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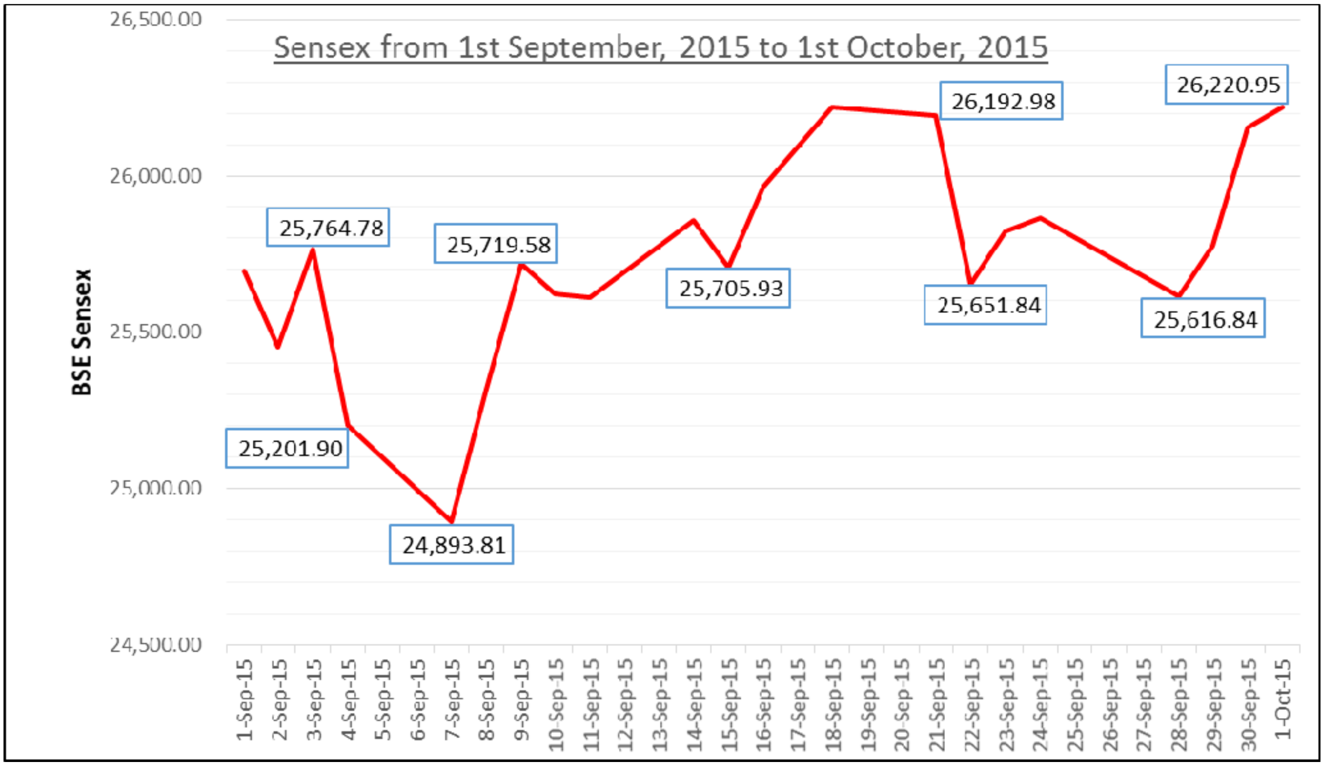
Flat but Volatile September



Markets Stabilize in September – DII flows strong

After the sharp selloff in August, the markets somewhat stabilized in September with a monthly decline in the Sensex of just 0.49 %. While the sentiment remained subdued, the actual fall in values was contained due to sustained domestic buying at lower levels. Local mutual funds, banks and insurance companies, commonly known as DIIs, more than absorbed the selling pressure of the FIIs (-5,695.70 crores).Their net purchases of 10,273.06 crores were over and above the record Rs. 16,248.42 for the previous month.

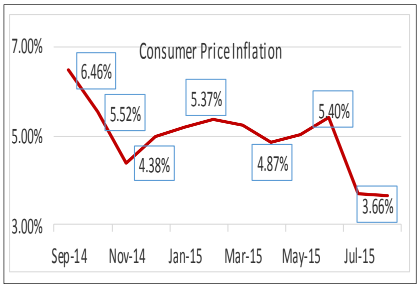
8 Months of Positive DII Flows	
Month	**Net Investment (in crores)**
Feb-15	**1,711.88**
Mar-15	**194.76**
Apr-15	**11,571.64**
May-15	**8,582.26**
Jun-15	**12,026.55**
Jul-15	**737.36**
Aug-15	**16,248.42**
Sep-15	**10,273.06**
Total	**61,345.93**

This was the eight consecutive month of positive DII flows and clearly reflects the shift in domestic savings away from real assets such as gold and property to financial products such as equities, mutual funds and insurance products.

For this, the markets owe a debt of gratitude to the present RBI Governor Dr. Raghuram Rajan. His single-minded focus on containing inflation has led to sustained positive real interest rates. This has made financial assets, especially equites more attractive to Indians, who traditionally have a very high savings rate, but are generally averse to investing in stocks.

Lower Inflation Positive Real Interest Rates

In a high inflationary scenario, *real* interest rates, which the difference between the actual rate of interest and the inflation, are negative i.e. inflation is higher than the interest rates. Since interest rates do not cover the cost of inflation, investors are driven to hard assets like gold and real estate; away from financial assets where the returns are linked to interest rates.



Fortunately for India, inflation has been steadily reducing (see graph) and that has led to positive real interest rates and ergo the preference for financial assets such as equities.

Indian Savings being Diverted to Equities

Absence of other good investment avenues supports this trend. Prices of Bullion have been flat to declining. The same is the case for real estate and since investing abroad is restricted, we have seen sizable inflows to equities directly and through mutual funds. The adjoining table of assets under management in equity mutual fund schemes reflects the growing preference for financial assets. *It is interesting to note that money has been flowing into equity schemes despite flat returns in the Sensex.*

Equity Mutual Funds Assets under Management				
As on	in crores	% increase	Sensex	% increase
Sep-14	280,397.40		26630.51	
Dec-14	319,477.52	14%	27499.42	3%
Jun-14	372,313.10	17%	27780.83	1%

FII Selling due to Problems in Emerging Markets

Unfortunately, foreigners have been liquidating their holdings here and that is the major challenge our markets are grappling with. The reason for their selling is not disenchantment with India, but risks in Emerging Market (EM) as an asset class.

Their negative view is on account of

- Poor returns in EM (see chart)

Emerging Markets Stock Indices Returns for last 6 Months				
Index	Country	31/03/2015	30/09/2015	% Chg
Bovespa Index	Brazil	56,352.09	45,059.34	-20.04%
Shanghai Composite	China	3,747.90	3,205.99	-14.46%
Hang Seng	Hong Kong	24,900.89	20,846.30	-16.28%
BSE Sensex	India	27,957.49	26,154.83	-6.45%
S&P CNX Nifty	India	6,177.45	4,624.30	-25.14%
Jakarta Composite	Indonesia	5,518.68	4,223.91	-23.46%
South Africa's FTSE/JSE Africa All Shares Index	South Africa	52,181.95	50,088.86	-4.01%

Threat from Rise in US Interest Rate

- Fears of a rise in US interest rates, postponed at the last FOMC meeting held on 16-17 September, could reverse the flow from emerging markets back to US debt markets.

In the past, low to nil interest rates in developed economies, pushed investors there to pursue growth in overseas emerging market. However, with higher interest rates in the world's largest economy, there is likelihood that global capital flows may be attracted back to the US debt markets. There are good reasons for this scenario to play out. For one, there is safety of principal. Secondly, currency risks are avoided; in fact a rising dollar makes US debt markets even more attractive and lastly, with commodities facing a brutal bear market, the wind is out of most EMs as their economies are closely linked to commodity cycles.

India is an exception; which is why we have out-performed other EMs (see chart above) but when there are outflows from EM funds, we too bear the brunt of selling to meet redemption pressures of investors seeking to reduce their EM exposure.

A rout in EMs is the principal risk factor for our markets. FIIs own 38.57% of the free float of listed stocks are if there is unabated supply from them, there is no domestic investor large enough to absorb their selling.

The daily FII trading volumes is the most closely watched data point which the market is tracking. The point at which this number turns neutral or positive could be the turning point for our markets. DIIs are already net investors and if the FII selling gets contained then liquidity situation will improve and the bull market can resume its upward journey.

There are factors which support the theory that even if US Fed raises interest rates, global liquidity will remain strong and deserving markets such as India will receive their share of capital flows. This argument is based on the fact that even though US may be tightening, other large economies such as EU and Japan are following accommodative policies and quantitative expansion. This could act as a counter balance to US tightening its monetary policy. Nonetheless, reversal of US monetary policy remains a threat for our markets and since predicting global flows is highly complex, investors are better off just monitoring the daily FII investment flows and when this trend turns positive, we could safely say that a bottom has got created.

Bull Market Correction or Beginning of a Bear Market ?

In our last newsletter, we had raised the question about whether the fall in stocks since the 4th March Sensex top of 30,024.74 was a bull market correction or the commencement of a bear market. In the study we had presented, we had set two conditions for bear market. The first was a prolonged fall in stock prices for a period in excess of six months. That condition has been met. The second was the decline in corporate profitability. In that context, the upcoming September quarter earnings season is extremely important. If the corporate results are disappointing then there is room for stocks to decline even more. On the other hand, if companies' performance is encouraging then stock prices could rebound and we could see the earlier highs being breached. Keeping this in mind, we are inclined to view October as the make or break month for our equity markets.

RBI Policy Spring a Positive Surprise

The surprise in September was the RBI policy on 29th September in which they slashed the Repo rate by 0.50 % to 6.75 %. The street expectation was for a 0.25 % cut and a 0.50% cut was well received. The good news did not end there. The RBI lowered its inflation forecast for January 2016 from 6.00 % to 5.80 % and further down to 4 % by March 2017. There was also the indication that they were not done with interest rate easing. This was a change from their earlier stance which was broadly on the lines that they, were nearing the end of their interest rate cutting cycle and that markets would have to live with the present levels of around 7 % for the Repo rate. With this fresh outlook, there are chances for another 0.25-0.50% cut in interest rates over the next 12 months. This will not only lower cost of borrowing for industry but also give a further boost to savings being diverted to equities as debt market and fixed deposit yields come down; both of which are very positive for stocks.

Our View on Stocks

In our previous newsletter, we had adopted a positive view on stocks and advised " *investors to gradually buy into good quality stocks… with focus on companies which have good corporate governance standards and steady performance over the past few quarters.* "

We maintain this view but with caution. From our point of view, sectors in which investors are overweight in, need to declare good Q2 results for them to remain interested. If the companies within these sectors deliver / beat analyst expectation then we would be out of the woods and markets will regain their positive rhythm. On the other hand if there are many misses, then investors may throw in the towel and liquidate even their blue chip holdings.

The wild card is the volatility in the global markets, which is difficult to call. Since our markets move in tandem with other stock markets in the short term, we have to account for and consider developments there. On this count our observations are that the problems started with the cracks in the Chinese stock markets and the slide in crude oil prices. Fortunately, these markets have stabilized and new lows are not being created. This could signal lower stress in world equities market and that is also positive for our Sensex and Nifty.

As has been our practice, we are disclosing the average returns of the portfolios managed by us are as follows :

	1MONTH	3 MONTH	6 MONTHS	1 YEAR	3 YEAR	5 YEAR
Axis Equities Portfolio Performance	1.00%	1.21%	2.32%	22.25%	29.25%	14.89%
SENSEX	-0.24%	-6.50%	-6.48%	-2.92%	9.26%	2.90%
NIFTY	-0.26%	-6.03%	-6.56%	-1.59%	9.17%	3.12%
Out Performance (higher of Sensex or Nifty)	1.24%	7.24%	8.80%	23.84%	19.99%	11.77%

We also take this opportunity to wish our readers a Happy Dussehra !!

Dipan Mehta