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Sensex at Sep-03 Levels

Quick Comment – Market has de-rated: One investor we spoke to argued just before the recent rally that the market had not corrected enough since its September 2010 high. Indeed, for several market participants, this has been the moot reason for not being in the market, i.e., the market just did not go down enough in response to the bad macro, politics and tepid earnings after September 2010. Given that the index is now trading ~10% from its all-time high, the argument seems even more credible.

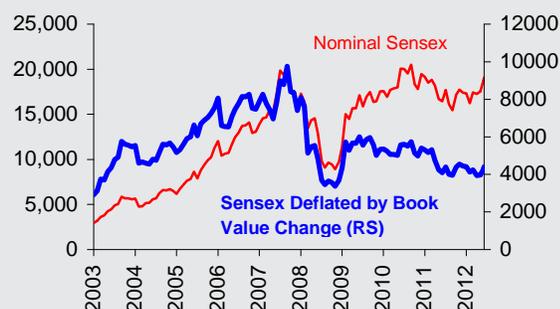
However, a closer look at the index reveals that the market has not only declined since September 2010, but it is trading at a level similar to September 2003. The market is close to the level it was trading at nine years ago. We arrive at this conclusion by deflating the index by the change in the book value and earnings per share of the index (Exhibit 1 and 2). There is not much difference in the deflated index values whether we use book or earnings (Exhibit 3).

In other words, there has been almost no change to the absolute market multiple in nine years. Arguably, the growth outlook is a lot better than it was in 2003 (the trailing five-year EPS growth then was 2.2% versus 10.2% now). In fact, the gap between the nominal index level and the “real” index level (the one deflated by book) is higher than ever before, signifying a big compression in multiples in recent years. The market is pricing in a considerably lower long-term earnings growth outlook than in the boom years of 2005-2008.

Ample upside to the market: This means there is ample upside to the market if the growth outlook improves. Arguably, India’s structural story is intact, and hence, the growth outlook could pick up if the economy were to rebalance and certain reform measures hit the ground running. We are seeing early, though fragile, signs of that, with a declining CAD and a slight improvement in the public investment rate (Exhibit 4).

Exhibit 1

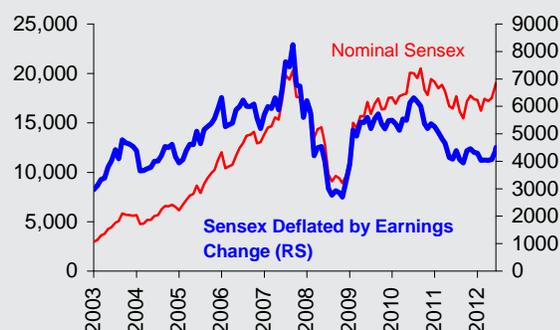
BSE Sensex Deflated by Book Value/Share



Source: FactSet, Morgan Stanley Research

Exhibit 2

BSE Sensex Deflated by EPS



Source: FactSet, Morgan Stanley Research

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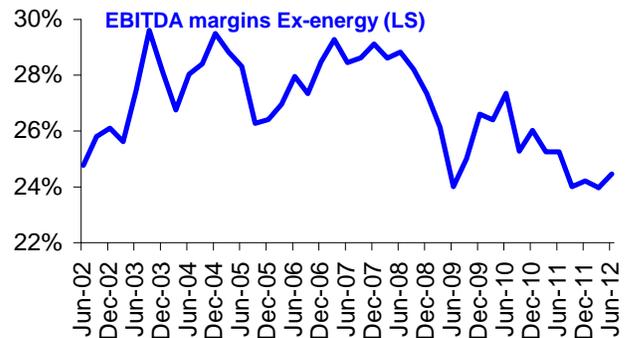
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The current account deficit, although high, is declining at the margin, thanks to better terms of trade and a waning appetite for gold. The investment rate is seemingly stabilizing thanks to a recovery in public spending, and this will be good for corporate margins. Corporate margins are coming off multi-year lows (Exhibit 5), and the market's current view of future profits is anchored to these low margin levels. As corporate margins rise, it leads to a virtuous cycle of a lower current account deficit via higher corporate savings. Another critical indicator for better macro stability is lower inflation. While inflation will receive help from an appreciating currency dependent on the government's ability to keep up reforms momentum and therefore flows, the big change will come if the government is able to contain the fiscal deficit. Hence, to us, the most critical news flow from India will revolve around the investment spend push by the government (via the National Investment Board) and moves to reduce the fiscal deficit (for now largely through asset sales).

Exhibit 5

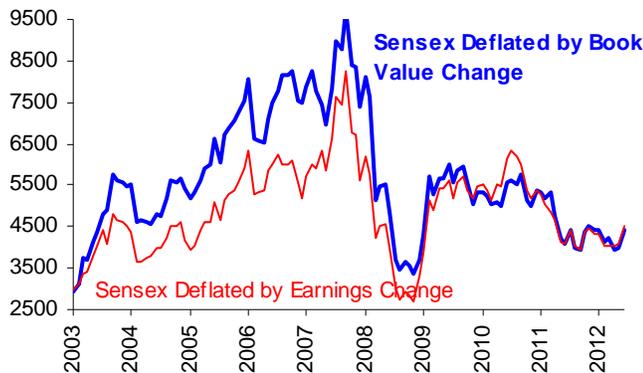
Corporate Margins at Decade Lows



Source: Company data, Morgan Stanley Research

Exhibit 3

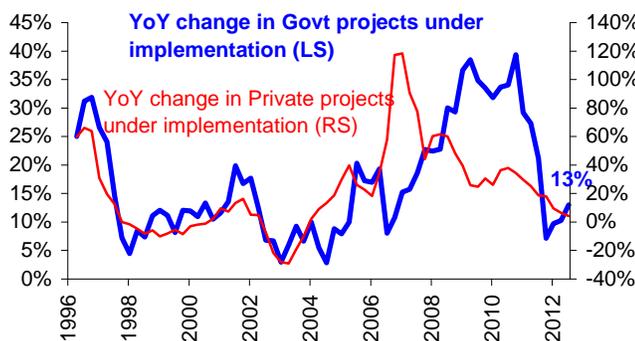
Not Much Difference in Deflating by Either Book or Earnings



Source: FactSet, MSCI, Morgan Stanley Research

Exhibit 4

Tick up in Government Projects



Source: CMIE, Morgan Stanley Research

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