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Dr. Ajmera's column as on April 07, 2018

RBI keeps policy rates unchanged and lowered inflation outlook; all eyes on Q4FY18 earnings..

Indian markets remained highly volatile during the first week of the financial year 2019 amid global and domestic cues including RBI monetary policy and trade war worries between the world's largest economies, US and China. While the Reserve Bank of India maintained status-quo on rates, it cautioned against higher inflation trajectory in the coming months. The Monetary Policy Committee (MPC) kept the policy repo rate unchanged at 6.0 percent and reverse repo rate at 5.75 percent, and the marginal standing facility (MSF) and the Bank rates at 6.25 percent. The Nifty reacted positively to the MPC outcome and posted 2 percent gains to end at 10,325.15.

On a weekly basis, the BSE Sensex registered a gain of 658.29 points, or 1.99 percent while the NSE Nifty rose 217.90 points, or 2.15 percent. The Implied Volatility (IV) of calls was down and closed at 13.22 percent while that for put options closed at 13.71 percent. The Nifty VIX for the week closed at 14.8 percent.

The value of shares pledged by promoters of BSE-listed firms stood at Rs 2.4 trillion at the end of March quarter, a decline of 21 per cent from the preceding three months, the bourse data showed. The value of shares pledged by promoters stood at Rs 3.03 trillion at the end of December quarter. Share pledging is typically done by promoters to raise funds either in the same company or for financing other projects. High pledging levels are typically not considered a good sign by the investors as a downturn in the market price can lead to invocation and change in management. Till March this year, pledging of shares was seen in as many as 3,074 of the 5,035 BSE-listed companies. The value of these shares pledged was Rs 2.39 trillion, the data noted. At the end of last month, value of shares pledged with



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non-banking finance companies (NBFCs) was Rs 1.43 trillion. Besides, there were 461 firms in which 5-30 per cent stake of the promoters was pledged, while in case of 140 companies, 30-50 per cent holding of the promoters was under pledge. As many as 81 companies had 50-75 per cent of promoters' holding under pledge.

Sectors and stocks

Pidilite Industries has entered into the league of corporate entities with a market value of over Rs 500 billion after the stock price of the company hit new high on the BSE. Pidilite Industries with the m-cap of Rs 500.73 billion stood at number 62nd position in overall m-cap ranking at 10:28 am, the BSE data shows. Pidilite is a dominant play in India's adhesive market with a market share of around 70% in its leading brand categories (Fevicol) in the organized segment. In past one month, Pidilite Industries has outperformed the market by surging 12% after the company has entered into collaboration with Jowat SE, a German family-owned enterprise and one of the leading suppliers of industrial adhesives worldwide. On comparison, the S&P BSE Sensex was up 1% during the same period. As part of the collaboration, Pidilite will exclusively handle sales and distribution of the entire range of Jowat adhesives in India and other neighbouring countries including Sri Lanka, Bangladesh, and Nepal.

Galaxy Surfactants dipped 2% to Rs 1,400 on last trading day of the week, extending its past three days 5% decline after the company received Form 483 for two of its facilities in Maharashtra after United States Food and Drug Administration (USFDA) audit. "The company's two of the facilities (M3 & N46) at Tarapur (Maharashtra) have undergone USFDA inspection which was concluded on March 30, 2018. This is the first USFDA inspection and they issues Form 483 with total 13 observations. The M3 facility received 4 and N46 facility received 9 observations," Galaxy Surfactants said in a regulatory filing. All the observations are procedural in nature and none of them are related to any data integrity. The company is in midst to providing a comprehensive response to the observations and would be replying to the USFDA within the stipulated time, it added. These facilities manufacture two products, Octyl Methoxy Cinnamate and Octocrylene, which have USP monograph. The company said the revenue from the US market for these products is less than 1% of the consolidated revenues and company not expect any financial impact of the same. Galaxy Surfactants has five manufacturing facilities India, one located at Taloja (Maharashtra), three located at Tarapur (Maharashtra) and one located at Jhagadia (Gujarat). The stock was trading at its lowest level since listing on February 8, 2018, fallen 17% as compared to 2% decline in the S&P BSE Sensex during the period. Galaxy Surfactants raised Rs 9,370 million through initial public offer (IPO) was subscribed 19.96 times. A manufacturer of specialty chemicals had made a decent debut, as the scrip got listed at Rs 1,698 on BSE, a premium of 15% over its issue price of Rs 1,480.

Global Markets

For the week, Dow Jones was down 0.7 percent while the S&P500 slipped 1.4 percent this week, as volatility continued in trade. The Nasdaq composite was down 2.1 percent. The volatility was further aided by the US and China after the two countries escalated the trade war with new tariffs. US President Donald Trump threatened more levies on Thursday, and considered USD 100 billion in additional tariffs against China, after it announced fresh tariffs



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on 106 US products on Wednesday. This was further aided by weaker-than-expected jobs data. The Labor Department reported that the US economy added 103,000 jobs in March while economists polled by Reuters expected a gain of 193,000.

The US-China trade war also rattled European markets as they closed lower. Despite stocks finishing lower on Friday, markets registered a second straight weekly gain, after Trump threatened China with additional tariffs. For the week, the pan-Europe gauge rose 1.1 percent, marking its second weekly rise in a row.

The DAX fell 0.5 percent to 12,241.27 while the CAC 40 index slipped 0.4% to 5,258.24, after its best one-day rise in almost a year. For the week, the index rose 1.8 percent. The pan-European STOXX 600 declined 0.35 percent, erasing part of Thursday's 2.4 percent gain though posting a weekly rise of 1 percent. It remained on track for a weekly advance of 0.9 percent.

Japan's Nikkei 225 slipped 0.36 percent, or 77.9 points, to close at 21,567.52 amid choppy trade. Despite the move lower amid elevated trade tensions, the benchmark finished the week higher by around 0.5 percent.

The Hang Seng Index added 1.1 percent to close at 29,844.94, but it fell 0.8 percent for the week. China's manufacturing activity expanded at its weakest pace in four months on April 2 while activity in Japan's service sector expanded at the slowest pace in 17 months in March as new business growth cooled.

Ajcon's view

Indian equities were on a roll for the most of 2017-18 aided by strong domestic liquidity and favourable macroeconomic conditions. In fact, the ride till January this year was so smooth that the market did not witness a single correction in excess of 5 per cent. The rally, however, has been derailed since February, and we believe 2018-19 will be a volatile year. Indian equities corrected 5 per cent in February and another 3.5 per cent in March, eating into the gains clocked during the first 10 months. Thus, the S&P BSE Sensex ended with gains of 11.3 per cent and the 50-share Nifty was up 10.2 per cent in 2017-18.

On the brighter side, earnings growth, which was a drag in the first two quarters due to demonetisation and goods and services tax (GST) rollout, was promising in quarter ending December 2017. We believe that an economic recovery is on its way and that should help corporate earnings grow in double digits in FY19.

The global markets have somehow shrugged off fears emanating from rising bond yields (which still remain pretty elevated), a rising interest rate cycle, cyclical inflationary pressures playing detrimentally on discretionary spending patterns and the narrowing of spreads between the 10yr government paper and riskier asset classes like equities. The following factors have a bearing on the equity markets in the coming few months:

Trade wars: First and foremost, we need to understand that a trade war was last seen nearly 80 years ago and that led to the great depression of the 1930s. Technically, trade wars are negative for 2 reasons. Firstly, higher import tariffs do not encourage domestic



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industry but they surely lead to higher levels of imported inflation. Secondly, trade wars eventually degenerate into currency wars with countries trying to competitively devalue their currencies to make their exports more attractive. While the EU and China have threatened to retaliate, we have not seen any concerted action. Both the EU and China are just seeing their economies recover from a prolonged economic slowdown and they will not be keen to get into a trade war at this point of time. We are confident that more acceptable solution will be found without degenerating into a trade war.

Crude Oil: This might be a joker in the pack. In FY17, India's import bill was close to \$86bn with the presumption of crude prices hovering around \$55/barrel mark. With Oil prices around \$60/barrel and if they stay this way for the better part of the remainder of this fiscal, the import bill might go up by \$8bn assuming the currency movement against the dollar is not adverse. A general rule is that a \$10 increase in oil prices can push up CPI inflation anywhere between 0.35 to 0.50%. A higher oil price scenario can thus negatively affect our trade, current and fiscal equations (due to more subsidies), create input cost inflation, affect corporate profits and put a wheel in the spanner in a recovering investment cycle. Though it is an outside risk for the markets, increase in prices shall lead to higher US Sale production (drawdown in US Inventories need to be closely monitored) offsetting the production cuts by OPEC countries and bring stability to prices. It thus should not be a risk factor until it crosses the \$70 mark and stays above it.

Rising Bond yields: It's been a phenomenon that the bond yields have moved significantly higher both globally and domestically. Fundamental factors like fear of rise in crude prices, possibility of more aggressive rate hikes by the US FED, domestically inflation moving higher than RBI's estimate of 5.1% (though the latest print had a softer number) and the flow of easy money getting reduced with global quantitative easing being reversed shall have a bearing on the short end of the curve. If yields continue to remain on an elevated path there are chain of cyclical events that may be construed to have detrimental impact on equity markets. The obvious foregone conclusion with yields moving up is the deposit/savings rate move up resulting in diversion of money flow towards the safer investment option presented by the debt/fixed income markets. The institutional activity can also have a similar impact and the resultant movement if rates were to go up would be lesser corporate margins and earnings forecast getting lowered. The perceived risks associated with bond prices and yield movement need to be closely and constantly monitored.

Corporate earnings: The rerating of equity markets from this point onwards shall hinge upon the manner/trend in which the corporate earnings cycle gets skewed. The last quarter's numbers showed some initial signs of corporate profitability limping back but the next few quarters numbers shall define the direction for the markets. Two things that should work in favour of recovery of corporate earnings are a) on a comparative year on year comparison they should reflect better numbers on a low base due to Demonetisation and the disruptions caused by GST last fiscal and b) GST in the next few quarters with expectations of pick up in the reported numbers should have incremental flow of business to the organized sector albeit in a gradual manner but which shall ultimately reflect in better earnings profile for India Inc and ultimately this earnings rub-off should reflect in the Index earnings projections over the next few quarters. Our sense is that corporate earnings should



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compound at 13-14% CAGR over the next two years and that should give the impetus of justification in forward multiples underpinning Index valuations.

For the year 2019, the equity markets could be driven by a mix of domestic and global factors. Firstly, the hawkishness of US Fed will be the key as anything above 3 rate hikes can be negative for global markets. Secondly, if the trade war actually degenerates into a currency war then the impact across emerging markets could be quite heavy. Thirdly, Lastly, Indian economy is likely to go through a political and structural shift in the next few months. It needs to expand spending ahead of elections but needs to keep its fiscal deficit and inflation expectations under control. How the government manages to balance the demands of economics and the reality of politics will eventually determine how the Indian markets pan out during the year.

Global markets will be betting a lot more on the return to growth and to witness the benefits of US tax cuts. How the US Fed rates and the trade wars pan out will be a key deciding factor for global markets!

Considering the recent correction, we believe there are many opportunities available to investors. We recommend investors to be stock specific and consider companies with good earnings visibility at a decent valuation.

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