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India's foreign funds flood not guaranteed

By Kunal Kumar Kundu

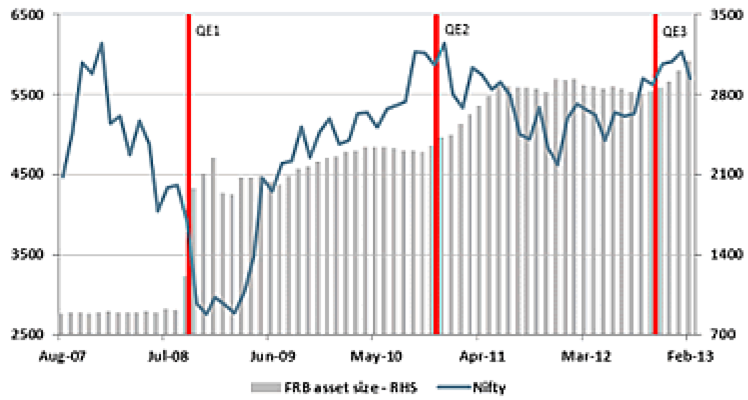
NEW DELHI - Over the last few months India witnessed fairly strong inflows of foreign institutional investments (FII), which also coincided with the Indian stock markets moving towards pre-crisis level highs.

Part of this is attributed to a third round of US Federal Reserve quantitative easing (QE3) coming into force during late 2012. It is also part due to global risk perception turning risk-on (wherein investors start moving their money to risky assets such as emerging market equities, bonds and currencies) from risk-off (wherein all the risky bets are taken off the table and there's a safe haven impact as money flows back into dollar denominated assets). This switch is in turn attributable in part to an easing of the threat of an exit by Greece from the eurozone and European Central Bank chairman Mario Draghi's famous "whatever it takes" speech that helped reduce the sovereign yield spread of Italy and Spain to manageable levels.

It has been well documented that liquidity created through quantitative easing flows to the financial economy and not as much to the real economy. Thus, while the health of the US economy is far from being nursed back to normal even after two massive rounds of QE (which resulted in QE3 becoming necessary) assets prices have been the biggest beneficiary. Hence, there's a belief that when the QE is on, FII inflows to India will remain strong, which will be positive for the Indian equities market.

However, there's a reason to believe that while QE does lead to a surge in investments in various emerging market equities, India will not necessarily be an automatic choice. All will depend on which country offers a relatively better fundamental story at a particular point in time.

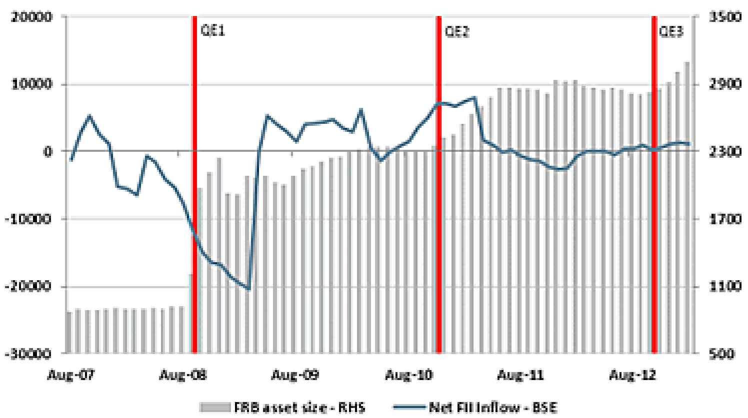
To understand this, let's look the developments since QE1.



Source: Federal Reserve Board (FRB), CEIC

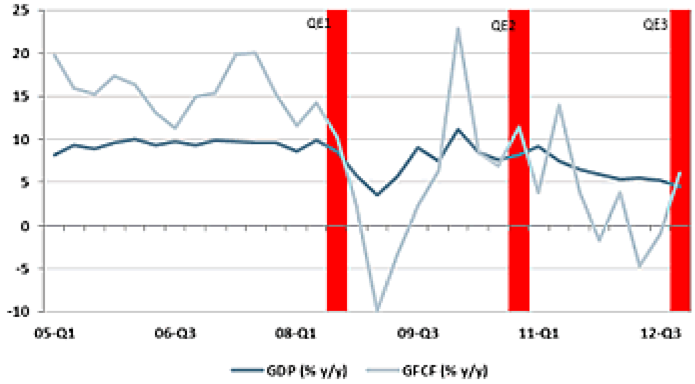
As can be seen from the chart above, India's stock markets doubled from the post-crisis low after QE1 happened but the same result was not visible post QE2.

The story for FII inflow is similar. While there was surge in inflows post QE1, QE2 actually saw a dip.

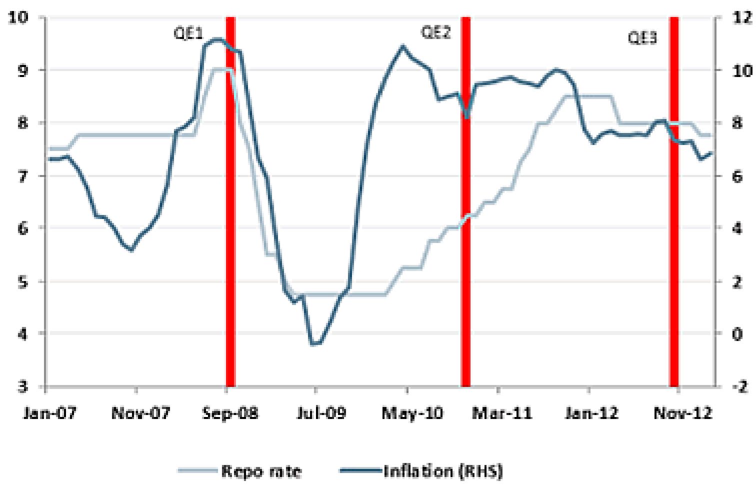


Source: Federal Reserve Board (FRB), www.bseindia.com

Before the global financial crisis erupted, India enjoyed a period of high and sustained growth. Capital formation also remained quite strong. However, after the financial crisis, there was a sharp slowdown in global growth, and the Indian economy also felt the heat. However, the economy recovered quickly on the back of economic stimulus as domestic demand recovered fast, aided by falling inflation and a fast pace of easing by India's central bank, the Reserve Bank of India (RBI).



Source: CEIC



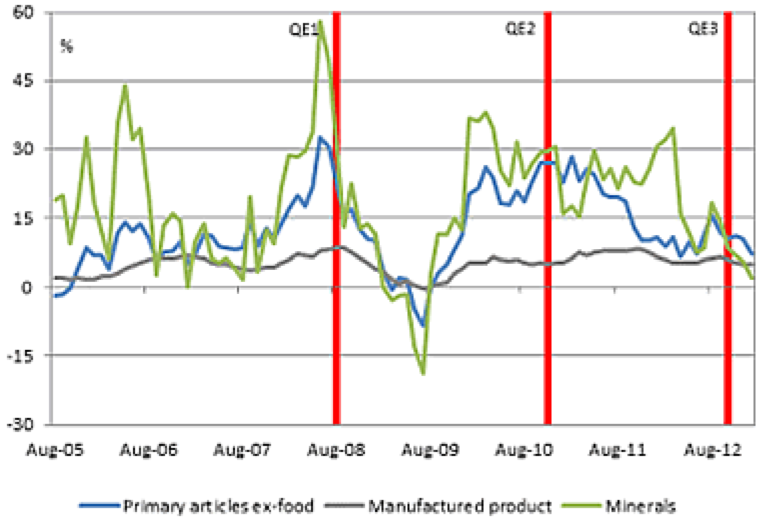
Source: CEIC

However, domestic consumption led growth without adequate capital creation and inappropriate government policies coupled with rising global prices of commodities resulted in a sharp spurt in inflation. The RBI was slow to react and even when it did, the pace of its tightening was much too slow for comfort, which resulted in inflation and inflationary expectation galloping away.

When the RBI realized its folly, it started tightening way too fast. By that time, the harm was already done and inflation remained high. The resultant high inflation and interest rates took their toll on domestic demand. Thus, by the time QE2 started, the economy was slowing down while inflation was at near double digit levels.

The problem was further exacerbated as the Indian political environment worsened and policy paralysis gripped the country. An unending stream of populist expenditure and a worsening global environment meant that the high dual deficit (the fiscal deficit at 5.8% of gross domestic produce and current account deficit at 4.2% of GDP during the fiscal year to March 2012) pulled down the economy even further.

Not just the macro factors but also corporate performance was reflected in the broader equity market performance. As input inflation started to fall, strong domestic demand ensured better pricing power and hence corporate margins remained healthy, resulting in improved stock market performance. However, by the time QE2 came into existence, input inflation was up again, while continued demand destruction meant much weaker pricing power for the corporate. This resulted in stable output inflation and hence worsening corporate profitability.



Source: CEIC, author's calculation

The surge in FII inflow post QE3 has to do with the then-prevailing belief that the Indian economy had bottomed by the first half of 2012-13. By that time, the government also mustered up enough courage and announced several pro-economic policy measures, which included allowing foreign direct investment in multi-brand retail and raising prices of regulated oil products, among others. Corporate margins also showed signs of improvement. Globally, as mentioned above, the tail risks for Europe too had dissipated by then. Thus the Indian stock market surged.

However, the valuations of the Indian markets now appear stretched. Marco economic fundamentals have weakened. The third-quarter GDP data belied expectations on the downside, and there's a belief that the economy has not yet bottomed out. The proposed fiscal consolidation now seems to be more of an accounting exercise than real intent.

As India enters the home stretch for elections in 2014, the government may not be able to walk the talk and might have to give into populist measures, thereby possibly weakening the macro fundamentals. Globally, austerity fatigue has set in, as can be seen from the results of the recent election in Italy, problems resurfacing in Greece and with France even proposing a slowdown in austerity expectations. As problems in Europe resurface and may even intensify, the bet is shifting again to risk-off assets.

There is, therefore, no reason to believe India will see huge inflows of FII money during the whole of 2013. Everything will depend on how the global situation pans out and how India's macro fundamentals move, more so in comparison to its emerging market peers.

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