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Research
India

India Strategy

Three Legs of a Bear Market

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Three Legs of a Bear Market

- **Short-lived rally, downward draft resumes and it seems to be the third leg of this bear market**: The market seems to have fallen short of the 10% rally that we had expected and resumed its downward draft. The reasons are aplenty for such a short pull back – a worsening monsoon picture, rise in crude oil prices, bad macro / stagflation type numbers, rising long bond yields and tepid earnings from Infosys – mostly the same factors that have been plaguing the market since the start of the year. So despite the severe price erosion that the market had suffered in June and subsequent improvement in the valuation story, equities seem to be failing to push higher levels.

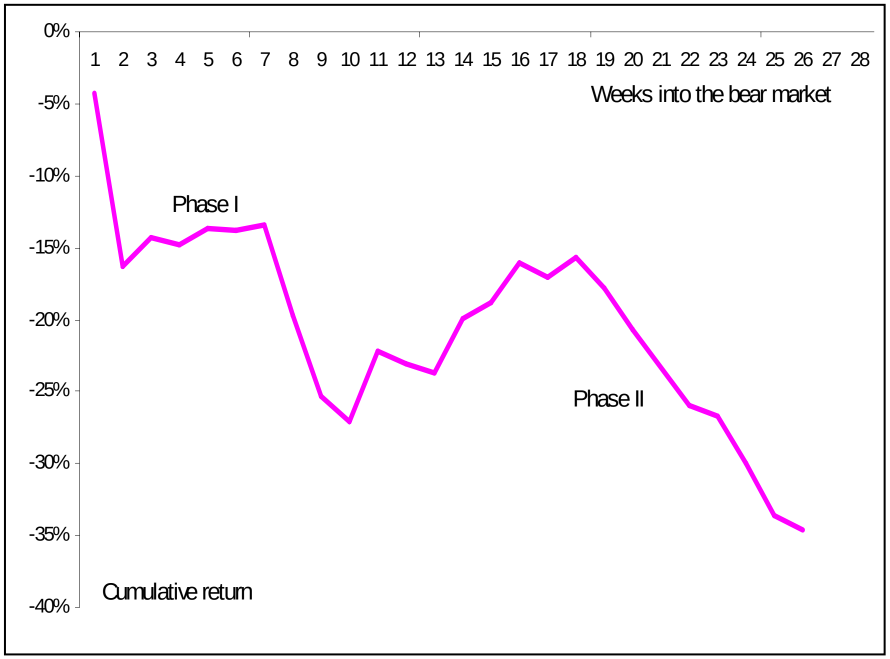
- **First two legs of the bear market are over**: The market may have completed two out of the three legs in its bear phase. The first leg was an a sell off across the market led by global macro concerns. The market multiple fell but the damage to the relative multiple was limited. The second leg was more discrete. Sectors with weaker fundamentals and rich valuations bore the brunt of the fall. This allowed the valuation and return dispersion to narrow from where we were at the peak of the market. The second phase has also taken the market closer to fair value and most of India's relative valuation excess has been wiped out. Thus from trading at nearly twice the emerging market multiple, India now trades at around 15% premium to EM – a distinct de-rating. The second phase witnessed the beginning of macro concerns but earnings estimates remained largely unchanged and domestic sentiment was characterized by hope. India's excess return over emerging market also fell during the first two phases but India remained a long run outperformer.

- **Third phase will likely last longer in time terms**: We think that we are now entering the third phase of the ongoing bear market as and when the ongoing trading rally is over (if it is not already). This phase will probably end with the market below fair value. The first two phases lasted 26 weeks – the third leg could last longer than the first two put together, i.e., 25-50 weeks. Another distinction from the first two phases is the rate of price fall which we think will slow distinctly in the third phase. The average weekly loss the first two phases was 1.3%. Valuation and return dispersion will narrow further. The final phase of the bear market will be accompanied by poor fundamentals – worsening macro and earnings downgrades. India's relative returns and valuations to emerging market could fall below zero and long-term mean, respectively. Investors should also ready themselves for outflows in funds.

What to expect in the third phase of the bear market?

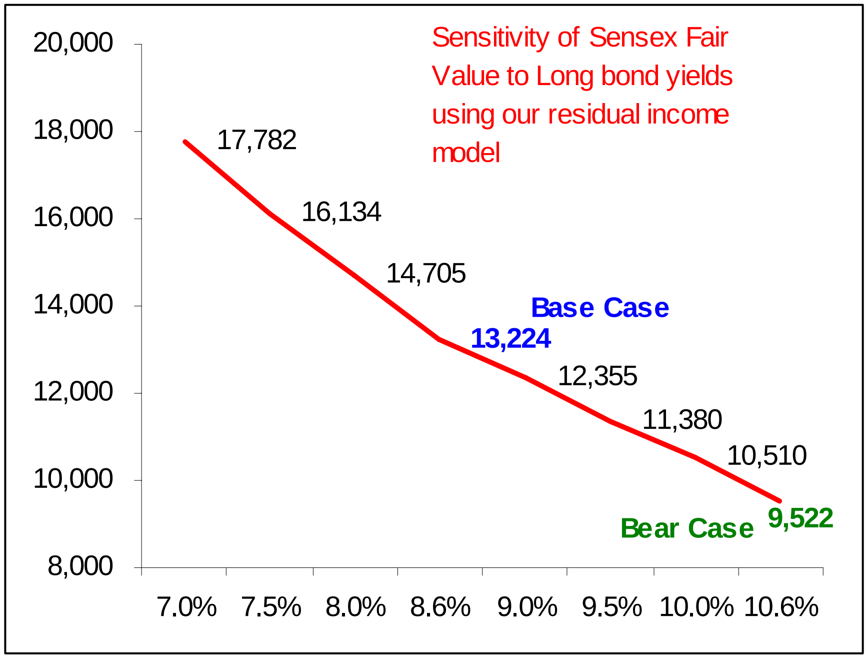
1. Market likely to go below fair value before bottoming out
2. Phase III will likely last longer than the first two phases (which lasted 26 weeks in total). At the same time the rate of decline will slow down – phase III will likely characterized by a grinding fall to its low point.

Phase III – Longer and Slower Fall



Sources: Bloomberg, Morgan Stanley Research

Market Likely to Go Below Fair Value

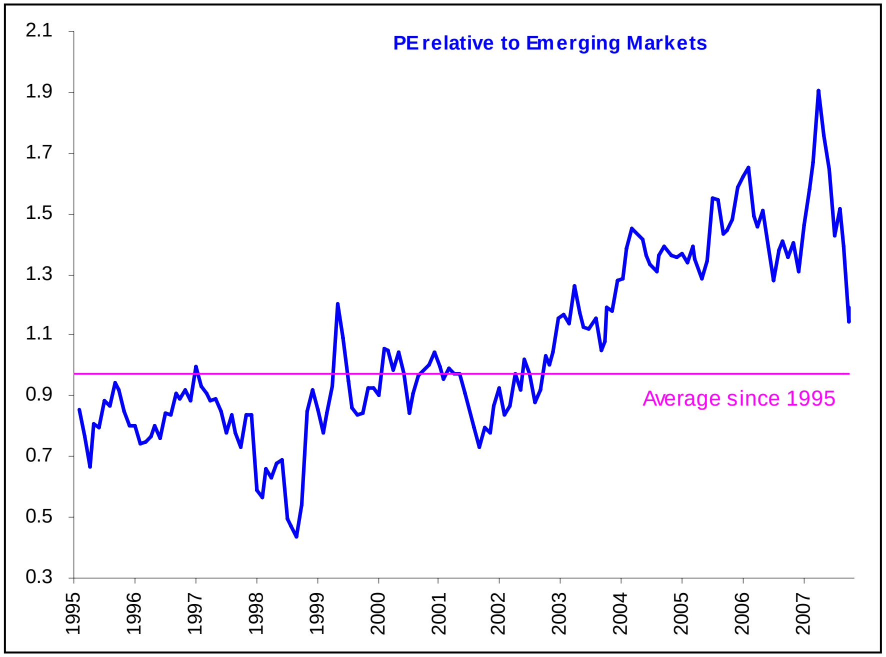


Source: Morgan Stanley Research

What to expect in the third phase of the bear market?

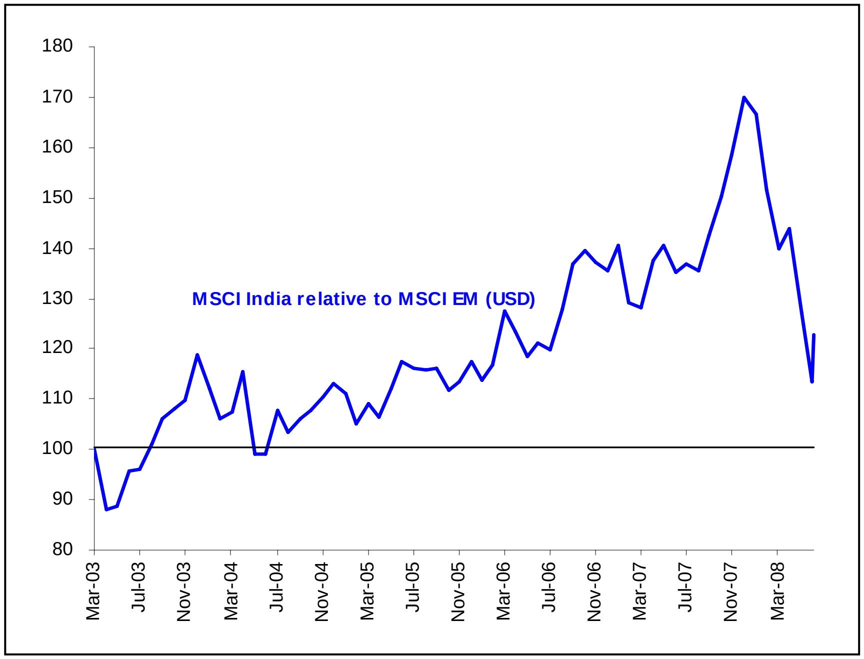
3. India's long-term relative returns to emerging markets may turn negative
4. India's relative valuations to EM may fall below long-term averages.

India's Relative Valuations Could Go Below Mean



Source: FactSet, MSCI, Morgan Stanley Research

Long-term Relative Returns Could Turn Negative



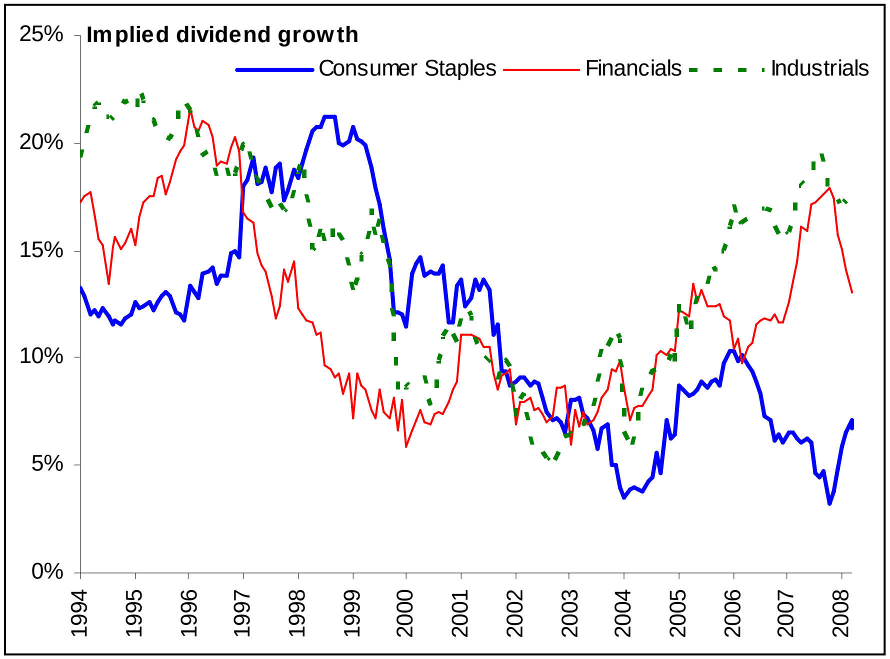
Source: FactSet, MSCI, Morgan Stanley Research

What to expect in the third phase of the bear market?

5. Valuation dispersion may narrow further.

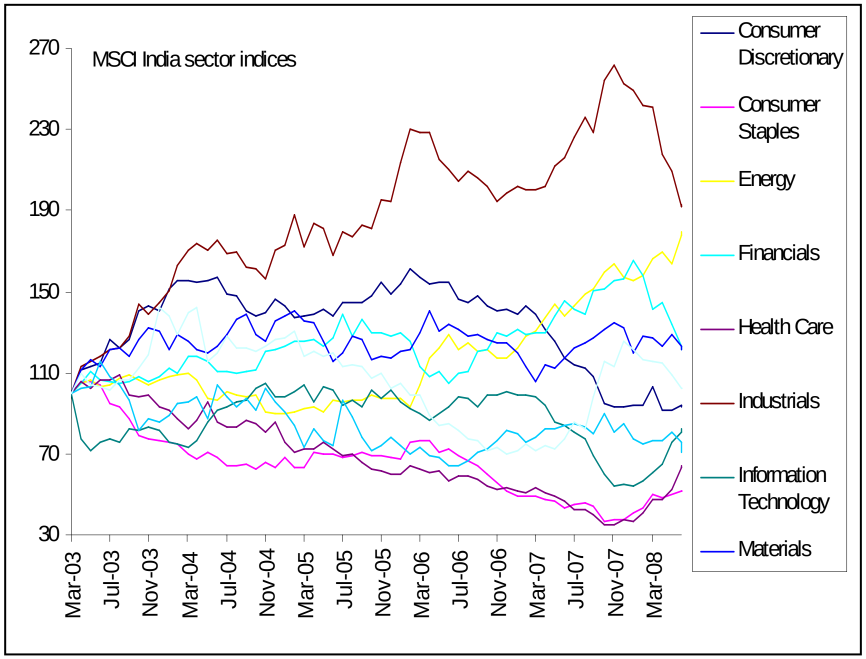
6. The performance gap across sectors may also close. Thus consumer staples, healthcare, technology could continue to outperform while industrials, financials and materials underperform.

Valuation Dispersion Will Likely Narrow



Sources: FactSet, Morgan Stanley Research

Performance Gap Across Sectors May Close



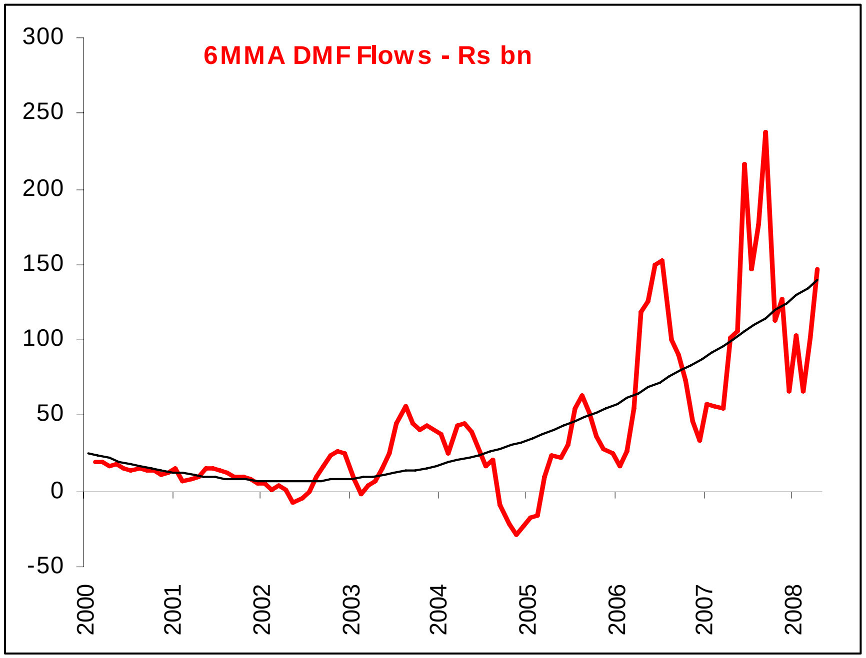
Source: FactSet, Morgan Stanley Research

What to expect in the third phase of the bear market?

7. Macro fundamentals (defined as long bond yields, growth and inflation) will likely worsen. Eventually earnings estimates will have turn down.

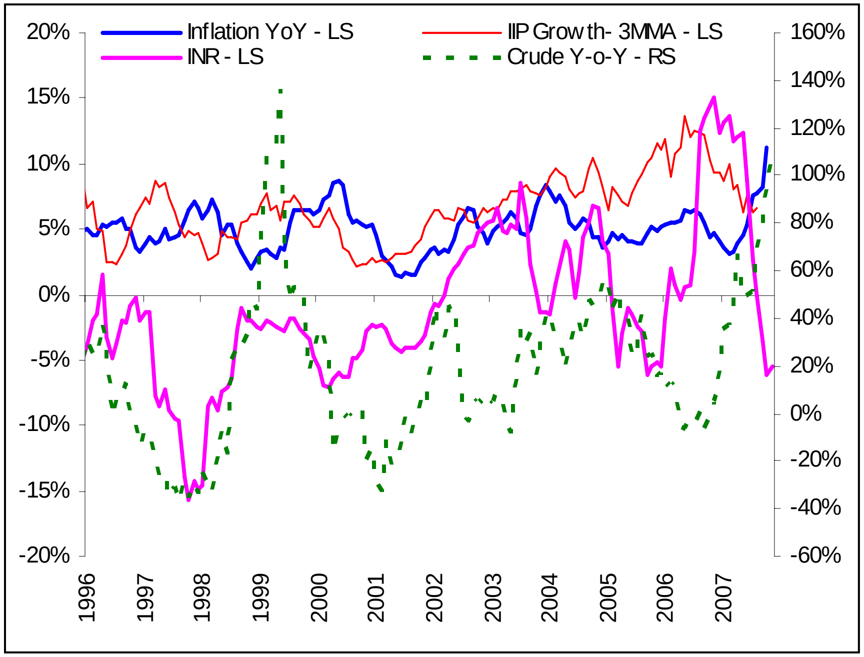
8. Domestic mutual funds will likely face outflows.

Domestic Mutual Funds: Awaiting the Outflow



Source: AMFI, Morgan Stanley Research

Key Macro Variables May Worsen



Source: CSO, Bloomberg, Morgan Stanley Research

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