Mr. Ajmera's column as on May 12, 2014

Buoyancy continues in market based on expected exit polls outcome..

The markets seem to be sanguine at the prospect of a Narendra Modi-led, stable government after May 16. The markets had raised an early toast to Narendra Modi on Friday as rumours of an exit poll predicting the formation of a BJP-led NDA government fired up the Sensex to a new life-time high of 23,048 before closing within kissing distance of the 23k mark at 22,994. And after the gains this morning, the Sensex has now added more than 1000 points within a span of little more than a day.

The final day of voting is set for Monday and the exit polls that are expected to trickle in post 5pm on the same day. The campaigning for the Lok Sabha elections 2014 has come to an end and 41 constituencies, including Varanasi, would go to the polls. The April CPI and March IIP data, scheduled to be released next week, would also influence sentiment going forward.

The markets have maintained the spectacular momentum witnessed on Friday, thanks to blockbuster gains in index bellweather RIL and banking stocks. The Sensex has reclaimed the 23k mark touched in the previous session, the Nifty has surpassed 6,900 and the Bank Nifty is above 14,000. The Sensex is at 23,319, stronger by 325 points, the Nifty is 6928, up 69 points and the Bank Nifty is at 14,049, up 335 points. The midcap index is at 7493, higher by 37 points and the smallcap index is at 7614, up 22 points. All the sectoral indices are in the green, with the exception of consumer goods and pharma.

Stocks in action

Shares of oil and gas companies have firmed up for the second day in a row on optimism that Narendra Modi led Bharatiya Janata Party would form the government at the Centre after the conclusion of Lok Sabha elections. The results are scheduled to be announced on May 16, 2014.

Reliance Industries, Oil and Natural Gas Corporation (ONGC), Hindustan Petroleum, Gail India, Oil India, Indian Oil Corporation and Bharat Petroleum Corporation are up 1-4% on the BSE.

The S&P BSE Oil and Gas index, the largest gainer among sectoral indices, is up nearly 3% as compared to 1.4% rise in S&P BSE Sensex at 0935 hours. The oil and gas index has surged 6% in past two trading sessions against 4% rise in benchmark index.

Reliance Industries has surged over 5% to Rs 1,048, its highest level since April 2011 on the BSE. So far in 2014, the stock has rallied 17% against 10% rise in S&P BSE Sensex. The company along with British energy major BP Plc and Canadian explorer Niko has jointly served an arbitration notice over implementation of a new gas price from April 1, 2014.

ONGC has gained nearly 4% to Rs 361, slightly away from its record high of Rs 368 touched on September 2010. We remain positive on ONGC due to likely increase in net realization due to lower subsidy, driven by continued diesel price hikes, significant beneficiary of scheduled gas price hike from 1 April 2014, and attractive valuations.

Shares of IRB Infrastructure Developers have surged 7% to Rs 141, extending its 15% rally in past five trading sessions, after the company said it has bagged an Rs 2,300 crore road project in Haryana from National Highways Authority of India (NHAI). The stock opened at Rs 133 and touched high of Rs 142, its highest level since December 2012 on the BSE. The counter has seen huge trading activity with a combined 4.23 million shares changing hands on the BSE and NSE till 1025 hours. The road project is for the construction of four lane road connecting Kaithal-Rajasthan border section of NH-152/65 from 33.250 km to 241.580 km in Haryana. It will be executed as build-operate-transfer (BOT) pattern under National Highway Development Project (NHDP) Phase IV. Last month, IRB had announced that it had won a Rs 3,200 crore project from NHAI in Maharashtra for four-laning of Yedeshi–Aurangabad section of NH-211 from 100 km to 290.20 km. IRB's announced that the construction order book will increase from Rs 8,600 crore to approximately Rs 10,600 crore, the company said, adding that the orders have to be executed in the next three to four years.

On the global front, Asian shares were trading mixed as investors turned cautious due to re-emergence of tensions in Ukraine and Russia. Hang Seng and China were up over 1-1.6% each, while Nikkei and Straits Times were trading marginally lower.

Major US stock indices ended with marginal gains on Friday but selling pressure in Apple Inc weighed on the broader S&P 500 and the Nasdaq. The Dow Jones ended up 0.2% at 16,583, S&P 500 rose 0.15% to close at 1,878 and Nasdaq rose 0.5% to end at 4,072.

Ajcon's Outlook

The Indian economy in the past four years has steadily declined, owing partly to tepid global growth and partly to uncertain policy actions. It has reached a critical juncture where the election outcome could define the path for the next five years and beyond. In the past two years, gross domestic product (GDP) growth has become inconspicuous amid slowing personal consumption, as evident from falling automobile sales numbers and incapacity of the government to expand fiscal policy owing to a high fiscal deficit. Inflation has been in abundance with the sticky Consumer Price Index (CPI) headline number around eight per cent, resulting in a tighter monetary policy by the Reserve Bank of India (RBI) and interest rates at the higher end of the five-year range. Earnings growth has fallen to single digits and the banking system, critical to the growth of the economy, is facing heat as policy paralysis hits the debt servicing capacity of the companies. Rating agencies are critically watching the elections and have warned of a downgrade in case of a fractured mandate.

Against this economic backdrop, let us ascertain what the equity market is pricing in at current levels. The Nifty has rallied 10 per cent in the past two-three months, to trade at 15 times the one-year forward price-earning ratio (P/E), which has been on the higher end of the range in the past four years. Foreign institutional investors (FII) have pumped in close to $5 billion and cyclical (banking/capital goods) stocks have outperformed the defensives (information technology/fast moving consumer goods/pharmaceuticals) by 30-50 per cent in the the past couple of months. Hence, the market is pricing in a favourable National Democratic Alliance (NDA) government, expected to start the investment cycle (without which any pick-up in GDP growth would be inflationary and so, not sustainable) and roll the economy on to a new sustainable, salubrious and multi-year growth path. The trajectory for the markets would be shaped by:

Domestic factors: Strong government formation at the Centre: With the current macro economic situation, a strong government at the Centre is a "necessary" but not a "sufficient" condition to start the growth cycle. A revival in the currently stalled investment cycle would require strong decision making; hence, a strong government is the need of the hour. A weak coalition with less than 220 seats for the NDA could trigger a sharp fall in the market. Some of the FIIs which invested in anticipation of a positive political outcome might withdraw owing to an apprehension that tough economic decisions required to pull the economy out of downward spiral may be difficult to come by. On the other hand, a strong government with more than 250 seats for the NDA will instill confidence in market participants of the direction of the economy.

P/E expansion: The Nifty is presently trading at a one-year forward P/E of 15 times, a fair valuation. It would require a P/E expansion to sustain the move higher. The expansion may come either through fall in interest rates or pick-up in growth or both. Let's analyse both factors:

Interest rates: Under the inflation scenario, is still facing the risk of a weak monsoon due to rising probability of El Niño, interest rates are expected to remain sticky for the next six-nine months. This creates an opportunity cost of 9-9.5 per cent for Indian households to invest in equity markets, resulting in tepid flows (domestic institutional investors are marginal sellers even at new highs).

GDP growth: Languishing at sub-five per cent levels for the past seven quarters, it requires some strong and tough action from the new government to see a pick-up. At present, it is difficult to envisage a major turnaround in a short period and we expect GDP to grow 5-5.5 per cent for 2014-15.

Global factors: On the global front, developed countries' GDP growth is expected to fare better. China, struggling from internal financial leverage, might fall behind the targets. Given this, the US is slowing the injection of liquidity by tapering of quantitative easing (QE) while China is providing stimulus to provide a base to faltering economic growth and Euro zone stands ready to fight the deflation threat and could take over from where the Federal Reserve might leave after the QE taper. From the perspective of Indian equity markets, the global factors are rather neutral, except for geopolitical issues such as Ukraine.

A strong NDA government would provide a boost as markets would likely price in higher economic growth and a resultant P/E expansion to 18 times (the Nifty may trade in a P/E range of 14-18 times) but the sustainability would be dependent on the economic policies outlined in the months to come. On the other hand, a fractured mandate might result in tepid market sentiment and a possible rating downgrade and resultant P/E contraction towards 12-15 times (the Nifty might trade in a P/E range of 12-15 times, i.e. 5,700-6,700).

A note of caution: Once the euphoria of election settles down and the new government takes over, the real work will start. Except the sentiments and pyscological boost, we do not see any fundamental change hapeening in sometime to come. Hence, we advise the investors to exercise great caution building up long positions at this juncture. The markets on fundamentals were good for buying at 5800-6200 Nifty levels as recommended by us time and again. But, when the time has come to book partial profits, fresh buying at present levels especially in the index based stocks may be very risky.

Having said this, we still recommend buying in second rung infrastructure, capital goods, engineering and construction stocks which have not yet caught fancy of investors but are having strong fundamentals.

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