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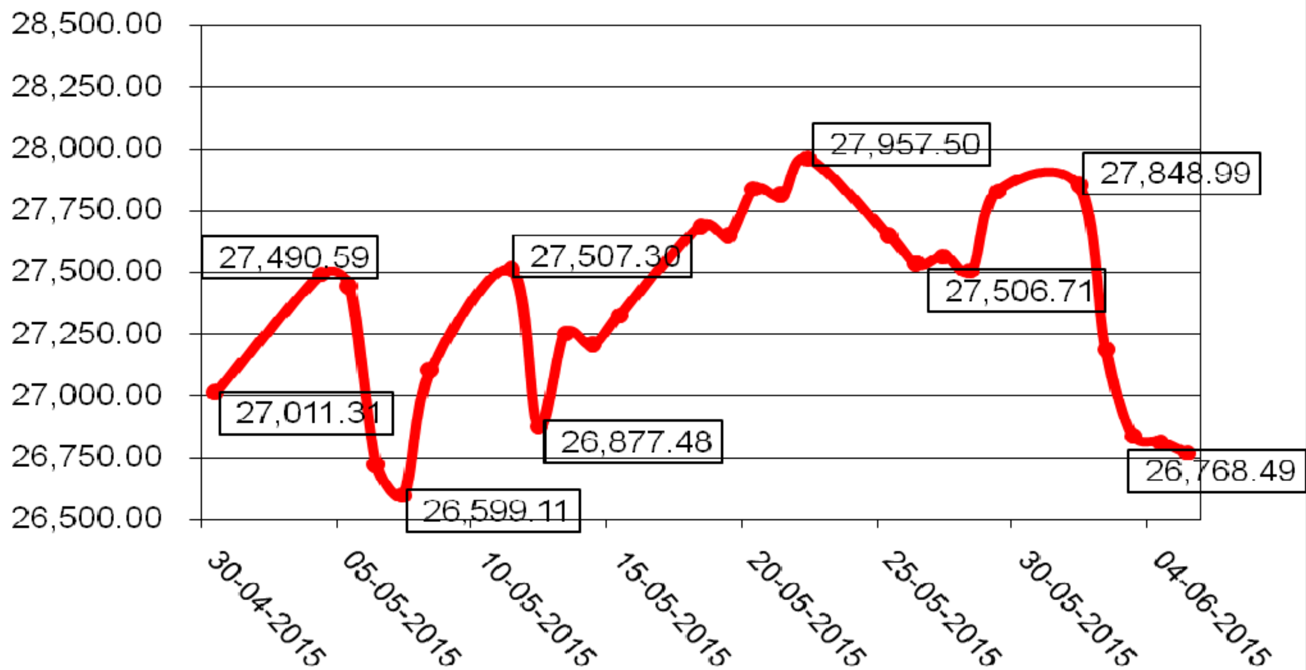
Recovery in May but RBI Disappoints



Sensex recovers in May but erases gains in June first week

The Sensex staged a smart recovery in May rallying by 3.03 % and nearly recovering its 3.38 % loss in April 2015. However, the big news was the RBI policy on 2nd June. This was a major disappointment and dragged the benchmark index close to its 2015 low of 26,599 (7th May). At the current level of 26,768 (5th June), the index is just 169 points away from piercing the 7th May low, and creating a new bottom.

FIIs net sellers, DIIs net Buyers

FII flows turned negative Rs. 3,460 crores but Domestic Institutional Investors (DIIs) pumped in Rs. 8,582 crores. The same trend was visible in the first 5 days of June with FIIs net selling Rs. 653 crores and DIIs buying Rs. 1,506 crores. The reason stock purchases / sales by DIIs does not have the same effect of FII buying is in their style of market operations.

FIIs, when they buy, generally chase stocks, place market orders and insist on full execution forcing the broker to complete the order even at a higher price. DIIs, led by LIC, on the other hand follow a more conservative approach. They place buy orders at limits below the prevailing touchline price and are satisfied with whatever quantity hits their buy orders. These trading styles are maintained even when they sell.

FIIs are more aggressive whereas DIIs, are measured, selling mainly at upticks. This explains why FII selling or buying sets the trend for stocks. FIIs are primarily *'price makers'* and DIIs are *'price takers'*. It is for this reason that FII purchase / sell figures are closely watched. Another element to consider is the financial capacity of the FIIs and their large ownership position in most counters; which make them the force to reckon with in our markets.

June 2nd RBI Policy a game changer ?

In our previous newsletter we had discussed 2 important technical parameters – the 200 Day Moving Average and the Crossing of the 50 day and 200 Day Moving Average Series. This newsletter focuses on the recent RBI policy and its long term implications for our markets. The discussion has been appropriately titled as 'Linking of Interest Rates to Consumer Price Inflation (CPI) - A Paradigm Shift in the Monetary Policy'. What conclusions we have drawn from this analysis are important for formulating any investment strategy.

Linking of Interest Rates to Consumer Price Inflation (CPI) - A Paradigm Shift in the Monetary Policy

There is a paradigm change in India's monetary policy which has gone largely unnoticed by the media and the average investor. However, it has very serious implications for every Indian and the global economy as well. Even the economists and other market pundits have missed this important event which has serious implications for our country and its growth rates. Before we explain this phenomenon; a brief chronology of important events that led to this tectonic shift.

Events which have shaped RBI policy in recent times

19th February, 2011 – New Consumer Price Inflation Index (CPI) is launched with 2010 as its base year and 50% weightage to food and beverages. Although India always had a Consumer Price Index, it was widely perceived to be archaic and inaccurate. There were gaps in its design and data collection and therefore, few followed it; and even fewer based their strategy on this series. The RBI and every economist used to lament the absence of a credible Consumer Price Index to measure inflation at the consumer level.

Launch of new CPI

We did have a Wholesale Price Index (WPI), which captured the prices at the factory and farm gates, but no reliable index which measured the cost of products and services at the consumer level. The government was aware of this inadequacy and after thorough research and deliberation; a new CPI was launched on 19th February, 2011. Being a new index, it suffered from absence of historic data and hence its adoption was slow in the first few years. However, by 2013-14, three years into its life, this nascent index had gained widespread acceptance and following.

Change of guard at RBI and formation of Urjit Patel Committee

3rd September, 2013 – Raghuram Rajan takes charge as Governor of RBI for a three year term

12th September, 2013 – RBI sets up and expert committee under Deputy Governor Dr. Urjit Patel to examine the monetary policy and make recommendations to strengthen it. This committee has external experts of eminence from J.P. Morgan, Nomura Securities, BoB, Williams University and the Indian Statistical Institute. Dr. P.J Nayak, the legendary ex-CMD of Axis Bank is also a member this think tank.

Urjit Patel Recommendations

21st January, 2014 – The Urjit Patel Committee releases its recommendations on strengthening the Monetary Policy. The key suggestions being

- RBI should base its policy on consumer price inflation
- This inflation should be brought down to 4 % with a band of +/- 2% around it within a time horizon of 2 years.

Inflation targeting RBI's primary objective

Post the release of this report, Governor Rajan, emphatically stated that RBI's primary objective would be to curb price rise at consumer level. He also forcefully articulated his view that real interest rates should be around 1 ½ - 2 %. Real interest rates are the difference between the prevailing interest rate and inflation. When this announcement came, few in the stock market understood its true implications.

However, about 18 months later, when the RBI announced its policy on 2nd June, 2015, the real impact of these events has sunk in. More about this later, but the last of the important dates, was April Fool's Day (1st April) of 2014 when the RBI in its Bi-monthly Monetary Policy announced the acceptance of the recommendations of the Urjit Patel Committee.

Implications of basing interest rate on CPI

The pun of April Fools day was intended as on that day, India's Central Bank, took a huge gamble and shifted its benchmark for interest rate setting from the WPI to the CPI. Whether this was a foolish move or a sensible one, time will tell but let us first understand its implication.

Real interest rate target of 1 ½ - 2 %

1. Keeping interest rates 1 ½ -2 % above inflation is a fair and universally well accepted norm. It not only provides an adequate incentive to save but also protects the saver from the deleterious effect of inflation. This premium, referred to as the *real interest rate* by economists, ensures that the saver earns a return higher than inflation and the borrower will take on debt only if he is confident of returns higher than inflation. Having a positive real rate of interest removes distortions caused by inflation and in the long run, creates a strong culture of savings and responsible borrowing. Such a background sets a strong economic foundation for any country. It is a prerequisite for large scale wealth creation which could take the country from a developing one to a developed one. Positive real rates of interest raises the per capita income in real terms and spreads equitable prosperity. All of this is much needed in India and therefore there is no arguing that we should have a positive real interest rate. The level of 1 ½ - 2 % has historically proved to be adequate for the outcome referred to above.

2. Since the RBI was formed in 1937, and it began setting interest rates post independence, the WPI was the benchmark for determining interest rates. If the WPI was '*X* %', RBI's interest rate would be '*X* + (1 ½ - 2) %'. What changed on 1st April, 2014 was that the anchor for setting interest rates shifted from WPI to CPI.

Consumer price inflation higher than Producer price inflation

3. In the Indian context, the rate of change of CPI has always been higher than the WPI. This is because 50% of the weight in the CPI is food and beverages. Our demographics and structure of agro markets are such that prices of cereals, fruits, vegetables, eggs, meat and milk are perpetually rising. This leads to high consumer price inflation. The WPI with low weightage of food does not rise as much as the

the CPI. By linking interest rates to CPI, the RBI has limited its scope to reduce interest rates and therein lies the gamble.

Reducing interest rates to boost economic growth is a time tested formula. It has been extensively used around the globe to raise growth rates and prevent recession. With a self imposed band of 1 ½ - 2 % over the retail inflation rate, the RBI has reduced its flexibility to cut interest rates and that has ramifications for growth. If the central bank is not able to cut interest rates, how will growth rates pick up ? India is a capital starved country. The level of interest rates determines economic activity. If the Central Bank continues to follow a tight money policy because of its recent change in benchmarking; growth may remain subdued. We can forget about double digit GDP growth rates and may have to live with the present levels of 7-8% GDP growth rates.

Past scenario when WPI was negative

4. For the month of April, the WPI is at (–) 2.65% and if that was the data point for determining interest rates, then we would be having zero rates as against 7.25 % (at present). In fact, the last time we had negative WPI, in July 2009, the RBI had dropped its lending rate to 4.75 %. However, by following the CPI, (4.87 % for April), the RBI, set the Repo rate at 7.25 % and this is certainly going to affect growth.

   Although the present Repo rate of 7.25%, set at the recent Policy announcement, is about 2.25 % higher than the consumer price inflation, RBI’s view was that retail inflation would inch up to 6 % over the next few months and therefore a 7.25 % interest rate was appropriate. In the same policy, they categorically stated that further interest rate cuts were unlikely given their forecast of inflation.

RBI Interest rate cut reduction cycle over and done with?

5. From the view point of an investor, this equation of

   Consumer Price Inflation + (1 to 1½ %) = Interest rates

   is very important. It signals that interest rates may not dip below 7 % as consumer inflation is unlikely to fall below the 5 ½ - 6 %; for an extended period. Even though it is sub 5 % at present, oil prices have since risen and there could be stress on food prices if the monsoons are erratic.

   A case for interest rates of around 6 %, the point at which the last bull market of 2004 -2007 started, is a highly unlikely. In India, a stable consumer price inflation of 4.5% for a long period, is next to impossible and that would limit the capacity of the RBI to reduce their Repo rates.

   The reason why we say that consumer inflation levels of 4 ½ % is *“next to impossible”* is because food contributes to half the inflation increase and given the

   - vagaries of the monsoon
   - the inefficient structure of our *mandis,* and
   - the government’s grain procurement policies

   such a low inflation rate at retail level has never occurred in our history and is unlikely to take place unless there are structural reforms.

Furthermore, even if by some good fortune, a 4 ½ % consumer price inflation is reached and RBI does drop the interest rate to around 6%, growth would dramatically pick up and soon inflation will start inching above 4 ½ %; leading the RBI to then tighten its monetary policy.

Effects of high interest rates on capital intensive businesses

The sum and substance of this analysis is that investors will have to work with 7 % interest rates for the foreseeable future. The present GDP growth rates could be the norm going forward as interest rate cut triggers to boost growth are not forthcoming.

Given this scenario, capital intensive businesses will find the going tough as high interest rates will negatively impact their bottom-line. One could argue that with global interest rates being low, these companies could reduce their interest costs through overseas borrowing. However, there are restrictions and limits on foreign borrowing. Moreover, there is the risk of Rupee depreciation making these loans more expensive.

Lower demand

Another impact of higher interest rates is felt on the interest sensitive sectors of auto, real estate and capital goods. The demand from end customers of these industries is impacted by interest rates and therefore, if lending rates are high, their activity could remain subdued.

Interest rates and price earnings ratio

One could argue that high interest rates will have a negative impact on price earnings (PE) multiples. However, here there is an anomaly. Normally, high interest rates would lead to investors paying a lower multiple, and this is true for Indian investors who are in a high interest rate economy. However, foreign investors continue to operate in a low interest environment and for them bidding a higher PE multiple is not a deterrent. Unlike our debt markets, there are virtually no restrictions global fund flows into India's stock markets. Therefore, higher PE ratios may sustain.

The question which then arises is which are the stocks and sectors these investors would favor; and the obvious answer would be the low capital intensive sectors. It is for this reason that PE multiples of FMCG, IT, Pharma, Media etc., which are asset light, have higher PE ratio than rest of the market. Their high RoEs provide comfort and buttress the case for high multiples. The cue from all these trends and inter linkages is to focus on businesses which do not rely on too much debt for growth.

Other implications of high interest rates

Other larger fallouts of a high interest rate regime are:

- Low Gross Domestic Product (GDP) growth rates
- Slow development of infrastructure projects such as power, roads, railways, ports and airports due to high cost of capital
- Lower demand for retail loans

All of these are also negative for stocks.

Corporate India and the government has been clamoring for lower interest rates to boost the economy but this linking of interest rates to CPI means that we are more or less done with the interest rate reduction cycle. Other triggers are required to give a fillip to the economy. This could be higher government spending, but here too, there are problems and government's fiscal position cannot support a higher spending program. This is the position we are in – stuck between a rock and a hard place.

Our View on the markets and potential positive triggers

In the previous newsletters, we has raised the red flags for equities by presenting the technical setup of the market, and while that scenario has not changed, the RBI policy and its implications discussed above has put further pressure on stocks. We advise investors to stay on the sidelines and wait for positive triggers. These could be in the form of

- ✓ Normal monsoons
- ✓ Government reforms / tough measures including the passage of the GST and Land Acquisition Bill in the Parliament
- ✓ Further up move in global stock markets caused by
    a. Resolution of Greece debt crisis
    b. Postponement of US Federal Reserve's interest rate increase
- ✓ Reversal of the recent spike in crude oil prices from sub $47 per barrel to $63.16 at present (05-06-2015)

The March quarter earnings season displayed stress in several sectors and choice of stocks and sectors has only narrowed since then. In conclusion, we remain cautious on stocks and would like to wait and watch.

There are chances that Sensex and Nifty could drift lower till the monsoon picture is clear. Any further fall (4-5% in the Sensex) could be a good opportunity for investors with low exposure to equities to increase their allocation especially to quality blue chips with asset light business models.

We end this newsletter with a table showing the returns of our portfolio management division and how it has fared versus the Sensex and Nifty.

Dipan Mehta

Our returns table

Date From	27/02/2015	27/11/2014	29/05/2014	29/05/2012	30/05/2010
	3 MONTH	6 MONTHS	1 YEAR	3 YEAR	5 YEAR
Axis Equities Portfolio Performance	4.62%	12.58%	46.87%	36.66%	18.37%
SENSEX	-3.07%	-1.62%	12.54%	18.30%	8.77%
NIFTY	-2.75%	-0.18%	14.28%	18.17%	8.96%
Performance comparison	7.37%	12.76%	32.59%	18.36%	9.41%
(higher of Sensex and Nifty)					