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Investment Matters

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EQUITY OUTLOOK FROM CIO'S DESK

The Indian markets were down -1.1% in July as (i) The markets await concrete proposals from the government to revive economic growth (ii) India is facing drought conditions (iii) Lacklustre Earnings season & (iv) RBI continues to hold interest rates high due to high inflation.

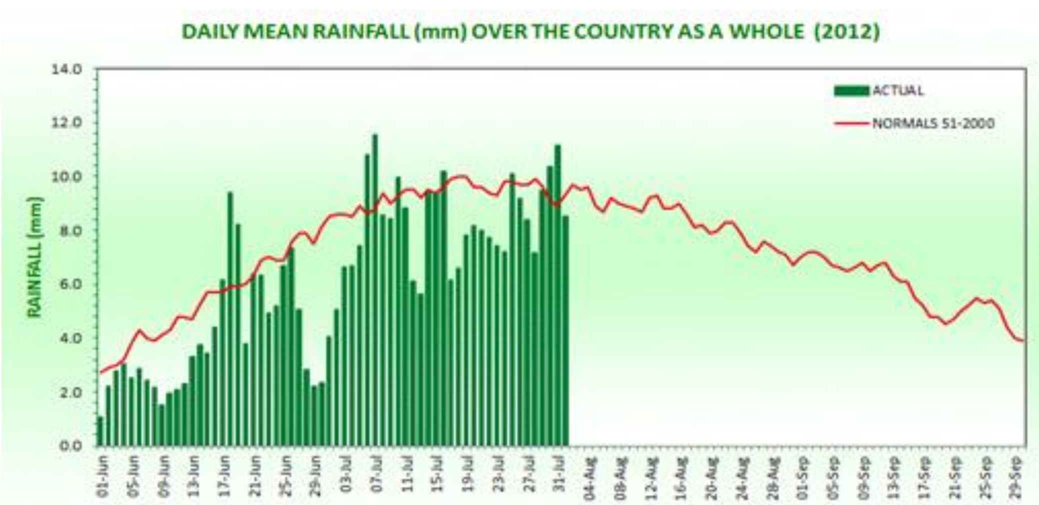
Wait & Watch on Political Developments

Indian markets are in 'Wait & Watch' mode as they await concrete proposals from the government to push growth with P Chidambaram appointed the new Finance Minister (FM) after a hiatus of three and half years. With the parliament in session from 8th August, markets are hoping for positive announcements over the next 30-60 days to resurrect the Indian economy.

While the Prime Minister has urged his officials to revive 'animal spirits' in the economy, the new FM in his first address has promised to (i) outline path for fiscal consolidation (ii) take a relook at retrospective tax laws (Already reshuffled RK Gujral, the architect of GAAR proposal out of Department of Revenue) (iii) regain investor & business confidence & (iv) tackle inflation & bring down interest rates. We think the need to avoid a Sovereign Credit Rating Downgrade as much as to fund themselves for the next elections in 2014 is finally prompting this government to pursue reforms actively. While there has been a lot of positive posturing in the run-up – a lot of back door manoeuvring will be required to make these palatable to their political alliances.

Drought to affect GDP negatively

Cumulative rains in the country from 1 June – 01st August 2012 were below normal by 19% with actual rainfall at 374.1 mm against 461.7 mm. Weak rains are broad-based with 22 out of 36 divisions in the country receiving scanty or deficient rainfall.



Agriculture is important to India as (i) Directly accounts for 15% of India's GDP, indirectly weak sentiment will further affect rural consumption & (ii) India is already struggling with high inflation, high food prices will only add to the worsening scenario and keep interest rates elevated in the system. In the previous two droughts in 2002 & 2009, the Agri GDP grew -8.1% and 0.7% respectively so expect some downward revisions to GDP forecasts across.

RBI stays put

Given upside risks to inflation from poor monsoon, RBI kept key rates unchanged, Repo at 8.0%, Reverse repo at 7.0%, CRR at 4.75% but surprised by cutting SLR by 1% to 23%.

In fact RBI has done well by implementing liquidity measures to bring down overnight liquidity deficit (White line) to manageable levels from US$40bn to US$5-6bn and drive down short term interest rates (Orange line).

Earnings season lacklustre – but currency benefits starting to benefit

July also saw the beginning of the 1QFY12 earnings season, while earnings have been lacklustre in general with sentiment further worsening on the back of poor rains; the bright spot has been gains from currency depreciation especially evident across results of small cap IT companies, Pharmaceutical companies and engineering exporters. While some existing large exporters may be seeing weak demand for their exports (eg Cummins India), we are seeing many other companies being selected as a sourcing base for their parents (Whirlpool is going to export to LATAM this year and Honda Siel will start exporting to US & Europe).

Another example – India and Philippines' compete for BPO jobs globally. Attached is the 5 year chart of their currencies where the Peso has gained 50% over the INR. This is clearly helping India's competitiveness.

Our portfolios have benefited from significant allocation towards Consumer and Pharmaceuticals companies. We expect the current trend to continue as earnings growth profile remains robust along with strong balance sheets and high ROCE for select companies in these sectors. Going ahead as indicated earlier in the note, good manufacturing companies in India are likely to significantly benefit from Rupee depreciation against the US$ on account of potential for higher exports. This trend, if it sustains, can be a big boost for India as an economy in general and market performance in particular. Overall we expect FY13 to be a year of stock picking with markets mostly range bound and better performing companies being rewarded for their consistent performance.

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DEBT OUTLOOK

With corporate earnings season underway, P. Chidambaram taking over as new Union Finance Minister and commencement of the monsoon session of the parliament in August, the focus would shift back to Government actions on policy fronts. Markets will except that much needed impetus to slowing economy comes soon. During the past month RBI in its quarterly review monetary policy left repo rate and CRR unchanged while reduced the SLR by 1% to 23% primarily due to upside risks to inflation arising from poor monsoons, lack of action on fiscal front. RBI's stance remained hawkish with primarily focusing on controlling inflation and managing liquidity within its comfort zone. RBI further cut the growth forecast to 6.5% from 7.3% earlier and raised inflation projections for March 2013 to 7% from 6.5% earlier.

Reduction in SLR is expected to release about Rs 600 bn of liquidity in the system. Currently banks are maintaining 26 to 27% as SLR which is more than the RBI's requirement. We believe that baring for small banks the move may not result in desired results and hence may not translate in actual lending.

On the macro economic data front thing continued to be gloomy without much encouraging key parameters driven by weak domestic growth momentum.

- Annual Inflation for the month of June came at 7.25% as compared with 7.55% for the previous month. Core inflation remained flat at 4.85%.
- IIP for May grew by 2.4% against 6.2% growth previous year and from a revised IIP of -0.9% from April month. Capital goods continued to contract with -7.7%. Capital goods contracted in 9 months out of past 12 months.
- Fiscal Deficit for FY13 as of May stood higher at Rs 1415.87 bn vs Rs 1307.26 bn last fiscal.
- During the month rupee appreciated by 0.9% and closed at 55.81 against USD due to the steps taken by RBI to arrest Rupee volatility. Rupee has declined -4.6% YTD.

Liquidity conditions eased considerably given the decline in government cash balances with the Reserve Bank, injection of liquidity of about Rs 860 bn by way of open market operation (OMO) purchases of securities and increased use of the export credit refinance facility by banks after the increase in the limit effective from June Mid-Quarter Review . The average daily net borrowing under the liquidity adjustment facility (LAF), which was 2.2 per cent of average net demand and time liabilities (NDTL) in Q4 of 2011-12, declined sharply to 1.3 per cent in Q1 of 2012-13 and further to 0.7 per cent in July 2012 (up to July 26, 2012). The average daily borrowing under LAF as of month end was RS 553.4 bn. Short end rates may be better anchored for the months ahead owing to the present liquidity conditions although a lot will be determined through evolving credit to deposit ratios. The benchmark G-Sec space saw a sudden decline of around 8bps in yields to inch to 8.23% levels given the fact no rate cut was announced and liquidity boosting measure by SLR cut was triggered. Given the net supply of government bonds over next 2 months in excess of Rs 1,000 bn and an additional borrowing of Rs 250 bn by the states there could be near term pressure on yields on the longer end. This should be looked as an opportunity to build long exposures gradually over the next few months.

We believe growth in the next few quarters can continue to remain subdued given the RBI's latest forecast. We believe that, any developments on the policy front in the upcoming monsoon session of parliament such as the diesel and LPG price hike, steps for fiscal consolidation and reviews of retrospective laws to provide clarity and create investment environment could play a significant role and allow the RBI to cut rates gradually. The monsoon so far is been below normal as per the Metrological department which can eventually further push pressure on primary inflation.

DEBT OUTLOOK

We remain intact with our view that longer end of the yield curve is expected to remain volatile given projected high fiscal deficit and government borrowing programme this fiscal. Short term rates may have bottomed out and may remain in the current range for some time given the eased liquidity condition.

Going forward we expect the yields to fall. Rate of corporate bonds in 2 -3 year segment is still high which is giving good carry along with a chance to make some capital appreciation in coming time. The short end rates currently have come off their peaks and seem to have bottomed out hence we suggest short term funds with low average maturity and high carry in the portfolio as a superior investment option. Longer end of the curve would react once there is clear sign of RBI indicating policy rate cuts. Investors with higher risk appetite can invest a part of their portfolio in income and dynamic bond funds to play safe duration calls to generate better risk adjusted returns.

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