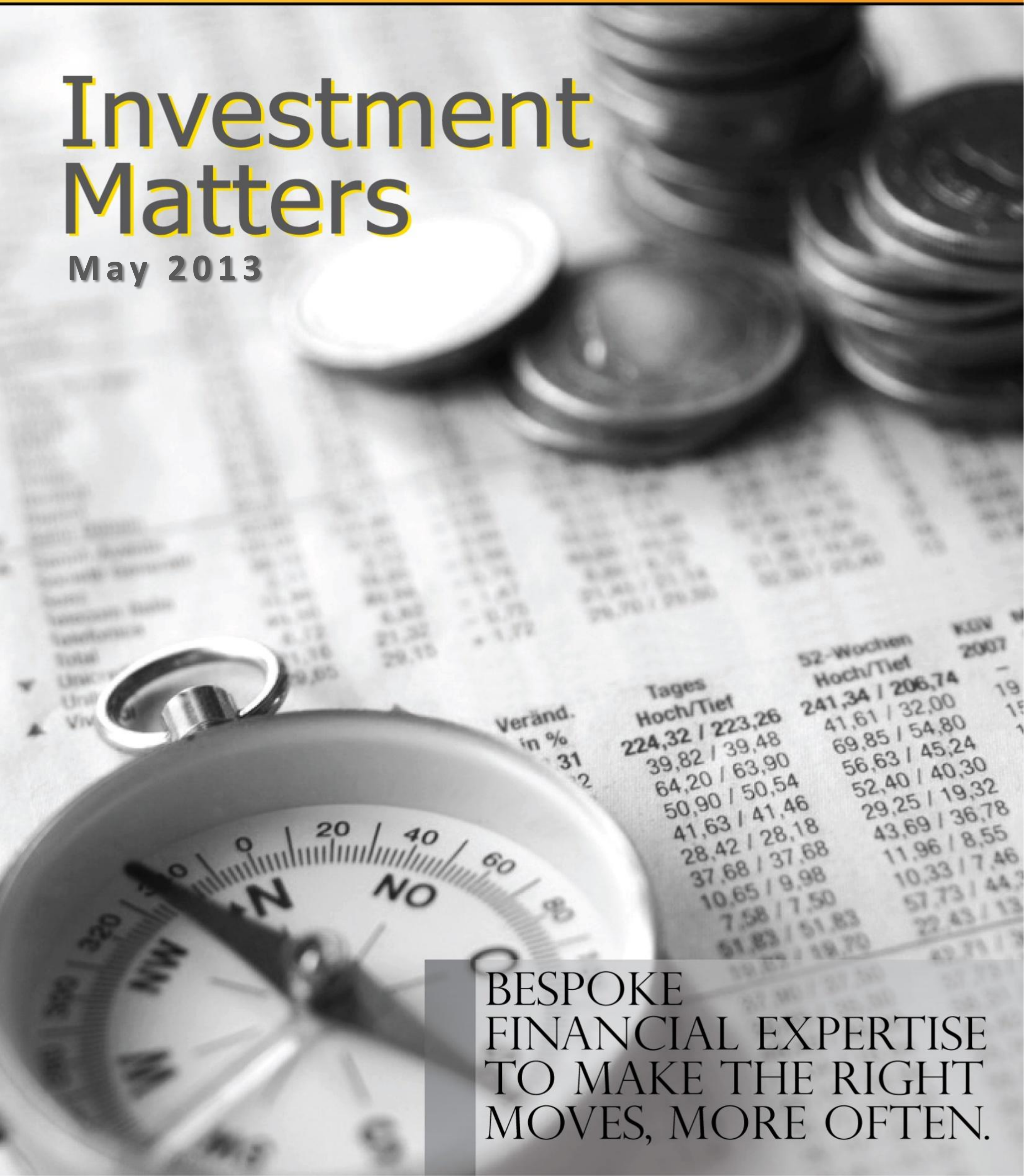
ALCHEMY
PRIVATE WEALTH

Investment Matters

May 2013



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

EQUITY OUTLOOK FROM CIO'S DESK

Equity markets rebounded during the month post a weak Jan to March 2013. CNX Nifty went up by 4.4% while the BSE 500 by 4.2%. FIIs continued to invest in the Indian markets with net positive flows during the month at $0.8bn on the other hand, DIIs continued to sell with net selling at -$0.4 bn.

A spate of Open Offers/Delisting/Buyback's by MNC's into their Indian subsidiaries has driven up the valuations of these MNC stocks during the month led by HLL, Glaxo Consumer, Fresenius Kabi, Astra Zeneca etc. We take this as a sign of confidence that large multinational companies have in the long term potential of India. What is significant is that this investment qualifies as significant inflow in the form of long term FDI into India. The recent Jet Airways-Etihad deal is also positive as it signals interest in an otherwise beleaguered sector in the country and speaks volumes of the growth potential in India. Sometimes these kind of deals put competitive pressures on other peers to follow. The open offer by Unilever to acquire 22%+ stake in HLL alone is likely to bring in fresh FDI to the tune of $5.4 bn apart from the other offers mentioned above. From a macro economic perspective, we have been highlighting our concern on high current account deficit which India faces today and the need to bring this down to a more reasonable level of around 2-2.5% of GDP from current 5% for FY13. The year FY14 has started on a very positive note on this count with commodity prices correcting sharply including crude and gold – key to our high CAD – and at the same time FDI flows have picked up meaningfully. This has positive implications for the Rs/$ rate in the short term and allows both the government and the RBI room to focus on growth going ahead. Apart from the FDI flows, the government in the finance bill 2013, has reduced the withholding tax for all FII investments into fixed income instruments including government securities to 5% from 20%. This is a much anticipated move by the government and was essential to encourage large long term institutions to invest in a big way into government securities/corporate bond market in India. This is another big step by the government to ensure India continues to get high FII flows into the country given the high current account deficit.

Over the next 12 months, markets will witness heightened activity on the political front with a slew of state elections round the corner (see table below) and also the general elections in CY14.

Upcoming State Elections

State	Date	Representation in Lok Sabha	% in Lok Sabha	Incumbent
Karnataka	May 2013	28	5.2	BJP
Chhattisgarh	Nov 2013	11	2	BJP
Jammu & Kashmir	Nov 2013	6	1.1	JKNC
Madhya Pradesh	Nov 2013	29	5.3	BJP
Delhi	Nov 2013	7	1.3	Congress
Mizoram	Dec 2013	1	0.2	Congress
Rajasthan	Dec 2013	25	4.6	Congress

It is very premature to hazard a guess on which political party will have a edge in these elections, however one can, based on past experience, conclude on a few key variables which are likely to have an impact on the equity markets –

1. Government spending is likely to pick up meaningfully over the next 12 months – In the past, a year prior to general elections government spending has increased within a range of 20% - 30% compared to the prior year. Interestingly, FY14 budget promises to up capital spending by 30% over FY13 estimates.
2. Reform measures will be limited in nature – We expect reforms like Reduction in fuel subsidy, hike in power tariffs to take a gradual back seat and the government to focus more on social spending to boost sentiment .
3. Significant new projects/schemes being announced by various governments largely on social spending – Government is likely to work extra hard to pass the food security bill entailing additional food subsidy of 20-30k crore and also work on direct cash transfers for distributing subsidy like scholarships, fuel etc
4. Parliament may continue to be disrupted as has been the case in the past – With a number of corruption cases coming out in the open, we continue to expect the parliament to be disrupted as has been the case in the UPA II regime.

Overall, news flow will at the best be mixed with improvement on the macroeconomic parameters, a key positive, while hike in social spending and promises for more to come a key negative. It is in this kind of scenario we expect good stock selection can play an important role in investor's portfolio. We at Alchemy endeavor to work diligently on identifying the better performing companies and invest in them to drive alpha for the client over the long term.

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DEBT OUTLOOK

Fixed income markets have rewarded investors consistently for last 2 years. In 2011 as the yields were high, FMP and short term fund category did well. In Year 2012 as interest rates started falling, Income and Gilt funds posted good returns. In short to make consistent return one needs to be patient and build the portfolio with the changing scenarios.

We have entered the new financial year with many positives. In last four policy meetings RBI has reduced Repo rates in three meetings. Please recall any of our newsletters in past six months, we were positive on interest rates and managed our debt investment strategies accordingly. Following are the key points of the meeting:

•In its May policy review meeting Reserve Bank of India cut its benchmark repo rate by 25 basis points for the third time since January 2013, as expected, but said there is little room for further monetary policy easing in near future. The central bank kept the cash reserve ratio (CRR) for banks unchanged at 4%. However, it warned that the risk of inflationary pressure persists despite a recent sharp decline in Wholesale Price Index (WPI) -based inflation, and said a high Current Account Deficit (CAD) poses the biggest risk "by far" to the Indian economy.

•In its annual monetary policy review, the Reserve Bank of India (RBI) cuts the benchmark repo rate by 25 bps to 7.25% and accordingly the reverse repo was revised down to 6.25%. Marginal Standing Facility (MSF) and bank rate have been revised to 8.25%, lower than 8.5% before the rate cut.

•The central bank opted to keep the Cash Reserve Ratio (CRR) unchanged at 4.00% after it was reduced by 25 bps in the third quarter policy review on January 29, 2013. The RBI's baseline projection of GDP growth for 2013-14 stood at 5.7%.

•According to the RBI's guidance, WPI inflation is expected to be range bound around 5.5% during 2013-14.

•Limits of Held-to-maturity (HTM) have been realigned from the present limit of 25% to 23% and would become effective by way of reduction of at least 50 bps every quarter, beginning with the quarter ending June 2013.

The statement highlighted: "Recent monetary policy action, by itself, cannot revive growth. It needs to be supplemented by efforts towards easing the supply bottlenecks, improving governance and stepping up public investment, alongside continuing commitment to fiscal consolidation. With upside risks to inflation still significant in the near term in view of sectoral demand supply imbalances, ongoing correction in administered prices and pressures stemming from MSP increases, monetary policy cannot afford to lower its guard against the possibility of resurgence of inflation pressures. Monetary policy will also have to remain alert to the risks on account of the CAD and its financing, which could warrant a swift reversal of the policy stance. Overall, the balance of risks stemming from the Reserve Bank's assessment of the growth-inflation dynamic yields little space for further monetary easing. The Reserve Bank will endeavor to actively manage liquidity to reinforce monetary transmission, consistent with the growth-inflation balance."

There is also wide spread debate going on about non transition of rate cuts by banks in lending rates, Key reason being the liquidity problem in the banking system. Loan-to-deposit ratios have remained at elevated levels as deposit growth remains at a 10-year low. In turn, the key driver for low deposit growth is that inflation expectations, as measured by CPI inflation and indicated by RBI's inflation expectations survey, have remained high even as WPI inflation has been moderating. Please recall RBI governor's comment in ET dated 7th May 2013 "RBI to use all means to manage liquidity - He has categorically said the assumption that OMOs will be the preferred tool is wrong.

Don't go by this assumption. We will use all options available to us depending on the liquidity situation...it could be OMOs, it could be CRR cut or it could be something else..” we believe that it will take a while before these policy rate cuts are fully transmitted to reduction in lending rates.

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 10 year G-sec to be fall and settle between 7.40% to 7.75%. As a strategy we are overweight on Dynamic and Income fund category with investment horizon of more than one year. We don't suggest FMPs at this point of time due falling yields.

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