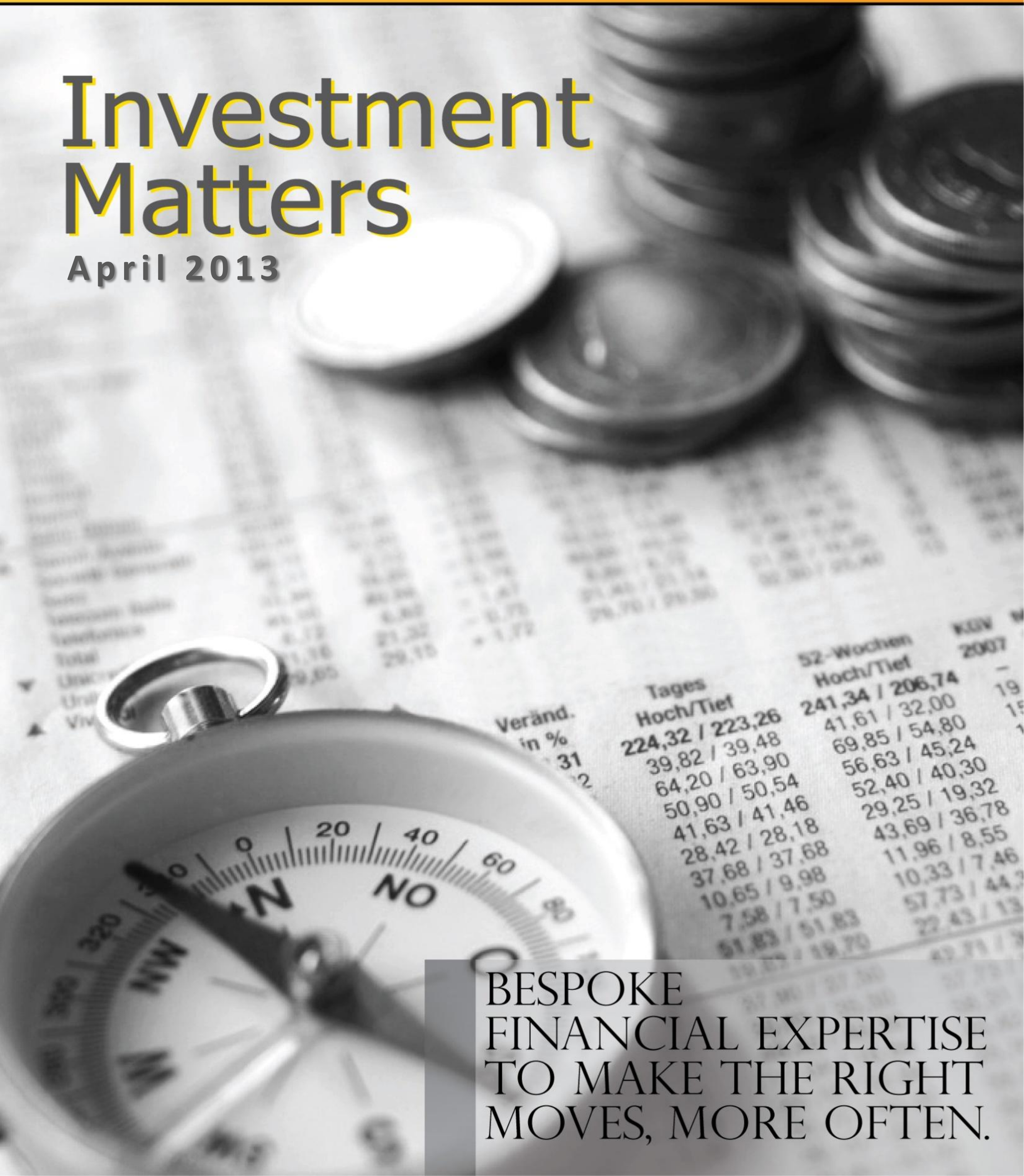
ALCHEMY
PRIVATE WEALTH

Investment Matters

April 2013



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

EQUITY OUTLOOK FROM CIO'S DESK

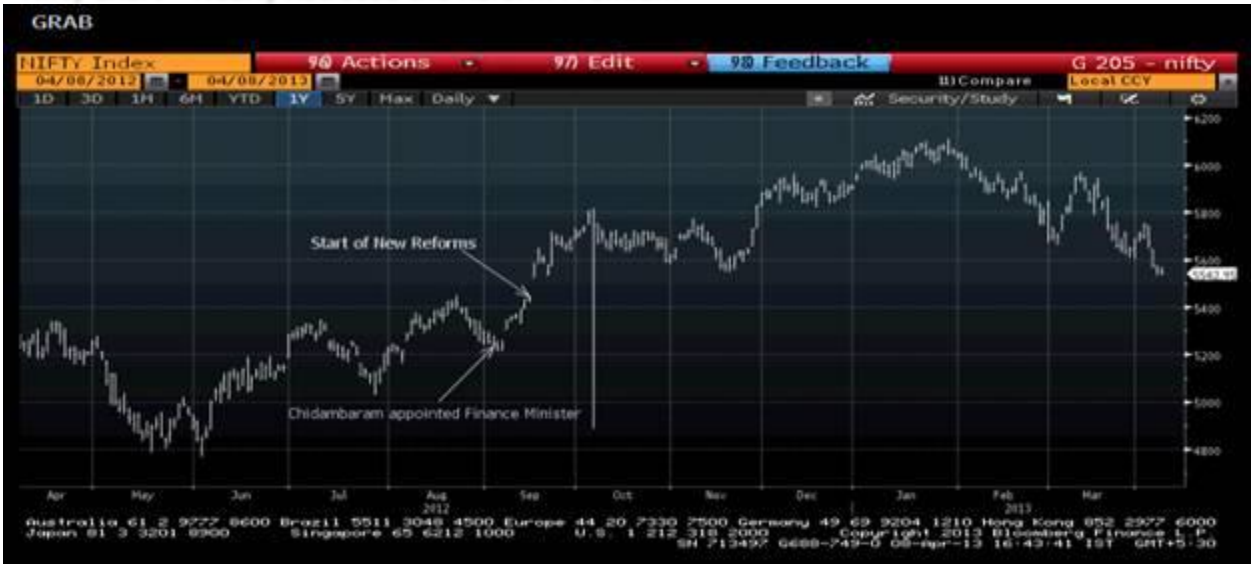
Indian markets started 2013 on a positive note but the gains could not be sustained. Q12013 turned out to be one of the worst quarters in the last 12 months placing India amongst the worst performing emerging markets for the quarter. This is despite significant inflows from FII's (US$10bn) the best in any quarter! The strong flows by FII's have to a large extent been negated by continuous selling by retail Indian investors as evidenced in the negative flows from domestic mutual funds and insurance companies who have been faced by redemptions. The poor point to point returns from equities – 6% over last 30 months has exasperated the spirits of local investors. They have preferred to invest instead in gold (30 months return: 53%), real estate (where the perceived downside price volatility is zero) or fixed income securities as yields have been high. It is unlikely that the domestic investors would return in any significant manner till after elections.

Despite the budget being in-line with expectations but bereft of any radical new vision, markets witnessed a sharp sell-off on political uncertainty. A key ally of the UPA, DMK withdrew its support to the government threatening instability and early elections. We believe that the immediate fall of the government would not be imminent as no political party is prepared for an early election despite rumblings to the contrary. Most astute political observers feel that earliest that an election would be called is in November 2013 instead of early 2014 - (http://www.moneycontrol.com/news/politics/elections-likely-after-6-months-shekhar-gupta_845451.htm). The signal from the Congress leadership is that the government would continue with its reforms drive (refer our budget note – the action is outside!) and fiscal consolidation albeit with limited political maneuverability. As soon as the budget session ended for a recess, the third diesel price hike was effected, partial sugar decontrol was announced and CERC (the Electricity regulator) allowed tariff hike to Adani Power's Mundra Power plant to compensate for higher imported coal costs. We should expect more reforms to be announced in rapid succession.

With a GDP print of 4.5% for Q3FY2013, falling core inflation, flat industrial growth and fiscal consolidation in the budget, the RBI obliged by reducing rates by 25 bps and tilted its policy stance towards growth albeit highlighting its concern on higher CPI inflation and unsustainable level of trade deficits which could constrain the space for aggressive rate cuts. However, the latest rate cut did not result in any softening of rates for borrowers as liquidity is still very tight and banks continue to borrow from RBI under the LAF facility. These very tight monetary conditions have been created partly because deposit growth has slowed but more importantly - because the government in its enthusiasm to achieve fiscal consolidation has put a complete break on government spending. This is corroborated by several companies we interacted with in the recent past. All subsidy related payments and government buying has been held back to meet stiff fiscal deficit targets. This should result in an unusually weak Q4FY2013 revenue growth for companies in an otherwise seasonally strong quarter. The consumer discretionary sector which has held out so far is also experiencing a slow down with most companies experiencing slower sales post a good January. Many consumer companies (and quite many amongst our portfolio companies) are using this opportunity to invest aggressively in new product innovations coupled with expanding their retail footprint to drive sales and compensate for the temporary slower same store sales growth. We believe this strategy should suit them well to capture share and the next upswing in demand.

EQUITY OUTLOOK FROM CIO'S DESK

Nifty Chart – Nearly Retraced the Reform Premium



The recent headwinds in the markets have brought them back to levels where the rerating of Indian equities has started in July-August 2012 when Mr. Chidambaram took over as the FM. Since then many reforms have been put into place – FDI in Retail and Aviation, fuel price deregulation, restructuring of SEB's to reform the power sector, the setting up of the CCI to speed up stuck infrastructure projects, guidelines for issuing new banking licenses and two 25 bps rate cuts by RBI. Simultaneously - Oil and Gold prices have corrected – which were the biggest contributors to our widening CAD. If the soft price trends in these two major commodities sustains it could mark a turnaround in our macro fundamentals.

I had mentioned in my Jan note that the investment universe and opportunities will expand going forward as the government works through some of the challenges via reforms, companies move forward towards restructuring and deleveraging by selling assets and stable to declining oil and gold prices potentially put a floor to our challenging macro. Though the markets maybe challenging in the near term they will present a great entry opportunity and smart money should start increasing their allocations to Indian equities partly over the next few months – ahead of the elections and partly post. While news flow could continue to be bad – in long term investing it is the entry valuations that matter most – and those are available only when the macro is challenged!

Hiren Ved

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DEBT OUTLOOK

March being the last month of financial year is always full of events. Most awaited event RBI's Policy review meeting happened on 19th March 2013. While the RBI cut repo by 25 bps as was expected by consensus, the relatively hawkish tone of the policy caught many by surprise. Thus the central bank assessed headroom for further monetary easing to be 'quite limited'. The concerns exhibited have been quite consistent since the January policy review (where again repo rate was cut but the Governor sounded quite hawkish in analyst interactions afterwards). Headline WPI is sticky despite recent fall in core inflation, CPI has been climbing thereby driving a wedge with WPI, and current account deficit remains a central worry. Though growth is clearly a concern as well, the RBI assesses that the bulk of the effort in this regard has to be undertaken by the government in form of bridging the supply constraints, staying course on fiscal consolidation, both in terms of quantity and quality, and improving governance.

Current account deficit widened to all-time high in Dec-12: The current account deficit widened to a record time high of US$32.6bn (6.7% of GDP, annualized) in Dec 12 from US$22.6bn (5.4% of GDP, annualized) in quarter ended Sep-12. The higher-than-expected number was primarily due to lower remittances and services exports growth. Current account deficit tends to be seasonally higher in Sep and Dec quarters. Export growth lagged import growth in QE Dec-12: Trade deficit widened to US$59.6bn (12.3% of GDP, annualized) during QE Dec-12 compared with a deficit of US$48.2bn (11.7% of GDP annualized) in the QE Sep-12. In YoY terms, trade deficit rose 22.4% in QE Dec-12 compared to 8.5% in the previous quarter. Both exports and imports grew on a YoY basis, reversing the decline in the prior quarter; however, exports growth lagged import growth. Exports grew a mere 0.6% YoY in QE Dec vs. a decline of 12.2% YoY in QE Sep-12. Imports growth rose sharply to 9.4% YoY in QE Dec vs. a decline of 4.8% in QE Sep-12.

The growth path of the domestic economy continued to weaken. After reporting a 5.3% growth in the September 2012 quarter, the GDP fell further to 4.5% in the December 2012 quarter - the weakest in the last fifteen quarters. Both the Central Statistics Office (CSO) and the central bank projected the GDP growth at 5% and 5.5%, respectively, for 2012-13, which is a matter of concern for the domestic economy. Along with this, industrial production remained at a subdued level and the cumulative growth figure for the period of April-January 2012-13 stood at 1.0% against 3.4% recorded in the corresponding period last year. The external demand has also weakened due to tepid global growth and consequently, exports demand remained lower during the current fiscal. Higher trade deficit adversely impacted the external front of the economy.

GOI will borrow INR 349,000 crores between April – September 2013 out of gross scheduled borrowing of INR 579,000 crores for the year. Thus, 60% of gross total will get borrowed in first half versus 66% done first half of last year (against final revised total borrowing number of INR 558,000 crores for FY13) Net borrowing is pegged at INR 274,265 crores (57% of total) versus INR 284,926 crores (61% of total) in the previous year. However, net borrowing of INR 152,249 crores in April – June is higher than corresponding number of INR 127,426 crores in April – June last year. This is because most bond maturities this year are in August – September period versus in April – May last year Finance ministry sources indicate that between INR 12,000 – 20,000 crores of the borrowing will be in the form of inflation indexed bonds. The structure of these bonds is still being worked out.

The liquidity deficit remained tight as evidenced by very high LAF numbers. RBI infused average net liquidity worth Rs.164Tn in last week of March 2013, compared to Rs.1.36Tn the previous week.

DEBT OUTLOOK

The call and CBLO rates too shot up during the last week of the Month. While the average call rates was higher at 14.66% compared to 7.67%, in the previous week, the CBLO rates averaged around 12.47% as against 6.87% in the previous week. Due to tight liquidity situation, the yields in the money market segment shot up quite steeply during the week. While the money market papers with residual maturities of 5-10 days dealt at levels as high as 15-18%, the 3 month & 1 year segment too witnessed some selling pressure.

So looking at relatively high supply of Government bonds in first six months, RBI's hawkish tone and High CAD and fiscal deficit we expect 10 year G-sec yields will be volatile in first half of FY 2014. We expect RBI to keep on supporting credit market by more OMOs in 2014. RBI will try to maintain liquidity in the system in order to support ongoing borrowing program and restrict the increase in benchmark yields. Overall, we believe that interest rates are going to fall in coming time, only matter is how much and by when. We expect interest rate to fall by 25-50bps in next 6 to9 months.

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