'Market rally transitioning from being liquidity-driven to earnings-driven'

JOHN PRAVEEN, managing director and chief investment strategist at Pramerica International Investments, tells **Vishal Chhabria** the recent stock market correction is due to high valuations, strong year-to-date market gains, geopolitical tensions and profit-booking by investors. However, the trend remains positive. Edited excerpts:

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Markets globally have corrected recently. Do you see a further decline?
Global stock markets sold off in early August amid heightened geopolitical tensions between the US and North Korea. Additionally, US President Donald Trump's political troubles have increased, which has raised doubts about whether his reflation agenda might get delayed or derailed.

Further, equity valuations are expensive in most markets. Finally, June to September is seasonally a slower period for stock markets. Global stock markets have also posted strong gains in 2017. Thus, investors appear to be taking some profits.

Stocks have since rebounded and are back close to end-July levels as geopolitical tensions appeared to ease. We still expect bouts of volatility in stock markets, especially with the US and South Korea expected to hold their joint war games in late August. However, we expect the increased tensions to gradually ease as the US works with China in de-escalating the situation in the Korean peninsula. Easing tensions should help stock markets to remain in an uptrend, supported by strong earnings growth, improved global GDP growth, QE (quantitative easing) buying by Bank of Japan (BoJ) and rate cuts in some emerging markets (EMs).

There are contrasting views on how US Federal Reserve rates will move. Your take?
There is no reason to believe the Fed is going to be more aggressive in raising rates. There is no need, as their inflation is still quite low and below its two per cent target. We expect one more Fed rate hike this year and some balance sheet reduction or normalisation but at a very gradual pace. It's not that they are not buying bonds anymore, but they are not reinvesting the bonds/papers that are maturing. So, it's more of a passive approach towards normalisation.

The ECB is also talking of reducing QE. Put together, what impact do you see on the markets?
We have had liquidity tailwinds with QE by the ECB (European Central Bank) and BoJ in recent years. Though the Fed has stopped QE, there was a low interest rate environment. These were supporting the financial markets. The Fed has now started to raise rates and then will do balance sheet normalisation. The ECB is probably going to start QE tapering later this year, while BoJ is likely to continue QE. So, the tailwinds are not going away, but we will have less of these. In contrast, EMs' central banks are still cutting rates, as inflation is under control. So, there are still liquidity tailwinds, from the EMs and BoJ. Look at other factors. US growth is improving. Recent China data was a positive surprise. For India, the demonetisation impact is fading and once GST (goods and services tax) hiccups go, its growth should pick up. After a long time, Europe and Japan are growing at above-trend pace. So, the global growth picture is quite positive and, hence, you don't need so much of central bank stimulus.

As rates rise and QEs are wound up, will liquidity flows continue into EMs?
Liquidity is becoming less but in the past couple of years, earnings were quite weak across all markets. So, it was a liquidity-driven rally. It looks like the markets are transitioning from a liquidity-driven to an earnings-driven rally. Because you have good growth, you will have good corporate profits. So, the markets will continue going up. However, fund flows are going to be driven much more by earnings than pure liquidity.

Corporate earnings growth in India has disappointed in recent years. This year also, they are high at over 15 per cent. Your take?
The demonetisation impact is probably behind us and if GST is not going to lead to major disruptions in the supply chain and in economic activity, we should probably see earnings recovery. Maybe the earnings expectations are a little on the higher side, at 15-16 per cent. So, there might be some disappointments, which is a risk because we have had a big rally and the markets are somewhat expensive. In that case, we could see some profit-taking and some consolidation in the market.

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