Business Standard

This is the year to pick & choose sectors and firms carefully: Devina Mehra

'India will be an outperformer this year and that has panned out in spite of the currency epreciation'

Puneet Wadhwa **October 10, 2022** Last Updated at 06:15 IST

Devina Mehra, founder, chairperson & managing director, First Global, and India and Global Quant Asset Manager

Do you think the up-move in global equity markets, including India, since June was a bear market rally?

I have been saying from the beginning of the year that India will be an outperformer this year and that has panned out in spite of the currency depreciation. I expect this to continue. India will remain one of the stronger markets.

For context in mid-June, I had said that it was time to be invested in the markets, otherwise the risk of missing out on a big up-move was very real. The Indian market went up 18 per cent from there in little over two months. For India, the move hardly qualifies as a bear market territory in the first place. In India, while I expect volatility, a big downside from here is unlikely. Globally, the turmoil in Europe will continue, driven primarily by uncertainty on energy issues.

As regards the US, a lot of the pain is already in the price, especially in the non-tech space. While the US may not outperform the way it did in the past decade, reasonable stability appears to be on the cards. In any case, usually, whether something is a bull market or bear market rally is evident often only in the hindsight.

Is the risk-reward still favourable for equities as an asset class over the next year?

Yes, I still favour equities as risk-reward is most favourable for the equity markets after such a correction. In the global context, past data suggests that every time the market has been down so much for the year, there is a high likelihood of a rally thereafter. In any case, this has been one of the unusual times when almost all asset classes and almost all countries, barring a handful of commodity-related markets, have declined for the first nine months of the year.

Given the rate tightening, fixed income has also not been a good place to be globally, with all fixed income indices going down substantially. Commodities have given up their gains for the year, with finally even oil coming down to January levels. However, part of this is only the dollar appreciation as prices are quoted in US dollars; commodity prices have gone up in other currencies. The best place to be in this year has been the US dollar itself, which is up 19 per cent on average against other currencies, and still not showing signs of weakness.

Would you prefer large-, mid-, or small-caps from a 12-month perspective?

In India, I expect mid- and-small caps to give higher returns than large-caps, although large-caps will be more stable and less volatile. Nevertheless, in our PMS schemes, we limit small-cap exposure simply as a risk management parameter as liquidity can disappear in these very quickly on the way down. Having said that, 2022 has not been -- and will not be -- the kind of 2021 bull market, which lifted all boats. This is the year to pick and choose sectors and companies carefully.

From a short-term perspective, do you think risks for the markets are mounting and rallies will eventually get sold?

We are near the bottom in the US, although some European and emerging markets may have different dynamics. However, the equity markets will still be volatile and it may take another quarter for stability to return for global markets. For India, I believe the worst, which itself hasn't been so bad, is behind. In any case, all academic studies across multiple countries show that sentiment is a contra indicator for future returns. When sentiment is poor, returns in the next period are above average and when sentiment is at a high, as it was in 2021, the next period returns are below average.

How comfortable are you with the market valuation at this stage?

India is trading at a premium to the other emerging market (EM) peers in terms of price-to-earnings (P/Es). Of course, P/Es are not directly comparable because of differences in interest rates, as well as the sector composition in each country. For example, a number of EMs have a very high weighting not just for financials (which is true of India, as well), but also for commodities and real estate, which are typically low P/E sectors. Therefore, it is not an apple-to-apple comparison. Relative to its own history, India's P/E is at a discount to its 10-year average. However, I am not a big votary of looking at market-wide averages, which can get skewed by the results of a few companies.

Valuation-wise, how do we compare with our peers?

Indonesia, Hong Kong, Taiwan, and South Korea are also trading at a huge discount to their 10-year average multiples. And, among developed markets, so is Europe. It is trading at a 41 per cent discount to its 10-year average multiple, but then the past 10 years were characterised by declining interest rates until they went to zero or even negative. The pain is very real when rates go up from there.

Another thing which I never focus on is the inflow from foreign portfolio investors (FPIs), as all our data studies show that this has no correlation whatsoever with market movements, except possibly on a one-day basis. For context, FII money started coming into India in 1993-94, and 1994 to 2003 was practically the only nine-year period in Indian stock market history when the returns were zero. Investors should focus on their view of the economy and companies rather than waste time on estimating flows.

What has been your investment strategy at First Global in this rising interest rate and inflationary backdrop?

We have been cognizant of the fact that this year there will be a rising rates environment, and particularly in the West, where rates are coming off near zero, the percentage change is very substantial. Unfortunately, globally, almost all asset classes and all geographies have seen a decline this year -- leaving little room for long-only strategies. As I have been saying from the beginning of the year, India looked like an outperformer. Even in our global funds we have had our highest-ever weighting to India. Over the next few months and quarters, I expect India to be an outperformer globally and in absolute terms. I do not see a very significant downside from here, although some volatility is to be expected.

Do you see earnings downgrades over the next couple of quarters as input costs bite?

If you see the past data, normally consensus earnings drift down over the period as most securities firms start off with very optimistic estimates. In terms of ground reality, most of the input price increases came in the first half of the calendar year and broadly commodity prices have come down since. Of course, the rupee depreciation has had some negative impact.

Even so, I do not see margin compression as a significant risk area going forward. In fact, you may well see some margin expansion at least compared to the past two quarters. Sectoral trends will be divergent, with certain segments like capital goods & banking showing better results.

On the demand side, while there is a definite revival from the sluggish conditions of the past two years, various segments of the economy are growing at a different pace, with still many citizens below the creamy layer continuing to hurt. Still, even on this front, things are better than what they were a couple of quarters ago -- showing in a host of indicators from better job growth to two-wheeler sales.

Will the secondary market nervousness weigh on the primary markets, as well, where companies either postpone the float or trim the issue size?

IPO frenzies always come and go. Historically, they usually come after a big secondary market bull-run. Last year, when the IPO market was extremely buoyant, I had said that this would not sustain and a crash was imminent. Among other reasons, at the time, many new valuation metrics were being sold but there is only one way to value a security. Anytime one is looking for new ways to value something, they are only looking to justify a valuation, not to do a valuation. I do not think the 2021 kind of IPO market will come very soon, although there will always be a market for sensibly priced good issues. Retail investors should not, at any point, look at the IPO market as a lottery and should evaluate each issue on its own merits just as they would for buying a stock in the secondary market.

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