



The current spate of fall in prices of all asset classes- be it equities, gold or real estate- has left investors unnerved. To swim against the tide or swim to safety is the dilemma facing an average investor. In short whether to buy or say bye to investments. Here we will analyse what should an average investor do in the current scenario- both in a short time horizon as well over a longer time horizon. Whether to invest in equities is one of the toughest decisions to take. We will look at both sides of the story- optimistic and pessimistic- and the scenarios that could pan out. Finally we will give a final word.

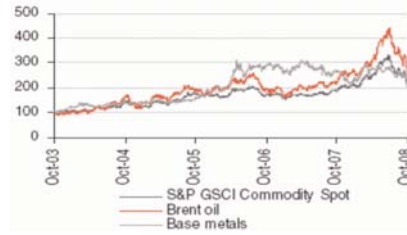
Reasons to Invest

The optimistic amongst the analyst and experienced market men tell if you have never invested in the equity market, probably the best time to start is now. You must have heard the famous and much quoted dictum by Baron Nathan Rothschild: The time to buy is when blood is running in the streets. And right now, those words could not be more apt.

Almost every other day there's some good news that gives the market a boost, only to be followed by some bad news that sends it reeling again. And investors keep waiting on the sidelines to hear some good news before they commit to putting their money in. Holding ones nerve in such a market is far from easy. But you should heed to a simple and time tested advice: Do not time the market. Ride out the volatility. Do not attempt to dip in and out of your investments. Investors should not run away from the stock market, a natural reaction at this time. Stock markets tend to rise well before the official data indicates a recovery in the economy. If you wait for the statistics to confirm an improvement in economic conditions, you will end up missing the bounce in prices that often heralds the start of a new bull run.

Let us look at a few of the reasons that lead to a recovery in economic situations and herald a recovery in stock markets:-

• Sharp fall in commodity prices



Commodity prices (Re-based to 100) (Source-HSBC)

One of the prime reasons for deterioration in economic fundamentals was steep rise in prices of all commodities. India being a net importer of commodities suffered. The hike in oil prices lead to weakening macro-economic situation and increase in budget deficit well beyond the government target levels. The rise in commodity prices also lead to an increase in input costs to the industry. As the full pass through was not possible it lead to a fall in bottomlines. However with steep fall in commodity prices all these fears have receded. This will lead to an improvement in BoP (Balance of Payments) of the government.

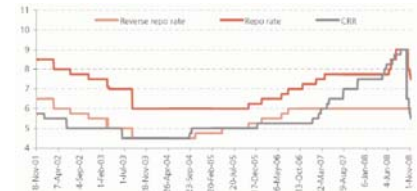
• Falling Inflation



Falling Inflation (Source-HSBC)

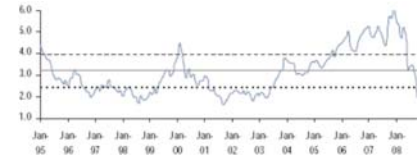
Inflation had been a bugbear of the markets since the beginning of the year. It rose way above the tolerance limit of the government. However with inflation coming down steeply in last month and in the most likely scenario of continued fall, should bode well for the market. High inflation had lead to tighter interest rate regime by the RBI. This lead to higher cost of borrowing by the corporates and consumers alike. But, falling inflation has already lead to a change in stance of RBI. RBI cut CRR after four years and repo rate after three years. With key rates being cut and with an expectation of further cuts, the

interest rates are headed only one way- down. This will lead to increased offtake of credit and stimulate demand the effects of which would be visible after six months.



Key Rate movement (Source-RBI)

• Sharp fall in Valuations



MSCI India Price/Book Value (Source-MSCI)



MSCI India Price/Earning Ratio (Source-MSCI)



PE Ratio of various markets in Asia

Battered by global credit market issues and fears of a prolonged slowdown, the Indian equity markets are now trading at historic trough levels even assuming zero growth in earnings over FY09E-10E. India continues to trade at a premium to regional peers but the gap has narrowed considerably this year with the sharp under-performance of India. Of course India has traded at a discount, with a maximum discount of 40% in past 14 years. Relative valuations are no longer expensive especially if Indian earnings see relatively lower downgrades.



Reasons to not Invest

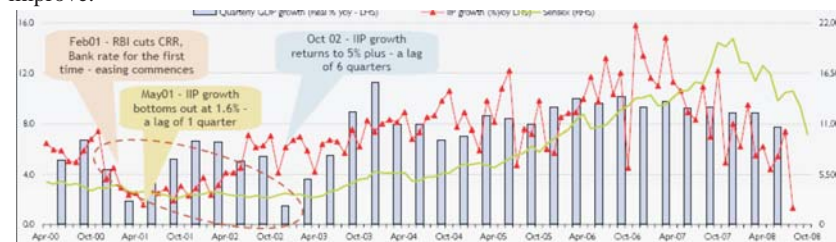
These days it is not uncommon to see persuasive newspaper headlines coaxing investors to come out for bottom fishing. The common baits are 'multi year low prices' and 'compelling valuations'. "Be greedy when others are fearful", many commentators have invoked the old adage. One does not doubt that winters are invariably followed by the spring. In fact we need to prepare for the spring while it is still winter. But venturing out while the snow storm is at its furious best would probably be a little too adventurous. There are several key pointers that the worst is not behind us and we may be in for a harsh winter in the near future.

● Impaired growth visibility



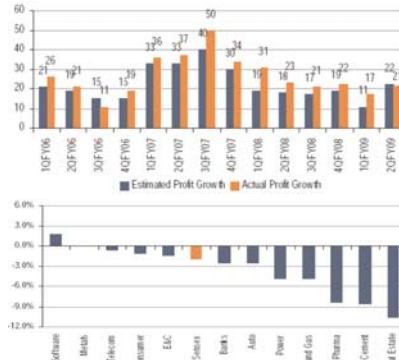
Fall in Commercial Vehicle Sales

The high growth visibility of India has certainly got impaired. The potential 9.5-10% real GDP growth which might have looked possible a year ago seems like a mirage now. Even 8% real GDP growth target, which was a given till couple of quarters ago, is looking challenging. The Prime Minister's Economic Advisory Council (PMEAC) expects the FY08 growth to moderate to 7-7.5% level. As per IMF estimates in 2009 India's real GDP growth could collapse to 6.3%. The slowdown is marked by a distinct slowdown in industry sector, particularly manufacturing. The decline in commercial vehicles and cement sales for the month of October and consequent productions cuts clearly indicate slowing economy activity. Downward earnings revisions across sectors point to a challenging H2FY09. Globally also, economic conditions are expected to worsen further before they improve.



Falling GDP & IIP Growth (Source- Bloomberg)

● Falling profits and margins



Falling profit margins across sectors

Sensex is a mirror of all the companies listed. If we take Sensex, there has been a marked decline in bottomline of the companies if we analyse closely. For Q2FY09 the strong headline profit growth for the Sensex companies at 21.4% was camouflaged by exceptional earnings growth of Tata Steel. Excluding Tata Steel, the profits grew at a meagre 8.3% (EPS growth less than 5%). 8 out of the 30 Sensex companies have reported falls in profit. Profits failed to beat analyst estimates for the first time in 12 quarters. Margins across most sectors are facing serious pressure. Increase in input costs, falling demand and lack of pricing power have lead to lower profit margins. In Q2FY09 the margins of Sensex companies contracted by close to 200bps, led primarily by Real Estate (1040 bps), Cement (850bps) and Pharma (830bps). Moreover, the Q2FY09 profit growth was highly concentrated with the top three companies (TISCO, SBI and Infosys) accounting for 85% of the growth. Similarly the top three companies (TISCO, Infosys and Bharti) accounted for 75% of the EBITDA growth.

● Pressure on Emerging Markets to continue

The US housing crisis that morphed into a banking crisis is now morphing into a

global economic crisis. As we discover the contours of the crisis, we believe the markets will continue to be volatile. The unprecedented policy response from central bankers across the world, including India, might have stemmed the panic reaction, but deleveraging and risk aversion continues. The pressure on emerging market equities may therefore continue for some more time.

● Impeding Elections

The impending general elections in India would also impact sentiment. Historically markets have witnessed heightened volatility during and around election time. The Sensex fell over 11% during seven weeks (Dec'97-Feb'98) when Gujral government fell and Vajpayee formed a minority government. The Sensex fell over 20% during Apr-May 2004 elections, when Manmohan Singh formed government.

History of Bear Markets in India

When we look back through history - or think about the underlying economics of business cycles - we realize that every financial crisis and bear market in the past has been a buying opportunity because we can see, with hindsight that the world never did come to an end. A pertinent observation is that if everyone in the market knew that previous financial crises and bear markets always created buying opportunities, then a new bear market could never occur. But why do we still go through bear markets when everyone knows past bear markets offered buying opportunities? We can only go into a bear market if potential buyers believe that the latest financial crisis was somehow different - and worse - than any that had gone before. If people believed that this was just an average sort of crisis, they would now be buying instead of selling, and there would be no crisis. In other words, a bear market is only possible if there is a consensus that a financial crisis is significantly worse than ever before. And that is why we are currently in a bear market. In the current market scenario various people have again touted this to be the most severe financial crisis in the world in last