Policy push needed for the next leg up

Indian equity market would need domestic triggers to sustain the liquidity-driven rally

March cluttered with events—poll results, budget, RBI policy: This March has several key events like election results (March 6, 2012), the Reserve Bank of India (RBI)'s policy review (March 15, 2012) and Union Budget (March 16, 2012) in addition to the usual liquidity pressure driven by the advance tax payment. The high turnout in the Uttar Pradesh elections and media surveys suggest a possible gain in vote share by Samajwadi Party (SP) and Congress Party at the expense of the ruling Bhahujan Samaj Party (BSP), which could lead to an alliance of the Congress Party and SP at the state level and a possible extension of the same at the Centre. This would reduce the ruling United Progressive Alliance (UPA)'s dependence on Mamata Banerjee's Trinamool Congress (TMC) and enable the government to push forward reforms. Though no fireworks are expected from the budget, the key triggers to watch out for are: a credible roadmap for fiscal consolidation and some definitive steps to boost the investment cycle.

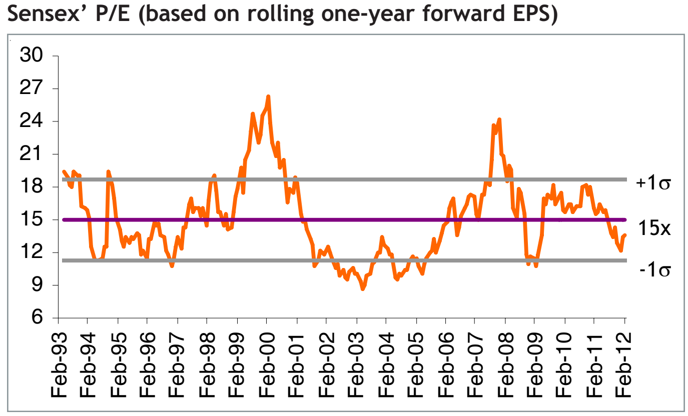
Inflation and economic growth moderate sharply but firm crude prices cast a shadow on the trajectory of monetary easing by RBI: The sharp run-up of 17% to $125 per barrel in the crude oil prices since January this year, fuelled by the rising geopolitical tensions and easy liquidity conditions globally, has brought back the fears of its damaging impact on inflation and economic growth globally. India's dependence on imports for its crude oil needs and lack of reforms in its oil sector make it more vulnerable in such a scenario and could result in the reallocation of funds by foreign investors away from India to resource-rich countries (like Brazil, Russia, Indonesia) within the emerging markets. Moreover, the RBI could delay the much-awaited policy rate cuts in view of the inflationary pressure emanating from the rising crude oil prices.

Q3 earnings growth below expectations but pace of earnings downgrades slowing down: While the Q3FY2012 earnings growth was in low single digits, the revenue growth momentum remains strong driven by a healthy growth in volumes, better price realisation and a favourable currency. Since April 2011 the Sensex' earnings estimates have been downgraded by 7.5% and 14.8% for FY2012 and FY2013 respectively. But the pace of the earnings downgrades has slowed down considerably with a marked improvement in the earnings upgrades/ downgrades ratio in the third quarter of FY2012. However, the revival in the corporate earnings upgrade cycle is possibly still a couple of quarters away and would depend on the RBI and the government's policies.

Short covering blip behind us; fundamentals would come to fore again: The BSE small-cap index appreciated by 25% compared to the 14% upmove in the benchmark indices. The short covering in view of the surge in the market has resulted in more than 50% rise in many debt-laden high beta stocks. This has provided an opportunity to churn portfolios in favour of quality stocks, not necessarily from the defensive sectors. With the technical blip behind us, we expect the fundamentals to come to the fore again.

Need policy push for further re-rating of multiples: After the recent run-up, the Sensex' valuations have expanded from around 12x to close to 14x FY2013 earnings estimate which is close to its long-term average multiple. The global scenario is much more conducive now with the injection of huge liquidity through the Long-Term Refinancing Operation (LTRO) in Europe and improving economic data points in the USA. However, for the liquidity-driven rally to sustain, there is a need for domestic triggers in the form of adequate support from the government policies (in power, infrastructure, subsidy, foreign direct investment [FDI] etc) accompanied by monetary easing from the RBI. Our base case assumption is a likely consolidation phase around the current level before another leg of the rally unfolds.

Sensex' P/E (based on rolling one-year forward EPS)



Source: Bloomberg

March—big events awaited (poll results, budgets, RBI policy)

Several events like Union Budget, state assembly election results, Railway Budget and the RBI policy review will fall in March this year, thereby making it a crucial month for the market. Apart from that, liquidity will remain exceptionally tight due to the advance tax payments and credit disbursal by banks. Since the market has rallied substantially ahead of these events, investors would be looking at these events for future course of the market. While the election outcome will determine the strength of the government in pushing through reforms, the budget will throw light on the means and measures to contain the twin deficits. The expectations from the RBI's policy have come down in the wake of the high crude prices and the market may take solace from a likely cut in the cash reserve ratio (CRR) in the coming monetary review.

Events in chronological order

Date	Events
06-Mar-12	Election Results
12-Mar-12	IIP
14-Mar-12	Inflation
14-Mar-12	Rail Budget
15-Mar-12	RBI mid-quarter policy review
16-Mar-12	Union Budget

Political permutations will shape the market

The poll results will be out for five states (Uttarakhand, Punjab, Goa, Manipur and Uttar Pradesh, which is the most crucial state among these) on March 6, 2012. The high turnout in the Uttar Pradesh polls in all the six phases indicates trouble for the incumbent BSP government which will either benefit SP or the Congress Party. Further, most of the opinion polls, surveys etc indicate the possibility of a hung assembly in Uttar Pradesh with no single party likely to get a majority. In such a case, three scenarios are possible: (1) an SP-Congress alliance; (2) a BSP-Bharatiya Janata Party (BJP) alliance; and (3) mid-term polls. The SP-Congress alliance will be positive for the market as the alliance could be extended at the Centre and would aid in the passing of some of the controversial bills even without the support from the TMC. The BSP-BJP alliance would further consolidate the opposition against the government and affect the key decisions which would be perceived as a negative by the market.

Possible combinations (SP-Congress, BSP-BJP)

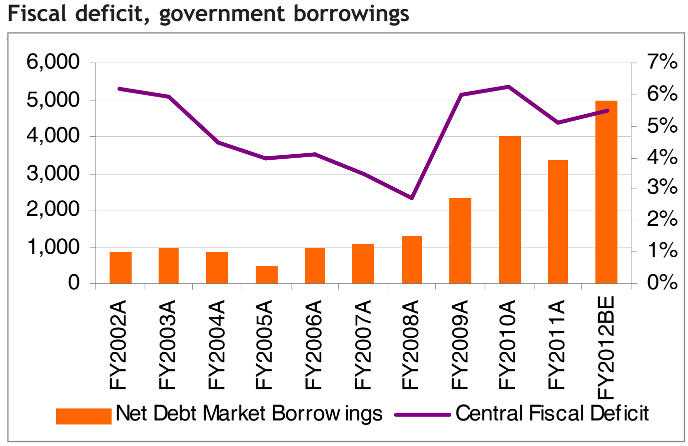
States	Poll dates	Verdict
Punjab	Jan 30, 2012	Mar 6, 2012
Uttarakhand	Jan 30, 2012	Mar 6, 2012
Manipur	Jan 28, 2012	Mar 6, 2012
Uttar Pradesh	Feb 8-28, 2012 (in 7 phases)	Mar 6, 2012
Goa	Mar 3, 2012	Mar 6, 2012

Source: Election Commission of India

Union Budget—likely to address fiscal deficit and growth concerns in a limited way

The Union Budget, to be tabled in the parliament on March 16, 2012, will throw light on fiscal management amid high pressure on the expenditure side (food security, subsidies etc). We do not foresee any path-breaking measures except for some initiatives on increasing the indirect taxes, such as customs duty, import duty and services tax. Given the limited flexibility on the revenue side, the fiscal consolidation will hinge on disinvestment and collections from the 3G auctions. Therefore, the market would look on the fiscal deficit estimate and the borrowing target that would shape the RBI's policy, and the reforms announced will be taken very positively by the market.

Fiscal deficit, government borrowings

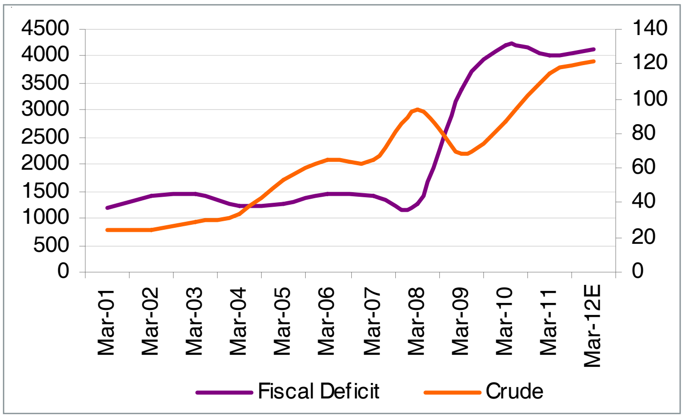


Source: Economic Survey

RBI's monetary action hinges on fiscal roadmap to be given by the government

The market has rallied based on the indications of the RBI cutting rates against the backdrop of a slowing growth and the peaking of inflation. However, the RBI in its third quarter policy review had clearly articulated that reduction in policy rates would depend on credible action from the government on the fiscal deficit front and allaying of the inflation fears. So inflation continues to be an issue due to the increase in the crude oil prices while fiscal deficit will remain high contributed by the lumpy expenditure budget. This could actually delay the much awaited repo rate cut and we expect that to happen not before April 2012. Therefore, in the budget the government will try to address the concerns on fiscal deficit and promote the investment activity in the economy.

Fiscal deficit and oil prices

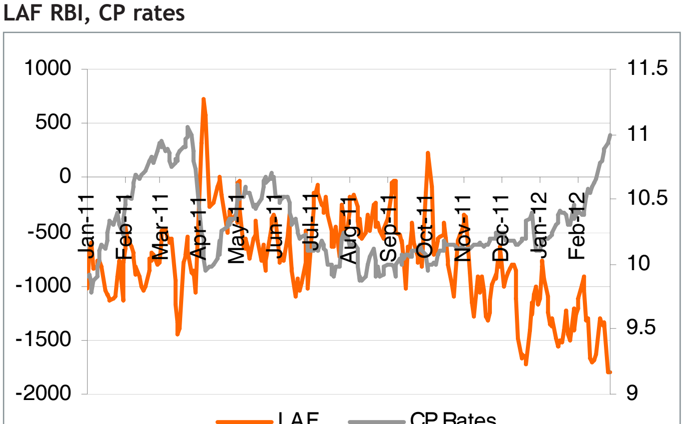


Source: Ministry of Finance, Bloomberg

Acute liquidity shortage (advance tax, capital mop-up) will lead to CRR cuts

The borrowings from the liquidity adjustment facility (LAF) window of the RBI have increased to Rs1.9 lakh crore (as on March 1, 2012) compared to the RBI's target of about Rs60,000 crore. This indicates an acute liquidity crisis which has fired the short-term rates and may affect the smooth functioning of the market. The current crisis has been driven by a rise in disbursement by banks, a slower deposit growth and highter government borrowings. Going ahead, the initial public offering mop-ups (through divestment of ONGC etc) and advance tax payments could further strain the liquidity. Therefore, the RBI could ease the CRR or the statutory liquidity ratio (SLR) to address the liquidity issues in the March mid quarter policy review.

LAF RBI, CP rates

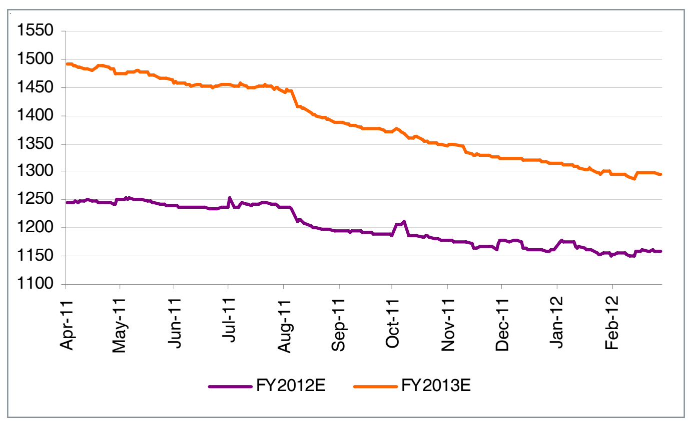


Source: Bloomberg

Earnings growth yet to pick up but downgrades bottoming out

While the Q3FY2012 earnings growth was in low single digits, the revenue growth momentum remains strong and exceeds the estimates. So for the past three quarters the top line growth has been expanding even on a sequential basis whereas the rising input cost and interest cost are hurting the profitability. The other contrasting thing seen in the Q3FY2012 results is the significant drop in the downgrades which indicates a likely peaking of the downgrade cycle. Since April 2011 the Sensex' earnings estimates have been downgraded by 7.5% and 14.8% for FY2012 and FY2013 respectively. This suggests the factoring of the imminent concerns and the bottoming of the downgrade cycle which augurs well for the market. However, the revival in the corporate earnings cycle is possibly still a couple of quarters away and would depend on the RBI and the government's policies.

Sector-wise earnings growth in Q3FY2012, earnings estimate downgrades and upgrades

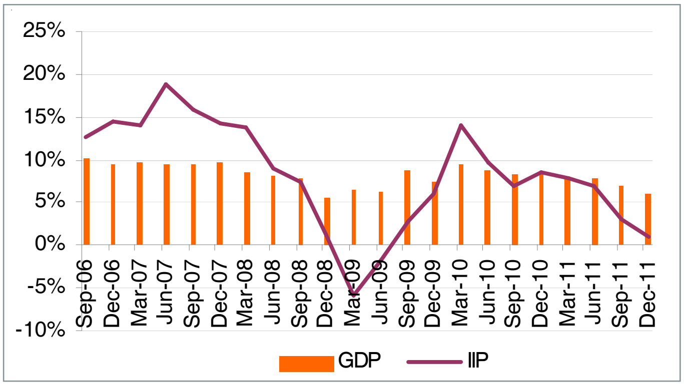


Source: Bloomberg

Macro indicators suggest sluggish recovery

Macro data remains weak as the gross domestic product (GDP) growth has decelerated to 6.1%, the lowest in ten quarters, while industrial production is growing in low single digits. The weak core sector numbers (in January 2012) and a secular decline in the fixed capital formation remain causes for worry as the same would affect the investment activity in the economy. The 7% growth targeted for FY2012 and the target of around 7.5% growth for FY2013 seem to have been factored in by the market but the downside risks are more than the upside risks. This requires the government to focus on structural problems like the easing of the supply-side constraints to tackle the price pressures and fiscal consolidation.

GDP IIP, fixed capital formation

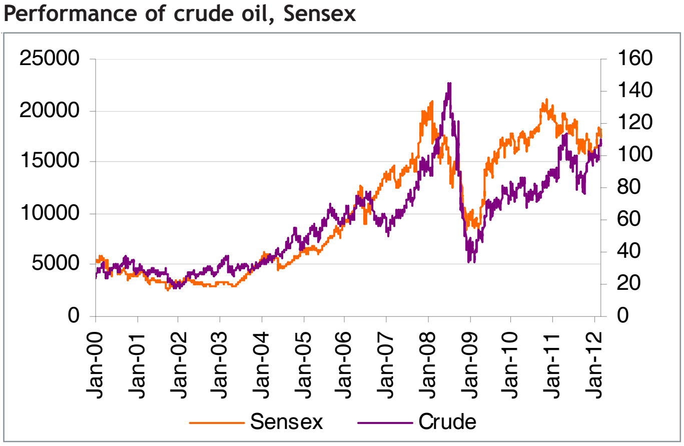


Source: Bloomberg

Rise in crude prices raises macro concerns

The crude oil prices have appreciated by almost 17% in the year till date (YTD; about $125 per barrel) fueled by global liquidity. The rising crude oil prices will feed inflation and the RBI may delay the unwinding of the monetary tightening policy which will weaken the market sentiment. Further, the rising crude oil prices would derail the global recovery that is already quite fragile and would affect our export scenario. India is more sensitive to a rise in crude oil prices as the same will increase the input cost and feed inflation especially in H2FY2013 when the high base effect will wane. Further, this will delay the easing of the interest rates by the RBI, thereby affecting the economic recovery and the outflow of funds.

Performance of crude oil, Sensex

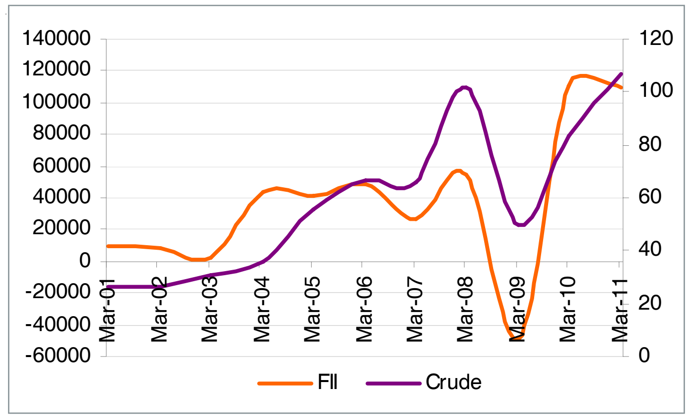


Source: Bloomberg

FII flows—so far so good

Led by an influx of liquidity on account of the LTRO the market has appreciated sharply. In 2012 so far the foreign fund flows in equities have been to the tune of $7.3 billion compared with -$512 million in the entire CY2011. The flows have been relatively higher on the debt side compared with equity. Going ahead, the foreign institutional investor (FII) flows would be supportive and will be aided by LTRO II of around $713 billion. In the event of sustained firmness in crude oil prices there could be a shifting of foreign investors' allocation to the other resource-rich countries (like Brazil, Russia, Indonesia) within the emerging markets.

FII inflows and crude prices

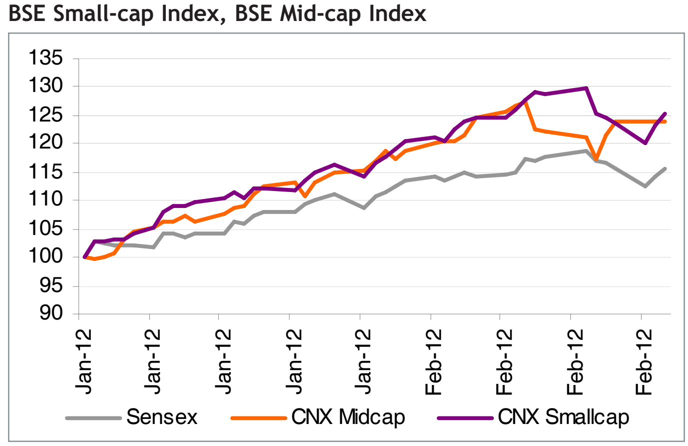


Source: Bloomberg

Short covering blip behind us: fundamentals would come to fore

The CNX Small-cap Index has rallied 24% while the CNX Mid-cap Index has climbed 26% YTD compared with the 13% appreciation in the benchmark indices. The CNX Mid-cap Index, which had reached the lows of 6,095, bounced back driven by the short covering of high beta stocks, indicating the factoring in of the imminent concerns. Individual stocks have risen by as much as 50% in the first two months of CY2012. This has provided an opportunity to churn the portfolios in favour of the quality stocks and avoid the debt-laden mid-cap/small-cap stocks. Since the technical blip is behind us, we expect the fundamentals to drive the stock valuations going ahead.

BSE Small-cap Index, BSE Mid-cap Index

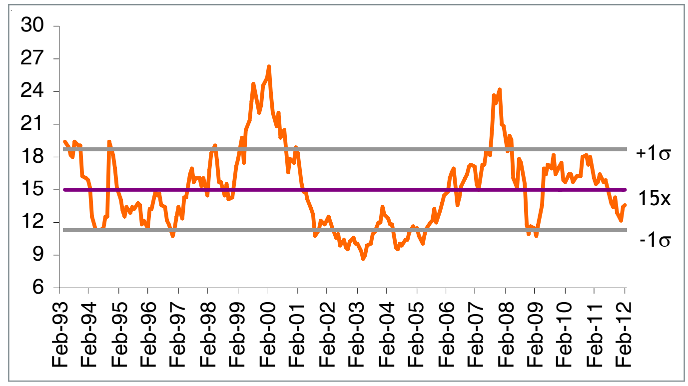


Source: Bloomberg

Valuations

The Sensex' valuation has expanded to about 14x one-year forward earnings and the benchmark index now trades closer to its long-term mean of 15x. The global scenario is much more conducive now with the injection of huge liquidity through the LTRO in Europe and the improving economic data points in the USA. Barring a few blips on account of events like budget or election results, the fundamentals would come to the fore again. However, for the liquidity-driven rally to sustain, there is a need for domestic triggers in the form of adequate support from government policies (in areas of power, infrastructure, subsidy, FDI etc) accompanied by monetary easing from the RBI. Our base case assumption is that the market would consolidate around the current level before another leg of the rally unfolds. The consolidation phase could provide entry points for the fence-sitters (investors waiting on the sidelines) who have missed out on the initial phase of the rally.

Sensex' P/E (based on rolling one-year forward EPS)



Source: Bloomberg

Sharekhan Limited, its analyst or dependant(s) of the analyst might be holding or having a postition in the companies mentioned in the article.