

## RESEARCH REPORTS

Equity Report

**Markets are bracing for more turbulence**

By Mr. Aseem Dhru MD & CEO - HDFC Securities Ltd.

Published on Mon Sep 26, 2011 at 06:23 PM

# Emergence of Inter-linkages:

Since the World War II barring a few extra-ordinary events like the 9-11 the world has been a relatively normal place. You saw economies prosper like the United States, Japan, Germany, United Kingdom, France, Italy etc; you also saw economies like Japan tripping on growth and entering a long period of stagnation, which has already now lasted over 15 years. You saw the emergence of China as a major force and nations such as Brazil, India, and Russia grow in terms of their contributions to the world economy.

Under "normal" circumstances, relationships between variables are established. The relationships between currency markets, commodity markets, stock markets are more predictable. The relationship between economic policies and their impact on the economy as obvious. Every country could manage to spur or cool growth and inflation through known and established Fiscal and Monetary policy instruments.

Globalization and its consequent inter-linkages of economies and markets have been hailed for the benefits it has brought to world trade. It made sense for the country with the ability to manufacture the product at the lowest cost-China, Korea, Indonesia, Taiwan etc did so. Countries with the ability to use its vast English speaking engineer workforce laid its claim to be the back-office of the world-India.

Emerging economies needed capital and expertise to grow to their potential. With growing confidence they opened up their gates and welcomed Foreign Direct Investments in their economies and Foreign Portfolio Flows into their stock markets.

The world was balanced out with the exporter engines of Germany, Japan and China found a willing customer -The United States of America. After the Asian Currency Crisis, lessons were learnt and emerging economies focused on exports and started building foreign exchange reserves. The world's largest importer was also the world's largest debtor and its growing fiscal deficits between its revenue and expenditure were readily financed by the exporters who needed somewhere to park their growing reserves and what safer than to park it in US Sovereign Bonds. The world was in good balance; on the flipside the inter-linkages between economies and markets became so strong that any disturbance caused anywhere will have whiplashes everywhere else.

### Unintended Consequences of Globalization:

After months of worries on, will it, wont it; the US has entered into a double dip recession. Europe, make no mistakes is in a crisis much worse than Lehman, which blew up the world, markets in 2008. Sure, Lehman was a big Wall Street bank, but this time we are talking countries, Greece, Portugal, Ireland. The debt to GDP ratio of US, France, Italy are un-sustainable and the US has already seen a first - Standard and Poor have taken away its AAA status which it held since 1942. The Euro is in an existential crisis and if a few of these countries are not allowed to go out of European union in an orderly manner, a disorderly unwinding if it unfolds, the world will pay a heavy price.

Growth in China, India Brazil is slowing down. The world was saved from a collapse in 2008 by steroids in the form of injecting massive doses of cheap liquidity in economies of US, Europe and China. This liquidity pumped up the commodity and stock markets across the world creating an illusion that all is well.

Markets, addicted to liquidity were clamoring for QE-3, which is nothing, but printing of more money. When the US Fed instead of playing into the market, which they did earlier, wisely announced its Operation Twist, which is buying 30 year US Bonds, which are at an unbelievable, sub 3% and simultaneously selling short dated paper. This will be liquidity neutral and also put pressure on the 10 year Bond yields bringing the interest rates in the economy, already low, even lower.

This spooked the markets and we are seeing a global sell off. Also, the dollar carry trade which had emerged stronger; borrow in dollars at cheap rates and lend in emerging economies where monetary policies are being tightened to combat inflation. In fear there is a flight to safety and money moves back into the US Dollar this trade unwound opening up severe gashes in the emerging market currencies. The Brazilian Real, Turkish Lira and the Indian Rupee depreciated upwards on 9% in days.

### **Domestic Woes**

Unlike 2008 where India was impacted only by global factors, it had no worries on domestic front, this time it is different. Policy inaction, an inflation which has proved stickier on its way down than it was imagined leading to 12 interest rate increases over a 19 month period pushing up rates which will impact investments and growth. The next three quarters, we are likely to witness deceleration of growth in the Indian corporate sector. The drop in savings and capital formation, difficulty in land acquisition, high interest rates of debt, environment and project clearance issues and the general loss of confidence in the environment has slowed down companies from announcing new Greenfield and Brownfield expansions which will have its impact on future growth.

### **What does this mean?**

It means that we are likely to see further downside risk in the immediate and high volatility as the world reacts to each new development and tries to interpret the unprecedented events. It is a fact that money is made when you have the courage to go against the tide and invest in gloomy environments. While all the traditional wall street wisdom has been turned on its head right now, the ancient Zen saying investors need to remember. This Too Shall Pass. Systematic monthly investments; either in a Mutual Fund or just buying the Nifty ETFs every month and then patiently wait. While the permanent recovery may be very long of, any further drop in the Dow will increase the clamoring for QE-3 and the US government has not so far found the will to displease markets. If this comes through in meaningful doses, we will have a refueling faster than we think.

**By Mr. Aseem Dhru  
MD & CEO - HDFC Securities Ltd.**