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Daily Voice | More correction likely as these four risk factors not priced in yet, says Dhananjay Sinha of JM Financial

"It will be early to assume that the full impact of headwinds (that confront the global and Indian economy currently) are priced in," says Dhananjay Sinha, Managing Director and Head Strategist and Economist - Equity Research at JM Financial Institutional Securities.

Gauging the markets using this monitor, JM Financial sees that 30-35 percent of the characteristics of past capitulation are visible as of now, leaving further scope for adjustments. Hence they expect commodity prices to correct further and crude would be the last to collapse, giving rise to a scenario of market capitulation. Thus, the markets may still be afar from a deep value situation, Sinha shares in an interview with Moneycontrol.

Excerpts from the interview:

Do you think the market fully priced in all these risk factors? Do you see any other risk that the market hasn't factored in yet?

While it is true that the market now knows the various risks that confront the global and Indian economy, it will be early to assume that the full impact of these headwinds are priced in. For instance, the advent of the Federal Reserve's balance sheet taper and its impact on US money supply/GDP are yet pan out. It is an important variable impacting market valuations over time.

Secondly, while the market has absorbed the impact of the bond market meltdown, we have yet not seen the peak levels of volatility measures, market risk premium and credit spreads.

Thirdly, despite the ferocity of market correction there are still several pockets of overvaluation, especially in illiquid stocks. And fourthly, we have not yet seen actual earnings downgrades; we expect that to begin with the Q1FY23 results.

Do you think the market correction is over?

Our market capitulation monitor assesses how far we are from the ultimate bottom against 10 macro-market components such as a) economic surprises, b) inflation surprises, c) equity risk premium, d) credit risk premium, e) currencies (dollar index), f) commodity inflation, g) treasury term spreads, h) index option spreads for high yielding credit, i) financial market conditions, j) inflation expectations and real rates (TIPs).

Gauging the markets using this monitor, we see that 30-35 percent of the characteristics of past capitulation are visible as of now, leaving further scope for

adjustments. We expect commodity prices to correct further and crude would be the last to collapse, giving rise to a scenario of market capitulation. Thus, the markets may still be afar from a deep value situation.

If the US and Europe enter into recession, then do you see major impact on India as well, the fastest growing economy?

Recessionary tendencies in major economies would have far reaching impact across the world. India would be affected through the channels of global trade, inflation, financial systems, and financial markets linkages. These will be affected through a) tightening of financial conditions, b) currency depreciation, c) re-emergence of twin deficits, fiscal and balance of payment (BoP) due to elevated crude oil prices; there is a fair possibility of further drawdown of RBI's forex reserves, d) slower global trade, which has been a major contributor of India's post covid revival, and e) erosion of asset price.

Capital flows into emerging markets (EMs) and India have slowed in the wake of stronger dollar. FPI outflows have been at an unprecedented scale since October 2021 and it can continue as the US Fed has committed to further tightening. The context of slower growth and moderation in capital inflows can complicate the policy conundrum for India. The 3 years CAGR real GDP growth till now is around 2 percent, and looking beyond the volatile element of the 7.2 percent projection for FY23 the terminal growth is around 4 percent. Deceleration in global growth will also mean scaling down of both real GDP and earnings projections for India.

Do you think the new age tech companies will delay their IPO plans especially after already listed new age companies hit quite badly in recent turmoil and corrected more than others?

As money becomes dearer, the evaluation metric for investments become stricter and investors start looking for companies with strong fundamentals, companies generating free cash flows and money starts moving away from high growth high PE stocks to growth with visibility. Thus, new age companies whose cash flows are non-existent or are far into the future would be exposed to greater scrutiny.

We expect this trend to continue regardless of whether we are referring to the public of private markets. There are early signs of cost cutting by start-ups resorting to layoffs in the private/unlisted space.

Indian markets have seen correction in line with global trend. So have you spotted any big investment themes in India?

The current market scenario has played out broadly in line with our global inflections theme since mid-2021. The ferocity of the market correction since the start of 2022 is characterised by extraordinarily high volatility. First, resonating the collapse in the US Nasdaq index, India IT index has eroded by 30 percent, b) Small cap index has corrected by 35 percent for the peak compared to the 18 percent decline in the Nifty 50 index, and c) cyclical sectors led by metals, reality, industrials and capital goods have taken a huge knock.

What has held up relatively better are the domestic consumption theme, telecom, utility and consumer staples, where the visibility of earnings trajectory is less volatile.

What is different from the earlier phases of capitulation is that both pharma and the technology pack have not provided shelter.

Our study across the past three decades of multiple business cycles involving global inflections indicate that segments that do well in the progression of the inflection point will be domestic themes in consumption, automobile, retail lending, technology, household products, personal products, hotels & restaurants, and durables.

In a scenario of volatile commodity prices and its impact on sales growth it will still take some more time for private capex intent to revive in a significant way. As the capitulation phase plays out, we expect deep value to emerge in companies that have delivered consistent return ratios and gains in market share across cycles; we will concentrate on them.

The IT sector, which was one of biggest gainers since 2020, has slaughtered in current turmoil. Is it the right time to buy this space or should one be selective?

The savage erosion of the IT pack has been driven by a) the sympathetic response to deep correction in US tech bubble created by the post-covid consumer digitisation theme, which is not a comparable universe for Indian IT companies, b) hardening in risk-free rates eroding the lofty valuations in the post-pandemic rally, and c) the fears of an impending US recession creating concerns on future revenues outlook. There have also been concerns of margin compression due to rising wage cost and high attritions.

We believe that valuation for IT companies are now closer to fair value and the feedback form companies suggest that revenue outlook thus far is intact. There may be some downside due to an eventual recession. But it may be temporary as we see structural tailwinds for IT spending by US companies over the longer horizon. A potential recession or an economic slowdown could ease the wage cost pressure for India IT companies over time.

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