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Bearish But Invested

November 11, 2011

A crisis of confidence has engulfed India and its financial markets. Investors are despondent about the macro situation, specifically concerned about the fiscal situation and current account, worried about the growing perception of policy paralysis, and questioning the trend rate of the country's growth. Though investors are respectful of the Reserve Bank of India (RBI) and its guidance, no one is willing to give the current government the benefit of the doubt. This government has a serious credibility problem, with a negative perception about its ability to take decisions and lack of a holistic economic master plan. Investors will only believe in it once decisions are taken. Having burnt themselves out in the past two years owing to government indecision, until policy decisions are taken and corporate and bureaucratic confidence improves, don't expect many of the big long-term investors to increase allocations to India.

Given this background, and all the issues surrounding Europe and its sovereign debt problem, why don't investors just exit India and sit on cash? Why are investors not selling India in a much more aggressive fashion? After all, year to date, foreign institutional investors (FIIs) are still only slightly negative in terms of flows. This slight negative flow is despite economic growth and earnings estimates being cut and the RBI being far more hawkish than most had expected at the beginning of the year.

There are a few pertinent points here. First, India will continue to grow at least six to 6.5 per cent in terms of gross domestic product (GDP) and 12 to 15 per cent in terms of earnings (on a normalised basis). Though at 13 to 14 times, markets are not particularly cheap, they are not very expensive either. Earnings have not grown for two years now, nor is corporate profitability at a peak. There is a view that in a very bad global market environment, India still stands out as an oasis of growth. Growth naturally draws investors, and in a world of no-growth, they will invest in whichever country can deliver.

The second issue is that one can bet that we will get at least a tradeable bounce in India in the coming months. Markets are normally sensitive to monetary policy, and bottom out with the peak in the interest rate cycle. Markets will start moving up at least three to six months before any interest rate cuts. If one takes the RBI at face value, then there is a decent probability that we have just seen the final rate hike and could be about six months away from rate cuts. Thus, a market rally is on the cards, unless the inflation situation once again goes out of control and we see renewed rate hikes by the RBI.

So, given the possibility of a tradeable bounce, investors do not want to miss out. India remains one of the very few countries where monetary policy has scope for easing.

The third point is about being invested and trying to time the markets. Numerous studies have been carried out to show the futility of market timing. A study by Davis advisers tracks returns for the S&P 500 over the 15-year period from 1993 to 2007. In this period, for someone fully invested at all times, their returns were 10.5 per cent per annum. In case the same investor missed the 30 best trading days (not invested on those days), their returns dropped to only 2.2 per cent, and if you missed only the 60 best days over a 15-year period your returns actually went into negative territory, with a minus 3.2 per cent per annum returns profile. This is the huge cost of trying to time the markets; you miss 30 days and your annualised return over a 15-year period drops by 8.3 per cent.

A study on emerging markets by J Estrada of IESE Business School, "Black Swans in Emerging Markets", comes to a similar conclusion. In the study, Professor Estrada looks at data for 16 emerging markets and 110,000 daily data observations. He shows that across all these markets and observations, if you missed only the 10 best trading days or .15 per cent of the days considered in the average market, your portfolio would be 69.3 per cent less valuable than someone fully invested at all times. Again, just being out of the markets for a fraction of the days considered can severely harm your long-term returns.

The Estrada paper looks at India and shows that missing the 10 best days for an Indian investor (over a 28-year period) dropped annualised returns from 20.2 per cent to 16.1 per cent. This is over 28 years ending 2007. A reduction of 4.1 per cent in annualised returns over 28 years leads to a 61 per cent lower terminal value — a huge difference.

For any investor who has been in India, this data resonate. The Indian market does tend to move very quickly whenever investors turn bullish or gain confidence. Take the case of 2009. Anyone underinvested in the circuit-up market move after the elections would have been unable to catch up in performance. Your whole return profile in 2009 and whether you were able to keep up with a surging market or not were driven by whether you were fully invested going into the election results.

One can, thus, easily see a situation in which if the government in Delhi were to take some tough decisions and India Inc's confidence improved, the market can quickly and decisively move upwards. Local investors at present have limited exposure to equities and will drive a strong market rally if they gain confidence.

Given that the RBI is likely to have done its final rate hike of this cycle, many investors see this as setting a floor for the markets. Markets are unlikely to go down significantly from here if the RBI will start cutting rates soon. By the same token, if the absolute downside is limited from here, with a time-based correction more

likely than a severe price fall, investors want to remain invested, given the tendency of the Indian markets to move sharply higher at the first signs of decisiveness and reform from Delhi.

Though many of us are very seriously concerned about the state of governance, lack of corporate confidence in India and the weakening macro situation, unless you see a large absolute downside, it may not be worthwhile to try and time market and stay underinvested from here, especially if you can find good companies at reasonable prices, many of which are now available. Despite being uncomfortable with the Indian markets in the short term, the odds and market history indicate you should consider getting invested, if you can take a genuinely long-term view.

Only if another Lehman-type episode were to occur would one go very wrong on this approach. Keep some cash for such a possibility. In any case, start getting invested.

As an individual you are only accountable to yourself, and don't have the institutional imperative to try and maximise short-term performance, and minimise volatility often at the cost of long-term returns. Over a three-year horizon, you are unlikely to be proved wrong.

The Investor's Dilemma

October 27, 2011

This has been one of the more difficult environments for investors to operate in for quite some time. Macro risks have been all-pervasive and one just cannot get away from having a view on Europe and sovereign debt. Even at a micro level there has been an extreme sense of sectorial dispersion, with huge disparity in performance. Investors have to juggle various scenarios in their minds and come up with an actionable investment plan.

First of all, no matter how much one tries to avoid it, you have to have a view on the macro situation. Whether we are going to be in a risk-on or risk-off mode has a huge bearing on asset allocation, which asset classes will do well and even which type of stocks will perform. The majority of the huge volatility we are seeing in the markets currently is linked to the market moving between these two modes.

For India, there is a clear cyclical trade being set up, linked to stabilising inflationary expectations and the RBI coming to a halt by the end of this year. Unless one believes that inflation is more structural in nature, and will not trend down towards 7 per cent by Q1 2012, there is a strong case for the RBI to go on hold by the end of this year. The view that inflation is more structural and unlikely to stabilise is still a minority one, but bears watching. Many market participants, including the bond markets, feel that the RBI will start cutting rates by the middle of 2012. These rate cuts will be driven by greater confidence on inflation stability as well as greater fears around sustaining economic growth. Markets normally bottom out with the last rate hike, and will have a cyclical bounce as they begin to pre-empt rate cuts.

The only way this scenario does not play out is if global commodity prices continue to move up relentlessly, which would indicate a risk-on environment, wherein India will under-perform on the way up, but still show absolute positive performance. Thus, the odds favour a cyclical trading bounce in 2012, pretty much either way. If commodities roll over, India will move on expectations of interest rate cuts; if commodities move higher, a risk-on environment which this typifies will cause all emerging market equities to move higher (India will clearly under-perform, however). Only in stagflation does this not work.

However, as to whether this cyclical trading bounce transitions into a more secular bull market, clearly depends on governance and confidence in India. Unless India Inc. and other decision makers regain confidence in the country and its long-term growth trajectory, this cyclical trade will eventually fade. A couple of years back, most investors were convinced that India's trend rate of growth was between 8 and

9 per cent. They felt they could underwrite this rate of growth for a decade at least. Investors built their earnings expectations on this basis, pencilling in 15 per cent-plus earnings growth for India as the norm. Corporate India also implicitly built these growth expectations into their capex plans, with growth and volume assumptions predicated on 8.5 per cent growth.

Today there is a growing body of opinion which believes that India's trend rate of growth is more between 6 and 7 per cent. In fact, the bears feel we are even today growing at sub-7 per cent, if you adjust for the export numbers. While I do not yet subscribe to this view, if correct it is massively negative. A decade of 6.5 per cent growth, as opposed to 8.5 per cent, has massive implications for earnings expectations, the fiscal, corporate capex and valuation multiples. Companies will hold back on capex, as they recalibrate volume assumptions, and investors are not going to give India the premium valuation multiples we are used to if our growth is no higher than emerging market averages. The government will have a fiscal crisis, if revenues track a 6.5 per cent growth trajectory, given the structural rigidities we have on the expenditure side.

This mood of resetting India's growth expectations lower is basically linked to a crisis in confidence around governance, policy paralysis and India Inc. not willing to invest and put money on the ground. Unless this mood changes and investors get more comfortable with the direction the country is taking, the transition from a cyclical trading bounce to a secular bull market will not happen. The reality remains that a bigger obstacle to corporate capex is policy bottlenecks and regulatory uncertainty, as opposed to just a high cost of capital.

The other dilemma investors face is linked to sectoral dispersion. The so-called defensive sectors are trading at very expensive valuations, with many stocks here at life-time highs. This trade is to my mind at least very late in the day, very crowded and with hosts of investors hiding in these stocks. Investors will have to consider moving money into more economically sensitive sectors as they position for at the minimum a tradeable bounce in 2012. This sectoral movement of capital will be initially painful and performance-detracting, but will pay off in spades as we move into 2012. It will also be very tempting to overstay your welcome in these consumer stocks as growth flags. How investors handle this transition will to a large extent determine their relative performance in 2012.

The quality premium has also gone to an extreme. Companies with a strong history of governance and performance are trading at quite elevated valuations, while any company with any doubts is trading at junk valuations. Investors will have to find

companies which meet their quality standards, yet are not fully recognised, for well-known high-quality stocks are not cheap, and one does not advocate buying junk (even though it is available at junk prices).

The last nine months have been very tough for most investors, with huge volatility, massive whipsaws and the ever-present macro tail risk. As we move into 2012, a tradeable bounce in the Indian markets is definitely on, but whether this bounce has any legs will ultimately depend on governance. As global events have shown, governance globally is a concern, with investors citing a lack of confidence in governments in both the EU and the US as the primary cause of the market malaise. India is unfortunately not alone in this.

Marketing India

October 14, 2011

A couple of investment conferences I attended in the US last week focused on real money investors and sophisticated limited partners. In the conferences, which were global in nature and discussed investment opportunities across asset classes, I participated mainly in the sessions on emerging markets, speaking on India.

It was an interesting experience to be in the US at a time of global angst, and when significant pools of long-term money were discussing their world view, current positioning and long-term direction.

Some of the key takeaways are as follows:

- (i) This is not 2008; nobody has the kind of leverage and complacency exhibited then. Most large family offices or endowments have liquidity and are not caught in the kind of asset-liability mismatch they were in 2008. They are far more aware of the downside risks, and have tilted their portfolios accordingly. Their exposure to illiquid assets is also more balanced. Pretty much irrespective of what happens in Europe, it's unlikely that we will see the kind of wave of forced redemptions we saw in 2008. Private-bank driven funds, which led these redemptions in 2008, are far smaller now, with far less leverage. Therefore, for a market like India, I don't think we have to fear another year of \$15 billion-plus in equity market outflows. India is also far less owned and loved today than in 2008, when we were coming off a five-year bull market and even global macro funds were positioned into Indian mid-cap stocks. Markets can come down, but they are unlikely to spiral down owing to excess leverage or overaggressive positioning. The positioning across investors is far more risk-averse than in 2008, when most were caught unprepared.
- (ii) India is massively out of fashion. Most investors had no real interest in hearing about India, and the long-term bull case. In fact at a large India conference held in New York recently, attendance was at a record low, and even senior government officials had few investors interested in meeting them. People were disappointed about inflation, its stickiness on the way down and how the Reserve Bank of India was fighting a lone battle using only one policy instrument — interest rates. Investors also questioned how rates and inflation would come down since most thought much of the inflation was structural. Food prices will remain high, given the increase in purchasing power in rural India and the need for protein.

Nothing is happening on the supply side through policy response that could boost productivity. Though people did acknowledge how India would benefit from falling commodity prices, most of those gains were wiped out by rupee depreciation. Most did not see a case for interest rates to come down significantly, and in a hurry. Also, there was tremendous disappointment about the perceived lack of governance in Delhi. Most were fully aware of the sense of policy drift in the country and highlighted the lack of confidence visible in India Inc., something they had never seen before. I was questioned for the first time how the country could sustain eight per cent as its long-term trend line, given the state of affairs. Many thought India would be lucky to sustain seven per cent (still good by global standards but disappointing for India). Many investors were aware of the societal type of transition India now seems to be starting, but seemed worried about the economic costs of such a transition. It is very hard to boot out vested interests. One or two savvy investors pointed out India's hostile business environment, citing the case of Qualcomm and Cairn. This particular investor thought that global corporations would have to raise their risk premium and hence hurdle rates of return for India. Markets were also perceived to be overpriced, still trading at a premium of 25 to 30 per cent for their Asian peers. There seemed to be little appetite to increase allocations to India. Now all these could be contrary indicators, but it looks unlikely that India will see huge inflows soon, at least not until the markets begin to move upwards and show price momentum. However, most thought greater confidence in governance and policy action was critical to changing their view.

- (iii) Though most admitted they were underweight emerging markets in their current asset allocation, they saw this going up in the coming years. Many acknowledged that this was a good time to increase emerging market weights, but pointed out the difficulties in getting this through investment committees when the US and EU equity markets also looked very cheap. There was still enough risk aversion in the air, to short-circuit big asset allocation shifts of this type.
- (iv) Most were very bearish about China, convinced that something bad was bound to happen there. They specifically pointed to the property market and property developers and thought China could very easily disappoint on growth. Most thought that economic conditions were far worse than the statistics seemed to indicate.

- (v) Governance was panned universally. India was clearly not an outlier here, as investors ranted about poor leadership even in the United States and the EU. Most attributed the weak markets in the US to the shocking gamesmanship around the debt ceiling debate, and people seemed to have given up on Europe owing to the inability of its politicians to understand the magnitude of the problem. Markets would have to riot to force EU political leadership to do the needful.

- (vi) Nobody seemed positioned for a strong risk rally and a short-and- quick market bounce back. Most investors still believe that markets will need to continue to riot, forcing policy makers to do the needful on both sides of the Atlantic. Nobody believes any rally will have significant legs.

All in all, it was an interesting bunch of interactions. Investors are far more aware today than a few years back. India has also received a great deal of negative publicity in the mainstream western media, and most were aware of the challenges facing the country over the coming years. Maybe there was a sense of risk aversion in the air, but time horizons for most investors had shortened considerably, and nobody was really willing to take a medium- to long-term perspective on India. The country has clearly lost some goodwill and investors are less willing to give it the benefit of the doubt. We will need to work to regain this faith.

Before It's Too Late

September 23, 2011

Many market observers are expecting markets to do much better in calendar year 2012. The argument is primarily based on interest rates peaking, with the Reserve Bank of India (RBI) moving to reverse the monetary cycle in the first half of 2012. Combine this with hopes of some impending reforms being passed, an easing of commodity prices, valuations near their long-term mean, an acceleration in corporate earnings and the picture is complete. The bulls also hope that foreign institutional investor flows into India will accelerate in 2012, as global fund managers search for domestic-driven growth stories, decoupled from the West. At some stage, domestic investors will also return to equity markets, and a reversal of the interest rate cycle will hopefully aid this asset allocation shift among the locals. I have much sympathy for this view and believe that the odds favour India to do well next year. Weak global growth, easy liquidity conditions, stable commodity prices and a weak dollar are exactly the conditions under which India performs, and this remains the most likely scenario for the year 2012.

However, some threats to this scenario are gaining credence. First, inflation has proved far more sticky on the way down than one would have thought. The expected monetary easing cycle may be further off than what the bulls are expecting. Many investors are also expecting commodity prices to go parabolic after the announcement of a third round of quantitative easing (QE3), which can potentially derail any RBI easing.

Any attempt at QE3 will be accompanied by regulatory changes, which in turn will short-circuit a commodity price spiral. Simple changes in margin requirements or changes in rules governing physical exchange-traded funds should be sufficient to keep a lid on most commodity prices, or at least avoid liquidity-fuelled speculative excesses. The United States Federal Reserve surely understands the impact higher commodity prices have on US consumer disposable income and the headwinds to growth it creates. In the absence of liquidity-fuelled speculation, the weakness in global growth should lead to stable, if not declining, commodity prices.

At present, RBI is also sufficiently ahead of the curve, so it is unlikely that it will need to over-compensate and be hyper-aggressive to catch up.

A far greater risk to a bullish scenario is the shocking policy paralysis. My sense is that we will end up near seven to 7.5 per cent growth in FY 2012 (helped by a really good monsoon). However, the way decisions are now getting delayed in Delhi, I fear

growth in FY 2013 will be still lower, maybe even six to 6.5 per cent. Before being astonished by such a low number, just think about the constituents of growth.

There is no way that exports can continue at their current scorching rate of growth (which confounds most). Given the confusion surrounding the current 60 per cent-plus growth rate in exports, it would be no surprise if we have a flat year for exports in FY 2013. Whether there is some double counting of exports data or round tripping of capital, such a growth rate cannot sustain, and things will normalise in FY 2013.

Look at agriculture. Given how good the monsoons have been this year in terms of both quantity and spatial distribution, record harvests are likely. So a flat or limited growth in FY 2013 on this high base is quite likely.

As for private sector capital spending, the story is dismal: the investment or projects we are seeing today are a spillover from the projects begun earlier. Whether you speak to bankers or companies, there is just no conceptualisation of new projects. Banks maintain that no new projects are coming for sanction or even appraisal. Infrastructure in general and power in particular are so bedevilled with policy challenges that no wants to either set-up or fund a new project. Over the past few months, I have interacted with people from at least 10 of the top 20 business houses in India. No one wants to set up a new greenfield project in the country, citing land acquisition, environmental clearance, policy lacunae, non-movement of files in Delhi or, simply, fear. They are all happy to invest overseas. High interest rates, which are crippling project returns, do not help either. Given this backdrop, there is no question that capital spending will decline further in 2013.

As for government spending, if we are to meet our long-term fiscal targets, then growth in government spending in 2013 has to be subdued.

That only leaves consumption, and rural consumption at that, as the growth driver for the economy. Can this single pillar of growth deliver more than six to 6.5 per cent GDP ?

If this bearish prognosis were to be even directionally correct, it would spell disaster for markets and we would clearly have one more major leg down. The markets are not currently priced for a further slowing of growth in 2013 (most economists have growth accelerating to between eight and 8.5 per cent), and we would see significant earnings downgrades were this to happen. Price earnings multiples in India would also get compressed in this scenario, since investors drawn towards India for its long-term growth profile would get spooked. I can see many global investors throwing in the towel were this scenario to play out.

We have all forgotten how an economy growing at six per cent feels. Compared to growth of eight to nine per cent, it will feel like a recession. There will also be serious slippages in tax revenue, as revenue buoyancy collapses, and companies will continually miss growth targets.

I still think the six per cent growth scenario is not the base case for FY 2013, but the longer Delhi dithers taking basic policy actions and being seen in control, the odds will rise.

Time is running out. Governance and decisive decision making have to be demonstrated so that economic actors can regain confidence and the animal spirits of entrepreneurship and risk taking can once again resurface to drive our economy. Investors want to see an economic game plan from the government and a willingness to take decisions in the long-term interests of the country. The longer they have to wait, the more worried we should be about 2013.

Is The US Slipping into Another Recession

September 9, 2011

Whether the US can avoid slipping into another serious recession is a subject of considerable debate among market participants. Along with Europe's sovereign debt problems, the risk of a serious renewed recession in the US is one of the major clouds hanging over global equity markets.

Gross domestic product (GDP) growth in the first half of this year has already been subdued, running below one per cent. Though the hard data over the past month have been stable, with retail sales increasing by 0.5 per cent in July, personal consumption expenditure increasing by 0.8 per cent and industrial production rising by 0.9 per cent, all these data points are backward-looking.

The more forward-looking survey data show significant deterioration. The Philadelphia Fed Index has dropped to -30.7, a level only observed previously during or on the cusp of a recession. The National Federation of Independent Business survey for small businesses has also weakened, with an increasing number of firms now expecting a decline in sales over the coming quarter. The biggest shocker has been the collapse in the University of Michigan Consumer Sentiment Index. It hit a 30-year low in August, even lower than levels in November 2008. Bond markets are clearly signalling economic weakness, with US 10-year rates slipping below two per cent.

Though the US economy may possibly slip into a shallow technical recession, two quarters of slightly negative growth, it is important to ensure that this does not turn into a deep downturn. The fears about a sharp downturn arise from the lack of ammunition with the authorities to tackle such an event (limited room on both fiscal and monetary front), and the savage effect it will have on corporate earnings in the US, the stock market and household wealth.

Though the lack of room for policy action is well known, few people realise just how elevated corporate earnings are in the US.

The profit share of GDP in the US is at an all-time high (nearly double its long-term average). This is driven by several factors: the effective tax rate has fallen to 25 per cent from 40 per cent in the year 2000; interest costs have dropped to less than 1.5 per cent of sales from four per cent in 2000; and real unit labour costs are at 60-year lows, with wage share of GDP at a 50-year low. The final factor in the elevated

profitability of corporate America is the weak dollar, and the translation effect of converting overseas earnings streams into the dollar.

A deep recession will lead to at least a 20 per cent drop in earnings in the US, which is easily possible, given high earnings today. Thus, the market will no longer look as cheap as the bulls would have you believe.

This is the big risk that investors are worried about. The US economy double dips, the authorities cannot do much to address another sharp downturn, earnings decline 20 per cent-plus, and the markets have one more leg down, dragging everybody down once again.

But to come to the main point, will the US have another steep decline? To answer this question, one must understand why growth in the US slowed sharply to just 0.7 per cent in the first half of 2011. Growth in real final sales (GDP growth minus the inventory contribution) declined from 2.9 per cent in the second half of 2010 to just 0.7 per cent in the first half of 2011. The slowdown in personal consumption expenditure accounted for 1.3 percentage points (57 per cent) of this growth downshift and a slowdown in government spending accounted for 0.5 percentage points (23 per cent). Looking at the data in more detail, it becomes clear that about half the decline in consumption was owing to a drop in auto sales and another 10 per cent owing to a reduction in gasoline purchases. It is clear that the earthquake and tsunami in Japan, which had a significant impact on the global auto supply chain, and the surge in fuel prices led to a reduction in auto and fuel sales in the US in the first half of 2011. Looking ahead, prices for most agricultural and industrial commodities, along with fuel costs, are likely to be lower in the second half of 2011. Also, the supply disturbances out of Japan are now mostly over. Motor vehicle production increased by 5.2 per cent in July, while both orders and shipments increased by 12 per cent. A reversal in commodity inflation and auto supply disruptions should provide some stability and support to consumption in the second half of 2011, and enable the US to avoid a sharp slowdown.

If we assume that consumption in the US will stabilise, then the bigger risk to growth is fiscal restraint. The question is: how much of a headwind on growth will it end up being? Fiscal tightening probably cut growth in the first half of 2011 by 0.75 to one per cent, and if current policy settings remain, this drag on growth will increase to between 1.5 and two per cent in 2012. The political environment in the US today is such that fiscal policy has become a major election issue along with jobs. The tea party movement, and its influence on the Republicans, has severely constrained the room for policy flexibility in this area. The Republicans were seemingly willing to even risk default to ensure spending cuts. The increase in fiscal drag in 2012 is largely owing to the scheduled expiry of the payroll tax cut at the end of 2011. If this is not extended, it will raise the tax burden on US households by

\$110 billion annually (0.7 per cent of GDP). If US President Barack Obama is able to convince the Republicans to extend this payroll tax relief and, hopefully, introduce some other job creation-related fiscal sops, than the fiscal drag on growth in 2012 will be no worse than in the first half of 2011. It will be critical for investors to track progress on this front over the coming months.

The single biggest risk that could push the US into another deep downturn is that of significant fiscal tightening, hitting an already weak economy. With Federal Reserve Chairman Ben Bernanke having fully understood the risks of premature fiscal tightening, US policy makers will hopefully pay heed to his advice and avoid rigid ideology-based policy positions. As for Europe pushing the US over the edge, direct US exposure is limited, since exports to the European Union (EU) only account for about two per cent of US GDP and cross-border exposure of most US banks is quite limited. However, a blow-up of any large EU financial institution will have unexpected consequences in the US.

As for other issues that could push the US into a deep downturn, there seems to be a reasonable amount of pent up demand in the US economy. The stock of capital goods has declined sharply as a share of GDP. On a flow basis, spending on these cyclical sectors is about 19 per cent of GDP, more than five percentage points below the post-1970 average. It would be a break from history for the US to go into another deep downturn, with cyclical spending already depressed.

Hopefully, the US can avoid another sharp leg down in its economy. Consumption seems stable, fiscal restraints can be eased, and most cyclically sensitive sectors are already depressed. A technical and shallow recession may still hit, but in the absence of a sharp renewed downturn, earnings should hold up, and markets don't look that expensive.

Is It Time to Buy India

August 26, 2011

I have been part of many discussions over the last week with prospective investors trying to figure out whether this is a good time to put money to work in India. Everyone is naturally cautious and worried about the drawdowns and mark-to-market pressures. Also, most markets in the world are in bear market territory (down 20 per cent from their recent peak). Thus, someone with capital to invest is spoilt for choice. On paper, India does not look particularly cheap. European and American markets are trading at 12 or 13 times their prospective earnings with bond yields nearly two per cent, while India is trading at 13 or 14 times with bond yields above eight per cent. India is also trading at a 25 to 30 per cent premium to the emerging market averages. So why come to India when the majority of global markets are far cheaper?

If one takes a 12-month view, then the following becomes clear:

- (i) Interest rates in India are going to be lower than they are today. The Reserve Bank of India (RBI) has been the most aggressive central bank in the world in normalising rates. Our interest rates are within 50 basis points of where they were before the collapse of Lehman Brothers in September 2008. Given the leads and lags of monetary policy in curbing inflation, the clear economic slowdown we are entering both in India and globally, and the likelihood that commodity prices will stabilise if not go down, it would be very surprising if rates do not come down in the next 12 months. India has the ability to cut rates, and has already gone through an inflation spike. Most countries do not have this flexibility.
- (ii) The global economic environment seems to be one in which the West will stumble around at near recession levels of between 1 and 1.5 per cent gross domestic product (GDP) growth. Liquidity will remain very easy and interest rates are going to remain near zero for at least 24 months. With global interest rates at zero, capital will flow into the emerging market asset class in search of growth, returns and to move away from the exposure to the US dollar. I believe enough regulatory action will be taken to prevent this capital driving commodities parabolic.
- (iii) India will probably grow at seven per cent, with the RBI itself mentioning 6.8 per cent (growth rate in the financial crisis) as being a disaster scenario and the absolute worst case. Our domestic-oriented, non-

correlated growth will be far more attractive and get a lot more attention in a growth-starved world. Indian companies will be able to deliver 15 per cent earnings growth, which will stand out globally. As the capital spending cycle restarts (it will eventually have to unless the country comes to a halt), this will also jump-start earnings growth for the market. With a robust monsoon so far, consumption demand for the coming year is going to be strong, which will also underpin earnings.

- (iv) Indian valuations, which are currently about 13 to 14 times March 2012 earnings, will be nearly 11 times March 2013 earnings. These valuation multiples are arrived at after cutting earnings estimates by five to eight per cent for FY 2012 and 10 per cent for FY 2013. While there may be some more earnings downgrades, investors have already built that into their calculations. Rarely does India stay at these levels of multiples for long. In a weak global growth environment, the growth visibility that India has will attract premium valuations. Mid-cap valuations in particular are starting to get very attractive. As these stocks have underperformed the broad market, investors are bailing out and want to have only large cap investments to reduce portfolio risk. There has also been significant sectoral dispersion. If one can take some short-term pain, valuations of companies with economic sensitivity are at very reasonable levels. Indian multiples are at a premium to the region, but arguably, so are the return ratios and growth visibility.
- (v) The current policy paralysis and standstill in government decision making cannot go on. Either the government should take the initiative and start governing, or we will have some change. This fire-fighting approach to governance is not sustainable. India is one of the few countries that have the opportunity to undertake fundamental game-changing policy reforms. The goods and services tax Bill is one example. Government policy action can make a huge difference to structural growth and investor sentiment.

One was negative on markets at the beginning of the year, as valuations were high, earnings estimates were too optimistic, and interest rates were rising much higher and faster than the consensus. Over the next 12 months, interest rates will decline, with valuations getting far more interesting, and the global economic difficulties will highlight the value of India's growth story. There are very few large markets that can deliver double-digit growth and earnings, independent of all but the most extreme global economic conditions. Combine this with the fact that retail participation in the markets is next to zero, all investor surveys show most

professional investors under weigh India, and record outflows from emerging market equities. This market is not over-owned, especially not from a longer-term real money perspective.

We are going through a classic bout of risk aversion and investor fright, when risk is taken off the table indiscriminately. This will settle down and the fundamentals will then become relevant again.

So should one buy now? It really depends on the time frame and positioning. If one has a genuine longer-term view and underweight equities (as most Indians are), then we are close to a very interesting entry point. I am convinced that investments made slowly and systematically over the coming three to six months will deliver good capital gains over an 18 to 24 month time frame. If one has the ability to time markets or is very concerned about short-term mark-to-market pressures, then one can wait and be more opportunistic. There is the possibility of one more leg down in markets, as markets need to riot to force western policy makers to act decisively. We could have another five to ten per cent downside. However, to remain bearish from here, you have to believe that either this policy paralysis is the new normal for India or the Indian growth surge of the past decade is unsustainable. You would have to believe that India grew at 7.2 per cent over the last decade owing to global capital flows and a very benign global economic backdrop, both of which will now reverse and thus Indian growth will slip to five per cent.

I do not belong to this bearish camp and genuinely believe that the economy has enough momentum and the polity has the understanding of the consequences that such a downshift in growth will not happen. I also believe all the noise today will eventually lead to structurally better governance. This is a transition that we have to go through.

Keeping the growth story alive

June 10, 2011

Investor sentiment towards India is clearly at a low point. Money managers are worried about both the macro and micro environment. On the macro front, it is feared that the recent 50 basis point increase in key policy rates by the Reserve Bank of India (RBI) may signal a determination to be more aggressive and single-minded about fighting inflation at the cost of growth. One cannot rule out another two or three increases by the RBI in the months to come, and we may see rates being kept at an elevated level for an extended period. The RBI seems determined – and rightly so – to put the inflation genie back in the bottle and squash any chance of an inflation spiral driven by rising expectations or wages. Inflation has also proved to be far more structural and deep-rooted than was initially thought.

The economy is slowing down, with GDP likely to clock between 7 and 7.5 per cent, nowhere near the originally targeted 9 per cent. Corporate capex is in cold storage and the first signs of a slowdown in consumption are now evident. The transition in growth from government consumption to private sector investment is not happening.

Another issue is governance, with reform momentum seeming to be totally lost. It appears the government is in a non-stop fire-fighting mode and, therefore, decision making stands paralyzed. All the discussion about big bang reforms or a Cabinet reshuffle now seems far-fetched. A lack of co-ordination among major ministries is also evident.

On the micro front, corporate earnings are poised to disappoint, with a lack-lustre quarter (Q4 2011) just delivered. India has one of the the worst earnings revisions among major emerging markets, and while consensus earnings estimates for 2012 are about 1240 for the Sensex, my guess is that this number will finally hit below 1200.

On that basis, the market is not cheap — it is trading at 15 times its March 2012 estimated earnings. India still enjoys a PE multiple premium over other emerging markets, though our return on equity is now only in line with the emerging market average.

Besides, all buy-side surveys show India as a consensus underweight, and even the local institutional pools of capital are defensive. For the first time even the smart proprietary pools of capital are being found to be cautious.

So we have a weak macro and micro environment, a market that is not particularly cheap, but refuses to go down. It's true that India is the worst-performing market in Asia, but considering how much we have risen in the past two years, we are down only 10 per cent this year. The resilience demonstrated by the market is surprising.

Despite negative investor sentiment, India has on a net basis not seen any foreign institutional investor outflow this year. Investors seem to talk bearish, but are not willing to actually sell.

What accounts for this resilience? Why does the market not seem to want to go down?

One reason could be that everyone is already so bearish and sentiment is so weak that markets have already bottomed out. Allocations and positioning towards India can only improve from here, driving the market higher, once investors turn more positive. Going by that, the market has absorbed a huge amount of bad news, without cracking, indicating that it has bottomed out. However, given the lack of selling on a net basis, this seems unlikely. One does not get any sense of capitulation or selling exhaustion that would be expected if this were a sentiment-driven bottoming-out.

A more likely reason is that investors have not lost faith in the long-term growth trajectory of India. The current environment is still being seen as a short-term aberration which will be corrected quickly. Investors are assuming that in a functioning democracy, the governance and policy paralysis cannot continue indefinitely and will not impact longer-term growth.

This is why at every fall, genuine long-term capital continues to flow into the country. Even in March, we saw \$2 billion to \$3 billion come in quickly from sovereign wealth funds and pensions. In a world of very low growth, and a declining dollar, India with its expected 8 per cent growth trajectory continues to stand out. Few large economies can credibly aspire to achieve these growth rates, and real money investor positioning is still underweight. Many investors who missed out on the rally of the past 24 months now see this consolidation phase as a good entry point.

The growth argument is quite simple and rests on the assumption that India will have a savings rate of 34 to 35 per cent, current account deficit of 2 per cent, yielding an investment rate of 36 to 37 per cent. With an incremental capital output ratio of 4 to 4.5, this will drive real GDP growth of 8 to 9 per cent.

Thus, the only way investors will start doubting the India story (by this framework) is if they start questioning the 35 per cent savings assumption. Given that household savings are reasonably stable, the delta will come from corporate savings and the government sector. As long as you believe that corporate earnings will remain strong, and the government is able to rein in fiscal deficit, we should be able to deliver the targeted investment rate and GDP.

Unless government finances totally fall apart, or corporate India fails to deliver the profitability we have come to expect, investors are not going to let go of their 8 per

cent growth (for a decade) assumption. They do not seem to be willing to factor in the investment and policy environment into their growth calculations.

Investors using this framework will continue to look through the valley of short-term headwinds and put money to work. Despite many investor misgivings, India may not have a significant downtrend from here. It could be 5 per cent, or even 10 per cent, but is unlikely to fall further. The bears calling for a market collapse are unlikely to be right. At every level, long-term capital will come in, unable to find other credible, sustained and long-duration growth opportunities.

It is amazing how much benefit of doubt investors are willing to give the country. Starved of alternative growth opportunities, they are willing to look through the serious challenges that the country currently faces, hoping that we have so much going for us in the long term that we will not disappoint.

We have been given a long rope by investors. Let us hope that we do not abuse it. If international capital gives up on our story, the country will have to face serious challenges in the future.

Global commodities and India

May 27, 2011

India needs a calibrated policy framework to operate in an increasingly resource-scarce world

Once again the buzz is around commodities and their long-term outlook. Goldman Sachs has just raised its outlook on commodities and reaffirmed their long-term bullish thesis. Morgan Stanley and Macquarie have also raised their oil forecasts for 2011 and 2012 to \$120 and \$130, respectively. Jeremy Grantham of GMO has recently come out with a paper outlining the case for commodities to remain in a structural bull market. He feels that we are running out of all commodities, and the 100-year downtrend in real commodity prices has been conclusively broken. The fact that a 100-year, 70-per cent real decline in commodity prices till 2002 has been erased entirely since then indicates that we are now entering a new paradigm, far removed from the old downtrend.

Much of the bullish argument about commodities centres around China. China today consumes over 50 per cent of the world's cement and iron ore, and between 43 and 50 per cent of steel, copper, nickel and zinc. The bulls will argue that China is still a poor country, with per capita GDP only 20 per cent that of the US. Even as China continues to grow at 8 or 9 per cent per annum, its demand for all commodities will keep compounding, to the point where supplies will remain strained.

The fallacy of this argument (at least for base metals) is that though China is a poor country, its per capita consumption of these metals is already higher than its developed peers. On a per capita basis, China already consumes 34 per cent more zinc, about as much copper and nickel and only 16 per cent less aluminium than the US (source: BCA). The per capita consumption of these metals has been stagnant in developed countries over the past few decades, reflecting the shift towards services in their industrial structure.

This implies that as China continues to grow, and more closely resemble the industrial structure of a developed economy, in the coming decades its per capita commodity demand will not be substantially different from what it is today.

The BCA has modelled out the annualised growth in base metal consumption that China will experience if its per capita consumption in 2030 converges with South Korea, another manufacturing powerhouse. Remember that Korea's per capita consumption is three times the US'. These studies indicate that China's copper consumption will grow at only 6 per cent per annum over the next 20 years, compared to the 15 per cent annualised growth over the past decade. This would mean a 30 per cent reduction in annual incremental demand in terms of copper

tonnage. For aluminium, the last decade's growth rate of 17 per cent drops to under 5 per cent — something similar has happened in the case of other metals.

This implies that for the prices of these commodities to remain at elevated levels, another growth driver – most likely India – will have to kick in. If India were to have a less commodity-intensive growth profile than China as it develops, it is unlikely that prices will sustain, given the supply coming on line. Therefore, it is India, not China, that will determine the future pricing trajectory of base metals in the coming years. The fact is the world cannot support another equivalent of China, and unless we want all commodity prices to spike, our growth model has to be a lot less commodity-intensive.

Unfortunately, the story for oil is far less sanguine. China consumes only about 10 per cent of world supply, roughly equal to its GDP share. As China continues to grow, adding more automobiles on the road, its current low per capita consumption will rise. A significant downward shift in the growth of Chinese demand for crude oil over the coming years is unlikely. On the other hand, Indian demand will accelerate. Oil consumption will, thus, peak within a decade. Globally, over 70 per cent of crude is used for transportation. Unless we move away from the internal combustion engine, we cannot overcome our addiction to crude oil.

The story for agricultural commodities also seems grim. Here, as Mr Grantham points out, the growth in crop yields per acre has dropped to about 1.2 per cent per annum, which is close to the growth rate of global population. Little new arable land is available, and as the poor consume more meat, the grain intensity of their diet triples. So, we have very little margin of safety.

India is quite vulnerable to global commodity prices. Our whole macro economic framework comes under pressure if commodity prices surge, with the current account, fiscal balance and inflation all under stress. While we cannot control global oil prices, our energy efficiency is pathetic and we need to reform the whole pricing mechanism. The economy has to be given appropriate price signals, reflecting the true scarcity of crude and our import dependence.

In agriculture, too, the whole supply chain has to be cleaned up so that producers receive true and remunerative market-based prices. We continue to have yields well below global averages for most crops except cotton (where Bt seed has made a difference). There is plenty of scope for technological inputs to lift yields and boost farm-level economics. The policy framework has to allow this to happen.

In other commodities like iron ore and coal, we have huge reserves, but again a very poor policy framework in place. We cannot afford to take nine or ten years to operationalise mines. The whole approach towards the allocation of mineral resources is opaque and open to abuse. The government has spent years trying to formalise a mining bill, but to no avail. We must be the only country in the world that despite having huge reserves of coal will need to import over 100 million

tonnes over the coming 24 months, enriching the economies of Indonesia and Australia. This is because we are unable to get our policy co-ordination right.

For such a vulnerable economy, and one that on the margin will drive the prices of many commodities globally, we do not seem to have a holistic commodity security strategy in place. Our policy framework is inadequate to ensure full and effective utilisation of domestic resources, and we do not have the infrastructure or global assets to ensure uninterrupted access to critical raw materials. Unlike China, where the state is active in ensuring long-term access to key raw materials, we seem to have sub-contracted this to our private sector and hope for the best. Much work needs to be done across many areas.

The China debate

May 13, 2011

Getting China right is one of the most important calls investors have to make. The importance of China is driven by its impact on global growth, incremental consumption of commodities and its emergence as the second-largest economy in the world. If the economic boom in China persists, global economic growth will continue, emerging markets should continue to outperform and global commodity prices will be robust. However, if the bears are right, and we see a huge over-investment-related bust, industrial commodities will collapse, global growth will get a shock and all risk assets may encounter turbulence.

Both sides of the debate seem to agree that China will slow in 2011, and even 2012. Nobody expects China to continue growing at 10 per cent-plus, with expectations converging around 7 to 8 per cent in the foreseeable future. It is being agreed that domestic consumption will increasingly drive this growth. The Chinese government has introduced a slew of measures to raise consumption, such as lowering taxes, improving the social safety net and boosting workers' disposable incomes.

The bulls believe that China will have a soft landing, exports will hold up and domestic consumption will accelerate — all this will compensate for some weakness in capital spending.

The bears are calling for a hard landing, with a sharp slowdown in capital spending led by real estate and construction in particular. This is the crucial point of difference. China bears are convinced that there has been huge over-investment, poor capital allocation and an asset bubble, while the bulls are far more sanguine. There was a fascinating article on this subject recently in the BCA, some points from which I have tried to encapsulate below.

The bearish case is based on the following:

- China's investment rate is too high, and has been at elevated levels for far too long. Investment in China is running at 47 per cent of GDP, and has been over 40 per cent since 2005. In both Japan and South Korea, the investment rate peaked at about 38 or 39 per cent. It is hard to believe that there has not been a significant misallocation of capital in a country that has been investing so much and where local governments and state-controlled banks are heavily involved in capital allocation decisions. This poor capital allocation will eventually lead to the creation of non-performing assets in the banking system, poor profitability, stranded assets and falling returns on capital.
- The second point deals with property prices and the imminent bust in construction activity. Various commentators have pointed out that in real

terms, property prices in China are one standard deviation above the mean, even assuming that this mean value is rising over time as incomes increase. The average property price-to-income ratio is already about 10 across China and over 15 in the larger cities. The US housing bubble peaked with this ratio at six. Obviously, the ratio will be higher in China since incomes are rising much faster, but the gap remains excessive. The problem is that people who need to buy cannot afford to do that since first-time buyers are priced out of the market. As far as over-building is concerned, residential floor space under construction in urban China has surged seven-fold in the past decade to over 3 billion square metres. The number of new housing units constructed as a percentage of the number of households in China (over the last 15 years) is much higher than in Japan or the US at any point in their history. China also consumes 50 per cent of the world's cement. Also, per capita cement consumption in China is now higher than any other nation, despite half of the country's population living in rural areas. Such cement intensity hints at massive over-building in the cities. Data from BCA also show that investment in residential construction as a share of GDP in China exceeds that of Japan and Korea at the peak of their construction booms.

The bears make the case that as the government is tightening monetary conditions and putting in curbs on speculative property purchases, demand for housing at current price points will drop, just as a huge slug of new supply comes to market. This will force property prices to correct, and private construction activity will contract significantly, hitting growth and commodity prices. Many real estate firms will get into serious trouble and banks will be stuck with dud collateral and assets.

The bulls obviously disagree and make the following case:

- As regards over-investment, the incremental capital output ratio (ICOR) in China is not much higher than its Asian peers and does not indicate any gross inefficiency in capital spends. China has also been the biggest recipient of foreign direct investment over the years, indicating that global multinationals are able to earn reasonable returns on capital, unless you assume all these companies have been, and continue to be, irrational. The return on equity in China is reasonable and stable, with no collapse in return ratios. The improvements in infrastructure brought about by this investment are also noticeable and are enhancing productivity in the economy. Just because China invests so much does not imply that it is inefficient.
- On the over-build in the housing sector and the imminent bust in construction activity, the bulls totally disagree. They think that data on excess housing units, constructed or under-construction, do not take into account the removal of poor quality housing stock from the system. Even if one assumes that only 1 per cent of the existing housing stock is replaced, the net increase in housing stock over the past decade has barely kept up with household formation. Data on housing prices on a national basis also show that since 1998 – when China implemented housing reforms and

privatisation – home prices have lagged household incomes, implying no deterioration in affordability on a nationwide basis. China is still in the middle of its urbanisation process, with half the country's population still residing in rural areas. All other major economies that rapidly underwent urbanisation experienced a massive boom in residential construction, much like China today. While private construction activity may slow, as rising rates crimp demand in the short term, the government's desire to build 36 million units of low-cost housing should cushion construction and investment activity. The froth largely exists in the top-end of the market, and is not large enough to impact the broad economy.

It seems if China has a problem it will be short-term and cyclical. Given the type of productivity growth still available to an economy that has 670 million people living in the countryside even today, most of whom will move to manufacturing or service jobs in the cities, it is difficult to see China go into any type of an extended slowdown. The government has enough fiscal levers available to cushion the economy, and domestic consumption still has a long growth runway left. China's global competitiveness as a production base is still unquestioned.

One hopes that China will slow to cool off commodity prices, which will bring India great relief. But do not bet on any slowdown being significant in either duration or depth.

Beyond quantitative easing-II

April 8, 2011

Historically, equities have always wobbled around the first Fed rate hike, after a recession. In the process, they have demonstrated a clear setback in prices, while avoiding a bear market. The first rate increase would also normally trigger a bout of sector rotation, with cyclicals and banks underperforming and giving way to the more defensive sectors in the market. Risk assets never like rising rates and draining liquidity, and given the current low levels of interest rates, any tightening will be extended in both duration and extent. Given that most people feel that the markets are currently being driven by easy liquidity, one would expect investors to fear any move to reverse these monetary and liquidity conditions.

However, the bulls argue that the first actual rate hike by the Fed is a long time away, probably not before Q1 2012, so why worry today about an event 12 months away? They feel the party can continue until the Fed actually begins raising rates. Also, given the fact that rates are at zero, even a 25 to 50 basis point hike in rates is unlikely to alter the attractiveness of equities or change interest rate-based valuation models, they argue.

My sense is that instead of waiting for the actual rate hike, markets may start pricing in tightening well before the actual event. Market movements and price patterns may start exhibiting the start of the tightening theme far earlier this time.

Markets are probably just waiting for a change of language from the Fed (extended period and exceptionally low being the key operative phrases) in the publicly released policy statement. Given the extraordinary nature of monetary easing in this cycle, a change of language will signal the intention of the central bank to move back to more conventional policy settings. Also, historically, central banks were far less communicative, with regular Federal Open Market Committee commentary only beginning in 1999. With the change in approach towards communication, the policy statement has a clear signalling effect. Given the type of hawkish statements being made recently by certain Fed governors, a change in tone from the Fed is imminent. There is also a growing feeling that we are approaching the end of this phase of quantitative easing (QE). QE2, as it was called, is likely to be wound down by June, with the completion of the Fed's buying programme of \$600 billion worth of treasuries. Though there is still hope on the part of investors that this programme will get extended, the politics of Washington would seem to indicate that any extension is unlikely. The decent employment report released last week and the strength in markets make the case for extension weak. Recent comments by the Fed also indicate debate and disagreement, with some members even arguing for an

accelerated tightening programme. The formal winding down of the QE2 programme will be definitely taken by the markets to signal the end of extraordinary easing and opening the doors to the start of policy normalisation. The Fed will have to shrink its balance sheet, and any steps taken to do so cannot be good for risk assets.

At the same time as the Fed is likely to wind down QE2, we have the European Central Bank (ECB) embarking on a tightening agenda. Most market observers expect the ECB to hike this week itself, despite the clear difficulties being currently faced by the peripheral European economies. The ECB seems to prefer targeting incipient inflationary pressures, rather than trying to ease the economic pressures on the highly indebted periphery. In the next couple of months, the Bank of England will also move to tighten. Thus, by June we will have all the major developed world central banks (except Japan) either tightening or, at the least, no longer injecting liquidity into the system.

Combine this with the fact that all major emerging market central banks in China, India, Brazil, Turkey and Russia are also implementing some form of quantitative tightening if not outright interest rate increases, and the outlook for equities and risk assets should be challenged. Most of the emerging market central banks including India are still in the midst of their tightening cycle, with still some way to go.

Going by the recent past, markets will wobble, once some of the extraordinary stimulus measures are wound down. If we look at the last two years, global equity markets bottomed in March 2009, as the US began QE1 (buying treasuries, agency bonds and mortgage-backed securities). Markets began to struggle in April 2010, once this buying ended and then picked up again with the announcement of QE2 in August 2010. Logically, markets should struggle once again, now that we are about to complete the latest and probably the last bout of Fed asset buying.

Markets, however, do not seem to be perturbed at the moment. Maybe market participants feel that given all the headwinds around global growth in terms of debt burdens, housing market weakness and unemployment, we will not see an extended period of tightening. However, it is difficult to envisage any tightening without interest rates rising significantly, given the current levels.

The headwinds for global equities continue to build. We have the tightening of liquidity discussed above, oil prices at \$120 and rising, sovereign issues and surging commodity prices. Yet, markets continue to rise. Whether it is the yen carry trade being put back on, or investors trying to time their exit from markets to perfection, risk appetite remains strong. This seems unlikely to last. The Australian dollar, Brazilian real, gold, silver and soft commodities all are in a strong uptrend. The Russell 2000 index of small cap stocks is at an all-time high, even crossing its 2007 peak. All the money pumped in by the Bank of Japan seems to be finding its way to

all sorts of financial assets. Though this cannot continue indefinitely, it is very difficult to predict how much steam markets have left. It is prudent to remain cautious and not chase momentum.

India has done extraordinarily well over the past two weeks, with markets rising by more than 10 per cent from the bottom. The Indian markets also seem to be caught up in this momentum trade, with markets going up despite oil prices, inflation and other domestic issues. India is not cheap, and earnings are going to be at risk. What the upside is from here in the short term is debatable.

Too early to pop the bubbly

March 25, 2011

Fundamental weaknesses could send the global economy into a tailspin

After going through a few harrowing days in the last week post the tragic earthquake in Japan, markets now seem to be convinced that all is fine. Immediately post the quake, markets seemed to wobble a bit, with the uncertainty around the impact on global supply chains as well as the concerns around the possible meltdown at the nuclear plant in Fukushima. Now, most market observers feel that the reactors are in control, the impact on global growth will be no more than 50 basis points and the supply chain disruptions are by and large manageable; So much so that markets in the developed world are back close to pre-quake levels, despite the possibility of new tail risks emerging in Libya, where we have the possibility of an extended conflict and no clear end game.

Global markets seem to be in a mood to keep rising, ignoring the continuing build-up of concerns. We now have oil prices firmly ensconced at levels of \$110, ongoing worries in the West Asia and North Africa region, with Yemen and Bahrain in stress. The West seems to be getting entangled in a protracted conflict in Libya, from which there is no easy or clear exit. Portugal now looks likely to need a formal bailout, with fresh elections a strong possibility. Ireland remains a sovereign debt concern. The European Central Bank and Bank of England look likely to raise rates very soon, and the Federal reserve also will have to allow QE2 (quantitative easing) to wind down post June. Interest rates will soon start rising in Europe, and the Federal Reserve will no longer buy treasuries. The impact of all this on markets and rates could be disruptive. The fiscal issues in both Europe and the US remain unanswered, with most long-term investors pessimistic due to the huge debt burdens and unsustainable fiscal arithmetic we see in these countries. Sometime soon, somebody will have to address these fiscal and debt issues and the actions needed to correct these problems will be painful and growth destructive. China and its attempt to soft land its economy, is another potential tail risk event.

Yet, despite all of the above baggage, markets refuse to give up, money continues to flow into developed market equities and momentum remains on the side of the bulls. Investors seem happy to play the accelerating growth profile of the US in 2011, and believe that earnings can continue to rise with expanding margins. The bulls point to current valuations being cheap, especially relative to interest rates,

totally ignoring longer term valuation metrics like the cyclically adjusted private equity.

We will need a growth or inflation scare in the developed markets to shake the complacency markets are now in. The growth scare could come in the second half of the year, especially in the US, when some of the tax cuts and fiscal stimulus expire, and economists will have to pencil in slower growth in 2012. If growth were to slow next year, markets will wobble and fears of an extended period of sub par economic performance will reemerge. The winding down of the QE2 experiment, will also throw up some interesting challenges as to how do markets handle this transition? Will rates move up quickly? Who will be the buyer of treasuries to replace the Fed? Stopping further quantitative easing is one matter, but how will the Fed bring down its bloated balance sheet, and unwind its bond holdings? When will bond markets force action to tackle the fiscal mess, will international investors allow the dollar to go to zero? All these are questions, which will have to be addressed in the second half of 2011. While markets are complacent today, all these concerns are building. Assuming for the moment that global markets hang in there for some time, before the inevitable day of reckoning, how will India fare? Surely, strong global markets and risk appetite will be good for India as well.

The problem to my mind is that the way markets are reacting, commodities and oil are leading financial markets on the way up. These asset classes seem to immediately catch a bid at the first sign of positive investor sentiment. India as we all know struggles in an environment of strong oil and commodity prices, with the fiscal, corporate earnings, inflation and current account all in stress. If one were to take current oil and commodity prices as a given, India would have to raise inflation estimates, earnings would have to be cut, interest rate will rise and valuations would not be in an attractive zone. India may go up, but will definitely lag other markets as it is difficult to see significant absolute upside. The equity market (EM) versus the debt market (DM) trade will also continue in such an environment. The reasons DM has been leading the way in 2011, viz. a narrowing economic growth gap with the EM economies, lower exposure to commodity and food inflation, less margin pressure on companies, etc will all be still operative.

India will actually do better (at least relatively) if global markets and risk appetite weaken. As one saw in the first couple of days post the quake, market weakness was led by oil and commodities and India did much better than its EM counterparts. Much of our underperformance was made up in a matter of a few days.

Thus, if global markets continue to go up, India will underperform on the way up, and has limited upside on an absolute basis, as the surge in global commodity prices

will cap our upside. If global markets weaken, led by falling commodity prices, India will do better, but only in a relative sense, falling by less. Until we get our inflation issues sorted out, or push ahead on governance and economic reform-related issues, the market is probably stuck in a broad trading zone. The only caveat to this is investor positioning. Most funds are underweight in India, trading volumes have collapsed and investor interest in the country limited. The pain trade would be if markets move up, and catch investors on the wrong foot. Markets consolidating around current levels still seem the most probable outcome.

More Equity in Infrastructure

March 11, 2011

Absence of financial depth may dampen private sector participation in infrastructure projects

The government of India has outlined very ambitious plans for building infrastructure in India over the coming decade. In the upcoming 12th plan (2012-2017), the government has targeted total infrastructure spend of about a trillion dollars. Of this, the private sector is supposed to fund 50 per cent.

One has seen numerous articles debating the ability of the private sector to access enough debt to fund this build out. The need to develop a corporate debt market, the asset-liability mismatch banks are running in funding infrastructure, the need to attract genuine long-term capital like insurance and pension monies in the space, are all well flagged issues. The government has already moved on some of these pain points and seems seized of the problem. In this Budget, we saw the FII limits on corporate bonds for infrastructure being raised by \$20 billion, and numerous discussions to activate the corporate bond markets, encourage take-out financing, etc. are currently active.

Beyond debt, I think there is an issue on the availability of equity capital, simply put our infra developers do not have the market cap for the build-out.

The infrastructure sector (comprising both project developers and construction companies) has got massively de-rated by investors over the last few years. After being a darling of the markets in the run-up to the peak of 2007, the sector has consistently underperformed. The sector is so out of favour that it currently seems incapable of raising any new equity from the public markets. Its only source of equity capital is from private equity players and that too in mostly structured/guaranteed return transactions.

If we look at a universe of more than 60 private sector infra companies (excluding Larsen and JSPL; they are doing more than just infra) their combined market cap is just \$55 billion (out of total market cap of \$1 trillion). The typical promoter holding is below 50 per cent. Of this \$55 billion, about \$28 billion is the market cap of pure-play power developers.

If we want the private sector to invest \$500 billion in infrastructure over the coming five years, even assuming a 70/30 debt equity structure, this implies a need for \$150 billion of equity over five years. How will a sector with a total market cap of

\$55 billion (50 per cent promoter holding) generate \$30 billion of equity contribution per annum? This is difficult to contemplate as companies will not be able to raise multiples of their current market cap. At best one can assume a 30 per cent dilution and that to, once every two years (yielding only \$15-16 billion every two years and that too if every company can raise equity). The constant need to dilute will also prevent the market cap of these companies from rising exponentially. Thus, neither will markets support the quantum of equity fund raising needed, nor will promoters accept bringing their stakes down to zero. Market cap is relevant, as most of these infra developers generate no-free cash flow as of today, and hence equity contribution will have to come from fresh fund raising. The quantum of new equity any company can raise is intrinsically linked to its current market value. Without the equity, it does not matter how easily debt is available, as no project will get financial closure. Debt approvals are normally contingent on equity being brought in first. The reality is that the Indian infrastructure sector does not have the size, financial muscle and market clout to fund the infrastructure this country needs.

While power projects may still go ahead, as we have 4-5 large power developers with a combined \$28 billion of market cap, \$27 billion of market cap has to support everything else from roads to ports, airports, sanitation, etc. Again, the needs dwarf the capital, which can be raised.

There are various implications of this mismatch between current market cap, and incremental equity requirements.

First of all, we are going to be very dependent on foreign equity coming directly into project level investments. This equity will need to come from specialised infrastructure funds or from global project developers who are willing to fund projects and can bring in the capital. As a country, we may have to accept foreigners owning large chunks of our infrastructure, as is the case today with ports.

Secondly, the big boys of Indian industry will have to get more involved in infrastructure. Their balance sheets and cash flows have to come into play. The current lot of entrepreneurs in the space do not have the financial muscle, nor market credibility to fund the needed build out. We have already seen this happen in the power space, with all the top business houses contemplating investments.

Thirdly, markets have ignored the sector, given the poor economics demonstrated. Most infra projects/developers generate no-free cash flow, have low ROE's and are very susceptible to project delays and policy risk. Investors are tired of projects

stuck in red tape or subject to the whims and fancies of ministers. Most of the large infra projects are also seen to be disguised bets on real estate, as their entire economics depend on the monetisation of some land parcels bundled along with the project. Unless these project characteristics improve, money will not flow. Investors currently feel that only those developers who can manage the system, can make money in this space. This perception has to change.

We will also see significant concentration risk among a handful of companies. In the power space, for example, only Reliance Power, Adani, Tata Power and JSPL have a market capitalisation in excess of \$5 billion. Any project above a certain size can only be put up by one of these four. In ports, the only company with a market cap in excess of \$1 billion is Mundra. In roads, only IRB has a market cap in excess of \$1 billion. Larsen, with a market cap of \$ 21 billion, is larger than all the other infra players combined (excluding the pure-play power developers). Is the government and public policy environment prepared to have 2-3 private companies dominate every sector? How will banks handle group exposure issues?

India is attempting to implement one of the most ambitious public-private partnership programmes ever conceived. Driven by a lack of resources with the government, we need the private sector to step up and fund/develop \$500 billion of investments over the coming five years. In a market with ROE's of 20 per cent, investors will not give capital to the infra developers, unless their projects can be seen to deliver similar returns (adjusted for leverage). Will our public policy framework allow private developers to earn these type of project returns, on the scale needed and will the public be willing to pay the prices for infra services needed to deliver these high returns? This is a fundamental contradiction and policy dilemma. We are not a capital surplus country, our high cost of capital and high corporate returns, much lauded by investors is actually a disadvantage when trying to build out infra projects. Investor hurdle rates are too high. We need a new set of investors, satisfied with steady 12-15 per cent annuity type returns, and willing to sit through multi-year project implementation cycles.

Muddling Through

March 25, 2011

After going through a few harrowing days, in the last week, post the tragic earthquake in Japan, markets now seem to be convinced that all is fine. Immediately post the quake, markets seemed to wobble a bit, with the uncertainty around the impact on global supply chains as well as the concerns around the possible meltdown at the nuclear plant in Fukushima. Now most market observers feel that the reactors are in control, the impact on global growth will be no more than 50 basis points and the supply chain disruptions are by and large manageable. So much so, that markets in the developed world are back close to pre quake levels, despite the possibility of new tail risks emerging in Libya, where we have the possibility of an extended conflict and no clear end game.

Global markets seem to be in a mood to keep rising, ignoring the continuing build up of concerns. We now have oil prices firmly ensconced at levels of \$110, ongoing worries in the MENA region, with Yemen and Bahrain in stress. The west seems to be getting entangled in a protracted conflict in Libya, from which there is no easy or clear exit. Portugal now looks likely to need a formal bailout, with fresh elections a strong possibility. Ireland and the new government remain a sovereign debt concern. The ECB and Bank of England look likely to raise rates very soon, and the Fed also will have to allow QE2 to wind down post June. Interest rates will soon start rising in Europe, and the FED will no longer buy treasuries. The impact of all this on markets and rates could be disruptive. The fiscal issues in both Europe and the U.S. remain unanswered, with most long term investors pessimistic due to the huge debt burdens and unsustainable fiscal arithmetic we see in these countries. Sometime soon, somebody will have to address these fiscal and debt issues and the actions needed to correct these problems will be painful and growth destructive.

China and its attempt to soft land its economy, is another potential tail risk event. Yet despite all of the above baggage, markets refuse to give up, money continues to flow into developed market equities and momentum remains on the side of the bulls. Investors seem happy to play the accelerating growth profile of the U.S in 2011, and believe that earnings can continue rising with expanding margins. The bulls point to current valuations being cheap, especially relative to interest rates, totally ignoring longer term valuation metrics like the cyclically adjusted PE.

We will need a growth or inflation scare in the developed markets to shake the complacency markets are now in. The growth scare could come in the second half of

the year, especially in the U.S, when some of the tax cuts and fiscal stimulus expire, and economists will have to pencil in slower growth in 2012. If growth were to slow next year, markets will wobble and fears of an extended period of sub par economic performance will re-emerge. The winding down of the QE2 experiment, will also throw up some interesting challenges as to how do markets handle this transition? Will rates move up quickly? Who will be the buyer of treasuries to replace the Fed? Stopping further quantitative easing is one matter, but how will the Fed bring down its bloated balance sheet, and unwind its bond holdings? When will bond markets force action to tackle the fiscal mess, will international investors allow the dollar to go to zero? All these are questions which will have to be addressed in the second half of 2011. While markets are complacent today, all these concerns are building.

Assuming for the moment that global markets hang in there for some time, before the inevitable day of reckoning, how will India fare? Surely strong global markets and risk appetite will be good for India as well.

The problem to my mind, is that the way markets are reacting, commodities and oil are leading financial markets on the way up. These asset classes seem to immediately catch a bid at the first sign of positive investor sentiment. India as we all know struggles in an environment of strong oil and commodity prices, with the fiscal, corporate earnings, inflation and current account all in stress. If one were to take current oil and commodity prices as a given, India would have to raise inflation estimates, earnings would have to be cut, interest rate will rise and valuations would not be in an attractive zone. India may go up, but will definitely lag other markets as it is difficult to see significant absolute upside. The EM versus DM trade will also continue in such an environment. The reasons DM have been leading the way in 2011, viz. a narrowing economic growth gap with the EM economies, lower exposure to commodity and food inflation, less margin pressure on companies etc will all be still operative.

India will actually do better (atleast relatively) if global markets and risk appetite weaken. As one saw in the first couple of days post the quake, market weakness was led by oil and commodities and India did much better than its EM counterparts. Much of our underperformance was made up in a matter of a few days.

Thus if global markets continue going up, India will underperform on the way up, and has limited upside on an absolute basis, as the surge in global commodity prices will cap our upside. If global markets weaken, led by falling commodity prices, India will do better, but only in a relative sense, falling by less. Until we get our inflation issues sorted out, or push ahead on governance and economic reform related issues

the market is probably stuck in a broad trading zone. The only caveat to this is investor positioning. Most funds are underweight India, trading volumes have collapsed and investor interest in the country limited. The pain trade would be if markets move up, and catch investors on the wrong foot. Markets consolidating around current levels still seems the most probable outcome.

Where is the Equity?

March 10, 2011

The Government of India has outlined very ambitious plans for building out infrastructure in India over the coming decade. In the upcoming 12th plan (2012-2017), the govt. has targeted total infrastructure spend of about a trillion dollars. Of this, the private sector, is supposed to fund 50%.

One has seen numerous articles debating the ability of the private sector to access enough debt to fund this build out. The need to develop a corporate debt market, the ALM mismatch banks are running in funding infrastructure, the need to attract genuine long term capital like insurance and pension monies in the space, are all well flagged issues. The government has already moved on some of these pain points and seems seized of the problem. In this budget, we saw the FII limits on corporate bonds for infrastructure being raised by \$20 billion, and numerous discussions to activate the corporate bond markets, encourage take-out financing etc. are currently active.

Beyond debt, I think there is an issue on the availability of equity capital, simply put our infra developers do not have the market capitalization needed to fund the needed build-out.

The Infrastructure sector (comprising both project developers and construction companies) has got massively de-rated by investors over the last few years. After being a darling of the markets in the run-up to the peak of 2007, the sector has consistently underperformed. The sector is so out of favour, that it currently seems incapable of raising any new equity from the public markets. Its only source of equity capital is from private equity players and that too in mostly structured/guaranteed return transactions.

If we look at a universe of more than 60 private sector infra companies (ex Larsen and TNSI as they are doing more than just infra) their combined market capitalisation is just \$55 billion (out of total market cap of \$1 trillion). The typical promoter holding is below 50%. Of this \$55 billion, about \$28 billion is the market cap of pure-play power developers.

If we want the private sector to invest \$500 billion in infrastructure over the coming 5 years, even assuming a 70/30 debt equity structure, this implies a need for \$150 billion of equity over 5 years. How will a sector with a total market capitalisation of \$55 billion (50% promoter holding) generate \$30 billion of equity contribution per

annum? This is difficult to contemplate as companies will not be able to raise multiples of their current market cap. At best one can assume a 30% dilution and that to, once every two years (yielding only \$15-16 billion every two years and that too if every company can raise equity). The constant need to dilute will also prevent the market capitalisation of these companies from rising exponentially. Thus, neither will markets support the quantum of equity fund raising needed, nor will promoters accept bringing their stakes down to zero. Market capitalisation is relevant, as most of these infra developers generate no free cash flow as of today, and hence equity contribution will have to come from fresh fund raising. The quantum of new equity any company can raise is intrinsically linked to its current market value. Without the equity, it does not matter how easily debt is available, as no project will get financial closure. Debt approvals are normally contingent on equity being brought in first. The reality is that the Indian infrastructure sector does not have the size, financial muscle and market clout needed to fund the infrastructure this country so desperately needs.

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Good Packaging

March 1, 2011

The finance minister (FM) has done, for once, a good job of giving a positive spin to the Budget and its arithmetic. He positively surprised the market by delivering a fiscal deficit number of 5.1 per cent in FY11 and proposed 4.6 per cent in FY12. The 4.6 per cent number is way below embedded market expectations of 5.1 to 5.2 per cent for FY12. He has managed to get to these numbers without any windfall like an amnesty scheme or asset auctions, which makes it even more creditable.

The problem, however, is that his math seems dodgy. He has actually budgeted for a decline in subsidies in FY12! The FM has budgeted for a reduction in oil subsidies from Rs 38,000 crore to Rs 23,000 crore, a drop in fertiliser subsidy from Rs 55,000 crore to Rs 50,000 crore and stable food subsidies at Rs 60,000 crore. There is no way these subsidy numbers for FY12 are even remotely credible, especially with oil at \$105 a barrel. There is a minimum under-budgeting of Rs 50,000 crore. The only way these numbers can be met is if the FM moves immediately on de-control of diesel, raises other fuel prices and goes in for a nutrient-based subsidy regime for urea (with an immediate price rise). These are great reforms if he can get them done, but the track record does not inspire confidence. He has also not provided anything for the Right to Food Bill. Even on the revenue side, assuming an 18 to 20 per cent increase in tax revenues is ambitious (on a high base).

Thus, the entire fiscal arithmetic seems flawed, we will end with a fiscal deficit probably closer to five per cent, than 4.6 per cent. Commensurately, the net market borrowing target is going to be closer to Rs 400,000 crore as opposed to the Rs 350,000 crore given in the Budget. With this amount of market borrowings, interest rates and bond yields will remain under pressure.

Even though the FM may not meet his targets on the fiscal, he should be commended for appearing as non-populist as we have ever seen him. He is targeting total expenditure growth in FY12 of only 3.5 per cent over the revised estimates for FY11. He has actually budgeted a decline of one per cent in non-plan expenditure in FY12. While he may not be as tightfisted as that, clearly the days of government expenditure growing at 15 to 18 per cent are thankfully over. He has also taken a lot of pressure off the Reserve Bank of India (RBI), by trying to instill discipline on the spending side.

If this marks the beginnings of a desire on the part of the executive to stand up to the National Advisory Council, and its spend-at-any-cost policy orientation, it is a huge positive. The primacy of fiscal consolidation will be well received.

Thus, on the fiscal side, I would say, while things are not as good as he projected, the desire to control spending and the implicit intention to move on fuel and fertiliser subsidy is a plus.

On structural reform, the clear positive to my mind is the stated intention to move to a system of cash-based subsidy for fuel and fertiliser by the end of FY12. This is a huge structural positive, possible game changer and may also explain his under-budgeting of these two items in the Budget. We seemed to have finally moved beyond talk on this issue.

The FM also spoke at some length about Goods and Services Tax preparations, the intention to implement the Direct Taxes Code by FY12, and sent out a clear message that both these critical tax reforms would be on the statute books by FY12.

The stated intention to move ahead on financial reforms, through the introduction of various financial sector Bills like Insurance and Pension Fund Regulatory and Development Authority (PFRDA), as well as the RBI outlining guidelines on new bank licences is another positive. The promised introduction of the new Companies Act legislation is one more in a series of measures to demonstrate that this government is firmly in charge and moving ahead.

The decision to not tinker with tax rates (especially indirect taxes) but keep them stable and instead focus on reducing exemptions and laying the ground for tax policy stability is a good development. Predictability and stability of taxes is a boon and aids long-term decision making. No longer will the government change industry economics through the stroke of a pen.

The decision to raise the limit on corporate infrastructure bonds by \$20 billion and making them tradeable among foreign institutional investors (FIIs), despite a five-year lock-in, is a positive, though one will have to see how FIIs use this. Allowing foreigners to invest in mutual funds is an incremental positive.

As for the negatives, we missed the opportunity to allow foreign direct investment (FDI) in retail, nor was anything done to incentivise the states to clean up the regulatory framework around the agricultural supply chain (Agricultural Produce Market Committees Act, mandi tax etc.) The whole issue of monetisation of state natural resources was dumped on another Group of Ministers (GoM) to go through

the environmental regulatory environment. The market will see both of the above as ducking a decision.

The setting up of another GoM on corruption is not likely to inspire much confidence.

The FM disappointed with no immediate movement on a nutrient-based subsidy for urea, nor was there any mention of a framework on land acquisition to enable projects to get a move on.

On the whole, a reasonable effort, better than expectations for sure, but I don't think enough has been done to break the market out of its trading range. We will remain hostage in the short term to macro and governance headwinds, till we see action on some of the structural reform hinted at in the Budget.

Confronting the Fiscal Reality

February 25, 2011

The forthcoming Budget is a real opportunity for the UPA government to regain momentum and show the country that it is firmly in charge. One of the concerns of global investors is the sense of drift and helplessness in Delhi as well as the total stalling of reforms. Investors are convinced that if policy makers continue to fail to assert themselves, it is only a matter of time before both corporate and consumer confidence will be impacted, with telling consequences on growth.

As for what investors want to see, the first priority has to be fiscal consolidation. Without the government regaining control of the fiscal, most investors do not see how inflation can be brought under control. If the Reserve Bank of India (RBI) is to continue battling inflation single-handedly, it is bound to eventually tip over the economy with sustained interest rate hikes. Fiscal policy has to play its part. Interest rates have to moderate to enable the supply-side constraints to ease through higher private sector investment. Investors are worried that India is entering a sustained period of high rates and sticky inflation. Without fiscal correction, rates will not moderate.

The March 2011 deficit numbers will be met, thanks to a high nominal GDP base and the spectrum windfall. Can we get to the outlined 4.8 per cent fiscal deficit target for 2012? Arguably, even more important than the 4.8 per cent number is the net borrowing target for the central government. This absolute number should come in below Rs 3.6 lakh crore to ensure there is enough space for private sector funding requirements, and interest rates and liquidity are not stretched, nor are we beholden to foreign capital flows.

Most investors are not convinced of the government's ability to hit the 4.8 per cent target for 2012, given the absence of one-time windfalls like the 3G spectrum auctions in 2012. Beyond a disinvestment target of Rs 50,000 crore, the government will have to come up with some other windfall to hit the 4.8 per cent fiscal deficit target. Two obvious candidates are a one-time overseas black money amnesty scheme, and the beginnings of a process to more systematically monetise government assets, starting with the auction of coal blocks, idle land and FM licences. Another source of windfall gain can be 2G telecom licence fees and penalties. One will look for announcements on all these fronts.

From 2013, ideally both the direct taxes code (DTC) and the goods and services tax (GST) will be in operation, and hence the central government will have less need for one-off gains, while the auctioning of government assets like coal should become a continuing process. The finance minister needs to bring the spending trajectory down to 10-12 per cent growth, while not starving capital expenditure.

Let's hope the finance minister does not tinker much with duty rates, avoiding the temptation to hike selectively and focuses instead on removing all area- and classification-based exemptions (in preparation for DTC), and getting rid of the Central Sales Tax and harmonising duty rates (in preparation for GST).

A status report on the preparedness of IT systems, forms, procedures and classifications for the phasing in of GST by April 1, 2012 will give the market great comfort on the seriousness of the government to get this reform completed. Politics aside, investors need to know where we are on getting this critical reform done. A time-bound commitment to pass DTC is also important.

Investors will also want to see far greater commitment and action for moving towards a cash-based subsidy transfer system. States like Bihar have already moved on this front and markets want to see a visible commitment to improving the delivery and targeting of public services/subsidies. Investors want the finance minister to outline in far greater detail how he will use the pilots initiated by the Nilekani taskforce on cash transfers to move ahead on this critical reform. How will the government use the unique identity roll-out to better target subsidies? Can better delivery of subsidies ensure we can cap our financial commitments at current levels? Everyone is convinced that the public distribution system is beyond repair. Unless we can control subsidies, there is no way the mix of government expenditure can ever improve.

In agriculture, investors will expect movement on the whole distribution chain. States have to be incentivised to scrap the Agricultural Produce Marketing Committee (APMC) Act, scrap mandi tax and take horticulture and vegetables out of these outdated regulations. Movement on a nutrient-based subsidy scheme for urea, which will help cap fertiliser subsidies as well as improve the fertiliser mix in the soil, is long overdue. All the concerns around agriculture, food prices and the broken supply chain can also be used as cover to bring in foreign direct investment into multi-brand retail.

Investors will want to see measures to help boost infrastructure. Measures to activate the corporate bond market are critical, as are steps to improve the viability

of state electricity boards and allow genuine open access (a critical constraint in private power project viability). Pension and insurance reform to create larger pools of long-term debt capital will also be eagerly awaited. Some announcement of a timeline in pushing through a land acquisition Bill using some of the models now in place in Haryana and Punjab (a combination of lump-sum and annuity payments) would also show how serious the government is about addressing project delays.

Investors have no expectation of more structural reforms like labour law relaxation or fuel subsidy reform; these are perceived as being too hard in today's environment. Another area of low expectation is around state funding of elections, on which, I am sure, a lot of noise will be made, but vested interests are far too entrenched. Any movement on the above issues will be a huge positive.

Let us hope we are not treated to another business as usual, tinkering-around-the-edges type of Budget. This document has to capture the imagination of the people.

Don't Panic

February 11, 2011

The Indian markets are now seemingly on the verge of panic and capitulation. The markets are falling everyday, mostly on limited volume, with the mid- and small-caps getting hit particularly hard. Markets are now down over 15 per cent in dollars, being the worst performer among the larger EM universe. We are now approaching the levels of January 2010, effectively implying that the majority of the gains the markets delivered in 2010 have evaporated. So, in little over a month, we have opened up a performance gap of 20 per cent vis-a-vis the US and given back most of the gains of the last 12 months. In certain sectors like real estate, infrastructure and construction, we are back to the lows of early 2009, and below those levels if one were to adjust for the incremental equity raised since then. India has gone from being fashionable, where investors were convinced of a great long-term growth outlook, to being panned for its governance and economic weaknesses, all in a matter of a month. In 2010, investors could not get enough of India, in 2011, they can't seem to leave fast enough!! The reasons for this change of view are all well known, from inflation to interest rates, commodity prices and governance.

So, what does one do now? It is probably too late to sell, unless one expects a total collapse (something I do not subscribe to). On a stock-specific basis, good values have already begun to emerge (many stocks are down 35-40 per cent). Even for the broad market, valuations are approaching reasonable levels. My sense remains that we will see Sensex earnings of about 1,200-1,225 per share for the year ending March 2012. Taking a multiple of about 13.5 times (slight premium to the EM average) on that leads to a Sensex target of about 16,500, giving a further downside of about 5-7 per cent. At that type of market level and multiples, one can build a strong long-term investment case for India.

I remain convinced that irrespective of all the inflation issues and governance deficit, the country will grow at between 7.5 and 8 per cent for the coming three-five years. Combine this with inflation coming down to about 5 per cent, and we have a nominal GDP trajectory of about 13 per cent. The listed corporate sector will grow earnings slightly faster, as it doesn't have the drag of agriculture (most of the listed sector represents the faster-growing industrial and service sectors), and is gaining share from the government in many sectors. Thus, we have the listed corporate sector delivering an earnings trajectory of near 15 per cent, with an ROE of 20 per cent and limited leverage. This earnings profile can be accessed through some great companies and management teams. This earnings trajectory has also only limited

correlation to US and EU consumption demand. Will investors be willing to pay 13-14 times earnings for this type of growth profile? Given the likely subdued longer-term growth trajectory of the West, I see no reason why these multiples are not sustainable (the main factor constraining our multiples is our vulnerability to external capital flows and the exaggerated volatility they cause). All you need is one quarter of poor economic data coming out of the US, and see how the search for uncorrelated growth picks up again.

The fact also remains that India is under-represented in all market indices (because of the free-float adjustment), and its weightage will only increase over time. Most smart investors I talk to already have country allocation for China and Brazil, but are still sitting on the fence for India. Not yet fully convinced on the country, they will eventually bite the bullet and allocate over the coming years. In this sense, you don't get the feeling that India is over-owned, at least not by the smart, long-term money.

The markets have already given up on this government and expect no reforms; no further disappointment is likely when expectations are already so low. If this government can get even a few basic things done on financial sector reform, skills-building and education, tax reform, infrastructure, etc, markets will react positively. Earnings expectations are also getting whittled down, and are now more realistic. Budget expectations are also now very muted, just maintaining basic fiscal discipline and meeting their own fiscal deficit road map will be seen as a victory by the markets.

The buying power of local institutions is also compromised in the short term because of regulatory issues. As we cycle through these distribution changes, money flows will resume to both mutual funds and insurance, we are probably at a cyclical low point in flows today.

India as a country has got de-rated, nobody expects anything positive to come out of this government, nor any policy action. While maybe true in the short term, this cannot remain so, something has to give, the government will be forced to be more decisive. Policy inertia forever cannot be the base case assumption. India is also getting hurt by rising commodity prices, again more a cyclical issue and not something which will be permanent.

Can the market come down a lot more? Yes, obviously it can if we have further political uncertainty, and mid-term polls. Alternatively, if there is any shock to global risk appetite, triggering a massive outflow of equity capital, equity indices can fall sharply. Markets can also easily overshoot, and become much cheaper than you

would expect (for a short period of time). RBI could also overshoot in its desire to be seen as being tough on inflation.

It is fashionable to bash India right now, and sentiment has seemingly turned on a dime, but investors would be better placed to do the work and spend the time to figure out what they can buy over the coming months, rather than trying to scramble to sell. You are probably too late, with the risk/reward against you, unless one is looking for a quick trade.

The contrarian bet from here is, if Parliament actually functions, some Bills get passed, Budget is reasonable, some governance-related clean-up happens and markets stabilise.

The markets are oversold, expectations are very low, valuations are nearing attractive levels, and perception is worse than the ground reality. An intriguing combination for someone looking to put money to work.

A Consensus Trade

January 28, 2011

It has now become fashionable to be underweight India in portfolios or talk about which stock or sector will get hammered next. In any survey of fund managers one reads, India is a consensus underweight in global, emerging market (EM) and Asian portfolios. Sell-side strategists marketing in Asia and Europe report the same phenomena, deep bearishness on the country and everyone claiming to be either short or below benchmark weight (depending on the type of fund). A major global investment bank reported that in January, their single-biggest demand for downside protection in all of EM was India. So, the stars all seem to be aligned, and India has had a tough start to the year, delivering the worst relative performance of any of the major EM markets. When compared to the developed markets, we have already opened up an adverse performance differential of over 12.5 per cent in less than a month (India down 9 per cent in dollars, US up about 3.5 per cent).

Now when a trade is this much consensus, and so well-understood and obvious, it very rarely works. The market has a tendency to not allow you to make money in such a simplistic manner. The pain trade from here would clearly be if India were to actually go up, as no investor seems to be positioned for this. A short, sharp bounce, to force investors out of their bearish complacency, is quite possible.

The bear case is quite obvious, the markets are going through a period of PE compression, driven by inflation, rising interest rates, commodity price spikes, governance and reform concerns and fears around a slowing GDP growth and earnings trajectory. Multiples are also compressing, as the premium India received for its more domestic-oriented growth model will recede in an environment of strengthening US growth. The bears concede that earnings are still likely to come in at about Rs 1,200-Rs 1,225 a share for the Sensex for the year ending March 2012. If you put a multiple of 14 on those numbers (approximating the median of the last few years), you get a Sensex target of about 16,800 to 17,000, compared to about 19,000 today. These numbers give a potential downside of about another 10 per cent. This fairly simplistic analysis simply brings Indian valuation multiples down from the stratosphere to a more normalised level, without any significant haircuts to expected earnings.

In that sense, it is by no means a disaster scenario, things could get far worse, with lower multiples on lower earnings. The bears also argue that given the lack of fiscal discipline, long-term supply constraints on agri-products, infrastructure and skilled

labour, India runs the risk of being caught in a structurally higher interest rate regime, leading to structurally lower multiples. The final point is simply on flows, India received about \$28 billion in FII inflows in 2010, all of this cannot be long term and structural in nature, some money will flow out as price and earnings momentum turns against the Indian markets. With limited equity flows into domestic institutions, partly due to regulatory changes and partly due to rising rates, where will the buying come from to offset the foreign outflows? Whatever limited buying power exists with the domestic players will be conserved to ensure the PSU divestment programme goes through. The Indian markets are extraordinarily vulnerable to even minor outflows of a couple of billion dollars.

The bull case rests on things improving from here, India has an inflation issue. But so does the rest of the EM world and India is far further down the road of normalising monetary policy than most. The bulls also feel that all these scams will ultimately lead to systemic improvements, and reforms will be forced on the government. The headwinds of rising oil and commodity prices, and asset allocators preferring North Asia will fade as the US eventually downshifts back towards 2.5 per cent long-term GDP growth. While the markets are down about 9-10 per cent in dollars, many stocks are down 20-25 per cent, thus on a stock-specific basis, valuations are now getting interesting. India has always been a bottoms-up market, and as individual stocks start looking interesting, money will come in. On flows, the bulls point to the noticeable lack of selling thus far. Despite the market declining by almost 10 per cent in dollars, the total selling by FIIs on a net basis is less than \$700 million. To the bulls, this indicates that a majority of the money which flowed into India in 2010 was more sticky and structural in nature, coming from long-term real money accounts, making a genuine long-term bet on the country. This capital pool does not seem to have changed its view on India's long-term growth prospects, it seems to be viewing current economic and political developments as only short-term noise. If this is true, the risks of a big outflow of capital are minimal.

The key issue remains, to my mind, FII flows. I don't see how all the capital coming in last year could be from longer-term sources. None of the India dedicated funds received much by way of inflows, these flows being a country-specific allocation, you would guess would be more permanent in nature. Instead of through country funds, at least \$6-7 billion of inflows were through ETF-type structures, which given the nature of the instrument, you would think would be more momentum- and retail-oriented. One would think that this capital would flow out as soon as India begins to underperform, which has already started. Yet no major outflows to date. Are these investors still holding on, thinking that this is just a short-term correction?

Has the downwards move been so quick (a matter of only about three weeks) that they have not yet reacted?

It is difficult to tell, but this holds the key, if we continue to see no major outflows, then it looks unlikely that markets will cave in further. We could see a slow and gradual drift downwards on low volumes, and the market will be in a broad trading range. If we do get a couple of billion dollars of cash-based selling, then the risks of the market being pushed down another 10 per cent quickly are quite clear.

Unfortunately, as has been the case in India till now, the foreigner on the margin will drive the market and holds the key to short-term market direction. Foreign investors till now seem to be still believing in their long-term thesis on the country. Let us hope the consensus bearishness has it wrong.