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## **From Uncertain to Unstable Markets**

25 December 2009

With the reversal of emergency economic measures in 2010, something nasty may surface.

The year 2010 is shaping up to be a very interesting year indeed. After two years of huge oscillations in equity prices, can we expect a more sober and measured market in 2010? After the wild swings of 2008 and 2009, it is unlikely that returns in 2010 (in either direction) will be as dramatic.

My starting assumption remains that equity markets (in the developed world at least) are not in the midst of a new secular bull run. Secular bull markets require cheap starting valuations, strong, accelerating and sustained economic and earnings growth, as well as easy liquidity and rising leverage. None of these three factors are in play in 2010.

The most likely outcome remains that this current rally ends in the first half of 2010, we get a short and sharp correction, and then an extended range trading market for some time after that. This is historically the template for equity markets in the aftermath of secular bear markets as outlined by the folks at Morgan Stanley in numerous publications.

The immediate question is, of course, as to what can short-circuit the current rally.

The obvious cause will be the normalisation of fiscal and monetary policy, as we remove the various emergency measures put into operation in 2009. As we exit these support measures, the global economy will be stress-tested as to the true durability of the recovery. The other outcome will be the effects on interest rates, with rising rates a clear negative for equity multiples. If bond yields in the US normalise to higher levels (as real rates rise), beyond its impact on valuation multiples, given the continued high leverage in the system, any rise in yields will be a big negative on consumption and growth. Can US consumers in their current weakened state handle significantly higher rates? It is not clear that markets can handle a normalisation of monetary and fiscal policy, but normalisation is a given in 2010, it will happen. There is bound to be turbulence around this.

The other factor which could snap the rally is a wake up call as to embedded earnings growth assumptions. This rally, as is typical of rallies from a bottom, has been all about price-to-earnings (P/E) expansion, as markets discount an economic and earnings recovery. Now, however, in 2010, earnings have to catch up as the P/E expansion phase is over. Markets will now move with earnings. I doubt that earnings can surprise hugely from here, given the still subdued economic recovery that one expects. Margins are already at record levels and if economic growth is sub-3 per cent, with limited inflation, a nominal GDP growth rate of 5 per cent is not conducive to strong absolute earnings growth. Consensus earnings growth expectations seem too high. If earnings falter vis-a-vis rising expectations, that could be the reality check needed to snap the current rally.

Thus, in 2010, we will see markets have the headwinds of rising rates, not inexpensive valuations and limited possibility of any further upgrade to growth or earnings

expectations. This is the exact opposite of 2009, when rates were being cut and, at record lows, earnings and growth expectations were rising and markets were able to re-rate.

There also exists the possibility of another shoe-dropping in the OECD world in 2010. We could see a sharp counter-trend rally in the dollar, which could reveal a lot of skeletons, and, of course, everyone is now worried about sovereign issues, with Greece being in the spotlight currently. As the emergency economic measures are reversed, there does exist the possibility that something nasty surfaces, hidden currently by all the government and central bank liquidity support.

If this is the outlook for the developed markets, then how should one approach the emerging market (EM) asset class? First of all, if we do get the short, sharp correction that one expects, even EM equity markets will get hurt. However, in the subsequent range trading environment, one should expect these markets to once again begin to outperform. The dynamic to move out of dollar-based assets as well as a desire to be where the growth is will combine to ensure continued flows into these equity markets. To the extent that liquidity is still sloshing around in 2010, the EM asset class is where it will go to.

As for India, I think once again it boils down to the level of comfort investors can derive about the long-term outlook for the country. We once again have a whole bunch of economic reform initiatives pending. From the PFRDA Bill, to the GST and direct taxes code, to opening up education and the land acquisition Bill. There are many things for the government to tackle and handle. Unless we see movement on these issues, I don't see how the markets can go up significantly from here. To get market performance from here, the P/E multiples have to hold, which is unlikely in the absence of serious movement on these many fronts. The government has also got to show determination and resolve to bring the fiscal deficit under control. In the absence of fiscal moderation, interest rates will rise sharply as credit growth expands, significantly dampening market and economic performance.

India has so much low-hanging fruit, productivity levels are still so low across sectors that government policy matters. Anything on the policy front which can help raise productivity levels will have a huge multiplier.

In India, we will also have to tackle our own exit from low interest rates and government stimulus measures. Can the Reserve Bank of India balance growth with inflation? How do you calibrate monetary policy when you have double-digit food price inflation largely caused by supply shocks? How does the government balance cutting the fiscal deficit, through tax hikes, but not killing off the economic recovery?

India has the ability to attract huge capital flows, and, in fact, will need to do so in 2010 if the government is even half serious about the disinvestment programme, but we need to improve our absorptive capacity.

If the government takes action to move ahead on some of the issues highlighted above, then the markets can give a decent return even in 2010. However, in the absence of government policy action, the outlook looks tough.

## State of Play

27 November 2009

Risk assets have been in a real sweet spot since March-April 2009. Leading indicators of growth turned upwards, liquidity injections were at unprecedented levels, the Great Depression-2 was avoided and policy-makers seemed determined to skip any action which could spoil the party. How long can this intoxicating cocktail continue, where markets can see and bet on a recovery, but policy-makers are still too nervous to move on monetary and fiscal policy? It seems highly unlikely that this favourable environment can continue into 2010. Either growth will fade and rates stay low, or leading economic indicators like the ISM (Institute of Supply Management) will prove right, growth will take hold and policy-makers will be forced to move on liquidity and rates.

If growth truly continues to recover on a sustained basis, then policy rates will rise, liquidity will be withdrawn, and markets will have to deal with the dreaded exit policy and its consequences. Even if policy-makers want to delay normalising rates, their hand may be forced by fears of creating new bubbles in asset markets or spikes in oil and related commodities. Bond markets may leave policy-makers with little choice but to reverse the emergency measures of 2008 if growth were to surprise on the upside.

If, on the other hand, growth were to fade in 2010, then while policy rates may stay low, corporate earnings will be in serious question, and fears of a double-dip, further stress on the banking system et cetera will all resurface. Multiples will start looking very stretched if earnings do not come through. Markets are not particularly cheap even if stretched earnings forecasts come good, if earnings disappoint, valuations will look even higher. Exit from the current stimulus measures will look far-fetched, and markets may continue to worry about the dollar, fiscal sustainability and policy flexibility to handle further economic stress. There seems to be no political capital or financial resources available to deal with a further downshift in growth in the G-7 economies.

Between the two outcomes outlined above, which one is better for equity markets, specifically emerging market (EM) equities? Every market cycle has a sweet spot for equities like the one we are in now, and these cycles normally end with central bank tightening. Historically, however, the first move to tighten does not end the rally. The first move does cause market disruption, a correction and some type of sectoral rotation in terms of which sectors start outperforming/underperforming. However, equities can go on and make new highs. As Gerard Minack of Morgan Stanley points out in a recent note, in severe recessions, interest rates or rate expectations and equities can become positively correlated. In more normal times, they are negatively correlated.

If we get a scenario where growth in the US or, more broadly, OECD (Organisation for Economic Cooperation and Development) surprises on the upside, and interest rate tightening or an exit from the emergency measures of 2008-09 is faster than currently envisaged, then this could spell trouble for the EM asset class both on an absolute and a relative basis. Developed markets may perform in line with the thinking outlined above of the first hike not creating a peak in equities, but EM equities could falter. First of all, stronger growth and a quicker exit from QE (quantitative easing) will most likely strengthen the dollar, and cause a blip in the carry trade. A reversal of this crowded and

perceived one-way trade is bound to have consequences for risk assets like EM equities. A dollar reversal is almost certain in the growth revival scenario as the US will most likely outperform the EU and Japan on the way to recovery.

A rise in rates in the OECD economies will also give cover to many EM central banks to embark on their own tightening. As it is, most market observers expect many of the EM central banks to lead the way in raising rates and tightening liquidity. Many policy-makers in the EM world have been constrained to an extent by the record low rates in the US and the EU. They will only get further emboldened in the above scenario. Tightening and liquidity removal will pressure equities in the relevant markets and act as a dampener more broadly on the whole EM asset class.

A reversal of the dollar trade (even if temporary) and tightening of domestic liquidity cannot be positive for EM equities (at least for the short term).

If, on the other hand, we were to go down the route of there being a growth disappointment, and thus an inability on the part of central banks in the developed world to exit their fiscal and monetary policy measures, then in my opinion the EM asset class will continue doing incredibly well in both relative and absolute terms. In such a scenario, rates will remain low globally, the dollar will continue to be under pressure, the carry trade will be alive and, well, even the EM central banks will be more constrained in raising rates.

In such an environment, the growth differential between the large EM economies and the G-7 will only expand. Investors will also be willing to pay more for any growth visibility. As the folks at UBS point out, one of the best predictors of relative outperformance of EM equities is the relative gap in dollar-based nominal GDP between the EM economies and the OECD economies. This gap will expand in a weak growth scenario.

A potential double-dip will also spook investors in the US and the EU, as doubts on the capitalisation of the banking system resurface, fiscal sustainability comes in with renewed focus and doubts around a Japan-like lost decade once more come to the fore.

Capital flight out of the OECD economies will only accelerate as investors look for returns and growth in Asia. The current environment is unsustainable. Risk assets are in their sweet spot, with both very supportive liquidity and policy conditions, and hopes of a recovery in growth in 2010. Something has to give, either growth will disappoint and rates remain extremely low or rates rise as the growth bulls are vindicated. The likely path for EM equities' absolute and relative performance is very different depending on which scenario unfolds. EM investors are probably better served hoping for a growth disappointment in the OECD world.

Investors should be careful about what they wish for.

## **The Coming Bubble in Power**

13 November 2009

Many market observers are convinced that the ongoing surge in risk assets and risk appetite will ultimately end in a huge bubble in the emerging market asset class broadly, and the BRIC economies in particular. I also happen to subscribe to this view, and believe that India will see significant inflows into equity markets as the momentum builds. Drilling down further, as equity investor, one needs to think about which sectors will lead the market? Where can a valuation bubble build at a sectoral level? Which sectors will be the new darling of the markets?

My contention is that the one sector which is a leading candidate to lead the market, and where we will see bubble like investor behaviour and valuations (arguably already so), is the power generation space. This whole theme of merchant power is one where we already see a lot of activity and action, but it is just the beginning.

As to why I think we will see a huge bubble in merchant power, there are many characteristics of the sector which make it very ripe for market hype and hysteria.

First of all on a macro level, there is no denying that India is hugely deficient in power capacity, and demand will continue to outstrip supply for years. It is very easy to see the macro opportunity, it is, in fact, obvious.

Secondly, in Jindal Steel and Power, we have proof of concept that merchant power works and is hugely profitable. JSPL earns an ROCE (return on capital employed) of over 80 per cent, and is a cash machine. Every developer will point to JSPL's economics and extrapolate the same.

Third, a majority of power companies (with large merchant power portfolios) which are floating IPOs today, have all long-tailed projects coming on stream only three-to-four years down the road. It will thus not be obvious until they actually go on stream as to what are the true economics of these projects. Today they are only project reports and analyst DCF (discounted cash flow) models, implying that you can arrive at any valuation you want depending on your modelling assumptions. It will not be possible to debunk these assumptions for the next three-to-four years, till such time as this capacity comes on line.

Fourth, given the amount of equity and debt issuance expected in the sector, all investment bankers and analysts are incentivised to put as positive a spin as possible on the sector, its growth and profit potential. Ultimately, a huge pool of investment banking fees are dependent on markets backing the sector and the major players within it. It would be a surprise to see any major brokerage come out with a strong negative view on these companies at this stage.

While the whole merchant power theme is going to be huge, I think investors must be careful in not getting carried away. One cannot take today's spot merchant rates of Rs 6-8 per unit and extrapolate this beyond the next 18 months. Execution is also critical, completing billion-dollar projects on time and in budget in India is not trivial. Land acquisition, environmental clearances, these are all serious issues. Companies will need to be sensitive to financial risk and the percentage of power capacity kept merchant.

Current spot rates are based on a total merchant capacity of at best 3,000 MW. It is actually quite a thin market. It is not at all clear that when 25,000-30,000 MW of potential merchant capacity comes on line, will we have the evacuation infrastructure or payment capacity to handle this quantum of merchant sale? Demand for the power will be there, but at what price?

Power is the ultimate commodity, which can neither be stored nor differentiated. It is also very prone to price cutting as it has a high, fixed-cost structure and comparatively low variable costs per unit (just like airlines or telecom). A power plant also cannot be backed down easily or shut down, thus you are forced to produce, pretty much independent of demand or pricing. Even today with all the talk of Rs 10 pricing in spot power markets, there are periods of time when the power has to be sold at almost zero realisation due to lack of demand or evacuation capacity. Any marginal demand-supply mismatch even if seasonal can decimate pricing.

There is also the question of how much high-cost power can the industrial structure of our country or government finances absorb? SEBs are already bankrupt, and buying power at Rs 8 to sell it to consumers at Rs 3 is a guaranteed recipe for ruin. SEBs can absorb today 3,000 MW at this rate, not 25,000 MW.

We also have the question of regulation. The industry is still quite young and the regulatory structures evolving. You already have states like Orissa imposing an emergency and not allowing units in the state to export merchant power (forcing them to sell to the SEB at lower rates), thereby compromising on realisations. The CERC has capped power trading margins and, for a brief period, had put a cap on power rates as well. There is a clear regulatory risk.

Today with the government keen to incentivise private power generation, and only about 3,000 MW actually merchant, we may not see much regulatory interference in terms of capping prices or financial returns. The picture may change with 25,000-30,000 MW of merchant, this quantum of power will be significant enough to affect the average tariffs in the country and thus may force the regulators to act.

Additionally, we have the issue that in most cases, these huge profits are only possible because of captive coal blocks handed out by the government. You are effectively giving a licence to print money to any power developer granted a captive coal block. Can our polity and country countenance private companies making billions of dollars in profits from exploiting state assets? I do not think India is Russia. When too much money starts being made, questions will be asked, and checks and balances put in place.

Ultimately investors should treat these power companies just like any other commodity producer. Focus on cost of production per unit of output, where the company is on the

cost curve, and companies must maximise scale to reduce unit costs. Power prices will probably settle at a level high enough to give a decent return to the most efficient producer, but not windfall gains to everyone. Can the most efficient players get 25 per cent ROEs (return on equity)? Probably yes. But can every player, irrespective of its cost position, make a 50 per cent plus return as some think? Definitely not.

You will have a slew of equity issuances from this sector over the coming 12 months. One must take the time to question the assumptions in earnings models and figure out who can execute and who cannot. Money will be made in the sector, but one will need to be choosy. There is a real risk of valuations getting out of hand as bankers and companies try to extrapolate current windfall profitability achieved by one or two plants onto a much larger scale.

## **The Capital Inflow Conundrum**

23 October, 2009

A few days ago the investment community globally was surprised by the announcement that the Brazilian authorities were planning to re-introduce the IOF levy (a tax on foreign financial transactions). A measure clearly designed to reduce appreciation pressures on the Brazilian currency. This tax used to exist and was only abolished in 2008 (when the global financial system was on the verge of collapse, and all emerging market, or EM, countries were seeing huge capital outflows). The new avatar of this tax is likely to cover more types of transactions (including equities) and have a higher peak rate of 2 per cent as compared to 1.5 per cent. As investors had seen this animal before, beyond an initial hiccup and mild sell-off in regional currency and equity markets, they seemed to have shrugged off the re-introduction of this levy as only a minor irritant.

However, given a global environment of surging risk appetite, extremely low OECD (Organisation for Economic Cooperation and Development) interest rates, a collapsing dollar and widening growth differentials between EM and OECD countries, the risk is that more EM nations may be forced down this path.

Jonathan Anderson of UBS in a recent article highlights some of these issues. He points out that Brazil was forced to act due to intense pressure on the real to appreciate. Since the beginning of the year, the Brazilian real has strengthened more than any other currency in the emerging world (source: UBS).

He makes the additional point that this rapid appreciation occurred despite Brazil not being an outlier in terms of capital inflows as a percentage of GDP or pace of reserve accumulation. Other countries have actually had faster reserve accumulation, or higher implied capital inflows. In those other cases of strong inflows, however, the respective central banks were able to continue intervening, mopping up the inflows and preventing significant currency appreciation. These central banks were able to handle the inflows without having to contemplate capital restrictions or taxes like Brazil has just announced.

He also makes the point that Brazilian policy-makers, despite their concerns about currency appreciation, were unable to intervene more aggressively due to the level of local interest rates. With short-term interest rates at nearly 9 per cent and long-term bond yields at 10 per cent plus, Brazil has some of the highest rates in the EM world. This is the critical difference, and accounts for Brazil having to adopt some type of capital inflow disincentives to control appreciation pressures.

It is much easier for a country like China to run huge current account surpluses and accumulate massive reserves when their interest rates are not much different from those in the US and the EU. In this case, the implied cost of sterilisation is minimal, and thus Beijing can keep the renminbi at whatever level it wishes to.

It is much harder to maintain a stable currency and allow in unencumbered capital flows, when there is a 700-800-basis point interest rate differential. This positive carry will

attract huge capital inflows and make the implied costs of sterilisation prohibitive as the central bank has to bear this rate differential.

Even though Anderson's article is based on Brazil, many of the points he makes are applicable to India as well. Already long bond yields in India are near 7.5 per cent, and will only rise. As inflation begins to spike towards the beginning of 2010, the Reserve Bank of India (RBI) will have to commence tightening and raising short-term rates. RBI, therefore, finds itself in a similar dilemma to Brazil. How should it handle strong capital inflows with a large and growing negative interest rate gap against it?

To my mind, these problems will only get compounded as flows increase in their ferocity. I along with many others believe that this whole cycle will ultimately end with a huge bubble in the asset markets of large EM countries. Thus financial flows into India are only likely to accelerate. The current spate of huge equity capital issuance from Indian corporate houses being a case in point.

To handle large inflows, RBI has basically four choices:

It can let the rupee appreciate.

It can intervene strongly, without sterilisation, to protect the rupee but let local asset markets inflate due to strong liquidity in the system.

It can intervene to protect the rupee from appreciation, sterilise the liquidity impact domestically but bear the costs.

And finally, it can try and dampen inflows through capital controls, taxes and other restrictions.

While the simplest and cleanest solution to handling large inflows is to let the rupee appreciate, this is not as simple as it looks. Our export sector is already badly hit with the OECD slowdown, and the employment intensity of exporters like textiles and gems & jewellery, and SMEs cannot be ignored. We will also be loath to let the rupee appreciate when our competitors in the region are unwilling to follow suit. Even today, policy-makers across Asia are unwilling to let their currencies appreciate.

If we intervene but do not sterilise, we run the risk of stoking an asset bubble locally and fanning inflationary pressures. With the Consumer Price Index (CPI) already in double-digit territory, and all projections of the Wholesale Price Index (WPI) showing a strong upward trajectory, this approach does not seem tenable.

The third choice has the issue of the cost of sterilisation in an environment when the spread between local interest rates and those of the US and the EU are at extremes. Who will bear this cost of sterilisation?

Thus one can see the attraction from an RBI perspective of moving down the road of some type of capital controls, inflows tax etc. Policy-makers may logically feel this is the best approach to handle a possible deluge of capital inflows if the EM asset class is the

epicentre of the next asset bubble. While logical, it would be a mistake in my humble opinion.

We still run a current account deficit and, as an economy, are very sensitive to external capital flows. India is probably the most leveraged EM country (of size) to foreign capital. If capital flows are strong, we are able to fund both the government and our corporate sector, as large borrowers move offshore and we are able to avoid a crowding out of the private sector. With healthy capital inflows, interest rates stay stable and economic growth robust, leading to revenue buoyancy.

In an environment of negative capital flows, the India story tends to fall apart. Interest rates spike, economic growth slows, the private sector gets crowded out and liquidity dries up. Post the Lehman collapse, outflows of a mere \$25-30 billion shook our economy, almost causing our own financial system to choke.

Being a capital deficient economy, and very vulnerable to external capital flows, we must not attempt any measures which could disrupt these flows. There is a very fine balancing act in designing measures, which are punitive enough to slow capital inflows, but not stop them entirely.

We must also recognise that given the volatility in oil/commodity prices, and the still fragile external financing environment, we must have a greater margin of safety in terms of our forex reserves.

RBI was very innovative in introducing the MSS bonds to handle the surge in capital inflows in 2006-07. It would be better to once again go down this type of route instead of trying to introduce some type of capital controls or disincentives, which could severely backfire and disrupt markets.

Given our dependence on external capital, let us not play with fire.

## **A Dangerous Time**

9 October, 2009

Markets are going through a dangerous and choppy phase. If economic growth is strong and confidence comes back, pressure will continue to build on governments and central banks to roll back quantitative easing and other emergency fiscal and monetary measures. The political mood seems to have changed in most OECD (Organisation for Economic Cooperation and Development) capitals, and it would be very difficult for any government to justify new stimulus measures in today's environment. Public pressure to reduce government budget deficits and minimise public debt burdens is growing across the developed world.

Thus economic policy-makers are caught in a dilemma: how and when to exit these emergency measures? If they exit too soon, we run the risk of relapsing into weak economic performance and deflation (the dreaded W). In fact, in recent days, the CEOs of both HSBC and GE International have warned of the risks of an economic double dip and premature exit from the monetary and fiscal stimuli currently in place. If policy-makers delay the normalisation of policies, then we run the risk of higher inflation expectations getting embedded or the surplus liquidity creating fresh distortions in asset markets. Central bankers are rightly concerned with sowing the seeds of the next asset market bubble/bust in today's hyper-stimulative policy framework. A laissez-faire approach to asset bubbles is no longer accepted in central bank circles. Nobody wants to clean up another mess.

Even markets are caught in a Catch-22 situation. If economic growth does bounce back with a vengeance, as some of the bulls think, it will force the hands of policy-makers to quickly pull back the emergency measures, which will ultimately be a strong negative for equity returns. It is unlikely that equity markets can continue their manic rise in the face of tightening liquidity conditions. Markets will probably do better if growth is slow enough to not force tightening. Yet, given the market reaction to the recent weak economic data, equities do not seem to be able to digest sub-par economic numbers, implying that an element of growth is already priced in. Markets seem to need incoming data to continue surprising positively to sustain the uptrend.

Equities are only cheap if you believe in a strong earnings recovery. However, to get a strong earnings recovery, you need robust economic growth. As it is unlikely that corporate houses can do much more cost cutting, we now need top line growth. If we get a robust economic recovery (as earnings estimates imply), policy-makers will reverse the emergency fiscal and monetary measures, which will tend to be a drag on price-to-earnings (PE) multiples.

Thus, unless we get a perfect "Goldilocks scenario", where growth is strong enough to deliver earnings, but slow enough to not force policy-makers' hands, equities are going to have a choppy few months as the countervailing forces of economic acceleration and liquidity withdrawal fight each other. It is not clear who will triumph.

Even in the Indian context, we need to worry about RBI beginning a new tightening cycle and rising interest rates. This tightening cycle will be a negative as RBI is not raising

rates because the economy is overheating. The central bank is doing so because of inflation concerns in the face of spiking agricultural prices. G-sec yields are rising, hence, ultimately, interest rates will rise system-wide because of a huge government borrowing programme. In fact, bankers talk of a lack of credit demand from good quality borrowers. If interest rates were rising because of strong economic growth and an overheating economy, very strong corporate earnings would have compensated for the impact of rising rates on valuation multiples. However, rising rates will only damage multiples now, with no earnings offset. A strengthening rupee will further tighten financial conditions and damage profitability.

We are also yet to see any credible plan from the government to put the fiscal in order. We all seem to be betting on growth to bail out government finances. Unless we find a path to bring the fiscal under control, at the first signs of strong credit demand from corporate India, rates will spike further and we will be hugely dependent on global capital flows to sustain growth.

Having said all of the above, and while I do feel equities may be in a bit of a funk till some of these issues get sorted out, there is no denying that the picture is good in the longer term.

The reality is that most funds we speak to have not received much inflows this year. This applies to both India funds as well as pan-Asian vehicles. A lot of the flows have been either global macro guys allocating to India through ETFs, or regional and GEM funds raising their India weightage. However, everyone is talking about increased client interest, client visits etc. There does exist the possibility that we may see a surge of inflows into these funds towards the end of the year as investors position for 2010.

One can see increased research and press reports on this theme of the economic centre of gravity of the world shifting east. Not a day passes by when one does not see a research piece on this topic. The year 2010 will see China becoming the second-largest country in the world, the G-20 gaining importance, the shifting of voting power in the IMF/World Bank etc—all these are points reinforcing this theme. The perceived imminent collapse of the dollar also plays into this theme. Economic decoupling is back on the agenda, and the stark differences in the relative health of financial systems and growth outlook are apparent.

Many smart commentators feel that this whole cycle will ultimately end with a bubble in the emerging market asset class. This bubble will be led by large emerging markets like China, India and Brazil. Even today, according to most surveys and anecdotal evidence, a vast majority of the real-money, long-term investors are not positioned adequately in these large markets. They need to raise their weighting and move out of dollar-based assets.

Thus, while we may have a bit of a hiccup, if we can hold on and live through some short-term volatility and price declines, gains are likely. A correction is quite a possibility, which may even be severe but nothing like 2008

## **The Dollar Carry Trade**

25 September, 2009

Investors should be careful in assuming that dollar weakness is a given; this could easily reverse.

Recently we have seen a very strong negative correlation develop between the dollar and an assortment of risk assets. It almost seems that the only thing one has to track every morning is the strength or weakness of the greenback. If the dollar is weak, gold, oil, commodities and equities all will be up, and if the dollar is strengthening, then we have the exact opposite behaviour in these asset classes.

The dollar, it seems, is moving from being the de facto reserve currency of the world towards an additional role as a funding currency for risk-based trades. The dollar is effectively now competing with or even replacing the yen as the favoured funding currency for carry trades. The three-month interest rate differential between the US and a weighted average of its major trading partners has moved from plus 2 per cent a few years back to negative today, highlighting the interest rate advantages of borrowing in the dollar.

The classic yen carry trade involved investors borrowing yen at near-zero interest rates, selling the yen for dollars, and then buying government bonds yielding 4-5 per cent with these dollars. As long as exchange rates did not move against you, the investor could make a clean spread of 5 per cent. The trade would be leveraged at least 10 times to give a potential return of nearly 50 per cent, and on huge size.

The big risk in the above structure is the exchange rate: if the dollar weakened against the yen, then the investor could be sitting on a large loss. Given the highly leveraged nature of the transaction even a small variation in exchange rates could cause serious losses, unless the position is hedged in an appropriate manner. Any hedging of the currency risk will obviously cost money and reduce potential returns.

Given the current very easy liquidity conditions in the US and the desire of the Fed to keep interest rates very low for an extended period of time, one can see the parallels with Japan. There is also a strongly held view that this administration is willing to live with a weak dollar to boost the US domestic economy. You can see the obvious attraction to an investor, a chance to fund risk asset purchases via borrowing at very low rates in a currency which seems to be weak on a multi- year secular basis.

To the extent that this dollar carry trade is now replacing the former yen carry trade, one is seeing purchase of yen to repay the original funding source, and selling of dollars to set up the new dollar carry. In effect investors are moving the funding source from yen to dollars, causing steady upwards pressure on the yen vis-a vis the dollar.

The obvious carry trade today is to fund in dollars, and buy assets in the emerging markets (EM), given the higher growth in these economies, higher returns available and the strengthening bias of their currencies. The prospects of a prolonged period of

disappointing returns in the developed markets also suggest that risk capital should continue to flow out of the OECD economies. The dynamic of strong capital flows into the EM world is thus quite clear. EM equities should continue to benefit from these strong capital inflows.

Many dollar bears are pointing to the use of the dollar as a funding source in carry trades to highlight the further downside potential in the currency. They also point to the legacy of unprecedented fiscal and monetary policy action in the US. The US has seemingly led the world in adopting these high-risk policies. Market participants are naturally worried that the move towards quantitative easing (QE) and huge fiscal challenges will debase the dollar. The bears also point to the need for dollar weakness to rebalance the global economy. A third point of view is the likelihood of the dollar weakening as the safe haven trade reverses and investors stop worrying about a great depression.

Given the recent weakness in the greenback it is all too easy to become too bearish. It has become too much of a consensus and very crowded trade. Everyone seems to be convinced that the dollar will continue to weaken.

Funding issues aside, there are many reasons why the current bearishness on the dollar may be misplaced.

First of all, the risk of the dollar being debased by the extraordinary policy response in the US is not reflected in government bond markets, where yields and break-even inflation rates remain low. Much still depends on the exit strategy from QE, but given the extent of the output gap in the US, it seems premature to worry about runaway inflation debasing the dollar.

It also seems likely that if/when the global recovery starts fading and fears of a potential double dip resurface, the safe haven demand for dollars is likely to re-emerge. As risk appetite abates, the dollar will strengthen.

Fears of the dollar being supplanted as the global reserve currency also seem premature, as no real credible alternative exists as of today. It also seems unlikely that the US authorities will actively seek a weaker dollar beyond a point, despite the economic benefits, due to the risks a loss of confidence in the currency will pose to global financial stability. The last thing the world economy needs today is a disorderly sell-off in the dollar.

The reliance of the US on foreign capital is also reducing as households delever, savings rise and the current account deficit shrinks.

The US should also grow much faster next year compared to the eurozone or Japan. Every day brings new confirmation of the strength of the US recovery (yesterday's jump in the Leading Economic Indicators index being the latest example). In the recent past investors have got used to linking strong economic growth with a weak dollar, but this has not always been the case; the pendulum could easily swing back to the markets linking strong growth with a strong dollar. The amazing resilience and adaptability of the US economy should be in display by next year, as it easily outgrows a stagnant eurozone.

It is difficult to quantify the extent to which the carry trade has caused dollar weakness. International banking statistics provided by the BIS would be a useful source of information, but the data is not timely enough to cover the recent period of dollar depreciation. While the dollar bears are convinced that the currency is a one-way trade, with its new-found role in the carry trade being the latest nail in its coffin, market participants should be cautious. Interest rates are very low across the OECD economies, and given the differing long-term growth outlooks for the US vis-a-vis Europe and Japan, it is not obvious why the dollar should be a more attractive funding currency than euro, sterling or the yen.

Investors should be careful in assuming that dollar weakness is a given; this could easily reverse. Given all the issues corporates in India have had in the recent past with exchange rate derivatives, they would be well advised to think about any long-term leveraged exposure they have which builds in continuous dollar weakness.

The message from the recent G-20 meeting was crystal clear; do not expect central banks to take the risk of short-circuiting fragile recoveries, either through premature tightening of monetary policy or phasing out of fiscal stimulus. The assembled cast of policymakers seemed to be in total agreement, there is no question of reversing the emergency measures until a global recovery is totally secure. While the media devoted countless pages to the eye-catching headlines around proposals to curb banker bonuses, much less attention was devoted to the consensus over macro-economic policy that emerged from the G-20 meeting.

All the assembled finance ministers and central bank chiefs seemed to agree that the greatest danger facing the world economy would be a premature reversal of the monetary and fiscal measures taken, and market worries around inflation and excessive stimulus and debt were dismissed. Ignoring warnings of many market pundits concerning the long-term buildup of inflationary expectations or a rising government debt mountain, preventing a second leg down in the global economy seemed to be priority number one.

For fiscal policy, the clear message coming out of the meeting was that budget deficits should not be cut back for at least a year, despite growing nervousness in the US in particular about ballooning debt burdens. On monetary policy, the assembled central bankers seem to be clear that there can be no question of raising rates for at least a year, if not longer. Even someone as hawkish as Trichet seems to have signed up for this new-found consensus as outlined in an article he wrote for the Financial Times.

Despite the seeming clarity on the part of the assembled policymakers, the reality is that central banks have an exceedingly tricky task ahead in deciding how and when to calibrate their exit strategies from the emergency policy actions of 2008. While changes in fiscal policy are largely political decisions, central banks in most of the OECD economies have independence over monetary policy.

Monetary policy has different channels through which it acts to stimulate the real economy. It works through falling interest rates and lowering of risk spreads, increased lending by banks and increases in asset prices and risk appetite. A combination of these metrics and other factors like currency normally go into calculating a financial conditions index which is able to express the true level of monetary easing. Short-term interest rate reductions are not the only way monetary easing stimulates the economy. The interplay between all the above-mentioned channels boosts consumer and business spending and hence improves economic growth.

This cycle has, however, seen only a partial working of the normal transmission mechanisms.

When central banks cut policy rates, other interest rates respond very quickly, and by providing cheap funding, central banks aim to encourage spending and production. This interest rate channel will typically be the first line of defence in reviving the economy, and do most of the heavy lifting to kickstart economic growth. However, in this cycle

interest rates that are relevant for borrowers have fallen very slowly and, due to the crisis, much later than policy rates. The clogged financial system had prevented an immediate rate response. A further complication is the lack of desire to borrow on the part of households (in the US particularly) as they seek to rebuild decimated balance sheets. Sticky rates to the downside and an unwillingness to leverage up on the part of households have thus rendered this channel of monetary policy transmission far less potent than normal. The shrinkage in credit outstanding among households in the US over the past few months is a testament to how weak this channel of monetary transmission has become in this cycle.

The flow of credit to the private sector is also likely to be weaker than normal as deleveraging among financial institutions has sapped their ability and willingness to extend credit. Banks are happy to use the positive carry from an engineered steep yield curve to rebuild their own balance sheets as opposed to taking on more credit risk. The demise of the shadow banking system has reduced system-wide credit availability. Measures to force banks to further increase the quantum and quality of capital adequacy (also discussed at the G-20 meeting) will only further accentuate the difficulty of the banking system in lending aggressively.

Risky asset prices have, however, performed extremely well since the rally began in March, with risk appetite slowly coming back. Risk assets are currently in a sweet spot, with strong expansionary policies in place, and likely to remain so, combined with a clear bottoming out of the economic fundamentals. This channel of monetary policy transmission has been far more powerful than the others in this cycle, trumping the interest rate and credit channels by a large measure. We have seen record issuance of corporate debt, and a thawing of the equity capital markets to new issuance.

It is this imbalance among the various channels of monetary policy transmission that will ultimately create complications for the monetary authorities and pose a dilemma.

If asset prices keep moving higher, and the central banks decide to do nothing, in effect accepting higher asset prices to compensate for the very weak transmission of monetary policy through the interest rate and credit channels, then we are setting the stage for another bubble in asset prices. It would be ironic if the policy solutions to the current crisis set us up for another bust down the road. No central bank willingly wants to go down this road, but there may be no choice.

On the other hand, learning from the last 18 months, if they target the building asset bubble, while the other monetary transmission mechanisms are still weak, the authorities could jeopardise the whole economic recovery, by causing a premature tightening of policy. This would seemingly go against the emerging consensus coming out of the G-20 meeting. Having come so close to economic collapse, no policymaker wants to risk another economic downdraft.

Thus the central banks have a real dilemma, and one fraught with political risks. The structural nature of the problems confronting consumers in the US seems to preclude a vibrant recovery in the other channels of monetary transmission. An overleveraged consumer and financial system will not correct its imbalances overnight. Central banks

may have no choice but to willingly let loose another asset bubble, and this time emerging market assets are a prime candidate to be at the centre of this growing frenzy.

## **Time to Buy Protection?**

27 August, 2009

Given the magnitude of the returns this year, it is prudent to protect them to the extent possible, says *Akash Prakash*

There is a general sense of unease among professional money managers towards the equity markets. We have had a huge rally across global equity markets, with Asia up almost 50 per cent for the year, and even the OECD markets up 40-50 per cent from their mid-March lows.

Investors' biggest concern is the sustainability and pace of the economic recovery, especially in the OECD economies. The bears are convinced that while the US and European economies have stopped contracting, and will show growth in the second half of 2009, equity markets are way ahead of themselves. The concern is that the recovery will be too weak to validate the bull case. The economic recovery will be very subdued, sub-par and jobless, and in no way resemble the V-shaped outcome equity markets seem to be pricing in. Continued deleveraging and lack of income among consumers, limited ability and willingness to lend on the part of the financial system and excess capacity precluding any need for investment among corporates are most often cited as the causes for a subdued growth trajectory. Given the uncertainties of this cycle, a double dip can also not be ruled out as governments withdraw emergency measures.

While the bears may be right about growth coming out of this recession being a disappointment, is such an economic outcome necessarily negative for equities? One can easily make the case that the best environment for equities is one of subdued growth, and not the V-shaped recovery bears fear the market is pricing in. A subdued and halting economic recovery will allow equities to remain in the sweet spot of easy liquidity, low inflation but improving economic and corporate fundamentals. This is the point in the economic cycle where policymakers are still totally focused on stimulating growth, and inflation is not yet an immediate concern, but the beginnings of growth are visible.

On the other hand, a sharp V-shaped recovery will in all probability force the hand of central bankers and we will see a shift in policy to exit the current super-stimulative policy regime. Such a policy shift will in all likelihood have a serious negative impact on equity markets. Given the trading pattern of the last few months, markets seem hypersensitive to even discussions of policy shift on the part of the central banks.

Thus the bears may be right about the upcoming economic recovery in the US and Europe being far more anemic than the market is thinking, but ironically such a scenario may only go to extend this cyclical bull rally.

This rally may still have some legs given that the most likely cause for a short circuit — viz a change in policy stance so as to roll back liquidity, fiscal stimulus and quantitative easing — seems to be still some distance away.

Having said this I think there is a very strong case, at least from a tactical perspective, to buy insurance to protect your portfolio from a 10-15 per cent type of correction, through either buying options or building cash levels.

We are, first of all, entering a seasonally very tough period for equities. The months of September and October have normally not been kind to equity markets, and historically one has seen many sell-offs in these months.

Secondly, the cost of protection has come down globally, with the VIX index having fallen by 67 per cent over the last nine months. Risk aversion has clearly reduced. Contrarian sentiment indicators measuring the bullishness of retail investors and fund managers also indicate much more complacency towards equity risk.

The performance of Chinese equities is also a cause for concern, given that these markets have been leading indicators for global markets over the past 18 months. At one stage last week, they were down 20 per cent. The continued decline of the Baltic dry bulk index, despite the stabilisation of the Chinese equity markets, is also a worrying divergence. Trading volumes and breadth, at least in the US, do not give comfort on the short-term sustainability of this rally. The Bank of Israel hiked rates with the highly respected Stanley Fischer as governor. Could this mark the beginning of a reversal of the global cycle, far earlier than markets are pricing in?

The case for buying protection is even greater in the case of India. Our markets have been among the best performing large markets this year. Despite this huge run-up, protection has rarely been cheaper, as volatility skews have flattened.

What bothers me about India is that even though most professionals are nervous, they are unwilling to sell stocks or pay up for protection, as going against the markets the last five months has been a very painful and expensive proposition. Desperately chasing performance, and trying to catch up with the markets' breathtaking run, investors are loath to give up returns by either selling too early or paying for useless protection (useless till date at least). Even the smartest proprietary traders have lost so much money trying to anticipate a market break, that they no longer have the risk appetite to go against the trend.

In the case of India, due to the weak monsoons, we are seeing cuts in growth forecasts for 2010. Along with lower growth, serious risks in the form of a surge in food prices and inflation exist. Chances are that the fiscal situation will only worsen as the government has to engage in drought relief and ramp up food subsidies. Interest rates have already started creeping up, despite enormous liquidity in the system and the next move of the RBI is to hike.

A combination of factors — cuts in GDP growth rates, rising interest rates and stress in rural India — does not equate with corporate earnings upgrades. Commodity prices have also risen in the last six months, which will offset much of the margin expansion we have seen in corporate India in the last quarter. The market is also not particularly cheap. Supply of paper is seemingly limitless, and we have just seen one very large IPO have a disappointing listing.

Policy traction from the government is still not aggressive enough, and not enough has been accomplished, despite the setting out of clear 100-day goals by many ministries. While we do expect a correction, any fall will be a buying opportunity, as I still believe India will be a very exciting investment destination over the coming years. There is still

so much low-hanging fruit on the policy side, which can keep markets enthused and ensure strong growth.

There still exists the strong possibility that this whole cycle will ultimately end with a bubble in emerging market stocks. India will be a major beneficiary of any such rush of liquidity into the asset class.

Given the magnitude of the returns we have seen this year, I think it is more prudent to try and protect these returns to the extent possible as opposed to trying to make the last 10 per cent. One will get a chance to buy stocks cheaper, it is only a matter of time.

## **Why India will do a China**

24 July, 2009

Thanks to political changes, India is in the midst of a long-term growth path that will mirror China.

I think India will be a very exciting investment destination over the coming five years. The reason for my confidence is simple: We are likely to experience high and sustained economic growth (in a low-growth world) which will drive corporate earnings and equity market performance. My sense is that India is in the midst of a growth acceleration, which will last years and surprise the world much like what China has delivered over the past ten years.

If one looks at India as China with a 10/12-year lag, you can see great similarities. China began its reform in 1979, compared to 1991 for India, and this lag seems to hold good even today. The growth acceleration India began to see in 2004 corresponds reasonably well to China's own growth path and should be just the beginning of an extended and accelerating growth trajectory.

The similarities with China are reinforced by the fruits of the demographic dividend, which will be realised over the coming years as well as rising savings and investment ratios which are now over 35 per cent compared to 23-24 per cent when liberalization began.

However, the most important change to my mind is that the Indian politician has now finally a vested interest in economic growth. This may seem an obvious statement, but the reality remains that till recently politicians would openly question the premise that economic growth or good economic governance brought with it electoral votes.

This election seems to have changed all that, as the clear takeaway has been that success in transferring significant resources into rural India has delivered votes. Spend large chunks of money on social schemes targeted at rural India, ensure reasonable delivery of these schemes and you will get votes. Every political party has understood this message, and this trend of increased resource transfer towards the poor through enhanced social security schemes is here to stay. For example, the NREGA outlay has already moved up to Rs 39,000 crore, this will only increase further as the scheme gets extended to urban areas and wages are maintained in real terms. There is now the imminent launch of the Food Security Act, and we will see more such schemes given our poor development indicators.

The desire and intent to spend money is clear. While the government will be able to improve the delivery and targeting of these schemes through IT and smart cards etc, any savings realised will be re-invested. The needs are so great that we are still only scratching the surface.

The question then comes to how will we fund all these schemes and social expenditure, and this is where the political imperative to ensure high economic growth kicks in. For the simple truth is that unless we get back to an 8 per cent-type GDP growth, we will be unable to simultaneously get the fiscal deficit under slower economic growth and an eventual domestic debt spiral as growth and revenues slow. The fiscal deficit has to come under control, no country can continue indefinitely with double-digit deficits.

n We may decide to turn the clock back 35 years and introduce punitive taxation on the wealthy. Why not take corporate taxes back upto 50 per cent, income tax peak rates to 70 per cent, put excise of 50 per cent on cars etc? This is unlikely to work as high rates encourage evasion and discourage entrepreneurship. The economy would slow massively. The government has shown no

inclination to move down this road as even in the latest Budget, peak rates of income tax were reduced and the role of the private sector in driving the economy forward unchallenged.

Rapid economic growth is the only way this equation solves. You cannot fund schemes of the scope of NREGA and the proposed Food Security Act unless you get back to at least 8 per cent GDP growth; you simply will not have the money. You have no fiscal flexibility left. Over the last two years the entire incremental expenditure of Rs 300,000 crore has been funded by incremental borrowing, this game is over. Higher expenditure now requires higher revenues.

This is why the GST is so critical and will get implemented, along with other reforms in education, FDI, fertiliser and fuel pricing and infrastructure, as without structural steps of this kind we are not getting back to sustained and high growth. This is also why disinvestment will happen, we simply need the money.

Everyone knows what India needs to do to unshackle its economy and get back to the growth rates of 2004-08. Just read the Economic Survey, what has been lacking is political will. As politicians understand the link between economic reform, growth and their ability to spend money and win votes, the willingness to overcome vested interests will increase.

Most of the reforms investors want to see — be it disinvestment, FDI limit hikes, education reform, tax rationalisation etc — will happen over the coming years. Maybe not in the next six months as investors want, but it will happen. We only reform with our backs to the wall, and the fiscal situation leaves us with little choice. Without serious structural reform we will not get the growth we need to fund our social commitments.

In China the political leadership obsesses over maintaining 8 per cent GDP growth to ensure its own legitimacy. A parallel with India is our political leadership needing to maintain 8 per cent growth to have the resources to spend on social schemes to ensure re-election. Both the imperatives ensure that high growth is top-most on the agenda. This has been true for some time in China and just beginning in India.

The markets may consolidate and be range-bound for some time as they have had a huge move. We are also seeing valuation and equity issuance challenges at these levels. That may hold true for the next few months, but India is going to be a very exciting investment destination over the coming five years.

The stars are beginning to align.

## **A Disappointment**

7 July, 2009

The markets have reacted to the Budget with a sense of unease and disappointment. Maybe expectations were unrealistic, and we are unfair in expecting so much in the short period of time the FM had to prepare and present the Budget.

To start with the positives, the commitment to move ahead to implement the GST from April 1, 2010 is the biggest plus to my mind. While we may still see delays, we must try to push ahead on this major reform. The second big positive is the phasing out of the FBT, a hated and tiresome tax with serious procedural headaches. The decision to introduce a draft new direct tax code within 45 days is also a pleasant surprise, assuming of course that the new draft code will significantly ease taxpayer interaction with the government. The elimination of the surcharge on personal income tax, raising the MAT to 15 per cent and increasing allocations to most major infrastructure programmes are other good measures. The focus to make the new pension scheme attractive through fiscal measures is also a step in the right direction. Keeping with the STT and not going back to a capital gains tax is also a good move to my mind.

I think what has spooked the markets is basically the fiscal deficit. At 6.8 per cent at the Centre and probably upwards of 4 per cent at the states, we are clearly in unsustainable territory. The unwillingness to give a time-bound long-term fiscal target, or the gameplan to bring this deficit down is a very big negative to my mind. Waiting for the finance commission to give its report seems to be a case of ducking the issue. With a government borrowing programme of almost Rs 400,000 crore, interest rates can only go up from here. Thus while the government may be spending more to give a stimulus, the higher interest rates caused by all this spending will be a serious drag on economic growth. With this extent of resource pre-emption we are only further increasing our dependence on external capital to fund private sector capex. Our fiscal sustainability is very leveraged to getting back to high growth rates, but can we simultaneously finance 9 per cent GDP growth and a double-digit fiscal deficit?

The deficit numbers mentioned above seem to take credit for Rs 35,000 crore of 3G auction proceeds which is one-time, but we make no mention of the costs of the new food security act, which will come into being in all likelihood by the next Budget. This one new scheme may itself cost Rs 25,000-30,000 crore. We continue to spend without restraint, with expenditure rising by 36 per cent in 2010, but seem to have little idea on how to finance all this. PSU disinvestment cannot be the panacea for all our fiscal ills. Even if we do get Rs 25,000 crore a year through this route (too high an estimate to my mind) it will not solve our fiscal challenges. Through the laudable desire to make our growth more inclusive, we seem to be committed to a path of very high expenditure growth. This will have to eventually be paid for one way or another. Either we target our subsidies better and thus get more bang for the buck out of current spending, or taxes have to go up. While everyone understands that deficits will be high globally because of the economic downturn, India's seems much more structural given the desire for big government and substantial funds transfer to rural India.

There also seemed to be a worrying lack of mention on structural reforms. Nothing on FDI limit hikes, no formal disinvestment target, nothing much on targeting subsidies beyond one more committee on petro-product pricing and some scheme(lacking detail) to shift fertiliser subsidies away from producers to consumers. It was almost as if the FM was trying to shy away from talking about these more structural type of measures. Does this indicate a worrying lack of consensus in the coalition or the Congress party itself on these issues? Are we still uncomfortable talking of disinvestment, easing FDI limits, subsidy targeting despite the exit of the Left? The Economic Survey had obviously raised hopes that this government meant business. But suddenly

we have no mention of most of the things the Survey talks about. Nobody expected action, but at least a statement of intent would have been reassuring.

I think if the FM had spent more time on these type of structural issues, and made at least some announcements, even in the form of intentions/long-term targets etc, it would have captured the markets' attention and enabled investors to focus on the long-term growth trajectory of the country. Instead, investors are almost totally focused on the fiscal deficit, its impact on interest rates and the lack of reform. Concerns on India's rating are also back to the forefront.

In the end it comes down to a case of packaging. By not spending any time on structural issues, and giving no commitments on the trajectory and gameplan for getting the fisc under control, investors have begun to wonder whether UPA-II will go the same direction as UPA-I in terms of significant structural reform.

The Budget seems to be too much of a status quo document for a government which claims it is in a hurry to get us back to a 9 per cent GDP growth trajectory.

The markets have obviously sold off significantly, we may not have too much more downside from here (5-10 per cent) but neither can one make out a case for big upsides. More likely we will go into a holding pattern type of trading range, as the markets wait to assess the seriousness of the government in implementing the slew of suggestions highlighted in the Economic Survey.

This Budget has unfortunately failed to capture the imagination of investors, who feel that we will not get back to 9 per cent growth without serious structural reform. One can only hope that the next Budget in six months' time will make the government's intentions on this front clearer.

## **The Return Of Stock-Picking**

June 26, 2009

In a more narrow range-bound market, stock-specific issues will once again come to the fore.

The last two-and-a-half years have been a crazy roller coaster ride in the Indian equity markets. 2007 marked the culmination of a strong five-year upmove and ended in a meltup, with markets exploding to the upside from September to end-December. The quality of the companies you were buying mattered very little in this phase. Real estate, infrastructure developers and capital goods companies were all the rage and as long as you owned companies in these sectors you out-performed the markets. If you did not own this stuff, you could deliver strong returns on an absolute basis, but it was tough to beat the market indices. Momentum investing was in full cry, and as is typical of bull market tops, growth (of both top line and earnings) was given overwhelming importance at the cost of capital efficiency. No one really cared about ROE or ROIC metrics, 'show me top line growth and I will give you a valuation' was the mantra. Concept stocks were also in fashion, and investors were willing to give high upfront valuations for long gestation business models like retail or insurance.

The macro calls, viz which sectors to be in, whether you want to have more beta in your portfolio etc were far more important than stock selection. If you understood the markets' obsession with growth at any cost, you were fine.

In 2008, the picture changed in the sense that almost everything came down, and what was more important was judging the extent of FII ownership of a particular company. The more widely owned the company, the more the selling and hence the deeper the fall. Again stock selection was less important than getting the macro call of being defensive right. The momentum sectors of real estate and infrastructure kept their beta, but this time it was on the way down. Once again no one really cared about ROE etc; only FII ownership and debt levels mattered. If you understood the extent of fear and over-ownership globally you were fine.

Now in 2009, we have had periods of both of the above. Indiscriminate selling irrespective of company fundamentals, and now desperate buying trying to keep pace with the markets. The move-up in the last ten weeks has very closely resembled the market environment of Sep-Dec 2007. Market participants are beginning to question whether once again momentum investing is back in fashion.

This is not a new normal in my view. Markets do not go up or down 60 per cent in a single year on a continuous basis. Macro investing is not always overpowering, it does not always swamp everything else.

Investors, having got used to the wild swings of the past 30 months, are questioning the relevance of stock-picking in India these days. Their legitimize point is, what great value has fundamental research brought to the table? One has only needed to get the macro beta

call right, nothing else has mattered. Whatever level of company-specific analysis one may have done, it has provided little edge.

My own point of view is that the environment is going to change and very soon. We will soon enter a consolidation phase in India, where for a period of time markets will have reduced volatility and trade in a reasonable range. The markets have to become a little boring for a time and we need to get away from the wild swings of the last 30 months.

In more narrow range-bound type of markets, stock-picking will once again come to the fore. Stock-specific issues will matter, and companies will deliver significantly different return profiles dependent on their own long-term growth prospects and capital efficiency. Investors will once gain focus on ROE, free cash flows, valuation multiples and quality of management. Which company you are invested in will once again matter.

During the mid-1990s, all the way upto 2006, India was always known as a stock-pickers' market, investors would always point to an Infosys or a Bharti as examples of companies you could discover, buy and hold and make serious money independent of market conditions. India's strength was its ability to continually throw up new companies and entrepreneurs who could scale and build world-class companies. The breadth of sectoral representation was always seen as a strong positive for the markets.

I think such an environment will return. Stock-picking will once again deliver alpha.

An interesting corollary to this possible move to stock-picking is about how all the infrastructure will get funded. The momentum markets of 2007 allowed all sorts of long-gestation infrastructure projects to get funded. As the market environment changes, so will appetite for this type of paper. Stock-pickers tend to prefer high ROE, strong free cash flow type of companies. They normally do not favour companies which need to raise equity at regular intervals, like our real estate and infrastructure plays. Also, by definition, for infrastructure projects at least, equity returns will be capped, if not for the first few projects, definitely over time. Infrastructure projects will also normally be very long-gestation in nature, with returns coming over time. Public market investors do not normally pay much upfront for a project whose cash flows will only begin in three-five years.

How will these companies raise the billions they need in a new, more sober market environment? The failure of many QIPs is already a pointer to this trend. Can a more sober, less growth-obsessed capital market fund the equity needs of all the infrastructure and real estate developers? If not, what does that mean for India's huge infrastructure build-out?

It is also a commonly known fact that the stars of previous bull markets rarely tend to lead in a new market upcycle. Thus we have a dilemma as to how will all these new infrastructure and real estate projects get equity funding. Either a new growth-obsessed equity market environment has to emerge or new specialist infrastructure investors come to the fore whose tenure of capital and expected return profile are different. You will see the emergence of many more specialist infrastructure equity funds (many at the project level) of the type IDFC has already begun. Without these specialist funds I don't see how the private sector can raise the equity it needs to build out India's infrastructure.

## **The US Bond Sell Off**

12 June 2009

At this stage of the economy's recovery process, the US can ill afford a further sell-off in treasury prices.

In the last few weeks we have seen a significant and sustained rise in the most important interest rate in the world. On single days over the past few weeks the yields on the 10-year US treasury bond have moved by over 15 basis points, a highly unusual event. With the yield now at 3.9 per cent, the move has been over a 100 basis points this month alone. Yields are now higher than before the whole quantitative easing policy was announced. This type of upwards move in rates has occurred despite the Fed funds rate at effectively 0 per cent, and the Fed buying securities directly in the markets. So what is going on? Should investors and policymakers care? What are the implications for longer-term growth?

First of all, the markets are finally understanding the reality that the US may be stuck with trillion dollar deficits for some time. The combination of the fiscal stimulus plan, funding multiple bail-outs and weak tax revenues, has thrown the US budget seriously out of balance. The US is expected to have a deficit of over \$1.5 trillion or 10 per cent of GDP this year, and while everyone including Obama believes that this is unsustainable, it is not clear how this number can be brought down in a meaningful fashion without large tax increases, which in turn will damage long-term growth rates. If you assume that the US is unlikely to grow at more than 1-2 per cent (over the next two-three years), and given Obama's desire to universalise healthcare, significant tax increases are the only way forward in the US.

The current \$1.5 trillion deficit does not even address the huge upcoming liabilities for social security, Medicare and Medicaid. As the baby boomer generation in the US retires, these liabilities will crystallise. Private thinktanks have estimated that spending on these three items will have to increase by about 6 per cent of GDP over the next 20 years, leading to even larger deficits, or alternatively higher taxes. Collectively these three programmes represent a \$40 trillion liability for the US government and, if not paid for, will have to be added to the current debt load of \$10 trillion.

The added issue weighing on the markets is who will buy all these new bonds? Market experts expect about \$3 trillion of new treasury issuance on a gross basis and about \$2 trillion of net issuance in 2009. This is four times the number for 2008.

Prior to this year, the recycling of the US trade deficit/current account created enough natural demand for treasuries to fully absorb all new issuance. Now with this amount only about \$500 billion, it is obvious that even if they wanted to, the Chinese and other surplus nations cannot absorb the quantum of planned issuance. Who will absorb the incremental \$1.5 trillion? The US banks and retail investors will have to step up, but can they continue absorbing this quantum of paper on an annual basis? What will this do to private sector borrowing costs?

The concern is that in the long term this absorption of paper can only happen in two ways. One is for bond yields to rise in a sustained and structural fashion, and the second is for the Fed to remain involved in the markets as the buyer of last resort. While rising bond yields are negative for growth and equity valuations, the continued use of the Fed's balance sheet to absorb treasury paper will risk long-term inflationary consequences and dollar weakness. Make no mistake, the US has some tough choices ahead.

Markets have also begun to understand that it will not be easy for the US authorities to drain out the huge amounts of emergency liquidity that has been pushed into the system. It is always difficult to know when to reverse course, and given the unprecedented nature of the current policy support, the consequences of a course reversal are even more unclear. Once a system has got used to life support, how do you cut off the oxygen? Can the markets, banking system and the real economy thrive today independent of Fed support? It is going to be a very delicate balancing act to withdraw Fed support, with risks of a renewed down-leg in markets and the economy. The much-feared W-shaped recession is a real concern if withdrawal of emergency support facilities is not handled delicately. Given the risks associated with an early withdrawal of emergency support, there is a real risk that the Fed will overstay with the attendant consequences on inflationary expectations.

The markets have also been spooked in part by S&P's announcement earlier this month that put the UK's AAA rating on negative outlook. Given the many similarities between the economic outlook and issues facing the US and UK, this was a reminder that sovereign risk in the US could also one day come into question. More than just a US issue, this is a worry more for all the Asian central banks holding trillions of dollars worth of US paper. Though a remote possibility today, it may eventually raise risk premiums on US paper.

There is an argument that all one is seeing is more a normalisation of bond yields rather than anything more sinister. Bond yields always rise in economic recoveries without causing W-shaped recessions. As per this chain of thought, stronger economic prospects push treasury yields higher, but also cause a narrowing of credit spreads, thus protecting the real economy from any interest rate shock. While there is some element of truth to this line of thought and it may partly explain the rise in yields, I think the markets are more focused on the longer-term structural issues outlined above.

The treasury bond sell-off is now putting pressure on other parts of the US economy. The biggest worry should be in housing where borrowing rates are beginning to rise independent of Fed mortgage buying. Housing is central to the recovery and stabilization of the US and no sustained economic recovery is possible without house prices stabilizing. Rising oil prices have further complicated the situation. There is no way the US consumer today can withstand simultaneously higher fuel prices and interest rates.

At this stage of the economy's recovery process, the US can ill afford a further sell-off in treasury prices. In order to cap yields one is likely to see the Fed more active in buying up mortgages and treasuries and for longer than the market currently anticipates.

The green shoots may themselves sow the seeds of the economy's relapse. As more people buy into a recovery scenario, we are seeing yields, oil prices etc all normalize and increase. This process of normalization is itself making the risks of a relapse greater.

## Why FIIs Are Buying

May 22, 2009

There is a huge opportunity to bring about structural change, but the new government must deliver, says *AKASH PRAKASH*

The markets have given a resounding thumbs up to the strengthened mandate given to the Congress party and Dr Manmohan Singh. Equity markets were up 17 per cent on Monday and then kept their gains the following day, with record volumes driven by a billion dollars of FII buying. FII flows look to remain strong, and it seems as if the markets have entered a new and sustained higher base level.

What accounts for this renewed FII interest? Why is everyone so excited about India once again?

FIIs are basically making the bet that in their new term, Dr Manmohan Singh and his cabinet will move ahead decisively on economic reform and policy action. The government knows what needs to be done, there are enough committees and commissions whose recommendations are lying unimplemented and investors are making the bet that the new government has the political will to push ahead. This government has the chance to fundamentally strengthen the country's structural growth outlook.

There is a clear feeling that the quality of the mandate is vastly different today compared to 2004, both in terms of the relative strength of the Congress vis-a-vis its allies and the credibility of Dr Manmohan Singh within the Congress party itself. There are no excuses for non-performance this time. Many serious investors are also drawing positive longer term conclusions from the revival of national parties, greater correlation at the state level between governance and votes and the Indian public's desire for a stable and centrist government. Talk of a maturing of the Indian democracy is all pervasive.

There were three main reasons why investors were cautious on India.

One was the proximity to Pakistan and the related geo-political risks.

The second was the risk of a severely fractured electoral verdict leading to a compromise candidate for PM, and the Third Front led by the Left coming to power. The risk of weak governance threatened to derail the country's long-term outlook in the minds of investors. A weak government would not be able to tackle structural issues like the fiscal deficit or targeting of subsidies.

Third, the bears have been going on about the risks to the India growth story if global capital flows were to remain negative. The idea being, how will India fund its infrastructure deficit, given the limited local sources of long-term capital? Without strong inflows we cannot finance the fiscal deficit and 8 per cent GDP growth simultaneously.

Of the three bear arguments only Pakistan remains, as the electoral verdict has been far clearer than expected, and already Indian companies have regained access to global capital. In the last 10 days alone Indian companies have raised almost \$2 billion of

equity. Strong inflows, both FII and FDI, will restart a positive feedback loop of rising investment driving strong earnings, leading back to investment.

Investors now once again seem willing to place India along with China as one of the handful of countries which can get back to trend growth rates in 2010. Global players seem to be willing to re-rate the country and have the confidence to look through the short-term growth slowdown and focus once again on the long-term picture.

A second related issue driving market performance is the level of under-investment among investors. Most India dedicated funds are either too defensively positioned in terms of sectors and stocks or have too high a cash level. Among the regional funds, India for most shops had been an underweight, and now most are scrambling to catch up and in fact go overweight. A lot of regional investors are a little worried on China and seem willing to take some money off the table there and redeploy it to India. The India dedicated hedge funds are at best 30-35 per cent net long, and once again have the potential to up their exposure. Even locally one can expect the surge in confidence to push money into the markets either directly or through insurance and mutual funds.

Therefore one can expect to see continued strong FII inflows into India, as investors play catch up. At every dip one can expect strong buying. India's very strong performance year to date (especially after the elections) only adds further pressure to not be seen being underweight.

There is also the strong possibility that many of the India funds will now get inflows, as retail flows chase performance, and most investors bet on further convergence between India and China's market performance.

What can go wrong? Obviously, the new government can fail to act and continue dithering on policy action. If we see no action and just continued setting up of committees and groups of ministers, then that would be extremely unfortunate and set us up for huge disappointment.

Sign posts that investors will be using to calibrate the heightened expectations begin with the new cabinet. Obviously a technocrat becoming the FM would be seen as a big positive both from a capability perspective and in sending a clear signal that the Prime Minister is in charge. Investors will also want to see greater representation of youth as well as the critical infrastructure ministries going to capable ministers. There remains some doubt on Dr Manmohan Singh's assertiveness and willingness to tackle entrenched political equations, and the new cabinet formation will answer many of these questions.

The next important milestone will be the budget itself. What is the game plan to tackle fiscal issues, better targeting of subsidies, infrastructure funding, the GST, etc?

Independent of the government being indecisive and frittering away the mandate, the only other negative in this scenario is the huge and almost inexhaustible supply of paper in the pipeline. Corporate India has already raised about \$2 billion in the last 10 days, and the tap is now wide open. Combined with some disinvestment from the government, we could easily see \$8-10 billion being raised in equity capital this year. This will act as a

natural cap on the markets, though it will be great in boosting domestic capital formation and growth.

Valuations are not really cheap either, though earnings are likely to get upgraded, and this can also cap the markets upside, at least in the short term.

This election is being seen by many as a game changer. India has a real chance of breaking out, attracting strong inflows and being positioned in investors' minds alongside China. We were always supposed to have an economic model more suited to today's economic realities but with much weaker governance, could the governance handicap be reduced?

From the financial markets perspective, everything now depends on execution. The new government has the mandate, there is a huge opportunity to bring about structural change across sectors, and the policy road map is also clear. We need the new government to deliver.

## **On The Horns of a Dilemma**

May 8, 2009

The rally is likely to last longer than people think, and unlikely to correct severely.

The strong rally in global equity markets continues to confuse and surprise most market participants. Most hedge funds seem to have been caught underinvested, and the long-only folks by and large are stuck in the wrong sectors, being heavily overweight defensives. A continuing stream of better than expected economic data is forcing investors to reposition portfolios, and this act of repositioning is driving up markets to levels that no longer seem attractive from a valuation perspective. Having gone through a very tough 12 months, investors are naturally worried about not taking further losses, and are thus loath to chase this rally. Investors are damned if they do and damned if they don't. If they buy now and the markets fall, they are bound to get asked questions on chasing the market, and if they do not participate they will be asked on underperformance. Invariably it is now when fund inflows will also start. It is rare to have so many investors, all hoping for a market pullback, and unhappy as the market keeps rising. There is a very strong left-out feeling globally and across investors.

Because of the above dynamic, the rally is likely to last longer than people think, and unlikely to correct severely, unless we get a new unanticipated external shock.

As the folks at GaveKal point out, the number of months when the MSCI world index was up more than 10 per cent (April 09 was plus 11.6 per cent) are few and a rare enough occurrence to pay attention. It has happened only on five other occasions since the index was launched in 1969, and on each such occasion stocks were higher in 12 months. Thus buying post such a strong move has not been historically a recipe to lose money. They have also gone and done a similar study of market moves around the great depression period. The point they make is that while one saw strong single-month performance, which then faded away and were false starts in this period, in these false starts we never saw two consecutive strong months. The first time we had two straight strong months of market performance (July/August 1932), it marked the bottom for the Dow. The rally thereafter was huge with a subsequent retest of the lows, and another large upwards move, but the bottom held. They point out that we have just seen two straight strong months in the MSCI World index (plus 7.54 per cent in March, plus 11.5 per cent in April). Will the parallels hold?

The bulls make the point that we have now removed the financial system collapse scenario from the set of possible outcomes, and with the removal of this tail risk, markets should go back to a more pre-Lehman type of trading zone. If most credit market spreads have reverted back to a pre-Lehman type of world, why can't equities? The S&P was at 1,200 prior to Lehman's collapse. Prior to the Lehman collapse the world was worried about an economic recession and economic issues, not systemic collapse, we are possibly back to that type of a world. Equities in a way are effectively lagging the normalisation of other asset classes.

The bulls also point to the turn in economic indicators. The ISM survey, Michigan Consumer confidence index, Conference Board's coincident-to-lagging indicator — all these measures seem to have bottomed. The economy always bottoms within six months of these indicators troughing. Given the way the data has been breaking over the past few weeks, it does seem that we are past the midway mark in the recession at least in the US, and equity markets normally bottom around 60 per cent of the way through. Thus if one takes the economic indicators at face value, you can make a case for an economic and market bottoming.

The bears will make the normal arguments about the economy being weaker for longer than the current consensus assumes. Most bears expect no growth in the OECD economies even in 2010. There is also concern around corporate earnings, as they are bound to be weak in an environment of very low nominal GDP, and are coming off a very high profit share of GDP. Valuations are no longer cheap and, in any case, never got to levels that typically mark significant bear market bottoms.

Many also wonder where the \$500 billion of additional capital the IMF projects as being required will come from. There also exists the possibility of further macro-shocks linked to the dollar, sovereign defaults and some type of stress in the eurozone.

Be that as it may the reality remains that there is still too much scepticism on this rally. The pain trade remains the markets rising further, and we still have too much money sitting on the sidelines. I still feel that we are in a structural bear market, but within that type of construct we can have sharp and sustained bear rallies and this is what is currently going on. Investors seem to be desperately hoping for a correction, which indicates that any market fall will be brief and shallow. The markets will not stop rising till everyone gets sucked in, and people no longer feel nervous calling this a new bull market.

The problem for the bears is that at least until September, the bulls can keep on with the second derivative of data-improving type of theory with almost total impunity. The economic data is likely to keep improving slowly on the margin as restocking of inventories begins and confidence creeps back among corporates. Frankly until end-September the bears will not be able to show that growth is stalling or that 2010 will not pick up either and that earnings will remain weak. The onus is now on the bears to show that growth will not pick up in end-2009 and accelerate further in 2010. With the stress test results due this week, and given the muted market reaction to the leaks till date, there seem to be no other macro-hurdles for the market to cross in the near term.

India is currently part of this global rally, and for us to break out on either side we will have to wait for the elections. If we get a decent election outcome, the markets could really catch fire.

## **Lacking Conviction**

April 24, 2009

The extent of the rally is a surprise, but we need to tread water for some more time.

I will be the first to admit that this rally has caught most people, including myself, by surprise. Sure we were expecting some type of bear market pullback, given how oversold the markets had become, but nobody expected a rally like the one we have seen. The move over the last six weeks has been in excess of 35 per cent, and even the most die-hard bear has been forced to reduce risk and take notice. Besides, as far as bear market rallies go, the move in terms of percentage has been greater than most, and thus is a cause to ponder on what is really going on. The rally has caused tremendous pain, as most have been unable to participate fully, being under-invested or invested in very defensive sectors and stocks.

There is a tremendous feeling of being left out, and some observers are even calling for a new bull market.

The question is what does one do now? If you are under-invested should you chase the market? Or should one use this rally to lighten up on stocks that one wished one hadn't bought in the bull phase? The markets both in India and globally now seem to be going through a churning phase, where they will pause for a bit, catch their breath and we will see a battle between the bulls and bears.

I still feel that one should focus more on capital preservation, rather than trying to take on additional risk by chasing the markets here. If you already have significant investments in India like we do, then there is no need in my mind to try and double up and increase risk at this point. Given how much money is still on the sidelines, the markets may not retrace all the way back to 2,500 levels (Nifty), but I can't see the case for a significant upside from here either, in the short term.

Firstly we have the elections staring us in the face. By all accounts this is the most open election ever, with at least six leaders in the running to become PM. Nobody is quite sure how it will turn out, and as of today any of the three formations could come to power. I am not in the camp that politics do not matter. They may not have mattered when the world was growing at 4-5 per cent, and India had enough of a tailwind through heightened risk appetite and the benefits of past reforms to grow at 8 per cent-plus. However, they matter today, when the world is in the midst of a recession, we have structural fiscal issues and strong economic decision-making is the need of the hour. India has enough policy-based low-hanging fruit, that its growth can be protected at a relatively high level. But will we get the policy reform? The only way that India can be re-rated upwards in terms of valuation multiples is if we get strong policy action. Depending on which formation comes to power, and who is the PM, there is no guarantee that we will get the dose of policy action that we need. There is not an insignificant probability that we get stuck with a very weak and ineffectual government that may not even last a full term. Such an outcome is a recipe for inaction and policy drift.

Secondly at current levels, the markets are now trading at 13-14 times March 2010 earnings, not really that cheap. We can find many companies in the midcap space which are very reasonably priced, but frankly I still struggle to find real value in the large-cap universe. Things don't seem cheap enough for a real bull market to begin here. We may of course be wrong on earnings, which could surprise on the upside, and markets may be cheaper than they currently look. One can calibrate this view as we get more evidence of the real earnings power of corporate India. One of the mistakes a lot of us have made in this cycle is to give multiples to one-off earnings and not test the earnings for sustainability. In hindsight investors paid peak multiples on peak earnings. Having over-paid in the last cycle, investors will naturally want to be more cautious on assessing real sustainable annuity-based earnings today.

Thirdly, if markets even hold here, I think there will be a deluge of equity issuance. The paper will flood the markets and eventually cap the upside, at least in the short term. Corporate India having been denied equity capital for 15 months, is just waiting to correct its capital structure in certain sectors. The quantum of possible issuance will be more than enough to soak up most of the capital sitting on the sidelines.

Another feature of the rally has been that it has been led by the stocks and sectors which have been beaten down the most. Bear markets such as the one we are going through, serve the purpose of purging excesses and changing leadership. It is highly unlikely that the sectors/stocks which drove the rally in 2007 on the way up, will once again lead the market when we enter a new sustained upmove. Given the type of stocks leading this most recent rally, it still smacks of short-term momentum players and short covering, the stock/sectoral moves do not seem to indicate this is the beginning of a new sustained bull phase.

Having said all of the above, the reality is that there is a lot of money sitting on the sidelines, and a strong left-out feeling. It is unlikely that markets get back to the levels we saw in early March, which has a reasonable chance of being a bottom. In the next downward move, a lot of this money sitting on the sidelines will get sucked in and prevent a retracement all the way back to 2,500. My own sense is that markets will drift and we will get more of a time-based correction. The majority of the price destruction is over, but we need to tread water for some more time. The markets will trade in a narrow band, volatility will reduce and the remaining excesses will be wrung out over time.

Ultimately in the short term, liquidity drives markets, and we do run the risk that equity flows into the emerging market universe will continue to accelerate. In search of beta and momentum, asset allocators could pile in. In such a case investors will be forced to buy, irrespective of their conviction.

If markets globally continue moving up, we could see capitulation among many large long-term investors who, sitting on the sidelines till date, will now be forced to participate. We are very near the pain point for many of these institutions. The next few weeks and a level of 850-860 on the S&P 500 is critical.

In India I still feel one can afford to wait till the elections, and then decide the course of action. I would not chase here. I still feel a focus on preserving capital is more important than maximizing upside at this point.

## Leads and Lags

March 27, 2009

The stock market is normally a leading indicator, and has historically always tended to lead the real economy by approximately six months. In fact, in the construct of the series of leading economic indicators in the US, the stock market is one of the critical constituents of the leading indicator index. Even in this crisis, the markets broke down, before the crisis really began to eat into the real economy. The markets signalled early on that this is going to be much worse than a plain vanilla recession.

In the case of a traditional cycle, the economy overheats, inflation spikes, the Fed raises interest rates to cool the economy, growth slows and unemployment rises. Once enough of an output gap has opened up and inflation is tamed, the central bank will cut rates to stimulate growth and the cycle will continue. In this type of a classic recession cycle, brought on by central bank tightening, markets always bottom about six months before the economy. The typical recession will last about 10 months and investors will always lead the economic recovery. Markets will start rising before the economic data conclusively turns, and some people will be left scratching their heads as to why have markets moved.

Given the unprecedented nature of this crisis, the normal equation stated above is unlikely to work. This crisis is far more globalised and structural in nature. This is the first time we have a simultaneous contraction in both global GDP and trade flows in at least 60 years. The global financial system has imploded, and the multinational banks are just a pale shadow of themselves. Central banks across the world have been forced into overdrive and a race to zero interest rates has begun. Risk appetite globally has been decimated and even the real money capital pools are short of liquidity. The reality is that we have limited visibility as to when we come out of this economic morass, and what will be the unintended economic consequences of all the unconventional fiscal and monetary actions being taken today. There are long-term concerns around the dollar, inflation, fiscal balances and the new regulatory structure governing large financial institutions. China is willing to publicly question the safety of US financial assets.

The destruction of wealth has been totally unprecedented (as a case in point, at the recent bottom of S&P 500 below 700, the combined wealth loss in equity and property in the US alone was over \$11 trillion), and the near-collapse of the financial system has given investors a new appreciation of risk.

In the above context a big dilemma for investors is the extent to which they should lead a real economy revival. Can investors take on their normal role of being a leading indicator, and piling into risky assets before an economic revival is apparent in the data? Or should one recognise the unprecedented nature of this economic meltdown and be willing to wait for data to turn, before one gets fully invested? Do investors have enough confidence around the contours and trajectory of an economic revival to pre-empt it? If one believed in the normal lead/lag relationships, and agreed with the consensus view of a second half-2009 economic revival, then the time to buy is now. Valuations seem to be

reasonable, though arguably, 15-20 per cent away from true historic long-term bottom levels and investor scepticism high.

Given the wealth destruction and new-found appreciation for risk, my sense is that investors will be less of a leading indicator than the past, and a market revival will be more of a coincident event with the real economy starting to revive than past history would indicate. There is nothing like a market down 50 per cent for everyone to relearn the lessons of capital preservation. Investors will, I think, be more willing to lose some initial upside, than wade in early. Investors' capacity to bear further capital loss is very limited, naturally curtailing their willingness to be early. The question marks around the long-term impact of all the emergency fiscal and monetary policy action undertaken will also curtail any tendency to jump into markets at the first anecdotal signs of recovery. Investors will, I think, be in more of a "show me" mode, wanting to see clear sign of the economy recovering before they believe. The first green shoots of an economic recovery will most likely be treated with scepticism, rather than embraced as in more normal economic cycles.

The current rally, to the extent that it holds, seems to be more a normalisation of expectations and a pull back from extreme oversold conditions. Investors had gotten too bearish and priced in total collapse and nationalisation of critical financial institutions. Rumours were rampant of even senior debt holders having to take hair cuts on financial institution bonds. The Obama administration had also started losing credibility due to a continuing lack of concrete details around the toxic assets plan, and sentiment indicators were in panic territory. Some of the more extreme bearish outcomes for the banks now no longer seem on the table and we are getting more details around the Geithner plan.

While it is true that a series of economic data coming out of the US has surprised — with at least six or seven data points being better than expected, from the Philly Fed survey to new housing starts and new house sales etc —is this a case of expectations being too negative or a sustainable bottoming of the data? This is still a moot point.

Emerging markets seem to have clearly begun a new cycle of at least relative outperformance vis-à-vis the OECD markets, and this will hopefully extend to India as well, after our elections.

Even if this current rally is sustainable, it is unlikely that the markets just gallop away. We may at best have tested how low markets will go in this cycle. Given the type and extent of economic, financial and psychological damage sustained, the markets will give you numerous opportunities to enter. One of the lessons of structural bear markets is that they tend to tire you out, lasting for years. It would seem foolhardy to chase markets at this stage, given too much is uncertain even now.

## **Zeroing In On the Big Picture**

March 13, 2009

Focus on India's long-term potential can offset weak governance and sinking confidence in this time of crisis.

I had the privilege of attending a handful of India conferences over the past couple of weeks both in India and Singapore. There were numerous macro and lateral speakers present at these forums, with the likes of Omkar Goswami, Gurcharan Das, Dr Sanjaya Baru and Shekhar Gupta all discussing their views on elections, reform and economics.

The speakers were all convinced that India would grow at least 5 per cent in 2009-10, and that we would pretty quickly come back on a 7 per cent growth trajectory. While most acknowledged that it will be difficult to come back to 9 per cent growth, 7 per cent was seen as the long-term trend for India. Demographics, rising consumption, surging infrastructure spends and improving domestic productivity were all cited as the reasons why a 7 per cent trend growth rate was realistic. The basic point was, a savings rate of 29-30 per cent can support 7 per cent growth with little need for external capital flows.

I also got a sense that most speakers felt that the assembled investors were too negative on the country and its growth outlook. One of the speakers, when responding to a question on the rising fiscal deficit and poor governance, pointed out that these issues had always existed in India and that we had grown at over 6 per cent for 20 years despite this. Why should it be different going forward?

Another pointed out that economic policymaking had been by and large stable despite numerous government changes, when responding to investor worries about the upcoming elections. His point was, India will grow and has always grown despite the government.

Another speaker could not understand the doom and gloom when more than half the country (rural India) is doing just fine, and is out there spending. This rural demand is a huge stabilizing influence which few other countries have.

Now when one sits down to think about it, maybe the speakers do have a point. If India can grow at 5 per cent even in 2009, when the global economy will actually contract and trade flows decline; that is some achievement. If the speakers are right and we quickly re-accelerate back to 7 per cent then that will also be credible as most of the OECD and many other emerging markets linked to western consumption are unlikely to get back to their normalized growth rates in a hurry. There is also a feeling that in the new world of lower OECD consumerism, trend growth rates across economies are at a lower base level. Given the above, shouldn't India with its 7 per cent growth be a very attractive investment destination? Should not the country look very attractive to investors?

Yet investors seem clearly unconvinced, India has declined more than most markets in this downturn, and most investors one talks to are underweight on India. There also seems to be no urgency to put money back into the country. Investors seem happy to bide their time.

What accounts for this disconnect? Firstly very few investors are taking a long-term view on anything right now. Survival is topmost on everyone's mind and no-one can afford the luxury of being too early. The genuine long-term real money folks have liquidity issues, and thus are unable to invest in a serious way either.

Secondly, there is a very strong feeling among investors that we have blown a golden opportunity to correct many of the structural issues afflicting our economy. We had five years of 9 per cent GDP growth and a period where-in tax revenues were extraordinarily buoyant, yet we are exiting the 2009 financial year with a fiscal deficit of 12.5 per cent of GDP, the highest ever. The buoyant tax revenues have been frittered away in populist handouts and non-targeted subsidies. The incoming government will have to take some serious policy action, some hard choices will have to be made. There is great discomfort and disbelief in any Indian government being able to take the hard measures required to get our fiscal house in order. Without the fiscal coming into control, nobody believes that 7 per cent trend growth rates are sustainable.

Third, unlike most of the macro commentators who tried to make the case that governments do not matter, investors don't buy that thesis and, in fact, are extremely worried on the outlook for elections. The thinking goes that if the outgoing UPA government (with many serious reformers in positions of power) was unable to do much in the past five years, what will a new coalition do? The UPA was unable to do anything because of the constraints of the coalition. When they had serious believers in reform but still could do nothing, why won't the next coalition be even worse? The fragmentation of our polity seems designed to ensure inaction on the hard economic issues facing the country.

Also the current economic crisis has brought to the forefront the importance of government action and initiative. While governments and their policies may not matter much in a strong global growth environment, today, in the worst global recession most of us have ever seen, government policy action and initiative are both critical. With perceived weak economic governance, India does not inspire confidence.

The fourth factor is the inability even today to find a huge number of ideas which are trading very cheap. The large-cap high-quality companies are not yet dirt-cheap, with a few exceptions. One may argue that things don't look cheap because everyone is looking at only the downsides, and are not factoring in anything positive. That is, however, the way it is going to be for some time, as investors are still trying to recover from the shock of being down 50 per cent-plus on their portfolio.

Thus it is all about confidence, and how we make investors once again focus on India's long-term potential. How do we get investors to pay for growth again?

India has two choices. We can either wait for global markets to turn, in which case as money returns to emerging markets, India will also get its share. 'A rising tide lifts all boats' type of scenario.

n We can move ahead on reform and recreate excitement around the country. Get investors and market participants to feel once again that the country is on the move, and that economic policymaking is back on the agenda. If investors start believing in the growth potential of the country again, then they will be willing to pay for this growth.

Unfortunately, the current despondent mood among investors seems to indicate that we have very little chance of getting a government that can actually reform, and are going to have to go with a rising-tide-lifting-all-boats scenario. A pity, as we had a real chance of breaking out in this time of global crisis.

The hopeful view is that, as usual, the consensus of investors will be wrong, and we will be positively surprised by the new government.

**Crunch Time**  
February 27, 2009

India has a better chance of growing independent of the West than any other country in Asia.

The Chinese word for crisis is a combination of the words for danger and opportunity, and both apply to India at this juncture. If we do not get our act together on the economic reform front, the economy has a real danger of slipping into a multi-year slowdown. On the other hand, the global economic meltdown is also a real opportunity for India to differentiate itself from the export-driven Asian growth model.

The danger is apparent: Despite five years of 8.5 per cent economic growth and buoyant tax revenues, our fiscal situation is precarious. We will have a combined fiscal deficit of nearly 12 per cent of GDP in 2009, the highest on record. The government's own estimates suggest that this will only drop to 10-10.5 per cent in 2010, despite assuming benign commodity prices. God forbid if commodities spike again, in which case 2010 may be even worse.

Why worry about the fiscal at a time like this, you may ask? Isn't the whole world going overboard in spending, why then should we be left behind?

The problem is that such a high fiscal deficit makes us vulnerable and dependent on foreign capital flows to sustain our growth and infrastructure investment. Our deficit is also far more structural in nature, and such huge spending gives very little stimulus, if any, to the suffering sectors of the economy.

The much-heralded surge in savings in India from 27-28 per cent in 2003 to 35 per cent last year, was largely brought about because of the improvement in corporate savings which almost doubled (as a percentage of GDP) and a reversal from dis-saving to saving by the government sector — in the initial years of the UPA government the fisc was in control. We did not actually get much improvement in household savings. With the deterioration in the fiscal situation, the government will be back in a dis-saving mode, and even on the corporate front, savings will be less than half of last year's as profits cave in. Thus from a savings rate of 35 per cent, we will be lucky to hit 27-28 per cent in the coming year, and therefore investment rates will drop from 37-38 per cent to something under 30 per cent. This will be a real drag on growth and capital formation.

With such a huge fiscal deterioration, we will also have a crowding-out problem, with the net GoI borrowing requirement for this year crossing Rs 300,000 crore (even after netting off the MSS bonds). In a year when corporate credit demand is weak, this type of borrowing requirement may get filled with domestic savings, but as soon as economic activity picks up, domestic savings will not be able to meet the growth needs of corporate India as well as finance, surging government expenditure. There is no way that interest rates can be kept at reasonable levels if we need to finance a 12 per cent fiscal deficit and finance 8 per cent GDP growth in the absence of large foreign inflows of capital. Large chunks of corporate India moved their financing offshore in recent years, most of which will now come back onshore for refinancing. If interest rates spike, it again constrains growth, investment and corporate profitability.

The other issue is of course our infrastructure deficit. The government has tried to take the route of PPP to attract private capital to supplement its own lack of resources. With such a large fiscal deficit, there is no money available to put into infrastructure, and now very little risk capital available globally to come in and fill the breach. We still have policy issues in many areas of infrastructure which has prevented PPP from taking off,

but independent of these policy disputes, there is no way that the country can attract anywhere near the hoped-for private capital flows to meet the plan targets. In the absence of infrastructure investment, how will growth sustain?

The reality is that a huge fiscal deficit makes India very dependent on private foreign capital flows to finance our corporate sector and infrastructure. In the absence of strong capital inflows we will be unable to advance at the rates of growth the country now expects.

At a time when we are very dependent on capital inflows, the global environment has turned very hostile to risk capital. There is system-wide de-leveraging ongoing in the global financial system, and equity and debt flows are constrained. Very few sources of long-term capital have liquidity currently or, alternatively, wish to take risk. As banking systems across the OECD head for quasi-nationalisation, capital will tend to get pulled back into the home country.

We have to recognise that India has no God-given right to receive billions in capital; we have to make our policy framework attractive to capital, and build confidence in global financial investors that the country means business. We have to be able to convince long-term investors that we can take the hard economic decisions which are needed to sustain our long-term growth. We will have to compete for the limited capital which is available with many other attractive emerging markets. Global investors have to once again get excited about our structural growth rates and ignore the macro-vulnerabilities. I sometimes think we are too complacent, we feel investors have to be in India: While partly true for FDI, there is no such compulsion for financial capital. No investor has to be in India. Investors will only go where they see returns.

The only way to tackle the structural fiscal deficit issue is either to aggressively target our expenditure and subsidies or undertake significant disinvestment and creatively sell government assets like spectrum. In the absence of these moves we will be stuck with a double-digit deficit, high interest rates, poor infrastructure and a potential sovereign credit downgrade. We could easily spin into a negative loop, with the poor fiscal causing a credit downgrade, which would further spook investors, reduce capital inflows, lower growth, spike rates —and the cycle would feed on itself. The only way to tackle the structural fiscal deficit issue is either to aggressively target our expenditure and subsidies or undertake significant disinvestment and creatively sell government assets like spectrum. In the absence of these moves we will be stuck with a double-digit deficit, high interest rates, poor infrastructure and a potential sovereign credit downgrade. We could easily spin into a negative loop, with the poor fiscal causing a credit downgrade, which would further spook investors, reduce capital inflows, lower growth, spike rates —and the cycle would feed on itself.

However, lest I sound too pessimistic, all is not lost. If the new government moves ahead decisively to tackle the fiscal and delivers on second generation reforms in areas of education, labour policy, financial system etc, then we can regain investor confidence and claim our rightful share of global capital flows.

India is actually very well-positioned for the new post-US consumption world. We are a large economy with very little dependence on exports. Consumption is about 65 per cent

of the economy, our demographics suggest it will remain strong. Our banking system is solvent. Capital investment will lead to huge productivity gains. We have good entrepreneurs and as the government share of the economy falls, there are huge growth opportunities in the domestic market. We do not need a growth model change like in China, which has to move away from exports/capital investment and towards consumption as its growth driver.

India should actually attract a lot of investor interest in today's world, where the less globalised an economy, the better is its outlook. If our government can deliver on second generation reforms and tackle our structural deficit issues then we can be the toast of the investment world. Ironically, the more effective we are in reducing our dependence on foreign capital inflows, the more likely we are to attract these same flows.

India is unique in that our fate lies to a large extent in our own hands. There is enough slack in the system that good policy can make a huge difference to productivity and growth. If we deliver economic reform and strong economic policymaking, we can grow rapidly and attract investor attention. We are not as dependent on a US bail-out or recovery as most of Asia. We have a better chance of being able to grow independent of the West than any other country in Asia.

We once again have a chance to really stand out and differentiate ourselves. Will we take this opportunity?

## **Equities for the Long Term**

February 13, 2009

Just when they look risky, equities may be coming close to a really good long-term entry point.

All of us have always been taught that equities are by far the best long-term investment one can own. They capture the growth and dynamism of the corporate sector and are the best way to participate in economic development. “Buy and hold” has been the prevalent mantra, and that was always seen as the best way to maximise long-term wealth creation. However, looking at data over the recent past one can be forgiven for being sceptical and questioning the logic of the “buy and hold” investment style.

The MSCI global equity index today (as of end-December 2008) is no higher than it was in early 1997, and in real terms (inflation-adjusted) it is astonishingly back to the levels of 1973. When one thinks about it, it is truly amazing that the global equity markets have shown no rise in real terms for over 35 years. The above numbers only look at returns for global equities without considering dividends (only capital appreciation assuming no dividends), and on that data equities have massively underperformed for decades. If we look at total returns — which include dividends and capital appreciation (assuming that all dividends were reinvested) — then equities have done a little better, underperforming from the mid-1990s.

Looking at total equity returns in comparison with bonds and cash also throws up some disturbing results. Investors would have been better-off holding a diversified basket of global government bonds than equities since 1970 and even cash has done better than global equities since 1987. On a risk-adjusted basis, the results have been even worse, for global government bonds have been able to deliver superior absolute returns with far lower risk, not to speak of zero-risk cash outperforming equities.

These are obviously horrible results for anyone who believed in buying global equities for the long term and adopted a passive “buy and hold” strategy. One could have obviously done much better if you had been able to time the ups and downs in the markets, and entered and exited in time, or were able to buy the right countries and stocks, but most large long-term investors tend to adopt a more passive approach. This comparison data is for the MSCI global equity index, and one should not forget that the majority of active managers actually fail to consistently beat the relevant indices, and so chances are that any manager you had employed to manage a global pool of equity assets would have done even worse than the above data.

It is surprising that one has not seen more coverage and debate on the poor returns delivered by global equities over the last decade. Confidence in equities as the best place to park your long-term savings has got to have been shaken. Having just experienced two severe bear markets this decade alone, investors must be questioning their asset allocation towards equities. We run the risk that investors get disillusioned and use any strength in markets to lighten up on their equity exposures. Such behaviour, were it to come to pass, would set a ceiling on the equity markets for the short term at least, as any strength in the markets will be met by selling by investors looking to allocate out of equities.

A lot of the asset allocation policies adopted by many of the real money long-term investors must also be now under question. These policies are based on the framework that over the long term, equities always deliver the highest absolute returns. Most such strong hands, be they foundations, family offices or sovereign wealth funds, must now be questioning their long-term equity allocation. Most have upwards of 50 per cent in equities, and given the poor performance of equities vis-a-vis bonds, this number must be under debate. Also given the beating many of these institutions have taken over the last year, they must be anyway in a mode to curtail their risk appetite. I am not sure these institutions were set up to be able to handle the type of volatility and synchronized draw downs that we saw in 2008. Could we see a wave of rebalancing coming up from these strong hands? If we do, that is a real problem, for there are no other strong hands in prospect which could absorb these flows.

This poor performance also highlights the continued importance of dividends in establishing a reasonable return profile for equities. For the first time in 50 years, dividend yields had risen above bond yields (for a short period), potentially highlighting a behavioral shift where investors seek the safety of dividend payments over capital gains.

All of the above obviously point to the risks we see if investors start questioning the long-held assumption of equity being the highest returning asset class. However, the horrendous performance of equities over the last two decades also may point to us coming to a really attractive long-term entry point for global equities vis-a-vis government bonds and cash.

G-secs globally look totally overpriced, and interest rates are at all-time lows. The world will not be in a deflationary bust environment forever. Yields and interest rates will have to normalize at some stage, as the world's central banks cannot hold short-term interest rates at zero for extended periods. These assets are being bid up by a flight to safety, and on a relative basis equities have never been cheaper. Even on an absolute valuation basis, long-term measure like the Graham and Dodd PE and Tobin's Q indicate that equities are cheap, much cheaper than they have been in the last two decades. All these valuation metrics have normalized and are at their long-term averages, but still need the markets to fall by another 15 per cent to reach typical bear market bottom type of valuations.

Equities have been a horrible place to be over the last two decades, and will inevitably put pressure on investors to forsake the "buy and hold" approach. However, just when investors begin to question the place and weightage of equities in their long-term asset allocation, we may be coming close to a really good long-term entry point for investors who wish to capture a serious upside over the coming decade (at the minimum, on a relative basis at least).

## Are Indian Markets Cheap?

### Markets are cheap but not yet distressed

January 23, 2009

India has not yet reached a stage of extreme price attractiveness - markets are cheap, but not yet distressed.

Most external observers can be forgiven for automatically assuming that Indian equities must be dirt cheap and at all-time valuation lows. After all, the markets are down by more than 50 per cent in 2008, and if you look at midcap indices the drawdown is over 70 per cent. With such price destruction how can companies not be historically cheap? After all, the Indian economy is still growing at 6 per cent and we do not have the excess leverage issues of the West.

The reality, however, is that for most money managers they are still not finding distress values in the equity markets, especially in the higher-quality and large companies. This is not yet 2003, when the markets really looked cheap, pretty much across the market cap spectrum.

There are pockets of really cheap valuations in India, among the midcaps for example, or in certain sectors, but it is difficult to come up with a list of stocks where you have high absolute conviction in the valuations and where you can deploy very large chunks of capital.

Take a look at the valuations from a numerical perspective.

- India's absolute valuations are near historical lows using earnings-based metrics, though not on dividend- and price/book-based measures. The Morgan Stanley composite valuation indicator is at its third lowest level ever, with the market being cheaper only in September 2001 and November 1998. MSCI India PE is the lowest it has ever been.
- Broader measures of value such as market cap/GDP have also normalized, with the ratio dropping from 160 per cent at the peak to near 60 per cent today. However, at 60 per cent we are only at the world average and still the highest among the BRIC countries.
- On any interest rate-based valuation measure like the bond/equity yield gap, India has never been cheaper. The moot point here is, of course, the sustainability of these bond yields. Can a country with a fiscal deficit of 10 per cent of GDP and in today's constrained global capital flows environment have G-Sec yields below 6 per cent? Like any relative valuation measure, these interest rate valuation tools suffer from the problem that they can seem cheap because they are being compared against something overvalued. In this case equities look cheap because bonds are overvalued.
- Relative to other emerging markets (EMs), India is now no longer the most expensive market in the EM world, an honour it held for most of 2006 and 2007. Having said that, we are still in the upper third of markets ranked by valuation, still far away from 2003

(when the last bull market began), when Indian markets were trading at a discount to the rest of the EM universe.

There are, however, a couple of issues with the valuation measures discussed above. All the earnings-based measures suffer from the problem that earnings are coming off a huge surge in the past five years. As Morgan Stanley points out, the BSE Sensex constituents have grown earnings fivefold in the past five years. The earnings quality has also deteriorated, in terms of percentage other income, cash flow conversion etc. There is also tremendous uncertainty on the earnings outlook for 2009-10. Thus investors are uncomfortable using earnings-based valuation tools as there are worries on what is the real earnings power of companies. I am not talking about fraud here but simply the fact that earnings have risen as a percentage of GDP, and as is typical in strong economic cycles, companies have potentially over-earned compared to the sustainable profitability of their underlying business model. If companies have over-earned in the past few years how does one adjust for this? Over the last few years, we had a virtuous cycle of rising capacity utilization, falling rates, significant pricing power, easy access to capital and surging growth rates. All this combined to supercharge earnings and capital efficiency ratios. Unfortunately most of these factors are now in reverse, with the inevitable consequence on earnings. Investors are beginning to realize that in many companies earnings are far more cyclical than they had realized. Strong economic growth can disguise inherent cyclical, and once exposed, cyclical earnings attract lower multiples. Many supposedly secular growth stories will be exposed as cyclicals which benefited from the huge tailwind that India had over the last five years.

Post Satyam, one also gets the feeling that promoters will be more careful about balance sheets and earnings statements. I would not be surprised to see a slew of write-offs and other adjustments as auditors get tougher and force more disclosures and tighter standards. With the markets being in a bear phase, there is also every incentive for companies to clean up their books and take all write-offs etc, as unlike in a bull market, supernormal earnings will only attract scrutiny and suspicion.

If one were to move away from earnings-based models then the two most commonly used measures — dividend yield and price/book — while screening to be cheap, are not near all-time lows. In both cases the markets will have to drop by about 25-30 per cent to get there.

Thus while the market may be near all-time lows on earnings- and interest rate-based valuation models, investors are not convinced on the sustainability of current yields or earnings, and on non-earnings-based valuation tools the market is not yet at distress levels. On a stock-specific level where there is clarity on earnings, valuations are not cheap, and those stocks looking cheap have absolutely no earnings visibility. All you need is one bad quarter for erstwhile cheap stocks to suddenly start looking expensive.

Another similar issue as to why investors are nervous about buying today is the sheer scale of economic volatility. One has never seen the economic assumptions on which one has based a buying decision turn so dramatically and so quickly. If, for example, one had bought an auto ancillary, you would never have modelled that truck sales in India would decline by 60 per cent in this quarter or that car sales in the US would go to mid-1980s' levels. Almost no one would build in such scenarios. Thus there is unparalleled

uncertainty on the future course of earnings, and investors want to build in the worst they can imagine and then want stocks to be cheap off those worst case assumptions.

We are coming off a huge bull cycle in 2003-2007. Given the quantum of stock price appreciation, it is logical that the markets will only bottom out with time and when they appear very-very cheap. India has probably not yet reached that stage of extreme price attractiveness — the markets are cheap, yes, but not yet distressed

With the passage of time as we get more comfortable with the economic outlook, one may need less margin of safety on earnings and have a greater willingness to pay up for growth. Investors have to be willing to extend their time horizons again and not become obsessed with the next quarter. For that we need the elections out of the way, and some semblance of normality globally.

## India's Enron

January 9, 2009

The Satyam saga will go down as the worst episode of corporate governance failure in India.

The saga of Satyam Computers will go down as the worst episode of corporate governance failure in corporate India. The fraud which is in excess of Rs 7,000 crore, is unfortunately of a truly global scale. Post the aborted merger with Maytas, many had suspected that Ramalinga Raju and family were heavily leveraged at a personal level, stuck in property and thus needed a bail-out. Nobody, however, I think suspected that Satyam itself was a fraud, with no cash and a non-existent margin structure. Raju's letter implies that the company is basically unprofitable at a net level, and made no money over the last few years. How can Satyam, with 50,000 employees and global scale, make no money at all, when even mid-tier mediocre IT companies make at least 10 per cent operating margins? How can this fraud be going on for years? How can the auditors not have confirmed cash balances, and that too of Rs 5,000 crore? Cash is supposed to be real, profit an accounting fiction, but here the cash itself was fraudulent. Raju goes on to state that he was going to merge Maytas Infra and his privately-held property company to bail out Satyam, and not use Satyam's cash to bail himself out (as assumed by most who opposed the merger). Raju also writes that he pledged all his shares to raise cash to pump into Satyam, to keep the charade going.

While the truth will eventually come out, I still find it difficult to believe that Satyam actually makes no money, even though the revenues, clients and employees are real. How is it that a company with a scale of 50,000 employees, which pays employees industry standard wages and has billing rates comparable to industry standards, makes no money when TCS, Infosys and Wipro make 25-30 per cent operating margins? Even mid-tier companies with only 5,000 employees make 10-15 per cent margins. If Satyam really makes no money, what accounts for the margin leakage? Where are its costs out of line? Is money being sucked out of the company? Was Raju really willing to shortchange himself and family to bail out a company in which he had no more than an 8 per cent stake (as he claims he wanted to do by merging Maytas)? I suspect Raju's letter may not be the last word in this saga.

While this sad episode will obviously raise doubts on India Inc and have damaged the country's reputation, I do not believe the damage is permanent. Tragic episodes like this do happen, and this in no way dampens the IT or India growth story. Every boom/bust cycle invariably exposes weak players and Satyam will not be the last fraud we see in this country. The shock is, however, magnified both due to the scale and because it has claimed a top 5 player in the IT sector, a sector which has been the poster child of a more progressive and investor friendly corporate India.

Post Enron in the US, we saw a slew of regulations culminating in the Sarbanes-Oxley Act. In India, we have by and large adequate laws and disclosure standards, though we can improve disclosure in areas like promoters-pledged shares or detailing the bank accounts where the company's cash is parked. Our framework of a majority of

independent directors, minimum frequency of board meetings, shareholder approval needed for major decisions etc is of global standards. We also force our CEO and CFO to certify the accuracy of the published accounts. We can tinker with new disclosures but it is unlikely to make much difference. Satyam after all reported its results in Indian GAAP, IFRS and US GAAP, and even gave audited half-yearly statements. With a US listing it was also under the jurisdiction of the SEC, but none of this made any difference.

We now need to ensure that the guilty are brought to book and we see a swift and coordinated regulatory response. In the case of Enron in the US, the guilty were tried within three years — we cannot allow a 20-year litigation cycle (like the 1992 scam) in this case. We must quickly investigate, find out the truth, and then move against all the actors in this fraud. The company and Raju cannot have single-handedly pulled off a fraud of this magnitude and duration. Bankers, auditors and the finance function in Satyam will all be involved in some form or fashion. At the least they can be accused of incompetence. Investigation and action must be directed at all these service providers. It is especially critical that the sanctity of the independent audit process be maintained. The CA institute has to tighten standards and move against proven incompetence.

The only way to win back investor confidence is for justice to be done quickly and the punishment be severe enough to instill fear and disincentivise corporate fraud. In the case of Enron both the company and its auditors (Arthur Anderson) went out of business.

The ultimate defense against poor governance is the market itself. It was well-known that Satyam had a suspiciously high and growing current account balance, as well as nearly Rs 400 crore interest accrued but not received on deposits. Why will a company keep Rs 2,000 crore in a current account? Why will the bank not credit interest to a deposit for multiple quarters? While investors can legitimately claim that they were relying on a Price Waterhouse-signed balance sheet, one of the lessons of the sub-prime debacle is that investors cannot rely blindly on external service providers.

Investors should exercise proper due diligence, and not allocate capital to companies with poor disclosure or governance practices. Investors cannot allow large companies to have unknown auditors, or rubber-stamp boards and must force them to split the CEO/chairman role in substance. If investors refuse to back poor managements, you will see large valuation gaps for companies in the same industries. If poor governance attracts poor valuations, it will incentivise shareholder-friendly behaviour and marginalize companies with weak corporate governance. Investor memory also cannot be short, poor governance has to attract a permanent de-rating.

This episode should further galvanise shareholder activism in India, with the HIRCO and GACL episodes being the first signs of greater shareholder organization and participation. We must see a greater market for corporate control in India. Investors must be willing to throw out poorly performing managements and boards, especially in companies where institutional investors have a higher stake than the erstwhile promoter group. Only when poor governance practices lead to poor valuations and hence vulnerability to takeover, will the economic incentives be aligned to prevent a recurrence of Satyam.