CIO Newsletter

TATA MUTUAL FUND

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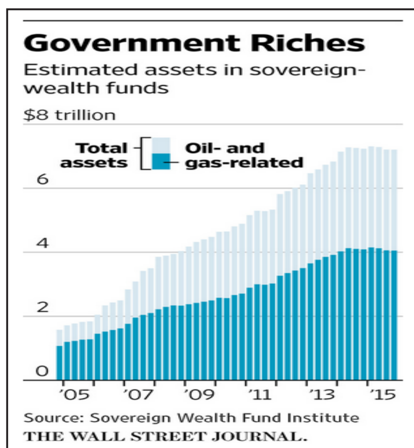
Global Macro Environment

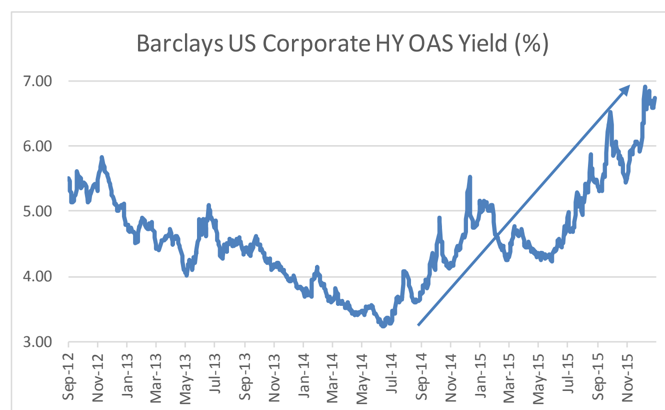
Volatility and liquidity were the overarching themes of 2015 and we had plentiful of one and simultaneously lacking in the other during the year. One of the most important developments in the last year was depletion of global forex reserves held by central banks and asset sales by petro dollars funded sovereign wealth funds. 2015 marked a key inflection point for Emerging Market (EM) forex reserve holdings; large EM central bank liquidations became significant market uncertainty. From a peak of around $12tn in the beginning of the year, global forex reserves shrunk to $11.25tn. Except for a brief while during the height of the financial crisis in 2008-09, global forex reserves have been increasing, providing much needed global liquidity. With major forex reserves denominated in dollars, and with dollar as the reserve currency of the world, this decline in reserves has serious implications for global liquidity and could lead to a squeeze on dollar funding. Countries have fallen back upon their sovereign wealth funds during tough times to tide over liquidity crisis. Kazakhstan's $55bn sovereign-wealth fund helped pull the country through the global financial crisis and offered funding for the country's bid to host the 2022 Winter Olympics. But the collapse in oil prices has hit Kazakhstan and its fund hard. In October, the fund borrowed $1.5bn to help a cash-strapped subsidiary with a troubled oil-field investment. The world's sovereign-wealth funds together have assets of $7.2tn, according to the Sovereign Wealth Fund Institute, twice their size in 2007 and roughly 60% of these assets are deployed in funds dependent on energy exports. As oil revenues fall, some funds are being tapped by the government, forcing them to borrow or sell investments. If oil and commodity prices continue to remain low, the future of these funds and the impact of the selloff will be important for global asset prices and volatility.



Ritesh Jain

The High Yield Space

The collapse of crude oil had an unlikely victim in the high yield (HY) fixed income space. We saw a lot of volatility in the HY segment towards the second half of the year as investors shaken by contagion fears turned risk averse. Many hedge funds and asset managers in the HY space faced with large redemption requests had to unwind these funds and close shop. Third Avenue Focused Credit Fund, a high-yield mutual fund began blocking investors from making redemptions, sparking a panic in high yield funds investors.



Source: Bloomberg

Third Avenue later declared it was shutting down the $800million credit fund sparking the biggest one-day sell-off in U.S. junk-bond markets in five years. Lucidius Capital Partners, a high yield credit fund is in the process of returning the $900 million of assets under management after it received a big redemption request.

On a lighter note, as per Deutsche Bank, 40% of government bonds in Europe now trade with negative interest rate which amounts to $3.2tn. Switzerland and Germany have the highest proportion of negative yielding sovereign debt at 75% & 65% respectively. The ECBs expansionary programme threatens to push low and ultralow rates even further down. With US fed hiking rates for first time in a decade, the world could not have been more divergent.

Emerging Market Currency

Emerging Market currencies were among the biggest contributors of volatility this year with some currencies like our BRIC cousin, the Brazilian Real, dropping about a third, the worst year since 2002. The dollar rally and softening in energy and commodity prices meant that economies dependent on energy/commodity exports or with high foreign currency debt were the most vulnerable and saw their currencies depreciate the most. In this regard, India is fortunate to be in neither groups and that is reflected in the rupee's performance vis-à-vis other currencies. In 2013 during taper tantrum, the rupee was among the most battered currencies but the story was quite different this time leading to the Fed liftoff when the rupee held its own against the dollar when most EM currencies struggled against the dollar.

Country	Taper Tantrum (May-Aug 2013) %	Fed Liftoff (May-Nov 2015) %
India	**-24.2**	**-4.3**
Brazil	-19.2	-28.5
Turkey	-13.7	-7.6
Russia	-6.2	-28.1
Malaysia	-8.5	-19.1
Indonesia	-16.1	-6.5
South Africa	-13.9	-19.8
Mexico	-9.7	-7.1
Argentina	-9.3	-8.5

The Rupee was among the most battered EM currencies in the taper tantrum but stood out as among the best performing EM currencies leading to the FED liftoff

Rupee's resilience

I believe that Rupee will be much more resilient and much less volatile in this uncertain global environment. There is an increasing acceptance that competitiveness enjoyed through currency depreciation has to give way to competitive gains through productivity increases. I have talked about it in my previous newsletter also *(http://www.tatamutualfund.com/docs/other-documents/cio-newsletter-vol-005.pdf)*. I believe the unstated policy of 8-10% currency depreciation every year to maintain export competitiveness is negative in long term for India. Inflation targeting and positive real rates will ensure that INR depreciation will be much milder (3-5%) in future and will help make manufacturing competitive and increase FDI flows into the country.

The dollar, Crude & China: The Trinity

Important factors to watch out in 2016 would be dollar, China and crude oil – though not necessarily in the same order. A strong dollar has a deflationary effect on commodity exporters – most global exports being largely denominated in dollars and in extension to the rest of the world. A further dollar rally could intensify deflationary forces at work and curb growth. China, in my opinion is a bigger impending obstacle to a global recovery. China is slowing down rapidly and taking a large bite out of global GDP growth. Investors are realizing this and capital is fleeing China fast. We saw Chinese equities trading being suspended earlier this week after hitting consecutive circuit breakers & Chinese authorities starting to police the nation's foreign exchange market in a way currency traders have rarely seen before. China has spent a lot of forex to support the Yuan in the last 6 months. If Beijing buckles under pressure and further accelerates the Yuan's depreciation, it will trigger another round of competitive depreciation by exporters triggering deflationary pressures. In October 2014, I had written about a black swan event lurking around – a possible devaluation of the Chinese Yuan which actually happened in August 2015 (*http://www.tatamutualfund.com/docs/other-documents/cio-newsletter-vol-002.pdf*). The natural state of the world is deflationary, due to demographics, technology and debt. This is the outcome central banks fear most. Deflation increases the real value of debt and accelerates defaults. We're already seeing this in energy and other junk debt. As per Standard & Poor's, corporate defaults rose to the highest level since 2009 with 107 globally this year and 40% of them in the oil & gas or metal and mining sectors.

The Dollar, China & crude trinity will be the key determinant of global economic health and liquidity going forward. The collapse of crude oil and in extension, petro dollars has changed a lot of parameters in the global liquidity equation. Oil producers (most of their economies are pretty much dependent on oil exports) are adjusting to the new reality of lower oil prices – low enough to ensure budget deficits on some of these economies for the first time in recent memory. The result – initiate spending cuts or dip into sovereign wealth funds to make up for the lower revenues in order to keep the capex going. Sovereign funds, fuelled by energy and petro dollars have bought treasury, commodity assets, real estate, stakes in companies in the last 15 years. With these buyers coming to the market to sell some of these hard-to-trade assets, liquidity will be a victim, thats for sure. The shortage of dollars is threatening to choke off erstwhile easy access to dollar debt. EM economies and high dollar-leveraged corporates are the most vulnerable. A paradox has emerged in the financial markets where although unconventional monetary policies have created a massive overhang of liquidity, but a series of recent shocks suggests that macro liquidity has become linked with severe market illiquidity! Liquidity is a coward – it runs away from you when you need it the most. Watch out for global liquidity (or rather the lack of it?) going into 2016.

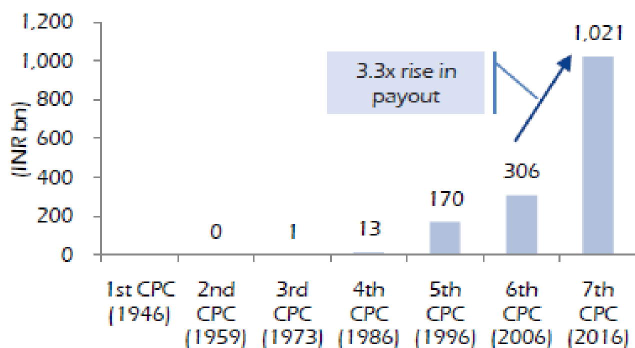
The Seventh Central Pay Commission (CPC) has recommended a 16% pay hike translating into total increase will be 23.55% in pay, allowances & pensions (PAP). The immediate impact of pay commission will be felt on ~7.5- 8mn central govt. employees and pensioners (~3.1mn civilian central government employees; ~1.3mn defense personnel; ~3mn pensioners). The cost of these recommendations is at Rs.1,021bn (Rs.737bn for non-Railways and Rs.284bn for Railways). The minimum pay is recommended at Rs18,000 per month and the maximum pay at Rs225,000 per month for Apex scale and Rs250,000 per month for Cabinet Secretary and others at the same level. The rate of annual increment has been retained at 3%. Commission recommends abolishing 52 allowances while another 36 are to be subsumed in existing allowances or in newly proposed allowances. Status quo has been recommended on the retirement age of Central government employees at 60 years. The Seventh CPC report is proposed to be implemented from January 1, 2016.

Exhibit 1: Impact comparison of Seventh CPC and Sixth CPC on government finances

Ratios (%)	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	
									W/out 7th CPC	With 7th CPC
Pay & Allowance	2.05	2.47	2.03	1.94	1.92	1.87	1.88	1.86	1.84	2.28
Pensions	0.84	1.2	1	0.94	0.95	0.92	0.92	0.91	0.91	1.12
PAP	2.89	3.67	3.04	2.87	2.86	2.79	2.81	2.77	2.75	3.4
Rise in PAP		0.77								0.65

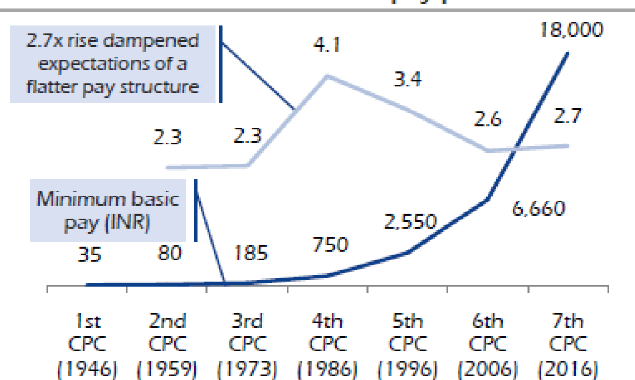
Source: Elara Capital

Exhibit 3: Financial impact of the Pay Commission



Source: Pay Commission reports

Exhibit 2: Rise in minimum basic pay per month



Source: Pay Commission reports

Source: Elara Capital

Impact on the economy

- **Fiscal:** While the actual fiscal impact will be known after the 7CPC submits its recommendation, estimates based on 11.5% nominal growth over FY16E, overall increase in expenditure would be ***equivalent to 0.81% (including three month arrears) of GDP***. A similar impact is likely on consolidated state government budget, though it could be spread over FY17-FY18 period.

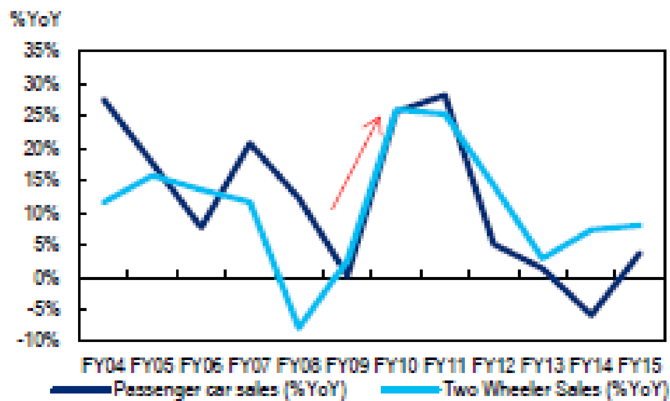
- **Consumption:** With a combined stimulus (center + state) of >1% of GDP in FY17- FY18 period, and a sentiment boost for around 15mn employees and pensioners, private consumption growth is expected to improve from 6.3% YoY in FY15 to 8.4% YoY in FY17. Particularly unlike last pay commission, ***there wouldn't be significant arrears receivable this time, which could limit the gain***.

- **Inflation - Risk to CPI limited:** Given soft global commodities prices (energy, food), excess capacity in certain sectors and anti-inflation policies of RBI and government, the immediate risks to CPI inflation from pay hikes could be limited. However household inflation expectations that are already in double digits may potentially stay elevated for a bit longer.

Likely beneficiaries of Seventh CPC

As per expectations, **the biggest beneficiaries will be durables, travel & leisure on the consumption side.** On the investment side, **a major boost is likely in bank deposits, life insurance & others (physical assets like land).** One major **spending will be seen EMI payouts** – owing to a rise in ability to pay more – that could largely characterize home loans, and, to some extent, other consumer loans.

Case in point: Significant uptick in passenger auto and 2 Wheelers sales (% YoY) in 6CPC



Source: CEIC, Citi Research

Based on past trend of CPC's – incremental spending pattern is likely to be on the following:

- Durables will see additional demand valued at Rs133 bn over FY17
- Travel and Leisure will see incremental spending of Rs144 bn over FY17
- Banks would mobilize fresh deposits (helped by positive real rates) of Rs215 bn over FY17. The bulk of these deposits will be time deposits as default for this incremental savings is held for future routine expenses or non-routine contingencies.

Equity Outlook

While in 2015 stock markets started off euphorically, it ended the year on a tepid note. Government actions lagging expectations, weak monsoon, deflation cycle, Fed rate hike weighed on market performance. 2015 marked systemic initiatives by the government, but the benefits are expected to accrue with a lag, the first signs of which should be visible in 2016. This year was marked by much lower FII flows and for large part of second half they were actually sellers in the market. However domestic mutual fund industry is seeing very good inflows and totaled almost Rs.75,000cr on net basis for 2015. We believe such flows can continue as real interest rates have turned positive after a long time and other investment avenues like gold and real estate are incrementally not very attractive. Although, FIIs are still significantly overweight on India within emerging markets, other emerging markets have corrected significantly making them apparently cheap. So for India to attract FII flows again, the reform process, capex revival and lastly earnings growth will hold lot of importance.

In 2016, on the policy side the Union Budget and the direction it tries to give to the economy would be important. Passage of certain key bills GST, real estate etc which as of now are seen not happening would be added trigger. Implementation of 7th Pay Commission recommendations and project awards in roads, power T&D, railways etc would be the catalysts for consumer and infrastructure sectors respectively in the year coming ahead. We believe that consumer discretionary sectors like automobile, building materials, retail & apparels would do well with more money in consumers' pocket on account of lower inflation, lower EMIs and 7th Pay Commission implementation. Even some of the consumer staple companies hold good promise as raw material price benefits continues. We are bullish on cement, road EPC and BOT, power T&D and defense related companies as well. Retail financiers should also outperform their peers who primarily lend to corporates as the stress level of corporates is not abating yet. Certain pharmaceuticals companies are also looking good with the US product pipeline launch perspective over next 3-4 years and price correction related to FDA related issues mostly behind. We continue to hold bearish view on PSU banks and commodity companies. We are avoiding PSU banks as well as few private banks which are facing asset quality issues. We are also avoiding highly leveraged companies from metals and infrastructure sectors. We believe mid and small-cap stocks would continue to outperform larger peers over medium to long-term time horizon. Primary reason being many of these larger peers deal with commodities or are facing growth or leverage challenges and many of them have made and continues to make wrong capital allocation. Capital misallocation and entering in to unrelated businesses is affecting growth, cash generation and RoE profile of these large-cap companies. So despite looking cheaper, we believe such companies would continue to underperform broader markets.

Accordingly we continue to focus on companies with stronger business models, increasing market shares or having margin tailwinds etc. These are basically quality companies run by good managements and delivering consistent bottom-line growth, may be trading at slightly higher valuations. We are staying away from companies in sectors which are trading at apparently cheaper valuations but facing serious issues. We are of the view that, it is too early to take call on revival of such companies/ sectors.

Last year's list of big winners include paints, aviation, auto, Oil marketing, roads companies and so on. The commonality in the big winners list is that they benefitted disproportionately from favourable external factors, massive tailwinds like low commodity prices, CV recovery, new roads orders, that drove earnings and stock outperformance for most of these companies. However, the list also includes companies that did extremely well despite macro headwinds and their performance diverged materially from their respective sectors. Notable examples will be select private banks, agri-input companies where there were material sector level problems like bad monsoons, corporate debt restructuring. The choice here is between predicting next year's biggest winner versus betting on value creation over time. We live in a world of ever changing realties, which are impossible to predict, (who could have predicted $35 oil at the start of 2015), but a few companies will be able to continuously create value despite the environment. While the New Year is sure to bring surprises, we continue to believe that in 2016 as well value be created by paying more attention to strength of business models and avoiding companies with history of misallocating capital.

The Year that was....

The year 2015 began on a positive note, with lots of expectations built up on monetary easing by RBI, as the menace of high inflation finally appeared to have been tamed. As the inflation situation remained well under control and the commodity prices, especially oil, remained benign, RBI eased the policy rates by 125 bps, well above the optimistic expectation of a maximum of 100 bps by the market participants.

However, the impact of the rate cut on sovereign bond yields, especially at the longer end of the curve, was quite muted. While the 10 year yield, which was hovering around 7.90-95 levels at the start of the year, eased marginally by 10 bps by the year end, the yields at the far end of the curve in fact hardened.

Yield Curve Returns – Medium Segment outperforms

In contrast to the sticky nature of yields at the longer end, the yields at the shorter/medium segment of the curve end eased significantly. The yields at the 3-7 year segment eased by 25-35 bps compared to 10 bps in 10 year benchmark yield. Some of the factors which led to stickiness of the long term sovereign bond yields are:-

- Higher share of longer dated papers – Due to higher maturities in the next few years, the Government preferred to issue securities at the longer end of the yield curve The primary supply in the sub-7 year segment during FY16 was just 2% as against the historical average of around 20%
- Subdued rate of deposit growth and limited appetite for bonds – Deposit growth during the current year has been quite muted, limiting bank's appetite for SLR bonds
- Uncertainty surrounding the FED lift off and its impact on Rupee too contributed to the cautious mood in the bond market
- Uncertainty on the Government's ability to stick to fiscal consolidation path due to 7th pay commission burden and slower pace of nominal GDP growth
- Re-emergence of inflation risks due to failure of monsoon – Failure of monsoon for the second year in a row and the re-emergence of the food inflation, especially in pulses, also kept the market mood somber, as the memories of high inflation are still green in investor's mind. However, so far, the Government has managed to contain the negative impact of failed monsoon through timely action on imports and other supply side measures.

Corporate Bond Spreads Compresses

Search for yields and the investor's preference for shorter/ medium end of the yield curve led to credit spreads compression by around 10-15 bps compared to previous year. The 5 year AAA spreads compressed to 35-40 bps against the historical average of around 75 bps.

What is in store for 2016?

We firmly believe that sovereign bond yields in India are on their secular path of easing, given the sound fiscal and monetary policy framework currently under implementation. As per the fiscal consolidation path, the fiscal deficit is expected to be reduced to 3% by FY 2018. Similarly, as per the formal inflation targeting agreed upon between the Central Government and RBI, the Reserve Bank is committed to bringing inflation below 6% by January 2016 and subsequently to 4%, with a band of plus or minus 2%. The fiscal consolidation path and the inflation targeting agreed upon will lead to stable exchange rate, lower inflation and eventually lower interest rates.

Monetary Policy – Scope for further policy easing in 2016 ?

Given the expectations that commodity prices, especially oil will remain subdued, and the ability of the Government in managing the food inflation through supply side measures, we believe that the inflation is likely to remain in the comfort zone of 5-5.5% in 2016. This may provide a small window of opportunity for RBI to ease policy rates by another 25 -50 points, but the same is contingent upon the Government adhering to its stated fiscal consolidation path in the forthcoming budget.

Challenges to Fiscal Consolidation path

The burden of One Rank One Pension (OROP) and the pay hike recommended by the 7th Pay Commission is likely to pose challenges to the Government's adherence to fiscal consolidation path. The recommendations of the Seventh Pay Commission, along with the arrears and OROP are expected to add Rs 1tn or 0.70% of the GDP in the first year, to the government's expenditure. Added to this, the lower than expected growth in GDP in nominal terms may also pose problems in meeting the fiscal deficit target as pointed out in the Mid-Year Economic Review. The nominal GDP growth for the first six months of the year came in only at 8.2% as

against the assumption of 11.5% in the budget. This lower than expected economic growth has led to the ministry revising the expected nominal growth for 2015-2016 to 8.2%. The review pointed out that, in the scenario of lower than expected economic growth, if the government sticks to the pre-determined path of fiscal consolidation, the same would further detract from demand. This is a clear indication that the Government is seriously considering revisiting the fiscal consolidation path. Though there is a merit is in this argument, the same may lead to loss of credibility, impacting the market sentiments negatively.

India's savings moving towards financial assets a big positive

According to Reserve Bank of India, Households' financial savings is steadily increasing. It rose from 7.3% in FY14 to 7.5% of GDP in FY15. Households have been putting more of their money in financial assets like bank deposits, equities, insurance, mutual funds and pension funds, while investing less in gold and real estate in the past few years. This has been largely possible because returns have become attractive with a moderation in inflation as well as a pick-up in economic activity. A slowdown in inflation resulted in higher disposable income for Household savings. India's average inflation at 5.9% YoY during FY15 was significantly lower than 9.5% FY14. This gradual shift in the nature of Indian household savings from physical assets to financial assets is positive for corporate India which has traditionally suffered from a high cost of capital in a country which has the among the highest savings rate in the world.

Global Allocation to Fixed Income Market to continue

In contrast to the fragility exhibited in 2013, the Indian currency has remained a 'sea of calm in an ocean of turbulence' in the last 2 years. Due to better macroeconomic fundamentals, India has stood out amongst the Emerging Markets peers. A combination of soft commodity prices supporting the 'twin deficit'; a strong political mandate and a prudent central bank, maintaining financial stability through sound monetary policy, has made India a favorite destination for global investors. Indian Sovereign Bonds are under-owned by FIIs and as such, the available sovereign debt limits are more or less fully utilized. RBI has been following a gradualist approach in raising the sovereign debt limit for FIIs to maintain the financial stability. We expect FIIs to fully utilize the sovereign debt limits as and when such limits are released.

Where the Yields are headed?

Our base case scenario for bond yields in 2016 is of an easing bias, albeit at a slow, grudging pace. If the Government indeed re-visits its fiscal consolidation path, as hinted in the mid-year economic review, the yields may remain sticky. As the banking sector continues to reel under the weight of high NPA and slower credit growth, demand/supply for SLR bonds are evenly balanced for FY17, even assuming a slightly higher than the earlier set fiscal deficit target of 3.5%. However, given the demand-supply dynamics of longer dated bonds, we expect the yield curve to have a steepening bias for the following reasons

- Higher gross issuances due to huge maturities – Given the fact that nearly Rs.2.2tn worth of debt is maturing in FY17, the gross issuances will remain high
- We expect the share of long tenor bonds in the primary supply will be far higher than at the shorter end, which will lead to participants demanding higher tenor premium
- Lower primary supply and the attractive spreads and the accommodative stance of the monetary policy, would attract the investor at the shorter – medium segment of the yield curve

Bond Spreads to Remain Stable

The AAA corporate spreads compressed significantly in 2015, (currently at 35-40 bps against the historical average of 60-75 bps) and we do not see much scope for credit compression in 2016. However, as we expect the underlying sovereign yield curve to exhibit a steepening bias, the AAA corporate bonds at the 3-5 year segment will continue to be a preferred space of investment.

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