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Subject: FINANCE DOCTOR's Concise View for 2008
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CONCISE VIEW FOR 2008 designated as Year of the Rat by Chinese and the International Year of the Potato by UN Jan. 8, 2008, Sensex at 20813

Jan 4, 2007, Sensex at 13875- my note of previous year is also attached

Issue central to 2008 forecast

-Whether international and domestic fund managers will still invest money in Indian equities

At the same time last year, writing a similar note was much easier. Global economic conditions were lot better and it was relatively easy to forecast that Indian equities will fare well. 2007 proved to very good for the Indian markets with Sensex going up by 47% and mid caps and small cap indices doing even better.

Global economy has more problems this year. Will these problems affect flows to the emerging markets? Will Indian economy continue to grow at a high rate even if other economies slow down thus inviting the term decoupling? Will domestic savings be channelized to equities even with high valuation ratios?

The mindset of International Fund Manager- GLOBAL ECONOMIC CYCLE STAGING

Ailing housing market and tighter credit is slowing down the USA growth in 2008. Consumers are likely to spend less and Federal Reserve is expected to reduce interest rates through the year. However, this slowdown will be partially alleviated by rising USA exports. On the other hand, Europe and Japan are also likely to slowdown because of stronger Euro and Yen. At this point of time, the most likely scenario seems to be a slowdown and not recession.

Meanwhile, emerging markets are likely to be doing well. China's exports might be affected but domestic spending will continue to rise. Russia should also continue to do well because of high oil prices. India with its strong service sector should also grow well.

The year 2008 will sharpen the shift in world growth. Developing economies will surge ahead, expanding by about 7.6%, while developed economies are likely to grow at a sluggish rate of 1.8%.

Therefore, it is highly probable that international fund manager will increase his emerging market allocation. India might even be more attractive, with its economy being more dependent on domestic consumption and a long-term trend of appreciating currency.

The mindset of Domestic Fund Manager- INDIAN ECONOMIC CYCLE STAGING

Is India's economic growth sustainable? Is it laying the foundations for a long stay at the crease? At a macro level, savings are being channelised towards investment and creating additional capacity. Infrastructure is being created in terms of roads, port, airports and more proactive energy policy. Fiscal deficit has been brought down from almost 10% of GDP in 2002-3 to 5.2% in 2007-08.

Prudent monetary policy combined with appreciating currency, fiscal measures and supply side measures have controlled the inflation well. Corporate earnings have continued to grow at a healthy pace.

Indian economy is dependent on domestic consumption, which is likely to sustain itself on increasing income levels. Service sector is continuing to do well and now manufacturing sector is starting to do better. Agriculture's contribution to the economy is also improving

Valuations are stretched but equities still have room to go up because of earnings growth momentum. Domestic fund manager is also not finding much value in other asset classes like Debt with stable interest rates. Therefore more domestic money will be allocated to equities.

Risk factors and indicators to look for

- USA recession with downward multiplier effect
- Prices of Oil and other commodities
- Indian elections uncertainty and populist measures
- Stretched equity valuations
- Slowing of earnings growth momentum
- Inflation
- Choice of wrong sectors, themes and fund schemes

Divergent performance of sectors, themes and fund schemes

In the year 2007, returns varied a great deal amongst different sectors and themes. For example while infrastructure funds performed well, IT sectoral funds performed poorly. DSP Merrill Lynch TIGER, an infrastructural fund gave a return of 88% in 2007 while Franklin Infotech, an IT fund lost 20% during the same period.

2008 will also favour certain sectors like infrastructure, engineering, construction, oil & gas services, real estate, hospitality, cement, financial services and media. Appropriate sector selection and rotation is important.

Similarly schemes in the same space also showed very varied performances. For example, amongst mid cap schemes, JM Emerging Leaders provided 92% return, Reliance Growth 80% while Franklin Prima faltered with only 47%.

Conclusion & Recommendation

Equity will still be the preferred class but the investor will have to act with care. Returns expectation will be consistent with earnings growth since valuations are on the higher side already. With all the risk factors, it can be a challenging year – the investor has to be more selective and disciplined with a

readiness for portfolio rebalancing if there is a sharp spike up. Volatility in the markets is likely to be on the higher side.

Selecting the right fund schemes could be a major source of value addition. Through our quantitative and qualitative modeling of fund performance, we are identifying managers with a very consistent upper quartile record with a significant duration. Best way given the volatile outlook is to allocate money to fund schemes, which have a broad flexible mandate, managed by the best performing managers. We are also recommending allocation to some contra funds within the portfolio.

NRI's will be able to enhance their total portfolio returns by allocating a significant part of their portfolio to Indian equities and even more so as the long-term appreciation trend of Indian rupee remains intact.

Certain principles of allocating in volatile assets like equities remain sacrosanct. These are appropriate time horizon, diversification and valuation.

Best Wishes,
Dr. Sanjiv Mehta

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Attachments

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