CIO Newsletter

TATA MUTUAL FUND

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Dear Reader,

At the outset, I take this opportunity to wish you and your family a very happy and prosperous 2015.

It also gives me pleasure in presenting my third newsletter. Your feedback and suggestions are much appreciated and I have tried to incorporate some of them in this newsletter. As usual I focus on themes that could affect our investors and try to address them in an easy-to-understand manner.

With the reform engine gaining steam, fundamentally India is not in a bad shape; however it is the external sector which could test India's resilience. 2015 could be a volatile year for the rupee with global macro and geopolitical wounds remaining open. Only time will separate the men from the boys and one line sums it up all–" India's strength versus global weakness".

As with my previous newsletters I have tried to present an exciting equity theme; this time the focus is on abounding opportunities for the Indian pharma sector. Indian pharmaceutical companies have transformed the global pharmaceutical industry, recording impressive revenue growth over the past 20 years. In the next phase of growth, Indian pharmaceutical companies are set to ride the third wave given their ability to adapt, endure regulatory frameworks and focus on incremental innovation.

Best Regards,

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India's strength versus global weakness

The recent turmoil in the Emerging Markets (EMs) took international investors by surprise and set them wondering whether it is prudent to differentiate within the asset classes based on fundamentals or if all constituents of an asset class had a tendency to move in tandem. Consequently, the entire EM basket was painted with a single brush and investors rushed to developed markets, making EMs look vulnerable by the end of 2014. However, in hindsight, deeper analysis reveals clearly that there are pockets of resilience and, I believe that investors have begun to appreciate these pockets of resilience. While 2014 tested India's resilience, 2015 will do so too, without an iota of doubt.

A couple of other factors caught almost all stakeholders off guard – these were the sudden collapse of crude prices and the crash of the Russian Rouble, which became the most disliked currency of 2014. Crude prices fell by more than a half from $110/barrel levels, triggering a massive depreciation of the rouble against the dollar. The immediate victims were high yield (HY) credit funds which shed 5-8% in a span of two weeks. Against this backdrop, investors fled to the safety of dollar assets in an uncertain economic environment and capital flowed out of EMs.

Dollar Dominion

So, is this the opportune time for investors to flock to dollar denominated assets? As I had pointed out in my previous newsletter <http://www.tatamutualfund.com/docs/scheme-documents/cio-newsletter-vol-002.pdf> there are a number of reasons that suggest that it is. These include a strong dollar rally against the world currency basket as a result of optimistic US growth expectation with global dis-inflationary expectations. Investors and policy makers alike expect the US to grow northwards of 3% in 2015 (against a growth of 5% in the third quarter of 2014 and 4.6% in the second quarter) at a GDP base of $17 trillion - that is quite a formidable addition of over $500 billion each year. In a nutshell, the dollar seems bound for an upward trajectory this year. On the other hand, the inflation target of 2% looks unlikely in the medium term hereon on the back of the unanticipated softening in crude prices, which is likely to depress headline inflation. While Chairperson Yellen has said that the committee will be 'patient' in deciding when to remove accommodation, she also suggested that the committee's expectation for the policy trajectory has not changed. This poses the risk that the US may hike rates, sooner rather than later – and the market is not prepared for earlier and more aggressive hikes.

The Oil Glut

As oil prices continue to soften, the important question is – where will they stabilize? A slower European Union and more importantly a slower China could reduce overall energy demand and keep prices at lower levels in the medium term. It is difficult to say what will happen but I believe that crude prices could transition to a new equilibrium level, which is lower than that which prevailed in the last five years. This is good for energy hungry EMs as well as Europe.

Respite from the Rigid Rupee

Back home, the rupee had a slightly different story to tell until now. You will recall from my previous letter where I had put forward my view that the relatively stable rupee (compared to a rapidly depreciating EM currency basket) during the last couple of quarters, has the potential to destabilize exports. India competes with many of these EMs for exports and could find it increasingly difficult to remain export competitive if the rupee continues to outperform the EM currency basket. However, the rupee could face some pressure due to imminent US growth, the rate differential between the US and the rest of developed world and the struggle to keep the fiscal deficit under check. Additionally, soft crude prices could potentially slow capital remittances and capital inflows (FII as well as FDI) from the gulf region. This could partially offset gains accruing from lower oil prices. Coupled with a lower inflation trajectory and higher productivity, I believe that the rupee is in for a gradual depreciation against the dollar and is sure to bring respite for exporters.

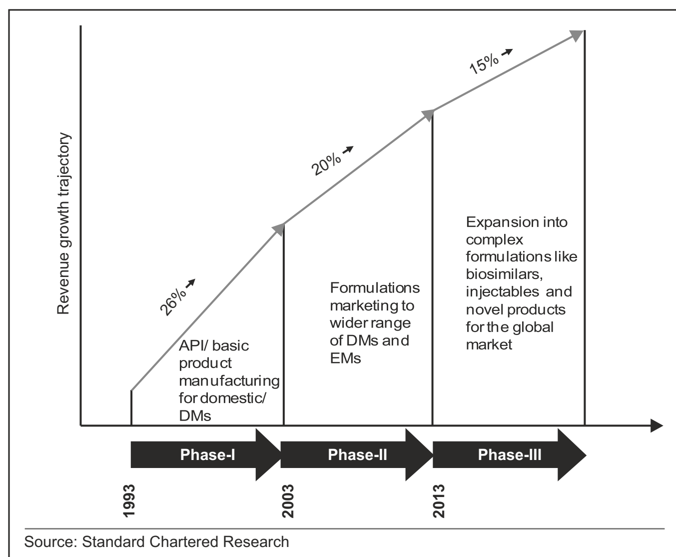
India and the world

With the reform engine gaining steam, fundamentally India is not in a bad shape; it is the external sector which could test India's resilience. An orderly depreciation of the rupee is good for the economy; it is the accompanying bouts of high currency volatility which we should guard ourselves against. 2015 will continue to be a volatile year for the rupee with global macro and geopolitical wounds remaining open. Overall entropy will remain high and only time will separate the men from the boys. One line sums it up all – **"India's strength versus global weakness"**.

Investment Theme:
Indian Pharma – opportunities abound

This time, my focus is on the Indian Pharma theme. We are all aware that Indian pharmaceutical companies (IPCs) have transformed the global pharmaceutical industry, recording impressive revenue growth over the past 20 years. In the first wave (1993-2003), the industry reported a 26% CAGR, driven by basic chemistry/manufacturing skills to produce small molecules in India and APIs in developed markets. The second wave (2003-13) saw 20% revenue CAGR, driven by complex formulations, benefits from the patent cliff and a tentative reach into global markets.

Indian pharmaceutical companies (IPCs) are in their third phase of growth, moving into complex products and expanding their reach. **IPCs are set to ride the third wave** given their ability to adapt, endure regulatory frameworks and focus on incremental innovation.



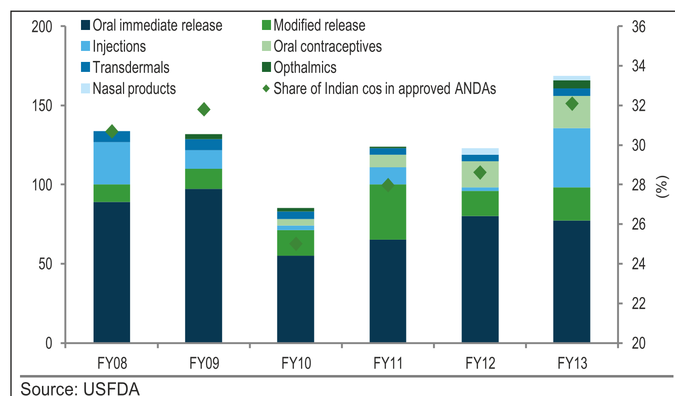
Source: Standard Chartered Research

US: Staring at an annual US$35-40 billion patent expiry opportunity

The US is the largest pharmaceutical and generics market in the world. It accounts for 34% of the global pharma market and over 60% of the developed world's generics market. The USFDA aims to clear 90% of the current application backlog by September 2017 and shorten the current approval timeline from 31 months to 15 months for 60% of the ANDAs submitted over the 12 months period - October 2014 to September 2015 - and finally, to 10 months for applications submitted after October 2016.

Even post the patent cliff, the drug expiry run-rate remains healthy with products worth US$220 billion in sales slated to go off-patent over the next six years (annual range of US$35-40 billion). IPCs are improving their product pipelines by developing portfolios of complex products in niche categories, novel products and biosimilars. They are also increasing their focus on the chronic segment. In the US, injectables (31% of the market), biosimilars (25% of the market), many complex or niche therapy areas, and differentiated drug delivery systems have yet to be penetrated by IPCs. The next frontier is likely to be complex products such as oral contraceptives, vaccines, transdermal, extended release, sprays, inhalers and injectables.

Indian Companies' US filings



Source: USFDA

Emerging Markets, India and Japan also offer good opportunities

Sales in Emerging markets (EMs) are likely to account for 33% of global pharmaceutical spending by 2017, up from 23% in 2012. EMs are expected to grow at a 12% CAGR while the global markets are expected to grow at a modest 4% CAGR. Furthermore, generics within the EMs are expected to grow at a 14% CAGR. The share of generics within EMs is expected to move up from 58% (2012) to 63%

by 2017. More importantly, branded generics form 50% of the market according to IMS Outlook. IPCs are well suited to capture EM opportunities.

The Indian market still has enough potential to sustain a 13-15% growth. It is primarily volume driven and prices are capped or at a significant discount to other EMs. Broadly, 75% of the Indian market comprises branded generics with chronics comprising 38-39%. The Indian pharmaceutical market has expanded at a 10-13% CAGR over the past 10 years.

Japan is the world's second-largest pharma market. But IPCs have not been able to make inroads in this market and overall, generics penetration remains low. Japan plans to increase the share of generics, driven by rising costs. Industry experts expect Japan's healthcare costs to reach 10% of GDP by 2020.

R&D – a must to ride the third wave

While global pharma companies have been cutting R&D spend, IPCs have been maintaining stable R&D spend of 5-7% of sales. Going forward, a focused approach towards R&D will be a key differentiator for IPCs.

The focus needs to shift towards more complex and higher-development-hurdle products. These products can have high development costs of US$10-30 million, but will have limited competition. Over time, larger IPCs should have significant portfolios of approvals and their R&D will be focussed on injectables, extended-release products, ophthalmic, derma, OTC, biosimilars and similar complex/niche products.

The third wave of growth has brought its own set of problems – rising competition, a tougher regulatory environment, increasing cost structures and slower approval rates. Furthermore, IPCs now face increased competition from (1) global generics, (2) new generic companies that plan to establish a global footprint and (3) arms of 'big pharma' that are focused on generics. I believe IPCs are resilient enough to face these challenges. **Given their skill sets and cost advantages, they could still be in the hunt to achieve a respectable 15-17% growth in this third stage of growth.**

Equity Outlook – 2015

2015 would be dominated by key events, both on the global and domestic front. On the global front, a likely hike in US Fed rates and quantitative easing in the ECB will be keenly watched events. Within India, RBI's stance on rate cuts and the Budget would be important. The timing and outcome of all these events will keep markets volatile in the coming year. Nevertheless, the equity as an asset class is expected to continue to follow an upward trend.

Not only returns; margin of safety too will matter

For a large part of the last year, particularly post general election results, broad markets gave a solid return. The concept of margin of safety and quality were put on the back burner by many. However, that was possible because at the starting point, valuations were hugely favourable. That is not the case anymore. Moreover, the coming year can be volatile, considering the line-up of global macro events throughout the year and probable currency wars. So, investors have to be amply sure about their margin of safety. Maintaining a margin of safety doesn't imply not buying 'expensive' stocks; one should buy companies that meet fundamental criteria like business moats, good management and reasonable growth profiles, etc. rather than value turn-around candidates.

Differentiate apples from oranges

A large part of the market has given phenomenal returns in the last year. These broad-based returns came from the expectation of bottoming out of GDP and improvement in earnings growth. However, as the focus shifts towards execution and delivery in the coming year, one would be better off shifting to companies with sound financials and capabilities rather than staying invested in companies with sub-optimal financial health and/or commoditized products or service offerings.

Stock selection over sector preference

As we are heading towards a revival in the overall economy, many sectors, barring sectors linked with global commodities, would benefit in varied proportions. However, bottom-up investing would work better than painting the whole sector with a broad brush. For example, within banking, private banks are on a significantly stronger footing than PSU banks. In the consumption basket, urban-centric discretionary companies' prospects are looking much better than rural-focus staples companies, etc.

Outlook

I retain a positive outlook on the Indian equity markets. After a strong run up in 2014, markets are trading at fair valuations. Global liquidity is benign and India is being viewed favourably by global investors, due to its reformist government. The country is also a beneficiary of lower commodity prices. As a result of all these factors, valuations are likely to remain well supported. Markets will henceforth reward earnings growth and a further re-rating on valuations would be contingent on earnings improvement.

The main risks to markets at this juncture seem global. Competitive devaluation and resultant moves in currency markets, and recessionary conditions in many economies of the world can lead to higher volatility in the markets. I would urge investors to invest systematically in the equity market and use the possible increase in volatility to their advantage.

Fixed Income Outlook

Interest rate cuts expected with a lag

We are going through our very own rate cut drama with the RBI keeping everyone playing the guessing game on when the rate cut will happen. Inflation is over achieving the glide path; while it's true that we do not have a formal inflation targeting regime, this possibility is being discussed at RBI. The RBI's own March-15 CPI target has come down to 6% and both the CPI and WPI are within the comfort zone. However, I believe that the RBI will perhaps wait for more discipline in fiscal consolidation. At the same time, emerging risks to the fiscal consolidation plan could prove to be a delay in the divestment plan and cause a slowdown in tax receipts. Further, real rates have turned positive after a long time – the RBI has reiterated its stance on keeping the real rates positive in order to motivate households to park their savings in financial instruments. The shift of household savings from physical assets to financial instruments due to falling inflation and higher real rates will lead to higher incremental savings being channelled to financial assets. Implementation of the much awaited Goods & Services Tax (GST) will lead to an improvement in tax revenues and present a big positive for the economy. I believe that the RBI will wait for the fiscal outturn for 2014 and the fiscal stance taken by the government in the Union Budget next year, before reducing interest rates.

Interest rate view – Watch out for volatility

I expect G-sec yields to be volatile with a downward bias on the back of rate cut expectations and the gradual fall in the CPI. The RBI may initiate rate cuts in the first quarter of 2015. The 10-year benchmark yield should trade around 7.50% levels by the second half of 2015.

On the corporate debt side, I have a negative bias towards lower rated bonds which are currently trading at compressed spreads. While I expect the government issuances to moderate on the back of the fiscal prudence policy of the government, I see corporate issuances increasing due to an improvement in credit off-take and capital investment. I am, however, more positive about AAA rated papers than ones with lower ratings. Duration strategies would yield better return opportunities than accruals, going forward. The risk to this view is currency volatility; while the rupee has remained relatively stable compared to its EM peers until now, any substantial global risk could induce bouts of volatility in the rupee; investors should use that window to their advantage by adding to their financial investments.

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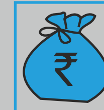
*** Investors should consult their financial advisors if in doubt about whether the product is suitable for them.**

Note: Risk may be represented as:

(BROWN) investors understand that their principal will be at high risk.

(YELLOW) investors understand that their principal will be at medium risk.



(BLUE) investors understand that their principal will be at low risk.

Contact Your Financial Advisor

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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