

**INDIAN ECONOMY**

# Watch out for early signs of peaking inflation and slowing growth

RAJIV DEEP BAJAJ, for Reuters

Indian equities, after recovering smartly during much of 2009 and 2010, have again started exhibiting high volatility over the last six months. At a global level, this time it is emerging markets which are leading the downside in equities. Even among emerging markets, Indian stocks have looked weaker.

Macroeconomic headwinds in the form of high inflation, fiscal imprudence, corruption and lack of investment growth threaten to dent the premium that Indian markets enjoy over their emerging market peers.

Here's a look at the various factors that can affect equities in the near future:

**GLOBAL FACTORS**

With none of the headwinds that led to the global financial crisis in 2008 being addressed properly, problems that led to the biggest recession in the last eight decades are not yet behind us. The recovery in equity markets seen in 2009 and 2010 was more due to the flow of cheap money across the globe as a part of the RISK-ON trade. However, there are several issues today that we believe can be the RISK-OFF trade surfacing back, and this will not be good for risky asset classes such as equities and commodities. The following are some of the factors -

**High inflation and rising interest rates in emerging markets**

An ultra-loose monetary policy in developed markets coupled with weakening currencies, particularly in the US, Europe and Japan, growing demand from rapidly industrialising nations such as India, China and Brazil coupled with production disruptions across the world have led to a sharp rise in commodity prices and hence inflation.

Will it continue in the future? Doubtful, because most commodity prices, particularly oil, have reached a point where they start affecting growth. Sooner or later demand supply dynamics will take precedence thereby cooling off commodity prices.

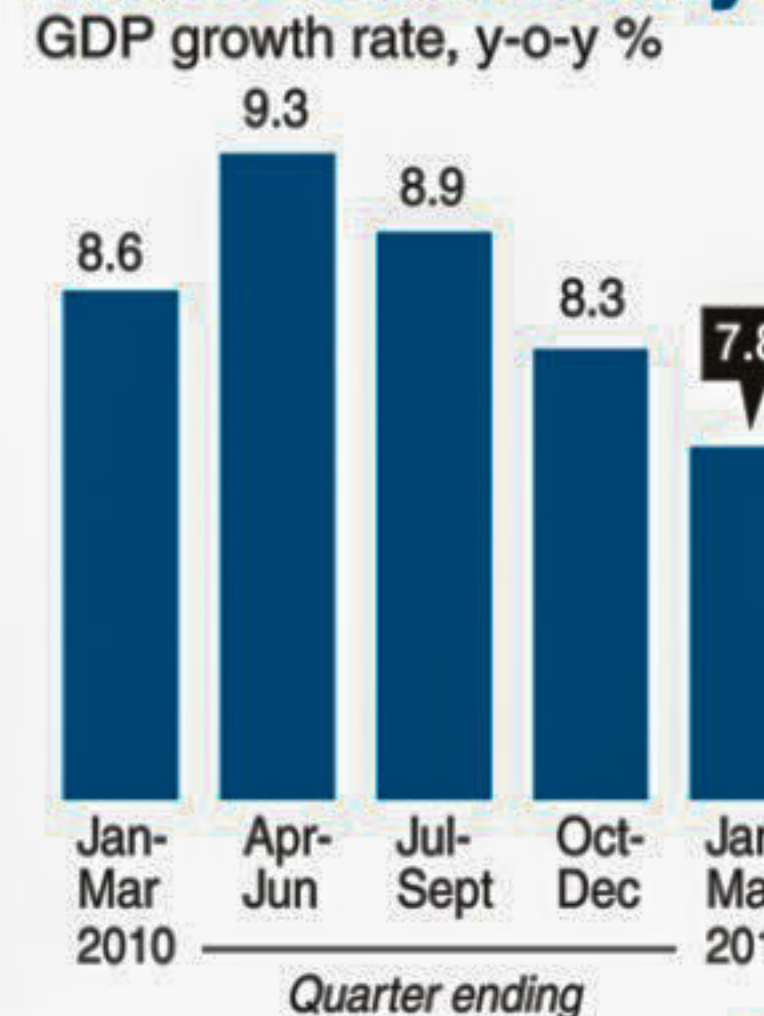
**Renewed fears on Sovereign Debt crisis in Europe**

Greece is once again on the brink of default. The difference in yields of benchmark Greek and German treasuries is at more than 13 percent. EU has failed to get consensus on another bailout package for Greece. Tremors of any untoward incident in Europe will be felt across the world, including



Indian tea garden workers pluck tea leaves in the Dagapur tea garden on the outskirts of Siliguri. Darjeeling tea, a black tea globally known for its flavour and high quality, is becoming popular in China, which is a predominantly green tea market. India's economic growth slowed to 7.8 percent in its fiscal year's final quarter as an aggressive series of interest rate hikes hit activity, according to official data.

**India economy**



could make Indian equities look attractive once again from a valuation perspective.

**Stock specific opportunities abound in the mid cap and small cap space**

Even though the leading indices are down only 12-13 pct from their 52 week highs, most stocks from the small and mid-cap space have been hammered badly. Some of these definitely look attractive from a value investor's perspective. Lot of opportunities can be found in the infrastructure, midcap IT, capital goods and engineering space. Value style equity mutual fund schemes such as ICICI Prudential Discovery Fund and UTI Master Value Fund look attractive over a medium term investment horizon.

**Key Triggers to watch out for**

Rising risk free rate of return and risk premium have raised expected returns from equities even when earnings growth is decelerating. This has led to a de-rating of Indian equities. What can reverse this? Firstly, acceleration in earnings growth, which is not possible with inflation and interest rates being where they are. Secondly, a lower risk free rate of return (i.e. interest rates). Both of these are not possible unless interest rates come down. What can bring interest rates down? Lower inflation or significant erosion in growth momentum! One should keenly watch for early signs of a peak in inflation or dent in growth.

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India, as it will give rise to the Risk-Off trade globally.

**End of QEII in the US and failure to enhance the debt ceiling of \$14.3 trillion**

An anticipated end to QEII in the U.S. might result in a temporary reversal in liquidity flows affecting the so-called risky asset classes. Also, the U.S. Congress has, till date, failed to get a consensus on increasing the \$14.3 trillion ceiling on debt, in the absence of which, the U.S. might default on its debt, the repercussions of which are still unfathomable.

**Crisis in the MENA region and higher oil prices**

High oil prices adversely affect growth across the world. The rise in oil prices due to geo-political reasons, even when the global recovery is on shaky grounds, is a double whammy. Longer the oil prices stay at elevated levels, higher the chances of a double dip.

**DOMESTIC FACTORS**

**High inflation**

High inflation and rising interest rates remain the biggest domestic

headwind for equities. The sharp rise in interest rates (risk-free rate) has led to a sharper rise in expected returns from equities as the risk premium has risen due to higher volatility thereby leading to a de-rating of stocks.

Moreover, higher input costs and high interest rates have dented the profitability of corporates. High interest rates deter investments. The hawkish stance of the central bank indicates more rate hikes might be in the offing and growth might simply suffer.

**Slowing growth**

Manufacturing growth has weakened substantially. Real GDP growth for Q4FY11 is below expectations at 7.8 pct. Moreover, growth in FY11 has primarily been led by acceleration in agriculture. Manufacturing and services sectors have instead seen a deceleration in growth. Growth in investments (gross fixed capital formation) has also come in at a mere 8.6 pct in FY11. During FY06, FY07 and FY08, it used to average around 14-15 pct p.a. Equities seldom do well when growth is decelerating.

Also, robust GDP growth does not

always mean higher corporate earnings growth particularly when interest rates, input costs and taxes are rising. Earnings growth for Q4FY11 as well as FY11 as a whole has been below expectations. The trend might continue in FY12, unless inflation and interest rates ease off.

**Relatively Expensive Valuations**

Indian equities are already in the Underweight list of many global investors, primarily due to high inflation, fears of further rate hikes and slowdown in growth as well as relatively expensive valuations as compared to other emerging markets. Inflows from overseas are likely to remain volatile in the near term.

**Do we expect a meltdown in Indian stock markets?**

No. Valuations of Indian stocks, if not cheap, are not very expensive either. The BSE Sensex is trading at approx. 16-16.5 times its one year forward EPS -- in fair value plus zone, but definitely not a bubble. A price correction of 12-15 pct from these levels or a time correction of say 6-9 months or a combination of both

**US ECONOMY**

# Stalled economy, less stimulus ahead

REUTERS, London

Nearly half way through the year, 2011 is looking remarkably like 2010 -- markets in the doldrums and the stability of the global economy in the balance.

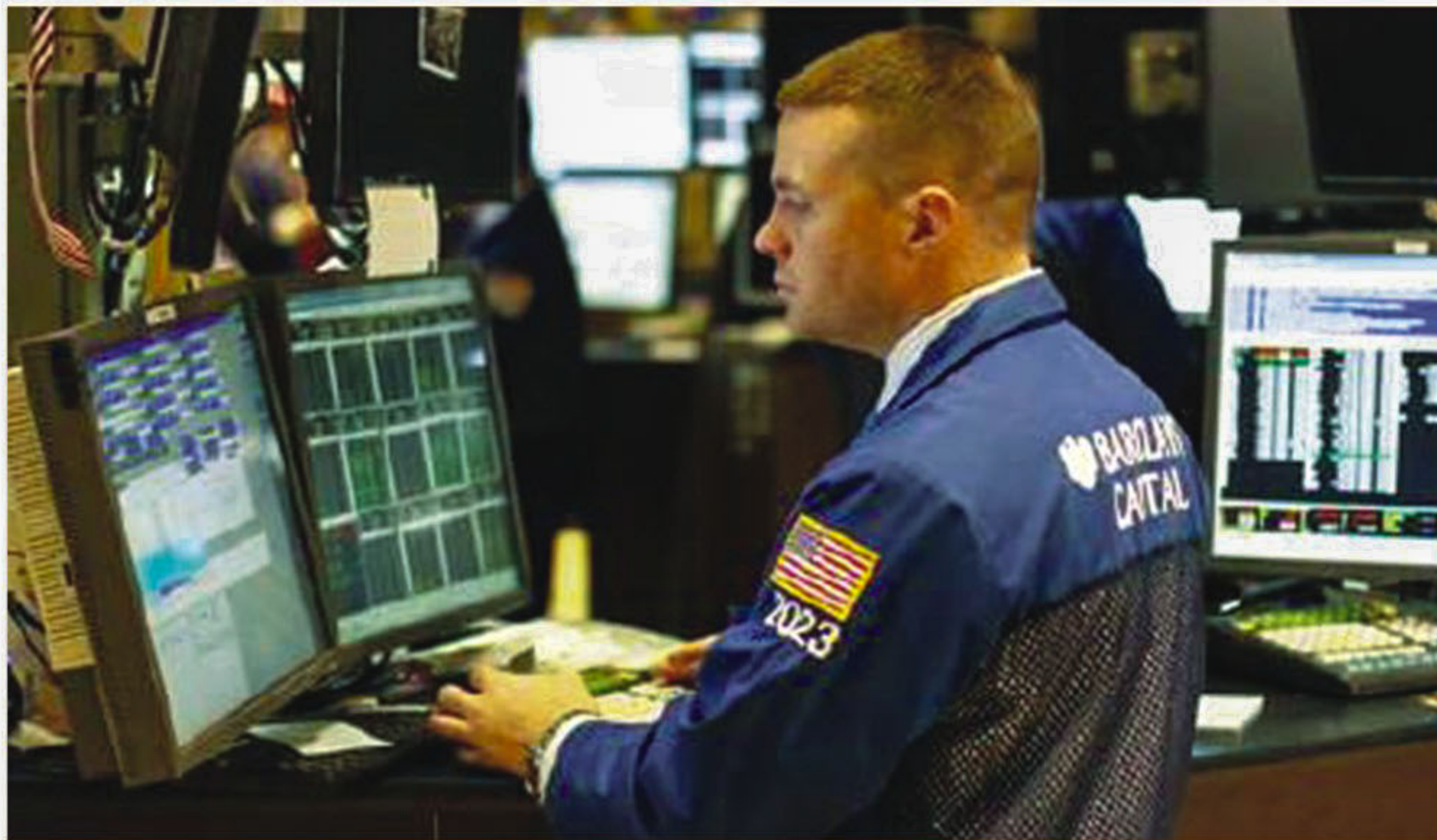
Last year, the US economy gave up the ghost around mid-year and markets swooned, prompting the Federal Reserve to step in with another huge infusion of money that triggered one of the biggest global rallies in risky assets in recent times.

The odds are neither event happens this year, but the same questions are being chewed over by investment analysts -- many of whom will be visiting Reuters bureaus in the coming week for the Reuters Investment Outlook Summit.

Is the global economy just stalled or about to tip over? Will turning off the stimulus taps make things worse, or can it stand alone? Are governments too broke to make it right? Is inflation in the pipeline? Are private firms in good enough shape to overcome the macro headwinds?

What has been different to 2010 has been the scale of leftfield events markets have had to navigate in the first half.

Huge damage to the world's third-largest economy, Japan, from a 1-2-3 earthquake-tsunami-nuclear collapse was not in any of the 2011 outlooks.



A trader works on the floor of the New York Stock Exchange.

Nor was a fast-rising oil price triggered by popular rebellions across North Africa and the Middle East.

Other headwinds -- notably a sluggish US economy, a stubborn euro zone debt crisis and an end to extraor-

dinarily easy monetary policy -- might have been more expected. But perhaps not their strength.

The result? World stocks as measured by MSCI are up only around 3 percent for the year-to-date, with

emerging markets flat.

Meanwhile, bonds -- outside of some wonky peripheral euro zone ones -- have not sold off in any meaningful way despite offering little in the way of yield.

Ten-year US Treasuries have returned around 5 percent, only slightly less than the MSCI index when dividends are included.

The key for investors now is that it is by no means clear that the headwinds currently facing them are about to dissipate.

The latest Reuters asset allocation polls reflect this strongly.

Percentage holdings of equities were at their lowest level since August last year while exposure to traditionally safer bonds and cash was the highest since September.

Although struggling, stock markets have actually been doing better so far in 2011 compared with the same period last year.

But the second half of 2010 embodied both strongly improving corporate earnings and a huge stimulus from the Federal Reserve in the form of its asset-buying quantitative easing (QE) programme.

Both of these stimuli are ending. QE is due to wrap up at the end of the month and earnings growth is falling back to solid, but unspectacular levels.

Thomson Reuters Proprietary Research finds fourth-quarter 2011 earnings growth estimates for the S&P 500 index at 14.4 percent. By contrast, actual growth in last year's fourth quarter was 37.2 percent.

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