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**Market view**

Though a superficial view on geo-politics given the lack of 'breaking news', real economies as reflected in statistical data and the behavior of financial markets measured through risk premium and volatility would give a sense of 'business as usual', underneath there are seismic changes taking place. To list a few, this is about a new architecture for financial system, regulation and its repercussion on real economies, state of finances of government and its long term implications, the future of globalization, move from a uni-polar to a multi-polar currency regime, the real test of Euro, a major transition of economic and political power, environmental issues and related aspects of coming food and water crisis. These are orbital changes. One of the interesting anecdotal evidence of how the world is changing is the fact that FaceBook has overtaken Google in terms of internet hits.

Agreed, we have come out of a great crisis. The jury is still out, what led us into the credit and financial crisis. Was it excessive leverage and over-consumption in west, or mercantilism and excess savings in east, laxity in regulation or proliferation of derivatives? Genesis of the crisis was in excessive leverage and a credit boom which typically ends as a bubble that bursts. Ironically, the people responsible for inflating the pipes to the point of burst are the ones trying to fix it again. They are still using Dr. Fixit when what is really needed are new pipes or rather a completely new system. Band-aids can't be solution to patients with severe injuries.

Heated debate is on between Keynesians who are preaching policy makers to continue pumping more fuel to keep the animal spirits on while effectively inflating the accumulated debt and others who argue for austerity and warn against this 'more Alcohol to treat hangover' policy. Truth lies somewhere between. Given the powerful forces of private sector de-leveraging, governments have to fill the void by taking leverage, however, the scale and magnitude is reaching alarming levels and a credible medium term plan to cut deficits and debt ratios are the need of the hour. We believe that central banks in US, Europe and Japan are unlikely to raise rates in the foreseeable future. Along with governments, they would do whatever it takes to ensure that those economies don't drift into another recession. But we must keep in mind, the single biggest risk for the world is stretched government balance sheets and lack of credible ammunition left with central banks. Greece seems to have managed a bail-out or so to say with the help of other EU members, major support from Germany and France and likely intervention from IMF, however, peripheral European government balance sheets are too stretched and would remain a cause of concern. Same is true about UK, Japan and US fiscal position. Bond markets were so far neglecting the risk, however, the recent spike in US treasury yields point to early warning signals. The dollar is doing well against major currencies and is likely to remain strong as relatively US is still the best destination for investment among the developed world. Euro and Yen are likely to weaken further. This could actually turn out to be blessing in disguise for export machines like Germany and Japan. Dollar is likely to weaken against currencies of developing economies. This is a structural move as emerging economies would attract far greater capital flows in view of huge growth differential.

One of the bright features of the world economy is that corporate balance sheets are in pink of their health. This is one of the main reasons behind the rally in equities and credit markets. High-grade corporate bonds in several places trading at yields lower than government bonds. Even in India, spreads have compressed quite a bit and could shrink further as market would be swamped with government bond supply. Though, one must remember, if push comes to shove, governments will ultimately have to raise taxes in some or the other form and balance sheets which have cash will have to bail others out!

Another debate is going on China's role in the global economy. Between who call China a currency manipulator and want severe trade sanctions against it and liberals who believe China has acted as a pivotal to revive global growth. We have a firm view that China would allow gradual appreciation of Renminbi but would not like to be seen doing it under pressure from US. A silence in Washington on this matter would get things done. Indeed, China needs to make a transition from investment led growth to a more balanced growth model and a closer look at recent trade and GDP data indicate that they are moving towards that direction. One can surely debate the pace and how smooth the transition could be made without likelihood of serious disruption. To solve the global imbalances, it is inevitable that in this decade, US will have to export goods instead of debt and China has to boost consumption through a strong currency.

There is a high possibility of India overtaking China in terms of growth in this decade. A combination of better growth potential, higher interest rates and positive view on currency could lead to massive capital flows and complicate matters for RBI in the short term as the absorption capacity of the economy remains constrained. Contrary to China, India remains a supply-constrained economy and the central bank has to shoulder the unpleasant burden of dealing with overheating when actually the state should remove the structural rigidities. RBI surprised the market by hiking the policy rates in March by 25 bps, ahead of the next policy review scheduled for April 20. The RBI cited anchoring of inflationary expectations amidst signs of capacity constraints as the reason behind this move. We expect very interesting opportunities to build duration next quarter as consensus is becoming polarized.

Globally, the environment will remain one where the only certainty is uncertainty, so what should investors do.  We believe given the expected higher volatility in real economy variables (the magnitude of surprise and change at margin would be greater than historical standards), shorter cycles and hyper-connectedness of markets require more nimble and humble approach towards portfolios. In this kind of environment, maintaining a discipline of asset allocation while retaining flexibility of mid-term course correction would be important for investors. While we remain very positive on long term prospects of Indian economy and focus on generating alpha through bottom up stock-picking, we will keep an eye on the macro developments to hedge against the tail risk.

You don't know when you are part of history. We live in one such time. Did someone bless us "may you live in interesting times!".

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