

# 2012 Market Perspective

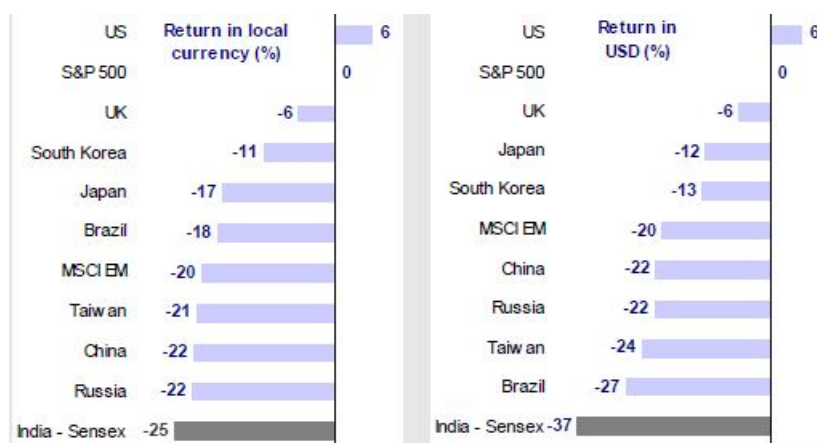
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January 2012

## THE YEAR GONE BY

For International Investors, the year 2011 was one of despair with regards to their India Equity Asset Allocation. Last year, the Indian Equity Market was a victim of slowing economic growth (despite being one of the high GDP growth engines of Global growth) characterized by high inflation (both core and food), higher interest rates, slowing industrial production and waning business confidence. The legislature hardly cleared any new economic reforms bill. The Government's lackadaisical attitude resulted in policy paralysis. The outcome was the widening Fiscal and Trade deficit. Throughout the year, the Euro Zone Debt crisis impasse in general, gave rise to risk aversion towards emerging market investments. These two factors affected incremental India FII allocations. The effect of all these was a big negative on both the Equity and Currency markets. India turned out to be the worst performing equity market in 2011 (see exhibit 1)

## CY11 world equity returns (%): India the worst performer



Source: Bloomberg, Motilal Oswal

**Will 2012 change any of the above?** Yes, some of them would get better in the short term (3-6 months) whereas some others would take little longer. On the domestic front, the current year would see several of India's Federal States going to Polls, the important one being - the most populous Uttar Pradesh in Feb/March. The Union Budget (tentatively on 15<sup>th</sup> March 2012) will be presented after the poll results. It is appropriate to analyze and anticipate possible macro economic trends in two parts – pre state elections/ budget and post election/budget (March - Dec 2012) as economics and politics are closely woven in the Indian context. Before that let us look at the global factors that could affect the Indian markets.

We would see more summits/meetings throughout 2012 to resolve the Eurozone Sovereign Debt crisis, infuse confidence in and provide stability to EuroDollar and soften the blow on the otherwise deepening recession in Euroland. This could usher in another Quantitative Easing (QE) in some form by the central banks of the developed world. Global risk appetite may improve. Liquidity flows into emerging markets in general and India in particular may stand to improve. **Earlier QE (in 2009/10) has helped Indian Equity markets and this time too it may be no different.**

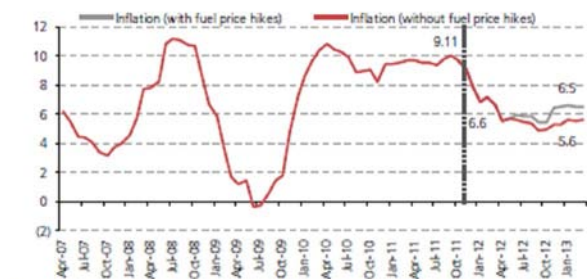
## JAN – MARCH 2012

In the next two months, in the run-up to the State Elections and the Union Budget, one may continue to witness the Government policy inaction and continuance of deterioration on the fiscal and trade deficit front; but one can expect some favorable monetary policy

measures/indications from the Reserve Bank of India (RBI). The food inflation has already dived to negative territory (-3.6% yoy). The central bank expects the inflation to fall from its current level of 9% plus to 7% by March 2012 backed by food inflation and the base effect. Kotak Institutional Equities estimates too indicate the same and expect it to come off further during the year. Though we expect the RBI to maintain its anti-inflationary stance in the near term and hold on to its pause on interest rates until the inflation reaches its projected level by March, **any policy rate cut in the interim would be a very big surprise and a positive for equity markets.**

### Inflation may decline through FY2013E

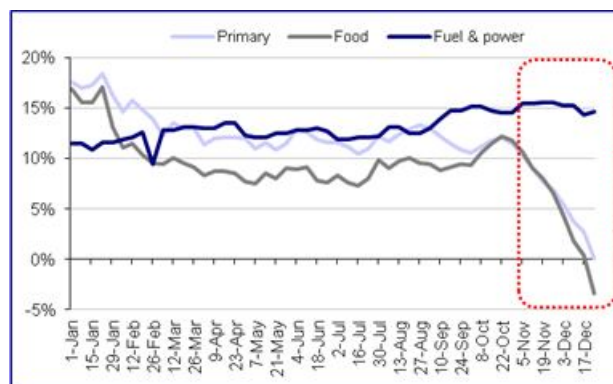
WPI inflation (yoy change), 2008-13E (%)



Notes:  
 (1) Assuming (a) Rs2.5/liter price increase in diesel in June and November 2012, (b) Rs2/cylinder increase in LPG prices each in June and November 2012, (c) Rs2/liter increase in kerosene prices each in June and November 2012.  
 (2) In our scenario without fuel price increases, we assume no change in prices of regulated fuels through FY2013E.

Source: Kotak Securities Limited, a Kotak Group Company

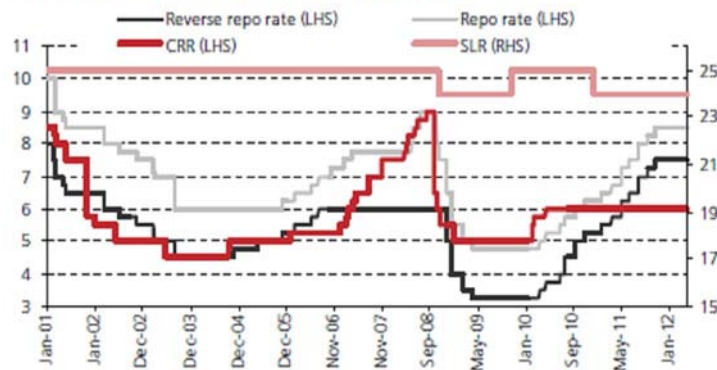
### Food Inflation on the descent



Source: Motilal Oswal Securities

### RBI to maintain its anti-inflationary stance in the near term

RBI's repo, reverse repo rates, cash reserve ratio and SLR (%)



Source: RBI, Kotak Securities Limited, a Kotak Group Company

On the currency front, to reduce the volatility, the RBI has taken measures to bring down the speculative hedging/trading volumes by corporates, FII's and banks by imposing/reducing limits on their currency exposures. Further it has also de-regulated the NRE deposit rates. The FII limit in G-Sec and corporate bonds have been increased. Though the central bank has shied away from any direct intervention in the currency market, we see these steps as quite effective in the near term to provide stability to the INR. The comfortable forex reserve in excess of USD 310 bn could be put to use in future, for any further stabilization. As a consequence we might see the INR recovering some of the lost ground against USD in the near future. **Thus any incremental investment into Indian equities may see some returns in the form of INR appreciation as well.**

**The Government's decision to allow foreign non-institutional investors to buy Indian equities is a sentiment positive step for the markets.** The current inflows happen to be largely debt based and this move could alter the composition going forward.

**On the Industrial production front there is some indication of business confidence returning with the HSBC PMI index going up from sub 51 to above 54.2 levels in December 2011.**

We are entering the Q3 result season with an already moderated/lowered earnings estimate for FY12 by street analysts. Thus most of the negative earnings are factored in the prices. We expect disparity in the earnings of various sectors comprising the broader market Index (Sensex/Nifty). As per KIE estimates, the Sensex is trading at 12 X 1 year forward (rolling basis) and are thus at historical averages. The S&P CNX Midcap Index is currently trading at 8.97x FY13 EPS as compared to broader S&P NIFTY Index which trades at 11.55x FY13 EPS, implying a discount of 28.7% to the midcaps (Bloomberg estimate as of 31<sup>st</sup> December 2011). **Thus valuations at current levels should provide comfort to investors and hence with incremental flows the markets should start moving up in the near term albeit with intermittent volatility. The attractiveness of midcap investment has improved with widening valuation differential.**



Source: Kotak Securities Limited, a Kotak Group Company

Thus in the near term, monetary policy and its outcome could surprise markets rather than any fiscal consolidation or reforms from the Government. The stabilizing INR could bring in additional comfort for India investors and valuations would support market at current levels. Overall these three aspects could bring in some cheer to the investors.

### BEYOND MARCH (POST STATE ELECTIONS AND UNION BUDGET)

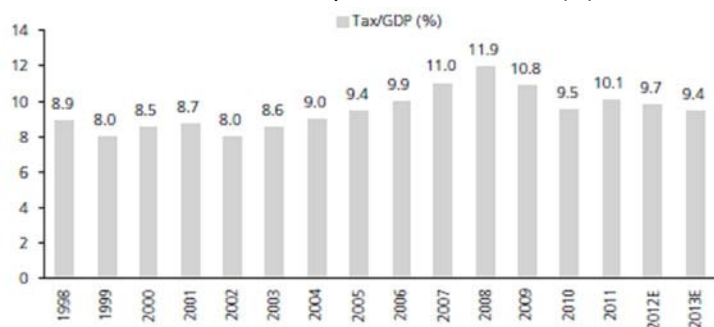
Now let us look at some of the changes that could come in the medium to long term. Once the elections are over, we expect the Government to take some hard decisions to tackle the fiscal mess. Hence we could see not a Populist Budget but one which would strive to give a fillip to the economic growth. Some of the things to watch out for would be:

Measures to enhance tax collection by bringing in more services under the professional tax income and Increasing/rationalizing indirect taxes on some luxury/lifestyle products.

One of the major reasons for India's widening fiscal deficit has been poor tax collection.

### India's tax-to-GDP ratio (based on Central taxes) has languished around 10% for the past few years

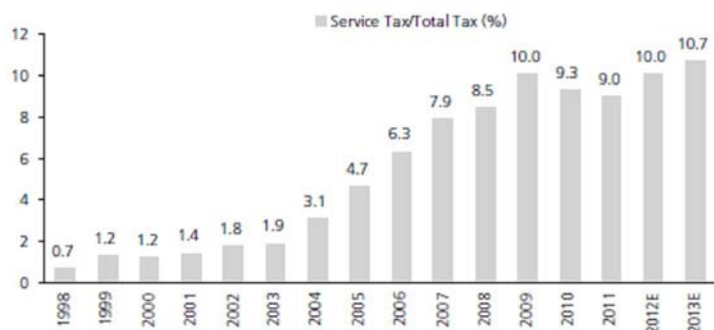
Tax-to-GDP ratio, March fiscal year-ends, 1998-13E (%)



Source: CEIC, Kotak Securities Limited, a Kotak Group Company

### The share of service tax is very low in total

Service tax to total tax, March fiscal year-ends, 1998-13E (%)



Source: CEIC, Kotak Securities Limited, a Kotak Group Company

Public Sector Disinvestment could once again become priority. SEBI, the market regulator has already relaxed the norms for companies to bring down the promoter ownership through qualified institutional placement. This could provide a shorter and faster mechanism (instead of Public Issue) for PSU disinvestment as well.

Details of the 12<sup>th</sup> Five year Plan (2012-2017) would be made public by the Planning Commission before 2012 and this could give the much needed thrust to Infrastructure and other long term investments.

Some of the pending Bills in the parliament like the Lokpal Bill, New Companies Act, Mining Regulation, Land Acquisition, Pension and Insurance Regulation etc may be deliberated and legislated. We also feel that the FDI in Multibrand Retail which had become a casualty due to political differences both within and outside the ruling coalition may through during the year. The Direct Tax Code (DTC), Goods and Services Tax (GST) which has got postponed by a year may be finally put through in 2012 to be implemented by the next fiscal year.

Aided by easing inflation, the Central bank may once again start addressing growth by way of policy rate cuts. **We expect interest rate cuts totaling 100 bps in FY13 to start only beyond March 2012. If past is any indication (2005- 2007), interest /policy rate cuts are inversely co-related to equity markets and hence such a move should auger well for Indian equity throughout 2012.**

Though Fiscal deficit may continue to remain a concern, it may not be as heightened as we saw in 2011. Budgetary measures on improved tax collection and dis-investment targets being met would alleviate pressure on fiscal deficit. The Fiscal Responsibility and Budget Management Act 2003 was suspended in FY09 during the global sub-prime crisis. **We may see revival of the same in a modified form which could improve Fiscal Consolidation. These steps, if taken, could bring back Foreign Investor confidence into the Indian Equities.**

**Overall, in 2012(fiscal year FY12-13), if the government gets its act right and pushes the economic reforms agenda ahead and the central bank lead monetary policy easing could bring in the much needed thrust for the Indian equity market. A clearer picture would emerge by mid 2012.**

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