ALCHEMY
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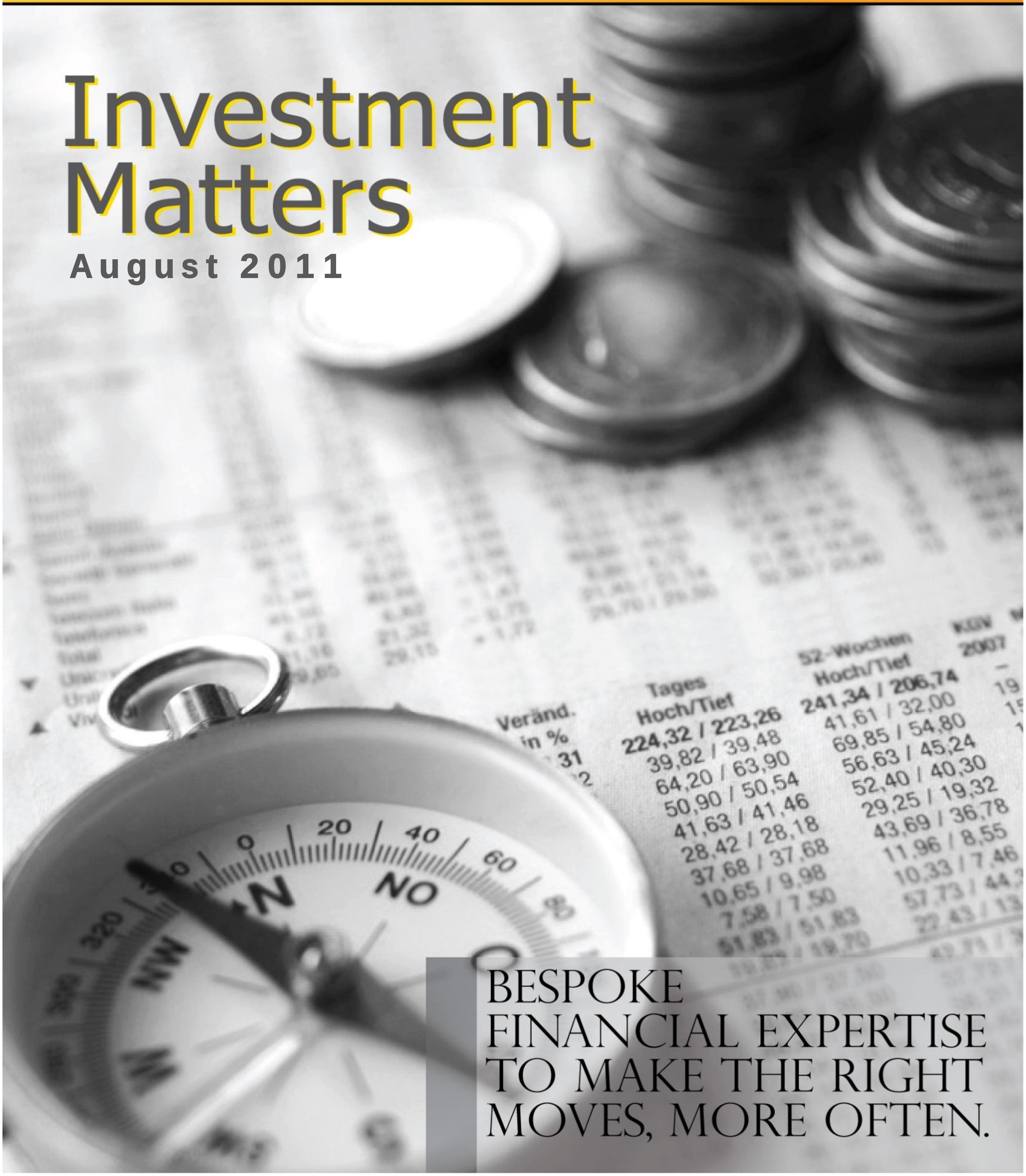
Investment Matters

August 2011



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

EQUITY OUTLOOK FROM CIO'S DESK

The past few days have seen a complete rout in global equity markets …

On Friday Aug. 5, 2011, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the United States of America to 'AA+' from 'AAA'. The outlook on the long-term rating is negative. At the same time, Standard & Poor's affirmed its 'A-1+' short-term rating on the U.S. In addition, Standard & Poor's removed both ratings from CreditWatch, where they were placed on July 14, 2011, with negative implications.

The downgrades were a result of the prolonged controversy over raising the debt ceiling and the fact that fiscal consolidation lacks revenue boosting measures and solely depends on cost cutting measures.
The ratings cut will not lead to an immediate increase in interest rates as the growth outlook for the US looks weak. We should also expect several more downgrades (in Europe) to occur.

Growth outlook therefore for developed markets looks very weak, and for a prolonged period of time.

The correct thing to do for governments is to cut spending and reduce deficits. Politically, this is of course also the most difficult thing to do. The easiest therefore is to print currency and inflate the economy in the current deflationary environment (this will be inflationary for Emerging Markets eventually).

Efforts to pump up the economy by buying back debt/bonds etc. will be one measure that we expect the ECB to adopt. This will require a EUR 1tn of funding – basically printing more money – which eventually will be inflationary for those economies. But till inflation begins to show up, this strategy seems to be the only one that can do the trick in the short-term. We also expect interest rates in the US and EU to remain low for a prolonged period of time. The US Fed has made a statement to that effect – that policy rates will remain low till mid-2013 and they would use whatever suitable tools available to them to stimulate the economy.

Post the S&P downgrade of US debt, world markets have seen a complete aversion to risk and have corrected very sharply.

We continue to believe that the GDP growth in India will slow to sub 8% - perhaps 7.5% or thereabouts. This is still very decent given the lack of growth elsewhere in the world. We also think inflation and therefore interest rates, will peak within the next six months – and given the recent correction in global commodity prices, this may occur even earlier. We therefore see a pick-up in GDP growth in FY13 as investment (in infrastructure) gradually picks up.

Lack of government action is hurting. Infrastructure spending is weak and we need to see decisive action from the government regarding policy action to change this trend. We are hopeful that the government given the recent global events will be forced to act. This is one counter cyclical measure that can help improve investor sentiment.

Eventually global investors will move to where growth is !

EQUITY OUTLOOK FROM CIO'S DESK

We therefore strongly believe, given that global investors are underweight on India in general, the fact that India has underperformed hugely YTD and that inflation / interest rates should peak out in India, using this market correction to add exposure to India is a sensible way forward to go – despite the short-term pain and uncertainty.

We will continue to focus on bottom-up ideas. Given that the export markets are in turmoil, we will be very selective at adding any such names. Our focus will be more on domestic themes and we use this correction to add to such names.

Hiren Ved
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DEBT OUTLOOK

On 26 July RBI surprised all the market participants by hiking policy rates by 50 bps against the market consensus of 25 bps. Highlights of RBI's 1st Quarterly Review of Annual Policy – FY 12

- Reserve Bank of India in its 1st quarterly review of Annual policy – FY 12 hiked the repo rate by 50 bps to 8%. Consequently the reverse repo stands revised to 7% & Marginal Standing Facility to 9.0 %.
- Bank rate and CRR rate maintained at 6.0% each
- RBI Governor in his speech said that inflation so far has been higher than expected. In particular, non-food manufactured product inflation has been significantly higher than the average rate of 4 per cent over the last six years. Crude oil prices remain volatile and are a major risk factor. The recent increase in domestic administered fuel prices and the minimum support price for certain food items will also keep inflation under pressure.
- The baseline projection of real GDP growth for the current year has been retained at 8.0 per cent.
- RBI guided that going forward the monetary policy stance will depend on the evolving inflation trajectory, which in turn will be determined by trends in domestic growth and global commodity prices. A change in stance will be motivated by consistent significant fall in growth below trend.

We believe that, RBI has continued with its anti-inflationary policy. As the growth numbers are still sustaining and inflation is still high, the RBI has chosen to aggressively tackle inflation. The monetary policy stance in future will be determined by evolving inflation trajectory, which in turn will be determined by trends in domestic growth and global commodity prices. A change in stance will be motivated by signs of a sustainable downturn in inflation. 10 year G-sec yields were up 12bps and closed at 8.44%. We expect yields to move up gradually on expectation of further rate increase and supply fears. 10 year G-sec is expected to be in the range of 8.30% to 8.50%. Further RBI's concern over fiscal deficit is worrisome and will keep pressure long term bonds.

Another interesting thing to watch out is the decision on US debt ceiling. The US needs to raise its USD 14.29 trillion borrowing ceiling by 2nd August 2011 to avoid a cash crunch that would force it to go back on spending commitments and possibly default on its debt. If the ceiling is not raised US could default on its debt. This would cause possible down grade in its credit rating.

Going forward we suggest investors to avoid long term debt and high duration portfolios. It would be prudent to invest in short term funds and low duration portfolios as we are near the peak of short term rates. Current high yield of short term papers make them further more attractive on risk adjusted basis.

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