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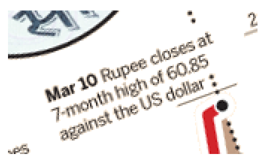
Election hopes spur India relief rally

By James Crabtree in Mumbai

Last week's announcement of May 16 as the results date for India's national election brought solace to the country's eager politicians, allowing campaigning in the world's largest democracy to begin in earnest.

For investors the relief appeared equally palpable, as equity markets kicked off a full-throated rally, setting a series of all-time highs on optimism over a post-election fillip for India's economic fortunes.

Modi momentum



The benchmark Sensex index retreated slightly on Tuesday, but the day before it nosed above 22,000 for the first time in its history, having set record closing highs on consecutive days last week.

Markets have risen 3 per cent since last Wednesday, the day on which election details were revealed, and more than 7 per cent since last month, making India's bourse the second-strongest performer in Asia, after the Philippines.

"The economic fundamentals haven't changed, but sentiment certainly has . . . There is a strong sense that the worst is now behind India," says Eswar Prasad, an economist at Cornell university.

Unusually for an emerging economy, in India roughly half of freely traded shares are owned by foreign investors – meaning that market rallies are often driven by an influx of international capital.

Some of the mood swing is in response to an improvement in the external environment. India has proved unexpectedly resilient to the US Federal Reserve's gradual unwinding of its ultra-easy monetary policy, especially when compared with the likes of South Africa and Turkey.

But this week's investor enthusiasm seems more rooted in domestic factors – notably renewed expectations that opposition leader Narendra Modi is likely to become prime minister.

"The prospect of a change in government has buoyed sentiment, and the hope is that the paralysis that has long afflicted much of Indian policy making might soon be over," Mr Prasad says.

More specifically, investors expect that Mr Modi's arrival in power would provide a speedy boost to the economy, partly by kick-starting infrastructure spending – a theory that has led to sharp shifts in sectoral performance during the rally.

Previously inexpensive and unfancied stocks such as those of state-owned banks and capital goods companies have risen sharply. The Bombay Stock Exchange's capital goods index has surged more than 20 per cent in a month, while Bharat Heavy Electricals has risen 13 per cent in the past five days.

By contrast, shares in higher-quality, export-focused businesses such as software outsourcing mainstays Infosys and Tata Consultancy Services, to which investors flocked for safety during a period of capital flight last year, have steadily fallen back.

An influx of foreign investment has buoyed the market more generally, with global fund managers pouring $937m into Indian equities so far during March – roughly three times the level of inflows in the previous two months.

That capital infusion in turn has provided a boost to the battered rupee. The currency closed on Monday at Rs60.9 against the dollar, its strongest level for more than six months, banishing memories of the bruising period last August when it sank as low as Rs69.

Beyond excitement over politics, two more concrete factors are also probably playing a part in the market upturn, analysts say.

Mildly positive economic figures are the first. Data last week showed the once foreboding current account deficit had narrowed once more in the final quarter of last year to its lowest level in four years.

Projections from Deutsche Bank also suggest that data later this week should show the elevated inflation rate has moderated further, even though the economic growth rate remains stubbornly stuck below 5 per cent.

The second factor is India's position relative to other emerging economies. Asia's third-largest economy is benefiting in particular from rising anxiety over China, says Herald van der Linde, head of Asia-Pacific equity strategy for HSBC. He points to concerns over a recent corporate bond default and broader worries over slowing Chinese growth.

"But if people are shying away from China, where else do you go? Some go to Asean, but that is often too small for big investors, so India looks like the best bet," Mr van der Linde says.

Will this good fortune continue? The main risk is that the election does not go the way investors hope, according to Sanjeev Prasad, head of research at broker Kotak Institutional Equities in Mumbai.

"If that doesn't happen, you could see anything up to a 30 per cent correction in the names that have gone up so strongly over the last week . . . Elections are always difficult to predict. It's not an open and shut case," he says.

"The market wants only one outcome, which is [Mr] Modi. Nothing else will do."

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