



Thousand (or 500) cuts - December 2016

Demonetisation has introduced timeless uncertainty

While currency de-monetisation undoubtedly would have positive implications on the way business is conducted here in India, the impact over the next year still seems unclear. In the interim, risk of extended damage to certain pockets of the economy has risen, namely (i) housing, (ii) high-value discretionary and (iii) the cash-dependent informal sector. Slow supply of new notes has been a negative so far, and going forward the tightening of screws on tax evaders can affect sentiment and business models of the segments which were feeding off the informal economy. We also listened to a host of company conference calls to discuss demonetisation. While most of them are braving it out, some of the phrases being used by managements like "taking-one-month-at-a-time" summarises the corporate mood at the moment. As long as this uncertainty persists, the impact will continue be felt by the equity markets.

India has surprisingly performed in line with EMs, could drift further

Considering the subdued economic outlook over latter half of fiscal, Indian equities have withstood the impact relatively well. Nifty 50 is down only ~6.5% since November 8th, in line with MSCI Emerging Markets and MSCI EM Asia during this period. India's at-par performance relative to other EMs has also been despite the adverse environment for EMs given the bond-yield increase in US and the stronger equity performance in the developed markets. In fact, the Nifty Midcap 50 index is down only 9% in the same period; compared to previous macro driven corrections (in August-15 and Dec-15) which had driven bigger under-performance in this space. We could therefore argue that mid caps particularly could continue to see further pressure, thereby normalising the valuation differential relative to large caps (small premium currently relative to the median 15% discount).

Domestic liquidity has cushioned the decline

The simple explanation is that domestic flows and buying (USD 2.6bn in November) has offset the FII outflows completely. And that has continued in December so far. This is despite the fact that a material portion of domestic money also flows into mid caps and hence one cannot do pure apples-to-apples offset of the FII outflows. Perhaps the memory of recent corrections (especially the market bottom in Feb-16) being good buying opportunities is still fresh in domestic investor's minds. That and the returns from other asset classes (debt, gold, real estate) has seen a structural diminution, thus leading to steady inflows into domestic MFs month after month.

Investing: Wait and Watch

In the last edition of our newsletter, we had advised investors to create more cash as we believed that further downside was possible over next few months in this uncertain environment. We had also mentioned that partial reallocation of portfolio was in order, to include exporters including select IT and pharma names. As we approach the initial 50-day deadline set by the Government on easing restrictions related to cash withdrawals, we would still be wary of a speedy recovery in economic activity. In fact, it does seem now that the next goal post would be Feb-March 2017. As such, we would continue to maintain a slightly more balanced strategy with a diluted position in sectors leveraged to domestic recovery. There is of course the early Union Budget this time, which could generate more interest in terms of sops, incentives & public capex, likely to be doled out to balance the pain of demonetisation and hence create the chance of a short pullback rally. The only way we would play this is to focus on large caps with better financial resources and superior track record of managing growth and downturns.

There are definite positives that will emerge from demonetisation exercise in the long run i.e. higher liquidity in the banking system, improved fiscal standing (higher tax/GDP) and market share gains for the organised vs. the unorganised players. So while all this makes us positive on the markets from a 6-12 month perspective, domestic buying led support to Nifty valuations (14.5-15.0x FY18E, close to the long-term mean), is already partially factoring the recovery in FY18.