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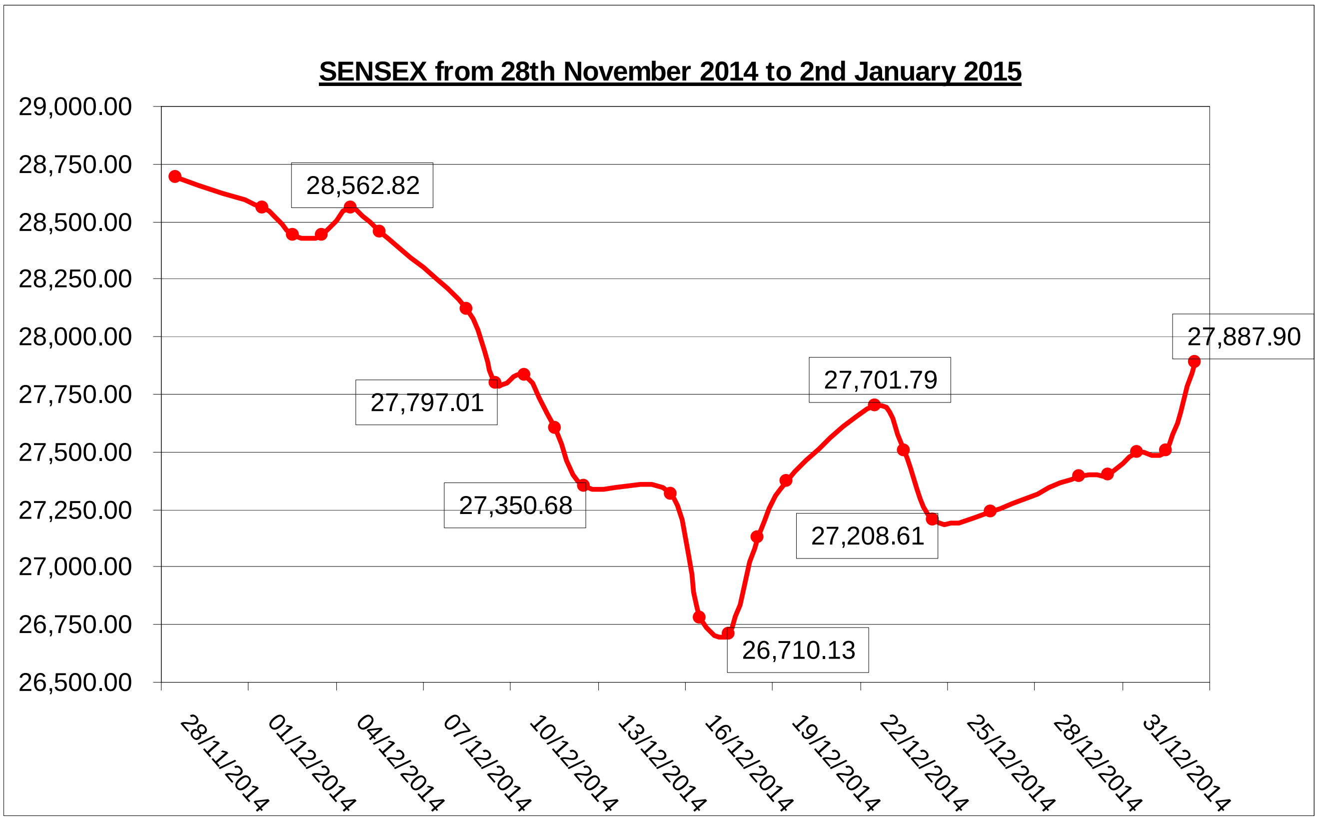
Another Minor Correction



Minor Correction in December, FII flows Negative, DIIs Buyers

Markets were under pressure in December with the Sensex sliding by 4.16 %. (The losses would have been higher but for a smart recovery towards the end of the month. For the year 2014, the Sensex has gained a phenomenal 30 %. This is the third consecutive year of positive gains. In 2012, the Sensex delivered a 25.70 % and in 2013, it eked out minor gains of 8.98 %. In the earlier two years, the broad market index was just recovering lost territory and it was only in 2014 that fresh ground was covered and all time high peaks attained.

FII flows turned negative at Rs. 2,440.65 crores during December. This was after a gap of 11 months. The last time FIIs had net sold was in January 2014 (Rs. -141.30 crores). Fortunately, domestic institutional investors were net buyers to the tune of Rs. 6,775.54 crores. They took advantage of the correction in stock prices to reduce their cash levels and increase their equity exposure.

The year 2014 has been great for local mutual funds as investors have poured Rs.43,965 crores (upto November 2014) into equity mutual fund schemes. Their assets under these schemes are at record highs as retail investors seek to participate in equity markets through mutual funds. This is a positive sign and we hope more savings are channelized into productive assets such as equities rather than unproductive ones like gold, real estate etc.

Optimistic in 2015

As we step into 2015, the mood is very optimistic and most market pundits expect the New Year to be a good one. Sharp fall in oil prices, lower inflation, expectations of a more supportive monetary policy and better governance are the main pillars on which 2015 is predicted to be a good year. While broadly we agree with this prognosis, there are several risks to this bull market and in this newsletter, we have highlighted two – one external and the other internal.

In a manner of speaking, we are continuing from our previous newsletter in which, after comparing this bull market with the earlier two bull markets, we ended with an observation, and we quote:

> *"…that in the not too distant future, the bulls will be tested. A sharp correction of the magnitude of 10-15 %, perhaps even briefly breaching the 200 day moving average of 24,836 (05-12-2014) is a probable event".*

At this juncture, it is necessary to understand events and developments which could cause such a deep correction and investor's approach in such a scenario.

External Risk Factor – Global Slow Down and Pressure on Sovereign Debt

A peek into what could be the greatest risk factor to our bull market was provided by the trading pattern in December and early January. There was a minor sell off in all global markets on account of crash in crude oil prices. It is worth noting that not only the stock markets of the oil producing countries declined but equities of oil consuming economies also corrected. Why should the markets of oil consumers decline? They are the biggest beneficiaries of the drop in crude oil prices. Why then, did investors press the sell button there?

The answer lies in the reasons behind the crack in oil prices.

No doubt, the rise in US oil output through shale extraction has negatively impacted crude oil prices. However, another angle to the fall is that consumption is also slowing. In part, lower consumption, can be attributed to better energy efficiency, but the real fear is oil prices declining due to slowdown in the global economy. There is close correlation between world economic output and crude oil consumption. A school of thought suggests that the recent fall in crude oil could be signaling slower growth and that is very negative for global equities.

One could argue that India is relatively insulated from a worldwide slowdown. We are net commodity consumers and slower global growth and resultant fall in commodity prices (especially crude oil) is very positive for the Indian economy. While this is true in the long run, in the short to medium term, our markets do get rattled whenever there is a scare or actual slowdown in global growth. The reason for that can be explained by the adjoining table which shows the sovereign debt of large economies as a percent of their GDP. These ratios are precariously high.

Government Debt to GDP (%)

Country	Actual 2013	Forecast 2014	Forecast 2015
France	112.6	115.1	116.1
Germany	85.9	83.9	79.8
Greece	186.0	188.7	188.2
Ireland	134.6	133.1	132.0
Italy	145.5	147.2	147.4
Japan	224.6	229.6	232.5
Spain	104.0	108.5	111.5
Switzerland	46.2	45.9	45.3
United Kingdom	99.3	101.7	103.1
United States	104.3	106.2	106.5
Euro area (15 countries)	106.7	107.7	106.9
OECD-Total	109.5	111.1	111.2

Since the financial meltdown in 2008, governments of the developed countries have been piling on debt either to stimulate their economies or cover the fiscal deficit caused by lower tax revenues; an outcome of slower growth. A few of the banks there are also vulnerable. The only way this debt problem will get tackled is if economic output revives and taxes collections increase.

Scare of a Risk Off Trade

The real scare is that if growth flags then government revenues will be negatively impacted and servicing debt could become untenable leading to defaults. In such a scenario, a risk off trade (see box for definition) gets initiated as international investors seek refuge in defensive assets like gold and US treasuries.

> *Definition of risk on, risk off by* ***Financial Times***
>
> Risk-on, risk-off (RoRo) investing describes a process where investors move to riskier potentially higher yielding investments and then back again to supposedly lower yielding investments which are perceived to have lower risk.
>
> Quite often risk-on, risk-off behavior follows global markets, where periods of perceived low financial risk encourage investors to take risk, therefore creating a risk-on situation, and periods of perceived high financial risk cause investors to take less risk, creating a risk-off situation.

Default is what caused the financial crisis of 2008 and that is why a precipitous fall in an economically sensitive commodity like crude oil cannot be ignored. If it is a precursor to a global slowdown of the magnitude that sovereign balance sheets are stressed, then the resultant risk off trade will not spare India. It was the global risk off trade in 2008 and then again in 2011-12, during the PIIGs crisis in Europe, that brought our stock markets to their knees.

In our view, the fear of a slowdown or actual slowdown in the world economy is a major risk factor for this bull market. No doubt, we will recover from such a jolt. However, investors will have to be patient and ride out this storm. History has repeatedly shown that players who held their nerve during a crisis were well rewarded once normalcy returned.

Performance of Modi Government a Risk Factor

The second risk factor to this bull market, which is internal in nature, is the performance of the Modi government. So far, a few steps have been taken to improve governance. The work ethics have improved and there is a genuine attempt by the administration to remove road blocks to growth. However, the path of reforms is filled with obstacles and even after decisions have been taken, implementing them is a challenge.

Fortunately, the faith in the new Modi government remains strong. The recent election wins in Jharkand and Jammu and Kashmir amply demonstrate that the public still believes that the new government will improve governance. However, if the patience of the electorate and of corporate India runs out due to non performance then the India premium which investors are paying now could disappear. This development could negatively impact equity returns. In such a scenario, investors will have to revise their strategy and focus on businesses which are less vulnerable to government action.

The joker in the pack is the RBI move on interest rates. Our view is that interest rates have a far more important role to play in reviving growth than government measures. The RBI doesn't think so, going by recent statement made by the governor. On December 12, Governor Rajan told reporters that *"Interest rate cut by itself would not lift the economy. It is not the only thing which is holding back economic growth"*.

Even if the government falls short in delivery, but the interest rate cycle turns soft, then investment and consumption will pick up. That will drive corporate profits and fuel a further rally in stocks.

These two major risks and many more known and unknown perils exist for this bull market. The objective of the above discussion is not to dampen spirits but prepare investors to deal with these negative events both mentally and in terms of investment strategy. Over the past decades, there have been many adverse internal and external developments, which have caused damage to investor sentiment in the short to medium term.

Positive View on Stocks for Long Term

However, in the long runs, stocks have continued to deliver good returns. Investors who held on to their investment positions though such rough patches have been amply rewarded. The bull run of 2014, after several challenging years, is a testimony to this hypothesis. We see no reason why this logic will not prevail in future.

Our stance on equities over the long term remains positive but there could be short term volatility which investors will have to ride out. Buying stocks at corrections could prove highly profitable for deep pocket investors. We would like to end with a quote by the legendary investor Warren Buffet that epitomizes his investment style:

“Be Fearful When Others Are Greedy and Greedy When Others Are Fearful”

Dipan Mehta