnings recover sharply to justify the current rally in indices.

Sensex	PE	PB	Dividend Yield
42273 (Jan-2020)	25.67	3.21	1.03
38989 (Aug-2018)	25.07	3.22	1.14
30024 (Mar-2015)	20.22	3.17	1.13
21108 (Nov-2010)	23.03	3.71	1.06
21206 (Jan-2008)	25.53	6.35	0.88
6150 (Feb-2000)	24.32	3.98	1

Source: bseindia.com

Sensex is currently hovering around the same multiples from where indices corrected sharply in the past as revealed by the above illustration.

Currently, Sensex earnings multiple is around 24.72 with a dividend yield of 1.04 and Price/Book multiple of 2.78 making it vulnerable for a sell-off.

To prevent this scenario only option available is a sharp increase in earnings which looks unlikely in the next 6 months stoking the fears of a bubble or slipping into a prolonged sideways phase with limited upsides.

In light of the above discussion, a beginning of a multi-year bull market from the panic lows of March can be ruled out. Our best-case scenario for equities should be prolonged sideways consolidation in the next 6 – 9 months with limited upsides but in case of correction, downsides can be at least 10%.

Hence, traders or investors should remain alert without developing FOMO as fall can be a minimum of 10 percent as happened in the past.

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