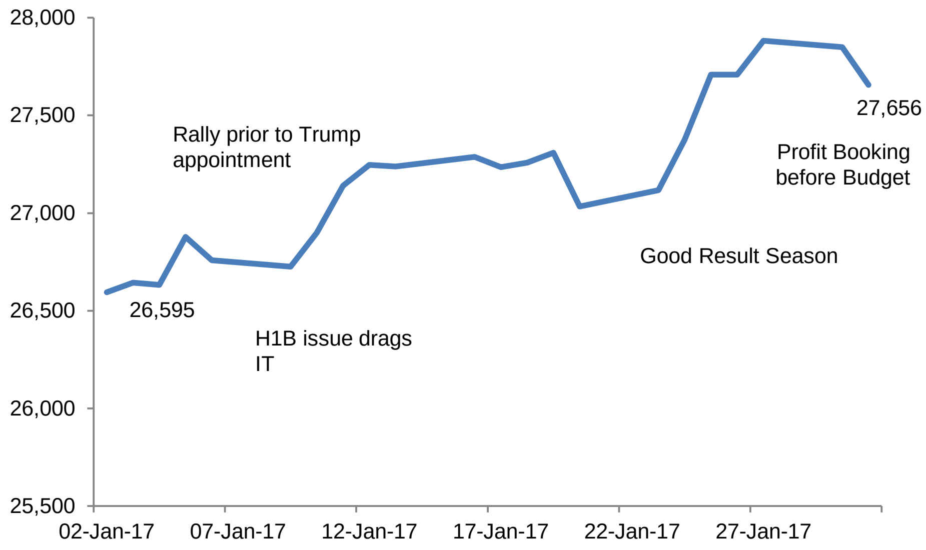
Equity & Debt Strategy

Mid Feb - Mar’2017

Equity Market Update
&
Equity MF Strategy

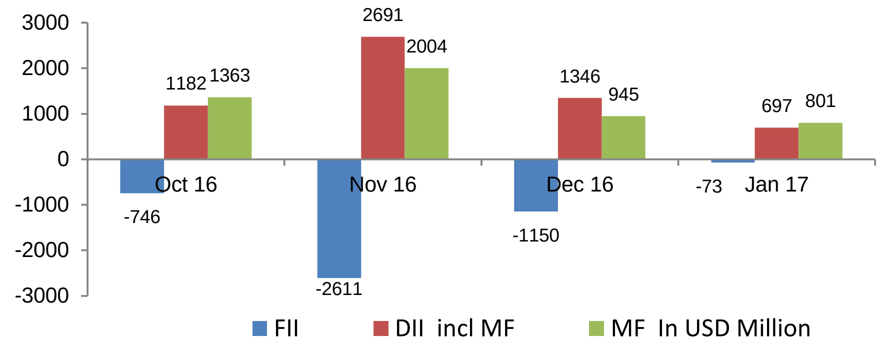
Domestic Flows &
decent initial earnings lift Indian equity market

Sensex rallied as companies posted results not as bad as feared post demonetization

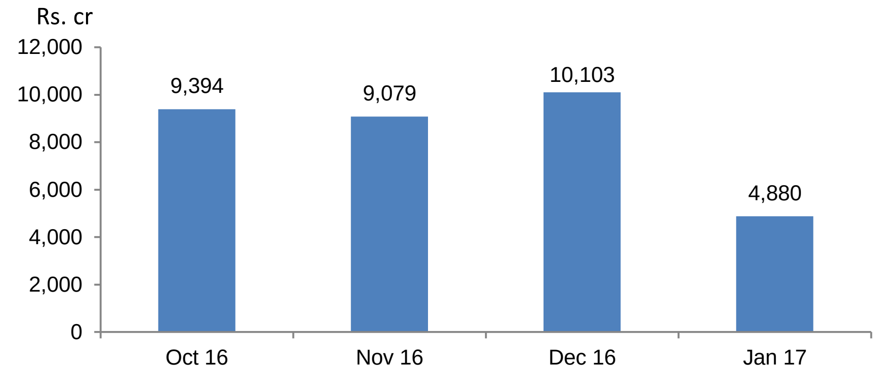


Jan 2017	Sensex	Nifty Mid Cap	BSE Small Cap
1M Return	4.0%	6.4%	6.1%

FII selling stopped in January but MF buying continued



Indian domestic flow to Equity MF decreased before Budget but continue to be strong

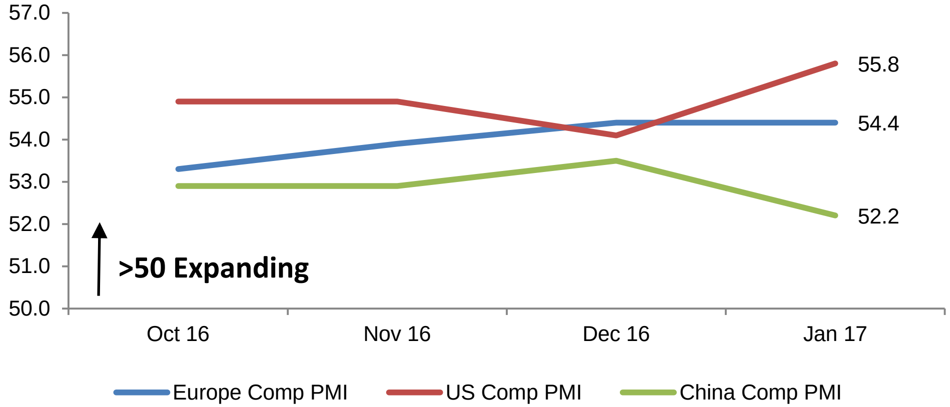


Source: Bloomberg, AMFI, Kotak Institutional Equities (KIE)
YoY% unless specified

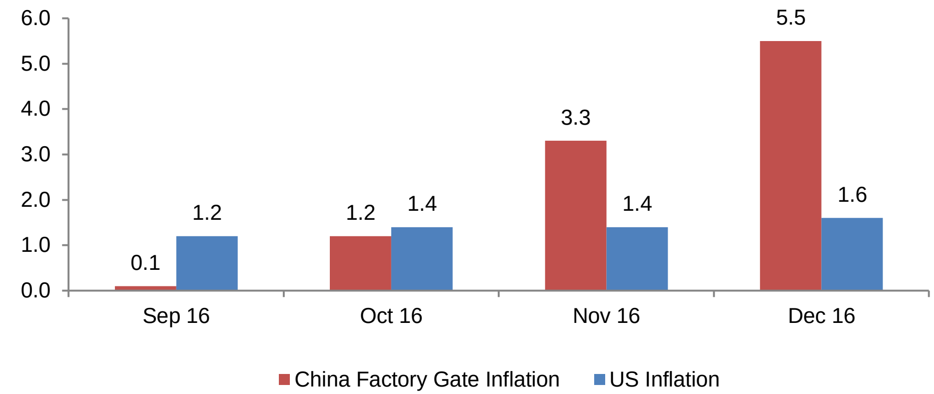
Global economy improving ;

need to watch out for political risks in US & Europe

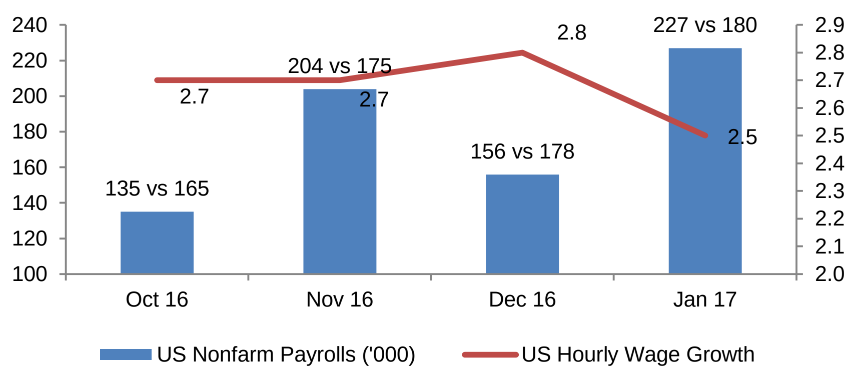
World economic activity is picking up



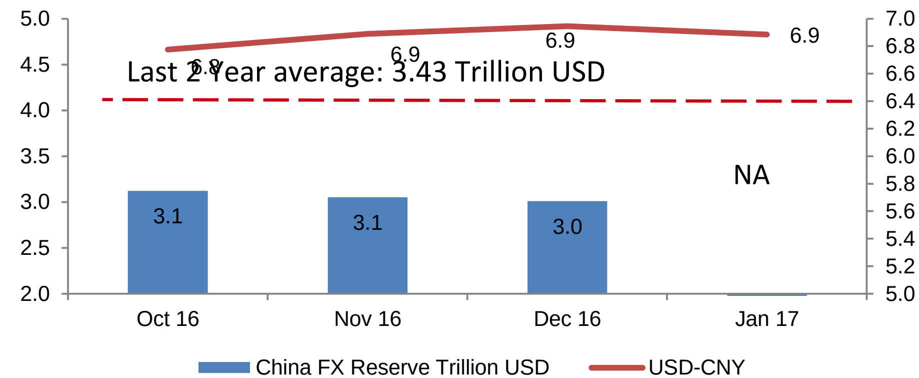
US inflation closer to Fed 2% Target due to rising wages, higher commodity prices and Chinese exports



Wages increased modestly this month but numbers have been strong recently boosting chances of Fed hike



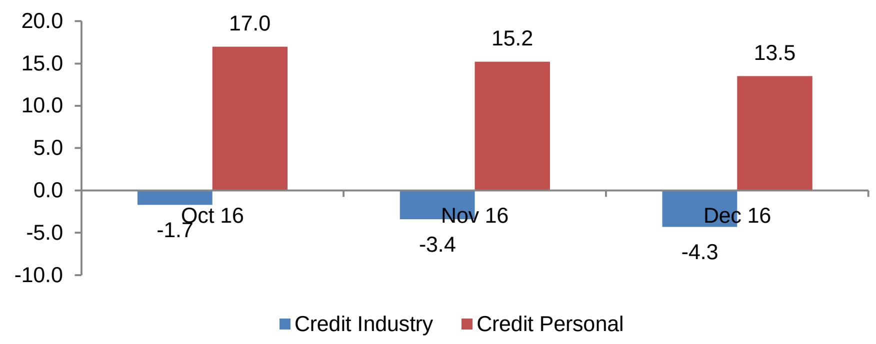
Chinese Yuan was stable as PBOC raised short term rates



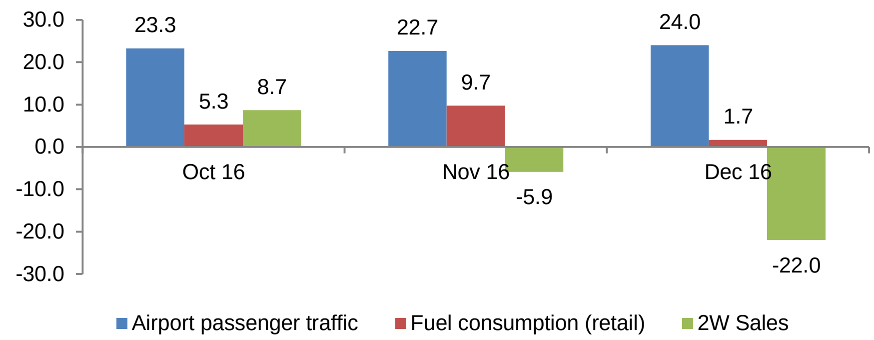
Source: Bloomberg
YoY% unless specified

Consumption bears brunt of Demonetization ; other sectors have been resilient

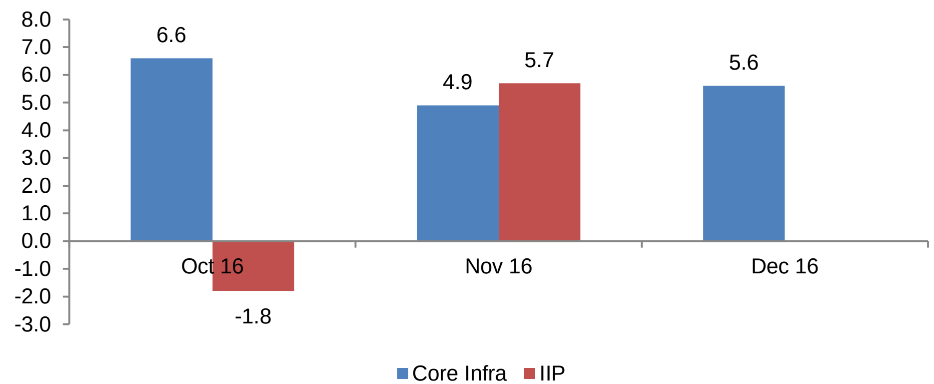
Credit – Industry growth hampered by Demonetization but personal loan growth still high



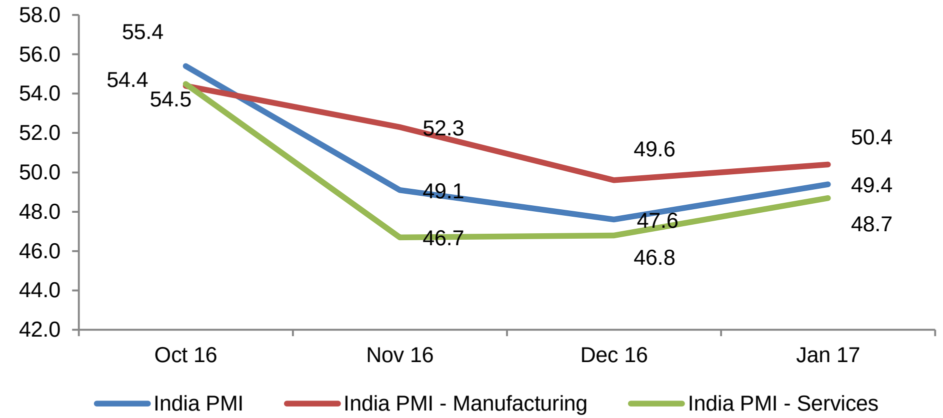
Consumption – Still subdued, air traffic suggests organized sector was not much impacted



Manufacturing – Little impact of Demonetization on manufacturing sector so far



PMI – Manufacturing activity to expand this month



Source: Bloomberg, KIE
YoY% unless specified

Budget 2017 was positive for most sectors

Sector	Key Impact	Overall View
Power	Government to achieve 100% rural electrification by May 1, 2018	**Positive**
Tobacco	Government hikes excise duty on various lengths of cigarettes by 2.5% & 6% but below 10% expectation	**Positive**
Cement and Infra	Government allocated Rs 3.96 lakh cr for infrastructure	**Positive**
Real Estate	Capital gain tax in land and building: Holding period reduced to two years (from three years). Indexation moved from 1981 to 1.4.2001	**Positive for investors**
	Tax benefit on loan repayment of second house will be restricted to Rs 2 lakh per annum. Individual tax payers having loss of more than Rs 2,00,000 will now have a higher tax outgo.	**Negative**
Retail, Automobile and FMCG	Government reduces existing tax rate for personal income of Rs 2.5-5 lakh to 5% from 10% Government raises allocation for MNREGA from Rs 38500 cr in FY17 to Rs 48000 cr in FY18	**Positive**
Banks	Govt. allocated Rs 10,000 cr for recapitalisation of PSU banks Fiscal Deficit target for FY18 set at 3.2% Higher Lending Target under MUDRA	Recapitalization lower than expected, FD target allows room for rate cut **Overall - Positive**

Budget is overall good for most sectors with no negative surprises

Source: KIE

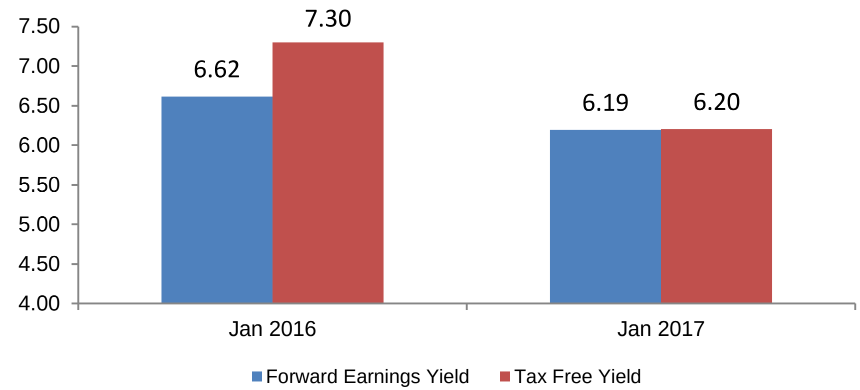
Earnings and Valuation

Expectation of earnings revival again shifts to next fiscal year

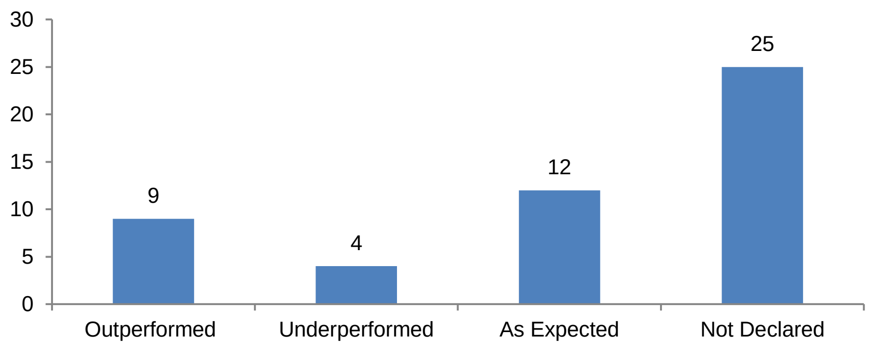
Sensex back to slightly expensive 17x Valuation

Sensex @28500	Current 12M Forward PE		10 Year Average Forward Bloomberg P/E
Valuation	Bloomberg Consensus	KIE Estimate	
Large Cap - Sensex	16.15	17.08	13.92
Mid Cap - Nifty Mid 100	17.17	-	12.68
Large vs Mid Premium	-1.26%	-	10.64%
Sensex FY 17-18 Earnings growth	**18.9%**	**16.0%**	

However there are no other investment alternatives as debt yield is close to earnings yield



Nifty Q3 2017 Results have mostly exceeded expectation



We expect flat growth in Sensex for Q3 2017

Sector/ Index	yoy	qoq
Automobiles	-16.0	-10.9
Banks/Financial Institutions	-5.9	-6.4
Consumer products	-5.1	-4.6
Energy	11.5	-3.4
Technology	0.4	-3.3
BSE-30 Index	1.2	-2.3
BSE-30 Index (ex-energy)	-1.4	-2.0

Source: Bloomberg, KIE Estimates
YoY% unless specified

India Equities: Triggers

Positive Triggers

- **Global Economic data :** World economy improving. Expectation of fiscal stimulus from Republican Government
- **Lower Domestic Interest rates:** Many Banks have cut their MCLR sharply which should help in reviving credit demand
- **Currency Liquidity Improvement:** High pace of currency printing could lead to normality before Mar-17
- **UP Election** Victory for NDA in UP would boost reform policies
- **EM outflow Reversal:** FII outflows have already halted and Lower than expected fiscal expansion from new US Government policies has the possibility of reversing the EM outflow

Risks

- **Higher Crude Prices:** Further sharp up-move could affect our CAD, though inflation could be curtailed by lowering additional excise duties
- **Political Risk:** Victory of Euro-sceptic parties in 2017 General Election in France, Germany, Netherlands
- **Demonetization impact on Banking/NBFC**: Liquidity crunch in Nov, Dec could have led to higher Delinquencies in SME,RE ; Any Irregularities by bank employees during deposits would impact Bank’s P&L
- **US Policies:** Execution of talks of increasing H1B min salary, border tax, Pharma regulations etc.
- **Valuation:** Market has almost discounted Demonetization, any impact on Q4 earnings would hurt given high market valuations

Source: Bloomberg, KIE

India Equities: Valuations & Strategy – Maintain Neutral Stance

At current levels of approx. 28334.25 (10th Feb,2017), Sensex is trading at a 1 year forward PE of 17.2X. Also the ratio of potential upside to downside is at 1.5 : 1.

Risk-Reward Scenario based on earnings growth & valuations:

Sensex @ 26700	Fwd PE(X)	Fwd EPS Estimate	Estimate Target	Sensex Level	% Upside / Downside
1 Year Upside	17.5	1928	Jan-19	33,740	**29.08%**
Downside	15	1643	Jan-18	24,645	**-13.02%**

On a risk-reward basis we continue to maintain Neutral stance

Existing Investments:

- We recommend putting a hold on profit booking

New Deployments:

- **Mutual Funds**: **Invest 33% immediately** and subsequent in tranches via SIPs/STPs

- **Recommended allocation within equity mutual funds is as under:**
  - 100% Large Cap allocation (Prefer Large Caps due to relatively Favorable Valuations)
  - This allocation to Large caps can also be taken through Opportunistic Funds which currently have a bias towards Large cap
  - For investors who want equity exposure but have low appetite for volatility, they can take equity exposure through Balanced Funds. Balanced Funds have 20% to 30% allocated to Debt which provides cushion to the portfolio returns during market volatility.

Source: EPS Estimates by KIE

Debt Market Update
&
Debt MF Strategy

Debt Market: Key Variables

Indicators

Policy Action
- RBI signals end of rate cuts
- Changes stance from accommodative to neutral
- See very little scope of any further rate cuts

10 Year G-Sec Benchmark Yield
- 10 yr yield likely to remain in range
- Range likely to be 6.65% to 6.90%

Liquidity
- Liquidity stands at ~Rs 3 trn & expected to be ample in near term
- MSS Bonds are not being rolled over and reverse repo's being used by RBI to drain the surplus liquidity.

Inflation
- Jan'17 CPI is 3.17% lower than consensus 3.25%
- Inflation to significantly undershoot the RBI's March 17 target of 5%
- RBI to focus on achieving CPI at 4% on durable basis over medium term focusing more on Core Inflation which is sticky

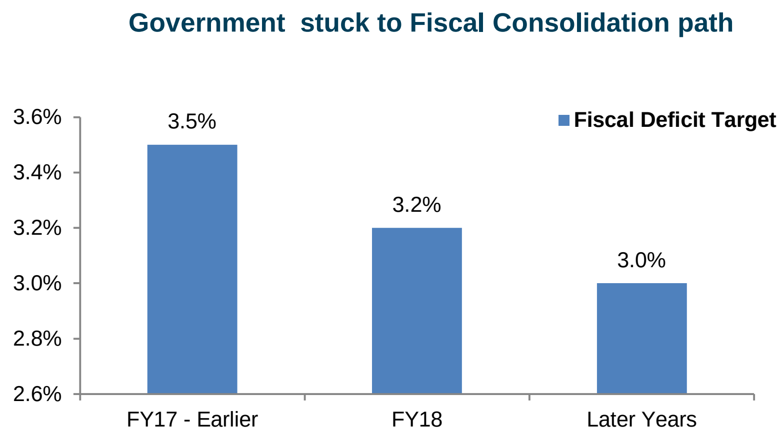
INR
- Gradual depreciation bias expected in coming months

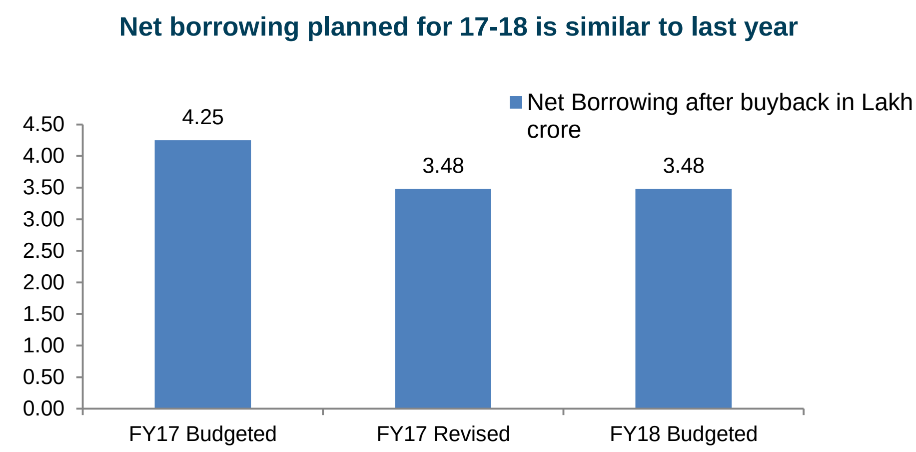
Government Borrowing in FY18
- The gross GSec supply is expected to be Rs. 5.8 trn
- SDL issuance of ~4 trn in next FY vs. ~3.4 trn in17
- Need to be supported by OMO purchases.

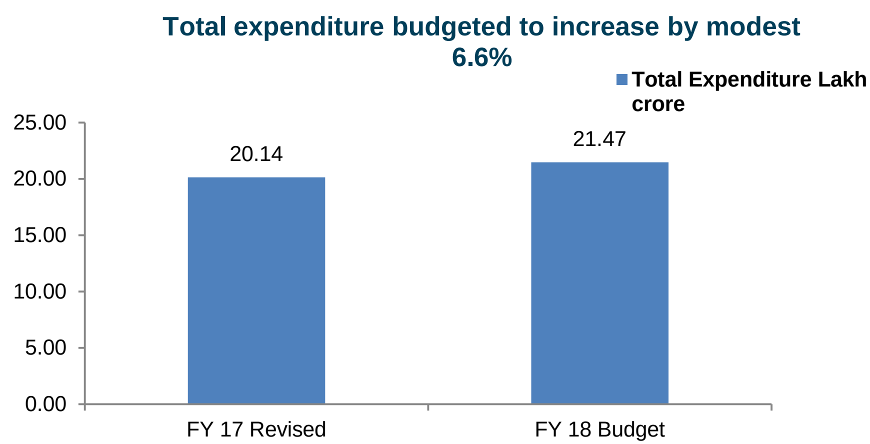
Key Risks
- US policies
- Early or aggressive Fed hikes
- Further strengthening of US Dollar
- Global commodity price escalation including crude

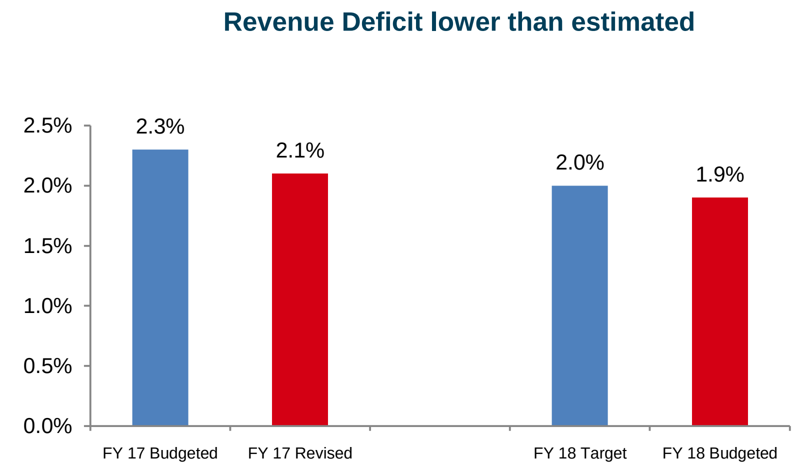
Source: Bloomberg, KIE

Budget FY18 – Fiscal prudence prevails







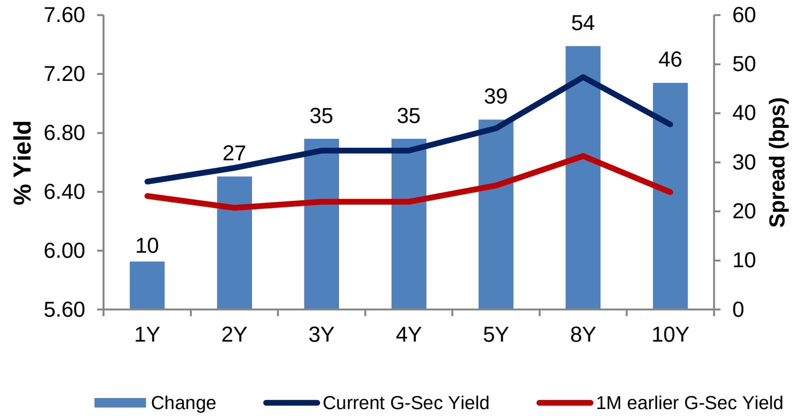


Source: MFI, Bloomberg, Budget 2017

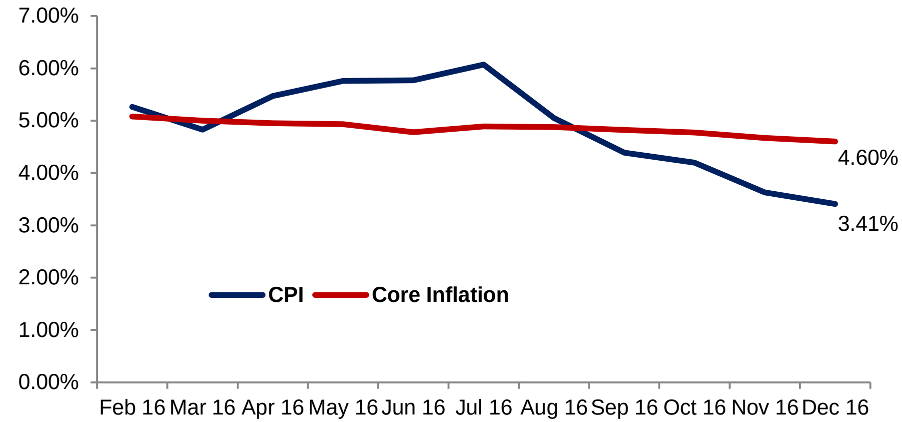
Fundamentals

Hawkish RBI indicative no trigger for rally in bonds

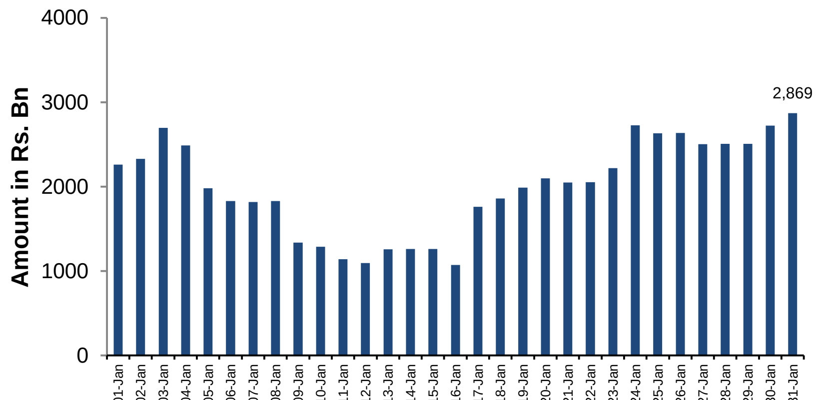
Sovereign Curve steepened after RBI policy



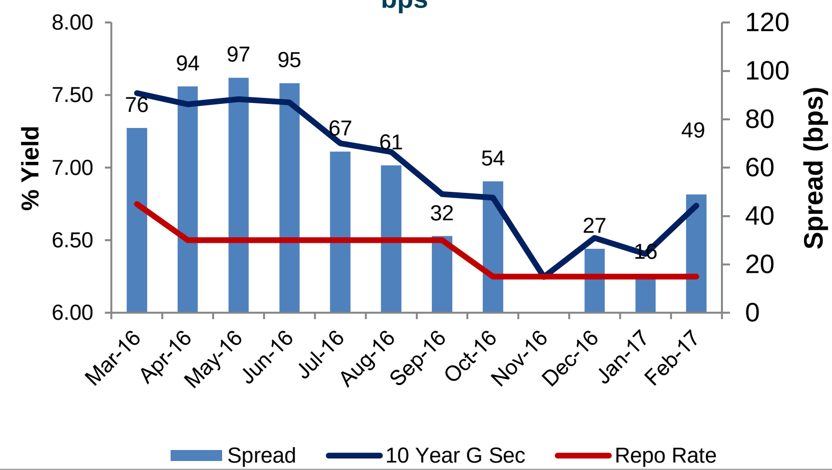
Core Inflation remains sticky



Liquidity likely to remain in surplus



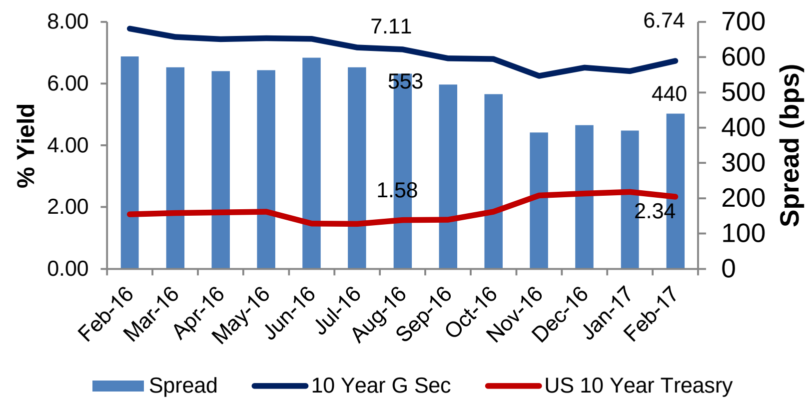
The spread between 10 Yr G-Sec and repo now at 49 bps



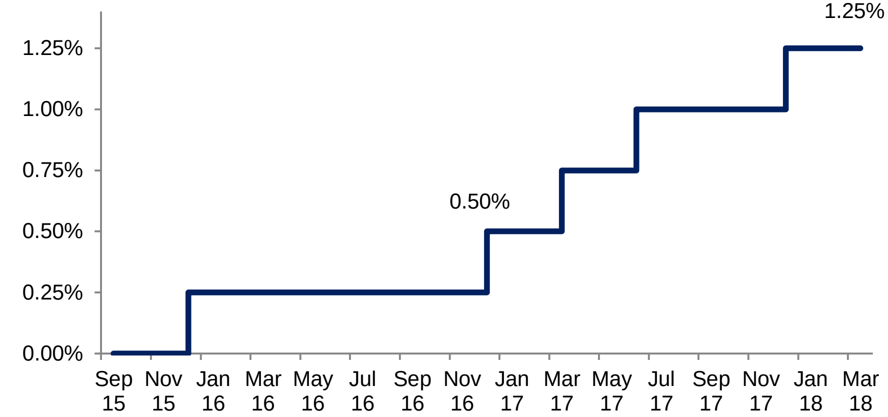
Source: Bloomberg
As of 8th Feb 2017

Fundamentals – External situation warrants caution

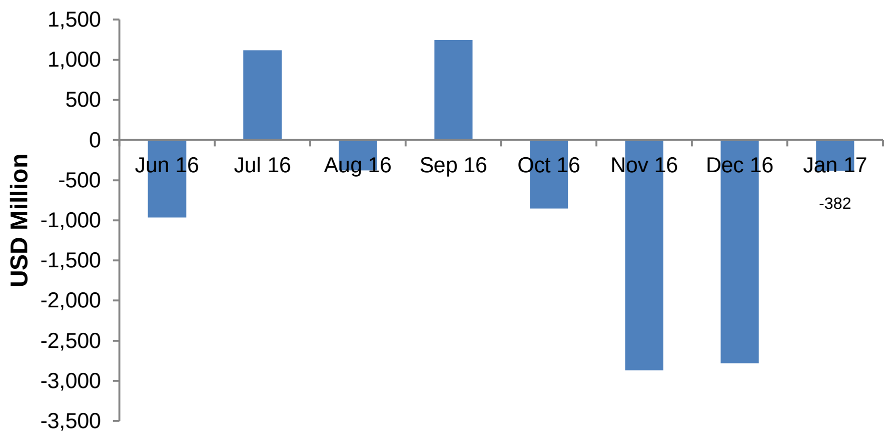
The Spread between India and US 10 year is still significantly below the long term average



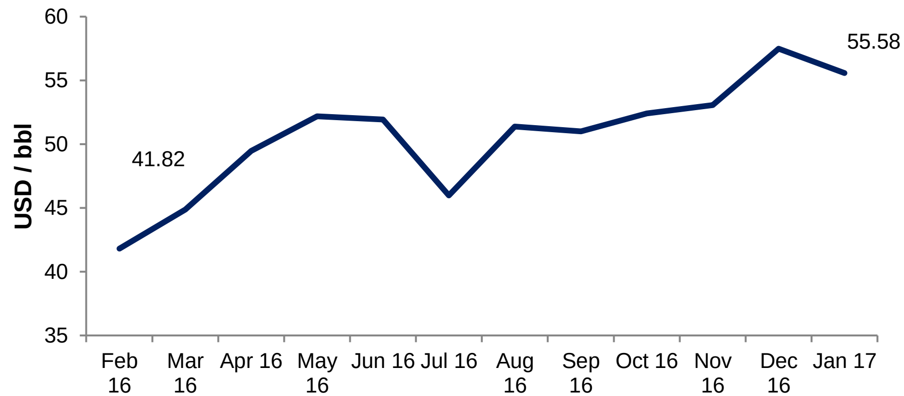
US Fed rate trajectory likely to impact domestic yields



FII's sold debt significantly in last 2 months



Crude has inched up gradually and remains in range



Source: Bloomberg

India Fixed Income: Strategy

Substantial part of the portfolio should to be played through a mix of high rated and credit accrual strategies.

Passive Accrual-Oriented Debt funds – Buy

- High quality portfolios (~100% AAA / Sovereign), **avg. maturities of 3/5/7/10 years,** attractive risk-adjusted returns
- **Portfolio is run on a passive accrual basis** i.e buying a bond and holding it till maturity thereby earning from the accruing of interest
- **Higher predictability of return, lower volatility & lower interest rate risk** if held for the complete term of the portfolio, **open-ended vs. FMPs**
- **More tax-efficient & liquid option** to generate stable returns from high quality debt instruments vs. Direct Bonds / Deposits etc

High Yield Credit-Oriented Funds – Buy

- Low volatility on account of **maturity of portfolio between 3 – 5 years, attractive and stable accrual yields**
- **Strong risk management framework**, sophisticated deal selection & execution and typically superior financing terms
- Experienced teams to carefully evaluate and tightly monitor high yielding debt instruments
- **We believe that this segment will outperform all other segments over next 3 years.**

Short Term Bond Funds – Buy

- **Actively managed** to run a low avg. maturity of 2-3 years, **attractive risk-reward**
- **Lower volatility and interest rate risk** than Dynamic Bond Funds, better suited from a risk-adjusted basis in volatile markets

Continue to recommend ultra short term relative to liquid funds (up to 3 Months)
For short term parking of funds for a minimum of 6 months, Arbitrage funds preferred over ultra short term funds on back of better tax adjusted returns

Source : AMCs, other Financial websites

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