A warm glow of significant performance in the markets marks the year 2014. Stock markets in India reached at an all-time high (though a correction in December 2014 has tempered those numbers), bond markets seem to be rallying and there is much optimism regarding the 2015 Union Budget that may signal reform in a meaningful manner. Against this backdrop if we look outward, global equities too have done handsomely across the spectrum and despite no significant change in government indebtedness whether in the United States (US) or the European Union (EU), the markets seem to be progressing and seem to be suggesting that there is genuine recovery.

While it is comforting to be in this situation it would be worthwhile to visit the situation more closely, both globally and then in India which I shall cover in the later part of this note. Let’s start with a closer look at the risks as there are possibly not many December months that incorporate as many risks as December 2014 seems to show.

**Potential risks in 2015**

**Oil**

Low oil prices mean economies such as Russia to Venezuela can be at the risk of serious destabilization. Venezuela, already reeling in debt woes can default, thereby unleashing another contagion depending on the banks which are affected the most.

**Geopolitical risks**

While geopolitical risks are always present, the risks in Europe are the sharpest with a standoff between Russia and a nervous European Union. Donetsk and much of eastern Ukraine remain under control of Russian separatists after the country effectively split over whether to tie its future to the EU or with President Vladimir Putin’s Russia. The Russia/Ukraine situation was seen as by far the biggest geopolitical risk for 2015, according to 84 economists who participated in a Bloomberg News survey in December 2014.

Unrest could also arise via planned elections from Israel to Greece to the U.K., where extremist parties threaten to disrupt the established groupings. Japan and China continue to be locked in a war of words across the China Sea and North Korea continues to rattle its sabre. The situation in Iraq and the Middle East driven by concerns surrounding the ISIS and its forward march continue to bother strategists, signaling further uncertainty.

**Oil impact on producing nations’ currencies and economies**

Falling oil prices already pushed Russia’s Ruble down by around 52 percent in 2014 and Venezuela’s Bolivar has fallen by about 65 percent on the unofficial exchange. Swaps traders are overwhelmingly betting that Venezuela will default. In Russia, Iran and Nigeria, falling prices may prompt governments into unorthodox measures to bolster economies or retain public support. Benchmark prices in New York are down about 44 percent this year to about USD57 a barrel. Iran needs oil at USD143 a barrel to keep its budget balanced, according to data compiled by Bloomberg. The figure for Russia this year is estimated to be USD100.

**The U.S. Presidential Elections**

The U.S.’s ability to confront global risks could be hampered due to the 2016 presidential campaign, which gathers steam in 2015. It may be that wild cards may flourish in such an increasingly disorderly world.

**So what should investors do in such a world? As Albert Einstein stated “In the middle of every difficulty lies an opportunity”.**
So where do we see the opportunity?
India has embarked upon a path of reform for some years now. It has had a checkered history with regard to its success on this path but largely we could conclude that the past 20 odd years have been somewhat positive. However for tangible benefits to be reaped, this reform has to be consistent and coordinated. With the most positive of intent behind it, the government has seen much of the initiative being robbed by procedural delays, lack of coordination among various wings of the administration and also to populism.

We see that regardless of the slow pace of reform in the past there are significant success stories that bear testimony to the India story and see them as torchbearers for the future. We prefer to call them the three Ds. Demographics, Deregulation and Domestic Demand.

1. Demographics
This is a well described criterion in India for the past few years but some statistics will help buttress this story further. India will soon have the world’s largest population aged under 25 years. Falling birth rates and rising life expectancy will ensure people will be living longer and with a progressively higher standard of living. This has a very significant impact for countries such as India and China. More importantly higher propensity to consume combined with higher incomes will lead to a sustained period of growth for most companies addressing this part of the pyramid. India will be a major beneficiary of this developing scenario.

2. Deregulation
Since its independence, India has followed a planned approach to growth. However this approach has not been found to have led to sustained growth. It was in the early 90’ s that the country embarked on a path of deregulation under the “Reform Agenda”. While a lot has been done, many tougher decisions are still to be taken. We believe that the opportunity unleashed through this “D” will be the low hanging fruit that offers a substantial upside, unlocking asset value. Archaic laws and legacy issues have bottled up scarce and valuable resources. Just a judicious change in the laws can unleash a tremendous amount of value creation without possibly investing a single dollar. We have seen the benefits of deregulation in other countries and to a certain extent, also in India (e.g. Telecom, Cement etc.) in the past.

3. Domestic demand
Somewhat linked with the first “D” this is what has kept India chugging along in the past few years when other Asian economies and Developed Markets stumbled. The sheer demand generated by 1.2 billion people controlling a GDP of around USD 1.3 trillion is enough to rumble along in the most trying of times. If normalization in growth across the world is achieved, this can be a powerful leg to the India story. Domestic consumption trends have always been strong and the excellent performance of the Fast Moving Consumer Goods (FMCG) industry in India is a testimony to the same. We believe we have just scratched the surface of the opportunity so far and the real growth is yet to be seen. Domestic demand encapsulates demand for consumer goods as well as for a host of services including infrastructure such as Airports, Railways and Roads.

Conclusion
Looking at India in this backdrop it is difficult not to get excited about the opportunity. The word of caution only comes from history that has showed that despite great opportunity growth has come in trickles. Weighty regulatory issues or the glacial pace of decision-making hindered the free flow of markets too many times in the past to make a prediction of unbounded growth in the future.

No matter what the outcomes are, the bigger picture in India is unmistakably positive. Investors should be mindful of risks; however they should not get bogged down with the many issues that are likely to come up. Like all emerging markets India too will one day emerge to be a large economic power and the participation in the goal should be very rewarding for investors.

In conclusion, financial assets look very attractive given their respective valuations compared either to history or on an absolute basis. Interest rates seem to have peaked and inflation coming off can support a rally in the bond markets. At a later stage a re-rating in the equity markets will only provide more reason to cheer. Investments have not picked up yet, but a gradual return of capital and an enabling environment can unleash a multi-year cycle. However near term risks in the form of uncertain global markets, entrenched infrastructural problems and high interest rates can delay the progress for an indefinite time.
What should investors do?
We prefer an asset allocation approach rather than a blanket choice of a single asset class this year. It is a well-known phenomenon that returns of longer term portfolios are driven more by allocation than securities selection. Hence a judicious mix of assets can provide a great long term investment experience than trying to time the markets on a yearly basis.

So what are the cues on allocation for 2015?
Clearly the manner in which inflation is heading, a relatively weak credit demand scenario coupled with less pressure on the fiscal, driven by lower crude prices indicate a low interest rate scenario. Real rates are also rising indicating a need to allocate higher assets to long duration bonds. Liquidity is appearing to be adequate given tepid credit demand at least for the first half of the year and hence a bar bell approach of part allocating ones fixed income portion to very low duration added to a high duration product seems appropriate. In other words we prefer long bonds and liquidity products. Global equity and Indian equity also looks quite attractive on a sustainable basis given the above trends. We would encourage investors to allocate a significant portion to this asset class this year.

Toward the end of 2015, or even driven by events during the year, there may be a need to re-look at portfolio allocation, but the longer term trends indicate a preference toward the equity asset, followed by long bonds and the rest in liquidity, fine-tuned for individual preferences and risk appetite. We find mid-caps also relatively attractive within the equities space.

We would suggest that investors continue to follow a disciplined approach to investing. We have been and continue to be of the view that investors should make allocations in keeping with their risk appetite and investment horizon. We also believe that asset allocation offers the best opportunity to balance risk and reward.