JANUARY 2017

QUARTERLY OUTLOOK

EQUITY

FIXED INCOME

REAL ESTATE

IIFL WEALTH & ASSET MANAGEMENT | ASSET MANAGEMENT

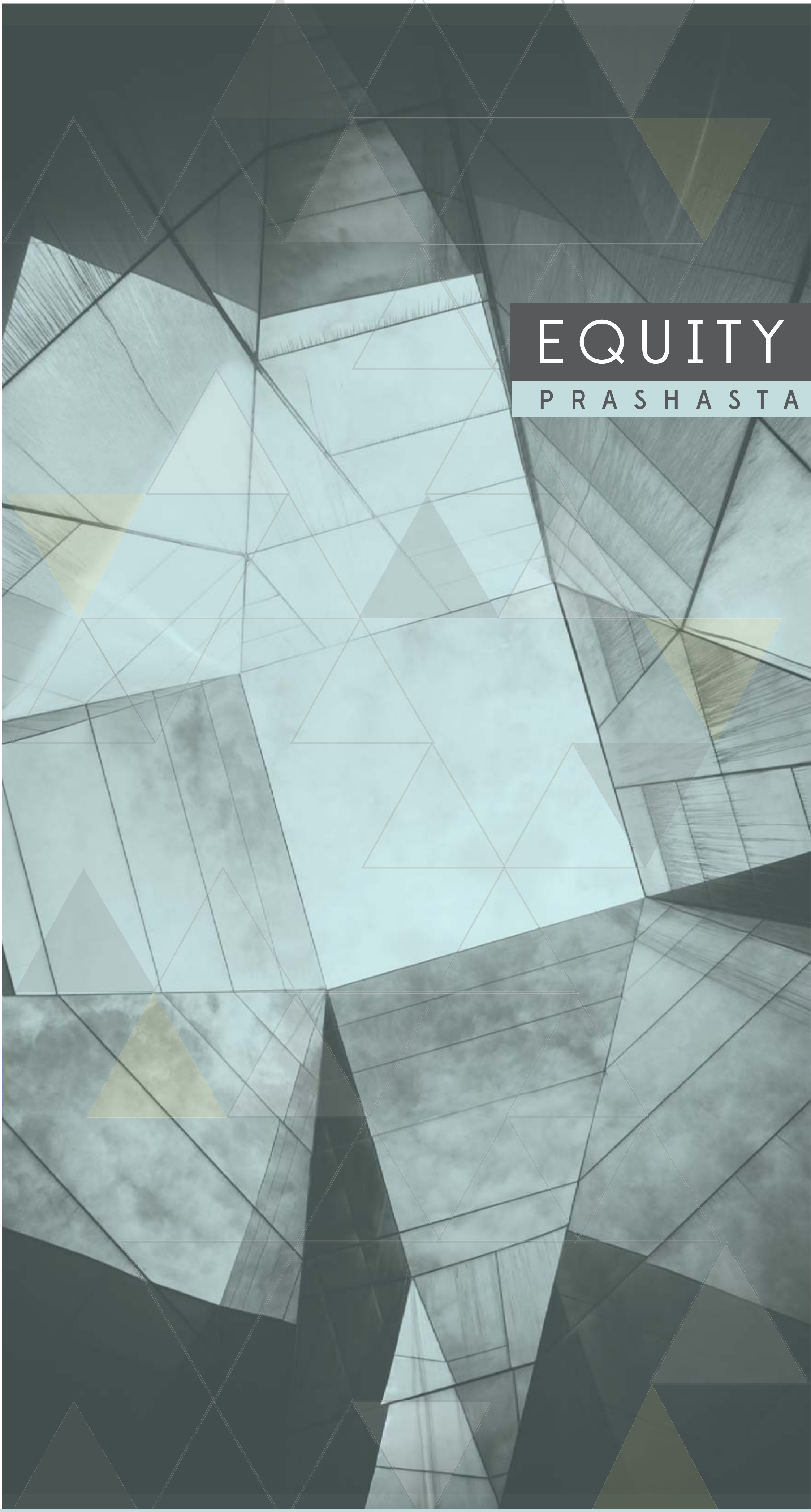
STAYING MEASURED IN EUPHORIC TIME

The world has changed in many ways in 2016 and despite a year of extreme volatility and unexpected turn of events, what has not changed is that, India remains the world's fastest growing large economy. The United States (US) Presidential election outcome and Brexit to an extent signified a departure from the 'status quo' with globalization and immigration being common grievances. The global economy faces a handoff from monetary to fiscal policies in developed markets; a move from globalization to de-globalization, and the evolution of China's foreign exchange regime toward a managed or even free float.

Our approach to the market will be measured as there is a lot of euphoria in certain sectors due to the Trump effect. Markets are overestimating the kind of infrastructure investment and other reforms that the Trump government will be able to achieve. Oil has risen post the Organization of the Petroleum Exporting Countries (OPEC) deal and we expect it to remain at elevated levels for long.

Corporate earnings, Union Budget, rollout of Goods & Services Tax (GST), Rupee movement, fuel prices and Reserve Bank of India (RBI) policy will influence market movement. We expect bond yields to trade in a range-bound manner with little chances of a significant downside in the near term. The trajectory of rate hikes by the Federal Reserve (Fed) will be on investors' radar later in the year. Real estate segment will see increased demand in the affordable housing sector. Correction is likely in hi-value residential and land banks. With skimpy prospective returns expected in most asset classes, we expect more money to flow into Indian equities. Domestic liquidity through Mutual Funds (MFs) and insurance companies is on the rise and a significant part of it is coming from Systematic Investment Plans (SIPs) which now average US$700mn a month. High Networth Money is also creeping in either through Portfolio Management Services (PMS) or Alternative Investment Funds (AIFs). Foreign Portfolio Investors (FPIs) have been net buyers of Indian equities in 21 years out of the last 24 calendar years. Sooner or later, we expect them to be back in India.

AMIT SHAH



EQUITY

PRASHASTA SETH

The year 2016 was a tough year to manage money. Extreme periods of volatility, unexpected turn of events with Brexit happening, Trump winning, demonetisation and no margin of safety available in stocks, made it a difficult year to construct a portfolio.

Will 2017 be a different year? Or will it be as difficult as 2016? These are questions on investors' minds and there are no clear answers as yet. There are positives and negatives as always. The positives that have led to a global rally since Mr. Donald Trump's Presidential election victory include:

- The global economy seems to be on a much stronger footing than over the last few years. Producer price data from China, PMI data from Europe and unemployment rates in US are all pointing to a global economy that has strengthened.

- The global central banking policies continue to be supportive. European Central Bank continues on its quantitative easing spree while US Fed has been extremely cognizant of the impact on the financial markets of any decision that it takes.

- There is renewed optimism on the global reflation with markets betting on the massive fiscal stimulus; big increases in Gross Domestic Product (GDP) growth, corporate profits and jobs; higher inflation than otherwise would have been the case. A rally in metal prices post Trump victory is also heartening.

- In India, the domestic inflows continue to be fairly robust. Inflows in domestic MFs would be in excess of $10bn in 2016; the third year of robust domestic inflows. A significant inflow comes from SIPs, which now total $700mn monthly. This, coupled with other domestic institutions and insurance companies mean a net inflow of $20bn - $25bn annually.

However, there are a host of factors that warrant caution for India as well as other Emerging Markets (EMs):

- Continued up-move in the US dollar index (DXY); the optimism surrounding the US economy and the rising interest rate environment in US has meant that the DXY has now moved to a 14-year high.

- There is a structural move globally on lower trade given the lower demand in developed world. Coupled with this, Donald Trump's stance on international trade pacts (an area in which a President has unusually broad power to take unilateral action), his threat of imposing import duties on goods made in China and Mexico, and the resulting possibility of trade wars are causes for concern.

- China continues to see outflows on the foreign exchange front. In spite of government efforts to stem outflow, China continues to see foreign exchange coming down and reserves are down to $3 trillion. This has led to continuous pressure on Yuan, which has now depreciated by 6.2% over the year pressuring the entire emerging market currencies. Depreciation of Yuan is what triggered a massive sell-off in global markets during the initial months of 2016. Though markets took the same in their stride, this is something that can roil the market during the course of the year.

- Demonetisation has led to a near-term uncertainty in India. Though it's difficult to make a fair estimate of the extent of slowdown that we are seeing because of demonetisation, it's fair to say that the impact will be significant in 2HFY17. The heartening thing is that things haven't collapsed but at the same time it's going to have a double-digit impact on sales which could lead to a much bigger impact on the profitability. Even without the impact of demonetisation, Indian economy is likely to slow down in 2HFY17; an additional impact emanating from demonetisation will make it incrementally harder for companies. Also, the recovery is likely to be gradual as liquidity will take time to normalize. Further, there is uncertainty over future government action, which has again hurt sentiment.

- Rising commodity prices could hurt India as it's a net importer of commodity and also a negative beta play on commodities. In an environment in which commodity prices are moving, India is not a favored destination for FPIs. Given the uncertainty in the Indian economy and higher valuations, there is always a risk that FPIs may choose to be underweight on India at least for the next few quarters.

- Higher interest rates mean that Price Earnings Ratio (PE) expansion might not happen. The entire rally in India from 2013 onwards has been built on PE expansion as interest rates have collapsed. With global yields rising and demonetisation not reaping the kind of windfall gains that was expected, it looks like there is a limited scope for yields to contract over the next few quarters. Thus, any PE rerating is unlikely and the returns have to be driven by earnings growth for which, the visibility at this point is extremely poor.

As a result, it appears, we are in a neutral to negative environment for markets for the next couple of quarters. The markets may most likely consolidate around current levels. What happens to the portfolio strategy and how do portfolios change is another question to think through? Our strategy for most of 2016 was based on the themes of long consumption, short oil and long gold. Each of these themes have behaved the opposite way since Nov 8 and as a result, our portfolios have not performed well in the last couple of months. Given, everything that could go wrong has gone wrong, one would have expected a much worse performance to our portfolio. But here is where our risk management helped. We had been increasing the weightage of IT and Pharma in our portfolios for the last couple of months. This is what saved us as these sectors did well over the last couple of months. Over the last 6 months, as valuations in most of the domestic-focused sectors went through the roof, we increased weightage to defensive sectors like Utilities, Telecom, IT and Pharma. Our cumulative exposure to these sectors has doubled from 16% in beginning of 2016 to 33% in end of December 2016.

Nevertheless, we are under-represented in sectors that have done well – global cyclicals and energy. The key question is if we should increase our weightage in these sectors. Also, we are over-represented in sectors like consumer which are likely to suffer. Should we decrease our exposure to those sectors? We have been grappling with these questions over the last couple of months and though we have been making changes in our strategy, we have refrained from any widespread changes. The reasons for us to stick to our earlier strategy are:

- We think there is a lot of euphoria / pessimism in certain sectors with respect to Trump. This is much akin to what we saw in India a couple of years ago with Mr. Narendra Modi coming in as Prime Minister. In our view, markets are overestimating the kind of infrastructure investment and other reforms that the Trump government will be able to achieve. Examples here have been estimates of investments of up to $1 trillion being made in infrastructure without realizing that the infrastructure in US is a state subject. We do think that this rally will halt and give back some of the gains impacting sectors like global cyclicals that have seen a sharp up-move.

- Similarly, oil has moved up significantly on the OPEC deal to cut output. OPEC members have been notorious in not following the price cuts and at $55 - $60 levels, a lot of shale fields and even Canadian sand oil start becoming viable. Hence, the price up-move is unlikely to sustain post the winter season gains when demand is traditionally high.

- We believe excessive pessimism is being built into Information Technology (IT) stocks on two counts 1) A large section of the industry will die due to changes such as automation and 2) Trump coming in will lead to a much higher operating costs for the industry. We think there is a severe skill shortage in US tech industry and hence Indian technology / Indian software engineers will continue to play a very critical role here. On account of prevailing concerns, we are able to get companies with strong balance sheet and good cash flows at reasonable valuations.

We have been increasing our exposure to Utilities, IT, Pharma and Telecom gradually and would continue to do so. We would be decreasing our relative allocation to financials till we get more clarity on the demand and economic environment in India.

We continue to be under-represented in global cyclicals and energy and would want to see the first few days of Trump administration before taking a call. If these sectors continue to do well and IT continues to underperform on Trump euphoria, our portfolios may underperform the benchmark and peers, which are are severely underweight IT and more bullish on domestic themes.

FIXED INCOME

RITESH JAIN

Markets have generally seen risk-on since US election and new President's announcement. Yet, uncertainty remains over the course of future fiscal and monetary policies, and volatility are likely to persist going ahead. The range of potential economic outcomes is complex and both left and right-tail risks have grown. Pro-growth policies in the U.S., including major infrastructure spending and tax cuts, could support riskier assets. But tougher trade policies could create foreign policy risks, triggering sharp risk-off moves. In addition, Mr. Trump's presidential victory underscores the rise of populism, which has the potential to stoke volatility in 2017. The global economy faces three tricky transitions: a handoff from monetary to fiscal policies in developed markets; a move from globalization to de-globalization, which could create headwinds for productivity and spark inflation; and the evolution of China's foreign exchange regime toward a managed or even free float.

US Treasury moves up sharply

The US 5-Year Treasury yields moved up sharply in the last quarter by over 75 bps from 1.15% at the end of September to about 1.93% by the end of December. The 10 year treasuries during the same period moved by over 84 bps. The Republican sweep of the White House and Congress, coupled with president-elect Donald Trump's promise to unleash a USD 1tn economic stimulus package of tax cuts and infrastructure investments, has caused a seismic shift in global bond markets resulting in huge spike in US treasury yields and global yields. Trump's victory had a significant impact on 2016 asset market returns. Bonds and bond-proxies which had done exceedingly well till 3Q'16, were dealt a blow as investors braced for higher US rates, on the back of recovering inflation, expectations of larger fiscal support and a Fed, that is ready to take further steps towards monetary policy normalization. Emerging markets' outperformance halted, at least temporarily, as flows turned negative. In Fixed Income, the return tables got skewed towards high yield from sovereigns and investment grade as long duration assets were penalized. Long duration underperformed to make 4Q'16 the worst calendar quarter for long duration bonds in the last 20 years. The real story for 2016 was the significant compression in credit spreads; a pronounced divergence from the rating action by agencies.

Finally, the Fed moves again

US data showed stronger-than-expected third quarter growth, higher housing prices in September and a sharp rebound in consumer confidence in November. With the US on the cusp of full employment and inflation gradually approaching the Fed's target, the global rates markets had by mid November already assigned a 100% probability to a Fed boost. As anticipated, the US Fed has raised short-term interest rates by 25 Basis Point (bps) for the second time in a decade and forecast a faster pace of tightening in the coming year, as it responds to a US economy that has been gathering momentum and may receive further stimulus from an expansionary fiscal policy involving higher government spending and Republican tax cuts.

Indian dollar bond credit spreads tightened marginally

Indian Investment Grade Bonds, especially the shorter dated bonds, continued to remain in demand with yields on these bonds widening by only about 40 bps compared to the relevant benchmark, which moved up by about 57 bps during the Q4.

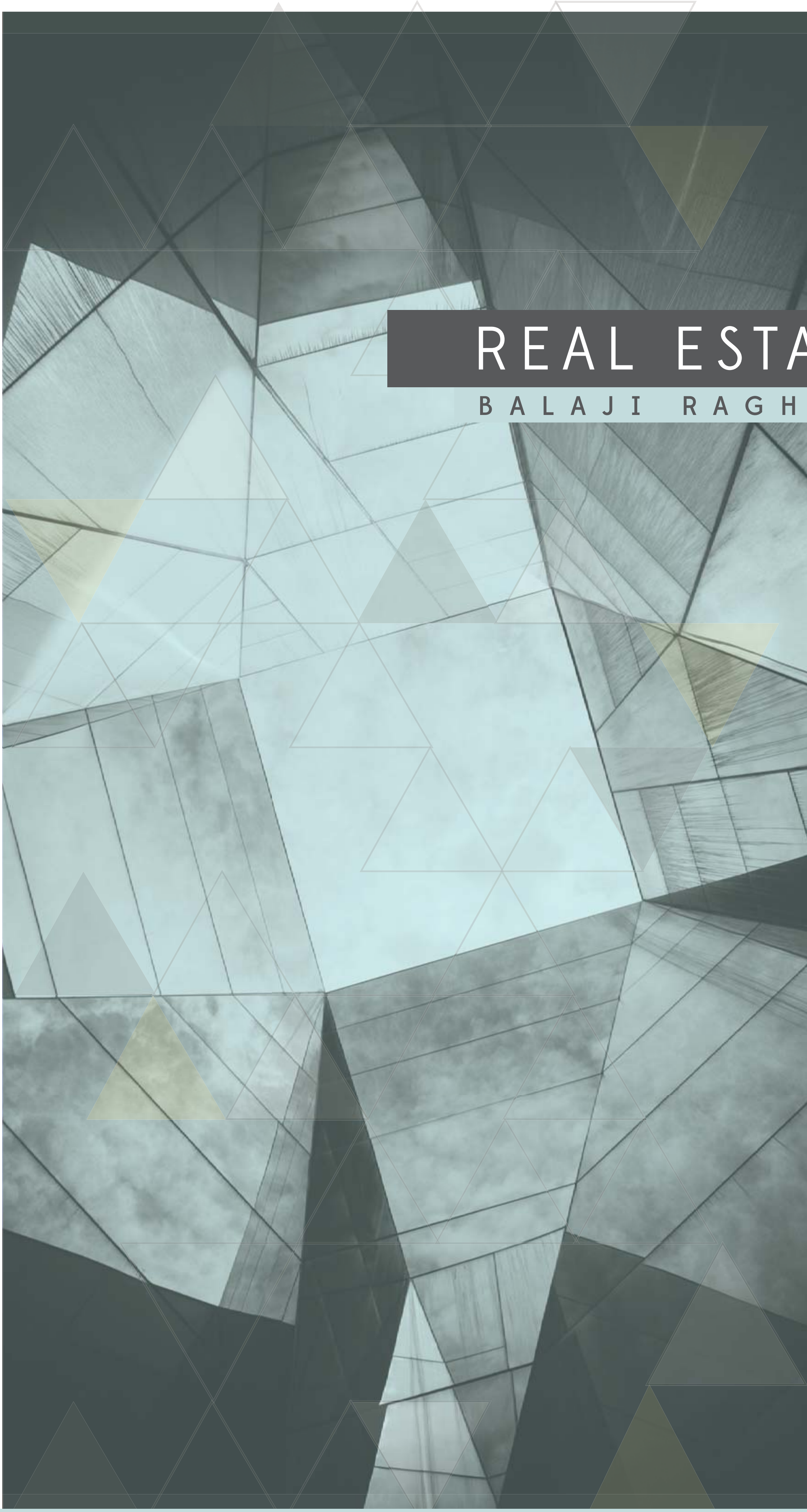
Indian Market

Back home in India, toward the fag end of the year, bond yields started rising again. First, RBI chose not to cut rates in its December policy; against market expectations of a 'minimum' 25 bps given the anticipated growth impact of demonetisation. RBI sounded reasonably hawkish, assessing that growth effects were likely to be transitory and noting risks to inflation. Secondly, the US Fed hiked rate as per expectations, and sounded more hawkish. 2016 saw local bond yields crashing to yearly lows amidst both domestic and international events and changing macro-economic dynamics. After starting on a shaky note, the year proved to be quite rewarding in the fixed income space. Budget 2016 was a positive surprise with Govt's renewed focus on fiscal consolidation. With the onslaught of April 2016 policy, RBI changed its liquidity stance from negative to neutral/positive and triggered buyback of bonds from the market [Open Market Operation (OMO)]. These factors not only facilitated comfortable absorption of bond supply, but also allowed yield curve to settle lower. The announcement of no-extension for RBI Governor Raghuram Rajan triggered the next bout of the rally in bonds, as participants started looking forward to a relatively dovish new governor. Next came Brexit wherein expectations increased that global central banks would turn more dovish in order to support growth.

The Outlook

After Brexit referendum, the election of Trump provided rude shocks to global bond markets. Markets are waiting nervously to see what Mr. Trump's plan of action. Increase in trade protectionism and an upsurge in corporate defaults if Fed raises rates will offset Trump's reflation policies. These are some of the risks, which may lead to a consistent outflow of foreign funds from emerging markets including India and push bond yields higher. Global crude oil prices have surged to their highest level since July 2015 and further increase in oil prices may dampen market sentiment. The trajectory of rate hikes by the Fed will be on investors' radar, with the U.S. central bank projecting three hikes next year. In the Euro-Zone after Italy's referendum vote, markets anticipate Europe to deliver more blows. France, Germany and the Netherlands will hold elections, just as support for populist candidates is swelling. On the domestic front, the upcoming budget 2017 followed by the RBI policy likely to set the tone for the year.

We expect bond yields to trade with a bearish bias in the first half, and then settling in line with the evolving dynamics. However, all this uncertainty can also provide great investment opportunities. We shall continue to watch out for major events that might impact the credit and rate markets.



REAL ESTATE

BALAJI RAGHAVAN

The year 2016 has been a year of transition for the real estate sector, with several policy initiatives aimed at making the sector more organized, formal and mature. The significant events of 2016 impacting the sector are listed below:

1) **Real Estate Regulatory Act (RERA)**
The Real Estate (Regulation and Development) Act, 2016, which came into force in March 2016, aims to enhance transparency, bring greater accountability, set disclosure norms to protect the interest of all stakeholders and also ensure speedy execution of property disputes in due course.

2) **Boost to affordable housing construction**
In a bid to promote affordable housing, the Honourable Finance Minister proposed 100% deduction in profits to an undertaking from a housing project for flats up to 30 sq. meters in four metro cities and 60 sq. meters in other cities, which are approved during June 2016 to March 2019. Another condition was that the project should be completed within three years of grant of approval.

3) **Interest subsidy to home buyers**
To stimulate housing demand from first-time home buyers, the Union Budget 2016-17 also proposed deduction of additional interest of Indian National Rupee (INR) 50,000 per annum for first time home buyers, for loans up to INR 35-50 lakhs sanctioned during the next financial year.

4) **Benami Transactions Act**
The Benami Transactions (Prohibition) Amendment Act, establishes a regulatory mechanism to deal with disputes arising with such transactions and levying penalties as needed to increase the institution investor participation and regulating the sector with an aim to make India an attractive investment destination.

5) **Service tax exemption**
Exemption of service tax on construction of affordable houses up to 60 square meters under any scheme of the Central or State Government including PPP schemes will further propel construction in affordable segment across India and encourage greater collaboration between the public and private sector as well as participation in affordable home construction.

6) **DDT exemption**
The Union Budget 2016-17 exempted any distribution made out of the income of the Special Purpose Vehicles (SPVs) to the Real Estate Investment Trusts (REIT) and Infrastructure Investment Trusts (InvIT) from the levy of Dividend Distribution Tax (DDT). This paved the way for the REIT model to become financially viable for retail investors.

7) **Goods and Services Tax**
Goods and Services Tax (GST) is a positive move towards simplification of Indian tax system. However, the real estate industry is still awaiting clarity, also if the implementation of GST will subsume

existing service tax and value added tax (VAT) which are levied for under construction projects currently.

8) **Demonetisation**
The recent demonetisation by Honourable Prime Minister is perceived as a significant reform. In the long run, this measure along with RERA will align the real estate sector to the international standards of doing business resulting in more fund flow from institutional investors, banks and higher unit sales

9) **PRS for foreign investors**
The Union Cabinet approved the grant of Permanent Residency Status (PRS) to foreign investors subject to various conditions and with a provision for renewal for another 10 years. As PRS allows the holders' spouse/dependents to take up employment in India as well as the purchase of one residential property for end-use, the end user pool, mainly for high-end and luxury segment products stands increased which can promote the asset class in a big way.

Outlook

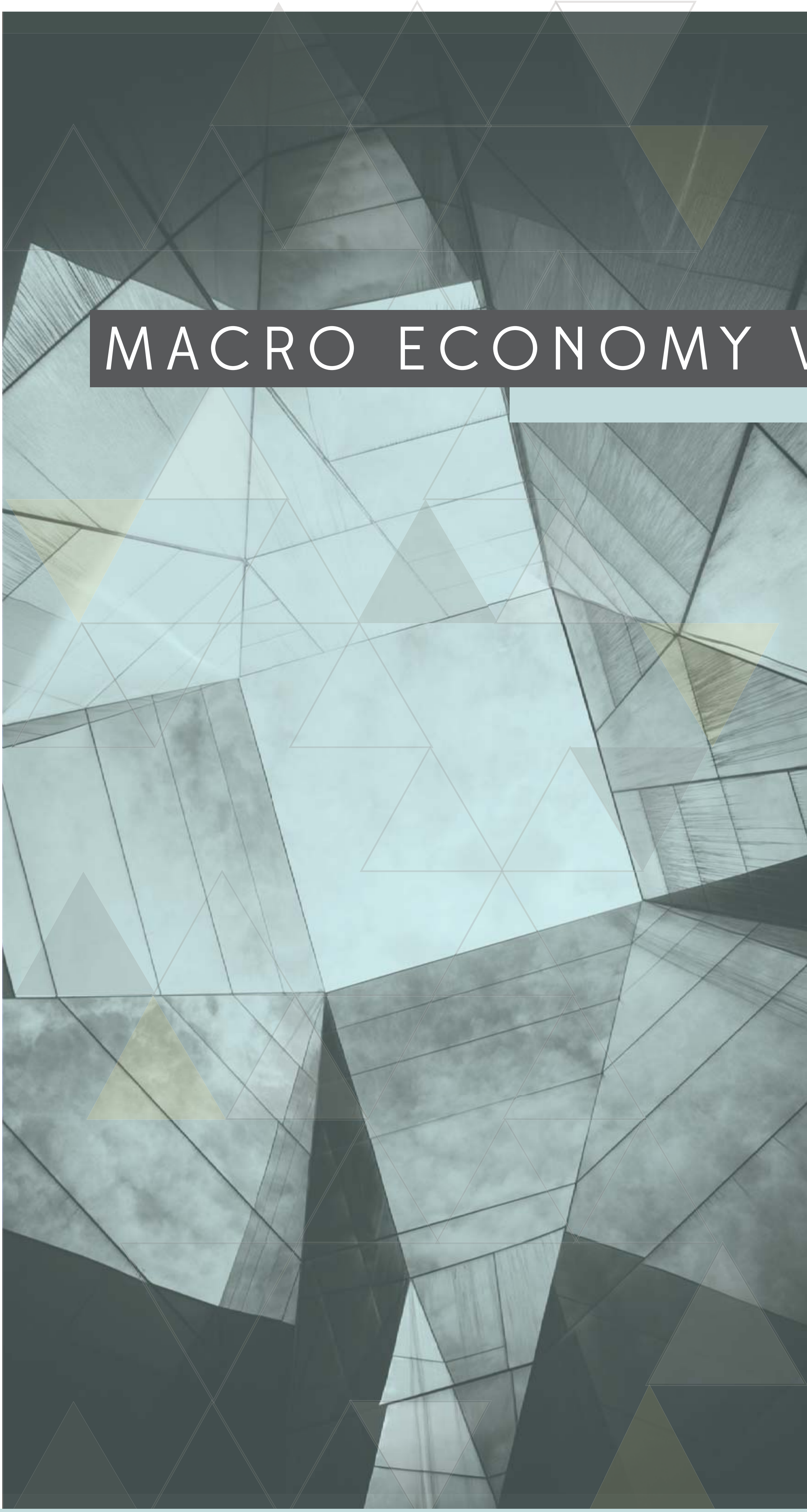
Although 2017, began with subdued sentiments, the year will reap the positive impact of demonetisation along with improvement in sales.

- Correction is expected in certain segments, like the Hi- Value Residential & Land Banks. However, we are yet to witness any transactions indicating the same.

- End users are showing interest in the affordable segment. Transactions have been slow, though more traction is expected especially with anticipated decrease in interest rates and awaited tax -breaks for homebuyers in the budget.

In the medium to long term, given the measures announced by the government, combined with interest subsidy, demand in the affordable housing sector will increase. On the supply side, Foreign Direct Investment (FDI), RERA and government reforms will provide the necessary impetus for developers to undertake more efforts to increase affordability and develop large projects. The awaited RERA is anticipated to be a beneficial initiative, with a promise to enhance transparency and simplicity in the buying process for both, developers and buyers.

MACRO ECONOMY VIEW

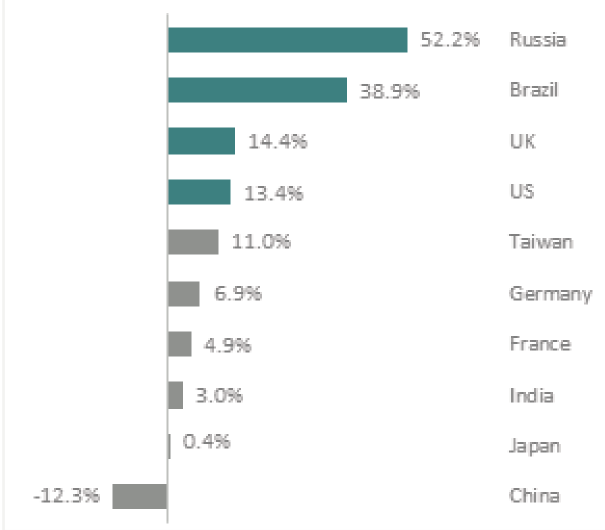


LOOKING BACK

The year 2016 will go down in history as one of the most eventful and unexpected years not just for India but also for rest of the world. There was no dearth of events and markets remained on tenterhooks. The first half of the year was mainly dominated by fears of Brexit and Chinese slowdown and its fallout on global economy and trade. Global markets, including India, saw a sharp rebound in the months post April as the fears seemed unfounded and too premature. The macro situation saw improvement with both US and Euro zone reporting better than expected economic indicators and all focus shifted to the US Presidential elections. Thereafter, there was the surprise move of not extending the tenure of RBI Governor Raghuram Rajan and replacing him with Urijit Patel. Hopes of a rate cut from the new governor and better than expected macro numbers helped in stemming any fall in the domestic markets.

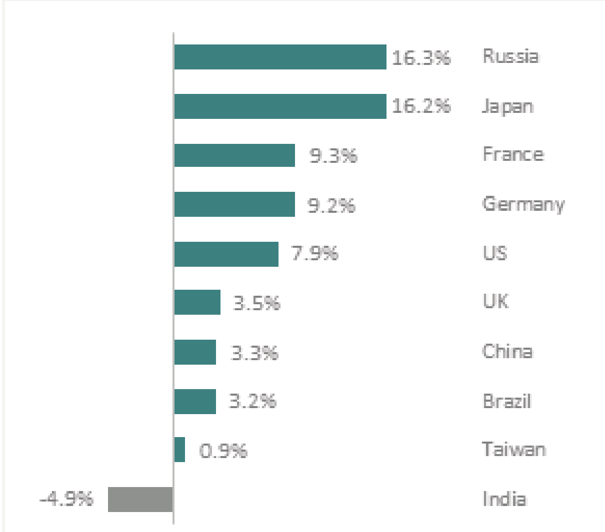
The last two months of 2016 had major surprise elements, which wiped off most of the calendar year gains in emerging markets especially India. First was the surprise win of Donald Trump in the US Presidential elections. His comments and views of reviving the American investment cycle and driving growth in domestic economy led to rally in equity markets in developed economies and rout in bond markets. Emerging markets saw consistent outflows since then due to his protectionist views. To add to it was the demonetisation announced on Nov 8, 2016, which triggered further outflows on fears of GDP slowdown and earnings uncertainty. This led to India becoming one of the worst performing markets globally in the last quarter of CY2016.

Performance of global indices in CY2016



Source: Bloomberg, IIFL Research; data as on 31st Dec 2016

Performance of global indices in the last 3 months

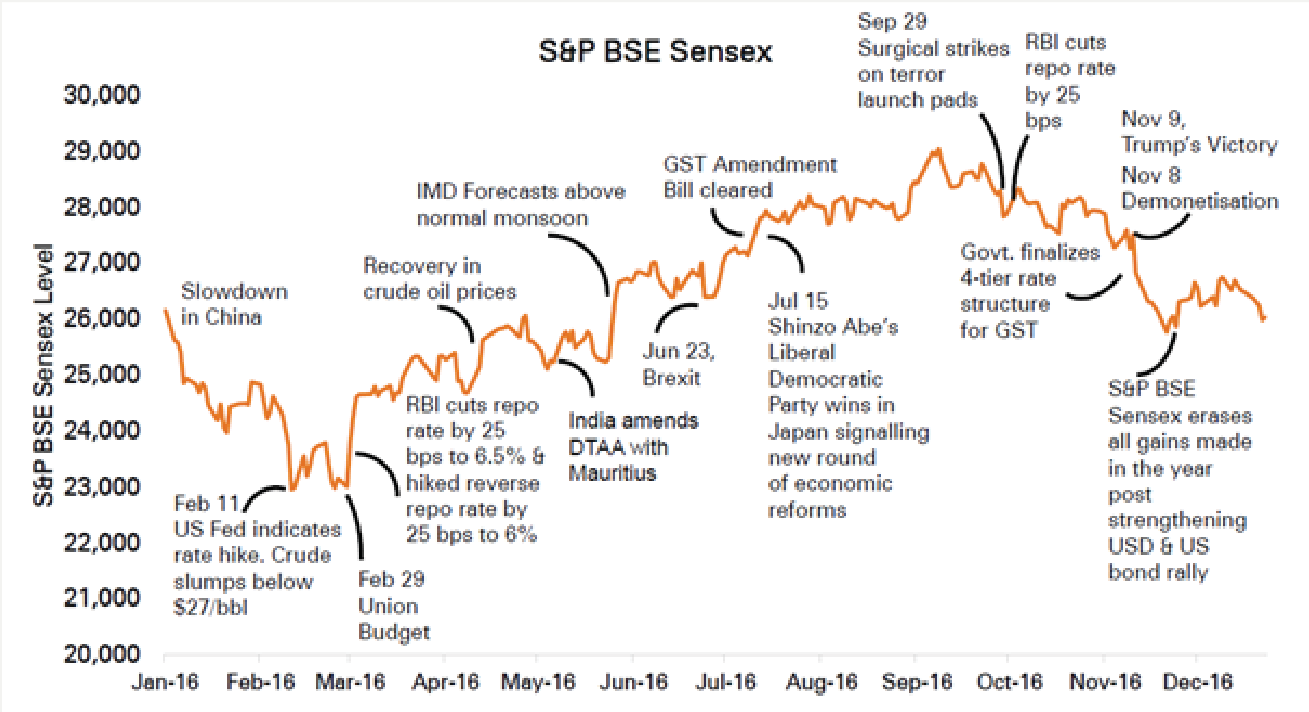


Source: Bloomberg, IIFL Research; data as on 31st Dec 2016

The backdrop has changed dramatically in the last two months of 2016 to say the least. A couple of months back, the macro situation for India was quite favourable (low commodity prices, declining interest rates, narrowing deficits, a stable currency and a benign global economic situation), along with growing hopes of a strong revival in corporate earnings in H2FY2017. However, the Government's surprise move to demonetise 86% of high denomination currency led to a sudden disruption in consumer demand, making FY17 a washout year for growth in corporate earnings.

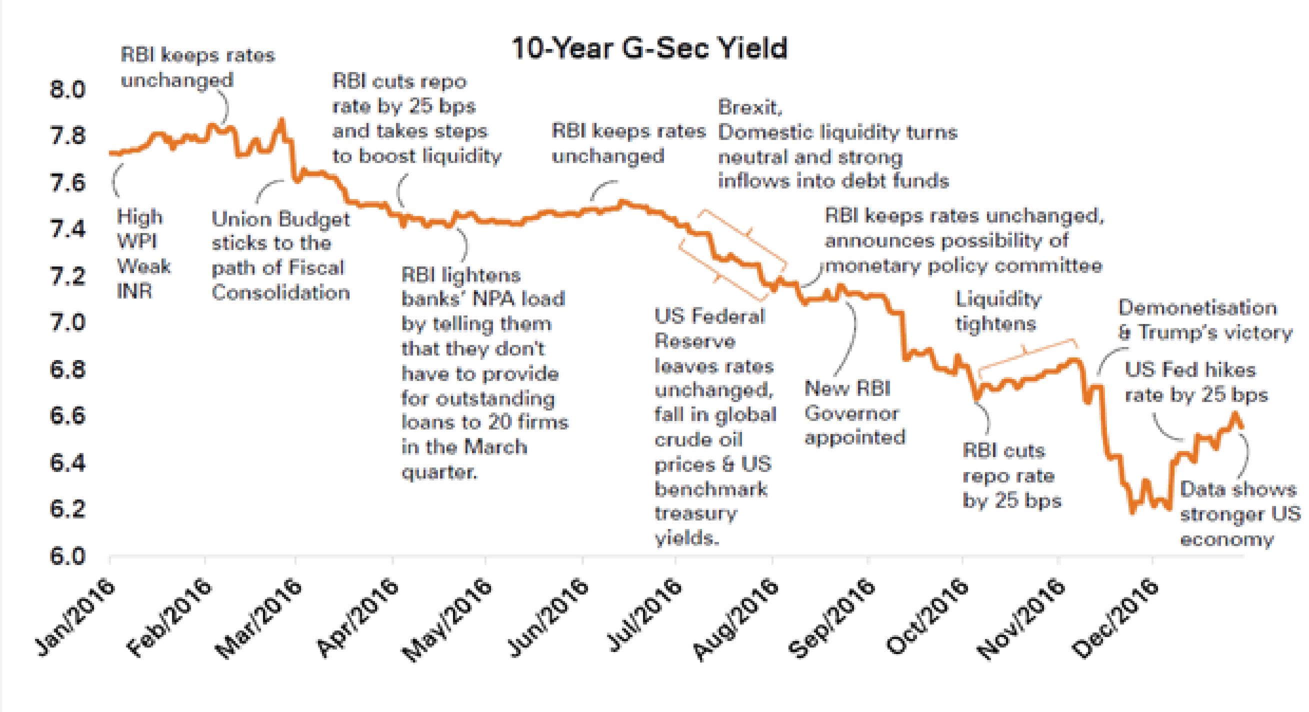
As seen from the graph of sectoral indices performance during last quarter of 2016, almost all sectors, barring the commodity sectors (Oil & Gas and Metals), have seen a washout. Healthcare and Real Estate were two sectors, which saw additional sell-off in the last quarter post the US elections as fears of protectionism and generic drug pricing investigations were on investors' mind. Also, demonetisation impact hurting real estate sales led to pessimism in Real Estate stocks. Commodity prices (including crude oil) are firming up and would further hurt profitability of the Indian businesses, besides adversely impacting government finances. If that wasn't enough, the global environment has turned uncertain, underscored by a rout in bond markets and flow of money reversing out of the emerging markets (EM).

Indian Equity markets in 2016



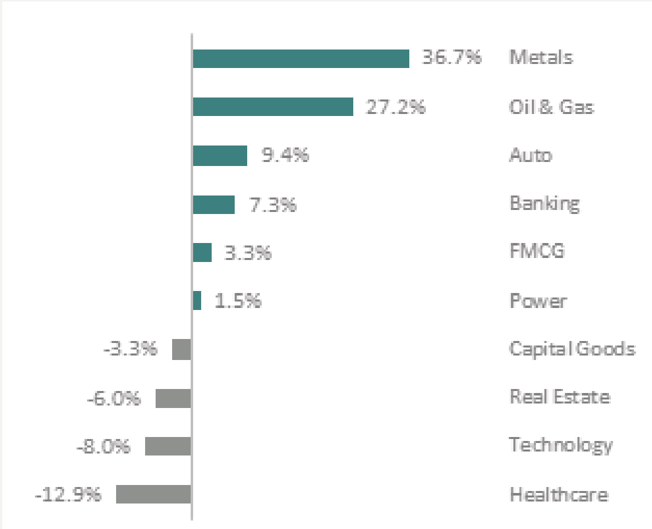
Source: Industry reports

Indian Debt markets in 2016

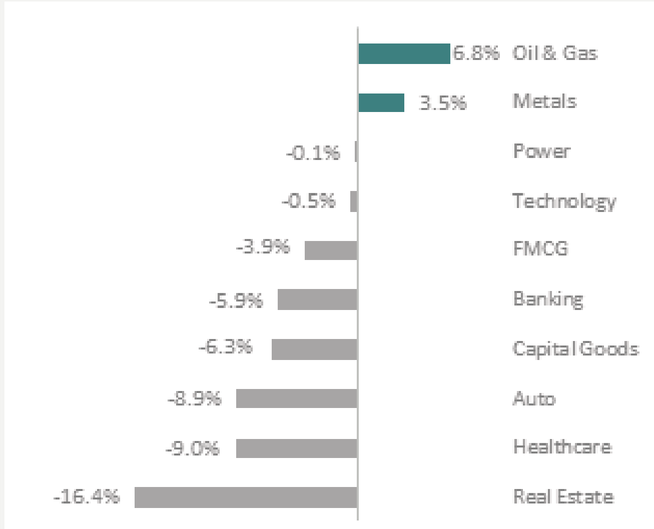


Source: Industry reports

Sectoral performance during 2016



Sectoral performance in December quarter



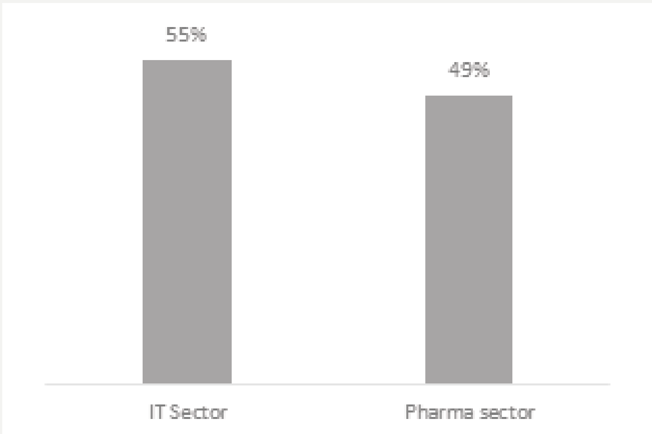
Source: Bloomberg, IIFL Research

Expectations are running high on US President Donald Trump's ability to roll out an effective fiscal policy framework (key proposals would include cut in corporate taxes, huge investment in infra) that would provide enough stimulus to the US economy and take the US GDP growth to 3-4%. However, expecting the new US President to quickly come out with a resurrection plan, followed by the US Congress not delaying or diluting the proposals, and expecting immediate benefits from fiscal policies is perhaps too optimistic.

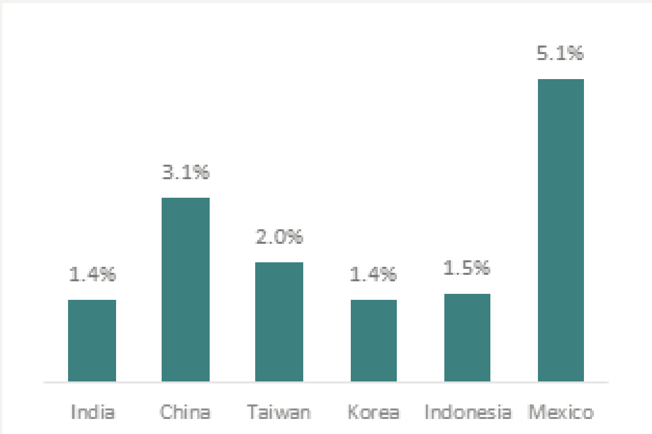
We believe what could really hurt the global trade balance is the protectionism policies which, Mr. Trump has been advocating all through his campaign. Bringing back the manufacturing jobs to America has been his focus. Though India would be less impacted as far as manufacturing is concerned, IT and Pharma are two sectors, which could hurt Indian companies. India has historically been the largest recipient of H1B visas, granted to technology workers for IT-related work in the US. While we don't expect caps on the number of visas issued to Indian firms, the possibility of increasing minimum wages for an IT worker under H1B in the US could hurt margins and reduce pricing competitiveness.

Pharma is the other sector, which faces headwinds post the election of Trump. US is the largest export market for generic drug-makers in India. Initially, high drug prices were on Hillary Clinton's campaign agenda, but Trump has more recently voiced his concerns. The extent of pricing pressure in the base business and stricter compliance with US Food and Drug Administration (FDA) guidelines will be the key catalysts for Indian firms with presence in the US. We expect pricing pressure on base businesses to remain high, but a strong product mix and consistent new launches can mitigate this impact. FDA scrutiny has become more rigorous and Indian companies need to be more proactive to remain compliant.

US exposure in IT and Pharma sector



Exports to US as a % of GDP

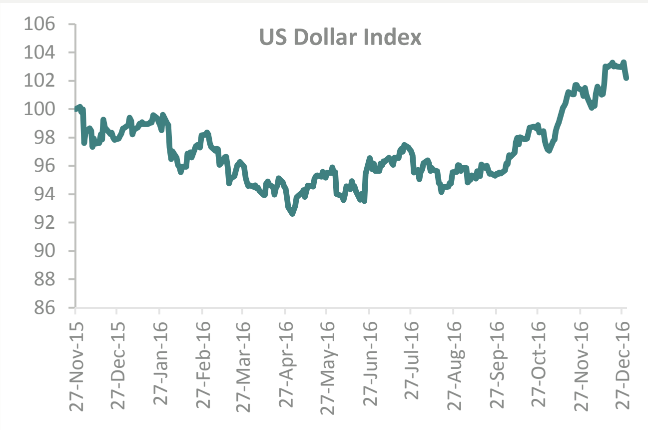


Strong US economy could boost dollar index and hurt EMs; India could be relatively less impacted

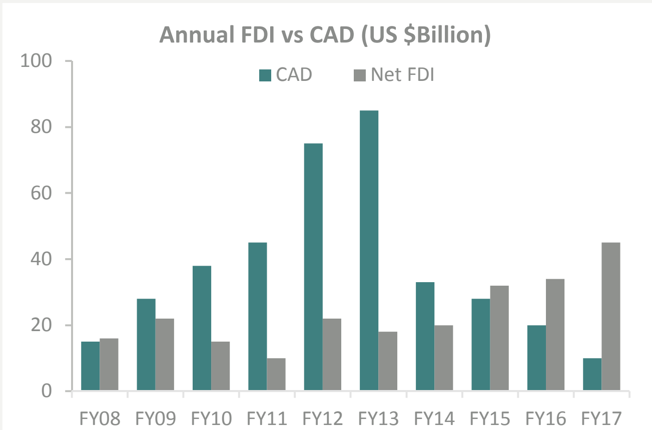
The dollar index saw a strong rally during the year on the back of strong expectations of rate hikes by the US Federal Reserve. The US dollar could further continue to strengthen in 2017 against other currencies considering the fact that the US Fed has raised its guidance on rate hikes to three than two which, was earlier expected, however, the tone for rate hikes is gradual. Although, markets are pessimistic with regards to the three rate hikes in 2017, there is no denial of the fact that the US economy has gained strength and rebounded strongly following a weak first-half performance, with output growth trending around 2% YoY through the third quarter. Consumer spending and housing activity are leading the way, underpinned by a robust job market and rising income gains. Labour market conditions continue to tighten, with the unemployment rate holding below 5%, and wages posting their biggest gains since 2009. Retail sales, and motor vehicle purchases are on improving grounds and consumer confidence is near a decade high.

US interest rates and continued low-interest rates in other developed countries will likely lead to a stronger US dollar, which in turn would pressure overseas profits and create headwinds for EMs particularly Brazil, China and Russia, which statistically have the highest negative correlation to the dollar. India would be relatively less impacted as its Balance of Payments (BoP) position has improved significantly with FDI now higher than its current account deficit of US$ 15bn. Rising oil prices pose a risk, with every US$1/bbl increase impacting India's Current Account Deficit (CAD) by US$1bn. Even at US$60/bbl, India's CAD is unlikely to go higher than US$40bn and will remain covered by FDI. Recent crackdown against black money could bring down gold imports, which, could help India's CAD.

Surging Dollar Index has been worrying



India's higher FDI gives it cushion over CAD



Budget 2017: Expectations run high on fiscal consolidation and developmental projects

The Budget is always a tightrope walk for the government as it needs to balance fiscal deficit and spending growth. Given limited resources, we believe the focus will be more on social infra (viz housing and infra) this time. A combination of gains from demonetisation and a partial relaxation of the fiscal roadmap should enable the government to raise its overall spend by Rs2tn YoY in FY18, ie the same jump as the last year. This higher spend would only be an internal reallocation of funds and not a net boost to the economy as the overall fiscal deficit should still reduce YoY.

Key expectations from the budget are mostly on the social spending side. These include:

- The priorities of the government are likely to be Housing for All, irrigation, rural development and a continued capex push for railways and roads.

- We expect the government to double the Housing for All allocation to Rs400bn+ in FY18 with a bigger jump likely in the scheme's urban component.

- The total expenditure on rural/agri schemes (roads, jobs, irrigation, crop insurance, etc ex-housing) in FY17 was budgeted at Rs1.0tn, or +15% YoY. The allocations here are likely to be stepped up by another 15-20%.

- Off-balance sheet funding [viz market borrowing by National Highways Authority of India (NHAI), Indian Railways Finance Corporation (IRFC), National Housing Bank (NHB), etc] is also likely to be a funding source for infrastructure/social spend.

- We expect no meaningful jump in Public Sector Undertaking (PSU) bank recapitalisation.

On the whole, we believe the government will drive capex in the economy, which in turn will trigger the return of private capex which is yet to pick up.

Political landscape to be eventful in Q1CY2017; could set the mood on the street

In the first quarter of CY2017, we have assembly elections in the states of Uttar Pradesh (UP), Punjab, Goa, Uttarakhand and Manipur. Among these, UP elections is the most interesting and would be an important litmus test for Mr Modi's popularity post the demonetisation announcement. Also, UP has the largest seat share in both the houses of the parliament (13% of Upper House and 25% of Lower House).

Bharatiya Janata Party's (BJP) performance in previous UP state elections in 2012 was weak (12% seats in state) but the party hopes to significantly scale up its presence in 2017. Two major events in 4QCY16 - the 'surgical strike' against Pakistan and demonetisation - have significantly impacted the political landscape. UP was one of the key reasons for the BJP securing an absolute majority during the May 2014 general election. It has complex caste equations, a large population of poor people and a big trader community. The UP election may be taken as a referendum on the BJP-run central government's performance so far, especially on the demonetisation move.

Outcome of the elections would play an important role in setting the mood for the street. Any strong show from BJP could be seen positively by the investor community as a sign of continuity of government at the centre beyond 2019. The recent opinion polls suggest that BJP is the largest party in UP. The split in the ruling Samajwadi Party (SP) has also improved BJP's prospects.

Despite a wave of state elections in early 2017, the upper house situation is unlikely to significantly change until mid-2018, with BJP and allies remaining in the minority. The next most important elections will take place in December 2017 (Gujarat - Modi's home state), followed by several "semi-final" elections in 2018 (Karnataka, Madhya Pradesh, Rajasthan). This implies that mid-2017 (March-September) may be the last stretch to push through significant reform action.

Revival from the impact of demonetisation

2017 was expected to be the year when growth accelerates past the 8% mark led by a confluence of factors: strong rural demand post a good monsoon; revival in urban consumption on the back of pay commission payouts; lower interest rates and lower commodity prices; and gradual revival in the capex cycle as utilisation levels inch up. Instead, we are faced with the fog of demonetisation. It is difficult to project how much and how long demonetisation will affect the economy. However, the general expectation that demonetisation will have a transient impact and that activity will revert to the earlier trend within a quarter or two is highly optimistic, in our view. We believe, the impact of demonetisation on the economy, is playing through the following three channels and liquidity is just one of those:

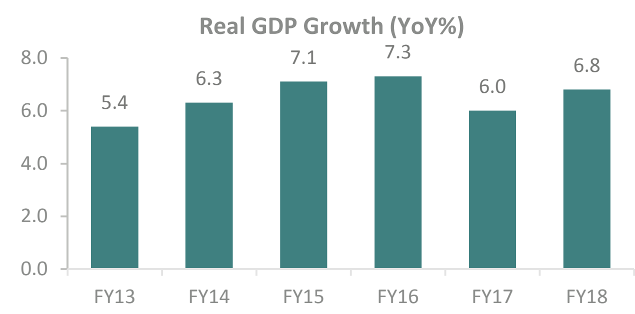
- **Dried up liquidity:** This was the immediate impact of demonetisation. For many households and businesses that transact predominantly in cash, their medium of exchange as well as their store of wealth evaporated overnight. This is a transient impact on the economy as liquidity will be restored over a period and in many cases people will move on to other forms of transacting (electronic payments, cheques etc).

- **Loss of income due to hit to trade:** The consequence of loss of liquidity has resulted in trade (manufacturing as well as services) being impacted. Our visits to various parts of the country in early December suggested that business was down 20-80% across categories in November. Loss of trade means loss of income to the entire value chain, which includes small businesses and casual labour.

- **Loss of confidence due to policy uncertainty:** The third source of impact on the economy is loss of confidence among businesses due to uncertainty over future policy action. Without doubt, policies designed to crack down on businesses that evade taxes are necessary from a social/moral perspective, in short-run

- businesses that have operated by avoiding taxes and have been disrupted. Unless, things revert to 'status quo ante' (a highly unlikely scenario, given the government's pronouncements so far), these disrupted businesses will take time to reorganize themselves either in the same businesses or in different sectors.

Thus, it seems to us that on balance, economic activity will not revert to the earlier trend immediately after liquidity is restored. We do not believe that this changes (for the worse) longer-term growth outlook for India either. It is just that recovery from demonetisation-led slowdown is likely to be gradual with growth estimates taking a hit even in FY18 and not just in 3QFY17. Accordingly, we expect FY18 GDP growth [Gross Value Added (GVA) basis] at around 6.8% as against 8% estimated earlier. Further, unlike in a normal year when the confidence level associated with this projection tends to be high, confidence level associated with any macro projection is relatively low due to what we call the 'fog of demonetisation'.

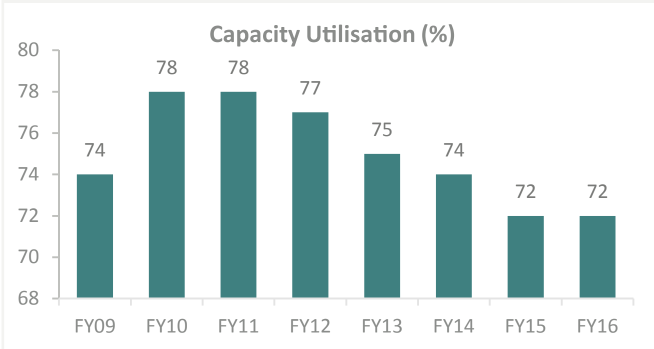


Although both consumption and investments are likely to suffer in this slowdown, the impact will be disproportionate on consumption. Within consumption, both staples as well as discretionary consumption are likely to be affected although the impact will be relatively small in case of staples. Slowdown in sectors such as construction and smaller business will keep wages depressed in the unorganised sectors. This will affect lower-ticket consumption. In addition to loss of income, weak sentiment and a desire to remain below the radar of tax authorities might hurt higher-ticket discretionary consumption in the near term.

Rural wage growth has been flat for last 2 years in real terms

Source: CMIE, IIFL Research

Capacity utilization is at eight-year low



Source: CMIE, IIFL Research

The government will try to offset some of this drag through higher public spending.

However, given the divergent demands on the fiscal next year of higher rural spending, lower taxes, and infrastructure spending, it is not clear what the government will prioritise. That said, given that there are no major state elections after the first quarter of the year until late 2018, there is a chance that the government will prioritise public investments in the upcoming budget.

Earnings: Downgrade cycle likely to continue

The last few weeks have seen acceleration in earnings downgrades for FY17 and FY18. While for FY17 consensus estimates have seen ~3% cut, earnings downgrades have been modest in aggregate for FY18 at just around 1%. This is not surprising, given deterioration in growth outlook following demonetisation.

However, what is surprising is that consensus estimates imply a sharp rebound in earnings growth of 20% in FY18 for BSE100 companies. Even excluding PSU banks and metals, earnings growth is expected to accelerate from 9% in FY17e to 16% in FY18e. Thus, FY18 earnings estimates are significantly higher than nominal GDP growth (~10-11%) with the added drag from demonetisation. It is almost as if the market is expecting next-to-zero impact of demonetisation on growth in FY18 with some bit of lost growth in 3Q and 4Q of FY17 being recouped. Given our expectation of only a gradual recovery from the demonetisation-driven downturn, with FY18 growth also taking a hit, consensus earnings estimates appear overly optimistic. It would not surprise us if FY18 earnings growth eventually drops to single digits. Thus, FY18 will mark the seventh consecutive year in which we will witness an earnings downgrade in aggregate.

Consensus estimates imply limited impact of demonetisation

Consensus Earnings Per Share (EPS) change (%)	30th Sept – 8th Nov		8th Nov – 31st Dec	
	FY17	FY18	FY17	FY18
Sensex	(1.9)	(1.5)	(3.4)	(0.2)
Nifty	(1.1)	(1.0)	(2.9)	(0.3)
BSE100	0.3	(0.8)	(3.0)	(0.6)

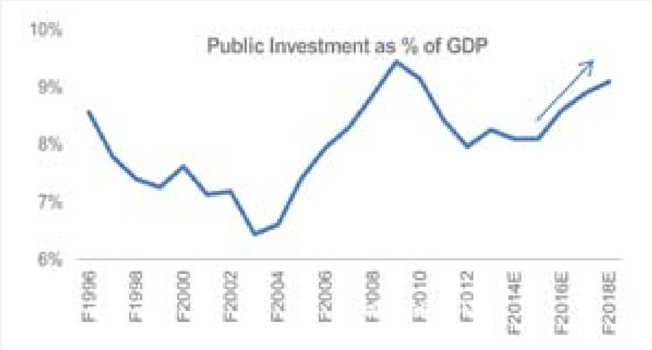
Source: Bloomberg, IIFL Research; data as on 31st Dec 2016

Private Capex pick-up likely only in 2018

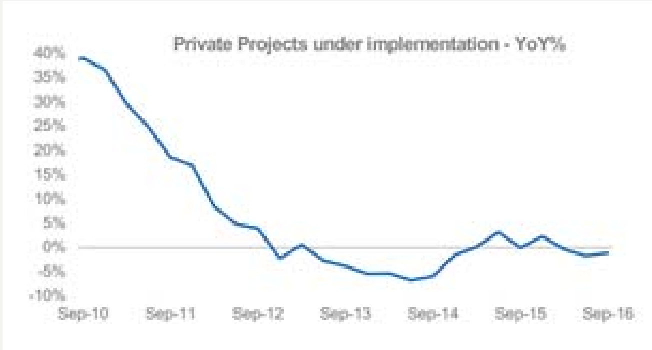
We expect private capex growth to be weak in 2017 while the government continues to push public capex in infrastructure. The private capex recovery will be held back for one more year in view of low industry capacity utilization, plus the weak balance sheets of PSU banks and select industrial sectors. We believe that, in the initial period, capacity utilization levels will pick up as consumption demand recovers after the near-term hit from the demonetisation and as external demand stabilizes. We expect corporate profitability to improve with a better trend in inflation. This will create the base for private corporate capex to pick-up meaningfully. We expect private capex to stabilize at low levels in the coming months and a full-fledged recovery to take place from early 2018. 2018 should be first year of recovery in private capex after six years of a weak trend.

year. Nifty is trading at ~20x on trailing PE basis, broadly the same at the start of last year and almost 1 Standard Deviation (SD) above its long-term average.

Public capex expected to remain robust



Private capex remains weak, recovery expected in 2018



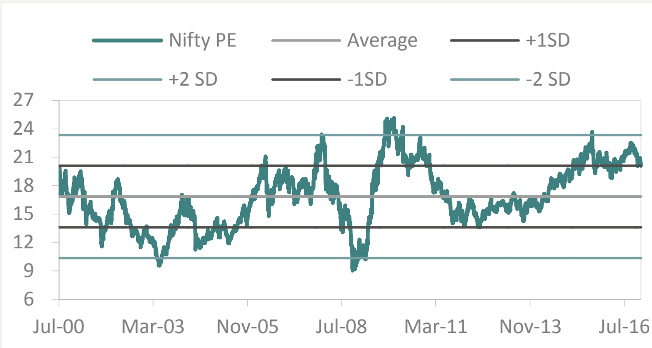
Source: CMIE, IIFL Research

Valuations reasonable, scope for re-rating

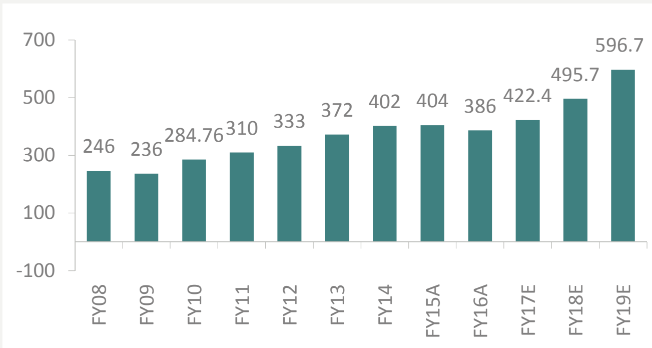
Aggregate market valuations have corrected in the last few weeks as the market has fallen ~9% from its high in September-2016. However, despite this, starting valuations this year are broadly comparable to those at the start of last

Similarly, the broader BSE100 Index is trading at around 21x on trailing PE basis, just over 1SD above its long-term average but higher than the level at the close of 2015. However, what has changed significantly is the domestic cost of capital. Seen in this context, aggregate market valuations look more reasonable.

NIFTY PE chart



NIFTY EPS



Source: Bloomberg, IIFL Research

Yield on the benchmark 10-year government bond has fallen 125bps through the course of 2016. Consequently, valuations look reasonable, adjusted for lower cost of capital. However, the macro environment for India is the exact opposite of what it has been in the past few years, which have been characterized by an improving Indian economy and a benign global liquidity/risk environment that resulted in people paying up for growth certainty, leading to rerating of Indian stocks. However, in 2017, the backdrop is of an uncertain domestic growth environment and less benign global liquidity environment with US interest rates likely to increase further.

Thus, it appears likely that valuation multiples might compress in the face of this uncertainty. On the flipside, this will probably create an opportunity to buy stocks aggressively as the macro picture becomes clear at some point during the year, hopefully at valuations that are more reasonable.

Rupee: Well above long term average

Indian rupee has been among the best performing currencies in emerging markets in the past few years. It has outperformed a basket of EM currencies by 1 Percentage Point (PPT) in 2016 on top of a ~20ppt outperformance in 2015 and ~12ppt outperformance in 2014. This reflects a combination of modest current account deficit and buoyant capital flows requiring RBI to absorb the excess capital flows to prevent appreciation in the exchange rate.

A consequence of these excess capital flows has been the appreciation of INR relative to its trading partners. On a real effective exchange rate (REER) basis, INR is currently well above its long-term average.

Source: Bloomberg, IIFL Research

FOOTPRINTS OF IIFL WEALTH GROUP

IIFL SINGAPORE

IIFL Securities Pte Ltd.,
6 Shenton Way
Oue Downtown 2 # 18-08B
Singapore 049319
Tel: +65 6511 6160

IIFL HONG KONG

IIFL Private Wealth Hong Kong Ltd.
Suite 2105, Level 21, The Centre
99 Queen's Road, Central
Hong Kong
Tel: +852 3975 2622

IIFL UAE

IIFL Private Wealth Management (Dubai) Ltd.
DIFC, 808 Liberty House,
P.O. Box 115064,
Dubai, UAE
Tel: +971 4 3863661

IIFL UK

IIFL WEALTH (UK) LTD
45, King William Street,
Suit no 121, 1st Floor,
London, EC4R 9AN
Tel: +44 207 993 6929

IIFL SWITZERLAND

IIFL Private Wealth (Suisse) Ltd.,
3 Rue La Croix, D'Or,
1204 Geneva
Switzerland
Tel: +41 22 310 99 90

IIFL USA

IIFL Inc.
Hippodrome,
1120 Avenue of The Americas, Suite 1502,
New York, 10036
Tel: +1 212 221 6800

IIFL USA

IIFL Inc.
1980 Post Oak Blvd, Suite 1500,
Houston,
Texas 77056
Tel: +1 713 360 4882

IIFL MAURITIUS

IIFL Private Wealth Management (Mauritius) Ltd
Le Caudan, 530, 5th Floor,
Barkly Wharf, Port Louis
Republic of Mauritius
Board: +230 210 3486/4078
Fax: +230 210 4624

IIFL INDIA

IIFL Wealth Management Ltd ,
7th Floor, IIFL Centre,
Kamala Mills Compound, Senapati Bapat Marg,
Lower Parel, Mumbai 400 013.
Board Line: +91 22 3958 5600
Fax: +91 4646 4706

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IIFL Asset Management Limited (hereinafter referred as IIFLAMC), a Company incorporated under Companies Act, 1956, is the Investment Manager for Schemes of IIFL Mutual Fund, IIFL Alternative Investment Funds and also provides Portfolio Management Services.

Contact Details:
Registered Office: IIFL Centre, 6th Floor, Kamala City, Senapati Bapat Marg, Lower Parel, Mumbai – 400013, **Tel:** (91-22) 3958 5600. **Fax:** (91-22) 4646 4706
E-mail: investordesk@iiflmf.com. **Website:** www.iiflmf.com

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