

Title: Cyclical Strengths v/s Structural Headwinds.

Region: GLOBAL/INDIA Date: 31st May 2010 No of Pages: 6

The Global stock markets (Table I) since the mid April 2010 peak have shed around 13%, a loss of market capitalization of USD 6 trn, as risk appetite waned. The global stock markets have now given up almost 27% of the gains notched up since the trough hit in March 2009 last year. As expected, with risk appetite fading, Gold outperformed and the other risky assets such as commodities fell and credit spreads widened.

Table I : Global Asset Markets and India : Capitulation ?

	Global Market Cap Change in USD trn	Global Market Cap Change in %	BSE Sensex Change in %	USD-INR Change in %	GOLD (in USD/oz) Change in %
Bottom (Mar 09) to Peak (Apr 10)	22.86	88%	120%	14.78%	42% *
Peak (Apr 10) to 28 th May 2010	-6.23	-13%	-6.16%	-4.65%	-1.78%*

Source: Bloomberg; WCAUWORLD Index

* Gold: Bottom and Peak in Apr 09 and May 2010 resp.

What are the fears for the bulls or boon's for the bears in global markets?

- The fear of a widespread contagion of the European sovereign crisis. Spain lost its AAA rating last week. More to come. ECB warning of more bank losses coming.
- The fear of the austerity measures and fiscal tightening in Europe would hamper economic growth world over resulting in a double dip. The "W".
- The geo political risk of a war in the Korean peninsula or Isarel-Gaza conflict.
- The fear of Chinese economy overheating and the central banks raising interest rates to preempt a boom bust cycle. And the subsequent impact on global markets including the commodities ones.
- The fear of overregulation in banking sector in US and elsewhere in the world. The banning of naked shorts by Germany or US the passing the reform bill.
- The topping out of some of the global leading economic indicators putting the cyclical recovery at risk. (Chart & Chart)

How Indian did markets fare in this global upheaval?

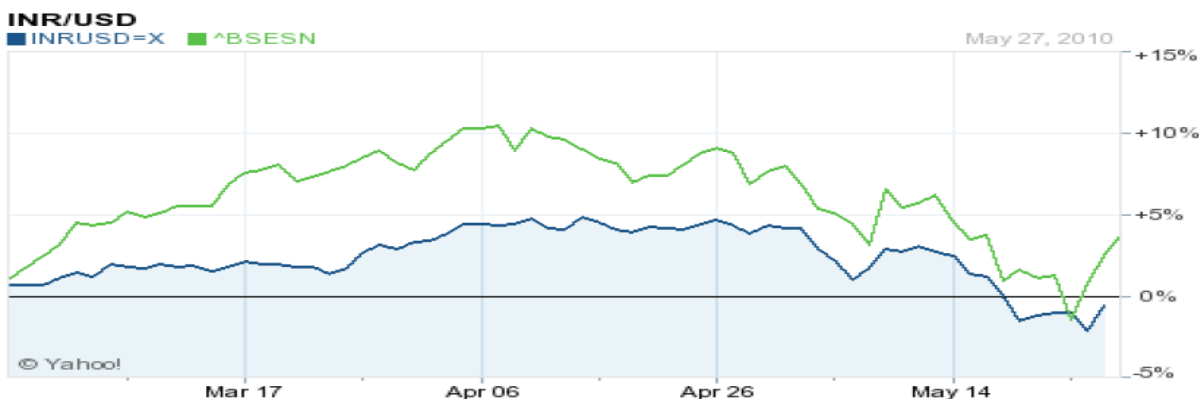
The benchmark stock index BSE SENSEX fell from an intraday high of 17,995 on April 12, 2010 to an intraday low of 15,960 on 25th May 2010, a fall of 11.3%. On a closing basis the SENSEX was down by 6.16% from the peak, which is much lower then the fall in global markets. Are we decoupled then? Well not exactly. In fact in a global rout of stock markets, the Indian markets beta to the developed markets in the short run is a more of a function of the nature as well as the reasons for the global rout. The Indian markets have held on well due to its stronger growth outlook and policy actions. Indian markets have given up around 10% of its bottom to peak gains, whereas the world markets have given up 27%.

Title: Cyclical Strengths v/s Structural Headwinds.

Region: GLOBAL/INDIA Date: 31st May 2010 No of Pages: 6

Similarly the INR too fell by 4.65% since April 2010, again proving the point that the USD-INR parity remains driven by FII inflows & outflows and the SENSEX directional moves in the short run, rather than fundamentals. Thanks to the strong influence of the FII flows on the stock markets.

Chart I : USD-INR and SENSEX : One leads the other



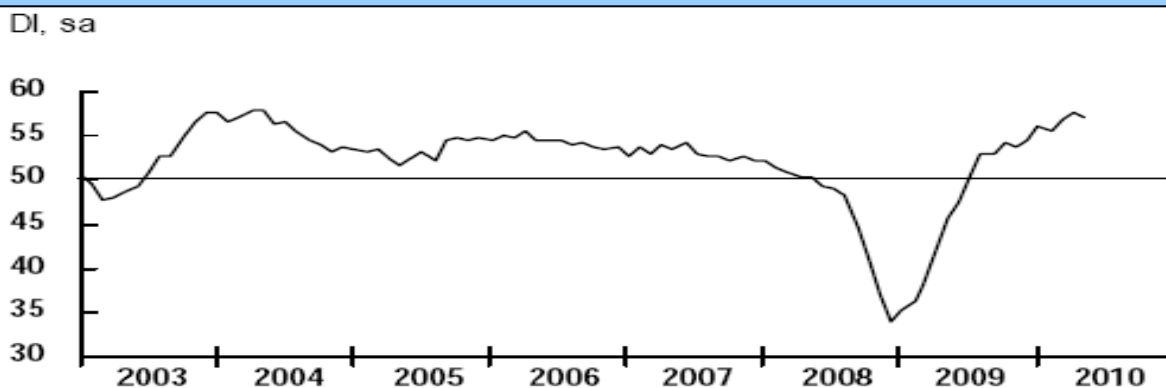
Source: www.yahoofinance.com (Data upto 27th May 2010)

Gold in USD behaved more like a risky asset in times when risk appetite world over was rising. It delivered 42% since the global stock markets troughed in Mar-Apr 2009. This was sending contradictory signals on the state of underlying global economy and financial markets. Which markets are right? Gold or the Stocks?

So the world is now being confronted with two opposite forces: Cyclical Strengths v/s Structural Headwinds. Who will win in the long run?

The Cyclical Strengths: The global economy was slowly finding its momentum after the strong monetary and fiscal stimulus's by the central banks world over. Various lead indicators such as composite PMIs, Business and Consumer Confidence etc were showing strength, though the rate of growth had marginally slowed down. (Chart II). But nevertheless they remained elevated well above the threshold level of 50.

Chart II : JP Morgan Global Manufacturing PMI : Topping Out ?



Source : JP Morgan Research, Markit Economics

Title: Cyclical Strengths v/s Structural Headwinds.

Region: GLOBAL/INDIA Date: 31st May 2010 No of Pages: 6

Stock markets though had rallied as risk appetite was back. Financing conditions had eased. Developing and Emerging countries, especially Asia witnessed robust growth, lead by China and India accompanied by rising inflation and capacity utilization. Global Trade and Capital flows had recovered too. Some indicators were close to pre crisis levels. Inflation levels in developed markets were contained and many of the developed central banks were in no hurry to raise rates till the recovery becomes broad based and well entrenched. Most of the multilateral institutions had raised there global growth estimates. Though jobs and bank lending remained sluggish in US.

And the Structural Headwinds: But there is no free lunch. As the private sector delevered its balance sheet in developed markets, the public sector took all of the debt on its own books, leading to unsustainable budget deficits and public debt especially in Europe, UK, US and Japan. And the fear of a contagion of sovereign defaults in Europe though the financial channel and cross holding of banks send shivers down the global markets, threatening the cyclical recovery in the world economy. Trying to repaying debt by creating more debt lead to rating downgrades of countries such as Greece and Spain. Unless Europe gets it act through on fiscal policy coordination and bringing down the structural deficits, the overhang of crisis will continue to haunt the global markets. Some of the Asian economies had there own set of problems like Inflation (India) and Overheating (China). And crude oil flare up remains a wild card for the whole world.

Where do Indian markets fall in the global maze of headwinds and sovereign crisis? We did discuss the impact on Indian markets and financial system in detail in our recent publication [Fat Fingers and Channels of Contagion. PDF.](#) Nevertheless we cover in a little more in detail in this note, especially on the Europe-Indian markets & real economy links.

Table II: Europe & India: The Bridges of Contagion

India :Trade and Financial Flows	Nature of Link	Extent of Link
Euro zone Exports to GDP	Trade	3.5%
Exports to PIIGS to GDP	Trade	0.7%
Imports from Euro zone to GDP	Trade	3.4%
Imports from PIIGS to GDP	Trade	0.4%
FDI flows from Europe + UK to Total FDI of USD 25 bn FY 2010. (25% of Mauritius FDI assumed to be from Europe)	Financial Flows	18%
Net FII inflows (from Europe + 25% of Mauritius assumed to be from Europe) of Total FII flows in CY 2009 (up to Nov 19,2009)	Financial Flows	41.3%

Source: Emkay Research &Delta Global Partners Research

As can be noted from the above Table II, if a European led sovereign crisis blows up, the impact on Indian economy on the trade front will be best limited. The trade links with the PIIGS countries are further weaker. But the links through the financial flows are relatively stronger and may have more impact on stock markets and thus on business and household confidence. The problem is that a global risk aversion would also disrupt the non Europe flows too. And the global credit squeeze, if any, would also hamper

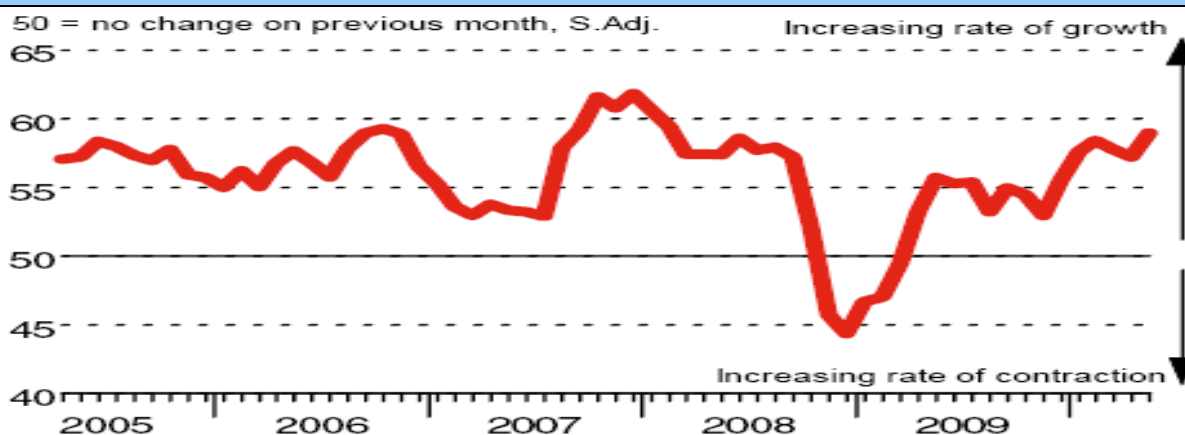
Title: Cyclical Strengths v/s Structural Headwinds.

Region: GLOBAL/INDIA Date: 31st May 2010 No of Pages: 6

ability of some Indian corporate and banks to roll over existing debt or raise fresh ones. The cost of roll over or fresh debt will be higher too in form of higher spreads. And more important is the fact that India's growing external deficit is funded by these global capital flows, including from Europe.

The Indian Economy grew at a healthy rate of 7.4% in FY2010, driven mainly by manufacturing and services. The lead indicators (Chart III) of the economy are also pointing towards a 7.5-8% real GDP growth rate for the next year; with an upside bias Policy environment is becoming positive. Forecasts on Indian economy from professional economists, analysts, government officials and multilateral institutions are in the same range.

Chart III : HSBC India Manufacturing PMI



Source : HSBC Research, Markit Economics

The non government GDP growth is reasonable, indicating a self sustaining and autonomous recovery. Private consumption though needs to take over the mandate of growth from government expenditure. Though some of the lead indicators have been reaching inflexion points (Chart IV), the structural trend remains robust. In that case due to base effects the year on year economic growth rates may slow down, but not awfully. Again if the economy slows, earnings growth would too with a lag, but will remain in mid teens.

The economic growth has helped the corporate earnings remain stable and rising in the 4QFY2010. The broader market revenues and net profits were up (year on year) by 30% and 39% respectively, driven mainly by rise in margins, especially if the energy sector is excluded. Higher pricing power and rising operating leverage is helping too.

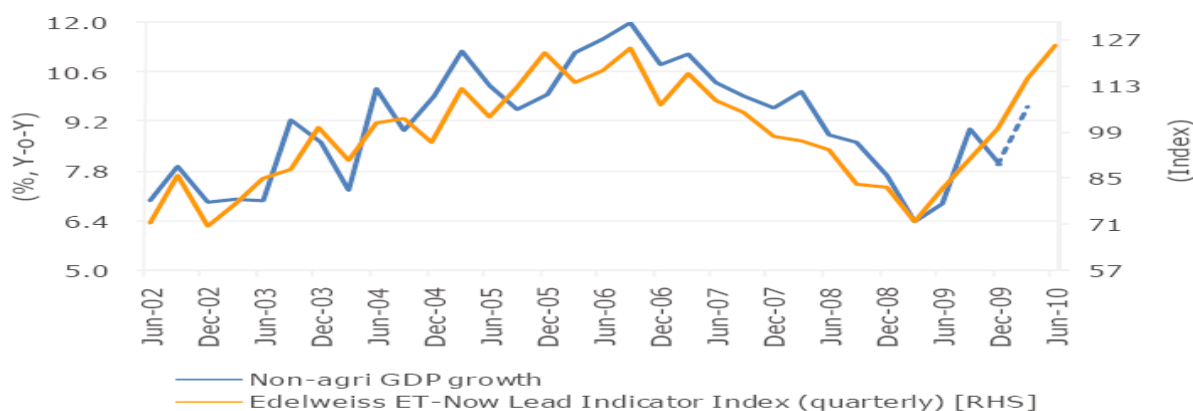
As we discussed earlier, if the storm of the “Europe Sovereign Crisis” does hit the Indian shores, the impact via the trade channel is expected to be minimal. The real channel of contagion will be the “Financial Flows” and the sudden stop/reversals of the same. The storm will hit the financial economy more than the real economy being more of a domestic driven economy. And the subsequent adverse impact of disproportionate

Title: Cyclical Strengths v/s Structural Headwinds.

Region: GLOBAL/INDIA Date: 31st May 2010 No of Pages: 6

capital outflows on stocks, money, bonds and currency markets is well known, at least to those who were long in 2008 and during the Lehman crash.

Chart IV: ET Now-Edelweiss LEI: Inflexion point?



Source: CSO, Edelweiss research
Note*: Refers to expenditure on social, personal, and community services

Source: Edelweiss Research

Let's run a "Scenario Analysis" on various outcomes of the ongoing sovereign crisis and the impact of each of them on Indian asset markets and macro economic variables.

Chart V: India and European Sovereign Crisis: A Scenario Analysis

<p>Worst Case Sovereign Debt Crisis engulfs the world and the growth rates collapses.</p>	<p>Hopeful Case The crisis slows down the global growth moderately and world economy chugs along.</p>	<p>Best Case The world recovers from crisis back and above its trend growth rates</p>
--	--	--

Source: Delta Global Partners Research

Each of the above scenarios is self explanatory. In Table III below, we have tried to estimate on a thumb rule basis, the likely asset market levels and macro economic variables in each of these scenarios crystallize.

Table III: India and European Sovereign Crisis: A Scenario Analysis

Variables	Worst Case	Likely Case	Best Case
Real GDP Growth Rate	5.5-6%	7.5%	9%+
SENSEX 1 yr returns from current levels	-25%	+10-15%	+20%
Capital Flows (FII net inflow in next 1 year)	USD -12bn	USD 6-7 bn	USD 10 bn
Interest Rates (10 year GOI Yield)	7-7.25%	7.25-7.75%	8-8.50%
USD-INR	49-50	46-48	42-43
Inflation (WPI yoy in %)	4-5%	6-7%	9-10%

Source: Delta Global Partners Research (Numbers are estimates and likely scenarios and not forecast's)

Title: Cyclical Strengths v/s Structural Headwinds.

Region: GLOBAL/INDIA Date: 31st May 2010 No of Pages: 6

Every dark cloud has a silver lining too. And the sovereign or any other severe global crisis has. Global Central Banks (except for India which should not) would delay the proposed rate hikes further ahead in time, thus aiding risky assets. For India, the silver lining comes in form of lower oil prices, lower commodity prices helping inflation lower, cheaper imports from Euro region, lower or steady policy interest rates and higher gold prices for infinite Indians holding it.

So are the stock markets (SENSEX) at current level of Price Earnings Ratio (PER) 15.1x (FY2011 EPS) Very Cheap ? NO. Very Expensive? NO. It's around its long term average of PER. But if the Worst Case scenario is excluded, India's economic growth rate and corporate earnings may get bumped up, making the markets cheaper, especially if it falls sharply due to exogenous fear factor. These valuations, economic growth and corporate earnings are India's "shock absorbers" for the stock markets and the real economy in event of an outright sovereign crisis.

We all do hope that the Cyclical Strengths win over the Structural Headwinds, since the world can't afford a new set of crisis conditions, since the ammunition to fight the same is very limited now.

Devendra Nevgi
Delta Global Partners
Founder & Principal Partner
deven@dgp.co.in
Tel: + 91 9867 277 977

IMPORTANT DISCLAIMER:

The note and the suggestions are for information purposes only and not to solicit any business or give any recommendation. Delta Global Partners do not take any responsibility of the losses that may arise out of actions taken based on the note. The figures and charts are not authenticated by any authority. Please make an independent review before taking any decision. Delta Global Partners does not intend to act as a portfolio manager or investment advisor registered with SEBI or under any other law. The author of the note may or may not exposure to the strategies suggested, if any.