ASIA TIMES Online
www.atimes.com

South Asia

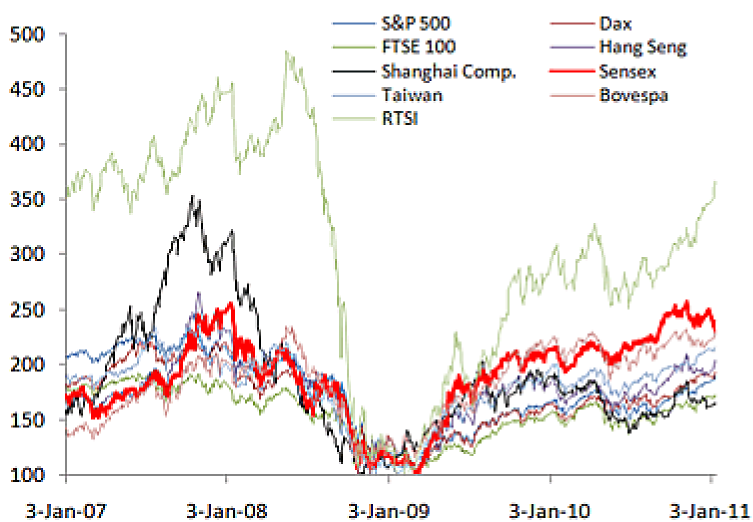
Jan 20, 2011

Indian stocks lose their winning looks

By Kunal Kumar Kundu

India was the toast of the world in 2010 as the economy posted near 9% growth during the first half of the financial year, with the potential to grow at near double-digit rates for a fairly longish period.

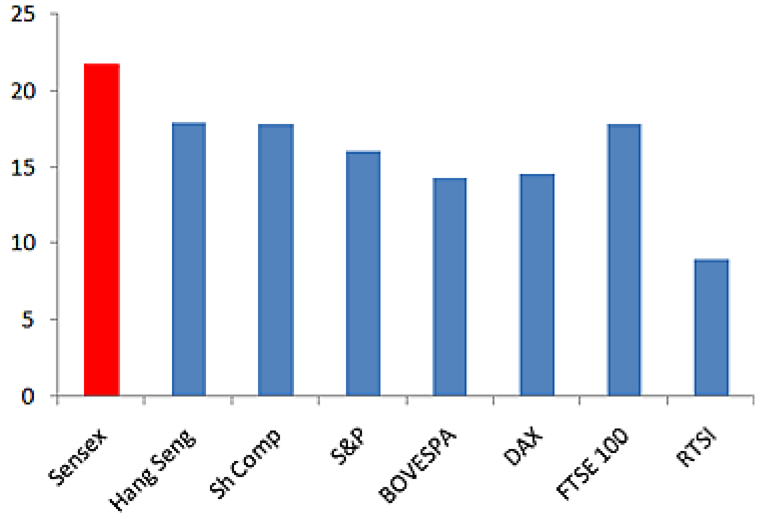
With the Indian economy being one of the few bright spots in the dismal global outlook (more so given that India was able to weather the global crisis much better and returned to growth path much faster, buoyed by strong domestic demand), foreign institutional investors (FII) have been pumping in money like there was no tomorrow. Total net FII inflow in the equity market during 2010 was a tad above US$29 billion. Not surprisingly, the market rose and the stock market - as gauged by the Sensex - was one of the best performers in the global equity market.



Source: Bloomberg, my calculation. Note: All the indices have been indexed at 100, at the their lowest daily closing during the crisis

Having touched its lowest closing value of 8160.4 as on March 11, 2009, the Sensex has grown by a little more than 131% as of January 14 2011. Only the RTSI index of Russia grew faster. Among the BRIC - Brazil, Russia, India and China - economies, The Brazilian index (Bovespa) gained 127%. China grew 63.8% during this period.

During the current rally, the Sensex closed at its historic high of 20,932.5 on November 9, 2010. It is important to note that, other than India, none of the indices of the BRIC economies could touch their historic high during the current rally. This led to stretched valuations in the Indian market. This can be gauged by the price to earnings (P/E) multiple that the Sensex was commanding. With a P/E 21.73, the Sensex was well ahead of other markets.



Source: Bloomberg. Note: P/E as of January 14, 2011

With overstretched valuations and a jittery global economic scenario, the Sensex was only a bad news day away from taking a tumble, and India gave investors dollops of bad news to contend with.

The second half of 2010 was marred by a series of news events pertaining to corruption in various echelons of society. The tone was set by the Commonwealth Games fiasco, which put India to shame in the eyes of the world (see India's commonwealth fiasco, Asia Times Online, October 2, 2010).

The scandal over sales of second-generation telecom spectrum was another shocker that rocked the country. Then there was the Adarsh Society scam, where land allocated to the martyrs of the Kargil war in 1999 was usurped by the high and mighty (including some high-ranking army officials, and politicians, who flouted all civil norms with impunity) and the apartments distributed among their cronies.

The chief minister of one state allocated valuable plots of land to his kith and kin, for next to nothing and so on - the list is endless. This barrage of bad news spooked investor confidence.

Added to that, inflation reared its ugly head - and how. Spiraling food prices, rising commodity prices (including oil, of which India is a major importer) resulted in inflation remaining at a highly elevated level for weeks, recently going up to 8.43%.

The stubbornness of this inflation has resulted in the government recently raising its inflation forecast for the fiscal year ending in March 2011 to more than 7%, while even a few weeks back it was vocally confident about its ability to contain inflation at below 5%.

Given the inflationary pressure, I expect the Reserve Bank of India (RBI) to raise interest rates by 50 basis points (bps) in its next review meeting (although the recently released industrial output numbers indicate a slowdown in production - see Indian output still weak, Asia Times Online, January 14, 2011) and expect interest rates for the whole year to be increased by 100 bps. The RBI was one of the most aggressive central banks in Asia in 2010 as it raised rates six times over the year. Given that monetary policy measures start impacting with a lag, India is destined to have a high interest rate regime in the short to medium term.

Clearly, India's strong domestic demand, which helped the country weather the global financial crisis much better than many others, faces a strong headwind, much to the discomfort of investors. As high inflation starts impacting corporate bottom lines, faltering demand will reduce the ability of companies to pass on the cost pressures to consumers.

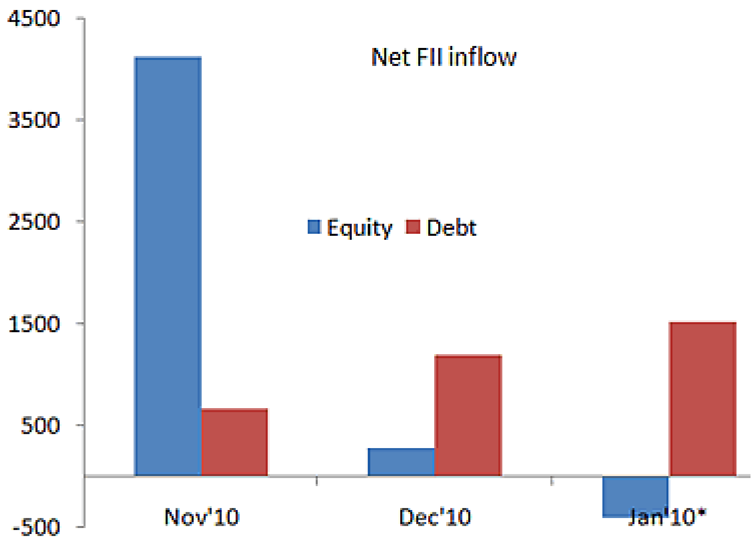
On the other hand, the latest round of quantitative easing in the United States seems to have helped that country weather the storm, albeit for a short term. Thus the corporate performance outlook has improved in the

US. Similarly, German companies are showing some strength. While the outlook for the peripheral economies in the euro zone continues to be bleak, the stronger economies like Germany and the Netherlands still look comfortable.

As a result, Indian equity markets have witnessed huge selling pressure from foreign institutional investors. Since the middle of November, when overseas investors started to sell in big numbers, the Sensex has slipped by about 10%. Even then, the Sensex P/E remains at an elevated level compared with other markets.

Agreed that India's potential growth rate should translate into a higher valuation multiple that investors would like to pay, but at present, looking at other markets, there is a compelling relative valuation story. In fact, there is now increased evidence of a shift in asset allocation of foreign investors from emerging economies to developed economies.

Therefore, although the long-term emerging market story (especially that of India) remains fundamentally strong, in the short to medium term the outlook for the Indian stock market isn't so good. Interestingly, while FIIs have been net sellers in equity markets in India, they have been net buyers in the debt market (of late) as interest rates move upwards.



Source: Securities & Exchange Board of India. * - till January 14

I expect 2011 to close with possibly modest gains in the Indian stock market and the year will be characterized by a high level of volatility, owing in a large measure to the ebb and flow of liquidity. From an investor's perspective, therefore, the investment approach should strictly be stock-specific.

Kunal Kumar Kundu *is Senior Practice Lead, Infosys Technologies Ltd, Bangalore. The views are those of the author. The author's website is http://kunalsthoughts.weebly.com*