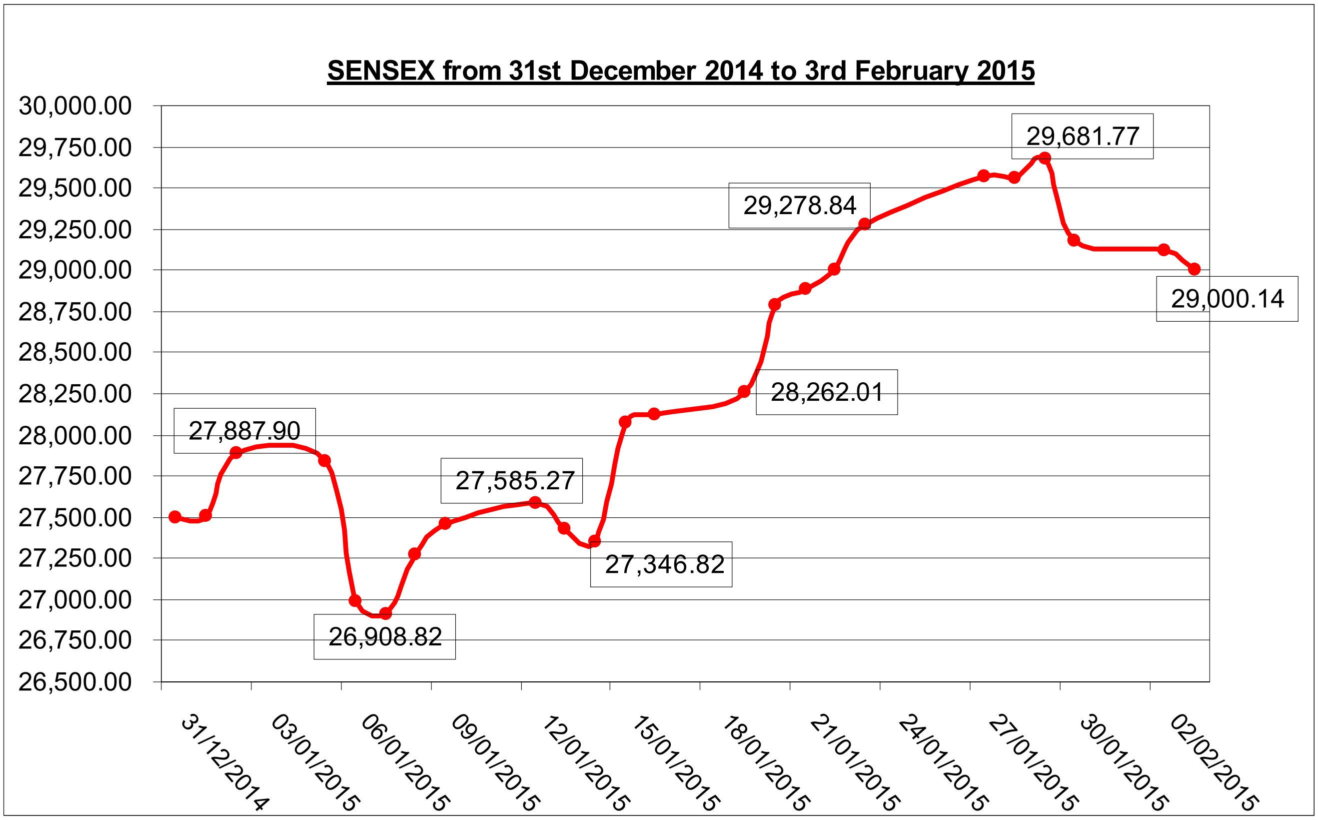
AXIS Equities Pvt. Ltd.
58, Mittal Chambers, 228, Nariman Point, Mumbai - 400 021.
Tel: 6115 1919 Fax: 6115 1999 E-Mail:dipanmehta@vsnl.com

Another All Time High in January



Sensex at new High in the New Year

Indian stocks rallied to new highs in January. Sensex, the benchmark index, touched an all time peak of 29,844 on 30th January. It appreciated by 6.49 %; the highest monthly gain since of May 2014 when the Lok Sabha Election results were declared.

Surprise Cut in Repo Rate by RBI

The catalyst for this further up move was the surprise rate cut by RBI on January 15th. Ever since the decline in retail inflation data and more so since the crash in crude oil prices, there have been umpteen calls on the RBI, from all quarters, to reduce the Repo Rate (rate at which RBI lends to Banks). The RBI on its part had been waiting as it wanted to be absolutely sure that *victory* over Inflation was total and comprehensive.

No Central Bank likes to follow a flip flop policy where it reduces interest rates, and is then forced to hike it within a few months as inflation has reared its ugly head. Therefore, the Reserve Bank was resisting calls to reduce interest rates. In this context, the statement made by Governor Rajan on 6th August is worth mentioning and perhaps explains the delay in reducing interest rates – *"Let's fight the anti-inflation fight once and let's win. That will create the best condition for sustainable growth."*

A Discussion on RBI's Monetary Stance

These and other statements / policy announcements discussed in this newsletter provide an insight into RBI's monetary stance and their view on interest rates. A better understanding of the RBI's strategy for containing inflation and spurring growth are important for investors as post the budget in February 2015, the most important domestic factor impacting stocks will be the RBI's monetary policy.

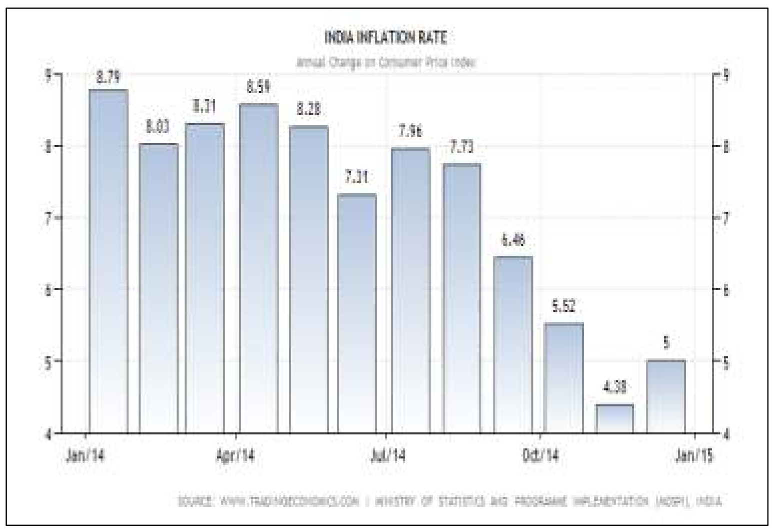
In this communiqué, we have discussed the RBI's thinking and approach on interest rates, since the change of guard at RBI in September 2013, when Governor Raghuram Rajan assumed charge. Hopefully it will enable us to predict their actions and accordingly plan our investment decisions.

Focus on Containing Inflation

1. RBI's top priority is to contain inflation. Their target inflation rate is 6 % by January 2016 and further down to 4% over the long term, with a band of +/- 2%. More important than reducing inflation is curbing inflation expectations. The ultimate triumph over inflation is when the consumers and the producers do not expect a rise in prices. That in turn impacts their decision making in a manner, such that price rise actually does not take place. When producers avoid hoarding and consumers do not chase goods and services, then inflation automatically subsides.

   It is RBI's firm view that :

   "To secure a sustainable growth of at least 7% over the medium-term, microeconomic policies that improve activity levels and productivity will be needed so that they can work in tandem with a supportive macroeconomic regime with a reasonably positive real interest rate, low inflation, moderate CAD and low fiscal deficit," - RBI Annual Report for 2013-14 released in August.



   This thought process has been consistently articulated in every policy statement and speeches made by senior RBI officials.

   The adjoining consumer price inflation (CPI) graph shows that after several months of inflation rate of around 8 %, the CPI fell to 4.38% in November 2014 and 5 % in December 2014. This data may have prompted the RBI to cut the Repo rate on 15th January.

   From an investor's viewpoint, it means that so long as monthly retail inflation figure is trending lower towards the 4% mark (see graph), the RBI will lower interest rates. This will boost equities, as we have seen in the month of January, when a surprise rate cut pushed the market to new highs.

Real Interest Rates Targeted at 1.5 – 2 %

2. The next question which comes to mind is to what extent will the central bank cut interest rates?

   The answer to that is also provided by Governor Rajan.

   Time and again, he has reiterated that he is comfortable with a real interest rate of 1.5 % to 2% (Real Interest Rate = Interest Rate – Inflation)). Assuming that inflation should stabilize at 5-5.5% in 2015, the RBI's repo rate and consequently, the G-Sec yields could drop to around 6.5-7 % from 7.75 % at present.

   A fall of this magnitude could be very positive for stocks in two ways. Firstly, lower cost of capital leads to lower interest outflow and therefore higher profits. Secondly, there is increased flow of household savings into equities, as yields on bank deposits and debt market become unattractive. This provides the necessary liquidity support to a bull market.

   A further reduction of 0.75 – 1 % in the Repo rate through 2015 is the consensus street expectation as and when the RBI cuts interest rates, stocks should rally.

Consistency in Monetary Policies

3. The RBI is very circumspect that its policies should be consistent and predictable. It does not want to be in a situation where after signaling an easy money policy, it has to reverse this (in a short period of time) because inflation has picked up.

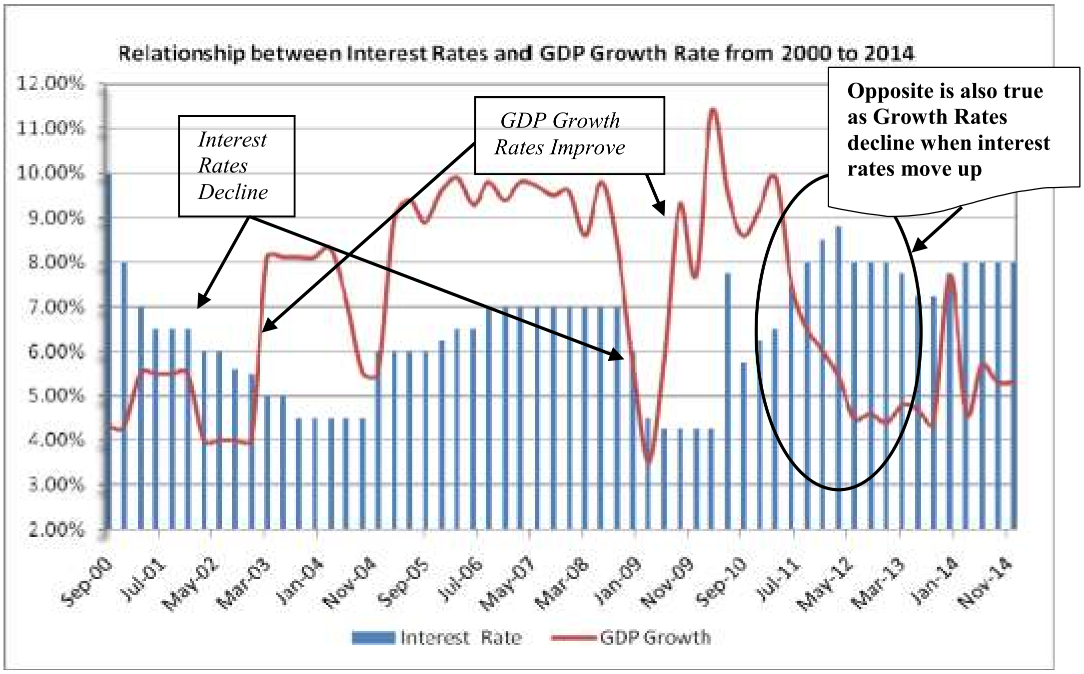
   "There is no point in cutting interest rates to see inflation pick-up again,"
   - Governor Rajan … September 2014.

   What we can read into this is that once the RBI begins its monetary easing process, it will not reverse in a hurry. Furthermore, every subsequent reduction in Repo rate will be measured and determined by the prevailing inflation scenario. This clarity in monetary policy has been well appreciated and provides cues to investors and corporates. Savvy investors will watch the inflation data and so long as it is benign, they will factor in an RBI rate cut and the consequent benefits of such a move.

Relationship between Interest Rates and GDP Growth

The reason we have devoted a large part of this newsletter to interest rates is best explained by this underlying graph which captures the relationship between interest rates and GDP growth rates. From this, we can easily conclude that as interest rates drift lower, economic activity picks up, as reflected in the GDP growth rates.

Since corporate profits and stock prices are closely linked to GDP growth rates (over the long term), movement of interest rates is of paramount interest to every market player. The fall in interest rates and the uptick in business activity will be the central theme in 2015. It the main bulwark on which will this *Modi-fired* rally is expected to sustain and grow.



Budget on February very Important

Apart from interest rate movements, another major domestic factor which impacts stocks is government policies. In this context, the Budget to be presented by FM Jaitley on 28th February will be very important. Hopes are pinned that he will do a better job than his first budget presented soon after he was appointed FM. That exercise was a damp squid. It was an extension of the policies and framework of the previous UPA government; which had disappointed on many fronts. With more time on hand, and a new team of secretaries and advisors, expectations are riding high that the Budget will be different, perhaps more bold and pragmatic.

Interest Rates and Government Policy Driving Factors

How the budget will be received by the market will set the tone for trading in March. The reason for focusing on interest rates and the budget (government policies) in this newsletter is that we perceive these 2 variables to determine the stock market trends in the short to medium term. In recent times, events in the global markets have had a limited impact on equities, as there is general consensus that we are in a trajectory of our own. Corrections, forced by tremors in global financial markets, have been buying opportunities. The only reason we have not had a serious decline in stocks is because the domestic scene has been steadily improving. Any negative newsflow on interest rates, government policies or any other internal factor could trigger a sharp fall and investors should be aware of this risk.

Our View

We maintain our long term bullish stance on equities but are a bit circumspect in the short term. With major events like the Budget on 28th February and the RBI policy in April, there could be turbulence /volatility if the outcomes are not upto street expectations. Moreover, valuations for quality businesses are on the high side and unless corporates provide a surprise on the earnings front, buying at these elevated levels is not advisable. Investors could wait for correction if they have investible surpluses. Those fully invested need not sell as over the next 2-3 years, stocks will still deliver stellar returns.

Dipan Mehta