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## Economy & Market Updates

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## Indian equities caught in the midst of global tumult & fears of sharp rise in stressed assets in the domestic banking sector amidst tepid economic recovery & lacklustre earnings growth

Indian equity market has been caught in a whirlwind of global tumult over the past few weeks. The pressure points emanate from fears of impending global recession due to worries over implosion in Chinese economy, rout in global commodity prices bringing commodity-exporting economies to heel and sharp increase in risk aversion leading to massive fund outflows from emerging markets (EM) in view of impending 'normalisation' of interest rates in the US over the medium-term.

### Plunging currencies, rising interest rates, sputtering demand become the hallmarks of commodity exporting Emerging Markets

Massive exodus of funds out of EM has exacerbated the fall in their currencies which were already battered due to plunge in export demand for their commodities as a result of anaemic global growth. Many EM Central Banks (Brazil, Mexico, Chile, Columbia, Saudi Arabia, UAE, Kuwait, Hong Kong, etc.) were compelled to respond by raising interest rates in their feeble attempts to stop this currency carnage but the collateral damage of these rate increases has been further weakening of domestic demand due to higher interest rates.

### Chinese growth in 2015 slows to its weakest in more than a quarter of a century

Although as per the Chinese Premier Li Kequiang, its economy has grown around its targeted rate of 7% in CY2015 (vis-à-vis 7.3% in CY 2014) and the country still remains one of the fastest growing economies in the world creating 10 mn urban jobs as targeted; it is the weakest GDP growth in more than a quarter of a century. Over the last few years, China has been attempting to re-orient its economy away from investments & exports to domestic consumption & services. The rebalancing has resulted in services constituting nearly 50% of its GDP and consumption nearly 60%.

### Mountain of debt, massive capacity build up and falling utilizations leads to Chinese dumping threatening viability of many firms in its trading partners

The Chinese economy has been weighed down by excessive build up of debt up from 150% of GDP to 250% in the wake of government's attempts to pump prime the economy after Global Financial Crisis of 2008 leading to massive mal-investments in sectors such as Housing, Metals & other Industrial Commodities. This excess build-up of capacity in a slowing domestic milieu and compulsion to operate plants at reasonable utilizations to avert any social tumult (which is feared the most by Chinese Central & provincial governments in the event of large-scale job losses) is leading Chinese firms to flood global markets depressing prices and causing large scale injury to firms in its trading partners. Many pessimists believe that the statistics trotted out by the Communist regime are massaged and the real growth based on indicators like electricity consumption, freight movement, etc. is somewhere close to 4% to 5%. This is countered by optimists who believe that rather than excessively concentrating on investment-heavy indicators one must increasingly look at services sector & consumption-led indicators like retail sales, auto sales, etc. in the wake of China's ongoing economic re-orientation.

### Ham-handed approach and opaque regulatory environment adds to worries about Chinese markets

Investors have been spooked by ham-handed approach by the Chinese regulators in managing the Yuan and intervention in functioning of stock markets which is down nearly 18% since the start of CY2016 and around 40% from its peak in June 2015. Lack of transparency in policy stance was evident as the Chinese Central Bank allowed Yuan to weaken relatively rapidly over the last weeks, reversed new rules on circuit breakers and continued the ban on sale of more than 1% of total shares outstanding within 3 months by shareholders. This ban was imposed 6 months back and was to set to expire last week. The continuation of ban was reportedly aimed at 'preventing concentrated share reduction' and 'stabilizing market expectations'. Markets are closely watching the commentaries from corporates announcing their results to gauge whether consumer companies have weathered the slowdown better than investment and export oriented firms.

## Glut in supply causes oil to fall back to 2004 levels

Besides Chinese growth jitters the other major pressure point for global markets was continuing slide in crude price which with Brent breaching $30/barrel mark and down nearly 70% in the last 18 months. Oil prices have fallen back to 2004 lows. The slide is being fuelled by glut in supply. As against global demand of 95.4 mn barrels/day, supply stands at 96.9 mn barrels/day (Supply by OPEC member states is at 31.7 mn barrels/day). No country is willing to cut back for fear of losing volume market share when global demand remains tepid.

## With OPEC's refusal to cut production and Iran's impending gush of supply, will Oil fall further?

During previous gluts, Saudi Arabia acted as the swing state by cutting down its production or convincing other fellow OPEC members to follow suit. However, in its resolve to break the back of frackers (shale oil producers) in the US, the Saudis tried to test their mettle by allowing the slide to continue assuming that lower prices would shutter down many frackers. This has played out to a certain extent with higher cost oil fields shutting down and investments in new fields plunging. Private fixed investments in oil exploration as a percentage of total non-residential fixed investments in equipments & structures is down to just 5% from a recent peak of 11% in around 2012. Frackers have responded dynamically by deploying advanced technologies to cut flab and brought down marginal cost of production. Since 2008, US oil production has nearly doubled due to boom in shale oil production with shale adding 3 mn barrels/day to global markets. With the West lifting sanctions on Iran, its oil exports are expected to add nearly 500000 to 700000 barrels/day to the already oversupplied market. Any detente between warring factions in Libya could add to the global glut.

## With doddering government finances, many sovereign wealth funds turn large sellers impacting global markets

Government finances of many commodity exporters in the Middle East, South America, Africa, Russia, etc. are in precarious state due to sharp fall in commodity prices and failure to develop other sectors of economy leading to overdependence on revenues from commodity exports. Many of these countries have authoritarian regimes or monarchies that have built an implicit social compact with their restive populations by depriving them of political rights but erecting a welfare-heavy State structure that massively subsidies essentials like electricity, fuel, food items, rent, etc. All this worked fine during the boom years but without any structural reforms, it left the countries vulnerable to any shock from plunge in commodity prices. It is this social compact that is fraying as government revenues dry up and budget deficits soar. With budget deficit at 15% of GDP in 2015, Saudi Arabia, for instance, has unveiled plans to rein in subsidies and capital expenditure. Many other exporters are following suit. Direct fallout of this has been large redemptions by sovereign wealth funds (SWF) which have sold assets worth $100 billion between March and September of 2015 with Saudi Arabia itself contributing nearly half of that. Most of the $7.2 trillion in SWF belong to countries that rely on oil & gas exports to sustain their economies. These redemption pressures along with sell-off from broader EM funds have put sustained pressure on global equities.

## Will SWF redemptions lead to surge in global bond yields, accentuating problems for global growth?

Another worry for investors would be a disruptive surge in global bond yields if the selling pressure from SWF gathers pace upsetting the US Fed's plan to gradually raise rates without disrupting the feeble US recovery and directly contradicting the ECB & BOJs on-going monetary accommodation through quantitative easing. A sharp spike in developed market bond yields would force many foreign investors to pull out money from EM debt (due to increase in differential bond yields), further hammering their already-fragile currencies and wreak havoc with their economies making it difficult for them to repay foreign debt and forcing them to raise interest rates dampening demand adding to fiscal stress.

## FII redemption pressure & vulnerabilities in Banking sector drag down Indian equities

In addition to these global headwinds, Indian equities also face many domestic challenges. Between 1st and 15th January 2016, FIIs have been net sellers to the extent of Rs. 7604 cr while DIIs have bought shares worth Rs. 5357 cr.

Rupee fell to a 28-month low of Rs. 67.59/$ on 15th January 2016.

Bank shares in particular have witnessed sharp erosion due to concerns on sharp spike in provisioning requirements as a result of RBI's directive to clean-up their balance sheets by March 2017. RBI has identification 150 corporate accounts where it wants banks to make additional provisions to bring about uniformity in treatment of stressed assets and stop promoters from playing one bank against the other. As per RBI's latest Financial Stability Review, gross NPAs of banks stood at 5.1% (Rs. 3.5 lakh cr) as of Sept. 2015 while total stressed assets (including restructured assets & NPAs) stand at 11.3%. FSR expects NPAs to rise to 5.4% by March 2016. Provisions made by listed banks stood at around Rs. 49000 cr by end-September 2015 with Rs. 9808 cr being provided in 2Q FY16; but if they are required to provide for these 150 accounts then it is expected that total provisioning would go up substantially in 2H FY16 and FY17. Although the names of these accounts and amount to be set aside have not been made public, estimates for provisions vary from Rs. 30000 cr to Rs. 50000 cr. Besides this, RBI is also closely reviewing implementation of measures like 5/25 scheme (extending tenure of loans to 25 years with re-financing every 5 years so that long term projects' cashflows match repayment obligations) and strategic debt restructuring (where banks can convert debt in majority equity holding and then find a buyer within 18 months).

## Lacklustre industrial output and contracting exports bedevil Indian economy

IIP contracted by 3.2% in November 2015 (the most in 4 years) against an expectation of 2% growth (and 5.2% rise in November 2014) mainly led by 4.4% fall in manufacturing activity (which constitutes 75% of IIP) vis-à-vis 4.7% rise YoY. On a YoY basis, capital goods contracted sharply by 24.4%, consumer non-durables declined 4.7% while consumer durables grew at 12.5%. Fewer working days in Diwali could be one of the reasons for the lacklustre number. The outlook for December 2015 numbers looks sombre due Chennai floods, slowing exports and tepid rural demand. Exports contracted for the 12th consecutive month in November 2015. Exports during April-November 2015 fell 18.46% YoY to $174.3 bn and are expected to fall 13% in FY 15-16 to $270 bn vis-à-vis $310.5 bn in FY 14-15.

## With consumer inflation inching up, RBI is likely to hold policy rates in its February meeting. Will government relax FY16-17 fiscal deficit target?

Consumer inflation (CPI) rose to a 15-month high at 5.6% in December 2015 vis-à-vis 5.41% in November 2015 led by 46% rise in pulses. December 2015 WPI at -0.73% remained in the negative territory for 15th straight month.

We expect RBI to hold policy rates in its next meeting on 2nd February 2016 and closely watch government's medium term fiscal consolidation plans in the Budget on 29th February 2016. With seventh-pay commission recommendations expected to cost additional Rs. 1 lakh cr. (0.65% of GDP) and OROP another Rs. 8000-10000 cr, the Chief Economic Advisor has tried to make a case for relaxation of fiscal deficit target of 3.5% in FY16-17 to ensure that there is no adverse fallout on infrastructure capex. Fiscal deficit target was set in the Budget at 3.9% in FY14-15 and 3% in FY 17-18.

## Moribund private sector capex, weak rural demand, faltering exports hold back recovery. Government attempting to impart momentum through investments on roads & railways.

A delay in uptick of private sector capex as a result of excessive debt binge in the previous cycle and subsequent stalling of projects; two consecutive monsoon failures, plunge in global agricultural commodity prices & tepid rise in MSPs impacting rural demand; fall in exports due to slow global growth and a sharper fall in competing countries' currencies has compelled the government to reduce FY 15-16 GDP forecast to 7%-7.5% from 8.1%-8.5% previously. Government is imparting positive momentum to the economy through its aggressive spend on key infrastructure sectors like Roads & Railways which would have a multiplier economic impact in the medium-term.

## 3Q FY16 earnings season kicks off to a slow start

3Q FY15-16 quarterly earnings season is underway. A few bellwether companies like Infosys, TCS, Hindustan Unilever, Zee, IndusInd Bank have announced their results. Domestic demand environment continues to pose challenges with companies having limited pricing power and companies being forced to pass on fall in raw material prices to consumers to perk-up demand. Brightening economic prospects in the US would be the key determinant of fortunes of Indian IT companies but in the run-up to next US Presidential polls in November 2016, they need to brace themselves for a slew of negative attacks on 'outsourcing of US jobs to India'.

## Sectoral stance in portfolio

We remain overweight on Pharmaceuticals and Auto & Auto Ancillaries, equal weight on BFSI and Capital Goods / Construction. We believe that select IT names with strong free cash flows, negligible debt and reasonable valuations can offer good shelter till domestic demand environment improves. We will continue to stay away from global cyclical sectors like steel & non-ferrous metals till global commodity prices stabilize.

## India emerges as a strong FDI destination

Hiking of caps for foreign participation in certain sectors, opening up of new sectors & improvement in ease of doing business has led to India emerging as one of the most favoured destination billion for FDI with inflows of $26.51 during January-September 2015 (18% rise YoY) as against $28.78 billion in entire 2014.

**Indian equities will mirror its strong macro-economic fundamentals in the medium to long term. Current turmoil offers an excellent entry point**

India's strong macro-economic fundamentals - one of the fastest growing economies, falling inflation & interest rates, strong forex reserves, sharp improvement in current account deficit, commitment to fiscal consolidation path and above all, massive terms-of-trade benefit due to plunge in global commodity prices which are expected to remain benign in the medium term - will act as a magnet for large FII flows once current volatility subsides. We believe that current turmoil roiling global equities which has also dragged Indian equity market lower offers an excellent entry point for medium to long term investors.

## PMS Strategy-wise Performance

### Performance as on 31-12-2015

| | Multi Strategy Portfolio (%) | Equigrow Strategy Portfolio (%) | Sensex (%) | Nifty (%) |
|---|---|---|---|---|
| Post New Investment Team# | 91.2 | 109.4 | 43.3 | 47.4 |
| Two Yearly | 61.3 | 72.7 | 23.7 | 26.4 |
| Yearly | 10.2 | 13.7 | -5.0 | -4.0 |
| Half Yearly | 7.6 | 10.3 | -6.0 | -5.0 |
| Quarterly | 4.6 | 5.7 | -0.1 | 0.0 |
| Monthly | -0.3 | -0.1 | -0.1 | 0.1 |

#Since 19th August 2013

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**Note:** The above strategy returns are of model clients as on 31st December 2015. Returns of individual clients may differ depending on time of entry in the strategy. Past performance may or may not be sustained in the future and should not be used as basis for comparison with other investments. Strategy returns shown above are post fees and expenses.

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