ALCHEMY
PRIVATE WEALTH

Investment Matters

OCTOBER 2013

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

EQUITY OUTLOOK FROM CIO'S DESK

It is common perception, fueled by the various pre-poll surveys and analysis, that the forthcoming general election could result in a hung parliament. While the BJP has been gaining in polls and the congress losing from its current tally, the gain for the BJP is not large enough for it to get a clear majority with its current allies. The poll math suggests that either of the two national parties would have to get 182 + seats to take a serious shot at forming the government.

To recap, a party needs support of 272 members of parliament out of a total of 543 to form the next government at the centre. CY09 general elections saw the Indian National Congress party win 206 seats with a share of 37%, a big jump of 61 seats from its first term of only 145 seats, and along with the support of allies, the UPA II government total strength in the parliament went up to 234 (a minority government). However, including the outside support of parties like SP, BSP, JDS and RJD the present UPA government's total tally goes up to 283 – a majority position in the parliament. It is this mathematics that has helped create a government at the centre and the same numbers has not allowed the present government to function smoothly with the opposition parties being able to disrupt the parliament consistently specially in the past 4 years of UPA II without much business being transacted.

It is important to note that increasingly regional leaders who have formed their own parties have been gaining strength on the back of good work done at the respective state levels for example the Biju Janata Dal (BJD) from Orissa won a total of 14 seats in 2009, JDU (Bihar) won 20, AIADMK (TN) won 9, DMK (TN) 18, SP (UP) 22, BSP (UP) 21. The total vote share for parties other than the Congress and the BJP has consistently been above 50% of the total vote in the country over the past few decades. The increasing size and scale of these regional parties necessarily means that the next central government most likely will be a coalition government of 1 national party either congress or BJP and combinations of various regional parties.

This is the second term of the UPA (united progressive alliance) government at the centre with some changes in the allies compared to its first term. This term of the government has been mired with a host of corruption scandals and seen some of the responsible ministers being sent to Jail by the Supreme Court. Most macroeconomic indicators have been relatively weaker over the past 4 years with slower GDP growth, higher inflation and higher interest rates. At the outset, history shows that it has been very difficult to retain majority for any government – good or bad – beyond the 2 full consecutive terms in fact since 1991 India has never seen a government win two consecutive elections except for the current UPA alliance. The odds are very much against the current UPA government to win a third term to run the country. The various opinion polls suggest a prospect of a hung parliament with both the BJP and the Congress failing to touch the magic figure of 180 seats in the parliament, however, as always, election results can and does throw surprises and it is important to gauge the mood of the nation closer to the actual election than a survey made some 9-12 months prior to the actual event.

Opinion polls closer to May 2014 will be more relevant to analyze and more importantly the upcoming 5 state elections in November 2013 i.e Delhi, Rajasthan, MP, Chhattisgarh and Mizoram will provide insights into what is likely to happen in May 2014 –

Recent polling

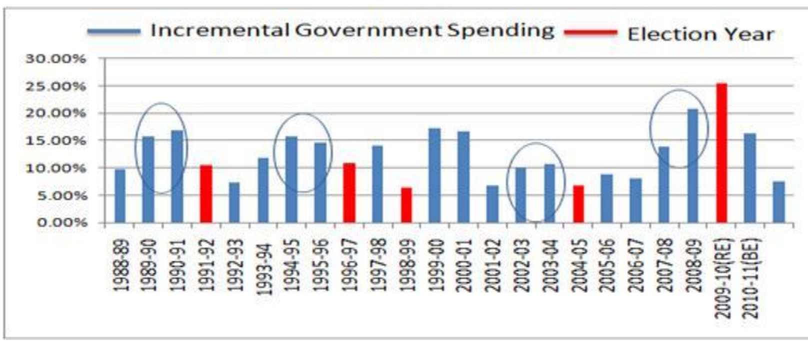
Party	Times Now April 2013	CNN IBN July 2013	India Today August 2013	Poll range	Poll avg	2009	Gain/(loss)
Congress	113	135	122	113 - 135	123	206	(83)
Congress Allies	15	18	15	15 - 18	16	28	(12)
BJP	141	161	135	135 - 161	146	116	30
BJP Allies	24	15	20	15 - 24	20	18	2
Left	26	25	30	25 - 30	27	25	2
SP	35	19	34	19 - 35	29	22	7
TMC	27	25	23	23 - 27	25	19	6
AIADMK	27	18	30	18 - 30	25	9	16
BSP	26	17	27	17 - 27	23	21	2
JDU	19	17	10	10 - 19	15	20	(5)
BJD	13	14	13	13 - 14	13	14	(1)
YSR Congress	12	13	13	12 - 13	13	0	13
RJD	7	10	13	7 - 13	10	3	7
TRS	9	7	12	7 - 12	9	2	7
TDP	9	8	9	8 - 9	9	6	3
Others	40	41	37	37 - 41	39	34	5

Source: CLSA; C-Voter State of Nation report; India Today-CVoter Mood of the Nation opinion poll, CNN-IBN, Times Now

In terms of the election manifesto – key promises by both the principal parties – you do not find too much of a difference in the end objective. Both parties (Congress & BJP) on the whole have been promising sustainable and inclusive growth with low inflation, the 2009 manifesto is worth a read of both the parties – they both highlight the need for a decisive government at the centre which can bring sustainable inclusive growth in the country and at the same time inflation along with interest rates being low. Both parties have some interesting thoughts on how to achieve the end objective for example the BJP wants to focus on skill development and empowering the people to make their destiny while the congress wants to focus on providing security in terms of food, education, health and putting money in the hands of the consumer to spend more thereby achieving higher growth in the economy. Both parties have a tendency to be a bit populist, however the Congress strongly believes in the entitlement system, increasing subsidies and bloating the balance sheet with consequences we have seen in the recent past like high inflation and high twin deficits. The BJP though and especially under the leadership of Narendra Modi believes in "Less Government" but better "Governance" and focus on skill development which we think makes more sense to achieve sustainable growth. One needs to increase the size of the cake before distributing it to the ones that deserve it the most.

EQUITY OUTLOOK FROM CIO'S DESK

Closer to elections, historically, the ruling party has on most counts been pro growth, focused towards putting more money in the hands of the consumer and higher than normal capital expenditure on developmental activities largely infrastructure. Naturally, GDP growth closer to elections has been higher than the immediate past, however on the flip side, fiscal deficit has also been difficult to contain since during these times typically subsidies tend to move up, the government tends to avoid taking tough measures like hike in diesel/petrol/LPG/Fertilizer prices. However the interesting fact is that equity markets mostly behave better closer to elections and returns for investors are pretty healthy during such times as can be seen from the table below –



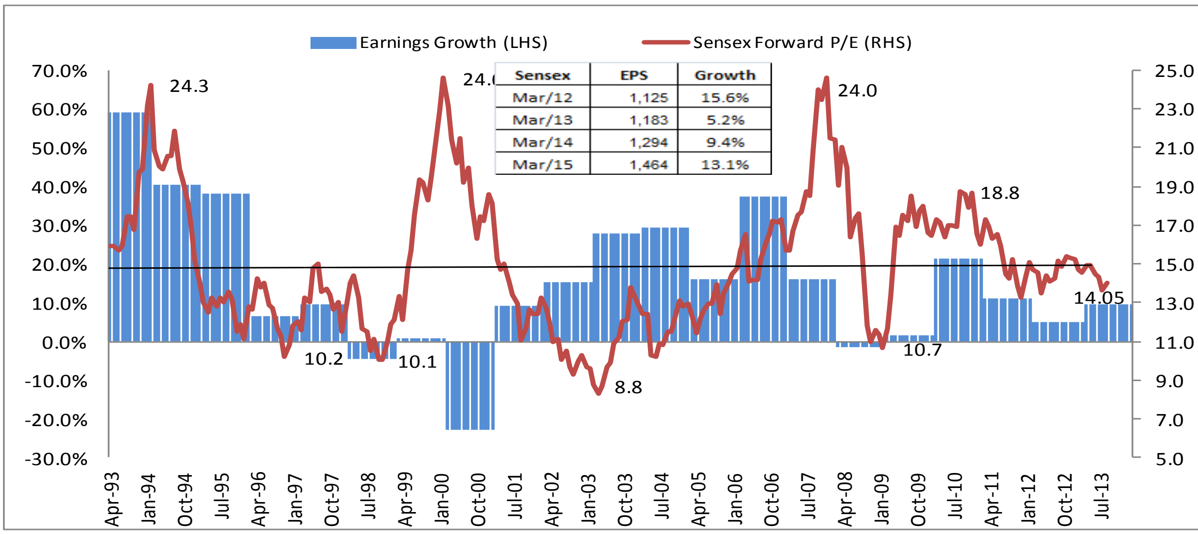
Election Year	Financial year prior to election year	Sensex Returns
1991	1990-91	55.33%
1996	1995-96	22.13%
1998	1997-98	4.24%
2004	2003-04	91.06%
2009	2008-09	-9.34%

It remains to be seen how FY14 pans out, however, we are already seeing the first signs of the government trying to clear investments in infrastructure projects led by the Delhi Mumbai Industrial corridor (DMIC) worth $10 bn spread over the next 5 years – contracts for implementation of the first phase have been awarded already. The government is also working hard in clearing various hurdles for the power generation industry led by coal supply linkage from Coal India and fuel cost pass through mechanism. Though the benefits of this will be visible over time, however these are sentiment boosters for the sector. On the flip side, the government is taking baby steps in lowering of the fuel subsidy and is risking to overshoot the fiscal deficit target of 4.8% for FY14 at the same time it is working with the RBI to bring more FII flows on the fixed income market to fund the current account deficit. Ultimately, the new government will have to take concrete steps to resolve the fiscal as well as the current account deficit.

The election season is upon us and we are sure to see interesting times in the market. While people are still skeptical about a regime change in 2014, we believe that the NDA led by the BJP has momentum behind it and while it is not a certainty, we believe a very high probability, that in the end they might just make it. Some of the skepticism about NDA's ability to win in 2014 could wane once the results of the four state elections are out and the markets may start building in a "Modi premium" ahead of the elections.

Source: Alchemy Research

EQUITY OUTLOOK FROM CIO'S DESK



The valuations in the markets are reasonable more so for the broader markets and we are past the worse in terms of the currency crisis and growth. The CNX Mid Cap Index is now trading at a 440 bps discount compared to the Nifty index PE, the average discount being 200-250 bps. We strongly recommend investors go overweight equities going into the elections rather than waiting for the final outcome. It is in uncertain times that the greatest gains are made.

Hiren Ved

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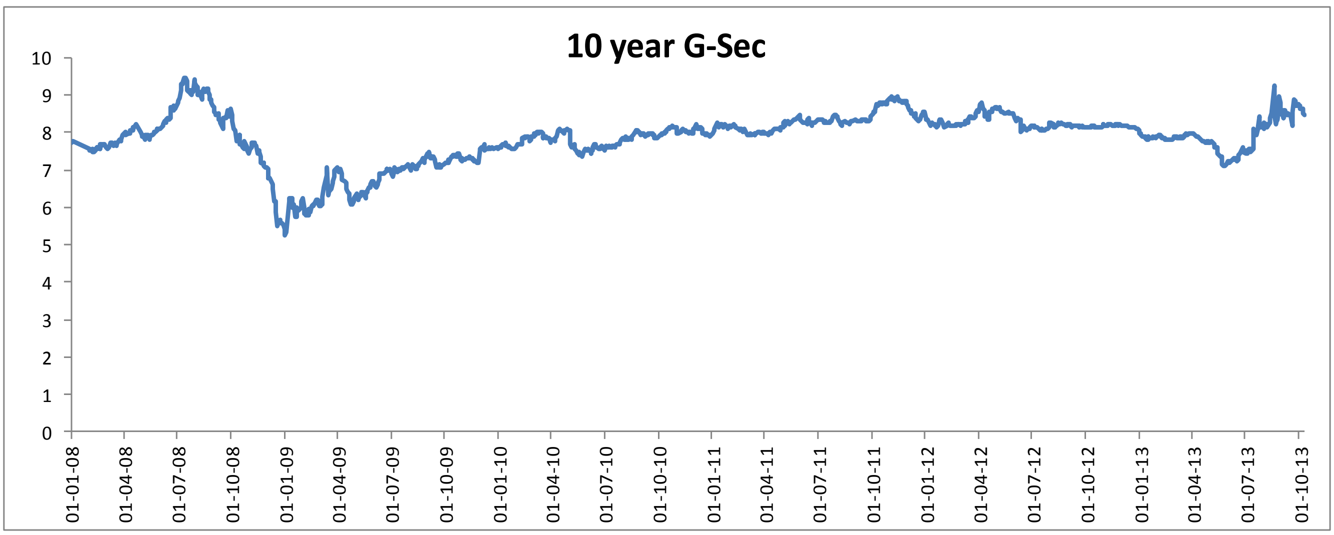
Source: Bloomberg, Alchemy Capital Management Pvt Ltd.

DEBT OUTLOOK

Recent volatility in fixed income markets has shaken the confidence of investors. So this time I thought, I should focus on demystifying the reasons for such volatility and what one can expect going forward. Before going in detailed examination of reasons, let me first list down the risks involved in debt products: Interest rate risk, Credit risk, Reinvestment risk and liquidity risk. Current volatility in debt products is happening due to interest rate moments. Whenever interest rate goes up the bond prices goes down and vice a versa. As Debt funds are marked to market the fall/rise in the bond prices has to be accounted for in calculating the net asset value.



Interest rates moved up dramatically in the month of July 2013 due to the initial liquidity tightening measures announced by RBI and caused interest rates across the curve to spike higher. The new 10 yr benchmark yield hit multi-month high level of 9.48 on an intra-day basis because of weakness in currency and spike in crude oil.

RBI's subsequent announcement on 20th August 2013 of OMO purchase and relaxation of rules for bank holdings of government securities caused market to subsequently rally substantially.

On 28th August 2013 RBI announced that it will offer a forex swap window to meet entire daily dollar demand of the 3 oil marketing companies (OMCs)

Source: Bloomberg, Alchemy Capital Management Pvt. Ltd.

RBI also offered a special concessional window to banks to hedge dollar risk on fresh deposits garnered under FCNR (B) deposits for a minimum period of 3 years. This dollar swap will be available at a fixed rate of 3.5%. This is a good 350 – 400 bps lower than market levels for the hedge. Additionally, under an earlier guideline the RBI had exempted maintenance of CRR and SLR on such new FCNR deposits and also allowed banks not to maintain priority sector lending on advances made against such new deposits. In total, these measures have substantially brought down the 'landed' cost in rupee terms of raising FCNR deposits. With these new guidelines these deposits may become the cheaper option. Foreign banks are expected to bring in substantial flows via this route as they can offer leverage to their off-shore NRI investors and thereby increase manifold the quantum invested under such deposits.

The month of September 2013, witnessed the both the US Federal Reserve (Fed) and the RBI surprising the markets by their policy actions. Firstly, the Fed continued with its asset purchase program at $ 85 billion a month, surprising markets that were expecting a partial rollback in the US central bank's September 18, 2013 policy meet.

The RBI in its Mid Quarter Review of Monetary Policy FY 2013-14 held on Sept 20, 2013 took the markets by surprise by effecting 25 bps Repo Rate hike along with steps towards cautiously unwinding some of the exceptional tightening measures undertaken in July 2013 to restore normalcy to financial flows. The markets were expecting some reduction in the spreads between the MSF and the Repo Rate which was indeed brought down by RBI to 200bps from the earlier 300 bps.

The Wholesale Price Index (WPI) rose to a six month high of 6.10% in August 2013 from 5.79% a month ago due to a weak rupee and rise in the prices of food articles. The food inflation rose sharply to 18.2% in August 2013 from 11.9% in July 2013. India's current account deficit widens to $21.8 bn, or 4.9% of GDP, in the June quarter from $18.2 bn in the previous quarter. GDP growth rate is expected to come down below 5%.

All of the above mentioned events have made yields very volatile. Our assessment is that, given where we are in terms of the economy, wherein we are struggling for growth, it is very unlikely that we will see significant repo rate hikes from here on. We believe that RBI would try to narrow the gap between Repo & MSF rate further more to address liquidity issues. We feel that Short term yields will come down in next 1-2 months and long term yield (10 year G-sec) would range bound between 8 to 8.75%. Suggested Investment strategy is to follow asset allocation and diversify the debt portfolio between short term funds, long term funds and FMPs. Conservative clients can also look at allocating some amount to Tax free bonds. Current high yields make them very attractive from long term investment perspective.

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