

INVESTMENT MATTERS

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Of Worry Walls and Headwinds

The Indian markets over the last three weeks have had to portend with global worries – triggered by a single day 8% correction in the Chinese markets, the strengthening of the Yen and hence fears of unwinding of the Yen carry trade and the potential negative impact of the US sub-prime lending failures. Simultaneously we have had to deal with domestic headwinds in the form of rising inflation and hence an activist government resorting to micro tinkering in order to douse the inflationary fires, an insipid and uninspiring budget and the recent difficulties the state governments are facing in actualizing our SEZ policy. All these factors have coincided in just three weeks giving the Indian markets a distinction of being one of the worst performing emerging markets in 2007. Coming to the global factors first, there is no doubt that we are living in times where significant global economic and financial imbalances exists –the yen carry trade, the overleveraged US consumer, widening US trade deficit specifically with China, slowing US economy, the weakening of the US dollar, overheating in China to name a significant few. Strategists, economists, market historians and money managers have been warning us of the negative impact these factors could pose for global equity markets. How, when and in what form these factors would play out is very difficult to judge. But because a high correlation between the US and emerging markets still exists, any turbulence caused by some of the factors mentioned above will undoubtedly have an impact on our markets as well. In fact, if emerging markets in general and India in particular are truly in a “structural and secular bull market”, it would be interesting to see how they survive the periodic shocks and challenges that they have been experiencing thus far and may experience in the future as well. One of the significant technical traits of markets which are in a secular bull phase is that they seldom trade below their 200 day moving average on a sustained basis (though they do occasionally come close to it). This can be seen from the charts of the US (1990-2000) and Japanese (1980-89) bull markets.

Dow Jones 1990-2000



Nikkei (1980-89)



Similarly if we look at the performance of the emerging markets in general and India in particular from 2003 onwards, we see that they have also thus far traded above their respective 200 DMA's except for a short period in 2004 and 2006 when most emerging markets experienced significant corrections. But given that emerging markets have a strong correlation to developed markets and are significantly more volatile, it is very much possible that they undershoot the 200 DMA for short periods – 4 months during 2004 and 3 months during 2006.

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MSCI Emerging Markets Index



Sensex



On the domestic front the mood has turned more somber and circumspect as politics begins to interplay with economics, but that in a democratic and diverse country like India is to be expected. Whenever, the markets tend to trade at the lower end of its band, pessimism creeps in. People are already beginning to price in lower GDP and corporate profitability growth and zero reforms until the next general elections. While there is no denying that we are currently experiencing challenges and headwinds both on the domestic and global fronts, in our assessment the hard circumstantial evidence seem to suggest that the long term fundamentals viz – economic growth (8-9%), corporate profitability (20%) & productivity the investment plans of both the public as well as the private sector are still very much intact. Our interaction with company managements across the board suggests that there is no let down in their assessment of the growth opportunity and their investment plans are largely ring fenced from any short term challenges.

MSCI Emerging Markets Index: Sensex

From a portfolio strategy perspective we were well prepared with reasonable levels of cash going into the correction and also steered clear of interest rate and inflation sensitive sectors like – banking, cement and auto's. I think the markets are well liquidated and are now trading around their long term historical average of 14.5-15X one year forward earnings. I believe that the markets should hold the current levels 12400-12600 levels unless there is fresh round of sell off in the global markets. We see this correction as an opportunity to build the portfolio with our long term, high conviction ideas.

India Historic P/E Chart

