Kotak Mahindra Bank

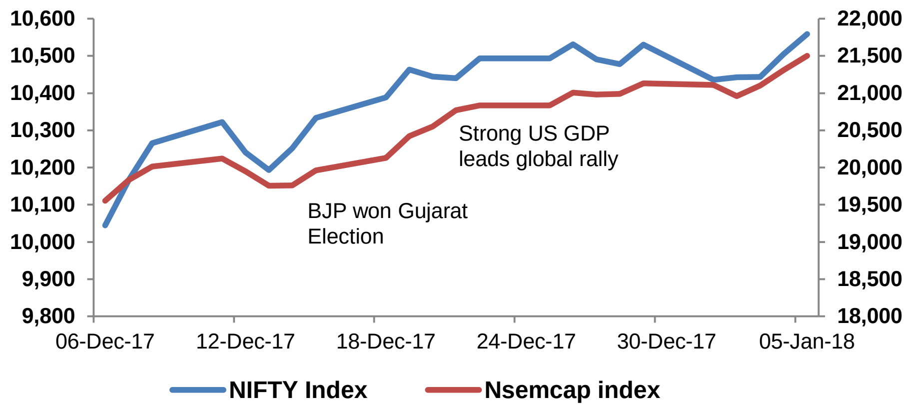
Equity & Debt Strategy

Mid Jan – Feb’ 2018

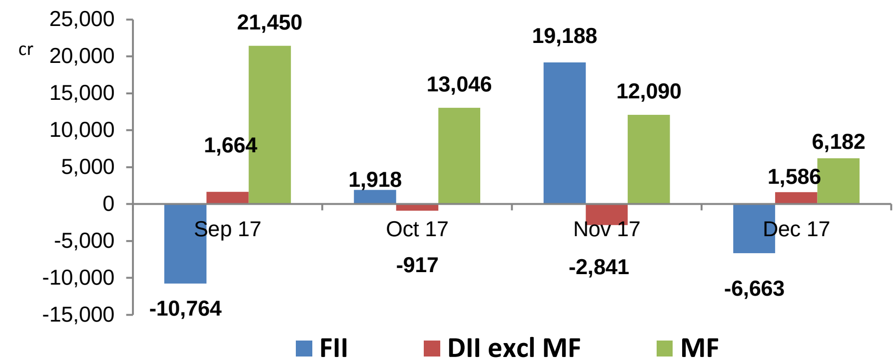
Equity Market Update
&
Equity MF Strategy

Equity market ended 2017 on a high note, Nifty 50 up by 28% in CY17

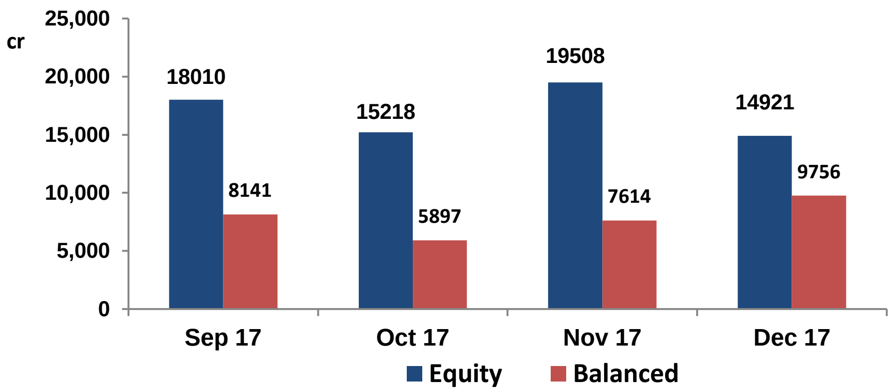
Nifty up 3% in Dec, MidCap Index up 6.2%



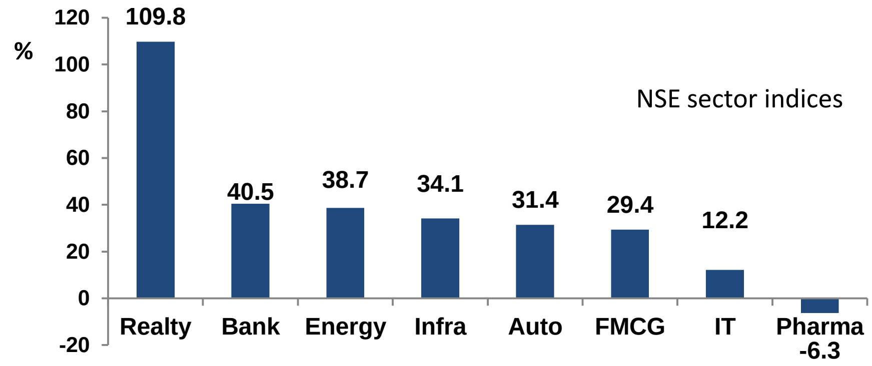
FII flows reversed while MF investments slowed down in Dec



December saw higher contribution through Balanced Funds



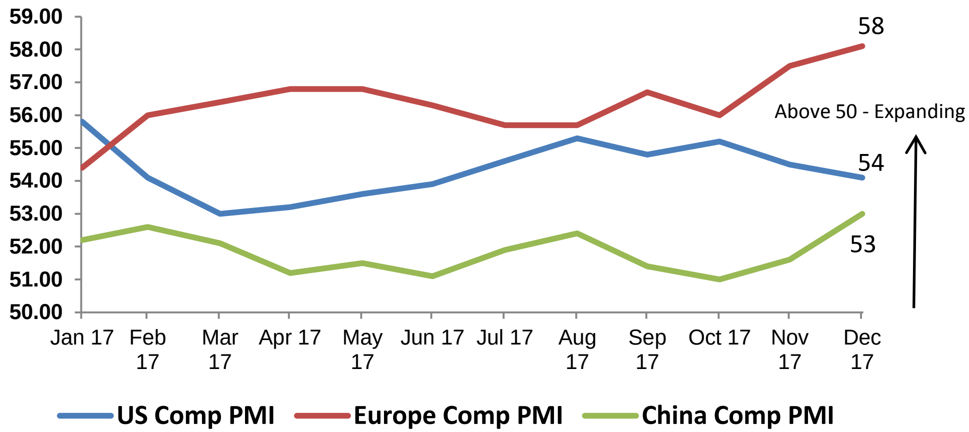
In 2017, sectors which had been lagging like Realty, Energy and Infra did well



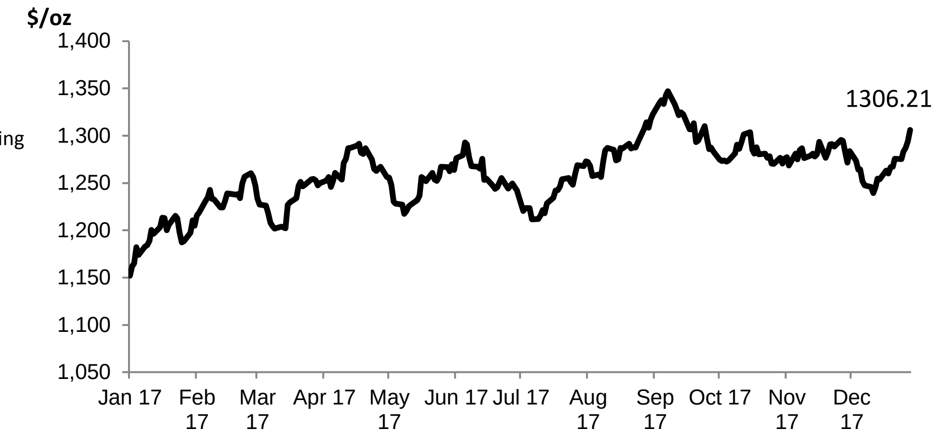
Source: Bloomberg, Kotak Institutional Equities (KIE)
As of 5th Jan 2018

Emerging Markets have benefited from rising global demand and weak USD

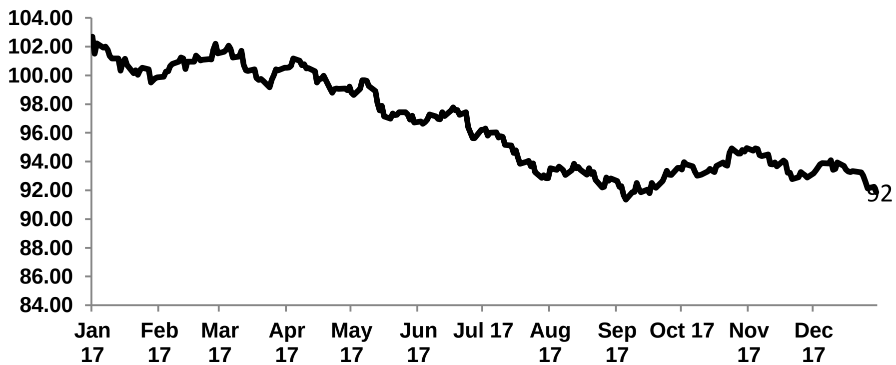
World Economy has been expanding in 2017



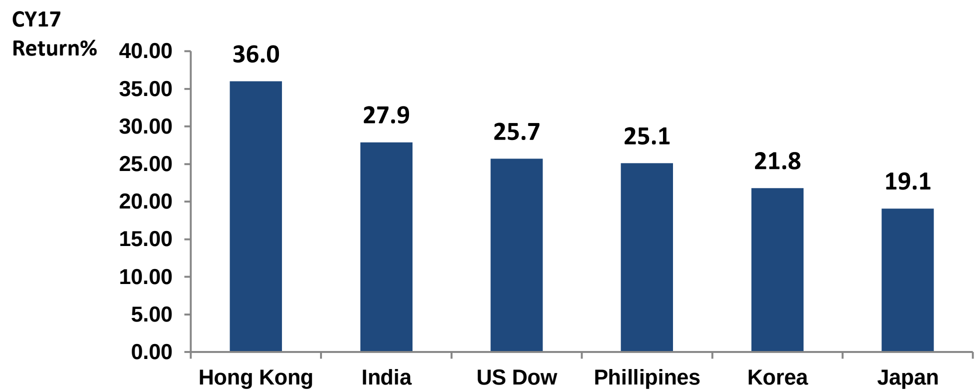
Other than Equities, even Gold was up 13%



US Dollar has remained under pressure despite decent US data



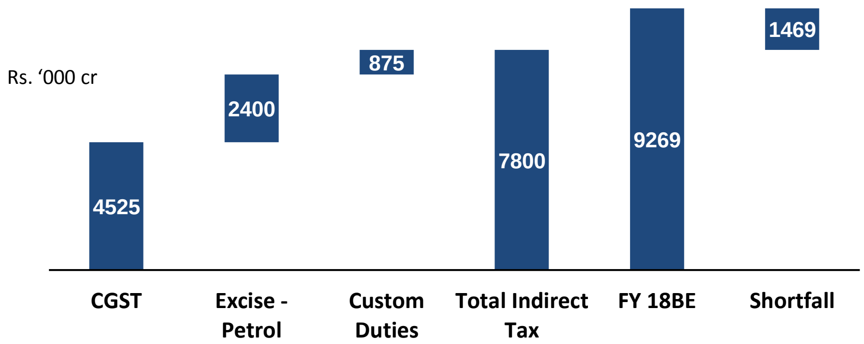
Weak dollar has helped fuel Emerging marker rally globally



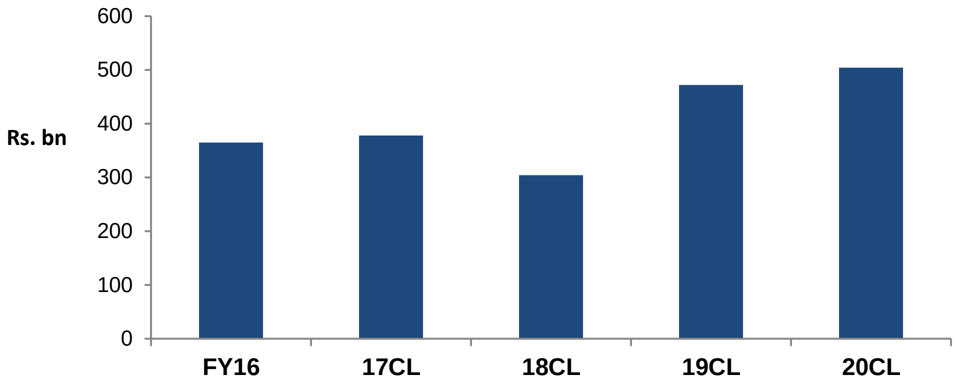
Source: Bloomberg

Equity Markets Trends

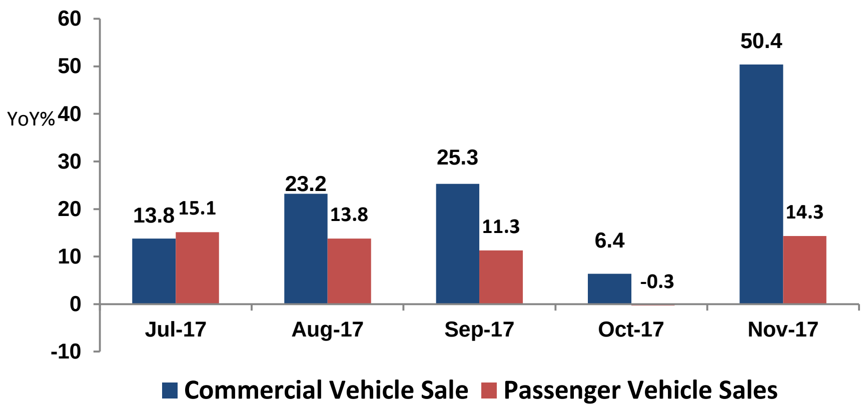
Based on current run rate, Government is expected to have 1% of GDP shortfall in indirect tax collection



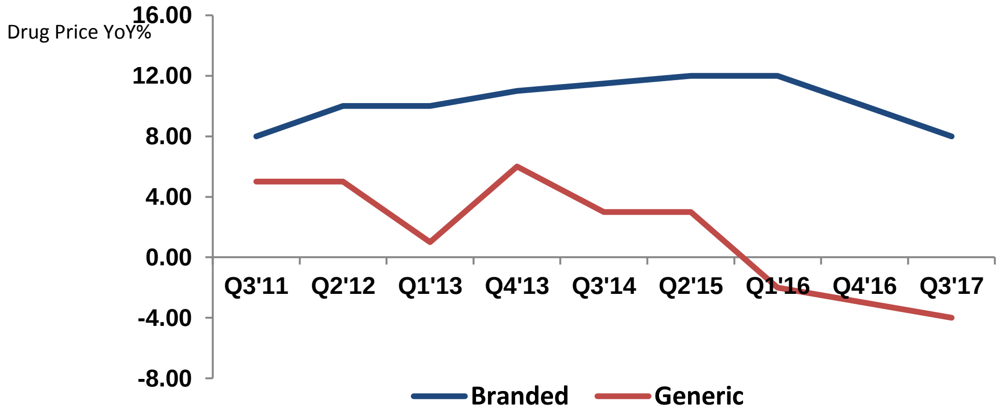
Metal companies are likely to restart private capex, cement and power might follow



Auto Sales have been rising at high pace reflecting strong consumer sentiment and demand



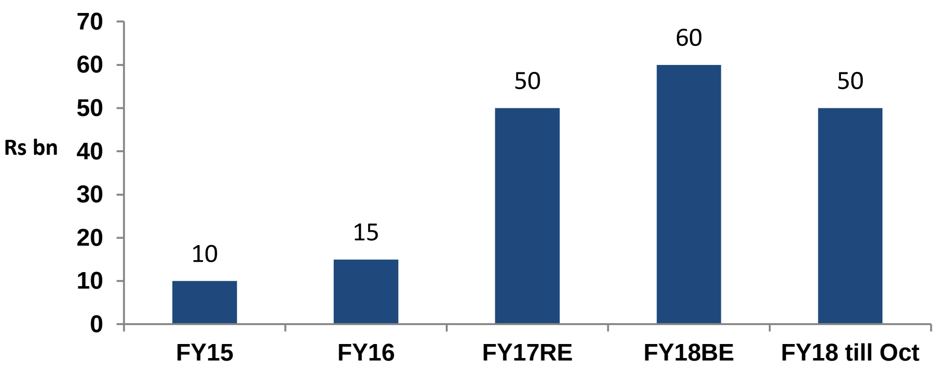
Intense pricing pressure in USA due to customer consolidation is leading to consolidation in US generic space (eg. Teva)



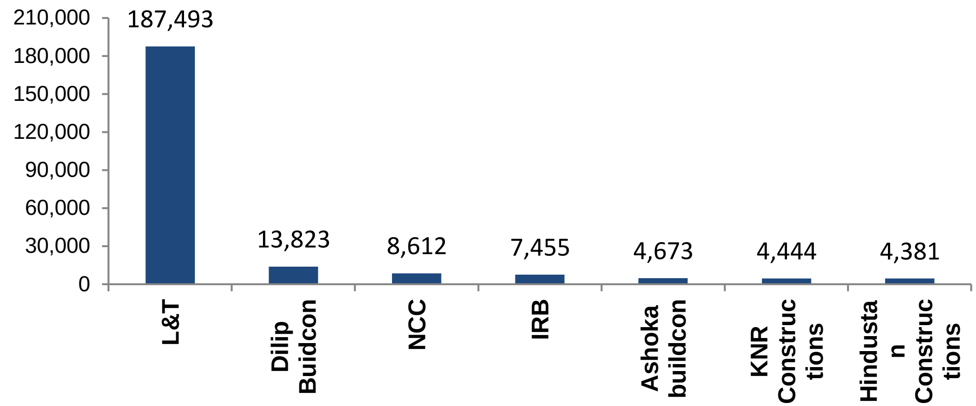
Source: KIE, CLSA

Opportunity in Infrastructure

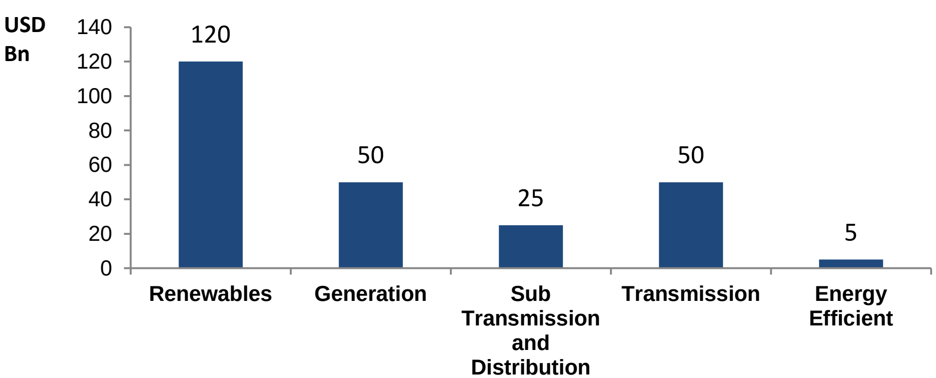
Government had planned higher spend for Affordable Housing and has spent a large proportion already



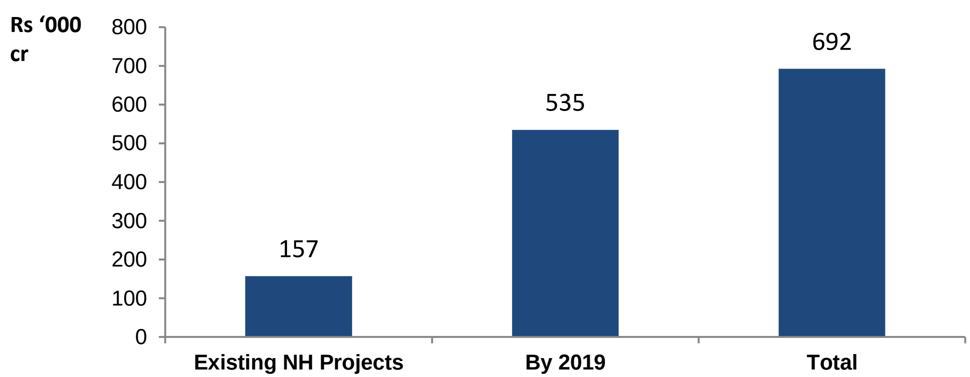
After L&T , 2nd highest EPC player has a market cap of only 14k cr



Government's "Power for All" initiative will pay out $250bn in capex with $50bn opportunity in Transmission by FY22



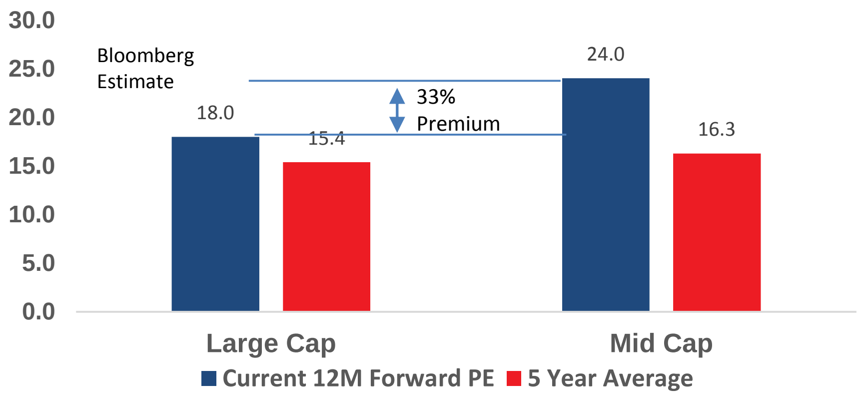
Government has announced 6.92 lk crore spend on roads under "Bharatmala" project by 2022



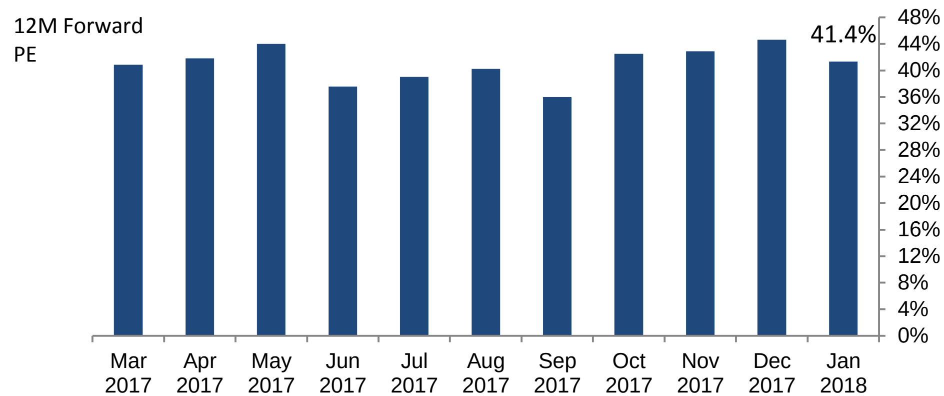
Source: Blooomberg, CLSA, Ministry of Power

Earnings and Valuation –
Liquidity and Hope of strong Earnings growth has led to slightly expensive valuations

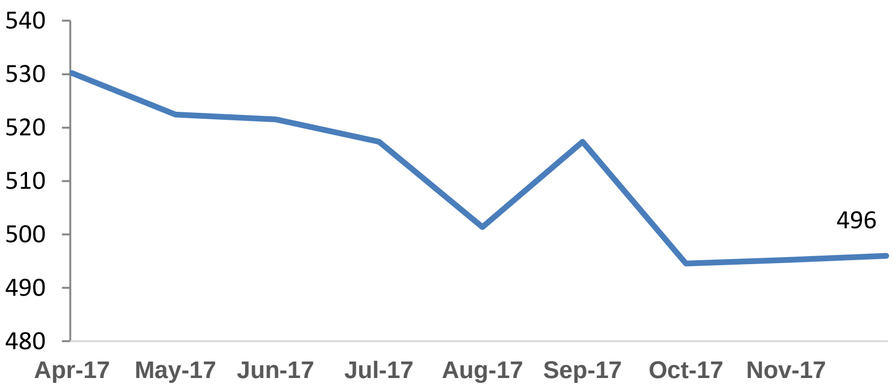
Mid Cap Index consensus earnings expectation has seen recent downgrade leading to widening premium over large cap



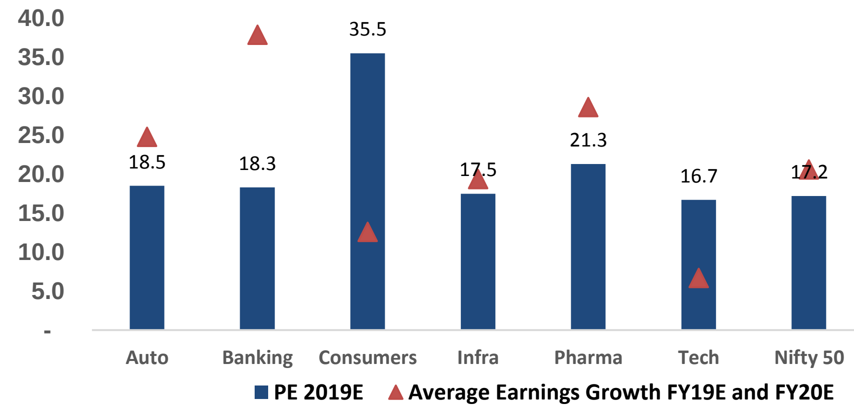
MSCI India P/E Premium over MSCI EM is above long term average of 35-40% despite broad rally in EMs



Bloomberg Consensus FY18 Nifty earnings cut have slowed down recently



Infra looks attractive in terms of valuation, Consumers most expensive



Source: Bloomberg

Actual/Expected >1.05 – Better , Actual/Expected <0.95 - Worse

Key Triggers – Resolution of NPA & Earnings

Positive Triggers

- **Global Demand:** GDP growth strong in US and Europe, exports oriented sectors can benefit
- **Commodity Prices:** Sustained high prices is expected to lead to high earnings growth in Steel/Oil sector and thus indirectly benefit Banks on NPA issues
- **Resolution of NPA:** Effective addressal and high recovery rates of NCLT cases will be positive for Banks
- **Weaker Rupee:** Benefit IT and Pharma
- **Lower Corporate Tax:** Talks of lowering tax rate in next Budget
- **Government Capex:** Government might increase spending irrespective of fiscal concerns ahead of General Election

Risks

- **Outflow from EMs:** US tax reforms could again trigger capital flight back from EM to US
- **Earnings:** Consensus expected earnings growth for domestic equities is high at around 15-20%, any downgrade would make the valuations more expensive
- **Geo-Political Risk:** Uncertainty in Middle East, North Korea
- **Monetary Policy:** Faster than expected monetary tightening in Europe and US
- **Economy Slowdown:** Economy has been suffering for last 1 year and none of the economic indicators have shown signs of recovery yet
- **Changes in Budget:** Government could introduce LTCG tax on equity due to revenue shortfall post lower than expected GST collection

India Equities: Valuations & Strategy – Maintain Neutral Stance

For the month of December, Indian Equity markets continued its rally to make new life-time highs on the back of BJP's win in key states of Gujarat and Himachal Pradesh. With this gain, equity markets have locked in a gain of ~28% for calendar year 2017. Inflows by mutual funds also continued post a small dip seen last month.

At current levels of approx. 10,637 (10th January, 2018), Nifty is trading at a 1 year forward PE of 19X. In the current scenario, **we continue to maintain a Neutral stance**.

Mutual Funds: As domestic liquidity continues to drive markets, we advise new investments in Mutual Funds to be deployed 25% in lumpsum 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 around 25% to 30% of their portfolio into Debt instruments which provides cushion to the portfolio return during market volatility.

Source: EPS Estimates by KIE

Debt Market Update
&
Debt MF Strategy

Debt Market: Key Variables

Indicators

Policy Action
- For now, the rate cut cycle seems over
- Tone of the policy seemed neutral but with caution on inflation

10 Year G-Sec Benchmark Yield
- Near term upward pressure, can settle lower

Liquidity
- Liquidity surplus has reduced significantly
- Expected to drift towards neutrality

Inflation
- CPI inched up to 4.88% in Nov 2017, higher than RBI forecast
- RBI increased CPI forecast by 10 bps to 4.3%-4.7% for 2HFY18
- We expect CPI to remain firm at around 5% by Mar 2018

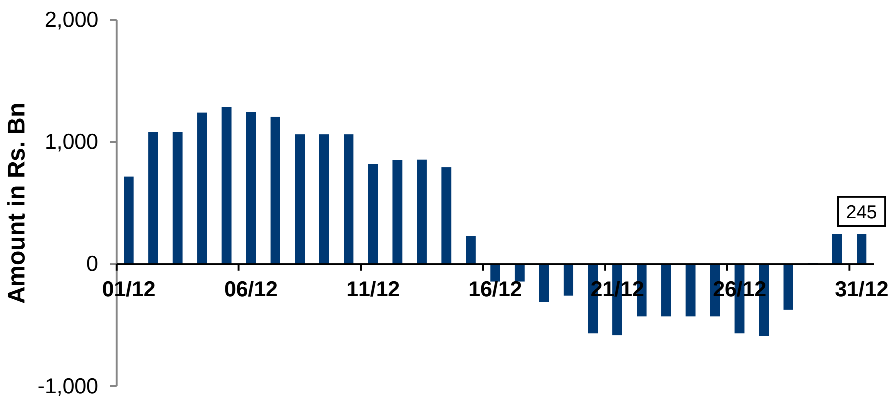
INR
- INR to remain stable relative to remaining EM universe
- Expect mild depreciation towards 65.5 over 1 Year
- Broad range of 63-66 to hold

G-Sec Supply
- Additional borrowing of INR 50,000 cr announced
- Higher borrowing could lead to slippage in fiscal deficit to the tune of upto 50 bps
- SDL supply for Jan - Mar quarter at INR 1.3 Lac Crs

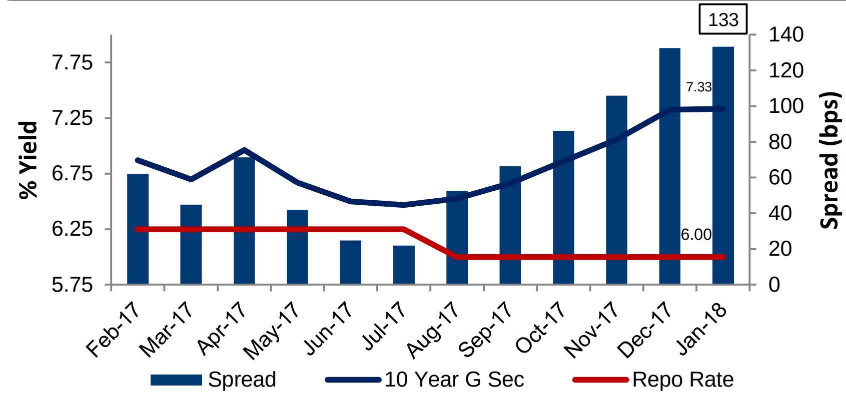
Key Risks
- Global monetary tightening
- Strengthening Crude Prices
- Impact of GST revenues and spending on Fiscal Deficit
- Higher inflation print

Yields have spiked over concerns on Fiscal Deficit, rising core inflation and falling Liquidity

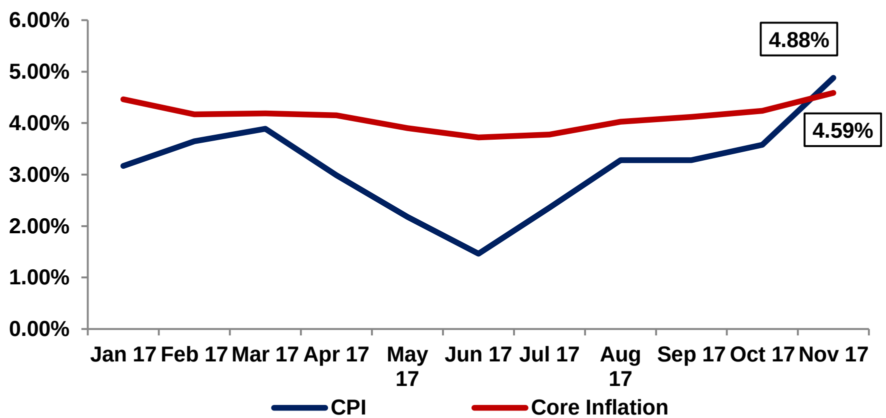
Liquidity back to neutral level near quarter end



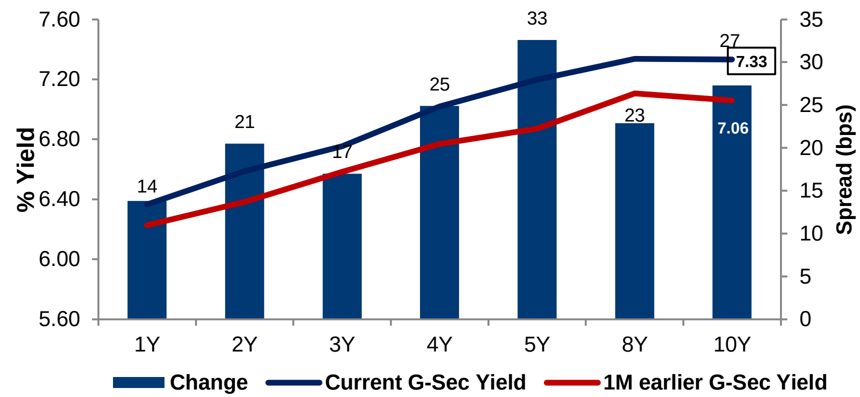
G Sec Spread over Repo near highest in last 1 Year over fiscal and inflation concerns



Core inflation is inching up



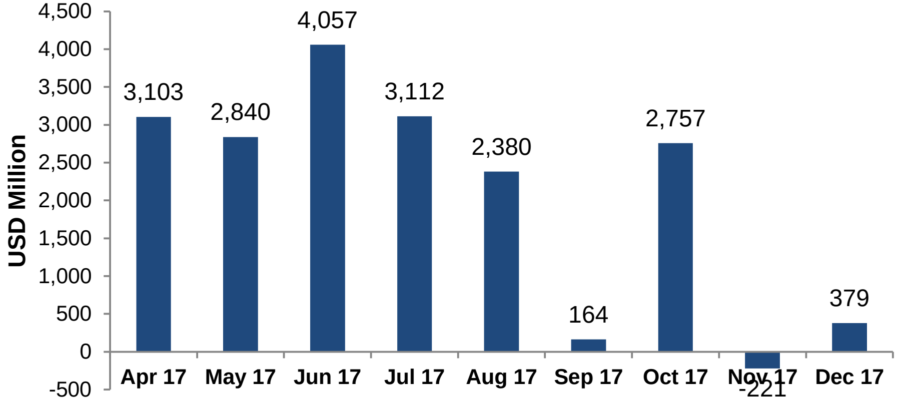
G Sec yields rose across the curve



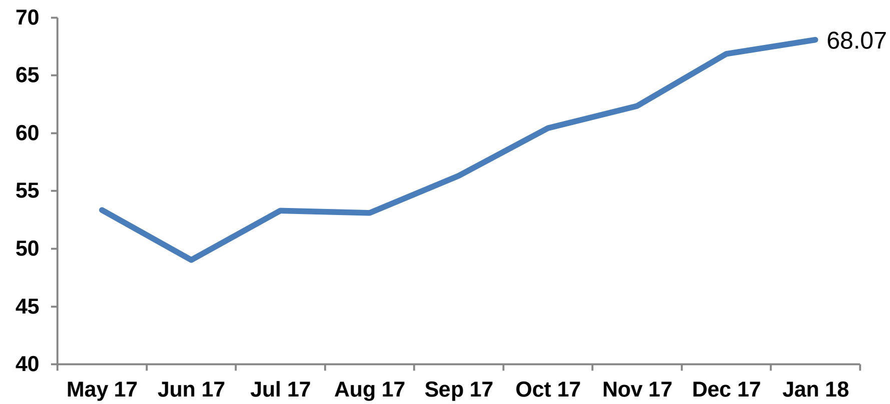
Note: As of 4th Jan 2018, Source Bloomberg

Indian Bonds are still attractive to Foreign Investors however limits are almost utilized

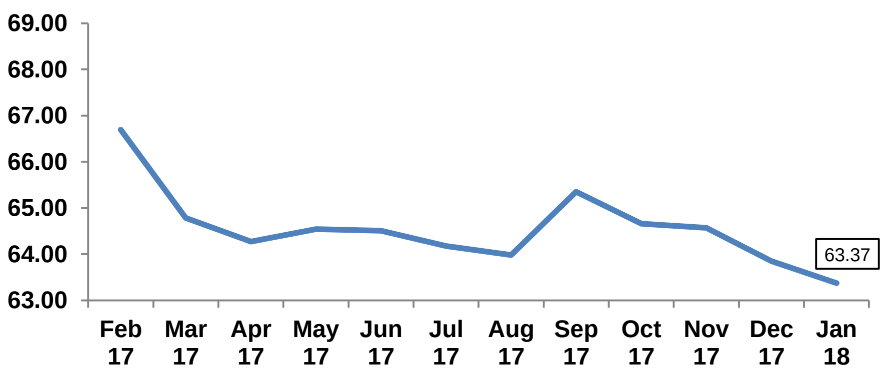
FIIs buying has slowed down despite Moody's upgrade since Utilization level is near 100%, CYTD $23bn inflow from FIIs



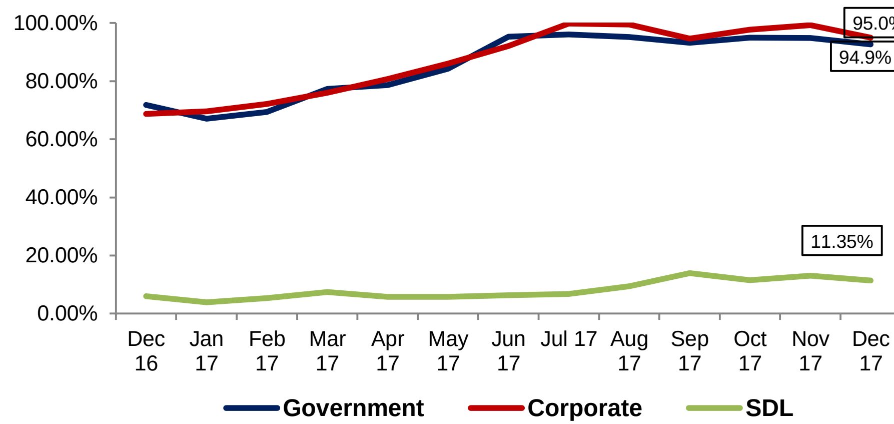
Crude prices have increased over events in Iran



Indian currency has gained on global Dollar weakness



FII Debt Utilization in GSecs and Corporate near 100%



Note: As of 4th Jan 2018, Source Bloomberg

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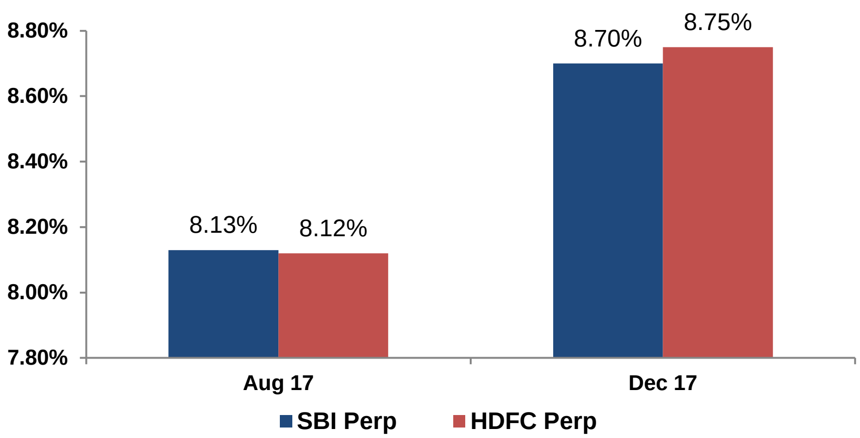
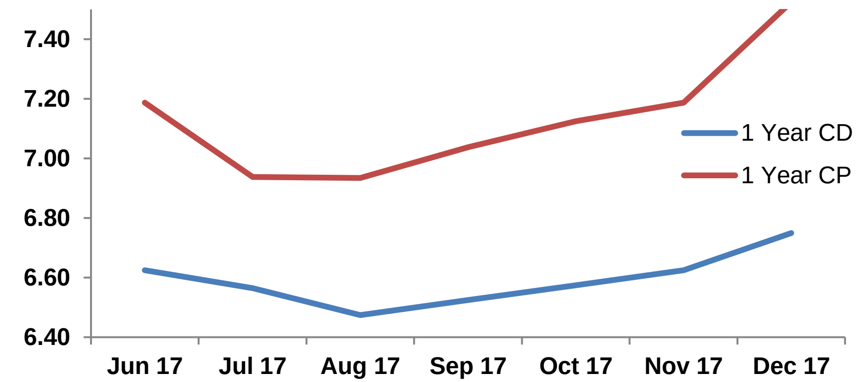
Debt Market Trends

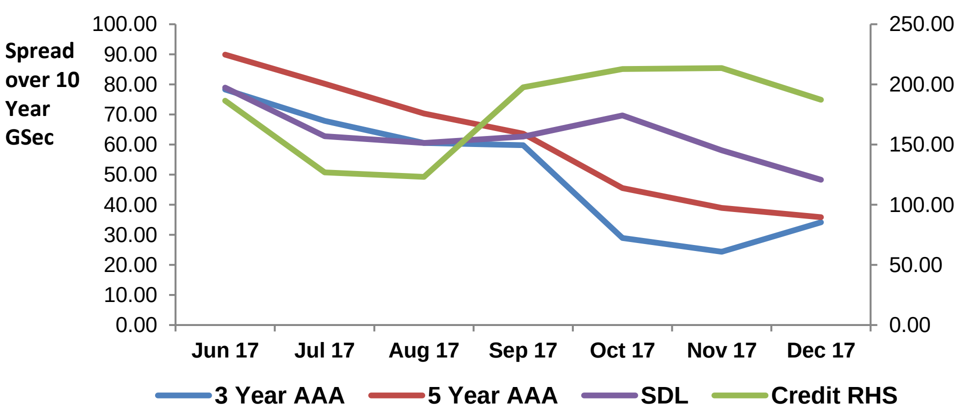
Perpetual Bond yields have become attractive



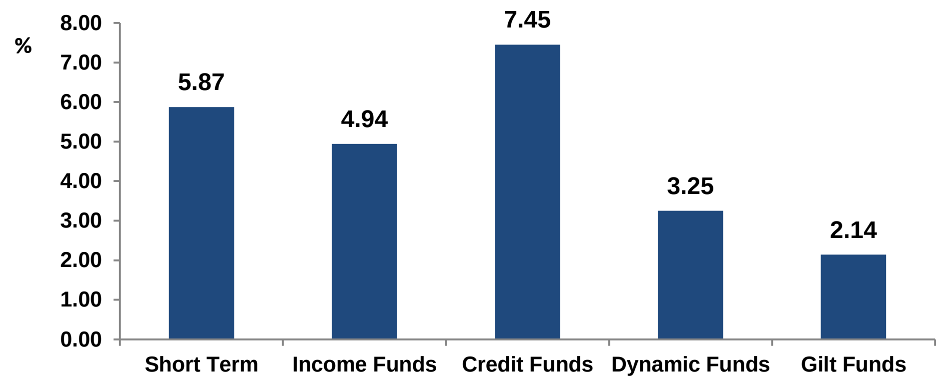
CD and CP yields have spiked due to falling Liquidity leading to underperformance in Ultra Short Term Funds



AAA Corporate Curve spreads over GSec have reduced significantly in last few months



In 2017, Credit Funds were the best performers, Gilt Funds were the worst performers with just 2% return



Note: As of 31st Dec 2017, Source Bloomberg, MFI

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India Fixed Income: Strategy

Substantial part of the portfolio should be deployed through a mix of high rated and credit accrual strategies. Exit from duration funds only for investors who have completed 3 years and can deploy with another 3 years view.

Investment Focus:

Passive Accrual-Oriented Debt funds

- High quality portfolios (~100% AAA / Sovereign)
- 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

High Yield Credit-Oriented Funds

- Low volatility on account of maturity of portfolio between 3 – 5 years, attractive and stable accrual yields
- Experienced teams to carefully evaluate and tightly monitor high yielding debt instruments

Short Term Bond Funds

- 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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