Impact Consultancy Private Limited

Tremors

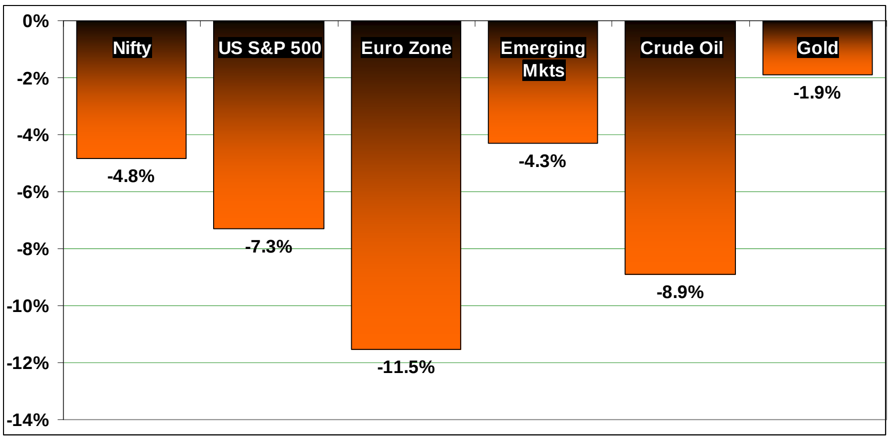
The Big Picture

17th October 2014

Overview

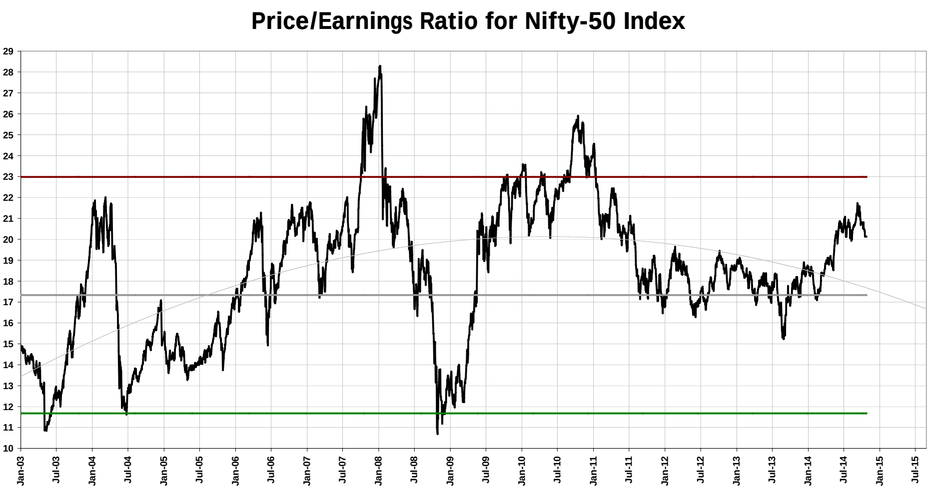
In our Market Outlook of 22nd September, we had said that *"the likelihood of an impending correction has increased significantly"* and *"the S&P 500 looks highly susceptible to a deep correction"*. Over the last four weeks, most risk assets have fallen sharply, particularly the US and European equity markets and surprisingly Emerging markets which tend to have a higher beta have outperformed. The principal factors contributing to these declines are a sharp slowdown in the Euro-zone economies and the impending likelihood of the US Fed increasing rates. If these headwinds continue, this weakness in the markets could persist. Especially in the case of the US S&P-500, as of now, it looks like the 5-year year bull market is ending and it is entering a prolonged bear phase. If that happens, emerging market including India, which are considered more risky, will fall disproportionately.

Percentage change from 22-September to 16-October



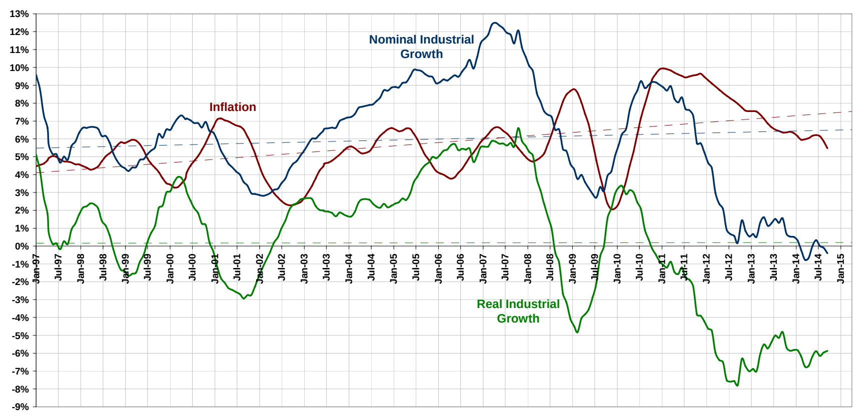
Earnings Season

The earnings season for the second quarter of 2014-15 has started off well enough and the earnings growth for Nifty-50 is expected to be 14.5% (y-o-y) compared to 9.3% at the end of last quarter. Both profit margins and return on capital are expected to be "flattish" at 10.5% and 16.4%. Although the recent fall in prices and increased earnings will push the Price/Earnings ratio down, it is still likely to be higher that the long-term average.



Macro-Economic Outlook

Perhaps the most disappointing data currently is the absence of any improvement in the broader Industrial growth. IIP-Manufacturing growth continues to be flat in nominal terms (long-term average is +6.2%) and negative in inflation-adjusted real terms. WPI Inflation (normalized) is now down to 5.47% and is now in the RBI's "comfort zone" (4-6%) after more than five years. As per our simulations, we expect the inflation rate to be in 4.0-4.5% range by end of FY:2014-15. Therefore the likelihood of rate cuts by RBI during this fiscal is very high, especially if global crude oil prices remain in the $80-90 range and there are no major global disruptions. But unless the IIP growth improves and the investment cycle turns, the hope for an immediate and robust recovery would seem elusive.



Outlook

Although it is still premature to suggest that we might be entering a deep global bear market, the recent concurrent sell-offs in equities, commodities and treasury bonds is troubling. A 10-15% downside in the S&P-500 still exists even from current levels. If that happens, higher risk markets like emerging markets will be highly susceptible to sharp corrections. We are still bullish in our long-term outlook but are increasingly cautious in the short-term.

Happy Investing.

Sashank Vipparthi
sashank@idika.com

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