http://www.ft.com/cms/s/0/230e2a8e-85ba-11de-98de-00144feabdc0,dwp_uuid=770044b2-9c82-11da-8762-0000779e2340.html?ftcamp=rss

FT .com
FINANCIAL TIMES

Comment: Stock market optimism – a sense of déjà vu

By Kunal Kumar Kundu

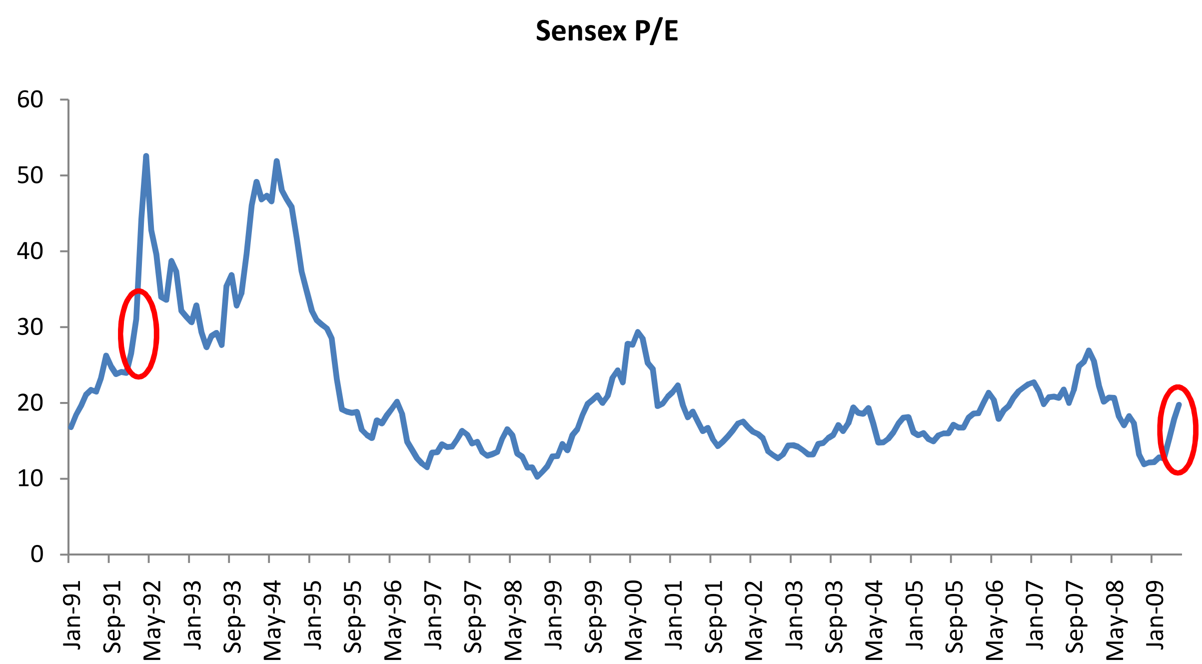
Published: August 10 2009 15:29 | Last updated: August 10 2009 15:29

When the Bombay Stock Exchange's benchmark Sensex tanked by around 60 per cent from its peak at the height of the global meltdown, there were many people who felt that the markets had turned cheap. But after dithering for some time, the market gathered momentum. Many investors felt left out as the market started to move up following the increasing inflow of Foreign Institutional Investor's money.

Things took an even more dramatic turn after the recent general election results. The market welcomed the newly elected government, which it viewed as more reformist and helped the Sensex rise by a record 17 per cent.

Although the reform potential of the government has been belied with no major reform announcement being in sight, India's perceived growth potential in the world of gloom and doom continues to be strong and has perked up the investor sentiment.

And, therein lie the problem. The run-up has been too fast and too ahead of fundamentals for comfort.



Source: www.bseindia.com

During the period for which the data is available, this is clearly the second fastest run-up in the Sensex in Price/Earnings terms and that's a concern.

There have been four major peaks so far, each of which were related to events that that led to a market frenzy not justified by fundamentals.

The 1991-92 peak, which saw the sharpest run-up, was more about market manipulation by Harshad Mehta, which were initially construed as impact of reforms. However, after the scam unfolded, the market dipped equally sharply. Nevertheless, reform was a reality and as the tightly controlled economy was unfettered, the animal spirit was unleashed and businesses started to believe in the growth potential.

Unfortunately, in their eagerness to grow fast, the business run-up exceeded fundamentals as they became over-leveraged in their pursuit of capacity creation.

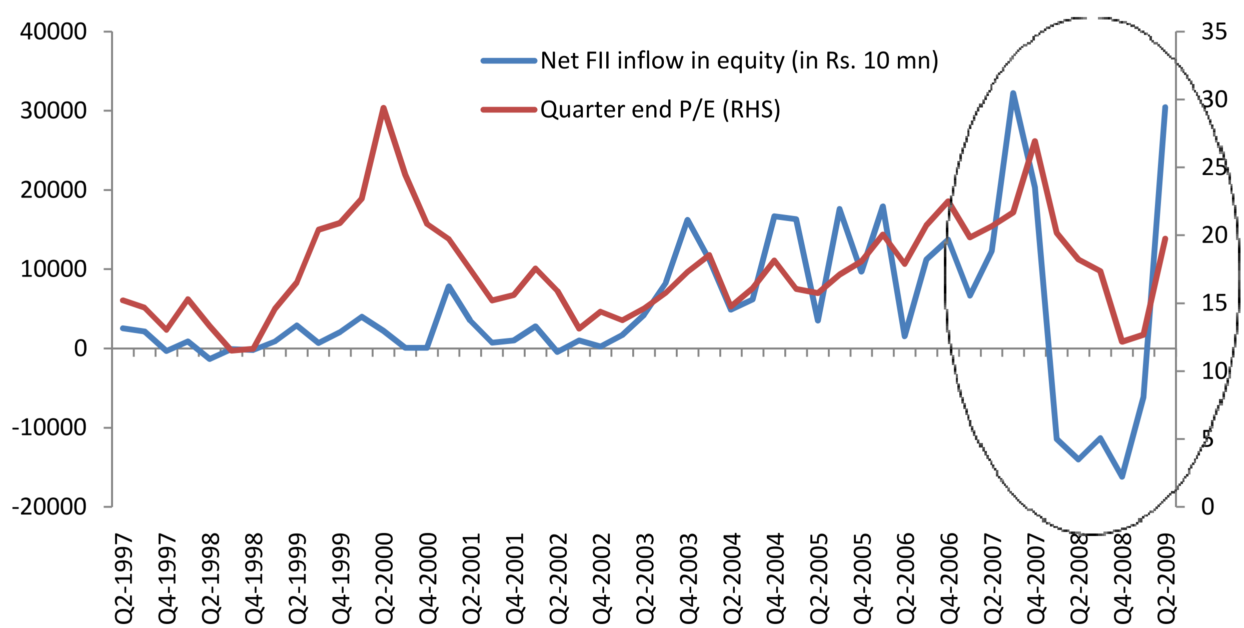
Soon, excess capacity and high finance cost caught up and the market had to slide. The next peak saw the culmination of the tech bubble, which was well supported by the manipulative Ketan Parikh.

The most recent one was of course the effect of financial excesses resorted to by global financial institutions of various pedigree that might have even made LTCM scurry for cover.

As excess liquidity started chasing equity assets all over the world (mostly in emerging markets, what with risk being severely under-priced), India became irresistible to the foreign investors. Driven by mindboggling levels of liquidity sloshing around, the market shot up like nobody's business. And then, as the bubble burst, the retracement was equally sharp.

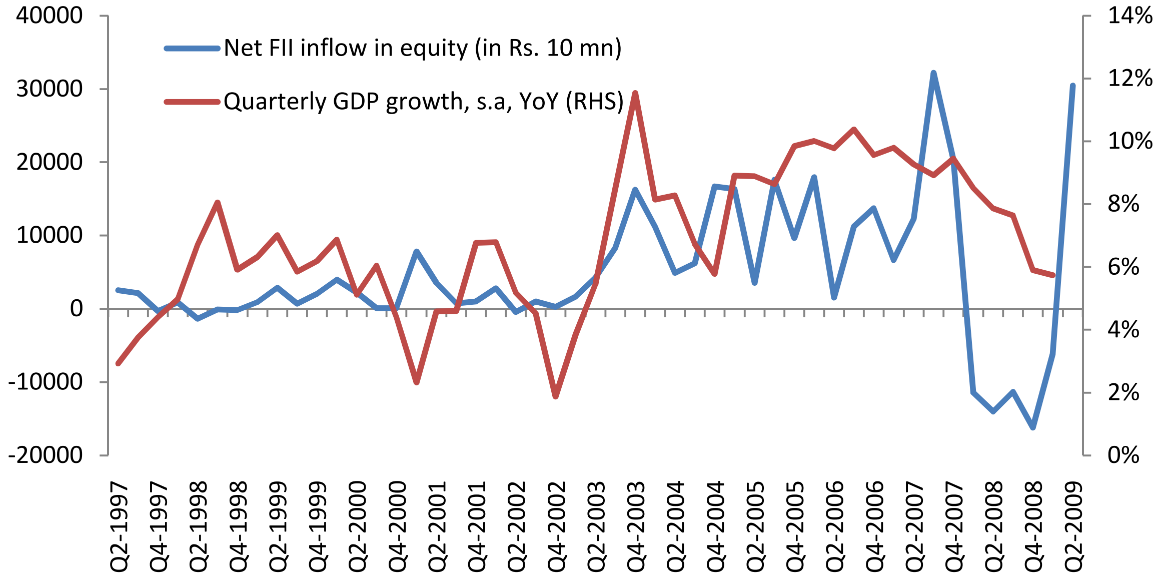
As severe recession engulfed the global economy, the response has been huge bailouts and stimulus packages. While the basic problem still remains unaddressed and the same financial institutions, which raised the bogey of TBTF (too big to fail), continue to be the same.

While the fear of recession seems to be abating, nobody is sure where the growth is going to come from except for countries like and China. Hence we again have a situation where the excess liquidity has started chasing equity assets again. Result? The recent sharp uptick.



Source: www.bseindia.com

As was the case with the previous spike, this was also not backed by macro fundamentals.



Source: www.bseindia.com, Central Statistical Organization (CSO) and my calculation

Fact is, net FII inflow (for equities alone) on a quarterly basis during the second quarter of 2009 was the second highest ever recorded, leading to the spike in Sensex Price/Earnings during this period. The previous high being recorded during the third quarter of 2007. More importantly, this spike was despite the falling trend in quarterly GDP. It's, therefore, quite possible that the rally will soon become a victim of its own swift success as the market has now moved from being undervalued to being fairly valued or even overvalued. So a major tailwind that propelled stocks has now disappeared.

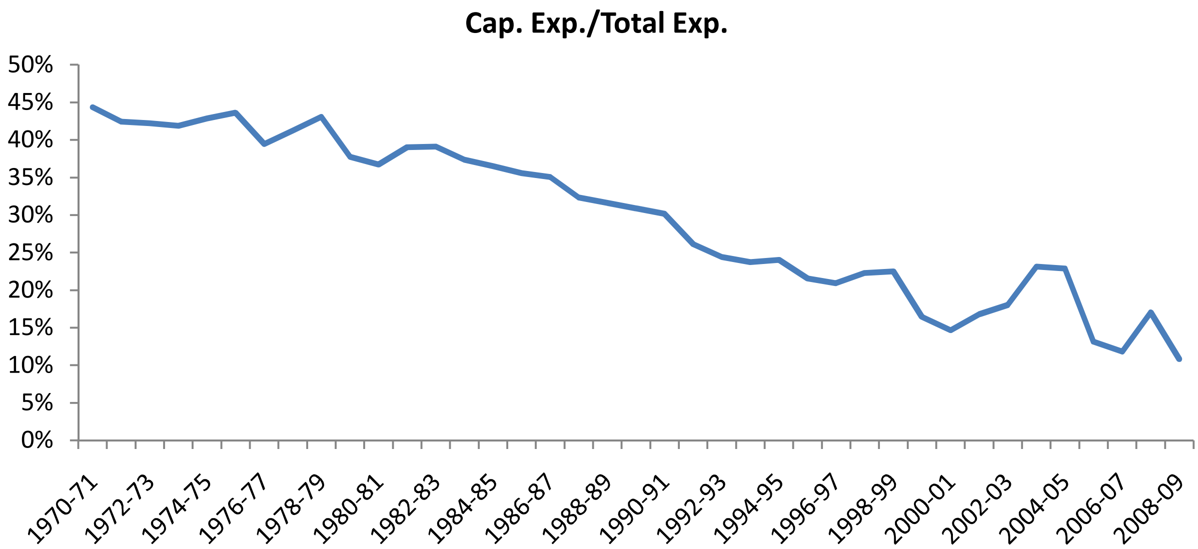
While it's not uncommon for market valuations to rise in the latter stages of a recession, because stock prices tend to move in anticipation of a recovery, a higher level of Price/Earnings is not sustainable because India is not there yet.

Infact, on running a simple linear regression between seasonally adjusted quarterly GDP and quarter end value of the Price/Earnings, one finds that a GDP growth of 7 to 7.5 per cent corresponds to a Price/Earnings of around 16.9 to 17.8. At this point in time, the market indeed seems to be overvalued, especially since the overall GDP growth for the current year should, at best, be 6 per cent.

Why so? Last year, India experienced a great pullback by domestic consumers. The contribution of private consumption to aggregate growth declined dramatically from 53.8 per cent in 2007-08 to a mere 27 per cent in 2008-09. Even external demand also suffered as India's major importing countries grappled with recession. To a certain extent, gap left by falling domestic and external demand was partially filled by an increase in the government consumption expenditure (impact of stimulus package) and its contribution to growth rose from a level of 8 per cent in 2007-08 to 32.5 per cent in 2008-09. This has prevented the economic growth from worsening. However, it's important to note that an important component of the stimulus package has been huge salary payout arrears given to the Indian civil servant as part of the 6th Pay Commission report, something that will cease to be a boost.

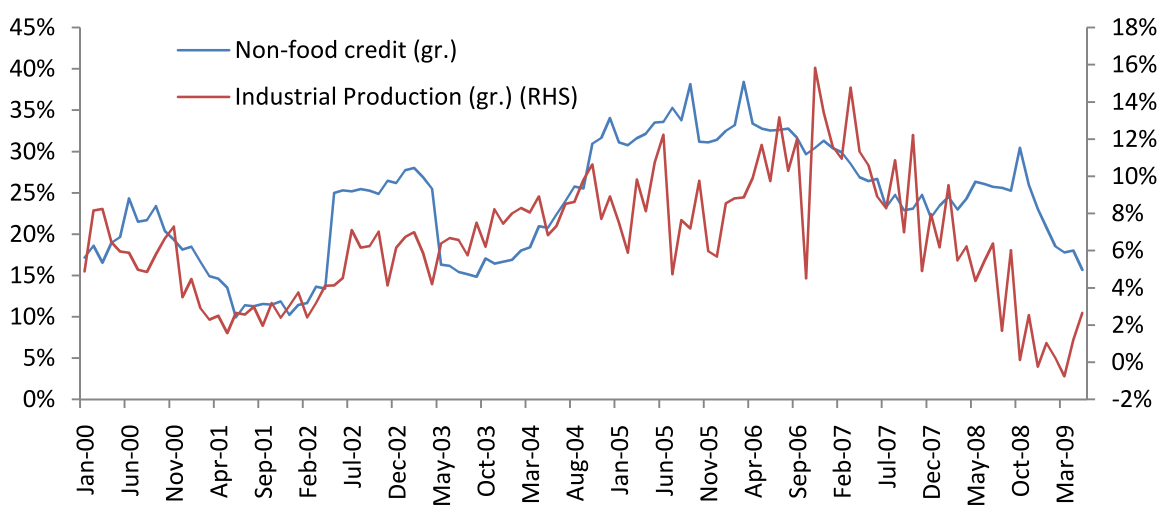
This apart, this year also, the global problems are not going to go away. Growth triggers have to be largely domestic led. But large deficit will continue to be a problem that will limit the ability of the government to pump prime. Not surprisingly, while the 11th Five Year Plan document stressed on the need to invest about Rs6000bn in agriculture during the 5-year plan period to enable the sector to record a 4.1 per cent growth, there is an investment shortfall of nearly a 3rd during the first year itself. Similarly, while recent economic survey stressed on the need to invest about 9 per cent of the GDP in physical infrastructure, the envisaged investment for the current year is less than 5 per cent. Clearly the financial constraints are showing up.

With the governmental expenditure going up (non negligible amount be wasteful in nature) big leakages from various delivery mechanisms for social projects, there have been ever decreasing allocation of resources for capital expenditure as is evident from the falling share of capital expenditure in total expenditure.



Source: Reserve Bank of India (RBI) & my calculation

Also, with domestic demand yet to rev up adequately, manufacturing numbers have been quite weak so far and, in keeping with this, credit growth has also been on a downward spiral.



Source: RBI & CSO

The falling level of investment so far will weigh down on the economy this year. The problem will be further exacerbated by weak monsoon prospects.

The market is clearly ignoring these ground realities as liquidity flows in, in search for return. Another bubble in the making?

The writer is Head of Client Operations at Infosys Technologies, India's second largest software services exporter. The views expressed here are personal

Note: The charts in this section will not be visible in the FT website since they could not upload the same in my article for some technical reason. I have added these here (which is in my original draft) for sake of better perspective