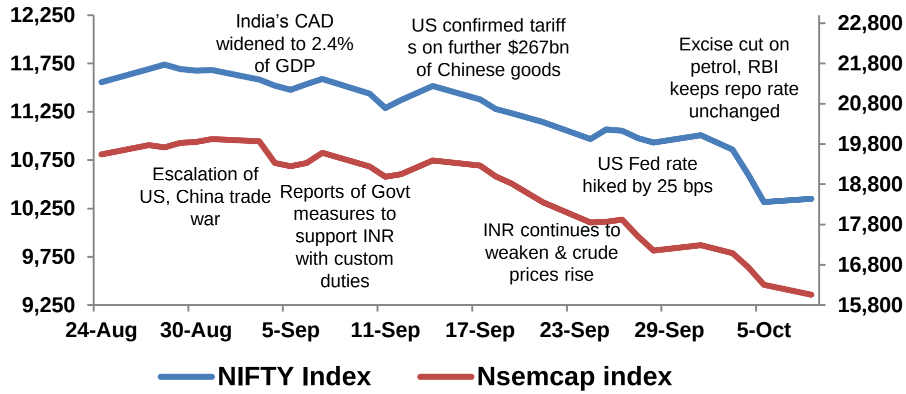
Equity & Debt Strategy

Mid Oct – Nov' 2018

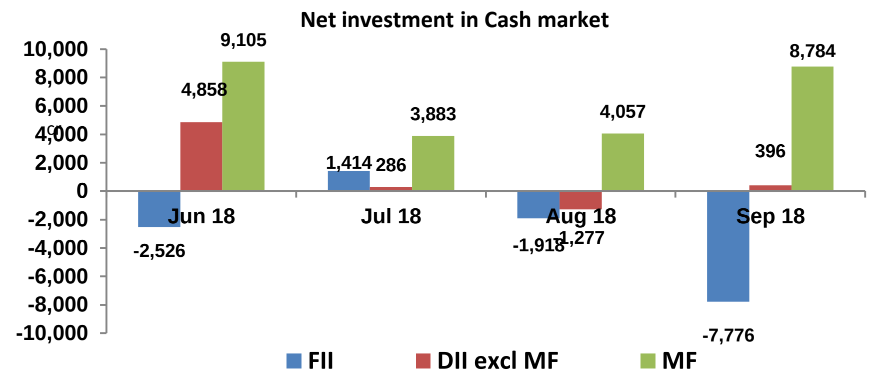
Equity Market Update
&
Equity MF Strategy

Nifty 50 fell 6% and Midcap declining 13% in September

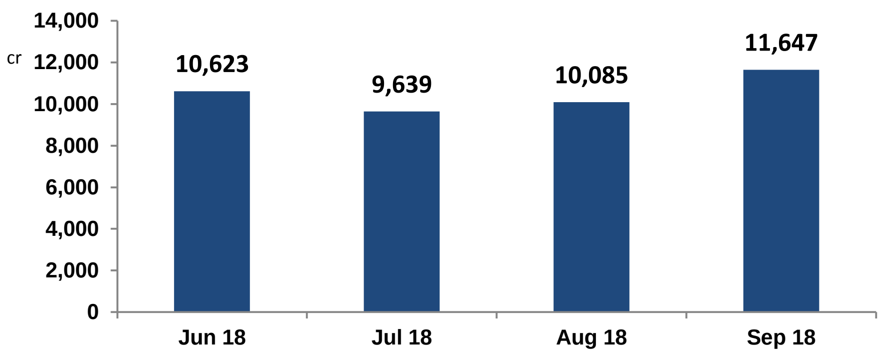
Nifty 50 and Midcap 100 saw corrections; weak macros, trade tariffs & NBFC concerns dampened sentiments



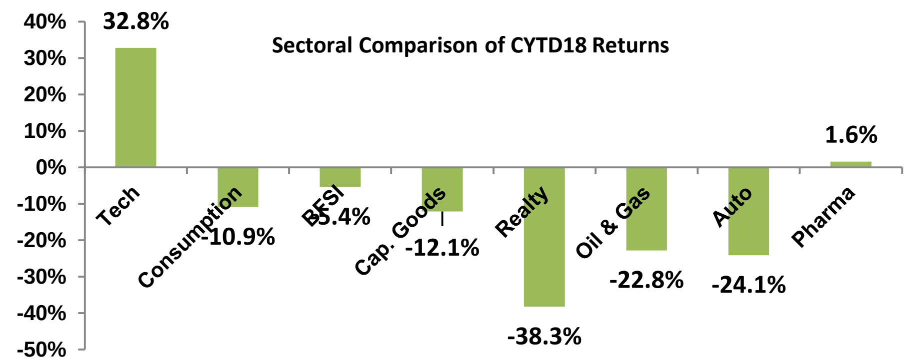
MF buying strong despite falling markets and FII selling



Net Flows to Equity Mutual Funds remained above 10k cr



Technology sector benefited from INR depreciation



Note: Amount excludes Arbitrage Funds, assumes 65% equity flow from Balanced

Source: Bloomberg, Kotak Institutional Equities (KIE), AMFI, NSE Infoedge, Citi Research
As of 10th October, 2018

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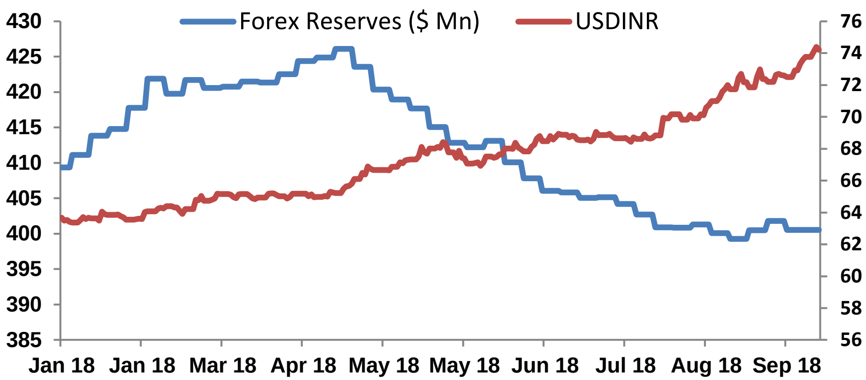
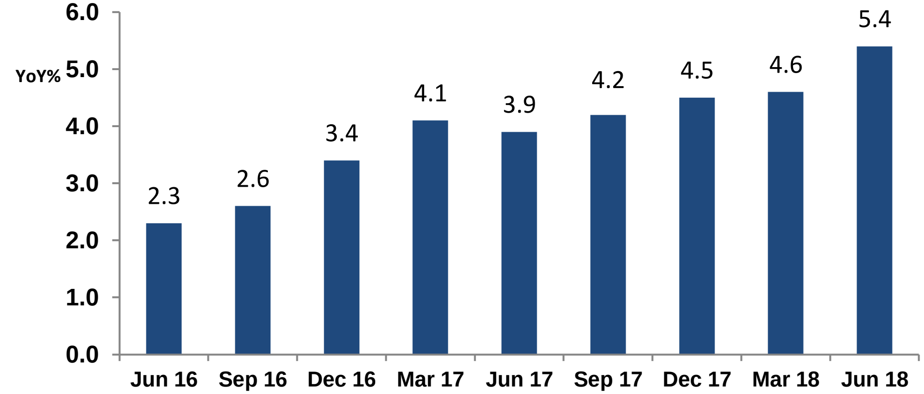
US Fed tapering with strong US GDP growth; impacting EMs equities including India

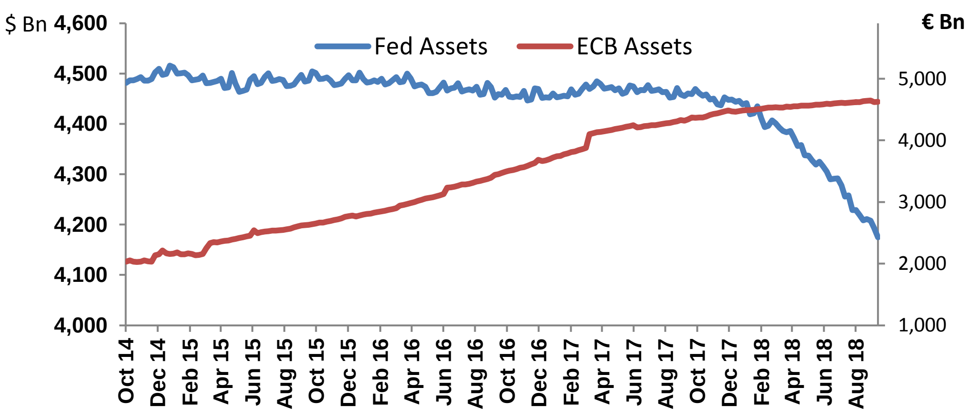
INR depreciated 12% in FYTD19 on macro concerns despite RBI intervention



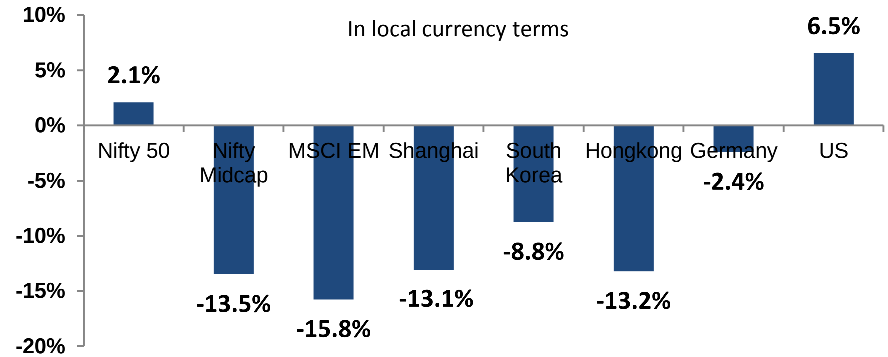
US economy growing at strong rate (seen in GDP numbers) over 2 years



Fed Balance sheet leaner by $286 bn in last 1 Year; ECB Bond buying slowing, reduced from 30bn to 15bn monthly



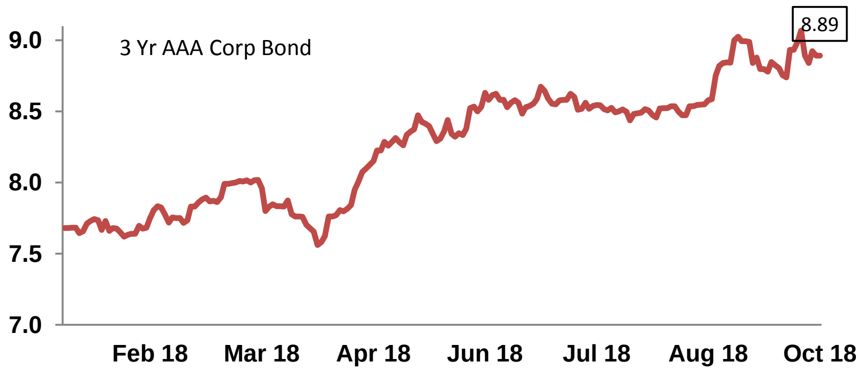
Since 1st Apr, Emerging markets have corrected by 16%, Nifty 50 has been an outlier



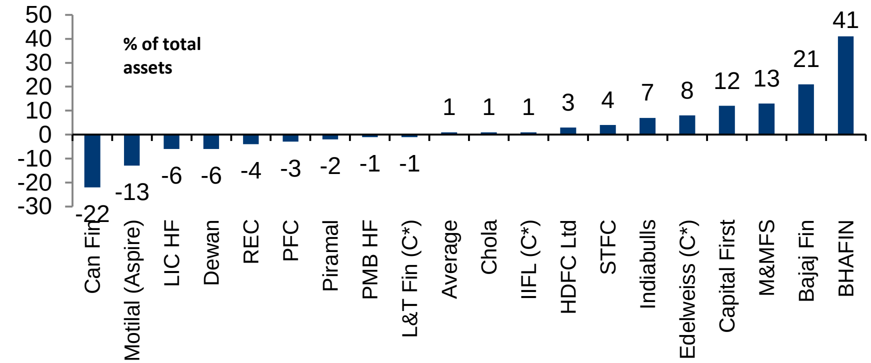
As of 10th October 2018
Source: Bloomberg, KIE

Concerns on NBFC impacting equity markets

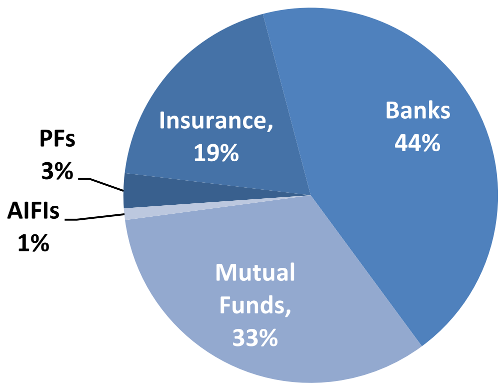
Longer tenure yields have spiked in the last 1 year, leading to pressure on NIMs & incentivising NBFCs to borrow from short term



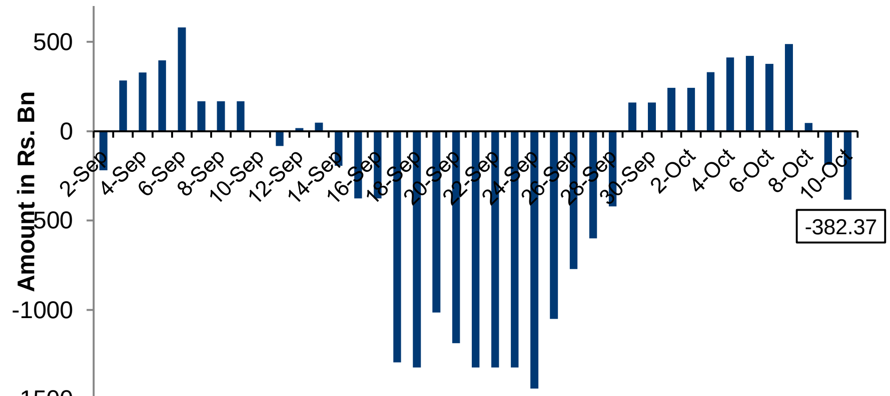
Some NBFCs have ALM mismatch in less than 1 year tenure



Mutual funds have been an important source of funding to NBFCs, incremental lending has slowed post-ILFS issue



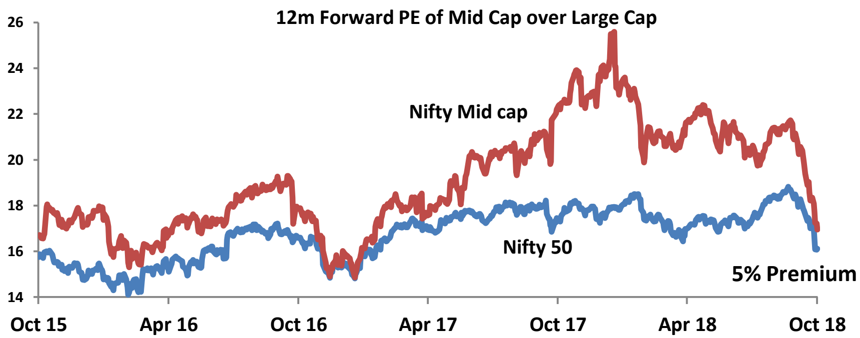
Banking liquidity had turned negative in September



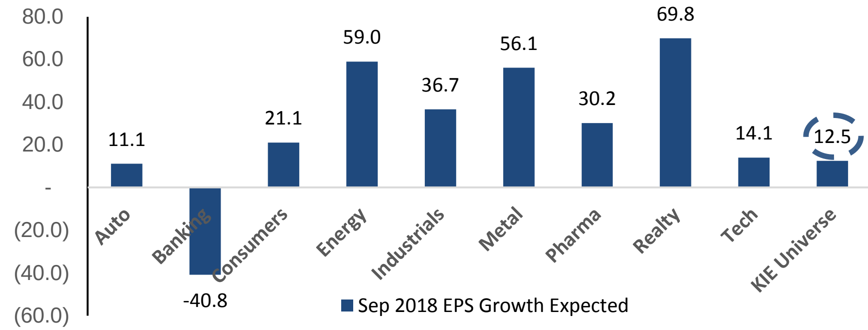
Source: Bloomberg, CLSA
YoY% growth

Earnings and Valuation

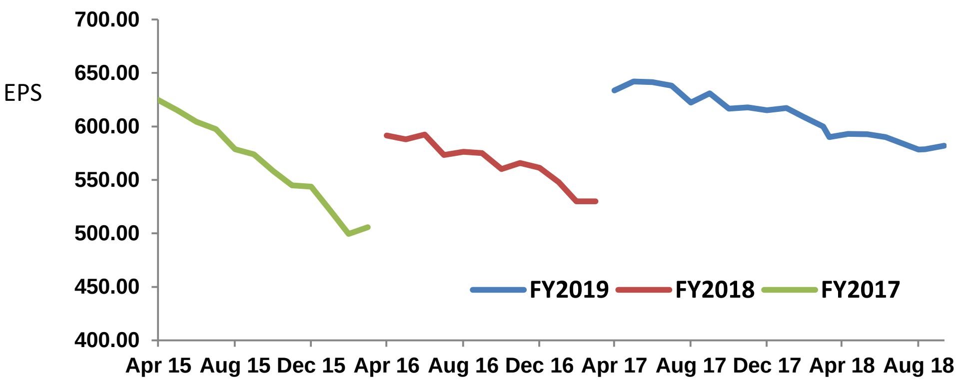
Post recent correction, Mid Caps now are at a 5% premium over large caps



Q2FY2018 PAT for our universe expected to grow at 12.5%, PAT impacted by Bank provisioning and base effect



FY19 earnings outlook relatively stable compared to FY17 and FY18



India still expensive compared to EM peers post correction since Sep

	Current PE	Premium/Discount to 10 Year average	1 Month Return
MSCI EM	11.8	-13	-3
India	21.6	14	-8
China	12.3	-25	-2
Brazil	19.3	-44	0
South Korea	10.4	-38	-5

Source: Bloomberg, KIE * Based on KIE Estimates on free float basis.
As of 10th October 2018

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Key Triggers

Positive Triggers

- **Global Economic data :** World GDP improving
- **Domestic Q1 Earnings:** Several companies posted strong growth in Q1FY19
- **Resolution of NPA:** Effective addressal of NCLT lists
- **Weaker Rupee: To b**enefit export-oriented sectors like Auto, Chemicals, IT and Pharma
- **Monsoon/Rural recovery:** Government focus on rural economy including increase of MSP could benefit rural consumption
- **Inflation:** Despite INR slide, CPI inflation is lower than RBI's target

Risks

- **Trade Wars:** Further tariffs imposed by US/China and strict enforcement of Iran sanctions
- **Monetary Policy:** Faster than expected monetary tightening in Europe and US
- **Weaker Macro:** Higher crude prices, weaker currency and low GST collection could lead to lower re-rating of Equity valuations
- **State Elections :** A combined opposition can be a threat to BJP in the upcoming elections
- **Weaker Rupee:** Would impact on FII flows
- **Contagion effect in NBFC sector:** Liquidity concerns coupled with ALM mismatch leading to stress in select companies

Source: Bloomberg, KIE

India Equities: Valuations & Strategy – Shift from Neutral to Underweight

Nifty fell 6% for the month on the back of the various global factors like increased crude oil prices, stronger USD along with various domestic factors like status quo maintained by RBI, depreciating INR and a default by a large financial institution. All these led Equity markets to remain in risk-off mode.

Given various factors and the visibility of a volatile election year, **we continue to maintain a "20% Underweight" in Equities.**

Mutual Funds: As domestic liquidity continues to drive markets, we advise new investments to be staggered in Mutual Funds via SIPs/STPs.

Recommended allocation within equity mutual funds is as under:

- 50% Large Cap allocation (Prefer Large Cap stocks over Mid cap since Mid cap valuations are still above historical levels)
- 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 Aggressive Hybrid Funds. Such funds have around 25% to 30% of their portfolio into Debt instruments which provides cushion to the portfolio return during market volatility.

	Units	Now	1 Yr Prior
Macros & Flows			
Nifty 50		10,300	9,900
12 Month Forward PE		17.6	17.96
FII Inflow (cumulative CYTD)	$ bn	-2.70	7.09
MF Inflow (cumulative CYTD)	$ bn	7.64	9.33
Gsec Yields	%	7.99	6.73
USD INR		74.00	63.98
US Yields		3.22	2.30
Micros			
Earnings Growth (KIE Universe)		13.00	-8.1
GDP Growth (Qtr)		8.2	5.6
PMI		50.5	49.0
Non-Food Credit Growth		13.2	7.1
Capital Goods Import (YoY%)		45.3	14.6

Source: EPS Estimates by KIE

Recommended Large Cap, Multi Cap & Balanced Fund Performances

Scheme Name	Corpus (In crs.)	1 Year	3 Years	5 Years	Investor Suitability
Large Cap Funds					
Aditya Birla Sun Life Frontline Equity Fund	20,227	-3.37	8.37	15.20	All Risk Profiles except Secure
Axis Bluechip Fund	2,877	4.27	10.01	14.37	All Risk Profiles except Secure
ICICI Prudential Bluechip Fund (erstwhile ICICI Prudential Focused Bluechip Equity Fund)	18,966	1.36	10.66	15.23	All Risk Profiles except Secure
SBI Bluechip Fund	19,213	-4.06	7.81	15.95	All Risk Profiles except Secure
UTI Nifty Next 50 Index Fund	241	-	-	-	All Risk Profiles except Secure
Large & Mid Cap Funds					
Aditya Birla Sun Life Equity Advantage Fund (erstwhile Aditya Birla Sun Life Advantage Fund)	5,664	-12.98	8.83	19.25	All Risk Profiles except Secure
IDFC Core Equity Fund (erstwhile IDFC Classic Equity Fund)	2,805	-2.91	11.49	13.78	All Risk Profiles except Secure
Invesco India Growth Opportunities Fund (erstwhile Invesco India Growth Fund)	863	1.70	10.89	17.21	All Risk Profiles except Secure
Kotak Equity Opportunities Fund (erstwhile Kotak Opportunities Fund)	2,324	-5.94	8.93	16.14	All Risk Profiles except Secure
Mirae Asset Emerging Bluechip Fund	5,681	-2.62	15.26	29.60	All Risk Profiles except Secure
Multi Cap Funds (Multi Cap/ Value/ Focused/ Dividend Yield/ Contra)					
Axis Focused 25 Fund	5,853	2.30	13.31	16.59	All Risk Profiles except Secure
Kotak Standard Multicap Fund (erstwhile Kotak Select Focus Fund)	20,382	-1.07	10.86	18.80	All Risk Profiles except Secure
L&T India Value Fund	7,743	-6.58	10.06	22.83	All Risk Profiles except Secure
Mirae Asset India Equity Fund (erstwhile Mirae Asset India Opportunities Fund)	8,755	1.23	12.23	19.94	All Risk Profiles except Secure
Motilal Oswal Multicap 35 Fund	12,769	-8.71	9.97	-	All Risk Profiles except Secure
Mid & Small Cap Funds (Mid Cap/Small Cap)					
Aditya Birla Sun Life Small Cap Fund (erstwhile Aditya Birla Sun Life Small & Midcap Fund)	2,051	-16.68	10.48	22.64	All Risk Profiles except Secure
HDFC Small Cap Fund	4,948	4.14	16.63	21.41	All Risk Profiles except Secure
Kotak Emerging Equity Scheme	3,114	-7.70	9.99	25.76	All Risk Profiles except Secure
L&T Midcap Fund	3,095	-8.00	13.04	26.41	All Risk Profiles except Secure
Aggressive Hybrid Funds					
Aditya Birla Sun Life Equity Hybrid '95 (erstwhile Aditya Birla Sun Life Balanced 95)	13,827	-4.63	7.86	15.37	All Risk Profiles except Secure
L&T Hybrid Equity Fund (erstwhile L&T India Prudence Fund)	10,219	-2.21	8.08	16.44	All Risk Profiles except Secure
Reliance Equity Hybrid Fund	13,603	-2.32	8.75	16.57	All Risk Profiles except Secure
SBI Equity Hybrid Fund (erstwhile SBI Magnum Balanced Fund)	27,305	0.86	8.56	16.49	All Risk Profiles except Secure
Balanced Advantage Funds (Balanced Advantage OR Dynamic Asset Allocation)					
ICICI Prudential Balanced Advantage Fund	28,616	2.41	7.91	12.96	All Risk Profiles except Secure
Kotak Balanced Advantage Fund	2,053	-	-	-	All Risk Profiles except Secure
Indices					
Nifty		3.46	8.71	11.68	

Source: MFI Explorer

Returns are CAGR as on Oct 16, 2018 and for Regular Plans with Growth option. Corpus size is as on Sept, 2018.

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Debt Market Update
&
Debt MF Strategy

Debt Market: Key Variables

Indicators

Policy Action
- MPC retained repo rate at 6.5%
- Policy stance changed to "Calibrated Tightening"
- Given the benign near-term inflation trajectory, we could see limited scope for a rate hike in December

Corporate and G-Sec Benchmark Yield
- We expect 10 Year to range 7.9-8.1%
- We like AAA segment in 1 to 3 year tenor

Liquidity
- Liquidity conditions improved significantly with the system
- RBI scheduled to do 3 OMOs of INR 12,000 cr each in October
- Facility to Avail Liquidity under Liquidity Coverage Ratio (FALLCR) increased from 11% to 13% of deposits to allow banks to avail of higher liquidity

Inflation
- CPI inflation at 3.77% in September compared to 3.69% in Aug
- Depreciating INR and rising crude remain key risks to inflation as MPC as highlighted they will only respond to adverse inflationary impact

INR
- INR likely to remain under pressure as the DM monetary policies unwind and their effects on EMs are visible over the next few years
- As the global economy undergoes a prolonged period of adjustment from the winding up of easy monetary policy in DMs, phases of pains in the EMs will continue

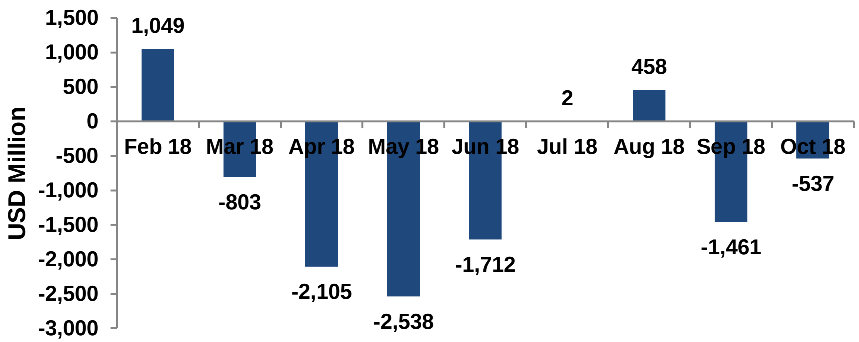
G-Sec Supply
- RBI has done 4 OMOs, aggregating to 42,000 Cr. 2 additional OMO of INR 12,000 Crs each announced
- Government cut Gross borrowing for H2 by INR 70,000 cr by reducing buybacks while Net G-Sec supply will remain same

Key Risks
- Global monetary tightening,
- Crude Prices,
- GST revenues,
- Inflation,
- Contagion effect in NBFCs

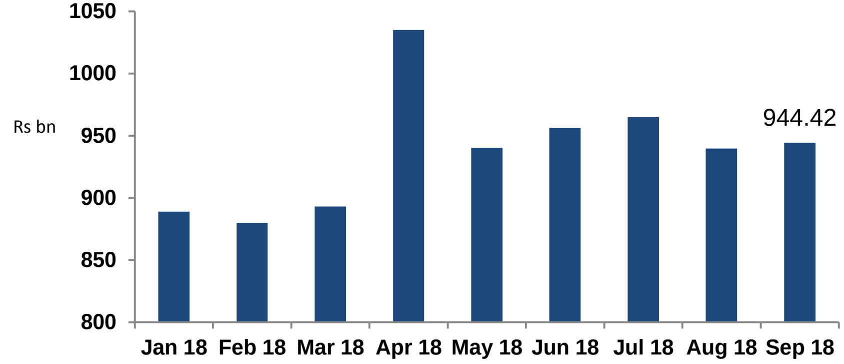
Source: Bloomberg, KIE

Rising Crude prices have impacted Current Account Deficit leading to INR depreciation and heavy FII outflows

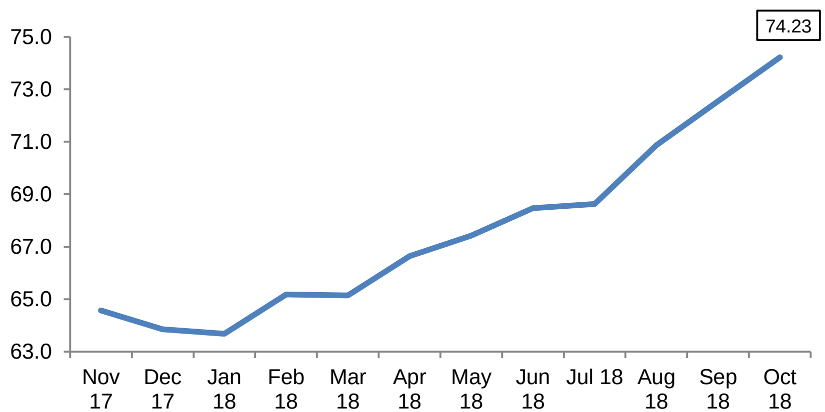
FIIs have sold $2bn of Debt in last 2 months on concern over Crude prices and rising US interest rates



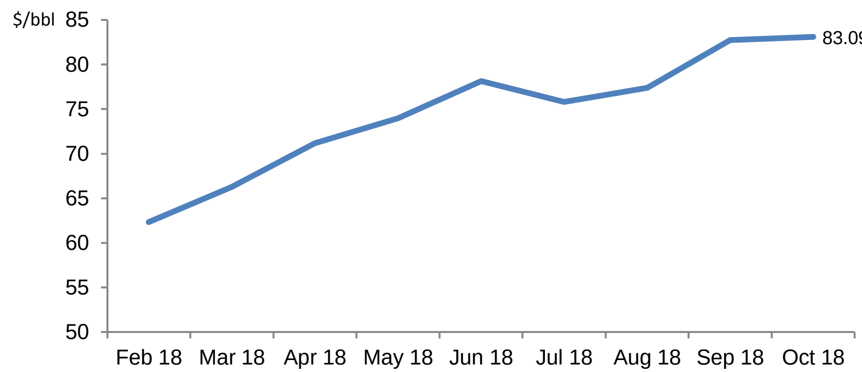
GST collections have again stagnated, well below breakeven rate



Indian currency has depreciated due to rising CAD deficit and heavy FII outflows from both Debt and Equity capital markets



Crude price increased over concern on Iran sanctions



Note: As of 11th October 2018, Source Bloomberg, Nomura

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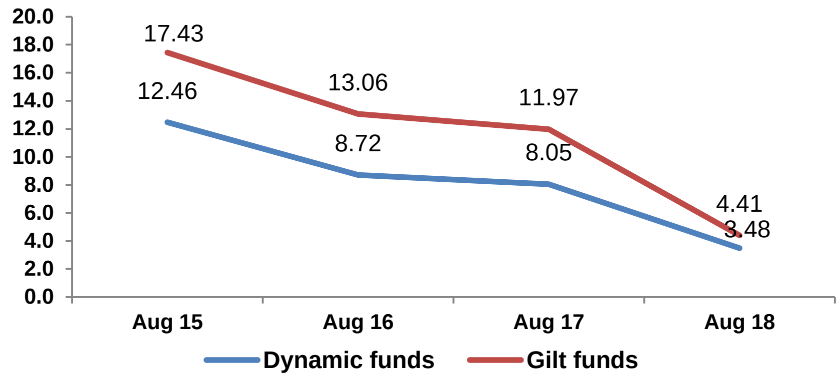
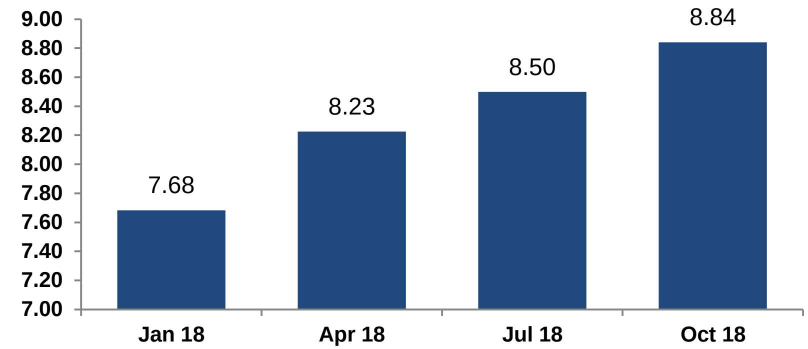
Most indicators leading to pressure on rates

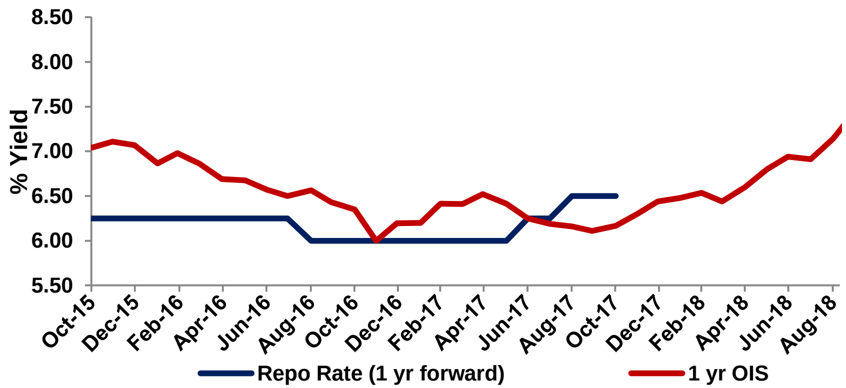
Long end funds have cut duration significantly



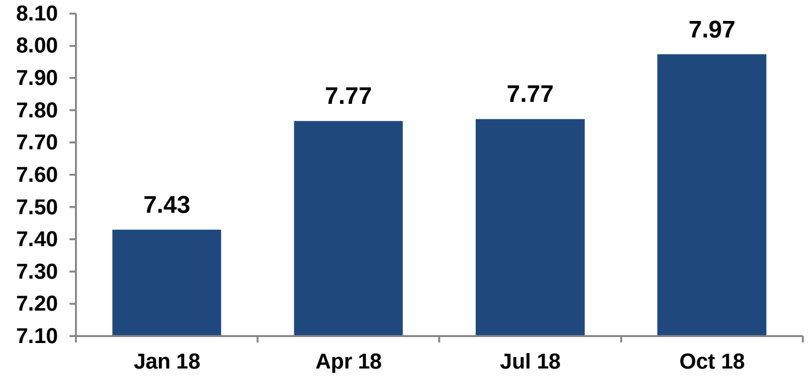
3 Year AAA has inched up by 125 bps in last 9 months



Shorter tenure yields increased due to rate hike



10 Year yield at ~ 8%



Note: As of 11th Oct 2018, Source Bloomberg, MFI

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Macro Variables

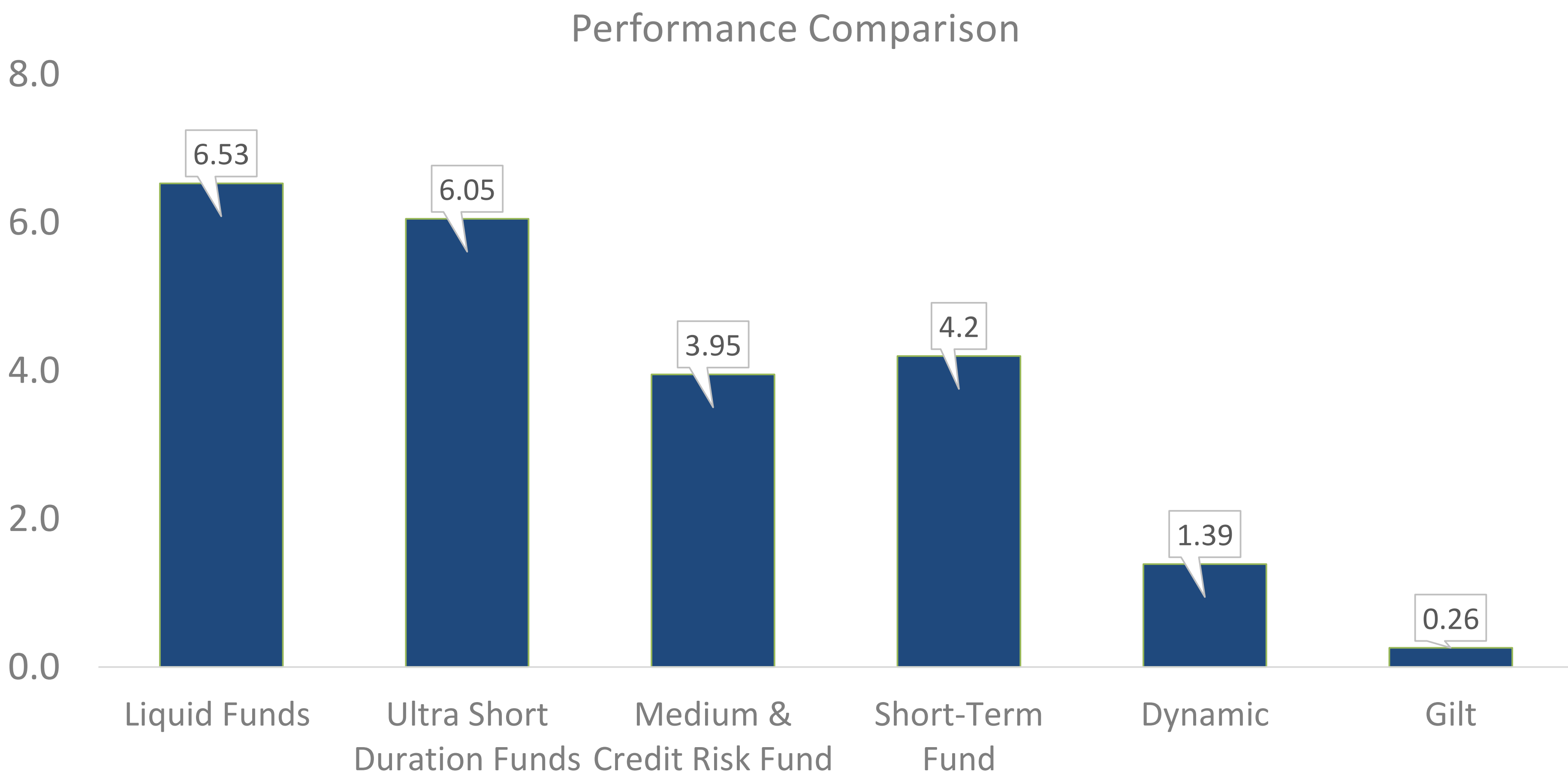
Witnessing weakening of macro variables in last one year

	Now	1 Year Prior
Policy rate %	6.5%	6.0%
INR	72.49	65.27
Brent oil $/bbl	82.72	57.54
Trade balance $ bn	(17.4)	(12.7)
FII Net flows (CYTD) $ bn	(7.1)	20.0
Liquidity Rs bn	-420.8	1860.29
CPI %	3.77%	3.28%

Note: As of 11th Oct 2018, Source Bloomberg

Debt Funds Performance – Last 1 Year

Significant inch-up in yields has led liquid funds to out-perform all other segments



Performance as on 8th Oct 2018

Credit Spreads

The current spreads call for high quality (AAA) in upto 3 year segment

Tenors	G-Sec	AAA - PSU	AAA- Corp	AA+	AA	AA-	A+
3M	6.1	7.8	8.1	8.3	8.6	8.8	9.6
6M	6.3	8.1	8.4	8.6	8.9	9.1	9.9
1Y	7.5	8.7	8.9	9.1	9.3	9.4	10.2
3Y	7.8	8.8	8.9	9.2	9.4	9.3	10.2
5Y	8.0	8.8	8.8	9.2	9.4	9.3	10.2
7Y	8.0	8.9	8.9	9.2	9.5	9.3	10.2
10Y	8.0	8.9	8.9	9.3	9.5	9.5	10.3
15Y	8.3	8.9	8.9	9.3	9.5	9.6	10.5

Source: Bloomberg, KIE

India Fixed Income: Strategy

10 Year Gsec is hovering around 8% on concerns of INR weakening despite few steps announced by RBI and Government like OMO and reduced Gross borrowing. Despite the earlier rate hike, **10 Year spread over repo is still at high level** (~150 bps vs ~60bps historical). Since rates could remain volatile in the short term, **we prefer "Roll Down" strategies** with low duration risk if held till maturity like FMPs.

Additional spread of Credit Funds over AAA have reduced due to increase in AAA/AA yields, hence we prefer funds with AAA, AA allocation from risk-reward perspective. **Therefore we recommend no incremental allocation to "Credit Funds" in current market environment**.

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
- Prefer core allocations in the 1 to 3 year segment

Due to absolute high yields, we advice investors to allocate excess liquidity to Debt funds at current level via FMPs/Roll Down Strategy.

Source : AMCs, other Financial websites

Recommended Short Term Bond, High Yield & Debt Others Performances

Scheme Name	Corpus (In crs.)	6m	1Yr	2Yr	Investor Suitability
Short Term 1-3 yrs (Corporate Bond/ Banking & PSU/Short Duration)					
Aditya Birla Sun Life Corporate Bond Fund	13,271	4.89	5.06	6.30	All Risk Profiles except Secure
Axis Banking & PSU Debt Fund	1,231	4.52	5.60	6.64	All Risk Profiles
ICICI Prudential Banking & PSU Debt Fund	4,965	3.23	3.65	5.69	All Risk Profiles except Secure
IDFC Banking & PSU Debt Fund	618	3.85	4.32	5.45	All Risk Profiles
L&T Triple Ace Bond Fund	333	0.77	1.83	2.77	All Risk Profiles except Secure
Sundaram Corporate Bond Fund	343	0.72	1.16	4.17	All Risk Profiles
Dynamic Debt (Medium to Long Duration/ Dynamic Bond/Gilt)					
ICICI Prudential All Seasons Bond Fund (erstwhile ICICI Prudential Long Term Plan)	2,023	2.98	2.99	5.73	All Risk Profiles except Secure
ICICI Prudential Bond Fund (erstwhile ICICI Prudential Income Opportunities Fund)	2,854	1.30	1.59	4.19	All Risk Profiles

Source: MFI Explorer

Returns are CAGR as on Oct 16, 2018 and for Regular Plans with Growth option. Corpus size is as on Sept, 2018.

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