

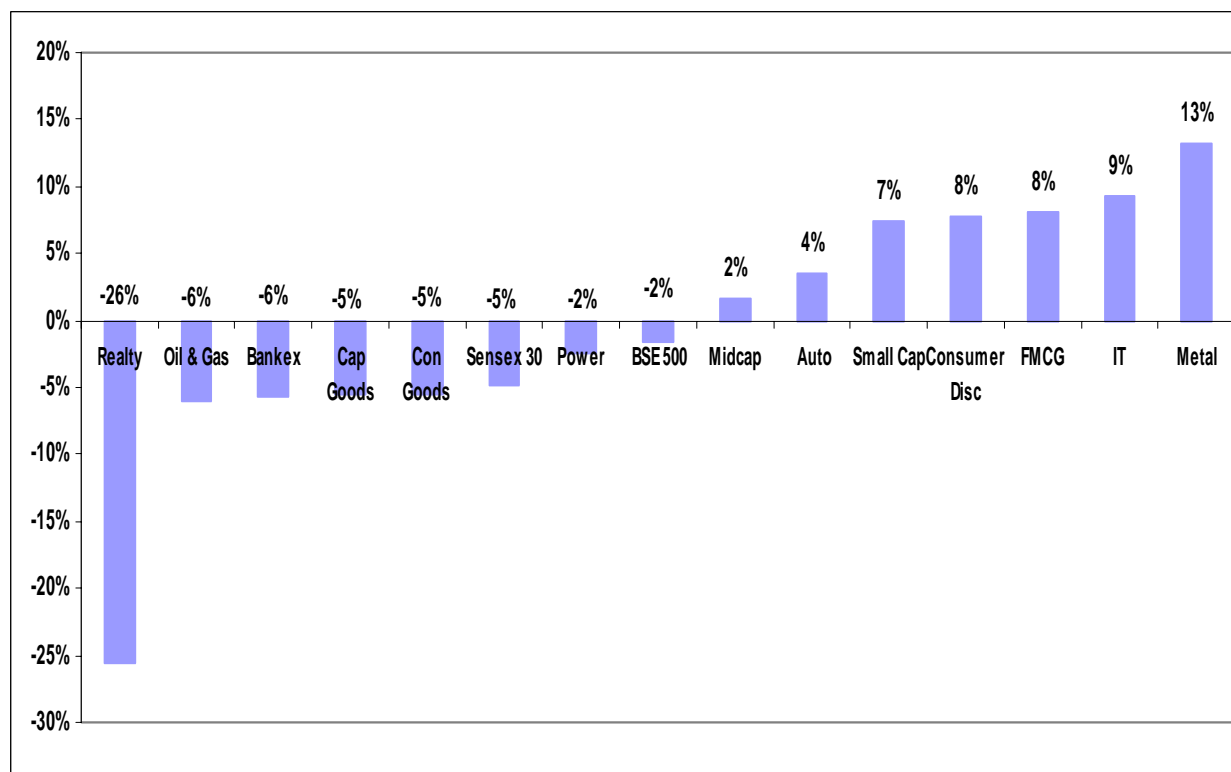
Title: The lost quarter for Indian Stocks

Region: INDIA Date: 27th January 2010 No of Pages: 4

The “Lost Decade” term was coined in early 2000, when Japan went through a asset price and real estate turmoil in the period of 1990 to 2000. In this decade in Japan real estate & stock prices had collapsed sharply. And the policy response to the crisis in those days is debated even now. And the current decade till 2009, has been a lost one for US markets too. The Dow is almost at the same level where it was in 2000.

Coming to Indian markets, the decades have always been extremely profitable to investors in Indian stock markets. Specially the current decade starting from 2000. The BSE Sensex has returned around 240% on absolute basis, excluding the dividends since the beginning of 2000. Way ahead of the developed markets. Especially in the year of 2009, the markets were higher by more than 100% from lows. Further some stocks are up by almost 8-9 times from there lows.

Chart I: The Lost Quarter in Indian Index Stocks



Source: Delta Global Partners Research & www.bseindia.com. All BSE indices
Data from 30th September 2009 to 27th January 2010

But what’s going on since September 2009? The Sensex 30 (known as narrow markets) is not going anywhere. In fact it’s lower by 5% since 30 September 2009 and lower by 7% in the year 2010. China’s recent tightening stance and the fear that the central banks worldwide would start putting an end to the global liquidity glut spooked the risky assets like EM stocks. And India has not yet decoupled

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So the index funds investors have lost marginally since September 30th. Not even the rising inflation has been taken care of. On the other hand action has moved from the front benchers (index stocks) in a school to the back benchers (non index stocks). It seems the front benchers have nothing new and exciting for the teacher. The action did move to the Small Cap & Mid Cap stocks, the back benchers. (Chart I). Some of the sectors like Auto, IT and Metals continued there good runs and Realty, Oil & Gas and Banking have lost its way. Why not all the sectors and stocks have returned the same? We will read more on that later in the note.

Though such moves have been hardly surprisingly. Indian markets as well as Global ones have moved in a Copy Book fashion since March 2009. Why Copy Book? Since the stocks exactly behaved in a manner they were expected to coming out of a recession or a slowdown.

What are Copy Book manner stock movements when the economy starts recovering?

The markets typically bottom out a little before the economy starts recovering and the corporate earnings troughs. The recovery rally begins in the markets with the PE multiples (PER) expanding. This PER expansion is driven mainly by “easy liquidity and hope of economic recovery”. Here the economic lead indicators start turning up though the Corporate Earnings continue to fall keeping the Return on Equity ratio (ROE) lower. Analysts slowly start upgrading the earnings estimates hoping for a better future. Liquidity (Chart II) first moves into the large cap stocks in the indices and the VIX (markets volatility) index starts falling in line with rise in risk appetite. Markets returns are the highest in this stage. The stock and sector co relations are very high. Cyclical sectors tend to do well. Everything rallies, the horses as well as the donkeys. It’s a unilateral move making the markets easy to read. This is the *Goldilocks stage*. Liquidity, Hope and Unilateral movements.

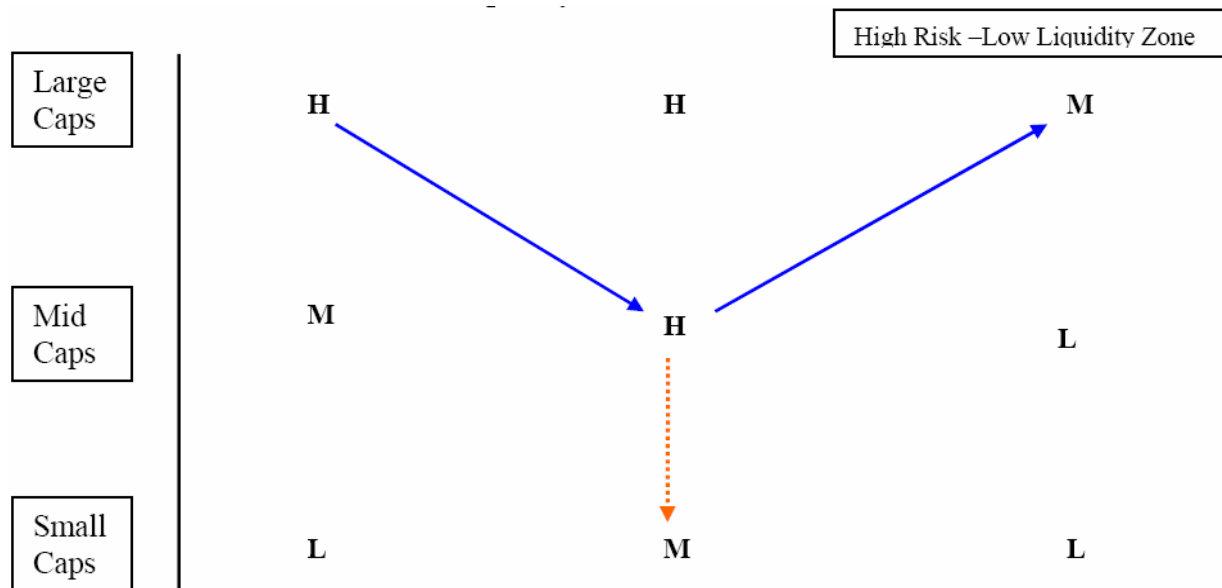
As Economic growth and Earnings starts catching up (hopefully no double dip) with the PER expansion, corporate earnings troughs and begin there ascend. Higher earnings growth and analyst upgrades drive the markets from here, with lower contribution from PER expansion. In fact PER starts falling as earnings growth outpaces PER expansion. ROEs too rise with higher earnings. Liquidity (Chart II below) in the markets start moving into mid and small caps looking for more opportunities as the large cap rally exhausts vis a vis the PER.

The valuation gaps between the large and the small/mid cap narrows down, making many of these stocks suddenly more liquid. The mid and small caps thus outperform the large caps. Stock/Sector co relations decrease. Stock picking or the Bottom up approach does well as evident in Chart I. After hope and liquidity rally, the markets starts choosing the horses (stocks or sectors) which are likely to be the winners in the next run. And not all horses will win. Returns are reasonable in this “*Growth Stage*” but not high as the “Goldilocks” stage.

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Chart II: The Normal Liquidity Path in the Stock Markets



Time from the start of the liquidity driven Bull Run in stocks

Source : Delta Global Partners Research

Liquidity Legend : H=High M=Medium L=Low

In the next stage “*Greater Hopes*” one, the PER goes in for the final expansion spree as the Growth phase gets extrapolated with rising expectations from earnings and growth , sometimes unreasonable and irrational. Most of the times the economic and earnings growth come closer to there peak and more or less above the structural long term averages. The Earnings in fact start to be weaker and ROEs to be lower from the Growth stage and PER dominate the markets again. This brings the markets and the PER very close to its peak and may be a little above its fair value. The mid and small caps stocks then become less liquid and the markets move more to “Quality & Defensive stocks”. The stock and sector co relations fall considerably. Returns in this stage usually fall between the Goldilocks and Growth phase.

So to my understanding the recent stock moves since September 2009, are not at all surprising. More in Copy Book Style.

Where are the Indian markets now? In my humble opinion we are somewhere in middle of the Growth Stage. Where more or less earnings will contribute more to markets rise from here rather than the PER expansion. That makes the matching of expectations on economic growth, earnings and the actual growth, earnings very crucial for the markets in 2010. We all know that the other side of higher expectations is disappointment. The recent L & T earnings disappointment had a telling effect on the markets as the well as the sector. So far in general the broader markets have delivered reasonable earnings growth driven more by margins expansion then top line growth. So far so good. The

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flows in mutual funds continue to be weaker and they were sellers to the tune of USD 625 mn in 2010. The FIIs though bought stocks worth USD 785 mn (net), but the sales have accelerated in last few trading days.

What would count for Indian markets apart from Earnings : The coming Budget should ensure the road map of fiscal consolidation, policy reforms and strategy for inflation control. Monetary Policy hikes are more or less in the price. The Global head winds come in form of China bubble bust, US Double Dip, European Sovereign Risks etc, which can take the Indian markets either way, away from its intrinsic value.

To conclude, we all hope that we move from Growth Phase to Greater Hope one and not in the reverse way.

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