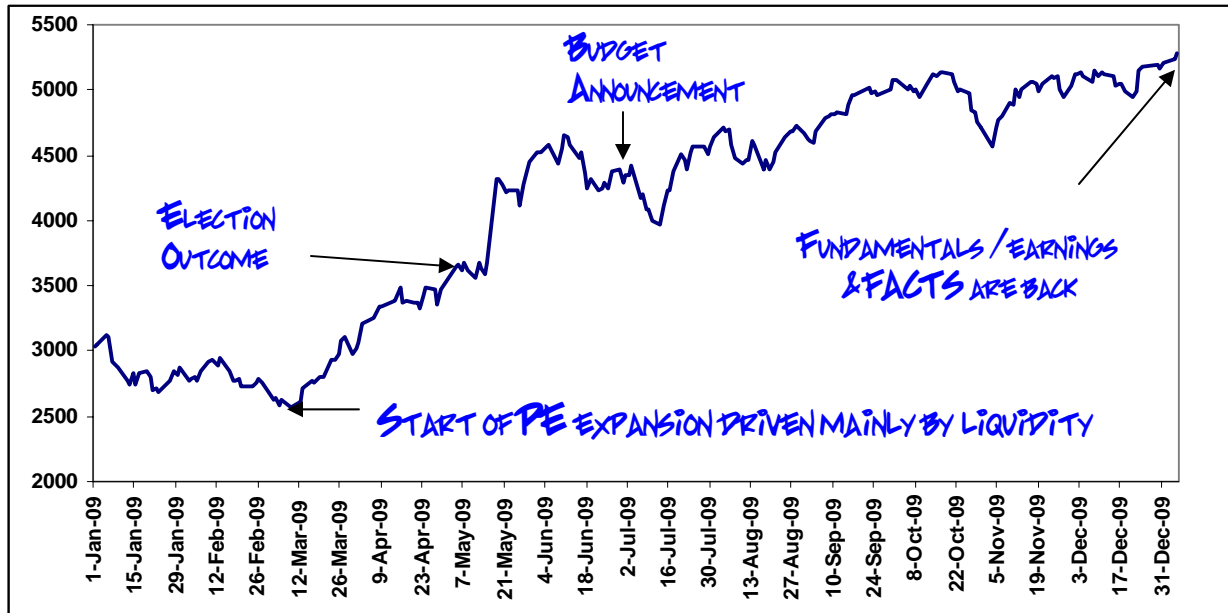


Title: The Headwinds & the Tailwinds for India in 2010

Region: INDIA Date: 06th January 2010 No of Pages: 5

In the first few days of a new calendar year one receives many “Markets Outlook 2010” in form of e mails. The co relation between the recommendations and strategies made by different sources is very high, making them a very crowded trade. In a bullish market zone, very few focus on the “Winds” for the aircraft of markets. We try and demystify the Head winds and Tail winds likely to be faced by Indian markets in 2010.

Chart I : NIFTY in 2009 and 2010 so far



Source : www.nseindia.com

Will the India GDP growth rate be above 7% in 2010? Yes, If there is no double dip in the world as well as in coming monsoons. If there is, then industrial growth should compensate for the growth deficit in agriculture. As of now the non agricultural sector continues to be reasonably strong. But what about the rural demand then which helped in 1009 & 2009? Back to Govt schemes and MSPs and so the higher fiscal deficits? Global calm and liquidity has to continue for growth in India. **And the contribution at an average of 2.5% to GDP growth was made by public consumption in last four quarters has to be replaced to a larger extent by private demand (consumption & investment).** History shows it's never at 100% replacement. Tall order? So much so for the internal demand, remember India is a domestic oriented economy, at least on the paper.

SUSTAINED GROWTH WITH LESSER GOVT SUPPORT

What about external demand? Oh yes, its been a “V” shaped recovery for US but jobless, sponsored by growth insurance in form of liquidity and stimulus from Govts world over, the premiums of which will be paid by tax payers for generations to come. Global Public Debt Mountain is now at staggering 36 trn dollars. How long will inventory restocking and recovering net exports will support world growth? **Will private final demand rise to occasion, after the stimulus is withdrawn?** Or like the humans were not able to survive on “Pandora” without the special masks (stimulus for us) in the movie Avaatar, the 2009's biggest blockbuster. So will it be V or W or L ? V is the best fit for India, since India remains coupled to the world through the foreign funds flows link. Sustainable growth is the key without stimulus or tax credits or cash for clunkers, or close to zero rates and beyond auto and the related sectors.

JOBS ARE LAGGING INDICATORS

IN US ALONE THE STIMULUS IS 2 TRN DOLLARS

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So much for the V Or L or U :Can the world, specially US recover without creating jobs, with banks holding tight on credit, with capacity utilizations very low, a weak housing sector, higher savings rate & the consumer not yet fully de leveraged to spend more.

So some recovery in Indian exports, with base effects in last few months & on rebounds in Global PMIs & ISMs. **But Imports have fallen more (a good sign for economy?) than exports, thus adding to GDP growth.** Well no worries, Indian Exports to GDP are just 15%, but the external demand accounts for almost 60% of Indian manufacturing.

But what about the exit strategy of the Government & RBI? Do we bother about higher interest rates and unsustainable fiscal deficits? The Swap markets is already pricing in reasonable amount of rate hikes. **But this credit policy (Jan 2010) and the Budget(Feb 2010) should necessarily have to provide the roadmap to liquidity unwinding as well as fiscal consolidation respectively, or else India faces an "Credibility Issue" (like in US now)** and uncertainty in the markets. And markets hate uncertainty.

If the entry into the global crisis was well managed by India (Govt & RBI), it doesn't need to be a Abhimanyu, who was not able to exit the "Chakravua" in Mahabharata Days. More than higher interest rates, which Indian corporate inc can manage with little help from external flows and a buoyant equity markets (thus lower cost of capital), the impact of deficits on the growth sentiments is an issue. Moreover as Indian economy globalizes every 100 bps rise in policy rates does not result in an equal rise in cost of capital for corporates. So much for the weaker policy transmission in India. And post stimulus withdrawal, the private demand should self sustain.

The CFO of the Indian economy, the Finance minister has a tough task on hand in this budget- **The Impossible Trinity? : Fiscal corrections, Ensuring Growth and Managing the runaway inflation.** Which one will he give up? Will he continue with the stimulus and increase the Govt borrowing program thus bloating the Public Debt further? With no support from MSS desequentering and unwinding, the support to the higher borrowing program in next year will fall on non banks and RBI, if a normal SLR demand is presumed from banks. If bank credit growth picks up on top of that, the problem will be further complicated on the rates side.

The CFO has very little leeway for fresh stimulus now with a large chunk of revenue expenditure in form of unproductive subsidies etc being "politically inelastic". The onus of fiscal adjustment will fall squarely on revenue side. The global rating agency will closely monitor the CFOs budget this year. **The structural reforms (Infra & financial) path is also on the bulls agenda for him.** And we all know what happened in last budget in July 2009 when the expectations on reforms were not met. He does have the "3G-D" revenue support system viz the 3G auction and Divestments as well as GST & Direct Tax code to increase his revenue buoyancy. He will need to heavily bank on the economic growth to cut defecits.

But will the global hedge fund managers support the CFO of Indian Economy with foreign inflows, especially if the USD appreciates in short run. Flows have helped boosting the India GDP growth and so the Govt revenues and so the taxes. In 2009, the help came in form of a check of USD 17.2 bn from all our foreign friends who rightly understood India as well as from those who rightly understood the state of developed markets in the West. India got almost 22% of the net flows into all EM, though the winner was South Korea. Hope is that external flows will be supportive even as valuations get stretched.

PRE
CONDITIONS
OF A
SUSTAINED
RECOVERY

IS STOCK
MARKET
RECOVERY=
ECONOMIC
RECOVERY

SMOOTH
EXIT
IMPORTANT

ROADMAP
WILL LOWER
UNCERTAINTY

TOUGH
BALANCING
ACT FOR
CFO

IN JULY 09
MARKETS
FELL BY 10%
INTRADAY

DOMESTIC
FLOWS ARE
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Will India's Corporate Inc help the CFO of Indian economy by generating higher profits (without yoy base effects) and thus higher taxes? Govt Stimulus, Lower input (commodity prices), lower interest cost and other cost cutting have helped corporates to protect some of its margins in 2008 and 2009 without revenue growth. In 2010 and ahead, the first three of the four factors would no longer be there or may not be as beneficial. Will the pricing power be back without the 3 factors? And corporate profitability does help job creation, increases income, consumption and savings, thus the GDP growth.

The market consensus has been pricing a 20-25% yoy growth in profits of Sensex companies in FY 2011. That makes the earnings growth at almost 2 times the expected nominal GDP growth rate (7% real + 5% inflation). Not that 25% earnings growth rate have not being seen in the past **but we do need stronger policy action on structural reforms and infrastructure and an environment (global & domestic) conducive to encourage investments by corporates.** Ultimately someone has to finance the economic growth and thus the earnings, either the private sector, or the Govt or the households or the external sector. And history shows that the fixed asset investment contributes almost 50% to the real economic growth.

Is most of the economic growth has been now priced in the "liquidity" driven PE expansion (almost 100%) that took place since March 2009? Past market cycles show that prior to the actual recovery in the economy, the liquidity driven PE expansion takes place. Subsequently the earnings estimates are revised by analysts as the economy appears to be emerging out of a slowdown. The actual earnings usually trough from here and commence their ascend. The cyclical sectors are the ones which usually move first in a recovery rally. **At this stage the fundamentals and earnings take over from liquidity as the driving force behind the markets, though additional liquidity will always be a bonus.** As earnings rise, the PE falls making the markets attractive again. In the final stages of a market recovery the PE again expands & peaks.

Table I: SENSEX Scenario Analysis with FY 10 estimated SENSEX EPS Rs 903 as base

SENSEX EPS FY 11 Estimated	Forward PE levels - One Year	Projected SENSEX Levels	Expected Returns in % from current Sensex of 17,687	Earnings Growth yoy rate required in % (*)	Scenarios
(A)	(B)	(A) X (B)			
900	15	13500	-24%	0%	Long Term Average One Year Forward PE & Earnings flat or rise
1000	15	15000	-15%	11%	
1100	15	16500	-7%	22%	
1200	15	18000	2%	33%	
1300	15	19500	10%	44%	
1100	16	17600	0%	22%	Current forward PE & earnings rise
1200	16	19200	9%	33%	
1300	16	20800	18%	44%	
1100	17	18700	6%	22%	Earnings & PE both rise-Best Case
1200	17	20400	15%	33%	
1300	17	22100	25%	44%	

(*) Earnings growth rate required for Sensex EPS FY 11 over current estimates of FY 10 Sensex EPS of Rs 903, (which is assumed to have been met).

Source : Delta Global Partners Research

POLICY & REFORMS CRUCIAL FOR GROWTH - A BIG TRIGGER

EARNINGS SHOULD MEET EXPECTATIONS

HOW MUCH OF GROWTH IS IN THE PRICE ALREADY?

TYPICAL EARNINGS & ECONOMIC CYCLE

WE ALL WOULD HATE THIS ONE

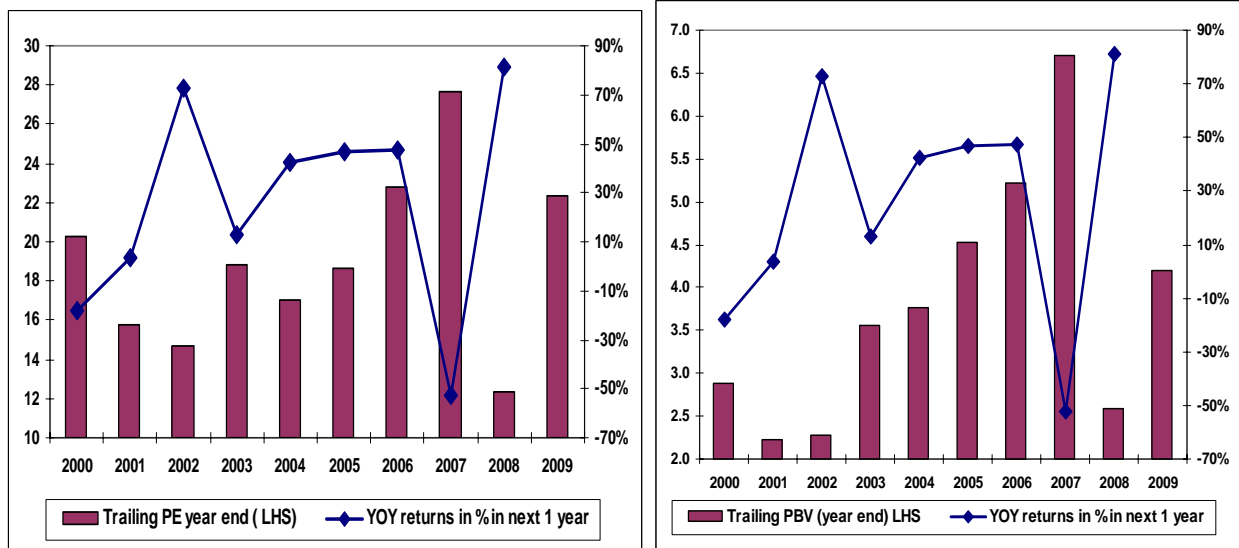
WE ALL WOULD LOVE THIS ONE

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And what about Valuations after a 100% rally from lows? At an SENSEX EPS (current consensus FY 11 estimate) of Rs 1100, the SENSEX level of 17,686 is at an FY11 PE of around 16x, and that's marginally higher than the long term average of one year forward PE of Sensex of around 14.5-15x. Indian valuations are also at a premium to the Global EM valuations. These premiums can sustain longer if India maintains its relatively higher economic growth, earnings & thus higher ROE trajectory. This can help India to attract long term capital flows in international markets.

Chart II : Sensex Trailing Year end PE, P/BV ratios and Returns in next one year



Source: Business Standard & Delta Global Partners Research

Well then the most ideal situation to come will be : **Better than expected earnings** (say Rs 1,200 or more on Sensex EPS) in FY 2011, which would bring the current forward PE down to 14.5x, leaving more scope for an PE expansion to say 16x. At Sensex EPS Of Rs 1,200 & a Forward PE of 16, the SENSEX would be at 19,200. And at the long term average of one year forward PE of 14.5-15x, the Sensex EPS (FY 11) of Rs 1,200 would take the Sensex levels to around 18,000. We have run a scenario analysis in Table I above. Let's hope for the best one.

The Indian markets may face other three Tail risks, one of them is domestic. One is if Crude Oil touches USD 100 per/bbl, if US recovers its lost consumption and EM like China/India continues to grow at current pace and delayed rate rises from US fans speculation in commodities including oil. We all know the impact of a USD 100 crude price on our deficits and inflation. The KG basin would be a savings grace.

And another tail risk comes from a short term USD appreciation, if any, due to risk global risk aversion. A normal USD appreciation should not be a problem for India, but a sustained USD appreciation driven by global risk aversion (such as due to a sovereign default) will create tailwinds for India through the financial flows channel. The local tail risk is of a spiraling inflation which goes beyond the current consensus expectations of 7-8% yoy on WPI. Something which the markets may not like.

LONG TERM 1 YEAR FORWARD PE AVG IS 14.5-15x

LOWER VALUATIONS INFLUENCE THE RETURNS IN NEXT YEAR

EARNINGS BETTER THAN ESTIMATES - A BIG TRIGGER

CAN ALL 3 OCCUR TOGETHER? AT LEAST 2 CAN

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So the year of 2010, will have its own head winds and tail winds, some global and some domestic. The CFO of Indian economy has to necessarily use the skills of a good pilot to navigate Indian aircraft, if the skies become rough during the year.

LOOK TO WIN
THE
MARATHON
NOT ONLY
THE SPRINT

Though there may be tail or the head winds, but the long run potential for India remains just awesome. Since 1978-79, Indian stock markets have returned a CAGR of around 17.5%, probably one of the highest in the world today. The longer term drivers for Indian economy are firmly in place viz Favorable Demography, Urbanisation, Demand for Infrastructure, Higher Savings & low Household Leverage, Consumption, Low retail investment in equities etc. Happy to be invested in India.

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**Delta Global Partners
Founder & Principal Partner**

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