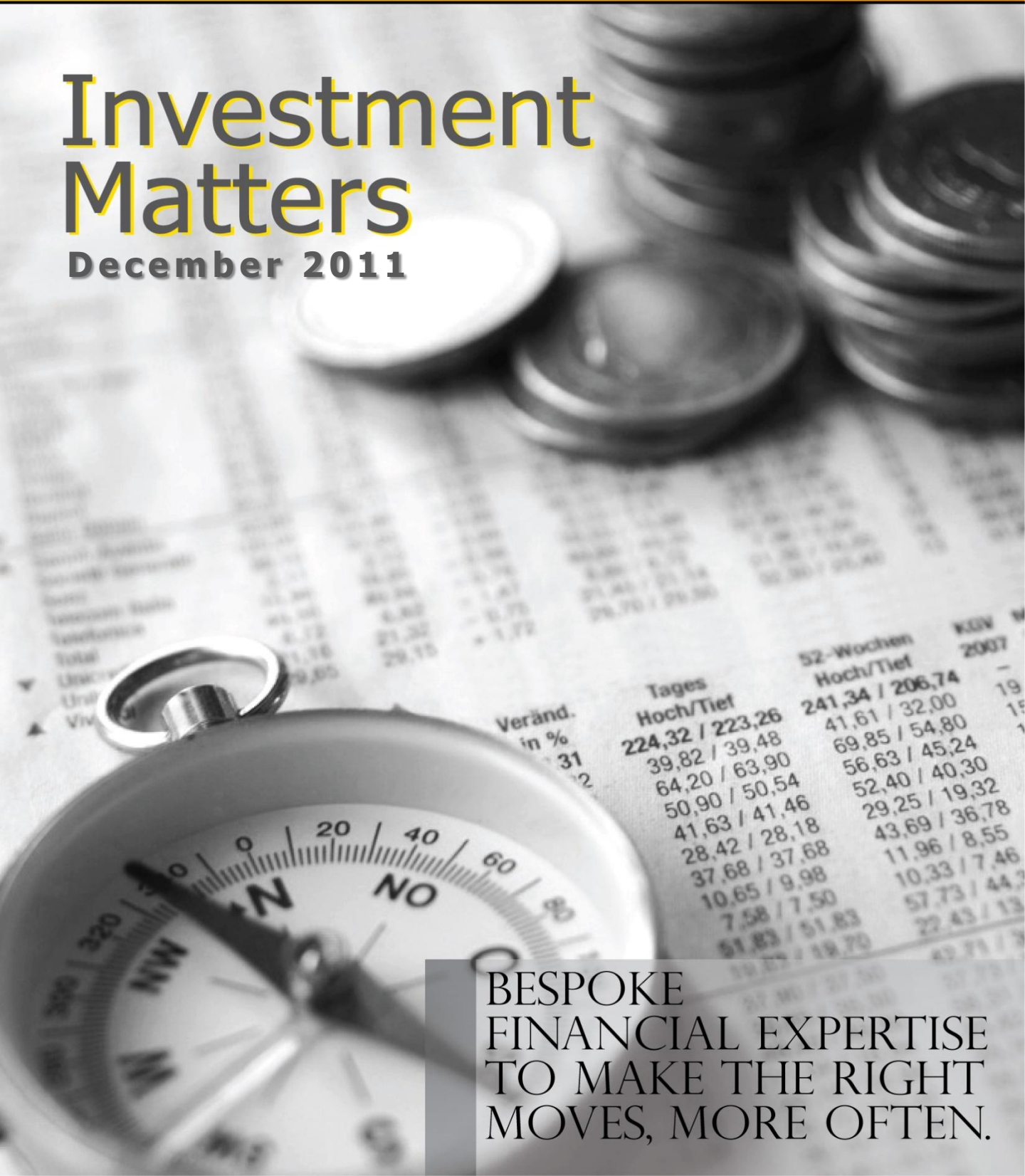


Investment Matters

December 2011



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

EQUITY OUTLOOK FROM CIO'S DESK

November was a poor month for risk assets in general, across the globe. Once again, events in Europe dominated the “risk-off” trade and except for a very sharp rally (~4%) in Europe and USA on November 30th (on the back of the cut in funding rates for US\$ swap lines between the US Fed and 5 other large central banks) equities and commodities (except for Brent oil) ended the month down.

For Indian equities, November was a very poor month indeed. FIIs turned net sellers and sold US\$ 860mn of equities. Their YTD net selling is US\$ 500mn. The Nifty was down -9.3%, the BSE500 fell -9.6% and the BSE Mid and Small cap indices fared worse and were down -10.6% and -12.6% respectively. Compounding the problem was the -6.7% depreciation of the INR vs. the USD taking it to a new life-time low. In USD terms, the MSCI India was down -16% and India was the worst performer in EMs tracked by MSCI. With the ~16% fall in the INR this calendar year, YTD MSCI India is now down -34%. Fortunately we saw some buying by domestic MFs whose November month net purchase of US\$ 150mn takes their YTD tally to US\$ 1.24bn.

For India, 2011 has so far been one of the worst years in history (1995, 1998, 2008 were worse) for equity markets. Lack of governance, lack of policy initiatives and the worsening fiscal situation have spooked investors. Growth in India is visibly slowing down. Credit growth is slipping. The September 2011 quarter GDP (2Q) is now at 6.9% and GDP growth in 3Q and Q4 is likely to slip further before bottoming out. Given that headline inflation is likely to come off, we should start seeing the RBI becoming less hawkish on inflation and given the growth pangs, change its stance and start easing (perhaps with a CRR cut first and then with a rate cut) in a quarter or two.

Responding to the policy paralysis accusations, the government did attempt to bring reforms by bringing in 51% FDI in multi-brand retail and 100% FDI in single brand retail. While the step was very welcome and would have sent out a very strong signal to the business community and markets both in India as well as outside, “mistiming” its introduction during the parliament session and without working out a “strategy” to bring the allies on board meant that the opposition parties got a great window of opportunity to put the government on the back foot and well meaning effort got wasted. Infact, the handling of the Anna Hazare Lokpal issue earlier in the year as well as now the FDI in retail fiasco shows that lack of co-ordination and strategy has meant that the government continues to shoot itself in the foot. Another classical faux pass was when the Deputy Governor of RBI openly said that we would not support the falling rupee. Even if that were the strategy (and we are not debating the merits of such a strategy or otherwise) it is was probably unpragmatic for central bankers to not be nuanced and allow speculators to take advantage of the fragile macro situation.

So where do we go from here? What are the continuing challenges and are there any silver linings? The continuing challenges are the situation in Europe which may continue to keep global markets in a “risk-off” mode and hence may keep the rupee under pressure thereby delaying the transmission of lower commodity prices to soften inflation. At home the fear is that there will be no meaningful reforms until the UP elections in April-May and that the government will continue to be “fiscally profligate” (eg. The Food Security Bill) Also there is a fear as to what strategy will the government adopt to compensate for its disinvestment target. If it resorts to steps which impound the cash with cash rich PSU's to the detriment of the companies and the minority shareholders it would send out a wrong signal. Then there is this slowdown in the economy, consumption demand is slowing down and investments have virtually come to a standstill especially infrastructure and industrial capex. Last but not the least could be geopolitical tensions with Iran which could lead to a spike in oil prices.

EQUITY OUTLOOK FROM CIO'S DESK

So where are the silver linings? For one, the upshot to “slow growth” is that interest rates have “peaked” and it is not just because of base effect as is popularly touted. The fundamental reason for interest rates to have peaked is that at the current rates of interest there is no demand for money for new projects – whether private capex or infrastructure other than for working capital where companies have no choice. Secondly, with global synchronization it has been observed that “monetary policy” also moves in tandem, albeit with a lag. Many countries (Australia, Brazil, China etc) have already begun to cut and India will follow suit but with a lag. Secondly, I do believe that we have reach a nadir as far as “policy paralysis” is concerned and while I agree that I might be in a small minority. While I concede that we are not naturally “pre-emptive reformers” but there is empirical evidence to show that we are “reactive reformers”. Most reforms have happened when the economy is in crisis or in near crisis mode. I am hopeful that the government will eek out some meaningful reforms – with some deft political “give and take” and with the some laborious and frustrating consensus building that is the hallmark of our politics.

The recent sharp depreciation in the INR has forced the RBI to act. They have increased the debt limits for foreign institutional investors who invest in Indian debt paper, by 20%, from US\$50bn to \$60bn. This should help ease the pressure on the INR as the bulk of the US\$ 10bn proceeds are expected over the next few months. The European crisis is going to be a long drawn affair with no quick fix solutions and we can only hope that the key players including the central banks of EU, Fed and others are able to avoid a “systemic risk”. But I think any investment strategy has to take cognizance of the fact that the sword of Europe will keep hanging.

Lastly, most sell side strategists have been aggressively cutting earnings estimates and their index targets. The adverse fx impact will be priced ahead of the Q3 results and maybe whatever cuts are left to be made to earnings will be done by the end of Q3 earnings season. As I mentioned in my last communication, it would be fair to assume that the markets will now trade in a wide range of between 14,500 to 20,000 for the next 18-24 months. There could be exceptions on either side but at the lower end of the range there will be “valuation support” and the risk reward favorable for long term investors. Historically, the process of bottoming out starts with the peaking of the interest rate cycle and the markets finally bottom out ahead while the loosening cycle is under process.

Our strategy over the last 12-18 months has been to be overweight “quality” and consumer discretionary as well as non-discretionary businesses. They have largely outperformed in difficult markets. But as is always the case, towards the end of the correction cycle the strongest stocks/sectors correct. While we have trimmed some of our holdings there, we will continue to hold them and take the short term pain as we believe that over the medium to long term the leaders will continue to outperform. So in effect we should be ready to take short term underperformance for long term structural gains. We also have some “cash” in our portfolio’s which we intend to deploy systematically as the markets correct. We would either add positions in the same/similar “quality” names or companies which should benefit from a reversal in the interest rate cycle.

While 2011 has been a poor year for Indian equities, 2012 may well end up quite differently.

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DEBT OUTLOOK

November was an eventful month for debt market. RBI started OMOs to ease liquidity. GDP growth slowed down dramatically but high inflation still persisted. In an unexpected move China slashed its reserve requirement for the banks first time in last three years. US Federal Reserve, European central bank, Bank of Canada, Bank of England, Bank of Japan and Swiss national bank coordinated with each other to offer cheaper swap lines, where local currencies are exchanged for dollar with the US Fed to ease the dollar crunch. All these events helped 10 year G-sec yield to ease by 14bps to 8.74%.

Adding to the global woes, the domestic data hasn't been too encouraging either. 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%. India's economy slowed down further and grew 6.9% in July-September, the slowest in over two years mainly to a contraction in mining and a steep decline in manufacturing growth. Eight infrastructure sectors – coal, crude oil, steel, petroleum products, natural gas, fertilizers, electricity and cement – virtually came to a halt in October 2011, a situation seen only six years ago. These industries grew a mere 0.1% in the month as compared to 7.2% in the same month last year.

India's headline inflation as measured by WPI for October came slightly higher at 9.73% compared with 9.72% for the previous month, marginally above market expectations of 9.65%. Primary articles' inflation declined to 11.40% (Y-o-Y) from 11.84% in the previous month due to sharp fall in non food prices, fuel & power inflation though climbed to 14.79% (Y-o-Y) from 14.09% in September. Manufacturing continues to remain a concern with at it stood at 7.66% (Y-o-Y) against 7.69% in September. Core Inflation (non-food manufacturing) that RBI closely monitors remained unchanged at 7.63% from 7.62% in September 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 10% by the end of March 2012 to around 7%.

The INR continues its weak run in November as it moved in the 48.69-52.48 range. There was an overpowering demand for the USD as the Euro zone crisis turned traders towards risk free assets. The RBI has a challenge in getting inflation down from the current levels. Clearly the decline in the rupee will lead to a higher inflation in the short term. Therefore, any easing in monetary policy by the RBI is well delayed into possibly late first quarter of 2012, possibly early second quarter, but certainly not in the near term.

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. 77,850cr. as on Nov 30, 2011). In a move which should be supportive of bonds, RBI announced INR 100 billion of bond buybacks through OMOs (Conducted on Nov 24th). This amount 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).

DEBT OUTLOOK

Both these moves should be supportive of government bonds, and expect the bond yields to ease a bit. Yields on Indian government 10-year notes fell 14 basis points last month, the most since February, to 8.74 percent.

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 8.75% - 9%. 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.

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