QuestPMS Newsletter - December 2017

2017: An eventful and rewarding year for Investors

Twelve months is a long time for the markets. Rewind back to December 2016 and one finds Indian markets reeling under demonetization and the world markets grappling with the rise of right wing nationalism across the developed world. While the world is still coming to terms with the new realities, investors across asset classes and markets have had an amazing year in the meanwhile! S&P 500 has given positive returns in every single month since then and most developed and emerging markets have seen double digit rise with India among the best performing markets in 2017.

The rise in the global markets have been supported by improving global growth outlook, successful passage of the Tax Bill in the United States, increasing commodity prices and easy liquidity conditions. Indian markets on the other hand have benefitted from favourable macro environment, reforms carried out by the NDA government and unprecedented domestic inflows in the stock markets. While global economic growth is likely to be even better in 2018, liquidity scenario may start tightening from H2CY18 as US Federal Reserve increases the pace of shrinking its Balance Sheet and the current bond buying program of European Central Bank (ECB) tapers off. India on the other hand faces a tricky wicket to bat on as the macro environment has already peaked and political backdrop has become fluid again on the back of Gujarat elections.

2018: Fluid political situation implies macro environment will deteriorate before it improves

Indian macros perhaps peaked in early to mid-2017 with CPI inflation and 10 year government bond yield falling to ~ 1.5% and sub 6.5% levels respectively and current account and fiscal deficit numbers being close to the best they have been in a long time. Increasing commodity prices (particularly crude oil) and uncertain fiscal situation post implementation of GST has meant deteriorating macro health over the last few months as is manifested in inflation data and rising yield in the bond markets. While GST will finally result in better tax to GDP ratio, in the short term it is likely to result in a shortfall in revenue collection due to leeway given to the business community (postponement of key features like matching of returns, e-way bill, reverse charge mechanism, etc.), reduction in GST rates on 178 items in November from 28% to 18% and loss of one month revenue in the current financial year.

Post Gujarat verdict, a BJP versus Congress battle will more sharply define the national political landscape, more so because the 4 major states that go to polls in 2018 – Madhya Pradesh, Rajasthan, Chattisgarh and Karnataka – are mostly straight bipolar contests. As BJP rules 3 of these 4 states, it has more to lose then to gain from these elections. While the market will prefer a favourable outcome for BJP to ensure continuity in policy making, it may not take too kindly to the government deviating significantly from its stated fiscal path. However, given the below average performance of BJP in rural Gujarat, the pressure to put out a ‘populist’ budget will be immense on the Modi government. Also, due to lack of any significant pick up in private capex, central government will have to continue to keep its tap open with respect to funding of infrastructure projects. Fiscal situation in all likelihood will therefore get worse before it gets better.

2018: Strong earnings momentum will be required to support ‘rich’ valuations

On the ground business environment in India, aggravated by demonetization and GST, has perhaps bottomed-out in June / July 2017. GDP numbers after declining for 5 consecutive quarters and showing a print of 5.7% in the June quarter improved to 6.3% in the September quarter. After over two years of muted earnings growth, September quarter numbers were quite decent and met expectations in many cases. Though businesses seem to have started returning to normalcy since August 2017, part of the improvement has been because of GST induced restocking. The next 2 quarter numbers are also likely to be helped by the low base of last year. However, continued tinkering with GST related policies and rates to shore up revenue, fall in Services PMI Index in November to 48.5 and strengthening of rupee against the dollar reducing export competitiveness would imply that recovery in GDP growth rates and corporate revenue and earnings may only be gradual.

Indian markets in the recent past have mostly been supported by increasing domestic inflows and 'hope of a better tomorrow' due to structural changes being brought about by the Modi government. While the tsunami of inflows has not lifted all boats (Pharma and IT sectors continue to underperform), companies that have shown some traction in earnings have been more than handsomely rewarded by investors resulting in extremely rich valuations in several segments of the market. Given rising yield in bond markets, very strong earnings growth will be required going forward to support valuations in these market segments. Indeed, in a deteriorating macro backdrop, this will be the biggest challenge for the markets as earnings growth may struggle to cope up with the rich valuations.

QuestPMS Performance

Quest PMS has been an early investor in select segments of infrastructure sector. Given the priorities of the present government, companies in these select segments presented very attractive growth prospects. Quest PMS had been tracking these companies for years and the same has enabled it to invest into these companies at an opportune time. Rapid growth in order book, increasing margins and improving Balance Sheet of these companies is attracting investors' interest and we believe that going forward a few other segments of the infrastructure sector will start showing traction as well.

Quest PMS investment in the infrastructure space as also its philosophy of investing in companies with sound business fundamentals and good corporate governance practices has been instrumental in delivering superior risk adjusted return in 2017 as well. The same is evident from the table below:

(Returns above 1 year are CAGR)

	PORTFOLIO	SENSEX	NIFTY 50	BSE MID-CAP INDEX	NIFTY MIDCAP 50
3 Months	15.4	8.9	7.6	15.5	18.2
6 Months	17.3	10.4	10.8	22.5	23.1
1 Year	47.5	29.2	30.0	49.7	52.1
2 Years	25.9	14.3	15.2	26.8	27.9
3 Years	21.5	7.5	8.5	20.4	18.5
4 Years	33.3	12.6	13.6	27.9	24.6
5 Years	26.2	11.9	12.3	20.2	18.6

The Above returns are of a Model Client as on December 29, 2017. Returns shown above are post billed fees & expenses.
Returns of individual clients may differ depending on time of entry in the Strategy.
Past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments.

Despite being richly valued, market continues to march ahead putting investors in a major quandary – whether to remain invested and risk losing money or take out some money and risk the feeling of being 'left out' if market continues to head up! We at Quest PMS have always practiced bottom-up stock picking where earnings growth is the focus rather than stock prices and absolute valuation takes precedence over relative valuation. While finding reasonably priced stocks today is more difficult than it was 12 months earlier, we believe keeping a close watch on changing business and industry dynamics and our philosophy of investing in ignored / turnaround stocks still allows us to identify companies that meet our investment criteria and deliver superior risk adjusted returns.

We estimate Quest PMS portfolio weighted average EPS to grow at a CAGR of appropriately 26% over the next 3 years (FY17-20) while it is trading at a PE multiple of 26 on FY18 and 20 on FY19 basis. This gives us the confidence in its ability to continue to do well going forward as well and achieve the targeted returns over the investment horizon.

Key risks as we see it

We see fiscal situation (likely to be aggravated further due to changing political landscape) and employment generation as the key challenges for the Modi government. The largesse bestowed in terms of tax revenue due to crash in the oil prices is now very much part of the fiscal base. Infact, recent increase in crude prices has forced reduction in taxes on petrol and diesel. Also, October and November GST figure of ~INR 83,300 crores and ~INR 80,900 crores is definitely discomforting. With the centre taking approval for second batch of supplementary grant (net cash outgo of over INR 33,000 crores) and increasing its borrowing program by INR 73,000 crores, fiscal targets clearly seem under threat. Add to this the election imperative of increasing government expenditure to prop up the rural economy and we know why the 10 year yield on government paper touched 7.40%!

Globally too, movement of interest rates and liquidity condition will be important determinants of the market trajectory. While Japan is expected to continue with its expansionary policies in the foreseeable future, bond buying program of ECB is being reduced to Euro 30 billion from January 2018 and is likely to further taper off in September 2018. The US Federal Reserve has already embarked on the path of quantitative tightening. While the shrinking of their Balance Sheet is expected to be gradual, this will be unchartered territory even for them and only time will tell what impact it will have on the interest rates and the financial markets. Impact of quantitative tightening by the US Federal Reserve and how North Korea will react to the economic sanctions imposed recently by the United Nations Security Council are the biggest unknowns of 2018.

Final Thoughts

The world economy has seen synchronous growth after a long time. All major economies of the world have done well this year. The good news is that global growth is expected to gather pace in 2018. Also, sharp reduction in corporate tax rate in US from 35% to 21% can trigger competing cuts in other countries (including in India which will be in line with the promise made by the Finance Minister earlier) as well which augurs well for corporate earnings! These tailwinds will be important as India head into a politically charged period with number of state elections lined up in 2018 followed by the general elections in the first half of 2019.

India has come a long way in the last three and half years. Modi government has delivered on several fronts as is now being reflected in the jump in rankings in 'Ease of Doing Business' and sovereign rating upgrade by Moody's. However, expectations have been even higher, partly because of the image that Mr. Modi has created for himself! Next 18 months are going to be crucial as Mr. Modi will not only have to deliver (and also seen as delivering) on the expectations of investors but also the voters who often have conflicting demands, at least in the short term! While investors will expect the government to stick to the fiscal road map, keep inflation and interest rates under check and continue with the tax exemption on long term capital gains, electoral compulsions will warrant higher Minimum Support Prices for agri-produce and sharp increase in social and rural spending till the general elections. Only time will tell whether Mr. Modi will succeed, but in cricket parlance, nobody is better qualified than Mr. Modi to bat on this difficult wicket!

Wishing all readers of this newsletter Merry Christmas and a happy, healthy and peaceful new year!

Jigar Shah / Sandeep Baid
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