“The party is on and nobody wants to leave the dance floor in a hurry”. 2017 has been a super year for the majority of markets across the globe with the US Market, the world’s biggest market represented by S&P 500 Index, seeing a continuous uptrend giving 19.42% return for the year with not even a 5% correction during the year. India’s NIFTY 50 has outperformed S&P 500 and has given a return of 28.65% for the year.

This continuing uptrend is backed by significant liquidity flowing into the Indian Equity Market through different avenues viz. Retail Investors Funds through Mutual Funds especially SIP route (approximately Rs. 5,000 crores per month), Increased Direct Equity Exposure by HNIs, UHNIs and DIIs.

The aforesaid liquidity flow is on account of:

Lower Interest Rate Regime inducing investors to take a higher risk to generate higher returns. Even retirees have started putting funds in Equity Mutual Funds with an objective to earn higher yields in the form of tax free dividend ranging from 10% to 12% p.a. as against Bank Fixed Deposit rates of 6% to 8% p.a.
Impact of Demonetization: Demonetization resulted in large amounts of unaccounted money coming into the banking system; a major portion of that money got re-channeled in the Equity Market.
Stagnancy in Other Asset Classes viz. Real Estate and Gold: Introduction of the Real Estate Regulation and Development Act (RERA) and Demonetization resulted in making the real estate market stagnant. The government’s policy to curb gold imports by increasing import duty and the introduction of the Sovereign Gold Bond scheme have resulted in reducing the demand for physical gold. Gold prices have, again, remained stagnant due to “Risk On” strategies perpetuated by global investors. This has culminated in Funds flowing into Equity markets rather than Real Estate and Gold.
The Impact of this Excess Liquidity on Equity Market Is Humongous

Due to excess liquidity NIFTY 50 Index is quoting at 27.5 P/E multiple which is around +2SD from long term mean of 18 P/E. (Refer below mentioned chart period considered 2003-2017).

The majority of small cap and mid cap stocks are quoting anywhere between 30 to 100 or beyond P/E multiples.

P/E multiple of 30 has become the new normal. Theoretically, the P/E multiple of 30 implies that a company's earnings are estimated to grow at a CAGR of 30%. In an economy where the GDP growth rate is estimated to be at 6 to 8% p.a. with inflation in the range 6% to 8%, an estimated growth of 30% in the majority of companies seems unsustainable when the economy itself is likely to grow at an overall 13% to 15% p.a. in nominal terms.

Thus it seems that there is a complete disconnect between the intrinsic value of the majority of businesses and the price at which they are quoting in the market.

The aforesaid significant overpricing could be attributed to huge excess liquidity chasing the prices of handful investable stocks rather than focusing on deriving intrinsic value of a businesses and investing rationally. In India, there are approximately 3,000 tradable stocks of which the first 500 comprise 95% of the total market capitalization. Again, Net Financial Savings as a% of Total Household Savings is approximately 42%. Out of these Net Financial Savings, Direct Equity and Mutual Fund exposure is approximately 4%. Hence, if Inflows continue in Equity Markets and share of Direct Equity and Mutual Fund increases in the future chasing only those first 500 stocks, then P/E multiple of these stocks will be astronomical.

How long will this Irrational Exuberance continue? Nobody knows! Only time will tell.

Are there any triggers which suggest that we may be on the verge of a significant market correction?

Let's discuss the probable triggers:

Impact of Fed Interest Rate Hike: In December 2017, the US Federal Reserve raised interest rates for the 5th time since December 2015. The Fed has hinted at hiking the interest rates further, at least 3 times in 2018. As the Fed raises the interest rates the following are likely:

FIIs are likely to divert capital flow towards the US due to lowered interest rates differential between India and the US.
The borrowing cost of Indian companies that have borrowed on US dollar terms will increase leading to adverse impact on the earnings of those companies.
The US Dollar is likely to strengthen against the Indian Rupee. This is likely to put pressure on imports.
Through the interest rate hike, the Fed is raising cost of funds and trying to control the supply of money. Any error in estimating the impact of hike in interest rates may affect the Fed's Balance Sheet which is highly indebted, and in turn, may trigger sell off in US Equity Market and have further contagion effect on global equity markets, including the Indian Equity Market.
Increase in Crude Oil Prices: Brent Crude oil price significantly declined from approximately $110/barrel in June 2014 to approximately $30/barrel in January 2016. After that, Brent Crude oil moved up and was trading in the zone of $40 to $/60 barrel until September 2017. During the aforesaid period of low crude oil prices, India which is a net importer of Crude oil and imports almost 80% of its crude oil, benefited considerably. The Indian Government did not pass on the benefit of decline to end consumers, but instead, levied higher taxes on crude oil which helped improve the fiscal deficit. Other metals like aluminum, steel, copper required

for manufacturing/industrial sectors were also available at cheap prices resulting in higher operating margins for the manufacturing/industrial sectors. This helped the Indian Government to keep inflation under control and reduce interest rates considerably. Reduced interest rates caused huge funds from retail investors to flow into the Equity Market in search of higher returns by assuming higher risk. Again low cost of capital caused implied Valuations of businesses to rerate upwards.

However, recently, Brent crude has broken out of the zone $40/barrel to $60/barrel and is currently quoting at around $69/barrel. Technical Analysis of Brent Crude oil chart as stated below indicates that Brent is likely to move up towards $75/bbl in the next 3 to 6 months. As the momentum builds in, headlines like “Crude Oil Likely to Move Beyond $70-$75 Towards $100 /bbl”, “End of Crude Oil “may start creeping in like in the last Bull rally in 2007 -2008. This could actually induce speculative rally in Crude oil.

Other metals have begun to move up recently and will most likely fuel the speculative rally and cause inflation to rise further resulting in the rise of interest rates, cost of capital moving up impacting Valuations of businesses adversely and thus causing significant correction in stock market.

Weekly Chart: Brent Crude Oil dated 10th Jan 2018

Marginal Victory for BJP in Recent Gujarat Election: Marginal Victory for BJP in the recent Gujarat Election may prompt the BJP led Government in the Centre to come up with a populous and generous financial Budget for F.Y. 2018-19 which is likely to put further strain on the fiscal deficit causing a rise in inflation, increasing interest rates resulting in significant market correction.

Significant Stock Market Correction Overdue: The Indian Market (SENSEX) had significant correction in 1992 (approx. 56%), in 2000 (approx. 58%) and in 2008 (approx. 62 %). Thus the market has shown a tendency of getting a significant correction every 8 years. In 2016, again the market had correction of approximately 23%, but this was not as severe as the earlier corrections. Thus, a significant market correction of more than 50% is overdue.

Technical Analysis of NIFTY 50 Chart: The Technical Analysis of NIFTY 50 chart as presented below suggest that NIFTY is likely to get considerable resistance in the confluence zone of 10800-10900 on daily chart basis. If NIFTY is able to surpass the aforesaid zone, the next logical confluence zone for NIFTY is 11,300-11,500 where it is likely to get significant resistance on monthly chart basis.

Daily Chart –NIFTY dated 10th Jan 2018

Monthly Chart: NIFTY dated 10th Jan 2018

Thus if probable Fundamental triggers as stated above confluences with Technical Resistance Levels mentioned, we may see significant correction in the market in 2018 with the caveat, “The market can remain irrational longer than you can remain solvent“. Let’s keep our fingers crossed.

Happy Investing!!!