



# What's next for the Sensex?

The Indian capital market has its own dynamics. **Matein Khalid** makes a call on the Sensex and select Indian stocks.

India has experienced a swift bear market rally with the Sensex up 32 per cent since early March. The rally on Dalal Street was triggered by an improvement in global risk appetite metrics. The dollar yen exchange rate moved from 88 to 101 as the Japanese yen lost its role as a safe haven. The Chicago Volatility Index, the barometer of fear and greed on Wall Street, plummeted from 80 last November to 35-38 now. The Treasury Eurodollar (TED) spread, a proxy for international banking credit risk, has fallen from 460 basis points last October to 95 now, its pre Lehman Brothers failure level.

The London G-20 conclave tripled IMF loan funding to US\$750 billion, leading to a compression in sovereign credit default spreads. High beta Asian markets like South Korea, Hong Kong and India surged as emerging markets fund managers increased their allocations to the region

that offers the best growth/value calculus in the developing world.

However, the rally in Indian equities has strong country specific components too. Foreign investors (the FII's who sold US\$13 billion in the 2008 Indian equities carnage) have finally purchased net shares on Dalal Street, with FII inflows followed by almost a Pavlovian surge in local bank and life insurance institutional investor buying. It is only natural that aggressive short sellers in the Nifty derivatives markets scrambled to cover before they were wiped out. Moreover, most global fund managers were underweight India after the Mumbai terrorist assault, pre-election campaigning risk, the Satyam scandal, the offshore money market run on ICICI Bank and the concerns about the fiscal deficit/sovereign debt downgrade. So when Sensex rose above 9,000, underweight fund managers scrambled to increase their exposure

to large cap Indian equities. For fund managers with a value paradigm, it was easy to allocate to India as Dalal Street no longer commanded a growth premium to Asian emerging markets. This is the first time the growth premium has vanished since 2003.

## Downside risks

Another trigger for the rally was that Sensex earnings expectations, which had been revised downwards since early 2008, began to exhibit a modest uptick in March. In essence, at Sensex 8,000, Armageddon was priced into Indian economic data and earnings risk at a time when the lagged impact of five Reserve Bank of India repo cuts finally began to lead to a higher credit flow and lower rupee money market rate. The immediate impact of monetary easing was a modest revival in auto sales, though industrial production, exports, capex,



private consumption, tourism and FDI are still in bearish mode. Global data optimism that turbo charged the India bulls were the Federal Reserve's quant easing in the March FOMC and the Japanese/Chinese stimulus, which ignited a rally in base metals, with Dr.Copper (the proverbial weatherwave of the global business cycle) up almost 40 per cent in 2009 on the London Metal exchange (LME).

Investors should also not underestimate the impact of the start of Reliance's Krishna Godavari basin gas production on the prospects for the Indian macroeconomy. This could well add 100 basis points to the Indian GDP in fiscal 2010 with its production of electricity and fertilizers as well as its contribution to import substitution. Economics, valuations, money flow, interest rates may determine the pulse of the stock market but it is imprudent to ignore the technical charts. After all, the Nifty has now convincingly moved above its 50 day moving average for the first time since January 2008, a bullish signal for systemic traders. This is all the more significant since volume and volatility both bottomed in February, a traditional prerequisite for a bull run in

Indian equities. The oil price fall since last summer and the fall in dollar and sterling LIBOR money market rates were also a boost to the input/borrowing costs of corporate India.

However, the spectacular move on the Sensex leaves it both overbought and vulnerable to economic/political and earnings shock. Earnings growth could contract as the Indian economy contracts as metrics as diverse as tourism revenue, exports and rail freight (a proxy for domestic manufacturing), all in free fall. The Indian rupee's weakness at 50 to the dollar demonstrates weak exporter demand, modest portfolio inflows, a weak FDI and increasing concerns about the general election, the fiscal deficit and the monetization of debt.

I envisage a myriad of risks that will derail the bullish momentum on the Sensex next month. One, polls suggest neither the Congress nor the BJP will be able to command more than 150 seats in the Lok Sabha.

This will mean coalitions with regional parties are inevitable, a negative for economic reform, as the Congress-Left Front coalition proved since 2004. Two, the Indian rupee is vulnerable to crisis of confidence on the fiscal deficit, a widening current account deficit as remittances from the Indian diaspora fall, risk aversion on Wall Street and the political risks of a weak coalition government.

### Ideal entry point

It was reckless, if politically convenient, for Dr. Manmohan Singh and the Congress to waive farmer loans, increase salaries of government bureaucrats and slash service/CAT taxes as a populist, pre-election pump priming strategy. Indian public finances are a recipe for disaster as the fiscal deficit will be double digit, making a downgrade in India's (S&P) BB minus sovereign credit rating inevitable. These events could mean 53-54 on the Indian rupee even if Congress wins the election, particularly since software/IT exports and remittances will continue to fall. It is also possible that steel/cement consumption and bank credit growth were driven by pre-election pump priming and will clearly reverse in the summer, with potential for GDP estimate

downgrades. Tourism has not recovered from the Mumbai terrorist carnage and excise tax collections continue to fall.

The Sensex is not expensive at 12 times current earnings, far below its own historic five year average at 18X earnings valuation metrics. If inflation falls, the RBI could cut interest rates, making the market valuation more compelling. However, political risk, the rupee, macro weakness, the twin deficits, the sovereign downgrades and Wall Street risk aversion mean that the Sensex could have a 10 per cent sell off in the next three months. So an ideal entry point on the Sensex would be in the 9,000/9,500 range.

The ideal sectors to overweight include telecommunications and health care, which are not hostage to the global business cycle. I can envisage a range of 9,000 – 13,000 for the Sensex in the next twelve months. However, investors will face opportunities to buy on dips as elections, earnings, sovereign debt downgrade and global risk mood swings could easily trigger 1000 Sensex point profit taking. Favourite short? Hindalco, as aluminium prices on the LME are in a free fall. Favourite long? Bharti Airtel, but only below INR450 for a INR750 target.

Infosys is India's bellwether IT services share and trades as an ADR on the New York Stock Exchange under the symbol INFY. The shares have risen from 21 to 29 in the current rally. However, revenue guidance for 2010 will be sober and could well mute the optimism in current prices. The shares are not expensive at 13 times current earnings, but almost all of the company's revenues are dependent on US and European clients. Naturally, INFY benefits from the depreciation of the rupee against the dollar, Euro and the British pound sterling. However, this benefit is offset by pricing pressure as its financial clients merge or shrink. It is significant that INFY fired 2500 employees in India, an indicator that senior management does not expect a quick growth snapback. I believe that Infosys will trade in a 25 – 32 range in the next twelve months.

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