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Investment Matters

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

After the scintillating results in the election, it was time for the BJP government to get down to business. Last week the Railway and the Finance Minister presented the Railway and the Fiscal budgets respectively. Both the budgets were keenly awaited by the investor community as they were the first formal occasion for the government to articulate its economic and social vision and programs.

Both budgets met the basic litmus test – they were simple, business like and shorn of any populism. Agreed, there was no "grand vision" or "big bang" reform announcements, but that was to be expected as the new government has had little fiscal space and little time to do anything very innovative or bold. To use a Cricketing parlance – this government is getting ready to score big by playing a Test Match (a game stretched over 5 days) v/s a T20 (a new shorter and faster format of the same game played over a few hours!). Considering that they have a mandate for 5 years, many reforms especially the more contentious and complex structural reforms are expected to be carried out over a period of time. It is Modi's style that all critical and important policy decisions are taken after much thought and after carefully evaluating all available options on the table and understanding their implications. Thus it would be fair to assume that we will see a series of incremental steps towards reforms rather than something big bang or "out of the box" – just not yet.

However, the policy direction and pronouncements in both the budgets is positive. The Railway budget for instance has laid the foundation to adjust tariffs based on movement in fuel prices something that was not done for 11 years! The idea is to put in place a mechanism for regular review of pricing rather than bunching it up at the end of the year and making it politically difficult to implement. So the theme is to move away from subsidies and administered prices towards market driven prices over a period of time. Secondly, rather than announcing new projects (which is what most railway ministers in the past have done to pander to their narrow constituencies) the focus has been on implementing the current pipeline of projects based on their importance and priority. Hence priority has been given to building railway lines that would help in evacuating coal from the mines. Similarly there is a plan to build rail connectivity to 16 important ports for easy movement of cargo. So other than rational pricing, in order to modernize, to enhance capacity and to substantially improve customer experience several areas have been thrown open to private sector via PPP projects and also allowing FDI in railways.

In the main budget – the key takeaway has been a resolve to stick to the big macro objective of restraining the fiscal deficit to 4.1% of GDP (which is tough by his own admission) with a promise to get it down to 3% by FY17. This aggressive roadmap for fiscal consolidation should help to lower long term interest rates in the future. He has also kept the revenue targets the same as in the interim budget despite increasing plan expenditure by 20% with a view to helping revive growth. Most analysts believe that the revenue assumptions (+19%) are optimistic, however we believe that these revenue projections are achievable as recovery in growth fuelled by an improving policy environment and more importantly, a positive uptick in both consumer and business sentiment should drive economic activity. Our interaction with retailers suggest that they have seen a clear uptick in consumer footfalls and sales with the onset of the new government. This is also evident in the auto sales numbers – Maruti (a portfolio company) recorded a 30% + sales growth in June.

The other notable feature of the budget has been the enhanced tax breaks on housing mortgages, opening up FDI in real estate and introduction of REITS for the first time. We believe this has the potential to attract large amounts of stable long term capital from institutional investors such as Pension & Sovereign Wealth Funds to the capital starved realty/housing sectors. Similarly for the infrastructure sector a REIT style fund is proposed to be introduced coupled with lower reserve requirements for Banks/NBFC's on infrastructure financing. While immediate large allocations have not been possible for the infrastructure space, a beginning has been made to develop more ports, smaller airports in Tier-2/3 cities and developing 100 smart cities. We believe that over the course of the year and before the next budget is presented the government would have figured out an effective mechanism to rationalize the various subsidies – food/fertilizer/petroleum – since we expect any potential savings from here would be targeted towards infrastructure building. The clear intent and focus of this government has been to improve the "quality" and "efficacy of spending" rather than just the quantum. So if the Indian economy would be likened to a company – this management is more focused on improving the ROCE and quality of earnings – along with growth!

We think that markets are most likely to enter into a consolidation phase and the unbridled rally in low quality high beta stocks will give way towards focus on growth with quality. We continue to be very constructive on the long term prospects of the economy and markets and are well positioned to take advantage of the impending multi-year bull market in India.

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DEBT OUTLOOK

Fixed income market has witness high volatility post election result. Initially 10 year G-sec yield reacted positively and fall to low of 8.55%, but again it rose by 20bps and currently trading at around 8.75%.

Reasons for back tracking are as follows:

1. Macro economic data points released over the last month showed some deterioration in inflation prints even as growth data indicated signs of improvement. The WPI data for May 14 registered a y-o-y growth of 6.01% as compared to expectations of 5.34% and previous month growth of 5.20%. The CPI however showed a decrease to 8.28% y-o-y for May 14 as against estimates of 8.40% and the previous month reading of 8.59%. Growth numbers released for the month showed sign of the economy picking up with IIP y-o-y growth for Apr-14 coming in at 3.4% compared to the 0.5% in March. The HSBC Composite PMI for June increased to 53.8 from 50.7 in the previous month. The trade deficit marginally deteriorated from USD 10.09 billion in April to USD 11.23 billion in May, even as exports increased 12.4% on a y-o-y basis.

2. Tension in Iraq has caused spike in oil prices, this could result in high inflation. Also Met department has a sub-par monsoon forecast and global weather forecasters are predicting a majority chance for an El Nino phenomenon this year. Furthermore, monsoon performance so far has been severely disappointing with rains tracking 38% below their long term average over June. Depending upon severity of the rain deficiency, market fears that primary articles' prices may spike again in the upcoming months.

3. Near term demand versus supply for government bonds seems weak. FIIs have bought approximately INR 30,000 crores of India's government bonds post announcement of election results. This had significantly improved the demand versus supply scenario of bonds. However, the regulatory limits given to FIIs for government bond investments have now been almost completely utilized. Owing to this and pending further relaxations to FII limits, demand versus supply for bonds is no longer looking as robust as it was before; at least in the near term.

First Union budget was presented by NDA government on 10th July 2014. The budget clearly demonstrates that the present government stays committed to the fiscal roadmap from last year with a target of 3% fiscal deficit by 2017. For the current financial year, the government has reiterated the interim-budget fiscal deficit target of 4.1%. Achieving this target is by no means plain sailing. In fact it will be challenging as the tax buoyancy assumed in the budget is aggressive and accounting for subsidies is lenient. However, the government has a leeway in achieving the fiscal target because the buoyant equity market provides it with an opportunity to be more aggressive in raising the money from disinvestment in PSUs. The government expects nominal GDP growth of 13.4% in FY15 versus 12.3% in FY14 - so a mild recovery has already been factored in. Net tax revenue is budgeted to rise 16.9% Y-o-Y in FY15 vs. 12.7% in FY14. The allocation to subsidies, at 2% of GDP, is largely left unchanged from the interim budget target (1.9%). Gross market borrowing increased to INR 6.0 trillion (INR 5.5 trillion in FY14), while net borrowing is flat at INR 4.6 trillion (INR 4.5 trillion in FY14); with around INR 500 billion of bond buybacks.

DEBT OUTLOOK

Announcement with respect to increase in long term capital gains tax for debt funds from 10% to 20% and the change in withholding period for long term from 12 months to 36 months has ended the arbitrage which existed between debt funds and other debt instruments, particularly bank deposits. With respect to indexation benefit, budget is silent, so we expect that the indexation benefit would continue. In that case if anybody is holding the debt funds for more than 36 months would get the tax benefit as compared to bank deposits. We still await more clarity with respect to its implementation.

We expect markets to stay volatile and long term yield would trade between 8.5% to 9%. Monsoon is one big factor that would decide the direction of interest rates. If monsoon is normal then yields may fall sooner than expected. Also near term supply of government bonds could put pressure on long term yield. We expect mutual funds to realign their debt products in line with the changes announced in the budget to make it attractive for investors. We suggest holding on the investments till complete clarity comes. Accrual funds are positioned well in current scenario.

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