ALCHEMY

PRIVATE WEALTH

Investment Matters

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EQUITY OUTLOOK FROM CIO'S DESK

India outperformed most major equity markets in the world and was the third best performer in June. Debt default concerns in Europe dominated events and despite a month end rally equity markets were in the red. Consequently the Dow was -1.2%, MSCI AC World Index -1.7%, MSCI EM Index -1.9%, MSCI AC Asia ex-Japan index -2.7%. MSCI India was +1.4%, Nifty +1.6% and Sensex +1.9% and bucked the trend – largely due to a correction in crude and commodity prices.

In India however it was the narrow market (Nifty & Sensex) that did well, largely due to short covering. The broad market did poorly. The BSE500 index was +0.4% while the BSE Midcap index and BSE Small cap index were down -0.8% and -1.0% respectively.

Some resolution to the crises in Greece led to a month end rally across equity markets including India. FIIs flows turned positive – both in the cash and futures segment – suggested large short covering.

Inflation continues to be the primarily concern in India. During the month the RBI hiked policy rates by 25bps to 7.5% (repo rate) and further rate hikes are anticipated.

After a 8% hike in petrol prices mid-May, the government finally took the plunge and hiked, after a gap of one year, prices of diesel (by 8% or Rs.3 per litre), LPG (by 16% or Rs.50 per litre) and kerosene (by 16% or Rs.2 per litre). This is positive for the fiscal deficit which is now expected to be at 5.5% of GDP vs. the budgeted 4.6% number. The oil subsidy burden is now expected at around Rs.80,000 crores.

These hikes however will be inflationary and will add directly 70bps to WPI.

With the progress of the monsoon satisfactory so far – except for the South where there is a large deficit – food grain production should be robust leading to some moderation in food grain prices.

The IEA, a community of oil consuming nations, have declared their intention to release 60mn barrels of crude oil in July and August to help cool down crude prices. Any fall in crude prices is positive for India both for the fiscal and for inflation.

The June quarter results season commences this week. It is expected to be a weak quarter and consensus expects the Sensex-30 companies to report a topline growth of 24% YoY, EBITDA growth of +14% YoY and a PAT growth of 14% YoY.

Sensex valuations currently are at P/E 15x FY12 (for expected 18% earnings growth) and are in line with historic trends. We see bottom up opportunities in the midcap and small cap space where valuations are much more reasonable.

The government after months of lethargy is beginning to take a few policy decisions. The monsoon session of parliament commences in August. A cabinet reshuffle is also on the cards. Action from the government is required and is now key to attracting strong equity flows to India.

Hiren Ved
Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

DEBT OUTLOOK

We are living in high interest rate regime. To control inflation RBI raised repo and reverse repo by 25 bps points to 7.50% and 6.50% respectively in its policy setting meeting on June 16. This was the 10th rate hike since last year. Once again Inflation scored over the growth in RBI's action. Wholesale Price Index (WPI) for May at 9.06% came in higher than market expectations and more worrisome was core inflation that was at 7.30%. RBI mentioned that inflation continued to remain its primary concern while there was no evidence of a broad-based deceleration in economic growth. RBI believes that underlying inflationary pressures are not fully captured in the headline number. In fact, the pass-through of higher global energy prices is yet to be factored in. RBI acknowledged that the monetary tightening so far has been effective in checking aggregate demand, but rightly appears ready to sacrifice some near-term growth for stronger sustainable medium-term growth in a lower inflation setting.
During the month Government increased the prices of diesel, kerosene and LPG. This has further ignited the worries of higher inflation. Due to revision in prices correction in global crude prices as a result of release of strategic reserves by IEA doesn't help much. With reduction in custom/excise duty on petro products raising concerns over fiscal deficit has put some pressure on 10 year and yields again harden to 8.33% by month end.

The month of June continued to witness the usual tightness on account of advance tax outflows of around Rs.30, 000 crores and due to the quarter end demand for funds. Despite the tightness, short term money market rates fell as mutual funds having enough maturities during the month bought aggressively. As far as liquidity situation is concerned, the worst seems to be behind us as structural mismatch in credit-deposit ratio is getting corrected.

G-sec markets were quite volatile during the month. The 10 year government bond touched a low of 8.19% before closing at 8.33% during the month. Post RBI policy announcement, government bonds reacted negatively, but rallied thereafter with global environment supporting risk free assets in the wake of Greek crisis. US treasuries touched a low of 2.87% before closing the month at 3.16%. In the first 15 days of the month, yields eased to low of 8.19% on optimism derived from lower than expected GDP and IIP number, However this momentum was reversed with May Inflation reporting at 9.06% much higher than market expectation. Short term rates corrected sharply. Three month CD rates corrected by 125bps to 8.50%.

We believe that Bond yields are unlikely to soften much from current levels in the immediate term in view of hawkish stance of RBI and continued supply pressure from government. However, we believe that RBI is near the end of tightening cycle in terms of policy rates and global environment is turning positive for bonds. While the near term pressures are evident, inflation could moderate in medium term given that global commodity prices are showing signs of cooling off. With the past rate hikes taking effect, we could witness some slowdown in growth targets forcing the RBI to soften its stance. But we are more concerned about the fiscal side where mounting subsidy bill and shortfall on revenue side and disinvestment targets could lead to slippages to the extent of 0.5% of GDP. The additional borrowing by the government in second half will keep the downside in yields checked. We suggest short term funds with low average maturity and high carry in the portfolio. For investments for year or more, FMP looks attractive investment avenue.

Rupesh Nagda
Head – Investments & Products
Alchemy Capital Management Pvt. Ltd

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Edited by: Rupesh Nagda (Ph: +91-22-66171785), Ambrish Jamodkar (Ph: +91-22-66171772) Copy editor: Lucy Bharadwaj
Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-66171700