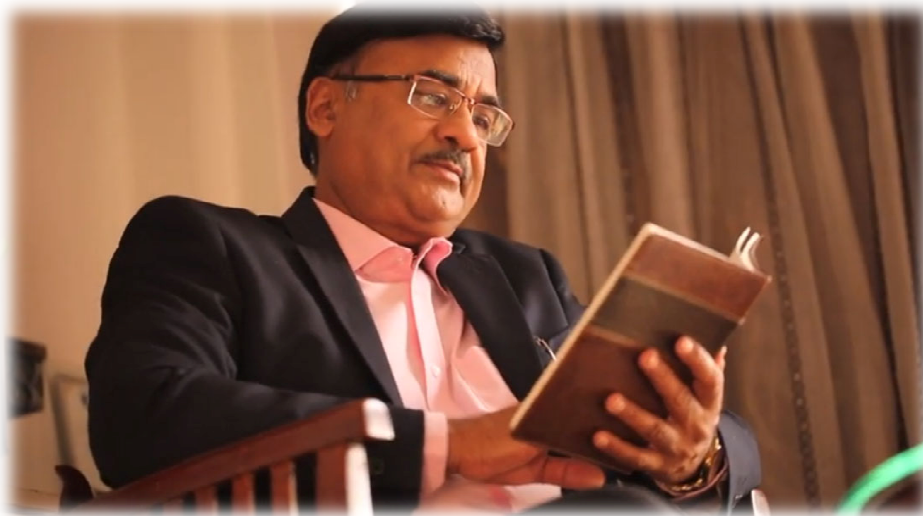




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Dr. Ashok Ajmera (FCA), CMD & CEO

Dr. Ajmera's column as on March 31, 2018

FY18 witnessed bulls losing steam; FY19 may become volatile but sun may shine soon...

The year 2017-18 saw the bulls losing their steam, with the S&P BSE Sensex rising 12 per cent, compared with a 16 per cent rally in FY17. On the other hand, the Nifty50 index gained 11% in FY18, as against 18% in the previous corresponding period.

Mid-and small-caps, however, outperformed their larger peers as money – both local and foreign – poured in. While the BSE Mid-cap index gained 14%, the Small-cap index rallied 20% during FY18.

Markets started losing momentum soon after the Budget on selling by FIIs as well as domestic investors weighed on Indian markets. The surprise announcement of Long Term Capital Gains (LTCG) tax caught both domestic as well as foreign investors by surprise. Rising inflation, muted macro data, dull corporate earnings and also detection of frauds in public sector banks dampened sentiment.

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.

The sharp rise in global bond yields was a key factor that contributed to the recent volatility. Yields on India's 10-year government securities also touched a four-year high in February on fears of high domestic inflation and aggressive rate hikes by the US Federal Reserve. Likewise, widening of the fiscal deficit targets raised concerns of a reversal in the policy



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stance by the Reserve Bank of India (RBI). This, coupled with the scam involving Punjab National Bank, weighed on banking shares that have significant weight in key stock indices. The reintroduction of the tax on long-term capital gains (LTCG) in the Budget and higher taxes on mutual fund investors also dampened sentiment.

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. Experts believe that an economic recovery is on its way and that should help corporate earnings grow in double digits in FY19.

Sectors and stocks

Among sectors, consumer durable and realty indices outperformed by rising 51% and 40%, respectively, for FY18 while pharma and PSU banks remained the biggest sectoral losers. Maruti Suzuki, Bajaj Finance, HUL, Reliance Industries and Tech Mahindra were the top gainers in the Nifty50, gaining between 38-51%. Lupin, Tata Motors, Sun Pharma and Bosch were the biggest losers, down between 22% - 48%, AceEquity data show.

Ajcon's view

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 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



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affect our trade, current and fiscal equations (due to more subsidies), create input cost inflation, affect corporate profits and put a wheel in the spinner 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 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 2018, 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, Indian stocks appear to be fully valued even after the correction and that will limit the appetite for Indian equities. 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.



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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.

Dr. Ashok Ajmera, FCA



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