



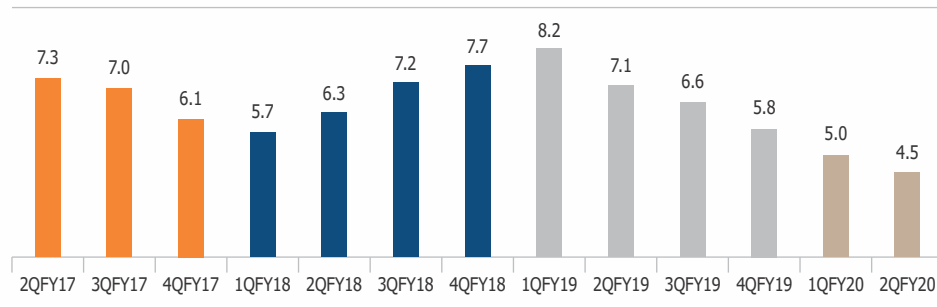
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MARKET
OUTLOOK

ECONOMY 2019 Revisited

GDP Growth

India had a volatile 2019 with GDP growth seeing a steady slowdown. Real GDP growth steadily declined to 4.5% in 2QFY20 from 6.6% in 3QFY19 and 5.8% in 4QFY19. Key macro-economic indicators such as fiscal deficit (3.4% in FY2019); inflation (average CPI at 3.2% in CYTD19) and current account deficit (0.7% in 4QFY19 and 2% in 1QFY20) remained broadly stable. Slowing global economic growth, falling trade intensity, and uncertainty over the US-China trade conflict are posing obstacles.

Chart 1: India GDP Growth (in % YoY)



Source: Bloomberg, as of 31st December 2019

Indian Rupee (INR)

INR depreciation has been relatively lower as compared to the previous calendar year where it had depreciated by ~8.7%. The INR's fall should be seen in context of the performance of other emerging market currencies (refer below table).

Table 1 : Emerging Market Currencies Vs USD (in %)

	Brazilian Real	Russian Ruble	Indian Rupee	Chinese Yuan (Offshore)	South African Rand
2018	-14.6%	-17.3%	-8.7%	-5.2%	-13.7%
2019	-3.9%	12.5%	-2.7%	-1.3%	-2.8%

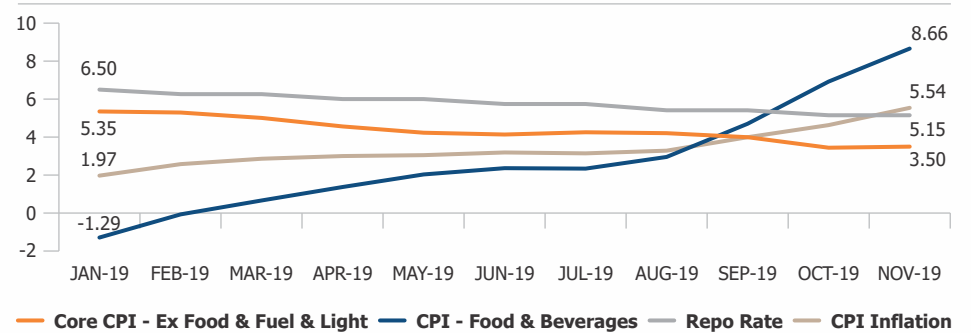
Source: Bloomberg, as of 31st December 2019

CPI Inflation and RBI Policy

CPI Inflation was 2.05% at the start of 2019, much below the RBI medium-term target of 4%. However, by the end of the year it rose sharply to 5.54% (Nov'19), propelled by a surge in food prices, which compelled the Central Bank to take a pause and hold rates in the December policy. The RBI has projected inflation at 4.7-5.1% in the 2HFY20 and 3.8-4.0% in 1HFY21.

Repo rate was at 6.5% at the beginning of 2019. With a new Governor taking charge at Mint Street, the Monetary Policy Committee shifted focus to slowing growth at a time when inflation was well below its target range and delivered 5 successive rate cuts - 135 bps cumulatively.

Chart 2: RBI on course of inflation targeting (in %)



Source: Bloomberg, as of 31st December 2019

Table 2: Indian Economy - A Snapshot

	FY14	FY15	FY16	FY17	FY18	FY19	1HFY20
Real GDP Growth	6.4%	7.4%	8.0%	8.2%	7.2%	6.8%	4.8%
CPI Inflation	9.4%	6.0%	4.9%	4.5%	3.6%	3.4%	3.5%
Real Interest rate (Repo-CPI)	-1.8%	1.9%	2.1%	1.8%	2.5%	2.9%	2.1%
Central Fiscal Deficit	4.5%	4.1%	3.9%	3.5%	3.5%	3.5%	3.4%*
Current Account Deficit	1.8%	1.3%	1.1%	0.6%	1.8%	2.1%	2.0%**

Source: RBI, MOSPI, Bloomberg *Budgeted for FY20 ** as a % of GDP for 1QFY20

DEBT Market

Review 2019

Even though 2019 started on a rather unpromising note for fixed income markets with sustained credit freeze post ILFS default, with a hawkish Fed, concerns on breach of fiscal deficit and slowing growth, the year turned out to be great for fixed income investors with interest rates falling significantly during the year, rendering debt fund investors a rather happy lot.

With a new Governor taking charge at the Reserve Bank of India, the MPC shifted focus to growth at a time when inflation was well below its target range and delivered five successive rate cuts —135 bps cumulative, starting right from its first meeting of the year in February'19. Alongside, system liquidity, which has remained negative over the past couple of years, turned hugely positive largely due to strong accretion to forex reserves, which grew from USD 393 bn in December 2018 end to USD 454 bn as on December 20, 2019 an increase of USD 61bn or nearly INR 4.27 tn (avg assumed USD 1=INR 70). Not surprisingly, system liquidity which was deficit of INR 2.8tn in end 2018, currently stands at surplus of INR 2.45tn.

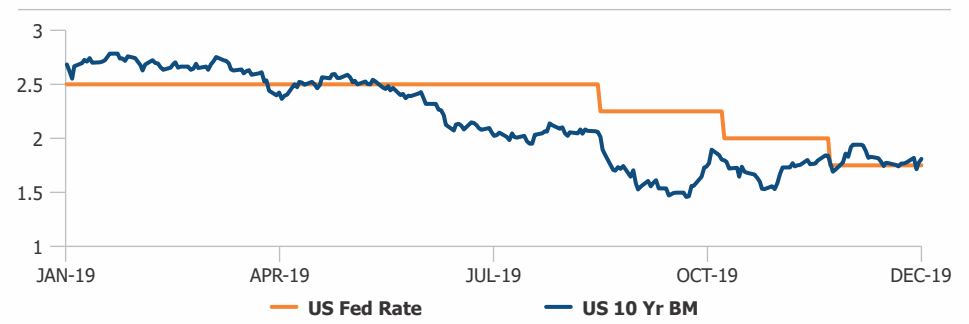
In another related surprise positive development, even as US economic data remained robust, the Fed took a U-turn and delivered three back to back rate cuts, terming them insurance cuts to pre-empt against any possible stalling impact due to ongoing trade war between the US & China (Refer Chart 3). Resultantly, India 10Y Govt Bond Index yield fell from a high of 7.70% in early 2019 to a low of 6.25% by late 2019. More dramatically, money market yields saw maximum transmission due to combination of rate cuts, high liquidity and credit risk aversion with 3 month T-Bills yields falling from about 6.60% to 5.0% by year end. Heightened polarization resulting in market concentration towards select few prime names resulted in rising challenges for fresh funding for a major section of the market, especially NBFCs.

The year saw many cases of default across sectors. As such, the market's credit segment underperformed and generally did not participate in the broader market rally. Towards 4Q2019, a highly accommodative RBI notwithstanding, long term rates began to face headwinds and benchmark 10Y yield rose to nearly 6.75% as concerns began to mount on a possible large fiscal slippage due to poor tax collections, which were much below the budget estimates.

A significant cut in the corporate tax rate to support a revival in growth further added to the concern. Around the same time, headline CPI inflation spiked from mere 3.15% in July to 5.54% in November, compelling the RBI to take a pause and hold rates in December 2019 policy. This resulted in strong adverse reaction at the long end with 10Y yield hardening to 6.80%. However, subsequently an "Operation twist" styled announcement by the Central Bank of buying long dated papers and selling short dated one resulted in some calm returning to the markets and the year ended with 10 year G-sec Yield closing at 6.56%.

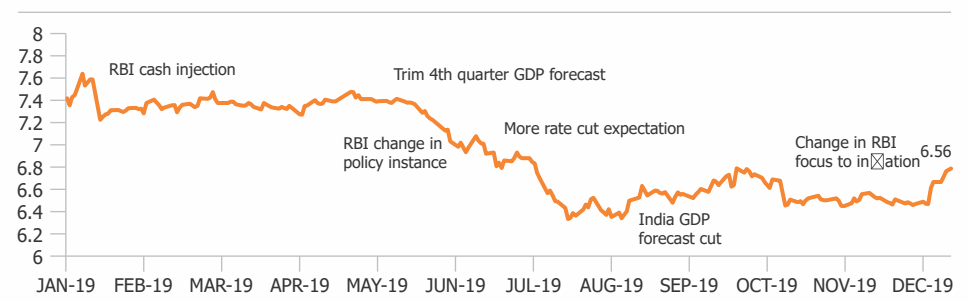
Overall, 2019 turned out to be a good year for fixed income investors, except those who got impacted by credit issues.

Chart 3: US Fed rate and 10 year benchmark (%)



Source: Bloomberg, as of 31st December 2019

Chart 4: India 10 Year G-sec (%)



Source: Bloomberg, as of 31st December 2019

Table 3: Money market and G-Sec yields (%)

	31-Dec-19	28-Jun-19	31-Dec-18
Call Money	5.25%	5.94%	6.53%
TREPS	4.82%	5.85%	6.35%
3 Months CD	5.10%	6.35%	7.00%
3 Months CP	5.45%	7.20%	7.45%
1 Year CD	6.00%	7.25%	8.10%
1 Year CP	6.75%	7.95%	8.95%
3 Years G Sec	6.24%	6.58%	7.02%
5 Years G Sec	6.47%	6.77%	7.19%
10 Years G Sec	6.56%	6.88%	7.37%

Source: Bloomberg, as of 31st December 2019

Debt Market Outlook 2020

Year 2020 is starting on a not so promising note for fixed income. Globally, after the initial hat-trick of pre-emptive cuts, the Fed seems to be in a prolonged pause mode, though through injection of massive liquidity via the repo route, some believe a de-facto fresh round of quantitative easing has commenced again in the US.

Other major global central banks seem to be on pause mode, notwithstanding the disappointing global growth outlook, except in US where incoming data seems to suggest a reasonable growth in momentum. The recent announcement of a phase 1 trade deal between the US and China has led to a fresh round of "risk on" within equity markets, both in the US and India hitting a fresh all-time highs. This may lead to some revival in inflation globally. Silver lining remains that given disappointing global growth outlook, any tightening by global central banks remains off the table, creating an elbow room for the RBI to maintain an accommodative monetary policy stance even in the face of strong macro headwinds.

Domestically, GDP growth is at 4.5% for 2QFY20, the lowest since shock of taper tantrum in 2013, which is disappointing with no low visibility of early revival. We can expect modest recovery in growth during CY20 supported by fiscal stimulus, credit pickup, recent pick up in inflation led by agricultural price improvement and easy monetary policy.

Macro headwinds are mainly related to rising inflation and fiscal challenges. Tax revenue collections remains well behind budget estimates. Even though the government may limit fiscal slippage in the current year with higher RBI dividend, aggressive disinvestment, higher allocation from small savings and

other off balance-sheet borrowings, the outlook for FY21 will be rather challenging on the fiscal front especially until a clear trend of pick up in GST revenue is not established. GST collections till Oct'19 is at INR 3.44tn are just 51.9% of budget estimates. Direct tax collections stand at INR 5.17tn being 38.7% of budget estimates. Thus, indirect and direct tax collections need to grow at 39.0% and 30.7% respectively, in the balance 5 months of FY20 against first 7 months actual of -0.3% and 3.5% respectively. This seems a tall order.

Inflation has ratcheted up in recent months to 5.5% in November from a mere 3.2% in July due to increase in agricultural commodity prices. Even as most analysts expect quick reversal on fresh crop arrival, past experience suggests that it may take up to 6 months for inflation to moderate. Hence, the outlook for monsoon for next year will be crucial on which at this point no forecast can be made with any reasonable confidence.

Brent crude prices have bounced by nearly 10% in December'19. However with slowing global demand and high shale oil production, crude price is unlikely to sustain high levels. Liquidity outlook remains benign with all hints of a continued positive outlook by foreign investors in India.

In essence then, all indicators point to the criticality of guidance and action by the Central Bank next year, more than any time in recent past. In the face of otherwise strong macro headwinds like rising inflation and widening fiscal deficit, benign global central banks and anemic growth provide a window for accommodative monetary policy stance.

Further, a large dividend and incremental one time transfer of excess reserves by RBI can help mitigate fiscal concerns to some extent. While market yields rose in spite of the previous few rate cuts, the India version of so termed "operation twist" tabilized sentiments. How aggressively the central bank follow this up with the next round of such operations will also be critical. If there are successive such auctions, yields may ease; however, consistency and aggressiveness in the past have been too much to ask simply because the macro environment changes too quickly.

To sum up, we should brace for heightened volatility in 2020, which seems typical of fixed income universe currently. Economic indicators change track quickly without much advance notice, causing frequent reset of monetary policy across the globe. With Central Banks committed to support growth, macro headwinds may be largely offset giving a neutral outlook for the year. We have seen the futility of even the Central Bank's projections. If they are data dependent, one should also be positioned accordingly.

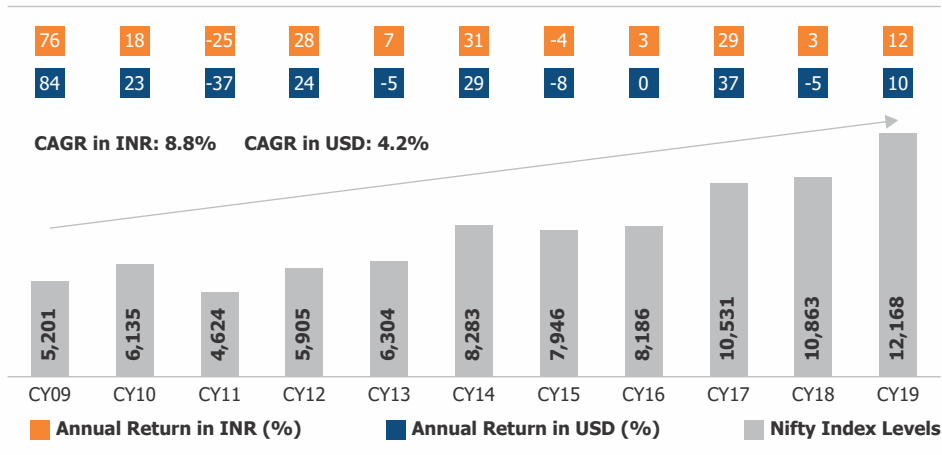
EQUITY Market

Review 2019

Divergence in large and midcap indices continued in CY 2019

The 2019 narrative shifted from global concerns to India election and eventually cyclical slowdown in the domestic economy in 2HCY19. In the backdrop of moderating economic environment, headline indices witnessed divergent returns trend. While the BSE Sensex and Nifty indices were up 12% and 10% CY19, BSE Midcap and BSE Small cap indices were down 5% and 10% respectively. Similar divergent trend was seen in 2018 too. However, now the midcap index is trading at discount of 12% against a premium of about 35% two years ago.

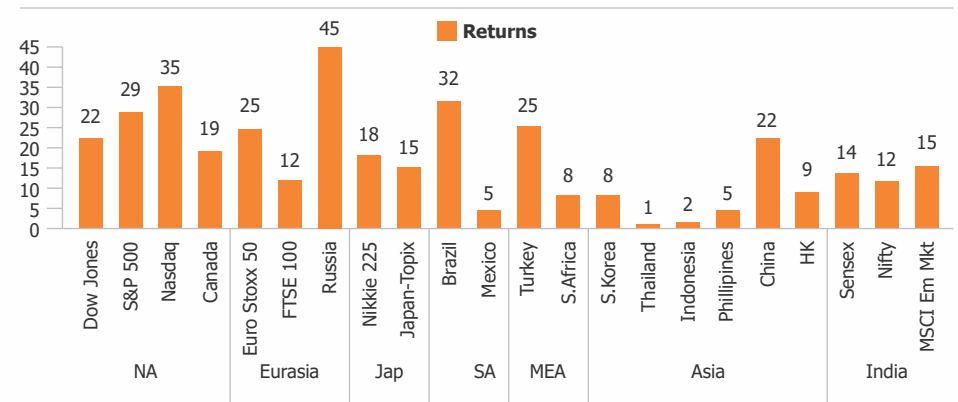
Chart 5: CY19 Nifty returns impressive post a muted CY18



Source: Bloomberg, as on 31st December 2019.

On the global front, key indices on CYTD basis are trading higher - Russia (+45%), Brazil (+32%), the US (+29%), Taiwan (+23%) and Japan (+18%) are the top performers. In India, foreign institutional investment flows stood at USD 14.5bn and domestic institutional investments have infused USD 5.9bn in CY19.

Chart 6: Performance of Global indices in 2019 (%)

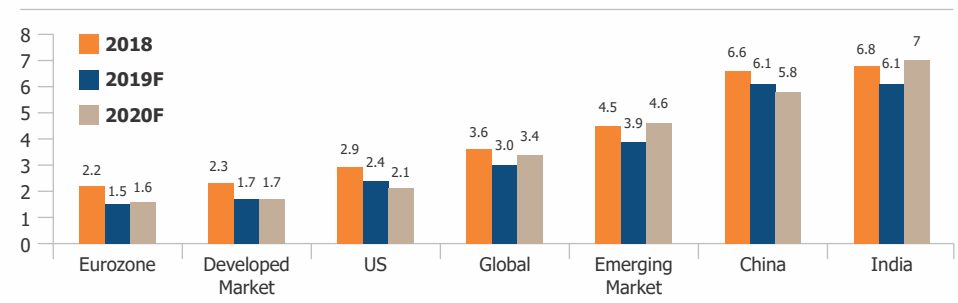


Source: Bloomberg, as of 31st December 2019

Trade war led cooling off in the Global Economy

CY19 was dominated by fears of a rising conflict over trade between the US and China, resulting in a slowdown in global as well as domestic growth. Meanwhile, the IMF lowered its growth outlook twice and now pegs global GDP growth at 3% in 2019 as against 3.5% predicted in October 2018. It lowered the growth outlook for most economies, including India, which IMF now estimates to grow 6.1% in FY20 against earlier estimate of 7.0%. The recent uptick in PMIs coupled with supportive monetary policies across the central banks is positive though. Continued QE by global central banks and trade war resolution could help emerging markets, including India.

Chart 7: Global GDP Growth (in %)



Source: IMF world economy Outlook, October 2019

On the positive note, strong political mandate empowers for bold policy actions

On the political front, BJP's decisive win in the May 2019 general elections empowers the Government for any strong policy actions. Subsequently, with demand weakness persisting, the Government announced a plethora of measures like reduction in corporate tax rates to 22%; recapitalization and consolidation of PSU (Public Sector Undertaking) banks; and privatization including strategic sale of PSUs. In addition, regular measures are being undertaken to address sector specific challenges in Infrastructure, NBFC, Real estate, etc.

Monetary Policy too tuned to address slowdown

The RBI maintained its 'accommodative' stance, implying its focus on addressing tepid growth as indicated by cyclical slowdown in domestic high frequency indicators and deteriorating global outlook. In CY19, cumulatively it has cut repo rate by 135bps.

Outlook for CY2020

We expect demand to recover gradually in CY20 driven by low interest rates, Government spending and rural recovery. We discuss the major drivers that can shape the market outlook in CY20 below.

Global outlook hinges on QE, and trade war resolution

While the Global manufacturing PMI improved for the first time in seven months, growth outlook continues to hinge on the outcome of the US-China trade talks. The December 13, 2019 announcement of an agreement on a Phase One deal is positive. While the details are yet to be out, this should augur well to support Global growth and commodity prices. We believe growth could be supported by Western Europe as many shocks fade (Brexit, trade war, Italian politics, and German auto industry) coupled with benefits from policy stimulus in China. However, towards the end of 2020, all eyes will be on US presidential elections as it will again have a meaningful bearing on various geopolitical issues and in turn on Global growth outlook.

Domestic economic slowdown should bottom out

Post August 2019, the Government announced several steps to arrest the growth slowdown and upcoming Union Budget too should lay path for recovery. The RBI too lowered interest rates by 135bps since Feb'19. A combination of fiscal and monetary response should feed into the growth impulse in CY20. Late sharp recovery in monsoon leading to higher reservoir levels also augurs well for rural economy and consumption. Overall from a macro perspective, we believe GDP growth is near bottom and should see a gradual recovery in CY20.

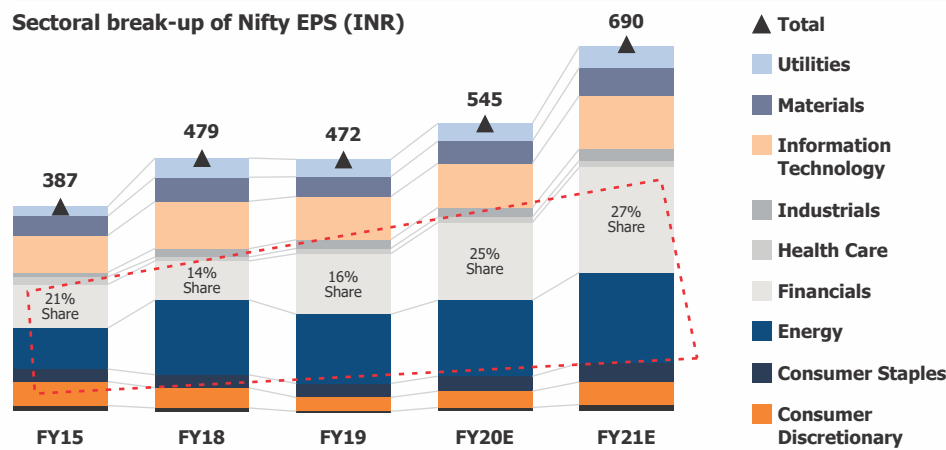
Macros unlikely to surprise adversely; recovery will be gradual

We expect macro data points (oil price, currency and interest rates) to remain supportive. However, demand should recover gradually in CY20 driven by: fiscal stimulus, low interest rates, government spending; and rural recovery. With current water reservoir levels at healthy levels post surplus monsoon in CY19, we expect the dependence on monsoons for kharif season of CY20 be less. Furthermore, increased Government spending in rural focused sectors should act as buffer. The impact of low interest rates on improving demand is yet to be felt given the delay in the transmission of rates, though a low interest rate environment and government spending will have a spill-over effect in other ancillary industries (petroleum, cement, steel, housing etc.).

Corporate earnings to improve

Nifty earnings might see a steady recovery in FY21 led by banks (asset quality improvement due to resolutions of NPLs), automobiles (benefits of BS-VI tailwinds), and NBFCs (normalization of businesses due to recovery in consumption), construction materials (cyclical recovery) and consumer staples (moderate recovery in volume growth and modest increase in margins). The recent Supreme Court decision to uphold the sanctity of the Insolvency and Bankruptcy Code process is structurally positive. Additionally, the reduction in corporate tax cuts announced by the Government does provide a good tailwind for corporate earnings.

Chart 8: Nifty EPS growth to be driven by credit cost normalization for banks



Source: Bloomberg, as on 31st December 2019.

Expect mid cap discount to narrow

Large part of CY18 and CY19 was characterized by widening of discount of midcaps and smallcaps vs. largecaps. As economic growth bottoms out and corporate earnings pick up, we expect the risk aversion diminishes, and narrowing of valuation discount vs. large-caps in CY20.

Chart 9: Midcap Index Premium to Large Caps (in %)

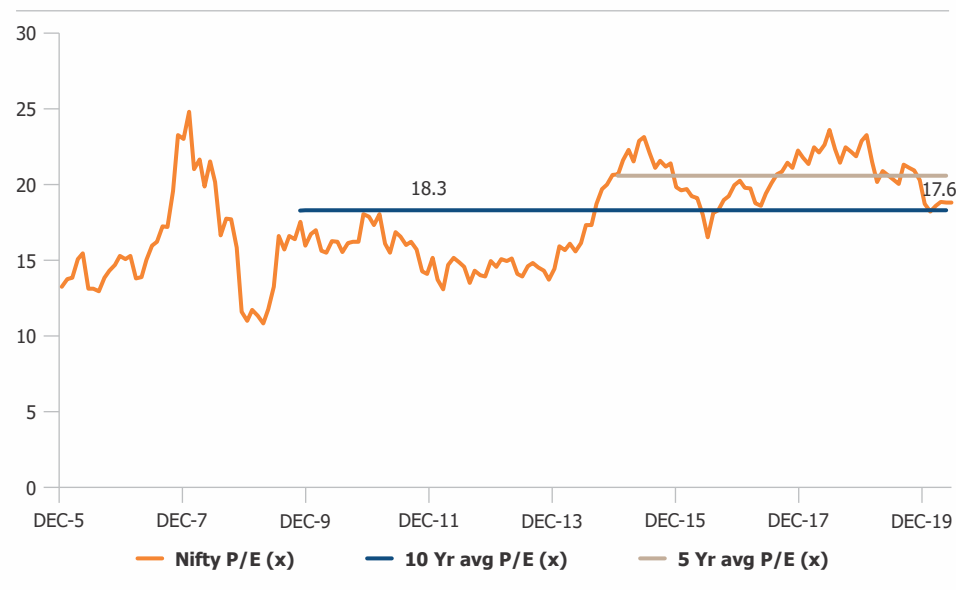


Source: Bloomberg, as of 31st December 2019

Risks to monitor

Key risks for CY20 in our view include the possibility of any protracted economic slowdown. From a global viewpoint, any sharp spike in oil price driven by geopolitical events, and volatility around US Presidential elections are key events to monitor.

Chart 10: Nifty 1 year forward P/E trend



Source: Bloomberg, as of 31st December 2019

Summary

In our view, the required building blocks for India's economic growth related to demographics and potential in infrastructure are intact. Structural policy reforms (GST, IBC and RERA), some of which, while disruptive in the short term, are expected to be beneficial in the medium to long term. The focus on digitization augurs well for overall productivity in the economy.

From a corporate earnings point of view, consensus earnings growth is currently pegged at ~21% CAGR from FY20 to FY22, implying P/E of 17.6x on FY21E. We believe that the market's valuations are reasonable as "earnings" is low compared to long term averages, given that the PAT (Profit after Tax)/GDP at 2.5% is at 15-year low. We remain positive on the market given the likely improvement in earnings growth, and low interest rate.

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