

SPECIAL EDITION

Budget 2008 – Implications for Equity Markets

- The focus was on inclusion of the broader public in the “India Growth” story in the lead up to the parliamentary elections in 2009. This was particularly illustrated by the waiver of loans to farmers to the tune of 50,000 crores plus.
- The expenditure focus was primarily on agriculture and rural, education, healthcare and financial concessions.
- The significant hike in Income Tax exemption limits leaves more disposable income in the hands of Indian consumers. The negatives on tax were a lack of any reduction in corporate tax and a hike in short-term capital gains from 10% to 15%.
- The cut in excise and customs duties reduces the prices of goods, which is positive for local consumption and for heightening concerns on inflationary.

These measures indicate a focus on the need to appeal to a broader audience and less so on capital markets, which have benefited from three fruitful years thus far under the 10th plan. Thus focus was on agriculture and promotion of rural growth which has been the laggard in terms of economic growth. This is particularly crucial in view of the rapid appreciation of food prices over the last 12 months, global shortages due to population growth in China and India.

The budget also focuses on achieving growth without inflationary consequences. This is achieved through reducing excise and custom duties, which is crucial in an environment when inflation is rising towards the upper band of comfort for the RBI. Thus whilst growth is showing signs of tiredness i.e. corporate top line sales receding as witnessed by 3Q 08 results, the RBI has its hands tied by inflation. The prime offenders are Oil and Food, both of which are crucial inputs from an Indian perspective. The budget indicates the need to play a balancing act between sustainable GDP growth and rising global inflation.

The tax cuts from a personal perspective provide a strong impetus to the consumer, leisure and retail segments. This places money in the hands of the consumer rather than being a positive for stock markets. The stock market will react negatively initially as corporate taxes were not cut. Additionally trading behaviour is being discouraged by increasing short-term capital gains. This is not a long-term impact, but rather a mild short-term negative.

The sectors which should be positively impacted by the budget are healthcare, agriculture, education, retailing, consumer-durable/discretionary and PSU banks.

International Market Impact on India

Whilst we view the budget as being positive for local markets, the news from the international markets continues to be increasingly grim. In the US the Federal Reserve rate cuts are not being passed onto the broader economy. Banks are not lending to corporates who do not have a premium credit rating. Most are starved for capital after taking on significant write-downs and are being cautious in their approach. Credit spreads remain relatively high and the impact is likely to be felt in small to mid cap companies. In fact recent results are showing the problems of the financials and housing segments are now reverberating across sectors, particularly those related to consumer spending. The consumer is becoming increasingly cautious due to rising inflation, unemployment and falling home prices. In this environment we are likely to see corporate profitability being impacted across 2008 as we enter a recessionary environment with rising inflation – the dreaded term referred to as stagflation.

In this weakening global environment we are unlikely to see Indian markets operating above 17x on a P/E basis, particularly with 17% earnings growth as consensus for the Sensex. That would mean it would be hard for markets to surpass levels of 18,000 for a significant period of time over the first half of 2008.