POLICY REVIEW AFTERMATH

PREPARE FOR HIGHER RATES

The Reserve Bank's accommodative monetary policy regime has come to an end. Recalibrate your borrowing and investment strategies to cope with the higher interest-rate environment that now appears imminent

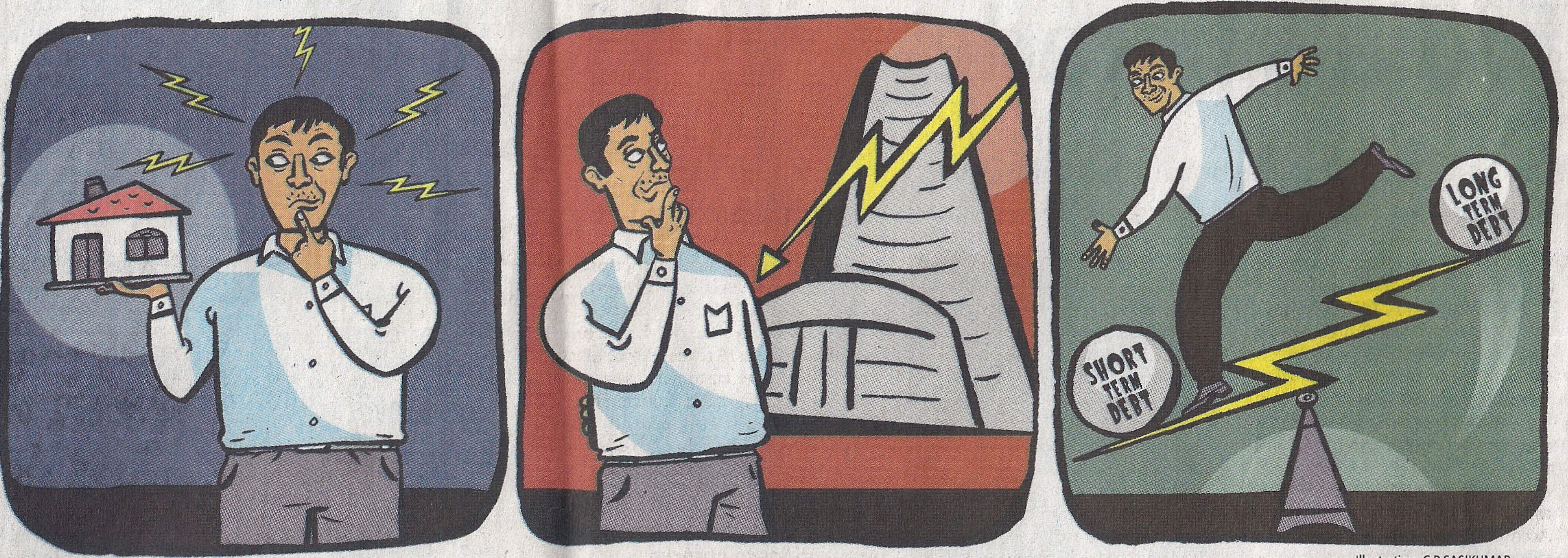

Illustration: C R SASIKUMAR

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ONE THING that is clear from the policy review document is that the Reserve Bank of India's (RBI) priorities have changed: in future it will pay more attention to containing inflation than to nurturing growth. Most economists expect the central bank to start hiking interest rates either before or during the next policy review. Sonal Varma, economist at Nomura Securities, expects RBI to hike the cash reserve ratio (CRR) around December. However, the rate hikes are likely to be gradual since the recovery is still weak. Varma

ket clause (that allows banks to reset the interest rate on even fixed-rate loans every three or five years). Alternatively, go for a teaser-rate loan where the interest rate remains fixed for the first three to five years. Prepay as much of the loan as possible during this initial low interest rate period, instead of investing your surpluses in other instruments.

According to Mumbai-based financial planner Vishal Dhawan, "If you are taking a teaser-rate loan, remember that rates are likely to rise in future. There is a huge amount of liquidity in the system globally that will drive inflation, and hence rates, up. Decide whether you will be able to afford those, go for a purchase."

If you are buying real estate for investment purposes, then weigh the decision even more closely. Prices are up already and interest rates are set to rise. Waiting for some time may be prudent. According to Pune-based financial planner Veer Sardesai, "As interest rates go up, there are fewer buyers in the market, which results in apartment prices dropping."

If you have already taken a loan — a floating rate loan — then in a rising interest-rate scenario pre-paying as much of it as possible is the only way you can reduce your interest burden.

Equity investors

raising the interest cost of corporates, they affect bottomlines, and hence the performance of stocks adversely.

Both in the first- and second-quarter corporate results profit growth has exceeded expectations. The primary reason: costs were under control. Commodity prices, interest rates and real estate costs were all subdued.

But interest rates are likely to rise gradually over the next two quarters. Commodity prices have already risen over the last few months. If they rise further, then in tandem with higher interest rates, they will create pressure on bottomlines. Now the topline needs to grow aggressively to justify current valuations.

norms for lending to the real estate sector. Together these factors will have a negative impact on realty.

Debt investors

DEBT FUNDS. When rates rise, the net asset values (NAVs) of long-term debt funds see a steeper decline than those of short-term debt funds. In the last few days long-term bonds and gilts have rallied because the markets had factored in an interest-rate hike that did not materialise. This provides investors a good opportunity to exit these funds. If you have invested in long-term debt funds with an 8-10 year horizon, hold on to them. But if you have invested for the short term, expects the cumulative increase in CRR, repo and reverse repo rates to be 125 basis points each during calendar year 2010.

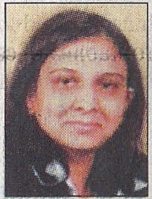
Even after RBI hikes rates in January, banks may not immediately follow suit with hikes in lending rates. They are also likely to take into account their own positions regarding demand, supply and cost of funds. With credit growth weak, raising lending rates would adversely affect credit offtake.

Though interest rates are likely to head up only gradually, it is clear that the interest-rate cycle has turned. This calls for some recalibration of your investment and borrowing strategies.

Home loan borrowers

Residential real estate prices have moved up during the last one or two quarters, especially in the metros. Home loan rates may remain stable for the next three or four months, but they are expected to rise thereafter. If you are buying a house for self use, go ahead and buy, irrespective of the current price level. Take a fixed-rate loan — one without the money mar- much higher, interest rates once the teaser rate period ends, and only then

Broadly speaking, higher interest rates affect the stock markets negatively. By



We expect RBI to hike the CRR around December, and by a cumulative 125 basis points by 4Q10. We expect repo and reverse repo rates to be hiked cumulatively by 125 bps in 2010

SONAL VARMA, Nomura Securities

If you have invested in long-term debt funds with an 8-10 year horizon, hold on to them. But if you have invested for the short term, exit these funds and move to products like bank fixed deposits

VEER SARDESAI, Financial planner

If you are taking a teaser-rate home loan, remember that interest rates are likely to rise. Decide whether you will be able to afford those much higher rates once the teaser rate period ends

VISHAL DHAWAN, Financial planner

Especially in the case of mid-cap stocks, valuations have run up over the last few months. "This might be a good time for investors to once again start focusing their portfolios on large-cap stocks," says Dhawan.

From a sectoral perspective, higher interest rates hit banking, auto and real-estate stocks the hardest.

Banking and financial services. This sector gets hit the hardest. "Banks work on narrow margins. As interest rates rise, credit offtake gets affected. In such a scenario, banks find it hard to pass on the higher cost of funds to customers and their margins get squeezed. Further, they are not able to make any treasury gains, as happens in a falling interest-rate scenario," says Sardesai.

Auto. Higher interest rates will have a negative impact on auto sales as most cars are bought on loans. If commodity prices also move up, it will raise the input costs of automobile companies. All these could have a negative impact on their profitability, and hence on their stock prices.

Real estate. Housing is also bought with loans. Further, in the policy review RBI tightened the provisioning

exit these funds and move to short-term debt funds, floating-rate funds and bank fixed deposits.

Fixed Maturity Plans. If you have bought FMPs and will hold them till maturity, you will get the expected returns. At present, only buy FMPs with a six-month to one-year tenure. As rates move up, FMPs offering higher returns will become available. Buy longer duration FMPs then.

Gold. As the rate of inflation increases, gold becomes a more important part of the investor's portfolio. "In India gold investors also have to factor in the movement of the rupee versus the dollar. But in general gold becomes more valuable in a high-inflation environment. Invest in it systematically rather than at one go," suggests Dhawan.

Broadly speaking, investors looking to commit money to fixed-income products for the longer term should wait for another six months to one year, when they might get the opportunity to lock in their investments at attractive rates. Fixed deposits, longer-term FMPs, and single-premium insurance products where expenses are low are some of the products they could invest in. ♦

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