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Where does the long-term investor hide?

EXPERT VIEW

RAHUL BHASIN

Respond to this column at feedback@livemint.com

ANIRUDDHA CHOWDHURY/MINT

Market risks: *Equity, like all other asset classes, is overinflated and hence runs the risk of losing purchasing power relative to short-term cash flows.*

After several taper tantrums, the US Federal Reserve had painted itself into a corner and was left with no alternative but to hike the interest rate in December, claiming that the rates were increased on the back of strong payroll data and the strengthening of the world's largest economy. With US gross domestic product (GDP) growth below 2%, velocity of money at a 60-year low, and the threat of a global recession looming large, the policymakers' commentary sounded dubious. Being lulled out of a false sense of complacency, the markets began the new year with a multi-asset class sell-off—$3.2 trillion wiped off the global equity markets alone in the first two weeks. So in this tumultuous world, the question for any investor remains—which asset class to invest in for the long term? Should one play it safe or ride the roller coaster called equity?

Cash is a great place to hide in the short run. Especially if you believe the world will shift from Keynesian to Austrian economics by acknowledging that the current debt levels are not viable, resulting in debt restructuring and asset as well as resource reallocation. In such a scenario, cash would give the best returns if one could find a safe bank to put it in and trust the government to somehow honour your debt while reneging on all others.

Governments have typically looked away when confronted with the prospect of actually letting markets clear bad debts and other misallocated capital. Central bankers' predilection over the last two decades has been to relentlessly expand M1. Despite this massive increase in base money, deflationary headwinds remain, as most of it continues to lie on bank's balance sheets. However, any inflection point in consumer/corporate borrowing can lead to a spurt in inflation and erode purchasing power quite significantly and suddenly. Central bankers will have neither the tools nor experience to restore real purchasing power of cash if this happens.

What about bonds? Government bonds supposedly defined risk-free rates, but Reinhart and Rogoff's research forces us to revisit this premise. The reality is that the collective will of people in nation states is often to not honour commitments which curtail today's lifestyle. One-off defaults bring to mind the Latin American nations but most miss Spain's 17 historical defaults or France's eight. When credit to governments become suspect, it becomes very difficult for banks to operate and sustain equilibrium in levels of monetary aggregate as they grapple with chronic shortage of their own capital. Forced deleveraging in an already tenuous economic environment, coupled with the record sovereign debt levels, is tough to ignore. In this scenario, both cash and bonds directly and effectively constitute return-free risk.

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The plummeting oil prices are deemed responsible for the global multi-asset class correction. While true, in the immediate context the established pattern is that a year later broader markets rise 1% for every 2% fall in oil prices.

Given the historical dominance of imports in the US energy continuum, this inverse correlation made immense sense. But the growth of the shale industry and the pain associated with its leverage would now weaken the correlation. Over trillion dollars of market capitalization has already been wiped off energy stocks worldwide and approximately $2 trillion of debt sold by oil and mining companies since 2010 is facing increasing likelihood of defaults. Moreover, the ebbing petrodollar savings of the sovereign wealth funds will only amplify the market stress further. But there is no reason to suspect that the correlation, albeit weak, will not hold in the US. However, this correlation will be sharper and steeper for countries such as Japan/South Korea/Taiwan with high energy imports and even more attenuated for countries such as India which not only import most of their energy needs but also have high energy cost as a percentage of their GDP.

The US and world's major economies embarked upon an unprecedented credit expansion, starting in the early 1980s (almost 35 years). This led to increase in credit capacity in each asset, thereby self-reinforcing price inflation across all asset classes. However, with the era of free money coming to an end in the US and the correction in one asset class (oil), the associated leverage has been squeezed out. This has reduced the overall monetary velocity and liquidity and led to a cascading correction across asset classes. Nevertheless, in time, the rise in disposable income in consumer's hands and increased incremental consumption will lead to renewed growth and equity returns down the line.

Equity, like all other asset classes, is overinflated and hence runs the risk of losing purchasing power relative to short-term cash flows. The extended zero marginal cost of capital has also fuelled a stream of innovation which will disturb market structures, competitive dynamics, margins etc. Skilled active managers will finally start beating indexed products. For the long-term investor, owning parts of superior businesses with expanding consumer franchises and cost and technology leadership in growing markets is the place to be, as it will retain relative purchasing power in any monetary scenario, in-spite of being subjected to rodeo-type excitement en route. The rest, getting lulled by a sense of continuity in risk assessment, will collect pennies in front of a road-roller, seemingly earning risk-free returns but susceptible to the one slip that will completely flatten their residual purchasing power.

The author is the managing partner of Baring Private Equity Partners India and a senior partner and global board member of Baring Private Equity Partners International.

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