March 2019

MARKET OUTLOOK

- Market Outlook
- Top Investment Ideas

Teena Virmani
teena.virmani@kotak.com
+91 22 6218 6432

MARKET OUTLOOK FOR MARCH 2019

Market Outlook: Markets have continued to remain volatile led by mixed global cues as well as border tensions across India and Pakistan. After the IAF strikes across the LoC, the advantage is now with the ruling party as against opposition. Domestically, macros have improved in terms of lower inflation, possibility of further cut in interest rates by RBI, easing off of oil prices as well as expectations of healthy growth in profits for FY20. However, border tensions, election dates, pre-poll alliances and more importantly the government's ability for striking a fine balance between populism and prudence will keep markets on their toes in the coming months. Globally, easing off of US-China trade spat, FOMC stance on balance sheet normalization, Brexit and oil prices will also be deciding factors for market movement.

Portfolio Strategy: Keeping in mind the volatility expected in 2019 led by factors such as developed market slowdown, US-China trade fears, Brexit, domestic elections, oil prices, it would be ideal to have a bottom up approach and pick and choose good quality, beaten down stocks from respective sectors. To weather the on-going volatility which may remain till middle of CY19 (i.e. till Central elections), it is ideal to have higher allocation into high earnings growth large caps and midcaps (with strong management pedigree and reasonable valuations). Among the large caps one can focus on select stocks from sectors like banks, select pharmaceuticals, IT services, metals & mining and oil & gas. In the mid-caps, one can focus on select stocks from sectors like capital goods, construction and auto ancillaries.

Earnings: 3QFY19 net profits of the Nifty-50 Index increased 2.1% yoy and were led by better-than-expected results of the downstream oil companies (higher-than expected refining margins). On an ex-energy basis, 3QFY19 net profits increased 11.1% yoy. Sectors that delivered strong YoY growth in earnings were banks, capital goods, and IT services. Sectors that disappointed on YoY earnings growth were automobiles, telecom, metals & mining and real estate. Based on our institutional forecast, we expect net profits to grow by 26% in FY2020 led mainly by sectors like banks, automobile, pharmaceuticals as well as consumption related sector.

Valuations: Based on 13%/26% estimated growth in earnings of FY19E/20E, the Nifty is currently trading at 21.6x/16.8x FY19E/20E, respectively (free float basis). Valuation of Nifty looks reasonable when viewed against recent historical valuations of ~18-20x on forward PE basis (mainly due to high earnings growth expectation). However, considering the border tensions coupled with election uncertainty, we expect volatility to continue and would recommend a bottom-up approach across large cap and mid-cap.

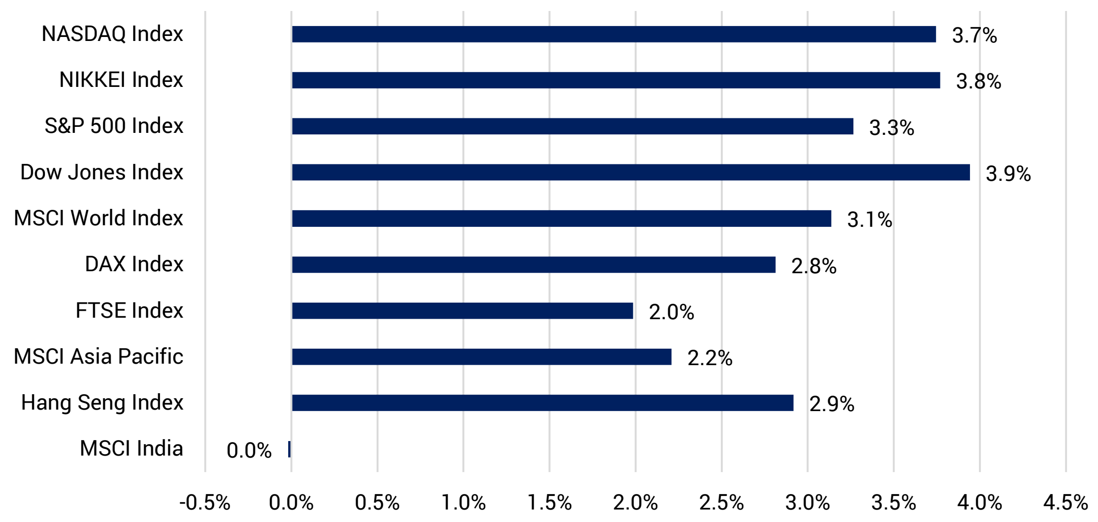
TOP INVESTMENT IDEAS

Recommended Stocks

Company	CMP* (Rs)	Target Price (Rs)	Potential Upside (%)	52 Week H/L (Rs)	Market Cap (Rs mn)
HDFC Life Insurance	352	435	23.5	548 / 344	710,579
LIC Housing Finance Ltd	476	590	24.1	584 / 388	239,967
Bharat Electronics	83	100	21.2	158 / 73	201,019
Aegis Logistics	199	250	25.7	300 / 170	66,433
Suven Life Sciences	241	425	76.5	338 / 161	30,656
Surya Roshini Ltd	224	330	46.1	454 / 185	12,185

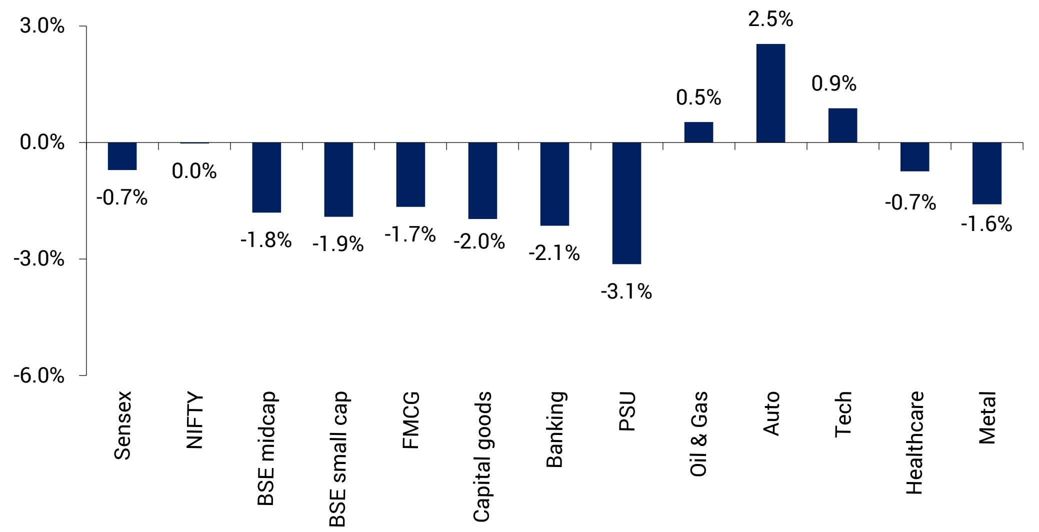
*Source: Kotak Institutional Equities; Kotak Securities – Private Client Research; *CMP as on 28 February 2019.*

1-month performance of benchmark global indices (%) - (February 2019)



Source: Bloomberg

Market performance – sector wise (February 2019)



Source: Bloomberg

GLOBAL MARKETS

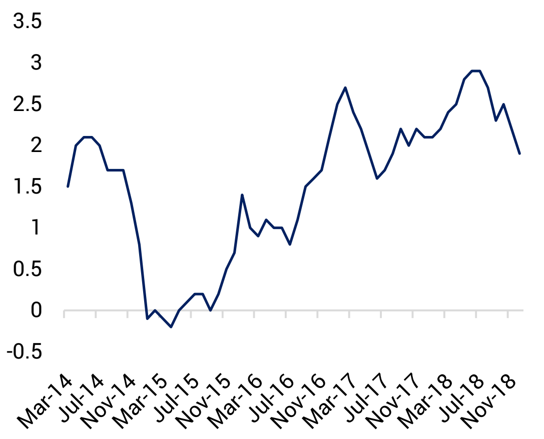
Global markets moved up during the month post FOMC's stance to keep rates unchanged as well as positive hopes on resolution of US-China trade spat. However, uncertainty regarding Brexit is still weighing on the markets and it is important to see how balance sheet normalization is going to be done in US.

US – Balance sheet normalization and rate decisions

For United States, the year started off with a partial government shutdown, which is costing the economy $11 billion along with the lower reading for US consumer confidence in January which although rebounded in the month of February. Domestic economic data points such as inflation, unemployment, GDP growth rate along with global uncertainties pertaining to growth slowdown, trade impasse and government budget negotiations are likely to weigh on the FOMC decision on rate hikes going forward.

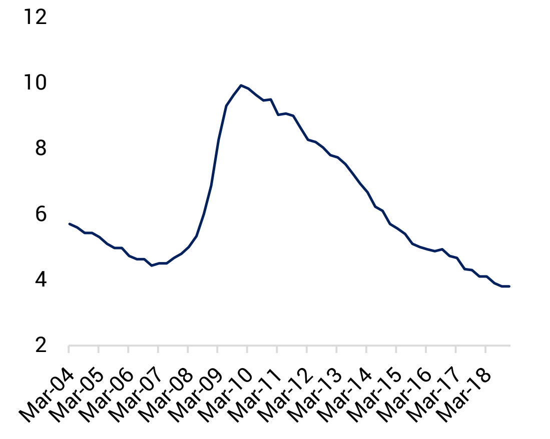
Along with FOMC meet, it is important to see how the central bank plans to proceed with the reduction of bonds upto $4 trillion it holds on its balance sheet. In August 2007, before the financial crisis hit, the Fed's balance sheet totaled about $870 billion. By January 2015, after large-scale asset purchases, its balance sheet had swelled to $4.5 trillion (currently ~$4 trillion). Balance sheet normalization paired with interest rate hikes will cause the economy to slow so it is important to see at what level it is going to end. While Fed officials expect it to happen smoothly but it has become a matter of concern as financial conditions weakened during fourth quarter.

US CPI inflation (%)



Source: Bloomberg

US unemployment (%)

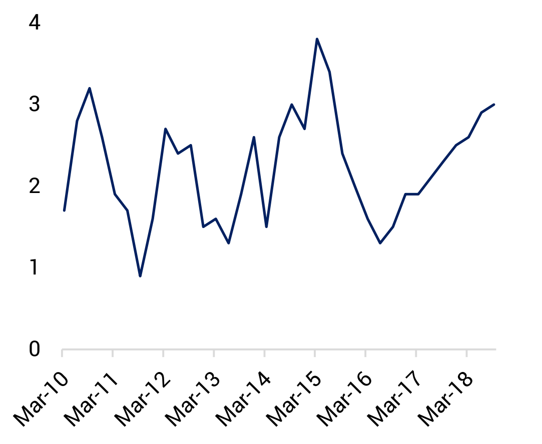


Source: Bloomberg

US GDP growth – Slowing global manufacturing activity, tighter financial conditions, sluggish business equipment spending, and lackluster federal government spending (due in part to the government shutdown in January) all contributed to the weakest quarter for U.S. growth in two years. US GDP grew at a 2.6 percent annual rate in the final three months of last year which marked a significant slowdown from the middle of the year, when tax cuts and government spending increases had briefly pushed growth above 4 percent. However, it stood better than the industry estimates. For the full year, growth topped at 3.1% for 2018. Going forward, FOMC expects US GDP growth to slow to 2.3% and 1.8% in 2020 and 2021 respectively.

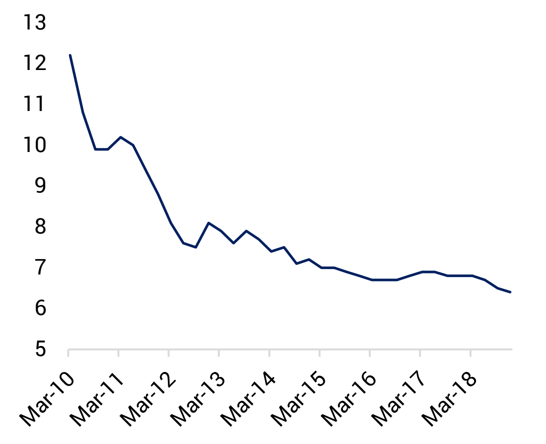
US china trade agreement timeline - US has delayed additional tariffs on China on substantial progress on bilateral trade talks between the two largest economies. US had planned to raise tariffs to 25 percent from 10 percent on $200 billion worth of Chinese imports into the United States from 1st March if an agreement between the world's two largest economies were not reached. Progress had been made in divisive areas including intellectual property protection, technology transfers, agriculture, services and currency between the two nations. Settlement of trade dispute between the two nations would ease some uncertainty from the markets.

US GDP growth (%)



Source: Bloomberg

China GDP growth (%)



Source: Bloomberg

Brexit uncertainty to weigh on markets – Uncertainty around UK's exit from the European Union is also weighing on the market sentiment. There is a possibility that Brexit may get delayed by two months as plans are being considered to extend Article 50 after the vote on Brexit deal has been put off in the Parliament until March 12. This decision increases the chances that Brexit may be delayed beyond 29th March to avoid a potentially disastrous situation where Britain exits with no agreement at all.

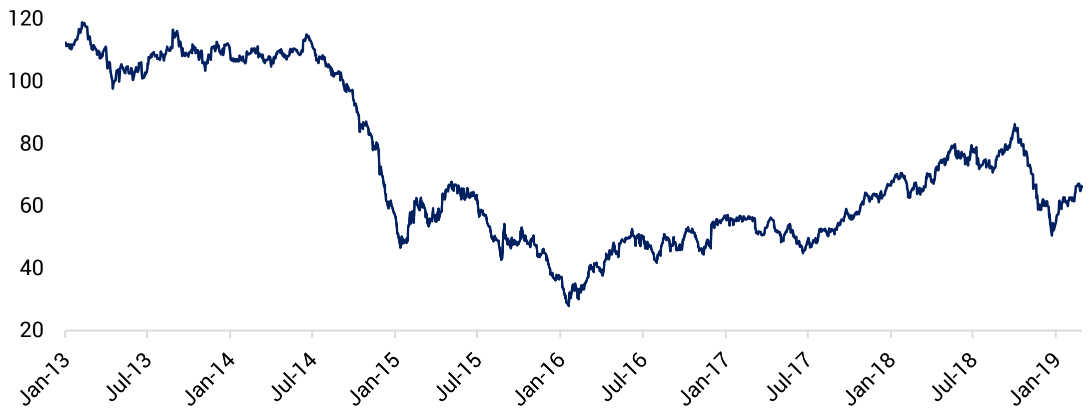
Recently, Fitch also mentioned that they may downgrade the United Kingdom's 'AA' debt rating based on growing uncertainty about the negotiations between Britain and the European Union over Brexit. European commission has already downgraded growth forecasts for Euro-zone to 1.3 percent this year from 1.9 percent in 2018 and expects it to rebound in 2020 to 1.6 percent. If it's a no-deal Brexit, the UK would sever all ties with the EU with immediate effect, with no transition period and no guarantees on citizens' rights of residence. The government fears this would cause significant disruption to businesses in the short-term.

Japan not in a hurry for normalization - Bank of Japan is not in a hurry to cut back on the stimulus and the central bank is even ready to ramp up stimulus if sharp yen rises hurt the economy and derail the path towards achieving its 2 percent inflation target. However, the hurdle for increasing the stimulus would be higher knowing that the profits of financial institutions were impacted negatively by near-zero interest rates.

Brent - Crude prices have moved up by nearly 20 percent since the start of the year, when the Organization of the Petroleum Exporting Countries and non-member producers, such as Russia, began cutting production in an effort to reduce a global glut. Optimism about a U.S.-China trade deal also helped prices to rally. Saudi Arabia and other OPEC members are likely to be cautious about relaxing their supply-cut plan after a boost in output in the second half of last year ahead of U.S. sanctions on Iran led to a steep slide in prices.

From January 2019, OPEC, Russia and several other producers have launched new production cuts that aim to remove 1.2 million barrels per day from the market. The alliance will again meet in April, 2019 to determine whether market conditions warrant keeping the curbs in place which expire in June, 2019. This can result in some upward spurt in oil prices from the current levels. But we believe that if developed market growth slows down then it will impact oil prices negatively.

Brent crude (US$/bbl)



Source: Bloomberg

DOMESTIC MARKETS

The month started off with Union Budget announcements with a revised fiscal deficit estimate, higher borrowings for FY20, tax rebates and PM-Kisan scheme to reduce distress in the farm sector. With capital infusion announcements for public sector banks, rate changes in GST to revive real estate sector and transfer of first tranche of Pradhan Mantri Kisan Samman Nidhi (PM-KISAN) scheme, government seems to be on track to meet its promises. After the IAF strikes across the LoC, the advantage is now with the ruling party and has enhanced the image of PM Mr Modi as a strong leader. This is also likely to reduce the political noise associated with agrarian crisis or Rafale deal and may have a possibility of making things challenging for the opposition. However, we continue to believe that in next few months with elections approaching, the markets are likely to be volatile and post that the focus is likely to shift towards earnings recovery.

GDP growth moderation

GDP growth moderated further to 6.6% in Q3FY19 from a downwardly revised growth of 7% for Q2FY19. This moderation was due to slowdown in agriculture and services and also impacted to some extent by an unfavorable high base. Agriculture slowed to 2.7% in Q3FY19 from 4.2% in Q2FY19 while services moderated to 7.2% from 7.4% in Q2FY19. Industrial growth improved to 7.1% from 6.7% in Q2FY19. The CSO expects FY2019 GDP growth at 7%, implying a GDP growth of around 6.5% in 4QFY19.

Going forward, we believe that global slowdown fears as well as domestic liquidity crunch can have an adverse impact on growth numbers in the coming quarters. Our economists expect FY2020 GDP growth to improve marginally to 7.1% from 6.9% in FY2019 led by the lagged impact of a loose monetary and fiscal policy. We do expect a rate cut of 25 basis points in April from MPC but if growth momentum slows further, we do not rule out the possibility of further 25 bps rate cut post April.

GDP estimates

	2016	2017	2018	2019E	2020E
Real GVA	8.0	7.9	6.9	6.7	6.9
Agriculture and allied	0.6	6.3	5.0	2.7	4.9
Industry	9.6	7.7	5.9	7.7	6.7
Services	9.4	8.4	8.1	7.2	7.5
Real GDP	8.0	8.2	7.2	6.9	7.1
Private sector GVA	10.1	8.0	6.5	7.3	7.0
Non-agriculture GVA	9.5	8.2	7.3	7.4	7.2

Source: CEIC, Kotak economics research

Results – Costs coming down

3QFY19 net profits of the Nifty-50 Index increased 2.1% yoy and were led by better-than-expected results of the downstream oil companies (higher-than expected refining margins). On an ex-energy basis, 3QFY19 net profits increased 11.1% yoy. Sectors that delivered strong YoY growth in earnings were banks, capital goods, and IT services. Sectors that disappointed on YoY earnings growth were automobiles, telecom, metals & mining and real estate. INR depreciation, government spending and GST rate cuts provided boost to sectors like pharma, IT, consumption while slowdown in global growth and trade-war fears coupled with liquidity crunch weighed on metals and mining, real estate and auto sector.

Sectoral outlook

Sector	Outlook going forward
Auto	Sector performance was impacted by higher raw material costs, disappointing volume numbers and increased competition. Going forward we expect moderation in costs and competition to drive growth in profitability.
IT	IT sector's contribution to Nifty earnings is likely to be lower in FY20 due to more gradual depreciation of rupee vs dollar, weaker demand from customers due to global slowdown fears and lower margins.
Banks/NBFCs	Banks are expected to report strong growth in net profits due to steep decline in loan loss provisions and possible recovery on loans already written off on successful resolution of a few large cases in the NCLT.
FMCG	Demand conditions are likely to be positive for the sector over next 12 months with various state government and central government continuing to spend on rural India owing to election schedule. Sector is likely to benefit from steady volume growth and stable margins going forward.
Cement	Volume growth remained strong for the sector but realizations were impacted by limited ability of companies to pass on higher costs. Costs seem to have peaked out and moderation is now being witnessed in pet coke and diesel prices which should get reflected in margins from Q4FY19 onwards.
Capital Goods	Results were broadly in line with our estimates. Margins seem to have bottomed out and are expected to improve from increased public spending on infrastructure and benign raw material prices. Capacity utilization stands close to 70% across major industries. Growth going forward is likely to be led by improved execution across key segments like railways, roads, mining, defence, steel etc.
Infrastructure	Strong order book, sufficient cushion on margins and healthy balance sheet has improved sector's performance. The challenge came mainly from delays in financial closure and delays in receiving appointed dates for HAM projects. However, we expect these issues to get resolved in 1-2 quarters and expect continued healthy execution performance owing to strong book to bill ratios.
Building material	For Building material sector, volumes have been on an uptrend while realizations have still not seen meaningful improvement due to increased competition. Significant benefits from e-way bill implementation are yet to be reflected in volumes and market share. Going forward, gains are likely to be led by volume gains in each segment.
Pharmaceuticals	Pharma sector growth going forward is going to be led by pickup in new launches of generic products in the US from 2HFY19, which will drive US generic revenues and overall, revenues and profits
Metals	The metals & mining sector has seen meaningful earning downgrades on growing concerns about global economic slowdown and US-China trade spat. Going forward, earnings recovery would be contingent upon how developments span out on US-China trade spat and global economic recovery.
Oil and Gas	The earnings of the downstream oil sector are somewhat uncertain given risks of possible government intervention in pricing of diesel and gasoline before elections in case oil prices were to rise sharply from here on. For upstream companies, meaningful subsidy burden is not expected in FY20.

Source: Kotak Securities, Kotak Institutional estimates

Going ahead, with reduction in brent crude prices, overall costs for various sectors have come down which should get reflected in the profitability. However, it is important to see if there is any impact on the underlying demand from global slowdown as well as liquidity crunch. With upcoming elections, shift in government's focus from capex and infrastructure spending towards rural spending may also have a negative impact on earnings.

Based on our institutional forecast, we expect net profits of Nifty-50 to grow by 26% in FY2020 led mainly by sectors like banks, automobile, pharmaceuticals as well as consumption related sector.

RBI to cut rates by another 25 bps in April

As per the minutes of February MPC meeting, subdued inflation and faltering growth may lead to MPC going ahead with another 25 bps rate cut in April. The minutes acknowledged that given that the objective of low and durable inflation has been achieved, the focus then shifts to addressing growth. Further monetary accommodation beyond April would, however, depend on the evolution of growth and inflation.

Our economists believe that softer-than-expected January CPI print of 2.05%, MPC's downward revision of 60-80 bps to the MPC's 1HFY20 inflation projections to 3.2-3.4% and the opening up of the output gap have improved the probability of multiple rate cuts in 2019. But it would depend on inflation trajectory as there are upside risks to inflation coming from volatility in food and fuel prices, monsoon, fiscal slippages and elevated core inflation.

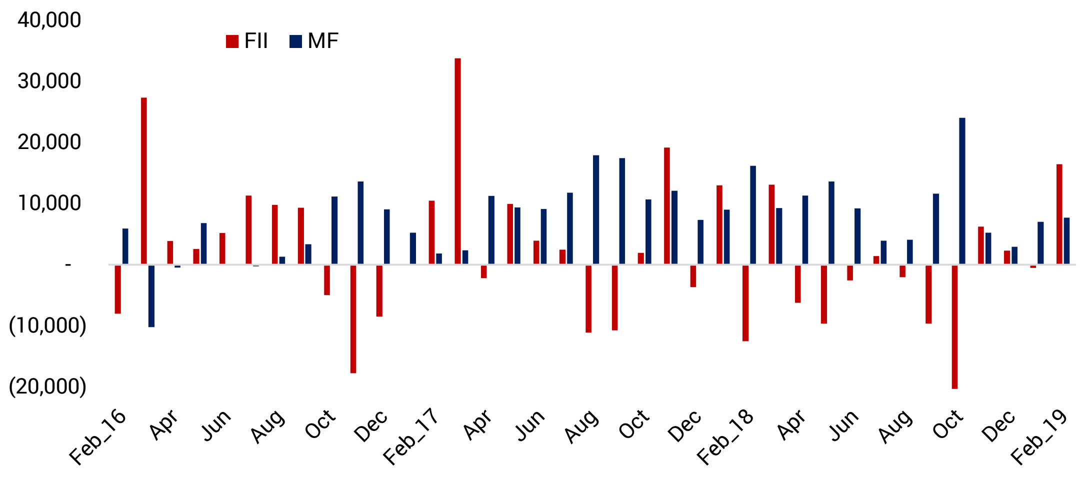
MPC also noted that the slowdown in global growth may also lead to softening of crude oil prices and moderation in inflation. The downside risks to the inflation outlook also include continuing moderation in food inflation. Oil prices have stabilized currently between $60-65$ and risks of significant overshooting on a sustained basis have reduced sharply. Upside risks to inflation and oil prices would include any kind of supply disruptions in crude oil and geopolitical tensions.

FII and MF inflows

Overseas funds have turned buyers again in Feb 2019 led by Fed's stance to keep the policy rate unchanged at 2.25%-2.5%. YTD in this calendar year, FIIs have bought stocks worth Rs.159 bn whereas domestic Mutual Funds have bought stocks worth Rs.145 bn till 27th Feb, 2019. However, on a monthly basis, FII inflows stood at Rs.164 bn and MF inflows stood at Rs.73.5 bn.

Average monthly net inflows into mutual fund equity schemes have come down and it stood at Rs 61.5 bn for January 2019, down by 6.7% from December 2018 and by 60% from January 2018 inflows. This was impacted by continued volatility in markets and even political uncertainty. FII inflows are improving and going forward if we see Fed pausing sometime in the first half of CY19 then we can expect FII inflows to resume in emerging markets and India. Flows in CY19 could also be a function of the election outcome.

MF/FII flows (in crores)



Source: Bloomberg

Recommendation

Based on 13%/26% estimated growth in earnings of FY19E/20E, the Nifty is currently trading at 21.5x/16.8x FY19E/20E, respectively (on free float basis). Valuation of Nifty looks reasonable when viewed against recent historical valuations of ~18-20x on forward PE basis (mainly due to high earnings growth expectation).

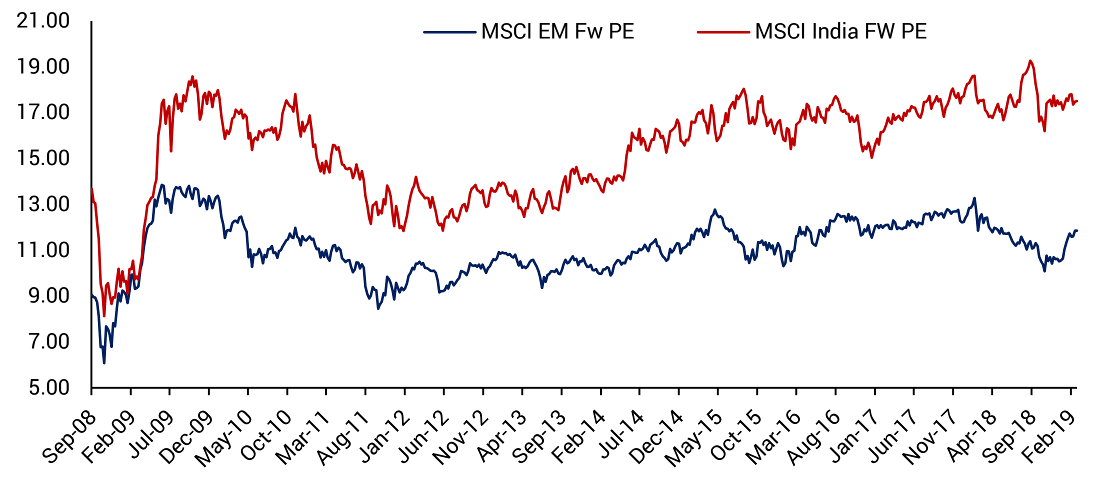
Based on Bloomberg consensus estimates, the one year forward PE of Mid Cap Index has now come down to 15.2x and compared to 17x of Nifty-50. We feel the froth and over valuation in the Mid Cap space has come off sharply due to the underperformance vis-à-vis Nifty. We feel there is very high probability of mid & small caps outperforming the large caps in CY19. For this thing to fully materialize in CY19, we need earnings recovery and a clear mandate or a single party led coalition Government at the Centre. Scope of valuation re-rating remains very high in host of mid & small caps provided earnings come in line with estimates.

On a 1 Year forward basis, MSCI India is trading at 17.5x Vs 11.9x of MSCI Emerging Markets. At present the premium of MSCI India over MSCI EM is 48% as compared to the 10 year average of 40%. Considering the election overhang and slightly higher premium over MSCI EM we see less room for any re-rating in India's valuation.

Our strategy, keeping in mind the volatility expected in 2019 led by factors such as developed market slowdown, US-China trade fears, Brexit, domestic elections, oil prices, would be to have a bottom up approach and pick and choose good quality, beaten down stocks from respective sectors. To weather the on-going volatility which may remain till middle of CY19 (i.e. till Central elections), it is ideal to have higher allocation into high earnings growth large caps and midcaps (with strong management pedigree and reasonable valuations). Among the large caps one can focus on select stocks from sectors like banks, select pharmaceuticals, IT services, metals & mining and oil & gas. In the mid-caps, one can focus on select stocks from sectors like capital goods, construction and auto ancillaries.

India has underperformed other major Asian markets like China, S.Korea & Taiwan. From the recent low of 10.5x the MSCI EM Fw PE has moved up to 11.9x. MSCI India has been trading in a narrow range and currently trades at Fw PE of 17.5x.

MSCI Emerging Market Vs MSCI India 1 Yr rolling FW PE



Source: Bloomberg

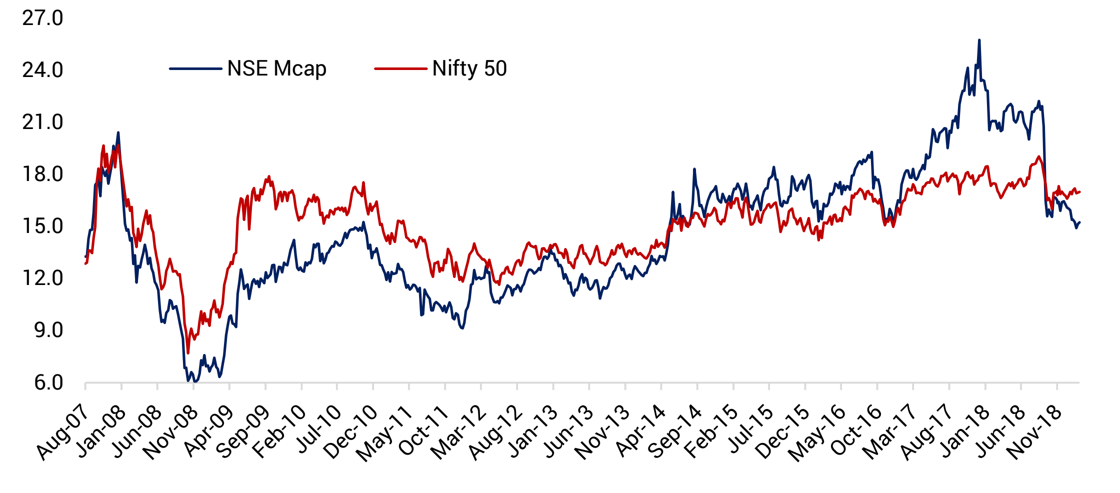
India's premium to MSCI EM is now coming closer to the 10-year average. From the peak of 70%, the premium has come down to 48% (10-Yr average premium is 40%). The major reason for the narrowing of premium is the 16% rally in Chinese markets from its recent low.

MSCI India Vs MSCI EM - Premium (on FW PE basis)

Source: Bloomberg

From super premium a year ago the Mid Cap Fw PE has now touched the Dec'16 low of ~15x. The Mid Cap Fw PE is now trading 180 bps below the Nifty Fw PE of 17x. As the Mid Cap Fw PE has corrected to ~15x, value is emerging in host of mid cap stocks.

One Yr Fw PE chart: Nifty Vs Mid Cap Index



Source: Bloomberg

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BUY	–	We expect the stock to deliver more than 15% returns over the next 12 months
ADD	–	We expect the stock to deliver 5% - 15% returns over the next 12 months
REDUCE	–	We expect the stock to deliver -5% - +5% returns over the next 12 months
SELL	–	We expect the stock to deliver < -5% returns over the next 12 months
NR	–	**Not Rated.** Kotak Securities is not assigning any rating or price target to the stock. The report has been prepared for information purposes only.
SUBSCRIBE	–	We advise investor to subscribe to the IPO.
RS	–	**Rating Suspended.** Kotak Securities has suspended the investment rating and price target for this stock, either because there is not a Sufficient fundamental basis for determining, or there are legal, regulatory or policy constraints around publishing, an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
NA	–	**Not Available or Not Applicable.** The information is not available for display or is not applicable
NM	–	**Not Meaningful.** The information is not meaningful and is therefore excluded.
NOTE	–	Our target prices are with a 12-month perspective. Returns stated in the rating scale are our internal benchmark.

FUNDAMENTAL RESEARCH TEAM (PRIVATE CLIENT RESEARCH)

Rusmik Oza
Head of Research
rusmik.oza@kotak.com
+91 22 6218 6441

Arun Agarwal
Auto & Auto Ancillary
arun.agarwal@kotak.com
+91 22 6218 6443

Amit Agarwal
Transportation, Paints, FMCG
agarwal.amit@kotak.com
+91 22 6218 6439

Nipun Gupta
Information Tech, Midcap
nipun.gupta@kotak.com
+91 22 6218 6433

Deval Shah
Research Associate
deval.shah@kotak.com
+91 22 6218 6423

Sanjeev Zarbade
Cap. Goods & Cons. Durables
sanjeev.zarbade@kotak.com
+91 22 6218 6424

Ruchir Khare
Cap. Goods & Cons. Durables
ruchir.khare@kotak.com
+91 22 6218 6431

Jatin Damania
Metals & Mining, Midcap
jatin.damania@kotak.com
+91 22 6218 6440

Cyndrella Carvalho
Pharmaceuticals
cyndrella.carvalho@kotak.com
+91 22 6218 6426

Ledo Padinjarathala
Research Associate
ledo.padinjarathala@kotak.com
+91 22 6218 7021

Teena Virmani
Construction, Cement, Buildg Mat
teena.virmani@kotak.com
+91 22 6218 6432

Sumit Pokharna
Oil and Gas, Information Tech
sumit.pokharna@kotak.com
+91 22 6218 6438

Pankaj Kumar
Midcap
pankajr.kumar@kotak.com
+91 22 6218 6434

Krishna Nain
M&A, Corporate actions
krishna.nain@kotak.com
+91 22 6218 7907

K. Kathirvelu
Support Executive
k.kathirvelu@kotak.com
+91 22 6218 6427

TECHNICAL RESEARCH TEAM (PRIVATE CLIENT RESEARCH)

Shrikant Chouhan
shrikant.chouhan@kotak.com
+91 22 6218 5408

Amol Athawale
amol.athawale@kotak.com
+91 20 6620 3350
+91 22 62185499

Faisal Shaikh, FRM, CFTe
Research Associate
faisalf.shaikh@kotak.com
+91 22 62185498

Siddhesh Jain
Research Associate
siddhesh.jain@kotak.com

DERIVATIVES RESEARCH TEAM (PRIVATE CLIENT RESEARCH)

Sahaj Agrawal
sahaj.agrawal@kotak.com
+91 79 6607 2231

Malay Gandhi
malay.gandhi@kotak.com
+91 22 6218 6420

Prashanth Lalu
prashanth.lalu@kotak.com
+91 22 6218 5497

Prasenjit Biswas, CMT, CFTe
prasenjit.biswas@kotak.com
+91 33 6625 9810

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Following analysts: Ajinkya Bhat, Aditya Mongia Nischint Chawathe, M B Mahesh, Dipanjan Ghosh, Shrey Singh of Kotak Institutional Equities and Amit Agarwal, Ruchir Khare, Cyndrella Carvalho, Ledo Padinjaratahala of Kotak Securities – Private Client Research hereby certify that all of the views expressed in this report accurately reflect their personal views about the subject company or companies and its or their securities. They also certify that no part of their compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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