ALCHEMY
PRIVATE WEALTH

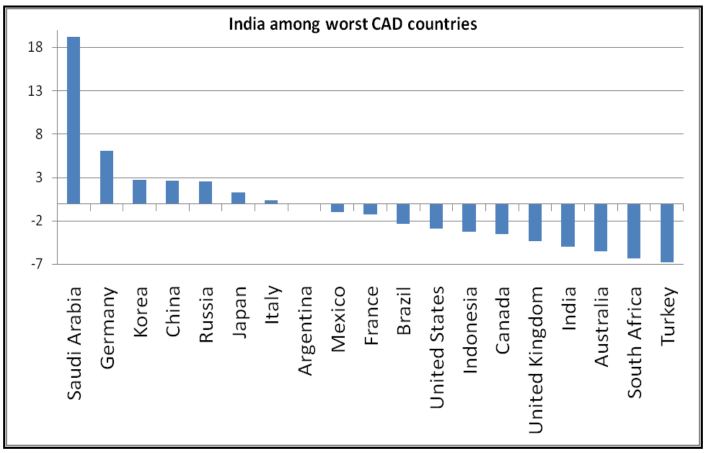
Investment Matters

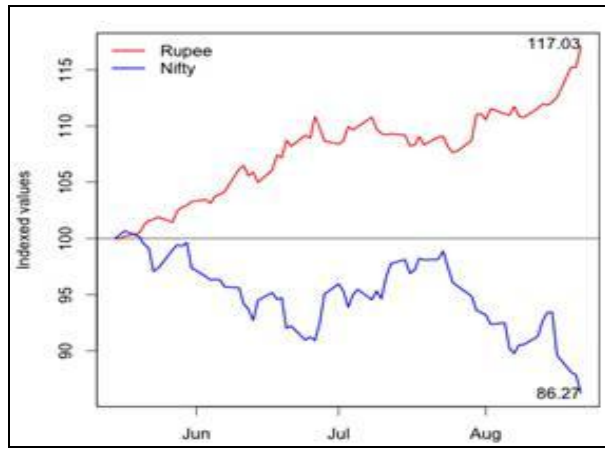
SEPTEMBER 2013

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

EQUITY OUTLOOK FROM CIO'S DESK

The Indian markets have been in a funk since May of this year primarily driven by the dramatic fall in the currency. The almost 20% correction in the INR has been triggered due to the Fed talk of tapering exacerbated by the country's widening CAD in the last 12 months. While many EM's have been at the receiving end of the Fed taper talk, India is amongst the most impacted along with South Africa, Brazil, Indonesia and Turkey.

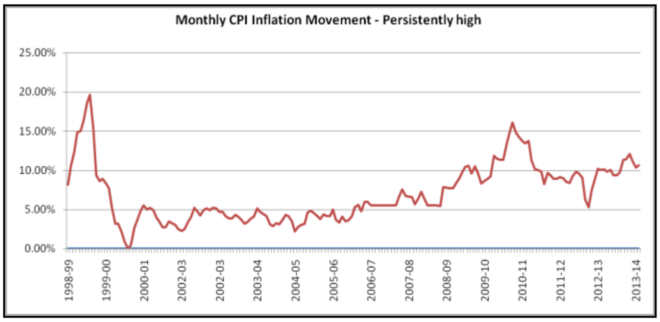


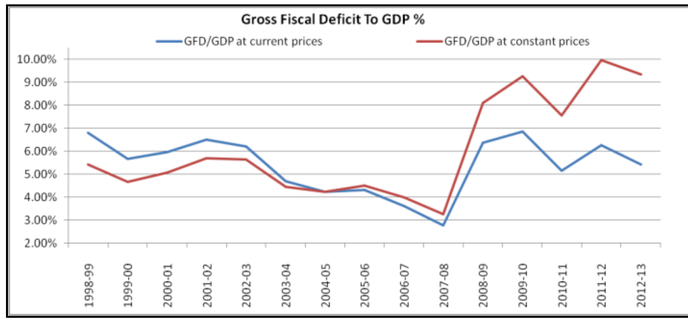


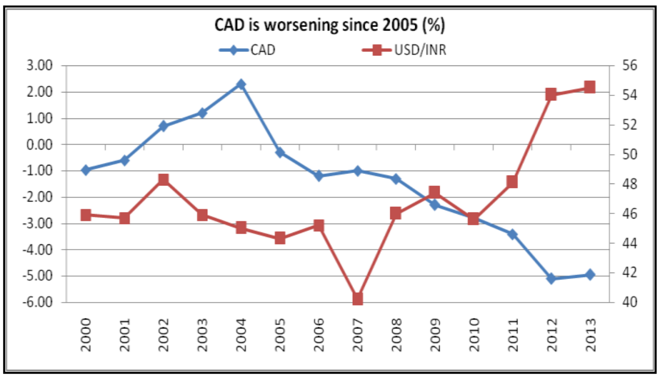
Source for Right Hand Chart Ajay Shah Blog (Rupee depreciated by 17% and Nifty dropped by 13.7% from 15th May 2013 to 21st August 2013)

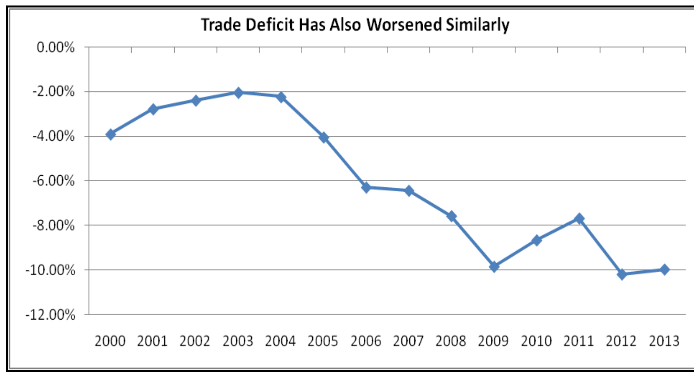
Weakening of EM currencies and stock markets have coincided with the outperformance of developed markets like US and lately even Europe lending credence to the argument that the EM fever (flavor!) is out of the window for now. The local and international press is replete with stories of how the erstwhile darlings of the global investment community are turning into ugly ducklings. Closer back home in India - the great India growth story - is being questioned and the local press and social media is having a field day with jokes, innuendos and cartoons of our politicians, the rupee and the price of onions!

To be fair and to regain any shred of credibility, it would be worthwhile to accept that a lot has gone wrong with India viz. rising deficits – both fiscal and CAD, high inflation, rising interest rates, policy inaction, policy missteps, sharp depreciation in the currency and slowing growth and a dysfunctional parliament. Some of our problems have been exacerbated by global macro events – initially the two rounds of QE led to a sharp hike in commodity prices of which India is a net importer and now weakening currencies and outflows because of the anticipated tapering by US fed is having debilitating impact on the rupee, the debt markets and equities. However, an equally significant part has been the many problems which seem self inflicted. Yes, India does have some structural problems – if it did not, it would already have been a developed market! – but we are also in the current situation because the government became complacent and made some missteps.









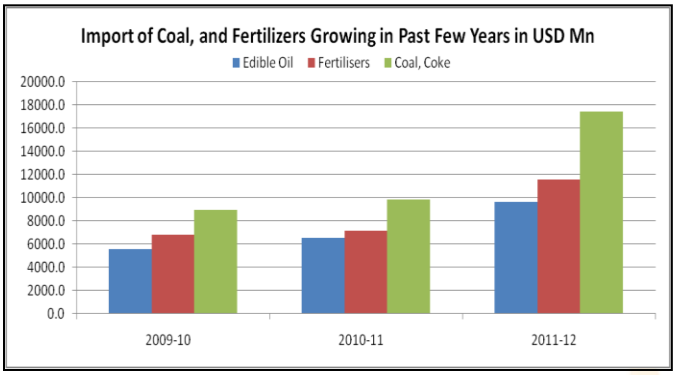
While structural issues cannot be solved overnight and need strong leadership, tough decisions and some patience, missteps can be corrected if there is humility to accept that you were wrong in the first place. A classic example of that misstep in 2012 was to bring a retrospective tax on Vodafone and which was then proposed to be widened across to all foreign investments. However, when P. Chidambaram the current Finance minister replaced the erstwhile FM, Pranab Mukherjee (whose brainchild this policy was) – he realized that what we had done was completely untenable and had we persisted with that policy we would be no better than a banana republic. So he accepted the folly and reversed the decision. Similarly, currently in our zeal to prevent the currency from depreciating – which frankly had more to do with what was happening globally, only that the extent of the impact was higher for India due to higher CAD, the RBI decided to squeeze liquidity by raising short term interest rates and bringing in some insignificant and undesirable capital controls (restricting the amount of forex, Indians/companies can invest abroad).

The collateral impact was that the increase in short term rates fed into long term rates and spooked markets into believing that India is going back on reforms on the capital account. This at a time when growth is slowing and we are out to attract more foreign investments! Most experts reckon that this was a policy misstep and that no country has been successful in managing the value of its currency on its own. That it was battle not worth taking on. Done in the garb of "we want to manage the volatility of the rupee not its level" – a study shows that the volatility in fact increased (doubled) post these policy announcements. Again (hopefully!) there is a sense that this could have been a misstep, the RBI decided to ease long term rates by buying government securities. But clearly we need to normalize the monetary policy as it has not achieved the desired objective. It is now expected (again hopefully!) that the new RBI Governor – Raghuram Rajan, would realize and accept with all humility the current policy has not worked and do the needful.

EQUITY OUTLOOK FROM CIO'S DESK

Most studies show that the fundamental value of the rupee should be in the range of 59-61 based on its REER (real effective exchange rate). However, markets tend to overshoot and short term events and sentiment can keep the level of the currency at deviance to its fair value. So while fundamentals warranted a depreciation, there also seems to be an overshoot which can correct once confidence comes back.

On the structural front – some steps have been initiated but a lot more needs to be done. One of the major causes of a worsening CAD on the import side, other than oil and gold which are very well publicized, is the import of coal (of which we have the 4th largest reserves in the world) and the ban on iron ore mining of which we were major exporters and have now become importers at the margin. If environmental clearances are given and the case is made to the judiciary to re-open shut mines (obviously with safeguards), the additional production of resources would not only help in reducing our import burden but also help in driving up industrial production which is now in negative territory. And then there are other ancillary benefits like more demand for trucks and earth moving equipment. It is sad that as a country, while we have basic resources like iron ore, bauxite and coal, we have not been able to become competitive producers of steel, aluminum and other building block metals. That too at a time when we have strong advantage in manufacturing of value-added goods like engineering, autos and auto ancillaries where Indian companies have demonstrated their prowess by exporting to world markets. We need to get our policies on resources right, break state monopolies like Coal India.



Another major area and pain point over the last few years has been the power sector. There we have seen some progress – partly in the form of tariff hikes by many SEBs (State Electricity Boards) and partly in nature of bailouts to new power plants by allowing them pass through of higher coal prices. So we will see some improvements flow through from here on in terms of higher generation. Our talks with companies in the south which were facing an acute power shortage corroborate the view that the power situation has improved in states like Tamil Nadu and Andhra Pradesh.

EQUITY OUTLOOK FROM CIO'S DESK

Other than CAD, the other major problem has been the fiscal deficit (FD). Last year the government (post P. Chidambaram took over as FM) squeezed planned expenditure to bring down the FD from an expected 6.4% to less than 5%. This year he has promised to bring it down to 4.8% of GDP. As things stand today, that seems tough to deliver. Further the lower house of parliament, the Lok Sabha recently passed the Food Security Bill (FSB), which gives legal entitlement of food to 2/3rds of the population at highly subsidized rates. This will add to the burden of deficits in the future. With oil prices spiking again and the rupee depreciating, fuel subsidies will rise. Though petrol has been decontrolled, Diesel and LPG (subsidy capped) are not. Hence oil subsidies are again expected to be high and it has become imperative that the government raise diesel prices substantially or decontrol them completely. This will require political courage but we think it is inevitable. We think the government will need to aggressively open up the economy in various sectors to attract FDI which is stable long term capital – than just rely on debt and equity portfolio flows. While there is widespread skepticism in the markets – that no major reforms will be done till elections, we do not entirely subscribe to this view. We think some reforms will be done as no government would like to go into an election with a faltering economy. So in the interest of self preservation, they will be forced to reform! For instance, the government did increase FDI in some sectors such as defence, etc. but no investments have been forthcoming till date due to the global situation as well as rupee depreciation.

India lost the plot to differentiate itself post the global financial crisis (GFC). Most policy makers and government found it convenient to heap all the blame on global macro environment reveling in the fact that India's large domestic economy would be relatively better off and a sense of complacency set in. While it is true that the economy has had to face global headwinds, however, that is the common denominator for all EMs or in investment parlance, that is the global beta. What each country does will determine its fate and what they call alpha! Alas, that time has come and a crisis like situation will create reform.

Valuations are now reasonable with India's market cap to GDP now at 58% and markets trading at 13.5X earnings. We think there are world class companies in India which have the ability to create genuine wealth. This is a good time, if any, to increase allocations to equities with a long term view.

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DEBT OUTLOOK

Indian Economy is going through a rough patch. Macros are deteriorating by each passing day. August like the month of July was highly volatile month for fixed incomes. G-Sec yields had hardened on the back of INR depreciation, hardening US Treasuries (on expectation of tapering of QE) and high crude prices. Given the measures announced in July, the tight liquidity led to steep rise across all segments of the yield curve. Benchmark ten year yields traded intra month high of 9.48%. Rupee keep continue to depreciate against Dollar and touched the high of Rs.68. Measures announced by RBI in the month of July to control Rupee depreciation seems not working. On 20th August RBI announced some steps in order to address the significant rise in yields.

The RBI has announced following measures:

•Open market purchase operations (OMOs) of long dated G-Sec of Rs.8,000 crore on August 23, 2013 .

•Banks can transfer 24.5% of SLR securities from the Mark to Market (MTM) portfolios to Hold to Maturity (HTM) category as a one-time measure. Banks can value these securities as on 15 July, 2013 when the first sets of tightening measures were announced.

• Banks can account for net depreciation on account of MTM valuation over the remainder of FY 2013-14 in equal installments.

•RBI has also mentioned that, it will calibrate the issue of cash management bills (CMBs), to keep the short term rates around MSF rate (10.25%) until the volatility of rupee eases.

The RBI has attempted to address the risks to macroeconomic stability from external sector imbalances. At the same time, it is has tried to ensure that the liquidity tightening does not harden longer term yields sharply and adversely impact the flow of credit to the productive sectors of the economy. It may be recalled that in its first quarter monetary policy statement of July 30, 2013, the Reserve Bank had said that the stance of its monetary policy is intended, among other things, “to manage liquidity conditions to ensure adequate credit flow to the productive sectors of the economy.” The measures announced are in pursuance of these objectives.

DEBT OUTLOOK

Depreciating Rupee is giving sleepless nights to RBI. On 28th August 2013 RBI announced that it will offer a forex swap window to meet entire daily dollar demand of the 3 oil marketing companies (OMCs). Under this facility, the central bank will undertake sell/buy USD-INR forex swap for fixed tenor with OMCs via a designated bank. The tenor of swaps offered was not specified with the announcement. Apart from the INR defense already mounted via hiking cost of carry, the other desperate need was to enhance dollar supply to the market. The forex swap addresses this problem to a significant extent since OMCs have the largest and most consistent demand for dollars. The forex swap line leads to further tightening of spot rupee liquidity in the banking system, since the RBI buys rupees and sells dollars in the first leg. This will lead to tight liquidity in coming month. We will not be surprised if RBI reduces or eliminate the issuances of Cash management bills to support liquidity.

The 1Q FY14 Real GDP growth remained at sub-5% for three consecutive quarters and recorded 4.4% yoy - slowest since June 2009. The details also disappointed. Higher agriculture growth and increased government spending propped up growth. Industry and Services growth slowed down. Private consumption and Investment continued to moderate. India's industrial production contracted by 2.2% in June, more-than-expected from a year earlier. More importantly, data for May 2013 was revised, registering a contraction of 2.8% from an earlier negative growth of 1.6%. The wholesale price index (WPI) inflation rose to 5.79% in July from 4.86% in the previous month. Inflation for May was revised down to 4.58% from 4.7% estimated initially. Inflation rose to a five-month high in July, pushed up by a steady increase in fuel prices because of the weaker currency and double digit rise in food prices.

Under present conditions we expect fixed income market would be volatile in coming days. Depreciating Rupee, Rising US yields and higher oil prices due to fear of Syria crisis bond yields will be under pressure. In our view, it will be difficult for RBI to disregard the growth mandate even if the number one priority remains currency. This is because in a global context, weak growth for emerging nations like India will be construed as a credit trigger. This in turn will have further implications for the currency. We believe that RBI will reverse the liquidity measures once the currency stabilizes. RBI cannot for long period hold these liquidity measures as it is affecting adversely the overall economy in many ways. We recommend investors to diversify the portfolio between FMPs, short term products and duration production depending upon their liquidity requirement and risk profile. Conservative investors can take benefit of higher yields by allocation their money in FMPs.

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