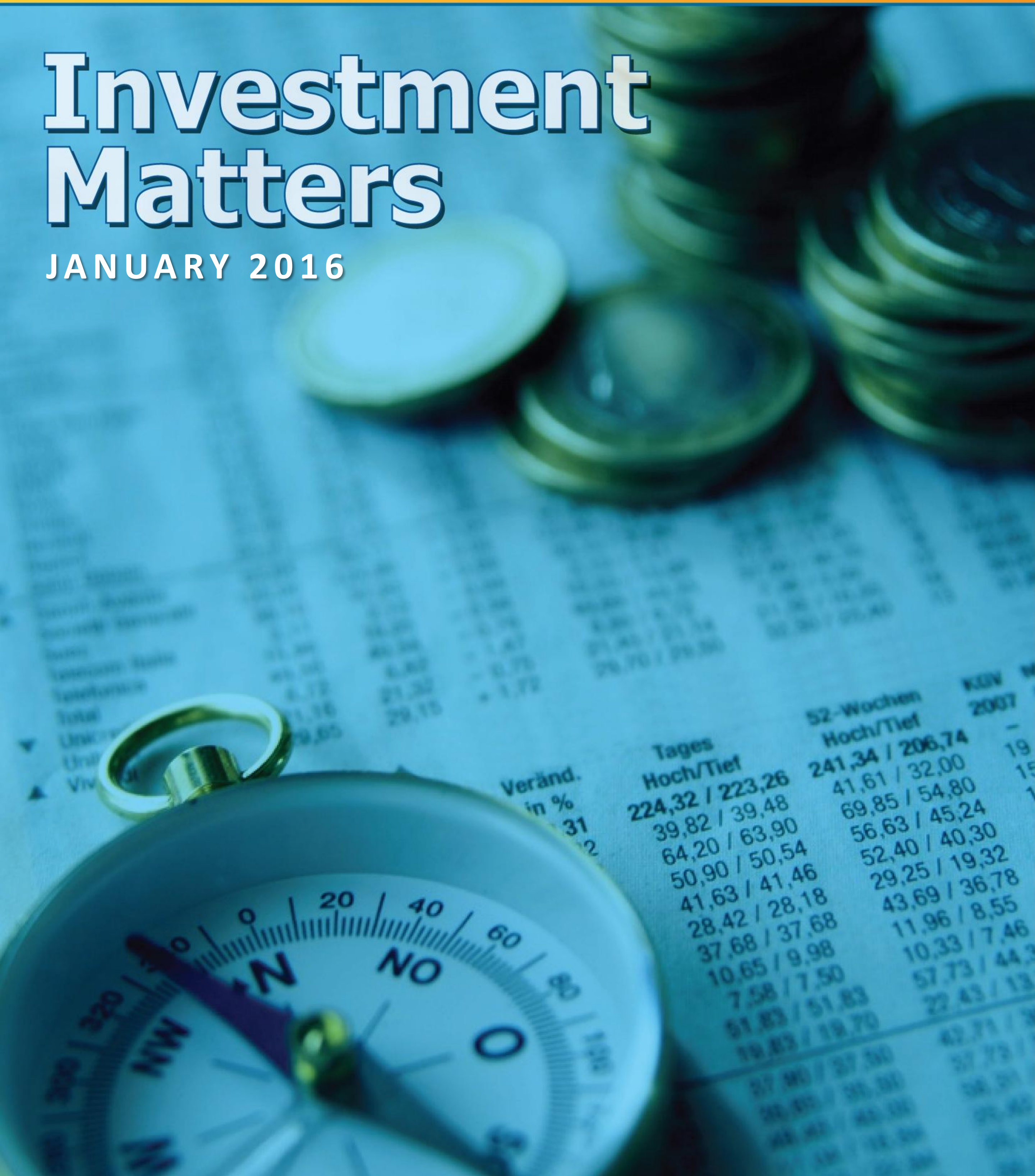
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

JANUARY 2016



EQUITY OUTLOOK

At the outset let me wish you all a Happy New Year. The year 2015 ended on a somber note as the carryover of the optimism from 2014 faded as the year progressed. While India clocked a nominal GDP growth of 7.4%, revenue growth for the listed corporate sector was almost flat and earnings estimates continue to be cut with every successive quarter. A pick up in the investment cycle still eludes us and is a bit surprising, though with the benefit of hindsight we know why, as the corporate deleveraging cycle continues, bank credit growth is tepid and the NPA problems come to the fore and capacity utilisation is still at low levels. To add to this the rural distress continues on the back of two back to back bad monsoons and lower agricultural crop prices. The construction and real estate sectors, amongst the biggest employers of unorganised labour continue to struggle.

To top it all, low or virtually zero trade growth worldwide has meant that Indian exports have been degrowing for most of 2015.

However, amidst all this malaise there have been a few silver linings.

Global slump in Oil prices has helped to bridge the fiscal gap which otherwise would be very difficult to meet given the lack of corporate profitability growth. Subsidies have been effectively cut using the DBT (direct benefit transfer), the increased use of which can transform many areas of expenditure management and make social investments more effective and productive. Recently, the state government of Tamil Nadu disbursed $120 MN (Rs. 700 crores) in a single day to flood affected families, something which would be unthinkable a few years ago as a significant amount of the relief money would have been lost to corruption and leakages notwithstanding the inordinate delays which would have made such financial help irrelevant. The opening of several million bank accounts and linking it to Aadhar - are revolutionary in itself as they lay a base for the eventual financialistaion of the economy.

18 months of the new NDA government has produced a few star ministers which have done some commendable work. Ramping up Coal production is a prime example. Power reforms have started and seem quite sensible as they enable the states to bailout the SEB's but not without an obligation to reform. Similarly, the road ministry has ramped up road construction by moving away from BOT to EPC. The Railway ministry under Mr. Suresh Prabhu though initially slow 'with his experiments in decentralisation is now showing clear signs of pick up in capital spending including a focus on improving customer amenities and services. The next big spending thrust is likely to come from Defense spending as that is the cornerstone of the Modi governments "Make in India Policy" and a key geo-political and economic leverage India is likely to use effectively as evidenced by key defence contracts given to US, France and Russia.

EQUITY OUTLOOK

The other big success is the aggressive wooing of FDI which has crossed its highest ever annual inflows in 2015 at approx. $35bn. Given PM Modi's personal involvement in wooing FDI and India's absolute as well as relative attractiveness, we have no doubt that FDI flows are likely to remain robust as the government tries to de-risk the investment cycle purely from domestic Indian corporate sector. The governments love for social media and startups has also cranked up significant inflows in India's fledgling but fast growing e-commerce sector. The launch of 4G by Reliance JIo and the other incumbents in the Telecom sector should create a potent ecosystem for new business models to flourish. This we believe is likely going to pose a challenge to current incumbents in several sectors as they get more competition from a liberalised FDI regime on one hand and a fierce e-commerce sector on the other. Hence, adaptability and focussing on remaining competitive will be very important.

On the political front, with the success in Delhi and more especially Bihar has given the opposition (unity irrespective of ideological differences) a template to defeat the enormous popularity of Modi. Hence, the BJP will have to innovate to stay in the game and cannot just rely on the popularity of PM Modi to win forthcoming assembly elections. A big loss in Bihar would also mean that the government will have to channelize more resources to the rural and farm sector to alleviate stress without losing fiscal prudence. That will be put to test in the coming budget. We are hopeful that BJP will regain its political chutzpah to get the opposition to agree on passing the GST a key reform legislation before everyone gets back into election mode for the all important UP state in 2017.

Several high frequency indicators followed by several research houses have indicated that the economy has turned the corner. While passive global flows to Indian markets may still be a challenge given the overall weak sentiment towards EM's, active India funds and local investors are likely to remain constructive given the long term structural opportunity in India. We are hopeful that the much elusive earnings growth will set in some time this year and markets will tend to discount this much in advance and that there will be reason to cheer as we progress into 2016.

Hiren Ved

Chief Investment Officer
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DEBT OUTLOOK

New Year Greetings from Team Alchemy!

What a year 2015 was, a roller coaster ride full of anxiety and excitement. Year 2014 started on optimism but ends with pessimism. It was a rare year when all the asset classes posted negative return except debt which posted marginal positive return. During the year RBI cut rates by 125 bps However, the impact of the rate cut on sovereign bond yields, especially at the longer end of the curve, was quite muted. While the 10 year yield, which was hovering around 7.90-95 levels at the start of the year, eased marginally by 10 bps by the year end, the yields at the far end of the curve in fact hardened.

Interesting thing to note is that while there was marginal fall in longer duration yields, Medium to short term yields fells more and hence out performed long duration segment. The yields at the 3-7 year segment eased by 25-35 bps compared to 10 bps in 10 year benchmark yield. Some of the factors which led to stickiness of the long term sovereign bond yields are: Higher share of longer dated papers in government issuance, Subdued rate of deposit growth and limited appetite for bonds, Uncertainty surrounding the FED lift off and its impact on Rupee too contributed to the cautious mood in the bond market, Uncertainty on the Government's ability to stick to fiscal consolidation path due to 7th pay commission burden and slower pace of nominal GDP growth, Re-emergence of inflation risks due to failure of monsoon. So in 2015 short term and accrual strategy performed better then long term funds.

With the RBI highlighting the impact of pay commission on the fiscal numbers, it would want to wait and see the markets response to the government's ability to meet the 3.5% Fiscal Deficit target. If the market senses that the budget numbers are credible and the government has resources to meet the 3.5% target, it would improve investor confidence and the RBI will be able to utilize the limited space available to cut rates to 6.5%. Any reduction in interest rates post that would depend on the RBI achieving the 5.0% inflation target.

Asset allocation is the only way to generate consistent returns. We suggests investors to have a diversified approach and invest in Short term funds, Long duration funds, Accrual strategy and part in tax free bonds. We expect interest rates in long term would be at lower levels compared to current levels and hence 7.2% to 7.40% tax free yield is good rate to invest in. Also as interest rates falls these bonds may trade at premium resulting capital appreciation. We advise existing investors to hold on to their duration portfolio and wait for further reduction in the yields. For new fixed income investments we suggest to invest larger allocation of 40% in short term funds, small allocation of 20% in duration funds to generate capital gains and another 20% allocation in accrual strategy and remaining 20% in tax free bonds to get benefit of current high yield available in the market to generate consistent returns.

Advisory Team

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