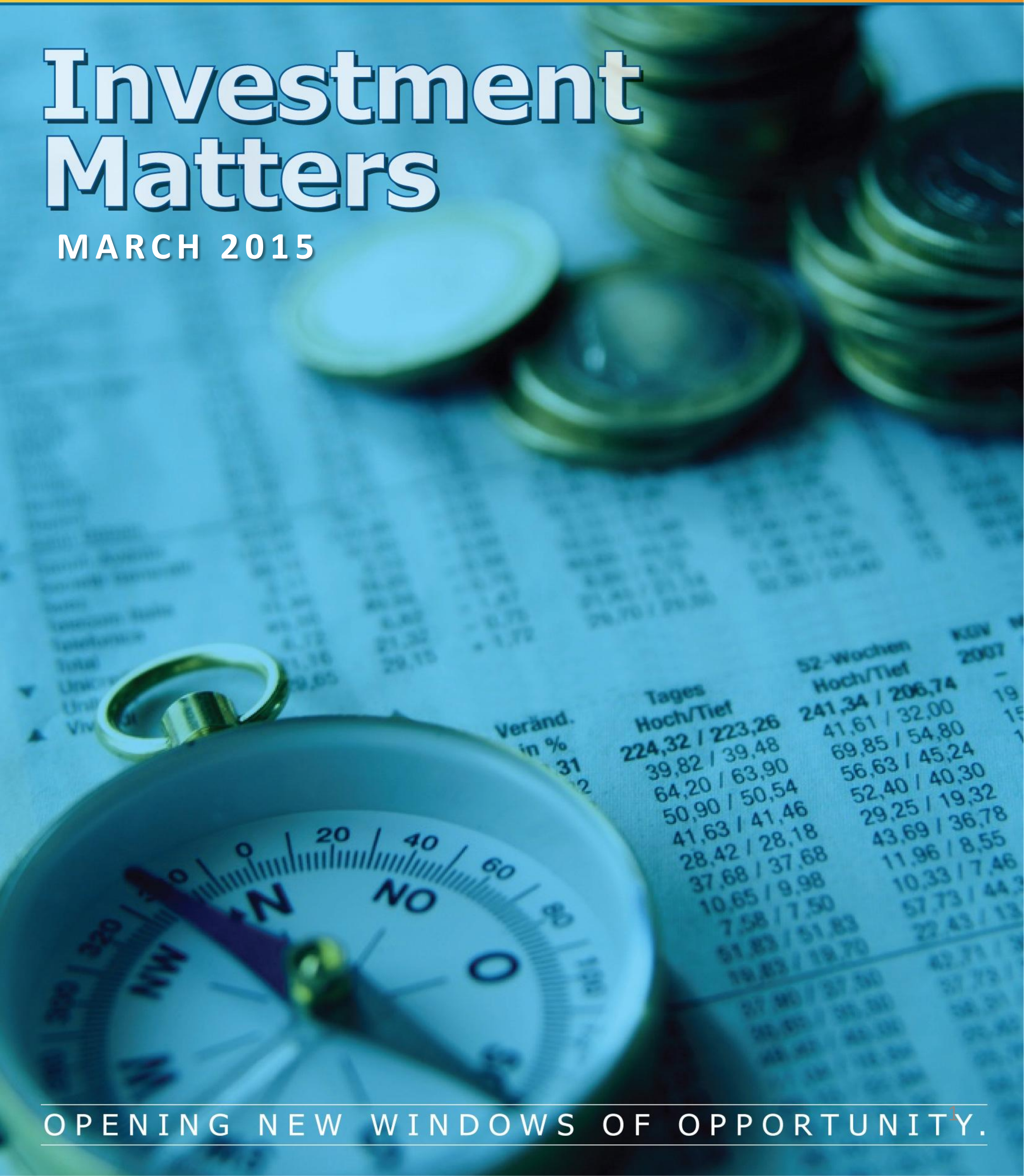
ALCHEMY CAPITAL MANAGEMENT

Investment Matters

MARCH 2015



OPENING NEW WINDOWS OF OPPORTUNITY.

EQUITY OUTLOOK

India today is saddled with a weak investment cycle on the back of weak corporate balance sheets, low profitability of projects in the infra space which are being executed by the private sector. Aggressive assumptions at the time of bidding and delays in project execution coupled with the inability of the government to invest aggressively on its own account due to fiscal constraints exacerbated the situation. A bad agriculture season, and lower MSPs and rural wages has also impacted consumption over the last few quarters.

On the positive side, global commodity prices, specially crude, have corrected in a material manner; at the same time, the government of India has decided to fully decontrol pricing of Diesel and Petrol for the end consumer thereby reducing the subsidies provided to a level of Rs 40,000 cr approx compared to Rs 1,00,000 cr in the earlier years. This large correction in commodity prices has also helped bring down inflation in the economy enabling the RBI to cut benchmark interest rates by a total of 50 bps in two tranches.

It is in this backdrop that the Railway and the Union Budgets for 2015 were presented last month. Realizing the above challenges, the government has rightly prioritized on hiking spends on infrastructure to kick start the investment cycle. The first glimpse of this intent was very clearly given in the Railway Budget where after many years the railway minister has decided to spend Rs. 1 lac crore in 2015-16 itself and a whopping Rs. 8.5 lac crore over 5 years. While we still have to see how such huge resource mobilization will be done, but assuming that the railway ministry is successful in doing so with a combination of budgetary support, some internal resource generation, FDI and some long term borrowing from international as well as local debt markets, the sum for capex over next 5 years is very significant. The read through the budget and consistent pronouncements by the government clearly point to Railways, Defence, Roads and Ports to drive infra spending. This will have implications in terms of investment opportunities that we would look for to allocate incremental investment capital amongst other sectors for the long term. The decision to be counter cyclical by slightly relaxing the FD target to 3.9% of GDP as compared to the 3.6% expected is worth taking given the current circumstances. We believe that the revenue assumptions taken by the FM are conservative and revenues from coal and spectrum auction alongwith a 70,000 cr disinvestment target has enough cushion built in to on the revenue side Another important decision taken by the finance minister during this budget is to accept the recommendations of the XIV Finance Commission to distribute 42% of revenues to states compared to the past number at 32%. This would mean that all the states would have larger funds at their disposal and importantly the role of planning and spending money on their individual requirements would be left to them with no interference from the central government. One important implication of this decision would be that it would now be easier for the finance minster to convince all the states to go ahead and implement the GST regime – a single tax regime across the country. This can potentially be a game changer for India over the next few years if implemented in the right manner with optimal rates of taxes bringing higher tax revenues for the government by bringing a large part of the economy into the tax net, benefiting the organized sector, lower logistics costs, greater efficiency in manufacturing and overall ease of doing business in India. The Finance Minister has announced to bring down the corporate tax rate from the current 30% to 25% over the next 4 years. This will go a long way in tax compliance for the government revenues and higher profitability growth for Indian corporate benefiting the equity markets over the long term.

EQUITY OUTLOOK

A beginning has been made in this budget to kick start the investment cycle by up fronting of spending by the government with the expectation that in the medium to long term private sector will once again come forward to invest in large projects and partner with the government. The intent of the government seems to be to clearly push ahead with reforms, however its ability to get the various ordinances converted into law in parliament will be tested. The Land bill may be the contentious one but there is a reasonably high probability of the others to get passed without the requirement of a joint session of parliament which is an option on the table. Pending the passage of these critical bills the markets may consolidate for a while, however we continue to remain bullish on the markets in the medium to long term.

Hiren Ved

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DEBT OUTLOOK

Budget 2015 was a keenly awaited event, given that this was the first full budget for the BJP led government. The FM has laid a clear growth roadmap with focus on infrastructure, tax rationalization, fiscal consolidation and states empowerment. The revenue assumptions across categories are realistic under the current growth environment. While the headline deficit number at 3.9% look higher than the FRBM target of 3.6%, a very significant transfer of tax revenues to states had constrained FY16 finances for Centre (should get reflected in combined State and Centre deficit).

The RBI surprised the market again by cutting repo by 25 bps to 7.5%, ahead of the official policy review in April 2015. It factors in RBI's assessment of the fiscal consolidation measures announced in the Union Budget, global trend towards monetary easing and also the slack in the economy, which is at variance with the revised GDP numbers. The RBI has assessed the quality of fiscal consolidation to be better both in terms of the intent as well as the projections. Even though the targets have been deferred by a year, the quality of consolidation has been assessed to be better. The comfort from the fiscal numbers arises from the following facts:

•Realistic revenue side projections and attempt to clear the legacy issues such as deferment of expenses leading to a higher amount of consolidation than implied by headline numbers

•Focus on better targeting of subsidies via Direct Benefit Transfer

•Focus on infrastructure investment for sustainable growth and a higher transfer to states which may lead to reduction in consolidated fiscal deficit

The Inflation targeting framework instituted in the Monetary Policy framework would entail that the hurdle for aggressive monetary easing moves higher. Recent developments on the inflation outlook provide reasonable confidence of medium term inflation closer to 5.0% to 5.5%. With the stated comfort of the central bank on a real policy rate in the range of 1.5% to 2.0%, the expectations of a terminal repo rate in the range of 7.0% to 7.25% seems achievable, at this stage. Continuation of favorable inflation momentum, continuing progress on fiscal consolidation and supply side reforms could provide space for additional cuts.

While any volatility in the global markets could also affect our bond market, the impact is likely to be much muted as compared to the experience in 2013. The differential between bond yields globally and Indian yields is very wide and adjusted for volatility in our bond/currency market as well as the CPI trajectory, Indian bonds are likely to remain attractive for global investors. We expect 10 year G-sec to consolidate at current levels before falling further. We expect 50 bps rate cuts in next 12-15 months. Given the fact that while deficit reduction plan has been decelerated somewhat there is a marked improvement in quality of fiscal accounting, combined deficit is still on accelerated deficit reduction path and greater focus on infrastructure spend as opposed to consumption boost. We have been giving bullish call on Interest rates since last 8-9 months and still maintain our view on lower interest rates going forward. We suggest investors to maintain their position in Duration funds to take the advantage of falling interest rates. At this point we suggest allocating some investment in accrual strategy as well to get the benefit of higher yield.

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