features

STOCKS

Sensex 2006: Target 12,000?

Another year of spectacular foreign inflows, or is the best over, or is there a sharp correction on the cards-what lies in store for the Indian stock markets in the new year?

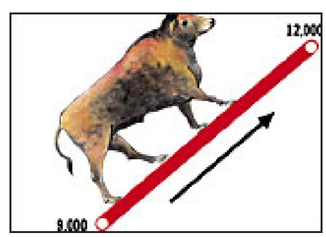
By Mahesh Nayak

It took all of $4.3 billion (Rs 19,350 crore) of inflows from foreign institutional investors (FIIs) to propel the benchmark Sensex from 7,000 to 8,000 points. On November 28, when the 30-share BSE index shot into the stratosphere of 9,000, it took just $796.20 million (Rs 3,583 crore approx.) of FII greenbacks to boost it into that region from the October 28 closing of 7,656. Don't delude yourself into believing that perhaps the liquidity created by domestic mutual funds and the good old retail Joe contributed their mite to the Sensex surge. The simple truth is that when the index touched 9,000-for the first time in 131 years of trading on the BSE-the spurt came on the back of low volumes-9 per cent lower than in October. That's enough reason for concern in pockets of Dalal Street. As Andrew Holland, Chief Administrative Officer & Executive Vice President (Research), DSP Merrill Lynch, points out: "The mood is extremely cautious as the market from these levels looks overvalued. The lower volumes and lower FII net investments have also contributed to that mood."

Then again, you have the bulls, one of them being Gurunath Mudlapur, Managing Director, Atherstone Institute of Research. Mudlapur is convinced about the long-term opportunity that exists on the Indian markets, courtesy strong economic growth and attractive relative valuations. He's hopeful that good GDP numbers, boosted in no small measure by an impressive Rabi crop, will boost rural spending. Mudlapur expects the Sensex to hit 11,500 in the next six to 12 months. "My optimism is based purely on the India growth story and the impressive second quarter GDP growth of 8 per cent (6.7 per cent in the previous year's corresponding period), which was driven by strong growth in manufacturing and services."

BULLISH SCENARIO

Sensex pole-vaults into 12,000 territory



LIKELIHOOD: 40-50 per cent in the next six to 12 months

EARNINGS GROWTH PROJECTION: 20 per cent for the next four quarters

P-E AT THESE LEVELS: 18-19

REFORMS FROM GOVERNMENT: Many

GDP GROWTH PROJECTION FOR 2005-06: 8-8.5 per cent

OTHER JUSTIFICATIONS: Government embarks on second wave of reforms, like allowing FDI (foreign direct investment) in retail space or further opening up the power sector or the introduction of pension reforms; flows from local funds and retail investors gather momentum; investments in infrastructure register a significant increase; rural spending rises on the back of a good Rabi crop and higher industrial activity

STATUS QUO SCENARIO

Sensex hovers around 9,000 territory

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K Subrahmaniam, Covansys President and CEO, spoke to BT's Nitya Varadarajan.
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LIKELIHOOD: 15-30 per cent

EARNINGS GROWTH PROJECTION: 15-20 per cent

P-E AT THESE LEVELS: 15

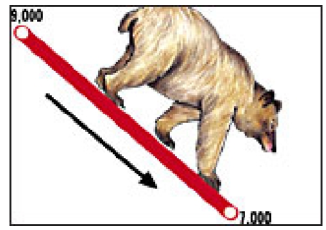
REFORMS FROM GOVERNMENT: Few

GDP GROWTH PROJECTION FOR 2005-06: 7-8 per cent

OTHER JUSTIFICATIONS: Corporate earnings growth, though not disappointing, is in line with market expectations, of 15-20 per cent; FII inflows are targeted more towards the mid caps than the large caps, resulting in modest liquidity conditions; the markets will continue to be rangebound, as upward moves aren't backed by strong volumes and robust inflows from foreign institutional investors (FIIs)

BEARISH SCENARIO

Sensex slips back into 7,000-7,500 territory



LIKELIHOOD: 10-30 per cent

EARNINGS GROWTH PROJECTION: Lower than 15 per cent in the next two to three quarters

P-E AT THESE LEVELS: 12-13

REFORMS FROM GOVERNMENT: Negligible

GDP GROWTH PROJECTION FOR 2005-06: 6-6.5 per cent

OTHER JUSTIFICATIONS: FII flows dry up, global crude prices touch $70 (Rs 3,150) per barrel in the January-March period, rupee weakens on account of a strengthening dollar, India's current account deficit, already 2.5 per cent of GDP, continues to rise, corporate performance slows down to under 15 per cent earnings growth, lack of reforms ahead of elections in West Bengal and Kerala

So, is the Sensex set to break out of the 8,900-9,000 range, and shoot into further uncharted territory? Or can it slide back to the 7,000-7,500 levels? One area of concern is the seemingly overvalued nature of the Indian markets, what with the Sensex quoting at a price-earnings (p-e) multiple of 18, based on 2005-06 earnings. This makes India one of the more expensive markets in the world, more dear than Russia, Brazil, Korea, Pakistan and Sri Lanka. Yet, the bulls out there are counting on solid future earnings growth, which will effectively rein in on the high p-e levels at higher index levels. Amit Rathi, Managing Director, Anand Rathi Securities, actually feels that the Indian market looks cheap if you consider the earnings growth that's yet to come. At the current index levels, his brokerage has projected a p-e of 14.4 times on March 2006 earnings and 12.56 times on March 2007 earnings.

The bulls are riding on their conviction of the long-term India story, courtesy strong growth and attractive valuations

Still, you have to be an unabashed optimist to be able to confidently predict profits of Indian corporates for the next six quarters. The current trend isn't very encouraging, pointing to signs of a slowdown. For the quarter ended September 2005, net profits grew by 13 per cent compared to 29 per cent in the corresponding period of the previous year. Sales growth also stuttered, from 21 per cent last September to just 8.3 per cent. What's more, for the second quarter of 2005-06, earnings growth of the Sensex was 23 per cent on a year-on-year basis, which is lower than the 31 per cent growth reported in the first quarter. "Markets aren't cheap at current levels," grimaces S. Naren, Co-head (Equities), Prudential ICICI AMC, who feels there could be disappointment on the corporate performance front, as the market has already discounted 2007 earnings.

With the Indian markets still largely driven by FII liquidity, plenty depends on which direction the inflows are headed. Says Naresh Kothari, Head (Institutional Equities), Edelweiss Securities: "Liquidity will be the biggest factor in dictating the trend in the market. If liquidity stops, the valuations will get lined to their fundamentals. There are possibilities of the Sensex coming down to the 7,000-7,500 levels." Holland feels that with the Sensex p-e trading above 17 times and the us interest rates expected to rise to 5 per cent, FII inflows can only slow down. Pressure on liquidity could also arise in the wake of rising commodity prices, especially global crude oil, currency depreciation, rising deficit of the government, liquidity pressure in the economy and delay in implementation of infrastructure projects.

The current account deficit, which is about 2.5 per cent of the total GDP, is one sure-fire worry. If one looks at the Indian trade deficit numbers, there is an average deficit of $3 billion (Rs 13,500 crore) per month. So far, this gap has been made up by FII inflows. The day the deficit is no longer matched by corresponding capital flows, it will impact the rupee exchange rate. The high trade deficit continued to weigh on the rupee, which weakened by 1.7 per cent in the last one month.

If Ajay Mahajan, President (Financial Markets & Institutions), yes Bank, is upbeat that the rally will continue, it's for all the usual reasons (strong fundamentals, outsourcing story, second wave of reforms et al). Plus he's also banking on increased participation from the retail investor. Clearly, the indices are surging upwards on the back of strong FII flows, but if the bull market has to be sustained over the longer term, more and more retail investors will have to become disciples of the equity cult.

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