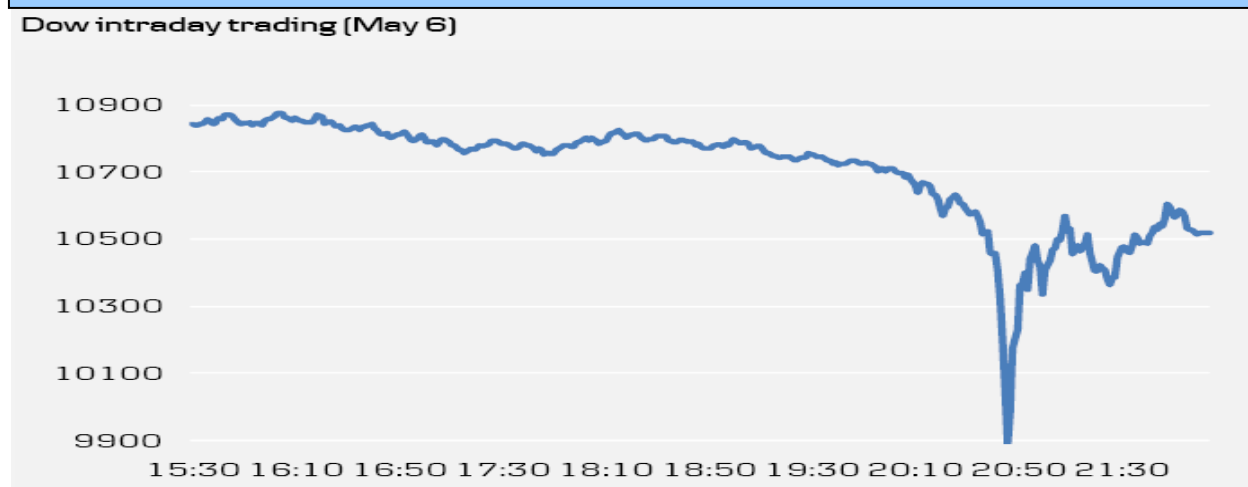


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The US stock markets sputtered close to a 10% intraday fall on 06th May 2010, the largest intraday fall since the Black Friday in 1987 (Chart I). The steep fall was attributed to a “fat finger” trading error by the media, whereby apparently a trader erroneously punched in deals at prices almost 50-60% lower. Investigations on the reasons are still on. And we always felt that Indian markets are shallow. At that point of time market capitalization worth almost 1 USD trn evaporated in minutes. So much for the high speed & powerful computers used in electronic trading, the extensive use of algorithms and risk management in stock exchanges. Bonds and precious metals rose world over as a safe haven bid. The euro further lost ground. Indian stock markets were lower by around 1.5%. INR was lower too. Global stocks are now lower by 8-10% from its mid April 2010 peak.

Chart I: Dow and Fat finger effect on 06th May 2010



Source: Danske Bank Research

So what's hurting the global markets now? The impact of negative news flow is the highest if the markets are at its recent peak.

- The deteriorating sovereign scenario in Europe starting with Greece (restructuring of debt) and the political imbroglio resulting out of it. The fear of Contagion to peripheral countries such as Spain, UK and Portugal. The cross holdings of European banks with each other have weaved a complex web of debt in Europe. Deaths and strikes in Greece in response to the austerity measures have made life difficult for policy makers who are already being accused of inaction.
- Worries on the lofty earnings estimates of S & P 500 companies factored in markets now and whether they will be met in event of a double dip in US economy.
- China's monetary tightening and steps taken to cool down its economy and the bank lending specially to the real estate sector. The subsequent impact of a hard landing, if any, in China on global economy and commodity prices. Commodity prices are already lower by 5-10% from its April 2010 peak.

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- Newer taxation (such as mining tax in Australia) and risk of over regulation in US, would negatively impact the corporate investments and earnings.
- Some of the Global indicators rolling over leading to doubts on a sustained global economic recovery.

How will a full blown sovereign crisis in global markets will get transmitted to Indian markets & economy?

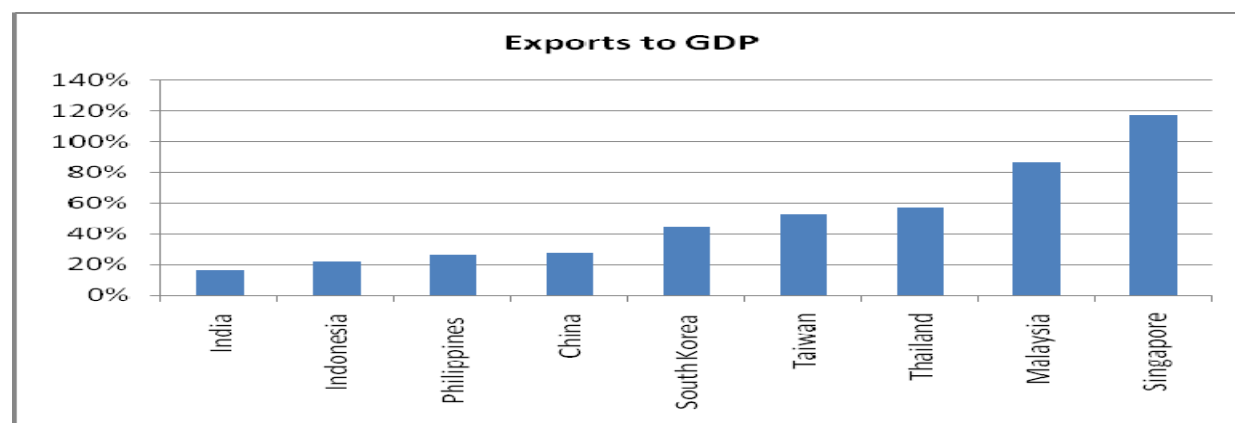
Global markets impulses get transferred to the Indian economy and the markets mainly through the following channels:

- **Trade & Services Channel:** Exports from and Imports into India including services which gets impacted due to global changes.
- **Financial Flows Channel:** The Capital Flows (inflows and outflows) such as FII, FDI, ECB, Remittances etc, which mainly influences the domestic asset markets and financial system including liquidity, foreign exchange and interest rates. The FII flows and the reversal of the same have been crucial to Indian stock markets.
- **Confidence Channel:** The business and consumer confidence channel which is affected by global developments and the subsequent spillover effect on real economy.

Let's briefly discuss the relative importance of the above channels in the current crisis.

First the Trade and Services channel: India's global trade integration measured by its Exports to GDP ratio remains very low vis a vis its Asian peers. (Chart II). The contribution of Net Exports to GDP is just below 20%. As far as exports go India remains a relatively a closed economy, if compared to its Asian peers like Singapore and Malaysia which remain more vulnerable to global trade shocks, if the sovereign crisis deteriorates further leading to a global slowdown.

Chart II: India and Exports to GDP-India remains more or less a Domestic Economy



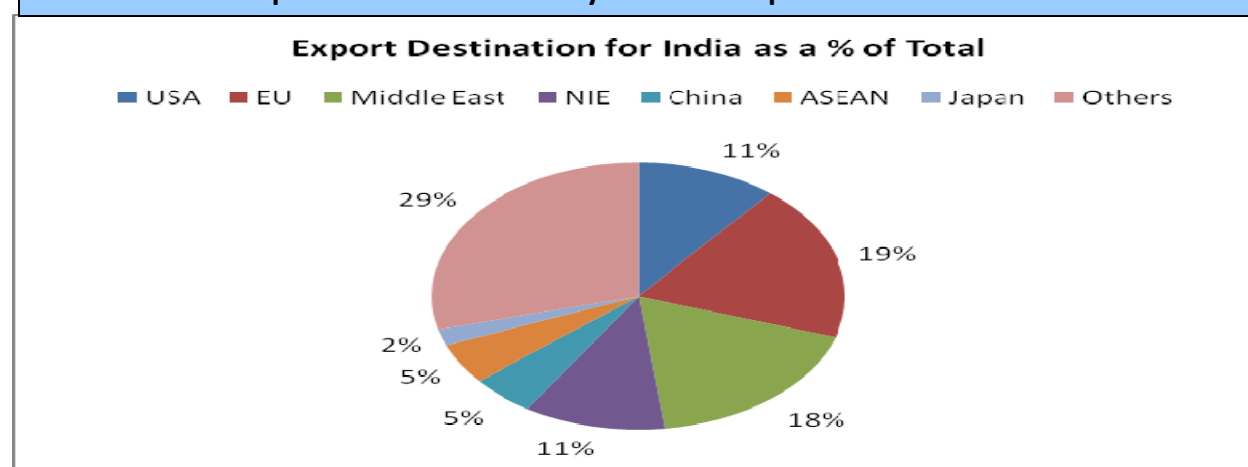
Source: Bloomberg

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Out of the total exports from India only around 19% have Europe as their destination, which again is not a very high figure (Chart III). Again India imports only around 18% of its total imports of around USD 300 bn from European region. Thus the trade channel impact of the sovereign crisis unfolding in Europe will be only marginally negative for India as compared to other Asian peers, with exports oriented growth models.

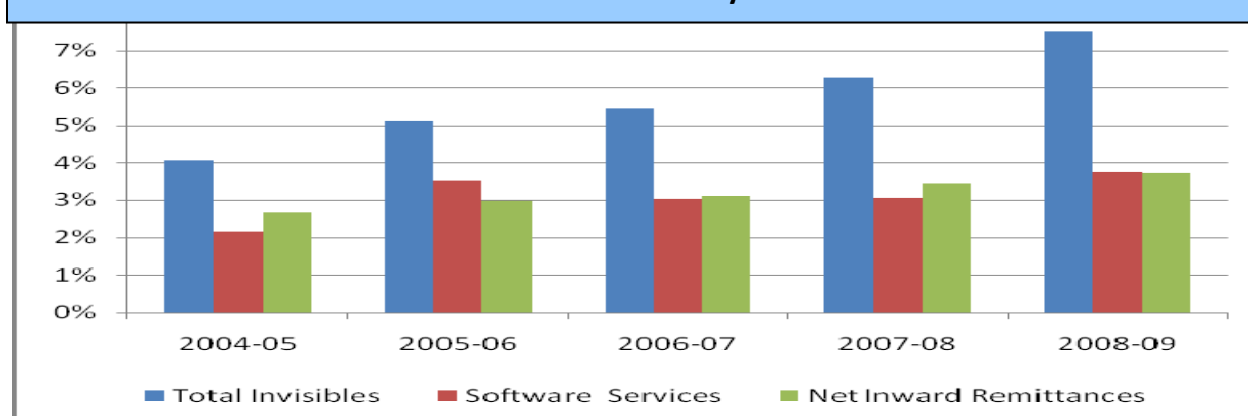
Chart III: India Exports Destinations : Only 19% to Europe



Source : RBI

On the Services front too, the total net invisible receipts to GDP ratio remains low at less than 8% of GDP, including software receipts and net inward remittances. In fact in the recent times, the remittances have been relatively immune to global vagaries and have exhibited a steady to higher trend, though software receipts get impacted in event of a global crisis, but not substantially. (Chart IV).

Chart IV: India Invisibles and Services to GDP : Steady trends



Source : RBI

The next channel is the Financial or the Capital flows channel: India growth story and higher interest rates have been attracting foreign money flows (FII and FDI) right from the time India opened up in 1991. This channel is the one, through which a

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sovereign global crisis would first manifest itself, viz large capital outflows (mainly FII hot money) due to global risk aversion and reversal of leveraged carry trade. And this is the channel which will have the maximum short term negative impact on stock markets, economy and business confidence in event of a sovereign global crisis. The year of 2008 is an evidence of this when Indian markets were lower by 50% as FIIs took away USD 13 bn from stock markets.

Though India trade links to the world remains weak, the “financialisation” of the Indian economy in the recent times has ensured that Indian asset markets retain high correlation to the global risk appetite via these hot capital flows. The cheap money in USD has encouraged the carry trade and flows in India are a part of the trade too. The correlation of Indian stock markets with developed ones especially US also remain high. And when these large inflows reverse, in short run they do affect stock markets, interest rates, banking liquidity and Rupee/USD markets.

The financialisation of Indian economy and markets is evident from Table I. India received capital flows much higher than the Current Account Deficit (CAD) in 2006-07 and 2007-08. These flows touched a high of 8.7% of GDP in 2007-08, they year in which stock markets rallied to new highs, interest rates troughed and INR appreciated sharply.

Table I: Capital flows vis a vis Indian GDP				
	2006-07	2007-08	2008-09	2009-10*
Current Account Deficit (CAD) as a % GDP	1	1.3	2.4	2.5
Net Capital Flows as a % of GDP	4.8	8.7	0.6	3.8
Capital Flows in excess of CAD (USD bn)	36	92	-20	14
INR appreciation /depreciation vis a vis USD	2.3	9	-21.5	12.9

Source: RBI. * Rough RBI estimates

Such flows (disproportionate to GDP) if not absorbed by the real economy or if not sterilized by RBI, usually spill over into the local asset markets creating bubbles. These flows also complicate the foreign exchange and monetary policy. Very often such short term flows which chase absolute returns or interest rate differentials often become a nuisance for the central banks and policy makers. Such flows leave the countries shores at the first sign of global risk aversion. There have been several instances of speculative attacks on countries such as Iceland using hot capital flows.

FIIs now hold close to 19% of the broader market capitalization of Indian stock markets and have been a force to reckon with especially during a crisis. The estimated market value of FII holdings stands now at USD 214 bn (Source: www.equitymaster.com) and even 10% of it moves out of the country in a short span due to global risk aversion, the stock markets would be rattled. Though the proportion of Participatory note (PN) holdings has substantially come down (around 13% of total) after SEBI's tighter

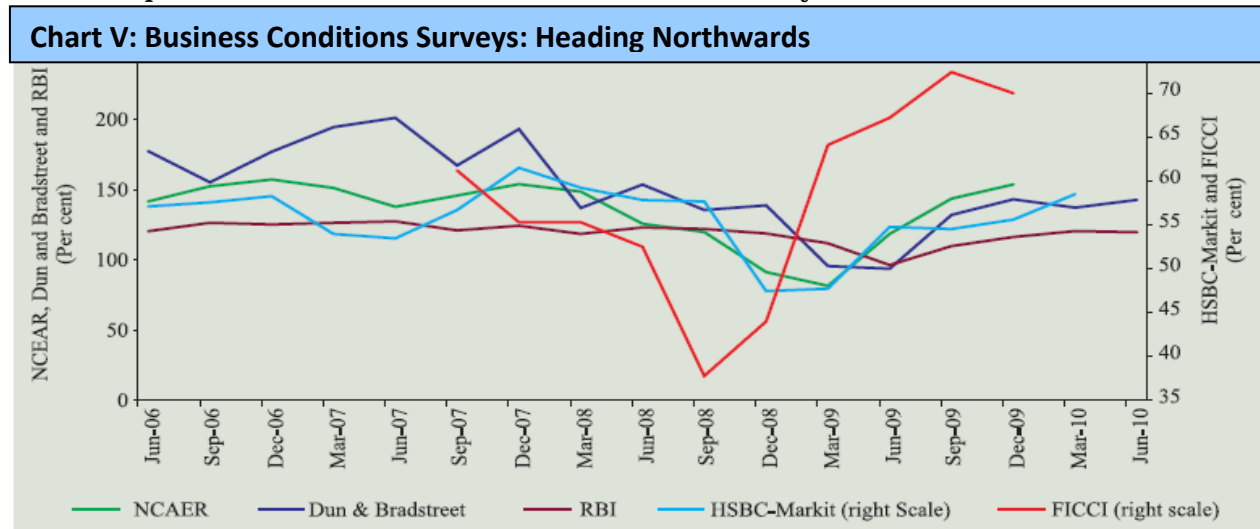
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regulations. In recent time's much of the capital inflows into stock markets have come from foreign listed India dedicated ETFs which may reverse in no time.

So if a sovereign crisis turns out to be nasty one, Indian stock markets will be hit through this channel initially (being a high beta market), irrespective of the underlying real economic trends. And subsequent negative impact on interest rates, USD-INR and liquidity as a result of large capital outflows driven by global risk aversion is well known. We have to remember that Indian Current Account Deficit is funded by volatile capital flows unlike countries like China who have a trade surplus. This fact accelerates the negative feedback loop of foreign money outflows on Indian real economy in general. Though India's defense to these rapid outflows remain strong due to its foreign exchange reserves position, a sound banking system (no cross holdings in European banks) and lower external short term debt to total debt ratio.

The spillover of the negative effects of the financial flows channel is on the “**Business Confidence Channel**” (Chart V). As the sentiment in stock, money and foreign exchange gets negatively impacted due to a global crisis, the real economy too gets affected. The business and household confidence moves down sharply resulting in cutting of spending by households as well as investments, expansions and hiring by corporates. This has its impact on real economy. The lack of rollover of or fresh external borrowings also impinges corporate in a global credit squeeze. The Government then has to step in to stimulate demand and thus the economy.



Source: RBI

Let's quickly review where the fundamentals are for India, irrespective of the impending sovereign crisis around the world. The SENSEX is now valued at around 15 times the FY11 earnings (consensus) which is just around its long term historical average, but not yet in a bubble stage. Indian markets are going at a premium to the valuations of some of the emerging as well as developed markets, but that has been the case for some time now. Higher trend economic growth rate, Higher Returns on Equity and the predominantly domestic nature of the economy do partly justify the premiums.

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Indian economy is expected to grow at 7-8%, and even during the subprime crisis; the growth rate fell by only around 2% from that figure. The long term trend growth rate of Indian economy does remain at 6-6.5% and higher. RBI in its recent report was very buoyant on India growth prospects, subject to usual caveats. And so were many other research organizations. Though inflation and global upheaval remained the tailwinds.

Post the global subprime crisis, the Indian economy rebounded strongly as the fiscal and monetary stimulus worked wonders along with the improving global scenario. As the economy rebounded and the economic growth became more entrenched, the corporate earnings followed the suit with a lag. As the demand pressures were back, corporate got back some of the lost pricing power. The capacity utilizations rose above trend levels. As a result many of the corporates have beaten the street expectations on their earnings.

So far the broader market revenues and earnings (Q4FY10) are higher year on year by 36% and 37% respectively. For SENSEX corporate so far the figures are 45% and 24% year on year respectively. Earnings and revenues though have been concentrated in cyclical sectors such as Consumer discretionary, Financial and Materials. But the rising input costs and inflation has kept a lid on operating margins.

The leading and co incident indicators of Indian economy are showing strength and pointing towards an 8% + growth rate in FY11. This would hopefully should lead to good earnings growth in the coming FY11 in line with expectations. *And if earnings deliver, and markets fall due to exogenous reasons such as a sovereign crisis, long term investors (domestic and international) would certainly find it cheap to invest at 13x or lower the FY12 earnings.* So the earnings cushion remains the key in crisis, if any.

The global economy now is being pulled in opposite direction by two forces: “Cyclical Strength in the economy and Structural Headwinds of Sovereign crisis”. But if the world goes into an double dip as a result of this sovereign crisis, India’s government don’t have room to accommodate more fiscal stimulus, as the budget deficits and public debt are already at elevated levels. Moreover, around 30% of the SENSEX earnings come from Metals and Energy sector. Both of these sectors are vulnerable to a global crisis.

India’s domestic nature of the economy and the structural factors will continue to make it an important destination for capital deployment. Policy making has to be more conducive to unlock the impediments to harness the tremendous potential.

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