Bellwether CONSULTING

Your Quarterly Update on the Financial Markets

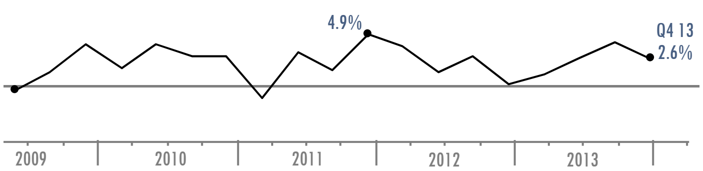
March 31, 2014

1st Quarter

MARKET Recap

The Economy: "Minding the Gap"

Annualized Real GDP Growth

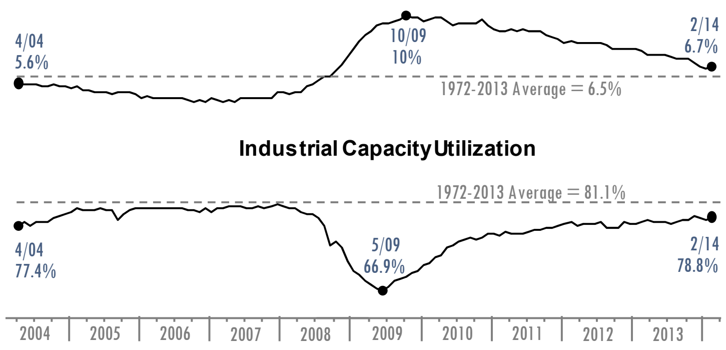


Economic growth slowed in the final quarter of 2013, as the pace of inventory expansion moderated. Incremental data points in the first quarter were undramatic; last quarter's action was geopolitical in nature, not economic, with the manufacturing and service sectors performing well. The resulting growth rate may be disappointingly slow to some, but growth expectations have been adjusted accordingly.

The upper limit of real economic growth became top of mind at the end of February when the Congressional Budget Office released revised projections of long-run potential GDP. These projections form the basis of the "output gap", the difference between what the economy currently produces (gross domestic product) and what it could produce if all factors of production (e.g., labor and capital) were fully employed. Once nominal GDP exceeds potential GDP, the expected result is price inflation instead of real growth. The existence of economic slack is the principal justification for continued monetary stimulus by the Fed, although at a tapering rate.

U.S. Unemployment Rate

Industrial Capacity Utilization

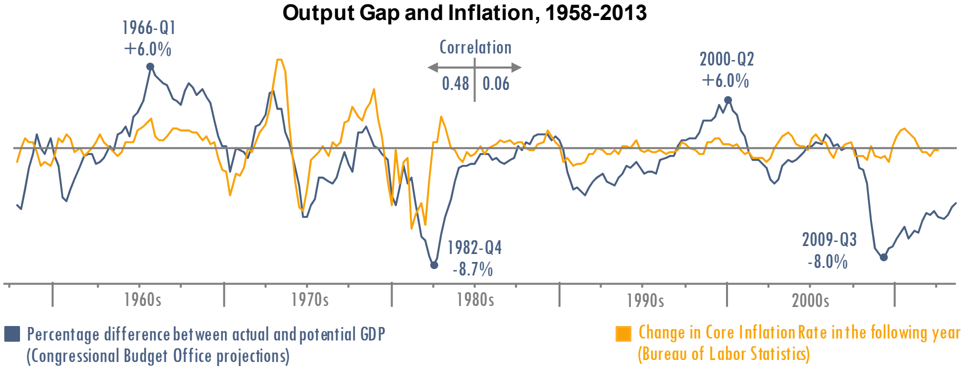


The output gap is one of several slack-related statistics observed by the Fed as they formulate policy; unemployment and capacity utilization are two other common measurements. Until now, the Fed has cited unemployment as the key policy driver, intending to continue stimulus as long as the rate remains above 6.5% and core inflation is below 2%. However, with unemployment approaching pre-recession levels, Chairman Yellen was careful to distance herself from that specific target following the March 19th meeting. Future policy "will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments."

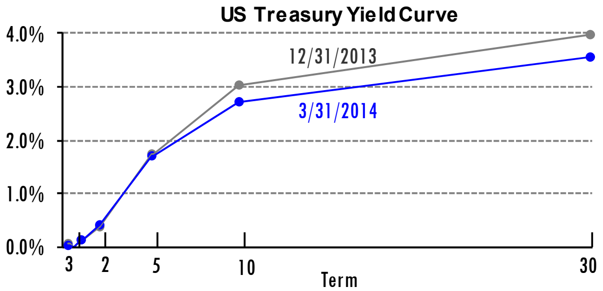
Historically the CBO measurement has tended to be a better predictor of future price inflation than single-factor statistics like unemployment. The Fed has written much about the output gap over the years, noting that correlation to future changes in the inflation rate is reasonably high compared to other statistics. However, that relationship appears to have changed over time, hence the need for a revision. Potential GDP for the year 2017 was reduced by $1.5 trillion (7.3%) compared to forecasts issued prior to the 2007 crisis. About 2/3 of the reduction was attributed to economic trends that were in process prior to the recession, primarily related to labor force participation. A reduction in potential GDP suggests that the output gap is narrower than previously believed. In other words, there is less slack in the economy, and less of a basis for continued stimulus.

Bond investors appeared to put two and two together. Following the FOMC meeting, 5-year bond yields rose 19 basis points and the curve flattened. Language that seemed intended to calm the markets was instead interpreted as hawkish. Markets appear to have accepted the notion that slow growth is now normal for the US; not inspiring, but better than recession.

Output Gap and Inflation, 1958-2013



The US Bond Market



Source: Bloomberg

The first quarter saw two Federal Open Market Committee ("FOMC") announcements of modest tapering in the pace of its asset purchases. Following Ben Bernanke's last meeting as Chairman, the January 29th press release indicated that monthly purchases of Agency MBS would decline from $35 to $30 billion, and that of longer-term Treasuries from $40 to $35 billion, for a total reduction of $10 billion per month. It was the first unanimous vote since June 2011. On March 19th the FOMC released another tapering announcement, cutting each of the two asset buybacks by $5 billion for total future monthly purchases of $55 billion. This was Janet Yellen's first meeting as Federal Reserve Chair. Following the announcement the 10-year Treasury yield increased to 2.77% from the previous day's 2.67% and 2- and 5-year Treasuries also rose significantly.

With the Fed signaling eventual rate increases, we saw an interesting move in Treasury yields with higher shorter-term yields beyond 1-year. While 3-month yields fell and the 1-year yield remained steady, the 2-year and 3-year both rose from 0.382% to 0.420% and 0.766% to 0.869%, respectively, even as 5-year and longer-term yields have come down noticeably due to controlled inflation expectations and a general outlook for slower economic growth. The yield curve is trying hard to flatten, struggling against the 0% peg at the short end. As noted last quarter, the 266 basis point spread between the 10-year and 2-year yields was 1.82 standard deviations above the 86 basis point average spread from 1977 to 2013. This quarter it came down only 35 of that 180 point difference, leaving plenty of room to flatten more, potentially exposing investors on the short end to greater pain than those on the long end.

Bond Indices - Total Returns

	1Q14
BarCap Aggregate	1.84%
BarCap Interm. Gov't	0.64%
BarCap Long Gov't	7.01%
BarCap Interm. Credit	1.63%
BarCap Long Credit	6.30%
BarCap High Yield	3.29%

Bond performance reversed 2013's negative trend, with Treasuries and high-grade corporates posting positive returns across all maturities. High yield returns were also positive across the board with the exception of lowest-rated long bonds. CMBS, MBS, and agencies came in positive as well, except for GNMA 3-year adjustable rate mortgages which were very slightly negative. Convertibles performed well overall, especially in the distressed category.

Corporate America's love affair with debt intensified in Q1, as record levels of borrowing took place ahead of the feared interest rate increases that have yet to materialize. Year-to-date through early March, companies issued $236.6 billion in investment grade loans, the highest on record, according to ThomsonReuters. The first week of March alone saw $43 billion put on the market, the second-highest single-week total since at least 1980 – all this following an already impressive run during Q4, when total corporate nonfinancial company debt ballooned to $13.6 trillion, increasing 7.1%, according to Fed data.

Demand for yield persisted as investment grade spreads hovered near their lowest point since before the crisis. The quarter also saw developed market high-yield bonds take the place of emerging market debt as investors continued to search for yield. Global high-yield funds experienced $22 billion of inflows through early March according to data from Boston-based fund tracker EPFR, whereas emerging market debt saw outflows of $38 billion. To investors for whom yields on US Treasuries are not attractive enough, developed-world corporate debt with below BBB- ratings bridges the gap. Analysts at Merrill Lynch said, "To put the current disdain for emerging market assets into perspective, last time retail outflows from EM equity and debt funds were this severe and persistent was during the 2008 global financial crisis," with wider emerging market spreads reflecting heightened investor perception of risk, particularly in the debt markets of troubled economies known as the "Toxic Trio" - Argentina, Ukraine, and Venezuela.

Despite the demand, high-yield issuance is currently lower than last year, partly due to uncertainty over US regulatory changes that curtailed the leveraged buy-outs for which companies often issue debt. Demand is still strong with sectors such as US energy booming due to shale gas and global high-yield default rates remaining at historically low levels under 1%. However, as with emerging debt last year, some fund managers say the high-yield market is turning frothy with default rates poised to rise as restructuring fears hit firms. Yields are also being compressed to cycle lows as a result of the relentless drive into the asset class, leading to the question of whether and how much more yields can continue to fall.

Inflation expectations returned in 1Q2014, perhaps a sign that investors have doubts that the Fed will be able to finesse the end of quantitative easing. According to Bloomberg, the 12 ETFs that track Treasury Inflation Protected Securities saw $399 million in inflows over March, the first time combined inflows surpassed redemptions since August 2012. The BarCap US TIPS Index returned 1.95%, after returning -2.00% in 4Q2013 and -8.60% for the full year, making 2013 the worst year for TIPS since their introduction in 1997.

The US Stock Market

Performance was mixed during the first three months of 2014, but stocks finished Q1 in positive territory. January saw a sell-off in markets driven by concern over an impending end to the Fed's quantitative easing program. However, subsiding concerns and strong Q4 earnings growth in February helped to more than make up for January's losses. Stocks were up slightly in March, but not until shrugging off fears of both of Russia's military intervention in Ukraine and Janet Yellen's comments on tapering and interest rates at month-end.

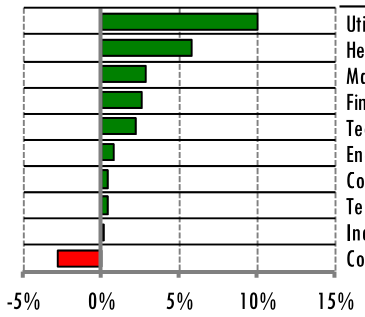
While previous quarters have been characterized mainly as "risk-on" or "risk-off", this was not the case in Q1. Performance was mixed for both cyclical and defensive stocks, as fundamentals helped drive returns. This should come as a relief to bottom-up equity managers, who have been frustrated with the significant impact of macroeconomics on markets recently.

Stock Indices - Total Returns

Largecap Stocks	1Q14	Midcap Stocks	1Q14
S&P 500	1.81%	S&P Midcap 400	3.04%
Russell 1000	2.05%	Russell Midcap	3.53%
Growth	1.12%	Growth	2.04%
Value	3.02%	Value	5.22%
Broad Markets		**Smallcap Stocks**	
Russell 3000	1.97%	S&P Smallcap 600	1.13%
Growth	1.07%	Russell 2000	1.12%
Value	2.92%	Growth	0.48%
		Value	1.78%

Utilities led performance among largecap stocks as both gas and electric utility companies benefitted from cold weather. High consumer demand coupled with low short-term supply drove natural gas and electricity prices higher. In fact, the Electricity Price Index (EPI) reached an all-time high in January. Despite this, high-dividend stocks returned only 0.99%, as measured by the S&P 500 Dividend Aristocrats Index, underperforming other largecap constituents. Strong performance in utilities will certainly hurt many active managers, who have historically underweighted the sector. The consumer discretionary sector was both the worst Q1 performer and the only sector with negative returns. Internet retailers and specialty stores suffered from disappointing holiday sales, most notably Amazon, Bed Bath and Beyond, GameStop, and Staples. General Motors recalled 4.8 million vehicles through March 31st for a variety of reasons such as ignition switch defects, power steering failures, and loose fitting transmission oil cooler lines. In 2014 the auto giant has already recalled more than 6 times the number of vehicles in 2013 and has admitted to being aware of the ignition issue for several years, leading to a Congressional investigation.

S&P 500 Economic Group Components - Total Return



Sector	1Q14
Utilities	10.09%
Health Care	5.81%
Materials	2.86%
Financials	2.61%
Technology	2.28%
Energy	0.79%
Consumer Staples	0.50%
Telecom	0.47%
Industrials	0.14%
Consumer Discr.	-2.80%

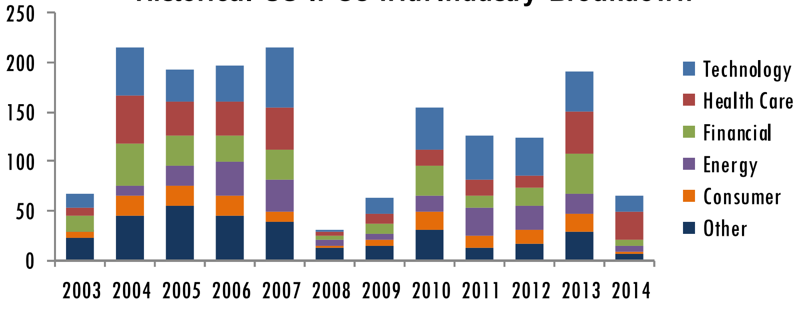
Source: Standard & Poor's

Midcap companies outperformed largecaps and smallcaps. Across all market cap segments, value stocks outpaced their growth counterparts, most significantly in the midcap space. Consumer staples led the midcaps returning 10.65%, followed by utilities at 7.96%. Strong gains in the food products industry was aided by Keurig Green Mountain, whose shares soared on news that Coca-Cola would purchase a 10% stake in the coffee company. Technology was the laggard (+0.82%) as IT service and internet software industries sold off on uncertainty over corporate spending. This, in combination with the CEO's announced retirement, hurt Rackspace Hosting considerably.

In the smallcap segment, the energy sector was the best performer (+10.58%) as the telecommunications (-2.45%) and healthcare (-1.53%) sectors traded lower. Increasing natural gas prices gave a boost to onshore drillers where horizontal drilling activity has been growing, pushing rig counts higher. Biotech stocks continued to have impressive performance, but were more than offset by losses in the healthcare-technology and pharmaceutical industries.

As equities charge higher, companies are becoming more comfortable entering the IPO market. In 2013, 190 companies went public, reaching pre-2008 levels. Especially noteworthy is the number of IPOs during the first three months of 2014, as 64 companies have already made public offerings. This puts 2014 on track to see around 250 IPOs, a record not seen since the tech bubble. While many view high IPO activity as a bearish signal, it's worth noting that investors have shown discipline, as opposed to indiscriminately buying new shares without proper due diligence, in contrast to the period before the tech market crash. A number of companies have either postponed or withdrawn altogether from an IPO because of this, while others have struggled out of the gate. Additionally, recent issuance has been spread out across the technology, healthcare, and financial sectors, compared to only the technology sector leading up to 2001.

Historical US IPOs with Industry Breakdown

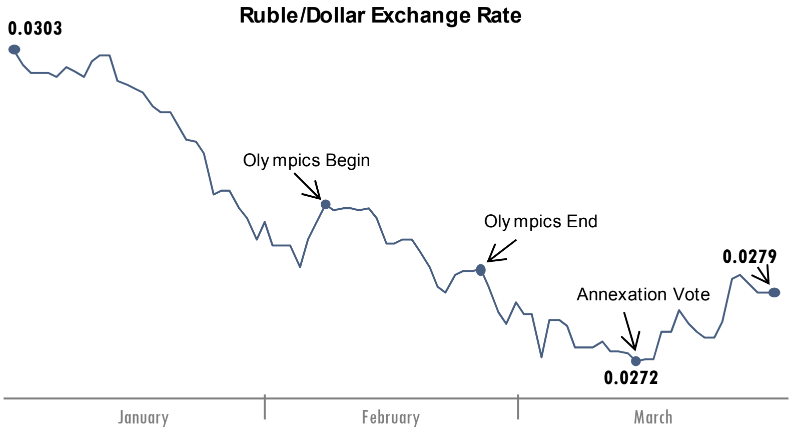


Source: Renaissance Capital

Overseas Markets

Overseas markets began the year as they ended 2013, mixed with flat to modest performance throughout developed regions and weaker returns in emerging regions, especially in Eastern Europe. The year began on a hopeful note with the Sochi Olympics in February, but the climate of sportsmanship and cooperation quickly evaporated in March with Russia's annexation of the Crimean peninsula.

In the wake of the essentially bloodless coup the US and Europe instituted economic sanctions against Russia that amounted to a slap on the wrist. The situation remains fluid and no one knows what the ultimate global economic impact will be. However, the EU has significant trade ties with Russia, importing approximately 30% of its energy from the region, and the Europeans are unlikely to want further trade and financial sanctions that might threaten the ongoing economic recovery in Europe. However, Russia's economy had already been slowing prior to the political conflict, which has further impacted financial stability.

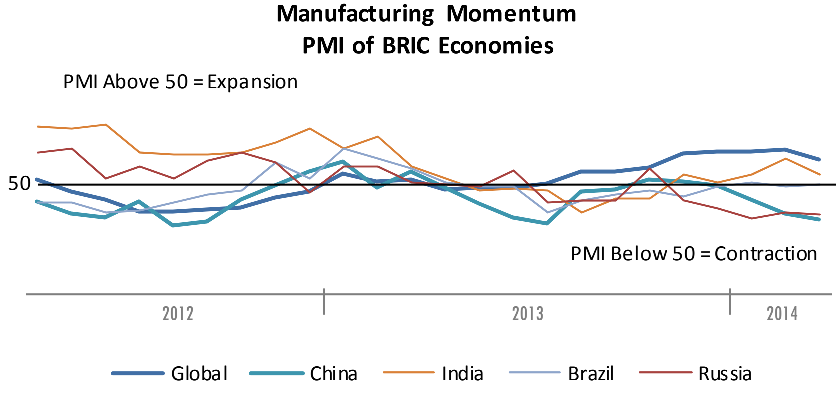


Prior to the annexation Sberbank, Russia's largest bank, warned of impending recession with capital outflows of hundreds of millions of dollars. In February Russia's GDP grew only 0.3% year-over-year, down from 0.7% in January. Alexei Ulyukayev, the Russian Economy Minister, said capital flight from Russia in January and February, prior to Crimea's annexation, totaled US $35 billion. The ruble dropped 10% against the dollar as tensions rose, but moderated toward quarter's end on word of negotiations. The ruble ended down about 8% versus the dollar and 7.5% versus the euro.

Before this crisis diverted global attention, international headlines were dominated by territorial disputes of both land (island) and sea in the South China Sea. These disputes are ongoing and involve several different sovereign states within the region. The main players at the moment include China, Japan, and the Philippines. These nations are interested in the potential exploitation of crude oil and natural gas under the waters of various parts of the region, acquiring fishing areas and shipping lanes as the region is one of the biggest shipping routes in the world. While all eyes are on Russia, China is likely watching the rest of the world and carefully analyzing the global response to Russia's actions. The annexation of Crimea resulted in very few consequences, economic or political, which may be an encouraging result for military hawks and expansionists in China.

Major General Luo Yuan, a retired People's Liberation Army officer and a vice-president of a Beijing-based think tank, feels that it is becoming increasingly likely that China will go to war with Japan over territorial disputes. He argues that the US would not intervene in a conflict between the nations, and the United Nations is unlikely a concern to China. The Philippines did submit evidence to the UN against China's territorial claims in the South China Sea, but the Chinese have refused to take part in arbitration. In our view it is this region, not Crimea, which should demand investors' attention.

Meanwhile analysts are predicting the lowest economic growth in China since the first quarter of 2009. Most are expecting growth of 7.3% or 7.2%, down from 7.7% at year end. This slowdown is likely a result of several weaker-than-expected outputs. A preliminary factory survey released in mid-March showed the manufacturing sector shrinking for the third consecutive month. The Chinese economy was hurt by a significant fall in exports and lower than anticipated industrial output figures for January and February. In February exports fell more than 18% from the prior year and factory output and new orders both weakened with the purchasing managers' index (PMI) falling to an eight-month low in March to 48.1. Readings below 50 are suggestive of a contracting sector.



Source: Trading Economics

On March 17th the People's Bank of China doubled the daily trading band on the renminbi against the dollar from 1% to 2% on either side of a government-set parity rate. The new policy is reaffirmation that China is pushing ahead with reforms despite decelerating growth. In the final trading days of the quarter yuan intraday volatility intensified to 300-400 pips compared to less than 100 pips for most of 2013. President

Xi Jinping plans to liberalize interest rates in order to allow more capital to flow into and out of China. Many economists feel that this should slow the accumulation of debt by preventing investments funded by artificially cheap credit. All of these reforms are part of an effort to move the economy away from dependency on exports and investments by transitioning to consumer demand as the primary growth driver. But how much pain is China willing to endure for the sake of these new economic reforms?

Back in Europe, the European Central Bank kept rates at record lows with President Mario Draghi stressing that the central bank will remain accommodative for as long as necessary. Mr. Draghi said the bank stands ready to take further action to prevent excessively low inflation from derailing the Eurozone's fragile economic recovery. "We remain determined to maintain the high degree of monetary accommodation and take further decisive action if required," Draghi said. He added that he did not see deflation as a threat. However, worsening of its medium-term outlook for inflation, or an unwarranted tightening of money-market or bank lending rates, could lead the ECB to act. The annual rate of inflation across the 18 countries sharing the euro fell to a record low in January, a development that will increase pressure on the European Central Bank to act more decisively to head off the threat of falling prices.

Foreign Stock & Bond Indices - Total Returns

MSCI Broad Indices	1Q14	Barcap Global Indices*	1Q14
World Index	1.26%	Global Aggregate	2.40%
EAFE (Developed)	0.66%	Pan-Euro	3.08%
Emerging Markets	-0.43%	Asian-Pacific	2.86%
		Eurodollar	1.35%
MSCI Regions		Euro-Yen	2.55%
Europe	2.10%	Other Currencies	1.67%
Japan	-5.61%	**Unhedged*	
Pacific ex-Japan	2.96%		
Latin America	0.33%		

According to Eurostat (the EU's statistics agency) consumer prices rose by just 0.7% in the 12 months through January, down from a 0.8% annual rate of inflation in December, and further below the ECB's target of around 2.0%. The ECB last cut its benchmark interest rate in November, responding to a fall in the annual rate of inflation from 1.1% to 0.7% in October. The drop in the inflation rate is fueling fears that low inflation will hinder the area's recovery from its long debt and banking crises, and increases the risk of a slide into deflation. An extended period of falling prices would be highly damaging for the Eurozone, as governments and households are already struggling to reduce their elevated levels of debt. When prices fall, the effective debt burden rises.

However, there have been some positive signs that economic recovery is gaining momentum, and that consumer spending is likely to rise in coming months, providing some support for prices. In January the number of people without jobs across the Eurozone fell by the largest amount since April 2007. Eurostat said the Eurozone's unemployment rate was unchanged in December at 12%, having revised the November figure down from 12.1%. But the number of people without jobs fell by 129,000, the largest drop since April 2007, well before the onset of the financial crisis. The decline in the number of jobless was led by Spain, but also included Germany, Italy, and Portugal.

In Japan, Prime Minister Abe continues to face pressure to get results in the long-running fight against deflation. He has run into an unexpected nemesis in his fight – Japan's youth. Many young workers have continued to hoard yen, building cash nest eggs with the expectation that their deflating money would be worth more as time went on. The young have never experienced inflation, and savings habits are hard to break. Mr. Abe hopes his policies will change that. Since coming to power in late 2012, in an effort to end deflation, he has pursued aggressive economic and monetary policies. His initial tactic, a doubling of the country's money supply, has weakened the yen and increased prices, pushing up the cost of energy and food imports. Signs of broader price increases are mixed. The CPI rose just 0.4% in 2013. Discounted for energy and food prices, the index actually fell 0.2% compared with 2012. Both measures are well below the Bank of Japan's target of a 2% inflation rate. In early March, the central bank voted to keep its policy on hold.

Like John Maynard Keynes during the Great Depression, Mr. Abe is urging cash hoarders to change their mind-sets and begin spending as one means of reflating the economy. Some economists are now questioning Mr. Abe's policies, believing that inflation should be driven by demand for goods and services, not by higher input costs for energy and raw materials, which is what appears to be happening. Cost-push inflation could become a real threat to Japanese stuck in a deflationary mind-set as consumers see their savings eroded by rising prices. Choices that made sense under deflation (e.g. renting instead of investing in property) could saddle them with mounting costs and erode their standard of living.

Overall performance in Latin America was relatively flat, but concerns across the region abound. In January Argentina's international reserves were dwindling in conjunction with an overvalued exchange rate. This along with inflation believed to be running above 25% signified a deep economic crisis. The government quickly devalued the Argentine peso by 20% and the official exchange rate has stayed at 8 pesos to the dollar since late January. In an effort to keep money in the country the Argentine central bank raised interest rates by 6%, to about 29%. This has steadied things for the time being but concerns remain that demand for commodities is weakening in places like China which could significantly harm Argentina and other commodity driven Latin American economies such as Venezuela. In Brazil, inflation remains elevated and interest rates continue to climb. The country is also bracing for a hit to its large automobile industry as Argentina is one of Brazil's largest export markets, and the turmoil within Argentina is bound to influence demand.

Focus On: *Creative Destruction in India*

Creative destruction. The Austrian-American economist Joseph Schumpeter called it the "essential fact about capitalism." First introduced in his 1942 work *Capitalism, Socialism, and Democracy*, it's a term that has pervaded economic journals since that time and has become shorthand for the way free markets move forward. A 2013 McKinsey report on disruptive technologies noted, "The most significant advances in economies are often accompanied by a process of 'creative destruction,' which shifts profit pools, rearranges industry structures, and replaces incumbent businesses." To accept Schumpeter's theory is to concede that job loss, failing companies, and changing industries are inherent parts of economic growth. Schumpeter believed that, over time, societies that allow creative destruction to occur grow more productive and richer. The jobs and companies that go away are replaced with better jobs and stronger companies. Society ultimately benefits from new and higher-quality products and improved standards of living. We tend to agree and see the debate on foreign direct investment currently unfolding in India as the latest example of Schumpeter's theory in practice.

> "The opening up of new markets, foreign or domestic, and the organizational development from the craft shop to such concerns as U.S. Steel illustrate the same process of industrial mutation — if I may use that biological term — that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of **Creative Destruction** is the essential fact about capitalism."
>
> \- Joseph Schumpeter
>
> *Capitalism, Socialism, and Democracy*

A Little History

In 1991, a balance-of-payments crisis pushed India to near-bankruptcy. With foreign exchange reserves all but depleted and inflation rising, the government had to airlift 67 tons of gold (20 to the Union Bank of Switzerland and 47 to the Bank of England) to secure a bailout from the International Monetary Fund. As a result, the rupee devalued, and economic reforms were forced on India as part of the bailout in order to unshackle the economy. Controls started to dismantle. Tariffs, duties, and taxes were progressively lowered, and state monopolies were broken down. The economy was opened to trade and investment, competition was encouraged, and India slowly started to embrace globalization. Ultimately, the effects of these changes were widespread liberalization and deregulation of financial markets. Cross-border mergers and acquisitions and opportunities for foreign investors increased as well, and rapid advances in modern telecommunication and information technology were made. All the change resulted in a tremendous upsurge of international capital flows into India. However, foreign direct investment, particularly in the retail industry, lagged – largely due to government restrictions and the widely unorganized structure of the sector. With recent policy changes implemented and further liberalizations proposed, we have the opportunity to watch creative destruction in action – with all the pain that is inextricably linked to capitalism's gain.

What is Foreign Direct Investment (FDI)?

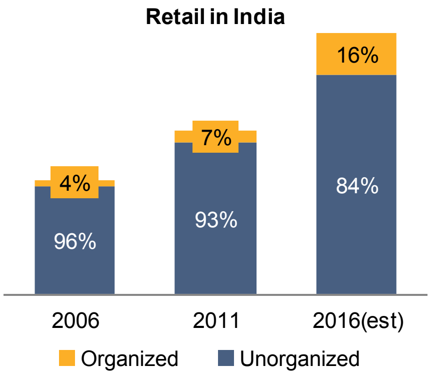
Foreign direct investment is direct investment in a foreign country through the acquisition of a local company or the expansion of an operation into that country. It simply refers to capital inflows through an enterprise operating in an economy rather than through that country's stock exchange. It excludes investment through purchase of shares, and it usually involves a joint venture that includes participation in management and the transfer of technology and expertise. FDI provides a win–win situation to both the foreign investor and the country receiving the investment. The foreign investor gains access to new markets, while the country invested in acquires technology and training for its domestic workforce, along with increased domestic savings and foreign exchange. Among the various forms of foreign investment received, FDI flows are typically preferred by countries over other forms of external finance because they do not create debt, are less volatile, and their returns are directly linked to the performance of projects financed by the investors, creating an alignment of interests. While investment in India has grown substantially as an emerging market, to date, this has been accomplished largely through the purchase of stock rather than through direct investment.

Case Study: India's Retail Industry, Primed for Transformation

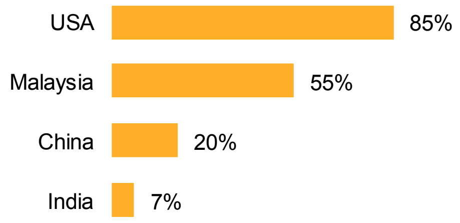
India's retail sector is the 5th largest globally at roughly $500 billion annually (compared to a $5 trillion retail sector in the US). Expected to cross the $1 trillion mark by 2020, India's retail sector is one of the fastest growing in the world. Estimates put the industry's annual growth rate at 12-15% for the next 5 years. The retail sector accounts for roughly 15% of India's total GDP (vs. 17% in the US) but employs only 5% of the population.

India's retailing industry is highly unorganized. Traditional low-cost retailers like local *"kirana"* (neighborhood) shops, owner-manned general stores (*"paan/beedi"* shops), and street vendors account for 93% of the sector. Organized retailing is at a very nascent stage and accounts for only about 7% of the industry. It exists in the form of corporate-backed hypermarkets (i.e., supermarket/department store combinations) and retail chains present only in large urban centers. Organized retail generally refers to trading activities undertaken by licensed retailers - that is, those who are registered to

Retail in India



Organized Retail Penetration
As % of Total Retail, 2011



Source: FICCI Report on FDI in Retail, Nov. 2012

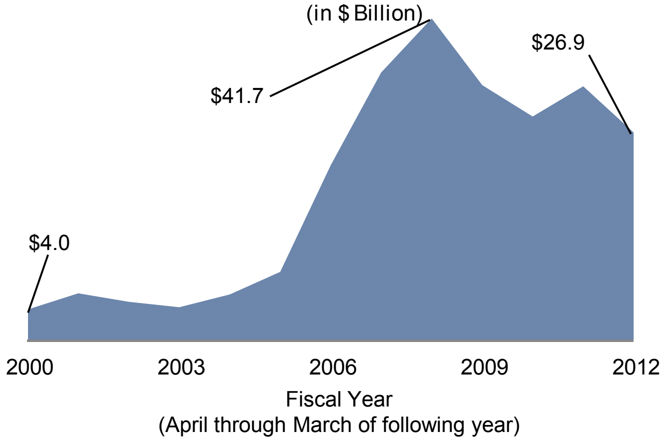
pay taxes (e.g., sales tax, income tax). While the retail sector in India is growing by about 12% per year, organized retail has grown by approximately 40% per year over the past 5 years.

FDI in India's retail sector is permitted through two models: 'single-brand' (e.g., McDonalds, Reebok, Nokia) and 'multi-brand' (e.g., Wal-Mart, Target, Carrefour, Tesco). If a retailer obtains permission for a single brand enterprise, separate permission is required for each additional brand sold, and these additional brands must each be distributed through separate and distinct outlets. Permission as a multi-brand retailer allows a firm to open stores offering a range of household items and groceries directly to consumers and to compete with the ubiquitous *kirana* shops utilized by the overwhelming majority of India's population.

Foreign investment in India is regulated by the 1999 Foreign Exchange Management Act (FEMA). In practice, the Indian government imposes caps on FDI by industry or sector with a long-standing trend in most sectors to eliminate caps completely. However, this has not been the case in the retailing and insurance sectors, where Indian businesses have fiercely opposed any loosening of restrictions on foreign investment. Despite this, the government eased retail policy for the first time in 2006, allowing up to 51% FDI in a single-brand retailer, while FDI in multi-brand structures was still prohibited. The more-lenient FDI policy failed to attract significant foreign investment, so in December 2011 the Indian government completely removed the limitation on foreign investment in single-brand retailers and opened multi-brand retailers to as much as 51% foreign investment in September of 2012. (Originally the liberalization of the multi-brand restriction was to occur in November of 2011, but it was put on hold due to widespread protests from opposition parties, traders, and retailers.) The intended outcome was increased investment and the creation of jobs along with an infusion of updated technology into an industry that sorely needs it. Additional benefits of FDI would also include the transfer of expertise in supply chain management and logistics as well as other operational best-practices applied by global businesses today.

For example, the spoilage rate of food harvested in India averages about 30% per year, one of the highest rates in the world, due to limited storage technologies as well as poor infrastructure and supply-chain management. The opportunities created by even small improvements in technology and/or operations could be quite profitable, not to mention extremely beneficial to India's population. But despite allowing 100% FDI in cold-chain infrastructure, foreign investors have remained uninterested in this sector due to low demand from organized retailing firms (which comprise only 7% of the industry) and no expressed demand from the remaining 93% of the industry. In the absence of organized retail competition to force technological advancement, a direct result of the limits on foreign direct investment in multi-brand retailers, FDI is unlikely to commence in cold storage or any other farm-logistics infrastructure any time soon.

Total FDI Inflow into India
(in $ Billion)



Source: Handbook of Statistics on Indian Economy, 2013-RBI

Shifting Profit Pools and Replacing Incumbent Businesses

Looking beyond technology, operations, and infrastructure, another example of the negative impact of the unorganized retail sector in India is the perpetuation of an inefficient, multi-tiered distribution chain for produce and other grocery items. Due to a number of intermediaries involved in the traditional Indian retail chain, pricing lacks any transparency. In addition, India, like many other emerging markets, has a reputation for pervasive corruption with bribery as a regular requirement to transact business. Margins for the multiple middlemen involved frequently exceed 60% of the eventual cost of an item, suggesting that farmers or other producers receive little from the prices consumers pay. The effect of this inefficiency has been limited growth and innovation in the retail industry. Large hypermarket players in the US like Wal-Mart benefit from managing an efficient supply chain. Many economists believe that the opening of India's retail industry to similar free market competition would lead to rapid growth in the sector by improving supply-chain logistics, reducing spoilage, creating employment, improving health and safety standards, and reducing inflation in consumer staples.

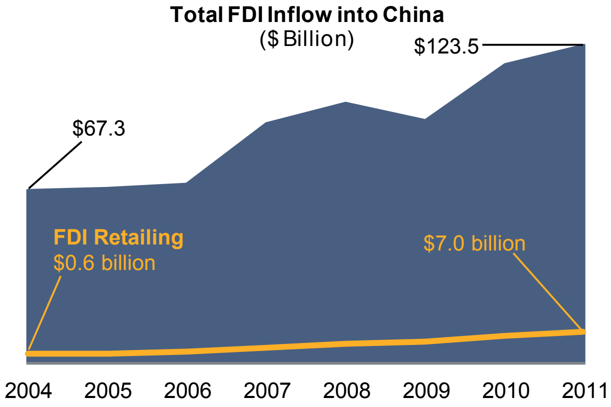
Why then is there such opposition to FDI in multi-brand retailers? The obvious answer is that the local *kirana* and *paan/beedi* shop owners fear they will be edged out with the introduction of larger, more efficient, global retailers. In fact, the Bharatiya Janata Party (BJP), India's main opposition party and the party expected to triumph in the April national elections, has maintained that the domestic retail industry must be made competitive before foreign investment is allowed. This position is no surprise as small retailers form a key BJP constituency.

But objections to foreign investment are usually more far-reaching than that. As foreign investment increases, domestic companies often worry that they may lose their ownership to overseas firms. Businesses argue that large global giants will focus their significant resources on the highly-profitable sectors of a market, leaving the less attractive segments to the smaller home-country firms. Local populations often feel that foreign companies care more about and invest more in machinery and intellectual property than in the local workforce. These objections are not new. In fact, they echo those heard in the US when foreign automakers sought to set up American production plants in the early 1980's. At that time, auto manufacturing jobs were clustered in Michigan, Ohio, and Indiana, and auto workers were mostly represented by the UAW. By 2012, auto manufacturing jobs had declined by more than half, with about 50% of those jobs in foreign-owned, non-union facilities, mainly in the South.

FDI Success and Embracing Creative Destruction

FDI in retailing was permitted in China for the first time in 1992. Foreign retailers were initially permitted to trade in only six Provinces and capped at a 26% stake. In 2001, this cap was raised to 49%. Foreign ownership restrictions were progressively lifted and completely removed in December of 2004 following China's ascension to the World Trade Organization (WTO). Currently, the sector employs 7% of the population and contributes 9.7% to China's GDP. Between 1996 and 2001, the number of traditional retailers increased by 30%. By 2012, total retail sales in China accounted for more than $3 trillion, making it the second-largest retail market. Liberalization in the retail sector drove a number of changes including the opening of over 600 hypermarkets between 1996 and 2001 and an increase in employment in the retail and wholesale sectors from 28 million people in 1992 to 54 million people in 2000. But perhaps most surprising to those arguing against the removal of the remaining FDI restrictions in India is that China also saw an increase in the number of small outlets (*kiranas* equivalents) from 1.9 million to over 2.5 million in the same period.

Will India have the same experience? It's hard to tell. It seems likely that restrictions will ultimately be lifted, but the timing is hard to predict. The domestic debate still rages as Indians embark on a general election that will take over a month to complete. The debate itself is not surprising. While creative destruction can result in significant advances in an economy, these advances are typically long-term payoffs achieved through significant, and usually painful, short-term disruption. The temptation to block the process through policy and regulation can be hard to resist, especially for officials facing regular elections.



Source: National Bureau of Statistics of the People's Republic of China

As for implications for US investors, removing the remaining restrictions on FDI in India's multi-brand retail market should present significant opportunities to retailing giants like Wal-Mart, Carrefour and Tesco – common portfolio holdings. While India is the 10th-largest economy in the world by nominal GDP, it ranks 3rd (after the US and China) by GDP when adjusted for purchasing power parity. And for now, it appears these firms are preparing to take advantage of that. Wal-Mart disbanded a 6-year partnership with Indian retailer Bharti Enterprises in October of 2013, which most have interpreted as a preliminary step for the multi-brand retail giant to ultimately move to a 100%-staked venture once restrictions have been loosened. Then in December of 2013 British retailer Tesco sent an application to India's Department of Industrial Policy and Promotion to invest $110 million in collaboration with Trent Hypermarket Limited (a Tata group enterprise) with plans to open 3 to 5 stores every year. Stay tuned.

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