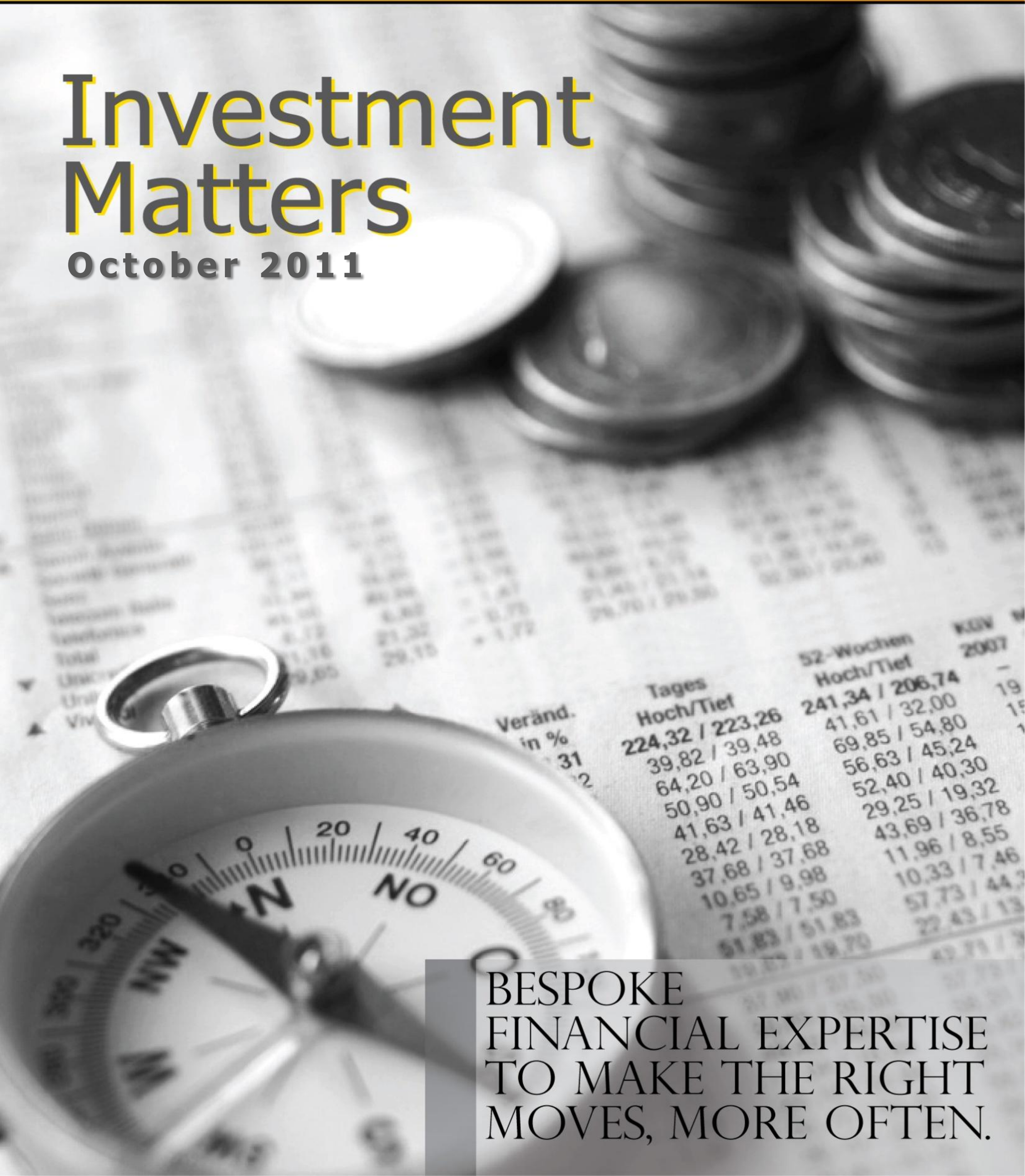
ALCHEMY
PRIVATE WEALTH

Investment Matters

October 2011



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

EQUITY OUTLOOK FROM CIO'S DESK

September was another poor month for global equities with the MSCI AC World Index was down -8.8%. Fears of debt defaults in Europe, a growing perception of a double-dip recession in USA and slowdown in China resulted in a sharp sell-off in crude and commodities. Gold fell -11% and Crude -10%. Corn was down -23% (confirm this from MS note). India however outperformed and was the second best performing EM (among the 21 tracked by MSCI). The MSCI India index was down -6.6% MoM.

In INR, local currency, Indian equities held on well with the Nifty down -1.2% and the BSE500 Index -1.6%. Small caps and Midcaps fared slightly worse and were down -3.5% and -2.3% respectively MoM.

Concerns with FII outflows (US$ -204mn for the month and now US$ -149mn YTD) and with the widening current account deficit resulted in a sharp -6.2% depreciation in the INR during the month. While these reasons could be attributed for the depreciation, the rupee fell more or less in line with other Asian currencies like the Korean Won.

Inflation is the primary macro concern and WPI spiked to 9.8% in August. This is the highest level for the WPI in the past 13 months. The recent INR depreciation adds another degree of inflation (via imported crude and metals). Oil companies hiked petrol prices mid-month by Rs.3.14/litre or ~5%. A small inflation impact will flow through over the next few months from this.

The RBI has hiked repo rates by +25bps in September (YTD this is now a +200bps hike in repo rate to 8.25%) and another +25bps rate hike in October could be expected as the central bank continues to be focused on inflation control.

Monsoons have been bountiful and well spread out this year. The season has seen ~900mm of rainfall, 2.3% above its long-term average. Spatial distribution is very good with 4.4% of cropped area with deficient rain vs. 20.5% YoY. Rainfall in "rain dependent areas" is +8.7% above its long-term average. Kharif crop sowing acreage at 104mn ha is +2.9% YoY. There is record sowing in oilseeds, sugarcane and cotton this year. Even rice planting is up +2.9% YoY. All of this should lead to higher production and a moderation in the high food grain prices witnessed these past few months – and therefore the peaking out of food inflation in India.

Given that the world is worried about downside risks to growth, a correction in global commodity and crude prices should lead to a peaking of manufacturing side inflation.

So despite the fact that inflation in India will remain rigid for some more time, the trajectory, now, is lower. This in turn should within a few quarters, lead to the peaking of the interest rate cycle in India.

Unfortunately, the GoI announced a higher borrowing program for the year – leading to a spike in the 10 year bond yield. Bond yields are now at their October 2008 levels.

So then why buy equities and why buy them now?

The best time to buy equities is when the interest rate cycle is peaking and valuations are attractive.

EQUITY OUTLOOK FROM CIO'S DESK

In this rate hike campaign, RBI has hiked repo rates 12 times since March 2010 and raised policy rates by 350bps from 4.75% to 8.25%. Of this 200bps have been increased this fiscal (and 150bps in 2010). They are expected to hike repo rates again in October by another 25bps.

The high interest rates in India are beginning to bite. Companies are reporting slowing growth. At current interest rate very few new projects will be viable. So capex cycle which has lagged so far will drop off the cliff. Banks are unable to hike lending rates (or deposit rate) – the transmission of monetary policy is clearly breaking down. So even if the RBI hikes, banks will not be able to pass these onto now reluctant borrowers. Loan growth will taper off. GDP growth could dive sub 7.5% for a quarter or two.

We therefore expect the interest rate cycle to peak within the next six months as inflation peaks out and growth slows down.

YTD India is amongst the worst performing markets and the MSCI India index is down –28%. Valuations for the Sensex (which is currently at 16,000) are now at 12.3x FY13e earnings. GDP growth will be in the 7% range, good by global standards. Historically we have seen markets trade at 11x one-year forward earnings. We have also see that from those levels equities hugely outperform other asset classes over the next couple of years. Valuations for several midcaps is much lower and offer very good value. So despite the steady flow of bad news these days the risk-reward of owning equities is clearly becoming more and more favourable.

Hence we strongly believe that investors must now look to allocating more to equities in the next few months. Focus on bottom-up stock picking buying companies that have a good franchise, low debt and reasonable growth outlook.

Hiren Ved
Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

DEBT OUTLOOK

Month of September 2011 witnessed many unexpected events. Just to recall that we were very vocal about concern on extra borrowing from the government in our past communications. The government's announcement of extra borrowings of Rs.52800cr has sent the bearish signals to the market. The expected announcement of the Government borrowing calendar for the second half of FY12 kept the yields up during the week amid lower volumes. However, yields suddenly jumped up after the Government announced much higher than budgeted borrowing. Hence, the most traded 10-year bond augmented 20 bps to 8.52% over the close on last Friday. As per the calendar, the Government will borrow Rs 2.2 lakh cr. in the second half (October to March) of FY12 significantly higher than the balance gross borrowing of Rs 1.67 lakh cr. as announced in the annual budget. In the first half of FY12, Government gross borrowing was Rs 2.5 lakh cr. from Rs 4.17 lakh cr. budgeted for the full year.

RBI in its Mid-Quarter Monetary Policy Review on 16th September 2011 increased the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 8.0 per cent to 8.25 per cent with immediate effect. Consequent to the above increase in the repo rate, the reverse repo rate under the LAF will stand automatically adjusted to 7.25 per cent and the marginal standing facility (MSF) rate to 9.25 per cent with immediate effect. RBI continued with its anti inflationary approach in this meeting also. Going forward, the stance will be influenced by signs of downward movement in the inflation trajectory, to which the moderation in demand is expected to contribute, and the implications of global developments.

India's headline inflation as measured by WPI rose to a 13-month high of 9.78% y-o-y in August from 9.22% in July, surprising the market on the upside. Food inflation (primary and manufactured) rose sharply to 9.1% y-o-y in August from 8.0% last month, while the Core inflation, as measured by non-food manufactured WPI, also rose to 7.8% y-o-y in August from 7.5% last month. The steep rise in the August core inflation reading suggests that demand-side pressures have not moderated by as much as earlier thought and they may continue to put upward pressure on headline inflation for a few more months. Encouragingly, global commodity prices have remained low to stable in the last few months and will help inflation gradually settling lower, despite the depreciating currency shaving off a part of the benefit.

Liquidity in the system tightened further during the last week on account of quarter ending requirement. The net average LAF was negative at around Rs. 77,000 cr. as against negative Rs. 58,600 cr. during the previous week. Overnight call was in the range of 7.75%- 8.40% during the week. Currently, systemic liquidity is in the negative territory (LAF is – Rs. 65,000 cr. as on Sep 28, 2011) and the RBI's intervention in the FX market has been negligible so far. Therefore, the impact on systemic liquidity was marginal. However, a large-scale outflow in a short time period could have a major impact on systemic liquidity and therefore could push over-night rates higher.

We believe that Bond yields are unlikely to soften much from current levels in the immediate term in view of hawkish stance of RBI and continued supply pressure from government. However, we believe that RBI is near the end of tightening cycle in terms of policy rates. The additional borrowing by the government in second half will keep the downside in yields checked. We suggest short term funds with low average maturity and high carry in the portfolio. For investments for year or more, FMP looks attractive investment avenue.

Rupesh Nagda
Head – Investments & Products
Alchemy Capital Management Pvt. Ltd

ALCHEMY
PRIVATE WEALTH

DISCLAIMER

General Risk factors

- All investment products attract various kinds of risks. Please read the relevant Disclosure Document/ Investment Agreement carefully before investing.

General Disclaimers

- The information and opinions contained in this report/ presentation have been obtained from sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete.

- Information and opinions contained in the report/ presentation are disseminated for the information of authorized recipients only, and are not to be relied upon as advisory or authoritative or taken in substitution for the exercise of due diligence and judgement by any recipient.

- The information and opinions are not, and should not be construed as, an offer or solicitation to buy or sell any securities or make any investments.

- Nothing contained herein, including past performance, shall constitute any representation or warranty as to future performance.

- The services related to Mutual funds, Insurance, Real Estate, Art, Commodity etc. may merely be a referral / advisory services in nature. Such third party investment products or services do attract the general and specific risk factors unique to those respective products or services, which would be mentioned by the manufactures of those products in the respective product documentation. The prospective investors in such third party products are advised to read and understand those risk factors & disclaimers, in addition to what has been stated herein. Alchemy Capital Management Pvt. Ltd., its Group or affiliates have not verified and do not take any responsibility for any statements, numbers or claims made, omitted to be made or implied in any documentation, presentations etc. which have been created by the manufacturers of such third party products or services.

- The client is solely responsible for consulting his/her/its own independent advisors as to the legal, tax, accounting and related matters concerning investments and nothing in this document or in any communication shall constitutes such advice.

- The client is expected to understand the risk factors associated with investment & act on the information solely on his/her/its own risk. As a condition for providing this information, the client agrees that Alchemy Capital Management Pvt. Ltd., its Group or affiliates makes no representation and shall have no liability in any way arising to them or any other entity for any loss or damage, direct or indirect, arising from the use of this information.

- This document and its contents are proprietary information of Alchemy Capital Management Pvt. Ltd and may not be reproduced or otherwise disseminated in whole or in part without the written consent.

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