

# IS IT TIME TO SELL?

Several warning signs from the stock markets say that investors should book profits now.



GETTY IMAGES

By Narendra Nathan

**A**fter months of small dips and immediate recoveries, the Sensex slipped by more than 2,500 points last week. Is this the start of the long-awaited correction or just another blip in its one-way rally? The Indian stock markets have not witnessed a genuine correction since March 2020. In stock market parlance, a correction means a fall of more than 10% in the major indices from their recent top. Although the Sensex has not breached that level yet, experts say that this one-way rally can't continue

forever and, therefore, investors should consider booking some profits now. There are enough warning signs coming from the markets and a full-fledged correction can't be far away. Let us examine these warning signs and what they mean for investors.

## Valuations are high

The Indian equity market has been overvalued for quite some time. But the overvaluation has reached worrisome levels now. The Sensex forward 12-month PE is at a 12-year high and well above its 10-year average (*see graphic*). Besides, the Indian market is now significantly overvalued

compared to other emerging markets (*see graphic*). The valuation premium has been calculated using the PE ratios of MSCI India Index and MSCI Emerging Markets Index. Due to this overvaluation, foreign portfolio investors (FPIs) may book profits in Indian equities and invest elsewhere. In fact, this has already started.

What do these high valuations mean for investors? "Since the market is expensive now, the next one year's return is going to be muted," says Sameer Kaul, Managing Director & CEO, TrustPlutus. "The high valuation can't be sustained because it is not supported by fundamentals. As of

now, the market is over discounting the future earnings," says Hasit Pandya, Director, HPMG Shares & Securities. "Investors should be cautious because the current valuation is factoring in 2023-24 earnings. Analysts are rolling forward their estimates to 2023-24 and upgrading individual stock targets based on that," says Shyamsunder Bhat, CIO, Exide Life Insurance.

## Halt in earnings upgrade cycle

To be fair, the better than expected growth in corporate earnings in the past few quarters had justified the high valuations.



Analysts used to upgrade the projection for the full year after every quarter. However, this upgrade cycle has now come to an end (*see graphic*). The expected Nifty EPS for 2021-22 has not moved up in the past six months. "Corporate earnings are muted because margins got compressed due to rising costs. A similar trend is expected in third quarter also," says Pandya. Supply disruptions, like the chip shortage forcing auto companies to cut production, is also impacting aggregate earnings. If supply disruptions continue for some more quarters, we may even see earnings downgrades.

Despite the halt in upgrades cycle, the broader market is still holding up due to two factors. "The market is taking solace from the fact that the top-line growth was better than expected," says Sanjay Sinha, Founder, Citrus Advisors. Though high revenue growth is a good indicator, it is not a substitute for higher earnings growth. Investors' strategy of carrying forward this year's lower growth to the next year is another reason for this. Since corporate earnings were not growing at the expected rate earlier and the market was doing well based on hope, investors think that it will continue to rise. However, hope can't be an investment strategy; especially after the earnings upgrade cycle came to a halt.

## Liquidity is ebbing

After pumping in large amounts of liquidity, global central bankers have realised that just like you can't extract too much juice from an orange, they can't extract additional growth by keeping the tap open. They have therefore started closing down the liquidity tap. The additional liquidity can't be used productively for economic growth, so the excess money is chasing all asset classes (and even non-existent asset classes like cryptos) and pushing their prices to new highs. This has resulted in a big jump in commodity prices and in turn, resulted in higher inflation. So, central bankers have no option other than reducing liquidity. The US Federal Reserve has already announced its plan to reduce the quantity of bonds it will buy.

Will this impact equity investors in India? Certainly, because the entire rally in 2020 and 2021 was driven by liquidity and not because of the economic growth. In fact, even after the smart recovery in 2021, the GDP has only reached its 2019 level. "Since liquidity drives up the froth, its reduction across the world will put pressure on the markets. However, this withdrawal will be a gradual process and will take around six months," says Mayank Khemka, CIO-India, Deutsche Bank.

Given that domestic inflation has started easing, RBI may not get on the rate hike wagon soon. However, a sudden weakening of the rupee could become the turning point. "Domestic and global liquidity is expected to be withdrawn slowly. However, domestic liquidity will fall fast if there is a sudden fall in the rupee and RBI starts defending the currency," says Kaul.

## FPIs are booking profits

Selling by FPIs has accelerated in recent months. They have already withdrawn \$3 billion (₹22,500 crore) from the equity mar-

kets in the past 12 months.

FPI investments in IPOs are also counted as inflows, otherwise the reported outflow would have been much higher. FPIs are booking profits in Indian stocks partly because of high valuations and high historical returns. They are also selling because of the reduction in global liquidity and the resultant repatriation of funds back to the US. As of now, increased domestic inflows from all quarters, including mutual funds, HNIs and retail investors, were able to match the outflow and thereby give some stability to the market. However, there is no guarantee that this balance will continue in future. "The risk appetite of retail and HNI investors can change very fast. If the FPI selling continues unabated, it will impact their sentiments," says Deepak Jasani, Head of Retail Research, HDFC Securities.

It might sound counter intuitive, but the FPI selling may stop if the market corrects. "FPI selling, to some extent, is because of relative attractiveness of China. Once the correction happens, India will also become attractive," says Jaspreet Singh Arora, CIO, Equentis Wealth Advisory Services.

## IPOs are draining liquidity

In addition to the liquidity reduction on a global scale, a large number of IPOs have hit the Indian market now and more are expected in the coming months. The IPO rush has drained out liquidity from the secondary market. "IPOs with very high valuations and money flowing towards the IPO market are the biggest worries for the market now," says Pandya. According to Prime Database, fund raising through the IPO route during the year has already crossed ₹1.03 lakh crore. This is only slightly lower than the ₹1.37 lakh crore raised during the previous four years (*see graphic*). Collection are expected to rise further in the coming months because IPOs worth ₹43,778 crore are waiting with valid Sebi approvals while IPOs of ₹82,515 crore are filed and waiting for Sebi approvals. In addition to sucking out liquidity, these giant IPOs are also a warning sign for the market. "Large, overpriced IPOs usually come at the end of the bull market and therefore, usually signals the end of the secondary market rally," says Khemka.

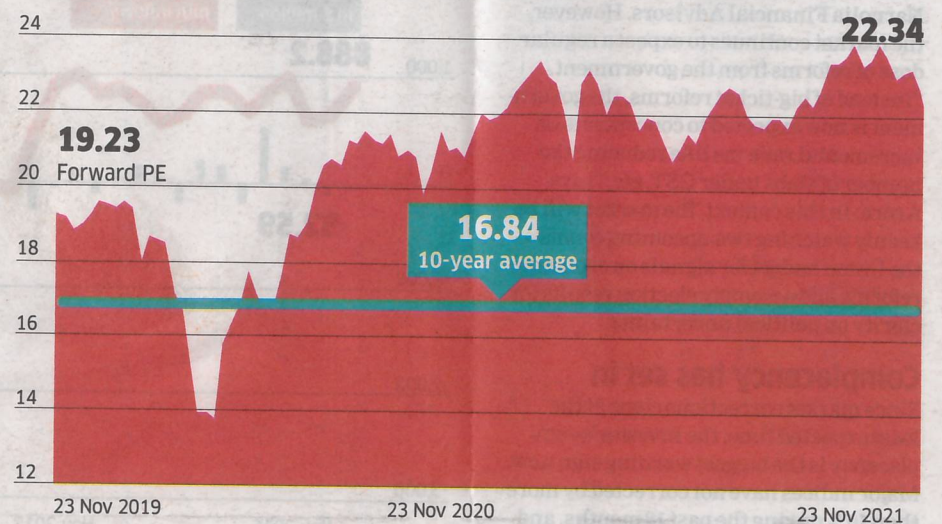
Will the recent Paytm fiasco burst the IPO pipeline? Analysts are divided on the impact (*see box*). "One issue will not dampen the IPO pipeline. But this will bring some correction in IPO valuations. The IPO pipeline will continue so long as the secondary market remains stable," says Pranav Haldea, Managing Director, Prime Database. "It seems the market has already discounted the fallout of the Paytm IPO. However, the primary market sentiments will get dented if another big IPO also gets listed at a discount," says Jasani.

## Reform backtrack

The BJP's losses in recent byelections raised some concerns of political uncertainty in the market. The Uttar Pradesh assembly elections which are due in 2022 are critical because the state has the highest number of parliamentary seats. The recent decision by the Central government to withdraw the farm bills has dampened

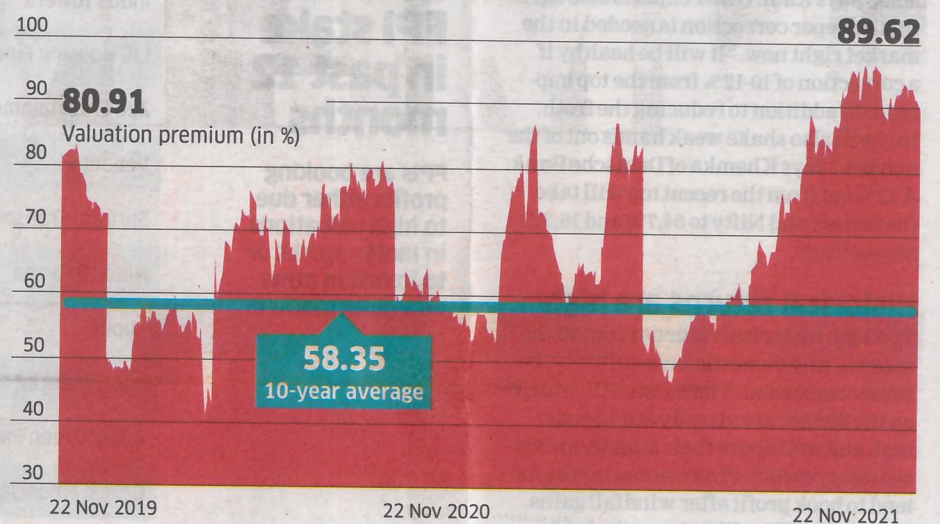
## Sensex forward 12-month PE is well above its long-term average

Further PE expansion is difficult because it is already at a 12-year high



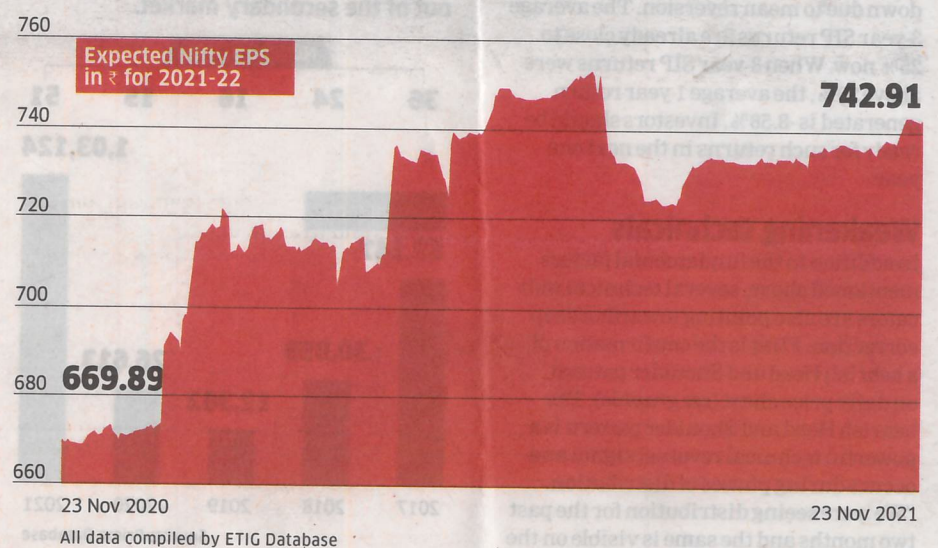
## India's valuation premium, compared to emerging markets, reached a new high

Due to overvaluation in India, FPIs may book profits and invest elsewhere



## Earnings upgrade cycle has halted after Q1 numbers

If supply disruptions continue, we may even see earnings downgrades.





the market sentiment further. “Reversal of farm bills has raised doubts whether the central government will initiate new ‘hard reforms’ till the general elections in 2024,” says Shailendra Kumar, CIO, Narnolia Financial Advisors. However, the market continues to expect a regular dose of reforms from the government. “Instead of big-ticket reforms, the government is now expected to concentrate on incremental reforms like reducing the number of slabs under GST, etc,” says Arora. In this context, the market will be keenly watching two upcoming events—the Union budget for signals on economic reforms and assembly election results for clarity on political uncertainty.

### Complacency has set in

Since market corrections come at the least expected time, the investor’s complacency is the biggest warning sign now. Major indices have not corrected by more than 10% during the past 18 months, and therefore, most investors have started believing that any correction will be only 5-7%. “Investors have become complacent and therefore, market need a proper correction. Since the 16,000-16,500 level can be treated as fair valuation zone for the Nifty, a correction to that range is reasonable,” says Kaul. Other experts also agree that a deeper correction is needed in the market right now. “It will be healthy if a correction of 10-12% from the top happens. In addition to reducing the froth, this will also shake weak hands out of the market,” says Khemka of Deutsche Bank. A 12% cut from the recent top will take the Sensex and Nifty to 54,776 and 16,372 respectively.

### Historical returns are high

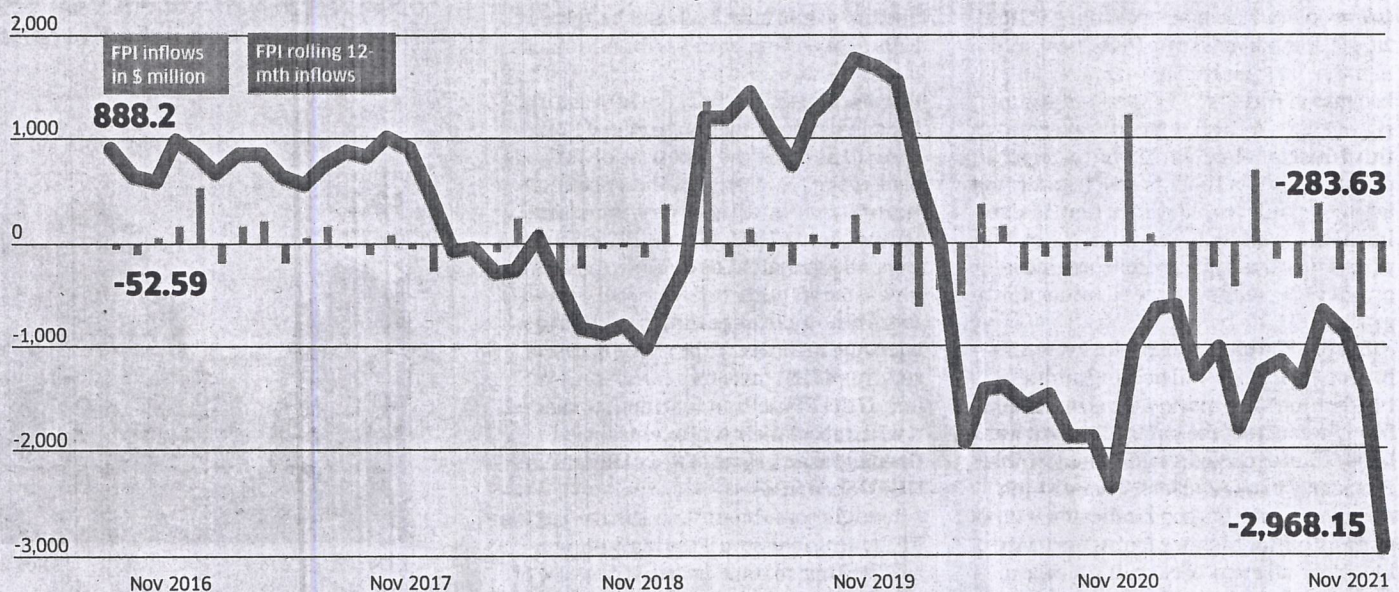
The high historical returns is one of the reasons why domestic investors have become complacent. The 3-year SIP returns on the Sensex are already at a 12-year high and well above their long-term average (see graphic). Professional investors tend to book profit after windfall gains. In fact, the FPI selling is partly due to this. Retail investors, on the other hand, usually chase historical returns. The enormous amount of money flowing into domestic funds now is proof of this. However, investors should know that no market can continue on a one-way trip like this. The returns ultimately come down due to mean reversion. The average 3-year SIP returns are already close to 25% now. When 3-year SIP returns were above 20%, the average 1-year return generated is -8.58%. Investors should be ready for such returns in the next one year.

### Weakening technicals

In addition to the fundamental factors mentioned above, several technical indicators are also pointing towards a deep correction. First is the confirmation of a bearish Head and Shoulder pattern on daily price chart (see graphic). The bearish Head and Shoulder pattern is a powerful technical reversal signal and occurs during phases of distribution. “We were seeing distribution for the past two months and the same is visible on the

## FPIs have withdrawn \$3 billion in the past 12 months

Domestic inflows have been robust but won’t be able to nullify the impact if FPI selling continues unabated



## Companies with biggest decline in FPI stake in past 12 months

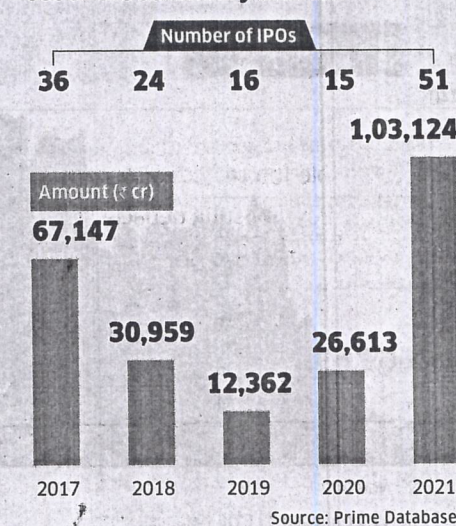
FPIs are booking profits either due to high valuations in Indian stocks or to invest in other emerging markets

COMPANY	FPI HOLDING (%)		FALL IN HOLDINGS (% POINTS)	APPROXIMATE VALUE OF STAKE SOLD IN ₹ CR
	30 SEPT 2020	30 SEP 2021		
Indus Towers	40.89	26.83	14.06	11,142
LIC Housing Finance	34.44	24.07	10.37	2,260
Zee Entertainment Enterprises	66.24	57.18	9.06	2,968
Vedanta	17.50	8.69	8.81	12,037
Shriram Transport Finance Co	60.52	53.67	6.85	2,881
Natco Pharma	19.32	12.53	6.79	1,023
Lupin	20.35	15.66	4.69	1,914
Max Financial Services	32.40	27.72	4.68	1,550
Adani Green Energy	22.43	17.83	4.60	10,107
Oracle Financial Services Software	12.42	8.53	3.89	1,398

\*Based on the market cap as on 25 Nov 2021

## IPO collections are surging

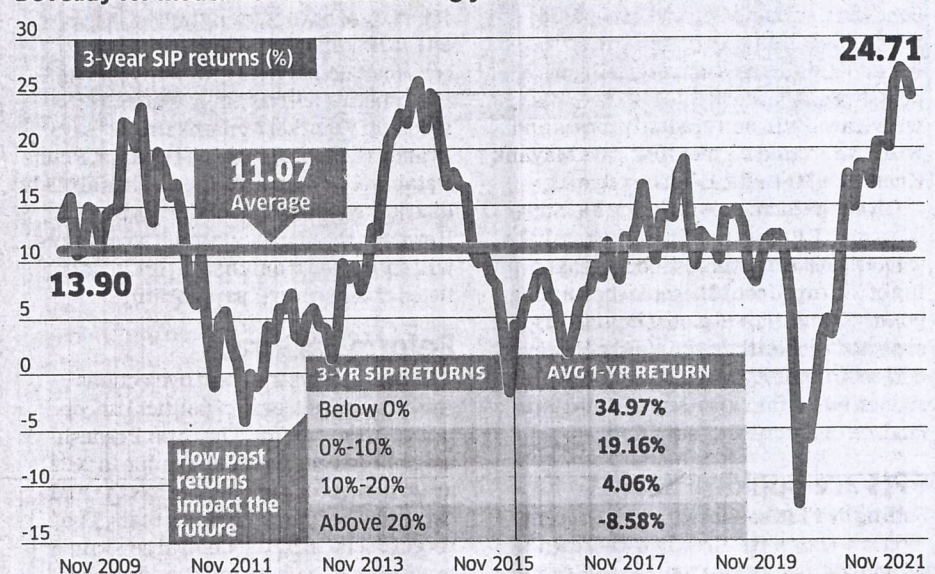
Large IPOs will suck liquidity out of the secondary market.



Source: Prime Database

## 3-year SIP returns are at 12-year high

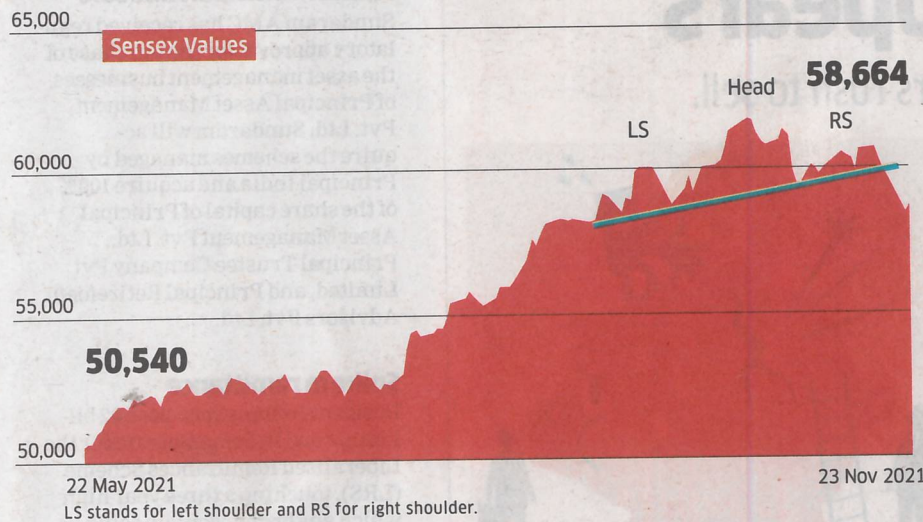
Be ready for moderate returns in coming years due to mean reversion





## Bearish Head & Shoulder pattern confirmed

This is a distribution pattern and therefore, a strong signal



Head and Shoulder pattern. Since break down of its neckline has happened now, the correction is expected to continue for some more time," says Ajit Mishra, Vice-President, Research and Religare Broking. The Head and Shoulder pattern's target is based on its height. Since the breakout happened at 59,500, its total height is 2,700 points and fall after the breakout will be the same. So, the pattern target is 56,800 for the Sensex and 16,700 for the Nifty.

Other technical indicators also point towards a correction. The weekly Sensex MACD has shown negative divergence after a gap of two years (see graphic). MACD stands for moving average convergence divergence and is the difference between two moving averages – ie 12 days and 26 days used for the chart. A moving average of the MACD is used as trigger line (9-day moving average used in the chart). MACD going below its indicator is a sell signal (marked with down arrow) and going above is a buy signal (marked with up arrow). Though such crossovers occur frequently, divergence occurs only occasionally and therefore, has higher significance. As the chart shows, the MACD did not climb above its previous peak, despite the Sensex doing so. This is a negative divergence.

In addition to Head and Shoulder pattern and the MACD, some other technical patterns and indicators are also signalling bearish outlook. "Sensex decisively going below its 50-day moving average is a warning signal. If it doesn't recover by December, it will be the first negative quarter after March 2020 and that means the correction will then be for the entire rally that started in March 2020," says Jay Thakkar, Vice-President and Head of Research, Marwadi Shares & Finance. A correction like this usually takes the index to important retracement levels like 23.6%. This level is 54,000 for the Sensex and 16,000 for the Nifty.

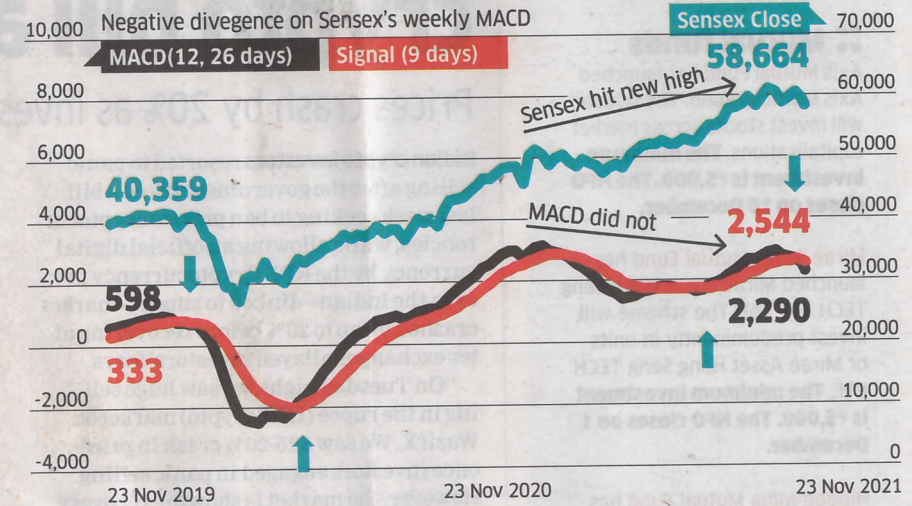
### What investors should do now

"The best strategy now is to book some profit and move that part of the money to debt," says Pandya. Another option is to cover your remaining equity position by buying a put option or by writing a call option. You also need to restructure your

portfolio. Since the market has run ahead of itself, even companies with modest growth are also trading at very high valuations. "Profit booking is happening when the earnings growth is not as expected by the market. Check all stocks where the forward PE is over 25 times and make sure

## Weekly MACD giving negative divergence

Investors should be careful because this has happened after 2 years



## Will Paytm listing impact the IPO market?

The Paytm listing shook the market but may not affect investor enthusiasm in IPOs.

**AFTER A DISASTROUS** start, Paytm shares bounced back last week, but still closed 17% below the IPO price of ₹2,150. The largest ever IPO by a domestic company raised ₹18,300 crore through the issue. Within two days, the shares had fallen more than 40% to ₹1,271.

Analysts have assigned several reasons for the disastrous start, including an overoptimistic valuation for a company deep in losses, the large size of the IPO and even a report released on the listing day by equity research firm Macquarie. "The IPO pricing was not in sync with the prospects of the company. High valuations based on reported institutional commitments led to high pricing despite the fact that the business model of the company had come under pressure lately," says Dhiraj Relli, Managing Director and CEO of HDFC Securities.

Leveraged subscriptions by HNIs may have also played a role. IPOs often get oversubscribed, leading to lower allotments. So HNIs usually borrow and apply for more shares than they want. But the megasized Paytm IPO was too big. "There was hardly any oversubscription and everybody got more shares than their real appetite," says Kunj Bansal, CIO of Karvy Capital. As Paytm shares fell, it



triggered forced selling by lenders.

The Macquarie report took a dim view of Paytm's prospects and set a target of ₹1,200 for its shares, nearly 45% below the issue price. The share price dipped below ₹1,300 briefly but later recovered. However, analysts are divided over whether the worst is behind for Paytm. "If there is no basis to justify the IPO price of ₹2,150, there can't be any basis to justify ₹1,200 also because the company is making losses and there is low visibility of profitability in the foreseeable future," says Bansal.

Will the Paytm listing debacle impact future IPOs? Analysts believe that the sentiment has been

dented, at least in the short term. "Markets are driven by sentiment. In the same manner that Nykaa helped the IPOs that were coming after Nykaa, the Paytm IPO would take away something from there," Zerodha Co-founder and CIO Nikhil Kamath told ET Now last week. Investors have also learnt a valuable lesson. "It might impact the enthusiasm amongst investors to subscribe to all kinds of issues," says Bansal. Also, lead managers would be wary of bringing in the IPOs at unjustifiable valuations. "Future valuations by new age companies could be more modest. Though retail memory is short, IPOs expected in the coming months will try to leave something on the table for investors," says Relli.

Now that the share price has recovered, what should Paytm investors do? Bansal says the decision to remain invested cannot be based on the loss or profit from the IPO price. "Monitor the company's performance for a few quarters. If the financial performance is satisfactory, hold. If not, exit," he says. Relli has some advice for those singed by the listing losses. "Restrict the amount to be invested in each IPO and keep a strict stoploss in terms of absolute loss per IPO," he says.

that this high valuation is justified," says Kaul of TrustPlutus.

This advice is only for investors who are already in equities. If you are a new investor and planning to invest in stocks because everybody is making money, we advise you not to venture in now. Enter

only after the market witnesses a deeper correction. As we have explained, this may not be too far away.



Please send your feedback to [etwealth@timesgroup.com](mailto:etwealth@timesgroup.com)