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## **Tough Times Ahead?**

December 24, 2010

As we close out the last few trading days of 2010, it is time to turn our attention to 2011. The year 2010 was a decent year for the markets with most broad indices up between 12 and 15 per cent, in line with the long-term trend rate of market appreciation.

I, however, have a sense that 2011 will be a lot more difficult, at least in the first half of the year.

First of all, I believe that the Indian economy will slow in calendar 2011 and not accelerate further as many believe. A combination of the base effect and law of large numbers, the lagged impact of RBI tightening, regulatory cholesterol blocking project implementation, withering international competitiveness and a slowdown in decision-making across the government complex, will all combine to slow down the economy. Already the first signs of demand moderation are being seen and discussed. The talk of the Indian economy hitting a growth rate of 10 per cent is, to my mind, fanciful in the absence of some long-pending reforms. In reality, I don't believe the Indian economy, as structured today with our fiscal, governance and infrastructure deficits, can grow much beyond 8-8.5 per cent, without the wheels starting to fall off. We need reforms in governance, the fiscal, quality of government expenditure, skill building, project implementation etc to raise our trend rate of growth, but unfortunately there seems to be no visibility of movement on any of these fronts. There is also a non-trivial probability of a serious spike in the commodity complex, especially oil, which would force RBI to aggressively hike rates and further ingrain inflationary tendencies into our psyche. Already the inflation issue in India is threatening to become structural in nature, being very sticky on the way down. Further tightening of financial conditions will only cement the outlook for a slower growth trajectory in 2011 than the current consensus expectation.

Combined with a slower growth outlook, I think corporate profit margins will be under pressure in 2011. Higher commodity prices, rising cost of debt, surging wages and increased competitive intensity across sectors will combine to put margins under downward pressure. Historically, corporate India has protected itself from surging commodity prices, through high top line growth and the ability to leverage fixed costs through operating leverage. With a slower macro backdrop and huge cost push on fixed costs, this operating leverage dynamic is unlikely to play out in 2011. Thus, earnings growth, much beyond 15-18 per cent for the broad market in 2011 looks tough. Once again, stocks levered to consumption seem best positioned to deliver on earnings growth, with the investment cycle likely to continue to disappoint.

In terms of flows, I feel there is a real possibility that the developed markets, particularly the US, will outperform the EM markets for a period, especially the first half of 2011. Most economic commentators have revised upwards their growth outlook for the US, and many top-quality blue chips in the US trade at far more reasonable valuations than their EM counterparts. It is not inconceivable that some capital may flow back into the US. While there is still considerable debate about the sustainability of the US growth outlook, many investors will take a short-term view to play the expected growth acceleration in 2011, before re-assessing their longer-term outlook for the US. With global growth

accelerating, EM flows into Asia will also be more North Asia-centric, and India's perceived domestic demand drivers less attractive from a relative perspective. I don't think portfolio flows will be negative, but are unlikely to hit \$30-billion run rate again, especially in the first half of the year.

I also feel that our markets will find it difficult to hold current PE multiples. With interest rates rising, earnings and growth below current consensus, and flows not particularly strong, multiple compression is far more likely than expansion. All our recent scam-related adventures are also going to have an impact on PE multiples. We simply cannot have the highest multiples in the EM universe, with the type of governance and institutional corrosion displayed over the last few months. We are also as an economy far too leveraged to global financial conditions and risk appetite, when the going is good all is fine, but in a global shock we are very vulnerable. Being so pro-cyclical an economy also argues against elevated valuation multiples.

Thus, taking all of the above, the markets will probably still deliver positive returns, but multiple compression combined with slower earnings growth will force returns to be quite modest. I think in a low-return environment, stock-picking will again come to the fore as stock-specific performance will vary considerably, and all boats will not rise. Expect the current focus on high quality and high returns on capital business to continue.

What could change this outlook? First of all, the US economy could disappoint in 2011, longer-term structural issues drowning out any short-term stimulus-driven rebound. In such a situation, the EM carry trade will come back on, capital will flow out of US equities and India will be a major beneficiary, just like 2010.

If global growth disappoints, commodities may not spike and the extreme pressure on Indian earnings, macro and inflation will subside.

The government may also surprise us and actually push through some fundamental reform. The Budget will be a test case of this. As of now, no investor believes the government has any chance of meeting its outlined long-term fiscal and public debt targets. In the absence of GST, no movement on food/fuel/fertilizer subsidies and no signs of expenditure reform or targeting, the numbers do not add up. If the finance minister can deliver on some of these issues, that can be a trigger to re-rate markets. Another trigger could be some positive outcomes coming out of all the scam-related investigations. Judicial reform, greater accountability and measures to strengthen institutions are all steps which would enthuse the market and give investors greater confidence on the sustainability of our growth trajectory and thus allow PE multiples to expand.

I think there is too much complacency in India, we are told that 9 per cent growth will take care of everything from the fiscal (through tax buoyancy) to the current account (by attracting capital flows), to greater inclusion, but are we taking the steps needed to hit this 9 per cent number? What happens if we slip back to 7 per cent growth (still a good number)? How will the fiscal and current account be financed then? Our leverage to growth and international capital flows is sometimes underestimated in my view.

The year 2011 looks to be a year of consolidation, the economy, corporate houses and policymakers will all get some breathing space to build on the next phase of growth. It is not necessarily a bad thing to have a year of slightly slower growth to build capacity, optimize organizations and let infrastructure catch up to surging demand. To ensure that this is only the pause that refreshes and not a permanent slowdown, concrete action is needed by policymakers across a whole spectrum of policy issues. Hopefully, we will seize the initiative. The consequences of not doing so are dire indeed.

## Why Are Our Markets Underperforming?

December 10, 2010

The outlook for global equities has been uncertain the past few weeks, with serious concerns around European sovereign contagion and insider-trading allegations. However, the developed markets (DMs) now seem to have begun a cycle of outperformance vis-a-vis their emerging market (EM) counterparts. Most economic commentators are revising upwards their global growth outlook for 2011 and 2012, driven by higher expected growth in the US and the OECD. Many leading economists now expect the US economy to exit 2011 on a growth trajectory greater than 4 per cent (above the trend rate of US growth) and maintain this rate in 2012.

The growth gap between the EM and DM worlds is expected to narrow both in 2011 and 2012, as the EM economies consolidate. The inflation and liquidity outlook for the DM economies looks to be more benign and better suited to risk asset performance compared to the EM universe. Investor positioning also supports DM outperformance, as going long in emerging markets had become a consensus trade. As investors pull capital back into DM equities, emerging markets will face outflows. In the developed markets, many institutions will also complete long-pending rebalancing between debt and equity allocations, with money moving towards equities. As interest rates on bonds in the US rise in response to an improving growth outlook, the EM carry trade will lose attractiveness.

While this phase of developed market outperformance will continue for some time (a few months, maybe even a year), at some stage, the structural fiscal and financial leverage problems of the developed economies will come back to haunt them. The emerging economies will also eventually tackle their inflationary pressures either through appreciating currencies or rising rates. Once both these dynamics are in place, the EM world should recommence its economic and financial market outperformance.

However, within the EM world, India has begun to underperform quite noticeably. There are various reasons for this:

First of all, with the expectation of a strong and more balanced global growth, global commodities are expected to perform well in 2011. Easy liquidity has combined with improving economic fundamentals to drive crude prices above \$90 per barrel. Many of the best commodity strategists are already calling for crude prices to cross \$100 in 2011. Rising commodity prices, especially crude, are a clear negative for Indian equities. We get hurt through rising inflation, an expansion of the current account deficit and a blowing out of the fiscal. With inflation still near double-digit levels, we have no capacity to handle a commodity spike, at either a micro (corporate earnings) or macro level.

Second, the series of scams has obviously not helped. In many global investors' minds, the media in India is now seen to be severely compromised, crony capitalism rampant, the system of checks and balances non-operational, and there is general amazement as to how the government functions. The dismal level of execution, lack of policy vision and general poor governance, have been exposed for all to see. Not all of these perceptions are fair or accurate. However, many investors cannot understand how India can command

the highest multiples in the entire EM universe, with this quality of governance and policy formulation. The cynical view among most investors is also that nothing much will change, and government will not alter its style of functioning.

The third fear of investors is around the macro. Local liquidity conditions seem very tight, banks are hiking rates and this will have an impact on growth. Rising interest rates and falling growth are normally toxic for valuation multiples. The current account is seen as also being vulnerable given the quantum of the deficit and the composition of how it is financed. The European sovereign crisis serves as a stark reminder to investors of how macro imbalances can damage markets. Investors worry about the lack of reforms and the Budget for 2011-12. How will the government meet its fiscal targets? GST seems to be seriously delayed, the DTC a shadow of its original version in terms of removing exemptions and broadening the tax base, and no rationalization or better targeting of fuel, fertiliser and food subsidies in sight. The government also seems unable to control spending, with a slew of new and modified social sector schemes on the agenda. We were able to meet our 2010-11 fiscal targets due to the 3G and PSU disinvestment bonanza, no such windfall seems to be in sight for 2011-12. With fiscal slippage, the issues of crowding out of private sector investment, falling national savings rates and sticky interest rates all come back on the table.

Investors are also worried about policy risk around projects and investments. The number of high-profile projects caught in land and environmental issues is amazing. What were the previous operating procedures of this ministry, if most large projects are now shown to have violated environmental guidelines? Will this not impact project completion, and ultimately economic growth? As another example of policy risk, what about financial investors in stock exchanges? Suddenly they find that their investments may have no listing and a cap on profitability, a sure recipe for capital loss. A lack of predictability around policies and their implementation is a cause for worry.

From a micro perspective, the earnings season for Q2 was a slight disappointment, with no earnings upgrades. Many strategists have, in fact, cut their earnings estimates, as can be seen from the consensus numbers. A market like India, given the premium valuations at which it trades, cannot afford to have earnings downgrades. To sustain its multiples, earnings have to continually beat expectations, and estimates have to keep rising. This upwards revision cycle seems to have been temporarily short-circuited.

The markets also seem to be going through a cleansing process. After the Money Matters scam, many speculative positions have been squared up, market operators forced to liquidate and Sebi has seemingly been very active in pursuing stock price manipulation. Mid-cap stocks have been decimated and stock-specific risks never higher as SEBI seems to have succeeded in scaring many corporate houses and getting them in line. All this is very healthy for the markets but will cause pain in the short term.

India will go through a period of relative underperformance until some of these issues get sorted out. Ultimately we are a resilient democracy and we will find our way through most of these problems. We will find our own unique way to bring in the required changes and the government will eventually realize that you cannot get 9 per cent growth without serious reforms in policy and government functioning. Bihar has shown politicians once again that people are hungry for governance and growth. India is a huge

leveraged bet on economic growth. Without 8-9 per cent growth, we will not have the tax revenues or international capital flows to finance the fiscal and current account deficits. We frankly have to make the changes, for we need international capital to be able to grow at the rates we aspire to. International capital will shy away till we make India once again a predictable and hospitable place for investing.

## **Back to Basics**

November 26, 2010

The market may be choppy and outlook uncertain, but EM and Indian equities should do fine

This is obviously a very confusing and difficult investment environment. You have a seemingly never-ending European sovereign crisis, with contagion moving from Greece to Ireland, and Portugal probably next. Debt restructuring in some form or fashion is inevitable. To this we have to add the madness of North Korea trying to assert its relevance, and the obvious geopolitical implications of the same. Combine the above with the rumours swirling around of a huge insider trading investigation being conducted by the US authorities in which some big names are supposedly involved. China has also tightened far more abruptly than anyone would have imagined. To add to the confusion, after QE2, interest rates have actually moved up, the dollar has strengthened and equity markets have gone down, the exact opposite of the Fed's stated intention, financial conditions in the US have actually tightened rather than easing.

Given all the above and markets whipsawing in a narrow range, investors can be forgiven for sitting on their hands and being confused on the outlook. Most investors I talk to are unhappy, uncomfortable, confused and worried, despite many being ahead of their benchmark. Most talk about this being one of the most difficult investment environments they have ever faced. There is a very wide divergence of views within most organisations and among strategists, adding to the confusion. There are so many things to be worried about: are emerging market (EM) equities in a bubble? Will the US go the Japan way? How will fiscal sustainability be restored in the West? Is China about to explode? Is the euro about to break down?

So many questions, very few answers.

In times like this, it is probably best to step back and re-look at the basics.

The economic outlook for most of the OECD countries seems to be a slow and gradual muddle-through type of scenario. Interest rates will remain low, liquidity plentiful, core inflation subdued and economic growth around 2 per cent, the so-called new normal. It does not look like these economies will go back into a recession, but the recovery is likely to remain modest, the typical pattern after coming through a deep financial crisis.

If we accept the above, then except under the most dire economic scenarios, it looks difficult to see how equities will underperform bonds from here. By buying bonds now, you are basically making a bet that a Japan-style environment of limbo, deflation and no growth will come to pass.

There are numerous blue chip companies which, at current prices, are delivering you a dividend yield higher than government bonds'.

Even very pessimistic scenarios, with conservative assumptions, show global equities over the coming decade delivering at least a 4 per cent per annum return, higher than what you can get in most OECD bond markets. Corporate earnings have held up very well, and there is a huge cash mountain building up in corporate balance sheets. Equity valuations look reasonable and investor sentiment by no means exuberant.

Cash earns nothing today, and its opportunity cost is just too high.

If one accepts that equities are the place to be, then the next obvious question is whether you should be in EM or developed market (DM) equities, and the appropriate allocation. On this question, frankly, DM equities look better placed in the short term. Valuations relative to history are cheaper, sentiment far less positive, liquidity conditions superior and many instances of great franchises with significant EM exposure being valued far more conservatively than their EM counterparts. A short period of DM equities outperforming their EM counterparts can be very much on the cards. However, on a longer term outlook, EM equities should continue to prevail and deliver outperformance. The economic growth differential (6 per cent for EM, 2 per cent for OECD countries) has never been higher or macro-risk lower and even though everyone gets the EM story, and it feels like a consensus trade, most institutions are nowhere near where they want to be in terms of allocations to emerging markets. EM equities are now about 13 per cent of world market cap, with most long-term investment institutions (especially in the US) still closer to 4-5 per cent in terms of their EM exposure. The long-term trend is clear, allocations will rise, large chunks of money will move eastwards and EM equities will trade at a significant premium, all before this cycle ends. Every market correction should attract capital flows as the allocation gap closes. Thus, while in the short term, tactically, EM equities may be a little choppy, their cycle of outperformance is not yet over.

Within the EM universe, India should continue to do well. India's weight within the EM indices will rise over time as its free float continues to increase. India is also not as expensive as is commonly made out to be, if you adjust for sectoral composition. Very few markets can give you reasonable visibility towards delivering a sustained 15 per cent EPS growth, with limited global economic exposure (compared to other large EM economies). In a world starved for growth, India's economic outlook, sustainability, focus on returns and translation of economic growth into corporate earnings stand out. Investors fundamentally believe that governance and execution will improve, and that our politicians will react to the growing public clamour for the government to deliver.

There is significant under-ownership among the domestic investor base and we are nowhere near the excesses of end-2007, either in terms of corporate euphoria or market valuations.

India, however, remains extremely vulnerable to any type of global financial market shock. Case in point being the huge inflows of over \$24 billion year-to-date into Indian equities. Most India-dedicated funds have not seen much of these inflows. Either they have come through ETF's or through asset allocation shifts within investment organisations. The surprising fact is that in most fund manager surveys, India consistently shows up as an underweight, so who is buying? There is a strong sense that many of these flows into India are being parked here for the market beta and can reverse in short order. Thus, while euphoria among the domestic investor base is non-existent, sentiment

internationally towards India cannot be said to be muted, the flows have been too strong. This is a clear short-term risk.

The bottom line is that one should stay invested and not get spooked out of one's equity holdings. The market may be choppy, this correction may continue a while longer and the outlook may be uncertain, but if one goes back to the basics, EM and Indian equities should do fine. Till such time as interest rates begin to rise in the West, the current market cycle and its leaders should continue their relative outperformance.

## Emerging Markets & Liquidity

October 22, 2010

Investors continue to pour money into the EM asset class. Weekly inflows into EM equities funds remain strong with no sign of let up. Just look at India, we have already received \$23 billion of FII inflows, the highest level ever. Coal India has received a great response, with the institutional portion subscribed 15x, FII's scrambling to get an allocation and the money continues to pour in. Investors are rushing to raise weightings in EM stocks, before chairman Bernanke can fully unleash his plans to purchase possibly a trillion dollars worth of long term debt instruments and lower long term interest rates in the U.S. Given how weak the dollar has been, and this is likely to continue, investors seem to be in a desperate hurry to move out of dollar based assets. There is a strong intuitive appeal to this trade, the Fed cuts rates and money rushes into EM equities. Investors chase growth, bid up these markets and it all ends ultimately in one big bubble. This trade is the consensus view of how things will unfold, and most money managers are positioned to benefit from and expect further EM outperformance. It looks like a very crowded and one way trade at the moment.

In this context a recent note by the EM strategy team at BCA, is worth noting as it raises doubts on the inevitability of the above mentioned sequence of events. It asks the very pertinent question of whether a Fed easing always leads to an EM rally.(BCA EMS bulletin dated 19/10).

The note makes the point that in the early 1990's, emerging market share prices were negatively correlated with the Fed funds rate. Low interest rates in the U.S drove capital into the Emerging markets, where growth was stronger, much like today. The EM equities asset class had a huge run, almost bubble like conditions and a long term secular peak was formed in EM equities in 1994-5. This is pretty much what most investors expect to see going forward for EM equities over the coming months.

The note also points out however that from this 1995 peak, till very recently, emerging market equities were actually positively correlated with U.S interest rates. In this period, Emerging Market equities were seen as a call option on global growth, and far more sensitive to global growth expectations than interest rates. EM equities actually did better in an environment of rising U.S rates, as hikes in Fed fund rates reflected strong global growth conditions. Any weakness in global growth actually impacted EM equities harder than any other asset class, with serious consequences for EM relative performance. In this period(1995 onwards), there were a few divergences between interest rates and the performance of EM equities(when the correlation became negative again), but these divergences (in 2001 and 2007)were temporary and not lasting beyond a few months.

The note thus makes the point that investors need to make a judgement call as to whether the current rally in EM equities is a more sustainable bull run like in the early 1990's, or something which will fizzle out soon, similar to 2001 or 2007, when EM equities faltered despite continued declines in U.S interest rates as global growth weakened. Can EM equities outperform on the basis of liquidity and flows alone, without a pick-up in global growth?

In trying to understand the different reaction function of EM equities to U.S interest rates pre and post 1995, one clear difference between the two periods is the external position of the EM economies. Prior to 1995, most of the EM economies had current account deficits, an externally leveraged corporate sector and were thus very sensitive to both cost and availability of external capital. Cheap and easily available credit made a huge difference to many of the larger EM economies and their companies. Post the Asian crisis, most of the larger EM countries have a current account surplus or very small deficits, and a corporate sector with little external leverage, thus they do not benefit as much from cheap and easily available financial capital. They are more dependent today on global growth to sustain their exports, current account and maintain economic momentum.

Markets, today however seem more likely to follow the pre 1995 template (where EM's did well with falling rates). Investors are desperate to get out of dollar based assets. Many believe that the "new normal" is for a decade or more of extremely low nominal growth rates in the west, and EM economies have demonstrated great resilience. Unlike the post 1995 period when global growth was strong and EM's posted superior relative performance, today except for the EM economies there is just no signs of sustainable growth. The financial metrics for most EM economies are far superior to the west, with many convinced that most economies in the west have intractable fiscal sustainability and balance sheet issues. Trade within the EM countries themselves has also exploded, and gives them greater resilience to an OECD slowdown. Record low interest rates are also driving a mad scramble for yield and returns. If you wish to remain invested in "safe" fixed income instruments in the west, your returns are basically nothing. There also seems to be a secular and long term asset allocation shift towards EM assets, much like the early 1990's when the asset class was first discovered.

Whichever way EM equities trade, there is very little doubt that this is a great environment for India. India has low export dependence and needs global capital to finance its huge investment needs, running one of the larger current account deficits among the major EM economies. This makes India one of the only beneficiaries of today's environment of very subdued demand among the OECD economies and record low interest rates. The tightening by China last evening, will once again pressurise commodities, further enhancing India's appeal. India had begun to underperform as commodities began moving higher, but this underperformance should reverse as commodities come off. As India has a genuine inflation problem it also seems more willing to tolerate rupee appreciation than many other EM central banks, further boosting returns for dollar based investors. India is in a sweet spot, but just as the beta is high on the way up, so it is on the way down as well. Any change in global risk appetite will impact India disproportionately. The only hope is that given the funk the U.S finds itself in, liquidity conditions will not reverse in a hurry. Our more domestically oriented economic model and strong entrepreneurship are in fashion. We must use this window of low cost capital availability to suck in long term capital, improve the government balance sheet and build out productive assets.

## Global Equity Returns

September 10, 2010

There seems to be great fear and concern towards equities in the developed world at the moment. In a world where a company like Johnson & Johnson (J&J) can issue 10-year corporate bonds at a record low yield of 2.95 per cent, even lower than its dividend yield, and the bonds get lapped up, but no-one wants to touch the equity, something odd is happening. What is the chance of the J&J bond-owner outperforming the equity-holder over the coming decade? The only rationale can be investors expecting a deflationary type of an economic environment, wherein equities drop significantly from here, and any yield is valuable. Despite the current level of bond yields, even now we see continued outflows from equities towards bond funds.

However, realistically what type of returns can global equity investors expect from here over the coming decade? Do these expected returns justify a seemingly irrational desperation for capital preservation and yield at any price as shown by the J&J bond?

To forecast long-term equity returns, one has to make certain forward projections of earnings per share (EPS) growth, dividend yields and then make an estimate of an appropriate multiple one can apply to these earnings.

The starting point for forecasting long-term earnings growth is normally nominal GDP, with the assumption being that EPS broadly tracks nominal GDP over the long haul. At first glance, this looks reasonable as in the US, EPS growth since 1980 has been about 5.5 per cent per annum, broadly in line with nominal GDP growth of about 5.9 per cent (source: BCA). For global markets as a whole, over the last 15 years, EPS growth has actually been slightly faster than that of nominal GDP. However, as the folks at BCA point out in a recent study, while EPS has kept up with nominal GDP, sales per share growth has actually lagged quite significantly. The implication of this divergence is, of course, that rising profit margins have filled in the gap. Profit margins have risen considerably across regions, and there are obvious limits to how much more they can expand. BCA points out that if you recast the numbers by holding margins flat, then EPS growth across the world has significantly lagged that of nominal GDP. The EPS growth for US companies (since 1980) would have been only 4.5 per cent (not 5.5 per cent). The adjusted numbers are even worse for non-US and emerging market (EM) companies. For developed market (DM) companies as a whole, EPS growth (since 1995) was 2.6 per cent per annum compared to 4.1 per cent for nominal GDP, and for the EM, world EPS growth was an annualised 4.3 per cent compared to a nominal GDP rate of 9.3 per cent.

With the benefit of hindsight, this gap between EPS and nominal GDP is not surprising. Even though the profit share of the overall corporate sector to GDP has been quite stable, as new private companies get created, they take a larger share of the profit pool, reducing the share attributable to the older, more established listed entities. This phenomenon is especially pronounced in the faster-growing EM countries which, combined with greater equity dilution to fund growth, explains the higher EPS gap in these economies.

Now in a world where we expect economic growth to be subdued, and profit margins seem unlikely to expand as robustly as they have over the past two decades, the outlook for EPS growth is quite challenged.

The second part of the equation relates to PE multiples, and what is a fair number to use, looking out 5-10 years ahead. Over time, PE multiples have clearly reverted to the mean and hence some type of long-term average should work as a reasonable estimate. Currently, US equities trade at about 15 times earnings, below the long-term average of 17, and the average PE multiple of 23 since 1995 (source: BCA). Global equities trade at about 12 times earnings, well below their average of 17. On this basis, equity returns over the coming decade should be boosted by some valuation expansion, as multiples move towards long-term averages. The only reason this may not occur is if, as expected, real interest rates rise significantly over the coming decade, given the currently artificially low levels, which would act as a natural dampener to multiple expansion. Another factor weighing on multiples would be the economic uncertainty we currently face — deflation, another Japan-like lost decade, a European sovereign crisis? Global economic uncertainty has rarely been higher.

The folks at BCA have been conservative in their study and have assumed no multiple expansion in their five-year projections, thus their market return assumptions are based purely on EPS growth and dividend yields.

On the above basis, they come up with an expected annualised real return of 4 per cent per annum for the MSCI global equity index, with 2.9 per cent of this coming from dividends and the balance from EPS growth-linked capital appreciation. While lower than the average return of 6.1 per cent since 1980, it will still outpace anything available from fixed income assets. Once again, one wonders what the buyers of the J&J bond were thinking.

An additional insight from the study is the realisation that the huge outperformance the EM asset class has enjoyed over the last decade is likely to come to an end. While the BCA study expects EM equities to outperform DM equities over the coming five years (4.8 per cent versus 3.7 per cent), this performance differential is nothing compared to what actually transpired in the last decade (EM equities delivered a real annualised performance of 6.6 per cent versus 2.1 per cent for DM equities). The last decade's outperformance of EM equities was driven by rapid margin expansion as well as the fact that EM equities began the decade far cheaper than their DM counterparts. At some stage, EM profit margins will plateau (they are already 3.2 percentage points above DM margins), and today, on virtually any valuation measure, EM stocks are more richly valued than their DM counterparts. The EM valuation premium is also visible across sectors.

India stands out in the BCA study as being the most expensive of the BRIC markets, and, in fact, screens as being among the least preferred with lower-than-average expected returns over the coming five years. The low expected return for India is driven by multiple compression as the methodology of the study brings our multiples down in line with the EM average. If India can continue delivering strong economic and earnings growth, backed by determined political leadership, then this multiple compression need

not take place. If we can hold our current valuation multiples, then India's expected return profile moves from being in the lowest quartile to the highest quartile.

The bottom line is that for Indian equities to deliver strong returns from here, we have to hold on to current valuation multiples. In the absence of improvements in governance, political will and economic decision-making, this will not happen.

A bet on India today is implicitly a bet on improved governance, more decisive economic reforms and the ability to take on vested interests. Can we deliver? There is no room for error.

## The 9% Question

August 27, 2010

Morgan Stanley (MS), in a recently released report titled “China and India: New Tigers of Asia, Part 3”, argues that India’s growth will accelerate to a sustainable 9-10 per cent by 2013-15, after delivering an average growth of 7.3 per cent over the past decade. Chetan Ahya, the author of the report, bases his case on the combined impact of demographics, globalisation and structural reform. His argument is basically that the interplay between the above-mentioned three factors will lead to a virtuous cycle of income growth, job creation, higher savings and investment, ultimately leading to higher GDP growth. He makes the point that by the time India hits its peak growth trajectory in 2013-15, it will have overtaken China to become the fastest-growing large economy in the world. The Indian media predictably lapped up the report, and one got the sense that it was seen as one more independent confirmation of the inevitability of India’s rise to economic greatness. The MS report is one more in a series of bullish publications about India and its projected future growth prospects. Many in India seem to take our growth for granted, and there is a sense of “we have arrived” developing among many in the intelligentsia.

As a good counter to these optimistic, forward-looking projections, two recent articles by T N Ninan in *Business Standard* and Ajay Shah in *The Financial Express* make the counterpoint of how we cannot take rapid structural growth for granted. Both the articles detail the many challenges we face in realising this growth potential. From poor fiscal discipline to corruption and the rise of oligarchies to the lack of institutional capacity and a drift in political leadership, all are constraints on realising our potential. Both also make the point that there have been many other countries in both Asia and Latin America which were similarly poised in the eyes of the world to deliver strong economic growth, but which ultimately could not do so. It is easy to extrapolate current trends into the future, and while the bulls will dismiss many of the constraints highlighted as being typical of where we are in our growth and political maturity cycle, and wax eloquent about the quality of our entrepreneurship and the aspiration among the young, is the case really as open and shut as many of the bulls seem to imply?

I think every investor in the Indian equity markets today has to make up her mind as to where she stands on this debate. Will the Indian economy deliver a decade plus of 8-9 per cent growth or not? For the reality is that the markets are clearly priced as if they will. I think there is very little case to buy India today, at current valuations, unless you make this fundamental long-term growth assumption. Most of the quality companies in India are already priced for strong future growth, with analysts already using 2012 or 2013 earnings to justify current prices. To make double-digit returns, you obviously need earnings to continue compounding much beyond the next two-to-three years. In the last 12 months, the huge FII inflows have also been attracted by the perceived predictability and stability of India’s growth, the case on which these institutions argue for higher allocations towards India is based on this perceived long-term growth trajectory. The desperation on the part of MNCs to set up base, so visible in recent times, is also linked to this fundamental growth assumption. The India growth story is seen as being China of 10 years ago, but far more investable, with much better quality companies. For any investor today who has doubts on the sustainability of an 8-9 per cent growth trajectory,

she should be selling and getting out of the markets. For any growth disappointment is bound to lead to earnings downgrades, a reversal in capital flows and a valuation multiple de-rating as numbers disappoint.

Given how important this view on long-term growth is to one's investment stance, it is quite remarkable how little debate one sees on this issue among investors. Most just seem to extrapolate the current growth acceleration into the future, without much appreciation of the constraints and weight of economic history. India may still deliver, and hopefully will, but it is by no means a sure thing.

The other interesting angle is the historically poor linkage between strong economic growth and equity market returns. Thus, even if India were to deliver a decade of 8-9 per cent economic growth, that by no means guarantees strong equity market returns. There are many instances, the most famous being China, where strong GDP growth has had absolutely no correlation with market returns. In fact, in some cross-market studies, there is even a negative correlation.

For there to be a linkage, the companies and sectors comprising the listed market must be able to convert the GDP growth into earnings per share (EPS) growth, which is a product of margins and equity dilution. If margins are at a cyclical peak, they will mean revert, and this will lead to earnings lagging the macro nominal GDP numbers and breaking the linkage. Likewise, if companies do not exercise capital discipline and dilute excessively, we may see robust earnings but very poor EPS growth. This is a common problem in high-growth emerging markets, growth inevitably leads to a deluge of capital issuance, disrupting capital efficiency ratios and EPS projections. The second factor is the ability of the market to hold its valuation multiple. Very often a period of strong economic growth does not translate into market performance, despite earnings delivering, as the market having already priced in growth has to face the headwind of multiple compression which drags down equity returns.

The Indian markets have historically had a decent record in converting economic growth into corporate earnings, with a very strong correlation between earnings growth and the nominal IIP (source : Morgan Stanley). Profit share of GDP in India currently also does not seem to be out of sync with past history. Indian valuations, while not cheap, do not seem to be at levels that would lead to significant multiple compression over the coming years. Thus in India's case, strong growth will hopefully continue to drive market returns, as has been the case over the last decade (trailing 10-year CAGR in returns is 14 per cent).

However, once again I am surprised as to how little debate there is on this issue among investors. Everyone just seems to automatically assume the linkage between economic growth and market performance, despite broad cross-country evidence to the contrary.

In a world of low nominal GDP growth and poor growth visibility, India is trading like a growth stock, attracting strong capital inflows due to the visibility of its growth potential. We are among the most expensive markets in the world due to investors believing that we will deliver a decade of sustained 8-9 per cent GDP growth, and this growth will drive corporate earnings and ultimately market performance. Both these assumptions, secular GDP growth and the linkage between growth and equity returns are being implicitly

assumed by the market as being a sure thing, as they have been delivered in the past decade. However, the weight of history suggests that neither can be assumed simply on the basis of extrapolation, there is a non-trivial probability of these assumptions not coming to pass. Any failure to deliver on the above will lead to a serious loss of capital.

## Investing In A Deflationary World

August 13, 2010

Gradually over the last month, the drumbeats around deflation have been getting louder. More and more serious economic commentators now accept that this is a more serious and immediate threat to the US economy than inflation. In the last weekend alone, there were more than half a dozen articles on the topic in the mainstream print media in the US. Many commentators now worry about deflation in the near term and then eventually inflation as authorities globally put policy measures in place to fend off the deflation bogey. Signs of deflationary worries in the markets are spreading.

The yield on the two-year note is at a record low of 0.5 per cent, and the 10-year note is at a 15-month low of 2.82 per cent. The bond market seems to paint a far more worrying picture on the outlook for the US economy than equity markets. These markets are not pricing in any fears of oncoming inflationary pressures. The Fed funds futures contract suggests the first move on Fed tightening will take place only in August next year. Year to date, the best returning security in the US has been the 30-year zero-coupon bond, and bond markets have beaten equities hands down. Inflation expectations as measured by the yield on five-year Treasury Inflation-Protected Securities (TIPS), have sharply dropped from their peak of 4 per cent in mid-2008 to less than 0.5 per cent today. Another pointer to market fears around deflation is the rising correlation between bond yields and stock prices. We have been taught that the traditional relationship between bond yields and stock prices is an inverse one, when bond yields rise, equities fall and vice versa. Today, however, the correlation has turned positive, in that falling bond yields are causing equity markets to weaken, with markets hoping for rising yields. This positive correlation has a few historical precedents, all periods in which deflation was either a reality or distinct fear.

Deflation fears were also highlighted recently when regional Fed president Bullard warned of the US economy getting caught in a Japanese-style deflationary outcome over the coming years. Wall Street is full of rumours of the Fed setting the stage for quantitative easing Part 2, some sort of a trillion-dollar package designed to benefit home-owners with negative equity. Fiscal stimulus of some type to kickstart the economy and job creation seems inevitable, despite severe political opposition.

Deflation halts every type of activity as consumers, investors and business people go into a postponement mode in the expectation that costs/prices will only go lower as time goes by, and is thus corrosive to economic growth. Japan is, of course, the poster child of what deflation can do to an economy and markets if it gets embedded in the psyche of the economy and consumers. Consumer prices have been falling in Japan for 15 years now, but never more than 2 per cent a year. Japanese equity markets remain down by 70 per cent from their peak.

Given the fears around deflation and the Japanese experience, the Fed will do all it can to prevent the US economy from slipping down this road. Mr Bernanke and the Fed have extensively studied the mistakes made by the Bank of Japan (BOJ), and are determined to not let it happen in the US. They are prepared to throw everything they can at the

problem, as they have highlighted the weak, delayed and unimaginative response of the BOJ as being one of the principal reasons why Japan collapsed as it did.

While I do believe that Mr Bernanke and company will be able to prevent a Japanese-style outcome in the US, it is worth thinking about how investing will change if deflation were to truly emerge. This is not a type of investment environment that many in the US or Europe have experience with.

First of all, cash is king becomes the operative buzz word, as capital preservation trumps any attempt to make a return on capital, and cash is one of the very few safe investments you can make in this scenario. Cash will also give you huge options in an environment where asset prices are tumbling and distress sales common. Anyone trying to move down the quality curve in search of yield will get punished mercilessly.

Short highly leveraged equities, as companies will find it very difficult to generate enough cash to pay off debt, and refinancing will become constrained. In a deflationary environment where prices, margins and cash flows are declining, debt of any type is a killer as real interest rates get magnified, and debt burdens in real terms keep rising. The days of leveraged buyouts will be history, and companies will focus on rebuilding balance sheets. Banks will also have a tough time as credit quality issues surface and credit demand weakens.

Avoid real estate, rent property rather than own, as prices will come down and foreclosures will spike. Anyone with a heavy property exposure will simply drown in the debt. Go long the dollar, as the economic and balance sheet uncertainty surrounding a deflationary period should make the greenback hold up well.

Go long technology stocks, as these companies have experience in handling falling end-product prices. Technology pricing curves are continuously downward sloping, and thus the whole business model is designed to handle negative average selling prices. Tech companies are also very cash-generative, and thus have no debt overhang. Other industries will have to ramp up investments in technology so as to adapt their business model to falling prices, and cut costs. Productivity-enhancing and cost-cutting tools like technology will be in demand.

Buy long-term bonds as another alternative to cash. As the Fed eases to fend off the deflationary threat and bond yields decline, the underlying bond should hold its value. While equities are in general to be avoided, high-quality, dividend-paying companies may still hold their value, if they are debt free, can sustain their dividends and have dominance and pricing power in their respective industries. Short leverage in any form, as deleveraging will be a dominant theme across asset classes.

While deflation may be a risk for the West, in the emerging market world, inflation is a far greater bogey. In an inflationary environment, your asset class selection is almost exactly opposite of what has been outlined above. In inflationary periods, cash is trash, and one should go long real assets like metals and oil, while leverage is cheap and to be embraced. Given current yields, fixed-income investments will be a disaster in an inflationary environment, and one should be short.

Given the two-speed world we are in, and the differing risks to each, investors may have to handle investing in the emerging world very differently from how they position their portfolios in the West. It will be interesting to see how investors balance the investment styles and asset allocation frameworks needed to succeed in the competing scenarios.

## **Lunch with the Masters**

July 09, 2010

I had the privilege of attending a fascinating event this week, where, on the occasion of a market legend reaching a personal milestone, a unique panel discussion was organised to discuss and debate the outlook for Indian equity markets. On the panel were four of the smartest minds involved with Indian equities, three being individuals running their own capital, and one a large Indian institutional investor. In the audience was a veritable who's who of the Indian equity market. I have never seen such a large gathering of the so-called smart money at a single forum, and the quality of the turnout was a reflection of the respect and affection market participants have for the individual in whose honour the discussion was organised.

The panel was quite uniformly bullish on the long-term prospects for India and Indian equity market. All the panel members were convinced that the trend rate of growth in India was somewhere near 8 per cent, and in an environment where western economies were under huge fiscal pressure and struggling to grow at even 1-2 per cent, India would stand out. The group felt that India's time had come, and the quality of our growth and our domestic consumption-based economic model were starting to get recognised. The strong end-consumer demand we are seeing across sectors was seen as sustainable, and a sign that India had hit an inflection point.

On valuations, while everyone agreed that India was not cheap, 16 times March 2011 earnings was not outlandish, given a sustainable corporate earnings growth stream of 16-18 per cent and 20 per cent return on equity (ROE) with limited debt at the corporate level.

On the fiscal issues, one panelist felt that with the introduction of GST and DTC, the tax-to-GDP ratio would improve by 150 basis points over the coming five years. Taking a nominal GDP growth profile of 14 per cent, tax revenues should compound at 18 per cent (as tax-to-gdp improves), and this type of revenue growth would bring our fiscal deficit to 3 per cent, and enable the government to meet its public debt targets. This task would be helped by the recent decisions to tackle fuel and fertiliser subsidies, the possibility of freezing these subsidies at current levels was a significant positive. If we can bring the fiscal deficit down, that should enable a gradual reduction in interest rates and further boost consumption and investment. There was a clear feeling that India had always been a good micro story with weak macro, but given the deterioration in the macro indicators in the West and our expected improvement, macro can no longer be held against us.

On the issues of governance, there was a strong feeling that given our stage of economic development, our institutions are actually quite robust, with enough checks and balances. Parallels were drawn with other BRIC economies and with the quality of governance in the US at a comparable stage of GDP per capita. Most were heartened by the younger lot of political leaders, the use of RTI and the gradual maturation of the electorate. The panelists felt that there was hope for serious improvement in governance over the coming years through the use of technology. The Unique ID project was seen as a game-changer, plugging leakages and improving effectiveness of public expenditure. Examples were given of Gujarat, the rise in both crop yields and the water table, the transformation of

Ahmedabad, the effectiveness of the bureaucracy, etc. Why cannot this be replicated in other states?

There was optimism on Indian manufacturing, especially with the introduction of GST, and many felt that high-end engineering was an area in which India can dominate. One panelist was quite optimistic about the scope for another agriculture revolution. He pointed out the scope for yield improvement, giving the example of how cotton yields have tripled in Gujarat from 220 kg to 660 kg in a matter of a few years with the introduction of BT cotton. Yields in India are below Pakistan and Bangladesh in many crops, but the economics of farming have improved sharply in the last three years, and thus the capacity of farmers to use and pay for better quality inputs.

There was a belief that power capacity additions will surprise on the upside in the 2012-2017 Plan period, with the entry of the big boys from the Indian private sector. One panelist even felt that we could see upwards of 110,000 Mw of capacity being added. If true, this would crash merchant power prices, reduce power outages and give a huge fillip to economic growth.

On the question of large upcoming and ongoing equity issuance, one of the panelists made the point that there was approximately \$30 trillion of money held by institutional investors in the world of which India had less than \$75 billion. India should continue to attract large sums of money going forward, as we are under-represented in the relevant indices and, by default, in institutional portfolios. The quality of issuance was also the key, if we bring to the market good quality papers, buyers will emerge. The panel felt that large issuance, especially of good quality, would not derail the bull story, but attract new investors.

In terms of needed reforms, the panel felt that, land and labour, were the key to enable an adequate supply-side response to handle 8 per cent growth and unlock our mineral and low-cost labour resources. We need to handle land acquisition in a fair and transparent manner to enable all stakeholders to get a fair deal.

Inflation was seen as a temporary problem, with a clear view that assuming monsoons are normal, inflation will come down to 5-6 per cent by March 2011, perceived as an acceptable level for our rate of growth. There were no takers for the view that our inflation was more structural, as the panel felt that one should look at inflation over a longer period, and if you adjust for the monsoon failure, and last year's 1 per cent inflation number, today's double-digit print is less threatening.

There was concern on the short-term outlook, both due to global factors and the feeling that earnings in Q1 may disappoint, with year-on-year growth slowing from 30 per cent to 18-19 per cent. India's relative outperformance was also a concern, with China down more than 25 per cent year-to-date, and India basically flat, though one panel member felt that India's cycle of outperformance has just begun, and while this may be a concern in the short term, it will eventually pull in money as global investors chase performance. A correction was unlikely to be severe, and most likely in the range of 10-15 per cent.

In terms of sectors, the panel was uniformly underweight on commodities due to global growth concerns, and strongly overweight on the end-consumer facing business. There

was also a positive bias towards agrochemicals and certain technology-oriented auto ancillaries. Some expressed concern around tech, given global growth issues, the rupee and valuations.

While broadly agreeing with the above, I tend to be a little more cautious in the short term, especially on the fiscal and quality of governance. I think we run the risk of the government spending away the gains we realise from tax buoyancy as populism continues to win elections, and governance, to my mind, remains weak in many key areas. I also worry about the supply side across education, infrastructure, etc. being geared for 8 per cent growth. Global concerns could still cause a flight of risk capital, and I am surprised about the lack of concern around our current account and trade deficits, which have worsened markedly in the last 18 months. Despite these issues, I do agree that India could break out, and the long-term bull scenario has a reasonable probability of coming to fruition.

On the whole, it was a fascinating discussion, and an honour to be able to hear these gurus in person.

## Europe Continues To Wobble

May 28, 2010

Markets remain extremely skittish and worried about the outlook for Europe, Greece and the West in general. Despite the best intentions of European policy-makers, markets are not willing to settle down and take at face value the various austerity programmes being rolled out across Europe. Markets have been spooked by the unilateral measures on the part of Germany to ban naked short-selling on sovereign bonds, CDS (credit default swap) and 10 major financial institutions' equity shares. The measures have caused concern as they have exposed the lack of policy coordination in Europe (once again) and made investors into the bad guys causing irrational pain for the real economy. Politicians, instead of trying to address the credibility gap they face with markets, are trying to effectively badger investors into falling in line. Comments of a war between markets and politicians do not help matters, and investors continue to fear that the German move could be duplicated by other European Union (EU) states.

The crux of the problem continues to be the markets' unwillingness to accept the sustainability of the Greek rescue plan. While it is true that Greece has effectively been backstopped for two-and-half years, and has no need to approach investors for any funding whatsoever over the next 30 months, markets are still not convinced. Bears point out that Greece will come out of the bailout period with a public debt-GDP ratio of 150 per cent, so even after 30 months of credit support, how will the economy be any more viable? Why will the markets support its borrowing programme then, if not willing to do so today at lower levels of indebtedness? The bears continue to question the solvency of Greece, the bailout has solved the liquidity risks and bought some time but does nothing to address the longer term solvency issues. The only way for the country to regain solvency is to correct the fiscal and improve competitiveness as an economy, both of which require huge political will and local populace buy-in, neither of which is yet obvious in Greece. The question of how can you force a massive austerity on the local population and pay out creditors in full is a matter of current debate. Will local politics permit the entire pain to be borne domestically with no cost to international creditors?

The bears continue to expect a debt restructuring in Greece, with creditors forced to take haircuts on their debt holdings. If Greece restructures, then inevitably the expectation will be that the other PIIGS will follow, sooner or later. Just for context, the Royal Bank of Scotland estimates that €2 trillion is the amount of debt issued by public and private institutions in Greece, Spain and Portugal and held by financial institutions outside these three countries.

The fear around restructuring, contagion and its implications brings about the inevitable comparisons with the Lehman collapse.

Though Greece is a small economy (only about 2 per cent of EU GDP), European banks own billions of dollars of its debt (largely French and German banks). Any restructuring will involve these banks having to take a significant haircut on their Greek bond holdings, which will blow a big hole in their balance sheets. To fill this hole, the respective EU governments will have to recapitalize the banks.

This is where the contagion, fear and comparisons with Lehman become more relevant. If the banks have huge losses on Greek bond holdings, everyone will start trying to figure out who is holding these bonds, exposures etc. Interbank funding markets will start to tighten as nobody will want to deal with banks perceived to be sitting on huge sovereign bond losses. As counterparty issues resurface, liquidity tightens, banks and their clients are forced to de-leverage, we enter the whole Lehman death spiral once again. The markets will then go after the other PIIGS. Thus, irrespective of how small Greece may be, this is obviously a huge problem with systemic implications. Initial signs of rising Libor rates, elevated swap spreads and unease in funding markets are obviously spooking the markets and forcing everyone to pare back on risk and de-leverage. Having just gone through a near-death experience 18 months ago, no institution wants to be caught napping this time. The strong correlation in price movements between gold, crude oil, stocks, commodities and spreads indicates that risk of all types is being taken off the table.

The only way out seems to be for Greece to accept and implement austerity measures, combined with an orderly and assisted debt restructuring plan. Once they accept the need for debt restructuring, EU authorities can then firewall the affected banks through disclosures and capital support, so that interbank funding markets do not seize up. This has to be accompanied by Spain, Portugal and the other targets moving quickly to implement their own austerity programmes and thus convince the markets of their solvency.

While one can be tempted to buy today, it may make sense to wait till Greece finally accepts the need to restructure and we go through the inevitable fallout from such an announcement, before taking on more risk in your portfolio. Such an announcement, if handled sensibly by EU policy-makers, will be a buying opportunity and not the beginning of another Lehman-like meltdown.

While India is relatively unaffected by what is happening on the real economy side, the linkages are obviously more through fund flows and risk aversion. Once again, at the first signs of global risk appetite being reduced, our markets have taken it right on the chin, with Indian equities down over 13 per cent in dollars terms this month alone.

Hopefully, our policy-makers will also understand from the Greek problem that the markets' patience for tolerating irresponsible fiscal policy is not endless. Already over the past 10 days, in three global emerging market (EM) presentations, I have seen strategists highlighting India as the only large EM country with fiscal and current account issues and vulnerability. Investors do not seem worried yet, but focus on fiscal sustainability has never been higher. We fund our deficits internally, and thus cannot be attacked by global markets, but we do need to get our fiscal deficit under control. We will not be able to attract the FDI and FII flows we need, unless investors are more comfortable with our macro framework. The finance minister has outlined a road map to bring the fiscal deficit and public debt/GDP under control. Now we will need to move ahead aggressively in implementing the direct taxes code and goods and services tax reforms which underpin these targets.

## **The Euro Bailout**

May 14, 2010

Last week's panic in financial markets finally forced European policy-makers into taking decisive action. Convinced that inertia would potentially lead to the collapse of the euro itself, European Union (EU) leaders effectively threw the kitchen sink and whatever else they could at the issue. The outcome was a new financial stabilisation package of up to euro 750 billion. There are three pieces to the package: First, opening up the EU balance of payments facility to all euro area countries and increasing its ceiling from euro 60 billion to euro 110 billion. Secondly, a new European stabilisation fund, which will provide guarantees worth up to euro 440 billion. Finally, an additional International Monetary Fund (IMF) facility of up to euro 250 billion. In addition, ECB has announced that it will intervene directly in public and private debt markets, and in conjunction with the Fed has re-opened USD swap lines, allowing European banks to obtain USD funding against euro collateral.

These measures have been accompanied by a strong commitment from the respective euro area governments to ensure fiscal sustainability. Portugal and Spain have committed to additional fiscal consolidation measures in 2010 and 2011, which will be presented on May 18. Governments have also committed to reform the Stability and Growth Pact to ensure fiscal discipline. It was also made clear that any country drawing down on any of the above facilities will have to subject itself to strict IMF conditions and monitoring.

These measures are critical in importance not only because of the size of response, but also the speed and cohesiveness of the policy action. Investor negativism towards euro assets over the past few months has been based on more than just the deteriorating fiscal. For, in reality, the euro area's deficits and debt ratios are no worse than many other developed economies. The aversion to euro assets was based more on the EU institutional weakness, exposed while handling this crisis. The core problem of Europe not having a strong, centralised and empowered political leadership which can take quick, decisive action was shown up. The initial reluctance on the part of Germany to support Greece, the need to constantly revise the rescue package and the need for parliamentary approval in each country further highlighted the fractured decision-making model.

The sovereign credit crisis has brought Europe to a critical fork in the road as to its own existence. It can choose either closer political and fiscal integration or eventual disintegration. This crisis is similar to the ERM currency crisis during the early 1990's which eventually pushed the main body of European countries towards a monetary union.

While the real efficacy of the announced policy package is still to be tested, it clearly shows that the EU leadership is not prepared to give up on the single currency, and, in fact, seems to be prepared to move further down the road to much greater cooperation on fiscal and budgetary issues. This crisis may go down in history as the turning point wherein Europe accepted the need to move towards a loose fiscal union with far greater coordination and monitoring of each other's budgetary matters. As to the outlook for markets from here, there are two clear schools of thought.

One group is of the view that this package does nothing to address the fundamental issues of sovereign solvency. All we have done is given Greece, Portugal and Spain some time to get their fiscal house in order (without even addressing the issues in Italy and Ireland). This group is not optimistic about the ability of these countries to actually implement fiscal adjustments of the magnitude of 10 per cent of GDP and that too in a few years, and without being able to devalue the currency. The bears don't think there is enough political will or willingness to endure hardship in the above-mentioned countries, and a serious moral hazard problem. This group also questions the entire burden of adjustment having to fall on the local populace of these countries (through the fiscal consolidation). A more fair adjustment process would involve creditors also taking a haircut (be they banks on their bonds or other countries on their fiscal transfers). The bears fear the burden of adjustment on the local populace will be too high, growth will collapse, leading to a negative spiral of contracting GDP and rising debt ratios, and some type of debt restructuring will be inevitable and still lies ahead.

The counter point to this is an interesting study done by BCA which points out that in the past 30 years, there have been seven instances of successful fiscal adjustment in Europe where we have seen a fiscal correction of more than 10 per cent of GDP. In each of these fiscal adjustments (except for Greece), GDP growth actually accelerated as the relevant country gained competitiveness and sustained productivity improvements. Key success factors which enabled these fiscal adjustments were a focus on expenditure cuts rather than tax hikes and a societal consensus supporting the necessity for the fiscal retrenchment. One may need to track the progress of Greece, Portugal and Spain on both these counts, to better handicap their chances of successfully completing the fiscal adjustments needed. The BCA study shows that it can be and has been done before.

The bulls point to the fact that global growth continues to surprise on the upside, with the latest US employment numbers surprising positively and purchasing managers indices (PMIs) improving across all regions. The current earnings season also continues to surprise positively, with the majority of companies continuing to beat analyst estimates. With strong earnings and low rates, markets seem cheap. Liquidity conditions will also continue to be supportive, as the latest crisis will only further push out any attempts at normalisation of monetary policy on the part of both the Fed and ECB. Markets thus continue to be in the sweet spot of very easy liquidity, super low rates but improving growth and earnings. For this camp, any corrections are a buying opportunity, as they continue to believe in the inevitability of markets rising till such time as the central banks remain on hold. Risk assets will get a bid, and capital will keep moving towards those asset classes and regions where growth is strong and benefiting from very easy macro policy settings.

It looks like being a very tough call, but I would tend to slightly tilt towards the bulls, and thus would remain invested, but have portfolio protection to safeguard against another potential shock. The markets should do fine if the relevant countries can deliver credible fiscal adjustment plans (based on spending cuts, not huge tax hikes) and we see greater buy-in from the local populace in understanding the need for austerity. In the absence of local buy-in, sharing the adjustment pain more broadly through debt restructuring comes back on the table, with potentially very serious consequences for the EU banking system and global liquidity. The only clear trade seems to be a further depreciation of the euro. Net net, stay invested but remain paranoid...

## Complacency Setting In

April 23, 2010

We have a long, hard road ahead of us, so we must not get complacent

It is now widely acknowledged in investing circles, at least among emerging market investors, that India is one of the better long-term stories out there. Chris Wood of CLSA has for years now highlighted India as his single-best long-term bet in Asia. He makes the point about entrepreneurship, focus on domestic consumption in the economic model, and greater respect for capital among corporate houses as his reasons for being bullish. The emerging market (EM) strategist at BCA also highlighted India as his single-best idea over the next five years at a recent seminar that I attended. He talks of India being a severely under-invested country which, despite the under-investment, is showing good productivity growth. He makes the point that India has now begun to invest, and betting on a country which is under-invested but is now investing because of rising domestic savings normally leads to profitable outcomes.

Jim Walker of Asianomics is another noted economic commentator who is quite bullish on India for the long term, and has very high regard for our economic policy-makers in general and the Reserve Bank of India (RBI) in particular. Consistent with the above, he expects far less capital destruction in India than in other Asian markets, and far better capital discipline and a more pronounced domestic orientation in our growth strategy.

Everyone is, of course, aware of the famous Goldman Sach's BRIC report, and its contention that India will grow faster for longer and has the best longer term growth outlook among the four economies.

I could, of course, go on and there are many more equally famous market observers who have made similar comments. Thus, one can understand why everyone in India may be getting a little complacent and even smug. It is almost as if investors and policy-makers are convinced that this rosy outlook is baked in the cake, so to speak. If it is going to happen and India is going to march ahead anyway, why take hard decisions? Does one really need to battle vested interests when 8 per cent or even 9 per cent long-term growth is assured?

In this context I had some very interesting meetings over the last few weeks, with some very savvy and seasoned global investors who had an interesting perspective on this issue.

They first of all made the point that there are many instances of countries growing strongly for a period and then stalling. Brazil was cited as the most obvious instance, where, after a period of strong economic performance, the country totally stalled in the 1980s and 1990s. There have been only 12 or 13 countries which have been able to grow at 8 per cent or faster for at least 25 years. Of this number, at least half have little relevance being single-resource dependent or city states. India, therefore, cannot take its current success for granted, only four countries (of a reasonable size) have been able to do what India aspires to. What investors are assuming is a done deal is actually extraordinarily rare.

The second point made was the increasing politician-industrialist nexus. To these investors, parts of India were beginning to resemble Russia, with the same characteristics of crony capitalism and huge wealth transfer from state assets to private ownership. India may not like hearing it, but in certain sectors, its institutions are too weak to face off against corporate interests.

An additional point was made on the inability to take decisions and build consensus. Why would a country go on agonising over foreign education providers when there is such an obvious shortage of capacity in higher education? Even if you get foreign institutes to come in, they will only supplement the domestic institutions and just scratch the surface in terms of meeting unfulfilled demands. This was cited as another example of a total unwillingness on the part of the government to take on vested interests. It was surprising to one of the investors how even small sections of society can seemingly hold back progress and the whole country to ransom. In a country like India with a general resistance to change, any progress requires vested interests or rent-seekers to be pushed aside, and an unwillingness to do so severely impairs progress.

These investors also felt that India had an intractable problem on the fiscal front, as any progress would be frittered away in poorly designed or executed social sector give-aways. This genie has now been let out of the bottle, and no government will be able to resist the temptation to keep spending. Spending has now got strongly associated with winning elections. India may have got away with it right now given the poor fiscal situation globally, but the country has a structural propensity in recent years towards populism. This poor fiscal discipline will ultimately lead to structural crowding out and inflation issues.

There were additional points made on the extremely poor supply-side response in infrastructure, and as to how this was a systemic issue related to land and process and not to funding or capacity constraints. Being a systemic issue, it was not likely to get resolved. What would cause it to change today which could not have been done years ago? Infrastructure deficit was now binding, and unless it was resolved, it would not permit the desired growth.

There was concern around India's demographics, with the fear of this being a demographic disaster, rather than dividend. Given our levels of vocational training, higher education and labour market rigidities, questions were asked on how would the country move hundreds of millions of people off farms and improve their productivity? They were surprised at the very low levels of political noise around job creation compared to China, where the government has an almost single-point agenda around creating 20 million jobs per annum.

India's huge dependence on global capital flows was also highlighted. One investor went so far as to say that India was the most leveraged market to global capital flows and hence risk appetite in the world. Without strong foreign capital flows, the growth story did not stand, was the simple point.

There was concern around governance, or the lack of it. And, India as an investment destination was perceived to be a tug of war between a good micro-company-specific story and very poor and worsening governance.

It was to put it mildly a sobering series of conversations. While one does not necessarily agree with all the points made, it does go to show that maybe we should not get carried away. We can potentially have a strong growth trajectory, but it will require strong political will to implement long overdue fundamental changes. These required changes are well known but still do not get implemented. Someday soon this has to change. We have a long hard road ahead of us, we must not get complacent. Maintaining growth will require decisive action, determination and a clear head. We cannot let ourselves get diverted.

## Concerns on China

April 9, 2010

One recent trend that seems to be gaining momentum is concern about China and its growth outlook. Is China a bubble waiting to explode? Will the coming collapse of China take down all emerging and commodity markets? These are some of the issues on investors' minds these days. The concerns around China are clearly benefitting India as investors seem to be far more sanguine about India's long-term growth prospects. No one thinks India is in the midst of some super bubble, and the noticeable pick-up in investment flows from foreign Institutional Investors (FIIs) into India can be partly traced to some asset allocation shifts on the margin from China to India.

There are two-three interesting articles laying out the bear case on China, all available on the web. The presentations by Jim Chanos, Vitaliy Katsenelson and Edward Chancellor of GMO are the most interesting. I have chosen to focus on the GMO white paper in this article, but the points being made by Chanos and Katsenelson are quite similar to what Chancellor outlines in the GMO paper.

Chancellor, who is a noted financial historian, makes the point that China today exhibits many of the characteristics of great speculative bubbles or manias. He starts out by outlining some of the common features or characteristics of previous financial bubbles and then points out how they can be used to describe China today. Historically, rapid (above trend) credit growth has been the single most important indicator of a developing financial bubble. This is closely followed by the build-up of an asset price bubble. Very low and sustained interest rates and rapid money supply growth over an extended period are also classic warning signs. Investment manias have always been built on compelling and credible growth stories like China's. A general increase in capital investment leading to misallocation and wastage of resources is another classic sign of a developing investment mania.

Testing the current China story against these historical markers of an impending crisis, Chancellor concludes that it fits the bill on most of the criteria. In fact, there are red flags wherever you look at China. First of all China is clearly a huge economic success, and one can see why it is such a compelling long-term growth story around which a bubble could easily develop. China has 1.3 billion people, with a per capita income only about 10 per cent of US levels, and over the past 30 years the country has increased its GDP 16-fold.

Over the last year, China has overtaken Germany as the world's number one exporter and Japan as the second largest economy. Over the coming decade, 300 million rural inhabitants are expected to move into cities, laying the foundation for continued 8-10 per cent GDP growth for many decades. Its economic momentum seems unstoppable. Chancellor's contention is that investors are simply extrapolating recent growth rates and that forecasts for urbanisation and growth may be exaggerated. He also feels investors are ignoring the growth-inhibiting aspects of the Chinese demographic story.

If one were to look for an investment boom characteristic of a bubble, it can be found in 2009. Last year, in the midst of a global recession, Chinese fixed asset investment rose 30

per cent to a record 58 per cent of GDP, contributing 90 per cent of the year's economic growth. Infrastructure accounted for more than two-thirds of the spending although China already has adequate infrastructure, with highway usage running at just 12 per cent of the OECD average. Capital spending in an industry like cement increased by two-thirds despite utilisation running only at 78 per cent. There are numerous anecdotal stories of empty roads, airports and huge excess capacity across the industrial complex.

Chinese interest rates are also seemingly artificially depressed. As a general rule of thumb, nominal interest rates should broadly track nominal GDP growth over the medium term. In the US, for example, the prime rate has averaged about 1 per cent more than nominal GDP over the last 40 years. In the case of China, the prime rate has averaged 9 percentage points lower than nominal GDP since 1990 (source:GMO). Low interest rates are one of the tools the Chinese authorities use to subsidise state-owned enterprises and boost investment.

China is currently going through a huge credit boom. In 2009, bank lending increased by RMB 10 trillion, approximately 29 per cent of GDP. Money supply growth exceeded 30 per cent, but it seems unlikely that credit could have expanded at this pace with no decline in asset quality, and the Chinese banking system could be overwhelmed by NPAs. In a world where most are de-leveraging, China has seen the fastest credit expansion in its history.

There seems to be an asset bubble developing in China's property markets. First, on the residential side, prices are clearly stretched. Nationally, home prices have climbed to around eight times the income and in Beijing the ratio is 15. As Chancellor points out, in Tokyo, at its peak, this ratio was 9. Commercial rents in leading Chinese cities are already at international levels, with rents in Beijing and Shanghai rivalling those of New York.

Chancellor makes the point that China's real estate market, its economy and financial system are all working on the assumption that past rates of growth will continue into the future. This assumption justifies continued investment, leading to strong growth and this growth drives further investment, thus confirming the initial thesis and setting up a positive feedback loop. If growth were to disappoint, this can easily reverse into a negative spiral. He equates the China of today with the last stages of the dotcom bubble when investors extrapolated growth and a surge in investment created a spike in demand that justified even the most optimistic predictions. Once the initial predictions were exceeded, investors quickly went overboard in their expectations and long-term modelling of demand.

My own sense is that predicting the timing of any collapse is impossible, and being a state dominated economy China may be able to delay its day of reckoning. It has huge resources, in terms of foreign exchange and in the fiscal elbowroom it enjoys, to keep this party going. As long as it continues to convince the world that it will underwrite 8 per cent growth, the believers will keep investing. The political consequences of dropping below 8 per cent growth, will also ensure that the government will leave no stone unturned in propping up growth. However, if history is any guide this will ultimately end badly.

How to invest with one eye on long-term structural issues like China and yet remain tuned to the short-term momentum of investor enthusiasm for emerging market assets is a dilemma that every investor faces today.

## **A Difficult Six Months**

March 26, 2010

The equity markets have rebounded strongly following the presentation of the Union Budget, rising by more than 10 per cent from their lows. This surge has been caused by a combination of strong global markets as Greece has seemingly bought itself some more time, and a generally favourable response by investors to the Budget and its fiscal targets. Inflows from foreign institutional investors (FIIs) have resumed as many of the large, long-only funds have received significant inflows, and we are in that part of the year when domestic insurance flows are at their maximum. The markets are trading well and seemingly want to go up. The recent move of the ratings agencies to take India off the credit watch status has been a further boost to market sentiments.

However, in my opinion, the next six months is going to be a difficult time, full of risk and an environment where one must exercise caution and not get carried away.

First of all, we are by no means over with these sovereign risk issues. Greece is still in trouble, and the EU is seemingly split as to how to bail out the country. Germany and France are opposite ends of the spectrum on using the International Monetary Fund (IMF) to help a bailout, and Greece has over 20 billion euros of funding needs in April and May. The country is running a fiscal deficit of close to 16 per cent, and not 12 per cent as commonly reported. And, to get this deficit down to a manageable number will involve huge economic and social costs. It is not clear if the country has the stomach and maturity to implement a double-digit fiscal correction. Post-Greece, we have similar issues with Spain, Portugal, Ireland and eventually Italy as well. All this will come to a head over the coming six months. Given the size of funding needs, the quantum of sovereign debt held by the EU financial system, and general political unease over sovereign bail-outs, risk aversion could reassert itself anytime. The euro remains weak and clearly headed lower.

Back home in India, the obvious problem is inflation. The Reserve Bank of India (RBI) governor has probably the toughest job in the country trying to calibrate monetary tightening so as to promote growth, stifle inflation and simultaneously still put through the huge borrowing programme of the government at a reasonable cost. India probably needs higher interest rates to prevent the current food-based inflation from spilling over into a more generalised price spiral, but higher interest rates will hurt the growth transition currently underway. We need to move away from government stimulus being a driver of growth towards private investment demand, and a spike in rates will hurt this transition meaningfully. A 300 basis points higher cost of debt affects project IRRs materially.

India has another problem in that at high rates of growth, anything over 8.5 per cent on a sustained basis, and everything starts falling apart in the country. From power, ports, airports, skilled manpower to railway wagons, everything goes into short supply, and inflation starts to spike higher. Remember, the last inflation scare in 2007 was not driven by food prices at all, but by surges in commodity prices and a general overheating of the economy. We are a fundamentally under-invested country, and to address the structural issues of an economy which cannot handle sustained growth of over 8.5 per cent without

overheating, we need large-scale investments to improve the supply side response to growth in numerous areas of soft and hard infrastructure. To improve the supply side, we need huge investments. These investments are sensitive to rates, and will not be made in an environment of high and rising interest rates. Thus, ironically, one can argue that to tackle inflation on a more structural basis, we actually need low interest rates, not tight monetary policy.

The RBI governor thus has a thankless job, having to make a very delicate balance between growth and inflation. He cannot let the country move into an era of generally higher inflation and interest rates, as once out of the bottle, that genie is very difficult to control. But he cannot use a sledgehammer approach either. He anyway has to handle the inevitable crowding out issues as private sector credit demand picks up.

Interlinked with the above, the biggest risks on the horizon for India are the monsoons and oil prices. Another monsoon failure (God forbid) will throw the whole food price situation out of control, besides seriously damaging consumption, growth and the fiscal. We dodged the bullet of a poor monsoon in 2009 (in terms of economic impact), but two poor years back to back will put a huge strain on the economy. RBI will be forced to act, as no government will be able to withstand the political pressure that will be mounted following a second year of double-digit food price rise. Agriculture will dip by a lot more than the 2 per cent the government statisticians project for 2009, and rural consumption will slump with food subsidies spiralling out of control.

India is also extremely vulnerable to higher oil prices. There is a worrying tendency recently on the part of many global oil analysts to become more bullish and raise their price forecasts, which is a clear red flag.

High oil prices have a huge impact on the fiscal side in India through petroleum product subsidies and higher fertiliser subsidies, or on inflation in case prices are allowed to adjust. We can only hope that prices behave. Whether the impact is through the fiscal or inflation, the end outcome is the same — higher rates.

The next six months are also critical in that the government will have to demonstrate progress on tax reform through the direct tax code and goods and services tax. As pointed out before, both these reforms are absolutely critical to achieving the fiscal deficit targets outlined in the Budget. We will know within the next six months whether the government has been able to withstand the lobbyists and special interest groups, and deliver on these landmark legislations.

The markets, to my mind, should be stuck in a broad trading zone till such time as we get better visibility on the monsoons and oil prices. Normally, the rains do not have such importance, but given the inflationary and fiscal challenges already confronting the country and the policy-makers, we need to cross this hurdle for the markets to break out of their current range.

Markets can handle a 125-150 basis points rate hike over the coming 12 months, that is baked in the cake, but anything higher than that will be corrosive for PE multiples and market performance.

If the rain gods are kind, and the government does deliver on tax reform, then we are looking at a very positive market outlook in the second half of 2010.

## India Versus China

March 12, 2010

I came across a recent research note titled “Buy chaos, sell order” put out by Russell Napier of CLSA. In the research piece, Mr Napier highlights the argument for why over the coming years India should be a far better investment destination for financial investors than China. He makes the point that India’s troubles come from tackling its most difficult problems first, and he senses a tipping point, where the structural impediments holding India back are slowly fading. He also makes the point that China’s state-imposed order will slowly disappear as its growth dynamic evolves. He urges investors to not get fooled by China’s superficial order and India’s apparent chaos.

Napier makes the point that there is little correlation between levels of economic growth and returns from equities, especially in emerging markets (EMs). One of the chief causes of this is the mercantilist policies followed by most of the EM world, involving ultra-cheap exchange rates and a near total dependence on export growth. These policies hamper equity returns as a thriving and heavily-favoured export sector is normally poorly represented on stock markets, and targeting of the exchange rate can produce extreme monetary conditions, causing severe volatility in economic cycles. A boom/bust cycle can severely damage long-term equity returns.

Today, there seems to be a broad consensus that mercantilist policies have now been maxed out. The OECD economies can no longer continue absorbing an endless supply of goods from East Asia, and this export-led growth approach cannot deliver western living standards to large economies like India and China. The pressure on China to move away from this growth dynamic will keep mounting. Napier argues that the key question for any EM investor is to determine which countries can make the transition to a post-mercantilist world, and it is here that India is better positioned.

India is far more advanced than China in developing a functioning private sector financial system, with the cost of capital being far more real and market-determined than in China. India is also a much more productive user of capital, due to its historic high cost and limited availability. He makes the point that reforming a command-economy banking system is extremely difficult and China continues to shy away from going down this road. The distortion and artificiality in the pricing of money are the key weaknesses of the Chinese system, and it is difficult to think of any command economy banking system that has transitioned into a private sector system without a crisis marking the transition.

Napier also makes the point that India is far better positioned for the post-mercantilist world than China. He bases this observation on the fact that India is far closer to a market-based exchange rate and free interest rates than China. India is also far less dependent on exports, and can move much more easily to a consumption-driven model than China. India’s banking system can also far more easily provide consumer credit to support and encourage domestic consumption. The Chinese financial system is still geared towards funding state-owned enterprises and business. The Indian economic model already has consumption as its centrepiece, while China will have to significantly rejig its economic incentives to push consumption.

He also makes some encouraging comments on India's demographics, evolving democracy and improving bureaucracy.

Napier has strong credibility globally, and his piece will, I am sure, attract attention. One has also seen recent articles from Templeton and other large EM investors, making similar arguments and outlining the long-term case for India. Even the Financial Times has been making encouraging noises to this effect.

However, after discussion with serious long-term real money investors in the US and Europe over the past few months, one does not get a sense that they believe in Napier's or Templeton's conclusions. Most investors remain very enamoured of China, its execution and economic model and believe it will continue to outperform India — in economic growth numbers for sure, and implicitly in financial market performance as well. Nobody has thought about the possibility of India actually being able to outgrow China over the next two to three years, something which the Indian intelligentsia feels is a real possibility.

Almost all the investors I speak with have large, dedicated allocations to China, and they do not question the need to have a specific China allocation. The country is too big, markets too large, capital needs too significant and we need a specialist on the ground, is the usual refrain. China has clearly created a separate asset class for itself. The country is simply too important for the global economy and the commodity complex. There are signs of similar things happening for Brazil as well, with many investors incredibly optimistic about it and its long-term outlook.

For India, however, I still feel many investors have not made up their minds on the country. Many of the world's largest and most sophisticated investors have limited specialist India exposure. They are not convinced the country deserves a full-time specialist allocation. India has not yet been able to market itself as a separate asset class the way China has. This anomaly is there despite India having a far greater investable universe than China. India's real attraction has always been seen as being the entrepreneurship of its private sector. One would have thought that stock-picking and specialist-on-the-ground exposure would be far more important and fruitful in a market like India. Also, most LPs (limited partners) seem to have more money in India on the private equity side than on public markets' side, another oddity considering that most private equity investors in the country are anyway investing in public markets.

All this will hopefully change over the next few years as we continue to grow, develop and confound the sceptics. The biggest fears around India remain the fiscal deficit (its sustainability), hopeless implementation skills, weak governance and corruption. Many of the changes one expects to see over the coming years — in areas like the UID project, adherence to the Finance Commission recommendations, better governance and targeting of government programmes, etc. — will go to counter some of these fears. Ultimately, investors will have to stand up and take notice. In the new post-mercantilist world, very few countries have the growth potential and economic model that India has.

If India is able to make the transition into being seen as a separate asset class, then a significant upside remains for the markets in terms of potential inflows. Being able to

attract these flows remains very important to ensure our financial markets have the liquidity we need to finance our growth potential.

## **A Reasonable Effort**

February 27, 2010

The budget presented by the finance minister yesterday was notable in that there were no nasty surprises, and a grateful market responded (largely through short covering) by rising upwards of 1.25 percent. Market expectations were obviously muted, and the FM managed to satisfy these low expectations.

First of all, on the positive side, the FM began his speech by talking about the need to concentrate on social sector spending and create an enabling environment for growth without getting involved in every sector. This is an usually clear and forthright statement from this government.

The FM also took on the issue of PSU disinvestment directly, budgeting for a revenue mop-up of Rs 40,000 crore from divestment and talking about the advantages of selling government stakes in these companies. This is again a far more direct approach and there no longer seems to be any need for apologies on this count.

The willingness of the government to accept the 13th Finance Commission recommendations on the targets and transparency of approach towards fiscal consolidation is another positive. The desire to move to a fiscal deficit target of 4.1 per cent by FY 2013, and hopefully 3 percent by 2014 are all good. The willingness to accept a public debt/GDP target is again a sea change. The clear statement that the government will not issue fertiliser or oil bonds and pay all subsidies in cash is positive for companies in these sectors and also ensures transparency in the fiscal calculations. The ability of the FM to hit the 5.5 percent fiscal target in 2011 has also cheered the market as has the lower net market borrowing target of Rs 345,000 crore (at least Rs 25-30,000 crore below market expectation).

The FM must also be commended for using quite credible macro targets. It looks as if the budget document is using nominal GDP growth estimates of about 13 percent and net tax revenue growth of 15 percent, both of which look quite believable. Expenditure is also moving in the right direction, with a strong 15 percent plus growth in plan expenditure and only 6 percent growth in non-plan, though one can question the government's ability to hold total spending at just 8.5 per cent.

The recasting of tax slabs so as to leave an additional Rs 25,000-30,000 crore in the hands of the middle class is another huge boost to urban consumer sentiment and helps consumption. The hike in MAT to 18 percent is, to my mind, a positive as it will force us closer to the DTC ideal of a low rate of tax which every company has to pay, with limited exemptions. The excise rollback of only 2 percent is also a positive surprise to the markets.

Other associated reforms like the move to auction coal blocks and have a coal regulator, the seeming willingness to open up new bank licences to the private sector, incentives for legal reform are major positives.

The problem I have with the budget is it is again a case of reforms pushed out. The FM has managed to bring the fiscal deficit down to 5.5 percent of GDP from 6.9 percent, despite only a net Rs 20,000 crore incremental incidence of taxation. The budget maths relies heavily on being able to keep expenditure growth under control at 8.6 percent, and being able to raise Rs 75,000 crores from disinvestment and 3G auctions, neither of which is fully under government control. The only real revenue-raising measure is the hike in duties on petro-products, which is invariably going to be inflationary. In fact, the bond markets, after initially gaining on the lower borrowing programme for 2011, gave back all the gains as the inflationary consequences of the fuel hikes sank in.

Real structural changes on the expenditure side are still not in sight. There was no movement on the Kirit Parikh report, no further details on the nutrient-based scheme for fertilisers and no movement on targeting food subsidies. The fiscal remains very vulnerable to any serious spike in crude prices. Can we really continue to keep total expenditure growth at sub 9 percent beyond 2011, with the Right to Food Bill and the Right to Education Bill costs still to enter the budget arithmetic?

Both the major revenue reforms, the GST and DTC will happen only in 2011-12. There was also no further clarity on what will actually go into the direct tax code, or the expected rates to be adopted for GST. One can only hope that the government manages to convince the states to accept the finance commission's view of a single rate with limited exemptions. The unfortunate tendency to micro manage on the tax side continues, with micro-level changes in sector specific tax rates and exemptions.

The budget has the big positive of being committed to the fiscal targets of the 13th Finance Commission and the FM deserves full marks for that. Investors both local and international will applaud the targets outlined, but the details of how we will get there are still not clear. In terms of key reforms still to be implemented like GST/DTC and subsidy rationalisation, the hard decisions are still ahead of us. Markets are for the moment happy with the fiscal targets outlined, but will eventually start focusing on how we reach these targets. If one is willing to give the government the benefit of the doubt, then one can say that the details on both the expenditure and revenue side will become clearer over the coming 12 months.

On the whole, not a bad effort as it has given the government a little more breathing time to implement some of the more difficult structural reforms. However the government has to realise that at some stage it will have to deliver on these big ticket items. The market will not accept mere targets without credible action forever.

## **An Important Signal**

February 12, 2010

The Budget to be presented on February 26, 2010 is one of the most important economic documents the UPA government will present in a long time. Over the past five years, though important, Budgets have not had the potential signalling impact that this upcoming event has acquired.

First of all, this upcoming document has come to be seen as a litmus test by foreign investors on the seriousness of the new UPA government to move ahead on structural reform. There can be no more excuses; the finance minister got away last time by citing the limited time available to present Budget 2009. He deflected the need to present a credible game plan to bring the fiscal deficit under control, citing the pending (at that time, but since submitted) 13th Finance Commission report. The policy-makers talked of doing reform throughout the year, and not bunching it all up in one Budget document; well, that bluff has also now been called over the last nine months.

Investors want to see intent on policy reform, willingness to bite the bullet and take some hard decisions as well as awareness that we have a serious fiscal problem. Nobody wants to see yet more committees set up, lip service to how this deficit is unsustainable, but no action.

The minimum investors will want to see is a credible plan to cut the fiscal deficit, which actually leads to structural changes on both revenue and expenditure side. Can there be movement on things like the Parikh committee report, a nutrient-based subsidy framework for fertilisers, further targeting of food subsidies? On the revenue side, will we get a credible date and structure for the GST, where are we on the direct tax code? Attempts to bring the deficit down by recasting the GDP data, and assuming high growth rates will not cut it. Investors will, in my opinion, not react positively to a deficit-reduction plan which is in effect a simple and blind bet on high growth. This is seen as too risky, as any slippages in growth for whatever reason can have very serious fiscal and economic consequences.

The importance of these structural issues is due to the need to cut the deficit and yet not harm growth. Structural reform like GST is so critical, as it will plug revenue leakages and thus boost growth, corporate profitability and economic efficiency simultaneously. Similarly, with the direct tax code, one has the chance to clean up exemptions, raise effective tax rates and improve productivity and efficiency.

The fear with cutting the fiscal deficit in OECD countries is the huge economic cost, as already weak growth impulses will get further crushed. India has a unique opportunity of being able to streamline and improve its tax structure, which will generate strong revenues and boost growth. Cutting the fiscal deficit in India's case does not necessarily have the negative economic consequences of the OECD world. Our tax structure is warped enough, so that, if improved, it allow us the opportunity to fundamentally strengthen the economy.

Investors have cut India a lot of slack on the deficit, partly due to global circumstances — when the whole world is running double-digit deficits, why single out India — not realising, of course, that our double-digit deficit has very little to do with the global financial crisis, and everything to do with our own structural problems. High growth and the admittedly-credible resilience of the Indian economy in 2008-2009, when the world was imploding, have also taken the focus off other structural issues like the fiscal. Investors are, however, a fickle lot, all you need is a surge in the oil complex, or a Greece-type situation to remind everyone of India's macro vulnerabilities. We have already gone through a bout of this in 2008-2009, when our current account position came into question with oil prices surging past \$125. We are too dependent on external capital to let this happen again. Even though we fully fund our deficit internally, external capital is important to fund incremental growth.

I already detect a lack of patience now building up, investors want to see action. There is nervousness among the investor base, given the events of the past few months. The 3G auctions seem to be delayed once again, with absolutely no visibility on timing, so that is Rs 30,000 crore gone. The GST implementation is also delayed and caught in procedural and state-level issues, with again limited visibility towards time frame. The government remains committed to new social sector programmes like the Right to Food Bill, thus expenditure pressures continue. The NTPC follow-on public offer was not particularly encouraging either, having been effectively bailed out by certain large public sector investment institutions. Not a particularly great start to an aggressive disinvestment programme. Retail investors remain conspicuously absent from new equity issuances. The life insurance companies have, in effect, become the investor of last resort. They are the only institutions with enough firepower to stand up to sustained FII selling, bail out the corporate sector as we saw in 2009, or even support the government borrowing programme. One can only hope that no legislative changes are made which seriously impact flows into these institutions.

A strong and credible policy document delivered by the finance minister is the need of the hour, it will seriously enthrall the investor base and potentially trigger strong capital inflows.

One can argue that India should not care about investors, especially foreign ones. The harsh reality, however, is that disinvestment seems to be (at the moment) the only credible plan the government has to bring down deficits, and without foreign investors, there will be no serious disinvestment. Foreign capital providers will also be critical to ease the inevitable crowding out issues faced by the Indian private sector, as we try to simultaneously fund huge deficits and strong credit growth.

The world is searching for alternative growth engines, beyond the US and the OECD economies, and everyone wants to believe that India has a decade of 8-9 per cent GDP growth ahead of it. The time has come to seize the opportunity and convince the investors that India and the UPA mean business. Serious structural reform and a credible policy framework are needed to set the stage. Beyond the fiscal, one must also see policy movement on FDI and improvement in the capacity of the economy to absorb investment and accelerate supply-side response. The upcoming Budget is a unique opportunity, we must not let it slip.

## **The Rise of ETFs**

22 January, 2010

One of the major trends in the asset management industry currently is the relentless rise of exchange-traded funds (ETFs). ETFs now account for over a trillion dollars in assets, up from only about \$75 billion in the year 2000. ETFs have gained huge popularity over the last decade as they can be used to gain exposure to a number of asset classes including equity, fixed income, commodities and currencies. They can also be used to gain exposure on either side of a trade, i.e. long or short as well as on a leveraged basis. ETFs have several advantages over index funds: In the types of asset classes covered and ability to short as well as their ability to offer intra-day liquidity, being traded on the secondary markets.

ETFs have now started becoming very popular in India as well, with over 25 per cent of all secondary market FII flows into India coming through this route in 2009 (about 15-20 per cent of total FII flows including primary market issuance, Credit Suisse estimate). Despite this accelerated flow through ETFs into India, single-country India ETFs are still extremely small compared to China or Brazil. Brazil single-country ETFs, for example, are almost seven times the size of India ETFs, giving a sense of how much bigger India ETFs can become. The difference in size is really because of the much later launch of these products for India due to historic regulatory issues. The cumulative flow into India from ETFs [both single-country and Emerging Market (EM)] is over \$6 billion (source: Credit Suisse) till date, making it equivalent in absolute size to the largest country funds.

The reality today is that anyone trying to raise new money for either an India hedge fund or even a long only mutual fund, is faced with intense competition from the ETF. The sad truth is that over the last three years, very few funds have been able to outpace the benchmarks by enough of a margin to justify their fees. Most funds have also clustered around quite similar performance numbers, making differentiation for investors difficult. Many investors were also spooked by the illiquidity of non-index based stocks in India, when they tried to exit, and experienced significant price damage as their funds liquidated holdings to meet redemptions. Why not use a highly liquid, cheap and index-tracking

instrument rather than bother about trying to figure out the small sub-section of managers who can truly beat their benchmarks in a sustained manner? This is a logical question being asked by more and more investors. Investors are also questioning the need to be in mid caps after the huge drawdowns and volatility of 2008-09 — so why not just be in index stocks? Play the macro country story, does one need to drill down and look at stock-specific alpha creation? I am pretty sure that a lot of asset allocators are using ETFs rather than investing through funds. It is one of the reasons that most India funds have received very little by way of new inflows through this rally. Just anecdotally in my own discussions with prospective investors, the use of ETFs seems to be destined to be far greater going forward than it has been in the past few years.

Another reason for the popularity of the ETFs, is the serious bruising most macro funds received in their attempt to exit India in 2008, when markets got crushed. Macro funds are by definition not stock-pickers, and are perfectly happy to play the index, rather than trying to get involved directly in specific stocks. For as they discovered, with the exception of a handful of index heavyweights, liquidity just vanishes for most equities in India when markets retreat. Macro funds are very active and on the margin, driving the global move away from dollar-based assets. ETFs are the perfect vehicle for a top down macro fund to execute its strategy seamlessly.

To me, it seems as if this trend towards ETFs will only accelerate, and I would not be surprised to see an even greater percentage of secondary market flows in 2010 come through this route compared to the 25 per cent we saw in 2009.

What are the implications of this trend coming to pass?

First of all, it will be interesting to see how the huge expected equity issuance of \$30 billion in 2010 will get sold, if a large chunk of FII flows come in through the ETF route. ETFs do not buy QIPs or IPOs, and thus bankers may find that the major source of funding for new equity issuance comes from local institutions. One should be prepared to see many issues, wherein the anchor investors or the majority of the book are filed by local institutions. There is nothing negative in this, but it will probably mean a change of focus for the I-banker community and companies. Local investors will increasingly have to become the first port of call for any deal.

Secondly, as most Indian brokers will not be able to get the execution orders for these ETF flows, one may see a relative shift in market shares between local and international brokers. Since these trades are largely done as large programmes on very low commissions, the commission pool will also get compromised to a certain extent.

These flows will go into the large-cap liquid index stocks, thus pushing them even higher and creating a valuation cushion for the mid-caps to move up. In most sectors, the large-cap index stocks trade at a premium to the sector, as these valuations get pushed up even more because of blind index-based buying through the ETF route, space gets created for selected mid-caps to play catch up and have PE expansion of their own. The continued upwards valuation creep for the large-cap index stocks will also push more knowledgeable local investors into mid caps, as they are unable to justify to themselves the large valuation premiums of the index constituents. Ironically, just as ETFs have gained prominence due to the perceived inability of most funds to outperform their benchmark, their own popularity will create the valuation space to encourage and reward stock picking.

To the extent many macro funds are using the ETF route for EM exposure, and given their liquidity, this instrument does integrate India even further with global flows and trends. Any change in stance towards the EM equity asset class can be immediately expressed through these ETFs, and thus, a lot more asset allocation flows will enter and exit our markets and with greater velocity. We will become more exposed to top down macro themes.

ETF's are here to stay and are now a legitimate part of any investor's choice set when looking across asset classes and markets.