

## As India goes to the polls, growth outlook remains strong, says F&C's Mahtani



With India's fifteenth general election underway, investors should expect the stock market to remain volatile until the results are announced next month. Nevertheless, on a longer term basis, India still looks attractive, according to Sam Mahtani, Director of Emerging Equities at F&C.

Mahtani explained India is experiencing an investment-led slowdown as higher interest rates and weakening demand bite into the real economy. However, rural India, which accounts for around 70% of the population and one third of GDP, continues to remain relatively insulated helped by higher crop prices and several large government programmes. Mahtani believes that this will sustain overall private consumption, which has grown by 6% this year.

"I believe that the Indian economy will turnaround within the next couple of quarters, possibly earlier given their slowdown began in January 2008," Mahtani said. "Indeed, some of the recent statistics for sales of cement and consumer durables suggest the economy may be starting to turn now, ahead of consensus views".

Inflation has now peaked and fallen to 0.4% pa and Mahtani feels inflation is not a concern, given the high base affect from a year ago. India is clearly a beneficiary from the drop in oil and commodity prices, which have a high weighting in the country's measure of inflation, the WPI index. Monetary easing continues, with India's central bank cutting its key benchmark rate by 25 basis points this week to a record low of 3.25%. Foreign investors have sold a net US\$563m so far this year and foreign ownership levels have dropped to the same level as 2003. As such, Mahtani believes that perhaps the bottom has been reached in terms of selling by foreign investors.

"The Indian stock market has been one of the better performing markets this year, rallying 16% YTD, however it has rallied 35% from its low point in early March 2009. The MSCI India is now trading on 12.4x for 2010 (calendar year), which still offers value for investors prepared to take a medium to long-term view on India's economy, however in the short term we could see some consolidation and a small correction given the sharp run up from the low point in March", he added. Currently, Mahtani's favoured stocks include HDFC, the leader in the mortgage market within financials, and Jindal Steel & Power, an integrated steel manufacturer which has just commissioned a large 1000MW power plant. Mahtani believes that, at this early stage, either a BJP or Congress led coalition government should be supported by the market whilst a 'left wing' led coalition, although not likely, would be taken negatively.

"We continue to expect a further easing of monetary policy going forward and strong domestic demand to drive 5.5% of GDP growth, making India the second fastest growing economy in the world after China", Mahtani concluded.

### Opportunities abound for the shrewd high yield investor

The European high yield market has been as volatile as the equity markets with investors trying to work out the benefit of the stimulus packages from the US, Europe and the rest of the world. As always, sentiment is a significant factor in any market recovery. Overall the Merrill Lynch European High Yield BB-B Constrained Index returned 6.25% hedged to Euros in Q1, with the iTraxx tightening significantly. January saw a rise of 7.36% on the back of the US government's commitment support to the US car industry.

"Subsequently, in February the index dropped by -2.09%, as investors re-focused attention on the deteriorating fundamental picture", said Andrew Lake, co-fund manager of the F&C European High Yield bond fund with Kevin Matthews. In March however, investor sentiment again turned positive posting a 1.01% total return as a result of a good PPIP (Public Private Investment Programme) number, a successful G20 meeting, and some better than expected macro data.

"The key issue remains an economic one", Lake continued. "We anticipate that the US will be the first economy to emerge from the recession and that signs of recovery will show during the second half of this year, offering the potential for significant total returns for investors over the next few years. Europe remains further behind the curve and may take longer but by the time defaults peak, the recovery will be well under way". According to Lake, some investors have already moved back into the asset class in the belief that spread levels are attractive with €6.3bn flowing into the High Yield market during the first quarter of 2009.

Lake reckons that with credit spreads at near to all time highs, the high yield market offers attractive value in certain sectors and stock specific areas. He remains largely underweight in both financials and automotives, and heavily overweight telecommunications and consumer non-cyclicals, a decision which saw the fund outperforming for the quarter by 57bps. "We are currently seeing some of the highest yields in the history of high yield debt", he added. Average yields of close to 20% are more than compensating investors for the risk of rapidly rising defaults. In 2009, high yield default rates are expected to rise to 10%, as a consequence of the sudden drop in demand across all sectors beginning in Q4 2008. This slump in demand caught a lot of companies by surprise, and has resulted in many highly levered high yield issuers declaring Chapter 11 or bankruptcy already this year.

Lake has begun to gradually increase risk in the portfolio. "But this is a slow and cautious process given our central view that the market's recent strength is premature and the expectation for a rapidly rising default rate, in particular in the CCC space". He also thinks that recovery rates on defaulted loans and bonds will be lower than historic averages. This reflects lower valuations for businesses as EV/EBITDA multiples fall, as well as a lack of prospective buyers of the bonds. "Our outlook will become increasingly more constructive as 2009 unfolds", he concluded. "European high yields should rally along with the US on the back of the close correlation between the two markets, despite Europe's recovery lagging the one of the US."

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