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PRIVATE WEALTH

Investment Matters

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

EQUITY OUTLOOK

India was one of the best performing markets amongst the MSCI Indices, helped by RBI surprising markets with an out of policy rate cut by 25bps on 16th January 2015. The markets took it extremely positively as the RBI governor had indicated that once the policy stance shifts, subsequent policy actions will be consistent with the stance, however the degree of rate cuts will be data dependent. In media interviews post the 3rd Feb policy meeting, where rates remained unchanged but bank reserve requirements were reduced by 50bps, Governor Rajan has been quoted saying that he does not expect rates to rise for the next 3 to 4 years. We are finally seeing fiscal and monetary policy aligned to boost growth in the country.

The confidence in the Modi government to kick start India's economic revival, ongoing economic reforms, macroeconomic improvement (lower commodity prices) and strong global liquidity in the current context of low growth and deflationary concerns globally does make India stand out amongst other EM's, however the ongoing 3Q15 earning season has dispelled hopes of a near term recovery in earnings and economic activity. While markets have scaled to new highs almost every month (except Dec-14) since the general elections, weak earnings across sectors like Auto's, Banks, Cement, Construction, Consumer Staples, Metals, Power and Utilities should result in index earnings being revised downwards by about 5%. A common refrain we here from company managements is that while confidence levels about the economy have improved; economic activity continues to remains sluggish. Various reasons being sighted are global economic slowdown, sharp fall in commodity prices, which have led to destocking of old inventory and put near term pressure on pricing and hence topline growth , high interest rates, spurt in online buying hurting trade channels, uneven monsoons and deceleration in rural wage growth and lack of job opportunities and hence income growth.

Another strong headwind for economic growth in our belief is the sharp cut in expenditure by the government (about US$13bn as per press reports), large part of which will happen in 4Q15 as the Union Government tries to meet its fiscal deficit target of 4.1% of GDP as tax revenues are way below budgeted targets. The fast pace of fiscal contraction should have been ideally offset by much faster interest rate cuts by the RBI but for the Governor's concern about currency stability in light of risks emanating from US interest rate hikes has prevented him from cutting rates sharply.

With several critical issues confronting the economy, one of the initiatives of the new government is to conduct sector specific solutions by organising "Breakout Groups" or conferences which debate amongst all stakeholders and policy makers about the problems / challenges facing the sector and get feedback on actionable solutions/policy reforms to address them. We interacted with some key participants of the first such Knowledge Conclave on Banking. Public Sector Banks were very happy with the exercise as it was the first time in decades, the government was at least willing to listen to their grievances.

The likely policy actions were split on what can be achieved in a 1 year & 3 year time frames. Any reform which needs parliamentary approval was put in the 3 year time frame as by then the current Government hopes to be in majority in both houses of parliament easing passage of bills. The key issues were

Non Performing Assets – There were no immediate concessions from RBI or the government. A comprehensive bankruptcy law is being debated in place of the current Debt Recovery Tribunal & SARFESI Acts which see too many adjournments delaying the recovery process for banks. Top 4-5 banks are keen to float an Asset Reconstruction Company (ARC) so that they can accrue benefits from the recovery process. Coal and Mining ordinances being pushed through parliament should see things improve in 6-9 months.

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Recapitalisation of Banks – Public sector banks require capital infusion of US$40bn over next 5 years. Government is ready to reduce stake to 52% which will help raise about US$13-15bn at current market prices which leaves the balance US$5bn to be raised per annum. A good solution is to create a Bank Holding Company which will raise bonds via implicit guarantee from the government and uses dividend proceeds to service the debt. The benefits of a Hold Company are (i) Bank Nationalisation Act does not apply to Holding Company and (ii) it comes out of the purview of Central Vigilance Commission (CVC). This is a positive as current fear of CVC is holding back bank managers from disbursing credit to even deserving projects. The likely stumbling block in creating a Holding Company is (i) it needs legislative action & (ii) RBI is adamant that both Bank and Holding Company should comply with Basel III norms.

Governance / HR – The need to create a Banking Board Bureau to be chaired by eminent Bankers who in turn will be responsible for appointing Chairmen's of PSU Banks, thereby eliminating political influence in the selection process. The government also debated ways to bring better talent in to Public Sector Banks as currently the Supreme Court bars any lateral or campus recruitment.

Bank Restructuring – The government does want larger world class banks. It is giving banks 18-24 months to improve performance otherwise will force mergers or differentiated bank licenses on them. The parameters for merger being balanced portfolio across corporate, retail, priority sector lending. The Government also believes that the banking industry on its own cannot fund India's growth and that there is an urgent need to develop and deepen the corporate debt markets.

Social Objectives – In India, private sector banks have ROA of 1.7% vs 0.5% for public sector banks. Public Sector banks believe that their ROA's can double if they are properly compensated for the social objectives they help fulfil. For e.g. In the Jan Dhan Scheme for financial inclusion which targeted opening 100m accounts in six months by the Modi government, 75% of all accounts were opened by Public Sector Banks. Majority of these accounts are zero balance and hence are incurring losses for the banks. Banks have given feedback to the government that while they are happy to be instruments to bring about greater financial inclusion and help fulfil some of the social objectives of the government, they need to be be compensated for the costs incurred in order to have a level playing field with their private sector counterparts. The government has assured them that they would consider some compensation mechanism soon.

While we don't have any meaningful public sector banks exposure in our portfolio, we were quite enthused by the feedback we got about the governments seriousness to work on some creative solutions to address some of the structural issues facing the industry. We are likely to see more sector specific approaches going forward thereby potentially increasing the universe of investible opportunities going forward.

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DEBT OUTLOOK

In the February review, RBI kept policy rates unchanged. RBI however announced some other changes which are as follows:

1. Reduced SLR by 0.5% to 21.5% of net demand and time liabilities (NDTL) effective February 7, 2015.

2. Discontinued the export credit refinance (ECR) window entirely as a means of providing liquidity. However, commitment to daily variable liquidity operations, over and above term repo operations, remains.

In RBI's macro-projections, real GDP forecast is retained at 5.5% for current year (on old base) and pegged at 6.5% for next year, CPI inflation is expected to meet RBI's objective of 6% by January 2016, Current account deficit (CAD) is expected at 1.3% of GDP in current year. Besides, the RBI has made some changes / liberalizations to financial markets. Some of these are as follows: 1) Further increased limit under Liberalized Remittance Scheme (LRS) to USD 250,000 per person per year. 2) Allowed reinvestment of coupon in government security investments by FPIs even though the current limit of USD 30bn is getting fully utilized. 3) Introduced minimum investment threshold of 3 years for FPI investment in corporate bonds in line with the regulation that exists for government bonds. However, there is no lock-in on such investments. 4) Introduced new contracts in Interest Rate Future (IRF) for 5 – 7 years and 13 – 15 years besides the 10 year contract that currently exists.

After giving surprise rate cut of 25bps in the month of January, We expected RBI to maintain status quo. We believe RBI is watching and would look at incremental data both domestic and international before taking further policy actions. Currently all the data looks supportive and would give some leeway to RBI for further rate cuts. On CPI specifically, the base year is slated to be updated with accompanying weight and basket modifications. While the general consensus is that this will cause very minor variations to the CPI reading, the RBI may want to be surer on this count. Similarly, recent commitments from the finance minister as well as government already moving to shore up indirect taxes to fund infrastructure seem to indicate that the government will unveil a responsible, 'high-quality' budget at the end of the month. But again Rajan has chosen to wait and see how this pans out before making his next move. Budget is very important event to watch out for.

Monthly inflation numbers came at 5% for CPI and 0.11% for WPI further positively surprised the market and were better than market expectations. This gave market participants more confidence on the downward trajectory of the inflation. India's trade deficit reduced sharply to US$9.4bn in December vs US$16.9bn in November. The improvement was mainly driven by significant fall in gold and oil imports in December 2014.

World is facing possible deflation and the mounting disinflationary pressures have forced Central Banks across the world to begin easing policy rates in January. While some have already begun the action, few others like New Zealand, Australia, Hungary, Malaysia and Thailand have started to sound dovish gearing towards a rate cut in the next few days. Monetary Authority of Singapore in an off policy action cut the slope of the S$-NEER policy band this week to arrest the significant downward shift in inflation outlook. Denmark Central Bank (DNB) cut the interest rate on certificates of deposit by another 15 bps to a new all time low of -0.5%. Russian Central Bank also cut the key policy rate by 200bps to 15% on concerns of looming recession despite high inflation. In contrast, the US Fed sounded more upbeat about the economy while noting the temporary downward move in inflation. In fact, the statement noted that the fall in oil prices has been beneficial in boosting household spending power. Meanwhile the Fed continued to note that it could be 'patient' with respect to normalizing the stance of monetary policy.

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This effectively rules out an April rate hike, suggesting a more likely decision later in the year. Also, the balancing act of strong growth and slow inflation may result in a more gradual tightening than earlier anticipated. The European Central Bank announced its asset purchase program of EUR 1.1tn at a monthly rate of EUR 60bn till Sept 2016. The quantum is in line with market expectation but the program has been kept open ended with room for more purchases if needed.

This suggests that there would be ample liquidity in the market and India being well positioned both in terms of economic growth and improving fiscal could find great demand for Indian bonds. The 10-year bond yields dropped 16 basis points in January on better macro data points, a surprise mid policy rate cut and strong demand from foreign investors. Fall in global oil prices and fall in global bond yields also helped sentiment. The benchmark 10-year bond yield closed at 7.70 percent at the month end after hitting 7.65%, a low it had touched in 2013.

Going forward we believe expectation of outlook Upgrade from leading international rating agencies like Moody's and S & P on India's rating will prove to be positive for Indian fixed income markets. Macro developments are extremely positive for fixed income markets and are structurally building-up a case for lower interest rates in the near future. We have been given bullish call since last 6 months and recommending investments in long duration funds. The shorter end of the curve is likely to remain supported as the outlook for liquidity remains comfortable. We suggest some allocation in duration products to get the benefit when interest rates would fall.

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