Kotak Mahindra Bank

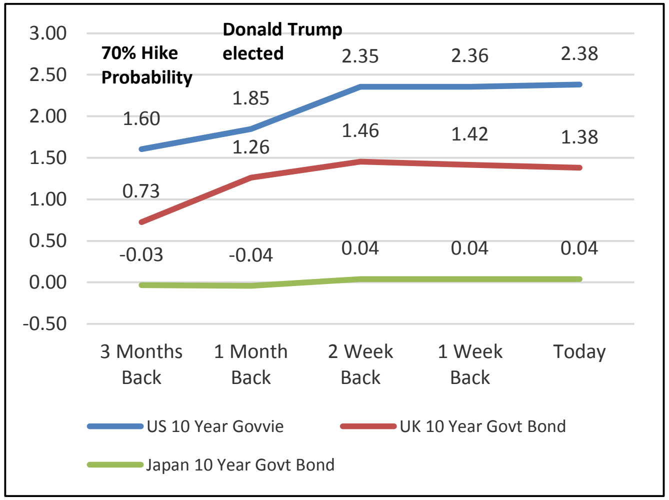
Equity & Debt Strategy

Mid Dec'2016 - Jan'2017

Equity Market Update
&
Equity MF Strategy

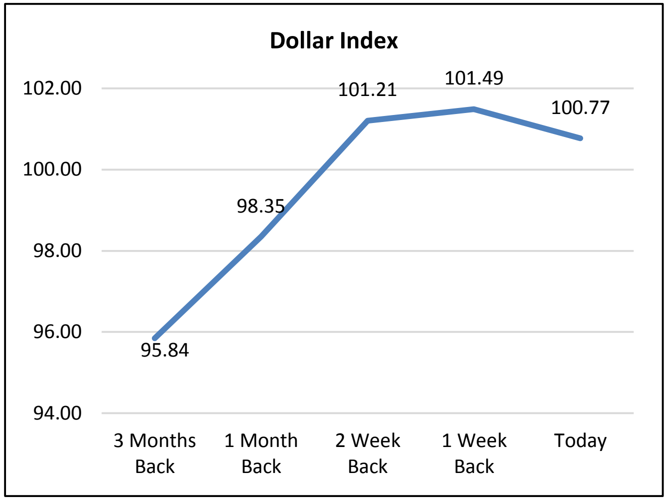
Global Macro Overview: Awaiting policy clarity from US, keep crude on watch

1 Yields rise fearing fiscal stimulus



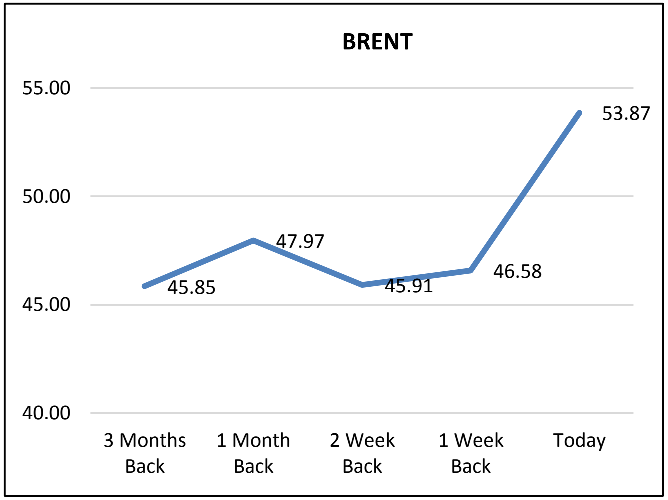
- US Bond yields have risen more than 50 bps
- US assets becoming attractive leading to sell off in other markets

2 US Dollar strengthens



- Due to capital flows to US and fear of trade protectionist measures by the US Government
- Expectation of depreciation of EM currencies leading to heightened capital outflows

3 Crude zooms post OPEC cut



- OPEC members decide to cut oil output by 1.2 million barrel a day
- However, US shale would become economically more viable limiting the upside for prices

2017-2018 GDP Growth Projections:

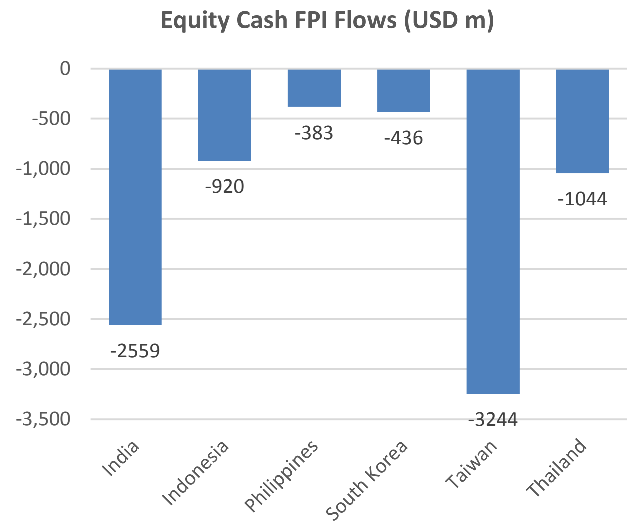
World: 3.3% - 3.4%; US: 2.1% - 2.2%; Eurozone: 1.4% - 1.6%; China & India: 6% - 7%; EMs: 4.9% - 5.3%

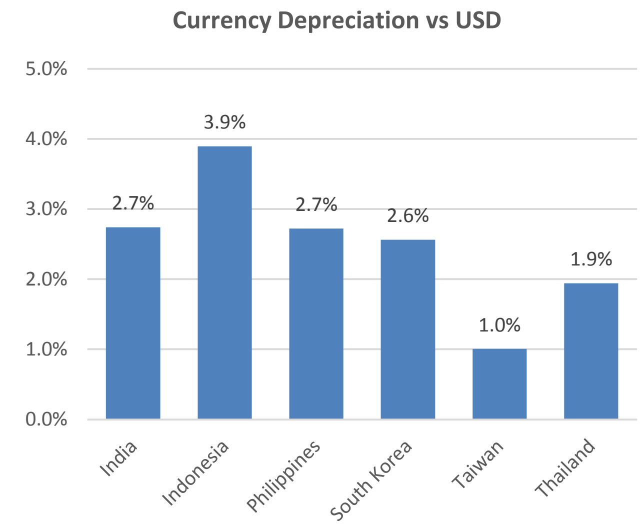
Source: Bloomberg, IMF

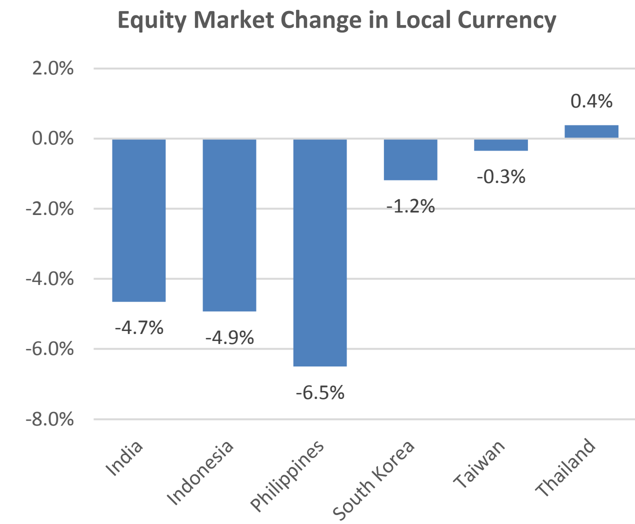
As of 4th Dec 2016

India v/s Other Emerging Markets:

Emerging Markets underperformed, India was impacted by both Demonetization and FII outflows







- Sentiment improving for US Equity on hope of fiscal measures and attractive yields in US bond market
- In India, non-ETFs saw higher outflows, both India dedicated and GEM saw outflows

- EM outflows weaken currency
- INR was relatively stable, depreciating by just 2.7% amidst both FCNR deposits and FII outflows, rising crude prices and falling yields

- Indian market fell 4.7% due to double whammy of demonetization and FII outflows
- Mutual Funds saw aggressive buying with an inflow of 1,888 Million USD, thus limiting the impact of foreign selling

REVERSAL OF CARRY TRADE? Decision on US rate hike stance would lead to further EM outflows, dragging Indian markets for short-medium term

Source: Bloomberg, EPFR, Kotak Institutional Equities (KIE)
1st Nov 2016 to 30th Nov 2016

Impact of Demonetization : Several Sectors impacted

Reduced Luxury consumption

Move to digital solutions, deposits ↑

Increase in tax base

Interest Rate, inflation will fall

Temporary Cash crunch

Govt. Spending Impetus

Impact on different Sectors

No/Low Impact	Short Term -ve, Long Term +ve	Long Term -ve
• **Oil & Gas, Pharma, IT, Engineering, Mining, Power Distribution , Defence** likely to have no impact • **Consumer Durables** should have a quick recovery • **Agriculture** – low impact as seen from Rabi sowing data • Watch for possible positive impact on **Infrastructure** post Government spending from tax collection	• **Banks** will face pressure on NIMs given huge despots and slow lending activity • **FMCG** – Consumers are preferring to buy only essential items until liquidity situation improves • **Automobile** Demand might get impacted for next few quarters, especially on higher value segment • **Microfinance NBFCs**	• **Real Estate** – Middle to High end properties and independent developers will be impacted • Select **NBFCs like Gold Loan** and those with huge **exposure to LAP/MSME** • **Jewellery**

The consensus remains that ~2 Quarter of earnings will impacted, however the move will be medium to long term positive for the economy

Source: Various AMCs

India Macros Overview: Strong Consumption and Industrial numbers for Oct'16

Positive Indicators

Indicators	Data*	Sep-16	Oct-16	Nov-16	Remark
Inflation	CPI Composite	4.39	**4.2**	**3.63**	**The sharp deceleration in November CPI inflation was attributed to continued correction in food inflation and is the first crucial macro print post demonetization**
Industry / Infrastructure	Composite IIP ↑	0.7	**(1.9)**		**The decline was partly owing to lower number of working days and partly due to decline in production adjusting for the festive month**
	Core Infrastructure	5.0	**6.6**		**Highest since April led by steel, cement**
Trade YoY%	Exports Growth ↑	4.8	**8.2**		**Exports Growth in EU and Japan**
Consumption Yoy%	Airport Passenger Traffic	23.5	**23.3**		**Consistent strong growth in Air Traffic**

Negative Indicators

Indicators	Data	Aug-16	Sep-16	Oct/ Nov16	Remark
Industry YoY%	Credit Growth	**(0.2)**	0.9	**(1.7)**	**Indicate no improvement in private capex**
	Coal Production	**(9.2)**	**(5.8)**	**(1.6)**	
	India PMI Composite ↓	54.6	**52.4**	**55.4 /49.1**	**November data impacted by demonetization, services more impacted than manufacturing**
Consumption	MHCV Sales ↓	**(10.8)**	**(20.6)**	**16.9/ (10.0)**	**New Purchases might be delayed again due to demonetization**

Key Takeaways

1) Industrials were showing sign of revival – Core infrastructure

2) Consumption was also strong; healthy growth in MHCV Sales and Air Traffic

3) November PMI data and MHCV Sales confirm slowdown, consumer goods & services PMI were the weakest performer this month

October Economic indicators were positive , but we believe economic recovery will be pushed back several months due to demonetization

Source : Bloomberg, KIE.

*YoY% Growth Unless otherwise specified

↑ - Improved from Negative to Positive Indicator , ↓ - Worsened from Positive to Negative Indicator

India: Q2-FY17 Earnings

Net income of Sensex increased by 7.6% compared to our 4.0% expectation yoy

Sector-wise earning for Sensex

	PAT Rs. Mn		Change (%)		
Sector	Sep-16A	Sep-16E	A/E	yoy	qoq
Automobile	89,661	98,299	(8.8)	28.1	8.3
Banks/ Financial Institution	215,973	205,787	4.9	8.6	11.4
Consumer Products	67,561	69,383	(2.6)	1.0	(0.2)
Energy	210,665	204,991	2.8	59.0	(10.2)
Industrials	20,760	23,100	(10.1)	63.9	29.7
Pharmaceuticals	40,445	35,231	14.8	19.5	2.7
Technology	153,439	147,312	4.2	4.7	2.1
BSE-30	610,899	591,497	3.3	7.6	2.2
BSE -30 (ex energy)	474,864	469,329	1.2	5.0	1.8

Q2 2017 Results for Sensex have been encouraging

Sector	PAT exceed KIE Expectation*	PAT met KIE Expectation	PAT below KIE Expectation
Automobile	3	0	1
Banks/ Financial Institution	2	2	1
Consumer Products	0	3	0
Energy	2	0	0
Pharmaceuticals	1	1	2
Technology	2	1	0
BSE-30	14	9	6

Key Takeaways

1) Pharmaceuticals and Banks exceeded Earnings expectation

2) Next 2 Quarter of growth is expected to be impacted by demonetization

Source: KIE ,* Actual >5% Expectation taken as exceeding expectation and vice versa
Earnings Upgrade/Downgrade as of 4th Dec 2016

India Equities: Valuations & Strategy – Maintain Neutral Stance

At current levels of approx. 26700 (13th Dec,2016), Sensex is trading at a 1 year forward PE of 16.2X. Also the ratio of potential upside to downside is now favourable at 3.5 : 1.

Risk-Reward Scenario based on earnings growth & valuations:

Sensex @ 26700	Fwd PE(X)	Fwd EPS Estimate	Estimate Target	Sensex Level	% Upside / Downside
1 Year Upside	17.5	1937	Nov-18	33,903	**26.98%**
Downside	15	1644	Nov-17	24,665	**-7.62%**

On a risk-reward basis we continue to maintain Neutral stance

Existing Investments:

- We recommend putting a hold on profit booking

New Deployments:

- **Mutual Funds**: **Invest 50% immediately** and subsequent in tranches via SIPs/STPs

- **Recommended allocation within equity mutual funds is as under:**
  - 100% Large Cap allocation (Prefer Large Caps due to relatively Favorable Valuations (Prefer Large Caps due to relatively favorable Valuations - Large Cap Funds trading at ~17X P/E vs. Mid Cap Funds at ~19.4X P/E with similar earnings expectations for FY18**)
  - This allocation to Large caps can also be taken through Opportunistic Funds which currently have a bias towards Large cap
  - For investors who are vary of the current volatility and are not okay with a 100% equity exposure can invest through Balanced Funds

Source: EPS Estimates by KIE, ** Source: Respective AMCs of recommended funds as of Nov end 2016

India Equities: Triggers

Positive Triggers

- **Global Economic data :** US GDP expected growth of 3.2% in Q3
- **Interest rates likely to soften :** Led by increased liquidity and disinflationary pressure of demonetization
- **Better Valuations:** Correction puts valuations in comfort zone. On a regional basis India's growth premium down to 20% vs avg.~40% .
- **Government Spending:** Increase in fiscal spending by the government led by widening tax base post demonetization

Risks

- **Trump's Policies:** Could be disruptive. Especially for Pharma & IT
- **US Fed rate hike:** Guidance of multiple future hikes may reverse carry trade
- **Higher Crude Prices:** OPEC output cut could affect our CAD
- **Demonetisation**: Liquidity crunch in short term. Any fresh agenda against black money may cause collateral damage to the economy.
- **Earnings: Uncertainty on actual impact.** Most companies unable to assess full impact to business disruption in short term and long term.
- **Reforms:** Political opposition consolidating – may stall continuation of reform agenda, and in turn GST

Outlook – We expect heightened volatility due to uncertainty from demonetization and possible political surprises Globally. Still expect continuation of accommodative policy from ECB, BOE and BOJ

Source: KIE, Equity Desk

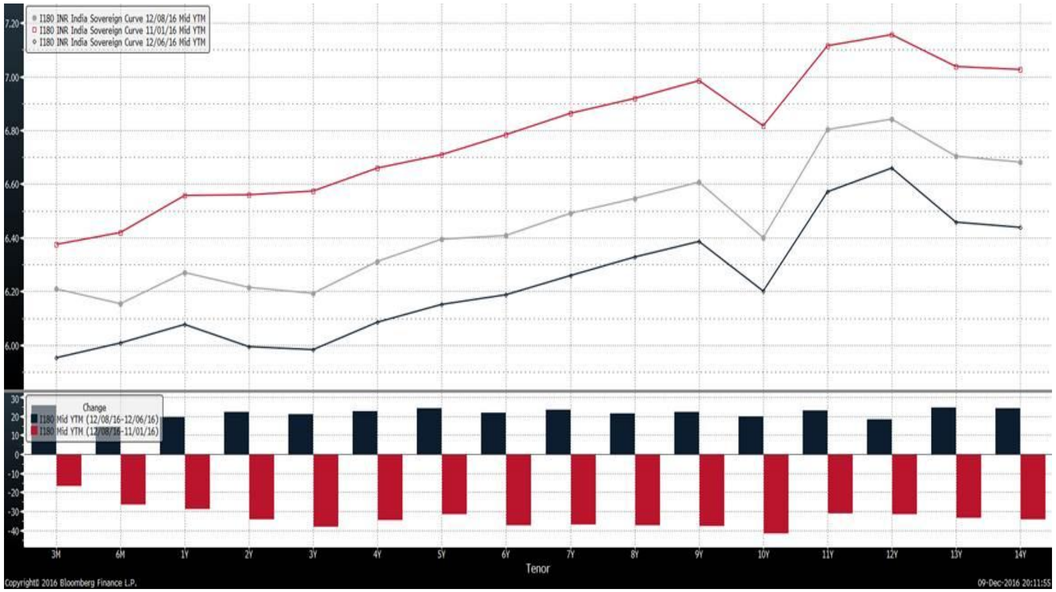
Debt Market Update
&
Debt MF Strategy

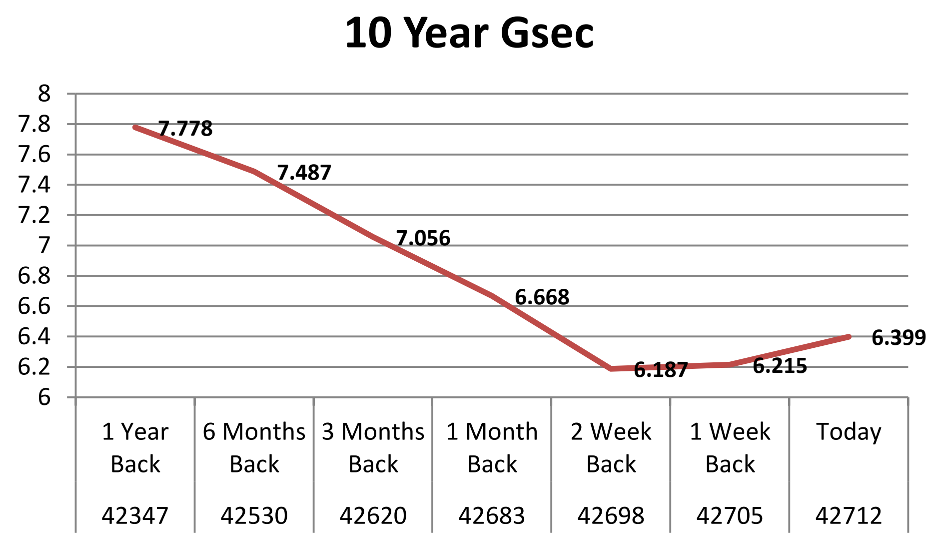
Debt Market: Key Variables

Indicators	Data	Remark
Policy Actions	• **RBI kept its policy rate unchanged at 6.25%, contrary to our and market expectations.**	• Significant change in its stance compared to last policy. • Remained accommodative but adds caution. • **Directionally, we believe rates are still headed down**. However, the pace and timelines of rate cuts going forward has been pushed ahead.
10-year Benchmark	• **Volatile month for the benchmark** and yields in general • 10 Year made **a high of 6.85%** in November start and **a low of 6.10%** in the first two weeks of December & **currently trades at 6.51%** • The **outstanding of new benchmark now stands at Rs. 53000 Crs**. but the earlier benchmarks remains the top traded security.	• **10 Yr likely to remain in range in near term.** • We **don't see 10 year G-Sec yield inching up meaningfully** from current levels
Sovereign Curve	• **The short to mid end of the curve remains steep in line with our expectation.** • The long end of the fund is flat and kinked. **With rate cut expectation toning down, long end is likely to be more reactive.**	• **Short end of the curve is likely to be supported by liquidity in near term.**
System Liquidity	• **Volatile month in term of liquidity**. From a deficit, it moved to Rs.5.5 trn on back on demonetization • **Temporary CRR measure toned down the liquidity**	• Demonetization has resulted in flush of liquidity in banking system. • RBI had to increase MSS limits from **30000 Cr to 6trn** to absorb this massive liquidity • **Liquidity is expected to be ample in near term.**
Corporate Bonds	• **Spreads have widened by 8 -12 bps over the course of last one month.**	• The **spread of 3, 5 and 10 year AAA PSU over 10 yr benchmark** stand at 81, 76 and 82 bps respectively. • The **current spreads (higher by 6 -10 bps) looks attractive** relative to historical averages.
Inflation	• **Nov '16 CPI came at 3.63%, lowest print since Nov 2014**, on account of continued correction in food inflation.	• Core inflation remained sticky at 4.9% from 4.86% in October, although the sequential increase has slowed, partly reflecting the impact of cash crunch

Source : Bloomberg, KIE

Sovereign Yield Curve

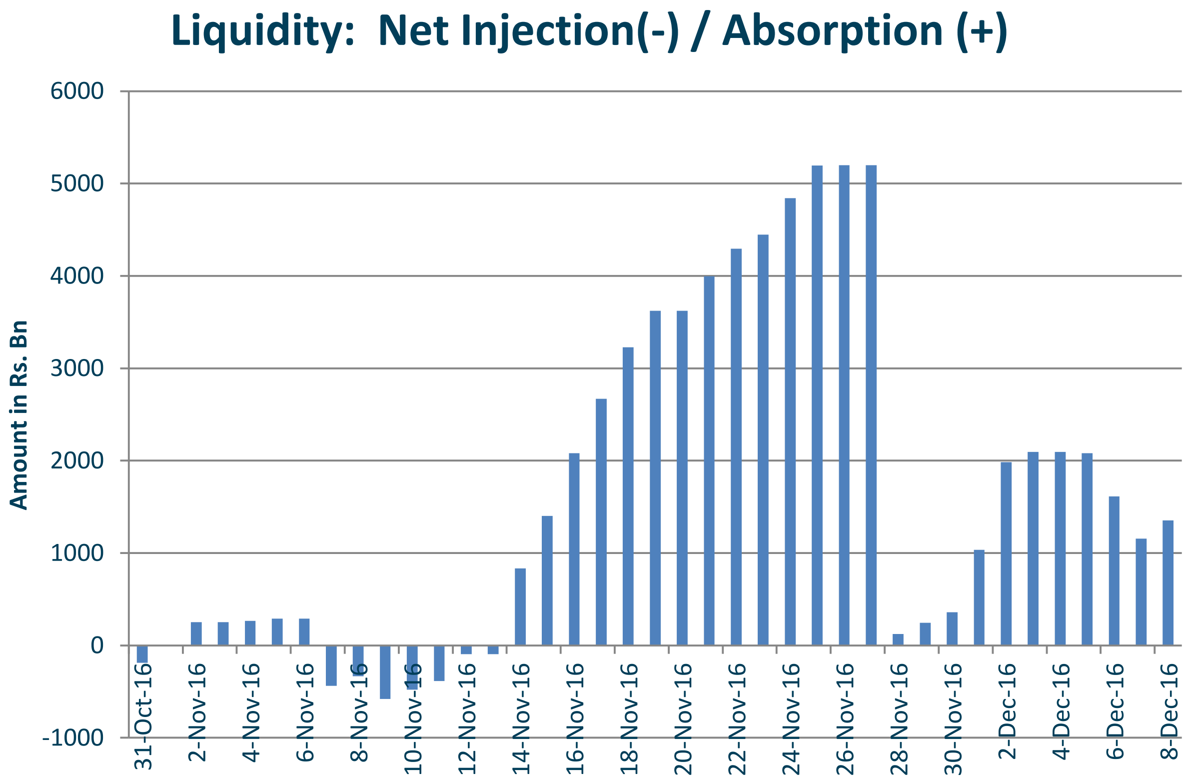




- **The curve has shifted up to the tune of 20-25 bps across the curve post RBI Policy**
- **The short to mid end of the curve remains steep in line with our expectation.**
- The long end of the curve is flat and kinked. **With rate cut expectation toning down, long end is likely to be more reactive.**
- **Short end of the curve is likely to be supported by liquidity in near term.**

Source : Bloomberg

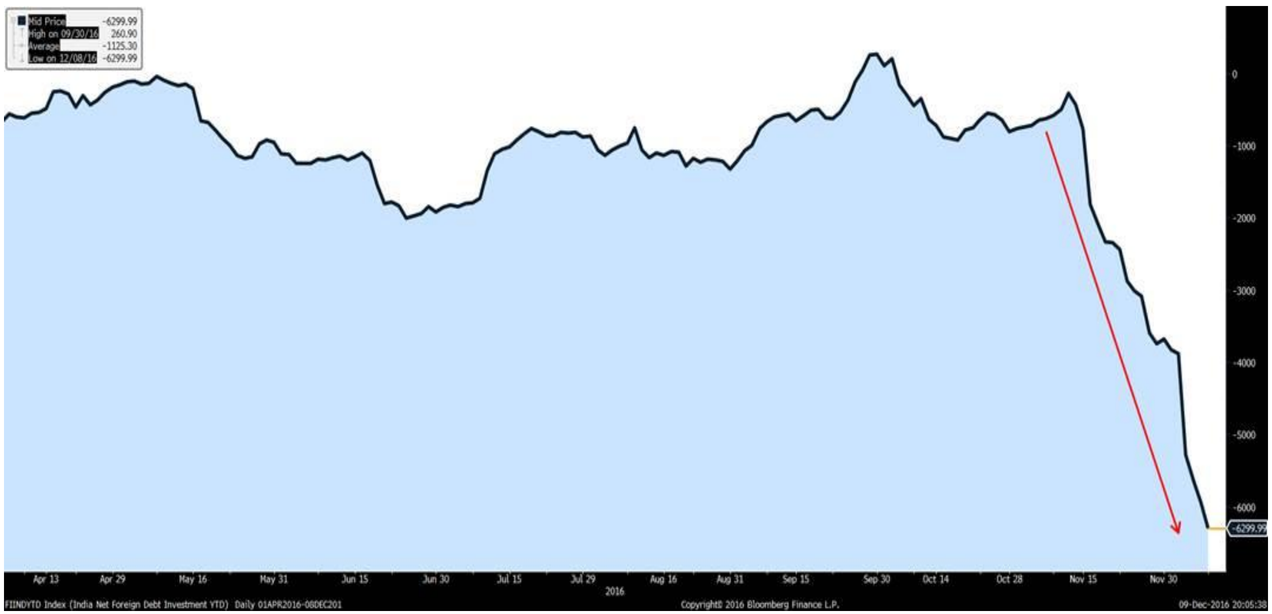
System Liquidity



- **Volatile month in term of liquidity**. From a deficit, it moved to Rs.5.5 trn on back on demonetization
- **Temporary CRR measure toned down the liquidity**
- Demonetization has resulted in flush of liquidity in banking system.
- RBI had to increase MSS limits from **30000 Cr to 6trn** to absorb this massive liquidity
- **Liquidity is expected to be ample in near term.**

Source : RBI, Bloomberg

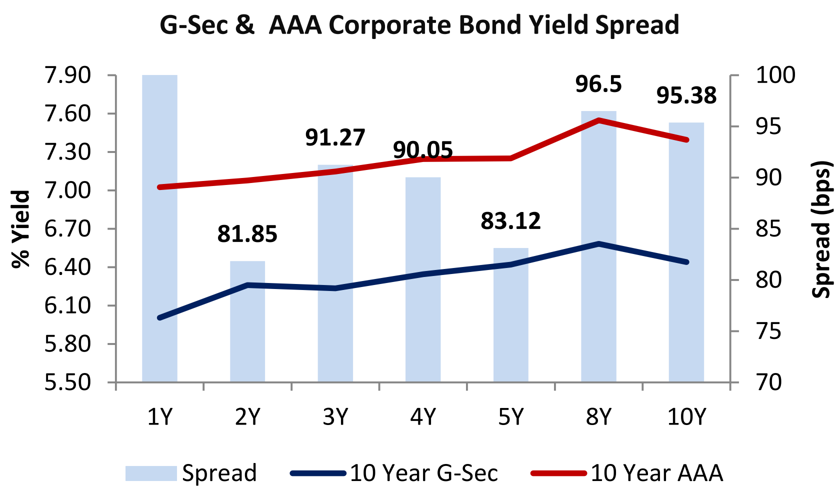
FII's investment in Debt

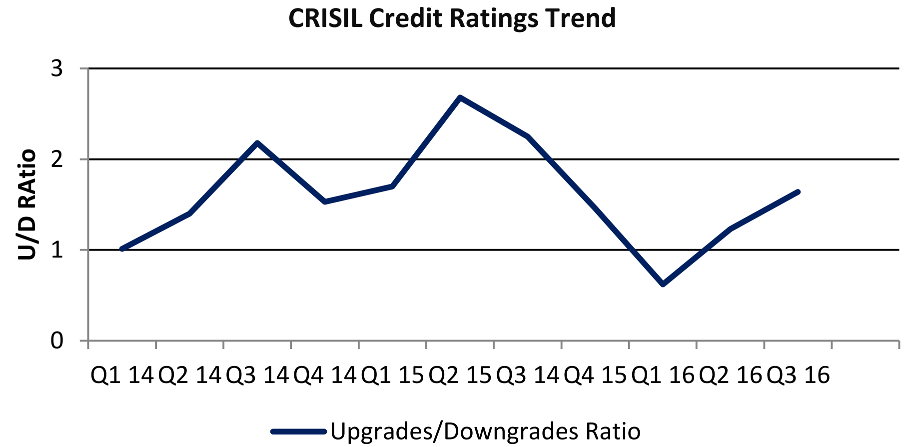


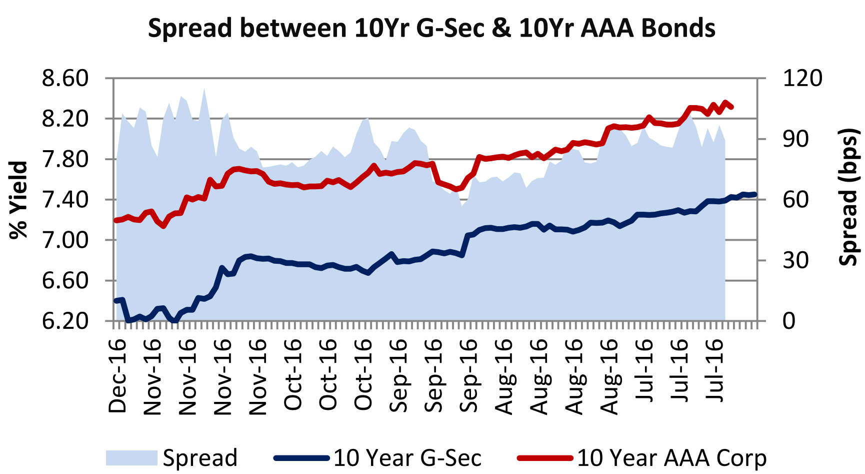
- **Significant selling by FII's** in last 30 days
- The **YTD number stands at around $6bn.**
- **FII's have sold close to $5.5 bn since demonetization was announced on 8th November 2016**

Source : Bloomberg

Corporate Bonds: Spreads inch up







- **Spreads inch up:** Spreads widened to the tune of **8 - 12 bps** across the curve.
- The **spread of 3, 5 and 10 year AAA PSU over 10 yr benchmark** stand at 81, 76 and 82 bps respectively.
- The **current spreads (higher by 6 -10 bps) looks attractive** relative to historical averages.

Source : Bloomberg

India Fixed Income: Strategy

Dynamic/ Income/ Gilt – Hold

- We advice existing investors to keep holding long end funds
- No fresh deployment is advised in these funds given 3 years perspective

Passive Accrual-Oriented Debt funds – Buy

- High quality portfolios (~100% AAA / Sovereign), **avg. maturities of 3/5/7/10 years,** attractive risk-adjusted returns (net YTMs* of ~6.40% – 6.75% p.a.)
- **Portfolio is run on a passive accrual basis** i.e buying a bond and holding it till maturity thereby earning from the accruing of interest
- **Higher predictability of return, lower volatility & lower interest rate risk** if held for the complete term of the portfolio, **open-ended vs. FMPs**
- **More tax-efficient & liquid option** to generate stable returns from high quality debt instruments vs. Direct Bonds / Deposits etc

High Yield Credit-Oriented Funds – Buy

- Low volatility on account of **maturity of portfolio between 3 – 5 years, attractive and stable accrual yields** (7.5% - 7.75% p.a on net basis*)
- **Strong risk management framework**, sophisticated deal selection & execution and typically superior financing terms
- Experienced teams to carefully evaluate and tightly monitor high yielding debt instruments
- **We believe that this segment will outperform all other segments over next 3 years.**

Short Term Bond Funds – Buy

- **Actively managed** to run a low avg. maturity of 2-3 years, **attractive risk-reward at net YTMs* of ~7.% p.a.**
- **Lower volatility and interest rate risk** than Dynamic Bond Funds, better suited from a risk-adjusted basis in volatile markets

Continue to recommend ultra short term relative to liquid funds (up to 3 Months)
For short term parking of funds for a minimum of 6 months, Arbitrage funds preferred over ultra short term funds on back of better tax adjusted returns

YTM data on approximate basis as of end-November '16, YTM Source : MFI Explorer Software

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