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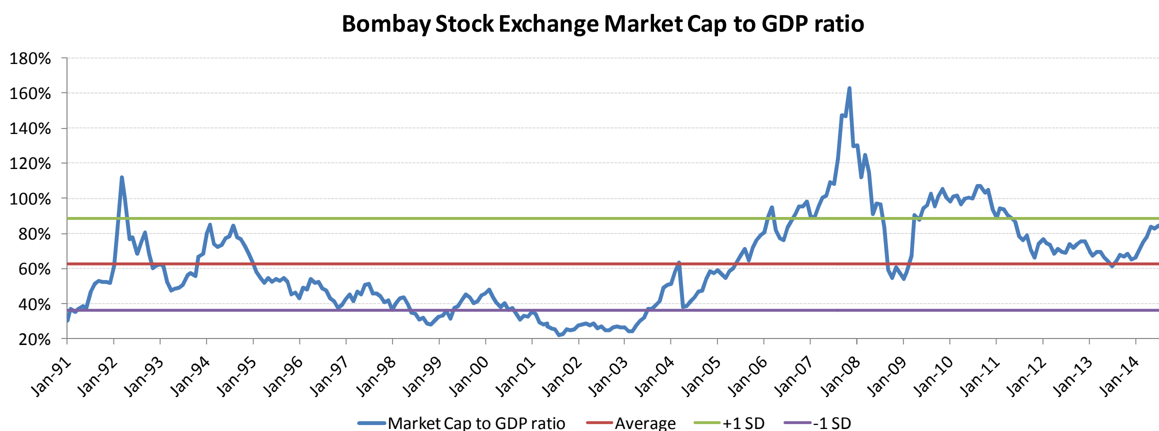
Dear investor,

Investor sentiment on Indian equities is extremely bullish and markets continue to rally almost in a straight line. The new government does seem to be working towards increasing India's economic productivity so we can only hope they remain on this path. So far domestic economic activity has remained subdued but there are expectations of a pickup materialising in short order. In this letter we consider India's equity valuations in a global context and analyze the potential impact of falling global inflation expectations on equity returns.

Market cap to GDP – India's valuation in a global context

In last quarter's letter we had looked at a time series of India's market cap to GDP ratio (M:GDP). An updated version of that graph is below, which shows that the ratio has gone up from 83% to 88% in the last four months and is close to one standard deviation above its historic average.



Source: BSE India web site; RBI

Given the globalization of financial markets investors have the ability to allocate their capital among countries. Hence, taking the above analysis a step further we look at the trend of M:GDP of the world as a whole over the years. And also look at how India's M:GDP compares to the global figure over time in order to get a sense of India's relative valuation compared to the rest of the world.

As shown in the following chart, over the last 25 years, global M:GDP has been in the range of 45% to 115%, with a current value (as of Dec 3, 2014) of 85%. The US is by far the dominant influence, constituting 23% of global GDP and 43% of global market cap. By comparison, China constitutes 13% of global GDP and 6% of global market cap.

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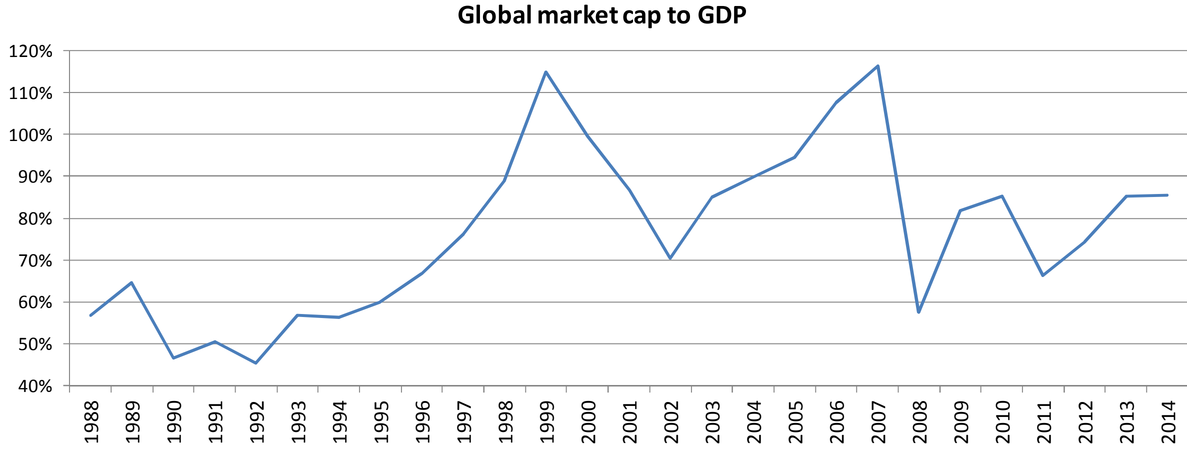
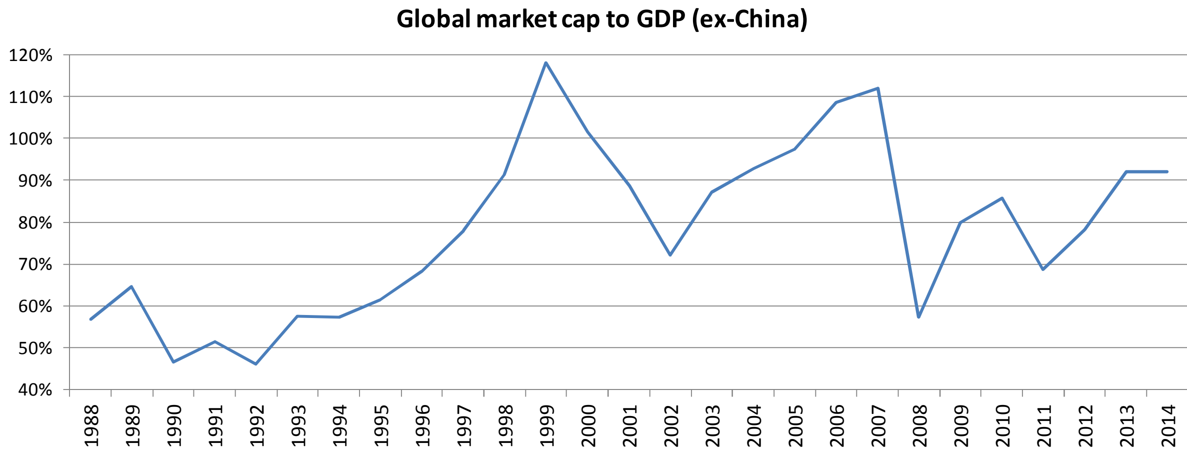


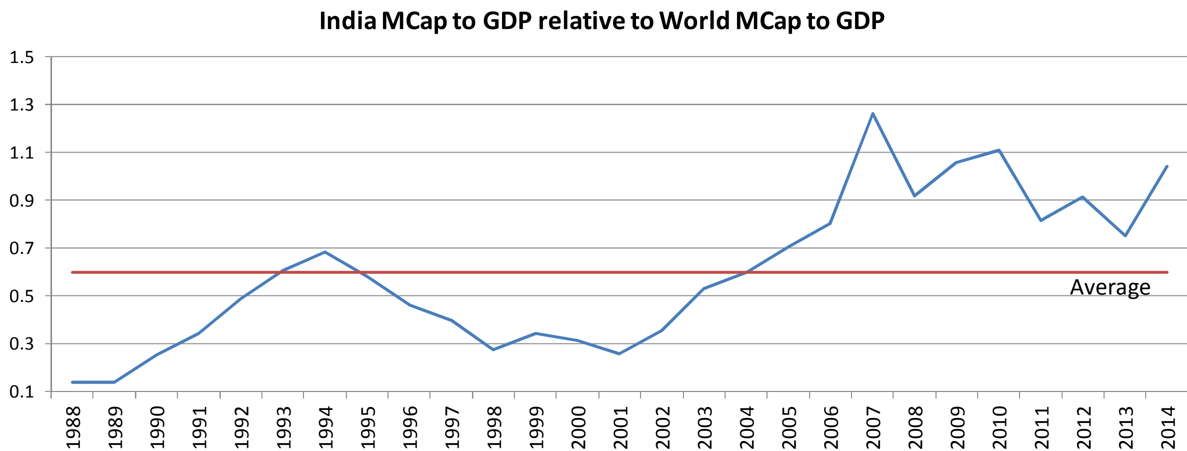
Source: World Bank; IMF; Yahoo Finance

China's equity market performance over the last few years has been dismal relative to its reported GDP growth. So unsurprisingly, excluding China from the above analysis makes the current ratio look slightly higher relative to its history.



Source: World Bank; IMF; Yahoo Finance

Around the turn of the century the ratio of India's M:GDP to global M:GDP (shown below) was around 0.3x. This ratio went as high as 1.25x in 2007 and now sits at 1.05x.



Source: World Bank; IMF; Yahoo Finance; BSE India web site

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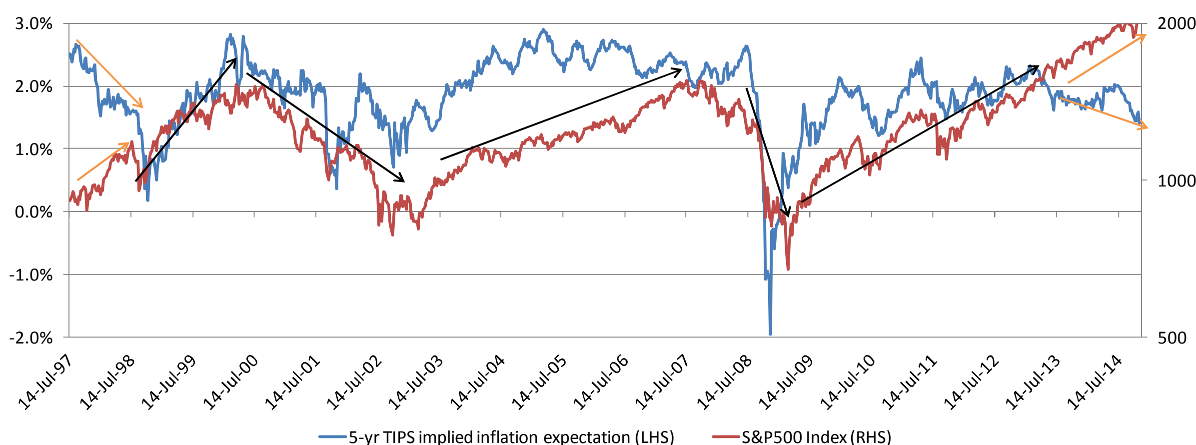
Readers know that we have been wary of downside risks in global equity markets, led by the USA. In the context of relative valuation, India's M:GDP ratio may not have much higher to go relative to the rest of the world. So in case of a meaningful correction in global equities the Indian market may not prove particularly resilient, irrespective of domestic fundamentals. Additionally, if for some reason there is an adverse change in investor perception of India, and the Indian M:GDP to global M:GDP ratio mean reverts towards 0.6x from 1.05x currently, there is potential for a significant decline in Indian equities. While the latter scenario seems to have low probability as of now it is worth keeping in mind.

Inflation expectations and equity returns – Flashing red

Since the 2008 financial crisis, Central Bank policies (led by that of the US Federal Reserve) have arguably been the key driver of asset returns, especially for equities. In a world awash in debt, it seems that nothing will scare a central banker more than the prospect of deflation. In a deflationary environment the real burden of debt increases, penalizing borrowers and benefiting savers. Since today's central bankers (with some exceptions) view the world through the prism of financial markets, their policy decisions are highly influenced by the need to ensure that inflation does not fall close to or below the zero threshold.

Similarly, equity markets do not seem to respond well to periods of low and falling inflation expectations. Using US 5-yr TIPS implied inflation as a proxy for inflation expectations, the chart below shows a fairly tight correlation of inflation expectations with the S&P500 index[1].



Source: Datastream

Historically, rising equity markets have been accompanied by low but rising inflation expectations and falling equity markets with low and declining inflation expectations[2]. In the last 27 years there have been two extended periods of material "divergence" between the direction of equity prices

[1] It is worth pointing out that while a correlation exists the magnitude of moves will obviously be very different. While inflation expectations will vary within a range, equity markets tend to appreciate over time

[2] The historical context here is limited to the last 27 years and indeed there were periods like the 1970s when very high levels of inflation were coincident with very low equity prices. However, in the period depicted in the graph, inflation expectations have never been too high and therefore a comparison may not be relevant

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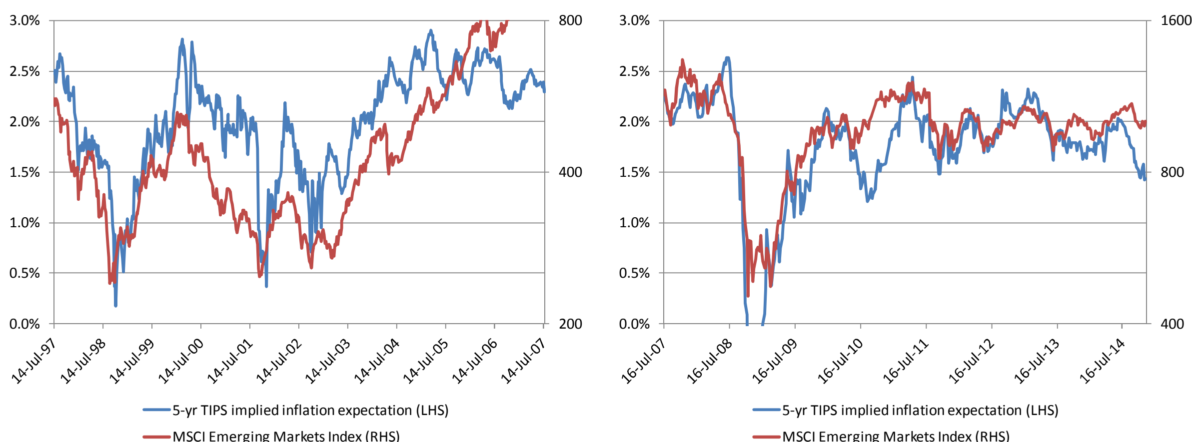
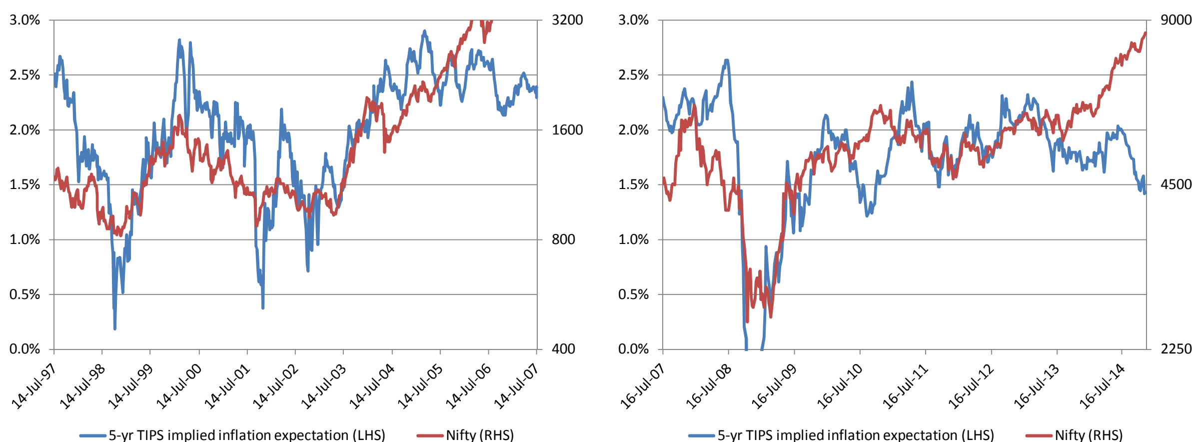
and inflation expectations. From late 1997 through mid 1998 equity markets rallied in the face of declining inflation expectations. This was eventually resolved through a sharp but brief equity market correction in 1998 during the so called "Asian crisis", followed by a rally in both equities and inflation expectations. The second period of significant divergence has been persisting since early 2013. While the S&P500 has rallied about 30% from early 2013 to present, inflation expectations have dropped from >2% to ~1.4% as of last count.

Inflation expectations also have a strong correlation with the broader emerging markets as represented by the MSCI Emerging Markets Index.



Source: Datastream

Similarly, the historic correlation with the Nifty index is very strong as well. However, as with the S&P500, a significant divergence has developed between the two since early 2013.



Source: Datastream; NSE India web site

The recent sharp decline in oil prices is only exacerbating the disinflationary impulse in the world's large economies (US, Europe, China and Japan), which are the ones weighed down by the largest amounts of debt in proportion to GDP. While some of the decline in oil prices is likely supply driven, coincident declines across a wide variety of base metals, including iron ore and copper, point towards deficient demand as the primary cause of declining inflation expectations.

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In addition, Japan is effectively exporting deflation to the world through its policy of Yen depreciation via large scale debt monetization. In the event that China is forced to follow suit through a significant RMB depreciation at some point, the deflationary shock could be compounded significantly. There is about $9 trillion in US$ credit given to non-banks outside the USA[3]. The dollar has been strengthening against most currencies. Using the DXY Index as a proxy, the US dollar is potentially reversing a multi-decade decline and entering a bull market. This is deflationary for the US economy and financially destabilizing for the borrowers, of which a large number are likely to be unhedged. Additionally, about 45% of the $9 trillion dollar credit is accounted for by non-banks, which tends to be less sticky and more vulnerable to reversals. Currency movements need to be watched carefully in the time ahead as they could be both a symptom and cause of disruptive moves in other financial markets.

Central bankers have been unable to engineer higher inflation for the past few years despite their policies of zero interest rates and consistent and large scale quantitative easing. While they may have more bullets left in their arsenal, disinflation seems to be the dominant theme for now. Based on history, the divergence between falling inflation expectations and rising equity prices is unlikely to persist for much longer. Either equities are going to correct meaningfully or inflation expectations are going to turn around and head higher. At this time it seems that the former is more likely.

Portfolio positioning – Higher equity exposure but remain cautious

As of quarter end Sep 2014 we were 47% equity net long (64% long, 17% short), with 21% of the portfolio in Gold and 15% in cash equivalents (the short positions are via futures). The long equity portion increased substantially as we added to an existing position and included new stocks in the portfolio. Simultaneously, we also added a new short position, taking up the short exposure.

We estimate that the long positions, despite significant price appreciation in the last nine months, in aggregate still have about 40% upside to their intrinsic value under base assumptions. Under stress scenarios the aggregate intrinsic value is 5% lower than current prices, indicating limited risk of permanent capital loss. For our short positions we estimate base case intrinsic values approximately 25% below current prices and believe that the stocks are currently trading at their optimistic estimates of intrinsic value.

While we keep a keen eye on macroeconomics developments and trends in various asset markets in both India and globally, our intent is not to try and time the market. This should be evident from the increase in our equity net long position (versus three months ago) despite our continued, and indeed increased, caution on risks of a broad market correction. We will continue to add exposure in individual stocks as and when we find value. When the overall risks seem high we are simply more discerning in stock selection and weighting in the portfolio.

[3] Source: "Financial stability risks: old and new", Hyun Song Shin, Bank of International Settlements, Dec 4 2014

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Stocks in the portfolio – A few additions

New positions added to the portfolio are SunTV Network, Sukhjit Starch, and DSP Blackrock World Gold Fund. We added further to our position in Noida Toll Bridge, which is now the largest position in the portfolio, followed by Gold, Blue Star, and SunTV in that order. The other positions of roughly equivalent size are Manugraph, Sukhjit Starch, Thangamayil, DSPBR World Gold Fund, and Jagran Prakashan.

We added to our position in Noida Toll Bridge even at current prices as the risk reward remains extremely compelling, especially in the context of other investment opportunities available. The stock trades at ~7.5x FY15e P/E with an estimated dividend yield of ~12%. The company has no debt and is paying out all its earnings as dividends. Earnings and cash flows will continue to grow over time through a combination of traffic increases and tariff hikes. Outside of extreme regulatory action, which is very low probability, it is difficult to see downside from the current stock price. Indeed, the total return from the stock should range between 50%-100% over the next two years.

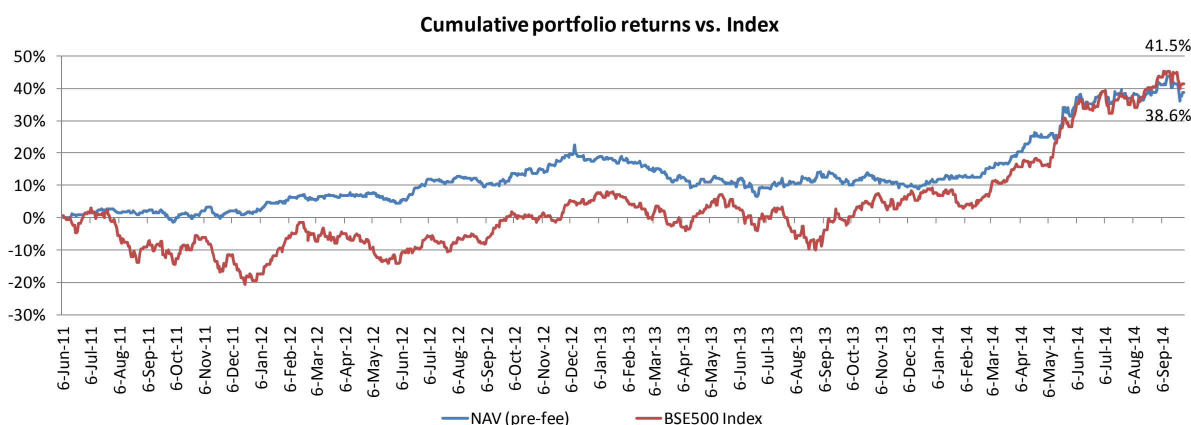
After having sold our SunTV position earlier in 2014 we have rebuilt a large position on a significant decline in the stock price during the quarter. Our take on the business remains unchanged. This is a high quality franchise with a strong competitive position and an excellent balance sheet. The noise surrounding political troubles of the promoters, which is probably responsible for the recent stock decline, should not have any material impact on business economics. At our average purchase price the stock trades at ~19x FY15e P/E with a 3.5% dividend yield. Earnings are currently depressed in our view and can comfortably double over the next 3 years. In this context current valuation seems extremely attractive. By comparison, its peer Zee Entertainment currently trades at 40x P/E and the Nifty P/E is 21x.

Sukhjit Starch and Chemicals is a manufacturer of starch and related value added products. This is a commodity business which is well into the fourth year of a down cycle, with margins currently at historic lows. We think the company's business cycle is turning up, which could result in high earnings growth over the next one to two years as margins normalize. The stock trades at 10.5x TTM P/E on what are depressed earnings. P/B valuation is only 1.1x and the company is valued well below replacement cost. In our opinion the combination of reasonable to cheap valuation and improving fundamentals warrants a small position in the portfolio.

The DSP Blackrock World Gold Fund in a feeder fund for the Blackrock World Gold Fund which invests in gold mining equities globally. From both a price and sentiment perspective, gold mining equities are one of the most depressed asset classes in the world today. Indexes that track gold mining shares are at multi decade lows even relative to the price of Gold. Clearly the fundamentals of these companies are tied to the price of Gold, but even from a micro perspective capital allocation and cost control across the industry seems to be improving after a long period of excess and misallocation. This change in industry dynamics, coupled with our positive view on Gold, lead us to believe that the risk/reward in this sector is extremely compelling. The Blackrock Fund has historically been a reasonable performer relative to peers and seems like a good vehicle to gain exposure to this asset class.

Portfolio performance – In line with the index

In the 3.2 years from inception in June 2011 till end September 2014 the portfolio is up 38.6% while our benchmark, the BSE500 index, is up 41.5%. This translates into a CAGR of 10.3% for the portfolio vs. 11% for the benchmark. Of late, portfolio performance has been particularly dragged down by our Gold and short positions. Additionally, after initial sharp rallies in the first half of the year, most of our long equity positions have not appreciated much in the past 3 months even as the broader markets have continued to head higher.



We are confident that we are investing your money prudently such that there is a high probability of reasonable absolute returns while significantly limiting the risk of permanent capital loss. Over time this should result in higher than index returns as well. During periods of extremely positive market sentiment it will usually be tough for us to outperform the indexes. Indeed we will be quite happy if we can continue to keep up with the broader markets. While the future looks extremely rosy as of now, sentiment is an extremely fickle beast and should not be taken for granted. At any given point in time there are various possible scenarios for the future state of the world, both at a macro and micro level. While only one scenario eventually comes to pass it would be reckless to invest by assigning 100% probability to any one outcome. Hence while we continue to search for companies that have the potential for material price appreciation, our enthusiasm is tempered by the degree of optimism that is already priced in.

Gaurav Jalan
December 7, 2014

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