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**From:** "finance doctor" <financedoctor1@yahoo.co.in>

**Subject:** Intense Fast Correction in Jan. 2008- Trend Reversal or Buying Opportunity? Market view feb 7, 2008

**To:** "sanjiv mehta" <sanjiv\_mehta@yahoo.com>

## **Intense Fast Correction in Jan. 2008- Trend Reversal or Buying Opportunity?**

**Dr. Sanjiv Mehta, [www.financedoctor.biz](http://www.financedoctor.biz)**

*Feb. 7, 2008 Sensex at 17526*

### **Central Issue**

*Extent of Indian economy's decoupling from USA economic growth*

### **Background**

Less than a month back in my 2008 view note sent on Jan. 8, I had written that this year could be a difficult and volatile year as compared to 2007. The first risk factor I pointed out was USA going into recession or a major slowing down. Concrete signs of a slowdown emerged rather quickly in the year and the severity surprised Federal Reserve. They were stung into action and called for a rare emergency meeting just a few days before their scheduled meeting of Jan. 29, 2008. They cut the Fed Fund rate by a huge 75 basis points and a further 50 basis points in the regular meeting. USA being the locomotive for global economy for such a long time, this resulted in markets worldwide coming down. Dow Jones, Nikkei, FTSE, DAX, Hang Seng, Sensex all fell between 12-18% in the month of January.

### **Analysis of Decoupling**

Decoupling was always a misnomer if it implied that an American recession would have no impact in India. Instead the real issue is the extent of decoupling in absolute terms and also in comparative terms in relation to other countries, especially in Asia.

The most telling argument is when Federal Reserve was cutting its rate by cumulative 1.25% in a week on Jan. 29, coincidentally RBI was also conducting its credit policy meeting the same day and decided to keep Indian interest rates constant. As one commentator wrote that there is little reason why the monetary policy of a booming economy has to mimic that of a key industrial economy that is precipitously close to recession.

The main reason to be optimistic in India is that its economy is much more broad based as compared to many other countries like Japan. Analyzing different components of economy one by one shows the following:

- Consumption - Consumer spending is a major component of India's economy. Often cited reasons like favourable demographics and rising incomes will keep domestic consumption strong.
- Investment - Capacity utilization is high, company balance sheets are stronger and real interest rates are low and there is room for those to head lower. Firms are less likely to slash investment.

- Government spending - Fiscal position is much better, providing more scope for fiscal stimulus to support growth.
- Exports - America's slowdown will definitely affect the exports to America but those are equivalent to only 2% of GDP. Comparatively, China's figure is 8% and Singapore, Hong Kong and Malaysia are the most exposed with comparative figures of 20% or more. Interestingly last year, even economies with higher export component grew well despite a slowdown in America's imports.
- Foreign exchange reserves - India's reserves are healthy and make it less vulnerable to shocks.
- Monetary policy - RBI has a lot of room on this front because of wide interest rate differentials and a well-controlled inflation.
- USA's reaction - it has responded to slowdown with strong fiscal and monetary tools. Therefore a sharp recession might be averted, however long term structural problems will take time to improve. The most likely trajectory for U.S. economy is sub par growth for many quarters rather than a very rapid decline. This is relatively better scenario for emerging markets. A slow decline does not lead to emergency adjustments and at the same time will keep prices for oil and other commodities under some control.

Overall, Asian economies will be less hurt by a recession than in the past. Economists are predicting that Indian economy might still grow at the rate of 8.5%, losing only 0.5 to 1%.

### **Analysis of Fund Flows**

- Federal Reserve has responded very strongly with interest cuts and to a certain extent other central banks might follow at varying times. Global liquidity will be much higher.
- Presently with USA slowdown, risk aversion in the markets is higher. USA monetary and fiscal responses are likely to avert a very sharp slowdown. With some stabilization signs over the next few months, the extreme risk aversion is likely to subside and some of the global liquidity will again return to emerging markets especially India.
- Falling USD and appreciating Indian Rupee over medium term will be another catalyst for more funds.
- A higher proportion of funds from regions and countries including the Middle East and

Russia might favour emerging countries especially India .A slowdown in the developed economies is likely to highlight the divergent economic growths more sharply.

- Interest rate differential is also widening which will attract more flows to India.
- Domestic savings are being channelized more and more into Indian stocks. Even with a sharp correction in the markets, these have not abated. On the contrary, both anecdotal and actual figures show that domestic investors consider the present levels as good buying points.

### **Conclusion & Recommendation**

Slowdown in Indian economy is likely to be meager and financial markets might be exaggerating the potential damage. Fund flows, once this wave of risk aversion has abated, might come back strongly with the present USA slowdown delineating sharply the growth rates of different economies.

Indian Equity will still be the preferred class but the investor will have to act with care. 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.

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

*Attachments-* 2008 view sent on Jan.8, 2008 with Sensex at 20813

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#### **Attachments**

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 **2008\_jan\_8\_view.doc** (30k)