CIO Newsletter

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Dear Reader,

This is my first newsletter to you where I have tried to stitch together an essay of some of the key issues that, both in direct & indirect ways, affect us as a member of the investment community. I have attempted to keep the narrative crisp and ensuring relevance to our areas of interest.

We are in a very dynamic environment with geopolitical upheaval in Iraq and Ukraine and rising fears of a high yield debt market bubble in the US. Back home, fears of a weak monsoon seems more realistic now as the country recorded the third driest June in 115 years with 43% deficient rains for the month.

The rupee has rebounded substantially since touching an all time low of 68.8 against the dollar in August 2013 on rising foreign inflows and general investor optimism. Although widely cheered, this could have uncomfortable repercussions for the export industry given the Asian emerging market (EM) currency basket's depreciation against the greenback in the last 10 months which could render our exports relatively less competitive, atleast in the short term.

In the US, recent uptick in CPI data US has led to inflationary scare, albeit dismissed as 'noisy data' by FED chair Yellen. This, however, has to be taken seriously, more so when availability of cheap money worldwide has sent investors searching for yields, thereby pushing bond prices to dangerously high levels.

Finally, on a lighter note some interesting anecdotes and charts on the FIFA World Cup and taking a cue from empirical data, investment advice associated with the event.

I would appreciate your feedback at rjain@tataamc.com

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ISIS' C-rude shock

We all are aware of the events in Iraq and the 'C-rude' shock which it has delivered and how it has the potential to disrupt the oil scenario at least in the short to medium term. Interestingly, the militant group ISIS, while being a splinter group of AL-Qaeda, is sophistically organized and a very well oiled (pardon the pun!) machinery; it has been publishing annual reports for the last 2 years, meticulously outlining, in graphical detail its exploits – number of bombings, assassinations, suicide missions, cities taken over etc. In 2013 alone, the group's report claimed nearly 10,000 operations in Iraq including assassinations, improvised explosive devices planted and the hundreds of radical prisoners it has freed. One would wonder why would a militant group like ISIS, instead of ensuring covertness, is openly boasting about its terrorist achievements. It may be reasoned that the group is trying to portray itself as an organized outfit with a clear political mandate rather than the splinter terrorist tag that has been attached to it by the Iraqi establishment in order to undermine its activities and deem them equal to other terrorist activities around the world. To quote a popular columnist - with a detailed annual report whose volume exceeds most other annual reports by large corporations, all that is missing is an IPO and a conviction 'buy' recommendation from Goldman Sachs!

"Investment highlights" from 2013 annual report

Did you know that: ISIS' annual report for 2013 contained 410 pages replete with images and graphical data... enough to put disclosure standards of many large corporations to shame!

El Nino

A lot has been talked about El Nino, and should it occur, its potential adverse effects on agri output and especially the Kharif harvest in the near term. However, I decided to find more about the real threat and possible outcomes taking a cue from historical predictions and outcomes. Now - EL Nino was predicted in 2006 and 2009 and while the latter year did turn out to be a disastrous monsoon year, 2006 was a perfectly normal year with actual rainfall being 102% of the Long Period Average (LPA) when the IMD prediction was 93%+/-5% of LPA. Historically, rainfall has not always been deficient in case of EL-Nino.

Year	El-Nino Forecasted	IMD April Forecast for South West Monsoon	Actual Rainfall (% of LPA)	Comment
2003	No	96% +/-5% of LPA	102%	Normal
2004	No	100% +/-5% of LPA	86%	Deficient
2006	**Yes**	**93% +/- 5% of LPA**	**100%**	**Normal**
2007	No	95% +/- 5% of LPA	106%	Above Normal
2009	**Yes**	**96% +/- 5% of LPA**	**78%**	**Deficient**
2013	No	98% +/- 5% of LPA	105%	Above Normal

Source: IMD, BOAML Research

EL Nino is the warming of the Pacific Ocean which has a significant impact on the flow of moisture across the Pacific. It has a significant impact on the weather across the Pacific and on the monsoon across the Indian Sub-Continent.

Did you know that: EL-Nino has a poorer, less celebrated cousin called La Nina which is associated with strong monsoons as a consequent of cooling of the Pacific!

Budget Expectations

The build up to 2014 budget has begun on a fairly positive note with the rail passenger & fare hike (suburban fare hike partial roll back notwithstanding). One clear message here is that the leadership under Modi is committed to reduce subsidy even if it means pushing the reform agenda through un-popular measures like these. The budget is a good opportunity for a new government to communicate to the outside world of their plans and strategies for the medium term. While the change in political landscape and widespread optimism in the economy has created strong expectations from the budget, however, as has been the norm with new governments, this budget is not expected to be big bang as the new government gets it bearings in place. Additionally, there is a substantial rollover from the previous fiscal which needs to be taken into account while planning for the government's balance sheet for FY15.

I expect the government to move conclusively on food procurement and pricing and act decisively on subsidies. Curtailing of subsidies of both food and oil will be the key to cut expenditure including overhauling of MNREGA scheme in its present avatar which is inefficient and a drain on the country's balance sheet. The new government may not resort to increase in taxes to prop up revenues; hence divestment path for under-performing public units will be critical. The divestment process has to move towards privatization – small share sales act only as a stop gap arrangement to tweak the deficit and nothing more beyond that. A host of tax incentives are expected for promoting exports as well as reduction of legislative uncertainty caused by retrospective amendments. On GST, I believe we will get a fresh timeline perspective. My personal belief is, and which has not been talked much about is the spending on defence. This, I believe has to go up and with the appointment of the new National Security Advisor (NSA), a whole lot of reforms could be on the cards, as will be budgeted expenditure. The buoyancy in capital markets could offer some respite from recapitalizing banks as they are now in a better position to hit the market and raise capital on their own. With monsoons playing truant after a good year in 2013, we will have additional clarity in the next 10 days on the situation. If there is no tangible improvement in the monsoon situation, the government might want to set aside money in the kitty to tackle a weak output and support farmers. There have been indications of increasing the exemption limit for investments limit u/s 80C from Rs.1lac currently. If implemented, it could provide the much needed impetus to household savings in financial instruments.

Overall, the budget may not have a very friendly market undertone if the 'bitter pill' to restore the economy guidance set by the new prime minister is anything to go by.

Did you know that: The word Budget was derived from the Middle English word bowgette, which came from Middle French bougette or bouge, meaning a leather bag or a purse!

Emerging equities themes; logistics & defence

In May this year, Indian Electorate's decisive vote saw a majority government coming to the Centre after three decades, the last being in 1984 during Mr. Rajiv Gandhi's tenure. The mandate, which cut across class, caste, religion and geographies, clearly indicated that the society at large voted for a decisive change. NDA has caught voters' imagination by promising better economic growth, increased job, controlled pricing and good governance.

The fact that the new PM has headed one of the fastest growing states in the Country for over a decade has raised hopes and aspirations across business segments for an encore at the National level. During his Gujarat tenure, all three sectors – agriculture, industry and services – grew faster than India. Growth in Gujarat during slowdown period equaled that of India during the boom period. In Gujarat, contribution of govt sector to GDP is among the lowest in India. Key to this success was industrial performance that was able to absorb surplus labor from agriculture, in sharp contrast to the all-India stagnation in industrial employment.

The techtonic shift in the country's leadership has allowed us at Tata AMC to change our Cautious stand to one of 'Quiet Confidence'. We think that some key sectors/business models that have suffered over the last few years owing to slow decision making and lack of clear leadership would have a good chance to recoup lost ground and outperform over the next few years. We have identified these as key themes to focus on over the next few quarters.

One such theme that comes to mind is 'Transportation' – comprising Logistics, Railways, Ports, Shipping, Roads and allied segments. A few points below highlight this theme's outstanding potential over the next few years.

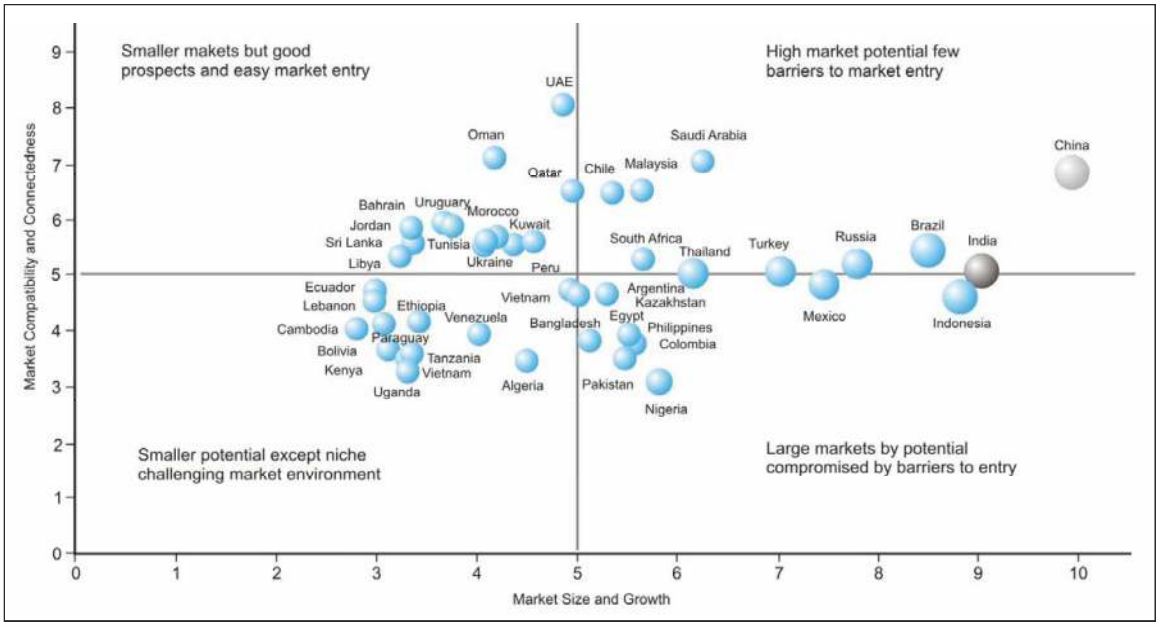
Scope in Logistics

Over the years India has emerged as a preferred investment destination and manufacturing / outsourcing hub, which is visible in the 101.1% trade volume CAGR over CY00-CY12. The Indian Economy is the 10th largest in the world with a nominal GDP of US$1.8 trillion and is expected to double over next 5

years. India is slated to be an export hub for grains and for import of heavy civil infrastructure and capital goods. According to industry experts, the Indian Logistics industry was estimated at Rs12.8 trillion in FY13 and is expected to clock ~19% CAGR over FY16E.

Recent efforts to improve connectivity between ports and the hinterland via DFC and DMIC are significant value unlockers. Steps like GST too are likely to immensely benefit the logistics sector.

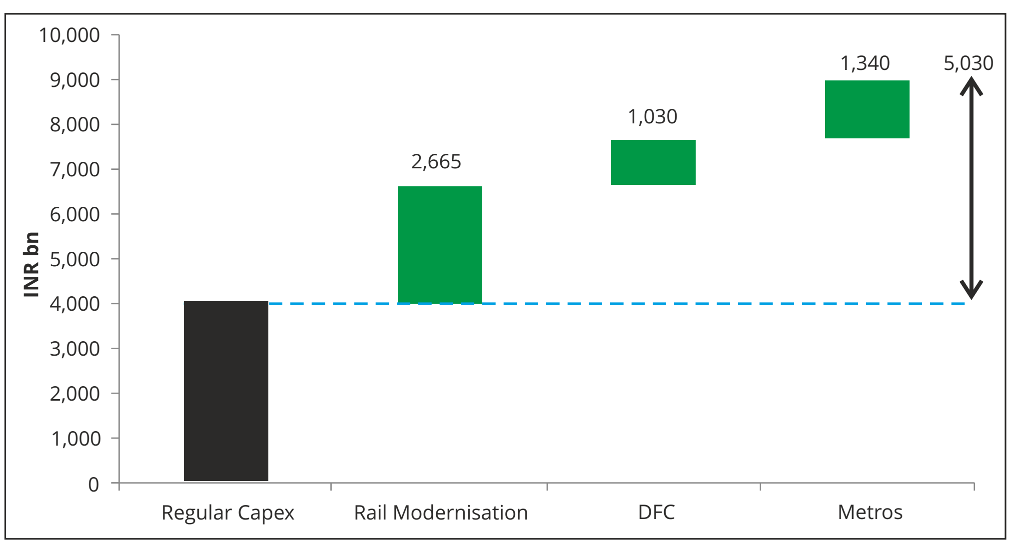
India remains a preferred market for investment



Source: SBI Cap Securities

Railways – A Rs.5 trillion opportunity: Freight costs account for 13% of GDP in India, versus around 5-7% globally. Railways have only a 32% share of freight in India, while the global average is 70%. The average speed of freight rail in India is only 25km/hour. Given that road freight is at least twice as costly as rail freight, investment in rail infrastructure is an economic imperative – even a small increase in incremental capex will result in significant benefits. This capex is likely to be geared towards rail modernisation, dedicated freight corridors (DFCs) and new metro lines.

The US$18 bn DFC project is similar in cumulative scale of investments to the highway program of the past 15 years and will likely have as big an impact. Along with other feeder routes and the industrial corridor, the DFC could pull in investments of US$40-45b in the next five years. The DFC will boost the total capacity of the network by 30-40%, with a more dramatic increase in the routes it operates on. Freight trains will run to a timetable, at an average speed of 75-80km/hr vs the current average of 25. The trains will be twice as long and load per wagon will be nearly 30% more. The average productivity of trains can potentially be 8-10x higher. The operating cost per unit (NTKM) is estimated to be 50% lower and total cost, including capital costs, about 30-40% lower.



Source: Standard Chartered Research

About the opportunity in defence

Addressing the defence situation in the country will be on the new Prime Minister's priority list as he takes stock of the defence requirements to beef up the country's capabilities in an ever de-stabilising geo-political scenario. Mr. Modi appointed Ajit Doval, a veteran intelligence officer and a former director of Intelligence Bureau who has spearheaded various covert operations as the fifth NSA to the PM. India's spend on defence technology has been low; just to put things into perspective, in 2013, our defence expenditure per capita was less than half of that of China. With expenditure on security strengthening being low on the government's priorty list post independence, it was only following the Chinese debacle in 1962 when the wisdom of expanding our defence sector was realized. However, as it stands, even after 64 years of independence, with the second largest growing economy and one of the highest end user of defence equipment, we are still dependent of foreign sources to meet 70% of our defence requirements. There have been efforts to beef up defence production capabilities like the policy shift in May 2001 when the government allowed participation of private sector in defence production (in contrast to 100% procurement from ordinance factories & PSUs) but little headway has been made thus far.

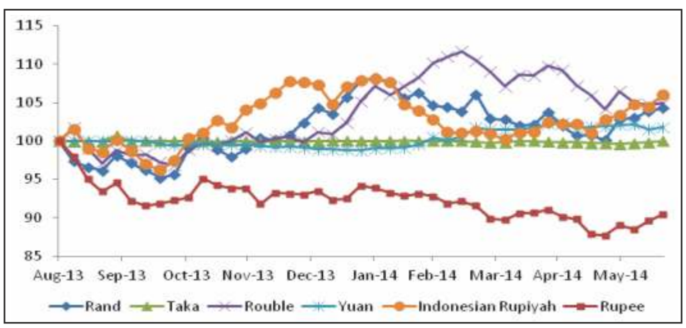
India spent roughly half on defence expenditure in 2013 compared to China. With an estimated expenditure \$100bn[1] on defence acquisitions in the next 10 years, even if a fraction of this is diverted in-house, it will vastly help stabilize the current account deficit in the long run and not to speak of the immense employment opportunities. While currently, we have advantages of investible capital and access to technology earlier denied by defence production western giants which does not offer an immediate compelling push to reduce dependence on imported weapons and invest in domestic production, it is imperative to bring about a qualitative and quantitative transformation in defence sector including integration of private players in the entire defence eco system. The private players could be involved in research and developmental work provided they are assured of sustained orders as well as participation in international marketing opportunities and clear agreement on R&D cost sharing. Perhaps the government should borrow a leaf from ISRO which outsources components, hardware and subsystems both in the public and private sectors. Some of the bigger private sector outfits have displayed willingness to get integrated with this eco-system and contribute their share to augment India's defence preparedness. The government has little choice but to give private sector players a slice of this pie... and the pie is huge.

[1] *India's Defence Production and Research – Need for Transformational up-gradation – Ajit Doval*

Rupee appreciation & export competitiveness

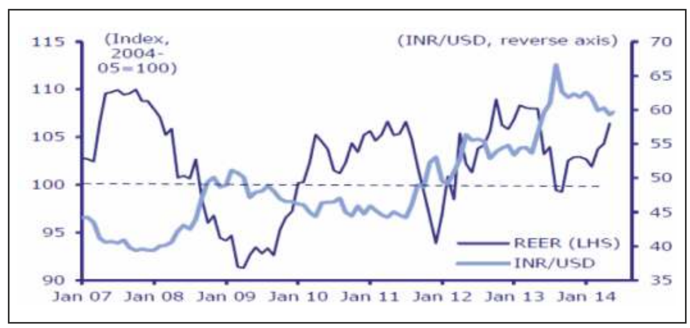
The rupee's appreciation in the last 10 months has thrown an interesting perspective. Most EM currencies, except the rupee, have depreciated against the greenback in this period, thus helping their exports. Not only do our exports depend on the rupee's value versus the dollar but also on the value of other export competitors' currency relative to the dollar. We compete with Bangladesh, Vietnam and China in textiles, Brazil in sugar, Russia in gas-based fertilizers, China in basic chemicals and electricals, Turkey in gems and jewellery (16% of exports) - most of these EM currencies have depreciated from their September highs. A fast depreciating EM currency basket will dent our export competitiveness even if it is in the short term. Critically, as of now, exports are the only positive which can push up the GDP. The INR is now overvalued by 6.4% in REER terms (see chart below). To quote an eminent risk consultant, Mr. Rajwade, the rupee should trade at 70 versus the dollar (equilibrium value) in REER terms.

Trend of select EM currencies v/s the dollar*



Source: Bloomberg
** a lower index reading indicates appreciation in the currency value v/s. the dollar*

INR / USD and REER



Source: CLSA

Did you know that: Measured against the dollar, the rupee appreciated by around 8% by May 2014 from its January lows versus a 5% depreciation in the EM currency basket (measured by JP Morgan Emerging Markets Currency Index) during the same period

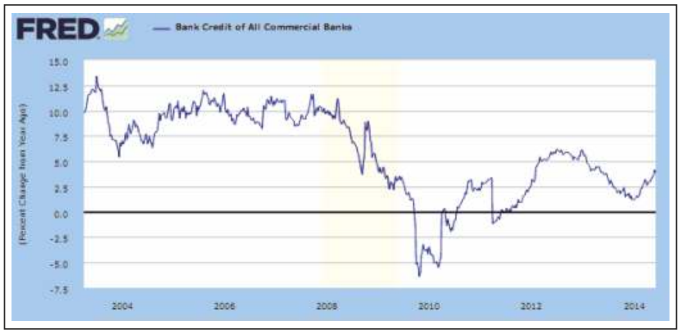
All VIXED up?

Curious reading on the VIX which is at a historic low is suggesting that markets are in for being complacent. The CBOE VIX is at a 6 year low and the geopolitical situation in Iraq and Ukraine doesn't seem to tie up with this calmness. To see how the VIX has printed during previous crises, I have marked them on this VIX reading across the last 6 years. Could we be in for a sharp and sudden VIX spike and market shocks? As I write this, the Dubai stock market has tanked, with what could be seen as entering a bear phase after a 5 year strong bull run; the market is now 20% off its May peaks.

Source: Bloomberg

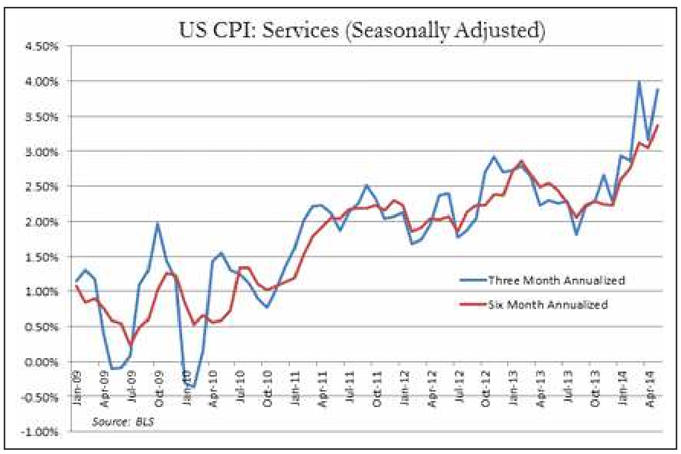
US CPI and Credit Growth

A noteworthy development here; while the RBI has made a lot of noises on using inflationary data as a 'forward guidance' monetary policy tool, cues from the recent press conference by FED chairman Janet Yellen point otherwise where she dismissed the recent uptick in US CPI as mere 'noise'. With regard to the expansionary policy followed by the FED, a large increase in the money supply will always lead to price increases somewhere in the economy. Growth in US banking credit is already seeing a sharp uptick combined with the 3 month US services CPI printing above the 6 month CPI (see chart below) for quite a while and now threatening to break away. Is Janet Yellen 'behind the curve'? It sounds scary!



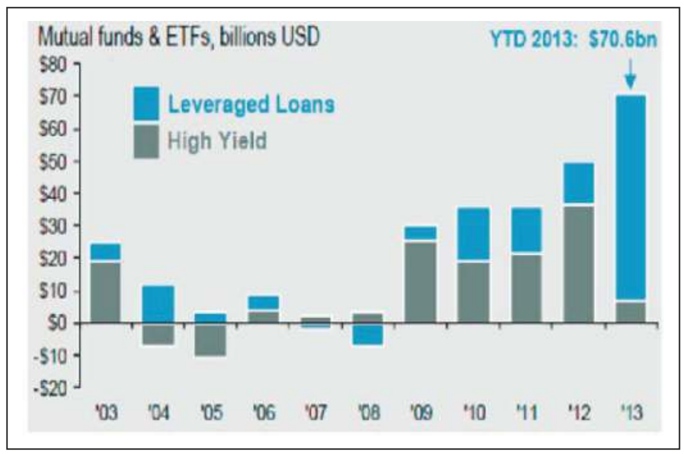
Junk Bonds too bubbly?

The rock-bottom yields on offer in the debt markets worldwide are enticing investors to search for yields elsewhere from high yield corporate bonds to junk bonds issued by countries with little history of issuing external sovereign debt. There are two clear camps of investors here, the first camp, undeniably conservative is preferring to wait out the bond market and is confident of normalized 5% risk free returns which is unlikely to happen this year. At the same time, there are the risk taking investors who are overreaching for yield by entering ever more speculative bond structures, such as Greek bonds and leveraged loans as well as sovereign debt issues by countries like Ecuador and Kenya which together raised $4bn worth of sovereign debt recently. The Ecuadorian and Kenyan issues yielded around 8% and 7% respectively in US dollar terms. This is Kenya's first ever international bond sale post its debt default in 2008. Interestingly, this is the largest ever debt sale by any African country ever! With most central bankers throwing easy money to revive a moribund economy, the search for yields have driven investors to newer markets and complicated structures.



Junk bonds are supposed to yield substantially higher than equities as they are riskier than equities; since March 1995, junk bonds have paid an average yield about 4.2% higher than the earnings yield on the S&P 500 stock index. However, in May 2014, junk bond yields were yielding as much as the S&P 500; the earnings yield on the S&P 500 was 5.8% and the yield on the iShares iBoxx $ High Yield ETF (Blackrock's high yield dollar denominated corporate bond ETF) was 5.85%. This is quite unusual for any period. Suggests that either equities are cheap or bonds are expensive; Bloomberg estimates for forward P/E of S&P 500 suggest that stocks are not alarmingly overvalued. Is it a case of bond markets being pushed into a price bubble?

Trend of annual fund flows into high yield and leveraged loan funds

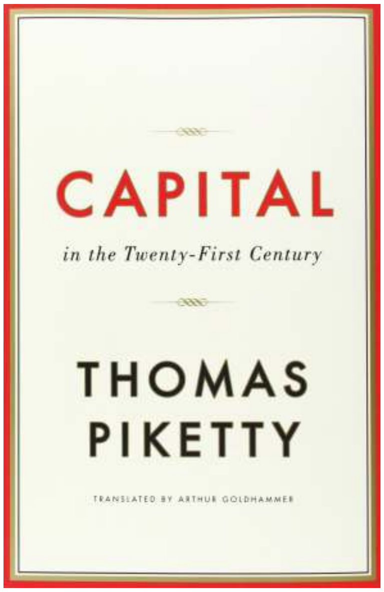


Source: JP Morgan

Did you know that: VIX is nicknamed the investor's “fear gauge” because investors tend to be more fearful when market volatility is high and less so when volatility is low

Book Review:
Capital in the Twenty-First Century

Thomas Piketty's “Capital in the Twenty-First Century” has attracted a great deal of attention. The rock star economist Piketty's book is mainly about income inequality in the rich world and its historical magnitudes and the factors influencing it. The primary source of income inequality originates when the rate of return on capital exceeds the rate of economic growth for extended period of time. Piketty finds that countries are on the path to “patrimonial capitalism”, with inherited wealth increasingly concentrated in few families. As long as the rich earn a return on their wealth that is somewhat greater than the country's growth rate, inherited wealth will rise relentlessly faster than national income. Piketty reveals that incomes of the top “one percent” of population, and of even narrower groups, are actually the big story in rising inequality. This conclusion is based on staggering 200 years of income data derived from historical tax records of over 20 countries! The table alongside, from the book shows how similar the current US inequality (2010) appears compared to that of Europe in 1910.

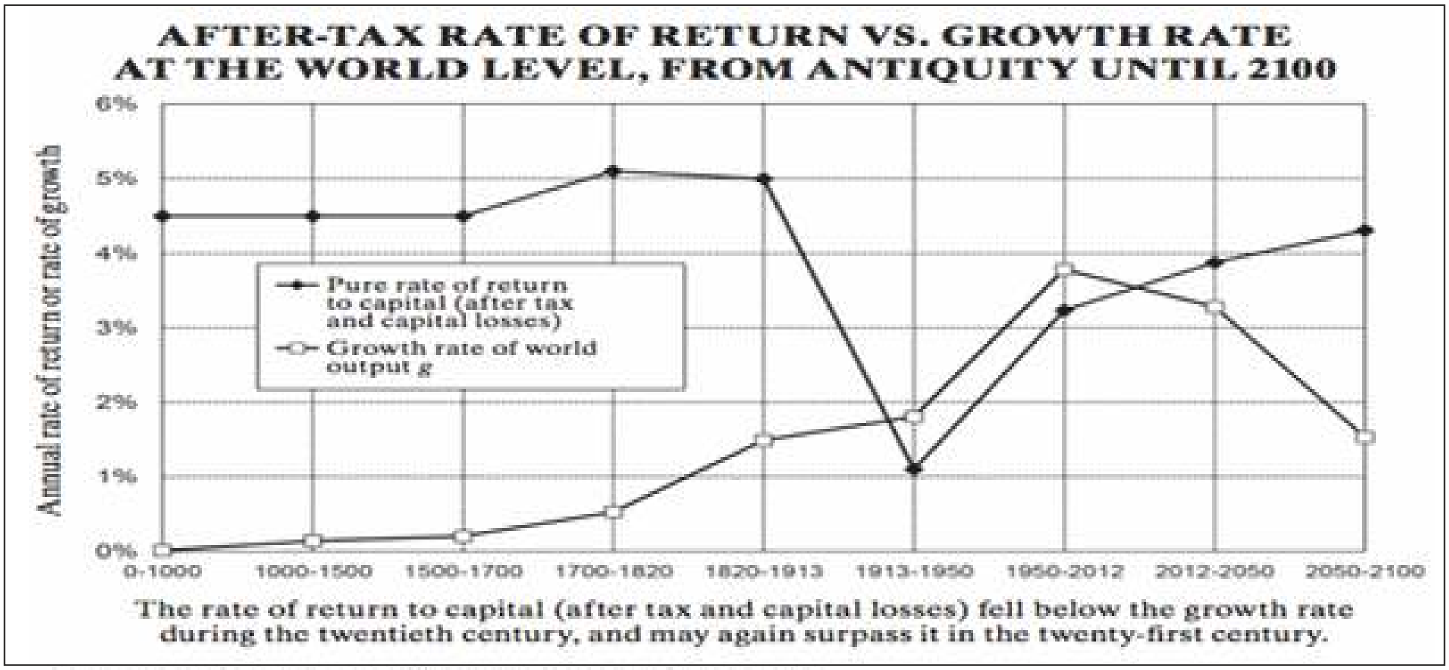


The conventional wisdom has long been that we needn't worry about rising income inequality, as the shares of capital and labour respectively in total income are highly stable over time. Over the very long run, however, this hasn't been true. Considering the example of developed countries, it is seen that while capital's share of income reduced from pre-World War I level until 1970, it begun to increase ever since. In Britain, for example, capital's share of income in the form of corporate profits, dividends, rents, or sales of property fell from around 40% before World War I to barely 20% by 1970, and has since bounced roughly halfway back. The historical arc is less clear-cut in the United States, but there too, there is a redistribution in favour of capital underway. Notably, corporate profits have soared since the financial crisis began, while wages - including the wages of the highly educated - have stagnated. The graph (next page) from the book shows the after-tax rate of return on capital has always been higher until pre-World War I era.

India being the part of top world economies was also part of the study. Piketty noted that top one percent of Indians own 8-9% of total Income. Ask any of the rest 99%, and they would admit that's just too low! Piketty immediately acknowledges the major problems with measurement of income inequality in India, in absence

INCOME SHARES

	Low Inequality (Scandinavia 1970s/1980s)	***Medium Inequality (Europe 2010)***	***High Inequality (Europe 1910, US 2010)***
Top 1%	**7%**	**10%**	**20%**
Next 9%	**18%**	**25%**	**30%**
Next 40%	**45%**	**40%**	**30%**
Bottom 50%	**30%**	**25%**	**20%**



Sources and series: See piketty.pse.ens.fr/capital21c

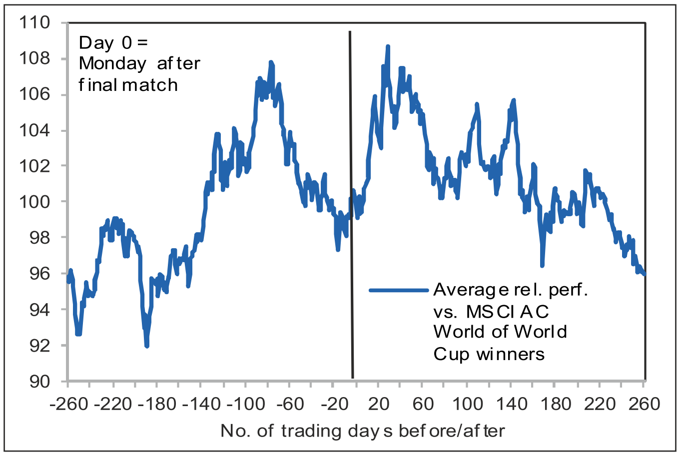
of getting reliable data on income tax statistics. Well, even ISIS – the militant group of Iraq- with their regular annual report publication, would score better! Nevertheless, trend suggests rising inequality in India since liberalization period of 1990s, with top “one percent” increasing their share of total income. This could be because - they alone were in a position to sell what the world markets wanted - or - just better access to state resources through political nexus. Piketty's mantra to reduce inequality with progressive income and wealth taxes as well as incremental focus on social services may require political intent and resources that is lacking so far. For now, sound implementation of existing regulation, effective taxation and smarter delivery of social services should be initial steps in right direction!

World cup 'bites' (pun intended)

The newsletter could not have been complete without mentioning the FIFA World Cup, undoubtedly the greatest sport exhibition on earth. Notwithstanding Uruguay's talented Luis Suarez's (or Suajaws?) tendencies to take a bite out of his opponent, the world cup frenzy is at its peak with South American teams proving a force to reckon with and the well-behaved Brazilian boys catching all the attention! Interestingly, Goldman Sach's came up with an interesting quantitative model to predict the winners and the subsequent stock market movements! The study notes a clear outperformance for the winner (3.5% in the first month) & a mixed trend for the runners up (see charts below). Im betting (not literally) on the formidable Brazilian team with home advantage (brownie points for the good behavior!). We will have to wait for how the Bovespa reacts if Neymar and company actually go on to conquer the cup!

A boost for the winner

Relative performance of World Cup winners one year before/after championship match

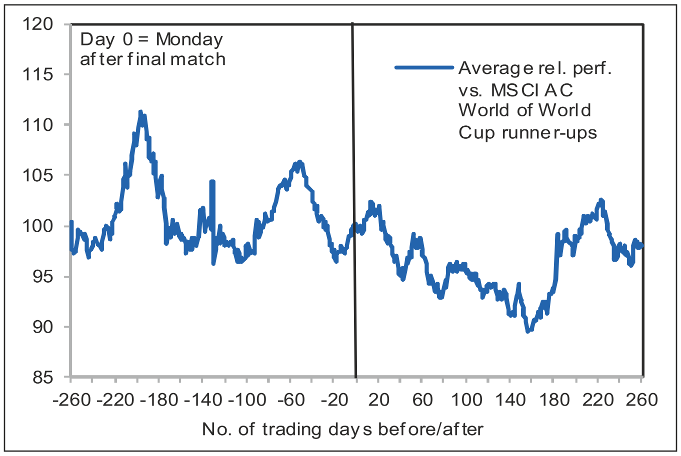


Note: Excluding Argentina in 1978 and 1986.

Source: Datastream, Goldman Sachs Global Investment Rese

A slump for the runner-up

Relative performance of World Cup runners-up one year before/after championship match



Source: Datastream, Goldman Sach Global Investment Research.

A final word : Taking into account all the data I have presented, I think investors are certain to face more volatile global moments ahead, concerns of which may prevent them from seeing the great investing opportunities that make up a secular trend of progress in an developing country like ours, as in Transportation' – comprising Logistics, Railways, Ports, Shipping, Roads and allied segments. We promise to take these easy ones bowled to us in the middle of our bat, and swing for the fences.