FLASH NOTE

ENAM Securities
India Research

Source: TOI

Election Results & Strategy

ELECTION OUTCOME: DOES IT MATTER FOR INVESTMENT STRATEGY?

The Lok Sabha election climaxes on May, 16th when the ballot boxes spill out the final verdict. The whole investment community awaits the final outcome of this mega spectacle, which will throw up myriad possibilities and political combinations. The key question is "**Will the electoral outcome lead to India's re-rating/ de-rating?"**

It is important to note that elections rarely manage to change prevailing economic and stock market trends in the medium term.

Global markets are getting back into "normalcy" mode as credit conditions are easing and even macro economic indicators seem to be bottoming out. Thus, market rallies are largely based on the assumptions that the global economy is likely to keep improving slowly at the margin and a recovery is in sight in the 2nd half CY09/ early CY10 despite concerns on sluggish economic growth and tepid corporate earnings/ profit growth. Stock market momentum seems to be betting that it is worth pre-empting the real economic recovery. Hence, liquidity has continued to rush into domestic demand-led EMs such as India, yielding a powerful 49% rally since early March 09.

The election results will have to be viewed in the context of – a) burgeoning global liquidity flows and b) local F&O build up, which has effectively hedged bets within a range. While elections pose a huge event risk, historical evidence suggests that elections, by themselves, have had little bearing on the broader market direction unless there is a radical government, which is unlikely in a coalition. India has had six elections and various coalitions at the helm since 1991 but not a single reform has been rolled back! What emerges thus is that leadership and ministerial personalities are more important than the number of parties or kind of coalition that ultimately forms a government.

Having expressed our view that election results do not matter in the medium term, we present 2 post-poll scenarios and appropriate strategies that could be used in the short run.

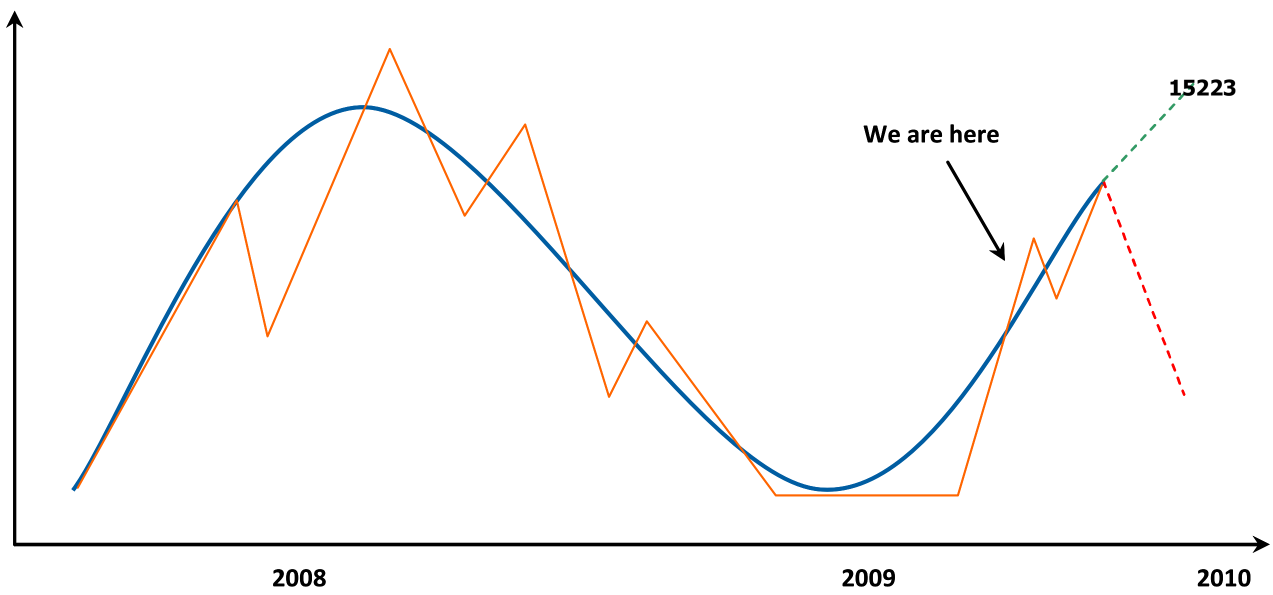
Currently, the market is discounting the prospects of a weak centrist coalition. If the outcome is a stronger coalition/ stable reformist government, then the market can catch fire given that India is a preferred destination within the global rally. However, if the outcome is a very fragmented and unstable coalition, the market can break off/ de-couple from the global trend for a while.

Stable Reformist Government	
Top Buys	**Top Sells**
PSU & Pvt Banks, SOTP	IT - Infosys, TCS, Wipro
ONGC, OMC's, RIL, Cairn	Divi's, Sun Pharma
NTPC, PFC, PTC	
DLF, Unitech, IBREL	
BHEL, LT, Suzlon	
Ultra, Grasim, Century	Ambuja, ACC, India Cem
SAIL, Sterlite, Nalco	TISCO, JSW, HNDL
Mundra Port, GMR, GVK	
Rcom, Idea, FT	
Titan, FMCG , Asian Paints	

Unstable Government	
Top Buys	**Top Sells**
Gold BEES, USD	SBI, PNB, BOI
IT-Infosys, TCS	NTPC
Cairn	Oil PSU's - ONGC, OMC's
HUL - most FMCG	BHEL, LT, ABB, Siemens, Suzlon
SUN Pharma, Divi's	Unitech & Realty
Bharti	Ambuja, ACC, India Cem
HZL, Sterlite	TISCO, JSW, Hindalco
Asian Paints	TAMO, MSIL
	Mundra Port, Concor

Note: Only stocks >$1bn considered for buys & sells

Current Investing backdrop



Bull Market	Bubble TOP PHASE	BEAR PHASE	LIQUIDITY PULL BACK PHASE	Determining period
Earnings expansion and inflation	Tops made across asset classes	Extreme sell-off due to deleveraging and global scare	Risk appetite returns & small buying/ short covering gives large price moves	Do fundamentals improve leading to new bull phase or do disappointments prolong bear phase rally

Source: Bloomberg, ENAM Research

The market is in a recovery phase after massive injections of capital, crashing of interest rates by central banks as also an unprecedented wave of fiscal stimuli across the globe. This invariably soothed frayed nerves and has started to reflect in slowly improving fundamentals and put a floor under markets.

However, recovery phase entails several false starts unless interest rates bottom out completely and corporates undergo a painful restructuring process until demand recovers fully. While it is true that globally business cycles are now far more synchronized than ever, it is inevitable that consumption and investment demand will stay muted until balance sheets of consumers and corporates deleverage and get repaired.

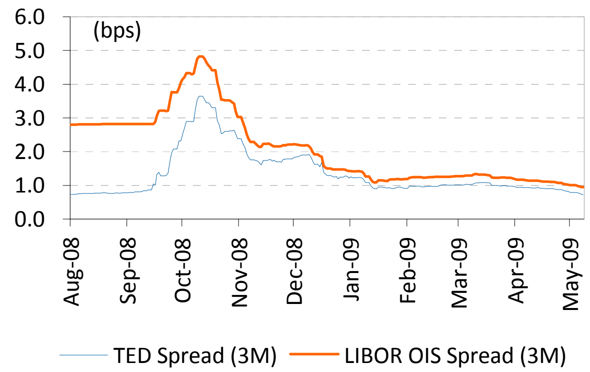
Indian elections have happened at a time when global liquidity has come back sniffing gradual fundamental recovery and the markets are seeking a fundamental trigger. While election results may not be a huge trigger by themselves in the medium term, a favourable election outcome that meets current market expectations could catalyse the recovery process in the short term or lead to a de-rating if the outcome is disappointing and unstable.

WHERE ARE WE TODAY? THE BACKDROP

GLOBAL: Markets have rallied

- Globally, markets are getting back into "normalcy" mode as credit conditions are easing and even macro economic indicators seem to be bottoming out (The ISM survey, Michigan Consumer confidence index in US, Chinese Ind production, credit growth etc).
- The much awaited stress tests of the US banking system (an exercise in evaluating the system's ability to withstand extreme shocks), yielded that only ~$75 bn of new capital was needed to provide protection and this came as a relief.

Libor & TED spreads at pre-Lehman levels



Source: Enam Research, Bloomberg

US banks' stress test allays worst fears

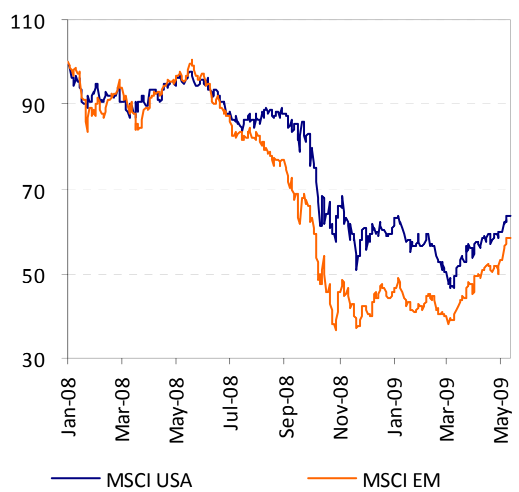
Bank	USD bn
Bank of America Corporation	33.9
Wells Fargo & Company	13.7
GMAC LLC	11.5
Citigroup, Inc	5.5
Regions Financial Corporation	2.5
Sun Trust Bank, Inc	2.2
KeyCorp	1.8
Morgan Stanley	1.8
Fifth Third Bancorp	1.1
PNC Financial Corporation	0.6

Source: Federal Reserve Bank.

- The global markets have rallied based on the assumptions that global economy is likely to keep improving slowly on the margin with a recovery in 2nd half CY09/ early CY10.

Equity & commodity markets have rallied

	Index value		Performance (%)		
	1-Jan-2008	11-May-2009	May09/ Jan08	52w Hi*	52w Lo*
Equity markets					
US (Dow Jones)	13,265	8,419	(37)	(36)	30
Japan (Nikkei 225)	15,308	9,452	(38)	(35)	35
Brazil (IBOV)	63,886	50,976	(20)	(31)	73
Russia (Micex)	1,889	1,029	(46)	(48)	108
India (Sensex)	**20,301**	**11,683**	**(42)**	**(33)**	**52**
China (HSCEI)	16,125	9,764	(39)	(32)	104
HK (H S I)	27,813	17,088	(39)	(34)	60
Korea (Kospi)	1,897	1,415	(25)	(26)	59
Singapore (Straits)	3,466	2,166	(37)	(33)	49
Taiwan (Taiex)	8,506	6,648	(22)	(29)	68
Commodities					
Aluminium ($/ton)	2,358	1,501	(36)	(54)	20
Copper ($/ton)	6,642	4,542	(32)	(50)	64
Zinc ($/ton)	2,354	1,516	(36)	(35)	46
Lead ($/ton)	2,546	1,416	(44)	(38)	62
Nickel ($/ton)	26,010	12,847	(51)	(52)	46
Gold ($/t oz)	834	913	10	(9)	34
Platinum ($/OZ)	1,526	1,121	(27)	(50)	51
Coal ($/ton)	127	63	(51)	NA	NA
Crude Oil ($/bbl)	95	58	(39)	(61)	52
Naptha ($/bbl)	95	51	(46)	NA	NA
Natural Gas ($/MMBtu	7	4	(41)	NA	NA



Source: Bloomberg, ENAM Research; Notes * Denotes trading high/ low

DOMESTIC

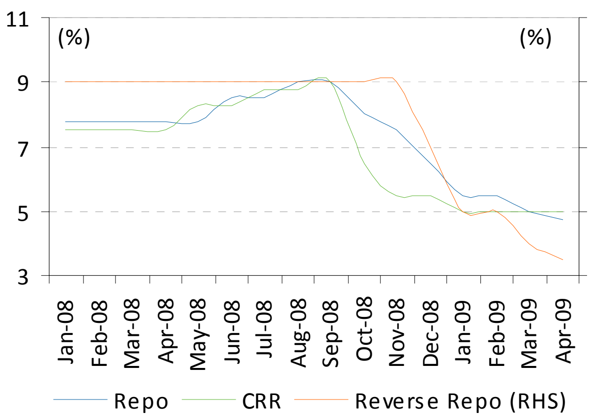
The inflation-interest rate-stock market cycle

The credit crunch seems to be easing globally and EM bond spreads as well domestic corporate bond spreads seem to be hinting at easing credit crunch. The RBI has eased interest rates and infused massive liquidity into the system. However, broader credit demand seems to be waning and availability of credit still is an issue.

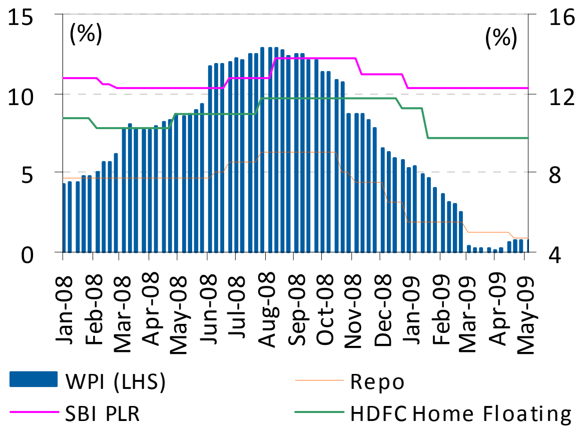
We believe that the backdrop is not yet conducive for a new bull market as :

a) **Real interest rates/ Bank PLRs are not low enough**: Inflation as measured by WPI is down ~1300 bps in India. In contrast, the RBI has cut policy rates by ~425 bps, and infused potential liquidity to the tune of ~7% of GDP. However, commercial lending rates, proxied by PLRs have softened by ~250 bps only. **This means that a large section of borrowers is still paying very high interest rates.**

Policy rates at their lowest



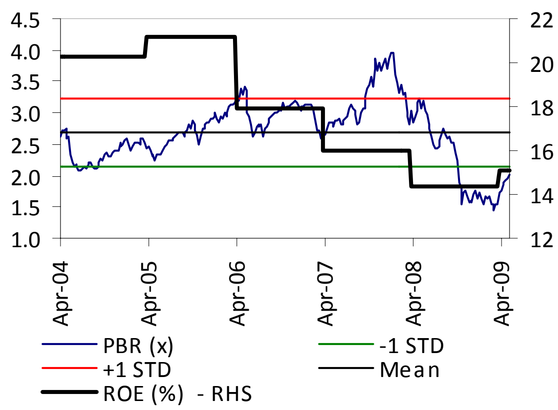
...But PLRs yet to reflect collapse in inflation



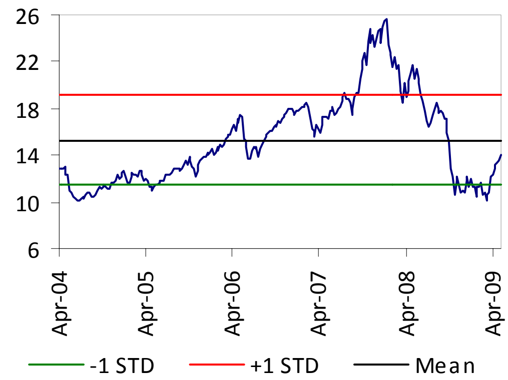
Source: CSO,RBI, ENAM Research

b) **Valuations are not cheap enough**: Since March, 9th, markets have rallied ~49% thereby skewing valuations from cheap to fairly valued.

PBR (x) vs. ROE (%)



PER (x)



Source: Bloomberg, ENAM Research

c) **Earnings recovery is not as strong or imminent as in 2004**: Around 2003-04, India Inc had emerged stronger having learnt the lessons of the SE Asian crisis. It had pruned down labour force, improved the working capital cycles and enhanced organizational efficiencies.

Thus, India Inc was better placed to capitalize on lower interest rates and rising commodity prices. This time however, companies are still reeling under the impact of credit crunch and higher fixed costs (esp labour) even as demand remains below medium term trend lines.

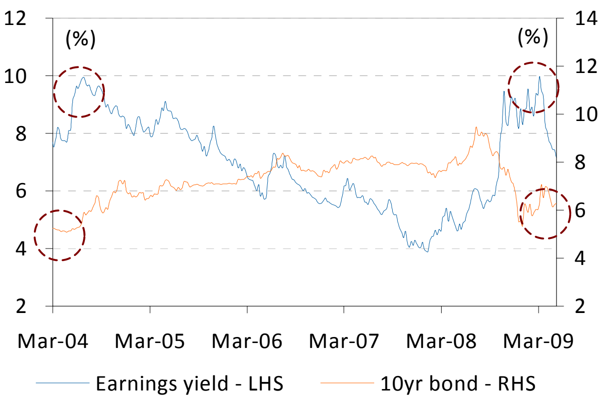
Based on the above we believe that the market recovery will remain pregnant until visibility of a strong earnings recovery in FY11 appears imminent.

The table below shows that interest rates are inversely correlated with Sensex movements. What is important to note is that in previous instances ie the SE Asian crisis, the dot com bust, Sensex earnings were flat to negative for ~2 years and it spurted thereafter as interest rates bottomed out. Even in the current instance, Sensex earnings dipped in FY09 and are likely to remain flattish in FY10. However, interest rates still need to fall to hint at a complete revival in Sensex earnings in 2011.

EPS growth shocks/ recovery wrt int rates

Year	EPS gwth (%)	10Yr bond	Index chg (%)
Mar-99	(10)	12.1	(8)
Mar-00	13	10.8	39
Mar-01	(19)	10.2	(28)
Mar-02	5	7.4	(4)
Mar-03	7	6.3	(10)
Mar-04	31	5.2	77
Mar-05	34	6.7	17
Mar-06	22	7.5	75
Mar-07	27	8.0	16
Mar-08	16	8.0	25
Mar-09	2	7.1	(39)

Bond yields still not low enough!

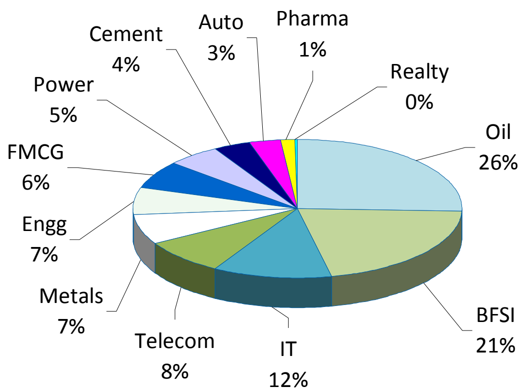


Source: Bloomberg

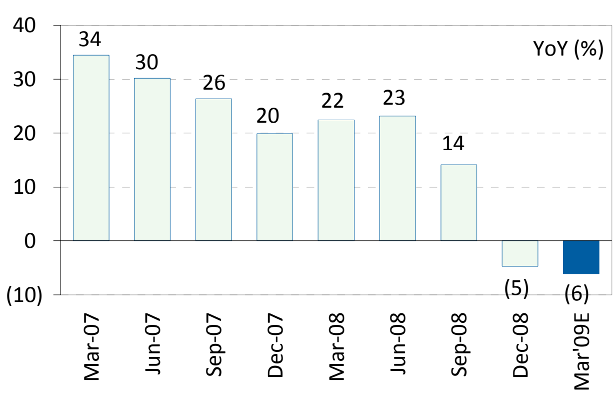
Markets: Earnings growth & technical factors

Concerns abound on corporate earnings/ profit growth, as earnings will suffer in a low nominal GDP growth environment. Recovery in profit growth is contingent on trough of low interest rates being reached, belt tightening by corporates and demand recovery, which is still very sluggish.

Sensex: PAT contribution FY10e



Sensex: Adj PAT growth y-o-y (%)

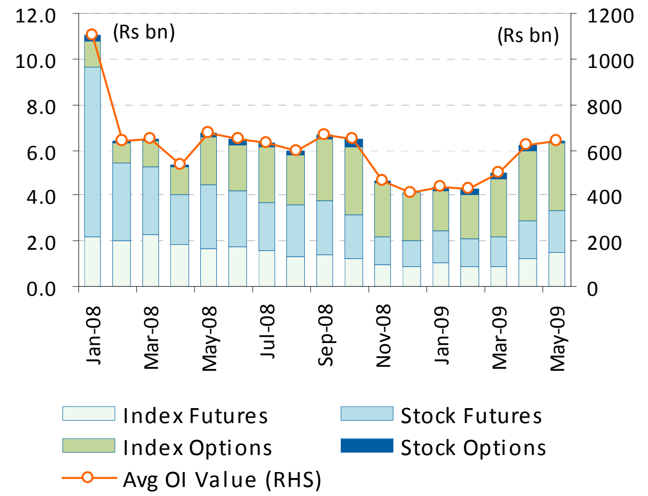


Source: ENAM Research

Technical factors hold sway

- Local markets have zoomed in the futures segment anticipating larger investment flows from FIIs.
- While valuations seem not so expensive and the Indian market seems to be trading near its long term average, it is technical factors that hold the key to market momentum going forward.
- The market run-up is largely led by F&O segment evidenced through an enormous build up in Index Options & Futures. Traders and smart money is largely hedged with a Nifty range of 3,400-3,800.

Stock futures have given way to ....

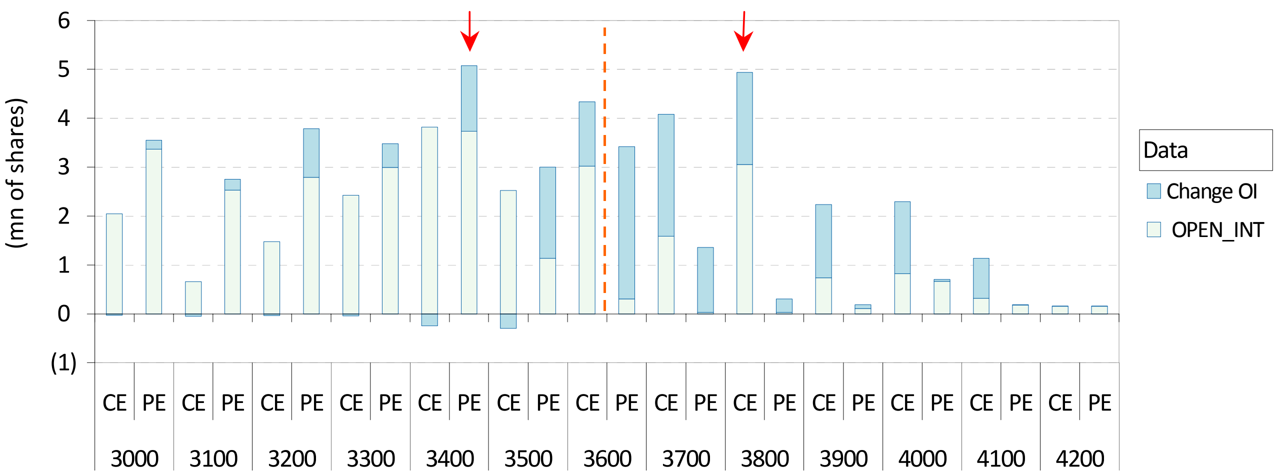


...Index options indicating hedged bets

(Rs bn)	(17-Jan-08) Total O/s	Total OI	(8-May-09) Total O/s	Total OI
Index Future	263	20%	150	21%
Stock Future	806	60%	190	27%
Index Options	205	15%	343	48%
Stock Options	71	5%	32	4%
Total OI	1344	100%	715	100%

Source: Bloomberg

Option Distribution suggests : Market to trade in 3400-3800 range



- It is clear from the above that **<u>large hedged bets on the index have been taken instead of stock futures. Hence markets are unlikely to break the Nifty range of 3400 to 3800 (corresponding to BSE Sensex range of 11200 to 12500) unless completely new factors need to be discounted.</u>**

ELECTION RESULTS: CAN THEY RE-RATE/ DE-RATE INDIA?

In the backdrop of a liquidity driven bear rally and slowly improving fundamentals, the market is seeking a re-rating trigger. While elections pose a huge event risk, historical evidence suggests that elections, by themselves, have had little bearing on the broader market direction. One would intuitively expect this as the emergence of a radically new govt is unlikely in a coalition environment that tends to stick to a "common minimum" programme.

Why are investors wary of a "Third front" government?

While India has had a trend of voting a non-Congress, non-BJP government into power roughly every ~10 years ie in 1977, 1989 and 1996, none of these governments lasted long. The longest that a non-Congress, non-BJP government has lasted is 28 months (*see Table below*). Moreover, such short-termist governments have culminated in crisis – although cause and effect may be debatable.

Non-Cong, non-BJP minority govts have been unstable and coincided with crisis

Type of Govt.	Duration	Months in office	Impact	Symptoms
Janata Party PM Morarji Desai	March 1977 – July 1979	28 months	Eco crisis 1979 - 81	High Inflation, bloated fiscal deficit, Bop crisis
Janata Dal (Ph 1) PM V. P. Singh	Dec. 1989 – Dec. 1990	12 months	Eco crisis 1990 – 91 (Gulf war)	High inflation, high fiscal deficit, Bop crisis
Janata Dal (Ph 2) PM Chandra Shekhar	Dec. 1990 – Feb. 1991	3 months	Eco crisis 1991 – 92 (INR Depreciation)	High inflation, huge fiscal deficit, Bop crisis
United Front (Ph1) PM Deve Gowda	July 1996 – Nov. 1997	17 months	E. Asian Crisis	-
United Front (Ph2) PM Inder Gujral	Nov. 1997 – March 1998	5 months	E.Asian crisis 1997 - 2000	High inflation, high fiscal deficit, incipient Bop crisis

Source: Media

But there is hope…

Yet, there are enough instances of minority govts that had strong personalities who catalysed major reforms and were hailed by markets (*See the table below*). Narsimha Rao and Dr Manmohan Singh earned the sobriquet of reformers despite being in a minority govt (during 1991-96). Similarly, the markets have not yet forgotten the "dream budget" presented by Chidamabaram on behalf of a minority govt in 1997.

Yet another chapter of reforms was opened up when the NDA govt that was saddled with the largest number of coalition partners kick started the Divestment programme spearheaded by Arun Shourie, Similarly, an unknown Maj. Gen. Khanduri changed the landscape of road infrastructure in India as did Suresh Prabhu with reforms in the Power sector.

Even the current PM in the UPA regime risked his govt to ensure the passage of the Indo-US nuclear deal. Praful Patel and Lalu Prasad Yadav turned the ever-burdened and sluggish airlines and railways into sectors that India is proud of!

These instances buttress our belief that it is determined leadership and ministerial personalities that shape out economic policy environment rather than the nature of coalition or the number of parties *(see table overleaf)*

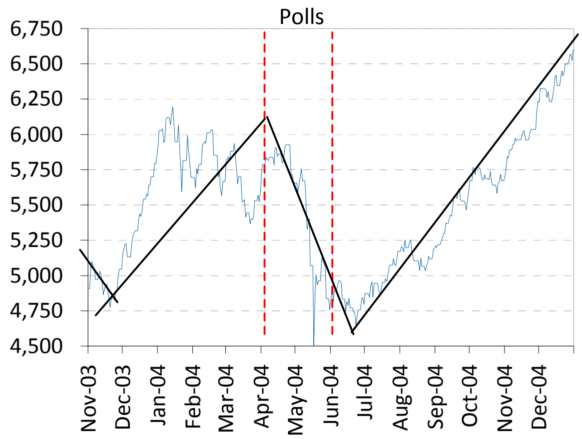
Personalities & leadership matters more than nature of coalitions

Year	Tenure	Nature	Reformers	Sectors benefited
1991	5 Years	Minority Coalition	PM: Narsimha Rao	Liberalization drive
			FM : Manmohan Singh	Industrial delicensing
			CM : Chidambaram	FDI & tariff reforms
1997		3rd Front	FM : Chidambaram	Direct Tax Reforms
1999	5 Years	NDA Coalition	PM : A. B. Vajpayee	
			FM : Y. Sinha/ Jaswant Singh	Capital gains waiver
			Arun Shourie	PSU Divestment, Telecom
			Suresh Prabhu	Power
2004	5 Years	UPA	PM : Manmohan Singh	Nuclear Deal
			Praful Patel	Aviation
			Lalu Yadav	Railways

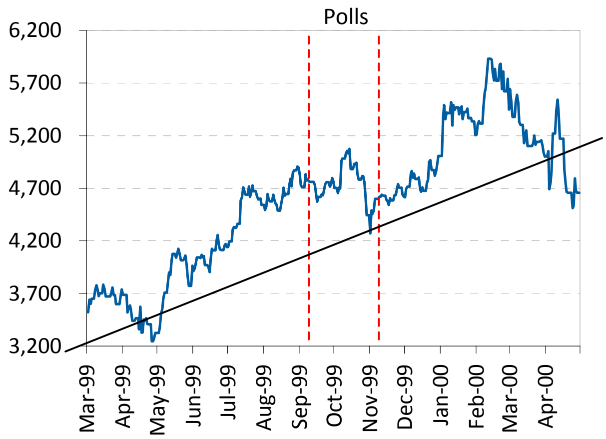
Source: Media

What emerges from the above as well as charts below is that general direction of the market remains intact despite ST hiccups around the polls. The BSE Sensex charts below trace market movements 6 months pre and post polls.

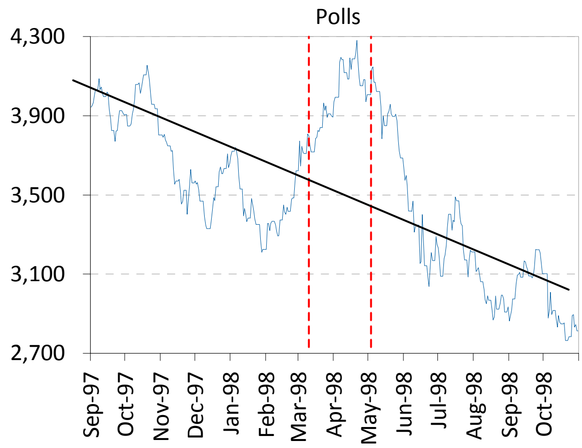
May-04: Economic recovery – W bottom



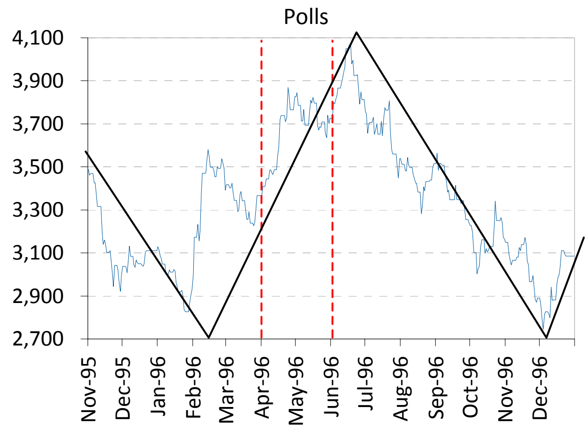
Oct-99: TMT mania build up



Apr-98: Asian crisis



May-96: Bear range (1995-1999)



WHAT TO DO POST ELECTIONS?

The simple message is that barring a "radically" different government, the basic direction remains unchanged. India has had six elections and various coalitions at the helm since 1991 but not a single reform had to be rolled back! We therefore present only "Stable v/s Unstable" government scenarios to help investors to orient their portfolios appropriately in either scenario.

Scenario I: Stable Govt

Currently, the market is discounting the prospects of a weak centrist coalition. If the outcome is a stronger coalition/ stable reformist government then the market can catch fire given that India has largely been a preferred destination in the global rally so far.

Assumptions that the markets would like to discount:

There could be welcome reform initiatives by the new government that could revive the confidence of local as well as foreign investors leading to a stronger currency as well:

1) **Clear roadmap of GST implementation**: The date of implementation is April 2010. However, the conviction and clarity in terms of roadmap will be the key.
2) **Low interest rate regime and return to fiscal prudence**: Huge govt borrowings of Rs 3.6 trn threaten to crowd out private investments and negate the interest rate cuts by RBI and keep interest rates under pressure.

   If the new govt articulates its roadmap of returning towards fiscal prudence, investor confidence will favour India. This shall ease the pressure on India's sovereign rating as well as its currency.

3) **Easier FDI/ investment climate**: While it may sound a tad contrarian when the developed world is getting protectionist, the time is ripe for liberalizing FDI and inward investment norms. This could attract global flows into India given its stable domestic driven growth that in turn could catalyse investment demand.

4) **Creation of profit opportunities for the pvt sector**:
   - **Disinvestment/ Privatization**: A disinvestment programme that could allow domestic investors to share "national wealth".
   - **Third Generation (3G) telecom spectrum auction** was put under the backburner at the fag end of the current administration. However, this is a move that could fetch the cash strapped govt ~$5-7bn in auction revenues.
   - **New Exploration Licensing Policy (NELP VIII) for oil & gas sector**: While incremental revenues to the government may not be substantial, exploration rights will catalyse further investments into the sector. Moreover, fructification of this will completely change the landscape of user industries over a period of time.

Scenario II: Unstable & Fragmented Coalition

If the outcome is a very fragmented and unstable coalition, the market can break off/ de-couple from the global trend for a while.

Assumptions that the markets will shudder to discount:

1) **Higher Interest rates and a depreciating INR**: The new government, knowing that it may have to fight an election within the next 18-24 months may decide to splurge on dole outs to various vote banks i.e. farmers, consumers and government employees. This will worsen the Fiscal deficit further and lead to higher interest rates. The INR will be suffer from collateral damage and depreciate rapidly.
2) **Job Reservations**: If the government is a short-termist alliance with radicals as key coalition partners, it may force job reservations even in the private sector, which may not go down well with the markets.
3) **Divestment/ Privatization on the back burner**: Given the repeated attempts by socialist parties in the past to stall divestment, an unstable government will have to put privatization and divestment on the back burner. This will dent investor confidence, foreign inflows and prevent fiscal improvement.
4) **Higher taxation**: A high fiscal deficit and socialist ideology may result in policies that raise direct taxes on corporate sector and high net worth individuals. This will not only dent India Inc confidence but will also jeopardize government tax revenues.

Scenarios with list of stocks (<USD 500 mn to >1bn)

Unstable Coalition (Fragmented Alliances)	
-ve INR, Interest rate ++ Job reservations ?? NELP 8, 3G auctions - domestic participation only Rural push Increase in taxation Export sops	
> 1BNUSD	
Top Buys	**Top Sells**
Gold BEES, USD IT-Infosys, TCS Cairn HUL - most FMCG SUN Pharma, Divi's Bharti HZL, Sterlite Asian Paints	SBI, PNB, BOI NTPC Oil PSU's - ONGC, OMC's BHEL, LT, ABB, Siemens, Suzlon Unitech & Realty Ambuja, ACC, India Cem TISCO, JSW, Hindalco TAMO, MSIL Mundra Port, Concor
> 500mn < 1BNUSD	
Top Buys	**Top Sells**
Jain Irrigation Britannia, Godrej Cons IVRCL, HCC Patni, Tech M	CNX mid-cap

Stable Reformist Government	
INR + interest rate benign GST implementation NELP 8, 3G auctions – global inflows PSU listings; fiscal recovery FDI liberalization Rural push Infrastructure drive	
> 1BNUSD	
Top Buys	**Top Sells**
PSU & Pvt Banks, SOTP ONGC, OMC's, RIL, Cairn NTPC, PFC, PTC DLF, Unitech, IBREL BHEL, LT, Suzlon Ultra, Grasim, Century SAIL, Sterlite, Nalco Mundra Port, GMR, GVK Rcom, Idea, FT Titan, FMCG , Asian Paints	Infosys, TCS, Wipro Divi's, Sun Pharma Ambuja, ACC, India Cem TISCO, JSW, HNDL
> 500mn < 1BNUSD	
Top Buys	**Top Sells**
Britannia, Godrej Consumer Yes Bank, Brokerages Thermax, Crompton, Voltas IGL, Guj Gas Mah Seam, Welspun Guj Torrent Power, CESC HDIL, Godrej Ind, Anant Raj, Brigade, Peninsula, Sobha, Madras Cement, Shree Cement, Prism Cement EID, Coromandal, Chambal Fert Redington	