It's only a speed-breaker

Recovery jitters offer a buying opportunity

- In addition to the uncomfortable valuations after the sharp run-up, the equity markets globally were pushed into a corrective phase by the growing concerns over the sustainability of the economic revival globally after the expiry or withdrawal of the financial stimulus programmes. The wave of regional banks going bankrupt in the USA and the further bail-out needed by large UK-based financial institutions only added to the prevailing nervousness in the equity markets globally.
- On the domestic front, the Q2FY2010 earnings were in line with expectations but not good enough to trigger any material upgrade in the consensus earnings estimates for the Sensex companies. Another round of earnings upgrades, which did not materialise in Q2FY2010, was crucial for the next leg of upside in the market. Moreover, the Reserve Bank of India (RBI)'s hawkish undertone in the recent monetary policy review has effectively set the stage for the reversal of the current accommodative monetary policy regime and a possible hike in the interest rates by Q4FY2010.
- While these are valid concerns, some of the key palpable positives outweigh the negatives. Firstly, the leading indicators (cement production, commercial vehicle sales, goods traffic, industrial production, exports etc) continue to report better numbers. Secondly, the outlook for the Q3 and Q4 earnings seasons is much better as in these quarters Indian companies would benefit from the anticipated improvement in the macro environment coupled with a favourable base effect.
- The government has expressed a strong desire to return to the fiscal consolidation process with renewed vigour towards disinvestment. We believe that a revival in tax revenues, further uptick in industrial production growth, disinvestment proceeds, and lower burden of subsidies and other expenditure should help lower the deficit in the years to follow. The fiscal consolidation, in turn, would help attract foreign capital flows—a must to put the investment cycle back on track.
- Though we expect the recent pull-back phase to result in a deeper price correction in the coming weeks, we remain positive and view the pull-back as an opportunity for investors to accumulate quality stocks with a 6-12 month investment prospective.

Global woes come to fore again

After the phase of considerable recovery in the global economy aided by huge liquidity infusion, bail-outs and fiscal stimulus measures, uncertainties are rising again. The recent events indicate that all is not well in the developed countries and the markets are worried about the sustainability of the economic revival in the face of pull-back or exit of some of the fiscal stimulus schemes.

- The United Kingdom (UK) has announced yet another round of bail-out to recapitalise two banks and has raised the limit of asset purchase to 200 billion pounds. A yet another round of capital infusion is making investors wonder if there is more to come still. And the answer to this is probably yes if we were to believe the International Monetary Fund (IMF)'s estimates of potential capital needs for meeting the write-offs and refinancing needs over the near term.
- In the USA also, the regional banks continued to flounder, with nine banks folding up on a single day on October 30, 2009, taking the tally of banks going bankrupt since 2007 to 187.
- Though the situation is still fragile, the central banks are forced to ponder on the gradual exit of fiscal stimulus measures considering the pressure on the government finances and peril of extended extremely low interest rates. The sustainability of the economic recovery after the withdrawal of fiscal stimulus is a question mark given the weakening consumer spending and worsening unemployment rate.
- On the other hand, some of the Asian countries have already started reversing their extremely loose monetary policy or have indicated change in their monetary stance.

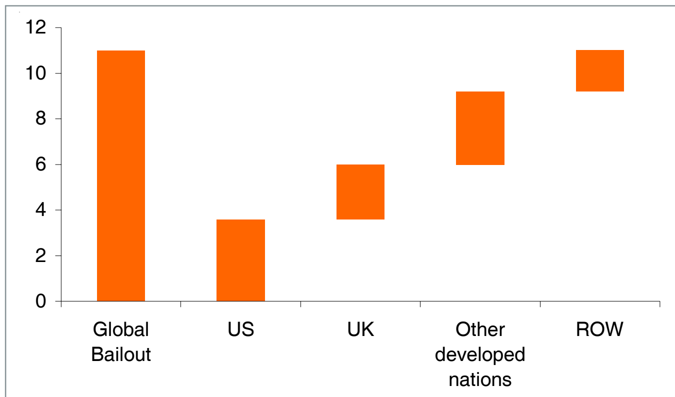
Global woes come to fore again

Bail-outs galore

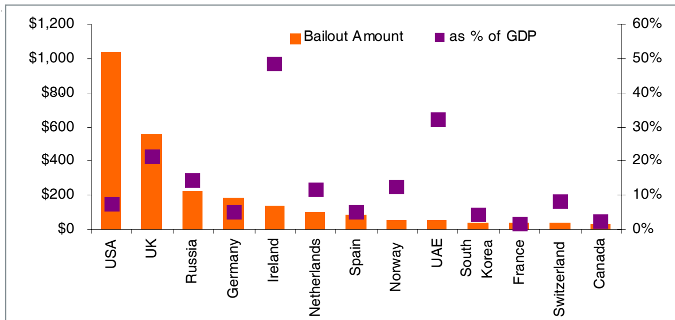
A year has passed since the global financial crisis unfolded with the bankruptcy of Lehman Brothers Holdings Inc. While the credit markets have stabilised to an extent since then, the jitters have not entirely died down. The most recent jitters came in the form of second bank rescue plan by the UK government aimed at jumpstarting lending and bolstering the stability of the nation's financial system.

Under the said rescue plan, the British Treasury will set up a wide scale insurance program aimed at protecting the banks against further losses and guarantee the bank assets backed by mortgages and other loans. In specifics, the UK government has pledged almost 40 billion pounds to two of the largest British banks—Royal Bank of Scotland Group Plc and Lloyds Banking Group. This capital infusion is in addition to 50-billion pound worth of infusion made during the last year. In addition to the specific bail-out of the two financial giants, the Bank of England has raised the amount of toxic assets it will buy to 200 billion pounds.

Comparison of bail-outs ($ tr)



Country-wise bail-out size



Source: Grail research

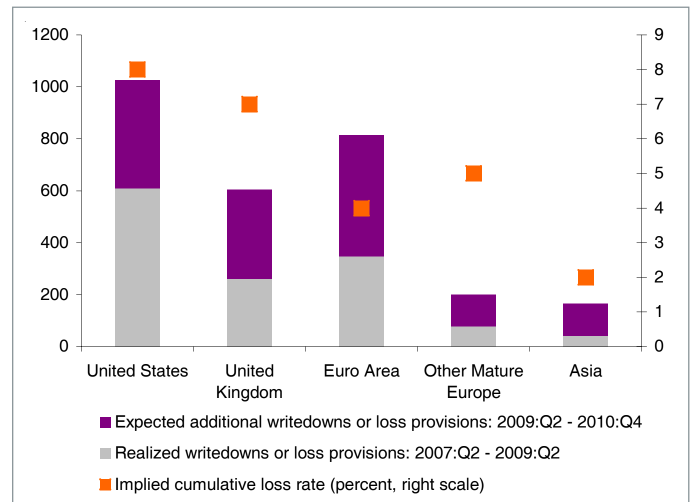
Is this the end of bail-outs?

The second round of bail-out announced by the UK government raises a very pertinent question: is this the end of bailouts? or is there still more to come? The question gets even more relevant considering that the IMF has lowered its estimated loss for financial institutions worldwide to $3.4 trillion from $4 trillion earlier. According to an IMF report, despite revival in banks' earnings, fully offsetting the anticipated write-downs over the next 18 months is going to be a tough call.

Effectively, insufficient earnings combined with continuing de-leveraging process implies need of additional capitalisation of banks. Importantly, banks must refinance a massive amount of maturing debt over 2010-2012—an unprecedented $1.5 trillion in bank borrowings is due to mature in the Eurozone, the UK and the USA by 2012.

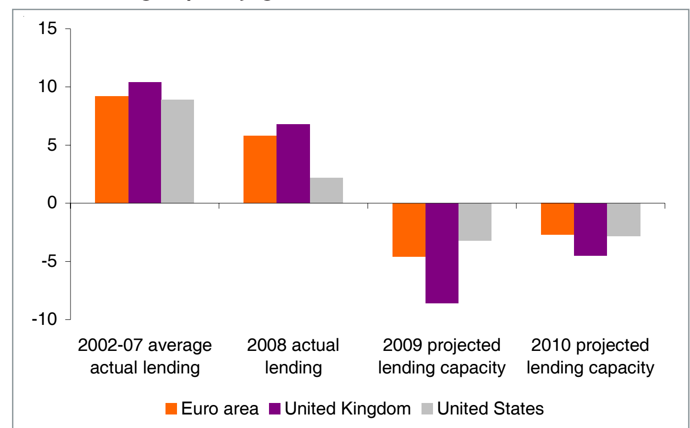
In the USA too the rate at which the regional banks have cried out for bailouts has been alarming, with 13 banks going down on a single day—October 30, 2009—taking the tally of banks going bankrupt since 2007 to 187. All these factors seem to be pointing that we haven't seen the last of bailouts/recapitalisations and that more may be on its way before we pronounce the end of the global financial crisis.

Realised and expected write-downs for banks by region ($ bn)



Source: IMF

Bank lending capacity growth



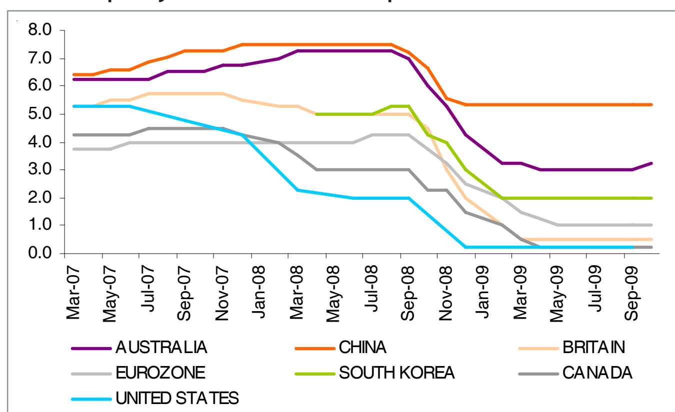
Central banks sweating over timing the exit

After worrying about the option of bailouts, the latest worry for the central banks worldwide is timing the exit of stimulus measures taken so far. The topic has been hotly debated lately and understandably so, as an early exit would jeopardise the whole recovery process set in motion while a delayed exit could have long-term ramifications (asset bubbles, inflation etc). On one hand, G20 members have agreed to keep pumping money into their economies until the global recovery is firmly secured while seeking to work out a clear strategy for withdrawing emergency policy steps later. On the other hand, some of the Asian economies are already executing plans to exit stimulus measures gradually.

- China has already expressed plans to wrap up most of the stimulus measures by 2011.
- Australia has already announced reversal in the interest rate cycle with plans to gradually withdraw the stimulus measures from the last three months of this year through 2011.
- India too has shown readiness to exit stimulus measures by raising the SLR in its recent monetary policy review.
- Eurozone expects to start removing the fiscal support for the economy in 2011.

The issue of timing the stimulus exit is more worrisome in case of the US and the UK considering that fact that while the stimulus is threatening to create asset bubbles, the consumer spending trends are too weak to even consider withdrawal. The acid test for the economic recovery would be to sustain this recovery in the absence of fiscal stimulus and highly loose monetary policy.

Trend in policy rates across developed nations



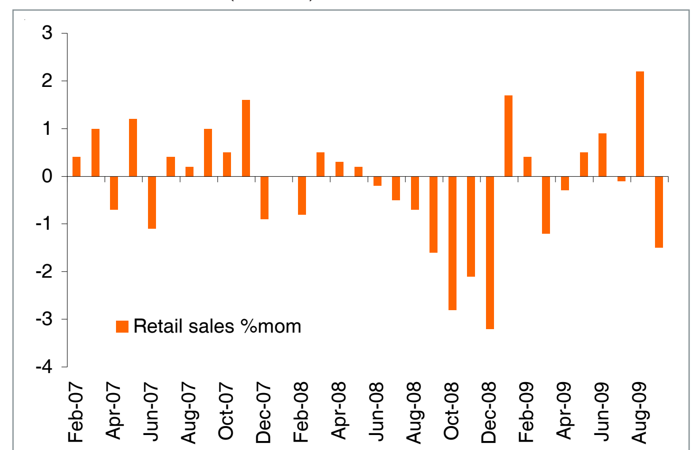
US: consumer spending dips as "cash for clunkers" ends

The US consumer spending data was showing improvement until September 2009, when the trend became gloomier, underscoring the fragility of the economy's recovery even as signs emerged that manufacturing may be picking up. A further dissection of the consumer spending data reveals that spending in the third quarter was bolstered by the popular "cash for clunkers" programme and incentives for house purchases. But with "cash for clunkers" programme ending in August 2009, consumer spending has retrenched in September 2009.

Moreover, the housing rebate is set to expire in November 2009, which may further bring down the overall consumer spending. With the unemployment rate inching up to 10.2% without any signs of trend reversal, pick-up in consumer spending is still out of sight. In fact, the 10.2% unemployment level now raises questions over the validity of the 'stress-test' of banks conducted by the Federal Reserve. Effectively, the trend in the consumer spending data during Q1CY2010 would be key for Federal Reserve's decision-making and hence the fate of the US economy.

Trend in retail sales 3MMA (%yoy) and unemployment rate

Trend in retail sales (% mom)

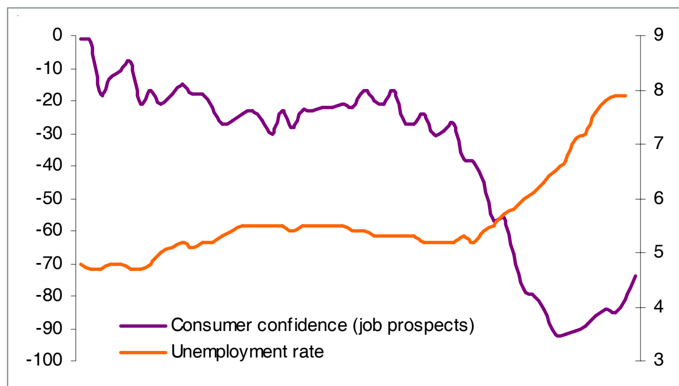


Ditto for UK consumers

Similar to the situation in the USA, the outlook for consumer spending in the UK is also bleak. For starters, British consumers are even more highly geared than their American counterparts. In addition, British employment has declined by 1.16% with the unemployment rate at a 13-year high of 7.9%. Collectively, these factors have caused the overall

income growth to slow down significantly with the consumer confidence badly shaken, which would lead consumers to sock away more savings in the event that they too lose their jobs. Moreover, the household balance sheets have been decimated by sharp declines in real estate and financial asset prices.

Trend in UK consumer confidence and unemployment



India: valid concerns, but outlook remains robust

On the domestic front, while there are valid concerns (inflation, lacklustre Q2FY2010 earnings, dip in GDP growth in Q3 etc) the medium to long term outlook remains quite robust. Our optimism over medium to long term stems from the resilience displayed by the Indian economy as reinforced by continued acceleration in cement sales, auto sales, goods traffic and industrial production. Moreover, the external trade data too has begun to improve with gradual slowdown in the pace of decline. Putting all these factors in context, the positives outweigh the concerns.

Q2FY2010 results fail to exceed expectations and trigger further earnings upgrades

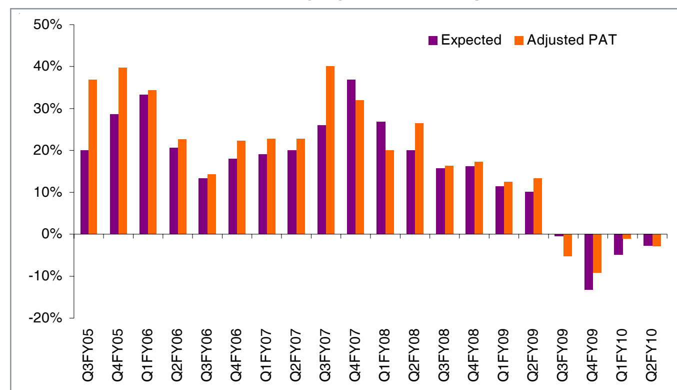
Unlike the previous quarter, Q2FY2010 earnings failed to positively surprise and exceed the street's expectations. Rather than any material upgrade in the earnings estimates, the consensus earnings estimates for the Sensex companies remained flat for FY2010 and FY2011.

The revenue growth for the Sensex companies (ex-oil) came in at 5.8% year on year. Though muted this is better than the flattish performance in the previous quarter. However, the decline of 2.8% in the cumulative Sensex earnings was largely in line with expectations.

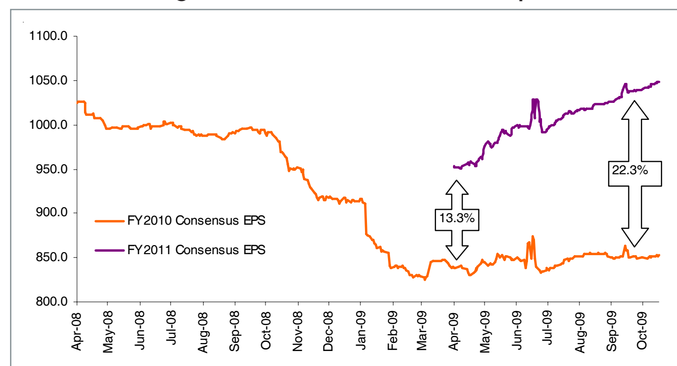
The cumulative operating profit margin (OPM) for the Sensex companies (ex-oil) improved by 110 basis points yoy to 26%, driven by lower raw material cost as percentage of sales and the benefits of cost rationalisation undertaken by the companies.

While the Q2FY2010 earnings season turned out to be uneventful from upgrades perspective, Q3 and Q4 earnings are likely to be better due to (further improvement in macro environment, favourable base effect etc).

Trend in the Sensex earnings growth vs expectations



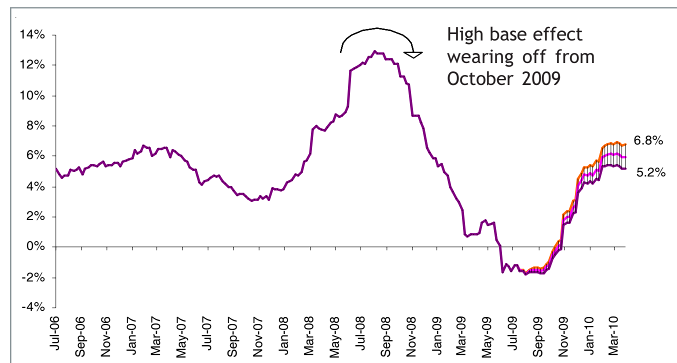
Trend in earnings revisions for the Sensex companies



RBI turns hawkish

Inflation is back in vogue and is inching up on the central bank's priority list, as growth-related worries have subsided somewhat. The inflation rate has moved up fast and now stands at 1.51% for the week ended October 17, 2009. Importantly, the food inflation has touched 13.4% as on October 24, 2009, highlighting the impact of poor kharif production this monsoon. In line, the central bank has expressed concerns on rapid rise in the inflation rate and has revised its inflation estimate upwards from 5% to 6.5%. The revised inflation rate estimate is now closer but still below our expectation of 6.8% inflation rate by the end of the current fiscal. The trajectory of inflation going ahead is likely to be quite steep considering the rising prices coupled with an unfavourable base effect.

Trend in inflation

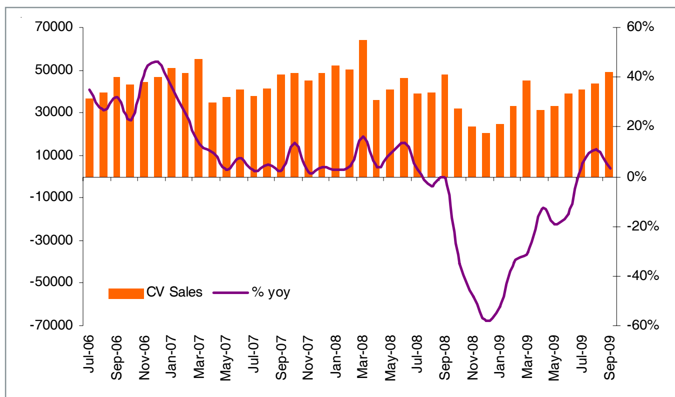


Interest rate cycle set to turn

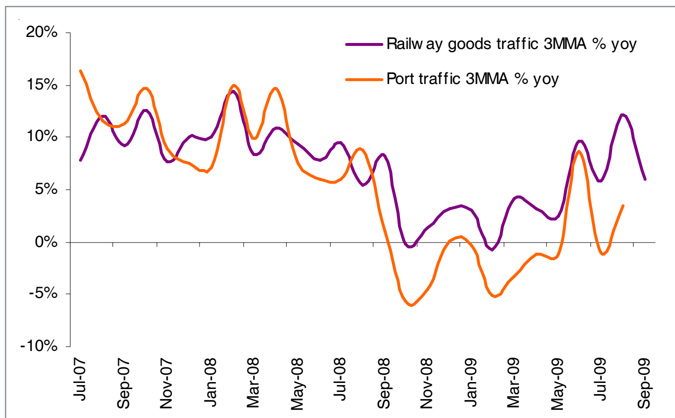
In consonance with our view on likely trajectory for the wholesale price index (WPI) inflation coupled with the uptick in the real GDP growth and industrial production growth, we believe that the central bank would consider hiking the policy rates towards the end of the current fiscal or the beginning of the next fiscal. While the Reserve Bank has paused on key policy rates, other monetary policy announcements (SLR hike etc) clearly signal the central bank's desire to reduce the excess liquidity in the system. We continue to expect the central bank to start tightening the policy rates by the end of the current fiscal or the first quarter of the next fiscal.

But, leading indicators going strong

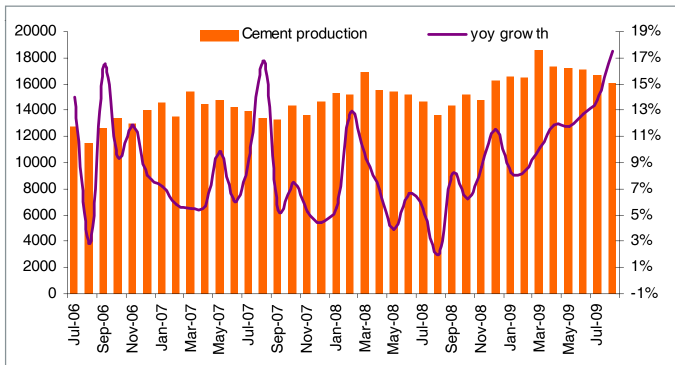
Trend in CV sales



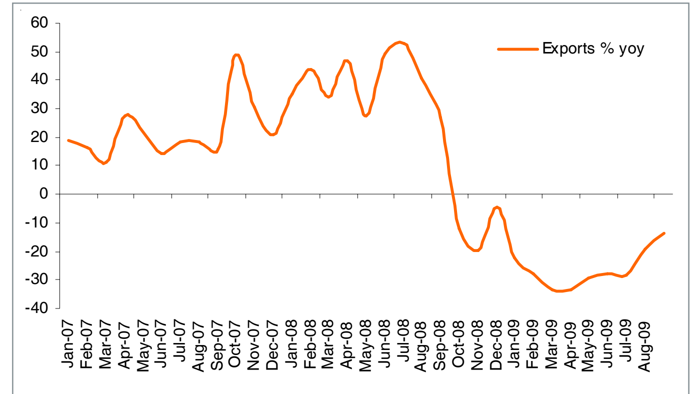
Trend in goods traffic



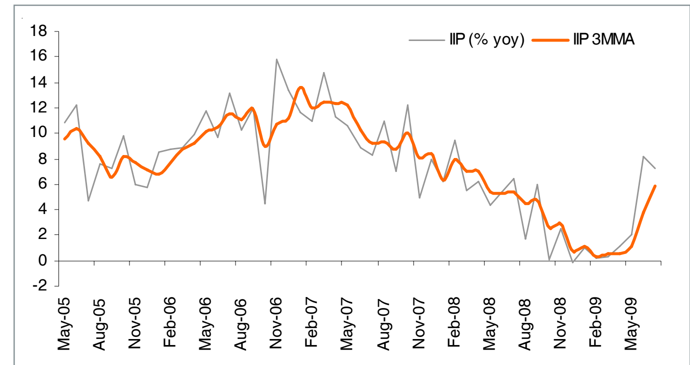
Trend in cement production



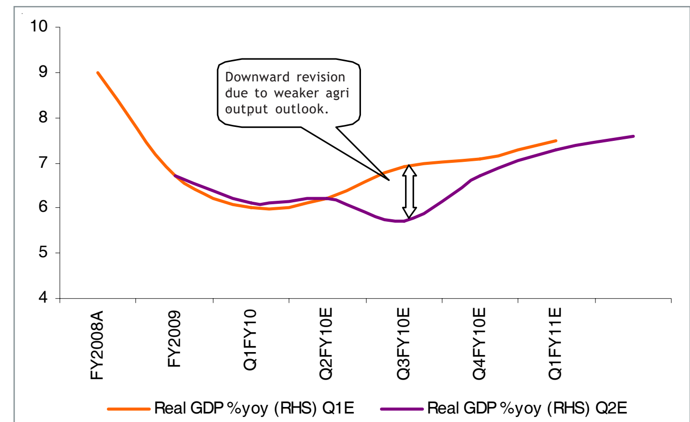
Lessening pace of decline in exports



Industrial production growth has revived



Q4 onwards GDP growth outlook too robust



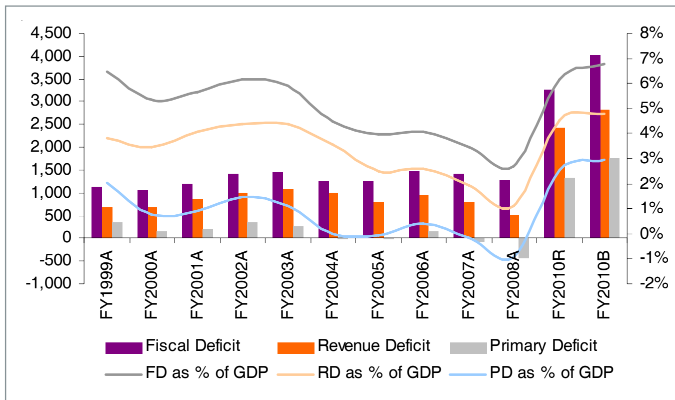
* Q1E = earlier forecast; Q2E = latest forecast

Fiscal consolidation on cards

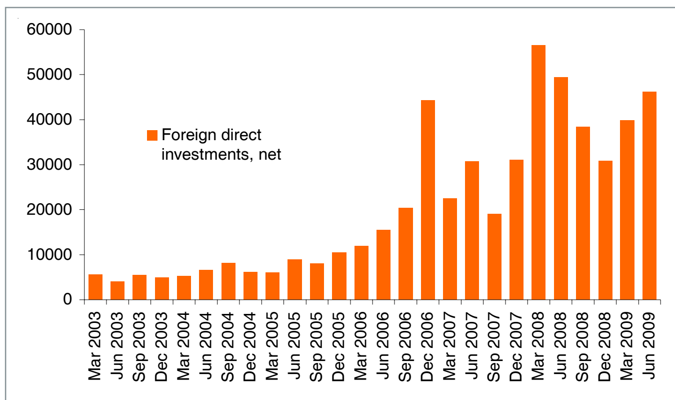
Besides the above mentioned positives, a key positive taking shape is the fiscal consolidation process. Some of the recent reforms announcements, especially the renewed vigor towards disinvestment, clearly indicate that the government is quite serious about consolidating its fiscal position as soon as recovery process is sustained. The fiscal deficit for FY2010 is pegged at 6.8% by the government. With the H1FY2010 fiscal deficit up by 92.7% year on year vs the budgeted estimate of a 23% increase for the full year, the government is likely to miss the target this year. However, we believe that revival in tax revenues, further uptick in industrial production growth, disinvestment

proceeds and lower burden of subsidies and other expenditure should help lower the deficit in the years to follow.

Fiscal consolidation



...can rekindle capital inflows

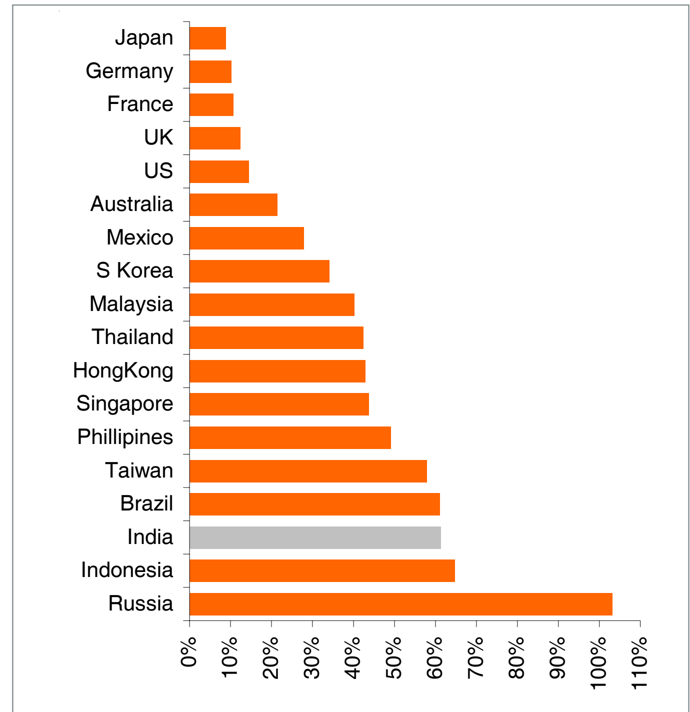


Valuation: Mean reversion

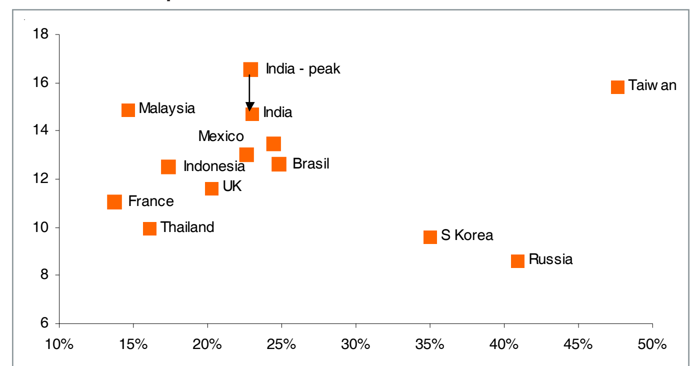
A quick economic rebound, capital inflows and better-than-expected corporate earnings have buoyed the equity markets in general and those of emerging markets in particular. The gush of liquidity backed by the dollar carry trade had pushed the Indian markets to uncomfortable valuations (i.e. beyond the one standard deviation band over the mean price-earning multiple of 15x for the last few years).

Given the growing concerns, we believe that the corrective phase in the equity markets could extend, in terms of price correction, in the coming weeks. However, this is an opportunity for investors to accumulate quality stocks with 6-12 month investment prospective.

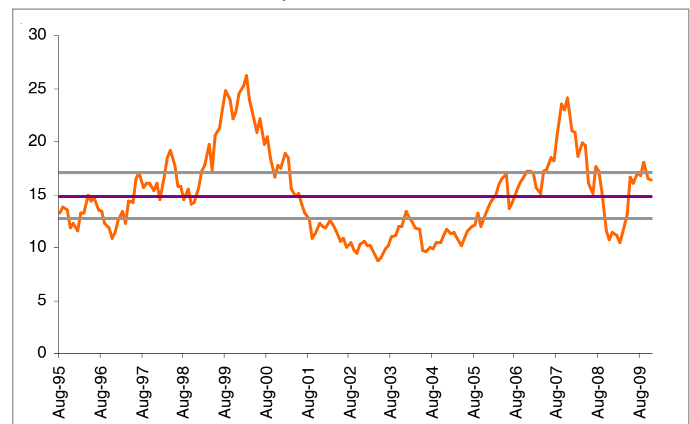
Performance of leading equity markets since January 2009



Valuation comparison



Trend in the Sensex one year forward PE ratio



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