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UNDERSTANDING THE REASONS BEHIND A K-SHAPED MARKET MOVEMENT

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Industry & Services Sector incl. MSMEs and PSUs

Automobile would be a key contributor to growth in profit pool as supply issues ease

Usually, most market chatter revolves around ‘inflection’ points or pivots, when markets change course. For astute investors, who are able to identify such trend ‘changes’, returns outpace the indices, as does AUM (assets under management) growth. One such often highlighted trend reversal was in 2002-03, after four-five years of a zig-zagging market from 1997 till 2002. The preceding phase, which exhausted even the most bullish investors, had favoured sectors like consumer staples; pharmaceuticals did well; IT services stabilized after the tech bubble crash of 2000. The mood was cautious, focus was on ‘clean’ balance sheets and even metal companies were adopting EVA (economic value added) as a key metric to measure the top management to improve their capital allocation policies in order to get investor’s nod! Metals & capital goods had shrunk, reeling from the expansionary mode of 1992-96; the economy, too, had withered after years of underinvestment, EPC/infrastructure owning companies were rarely found on the buy list of investors. Most investors were focused on keeping their portfolios ‘pristine’. Markets, however, were at an inflection point—winners of the past were soon to be left behind by new emerging winners for the next 4-5 years. From 2002 to 2012—despite the global financial crisis of 2008-09— sectors like capital goods, metals, oil & gas and even public sector banks outperformed the winners of the previous phase.

How does one sift through such moves to understand the underlying reasons for the K-shaped market movement? For simplicity’s sake, we have segregated the sectors of BSE 200 Index into two segments—stable and cyclical.

Stable sectors comprise: (1) retail focused banks; (2) retail oriented NBFCs like consumer lenders, AMCs, insurance, etc; (3) IT services; (4) consumer staples and durables; (5) healthcare, including pharmaceuticals, diagnostics and hospitals; (6) utilities like city gas distribution companies; (7) personal usage automobiles and ancillaries focused on supplying to this segment.

Cyclical sectors broadly comprise sectors with beta higher than 1x—(1) corporate focused banks, including PSU banks; (2) NBFCs focused on lending to wholesale/power/CVs; (3) automobile & auto ancillaries, especially for commercial usage; (4) industrials including capital goods; (5) telecom; (6) electric utilities; (7) commodities, including metals, oil & gas sectors.

As can be seen in the chart, for the period of 2002-12, earnings grew significantly faster than nominal GDP—BSE 200 PAT as a % of nominal GDP rose from 1.7% in 2002 to 4.9% in 2008. Even after the crash of 2008-09, BSE 200 PAT was around 4.2-4.4% of GDP till around 2012. From 2011 to 2020, aggregate earnings have consistently grown slower than nominal GDP, falling from 4.2% in 2012 to 2.3% in 2020. The frustrating story of earning downgrades during 2016-20, essentially, is a story of misses on the side of cyclical segment and the steady growth in earnings registered by stable sectors. As the table shows, the share of BSE 200 profitability follows a ‘cycle’. From 2000-02, the share of stable segment within BSE 200’s pool of profit inched up to 39% and their market constituted 64% of BSE 200 market cap! Between 2002 and 2008, this reversed stable sectors share in BSE 200 profit pool dropped from 39% to 17% and their share in the market cap of BSE 200 dropped from a high of 64% to 23%.

The K-shaped nature of the market is very visible from the period of 2012-20 in the table. The share of stable sectors in nominal GDP has consistently risen from 0.5% in 2002 to 0.9% in 2007 to 1.5% in 2021. The cyclical sectors' share on the other hand rose from 1.2% in 2002 to 4.1% in 2008 and has fallen back to 1% in 2020—rising to 1.6% in 2021.

Picture yourself in 2009 after the re-election of United Progressive Alliance (UPA), with Congress getting a bigger slice of Lok Sabha seats, as compared to UPA's first term where support from the communist parties was essential for the government's survival—What would have been the winning strategy? To double up on cyclical focused segments, winners of the previous phase of the market, or would you have been better off with focusing on the steadier stable segment? The answer was clear post 2011!

Fast forward, for almost a decade, the winning strategy has been to stick to companies from within the stable segment. This strategy has been validated, the movement in profit pool and market cap for this segment is reflected—stable segment share of BSE 200 companies jumped from 17% of profits to 58%, an all-time high contribution, while their share in market cap zoomed from 23% to 64% in March 2020.

Have we registered a similar inflection point in March 2021? The profit share of stable segment, after steadily improving over the past decade, fell; as did the market cap contribution. Is this the start of a new trend or is it just a one-off, exception which will reverse course quickly? The answer to this 'pivot' is best reflected in these key issues: For most winners within the stable segment have registered the following characteristics—(1) steady improvement in gross and Ebidta margins; (2) market share gains; (3) benefit from better organizational preparedness for GST and (4) demonetization and covid lockdowns, where smaller competitors and regional players were impacted disproportionately; (5) declining cost of capital, boosting DCF valuations, justifying ever expanding multiples at which these companies trade; (6) comparative profitability—market movement and profitability have followed the K path-shaped—select segments exhibiting modest but steady growth in profitability, while most other segments have registered erratic growth in profitability. Could this trend reverse and will profit growth be more equitably distributed, unlike the phase of 2012-20. Importantly, are investors well placed for such a 'pivot'?

For the following reasons, we expect profit growth to be driven by cyclical segment, as was the case in 2002-11 phase—higher inflation could limit pricing power enjoyed by stable segment companies and it may not be possible to keep improving gross margins. Second, PSU banks have been recapitalized and their provision coverage has been raised. These banks are forecast to report 'normalized' profits. As credit costs decline, they will be a significant contributor of profit growth for FY22-24 phase. Finally, segments like metals have aggressively deleveraged their balance sheets. Even if metal prices dropped, they would not face the burden of high finance cost—their existence, unlike the FY18-20 phase, is no longer uncertain. As supply issues ease, consumer demand is revived, driven by a new product cycle. Automobiles would be another key contributor to growth in profit pool, despite the threat of new technology. All these factors point to a high probability of cyclical segment emerging as the driver of overall profit growth for FY22-24. As we have seen in the past, market cap follows the profit pool movement.

Are investors' portfolios well placed for such a 'pivot', if such a trend gathers momentum over the next few years? Investors, it seems, have been lulled into complacency—buying great companies at any valuations. Will this not lead to capital loss? Yes, that could be true. However, sub-optimal returns could also be a distinct possibility going ahead.

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