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Investment Matters

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MOVES, MORE OFTEN.

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EQUITY OUTLOOK FROM CIO'S DESK

What a difference a few billion dollars makes!

FII's invested US$2.2bn in Indian equities and the broader BSE500 Index was up 13.3% for the month. Further with RBI taking steps to curb speculation in the INR and an additional US$3bn+ inflow into Indian Debt by foreigners saw rupee appreciate 7.2% in January. As of 8th Feb markets have completely erased the Nov-Dec 2011 fall in USD terms.

The sharp up move has taken many by surprise as participants were either underinvested or wrongly hedged (as the dogs of 2011 have become stars for 2012). Hence we have seen a lot of people chase momentum through high beta names.

While a lot of the money flow has been top-down driven, smart money has poured into cyclical and industrial companies where huge valuation gap exists relative to past valuation multiples but visibility still remains poor. On our part, we have not taken that contrarian approach as we believe some of these contrarian bets in industrials could eventually turn out to be value traps.

We find that better value and visibility is available in a lot of mid and small cap companies. After having attended 3 investor conferences over past 8 days we are clearly seeing heightened interest for meeting with managements of mid and small cap companies. Large asset managers seemed to have completely abandoned this space which should provide a lot of opportunity for us.

A couple of eye soars while markets keep chugging higher
- While RBI has categorically made it clear that they have shifted their focus from Inflation to growth, short term interest rates (3m CPs & CDs) are still in double digits despite consistent effort by RBI increase liquidity in the system through successive OMOs as well as the recent CRR cut for banks.
- Growth rates in India are already being affected by slowing investment cycle. We are now seeing consumption slowing with poor retail sales across product categories in the Oct-Dec'11 quarter. January has seen retail activity pick up but driven primarily by inventory clearance related discounts.

Finally, the current rally driven by LTRO in Europe has shades of the rally around QE2 announcement between Sept & Nov 2010 where markets rallied by about 17%. For this one to be more sustainable, India would at least need to get its act right in dealing with high twin deficits (trade and fiscal) and balancing policy between the need for fiscal consolidation and arresting the growth decline.

The Union Budget on 16th March 2012 will provide the answer!

Hiren Ved

Chief Investment Officer
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DEBT OUTLOOK

RBI in its Third Quarter Monetary Policy held on 24th January 2012 primarily spell out its broader view towards the monetary policy stance going forward. The three primary factors indicated were:

- Maintaining an interest rate environment to contain inflation and anchor inflation expectations
- Manage liquidity to ensure that it remains in moderate deficit, consistent with RBI comforts zone
- Respond to increasing downside risks to growth.

Key action and guidelines by RBI can be summed as:

- Cash Reserve Ratio (CRR) reduced by 50 bps to 5.5% from 6.0%
- Repo and Reverse repo rates kept unchanged at 8.50% & 7.50% respectively.
- Inflation projection till march end kept unchanged at 7.0%
- GDP forecast for FY12 lowered to 7.0% from earlier projected 7.6%.

High liquidity deficit along with increasing downside risks to growth propelled RBI for a CRR cut to infuse primary liquidity of Rs 320bn in the banking system. RBI going forward with its indication to alleviate the stress in inter-bank liquidity through open market operations (purchase of government securities) based on the assessment of the prevailing conditions further announced OMO for an aggregate amount of Rs 100bn to be conducted on 3rd Feb 2012. This is the ninth OMO by RBI in the last ten weeks and the first since it reduced the CRR. Since 24th Nov 2011, RBI has bought government securities worth Rs 719bn in aggregate in order to inject liquidity into the banking system. CRR cut along with OMO should be a positive sign easing pressure on call rates.

Annual inflation for December came at 7.47% compared with 9.11% for the previous month. Manufactured product inflation continued to remain sticky at 7.41%. Primary articles inflation fell at 3.07% vs. 8.53% in November. Core inflation in December moderated to 7.69% from 7.90% in November still above RBI's comfort level. IIP growth rate for the month of November stood at 5.9% as against -5.1 %(revised to -4.7%) reported in previous months much better than market expectation. Core inflation is expected to ease from current levels but growth as indicated by RBI would remain subdued in coming quarters. For further actions, particularly on repo rate front, apex bank will be closely monitoring the trend in core inflation and signs of fiscal consolidation in the Union Budget along with policy action to revive investment cycle. We believe that declining inflation and growth has increased the scope for RBI going with monetary easing as early as March 2012. Till that time we expect long term rates to be range bound between 8.20 to 8.40%.

Combination of slower economic activity and high deposit interest rates has led to a moderation of credit growth and more deposit accretion, leading to credit to deposit ratio falling.

DEBT OUTLOOK

Moreover, currency with public is falling, there are concrete signs of distinct growth slowdown both in India and globally, all these reasons make us believe that short end rates are peaking out hence we suggest short term funds with low average maturity and high carry in the portfolio will be a superior investment option.

Long term rates are expected to be range bound with downward bias. We expect first short term rates will fall as they are at their historical highs. Longer end of the curve would react once there is clear sign of inflation coming down with 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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