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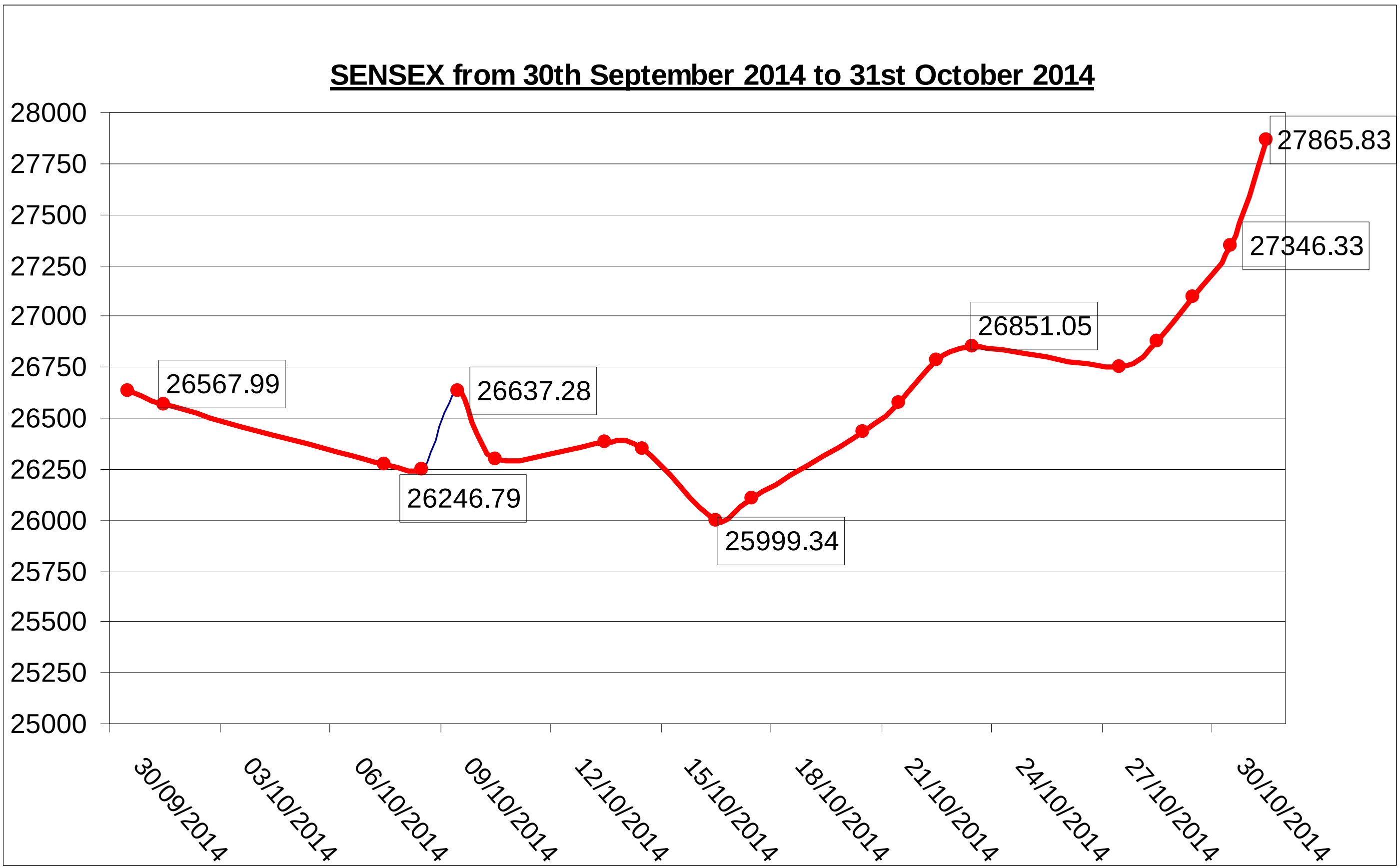
Fireworks in the Festive Season



Bull Market Resumes in October

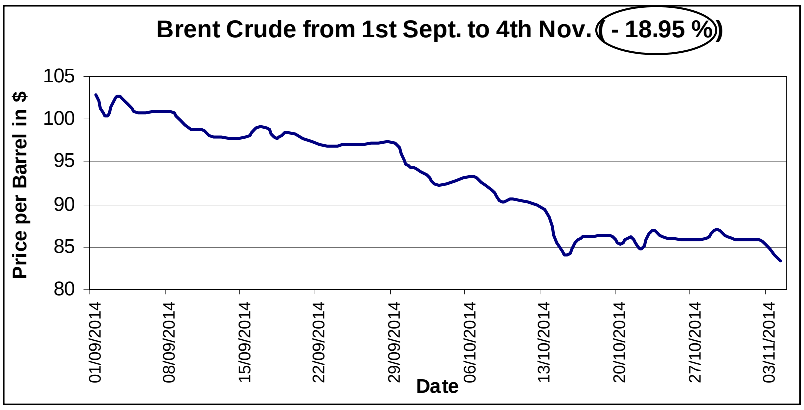
October turned out to be another milestone month in this *Modi-Fired* bull market. After languishing for September and the first half of October, the rally in equities, revived towards the later half of the month and the Sensex scaled to a fresh new high of 27,390 on 30th October. It also closed the month at an all time high of 27,865. For October, the rise in the BSE's leading broad market index was 4.65 %.

There are many reasons for the resumption / continuation of the rally. A few of these were unanticipated, such as oil price decline. However, others, such as government action were on the cards, but delayed. Nonetheless, stocks reacted positively to all of these events, which we shall discuss in detail in this newsletter.

Oil Price Fall a Boon for the Nation

India's sensitivity to oil prices is well understood. The inverse co-relation between our economy and stock markets to the movement in oil prices is clearly established. Our dependence on imported oil and the government's warped pricing policy has led to a situation where if oil prices rise, the trade and fiscal deficit come under pressure. As a corollary, the Rupee depreciates, inflation rises, interest rates harden and economic activity slows down. Stocks get pummeled as investors flee the market. FII selling intensifies and their outflows put additional strain on a weakening currency. Damage to business and investor sentiment is deep and extended. This structural problem has no visible solution as India does not have adequate oil reserves and energy consumption continues to rise.

Just as a rise in oil prices is damaging, a fall in oil prices does have an equally opposite positive impact on the economy and stock markets. Fiscal deficit eases as subsidy burden reduces. Inflation and interest rates also decline as fuel price reduction leads to lower input costs for several sectors, agriculture in particular. The country's forex position improves and a stabilizing Rupee attracts foreign investors. The sharp fall in oil prices over the past two months is one of the important reasons for the renewed and re-energized rally in equities.



The extent of the decline (see graph), over the past two months and the broad consensus that this decline will sustain and may be even deepen, is a notable event. Its beneficial effect will become visible over the next few months and may even advance the day when RBI will adopt an easy money policy. Lower interest rates are an important trigger for sustaining any rally in risky assets, stocks included. This round of up-move in stocks is largely because of crash in oil prices.

Reforms in True Earnest?

While the principle reason for the recent rally in stocks could be attributed to lower oil prices, there were other important reasons, which also contributed. Finally, the government began taking action on a few of the challenges facing the nation. In our prior newsletters we have been lamenting the status quo on the part of the PM and his cabinet; focusing on foreign policy rather than economic policy. Fortunately, announcement of the past month suggest that economy is now taking centre stage and a coherent plan will be put in place to improve growth. Consider the recent actions taken by the new government.

Diesel Deregulation

1. Diesel Price Deregulation and Increase in Gas Prices

The Petroleum and Finance Ministry took advantage of the fall in crude oil prices and proceeded to de-regulate diesel prices. Earlier, government controlled these and state PSU oil companies were not permitted to change prices based on prices movements in the open market. Going forward, diesel prices will move in tandem with international prices, as is the case with Petrol, which has long been deregulated. Since the prevailing international diesel prices were lower than government set prices, the first impact of diesel deregulation was to reduce its price by Rs. 2.25 per liter. Gas prices were increased as per long standing demand of the upstream oil companies and although more pragmatism is needed in gas pricing, the first step to partially address price anomalies for natural gas was taken during the month.

E-auction of Coal Mines

2. Ordinance on e-Auction of Coal Mines

The imbroglio caused by the recent Supreme Court decision to deem illegal the allotment 214 of coal blocks due to irregularities in allotment process has serious ramifications for the power and metals sector. The viability of several projects implemented / under implementation was in jeopardy. Urgent action was required on the part of the Modi government and fortunately, that did materialise. An ordinance was promulgated by the union cabinet and quickly approved, by the President of India. This facilitated reallocation of mines through a transparent e-auction system. The speed and agility on the part of the government was well appreciated by the street and the industry players.

New Appointments in Finance Ministry

3. Appointment of Chief Economic Advisor (CEA) and Secretary Level Changes

Although not a reform action, the appointment of Arvind Subramanium, an economist with pro-capitalistic leaning, as India's CEA is an important decision. Even more significant is the replacement of secretaries in the Finance Ministry.

The first budget of the NDA government was criticized as it was just an extension of the programs and policies of the previous UPA government. One explanation for the lackluster budget was that the bureaucrats who had framed the budget had served the previous FM and since their managing of the Finance Ministry left much to be desired, exits there could bring good tidings.

Expectations of a good budget were also raised when at a recent interaction with Secretaries of various ministries and departments PM Modi, urged them to prepare a budget which would be "*full of new ideas*" with transformational and measurable deliverables.

Other Measures of Significance

4. Other Significant Announcements / Proposals are

- Made in India Campaign
- 49 % FDI in Insurance
- Initiation of labor reforms for ease of business (single compliance report on 16 labor laws and computerized process for labor inspectors)
- Relaxation in FDI norms in construction sector
- Backing the Aadhar Project and the Jan Dhan Yojana, which at a later stage can help in direct cash transfer of subsidy to the under privileged
- Tweaking NREGA to create more durable assets
- Strengthening PSU Banks with revamped Bank Head selection process

These policies, programmes and reform initiatives are viewed positively by investors and go a long way in creating confidence that economic growth will revive and our true potential be unleashed.

Other highlights of the month were the election outcome in Maharashtra and Haryana, and the September quarter earnings season.

Maharashtra and Haryana Elections

First, the state elections results. In both states that went in for assembly, elections in October, BJP emerged as the single largest party for the first time ever. The conclusion was that the Modi magic was still working and his message of growth and development continues to resonate with the voters. Such political victories do strengthen the resolve to execute sound economic policies, which are the need of the hour.

September Quarter Results

The earnings season, which is underway, has also turned out to be different and interesting so far. The performing sectors of the past few earnings seasons viz. technology, pharma and select consumer oriented companies have disappointed whereas the laggards of the past viz. banks, cement, steel and engineering have delivered good results. It is the gains in these sectors, which has led the Sensex and Nifty to scale to new highs. The way this earnings season is panning out, it seems that investors will have to churn their portfolios in favor of India centric businesses, at the expense of export-oriented companies.

Our View on the Stock Market

We have been advocating a cautious to negative view of the markets for the past two months. To an extent, the markets did correct with the Sensex falling from its peak of 27,354 on 8th September to a low of 25,910 on 17th October, down by 5.27 %. However, a deeper correction has not materialized. On the contrary, Sensex and Nifty have crossed previous highs and the mid cap index too is close its earlier peak, for the reasons we have discussed in this newsletter.

From a fundamental perspective, the fall in oil prices is a game changer and has opened up new sectors for investing. Prior to the fall, we were factoring in cut in interest rates towards middle / late 2015. However, this could be sooner as lower oil prices will cool inflation and that may prompt the RBI to reduce interest rates earlier. Declining interest rates are positive for sectors such as Automobiles, Real Estate, Capital Goods and Infrastructure. It leads to higher demand through availability of cheaper finance. Banks benefit from increased credit delivery and trading gains in treasuries. Other industries such as oil marketing, plastic processing, auto and auto Ancillary, FMCG etc. benefit from lower input costs as oil and all derivatives from oil (plastics) turn cheaper. For FMCG, the consumers spending power increases as the burden of inflation reduces.

To sum up, a crude oil induced fall in inflation is positive for many sectors and investors could consider increasing exposure to the industries mentioned above. While caution must be exercised at all points for investing, as a strategy, investors could consider buying into selective stocks for the long term. From an earlier negative stance, we have turned more optimistic and suggest buying stocks at declines.

Dipan Mehta