October 29, 2013 1:52 pm

India equities enjoy stunning rebound

By James Crabtree

"Crisis? What crisis?" This seems to be the new motto for Indian markets. Stocks have built on a startling recovery, shrugging off a period of currency freefall and capital flight that had threatened to turn into a full-fledged crisis.

The buoyant mood seemed confirmed on Tuesday, as Reserve Bank of India governor Raghuram Rajan's decision to raise interest rates sent equities nearly 2 per cent higher. The benchmark Sensex index closed at 20,929, just a fraction below its all-time closing high, set last week.

What crisis?

Foreign capital moves back into stocks while gold duty hikes have an impact

Mr Rajan described the move as part of broader RBI attempts to "normalise" its policies following India's recent market turbulence, and included other steps to unwind emergency measures introduced to support the plummeting rupee earlier this year.

Investors have welcomed all such signs of a return to business-as-usual, prompting stocks to jump 14 per cent since the end of August.

"India has come back very strongly, although it is in some ways more of a relief rally," says Gaurav Kapur, a Mumbai-based economist at Royal Bank of Scotland.

Mr Rajan's arrival at the RBI in early September is widely credited with improving market sentiment, followed by the US Federal Reserve's decision to delay the rollback of its $85bn monthly asset-buying programme in the middle of that month.

The latter factor, in particular, helped to bring an influx of foreign capital back into Indian equities, with around $2bn flowing into the market during October.

Underlying economic factors have improved a little as well, in particular the country's troublesome current account deficit, which economists predict will now begin to shrink in the second half of this year, further reducing pressure on the rupee.

A succession of duty hikes on gold have also had a dramatic effect, cutting sharply imports of the yellow metal from an all-time monthly high of 162 tonnes during May, to just 7 tonnes in September.

As a result, the once-battered currency appears to have stabilised, ending the day on Tuesday at Rs61.31 to the dollar, up around 12 per cent from its record low of close to Rs69, hit towards the end of August.

In the equity market, the recent upswing has been felt most strongly in the same sectors that suffered most during the rupee's decline, a period in which investors flocked to the relative safety of India's IT and pharmaceutical exporters.

Banks have especially done well, with the Bombay Stock Exchange's Bankex index up 14 per cent this month, boosted in particular by the RBI's decision to reduce emergency short-term borrowing rates, which had weighed on valuations.

Stocks in the previously unfancied metals and industrial sectors have also bounced back, although analyst Neelkanth Mishra at Credit Suisse says this reflects "bottom-fishing" for undervalued shares, rather than a sustained turnround.

The generally positive mood has been further buoyed by unexpectedly positive earnings so far in the second quarter, with a number of major companies including automaker Maruti Suzuki, beating results expectations in recent weeks.

Investors say the recent bounce back has returned Indian stocks to something approaching their fair value, with stocks trading close to their average forward price-to-earnings ratio over the last decade of 15 times.

"If I compare India to the rest of the region, it now looks OK, but it isn't jumping out in terms of valuation," says Ayaz Ebrahim, head of Asian equities at Amundi, the French asset manager. "And we've probably got the most we are going to get from this rally, without more positive macro developments."

As yet, there are few signs of such a broader pick-up in India's struggling economy, where growth has fallen to decade-lows of roughly 4 per cent in recent quarters, and is predicted to recover only slightly early next year.

The rupee's stability remains to be tested as well, in particular when the RBI eventually closes the temporary facility it opened to sell dollars directly to state-run oil companies, a move that many economists credit with helping to stop the currency's fall.

India's fractious politics provides one further source of potential uncertainty, with investors hoping for a decisive result in national elections due to be held before next May, roughly the same time as the US Fed may look again at tapering its "quantitative easing" programme.

"The big question is whether the storm is over, or whether we are still in the eye?" says economist Eswar Prasad of Cornell University. "I fear the fairest answer is that we are indeed in the eye, and although the storm has become calmer, there are still plenty more choppy waters to come."