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Subject: Market Turbulence and the investor- Part 3
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Market Turbulence and the investor- Part 3

Bullish even at high valuations

Sensex at 19698, Nov. 18, 2007

Background

My Aug. 9, 2007 article with Sensex at 15101 and USA subprime crisis in the background forecasted continued upside to the Indian market. Part 2 of this trilogy written on Oct. 19, 2007 with Sensex at 17559 and P notes issue had the same conclusion. At this stage, with USA subprime crisis deepening and the Indian market running up to almost 20000 level, it is important to analyze and forecast what turn the market is expected to take.

Issue

In my book 'Winning the Wealth Game' three principles I advise for investing in the stock market are time horizon, valuation and diversification. Valuation presently in India as measured by P/E ratio is on the higher side. Therefore analysis at this stage becomes even more interesting.

Analysis

Economic fundamentals continue to be on sound footing and the answer to the important question about sustainability of Indian growth at 9% for the next few years is yes. Generally the signs of overheating will be inflation and deteriorating deficits. These are being controlled well. There is also a surge in capital spending leading to better supply side thus indicating a good virtuous spiral building up for Indian economy. Inflation is low, interest rates are stable and the productivity is building up.

Importantly, earnings growth is impressive even for bigger companies. Therefore PEG is still favourable. Opportunities in the Indian market with its size are plentiful. With the initial charge of big prominent stocks, now midcaps and small caps have started moving up. Consequently, with proper fund selection, it is still possible to find stocks with appropriate ratios and return potential. Moreover, rerating of Indian market is quite possible with sustainable growth standing in sharp contrast to sclerotic developed economies. Empirical research of the eight major stock market bull runs in the USA from 1953 onwards show that growth stocks lead the way in the final third of the profit cycle and the streak of outperformance averages 31 months. Growth stocks are favoured where momentum becomes the key. Emerging markets as an asset class is in such a phase and India within emerging markets occupies a prominent place.

Additionally, more liquidity is coming Indian way. Global flows are rising steadily with USD falling and Indian Rupee rising. A higher proportion of Indian savings is also increasingly being allocated

to equities.

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Risk factors

Since we are bullish at high valuations, risk factors have to be monitored very closely.

- USA recession-if there is a steep decline rather than soft landing it could cause Indian growth also to slow down
- High oil prices and of other commodities
- Political instability due to factors like Indo-USA nuclear deal
- Inflation picking up (although WPI is presently well controlled, CPI is running at about 7%)
- Agriculture (with engagement of 60% of the Indian population) failing to cross 4% growth rate
- Non inclusive growth

Conclusion

Retail investor should continue to allocate a significant proportion of his long-term savings to Indian equities. Of course, the three principles mentioned above remain sacrosanct. Given higher valuations, I would recommend an even longer time horizon of 4-5 years. NRIs can continue to participate with confidence in India story with an added advantage of Rupee appreciation in the long-term.

Best wishes,

Dr. Sanjiv Mehta

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