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Don't see big crash despite selective exuberance, take some profits in small caps: Devina Mehra

Mehra feels there are no significant risks to India from the global risks like the Yen carry trade, a possible US recession. Yet, the abundance of domestic liquidity can be no cover for faltering fundamentals.

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Devina Mehra, Founder, Chairperson and Managing Director of First Global

Multiple global developments are keeping markets on the tenterhooks. Devina Mehra, chairperson, First Global, with more than three decades of experience in tracking both Indian and global markets, spoke to *Moneycontrol* on global risks, impact of domestic liquidity, risk to India's fundamentals and her investment strategy now.

Your thoughts on the global market meltdown on Monday and the comeback?

I am not particularly negative on the US economy. For the past over a year the Fed has been trying to engineer some kind of slow down in the economy and the labour market and that has just begun to happen. It is hardly a disaster.

Then there is the Yen carry trade. What we forget is the interest rate differential between the yen and dollar has persisted for decades now. The trade plays out till one fine day the Yen appreciates. It has happened several times in the past, during the Asian crisis of the late 90s and then again around the Global Financial Crisis of 2008. However, I do not see a big displacement in the world markets this time due to the Yen, especially now that the Bank of Japan has said that they will refrain from sudden moves. Anyway, both at the time of the Asian crisis of 1998-99 and the GFC of 2007-8, the unwinding of the Yen carry trade was only an additional contributory factor, not the main cause of the crisis.

As for Japanese investments in India, these might see some outflows, but historically, foreign institutional investor (FII) flows have not correlated with Indian market moves -- contrary to popular opinion. This was the case even when Indian Mutual Funds or Indian retail investors were not such big players in the market.

Is a recession in the US inescapable?

A technical recession may happen or may not happen, but I don't see anything very or sustainably negative in the US economy.

Do you believe rate cuts are around the corner?

It's quite likely they'll implement a cut in September - definitely an over 50 percent probability of that happening. We'll have to wait and see, as central banks these days tend to focus on current data rather than trying to act as per their previous statements.

Are US market valuations a risk to their markets as well?

While US PE ratios aren't overly stretched, price-to-sales ratios are quite high, indicating that margins are at elevated levels. This raises questions about whether margins will sustain at these high levels or if there might be pressure, especially for tech companies. This is something I'm still evaluating, and I don't have a conclusive answer yet.

How do you factor geopolitical events into your investment strategy. They keep scaring markets every now and then?

We have analysed geopolitical upheavals over the past 50 years, including the Gulf Wars, Afghanistan, the U.S. bombing Libya, 9/11, and others. In every single case, the markets forgot about these events within six months to a year at most. The only lasting impacts, if at all, were typically on oil and gold, depending on the region.

About the current geopolitical flareups in some parts of the world, if the situation remains regional, it won't have a significant long-term impact. However, if it escalates into something more severe, like a nuclear or world war, then the markets may turn out to be the least of our concerns!

Do you see any of the global factors impacting India in any significant way?

Global geopolitical events usually have limited direct impact on Indian markets, unless they affect commodity prices that are relevant to us.

Do you feel large domestic liquidity coming into the market could support prices in the face of other negatives?

No, ultimately it is the fundamentals that drive prices. Whether it is at the market sectoral or even company or stock level, no matter how loved a category is, just pouring money cannot keep prices high.

If liquidity into specific areas was driving the prices, the sectors where thematic funds come should continue to soar, but history shows that most times the offerings in these thematic funds crowd in usually just before the peak in that theme.

Do you look at this as a contrarian indicator?

Yes. These funds tend to reach their peak in fund-raising right before the theme itself peaks in price, so a surge in investments might actually be a warning sign. Historically, a heavy influx of money into a specific category, whether it's pharma, IT, or small caps, hasn't supported long-term price levels -- quite the opposite.

In general sentiment is a contra indicator, whether in markets or themes. When everybody is bullish, happy, gung ho the next period returns are often below par. And when market participants are uncertain, fearful, anxious; the next period returns are above normal. This has shown up in research studies across the world from Europe to the US to South America.

With respect to India's fundamentals, do you see any macro risks on the horizon?

Yes, there are several macro risks.

One major concern is that India's GDP growth has been largely driven by government spending, with private consumption still lagging behind. Manufacturing, despite our focus on it, remains at historically low levels as a percentage of GDP—around 13-13.5 percent, which is the lowest we've seen since 1969. High youth unemployment is another problem, caused by a mismatch between the skills of job seekers and the needs of employers.

There are issues in the MSME sector. As per some estimates, the sector has shrunk by 10 million businesses instead of increasing by 10 million as expected. This is of significance as this is a major driver of employment - more than the larger companies.

Exports have also been disappointing. For many years even prior to the pandemic, India saw a decline in exports, while countries like Bangladesh and Vietnam had been making significant strides.

The market does not seem to be taking note of these, it looks like.

That's because the listed companies, operate in the organised sector and often deal with relatively affluent customers. Hence, they may perform better than the broader economy. For instance, listed real estate companies tend to serve the high-end market and may be doing well despite the broader economic issues. The same holds for luxury automobiles, for instance.

What is your take on the market and outlook for the next one to two years

For the next one to two years, I remain positive.

Rs 100 at the start of the 2010s grew to only Rs 230 by the end, while Rs 100 in 1980 turned into Rs 700 by the end of that decade. This historical context highlights the room for a potential bull run. We're still below the trend line, and substantial, sustained crashes usually occur when the market is significantly above it.

But we are cautious on certain segments like small caps, micro caps, and new IPOs. We typically allocate 13-15 percent to stocks with market caps between Rs 1,000 crore and Rs 5,000 crore, occasionally going as high as 20-22 percent. Currently, however, our exposure is at just 5-6 percent. We did this even though we knew that it would hurt relative performance in the short term.

In managing risk, traditional tools like stop-loss levels often do not work for small caps. These stocks can hit lower circuit limits for days on end, preventing timely exits.

Moreover, new investors often overlook that in each boom and bust cycle, many small-cap stocks disappear and never recover.

How do you view the potential impact of US recession on Indian IT companies?

Many IT companies have already gone through the slowdown and have shown resilience. In fact, there has been a recent pickup in their performance. The Indian IT index is up approximately 22% from its May bottom. As technology adoption continues to grow globally, the spending on tech, even if postponed, will eventually pick up. I don't foresee a significant negative impact on Indian IT companies.

Does this mean you are favouring IT stocks now?

Yes, we are somewhat overweight in tech stocks. We had anticipated a bottoming out and increased our exposure in the July rebalance. Previously, we were just above benchmark weight, but now we're more significantly overweight in tech.

Any particular pockets of the market where you see value?

We've been overweight in the auto sector, and recently, we've increased our exposure further in auto component stocks.

We are also overweight on capital goods and machinery since October 2021. While we have booked profits in many stocks and cut back considerably from the peak we still remain somewhat overweight.

Pharma and health care is another sector where we have gone even more overweight.

We have added some positions in the IT sector as it offers good opportunities. Chemicals have also made a comeback in our portfolio. After being a strong performer in 2021 and part of 2022, we had exited chemical stocks but have reintroduced them as they start to show potential again.

However, we are underweight on financials sector and have shifted some exposure to private banks from PSU lenders. Since our system has shown a decline in the non-lending financials like AMCs, stock exchanges, and broking firms, we have exited all such positions in our portfolios. We have also mostly exited utilities, energy, and power-related stocks.

Which are the pockets you are seeing exuberance in?

Enthusiasm in power and utilities sector seems to be overblown. Our system's recent assessments show a clear disinterest, suggesting that the current valuations might not be justifiable. We don't even like non-lending financials anymore.

There's also a lot of buzz around lesser-known small-cap stocks. While these may be performing well now, making people look smart. But the day they fall, then the same investors will be looking for villains that made them lose money. My advice for those invested in the frothier ends of the market would be to book some profits and invest them in a steadier portfolio.

(Devina Mehra is the Founder and Chairperson of First Global, a leading Indian and Global investment Management firm. She is a gold medalist from IIMA and has been in the Investment business for over 30 years. She tweets @devinamehra and can be contacted at info@firstglobalsec.com or www.firstglobalsec.com)