# Credible India

Valuations in the Indian stock market are stretched at the current levels. But with the country having touched the per capita milestone of US$1000, it sure is a long-term play, notes **Shankar**.

The byline of Indian tourism is 'Incredible India'. Indeed, for tourists seeking diversity, India is the place to go. However, this article will focus on the credible part of Incredible India, the markets and the country's way ahead in 2010.

India was not spared in the fallout of the global financial crisis. Its markets tanked, IPOs were postponed and real estate deals screeched to a halt. But, unlike in many other countries, there were no surprises. There were no bank collapses and no reports of corporate bankruptcy or government intervention in private enterprises. In fact, except for the Satyam Computers scam, there was hardly a ruffle. There were, of course, widespread job losses in the export sector, and real estate companies also floundered. Yet, they didn't fall.

That was then and this is now. Since October 2008, the benchmark BSE Sensex has come a long way from around 7700 to 17700 now, while most stocks are hitting all-time highs and the IPO pipeline is up and running again. Also, by buying gold from the International Monetary Fund at around US$960, India made a statement to the world that "All iz well (sic)", to borrow a quote from the latest Bollywood blockbuster *Three Idiots*.

But is everything well? It does seem so. But is it well enough to warrant a more than 100 per cent rise in stock markets? Each has his own opinion. But what are the facts on ground?

## Fundamentals

The stimulus that the Indian government announced really helped Indian industries get back on the rails, unlike some of the developed economies where the stimulus boosted the stock markets, thanks to the carry trade in the US dollar and emerging market stocks.

There are two aspects to India's growth: the growth in the GDP and the rise of the stock market indices. While growth in the GDP has been stable and almost dependable, the stock market, true to its nature, is fickle and has been all over the place.

India's GDP growth consensus for 2010 is 7.5 per cent, higher than the six per cent in 2009, which is good news. In fact, some brokerages are penning the growth at eight per cent. Many say that even the withdrawal of stimulus may not matter much, as domestic demand remains robust and export demand and pickup in investments will more than compensate for withdrawal of stimulus.

India's GDP growth is dependent on a few important factors like capital inflows, inflation and agriculture.

Risk capital flows from foreign countries provide liquidity, reduce the cost of capital and induce demand. While it is fine to have capital inflows, too much of it can be a problem. If capital inflows are above US$100 billion this year, then there will likely be higher inflation and asset bubbles created. This key driver remains a surprise element, as it depends on how the global recovery unfolds. Seeing it as it is today, however, a weak recovery in the EU and in the US means that more than normal inflows are possible.

Inflation is a risk if it moves much above the Reserve Bank of India's comfort zone of five per cent (it is currently at 7.3 per cent). There are two reasons why inflation can move up quickly. The first scenario is where industrial production rises by more than 15 per cent. If that happens, it will lead to price rises, since capacities would be constrained at that level of production rise. The increase in the price of oil can also be an issue. India imports around 80 per cent of its oil and sells it at a huge subsidy.

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With its fiscal deficit in a bad state, it cannot absorb large hikes in oil prices and would be forced to either hike oil prices aggressively (which is a contentious politically-sensitive issue) or increase borrowings (which leads to backdoor inflation).

Rising inflation is not bad for the equity markets if it is due to growth and is still within the central bank's comfort zone. If, however, it is a supply side issue like oil, then it is a negative for markets.

Agriculture remains a big wild card, since there was a crop failure in 2009 due to below normal monsoon rainfall in India. India's agrarian development is still so bad that most of the farmland is dependent on seasonal monsoon rainfall for growth of its crops. If monsoons are weak this year too, then the risk of food inflation going up is high, since food price inflation is already 19 per cent year on year. This could be a negative.

The government has provided stimulus of close to nine per cent of GDP through monetary policies and 1.8 per cent through fiscal policies (see table). Any withdrawal is likely to have an impact, too. Also, government spending remains at a


high level, and support is coming though private expenditure that has just started to pick up (see graph).

It is also notable that for the first time in the history of the country, India's per capita income has moved up to near US$1000 in nominal terms. This is considered to be the tipping point for any emerging market. China's per capital income took 25 years to move from US$400 to US$1000 (1978-2003) and zoomed to US$3000 within the next five years. In fact, all countries that went past the US$1000 mark have seen massive growth beyond the US$1000 point, including the likes of Malaysia, Thailand and the Philippines. If the per capita income growth is widespread and not concentrated, then the countries have usually followed an "S" curve of up-move that took them to a new level of growth.

## Current valuations

Market capitalisation is currently at 109 per cent of GDP. While this is the highest in the history of the country, it suggests overvaluation. In comparison, earnings yield and government bond yields are at an attractive 8.1 per cent, which could go up further. In comparison, the earnings yield of Sensex companies is at 5.39 per cent and the earnings yield-to-bond yield is also below the 15-year average, suggesting overvaluation. (Earnings yield is the reverse of PE – i.e. EPS/Price – and tells you how much yield one gets for the price.)

Return on equity has also fallen from 27 per cent in 2007 to 16 per cent currently. Yet, the markets are nearer to 2007 prices, trading at around 19-20 times earnings and at 16.9x FY11 estimated earnings for Sensex companies. With government borrowing likely to increase, thanks to the rising deficit and oil subsidies as mentioned above, an upward move in interest rates would badly hurt rate sensitive sectors, such as financials, on two fronts. One would be the slow rate of borrowing, thanks to the higher interest rate. The second would be the mark-to-market losses of treasury bond holdings that banks have in their trading and investment portfolios. There have been no major changes in earnings over the last few months to justify a further up-move in stocks.

## What to expect?

It now looks quite obvious that interest rates are likely to rise while

**Drivers of recovery: Monetary policy**

| Policy measure | Change |
|---|---|
| Reverse repo rate | -275 bps |
| Repo rate | -425 bps |
| CRR | -400 bps |
| SLR SLR | 100b-100bps |
| Actual/potential liquidity – CRR, MSS, special facilities | INR5617 billion (9 per cent of GDP) |
| Other measures: Relaxation in prudential norms, restructuring, relaxation in ECB norms, higher ceilings for NRI deposits | |

*Source: RBI*

**Drivers of recovery: Fiscal policy**

| | % to GDP | |
|---|---|---|
| Item | 2008-09 | 2009-10 |
| Tax reductions | 0.2 | 0.4 |
| Investment | 0.8 | 0.1 |
| Pay commission impact | 0.5 | 0.3 |
| Other expenditure | 0.9 | 1.0 |
| Total | 2.4 | 1.8 |
| Debt waiver | 0.3 | - |

*Source: RBI*


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stimulus will be withdrawn, at least partially. This means increasing excise duties and other taxes. While the GDP growth could be at seven per cent and even eight per cent if there are normal monsoons, market earnings are definitely not going to grow at 20-25 per cent to justify higher valuations.

Also, on the positive side, rising per capita income even in rural areas, thanks to job guarantee schemes and inclusive growth focus, has meant that a large part of the agrarian population earns 20-40 per cent income from non-agrarian sources that make it a little less vulnerable to monsoons and their dragging effect on the GDP.

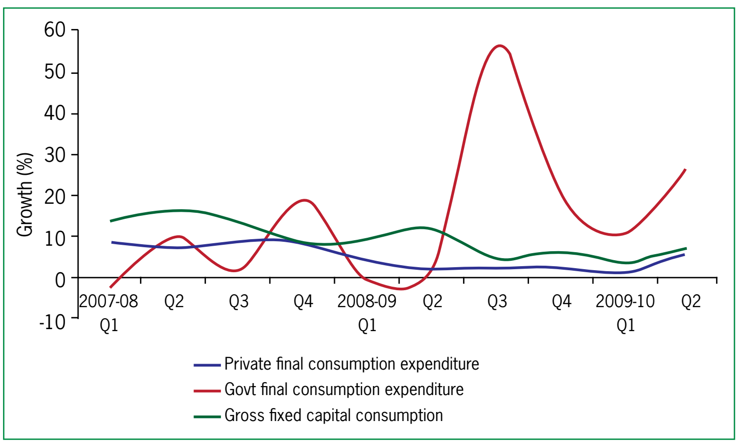
Besides, large-scale tax reforms in the cards and a general sales tax rollout make sales tax collection higher and easier to manage.

While short-term valuations look stretched, India is a long-term investment play. One can invest in tranches over the year and sit back for half a decade or more to reap rewards from a country that is truly on a growth cycle of six to eight per cent growth over the next decade and has no place to go except up.

One should not invest in India at these valuations if one is looking at double-digit returns in six months or a year. For long-term investors, one should be looking for bad news to get in during the dips. There is no doubt about the long-term potential of the economy, with its demographic dividend, working democracy, stable political scenario and even the regional chief ministers speaking more of growth and less of rhetoric.

While China is way ahead in terms of per capita income, infrastructure and just about everything else, India needs to grow on all of these fronts manifold to keep up with China. The good news is that while China's growth is top down – that is, from the political bosses to the masses – India's growth is bottom up, which makes it more attractive, since the growth cycle is hardly a couple of decades old.

This is a story like China's, but there are more open, dependable numbers. They are, of course, slower, but very much surer.

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