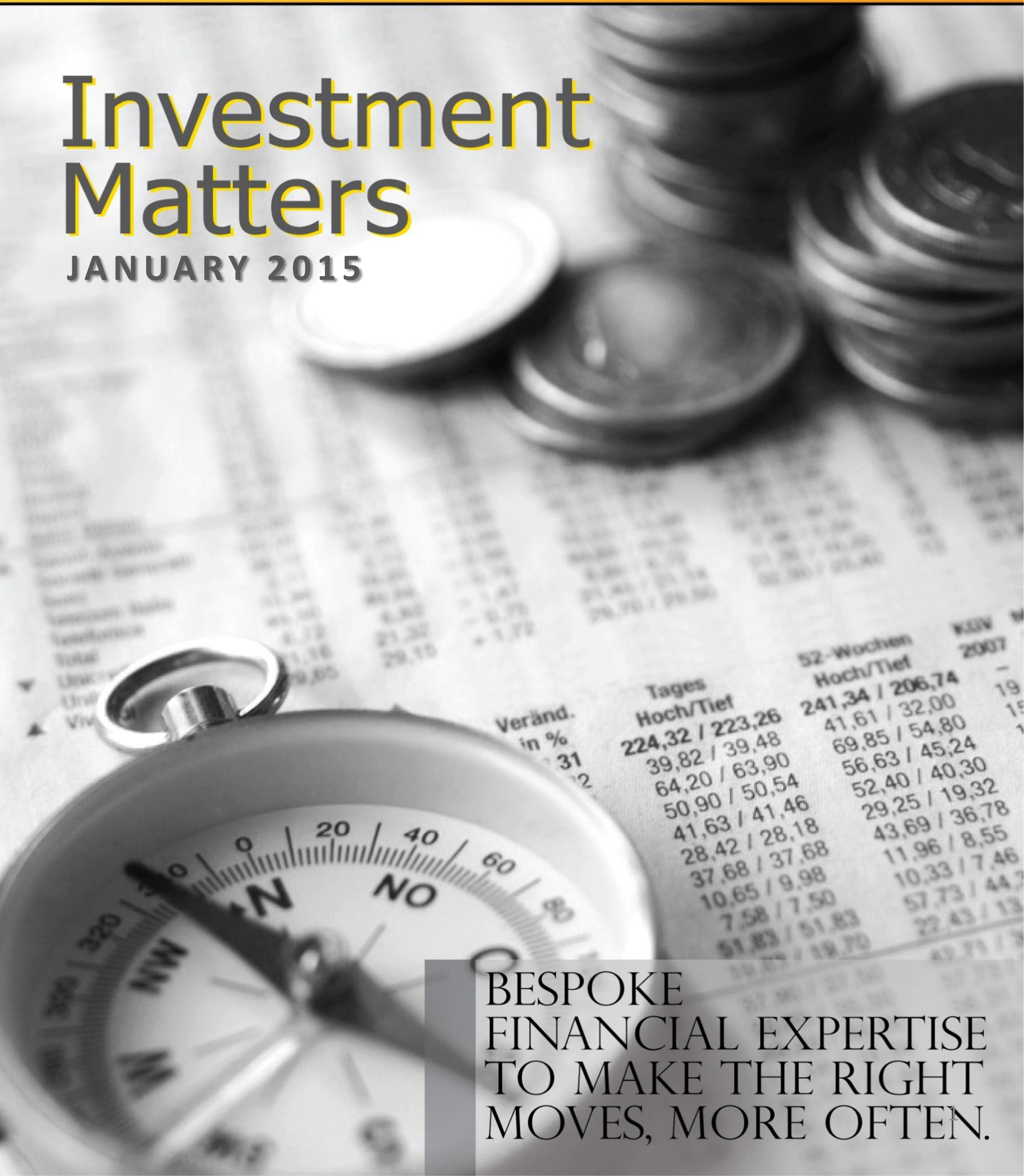
ALCHEMY PRIVATE WEALTH

Investment Matters

JANUARY 2015



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

EQUITY OUTLOOK

At the outset let me wish all our investors/friends a very Happy, Healthy and a Prosperous 2015.

Last year was a good year for Indian markets and a great year for Alchemy investors. The markets went through a significant re-rating process, both in anticipation and post the election of a majority BJP led government breaking a 30 year political trend in the country. Deft management of the monetary policy under the very able stewardship of our Central Bank Governor and the consequent stability of the currency also substantially helped in creating a favourable economic and market environment.

In the initial phase of the Modi rally, stocks/sectors which were cyclically related to the economy and/or in the beaten down sectors like industrials, infrastructure and the state owned enterprises and banks rallied hard. But few months into the new government that rally faded and many of the stocks from these sectors gave up a large part of their gains baring a few as performance shifted back to quality sectors and companies. Investors soon realised that the turnaround in the economy would take more time than anticipated coupled with the fact that, and rightly so, the central bank had held back from cutting interest rates.

So while markets have run up, economic recovery is still weak with many from India Inc and trade talking – "the sentiment has changed for the better however nothing has changed on the ground yet" implying that markets could have run up ahead of near term economic and earnings growth. The usual factors attributed to the slow recovery are – slow demand recovery, high interest rates and lack of pickup of the industrial and infrastructure capex cycle. While some of that maybe true we have an alternate take on why the slowdown still persists. For one the sectors/business groups that led the infrastructure capex cycle in the 2003-2010 period largely through the PPP model and largely funded by debt have not got any economic return or cash flows from those projects – either because they bid aggressively on assumptions which no longer hold true i.e. the project economics have changed and/or the projects are stuck due to regulatory/environmental/financial closure issues. Banks that have lent to these projects are stuck with these non-performing loans. So, unless these entrepreneurs deleverage their balance sheets by selling assets or raising equity and banks recapitalise so they can lend, again it is difficult to envisage a pickup in capex anytime soon. Secondly, a lot of economic activity in the past was driven by incorrect incentives/corruption of the various constituents involved in the value chain. With increased scrutiny by the regulators/courts and the media against corruption – decision making/economic flow slows down as using unaccounted cash for business or consumption becomes extremely difficult! Thirdly, we are beginning to see massive disintermediation in several sectors where middlemen are being eliminated in the business chain and the increasing use of technology and the internet comes into play. So if you were just a trader not adding much value or just a rent seeker you are increasingly getting squeezed out. This is a very welcome sign and a harbinger of greater productivity in the long run, however in the short run it renders some business models either obsolete or one which may require drastic restructuring. The aggressive onslaught of e-commerce companies is case in point for mall owners and retailers. The trend of moving from unorganised to organised is going to accelerate and there will be winners and losers in the process. Lastly, from a consumer stand point slow demand consumption can be related to slow new job creation, persistently high inflation and households having invested disproportionately in physical assets like real estate and gold where the price trend has clearly reversed. Therefore, our belief is that the investment cycle will not only take a while to pick up – but will have to be led by new actors/economic agents who come in with a clean slate and without any so called " bad institutional memory" of entrepreneur/banker/investor.

Hence that role will have to played by the government in the short run till private capital steps in. The good news is that the government has sensed this and early sound bites about redirecting government budgets to capex and somewhat relaxing the deficit targets in the short term could be considered. We will get a clearer picture on this when the budget is presented in end of February. Another very important source of funding could be FDI. Hence PM Modi's aggressive diplomatic outreach to capital surplus countries like Japan, UK and US and the very rich and diverse Indian Diaspora around the world is strategically the right decision and should yield good results in the medium to long term.

So the despite the slow pickup in real economic activity the markets have held up as investors are convinced about the directional change that is taking place. India has received a huge Oil Dividend which is helping it to rapidly repair its balance sheet. So far the government was constrained in spending as it had to adhere to the 4.1% fiscal deficit target. However, next year the savings so generated from falling subsidies can be re-invested in infrastructure and productive capex to kick-start growth. The government has shown very strong resolve in taking forward reforms by bringing in a slew of ordinances – on coal, land and insurance and there has been good progress on GST. PM Modi has also greatly strengthened his team by inducting experienced and reform minded ministers like Suresh Prabhu in the Railways and Manohar Parrikar in Defence alongwith including Prof Arvind Panagriya as the the head of the newly instituted think tank – NITI Ayog and Arvind Subramaniam as the Chief Economic Advisor to the government, both noted economists with free market credentials.

So while overall valuations may seem high compared to near term earnings projections, pockets of opportunity remain plentiful. We continue to see great opportunities as significant parts of the markets remained under researched and under owned. Incrementally we see opportunities in new emerging areas like defence manufacturing, companies benefitting from the shift from unorganised to organised markets, smaller MNC's which will begin to become active and serious about India and in sectors that have gone through a long phase of consolidation and are at the cusp of growth again.

Hiren Ved

Chief Investment Officer
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DEBT OUTLOOK

Happy New Year!

Year 2014 started on bearish note and markets were in chaos in first half of 2014, but ended on a positive note. Let's look on what changes occurred in last one year and where the markets are heading forward.

Particulars	Dec 2013	Dec 2014	Trend
Crude ($/BBL)	108	59	Expected to stabilize at current price
GDP Growth	4.7%	5.7%	Picking up
Forex Reserves ($ Billions)	295	317	Strong
Current Account Deficit	5.4%	2.1%	Big Positive
Fiscal Deficit	4.5%	4.1%	Stable with negative bias
WPI Inflation	7.5%	0.0%	Trending down
CPI Inflation	11.4%	4.4%	Trending down
10 Year G-sec	8.8%	7.8%	Trending down
Call Rates	8.7%	8.0%	Trending down
1 Year CP rate	9.8%	8.9%	Trending down
SBI 3year Deposit Rate	9.25%	8.75%	Trending down

Today India is in sweet spot as many Macro indicators which were negative for India during last year, have turned positive. Biggest positive is fall in crude oil prices. This has led to fall in Inflation, Current account deficit and raw material prices for many corporate. RBI governor in past 12 months created a war chest of Forex reserves to fight any dollar out flow due to global turbulence. Global economy is still weak and world is fighting with deflation. European and Japanese economy are in bad shape instead of keeping very low interest rates since very long. Recession worries are surrounding these countries. China after a spectacular decade with double digit GDP growth is slowing down with each month passing by. This would result in slump in global demand and further hampering the World growth. US economy is again on its path of revival. Latest data suggests US is recovering fast and this would put pressure on Fed to increase US interest rates. This can result in money out flow from emerging markets back to USD assets. This could further aggravate the emerging market currency depreciation and very high market volatility. RBI government has been holding on interest rates instead of favorable macros because of global weakness.

DEBT OUTLOOK

The way macroeconomic situation is shaping up, it is imminent that RBI will start easing its policy stance in 2015. We believe that 2015 will to be the year of Fixed Income and it can deliver an extraordinary performance. One of the important tailwinds for fixed income will be lower crude prices. The sharp fall in crude oil prices has addressed India's immediate problems of CAD, Fiscal Deficit and more importantly, inflation. Under such an environment we believe duration funds can continue to deliver good returns in 2015. Key risk that we envisage are rise in US rates earlier than expected, Inflation again spikes up and global deflation that may hit the exports and hence affect fiscal deficit.

Due to high CPI inflation real rates were in negative territory, this had created savings – investment disequilibrium in the economy, thereby making it easier to play seasonality on interest rates. We are witnessing a structural break in inflation, thus this incentive should continue in the years ahead. We strongly feel going forward re-investment risk would pose bigger challenge for Investors. In past two years due to high yield prevailing the market gave better tax adjusted returns in FMPs. Now that interest rates are falling one should prepare for reinvestment risk in coming times. Currently we are very bullish on Long duration funds and suggest 30-40% allocation in income funds. Accrual strategy is well positioned to generate consistent long term returns. We strongly feel 2015 will be the year of debt.

Rupesh Nagda

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