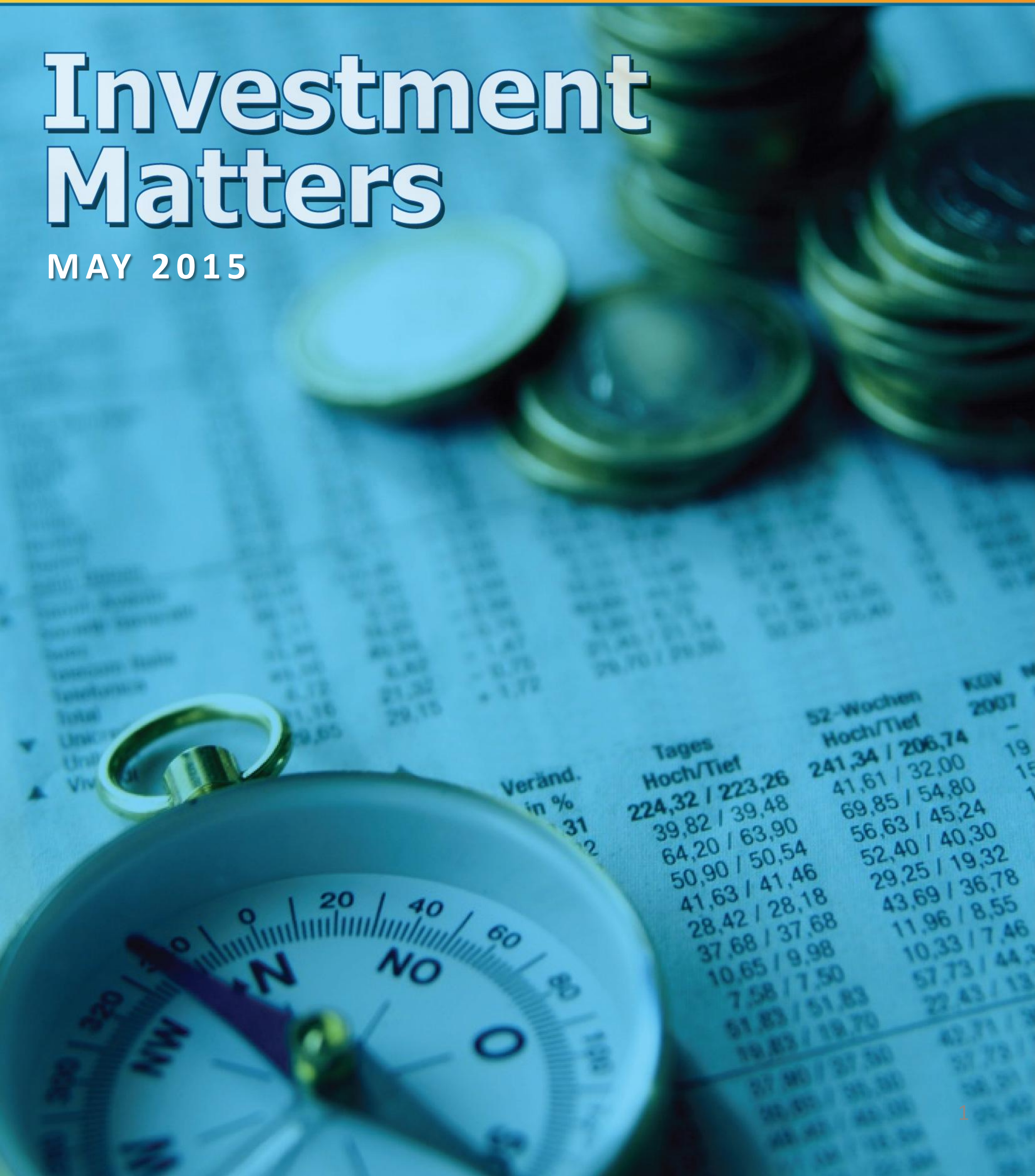
ALCHEMY CAPITAL MANAGEMENT

Investment Matters

MAY 2015



EQUITY OUTLOOK

AN ALTERNATIVE TAKE ON - WHY THINGS HAVEN'T CHANGED ON THE GROUND?

On the eve of the completion of one year of the Modi Government, it is obvious that investors are asking the Promise v/s Performance question or the Expectations v/s Reality question. Many economic indicators, especially growth indicators like IIP, exports, non-farm credit growth, volume growth across sectors like infrastructure, cement, metals, auto (barring HCV's) and including consumer sectors, are still either in negative territory or in very low single digits, begging the question – have things on the ground really changed? Quite relevant. The only indicator that seems to have grown is our GDP based on the New series.

To be fair, many other macro indicators have improved – Fiscal Deficit and Current Account Deficit for one, the rupee has been amazingly stable barring the current few weeks and the inflation trajectory is firmly down. But the lack of growth and the amazingly slow pace of industrial/capex cycle recovery is worrying investors.

The reasons are well known and debated – still relatively high interest rates as RBI has been relatively conservative in cutting rates; complex problems continue to plague the infra sector though clear attempts have been made to resolve several issues (coal auctions and higher domestic coal production, gas pooling, etc.); weak and still highly leveraged balance sheets of large corporates who were at the forefront of the pervious investment expansion cycle; weak bank balance sheets especially those of PSU Banks; poor agri commodity prices and a combination of unseasonal rains and lower wage growth having negatively impacted the rural demand.

All of these are relevant observations. However, we believe that there is an alternative take to the growth conundrum that is not very well debated, making the issue of "on the ground change" much more nuanced.

THE INVENTORY EFFECT – LOWER TOP LINE GROWTH AND POSTPONEMENT OF BUYING

Substantially lower commodity prices have meant that many companies and trade was sitting on previous high cost inventory of both raw material and finished goods. Usually, it takes a couple of quarters for the high cost inventory to work through the system. Especially, traders and intermediaries would be staring at immediate loss on inventory reducing their ability to buy immediately to build inventory, especially if they believe that prices will continue to come down. For value added producers, that means a lower top line as prices have to be reduced. This can be seen in the top line growth of BSE500 companies in the current quarter which has degrown by -5% (For 158 companies reported so far). Even after adjusting for Financials and Oil & Gas (RIL), the BSE500 reported sales growth is weak at 4.2% (For 122 companies reported so far ex-financials and ex-RIL).

THE WEALTH EFFECT – REAL ESTATE & GOLD

Over the last few years i.e. pre 2014, household savings have got locked into hard assets like gold and real estate, both favorite asset classes for investment. Gold prices have fallen from a peak of $ 1800 to now below $ 1200 (with customs duty and the Rupee depreciation, that has meant an even lower price). Real estate has been the most favored asset class in India. There is now an oversupply in several markets, prices are lower, investor demand has evaporated and volumes of transactions have dropped. Our interactions with mortgage finance companies and real estate dealers bear this out. According to them, a lot of liquidity has got locked up in real estate. Investors want to sell but prices are not attractive and hence volume of transactions have dropped. Genuine buyers are waiting for interest rates and prices to fall before they step in. This lock up of liquidity and an inability to liquidate is another reason that is impacting confidence in the system. If interest rates fall further, it would be possible to liquidate inventory or borrow against property at lower rates to use that liquidity elsewhere.

EQUITY OUTLOOK

BLACK MONEY AND CORRUPTION

Corruption was amongst the major reason (other than inflation) why the UPA lost elections and the BJP came to power. The spectacular win of the AAP party, also a crusader against corruption, also added to the environment where black money and corruption have taken centre stage in India's politics. No wonder, the current BJP government wants to enact a very strict anti corruption and black money law. Many studies have shown that the size of the unaccounted/informal economy is probably as big as the accounted/formal one. The recent regulatory noose on corruption, with investigating agencies like the CBI, CAG and CVC actively pursuing alleged corruption practices, has brought fear into both recipients as well as givers. It would be fair to assume that the fear of getting caught would have considerably reduced consumption, especially discretionary type like cars, real estate and land. This is one more reason why velocity of money and hence demand would have got impacted. How long this lasts is anybody's guess but in the short to medium term, it has definitely impacted demand.

BALANCE SHEET REFORM V/S P&L CUTBACK TO BRING DOWN INFLATION

Other than corruption, inflation was another major issue in the last election. The government has moved swiftly to combat inflation, obviously helped by lower oil and commodity prices. The government has clearly moved to decontrol petroleum product prices, cut subsidies and target them better through the roll out of Aadhar and UID (Unique Identification Number). The rate of increase in rural wages has been contained and minimum support prices paid to farmers has seen the lowest increase in many years. These are prudent and welcome steps, important to keep the fiscal deficit in check. But a cutback on giveaways, which directly go into the hands of the recipients, is also one of the reasons why demand, especially in rural India, has been so soft. Many reforms initiated by this government are what we would term balance sheet reforms – e.g. lifting FDI in several sectors, clearing stuck projects, trying to improve ease of business – however, all of these will hopefully have impact over the long term but the emphasis on cutting government spending and subsidies directly impacts current demand.

DISINTERMEDIATION IN SEVERAL SECTORS

The rapid growth of e-commerce and the mobile revolution is putting pressure on some old business models. Though the trend is still young, it has started impacting some of the businesses like traditional retailers. The VC/Private Equity players have been funding startups at a furious space. In the last 2 years, one - fourth of $22 Bn private equity Investments in India has gone to e-commerce alone. The aggressive rollout of services and price discounting has left the traditional business models unprofitable. How long will the e-tailers be able to survive with ever increasing losses is anybody's guess but currently, it is putting tremendous pressure on traditional trade channels. It is weaning the incremental buyer away from them curtailing demand for the traditional retailer. The recent consolidation in the retailing industry (merger of Future group with Bharti) is clear indication that on a standalone basis, they are finding it difficult to operate and make profits. It will take some time before the traditional businesses adapt to the this new competition or private equity dollars dry up funding these new startups. However till then, this creative digital disruption is causing short term pain.

We believe that some of the above factors are co-mingling with traditional factors and creating some short to medium term dislocations and challenges to growth. Hopefully, stakeholders in the economy will adapt to the new normal, but till then investors and policy makers will need to have patience till growth picks up again.

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DEBT OUTLOOK

RBI in its May 2015 policy meeting left interest rates unchanged and projected GDP under new series at 7.8% for FY 16 (from 7.5% in FY 15), but with downward bias and expects CPI to be around current levels in Q1 FY 16. The RBI aims to keep inflation 'at or close to' the mid-point of 4%.

Last year we saw good rally in G-sec yields especially in the 2nd half of FY 2014. Bond yields have remained flat over the last quarter in spite of a cumulative 50 bps policy rate reduction by the RBI. As monetary policy setting becomes largely anchored to the evolution of CPI trajectory and given the inflation targeting framework in place, the hurdle for the extent of incremental easing has moved up. At the same time, over the near term any market data that points to uncertainty surrounding evolution of CPI would have a bearing on bond yields. Over the last month, the bond market faced headwinds arising from an uptick in crude prices, weakening currency and the Meteorological department forecast for a below normal monsoon for this year. FII debt flows slowed down over the month with net outflows till about the 3rd week.

Bond yields moved up by about 10 bps over the month as near term uncertainties increased, accentuated by FII selling and weaker currency. Notwithstanding heightened uncertainties surrounding monsoons and its impact on inflation, macro-economic conditions and credible policy efforts provide confidence on a more durable moderation in CPI going forward. Government bond yields have also been impacted due to the illiquidity premium priced in most of the on-the-run bonds currently with current issuance sizes closer to the maximum caps. With first half bond supply being lower as compared to the previous year and also considering lower credit demand, the demand supply equation remains favorable at the margin.

On policy stance, while the RBI explicitly assures that accommodative stance will be maintained, future rate actions will depend upon a host of variables. These include transmission of previous rate cuts by banks, development in food prices from unseasonal rains and assessment of monsoon ahead, proactive efforts from government on supply response towards key inputs, rerouting subsidy into investment spending, reducing pipeline of stalled investments, as well as signs of normalization of US monetary policy.

CPI inflation for March fell to three-month low of 5.17% as compared to 5.37% for Feb-15. The trade deficit for March widened to USD 11.79 billion from previous month's USD 6.9 billion as exports declined by 21% YoY (to USD 23.95 billion) while imports contracted by 13% YoY (to USD 35.74 billion). The decline in exports was on account of muted global growth while rise in gold imports could be largely attributed to stocking on account of Akshaya Tritiya festival. Liquidity has remained tight during the month as government spending is yet to pick up, but it is likely that liquidity improves substantially over the next couple of months.

Global issues like muted growth, low inflation, weak manufacturing activities, easing measures by the central banks and concerns over Greece's exit from euro zone continued to dominate the markets during the month. US continued to post weak macroeconomic data: the sharp moderation of job growth in the month of March and weaker than expected US GDP growth at 0.2% annual rate in the first quarter of 2015. This has led to the expectations of US rate hikes being pushed back for now. China too continued to post weaker than expected data points. Chinese economy grew at 7.0% annual rate in the first quarter of 2015, its slowest rate in six years. China also witnessed bond defaults in April – a state owned company and a couple of private companies. Also, its central bank further eased its monetary policy by cutting the reserve ratio for banks by 100bps.

DEBT OUTLOOK

World is facing low growth across the globe and as a result we see accommodative policies from large economies. Currently, our nominal policy rates are actually higher than other countries with similar macro-dynamics and thus fixed income flows into the country have been substantial over the last year. This has resulted in rupee appreciating against virtually every other major currency in the year so far. In the absence of accompanying productivity improvements, this renders our exports incrementally uncompetitive. If major trading peers ease their monetary policy further and we don't, then on the margin this pressure via the currency channel becomes even more accentuated.

Given above challenges and RBI’s focus on targeting CPI around 4%, immediate interest rate cut seems to be postponed. We believe RBI will take in account the monsoon factor and its impact on food prices before further rate cuts. We are bullish on bond prices and except interest rates to eventually fall in next 12 months. As a fixed income investment strategy we suggest to invest part allocation in duration funds to generate capital gains and part in accrual strategy to get benefit of current high yield available in the market to generate consistent returns.

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