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PRIVATE WEALTH

Investment Matters

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BESPOKE
FINANCIAL EXPERTISE
TO MAKE THE RIGHT
MOVES, MORE OFTEN.

EQUITY OUTLOOK FROM CIO'S DESK

Two developments over the last month have been very positive for India, which we believe lower tail risk for investors in Indian Equities.

First, with rising exports and lower gold imports, India's Current Account Deficit is now likely to be under 3.0%, much closer to the 2.5% figure which the RBI & the international rating agencies believe is a fair level for a developing country like India. In addition to this RBI managed to garner US$34bn in its drive to raise FCNR deposits from Non-Resident Indians, much higher than the US$15-20bn street expectations thus putting India in a much better position to deal with any eventuality related to tapering of asset purchases by the US Fed. India is likely to post a Balance of Payment Surplus in 3QFY14 due to strong portfolio and FCNR flows in the current quarter.

Second, the BJP delivered a 4-0 victory by sweeping Rajasthan (bagging highest ever seats), retaining MP (for the third time with a higher number of seats and a better vote share) and Chhattisgarh (despite the sympathy vote benefit to the Congress in the southern part of the state due to killings of their leaders by the Maoists) and being the single largest party in Delhi (but not getting a clear majority). The Congress has been virtually routed in all these states. The game changer was the 28 seat win by Aam Aadmi Party (AAP), (a upstart party formed on the plank of anti-corruption) in Delhi which largely dented into the Congress vote and to some extent even the BJP's share.

While there is a complex interplay of factors which resulted in the state election results, some of the key learning's/trends from these results which could have some bearing on the 2014 general elections and beyond are:-

High participation rates: all four states witnessed very high voting percentages indicating strong willingness for people to participate in the democratic process and an overwhelming desire for effecting change. Higher voting percentages could also be a result of higher participation rates of the first time youth voters.

A record of good governance can and continues to pay handsome dividends in the form of pro-incumbency as seen in Chhattisgarh and MP. While other local factors may play a part, good performance track record is an important must-have qualification to win.

While there is still some debate on whether there is a Modi wave, we believe it for real and as time passes by it will gain prominence unless the BJP gets too arrogant or create some big blunders in the interim.

There is a clear anti-Congress wave and it will be very difficult for the party to reverse the fortunes in the remaining 5 months. So the large part of their 200 seats they won in 2009 is up for grabs especially to the BJP/NDA and some regional parties or even the AAP.

Despite the good showing by BJP, it has its work cut out as the AAP which had a fantastic debut in Delhi in a very short time frame is planning to fight the 2014 elections from many more states including urban metro's and hence could pose a serious challenge even to the BJP which will stand to gain from Congress's loss. We believe that the success of AAP is a "game changer" and while it's brand of politics may take a decade to be all pervasive, it will force the existing large parties to clean up their politics and give way to candidates which have clean image or completely new faces as their candidates. This has very positive long term ramifications of how politics is run in this country. This has the potential to emerge as a major trend just as the emergence of strong regional parties and state leaders emerged in last decade and two in India.

The politics of free dole outs and entitlements in the absence of good governance will not work (eg. In Rajasthan, where every possible social scheme was on offer). This was the principal strategy of the Congress for the upcoming elections. (eg Food Security Bill)

We strongly believe that the trends emerging from these elections are very positive for the long term future of politics in India as the centre of gravity clearly shifting towards good governance and clean politics. However, the path from here to the general elections in May 2014 has some interim hiccups built in depending on how the UPA reacts to its dismal showing in the state elections.

How will the government interpret the inflation problem (the Congress leadership has identified this as the key reason for their loss in the state elections)? Can it lead to more than expected tightening by the RBI?

Will diesel price hikes continue, which help reduce the subsidy burden? Reversal would be interpreted as backtracking on reforms.

Will they accelerate their populist policies as a last ditch attempt to reverse their political fortunes, thus putting the fiscal deficit target of 4.8% in jeopardy.

We continue to find good opportunities in quality cyclical and manufacturing / engineering space and have added exposure to these companies. These companies, we believe are attractively valued and their normalised earning potential is much higher than what the current numbers indicate. As confidence in the probability of a BJP led government at the centre and consumer / business sentiment improves the improvement in manufacturing / engineering space will accelerate.

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DEBT OUTLOOK

Debt markets are going through a rough patch. Interest rates are at elevated level consistently since July 2013, in spite of partial reversal of liquidity measures, encouraging Current account deficit numbers, strong inflows of Dollars through swap window, Bad GPD estimates etc. We try to go deep to analysis the reasons for hardening interest rates.

In last 5 years government has completely messed up the country's finances. In 2008-09 government did quantitative easing by the way of cheap loans and Varity of social schemes like NREGA, Farm loan waiver, Subsidies etc. Majority of investments undertaken by government turned out to be non productive and led to higher inflation by giving more money in the hands of people to spend without actual capital formation in the country. Apart from this, major crucial infrastructure and power projects got delayed or affected due to non clearance and other issues. This has led to higher CAD and fiscal deficit and higher interest rates and weak currency

RBI policy stance in the recent past has been guided by two major overlaying factors: volatility in Rupee and inflation expectations. RBI introduced a subsidized currency swap facility that incentivized capital flows into the country via FCNR deposits and overseas bank borrowings. The swap facility has significantly surpassed expectations by attracting more than USD34 billion in inflows over the last 3 months. In response to the inflows and delay in US Fed QE tapering, the rupee recovered sharply from its record lows in August. Amidst stability in the currency, RBI in September gradually started the process of normalizing the conduct of monetary policy. In its latest policy meeting in end-October, RBI further reduced the MSF rate by 75 bps from 9.5% to 8.75% thus bringing it close to its pre-tightening level.

During the month of November 2013, the yield on erstwhile 10-year benchmark Government bond (7.16% GoI 2023) ended higher at 9.05% as against 8.63% in October 2013. During the month Government issued a new ten year benchmark bond (8.83% GoI 2023) the cut off yield for which came in at 8.83%.

Towards, the end of the month, systemic liquidity conditions have eased significantly on account of large scale mobilization of NRI deposits by banks. The liquidity availed through various sources (Liquidity Adjustment Facility, export refinance, marginal standing facility and term repos) from RBI during the month was lower at Rs. 129,065 crs as compared to Rs. 130,772 crs in October 2013. The NSE overnight MIBOR ended at 7.72%, lower than the rate seen in end October 2013 (8.72%). The annual rate of inflation, based on monthly WPI, stood at 7% (Provisional) for the month of October 2013 (over October 2012) as compared to 6.40% (Provisional) for the previous month and 7.32% during the corresponding month of the previous year.

DEBT OUTLOOK

GDP grew by 4.8% YoY in 2QFY14, up from 4.4% in 1QFY14. Farm and Industry fared better at 4.6% YoY and 2.3% YoY respectively, while the service sector growth slowed down with growth of 5.9% YoY. Private consumption was up 2.2% YoY in 2QFY14 compared with 1.6% in 1QFY14, while Gross Fixed Capital Formation turned around to grow 2.6% after contracting 1.2% in
1QFY14.

The developments over the last couple of months and the changed RBI stance, with an emphasis on containing inflationary expectations has reduced the possibility of a near term downward trend in long term yields on a directional basis. We expect long term yields to be range bound. We reiterate our call to stay at the short end of the curve which benefits from relatively high carry (accruals) and possible roll-down as some steepness develops. Suggested Investment strategy is to follow asset allocation and diversify the debt portfolio between short term funds, long term funds and FMPs. Conservative clients can also look at allocating some amount to Tax free bonds. Current high yields make them very attractive from long term investment perspective.

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