From GaveKal Dragonomics

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A steady flow of terrible news has issued from the Indian sub-continent recently. The Sensex took a 1,000 point dive in the days following Prime Minister Singh's embarrassing reversal on efforts to open India's retail market to greater foreign investment. Meanwhile, India's commerce ministry admitted to overstating national exports for April through November by US$9bn (4.5%) due to "misclassification and errors." And on Monday industrial production data for October showed a dismal -5.1% YoY plunge (from +2% growth in September), well beyond the already bearish expectation of -0.7%. Much of this bad news has already been reflected in the Rupee, which has declined by -21% against the USD since August, nearly as much as the -23% decline registered in late 2008.

This sudden weakness from an economy that had been consistently robust over the past decade raises two questions. First, is the structural Indian growth story-and by extension the whole emerging markets growth story-overblown? And second, is it time to abandon Indian stocks? The second question remains pertinent to foreign investors, who have stayed in the Indian market even as domestic investors have fled.

On the structural question, India has a lot going for it in terms of fundamentals like a high saving rate and positive demographics. But it faces significant difficulties that will make the phenomenal growth of 2003-08 hard to match in the coming five years. Land allocation is a mess, which makes infrastructure projects and development of manufacturing centers both difficult and expensive. The country still suffers from a lack of skilled labor, rigid labor laws, and a rural employment guarantee program that creates worker shortages and wage inflation, and has prevented manufacturing from growing beyond its current small (16%) share of the economy. The failure of retail market reform suggests that political will for overcoming these obstacles will be absent until after the next election. On the whole we think the long-term India structural growth story is sound, but over the next 12 months the economic news will probably stay bad.

In the shorter term, the key issue for stock investors is the liquidity situation. Growth is slowing, but loosening is still risky. Despite a substantial increase in policy rates, headline inflation has remained above 9% for almost two years, and the prices of India's major commodity imports (oil and coal) remain high. Slowing growth indicates the RBI should loosen, but persistent high inflation means it will not.

Yet there is considerable scope for an increase in liquidity over the next two quarters. Seasonally, Indian liquidity tends to be tightest in January-March-when income tax payments come due-but then eases dramatically in the second quarter. If inflation eases significantly in the next few months, this could open space for the RBI to ease, which combined with the usual second-quarter expansion could lead to strong rebound in equity prices.

Another factor is the slowing world economy, and especially the deceleration in China, which paradoxically could be a good thing for India. India's economy is not export-driven, so a weakness in global imports hurts it far less than it does the export-driven economies of east Asia. And its persistent current account deficit is driven largely by oil. If, as we have argued, China accepts a deceleration of growth to +7-8% next year and does not engage in large-scale stimulus, a drop in the oil price is likely. This would close India's c/a deficit, and improve liquidity and consumer sentiment. In this scenario, what we are seeing now is the darkness before the dawn, not the beginning of a death spiral.

The positive signposts to look for would be a decline in the benchmark WPI inflation gauge, rate cuts, and a consequent stabilization of GDP growth. Investors with an optimistic bent can prepare by picking out the best cyclicals and beneficiaries of lower rates to buy if the prevailing winds reverse. Many of these equities are trading at large discounts to historical averages. Downside protection is probably better achieved by buying NIFTY puts, which are also fairly cheap, rather than selling off established positions.