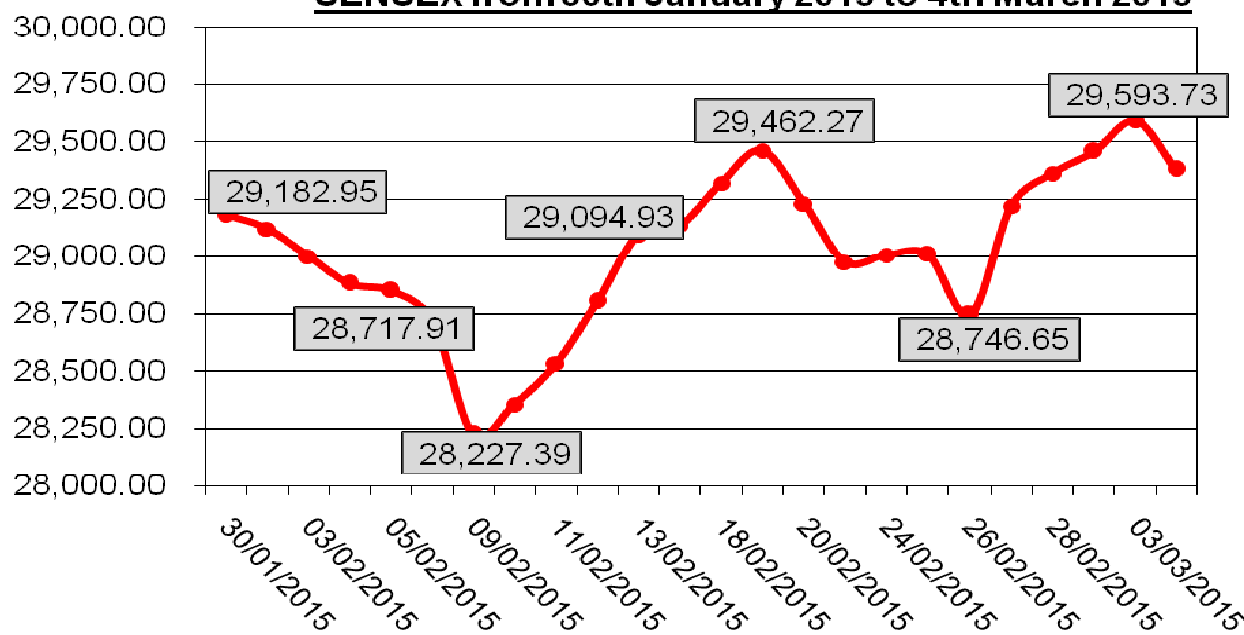




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Markets Consolidate in February – Sensex Crosses 30,000 in Early March

SENSEX from 30th January 2015 to 4th March 2015



Sideways Movement in February, New Highs in Early March

Equities consolidated their gains in February. After a 6.5 % upmove in January, the Sensex traded within a band of 1,250 points and closed the month with a marginal decline of 0.67 %. FIIs and DIIs were net buyers to the tune of Rs. 8,893 crores and Rs. 1,712 crores respectively; confirming the strong inflow of liquidity into the secondary markets. On an intraday basis, the Sensex breached the 30,000 mark post announcement of a surprise rate cut of 0.25 % by the RBI on 4th March. However, the event of the month was the second Union Budget of the new NDA government on 28th February.

High on Expectation, Budget Disappoints

Expectations were high that this budget would be path breaking, with big bang reforms. Fresh thinking, new ideas, bold measures were anticipated to deal with the structural weaknesses of the economy and public finances. It was supposed to be the most important budget since the beginning of the new millennium. Unfortunately, there were no such proposals. The Budget was staid and did not capture the imagination of either the corporates or the markets. Although most economists, industrialists and market pundits praised the budget in the media, we have a slightly negative view.

Our assessment of the key positives and negatives are summarized in the table below:

Positives and
Negatives of
the Budget
2015-16

Positives	Negatives
Budget Estimates are realistic, achievable and the fiscal deficit of 3.90% is not alarming. Earlier budgets of the previous government underestimated the expenditure and overestimated the revenues and that created a credibility issue with economists and market players.	<p>Tax rates have been raised:</p> <ol style="list-style-type: none"> 1. Service tax has been raised from 12.36 % to 14.5 %. 2. Surcharge on Income Tax has been raised by 2 % from 10 % to 12 %. 3. Excise duty on Petrol and Diesel Prices has been raised <p>There is also the mention of a further levy of surcharge for “Swachh Bharat”. This will push up the tax rates even more. These increases in taxes will lead to inflation, burden the consumer and perhaps affect consumer demand.</p>
Allocation for Plan Expenditure, particularly for infrastructure has been substantially increased. The objective is to kick start the economy and the capex cycle through public spending on large infrastructure projects. This is much needed as the industrial production remains weak and demand in key industries is a worry. Although a positive move, implementation of new projects has been slow in the past and that could negate this strategy to boost the economy.	Disinvestment target has been set at Rs.69,500 crores. Since no PSU reforms have been announced and their financial performance remains disappointing, the only manner in which this target could be attained is by forcing state owned insurance companies to subscribe to secondary sale by the government. In order to generate resources to support the government’s disinvestment program, these insurance companies (read LIC) will sell their blue chip holdings in the market. Supply from these insurance companies is negative for our markets.
Foreign Institutional investors (FIIs), the holy cows of our stock markets, have been given exemption from Minimum Alternate Tax (MAT). This is unfair as domestic investors (corporates / LLPs) will continue to pay MAT on capital gains, however, we view this as positive as it would make India an even more attractive destination for FIIs.	The new Direct Tax Code which was supposed to simplify tax administration has been scrapped. We will be saddled with all the complexities and inconsistencies in the present Income Tax Act which is now in its fiftieth year.
New investment pattern has been announced for non-government provident, gratuity and superannuation funds, such that a minimum of 5 % has to be invested in equities. This creates a pool of long term money for investing in the stock markets.	No thought has been applied to deal with subsidies on food and fertilizers which continue to rise year after year.

On the balance, our view is that the budget is negative for stocks and corporate earnings. Higher resources have been raised through tax rate increases and disinvestment of PSU shares. However, the key question is whether the government will be able to channelize these additional resources for productive use. Their track record on this count has been sketchy with plan expenditure targets being missed on a regular basis. Another adverse fallout of higher government spending is the wastage and leakage which take place when the state goes about allocating and disbursing funds.

No Proposals
to Boost
Economy
through Higher
Consumption

A better approach to improve the economy would be to boost consumption through lower taxes especially on the personal income. This would have encouraged the average Indian consumer to increase spending. Furthermore, if prices of goods and services are also kept in check (through lower indirect taxes) then that would be an additional boost for spending. There is the risk that surge demand could lead to higher inflation. However, given that there is adequate spare capacity and prices of basic materials remains low, the threat on this count is manageable.

Economics teaches us two ways to revive an economy. One is to increase government spending and the other is to incentivize consumer spending. We are in the camp that believes that encouraging consumers to spend more is a better strategy to improve growth rates. Time and again, it has been proved that a smaller government is better for the economy and the country at large. The NDA government is widely perceived to be in favour of a smaller government. Yet, this budget envisages a bigger role for the state.

Another
Surprise RBI
Rate Cut

To sum up, the Budget in no way gives a short / medium term boost to the stock market. That bounce was provided by the RBI, when for the second time, it declared a surprise interest rate cut of 0.25 %. Normally, interest rates are set by a central bank when it announces its monetary policy. If that announcement is on a day other than the day on which its policy is released then it is referred to '*an interest rate action between two policies*'. Such action does tend to surprise the street and sometimes that is the intention of the central banker. The RBI for the second consecutive time announced an interest rate cut '*in between*' two policies. The first one was on 15th January and the second one was on 4th March. The first one had an electrifying effect on the market and the Sensex rallied by 728.73 points. Unfortunately, the second one did not have the same impact. The market opened gap up on 4th March, but the gains could not be sustained and the bench mark index ended the day with losses of 213 points.

Sensex Crosses
30,000 Intra
Day

It was on that day that the 30,000 mark was breached in early trading.

The scaling of 30,000 is an important landmark in the journey of the Sensex, which began at 982.32 in January 1991. Over the past 24 years it has multiplied by 30.54 times; delivering a compounded annual return of 15.24 % (excluding dividends which are usually 1-2 % more). This number is impressive and what is even more interesting is that these gains have been delivered under extremely challenging conditions. During that period, our country has experienced war, famine, terrorist attacks, political instability, economic crisis, scams, scandals, international sanctions and many more disasters. Despite that, to deliver such superlative a return does reinforce our belief that long term investing could be extremely rewarding irrespective of the short term turmoil caused by negative events.

Our View on
the Market

While we remain extremely positive on the market in the long term, we maintain our cautious stance in the short term. As we look forward over the next 2-3 months, we do not visualize any short term positive triggers for the market.

The budget is over and done with and other reforms be it GST or Land Acquisition Bill have a broad roadmap. Coal and spectrum auctions have also commenced and their impact seems to be discounted as also a further interest rate cut by RBI. The marginal effect of an RBI interest rate cut can be gauged from the tepid response of the market when the second rate cut was announced on 4th March. Fourth quarter results which will be released in April are not expected to be much better in terms of growth than what companies declared in the third quarter; which was a disappointment.

Liquidity
Flows Remain
Strong

The main plank on which stocks could rally is liquidity inflow into markets which remain extremely strong, but unpredictable. Empirical and statistical evidence suggests that appetite for Indian equities is increasing globally and even domestically. How high the markets could rally because of strong fund inflows is anybody's guess. However, as mentioned in our previous newsletter, quality businesses are trading at rich multiples with little margin of safety. New investment ideas have become scarce and the trading screen does show first signs of a minor froth in equities.

Market
Strategy

We advise caution at this point of time. Investors who have relatively high exposure to equities should trim their holdings. Those intending to increase their equity allocation should wait and do so at corrections of 10-25 % in individual stocks in which they seek to invest in. Our intention is not to scare the long term investor, but only to prepare for turbulence which may envelope the markets from time to time.

The Sensex has rallied by 38.08 % over the past twelve months without any deep corrections. It may well continue to do so in the near future, but a healthy correction will strengthen the long term positive trends in our markets.

Dipan Mehta