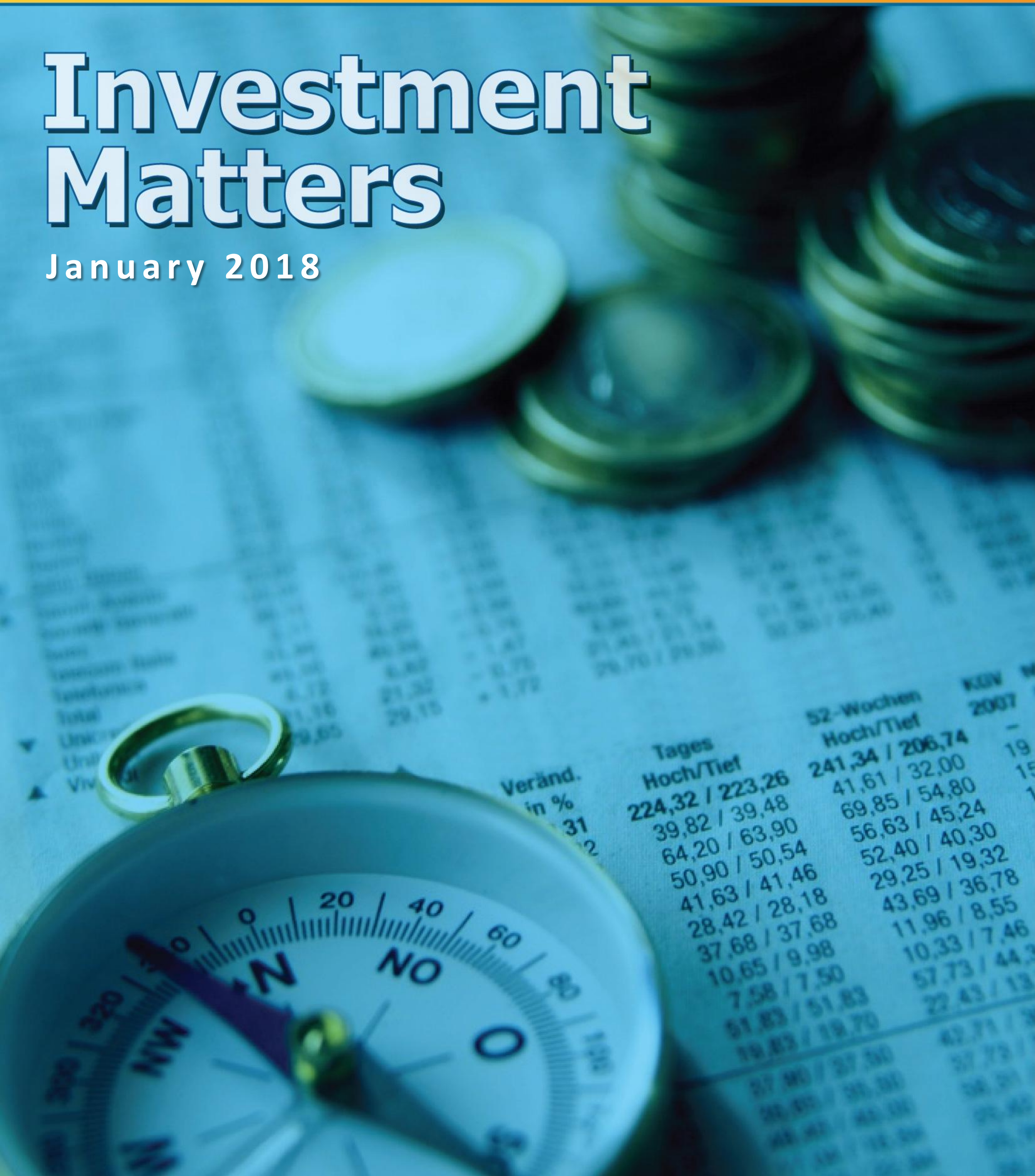
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

January 2018

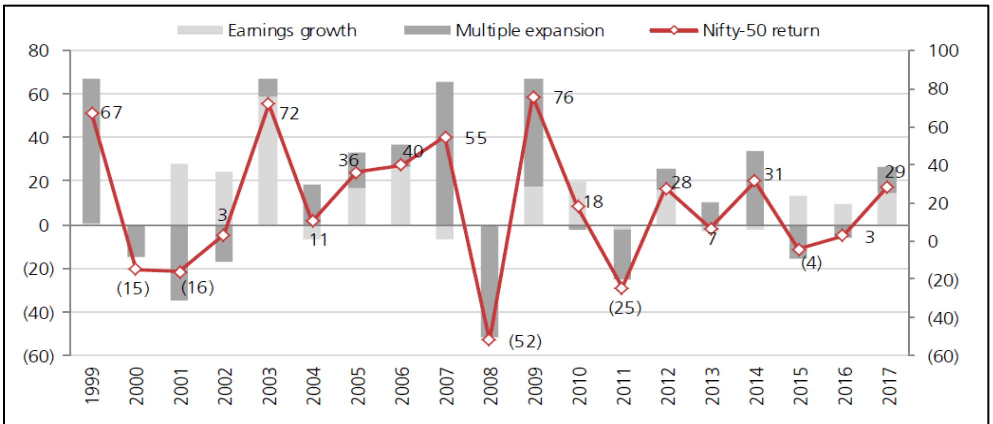


EQUITY OUTLOOK

At the outset, we wish you all a very Happy, Healthy, and Successful 2018.

2017 was a stellar year for equity markets with Dollar S&P BSE 500 rising by 44.72%. The markets have risen stupendously since the demonetization lows and to use a much clichéd term ‘markets climbed the wall of worries’. However, this was a global phenomenon with 2017 witnessing one of the smoothest bull markets across the globe accompanied by record low volatility.

This has put a spotlight on how expensive the markets are. However, if we were to look at a 3 year period, in USD terms, the absolute return was 39.5% translating to a moderate CAGR of 13.15%. For the Nifty, respective returns were even lower at 29.5% and CAGR of 9.6% during the same period.



Notes:
(a) Returns are based on calendar year. For 2017, returns are on CYTD basis.

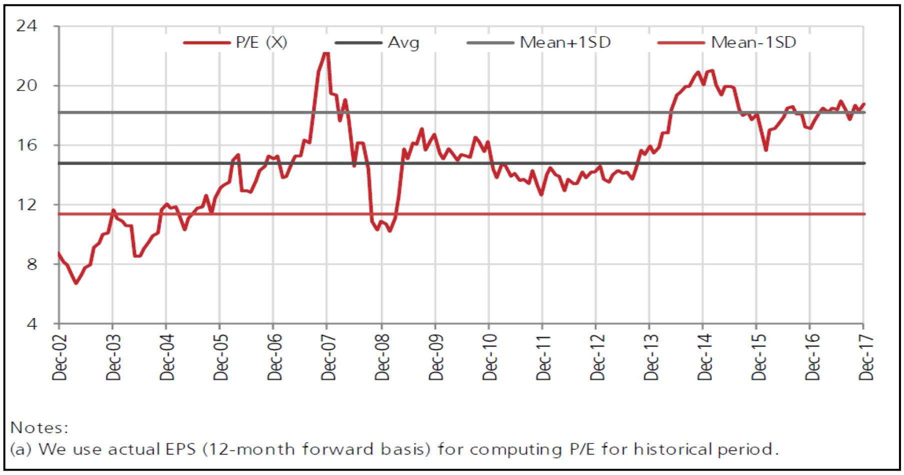
Source – Kotak

As we can see from the chart above, returns, in periods subsequent to the years where most of the returns were driven by multiples expansion, have been muted. The table explains the same in detail.

Year of Multiple expansion	Absolute Return %	Subsequent period	Absolute Return %	Return CAGR in subsequent period %
1999	67	2000-2002	-13.5	-5.2
2007	55	2008	-51.3	-50.3
2009	76	2010-2011	-10.7	-4.2
2014	31	2015-2016	-4.1	-2.8

EQUITY OUTLOOK

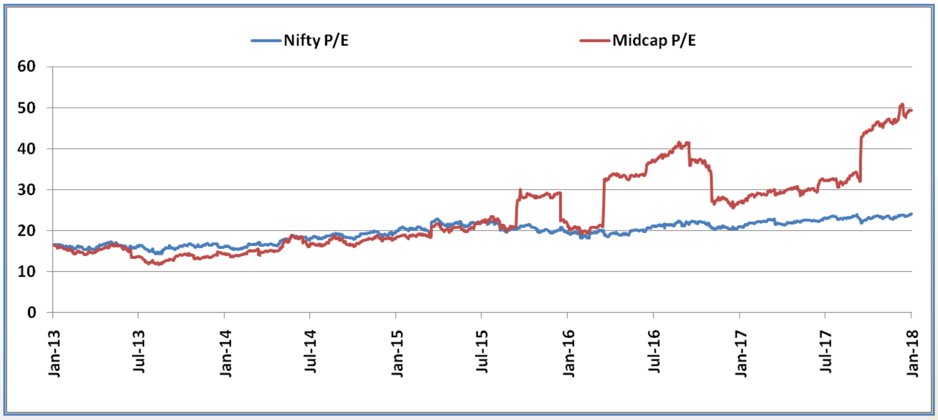
Indian markets have been trading at a one year forward P/E multiple of around 18 for more than 3 years now indicating that markets have been waiting for earnings growth recovery.



Source – Kotak

Hence, the strong returns of CY2017 were not entirely a result of P/E expansion (12% returns of the total 29% return on Nifty in 2017 can be explained by multiples expansion while the remaining 17% return is actually due to earnings growth). Hence, the biggest driver for returns from here on will be determined by earnings growth. Considering that the economy and corporate are recovering from the effects of demonetization and GST, this could well be the case in second half of FY2018 and FY2019-20.

While the overall markets are not expensive if earnings growth follows through, what is of concern is the unsustainable premium of small and midcap stocks relative to large caps.



As we enter 2018, we are entering a phase of shift from supportive macro to supportive micro and from P/E multiples expansion phase to an earnings growth phase for the market. Rising inflation and rising global yields coupled with several domestic state elections could drive volatility higher. However, the most critical factor to drive the market would be future earnings growth and the rest would be simply noise.

In the last 3 years, central government was focused more on bringing the fiscal deficit and inflation under control and carrying out several structural reforms. This adversely affected sections of the population, especially the rural areas and the unorganized business segment which was reflected in the lower than expected margin of victory in the Gujarat state elections for the BJP. Hence, there is expectation that the upcoming budget would be focused on agriculture and rural activities. There is fear amongst the market participants that the government would turn populist before the 2019 elections reflected in higher deficits which has caused bond yields to spike by 100 bps in last 6 months.

Earnings growth remained subdued for last 4 years due to a host of reasons such as highly leveraged corporate balance sheets, low capacity utilization, low private capex, and structural reforms which hurt the cash economy and the unorganized segment. A combination of these factors delayed the inevitable cyclical recovery. Government will be mindful of the impending elections and the insights gained from the recent election results. This is already partly reflected in the form of front loaded capex for FY2018 and increased incentives for the rural areas such as increased MSP prices, more allocation towards various rural schemes, road construction, affordable housing, etc. These initiatives are expected to lead the recovery and potentially have a cascading effect across other sectors. Thus, earnings growth is expected to pick up especially driven by revival in rural consumption and more by structural benefits from GST reforms post FY2019.

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