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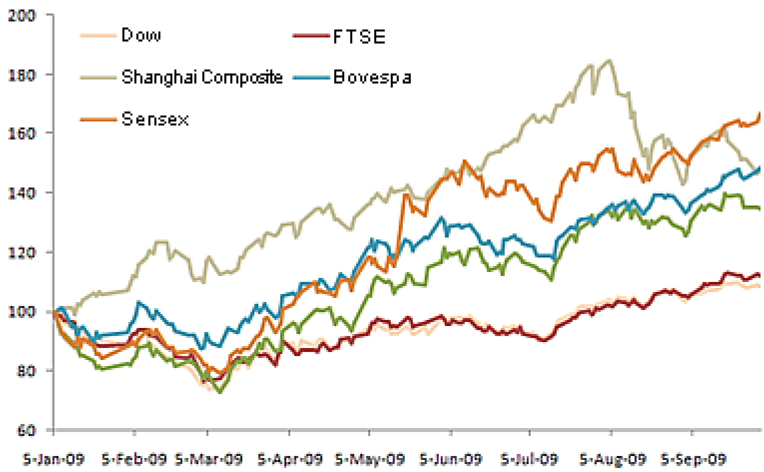
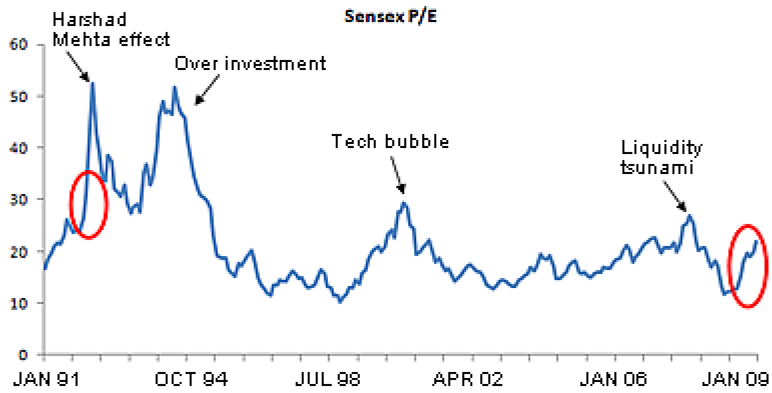
India's stocks in overreach mode
By Kunal Kumar Kundu

BANGALORE - India's benchmark stock index, the Sensex, posted a return of close to 67% in the nine months to the end of September, the highest among leading global indices. It even beat out China, which has started to retrace, owing to overheating concerns.



Source: Yahoo Finance

The rise of the Sensex, which has more than doubled since reaching a low on March 9, has not been backed by any substantial improvement in corporate performance. This is evident from the fact that the price-to-earnings multiple has been rising steadily, recording one of the steepest rises since 1991 - and credit for that gain in the early 1990s should go to stock broker and manipulator Harshad Mehta [1] rather than real economic performance.



Source: BSE website

In the above chart, the different factors that have led to the overheating of the Indian stock market since the 1990s are highlighted.

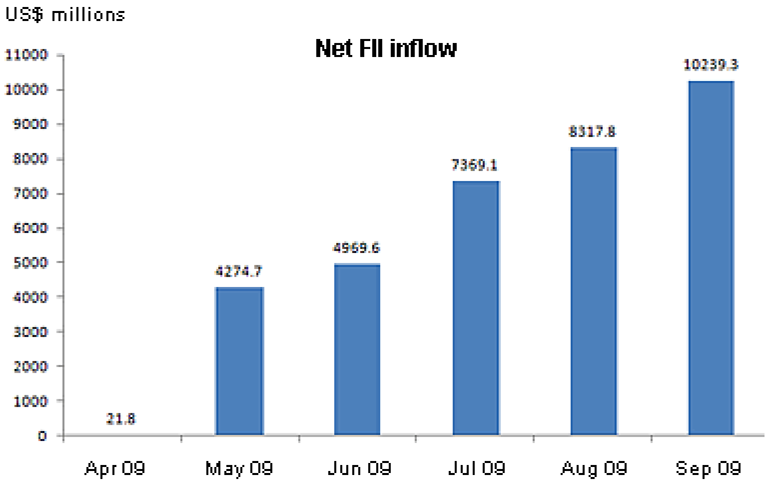
The spike in the stock market in 2007 can be mainly attributable to the large flow of liquidity, driven by foreign institutional investors (FIIs). With India averaging 9% growth in gross domestic product (GDP), the lure of the stock market was too hard to resist. As liquidity continued to be pumped into the market, the stock markets soon ran ahead of fundamentals. This coincided with the financial crisis that originated in the United States but soon engulfed the world. Just as the money arrived in droves, it went out at an even faster pace as panic started to spread and the market tanked by about 60%. As inflation inched up and growth slowed, pessimism ruled the market.

Sentiment, however, was reversed when it was realized that despite a slowdown, India was still in a much better relative shape when the developed world went into a recession and the developing economies in East Europe were simply vanquished, with a handful of them being forced to approach the International Monetary Fund for bailouts.

India, like China, stood out in the midst of severe devastation all around. Then out came the results this past May of India's general election. The mere fact that the left parties (whose obstructionist attitude had most of the time acted as a thorn in the government side) had been routed was perceived as reason enough to believe that all necessary reforms would see the light of day and India would revert to 9%-plus growth, sooner rather than later.

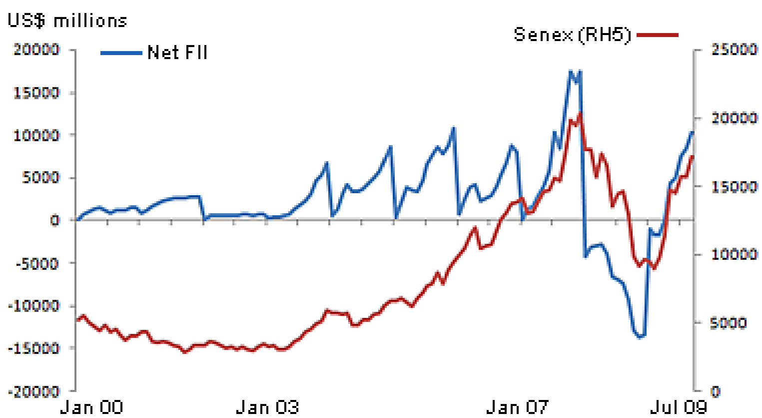
Added to this was the stimulus provided to the economy by the new government, as deficit concerns took a back seat.

As sentiment improved, liquidity began to move in, again more specifically from FIIs.



Source: Bloomberg

In the first two quarters of this financial year, total FII inflows crossed US$35 billion, with the majority of them taking place post the election. There is no gainsaying the fact that FII inflows have had a big impact on market valuation.



Source: Bloomberg & Yahoo Finance

However, their influence increased substantially from 2007 as a global glut of liquidity led to a deluge. Not surprisingly, while the simple correlation coefficient ("r") between FII inflow and the Sensex has been 0.215 from January 2000 to the present, the "r" value increased to 0.675 from January 2007 onward.

Clearly, the market is now much more susceptible to the vagaries of FII flows. While the 2007 deluge was followed by substantial pullback following the crisis, the recent liquidity injection by governments as part of their stimulus packages has resulted in liquidity rushing to equities as an asset class all over the world, and India is no exception.

In September, net FII inflows surpassed the US$10 billion mark. Not surprisingly, the rupee appreciated by about 4.5% in one month.

Another channel for foreign cash to enter the market is through the Participatory Note, or P Note, route. For the uninitiated, P Notes are instruments used by investors or hedge funds that are not registered with the Securities & Exchange Board of India to invest in Indian securities. India-based brokerages buy India-based securities then issue P Notes to foreign investors. These are thus instruments that are used for making investments in the stock market but are not actually used within the country.

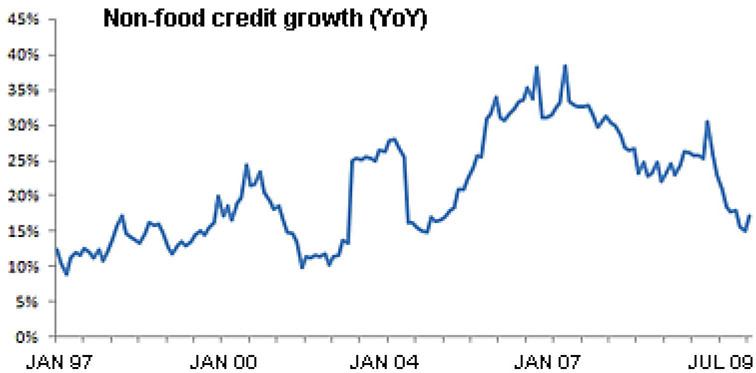
Inflows though this route have also been quite substantial and have been steadily increasing, nearly doubling this year to 1.1 trillion rupees (US$24 billion) from 658 billion rupees. Clearly, this is hot money, highly susceptible to sentiments and herd mentality.

(Rs billion)

Month	Total value P Notes with underlying Indian securities	Assets under management of FIIs	P Notes as % of assets under management
Jan-09	658.12	3921.66	16.80%
Feb-09	609.48	3691.55	16.50%
Mar-09	694.45	3919.54	17.70%
Apr-09	723.14	4690.93	15.40%
May-09	1,034.70	6244.88	16.60%
Jun-09	978.85	6310.47	15.50%
Jul-09	1,083.45	6925.22	15.70%
Aug-09	1,102.93	7107.92	15.50%

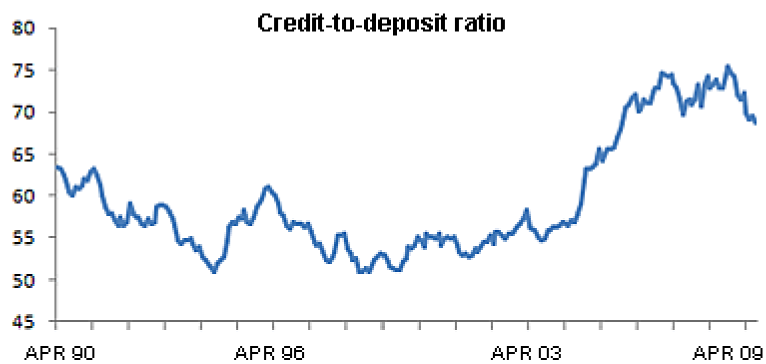
Source: SEBI

The surfeit of liquidity is not entirely of foreign origin. There's also ample liquidity in the domestic market, helped by loose monetary policy. This is exemplified by deposits growing at a faster pace while credit growth remains muted. In fact, non-food credit growth has been on a declining trend since October 2008, and only in July was there some hint of reversal.



Source: Bloomberg

Not surprisingly, the credit-to-deposit ratio (CDR) has been in decline.



Source: Bloomberg

And, despite a pick-up in non-food credit growth in July, the CDR was down by 80 basis points, indicating a much faster growth in deposits. Clearly, credit flow into the real economy fails to give the confidence of a higher GDP growth that the market is expecting. I have, on a couple of occasions earlier enumerated my concern why GDP growth this financial year will be below 6%, and nothing much has changed to warrant optimism. (See Indian economy drier than forecast , Asia Times Online, September 4, 2009).

On the other hand, monsoon worries have been justified. For the monsoon period June 1 to September 30, India experienced a deficient rainfall of 23%, a three-and-half-decade low - it was in 1972 that the rainfall was deficient by 24%.

The problem does not end there. The southern states received heavy rainfall toward the end of the monsoon period, and as a result they ended up being the least deficient region (at 4%). But rather than the rainfall being spread across the period, it was very heavy toward the end, resulting in widespread floods after a spell of drought. The states of Andhra Pradesh and Karnataka have been the worst affected. This has resulted in a tremendous amount of crop loss.

Initial estimates coming in from Andhra Pradesh pegged the estimated loss at 2 billion rupees, and this may increase. The situation in Karnataka is hardly different. The available information suggests the entire *rabi* crop, or spring harvest, has been completely ruined and over 70% of the *kharif*, or autumn, crop has been lost because of prolonged drought and then waterlogging for three to four days during the floods.

Despite the highly optimistic prediction of government officials, this year's GDP growth could struggle to cross 5.8%, the level I am expecting.

The stock market seems to be far more optimistic on the prospects for growth. Earnings growth of even 20%-plus will not be sufficient to justify a price-earnings ratio of 20. Hence the expectations seem to be unrealistic.

Last quarter's good corporate performance had a lot to do with stringent cost-control measures undertaken by companies and increased focus on reducing leverage.The top line, or revenues, hardly grew. Nor is there any indication that there will be a dramatic improvement in the top line in the next two to three quarters. Margin growth through pure cost-control measures is not sustainable. Sustenance requires consistent top-line growth, which does not seem possible in the short to medium term.

At present, therefore, the market valuation seems to be quite stretched and corrections are expected. In the long run, nevertheless, India's growth story remains intact, despite constraints such as weak governance and the inability of New Delhi to carry forward meaningful reforms. Improvement on those fronts will perk up the growth rates even higher. In the longer run, Indian equity markets remain well placed. Caution is advised in the short run.

Note
1. Harshad Mehta was eventually charged with 72 criminal offenses for his fund and share-dealing practices, and more than 600 civil action suits were filed against him. He died in 2002 with many cases still pending against him.

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