market outlook

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More pain before gains

A long consolidation phase before a possible sustained revival in the second half of CY2009

The good news is that the markets have reversed to a more rational level on the back of receding risk aversion globally. The massive fiscal and monetary intervention by various governments has helped ease out the panic in the global financial markets. However, the real economy is still struggling worldwide and the recessionary trend is much deeper and severe than the recent experiences; perhaps second only to the Great Depression of 1930.

India has also lost its growth momentum with a distinct slowdown in exports and overall industrial activity. However, India is better placed than its other Asian peers, as it is an inward looking economy with dependence on domestic consumption and investments to drive the bulk of its growth. Consequently, the Indian economy is relatively more insulated and is expected to be among the first few economies to revive by the second half of CY2009, driven by the lag effect of the recent fiscal and monetary easing, and an improvement in some of the key macro variables, such as declining energy cost, interest rates and inflation.

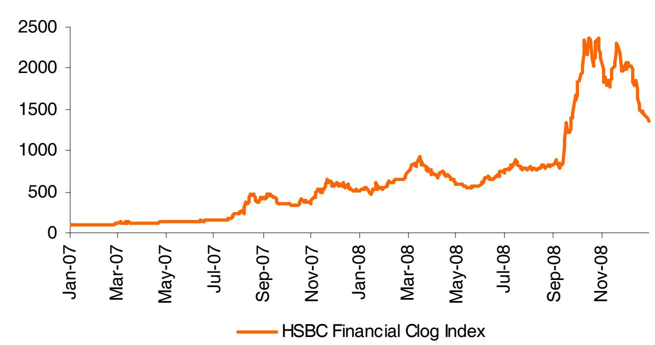
But the bad news is that the real economy is likely to slip further before the possible revival in the second half of CY2009. The corporate earnings would continue to deteriorate in the coming quarters. Forthcoming general elections and continued negative global news flow would also act as an overhang on the markets. Consequently, we expect the markets to remain range-bound and consolidate around the current levels for most of the first half of CY2009.

The best part about the consolidation phase is that it shall offer a significant portfolio building opportunity. That's because the downside risk shall be limited and the risk-reward ratio shall be hugely in favour of the long-term investors. Especially since the benchmark index is now trading at close to its historic low of around 10x one-year forward earnings.

Good news: Sanity returns as risk aversion recedes

Major advanced economies have announced a coordinated and coherent set of measures to deal with the crisis in the global credit markets as well as the after-effects of the crisis. We have seen massive liquidity infusions, steep rate cuts, bad asset purchase programmes, recapitalisation of financial institutions, and more comprehensive deposit guarantees. All the while, the effectiveness of these measures has remained a topic of debate. However, if we go by the indications from the financial markets, it's apparent that the myriad measures have indeed had effect, albeit to a marginal extent.

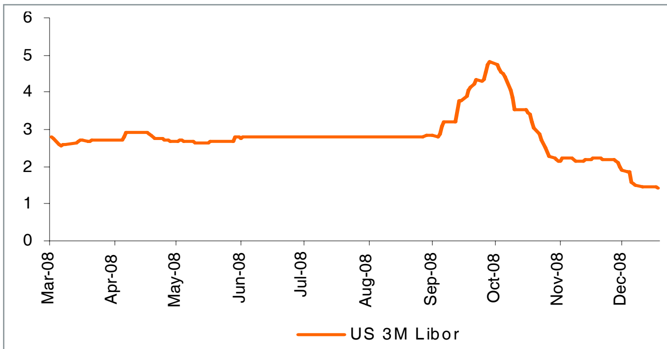
Financial clog has came down



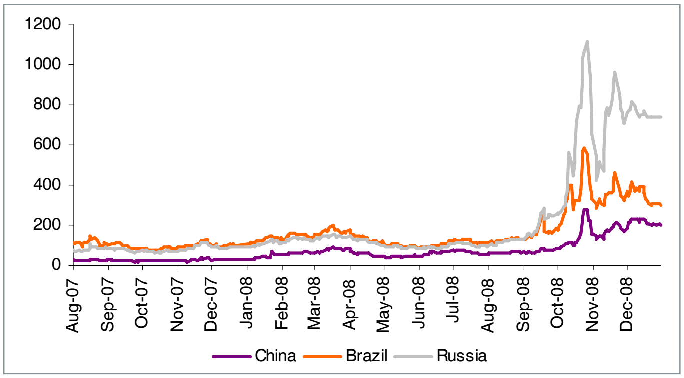
The HSBC Financial Clog Index measures the aggregate level of stress in the US financial system that includes:

1) inter-bank stress (TED spread and Libor-OIS spread),
2) financial institution default risk (US Financial CDS spreads),
3) mortgage agency credit spreads (Fannie and Freddie credit spreads), and
4) equity volatility (VIX index).

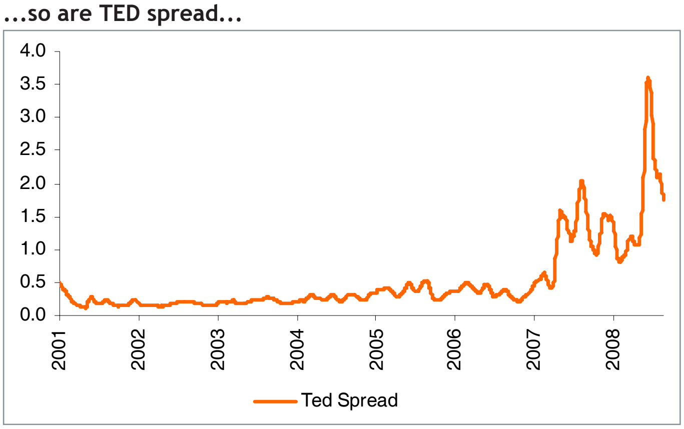
US Libor (three-month) has seen a steady decline



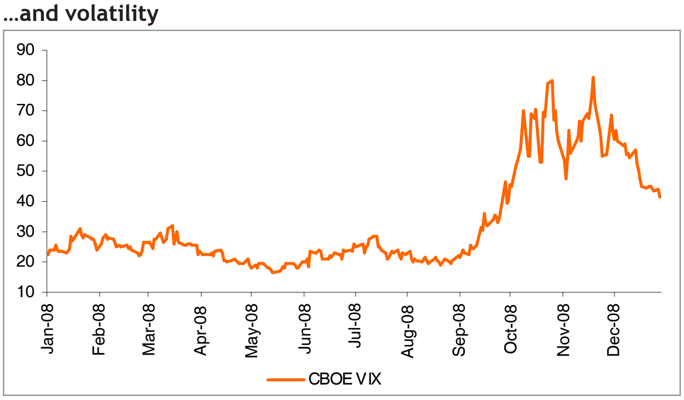
Sovereign CDS spreads are well off their peaks



...so are TED spread...



...and volatility



Markets have rallied after touching lows

In line with the easing of risk aversion, global indices have seen a decent appreciation from their respective lows in October/November 2008. India too has had its share of upside. As evident in the table below, the Sensex has gained ~27% from the low of 7,697 on October 27, 2008. Although the appreciation registered by the Bolsa and the Hang Seng is well above that recorded by the Sensex, yet India is clearly one of the preferred investment destinations in light of its relatively resilient economy. This is in line with our belief that the Indian economy is far better placed compared with many other emerging economies and this will ensure a quicker recovery from the ongoing economic slowdown. Moreover, we had expected some differentiation among the emerging economies with the return of sensibility among global investors.

Bad news: Revival of real economy still far away

Though risk aversion in financial markets has arguably eased off to an extent, the credit crisis has caused significant damage to the real economies of the advanced world. Moreover, the turmoil has engulfed countries not directly connected with the core problem, ie the US subprime mortgage crisis. Consequently, such countries are now dealing with pressure on the exchange rates, shortage of capital and other perils of financial disruptions. De-leveraging by financial institutions in advanced economies has made credit more expensive for households and companies. Importantly, there has been a sharp drop in consumer and business confidence across the globe, leading to rising unemployment, lower consumer spending etc.

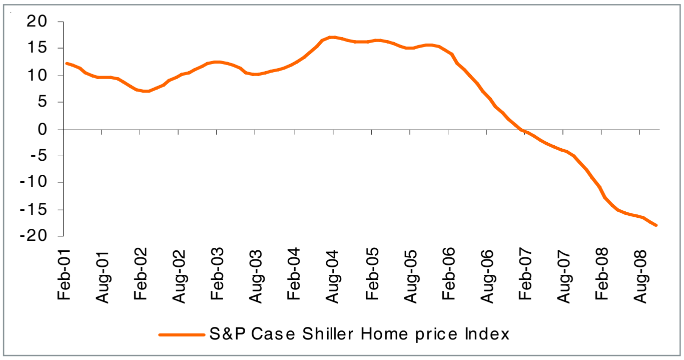
While the sizable stimulus packages have been announced, it will take time before economies worldwide start showing signs of revival in economic activity. As evident in the charts (next page), most of the economies (especially the USA and Europe) continue to face significant weakness.

Index	Current	52-wk low	Low date	% change
Mexico Bolsa	22420	16480	10/27/2008	36.0
Hang Seng	14387	10676	10/27/2008	34.8
Bovespa	37550	29435	10/27/2008	27.6
Sensex	**9778**	**7697**	**10/27/2008**	**27.0**
Nikkei 225	8860	6995	10/28/2008	26.7
Kospi	1124	892	10/27/2008	26.0
Jakarta Comp	1355	1089	10/28/2008	24.4
S&P 500	891	741	11/21/2008	20.2
FTSE 100	4393	3665	10/27/2008	19.8
Nasdaq Comp	1551	1295	11/21/2008	19.7
Straits Times	1762	1474	10/28/2008	19.5
Topix	859	722	10/28/2008	19.1
IBEX	9196	7737	10/27/2008	18.9
SE Of Thai	450	380	11/26/2008	18.4
Dow Jones	8668	7449	11/21/2008	16.4
Taiwan Taiex	4591	3955	11/21/2008	16.1
Shanghai Comp	1820	1665	10/28/2008	9.3

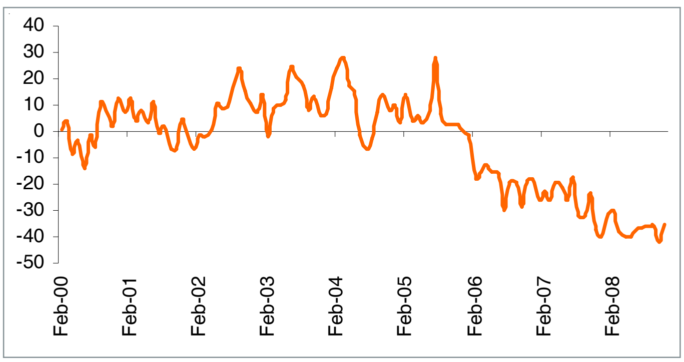
US housing sector's battle continues

The sector at the heart of the worldwide turmoil, ie the US housing sector, continues to witness further weakening with steep declines in home prices, dull demand for new homes and piling up of huge housing inventory. In line, the deterioration in real economy too is yet to show signs of stability.

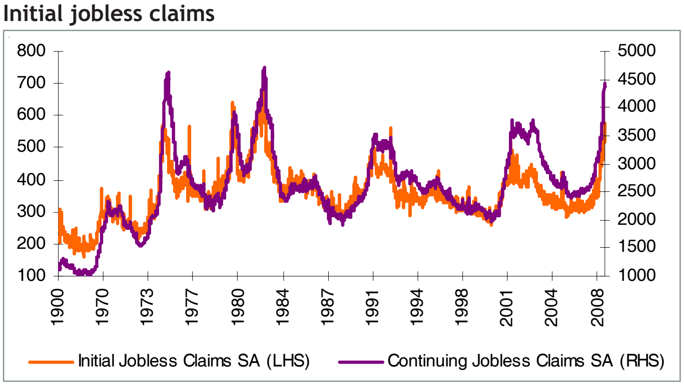
Decline in home prices continues unabated



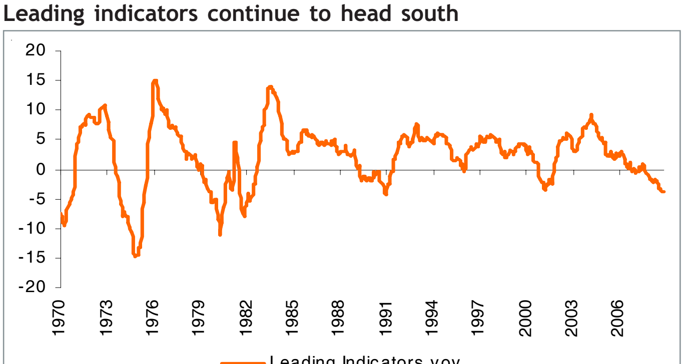
New home sales too remain weak



Initial jobless claims

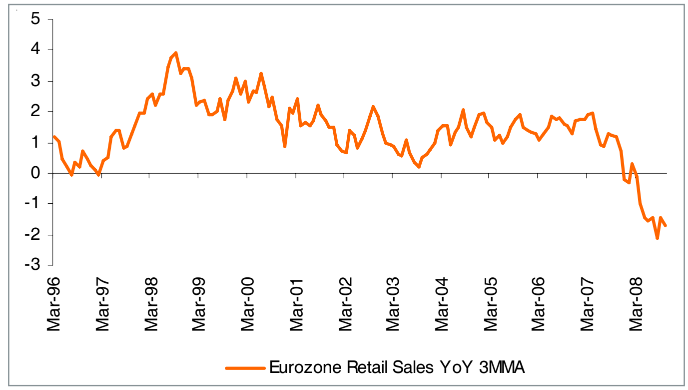


Leading indicators continue to head south

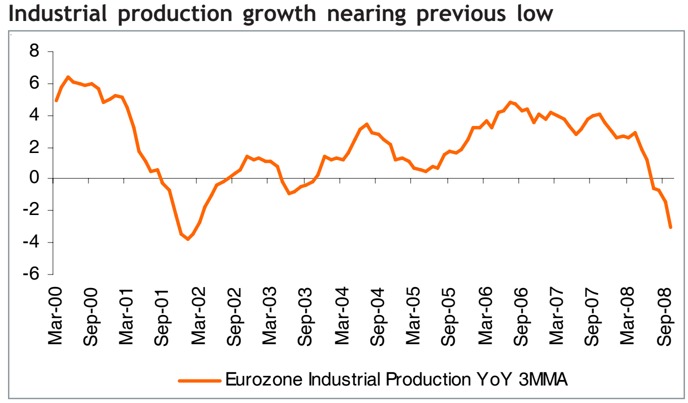


Eurozone: Weakness clearly visible

Retail sales growth at multi-year low



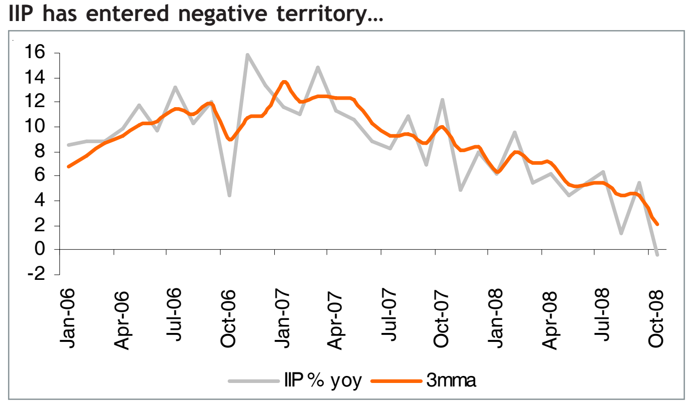
Industrial production growth nearing previous low



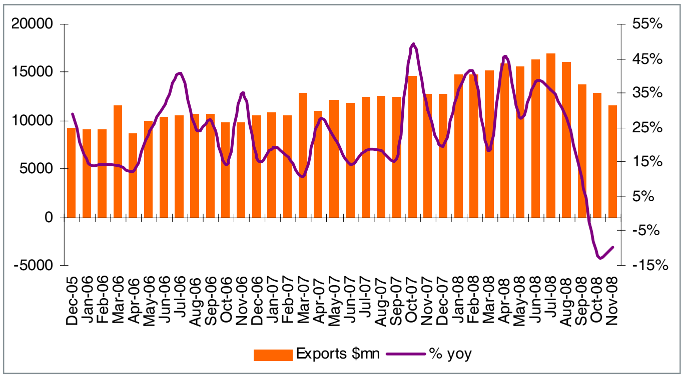
India: Mirroring global trends

In line with the global trends, India too has seen reversal in fortunes with industrial production in negative territory for the first time since the index was launched. Besides, exports growth, commercial vehicle production etc have shown a decline. Investment spending too has slowed down as reflected by the jump in the projects getting shelved. Meanwhile, there have been certain positives as well: Inflation has declined considerably, the government has launched aggressive rate cuts and fiscal measures to stem the economic slowdown etc. We now take stock of the current situation.

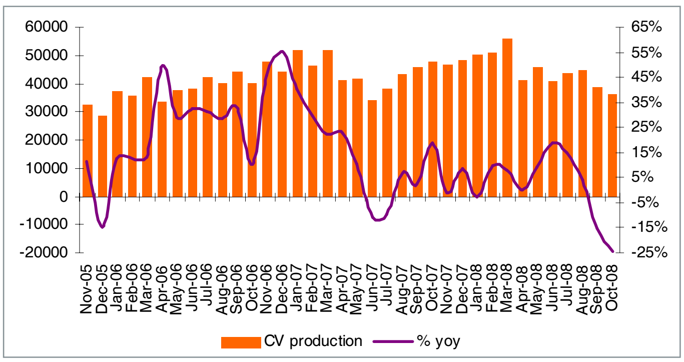
IIP has entered negative territory...



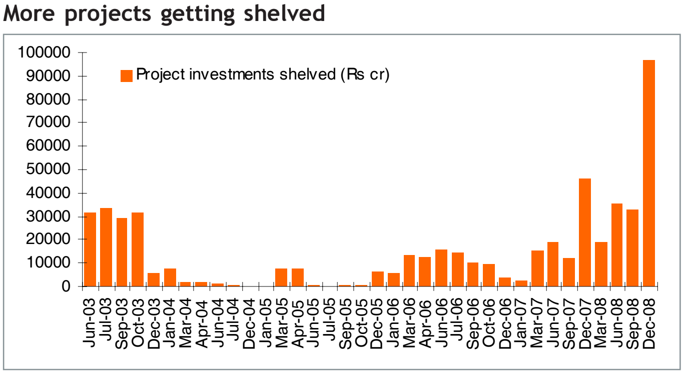
...ditto for exports and...



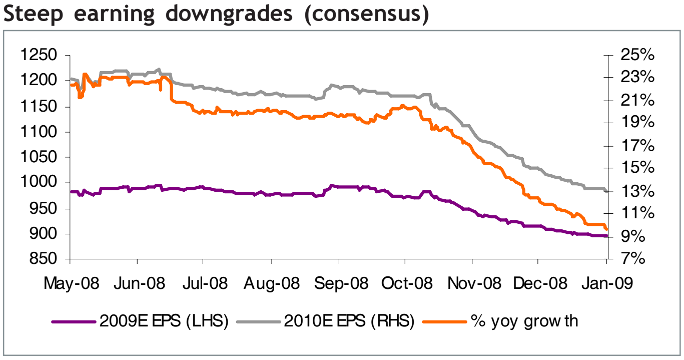
...commercial vehicle production



More projects getting shelved



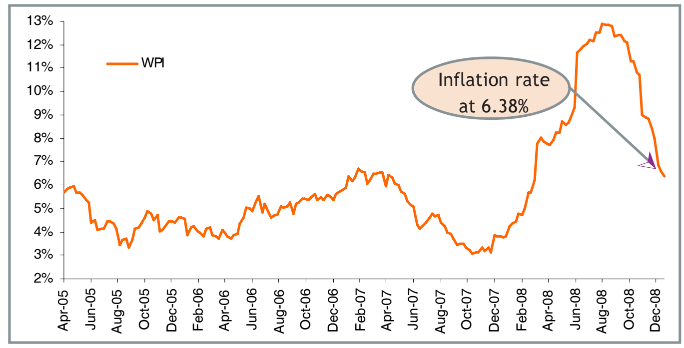
Steep earning downgrades (consensus)



Inflation has dropped off

Led by a significant decline in crude oil prices and other commodities along with a favourable base effect, the Wholesale Price Index has dropped rapidly from the peak (12%) in August 2008. With the inflation rate already below the Reserve Bank of India (RBI)'s fiscal-end target of 7%, there is more room for fiscal and monetary measures to revive economic activity. Notably, there is widespread expectation of the inflation rate dipping to ~1% level by the end of FY2009.

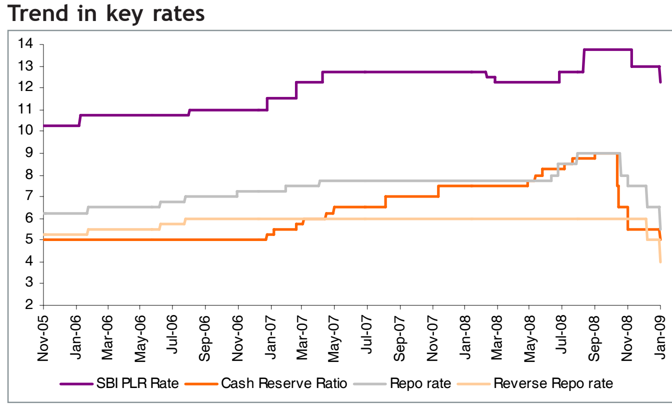
Trend in WPI % change yoy



Aggressive rate cuts

The credit-crisis-led liquidity squeeze had forced the RBI to adopt easy monetary policies to avoid any untoward development in the financial space. The key rates have been lowered quite aggressively with the cash reserve ratio (CRR) down by 400 basis points from its peak and the repo rate down by 350 basis points from its peak. Moreover, the effective statutory liquidity ratio (SLR) has been lowered to ~21% from the 25% level maintained in the last 11 years. Besides liquidity infusion, the rate cuts have led the banks (especially the public sector banks [PSBs]) to lower their lending rates and divert credit to productive sectors.

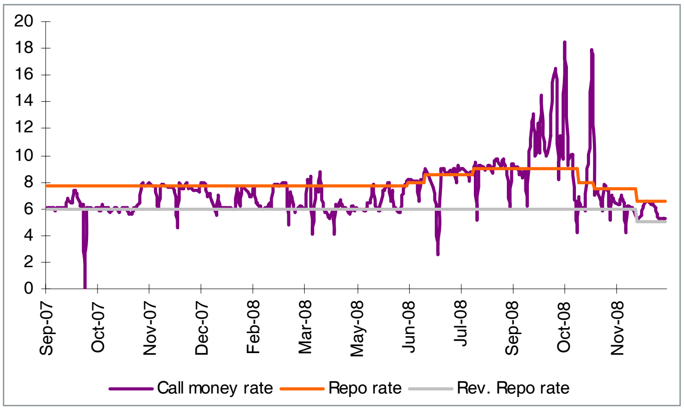
Trend in key rates



Liquidity crunch has eased out

In line with the various measures taken by the RBI (rate cuts, refinancing etc) the liquidity situation has eased off considerably. Importantly, the government has ensured availability of credit through PSBs, which is positive considering that the external sources of finance (external commercial borrowings [ECBs], foreign currency convertible bonds [FCCBs] etc) have dried up.

Trend in money market rates



Stimulus package

Besides the monetary measures, the government has announced certain fiscal steps. Though the size of the fiscal stimulus has disappointed market participants, it is a step in the right direction. Moreover, India's fiscal position does not leave enough room for any huge fiscal stimulus and hence monetary measures will remain the preferred tool for bringing the economy back on track. Notably, fiscal deficit as at end of November 2008 has already crossed the government's initial estimate of 2.5% of the gross domestic product (GDP).

Highlights of stimulus package II

Monetary measures

- The RBI has decided to cut the repo rate by 100 basis points to 5.5% from 6.5% and the reverse repo rate by 100 basis points to 4.0% from 5.0% earlier.
- The central bank has decided to reduce the CRR by 50 basis points to 5.0%, which is likely to infuse Rs20,000 crore into the banking system.

Other measures

- The government has relaxed the ECB policy further by removing the "all-in-cost" rate ceilings, and permitting ECB access to the housing sector for development of integrated townships and the non-banking finance companies (NBFCs) dealing exclusively with infrastructure financing.
- The foreign institutional investor (FII) investment limit in rupee denominated corporate bonds in India would be increased from USD6 billion to USD 15 billion.
- The government plans to create a special purpose vehicle to provide liquidity support against investment grade paper to the NBFCs fulfilling certain conditions up to Rs25,000 crore.
- Credit targets of PSBs are being revised upward to reflect the needs of the economy in the present difficult situation.
- To help maintain the momentum of expenditure at the state government level, states will be allowed to raise up to 0.5% of their gross state domestic product, amounting to about Rs30,000 crore, for capital expenditures.
- India Infrastructure Finance Company has been permitted to access an additional Rs30,000 crore by way of tax free bonds, over and above the Rs10,000 crore authorised earlier.
- Duty draw-back benefits on certain items including knitted fabrics, bicycles, agricultural hand tools and specified categories of yarn are being enhanced. These changes will take effect retrospectively from September 1, 2008.

The government does not envisage any further measures in the current fiscal and has acknowledged that economic stimulus measures have to extend beyond the current financial year. For the next fiscal, the government is considering the recapitalisation of the PSBs by infusing capital of Rs20,000 crore over the next two years. The proposed recapitalisation is aimed at avoiding capital adequacy constraints so as to enable a healthy credit growth for sustaining the economic momentum in FY2010.

Early signs of stimulus effect likely in H2CY2009

As discussed above, regulators have launched some aggressive monetary measures; however the effectiveness of these measures will greatly depend on the willingness of banks to lend in the current uncertain environment. Even if the Indian government's substantial stake in the PSBs allows it to push through its agenda focused on stimulating growth, the weakening business sentiments would act as a roadblock. All in all, the effect of the various measures on real economy will take time to appear with the early signs expected in H2FY2009. In the words of the US president elect, Barack Obama, "It will only get worst before it gets better."

Conclusion

Though the Indian economy is better placed than many of its Asian peers, it is in no way decoupled with the rest of the world and in the next few quarters it will grow at a rate much lower than the average growth rate seen in the past few years. Besides, the forthcoming Union elections and the unrelenting negative global news flow would continue to act as an overhang on the markets. But the good news is that the Indian economy is likely to respond to the recent monetary and fiscal measures, and could possibly witness a meaningful revival by the second half of CY2009.

Consequently, we expect the markets to remain range-bound and consolidate around the current levels for most of the first half of CY2009. In our view, the consolidation phase should be exploited as it offers a great portfolio building opportunity for the long-term investors. Though the uncertainties abound, the downside risk is limited and the risk-reward ratio is hugely in favour of the long-term investors. Especially since the benchmark index is trading at close to the historic low of around 10x one-year forward earnings.

Trend in one-year forward Sensex PE