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Time of reckoning?

Preamble

"The inevitable (usually) doesn't happen; it is the unpredictable always."

John M Keynes

Finally, (Buffetian) financial weapons of mass destruction have struck. Events over the last few months have been apocalyptic, though not surprising. These days Wall Street looks like *terra incognita*, a place unrecognizable. Really? The more it changes, the more it seems to be getting the same. Like Drucker said, the financial markets are one place where no real innovation has occurred even in a century. Structured finance products (or rather toxic substances at the root of the current problem) have been of a relatively recent origin (fifteen years). So this bewildering array of exotic instruments appears to bear an illusion of innovation, but is not. It is merely the old and familiar greed, hubris, sheer indiscipline and lack of integrity, but packaged in a new form. Now that it is caught in its own web of deception, Wall Street is scurrying for cover trapped in a maelstrom of financial tsunami, or a big bang. But of another kind.

Genesis of the troubles

But how did it reach such a mess? The answer partly is in the US growth model and partly lies in, by now famous, pump priming by US Fed led by Alan Greenspan. Any country (or for that matter any firm) can grow by either improving capital efficiency (or productivity) or by injecting more capital or both. Over the last fifteen years or so, there has been no material improvement in American capital efficiency; rather, there has been a decline. Hence American growth has been more and more sought to be driven by injecting more capital. Given its consumerist society, it generates no domestic capital to fund this growth; therefore, high reliance on external capital. Initially, that came more in form of equity capital and as that got scarcer, it has relied increasingly on leveraged capital. Given US dollar's status as universal currency, the source of "free" credit from the rest of the world by printing more currency notes or "promises to pay later" became too tempting and an easy idea. The world was awash with liquidity and the game got complete, of course aided by Fed policy of cheap and excess liquidity, aimed at keeping asset prices artificially high. The game worked so long as credit was easy and cheap, asset prices were rising and hence default rates were low. Given that scenario, profit multiplication seemed an incredibly simple task of mere inflating of American balance sheets regardless of asset quality. So, more and more leveraging became a virtue till the balloon burst.

The sheer size and (deliberate) complexity of the alternative finance or FWMD (financial weapons of mass destruction) as distinguished from the traditional finance is gargantuan: approximately USD 625 trillion have been outstanding in the global system today, thanks to this 'marvelous' innovation from US/London. Contrast this with the real world GDP at about USD 46 trillion! In this game, raters chose to be players rather then peddlers of opinion and through financial engineering junk assets (euphemistically called sub-prime) got converted into AAA. What was sub-prime was discipline and integrity while greed was over the top. Wall street went short on intellect and integrity and real long on greed and indiscipline. Firms like Lehman were leveraged an incredible forty times its capital. But they were not the only ones.

Clearly, Wall Street was trying to shoot from someone else's shoulder. Once interest rates started rising, asset prices started declining from their overbearing perch. Given also the poor quality of credit, the default rate shot up. The fact that the borrowers were leveraged and the banks were over leveraged made the combination lethal. However much you stretch straw, it won't become gold. The financial comeuppance finally gave way and businesses that stood the proverbial test of time for over a century are no more in existence. What was portrayed as "black swan" event looked a more pedestrian cycle repeating itself all over again, albeit in different form. The sheer executive greed is amazing: first create excesses, ride the gravy train, over bet, create false (present) profits, transfer risk to the future and strip off profits today. When inevitable risk will strike (and the resultant melt down), walk off to new pastures for a new time. By now, a sickening familiar pattern.

The unfolding scenario

America is now attempting an orderly chaos, or a systematic winding down. Easier said. There is a moral hazard: whether to save private capital at expense of public capital. This is much like that story of kids playing on railway track. Ten kids are playing on a busy railway track, despite being warned about dangers. One wise kid chooses to pay attention and is playing on a track in disuse and hence safe to play on. Suddenly a train is rushing in. Motorman has to decide whether to divert train to the unused track or let it stay course: to save one (wise) life or ten (errant) ones.

American finance is now struggling to save those ten lives even if it means sacrificing a lone sane voice. Fair? I don't know. But that is where it is headed today. Given the sheer size of these toxic instruments, the bailout package of USD 700 billion may be a palliative, rather than curative. Key issues are liquidity and solvency. Both. Not either.

Every lousy profit is a foundation of future losses. So, this one is not going to be different. Given the staggering profits created (not made) by American / European finance till even just six months back, losses by same measure will now come. In all previous crises, Main Street (real world) troubles were reflected on Wall Street (financial markets). This time, however, Wall Street troubles are spilling over in Main Street, losses moving from marked-to-market to real ones. Worse, Main Street has its own share of problems.

What may happen?

It will be churlish to assume that US problems will remain theirs only. Many banks in Europe have not very dissimilar problems. The concern is that European banks marked-to-market provisioning norms are rather lax and hence, some of the problems may emerge with a lag. Europe has also a difficulty in managing a respectable growth rate for itself for a long while now. Therefore, both US and Europe will have a long and difficult winter ahead of them. Europe has been fiscally more prudent of the two and so the winding down will be less severe for Europe. But shrink it will, for both.

The Asian situation is quite different though this time. Given the integrated world, it will experience some challenges but largely, it should cope well and still notch up a respectable growth rate. Asia will provide some kind of counter-balance to the perversity of situation in the western world. Following scenarios look very likely, some over long term and others over shorter term.

- Unipolarity of America as an idea would increasingly be challenged, along with a diminished overall American influence, be it geopolitical or economic.
- Concept of universality of US dollar as a currency would certainly come to grief. Therefore American growth model of "free of cost" funding from the rest of the world would increasingly be difficult.
- US balance sheet or American finance will have to shrink to account for evaporation of busted assets. Any meaningful shrinkage is typically a long haul situation like the Japan example shows. Reconstruction from the debris will begin but there is plenty of time before that happens for America.
- Troubles in US would percolate into its hedge funds, junk bonds market, corporate losses, retail loans and credit card obligations.
- Deleveraging of American finance will necessarily mean that American consumption has to crunch given that average American consumer lives on negative savings. With consumption accounting for 72% of US GDP, it will have deep consequences on GDP growth. How long? It is anybody's guess. Clearly it will take many years of growth to fill the void and to reach back the current level of GDP.
- Europe, to a much lesser extent, would still witness a not so dissimilar situation.

Indian Outlook: The pluses….

Economic history suggests that misfortunes of even the most dominant economies do not necessarily translate into affliction for the entire world. During such phases, the baton of leadership changes hands and the world readjusts itself to a new posture. The contemporary world is relatively far more integrated, but also far more responsive. It may appear insensitive but it is true that the difficulties of the western world may turn out to be disguised opportunities for countries like India, and some other growth economies in Asia and elsewhere.

The long-term journey that has begun some time back in favor of India should continue. In fact this may accelerate further. While it is easy to get dismayed by a lot of negative events in the world, it is useful to keep the perspective and balance. Actually some of the factors have turned to the advantage of India, yet Indian markets have suffered a bruising market capitalization erosion of 57% from the peak value nine months back. This is much more than just a rude interruption but definitely not a finale. There are reasons to believe that India, thanks to its structural positives and tactical gains, will emerge much stronger through this storm. As the dust settles, India's growth will assert itself and stand out distinctly on the (gloomy) global canvas.

Advantage India: The tactical benefits

It will be illustrative to take a closer look at some of the factors that turned favorable recently.

- Crude oil, from a peak price of USD 147 per barrel to USD 96 per barrel today represents annual savings of approximately USD 40 billion, about 4% of GDP.
- Sharp drop in metal prices and even softer outlook, imply a material economic gain for India, a major importer of many metals.
- Significant drop in most food grain prices
- Softer fertilizer prices, a major item of import bill and of subsidy burden.
- Recent major gas/oil finds in Krishna Godavari basin by Reliance, GSPCL and Cairns will have indelible positive impact on India's energy resources and security. Just the Reliance find will mean positive impact of approximately USD 20 billion or 2% of India's GDP. Oil output has already commenced while gas output will begin by Jan 2009.

Advantage India: The structural benefits

- About half the Indian economy is services; the other half is broadly divided between industry/manufacturing and agriculture in 2:1 ratio. This is unlike China which is much more manufacturing led, Russia which is dependent on oil & gas resources and Brazil which is driven by agrarian resources. This diversity of India gives it a strong resilience. It will be important to note that India has never de-grown in its post independence journey of sixty one years so far.
- Over 70% of Indian economy is domestic, unlike China which is far more dependent on exports for its growth.
- Significant and rising capital efficiency and productivity gains notched up over the last decade. Average return on capital employed of Indian corporate sector at about 21% is globally benchmarkable level and would probably be twice that of China.
- Not only India enjoys favorable demographics, but they are estimated to get even better for the next three decades.
- The three key bulwarks of India's strong growth remain intact, in a robust symbiotic balance with each other: rising consumption, healthy savings rate (35% of GDP) and as yet, robust investment demand.
- Indian banking sector has demonstrated strongly that it is run very robustly and with prudence, regulated with rigor and care, and is pretty solid and profitable. This, in the backdrop of global events, stands in stark contrast.

A dispassionate and objective analysis of the above make India a good case study for examining that the problems of western world do not have to be the challenges of India. And aren't. Certainly not in the same measure. What has been happening in developed economies is something one cannot ignore as a problem specific to them, but to color India with the same brush will indeed be a mistake.

….India Outlook: Minuses

While it is easy to see the positives, some seemingly obdurant and material challenges have emerged.

- The major challenge that has come by is the sudden depreciation of Indian Rupee. It is almost inexplicable why the currency has depreciated by such a wide margin and against dollar, given the significant drop in crude prices (the single biggest item on import bill), fertilizer prices and metal prices. Assumption would have been to expect Indian Rupee to appreciate but Keynes has prevailed: expect the unexpected! Considering the relative capital efficiency differential at margin (which favors India), relative growth rates and respective inflation adjusted interest rate differentials, the long-term assumption of Indian Rupee appreciating should play out. But in the short-term, it remains a major challenge.
- Inflation has remained stubborn at about 12% though not rising any more. So the level remains high while velocity seems to have peaked out. In sympathy, the interest rates remain even more stubborn. The bond yield curve shows the oddity of longer-term yields being lower than the short-term (below one year) rates. So it appears to be a short-term challenge, but an important one.
- As yet the investment demand continues to be very healthy but there are unmistakable signs that high interest rates are hurting. Housing demand has slowed down and so have auto sales. If interest rates persist for long, capital formation would get affected.
- Foreign capital flow may become a challenge going forward. At present it is unclear whether foreign capital will be busy dousing the fire in its own home turf or would have mindset and mental balance to seek opportunities in India. In the short-term this is impossible to predict but it will be fair to assume that over time, superior growth rates and capital efficiency would attract the requisite capital to fund India's growth potential.

Mega Trends

A broad trend has been in the offing for some time now: that of tilting of the relative balance, if not the power shift, from the developed, low-growth (now probably negative growth) economies to the rapidly improving economies in Asia and that of BRIC nations. Last year sixty one of the Fortune-500 companies came from emerging world, compared to fifty five in 2006. Some of the economies like India continue to meet with all the conditions that make for an attractive long-term investment proposition: strong growth, its sustainability, durability and capital efficiency. Simple mathematical computation would suggest that Indian economy and its markets over time have to be much bigger. This theme is a secular one, and not seasonal.

Like any other mega trend, this also is not free from its share of volatility and attenuations at margins, and current phase probably is one such breather. What began for China fifteen years back, and in favor of India five years back is something of tremendous amplitude and one which has full chance to create a multi-polar world. This has huge implications of deep positive import on what Indian markets will do over the next few years. The waning of American hegemony seems to be a distinct reality. The status of universality of dollar is clearly now a discredited idea. There are not adequate substitutes presently. But, a basket may emerge over time. The analysis of economic history of nations shows that the global economy doesn't like void: if someone creates it, others fill it out. That augurs well for India and her markets.

Investment Strategy

Bottom up stock picking always remains a valuable approach. Even more so in the current environment. Not all businesses are going to behave the same way or will end up the same way. For our investment selection, we favor income over assets, visibility (of earnings) over (distant) future and compounding emanating from continuity (of a business) over transactional fulfillment. The more tangible selection filters would emphasize a minimum threshold size of bottom line, a very strong present belief of its minimum of doubling over three years and outstanding and sustainable capital efficiency. Not to forget the management intangibles. Also, due attention to sensitivity to interest cost, energy charge and Rupee behavior is important.
When we map both of the above sets of factors, what emerges is that until a business has provided a minimum threshold of its capability, character and size, it is preferred not to be on a voyage to discover the obscure. Rather, it is better to favor only those opportunities which successfully pass all of the above sieves. Once they do pass these tests, they have to go through the usual rigor of investment analytics to find attractive price-value gap.

Sometimes there is a tendency to treat liquidity of an investment in dismissive if not contemptuous terms. The world has become more volatile and is unlikely to get different. Lifecycles of the businesses have shrunk. And sometimes dramatically, like recent events have shown. Liquidity of an asset is not as trivial as sometimes it is made out to be. A very theoretical construct about price-value mismatch, quality of business and the quality of management can serve to advantage only when underlying liquidity permits an execution of implied or assumed outcomes.

The Indian markets … Risk-Reward now compelling

Like always, the short-term is hazy and shrouded in mystery while the long-term looks crystal clear. The current challenges are more that of yo-yoing sentiments and the resultant volatility rather than ground reality. The issue is increasingly more of fund flows rather than fundamentals. Given the kind of low valuations for many compelling businesses of size and repute, clearly the challenges are more of mind battles and lasting out the uncertainty.

So what looks like a daunting challenge at this juncture will start looking like an opportunity some time down the line. The year of 2008-09 may not represent the most spectacular earnings growth year for India Inc, after a five-year stint of impressive earnings growth. But still, it may work out to 10-12% earnings growth which is not to be frowned upon, given the current global milieu. There is a full chance that by FY 2010 Indian corporates may reassert an earnings growth of 15-20%. Thereafter, growth should be back to the headier territory.

Valuations have come to attractive levels for large businesses and compelling for mid-sized ones. At the BSE Sensex level of 12500, it is valued at about 13X FY09 and 11X FY10, a level last seen in 2003. That year marked the five-year secular rise in Indian markets. If you go beyond thirty leading stocks, many large businesses are at modest double-digit valuations and most quality mid-sized businesses are at low to mid single-digit valuations.

Even the most stringent fundamental analysis suggests that risk of any further erosion is now moderate (not more than 10-15%) while many stocks, logically speaking, should multiply at least twice over, in two to three years' time. If the short-term is the view point or concern, then I would think one should refrain from participating because there is no prescient way of saying how the markets will behave in the short-term. Risk appears to be lying on the short-end of the curve while returns are to be had over medium-term. If that disconnect is not a bother, than Indian markets despite the current challenges continue to be a long-term powerful idea that it has been for last five years. When the dust settles down, this may go down as a marker event highlighting the beginning of second leg of secular long-term growth journey that Indian markets embarked upon five years back.

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