

The Big Picture

28th January 2012

On a Perch ...

Performance

The Indian Markets rebounded sharply from their December lows to rise by over 10% in the wake of continuing macroeconomic uncertainties and tepid corporate earnings performance. This rally was on the back of a global rally spurred by increased liquidity infusion by the European Central Bank and with the Federal Reserve continuing loose monetary policy. As a result, Nifty valuations have risen from slightly under-valued level to average level.

Tepid Corporate Earnings

Based on Q3FY12 earnings available till date, earnings have grown by 1.3% q-o-q and 10.1% y-o-y. We expect Q4FY12 earnings growth to further decelerate to 7-8% (y-o-y). Sales however continued to grow at a robust 21% and Net Profit Margins fell by 40 bps to 12.2%.

Declining Investment Attractiveness

The shrinking profit margins are a good reflection of the underlying weakness of earnings - this trend has been in force for 4 years now and is likely to extend into the next 4 quarters.

During the same period, Earnings/Book-Value reduced from 27.5% (in 2007) to a meager 16.5% currently, which indicates a structural problem of declining profitability of existing businesses. These perhaps have a greater bearing on decreasing investments and capital formation rather than interest rates and liquidity.

Pigs flying over Mint Street

The Reserve Bank of India had been pursuing a tightening monetary policy from March-2010 in response to elevated inflation levels, raising the benchmark Repo rate to 8.5%. However, while they signaled a pause in this policy in December-2011, last week they have changed course and cut the Cash-Reserve-Ratio by 50bps. While the case for a pause in the tightening cycle was compelling in the light of weakening growth, a change of stance at this point is both premature and baffling.

Inflation, which has been more than 9% for the last 15 months and at 7.5% currently, has been consistently higher than RBI's own 'comfort level' of 5-6%. During the course of this tightening cycle,

Chart 1: 1-year Growth in Nifty



Chart 2: Corporate Earnings Growth

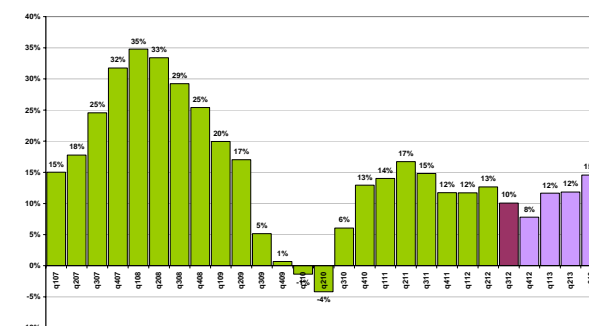
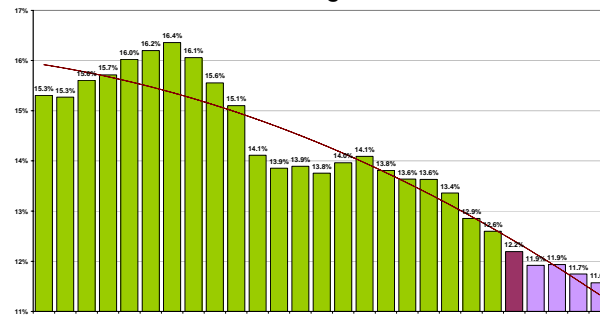


Chart 3: Net Profit Margins





manufacturing-inflation has actually risen from 5% to over 7%. Though food-inflation has declined from 20% to flat rates, there is evidence that it might have bottomed out. With increased global liquidity, commodities have been rising which will put further pressure both on inflation and the current account deficit.

Though our earlier assessment was that inflation would fall to 6-7% through the course of CY2012, it now appears that inflation could still stay above 9% and even touch 10% if inflationary expectations are elevated. If that were to happen, then the RBI would have to change their stance (yet again) and tighten rates further or keep rates high for a longer period of time - so the growth that they are trying to stimulate now would be at a greater risk in the future.

In December-2010, we had written that *“Reserve Bank of India’s sluggish reluctance to rein in inflation (which is at a 14-year high, is at best perplexing and at worst seriously damaging.”* It now appears that RBI’s change of stance will make worse a bad situation that was getting better.

No Quick-Fix

It is always been our belief that new investments and capital formation are primarily a function of financial attractiveness such as return on capital rather than on liquidity or cost of capital. One only needs to look at the US economy since 2008 where there has been unprecedented liquidity infusions and historically low interest rates - net private investment has been negative since 2008 and is now around -6%. Investment cycles, more often than not, are cyclical in nature and thus immune to policy.

Outlook

Though the Nifty bounced smartly from over-sold conditions, this is likely to be transitory and is likely to give back all its gains over the course of the first quarter. Both the earnings picture and the macroeconomic situation do not support a case for a long-term bottoming of the markets.

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Chart 4: RBI Repo Rate

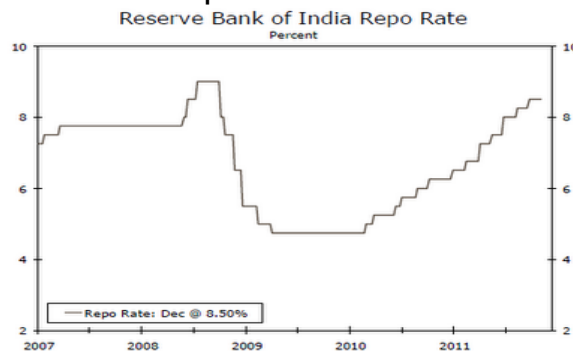


Chart 5: Inflation Rates

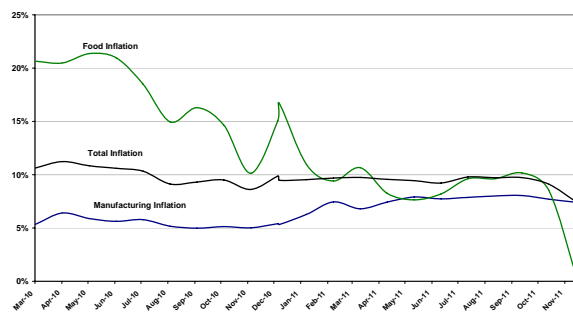
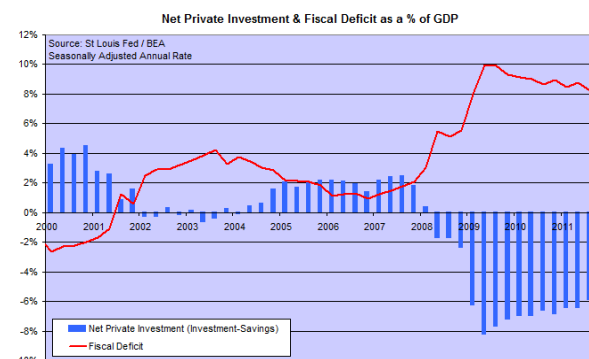


Chart 6: US Net Private Investment





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