
# DOMESTIC & GLOBAL DRIVERS FOR OUTPERFORMANCE OF INDIAN EQUITY MARKET OVER THE MEDIUM TERM

After scaling a high in early-March 2015, a slew of global & domestic headwinds were nudging the Indian equities downward. NIFTY had breached the 9100 level in early March 2015. The market was perched precariously by the middle of June 2015 with NIFTY briefly dipping below the crucial 8000 level amidst fears of a further fall.

## IMD'S MONSOON 'BLUES' & IMPACT OF MONSOON SHORTFALL ON THE ECONOMY

Foremost among the domestic headwinds was the Indian Meteorological Department's (IMD) bleak initial forecast in May wherein it predicted a 'below normal' monsoon at 93% of long-period-average (LPA) & revised it down in June to a 'deficient' monsoon at 88% of LPA. Although agriculture's contribution to the GDP at 18% has been falling progressively over the years nearly 68% of India's rural households still depend on it as the main source of income. Last year's kharif harvest was affected by poor rainfall (12% below LPA) which was followed by a massive damage to the Rabi (winter) crop due to unseasonal rains & hailstorms. Any deficiency in this year's rains would exacerbate resentment brewing in rural masses suffering from adverse terms of trade due to a massive plunge in global commodity prices, tepid rise in minimum support prices (MSPs) & lower allocation to rural employment social schemes like MNREGA. A poor monsoon impacts aggregate demand from the rural areas as nearly 50% of most consumer items is purchased there. Any shortfall in production of cereals, fruits & vegetables, pulses & oilseeds feeds into food inflation that constitutes nearly 45% of the consumer inflation (CPI) and makes it difficult for RBI to lower interest rates. Any pause by the RBI in lowering interest rates would constrain both consumption & investment demand and act as a dampener for economic growth.

## SKYMET'S MONSOON 'DUEL' WITH IMD

In contrast to IMD, private forecaster Skymet has all along maintained that monsoon would be normal at 102% of LPA. The rainfall for the month of June has been 10% above normal beating the forecast of both IMD & Skymet but the surplus has been falling by the week due to diminishing rain activity. Although IMD has predicted 8% & 10% deficient rainfall in July & August respectively based on strengthening El Nino, Skymet is maintaining that rainfall in July & August will be normal at 104% and 99% of LPA respectively as a result of Indian Ocean Dipole which is currently neutral & is on way to becoming positive by end of July. The Madden Julian Oscillation that helped good rainfall in June is also expected to help good precipitation in the second half of July.

## SIGNIFICANT IMPROVEMENT IN SOWING DATA & COMFORTABLE RESERVOIR LEVELS

The latest acreage data shows a 57.6% year-on-year (YoY) increase in sowing at 306 lakh hectares till July 3rd vis-à-vis 194 lakh hectares last year. Areas under pulses (133%), oil seeds (403%), cotton (69%) & coarse cereals (51%) have shown substantial YoY improvement while those under rice & sugarcane are almost flat. Water storage levels at 91 key reservoirs at 31% of storage capacity is better than storage position of last year and also better than the storage of average of last ten years.

## POINTERS TO REVIVAL IN INVESTMENT CYCLE

The other major domestic concern pertained to revival in investment cycle. The latest CMIE data shows an 8.4% rise in projects under implementation in the quarter ending June 2015 (1QFY16) which is fastest since quarter ending September 2012. Private sector projects under implementation rose 0.8% in 1QFY16, the first time it has expanded in eight quarters. There is also a significant dip in the stalled projects from a peak of 8.4% of GDP in 4QFY14 to 6.6% in 1QFY16. The unstalling process has happened mainly in the manufacturing & transport (road & rail mainly) services which together account for 50% of the stock of stalled projects. Investments worth Rs. 1.15 trillion ($ 18 billion) were announced in 1QFY16, a rise of 33% YoY though on a low base.

## STRESSED BANKING SYSTEM ACTING AS A DRAG ON ECONOMIC RECOVERY

Fresh investments from private sector are constrained due to high levels of debt, weak aggregate demand conditions in the economy & low capacity utilization levels in many sectors like steel, cement, aluminium etc. Total stressed advances (non-performing advances at 4.6% & restructured advances at 6.5%) of the Indian banking system have moved up to 11.1% of total advances in March 2015 from 10.7% in September 2014. RBI expects non-performing advances to rise to 4.8% by September 2015 and subsequently fall to 4.7% in March 2016. Five sectors- infrastructure (15% of total advances & 29% of total stressed advances), iron & steel (4.5% & 10.2%), textiles (3.4% & 7.3%), mining (1.3% & 1.4%) & aviation (0.5% & 2.4%) that together constitute 24.8% of total advances have 51.1% share of in total stressed advances. In infrastructure sector, power generation constitutes 8.3% of total advances & 16.1% of stressed advances and Telecom constitutes 1.6% of total advances & 2.2% of stressed advances.

Non-food credit growth at 8.6% fell to the lowest levels in more than 20 years in FY14-15. Although growth in credit in agriculture at Rs 7.7 trillion & personal loans at Rs 11.96 trillion was at a reasonable 15% & 15.4% YoY respectively, credit to industry at Rs 26.65 trillion & services sector at Rs 11.42 trillion fared very poorly at 5.6% YoY each. In FY13-14 industry & service sector credit had grown at 13.1% and 16.1% YoY respectively. Credit delivery is constrained due to large provisioning necessitated by rapidly rising stressed advances & rapidly falling capital adequacy levels.

## APRIL-MAY 15: GOVERNMENT EFFORTS TO FRONTLOAD ROAD & RAIL CAPEX, STRONG SURGE IN INDIRECT TAXES, BETTER QUALITY OF FISCAL CONSOLIDATION

With private sector's inability to revive the investment cycle, government's frontloading of large spend in public expenditure in sectors such as roads & railways is expected to crowd-in private sector investments. Government had budgeted a hefty Rs 70,000 crores ($11 billion) increase in investments in infrastructure in FY 14-15 over FY13-14 with an increase in gross budgetary support to roads and railways by Rs 14,031 crores & Rs 10,050 crores respectively. The capex of central PSU's at Rs 3,17,889 crores is expected to increase by Rs 80,884 crores over RE 14-15. In addition, a National Investment & Infrastructure Fund (NIIF) with an annual flow of Rs 20,000 crores is expected to raise debt & equity for infrastructure finance companies like NHB, IRFC etc which in turn can further leverage this equity many times over. Tax-free bonds for roads, railways and irrigation projects are also planned.

The financial year had started with a bang with government spending 13% of its plan expenditure in April-May 2015 vis-à-vis 10% in the same period last year with spends on focussed sectors like roads at 22% of full year's budgeted target verses 2% last year. The quality of spend too is better with plan expenditure rising by 4% YoY while non-plan expenditure declining by 9% YoY in April-May 2015 leading to fiscal deficit for April-May 2015 being lower at 37.5% of the Budget estimates verses 45.3% last year. Non-plan expenditure comprising salaries, subsidies and other recurring items was at 15.3% of Budget estimates verses 18.3% in the same period last year. Overall tax collections have risen 12.7% with indirect taxes like excise, customs & service tax which are a proxy to manufacturing activity in the economy rising by a whopping 39.2%. A significant part of the jump was due to imposition of additional cess on petrol & diesel as well as clean energy cess. Even without these new additions, the rise in indirect taxes would have been 12.6% & rise only in excise collections would have been 16.9% (overall excise collections was up 88% YoY in April-May 2015). Direct taxes like corporate tax & personal income tax have fallen marginally. Non-tax revenues in April-May 2015 were at 14.6% of full year's estimate verses 4.6% in April-May 2014.

## CORE SECTOR GROWTH AT SIX-MONTH HIGH- DOES IT PRESAGE STRONG INDUSTRIAL REVIVAL?

India's core sector index (which comprises of 8 key infrastructure sectors like of coal, crude oil, refinery products, natural gas, electricity, fertilisers, steel & cement and forms 38% of IIP) rose to a six-month high at 4.4% in May 2015. The index had contracted by 0.4% in April 2015 and had grown at 3.9% in May 2014. Industrial Production (IIP) rose by 4.1% in April 2015 vis-à-vis 2.5% in March 2015 on the back of 5.1% growth in manufacturing and 11% growth in capital goods. After witnessing heady growth in April (15.8% YoY growth) & May (4.7% YoY growth), passenger car sales have moderated at 2.4% YoY in June 2015. After witnessing continuous growth for the last 10 months in the Medium & Heavy Commercial (M&HCV) vehicle segment growth has started filtering down to the light commercial vehicle (LCV) segment. June 2015 saw M&HCV sales of both Ashok Leyland & Tata Motors at a strong 41% and 19%

respectively. Weak rural demand impacting sentiment & delayed purchases have impacted motorcycle sales which consist of 70% of two-wheeler sales in June 2015.

## GLOBAL HEADWINDS- FEARS OF US EARLY RATE RISE ABATE

Some of the global headwinds that were weighing over the Indian market also seem to be abating. The fear of increase in interest rates by the US FED before September 2015 has been allayed by the FED's dovish commentary. In its latest assessment the US FED has lowered its growth forecasts for US GDP growth. This comes in the backdrop of a contraction of US economy by 0.2% in 1QCY15. Even if FED were to raise rates by 0.25% sometime between September & December 2015, the pace of any further rate increases towards normalization is expected to very gradual. Although labour market slack has diminished in the US, the impact of anaemic global growth, ongoing large quantitative easing in the EU & Japan as well as strong US Dollar is acting as a drag on US GDP through lower net exports. Also, although a sharp erosion in commodity prices is providing a leg-up to consumption expenditure it can also act as a dampener for the FED in achieving its objective of 2% inflation (ensuring stable prices). Any sharp drop in commodity prices in a weak global demand environment can add to fears of hurtling into a deflationary spiral like Japan & the EU and the FED would do all it can to avoid getting into such a dreadful scenario. The FED has twin objectives of ensuring maximum employment and stable prices. A gradual rate increase in the US has stemmed fears of large-scale redemptions in FII debt flows out of India. FIIs have invested Rs 1.6 trillion ($26 billion) in debt in India in CY 2014 and followed it up with an investment of Rs 0.40 trillion ($6.2 billion) from 1st January 2015 till date.

## GLOBAL HEADWINDS- CHINA'S RETAIL INVESTORS' LED CREDIT-FUELLED RALLY SPUTTERING. KEY INDICES DOWN BETWEEN 20 TO 30% FROM EARLY JUNE 2015 PEAKS

After strong equity inflows of Rs 0.98 trillion ($ 16 billion) in CY 2014 by FIIs, India had seen some redemptions over the last couple of months (though FII investments in equities from 1st January 2015 till date stands at Rs 0.392 trillion ($ 6.1 billion). The outflows had gravitated to markets like China where the equity markets were on fire & the Shenzhen market had zoomed up by an astonishing 200% YoY till mid-June 2015 & trading at a Price to Earnings ratio of a little less than 80 times (vis-à-vis 19 times for S&P 500 and 17 times for NIFTY). But the major reason for the logic-defying rally is the credit-fuelled demand from small investors (According to the Economist in just one week in April 2015, 4 million retail investors opened brokerage accounts & overall two-thirds of the new investors in China had left school before the age of 15). This retail mania is most visible in Technology shares with a mere addition of the word 'Technology' in a company's name is leading to upward spike in its price. Since their early June peaks, the Shanghai Composite is down 21.5%, Shenzhen Composite 25.1% and ChiNext Composite 32.4%. The Chinese market continues its downward slide despite lowering of rates & reserve requirements by the Central Bank and government's efforts to talk-up the market.

## GREEKS TURN THEIR BACK ON BACK-BREAKING AUSTERITY, REJECT EU'S BAILOUT PACKAGE, STAGE SET FOR PROTRACTED & TORTOUS NEGOTIATIONS. SPIKE IN GLOBAL VOLATILITY TO FOLLOW

With the Greeks voting resoundingly in favour of rejecting the bailout terms being offered by the Euro Zone, a stage is set for protracted & tortuous negotiations between the two sides. An immediate rapprochement between the two sides looks remote given the recalcitrant stand adopted by the Greek government and the stridency with which the Greek PM and FM have denounced the creditor nations & their leaders as 'black-mailers & terrorists'. We believe that any decision to eject Greece out of the Euro Zone would not be driven solely by economic imperatives but would also be guided by geo-political, geo-strategic & socio-cultural reasons.

Greece's membership of the security alliance NATO complicates the issue & would certainly have a bearing on any decision taken by the Euro Zone. At a time when the West is 'almost-at-war' with Russia over EU's Eastward expansion in what Russia considers its natural zone of strategic influence (Russia's 'near-abroad'), the on-going armed conflict raging in Ukraine, Russia's 'annexation' of Crimean peninsula (from the West's standpoint) & an ever-closer axis developing between Russia & China against the West; the EU would be most reluctant to let go of Greece which has been making overtures to Russia & China. EU would also be worried about the signal that would go out to those countries that wish to come out of Russia's strategic ambit and closely align with the West.

We believe that in the wake of uncertainly engendered by the 'NO' vote there would be increased volatility in global markets with risk-on assets like equities coming-off, bond yields of peripheral countries in Europe like Spain, Portugal, Italy etc moving-up, weakness in Euro, Strength in the US Dollar, movement of money in safe-haven assets like US government bonds leading to compression in their yields, softening in global commodity prices like crude & other industrial commodities in anticipation of a doddering global recovery prospects. The ECB is likely to intervene and if necessary increase its monthly bond purchases under the QE program. It currently purchases government bonds worth Euro 60 billion per month from March 2015 to September 2106 (Euro 1.1 trillion).

## GREEK 'TRAGEDY'S LIMITED IMPACT ON INDIAN MARKETS, INDIA TO OUT-PERFORM IN THE MEDIUM-TERM

In the wake of the Greek vote, crude prices have plunged with Brent trading below $ 60/barrel. With nearly 80% of its crude requirements being imported, India would be a massive beneficiary of falling crude prices with narrowing of its trade deficit, CAD & fiscal deficit. This would also lower the pressure on fuel component in CPI. In its last monetary policy statement, RBI had flagged-off three concerns regarding a possible spike-up in CPI by the end of CY 2015. One of them was pertaining to rise in fuel inflation which would get addressed if crude prices remain benign. The other concern was regarding earlier-than-expected rise in US interest rates. The Greek 'tragedy' would weigh on the minds of the US FED which would if anything like to tread more cautiously on any rate increase. As it is the FED commentary was dovish due to weakening US GDP projections over the last one year. Lastly, if monsoon turns out to be better than IMD's bleak projections (and it has been 'near normal' from 1st June till date), the RBI may have to re-assess its stance and the current belief that there would a 'prolonged pause' in rate cuts could get reversed. This would aid growth impulses when the economy looks to be on a mend with government's strenuous efforts to frontload public expenditure.

As opposed to a credit-fuelled retail rally in China, the Indian rally has been based primarily on Institutional Inflows (both foreign & domestic) & is on a far firmer footing. At 8400, NIFTY is trading at a reasonable valuation of 18 times FY16 estimated earnings of Rs 467 (with an estimated earnings growth of 13.3% YoY). With an expected pick-up in investment cycle, RBI's success in tamping down on consumer inflation & reining in inflationary expectations, stable currency, rains turning out to be better than the grim forecast by the IMD, government's resolve in adhering to medium term fiscal consolidation targets & strenuous attempts to revive the investment cycle by front loading capital expenditure & creating conditions to crowd-in private sector capex, government sticking to its forward looking reforms agenda by trying to create consensus on the landmark GST bill & land acquisition bill, expected jump in FDI in the medium-term in sectors like Defence, Insurance, Railways where the foreign investment cap was raised; we expect Indian equity market to outperform others in the medium term.

# PORTFOLIO UPDATE

During the month, we increased our exposure in sectors like BFSI & Cement that would benefit from economic revival. We added to our positions in companies like Axis Bank, HDFC Bank, SBI & Shriram Transport in the BFSI sector and Ultratech & JK Lakshmi Cement in the Cement sector. We trimmed our position in Yes Bank & exited from Persistent Systems, Voltas & Ashok Leyland.

In June 2015, our portfolios performed in line with the benchmark NIFTY. Our portfolios have delivered 80-90% returns since restructuring on 19th August 2013 vis-à-vis a 55% rise in NIFTY. On a yearly basis, the portfolios are up 22-23% vis-à-vis a 10% rise in Nifty.

The change in key indices & key economic indicators for the month of June 2015 is as mentioned below:

| Benchmark Indices | 31/05/2015 | 30/06/2015 | % change |
|---|---|---|---|
| BSE SENSEX | 27828.44 | 27780.83 | -0.17% |
| CNX NIFTY | 8433.65 | 8368.50 | -0.77% |
| CNX MIDCAP | 13180.75 | 13009.65 | -1.30% |
| BSE 200 | 3532.73 | 3499.51 | -0.94% |
| USDINR | 63.74 | 63.60 | -0.22% |
| NYMEX CRUDE ($/BARREL) | 60.30 | 59.47 | -1.38% |
| BRENT CRUDE ($ BARREL) | 65.56 | 63.59 | -3.00% |

EQUITY | DERIVATIVES | COMMODITIES | CURRENCY | CORPORATE ADVISORY | INVESTMENT BANKING | PMS
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