# DON'T EXPECT THE MOON

*Market Outlook*

**Like 2021, 2022 will also be a rebound year in economic terms. Though, inflation remains a key risk.**

Global, emerging and Indian stock market produced handsome returns in 2021 albeit with considerable volatility triggered primarily by Covid concerns. Nifty is up 23% for the year, though at one point (October 2021) the returns peaked at 32%. Market factors are always pulled in opposite directions by positive and negative factors with greed and fear alternating. Our idea is to take stock of all factors and see how the overall market is positioned for 2022.

## Major positives

Like 2021, 2022 will also be a rebound year in economic terms. After falling a massive 7.3% in 2020, real GDP rebounded by 9.5% in 2021 and is expected to grow by another 8.5% in 2022, as called by IMF forecast. Of course, this is subject to Covid-induced uncertainties which can cause considerable changes. As of now, the expectation is one of strong economic growth triggering consumer spending and capex spending.

This will also spur credit growth which has been tepid for a while. From a double digit growth in 2019, credit growth came down to high single digit and was placed at 7% at the last. The economic revival along with government stimulus will certainly result in strong rebound in credit growth as well.

The country also enjoys strong forex reserves at over $637.69 bn (as of November 26, 2021, and counting!), enough to counter any major threats on the currency front. In fact, the strong growth in forex reserves is one of the reasons why Indian rupee has been a steady performer which actually produces better dollar-based returns for foreign investors.

While these are macro positives, there are market specific reasons as well especially the earnings growth. Both global and regional brokerage houses are penciling an earnings growth between 15% and 20% during 2022. After falling by 12% in 2020, earnings growth was placed at 23% for 2021.

## Key risks for markets

The key risk for 2022 is the rise in global interest rates, primarily that in the US. The Federal Reserve has announced that it will taper its bond buying program and will raise interest at least thrice in 2022. This will force other central banks to raise interest rates as well, including India. This means an increase in overall cost and availability of funds. Also, the foreign portfolio investments will also slow and this may lead to strong dollar and weak Rupee.

The next in line risk is the re-emergence of Covid in its various forms and mutations. Currently, the world including India is worried about Omicron variant. However, rapid vaccination will ensure minimum hospitalization and deaths unlike the previous

episodes that produced ugly outcomes. On the broader economy, the risks of twin deficits (fiscal and current) can pose a funding problem for the government. The fiscal deficit is placed at 10% and current account deficit at 1.4%. If fiscal deficit runs large, it may result in downgrading of credit rating that can again trigger outflows from investors.

But, overall, a key economic risk is the inflation, which is also now a global risk as well. The view so far is that it is temporary and transitory as it is triggered by supply chain woes more than anything else. However, if inflation turns out to be sticky, then RBI will need to increase interest rates sooner than later and this can hurt equity market sentiments as well.


## Outlook for 2022

An intuitive way to measure and model performance is to decompose returns in terms of their sources. Broadly speaking, nominal returns are driven by two factors, i.e., market cap and dividends. During the last 10 years, Nifty 50 achieved a nominal annualized return of 12.3% split into 11% from market cap expansion and 1.3% from dividend yield. Market cap changes occur due to changes in net income (earnings) and Price to Earnings (P/E) ratio. The 11% market cap appreciation occurred through a 7.2% growth in net income and 3.5% growth in P/E ratio. The net income is again influenced by real GDP growth, inflation, and net margin change primarily. The dividend yield is influenced by earnings yield and payout ratio.

For the year 2022, a similar exercise where assumptions regarding earnings growth, P/E growth, earnings yield, payout ratio, inflation, real GDP growth and net margin changes were made. Based on these assumptions, at the base case, Nifty 50 is expected to improve by nearly 10% for the year 2022. This scenario assumes a P/E contraction of 5% and net margin expansion of 2%. However, in the optimistic scenario where one assumes a P/E expansion of 5% and net margin increase of 5%, the Nifty outcome changes to nearly 25%. In the pessimistic scenario, where P/E contraction is assumed to be 20% and net margin change to be –5%, the Nifty 50 will deliver a loss of nearly 14%. It is always good to align with base case unless drastic changes happen in between.

## What should be the strategy?

Given the positive outlook, exposure to broad market through ETF is the best strategy. This will avoid the need to have sector or stock calls. However, if one is interested in additional alpha, then one may overweight sectors that will benefit from economic rebound, such as automobiles, banks, capital goods, real estate, chemicals, pharmaceuticals, consumer staples and cement. Due to equal but opposing forces in the market, the overall volatility of the market is expected to be high. Investors should stay liquid to take advantage of volatility. On days when markets gyrate in extremes, being liquid enables one to buy good stocks at reasonable prices. However, one should have the mental strength not to panic during such high volatility periods, which normally is the case.

In my outlook I have provided for three scenarios (Base case, optimistic and pessimistic). Other things being normal, one should embrace the base case. However, if market forces move towards pessimistic forecast, investors can do well to top up their position as the long-term story for a market like India is strong and solid. On the other hand, if the optimistic scenario unfolds, it may be a good idea to take some profits.

Happy Investing! ■

Reference # 20M-2022-01-08-01