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The Euro Bailout

May 14, 2010

Last week's panic in financial markets finally forced European policy-makers into taking decisive action. Convinced that inertia would potentially lead to the collapse of the euro itself, European Union (EU) leaders effectively threw the kitchen sink and whatever else they could at the issue. The outcome was a new financial stabilisation package of up to euro 750 billion. There are three pieces to the package: First, opening up the EU balance of payments facility to all euro area countries and increasing its ceiling from euro 60 billion to euro 110 billion. Secondly, a new European stabilisation fund, which will provide guarantees worth up to euro 440 billion. Finally, an additional International Monetary Fund (IMF) facility of up to euro 250 billion. In addition, ECB has announced that it will intervene directly in public and private debt markets, and in conjunction with the Fed has re-opened USD swap lines, allowing European banks to obtain USD funding against euro collateral.

These measures have been accompanied by a strong commitment from the respective euro area governments to ensure fiscal sustainability. Portugal and Spain have committed to additional fiscal consolidation measures in 2010 and 2011, which will be presented on May 18. Governments have also committed to reform the Stability and Growth Pact to ensure fiscal discipline. It was also made clear that any country drawing down on any of the above facilities will have to subject itself to strict IMF conditions and monitoring.

These measures are critical in importance not only because of the size of response, but also the speed and cohesiveness of the policy action. Investor negativism towards euro assets over the past few months has been based on more than just the deteriorating fiscal. For, in reality, the euro area's deficits and debt ratios are no worse than many other developed economies. The aversion to euro assets was based more on the EU institutional weakness, exposed while handling this crisis. The core problem of Europe not having a strong, centralised and empowered political leadership which can take quick, decisive action was shown up. The initial reluctance on the part of Germany to support Greece, the need to constantly revise the rescue package and the need for parliamentary approval in each country further highlighted the fractured decision-making model.

The sovereign credit crisis has brought Europe to a critical fork in the road as to its own existence. It can choose either closer political and fiscal integration or eventual disintegration. This crisis is similar to the ERM currency crisis during the early 1990's which eventually pushed the main body of European countries towards a monetary union.

While the real efficacy of the announced policy package is still to be tested, it clearly shows that the EU leadership is not prepared to give up on the single currency, and, in fact, seems to be prepared to move further down the road to much greater cooperation on fiscal and budgetary issues. This crisis may go down in history as the turning point wherein Europe accepted the need to move towards a loose fiscal union with far greater coordination and monitoring of each other's budgetary matters. As to the outlook for markets from here, there are two clear schools of thought.

One group is of the view that this package does nothing to address the fundamental issues of sovereign solvency. All we have done is given Greece, Portugal and Spain some time to get their fiscal house in order (without even addressing the issues in Italy and Ireland). This group is not optimistic about the ability of these countries to actually implement fiscal adjustments of the magnitude of 10 per cent of GDP and that too in a few years, and without being able to devalue the currency. The bears don't think there is enough political will or willingness to endure hardship in the above-mentioned countries, and a serious moral hazard problem. This group also questions the entire burden of adjustment having to fall on the local populace of these countries (through the fiscal consolidation). A more fair adjustment process would involve creditors also taking a haircut (be they banks on their bonds or other countries on their fiscal transfers). The bears fear the burden of adjustment on the local populace will be too high, growth will collapse, leading to a negative spiral of contracting GDP and rising debt ratios, and some type of debt restructuring will be inevitable and still lies ahead.

The counter point to this is an interesting study done by BCA which points out that in the past 30 years, there have been seven instances of successful fiscal adjustment in Europe where we have seen a fiscal correction of more than 10 per cent of GDP. In each of these fiscal adjustments (except for Greece), GDP growth actually accelerated as the relevant country gained competitiveness and sustained productivity improvements. Key success factors which enabled these fiscal adjustments were a focus on expenditure cuts rather than tax hikes and a societal consensus supporting the necessity for the fiscal retrenchment. One may need to track the progress of Greece, Portugal and Spain on both these counts, to better handicap their chances of successfully completing the fiscal adjustments needed. The BCA study shows that it can be and has been done before.

The bulls point to the fact that global growth continues to surprise on the upside, with the latest US employment numbers surprising positively and purchasing managers indices (PMIs) improving across all regions. The current earnings season also continues to surprise positively, with the majority of companies continuing to beat analyst estimates. With strong earnings and low rates, markets seem cheap. Liquidity conditions will also continue to be supportive, as the latest crisis will only further push out any attempts at normalisation of monetary policy on the part of both the Fed and ECB. Markets thus continue to be in the sweet spot of very easy liquidity, super low rates but improving growth and earnings. For this camp, any corrections are a buying opportunity, as they continue to believe in the inevitability of markets rising till such time as the central banks remain on hold. Risk assets will get a bid, and capital will keep moving towards those asset classes and regions where growth is strong and benefiting from very easy macro policy settings.

It looks like being a very tough call, but I would tend to slightly tilt towards the bulls, and thus would remain invested, but have portfolio protection to safeguard against another potential shock. The markets should do fine if the relevant countries can deliver credible fiscal adjustment plans (based on spending cuts, not huge tax hikes) and we see greater buy-in from the local populace in understanding the need for austerity. In the absence of local buy-in, sharing the adjustment pain more broadly through debt restructuring comes back on the table, with potentially very serious consequences for the EU banking system and global liquidity. The only clear trade seems to be a further depreciation of the euro. Net net, stay invested but remain paranoid...

Complacency Setting In

April 23, 2010

We have a long, hard road ahead of us, so we must not get complacent

It is now widely acknowledged in investing circles, at least among emerging market investors, that India is one of the better long-term stories out there. Chris Wood of CLSA has for years now highlighted India as his single-best long-term bet in Asia. He makes the point about entrepreneurship, focus on domestic consumption in the economic model, and greater respect for capital among corporate houses as his reasons for being bullish. The emerging market (EM) strategist at BCA also highlighted India as his single-best idea over the next five years at a recent seminar that I attended. He talks of India being a severely under-invested country which, despite the under-investment, is showing good productivity growth. He makes the point that India has now begun to invest, and betting on a country which is under-invested but is now investing because of rising domestic savings normally leads to profitable outcomes.

Jim Walker of Asianomics is another noted economic commentator who is quite bullish on India for the long term, and has very high regard for our economic policy-makers in general and the Reserve Bank of India (RBI) in particular. Consistent with the above, he expects far less capital destruction in India than in other Asian markets, and far better capital discipline and a more pronounced domestic orientation in our growth strategy.

Everyone is, of course, aware of the famous Goldman Sach's BRIC report, and its contention that India will grow faster for longer and has the best longer term growth outlook among the four economies.

I could, of course, go on and there are many more equally famous market observers who have made similar comments. Thus, one can understand why everyone in India may be getting a little complacent and even smug. It is almost as if investors and policy-makers are convinced that this rosy outlook is baked in the cake, so to speak. If it is going to happen and India is going to march ahead anyway, why take hard decisions? Does one really need to battle vested interests when 8 per cent or even 9 per cent long-term growth is assured?

In this context I had some very interesting meetings over the last few weeks, with some very savvy and seasoned global investors who had an interesting perspective on this issue.

They first of all made the point that there are many instances of countries growing strongly for a period and then stalling. Brazil was cited as the most obvious instance, where, after a period of strong economic performance, the country totally stalled in the 1980s and 1990s. There have been only 12 or 13 countries which have been able to grow at 8 per cent or faster for at least 25 years. Of this number, at least half have little relevance being single-resource dependent or city states. India, therefore, cannot take its current success for granted, only four countries (of a reasonable size) have been able to do what India aspires to. What investors are assuming is a done deal is actually extraordinarily rare.

The second point made was the increasing politician-industrialist nexus. To these investors, parts of India were beginning to resemble Russia, with the same characteristics of crony capitalism and huge wealth transfer from state assets to private ownership. India may not like hearing it, but in certain sectors, its institutions are too weak to face off against corporate interests.

An additional point was made on the inability to take decisions and build consensus. Why would a country go on agonising over foreign education providers when there is such an obvious shortage of capacity in higher education? Even if you get foreign institutes to come in, they will only supplement the domestic institutions and just scratch the surface in terms of meeting unfulfilled demands. This was cited as another example of a total unwillingness on the part of the government to take on vested interests. It was surprising to one of the investors how even small sections of society can seemingly hold back progress and the whole country to ransom. In a country like India with a general resistance to change, any progress requires vested interests or rent-seekers to be pushed aside, and an unwillingness to do so severely impairs progress.

These investors also felt that India had an intractable problem on the fiscal front, as any progress would be frittered away in poorly designed or executed social sector give-aways. This genie has now been let out of the bottle, and no government will be able to resist the temptation to keep spending. Spending has now got strongly associated with winning elections. India may have got away with it right now given the poor fiscal situation globally, but the country has a structural propensity in recent years towards populism. This poor fiscal discipline will ultimately lead to structural crowding out and inflation issues.

There were additional points made on the extremely poor supply-side response in infrastructure, and as to how this was a systemic issue related to land and process and not to funding or capacity constraints. Being a systemic issue, it was not likely to get resolved. What would cause it to change today which could not have been done years ago? Infrastructure deficit was now binding, and unless it was resolved, it would not permit the desired growth.

There was concern around India's demographics, with the fear of this being a demographic disaster, rather than dividend. Given our levels of vocational training, higher education and labour market rigidities, questions were asked on how would the country move hundreds of millions of people off farms and improve their productivity? They were surprised at the very low levels of political noise around job creation compared to China, where the government has an almost single-point agenda around creating 20 million jobs per annum.

India's huge dependence on global capital flows was also highlighted. One investor went so far as to say that India was the most leveraged market to global capital flows and hence risk appetite in the world. Without strong foreign capital flows, the growth story did not stand, was the simple point.

There was concern around governance, or the lack of it. And, India as an investment destination was perceived to be a tug of war between a good micro-company-specific story and very poor and worsening governance.

It was to put it mildly a sobering series of conversations. While one does not necessarily agree with all the points made, it does go to show that maybe we should not get carried away. We can potentially have a strong growth trajectory, but it will require strong political will to implement long overdue fundamental changes. These required changes are well known but still do not get implemented. Someday soon this has to change. We have a long hard road ahead of us, we must not get complacent. Maintaining growth will require decisive action, determination and a clear head. We cannot let ourselves get diverted.

Concerns on China

April 9, 2010

One recent trend that seems to be gaining momentum is concern about China and its growth outlook. Is China a bubble waiting to explode? Will the coming collapse of China take down all emerging and commodity markets? These are some of the issues on investors' minds these days. The concerns around China are clearly benefitting India as investors seem to be far more sanguine about India's long-term growth prospects. No one thinks India is in the midst of some super bubble, and the noticeable pick-up in investment flows from foreign Institutional Investors (FIIs) into India can be partly traced to some asset allocation shifts on the margin from China to India.

There are two-three interesting articles laying out the bear case on China, all available on the web. The presentations by Jim Chanos, Vitaliy Katsenelson and Edward Chancellor of GMO are the most interesting. I have chosen to focus on the GMO white paper in this article, but the points being made by Chanos and Katsenelson are quite similar to what Chancellor outlines in the GMO paper.

Chancellor, who is a noted financial historian, makes the point that China today exhibits many of the characteristics of great speculative bubbles or manias. He starts out by outlining some of the common features or characteristics of previous financial bubbles and then points out how they can be used to describe China today. Historically, rapid (above trend) credit growth has been the single most important indicator of a developing financial bubble. This is closely followed by the build-up of an asset price bubble. Very low and sustained interest rates and rapid money supply growth over an extended period are also classic warning signs. Investment manias have always been built on compelling and credible growth stories like China's. A general increase in capital investment leading to misallocation and wastage of resources is another classic sign of a developing investment mania.

Testing the current China story against these historical markers of an impending crisis, Chancellor concludes that it fits the bill on most of the criteria. In fact, there are red flags wherever you look at China. First of all China is clearly a huge economic success, and one can see why it is such a compelling long-term growth story around which a bubble could easily develop. China has 1.3 billion people, with a per capita income only about 10 per cent of US levels, and over the past 30 years the country has increased its GDP 16-fold.

Over the last year, China has overtaken Germany as the world's number one exporter and Japan as the second largest economy. Over the coming decade, 300 million rural inhabitants are expected to move into cities, laying the foundation for continued 8-10 per cent GDP growth for many decades. Its economic momentum seems unstoppable. Chancellor's contention is that investors are simply extrapolating recent growth rates and that forecasts for urbanisation and growth may be exaggerated. He also feels investors are ignoring the growth-inhibiting aspects of the Chinese demographic story.

If one were to look for an investment boom characteristic of a bubble, it can be found in 2009. Last year, in the midst of a global recession, Chinese fixed asset investment rose 30

per cent to a record 58 per cent of GDP, contributing 90 per cent of the year's economic growth. Infrastructure accounted for more than two-thirds of the spending although China already has adequate infrastructure, with highway usage running at just 12 per cent of the OECD average. Capital spending in an industry like cement increased by two-thirds despite utilisation running only at 78 per cent. There are numerous anecdotal stories of empty roads, airports and huge excess capacity across the industrial complex.

Chinese interest rates are also seemingly artificially depressed. As a general rule of thumb, nominal interest rates should broadly track nominal GDP growth over the medium term. In the US, for example, the prime rate has averaged about 1 per cent more than nominal GDP over the last 40 years. In the case of China, the prime rate has averaged 9 percentage points lower than nominal GDP since 1990 (source:GMO). Low interest rates are one of the tools the Chinese authorities use to subsidise state-owned enterprises and boost investment.

China is currently going through a huge credit boom. In 2009, bank lending increased by RMB 10 trillion, approximately 29 per cent of GDP. Money supply growth exceeded 30 per cent, but it seems unlikely that credit could have expanded at this pace with no decline in asset quality, and the Chinese banking system could be overwhelmed by NPAs. In a world where most are de-leveraging, China has seen the fastest credit expansion in its history.

There seems to be an asset bubble developing in China's property markets. First, on the residential side, prices are clearly stretched. Nationally, home prices have climbed to around eight times the income and in Beijing the ratio is 15. As Chancellor points out, in Tokyo, at its peak, this ratio was 9. Commercial rents in leading Chinese cities are already at international levels, with rents in Beijing and Shanghai rivalling those of New York.

Chancellor makes the point that China's real estate market, its economy and financial system are all working on the assumption that past rates of growth will continue into the future. This assumption justifies continued investment, leading to strong growth and this growth drives further investment, thus confirming the initial thesis and setting up a positive feedback loop. If growth were to disappoint, this can easily reverse into a negative spiral. He equates the China of today with the last stages of the dotcom bubble when investors extrapolated growth and a surge in investment created a spike in demand that justified even the most optimistic predictions. Once the initial predictions were exceeded, investors quickly went overboard in their expectations and long-term modelling of demand.

My own sense is that predicting the timing of any collapse is impossible, and being a state dominated economy China may be able to delay its day of reckoning. It has huge resources, in terms of foreign exchange and in the fiscal elbowroom it enjoys, to keep this party going. As long as it continues to convince the world that it will underwrite 8 per cent growth, the believers will keep investing. The political consequences of dropping below 8 per cent growth, will also ensure that the government will leave no stone unturned in propping up growth. However, if history is any guide this will ultimately end badly.

How to invest with one eye on long-term structural issues like China and yet remain tuned to the short-term momentum of investor enthusiasm for emerging market assets is a dilemma that every investor faces today.

A Difficult Six Months

March 26, 2010

The equity markets have rebounded strongly following the presentation of the Union Budget, rising by more than 10 per cent from their lows. This surge has been caused by a combination of strong global markets as Greece has seemingly bought itself some more time, and a generally favourable response by investors to the Budget and its fiscal targets. Inflows from foreign institutional investors (FIIs) have resumed as many of the large, long-only funds have received significant inflows, and we are in that part of the year when domestic insurance flows are at their maximum. The markets are trading well and seemingly want to go up. The recent move of the ratings agencies to take India off the credit watch status has been a further boost to market sentiments.

However, in my opinion, the next six months is going to be a difficult time, full of risk and an environment where one must exercise caution and not get carried away.

First of all, we are by no means over with these sovereign risk issues. Greece is still in trouble, and the EU is seemingly split as to how to bail out the country. Germany and France are opposite ends of the spectrum on using the International Monetary Fund (IMF) to help a bailout, and Greece has over 20 billion euros of funding needs in April and May. The country is running a fiscal deficit of close to 16 per cent, and not 12 per cent as commonly reported. And, to get this deficit down to a manageable number will involve huge economic and social costs. It is not clear if the country has the stomach and maturity to implement a double-digit fiscal correction. Post-Greece, we have similar issues with Spain, Portugal, Ireland and eventually Italy as well. All this will come to a head over the coming six months. Given the size of funding needs, the quantum of sovereign debt held by the EU financial system, and general political unease over sovereign bail-outs, risk aversion could reassert itself anytime. The euro remains weak and clearly headed lower.

Back home in India, the obvious problem is inflation. The Reserve Bank of India (RBI) governor has probably the toughest job in the country trying to calibrate monetary tightening so as to promote growth, stifle inflation and simultaneously still put through the huge borrowing programme of the government at a reasonable cost. India probably needs higher interest rates to prevent the current food-based inflation from spilling over into a more generalised price spiral, but higher interest rates will hurt the growth transition currently underway. We need to move away from government stimulus being a driver of growth towards private investment demand, and a spike in rates will hurt this transition meaningfully. A 300 basis points higher cost of debt affects project IRRs materially.

India has another problem in that at high rates of growth, anything over 8.5 per cent on a sustained basis, and everything starts falling apart in the country. From power, ports, airports, skilled manpower to railway wagons, everything goes into short supply, and inflation starts to spike higher. Remember, the last inflation scare in 2007 was not driven by food prices at all, but by surges in commodity prices and a general overheating of the economy. We are a fundamentally under-invested country, and to address the structural issues of an economy which cannot handle sustained growth of over 8.5 per cent without

overheating, we need large-scale investments to improve the supply side response to growth in numerous areas of soft and hard infrastructure. To improve the supply side, we need huge investments. These investments are sensitive to rates, and will not be made in an environment of high and rising interest rates. Thus, ironically, one can argue that to tackle inflation on a more structural basis, we actually need low interest rates, not tight monetary policy.

The RBI governor thus has a thankless job, having to make a very delicate balance between growth and inflation. He cannot let the country move into an era of generally higher inflation and interest rates, as once out of the bottle, that genie is very difficult to control. But he cannot use a sledgehammer approach either. He anyway has to handle the inevitable crowding out issues as private sector credit demand picks up.

Interlinked with the above, the biggest risks on the horizon for India are the monsoons and oil prices. Another monsoon failure (God forbid) will throw the whole food price situation out of control, besides seriously damaging consumption, growth and the fiscal. We dodged the bullet of a poor monsoon in 2009 (in terms of economic impact), but two poor years back to back will put a huge strain on the economy. RBI will be forced to act, as no government will be able to withstand the political pressure that will be mounted following a second year of double-digit food price rise. Agriculture will dip by a lot more than the 2 per cent the government statisticians project for 2009, and rural consumption will slump with food subsidies spiralling out of control.

India is also extremely vulnerable to higher oil prices. There is a worrying tendency recently on the part of many global oil analysts to become more bullish and raise their price forecasts, which is a clear red flag.

High oil prices have a huge impact on the fiscal side in India through petroleum product subsidies and higher fertiliser subsidies, or on inflation in case prices are allowed to adjust. We can only hope that prices behave. Whether the impact is through the fiscal or inflation, the end outcome is the same — higher rates.

The next six months are also critical in that the government will have to demonstrate progress on tax reform through the direct tax code and goods and services tax. As pointed out before, both these reforms are absolutely critical to achieving the fiscal deficit targets outlined in the Budget. We will know within the next six months whether the government has been able to withstand the lobbyists and special interest groups, and deliver on these landmark legislations.

The markets, to my mind, should be stuck in a broad trading zone till such time as we get better visibility on the monsoons and oil prices. Normally, the rains do not have such importance, but given the inflationary and fiscal challenges already confronting the country and the policy-makers, we need to cross this hurdle for the markets to break out of their current range.

Markets can handle a 125-150 basis points rate hike over the coming 12 months, that is baked in the cake, but anything higher than that will be corrosive for PE multiples and market performance.

If the rain gods are kind, and the government does deliver on tax reform, then we are looking at a very positive market outlook in the second half of 2010.

India Versus China

March 12, 2010

I came across a recent research note titled “Buy chaos, sell order” put out by Russell Napier of CLSA. In the research piece, Mr Napier highlights the argument for why over the coming years India should be a far better investment destination for financial investors than China. He makes the point that India’s troubles come from tackling its most difficult problems first, and he senses a tipping point, where the structural impediments holding India back are slowly fading. He also makes the point that China’s state-imposed order will slowly disappear as its growth dynamic evolves. He urges investors to not get fooled by China’s superficial order and India’s apparent chaos.

Napier makes the point that there is little correlation between levels of economic growth and returns from equities, especially in emerging markets (EMs). One of the chief causes of this is the mercantilist policies followed by most of the EM world, involving ultra-cheap exchange rates and a near total dependence on export growth. These policies hamper equity returns as a thriving and heavily-favoured export sector is normally poorly represented on stock markets, and targeting of the exchange rate can produce extreme monetary conditions, causing severe volatility in economic cycles. A boom/bust cycle can severely damage long-term equity returns.

Today, there seems to be a broad consensus that mercantilist policies have now been maxed out. The OECD economies can no longer continue absorbing an endless supply of goods from East Asia, and this export-led growth approach cannot deliver western living standards to large economies like India and China. The pressure on China to move away from this growth dynamic will keep mounting. Napier argues that the key question for any EM investor is to determine which countries can make the transition to a post-mercantilist world, and it is here that India is better positioned.

India is far more advanced than China in developing a functioning private sector financial system, with the cost of capital being far more real and market-determined than in China. India is also a much more productive user of capital, due to its historic high cost and limited availability. He makes the point that reforming a command-economy banking system is extremely difficult and China continues to shy away from going down this road. The distortion and artificiality in the pricing of money are the key weaknesses of the Chinese system, and it is difficult to think of any command economy banking system that has transitioned into a private sector system without a crisis marking the transition.

Napier also makes the point that India is far better positioned for the post-mercantilist world than China. He bases this observation on the fact that India is far closer to a market-based exchange rate and free interest rates than China. India is also far less dependent on exports, and can move much more easily to a consumption-driven model than China. India’s banking system can also far more easily provide consumer credit to support and encourage domestic consumption. The Chinese financial system is still geared towards funding state-owned enterprises and business. The Indian economic model already has consumption as its centrepiece, while China will have to significantly rejig its economic incentives to push consumption.

He also makes some encouraging comments on India's demographics, evolving democracy and improving bureaucracy.

Napier has strong credibility globally, and his piece will, I am sure, attract attention. One has also seen recent articles from Templeton and other large EM investors, making similar arguments and outlining the long-term case for India. Even the Financial Times has been making encouraging noises to this effect.

However, after discussion with serious long-term real money investors in the US and Europe over the past few months, one does not get a sense that they believe in Napier's or Templeton's conclusions. Most investors remain very enamoured of China, its execution and economic model and believe it will continue to outperform India — in economic growth numbers for sure, and implicitly in financial market performance as well. Nobody has thought about the possibility of India actually being able to outgrow China over the next two to three years, something which the Indian intelligentsia feels is a real possibility.

Almost all the investors I speak with have large, dedicated allocations to China, and they do not question the need to have a specific China allocation. The country is too big, markets too large, capital needs too significant and we need a specialist on the ground, is the usual refrain. China has clearly created a separate asset class for itself. The country is simply too important for the global economy and the commodity complex. There are signs of similar things happening for Brazil as well, with many investors incredibly optimistic about it and its long-term outlook.

For India, however, I still feel many investors have not made up their minds on the country. Many of the world's largest and most sophisticated investors have limited specialist India exposure. They are not convinced the country deserves a full-time specialist allocation. India has not yet been able to market itself as a separate asset class the way China has. This anomaly is there despite India having a far greater investable universe than China. India's real attraction has always been seen as being the entrepreneurship of its private sector. One would have thought that stock-picking and specialist-on-the-ground exposure would be far more important and fruitful in a market like India. Also, most LPs (limited partners) seem to have more money in India on the private equity side than on public markets' side, another oddity considering that most private equity investors in the country are anyway investing in public markets.

All this will hopefully change over the next few years as we continue to grow, develop and confound the sceptics. The biggest fears around India remain the fiscal deficit (its sustainability), hopeless implementation skills, weak governance and corruption. Many of the changes one expects to see over the coming years — in areas like the UID project, adherence to the Finance Commission recommendations, better governance and targeting of government programmes, etc. — will go to counter some of these fears. Ultimately, investors will have to stand up and take notice. In the new post-mercantilist world, very few countries have the growth potential and economic model that India has.

If India is able to make the transition into being seen as a separate asset class, then a significant upside remains for the markets in terms of potential inflows. Being able to

attract these flows remains very important to ensure our financial markets have the liquidity we need to finance our growth potential.

A Reasonable Effort

February 27, 2010

The budget presented by the finance minister yesterday was notable in that there were no nasty surprises, and a grateful market responded (largely through short covering) by rising upwards of 1.25 percent. Market expectations were obviously muted, and the FM managed to satisfy these low expectations.

First of all, on the positive side, the FM began his speech by talking about the need to concentrate on social sector spending and create an enabling environment for growth without getting involved in every sector. This is an usually clear and forthright statement from this government.

The FM also took on the issue of PSU disinvestment directly, budgeting for a revenue mop-up of Rs 40,000 crore from divestment and talking about the advantages of selling government stakes in these companies. This is again a far more direct approach and there no longer seems to be any need for apologies on this count.

The willingness of the government to accept the 13th Finance Commission recommendations on the targets and transparency of approach towards fiscal consolidation is another positive. The desire to move to a fiscal deficit target of 4.1 per cent by FY 2013, and hopefully 3 percent by 2014 are all good. The willingness to accept a public debt/GDP target is again a sea change. The clear statement that the government will not issue fertiliser or oil bonds and pay all subsidies in cash is positive for companies in these sectors and also ensures transparency in the fiscal calculations. The ability of the FM to hit the 5.5 percent fiscal target in 2011 has also cheered the market as has the lower net market borrowing target of Rs 345,000 crore (at least Rs 25-30,000 crore below market expectation).

The FM must also be commended for using quite credible macro targets. It looks as if the budget document is using nominal GDP growth estimates of about 13 percent and net tax revenue growth of 15 percent, both of which look quite believable. Expenditure is also moving in the right direction, with a strong 15 percent plus growth in plan expenditure and only 6 percent growth in non-plan, though one can question the government's ability to hold total spending at just 8.5 per cent.

The recasting of tax slabs so as to leave an additional Rs 25,000-30,000 crore in the hands of the middle class is another huge boost to urban consumer sentiment and helps consumption. The hike in MAT to 18 percent is, to my mind, a positive as it will force us closer to the DTC ideal of a low rate of tax which every company has to pay, with limited exemptions. The excise rollback of only 2 percent is also a positive surprise to the markets.

Other associated reforms like the move to auction coal blocks and have a coal regulator, the seeming willingness to open up new bank licences to the private sector, incentives for legal reform are major positives.

The problem I have with the budget is it is again a case of reforms pushed out. The FM has managed to bring the fiscal deficit down to 5.5 percent of GDP from 6.9 percent, despite only a net Rs 20,000 crore incremental incidence of taxation. The budget maths relies heavily on being able to keep expenditure growth under control at 8.6 percent, and being able to raise Rs 75,000 crores from disinvestment and 3G auctions, neither of which is fully under government control. The only real revenue-raising measure is the hike in duties on petro-products, which is invariably going to be inflationary. In fact, the bond markets, after initially gaining on the lower borrowing programme for 2011, gave back all the gains as the inflationary consequences of the fuel hikes sank in.

Real structural changes on the expenditure side are still not in sight. There was no movement on the Kirit Parikh report, no further details on the nutrient-based scheme for fertilisers and no movement on targeting food subsidies. The fiscal remains very vulnerable to any serious spike in crude prices. Can we really continue to keep total expenditure growth at sub 9 percent beyond 2011, with the Right to Food Bill and the Right to Education Bill costs still to enter the budget arithmetic?

Both the major revenue reforms, the GST and DTC will happen only in 2011-12. There was also no further clarity on what will actually go into the direct tax code, or the expected rates to be adopted for GST. One can only hope that the government manages to convince the states to accept the finance commission's view of a single rate with limited exemptions. The unfortunate tendency to micro manage on the tax side continues, with micro-level changes in sector specific tax rates and exemptions.

The budget has the big positive of being committed to the fiscal targets of the 13th Finance Commission and the FM deserves full marks for that. Investors both local and international will applaud the targets outlined, but the details of how we will get there are still not clear. In terms of key reforms still to be implemented like GST/DTC and subsidy rationalisation, the hard decisions are still ahead of us. Markets are for the moment happy with the fiscal targets outlined, but will eventually start focusing on how we reach these targets. If one is willing to give the government the benefit of the doubt, then one can say that the details on both the expenditure and revenue side will become clearer over the coming 12 months.

On the whole, not a bad effort as it has given the government a little more breathing time to implement some of the more difficult structural reforms. However the government has to realise that at some stage it will have to deliver on these big ticket items. The market will not accept mere targets without credible action forever.

An Important Signal

February 12, 2010

The Budget to be presented on February 26, 2010 is one of the most important economic documents the UPA government will present in a long time. Over the past five years, though important, Budgets have not had the potential signalling impact that this upcoming event has acquired.

First of all, this upcoming document has come to be seen as a litmus test by foreign investors on the seriousness of the new UPA government to move ahead on structural reform. There can be no more excuses; the finance minister got away last time by citing the limited time available to present Budget 2009. He deflected the need to present a credible game plan to bring the fiscal deficit under control, citing the pending (at that time, but since submitted) 13th Finance Commission report. The policy-makers talked of doing reform throughout the year, and not bunching it all up in one Budget document; well, that bluff has also now been called over the last nine months.

Investors want to see intent on policy reform, willingness to bite the bullet and take some hard decisions as well as awareness that we have a serious fiscal problem. Nobody wants to see yet more committees set up, lip service to how this deficit is unsustainable, but no action.

The minimum investors will want to see is a credible plan to cut the fiscal deficit, which actually leads to structural changes on both revenue and expenditure side. Can there be movement on things like the Parikh committee report, a nutrient-based subsidy framework for fertilisers, further targeting of food subsidies? On the revenue side, will we get a credible date and structure for the GST, where are we on the direct tax code? Attempts to bring the deficit down by recasting the GDP data, and assuming high growth rates will not cut it. Investors will, in my opinion, not react positively to a deficit-reduction plan which is in effect a simple and blind bet on high growth. This is seen as too risky, as any slippages in growth for whatever reason can have very serious fiscal and economic consequences.

The importance of these structural issues is due to the need to cut the deficit and yet not harm growth. Structural reform like GST is so critical, as it will plug revenue leakages and thus boost growth, corporate profitability and economic efficiency simultaneously. Similarly, with the direct tax code, one has the chance to clean up exemptions, raise effective tax rates and improve productivity and efficiency.

The fear with cutting the fiscal deficit in OECD countries is the huge economic cost, as already weak growth impulses will get further crushed. India has a unique opportunity of being able to streamline and improve its tax structure, which will generate strong revenues and boost growth. Cutting the fiscal deficit in India's case does not necessarily have the negative economic consequences of the OECD world. Our tax structure is warped enough, so that, if improved, it allow us the opportunity to fundamentally strengthen the economy.

Investors have cut India a lot of slack on the deficit, partly due to global circumstances — when the whole world is running double-digit deficits, why single out India — not realising, of course, that our double-digit deficit has very little to do with the global financial crisis, and everything to do with our own structural problems. High growth and the admittedly-credible resilience of the Indian economy in 2008-2009, when the world was imploding, have also taken the focus off other structural issues like the fiscal. Investors are, however, a fickle lot, all you need is a surge in the oil complex, or a Greece-type situation to remind everyone of India's macro vulnerabilities. We have already gone through a bout of this in 2008-2009, when our current account position came into question with oil prices surging past \$125. We are too dependent on external capital to let this happen again. Even though we fully fund our deficit internally, external capital is important to fund incremental growth.

I already detect a lack of patience now building up, investors want to see action. There is nervousness among the investor base, given the events of the past few months. The 3G auctions seem to be delayed once again, with absolutely no visibility on timing, so that is Rs 30,000 crore gone. The GST implementation is also delayed and caught in procedural and state-level issues, with again limited visibility towards time frame. The government remains committed to new social sector programmes like the Right to Food Bill, thus expenditure pressures continue. The NTPC follow-on public offer was not particularly encouraging either, having been effectively bailed out by certain large public sector investment institutions. Not a particularly great start to an aggressive disinvestment programme. Retail investors remain conspicuously absent from new equity issuances. The life insurance companies have, in effect, become the investor of last resort. They are the only institutions with enough firepower to stand up to sustained FII selling, bail out the corporate sector as we saw in 2009, or even support the government borrowing programme. One can only hope that no legislative changes are made which seriously impact flows into these institutions.

A strong and credible policy document delivered by the finance minister is the need of the hour, it will seriously enthrall the investor base and potentially trigger strong capital inflows.

One can argue that India should not care about investors, especially foreign ones. The harsh reality, however, is that disinvestment seems to be (at the moment) the only credible plan the government has to bring down deficits, and without foreign investors, there will be no serious disinvestment. Foreign capital providers will also be critical to ease the inevitable crowding out issues faced by the Indian private sector, as we try to simultaneously fund huge deficits and strong credit growth.

The world is searching for alternative growth engines, beyond the US and the OECD economies, and everyone wants to believe that India has a decade of 8-9 per cent GDP growth ahead of it. The time has come to seize the opportunity and convince the investors that India and the UPA mean business. Serious structural reform and a credible policy framework are needed to set the stage. Beyond the fiscal, one must also see policy movement on FDI and improvement in the capacity of the economy to absorb investment and accelerate supply-side response. The upcoming Budget is a unique opportunity, we must not let it slip.

The Rise of ETFs

22 January, 2010

One of the major trends in the asset management industry currently is the relentless rise of exchange-traded funds (ETFs). ETFs now account for over a trillion dollars in assets, up from only about \$75 billion in the year 2000. ETFs have gained huge popularity over the last decade as they can be used to gain exposure to a number of asset classes including equity, fixed income, commodities and currencies. They can also be used to gain exposure on either side of a trade, i.e. long or short as well as on a leveraged basis. ETFs have several advantages over index funds: In the types of asset classes covered and ability to short as well as their ability to offer intra-day liquidity, being traded on the secondary markets.

ETFs have now started becoming very popular in India as well, with over 25 per cent of all secondary market FII flows into India coming through this route in 2009 (about 15-20 per cent of total FII flows including primary market issuance, Credit Suisse estimate). Despite this accelerated flow through ETFs into India, single-country India ETFs are still extremely small compared to China or Brazil. Brazil single-country ETFs, for example, are almost seven times the size of India ETFs, giving a sense of how much bigger India ETFs can become. The difference in size is really because of the much later launch of these products for India due to historic regulatory issues. The cumulative flow into India from ETFs [both single-country and Emerging Market (EM)] is over \$6 billion (source: Credit Suisse) till date, making it equivalent in absolute size to the largest country funds.

The reality today is that anyone trying to raise new money for either an India hedge fund or even a long only mutual fund, is faced with intense competition from the ETF. The sad truth is that over the last three years, very few funds have been able to outpace the benchmarks by enough of a margin to justify their fees. Most funds have also clustered around quite similar performance numbers, making differentiation for investors difficult. Many investors were also spooked by the illiquidity of non-index based stocks in India, when they tried to exit, and experienced significant price damage as their funds liquidated holdings to meet redemptions. Why not use a highly liquid, cheap and index-tracking

instrument rather than bother about trying to figure out the small sub-section of managers who can truly beat their benchmarks in a sustained manner? This is a logical question being asked by more and more investors. Investors are also questioning the need to be in mid caps after the huge drawdowns and volatility of 2008-09 — so why not just be in index stocks? Play the macro country story, does one need to drill down and look at stock-specific alpha creation? I am pretty sure that a lot of asset allocators are using ETFs rather than investing through funds. It is one of the reasons that most India funds have received very little by way of new inflows through this rally. Just anecdotally in my own discussions with prospective investors, the use of ETFs seems to be destined to be far greater going forward than it has been in the past few years.

Another reason for the popularity of the ETFs, is the serious bruising most macro funds received in their attempt to exit India in 2008, when markets got crushed. Macro funds are by definition not stock-pickers, and are perfectly happy to play the index, rather than trying to get involved directly in specific stocks. For as they discovered, with the exception of a handful of index heavyweights, liquidity just vanishes for most equities in India when markets retreat. Macro funds are very active and on the margin, driving the global move away from dollar-based assets. ETFs are the perfect vehicle for a top down macro fund to execute its strategy seamlessly.

To me, it seems as if this trend towards ETFs will only accelerate, and I would not be surprised to see an even greater percentage of secondary market flows in 2010 come through this route compared to the 25 per cent we saw in 2009.

What are the implications of this trend coming to pass?

First of all, it will be interesting to see how the huge expected equity issuance of \$30 billion in 2010 will get sold, if a large chunk of FII flows come in through the ETF route. ETFs do not buy QIPs or IPOs, and thus bankers may find that the major source of funding for new equity issuance comes from local institutions. One should be prepared to see many issues, wherein the anchor investors or the majority of the book are filed by local institutions. There is nothing negative in this, but it will probably mean a change of focus for the I-banker community and companies. Local investors will increasingly have to become the first port of call for any deal.

Secondly, as most Indian brokers will not be able to get the execution orders for these ETF flows, one may see a relative shift in market shares between local and international brokers. Since these trades are largely done as large programmes on very low commissions, the commission pool will also get compromised to a certain extent.

These flows will go into the large-cap liquid index stocks, thus pushing them even higher and creating a valuation cushion for the mid-caps to move up. In most sectors, the large-cap index stocks trade at a premium to the sector, as these valuations get pushed up even more because of blind index-based buying through the ETF route, space gets created for selected mid-caps to play catch up and have PE expansion of their own. The continued upwards valuation creep for the large-cap index stocks will also push more knowledgeable local investors into mid caps, as they are unable to justify to themselves the large valuation premiums of the index constituents. Ironically, just as ETFs have gained prominence due to the perceived inability of most funds to outperform their benchmark, their own popularity will create the valuation space to encourage and reward stock picking.

To the extent many macro funds are using the ETF route for EM exposure, and given their liquidity, this instrument does integrate India even further with global flows and trends. Any change in stance towards the EM equity asset class can be immediately expressed through these ETFs, and thus, a lot more asset allocation flows will enter and exit our markets and with greater velocity. We will become more exposed to top down macro themes.

ETF's are here to stay and are now a legitimate part of any investor's choice set when looking across asset classes and markets.