OUTLOOK FOR 2014

POLITICS AND RETURN TO GROWTH TO BE THE KEY

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2013 was driven by increasing prospects of withdrawal of stimulus by the US Federal Reserve, central bank policies and improving macro in the US. 2014 could well be the year of accelerating growth in the Developed Markets, stabilising growth in the Emerging Markets and further actions that central banks might take. Looking at the year ahead, Soumendra Nath Lahiri, Head – Equities and Shriram Ramanathan, Head – Fixed Income at L&T Investment Management share their thoughts on the likely triggers for the economy and markets.

2013 – Year of central bank action

Global – Taper talks drive markets

A large part of 2013 was driven by one central theme – 'taper on/off' of US quantitative easing and what it would mean for the economies globally and how would it impact asset classes. Markets watched for key leading indicators of stabilising growth in the US and signs of an improvement in Europe. Political developments at various points in time also played an important role in determining market sentiment – election stalemate in Italy, tensions in North Korea, military takeover in Egypt, government shutdown in the US, elections in Germany and India and the threat of a US military intervention in Syria.

In the US, prospects of improving growth as evidenced by encouraging data on labour and housing market led the US Federal Reserve (Fed) to hint about a potential taper of its quantitative easing program. Consequently, financial markets across the globe witnessed volatility and a significant re-pricing of equities and fixed income, particularly in Emerging Markets (EM). India was the most impacted market on this count as this volatility brought to the forefront its large fiscal and current account deficit (CAD).

Euro area stabilised over the year with political risks diminishing and the region registering two successive quarters of growth. Even the peripheral countries showed some signs of stability. The European Central Bank (ECB) lowered the refinance rate in light of lower than expected inflation. Japan saw a rally in equities and a weak yen due to an expansive monetary policy which included a fiscal stimulus to the tune of 60-70 trillion yen by the Bank of Japan (BoJ).

EM oscillated between optimism and anxiety; but endured the maximum brunt of fears of tapering amid expectations that this would lead to a stronger US dollar, rising bond yields and hence capital outflows and relative underperformance of equities. Particularly, the countries with a CAD suffered considerable depreciation in their currency.

Overall, global equities surged over the year with many indices touching record highs while government bond prices fell. US equities rose 27%, German equities 25%, and the UK 14% while Japan was the best performing equity market with a spectacular gain of 57%. In contrast, EMs were an exception to the stellar returns seen in Developed Markets (DM) and posted negative to single digit returns. The US dollar gained ground against most currencies particularly EMs. Gold witnessed a huge fall in demand and posted negative returns of almost 27% in light of an improving economic outlook and strong performance of equity markets.

India – Volatile currency weighs on sentiments

2013 was a tumultuous year for India dictated by falling economic growth, a depreciating rupee, high inflation and tight liquidity conditions. While the year started on a favourable note with lower commodity prices, diesel price hike, low core inflation and interest rate cuts, fears of taper in the US led to notable volatility in the financial markets. The worst hit was the rupee which touched a high of 68.825 against the US dollar in August from the 61-62 levels seen earlier. However, the new Reserve Bank of India (RBI) governor Raghuram Rajan launched a slew of measures – hike in import duty of gold, special swap window to attract FCNR (B) deposits and foreign currency borrowings and special window for oil marketing companies to help meet their daily forex requirements. All these measures paid off and the rupee reverted to 62 levels. From its peak, the rupee appreciated by 10% at the close of the year. Despite the gain, the rupee declined by 12% against the US dollar over the year.

Since September, the RBI raised interest rates twice by 25 basis points each to curtail inflation. After remaining under 7% for four months, WPI inflation rose due to persistent rise in food prices. Meanwhile, improving trade deficit and a good response to FCNR deposit scheme (which saw an accretion of $34 billion) ensured a reduction in CAD. Moreover, a pickup in exports and a fall in imports dramatically improved the CAD/GDP ratio to 1.2% from a high of 6.7% in the not too distant past. Economic growth looks close to bottoming out, with the GDP rising 4.8% quarter on quarter. However, domestic demand remained weak due to a lacklustre capex cycle.

Equities – FII flows bolster markets

Against this backdrop, Indian equities delivered only a modest increase of 9% in 2013 vs 25% gain in 2012. Large caps posted lower single digit returns and the mid and small caps recorded negative returns. Despite a single digit gain, equity markets touched all time highs closer to the end of the year on account of persistent FII inflows and elections euphoria. Furthermore, India was the best performing market in BRICs and the only one to post positive returns. However, key point to note is that although the benchmark indices touched record highs, these levels were primarily driven by a small number of stocks rather than being a broad based rally.

Strong FII equity inflow of US$ 20 billion (on top of US$ 24 billion in 2012) more than offset significant negative debt outflowS of US$ 8 billion. Indian retail investors sold the biggest quantum of equities in 2013 at US$ 12.5 billion, despite being considerably under-exposed to equities.

Fixed Income – Volatility and high yields lead to dispersion in returns

2013 was a quintessential tale of two halves for the fixed income market. Although initially "the higher the duration, higher the risk" theme prevailed, the next few months saw a huge reversal in trend, forcing fixed income market participants to drastically reduce their risk positioning across all funds. From being large buyers, FIIs turned massive sellers and ended the year having reduced their positions by almost US $ 8 billion. The underlying dominant theme was the weakness in the rupee and poor policy coordination between government and the RBI, and implementation of interest rate tightening measures did little to support the currency. Both headline and core inflation reversed from the low levels seen earlier due to a combination of weak rupee and a sharp rise in food inflation. This was despite the year witnessing above normal monsoons. All these developments led to a risk-off sentiment and volatility in the fixed income markets. As such, the yield on the 10-year government bond started the year below 8%, touched a low of 7.1%, ended the year at 8.85%. Had it not been for the new benchmark security issuance, yields were expected to touch 9%.

The well thought out measures implemented by the RBI governor and those by the government to reduce the CAD helped the rupee stabilise in a narrow range. As a consequence, CAD narrowed sharply and coupled with improving global sentiment on the impact of tapering helped bring about stability in the markets. Tight liquidity conditions that resulted in sharp rise in yields too eased as the RBI unwound a lot of the earlier announced measures. Consequently, 1- year CD levels that had shot up to close to 11% levels, ended the year at about 9.25% - quite lower than the year highs, but still a fair bit higher than the 8.25% levels that it was pre-July.

Against this backdrop, not surprisingly, fund categories with the least interest rate risk viz. liquid and liquid plus performed the best. Short term funds did take some negative impact of the tightening, but still ended the year in high single digits. But, the worst impacted were the bond and gilt categories – where year-end returns were typically in low to mid single digits, with the laggards being just above zero. Dispersion among the best and worst performing funds was also high, as reluctance to cut duration in the face of mounting risks cost many of the funds dearly.

2014 – Economy and politics to drive the markets

Global – Economic recovery will be divergent

Going into 2014, fears over the tapering in the US, the eurozone crisis and outflows from EMs have eased. Markets are better prepared for the taper and investor sentiment is buoyed by expectations of economic recovery across the world. We expect the global economy to improve, albeit uneven at a country level, against improving set of macroeconomic numbers. EMs should be beneficiaries of improving growth in the DMs but could be weighed down by a strong US dollar and FII flows particularly if we see a significant rise in US Treasury yields.

Monetary policy is expected to remain accommodative in the US, UK and Europe. Fed taper will soon be a reality and would in all probability end the easing regime before 2014 ends. Beginning January 2014, the Fed will begin to taper $10 billion of asset purchases every month. It will now purchase $40 billion of long dated treasuries (as against $45 billion) and $35 billion of mortgage backed securities (as against $40 billion). The next Fed chairman Janet Yellen has suggested that rate hikes may not be a possibility till 2015. The ECB and the BoJ will likely lower interest rates and inject liquidity into the system. In contrast, Emerging Economies will most likely tighten monetary policy over the year, with growth momentum and inflationary expectations being the key driver.

The US growth will be supported by easing fiscal drag, a recovery in housing and improving consumption. The US budget expires on 15 January and the fate of the budget sequestration and the transition of Janet Yellen to the new Fed chair are near term concerns. US elections in November will also be an event to watch out for. The euro area has seen a sluggish but modest improvement in growth. Germany continues to drive growth in the region, while growth in France is still negative. However, the region's recovery hinges on the fiscal sustainability and sovereign solvency of the peripheral countries. The sovereign debts of Greece, Ireland and Portugal have seen maturity extensions, coupon reductions and deferral of interest payments. Weak coalition governments in Greece and Italy could prove to be a political risk. Furthermore, European Parliamentary elections will be held in May.

Japan could face a difficult year against a background of corporate tax cuts and consumption tax hike in April. Nevertheless, the economy would see benign growth in light of additional easing measures by the BoJ through increase in asset purchases. The long term growth story in Asia ex Japan remains intact, although tempered at an individual country level. China aims to launch a major reforms program aimed at overhauling its economy over the next decade. This plan, outlined at the third plenum in November will allow markets to play a decisive role in allocating resources and improve the government's role. Nonetheless, this will likely face near term challenges and the implementation of reforms will be a slow and steady exercise.

EMs will be increasingly driven by progress on reforms and the outcome of elections. India, Indonesia, Turkey, South Africa and Brazil will face elections in the first half of the year and these five are the countries with sizeable CADs. As such, political developments and currency movements will influence asset prices. As seen last year, central banks remain committed to correct the CAD position and policy responses could likely be dictated by inflationary expectations. Implementation of reforms post elections could provide the likely trigger for growth.

India – Elections and reforms to act as catalyst

Though the economy is still in a low growth phase, it looks close to bottoming out. GDP growth is looking set to better expectations after 10 quarters and is headed higher after hitting a trough of 4.5% for FY14. Liquidity stress is easing as influx of forex has improved liquidity at the shorter end. On the external front, an improvement in trade deficit has helped narrow the CAD. Improved forex reserves on the back of USD34b accretion through RBI swap window for FCNR(B) and bank borrowing have stabilized the INR at 62-63/USD levels, which may have provided some comfort to RBI to start rebuilding its reserves.

We expect 2014 to be a tale of two halves, with the first half driven by anticipation of elections and the second half by the outcome of elections and hopefully some actions on policy and reforms. This could result into a recovery in the economy and we could see a fall in inflation leading to softer interest rate regime, adding to the productivity of the corporate and finally investment led infrastructure segment. A cooling in commodity prices globally could be a contributor too.

Equities – Elections and return to growth will prevail over fears of US Fed taper & volatility

Indian markets hit new highs in 2013. Sensex RoE is trading at around long term average of 16.7%. Corporate earnings growth remained depressed for the last many quarters. Towards the end of calendar 2013, corporate profit to GDP is bottoming out ~4.5% and is starting to recover. 2QFY14 Sensex earnings grew 10% post a decline of 4% in 1QFY14. Interest rates are at high levels and earnings-to-bond yield at 0.8x. Market cap to GDP of ~60% is reasonable pricing and portends a favourable risk reward equation. Over the next 24 months, corporate India should be able to revert back to near its long term earnings growth of ~15%.

Recent state election results were a triumph of growth and governance over dole outs and entitlement, anti corruption issues even overshadowed competence like never before. India looks to be ready to turn a new leaf in sensible policy making in 2014, an important pre-requisite to build confidence and help kick-start the Capex cycle - global investors are keenly looking forward to that as well. We expect growth to pick up, with a favourable outcome in the forthcoming general elections should act as a catalyst for quick recovery.

Return of growth and stability of the currency is a virtuous cycle that feeds into one another and will endear steady FII and FDI flows which should create an environment for stability. Indian retail investors who have been taking out money from equity markets for the last two years will then have a compelling reason to reverse this and participate in the journey of growth and prosperity.

High inflation, fiscal deficit (and financing of the same) and international crude price rise beyond comfort level of $110 are the likely obstacles for the economy and the markets as they seek higher levels of growth and returns respectively. US Fed taper impact has been largely discounted by the debt market already. Equity flows may face some volatility in the short term on account of taper. As domestic issues of elections and economic recovery dominate, they will eventually offset this impact. Reversal in interest rates eventually will have an effect on equity returns. An improving global growth outlook bodes well for international trade and India’s exports.

In our portfolios, we are overweight sectors that will benefit from a decline in currency - these include information technology, pharmaceuticals and textiles. Telecom is another area which will gain from better regulatory clarity and reducing competitive intensity. We maintain an overweight bias towards private sector banks due to sustained growth and better asset quality. Among the consumer discretionary space, automobiles is best placed, particularly in the two wheeler segment gaining from rural growth and export opportunities. Our endeavour is to identify good quality stocks which have a combination of strong fundamentals and improving growth scenario.

Fixed Income – Expect 2014 to be a year of two halves

As we head into 2014, uncertainty still prevails – in the form of upcoming central elections, fiscal policies of the new government and structural food supply problems which lead to periodic high inflation. However, a couple of positives such as - attractive absolute level of yields, tapering being much less of an overhang, inflation possibly having seen its worst, a structurally lower CAD and hence a relatively more stable rupee do provide some support. While the year could start off as a mixed bag of positives and negatives, we do believe that if a strong government were to get elected, and prudent policies are put in place – the market could see a sharp rally in the second half of the year.

CPI Inflation is expected to moderate sharply, however the key is to watch whether it can drop significantly below the stubborn 9% levels. Important in this regard would be the new government's resolve to bring down inflation and implement effective supply side responses. Despite the government sticking to a fiscal target for FY 2013 and possibly for FY 2014, fiscal situation remains a concern. Over the next three years, a large number of government securities will mature, hence gross supply of government securities is likely to be very heavy. While the uncertainty on the government elections remains, we do expect policy to be well calibrated and forward looking, rather than reactive. The monetary policy framework is clearly changing. Increased emphasis on CPI (vs WPI), equal importance to headline inflation as given to core inflation, reduced usage of open market operations to manage yields and the need to generate a positive real return for savers are some of the important messages that have already become part of this new framework. Also, one can expect a buildup in forex reserves to be a theme over the next few years, and this will act as a guard against further rupee weakening episodes.

From a fund selection and allocation perspective, we think risk – reward at the start of the year is in favour of lower duration funds such as short term and accrual oriented funds. While tactical rallies are likely given elevated yield levels, for a sustained secular drop in yields, we need to see clarity on policies post government formation. Hence, while the second half could witness a sharp rally in yields, we still believe it is better for investors to be prudent in their allocations – especially given that short end yields are fairly attractive, with much lower risk.