market outlook

Global liquidity to dictate markets

Emerging markets to be the biggest beneficiaries of the Fed cuts

We have seen a sustained one-way rise in our stock market after the US Federal Reserve (Fed) cut the key short-term rate on September 18, 2007. The Fed cut has boosted not just our market but the other emerging markets (EMs) as well. It seems that the US sub-prime concerns are a thing of the past. So what has suddenly changed that the EMs look more attractive than ever before? We feel there has been no change in the fundamentals. What has changed is the liquidity condition and the increased liquidity globally is expected to drive the EMs to a higher valuation orbit.

A majority of the market participants expected the Fed to cut the rate by 25 basis points but Fed chose to cut it by 50 basis points, which came as a positive surprise. In the past, whenever the Fed had cut the rates, The EMs had rallied.

But that doesn't mean we don't have any more concerns and can move only upwards. We feel volatility will increase further in our markets. The major risk and concern that our market faces at this juncture pertains to the US economy going into a recession rather than achieving a soft landing. On the domestic front, there are risks of an economic slowdown owing to the Reserve Bank of India's (RBI) tight monetary policy and of mid-term elections as a result of political instability.

Some leading indicators continue to point towards a slowdown in certain domestic sectors (viz automobile sales, and exports). The Sensex' earnings growth for Q2FY2008 is expected to remain stable at around 20%. However, factoring in the sequential appreciation in the local currency, the reported earnings could be 3-5% higher than our expectations. Corporate tax collections have grown by 41% to Rs72,240 crore till September 30 in this fiscal which is a positive development and goes to show that corporate earnings are still healthy. Hence, there is no major concern with regard to the corporate earnings. Telecom and cement companies are likely to report high growth in earnings.

The Sensex has already scaled our December 2007 target of 16000 and taking note of the current situation we have rolled over our target for the Sensex to 19000 by September 2008. Our preferred sectors are those that are driven by domestic demand and capital spending, and therefore are relatively insulated from a US slowdown. Thus sectors like banking, capital goods, telecom and cement continue to remain our preferred bets. The fast moving consumer goods (FMCG) sector could also be a preferred bet but with a slightly longer-term perspective, say six months. The higher than predicted monsoons, political uncertainty over the 123 nuclear issue and the release of the Sixth Pay Commission's recommendations (likely to hit the market by April 2008) could make FMCG a safe heaven for investors in times of uncertainty.

Liquidity continues to remain the key driver

The subprime concerns look to be a thing of the distant past and EMs have rallied after the Fed cut the interest rate. The other important central banks in Europe have also kept their policy rate steady, which goes to show that the central banks would rather overlook inflation concerns than jeopardise growth. Thus, an easing monetary policy in the developed markets is likely to free up a lot of liquidity, which would find its way into the EMs and drive up the valuations of the assets there.

Emerging markets—biggest beneficiaries of the Fed cut

The EMs have turned out to be the biggest beneficiary of the Fed's rate cut even though the primary objective of the Fed's action was to stabilise the financial markets and limit the negative impact of the credit crunch. Post-Fed rate cut most stock markets in the EMs have recorded a 6-10% appreciation with the Indian market up 13.5%.

Fed easing—its impact on our markets

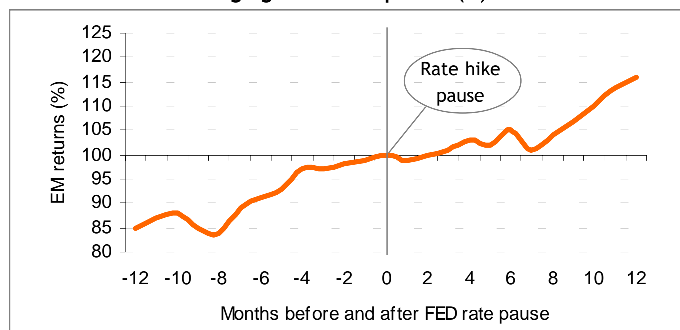
If the Fed does need to cut the rates further in the hope to revive the economic growth, what would it mean for the Asian markets, especially India? After a pause in Fed rate hikes whenever the Fed has started to cut rates and increased the liquidity in the markets, it has actually set the stage for the increased liquidity to move to some new asset class and drive up the asset prices. The asset class that has benefited the most has been typically that segment of the market that has had the best fundamentals at that point in time.

Some past examples:

- Post-1998 liquidity found its way into the technology sector, which had great fundamentals at that point.
- In 2001, after 9/11 the liquidity eventually found its way into the housing sector, which also had great fundamentals at that point.

This time it could be the EMs, which are showing the best fundamentals at the current juncture.

Returns on the emerging market equities (%)



Source: Bloomberg, Sharekhan Research

Strong Asian fundamentals

Asia has now become the strongest link in the global economic and financial system, and the same would be reflected in the valuations. Developed countries in Europe, Japan and the USA are no more the engines of global growth. The balance is shifting towards the fast growing Asian markets like China and India.

International fund managers turning slightly overweight on India

It is precisely such solid growth credentials that make the EMs even more appealing to global investors as growth is hard to find elsewhere. The table below illustrates the fact that fund managers have turned slightly overweight on India and China, and marginally underweight on non-Asian EMs.

International fund manager's pole on EM

	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07
Non-Asian EM	-0.25	-0.25	0.00	0.00	0.25	-0.25
China	0.25	0.00	0.50	0.50	0.25	0.50
India	0.00	0.00	0.00	0.25	0.25	0.50

Note: 0 is Neutral; up to +0.5 is Slightly overweight, above +0.5 to +1 is Overweight, above +1 is Very overweight and vice versa

Source: Dow Jones Monthly Survey

Structural shift in asset allocation likely

The strong US economy was instrumental in bailing out the world financial markets after the Asian crises in mid-1997 whereas the robust growth in Asia is likely to bail out the world this time. These contrasting fundamentals between Asia and the USA over the medium to long term could bring about a structural shift in asset allocation by global investors.

Asian valuations to expand, re-rating likely

Valuations in Asia are not cheap but are below 1993 and 1994 peak levels of 22-25x one-year forward earnings. The disappointing earnings growth profile of companies in developing countries due to a lack of focus on profitability and poor corporate governance had led to substantial derating in the 1990s. Money therefore had flown to the USA in big way later that decade with the earnings growth of US companies exploding on the back of the tech boom. However, the scenario has changed with the US economic growth likely to slow down and Asian economies likely to become the next global growth engines. The earnings trajectory and capital efficiency of Asia are also now superior to that of the more developed markets of the USA and Europe. Thus investors are once again gaining confidence to pay the higher multiples for the EMs and this could lead to an expansion in the price/earnings multiples in the EMs.

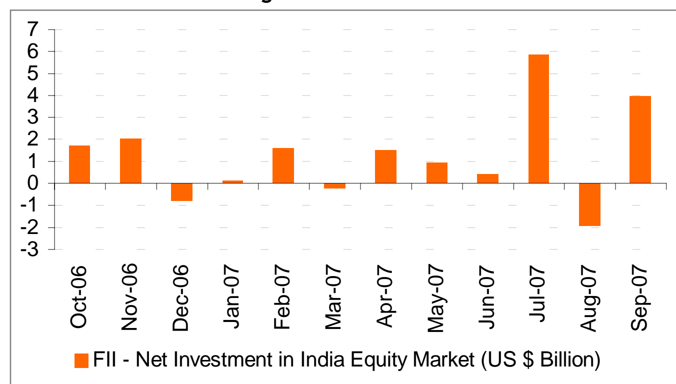
Risks associated with such capital inflows

In the medium term, a lot of this money from the developed markets would enter the EMs, asset prices would inflate and likely bubbles would be formed. Such high capital inflows into these EMs would also make inflation rear its ugly head sooner or later. Then central banks would be called into action to prevent such bubbles from bursting. However, things are likely to run their own course. For now, liquidity is driving the EMs across the world and would continue to do so unless the possible bubbles come to light.

FII flows continue, RBI hikes MSS ceiling

Our markets have seen very strong foreign institutional investor (FII) inflows in the last fortnight with the year-to-date FII inflows at around $13 billion. The subprime concerns had seen a rush of FII outflows in August but the situation has completely reversed in September 2007. Faced with this dollar deluge, the RBI has had to hike the Market Stabilisation Scheme (MSS) ceiling from Rs1.5 lakh crore to Rs2 lakh crore. This signals ceiling RBI's willingness to support the rupee.

FII inflows remain strong



Source: Bloomberg

Q2FY2008 earnings preview

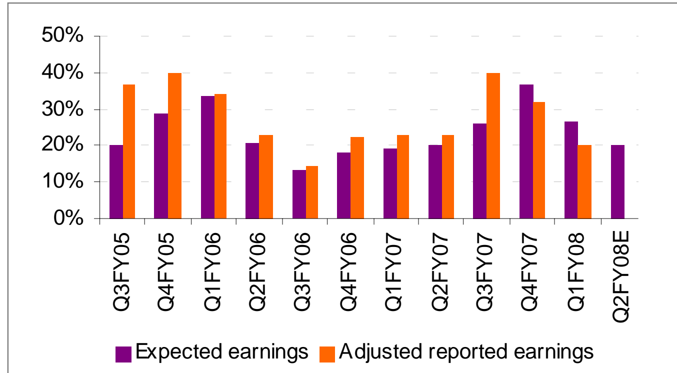
The earnings of the Sensex' companies excluding oil companies and adjusted for one-time items are likely to grow by 20% year on year and remain stable quarter on quarter in Q2FY2008. The Sensex' earnings ex-oil would be driven by companies from the telecom, information technology (IT) and banking sectors.

In Q1FY2008, we had seen that around 10% of the reported earnings had come from foreign exchange (forex) gains. Keeping the current strong uptrend of the rupee in mind, we may see companies reporting another 3-5% of one-time forex gains during the quarter. This would be in contrast to the initial expectations of forex losses in Q2FY2008, as the rupee had started to decline when our markets were facing the threat of large-scale withdrawal from the FIIs.

Companies where high earnings growth is expected in Q2FY08

Companies	% yoy growth
Bharti Tele	65
ACC	47
Grasim Industries	38
BHEL	35
Maruti Suzuki	30
TCS	25

Quarterly earnings growth trend

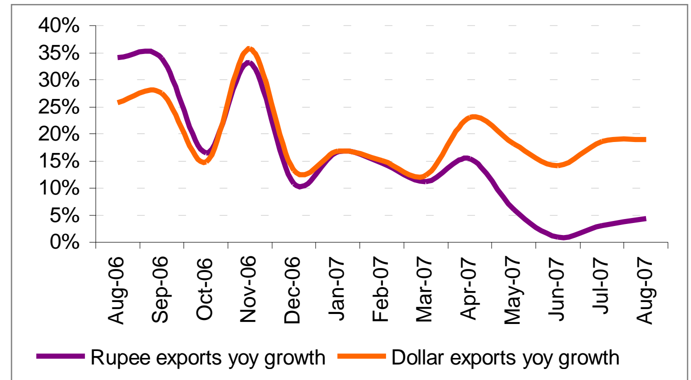


Source: Sharekhan Research

Some lead indicators point to a slowdown

Export oriented sectors remain casualty of a strong currency: However, a strong currency would continue to hurt our export growth in rupee terms. Our year-on-year export growth declined significantly to 4.3% in August 2007 from 15% in April 2007. Besides companies from the IT and pharmaceutical sectors, other large Sensex companies have also a 10-38% exposure to exports and this could have a bearing on the Sensex' aggregate earnings going forward. Thus major upgrades may not be witnessed in FY2008.

Trend in exports growth



Source: DGCIS

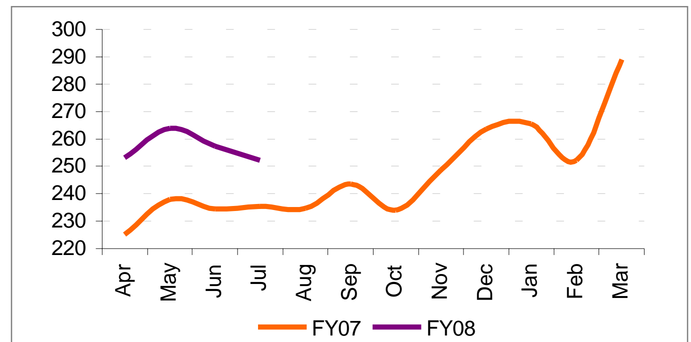
Other lead indicators also point to a slowdown:

- Two-wheeler and heavy commerical vehicle sales continue to decline with August sales down by 1% and 5% respectively.
- Revenues of manufacturing companies in the Sensex have slowed down to 13% in Q1FY2008 from 30% levels in Q1FY2007.
- Year-to-date credit growth stood at 2.8% compared to 6.7% in the corresponding period previous year.

Some concerns on IIP growth rates going forward

Higher base for IIP likely to restrict growth figures: Going forward, after the October 2007 Index of Industrial Production (IIP) growth numbers, the base index for the remaining five months is going to rise substantially and unless the growth picks up, we may see lower year-on-year growth figures for the IIP going forward. The July 2007 IIP at 7.2% could have been influenced by the floods in the major parts of the country but the production activity in various sectors needs to pick up with the onset of the festive season in the second half of this fiscal. Otherwise, with a higher base and lower production activity, the IIP growth numbers may be substantially lower than what we had seen in FY2007.

IIP—the base is going to be high going forward



Source: CSO

RBI likely to take cognisance of a possibility of a slowdown

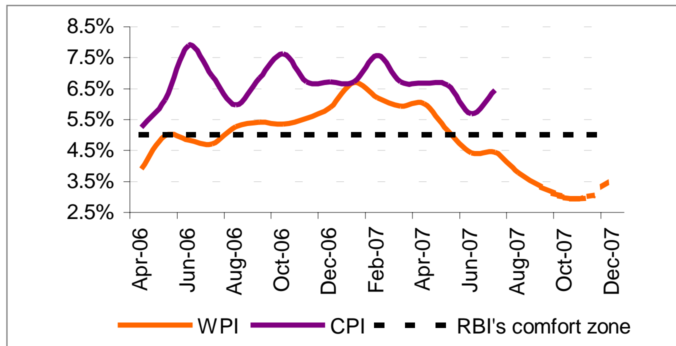
Our domestic interest rate cycle has peaked out and globally major central banks are either withholding policy rate hikes (European Central Bank and Bank of England) or beginning to cut rates (Fed). With inflation below 3.5%, we feel that the RBI would now take cognisance of the fact that due to its strict monetary tightening measures, domestic growth could have been jeopardised. Some lead indicators pointing towards a slowdown are a decline in the IIP and a low year-to-date credit growth.

Is RBI likely to cut rates?

As stated above, we feel that the interest rates have peaked out, however the chances of a rate cut immediately look dim due to the following reasons.

1. *Inflation:* Even though the Wholesale Price Index (WPI) is below 3.5% and hence well below the RBI's comfort zone of 5%, the Consumer Price Index (CPI) is still hovering around 6.5%. The RBI would also like to bring down the CPI before it starts cutting the interest rates.

Inflation not likely to remain a concern going forward



Source: MOSPI

2. *Money supply:* Money supply is still growing at 20% year on year (above the RBI's target of 17.5%) and continues to remain a concern with the possibility of foreign inflows remaining strong.

Monetary stance likely to shift to a neutral mode

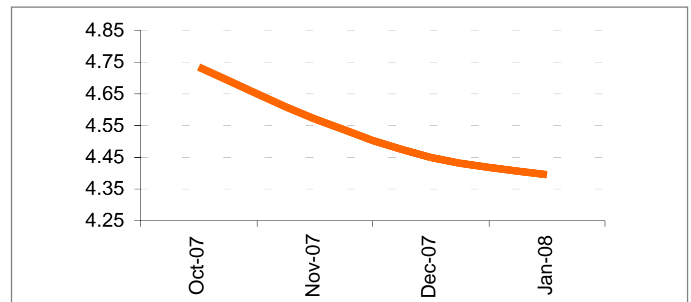
Hence, we feel the RBI is likely to change its stance from much hawkish to neutral and start to focus on growth once again in the next policy review scheduled at end October 2007. With regard to interest rates, we feel the market rates could soften (despite no change in policy rates or reserve requirements) once the banking industry gains comfort from (1) the RBI's neutral stance; (2) the high cost deposits run off the banks books; and (3) deposit growth remains above credit growth. In such a scenario bankers may consider reducing rates and providing a boost to credit growth, which should also help banks to protect their margins as a falling credit/deposit ratio is not margin accretive for banks.

Risks and concerns

Domestic—political risk: Apart from a possible slowdown in the domestic economy, there is risk on the political front. The domestic political scenario has suddenly changed with the Left parties voicing their concerns over the 123 nuclear deal that the United Progressive Alliance government is pursuing with the USA. The concerns have subsided now and resulted in the market getting back to its new lifetime high but the concerns could resurface. If the rift between these two ruling parties continues to grow over the nuclear deal, then the possibility of an early election in CY2008 cannot be ruled out. Although the elections could prove to be beneficial in the longer term, yet the same would give rise to significant volatility and expose our markets to the whims of the FIIs who may prefer to pull out money en masse. This could bring about a meaningful correction in our markets, by say 15-20%.

Global-US recession: Our base case assumption is that the US economy would make a soft landing rather than going into a recession. For the time being, the Fed has decided to cut interest rates and revive growth rather than focus on inflation. The August data on US employment has been revised from a decline of 4,000 to an addition of 89,000 jobs. Again, the September data shows an addition of another 110,000 jobs. The revision in the August data is substantial and completely unexpected while the September data is also robust. It indicates that the job market remains healthy and has reduced the odds of the USA going into a recession. The US economy has shown a lot of resilience and so far the housing turmoil has not yet percolated to the other sectors. Thus we believe our base case assumption of a soft landing in the USA still holds good.

Fed futures indicating further rate cuts



Source: Bloomberg, Sharekhan Research

Valuations

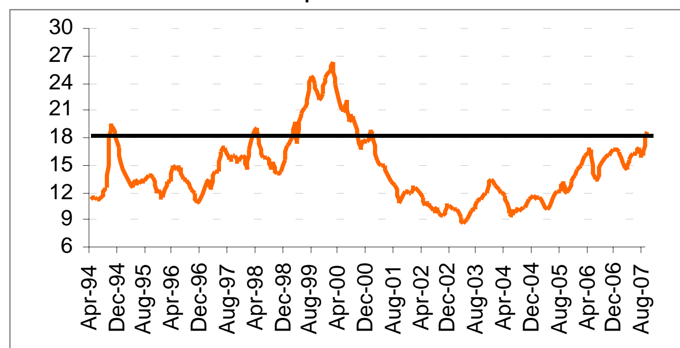
Sensex' valuations are not cheap but reasonable if we look at its ex-embedded value at around 16-17x one-year forward earnings. There are talks of a re-rating happening across Asian markets but whether the resulting rally would be of short-term in nature and be driven by only liquidity needs to be seen. Although the Fed futures are indicating further rate cuts, the latest economic data on jobs coming out of

the USA has not shown signs of deterioration and the US economy has proved to be rather resilient. Hence, the possible rate cuts factored in by the markets could get delayed and there could be a possible pause in the foreign inflows with the markets consolidating around the current levels. The manner in which the various Asian markets decouple themselves from a slowdown in the US economy is also important. Our markets are relatively insulated as 65% of our growth is domestic consumption driven. Hence, our long-term story remains intact but volatility cannot be ruled out.

Rolling over Sensex' target to 19000 by September 2008

The Sensex has scaled our earlier target of 16000 expected by December 2007. Taking note of the current situation we have rolled over our 12-month forward Sensex' target to 19000 by September 2008. The target is based on an expected growth of 18% in Sensex' FY2010E earnings, a 16 times earnings multiple and an embedded value of around 1500.

Sensex valuations not cheap



Source: Sharekhan Research

High cash levels protect major downside risks

The reversal in FII flows has always brought about a serious correction in our markets. But this time around, the high cash levels with the domestic mutual funds and the swelling corpus of life insurance companies could protect our markets from any major downside. LIC to invest around Rs12,000 crore in H2FY2008. The cash levels with mutual funds stand at around Rs14,000 crore or 9.3% of the assets under management (AUM) compared with Rs8,000 crore a year back.

Conclusion

In the near to medium term, keeping in mind the past trend (emerging market performance during Fed rate cuts) and views of global fund managers, we feel the surge of global liquidity would drive the equity markets of EMs. India being one of the best-positioned EMs, in terms of economic and corporate performance, should definitely receive a large chunk of the FII money destined for the EMs. However, the unfolding of the political risk is a concern and could see reversal of the so-called hot money that is betting on the short-term equity and currency market movements in case of an early election. We expect a soft landing for the USA and hence the future economic data releases from the USA would become critical and could also lead to higher volatility. Our preferred sectors are those that are driven by domestic demand and capital spending, and therefore are relatively insulated from a US slowdown. Thus sectors like banking, capital goods, telecom and cement continue to remain our preferred bets. The FMCG sector also looks attractive though from a slightly longer-term perspective, say six months.

The author doesn't hold any investment in any of the companies mentioned in the article.

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