February 7, 2012

Strategy

Macro data could halt the rally; opportunity not a threat

The likely fall in growth of the IIP for Dec11 may not necessarily hasten the onset of cuts in the policy rates. Inflation in Food Articles appears poised for a large rebound in Feb12 after the spike in the base settles down. The heavy influence of food articles suggests there could also be a large rise, y-o-y, in the WPI. The absence of weekly data may mask this rise, for a while. Our analysis indicates that the y-o-y growth of WPI, at monthly steps, is likely to rise to 8% in Mar12. The rally in Jan12 was driven by sectors with a strong link to an economic rebound and by stocks with deep value. The first week of Feb12 saw the momentum weaken in these sectors while the performance of 'defensive' sectors has begun to revive. However, valuations of Indian equities are still well below the stable levels of the past. So, a possible reaction to unpleasant macro economic data could well turn out to be another opportunity.

Volatile IIP may pull down monthly growth in the near term

Near term growth in the IIP could fall significantly from the 5.9% y-o-y growth for Nov11. Even if the IIP for Dec11 were to rise significantly over the Nov11 level of 167.4 the very high number for Dec10 is likely to push down growth to just above 1%. Uneven distribution of the IIP in FY11 could lead to volatile growth till Mar12.

Likely rebound in food prices, low base, may lift wholesale inflation

Inflation in Food Articles is likely to rise sharply in Feb12 as the base of 2011 begins to fall. The small but significant rise in prices for the latest four weeks, after two months of descent, too is likely to lift it. The y-o-y rise in Food Articles may rise to an estimated 8% at end of Mar12. The disproportionately high influence of food on the WPI suggests that overall inflation too may rise significantly during Feb12 and Mar12. The termination of weekly releases of the WPI may mask this impending rise in inflation. However, the monthly release of data too may reveal the rebound in Mar12.

Possible near-term headwinds to sectors with strong link to recovery

The rally in Jan12 was driven by sectors with a strong link to an economic rebound such as infrastructure, financials and real estate and by stocks with deep value. Three defensive sectors, Consumer, Pharmaceuticals and, IT Services representing over 27% of the Nifty contributed only 2% to the rise in Jan12. The first week of Feb12 is seeing some of the leading sectors of Jan12 lose some steam e.g. banks while the 'defensive' sectors have contributed 11% of the rise in the Nifty. A potential weakening of macro economic data in the near term could halt the momentum in the sectors such as infrastructure, financials and real estate. However, the P/E of the Nifty is well below the stable band between 14.5x and 16.5x that lasted till mid-2011. So, a possible reaction to weak macro data may actually provide another opportunity to investors rather than marking the end to the rally for 2012.

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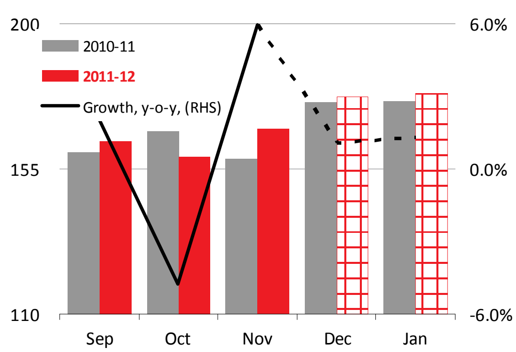
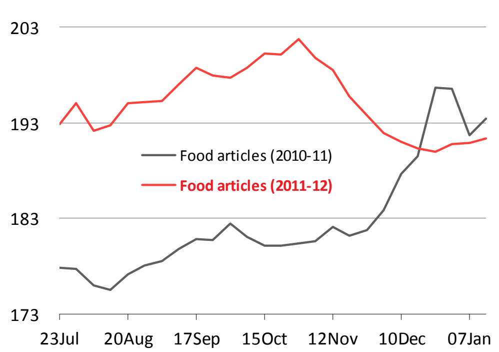
Key indices

February 06, 2012		1-m	3-m	6-m
Sensex (INR)	17,707	11.6%	0.8%	2.3%
Sensex (USD)	361	20.1%	1.7%	-4.6%
Nifty (INR)	5,362	12.8%	1.5%	2.9%
Nifty (USD)	109	21.4%	2.3%	-4.1%
BSE Midcap (INR)	6,123	16.4%	-2.8%	-7.1%
BSE Midcap (USD)	125	24.2%	-2.1%	-13.8%

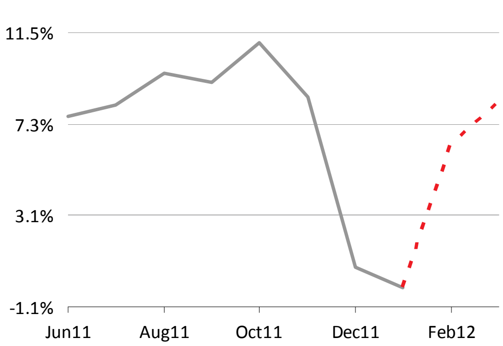
Monthly IIP and y-o-y growth



Index for Food Articles



Y-o-y change in index for Food Articles



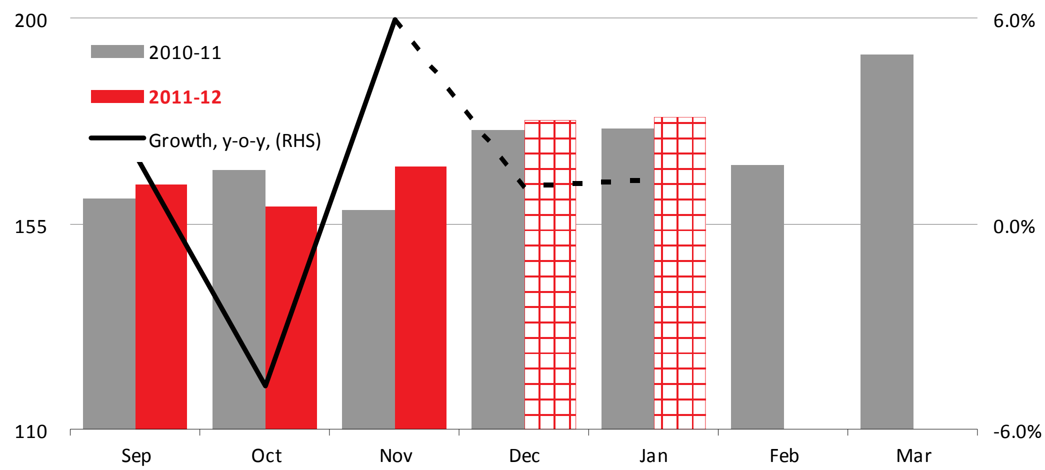
Volatile IIP may pull down monthly growth in the near term

Near term growth in the IIP could fall significantly from the 5.9% y-o-y growth for Nov11. Even if the IIP for Dec11 were to rise significantly over the Nov11 level of 167.4 the very high number for Dec10 is likely to push down growth to just above 1%. Uneven distribution of the IIP during much of FY11 could lead to volatile growth till Mar12.

The apparent strength in the IIP growth for Nov11 was due to the low base in Nov10. This effect is likely to reverse in Dec10 and Jan11.

Growth for Dec11 is may fall significantly even if IIP does rise rapidly as was seen in previous Decembers.

Exhibit 1: Monthly IIP and y-o-y growth



Source: http://mospi.nic.in, Avendus Research

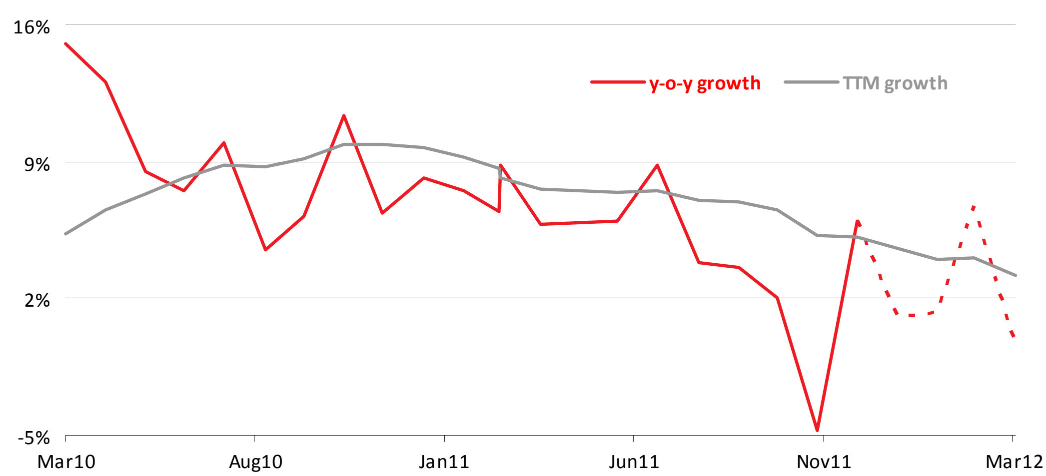
Tall base of Dec10 and Jan11 could depress y-o-y growth

IIP for Dec10 grew 11.1% over Nov10 to 175.6 driving y-o-y growth of 8.1%. The same effect was also seen in the Nov11 growth rising to 5.9% y-o-y. This volatility in the IIP has continued and its effect was most recently seen in the fall in growth for Oct11 to -5.0% followed by the rise in Nov11 to 5.9%. In three of the past four years the December IIP has risen by 8% to 10% over the mean for the preceding three months viz. September to November. Assuming a 9% growth for Dec11 the y-o-y growth would fall to 1.1%.

Volatile growth could extend till Mar12

The y-o-y growth for Feb12 could see a rebound but the base for Mar12 is very high. So, the y-o-y growth for Mar12 could again fall after a potential high single-digit growth in Feb12.

Exhibit 2: Monthly y-o-y growth and trailing-twelve-months growth in the IIP



Source: http://mospi.nic.in, Avendus Research

During the past four years, the IIP for March has grown by between 7% and 11% over the mean for the preceding three months. Assuming a 9% growth in the Mar12 IIP over the preceding three months the y-o-y growth for Mar12 could again fall after a potential high single-digit growth in Feb12.

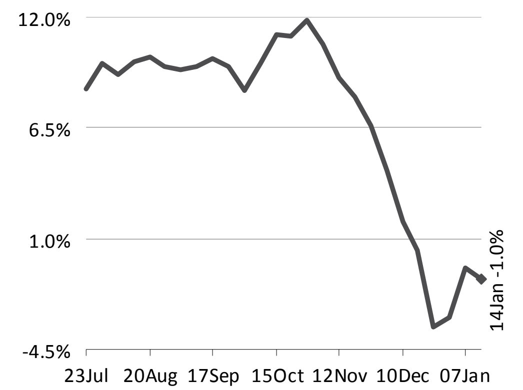
Robust rebound likely in food inflation in the near term

Inflation in Food Articles is likely to rise sharply in Feb12 as the base of 2011 begins to fall. The small but significant rise in prices for the latest four weeks, after two months of descent, too is likely to lift it. The y-o-y rise in Food Articles may rise to an estimated 8% at end of Mar12. The disproportionately high influence of food on the WPI suggests that overall inflation too may rise significantly during Feb12 and Mar12. The termination of weekly releases of the WPI may mask this impending rise in inflation. However, the monthly release of data too may reveal the rebound in Mar12.

Exceptional circumstances depressed food inflation in Nov11-Jan12

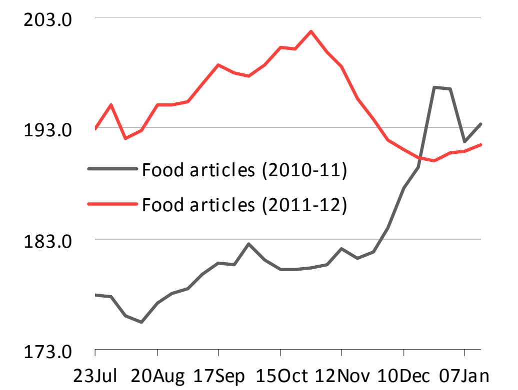
Food prices fell this year just when they had spiked up 12 months ago.

Exhibit 3: Y-o-y change in food articles



Source: http://eaindustry.nic.in, Avendus Research

Exhibit 4: Index for Food Articles



Source: http://eaindustry.nic.in, Avendus Research

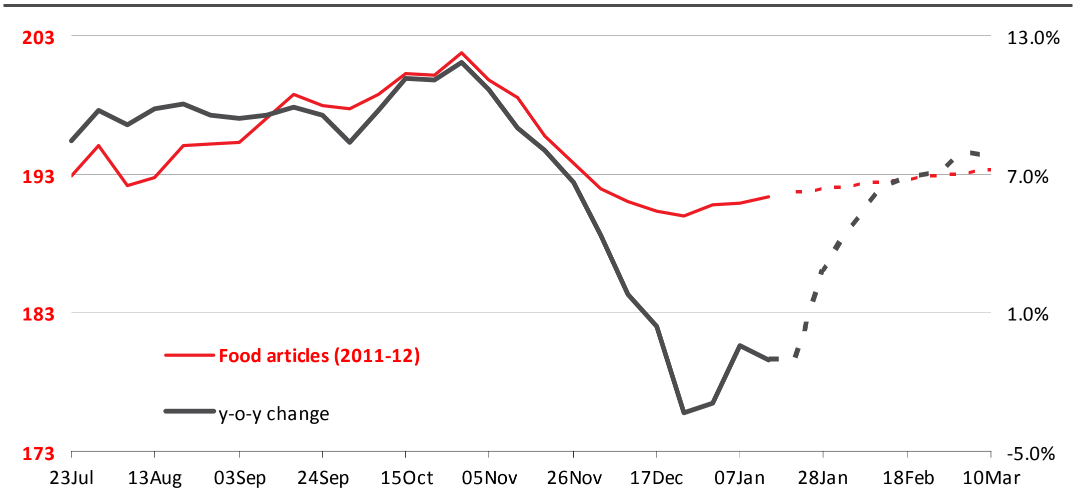
The slide in the inflation in food articles from 11.8% y-o-y (29th October 2011) to -1.0% (14th January 2012) was partly driven by the 5.1% fall in the index for prices of food articles between these dates. A larger influence was the spike in the food index in the preceding year.

Reversal in both base and current prices is under way

The food articles index for the latest four weeks (ended 14th January 2012) rose by 1.1 to 191.4. This corresponds to an annualized growth of 7.8%. On the other hand, the 10-week period from 15th January 2011 to 19th March 2011 saw the food articles index fall by 7.0% to 178.3. The effect of this reversal in trend on the base price and current prices would likely be seen in the weekly measure from the week ending 28th January 2012.

Even with a mild rise in food prices the inflation could rise sharply in the coming weeks.

Exhibit 5: Estimated weekly food articles index and the projected y-o-y change during Jan12-Mar12



Source: http://eaindustry.nic.in, Avendus Research

Halt to release of weekly data may conceal rebound in food inflation

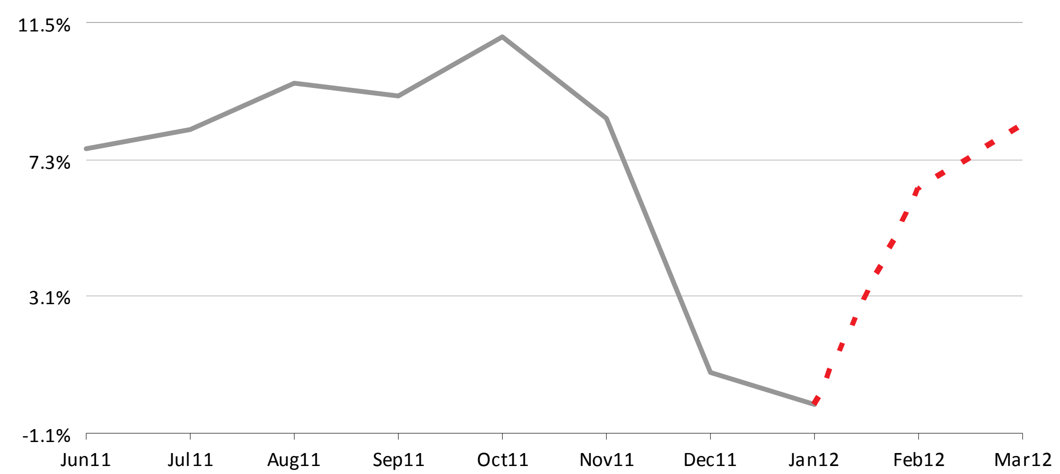
The weekly release of food and fuel inflation data based on the WPI was halted in January. The last date for this data was 14th January 2012 when the food articles inflation had fallen to -1.0% y-o-y. This means that the impending rise in the food inflation not be visible until the monthly release of the WPI.

Even if the rebound slows, food inflation may exceed 8% in Mar12

We assume the pace of the rise in the food articles index to slow down from an annualized 7.8% to 6.4% for the next 16 weeks, till 5th May 2012. Under this scenario, the estimated rise in the index would exceed 6% at end of Feb12 and 8% at end of Mar12. It may then moderate to c5% in May12.

Data for the month of February 2012 may reveal a large rise in food inflation.

Exhibit 6: Y-o-y change in the Food Articles index at monthly intervals

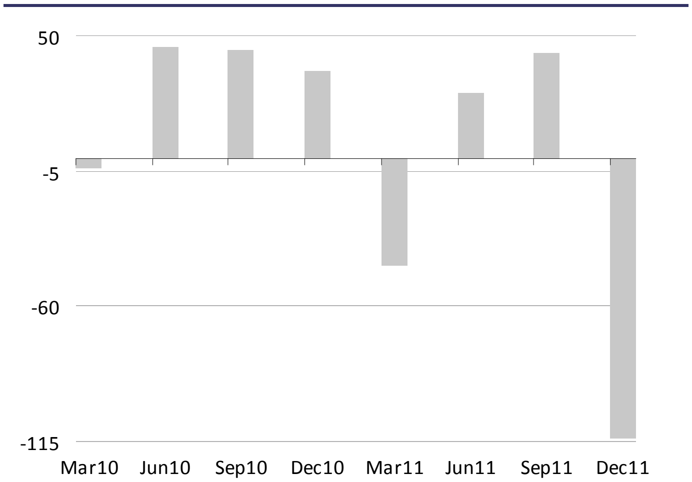


Source: Avendus Research

Food articles have disproportionately impacted overall inflation

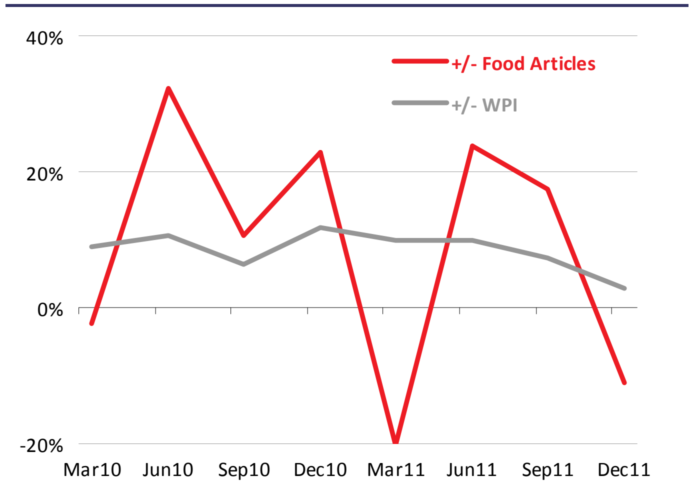
Changes in prices of Food Articles have had disproportionately high influence on the change in the WPI. The past eight quarters reveal that the quarterly change in the Food Articles has risen sharply above or, well below the corresponding change in the WPI. During quarters with high inflation, the contribution of Food Articles was well above its weight (14.3%) in the WPI.

Exhibit 7: Contribution of Food Articles to rise in WPI



Source: http://eaindustry.nic.in, Avendus Research

Exhibit 8: Annualised rise in WPI and in Food Articles



Source: http://eaindustry.nic.in, Avendus Research

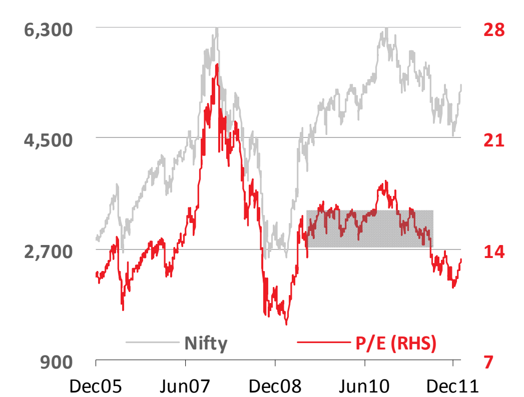
Potential headwinds for a few sectors; but not a long-term threat

The rally in Jan12 was driven by sectors with a strong link to an economic rebound and by stocks with deep value. Indices representing infrastructure, financials, real estate and mid-cap stocks were among the top sectors for the month. Large stocks from these segments made disproportionate contribution to the rise in the Nifty index. Three defensive sectors, Consumer, IT Services and Pharmaceuticals, representing over 27% of the Nifty contributed only 2% to the rise in Jan12. The first week of Feb12 is seeing some of the leading sectors of Jan12 lose some steam e.g. banks while the 'defensive' sectors have contributed 11% of the rise in the Nifty. A potential weakening of macro economic data in the near term could halt the momentum in the sectors such as infrastructure, financials and real estate.

Swift rebound but P/E still below 'stable' band

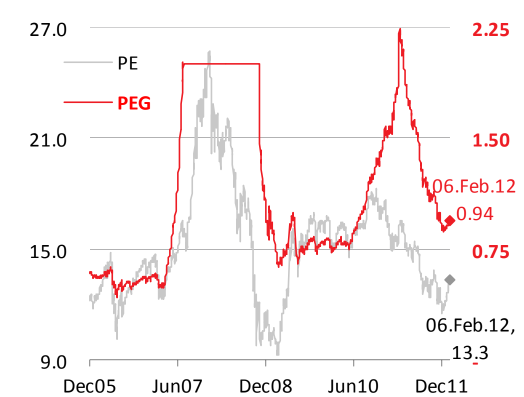
P/E of Nifty has risen from estimated 11.6x 1-year forward earnings at end of Dec11 to 13.3x in early Feb12. During this period the PEG rose from 0.86 to 0.94. While the recovery is evident the P/E is well below the band between 14.5x and 16.5x where it had stabilized for close to two years till mid-2011.

Exhibit 9: Nifty and the P/E



Source: Bloomberg, Avendus Research

Exhibit 10: Nifty P/E and PEG



Source: Bloomberg, Avendus Research

Exhibit 11: Weight of sectors in Nifty and their contribution in Jan12 and Feb12

	Index weight	Jan12	Feb12 (till 6th)
Automobiles	8.4	49.9	18.2
2-Wheelers	*2.5*	*(0.9)*	*4.9*
Commercial Vehicles	*2.9*	*40.4*	*5.0*
Passenger Vehicles	*3.0*	*10.4*	*8.3*
Cement	2.7	5.7	13.3
Construction	5.1	62.0	15.9
Consumer products	9.1	(4.8)	0.1
Engineering	1.7	5.5	6.7
Financials	26.0	231.6	37.8
PSU banks	*4.2*	*44.3*	*10.0*
New private banks	*15.1*	*151.4*	*24.7*
NBFC	*6.7*	*36.0*	*3.1*
IT Services	13.9	(1.5)	19.3
Metals & Mining	7.8	77.5	18.5
Oil & Gas	13.3	82.6	16.6
Pharmaceuticals	4.0	18.1	(1.5)
Telecom	3.2	15.1	8.1
Utilities	4.2	29.6	6.9
Real Estate	0.5	3.9	2.3
Total	**100.0**	**575.2**	**162.1**

Source: Bloomberg, Avendus Research

Some of the early winners have lost steam in February

Of the top ten indices, ranked by change in Jan12, six slipped down the ranks when measured by change in the first week of Feb12. Among the CNX indices, the largest fall in rank was seen in the Bank Nifty index which has slipped from 3 to 14. Other large falls were seen in the CNX DEFTY Index (4 to 11), CNX Energy Index (13 to 23) and the Avendus sector indices for Mining (11 to 21) and NBFCs (10 to 22).

Large increases in the rank were seen in the Avendus Cement index (23 to 1), CNX MNC index (19 to 6) and CNX PSE index (20 to 10).

Exhibit 12: Change in sector indices and their ranks

	------ Jan12 ------		---- Feb12 (till 6th) ----	
	+ / - (%)	Rank	+ / - (%)	Rank
CNX PSU BANK INDEX	25.8	1	5.1	4
CNX REALTY INDEX	25.7	2	8.2	2
BANK NIFTY INDEX	24.5	3	3.5	14
NSE S&P CNX DEFTY INDEX	21.4	4	3.9	11
NSE NIFTY MIDCAP 50 INDX	20.3	5	5.5	3
CNX INFRASTRUCTURE INDEX	19.1	6	4.9	5
India S&P ESG Index	18.7	7	4.5	8
NSE S&P CNX NIFTY JR IDX	17.8	8	4.3	9
NSE CNX MIDCAP INDEX	16.2	9	4.7	7
NBFC Index	14.8	10	2.5	22
Mining Index	14.2	11	2.6	21
NSE S&P CNX 500 EQTY IDX	13.5	12	3.5	13
CNX ENERGY INDEX	13.2	13	2.4	23
NSE CNX 100 INDEX	13.2	14	3.3	15
Utilities Index	13.2	15	3.0	19
CNX SERVICE SECTOR INDEX	13.1	16	3.1	17
NSE S&P CNX NIFTY INDEX	12.4	17	3.1	18
Telecom Index	11.4	18	3.7	12
CNX MNC INDEX	8.9	19	4.7	6
CNX PSE INDEX	8.7	20	3.9	10
CNX PHARMA INDEX	6.9	21	0.3	25
India National Stock Exchange	6.7	22	3.2	16
Cement Index	5.2	23	10.5	1
CNX FMCG INDEX	1.1	24	1.2	24
NSE CNX IT NIFTY INDEX	0.9	25	2.9	20

Source: Bloomberg, Avendus Research

Analyst Certification

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