ALCHEMY
PRIVATE WEALTH

Investment Matters

November 2011

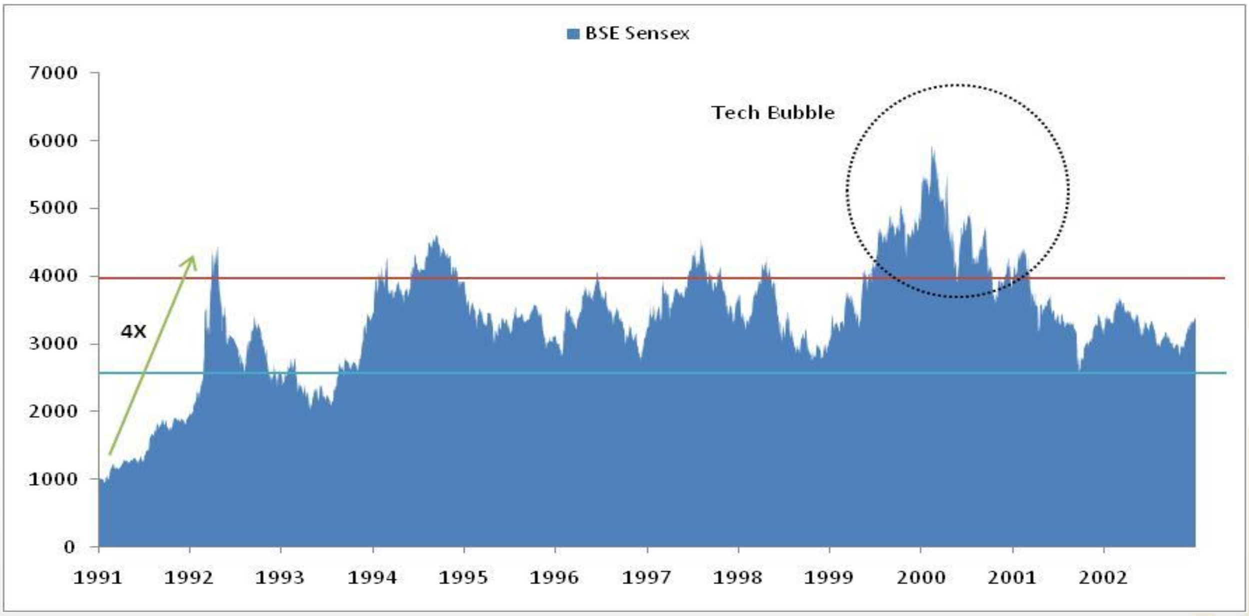
BESPOKE FINANCIAL EXPERTISE TO MAKE THE RIGHT MOVES, MORE OFTEN.

EQUITY OUTLOOK FROM CIO'S DESK

It is now approximately a year since the Indian markets peaked in November 2010 and since then have been on a steady declining path. The correction was catalysed by the alleged corruption scandals in the telecom and housing loan sectors followed by civil unrests in Egypt and the uprisings in Libya and other Arab countries, acceleration in inflation followed by a series of rate hikes by RBI, the S&P downgrade of the US credit rating and now the sovereign debt crisis in Europe. Over the past 12 months, Investors have had to consistently contend with nothing but bad news both on the global as well as local macro and political fronts. The sense of relief and cautious optimism which had crept in post the stimulus induced recovery of markets and the unexpected political mandate given to the congress party which led to the formation of the UPA 2 government in India in 2009 is now giving way to uncertainty and despair as the current political dispensation has been unable push any significant reforms. Far from carrying out any path breaking reforms, the events of the past 12 months has led to a perception that the government is even unable to carry out a normal functioning and is stumbling from one crisis to another. All this has left investors wondering as to what is in store for them from the equity markets.

Given the volatile and challenging environment we face, it is always hazardous to guess how markets would behave in the short run. However it would be interesting to attempt a big picture base case of how markets could unfold over the medium term taking advantage of lessons from history and making speculative judgments about the near term economic conditions and earnings trajectory.

In looking back at history, it would be relevant to go back to the early 1990-91 which was a turning point for the Indian economy and its equities market. It was a balance of payment crisis which forced the country to undertake its first major steps at liberalizing its economic policies. Dr. Manmohan Singh the current PM was the FM then and he enacted bold economic policies which led to first major rerating of the Indian stock market. The BSE 30 Index (Sensex) went from 1000 in 1990 to 4000 in 1992 a 4X return in just two years (refer chart 1)

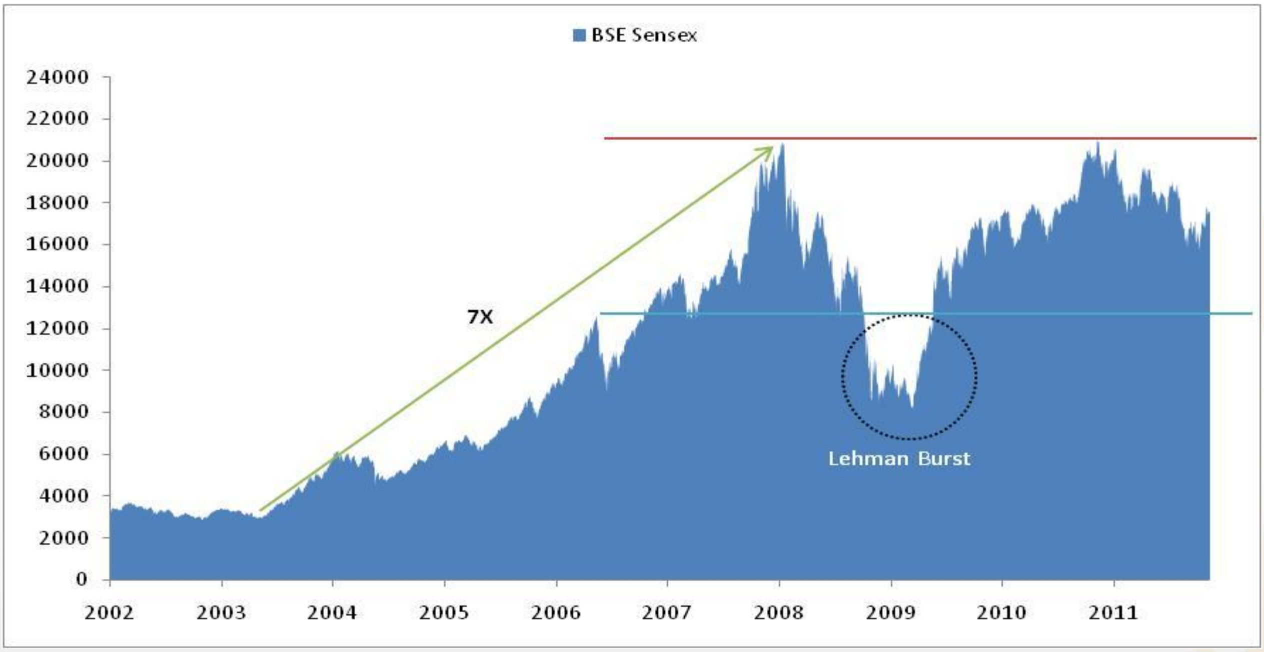


EQUITY OUTLOOK FROM CIO'S DESK

The peak of 1992 saw the break out of the Harshad Mehta stock market scam which led to the index crash to 2000 levels. Since then the markets entered into a long consolidation phase for almost a decade (1992-2003), with index hovering within a range of 2500 to 4500. The only exception was in 2000 when the index peaked at 6000 levels instead of the usual 4500 levels it did over the decade. But the long consolidation phase also saw 4 mini bull and bear market cycles (1994, 1996, 1997 and 2000) which culminated in the eventual crash after the tech bubble burst in 2001. During the long consolidation phase investors endured several geopolitical (invasion of Kuwait by Iraq in 1990 and the terrorist attack in the US in 2001), political (resignations of BJP PM Vajpayee in 1996 and again in 1999, Deve Gowda running a minority government in 1997 which did not last long) and global economic crisis like the collapse of Barings in 1994 and more notably the Asian economic crisis of 1997.

During this decade long consolidation phase the Sensex earnings which was Rs. 59 in 1991 had reached Rs. 271 by 2003 compounding @ 13.5%, while the markets compounded @ 8.3% during the same period. The markets peaked 4 times at around a P/E multiples of over 18X and bottomed around 12X.

Indian industry, especially the manufacturing sector went through a very difficult period post the Asian crisis in 1996-97 as India's GDP growth slumped from 8% in 1997 to 4.3% in 1998 and remained in the range of 4-6% growth until 2003. The upshot of this difficult period was that the industry used this opportunity to really cut costs, shed the flab and became competitive. With the tech bust and the resultant fall in economic activity meant that interest rates had to fall, the 10 year bond yield corrected from a high of 12% in 2000 to 5% by end of 2003. A lean corporate sector, low interest rates a complete apathy towards equities and low valuations (the markets were trading at a multiple of 11.2 in 2003) meant that there were ideal conditions for the birth of the new bull market. Thus in 2003 started a next major rerating of the Indian markets (please refer chart 2).



ALCHEMY
PRIVATE WEALTH

EQUITY OUTLOOK FROM CIO'S DESK

The Sensex rallied from 3000 levels in 2003 to 21,000 by 2008, 7X in 5 years! No doubt the massive rerating had a basis, earnings compounded @ 26 % and Sensex compounded at a higher 52% meaning that average p/e multiples rose, partly because of strong earnings growth, rising ROE's and tailwinds from a credit fuelled global economy.

The party was interrupted by the sub prime crises which erupted in 2007 and culminated with the bust of Lehman brothers which resulted in a massive 60% correction from the peak in 2008. Clearly, in hindsight the last rush from 15k-16k to 21k was quite euphoric and the correction from 12.5K to 8K in 2008 was equally excessive and the panic did not last beyond a couple of months before the markets recovered quickly back to 15k in early 2009. The markets did attempt a shy at 21K in November 2010 but were not able to surpass those levels.

Given the past historical trends and the environment that markets are currently faced with both because of risk of near recessionary trends in DM's, the euro zone crisis and our own domestic issues like a lack of policy impetus, high interest rates, high commodity prices and a slowing economy warrants that the markets would have to spend time consolidating in a range till these problems are sorted out. Given the complex nature of the Euro zone crisis, it would be too simplistic to assume that it can be sorted out anytime soon and without considerable pain and uncertainty.

So what could be the new range for the market then? We believe it could be between 12.5k to the recent peaks of 21k reached in early 2008. The rationale for this range is that the Indian markets have always traded in the range of 11-12X to 18-19X earnings with the average valuation being at 14-15x forward earnings. After three years of flat earnings of about 830 on the Sensex between FY 2007-08 and FY 2009-10, the earnings have now settled at 1065 for fiscal 2011 and estimated to be conservatively in the range of 1150 to 1200 for FY12. Assuming that earnings get pegged at 1150 to 1300 in the next 2 years, it would give you a range of 12.5K to 23K.

The markets have already spent the last five years in this range and it is not inconceivable that it spends another 2 years in the same range as we work through many of the challenges facing our economy and the developed world at large. Maybe a combination of much lower interest rates, lower commodity prices and new political dispensation post the 2014 elections which is younger and bolder and is capable of fulfilling the aspirations of a young and vibrant India could set the stage for the next big rerating of the Indian markets. We have a strong conviction that the long term structural bull market in India is alive, investors just have to work through the consolidation phase for a while.

Hiren Ved
Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

DEBT OUTLOOK

Month of October 2011 witnessed unprecedented events on the global front especially the euro area to credibly resolve its sovereign debt and financial sector problems. The trade and financial linkages increase the risks of the euro area instability transmitting through to emerging market economies (EMEs), which have already experienced large volatility in their financial markets, particularly their currency markets. While the prices of many commodities declined over the quarter, crude oil prices remained firm. Moreover the government's announcement of extra borrowings of Rs.53000cr previous month has sent the bearish signals to the market. The expected announcement of the Government borrowing calendar for the second half of FY12 kept the yields up. The most traded 10-year bond augmented 8.85% over the close on month.

RBI in its Second Quarter Monetary Policy Review on 25th October 2011 increased the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 8.25 per cent to 8.50 per cent with immediate effect. Consequent to the above increase in the repo rate, the reverse repo rate under the LAF will stand automatically adjusted to 7.50 per cent and the marginal standing facility (MSF) rate to 9.50 per cent with immediate effect. RBI expects inflation to fall from December and hit 7% by March. RBI also unexpectedly deregulated the savings bank deposit rate subjected to few conditions. Inflation is expected to moderate further in first half of 2012 – 13. Subject to inflation trajectory panning out as desired, the RBI has pretty much flagged an end to the rate hike cycle. Alongside containing inflation and anchoring inflationary expectations, there is explicit mention in the stance now to 'stimulate investment activity to support raising the trend growth'.

India's headline inflation as measured by WPI for September came marginally lower at 9.72% y-o-y compared with 9.78% for the previous month, in line with market expectations. Primary articles' inflation declined to 11.8% (Y-o-Y) from 12.6% in the previous month, reflecting high base effect; fuel & power inflation climbed to 14% (Y-o-Y) from 13% in August due to rise in electricity prices and manufacturing inflation declined marginally to 7.7% (Y-o-Y), from 7.8% in August, on fall in textile prices and base effect. Importantly, core inflation (non-food manufacturing) that RBI closely monitors also eased to 7.6% versus 7.8% in the previous month. Both the level and persistence of inflation remain a cause for concern. The domestic demand-supply balance, the global trends in commodity prices and the likely demand scenario would play a major role in shaping the inflation path.

Currently, systemic liquidity is in the negative territory (LAF is – Rs. 52,385 cr. as on Oct 31, 2011) and the RBI's intervention in the FX market has been negligible so far. Therefore, the impact on systemic liquidity was marginal. However, a large-scale outflow in a short time period could have a major impact on systemic liquidity and therefore could push over-night rates higher.

We believe that Bond yields are unlikely to soften much from current levels in the immediate term. With dominant concern shifting to increasing primary supply, we expect yields to remain under pressure. Benchmark bond may continue to trade in the region of 8.75%-89.25% in absence of any RBI actions in terms of OMO which could give some relief to the bond market. Moreover, since RBI is at the end of tightening cycle in terms of policy rates the additional borrowing by the government in second half will suffice to check any downside in yields. We suggest short term funds with low average maturity and high carry in the portfolio. For investments for year or more, FMP looks attractive investment avenue.

Rupesh Nagda
Head – Investments & Products
Alchemy Capital Management Pvt. Ltd

ALCHEMY
PRIVATE WEALTH

DISCLAIMER

General Risk factors

- All investment products attract various kinds of risks. Please read the relevant Disclosure Document/ Investment Agreement carefully before investing.

General Disclaimers

- The information and opinions contained in this report/ presentation have been obtained from sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete.

- Information and opinions contained in the report/ presentation are disseminated for the information of authorized recipients only, and are not to be relied upon as advisory or authoritative or taken in substitution for the exercise of due diligence and judgement by any recipient.

- The information and opinions are not, and should not be construed as, an offer or solicitation to buy or sell any securities or make any investments.

- Nothing contained herein, including past performance, shall constitute any representation or warranty as to future performance.

- The services related to Mutual funds, Insurance, Real Estate, Art, Commodity etc. may merely be a referral / advisory services in nature. Such third party investment products or services do attract the general and specific risk factors unique to those respective products or services, which would be mentioned by the manufactures of those products in the respective product documentation. The prospective investors in such third party products are advised to read and understand those risk factors & disclaimers, in addition to what has been stated herein. Alchemy Capital Management Pvt. Ltd., its Group or affiliates have not verified and do not take any responsibility for any statements, numbers or claims made, omitted to be made or implied in any documentation, presentations etc. which have been created by the manufacturers of such third party products or services.

- The client is solely responsible for consulting his/her/its own independent advisors as to the legal, tax, accounting and related matters concerning investments and nothing in this document or in any communication shall constitutes such advice.

- The client is expected to understand the risk factors associated with investment & act on the information solely on his/her/its own risk. As a condition for providing this information, the client agrees that Alchemy Capital Management Pvt. Ltd., its Group or affiliates makes no representation and shall have no liability in any way arising to them or any other entity for any loss or damage, direct or indirect, arising from the use of this information.

- This document and its contents are proprietary information of Alchemy Capital Management Pvt. Ltd and may not be reproduced or otherwise disseminated in whole or in part without the written consent.

Edited by: Rupesh Nagda (Ph: +91-22-66171785), Ambrish Jamodkar (Ph: +91-22-66171772)
Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-66171700