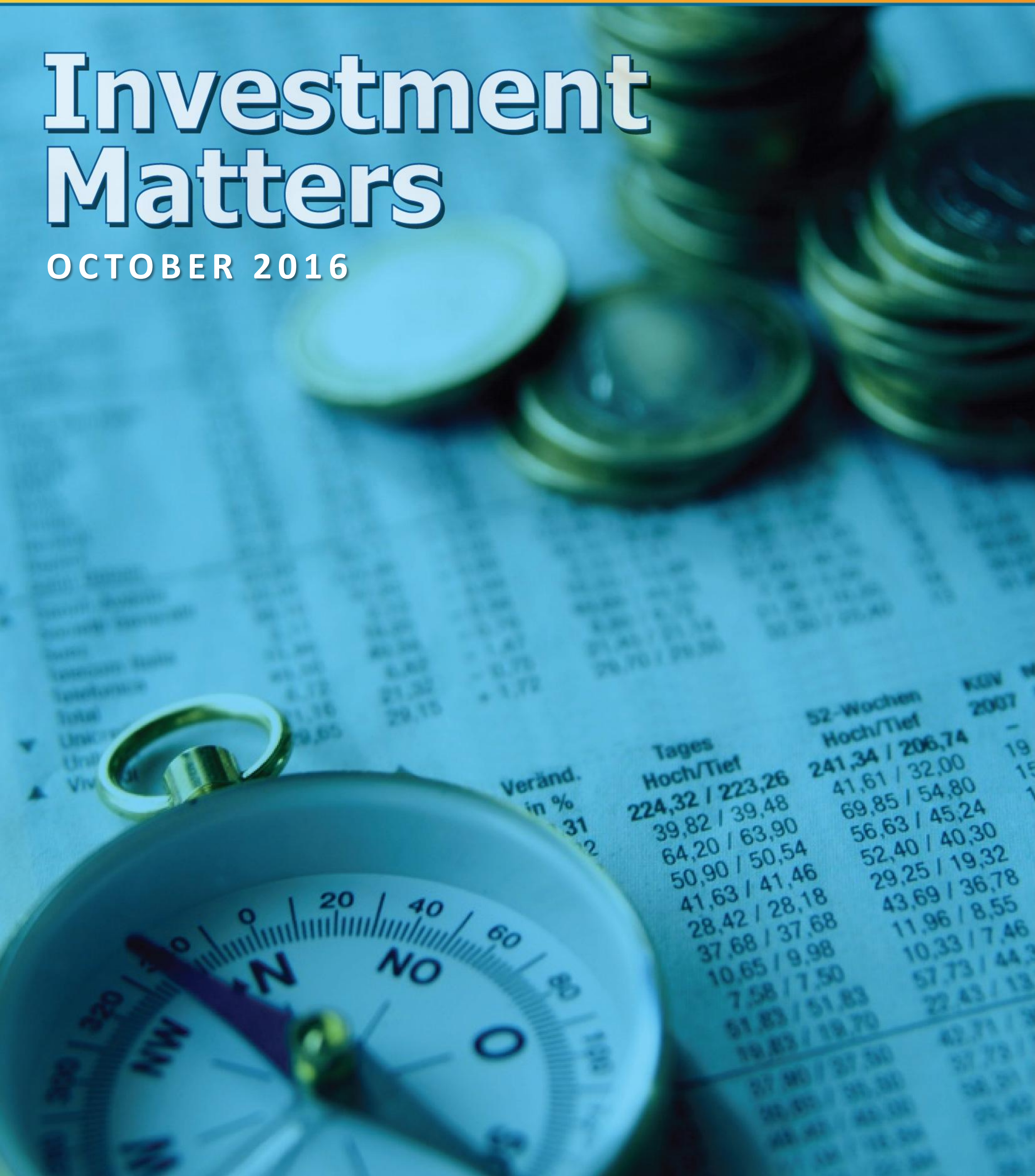
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

OCTOBER 2016



It's all falling into place

It is now proven beyond doubt that India's macro economic situation has indeed improved and stabilised and on that front, we have never had it so good in the recent past.. However, the improvement in macro has happened in the context of low global growth and a world that is in a deleveraging mode, resulting in no great tailwinds for growth in terms of trade/exports. Similarly, the good macros have also taken time to translate into good micros due to a confluence of several factors that we have discussed in the past – leveraged corporate sector, broken PSU bank balance sheets, crackdown on black money and cash economy, savings stuck in illiquid real assets and tight financial and monetary conditions.

However, a sedate micro is all in the base and we are seeing clear signs of a cyclical pick up in the economy led by consumption and government spending. A good monsoon, perhaps the best distribution of rains in several years, and the seventh pay commission payouts are likely to sustain consumption growth. Some of the sheen that the Modi government lost after year one is clawing back as reforms have progressed, notably the passage of GST has brought confidence back – both in government and industry. Another reform which is a game changer and is least talked about is the crop insurance scheme. Our interaction with a very senior farmer leader and other stakeholders in the agri community make us believe that the crop insurance scheme has been a big hit and has the potential to considerably reduce the volatility in income and put some kind of floor to the financial risks they bear due to inclement weather and volatile crop prices. Given the initial success of the DBT (direct benefit transfer) we expect large scale roll out to bring in further efficiencies in subsidy as also to put money directly in the hands of the bottom of the pyramid.

The transition from the ex RBI governor, Mr. Rajan's era to Mr. Urjit Patel's, has been relatively smooth. The read between the lines of the recent 25bps cut by the Monetary Policy Committee driven decision, clearly points to an era of easing financial conditions in India. Mr. Urjit Patel has also signalled that he is likely to take a more practical view of the NPA problem, thereby helping banks to better deal with the situation - thus alleviating the need for further provisioning. The shift in stance on dealing with NPA's (Scheme for Sustainable Structuring of Stressed Assets (**S4**) accounts) is more important than the 25bps rate cut which the bond markets had anticipated well in advance. A stable currency has allowed transmission of lower global rates to seep through into the local economy (Indian corporates have raised US$1bn+ over last two months in Masala bonds as per CLSA Financials Sector Outlook dated 14th September 16) and if this is now coupled with local easing of financial conditions, could be a powerful elixir for improving corporate profitability via lower interest costs and help the deleveraging process.

EQUITY OUTLOOK

The recent attacks by terrorists on an Indian army base in Uri created a flash point between India and Pakistan. PM Modi has tried hard to re-engage diplomatically with Pakistan in the first half of his term. However, persistent violations by the Pakistan army and their sponsored terrorist groups and the groundswell of anger on the latest attack prompted the government to finally give the nod to the Indian army to carry out a surgical attack on terrorist camps in POK. India's aggressive diplomatic efforts to isolate Pakistan and widespread support received, coupled with decisive action, has reinforced PM Modi's image as a tough, decisive leader. This incident has definitely improved his approval ratings and lifted the mood of the nation. We do not believe that the Indian government is interested in escalating tensions as it could potentially lead to a halt in new FDI flows which India desperately needs, and for which PM Modi himself has spent enough time and energy to market India as the most attractive investment destination. This event coupled with the recent finalisation of the 36 Rafale fighter order has given new momentum to the defence industry, a theme we have been quite bullish on for some time now.

Meanwhile, the markets continue to climb a wall of worries ever since Brexit. While most investors are weary about valuations (Nifty is trading at 23.5X P/E as per Bloomberg as on 30th Sept 16), we have to keep in perspective that earnings are at multi year cyclical lows and the cost of capital is falling in India. So in a cyclical recovery phase, valuations will tend to look expensive and probably the near to medium term recovery is already priced in. However, we believe that the long term growth prospects look solid and there are pockets where valuations are still cheap relative to growth if we assume normalised earnings cycle for those businesses. We have tilted our portfolios by increasing weights or including names that will benefit from an earnings and economic recovery, thereby improving the growth and valuation profile of the portfolio.

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