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PRIVATE WEALTH

Investment Matters

JUNE 2014

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

A Decisive majority government at the centre bodes well for the long term health of the economy. We have been highlighting in our past newsletters about the likelihood of the BJP led NDA government coming to power in India; the actual verdict has been much better than anticipated with the BJP getting 282 / 543 seats (336 seats won as NDA) which means a simple majority for a single party, a first in the last 30 years. The decisive verdict should help the BJP led government push through its progressive economic agenda unlike the fractured mandates of the past years which hindered the reform process.

Despite its numerical superiority, the new government may face potential challenges which are worth mentioning. However, our view is that they have a plan to address these challenges too.

1. India is a federal state and under the constitution, states have significant powers of legislation on key economic issues (states have exclusive authority to legislate on several key economic matters including water and joint authority on matters relating to land, labour and electricity). The BJP currently governs only 7 out of the 29 states in the country. Narendra Modi, being an ex-Chief Minister of Gujarat clearly understands this and hence has mooted setting up of the National Development Council (which include the state chief ministers) and Inter-State councils to smoothen the partnership between the Centre and the States to effectively execute the development agenda.

2. All new legislation has to be approved by both houses of parliament. However, BJP and its allies only control 62 / 250 seats in the Rajya Sabha (Upper House). Hence passing bills in the upper house could be a challenge. While a joint session of a Parliament can be called upon to resolve a deadlock (NDA has slightly over 50% if there is a joint sitting, this option has been only used thrice in the past). The members of the Rajya Sabha are elected by members of legislative assembly of each state and retire every six years. Hence the BJP will have to win upcoming state elections to augment its presence in the Rajya Sabha and given the state election calendar it will be a couple of years before BJP along with its allies can be in majority here. Hence the new government will have to rely on some deft political maneuvering to get its legislation passed. BJP's early moves to endear themselves to two strong non-NDA state governments of Tamil Nadu & Orissa soon after the elections are a step in this direction.

   The first few steps of the government suggest it is going to be a more decisive and purposeful government. The new cabinet comprises of only 45 ministers for now (79 ministers in the previous regime) and various ministries are being merged where synergies are possible. E.g. Coal and Power, given that coal availability is the biggest bottleneck for the power sector. The large number of Empowered Group of Minister's (9) and Group of Ministers (21) created under the previous government has been disbanded. Accountability has been fixed with each of the Ministries with regular review with the PMO. To re-energise the bureaucracy, the Prime Minister has assured the bureaucracy of protection against malicious prosecution for bona fide decisions.

EQUITY OUTLOOK FROM CIO'S DESK

The President of India on 9th June gave his introductory speech in the parliament which is like a vision document of the new government. The speech clearly highlights that the incoming government clearly understands the 'Development with Good Governance' mandate for which voters have elected them.

The key focus of the government as spelt out in the president's address points to focus aggressively on getting growth back, reign in high inflation, re-ignite the investment cycle by making it easy to do business and having a stable and a predictable tax regime and to focus on skill development to augment job creation and open up several sectors of the economy for FDI including some key sectors like Defense.

The next step is the budget announcement likely in the 2nd week of July'14 where a road map for implementation of the above over the next 5 years will be addressed. The markets have heightened expectations from the Finance Minister (FM) to present a firm roadmap towards fiscal consolidation (boosting revenue, lowering subsidies and meeting funding gaps for investment spending through innovative financing or disinvestments) and at the same time boost investment demand through faster clearances and reducing regulatory bottlenecks (there is already talk of loosening some environment norms). The markets expect the government to push towards implementing the Goods & Services Tax (GST) regime as well as open up FDI in a host of sectors including Defense.

There are other big tickets reforms ideas where the government seems to doing some ground work but will take time to be implemented. If implemented these would solve the capital needs of the banking sector and the productivity issues at Public Sector Companies.

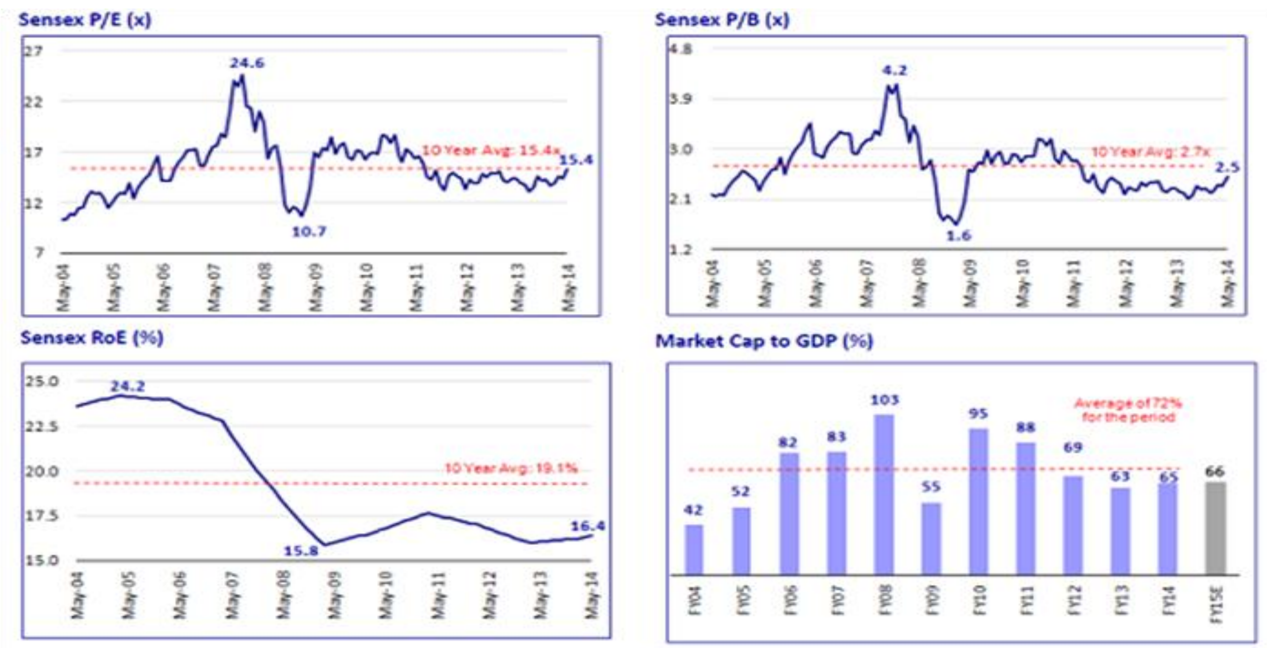
• Indian banks need US$40bn of capital over next 5-years as per various estimates. The idea is to setup a Public Sector Bank holding company which should help the government raise capital at both the bank as well as at the holding company level without diluting control. At present (holding company cannot be constituted under the Companies Act as public sector banks are corporations established under the Act of Parliament and are not companies, so a separate act will need to be passed for this). The Government of India ownership of PSU Banks stands at US$57bn.

• Setting up a holding company for Public Sector Units (PSU) – on the lines of Singapore's Temasek – to give autonomy and better manage state-owned firms. Most PSU chiefs would tell you that they would have performed better but for the interference of Ministers and their Departments. The idea is to take these companies away from the clutches of bureaucracy and have them report to an independent board comprising of distinguished experts in various fields. The Government of India ownership of non-bank PSU's stands atUS$177bn.

Meanwhile, the markets have already given a big Thumbs-Up to the BJP's historic victory with Sensex, Midcaps & Small caps rallying 8.0%, 15.6% and 18.0% in the month of May'14.

While markets have moved up in the short run and there are pockets of exuberance, valuations are far away from any overvaluation territory and we see enough opportunities across sectors. As a long term investor we are less focused on the near term market movement and more focused on the long term opportunities that this market offers and will continue to offer over the next few years

1. Valuations are near to long term averages, they peak at much higher multiples.



Source : MOSL

2. Consensus earnings estimates are building in 15-16% earnings growth over next 3 years but we know from past cycles (see table below) that when economic growth picks up after a downturn, earnings growth is much faster as operating leverage kicks-in as good companies use the bad period to reduce cost and become more efficient. Hence eventual valuation multiples may be lower than currently predicted.

Sensex Earnings Growth since 1990.

Year	EPS	Growth (%)
31-Mar-90	50	18.80%
31-Mar-91	59	18.80%
31-Mar-92	79	32.90%
31-Mar-93	81	2.90%
31-Mar-94	129	59.30%
31-Mar-95	181	40.30%
31-Mar-96	250	38.10%
31-Mar-97	266	6.40%
31-Mar-98	291	9.40%
31-Mar-99	278	-4.50%
31-Mar-00	280	0.70%
31-Mar-01	216	-22.90%
31-Mar-02	236	9.30%
31-Mar-03	272	15.30%
31-Mar-04	348	27.90%
31-Mar-05	450	29.30%
31-Mar-06	523	16.20%
31-Mar-07	718	37.30%
31-Mar-08	833	16.00%
31-Mar-09	820	-1.60%
31-Mar-10	834	1.70%
31-Mar-11	1,014	21.60%
31-Mar-12	1,125	10.90%
31-Mar-13	1,183	5.20%
31-Mar-14	1,294	9.40%

On the portfolio front, while we have not chased a Beta rally, the fund has done reasonably well on the back of exposure to select high quality companies which had valuation comfort and strong earnings growth. We expect better days ahead for the markets and portfolio performance should reflect the same going ahead.

Hiren Ved

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DEBT OUTLOOK

Debt markets cheered the thumping victory of BJP and we saw sentiments improved across segments. Market momentum has remained positive over the last month, with strong FII debt flows continuing post the election results. FII net debt flows were about Rs 201 billion last month, with strong flows seen in the Gilt category since the election results. FII interest has been reinforced by the strong election mandate and a stable currency even as in the context of soft global rates, the yield spreads remain very attractive. 10 year G-sec fell to 8.62% on 30th May 2014 from 8.82% on 30th April 2014.

On 3rd June 2014, RBI announced the following measures in its Bi monthly credit policy review:

1. Kept policy repo rate under the liquidity adjustment facility (LAF) unchanged at 8%;
2. Reduced the statutory liquidity ratio (SLR) of scheduled commercial banks by 50 bps from 23% to 22.5% of NDTL;
3. Liquidity provided under the export credit refinance (ECR) facility reduced from 50 per cent of eligible export credit outstanding to 32 per cent with immediate effect;
4. Introduce a special term repo facility of 0.25 per cent of NDTL to compensate fully for the reduction in access to liquidity under the ECR with immediate effect;
5. Continue to provide liquidity under 7-day and 14-day term repos of up to 0.75 per cent of NDTL of the banking system.

While keeping rates unchanged, RBI has attributed the recent rise in CPI inflation on seasonal increase in food prices and has acknowledged that the core CPI inflation has been edging down. RBI views the risks to its CPI target of 8% by January 2015 as broadly balanced. It is of the view that even though sub normal monsoon poses a risk to food prices, the likelihood of government measures to improve food supply, fiscal consolidation efforts as well as pass through of recent appreciation of rupee could be important mitigating factors.

RBI seems to be implementing the recommendations of the Urjit Patel committee. In the last policy, the central bank had further curtailed access to overnight liquidity window. This process has been taken forward by curtailing sector specific liquidity access via the export credit refinance (ECR) window and moving it to variable rate term repo. The SLR cut of 0.5% in June policy, is consistent with the longer term objective of reducing statutory limits in order to free up banks' resources for productive lending. As fiscal consolidation progresses and other sources of demand for government bonds get more robust, SLR will progressively get cut further.

A directional move in bond yields would be dependent on a more consistent and durable easing in CPI inflation and also the fiscal stance. The Union Budget to be presented by the new government would provide better clarity regarding the prospects of medium term fiscal deficit trends and the likely market borrowings for funding the same. We expect inflation to gradually fall and with the stability of Rupee, interest rates will be also cool off in next 6-7 months. Short term funds are poised to deliver better risk adjusted returns. We also advise investors to allocate 15-20% in long duration fund.

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