

JAYESH GANDHI/ MORGAN STANLEY MUTUAL FUND

Market rally is based on hope RBI will cut rates

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BLOOMBERG UTV

While market fundamentals have improved little, there is a lot of hope, especially for what the government can do post the state elections and in its annual budget, Jayesh Gandhi, executive director, Morgan Stanley Mutual Fund in India, says in an interview. Edited excerpts:

Has the year gotten off to a better start than you thought?

Absolutely. During times of volatility, generally our correlation with the international markets, particularly S&P 500, is very strong and so we would have expected that if there is a recovery in the global environment, India would have also participated. However, what has surprised a lot of people is that actually India is outperforming.

Is this a situation where you can't go below this?

Yes. In a way you are right that the macro or negative macro of India overwhelmed the long-term potential of the country. But now on the margin that is changing and that is what is leading to some outperformance. The sentiment today, to my mind, is hope.

We haven't really seen some of the fundamental factors changing, but there is hope. Equity is all about hope and the hope is that as the year progresses, you will see some of these major negative factors, which impacted our equity performance last year, change for the better. And if that change sustains then some of this out-performance will also sustain.

You made an important point. In fact, you said not really much has changed on the fundamental side but yet the hope seems to be building. Could you articulate that—which you think needs to be resolved, which weighed heavily on our markets as far as 2011 was concerned, and what would be the triggers for this hope actually converting into something more constructive and real fundamentally?

INTERVIEW

Well, the first and foremost factor would be the impact of the interest rates. I think last year our economy suffered and corporate profits in general suffered excessively because of high interest rate environment that we had. And today, the hope is that RBI (Reserve Bank of India) will push the interest rates down.

What's your view? Do you think it's time that they start cutting, given the situation as far as India Inc. is concerned?

Well, my view was that they shouldn't have tightened as much last year, but having said that, it is very difficult to comment on policy. But my sense is some bit of change to the CRR (cash reserve ratio, or the proportion of deposits banks must keep with the central bank,) could very well happen. I think their overall philosophy or overall view on the interest rate is very important and so if you were to take a view away from the policy into the whole year, clearly the direction is down. Now the question is can we get a 200 basis points reduction in interest rates over the next 6-12 months? If that happens, it will be a very big plus.

Will you be happy with that? For the next 6-12 months, it's a timing issue is what you are saying then. That's perhaps a given but the point is should RBI do it now and start it off or should it wait till March?

Well, I would love to have it as quickly as possible. The question is RBI is obviously constrained by its own reasoning and the way they go about making this decision, but I am pretty certain, it will happen over the next couple of quarters. The other key factor that we would be very positively looking at is the change in global environment. In the last quarter of 2011 we were amidst a major crisis in Europe. That is now looking to get resolved and the way it's getting resolved is leading to a situation where there could very



Diving deep: Gandhi says valuations in India have fallen to very attractive levels.

well be a prolonged period of loose monetary policy being followed in Europe.

Now the good thing about that is that the fund crunch that emerging markets in general and India in particular were likely to experience because of deleveraging from European banks may not actually happen. Most of the lenders in Asia are European banks and if they were to deleveraging in a big way then there could very well be a shortfall of inflows, especially in banking.

That's been one of the biggest concerns as far as corporate India is concerned but you believe that's receding?

That is receding very fast. So that is another very important change which has happened on the margin.

Does that explain to some extent that we have seen a bit of money flowing in and that too largely from long-only kind of funds out of the US in the past three weeks of this year?

Absolutely. The money flow generally depends on the view, on the global equity environment, and if you see the US market, which is the bellwether and the largest market, as well as the European market, they have been doing very well based on some of the key changes which have happened there. So there is a "risk on" trade which is happening in the world glob-

ally now and money is chasing that. And particularly for India, the global investors are fairly underweight. Not only global investors, Indian investors are fairly underweight. So obviously on the margin, if things have changed there would definitely be inflows towards India and that is what is really driving the current rally. More and more investors are now getting a feeling that they have been left out and that India was in an oversold position, which now in hindsight we know that in the last quarter and that should, on a margin, now change. Hopefully, that will get India to a much better valuation in terms of overall equity markets standing.

Many believe that the next 3-3.5 months that we have, given the elections, given the fact that the government is going to be perhaps more focused even though it hasn't actually happened, we have seen more action coming in the last one week than we have seen in the past. Add to that, what will the budget throw up? Is that something that the market is going to be keeping an eye on before it actually sets a pattern in which direction it's going to go?

Absolutely. I think one of the key events to watch this time around would be the budget. How does the finance minister manage to balance the books? Does he look at cutting expenditure and cutting subsidies or

does he burden the investors and the consumers with higher taxes? This is one of the key points or issues that we will watch for. The Indian economy is already slowing and on top of that if you increase taxes there will be more burden on the Indian consumers and of course the investors as well.

So the way he addresses the deficit problem is important. Also, to my mind, the most important factor to watch for would be the total borrowing that government of India has for the next 12 months starting April. That also has another important bearing on the interest rate for the next 12 months. So it is basically up to the government now with RBI and the budget to deal with this problem of high interest rates and government over-spending. If they can deal with that effectively then my sense is this rally has more legs to go.

As a man who, along with his team, manages a lot of money on behalf of investors, what have you been investing in? In the sense do you believe there is one school of thought who said over the last quarter, the fact that this is a good time to enter? Of course, you can't tell what the bottom is really but today do you believe that, that really has played out and that was perhaps a good time to enter? Would you be buying at these kinds of levels or would you be waiting and watching for all of this, the budget especially, to play out?

Well, we are fairly invested as of now but our portfolios are more skewed towards more defensive stocks, stocks where we have earnings visibility. They may be expensive but we position there. So obviously this rally has caught everybody by surprise and I think we are not different here but because we are fairly invested, we are also getting the benefits of that.

In fact, you barely changed your portfolio. You have been fairly stable in that sense.

Our view is that while there is a lot of hope, this rally is based on hope in a way. The key fun-

damental factors which we would like to watch for very closely are the interest rate environment, the inflation, the changes in our government policy at the ground level and more importantly, the global macro or the commodity prices in terms of crude oil and coal prices, etc.

Those have really not changed. So over the next couple of weeks or months we will be watching those factors very closely. More importantly the policy decisions that the government and RBI make to know for sure that 2012-13 doesn't turn out to be a decelerating growth environment, that we have already decelerated from something like 8.5% GDP (gross domestic product) growth in 2009-10 to something like 7% GDP growth in 2010-11. We don't want that 7% to go down to 6%. I would hope that the government through its various actions with some additional help from the global environment will be able to sustain a 7% GDP growth with an improvement in industrial production in their selectivity.

If that happens, I think earnings growth will be much better compared to what expectations are and if we do get a 10-15% earnings growth for next year then I think that much returns could very well come from equity markets. For the last three years, the average equity market returns have been probably 0. I mean if you take the average over last three-four years, it's been flatish. So we were around this level four years ago and we are pretty much there, we did go up to 19 or 21 but we have come down.

So equity market investors have really not made money and that's basically because the global environment and the domestic environment have been very volatile and of course some bit of valuations, of course earnings did not grow so valuations did not support. Now valuations have come down to very very attractive level.

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