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Kotak Mahindra Bank

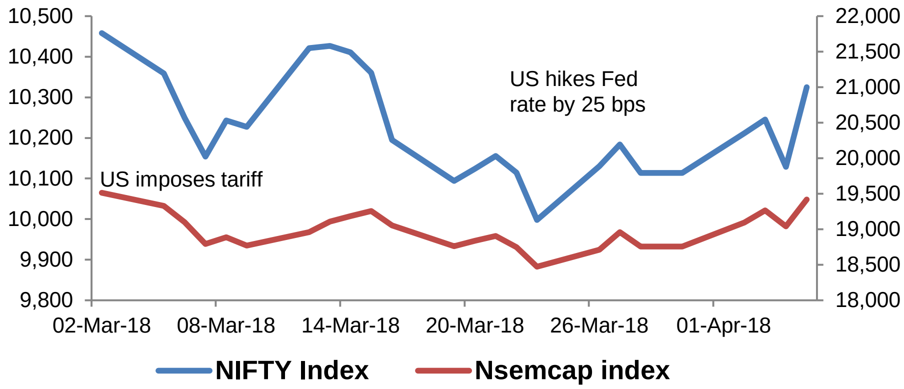
Equity & Debt Strategy

Mid Apr – May’ 2018

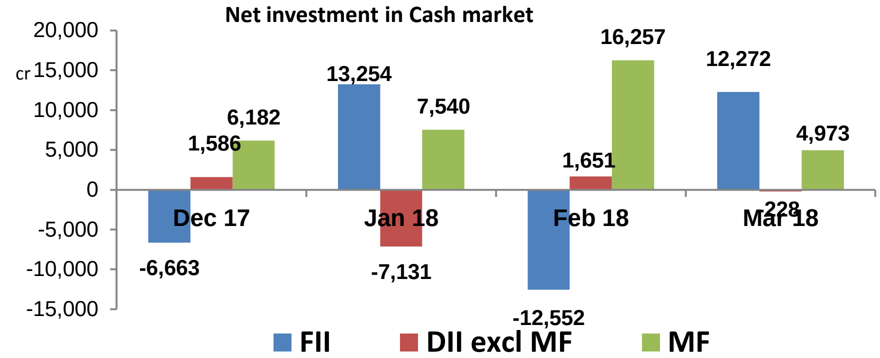
Equity Market Update
&
Equity MF Strategy

Equity markets corrected in Mar on global cues and selling pressure in Mutual Funds due to Dividend payouts

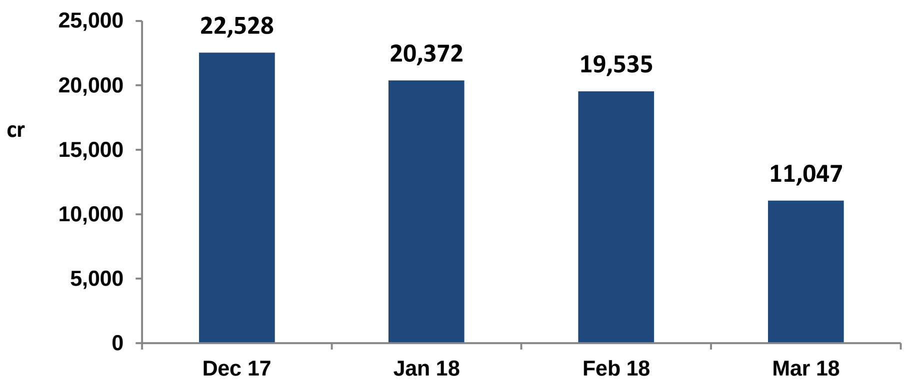
Nifty 50 and Midcap 100 corrected by 3.6% and 4.6% in March on global cues



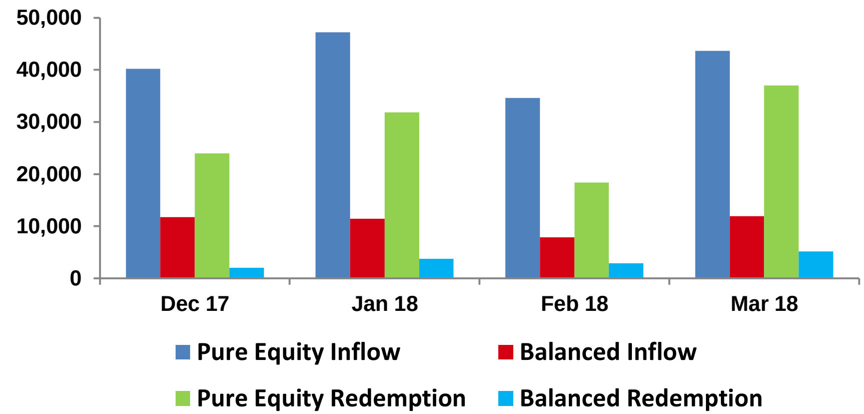
FII selling was concentrated in Derivatives market, MF flow was subdued



Flows to Equity Mutual Funds fell significantly in Mar 2018



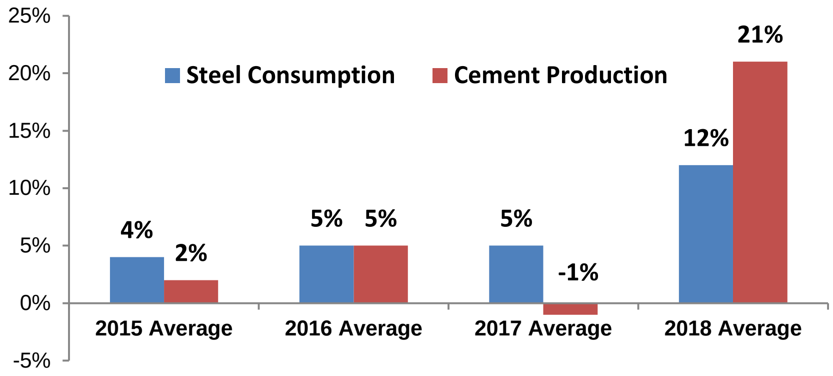
March net inflow was lower due to higher redemptions in both Pure Equity and Balanced funds possibly due to Dividend payouts



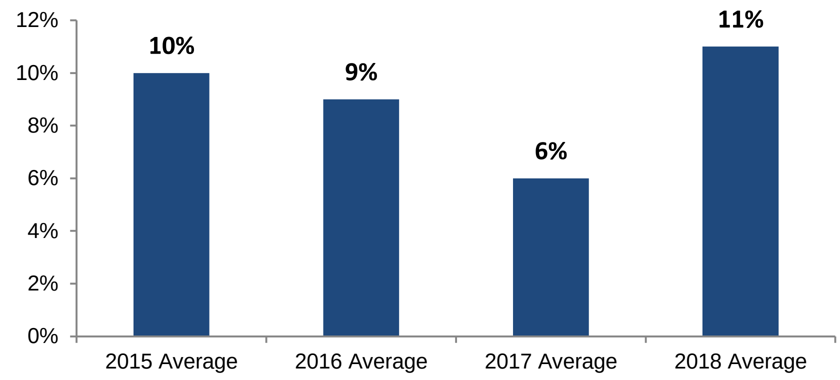
Source: Bloomberg, Kotak Institutional Equities (KIE)
As of 5th Apr 2018

Domestic Economy showing early signs of revival in selected sectors

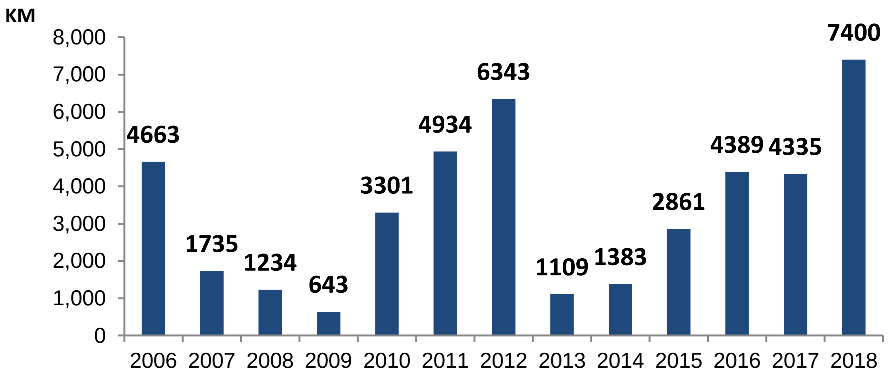
Steel and Cement production up reflecting strong infrastructure expenditure



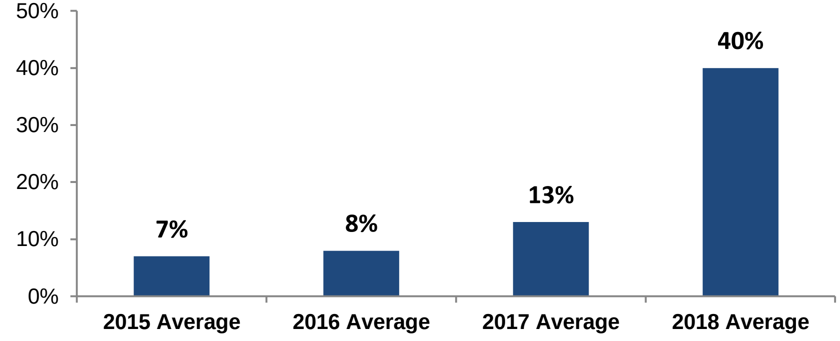
Bank Credit Growth has picked up due to strong Consumer and SME Working Capital demand



Ordering activity of NHAI saw a growth of 71% in FY2018 with guidance of healthy ordering next fiscal also



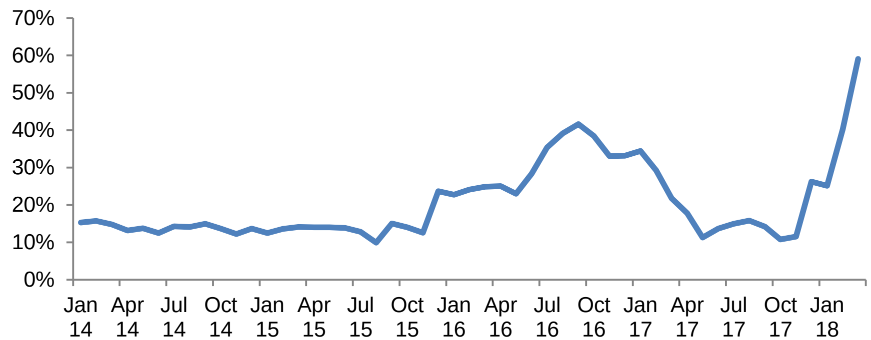
CV Sales posted healthy growth due to stricter truck overloading enforcement in UP and Rajasthan



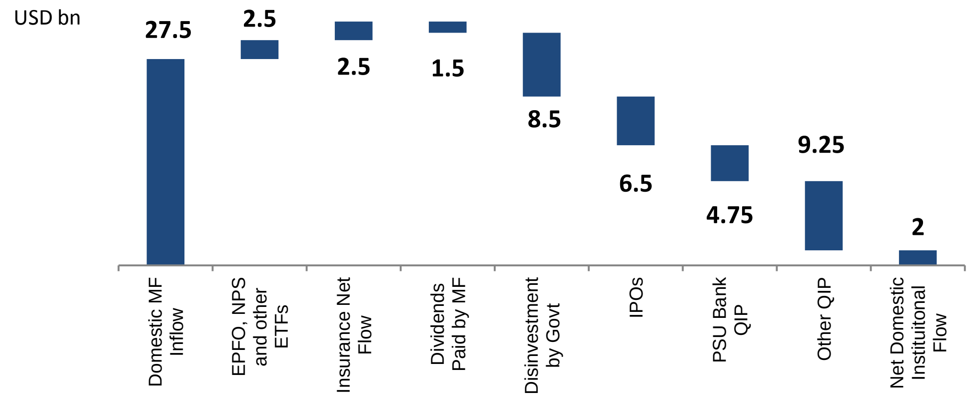
Source: Deutsche Bank, KIE

However favorable Liquidity scenario could reverse in 2018

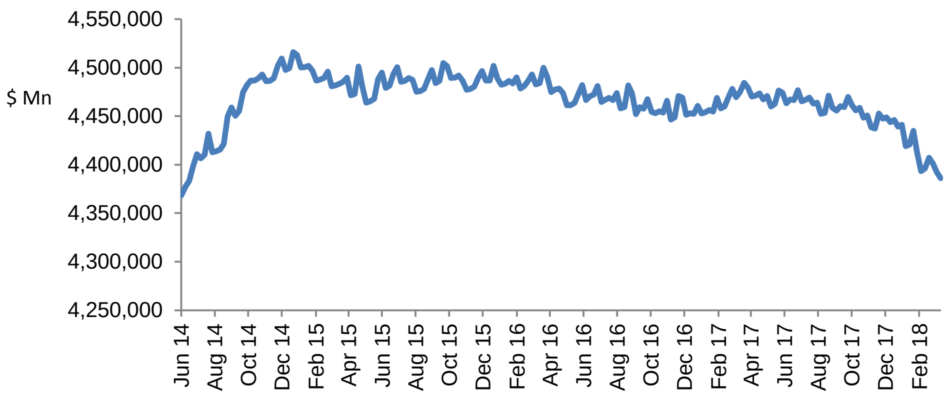
Libor – OIS spread, a measure of credit risk, is at highest level in last decade due to US Tax reforms



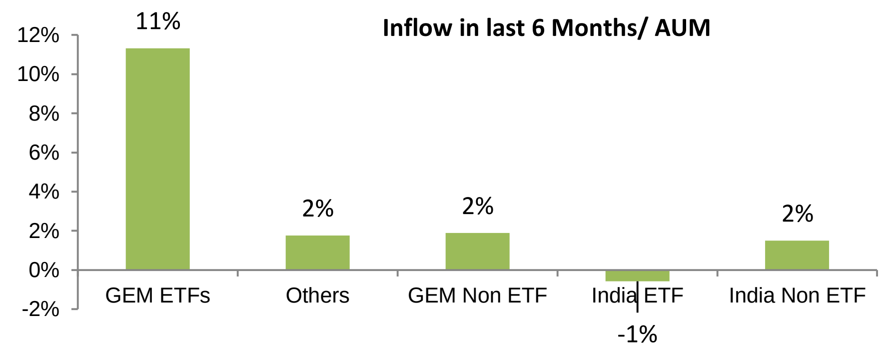
FII will continue to play an important role as domestic liquidity will be sucked by IPOs and disinvestments by Govt



QE Unwind program has resulted in asset drop of $74 billion resulting in lowest level of "Fed Balance Sheet" since 2014



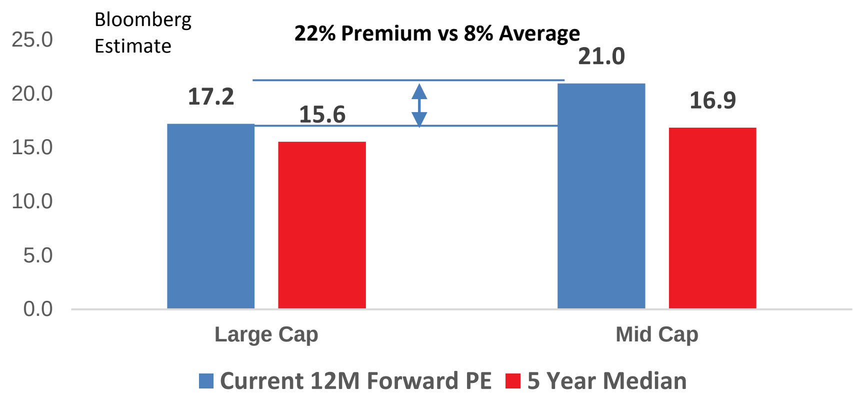
India has been receiving major inflows from passive GEM ETFs which could reverse on negative sentiment over EM in trade war environment



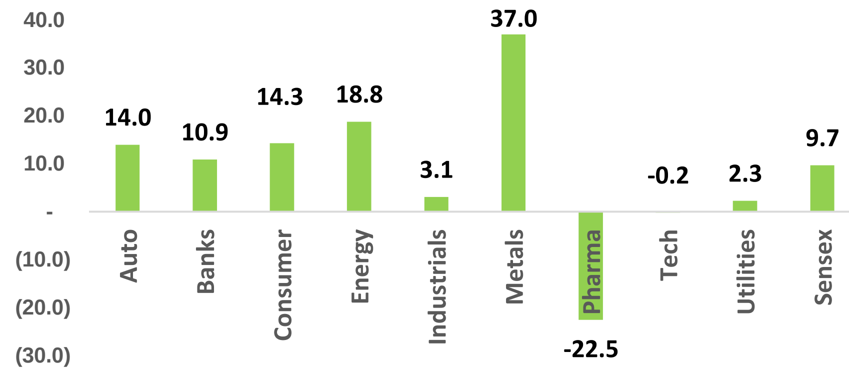
Source: DB,Bloomberg, CLSA

Market still remain overvalued compared to historic valuations, EPS growth coming from Auto, Metals and Banking

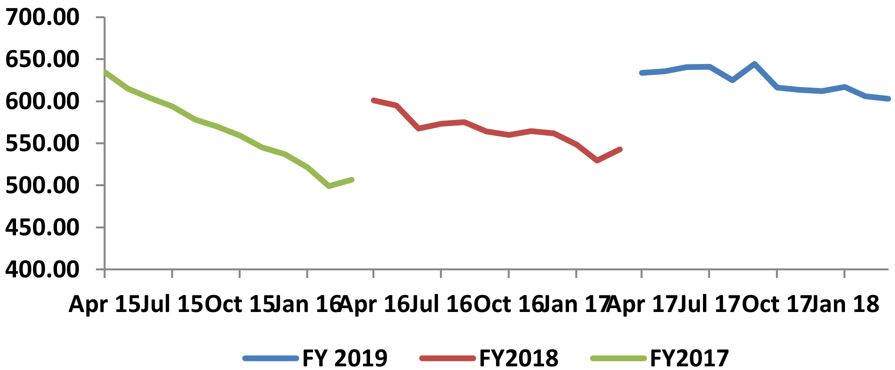
Mid Cap Index premium over large cap has been maintained in the correction so far



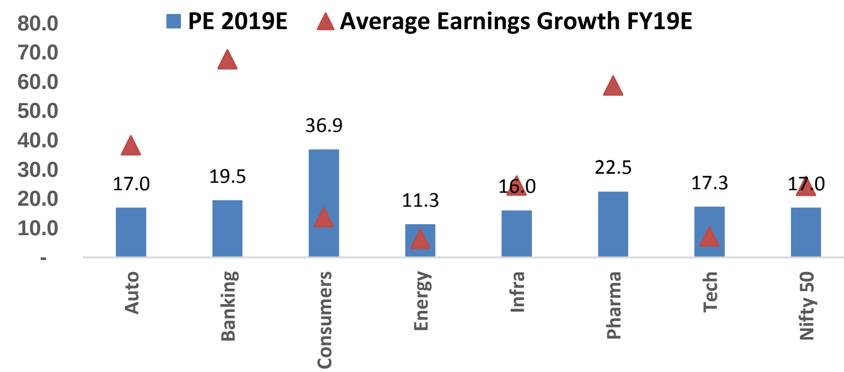
Q4 2018 Sensex PAT (KIE) is expected to increase by 10% yoy backed by Auto, Consumer, Infra, Metals and NBFCs



Consensus Earnings expectation of FY 2019 has been relatively stable compared to previous Fiscals



Infra looks attractive in terms of valuation, >40% of incremental profit expected from Banks due to lower provisions



Source: Bloomberg, KIE

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Key Triggers – Resolution of NPA & Earnings

Positive Triggers

- **Global Economic data :** World economy improving
- **Commodity Prices:** Sustained high prices is expected to lead to high earnings growth in Steel/Oil sector
- **Resolution of NPA:** Effective addressal by government of NPA issue in Indian Banks, initial bids for NCLT List 1 has been promising
- **Weaker Rupee:** Benefit IT and Pharma
- **Rural recovery:** Government focus on rural economy including increase of MSP could benefit rural consumption

Risks

- **Outflow from EM:** US tax reforms and rising global rates could trigger capital flight from Emerging markets like India
- **Earnings:** Consensus expected earnings growth for domestic equities is high at around 25% for FY19, any downgrade would make the valuations more expensive
- **Geo-Political Risk:** Further tariffs imposed by US/China
- **Monetary Policy:** Faster than expected monetary tightening in Europe and US
- **Weaker Macro:** Higher crude prices and low GST collection could lead to lower re-rating of Equity valuations
- **Tight Credit and Higher NPA:** Recent PNB event could lead to cascading effect in the whole banking system
- **Slowdown in Retail Flows:** Redemption pressure in retail possible post 10% LTCG and 10-15% correction in markets
- **State Elections:** Elections in Rajasthan and Karnataka are expected to be tight for NDA

India Equities: Valuations & Strategy – Maintain Neutral Stance

Indian markets lost ~4% for the month of March on account of weakness in markets worldwide. The financial year FY17-18 ended with a gain of 10.2% as against 18.5% for the previous FY. FII flows into equity markets turned positive with a net investment of INR 12,272 cr from negative last month.

At current levels of approx. 10,481 (13th April, 2018), Nifty is trading at a 1 year forward PE of 18.5X. In the current scenario, **we continue to maintain a Neutral stance on the back of healthy earnings growth expectations.**.

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:

- 50% Large Cap allocation (Prefer Large Caps due to relatively Favorable Valuations)
- 50% Multi Cap allocation (such funds currently have a bias toward 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
- No rate action as expected in Apr policy
- We expect repo rate to be unchanged for extended period of time
- Tone was softer and carried focus on upward risks to inflation

Inflation
- CPI was lower than expectation at 4.28% in March 2018
- RBI lowered expectation of 4QFY18 to 4.5% and 1HFY19 to 4.7-5.1%
- We expect CPI averaging around 4.3% for FY2019

10 Year G-Sec Benchmark Yield
- Short term triggers like favorable Gsec supply, favorable inflation Prints and expectation of hike in FII could sustain rally

INR
- Concerns over LOU limits and CAD put pressure on INR
- Expect mild depreciation towards 65.5 over 1 Year
- Broad range of 63-66 to hold

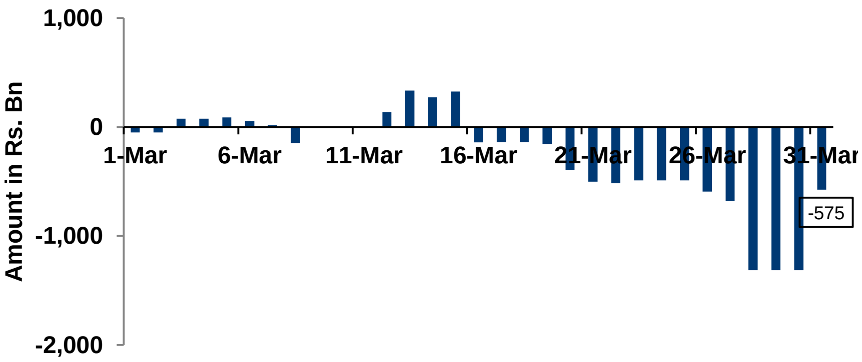
Liquidity
- Liquidity has gone to deficit from surplus due to tax payments
- RBI has reaffirmed their objective of maintaining a neutral level

G-Sec Supply
- Government announced to borrow INR 2.88 trn of bonds in H1FY19, lower by 50k cr compensated by lower buybacks and higher small savings
- Issuance in medium term segment of 10-14 years was reduced to 29% against 50% in previous years
- A hike in FII limit and/or support from RBI in form of OMO purchase could further improve the Supply-Demand dynamics

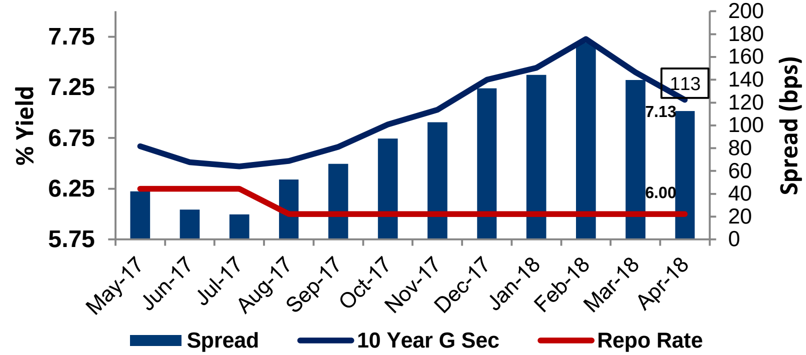
Key Risks
- Global monetary tightening
- Crude Prices
- Impact of GST revenues and spending on Fiscal Deficit
- Growth Recovery

Yields relaxed by 30-60 bps over positive news from inflation print, Borrowing announcement and RBI policy meet

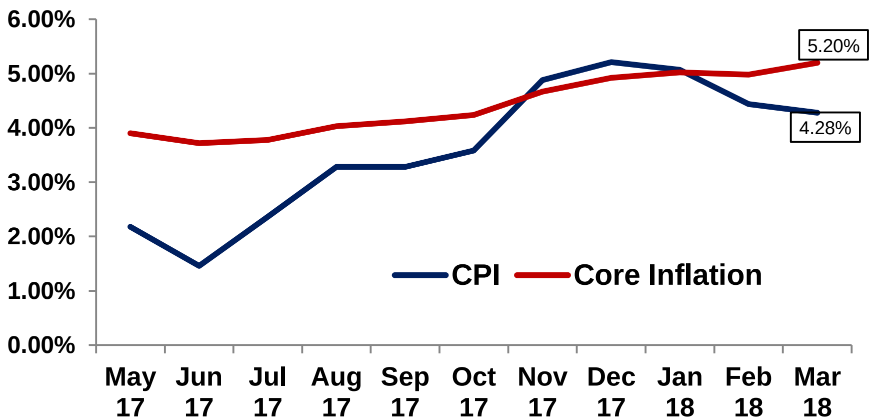
Liquidity gone to deficit level before Fiscal end



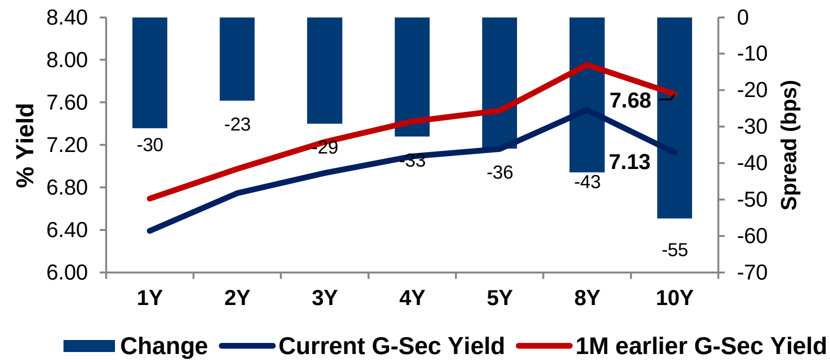
G Sec Spread over Repo has fallen from peak of 170 bps to 113 bps



Inflation for March 2018 was lower than expected however Core inflation of 5% warrants caution



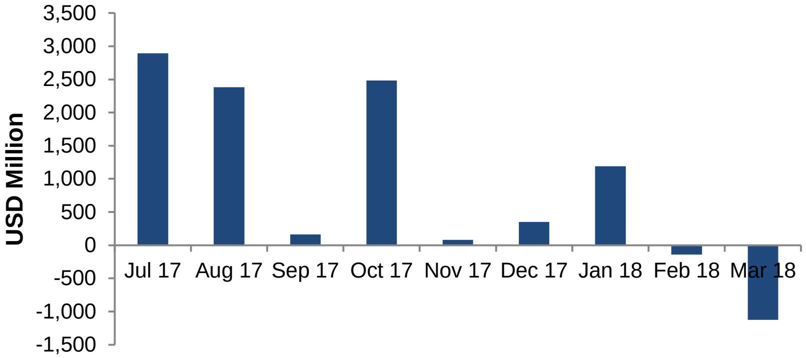
10 Year papers rallied the most due to lower gross supply announcement



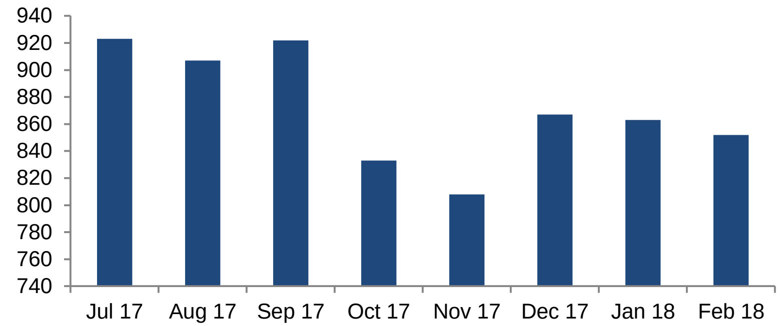
Note: As of 5th Apr 2018, Source Bloomberg

Decision to increase FII limit could lend support to Bond market and INR

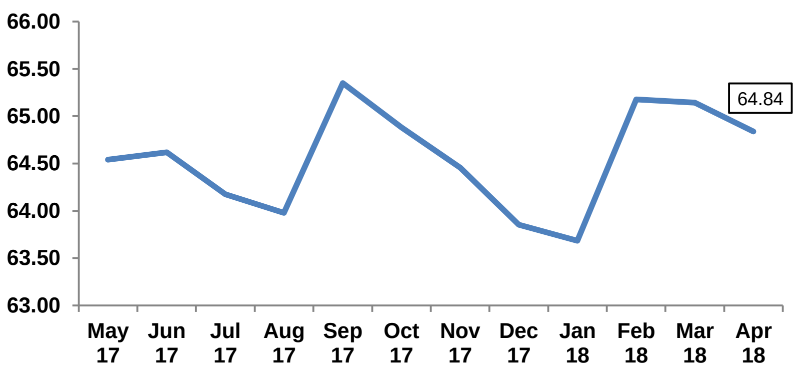
FIIs buying slowing down due to rising global rates and high utilization levels



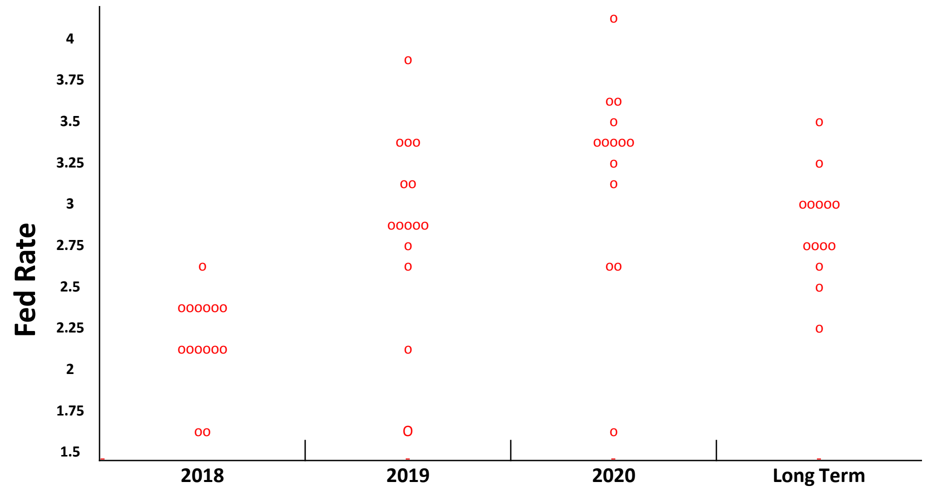
GST collections running below target rate of 1.1 Trillion Rs/month



Indian currency has depreciated on sustained dollar demand due to demand from importers and FII outflow from Equity



Fed expects 5 rate hikes in 2018, ~3.5% rate till 2020

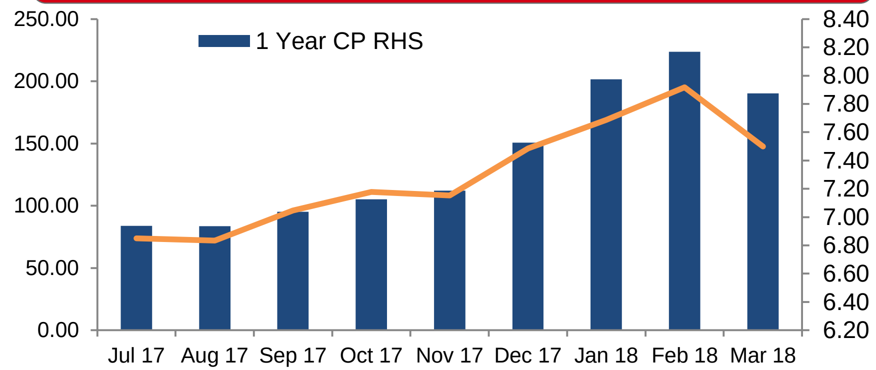


The Fed's Dot Plot chart: Dots represents number of members voting.
The chart represents where each participant thinks the Fed rate should be in the next few years.

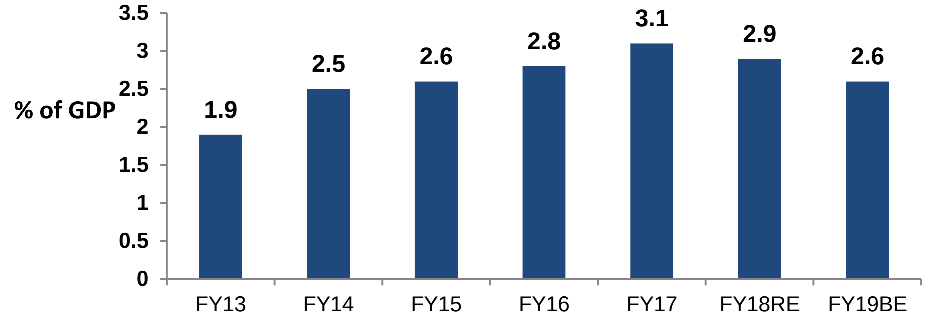
Note: As of 5th Apr 2018, Source Bloomberg

Debt Market Trends

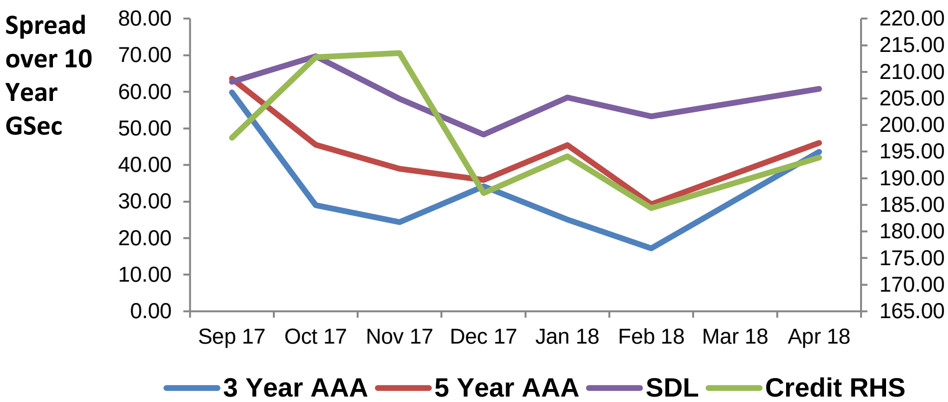
Spread of 1 Year CP over 1 Month CD has reduced but still at attractive levels



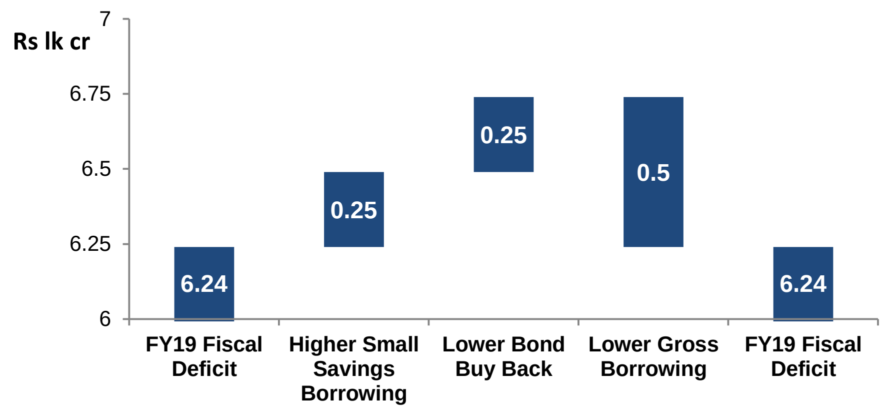
Due to better than expected Cess & stamp duty collection and low expenditure growth, State FD is expected to reduce this year



Government Yields rallied more than Corporate papers last month



FY19 Central Government Borrowing has been reduced by 50,000 cr, duration mix and H1 supply favorable for 10 Year paper



Note: As of 3rd Apr 2018, Source Bloomberg, MFI

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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