ALCHEMY PRIVATE WEALTH

Investment Matters

September 2011

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EQUITY OUTLOOK FROM CIO'S DESK

Global equity markets corrected sharply in August. Debt concerns in Europe (Italy, Spain) and the downgrade by S&P of US debt rating led to a fall across markets. The Dow ended the month down -4.4%, the MSCI AC World Index -7.5%, the MSCI EM index -9.2% and the MSCI AC Asia ex-Japan index -10.2%. The MSCI India index was down -12.5% during the month – among the worst performers.

In India, the inept handling by the government, of the Anna Hazare / Lokpal bill issue, were an additional drag on our equity markets. FII's were nervous and sold nearly US$ -2bn of equities and CYTD their flows are a meager US$ +150mn. As a result, the Sensex was down -8.4%, Nifty -8.8% and the BSE500 -8.8%. The BSE Midcap index fell -9.3% and small caps fared worse with the BSE Small cap index -14.1%.

Inflation continues to be the primary macro issue and at 9.22% (WPI) is still sticky at higher levels. The RBI has already raised policy rates by +175 bps this calendar year (repo rate hiked from 6.25% to 8%) and it is widely expected to increase policy rates by 25bps at its next policy meeting on 16th September despite a slowing economy (June 2011 quarter or 1QFY12 GDP growth came in at 7.7%).

India YTD is now among the third world performing EM's (rank 19 out of 21) and the MSCI India Index is down -22.5%. The BSE500 is down -18.5% while the BSE Midcap index is down -19.6%. The BSE Small cap index is down -26.3%. Brent, incidentally, in this period is up +20%.

We believe that with this sharp correction in August, a lot of the India risks are getting priced in. The risk-reward is definitely becoming more favourable for being long Indian equities. We are beginning to see the sell-side finally downgrade growth estimates for the Sensex for FY12 (from +20% to 10%-15%) and FY13 (after the poor June quarter reporting season where we saw EBITDA margins contract across sectors) to more reasonable levels. We think inflation will top out by December, purely from a base effect point. The monsoon across the country has been normal and very well distributed this year – a big positive for crops. We therefore believe food inflation in India will peak soon. We also think that the RBI may be getting closer to the end of its rate hike cycle. We are also beginning to see the government move ahead on the policy front.

The global concern right now is on the increasing poor macro data from the US where growth is beginning to sputter and the risk of another recession are increasing. There are talks of another round of quantitative easing (QE3) – details of which will be know later this month after the 21st September US Fed meeting. A QE3 would lead to a weaker dollar and a rise in global commodity prices including crude. This would definitely prolong the "inflation pain" for India.

Our portfolios will still largely be focused on quality companies that have a strong franchise, low debt and high return ratios. We continue to focus on the consumer side where the demand is still fairly robust. We will continue to identify companies, bottom-up, where we see growth and where we believe the risk-reward is favourable to our investors.

Hiren Ved
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DEBT OUTLOOK

Most unexpected event happened in the month of August in form of down grade credit rating of US to AA+ from AAA by S&P. This resulted in heightened volatility in all asset class. On one hand, gold saw a huge appreciation and on other equity market across the globe corrected significantly. Fixed income yield also witnessed high volatility. 10 Year Benchmark fell intra month low of 8.15% and settled at around 8.34%.

With sticky inflation and slowing growth on one side and fiscal stress and below target revenue collection on the other, the domestic macro environment is looking quite uncertain. There is now a greater appreciation of the rising risk to RBI's 8% FY12 growth forecast. India's 1QFY12 GDP growth came in at 7.7% vs. 7.8% growth last quarter. On the supply side, growth slowed for agriculture, but held up for manufacturing output and service sector activity.

Although, the WPI inflation published lower at 9.22% y-o-y in July '11 vs. 9.44% in the previous month, the underlying inflationary trend continues, as depicted by July non-food manufactured price (core) inflation. It is higher by 7.5% y-o-y in July from 7.3% in June, but encouragingly, core inflation on a m-o-m basis has come down to 0.1% from an average of 1.0% m-o-m during January-May, indicating that the momentum in inflation is waning. The primary and food inflation also continues to remain stubbornly high as is evident from the recent weekly releases. Meanwhile, May's WPI inflation number got revised up by 52bp to 9.56% y-o-y from 9.04% previously.

Liquidity remained negative with outstanding LAF balance at –Rs.384bn. Liquidity is expected to be remain tight in the month of September 2011 on account of Advance tax out flow around 15th September 2011. Market estimate of total outflow is Rs.50000cr.

We believe that RBI would continue with anti-inflationary policy in September meeting also, As the growth numbers are still sustaining and inflation is still high, RBI might hike policy rates by 25bps. But incrementally we believe that high inflation is due to structural issues in the system rather than demand driven. So RBI can't just keep on raising interest rates. We believe that RBI may pause in hiking the interest rates post September meeting.

We believe that Bond yields are unlikely to soften much from current levels in the immediate term in view of hawkish stance of RBI and continued supply pressure from government. However, we believe that RBI is near the end of tightening cycle in terms of policy rates and global environment is turning positive for bonds. While the near term pressures are evident, inflation could moderate in medium term given that global commodity prices are showing signs of cooling off. With the past rate hikes taking effect, we could witness some slowdown in growth targets forcing the RBI to soften its stance. But we are more concerned about the fiscal side where mounting subsidy bill and shortfall on revenue side and disinvestment targets could lead to slippages to the extent of 0.5% of GDP. The additional borrowing by the government in second half will keep the downside in yields checked. We suggest short term funds with low average maturity and high carry in the portfolio. For investments for year or more, FMP looks attractive investment avenue.

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