ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

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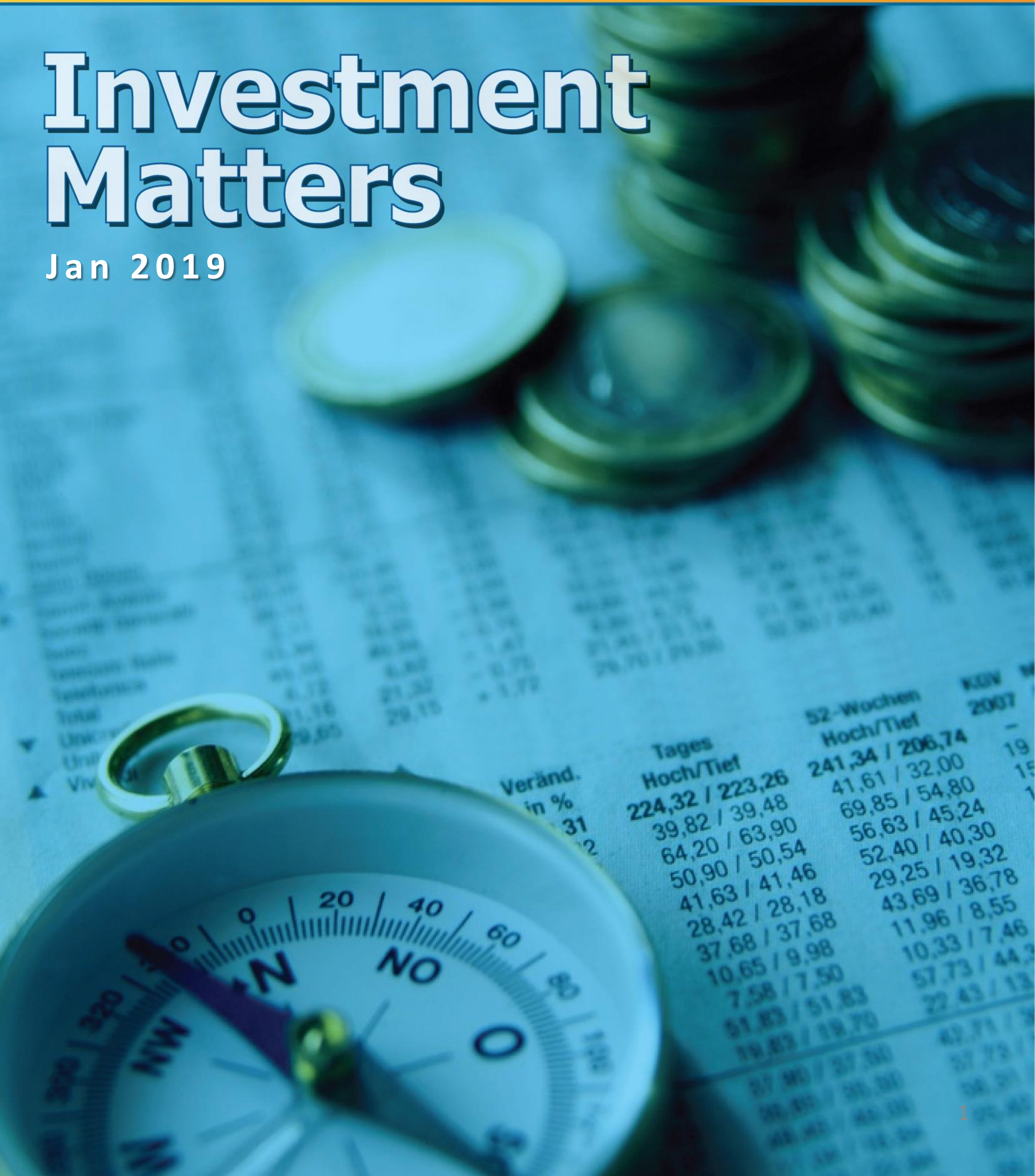

Market Overview

2018 was a tough year, though the CY 2018 returns of the narrow indices (Sensex & Nifty) do not reflect the pain experienced in broader markets. The table of CY 2018 returns of various indices is along with the peak to trough drawdowns is quite instructive.

CY-2018						
Indices	No. of Stocks in Index	Average Market Cap in Billions INR	Performance	Maximum DrawDown	Peak Date	Valley Date
S&P BSE SENSEX INDEX	31	2,062	5.91%	-14.26%	28-08-2018	26-10-2018
Nifty 50	50	1,556	3.15%	-14.55%	28-08-2018	26-10-2018
S&P BSE 100 IDX	101	952	1.19%	-14.70%	28-08-2018	26-10-2018
S&P BSE 200 IDX	201	583	-0.54%	-15.27%	28-08-2018	26-10-2018
S&P BSE 500 IDX	501	265	-3.08%	-15.74%	31-08-2018	26-10-2018
NIFTY Midcap 100	100	156	-15.42%	-26.36%	23-01-2018	09-10-2018
S&P BSE SmallCap	862	25	-23.53%	-32.65%	15-01-2018	09-10-2018
MSCI Emerging Markets In *USD	78	1,060	-7.30%	-22.97%	29-01-2018	26-10-2018

As we go down the market cap curve and wider breadth, the more severe was the correction. The peak to trough drawdowns saw a secular double digit fall, which was significantly amplified in the mid/small cap space. While the narrow indices recovered by the end of the year, the recovery in the mid/small cap space has been yet quite tepid.

After strong returns in 2017 and including the prior 3 years since 2014, to encounter a year like 2018 should not be surprising for investors. In September/October 2018, we had a perfect storm – rising oil prices, Fed raising rates, depreciating currency, the liquidity crisis triggered by defaults from IL&FS, BJP losing 3 important states and the RBI Governor resigning. In the beginning of the year we had written about higher valuations especially the premium that the small & midcap stocks traded over the larger caps. That premium at the beginning of the year shrunk by almost half and is now back up by the end of the year.

EQUITY OUTLOOK

As is the case most of the times, the bottom of the market more often than not coincides with the peak of the crisis. So it would be reasonable to assume that at the height of the IL&FS crisis and the headwinds created by rising oil prices the market and the currency did achieve a durable bottom unless there are significantly new factors that come at play. Since then we have seen oil prices recede, rupee snap back and proactive steps by the government and the RBI to infuse liquidity in the system. However, a more durable bottom and upward trajectory in the markets will depend to two critical factors in 2019. One is obviously the election outcome in April-May 2019. The base case for investors is still that PM Modi on the back of his still solid and widespread popularity will be able to get the NDA back even though with a lower margin of victory. Instead if we get some form of a non NDA coalition government it could disappoint investors but as we have seen in the past election results do not define the long term trajectory of either the economy or the markets. This is more so because we have seen some of the tougher and near term growth dilutive reforms over the last 4 years. The benefits of these will only accrue to the next government of the day

The more critical factor in delivering durable equity returns however is likely to depend on the revival of earnings growth which at a broad level has been elusive in the last 4-5 years. We have in the past enumerated the reasons for that – many policy level one offs – like demonetisation, GST, IBC, RERA, competition from deep pocketed online players and several technological disruptions, banks, both corporate and public hamstrung by NPA's and severe corporate deleveraging. However, all of this is now in the base. We should finally see a strong revival in earnings growth in CY2019/2020 on the back of substantial improvements in corporate bank profitability, the full impact of a 12% rupee depreciation on export profits and lower costs because of generally lower commodity and oil prices. Easy liquidity conditions, lower GST rates and some stimulus induced in the economy pre-election should lead to strong rebound in consumption followed by a recovery in private capex.

We believe that the pre-election uncertainty should be used by investors as an opportunity to build positions in the equity markets which we believe are set to benefit from the long term structural growth story of India powered by some world class entrepreneurs and companies.

Mr. Hiren Ved- Chief Investment Officer (CIO)

EQUITY OUTLOOK

The Indian economy is likely to build up slowly in 2019. After a tricky first half, we see stronger growth and improved stability later in the year - some leading indicators are already turning around. Consumption should continue to lead the way and the investment cycle should remain challenged for this year, at least.

The NBFC crisis in Sept-Oct 2019 led to the sector slowing down their loan book growth, as the lenders looked to stabilize their balance sheets. This has dried up credit to certain niche segments (SMEs, self-employed individuals) which should slow consumption in early 2019. It is a temporary factor – early intervention by the government and RBI has stabilized the sector and we expect loan growth to return by early FY20. In the short term, however, this is expected to slow growth.

The Loksabha elections are due to start in March 2019, which brings considerable policy uncertainty in the run-up. The BJP’s losses in the recent Assembly elections have raised worries about the outcome of the LS elections. In an uncertain environment, weaker consumer and corporate confidence would further impact growth, which will only partially be offset by the increased spending by parties around the election.

Tax revenue growth has been undershooting government estimates – 4% y/y vs 19% budget estimates for FY19. The government’s continued commitment to fiscal discipline implies that there is likely to be a postponement of expenditure in 4QFY19 to keep the headline deficit below the 3.3% commitment. This is, again, bad for growth – the axe is likely to fall on capital spending which, in turn, affects downstream sectors like capital goods, steel and cement. Some of the spending returns in FY20, which again sets up the 2H bounce back in CY19.

Agri prices have been soft in 2HCY18, driven by oversupply and, to some extent, disruption in the trade pipes that bring the produce from farm-gate to the market. Farm incomes have, thus, been affected and this is another headwind to consumption in 2HFY17. There has been some intervention from both the Central and State governments, the results of which are likely later in the year. Consensus GDP growth for FY19 is at 7.1% - compared to 1H growth of 7.6%, implying a 6.5% growth for 2H. There are risks that it could miss these numbers, given the likely impact of the factors listed above. The impact on aggregate earnings for the Nifty, however, may be muted given the base effects for corporate and PSU banks and the relative resilience of the higher-quality companies, which dominate the Nifty, to a broader economic slowdown.

The good news is that some of the headwinds are dissipating, and there is the scope for a sharp bounce-back in 2H.

Brent prices have corrected 40% from the highs of October 2018. This has arrested the slide of the Indian rupee and has delivered a positive impulse to the economy, on fiscal stability, the current account deficit and inflation. This has many positive externalities to the economy – eg, lower costs to manufacturers and easier liquidity in the domestic market.

The correction on crude prices and the low inflation environment has set the stage for interest rate cuts by the RBI. Bond yields have already corrected, partly helped by record OMOs from the RBI. We think that a 25-50bp rate cut in the Feb monetary policy is now likely, with a probable dilution of the stance on liquidity. The impact of lower rates on demand is lagged, but a move by the RBI in Feb could set up a second-half recovery in demand.

EQUITY OUTLOOK

The government has moved decisively on PSU bank recap, increasing the quantum of capital injection. This should help the PSU banks accelerate lending from FY20, as 3-4 of the larger banks will now be in a position to come out of the restrictive PCA norms by March 2019. This should help free up the credit bottleneck that has been choking parts of the economy – especially SMEs. The impact of this, again, is likely to be felt in 2HCY19 and adds to the multiple tailwinds.

The government has taken multiple reform measures in the last few years that have had a short-term negative impact on growth. The short term pain from GST implementation, for instance, should now start to dissipate – some operational issues are being slowly sorted. The longer-term positives from these reforms should slowly kick in through the year.

The recovery is likely to be consumption-led – the impact of the multiple stimuli listed above is likely to impact consumption in the first round. Consumer durables could see the bigger delta during the year.

The investment cycle is likely to remain muted. The process of deleveraging balance sheets, though progressing, is still not at an inflexion point. There may be some pockets of joy, though, as is reflected in the order books of some niche players.

There are risks to the story, of course. Global factors like a US recession, a hard Brexit or a crude spike could all destabilize the nascent recovery: the crude spike is the most material threat. Locally, a deeply fragmented mandate in the Lok Sabha elections could also destabilize the growth recovery, especially if there is no consensus on policy direction.

Mr. Seshadri Sen-Head of Research

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