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Economy Update

QE3-Good for the market, bad for the economy

There have been murmurs doing the round in American government and economic circles that the Fed may opt for another round of quantitative easing or QE3 as it is more commonly called. We believe that if the Fed with few weapons left in its artillery opts for QE3, it will spell nothing short of disaster for the world economy especially for emerging markets like India.

What will happen if QE3 happens?.........

During QE1 which was started after Lehmann collapse in Septmeber'08, the Fed purchased $175 bn of agency debt securities and $1.25 tn of mortgage-backed securities in addition to purchases of Treasuries.

If QE3 is taken up as the last measure in order to boost the morale of the US economy after suffering the humiliation of a downgrade at the hands of S&P, it will definitely *make markets all over the world happy—however, we believe for a short term*.

The easy money that will come out of the US will definitely see its way into stock markets worldwide. That will surely cheer things up in the bourses globally. However, we believe ***a huge portion of that money will also go into commodities thus boosting its prices***. Gold and silver however will see a crash as people will start to believe in a future global recovery. There is no doubt that within commodities, crude will be a preferred commodity to buy thus boosting its prices. This will again ***raise crude prices (Nymex) to $100 plus levels***. This is in turn will ***negatively affect the fiscal deficit situation in India*** and its' already skewed Balance of Payment position.

How it will affect India?....................

By November 2010, the Fed decided to expand its balance sheet by $600 bn through the purchase of Treasury securities as a QE2 measure.

QE3 if it happens will affect India in more than one way. ***Our export will also lose its competitive edge*** as excess dollars in the system will result in its depreciation and hence an appreciation in the Indian Rupee. Thus, there is every possibility that we may be facing a situation where ***our import bill touches sky high on account of astronomical oil prices*** and our export revenue takes a beating on account of rupee appreciation.

It is widely believed QE2 inflated asset prices and was one of the main reason that took oil prices above $100/barrel

The ***rupee appreciation will also be aided by further hikes by the RBI*** which may be compelled to do so if it sees inflation climbing up on account of high oil prices, as previously too our central bank has opted to control inflation through rate hikes even though inflation arising out of external factors or supply side constraints cannot always be controlled by it. This will have catastrophic effect on the so called India growth story. It will therefore not come as a surprise if the aforesaid events play out, the next country which might see a downgrade by the rating agencies is India!

However, we believe even after all these events plays out we will not see the stock market reacting for some time as ***excess liquidity will keep the market in high spirits for some time*** and they will be blinded by the mirage of a global recovery which will actually be hollow in nature. The realization will dawn only when the world realizes that the US has fallen into a debt trap which have very few escape routes and requires tougher determination. It will require a change in the whole mindset of the American system and people to learn to live within their means.

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We therefore hope that the Fed realizes the catastrophe that it will bring on the world economy if it opts for QE3 and would therefore resist it.

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Stock Rating Scale

	Absolute Return
BUY	>20
ACCUMULATE	12-20
HOLD	5-12
REDUCE	<5