FINANCIAL TIMES

Special Report – India Investment

Dust from Election Result Has Yet to Settle

Khozem Merchant analyses the reaction of international investors to a government backed by communists

Foreign fund managers' study of political risk is an inexact science and a misreading can be costly. The money-managers who flocked to India ahead of the election in May did not, in their worst-case scenario, foresee victory for a communist-backed government.

Their reaction was instant and brutal. A net $800m flowed out in May. It was the first negative monthly outflow since October 2002 when foreign institutional investors (FII) raised their exposure to India, culminating in the purchase of a record net $7.62bn of debt and equity securities last year. The net outflow in May may have been just 3% of FII funds in India; but domestic share markets nevertheless lost an important buying ally and equities have languished subsequently.

One Hong Kong fund with $2bn in assets in India sharply reduced its India weightage after the share market rout triggered by the election result in May. "We were unnerved. Global funds now want a budget that makes India an outstanding case for investment in its own right," says the fund manager.

"It's tough to have any confidence in any directional action until you see policy."

The budget, which will be presented in July, has assumed extraordinary importance for foreign funds, who see it as a template for government policy for the next few years.

"We've had a lot of comfort talk. Investors now await precision in policy," says Arshad Zakaria, a former chief of global markets at Merrill Lynch in New York who is set to launch an India investment fund.

The new government's communist fringe may have injected an alarmist tone yet, as many domestic fund managers argue, the underlying investment case remains appealing.

Corporate earnings are forecast to grow 18–20% in an economy expanding by 7% or 8%; the market is trading at a price earnings multiple of 11 times 2005 forecast earnings, which makes it as appealing for bargain-hunters as China (10.4), Thailand (9.9) and Taiwan (10).

FIIs hiccups coincide with factors encouraging investors to retreat from risky emerging markets: the prospect of rising US rates; China's soft landing; and rising oil prices. Indeed, fund managers say much of the outflow in May was attributable to the unwinding of "carry trades", triggered by the likelihood of tightening US rates.

Yet some argue that even the conventional wisdom of carry money leaving emerging markets for the US may have less resonance this time round.

"It is not as though growth in Asia has dramatically declined," says S Naganath, vice president at DSP Merrill Lynch Fund Managers in Mumbai.

Jon Thorn, who manages the $125m India Capital Fund from Hong Kong, argues that India's growth forecast of 7% or 8% is not only "conservative"; but certain nascent trends suggest a more positive outlook. He cites a rise in demand for business credit to expand capacity. "In India, the credit cycle is at the start of its uptrend, the opposite of Korea. This is a powerful index because it shows companies are raising funds for capital expenditure which means jobs and growth," he says.

This underlying trend has hardly drawn foreign investors back en mass, though in the early part of June FII flows did nudge back into the positive.

What is happening is a stubborn "wait and see" approach. **"It's tough to have any confidence in any directional action until you see policy," says Dr Thorn.**

A few points stand out on foreign funds wish-list from the budget: a definitive signal that government is on the side of investors; evidence of prudent fiscal management, in other words a rejection of populist spending measures; and a commitment to improving infrastructure.

With privitisation off the agenda, funds are looking at two broad investment opportunities.

Infrastructure spending will unlock the bottlenecks that stymie many areas of the economy, improving the outlook for companies in steel, cement and engineering.

Continued high growth will boost domestic consumption, helping a raft of companies from banks issuing retail products to companies manufacturing small cars. Low-cost finance, which could be reversing too, may fuel more current spending.

If that adds up to an appealing landscape, it is scarcely a trouble-free one. As one foreign money manager says: "The dust has still not settled from the election."

Financial Times – Special Report: India Investment / 23 June, 2004