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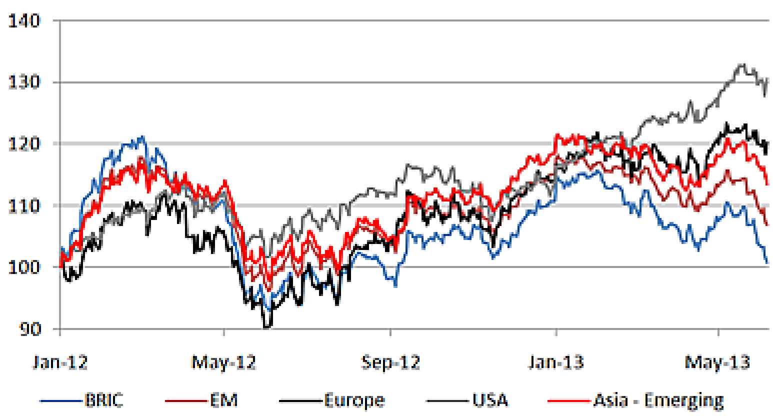
South Asia

Jun 14, '13

India still a good bet after market sell-off

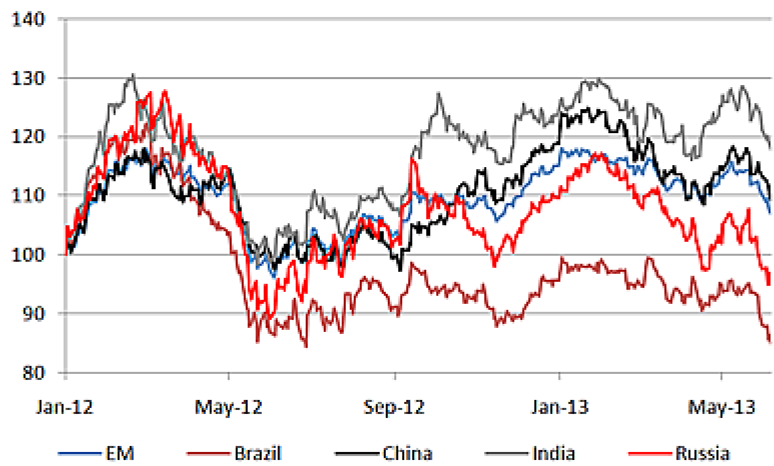
By Kunal Kumar Kundu

Indian equities may not perform too badly despite the recent sell-off. The past month witnessed a virtual carnage across stock markets in the emerging markets and more specifically the BRIC countries. So far this year, while the MSCI US index gained 15.1% and even Europe (the current epicenter of global crisis) gave a positive return (5.4% up in the MSCI Europe index), the MSCI Emerging Market index was down by 7.1%, with MSCI BRIC index contracting even more sharply, by as much as 9%.



Note: All indices indexed to 100 as on 2nd January, 2012. Source: CEIC, author's calculation.

Since the 2007/2008 peak, the BRIC Index has lost 42% in value, Russia leading the pack with a contraction of 56.8%, followed by China at 45% and India at 41%. And, with the commodity cycle coming off and oil prices cooling, Russia continues to be the worst performer even during 2013 with a loss this year of 12.6%, followed by Brazil (an 11.2% contraction).



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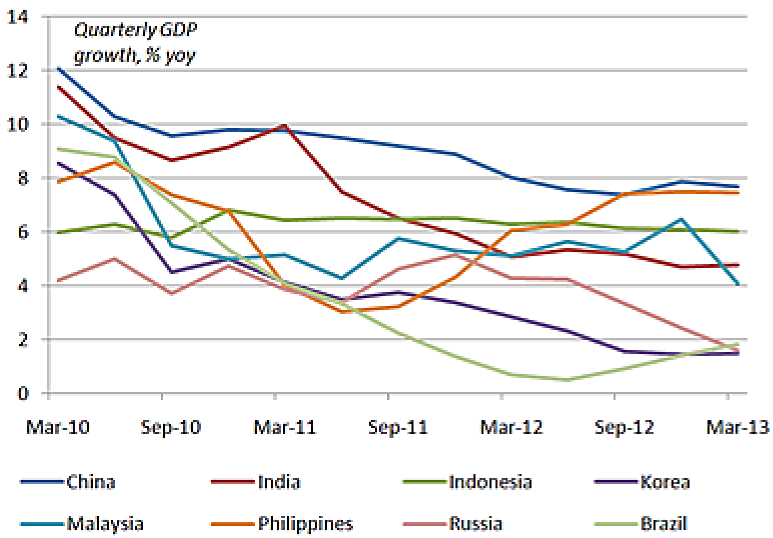
While the world looked at the emerging markets, especially those from Asia (and more specifically the two BRIC giants China and India) as the source of global economic growth as the US and, more specifically Europe failed to deliver, the stock markets seems to have taken a contrarian route. So, what gives?

Essentially it boils down to how liquidity reacts to multiple doses of quantitative easing (QEs) and ultra-low interest rates prevailing in the developed world. With QE totaling around US$2 trillion, the resultant liquidity tsunami unfortunately bypassed the real economy and started chasing assets around the globe. Not surprisingly, inflation remains subdued in the developed world (against conventional wisdom of high liquidity driving up prices) as economic growth stays anemic.

Corporate entities in the US focused on cutting costs through increased retrenchment and productivity gains. Thus as the share of wages in the US economy started to slide, the share of corporate profit rose steeply. These entities have preferred to use the pile of cash for share buy-backs rather than investing in the economy. According to a study by John Mauldin, share buybacks helped the S&P 500 to accelerate earnings per share growth by about 3% a year over the past two years.

Not surprisingly, weak economic fundamentals notwithstanding, the US equity market has been having a dream run. However, the stock market performance of the emerging economies depends on how the tussle between risk-on and risk-off plays out. The extent of crisis perception in the developed world and growth perception in the emerging markets decide the overwhelming direction of the flows.

The recent shares sell-offs can be attributed to two major developments: the threat of the US pulling the plug on QE (in anticipation of which, there was a global bond market sell-off resulting in the hot money going back home), on the back of some improved economic indicators, and under-whelming growth prospects in the emerging markets, with virtually all the major emerging market economies showing distinct signs of a slowdown.



Source: CEIC.

While the weak economic growth of commodity- and export-dependent economies is understandable, the general structural constraints have also come to the fore.

This of course does not mean that the emerging market story is petering out. For starters, the story of potential withdrawal of QE seems to be over played. US Bureau of Economic Analysis data show that US economic growth has slowed to an average of 1.5% over the past two quarters, down from the average growth of 2.5% in the recovery from 2010. At the same time, US Bureau of Labor Statistics data show private-sector employment-growth rates, which generally follow GDP growth accelerations, have been virtually flat since early 2011.

That apart, one needs to contend with disappointing global industrial and consumption numbers like weak US ISM (Institute for Supply Management) data, weak EU retail sales, and so forth. More importantly, the effect of sequestration is yet to be felt on the US economy.

Where does that leave India? There's no clear cut answer to that. On the economic front, India is definitely not out of the woods. The lowest annualized GDP growth in a decade during this year's first quarter, high inflation expectations, with strong headwinds such as currency depreciation, and potentially high food prices related to aggressive procurement by the government when the Food Security Bill becomes a reality soon, domestic investment far from being in a take-off mode, falling domestic demand, and continued political risk - all point to weak economic fundamentals in the short to medium term.

Compared with the other emerging market economies though, India is still a story worth chasing for investors given its domestic consumption, unlike the commodity and export dependent economies. However, even if the later optimism overwhelms the former pessimism, one should not expect investors to be overwhelmingly bullish on India and start pouring in the dollars once again. The outflow trend may yet be reversed but the deluge may give way to a trickle. Otherwise, volatility will be the norm.

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