FII MOOD SWING

With signs of a bounce in US revival, there are chances of a drop in FII allocations to emerging markets this year. FC Invest looks at its implications for Indian market...

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A big 'if' looms over all projections for the stock market and the broader economy in 2011. For, too many factors beyond the control of market participants or the government stare us in the face as we ring in the New Year — be it the sudden surge in crude prices, be it inflation, be it liquidity or the US economic recovery.

Beginning today, as foreign institutional investors return to the Street after a long holiday, market participants are going to watch their behaviour keenly over the next couple of weeks to get a fair idea of their strategies and fresh allocations for emerging markets.

With tell-tale signs of a bounce in US economic revival, there are apprehensions that FII allocations to emerging markets are going to come down this year.

That apart, any renewed strength in the US dollar can trigger a reverse flow of foreign investors' money or slow down investment in Indian equities.

For the whole of the past two years, India has largely been a contrarian play for FIIs as far as the equity market is concerned. There is little doubt that the surge in valuations in Indian equities during this period had more to do with excessive liquidity than earnings growth as such.

This liquidity was bought in almost single-handedly by FIIs as domestic investors put in less money in equities and retail investors stayed off the market.

FII inflows into Indian equities hit a record Rs 130,000 crore ($28.8 billion) in 2010. The previous record was $17.7 billion in 2007, just before the US sub-prime crisis hit the world. In 2009, FIIs had infused Rs 83,423 crore into Indian stocks.

"If the US economy rebounds, obviously it will attract more funds. So a re-allocation of portfolios can be expected. However, it is difficult to say what will be the exact impact on inflows to India. We believe India will remain a preferred destination for investors as the economy continues to exhibit high growth rates in the medium term," said Dipen Shah, senior vice-president (PCG Research), Kotak Securities.

The recent surge in FII inflows has been attributed to low returns and muted growth in overseas markets, a comparatively stable and strong growth outlook in emerging economies and rising concerns over European countries' debt issues.

But in the event of high inflation, tighter liquidity, rigid interest rates, slower offtake or a delay in the capex cycle by India Inc and a ballooning import bill on account of higher crude price and huge deficit of food articles, India's growth outlook might take a beating.

Market experts are already projecting slower growth for Indian benchmark equity indices in calendar 2011 at around 10-12 per cent for a target of 22,000-22,500 on the BSE Sensex compared with 17.5 per cent return in 2010.

"We believe equity markets will remain volatile in 2011 while maintaining an upward trend," said Nimesh Shah, managing director and CEO of ICICI Prudential Mutual Fund. "Even though the broader economy is well positioned, the outlook for the stock market is average, primarily because of higher valuations relative to other economies and a temporary good outlook for the US," he said.

Secondly, crude-induced inflation is bound to end low interest rate regimes in economies around the world sooner than expected. This, coupled with the war among economies on the currency front, may set off a reversal in dollar carry-trade.

"We reckon 2011 will be a year of below-average returns for Indian equities. Market performance is likely to be shaped by the macro-economic environment punctuated by wage pressures, rising commodity prices, return of inflationary pressures and tight liquidity," Nomura India managing director Prabhat Awasthi wrote in a note recently.

Private sector banks, financial institutions, select real estate players and middle-rung IT companies saw huge FII interest and the resultant spike in valuations in 2010. Public sector banks and companies in capital goods, chemicals and fertilisers, trading, power generation and pharma sectors had marginal or no foreign institutional investors' holding at the end of September quarter.

Any change in FII strategies and inflows may affect some of these counters over the next few months. Market veterans like Awasthi have already taken a defensive approach towards some of these sectors for the year.

"We recommend a relative underweight stance on rate cyclicals, construction and cement, and a relative overweight stance on consumer durables, pharma, power, oil & gas, metals and IT services," he said.

Venkata Rao, vice-president for investments at Star Union Dai-ichi Life Insurance, agreed global flows might get redirected towards the US market on signs of a revival in the US economy.

However, there is also a fair chance that things may not be as bad. With the outlook for the Indian economy continuing to be strong and earnings growth estimates pegged at 17 to 20 per cent, chances of a reversal of FII flows look slim.

"In the worst case scenario, inflows are going to moderate and outflows, if at all, would be temporary in nature. "Inflows from domestic institutions, mostly insurance companies, will fill in the gap," he said.

"A very good global environment will work in favour of important export-oriented sectors, such as technology, and improve the outlook for commodities sectors. FIIs have looked at India as the biggest play on growth along with Indonesia and Brazil. FII allocation to emerging markets such as China and India is expected to continue as long as our

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FIIs' favourites

Stocks from the BSE 500 pack, which have high foreign institutional investor holdings

Sectors	FII holding	Sectors	FII holding
Banking		**Real estate**	
Yes Bank	47.12	Indiabulls Realty	61.96
ICICI Bank	39.27	HDIL	37.18
Dhanlaxmi Bank	38.57	Unitech	34.62
South Ind.Bank	37.56	Sobha Developer.	26.96
Axis Bank	37.24	Anant Raj Inds.	26.30
Federal Bank	36.63	**Infra/construction**	
IndusInd Bank	33.75	IVRCL Infra.	57.66
HDFC Bank	29.72	Nagarjuna Const	33.68
IT		**Financial institutions**	
Geodesic	39.93	HDFC	59.11
Hexaware	36.28	IDFC	51.32
Infosys	35.78	LIC Housing Fin	41.70
Rolta India	31.92	Shriram Trans	38.00
Mastek	31.79	Dewan Housing	33.29
ICSA (India)	31.76	SREI Infra. Fin	28.17

Figures in per cent

Source: Capitaline

Little FII exposure

Stocks from the BSE 500 pack which have very low levels of stake holdings by FIIs

Company	FIIs*	Company	FIIs*
Capital goods		**Pharmaceuticals**	
Alfa Laval	0	Abbott India	0.16
Atlas Copco	0	Novartis India	0.28
Ingersoll-Rand	0.25	Pfizer	1.34
Bharat Bijlee	0.56	Wockhardt	1.83
Walchan. Inds.	0.64	**Chemicals & fertilizers**	
Reliance Ind Infra	0.66	NFL	0
Areva T&D	0.79	Monsanto India	0.05
Power		BOC India	0.06
Neyveli Lignite	0.19	RCF	0.13
SJVN	1.12	BASF India	0.54
NHPC Ltd	1.6	**Trading**	
Power Grid Corpn	1.65	MMTC	0
Torrent Power	2	S T C	0.03

*FII stake as on September 30

Source: Capitaline

growth environment is better than the global growth environment," said Nimesh Shah.

"Money chases growth. Returns in foreign economies are small and they have no option but to look at growth opportunities outside. We are substantially underestimating the appetite and desire of foreign investors to buy Indian assets," felt Aneesh Srivastava, chief investment officer of IDBI Federal Life Kotak's Dipen Shah bets on a return of DIIs.

"DIIs have been sellers in the market in the past few months mainly due to redemption pressures. To that extent, the market did not receive any support from DIIs. DII support is more dependent on the kind of inflows that can come into the schemes," he argued.

Also, in case of any swift selloff by FIIs, value buying will emerge from DIIs. With the savings rate in excess of 30 per cent and relatively lower exposure to equities, retail participation may increase at a lower level, unless of course risk aversion sets thanks to any unforeseen global meltdown.

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