FINly | Finstreet's Weekly Newsletter

K. J. Somaiya Institute of Management Studies and Research

15 Oct 2012

The little things

- **Forex reserves:** $295.039 billion as on Sep 21
- **Brent Crude:** 114.67 USD / bbl as on Oct 14
- **Sensex: 18,675.18** as on Oct 12p
- **Gold (10 gm)**: Rs. 31284.0 per 10 gm (as on Oct 15 in Mumbai)
- **Exchange rate (Rupee)**: Rs.52.75/USD as on Oct 15

Did You Know-

- The global bond market was valued at more than $99 trillion in 2011, according to a report from Morgan Stanley. That's nearly twice as large as the global stock market in 2011, which was valued around $54 trillion

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INDIA'S PROJECTED GROWTH RATE SLASHED TO 4.5%

The International Monetary Fund has projected India's Growth rate to be 4.5% for the year 2012, a reduction of 130 basis points from its previous forecast of 6.2% in July. This is the largest Growth Downgrade for an Economy this year. IMF said that Business Confidence in India is on the decline owing to High Inflation and the Huge Expected Fiscal Deficit of 9.5% of GDP.

S&P DOWNGRADES SPAIN'S RATING TO BBB-

S&P has downgraded Spain's Credit Rating by two notches to BBB- , just above the Junk Bond Status. This is owing to Huge Unemployment and Unrest in Spanish regions laden with debt. Markets across Europe fell and 10 year yields of the Spanish Bond rose to 5.96%. This downgrade has increased Spain's Borrowing Costs and the probability of Spain requesting help from the European Central Bank.

DAILY REVISION OF PETROL PRICES

The oil ministry is pushing state-run fuel retailers to revise the petrol price every day in tune with international rates, just like in US, Europe and Brazil. The price is decided on the basis of average regional bulk market price of petrol — and the rupee's value against the dollar in the preceding fortnight.

JAPAN GOVT SLASHES VIEW OF ECONOMY

Japan's government downgraded its view of the economy for the third month in October as worries about Europe's debt crisis and China's slowdown intensified. The Cabinet Office said factory output is decreasing, but maintained its view of exports as weak.

ASIA STOCKS FALL AS CHINA EASING HOPES DIM

Asian stocks fell as hopes dimmed for aggressive moves by China to stimulate its slowing economy. According Credit Agricole CIB in Hong Kong, interest rate cut by the central bank is unlikely although a reduction in the reserve ratio requirement — the ratio of cash that banks must keep on hand — might be possible later this year.

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Did You Know-

The Amsterdam stock exchange (now part of the Euronext exchange) first listed shares in 1602. The first stock to be traded was that of the Dutch East India Company, a multinational mega-corporation granted a monopoly by the Dutch government to conduct trade with Asia. The company operated for almost two centuries, paying out an 18% annual dividend for almost the entire time.

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Terminologies

Overwriting

Strategy of selling call or put options in quantity, hoping that they will not be exercised. Option writers do this when they suspect the underlying is incorrectly valued, and so the buyer will let the options expire and the writer will simply earn option premiums, but this is a risky strategy

Quanto option

Option in one currency, but which pays out in another. Quanto options are usually used in cases when investors are confident of the underlying asset's performance, but are not confident of the performance of the currency which the underlying is denominated in.

Sortino ratio

A variation of the Sharpe ratio which differentiates harmful volatility from volatility in general by replacing standard deviation with downside deviation in the denominator.

Pip

The smallest price change that a given exchange rate can make. Since most major currency pairs are priced to four decimal places, the smallest change is that of the last decimal point - for most pairs this is the equivalent of 1/100 of one percent, or one basis point.

Laffer Curve

A curve which supposes that for a given economy there is an optimal income tax level to maximize tax revenues. If the income tax level is set below this level, raising taxes will increase tax revenue. And if the income tax level is set above this level, then lowering taxes will increase tax revenue.

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Indian Debt Market

Authored by: Nikhil Goyal, PGDM-B

The Financial Markets in an economy primarily comprise of four types of markets- Money market, Debt market, FOREX market (Foreign Exchange) and Capital market with debt and capital market forming the major part of the entire financial structure of the economy. The worldwide trend shows Debt market tends to be three to four times larger than Equity markets but this is not the case in India where the debt market is still in the nascent stage of development because of late adoption of liberalization and deregulation measures by the country. Now post 2008 crisis the increased volatility in the returns on the equities from the companies has shifted the focus on Debt market even in India.

Beside this it is very important to remove financial constraints of any form to support India's endeavour to sustain the high level of economic growth. The banking system in its own capacity is incapable of meeting the long term capital needs of a growing economy without making the entire economy vulnerable to external shocks. By having the non-bank funding channels open we are able to spread the entire credit risk evenly throughout the financial system rather than accumulating them on banks' balance sheet. Moreover, Commercial banks are not able to fulfill long-term credit needs of the economy. Thus by developing corporate debt market the institutes which have the capacity as well as aptitude for longer maturity exposures can be developed. For example Financial Institutions like Insurance companies and Provident Funds which have long-term liabilities are generally unable to find high quality long-term assets to invest the funds. Creation of deep corporate bonds gives them an opportunity to invest in long-term corporate debt as well as diversify their risk across the financial sector. Even from the investors' point of view debt market offers many advantages as compared to equity markets:

Safety: As far as Government securities are concerned these are virtually risk free investments. Even the bond issues by the corporate are backed by sufficient securities and are required to be credit rated before being offered.

Fixed returns: In the wake of high volatility in the equity market debt market provides a safe alternative where the amount of returns are fixed and predefined in the form of coupon rate.

Simplicity: Trading in debt market is much simpler as compared to equity trading where investors are required to have a demat account for trading through any broker whereas in debt securities an individual merely has to place an order with the broker for the same.

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A Perspective on Banking Sector Liquidity

Diversification: In case of Debt securities there are variety of options available with the investors to choose from in terms of tenure for which they want to invest.

The debt market in India can be divided into 3 main segments:

Government securities– which primarily comprises of Centre, State and State-Sponsored securities.

Public Sector Units (PSU) bonds- which are the bonds of companies in which at least 50 percent stake lies with the government ant thus are considered as surrogate of sovereign papers.

Corporate Securities- which are the bonds and other debt instruments issued by various corporate houses.

In India Bond market has been dominated by the government security market because of various factors. There has been a persistent deficit in the government budget ever since the country embarked on the path of economic development in 1950 which has thus required the development of government security market to finance this gap. Beside this all the public sector banks are required to keep a certain fixed proportion of their deposits in the form of investment in government securities as given by SLR rate. Before the reforms were initiated in early nineties in the form of deregulation of interest rates and government decision to borrow only through auction mechanism and at market related rates the market was very passive ant the investors bought and held the securities till maturity.

In India, the proportion of bank loans to GDP is just around 36% and that of corporate debt is merely 4%. These figures are in stark contrast to not only of various developed countries but also that of various developing countries. The amount of corporate bond outstanding in USA is 70%, 147% in Germany and 41% in Japan. An analysis of top 8 Indian corporate which featured in Forbes 2000 showed the corporate debt accounted for only 21% of the total long term financing. The corresponding figures stood at about 80% of the total long term financing in four developed economies of USA, Japan, Germany and South Korea.

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A Perspective on Banking Sector Liquidity

There are still many problems that are hindering the growth of corporate bond market here. Small and medium-size enterprises are still facing problem accessing the debt markets. The corporate bond issuance is highly fragmented as till date bulk debts are raised through private placements. Trading is still concentrated only for top five or ten traded issues creating liquidity issues for the remaining securities. Some other problems include narrow investor base, high cost of issuance, lack of transparency etc. All this is happening despite the fact that all the pre-requisites that are required for the corporate market development are fairly well placed in India. There is a reasonably well developed government security market, all major stock exchanges have trading platforms for debt security transaction, Infrastructure for clearing and settlement in the form of Clearing Corporation of India Limited (CCIL) is present and there are multiple rating agencies that meet the requirement of an assessment framework for bond quality.

Conclusion:

The actual future of the Indian debt capital market and its true potential will only be realized if the government, the policy makers and the regulators function in a co-ordinate and prudent manner. With huge inflow of funds required in the coming years for ambitious infrastructure projects and other capital intensive industry, the demand for debt market is ought to increase. Also with India's increasing connectivity with the outside world and the country's attractiveness to the FIIs, more funds are destined to flow. The technological advancements in other economies along with invention of other exotic instruments, too, will be another deciding factor. In this regard, improvement on market infrastructure and putting appropriate checks and balances in place will become absolutely mandatory. The SEBI, RBI and other regulators till now, however, have performed their job quite well. All in all the future of the market and its potential to realize its capacity will be decided by the course of action to be taken by our policy makers and their willingness to become harbingers of change.

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