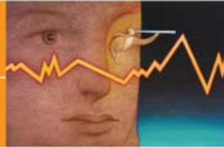
market outlook



Back from the brink

Panic subsides, sanity returns, but challenges to upside remain

With easing of risk aversion...

The unprecedented chain of events witnessed across the world in recent times has forced regulators worldwide to respond with equally unprecedented measures. The massive capital infusion by governments across the world totaling to over $1.5 trillion seems to have resulted in the easing of the extreme risk aversion globally. The TED spreads, 3M US LIBOR and CBOE VIX have cooled considerably and some sense of stability has returned to the world financial markets.

...relatively better fundamentals of Indian economy would come to fore

The stability in global markets and the significant correction in valuations after the free fall in October 2008 have set the stage for a possible reassessment of the emerging market assets by the global investors. This should pave the way for the differentiation of the emerging countries based on their level of resilience. With easing inflation, reversal in the interest rate cycle, comfortable external debt situation and anticipated improvement in the current account deficit during H2FY2009, India is relatively better placed compared with many other emerging market peers and could lead the emerging market pack when the tide eventually turns.

Possible peaking of earnings downgrade cycle

Earnings estimates for Indian companies have been gradually downgraded since the beginning of CY2008, with drastic downgrades witnessed during October 2008. Apart from the global concerns, the sharp downward revision in the consensus earnings estimates is driven by severe margin pressures (driven by a spike in the input cost owing to a surge in the prices of commodities especially coal and oil), rising capital cost and weaker demand outlook witnessed in the Q2FY2009 results. After the drastic revision in the earnings estimates, most of the downgrades are possibly behind us. Especially given the fact that there has been a reversal in some of the underlying trend assumptions, such as considerable easing in input cost pressures after the recent collapse in commodity prices, peaking out of inflation and the reversal in the interest rate cycle.

Valuations are inexpensive

Along with the possible peaking of the earnings downgrade cycle, the valuations too have become inexpensive. The Sensex' one-year forward price/earnings (PE) multiple has slipped to the single-digit territory, to a level where the Sensex has not remained for long in the past.

But forthcoming elections would act as a roadblock

Union election remains a key risk ahead as its result can potentially outweigh the likely convergence of the positive factors discussed above. From the capital market's perspective, a stable government led by the Bharatiya Janata Party (BJP) or Congress Party would be the most preferred outcome as this would ensure continuum in the economic policy and reforms. However, the possibility of a hung parliament or the emergence of a third front cannot be ruled out, which in all likelihood will be a market dampener.

FII flows: A key monitorable

The heightened risk aversion among the global investors has led to a reversal in the foreign fund flows across most emerging markets, including India. India has witnessed an outflow of $12.5 billion in the year till date, leading to a steep decline in the benchmark indices and a fall in the domestic currency. On a positive note, with risk aversion easing and valuations turning attractive, the foreign fund inflows have turned positive in recent weeks.

Massive liquidity injection subsides the panic

Unprecedented events...

Last two months have gone down the history as the worst period for financial companies worldwide. By the end of October 2008, US subprime led credit crisis had claimed well-respected companies as its victims while the others had been forced to sell out to the bigger players. A similar situation was brewing in Europe at the same time with some of the European financial companies severely hit due to their exposure to the US subprime market and domestic problems. In fact, the credit crisis pushed Iceland to the verge of bankruptcy and has forced many developing countries to reach out to International Monetary Fund (IMF) for a bail-out. The crisis has engulfed nations that are not even remotely connected with the US subprime turmoil.

...led to unprecedented responses...

In response, regulators have taken some unprecedented steps. Massive liquidity injections, bank recapitalisations and rate cuts have been unleashed to avoid a possible domino effect. The rapid response by central banks across the world indicates their willingness and ability to do more if needed. However, getting banks to lend when risk aversion reigns high is altogether a different matter. Yet banks' willingness to lend is going to decide whether a complete global meltdown will be avoided.

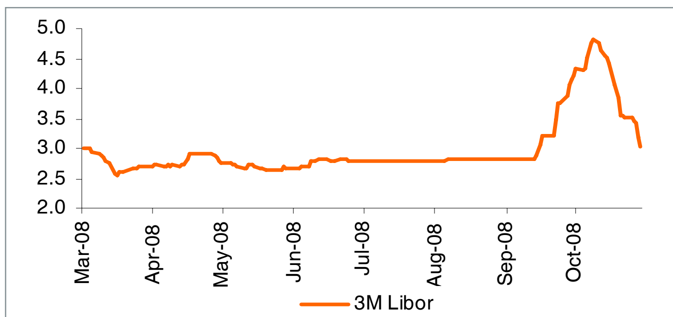
Rate cuts announced

	Recent high	Current	Change (bps)
United States	5.25	1.00	-425
United Kingdom	5.75	3.00	-275
Canada	4.50	2.25	-225
Australia	7.25	5.25	-200
India	**9.00**	**7.50**	**-150**
Eurozone	4.25	3.25	-100
Japan	0.50	0.30	-20

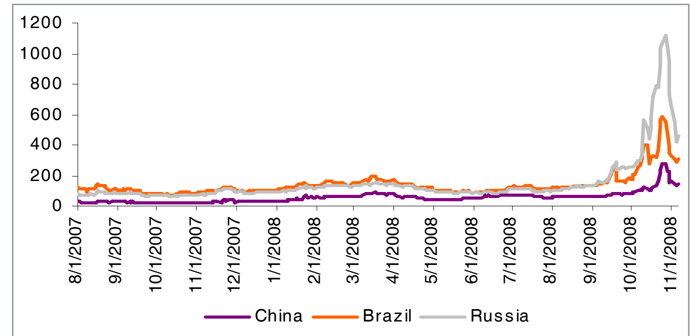
...culminating into easing in risk aversion

While the effectiveness of the measures will continue to be debated for a while, the measures have calmed the frayed nerves of global investors to an extent. Clearly, there is an increasing consensus that the various measures to recapitalise the capital of global banks should offer much more meaningful relief over time.

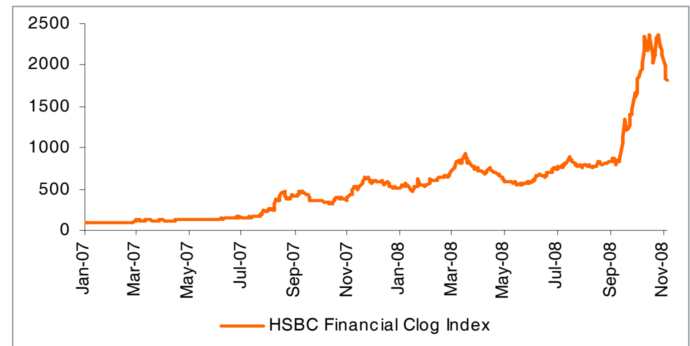
LIBOR has largely normalised ...



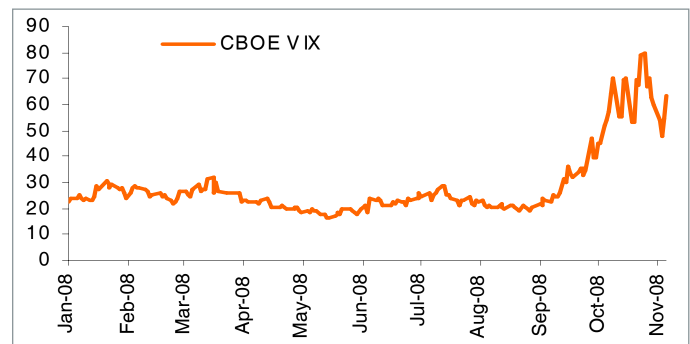
...so have sovereign CDS spreads



Stress in US financial system has peaked...



...leading to easing in volatility

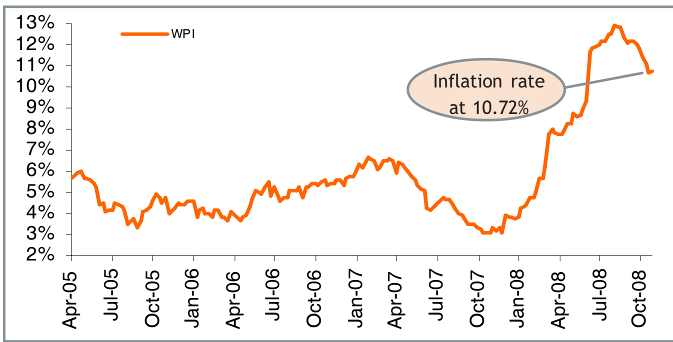


Fundamentals would come to the fore

Inflation has peaked out

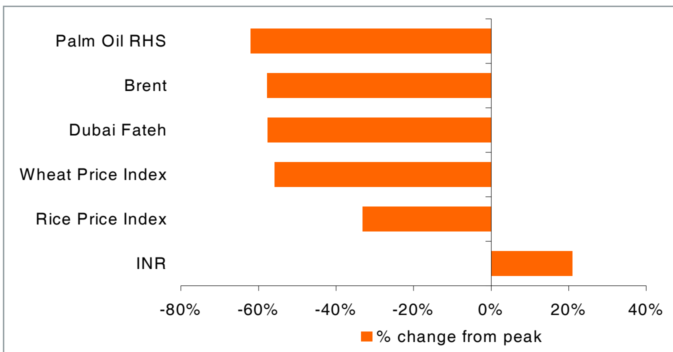
In the domestic economy, inflation, which has remained a key macro concern lately, seems to have peaked out. The Wholesale Price Index (WPI) indicated an inflation rate of 10.72% for the week ended October 25, 2008, compared with a peak of 12.91% in week ended August 02, 2008. Though still significantly above the Reserve Bank of India (RBI)'s tolerance level, the WPI has shown moderation in the past few weeks. The moderation stems primarily from the declining prices of global commodities (especially crude oil), as global economic activity and outlook have both weakened. A normal to better *kharif* crop, cut in air-turbine fuel (ATF) prices and a possible price cut in administered fuels as well will help to bring down the inflation rate closer to the RBI's target of 7% by the end of the current fiscal. The easing in the inflation rate at the current juncture assumes great importance as it allows the government to address the growth related concerns to an extent.

Wholesale Price Index



Importantly, India has not been able to fully realise the benefit of lower global prices owing to the depreciation in the Indian Rupee (INR). Hence, the movement in the INR will remain one of the key factors in deciding the extent of moderation in inflation ahead. As evident below, prices of crude oil and major agri-commodities have declined by 50-60% from their peaks, but a simultaneous ~21% depreciation in the INR has halved the potential benefit.

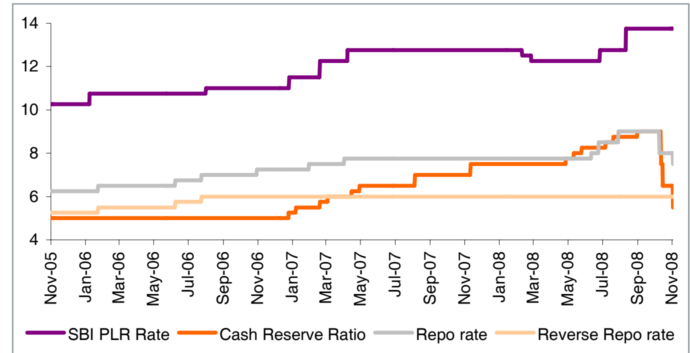
Collapse of commodities



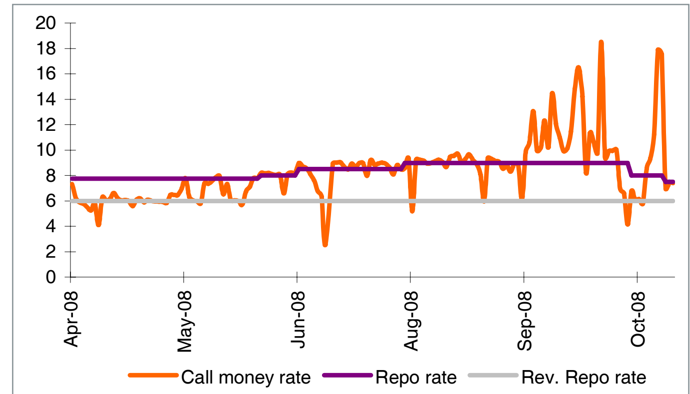
Interest cycle has turned

In the wake of the rising risk of an economic slowdown coupled with a tight domestic liquidity situation, the RBI has aggressively reduced the key rates recently. The repo rate has been lowered by 150 basis points and the cash reserve ratio (CRR) has been cut by 350 basis points from their peak of 9% each in the current fiscal, effectively ending the tight monetary phase of the past three years. Further, the statutory liquidity ratio (SLR) has been cut for the first time in 11 years (the last SLR cut took place in October 1997), by 100 basis points to 24%. This is a very strong signal. The 350-basis-point cut in the CRR alone amounts to liquidity infusion of Rs140,000 crore in the banking system. The 100-basis-point cut in the SLR would inject another Rs40,000 crore into the system. The actual liquidity infusion could be higher as the RBI has allowed banks to dip into the SLR up to additional 1.5% for meeting the requirements of mutual funds and non-banking finance companies.

Reduction in key rates...



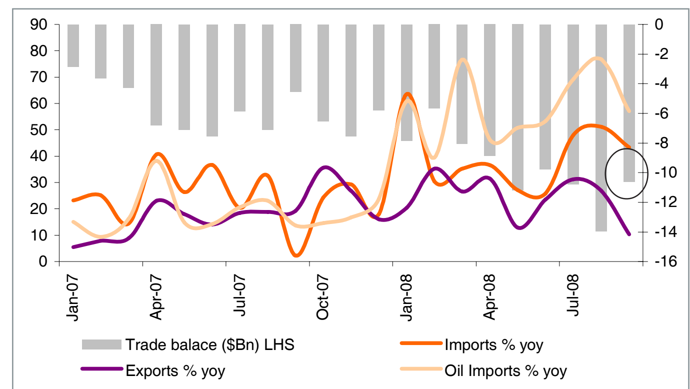
...has cooled off liquidity pressure



Current account deficit concerns may be misplaced

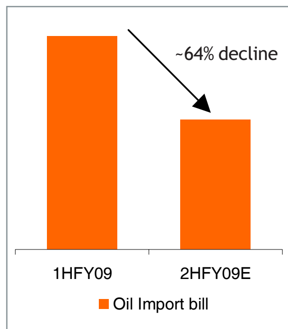
A positive outcome of the global turmoil has been the correction in the prices of commodities, especially crude oil, globally. For commodity importing countries, such as India, the higher crude oil prices were leading to a widening trade deficit. But with the significant decline in crude oil prices, the tide has turned and helped lower India's import bill. As evident below, the trade deficit declined to $10.6 billion in September 2008 from $13.9 billion in August 2008, on account of a 17% month-on-month decline in oil imports. Also, non-oil imports declined by 19.5% month on month during October 2008.

Trend in trade deficit



In H2FY09 the oil import bill may decline by ~64%. In continuation with the declining trend seen in the trade deficit in September 2008, if the crude oil prices stabilise at an average level of $70 per barrel for H2FY2009, India's oil import bill would be ~64% lower in the second half of FY2009. This indicates a saving of about $17 billion, if crude oil prices do not witness a significant surge again.

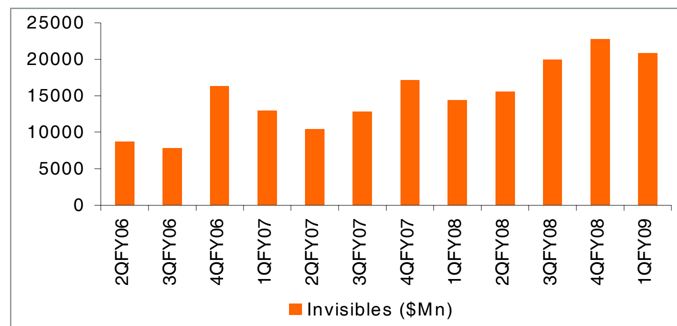
H2 oil import bill to decline



Besides the declining commodity prices, the commencement of oil production at Reliance's Krishna-Godavari Basin is likely to have a strong bearing on the current account deficit number at the end of the fiscal. In specifics, India's net import bill is expected to reduce by $70-75 billion over next five years, while average under-recovery savings are likely to be Rs10 billion a year during the same period. A better than expected current account deficit will, in turn, lead to the stabilisation of the rupee at a better level besides allaying the concerns of the global investors.

NRI remittances have been strong. Another positive development has been a jump in the remittances by the non-resident Indians (NRIs). According to the quarterly data released by the RBI, Q1FY2009 saw NRI remittances of $12 billion, an increase of ~54% year on year (yoy) from $7.8 billion in the corresponding period of the last year. The jump in the remittances may be due to the depreciation in the INR. The continued robustness in the remittances/ transfers along with the hike in interest rates on foreign currency non-resident (bank) and non-resident (external) rupee account deposits, and relaxation in external commercial borrowing norms would help contain the current account deficit.

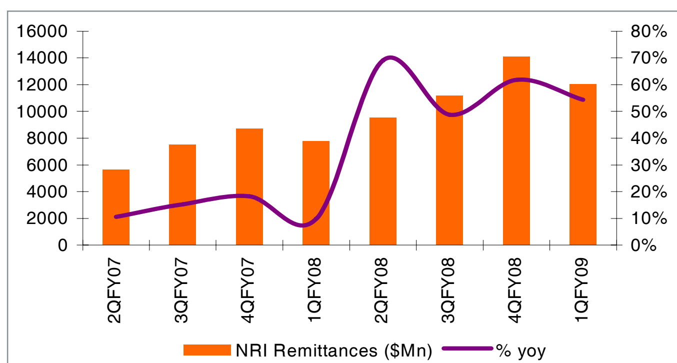
Meanwhile, growth in invisibles remains robust



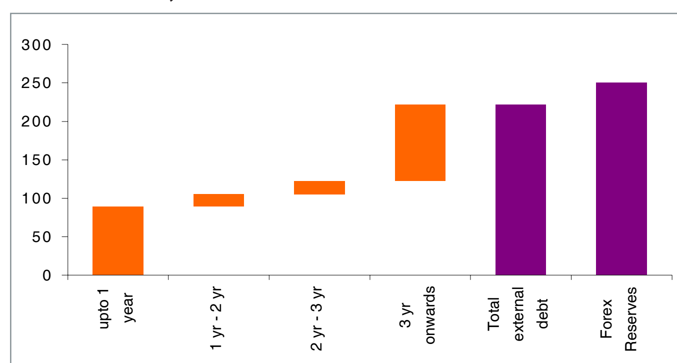
External debt remains comfortable

Another issue that seems to have been blown out of proportion pertains to the erosion in the country's foreign exchange (forex) reserves, which is feared to undermine India's ability to meet its external debt repayments. India's external debt stood at $221 billion as at end of June 2008; of this only $99 billion is payable within a year. The current forex reserves of around $250 billion are sufficient to meet the obligation of $99 billion.

Trend in NRI remittances



Forex reserves, external debt levels comfortable



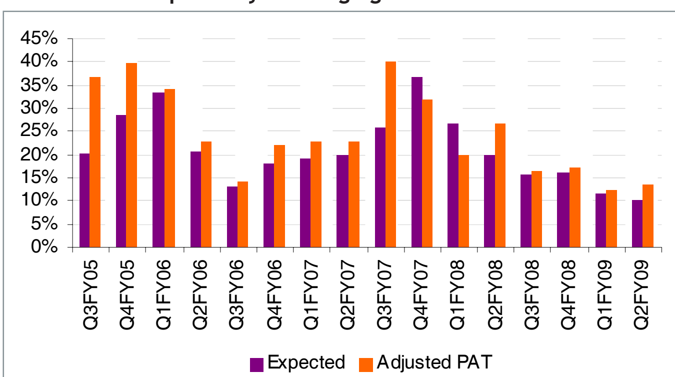
External debt position comparison

As at end of 2006	External debt to GNP (%)	Debt service ratio (%)	Forex reserves to total debt (%)
China	12	3	335
India	18	5	117
Brazil	19	37	44
Mexico	20	19	48
Russia	26	14	121
Thailand	27	9	121
Malaysia	36	4	158
Indonesia	38	17	33
Philippines	47	20	38
Turkey	52	33	30
Argentina	59	32	26

Q2FY2009 earnings: ahead of expectations but stress is visible

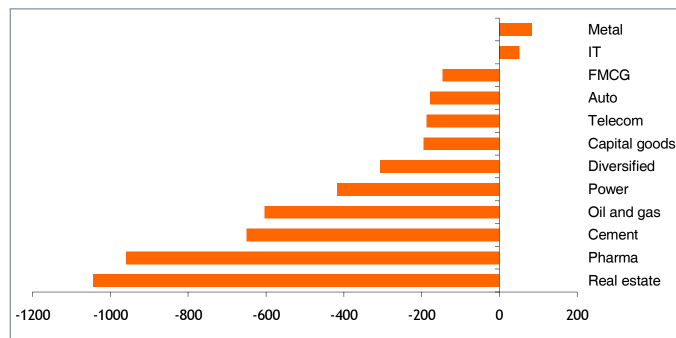
Against the backdrop of the anticipated moderation in the earnings of Indian companies, the Q2FY2009 performance of India Inc was eagerly watched. The earnings of the Sensex (excluding the oil companies) saw a growth of 13.4% yoy during the quarter and the same is ahead of our expectations (10.1%). From a sectoral perspective, the capital goods companies (earnings up 37.6% yoy), telecommunication companies (earnings up 34.3% yoy) and financial service companies (earnings up 26.9% yoy) witnessed a strong growth. Notably, the second quarter's earnings growth is above the growth seen in Q1FY2009. However, this by no means suggests the end of moderation in India Inc's earnings growth. Persistent challenges at the macro level will continue to have a strong bearing on the corporate earnings momentum going forward. Importantly, the coming quarters would reflect the fuller impact of the rising capital cost and the other myriad macro challenges faced by the Indian companies.

Sensex ex-oil quarterly earnings growth



Notably, the revenue growth for the Sensex companies (ex-oil and banking companies) was healthy at 28.3% yoy. However, the same could not translate into an equally good operating performance, largely due to a 170-basis-point contraction in the earnings before interest, tax, depreciation and amortisation (EBITDA) margin. The margins in most sectors were affected by the rising input and capital costs. The margin contraction was more pronounced in case of cement, pharmaceutical, real estate (read DLF) and power sectors. On the other hand, metal companies registered a nominal expansion in their EBITDA margin on an annual comparison basis.

Sectoral EBITDA margin performance



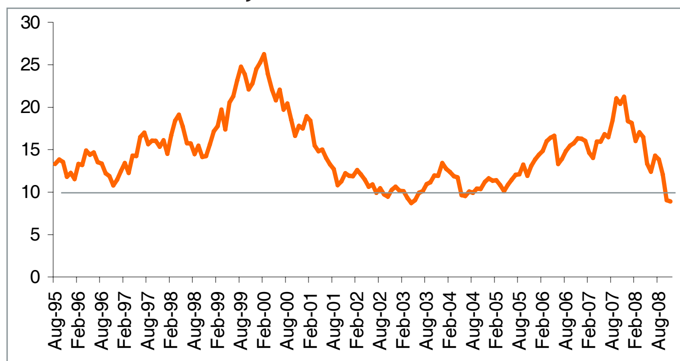
Steep earnings downgrades in October

In line with the weakening economic outlook and multiple macro concerns, the earnings estimates for India Inc have been gradually downgraded to factor in the rising input cost, higher capital cost and weaker demand outlook. Notably, the downward earnings revisions were drastic during October 2008 as the true size of the credit crisis and the rising possibility of a global recession dawned on us in this month. Considering the sharp downgrades seen recently and the reversal in some of the underlying trend assumptions (inflation has peaked out, interest rate cycle has turned), it seems that the bulk of the earnings downgrades is already behind us.

@ inexpensive valuations

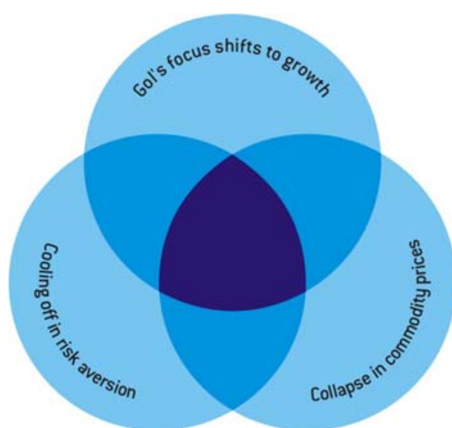
The Sensex' one-year forward PE has slipped to the single-digit territory, a level last seen during early 2003. Historically, Sensex' one-year forward PE has not spent much time in the single-digit range. Dissecting this further, since its peak in January 2008 the Sensex has been driven by twin factors: (1) contraction in valuation multiples as outlook weakened; and (2) earnings downgrades as expectations of moderation started setting in. With the bulk of the earnings downgrades already over and the valuations at historically low levels, the market is unlikely to fall below the low levels touched recently. However, the macro challenges remain largely intact and the benefits of the reversal in the interest rate cycle and inflation rate are yet to accrue. Hence, the market is likely to consolidate near the current levels. Effectively, further downside risk is limited because of the valuation correction but a sharp and sustainable upside is possible only after the return of the growth momentum.

Trend in Sensex' one-year forward PE



Convergence ahead

While it is difficult to hazard a guess on the timing of an economic bounce, we do see convergence of three key factors after eight to ten months.



Commodity collapse augurs well

- *Inflation:* As discussed above, the inflation rate has clearly peaked out on account of easing in global commodity prices. The recent cut in ATF prices, the expected cut in the prices of administered fuels, the moderation in prices of food articles on the back of a normal *kharif* output etc could help achieve the RBI's inflation target of around 7% by March 2009.

- *Trade balance, earnings growth:* Besides the direct effect in the form of easing in inflation, the collapse in commodity prices would help limit the trade deficit and alleviate the pressure on corporate profitability.

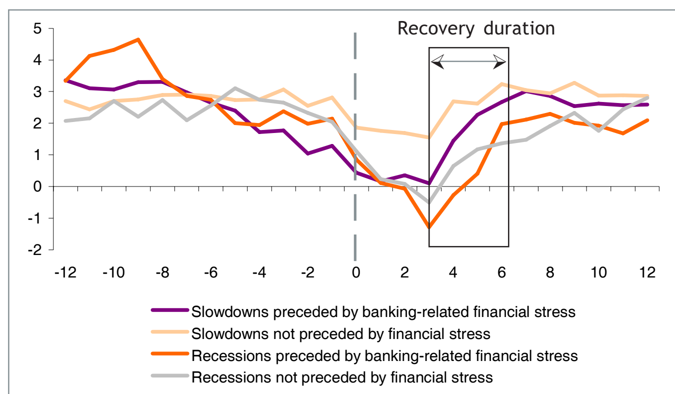
Macro situation likely to improve

- *Government's focus shifts to growth:* The risk of financial instability has led the Indian administration to shift its focus from reducing inflation to stimulating growth and ensuring sufficient liquidity.

- *Interest rate cycle reverses:* We have seen some aggressive cuts in policy rates and reserve requirements, which has effectively reversed the three-year long monetary tightening. The effect of recently announced monetary easing too will take time to play out and may start showing after eight to ten months.

Cooling off in risk aversion

The measures undertaken by regulators worldwide have helped calm investors' risk aversion to an extent. However, risk aversion still reigns high as the effect of measures taken is yet to reflect in tangible terms. We believe that the steps already taken and the possible additional policy actions will slowly but surely lead to easing in heightened risk aversion with passage of time. Based on a report by International Monetary Fund, recessions preceded by banking related financial stress tend to be more damaging and last longer than recessions not preceded by a financial crisis. On an average, it takes about three to four quarters after bottoming for the real gross domestic product growth to bounce back meaningfully (refer chart below). Importantly, the equity markets start discounting the pick-up in economic activity well in advance.



Source: IMF

Concerns

Elections: A key risk ahead

Union election is a key risk ahead as the results can potentially outweigh the likely convergence of the positive factors discussed above. The election, likely to be held around April-May 2009, will take place against a backdrop of a global financial crisis, a likely global recession, slowing domestic growth and a disturbed socio-cultural state of the nation (terrorist attacks, Singur debacle, unrest over regionalism). From the capital market's perspective, a stable government led by the BJP or Congress Party would be the most preferred outcome as this would ensure continuum in economic policy and reforms.

However, the possibility of a hung parliament or the emergence of a third front cannot be ruled out and this in all likelihood will be a market dampener. Importantly, the soon to be held state assembly elections in six states should provide some clarity on the psyche of the Indian voter. The BJP/BJP allies have won six of the 11 state elections held in 2007 and 2008 (YTD), indicating that the Congress Party is bearing the brunt of the higher inflation, high interest rates and now global financial crisis.

FII flow: A key monitorable

In line with the heightened risk aversion among the global investors, the FII flows have reversed for many emerging markets, including India. In specifics, India has seen an outflow of $12.5 billion in the year till date, leading to a steep decline in the benchmark indices and a fall in the domestic currency. On a positive note, with risk aversion easing and valuations turning attractive, the foreign fund inflows have turned positive in recent weeks. However, the joker in the pack continues to be the exchange rate.

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