

India Notes

Capital controls important to stem excessive short-term inflows: IMF

The International Monetary Fund on Thursday said capital control measures could be valuable for countries like Brazil and India, facing excessive short-term capital inflows that threaten to damage their economies. India has maintained that the economy is resilient enough to absorb the current short term FII inflows and, therefore, does not need capital controls at the moment. Brazil has, however, threatened to take more measures to stem the rally in its currency Real. Brazil had imposed an upfront 2 per cent tax on capital inflows in October 2009, paving way for countries like South Korea, Thailand who in 2010 adopted similar measures to safeguard their economy from excessive FII inflows.

India's food inflation rate spikes to 18.32 %

India's food inflation rate spurted to 18.32 per cent for the week ended December 25 from 14.44 per cent in the previous week on the back of the sharp increases in the prices of onions and vegetables. Government data showed that the inflation rate for fuel remained unchanged at the previous week's level of 11.63 per cent.

Demand for homes to drive real estate sector in 2011: Fitch Ratings

Credit rating agency Fitch Ratings Monday said the demand for residential units, driven by high growth rate in the Indian economy and rapid urbanisation, are the main drivers for the real estate growth in the medium term. Terming the outlook for the Indian real estate sector for 2011 as stable with negative bias, Fitch said the absorption rate is likely to be slowed down over the near term on account of strong increase in residential unit prices during the second half of 2010. The withdrawal of teaser interest rates by lenders and the increase in interest rates expected in the first half of calendar year 2011 are also likely to dampen the demand, Fitch said.

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Economy & Markets

Capital controls important to stem excessive short-term inflows: IMF

The International Monetary Fund said capital control measures could be valuable for countries like Brazil and India, facing excessive short-term capital inflows that threaten to damage their economies. The IMF added that though Capital controls are a little bit in the eye of the beholder, but they continue to be a necessary evil. Some capital control measures are focused on macro-prudential stability. Others focus on shifting the length of the maturity of inflows, as they are taxing short-term and encouraging long-term flows. India has maintained that the economy is resilient enough to absorb the current short-term FII inflows and therefore, does not need capital controls at the moment.

Brazil had imposed an upfront 2 per cent tax on capital inflows in October 2009, paving way for countries like South Korea, Thailand who in 2010 adopted similar measures to safeguard their economy from excessive FII inflows. IMF said that a number of emerging markets were facing substantial capital inflows at the moment, as their economies were recovering and growing rapidly. IMF also suggested that these are good signs. According to the report these flows are sign of strength and some of the inflows are structural and will be accommodated over time and help to promote investment and growth in those economies.

But when countries fear that they might be temporary, there's also a concern in some countries about what that might do to the macro economy. There is fiscal contraction and macro-prudential controls to strengthen the banking system and intermediation of these flows can be important according to the IMF. There are a range of measures that countries may take, some of which are focused on the way capital comes into the country and whether it should be taxed if it comes on a short-term basis, and if a bank gets capital it should have higher reserve requirements to pay back the capital when it needs to.

India's food inflation rate spikes to 18.32 %

The 18% YoY surge in food prices for the week ending Dec 25 has resulted in the index for primary articles once again crossing 20%. This spike is largely due to fruits and vegetables, which rose 39%YoY v/s 6.7% last month. (This segment has a weight of ~4% in the WPI.) But what is more worrying is that mounting food prices are not an entirely domestic worry – last week, the FAO Food Price Index which tracks global prices, crossed 2008 highs, fuelled by sugar, cereals and oils. Given extreme weather patterns across the globe (floods in Australia, snowstorms in the northern hemisphere); price rises could persist in the coming months. Many critical commodities and food products saw a significant spike in prices leading to public outrage and resulting in significant negative publicity for the Government.

Further as the price of Oil in the international markets increases there is bound to be further pressure on the Inflation trends. The Oil Subsidy which is one of the significant contributors to the fiscal deficit and the Government is trying to reduce the subsidy by marking fuel prices to market fluctuations. However as Inflation continues its rapid rise the Government may be forced to moderate the fuel price hikes which pass through eventually to the end user.

India posts outperformance vs. The global indices for the second consecutive year.

2010 was the year of the “E”s. Equity markets across the world delivered positive returns in 2010, even though sovereign issues in Europe caused periods of market volatility. Quantitative easing brought a flood of liquidity to Indian equity markets. Domestic factors also influenced Indian market performance, from the RBI's Exit to questions on government's Execution on reforms and the debates on corporate and political Ethics. Despite the uncertainty, backed by strong Earnings, India posted outperformance vs. the global indices for the second consecutive year.

What Should Investors expect in 2011

Indian policy makers have been boosting growth at the cost of macro stability risks, reflected in high inflation, a widening current account deficit and tight inter-bank liquidity due to low deposit growth. WPI headline inflation and non-food inflation have moderated to 7.5 percent YoY and 7.9 percent YoY in November 2010 from the peaks of 11 percent YoY and 8.9 percent YoY (in April 2010) respectively. Monthly trade deficit narrowed to 7.1 percent of GDP, annualised in November, from the peak of 10.8 percent of GDP, annualised in August 2010.

Inter-bank liquidity should also improve over the next three months as recent aggressive deposit rate hikes will help improve deposit growth. Private sector capex has been accelerating over the last 10 months and it will soon begin to reflect in the form of commissioned capacity. At the same time, monetary tightening — as reflected in the 300 bps rise in short-term rates (91-day T-bill yields) over the last eight months — is beginning to help reduce the above macro stability risks. Overall macro conditions will remain vulnerable over the next 4-5 months. Inflation, while moderating, will remain above the RBI's comfort zone and the current account deficit will also stay relatively high.

Recent optimism in the developed world growth outlook has increased the risk of a potential rise in crude oil prices to € 85/bbl (\$110-120/bbl). Similarly, there is additional risk of pass through of agricultural and commodity prices.

Will FII's continue to Invest after a record year?

India emerged a preferred destination among emerging markets for foreign institutional investors (FIIs) who pumped in a record € 21.95 bn (\$28.4 billion) (net of sales)(2010) into Indian equities, attracted by high growth and robust corporate earnings, but analysts remain divided on whether the country will continue to attract a similar quantum of foreign money in 2011. FII inflows into bond markets also touched a record high of € 7.73 bn (\$10 billion)(2010) as low yields in Western markets prompted investors to look for emerging pastures. An estimated growth rate of 8.5% that is largely domestic-demand driven and an estimated 20% growth in corporate earnings have helped India corner a disproportionately larger share of global fund flows in a world marked by macroeconomic uncertainty.

Buoyed by the highest level of inflows since India opened its doors to foreign investors in 1993, the broader market rose by 15.6% till 22 December this calendar year outperforming most of its emerging market peers including China and Brazil, where the markets declined in 2010. According to global fund database Emerging Portfolio Fund Research Inc., Indian equities received 15% of the total fund flow into Asian emerging market equities in the current year against a weightage of 11% in the MSCI Emerging Asia Index (which should mean that it should, in ideal conditions, receive 11%). While the Indian growth story is set to attract more fund flows, analysts are divided over whether the country will be able to surpass the record inflows seen this year. Some say that 2011 might see a moderation in flows with high valuations and inflationary risks making Indian equities look less appealing compared with its peers.

The previous highest inflow was seen in 2007, when FIIs bought € 13.6 bn (\$17.8 billion) worth of equities, net of sales. There are four key factors that might cause some moderation in flows: a higher allocation to developed market equities; rotation within emerging markets to the underperformers of this year's rally such as Korea and Taiwan; the resurfacing of debt problems in Europe, contributing to risk aversion and causing outflows from emerging markets; and disappointing earnings though that seems unlikely unless domestic demand slows or commodity prices spike.

The Market analysts see the shift to developed market equities from bonds as a sign of rising risk appetite and an indicator of better things for India and China. As long as corporate earnings are close to 25% and economic growth is in place, I think we should see more foreign inflows in the year ahead. The key risk to earnings comes from rising commodity prices which would exacerbate inflationary pressures, raising the prospects of interest rate hikes by the central bank and pushing up costs for firms. To be sure, the earnings growth estimate of 20% plus for Sensex companies remains nearly unchanged with the consensus earnings per share estimate at € 18 (Rs.1,055) as per Bloomberg data for fiscal 2010. The Sensex currently trades at 19 times its forward earnings for fiscal 2010 and at a 40% premium to the MSCI Emerging Markets Index. With valuations at a premium, any disappointment in earnings or even rise in the political risk perception could trigger a sell-off, as was evident during the recent correction.

Real Estate

Indian Listed Developers at 50% discount to NAV, suggests worst priced in

The Indian real estate sector has significantly underperformed the Sensex index by 30% over the past three months, with most property stocks being high beta down 20%-50% over the past three months. This was due to a slew of negative news/events such as: 1) a seasonally weak Q210, following the RBI raising the risk weightage and provisioning for mortgages; 2) controversy from 2G licence allottees and likely penalties, two being realty group companies; 3) a likely involvement of realty players in the loan syndication scam; 4) the risk of approval delays/cancellation of projects in Mumbai due to a change in the chief minister; and 5) a fluid political situation due to ongoing fraud investigations. The market has overreacted as core fundamentals remain intact. With valuations at a 50% discount to est. NAV and close to levels during the credit crisis, analysts believe the worst has been priced in.

Residential outlook healthy, albeit with a likely near-term slowdown

Given macroeconomic catalysts such as: 1) an average GDP growth forecast of 7.5%-8%, which would likely lead to higher asset prices; 2) favourable demographics; 3) an increased share of savings (around 20% of income) having a high probability of being invested in property; and 4) progress on the infrastructure projects, analysts expect key residential drivers to remain intact for most Tier I and II cities. The residential sector continued its strong growth trajectory in 2010, which it has been trading from the second half of 2009. Residential property rates have attained the previous peaks of 2008 across several markets. The year also saw an increased number of launches in the premium segment, mostly in the Mumbai market. However, sale velocities of houses have dropped by end of the year and further hardening of interest rates along with high inflationary pressure can be a dampener for residential sales in the coming quarters. Residential property rates are likely to continue their upward trajectory, albeit at a slower pace than 2010. However certain locations that have witnessed rapid increments in price, will not only witness resistance to any further price rise, but also some downward pressure.

Most Analysts expect rapid sale velocities in the affordable segment for projects which are priced at or below market averages. Likely hardening of interest rates, coupled with high inflationary pressures and rising property rates, will impact the purchasing power of home buyers in 2011, which will influence the absorption dynamics of the residential sector.

Strong pick-up in leasing—a key future catalyst

There have been promising signs of a recovery in the commercial/leasing markets. Growth has been largely driven by: 1) an increased demand for space from the IT/ITeS and banking/financial services sectors; and 2) rentals being at their trough levels across most markets. While oversupply and high vacancy rates of 15%-20% remain an overhang; however actual new supply is becoming rationalised and vacancies are at peak levels given soft rentals. Among the key markets, Mumbai, Gurgaon and Bangalore have witnessed the strongest increase in leasing activity. Meanwhile, other markets such as Chennai, Hyderabad and Pune are showing signs of a pick-up. It is expected that the commercial recovery to be led by volume, while rentals should remain soft.

The Outlook for Commercial in 2011

The effect of strengthening absorption of office space in the past 3-4 quarters has already resulted in a stabilisation of rental and capital values in most of the markets. The period from 2Q10 to 3Q11 provides a strategic window of opportunity for both buying and leasing office space, when both rental and capital values are at their cyclical lows. Capital values typically are a leading indicator and signs of strengthening of capital values in selected micro markets have already been witnessed. Several markets which were dormant during 2010 with respect to property rates will register an appreciation in valuations. The prime markets of Mumbai, Delhi and Bangalore are ahead in the property cycle in terms of transactional volumes and should be the first to register rental growth in 2011. However, the oversupplied suburban markets might still feel the pressure of inadequate demand levels and will be late to recover. Adequate volumes of office supply will keep hitting the markets every quarter, keeping the segment interesting for occupiers as well as investors.