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Of U, V, W and see saw

After the panic hangover, the macro improvements and strengths of corporate India will represent a compelling case for equities

Houses are burnt down and cars set ablaze. Hordes of people are badly injured and screaming. Streets are stained with blood. The villain has been killed. With fire and rage in his eyes, a badly beaten up hero walks. The movie ends and the audience applaud.

It is only in movies that 'The End' happens abruptly, with the death of the villain. In stock markets, as in real life, the story goes on. And deals with the worries that the reconstruction after trauma is painful, arduous and needs, above all, time.

The villain of the markets – oil – has been vanquished. From a peak of $147, it is now in two digits. The villain's henchmen – inflation and interest rate – are weakening. The hero – growth – is badly bruised. This scenario compels me to two conclusions: things will get worse over the next six months before they get better; and things will become as good as ever in 15 to 18 months.

Let me present my case on why things will get worse in the near term. In January 2008, the first correction was attributed to the subprime crisis blow out and India joining the rest of the emerging markets to correct it. The ferocity of the correction – 28 per cent on the Sensex – created the hope of a 'V' shaped recovery; which indicates a sharp fall and an almost instant sharp pullback. There was an expectation around Budget 2008, in vain. The March 2008 correction on the back of the Bear Stearns bail out was about 19 per cent – and a January to March correction of 31 per cent. It appeared that the worst was over, and a 'U' shaped recovery possible: an extended bottom before pullback to earlier levels.

When oil skyrocketed and inflation/interest rates surged, the Sensex fell 23 per cent in June-July 2008, bringing the y-t-d fall to 40 per cent. During these periods, markets did rally and suggested a 'W' shaped recovery process. In September, the market has fallen a further 8 per cent (up to 15 September) and y-t-d 33 per cent. It is only now that the focus has shifted to the hero - that growth would be impacted. We have moved from a state of denial to acceptance.

Global appetite for equity risk is low. Fear reigns high around problems in the US - financial institution meltdowns and a beleaguered US housing market. Therefore, the pressure on global investors to reduce exposure continues.

In India, we have a classic khatta meeta – a delicacy that is both sour and sweet. The big influencers of a macro situation have improved dramatically. Oil, in the lead, and other commodities have peaked off and the down cycle benefits India. Interest rates peaked ahead of inflation – both these variables have headed south. But, inflation rates can only drop to a single digit when the base year effect changes – unlikely before February 2009. And the impact on earnings growth - which was estimated at a robust 20 to 22 per cent at the start of this year – is now down to 12 per cent, though I believe it is more likely to be 14 to 15 per cent.

Daily movements of markets are based on news and events. And such movement over the near term is marked by high volatility. The Sensex has risen to 35 per cent over the past year, against a five year average of 26 per cent. We will see knee-jerk reactions to bad news flows, as fear and pessimism reign supreme. But, after the panic hangover, the macro improvements and intrinsic strengths of corporate India represent the long term compelling case for Indian equities. The see saw effect will continue.

The structural factors for India's growth remain unchanged. A $1 trillion plus economy is growing at 7 per cent at least. Add to it a young middle class population hungry for consumption. Infrastructure leaves a lot to be desired – pressing the case for capital investment, conservatively estimated at $500 billion over 10 years. India's strength as an English speaking knowledge centre is proven. These factors are known. It's a matter of 'when' and not 'if'.

For the story in the markets to come to fruition, a few factors are important. 'Vijay' (the legendary hero of Hindi movies) owed his success to his mother. For growth, the government has to play that mother's role and reforms' Version 2.0 is long overdue. It also requires discipline in fiscal and monetary measures that takes the short-term pain for long-term good. Mother India is known for her sacrifices!

The next set of reforms requires political will and decisiveness - and hopefully, the next elections will throw up a decisive combo to accelerate this. The worry, meantime, will be: who will that next 'mother' be – Nirupa Roy or Lalita Pawar? Keep watching the movies. ♦