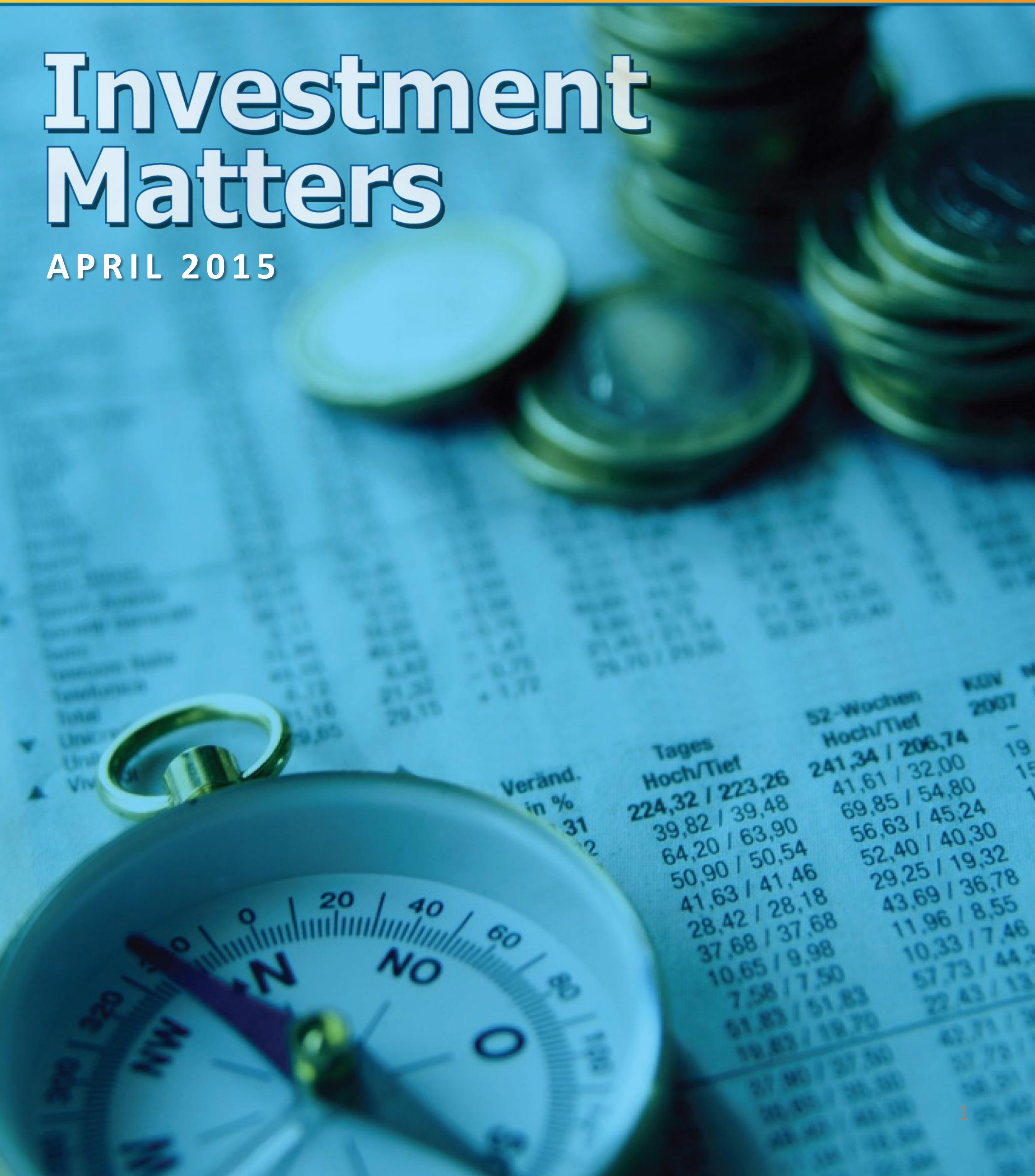
Investment Matters

APRIL 2015



EQUITY OUTLOOK

FY15 ended on a strong note for Indian markets with BSE Sensex returning 24.9% and BSE 500 33.2%. Over the past 12 months PE rerating has driven the markets higher with valuations for Sensex moving up by 300-400 bps to 16-17X FY17E earnings. The hope rally on the back of India choosing a reformist BJP government led by Mr Narendra Modi started amid large positive inflows from FIIs and end of outflows from domestic mutual funds. The new government has taken a gradualist approach to change with focus on consultation among various stakeholders ie states. A silver lining has been that FY15 was among the most productive year in the past decade for the parliament in terms of business concluded and productive discussions have taken place to reach final policy changes. Earnings growth typically a lagging indicator has yet to show any major sign of improvement with 6-8% growth in FY15. Market consensus is estimating an earnings growth of 15-18% CAGR over the next 2 years for BSE Sensex companies over FY15.

India to kickstart its growth cycle needs to focus on infrastructure investment in a major way. A beginning is being made for the same during the budget announced in February 2015 by the finance minster by allocating higher corpus for investments in Railways, Roads and Defense. However, due to financial constraints the amount is still not very large – in governments own estimate India needs to invest around $500 bn-$1000 bn over the next 10 years and FY16 incremental allocation is around $10-12 bn. The logical conclusion on this count is that real change in growth trajectory for the economy and in turn corporate earnings is likely to take some time with gradual improvement over the next 12-24 months.

RBI on its part is contributing to make a change in the growth cycle with the start of the rate cut cycle and has surprised the markets over the past 3 months with two consecutive rate cuts of 25 bps each taking the total cut to 50 bps in CY15. Economic growth in India specially IIP growth remains muted and is likely to be the primary motivator for the RBI to continue to be dovish. However, recent change in weather with unseasonal rains and hailstorm in many parts of the country can see a short term pick up in food inflation leading to delay in aggressive incremental rate cuts. The banking system has not yet passed on the previous rate cuts by the RBI fully and we expect the same to gradually take place over the next 3-6 months. Credit growth in the system is weak at around 10% with deposit growth running higher at 12-13% leading to banks investing surplus in Government securities – this phenomenon was witnessed during the 2002-2006 period as well where banks made large capital gains on account of fall in Gsec yields on the back of rate cuts by the RBI and used the gains to provide for bad assets on their balance sheet. Indian banks potentially stand to gain once again from this phenomenon over the next 24 months.

In the short term ie 3-6 months, earnings delivery by corporate is likely to be on the weaker side impacted by slow demand growth, forex fluctuations, large correction in commodity prices leading to one-off inventory losses setoff by improvement in profitability margins. The positive impact of lower interest rates, higher government spending and confidence among the corporate world is likely to manifest into stronger earnings growth in the medium term ie beyond 12 months. We expect 2HFY16 onwards to be a better period for earnings growth primarily driven by lower RM costs as a result of lower commodity prices and FY17 could be driven by revenue growth and operating leverage. We expect markets to consolidate for some time in a range post which a renewed upmove can set a stage for the next leg of the bull market.

EQUITY OUTLOOK

FY15 was a good year for stock pickers like us with many companies delivering strong performance. Among many names it is important to highlight a few hits and misses for us during the year and a few names where we expect performance likely to standout during the next 12-24 months – Leaders for the year (Hits)- Bajaj Finance, Cadila Healthcare, Sundram Fasteners, Maruti Suzuki, NBCC, Gati, Mahindra CIE etc while Laggards during the year were limited where performance is expected to turnaround meaningfully over the next 12-24 months (Misses) – Ipca Labs, GMDC. Ipca Labs during the year faced USFDA import alert for a few of its facilities. The adverse observations were to do with lack of automation in lab facilities with minor observations for manufacturing facilties. Over the past 6 months, the company has automated all its processes and has now invited the USFDA to reinspect its facilities for resumption of sales to the US markets. We expect the issues to be resolved by the company over the next 12 months and FY17 should be a good year for the company. GMDC on the other hand faced issues in scaling up production in 3 of their mines on account of delay in appointment of mining contractors and land acquisition issues. All these issues stand resolved in March 2015 and production growth is expected to pick up significantly from May 2015 onwards. We expect GMDC to report strong performance over the next 2 years with 30%+ profit growth. Over the past few months we have booked profits in a few names and have introduced a few new companies in our portfolios like BEML, L&T, Exide, Astral Poly, Ramkrishna Forgings etc where we expect performance to stand out over the next 12-24 months apart from the existing companies that we own.

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DEBT OUTLOOK

After surprising the market by 25 bps rate cut, RBI maintained status quo in its April policy meeting. Bond markets did not find much cheer in the review, as yields moved up around 5 bps post policy (7.73% to 7.78%). Rest of the yield curve too sold off on similar lines. The central bank has emphasized that the monetary stance remains accommodative with policy rate reductions contingent on incoming data. After the 50 bps reduction so far, based on CPI inflation consistently undershooting the glide path targets and considering the muted demand side pressures, the central bank has in this review focused towards ensuring policy rate transmission. Towards this, the RBI has proposed to encourage banks to migrate towards a uniform policy for setting base rates based on the marginal cost of funds. The RBI has also proposed to explore bank products pricing based on external market based indices. These measures and the Governor's post policy briefing underscores the intention to align bank lending rate movements with the policy rate changes and thereby facilitate better monetary policy transmission. The timing of future policy rate reductions is contingent on transmission by banks of RBI's front-loaded rate reductions, food inflation scenario (over and above transitory factors) and policy efforts by government to augment supply and hence growth. The expected normalization of the US Fed's monetary policy stance would also have a bearing on the RBI policy stance.

The liquidity availed through various sources (Liquidity Adjustment Facility, export refinance, marginal standing facility and term repos) from RBI during the month of March was marginally lower at around Rs. 98,252 crs as compared to around Rs. 97,838 crs in February 2015. The NSE overnight MIBOR ended at 8.35%, higher than the rate seen in end February 2015(7.79%). The INR depreciated to 62.50 against the US dollar as compared to 61.84 at the end of previous month. The net FII investment in equities & debt was an inflow of ~US$ 3.5 billion in March 2015 as compared to an inflow of US$ 4 billion in February 2015.The net FII investment in equities & debt has been US$ 12.8 billion in calendar year 2015.

WPI, stood at -2.1% (provisional) for the month of February, 2015 (over February, 2014) as compared to -0.4% (provisional) for the previous month and 5.0% during the corresponding month of the previous year. Headline CPI came in at around 5.4% YoY in February 2015 compared to around 5.1% in January 2015. Core CPI for February 2014 came in at around 4.9%.

The corporate bond segment remained adversely impacted post the monetary policy in the month of March as the RBI disallowed FII to trade in corporate bonds maturing up to three years. It may be noted that corporate bond segment has witnessed huge inflows from offshore investors in the recent past due to non-availability of G-sec limits. Traditionally a shallower market than G-sec segment, the credit spreads (yield spread between G-sec and corporate bond) witnessed some widening as they have been trading at considerable low level in recent times. Widening spreads between the bank lending rates and bond rates would encourage more bond issuances in the near term. The widening of spreads is more a function of realignment of market positioning rather than any adverse impact on the outlook of credits. Hence, as the issuer shift their supply pattern towards the medium – longer (5 -10 years) we expect demand to emerge from conventional end investors; viz insurers, retirement trusts, etc at higher spreads over the sovereign segment.

DEBT OUTLOOK

We expect 10 year G-sec to consolidate at current levels before falling further. We expect 50 bps rate cuts in next 12-15 months. Given the fact that while deficit reduction plan has been decelerated somewhat there is a marked improvement in quality of fiscal accounting, combined deficit is still on accelerated deficit reduction path and greater focus on infrastructure spend as opposed to consumption boost. We have been giving bullish call on Interest rates since last 8-9 months and still maintain our view on lower interest rates going forward. We suggest investors to maintain their position in Duration funds to take the advantage of falling interest rates. At this point we suggest allocating some investment in accrual strategy as well to get the benefit of higher yield.

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