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PRIVATE WEALTH

# Investment Matters

**July 2012**

EQUITY OUTLOOK FROM CIO'S DESK

**Hope in the air**

The last four weeks have been very eventful to say the least!

India's economy continued its downward drift – highlighted by the S&P downgrade of India's investment rating to 'negative' watch citing slowing growth and political roadblocks to economic policy making.

Inflation, particularly in food at a high 10.5%, is stubborn, driven also by a supply crunch as India's eating habits shift away from grains. Resultantly, despite widespread expectations, the RBI refused to respond to a set of moderating WPI numbers (7.0-7.5% in May) with a rate cut in its mid-June monetary policy review, thereby reinforcing its position on the management of inflation as its first priority. The RBI remains concerned over a weak global environment, as it recognizes that the 50-bps rate cut in April did not result in cheaper corporate loans, and that deposit growth – and India's savings rate – is at a seven year low. However, we believe that it is only a matter of time before RBI starts to cut rates as most other emerging market economies have start to cut aggressively in response to falling growth. Also, most lead indicators of inflation like commodities and oil have corrected anywhere from 5 to 15%. Though some of that benefit has been taken away from the sharp depreciation of the rupee in the last 3 months or so. To top it, the monsoons have played truant this year and unless they catch up over the next 10 days or so we may have deficient rains further complicating matters for food prices and hence inflation.

Demand, as reflected in consumption, may have registered a kind of bottoming out – passenger car/van sales picked up growth at 5.9% in May over April's zero gains; cement dispatches grew 13.9% for the same time period and the IIP came at least into neutral territory in April after de-growing 3.5% in March. However, stress remains high.

It is no surprise then that Finance Minister Pranab Mukherjee's eventful journey towards Rashtrapati Bhawan is viewed with much keenness by the investor community. The politics – and politicking – that overwhelmed recent public discourse on the nominations process for India's highest ceremonial office is now behind us. Left in its wake is a weakened Mamata Banerjee of the TMC, whose bluff was called by the Congress, as master politician Mulayam Singh Yadav played his hand as the emerging 'king maker' at the Centre. The numbers indicate the certainty of Mr Mukherjee's ascension as the 13th President of the Republic of India. The big focus, however, is on the seat that he has vacated which has for now been assumed by Prime Minister Manmohan Singh. Many believe that Mr Singh and Mr Mukherjee did not see eye to eye, creating one of the many a hindrance to the government's decision-making process (Read BS editor TN Ninan's column, PM as FM (http://www.business-standard.com/india/news/bt-n-ninanb-pm-as-fm/478928/). Others point out that reformist Mr Singh's attempts may have been foiled on more than one occasion by populist Mr Mukherjee, to open up areas such as FDI in retail and pensions.

The big bet, then, is on the fact that the Prime Minister will use this opportunity to finally call the shots in a Ministry that is crucial to India's growth prospects, and where he has expertise. And there is clearly much to be done, and much that can be accomplished – allowing greater ceilings in FDI, announcing landmark reforms in pensions, finally giving some push to the constantly reiterated focus on infrastructure and more importantly removing irritants to capital flows like the contentious GAAR provisions which was such a pet project of the previous FM and the bureaucrats in his ministry.

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This bet is however difficult to call because the fact is, it's a larger issue. The UPA, and vast sections of the Congress within it, especially Sonia Gandhi remain ideologically divided on critical issues. How much Mr Singh himself is resigned to living with the status quo or not is an additional 'open' question. While there is hope the good news is that there is also a healthy dose of skepticism in some quarters that the PM may not deliver upto the expectations (http://swaminomics.org/?p=2194). Willy-nilly then, despite the odds, hope must be vested in Prime Minister Manmohan Singh to take decisions that will bring back investors and unleash the "animal spirits" as he himself put it. There are still some tailwinds in the external environment – a slowing global economy, particularly China within it, can itself yield India some luck as commodity prices fall – already evident in the falling import numbers (and improved, albeit temporarily, trade deficit). Capital inflows could strengthen if the Euro crisis is resolved as investors shift their attention from low yielding US and German treasury bonds to emerging markets. But in the final count, it is not for the rest of the world to determine India's destiny but our own initiative. This can largely be led by the Government through right policies. Whilst we cannot set high expectations on the coming months, though some of that has percolated into the markets recently, we could justifiably allow ourselves a flicker of hope that leadership shifts in the finance ministry may be for the better.

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# DEBT OUTLOOK

Past month has been quite dynamic on the debt front owing to various developments in domestic and global markets. Following significant developments were of key importance:

- New benchmark G-Sec was launched at yield of 8.15% which rallied to up to 8.04% in anticipation of rate cut before RBI's mid quarter monetary policy.
- RBI against general market anticipation chose to keep the Repo rate and CRR unchanged at 8% and 4.75% respectively driven by elevated headline inflation, uptrend in retail inflation indices and the lack of supply side responses.
- In order to arrest falling rupee, RBI increased FII investment limit in G-Sec from $15 bn to $20 bn apart from increasing the ECB (External Commercial Borrowing) to $10 bn.
- Positive developments from the European summit making significant changes to the role of ECB was welcomed by markets globally as a positive development for future of Euro zone.

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

- Annual Inflation for the month of May came at 7.55% as compared with 7.23% for the previous month. Core inflation remained almost flatly at 4.84% against previous months 4.85%.
- IIP for April grew by 0.1% against 9.3% growth previous year mainly due to volatile capital goods index which contracted by -16.3% and mining which contracted by -3.1%.
- During the month, rupee breached the 57 levels and continued to decline only to later gain due to developments in Europe and steps taken by RBI to end the month with a 0.2% gain. Rupee has declined -5.4% YTD.

Domestic systemic liquidity plunged to over Rs 1,32,560 crores on payment of advance tax flows during the month, Liquidity deficit was at Rs 83,300 crores levels at month end. 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. RBI had also been aggressive on systematic liquidity aspect and had tried to keep it under control by conducting OMOs of almost Rs 67,000 crores since start of the current financial year. However with heavy supply of government bonds (Rs 61,000 crores in July and Rs 75,000 crores in August) scheduled it may not be prompted to conduct further OMOs during this period. Thus, government bond yield may face some upward pressure given the supply due over next 2 months.

We believe growth in the next few quarters can continue to remain subdued. We believe that, any developments such as the diesel and LPG price hike and crude remaining at lower levels should allow the RBI to cut rates gradually. Fall in the crude prices in spite of weakening rupee has been a major relief to arrest the slipping CAD. The erratic behavior of monsoon so far is beginning to cause concern and if lower than normal monsoon is recorded it could further push pressure on primary inflation. With change of guards at the Finance Ministry which now is being headed by Dr Manmohan Singh, market is building fresh hopes on reforms on fiscal consolidation and investments boosting measures.

# 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 have come off from their higher levels but are likely to remain range bound with. Going forward we expect the yield curve to steepen bullishly (short end rates falling faster than long rates) over the next 2 – 3 months. The short end rates currently high 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 dynamic bond funds to play safe duration calls to generate better risk adjusted returns.

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