India Strategy: Armageddon averted for now but big questions remain unresolved

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The event: In a frenzied bout of "kicking the can down the road" using smoke & mirrors, European leaders yesterday announced that: (a) Greek bondholders would take a 50% haircut on the value of their holdings; (b) The EFSF's rescue fund will apparently be leveraged up by 4-5x to reach the impressive figure of $1.4 trillion; and (c) European banks would be recapitalized to the tune of $150 bn. Stock markets and commodities rallied with the German market (up 5.4%) and Copper (up 6%) being the stars of the day. Some credit for the rally must also go to US GDP growth data - the US economy grew by 2.5% in Q3 (broadly in-line with consensus and up from 1.3% in Q2).

So what does this mean for the Indian stockmarket? Are we standing on the cusp of an explosive March-July 2009 style rally or will this mini-rally peter away before you can say "EFSF"?

Big questions remain unresolved vis a vis the European rescue:
Firstly, where will be the $1.4 trillion of rescue funding from? Germany has made it clear that the ECB will not be providing this capital. The suggestion seems to be that certain EFSF backed SPVs will buy a quantum of the PIGS' sovereign debt and then use the streams of income from this sovereign debt to issue bonds (with the EFSF providing some sort of first loss cover on these bond investments). But who will buy these bonds? And given that investors have just taken a 50% haircut on their Greek investments, how much first loss cover would the EFSF have to offer to persuade investors to buy these bonds?

Secondly, given that a 50% haircut has been taken on Greek debt held by private sector bondholders, why hasn't a similar haircut been taken by official bond holders (Central Banks, multilateral agencies, etc)? Doesn't such a staggered haircut amount to "default" and if so won't it hit sellers of Greek CDS'?

Thirdly, if financial firepower to the tune of $1.4 trn is available, why are the European banks being recapitalized by a mere $150bn? Even optimistic estimates suggested that these banks required $200bn. In our 17th October note we had said, *"…the cost of haircuts on account of European Banks' exposure to PIGS countries sovereign debt is likely to be ~US$200bn under extremely optimistic conditions i.e. without factoring in a recession and the consequent marking to market of banks' bond portfolios."*

Investment implications:
The paucity of detail in yesterday's announcement suggests that *there might be less to this rescue fund than meets the eye*. In particular, the lack of detail on the funding front leads us to reiterate our position that Europe's sovereign debt crisis can only be solved by large scale sovereign default (potentially to the tune of $1 trn given that the PIGS' sovereign debt is $3.5 trillion – see pg 2 of the attached note for more details).

The challenges facing Europe plus the growing seriousness of the economic problems facing India (more on this from us on Monday) suggest to us that investors should look to move towards "Battleship" stocks i.e. companies with strong cashflows, strong Balance Sheets and well entrenched competitive position (see attached note published by us on 19th October). Those who have more speculative bets in their portfolio (eg. low quality Real Estate, Power, Infrastructure, Capital Goods plays) should use this relief rally to exit such positions since: (a) the prevailing valuations in the market do not require investors to load up on such low quality names; and (b) the prevailing economic climate in India will not be able to nourish such second tier stocks.

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Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	>5%
Sell	≤5%

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