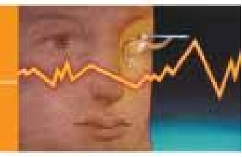
market outlook



Visit us at www.sharekhan.com June 30, 2012

# Silver lining in the midst of dark clouds

*Markets are poised for relatively better times ahead*

**Market negotiates through a tough global environment and a seasonally weak summer:** In our last Market Outlook report released in early May (titled "The heat is on"), we had turned cautious against the backdrop of the rising crude prices and the nervousness prior to some important global and domestic events in the already seasonally weak summer period. The market did lose some ground and the overall pessimism only heightened on the back of the Reserve Bank of India (RBI)'s status quo on policy rates, the downgrade of India's rating outlook and the fragile euro situation during the last two months. However, we believe that the Indian equity market has negotiated the tough period without much damage and is potentially poised for relatively better times over the next few months.

**Emerging positives amid despondency:** Given the slew of negatives, some of the positive developments and pointers have been largely ignored. These are as follows.

- ***Commodities cool off (including crude):*** A decent correction in commodities especially crude oil is inherently positive for the Indian economy, the corporates and the equity market. It does three things: eases the pressure on fiscal health; positively affects corporate margins and makes India better placed for foreign investors as compared with its commodity exporting peers like Brazil, Russia and Indonesia.
- ***Political changes could end policy inertia:*** The domestic political situation has turned more conducive with the prime minister taking charge of the finance ministry as well and the Samajwadi Party (SP) formally putting its weight behind the United Progressive Alliance (UPA) II, thereby marginalising the troublesome coalition partner Trinamool Congress' importance in forging a political consensus to push forward the pending and much awaited policy decisions. Mind you, we do not expect any major fireworks or path-breaking reforms but the very breaking out of the policy inertia is enough to boost the market's confidence as expectations are pretty low.
- ***Valuations and high cash levels supportive:*** The rupee's depreciation has turned the valuations of Indian equities all the more cheaper for foreign investors who are sitting on a record level of free cash (especially the Asian and emerging market funds), according to one of the recent surveys done for a global bank and research house.

**Euro zone: kicks the can down the road again:** The euro zone members have come out with a patchwork of a solution to soothe the unnerved financial markets. The plan to directly support European banks and intervene in the bond markets to support member states has led to a burst of optimism which could fade off after the initial reaction.

**Pressure points: resumption in earnings downgrades and weak beginning of monsoon season:** It could have been better for the Indian equities but for the disappointing Q4FY2012 results of some index heavyweights and the overall resumption of the downgrade in the consensus earnings estimates by research houses after a pause of a few months. The higher than expected asset quality concerns in the banking sector was the key negative takeaway from the Q4 report card. The monsoon could also play a spoilsport. The beginning is weak and the increasing probability of El Nino in the later part of the monsoon season would put further pressure on the economy, which is already suffering from slowing industrial activity with signs of a slowdown in the services sector also. Moreover, a weaker monsoon would boost inflationary pressures and could further delay the easing of the monetary cycle.

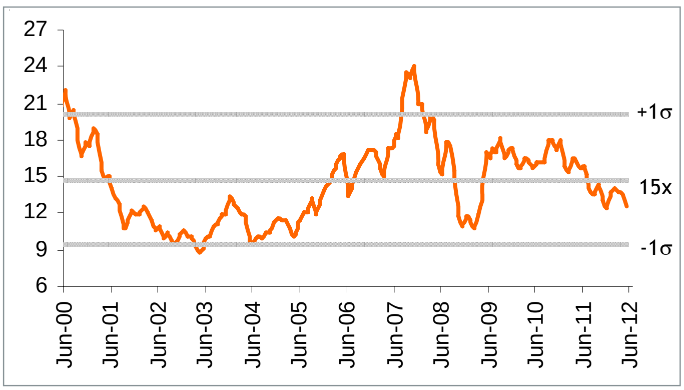
**No runaway rally but sentiments could change for better:** Having said this, we are not in any way implying that the benchmark indices would witness a runaway rally from here but are merely suggesting that the bias should turn positive from negative in the near term. The important thing to note is that in such an environment the beaten-down stocks from certain sectors where some policy decisions are initiated could surprise positively and outperform the currently fancied consumer and other defensive stocks in the next couple of months. Beaten-down and high-beta stocks from light engineering and construction/infrastructure sectors could turn out to be rewarding contrarian bets in such a scenario. The delay in the interest rate cuts would act as a drag on the rate sensitive sectors (especially automobiles) and the highly leveraged companies. In terms of valuation, the Sensex trades at 13.3x its FY2013 estimated earnings and 12x its FY2014 estimated earnings (in rupee terms). That is close to 15% discount to its long-term average multiple of 15x its one-year forward estimated earnings.

**Euro summit: Will the burst of optimism last long enough?**

There are both good and negative takeaways from the deal announced post-Euro Summit at Brussels. First, the good news that led to a burst of optimism in the financial markets globally. The euro zone members have decided to allow the rescue fund (European Stability Mechanism [$634 billion] and European Financial Stability Facility) to directly support banks and also intervene in the bond market to support the troubled countries of Europe. A single banking supervisor will be formed for all the euro zone banks. The aim is to break the vicious cycle between banks and their respective governments who are unable to provide the required financial support to the banks that are too big to fail. This is seen as the first step of Europe moving towards a "Banking Union".

The bad news is that the move would only forestall the crisis rather than find a more durable cure. In the past such decisions to kick the can down the road only led to a burst of optimism that normally would fade away when the euro zone politics would kick in and make it difficult to enact the announced plan in the right spirit. We keep our fingers crossed.

**Sensex' P/E (based on rolling one-year forward EPS)**

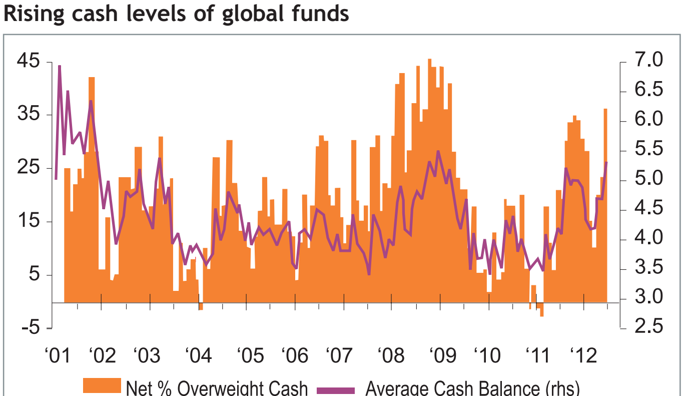



Source: Bloomberg

## Market sails through global and local turbulences

Due to the fragile European financial system, the weak macro data of the US economy and the sharper than expected deceleration in the Asian economies (especially China and India) the sentiment weakened for equities. On the domestic front, the policy paralysis continued amid threats of a ratings downgrade and even the RBI preferred to play safe by overruling the strong market expectation of a rate cut. The investment outlook deteriorated as global funds—which were positive on equities in early 2012—became underweight on equities. However, the Indian market weathered the turbulences without any major damage.

**Rising cash levels of global funds**

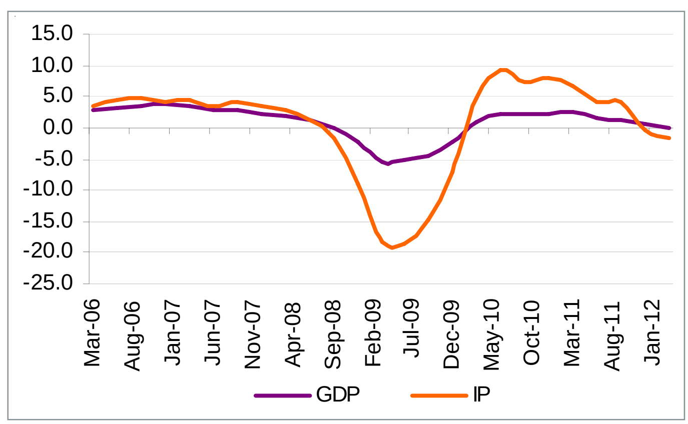



Source: Media reports

## Green shoots wilting but paving way for more easing in the US, euro economies

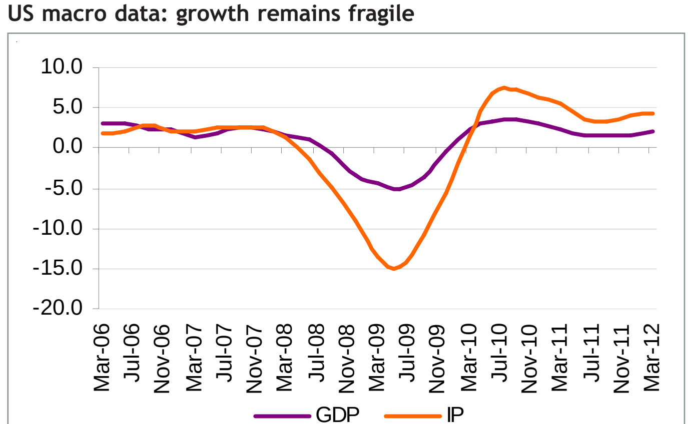
A weak housing statistics, drop in the manufacturing sector's momentum, decline in spending and consequent reduction in the growth forecast by the US Federal Reserve (Fed) negated the hopes of a recovery, if any, in the near term. In order to support growth, the Fed extended the Operation Twist ($267 million). The euro zone segment showed a sharp contraction in industrial production and retail spending with a drop in the business confidence

**Euro zone macro data: slowdown continues**




Source: Bloomberg

**US macro data: growth remains fragile**



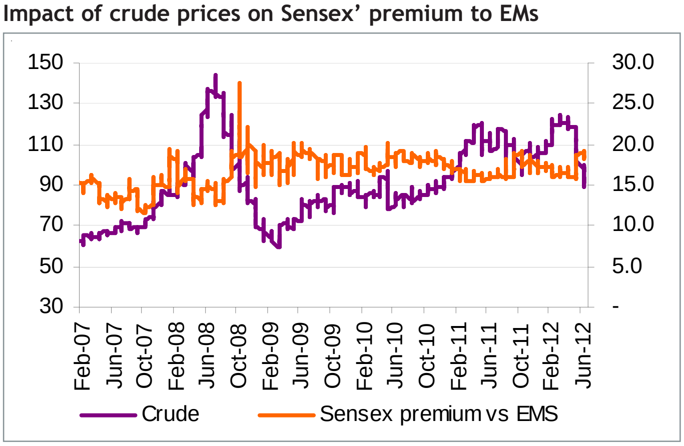

Source: Bloomberg

levels. The crisis in the banking sector aggravated leading to the de-rating of several banks in the euro area. Despite resistances, the European Union (EU) members have agreed to take adequate measures to strengthen the banking system. Going ahead, more measures are expected by the USA and the euro zone nations to revive the ailing economies.

### Softening of crude prices to provide some relief on deficit front

The current account deficit (CAD) spiralled to an all-time high of 4.3% of the gross domestic product (GDP; FY2012) led by a rise in the import bill and slower exports. However, crude oil, which constitutes 30% of the India's imports and whose prices have fallen by 20% in the past three months (though the benefit has been mostly offset by the local currency's depreciation), is likely to stem the rise in the CAD. Further, the gold imports (10% of total imports), which have been the key driver of the rise in the CAD, are moderating after the levies announced in the FY2013 budget. Therefore, the softening of the commodity prices will ease the inflation fears, improve the corporate performance and widen the scope for monetary easing. Traditionally, in a scenario of lower commodity prices India outperformed the other emerging markets due to increased allocation from the foreign investors.

**Impact of crude prices on Sensex' premium to EMs**




Source: Bloomberg

### Chorus on policy inaction get shriller, some fiscal actions likely

The criticism on policy inaction has grown shriller since the GDP growth tanked to 6.5% (the lowest in nine years), the rupee slid and the rating agencies threatened with downgrades. The prime minister—who has taken charge of the finance ministry as well—has indicated some measures to stimulate growth. Further, the aligning of the Samajwadi Party with the UPA cushions the government on a number of fronts and may contribute to the passage of a few legislations though path-breaking reforms still look doubtful. The government has already softened the stance on the proposed tax laws (General Anti-Avoidance Rules) to improve investor sentiment and is engaging with the aggrieved parties to resolve the issues afflicting the infrastructure sector. Given the low level of expectation, any fiscal measure, no matter how small, will be taken as a positive by the market.

### Earnings expectation gets more conservative

After the FY2012 results the consensus earnings estimate for the Sensex has fallen by 15% for FY2013 over the past 15 months. This largely factors the weakness in the broader economy and its impact on the corporate earnings. The telecommunications sector has seen the highest downward revisions whereas consumer goods and energy sectors have seen a higher number of upgrades. Currently, the earnings of the Sensex are estimated to grow at ~13% in FY2013. This seems quite conservative considering the 14.1% growth delivered by the benchmark index since the 1970s. Therefore, though the incremental risks remain on account of a sluggish monsoon and global events but the back-ended policy actions and monetary easing could also lead to upgrades.

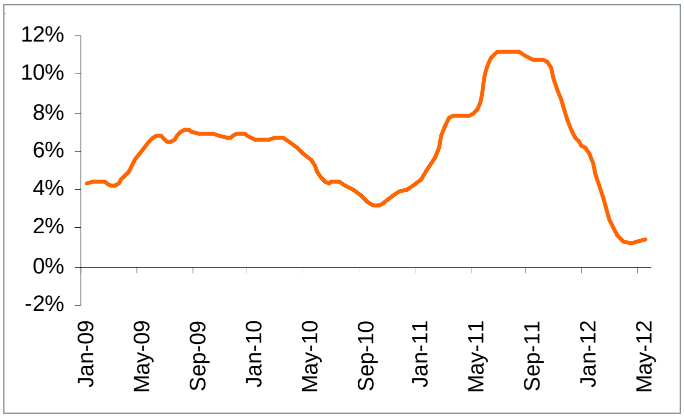
**Sensex' FY2013 earnings estimates**


Source: Bloomberg

### Pressure on rupee unabated; weak monsoon and inflation risks persist

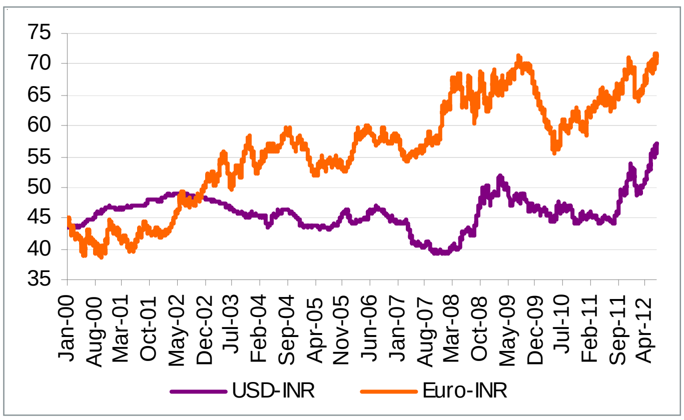
The rupee has depreciated due to a combination of global and domestic factors. The reversal of the softening of crude oil prices led by global liquidity or the deepening of the euro zone crisis could aggravate the currency risks. According to India Meteorological Department, the El Nino phenomenon is threatening this year's rainfall, which has had a weak start already. The government has hiked the minimum support price for the kharif crops which could keep food inflation at higher levels. A potential shortfall in the rains could further intensify the consumption slowdown concerns and raise the agriculture related non-performing assets of banks.

**WPI inflation trend**




Source: Bloomberg

**Movement of rupee vis-à-vis USD, euro**

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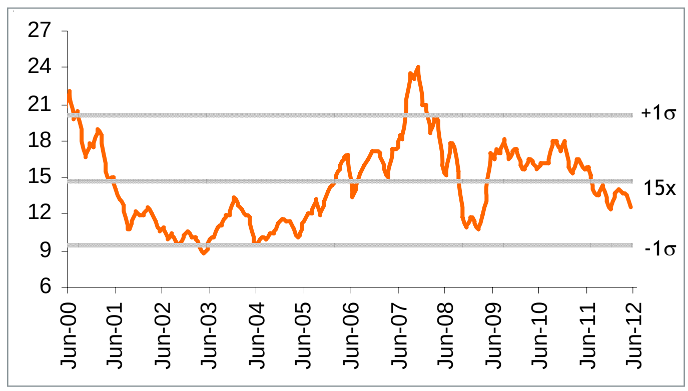


Source: Bloomberg

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