BUSINESS STANDARD ARTICLES – 2008

DECEMBER 2008

1. Fed to the Rescue
2. Characteristics of a Secular Bear

NOVEMBER 2008

3. Looking Through The Valley

OCTOBER 2008

4. A Buyer's Strike
5. A Time of Confusion

SEPTEMBER 2008

6. A Turning Point?

AUGUST 2008

7. India in 2009
8. India's Growth Purgatory

JULY 2008

9. Reform is The Only Way Out

JUNE 2008

10. An Alternative Scenario for Oil
11. Is It All Over?

MAY 2008

12. Oil Crisis – Bonds & Subsidies Won't Do
13. That 70s Show

APRIL 2008

14. What Now?
15. Why are Indian Markets Falling?

MARCH 2008

16. Stagflation

FEBRUARY 2008

16. The Credit Contraction
17. Decoupling or Recoupling?

JANUARY 2008

18. Decoupling Tested
19. India in 2008

Fed to the Rescue
December 26, 2008

Over the coming months, the Fed will broaden its policy initiatives and widen the range of markets it actively targets.

After the recent Fed FOMC meeting, there is now no doubt that the Fed has embarked upon a path of Quantitative Easing (QE). QE is when the Fed stops focusing on an interest rate target and directs its efforts towards providing a higher level of reserves in the banking system. Reserves make up part of the monetary base and, through the money multiplier, translate into money supply growth.

This move to QE is another manifestation of the willingness of the Fed to do whatever it can to combat this economic crisis. The speed and breadth of policy response on the part of the Fed has been unprecedented. Coupled with this we also have a huge Obama stimulus package, rumoured to be in excess of one trillion dollars, about to be unveiled.

Notwithstanding this policy response, most investors seem unconvinced that policymakers will be able to stimulate us out of this deep economic hole.

Most investors point to the fact that the crisis is already 18 months old and despite continued policy interventions, things have only progressively gotten worse. While true, investors have forgotten that the real heavy lifting on the policy front has only just begun over the last couple of months. It is only from October onwards that we have seen government-funded bank recapitalizations, government guarantees for bank refinancing and the removal of counterparty risk issues. It is also only in the last month that various Fed programs to buy non-government paper have started to get operationalised.

A similar situation also prevails in the UK and eurozone. There has been a lot of talk of bailing out the financial system, but concrete action is a relatively recent phenomenon. Even on fiscal policy, we have seen announcements, but the money has not been spent.

Any actions taken today will have a normal lag of at least 9-12 months, before the full economic benefits are visible.

The perception on the part of most investors that fiscal and monetary stimuli have already been tried and failed is, therefore, incorrect. The real economic impact of all the policy measures is still in the pipeline and yet to be felt. It is premature to declare policy measures as ineffective.

Beyond the point of there being lags, investors also seem to be underestimating the breadth and scale of the policy response. While Obama's stimulus package keeps rising with the latest count being at a trillion dollars, even at the Fed, policy is not static.

The Fed's balance sheet has already increased from $800 billion to $2.2 trillion, with the majority of the increase coming post the collapse of Lehman. There really is no limit to

the potential size of the Fed's balance sheet, as with its ability to print money and create reserves it can buy as many assets as needed to get the job done. Between 1998 and 2005, the Bank of Japan's balance sheet increased from 10 per cent to 30 per cent of GDP as it implemented its version of QE. While the Fed's balance sheet has exploded from 6 per cent of GDP in August to 15 per cent in November, clearly it can do more.

Two critical constraints that may have hampered the Fed being more aggressive in normal times are currently non-operative.

In normal times there are severe constraints on undertaking the type of monetary expansion proposed and already implemented by the Fed. This constraint is the fear of stoking inflationary expectations and, therefore, suffering a rise in bond yields which would short-circuit the simulative effects of monetary easing. But today, deflationary expectations are so overwhelming (with TIPS yields implying market expectations of near zero inflation over the next 10 years) that the Fed can ramp its balance sheet, with limited adverse consequences in the bond markets.

The other potential constraint on the Fed would be a collapse in the dollar. In normal times, one would have expected a dollar rout as the Fed kept stimulating. However, over the next few months, one should expect every other major economy to follow a similar policy prescription of zero interest rates and quantitative monetary expansion. This is already the case in Japan and Switzerland and will surely become so within months in the UK. The only major currency left will be the euro, implying that any dollar flight will have to be into euros. Given the current economic and political difficulties in the euro bloc, can we really expect investors to rush into this currency? What will a sustained euro appreciation do to a eurozone already threatened by a potentially more intractable recession than the US ?

If the euro strengthened dramatically, it may force the ECB to go down the same route as the Fed.

Yes, the dollar may weaken somewhat and that will suit US policymakers but due to a lack of choice, we are unlikely to see a dollar collapse which could constrain policy action.

Over the coming months, therefore, we should see the Fed broaden its policy initiatives and widen the range of markets it actively targets. The Fed has already put in place programs to purchase commercial paper, mortgages and asset-backed securities. One should not be surprised if they soon start targeting corporate bonds as well.

The Fed is going around a dysfunctional and recapitalizing financial system and liquefying asset markets directly.

While investors remain skeptical, the fact is that policymakers are throwing everything they can at this crisis. The authorities have the ability to ratchet up the policy response with limited short-term constraints.

While we cannot be certain, the odds surely favour the authorities eventually succeeding.

As for India, the bulk of our policy response has to be on the monetary front. With limited fiscal flexibility, the RBI will have to figure out a way to force the banks to

lend. We seem to have overcome the liquidity crisis but now have a confidence crisis amongst bankers which is constraining lending.

The US authorities are going around their dysfunctional financial system, through both direct intervention in asset markets and a strong fiscal response. We cannot do much on the fiscal but if banks continue to dither on lending, will the RBI consider intervening directly in asset markets to ensure the real economy is not starved of credit?

Characteristics of a Secular Bear

December 11, 2008

The US is in the middle of a secular bear phase much like it was in 1929-1942 and 1968-1982.

There seems little doubt now that the US and for that matter most global equity markets have entered into a secular bear phase. The unraveling of the credit bubble has produced severe wealth destruction on an unprecedented scale. In the past 12 months in the US alone, declines in home and equity prices have exceeded nine trillion dollars, equivalent to more than 60 per cent of US GDP. The combined value of US equity and residential real estate relative to GDP is back to the level of 1995. More than a decade of wealth creation has been wiped out in a single year. All the other major global financial markets have a very similar and chilling story of wealth destruction. The future of the financial system itself is up for debate.

If we focus on the US for a moment (being the biggest market with the most data), we find that there have really been only two other episodes which can be identified as secular bear phases.

One was the period 1929-1942 and the other was 1968-1982. As for what are the similarities between these bear cycles, beyond the quantum of wealth destruction, there are many other lessons that one can draw and which may be relevant in trying to dimension today's market collapse.

First of all is the period of time it takes to come out of a bear phase, one episode lasted 13 years and the other 14 years. If we go by this and assuming that our current bear phase really began in 2000 with the technology bubble burst, it is unlikely that a new sustainable bull phase can begin in the US until 2012-2013. The lost decade (still continuing) in Japan post its1989 equity market peak also further reinforces the fact that there is no quick end to a secular bear phase. You need investor fatigue to set in before this can end.

Secondly, in both of the above periods we had very strong multi-year bear market rallies within the secular bear phase (1932-37 and 1970-73). After these bear rallies failed, the subsequent price destruction was severe. Prices dropped by 65 per cent in real terms between 1937 and 1942 and by 63 per cent in real terms between 1973 and 1982. In both periods the counter trend bear rally began relatively quickly post the peak in the markets (within three years in the case of the 1929 peak and within 18 months in the latter case). Worryingly, in both cases, the longest phase of the bear market actually occurred post the fading out of these multi-year pull back rallies.

Even today we seem to be following a similar pattern with the markets peaking in August 2000, and then we saw a sustained bear rally from 2002 to 2007. We are now in the

severe wealth destruction phase (post the collapse of the bear rally) highlighted earlier. The point of greater concern is that if events continue to pan out as per prior history, then the longest phase of the bear cycle is still ahead of us, though the majority of the wealth destruction is done.

Another characteristic common to both the prior secular bear phases is that the level of real earnings was lower at the end of the bear market than it was at the beginning. This means that real corporate earnings actually declined marginally over a 13- or 14-year period. This highlights the potentially huge challenge to corporate sector profitability one can expect over the coming years. If this cycle were to follow the prior two, then real earnings should actually decline over the coming three to five years. The macro strategists have been pounding the table on how micro equity analysts across markets are still way too optimistic on corporate earnings, and the weight of history is on the macro side.

In both the previous bear cycles the PE ratio also ultimately came down to single digits on a trailing basis, before the markets bottomed. While many valuation indicators like the Graham and Dodd PE, Tobin's Q, interest rate-based valuation tools etc show the equity market to be either cheap or at fair value, we will probably need all these measures to overshoot before the market bottoms. It is very rare that we can bottom out without all equity valuation measures showing significant undervaluation, as opposed to showing markets being only fairly valued.

Another concern is around the whole equity cult. We have all grown up being taught that equities are the best long-term investment and must be held for the long term. In the current decade equity holders have already faced two huge market drops (in 2000 and 2008), heightened volatility and almost no returns in real terms over the past decade. Could we see a whole generation of investors turn away from this asset class? Is the dividend yield/bond yield crossover in US financial markets (the first time since 1958) a leading indicator of a change in attitude towards equity?

All this makes for somber reading of course, but will it necessarily be so bad?

We can argue that we are looking at only two periods in the US and that is not much in terms of data and history. One can also make the point that both these episodes were elongated because of certain unique characteristics. We had the policy mistakes and lurch towards protectionism in the 1929 period and the serious inflationary concerns of the mid-1970s. Neither of those concerns are valid today, the authorities are hyperactive on the policy front and we are more worried on deflation than inflation. Maybe this bear phase will end faster.

Also one can argue that while this may be valid for the US, emerging markets can probably come out of the bear funk much faster, given their growth and economic fundamentals. As long as the US stops falling, and gradually derates in real terms, this will allow the EMs to differentiate themselves. Much of the forced selling that has decimated the EMs should now slowly tail off.

In India specifically, I think one is seeing the beginnings of a bear rally which can continue for some time. Many of the building blocks for a more sustained bull phase are also now slowly coming into place, be it valuations, sentiment, interest rates and policy action. However, I find it difficult to see how we can break out in a sustained way on the upside till such time as the election uncertainty is put to rest. I think the last 12 months have shown us that eventually governance and reforms do matter. I think a new bull phase in India at the minimum will need investors to feel comfortable on the ability and desire of the new government to move ahead economically.

Looking Through The Valley

November 28, 2008

Investors will return to equities only when credit markets ease up and bond spreads decline**.**

This is truly an extraordinary period in financial markets, with investor fear all pervasive. We have yields on bonds at all time lows, the dividend yield on the S&P 500 higher than bond yields for the first time in decades, and a mass sell-off in all growth assets. In addition we have weakness in all emerging market currencies, and capitulation across commodities. Specific financials hit new lows on a daily basis, and despite the US treasury and Fed going to overdrive in spending money to unlock lending and liquidity, markets seem unwilling to respond.

Even in India, investors have been battered and bruised, with markets coming down relentlessly. There seems to be no respite, as the selling from FIIs continues unabated. Many of us have been doing this for a long time, but never have I seen markets fall by 70-80 per cent in a matter of 10 months (the decline for a dollar based investor). Having gone through this pain, investors are naturally wondering as to when it will end. India has not collapsed, and we should still have reasonable economic growth, so why are people still bailing out of our markets even at these levels? What will bring them back?

For investors to come back I think we need two or three things to fall in place:

First of all, the Indian economy clearly froze in end September-October. We know of numerous companies which report demand falling off a cliff. While conditions have improved in November, we are still limping along. While the problems were largely caused by global trade finance and local working capital issues which should normalize soon with the RBI becoming proactive, many investors believe this is only the beginning of a far more dramatic slowdown. Why can't we go back to 2003 or even 2001, when GDP growth was only 4.5 per cent, is a question many investors are asking. The first quarter of calendar 2009 will be critical to judge whether demand is stabilizing or we are going into a free fall. The bears see huge earnings and GDP risk, with a reversal of the corporate capital spending cycle, collapse in exports and a severe slowdown in consumption. The bulls point to the strong income growth in rural India, the fiscal stimulus of the Pay Commission and the huge improvement in India's macro with falling commodity prices. No matter which side of the argument they are on, investors are going to wait to see how the economic numbers pan out in Q1 2009, as nobody has the risk appetite to take a bet. The unprecedented nature of this crisis has left investors with no ability to dimension the downside, and thus, till they see economic stability, it is unlikely that investors will re-enter the markets aggressively.

Secondly, the credit markets have to ease up and bond spreads come down. It is for example possible currently to buy convertible bonds of Tata Motors at a yield to maturity of over 30 per cent, or Reliance Communications CBs with a yield to maturity of 28 per cent, or Mahindra at 21 per cent. With these types of yields in dollars available, why will someone buy equity? Also, these bonds are available in reasonable size. It is unlikely that equity markets can move up sustainably without these yields normalizing first. Till such time as we have yields of this magnitude, it also implies that the financing window for Indian companies remain closed. With no external financing, most investment plans will not go ahead.

The third issue deals with who will be the buyer of last resort. Bear markets exist to change sector leadership as well as move stock from weak to strong hands. In a normal bear phase, the weak hands, viz. leveraged investors, retail, speculators, etc., sell out and the real long-term investors like pension funds, insurance companies and endowments, etc., pile in, attracted by the cheap valuations. They know that if they have holding power, and can withstand volatility, the cheap entry price should ensure strong long-term returns. In India we have seen the selling out of weak hands, as more than $13 billion has exited the market from FII selling, but barring local insurance companies, very little strong hand buying. The reason for this is that most of the real long-term quality money globally seems to have short-term liquidity issues and is over-allocated to illiquid vehicles like venture capital or private equity. Having changed their model from a simple bond/equity asset allocation towards more alternatives, they do not in the short term have the ability to rebalance portfolios towards listed equities. This rebalancing used to act as a natural shock absorber to stabilise markets.

There is limited firepower available with this group to stand against the tide and be contrarian. For the limited capital that is available, there are many attractive investment opportunities globally across asset classes.

Even locally, though we are yet to see major redemptions among the local mutual fund complex, there are very limited inflows. There also exists the risk that we will see a shift among existing investors in ULIPs away from equity, and even a mix shift away from ULIPs themselves among new life insurance policy holders. If either of this were to happen, the only strong hands buyer in India will also get constrained. The only sign of hope here is that many companies have announced buybacks and numerous promoters are also doing creeping acquisitions. In India, companies/promoters may be the strong hands that ultimately set a floor for our markets. One needs to track this (strong hands buying) closely, as without stock moving into long-term stable hands, we will not form a sustainable base.

Valuations have now come down to more reasonable levels, with the Indian markets no longer expensive at least on an absolute basis. India has always been a stock picker's market, and at some stage micro stock-specific analysis will come back in fashion. Over the last two years macro has clearly trumped micro, with broad market and sector calls being far more important than any stock-specific work. This is also a cycle and at some stage stock-specific work will become relevant to making money again. India should do

well in such an environment, as the country's strength remains the quality of its entrepreneurs.

While all is not lost, the fact remains that there are many very attractive investment opportunities globally. India will come back, but we need to track the above sign posts closely.

A Buyer's Strike

October 22, 2008

Investors who can take a genuine long-term view, without worrying about mark-to-market losses, can start nibbling.

Equity markets in India are getting pummeled, and yet, buyers seem to be conspicuous by their absence. After being down almost 20 per cent in dollar terms in the month of September alone, markets have declined another 20 per cent-plus in October. For the year till date, a dollar-based investor would be down more than 60 per cent, and in excess of 70 per cent if he/she had the misfortune to be largely invested in midcaps. Despite price destruction of such magnitude, buyers still remain absent. What can explain this puzzling behaviour? Why are investors not piling in now?

The first issue is the huge and frankly unprecedented volatility in global equity markets. I have been following this for many years, but one has never seen such sustained volatility and fear. With such exaggerated volatility, the price for being too early is unacceptably high. One could be a buyer of fundamentally sound companies at reasonable valuations and still be down by 25-30 per cent in a matter of days, just because you had bought too early. In today's environment, where 25 per cent can be your total return in a good year, investors cannot stomach an entire year's return disappearing in a matter of a few days. For anyone running portfolios which are marked to market and accountable to investors on a quarterly or monthly basis, such outsized draw-downs are difficult to digest. There is also a general perception that given the magnitude of price destruction, there is no need to be early, as markets will take time to form a base and thus give one ample opportunity to enter equities post their bottoming out. A V-shaped rally looks unlikely given the proliferation of stranded sellers at all price points. Given the extent and pace of market decline and existing losses, investors do not have the risk appetite to be early.

Secondly, there is the issue of who has the money to buy now? Most international funds have redemptions, with the majority of the withdrawals coming from European fund of funds. Having taken on leverage themselves, these fund of funds are now being forced to shrink and call back capital as they delever. It is also almost impossible to raise new money for India right now. LPs have far more serious issues that they are tackling in the OECD financial markets, and India is frankly off the map. There are also concerns around capital flows to the whole emerging market (EM) asset class. With risk appetite in short supply, and OECD market valuations cheap, will investors be willing to venture into the EM asset class as aggressively as in 2007? As OECD financial markets get cheap, their expected return profile improves and this may negate the need of many institutions to boost returns by venturing into international markets.

One should also expect significant consolidation among funds over the coming three to six months. Many funds may simply give up given the extent of losses and we could see one more leg of final capitulation selling as some funds fold.
Investors have been shell-shocked at the pace of decline in Indian markets and the steep deterioration in our macro-fundamentals. For a market once positioned as being the most

immune in Asia to the global financial crisis and US slowdown, we have not lived up to our billing. Domestic redemptions have also started to accelerate and even for insurance companies, the mix of new sales is moving away from the once-total reliance on unit-linked insurance products (ULIPs). The harsh reality is that having absorbed over $10 billion of FII selling in the calendar year, there is now limited buying power left among the domestic investor base. Those funds which do have cash are conserving it for possible future redemptions.

Third, there are macro-issues around India to which there are no easy answers. The economy is clearly slowing, but to what rate is still unclear. Consensus expectations of 8 per cent GDP growth this year look to be too high, and an acceleration in FY 2010 even more unrealistic.

How long will this slowdown continue? Its impact on corporate earnings; The consensus still expects double-digit earnings growth for FY 2009 and FY 2010, but given the crack in commodities, spike in financing costs and the GDP slowdown, low single-digit earnings growth looks to be the best case. In that context the market is not particularly cheap, especially from a relative perspective. Sure there are individual companies which look very cheap, but the large liquid companies still do not look like sure things.

There is also the issue of India's dependence on external capital. We were able to get around our fiscal constraints and not crowd out private sector investment, due to access to global capital flows by corporate India. With the credit crisis, this access has now been cut, and the rupee depreciation has raised debt burdens by 25 per cent. With corporate India once again forced to compete with the government domestically to finance its investments, interest rates cannot drop by much till growth slows and demand for credit cools. Rising costs of credit and constrained access may also pressurize credit quality. Unless the government gets its fiscal house in order, we may be in for a greater slowing of both the GDP growth and corporate earnings than the market is currently prepared for. The country will have to face elections in the next six months, and these results will be critical in determining the pace and direction of the country's reform programme. The last six months have shown once again that investors cannot ignore policy risk, when looking at large emerging markets like India.

For investors to be willing to look through the coming valley of earnings and GDP slowdown, they need to have more comfort on the above issues. Currently there is too much uncertainty for investors to be able to dimension the downside.

While the longer-term drivers for India in terms of demographics, productivity improvements and urbanisation are in place, buyers are not willing to bite right now. India has some great bottoms-up stock-specific stories, and the macro-environment is already beginning to look better. Investors who can take a genuine two-to-three-year view, without having to worry too much about transient mark-to-market losses, can start nibbling, with a clear view to building up their portfolios slowly and systematically over the coming months. Those who cannot bear short-term volatility and pain will probably have to sit it out for a while longer, till we begin to form a market base.

A Confusion of Time
October 8, 2008

It still seems that early to mid-2009 is when equities will conclusively bottom.

Current market conditions are quite extraordinary, to put it politely. I have never seen such fear, panic and confusion all at the same time. One has seen bear markets before but the sheer pace and velocity of this plunge has been breathtaking.

One is also caught between two conflicting instincts. On the one hand, given the extent of damage and fear around, every contrarian instinct one possesses is shouting out to buy. Everyone has heard about buying when there is blood on the streets and fear all-pervasive. How can things get any worse? Also, are we not supposed to be buying when governments finally give up and actively intervene to shore up the financial system? Isn't a large financial institution going bust the indicator everyone was looking for? All indicators of fear and capitulation are flashing green. For anyone believing in mean reversion, your first instinct will be to buy and buy aggressively now.

However, one continues to remain hesitant, and it is important to understand why.

First of all, this is new and uncharted territory for everyone participating in today's markets. None of us has ever seen a credit contraction and deleveraging cycle of this magnitude. As we have never seen this beast before, one tends to be more cautious in facing it. When the mean itself is unclear, playing regression to the mean is a little difficult. We have lived through two decades of global credit expansion, and are not used to credit being simply unavailable.

There is a clear sense that this crisis has now spiralled out of control and become global in nature. It is also very difficult for anyone to dimension just how bad things can get. Never before has someone like GE found it difficult to access short-term funding markets. The credit freeze has to have forced all companies to reassess business, and consumers are running scared. We are most likely about to enter a very serious economic downturn, and most investors still do not seem prepared. This will be a consumer-driven recession and far worse then anything most current investors have seen. Analysts still expect earnings to grow in 2009, when they will probably fall 20 per cent. We have still to print even one negative quarter of GDP growth in the US, yet already 760,000 jobs have been lost and earnings are down 30 per cent (entirely due to financials).While we have seen the mother of all credit collapses, we are still in the very early stages of the consumer credit deterioration associated with an economic downturn. In prior recessions in the US, 60-65 per cent of the market and corporate profits decline tended to occur during the recession itself — could this still be ahead of us? It is only now in the past month or so that the US economic data has turned decidedly negative. If the recession is only now beginning then we may have a lot more downside ahead. Valuations are also not yet cheap enough on a cyclically adjusted basis, with longer-term earnings-based measures not yet in value territory.

While most probably all the actions undertaken by the Fed and other authorities globally will work eventually in unlocking financial markets, the consequences of these measure not working is extremely dire. We have no choice but to assume that the Fed and Paulson will be effective(what choice do we have?), but the story may not end with the troubled asset relief programme (TARP) plan. We could see a lot more measures needed and many unintended consequences, for truthfully, the authorities are making decisions on the fly. With such adverse repercussions to a negative outcome, one must be conscious of tail risk(a small probability of a very negative event actually happening). Given what happened to Lehman and AIG etc, investors

can be forgiven for being more focused on tail risk than normal.

One is also very uncertain about the endgame in terms of how the attitude of banks, regulations, investors etc towards emerging markets (EMs) will play out post this deleveraging cycle. Will investors still be interested in playing EMs, when the US itself is becoming cheap? How will flows eventually play out? How will investors' attitude towards risk assets change?

Even from an Indian context, while the commodity bust is going in our favour, and we have probably seen the peak in the monetary tightening cycle, earnings risk is still all-pervasive and the weakness in governance a serious overhang. We run large fiscal and current account deficits and have very limited room for fiscal man oeuvre. A country which needs FDI desperately to fund its current account, cannot afford to have a repeat of Singur or Posco. This is also our first credit cycle with significant retail leverage.

It probably makes sense to wait for some normality to return to the credit markets before one can become more aggressive. This may be one time when, given all the uncertainty, it may be worth giving up some of the upside in return for safety. Even after we see some unlocking of the credit markets, equities will still give us enough time to participate. To track the credit unlocking, one will need to see the TED spread, LIBOR and corporate spreads normalize.

We will see of course trading bounces, and given the panic, one should appear very soon, but it still seems that early-mid 2009 are when equities will conclusively bottom. I think investors should control their contrarian instincts, and recognize the lack of clarity in the environment and possibility of extreme outcomes. Capital preservation still seems to trump the need to aggressively position oneself for capital gains in the immediate short term.

A Turning Point
September 24, 2008

The environment is far murkier than usual. The year 2009 will be worse than 2008.

Faced with a total collapse of the global financial system, the US authorities have been forced to swallow ideology and accept massive government intervention to bail out their financial institutions.

A harrowing week began with the bankruptcy of Lehman Brothers (the largest corporate bankruptcy in history); the unintended consequences of the Lehman bankruptcy were to heighten counterparty risk aversion (no one was too big to fail now) and also drive a large money market mutual fund to break par on its NAV. Money market mutual funds suddenly did not seem to be as safe as once thought, and within a day we saw almost $90 billion get redeemed from these funds (2.6 per cent of total assets). Faced with large redemptions, the money market funds began hoarding cash, and soon the commercial paper market came under stress, putting pressure on the working capital funding of large corporates. For a time treasury yields actually went negative and inter-bank yields soared. There was total risk aversion and fear and nobody seemed willing to trust any counterparty. The whole situation worsened with the nationalization of AIG, raising concerns on differential treatment vis-à-vis Lehman and market players trying to understand who would be allowed to fail.

Compounding the problem, the shorts began targeting Morgan Stanley and Goldman, as the market questioned the sustainability of the independent investment bank model. Faced with a collapse in their share price, and a huge surge in their cost of default protection, it seemed as if these two banks had no alternative but to find a partner with stable long-term deposits.
Faced with a near collapse of the entire financial system, the US authorities had no choice but to act proactively on a huge scale and abandon the piecemeal institution-specific approach.

What Paulson and Bernanke have proposed is to first of all insure all money market funds so as to stem the redemption pressures and capital loss fears dogging this huge industry. They have in addition asked for authority from the US Congress to buy up approximately $700 billion worth of toxic paper from financial institutions, so as to clean up their balance sheets. This toxic paper will be housed in an entity similar to the RTC (Resolution Trust Corporation), which was effective in resolving the savings and loan financial crisis in the early 90s. By putting the paper in a new government-funded entity, we give the markets time to catch their breath and figure out what these assets are really worth. Today the forced cycle of de-leveraging, instrument complexity and panic are not allowing rational price setting.

These measures have been combined with a temporary ban on short sales on financials, designed to force short-covering and hurt the shorts.

Financial markets have responded to the measures enthusiastically, with global markets rising strongly over the last two days. The bulls are convinced that we have seen the capitulation that marks a market bottom, and that risk aversion should reduce as the market moves away from pricing in financial system collapse. Most Wall Street strategists have put out strong buy calls after these announcements.

Whether the new measures work will depend on a couple of key issues.

First through reverse auctions, at what price will the toxic stuff be taken off the books of the banks? If it is bought at current prices, then we will have a huge hole in the banks' balance sheets, which will need to be filled. Where will this capital come from? We are talking of capital needs in hundreds of billions of dollars. While this one-time clean-up will enable the markets to dimension the hole, and stop the relentless quarter-on-quarter spiral of mark-to-market losses, can the markets come up with this quantum of capital? Without the required capital, how will the banks grow their balance sheets and stop the cycle of de-leveraging?

Secondly after the bail-out, what type of new regulatory requirements will be imposed on Wall Street? There is no free lunch, and after bringing the whole system to the verge of collapse, we can expect significant regulatory oversight, higher capital requirements and greater disclosures from Wall Street. In the new post bail-out era, RoEs (return on equity), profitability and risk appetite will be fundamentally lower.

Also can markets bottom, when nothing has been done to stop the continued price spiral in property prices? Market experts expect a further 20 per cent fall in real estate values, even from here. None of the measures outlined above addresses this root cause of the bust.

As for whether this marks the turning point for the bear market, it is difficult to say. Undoubtedly, the extreme bear scenarios of everything collapsing are probably no longer relevant, but the fact remains that the US is about to enter a consumer-led recession, and the events of the past week have further damaged consumer confidence. We are in a period of protracted de-leveraging for both lenders and borrowers. The recession is now global and even risks spreading among the emerging markets. The year 2009 will be worse than 2008. Markets on a cyclically adjusted basis are still not cheap.

Even in the case of the RTC bail-out in the early '90s, markets bottomed only 12 months after the RTC was set up and the economy took two years to bottom out. While we will definitely get a trading bounce, as the worst case gets priced out, and given the levels of fear and cash, it may be no more then that.

There are still too many unanswered questions. Will such an infusion of liquidity cause inflation to spike or is deflation the bigger fear? Will the dollar get devalued? Will investors demand a higher risk premium for dollar-based assets? If the dollar is devalued, won't commodities spike again? With such intense government intervention and scrutiny in financial markets, will PE multiples derate? With risk appetite under threat, shall we see continued outflows from the emerging markets?

India also has unanswered questions. Is the market prepared for the inevitable earnings disappointments? How shall we fare in an environment of reduced global capital flows? If commodities spike, won't stress on the macro resurface? Election uncertainties loom in the months ahead.

The reality is that this is an unprecedented time, and the environment far murkier than usual. While a trading rally is clear, it is to my mind premature to make any statement beyond that. This could turn out to be the bottom, but it is far from being as obvious a buying opportunity, as the bulls make it out to be. While it is probably dangerous to have very high cash levels, I find it difficult to be fully invested, either. Given the volatility and uncertainty, having some cash still seems sensible.

India in 2009
August 27, 2008

The odds are the markets will bottom out before the middle of next year.

The current consensus on India is very negative, and it is difficult to find a real bull among major market participants. Almost everyone is underweight India in a regional or even broader emerging markets context and we have already seen outflows of over $7 billion. Trading volumes have collapsed, investor visits reduced and the hype around the India story almost totally dissipated. Analysts trying to market the India story keep reporting total disinterest among the investor base, and raising new money for India is extremely difficult.

With such a sea change in sentiment it would be helpful to remember as to how we got here in the first place. While financial markets globally are in turmoil, India has had some specific issues. The India story got derailed for three or four main reasons:

- Inflation spiked and forced the RBI to tighten aggressively, effectively choking growth and hitting corporate profitability. Growth expectations had to be revised downward for the first time in five years;

- The unanticipated surge in oil prices blew a huge hole in both the fiscal and current account;

- The government in its desire to get re-elected began to pursue suboptimal policies; viz. The farm loan waiver, higher than recommended pay hikes, industry level price controls, inability to cut subsidies, etc.;

- Paralysis on economic reforms;

- Valuations were stretched and there was excessive hype.

Now let us look at all these factors as we move into 2009, especially mid 2009.
First of all, we will have a new government in place with hopefully a five-year term. Given the fiscal mess the new government will inherit, and the present government being in its first year, the chances of serious, meaningful reform are bright. A first-year government with a slowing economy and fiscal stress will have the cover it needs to get things done, whether it be reducing subsidies or disinvestment. Also from a practical viewpoint, as long as any coalition at the Centre is independent of Left support, it is difficult to imagine it getting more bogged down on fundamental reform than the UPA. Given the disappointment on this front in the last four years, any policy action will be a positive catalyst.
The penchant on the part of the new government to keep doling out freebies and playing to the gallery will also be reduced. The further we are from elections, generally the more responsible is government economic decision making.
Secondly, it is highly unlikely that commodity prices will have the type of parabolic moves we have seen this year, especially in oil. Even if prices begin to go up again, on a higher base the impact of price rises will be muted. The lagged impact of the RBI tightening will also have totally played out and thus the inflation rate will most likely be around 5 per cent. With inflation under control and most monetary variables in check, the RBI will be about to commence an easing cycle. The new government will also be more focused on getting growth back on track, rather than remaining focused on reining in inflation at all costs. Economic growth ultimately drives employment and tax revenues and no government can ignore this. Bond yields will have peaked

and credit growth will start to accelerate again, especially retail, as the market recognizes the peak in rates for this cycle. GDP growth will start accelerating and we should exit the year at an 8 per cent trajectory again.

Thirdly, independent of where oil prices go, the year ending March 2009 will mark the peak in India's macro-economic vulnerability to rising oil prices. At 9 per cent of GDP, oil imports will naturally drop to below 6 per cent by YE 2011, due to the start-up of the RIL and Cairn oil and gas fields over the coming 12 months. (This will happen even if oil stays above $105). While Cairn will help the balance of payments, RIL gas will improve both the BoP and also the fiscal, through lowering costs for fertilizer/power plants and thus subsidies. Longer-term, both will also yield substantial revenues to the Go I through taxes and profit oil.

By the time we hit mid-2009, assuming the markets are still at today's levels, we would be trading at about 12 times (March 2010 earnings), which is not really expensive considering that return on equity will be above 20 per cent, and earnings will have started to positively surprise and re-accelerate. We would also have had an 18-month correction, more than enough time for corporate India to catch its breath, cut costs and consolidate. Just from a mathematical perspective, earnings will be accelerating as we move into 2010, purely from the coming on stream of the RIL and Cairn fields and their impact on the corporate earnings base
.
India is going through a cyclical slowdown, part of a normal business cycle and not a fundamental break from its trend growth rate of 8 per cent. Such a slowdown is important to remind people of cyclicality, temper overheated growth plans and forcibly reintroduce risk into the equation. Markets are leading indicators and normally bottom out a few months before the business cycle itself. Given the strong possibility of the RBI easing by mid 2009, and the economy and earnings bottoming out, markets should have a positive backdrop to 2009.

The difficulty will be in the performance of the markets in the interim till we get into early-mid 2009. Have markets and investors fully discounted the risk to earnings? How much more can PE multiples de-rate in the face of high and potentially rising bond yields? Will the RBI be too aggressive in its zeal to kill the inflation beast? What if oil goes to $150? We also have to accept that India can totally blow it, with a small possibility of a highly fragmented coalition coming to power in 2009, which will lack cohesion in economic policy making.

The odds are the markets will bottom out before mid-2009; one has till then to pick stocks, do the work and get your portfolio aligned for the next cycle. The key will be in finding which sectors will lead the market this time, for if history is any guide market leadership will move away from the capital goods/power and infra plays that led the market till January 2008.

India's Growth Purgatory
August 12, 2008

With the Left's withdrawal of support, the government seems to have an opportunity.

The concept of growth purgatory is normally applied to individual companies or stocks. It comes into play whenever an erstwhile growth stock trading at high PE multiples because of a history of very strong earnings and top line growth, and loved by growth investors, fails to sustain its growth momentum. As its growth outlook slows, growth investors abandon the stock and the stock PE multiple begins to derate. This process of PE compression has to continue till such time as the stock and its valuation become attractive enough to attract value buyers. This PE derating takes typically 12-24 months, and is very painful for anyone invested in the company during this period when the company is transitioning from a growth multiple to value.

I think to a certain extent this is what is currently happening to India as well. If we go back to the beginning of this year, India was a growth market and valued as such with PE multiples in excess of 20. India had delivered four years of 9 per cent plus GDP growth and consistently surprised positively on earnings. Investors felt that India was insulated from the credit crisis and would maintain its strong GDP and earnings trajectory. The market was over-owned and clearly trading like a growth stock with investors only looking for growth irrespective of capital efficiency. When you have growth-type valuations it is critical that you continue surpassing expectations and surprising positively to maintain the hype.

With the oil price spike, India's macro vulnerabilities were exposed and for the first time both GDP and earnings growth rates were revised downwards and confidence shaken. Investors began to question if India can really grow for a decade at 8 per cent. The weak policy response of a constrained coalition also sowed doubts on India's ability to handle these macro stresses.

Is 8 per cent really the trend growth rate? Are corporate earnings too high and margins bound to compress? If we do not reform, how can we sustain growth? How can any coalition find the stomach to take on vested interests? With such a weak fiscal how will infrastructure ever get fixed? These are some of the issues on investors' minds today.

Like a growth stock which begins to derate once its growth comes into doubt, India is also going through an inevitable derating process as investors no longer take 9 per cent GDP and 25 per cent earnings growth for granted. The general reduction in global risk appetite has also forced this re-assessment.

The problem for India right now is that the market is stuck in a kind of no man's land. It doesn't (at least in the short term) have the growth to justify a PE multiple of 18-20, but trading at about 15 times March 2009 earnings, neither is it cheap enough to attract the value buyers.

One of three things is likely to happen going forward.

First, the market may just fall by another 15-20 per cent, in which case value buyers may get a lot more interested. India at 12.5 times earnings with its quality of companies will attract many buyers. I know that historically India has traded cheaper at even 10.5-11 times and with 10-year bond yields likely to cross double digits, one can argue as to what is cheap. To my mind given the growing size of the domestic money managers, the quantum of money on the sidelines with

private equity players and the continued FDI interest in the country, it is unlikely the market will sustainably drop below these levels. India is also a lot more mainstream today than it was even five years ago, and too large to get ignored like what has happened to a Thailand or a Philippines. The growth potential of the country is too huge and companies are too smart for investors to give up. Even under the most dire of scenarios, India in the long haul will grow its GDP at 7 per cent plus and earnings at 15-18 per cent, for this growth stream to trade at 10 times implies huge and sustained risk aversion. Possible, but unlikely, in my view.

A second scenario is the markets just treading water and drifting along at these price levels for another 6-12 months. This ultimately achieves the same thing as bringing valuation levels down to 12.5 times, but we get to these levels through earnings being given time to catch up as opposed to stock prices falling immediately. This will be painful in terms of trading volumes shrinking, volatility dropping and a general sense of inertia pervading the capital markets. Many investors may prefer to have one large climatic sell-off as in scenario one, rather than the drip by drip Chinese water torture type of market movement implied by scenario two.

A third alternative would be that India regains its growth lustre. The only way that this can happen is for investors to see action on the ground from the government. We need to see movement on second-generation reform, whether it be infrastructure, education, financial system, targeting subsidies, etc. The current government has been able to do precious little on reform till date, now is its chance. If investors begin to feel that India is once again on the move, and is tackling structural bottlenecks, they will be willing to look through the current cyclical slowdown. The world currently lacks growth engines and if investors start believing once again in the 8 per cent trend growth for India, a lot of money will rush in. Investors have to feel confident that the current growth slowdown is only a cyclical blip in the structural growth dynamic.

The current government seems to have a window of opportunity in front of it; finally rid of the Left can they show their true reformist colours?

Whichever way one cuts it, the next six months is a good time to do the work and build a long-term portfolio in India. Reform can only accelerate compared to the pace of the last four years, and I for one still believe in the 8 per cent trend rate of growth. The markets will most probably give you an opportunity over the coming months to slowly and systematically build a quality portfolio at reasonable prices.

2009 will be a very interesting year, with a new refreshed coalition in its first year, facing severe fiscal headwind, and chances of serious reform are bright. The inflation headwind will also be significantly less and we will see a reversal of the monetary policy environment. Corporate India will also have tightened its belt and we could start seeing earnings surprises again towards the second half of the year.

In such a scenario investors are more likely to once again focus on India's growth potential as opposed to its macro weaknesses.

Reform is The Only Way Out
29 July, 2008

The Indian economy is slowing, and earnings are at greater risk than most realise.

Financial markets both in India and globally have been gripped by fear and panic in recent weeks. In no particular order, investors have been worried about global recession, stagflation or a systemic collapse of the entire financial architecture in the US. In India, we have had the additional concerns of a possible early election and political uncertainty. In the last week, as oil has finally started to retreat, hopes have been expressed that just maybe we have seen the bottom in financial markets, both in India and globally.

How justified is this hope? Could we have bottomed?

To have the confidence that we may have seen the worst, we need two or three things to fall into place globally, and India has other specific issues it needs to address.

First of all, unless oil comes down by another 15-20 per cent and stays down, it is unlikely that global or Indian markets can make much progress. Although it is too early to tell, the recent sharp drop in crude could be the long-awaited and sustained correction. Demand destruction is now clear globally, with fundamental shifts in consumer behaviour beginning to take place in the OECD economies. Oil consumption is dropping across the developed world.

As subsidies are being narrowed in Asia, higher prices should start biting here as well.

The negative reaction in global equities to rising crude prices also highlights their impact on global growth and the self-limiting nature of the recent rise in oil prices. In the recent oil price blow-off, stocks of oil companies have not fully participated; this divergence between oil and oil stocks highlights investors' concerns on the sustainability of current elevated prices.

Oil has been the ultimate momentum trade, and thus when it does break, we could easily see prices going into free-fall.

Many investors still question that with China being the source of marginal demand and still growing at 10 per cent, how can crude prices come off? The answer lies in the actual contraction in crude demand among the OECD economies. As a bloc, the OECD consumes far more crude than China, and the demand contraction here will eventually swamp any demand increases coming out of China. In fact, we may already be at this point. The recent hikes in fuel prices in China, as well as an anticipated slowing of its economy, will also cool down the demand side.

With demand and supply getting more aligned, the only joker in the pack remains geopolitical concerns. This is inherently unpredictable and any one event can cause a steep spike at any time.

If the recent oil price correction can extend and sustain, then one of the critical building blocks to a market base building will be in place.

The second big drag has been inflation and the rising CPI (consumer price index). While the US authorities have been able to get away with focusing only on the core CPI (ex food and energy prices), most central bankers have to answer to the headline CPI numbers, which are elevated and rising globally. These rising price levels put significant constraints on what the central banks can do to stabilise both the markets and the real economy. The US economy and its financial markets have been hit by a serious deleveraging cycle combined with falling asset prices, and this is now beginning to spill over into the UK and Western Europe.

Such severe asset price deflation and deleveraging need aggressive monetary reflation to counter it, but high and rising inflation is preventing the authorities from easing as much as they would like to. For example in the US, borrowing rates for both businesses and consumers are actually higher today than before the Fed began cutting, yet Bernanke is now being forced to talk about inflation risks and pause his easing cycle. In Europe, despite growth slowing, the ECB has actually hiked rates to counter rising headline inflation. The UK is another example of the policy dilemma, property prices are falling, the financial system is in stress and growth severely compromised, yet the Bank of England is unable to ease because of elevated food and energy prices.

The monetary authorities are losing their ability to engineer a soft landing, which is dangerous and could lead to far more volatile economic outcomes than we are used to. The potential inability of the central banks to act as countercyclical economic shock absorbers is very serious and could lead to higher risk premiums across asset classes.

We need to see both food and energy prices come down, and headline CPI start to fall. This will allow central bankers globally to focus on stabilising the financial system, counter deleveraging and cushion falling asset prices. Headline inflation has to come down, as unilateral monetary easing from the Fed will not be effective. If only the Fed eased, it will pressurise the dollar and spike commodity prices, the ECB and BoE have to join this party, and they will ease only if headline CPI comes down.

Subdued inflation will also take out of the equation the 70s-style stagflation, the collapsing PE scenario that some of the bears have been pointing to as the template for the markets.

In India beyond the above, we need to see some movement on reforms from this government. While measures like hiking FDI in insurance, changing voting rights in the PSU banks, etc have limited real world impact, reforms will boost sentiment considerably. The one measure with serious longer-term positives is pension reform.

The Indian economy is slowing, and earnings are at greater risk than most realise. With earnings disappointments likely, sentiment and its impact on PE multiples will be the key to support the market. If investors are confident on economic policy making, then they will be willing to look through short-term earnings weakness; otherwise we run the risk of both weak earnings and multiple contractions.

India is a consensus underweight among fund managers, and money has continued to move out of the country over the last six months. However, the market is not yet cheap enough to attract the value buyers. Either we wait for 12-18 months to let earnings grow and bring valuations down further, or we need to rekindle excitement on the country and its long-term growth trajectory through demonstrated economic reform and policy action.

There seems to be some light at the end of the tunnel for global equity markets, but it is too early to wave the all clear flag. We need to see continued movement on oil and inflation.

In India, we need to demonstrate our desire and commitment to sustain our growth trajectory, through economic policymaking and fundamental reform, both of which have been totally lacking over the last few years.

An Alternative Scenario for Oil
June 25, 2008

Apart from hiking prices to curb demand, you can expect moves to curb speculators.

Just about everybody has now thrown in the towel on oil prices. Despite many observers believing that we are in the midst of an oil bubble, oil prices refuse to come down on a sustained basis. Prices seem Teflon-coated, and despite global economic weaknesses, chances of rising interest rates, attempts to talk up the dollar, etc. oil prices refuse to cool down. The bull case is very clear — constrained supplies, strong demand from the large emerging markets and geo-political tensions. The bears are equally clear that this is another price bubble, and will end as all such financial market spikes ultimately do. Whatever be the arguments, the bulls are clearly winning. Most market participants accept that we are in a new era for oil prices and it is very unlikely that prices will come down anywhere near the pre-2005 levels.

As is the norm, just when everyone capitulates, the seeds of a reversal get sown. In the case of oil, there are steps being taken and they will cool down this red-hot commodity, but they are being ignored by the markets.

First, all the major Asian consumers of oil have now hiked retail prices. India, Indonesia, Malaysia, Taiwan and now even China have hiked retail prices by 12-40 per cent. This is a major break in pattern as these governments have now seemingly accepted the unsustainability of continuing to subsidise consumption. Having bitten the bullet, all now have plans to reduce oil subsidies further in the coming months. Once prices are hiked in these countries, they will not be reduced, independent of oil price movements, and thus consumers in these countries will now have to adjust to permanently higher fuel prices. Given the income profile in these countries, the impact on consumption should be far steeper than price hikes in the OECD economies. Already demand for petroleum products is shrinking in the OECD, with gas demand in the US dropping by 6 per cent year-on-year. Demand growth in the Asian countries should begin to stall as price hikes cascade through the system. Today's high oil prices are justified not on the basis of current shortages, but on the expected sustained growth in future demand. If the major Asian consuming nations, which account for all the incremental demand growth today, are on a clear path to remove subsidies and force energy efficiency, this has to have an impact on the trend incremental demand. As consumers accept that they will have to ultimately pay near global prices, demand and behaviour will adjust.

Secondly, there seems to be a serious mood change in the US towards energy security. The fact that John McCain has openly come out and suggested a revival of the US nuclear programme, and that the Governor of Florida has talked of re-examining the ban on offshore drilling, are just straws in the wind, pointing to a change in political mood. The US consumer is now feeling the pain of higher gas prices and the country will I think become more pragmatic in balancing environmental and energy security concerns.

Who would have thought that the Americans can ever be weaned away from their gas-guzzling SUVs? But that is exactly what is happening. As consumers adapt to high petroleum prices, this adaptation will soon manifest in policy change as well. One cannot rule out tax changes designed to reduce the carbon intensity of the economy.

There is also, to my mind, a high probability of some type of legislative changes designed to reduce speculation in the commodity futures markets. It could be as simple as imposing, on institutional investors, the same prudential and disclosure norms that currently govern ordinary commodity speculation. The loophole that currently allows investment banks to be treated as commercial hedgers, rather than financial participants, could easily be plugged. The governments in the US and Europe could reconsider the tax-free status of investments in commodities by endowments and pension funds, etc.

There is too much pressure on US lawmakers to be seen to be doing something, and this is an area where there is limited political opposition. Given the fiasco of laissez-faire regulation in the structured products and sub-prime arena, it will be difficult to resist the move to increase legislative oversight in these futures markets. Any moves in this direction are bound to have an impact on positions sizes and the number of participants in the commodity futures markets, and will reduce volumes and speculative activity.

The fourth factor is the gradual realisation among the large OPEC producers, viz. Saudi Arabia (with huge reserves still in the ground), that it is seriously damaging its own long-term prospects by letting oil prices get out of hand today. It is unprecedented for the Saudis to call a meeting of producers and consumers, which, even though not successful, underlines the growing sensitivity of Saudi Arabia to global calls to stop this parabolic rise in oil prices. The Saudis must be afraid of serious policy action in the major oil-consuming countries designed to reduce dependence on imported oil.

Oil prices have now become the single-biggest issue facing the global economy. The long-term negative impact of the sharp surge in oil prices far exceeds any effects of the sub-prime crisis. High oil prices affect the poor disproportionately, and will increase global poverty. Unlike the credit crisis, it is not investment bankers but the man on the street who will feel the pinch. The rise in prices from $70 to near $140 a barrel will alone transfer in excess of $2 trillion from oil consumers to producers. Countries and politicians can no longer wait for or afford the luxury of markets finding their own equilibrium. We will see action of the type outlined above and more as policymakers are forced to try and engineer a reduction in oil prices. Current prices are causing too much political and economic damage across too many countries and the beginnings of action to reverse this rise are now visible. I think we have crossed the limits and the world will act through all the policy levers at its command, both obvious and unconventional.

Oil prices will come down; it is only a matter of time and this will be a huge positive for global markets, especially Asia. They may not go much below $100, but even a move from $135 to sub $100 is huge in today's context.

Is It All Over?
June 11, 2008

This is a good time to build a portfolio, as the market will throw up many opportunities.

The Indian markets now seem to have cracked, delivering the worst performance in Asia (year to date). The markets are now hovering around 4,500 (Nifty) and are in danger of breaking the January lows. In dollar terms, the markets are down nearly 35 per cent, and that too all in a matter of six months. As is to be expected, the prophets of doom and gloom are out in full force, with the bears talking of sub-4,000 levels on the Nifty. One has also seen a series of articles questioning the long-term India economic story itself. Foreigners seem to be selling in droves.

But first, how did we get here?
There was clearly some hysteria and overconfidence in the markets and among companies in January 2008. We could clearly see signs of excess in terms of valuations, IPO pricing and fund flows. But what should have been a normal 10-15% correction has turned into a full-scale rout as the macro for India has worsened by far more than anyone could have imagined. Nobody predicted oil surging past $125, and at these levels the damage to India's current account (breaking 3-3.5%) and fiscal (consolidated deficit beyond 9%) is considerable. Inflation has also raised its ugly head, leaving no wiggle room on interest rates for the authorities to fight a growth slowdown.

The macro worries have been compounded by an election-oriented government, which does not have the political space to implement reforms or cut subsidies. Thus, we have seen a Rs 70,000 crore loan waiver and the Sixth Pay Commission recommendations being implemented at the same time as food, fertiliser and oil subsidies have risen to unprecedented levels. We are seeing the build-up of a potential fiscal time-bomb, despite having gone through five years of unprecedented tax buoyancy. All the hard fought fiscal gains seem to be at risk of being frittered away, and interest rates may blow out.

India has gone from having one of the best macro stories, to one of the worst. As is typical, investors have suddenly woken up to the fact that we are one of the few large markets to run large twin deficits (fiscal and current account), and need financial flows to sustain. The reversal in the rupee, where in October 2007, the RBI stopped P-notes to stem capital inflows till today, where the currency has dropped by over 10% in a couple of months, has only heightened investor anxiety on the macro. We are one of the worst impacted by high oil prices, and most now believe in oil having entered a new price zone.

The government's willingness to sacrifice growth to stem inflation, and its penchant to interfere in micro industry level pricing and profitability decisions have also dented investor perception towards the country and the willingness to pay for seemingly unpredictable earnings.

Even on the micro company level, we have seen signs of margin pressure and difficulties in meeting growth expectations and scaling up challenges.

However, is everything as bad as it looks today?
The fact is that even in a year like 2008, the economy should still be able to grow at 7-7.5 per cent, and corporate earnings are likely to see 10-15 per cent growth, in a relative sense still outstanding performance. Most of the world will have zero growth and negative earnings.

All the secular drivers of growth, viz. demographics, rising savings/investment rates and the entrepreneurship of corporate India remain in place. These are long-term secular forces which do not reverse on a dime. Even the fiscal hole being created will ultimately hit a crisis point and force fundamental policy action, in a typical Indian way. Serious investments are taking place in the economy, be it in infrastructure, education or industrial capacity and the fruits of this still lie ahead. Indian companies continue gaining global share and relevance. A growth slowdown for a year will also give breathing space to the economy and corporates to put their house in order after five years of helter skelter growth.

Also at these market levels, the valuations no longer look outlandish. We are probably trading at about 15 times March 2009 earnings, not absurd for 20% RoEs and a 15-20% long term earnings trajectory. At 8-9% long bond yields these multiples could drop to 12.5-13.5 times, but are unlikely to go sustainably lower. Which means either 6-9 months of sideways movement as the market grows into its earnings and looks towards March 2010, or another 10 per cent down from here.

The big move down in India has already happened, this is not the time to now question (as investors inevitably will) whether India can grow at 7.5-8 per cent on a trend basis or whether Indian companies can grow earnings at 15-20 per cent. I think the answer is a resounding yes on both counts.

Current government inaction does not mean that we will permanently have a political construct wherein no hard economic decisions are taken.

To sell now (independent of a short-term trade), one has to believe that the macro will truly fall apart and we will fall into a negative spiral of rising rates, falling rupee and negative earnings. Given the reserves at our disposal, continued flows on the invisibles account and the strong underlying growth dynamic, the odds of this happening remain low.

India remains an exciting growth story; it was probably never as good as the bulls made it out to be in January 2008, but neither is the story over. The last five years are not some cyclical aberration (8.5 per cent GDP growth); we have made a break from the growth rates of the past. The country is now a trillion dollar economy and is firmly on the global map for investors and corporates alike, and will not fade away. It is highly unlikely that we can just disappear off the radar of investors as we did in the decade of 1994-2003. The economy has serious macro headwind, but the odds remain in favour of us being able to grow through these issues, independent of commodity prices themselves normalising. We now have to live through 6-9 months of pain, partly brought on by an ineffective political construct, partly by unprecedented surges in commodities and finally by investor exuberance. This is a good time to build a portfolio, as the market will throw up many opportunities. Use the time wisely and patiently, as you will get rewarded disproportionately when things turn, as they inevitably will.

Oil Crisis – Bonds & Subsidies Won't Do
May 28, 2008

We are in an era where oil will remain far above accepted norms of pricing.

Just when we thought that the credit crisis was blowing over, we are now getting hit by an even bigger issue — the relentless surge in oil prices. Oil prices have clearly broken out, surging past $135 and showing no signs of cooling.

As we all know by now, rising oil prices are an unadulterated negative, raising inflation, reducing growth and discretionary consumption. They also reduce the flexibility global central banks have in dealing with and reacting to growth shortfalls. With oil prices now firmly stuck at these elevated levels, the dreaded stagflation word has resurfaced in market participant's dictionary.

Intriguingly, there is at the moment a raging debate going on in financial market circles as to the reasons behind this surge in oil. The fundamental bulls led by Goldman and some savvy commodity funds argue that a chronic and worsening demand-supply mismatch can explain oil at $135. They argue that major EM consumers like India and China have not passed on the oil hikes and thus consumption is still not getting fully hit. Oil production continues to falter, with Russia, Mexico and many other large producers hitting peak production. Where oil is available, e.g. Venezuela and Iraq, there exist serious political constraints to getting these reserves out of the ground. Whatever capacity growth that we have seen in the past few years has mostly come from bio-fuels, natural gas liquids and synthetic oils.

Their fundamental point remains that oil prices will have to keep rising to balance the trend global GDP growth of 3.8-4 per cent, with oil production growth at best 1 per cent. Oil prices will keep rising till demand growth comes in line with production growth — it is as simple as that. The bulls believe that this fundamental alignment of incremental demand/supply will not happen till oil crosses $150 in the short term and eventually even higher. The movement of the long-dated oil prices (five-year prices are now around $120) also confirms the bullish outlook.

The bears are much more sanguine on the demand/supply outlook and are comparing the current spike to the internet boom of the 90s, with a total de-linking of the fundamentals with prices. They point to the fact that between 2004 and 2007, global demand growth has slowed from 3.6 mbd (million barrels per day) to .7 mbd; thus demand is now growing slower than non-OPEC production, which rose by .8 mbd in 2007 (source: ISI). With OPEC production continuing to grow, the bears point out that we will soon have nearly 5 mbd of spare capacity (half of Saudi Arabia). They also point to the persistent news that Iran and some others are chartering huge numbers of tankers to store crude, which they are unable to sell at current prices. How can you have shortages if Iran cannot sell what it produces today? The bears also point out how the bullish oil price scenario assumes no policy response from the OECD or large EM countries. If the US, for example, were to adopt European type fuel economy norms for the US car fleet, this alone will cut US fuel consumption by the equivalent of China's entire gasoline demand. At some stage China and India will pass on oil price hikes to their end consumer.

Another theory is that institutional investors in the form of large commodity index funds are the real reason behind the rise in prices of oil and more generally commodities across the board. In recent testimony before the US Congress, Michael Masters, a long short hedge fund manager, made this case in great detail. He pointed out that commodities have now become an acceptable

asset class in which endowments, foundations and money managers of all hues wish to participate. They participate in the futures markets for commodities and through index funds to get portfolio diversification. As he states, at the end of 2003 there was $13 billion in commodity index funds , which has now grown to $260 billion. In many commodity futures markets, index funds are now the biggest players. In the first 52 trading days of this year, demand for commodity index funds grew by more than $55 billion.

While Masters has some good data in his testimony, and it is a worthwhile read (available on the net), he is in my opinion overstating the impact of these index commodity funds on the cash market and cash prices of these commodities. An index fund buys a futures contract for a commodity when money is first invested, and before the contract expires or needs delivery this same fund will reverse the original contract and buy another long dated one. Thus they do not affect the cash price of the commodity, which is based more on actual demand/supply. He also fails to explain why in many commodities like iron ore or steel, which are non-exchange traded and thus not in these fund's portfolios, prices have actually risen by a lot more.

I am a believer that oil prices in the long term are going to be at a new elevated level, and that supply constraints will be more binding than the ability of countries to find solutions to reduce demand. Prices will have to remain at levels where there is permanent destruction of demand, and where all types of alternatives, be it solar, wind, bio-fuel or nuclear, are economically viable.

Having said that, given all the hype around oil currently, there is a very high probability that we get a sharp correction in the near future, as the long trade is now getting crowded and the recent spike forced significant short covering.

This coming corrective phase should be used by the Indian authorities, to try and put our policy on oil pricing in order. We missed the opportunity to move to market-based pricing in 2003-2004, when oil was below $50, we have to use the coming correction to get a more market-oriented framework for fuel pricing. Obviously the current environment is not conducive politically to bring about any substantive change, but we have little choice. Any correction in petroleum prices will be shortlived, we have to accept that we are in an era where oil will remain far above accepted norms of pricing. We do not have an adequate policy framework in India to address permanently higher oil prices. When oil is above $100, band aid solutions of bonds and subsidies are not sustainable.

That 70s Show
May 14, 2008

There does exist the strong possibility that we are in a new price zone for most basic inputs.

Inflation has reared its ugly head as the next big risk to global financial markets, replacing systemic financial sector risks, post the Bear Stearns bailout. Investors are now more worried about oil and grain prices than the possibility of another large financial institution going bust. With oil prices at $125, and commodities across agricultural products, metals and minerals at elevated price points it is no wonder that inflation is now probably the biggest bugbear of investors, certainly in the emerging markets.

It is easy to understand investors' fears of inflation, as history consistently shows that high inflation environments are very unkind to financial assets. If you look at the decade of end-1969 to end-1979 (a period of high and rising inflation), equities delivered consistent negative real returns in both the US and UK (source: BZW). While weak, equities at least delivered better returns than bonds, which got totally decimated in this type of an environment.

The source of the poor performance in equities was not corporate earnings, as earnings rose in real terms throughout this period. Profits were able to outperform high inflation. The source of the poor returns was a structural compression of the PE multiple. As an example, the PE multiple for the S&P 500 started the decade of the 70s at 16 and ended the period closer to 7. It is almost impossible for equities to be able to deliver positive real returns when you face multiple compression of this magnitude. There is a clear and strong negative correlation between inflation rates and PE multiples.

What causes this compression and why is it structural?

The one obvious answer is that high inflation will trigger a rise in system-wide interest rates as central banks will be forced to tighten monetary policy to combat rising prices. Rising interest rates raise your opportunity cost of capital, and thus PE multiples have to adjust to raise the expected rate of return in equities to make it comparable to what is available in fixed-income markets. Also as rates rise they have a larger impact on long-duration assets like growth stocks and real estate, where multiple compression is the maximum as their cash flows tend to be more back-end loaded. Negative cash flow stocks have the toughest time of all.

The second reason for the PE compression is also the heightened economic volatility associated with a highly inflationary environment. Economic growth becomes more uncertain and the volatility of economic growth tends to rise and fall with inflation, including profit volatility. The need to control inflation through lowering aggregate demand can lead to recessions and sub par economic performance. We may also see muddled government policy and interventions in micro industry level pricing, which reduces economic predictability. With the economic and profit environment becoming more volatile, investors will typically demand a higher risk premium for perceived greater risk to earnings and cash flow. This higher risk premium translates into a higher earnings yield or lower PE multiples.

Another reflection of greater risk is the fact that in the high inflation environment of the 70s, the distribution of profits and profit growth across sectors also narrowed significantly. Significant

positive real earnings growth was delivered only by a few sectors, primarily oil & gas and financials. With such a narrow dispersion of profits, the perceived risk to corporate earnings rises.

High inflation is an unambiguous negative for financial assets, PE compression being the overpowering dynamic that trumps everything else.

The question we have to ask ourselves is whether we are truly entering a new higher inflationary environment.

It is currently tempting to describe the commodity rallies as highly speculative and bubble-like. A significant portion of current market opinion believes that what we are seeing in the commodity complex today is strong buying driven by speculative flows out of financial markets. Many of the more savvy players in this space are now coming around to the view that this may not be the whole truth. They point to the huge price spikes in commodities like cobalt, tungsten and manganese and many others where financial investors have almost no exposure or role to play. If financial speculation is behind the commodity move, how can one explain why these so-called inaccessible commodities have actually risen as much or more than widely traded metals like copper and aluminium?

The answer lies in rapid and sustained demand growth coming up against a surprisingly unresponsive supply side. In commodity after commodity (not just oil) we are seeing disappointing supply, in spite of prices being at levels that ensure strong financial returns to new projects.

This type of commodity-based inflation is a much greater risk to the emerging markets as their price indices will typically have a much higher weight for such basic inputs than in the OECD countries. The ability of their populations to absorb such hikes in prices of basic inputs is also far more limited. The structure and sophistication of most of the EM economies and their manufacturing base is also such that commodity price impacts have greater influence on margins than in the typical OECD economy. In the midst of a huge infrastructure build-out, the EMs are also facing enormous cost escalations as the commodity spike has raised their costs.

While I am sure we will see some correction in the commodity complex and definitely in oil, there does exist the strong possibility that we are in a new price zone for most basic inputs. This will be a strong negative for most of the EMs and countries like India, which are large importers of oil and many other commodities and where consumption is rising structurally.

India also has the additional problem: As prices of commodities like fertiliser and oil keep rising, we continue to create a bigger and bigger hole in the fiscal. A rising and unsustainable subsidy burden will pressure the fiscal deficit, raise interest rates and ultimately spill over into inflation. Rising interest rates, like inflation, are a killer for multiples and ultimately economic growth. India, already running a large fiscal deficit, has very limited ability to absorb a further spike in subsidies, and seemingly limited political will to tackle these issues.

Inflation is the new variable we should focus on. If you believe that commodity prices will come down, we are probably set up for a strong rally in financial assets, especially the EMs. If you believe that prices and inflation will remain elevated, all financial assets will have a difficult period ahead.

What Now?
April 23, 2008

It may be premature to assume that we have seen the lows in this cycle.

Global markets have had a nice bounce in recent weeks as the worst case Armageddon-type of scenarios now seems off the table. The actions of the Fed in opening up the discount window to investment banks now make it highly unlikely that another Bear Stearns type of collapse is possible. A combination of extreme negative sentiment, strong regulatory response to shore up the financial system, and by and large decent earnings(ex financials) have combined to give us a nice bounce in global equities. The inevitable question is: What does one do now? Should one remain invested and bullish, or do we run the risk of another leg down?

As attention moves away from the financial crisis and its impact on the solvency of the US financial system, (though there seems to be fresh trouble brewing in the UK), investors will once again have to refocus on the US economic outlook. How deep and long can the coming recession be? How much will corporate earnings growth decline?

There is to my mind a general sense of complacency among both investors and the sell side on the US economic outlook. Everyone accepts that the first half of the year will be weak, but the consensus seems to be that the upcoming $170 billion fiscal stimulus will stabilize economic conditions towards the second half of 2008 and we will be back to near trend growth in 2009. One can understand this type of forecast, given the pace and extent of the typical recession of the 1990s-2000. If we are in a typical recession, then the market decline of about 15 per cent from the top is about normal and the markets will bottom about 4-5 months before the end of the contraction, i.e. in May-June.

However, there exists the strong possibility that this recession will be far worse than the norm of the last two decades and the pain will be concentrated in the area of the consumer.

As the folks in Merrill point out, this cycle bears closer similarity to the recession of the mid-1970s as opposed to what happened in 1990 or 2001 (the last two recessions which are used as a guide post by most). Similar to the 1973-75 cycle we have today a sustained rise in food and energy prices as well as a severe squeeze on consumer balance sheets from simultaneous declines in both the housing and financial markets. In the 1973 recession, retailers ultimately fell by 50 per cent, regional banks also halved and the S&P 500 fell by 40 per cent. If this is the true template of what we are going to go through then all talk of the market having bottomed out is premature.

We are going into this recession with household debt at an all-time high, both when measured to income (140 per cent) and assets (20 per cent). It is amazing that the US debt/income ratio has risen as much in the last six years as it did in the previous 39 years. Never before have interest rates been so low, yet the debt service burden on households this high, going to show just how levered the US consumer is from a historical perspective. The trends in employment are also worrying, with private payrolls down by 141,000 in the last three months and most forward-looking employment data like hours worked or temporary agency employment numbers indicating that things will get far worse before they get better. Given the employment outlook as well as the pressures on real wages, it is no surprise that consumer confidence has collapsed and is at its lowest level since the 1981-82 recession. We could see a multi-year retrenchment in the

30 per cent of total consumer spend that is discretionary, as families rebuild savings and normalize debt service ratios.

On house prices, we are in a secular bust with prices falling in every single region of the US and the inventory of unsold homes at an all-time high. Many market observers expect house prices to fall by another 15-20 per cent before we hit the bottom. One can only shudder at the default rates and write-downs in such a scenario. Even if house prices were to decline by another "shockingly" high 20 per cent, we would have only retraced about a quarter of the price rise between 2000 and 2006.

We should be prepared for a very serious consumer recession in the US in 2008-09, all the signs point to it and we have not seen anything like this for the past 30 years (well beyond the memory of most active investors). Yet the consensus still sees double-digit earnings growth in the US in 2008-09 (ex-financials). What chance that these earnings growth rates will actually transpire? My best guess is that we will actually see zero earnings growth in the US this year, with exporters and global MNCs preventing a negative print.

If we get another leg down in the US as investors get disappointed with earnings and fully grasp how bad things could get for consumption that cannot be positive for the emerging market (EM) asset class, as risk aversion will rear its ugly head once again. We could have a two-stage correction in the US, similar to 2001, wherein we had a correction first in tech, and then a broad market decline driven by an economic recession. The first stage of pain and decline today is largely in the financials and we could now broaden out.

The EM markets also have their issues with inflation, and we have a cycle wherein all the major EM central banks are actually hiking rates and tightening monetary policy at a time of slowing global growth, not a recipe for strong out performance.

It looks like we have passed the worst of the financial crisis, and markets are naturally celebrating, but it may be a little premature to assume that we have seen the lows for global markets in this cycle. We have a potentially brutal consumer retrenchment ahead of us in the US, the likes of which most investors of today have never experienced. Markets may still have pain ahead of them and it would be unwise to use up all your financial reserves.

Why are Indian Markets Falling?
April 9, 2008

The capital markets seem to have fallen off the government's agenda.

The Indian equity markets have just completed their worst quarter since 1992, with the broad indices down about 28% in dollar terms and selected mid-caps down between 35 and 40%. Shell-shocked investors are obviously wondering what happened. Wasn't the credit crisis centred in the US? Isn't India supposed to be isolated from the financial system woes of the West? Why is India among the worst-performing markets year-to-date (YTD), and why are we dramatically underperforming other emerging markets?

Investor sentiment in India has turned extremely cautious, and outstanding open interest in the F&O markets is down about 65%. FIIs have sold about $3 billion YTD, and even local flows into mutual funds and insurance ULIPs have slowed down. There is a general sense of unease and nervousness and I know of very few people who are willing to commit fresh capital. The market, once seen as expensive, trading at over 20 times forward earnings, is now 15 times March '09 earnings, and, if you make a couple of adjustments for embedded value, about 12.5 times. At 12.5 times, the market is pretty much at its long-term average valuation multiple, and for a near 20% RoE, not outlandish. Yet nobody has the confidence to buy today.

Just three months back we were invincible, growing at 8-9%, insulated from the US and full of confidence. But all this confidence has now evaporated.

To understand the markets' poor performance, one can point to the obvious factors of global risk aversion and de-leveraging across all markets and asset classes. India had also had a dream run over the past few years and was thus seen as expensive, over-owned and a good source of profit. We also have an economy which is clearly slowing, though still likely to grow at between 7 and 7.5% in 2008-09, and in tune with most other emerging economies we have a growing inflation problem. The above issues are well-known and pretty much common across most large emerging markets.

I think India has lost out in two areas — first, the transparency and predictability of corporate earnings, and, second, government action.

One has to accept that the Indian corporate sector has hardly covered itself with glory in terms of disclosures and transparency over the past few months. We now have evidence of banks punting the IPO markets and showing it as normal earnings, numerous companies punting FX markets and now trying to pretend they were mis-sold these exotic derivative structures as the trades go bad, respected companies booking commodity losses, etc. There is a general sense of mistrust around company earnings, especially for the banks, and the more aggressive mid-caps and most investors are braced for March 31, 2008, balance sheets and whatever surprises may be in store there.

We have also seen many of the investor favourites (in the capital goods and power sectors, particularly) disappoint on execution and margins. Despite having solid order backlogs and supposed earnings visibility, these companies have not been able to deliver on very high investor expectations. In every sector, investors can now find reasons as to why earnings will disappoint. For consumer-facing sectors, the high and expected rising interest rate environment will dampen demand. For manufacturers, rising input prices will crush margins, for exporters the rupee is a

huge problem. For commodity producers, the government seems determined to kill their pricing power and anyone with capital markets exposure is toast. Anyone in need of raising fresh capital like the real estate boys is perceived to have little chance of either raising the money or making their numbers. Banks are faced with slowing loan growth and rising NPAs. Investors also now fret about negative operating leverage as growth slows.

I have never seen analysts or investors more uncertain on earnings than they are today. It is also an amazing turnaround, for just a few months ago conventional wisdom was confidently discounting 15-20% earnings growth as certain. Today suddenly all earnings numbers are in doubt, either due to margin or execution challenges. Investors are not used to downgrading earnings in India, and the past high valuations have been justified on the sustainability of earnings.

An expensive market where earnings come into question is bound to derate, and that has been India's fate as well. Expectations were too high and are now coming in. We are not seeing new buying at seemingly attractive levels as investors are still not clear as to the likely earnings trajectory in 2008-09. Investors hate uncertainty, and till we get more visibility on earnings, don't expect strong inflows.

A second issue in India has been the response of the government. Starting from the farm loan waiver to perceived government interference in all types of pricing, investors are worried about an increased penchant of the government to resort to price caps, export bans and moral suasion to control prices or compromise industry economics. How can you give full value to a company that is unable to maximise returns for its shareholders in good times, but has to bear the losses of the bad times? The government has also shown a willingness to use PSUs to support its social agenda, a case in point being the refining and marketing companies. Nobody questions the necessity of having petroleum subsidies, only as to why publicly listed companies should bear the burden and not the government budget. To many, the government has lurched back into a command economy mindset, when dealing with the recent inflation spike and government action has increased earnings uncertainty.

Even in the Budget, instead of recognizing the critical role the capital markets need to play to fund India's aggressive infrastructure and capacity build, we had a hike in the capital gains tax and changes in the securities transaction tax, which have seriously damaged trading volumes and sentiment. The capital markets seem to have fallen off the government's agenda.

Combine all of the above with an election year, public comments of a willingness to sacrifice growth to control inflation and one can see why investors currently lack confidence in India.

I don't think all is lost, the current earnings woes are temporary and visibility will improve. Pressure on the government to show action is also at its most intense today, and hopefully economics will once again take centre stage. Investors will return, but we need some more time to consolidate.

Stagflation?
March 12, 2008

It is unlikely that inflationary pressures will remain elevated in the US.

Fears of stagflation — an environment of high and rising inflation, low economic growth and poor corporate earnings — are rampant in financial markets. The reasons for this fear are clear — economic growth globally is headed lower and inflation across the world is on the uptick. To take the case of the US specifically, it is now quite clear that we are either already in or about to enter a recession, the debate having shifted to the length and depth of this downturn. Combined with this economic downshift, we now have inflation ticking up on both the core (ex food and energy prices) and headline CPI data. In January we saw the headline and core inflation measured by the CPI move to one-year highs of 4.3% and 2.5%, respectively. Both these numbers are higher than the perceived comfort zone of the Fed. Worryingly, inflation expectations measured at the consumer level are also edging higher, implying that the currently elevated inflation numbers may be getting embedded into the psyche of consumers. Measured by the University of Michigan's consumer survey data, we see that 5-10 year inflation expectations have inched up to 3% in the past few months, right at the top end of their recent range. If long-run inflation expectations continue moving higher, the matter will become a serious concern for the Fed, as it consistently maintain the importance of tracking these inflation expectations and making sure they remain in a tight range. Any breakout in these numbers and the Fed will have to take cognizance.

Inflation worries are now a global phenomenon. Just witness the reluctance of the European Central Bank to cut rates despite the strong euro and weak global economic picture, due to fears on inflation. Most of the large countries in the emerging market universe are also having to face these issues.

The weakness of the dollar, record high gold prices and the strength of commodities across the board are seen as further confirmation of a building inflation threat. The bears also point to the huge injections of liquidity into the financial system by the Fed and central banks globally as further fuel being added to the fire. Many observers point out the similarity between the mid-1970s (a period of slow growth and very high inflation) and today.

While there is no disputing the data and the fact that there has been a clear rise in core inflation over the past few months, the bulls remain confident that this is only a temporary aberration. They point out that inflation is a lagging indicator and recent trends reflect earlier strength in the economy. An environment of collapsing housing prices, credit contraction, consumer retrenchment and global recession does not seem one in which inflation can get embedded and thrive. An economic shock of the type we are currently experiencing is normally a deflationary event, not an environment in which one would expect prices to spiral upwards. Also there is no sign that the higher prices are getting passed through into higher wages, as wage growth has held steady and not accelerated over the past year. Unless we see a classic wage price spiral, it is difficult to imagine prices continuing to accelerate upwards. Once the US slows and economic slack builds up, one would expect price pressures to naturally recede, albeit with a lag. The bulls also point to the structural dis-inflationary forces of globalization, technology adoption, and global deregulation. As global growth trends down, it also seems inevitable that commodity price pressures will ease. The bulls also take great comfort from the fact that inflation expectations in the bond markets seem well contained, as bond prices are hyper-sensitive to changes in inflation expectations.

Hopefully the bulls are right and we are only going through a temporary period of rising prices and slowing growth.

The market fear around stagflation is based on the toxic effect such an environment has on financial market returns. One has to only go back to the mid to late 1970s and see how poor that environment was for financial market participants in the debt and equity markets. A stagflationary environment is corrosive for stocks as high and rising interest rates lead to PE compression and poor economic growth depresses earnings. Thus both the pillars of equity market returns are simultaneously attacked. Similarly a high inflation environment will cause both interest rates and defaults to spike in the fixed income markets.

Even more worrying are the constraints such an environment puts on the ability of the Fed to act aggressively to prop up the economy. Any bullish thesis today involves some variant of the Fed coming to the rescue and bailing out the economy. Any constraints on the ability of the Fed to move aggressively due to concerns on the inflationary backdrop are a clear and very big negative. At the moment Bernanke and gang seem to be willing to ignore the pick-up in inflationary pressures, arguing that the pick-up is transient and the dangers of the economy going into a freefall deserve precedence. While they may take this stance today due to the dire condition of the financial system, any further acceleration in inflationary pressures and we may see the Fed having to be less aggressive on monetary policy than they would wish.

Given the poor economic environment, it is unlikely that inflationary pressures will remain elevated in the US. However, all investors must realise that they are making an implicit assumption on this count if they expect the Fed to prevail and bail us out once again. If one truly believes that we are headed for a stagflationary environment, then it is still not too late to sell.

I am not a believer in the stagflation thesis, but the severe consequences of such an environment coming to pass force one to take cognizance of such a possibility, no matter how low the odds. It is also the worry causing many investors to remain on the sidelines, and be more measured than usual in putting money to work.

The Credit Contraction
February 27, 2008

We are going through a cyclical bear phase, a pause that refreshes, so to speak.

The fallout from the ongoing credit contraction is clearly much worse than anyone had initially thought. The OECD financial system, led by the banks, has already taken write-downs of over a $100 billion, and most observers expect another wave of bad news to hit in the next couple of months. Experts think that at the minimum, the total write-offs will eventually exceed $300 billion, and could go up to even $700-800 billion. There are many rumours swirling around the market place of the SWFs (sovereign wealth funds) renegotiating the terms of their already announced capital infusions, and were it to happen this would be a clear negative. The question is also asked as to where the banks will get their next chunk of capital. Even if the losses are ultimately $300 billion, the banking system in the west needs a huge slug of new capital, who will provide this? Nobody wants to provide capital when the eventual losses are still a moving target, and everybody wants to participate only in the final round of capital raising, as any investment prior to the final round will inevitably incur a hair cut.

Also given the complexity of the whole world of structured finance, and the degree to which financial structuring had permeated the financial system, most market participants are still unable to get a handle of how the crisis will spread and who will get affected next. Take the case of the issue around preserving the AAA rating of the monoline credit insurers, this has now become critical to stabilising the whole financial system, or the crisis around term auction securities, due to which even local government authorities are facing a steep hike in funding costs. Basically nobody is sure of which shoe can drop next, and where all the infected stuff is residing. In such an environment, risk aversion is but natural.

The other related problem is that despite the pace of the Fed easing, 225 basis points already and counting, it is at least till date having very little impact on actually easing costs and access to credit. Debt spreads have continued to blow out and are higher today across most products compared to when the Fed began easing. Even in absolute terms, credit costs for the person on the street have hardly dropped. Merrill Lynch has created a composite debt measure, taking into account actual borrowing costs for mortgages, auto loans, credit cards, etc, and calculated that for consumers, borrowing costs have only dropped by about 45 basis points, despite 225 basis points of Fed action.

On the mortgage front, because of the use of “teaser rates”, and option-payment mortgages, which enabled mortgage originators to keep initial interest rates low, despite the Fed cutting, the average mortgage rates consumers are resetting into are 300-400 basis points higher than what they were initially paying. This is something that the Fed can do very little about, as a very significant number of loans will reset over the coming year.

In addition to the costs issue, we also have the reluctance of both lenders and consumers to increase leverage. In the latest Fed senior loan officer survey, the percentage of banks willing to extend new consumer loans was basically zero (last time this happened was in the recession of 2001), and a record 17% of banks are now tightening consumer lending standards. Apart from costs, only about 5% of reporting banks are actually seeing increasing demand for consumer credit. As Merrill points out in a recent report, not one bank in the loan survey reported positive demand for either subprime or non-traditional mortgages, and only 2% of reporting banks have seen increased demand for even prime mortgages.

Just because Fed easing has not worked till date in either lowering the costs or increasing demand for consumer credit, it does not of course mean the Fed will not eventually succeed, as its policy actions do have lags. However, seeing the limited impact the Fed has had till date in loosening financial conditions, one can understand the bears "pushing on a string" thesis of how the Fed has very little ability to cushion the coming consumer-led retrenchment.

It is now pretty clear the US is going into a recession, the shocking Philly Fed survey numbers and other data points seem to confirm this, and the debate now is to the length and severity of the coming retrenchment. If we have a typical slowdown, the economy should start improving by the end of the year, and the equity markets bottoming out by May-June.

The worry is that we get a much more severe consumer retrenchment, and all the excesses built up over the years in the US need to get washed away. In such a scenario we could have a very slow and gradual recovery, which may mean significantly below trend economic growth in 2009 as well. If this were to play out, markets may bottom out much later. In either case, more downside for equity markets seems likely from here as markets have never bottomed out in the first months of a recession, and thus calling for an equity market bottom today seems premature.

As for India I think we seem to be in a trading zone, where we are too expensive for new money to flood in, but have decent enough fundamentals to avoid another big leg down. We may need to consolidate at these levels for a while and let earnings catch up and reduce the market multiples. Investors are currently shying away from the growth markets of India/China, partly due to valuations and partly due to concerns/uncertainty on the severity of the US recession and its impact on global growth.

As for India, investors are still convinced that growth will not drop below 7.5-8%, but seem unwilling to pay more than 14-15 times forward earnings. Thus either we have to wait 6-9 months for earnings to catch up or drop the markets by about 10-15%.

I still believe this secular bull market is not over, we are going through a cyclical bear phase, a pause that refreshes, so to speak. This correction will set us up for a strong and sustained market rise post the consolidation phase.

Decoupling or Recoupling?
February 12, 2008

This is not the end of the bull market, it is a much-needed correction.

After a horrendous start to 2008, most emerging market (EM) investors are now extremely worried about the prospects for this calendar year. Forced out of their complacency by massive fund withdrawals from the asset class (dedicated EM funds had over $15 billion in redemptions in January, after $54 billion in inflows in 2007) and serious price damage, most investors are wondering what happened.

Prior to January the script was very clear; irrespective of what happens in the US, the emerging markets were economically decoupled and thus would be able to grow through a US slowdown. Reams of research were written on how China was a more powerful driving force for the EM countries than the US, and how intra-EM trade was growing much faster than EM exports to the G-7. Economists also pointed out the strong domestic growth dynamic in many of the larger EM countries and the huge infrastructure and capex cycle currently under way in India, China and other EM stalwarts. With continued strong consumer and corporate confidence, the dent in the EM growth rates should not be more than 1-1.5 percentage points of GDP — this was the conventional wisdom.

For a time the markets acted in concert with this view. Post the initial crack in markets in August 2007, we saw huge inflows into dedicated EM funds and the asset class led by the BRIC countries held up much better than the equity markets of the G-7. Even when Wall Street faded and hit new lows in December, emerging markets continued to defy gravity and traded significantly above the August lows. Investors seemed to buy into the economic decoupling argument, and were prepared to chase growth in markets like India and China.

However, come January and all this seems to have changed. The emerging markets are now leading global equity markets on the downside, and the maximum price impact has actually happened in India and China plays. The EM asset class is behaving more in line with historical patterns of being a levered bet on global growth. Investors seem to have forgotten about decoupling, in favour of the old adage of if the US sneezes, the world catches a cold type of a scenario.

What accounts for this change of behaviour? Why are investors suddenly not willing to buy into the decoupling thesis?

There are some explanations I can think of.

- Only now has the true magnitude of the economic mess in the US sunk in. Investors are now convinced this will be a deep and prolonged recession that will take the whole world down with it. Investors were willing to play along with the decoupling thesis, till such time as they felt that we would only get a slowdown or mild recession in the US. In a full-blown consumer-led G-7 recession, all bets are off.

- We are going through a classic de-leveraging and risk reduction episode, wherein many funds, deeply under water elsewhere, are booking whatever profits they have left in the EM space. Also many funds were playing momentum and hiding in the EM markets; with the markets melting down, nobody wants to be caught holding paper they weren't supposed to be involved with.

- The valuation gap between India/China and the US became too large to stomach. I have heard many global investors question why they should pay 20-25 times March 2009 earnings for an Indian company, when they can buy world class US MNCs with 50 per cent plus global exposure and with proprietary brands or technology at 13-15 times earnings. Investors accept the higher growth thesis, but are not willing to pay for it beyond a point.

- The relative price action between G-7 equity markets and the EMs also created an issue as by the beginning of January the US markets had pretty much fully priced in a recession (having fallen nearly 20 per cent from the top) while the EM price drop was far less than typical. The risk/reward thus favoured selling the EMs as opposed to the US, which had already declined by as much as one would expect in a recession. Investors felt they were getting paid to bet on an economic recoupling.

Be that as it may, the question becomes as to what to do now. I still believe that the decoupling thesis has merit, and that the economic performance of countries like India will sustain. We will see some drop-off in growth from 9 per cent plus to 7.5-8 per cent, but unlikely it will go lower. Corporate earnings should also be able to sustain a 20 per cent type of trajectory. Most of the froth has been knocked off the Indian markets, and capital raising, which was rampant, has ground to a halt (witness the collapse of the Emaar-MGF IPO). The whole concept of SOTP will also be used much more judiciously. Speculation and outstanding positions have been dramatically reduced, and the retail investor is once again almost totally absent in direct form. Valuations have come down to more normal levels with the markets now trading at 15-16 times the March 2009 earnings. Again not cheap, but if we can grow earnings at near 20 per cent, when corporate earnings are declining in most other parts of the world, it does not seem outlandish. The domestic investor base is strengthening with the insurance industry alone expected to pump in almost $20 billion into the equity markets this year. The market fall has not had much of an impact on this flow as of now. Mutual funds and PMS schemes also continue to get inflows.

I don't think this is the end of the bull market, it is a much-needed correction that will bring capital market intermediaries back down to earth. This dull and listless phase, with the markets being range-bound, may last a while but will set us up for a much more sustainable rally and will extend the bull run.

Most investors recognize that India is a high-quality long-term growth story, and that has not changed. The visibility and sustainability of our economic growth are among the best in the EM universe. The capital efficiency and quality of entrepreneurship are well recognized. Our problem was valuation and excess hype and froth, both of which are now getting corrected. This fall will clean out most of the momentum players and bring in many longer-term investors sitting on the sidelines.

Keep the faith as the game is not over yet, we will see new highs, though it may take some time.

Decoupling Tested
January 23, 2008

The meldown will pose a tough test to the decoupling thesis.

The carnage in share prices witnessed over the last couple of days bears testimony to growing risk aversion and fear. Global markets are off to one of their worst starts ever with all major markets down high double digits since the beginning of the year. Surprisingly this downward move has been led by the emerging market asset class, which, at close to 20 per cent down, is now fast approaching bear market territory (the definition of a bear market is usually 20 per cent decline).

What has caused this selloff , and what should one do now?

The answer to the first question is very easy. Investors are finally accepting that the US is either already in a recession or about to enter one. There is also a growing feeling that this downturn will be a lot more difficult to counteract than previous economic slowdowns. The sell-side economists are going around propagating the view of "slower for longer" to describe the US growth outlook. This recession will be led by cutbacks in consumption, the engine of US growth (accounting for 72 per cent of GDP), and thus should be far deeper and more impacting than the downturn of 2001, led by business capital spending (capital spending was only 13 per cent of US GDP). The US consumer has steadily drawn down on his/her savings to an extent that income-based savings are virtually non-existent, and have relied on rising asset prices (mainly housing) and the ability to monetise the elevated asset values to sustain consumption over the last many years. This game is now coming to an end as asset prices have reversed and the credit squeeze is limiting the ability of consumers to monetise their asset values.

The so-called revolution in consumer credit. enabled by the boom in structured finance, has clearly ended, with the obvious consequence of reduced access to credit for the majority of main street America. Thus, the party of consumption growth exceeding income growth will not continue and finally the US consumer seems to be on the verge of capitulation.

The bears are convinced that a US recession, driven by low consumption, will drag the whole world down with it, and cannot see how the rest of the world can decouple. The related problem is China, where all the rate and reserve hikes over the past 12 months can finally begin to bite. There is a growing feeling that China will slow considerably in 2008, with both exports decelerating and domestic demand impacted by the lagged effects of the tightening. If China were to have a growth scare then all talk of decoupling will have to go out of the window. All the decoupling believers point to China being more important to the emerging markets than the US is, and trot out statistics of how for the EM countries, exports to China are now larger than their exports to the US. They also point out in defence of China itself how more of China's exports are now intra-EM than directed to the US. The fact is that if China were to slow, as many commentators now think, and as indicators like the collapse of the Baltic dry bulk now point to, then we have a serious global growth challenge ahead. The growth challenge is also not short-term as again investors are beginning to understand that a consumer-led recession, with a broken financial architecture, is far more difficult to reverse than the capex-driven slowdown of 2001.

The fact that the EM asset class is leading the markets down seems to indicate greater concern on China and on the duration and depth of any US recession than was the case in August last year. Back in August everyone thought that the EMs would be fine irrespective of the US outlook, the change at the margin is clearly due to greater worries on the China growth outlook.

There is also growing realisation that the problems in the global financial system will not end simply with the write-downs and recaps. We now have the whole issue of the bond insurers losing their AAA ratings and the new cycle of write-offs and losses this will trigger. We seem to be in a bit of a financial black hole, with no apparent end in sight, and with no answer as to how much new capital the system will really need. There also seems to be some doubt on all the sovereign wealth fund deals, as rumours seem to indicate that these deals have "puts, resets and other opt-outs" for the investors and are not clean straight capital infusions.

As for what one can do now, it is probably too late to sell already, and thus one will have to get through this period of volatility and hang in there. It looks unlikely that the Indian economy will grow at less than 8 per cent in calendar 2008, with the capex cycle still in full swing and no real issues in terms of either funding or management confidence. We will have another year of strong earnings growth in 2008, with an earnings trajectory of 20 per cent still on for this year. The next move in rates is also clearly down, which should help to stabilise the PE multiples as well as give a fillip to retail lending.

What we have therefore is a market down about 20 per cent, and where most of the froth has been knocked off. This correction, though obviously painful, is excellent from the point of view of extending the cycle, as PE multiples normalise and we get a chance to grow into our valuations. It will also stop many of the excesses in terms of opportunistic fund raising and the market's willingness to look at embedded value for just about anything.

We remain one of the best growth stories in the world as well as one of the most sustainable. One can find stocks again where the risk/return is in your favour.

The fly in the ointment could be the possibility of some type of global financial crisis. The way markets have traded over the last few days, we are seeing large amounts of forced liquidation. This could be either due to forced deleveraging or some type of financial institution in distress. A financial accident type of event is obviously unforecastable, but otherwise longer-term investors must use this meltdown to buy and lock in stocks they have been eyeing for some time now. For the retail players, this episode once again highlights the dangers of leverage and overtrading.

India in 2008
January 7, 2008

Earnings have surprised on the upside over the last five years, and look set to continue doing so.

We have all been blessed by an exceptional 2007, as anybody having anything to do with the Indian capital markets has had a banner year. Trading volumes, new issuance and M&As — all exploded to the upside. The markets were up 50% and we had the benefit of both strong earnings growth and PE expansion. The question obviously becomes as to what will happen in 2008. Can we sustain the run of strong double-digit price appreciation for a sixth year in a row?

On the face of it, it does look difficult as most of the levers for strong equity performance have pretty much fully played themselves out. Ultimately there are only three drivers for equity performance — the change in the valuation multiple at which the market trades, earnings growth, and (for foreign investors) the strength or weakness of the currency.

As for valuation multiples, it is very hard to make a case for further PE expansion, as the Indian markets have moved from 8-9 times earnings in mid-2003 to somewhat over 20 times March 2009 earnings. No matter which way you cut the numbers, there is no denying the fact that the markets are expensive, in fact, among the most expensive in the world. I am aware of the argument that if you look at the embedded value in certain stocks like Reliance and others, valuations drop. Even if you make these adjustments, valuations drop by only a couple of points, and I for one am not a fan of these embedded values or sum of the part valuation methodology for any and all stocks.

When looking at multiples, one also has to be mindful of the fact that the direction of rates globally is headed down, with India likely to follow the lead of the OECD central banks and eventually cut short rates. A falling interest rate environment is supportive of PE multiples, and should act to support current valuation levels.

To counter-balance the positives from a supportive monetary environment, we have a huge new issuance pipeline, the likes of which I have never seen before. In alone we should have $4-5 billion of issuance. Six power companies alone plan to raise nearly $10 billion (the entire amount raised last year) in the next three months. A friend who runs a large investment bank points out that the bank did 31 equity issues last year and already has signed mandates for 60 deals as of today, and the average size of each deal is higher than last year. Any company executive I meet these days invariably ends the conversation outlining fund-raising plans.

One cannot assume also that we will continue swamping every other market in Asia and once again attract $17-18 billion of new FII flows. The Indian retail investor has woken up and we are seeing that in sustained new equity flows through both mutual funds and the insurance companies; however, even this will not be enough to meet the seemingly insatiable demand from corporate India for growth capital.

Thus, the demand supply equation for equity paper argues for no further PE expansion.
In addition I would argue that as we get closer and closer to the Lok Sabha elections, the political uncertainties will rise and the ability and willingness on the part of this government to move on policy matters diminish. Such an environment will also not boost sentiment or drive up multiples.

Thus, I would argue that the best case is for the market to hold its current valuation levels, and not experience PE compression. The history of markets indicates that it is very difficult to sustain 20-plus multiples for any extended period of time (unless you go into a mania or bubble phase).

Therefore, market returns in 2008 will likely get no support from further multiple expansion; if anything we could see a drag on returns from multiple compression.

As for currency, international investors got a nice 8-10 per cent return (if unhedged) just by being in rupee assets in 2007. The pace and quantum of rupee appreciation this year is very unlikely to match this. So for an international investor this driver of returns is unlikely to contribute meaningfully in 2008.

This now brings us to the last plank of market returns — earnings growth. Earnings in India have consistently surprised on the upside over the last five years, and seem poised to continue doing so. Having said that, given the current level of corporate earnings, the high ROEs, the huge capex cycle currently under way, ratcheting up of competition across sectors, strong rupee, US recession, rising costs in India, etc. it is difficult to see earnings growing by more than 20-25 per cent for the broad market. While still a very good number, it is a slowdown from the pace of the last few years.

I think the market is likely to follow one of two courses in 2008; either the market will be up/down marginally as we go through some PE compression, and give ourselves some breathing room to digest the huge price run-ups of 2007 and we grow into our multiples. The strong earnings of 20-25 per cent will be largely eaten up by PE compression. While it may be painful in the short term, this PE normalisation will make the market much healthier to continue its long-term bull run and shake off much of the current froth.

India is a great long-term story but maybe a little ahead of itself, would sum up this view.

Alternatively, we could see a huge price run in the initial part of 2008 itself, as the Fed is forced to keep pumping liquidity into the system, which continues to get channelled into the EM asset class. This would be a type of EM mania, and going by the direction of flows into the EM markets since August, India would be a major beneficiary of accelerated flows into the space. In such an environment, valuations temporarily may lose relevance, as we see the sheer weight of money coming into play. This scenario would be like September/October of 2007, but even more fierce. This type of a market move may please the short-term punters and create froth, hysteria and huge short- term returns, but will ultimately end badly and mark the end of the bull phase in India and the entire EM asset class were it to come to pass.

I never thought I would say this, but let us hope for a subdued 2008, the more stable the market the better.