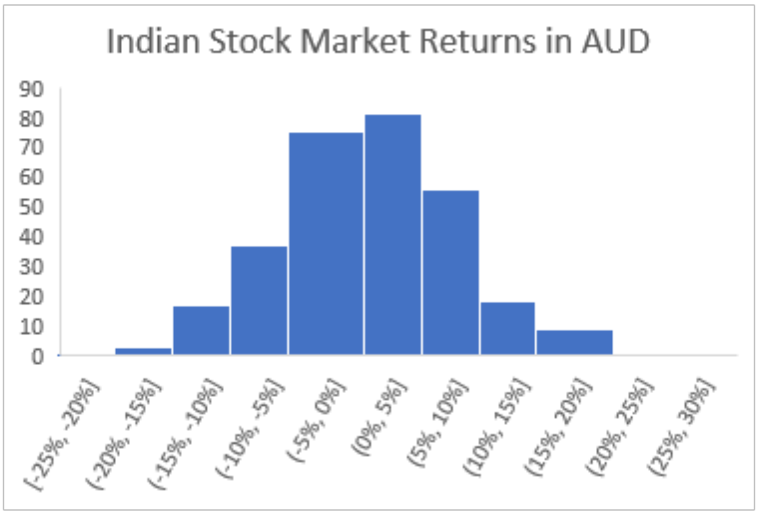
A Review of September 2018

The month of September 2018 was a poor one for Indian equity markets. The MSCI India, our benchmark fell by 7.15% in local currency terms. However, given the INR also fell against most currencies globally in September, the return over all approximately fell 10% for the month in AUD terms.

However, don't be alarmed – this happens when investing in growth markets like India. There are pauses along the way! We said we would keep you informed, and we expect the ride to be sometimes rocky, but always fruitful in the long-term

History of 10% falls in the Indian Markets

The last time we experienced a 10% fall in Indian markets (as measured by MSCI India in AUD terms) was January 2011. In the last 300 months i.e. 25 years it has happened 20 times (6.7% of months). Six of those months were in the "Tech Wreck" between March 2000 and March 2001 and five of those months were in 2008 during the "Global Financial Crisis". In the remaining 23 years, this has been a very infrequent occurrence. When it has occurred in abundance then it is more likely a global event like the two listed above which drives all share markets down, not just India's.



The chart illustrated, the strong positive skew for Indian markets. In fact, 57% of the time monthly returns are above 0%. Only 6.5% of months result in a 10% fall or more. Interestingly after a 10% fall (even including the Tech Wreck and the GFC), the average 3-month return after a 10% monthly fall has been +1.5%. Excluding the GFC and Tech Wreck periods the 3-month return post a 10% monthly fall averages +13.5%.

Source: Bloomberg

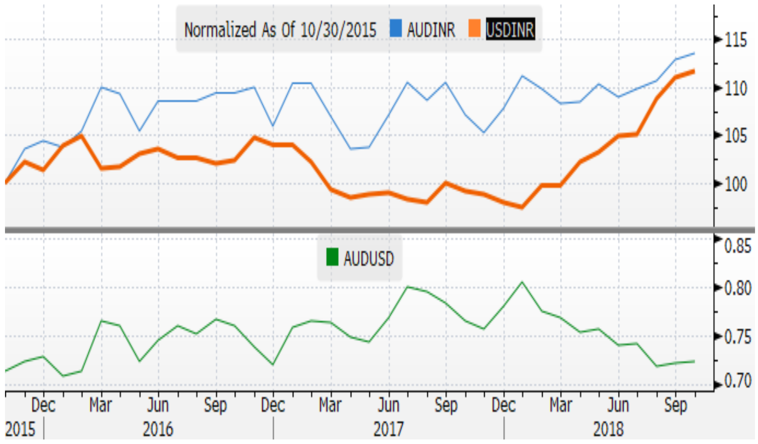
What led to the fall in September 2018?

1) Increasing tension around trade-wars and tariffs
2) US Federal Reserve continued vigil to normalise interest rates
3) Rising Brent Crude prices reflecting supply side restrictions and rising demand
4) Rising bond yields and tightening domestic liquidity in India

Prior to September, India's stock markets, as measured by Indices like MSCI India had outperformed their Emerging Market peers such as MSCI China quite handsomely. Whilst **trade-war talk** and the **US Federal Reserve continuing to raise interest rates** were generally negative for Emerging Markets, India continued to be seen by foreign investors as a region undergoing change through reform and being supported by need for consumption and infrastructure.

However, as we have explained to you in our prior fact sheets, all of the better performance (than EM share markets) of the Indian share markets can be attributed to the Top 5 stocks by market capitalisation. These large companies drove the gains as investor behaviour focused on safety, liquidity and largely foreign revenue generating companies as the INR continued to fall. Most of India's large IT companies generate their revenues in the US, UK and Europe and these businesses were seen as "safe havens" in the prevailing environment. However, small and mid-cap companies were meeting a similar fate in India to that of markets overseas.

There is growing concerns that **rising oil prices** would start to impact India's Balance of Payments, placing pressure on the INR to depreciate. In fact, a rise in Brent Crude of US$10 can add US$10bn to the current account of India. The price of oil has been rising on supply side concerns, with limitations coming from Venezuela, Iran and OECD jawboning on supply. The demand side of course remains strong driven by the growth of India and China. India as we know imports 82% of its growing oil requirements. Oil is its biggest import at over 1/3 of imports.



Source: Bloomberg

In order to defend a sliding currency, the RBI (Central Bank) has been conducting open market operations i.e. buying INR in the open market. This has resulted in some depletion of India's forex reserves (accumulated over the past few years with a favourable macro environment). India still has close to USD$400bn in the forex war-chest

Tightening domestic liquidity has occurred from the following factors:

- Escalating trade tensions leading to investors seeking safety in their investment portfolios
- Higher interest rates in the US as the Federal Reserve increases interest rates to counter fast growth and normalise US interest rates

Bond yields have risen from 6.6% a year ago to a recent high of 8.2% in India, reflecting tighter liquidity and the tightening of interest rates in India in response to INR weakness and some rising inflation. Unfortunately, rates are rising at a time which is early in the nascent growth cycle of India. With some major reforms like GST, Demonetisation etc out of the way, we would have expected to see a pick-up in the pace of growth. This may be slowed for FY19 (fiscal March year end in India) if oil remains elevated and the US Federal Reserve continues to be hawkish in tightening interest rates.

Rising bond yields in India do have an impact on growth over time. Typically, it will slow down commencement of projects and put spending on hold for some time as borrowers reassess the net present value of projects and investments. It also puts a squeeze on lenders funding costs as short-term interest rates rise, reducing their net interest margins.

Effect on Emerging Markets

Typically, during a tightening cycle in the US, Emerging Markets tend to be weak as a rising USD and less liquidity leads to a repatriation of capital back to the US. Weak currencies and those economies who have significant USD debt struggle from rising interest rate bills. Whilst India does not have significant foreign debt like say Turkey or Argentina, it is grouped in the EM category and quite often meets the same fate as global investors pull money out.

What we have seen this year as a trend is local investors in India becoming more of a force and off-setting the withdrawals of global investors. As local investors participate more, it is likely to reduce the volatility of India's share markets.

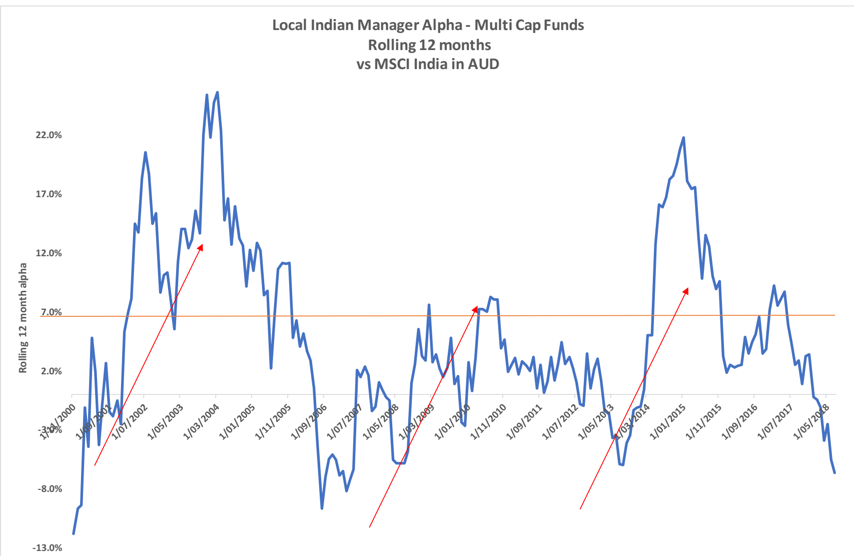
What the fall does to valuations of Indian markets

Still looks expensive to fair on one year forward P/E. However, that's at the Index level. Small and mid-caps have taken a beating

11,000	FY18 (March)	FY19 (March)	FY20 (March)
Nifty EPS*	462	545	670
% growth (Bloomberg consensus)		20	22.9
P/E	23.8	20.2	16.4
PEG Ratio	0.95		

The NIFTY Index comprises of India's 50 largest companies by market capitalisation
Source: Bloomberg Consensus data.

Typically, after such a fall in markets, it is interesting to observe the following:



Source: Bloomberg, India Avenue Research

In periods like 2018 when mid and small caps underperform significantly, investor's seek safety and liquidity as a priority. Post this period, we generally see a strong period for active management, where buying stocks with strong growth potential (after a sell-off) at good prices can provide strong outperformance over Indices, which are top heavy with large cap, liquid names.

We think it's a good time to re-focus on adding to exposure and a better environment to hunt for growth bargains. Investors in local markets in India, identify strong growth companies in environments generally, where all companies are not expensive.

Outlook for Indian markets

Negative Sentiment

In our view, Indian markets could continue to remain in a volatile environment over the next 6 -9 months. This will be driven by the following factors:

- Rising Oil prices from supply side tension globally
- Continued weakness in the INR (Rupee) as Balance of Payments position may worsen
- Weak domestic liquidity as interest rates and bond-yields rise
- State Elections in December/January as a pre-cursor to the National Elections in May 2019

It is in this period where it is likely that the best bargains can be found through patience.

Earnings

Earnings are currently showing signs of positive momentum, particularly in areas like IT, Pharma (weaker currency and supportive US growth) and rural spending driven Consumption. Additionally, given most of the reforms are now bedded in, we are witnessing a rebound from low activity levels in FY18. We expect earnings growth of 15% p.a. over the next 3 years.

Banking and Finance

There has been a significant focus on Banking and Finance sector in India of late due to this tightening liquidity, a crackdown on bad lending practices (primarily by State Owned Banks) through introduction of the Bankruptcy Code, which is being monitored by the RBI. This is bringing to the fore poor practices of the past and seeking to ensure the system is better capitalised to fund India's growth story in future. Again, it's a case of short-term pain for long-term gain!

National Election

It is likely that the National Election of May 2019 will cause volatility in Indian markets. Whilst a Modi-led BJP victory was a significant probability 12 months ago, there is increasing concern that coalitions can be formed to reduce the size of the victory. This may potentially impact the mandate for change in the next term. Land and labour reforms are very much on the agenda for the next term (2019-2024) – which will enable India to grow at a much faster pace and produce more jobs required to allow the demographic dividend to pay-off.