ALCHEMY
PRIVATE WEALTH

Investment Matters

MAY 2014

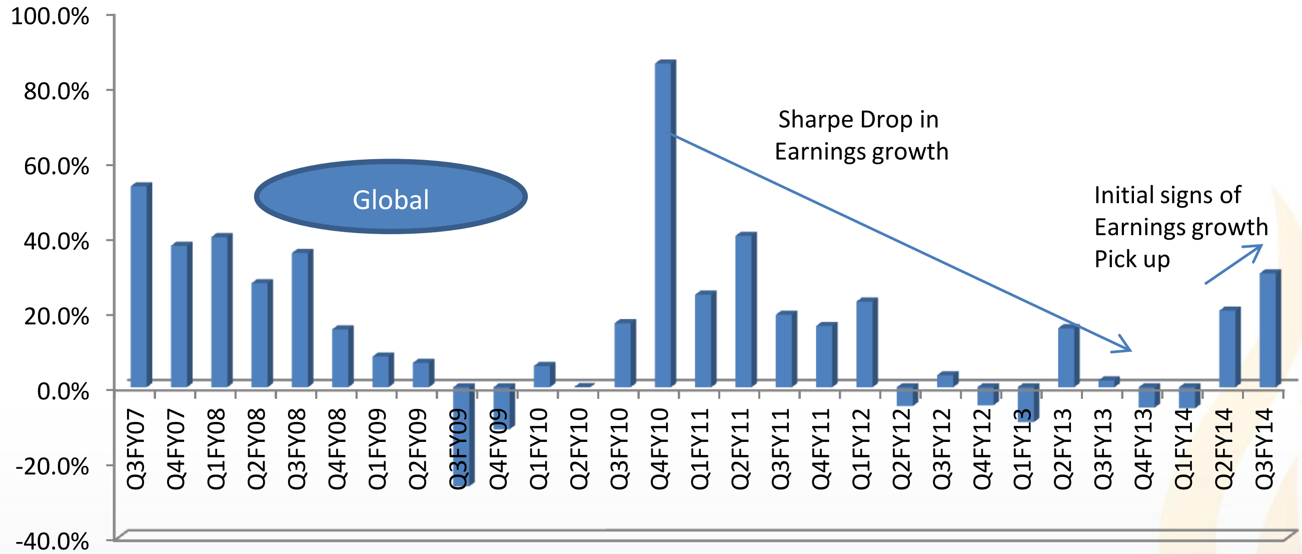
BESPOKE
FINANCIAL EXPERTISE
TO MAKE THE RIGHT
MOVES, MORE OFTEN.

EQUITY OUTLOOK FROM CIO'S DESK

Equity markets at all time highs – Sensex closer to 23000 levels - bring about various emotions from market participants. Most attribute the current rally to the prospect of a Narendra Modi led BJP forming the new government at the centre on May 16, 2014 and expect the markets to continue the bullish form going ahead. Some investors having seen a decent up move in portfolio stocks over the past 6 months, are preferring to play safe by booking profits either fully or partial and would invest again if the BJP is able to form the government with majority. While there are some who think that the markets have run up beyond what fundamentals warrant and hence are bearish on the markets trajectory going ahead.

All opinion polls predict the BJP to emerge as the single largest party and with some support from other allies will be in a position to form the next government at the centre led by Mr Narendra Modi as their prime ministerail candidate. Mr Modi's credentials are well known as a strong and able administrator. We believe that a Modi led government can prepone the growth prospects initially led by change in sentiment followed by pick up in capex both private as well as public leading to higher demand growth in the economy. Earnings growth trajectory for the corporate is likely to increase to high double digit on the back of a positive growth momentum.

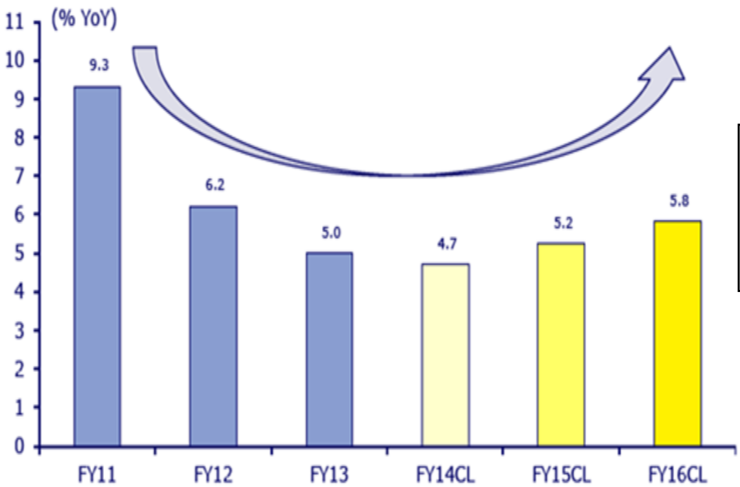
We are in the camp which believes that for the Indian economy worst is behind and infact recovery is on its way, though gradual. Interestingly, earnings growth for corporate India bottomed out in the September 2013 quarter and since then we have seen double digit earnings growth sustaining. GDP growth is also likely to be higher in FY15 compared to FY14.



Earnings growth pick up started from September 2013 – Expect double digit earnings growth over the next 12 months.

Figure 2

India annual GDP growth rate



Source: CLSA

GDP growth likely to pick up, though gradual – possibility of growth surprising on the upside in event of a BJP led government at the centre with majority.

An interesting observation worth highlighting is the fact that almost 45% of BSE 500 (Broad market benchmark index covering close to 90% of the market capitalisation of India) stocks are still below the levels reached in December 2010. Nifty/Sensex since 2010 have moved up by around 15% and the BSE500 index has moved up by 10%, however there are 224 stocks in the BSE 500 stock index which are still below December 2010 levels.

Another data point to highlight is the fact that valuations in the Mid cap space continues to be very reasonable and the PE difference compared with Nifty and the CNX Mid Cap index is still wide. As can be seen from the chart below the average historical PE difference between Nifty index and CNX Mid Cap index is around 200-250 bps which currently stands at 408 bps. It is observed in the past that whenever the Mid Cap PE discount widens to closer to 400 bps as it stands currently, the ensuing 12 months period is generally a good period for Mid Cap stock performance.

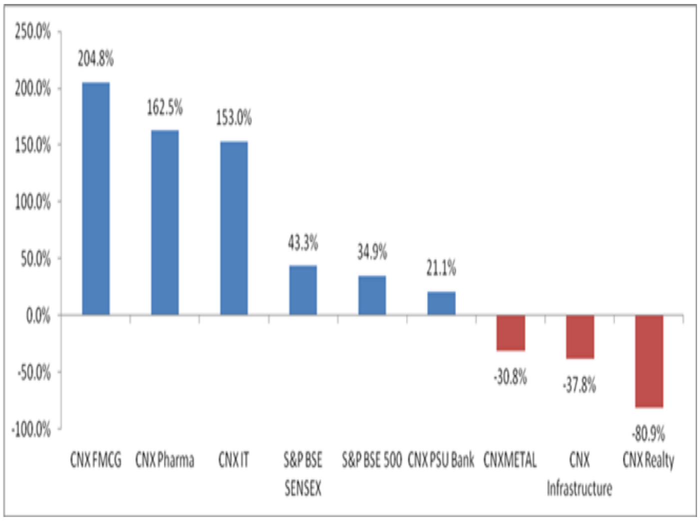
Mid Cap PE discount current at 408 bps – historical average stands at 200-250 bps.

Past experience suggest Mid Caps do well when discount rises to greater than 300 bps as it stands currently.

Breadth of the market is likely to improve significantly.

EQUITY OUTLOOK FROM CIO'S DESK

Over the past 6 years since the financial crisis in 2008, the market breadth has been extremely narrow with only a select few sectors/companies performing well whereas there are a whole host of sectors which continue to remain laggards in terms of performance as can be seen from the chart below. The better performing sectors of the past are today trading at all time high valuations while the underperforing sectors are trading at all time low valuations. This is clearly not sustainable and as and when the economy starts performing better, which we believe is likely to happen gradually over the next few years, the under performing sectors/stocks have a large potential to rerate. Needless to mention that one needs to be very choosy and selective and focus only on companies where management teams are strong along with a balance sheet which will allow the management teams to exploit the upcoming opportunities in terms of higher demand for their products.



FMCG, Pharma and IT have outperformed in large manner over the past 6 years – trading at high valuations.

Banks, Metals, Infra and Realty have underperformed and are trading at attractive valuations.

Scope of rerating exists in the underperforming sectors.

We believe with the economy health on the mend coupled with the prospect of a stable government at the centre led by Mr Narendra Modi, equity markets are likely to deliver healthy returns with the breadth of the markets improving and the Mid/small Cap segment of the market outperforming over the next 2-3 years and beyond. We in our portfolios are well positioned for this eventuality with close to 48-50% allocation to select mid caps, 10-15% small caps and balance 35-42% select large cap companies. We believe our investee companies are likely to grow earnings between 20-25% over the next 12-24 months and are available at reasonable valuations driving our confidence for a strong performance going ahead.

Hiren Ved

Chief Investment Officer
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DEBT OUTLOOK

April 2014 brought some cheers to the debt market. Market was stable and 10 year G-sec yield came off to 8.8% from high of 9% in the month of March. RBI in its April 1 monetary policy meeting maintained the status quo on policy rates with the broad direction of policy setting influenced by the Dr Urjit Patel committee recommendations. The policy stance underscores the disinflation “glide path” of achieving 8% CPI inflation by January 2015 and 6% by January 2016. Based on the current evolution of CPI inflation trends, RBI is likely to maintain a status quo on policy rates. In this context, a more directional stance on rates would primarily be dependent on the new government’s fiscal stance, with external sector developments also influencing the outlook on inflation. A more proactive liquidity management as seen in the last few months with term repo being the primary instrument would ensure that the overnight rates remain in line with the prevailing policy stance and also the short end of the curve remains well anchored in the absence of any additional liquidity premium.

Incremental news on inflation has not been positive and has put in place an upside risk to the near term inflation trajectory. Apart from the normal upward seasonality in coming months, recent disruptive weather in parts of the country has already started pushing up prices of some primary articles including vegetables. Seasonally adjusted momentum on core CPI remains sticky even as the headline print has softened somewhat. Finally, global weather agencies and our own met department are warning of an El Nino phenomenon this year which may result in deficient rains. On the positive side, if the new government indeed shows strong commitment to supply side measures, it can potentially take away some of RBI's burden and help achieve the targeted disinflationary path without further monetary policy action.

On liquidity front, RBI further restricted liquidity at overnight window to 0.25% of NDTL of banks amounting to around Rs.20,000 crores in the April policy. As a result, even with liquidity deficit fallen from around Rs.2,00,000 crores as at mid-March to Rs.1,00,000 crores towards mid April, overnight rates have continued to be volatile; averaging more than 8.5% for April. Besides, the central bank has also restricted FIIs from making incremental investments in treasury bills. This, along with volatility in overnight rates, has ensured that Treasury bill yields have remained in the 8.8 – 9% yield band.

Given the RBI stance on achieving the disinflationary glide path that sees CPI at 8% by Jan 2015 and 6% by Jan 2016 and continuous supply of Govt. securities we expect yields to be range bound between 8.70% to 9% for coming month. High short term rates would continue in May so we believe FMP and accrual strategies will keep giving attractive yields.

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