

**Title: Indian Index Investors: Every quarter can't be 20/20.**

**Region: India**

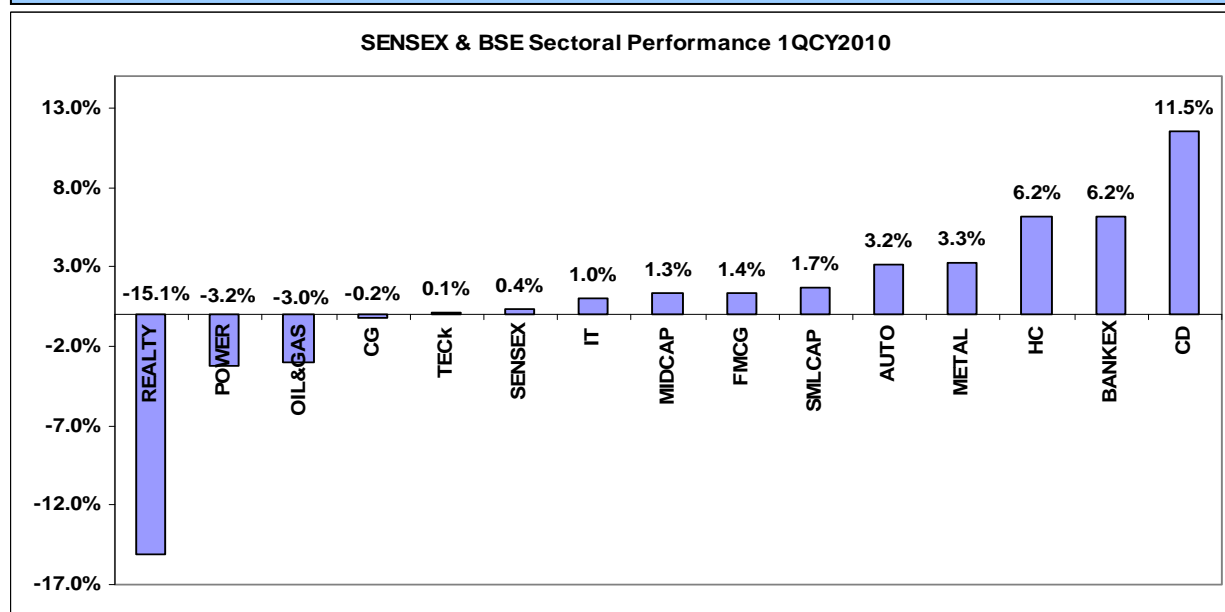
**Date: 02<sup>nd</sup> April 2010**

**No of Pages: 4**

The quarter ended March 2010 was a mixed one for Indian financial markets. Broader stocks indices (SENSEX) were flat, INR appreciated by 4%, FIIs poured USD 4.5 bn in Indian markets, Mutual Funds sold USD 1.25 bn of stocks and Insurance companies continued their stellar show by buying stocks worth USD 3 bn., Benchmark (10 yr), Gold was flat in USD but lower in INR, and Government Bond Yields were higher by 17 bps as inflation hit double digits and RBI hikes the policy rates as well as reserve ratios.

Elsewhere in the world, developed stock markets on an average were higher by 3-5%, thus outperforming some of the emerging markets like India. Japanese stock markets were the winners in 1Q2010 as the economy showed good signs of rebound. USD gained at expense of Europe's sovereign debt crisis, by 6%. Surprisingly Gold did not fall as much, was flat though, clearly appreciating the reason for USD rise being EUR's fall. In commodities space nickel (steel mills buying) and copper (20 month high) lead the rise.

**Chart I: SENSEX and BSE Sectoral performances in 1Q CY 2010**



Source : Delta Global Research and [www.bseindia.com](http://www.bseindia.com)

Index investors in India continued their losing spree ( second quarter on trot) vis a vis non index stocks in the current quarter, as stock picking (bottom up strategy) again delivered handsome returns. At the risk of sounding repetitive, we would like to reiterate that, the out performance of a stock picking strategy is not surprising. As the economy exhibits first signs of recovery, stocks rise rapidly as liquidity drives PE ratios higher, starting with liquid index stocks.. As PE expansion matures, market moves typically to stock specific ideas, for further superior returns.

The out performance of banks (almost 6%) vis a vis SENSEX in spite of the CRR and policy rate hikes, indicates better days for banks as the economy gathers steam and credit growth picks up. Historically as the rate hiking cycle begins the banks have

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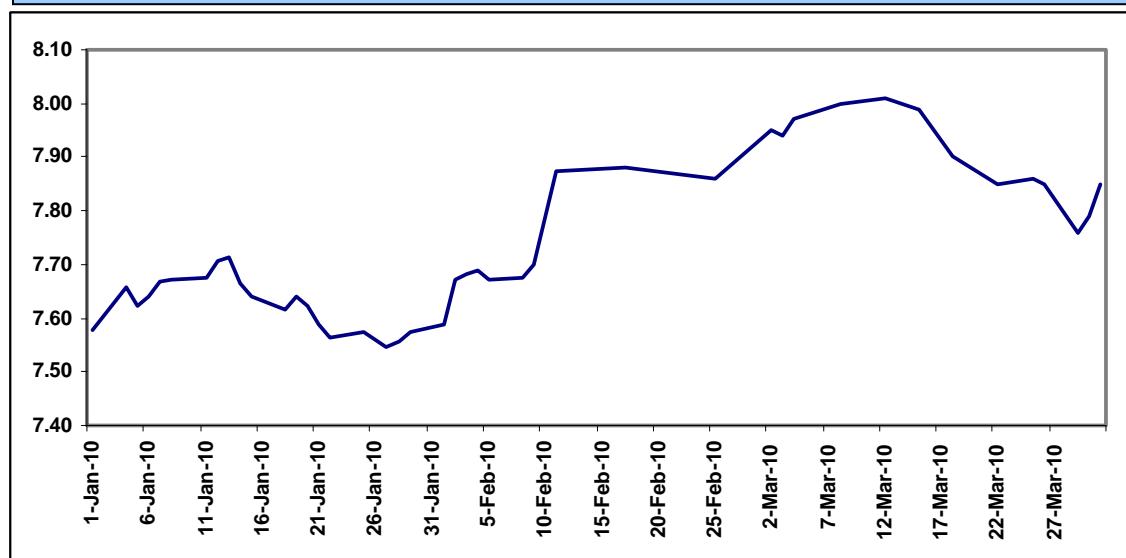
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underperformed and have picked up later as the economic growth becomes well entrenched and demand for credit rises. Sugar stocks lost its sweetness, and fell by around 40-50%, on higher production of sugar and rising cane prices. Realty continued its poor run, being lower by 15%. Though this was on back of rising property prices.

Consumer Discretionary led the winning sectors being up by 11.5%, mainly on account of Titan Industries, which was up by 40% in the quarter, as job markets and wage rises improved the spending outlook. Healthcare was higher by 6%, and did well in March, driven by news flow. Mid and Small Caps outperformed the Sensex, further narrowing the valuation gaps. Again this is a fairly normal scenario as markets looks for potential winners.

The Capital good sector too was flat, though there were good amount of advance clue's on rising capital expenditure and a buoyant industrial production index. The Auto sector continued its good show, though the number's seems to be peaking out soon. This sector will face headwinds from higher valuations, withdrawal of government stimulus and rising interest rates. The Information technology sector was hit in March when the INR appreciated on strong capital inflows.

**Chart II: The India GOI 10 year benchmark yield in %**



**Source : Delta Global Partners Research**

The Government of India (GOI) bond yields (10 year) rose by 17 bps in anticipation of higher supply, a hawkish RBI and rising inflation. 5 year AAA corporate bonds yields too rose in tandem by 14 bps. Surprisingly 5 year OIS (Overnight Indexed Swaps) were lower as compared to December 2009. The OIS markets are often used more for taking views on interest rates rather than for hedging purposes. There was a lot of hue and cry on the US Swaps rate going lower than the US Treasury rates. In India the 5 year OIS have been lower then 5 year GOI bonds for quite some time now. If the GOI bond yields

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rise to around 8.35-8.50%, it would make the bonds very attractive as compared to stocks.

So now what do investors need to pay attention in the balance 3 quarters of 2010?

- **First, one needs to watch the earnings for FY 11.** As of now the markets are factoring a year on year growth rate of around 25% for the SENSEX companies. With demand pressures coming back, pricing power back in reckoning, GDP going at 7%+ (lead indicators showing strength), capex cycle on an upturn, business confidence and liquidity high the earnings growth as of now looks achievable, with a slim chance of disappointment..
- **Second, the Valuations:** The SENSEX now is valued at around 15.8 PE on FY11 earnings and 13.5 PE on FY 12 earnings. The markets are not exactly cheap from an historical average perspective, but are not in a bubble stage too. Reasonable Earnings, Economic Growth and Steady global capital inflows can restrict the downside of the markets. But do not expect an encore of the 2009 returns. Historically the stock markets have delivered single (top end) digits returns in the second year of recovery. Remember, Economic Growth and Earnings lag the stock markets movements.
- **Third: The Global Scenario:** For Indian markets to do well, it needs help from FII investors (around USD 4bn inflow in March 2010). Domestic institutions are not large enough to support on FII onslaught, if any. And global calm and recovery is important pre condition to retain the risk appetite and thus the inflows. Remember, Indian economic cycle is linked to large extent to global risk appetite through the capital flows link. And the difference in growth rate without global calm is 2-3%. Lower. The rising price of Crude Oil and the deteriorating sovereign quality in Europe and US remains the risks to Indian economy and markets.
- **Fourth: Inflation and Interest Rates:** Inflation and thus the interest rates are on rise. Some media reports were talking about inflation falling sharply after June 2010. According to our calculations the Inflation (WPI) is likely to remain at elevated levels, closer to double digits for some time now. That will keep the RBI hawkish in further tightening rates and absorbing liquidity, especially when the bank credit is already on rise. The bigger problem is inflationary expectations rather than inflation itself, which alters the savings and investment patterns in the country. Due to weaker monetary policy transmission and access to global markets, the corporate cost of capital will rise but not in the same proportion. In past rise in interest rates in an accelerating growth environment have negatively impacted the PE ratios of markets, but only in the short run. And on the flip side rising inflation is good for corporate revenues and earnings.
- **Fifth: Fiscal Deficits and Exit Strategy:** Indian Government and RBI have the enormous task on hand of bringing the fiscals under control as well as enhancing growth. The timing of the exit strategy remains crucial, cant be too

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early (result; dip in growth rates) and can't be too late too (result: overheating and asset bubbles).

- **Lastly, Government Policies and Reforms:** Indian economy needs some serious reforms and some tough policy making to sustain its higher growth rate. Policy making in areas such as financial, agriculture, labour, education and infrastructure are required urgently. Reforms should be a bridge to higher investments and thus higher growth. So policy making should be conducive to higher investments. And policy execution delays or inefficiency remains a key risk.

Stock markets won't be a cake walk in rest the year 2010. Since October 2009, the SENSEX has returned just over 2%, for last two quarters, whereas certain stocks and sectors have done extremely well. But every quarter is not reflective of the long term potential of markets. Don't worry about the 20/20 performance, try and play the test match. One would need discipline and patience to realize sensible returns from stock markets over next few months. And the economic growth and earnings scenario looks reasonable to generate steady long term returns from India stock markets. And don't expect the magic of 2009 returns to work every year from stock markets.

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