

Market turbulence and the investor- Part 2

P Note-Peanut or Substantive?

Oct. 19, 2007, Sensex at 17559

My previous article (it is attached) written on Aug. 9, 2007 at the height of USA subprime crisis with Sensex at 15100 concluded with the recommendation that investor should continue to allocate a significant proportion of his long-term savings to Indian equities.

Market continued to move up merrily, actually at a much higher speed. Investor was just getting a bit comfortable when even a larger wave of intense turbulence hit him. This time it was the proposed changes in participatory note (P Note, pronounced as peanut by one participant in a TV show). P Note simply put is an off shore derivative instrument which unregistered foreign investors have utilized to invest in the Indian market. There has been a lot of debate earlier also whether it should be banned since it suffers from lack of transparency on who the end investor is.

Indian regulators have a tough job balancing various requirements. They have to ensure growth on a sustained basis while keeping the inflation at a low level. They also have to maintain a competitive rupee exchange rate and not compromise foreign investment at the same time.

Trigger for P Note amendment came from recent deluge of foreign money that caused a sharp rise in stock prices and also a very rapid appreciation of Indian rupee. Proposed amendments also seek to simplify the registration process for foreign investors. The objective as stated by the finance minister is just to moderate the quantum of inflows.

These proposed changes have caused intense turbulence in the Indian markets with intra day Sensex fluctuations of more than 1000 points. Investor again has a dilemma- whether to stay invested or not. Again the answer hinges on 2 factors- sustainability of economic growth and the continuation of flows.

Sustainability based on numerous macroeconomic factors, which I will be elaborating in my next note show a very positive picture of Indian economy .For example, the latest Q2 figures (based on a sample of 108 companies) show an average sales growth of 23% and an impressive earnings growth of 32%.

Momentum or sentiment for emerging markets in general and India in particular is very good after Federal Reserve cut the interest rate by half a percent in Sept. 2007. Global liquidity is again abundant and Indian domestic savings being increasingly invested in stock mutual funds is supplementing that.

However, the proposed P Note amendments might affect flows in the short term. Over a period of time, more foreign investors will register and invest without using P note route. In the long term it will provide more confidence by improving the quality and transparency of flows.

Therefore while the market might correct and be volatile in the short term, it will continue to provide significant returns in the medium to long term. Therefore my recommendation will be stay invested and watch carefully over the next few days. Any dips could be a good opportunity to add to the existing positions.

Best regards,

Dr. Sanjiv Mehta

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