QUARTERLY OUTLOOK

JAN 2018

EQUITY

FIXED INCOME

REAL ESTATE

A YEAR OF OPPORTUNITIES AND MORE!

As the curtain fell on 2017, the world began to acknowledge that India is getting better. World Bank lifted India's ease of doing business ranking to 100 from 130. Moody's Investors Service upgraded India's sovereign bond rating for the first time in nearly 14 years. This was seen as a long-due endorsement of the structural reforms being undertaken by the government to push growth while maintaining fiscal discipline.

Capital-raising activity was upbeat as the year saw raising of record high equity capital. ~USD 31.25 billion (bn) was raised from around 220 transactions. Interestingly, around 40% of this came from Initial Public Offerings (IPOs). As investors, you have encouraged our IIFL Special Opportunities Fund with your strong support and we are happy to share that the USD 1 bn fund could get even bigger in 2018. A strong IPO pipeline for 2018 means that our Fund will have many more opportunities to get into quality companies before they hit the street.

Domestic investors continued to pour money into mutual funds as Assets under Management (AUM) of the mutual fund industry scaled to record highs, and crossed the USD 343.75 bn figure. The encouraging aspect is that initial flows into mutual funds were dismissed by naysayers as a temporary post-demonetization phenomenon. The relentless flow into mutual funds has proved that it is more of a structural change being seen in the savings pattern. In the pages ahead, you will read that Indians are shifting to financial savings, helped by low inflation and low returns on property and gold. Financial savings have increased to 54% of annual savings in FY17 versus 40% in FY12. Equity participation is 10-12% of financial savings, mostly via mutual funds. We see this continuing; it could account for CY18/FY19 market inflows of USD $25-30 bn.

On the debt front in India, interest rates have already risen sharply in recent months and benchmark 10Y government bonds have been trading near 7.35%, the yearly high of 2017. A large section of the market believes that all these negatives are already factored in and any improvement in macro environment may allow rates to ease.

In real estate, the emerging challenge in the commercial space is to find good assets at the right pricing and yields. As the industry follows through with transactions, this could be a big opportunity, especially for smaller investors looking to participate in the real estate story in a structured way. In an era of low fixed income yield, our India Housing Fund on affordable housing theme is targeted to deliver healthy risk-adjusted returns.

Looking forward into 2018, challenges would be with regard to maintaining high expectations. Government would be in an overdrive mode as it heads into General Elections 2019 at the Centre. The year would be promising because of positive outcomes from past reforms that would start bearing fruits.

Wish you a very Happy New Year!

AMIT SHAH

EQUITY

PRASHASTA SETH

Uniquely Indian
Undeniably global

Indian equity markets closed CY2017 on a high - both on the Index and on optimism. This has been in spite of the twin shocks of demonetization and GST being implemented over the last 12 months. Indian equity markets with ~29% gains in 2017 was one of the best performing markets globally in 2017, largely on the back of strong domestic inflows. Midcaps and smallcaps led the show, outperforming largecaps once again as money chased few stocks and valuations soared. Though there hasn't been any meaningful increase in corporate earnings, but a price to earnings (P/E) re-rating has led to the recent rally over the past six months.

Liquidity always attracts fund raising activity and 2017 saw raising of record high equity capital. There were 220 capital-raising transactions, almost 40% higher than the previous peak in 2010. Total capital of USD 31.25 bn was raised, almost 50% higher than in 2010. IPOs contributed to 40% of the capital-raising activity, followed by secondary offerings, which contributed to a third of capital raising this year. Even as the capital markets saw buoyant activity, the underlying economic data was mixed. Economic growth was weak for most of the year due to lagged effect of demonetization and Goods and Services Tax (GST) transition. That said, high frequency data has improved in the last couple of months and the last quarter of 2017 should report Gross Domestic Product (GDP) growth of close to 7%, higher than the year-ago quarter. Thus, going into 2018, expectations on the economy are high. As also we head into budget in a month, hence all eyes would be on the macro stage.

Looking forward into 2018, we think, we have both a challenging and a promising year ahead. Challenges would be with regard to maintaining the high expectations as government would be in an overdrive mode as it heads into General Elections 2019 at the Centre. The year would be promising because of positive outcomes from the reforms of the recent past that would start bearing fruits. We believe there would be some key themes which would play out over the next 12 to 18 months.

Being the last full Budget of the current government, they would leave no stone unturned to ensure to keep the electorate happy. Thereby they could be treading a dangerous line between fiscal balance and slippage. Also

Time and again we have highlighted the need for capex in the economy which is the key driver for any type of all-round growth happening in the economy. With a strong USD 30 bn of equity raising in FY18 and similar expectations for FY19, coupled with government's USD 33 bn bank recapitalization plans, means the stage is set for the next leg of investment.

the recent close win in Gujarat elections has made the government sit back and take note of the displeasure among the rural masses. Therefore we see sustained policy relaxations for the agriculture and rural sector and this would be one of the themes to play out in 2018. Coupled with this would be the domestic consumption theme where we see sustained earnings growth owing to recovery in consumer sentiment, a supportive lower base and return to normalcy for trade channels post demonetization and GST.

Housing and infrastructure development are some other themes where we see the government primarily focusing on and also companies in these sectors gearing up for the upcoming opportunity.

On the global front we see rally sustaining as economic activity remains buoyant globally. A soft US dollar and adequate global liquidity have been ongoing trends over the past two years, helping India and global emerging markets.

We expect that to continue, although the US Federal Reserve's potential balance-sheet shrinkage remains a risk. Rising oil prices in 2HCY17 and the performance of internet/ecommerce/fintech stocks over 2016-17 worked against India. We believe oil prices could remain range-bound in the current range though it could remain volatile for some time due to geopolitical tensions in Middle East.

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expectations for FY19, coupled with government's USD 33 bn bank recapitalization plans, means the stage is set for the next leg of investment. This could potentially bring forward the expected capex cycle recovery meaningfully.

Having highlighted the brighter side of 2018, we see some risks to the equity markets too which investors need to keep themselves aware of. Valuations are something which have been too high for long, and current levels too do not provide any comfort as such. Lack of any meaningful pick-up in earnings would delay further re-rating in the stock valuations. Political uncertainty as we head into preparations for 2019 elections are one of the biggest risks for the market and Indian economy. The recent close win in Gujarat elections was not comforting for the market which was expecting a bigger majority in the home state of Prime Minister Narendra Modi. Any signs of lack of clear majority in 2019 would derail the whole engine.

All in all, we see meaningful wealth building opportunities in the market and 2018 would be a stock-pickers' year, as there are unlikely to be easy money-making opportunities like we saw in the latter half of 2017. Quality companies will continue to command a premium and earnings uptick would be rewarded by investors.

FIXED INCOME

RITESH JAIN

Unafraid to be Unconventional

We began 2017 on a strong footing as huge liquidity entered the Indian market due to demonetization, low oil prices and strong fiscal position. However, in latter part of the year, a strong rise in global crude oil prices, a spike in inflation domestically due to rising food, fuel and housing prices, disruption in revenues due to GST implementation and a hawkish Fed turned the market sentiments into negative zone. In 2017 several global equity markets reached new milestones and Credit spreads tightened to cycle lows. In US, the term spreads compressed which generated strong returns from the long end of the treasury curve. The Dollar-funded investments into global assets were rewarded as the Dollar weakened against prominent trading currencies.

The Fed in US moved ahead with monetary policy normalization, led by its third rate hike. ECB stayed put on rates but halved its asset purchases to €30 bn a month starting January. The Bank of England, Bank of Canada and Bank of Korea moved rates off multi-year lows. Low inflation allowed them the luxury of gradual normalization. Despite decent growth and Energy and base Metal prices ruling high, the inflation trajectory is a bit of surprise. Oil prices have been supported all year by supply side measures – Organization of the Petroleum Exporting Countries' (OPEC) production discipline and less than expected recovery in US shale production. Strong demand supply side cuts and low inventories made base metals the best performing commodity asset class in 2017.

On the domestic front, the elevation in Bond yields continues to happen for the fifth consecutive month now, and it picked up pace after the government announced an increase in its fiscal year borrowing amount. This raised concerns among investors about the government's fiscal prudence. The government will borrow an additional INR 50,000 crore through previously scheduled auctions in January and February 2018. Acceleration in retail inflation in November 2017 and expected future trajectory also dampened sentiment. Yield on gilt securities increased across maturities mirroring rationalization in participants' earlier expectation of a rate cut. The corporate bond yields too went up across maturities in line with the sovereign curve.

Additional borrowings announcement by the government has raised the possibility of a rise in fiscal deficit target of 3.2% for FY18. Market participants at present remain concerned of a possible fiscal slippage in FY18 and higher than expected fiscal deficit target for FY19. It is to be seen how the government reduces the revenue shortfall during the March quarter of 2018 when it collects large chunk of tax revenue. Hopes of a rate cut have vanished in the near term due to risk of rise in inflation in the second half of FY18. Thus, domestic inflationary pressure and international crude oil prices due to supply constraints will continue to remain in focus. In that context, the upcoming budget is likely to determine the course for the market going ahead. Near term, bond yields are expected to trade with an upward bias tracking the domestic supply and other macro factors. The positioning at the front-end of the curve with a defensive outlook remains the call as rate trajectory is likely to be volatile and risk-return is not yet in favour for long duration positioning. Any change in the macro-economic environment needs to be continuously tracked for change of stance if the situation requires so.

> ***Any improvement in macro environment may allow rates to ease.***

The silver lining though amongst this gloomy scenario is that interest rates in India have already risen sharply in recent months and benchmark 10Y government bonds have been trading at near 7.35%, the yearly high of 2017. A large section of the market believes that all these negatives are already factored in and any further spike in market rates is unlikely. On the other hand, any improvement in macro environment may allow rates to ease.

In conclusion, H12018 may witness a mild increase in benchmark rates given deteriorating macros. However, market rates may start easing in H2CY18 if initial glitches of GST stabilize, revenue collections show improvement and India has another normal monsoon allowing food prices to soften.

REAL ESTATE

BALAJI RAGHAVAN

Unconventional thinking to do what's never been done before

Housing loans have played a large part in bridging the affordability gap over the past few months. Interest rates have moved to an average of 8.5%, down from 9.5-10% ~18 months ago. The resultant impact has been similar to a discount of almost 20%. Buyers have to pay INR 800-850 / 100,000 on mortgages, instead of ~INR 1000 levels earlier. This push to affordability, clubbed with pricing that has largely been flat over the past few years is bringing end-users back to residential projects countrywide. Consumer confidence is returning as RERA implementation has stabilised across states. Most factors required for a demand revival seem to be slowly falling into place.

There seems to be emerging consensus that opportunity lies in the affordable housing space. Capital is following this opportunity. A few large players have already launched funds targeting this space. There seems to be good interest from international and domestic institutional investors as well.

However, data coming in from developers shows a clear polarisation. Trends indicate a consumer preference for OC ready properties (projects that have been certified as completed and awarded an 'Occupation Certificate'). It appears that consumers are yet to fully factor in the 12% GST on under-construction properties, and this amount is playing a role in buying decisions at least for the time being. Many developers have already launched promotion schemes to absorb all or part of this impact. Demand revival also seems to be driven by affordable and mid-market properties. Demand for high-value and luxury properties still shows flatness and there are value deals for serious buyers in this segment.

The supply side has largely mirrored demand trends. A recent report by JLL estimates that developers are providing 6-15% discount to move existing inventories. This has come in the form of interest rate subventions, finance scheme innovations, or discount on GST or registration charges. New launches have been subdued. Time taken for RERA compliance has impacted launch velocity. Developers are also re-planning projects to reduce unit size (and therefore price) or to try and launch schemes under the affordable housing incentives given by the government. As a result, fresh supply has been constrained.

These factors have together played out to push the market in positive territory. For the past four quarters, offtake in the top seven cities has actually exceeded new launches, reversing a trend that has prevailed for the past 12-16 quarters.

There seems to be emerging consensus that opportunity lies in the affordable housing space. Capital is following this opportunity. A few large players have already launched funds targeting this space. There seems to be good interest from international and domestic institutional investors as well. A few have launched platforms for directly investing in the space, others are anchoring or making large investments in funds.

We are tracking a few Real Estate Investment Trusts (REITs) also under filing. The emerging challenge in the commercial space is to find good assets at the right pricing and yields. As the industry follows through with transactions, this could be a big opportunity, especially for smaller investors looking to participate in the real estate story in a structured way.

MACRO ECONOMY VIEW

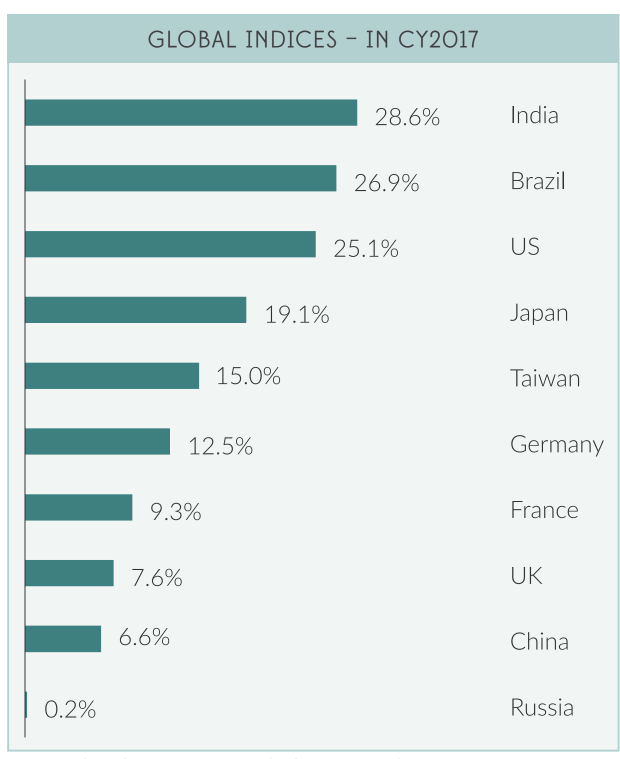
LOOKING BACK

"All's well that ends well" – William Shakespeare

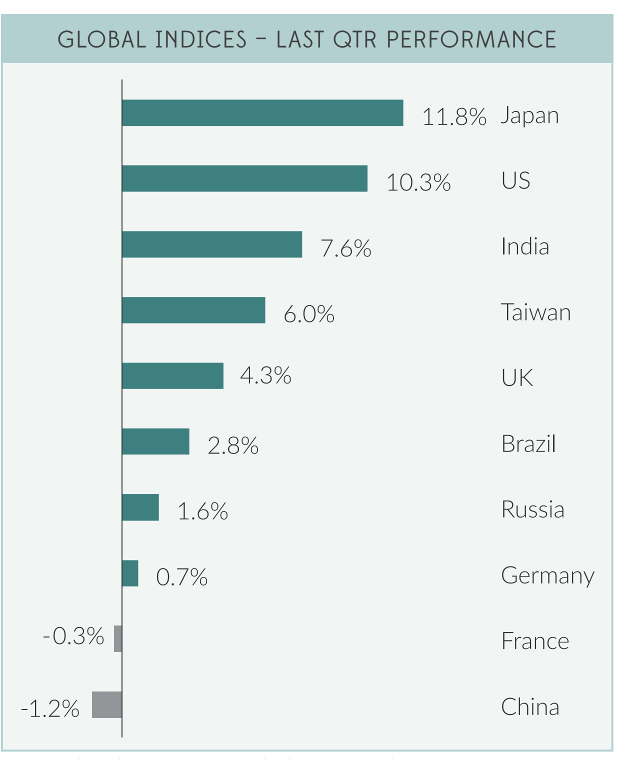
The above quote aptly summarises 2017 and would definitely find a special mention in our minds, in the history of the Indian stock market and the economy. We began the year on a sombre mood as the Indian economy was just recovering from the cash crunch caused due to demonetization towards the end of 2016. Also, US markets did not know what to expect in the year 2017, as they had a very unlikely candidate as their president. European markets too were languishing and 2017 seemed like a difficult year to begin with. But as they say, that the best bull market rallies have been there when you expect them the least. Half way through the year, when we thought the worst was over, the GST and Real Estate Regulation and Development Act (RERA) came knocking on our doors and business sentiment and earnings took a beating.

Yet the resilience of the economy was visible as Moody's upgraded their outlook and rating on India for the first time in 14 years. The Indian equity market touched life time highs and we ended 2017 as one of the best performing global markets with ~29% returns. Domestic flows into mutual funds scaled new peaks as the Assets under Management (AUM) of the mutual fund industry soared to record highs, and crossed the INR 22 lakh crore figure, while registering strong year-on-year (YoY) growth figures. A liquidity-driven rally has been the cornerstone of most market rallies in the past and the present is no different. The problem is when the liquidity dries up and that is anyone's guess. But unlike the past, the current flows into financial assets is the result of structural changes in the country, where the savings culture of investors has moved towards financial assets as opposed to physical assets and this is here to stay for now at least.

With regard to sectoral performances during the year, 2017 saw higher beta sectors clearly outperforming



Source: Bloomberg, IIFL Research; data as on 31st Dec 2017



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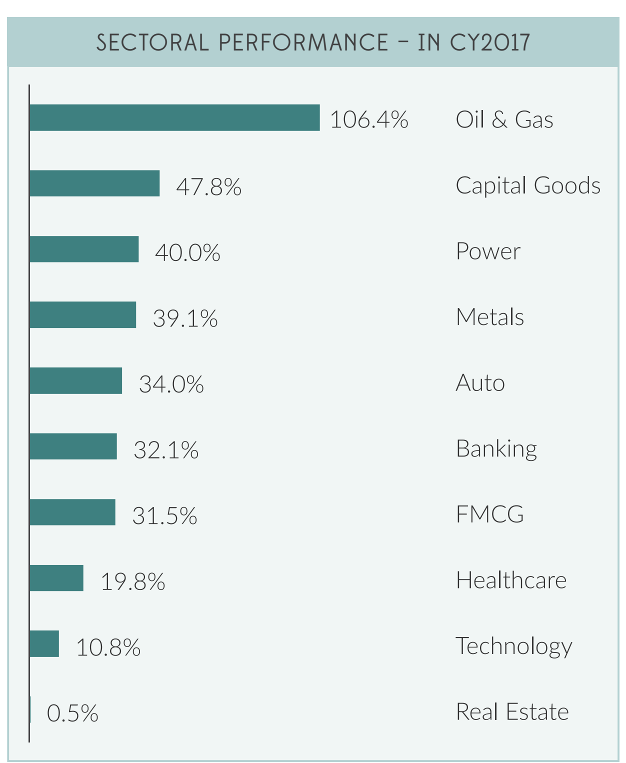
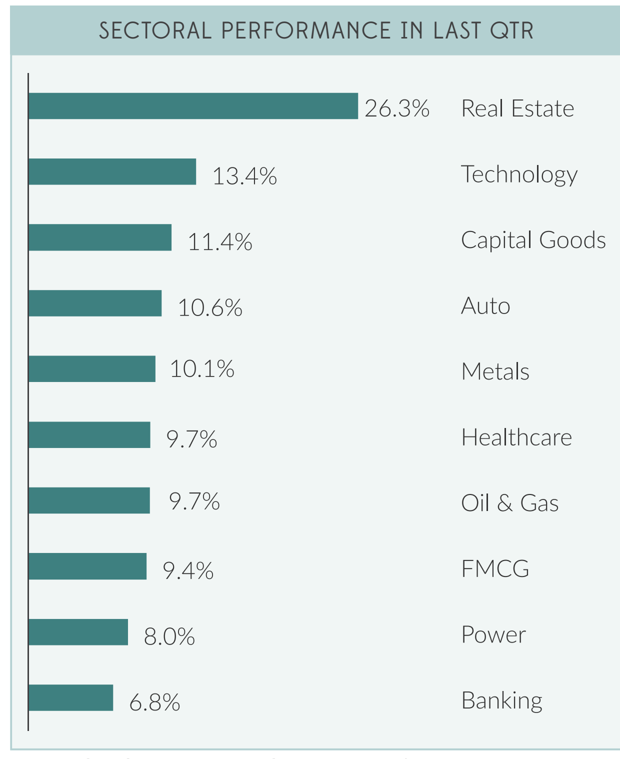


Source: Bloomberg, IIFL Research, Data as on 31st Dec 2017



Source: Bloomberg, IIFL Research, Data as on 31st Dec 2017

defensives as markets were on Risk-On mode and Oil & Gas, Capital Goods, Metals and Power Utilities were the top performing sectors during the year. The Risk-On mode has taken market valuations to not-so-comfortable levels and currently the benchmark indices are trading at around 20x FY19 consensus estimates. Earnings revival is absolutely critical for such rich valuations to sustain.

The companies which will out-perform this year would be companies that have room for further expansion in valuations and improving earnings trajectory. The Gujarat elections highlighted some loss of ground for the National Democratic Alliance (NDA) in rural areas. Taking note of this and the fact that the government would now be preparing for General Elections 2019, we see increased Government focus on specific programs to revive investment and the rural economy (higher spend on rural electricity, roads and water) as well as ensuring speedy implementation of various infrastructure projects and affordable housing.

OUTLOOK FOR 2018

GLOBAL MACRO ENVIRONMENT FAVOURABLE FOR COLLECTIVE GROWTH

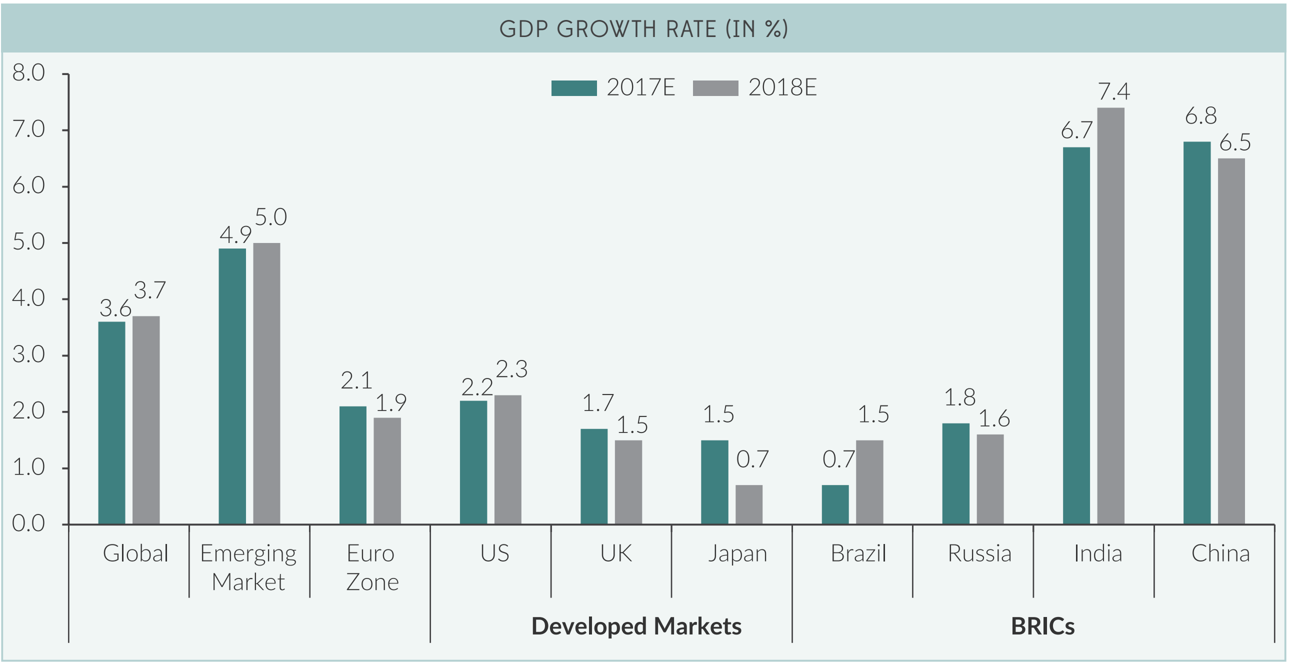
After years of sluggishness in global economic activity, 2017 was the first year of decent global growth after 5 years, which is evidence of improving economic activity globally. Major global economies (especially US) are poised for sustained recovery, as reflected in various central banks' intentions to hike rates. India and China continue to be the pillars of global growth and 2018 would be no different.

A soft US dollar and adequate global liquidity have been ongoing trends over the past two years, helping India and global emerging markets. We expect that to continue, although the US Federal Reserve's potential balance-sheet shrinkage remains a risk. Inflation has increased in most of the major economies, which can be partly attributed to the rise in crude prices, but also indicates that there has been some strengthening in consumer demand.

The US economy has been strong in recent months. Business surveys are indicating some of the best economic conditions for the eight-year expansion so far. The unemployment rate is at its lowest level in 17 years. Recently, President Donald Trump signed a bill which would immediately slash the corporate tax rate to 20% from 35%. This move is expected to provide further impetus to the US economy and increase disposable income in the hands of the employees of corporate America.

In Europe, we see two major events which could impact market sentiment. First is the Brexit discussions which should not be too disruptive, considering that the groundwork for a gradual transition is expected to be put in place. Other major event in Europe is elections in Italy, which could further bring to foreground the nationalistic sentiments and also question the sanctity of Euro zone.

Nevertheless, a poll of 229 asset allocators (managing USD 6 trillion) conducted by an independent agency "Absolute Strategy Research" (ASR), for their views on the outlook for economies and markets found a groundswell of optimism. It suggests that the probability of equities being higher by the end of 2018 was 61%, and that shares will beat bonds is 70%. The allocators think there is only a 27% chance of a global recession. And they are not worried about the prospect of the Federal Reserve pushing up interest rates.



Source: IMF Data

BUDGET 2018 TO BE A FINE BALANCE BETWEEN FISCAL PRUDENCE AND POPULISM

With Budget 2018 being the last full scale budget for Prime Minister Narendra Modi's government before it faces the electorate in 2019, it needs to be seen whether the government follows a path of fiscal consolidation or expansion in order to be populist. The central government had committed to reducing fiscal deficit to 3.2% of GDP in FY18 and further to 3% of GDP in FY19. However, given the transition to GST and slowdown in the economy, tax revenues are running below estimates.

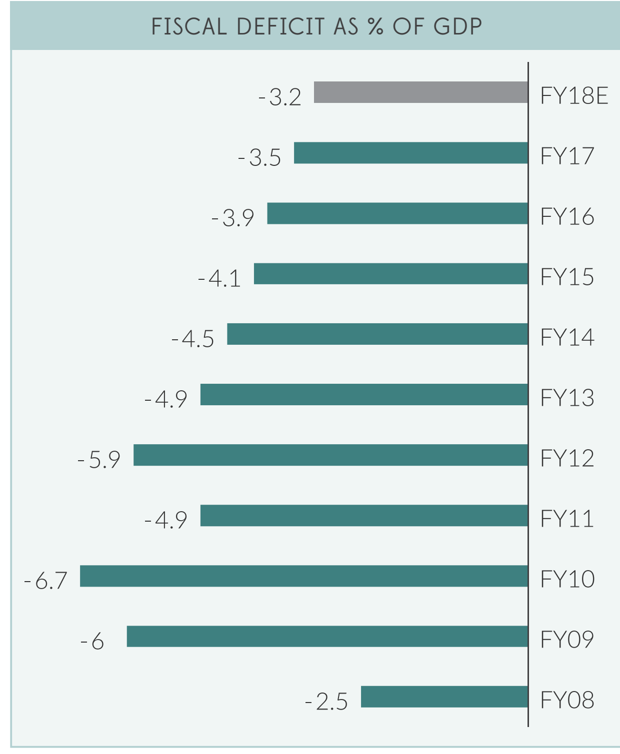
Although overall tax revenues (excluding the GST compensation cess) have grown at just over 12% in the first eight months of this year, broadly in line with the budget estimates, they have grown just 6% over the last three months, due to weaker indirect tax revenues. Unless indirect revenues accelerate, tax revenues are likely to miss the budget estimate by Rs 500 bn.

Non-tax revenues are also likely to miss estimates, due to lower dividend from Reserve Bank of India (RBI). Although there will some offsetting factors in disinvestment, we estimate the central government to miss its FY18 fiscal deficit target by around 30bps.

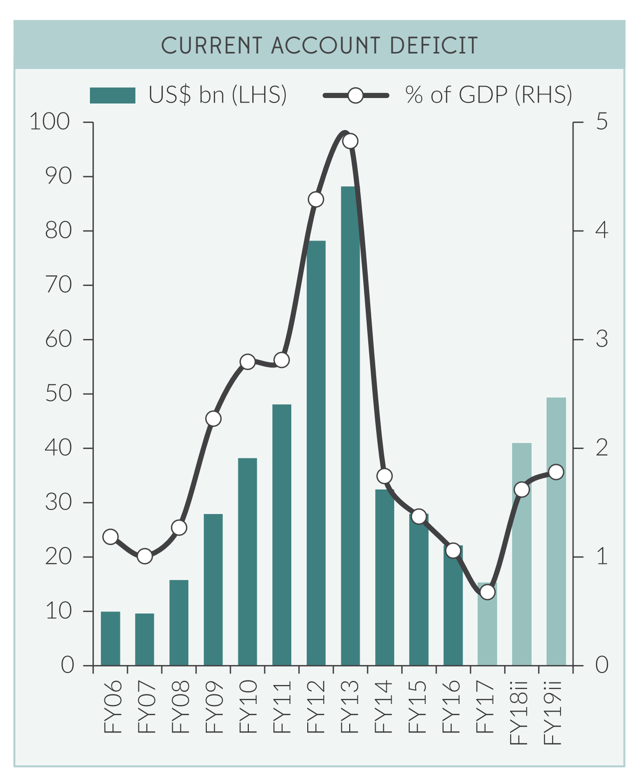
INDIA'S EXTERNAL ACCOUNT WORSENING BUT STILL BENIGN

After falling for four consecutive years, India's Current Account Deficit (CAD) will increase sharply in FY18, more than doubling YoY to just over USD 40 bn. This is largely due to higher commodity prices, especially oil. Oil prices have risen in recent months and the Indian basket of crude oil is currently over USD 60/bbl as against an average of just over USD 50/bbl during April-November this year. Thus, if oil prices remain at the current levels, CAD is likely to increase further in FY19 to around USD 50 bn. Although this is more than tripling of CAD from the low of FY17, CAD will still remain modest at below 2% of GDP. Thus, the increase in CAD is not very worrying yet.

However, what is changing is the way this higher CAD is being funded. After a sharp increase in FY15, the pace



Source: Bloomberg, IIFL research



Source: RBI data, IIFL Research

of Foreign Direct Investment (FDI) inflows into India has slowed. In FY17, net FDI inflows were flat YoY. In addition, in the first seven months of FY18 (April–October), net FDI inflows declined 10% YoY. Thus, FY18 will be the first year since FY14 when CAD will not be fully funded by net FDI inflows. Hence, the country will be dependent on volatile sources of capital such as Foreign Portfolio Investment (FPI) flows to fund CAD. With CAD likely to increase next year, dependence on volatile flows will only increase, unless FDI flows reaccelerate.

CAPEX CYCLE HAS BOTTOMED OUT IN ALL LIKELIHOOD

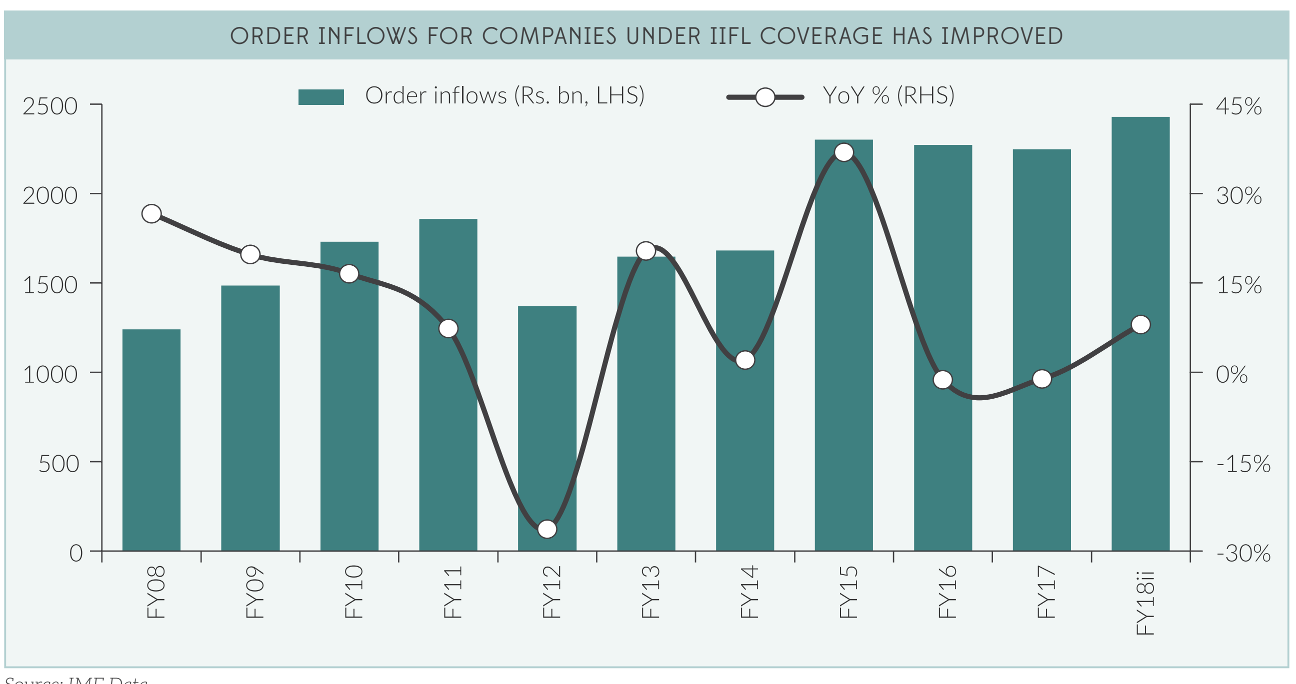
Contribution of Capex (gross fixed-capital formation) to GDP is now at decade lows mainly as private capex has been constrained by low capacity utilisations and weak housing spend. This year could mark the start of a new capex cycle as state-owned banks' (PSU) recapitalisation and the resolution of corporate bankruptcies initiates a new loan cycle. Alongside an upcoming housing cycle upturn, capex revival in select industries and continued government support will be positives. An additional USD 60 bn of equity raising over FY18/19 will help improve capex cycle trend.

Capex growth, which has been on a downdraft since the global financial crisis, is showing nascent signs of revival. Investment activity that is linked to government expenditure has already seen an uptick in the last couple of years. In roads for example, new ordering as well as execution has shown strong growth for a couple of years now. Similarly, Indian Railways has also seen an improvement in capex spends.

Industrial capex from core sectors is unlikely to replicate capex trends of the last cycle due to sub-optimum utilisation levels. However, some green shoots have been seen in cement, steel, and the Oil & Gas space, where large companies with a healthy balance sheet have initiated expansion activities in Steel sector and large Cement players, Refinery capacity additions and BS-VI emission norms are driving investments in the Oil & Gas sector.

CORPORATE EARNINGS PICKUP A MUST TO MAKE VALUATIONS ATTRACTIVE AGAIN

Earnings growth in India has belied expectations in each of the last six years and 2017 has not been an exception to this trend. However, the change has been that in the last few months and after the September quarter results in particular, earnings downgrades were negligible



Source: IMF Data

in most sectors. This has raised hopes that a revival in earnings cycle is likely in 2018 and an earnings upgrade cycle could start in 2018.

Economic growth and commodity prices are the key drivers of corporate profits in India. Both these drivers are likely to improve in FY19. With inflation likely to edge up, nominal GDP growth should also be in double digits. Thus, corporate profit growth should accelerate next year.

However, there are a couple of caveats. Firstly, current consensus estimates imply a strong rebound in corporate profits in 2HFY18. BSE200 profits are expected to grow more than 30% in 2HFY18 for the full-year estimates to be met. Although there is a favourable base effect due to the demonetization effect in 2H last year, estimate for 2H profit growth probably has downside risks.

Secondly, even though outlook for corporate profits is relatively bright for FY19, current consensus estimates more than factor in this already. Current consensus estimates, for instance, imply that profit growth for the BSE200 companies will double to 21% YoY in FY19 (excluding metals companies and PSU banks). Given the backdrop of higher commodity prices, these estimates still have a downside risk. Thus, on balance, the earnings downgrade cycle may continue in FY19 even as absolute profit delivery is likely to be higher in FY19.

CONSENSUS EPS ESTIMATE DOWNGRADES HAVE STOPPED

BSE200 Index EPS Estimate (FY18)

Source: Bloomberg, IIFL Research

ELECTION 2019 TO BE ON GOVERNMENT'S MIND – INFRA TO SEE BIG PUSH

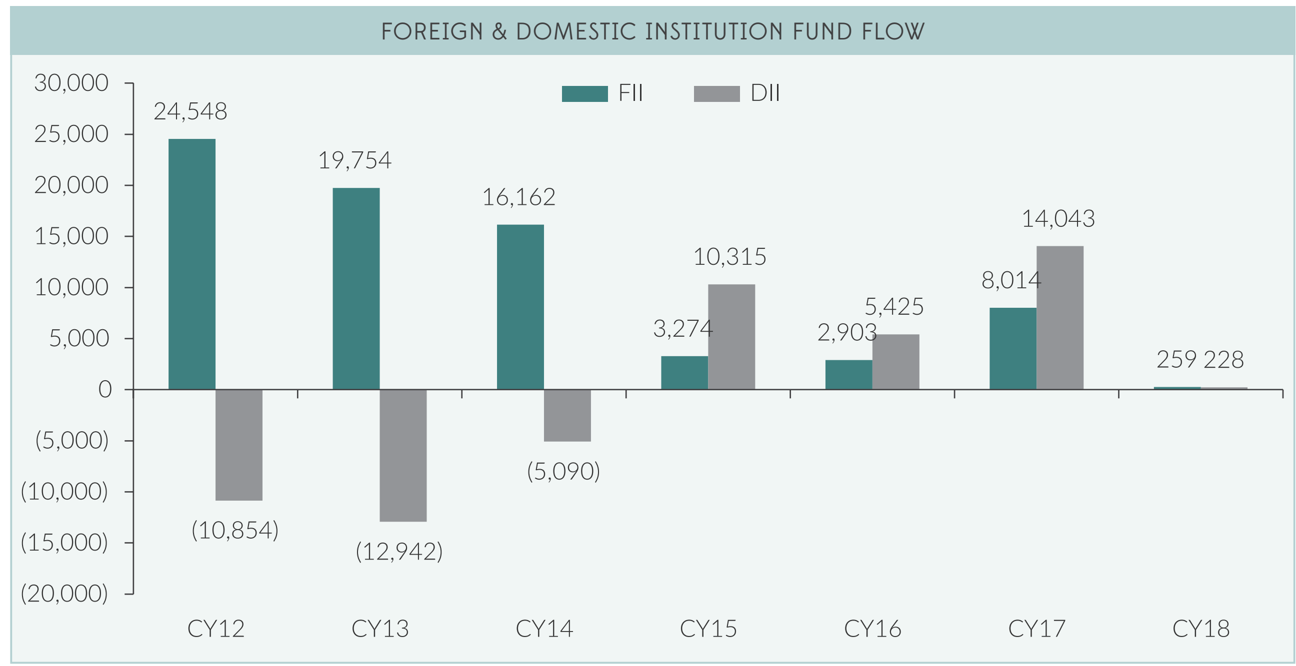
The government would be in preparatory mode now for General Elections 2019 and much of the next 12-18 months would go into implementation of stalled projects and drive growth. The outcome of multiple State Assembly Elections over the next few months (eight state elections in 2018) will be keenly watched. After an intense political campaign, Bharatiya Janata Party (BJP) won the recently concluded assembly elections in both the states of Gujarat and Himachal Pradesh.

However, the results of the Gujarat Assembly Elections also highlighted that the overall performance of BJP had taken some beating and was better in urban areas than in rural regions.

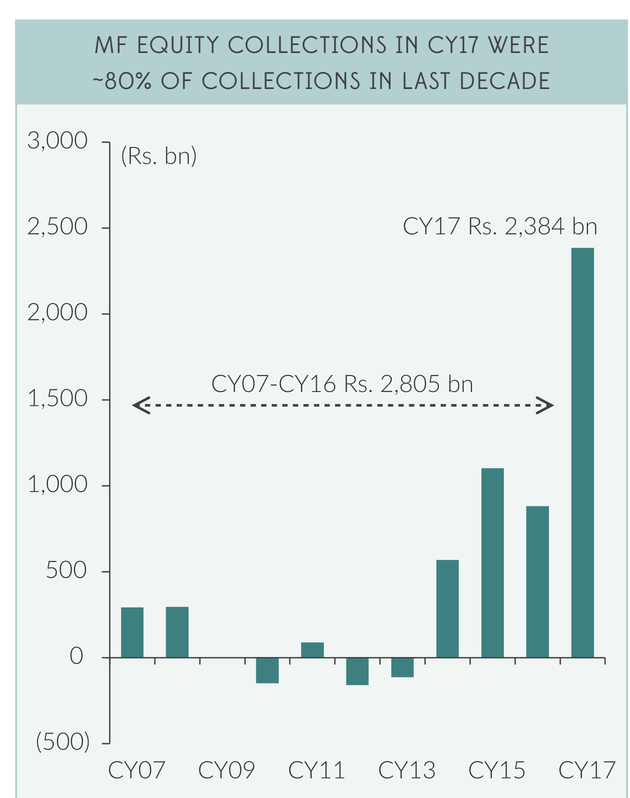
Annual farm growth dipped to 1.7% in the three months ending September, mainly on lower prices and output, while economic growth accelerated to 6.3% after growing at a three-year low of 5.7% in the previous quarter. Therefore it is likely that Government will further enhance its focus on spending towards agri/rural themes. One can expect more spending on rural infrastructure (Roads, Power and jobs) and higher procurement prices for crops.

DOMESTIC AND FOREIGN FLOWS TO REMAIN STRONG IN 2018

Post-demonetization what was thought to be just a temporary flow of domestic savings into financial assets through mutual funds is now seen as a more structural change in the savings pattern for Indians. Indians are shifting to financial savings, helped by low inflation and low returns on property and gold. Financial savings have increased to 54% of annual savings in FY17 versus 40% in FY12. Equity participation is 10-12% of financial savings,



Source: Bloomberg, IIFL Research



Source: Bloomberg, IIFL Research

mostly via mutual funds. We see this continuing; it could account for CY18/FY19 market inflows of USD 25-30 bn. Key risks are a potential high-end-property-market revival and changes in equity taxation.

FPI inflows into Indian equities have been lacklustre over the past three years, with an average of USD 3 bn per annum (pa). The average over FY12-15 was USD 17 bn pa. FPIs reduced their India weight due to expensive valuations, downward earnings revisions and better opportunities in other markets. We believe the possible earnings revival could see returning FPI interest, and build in USD 8-10 bn of net inflows in CY18.

SECTOR OUTLOOK AND MARKET VALUATIONS

With the increase in PE multiples, headline market valuations seem fairly demanding. The BSE500 index, for instance, is trading at more than two standard deviations above the average. It has never traded at these valuations in the past 15 years. Similarly, the large-cap Nifty index also trades at close to two standard deviations above its long term average.

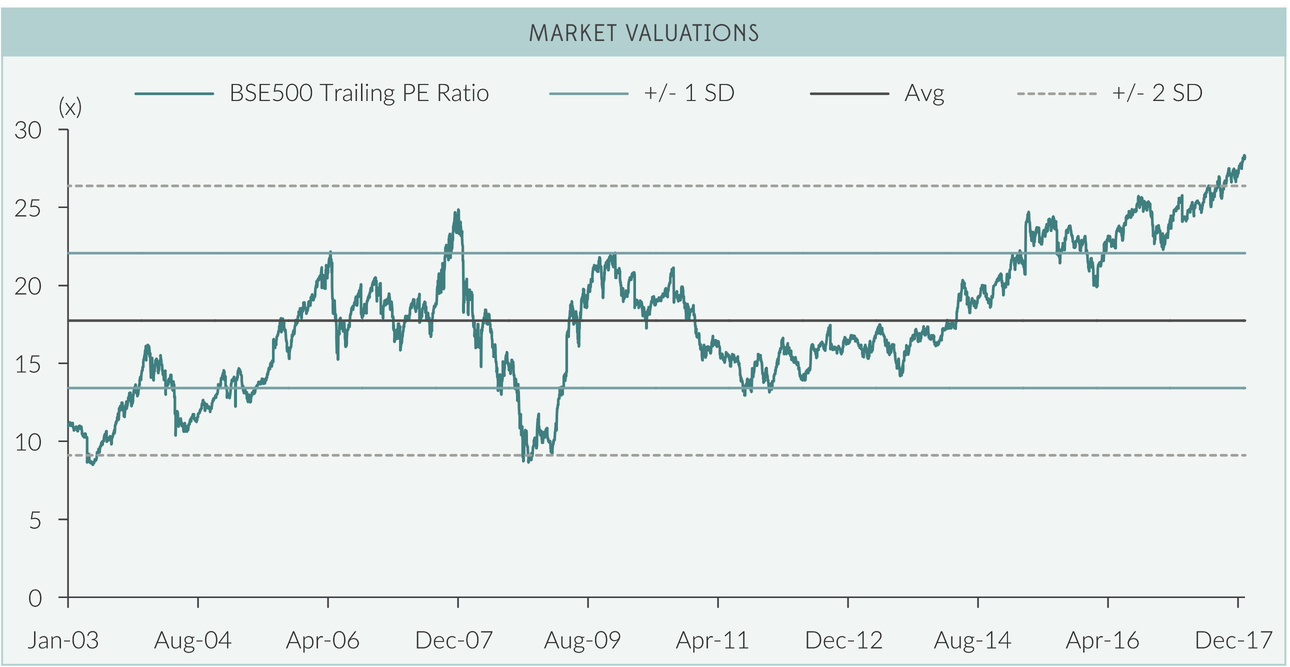
There are two arguments in support of these elevated valuations. The first argument is low cost of capital and second one is depressed profitability.

However, the increase in bond yields in the last few months (~100bps from early December 2016) has meant that cost of capital is no longer low. Yield on 10-year government bonds is currently 7.25%, only 20 bps below the average of the past 15 years. Therefore, it is no longer the case that cost of capital is low, and hence this explanation for higher valuations does not hold much water.

Thus, the bottom line is that valuations are demanding and lower cost of capital and a depressed profit cycle do not fully explain the high valuations. When valuations are this high, a mean reversion is a question of when rather than if. This was true at the start of last year as well, but with every further move of valuations into overvalued territory, the question of when becomes more pertinent. What this means is that even as we factor in an earnings recovery, we have to factor in normalisation on valuation multiples. The only question is whether this normalisation happens in 2018 or beyond. Thus, the best-case outcome for the market is continuation of the current multiples with low-to-mid-teen earnings growth and hence equivalent returns. However, any other outcome will mostly mean returns tracking lower (or even much lower) than earnings growth.

Given this backdrop, we believe investors should continue to build relatively conservative portfolios in 2018 with a higher focus on valuations. Given elevated valuations in many sectors, the markets may not tolerate any earnings disappointments. The key sectors on which we are overweight are energy, consumer discretionary, and utilities; the key sectors on which we are underweight are consumer staples, and rate sensitives.

As we highlighted earlier, 2018 would be a stock picker's year and it would not be easy making significant alpha as compared to 2017. Nevertheless, high quality companies having consistent earnings growth would be favoured by investors this year.



Source: Bloomberg, IIFL Research

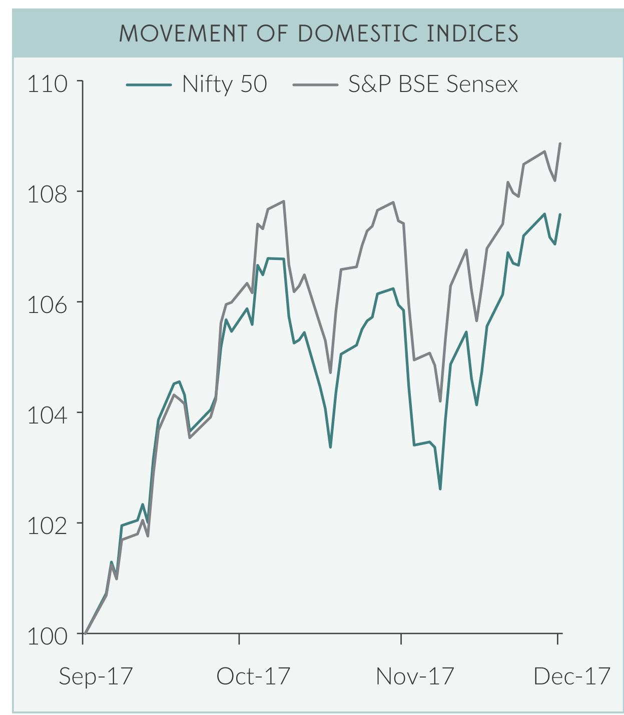
MARKET TRENDS & INVESTOR TAKEAWAYS

EQUITY MARKET

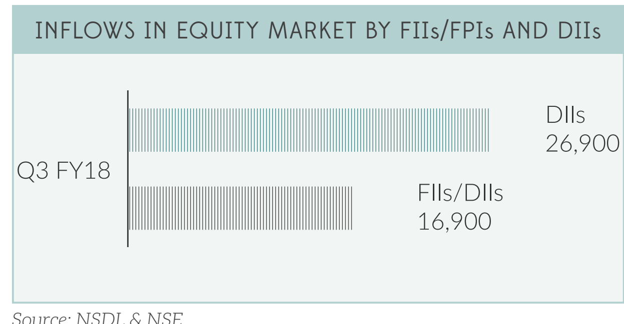
GLOBAL EQUITY MARKETS' TRENDS WERE MIXED IN OCT-DEC 2017

Source: Thomson Reuters Eikon, All indices data rebased to 100

DOMESTIC EQUITY MARKET SHOWED A RISING TREND IN OCT-DEC 2017



Source: BSE & NSE, All indices data rebased to 100



Source: NSDL & NSE

- Recapitalisation package of Rs. 2.11 lakh crore for banks
- Road infrastructure investment of ~Rs. 7 lakh crore over the next five years
- Changes in GST rules - offering relief to SMEs and exporters of technology-oriented goods and services; lowering of tax rates on 27 products and few services
- Victories in Gujarat and Himachal Pradesh by the ruling party

FIXED INCOME MARKET

- Q3 FY18 has seen good inflows in equity market by FIIs/FPIs and DIIs.
- 2017 has been a good year for IPOs, which is expected to continue in 2018
- Upgrade of India's sovereign debt rating by Moody's from Baa3 to Baa2

IPO TRENDS AND UPCOMING IPOS

- Robust inflows in Indian equity market to the tune of Rs. 1,48,108 crores were witnessed in existing stocks and initial public offers in 2017
- India's Bombay and National Stock Exchanges and junior markets recorded a 74% increase in deal numbers in 2017 compared to 2016, with 153 IPOs raising USD 11.6 bn (Ernst & Young)

UPCOMING IPOS – 2018

Company Name	Amount expected to be raised
Hindustan Aeronautics Ltd (HAL)	Rs. 2000 / 2500 crore
Aster DM Healthcare Limited	Rs. 1100 crore
Continental Warehousing Corporation	Rs. 1000 crore
Bharat Serum and Vaccines Ltd	Rs. 2000 crore
Acme Solar	Rs. 2200 crore
NSE (appr. pending from SEBI)	Rs. 10,000 crore
ReNew Power	Rs. 4500 crore
ICICI Securities	Rs. 3000 / 4000 crore
Reliance General Insurance	Rs. 4750 crore

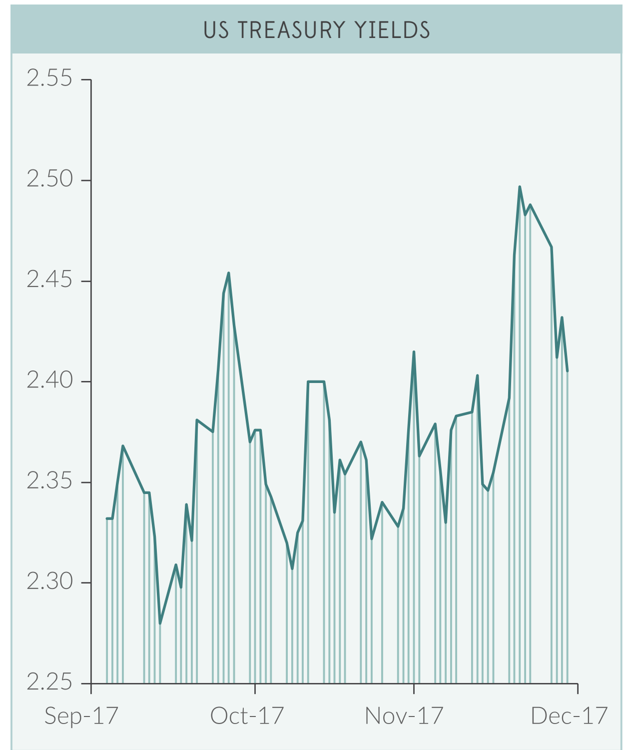
Source: Media

INVESTOR TAKEAWAYS:

Considering continued equity market appreciation, investments in Hybrid Funds may be a safe bet.

US FIXED INCOME MARKET ROSE 7 BPS IN OCT-DEC 2017

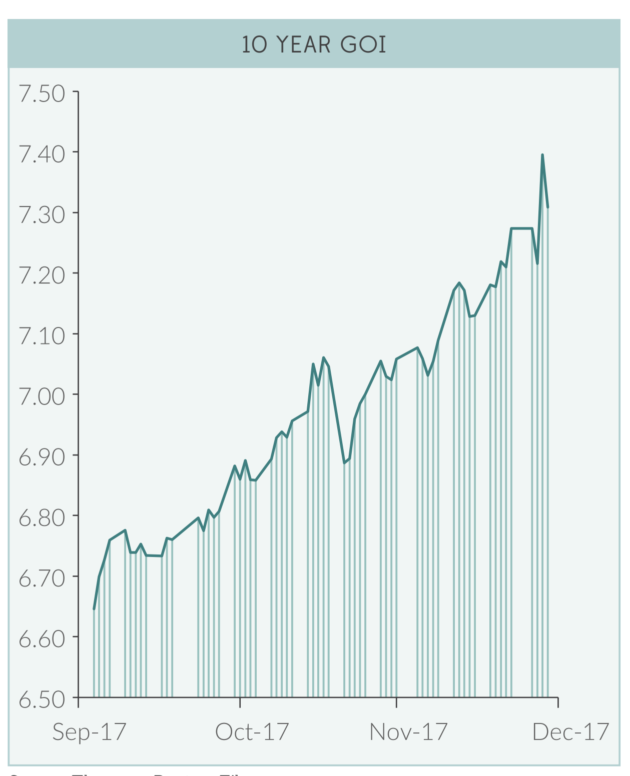
- US Treasury prices fell amid expectation of tighter monetary policies
- Market participants' pessimism on the progress of US tax reforms initiatives extended the losses
- Well-known companies reported strong earnings for the quarter and US GDP grew more than expected



Source: Thomson Reuters Eikon

DOMESTIC FIXED INCOME MARKET SURGED 68 BASIS POINTS IN OCT-DEC 2017

- Increase in government borrowings
- Increase in crude oil prices
- Concerns about rise in inflation
- Concerns about widening fiscal deficit
- Recapitalisation bonds for PSBs



Source: Thomson Reuters Eikon

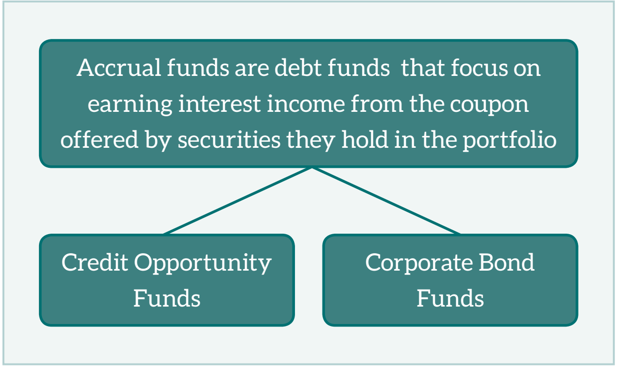
RECENT MONETARY POLICY ANNOUNCEMENTS

- Repo rate left unchanged at 6.00%
- Reverse repo rate left unchanged at 5.75%
- Marginal standing facility (MSF) rate and bank rate each kept at 6.25%. Statutory Liquidity Ratio reduced to 19.5%
- Inflation projection for the second half of 2017-18 raised to 4.2%-4.6%

INVESTOR TAKEAWAYS:

Considering rising interest rate environment accrual funds may be a safe bet.

WHAT ARE ACCRUAL FUNDS AND HOW ARE THEY HELPFUL UNDER THE CURRENT SCENARIO?



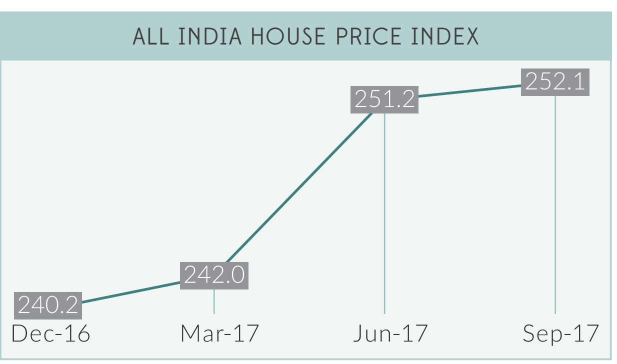
- In a rising interest rate environment, accrual funds are more immune to capital depreciation than duration funds
- At a time when there seems no scope of a rate-cut, investors looking for stable returns could opt for accrual funds

REAL ESTATE MARKET

PERFORMANCE OF REAL ESTATE SECTOR – A LOOK BACK AT 2017

- The year 2017 has set a new benchmark for the Indian real estate sector
- Demonetization in November 2016 had the entire economy reeling and the realty segment was one of the worst hit till the first quarter of 2017
- RERA and GST were announced in May and July respectively, which caused some initial jitters

ALL INDIA HOUSE PRICE INDEX



Source: National Housing Bank

GOVERNMENT INITIATIVES TO IMPROVE SECTOR PERFORMANCE

Ready-to-move-in properties and affordable housing have been kept out of GST

Real Estate Regulatory Act (RERA) gave birth to India's first real estate regulator

Each state will have its own regulator

Errant builders may face a fine of up to 10% of the project cost or up to 3 years of imprisonment or both besides losing the registration of the project

All real estate projects including alterations made will have to be registered with RERA

If the developer is unable to deliver the project on time, it will be liable for interest on the amount deposited in escrow account

Developers will have to deposit 70% of the amount collected in an escrow account

With various government initiatives and continued focus on affordable housing, 2018 may prove to be a good year for the recently launched housing funds

IIFL MUTUAL FUNDS PERFORMANCE

(as on December 31, 2017)

PRODUCT LABELLING DISCLOSURES

Name of the scheme	This product is suitable for investors who are seeking	Riskometer
IIFL INDIA GROWTH FUND (An Open Ended Equity Scheme)	**This product is suitable for investors who are seeking*** • Capital appreciation over long term; • Investment predominantly in equity and equity related instruments. ** Investors should consult their financial advisers if in doubt about whether the product is suitable for them.*	Investors understand that the principal will be at moderately high risk
IIFL LIQUID FUND (An Open Ended Liquid Scheme)	**This product is suitable for investors who are seeking*** • Income over short term horizon • Investments in money market and short term debt instruments, with maturity not exceeding 91 days ** Investors should consult their financial advisers if in doubt about whether the product is suitable for them.*	Investors understand that the principal will be at low risk
IIFL DYNAMIC BOND FUND (An Open Ended Income Scheme)	**This product is suitable for investors who are seeking*** • Income and long term gains • Investment in a range of debt and money market instruments of various maturities ** Investors should consult their financial advisers if in doubt about whether the product is suitable for them.*	Investors understand that the principal will be at moderate risk

MUTUAL FUNDS

IIFL India Growth Fund - EQUITY	31-Dec-16 to 31-Dec-17	PTP(₹)	31-Dec-14 to 31- Dec-17	PTP (₹)	Since Inception$	PTP (₹)
IIFL India Growth Fund - Regular Plan (G)	30.05%	12,996	13.30%	14,539	14.45%	15,334
IIFL India Growth Fund - Direct Plan (G)	31.82%	13,172	14.55%	15,025	15.73%	15,883
Benchmark*	28.74%	12,865	8.34%	12,714	8.35%	12,892
Additional Benchmark**	27.99%	12,790	7.40%	12,386	7.17%	12,452

*As on December 31, 2017 ; Point to Point (PTP) returns in ₹ is based on standard investment of ₹10,000; $ Since Inception date is 30-Oct-2014; * Nifty 50; ** S&P BSE Sensex; Managed by the fund manager since November 03, 2016; Scheme has been in existence for more than 3 years but less than 5 years. Different plans shall have a different expense structure. Past performance may or may not be sustained in future.*

IIFL Liquid Fund- FIXED INCOME	31-Dec-16 to 31-Dec-17	PTP(₹)	31-Dec-14 to 31- Dec-17	PTP(₹)	Since Inception$	PTP(₹)
IIFL Liquid Fund-Regular Plan (G)	6.18%	10,620	7.05%	12,720	7.42%	13,444
IIFL Liquid Fund-Direct Plan (G)	6.23%	10,625	7.10%	12,287	7.47%	13,469
Benchmark*	6.66%	10,668	7.45%	12,408	7.94%	13,715
Additional Benchmark**	6.35%	10,635	7.12%	12,136	7.67%	13,105

*As on December 31, 2017; * Crisil iquid Fudn Inex, ** Crisil 91 day T-Bill index; Point to Point (PTP) returns in ₹ is based on standard investment of ₹10,000 made on the $ Inception date 13-Nov-2013; Scheme has been in existence for more than 3 years but less than 5 years; Effective March 08 2017, Mr. Ankur Parekh has been appointed as Fund Manager of the scheme. The Scheme was managed till March 07, 2017 by Mr Ritesh Jain. Different plans shall have a different expense structure. Past performance may or may not be sustained in future.*

IIFL Dynamic Bond Fund - FIXED INCOME	31-Dec-16 to 31-Dec-17	PTP(₹)	31-Dec-14 to 31- Dec-17	PTP(₹)	Since Inception$	PTP(₹)
IIFL Dynamic Bond Fund - Regular Plan (G)	7.47%	10,745	7.21%	12,320	7.23%	13,708
IIFL Dynamic Bond Fund - Direct Plan (G)	8.03%	10,801	7.76%	12,511	7.77%	14,022
Benchmark*	4.70%	10,469	8.71%	12,844	8.49%	14,451
Additional Benchmark**	-0.07%	9,993	7.26%	12,338	6.31%	13,184

*As on December 31, 2017; * Crisil Composite Bond Fund Index, ** Crisil 10y Gilt Index; Point to Point (PTP) returns in ₹ is based on standard investment of ₹ 10,000 made on the inception date ; $ Inception date 24-June-2013; Scheme has been in existence for more than 3 years but less than 5 years; Effective March 08 2017, Mr. Ankur Parekh has been appointed as Fund Manager of the scheme. The Scheme was managed till March 07, 2017 by Mr Ritesh Jain. Different plans shall have a different expense structure. Past performance may or may not be sustained in future.*

MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY

IIFL FUNDS PERFORMANCE

(as on December 31, 2017)

AIF FUNDS

EQUITY FUND	Region	AUM (in USD mn)	Returns (in %) YTD	1 Year	Since Inception$
IIFL Asset Revival Fund 2	DOMESTIC	89.06	37.38	37.38	29.17
Nifty Index			37.27	37.27	21.81

$ Since Inception date of the fund is 04-Apr-2016

ALTERNATE	Region	AUM (in USD mn)	Returns (in %) YTD	1 Year	Since Inception$
IIFL Seed Ventures Fund (31st Aug'17)	DOMESTIC	56.46	44.47	44.47	67.11

$ Since Inception date of the fund is 09-Sep-2015

FIXED INCOME	Region	AUM (in USD mn)	Returns (in %)* YTD	1 Year	Since Inception$
IIFL Cash Opportunities Fund	DOMESTIC	76.17	6.23	6.23	7.77

*$ Since Inception date of the fund is 20-Aug-2015; * Returns as on 14th December 2017*

REAL ESTATE	Region	AUM (in USD mn)	Returns (in %)** YTD	1 year	Since Inception$
IIFL RE Fund Domestic Series 4	DOMESTIC	29.45	11.52	11.52	10.42
IIFL RE Fund Domestic Series 3 Class B	DOMESTIC	58.85	14.87	14.87	11.56
IIFL RE Fund Domestic Series 2	DOMESTIC	137.27	11.17	11.17	13.85

*$ Since Inception date of IIFL RE Fund Domestic Series 4 is 30-Jun-2016; IIFL RE Fund Domestic Series 3 Class B is 30-Mar-2016; IIFL RE Fund Domestic Series 2 is 30-Mar-2015; ** Returns of this fund available only in INR.*

AIF Schemes - Past performance may or may not be sustained in future. Returns greater than 1 year period are compounded annualized and less than 1 year period are on absolute basis. Distributions, if any are assumed to be reinvested.

AIF Schemes are governed by SEBI (Alternative Investment Funds) Regulations and can strictly solicit funds only through Private Placement. The performance of the Schemes stated herein is for information purpose only and should not be construed as an offer or solicitation to buy any Scheme(s).

FEEDER FUNDS

ALTERNATE	Region	AUM (in USD mn)	Returns (in %) YTD	1 Year	Since Inception$
IPEplus Fund	OFFSHORE	38.43	4.64	4.64	9.07
IIFL Global Bond Fund 2	OFFSHORE	29.47	8.40	8.40	3.75

$ Since Inception date of IPE Plus Fund is 23-Oct-2013 and IIFL Global Bond Fund 2 is 30-Jun-2016; Returns below 1 year is absolute & above 1 year is CAGR.

IIFL PORTFOLIO MANAGEMENT SERVICES

EQUITY	Region	AUM (in USD mn)	Returns (in %) YTD	1 Year	Since Inception$
IIFL Multi Cap PMS	DOMESTIC	172.69	36.83	36.83	22.94

Data as on December 31, 2017; $ Since Inception date of the fund is 31-Dec-2014; Returns below 1 year is absolute & above 1 year is CAGR.

All returns are in USD. USDINR as of 31st Dec'17- 63.8456

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