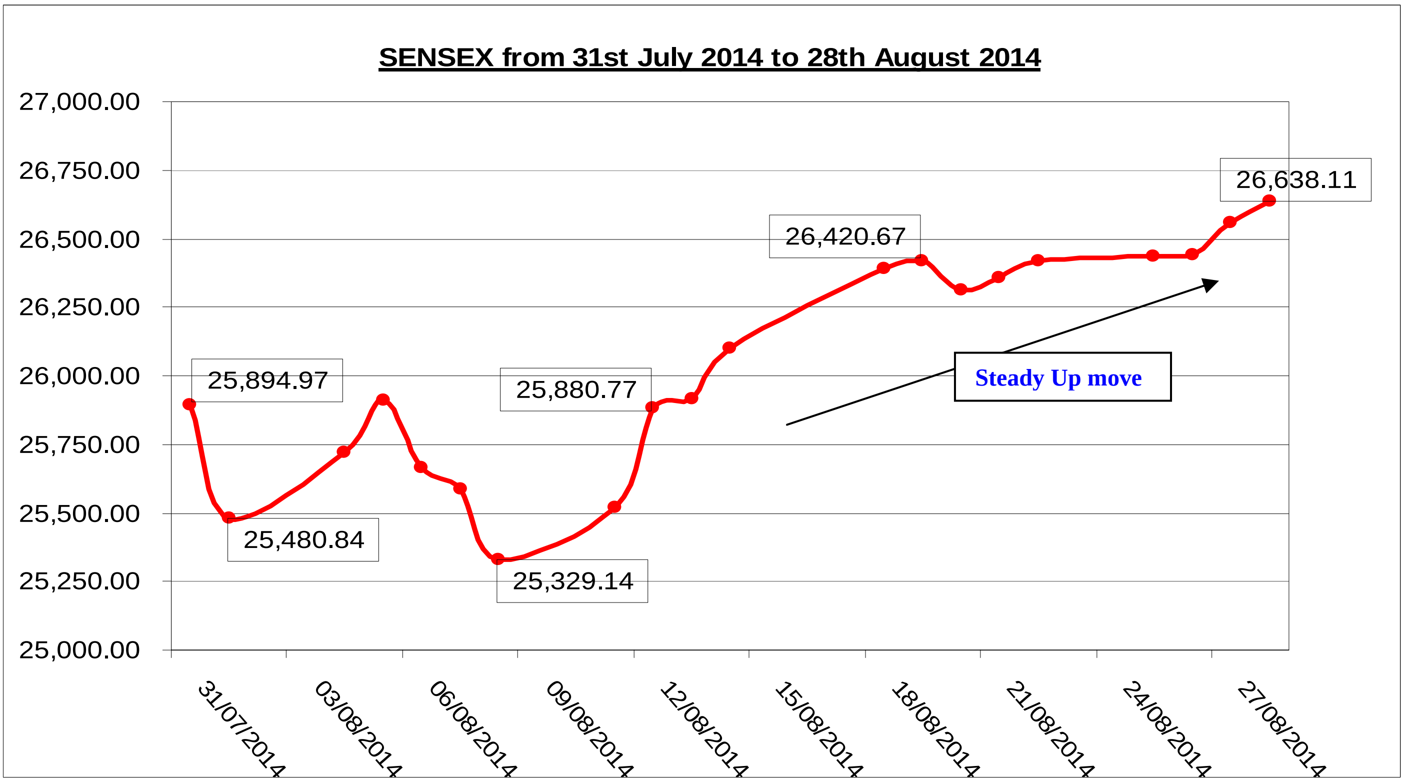
AXIS Equities Pvt. Ltd.
508, apeejay house, 130, bombay samachar marg, fort, mumbai 23
t:6636 5588 f: 2285 3210 e mail:dipanmehta@vsnl.com

Bull Market Rolls on in August



Bull Market in Stocks Continues

The *Modi-Fired* bull market showed no signs of weakening in August. The Sensex rallied by 2.87 % from 25.894.97 (31st July) to 26,638.11 by month end. On several days, new trading highs were hit and although there was a fair degree of volatility in the first half of the month, the latter half witnessed small yet steady gains for the Sensex and other broad market indices.

FIIs and Domestic Institutions Net Buyers

The highlight for the month was the institutional trading data. August was amongst the few months during which FIIs and domestic financial institutions (DIIs), were both net buyers in excess of Rs. 1,000 crores. (The threshold level of Rs. 1000 crores has been kept so as to identify the months during which net buying was of a material nature.)

The other months during which this trend was observed is given in the adjoining table. This data has been extracted from their trading pattern since August 2006 (97 months).

Month	FII	DIIs	Sensex Change
September-06	3,093.31	1,241.64	6.46%
April-07	7,298.25	1,031.80	6.12%
August-07	6,463.57	4,449.80	-1.49%
July-08	6,985.68	1,259.20	6.64%
December-08	4,145.04	2,321.90	6.10%
March-09	1,190.94	1,464.90	9.49%
April-09	4,740.86	2,383.50	17.46%
May-09	12,657.42	2,284.40	28.26%
July-09	13,205.91	1,823.80	8.12%
December-10	6,763.82	1,377.70	5.06%
February-11	1,007.63	1,388.10	-2.75%
June-11	7,151.72	1,022.20	1.85%
August-14	6,664.04	3,196.79	2.87%

Interestingly, there have been only 13 months in the last 8 years that this phenomenon has been observed. More often than not, if FIIs are buyers, then DIIs are sellers, supplying stock, and if the DIIs are buyers, then FIIs are sellers providing the supply. These see-saw movements of stock from one class of investors to another cap the gains for the stock market. It is only in such situations, when both are net buyers of a large value, do we witness the full impact of liquidity inflows into equities. Needless to say that the Sensex rallied in most of these months as can be seen from the table above. The quantum of net purchasing by the domestic institutions is a positive and reflects the net inflow into equity mutual fund schemes after a gap of several months, if not years.

Liquidity Flows into Equities very Strong

Liquidity is mother's milk for every bull market and this one is no exception. Another element in this liquidity analysis is the role of the primary markets and the real surprise is here. We are in the 12th month of this *Modi-Fired* Bull market and yet the primary markets are moribund. Soon after the installation of the new government, there was a flurry of fresh capital raising by corporates, but lately, there have been no large issuances. IPOs, QIP issues, private placements are virtually absent. As a result, investors have no choice but to invest into the secondary market. This is the key reason for stocks scaling new highs despite no fresh triggers on the fundamental side.

New Government a Laggard ?

In our previous newsletter, we had expressed our disappointment on the NDA Budget and a rather tepid earnings season. The slow pace of action and lack of imagination on the part of the new government is a risk factor for this market and we would like to elaborate a bit more on what it means for this bull market.

The stock markets have been excited, ever since the news of Narendra Modi being projected as PM candidate, started making rounds. He was and still is the beacon of hope in a country bogged down by slow decision making, structural economic problems and overall malaise in society and governance. The high voltage campaign of the BJP and the astonishing verdict of the electorate, which elected a single party after 25 years, resulted in a dream run for the stock markets. The Sensex has rallied by 53.23% over the past year.

All through these past few months, the nation was fed on expectations that this is a new era and that there would be a change; a fresh approach to solving our problems. It was widely anticipated that tangible steps would be taken to remove impediments to growth. Unfortunately, very little has materialized and with every passing day, the functioning of this new government resembles the much criticized previous one.

Consider the facts:

Inflation and Fiscal Deficit remain Problematic

1. India has a structural inflation problem. Supply side bottlenecks need to be removed as rising domestic consumption has resulted in shortages and high inflation expectations in the minds of the consumer. Rising prices have kept interest rates at elevated levels. This in turn is choking investments, particularly in infrastructure, which is capital intensive and very sensitive to interest rates. The new NDA government was expected to amend / abolish the APMC act, galvanize the Food Corporation of India, offer incentives to improve supply of key commodities and actively monitor and remove the constraints in the supply chain. However, f no concrete steps have been taken so far. Declining crude oil prices will have a salutary effect on inflation, but can the NDA take credit for it?

2. Fiscal Deficit is another area which needs urgent attention. The budget was expected to offer a plan to reduce subsidies and curb government expenditure. However, it failed on this count. Even the hope, that a more realistic fiscal picture would be presented, was dashed as questionable estimates of the previous FM were endorsed. Pricing of oil products, rationalizing subsidies on food and fertilizers and accountability in plan and non-plan expenditure is the need of the hour. However, here too, the initiative is lacking. There is dithering over deregulation of diesel pricing and reining in of fertilizer and food subsidies have been put on the back burner. Lower oil prices will reduce the subsidy burden and higher inflows from PSU disinvestments will also help the fiscal situation, but these are not a given in the long term. The structural problems of a government spending beyond its means are not being addressed. Sure, an Expenditure Management Commission has been constituted and it will submit a sensible plan which will involve taking tough decisions. The question is will the government bite the bullet? A few months ago, we were optimistic that it would. But now, we are not that sure. The impression that one gets is that the gumption to take on powerful lobbies is slowly fading.

No Progress on Reforms in Governance and Removing Retrospective Amendments

3. Reforming the government departments and the PSUs is another agenda which needs to be taken up in true earnest. It should have got priority given that Mr. Modi's mantra was "*minimum government*, *maximum governance*". Here the only visible change is that the bureaucrats in Delhi have been putting in more hours. Hopefully action will follow. However, reforming the PSU management structure and rationalizing government departments is not being spoken of nor are there any specific plans on this front. Although there is an urgency to tackle projects bogged down by indecisiveness (on the part of the government), actual outcome is inadequate.

4. Retrospective amendments are a bug bear for industry and foreign investors. When the BJP was in opposition, it had vociferously opposed the various retrospective changes made by the earlier UPA government. Promises were made to do away with this unfair approach of the government. However, now that it is in power, their resolve to deal with this problem appears to be weakening. Rather than remove this inconsistency of law, the matter is being referred to a high level committee within the CBDT. This is another instance of lack of will power on the part of the new government to *make a difference*.

Other Setbacks – Monsoons, GST, Insurance Bill, SC Judgment on Coal Mines

There have also been other setbacks for the new Modi government, caused largely by present circumstances and extraneous factors.

- Firstly the monsoon has failed and whether it gets classified as a drought year or not there is no denying that rural income, consumption and growth will get negatively impacted. There will be added pressure on the government to increase rural spending to counter the ill effects of lower agricultural output. This will make fiscal management even more challenging.

- Secondly, GST implementation has again got bogged down with key states voicing their opposition. The government has tried its best to resolve issues but there are far too many obstacles and this game changing legislation will take more time before it sees the light of day. Even after all states agree and the act is promulgated, implementation, procedural and operating infrastructure are additional risk factors which could cause disruption in the early phases.

- Thirdly, the failure on the part of the parliament to pass legislation on FDI in Insurance highlights the problems which may arise due to lack of majority in the Rajya Sabha. The NDA has the option of calling for a joint parliamentary session, but that choice has not been exercised.

- Lastly, the Supreme Court diktat on allocation of coal mines since 1993 as 'arbitrary and illegal' has deep ramifications for the core sectors of our economy. No nation can grow without free flow of energy or basic materials. We still have to devise a fair and transparent mechanism to allocate our natural resources and that is a cause for concern. The past decade has seen several scams involving the licensing of use of national property, be it minerals such as coal, iron ore, natural gas or even telecom spectrum. India has to tackle its share of crony capitalism and instituting a robust system of auctioning and monitoring these resources is a crying need of the hour.

Cautious View on the Market as Euphoria may Subside

These developments and the early steps (or lack of progress) taken by the new NDA government are a risk factor for the market. The present euphoria can easily subside if the government fails to deliver. There are umpteen examples of government falling out of favor with the markets. The UPA 2 went through it and in the 1980s, the Rajiv Gandhi government was also a big let down. The present honeymoon period will not last much longer and if the recent by-election results are an indicator, the disillusionment with the Modi government could seep in quickly unless urgent measures are taken.

Our outlook on the market remains cautious for the short term. We had echoed this view in our previous newsletter but the markets have continued to rally. The power of liquidity is difficult to gauge. Just as bottoms in bearish markets cannot be forecast, bull market tops too cannot be predicted. While we are convinced that a multi-year bull market is under way, a significant correction in <u>this</u> bull market is a high probable event.

We could be wrong in our analysis and government action could gain momentum. The growth in the economy and corporate profits could surprise on the upside. However, for the time being stocks are in a slightly over bought zone and there is little margin of safety. Investors should hold on to their purchases and if they are, too overweight in equities or have leveraged positions they could consider unwinding their long positions.

Dipan Mehta