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Investment Matters

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EQUITY OUTLOOK FROM CIO'S DESK

December was the worst December month for Indian equities in twenty years!

In 2011, Nifty & Sensex lost -25% while the broader BSE 500 lost -27%. Midcaps and Small caps fared worse with their indices dropping -34% and -43% respectively. Clearly, it was a year of most challenges and was infact one of the toughest years I have dealt with even after taking 2008 into account. The markets have had to endure several challenges – both internationally and locally – which are well known and debated now and hence would add no incremental value mentioning them. While we all like to look at markets in neat 12 months period, it would be important to mention that the peak (November 2010) to trough (December 2011) correction has been of the order of 38%+. If we take dollar returns, markets are down 50%+ from peak to trough. Given the extent of the correction, it is quite natural that most investors are quite circumspect and bearish going into the new year.

Like every year it therefore becomes customary for money managers to give their prognosis for the New Year – 2012 and how it will unfold. I think predicting macro events is a fine art and hence a tough job and given the significant interconnectedness and the impact of cumulative events cannot be foretold with much accuracy and much in advance. The dramatic weakening of the rupee in the later part of 2011 is a classic example. No one in 2011 had predicted and hence planned for a rupee at 53 levels and it was clearly a near black swan event for investors and the corporate sector.

While considerable challenges which were relevant in 2011 are and will still be relevant in 2012 as well, however what is important is how much of it already discounted and how investors are positioned. Typically, when a market tends to take a direction, it is natural for investors to assume the continuation of the trend and hence most investors tend to position themselves accordingly. Given that our markets have been in a correction mode, most investors are very conservatively positioned.

I think a significant amount of the current macro factors are discounted in the price. That is why p/e's have collapsed from 25X in 2007 to 12-13X now. After p/e, now it is the turn of earnings to slow down as is the case in every cycle. As I have mentioned in the past, markets are in the bottoming out phase and typically bottom out after the first few rate cuts as it still continues to price in a slowdown. Current valuations suggest that markets are trading well below their long term averages but a bit higher than most stressed valuation levels of 10-11x where we have historically bottomed out in extreme stress cases. But whether we will definitely get to those stressed levels is debatable and not necessarily a 100% probability. The likely turn of events over the course of the year will decide that.

However, currently we believe that at the margin, things could get better. For one, there is a realization within the government that growth is slowing. None other than the PM has now said that growth in FY12 will be 7% which is a significant climb-down from the past levels of 7.5%-8%. That is half the battle won. The other half and the more significant one is what the government does about it. I am hopeful that "reactive reforms" will take place as has been the empirical evidence in India, where we tend to reform only when faced with a crisis. We are there. Also after a lot of bungling, the government will hopefully display some political skill to deal with its allies to get some of the reforms back on track. To that end, the election results in the 5 states of UP, Punjab, Uttarakhand, Manipur and Goa which go to polls in Feb 2012 would be critical. The good news is that the Congress is going in with a very low base (as is the case in UP) and has the advantage of anti-incumbency factor that could impact the current non-congress regimes in these states.

EQUITY OUTLOOK FROM CIO'S DESK

It will also open up opportunities to potentially strike new alliances to strengthen its position at the centre. To that end politics will be a big decisive factor in the current year.

As we end 2011 and enter 2012 we still believe that near term global headwinds – European debt issues, upside risks to recession in Europe, a slowing Chinese economy, increased geopolitical risks in ME / Iran – persist. How we tackle the fiscal for next year i.e.. FY13 will the single most important determinant for markets from a domestic stand point. We will deliberate more on the politics and the budget in subsequent months. In sum despite the risks, I believe that as we enter 2012, the markets could surprise us on the upside after a near 40%+ correction over the last 12-14 months and some of the doom and gloom could alleviate as we move along.

WE WISH ALL OUR CLIENTS & THEIR FAMILIES BEST WISHES FOR THE NEW YEAR – GOOD HEALTH AND PROSPERITY IN 2012.

Hiren Ved

Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

DEBT OUTLOOK

RBI's mid quarter review policy primarily set the tone for further monetary actions as the view of the head bank turned dovish to further rate hikes owing to the moderating growth momentum and higher downside risks to growth. Debt markets witnessed lot of activities due to aggressive OMO's conducted by RBI. RBI has already bought bonds worth around INR 41,000 crores since 24th November. India's growth slowed down dramatically but inflation continued to stick beyond RBI's persistence level. The announcement of unplanned G-Sec auction of Rs 15000 Cr shot the 10 year G-sec to ease to 8.56%.

The domestic data hasn't been too encouraging. The government has run a fiscal deficit of 74.4% of the full-year estimates in the first seven months of the current year, almost confirming it will miss the target of 4.6%. The April- October fiscal deficit was well ahead of the five-year moving average of 64.1%. As the year ended the fiscal deficit of the government stood at 85.6% of its budgeted estimates. Government has further announced additional borrowing of Rs 40,000 crore in addition to previous borrowing of Rs 52,872 crore making it around Rs 93,000 crore which will inch the fiscal deficit beyond 5% of GDP. India's economy slowed down further and grew 6.9% in July-September, the slowest in over two years. India's key infra sector rebounded in Nov-11 with growth of 6.8% compared to 0.1% in Oct-11 and 3.7% in the year ago. IIP for October came in at -5.1%, the lowest reading since March 2009 much to the disappointment of the industry.

India's headline inflation as measured by WPI for November came slightly lower at 9.11% compared with 9.73% for the previous month, marginally above market expectations of 8.9%. Primary articles' inflation declined sharply to 8.53% (Y-o-Y) from 11.40% in the previous month due to sharp fall in both food articles and non food articles. While the food articles declined by 2%, non food items fell by 1.5%. Manufacturing continues to remain a concern with at it surged a little to 7.77% (Y-o-Y) against 7.66% in September. Core Inflation (non-food manufacturing) that RBI closely monitors pegged at 7.9% from 7.63% in October and continues to remain well above RBI'S comfort level. The domestic demand-supply balance, the global trends in commodity prices and the likely demand scenario would play a major role in shaping the inflation path ahead. As per RBI's guidance for the inflation it should certainly decline from the present level of around 9% by the end of March 2012 to around 7%.

The INR continued its weak run in the month of December and continued to slide down and breached the 54 mark and went till 54.31 levels on 15th December, wherein RBI had to intervene to announce measures to curb forex volatility which saw rupee to recover and close at 53.65. On the last day of the year (December 30) the rupee closed 53.10, down over 18.8 percent from the first day of the year. There was an overpowering demand for the USD as the Euro zone crisis turned traders towards risk free assets.

There is a shortage of liquidity, and with year end, and advance tax payments, we expect the liquidity to remain tight. Systemic liquidity stands in the negative territory (LAF was – Rs. 1,14,670. as on Dec 30, 2011). In a move which should be supportive of bonds, RBI announced bond buybacks through OMOs to infuse liquidity. This still is unlikely to inject liquidity in the banking system for it to be net surplus (Banks are borrowing INR 1 trillion from RBI under the Liquidity Adjustment Facility).

Also RBI announced increase in debt FII limits (for foreign investors to buy INR denominated bonds) by USD 5bn equivalent for both government and corporate bonds (total USD 10bn). Both these moves should be supportive of government bonds, and expect the bond yields to ease a bit. However the additional borrowing by the government would put pressure on yields.

We reiterate our view that we expect the yield curve to steepen bullishly (short end rates falling faster than long rates) over the next 3 – 6 months. We believe that Bond yields are unlikely to soften much from current levels in the immediate term. With dominant concern shifting to increasing primary supply, we expect yields to remain under pressure. Benchmark bond may continue to trade in the region of 8.3% - 8.7%. Moreover, since RBI is at the end of tightening cycle in terms of policy rates, the additional borrowing by the government in second half will suffice to check any downside in yields. We suggest short term funds with low average maturity and high carry in the portfolio. Investors with higher risk appetite can allocated a part of their portfolio in dynamic bond funds.

Rupesh Nagda

Head – Investments & Products
Alchemy Capital Management Pvt. Ltd

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Edited by: Rupesh Nagda (Ph: +91-22-66171785), Ambrish Jamodkar (Ph: +91-22-66171772)
Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-66171700