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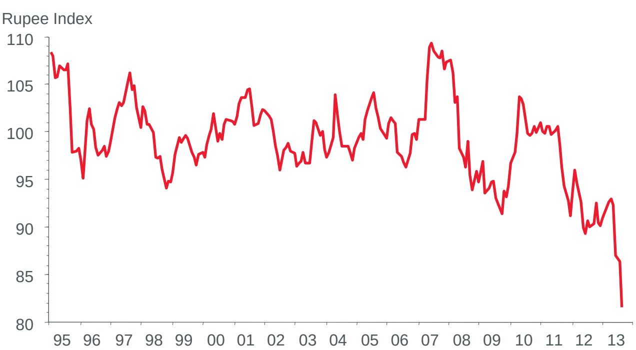
INSIGHTS

September 2013

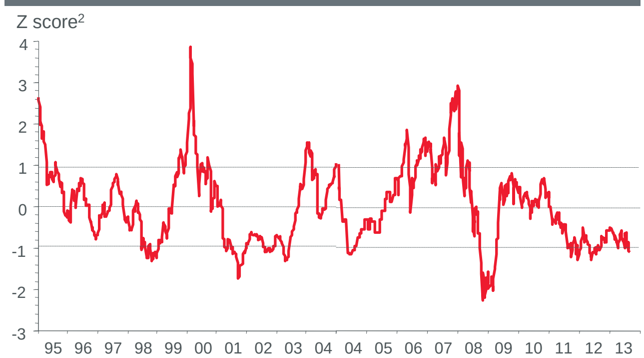
After the slaughter. Bottom fishing in India.

"Bottom fishing" does not mean that one necessarily expects equities to rally. Instead, it is where valuations are so low, it suggests any pain yet to surface, has been adequately discounted. That is where India stands today, we argue. More currency and equity turbulence seems likely as investors adjust to India's "new normal", but, value is apparent. "Tucking away" is definitely an option.

The Rupee is at its lowest since 1969[1], and …



… equities are near historical valuation lows.



Source: JP Morgan, MSCI and IBES from Datastream as at 10 September, 2013. [1] Real effective exchange rate trade-weighted. [2] Note that the "Z" valuation is a composite measure giving equal weighting to the variation of the historical . price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all values lie. The middle dotted line indicates the 10-year average.

The Rupee is oversold.

The rupee is at an historically low valuation. On a real effective exchange rate basis (see the above chart), it is not only valued below its 1993 low but is also at its lowest since the series started in 1969.

While the rupee looks oversold, it could still trade lower as investors assess both the response of the Reserve Bank of India to the fall and while waiting for the benefits of the sharply weaker currency to unfold. Equally, it could trade stronger.

So which will it be? The rupee has fallen, but has it fallen enough? The evidence suggests, "Yes".

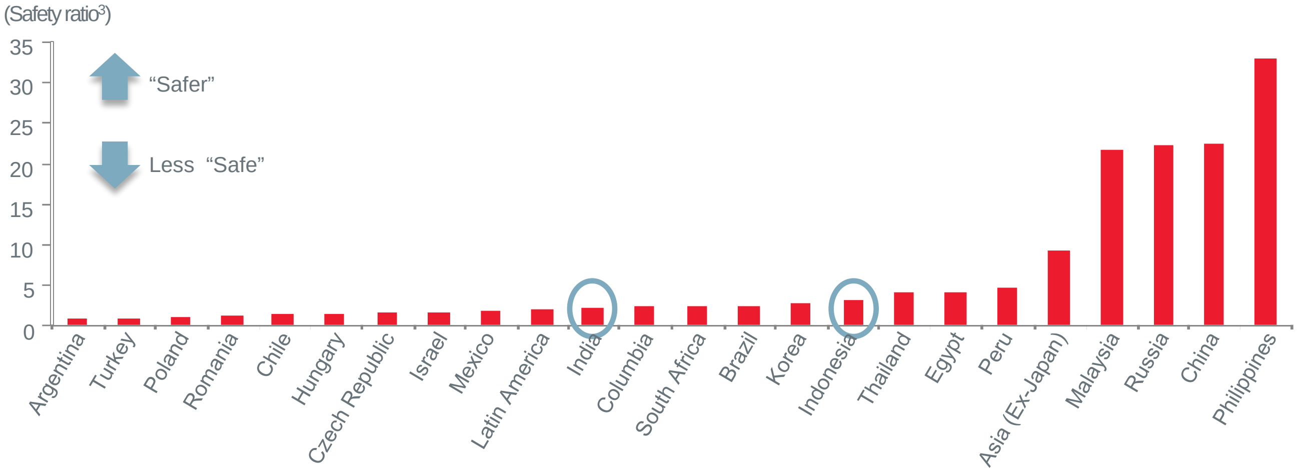
Emerging data points to a rupee bottom as it looks increasingly likely that export growth will surprise on the positive side. July export growth, for example, was at its highest in twenty months as companies aggressively pushed for exports.

There is also positive news on imports. Policy measures to curtail gold imports are hinting at success; gold and silver imports declined 35% year on year in July. Oil imports declined 8%.

It thus looks as though the trade deficit will narrow in the coming months, which should support the rupee. Badly burnt investors may want to see an improvement first before they act.

After such a sharp currency fall, inventors should also be aware that the trade deficit could deteriorate in coming months owing to the "J" curve effect. This is where the negative impact of rising import prices initially swamps the positive impact of rising export volumes. But given that July's rise in the discount rate to 10.25% has virtually removed negative interest rates, the case for a rupee floor looks solid.

**India had Asia's lowest "Buffer" protecting it from any capital outflows.
Pressure on the rupee was thus magnified.**



Source: Morgan Stanley Research August 2012. Sourced from Bloomberg, IIF, IFS, JEDH and national sources. [3]Safety ratio = (FX reserves + liquid foreign claims of local banks) / (2012F C/A deficit + S -T ext. debt + 12m forward amortization of M –T debt).

The rupee was Asia's most exposed currency

Magnifying the rupee's fall, was that when capital did leave, India had little "buffer" to shield itself (as illustrated above). It was a similar case in Indonesia, the other "hammered" Asian currency. But Korea, too, had a similar low level of "buffer", and yet the won appreciated.

The difference is that Korea runs a current account surplus (as does Thailand). The benefits of running a surplus and not being hostage to the needs of funding a deficit, are quite clear.

The message for India (and Indonesia) is stark; "Get your external deficits under control. Fast!"

"Big Bang" – Reserve Bank of India style

Investors may also find rupee confidence in the measures announced in early September by the incoming Governor. The Governor has said he not only wants to free the banks from state control but also reduce their requirement to buy government bonds, thus freeing capital for more productive investment. A full statement is due in September.

Whether this is sufficient to salve investors still jittery about US "tapering" has yet to be seen. The omens look good, we think.

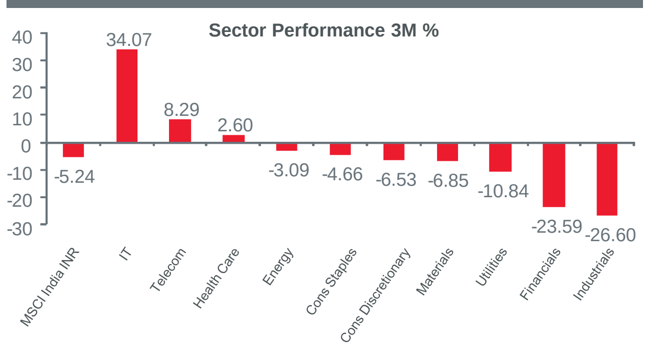
(Some) Indian equities look good value

Although equities fell per se, big differences appeared at the sector level. Those sectors, for example, that benefit from the rupee's fall out-performed by a huge margin, rising sharply.

The IT sector was the biggest beneficiary surging some 34% in the three months to end-August. In contrast, cyclicals (e.g. the banks and industrials), suffered, and were the main source of any outflow.

India clearly got caught in the US tapering fear backlash. But, given foreign selling was mostly in the rupee, rather than equities, it seems investors were not running from India's structural story. Both now look attractive. Bottom fishing anyone?

India sells off, but weak rupee beneficiaries soar.



Source: MSCI India index from Datastream as at August 31, 2013.

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