Indian Capital Market: A Corporate's Perspective

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Let us begin this discussion with a broad overview of the subject in question, before addressing the various factors that have affected it this year. The Indian capital market is a thriving macrocosm of trading activity that fuels the country's economy, thereby also helping the government meet its developmental goals. This is so because capital markets also provide funds for projects in backward areas. This facilitates economic development of pockets that have been neglected.

Specifically, capital markets are a marketplace for buying and selling equity and debt instruments. The savings and investments of suppliers of capital, such as retail investors and institutional investors, are channelled towards users of funds namely other businesses, the government and individuals. New stock and bond issues are sold to investors in primary markets whereas existing trade securities are dealt with in secondary markets.

In developing countries like India the importance of a capital market is self evident. In this market, various types of securities aid the mobilization of savings from various parts of population. The twin features of reasonable return and liquidity in a stock exchange are definite incentives to the people to invest in securities. This accelerates the capital formation in the country.

The Regulator

Any marketplace needs a regulator and our capital markets are no different. This role is performed by the Securities & Exchange Board of India (SEBI). Lately, the board has been playing a proactive role. We've observed several instances of action being taken against large entities mobilizing illegal money, major investigations being commissioned and the welcome crackdown against entities who have indulged in manipulating the market as well as introducing black money in trading. In short, there's been a sharp rise in the number of penalties being issued by the regulator.

This has been a very positive development for the economy. It has helped send out a very clear message thereby bolstering investor confidence. The domestic capital market has benefitted because the retail investor, who had vanished, has been encouraged to crawl out of the woodwork. That said, the regulator must assume a very balanced approach in order to enhance investor confidence further and not cause corporate entities and market intermediaries to distance themselves on the back of unwarranted controls and stringent provisions.

Our Stock Markets

The stock exchange acts as a conduit through which resources are channeled into the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels. In this way it stimulates industrial growth and economic development of the country by mobilizing funds for investment in corporate securities. The stock exchange provides a nodal point of convenience where buyers and sellers can easily purchase and sell securities. Easy marketability makes investment in securities more liquid as compared to other assets.

More Indians are showing a keenness to be a part of the country's growth story. There have been two million – and counting – new entrants into the stock markets in 2015. The previous year our stock markets were one of the best performing markets globally. This was illustrated in the way the BSE Sensex and NSE Nifty jumped 30% buoyed by hopes pinned on the Narendra Modi Government.

The year 2015, however, began on a mixed note. Analysts are of the opinion that the current sell-off is a periodic correction of the markets. Strong reforms in various sectors will be an important catalyst for the markets in 2015. Goods and Services Tax (GST) is a major reform that is expected. The last four or five years witnessed large outflows from equity markets into other asset classes like real estate and gold. For the future there is hope that this trend will be reversed and that the relative returns from equities will be better than other asset classes in 2015.

The valuation of the Indian stock market remains attractive. The markets have risen significantly, but remain within reach. 'Make in India', particularly, has given them a push. The sectors most likely to be benefactors of investor interest this year are infrastructure, manufacturing and industry. While certain themes are likely to earn investors profits, it is a good idea to avoid being too bullish for the sake of a quick buck.

Economic recovery need not have a one-to-one correlation with stock prices. Over the course of this financial year things will definitely get better. There is a general sense of optimism. The projection is that either this year, or the next, we will start witnessing double digit earning growth. The hope is that this will be a relatively broad-based phenomenon.

Inflation and its Impact

The bottom line is that inflation feeds into corporate earnings growth. India has been battling high inflation. It contracted sharply in 2014 due to lower food, oil and commodity prices. Consumer Price Index (CPI) inflation grew 4.38% in November, the lowest level since the index formation in January 2012. This has strengthened the case for softer interest rates. Decline in interest rates will be an important trigger for the markets.

Regarding valuations, in the market these are a function of the difference between inflation and earnings. This usually remains constant because when rates of inflation drop, so do earnings. Thus, valuations aren't affected by lower rates of inflation or interest rates.

Dropping interest rates impacts Private Equity (PE) positively, counteracted somewhat by earnings. Both inflation and interest rates are expected to fall next year proving to be beneficial to the industry as a whole.

Interest Rates

Relatively lower rates of interest announced by the Reserve Bank has prompted many companies to refinance their debt. The Indian equity market is also allowing some companies to raise capital at good rates right now. This may lead to a better recovery on earnings in the future. This is a significant considering that the Indian markets have witnessed growth rates in double digits till quite recently, when those rates dipped to single figures. We could hope for a turnaround. The likelihood of seeing above average earnings' growth has been increasing, year on year. It's important to focus on the growth stories on companies, rather than dwelling on a major macro-economic turnaround.

Investors

Capital is critical to generate economic output. This existence of Capital markets makes it possible to generate foreign capital. Indian firms are able to do so from overseas markets by way of bonds and other securities. The government has liberalized Foreign Direct Investment (FDI) in the country. Not only does this bring in foreign capital but also foreign technology which is important for economic development of the country.

With the Narendra Modi Government at the helm of things, the global enthusiasm for injecting more funds into the Indian economy has been on a high. Even domestic investors have had a steadying influence on the economy, and markets, for the last few months. All kinds of funds, including the asset management industry, have had steady inflows of money. With the exception of those foreign investors with dedicated India funds, all other kinds of global investors have an option between India and other emerging and lucrative markets.

The new regulatory regime, promising to make foreign investment in India an easier process, rechristened overseas investors as FPIs, or Foreign Portfolio Investors. Earlier in the year the Reserve Bank of India (RBI) and SEBI amended norms for FPIs, making it mandatory for them to make their future investments only in corporate bonds with a minimum residual maturity period of three years. However, there is a no lock-in period and FPIs will be able to sell the securities to domestic investors.

After easing inflation and rate cuts by the RBI, in January this year, foreign investors are betting heavily on further rate cuts in the Indian capital market by the apex bank. Besides, FPIs are allowed to invest coupons received on investments in government securities back into such bonds. These investments shall be allowed even after FPIs have exhausted the applicable limit of US $30 billion.

Individual investors should not consider that equity markets have been overvalued as this is not the truth. They are fairly valued, relative to the rest of the world. India is actually trading at much lower valuations than what the country has historically been trading at. Thus equity exposure is a given. Asset allocation to equities is still in a zone where valuations are reasonable.

With the help of secondary market investors can sell off their holdings and convert them into liquid cash. Commercial banks also allow investors to withdraw their deposits, as and when they are in need of funds.

Having touched upon the facets that govern and influence our markets let's look at some of the concerns that must be addressed. To begin with geopolitical risks, such as the situation in Russia and Ukraine, and ISIS-related problems in Iraq and the Middle East, are some of the biggest uncertainties that confront markets globally as well as in India. In fact the grim situation in Russia and Ukraine has been identified as one of the biggest geopolitical risks for 2015. Even though India has limited direct exposure to Greece, there is concern about the impact Greece will have on our exchange rates. The reaction of the euro to the turmoil in Greece is something all markets are monitoring, and the risk-off sentiment among global investors has been justified.

Another situation to be wary of is the US Central Bank, Federal Reserve, indicating that they may raise interest rates by the end of this year. If the US hikes rates sooner than anticipated, it could lead to the exit of foreign investments from India and cause volatility in our markets.

In May 2015, the combined net FII outflow from debt and equity markets amounted to Rs 14,262 crore. This was the first time, since August 2013, when the net outflow was Rs 15,696 crore, that the aggregate net flow in a month has been negative. With support in the form of strong FII inflows, between September 2013 and April 2015, the benchmark Sensex at the BSE jumped to over 45 per cent. In May 2015, however, both the equities and debt markets witnessed net FII outflow amounting to Rs 5,768 crore and Rs 8,504 crore.

Foreign investors have pulled out more than Rs 4,700 crore from Indian stock markets so far this year, mainly on account of better returns from Asian peers, concerns over a slow revival in corporate earnings and continued worries over taxation issues.

To round up the current situation, corporate India is readying for more activity. Capital market firms are trying to move on from painful restructuring to a more

sustainable and profitable future. In short, they are preparing for takeoff. With a gradual pick-up in demand, fall in raw material prices, as well as an improvement in economic conditions, corporate earnings are expected to gather momentum in the approaching quarter. In what remains of the year, we will see stock markets driven by a change in the fundamentals of India's companies.

On the whole India's economy is looking better than it did a year ago. The point is that directionally things are getting better, not worse. This, however, will take its time to start percolating through the system and translating into actual activity on the ground and profits.

In the medium to long-term, India is an attractive place for investment. Cyclic improvements in the market shall continue and lead to better earnings in the future. This year will end on a more optimistic note than it started on.

In addition to a stricter regulatory regime, new regulations like SEBI's Foreign Portfolio Investors Regulations 2014, Real Estate Investment Trusts Regulations 2014, and Infrastructure Investment Trusts Regulations 2014 have been welcome steps. Though FPIs' regulations were introduced in January 2014, and resulted in a positive movement in the market, still greater benefit is expected to accrue in the year 2015.