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India loses shine

By Kunal Kumar Kundu

Foreign Institutional Investors (FIIs), who pumped in about US$29.36 billion in to India in 2010, helping the Sensex benchmark equities index gain more than 17%, withdrew as much as $1.57 billion in 2011 as of February 17. In fact, they pulled out close to $2 billion from the secondary market, with a little more than $400 million being put in the primary market.

The FII inflow in 2010 was way ahead of foreign direct investment (FDI) that entered the country, being 40% more than FDI inflows of US$21 billion. However, with the new year, foreign investors do not seem to be as enthusiastic and the recent budget also failed to lift moods. Morgan Stanley has downgraded India to underweight from equal weight.

So what gives? Why is a country that was the apple of the investors' (read foreign) eyes even a few months back, seemingly be fading from their radar?

The factors are glocal in nature, as the terminology goes.

The global factors have come into play through some encouraging US economic numbers leading to reversal of flow toward the US stock market in the hope that a solid US economic recovery is round the corner. I am not very convinced. When the unemployment level is still very high, consumer sentiments not upbeat enough (case in point is the Michigan consumer sentiment index dropping to 68, precariously close to its all-time low), housing foreclosures showing no signs of abetting, how sustainable then is the recovery?

Housing wealth is one of the biggest drivers of wealth-effect induced consumption in the US, and it is still quite jittery, what with a potential bottoming out of prices still a way off. It seems that quantitative easing-induced money flow into the stock markets, along with money saved through mortgage defaults, is leading to a wealth illusion that might be spurring some spending activity. One may consider this rebound as fundamental to one's own peril.

This brings us to the local factors. Inflation, for one, is the biggest current worry in India. (See Indian inflation waiting to strike, Asia Times Online, December 23, 2010). Things do not look so good with the Reserve Bank of India upping its inflation expectation along with the fact that there is every likelihood of oil remaining well above US$100 per barrel for a fairly sustained period.

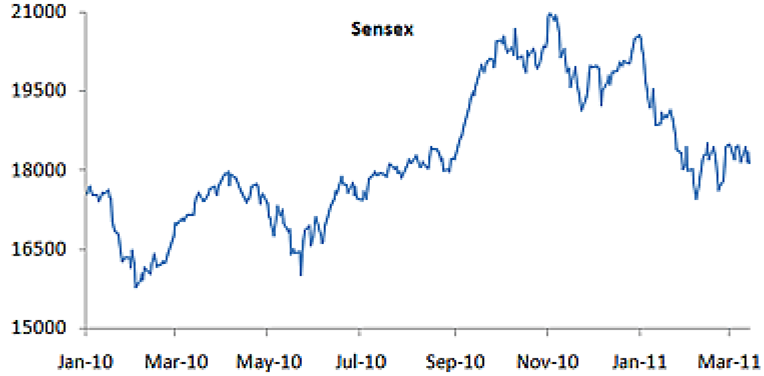
High oil price also puts pressure on India's finances. Given that India depends for the most part on oil imports, high oil prices will further fuel inflation if it is passed on to the consumers, or it will bloat the subsidy burden if not. In the first instance, the impact on inflation is direct, while in the second instance it is indirect as India's fiscal deficit will rise.

As was mentioned in my budget article (see Indian budget seeped in optimism, Asia Times Online, March 2, 2011), there was nothing in the budget that gives confidence that inflation and/or the deficit will be contained. The illusion of a lower deficit was created by some accounting finery along with hugely aggressive assumptions.

High levels of inflation will necessarily lead to higher interest, which can choke off investment, especially of the capital nature. It will also reduce demand on two counts. First is a higher cost of leveraged consumption and second, higher inducement to save, especially given rising interest rates. Add to that the uncertain global growth scenario, India's growth rate for the this fiscal year through to next March should be hovering around the 8% mark. This will be much lower than the growth rate touted by the government viz 9%.

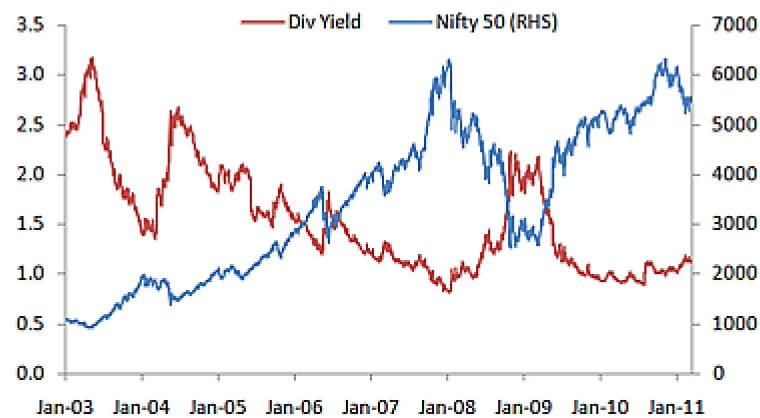
The other major concern, of course, is the plethora of corruption cases being brought to light, each one more impactful than the other. The Commonwealth Games corruption case, the telecommunications spectrum allocation scam, recent WikiLeaks files that show the ruling government in a very poor light and so forth, all add up to the negative perception about the country and its economy.

Under these circumstances, the Indian stock market may not offer adequate value buying opportunities at least in the short to medium term, although the market has corrected this year by more than 11.5% since last year's closing.



Source: Yahoo Finance

While many market participants are of the view that the Indian stock market is fairly valued, I think there's some more downside left before value would emerge. I would use a fairly old-fashioned way of valuing a stock. Namely, dividend yield. The dividend yield of Nifty 50 is now close to its historic low.



Source: National Stock Exchange

The current dividend yield of 1.14% for the Nifty 50 is close to its historic low of 0.84% (historic high being 3.18%). In a scenario where the interest rates are high and likely to rise, such low levels of dividend yield do indicate a further correction can be expected.

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