Global Markets - Close to bottoming out

We are becoming increasingly bullish on global markets, though the rally of the last few days should be seen as more of a relief, than a sustainable rally. We believe that there is one final leg down to global markets before we hit rock bottom.

More bad news to come...

Though most of the bad news is now out, we remain concerned that a number of factors are likely to spook the markets over the next few months. These factors include (i) rising credit card delinquencies, (ii) protectionism, and (iii) under-funded pension funds..

...and finally, capitulation

As in all bull/bear markets, stocks usually overshoot. On the downside, this could take the S&P index down towards the 600 level (-20%). At that point, capitulation is likely to emerge as the new global buzzword.

Market recovery will be gradual

We do not expect global markets to rise sharply from lows but rather expect a more gradual move higher, over the course of 2009 with the S&P index nearer to 700 by the year end. The good news, though, is that this will stabilise global markets and, more hopefully, we will move into 2010 on a more optimistic note.

Global economy still looks awful

We were never convinced that the huge financial and economic packages would provide the quick fix solution needed to arrest the impending recession. Indeed, our view is that U.S. unemployment may rise over 10% in very short order. Moreover, we expect house prices to drop by another 5-10% in the U.S. and Europe, creating a summer of unrest around the world.

India is off the radar

Given the impending elections, slowing economy, and rising fiscal deficit, it seems unlikely that India will offer any positive surprises this year. Without doubt, interest rates will head south, leading to the rupee depreciating further. As a result, we expect FII outflows of around US$5bn (currently US$2bn) this year.

India is a late 2010 story

Given our below consensus forecasts for GDP growth of 4.5% in FY09-10 and EPS of 750, we continue to expect the markets to trade in a narrow range, with 7000 being the lower level of our sensex range. In all likelihood, the sensex will end the year at around 8500 levels.

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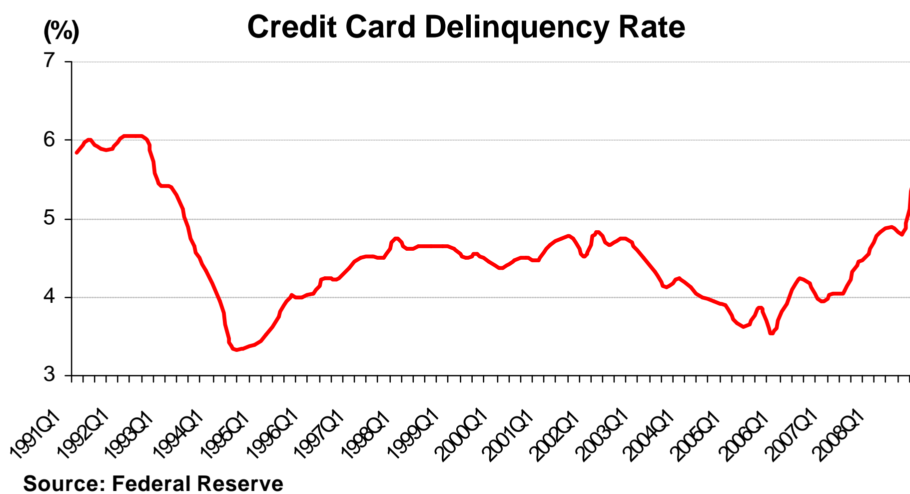
Global Markets

Without doubt, there was too much optimism coming into 2009 with the belief that the huge financial and economic stimulus packages, near zero interest rates, and appointment of President Obama would provide a quick fix to the global economy and, in the process, restore confidence. The classic 'V' shape recovery. Indeed, at markets approx 20% higher than today, some well-known investors were calling the bottom of the markets. However, we were never convinced that these packages would work so quickly….you just can't buy confidence…if people are fearful of losing their jobs, then they stop spending and start saving, bringing the economy to a screeching halt. We are in a deep recession with the likelihood that the man on the street won't start feeling more confident till well towards the backend of 2010.

The other argument for markets reaching a bottom has been valuations. Whilst we acknowledge that markets are trading at historic low PEs we firmly believe that the 'e' (earnings) is out of whack with reality, and that analysts will have to take a big red pen to revise down their forecasts. Only once this happens, can we argue in favour of 'cheap' markets.

That said, we do feel that a considerable amount of the bad news is already out there, be it financials, autos, or the credit crunch in Eastern Europe. As a result, we are increasingly becoming more bullish on developed markets. However, we do expect one more leg down before we declare an end to the downside. This view is based on our concern that a number of factors such as (i) rising credit card delinquencies, (ii) protectionism, and (iii) under funded pension funds, will spook markets over the next few months.



Source: Federal Reserve

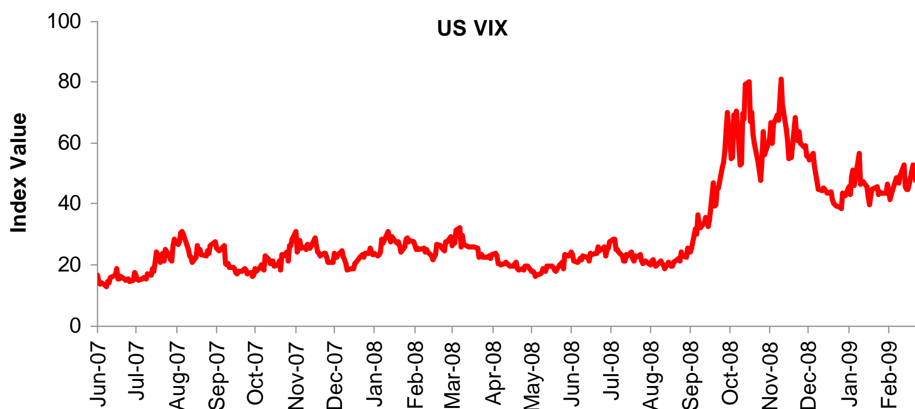
As can be seen from the chart above, credit card delinquencies in the U.S. have been rising sharply and are expected to reach 10% by the end of the year. Given that the U.S. credit card industry is a US$1tn market, the pressure on the U.S. banking industry is likely to remain severe and, in turn, place considerable strain on the banks capital and 'stress test' ratios. All in all, we expect further capital to be pumped into the U.S. banking industry this year, and by any other name, some banks will be nationalised.

In terms of protectionism, we are not so concerned about trade protectionism (though it will rise) but more with capital protectionism. It seems reasonable to us that, with most major banks in the U.K. and similar banks (if not in name) in the U.S and Europe being nationalised, most lending will be aimed at their own economies. We are sure it would not go down well with taxpayers to see their money being lent to companies in other countries. So, as we have just seen in Eastern Europe, this could lead to a credit crunch; in our view, Asia is probably

next to feel the downshift of this. A flight of capital from emerging markets is already likely underway; the prospect of this capital not coming back anytime soon could throw up additional stress areas for the global banking industry.

Finally, with the sharp fall in the markets, pension funds are finding that they are under-funded; figures of US$1tn for the U.S. pension industry alone are starting to be heard. The numbers look no different for U.K./Europe. So, there could well be an accounting and cash-flow hit for many companies over the next year.

Given the aforesaid factors that are likely to play out over the next few months, we believe that the markets have potentially one final leg down. As in all bull/bear phases, markets tend to overshoot on the upside and downside. Our guess would be that we could see the S&P index hit 600, a 20% fall from here. At that time, capitulation will likely be the global buzzword and will probably mark the bottom of the markets. Interestingly, despite the recent sharp fall in the Dow and S&P over the past month, the VIX has hardly moved. Perhaps, in this final leg down, the VIX will move nearer to 80 (see chart below).



Source: Bloomberg

Reaching a bottom, however, may not lead to a sharp rise in markets. Indeed, markets will have to deal with awful economic data over the next six months and beyond, and it will certainly not feel that there is an economic recovery in sight. U.S. unemployment is likely to hit 10%+ in very short order; moreover, with house prices expected to fall another 5-10% in the U.S. and Europe, it would not surprise us to see a summer of unrest around the world.

Our view is that the S&P would be nearer to 700 by the end of 2009; but, more importantly, this move from the lows will help stabilise global markets.

Domestic markets - how will India fare?

We maintain our view that, on the downside, the sensex may hit 7000; at this point, it will look attractive from a historical valuation standpoint, around 9x 1 year forward P/E. That said, even though our EPS forecast for 2009/10 is much below consensus, given our 4.5% GDP forecast (again below consensus), we do feel the pressure is towards the downside; the EPS figure, thus, could more likely be in the high 600s. Let us hope the monsoons are normal.

Of more significance than valuations at this juncture, is that the upcoming elections are unlikely to be provide any short-term positive surprises. Corporates will undoubtedly keep their hands in their pockets with respect to new capex plans until a new government is formed and even then await to see which new policies/reforms are in the offing (if any). Consumers are also likely to spend less and FDI will be a trickle. So, in our view, new investment will not kick off till next year.

Given the above, Indian markets will continue to play hostage to global events. As pointed out earlier, we expect one final leg down in global markets before we become universally bullish. For sure, the Reserve Bank of India, (RBI), will lower interest rates to try and kick-start the economy; this, however, will take at least six months for it to feed through to the economy. For the rupee, any further cut in rates will again put pressure on the currency and a level nearer to rupee/ USD60 cannot be ruled out. FIIs, for sure, if they believe this to be the case, will continue heading towards the exit and total outflows could reach US$5bn (currently around US$2bn). All told, India is off foreign investors' radar for 2009.

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