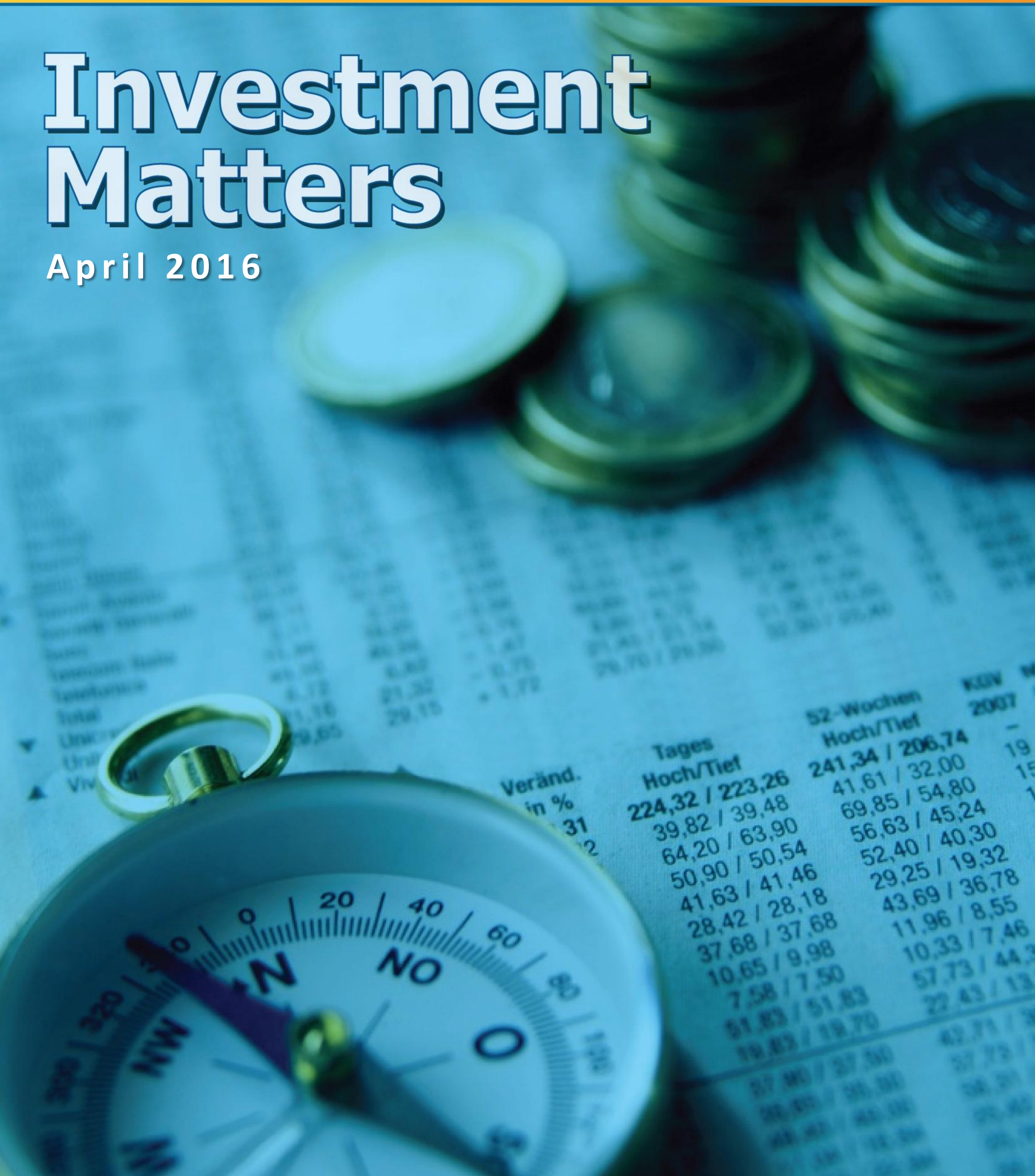
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

April 2016



EQUITY OUTLOOK

From Hope to Reality and now Slow Recovery

The first quarter of 2016 was a tough one for Emerging Markets and India was no exception. The markets corrected sharply intra quarter in Jan/Feb 2016 by ~ 17% in USD terms before recovering by 11% in March 2016.

A large part of the correction was triggered by fears of a potentially large depreciation of the Chinese currency and a rate hike by the US Fed in December 2015 with expectations of further hikes during CY 2016. These triggered selling by FII's across EM's. Closer home, fears about imposition of long term capital gains tax on share transactions in the budget also unsettled the markets. However, none of these factors actually played out. The Chinese currency is relatively stable for now, the Fed has held off a rate hike citing greater global uncertainties and finally the budget presented by Finance Minister Arun Jaitley met base case expectations (which were already running low) by meeting the fiscal deficit target of 3.9% for FY16. The budget was well received, especially by the RBI and rating agencies for sticking to fiscal discipline and laying out achievable revenue targets while tactically enhancing the allocations towards rural spending and infrastructure. Prime Minister Modi has realised that by putting more money into the hands of the rural poor and hiking spending on infrastructure, he will be able to achieve both objectives – create conditions for demand revival as well as send a clear political message that his government is pro-poor without being anti-business. However, to buttress the point of some income redistribution further, an additional dividend tax of 10% was imposed on dividend income over Rs. 1 million and new cess of 0.5% on all services was imposed, continuing with the practice of tax tinkering. Automobiles & Coal industries were specifically penalised by enhanced duties to fund clean energy & infrastructure.

The RBI Governor responded positively to the various data sets in last 2 months by cutting interest rates by 25 bps further and more importantly introduced several measures to enhance systemic liquidity which was running at a deficit of almost Rs. 1.5 trillion. These measures, coupled with earlier steps, will create conditions for better transmission of lower rates to borrowers. Continuing on his path of doing "what is right", Governor Rajan forced banks to recognise the problem of NPA's and take accelerated provisions to fully clean up banks' balance sheets by March 2017. While this arguably created a flutter, it was a much desired step towards addressing the problem head on and creating conditions for lending to restart. Consistently taking the "difficult path and taking the pain in the short run" and thereby ensuring a sustainable long term growth path for the economy, has been the biggest game changer for India, in our view. This has changed the quality of debate and mindset of the government to take a difficult path and do "what is right" rather than to postpone the problem to the future and try to generate growth in the short run by relying excessively on unconventional monetary policies and fiscal stimulus. The government, on its part, has also demonstrated an ability to take some hard decisions like reducing the interest rate on small saving schemes, hitherto considered as a holy cow and considered as a difficult political decision to take. So it does seem that the government is finally coming to grips with the economy. Some good work has been and is being done on Roads (increased execution and awarding of road projects), Power (through the UDAY programme which aims at getting the power sector on a sustainable path), Railways (focus on completing existing projects and increasing capacity rather than introducing new trains) & Defence (through the new DPP policy which enhances transparency and gives a fillip to "Make in India").

However, this is all the past and markets are forward looking so will the good macro translate into good micro? We certainly believe so and so does Governor Rajan. To quote him ***"I suspect we are on the verge of a revolution here"...."My sense is that we have almost everything for the leap in production, whether it is manufacturing or services....we can take the step forward"*** (dated 8th April 2016 and quoted from ET article)***.*** These are encouraging words from a person who is considered to be a conservative critic and speaks his mind without fear or favour.

EQUITY OUTLOOK

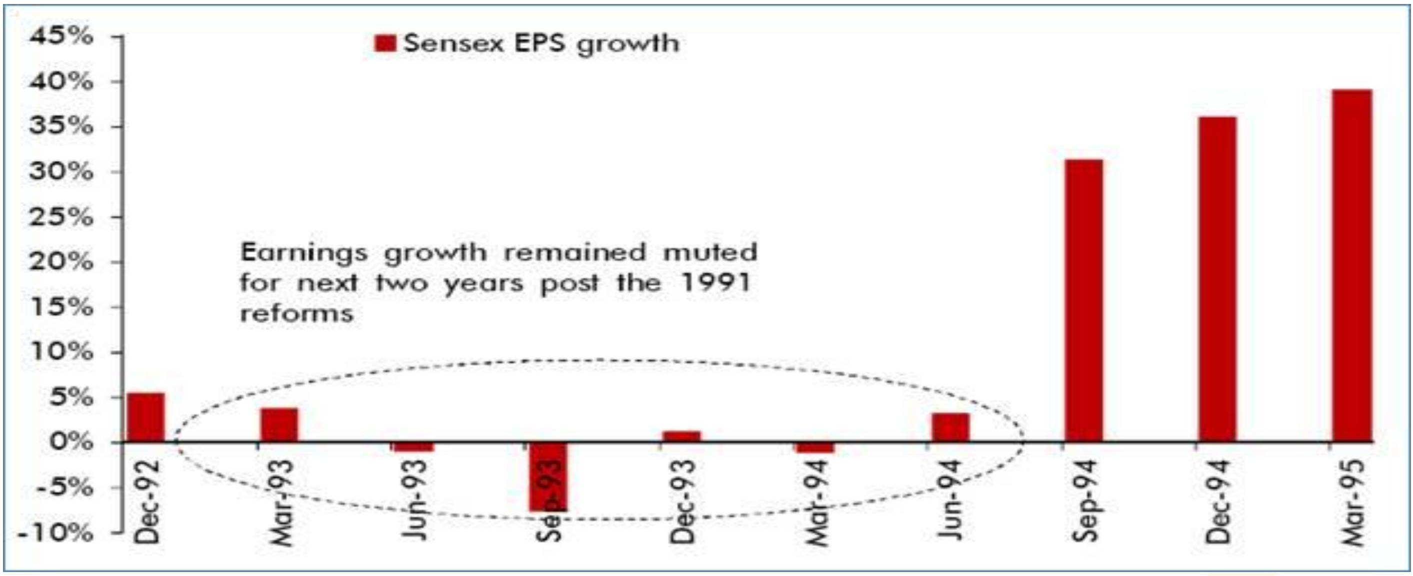
Recent economic and high frequency data, though mixed, does point to some green shoots of recovery. To illustrate –

Indicator	Reading	Comment
Manufacturing PMI	52.5 in March 2016 v/s 51 in Feb	Improving since November 2015 (49)
Services PMI	54.3 in March 2016 v/s 51.4 in Feb	At a 19 month high
Cement Production Volumes	15% in March 2016 v/s 9% in Feb	Could start averaging at 8-10% in 2017 compared to 6-7% in fiscal 2016
Power Generation	96075MU March, 11.3% YOY growth in March	5.6% fiscal 2016 v/s 8 % target
Commercial Vehicles	29% YOY in March	Approx 25-30% for the past 12 months
Two Wheelers	13.8% YOY in March	Indicates improving rural demand
Maruti Car sales	16% yoy in March 2016	Fiscal 2016 10.6%, though diesel car volumes have degrown
Air Traffic	24% in Jan/Feb 2016	Has averaged @ 20% in CY2015

Source : Various brokerage firms including (Morgan Stanley, JM Financial, Kotak Securities, Edelweiss, Elara, Antique, etc.)

However, earnings growth has still been tepid with consistent downgrades every successive month. SENSEX EBIDTA growth was 3% in Q1FY2016, 0% in Q2FY2016 and 5% in Q3FY2016 and are expected to remain in single digits in Q4FY2016 as well. We had given a detailed account of why overall growth was so insipid in our May 2015 monthly note titled "Why things haven't changed on the ground?" where we enumerated the key reasons being 1. Inventory effect as result of falling commodity prices 2. Negative wealth effect of fall in Gold/Real estate 3. Clampdown on Black Money & Corruption 4. Balance Sheet reform/Deleveraging 5. Disintermediation by e-commerce in several sectors, in addition to two consecutive bad monsoons. Several of these factors and resets by the Modi government have played out or are in the process of playing out, the impact of which is also factored in the base. For e.g., commodity prices have recovered by 25-40% from the lows, the government balance sheet is healthier given the savings in subsidy and hence the extra push to infra/rural spending as opposed to cut-backs in the last few years. With low inflation and real interest rates, savings are moving away from physical assets to financial assets (local investors put in a record $13bn in equity MF's in 2015).

We believe that we are witnessing something very similar to what happened in India post 1991 macro crisis. As the table below shows, earnings growth was virtually flat to negative for the first 6-7 quarters post the crisis as macroeconomic adjustments are always very painful in the short to medium term. Similarly post 2011-2013 macro adjustment has resulted in flat to negative earnings growth in FY2014 (EPS: 1338), FY2015 (EPS: 1354) and FY2016 E (EPS: 1332).



Source: Ambit

Accelerated write downs of NPA's for the banking sector may keep the overall earnings growth in flat to slightly positive growth territory in Q4FY2016. However if India witnesses a good monsoon, the economy could see a rebound in demand as farmer and consumer sentiment improves and several steps taken by the government like cleaning up bank balance sheets and spending on infrastructure/rural areas start to bear fruit, then the green shoots that we have witnessed so far will germinate into a full blown recovery.

Hiren Ved

Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

DEBT OUTLOOK

As we entered the new financial year RBI in its policy meeting reduced the reduced the repo rate by 25bps to 6.5% as expected, but highlight of the policy was the focus on liquidity and transmission. The RBI has decided to progressively reduce the systemic liquidity deficit towards neutral conditions from the current stance of persistently deficit conditions. Also, the apex bank stated that since short-term liquidity provisions may not fulfill durable liquidity needs of the system, it will resort to open market operations as and when needed. Both these steps are marked changes in the RBI's earlier stance and these steps along with introduction of marginal cost of funds based lending (MCLR) should improve monetary transmission going ahead.

Key steps announced by RBI in the policy review:-

- Reduce the policy Repo Rate under the Liquidity adjustment facility (LAF) by 25 basis points from 6.75% to 6.50%
- Reduce the minimum daily maintenance of the Cash Reserve Ratio (CRR) from 95% of the requirement to 90% with effect from the fortnight beginning April 16, 2016, while keeping the CRR unchanged at 4.0% of NDTL
- Continue to provide liquidity as required but progressively lower the average ex-ante liquidity deficit in the system from 1% of NDTL to a position closer to neutrality (the RBI Governor mentioned that the move to neutrality would not be immediate)
- Narrow the policy rate corridor from +/-100 basis points (bps) to +/- 50 bps by reducing the Marginal Standing Facility (MSF) rate by 75 basis points and increasing the reverse repo rate by 25 basis points, with a view to ensuring finer alignment of the weighted average call rate (WACR) with the repo rate. Consequently, the reverse repo rate under the Liquidity Adjustment Facility (LAF) stands adjusted to 6.0% and the MSF rate to 7.0%. The Bank Rate which is aligned to the MSF rate also stands adjusted to 7.0%.

The RBI anticipates that Consumer Price Inflation (CPI) will remain at around 5% in FY17, the impact of the 7th Central Pay Commission implementation on CPI inflation could be in the range of 100-150bps. Normal monsoon is very important to keep CPI in RBI's comfort zone. Improvement in systemic liquidity would help better transmission of lower policy rates (total cut of 150bps so far in the current cycle) in terms of lower lending rates from banks as their overall cost of borrowing comes down further. The average daily liquidity injection (including variable rate overnight and term repos) had increased from INR1.3Trn in January 2016 to INR1.9Trn in March 2016. Overall cost of borrowings in the system would likely come down and banks would have to lower lending rates to reflect the same. Banks have already announced the new Marginal Cost Lending Rate (MCLR) Base rate (w.e.f April 1, 2016) which is ~ 25-50bps lower than the existing base rates of banks. We expect that as liquidity improves in the system and the short term rates come down, banks will announce further lending rate cuts.

US Federal Reserve had kept its benchmark short-term interest rates unchanged amid potential risks to the US economy, signaling the central bank would slow the pace of future interest rate hikes this year. Standard & Poor's Ratings Services cut its outlook to "Negative from stable" for the Chinese government's credit rating, marking the second major ratings firm to take a dimmer view of China's creditworthiness in the past month. • ECB cuts its cut its deposit rate to -0.4% from -0.3% and the main refinancing rate to zero from 0.05 % and increased monthly asset buys to 80 billion Euros from 60 billion euro's.

In current financial year we expect that RBI will hold on the interest rates in first half of the year and depending upon inflation trajectory may reduce further by 25 bps in 2nd half. In short we expect interest rates to remain rang bound between 7% to 7.5%. Duration funds did well in last 30-40 days but from here on we suggest investors to invest in short term and accrual strategy to get steady returns.

Advisory Team

Alchemy Capital Management Pvt. Ltd

ALCHEMY
CAPITAL MANAGEMENT

DISCLAIMER

General Risk factors

All investment products attract various kinds of risks. Please read the relevant Disclosure Document/ Investment Agreement carefully before investing.

General Disclaimers

The information and opinions contained in this report/ presentation have been obtained from sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete.

Information and opinions contained in the report/ presentation are disseminated for the information of authorized recipients only, and are not to be relied upon as advisory or authoritative or taken in substitution for the exercise of due diligence and judgement by any recipient.

The information and opinions are not, and should not be construed as, an offer or solicitation to buy or sell any securities or make any investments.

Nothing contained herein, including past performance, shall constitute any representation or warranty as to future performance.

The services related to Mutual funds, Insurance, Real Estate, Art, Commodity etc. may merely be a referral / advisory services in nature. Such third party investment products or services do attract the general and specific risk factors unique to those respective products or services, which would be mentioned by the manufactures of those products in the respective product documentation. The prospective investors in such third party products are advised to read and understand those risk factors & disclaimers, in addition to what has been stated herein. Alchemy Capital Management Pvt. Ltd., its Group or affiliates have not verified and do not take any responsibility for any statements, numbers or claims made, omitted to be made or implied in any documentation, presentations etc. which have been created by the manufacturers of such third party products or services.

The client is solely responsible for consulting his/her/its own independent advisors as to the legal, tax, accounting and related matters concerning investments and nothing in this document or in any communication shall constitutes such advice.

The client is expected to understand the risk factors associated with investment & act on the information solely on his/her/its own risk. As a condition for providing this information, the client agrees that Alchemy Capital Management Pvt. Ltd., its Group or affiliates makes no representation and shall have no liability in any way arising to them or any other entity for any loss or damage, direct or indirect, arising from the use of this information.

This document and its contents are proprietary information of Alchemy Capital Management Pvt. Ltd and may not be reproduced or otherwise disseminated in whole or in part without the written consent.

Edited by: Naman Dhamija(Ph: +91-22-66171773)
Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-66171700
CIN- U67120MH1999PTC119811, Email ID: contactus@alchemycapital.com