TOP 10 ISSUES FOR 2016

Liquidity , events and valuations to drive the markets

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How did the World Equity Market behave in 2015?

Index	Country	Return for CY 2015 (%)
DAX	Germany	10
Shanghai Composite	China	9
Nikkei 225	Japan	9
CAC 40	France	9
Nasdaq	USA	6
Seoul Composite	South Korea	2
Dow Jones	USA	-2
KLSE Composite	Malaysia	-4
NIFTY 50	India	-4
RTS Index	Russia	-4
FTSE 100	UK	-5
S&P BSE SENSEX	India	-5
NYSE	USA	-6
Hang Seng	Hong Kong	-7
Jakarta Composite	Indonesia	-12
Bovespa	Brazil	-13

Germany, followed by China were the top performing equity markets globally in calendar year 2015

Brazil equity market fell the most

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DOMESTIC SECTORAL RETURNS

Sector Index	Return for CY 2014 (%)
S&P BSE Health Care	15
NIFTY MEDIA	10
S&P BSE IT	5
S&P BSE TECk Index	4
S&P BSE FMCG	1
NIFTY IT	0
S&P BSE AUTO Index	-1
S&P BSE OIL & GAS Index	-3
S&P BSE Power Index	-6
S&P BSE Capital Goods	-9
S&P BSE BANKEX	-10
S&P BSE Realty Index	-14
S&P BSE PSU	-17
S&P BSE SENSEX	**-5**
S&P BSE Mid-cap	**7**
S&P BSE Small Cap	**7**

- Pharma, Media and IT were out performers of 2015
- PSU, Real estate and Banking were the worst performers

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Top 10 Issues for 2016

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Is the world slipping into a recession?

Will China land hard?

How far will Crude prices fall?

Will NDA manage to get bills passed by Parliament?

Will the Budget be path-breaking or mediocre?

Will corporate performances improve?

Will retail investors continue to buy equities?

Will FII flows be positive?

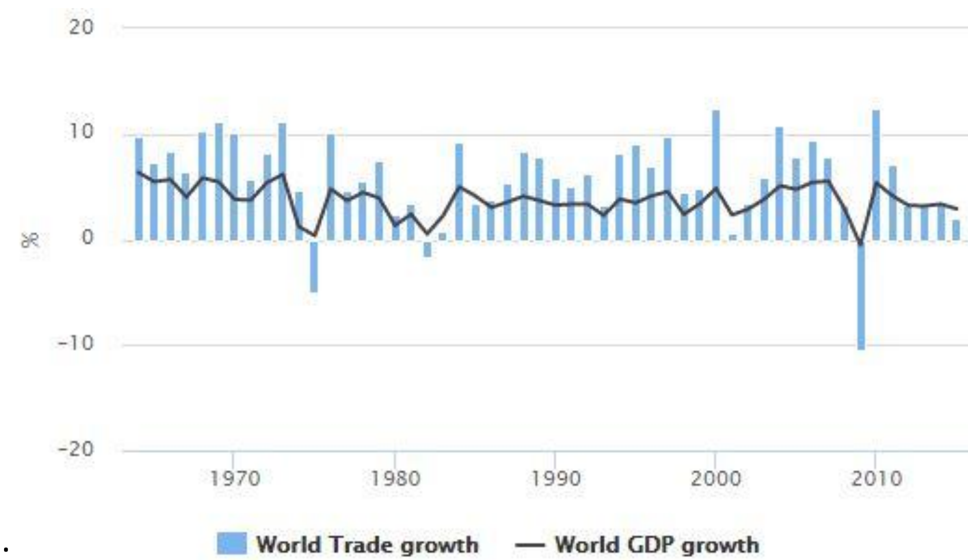
Will RBI cut rates?

MID CAPS

Will midcaps outperform large caps?

1. Is the world slipping into a recession?

- Slowdown in economic growth
  - World Bank has cut its 2016 global growth forecast from 3.3% to 2.9%.
  - IMF expects the global economic growth to be disappointing next year
- International trade has slowed relative to GDP growth
  - According to IMF, y-o-y change in global exports is at second lowest level since 1958 (second only to 2009)
  - 2015 was the year of weakest global trade growth after 2009
  - Traditionally, trade has risen at double the pace of GDP



Source: OECD

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1. Is the world slipping into a recession?

- According to OECD, there have been only 5 years in the last 50 years when global trade grew by 2% or less

- Major concerns
  - China economic slowdown
    - China accounts for 10% of global economic output
    - The economy is faced with extremely high levels of debt
    - Aggressive currency devaluations will flood the world markets with cheaper Chinese goods, adding competitive pressures in the developing countries and adding to problems of the developed countries which are already fighting very low inflation levels
  - Rising interest rates in the US:
    - In mid-December, the Fed raised its benchmark federal funds rate by 25 basis points.
    - The subsequent rate hikes will be gradual and the next move will predominantly be decided by the inflation trends.
  - European slowdown may be reversed
    - ECB likely to continue expansionary monetary policy
  - Emerging markets slowing down
    - Net investment in emerging markets is slowing gradually
    - Brazil, Russia and South America already slowing down

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1. Is the world slipping into a recession?
Signals that should be keenly observed

- Central Bank actions in terms of further quantitative easing or rate hikes
  - ECB and BOJ actions on QE to be keenly watched
    - Europe’s central bank began buying government bonds in March 2015. In December it extended the planned length of the program as inflation remained far below target of close to 2%. Lower oil prices have added to the woes
    - ECB's QE coupled with Japan's monetary easing is expected to increase flows into emerging markets, especially India
  - Fed Commentary and action on further rate hikes
  - Increasing divergence in monetary policies of the developed world. US Fed and Bank of England are pushing up interest rates while ECB and BOJ are providing stimulus.
- Further weakness in crude and commodity prices
- Stock indices displaying irrational exuberance – not supported with earnings growth
  - Ground ready for sharp correction

GDP GROWTH MOMENTUM- INDIA

Growth projections by different agencies:

Agency	FY16	FY17
IMF	7.3	7.5
World Bank	7.8 (calendar year)	7.9 (calendar year)
Nomura	7.8	8
ADB	7.4	7.8
S&P	7.4	8

- The Indian economy grew at 7% in the 1st quarter and 7.4% in the 2nd quarter of the current financial year

- **We expect: the GDP growth in FY 16 to be around 7.5%**

•The first six months of 2016 is very crucial for the global economy to prevent the onset of a recession

•It will be difficult to completely insulate the Indian economy from Global recession, in case it really happens

•There may be an impact on global portfolio flows as result and India will also witness outflows

•However, the relatively strong GDP growth will bolster India's chance of India being treated as a distinct asset class rather than as a part of emerging markets (EM) or Asia ex Japan allocation.

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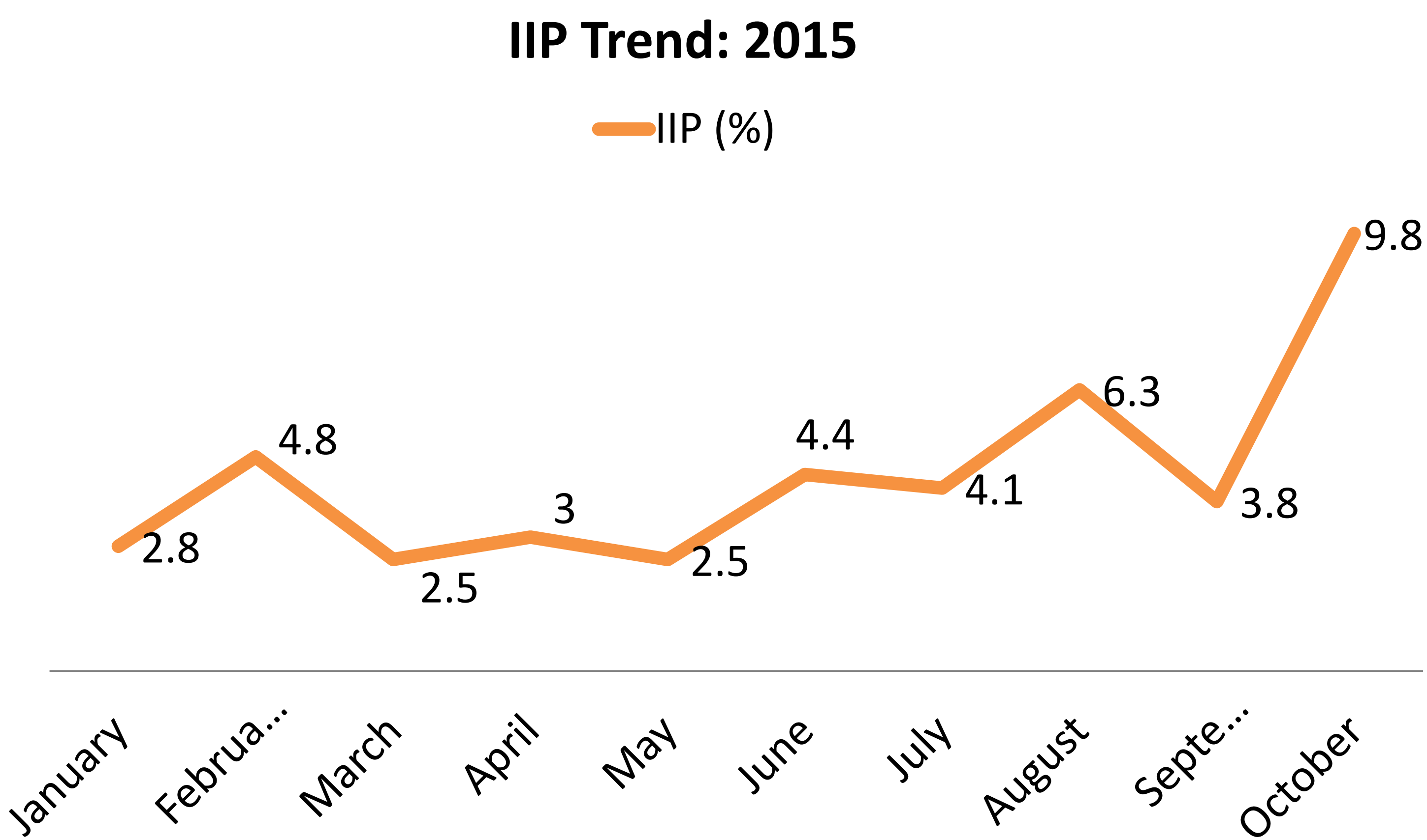
IIP Trend



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- **We expect:**
  - There are signs of recession in the world economy. India continues to look good relative to the world economic growth
  - Historically there has been a trend for the world on an average to slip into recession once every 8 years (study by Morgan Stanley)
  - Morgan Stanley doesn’t expect the Recession in 2016, if at all, to be of the same magnitude as 2008
  - Expect a volatile year ahead for stock markets

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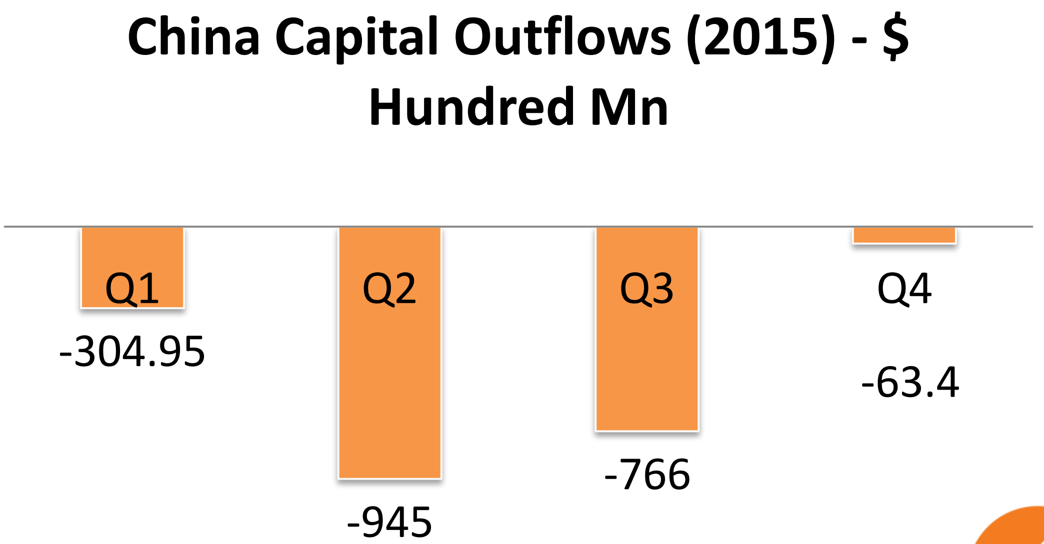
2. Will China land hard?

- GDP growth- signs of slowdown as the economy makes a transition from export led to one driven by services and consumption.
  - Q1: 7%
  - Q2: 7%
  - Q3: 6.9%
- Manufacturing activity has been in contraction since March. PMI touched a record low of 47.2 in September 2015.
- Sharp rise in China's debt-to-GDP ratio, with a 50 percentage point increase in the last 4 years – to the current ratio of 250%.
  - Loans being made without sufficient attention to credit quality
- Currency Devaluation
  - On August 11 2015, China’s central bank announced that it was moving towards a more market determined system for calculating its daily fixing rate for Yuan. It devalued the Yuan 4.6% lower (steepest shift ever) in a span of 3 days. This rattled world markets.

– China may be in a position to handle a debt crisis because of government control and nearly $3 trillion of forex reserves
– This may lead to currency wars

- China has seen record capital outflows in 2015 and slowing of export growth



- **We expect:**
  China is showing signs of a bumpy landing.

  China and its aggressive currency devaluations will be a major contributor to the volatility in global equity markets.

3. Will NDA manage to get bills passed by Parliament?

- In 2015 the Parliament was in the news for not functioning well – mainly due to the Opposition stalling passage of crucial reform bills.
- Important Bills in pipeline:

GST Bill:

Towards the end of 2015, the PM met Congress chief Sonia Gandhi and former PM Manmohan Singh to find a compromise on the GST Bill. A majority of the states, businesses and trade bodies strongly support the Bill

Land Acquisition Bill:

Right to Fair Compensation and Fair Compensation in Land Acquisition, Rehabilitation and Resettlement Bill has been sent to a joint parliamentary committee

Bankruptcy Code Bill:

The Insolvency and Bankruptcy Code, 2015, will replace the existing bankruptcy laws to make it easier for sick companies to shut down business or make an effort to turn it around. Will be debated in the Budget Session

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What has been achieved till now?

E-biz portal -All government departments in a common e-platform, making the process of obtaining licenses easier	**Bank bureau** -Set up a Bank Bureau with independent members who will select professionals to run PSU banks.	**Subsidy reforms** - Subsidy rationalization covered LPG and kerosene.
Fast-tracking FDI process - FDI limit increased in few sectors - For certain sectors, like defence, investment can now proceed automatically	**Insurance Bill** - FDI limit increased from 26% to 49%	**Black Money Bill** -A bill to deal with black money stashed abroad
Companies Amendment Bill -16 amendments were made to the Companies Act of 2013 related to winding up, board resolutions etc.	**Coal Mines & Mines and Minerals Bill** - Loosens the mining monopoly of Coal India - Greater transparency to the sector	**Faster Project Implementation (eg, Delhi Mumbai Industrial Corridor)**

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Politics – State elections

Political developments, including state elections will have a bearing on the ability of the government to pass key reforms

- Tamil Nadu and North eastern state elections will prove to be the litmus test for BJP especially after losing important elections in 2015

Legislative Assembly Elections	Date
Tamil Nadu	May-2016
West Bengal	May-2016
Kerala	May-2016
Assam	May-2016
Puducherry	May-2016

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Passage of Bills - Breakthrough

- **What is required?**
  - BJP does not have a majority in the Rajya Sabha (it has about 45 out of 245 seats). Hence there is more executive action rather than legislative action. Constructive dialogue with other political parties is important.
- **The outcome of the Bihar election has seen the ruling coalition adopt a more conciliatory approach.**

4. How far will crude prices fall?

- Crude oil prices started 2015 at relatively low level and fell even further by a staggering 35% in 2015.
  - Brent oil price dropped from $ 57.33 in the beginning of the year to $ 37.28 by the year-end
  - Reasons for the sharp fall:
  - United States domestic production has almost doubled over the last 6 years. There is sustained excess of crude oil supply over global demand.
    - Global inventories increased in each quarter of 2015, with a net inventory build of 1.72 million barrels per day, the highest rate since at least 1996.
  - Reluctance of OPEC to intervene to stabilize the markets
  - Vivek Wadwa of Cornell University: Combination of long term trends such efficiencies from “fracking”, energy efficiency and increase in supply on one side and build up of positions in the futures market on the other led to sharp readjustement of crude price sharply in 2015
  - Ruchir Sharma of Morgan Stanley: Oil prices not far away from their 100 year average. Commodity cycles boom for a decade, bust for 2 decades.

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- Tensions in the Middle East:
  - Saudi Arabia and Iran Cold war: These are 2 of the largest producers in OPEC, and increased tensions between the two countries could add to the discord within OPEC that has prevented the group from agreeing on a strategy to stabilize oil prices.
  - Syrian war: Syria and Libya saw a drop of about 40% or more to their oil output, as a result of physical damage to the sector and a fall in production. Conflict has severely hurt the economies of Libya, Yemen, Iraq and Syria. However, unlike geopolitical tensions in the past, it has not had a significant impact on oil prices
- **What we expect:**
  Oil prices are likely to remain low in 2016 as well. Sharp fall to $ 20 is bad as it foretells severe strain to global demand. Rise above $ 70 is also bad as it will strain India's current account deficit (CAD). Range bound crude is best for India

5. Will the Budget be path-breaking or mediocre?

- The Union Budget presented by the NDA government was very pragmatic and balanced. It had something for everyone.
- The Govt is likely to meet the fiscal deficit target of 3.9% for FY16
- Challenging fiscal situation for FY17 budget:
  - Lower than expected inflows from divestment
    - Budget estimate for disinvestment during FY16 is Rs. 69,500 crore. Amount raised so far is Rs. 12,700 crore through offer for sale (OFS) issues of REC, PFC, DCIL and IOC Limited.
  - 7th Pay Commission which might cost the government Rs. 1 lakh crore in FY17

- Major Expectations from Union Budget for FY17:
  - Focus on infrastructure: stepping up of investments
  - Big rural push: as the rural economy has been adversely affected due to droughts. Some measures to step up irrigation might be announced
  - Banking reforms
  - May be difficult for the government to offer any relief on personal income tax because of lack of fiscal space
  - Another round of service tax hike might be possible

Budget will be a good opportunity to send out a strong signal to the economy that despite Parliament log jam there has been significant progress on the economic front and prospectively more can be expected.

INFRASTRUCTURE

– Major announcements made related to infrastructure in the Union Budget 2015-16:

- The government has increased the allocation to Infrastructure by Rs 70,000 crore.
- Revitalisation of the PPP model with greater risk being borne by the Government
- Announced setting up of 5 Ultra Mega Power Projects under the plug and play model will give a boost to the power sector.
- 1 lakh km of road construction
- Launched National Infrastructure Investment Fund: The government will be investing Rs 20,000 crore in the fund. The objective is to increase investment flows into infrastructure projects. Another Rs. 20,000 crore will be expected from sovereign wealth funds
- Tax-free bonds for railway, road and irrigation projects will be issued
- The Cabinet has given its nod to set up India's first 500-km-long bullet train project, with the help of Japanese funds and technology. Connecting Mumbai to Ahmedabad, the cost will be Rs 98,000 crore.

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Infrastructure…contd

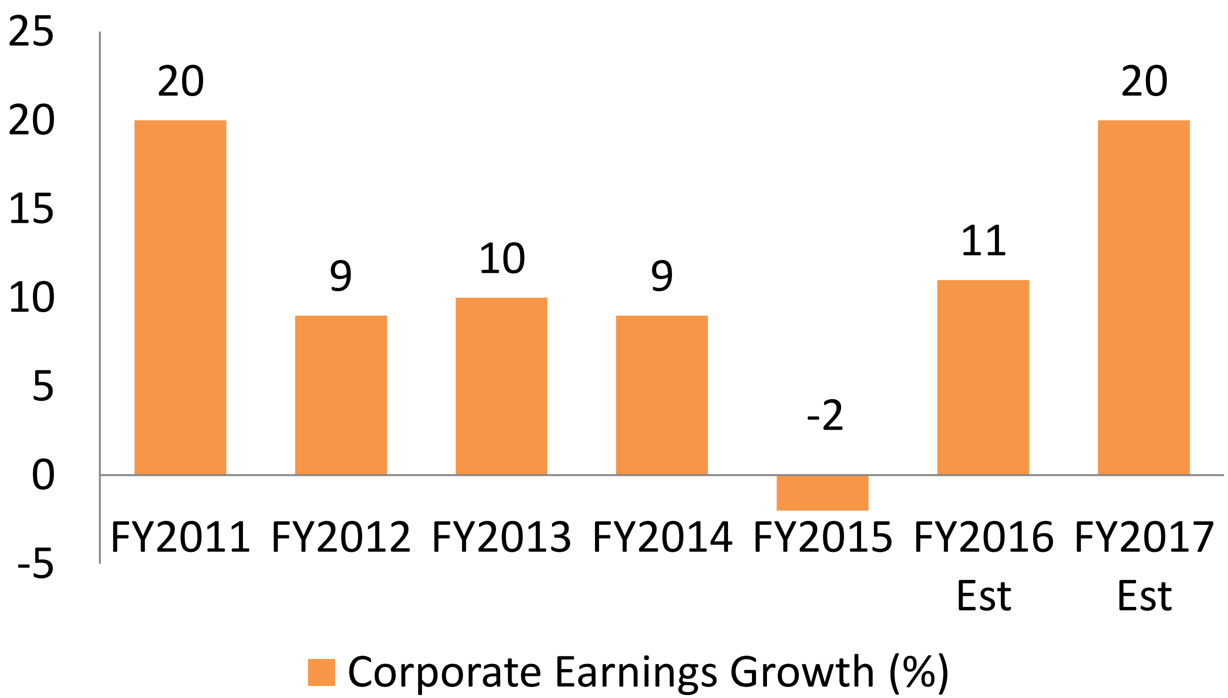
- ‘Pragati’ initiative:
  - Once a month, the PM holds a meeting with top state and central bureaucrats to check why projects have not got off the ground.
    Since March 2015, it has helped revive nearly $60 billion in central and state projects, according to government data through September seen by Reuters.
- As per a CRISIL report, India’s investment requirement in infrastructure sector could increase to Rs 31 lakh crore over the next five years. Of this, about 70 per cent will be required in power, roads and urban infrastructure sectors.

Our View:

- Government will try getting sovereign wealth funds and pension funds from other countries to invest in the NIIF
- The focus on reviving stalled projects to continue

6. Will corporate performances improve?

- Corporate earnings adversely affected in 2015 due to:
  - Global slowdown and fall in commodity prices
  - Slack demand from rural economy due to poor monsoons and unseasonal rainfalls
- Many experts expect earnings growth to improve in FY16
- Drivers for better corporate performance
  - Seventh Pay Commission may increase urban consumption
  - Higher government spending
  - Lower crude and commodity prices
  - Interest rate reduction
  - Normal monsoon



Source: CLSA

- **We expect:**

Corporate earnings to pick up in the first half of CY2016

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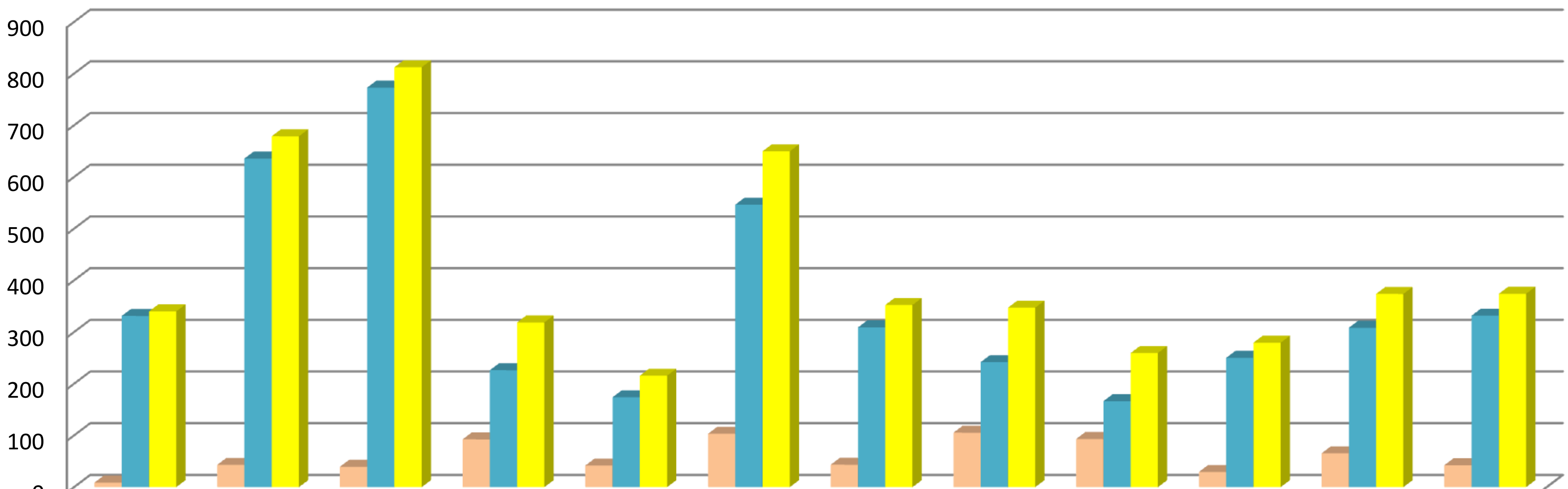
7. Will retail investors continue to buy equities?

- 2015 saw
  - Net inflows by equity mutual funds : Rs. 90,000 crs
  - Net equity purchases by MFs for 2015: Rs 70,800 crs (almost 3 times that of 2014)

2015: Domestic flows into MFs (Rs bn)



	January	February	March	April	May	June	July	August	Septembe r	October	November	December
Equity	9	43	39	92	42	103	43	105	93	29	65	42
Debt	331	636	773	226	174	547	309	242	166	250	308	332
Total	340	679	812	319	216	650	352	347	260	279	374	374

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Mutual Fund Trends reflect higher retail participation

- Asset Base increased to Rs. 13.4 lakh crore in 2015
- Equity assets have crossed the Rs 4 Lakh crore mark for the first time in the history of Indian mutual fund industry
- Fastest growth in the number of equity accounts this year – highest in 8 years. Close to 41 lakh retail folios have been added, taking the overall folio count of the Industry to around 4.5 crore in October.
- Nearly 11,000 equity accounts opened daily.
- Systematic Investment Plans (SIPs) book has seen growth of 40 per cent in the past year. The average monthly size of SIPs has also improved to about Rs 3,000 per account, against Rs 2,800 a year ago.
- **We expect:**
  Retail participation is now more mature than in the past. Two visible trends noticeable: a) Regular purchases through SIPs and c) Strong inflows during market corrections

  These trend are likely to continue in 2016 with a small hiccup

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8. Will FII Flows be positive?

Calendar Year 2015

Month	Equity (Rs bn)	Debt (Rs bn)	Total (Rs bn)
January	129	208	337
February	115	131	246
March	121	86	207
April	117	36	153
May	-58	-85	-143
June	-33	17	-16
July	53	0	53
August	-169	-6	-175
September	-65	7	-58
October	66	157	224
November	-71	-38	-108
December	-28	-55	-83

- 2015 saw inflows of Rs 17,806 crore into the equity markets and Rs 45,856 crore into debt, taking the total to Rs 63,662 crore
- For the first time in many years the domestic mutual funds were disproportionately (4X) of net FII purchases

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How will FII flows trend?

- India got sold into as part of the selling in emerging market (EM) basket
- While there may be some selling in emerging markets in 2016, this is largely a function of inherent weakness in their economies
  - BRICS Basket:
    - India has the highest GDP growth rate among all the BRICS nations now
    - Brazil, Russia and South African economies have suffered due to fall in commodity prices
  - Asia ex Japan Basket:
    - Most Asian economies are export dependent
    - India in contrast has a strong economy dependent on domestic consumption
- Historically FIIs turn net buyers once Market multiples falls below its historical average
- India is attracting a lot of attention from global investors:

We Expect:

FII flows may be erratic for most part of the year. As long as it is not a concentrated selling in a particular period, the impact on the market may be limited. It is quite likely that at FIIs will be net buyers in India if the markets correct sharply.

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9. Will RBI cut rates?

- RBI cut rates by a total of 125 basis points in 2015 because of inflation being in RBI's comfort zone. The softening of oil and commodity prices was a major factor
  - 15th January: 25 basis points
  - 4th March: 25 basis points
  - 2nd June: 25 basis points
  - 29th September: 50 basis points
- Decision will be guided by the following factors:
  - Inflation trajectory
  - Fiscal prudence
  - Global factors

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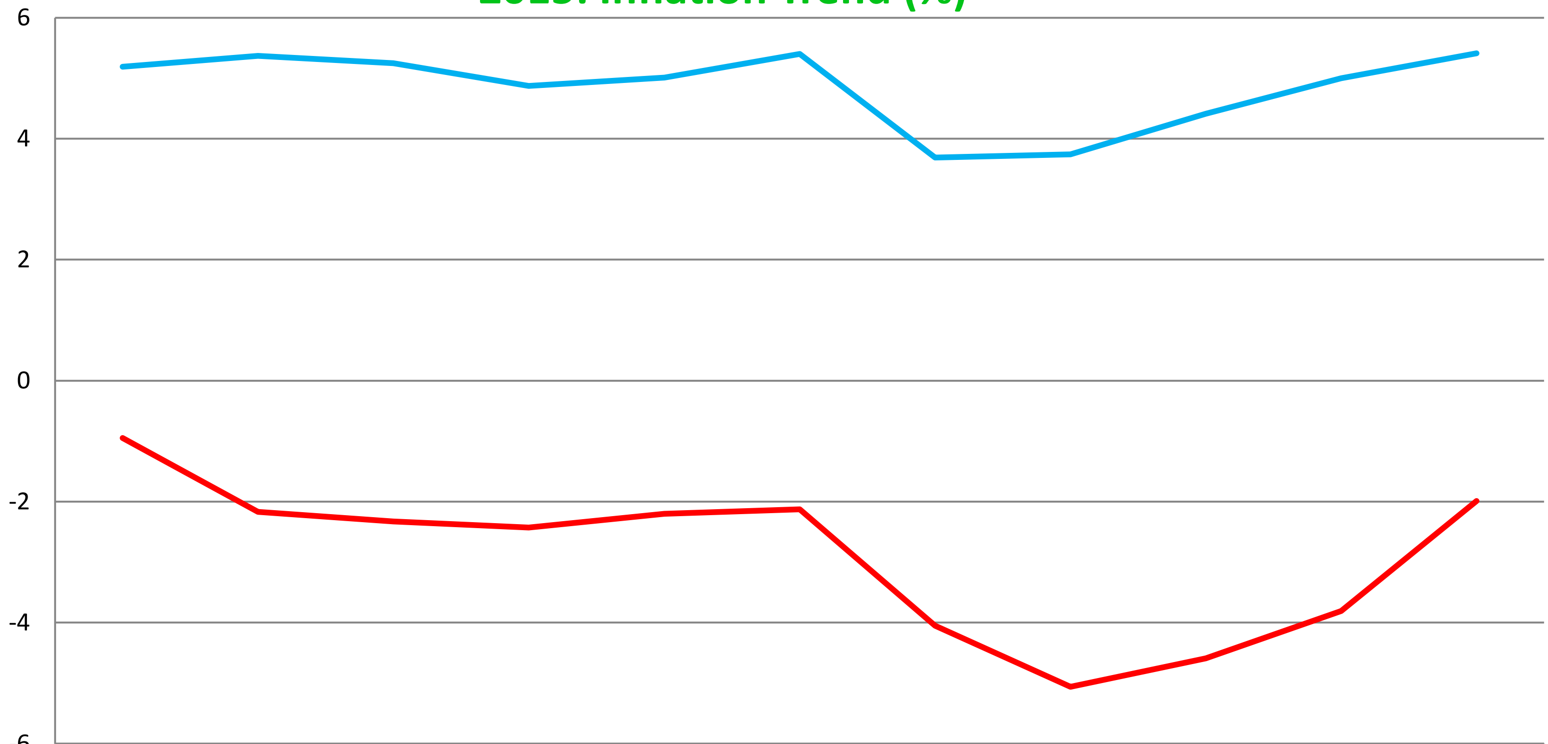
RBI Action to be strongly guided by inflation trajectory

- CPI inflation bottomed in July and WPI bottomed in August after which it trended upwards nearing January levels

2015: Inflation Trend (%)



	January	February	March	April	May	June	July	August	September	October	November
CPI	5.19	5.37	5.25	4.87	5.01	5.4	3.69	3.74	4.41	5	5.41
WPI	-0.95	-2.17	-2.33	-2.43	-2.2	-2.13	-4.05	-5.06	-4.59	-3.81	-1.99

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RBI – Fiscal and Fed

- **Fiscal Prudence:**
  - FY16 fiscal deficit targets will be met
  - If GST is passed, Govt's finances will be much better in FY17
- **Fed Action and Global Factors**
  - Market is overestimating Fed's activism and ability to raise rates 4 times by a cumulative 100 bp
  - In a sluggish Global economic environment, China slowdown and falling crude and commodity prices USA cannot be focused on its own economy alone
    - 50-60% of world's currency is tied to the Dollar (Source: Morgan Stanley)
    - 80% of the global trade is denominated in Dollar (Source: Morgan Stanley)
  - This will give room to RBI to cut rates

What can we expect from RBI

- RBI will focus not only cutting rates but also on ensuring more effective transmission of the previous cuts
- The focus will also be on improving the health of banks by addressing the huge issue of NPAs
- The initial operation of the new Payments Bank and Small banks will also be watched
- It is also expected that
- RBI will cut rates by 25 to 50 basis points in 2016.

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10. Will midcaps outperform large caps?

- In 2015:
  - S&P BSE Midcap Return: 7%
  - SEP BSE Sensex Return: -5%

P/E Ratio	Nifty 50	Nifty Midcap 100
31-Dec-2014	21.16	18.84
31-Dec-2015	21.49	27.43

Source: NSE

The midcap outperformance may continue in 2016 because of the following factors:

- Economic recovery and growth in demand likely to benefit midcaps
- Healthy inflows in domestic MFs which has seen more liquidity chasing mid cap ideas
- Fall in prices of raw materials like oil and metals
- Mid caps have seen both earnings growth as well as PE expansion and hence the outperformance over large caps

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OUTLOOK ON ASSET CLASSES

- **Equity vs Debt**
  - The Sensex/Nifty gave a return of -5% in 2015.

	Est. Sensex target – December 2016
CLSA	29,000
Deutsche Bank	29,000
Morgan Stanley	30,200
Citibank	32,000
Societe Generale	32,000

  - **We expect: While both equity and debt look attractive, equity will outperform debt**
  - **Within equity, midcap stocks will outperform**
- **Financial Assets vs Real Assets**
  - **Financial assets likely to out perform gold and real estate**

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