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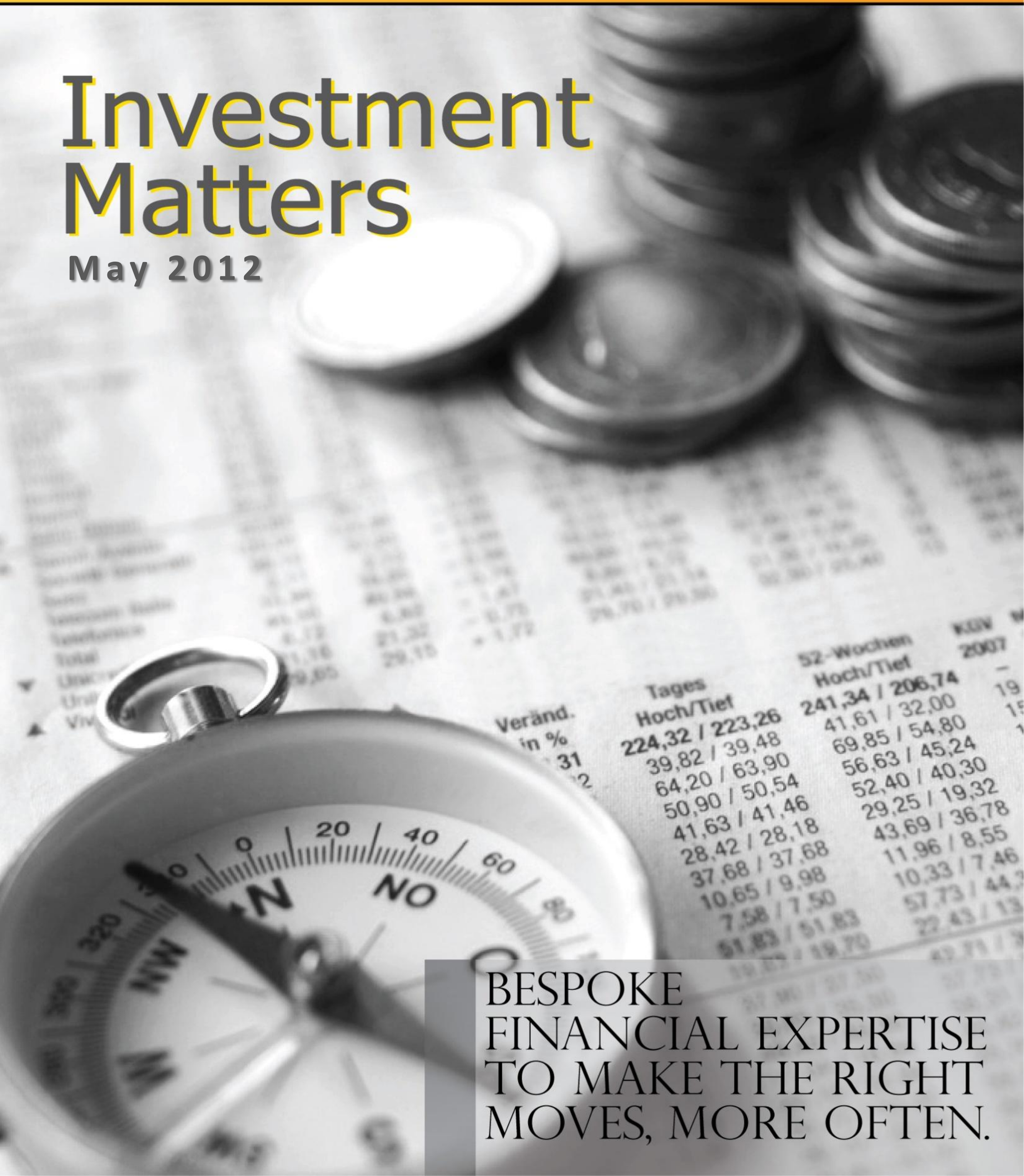
Investment Matters

May 2012



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

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EQUITY OUTLOOK FROM CIO'S DESK

The RBI surprised the market with a 50 bps cut in rates and bringing focus back to supporting growth rather than only inflation. We had written about this possibility (March newsletter) of government prodding the RBI to cut rates to support growth going ahead. However, RBI toned down expectations of further rate cuts indicating that the economy is operating below potential, but only with a modest output gap, and secondly, upside risks to inflation still persists. The central bank in our view is following the right approach and putting the ball back in the government's court by asking it to act on controlling fiscal deficit and work on improving the current account deficit in the long term.

As we have been highlighting, the inability of the government to control subsidies and bring down fiscal deficit continues to hamper growth prospects for India thereby affecting sentiment towards equity markets. The central government fiscal deficit can potentially be closer to 5.5-6% of GDP for FY13 if current state of affairs continues. Crude prices are a key determinant of the fiscal deficit and the high current account deficit. Right pricing of fuel in the domestic markets can bring a meaningful change in India's long term growth story. However, taking these unpopular decisions are not easy and needs strong political will at the centre. Post the recent state elections especially the UP elections, the current ruling coalition, which is already facing a difficult situation with most of its current allies, is now politically weaker. It would find it extremely difficult to pull through any serious reforms. A silver lining among all the bad news on fiscal deficit is that all state government combined fiscal deficit has been steady at closer to 2.4% of GDP, more positive is the fact that in terms of revenue deficit, state governments are performing much better with a close to 0% revenue deficit for FY12. Hence the combined fiscal deficit of central + state government continues to be steady, though has much room to improve going ahead.

Europe continues to be a region in news for the wrong reasons. Newsflow on the election verdict in a few countries like Greece, France, etc could result in uncertainties with respect to austerity measures and how that could potentially impact the fiscal support granted by EU/ECB. Officially on last count 10 European region countries have gone into recession with Q-o-Q degrowth in GDP for 2 consecutive quarters. Europe as a region will continue to grow at a slow pace till such time they are able to take care of their fiscal as well as high consumer leverage issues. The only upshot to poor growth could be its impact by way of lower oil prices which could be positive for India.

Monsoon will be a key event going ahead in India. Early indications suggest that FY13 monsoon will once again be normal. FY12 crop production has been at all time highs and the government is contemplating allowing exports for food grains in FY13, this has a potential to keep sentiment on the positive side among farmers thereby having positive impact on the consumption demand in the country.

We expect CY12 to be a year of stock picking with markets mostly range bound and better performing companies being rewarded for their consistent performance. Happy Investing.

Hiren Ved

Chief Investment Officer
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DEBT OUTLOOK

Bond market cheered RBI policy but showed their concerns on following developments:

- Rating agency S&P though kept India's sovereign rating at BBB- but downgraded its outlook from stable to negative primarily due to slowing economic growth and widening current account deficit
- GAAR continued to overweigh the market sentiments with no clarity emerging on the taxation to global investing flows (FDI & FII)
- Widening Current account deficit and high fiscal deficit
- Depreciating Rupee

April month had its mixed bag of events with key economic indicators listed below:

- Inflation for the month of March remained steady at 6.89% compared to 6.95% for the previous month. Core inflation fell sharply to 4.66% from 5.75% in February.
- IIP for February came in 4.1% as compared to 1.1% in the previous month and 6.7% in the same month last year.
- Fiscal Deficit as a % of budgeted target stood higher at 94.6% in Apr-Feb FY12 compared to 68.6% last year.
- The rupee remained under pressure during the month with a sharp fall of about 2.6% and finally closing at 52.52 levels against dollar.
- The advance estimate of the GDP growth of 6.9 per cent for 2011-12 by the Central Statistics Office (CSO) came close to the Reserve Bank's baseline projection of 7.0 per cent.

Reserve Bank of India in its Annual Monetary Policy 2012-13 reduced the repo rate under the liquidity adjustment facility (LAF) by 50 basis points. The repo rate accordingly dropped from 8.5 to 8.0 per cent. RBI also in order to provide greater liquidity cushion, raised the borrowing limit of scheduled commercial banks under the marginal standing facility (MSF) from one per cent to two per cent of their net demand and time liabilities (NDTL).The larger than expected rate cut had a direct impact on the bonds market which saw yields falling 15 – 25 bps across the curve. However, sovereign and corporate curves grappled with supply pressures along with continued liquidity issues which saw them shed all the gains. 10 year government bond yields rose towards 8.65% - 8.70% towards the month close. Inflation outlook remained worrisome due to weakening INR and elevated crude oil prices.

Domestic systemic liquidity conditions improved in the early part of April in line with expectations. With government spending approximately INR 1,17,000 crores from the amount collected as advance taxes in March till mid of April reducing the deficit to INR 85,000 crores. However, consequent seasonal leakage on account of currency with public took liquidity deficit back to INR 1, 20,000 crores level. Moreover with the volatility seen in Rupee, RBI is expected to intervene in forex market hence affecting rupee liquidity.

We believe the longer end of the yield curve is expected to remain volatile given projected high fiscal deficit and government borrowing programme this fiscal. Short term rates are still at elevated levels given the stressed liquidity. Going forward we expect the yield curve to steepen bullishly (short end rates falling faster than long rates) over the next 2 – 3 months.

DEBT OUTLOOK

The short end rates currently are still highs hence we suggest short term funds with low average maturity and high carry in the portfolio as a superior investment option. Longer end of the curve would react once there is clear sign of RBI indicating policy rate cuts. Investors with higher risk appetite can invest a part of their portfolio in dynamic bond funds to play safe duration calls to generate better risk adjusted returns.

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