The Crucial Week: Markets & Election Results

13th May, 2014

We have a positive outlook on the Indian economy for the current year and only if NDA fails to get over 200 seats, the markets may crash. If it manages to get between 200-230 seats, there may be a correction but not a deep one. Markets have currently priced in 230-250 seats for NDA at 7000 – 7500 levels, though a tally of over 250 may take Nifty beyond 7500.

We are describing here the major triggers driving our economy as well as the risk factors in short term and long term. We have been positive about economy and investment since early this year and reiterate that a correction in market now should be considered as a good investment opportunity. Investors can see our previous report 'Na Mo effect on markets' to find the sectors that are expected to outperform the markets. We have also designed two model portfolios to help investors build their own diversified portfolios (see details below).

OUR RECENT REPORTS:

We had recently released two brief reports on market forecast and sector outlook –

1. **Nifty Forecast – 9000 by August, 2016** – Long range technical analysis
2. **Na Mo effect on markets** – Election analysis mentioning sectors that will outperform the market

Model Portfolios: To help investors deciding their portfolios, we had recommended two model portfolios in early April, both generated exceptionally well returns in April (14.4% & 18.7% absolute).

1. Growth stocks portfolio: ROI 14.4% v/s -0.6% of NIFTY
2. Dividend Yield plus Capital Gain: ROI 18.7% v/s 0.3% of NIFTY

Our research reports can be accessed at **Research Page (www.rrfinance.com/Reserch/ResearchHome.aspx)**.

POSITIVE TRIGGERS FOR MARKETS:

Inflation to come down:

The major cause of persistent rise in inflation over time irrespective of good and bad monsoons was the populist policies of government – higher MSP (minimum support prices) for agricultural products, and inefficient NREGA schemes which raised rural labor costs without any meaningful output. Since MSPs had not been raised in recent times hence the food product prices are expected to remain low this year and in turn the food inflation is expected to fall. Major parts of inflation are food inflation (49.7% of the total inflation), housing, and energy. Other parts of core inflation are mainly correlated with currency strength. And in coming future housing prices are expected to come down, energy prices are currently stable and may fall in near future, and Rupee is expected to remain stable if not appreciate – all are indicating that inflation is expected to remain under control in short to medium term.

Additionally, the new regime is expected to improve supply side bottlenecks leading to further easing of inflation.

Stable Rupee:

Rupee has recovered after its August 2013 depreciation and is expected to stabilize near 59-60 post Raghuram Rajan.

The Balance of Payment has turned positive from negative. The current account deficit, which had touched an all-time high of 4.8 per cent in FY13 – has come down to 2.3 per cent of GDP during the first three quarters of FY14. Foreign exchange reserves have jumped to touch $309.91 billion. Following several steps taken by the central bank to encourage inflows, the reserves have been rising.

Better Energy Security:

Crude prices are stable and coal prices are also on a downtrend which is a big relief for the power sector as most of them are coal fired and were badly hit by coal shortage for last few years. Coal prices are now down 16% so far this year. They are likely to fall further in 2014 as mining output increases in an already oversupplied market while demand in emerging markets drops, amounting to a third straight year of declines. Asia is the biggest coal market and presently accounts for 67% of the global coal consumption. China with its ongoing industrial development consumes nearly 50% of the total global coal. While a slowdown in China's steelmaking industry is the chief reason, surging supply is another factor pushing prices down. Top producer BMA, a joint venture between BHP Billiton and Japan's Mitsubishi, had increased production 22% in the second half of last year. Japan is also increasing its thermal coal usage following the nuclear aftermath and the deactivation of the reactors. It is expected that mining output will rise in Australia, Colombia, and South Africa.

Prices of coal, the top fuel used to generate electricity in the world, have halved from a peak in 2011 and are down almost 70 percent from their all-time highs in 2008 and they are likely to weaken further. Chinese efforts to begin using more natural gas for power generation rather than coal, which is dirtier, could also reduce thermal coal prices.

Falling commodity prices:

A slowdown in Chinese economy is causing a fall in metal prices and except copper other metal prices are expected to continue moving downwards. Prospects of firm demand and low inventories in China are a positive for copper in the coming months. US economy doing well further reinforces a bullish view for copper going forward. China's factory output increased to 50.4 in April, less than the 50.5 level predicted by economists. People had lofty expectations that things were getting better, not just staying on track, but after Chinese data, that's being rethought. The manufacturing purchasing managers' index for Asia's largest economy rose from a level of 50.3 in March. Readings above 50 signal expansion. A similar gauge from HSBC Holdings Plc and Markit released last week was at 48.3, from 48 previously, indicating China's economy continued to contract in April. More confirmations of slowdown in China will continue to make metal prices fall further.

Global risks under control:

The outlook for the US economy as a whole brightened after the GDP reached a 3.2 percent annual rate last quarter on the strength of the strongest consumer spending in three years. Consumer spending surged in the October-December quarter at an annual rate of 3.3 percent — the best pace since 2010 and a big jump from the 2 percent growth rate of the previous quarter. Consumer spending is particularly important for US because it accounts for about 70 percent of its economy. Though there are risks and Americans struggling with long-term unemployment and stagnant pay might not get relief anytime soon. Areas such as manufacturing, construction and home sales remain in far from full health.

MARKET RISKS:

Immediate Risks:

Monsoon warnings:

The India Meteorological Department (IMD) has said that the country may get below normal monsoon this year. According to the IMD, there is a 60% possibility of El Nino during monsoon. The department will issue a second forecast on monsoon in June. The probability of a normal monsoon is 35%, while that of a below normal monsoon is 33%, the department said. Though the risks from lower monsoon may be offset by supply-side measures of government.

Electoral shock:

Though most people are certain of a BJP government after the current elections, but a weak majority or a failure to make government by BJP may prove strongly negative for the markets.

Long Term Risks:

1. Aggressive foreign policies of new regime – If NDA comes to power, its policies may increase geopolitical tensions with its neighbors
2. Hard landing in China – A slowdown in China will lower global growth. China has been focusing on credit fuelled capital investment to boost slowing growth, it should focus on growth by private consumption rather than by fixed investments
3. Fed Monetary Easing – Fed may raise rates too soon or too fast, causing economic and financial shockwaves especially in emerging markets
4. Zero rates – Fed may actually exit zero rates too late and too slowly leading to another asset-price boom, and bust
5. Emerging markets – Political, electoral risks, falling commodity prices, China's structural transformation, and Fed's monetary policy shift
6. Asia's terrestrial and maritime disagreements escalating into outright military conflicts

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