December 2018

MARKET OUTLOOK

- Market Outlook
- Top investment ideas for December 2018

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MONTHLY OUTLOOK FOR DECEMBER 2018

Global markets bounced back strongly in November on lower crude prices and reduction in bond yields. Indian markets posted one of the best monthly returns after a long time as sharp correction in crude prices abetted macroeconomic worries. FIIs turned buyers after three consecutive months of selling. Despite the rebound in the market small and mid-cap indices, continue to underperform the broader indices.

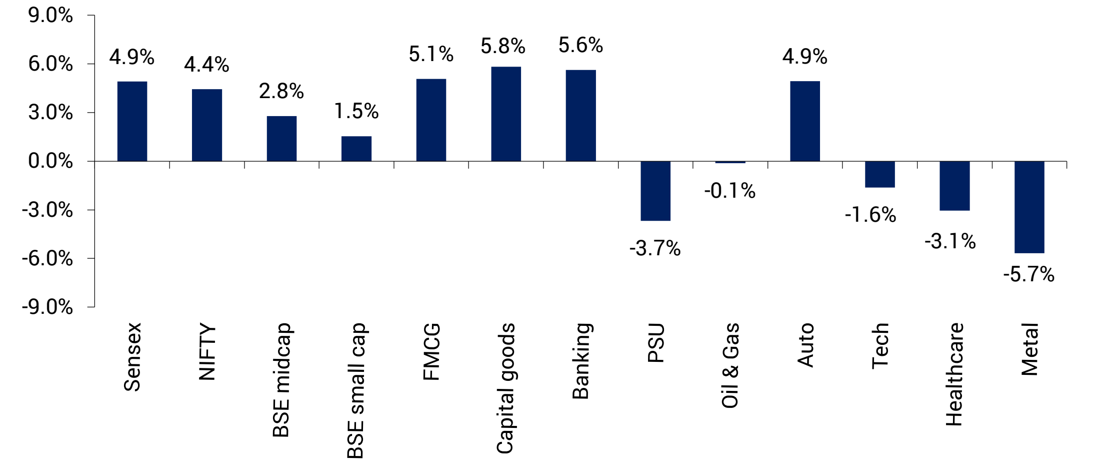
On the global economy front, we need to watch out for Fed action and pace of future rate hikes. Few other key events to watch are the G20 meet, trade talks between US and China, OPEC meeting and news flows on Brexit. So far as the Indian economy is concerned, Inflation has remained benign and there could be respite on the CAD (due to fall in crude prices). Data on credit growth and rising Capital goods order books suggests that the economic recovery is now gaining a foothold.

From an Indian equity standpoint, the key event to watch out would be the Madhya Pradesh/Rajasthan/Chhattisgarh assembly elections. We believe these elections are important, as they will be seen as an indication of people's mood towards the ruling party and could also be a precursor to the upcoming general election scheduled somewhere in Apr-May'19. However, the impact of state elections could fade away after few weeks of election result as market participants will again focus on international developments and fundamentals.

Based on Bloomberg consensus estimates, the one year Fw PE of Mid Cap Index has now come down to 15x as compared to 16x of Nifty. There is still a sizeable gap between the Equity PE and bond PE (refer chart 7) which could cap any big re-rating in equities (unless the 10 Yr G-Sec bond yields go to or below the 7% mark). With macros turning positive and after a 18% from fall from the peak , the overvaluation in mid cap Index has faded away. The risk-reward ratio has turned favourable for many mid and small cap stocks. Many of the mid & small cap stocks have gone closer to their historic low valuations. This provides enough comfort for bottom fishing at this level in the mid and small cap space. Any near term correction in the market due to political uncertainty should be viewed as a buying opportunity (provided crude & currency remain closer to the current levels).

Investors need to have bottoms up approach and pick & choose good quality, beaten down stocks from respective sectors. To weather the on-going volatility which may remain till middle of next year (i.e. till Central elections), it is ideal to have higher allocation into high earnings growth large caps and mid-caps (with strong management pedigree, and reasonable valuations). One can re-access the situation and re-shuffle their holdings post-election outcome. The next few months could be very volatile filled with uncertainty, which will also offer good buying opportunity for Long term investors. Conservative investors may spread their buying across the next few months to average out any rise or fall in the market.

Chart 1 Market performance – sector wise (November 2018)



Source: Bloomberg

Global Factors

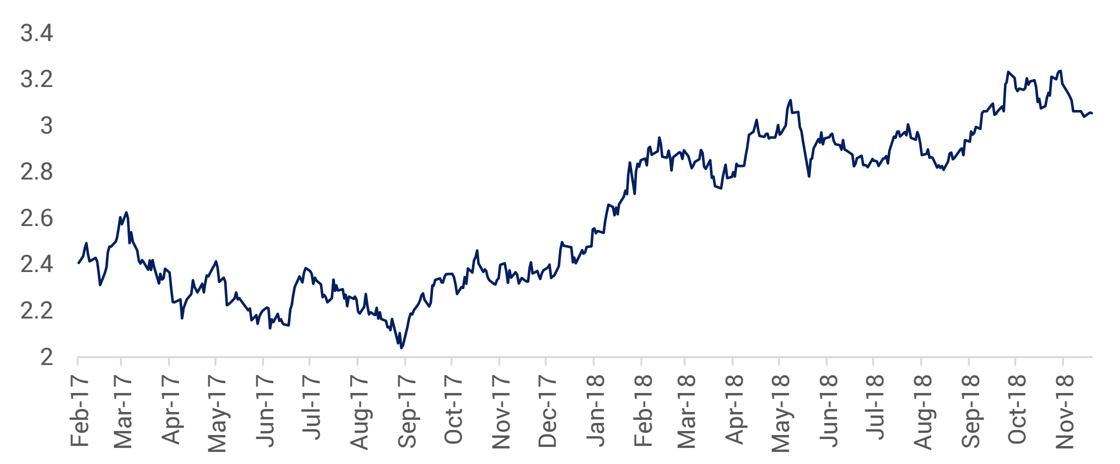
US-China trade standoff

As the G-20 finance leaders meet to discuss global policies in the Argentine capital of Buenos Aires on Nov. 30 and Dec. 1, one of the most pressing challenges will be the trade tariff dispute between the US and China. The outcome of meeting between U.S. President Donald Trump and his Chinese counterpart Xi Jinping is likely to decide the future course of Sino-U.S. relations and global trade. One needs to watch whether US goes ahead with the increase in tariffs - from 10% to 25% on USD 200 bn of Chinese imports (as scheduled to take effect from 1st Jan'19). Any negative outcome between the two sides could be harmful for global trade and emerging market currencies.

Treasury bond yields have eased

In its last meeting, the U.S. central bank left rates unchanged as expected, but maintained its plans to hike interest rates, saying it saw "further gradual increases" ahead. The bank did, however, note that business investment had "moderated from its rapid pace earlier in the year." As a result, bond yields eased off from their recent highs of 3.23%. Bonds also sold off following the U.S. midterm elections, which resulted in the Democrats winning the House of Representatives and the Republicans retaining the Senate. A split congress could stall plans for further tax cuts, which led to pressure on bond yields.

Chart 2 US 10 year treasury yield



Source: Bloomberg

Brexit deal

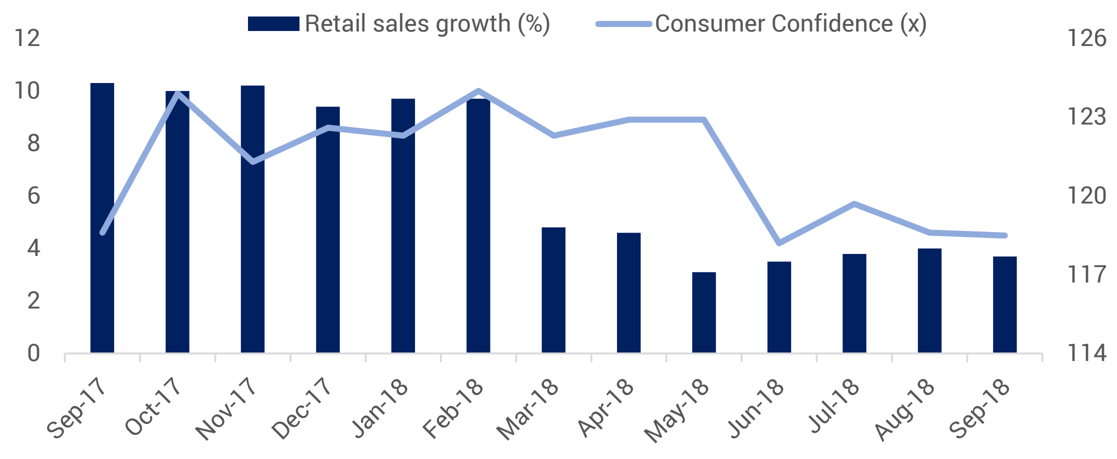
In an important milestone for Britain, EU leaders have approved an agreement on the UK's withdrawal and future relations - insisting it is the "best and only deal possible". Now, the withdrawal agreement is lined up to be approved by the U.K. Parliament on 12th December 2018. In case the deal is voted down by the U.K, the government could try to extend the deadline of March 29 (when the U.K. is officially due to leave the European Union) or the country crashes out of the EU without a deal.

Leaving the EU in March of next year without a deal would mean that World Trade Organization rules would apply. This would inevitably raise tariffs and costs for both producers and consumers. At the moment, the U.K. is a member of the EU single market of goods, meaning that trade is frictionless and with zero tariffs. There would be immense disruption and uncertainty, including in the energy market, the supply of medicines and medical devices, as well as in the car industry. A no deal exit could lead to a swift drop in the Pound, similar to that aftermath of the Brexit referendum in 2016.

Economic momentum in China

The Chinese economy is slowing down with most growth indicators barely in the expansion zone. Bloomberg Economics projects the Chinese GDP to be up by 6.4% in year. This will be the lowest growth figure since 1990. China has already embarked on fiscal and monetary measures (reduction of reserve requirements for large banks to 14.5% from 17%, VAT rate reduced to 16% from 17% for manufacturing and Personal income tax-free threshold raised to 5,000 yuan per month from 3,500 yuan etc) to support the economy but the Chinese government's efforts to support growth may be inadequate if ongoing China-US trade issues were to escalate into a full-blown trade war, which could result in further disruption in the Chinese economy. Other EMs could see collateral damage in the process although India would be relatively less affected given its low export dependence.

Chart 3 State of Chinese economy



Source: KIE, Bloomberg

Crude Oil price decline brings some relief

The recent decline in global crude oil prices reflects (1) higher oil production by several OPEC countries over the past few months and (2) temporary 180-day exemption granted by the US to eight countries to continue to import oil from Iran. However, the decline may be temporary as the US administration has unambiguously stated its intention to bring down Iran oil exports to zero eventually. Also, OPEC leaders will gather in Vienna on Dec. 6 to discuss how to manage the oil output, supply glut and demand slowdown.

Even so, the lower oil prices will result in stable macroeconomic conditions and from an election standpoint, (1) keep domestic retail auto fuel prices under check; steep increases in retail auto fuel prices before elections could spiral into an election issue and (2) provide the current government more fiscal freedom to spend before elections.

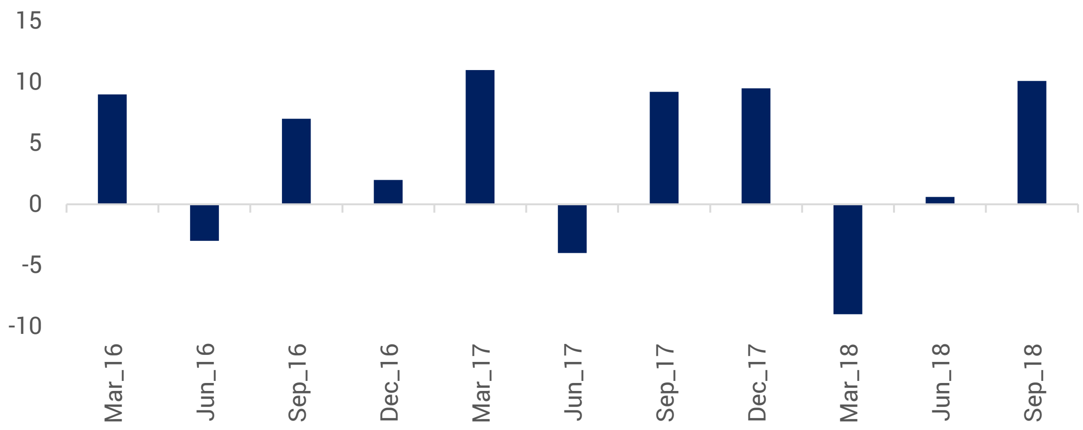
Chart 4 Crude chart

Source: Bloomberg

September ending quarter earnings Season

Adjusted net profits of the BSE-30 Index and Nifty-50 Index increased 10% yoy in the September ending quarter. However, excluding banking stocks, net income of the BSE-30 Index and Nifty-50 Index grew 12% and 11%, respectively. A few banks reported significantly lower profits on yoy basis due to (1) high loan-loss provisions arising from the February 12, 2018 directive of the RBI on stress recognition and resolution and (2) lower other income (high capital gains in base quarter). However, almost all the banks reported a significant improvement in profits on a qoq basis on the back of lower loan-loss provisions.

Chart 5 BSE-30 Earnings growth



Source: Kotak Institutional Equities

State elections – harbinger to general elections

In October, Election Commission of India (EC) announced polling schedule for Assembly elections in five states - Chhattisgarh, Madhya Pradesh, Mizoram, Rajasthan and Telangana. Chhattisgarh will vote in two phases, other states will vote in a single phase. Counting of votes in all the five states will be done on December 11. Past results in upcoming elections in 3 states – Rajasthan has witnessed alternate government formations, while MP and Chhattisgarh have been ruled by BJP for the past 15 years. We believe these elections are important, as they will be seen as an indication of people's mood towards the ruling party and could also be a precursor to the upcoming general election scheduled somewhere in Apr-May'19.

Election Schedule

State	No of Assembly seats	Incumbent Government	Election date	Counting
Rajasthan	200	BJP	7th Dec	11th December
Madhya Pradesh	230	BJP	28th Nov	11th December
Chhattisgarh	90	BJP	12th and 20th November	11th December
Telangana	119	TRS	7th Dec	11th December
Mizoram	40	Congress	28th Nov	11th December

Source: Media reports and Kotak Institutional Equities

As of now, opinion polls indicate that the BJP will lose in Rajasthan but retain power in Chhattisgarh and Madhya Pradesh despite close contests in those states. The market expects a similar outcome. Thus, a 0-3 (BJP losing all the three states) or 1-2 (BJP losing Madhya Pradesh and Rajasthan) tally for the BJP may result in a correction in the market. In this scenario, market may take a dim view of the BJP's prospects in the general elections given the importance of the three states in the BJP's 2014 win. However, a 3-0 or 2-1 (any combination) score for the BJP may fortify the market's expectations about the current BJP-led government forming the next government post the April/May general elections

Table – Opinion Poll Results

	CVoter	India TV-CNX	Times
Chhattisgarh			
BJP	40	50	47
INC	47	30	33
Others		10	10
Madhya Pradesh			
BJP	108	128	122
INC	122	85	95
Others		17	13
Rajasthan			
BJP	56	75	70-80
INC	142	115	110-120
Others		8	7-10

Source: Media reports and Kotak Institutional Equities

Declining crude price to mitigate macro risks

With 30% decline in crude prices, the rising macro risks to the Indian economy have begun to abate. The benefit is on several fronts. We look at some of them:

- **Indian Rupee** - With the crash in crude, India's CAD will not aggravate further as the market feared earlier. Hence, the INR has appreciated by a good margin to below 70 from 74.40 levels. Since the US 10 Year treasury bond yield has corrected to 3.06% from high of 3.23%, it has resulted in reduction in foreign fund outflows from Indian debt market. Taking note of the reduction in macro risks and easing of market valuations, FIIs stopped selling and have turned buyers in November.

- **Inflation** - CPI inflation eased to 3.31% in October from a downward revised print of 3.7% in September. This was primarily led by contraction of 0.9% in food inflation amid sharp drop in prices of vegetables and pulses. Food inflation is likely to remain benign, especially as most kharif crop prices remain well below the MSP prices. This coupled with reversal in crude prices in November, Inflation is likely to remain under control in the coming months, we believe.

- **Interest rates** - Given the strong focus of the Monetary Policy Committee on the headline inflation print, which should remain benign for the rest of 2HFY19 (we expect it in the range of 2.8-4.3%), the RBI is unlikely to (1) change the repo rate, (2) keep CRR unchanged and (3) maintain the policy stance at 'calibrated tightening'

Signs of economic recovery gaining strength

We are seeing early signs of uptick in economic growth. Some of the key parameters like credit growth, capacity utilisation and order intake for capital goods companies have started to show traction. Job outlook has started to improve as reflected by some momentum in IT sector hiring.

- **Credit growth** - On a year-on-year (y-o-y) basis, non-food bank credit increased by 11.3 per cent in September 2018 as compared with an increase of 6.1 per cent in September 2017.

Table - Macro snapshot

	Dec-07	May-13	Oct-13
Capacity Utilisation (Mar-18)	91.7	71.6	74.9
Credit Growth (as on 30 Sept 2018)	22	14.4	11.3
ROE Nifty 50 (Oct 18)	25.5	17.1	13
IIP - Aug 18	13.5	1	4.5
GDP Growth (Apr - Jun 18)	9.6	6.4	8
10-Yrear Govt Bond Yield	7.8	7.2	7.8

Source: RBI

- **Investment Cycle** - Demand for heavy equipment by Indian companies, an indirect measure of economic growth, is showing signs of rebound driven by government spending on railways, roads and smart cities ahead of the next general election. Siemens India Ltd., ABB India Ltd., Thermax Ltd. and Cummins Ltd. beat quarterly sales and operating income estimates. While mega/big ticket projects are yet to start, several consumer oriented industries have begun investing in capacity expansion/capacity optimisation projects, which is leading to better order book number for companies.

Table - Growth in Quarterly Order intake for key Capital Goods makers (in Q2FY19)

Company	YoY (%)
L&T	46
Thermax	-3
Siemens	37
ABB	21
Praj	38

Source: BSEIndia.com

Fund flows – FIIs turn positive. MF flows remain resilient

Overseas funds have turned net buyers in November so far. Two main factors that have led to FIIs reversal include INR appreciation against the USD and steep fall in crude price. YTD in this calendar year FIIs have sold stocks worth USD 5.5 bn whereas domestic Mutual Funds have bought stocks worth USD 16.3 bn. Other emerging markets like South Korea, Taiwan, Indonesia & Thailand have seen YTD outflows ranging between USD 4bn to USD 10 bn. However, on a monthly basis, FII flows have turned positive at USD 720 mn in Nov'18. In fact, this will be one of the few months when FII flow has been higher than MF flows (USD 353 mn).

Valuations have turned favorable for overall market

India's overall market valuations have become reasonable as compared to its 10 year average but is still slightly expensive when compared to the Bond PE. Current valuations factor in a strong recovery in earnings over FY2019-20E. At 16x FY2020E 'EPS' the Nifty 50 trades slightly below its 10 year average Fw PE valuations. Earnings growth of ~14-15% in FY19E will be highest in the last 4 years. Going forward our house is building in earnings growth of ~25% in FY20E mainly led by high earnings growth in the banking sector. Any disappointment in earnings of banking sector in FY20 could lead to sharp correction in the FY20E of Nifty EPS.

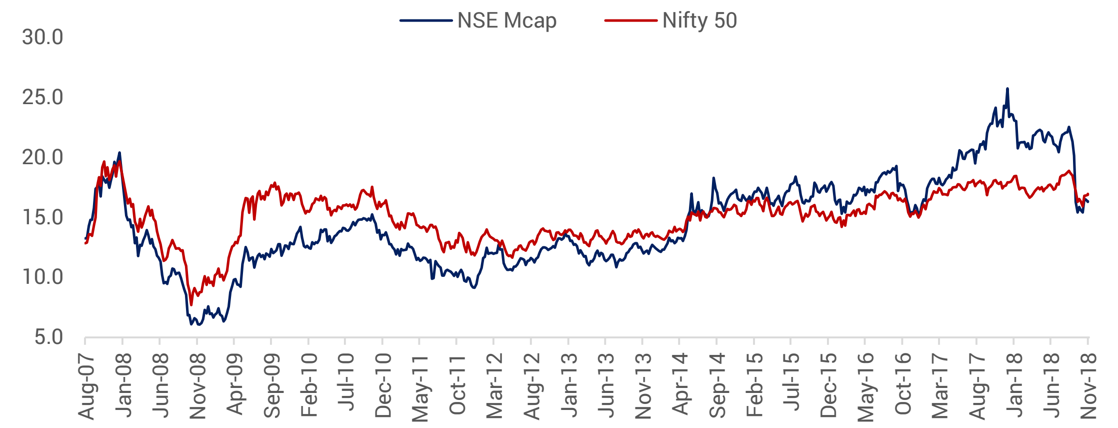
Based on Bloomberg consensus estimates, the one year Fw PE of Mid Cap Index has now come down to 15x as compared to 16x of Nifty. The above average gap between the Equity PE and bond PE could cap any big re-rating in equities (unless the 10 Yr G-Sec bond yields go to or below the 7% mark). With macros turning positive and after a 18% from fall from the peak , the overvaluation in mid cap Index has faded away. The risk-reward ratio has turned favourable for many mid and small cap stocks. Many of the mid & small cap stocks have gone closer to their historic low valuations. This provides enough comfort for bottom fishing at this level in the mid and small cap space. Any near term correction in the market due to political uncertainty should be viewed as a buying opportunity (provided crude & currency remain closer to the current levels).

Table – Valuation Comparison

	BSE Sensex	BSE Mid cap
P/BV (x) as on 16-Jan-18		
10 Y Avg Price to Book Ratio	2.4	1.75
Current Price to Book Ratio	2.7	2.4
Price to Book Ratio Premium	13%	37%
P/BV (x) as on 29-Nov-18		
10 Y Avg Price to Book Ratio	2.4	1.75
Current Price to Book Ratio	2.55	2.16
Price to Book Ratio Premium	6%	23%

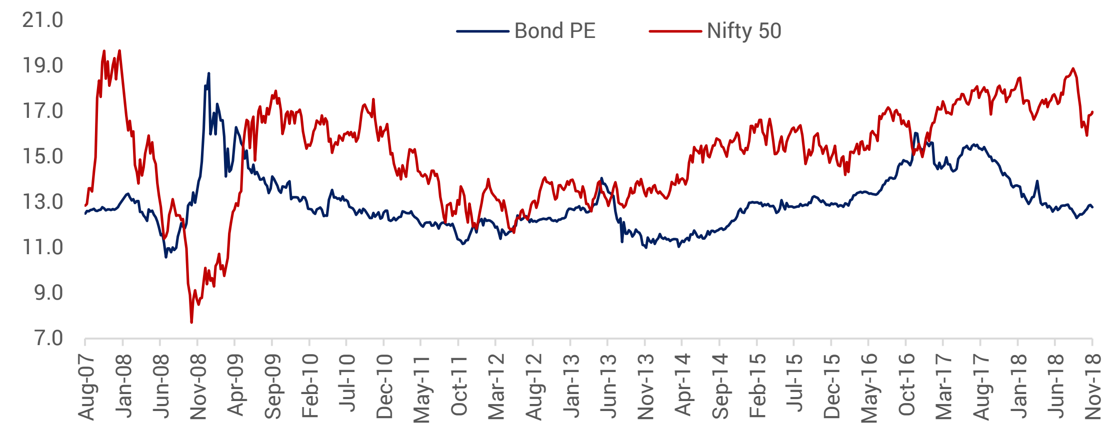
Source: Bloomberg

Chart 6 - One Yr Fw PE chart: Nifty Vs Mid Cap Index



Source: Bloomberg

Chart 7 - Bond PE Vs Fw Equity PE of Nifty



Source: Bloomberg

Economic Calendar for December

Date	Event	Remark
30-Nov	G20 meet	Trade talks between China and US
4-Dec	Monetary Policy meet	Rate hike unlikely given that inflation remains benign
30-Nov	Q2 FY19 India GDP data	Important to gauge the strength of economic growth
6-Dec	OPEC meet	Supply cut likely in crude output
11-Dec	State Election Results	Election results in MP
16-Dec	Fed rate	Fed may hike rate but more important is the glide path from thereon

Source: CNBC, RBI and MOSPI

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REDUCE	–	We expect the stock to deliver 0% - 5% returns over the next 12 months
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