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1. The Growth Debate
13 Dec. 06

There seems to be a lot of debate among policy makers and market participants on the likely growth trajectory of the Indian economy over the coming decade. On the one hand most academics and trained economists seem to dismiss notions of India being on a growth trajectory of anything higher the n 6.5-7% over the coming decade. All the talk of a trend rate of growth higher then this 6.5% (8% or even 9%) is considered wide eyed dreaming by incurable optimists unable to distinguish between trend growth and the peak of a business cycle. Most of these economists are convinced that anyone believing in Indian growth exceeding 6.5-7% over the coming decade is in for serious disappointment.

On the flip side are mostly businessman and market participants who are convinced that all notions of trend growth have to be revised. India has tipped and broken out. We as a country are undergoing a paradigm shift and backward looking historical data are not relevant when judging the future. Just as no trained economist or academician predicted 4 years of 8% plus growth ahead for the Indian economy back in 2003, these people are missing the growth acceleration once again.

This debate is of critical importance for the future of the markets, for the difference between a decade of 6.5% growth and 8-8.5% is huge for both the economy and corporate profitability. It is also the difference between what is already priced in and a positive surprise. I would wager that most people have built 6.5% growth into their forecasts and thus this would cause no upgrades to either corporate earnings or revenues. Most people however are still scared to accept the 8% plus scenario, lest they be proven badly wrong and get burned again.

Let us try and understand both sides of the argument.

The growth realists argue three basic points (to my mind atleast). They first of all make the argument that to grow at 8% plus, we as a country would need an investment rate of approximately 36%(assuming an incremental capital output ratio of around 4-4.25). Assuming that we do not feel comfortable running a current account deficit of over 2-3%, domestic savings have to be in the region of 33-34%(latest estimates indicate savings are at 29%). These economists do not see an easy path to this higher level of savings in the short term given the constraints on public savings and the long tailed impact of demographics.

Secondly they make the point that between 1980 and 2006, trend growth(defined as latest 10 year average) has improved from 3.5% to near 7%, and to expect a further acceleration to above 8% so quickly is unlikely. It took 25 years of momentous changes in our economy and policy framework to move trend from 3.5 to 7%, how can it suddenly move to beyond 8% ? Trend growth rates do not turn on a dime.

Thirdly many economists point to the oft neglected role of merchandise exports in boosting current growth rates. The last 3 years have seen strong global growth and trade expansion, which may not sustain on the same trajectory.

Another valid criticism is that since the Government is following pro-cyclical policies, they are artificially super charging short term growth or borrowing growth from the future so to speak.

The economic bulls have more anecdotal arguments. They point to the fact that in most of the Asian economies, the demographic transition India is about to undergo has added atleast a full percentage point to GDP. As infrastructure improves, as it inevitably will, this will add another point to growth as frictional costs in the economy will come down. As agriculture becomes an even smaller part of the economy sheer arithmetic will allow growth to accelerate. Exports (both goods and services) are growing at 25-30% and as they become a larger part of the economy this will boost growth. The bulls also point to the micro reality that corporate India has never been more competitive or confident. Most of the large ticket investments being planned are still to kick in and sectors like realty (with huge multipler effects) are undergoing huge investment booms.

Imagine the impact of RIL doubling the country's gas production on GOI revenues, petroleum subsidy and value addition across the economy as it replaces more costly fuel. The multiplier effects of producing 3 million cars by 2010, entry of organized retail dropping consumer prices by 10% and having pithead ultra mega power plants producing electricity at less then 2rupees per unit, will flow through the whole economy. How much will farmer's income increase with disintermediation of middlemen by the likes of Bharati or Reliance and a hike in yields? The improvement in logistics enabled through the NHAI program can have what type of an impact?

As telecom penetration improves in rural India , how will this boost rural productivity and incomes? Tax reform through GST and VAT will have huge impacts in rationalizing trade, boosting revenues and allowing India to join the global supply chain. One can go on giving example after example at a micro level. The fact is that we were growing at 6.5% before all this, so with all these improvements in productivity and reduction in frictional costs how can growth not accelerate further?

As for my own belief, I have more sympathy with the optimists, and I do genuinely believe that we are changing orbit. I have never in 15 years seen the type of changes in scale, competitiveness and ambition that one sees in corporate India today. Many of our constraints be they fiscal, infrastructure or flawed policy are on course to improve, and frankly the growth potential exists.

As for what can hold us back, I would highlight 2 issues.

The RBI may not believe this growth acceleration story, and in its desire to cool down its perception of an overheated economy, it may become overzealous in hiking rates.

Secondly I would point to the worrying political rhetoric coming out of the UPA government on reservations, minorities and all sorts of other political hot buttons. This may cause serious social and political turmoil, which can torpedo all hopes of 8% growth. Hopefully calmer voices will prevail on all sides of the political spectrum.

Each investor will have to decide where he or she stands on the growth issue, it is one of the bigger calls each one of us will have to make.

2. Misplaced Priorities?
28 Nov. 06

I had the privilege of being able to attend a 2 day conference on infrastructure, hosted by SSKI and IDFC in Singapore this week. The conference had a very good line up of all the major operators in the space as well Gajendra Haldea representing the GOI view.

The conference was useful in that one was able to get a grip on the constraints still present in the space and the efforts being put in by the government to clean up the regulatory framework through model agreements, MCA's etc. The single minded focus on Public Private Partnership (PPP) also came through very clearly.

Beyond the issues on the regulatory side, two other obvious constraints were the ability to finance this huge infrastructure build up, and the shortage of skills to execute projects on this scale.

While a shortage of skills is now pervasive across all sectors, the private sector seems to be responding through in house training, setting up institutes etc., and this problem will probably get resolved over time as there is no shortage of people in India, just a shortage of skills. The privatization of this skills building has now begun and will only accelerate.

The more worrying issue from my point of view, is the ability of the country to finance this $320-350 billion infrastructure build out(over the coming 5 years).

There are serious issues that have to be addressed in both the banking and insurance sectors as well as in building out a long term bond market and a functioning pension system.. If we do not address these matters it is unlikely that we will be able to accomplish what we need to do on infrastructure.

In this context, and given the limited room for manuever available to the Finance Minister it seems odd and misplaced as to why he is trying to use up all his political capital in trying to get the left to agree to hike the FDI limit in insurance to 49%.

It seems to me that there are a lot more important things which need to be done in the areas of insurance and pensions than hiking the insurance FDI limit.

I think it is far more important to get the pension regulatory authority bill through, even if it is only with a 26% FDI limit, then worry about taking the insurance limit to 49%. To have a well functioning pension system, where returns are maximized for all through professional management is top priority and a precondition to building a functioning long term debt market. The FM should use whatever means possible, but fight off the left's desire to guarantee returns or nationalize the management of these funds.

Also within insurance it is far more important to focus on and clean up the plethora of investment restrictions handicapping the ability of these institutions to become the true long term providers of capital to the private sector and infrastructure in general. Talking to people at the conference it became clear that there are too many obsolete rules hampering the ability of the insurance players to support long term capital formation.

Even if we were to look at the banking system, there seem to be many more pressing issues to think about. How will we solve the looming crisis on the capital adequacy of the banking system. To finance the expected growth in capital expenditure and infractructure build, the banking system will effectively have to almost double its capital base over the coming 5-7 years. How will this be possible, with the PSU banks being unable to dilute the GOI stake below 51%(in major banks like SBI and PNB, GOI already down to 59%), and thus being severely constrained in their ability to raise fresh capital. The PSU banks still have a market share of 75%, and we will not be able to finance growth unless they can play their part. Hybrid capital and other financial innovations are only stop gap measures to bridge this fundamental disconnect. It would be I think far more important for Mr. Chidambaram to try and negotiate some type of solution to allow the PSU banks to access capital and maintain their PSU character irrespective of GOI shareholding. Even the area of government small savings schemes distorting the interest rate structure or the need to remove the EPFO from the clutches of the politicians are issues that demand immediate attention.

The average age profile of the PSU banks exceeds 40 and radical measure have to be put in place on the HR and compensation front to revitalize these organizations. How will they compete for deposits and deepen the penetration of banking into newer areas unless these corrections are put in place?

It is not better to focus on all these difficult reforms and bargain with the left to push these things through and leave insurance for another day?

For if one thinks about it, what will hiking the limit to 49% really bring us in terms of enhanced efficiency or technology? All the current joint ventures in insurance have largely imbibed whatever systems and technology the international players could bring. They are by most accounts very well run and professional organizations with strong management. The actuarial functions in these organisations have been run by their global partners since inception in any case. In terms of the Indian partners not having enough capital to grow the business, that also seems unlikely given who the players are. Can anyone say that the Tata's, Birla's , Anil Ambani, HDFC,ICICI or Bajaj have any issues in terms of access to resources?

Just to clarify, it is not my position that we should not hike the FDI limit in Insurance as a matter of principle or anything like that. Given a choice I would be most happy if the limit was hiked to 76% or even 100%. It is just that in this age of coalition politics, the FM has very limited room to get things done, and has to pick and choose his battles. Given those constraints, I find it a case of misplaced priorities that Mr. Chidambram would choose to expend so much political energy and capital to get the FDI limit in insurance hiked to 49%. There are so many other more structural issues affecting our financial system, that need sorting out to be able to deliver 8% GDP growth on a sustainable basis. He should use whatever capital he has to focus on these structural drags, as any movement on these issues will have much greater and immediate impact.

3. Reflections from a Conference

8 Nov. 06

I had the privilege of attending a full blown 3 day India conference, last week in Mumbai hosted by JP Morgan. It was the first conference of this type that I had attended in years and was well worth the effort. JPM did a great job of not only bringing together the usual large cap. Indian corporates but had numerous lateral sessions with top quality guest speakers. They had invited the CEO's of GE, Federal Express, AIG, Shell,Cargill and others to speak on the experiences of MNC's in India. They also had speakers like Bibek Debroy, Omkar Goswami,Vinayak Chatterjee and Arvind Singhal to speak on the macro. All in all it was an excellent conference and hopefully something JPM will make an annual event.

In terms of takeaways, there were many, but let me just highlight a few:

1. There was a clear theme of investments which was all pervasive. We heard about how 5 players in retail alone had lined up investments of $24 billion over the coming 5 years across stores, real estate and their supply chains. Vinayak Chatterjee made a strong case of how investments in infrastructure had to accelerate to $320 billion over the next 5 years and every large corporate in presentation after presentation highlighted big capex plans.
2. What also came through quite clearly was the acceleration in job creation of the non-IT variety, Sunil Mehta of AIG spoke at length about how creating your own distribution was critical to success in financial services and the scope for job creation across India this presented. On the retail front also the roll –out of all the new entrants would create jobs for atleast 2million people across India. More importantly these jobs would not be restricted to English speaking, urban educated youth but have a much broader impact and dispersion. Every company, across sectors also highlighted plans to hire and train their workforce.
3. Another theme which came through clearly was an extreme shortage of skilled workers, skills shortages were pervasive across sectors and salaries and attrition levels were rocketing. Though a big issue today, most of the CEO's I spoke to seemed to feel that this was a temporary phase which would last for 2-3 years after which things would settle down. They also highlighted the efforts being made by industry to improve training infrastructure and the accelerating trend of returning Indians. No-one felt that this could torpedo their growth plans.
4. All the MNC's who spoke were clear that India was a long term bet, and one where short term easy profits were difficult to come by. Competition was intense across most sectors and the locals did not really care how great and global a company you were, if you could not show them immediate value. Most were actually complimentary of the government, pointing out that if you chose to, you could operate in a transparent and ethical manner without any short cuts. Most were also conscious of being seen as good corporate citizens, and pointed out that it did not pay to be seen as aggressive by the regulatory regime.
5. Globalisation and growth was a common theme across all sectors and presentations, the drive and ambition of corporate India was breathtaking.
6. A very interesting point made by Arvind Singhal in his presentation on retail, was his belief that prices for the typical basket of goods consumed by a middleclass household would drop by 10%, through the entry of organised retail and private label. If true, this will have a huge multiplier impact on consumption of other non essential goods and drive strong growth in other product categories. Its impact on branded FMCG players also bears watching.

7. Many participants felt that the time had come to look at rural and semi-urban markets, a large number of companies felt that their next leg of growth will come from these areas and that growth was now accelerating in the hinterlands.
8. Rising regional inequality was highlighted as a worsening and potentially destabilizing issue, though no-one felt the naxalite issue was serious enough to derail growth.

An interesting debate which I think has serious investment implications is the question of what is India's trend growth rate. We had Bibek Debroy make a very strong argument that India was now on a 8.5-9% growth trajectory, which will accelerate further to over 10% in the coming years. Even Omkar Goswami, talked of 7% as being the worse case outcome, which could accelerate to over 8% if certain steps were taken. I could sense the disbelief in the audience, and a feeling that the locals were getting carried away.

This is I think a critical issue which every investor needs to have an opinion or view on. Are you in the growth optimist camp, which believes that India has broken out and established a new growth trajectory of 8 or 9% per annum and can sustain this growth for years to come. Or do you believe that we are still on a 6.5% growth trajectory and the current 8% plus growth is just the peaking of the business cycle? Your stand on this issue, to a large extent will determine your view on the markets.

The growth profile of corporate profits will be dramatically faster in an environment of 8-9% GDP growth, as opposed to 6.5%, as a delta of 2-3 percentage points in GDP growth has a disproportionate impact on profitability. If you truly believe in our country being able to achieve these higher growth rates, then everyone will be wrong on corporate earnings growth. All the analysts and investors will be forced to upgrade their numbers and the markets will not seem so expensive on these new higher profit projections. If you, however are in the stable 6.5 % growth camp, then the markets seem way too expensive and earnings will probably disappoint somewhere down the road.

I have not seen much analysis done on this issue from market participants, but I think we all will need to take a position on this at some stage, for it is critical to determining your long term view of the markets.

4. Macro versus Micro
23 Oct. 06

The Indian stock market is at a very interesting juncture, poised within striking distance of 13,000 on the Sensex, and having confounded most market observers throughout the entire rise from its mid June low of approximately 9000. This rally has been powerful and surprising in that it has had limited retail participation, and till last week none of the hype and hoopla of the previous peak in May 2006. Most market observers have been caught out, and the market has followed the classic pattern of climbing a continuous wall of worry. I have yet to meet anyone who thought that the market would bounce back so quickly from the damage of May-June, and even today you have a huge chunk of money waiting for that elusive 10% correction.

The markets are poised very delicately, because depending on whether you approach the markets from a top down perspective(macro), or bottoms-up(micro) you get a very different answer on the risks and upside to investing in the Indian equity markets today.

If we first take the macro view, then caution would seem to be well advised. Emerging markets are basically still a play on global growth, and there is no doubt that, led by the U.S, growth is slowing across the world. This would normally be an environment where-in emerging markets would be expected to struggle. Given how leveraged the Indian equity markets have become to overseas flows, any hiccup in the emerging markets asset class will undoubtedly hit India as well. The asset class has also had a dream run over the last 3 years and thus a simple catching of breath, may be in order.

As for India specifically the macro concerns are many. First of all the markets are clearly no longer cheap, how expensive they are depends on your vantage point, but no longer cheap, for sure. There are also serious concerns on the sustainability of growth, can we continue to grow at 8% plus without overheating? Can we grow at 8% , without interest rates spiking, and infrastructure collapsing? When will the lack of progress on reforms over the last 24 months, come back to bite us? Markets have more than tripled, we have to have a negative year sometime, nothing goes up in a straight line. There is a bubble in real estate, in all types of Indian assets, and India has hit the cover of every magazine of repute in the last 6 months.

The much hyped return ratios are all headed south, ROE's(return on equity) have peaked as has free cash generation and incremental returns on capital are trending down. The new wave of capex, will ramp up competitive intensity across sectors further pressuring margins. Anyone thinking that Indian companies can continue growing earnings at 25%, and maintain greater than 20% ROE's are misguided at best or naïve at worst.

These are some of the common negative soundbytes one hears from the macro crowd, and each one is valid and not something you can dismiss lightly. The takeaway from a macro perspective is clearly to exercise caution, and to not get carried away.

When one turns to a micro perspective, things however look a little different. I have never seen corporate India more confident in the last 15 years, or more aggressive. The Tata –Corus deal is just one more manifestation of this. Look out for more such deals as the Tata's have shown everybody just how ambitious corporate India can become. Every company we meet talks of exports, global benchmarking and global scale. Corporate India is convinced that 8% growth is here to stay, and while infrastructure is a constraint no-one seems to feel it can torpedo their growth trajectory. All companies seem to be targeting 20-25% earnings growth, and building capacity to sustain this trajectory. Companies are also very confident on their growth visibility, saying it has never been better. The entrepreneurial energy is obvious and global relevance a goal across an increasing number of sectors.

A week spent with corporate chieftains will convince anyone that we are only at the beginning of a long cycle of growth. They point to demographics, changing income pyramid and globalization as the building blocks of a multi-year growth cycle.The continued influx of returning Indians only seems to confirm the bullish view. Why is paying 16-18 times earnings so foolish for an earnings stream that can grow at greater then 20% for a decade, argue the bulls.

So which perspective is right? The raw bullishness of the bottoms-up view or the caution of the top-down ?

Just as a norm, at turning points, macro is normally better at calling a turn in the cycle then a bottoms-up perspective, as very often companies do not detect any change in their business until it is too late. The early warning signs of change are picked up much better by macro.

However macro also tends to work using regression to mean as its base concept. Meaning that all events or observations are assumed to have a mean value around which they will oscillate. It operates on the principle that any substantial deviation in either direction will get regressed back to the mean value over time. Thus macro is not good at picking up a paradigm shift, where-in an economy for example moves to a whole new plateau of growth. Macro will always think that this growth is unsustainable simply because it has never been achieved before. It will not pick up a sustainable uptick in productivity for example, which is something I think India is experiencing.

To be comfortable in ignoring all the warning signs being flashed by the macro guru's, one has to believe that India has truly broken out and that its economic history is of limited relevance in judging the growth potential and trajectory of the economy. That is a brave and possibly premature call to make as one has lost count of the number of times people have perished saying that "this time it is different". Maybe it is different this time, who knows? but that is a clear leap of faith many of the super bulls are making today. Only time will tell whether they are right.

5. The Transformation
10 Oct. 06

I have been quite worried and still am as to the short term prospects for the Indian equity markets. In the short term the worries are many, the global slowdown, the possibility of our economy over-heating, the slow pace of reform, huge market gains over the last three years and the lack of valuation support. These issues have been bothering me for some time and continue to do so. We can have and most likely will have another correction in the markets which can cool things down., but that will be in the short term.

However having been recently given a mandate, to look at stocks with a genuine 3-5 year view, the picture and nervousness change quite dramatically. There is little doubt in my mind that the country is transforming, and if you are willing to take a three year bet ideas abound. The feeling of the markets being too expensive, fades the longer you extend your time horizon.

What lies at the root of my optimism is the changes evident in both manufacturing and agriculture. The services story in India is very well known, and it will undoubtedly be a strong growth engine, but on the margin the growth surprises will come from elsewhere.

In manufacturing the single biggest announcement to my mind is the statement that Nissan will set up a unit of about 250,000 cars, largely for export, this is over and above the use of Maruti's facilities to contract manufacture and export.

The auto industry is a big driver of industrialization, and has huge multiplier effects across the economy. It is not by chance that prior to globalization, each developed country had its own national champion in auto(witness Fiat,Volvo,Rover,Renault etc), or that China even today wants to (and says so explicitly) develop its own national champion. Autos are at the very heart of manufacturing, and anyone doubting India's ability to compete in high value added manufacturing has to look only at Nissan and its actions.

Basically two global automobile giants are testifying to the quality and productivity of Indian skilled manufacturing. Despite all the logistics and infrastructure hassles, they feel that India is the best location globally to manufacture compact cars. This is as much a testament to the quality of the Indian component base as it is to Maruti's undoubted manufacturing prowess.

The fact that Maruti makes over a 14% PBT(profit before tax/sales) margin, one of the highest in the world for an auto company, and that too at Indian net realizations, again proves the cost and quality of Indian auto components. This message is delivered not by Nissan alone as even Hyundai has announced plans to make India the hub for small cars and export almost 500,000 cars by 2010. In terms of engines and assemblies just see what Tata and Fiat have announced in terms of using Ranjangaon as a base to export diesel engines or the plans of Toyota for manual transmissions, and one can see an explosion in volumes.

While I am continuously harping on about the Auto industry, similar stories abound across sectors. India is clearly set for a take-off on higher value added manufacture, and the numbers will surprise people.

In terms of mass manufacturing, the hope here has to be textiles, the only sector where I think we can compete and have the scale to make a difference to the economy. The signs here while quite good initially, especially if you see the backlog with the textile machinery companies, it is still too early to thump the table.

The other leg of growth will come from agriculture. The move towards corporate involvement in agriculture is real and gaining momentum. Whether it be Sunil Mittal, Mukesh Ambani or Anand Mahindra,the big boys of corporate India are now getting involved. The scope for both yield improvement and value addition is huge. The case of cotton is a good example, where over the last 2-3 years there is a demonstrable improvement in yield as BT cotton seed and other variants have gained ground. Currently the hybrid penetration in India is only about 30%, but taking off very rapidly across crops like maize, sunflower and just starting in rice. Hybridisation will further accelerate as contract farming gains share and acceptability.

The potential for yield pick-up as the hybrid movement gains ground is enormous. Combine this with the improvements in logistics and price discovery brought about through direct purchase by large corporates dis-intermediating the middleman, and the building blocks for accelerated growth in agriculture are now slowly coming into place. Overlayed on top of all this is an improved and simplified regulatory framework governing the commercialization of agriculture.

Combine all of the above with Indian entrepreneurship and the mix becomes truly heady. Having met dozens of small companies after a long gap, one again comes to realize the extent of hunger, drive and risk taking ability present in mid sized Indian companies.

This is the one thing which continues to differentiate India from most other emerging markets., and is something which is very difficult to replicate. Even among the large Indian corporates, their willingness and drive for growth is unabated. Witness the house of Tata's, considered slow and bureaucratic a few years back, can anyone doubt their growth ambitions today.

As Mr. Ninan pointed out in a piece written a couple of weeks back, chances are that India has taken off, and it would need a particularly incompetent pilot to crash this plane now.

India is a classic growth story, valued like a growth stock, where-in it will continue to trade expensive as long as it can deliver growth. The spreading out of growth and competitiveness beyond just services is critical in underpinning the longer term growth prospects of the country. There are clear signs that this is now happening, and to the extent growth sustainability is improving that can only help valuation multiples.

6. A change of trend?
27 Sep. 06

Over the last couple of weeks global markets have begun acting in a noticeably different manner. Across asset classes and geographies, relative performance of markets has differed considerably from the trend of the last few years. Notably U.S large market capitalization stocks and the Nasdaq have been among the best performers over the last few weeks. For the first time since this rally began in 2002-3, these markets are being driven by multiple expansion despite all signs of a slowdown in earnings. Their long cycle of PE contraction driven by rising yields seems to be coming to an end.

Emerging market equities are no longer the high beta way to play a rising market. For the first time since the bust of 2000, emerging market equities have begun lagging the U.S and European indices at a time of rising global stock prices. Prior to this episode, emerging market stocks would always be at the forefront of any global stock rally. Since 2000, emerging market stocks have always outperformed and led from the front whenever global markets began to look up.

The multi-year bull market in commodities also seems to have been atleast temporarily interrupted. The weakness in commodities has hit the related equity sectors, and hence market leadership has shifted away from these sectors. Markets have begun to question whether the so called structural bull markets in commodities has come to a premature end. Weakness which began in the oil markets has now spread throughout the commodity complex. Weakness in commodities has also served to put pressure on emerging market equities.

In the U.S, share prices and bond yields have once again become negatively correlated as they were until 1998.

The U.S dollar has been firm despite the Fed having called an end to its tightening campaign, confounding the permanent dollar bears once again. Combined with the move in the dollar, bond yields have fallen globally over the past couple of months, indicating less apprehension on inflation.

So across different asset classes, markets are behaving differently from the pattern of the last few years, trying to tell us that something may have changed.

All of the above trend changes are signs that the market is pricing in a slowing of global growth, and making the relevant shifts in relative asset performance. Till such time as the global growth slowdown is not fully complete, or completely bought into by market participants these shifts in relative performance are very likely to persist. Inflection points in the global business cycle tend to mark shifts in relative performance between asset classes. To the extent that global growth has now peaked, we may be in for a period of very different market behaviour from what we had got used to over the last 2-3 years when global growth was accelerating. Investors may have to get used to a very different pattern of market behaviour, as leading sectors and geographies may turn into laggards in the new order.

All signs point to a slowing of global growth, be it U.S housing, leading indicators on both sides of the Atlantic or the marked deceleration (albeit from a very high base) in Chinese fixed asset investment.

In such an environment, emerging markets as an asset class normally has difficulty. Ultimately the asset class is still a bet on global growth and tends to be highly cyclical. It normally delivers super charged returns whenever global growth is accelerating and yields are actually rising. The asset class has a much tougher time whenever growth is slowing and we are entering the phase of the economic cycle when the next move in yields will be lower. Thus we may be in for a more difficult time for the EM asset class then the consensus currently believes. The bulls believe that given the strong fundamentals and reasonable valuations, emerging markets will be able to de-link from this global slowdown and outperform. This may happen eventually but there is every chance of some hiccups on the way.

Given that this slowdown has just begun and both the engines of global growth, the U.S consumer and Chinese fixed asset investment are under the gun, it is very likely that we will get a global growth scare somewhere down the line before this slowdown is over. Everyone still believes that we will have a soft landing in the U.S and hence in global growth. However I find it amusing that as the much abused U.S consumer finally begins to capitulate, the worst the market is pricing in is a soft landing. Can it not be possible that if the U.S consumer is truly as leveraged as everyone thinks and as dependent on rising housing prices and refinance cash-outs as we were lead to believe, that things could get ugly for a quarter or two? What if house prices actually decline?, what if Japan and the Euro area are unable to pick up the slack of a slowing U.S consumer?

God help us if we were actually to fall into a recession in the U.S. I do not think markets are yet pricing in such a scenario. Yet it does not seem so farfetched to think about such an outcome. It may not be the base case, but atleast worth considering.

If things were to get more difficult for the EM asset class, how will India fare? Undoubtedly to the extent that money flows out of the asset class, India will also suffer, but we seem to have a huge wall of money still waiting to enter our markets whether it be on the private equity side or venture capital and realty. The world's love affair with India seems to continue unabated. The world has discovered the quality of Indian companies,entrepreneurship and market potential and now seems unwilling to let go. Three years of 8% plus growth has got everyone extrapolating this for the coming decade. Given the spate of investment proposals announced, and the entry of global MNC's determined to make India a production base(eg.slew of announcements on turning India into a global production hub for small cars), it is difficult to see what can short circuit this party. As long as inflation and interest rates behave, there seems to be no other obvious speedbreaker.

The only risk remains that of the government, and its penchant for springing another reservation like surprise on an unsuspecting country.

India is an expensive market, with investors willing to pay up for growth visibility, this is unlikely to change if we can continue to deliver growth in a slowing world. The ironic thing for all the skeptics, will be if PE multiples expand even further in India as the country demonstrates strong economic and earnings growth, even in a slowing global environment.

Can we de-link from a slowing global economy? That is the critical question which will determine market performance over the coming months.

7. Keeping Your Word
12 Sep. 06

There are signs of a new and disturbing trend developing, where-in one can no longer take the Government of India at its word. Three examples come to mind straight away, but I am sure there are more. First of all the Government's refusal to sell the remaining stake in BALCO which, if my facts are correct it was bound to do so. Second is the refusal by the Reserve bank of India to recognize the CECA treaty, under which the GIC and Temasek are explicitly guaranteed treatment as separate and distinct organizations. Third is the decision by the IT department to challenge a ruling given by the AAR in the case of Morgan Stanley and all for BPO's in general.
These developments are to my mind very worrying for such actions if continued, will over the long term raise the risk premium of doing business in India. Compared to China we are no match when it comes to efficiency, quality of infrastructure, lack of red-tape etc. However we could always say that atleast we had a rule of law, no matter how ponderous and that once signed, a contract with the government of India will be honoured, irrespective of which party/coalition is in power. These developments strike right at the heart of this contention and portray the country in a very poor light.

I do not wish to make any judgement as to who is right or wrong or whether the various government agencies are right to reverse these deals or treaties, for that is not the point. Any government agency is entitled to its point of view, and it can and should debate and argue its case internally as strongly as it can.. However this debate should be outside the purview of the investor/counterparty signing the deal with the government. Fight and debate internally as much as you wish, take as much time as you wish to come to a final decision. Once the decision has been taken every government agency has an obligation and duty to stand behind this contract/treaty/deal etc. This obligation also extends to a change of government.

Take the case of the RBI and its attitude towards the CECA treaty signed with Singapore. In the CECA treaty, signed I may add on a visit by BG LEE (Prime Minister of Singapore) to India, it is explicitly stated that Temasek and the GIC(Government of Singapore Investment Corporation) are to be treated as separate entities. The implication of that is that each is to have a 10% shareholding limit like any FII, and they are not to be clubbed together. However in the recent issue of ICICI bank, as per press reports, Temasek and the GIC were not allowed to participate as the RBI decided that they should be clubbed and treated as one entity. As their combined holding was either at or near 10%, neither organization was allowed to participate in the fresh issue of equity.

Again I do not want to get into the merits or otherwise of the RBI position, I am sure they have a good rationale for their view and one must respect that. However they (RBI) should have made their case internally with the government before the signing of the treaty. If they did make their case and the powers that be in the government decided to over-rule their objections, the investor, or counterparties to the treaty cannot be made to suffer for this. If there is a feeling that the treaty is too one-sided then the negotiating team representing India should be taken to task, and it must be ensured that this never happens again, but you cannot run away from what you have signed or agreed to.

The RBI should not take a view that I do not care what has been agreed to on a government to government basis , I will do what I think is right.
Once signed, the RBI has an obligation to uphold and follow the provisions of the treaty.

If for some reasons the Singapore authorities have failed on their commitments, then this should be highlighted and publicized , so that they are also forced to follow through on their commitments.

Imagine the nervousness on the part of international and local corporates, if a treaty signed at the very highest levels between two countries that wish to develop a strategic partnership can be so easily reversed by actions on the ground. Can you fault any company for thinking that if this can happen to a Temasek or GIC why cannot something similar happen in my dealings with the government. This too when the issue as far as I can see is not even politicized, unlike the case of BALCO.

As far as Balco is concerned the whole deal now seems to have become very politicized and become hostage to this government’s nervousness on disinvestment per se. Again without going into the merits or demerits of this situation as it is a very complicated case with both sided having strong and valid arguments, the government seems to be reneging. On a superficial reading of the case through press reports, it appears that Sterlite/Vedanta is trying to enforce a clause in the shareholders agreement, and the delay is on the government’s side. This case appears to be more complicated then the ICICI example and with far less clarity , but if the present government is trying to get back on the BJP and discredit disinvestment per se through this example then that would be truly tragic.

India was always considered a tough place to do business historically, hence the low levels of FDI. It is only now that investors are truly waking up to India’s potential, and willing to go that extra distance to set up base here. The last thing we need is for investor’s to get spooked by the above events. We need FDI and anything that impedes it should be corrected immediately. Finally, the same government that managed to ensure that we met all our commitments in the unfortunate crisis of 1991, should ensure that we do no less today, even in more mundane and day to day issues.

8. My Biggest Worry
10 Jul. 06

Given the slew of research reports on the subject recently, it is quite clear that for most India strategists, the issue they worry about the most is corporate earnings. I have personally seen atleast 4-5 research reports from each of the major sellside houses, laying down their respective views on corporate earnings. The bearish strategist's make the case as to why earnings growth will disappoint, while the bulls make the opposite argument. One can understand this obsession with earnings growth, for India is an expensive market, and the only way that one can justify current valuations is to fall back on the earnings growth plank. Yes , India has the highest multiples in the region, but adjusted for growth it is actually very cheap, is the standard bull case argument. Also given the quantum of research on this topic, it is likely that the earnings outlook is top of mind for most investors as well, as investors questions normally drive top down strategy research.

While I do accept the importance of the earnings outlook, I am actually not that troubled by it. I am pretty sure that with 7% real GDP growth, our corporate sector will churn out 15% earnings growth on a long term sustainable basis. The simple math is that 7% real GDP will lead to a growth rate of about 12-13% in nominal GDP growth(5-6% Inflation). Given the weight of agriculture in GDP and the ability of the listed corporate sector to grow faster and gain share in the economy, 15% corporate earnings does not look to be farfetched. We may have one year here or there which has lower growth, but the long term trend here looks quite solid and sustainable. If macro conditions(including rates)remain stable, then earnings should come through.

The greater worry to my mind in India, is the outlook for interest rates. For interest rates will drive the outlook for both the real economy and financial markets. It is quite clear that we cannot sustain 7-8% GDP growth with our own domestic savings. We would need a savings rates in excess of 30% ,unlikely in the short term with our level of public sector dissavings.

We run the largest fiscal deficit in the emerging markets universe as well as one of the few current account deficits. Many question our ability to sustain 7-8% economic growth without rates spiking, given our twin handicaps. Others question as to whether the equilibrium long bond yield for a country with our growth and financing trajectory can be capped at only 8%. Many cite research pointing at out that in the long term, as economies develop equilibrium long bond yields should settle at nominal GDP. Those may be longer term issues, but even for the short term, in an environment of rising rates globally, tightening liquidity and domestic inflation there does exist the risk that interest rates in India can spike up further.

Already interest rates are up over 300 basis points(3%), over the past 12-18 months, yet one sees little concern on this issue. If you talk to Indian corporates, they seem to indicate no slowdown in demand for anything, and even bank lending figures to both corporates and retail still show very healthy growth. While this may be true for right now, I cannot imagine a 300 basis points hike in rates (even higher for most retail and corporate loans) not having an impact on both lending growth and credit quality. These effects have a lead time, and everything will seem fine until suddenly something gives. We are also in the unique position of never having seen a retail credit cycle in India before. How will the retail borrower react to rising rates? We have no history to fall back on, no ability to build credit models based on past behaviour. Just because credit has not slowed much yet does not mean it will not. How does one calibrate credit losses in this type of an environment? This is the first credit cycle of rising rates encountered by a newly leveraged middle class India. How will these first time borrowers behave? No one knows, and surprisingly this lack of data on past behaviorial patterns does not seem to worry too many people.

History of other economies would suggest that demand will get hit, credit defaults rise and cyclical sectors experience a significant slowdown. The impact of this slowdown will impact the entire economy either directly or indirectly. Since it has not happened yet, most investors believe it cannot, hopefully we are not in denial.

Beyond its impact on demand, rising rates will also hit profits of a corporate India embarking on a capex and leverage cycle. Corporate India has never been more confident of itself and its abilities. The rise in confidence is leading to a greater willingness to leverage. A significant chunk of the last 3-4 years profit growth came from de- leveraging and lowered borrowing costs, both of these factors are reversing.

The other worrying aspect of rising rates is the impact this will have on PE multiples. When interest rates collapsed from 12%(10 year bond) to 5%, it took time but we did eventually see multiple expansion. In fact PE multiples effectively doubled from 2003 till June 2006. It is interesting, now that rates are going in the opposite direction, that no one expects PE contraction. PE multiples have a clear negative correlation with interest rates, The relationship may break down for some time, but it will eventually reassert itself.
Also higher the current PE multiple, greater the impact of rising rates.
If one were to use the so called Fed model, at 5% long bond rates we could have justified a 20 PE, but at 8% yields, the fair multiple drops to 12.5, more then a little difference.

Thus more than earnings, I would worry about rates, for rising rates have the ability to hit both the levers of equity performance, earnings growth and PE multiples. If rates can remain in their current range, then we should be ok, but any spike to significantly higher levels, spells trouble.

The current consensus believes that rates will remain stable at these levels, I hope for all our sakes that this is one of the few times that the consensus is actually right.

9. Don’t Panic

24 May 06

The recent and ongoing sharp correction seems to have engulfed the market in fear and panic. Many investors are now fearing that the bull run has come to an end, and that that the glory days of easy money making are over. As is typical when markets begin to fall, all the proponents of doom and gloom come out of the woodworks, and now people are talking of the markets declining to below 9000 (BSE SENSEX). Some market guru’s have once again begun to talk about the fact that globally we are still in a secular bear market, and that the last couple of years was only a temporary lull before the bear reasserts itself.

Is this really the end? Has India once gain succumbed to the curse of shooting itself in the foot, this time led by the move on reservations and some misreporting on overzealous tax officials?

First of all it is important to set the context and understand what is really going on.
This is not an isolated correction in India alone, risk taking globally is in retreat, and most risky asset classes are under pressure.

Emerging market equities are down 12%, about the same as in may 2005, and even more so then the 8% correction of October 2005. Asian equities have been equally hard hit, down about 11% in aggregate, led by India and Indonesia down 17% and 16% respectively. The correction has been triggered by a reversal of foreign flows into the region as over the past couple of weeks almost $8 billion of capital has been pulled out of Asia, compared with net inflows of almost $20 billion year to date.

The pressure has been caused primarily(in my mind atleast), by markets beginning to understand that inflation could be a greater risk then they had priced in hitherto. There is a distinct possibility that the “goldilocks” scenario, where-in the Fed is able to slow down the U.S economy just enough to quell inflationary pressures, but not kill growth may not come to pass. Stagflation, where-in the Fed has to raise rates significantly to fight inflation, and kills off economic growth as a consequence, is no longer as far fetched a scenario as once thought. Markets are naturally fearful of any further prolonged tightening from here, even more so when healthy gains need to be protected.(Asia was up 20% ytd, before the correction set in). Others attribute the sell-off to a reversal in commodities and some talk about currency movements being the culprit. Whatever be the cause the fact is that, investors are nervous and once again beginning to understand the concepts of risk and volatility.

India understandably has got hit very hard in this downdraft, as speculation was rampant and the markets were clearly very overbought. Signs of excess were everywhere, with record inflows into mutual funds, property stocks going ballistic and greed overpowering fear. Whenever money making becomes so easy it can never last long.

As many observers have pointed out our markets and real economy both are very leveraged to foreign flows, and thus any reversal of risk appetite hits India more than most. Having tripled over the last three years, the gains on the table in India are also greater than most other markets.

The question facing investors is the outlook from here, is this just a correction, or should they fold and take whatever gains they have left ?

I personally think the foundations of this bull Market in India are based on three long term secular trends.

1. There is an ongoing shift in asset allocation among institutional investors globally, away from the listed developed markets towards either unlisted alternatives or international equities(specifically emerging markets). This shift is structural given the need for higher returns, and is nowhere near complete. The sheer size of this potential shift in terms of the quantum of money that will be needed to be redeployed is enough to give a strong multi- year tailwind to emerging markets in general. The G-7 financial markets are unlikely to be able to deliver anything more than low single digit real returns(at best). These returns are insufficient and thus institutions of all types need to expand their investment horizons in search of returns.

2. India has now entered a new growth trajectory of 7-8% real GDP growth. A decade of 7.5% growth will transform this country and throw up huge opportunity across sectors. GDP growth of 7-8 % should allow market earnings to grow at 15-17%. India also has arguably the strongest and deepest entrepreneurial culture in Asia, and will continue to develop, grow and list world class companies. Given the quality of Indian companies, their ability to generate world class ROE's, and the huge runway for growth, India will and should trade at higher than mean emerging market multiples.

3.The Indian household is underweight equities, especially when compared to its own past history. As demographics and economic growth combine to supercharge our pool of domestic savings, domestic flows into equities either directly or through funds will explode. This will be the ultimate and final leg to this bull market, when domestic flows and institutions will overpower the foreigners. It will happen, it is only a matter of time.

I think one should bail from the markets only if you firmly disbelieve any of the above core operating assumptions. For if these assumptions are right then we are in the midst of a long term structural bull Market in India, and while short sharp corrections of 15-20% can and do happen(even in secular bull markets), the patient investor will benefit by riding through this volatility. Already down 17% as I write this column, by historical standards, if this is only a correction as I suspect, the markets must be very near to bottoming out. While the markets after stabilizing are unlikely to immediately rocket back above 12,000(SENSEX), they should remain in a trading zone as earnings catch up and investors consolidate.

There are many who believe that India is more hype than substance, pointing to our binding infrastructure constraints, inability to move ahead on economic reforms, lack of sufficient domestic savings and complacency. Many believe our potential will never be realized. These investors were in India to play momentum, the markets were hot and could not be ignored, but they have no long term belief or interest in the country.

This is when markets truly test conviction. Do you really believe in the India story? Do you think that we are at an inflection point in India's economic history? If yes then be prepared to ride out some short term volatility, but keep buying selected growth stories on the way down. If you were only here to play short term momentum, then that game is pretty much over and done with., and you should be looking for the exit door at the next bounce back.

Each investor will have to make his or her choice.

10. Peak Earnings
26 Apr. 06

One of the biggest mistakes any investor can make is to forget the cyclicality of earnings, and the fact that earnings cannot grow faster than nominal GDP indefinitely. To compound this mistake at the top of a market cycle investors will start paying peak multiples on peak earnings. Normally all investors are taught to adjust the multiples you are willing to pay to take into account the cyclicality of earnings. Therefore one must pay lower multiples for peak profits and high multiples on depressed profits. However at the top of a market cycle investors lose this discipline and agree to pay top of cycle multiples on peak of cycle profits and this normally will happen whenever investors start believing that we have entered a new era, where-in earnings can de-link from nominal GDP indefinitely.

Is this what is happening right now? Recent research published by Dresdner does seem to indicate this being the case for the U.S and Europe atleast. In an interesting research piece released recently they make the point that equity earnings in the U.S over the long term have never grown by more than 6% per annum. They show a chart taken from John Hussman which shows log earnings, which when measured from peak to peak show that U.S earnings have never grown by more than 6% p.a. They then make the point that at this moment we are right at the top of this 6% growth channel, clearly in peak earnings territory. At this point, currently investors are making two mistakes, first of all they are extrapolating the recent growth in earnings into the future, despite clear historic evidence that at an earnings peak, growth slows. Secondly investors today seem to be willing to pay top dollar for these peak of cycle earnings.

Using the construct of Hussman PE's(a simple way of using trend earnings, all you do is use past peak cycle earnings until a new high in earnings is achieved) the research piece shows that except for the late 1990's bubble, U.S equities are as expensive as they have ever been. Another way of making the same point is to look at multiples whenever earnings have been near the top of the 6% channel talked of earlier. Except for the bubble years, on average since 1950 whenever earnings are within 5% of the top of the earnings band (like today), the Hussman PE has been 9, today it is 18. Investors thus seem to be willing to pay a peak multiple on peak earnings, the only way this can make sense is if the economy and corporate earnings have entered some new era and are able to grow faster for longer than history would suggest. Equities in the U.S are priced as if we have entered a new era, and we all know how this normally turns out.

It is also interesting how when one cyclically adjusts earnings and multiples in the U.S ,the market actually looks very expensive, a far cry from conventional wisdom, which argue how the U.S markets are actually cheap as they trade at only 15 X forward earnings.

Very similar arguments can be made about European equities as well. European earnings like their counterpart in the U.S are very close to the top of their long term band. Also like in the U.S, despite earnings being cyclically extended, the market is trading on a Hussman PE of 17x peak cycle earnings, where-in the long term average is 11.7.

11. The FTV Framework

12 Apr. 06

In a prior organization where I had the privilege to work, they very effectively used a framework called FTV to determine the relative and absolute attractiveness of markets. It was just a more systematic way to approach markets and determine your investment stance. FTV stood for fundamentals, technicals and valuation, with points being given for each from -2 to 2 and the sum total would indicate how attractive or unattractive a market was. The most attractive market would have ratings of maximum 6 and the most unattractive market -6.

I have found this framework useful when thinking about markets, and it would be interesting I think to apply it to India right now and see what rating we come up with.

Fundamentals (The F in FTV) are further broken up into earnings and interest rates. As far as earnings go I think the markets are too euphoric, having seen corporate earnings compound in excess of 30% over the past three years, investors as is their wont are simply extrapolating this performance. Ultimately corporate earnings cannot grow much faster than nominal GDP (profit share of GDP cannot rise beyond a point), and nominal GDP is unlikely to grow more than 13-15%.

As I have pointed out before, over the last three years corporate earnings have reaped the benefits of improving utilization, lowering leverage and strong free cash flow, all three factors are now reversing as corporate India goes into capex mode. I think investors are being too optimistic on long term earnings growth, ultimately earnings will regress to the mean of nominal GDP. The only reason this linkage between nominal GDP and earnings will not hold is if you make the argument that corporate India has a depressed profit share of GDP, and earnings are artificially depressed, in which case you could have years of very strong profit growth, delinked from nominal GDP as earnings catch up and normalize. However with ROE's in corporate India now higher then in the U.S, it is tough to make the depressed profitability argument. I would thus give a rating of -1 to earnings as I think the market will be disappointed.

As for interest rates, clearly there is serious pressure on rates to rise. We are not generating enough financial savings domestically to support the fiscal deficit and investment needs of our corporate sector. Whatever the RBI may do in terms of cutting CRR or SLR are only short term palliatives, fundamentally we cannot support real GDP growth of 8% and a fiscal deficit of 4.5%, with the current level of savings. Also the global backdrop of the G-3 being in tightening mode only reinforces the upside bias in rates. While the market does understand that rates will rise, I don't think people can imagine by how much and its impact on growth. If interest rates rise by 200 basis points what will be the impact on retail demand? I am inclined to give a rating of -1 to interest rates as well. Thus for fundamentals we have a rating of -2.

In the Technicals section, we can break it down into demand/supply and market sentiment. On demand and supply I think the rating should be neutral or 0. While demand for Indian equities is undoubtedly very strong, supply is now catching up(witness the FCCB market) as the government will at some stage in 2006 open the floodgates on PSU disinvestment. Remember the biggest supplier of paper in this country is the government, this tap has been shut the past two years for political reasons. All signs point to this tap being wide open towards the second half of 2006.

As for market sentiment, I would have normally given it a rating of -1, as we are witnessing record amounts being raised by funds both domestically and offshore, and retail participation is picking up. However most of the old hands are very cautious, and many funds are sitting on large cash balances. A buying panic will occur at some stage, before this is all over. Given the caution exhibited by most of the smart money, a neutral rating of 0 is I think more appropriate for market sentiment. It can and will get crazier.

As for valuation, the reading clearly has to be -1. India is among the most expensive markets in the whole EM universe. Trading at 18-19 times forward, no one can call this market cheap. We are trading at about 35-40 % above the average valuation of the past decade (on a whole host of valuation multiples). I know interest rates are much lower today, but still valuation both absolute and relative is not cheap.

Thus if we put all the numbers together we arrive at a rating of -3, which would imply that one should be underweight the markets, atleast from a 6 month perspective.

12. The Commoditization of Capital
22 Mar. 06

I recently had the privilege of attending a keynote address delivered by Dr. Vijay Kelkar at one of the investment conferences held in Mumbai last week. Dr. Kelkar is a passionate believer in the future of India and delivered an address entitled "India on the Growth Turnpike". In his speech he outlined the rationale of why over the coming decades, India would be able to accelerate its growth trajectory and eventually deliver China like double digit growth rates. Dr. Kelkar delivered a cogent and well argued analysis of why this growth acceleration is bound to occur and is irreversible. His credibility (in my mind) is greatly boosted by the fact that I heard him make a similar speech in Singapore over two years ago where-in he made similar predictions. At that time the audience was dismissive of India even getting to 8% growth let alone double digits. After three years of 8% growth Dr. Kelkar's predictions look much more mainstream today, but one must give the man credit for being very early and spot on in forecasting this growth acceleration.

One of the pillars of Dr. Kelkar's arguments is a coming surge in domestic savings (especially household savings) and India's overall savings rate over the coming decades. This spurt in savings is linked primarily to demographics, India's dependency ratio (ratio of over 65 and below 15 to population between 15-64) will drop over the coming decades and such a demographic transition has invariably boosted savings in every Asian country undergoing this phenomena. India's savings will be further boosted by the general rise in living standards in our country. Countless studies have clearly demonstrated that the propensity and ability to save is significantly higher as incomes rise. As India grows and millions are delivered from poverty, these people will move from having no savings to becoming providers of capital.

In addition to this expected surge in domestic savings, India has never had easier access to global capital pools. India is now one of the mainstream markets in Asia and flows of capital be they FII or FDI are unlikely to reduce from here. In fact for FDI a strong case can be made for continued strong growth as India is still not attracting its fair share.

India is benefiting from the global realignment of capital flows towards countries which have the ability and need to absorb capital, and can deliver growth and returns on this capital.
All of these trends will only get reinforced as India moves inexorably towards capital account convertibility.

Given the above backdrop, India is now entering a new era where capital has truly become a commodity. Long starved of financial capital and resources, Indian corporates have now almost as much choice as their competitors based in more established financial markets.

What are the implications of this commoditization of capital? The impact has to be looked at from the perspective of investors and companies separately.

For companies this new environment (of easy access to capital) has to be handled carefully. Indian companies are currently renown for their ability to sweat assets and drive down capital costs, especially when compared to their peers in Asia. This focus shows up in the best in class ROCE(return on capital employed) and ROE(return on equity) numbers delivered by Indian companies.

A big driver of this focus on returns and capital efficiency is the limited and expensive access to capital for corporate India(till recently atleast). Indian companies have naturally valued and used capital more judiciously than their Asian peers as they historically had much less access to it. In today's environment of unlimited and cheap access to capital, Indian companies must guard against complacency and maintain their capital allocation discipline.

The easiest way to abuse cheap money is to either put up huge capacities in search of growth or embark on an aggressive mergers and acquisitions strategy. Previously unviable capital expenditure plans or acquisition targets can suddenly look reasonable if money is cheap and being given on a platter. Signs of both types of behaviour are now visible and if not done properly will be strongly dilutive for corporate returns.

This is an important development to follow, as India's currently high valuation multiples (highest in Asia) can only be justified by the corporate sectors equally high return ratios(ROE and ROCE are the best in Asia). If these return ratios were to go into secular decline because of a lack of capital discipline, then markets may be headed for trouble as multiples will de-rate along with returns over time. Investors need to keep pressing their companies to continue focusing on returns, it is what sets India apart from the rest of the region, most notably China.

Another implication for companies is that the role of the CFO becomes even more important, not only to maintain capital budgeting discipline but to proactively use all the new sources of capital in imaginative and value additive ways.

For the investor, the commoditization of capital throws up different challenges. The traditional providers of long term equity capital to corporate India, be they the traditional established FII's like Capital Guardian or GSIC or private equity shops need to understand that they are no longer the only game in town. Companies today have many choices and thus PE (private equity) firms cannot take four months for due diligence, insist on exclusivity or demand affirmative rights which effectively supercede the board. Companies are far more aggressive in trying to determine the actual value-add(if any) that a PE fund can provide. Unless you can deliver specific value addition from existing portfolio companies, why should my company give you preferential equity/rights and board representation, is a question CEO's and CFO's commonly ask today.

For the large long term FII's, having invested in India through most of the 90's, they find it difficult to stomach todays valuations. Having bought everything cheap, they are now mostly underweight and frozen. They cannot understand how companies are able to raise hundreds of millions of dollars overnight in the FCCB markets, and probably pine for the days when no capital raising could get completed with them coming in as an anchor investor.

India has now entered a virtuous circle where strong economic growth attracts capital which enables even stronger growth. Both companies and investors need to get used to a new environment where choice prevails, both in type and instrument of capital as well as the provider.

A different and more specialized set of capital providers will dominate the Indian capital markets over the coming decade. The days of a few firms wielding huge financial muscle are numbered.

13. Here Come The Hedgies
21 Feb. 06

In the last couple of months at least three prominent fund managers, well known and respected in India have announced their intention to quit their organizations and set up hedge funds of their own. This is the beginning of a trend in India which is already well established overseas. The best talent in the large fund management complexes, slowly but surely is trickling out and going out on its own.

There are two broad reasons for this exodus, firstly the economics of a successful hedge fund are just way too compelling. There is no way that the established fund management complexes with their huge size but only 1% fees can compete with the 2 and 20 crowd(typical hedge fund fees are 2% management fees and 20% of profit). Payouts in the many millions of dollars are not uncommon for successful hedge fund managers.

The second common reason is that most of the established fund management complexes as they grow larger and larger get run more as a business, then as an investment shop. They tend to act and think more and more as index plus investors and no longer as pure stock pickers. The lead fund managers also are forced to spend more time marketing and less time picking stocks. The fund managers also very often lose control over their funds in terms of being able to dictate when to stop accepting money, capping size etc. Fund managers who wish to go back to the good old days of just focusing on stock picking, and not having to worry about benchmarks or peer group performance, also find the hedge fund model of absolute performance very tempting. Only focus on the stocks in your portfolio, not on the 200 stocks in the benchmark.

Talking to this new crop of hedgies, one got some interesting insights into the set up process and issues related to it. First of all none of them expected to get SEBI approval as an FII(Foreign Institutional Investor) To me this seems odd as these guys all have excellent track records and spotless reputations. They all lamented the fact that because their funds were start ups, SEBI would not consider their applications, even though they personally had long enough track records to meet any SEBI criteria. They also seemed unclear as to SEBI's attitude towards hedge funds, as some big hedge funds had got an FII licence, but some other equally large funds had been refused. All were expecting to use access products and synthetics to trade India, even though they much preferred having an FII licence. Given that hedge funds are the direction the fund management industry is moving towards globally, I do not understand SEBI's reluctance to register them as FII's. One cannot wish away hedge funds, the best talent is joining them and already they manage more than a trillion dollars globally. The client base of the established hedge funds are the best endowments and pensions, these are not fly by night operations. In fact they are now considered to be the smart money.

Is it not better to register them (hedge funds)as FII's and get whatever details you need from them, rather than have them access your markets through access products and synthetic structures. Because you have this reluctance to recognize or deal with hedge funds, nearly 50% of the total FII money in India is invested through access products. $ 50 billion of capital in access products! You have this strange phenomena in India of SEBI refusing to deal with hedge funds thus forcing them to use access products, while the RBI wants to ban all access products.

Does the RBI understand what a total ban on access products will do the stock markets? Just imagine $ 40 -50 billion of capital flowing out of the country? What will this do to the rupee, interest rates and stock markets? Seeing all these issues from the viewpoint of a hedge fund start up it seems crystal clear that SEBI should finalise a set of criteria to register and recognize bonafide hedge funds and the sooner the better.

The second interesting observation was the point of how difficult it was to actually operate any fund (raising money from overseas investors) out of India. All the three hedge fund guys I spoke to were planning to operate from either Singapore or Hong Kong even though they were focused largely on India. When quizzed on the location, the tax situation in India came into sharp focus, for if the funds were seen to be operating out of India they would attract Indian corporate tax, which would be totally unacceptable to the investor base. Also the difficulty in trying to invest in rest of Asia from India was highlighted, due to the insularity of the Indian markets and the fact that no international companies did investor road shows in India. Also all three felt that access to Indian companies was actually better sitting outside than in India. The general infrastructure in Mumbai in terms of quality of service providers (fund administrators,fund accountants etc.) was also felt to be lacking.

So much for Mumbai becoming a regional financial center, it seems that Mumbai cannot even hold on to fund managers focused on India. If we are serious about making Mumbai into a regional financial center, then some type of tax incentives to encourage the fund management industry ala Singapore will be necessary. Capital account convertibility and the RBI using the carrot of offering fund management contracts (for our external reserves) only to global firms setting up offices in Mumbai would also help.

All the three were setting up long term oriented hedge funds and were quite confident in being able to raise large sums of money though not as comfortable in being able to invest the same quickly. The old dilemma plaguing the fund management industry continues into the hedge fund world as well it seems. The best times to raise money are probably the worst to invest.

All the three start ups will do very well in my mind, and set a new standard in performance. They will give the existing India funds a real run for their money. The game is changing in India as everywhere else. Expect more high profile personalities to make the leap into the world of absolute investing over the coming 12 months. It is where the future lies.

14. U.S Housing – Lessons from other countries
21 Jan. 06

A key issue in 2006 will be the pace of slowdown in the U.S housing markets and the impact this will have on the U.S consumer, economic growth and asset markets.

In 2005 consumer spending in the U.S grew at 6.5%, fully two percentage points higher then disposable personal income growth. This gap, the highest since 1999 was filled by cash extracted from appreciated homes, occurring when they change ownership. Nationwide in 2005, home prices in the U.S rose by 12%, with over a third of regional markets exceeding this number (unprecedented breadth). This broad based appreciation was converted into spendable cash by a 10% housing turnover rate,(the fastest in 25 years).

While the strong housing market provided a strong tailwind for consumption growth in the U.S, the signs are evident that property markets in the U.S are beginning to hit resistance. Housing turnover has begun to slow, inventories are building, incentives on the rise and a whole slew of other leading indicators showing a peaking near.

Given the importance of this issue to anyone's global economic and market outlook, it is worth spending time examining the lessons thrown up by other economies which have recently gone through a housing slowdown.

The experience of the U.K and Australia can give a good sense of how consumer and housing dynamics have played out when property markets slow and the impact on asset markets. These two countries are good case studies as they share a great deal in common with the U.S housing situation but are further along in their adjustment process and can provide clues as to what may lie ahead for the U.S.

The commonality between these two countries and the U.S is a background of very sharp increases in house prices, significant home equity withdrawal and robust consumption confronted by policy tightening. The U.K and Australia have had a housing price boom as significant as the U.S,, household debt burdens at similarly elevated levels and record mortgage equity withdrawals. The only difference is that they both began their adjustment process approximately 12-18 months ago.

15. The One Number to Track
11 Jan. 06

As we enter 2006, everyone's in-tray is invariably flooded with reports and emails detailing the investment outlook for 2006. Most reports that I have seen are quite optimistic and expect 2006 to be another good year for global equity markets. While not entirely correlated, a strong outlook for global equity markets bodes well for the emerging markets asset class and hence India.

The investment argument for a benign equity market outlook in 2006 goes as follows:

1. Global liquidity conditions remain very strong, and though the Fed has hiked by 325 basis points over the past year and half, real interest rates both in the U.S and the G7 more broadly are still at very low levels(For the G7, real short rates remain at .5%). Expansion of money supply is also healthy and does not indicate a liquidity squeeze in the offing. Equally important is the fact that in all probability the Fed is very much near the end of its tightening cycle, while the ECB (European Central Bank) is unlikely to move aggressively higher anytime soon, given the desire to prevent a short-circuiting of the fledgling euro-area recovery. Even in Japan, though economic conditions are improving and the markets have been on a roll, it is unlikely that the Bank of Japan (BOJ) will do anything immediate to move away from its zero interest rate policy. Thus whichever way you cut it, it looks unlikely that global liquidity will tighten dramatically from here, atleast not in the immediate future. This is an absolutely critical plank to the bull argument, for if global liquidity were to tighten that would almost surely kill off any equity market gains in 2006. Easy money provides the fuel for rising financial markets, and as long as monetary conditions remain conducive, a decline in markets seems unlikely.

2. The bulls also point to continued strong economic growth as the second plank of their argument. While most observers expect the U.S to slow down in 2006, this will be led by a partial retrenchment of consumption as the housing market slows. The initial signs of a cooling in the U.S housing sector are already apparent, and if one were to go by the recent experiences of what happened in the U.K and Australia, when real estate cooled off, one should expect consumption to be directly affected. This coming economic slowdown (provided the housing market does not collapse) will however not result in a recession.

Providing a partial offset to the coming consumption slowdown is the expected drawdown of the huge financial surpluses lying with corporate America as fixed investment picks up.

A big difference in the global outlook this time as compared to previous years is the expectation that a U.S slowdown will not derail the global economy. The nascent recoveries in Europe and Japan should be able to withstand a mild U.S slowdown, and provide some ballast to the global outlook. The influence of the U.S has also declined somewhat in terms of a lower share of global trade (now below 16%, was over 20%). The influence of the U.S has also been tempered somewhat by the continued growth of China and the rapid rise of intra Asian trade.

The third plank to a benign global equity outlook, is the fact that global valuations are not hugely stretched, especially when factoring current low interest rates and inflation. Using composite valuation indicators which combine all of the above factors in fact indicates that markets are as cheap as they have been in years.

Thus the bull case looks quite compelling and difficult to refute. The bulls accept that global financial imbalances are large and still growing, but make the point that the day of reckoning will not arrive in 2006. It will arrive someday and with severe consequences, but not just yet.

The only worry in the above arguments to my mind is the implicit assumption that inflation will remain very tame and subdued. This is an absolutely critical assumption which anyone expecting benign financial markets in 2006 has to buy into. For if inflation were to misbehave, all the three planks of the bull case will fall apart.

Firstly, if inflation were to rear its ugly head, the Fed would have to immediately accelerate its tightening program and impose a monetary squeeze to nip all inflation expectations in the bud. Having all but killed off inflation over the last decade, the Fed will do whatever it can to not let this genie out of the bottle again.

A sustained Fed tightening cycle will tighten liquidity globally as other central banks will be forced to follow suit, and kill off the easy money conditions so critical to sustaining current global financial markets.

A rise in inflation and the accompanying rise in interest rates, will also have severe implications for the U.S housing markets. Any surge in rates will potentially disrupt the housing markets and cause a recession as consumers are forced to retrench. If the U.S consumer were to retrench in a significant manner then it is unlikely that the global economy could withstand a growth shock of this magnitude. Earnings would disappoint and global equity markets would be likely to sustain losses.

Also if inflation were to spike then the argument of valuations being reasonable on interest/inflation adjusted multiples, would also fall away as these multiples would rise (along with the underlying interest rates/inflation rates) and no longer screen cheap.

Thus while the bull case for benign financial markets in 2006 seems compelling, keep a watch on U.S inflation rates (particularly the core CPI)it is probably the single most important economic variable any investor can track in 2006.