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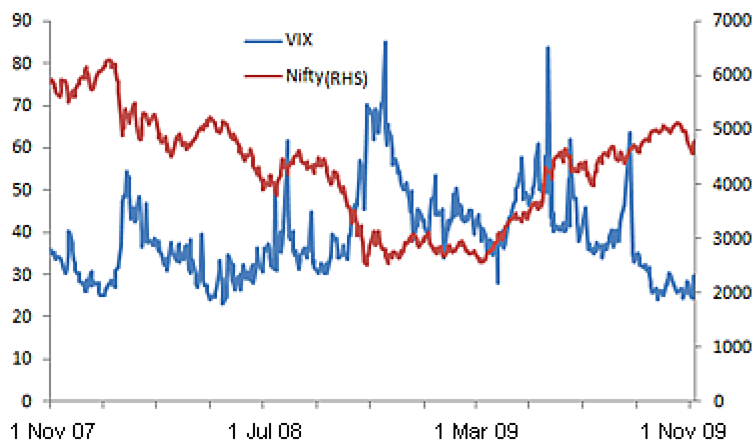
Indian stocks face power shortage

By Kunal Kumar Kundu

BANGALORE - The corporate sector profit performance in India has been quite strong over the past couple of quarters, helping to drive up stock values, with the benchmark Sensex index more than doubling since early March.

While revenues of non-financial and non-oil companies have hardly moved, profits have, on average, increased by more than 20%, an analysis by the Economic Times shows, and the market undertone remains quite bullish. This is evident from the National Stock Exchange Volatility Index (VIX), which is hovering near its lowest levels.



Source: www.nseindia.com

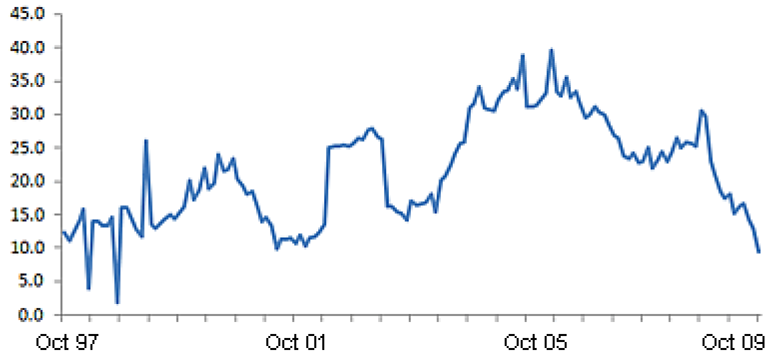
It is clear that the risk perception of the market is quite low. Yet, the Nifty Index, which tracks the stock of 50 large companies, has recovered from last year's collapse to be only about 20% down from its all-time high in January 2008, when the economic conditions were quite different. That could indicate that the market is under-pricing risk. Three factors are worth considering - liquidity, corporate performance and government intervention.

Liquidity: From early 2008, the Nifty nosedived from about 6,287 to just above 2,500 by late October and remained below 3,000 until late March this year. This can be attributed mainly to the virtual stagnation of global liquidity flows. With financial stress feeding through to the real economy, markets fell like ninepins. Then a plethora of stimulus plans were announced worldwide and liquidity suddenly increased.

The increase in liquidity was enhanced by the US dollar carry trade, with money borrowed in near-zero interest dollars seeking higher gains overseas. This liquidity did not percolate into the real economies, given increased risk perception; instead, it started chasing equity assets around the world. Not surprisingly, all the major global equity indices started moving up, as if there were no tomorrow.

India was no exception. Inflows from foreign institutional investors (FIIs) picked up by way of Participatory Notes, or P Notes. These are instruments used by investors or hedge funds that are not registered with the Securities and Exchange Board of India to invest in Indian securities. India-based brokerages buy India-based securities then issue the notes to foreign investors. This, coupled with domestic money moving to the markets through financial institutions, led to the current rally. At the same time, despite availability of enough liquidity in the system, credit flow to the real economy continues to falter, indicating a lack of corporate confidence in economic growth going forward.

Outstanding non food credit of Scheduled Commercial Banks (YoY gr.)



Source: RBI

Corporate performance: A tapering credit flow does not make for a positive corporate outlook, and with domestic demand remaining flat, corporate revenues have hardly moved during the past two quarters. Companies have improved net profits on account of depressed commodity prices, low interest rates and low labor costs. Going forward, none of these will be able to boost performance as they have in the past.

Commodity prices: After commodity prices peaked in 2008, they went into a tailspin.

MGM Index

Source: Reuters

This is clear from the movement of the MGM Index. It is an index of base metals (aluminum, copper, zinc, lead, nickel and tin) developed by Metallgesellschaft (MG), the West German metals, engineering and chemicals group. Recently, however, commodity prices have picked up sharply. This is attributable to restocking, mainly by China, but also to a large extent to the inflow of liquidity into commodities as an asset class. Whatever some experts might want us to believe, the uptick in commodity prices has nothing to do with a perceived likelihood of the global economy pulling out of recession.

The flow of liquidity in commodities has been further exacerbated by the plethora of commodity exchange-traded funds (ETFs), that are attracting investors in droves. Estimates put the value of investments in commodity ETFs at more than US$30 billion, while the amount of cash chasing oil future energy contracts is at around 15 times world demand for the actual commodity. With commodity prices ratcheting up, companies will face heightened cost pressures.

Interest rates: The recent announcement by the Reserve Bank of India clearly indicating a tightening of its monetary stance also implies that the period of cheap liquidity is over for Indian companies. While I am not expecting interest rates to rise soon, there are enough indications that as inflation picks up, interest rates will go north.

Certainly, present inflationary pressure has a lot to do with excessive food prices on the back of a poor monsoon, but food prices should moderate as output from the *rabi*, or spring, harvest enters the market early next year. However, rising commodity prices will start feeding into inflation and with monetary policy in a tightening mode, a pick-up in credit demand will also lead to a hardening of interest rates.

Labor costs: Anecdotal evidence suggests that the downturn in India's domestic job market is over. As companies come up with hiring plans and seek to retain talent, cutting workforces or holding back on wage increases will no longer be an option.

As cost reductions cease to be a feasible alternative for companies, maintaining a 20% or more growth rate in profits will clearly not be possible unless there's a dramatic increase in revenues. This would require a substantial increase in domestic demand, which does not seem likely. Added to this, a likely increase in interest rates will act as a dampener for leveraged consumption through loans and credit cards that many consumers have become used to in the past few years of cheap financing.

Government intervention: This is the third leg of the India growth story. In India as elsewhere, government intervention in the form of various stimulus measures has enabled the economy to grow at a relatively high rate, which raises the question of how sustainable will the impact of these measures be on future growth.

A recent Center for Economic Policy Research paper by Ethan Ilzetzki and others shows that the cumulative multiplier (referring to how many times a dollar put in as stimulus adds to the GDP) in high-income countries rises from an initial value of 0.24 (the impact effect) to a long-run value of 1.04. Hence, even after the full impact of a fiscal expansion is accounted for, output has essentially risen by the same amount as government consumption.

On the other hand, the cumulative long-run multiplier for emerging countries is just 0.79. In other words, in the long run, an additional dollar of government consumption crowds out some other components of gross domestic product (GDP) - investment, consumption, or net exports - by 21 cents. However, for highly indebted countries, the output response to increases in government spending is short-lived and much less persistent than in countries with a low debt-to-GDP ratio, although the short-term response is larger.

Indeed, while the output response for high-income countries remains significantly positive for the 24 quarters covered, it becomes zero (statistically speaking) after about only 10 quarters for developing countries.

According to the research paper, there is not much room in emerging markets for active counter-cyclical fiscal policy - such as cutting taxes during an economic downturn; and a worse combination is an emerging open economy with exchange-rate flexibility and high indebtedness.

India falls into this bracket. Given the level of national indebtedness and the level of fiscal constraint faced by the government, the multiplier effect tapers off sooner, rather than later, and leads to the crowding out of private investment. As mentioned, growth has been supported by increased government spending, inventory buildup and payment of arrears under the revisions by the Sixth Pay Commission. What all these mean is that the demand induced by the stimulus essentially results in bringing forward what would have been demand in the future. Hence current growth aided by stimulus-induced demand will essentially shave of a few basis points from India's future GDP growth numbers.

Future growth will also be hit by the eventual withdrawal of stimulus by a fiscally constrained government, with the fiscal deficit for the year already expected to be between 12% and 13% of GDP. That the government is also feeling the heat of its profligacy is clear from the rising rhetoric about selling off state-owned assets and a stated desire to spend the proceeds in the social sector, unlike earlier, when the government was very clear that the proceeds would be channeled into the National Investment Fund (NIF).

Hence, while the impact of the past stimulus will fade slowly, the exit, as and when it happens, will reduce the short-term multiplier effect on growth.

Similarly, support for an exit strategy is coming to the fore in other nations, both developing and developed. The exit will not take place at the same time across the board, but what this does indicate is that the excess liquidity that has been moving all over the world chasing assets will slowly ease.

Hence, with the performance of Indian companies likely to be less robust going forward, coupled with a slow drying up of liquidity in the near future, the performance of the stock markets in India is expected to be moderate next year.

Note

1. "How big are fiscal multipliers", Ethan Ilzetzki, Enrique G Mendoza and Carlos A Vegh, Center for Economic Policy Research, October 2009.

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