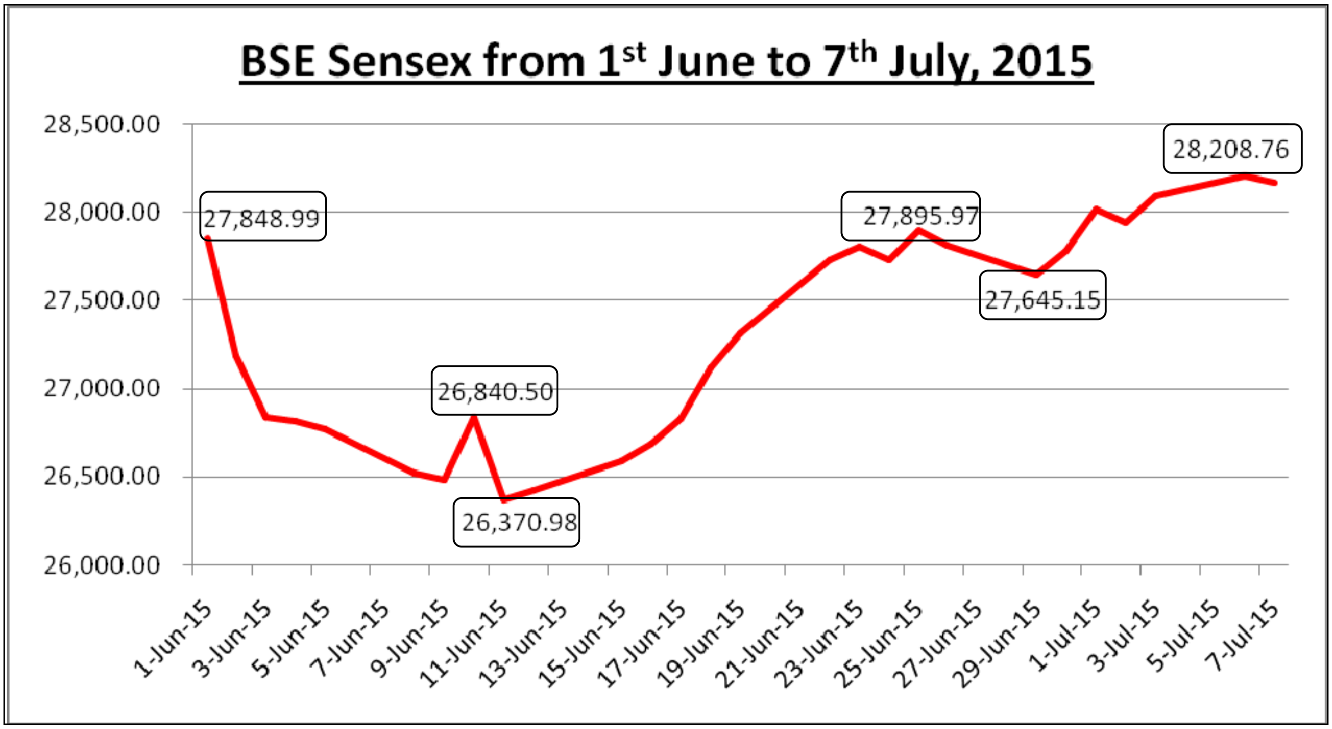
AXIS Equities Pvt. Ltd.
58, Mittal Chambers, 228, Nariman Point, Mumbai - 400 021
Tel. : 6115 1919 Fax : 6115 1999 Email : dipanmehta@vsnl.com

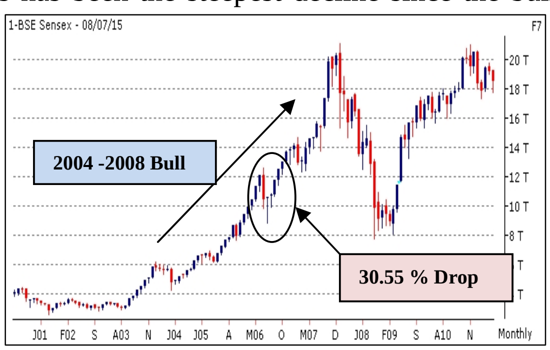
W- Shaped Recovery in June



W- Shaped Recovery in June post Steepest fall in this Bull Market

After the selloff in first half of June, markets staged a smart recovery in the second half and regained most of the lost ground. For the month of June, the Sensex therefore, closed flat with a net loss of just 0.17 % at 27.780.83.

At its lowest point on 12th June at 26,307.07, the correction from the recent peak of 30,024.75 (04/03/15) was 12.38 %. This has been the steepest decline since the bull market started in August 2013(a month before the BJP announced Narendra Modi as its PM candidate).

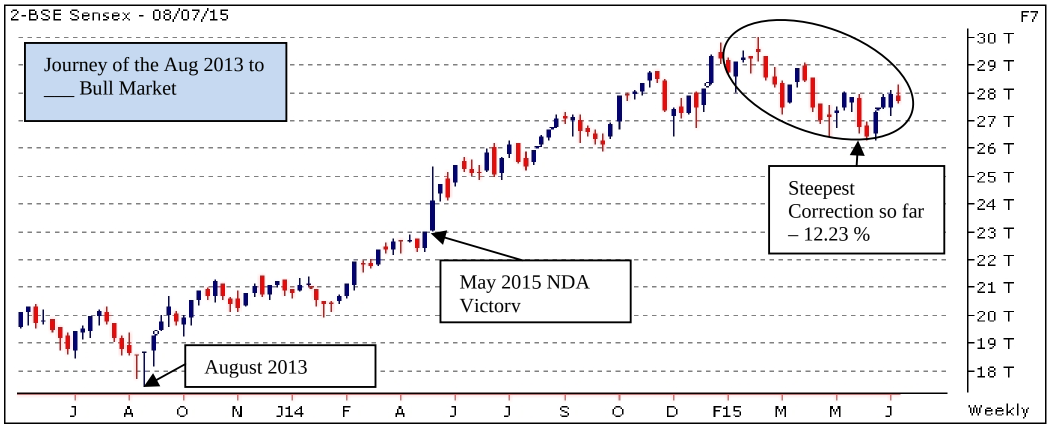


There are corrections in every bull market and long term investors generally take them in their stride. In fact, in the 2004-08 bull market the Sensex had corrected by a whopping 30.55 % , in May–June 2006, before scaling to its eventual peak of 21,206.77 in January 2008 (See chart above).

Investors who held on to their holdings gained significantly once the correction was over.

This bull market will also witness several major corrections of the type seen in March – June 2015 and this time too, investors, who remain invested will emerge winners.

There is a broad consensus that this is a multi-year bull market and since it has traversed just 23 months, since August 2013, there is more steam left in it.



Market Obsession with Interest Rates

The newsflow during the month was tepid and market players remained focused on just one major theme - **the anticipated movement of interest rates**. In the June 2nd RBI Monetary Policy, RBI did cut interest rates by 0.25 % but their outlook for further interest rate cuts was negative. They were factoring an increase in inflation back to 6% despite the April number (the last reading before the policy) being 4.87 %. Since RBI's target real interest rates are 1-1 ¼ % above inflation, the Repo rate cut to 7.25 %, assuming that inflation would inch back up to 6 %. Their message, too was clear - markets should not expect further interest rate cuts, unless there is a major improvement in the inflation scenario.

That change in situation was provided by the excellent onset of the monsoons. The street cheered the above average precipitation in June and losses post RBI policy were pared. There were renewed expectations of further interest rate cuts. A good monsoon has the potential to lower prices, agro products in particular, and that could be viewed favorably by RBI; perhaps nudging them to reconsider their forecast on inflation and therefore their stand on the rate of interest.

Why Markets Fret about Interest Rates

In our previous newsletter, we had extensively discussed the RBI's interest rate framework and how they are basing their monetary policy on the Consumer Price Inflation (CPI). In this communiqué, we would like to present our thoughts on why interest rates, off late, have become so important for stock markets not only in India but globally as well.

The most basic form of valuing a stock is :

Earnings Per Share (EPS) X Price to Earnings Ratio / Multiple (PER / PEM) = Market Price (MP)

Over the years, increased flow of information from companies, industry associations, governments, international researchers etc, coupled with sophisticated forecasting models has increased the accuracy of EPS estimates on which the stock price is based. In several instances, the managements themselves provide a revenue and profit margin guidance.

However, when it comes to the Price to Earnings Ratio (PER), there are many qualitative variables which need to be analysed. The market also ascribes a PER on a company based on the prevailing PERs in that industry.

Factors impacting PER

The PER is dependent on many factors, a few of which are linked to interest rates. The table below summaries the variables affecting PERs and their relationship with interest rates.

	Factor Impacting PER	Impact on PER	Affected by Interest Rates ?
1	Past and future growth rates of the company	Higher the growth rate, higher the PER. Low growth companies trade at low PERs.	Yes as lower interest rates drives retail consumption and spending by businesses to increase capacity thereby providing a fillip to growth.
2	Return on Capital Employed (RoC)	Companies with high RoCs have higher PE Multiples. Their capital requirement to generate growth is less and are therefore they are unlikely to take on much debt or dilute equity, both of which is positive for minority shareholders.	Yes, as lower interest costs improve the Returns ratios, be it on Capital Employed or Net Worth or Equity.
3	Corporate Governance Standards	Better the Corporate Governance Standards, higher the PER. Investors place more faith in the financials of the company and that gives confidence to pay higher PE multiples.	No
4	Scarcity Value	If the company is one of its type (listed), then scarcity value may lead investors to buy the stock at higher PER. Investors strive to gain exposure to the investment theme which the company provides a play on and therefore PERs are generally high. For example, Maruti, which is India's only listed passenger vehicle company or Infoedge, which operates popular websites like *maukri.com* and *magicbricks.com* are traded at high PE multiples	No
5	Volatility of Earnings	The more volatile the earnings, lower the PER	No

From the above table, two of the five parameters listed above are sensitive to interest rates. These are also the two most important factors for determining the PER.

Interest Rates and DCF Model

Another method for deriving a fair value for businesses and therefore stocks is the Discounted Cash Flow (DCF) method. As per this method, the future cash flows are discounted at an assumed interest rate. If this assumed interest rate is increased, the value of the business reduces and vice versa. In this valuation process, too, the worth of the business is dependent on the prevailing interest rates. In conclusion, the two most popular models for valuing equities factor the rate of interest to arrive at a fair value.

Liquidity Flows and Interest Rates

Interest rates also determine liquidity flows and in recent times, liquidity flows have become the single most important reason for global rally / correction in stocks. The co-relation between interest rates and liquidity flows is simple.

Savings are generally channelized into debt markets or equity markets. If interest rates are high then debt market is preferred and if interest rates are low, investors fancy equities. There is a constant tussle between these two markets and the winner is generally determined by the rate of interest. Many global market pundits have opined that the primary reason, for the bull market in US equities is because of the low interest rates there and the quantitative easing program carried out by the US Federal Reserve.

The recent surge in Chinese stocks is another example of how liquidity flows affect stock markets. Although the Chinese economy has not shown any improvement, their stock markets have been on the boil. The Shanghai Composite index has surged by 155% between July 2014 and June 2015, only to correct by a massive 54 % in the first few trading sessions of July. The bubble there was caused by huge liquidity injection by retail Chinese investors using their own and borrowed fund. A trigger for the rally had been the cut in interest rates by the central bank of China.

It is for these reasons discussed above that markets are obsessed with interest rates.

Our View on Markets

In our previous newsletter, we had a cautious view on stocks, because the interest rate scenario, post RBI policy, had deteriorated. A good monsoon may change that situation but it is still early days and the actual rainfall in July and August will determine if the monsoons are normal or not. We would like to wait and watch the progress of the monsoons before we get optimistic. Contrarian forecasts have only added to the confusion on this front.

Another source of worry is the crisis in Greece. The stand taken by Greek government and public is bold and unprecedented. Greece's exit from the European Union (EU) could lead to chaos if other weaker countries also follow suit. This could depress the sentiment for stocks as doubts would be raised on global growth rates going forward. The EU, collectively, is a the world's largest economy and turmoil there has serious implications for every other economy.

The volatility in Chinese stock markets is another factor our markets have to contend with. The connection between their stock markets and economy and the fallout on global economy and our stock markets is complex; but there is no denying that one more uncertainty has crept into the minds of investor.

The upcoming earnings season and the monsoon parliament session may also play a key role in determining market trends. After a disappointing March quarter earnings season, the street is pinning its hopes on better performance from India Inc. in the June quarter. The Parliament session is also important as the fate of key bills like GST and Land Acquisition are likely to be decided.

Keeping in mind all these market moving events and trends we retain our cautious view on stocks. Selective counters may do well depending on their quarterly performance and other fundamental parameters; but for the broad market, our expectations are that they may remain range bound with a downward bias.

Dipan Mehta