ALCHEMY
PRIVATE WEALTH

Investment Matters

JANUARY 2014

EQUITY OUTLOOK FROM CIO'S DESK

Here is wishing all of you a very Happy and Healthy 2014.

I did mention last year in my January 2013 note as to how the New Year forces us to take stock of the situation and deliver a prognosis for the New Year. So for this year's opening address, I decided to refer back to last year's note to see how much things have changed or remained the same! We set out by listing out what the consensus thought exactly a year back and what was discounted in equity markets then. So let us re-visit each of the hypotheses of early 2013 and see where we stand on each one of them today and if there are any new ones which could matter to markets in 2014.

The economy has bottomed out and we should witness a slow recovery

Interestingly, we are talking about it this year too! In fact, the economy actually slowed in 2014 as can be seen from the table below.

	Q1	Q2	Q3	Q4
CY 12	9.20	8.00	6.70	6.10
CY13	5.30	5.50	4.40	4.80

Despite the low base in H2CY2012, growth slumped in later part of CY2013. After bottoming out in Q3, we have seen a pickup in Q4CY2013. We can probably now say, supported with data, that we have bottomed out and that a combination of good monsoons and recovering exports will lead the recovery. However, industrial growth still continues to struggle and hence a sharp recovery is still elusive.

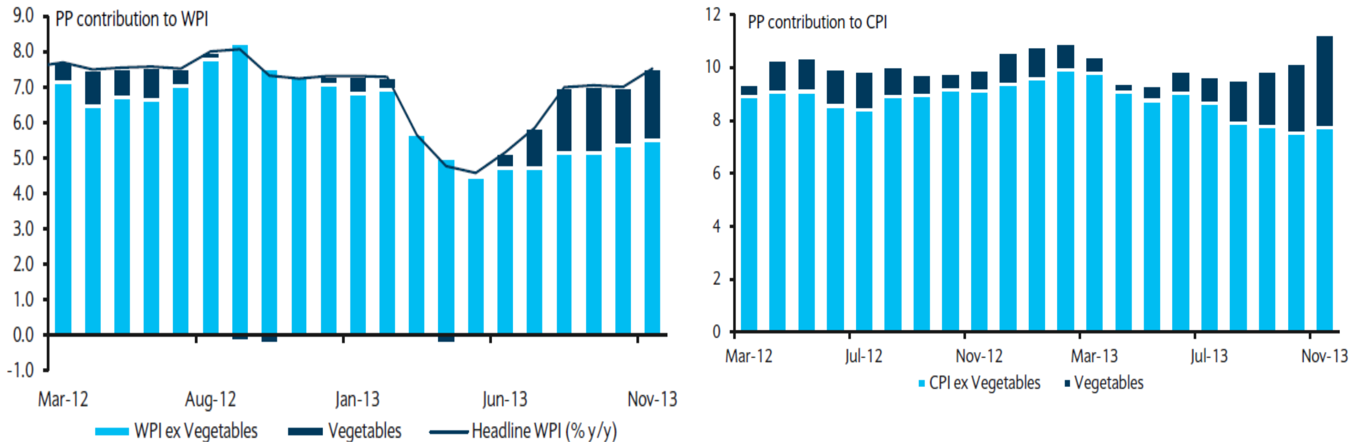
Global macro tail risks have receded though many uncertainties like the US fiscal/debt ceiling issues linger

While that was pretty much true, receding tail risks and an improving outlook for the US economy prompted the US fed to start talking about "tapering" in May which led to a steep correction in EM currencies and stock markets. So what could be construed as good for the developed world, in the first instance, particularly the US, turned out to be a major risk for EMs. Countries like India which had a large current account deficit saw a sharp depreciation of the rupee consequently. The dislocation of the currency was the biggest macro event for India in 2013. A crisis like situation forced the government and the RBI to take some corrective action. It would be fair to say that the new RBI Governor has been reasonably successful in bringing stability to the currency markets and making India better prepared for an eventual and significant withdrawal of Fed stimulus. In fact, India is now termed more as a 'taper tiger', an acronym used for countries which are better prepared than others. So as we get into 2014, a better outlook for growth in the developed world could benefit our economy by helping to lift our exports. But it could throw another challenge – will global investors be enthusiastic to invest in EM markets when their own markets are doing so well?

Inflation will fall and RBI will start cutting rates (100 to 150 bps during calendar 2013) and As the rate cut cycle begins so will the investment cycle start to improve

In fact, the opposite happened. Inflation soared led by food inflation and the RBI had to hike rates. But there could be a glimmer of hope this year as core inflation has collapsed because consumer confidence got dented post the currency depreciation and the effect of higher interest rates have started to cool down demand in the economy.

However, food and vegetable prices kept inflation high as can seen from the charts below.



Vegetable prices have begun to cool-off in past one month which should eventually bring down inflation and interest rates in 2014.

The investment cycle has not yet turned. And it is likely that it may now turn only post-elections when the corporate sector is clear about the visibility of political stability.

Reform momentum should continue at least till the 2013 budget

It was expected that being the last budget before elections in 2014, the budget of 2013 would see culmination of reforms and post that it would be just populism. While we did see a dose of populism with the passage of the Food Security Bill alongside some reforms like the passage of FDI in retail and decontrol of petrol and diesel price hikes since Jan 2013, the real pace of reforms seem to have accelerated post the currency crisis in mid 2013 and recently post the drubbing that the Congress received in the state elections. We have seen initiatives to clear projects, change of guard at the environment ministry, notifying new gas prices and talk of introducing FDI in many more sectors including railways. We believe that we have decisively crossed the hump of so called "policy paralysis" - whichever government comes to power, it will have no choice but to reform – as getting growth back is crucial to generate revenue, manage the fiscal deficit and avoid a downgrade by rating agencies.

Earnings should grow between 12-15% from a low base

That was the expectation in early 2013 about earnings ending in fiscal 2014. But as the year progresses the consensus earnings estimate were downgraded and till end of Q2FY2014, the consensus earnings were down by 4 to 5%. However, Q2FY2014 marked the first quarter where upgrades outweighed downgrades with rupee depreciation being one of the factors. Almost 60% of Sensex/Nifty earnings actually benefit from a depreciating rupee. But on a more sustainable note, we observe that most good quality companies and managements have retooled their business to survive and flourish in a low growth environment by cutting costs and improving productivity. This is similar to the trend we saw in the period between 1999-2001/02 where the old economy had ruthlessly cut costs. What will drive earnings going forward is the continued effect of a competitive currency and operating leverage once growth kicks in, in due course. Hence 2014 could witness an earnings upgrade cycle. We don't know which quarter but we are confident that it will happen and the market valuations will pre-empt that.

EQUITY OUTLOOK FROM CIO'S DESK

Narendra Modi will be BJP's candidate for the PM

That was one assumption which was proven right. Narendra Modi indeed did become the BJP's candidate for the post of the PM. Post the event and going into the state elections, the markets had already started discounting the possibility of a Modi led BJP/NDA to get 190+ seats in 2014 general elections. However, the phenomenal debut of the AAP in Delhi and the subsequent popularity and momentum that the party has received has dampened the enthusiasm of the markets and the Modi hypothesis has come into question. At this stage, it is unclear as to how significant the rise of AAP will have an impact on the final poll math. But these are early days and the typical behavior of extending a recent trend into the future could be fraught with risks. We believe that there will be several twists and turns going into 2014 and a clearer picture or even a basis for arriving at a judgment call will be nearer to the event if not after.

Markets could deliver moderate but positive returns (10-15%) for the year. Cyclical sectors will outperform defensives and quality in general

Last year turned out to be a moderately positive year for equities. In fact, the intra-year volatility was significant enough to leave investors with a feeling of being a wasted year. This was because some of the important hypothesis we discussed earlier – bottoming out of growth and earnings and falling inflation just did not materialize. This means that the markets continued to consolidate within the broad range that we have so often referred to. But as the economy bottoms out, earnings stabilize and start to grow and the conditions for a fall in inflation improve coupled with continuing reforms as we argued earlier, a stage has been set for an eventual break-out from the range and for the markets to move to new highs. Whether they happen now or after elections is another matter but there is a very high probability that they will in 2014!
In the recent past, we have seen the market breadth improve with cyclical, small and mid-cap stocks outperform the large-caps. This trend will likely continue but with intermittent corrections. But quality will still outperform (how can markets be behind, when politics is gunning for better governance!). 2014 though will belong to companies leveraged to export growth and those possessing global competitiveness, quality cyclicals especially in the consumer discretionary space, and large cap turnaround companies. Our portfolios are well balanced in these themes and we will continue to seek out opportunities during the course of the year.
Happy investing in 2014!!

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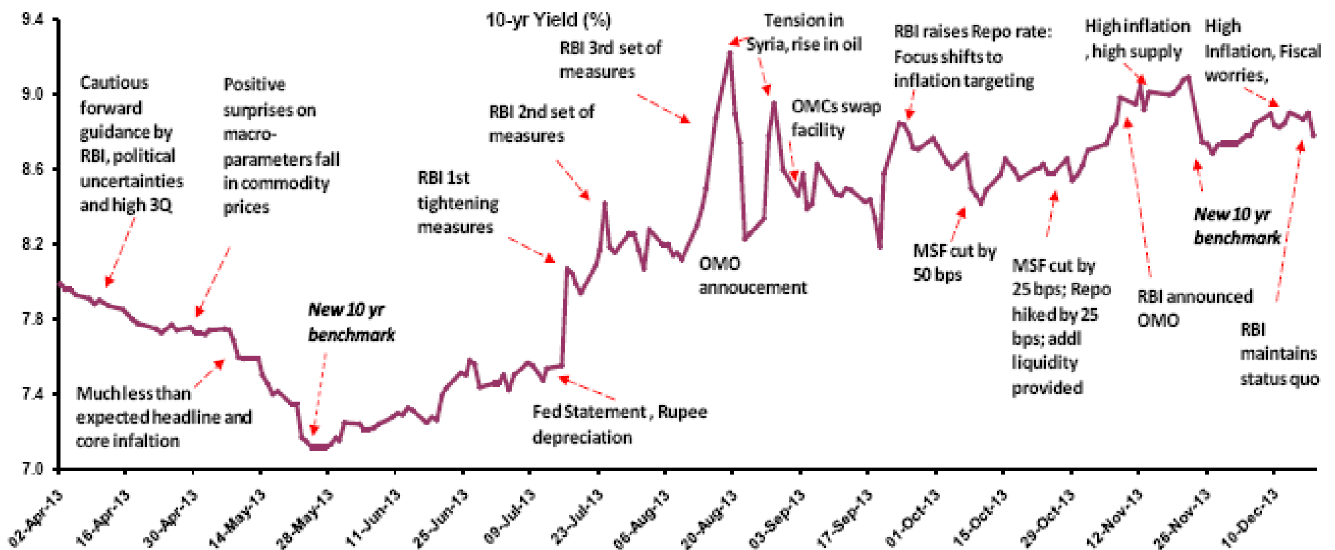
DEBT OUTLOOK

Wishing you all a very happy new year! Year 2013 was an eventful year filled with hopes, despairs and uncertainties. Period from Jan 2013 to May 2013 was a period of hope where market was expecting 10 year G-sec to fall further and lots of investments were made in long duration bonds and funds. But this was short lived as RBI increased MSF rates overnight on 15 July 2013 to defend depreciating INR. Please recall INR depreciated as low as Rs.68 against dollar. This action from RBI caused mayhem in the fixed income market and yields across the curve went up and especially 10 year G-sec yield rose to 9.24% in the month of August 2013. So investments made in 1st quarter of financial year yielded negative returns in their debt portfolios. This was a period of despair. The third period of 2013 is when the new RBI Governor took over in early September and came out with a series of policies to raise FX reserves, particularly through the FCNR-B deposit scheme at attractive rates and overseas borrowing by banks under Tier 1 capital. He also opened an RBI window for the dollar purchases by the oil marketing companies rather than having them buy from the open market. This measure took out a large and persistent demand for dollars from the market. All these steps calmed the nerves of the market as the exchange rate began to stabilize in a range against the dollar. Sentiment began to improve gradually as the RBI's scheme to collect dollar deposits garnered around $34 billion by end November, as compared to initial estimates of $15 billion. During this period suddenly inflation print came much higher than the market expectations. After falling below 5% level in the month of July 2013, Inflation again shoots up to over 7.2% in the month of Nov 2013. This prompted RBI governor to hike the repo rates by 25 bps in the month of Nov 2013. This is the period of uncertainty as interest rates movement depends on inflation numbers, which in turn are highly volatile.



(Source: Reliance AMC)

Above chart depicts fortnightly movement of 10 year G-gec yield. 2013 was a challenging year for fixed income investors. The benchmark yield at the beginning of the year at around 8% and went down to a low of 7.11% in May 2013, went up to 9.24% in August and is at 8.80% currently. At the current yield, the benchmark is about 100 bps over the LAF repo rate – above its long term average. Likewise even corporate bonds at the short end are trading at a spread that is higher than typical levels.

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DEBT OUTLOOK

RBI in December 2013 policy meeting kept all rates on hold against market consensus of a 25 bps hike. In fact there were sections of the market fearing a 50 bps hike as well. The accompanying commentary by no means takes the focus away from inflation. Specifically, the stated reasons 'to wait before deciding the course of monetary policy' are as follows: There are indications that vegetable prices may already be turning sharply, Disinflationary impact of recent exchange rate stability should play into prices, Negative output gap including recent slowdown in services sector as well as lagged impact of effective monetary tightening since July should help contain inflation.

There are many uncertainties prevailing in markets, which are raising many questions in investor's mind. Lets look some important questions as under:

Will RBI hike the interest rates in Jan 2014 meeting?

Expectation on rate hikes would incrementally be dependent on the inflation numbers going forward. If the CPI and WPI would tend to assume a moderating bias, we don't see any imminent case for aggressive rate hikes from the current levels. Bulk of the inflation is led by rise in primary articles, largely vegetables, which is already on the decline. This should cool off inflation to some extent in early part of 2014. Key risks playing on inflation would be the trajectory of core CPI and WPI, which would give RBI some indication of the generic nature of inflation.

Should one hold on to old investments in Long duration funds which are yielding near zero return?

We suggest investor to have patience and hold on to their investments. As they have already taken the pain of rising interest rates. Please note that whenever the interest rates rises, bond prices falls and vice a versa. Investments made in 1st quarter of the year, are suffering due to rise in interest rates. So when ever interest rate will fall the return would come back.

What is the Inflation Expectation?

WPI inflation rose to 7.5 per cent in November – 14-month high, from 7.0 per cent in October month. Consumer price inflation (CPI) for November also soared to 11.2 per cent from 10.2 per cent in October. Crucially, core inflation, measured by CRISIL core inflation indicator (CCII) as well as non-food manufacturing inflation rose marginally in November. Momentum indicators suggest that while inflation in primary articles is likely to moderate in the coming months, inflation in manufactured products could accelerate further. Over all We believe that inflation will moderate from these levels.

What is the expectation of CAD & Fiscal deficit?

CAD: The current account deficit (CAD) during Q2 2013-14 fell to 1.2 per cent of GDP from 4.9 per cent during Q1 2013-14. RBI expects the CAD to be less than 3 per cent of GDP during the current financial year. One of the major reasons for CAD coming down is that from July 2013 onwards exports have grown faster than imports.
Fiscal Deficit: The government's fiscal deficit in the first eight months (Apr-Nov) of FY14 has gone up to 93.9% of the full-year budgeted target. Other than weaker revenue collection the asset sales have been way below target. Thus instead of being expansionary, as RBI mentioned, tightening government spending in Q4 to meet budget projections will add to the growth headwinds.
We believe CAD would be under comfort level of RBI but Fiscal deficit number needs to be watched out keenly.

What should be ideal asset allocation strategy for debt portfolio?

We believe proper asset allocation would generate better post tax return with less volatility. Looking at recent developments we suggest following allocation:

S.N	Category	Allocation (%)
1	Double Indexation FMP's	15
2	Tax Free Bonds	15
3	Accrual Strategy	20
4	Short Term Funds	20
5	Long Duration Funds	30
	Total	100

Please note that investment in long duration funds should be made for period of 15-20 months. There could be some volatility. Above allocation aims to deliver better post tax return.

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