INDIA MARKET STRATEGY: ECONOMIC GROWTH BACK TO NORMALCY, HURDLES AHEAD

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India Strategy – Pulls And Pushes Increase Market Risk

- Indian economy has been on a path of recovery over the last four quarters. There has been a broad based improvement in growth suggesting tapering of GST and Demonetization disruptions.
- Three trends are evident currently

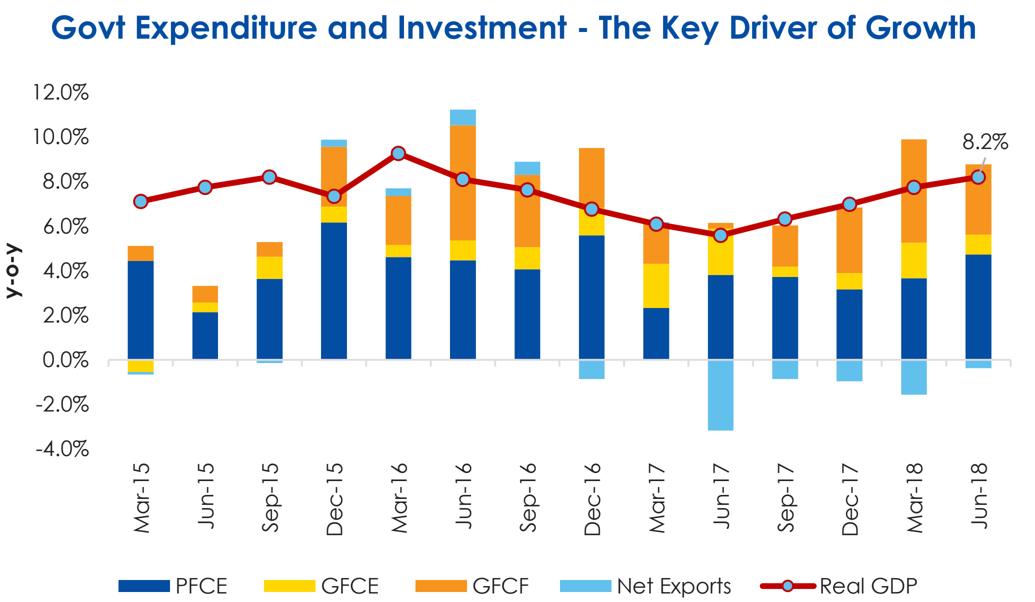
  1. Domestic economy seems to have recovered. Further acceleration in growth would require aggregate demand to pick up on a sustainable basis. Government expenditure, which was a key driver of recovery, is now mean reverting. Private sector activity will now dictate the trend strength or lack thereof.

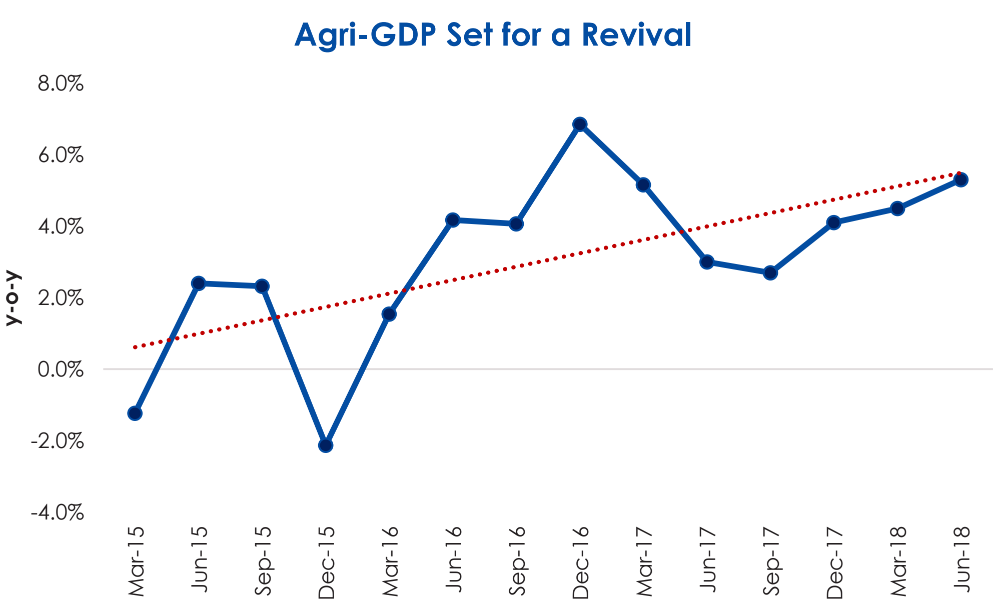
  2. Macroeconomic landscape **remains challenging and is deteriorating**. Many indicators like CAD, fiscal Deficit, rising bond yields, stagnant indirect tax collections, foreign flows are still worsening along with a challenging global economy. This would keep the margin of safety low and these macro indicators are important monitorables.

  3. Earnings growth has been a big challenge for domestic markets. Over the last two years earnings growth for stocks has been patchy and inconsistent. Q1FY19 was the first quarter where market wide earnings growth (ex-PSU banks) clocked a growth of 20%. A pick up in earnings can overshadow the other negatives and support markets. But downgrades cycle in FY19 is just like it was in prior years.

- Synchronous global growth of CY16 and CY17 is now behind us. Global economic growth is now fractured and is plagued with risks. US has entered a late cycle indicating peak growth and earnings dynamics. An intensifying dollar liquidity vortex is squeezing emerging markets one after the other and may create more problems if trade wars escalate.
- ***At nearly 20 times 1Year forward earnings Nifty Index (11,600) is trading at rich valuations creating a poor margin of safety. <u>We expect headline indices to face increasing odds of a deep correction of 10% or more or be range bound at best</u>***.

Economic Growth Escapes Policy Led Quicksand, Reverts To Normalcy



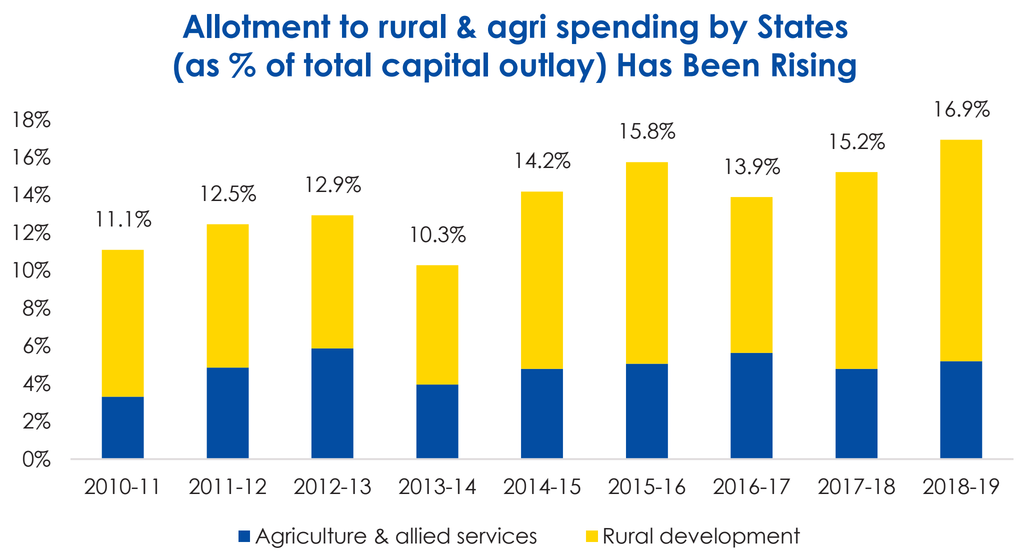


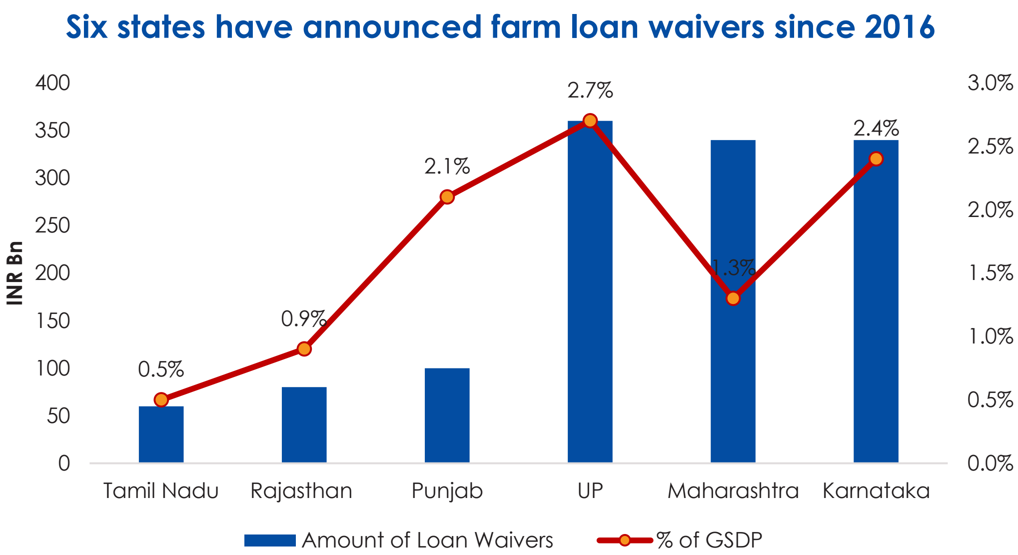
Source : CMIE, Edelweiss Investment Research

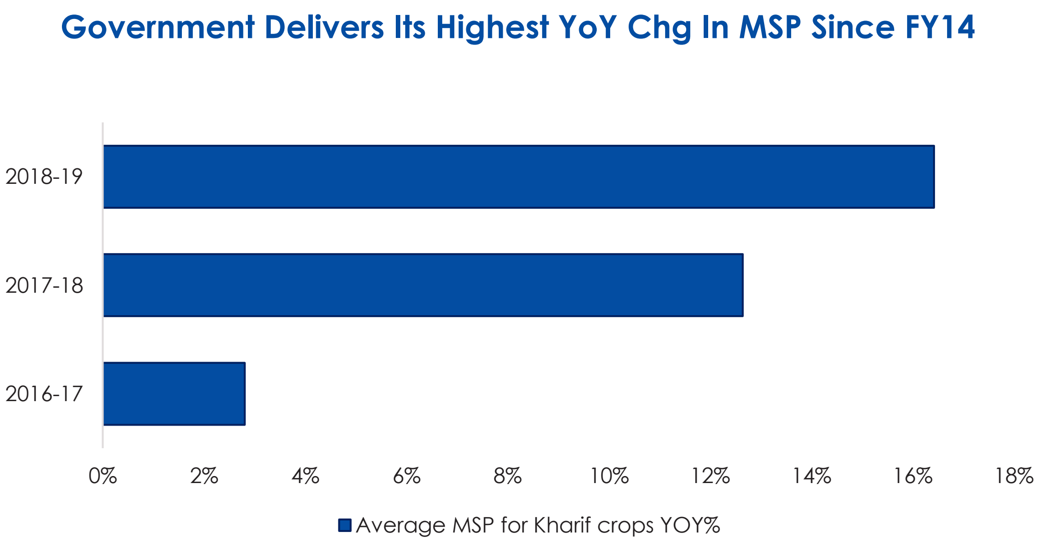
- Post demonetisation and implementation of GST, economic activity was under stress. However, GDP growth has gained traction and is expected to clock in 7.4% (y-o-y) growth in FY19. Q1Fy19's 8.2% growth is difficult number to repeat and growth is likely to revert to a slower pace ahead.
- Government expenditure and consumption has supported the growth from faltering. In case government expenditure slows the private sector activity will have to rise significantly to make up for it. Q1FY19 growth showed some signs of revival but sustainability is key.
- After experiencing a lull for four quarters, agri GVA revived. This has helped in reversing the slowdown in consumption. Q2FY19 will set the tone for agri growth for next few quarters as government's procurement cycle becomes clear.

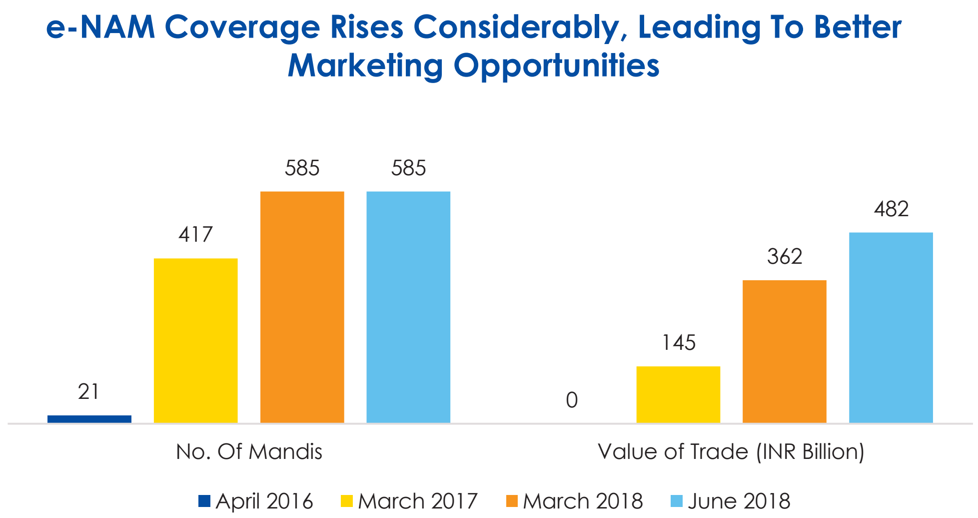
The pace of economic growth is likely to remain stable for now, but faces risk from challenging macros.

Government Focusing On A Rural Recovery







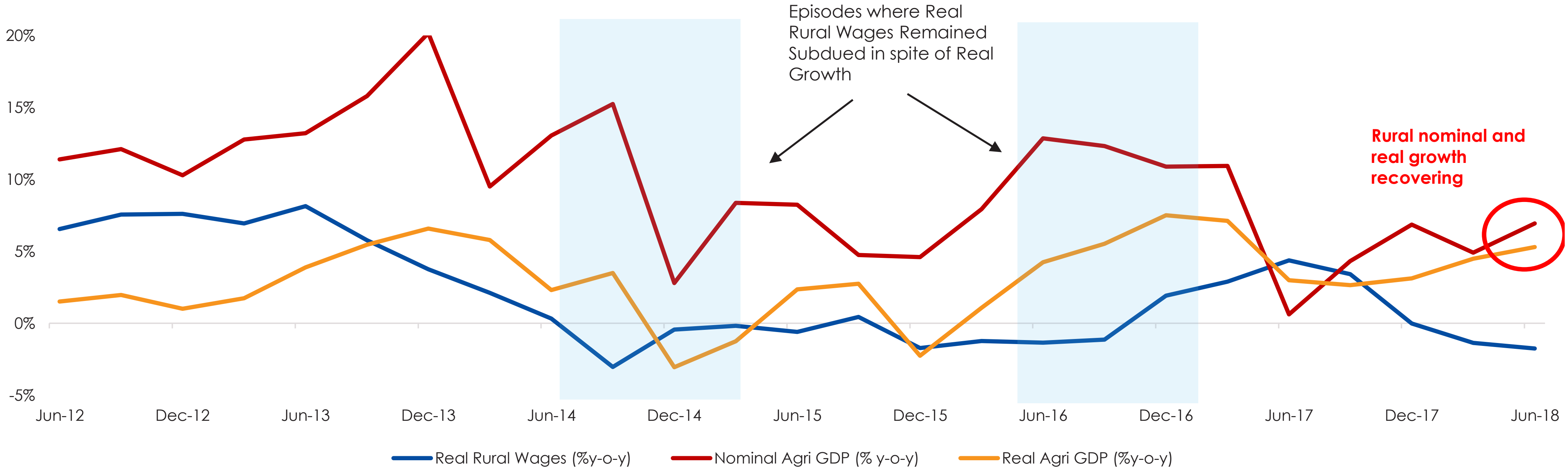


Source : CMIE, RBI, Bloomberg, Edelweiss Investment Research

Centre and State fiscal support to rural areas need to translate to higher rural wages

Government's Focus On Rural Revival Taking Shape, Yet To Show Up In Wages

Rural Growth Recovering, Needs To Translate To Higher Wages



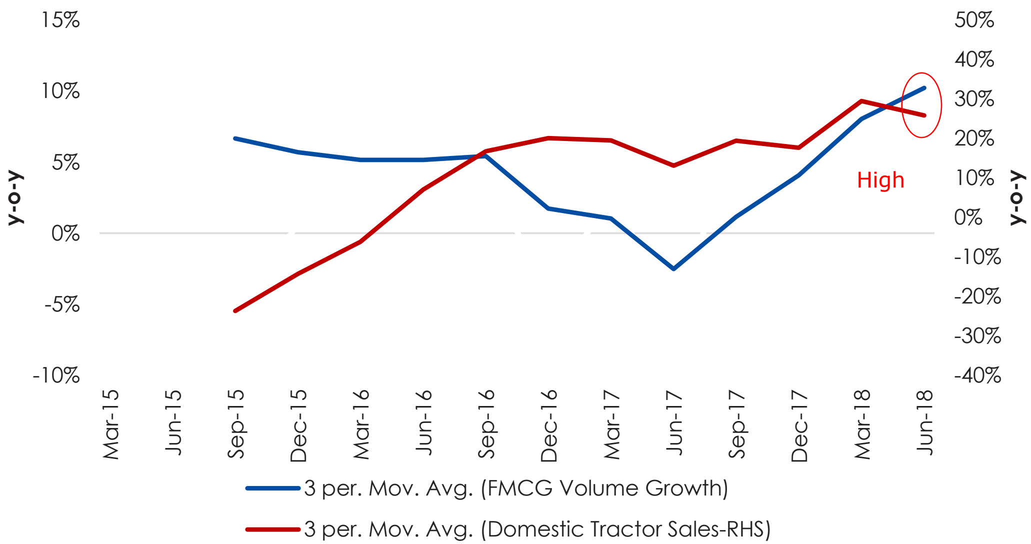
Source : CMIE, Edelweiss Investment Research

- In June'17 Nominal Agri GDP growth plunged below Real Agri GDP growth indicating deflationary phase.
- We observed that Real Rural Wages are more linked to Nominal Growth than Real Growth and thus, showing a falling trend.
- Rural inflation has been inching up aided by normal monsoons and some base effects. Higher MSP are likely to be supportive of this revival.

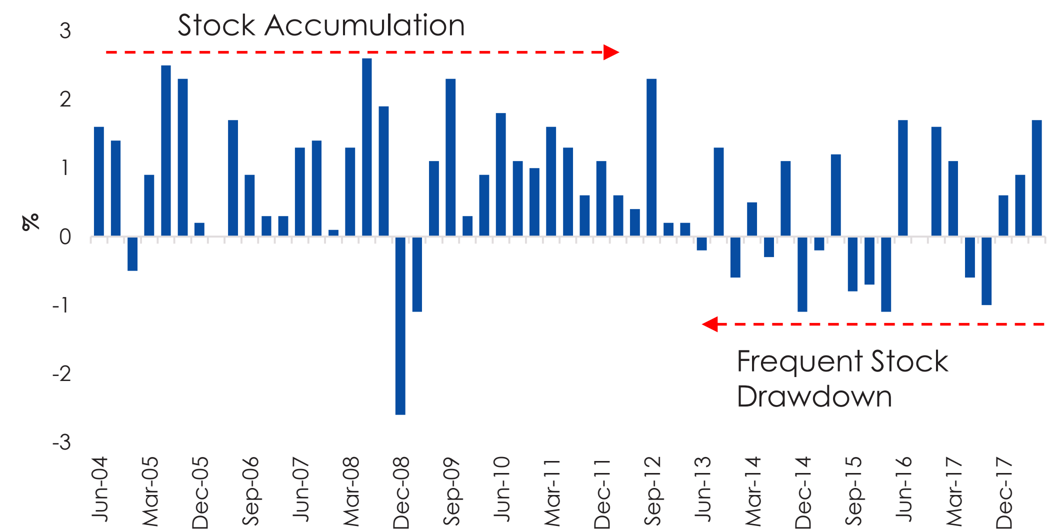
With Nominal growth coming back, Rural India takes the centre stage and can add up to 0.5% to India's GDP

Signs of Stability Visible In High Frequency Data

FMCG Volume Growth, Tractor Sales Robust



Addition to Inventories (%Sales) Climb to a 23 quarter high



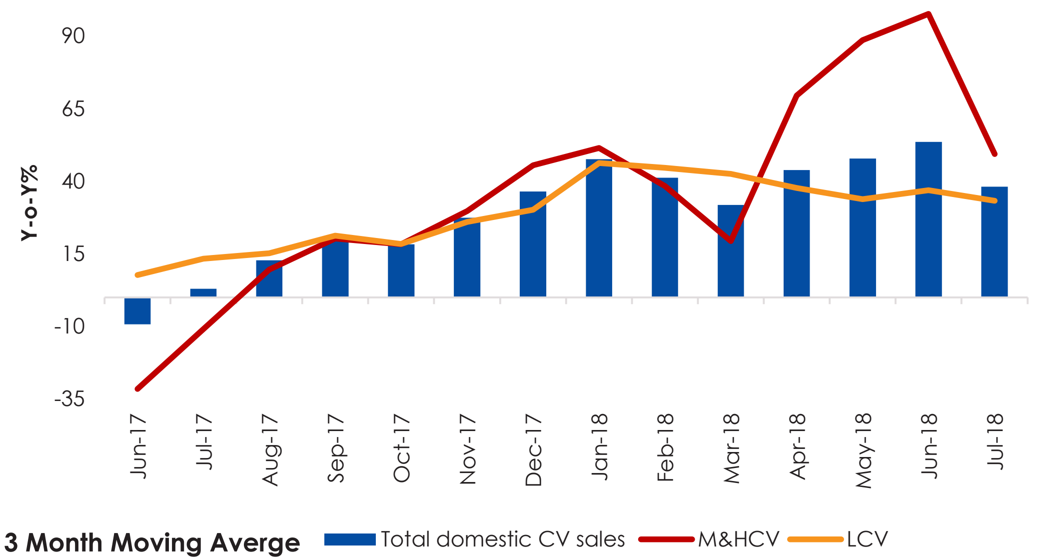
Source : Company Reports, CMIE, Edelweiss Investment Research

- FMCG Volume Growth of 13% in June quarter is a testimony to increasing rural expenditure. FMCG companies have about 60% sales exposure in rural areas. Other commentaries from cement companies, L&T, NBFC all point out to rising demand in rural areas.
- Domestic Tractor Sales have also witnessed healthy growth reflecting in positive rural sentiment.
- Re-stocking has helped most parts of the economy to come back to normalcy.

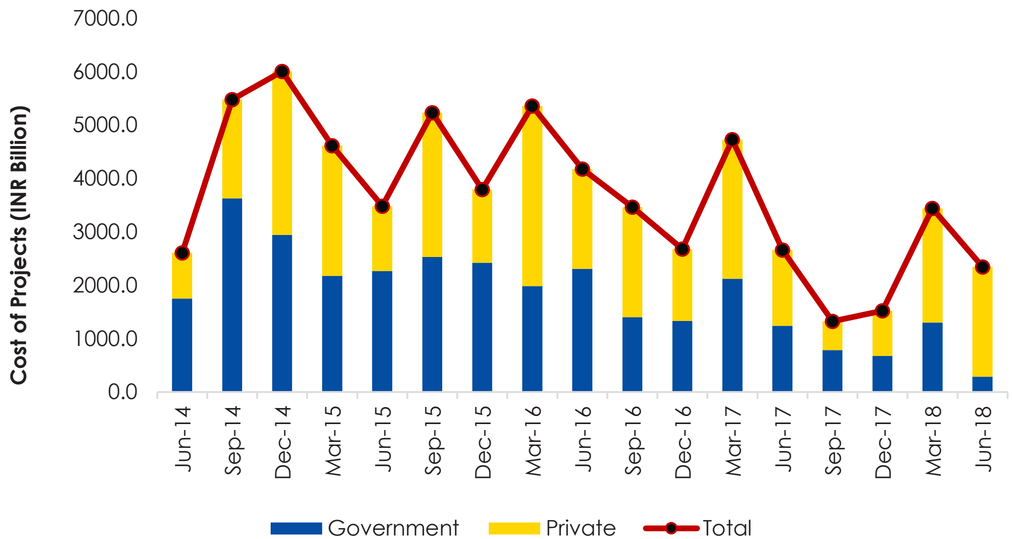
Rural focussed sectors to gain in current rural recovery wave.

Capex Recovering From Disruptions; Yet To Become Broad-based

Commercial Vehicle Sales Continue To Suggest Capex Recovery



Private New Projects Announcements Slowly Picking Up



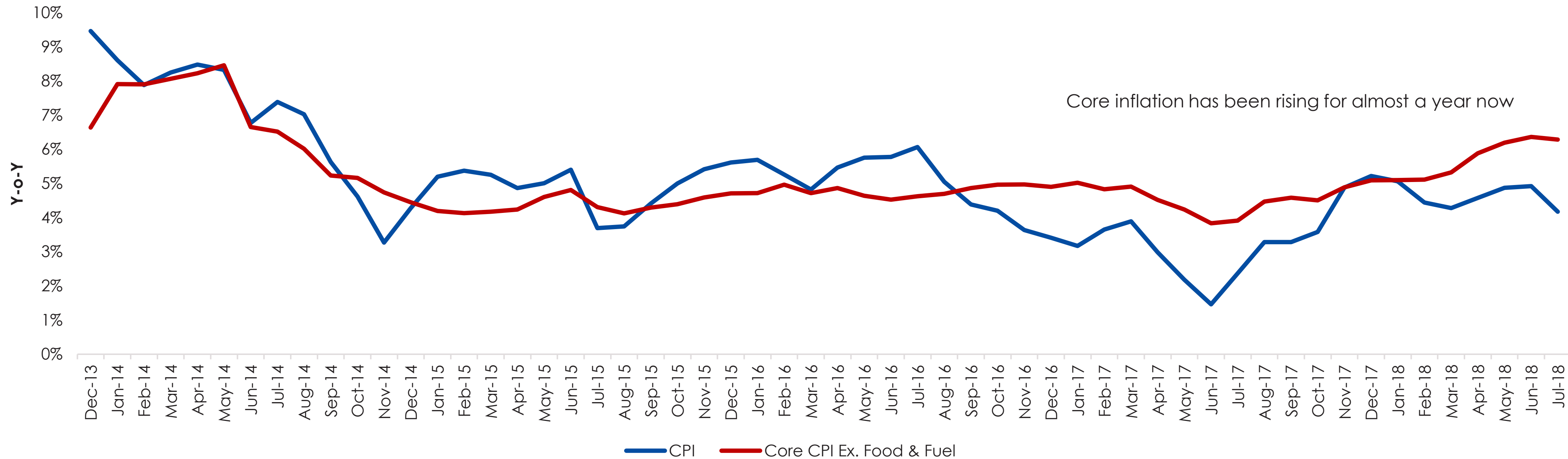
Source : Company Reports, CMIE, Edelweiss Investment Research

- Capex is aided by domestic demand and government expenditure at present.
- The tentative recovery in the private capex cycle was helped by falling interest rates and easy liquidity, but these two factors are now reversing.
- Weak domestic consumption demand, global overcapacity and negative impact of the goods and services tax (GST) on working capital has kept private capex in check. These factors are yet to reverse and support a capex recovery.

Private Capex cycle recovery is still tentative, faces headwinds.

Risk to Growth Normalcy Are Many – Inflation Flare Up Possible

Headline inflation cools down but core inflation continues to be a worry



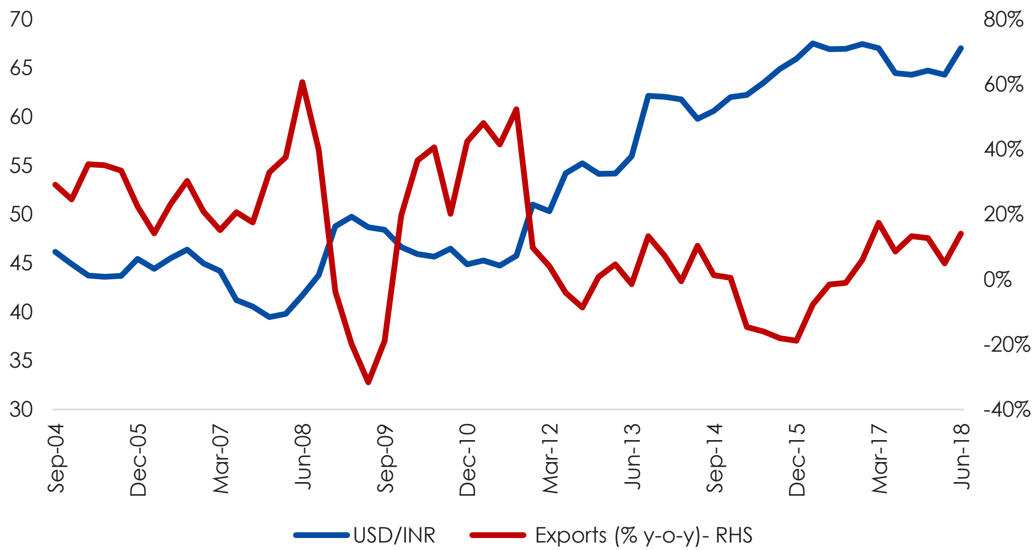
Source : CMIE, Edelweiss Investment Research

- Headline inflation softened in July on the back of moderating food inflation. Core CPI remains high on back of factors such as HRA impact, rise in input prices and base effects.
- Pass through of oil prices and weaker external position led currency risks aren't yet factored in consensus. Heightened risk from inflation remains a key monitorable as prior cycles have shown.

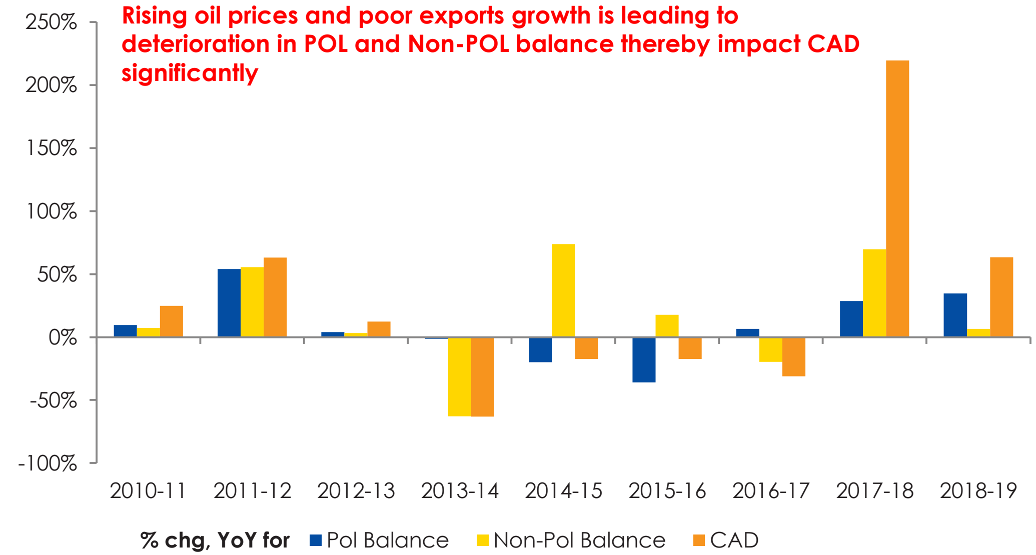
Flare up in inflation may justify front-loading of rate hikes by RBI

Exports Might Get A Boost Due To Weakening Currency, But No Relief To CAD

Exports May Gain With Rupee Weakness



Deterioration in Trade Balance Leading To Rising CAD



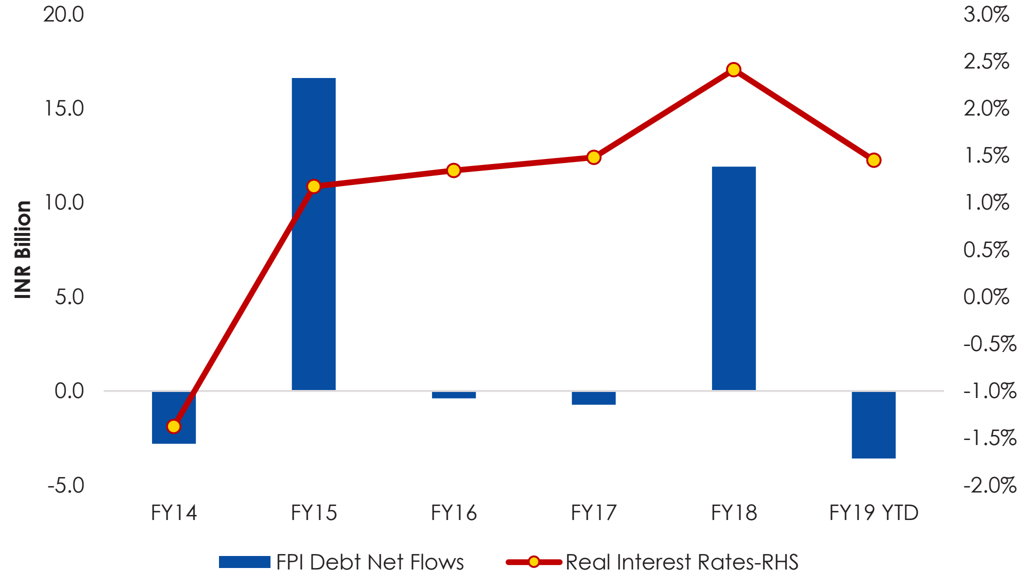
Source : CMIE, Edelweiss Investment Research

- India's export growth has been deteriorating. Recent uptick in exports has largely been driven by rising Petroleum and product exports. Non-Pol exports have seen no improvement. India imports have been on a sustained uptick. Pol and Non-Pol imports both have been rising at a faster pace than exports. This has led to a vicious cycle of weakening currency, rising imports.
- India's trade deficit could rise from $158bn in FY18 to $189bn in FY19. Current account deficit (CAD) **for FY19 could worsen from $49bn in FY18 to $80 bn in FY19**.

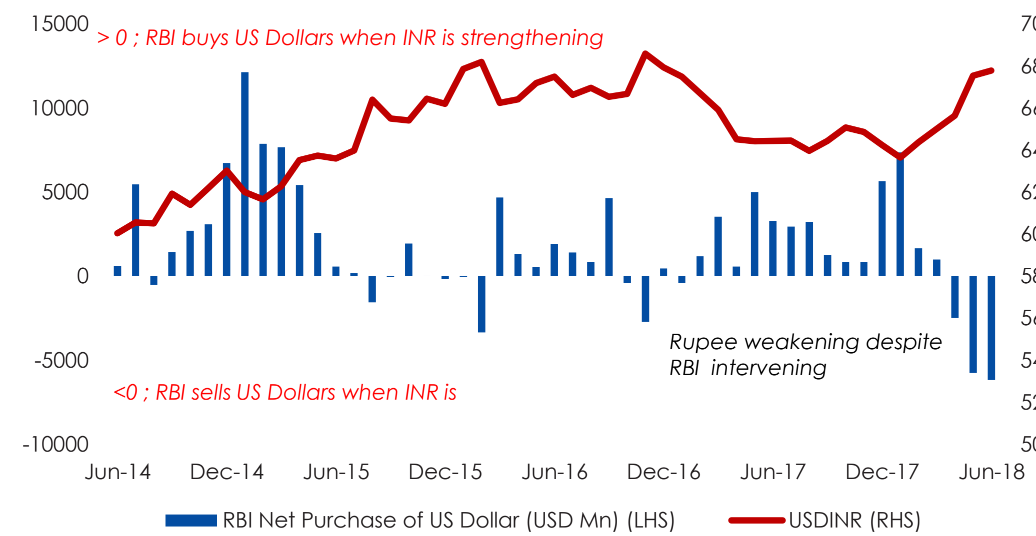
CAD will continue to be under pressure as imports have been growing faster than exports. Thus, benefit of depreciating currency will take a while to play out.

Indian Rupee On A Slippery Slope, May Depreciate Further

FPI Debt Outflows Continue Despite High Positive Interest Rates



RBI Dollar Selling Wouldn't Reverse Rupee Depreciation



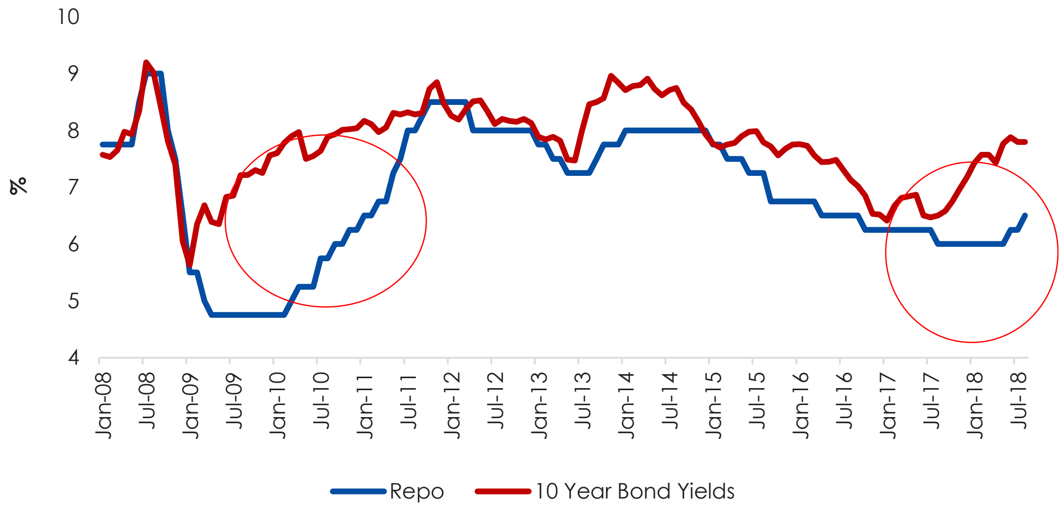
Source : Bloomberg, NSDL,BIS, Edelweiss Investment Research

- FPI Outflows, high CAD and trade deficit has led to weakness in currency. Despite RBI's intervention, rupee has been under pressure.
- In line with other emerging market currencies Indian Rupee is likely to weaken further. Though Indian macros are relatively better than its EM peers but it is sufficiently reflected in its outperformance over the last 5 years.

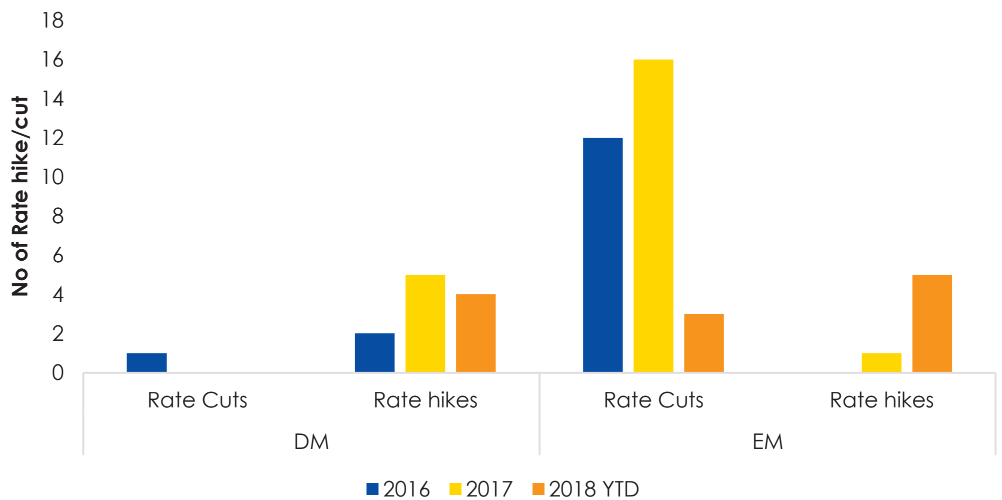
We believe high REER and other macro factors could drive USD/INR to further new lows in FY19

Macro Troubles And EM Rate Hikes To Keep RBI Hawkish

Bond Yields Surge before Repo Rate hikes



Rate hikes Superseding Rate Cuts Across EM and DM



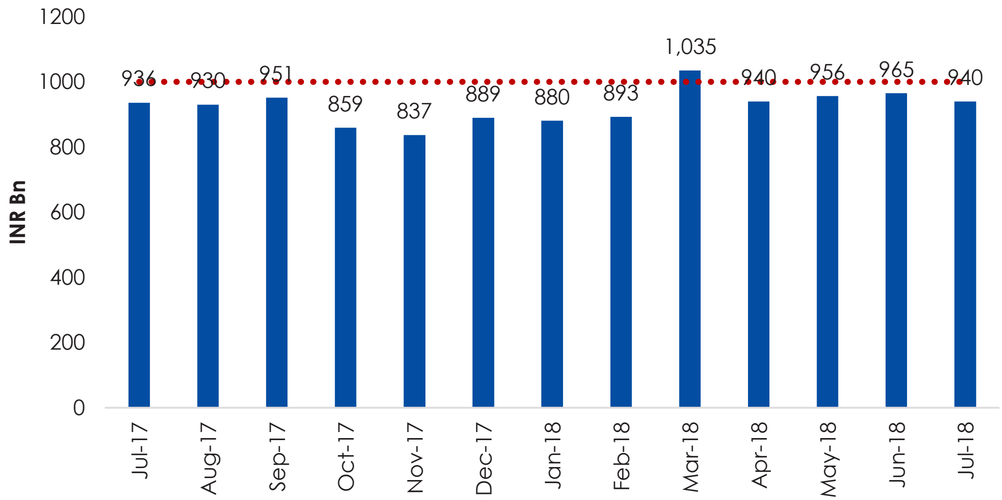
Source : RBI, Edelweiss Investment Research

- Headline Inflation and core inflation had been drifting away from RBI's medium term target of 4%.
- As a result, the central bank front-loaded its rate hike cycle with 2 back to back rate hikes of 25 basis points each, after 2 years of rate cuts.
- Bond markets are already indicating higher interest rates. Heavy government borrowing calendar, worsening CAD and rising inflationary trend may fuel further rate hikes.
- Most central banks across the globe are reverting to rate hikes in 2018. More so in the emerging markets with currencies plunging to decade lows.

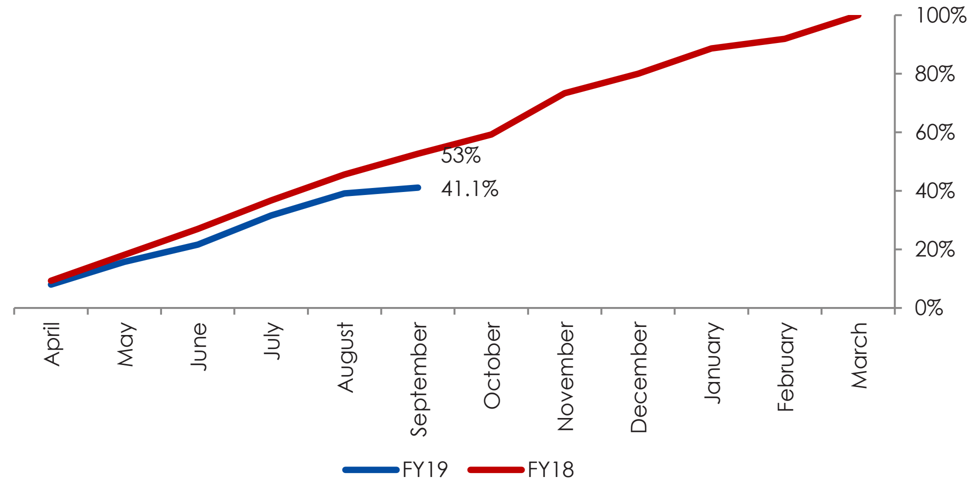
High interest rates would continue and would be a spoiler for nascent recovery in capital intensive sectors.

Fiscal Conditions, Government Borrowing To Lead Rates Higher

GST Collections Yet to hit the 1 trillion mark



Govt Borrowing In Rest of FY19 To Keep Bond Yields Higher



Source : RBI, Bloomberg, Edelweiss Investment Research

- GST collections have yet not hit the 1 trillion mark on a sustainable basis. The budgeted GST revenues assumes a steep 23% hike, which seems ambitious and difficult to achieve at current run rate of FY19.
- Moreover, when Government announced its borrowing calendar for H1 FY19 of INR 2.8 trillion which was less compared to previous years. Government anticipated higher receipts from Small Savings to support lesser borrowing. Recent rate hikes have led banks to increase FD rates while Small Savings Rates remain unchanged.
- The rest of FY19 has a heavy borrowing calendar. The borrowing in FY19 YTD has been significantly lower than that of FY18 and previous years.

Market Borrowing Calendar is likely to remain elevated in H2 FY19.

Government Support & Rural Revival Key, Headwinds Abound

- Economic growth is back to normalcy as effects of disruptions have tapered.
- A number of headwinds are intensifying
  - India external positions is deteriorating on back of rising trade deficit and thereby widening current account deficit.
  - Weak external position has contributed to a weakening of Indian Rupee. With core inflation still at elevated levels the threat of imported inflation is leading to weakening terms of trade. This would keep foreign investors away for a while contributing to external position stress.
  - RBI has raised rates twice this year. Heavy government borrowing calendar and tight fiscal positions would keep interest rates higher as inflation rises.
  - Earnings growth has been tepid and earnings are already facing downgrades and consensus estimates are being reduced, just like the previous years.
  - Global economy isn't in a synchronous growth phase like 2016 and 2017. The US economy especially is indicating 'Late Cycle' dynamics suggesting that present conditions are difficult to be replicated in the near future.

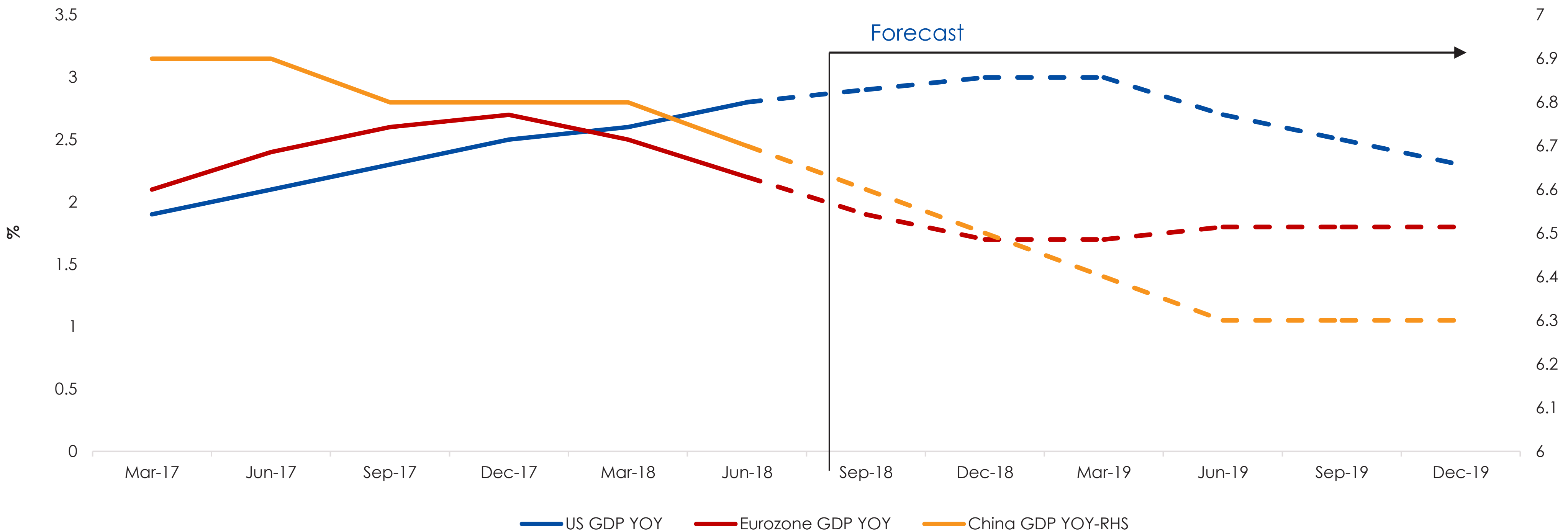
Risks to economy growth and markets are significant and may keep equity markets under pressure for the next few quarters.

Global Macro – Reality May Be More Disappointing Than It Appears

Present Conditions Too Hot To Continue?

- Global economy which was witnessing a synchronous growth in 2016 and 2017 has seen many countries fall behind.
- Growth in Emerging economies, commodity exports and Western Europe has slowed while US continues to grow and record pace.
- The sugar rush of 'US Tax Cuts and Jobs' act is likely to fade as the year progresses and the base effect will become a difficult to surmount challenge in 2019. Earnings growth of Q1 CY18 and Q2 CY18 at 25% and 21% for S&P 500 would likely fall to low single digits leading to a de-rating of multiples.
- Pre-tax earnings growth in US has been a meagre 0.2% as per the latest data indicating only tax cuts driven gains.
- **US economic cycle is in late cycle. The US is already in the second longest economic expansion since WWII. This is reflected in tight labour market and rising inflation as well.**
- However rising costs are not seeing a corresponding rise in wages. Average hourly earnings in US (adjusted for inflation) is completely flat indicating early stagflation dynamics.
- Consumer expectation also indicate softer growth trajectory in the future. Historically a gap between present conditions and future expectations have been indicating the same.
- US Fed tightening and US treasury borrowing (~$850bn in 2018 combined) is likely to lead to a US Dollar liquidity squeeze. Few EMs have already been hit hard, others may face similar fate ahead. Trade wars will further aggravate this situation.
- In conclusion, **the global landscape continues to remain troublesome and can be a source of negativity going ahead.**

Economic Growth Likely To Fall Off After Sugar Rush Of US Tax Cuts

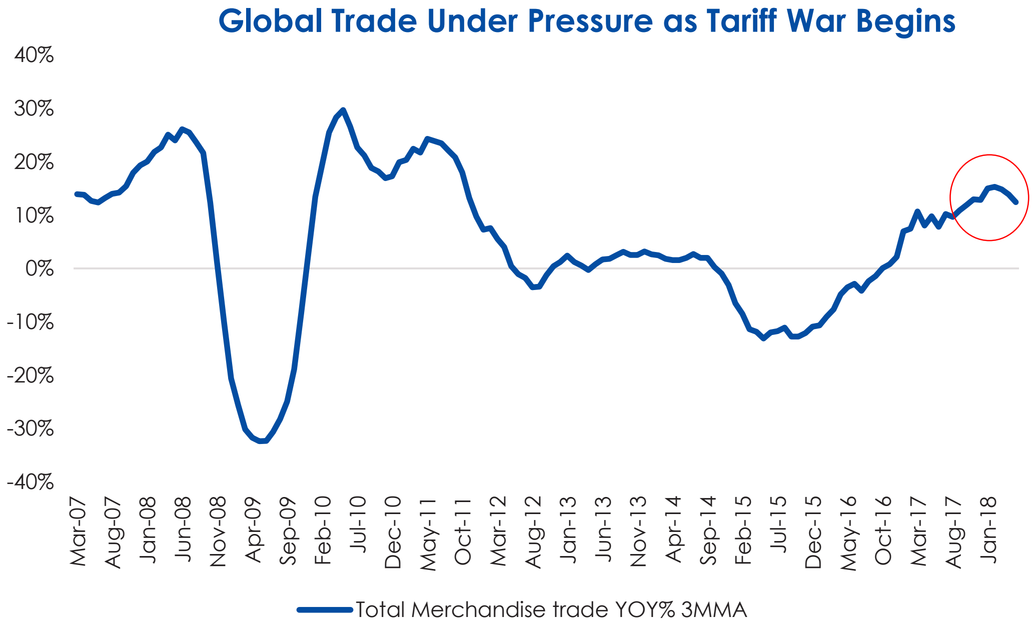


Source : Bloomberg, Edelweiss Investment Research

- Global economic growth rebounded in 2016 and has been going strong since. The outlook for 2019 doesn't look as rosy though
- Slowing global trade impacted by trade negotiations, falling commodity prices, tightening Dollar liquidity and an end to the tax cuts sugar rush in US could potentially slow the global economy.

In other words, 2018 might be "As Good As it Gets" for major economies and the growth might moderate from here on

Global Trade Starts Showing Initial Signs Of Pressure



Source : WTO, Bloomberg, Edelweiss Investment Research

- Global Trade growth, a proxy for global growth, is decelerating on the back of increased trade tensions globally.
- South Korean exports have historically been a good proxy for economic growth trends and even earnings cycles especially for EMs. Despite the latest uptick in numbers, outlook for exports from South Korea is seriously threatened by the US-China trade conflict, China being a major buyer of South Korean intermediate goods.

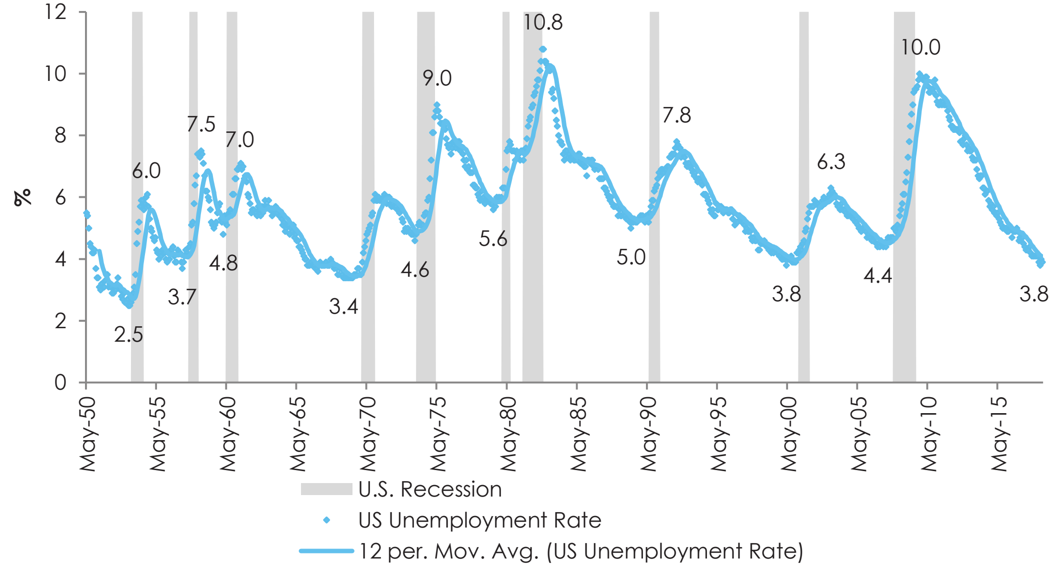
Global trade tailwinds are not as strong as they were and are in fact threatened by recent trade skirmishes.

US The Driver Of Global Growth Is In Late Cycle

US Eco Expansion in 2nd Longest Since WWII, It's Getting Old

Recession Start Date	Expansion Start Date	Peak US Unemployment Rate	Months of Expansion	Expansion began after months of recession
Dec-07	Jul-09	9.5	109	19
Mar-01	Dec-01	5.7	72	9
Jul-90	Apr-91	6.7	119	9
Jul-81	Dec-82	10.8	91	17
Jan-80	Aug-80	7.7	11	7
Dec-73	Apr-75	8.8	57	16
Jan-70	Dec-70	6.1	36	11
May-60	Mar-61	6.9	106	10
Sep-57	May-58	7.4	24	8
Aug-53	Jun-54	5.6	39	10
		Avg	66	12
		Longest	119	19
		Shortest	11	7

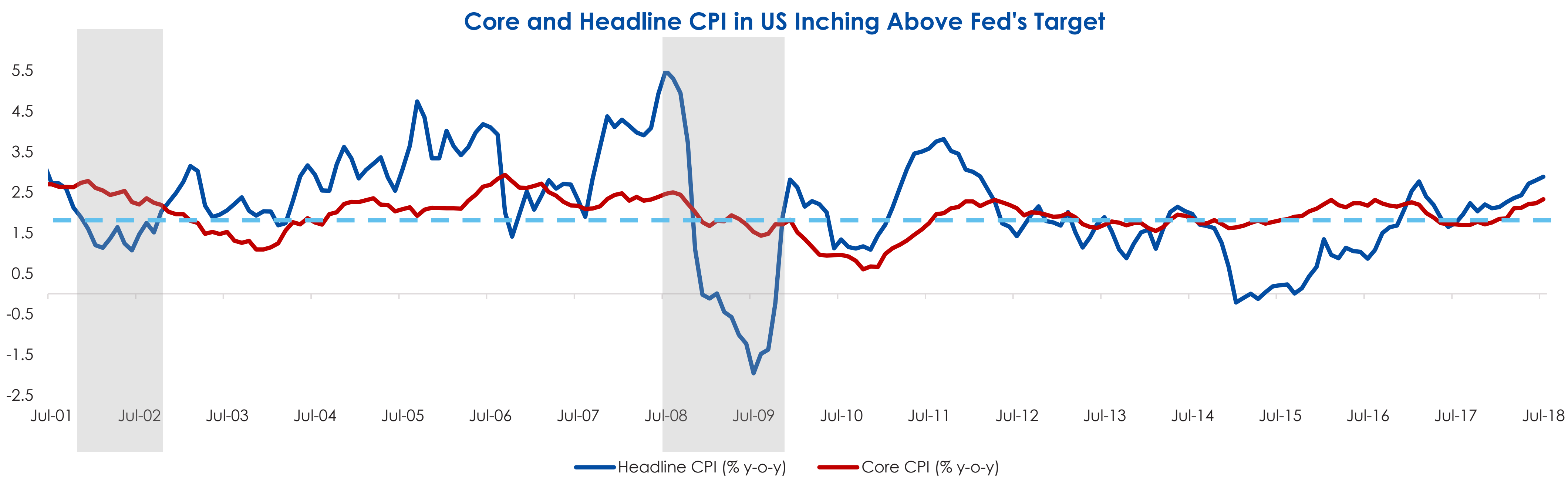
US Unemployment Is Near Its Lowest Level Since WWII



Source : WTO, Bloomberg, Edelweiss Investment Research

- US economy has expanded for 109 straight months. Economic expansions grow old and this cycle is already quite old.
- US unemployment hit its lowest level since 1970's in May'18 when it printed a rate of 3.8%. Interestingly whenever the unemployment rate rises above its 12 month moving average(MMA) it is followed by a recessionary phase. Currently the 12MMA is at 4.05% and the unemployment rate is at 3.9%.
- The Fed's measure of a Non - Accelerating Inflation Rate of Unemployment (NAIRU) is at 4.5%, which means a rise in unemployment towards Fed's measure could be enough to indicate slower growth in future.

US Inflation Inching Up At A Faster Pace



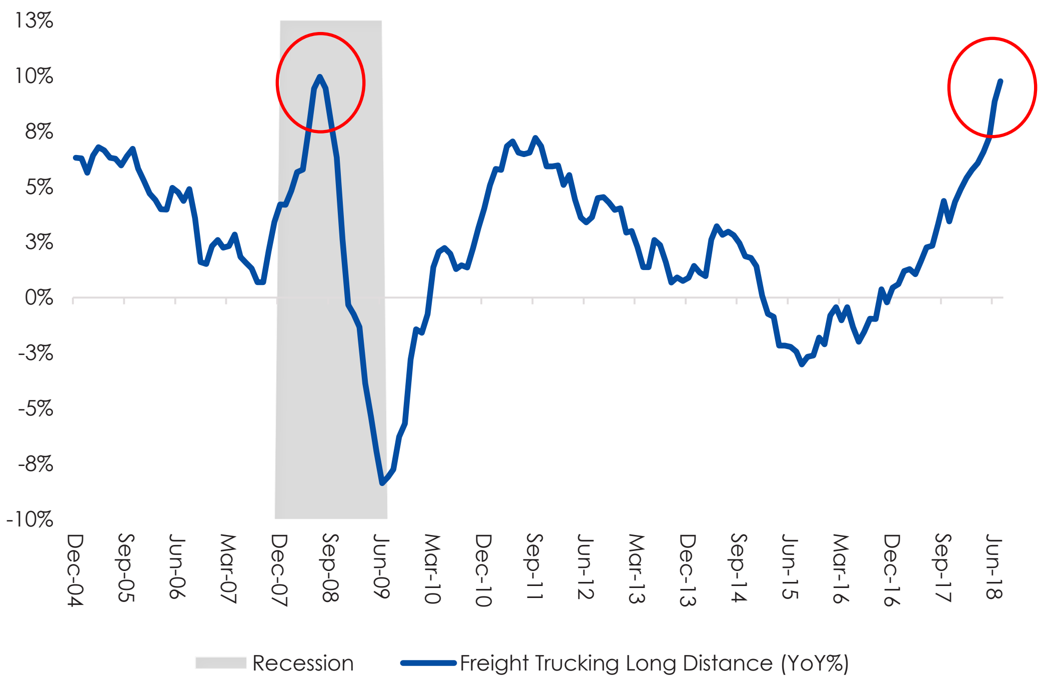
Source : MOSPI, Edelweiss Investment Research

- US Inflation which was below 2% target for quite some time has been inching up steadily. This is majorly because of rising fuel prices and housing prices.
- Housing constitutes about 41% of their CPI Index. Also, businesses are passing higher costs to the consumers.
- Recent inflation numbers support two more rate hikes by Fed this year.

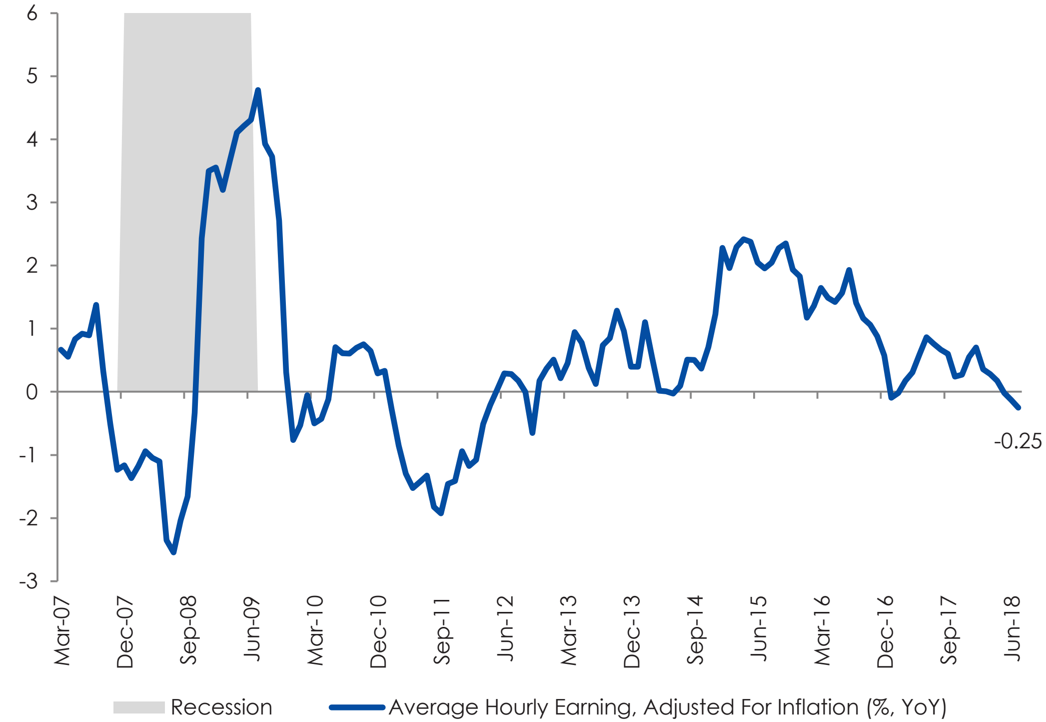
Though Fed in its commentary has advocated for a "symmetric" approach towards inflation, we believe the pace of hikes may fasten if this trend continues,

Wage Growth Not Compensating For Price Rise in US, Typical Late Cycle Dynamics

Freight Trucking At Its Highest Level Indicates Late Cycle Dynamics



Average Hourly Earnings In US Stagnant, Even After Tax Cut

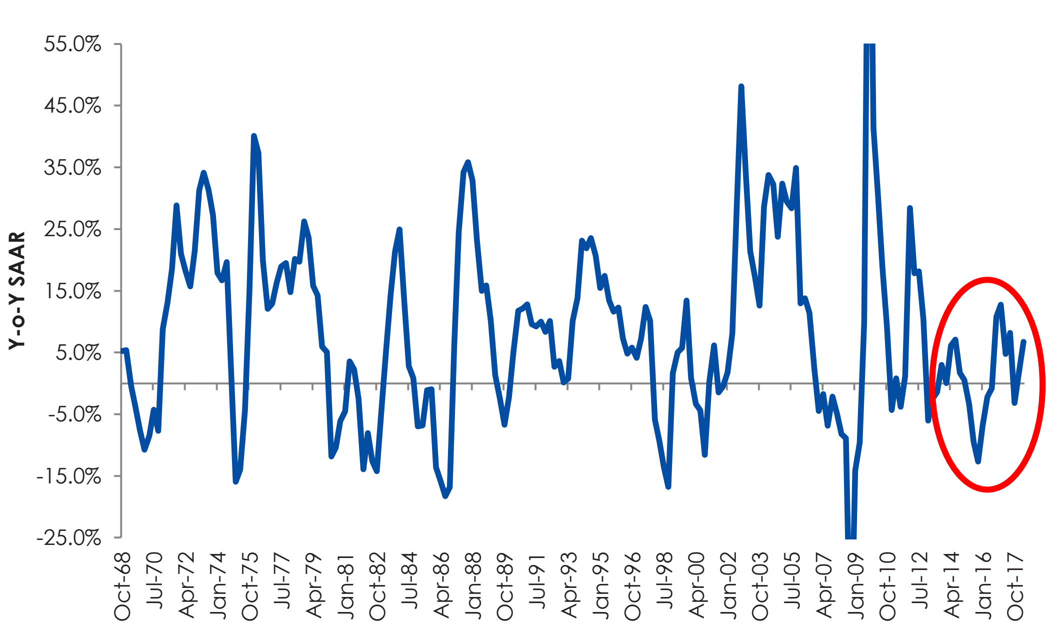


Source : Bloomberg, Edelweiss Investment Research

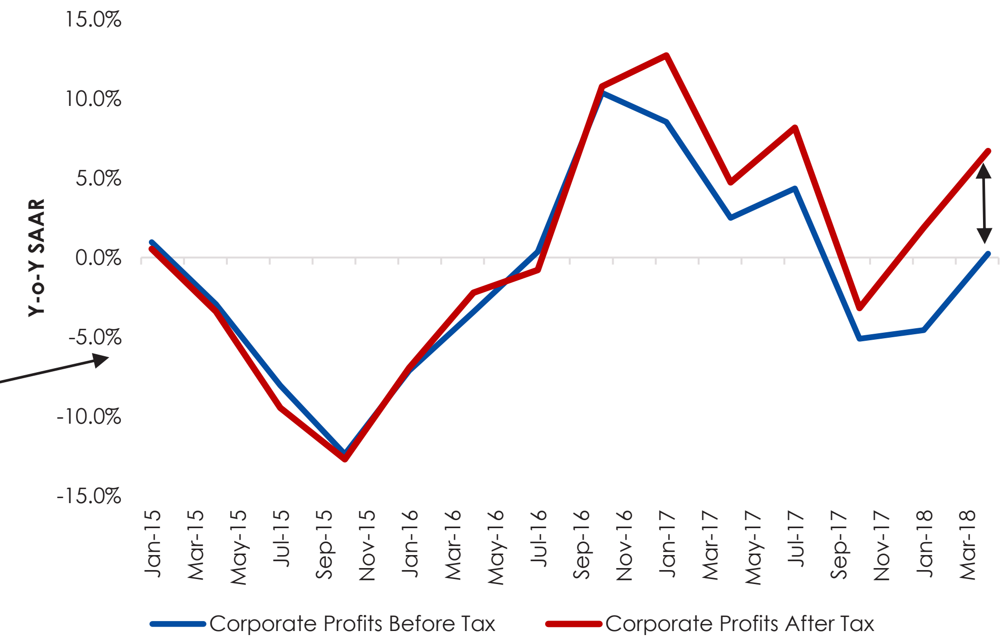
- Stagflation is when prices of goods and services rise beating the growth in wages. Many US corporations have begun to pass on price hikes for the first time in this cycle.
- Wage growth in US remains stagnant at best with average hourly earnings falling below the water mark in July'18

Can US Earnings Growth Last Beyond The Tax Cut 'High'?

US Corporate Profit Growth Has Been Key In Bull Markets



Pre-Tax Corporate Profits Stagnant

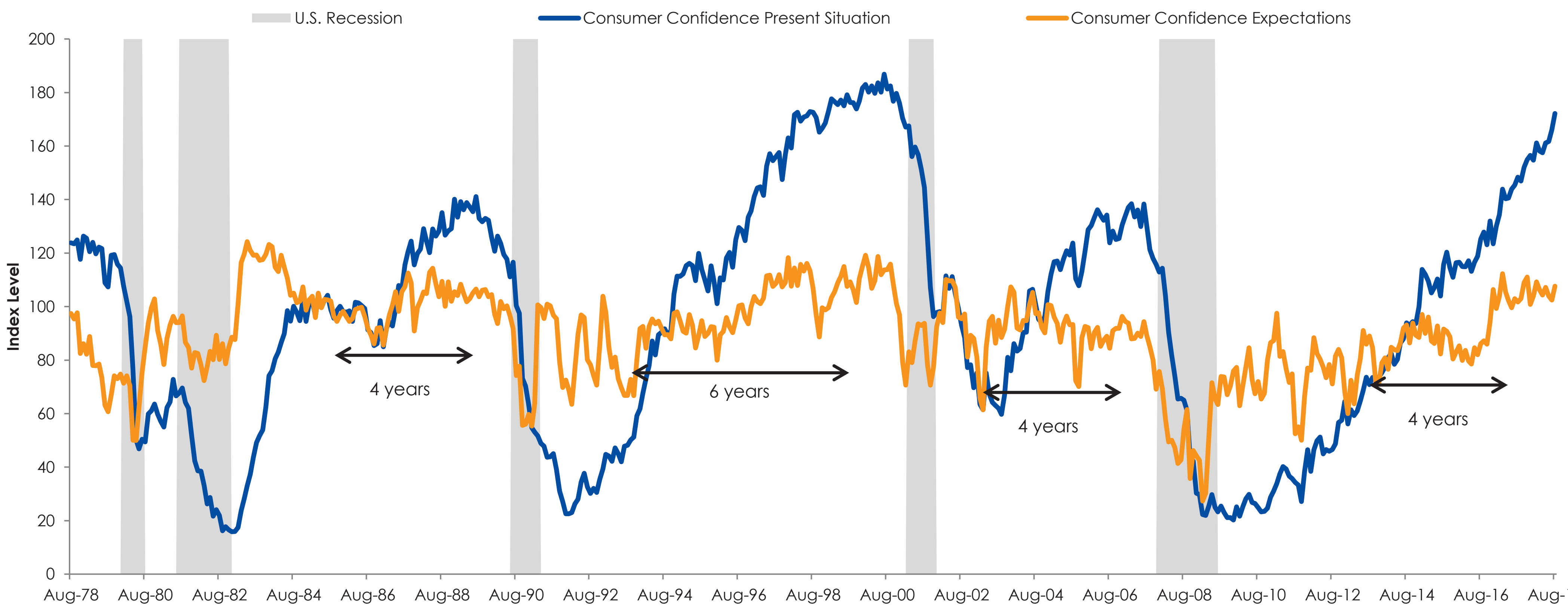


Source : Bloomberg, Edelweiss Investment Research

- US Corporate profits (without IVA and CCAdj) seem to have set off on a rising trend in their cycle. However, the widening gap between after-tax profits with before-tax profits reveals the reason behind the recent uptrend.
- Rising profitability has mainly been fuelled by the trump administration's huge corporate tax cuts. US Corporate tax expenses plunged 33% Y-o-Y in the recent period, and the federal government has had to tap the public debt market to fund them.

Future Expectations Are Nothing Like The Present

US Consumer Confidence Expectations Indicates Lower Growth and Consumption Ahead



Source : Bloomberg, Edelweiss Investment Research

Future expectations are not as good as the present. In some sense the US economy with its tax cut fuelled sugar high and robust stock earnings growth would find is difficult to repeat this performance in next few quarters.

US Bond Markets Not As Optimistic As Stock Markets

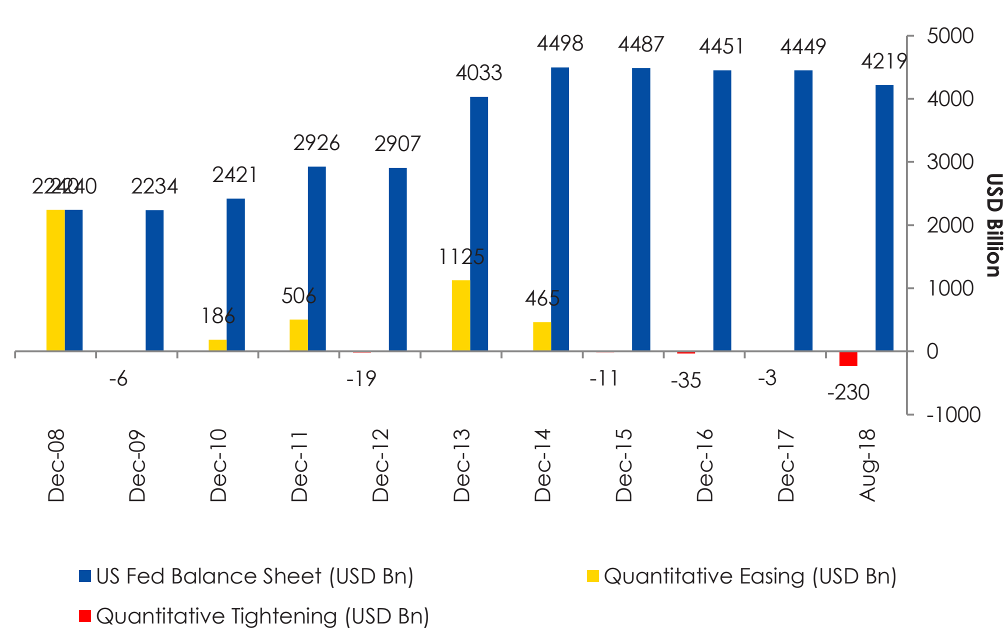
Source : Bloomberg, Edelweiss Investment Research

- The inversion of the Treasury yield curve has historically been an indicator of recession. As the yield curve continues to flatten out in recent months, an oncoming inversion may be on the horizon.
- As the FOMC still maintains a plan to gradually hike the federal funds rate, the bond market stands in some contrast and lacks enthusiasm about growth.

Yield curve inversion not only indicates a slower growth ahead it also effects the profitability of the financial sector.

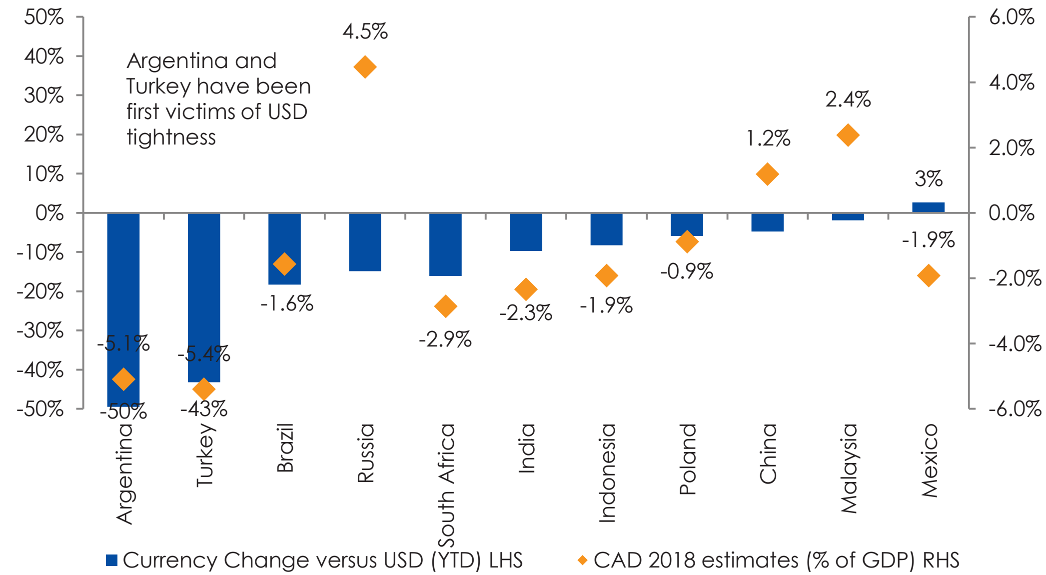
Fed QE Turns Into QT, Weak EM Hit By Dollar Liquidity Vortex

Fed Quantitative Tightening Removing Nearly $500bn / Year



Note: QE/QT represents net change in Fed's balance sheet and not the actual QE figures due to varying timelines

EMs With Poor External Position Face Currency Crises

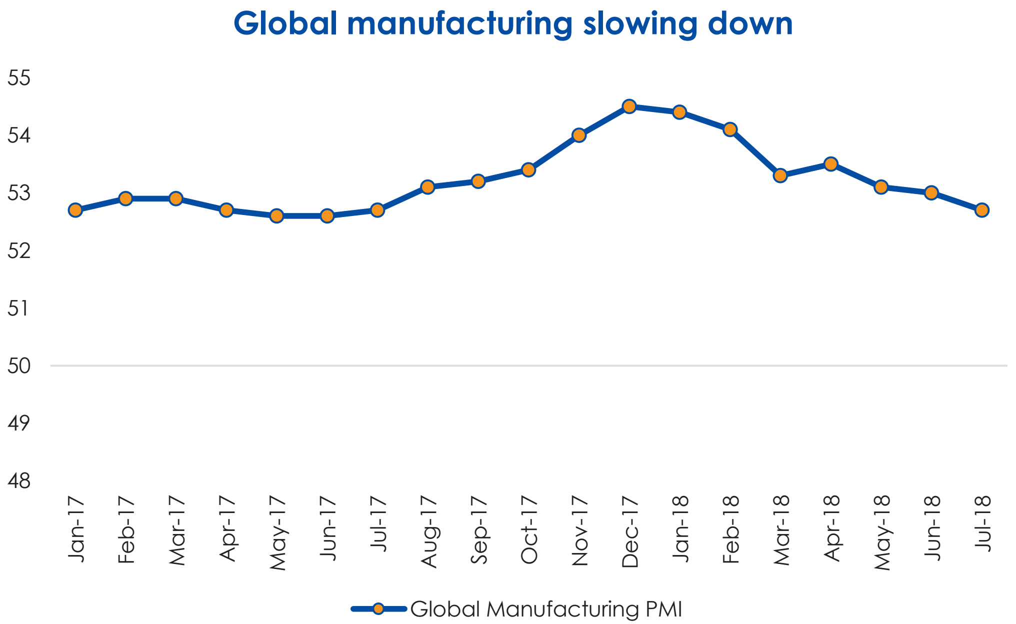


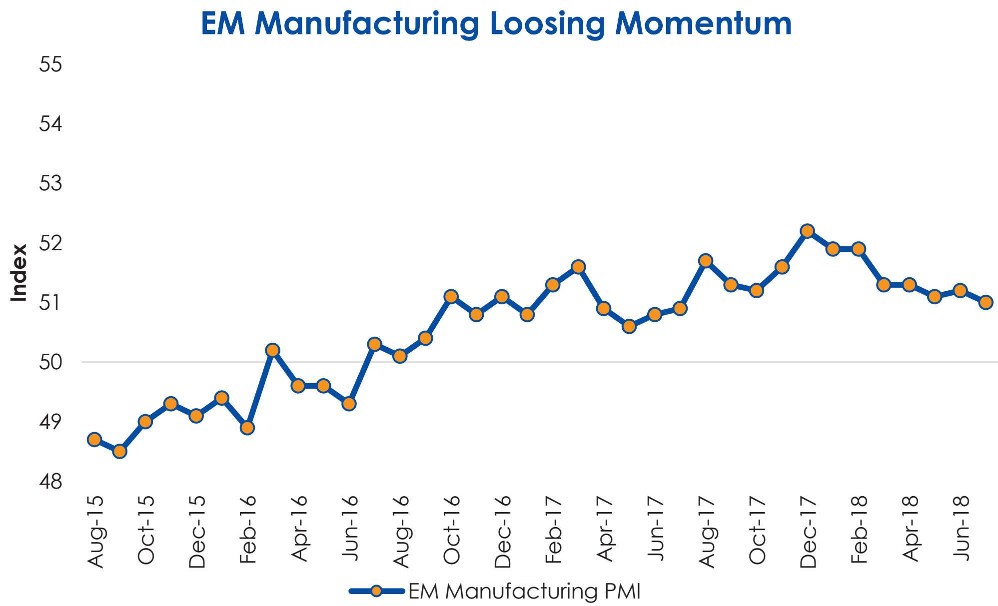
Source : Bloomberg, Edelweiss Investment Research

- The Fed is going to unwind ~$420bn of its balance sheet in 2018. In addition the US treasury is borrowing nearly $430bn over and above its 2017 borrowing. This reduces nearly $850bn of liquidity.
- The initial signs of Dollar liquidity troubles became apparent when Argentina suffered massive outflows earlier this year. Turkey is the latest victim of deterioration in financial conditions.

Historically EM problems are seldom isolated. As dollar liquidity reduces many more 'weak' EMs may come under stress.

Trade Uncertainty Adding To Woes





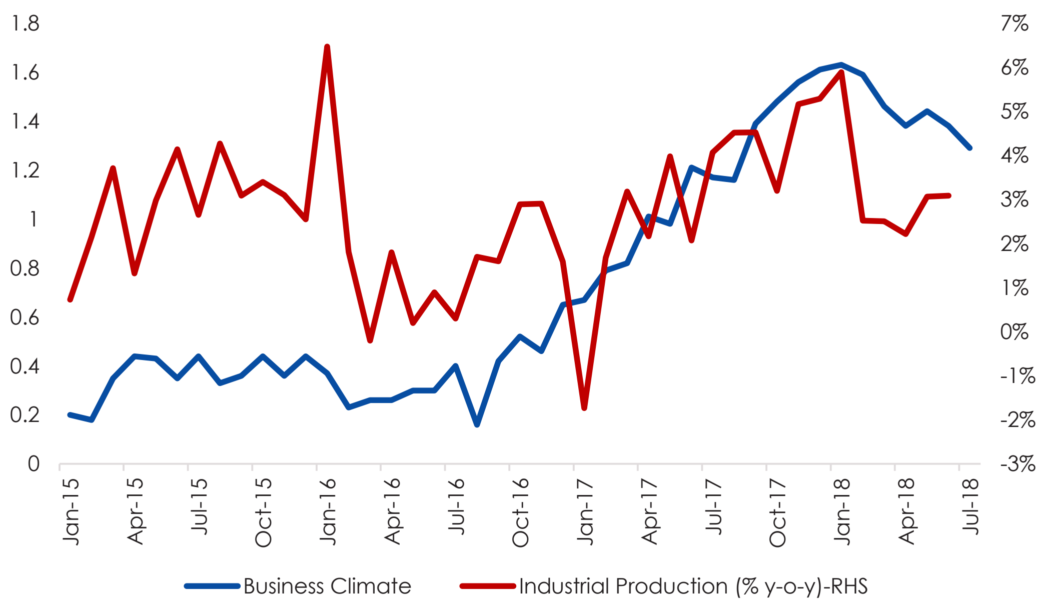
Source : Markit Economics Bloomberg, Edelweiss Investment Research

- Global Manufacturing is decelerating amidst escalating trade tensions, Oil geopolitics and currency volatility threatening exports.
- Domestic demand conditions haven't propped up enough to offset such pressures. Advanced economies including US and Europe are doing slightly better than the emerging market economies in this respect.
- Uncertainties has led to firms opting for wait and watch mode.

Trade War can loom on investment and manufacturing decisions of firms as reflected in slowing PMI

Eurozone : Good But Deteriorating, Breaking Synchronous Growth

Signs of Moderation in Industrial Production & Business Climate



EM Manufacturing Loosing Momentum

Source : Edelweiss Investment Research

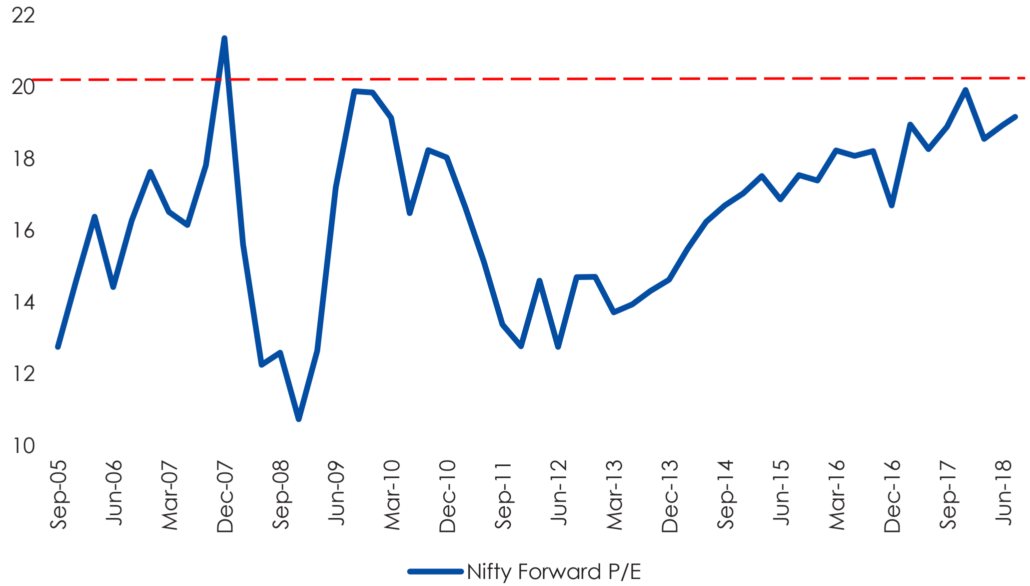
- Eurozone witnessed simultaneous increase in all its economic parameter from 2016 apart from inflation.
- Retail Sales continue to be strong, but high frequency indicators related to investments like industrial production, business climate and manufacturing orders have seen some weakness since Q2, 2018.

Investment concerns aside, we believe that pent up demand and relatively loose monetary policy should aid Eurozone to grow decently, if not great.

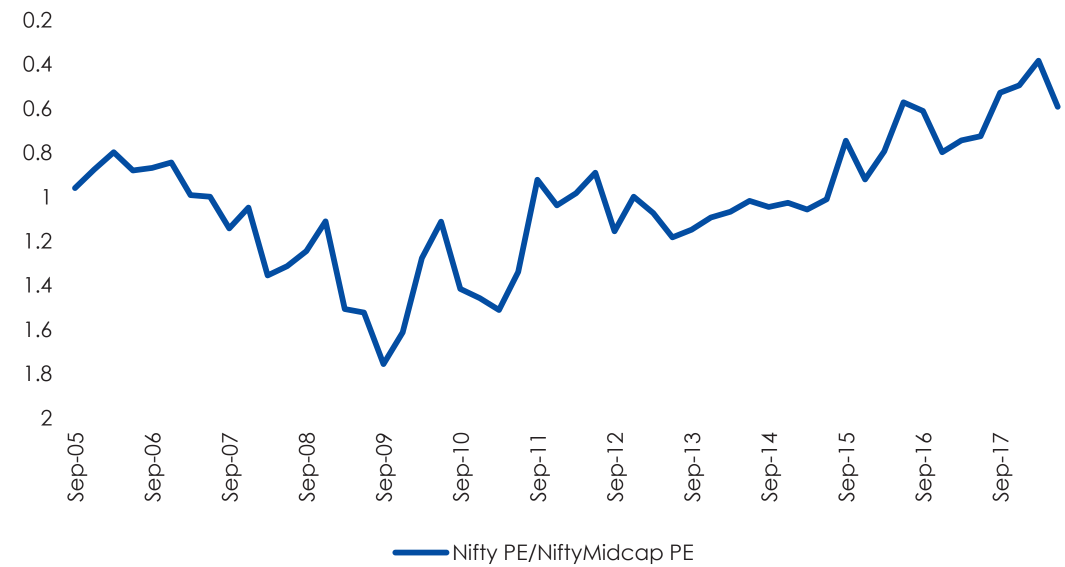
Indian Markets: Earnings Recovery Crucial, Valuations A Concern

Nifty & Midcap Index Valuations Soaring Dangerously High

Nifty Valuations Reaching Expensive Levels



Midcap Valuations Rich, Starting To Converge To Mean

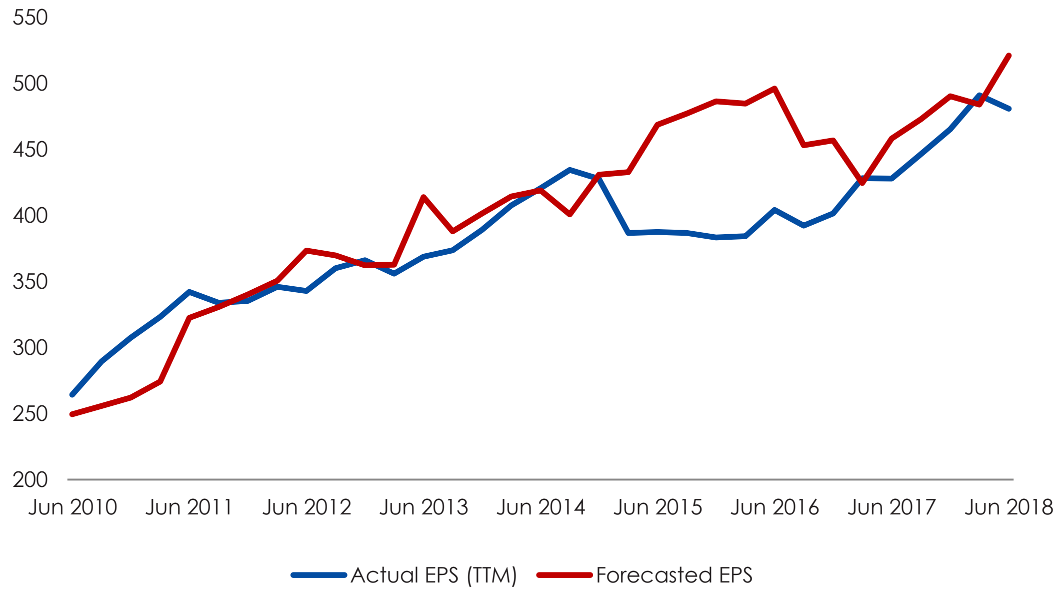


Source : Bloomberg, Edelweiss Investment Research

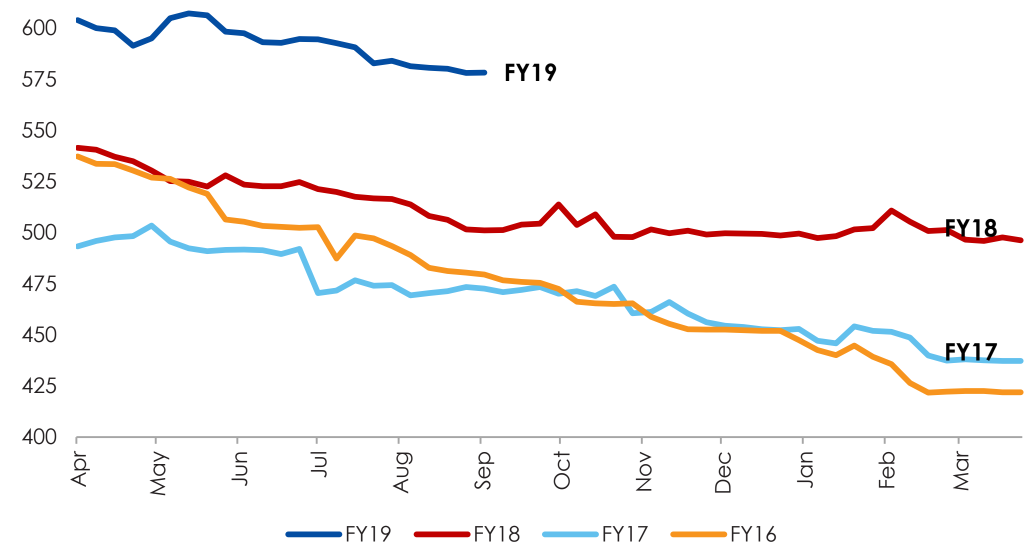
- Midcap valuations have been soaring higher than the large cap valuations since the start of FY16, and the Nifty to Nifty midcap P/E (TTM) ratio has been falling below its median ever since.
- The divergence seems to have given way to convergence this fiscal as midcap valuations are starting to fall.

Nifty Earnings Downgrades Resurface

EPS Downgrades make a comeback



FY19 Earnings Consensus Isn't Different From Prior Years

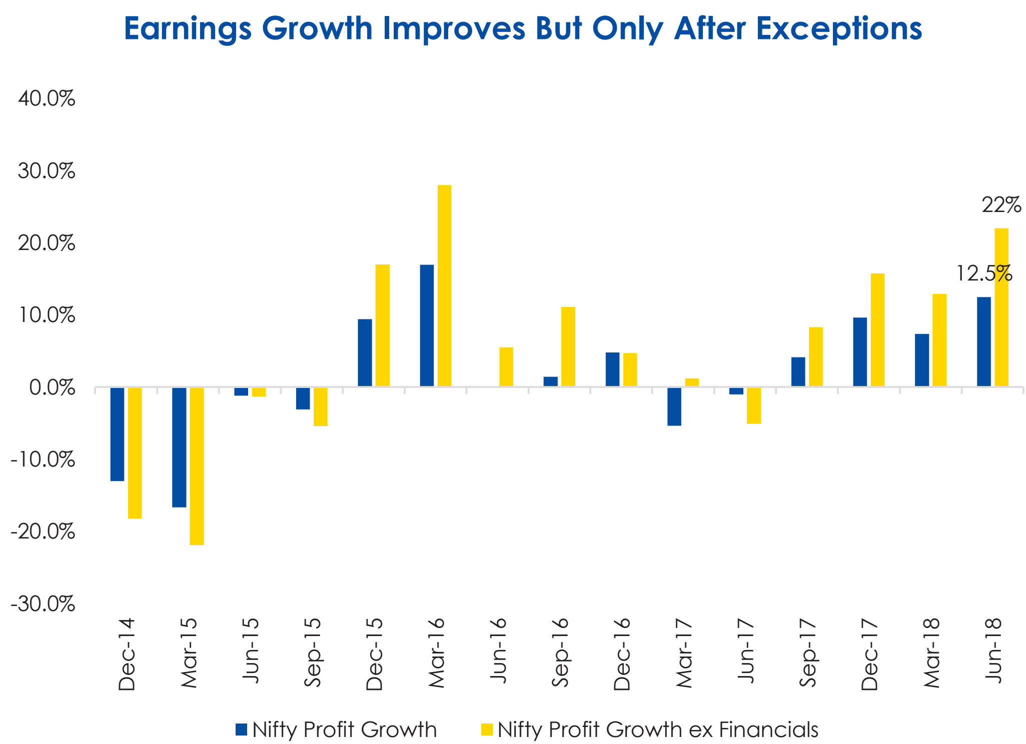


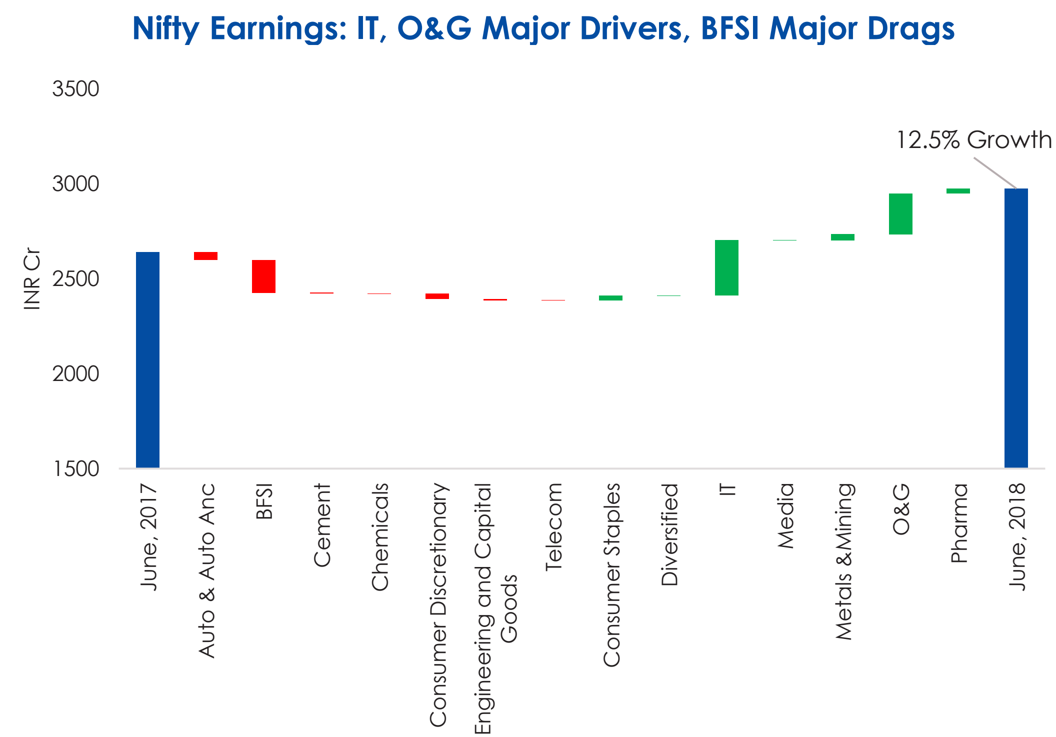
Source : Bloomberg, Edelweiss Investment Research

- Actual EPS numbers came below forecasts for the June-end quarter. EPS downgrades come back after taking a backseat last quarter.
- Nifty EPS growth is also backed by Rupee depreciation. A 10% INR Depreciation generally boosts Nifty EPS by 3-4% (ceteris paribus).
- FY19 earnings estimates have been cut after Q1FY19 results. If Q2FY19 delivers below expectation results the markets may correct full year FY19 earnings estimates.

Nifty EPS growth for FY19 is again facing downgrades for full year.

Earnings Growth Broadens In Q1FY19, Exceptions Remain





Source : Bloomberg, Edelweiss Investment Research

Low Base due to GST Restocking last year has driven earnings growth this year. While Sales growth met expectation, rising input cost weighs on bottom line.

Market Breadth Depicting Weakness

Each New Lifetime High On NSE 500 Index Has Seen Fewer Sectors At Fresh Lifetime Highs

Date Of Lifetime High	Nse500 Index	Total No. Of Sectors	Avg. % Of Companies At Lifetime High In Each Sector	No. Of Sectors With Above Avg. Highs	Total No. Of Companies At Lifetime High
04-Jan-08	5502.6	11	41%	5	211
03-Mar-15	7345.55	11	17%	6	97
08-Sep-16	7642.7	11	17%	6	102
23-Jan-18	9877.2	11	27%	5	160
28-Aug-18 (Ongoing)	9978.7	11	12%	4	63

Nse-500 sectoral breadths since 2007 (lifetime highs on 1-month rolling basis)

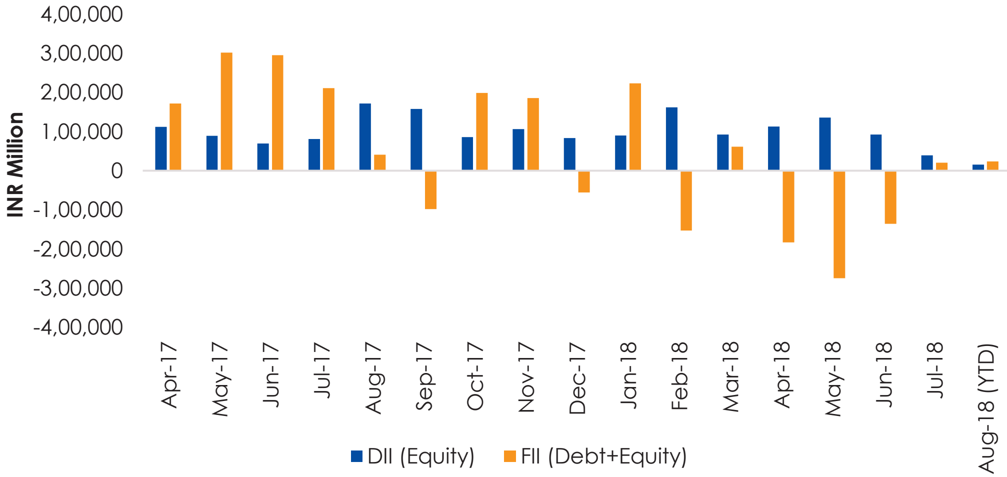
Source : Bloomberg, Edelweiss Investment Research

- As the NSE-500 index has made new lifetime highs over the years, the number of sectors with their own lifetime highs has been reducing i.e. the index has been getting more and more concentrated.
- The latest lifetime high of 9978.7 on 28-Aug-18 (ongoing) saw only 4 out 11 sectors reaching lifetime highs. Also, just 63 out the 500 index companies were at life highs of their own.

Ongoing market breadth position of NSE-500 is worse in a decade

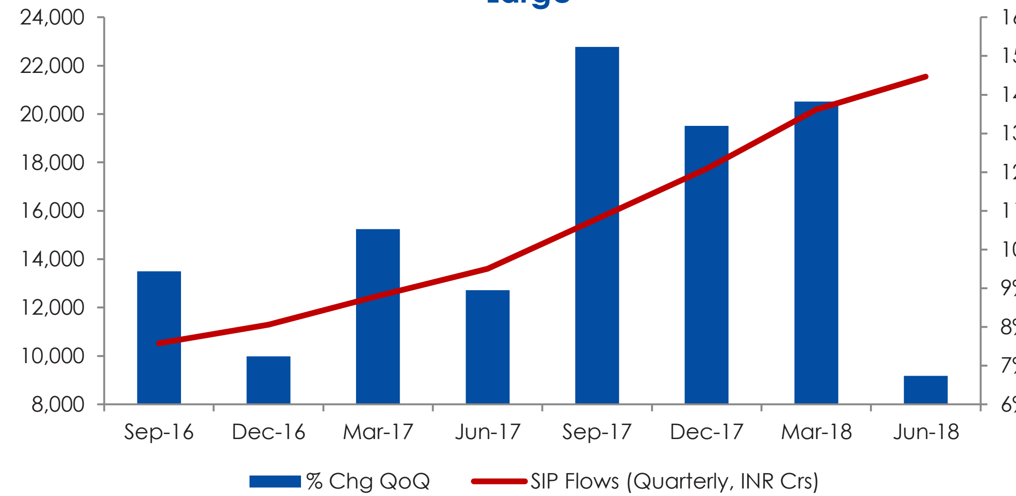
DII Flows Anchor The Markets, Will It Sustain?

Domestic Flows Have Begun To Taper

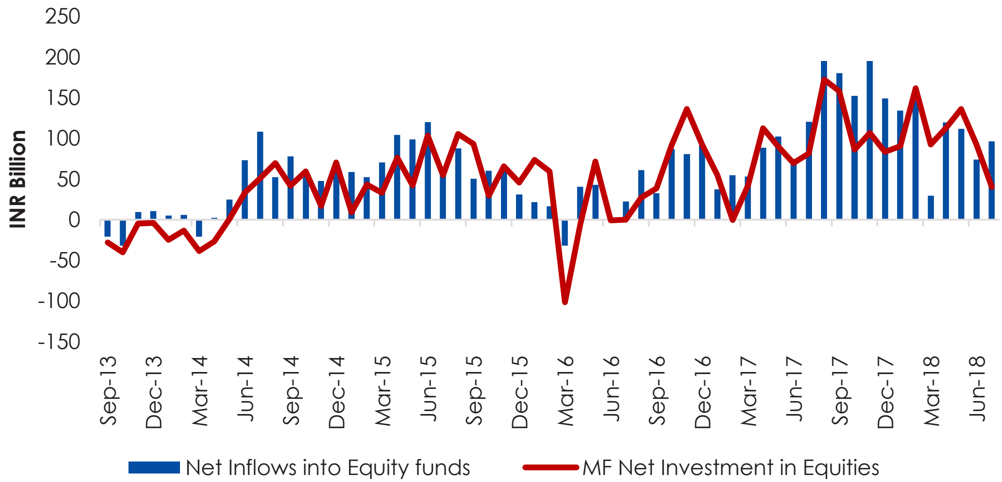


*DII Flows include only MF investments

Pace of SIP Accretion Is Slowing, But At $1bn/month Remain Very Large



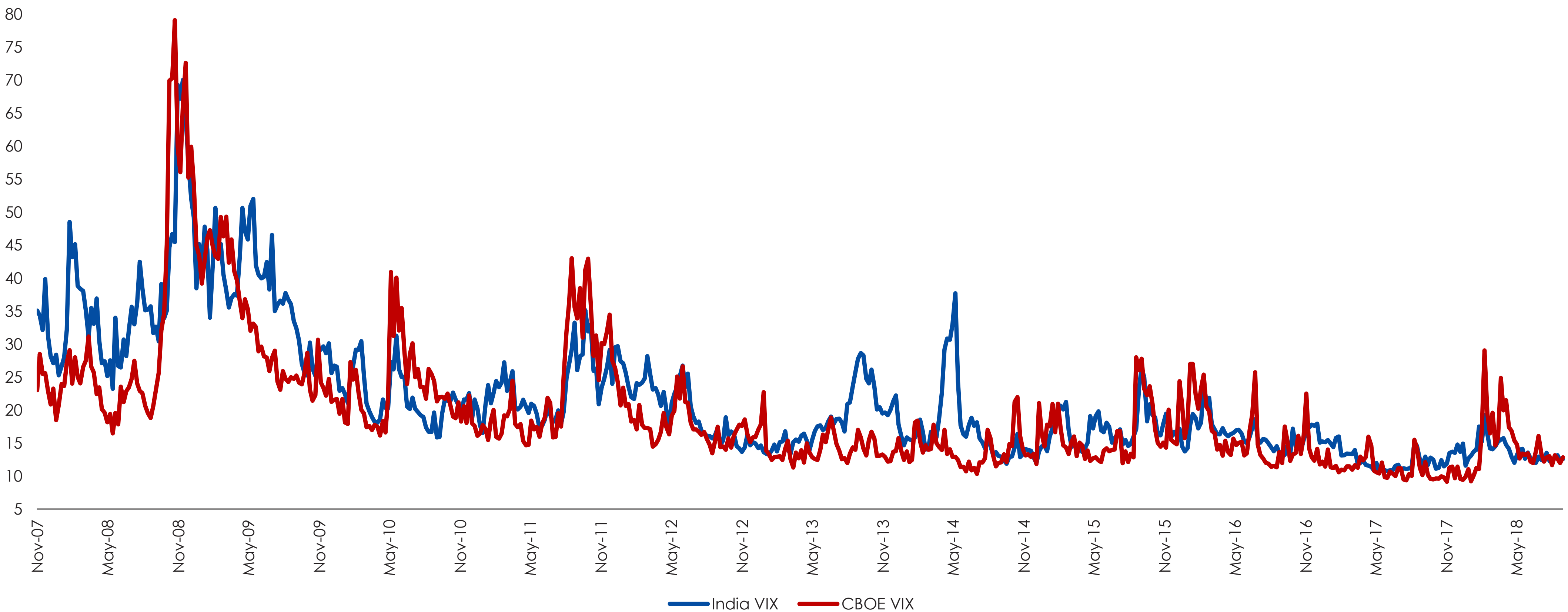
MF flows into equity slowing down



Source : AMFI, SEBI, Bloomberg, Edelweiss Investment Research

Inflows into equity mutual fund schemes slowed down to their lowest level in four months in July. Average inflows in the first 4 months of FY19 stand at INR 10,000 Crore. Slowdown in inflows has meant that MFs has pulled down investment in Equities. However, SIP flows continue to rise and give some optimism for long term outlook for domestic liquidity.

VIX Running Low: Complacency Might Be The Culprit



Source : Bloomberg, Edelweiss Investment Research

- Major stock market volatility indices are on a falling trend, indicating general confidence in the global market.
- India VIX shows calm despite a general nervous mood in Indian markets. This might indicate complacency as India VIX is based on Nifty, which has largely withstood the selling pressure on the back of a few major bluechip outliers.

Earnings Growth Crucial, But Valuations A Concern

- After eight quarters of downgrades, Nifty Earnings in Q1FY19 somewhat matched the expectations although dragged down by corporate lenders. However the downgrade cycle in FY19 seems to be similar to earlier years.
- FY19 earnings estimates have been cut after Q1FY19 results. If Q2FY19 delivers below expectation results the markets may correct full year FY19 earnings estimates.
- Indian markets are the best performing markets across and this could be because of growth momentum and DII support.
- Despite the earnings visibility, valuations remain a concern not only for Nifty but for midcaps as well.
- DIIs continue to anchor Indian markets but Inflows into equity mutual fund schemes slowed down to their lowest level in four months in July.
- There seems to be complacency in the markets as indicated by lower VIX.
- Nifty is currently trading at 25x at TTM P/E basis and 20x at 1 year forward P/E basis. Our estimate for Nifty EPS for FY19/FY20 is 530/640.

Despite Earnings Tailwinds, Valuations & Complacency remain key risk to the markets. We continue to hold our "Cautious" view on the markets

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