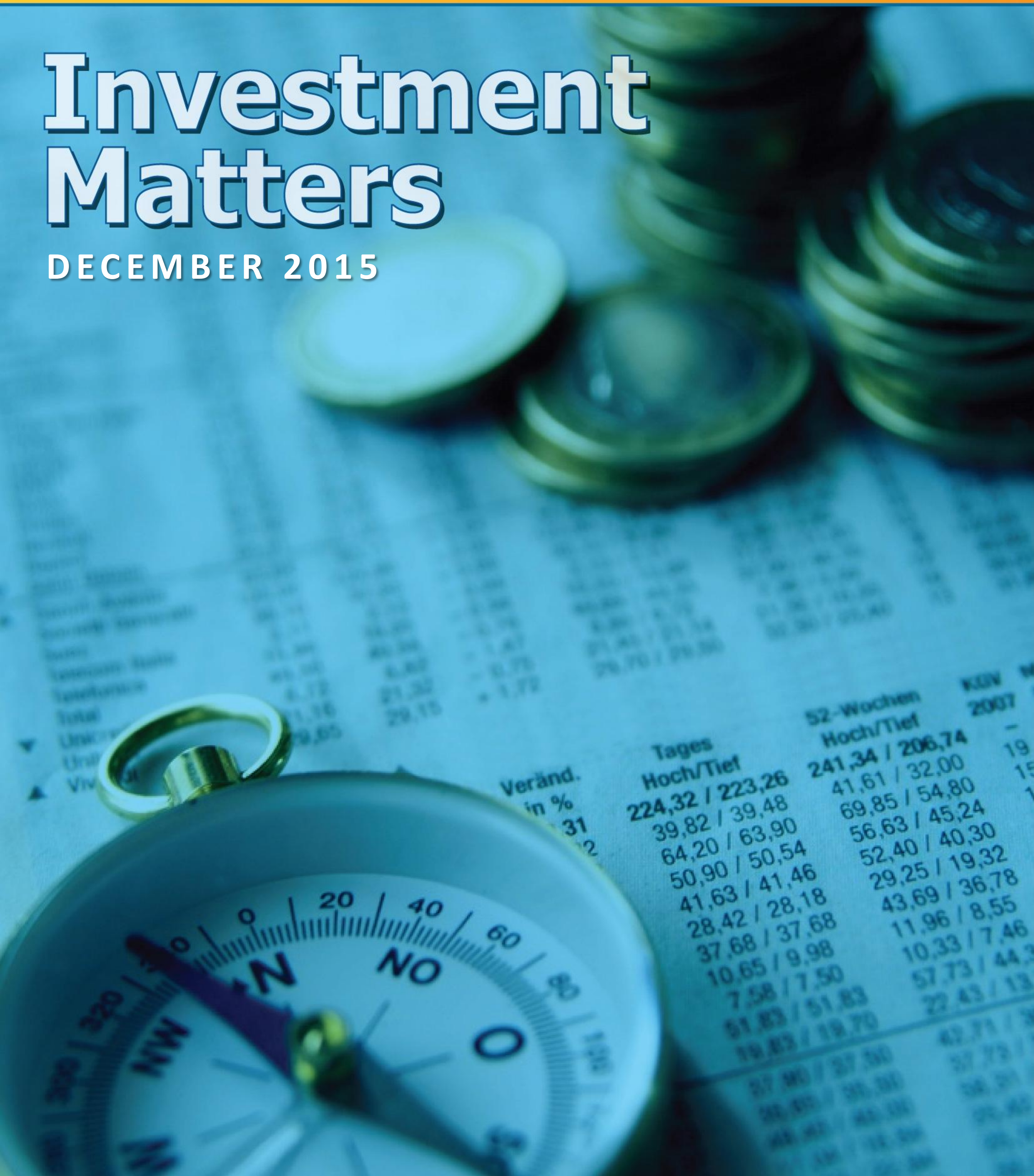
ALCHEMY

CAPITAL MANAGEMENT

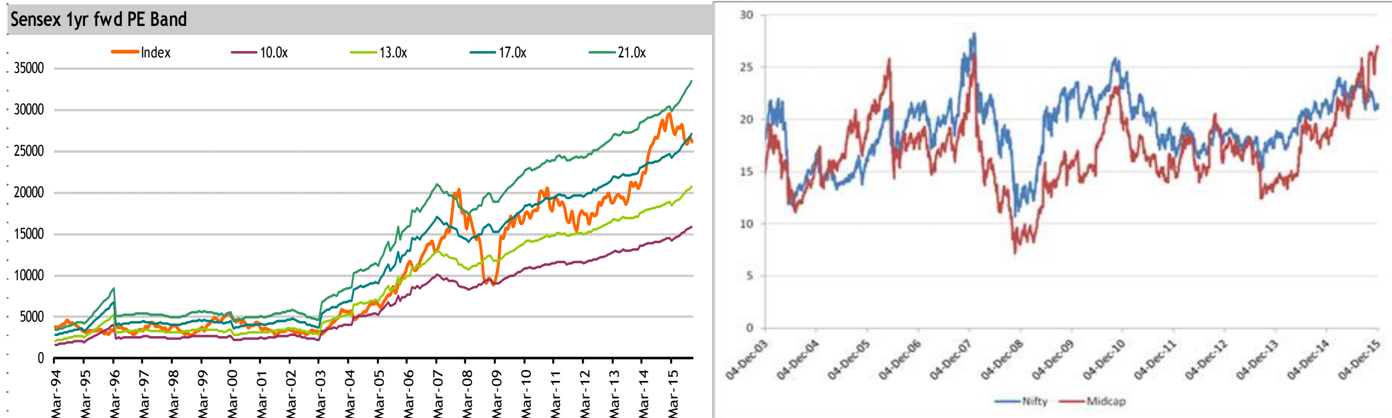
Investment Matters

DECEMBER 2015



EQUITY OUTLOOK

Markets continue to be in consolidation mode with Sensex correcting by -1.9% during November 2015 and the BSE 500 by -0.8%. FIIs were net sellers during the month at -$863 mn while the DII were net buyers to the tune of $895 mn (this is the 19th continuous month of buying by DIIs). Nifty during the year has continued to consolidate in a range with the index delivering a -4.2% negative performance YTD. Interestingly CNX Mid Cap Index and BSE Small Cap index are outperforming the benchmark index by a wide margin at 5.3% and 5% respectively (outperformance of 9%). This strong performance of the broader market is inspite of the fact that earnings growth is on the weaker side due to weak economic recovery and valuations for the mid cap index are now at a premium to the Nifty index on a trailing earnings basis.



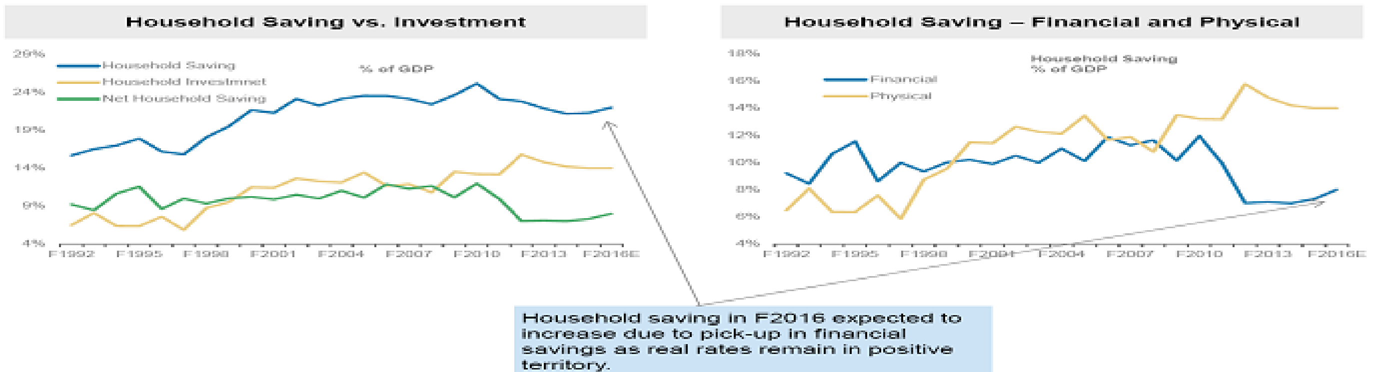
The CNX Mid Cap index is now trading at a 600 bps premium over the Nifty PE. In the past this phenomenon sustained during high earnings growth phase of 2004-2006. The markets seem to be suggesting a start of a high earnings growth phase on the horizon for mid cap companies driving PE for the index to such a wide gap compared to the Nifty companies. In case earnings growth disappoints then room for large corrections for the Mid Cap index is opening up and investors need to be selective in picking up mid cap/small cap stocks in their portfolio.

Nifty earnings growth over the past few years have been on the weaker side and is expected to remain so for FY16 as well, as can be seen in the table below. However, market consensus is expecting a rebound in Nifty earnings for FY17 on the back of recovery in economic growth driven by government capex, base formation on commodity price correction and lower interest rates. It is important to highlight that earnings growth expectations for Nifty for FY16 were equally optimistic at the start of the year and have seen downgrades to the tune of 7-8% till date. We are of the view that earnings growth expectations for FY17 will see some downside from consensus point of view by around 4-5%, however we do believe that a 10-12% profit growth for FY17 is possible and this double digit profit growth delivery for Nifty companies would be the start of a long term trend of healthy growth driving market up move.

EQUITY OUTLOOK

Sensex 26146				CNX Nifty 7935			
	FY15	FY16E	FY17E		FY15	FY16E	FY17E
EPS (Rs)	1346	1404.8	1676.5	EPS (Rs)	402	424	509
PER (x)	19.4	18.6	15.6	PER (x)	19.7	18.7	15.6
EPS Growth (%)	1.7	4.4	19.3	EPS Growth (%)	0.2	5.6	20.1

It is heartening to note that domestic savings have started flowing towards financial assets with the mutual funds and insurance companies being a large net buyer into equity markets over the past 11 month (net buying worth $9.5 bn). However, CY2015 is turning out to be a relatively muted year in terms of FII inflows with a net buying of only $3bn till date. FY16 is the first year of a rise in financial savings for household sector after a sharp fall since 2008 and a plateauing/reduction in physical savings ratio. This is positively being impacted due to the RBI keeping real rates in the economy positive which is driving flows towards fixed income and some benefit is being seen on the equity markets in terms of inflows to mutual funds/insurance companies. This over the long term is a very positive trend which we believe can help improve GDP growth for our economy higher and once again assist in infrastructure investments in the economy.



In absence of any meaningful revival in earnings growth over the short term, global factors are likely to drive market movement and one needs to evaluate the implications of the possible US Fed Rate hike in December 2015, concerns on potential further depreciation in the Yuan, Depreciation of Euro against the US$. We at Alchemy, our continuing to be very selective in investing in growth oriented companies with strong balance sheets and attractive valuations. We expect to tide through this rough weather on the back of our focused portfolio approach and are well positioned to gain when Indian economy accelerates on its growth over the next few years.

Chandraprakash Padiyar

Portfolio Manager
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DEBT OUTLOOK

Fixed income markets have turned volatile. Instead of surprise rate cut by RBI in September 2015, yields have again moved up and closed November 2015 at 7.76%. Before going in details of what we think about markets and returns one can get from debt markets, let's first understand from where the returns are coming under debt funds. Debt funds hold diversified portfolio of debt securities which are marked to market i.e. they are valued every day as per their closing prices. Returns under Debt funds come in 2 ways 1) Through Coupon income and 2) Through capital appreciation. Whenever interest rates move downwards bond prices move upward and hence capital appreciation is generated. It can be vice a versa also i.e. whenever interest rates move up, bond prices move downwards and hence can result in capital loss. Having understand this next natural question would be If RBI is cutting rates then why interest rate or yields moving up. Yields moved up in the government securities markets and Corporate bond markets due to expectation of hike in U.S Federal Fund Rate hike after the U.S non-farm payroll stood at 2, 71,000 for the month of October. CPI inflation for the month of October 2015 was at 5% levels due to higher prices of pulses and vegetables. The recommendation of 23.2% hike in the 7th Pay Commission Report makes the achievement of the fiscal deficit target of 3. 5% for the next financial year seem difficult. The RBI has cut rates by 125 bps since January 2015 but the total lending rate cuts passed on by banks have been less than 60 bps. For the economy to benefit from the low inflation and monetary accommodation; lending rates have to fall by more, and quickly. Even in the bond markets, post the fall seen in 2014 in anticipation of rate cuts; the bond yields haven't fallen by much, as supply outstrips demand.

Rupee was volatile with the currency falling to 66.50 levels from 65.20 levels against the dollar during the month of November. This was due to FII outflow in equity and debt markets in the month of November 2015. The ten-year yields moved up by 12 basis points and were trading at 7.76% levels from 7.62% levels at the beginning of the month. Corporate bond yields spread compressed from 40 basis points to 35 basis points in the AAA PSU names. The Certificate of Deposit rates remain stable with the 3-months rates trading at 7.20- 7.25% levels.

In the monetary policy, RBI left key interest rates unchanged and also maintained its accommodative stance. Although, it comes with a bit of caution. It has cautioned on the potential inflationary impact of the 7th pay commission as also on the need to be vigilant towards the price rise in some food products.

The RBI has still maintained its inflation target of around the 5.0% mark in March 2017. Given the factors laid above and the impact of increase in service tax in the next budget, it would be a great challenge to meet the 5.0% target.

With the RBI highlighting the impact of pay commission on the fiscal numbers, it would want to wait and see the markets response to the government's ability to meet the 3.5% Fiscal Deficit target. If the market senses that the budget numbers are credible and the government has resources to meet the 3.5% target, it would improve investor confidence and the RBI will be able to utilize the limited space available to cut rates to 6.5%. Any reduction in interest rates post that would depend on the RBI achieving the 5.0% inflation target. We suggest investors to have a diversified approach and invest in Short term funds, Long duration funds , Accrual strategy and part in tax free bonds. We expect interest rates in long term would be at lower levels compared to current levels and 7.2% to 7.40% tax free yield is good rate to invest in. Also as interest rates falls these bonds may trade at premium resulting capital appreciation. We advise existing investors to hold on to their duration portfolio and wait for further reduction in the yields. For new fixed income investments we suggest to invest larger allocation of 40% in short term funds, small allocation of 20% in duration funds to generate capital gains and another 20% allocation in accrual strategy and remaining 20% in tax free bonds to get benefit of current high yield available in the market to generate consistent returns.

Advisory Team

Alchemy Capital Management Pvt. Ltd

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DEBT OUTLOOK

The RBI cut interest rates by 50bps, The US Federal Reserve (Fed) delayed its decision to hike interest rates and the European Central Bank (ECB) has lowered the euro zone's growth and inflation forecast, due to a weaker-than-expected pace of economic recovery. These all auger well for bond markets in India. Debt markets were choppy since last 4-5 months but September brought much need enthusiasm to lift over all sentiments.

RBI surprised markets at the fourth bi-monthly meeting, with a larger than expected 50 bps policy cut. Additionally, this was followed through with a highly 'dovish' stance, with the RBI reiterating that it would remain in 'accommodative mode' beyond the 50 bps cut. This was the fourth rate cut by RBI in calendar year 2015, taking the cumulative rate cut to 125 bps. RBI clarified front-loading of the rate cut, as most of the pre-conditions set at the previous policy meeting were met satisfactorily. The dovish tone was underpinned by the emphasis on headwinds to growth particularly in emerging markets. This in RBI's view could drive commodities lower and help in disinflation the economy in the coming quarters. The cut was also premised on the basis that investment could respond more strongly if there was adequate visibility of monetary stimulus even if the transmission was slow. Even as it went further than expected on policy easing, RBI re-iterated its resolve to continue battling inflation and to anchor CPI at 5% by 2017 and 4% by March 2018. RBI also lowered its growth forecast for FY 16 by 20 bps to 4.4%, given the sluggish investment cycle, slowing trade, anemic global growth and subdued business confidence. However growth forecast for FY 17 was upped to 8%, while inflation guidance was lowered to 4.8%. RBI also announced a much larger than expected expansion of limits for foreign investment in Indian bonds. This would be increased in phases to 5% of the outstanding G-Sec by March 2018 and would give FPIs the room to invest an additional Rs 1,200 billion in central government securities.

Markets rallied quite strongly post the policy. There was a sharp up-move in the prices of both G secs and bonds. The benchmark 10 year G sec rallied to sub 7.60% from over 7.70% pre-policy. Benchmark AAA bonds also rallied by 20-25 bps post the policy.

Given the sharp rate reduction in the September policy, it will probably be expected that the RBI may not effect another rate reduction before the beginning of the next financial year. We reserve our outlook on the same, but feel positive on further rate reductions given the change in RBI's attitude and its focus on demand revival and comfort on inflation. Given the continued external headwinds from weak global growth, which may possibly intensify in the coming months and which could also pull retail inflation below the central bank's forecast, we believe that further monetary easing cannot be ruled out and more policy rate cuts could follow. While in the immediate term, we see the G-Sec market to be range bound, we continue to remain positive on the medium term outlook of long term bonds and gilts.

We advise investors to hold on their duration portfolio and wait for further reduction in the yields. For new fixed income investment strategy now we suggest to invest larger allocation in short term funds, small allocation in duration funds to generate capital gains and part in accrual strategy to get benefit of current high yield available in the market to generate consistent returns.

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