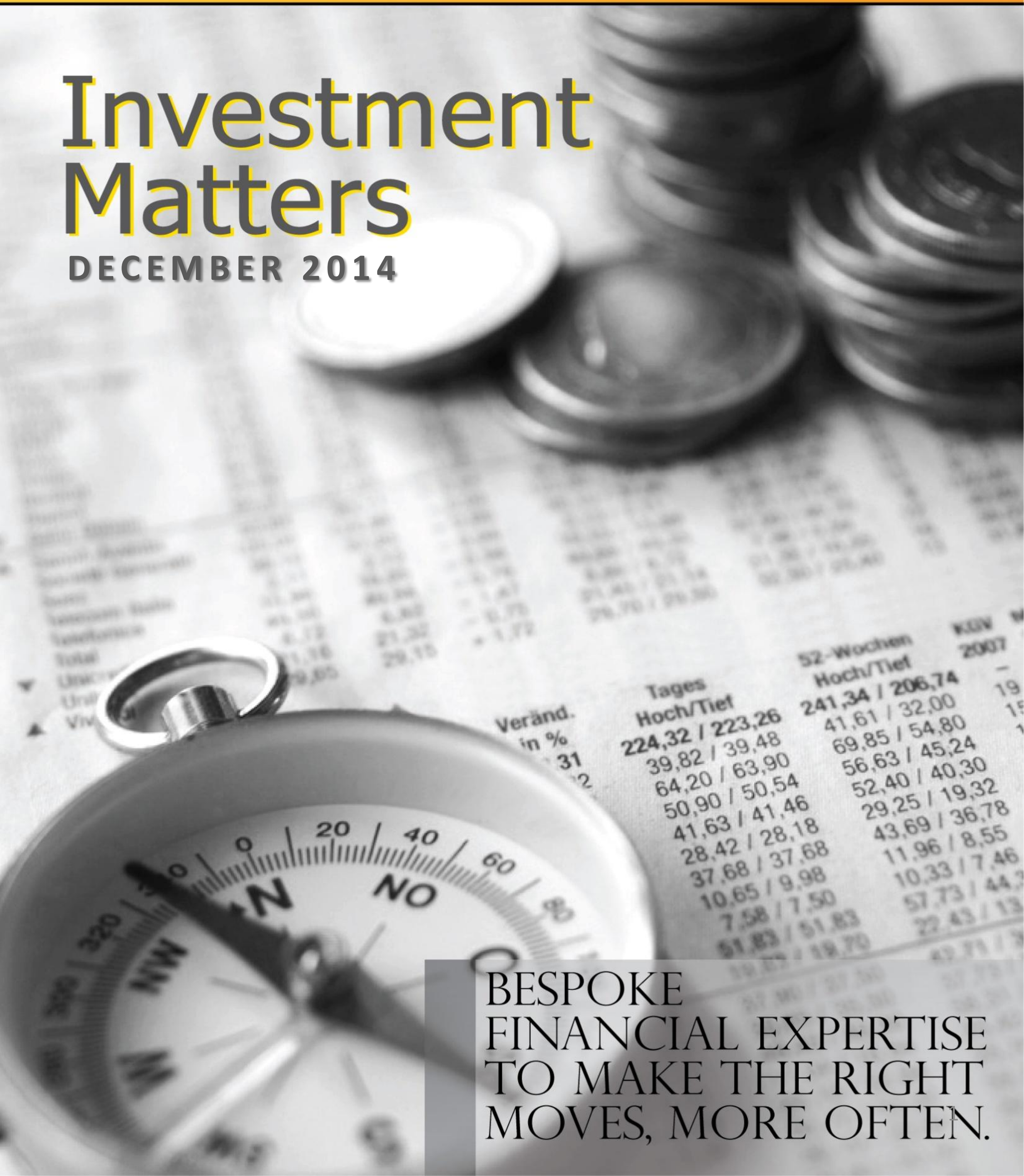
ALCHEMY
PRIVATE WEALTH

Investment Matters

DECEMBER 2014



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

EQUITY OUTLOOK

India as an economy is undergoing a gradual transformation, focused on decisive government at the centre, skill based development, pick up in investment cycle, discipline in government finances, digitalization of government records – Transparency, stability of currency against the US$, lower cost of capital (equity and fixed income), pick up in manufacturing activity led by improvement in demand dynamics and exploiting the demographic dividend.

The government has started on a promising note to address each of these elements one by one. To begin with the PM has handpicked the right people to man key ministries ie Power/Coal given to Mr Piyush Goyal, Railways given to Mr Suresh Prabhu, Defence with Mr Manohar Parrikar, Roads and Transport ministry with Mr Nitin Gadkari and the Finance Ministry with Mr Arun Jaitley. These individual ministries has now seen a significant shuffle at the secretary/bureaucracy level with a lot of bright people being inducted to support the ministers. The past seven months of this government has seen the placement of the right people at the right place (HR transformation in corporate language).

The biggest focus for the government as of now is to kick start growth momentum led by renewed spending on infrastructure development. The Roads ministry is the first to start on this area by coming out with bids worth >4000 kms ie Rs 40,000 cr approx – to put things in perspective, average bids in roads for the past 5 years has been less than 2000 kms and the new government has targets to do 3-4X this number every year starting with 4000 kms in FY15. The Rail ministry on the other hand continues to award large contracts for the ambitious dedicated freight corridor project (DFCC) funded by the Japanese agencies and the World Bank. The DFCC corridor has placed orders worth >Rs 12,000 cr over the past 12 months and the pace of ordering will gain further pace going ahead. The Coal ministry has initiated the process of auction of coal mines in the country for the first time ever. The process of the auction of mines is expected to be completed before the end of FY15 with separate mines allocated for the power sector and other industries. The objective is to increase fuel security for the power projects in the country and provide cheaper power tariffs to consumers. This will go a long way in solving the various issues being faced by the power companies currently. Apart from this efforts are on by both coal and the rail ministry to clear logjams in setting up new rail lines for transportation of coal from Coal India to various power plants – the government is targeting to double coal production by Coal India from current 480 mtpa to 1000 mtpa by FY19 through a mix of investment in new technologies in Coal India mines, removing hurdles for transportation of coal through the Indian Railways and allocating new mines to Coal India.

India is one of the largest country in the world in terms of defense related spending with 70%+ being imported. Domestic manufacturing of defense products has been entrusted with public sector companies with very low private participation. The government intends to change this with higher participation from the private companies within India. The new Defense minister along with the PM are focusing on formulating guidelines to make it easier for private companies to get technology from global companies and set up manufacturing base to make in India. The numbers are large at $ 38bn annual spending and can have a meaningful impact on capex/investment activity in the country over the next few years.

The finance minister is entrusted with a challenging job to fund all the capex of the government to kick start the economy, ensure the fiscal deficit is under control to achieve the targeted 3% of GDP by FY17. As of now the government/finance minster is lucky with sharp correction in crude prices. Crude prices have fallen to <$70 per barrel from $100+ a few months back. Every $1/bbl correction in crude prices helps the government save $600-700 mn on an annualized basis. However, to reach a 3% to GDP fiscal deficit, the government needs to focus on reforming the various subsidies being doled out ie Oil & Gas, Fertiliser, Food, Passenger Railways etc and at the same time broaden the tax base to enhance tax revenue. One major initiative which the government is working on is to implement the GST regime. The government has mentioned their intention to implement the GST regime from April 2016, however the act needs to be passed in the parliament where they do not have the required majority as of now and need support from the regional parties. The finance minister will need to take all the state governments along with him to help clear all pending issues of the states like compensation of under recovery to states by the center on implementation of the GST and reduction in CST rate of tax. This remains a time consuming process and the sooner it is implemented the easier it will be for the government to take care of its finances and improvement in macro parameters.

Faster execution of the various initiatives mentioned above can help the economy pick up pace early and lead to higher earnings growth for corporate going ahead. We are optimistic on both the pace of change and the team that is leading this change and hence are bullish on the market over the next few years. We believe corporate earnings can potentially grow at >20% CAGR for the immediate 2-3 years if the government is able to deliver on the points mentioned above led by higher GDP growth going ahead. However it will require patience which will be rewarded handsomely. In the words of Warren Buffet, "*Successful Investing takes time, discipline and patience. No matter how great the talent or effort, some things just take time: You can't produce a baby in one month by getting nine women pregnant".*

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DEBT OUTLOOK

Celebrations are back and Christmas bells are ringing again in debt market. Market has just ignored the RBI action and kept its upward move continue. 10 year G-sec fallen to 7.95% as on 2nd December 2014. Since September 2014 we have been giving bullish view on interest rate and mentioned that interest rate by its own would gradually come down even without policy rate cut. We have already seen rally of 50-60 bps since September. The RBI, in its bi-monthly monetary policy review, left the repo rate unchanged at 8% but the key highlight of the policy is its dovish guidance. The RBI has acknowledged that disinflation in past few months has been faster than anticipated, and hinted at easing early next year (even outside the scheduled policy reviews) in case disinflation and fiscal prudence continues, both of which are highly likely. Inflation projection for March 2015 has been scaled back considerably, while the policymakers do not see upside risks to the 6% target (January 2016) anymore.

Market is discounting all the positives in advance and moving forward with positive guidance from Macro economic developments. A sharp fall in recent CPI readings below the RBI glide path, weak credit and investment demand and also the correction in crude prices in the recent past had been expected to force the RBI to change the monetary policy stance in the December monetary policy review. However, the central bank has rightly stayed on course awaiting further data to validate the durability of disinflation impulses in the face of continued uncertainties especially related to agricultural production and also administered price corrections. Uncertainties surrounding the evolution of inflation post the reversal of base effects early next year and also the fiscal deficit targets have also supported a status quo at the current juncture. If the current disinflationary impulses sustain and fiscal developments remain encouraging, the RBI has hinted to change its stance early next year, including outside the policy review cycle.

Bond yields and swap levels have declined sharply over the month with expectations of the RBI stance undergoing a change. Foreign investors have invested a record $ 24 Billion in Indian bonds this year. With their limits for sovereign bonds getting exhausted, demand for corporate bonds has gone up resulting in credit spreads tightening substantially. The global deflationary environment as reflected in ultra-low bond yields in the rest of the world has led to aggressive bidding by foreign investors. India offers a high carry with expectations of relatively stable currency and a positive turn in the monetary policy cycle.

Outlook Upgrade from leading international rating agencies like Moody's and S & P on India's rating will prove to be positive for Indian fixed income markets. Macro developments are extremely positive for fixed income markets and are structurally building-up a case for lower interest rates in the near future. We believe, valuations in fixed income are reasonable and sentiments are negative, this makes a strong case for investing in fixed income today. We have been given bullish call since last 3 months and recommending investments in long duration funds. The shorter end of the curve is likely to remain supported as the outlook for liquidity remains comfortable. We suggest some allocation in duration products to get the benefit when interest rates would fall.

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