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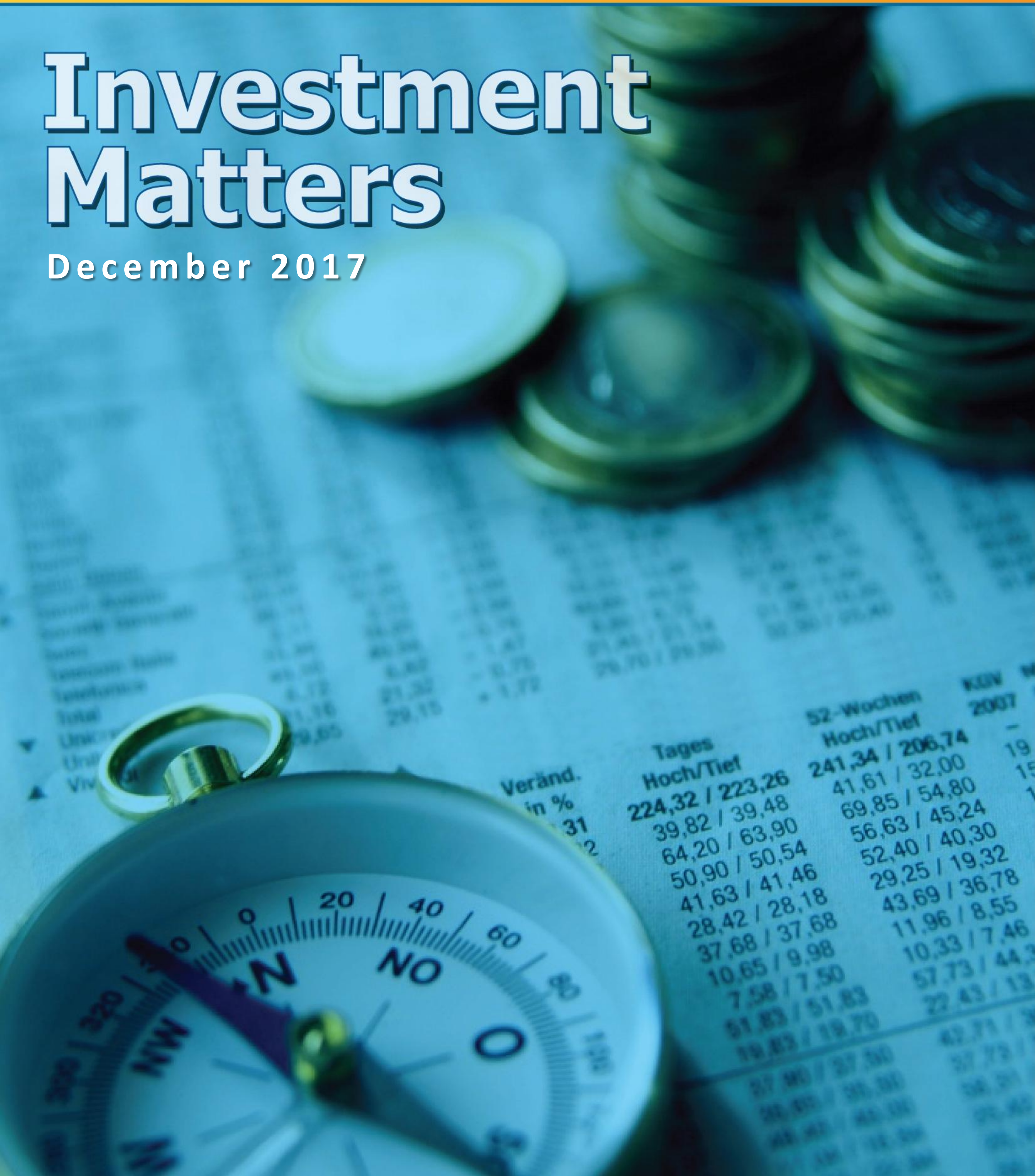
CAPITAL MANAGEMENT

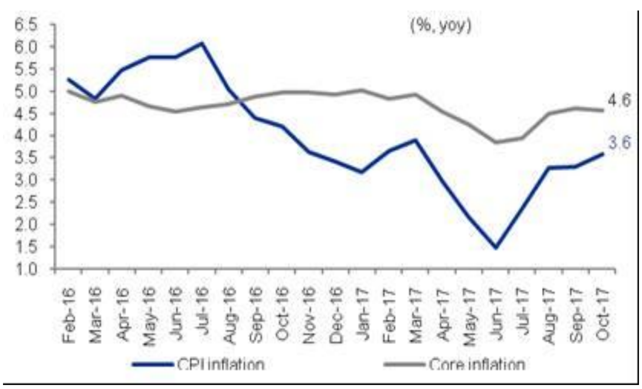
Investment Matters

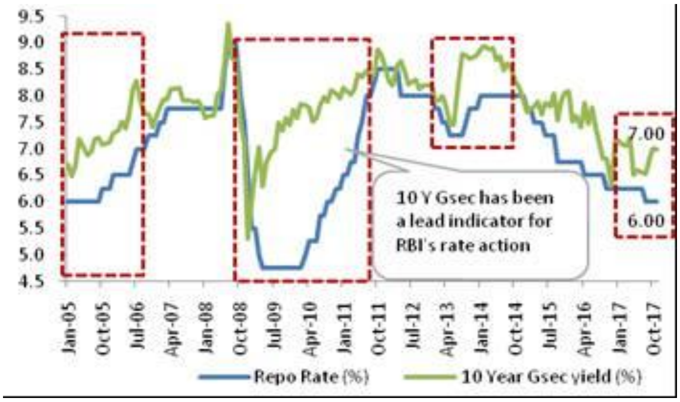
December 2017



EQUITY OUTLOOK

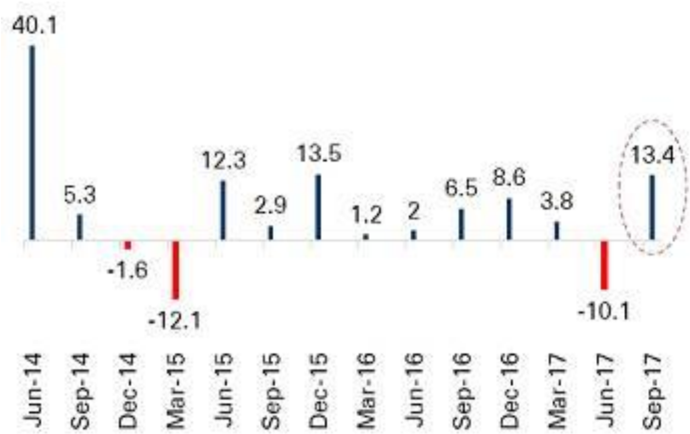
Inflation, Interest rates, Earnings growth and valuations are some of the important indicators tracked by participants on a regular basis to take a view on equity markets. Over the past 4 years, we have had benign inflation and interest rates in India and globally. In 2013, inflation in India stood at 9%+ while current numbers are sub 4%. Similarly, interest rate i.e. 10 year bond yield was close to 9% back then which currently stands at 7%. Developed world fixed income markets are even more stark with 10 year bond yields closer to all time lows between 1% to 2.5%. Fixed income markets have been very supportive of economic growth over the past few years since inflation has been on the lower side and globally central banks have been on a rate cutting cycle to prop up consumption demand. Earnings growth and valuations on the other hand has not been in tandem. Valuations have moved higher specially in CY17 while earnings growth remains on the muted side in India till date.





CY18 is likely to start on a different note, with inflation moving higher from here on. China is likely to be the key reason for this trend. Environmental pollution in China has been severe in recent years and this has led to closure of many basic commodity industries/plants in China including Chemicals – both intermediate and specialty, Steel, Aluminium, Paper, Fibre, etc. Though demand growth remains on the lower side for most commodities, plant closures on a large scale are leading to shortages in many commodities globally leading to a sharp movement in the end product prices. This along with crude prices and food inflation moving higher (though still region specific) is likely to lead to higher inflation going ahead on a low base of previous few years. With inflation moving higher, we have started to see this aspect getting priced in the form of global 10 Year bond yields moving higher by 20-50 bps including in India. If inflation moves towards 5% in India over the next 12 months, then it is very likely that interest rates in India can move up by 50-100 bps. It also means the rate easing cycle in India is over for the next few years.

As with inflation and interest rates, CY18 is likely to start on a positive note for earnings growth in India. On a low base of the previous few years, it is likely that we see Nifty companies reporting a profit growth of 15%+ CAGR for FY19 and FY20. Consensus is expecting a 20%+ CAGR for both the years together. Base effect of demonetisation, positive flow through of implementation of GST and other reforms, higher inflation leading to the need for more working capital, higher nominal GDP growth, pick up in government spending especially on infrastructure, peaking of NPA for banking sector, etc. will all lead to improvement in earnings growth going forward.



However, valuations to a large extent have already priced in this expected improvement and one needs to focus on the sustainability of growth in earnings for returns to sustain in future.

Past experience suggests that sustainable growth in earnings along with positive free cash flow is the biggest driver of equity market returns. Higher inflation rate leading to higher interest rate does impact short term volatility in the markets but does not change the direction of the market, at least in phases where interest rates rise is in its early stage. In fact initial few rate hikes by central bank is generally taken as a positive sign of growth picking up and hence does not impact equity market materially. Choosing the right business for ones' portfolio is the most important criteria for future returns. We at Alchemy Capital have identified select businesses growing at a fast pace available at reasonable valuations. We are optimistic of performance from our investee companies and on an average expect our investee companies to grow profits at a 30%+ CAGR over the next 2 years along with strong free cash generation with some room for valuation rerating going forward.

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