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State of the Markets - XXXII

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In the previous edition of the SOTM XXXI dtd July 28 2011, we had advocated a decline in equities, appreciation in bullion and a safe haven buying in food, water, fertiliser stocks – all of which have occurred. We also put forth our views that inflation and pay / job cuts would be major dampeners for the sentiments, even as financial markets were displaying a false sense of bravado. Click here to view that report – http://bsplindia.com/files/archives/jul11/sotmxxxi.pdf. The Nifty has tested the 4720 levels and have started rallying as some optimism is being seen in Europe's attempts at containing the debt crisis. While, any positive news triggers are welcome, we feel the celebrations seem to be a tad premature. We walk through our key concerns –

Geo political concerns

The US has indicated intent to withdraw it's troops from Iraq and Afghanistan, which is a welcome development from the US politics point of view. Iraq runs a risk of being influenced (or even controlled significantly) by Muqtada Al Sadr and his militia (Mehdi army). His anti American stand is loud and clear and so is his political doctrine on Oil being an Arab asset. The oil markets are sensing the change and pricing crude prices higher. For the uninitiated, Iraq has the 4th largest reserves and is a potential "swing producer" once pumping infrastructure is upgraded by overseas firms.

Afghanistan is a different ball game altogether and has ramnifications for financial markets which dislike terror attacks and state of low level conflicts. Bullion is likely to stay firm due to Iraq and Afghanistan.

Libya is unlikely to add to the global oil output as it contributes ~ 2% of global consumption, much of which was offered in the global markets since Gaddafi's tenure anyway. Upgrades and better infrastructure development are unlikely to add significantly to additional oil supply. The Arab spring does threaten to unseat some more regional heads in power and add to the froth in the global oil prices.

Europe has seen some calm returning to the markets as international bankers are now reconciled to a 50 % haircut on Greek bonds and endeavoring to re-capitalise their banks either by fund infusion and / or by asset stripping. In our opinion, both options are painful. Sizable fund infusion is difficult without running printing presses overtime and asset stripping is witnessing buyers quoting ~ 30 cents to a dollar for assets on the block. The bankers have till June 2012 to get the job done and the initial euphoria apart, much will depend on the hard numbers than the current hopes of a revival.

Debt – the rising concerns

The rising debt of economies world wide is raising concerns of maintaining social standards as we know them today. On the domestic front, the Govt has exceeded 55 % of the planned annual deficit in under 5 months of the fiscal year and is likely to borrow additional sums to meet it's cash crunch.

The disinvestment targets are on paper alone as the secondary markets are unable to absorb additional supply of fresh paper since retail players are disinterested. If the debt to GDP ratio is used, India is on a firm footing, but should the debt to tax receipts ratio be used, India has reached a ratio of 3, a level where Greece stood last year. The only options available to the govt are a) raise tax revenues b) cut debts aggressively. In the current high inflation scenario, raising taxes will be catastrophic and a cash crunch implies poor immediate re-payment capability. Investors should watch this aspect very keenly in the coming quarters.

The forex warning bell

If the stock indices are barometers of the financial markets well being, the national currency indicates the health of the nation in toto. The rapid collapse of the INR from 44 levels to the 50 mark vis-à-vis the USD is alarming for a knowledgeable investor. While exports are under pressure due to lack of orders, imports (especially crude oil) remain inelastic and therefore can upset the balance of payments equations. The INR is clearly under pressure and can stoke inflation much higher from the already alarming levels.

We feel the food security bill, proposed to be tabled in the parliament in the winter session (Rs 1,13,000 Crs) will exert downward pressure on the INR and push up our oil bill even higher. This raises risks of higher inflation as oil subsidies cannot be maintained at current levels. For the health check of the equity markets, investors should take atleast passive note of the forex levels.

The beaten path

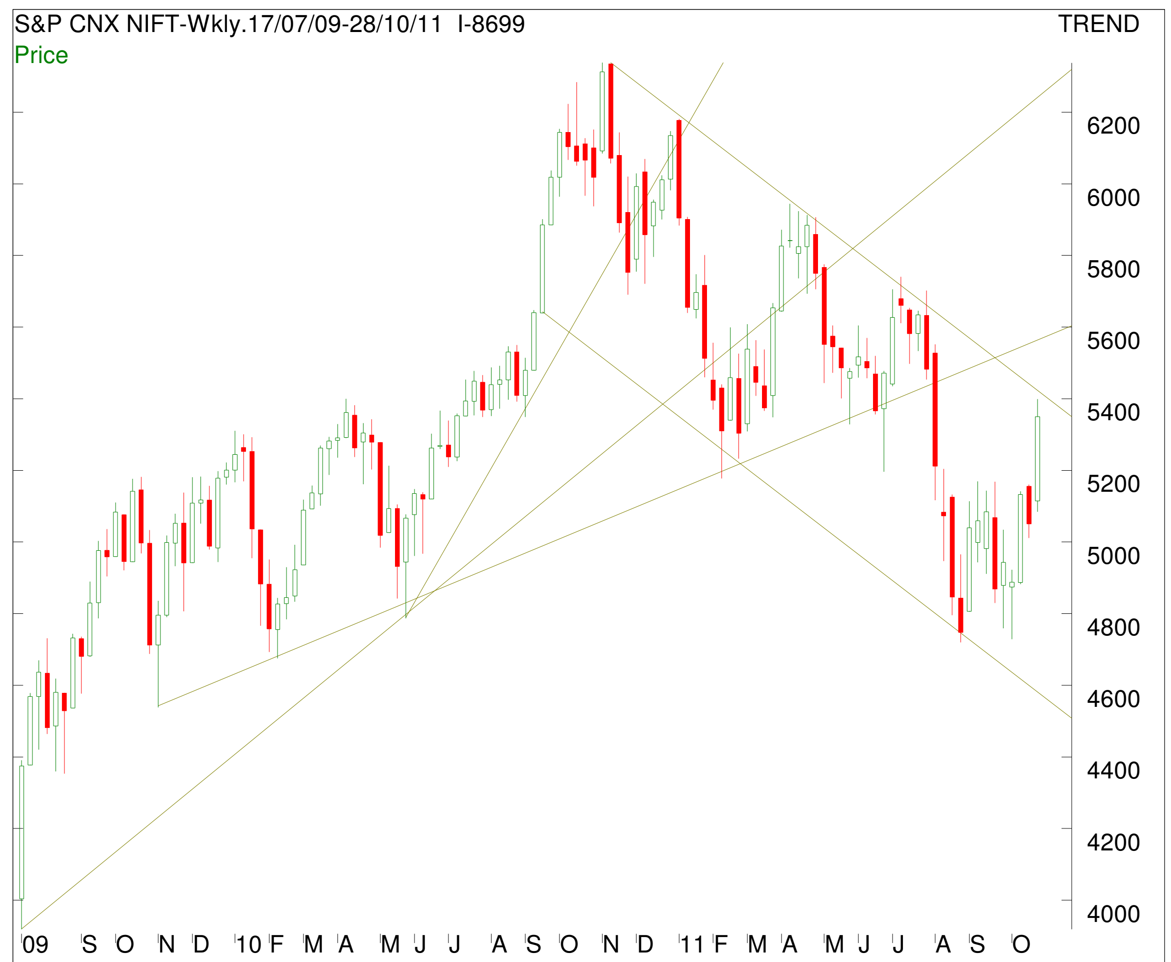
The govt is likely to issue bonds and “encourage” nationalized banks to subscribe to the same, to raise cash. The oil marketing companies will be the fall guys in terms of bearing the brunt of the rising landed cost of oil. Instead of pressuring it’s own balance sheet, the central govt will raise debt levels of oil marketing co’s to meet short falls and in the bargain, slash profitability of these corporations. Similar exercises maybe initiated to disinvest part of the govt holdings in some PSU’s to mutual funds (especially govt run schemes) if the secondary markets remain sluggish. Indian Oil Corp (IOC) has already raised it’s borrowing limits from Rs 80,000 Crs to Rs 1,10,000 Crs to meet operating expenses. We expect HPCL & BPCL to follow suit. Raising the savings account interest rates was another step in that direction to garner funds from the retail savers. Though short term in nature, these funds are sizable and cheap in cost terms.

Inflation – chronic illness

We have been highlighting our concerns on this front in this newsletter and our worries are proving well founded. The retail investor is all but absent from the markets as the costs of running a kitchen leave little for equity investments. With proteins like dals, milk, eggs, meat and soya slated to get dearer, the pressures on the common man are likely to exacerbate in the coming quarters. We feel the food security bill (FSB) has long term inflationary impact and will also impact the currency as the FCI (Food Corporation of India) may have to resort to importing grains to meet the expected procurement target of 65 Mn tons once the FSB becomes law. While the RBI opines inflation will be curtailed by Dec 2011, we see it as a challenge.

Technicals – the weekly chart of the Nifty shows a significant recovery from the 4720 double bottom and the benchmark remains constrained within the bearish channel which may act as a minor hurdle on the upside. Once overcome, the possibility of the ~ 5600 levels should not be ruled out. Sustainability of the upthrust will remain a concern and so far, the index during it's decline from Nov 2010 has not logged a single higher top formation. Going past, and staying above the 5800 levels will raise hopes of a higher top occurring over the medium term. For the immediate future, we feel the 5600 level will act as a near term significant resistance. A decline below the 4700 levels will pave the way for a test of the 4200 – 4300 levels on the Nifty. The volumes and other market internals have not been indicating significant buying conviction / enthusiasm so caution is called for.

We recommend staying with our favoured sectors – long on food, water and fertilizers, short on oil marketing companies, real estate, airlines and import dependent sectors. Bullion remains a safe haven for us, though buying afresh at current levels is aggressive. We suggest edible oils as a dark horse investment.



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The author of this piece is the author of "A Traders Guide to Indian Commodity Markets" – India's first commodity trading manual.

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