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Market cap to GDP ratio swells to 4-year high; should investors be wary?

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NEW DELHI: The aggregate market value of all listed companies as a percentage of the country's nominal GDP is at its highest level in four years, global investment bank HSBC said in a report.

As per the report, the ratio is at a 4-year high, although it is still way below the record high of 2007 when total market capitalisation as a percentage of GDP had reached 146%. The current market capitalisation of Indian companies is $1.6 trillion, which is 76% of 2014-end nominal GDP of about $2 trillion.

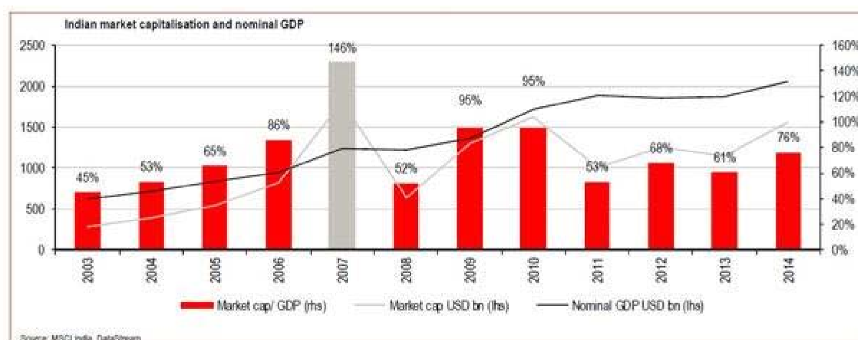
What does it signify?

Typically, when the market capitalization crosses the nominal GDP, the market is said to be overvalued.

"As a thumb rule it is seen that in the developed markets market capitalization to GDP ratio should be close to 100% and for the developing economy it should be close to 80%," says D K Aggarwal, CMD, SMC Investments and Advisors Ltd.

"Generally speaking if market capitalization to GDP goes above 100% it signifies overvalued stock market. However in case of our economy, one should also take cognizance of the growth trajectory that Indian economy is likely to achieve owing to various measures initiated by the government and central bank," he adds.

Also, rising market capitalisation is a function of two variables, say experts. First is, of course, the valuation of the already-listed stocks but equally important are additions to the universe of listed stocks.



"As more and more companies approach the market through IPOs and get listed, the total market capitalisation increases accordingly," says Rajiv Shastri, MD & CEO, Peerless Fund Management Co Ltd.

"As such, one needs to look at this ratio (market cap to GDP ratio) not only from a valuation perspective. It can also mean that a greater proportion of the corporate sector is listed, a proportion that is sure to increase as markets develop and the economy matures," he adds.

Should investors be worried?

Expansion in market capitalisation happened due to considerable re-rating of most of the stocks in the past 12-18 months. However, earnings are yet to catch up. This may make stock prices unsustainable at higher levels.

A slower-than-expected project execution nothwithstanding, market valuation has surged in the past year and a half, say experts.

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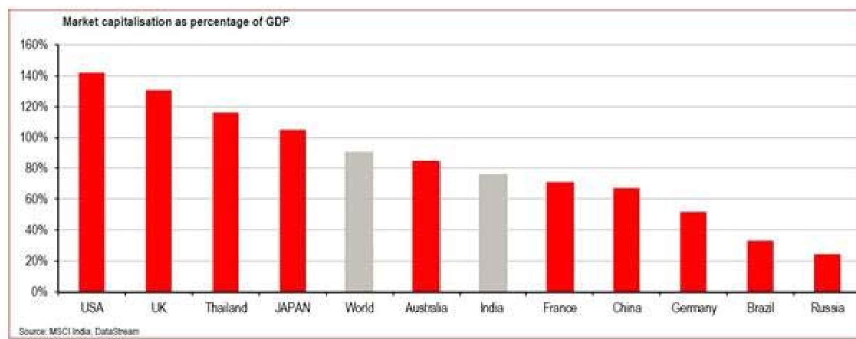

India's market capitalisation to GDP ratio compares well with other major equity markets. India has the highest ratio among the BRIC economics, while it was below those of developed economies such as Japan and the US.

India is 14 percentage points lower than the weighted average market capitalisation to GDP ratio of 140% for all world economies, said the HSBC report.

"I believe that the 76% market capitalisation to GDP ratio could not be a matter of concern for the investors and with the expected improvement in economic performance, the ratio is expected to remain below 70-90% for next couple of years," says Tushar Pendharkar, Equity Strategist- Right Horizons Financial Services.

"However, any level above 120-130% would be a signal of market correction and retail investors could shift their investments from equities to safe avenues," he adds.

Pendharkar is of the view that to reach the levels of 150%, India's market capitalisation needs to log a CAGR of 25% for the next 4 years, assuming the GDP would grow at a CAGR of 7% during the same period.

How should investors pick & choose stocks?

Typically, "normal" or "fair valuation" of a market is understood as market cap being at 100% of GDP. Of course, many companies are highly overvalued as far as "defensive" or safe sectors, such as FMCG and other consumer-oriented sectors, are concerned, say experts.

Buying in the stock market and valuation also depends on how the investors perceive about the future earnings.

"Some sectors which are going on "future growth" or government policy, such as infrastructure, goods, financials and banks should also be looked at cautiously," says Vikas Gupta, EVP & Fund Manager, Arthveda Fund Management Pvt Ltd.

"Sectors with high debt should be avoided. Other than that, there are many sectors and companies with stable businesses, rock-solid balance sheets, but some are facing near-term negative stories in terms of low growth for a few quarters," he adds.

Gupta is of the view that these are the companies that one should look at as long-term bets since they are available at low valuations.

Investors should need to gauge earnings of the corporate along with their guidance of how they perceive business environment going forward.

Aggarwal is of the view that normally markets run on the expectations of future earnings, and if the earnings growths do come up with a lag then it justifies the valuation. Else we may see selling pressure or consolidation in the stock market as a whole or it may be limited to stock specific movements, he concludes.

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