MIRAE ASSET

Building on principles

Economy and Equity Market Outlook - 2015

ECONOMY OUTLOOK 2015

The table below highlights what we feel was the economic picture for the Indian economy in CY 2014.

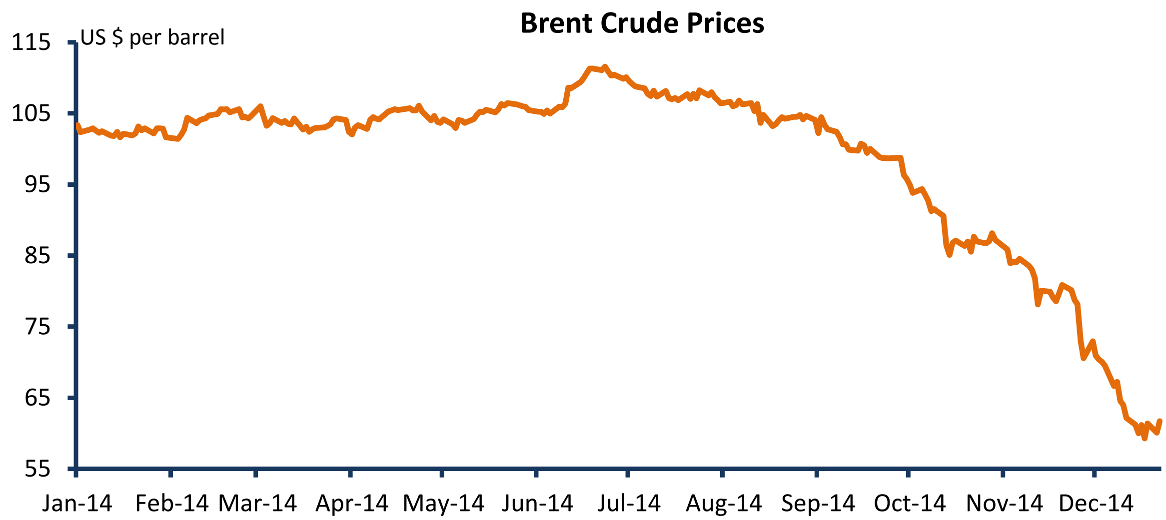
The Good	The Not So Good	The Bad
Remittances	Corporate Earnings	Fiscal Deficit
FII Flows	GDP Growth	
	Economic Reforms	
	Currency	
	CPI Inflation	
	Current Account Deficit	

The table below highlights what we expect the economic picture to look like in CY 2015. We feel a number of economic concerns will recede and hence the current Indian economic environment will change for the better in CY 2015.

The Good	The Not So Good	The Bad
FII Flows	Fiscal Deficit	
Remittances	CPI Inflation	
Corporate Earnings	GDP Growth (considering India's potential)	
Economic Reforms		
Current Account Deficit		
WPI Inflation		
Currency (in comparison with other emerging markets)		

Fall in Oil Prices – Game Changer for Indian Economy

Crude oil prices have corrected by close to 48% since hitting a peak in June 2014, driven by a structural supply glut and political gridlock. Crude Oil prices are currently at a 5 year low. Unlike in the past, the oil price drop is not linked to a crash in oil demand or risk-off in global equities. OPEC's decision to move away from being the sole manager of the demand-supply gap is unprecedented and could lead to low oil prices for the next few years.



Source: Bloomberg, 23rd December, 2014

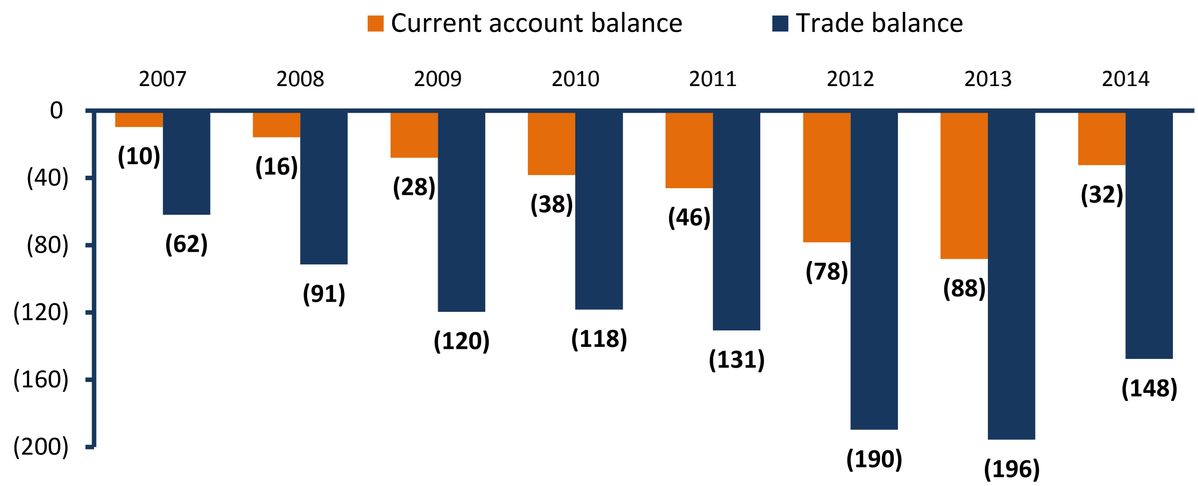
The current correction in Oil prices is hugely positive for India as highlighted below.

- Every USD 10/bbl. fall in crude oil price improves India's Current Account Deficit by around USD 9 billion or 0.5% of GDP
- Every USD 10/bbl. fall in oil price can boost GDP growth by around 10 bps and reduce fiscal deficit by 0.10 %
- Every USD 10/bbl. fall in crude oil prices lowers CPI inflation by 20 bps and WPI Inflation by 50 bps

Source: Asia Economic Outlook, Nomura, 24th November, 2014

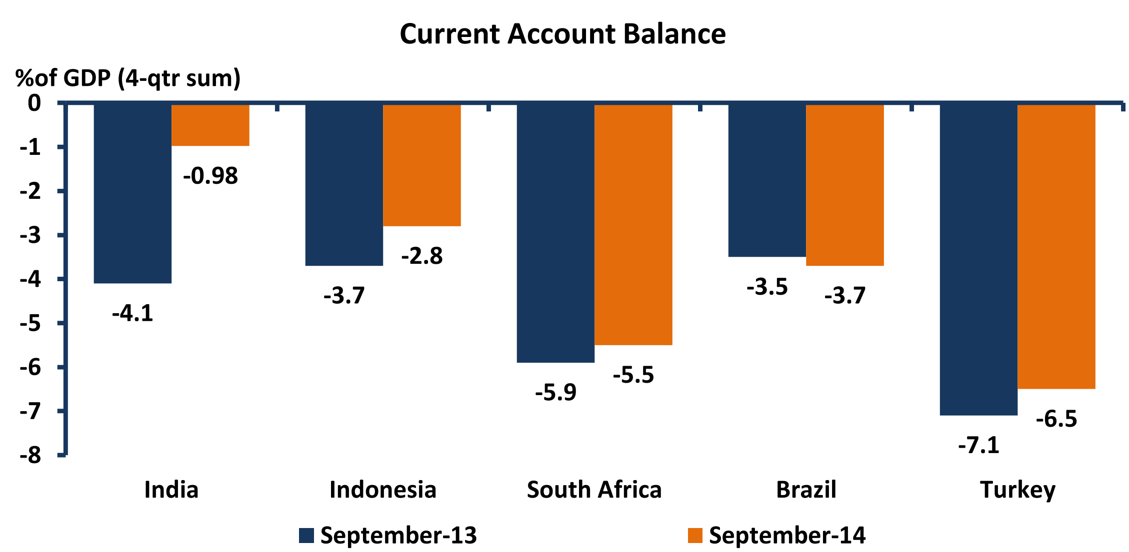
Current Account Deficit (CAD):

The CAD for the year's first half, April-September 2014, was $ 17.9 billion (1.9 per cent of GDP) as against $26.9 bn (3.1 per cent of GDP) for April-September 2013. CAD remains within RBI's comfort zone of 2.5 per cent of GDP. The balance of payments (BoP) was in positive territory.



Source: CEIC, Kotak Institutional Equities. Trade deficit and CAD, March fiscal year-ends, 2007-2014 (US$ bn)

CAD – India best placed:



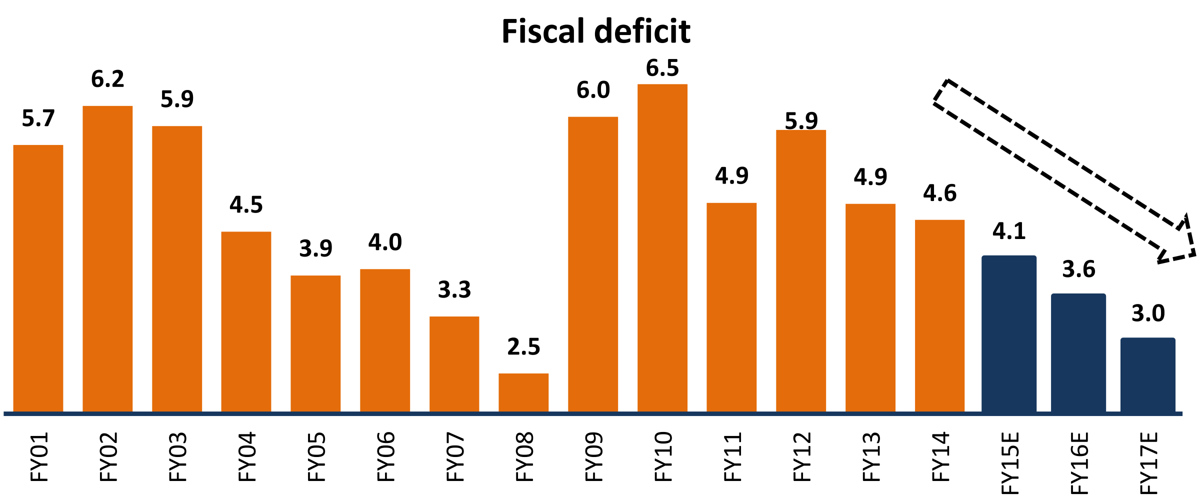
Source: Nomura, Asia Research, November 2014

Our View:

In FY14 when crude oil was at $108/bbl., India reported CAD of $ 32.4 billion with the help of restricting gold import to the tune of 350MT (assuming on the higher side). Taking gold at $1200/oz., the actual reported CAD would have been $ 46.4 billion.

In FY16, if we take average crude oil price at $80/bbl., the petroleum, crude and other products imports would be $76 billion against worth $102 billion in FY14. It will results in savings of $ 26 billion. So CAD in FY16E would only be $ 20 billion, which can be easily funded by capital flows

Fiscal Deficit:

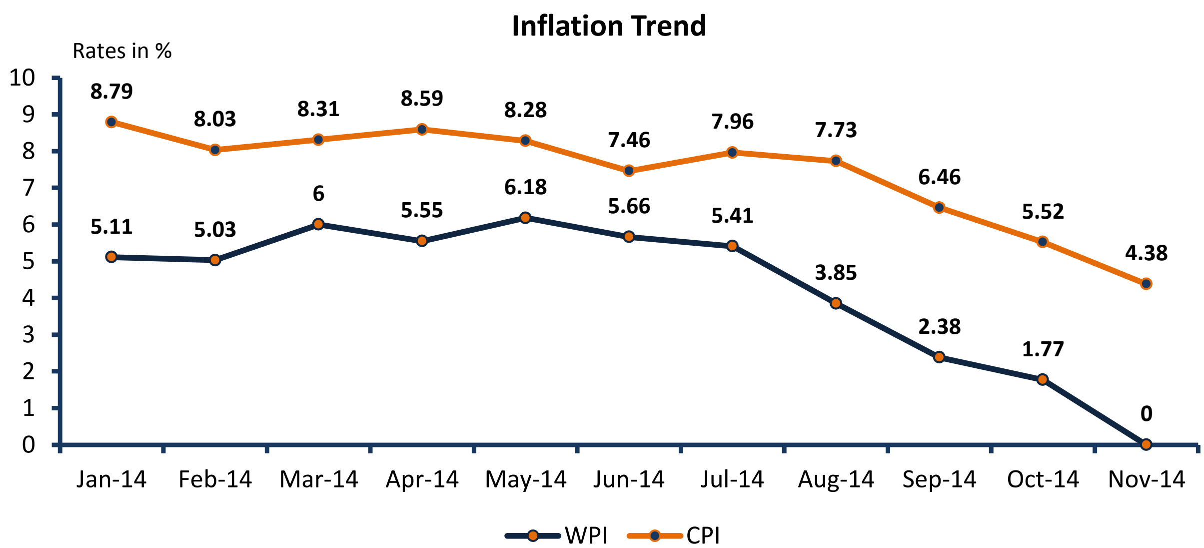


Source: Bloomberg, 31st July, 2014

The new central government has shown strong commitment towards fiscal consolidation, with fiscal deficit target of 3% over the next 2 years.

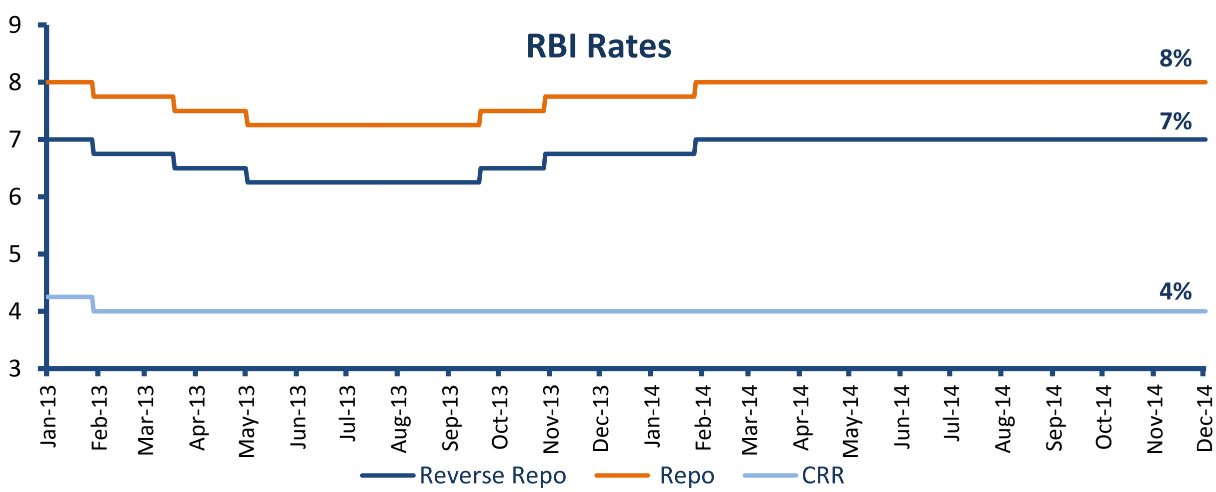
Inflation & RBI Policy Actions:

- India's WPI Inflation is at a 5 year low of 0%.
- India's CPI Inflation (the number keenly monitored by RBI) came at 4.38%, which is at lowest level since the new series of Consumer Price Index was released in January 2012.



Source: Bloomberg, 22nd December, 2014

There were no rate cuts by RBI in 2014, inspite of sharp fall of close to 450-500 bps in Inflation. However the 10 year G-Sec yields and 1 year Commercial Paper yields have fallen close to 100 bps in 2014 in anticipation of lower rates in 2015.



Source: RBI, 22nd December, 2014

Our View:

Inflation contributors under control - We expect inflation trend to be lower than CY'14 due to the following; lower global commodity prices, lower minimum support prices and other supply side measures taken by RBI.

Variables affecting inflation in 2015	
Crude oil prices	Recent fall in crude oil prices should help reduce CPI inflation by 60-80 bps.
Minimum Support Prices (MSP)	Fall in MSP increase from 22% to 5% should help lower CPI inflation by around 2pp over two year period.
Supply side measures by govt.	Measures to boost supply of fresh food can have considerable impact on CPI inflation in the near term
Other commodity prices	Marginal direct impact. Limited second round impact on lower input cost for manufactured goods

The RBI has maintained its estimate for real GDP growth in 2014-15 at 5.5% and expects only a gradual pick-up in growth momentum in 2015-16. RBI has acknowledged the recent deceleration in inflation and has revised downwards its March 2015 CPI Inflation projection to 6% from 8% and its January 2016 inflation projection has also been kept at 6%. RBI now sees the medium term risks around its January 2016 target of 6% as evenly balanced rather than to the upside, as in the last policy meeting.

RBI`s policy guidance removes uncertainties, despite the decision to keep rates on hold. Governor Rajan has laid the foundations for future rate cuts. Looking at current low international commodity prices and improving domestic inflation expectations we expect 50 bps rate cut in 2015.

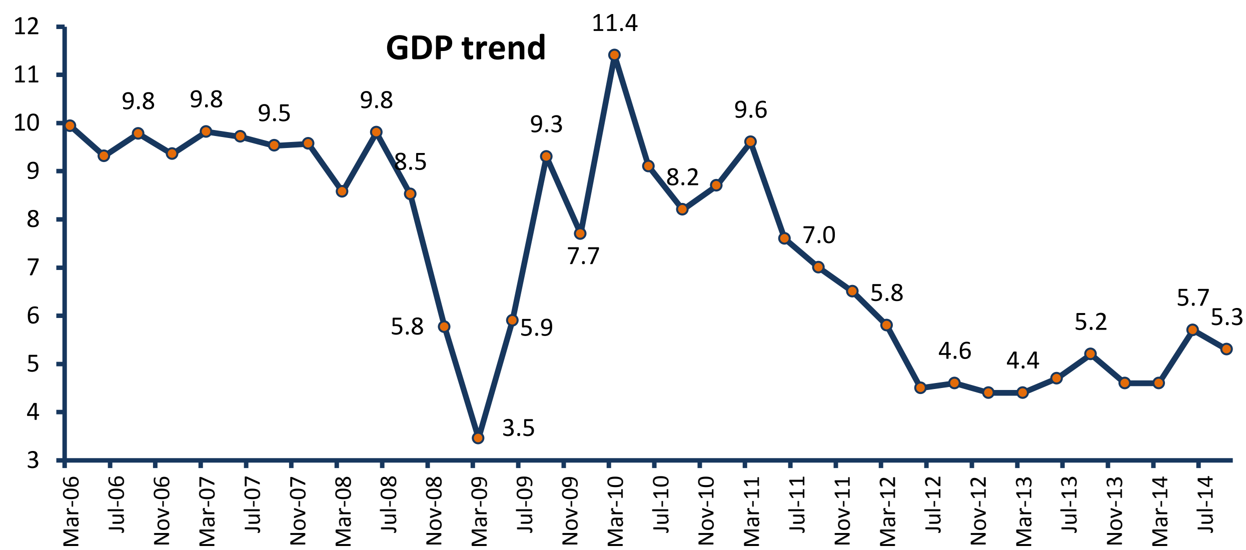
Falling interest rates will benefit equities as an asset class, as well as improve fundamentals of many rate sensitive businesses.

We feel global developments due to sharp fall in Oil, movement of Rupee and persistence of FII interest in India can proved to be key risks to this view.

Gross Domestic Product

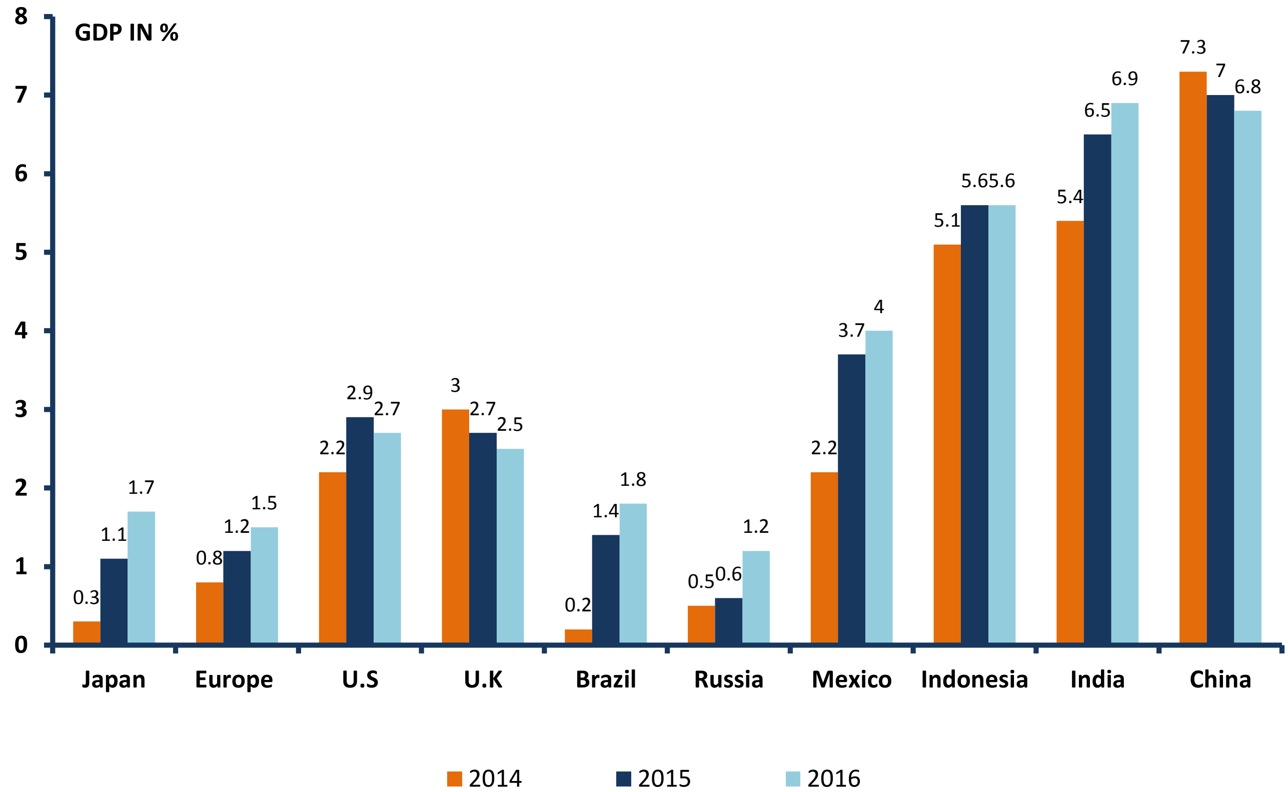
India's GDP grew by 5.7% in Q1FY15, the highest in 10 quarters and by 5.3% in Q2FY15. An uptick in investment demand and exports is visible.

- Private consumption demand remained sluggish but is expected to improve as indicated by higher sales of cars, and consumer goods.
- Several small steps announced by the government to improve the ease of doing business, are lifting investor sentiment - results of business confidence surveys are proof of that.
- Speedier implementation of stalled projects and gradual easing of mining bans will help further. However, the outcomes of the review of coal block allocations made in the past will be crucial to decide the fate of mining output.



Source: Bloomberg, 30th September, 2014

India: An Oasis of Growth



Source: Morgan Stanley, Barclays, Citi, Goldman Sachs

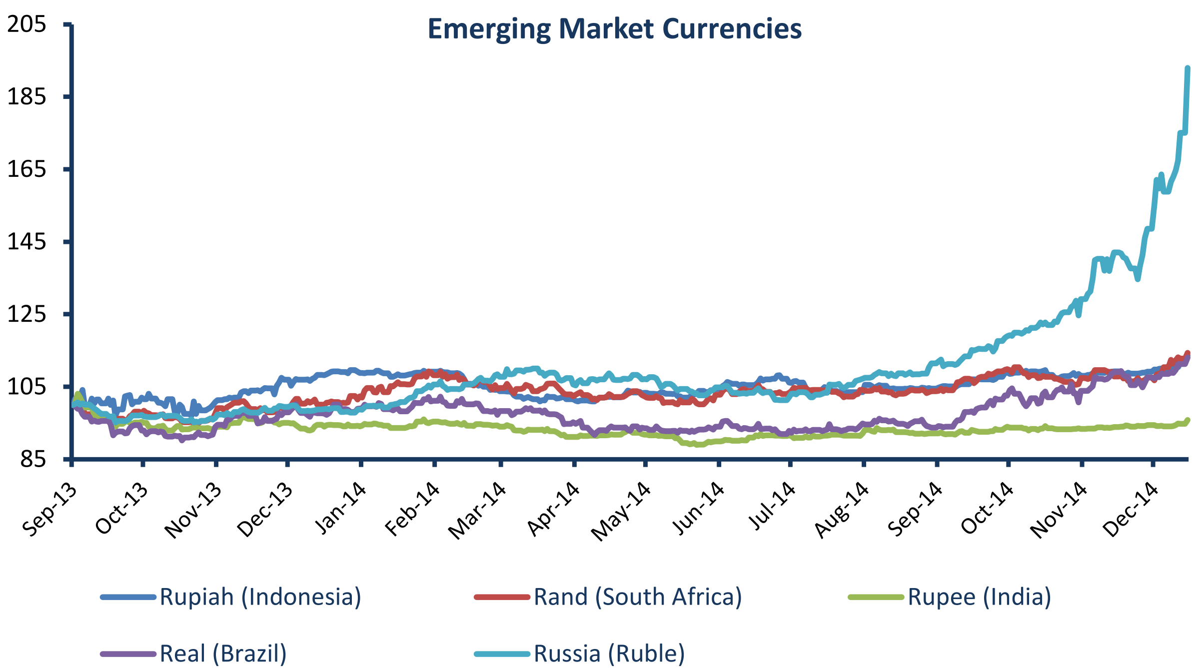
Goldman Sachs feels India's GDP growth will overtake China's and become the fastest-growing emerging market over 2016-18. They feel the Indian economy was at the beginning a new growth cycle, driven by reduced macro imbalances, benign global conditions (lower commodity prices) and structural reforms. Other emerging markets such as Brazil, Russia and South Africa are expected to grow at a much slower pace on weaker commodity prices.

Our View:

GDP growth will recover slowly as the investment cycle will take time to mend given extant funding and investment challenges. We believe that India is on way to 6.3%+ growth (+/- 0.3%) in FY15-16.

Stable Currency

The Indian Rupee has performed significantly better than other Emerging Market currencies in spite of end of QE (in US). This is due to improving current and fiscal deficit (boosted by sharp correction on crude oil prices).



Source: Bloomberg, 15th December, 2014

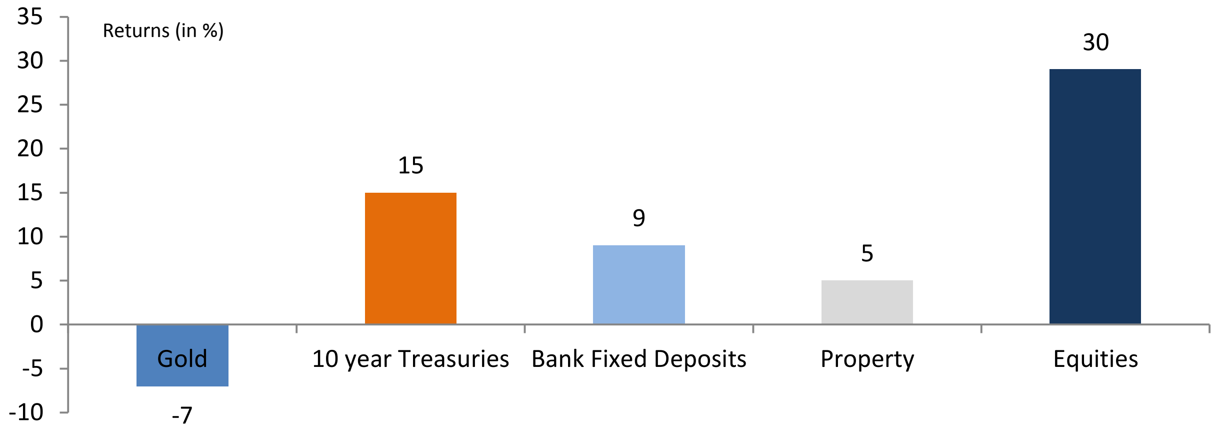
Goldman Sachs expects the Indian rupee to remain largely stable against the dollar, due to capital flows. This means that even as the US Federal Reserve begins to increase rates next year, India will not see the kind of turmoil seen in 2013. However, India's rupee could appreciate against other developed market currencies such as the Euro and the British pound.

In 2014, the INR lost close to 2% vis-vis the USD but appreciated by 4% and 10% against the British Pound and Euro respectively.

EQUITY MARKET OUTLOOK

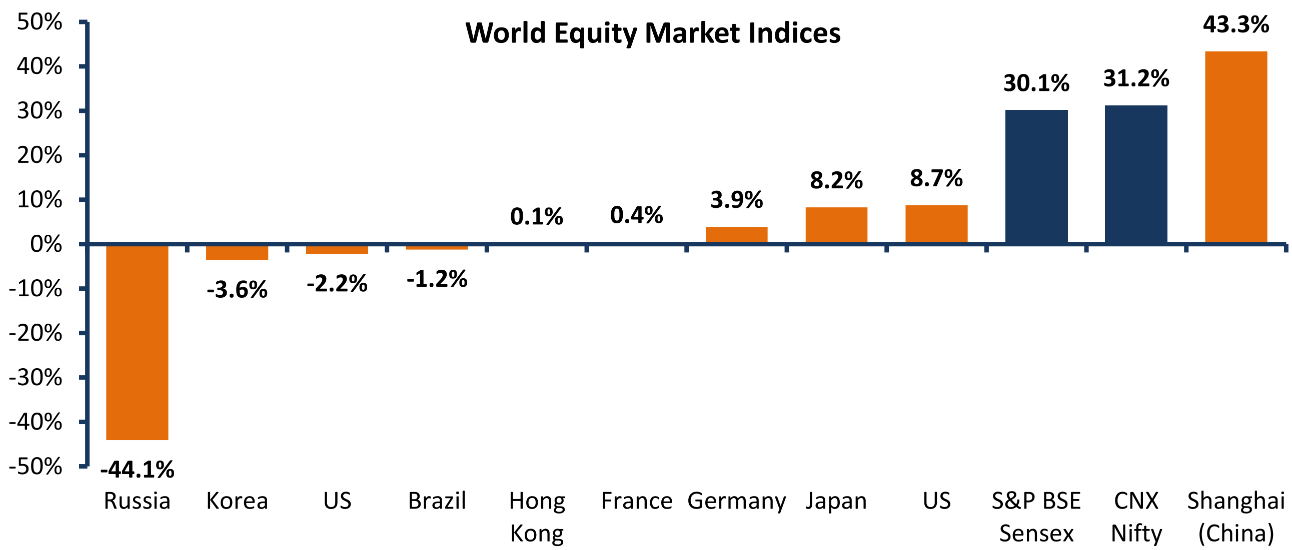
2014 Revisited

Equities were the best performing asset class in CY 2014.

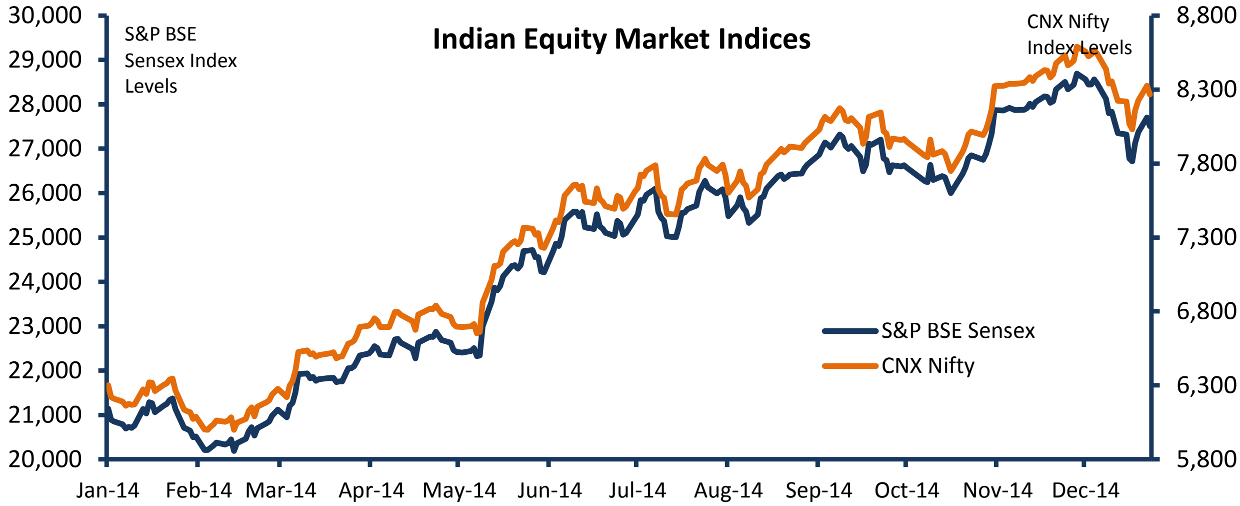


Source: Bloomberg and Mint, 29th December. Bank FD returns are for average SBI FD rates, returns for property are average price in seven metros for real estate and returns for Gold are domestic price for Gold.

Indian equities are one of the best performing global equity market this year, barring Shanghai market which has rallied in recent months.

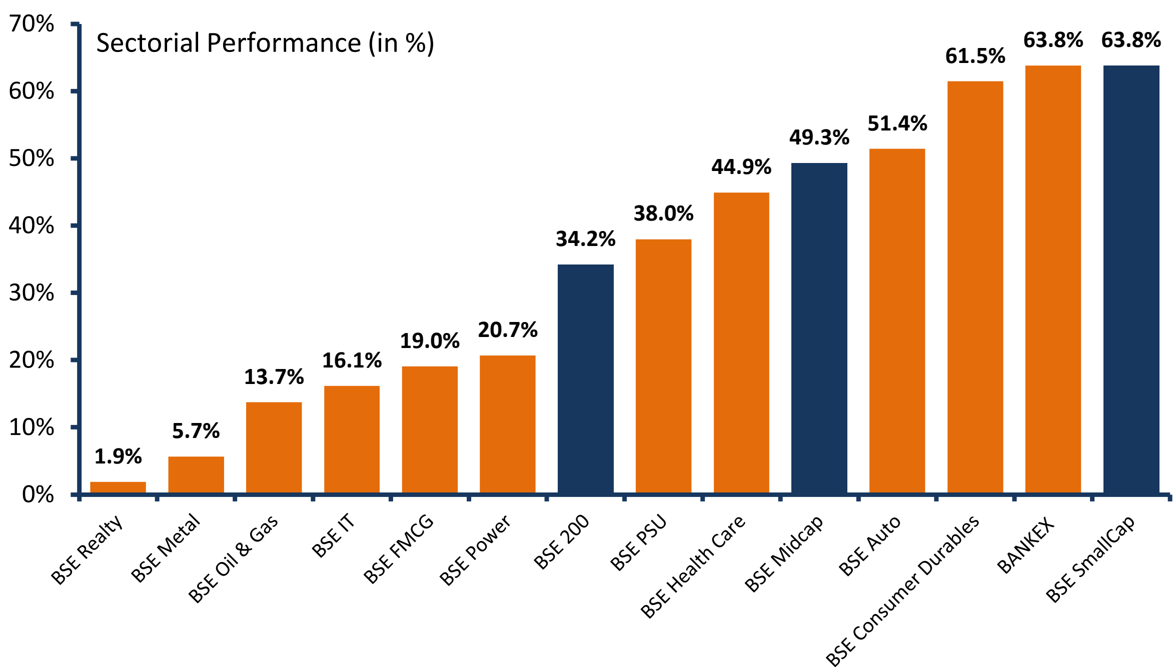


Source: Bloomberg, 23rd December, 2014



Source: Bloomberg, 23rd December, 2014

This year has been exceptional as all the sectors delivered positive returns. Amongst the sectors Consumer durables and Financials delivered highest returns of around 61% and 63% respectively. Realty, Metal and Energy stocks were at the bottom but delivered positive returns.

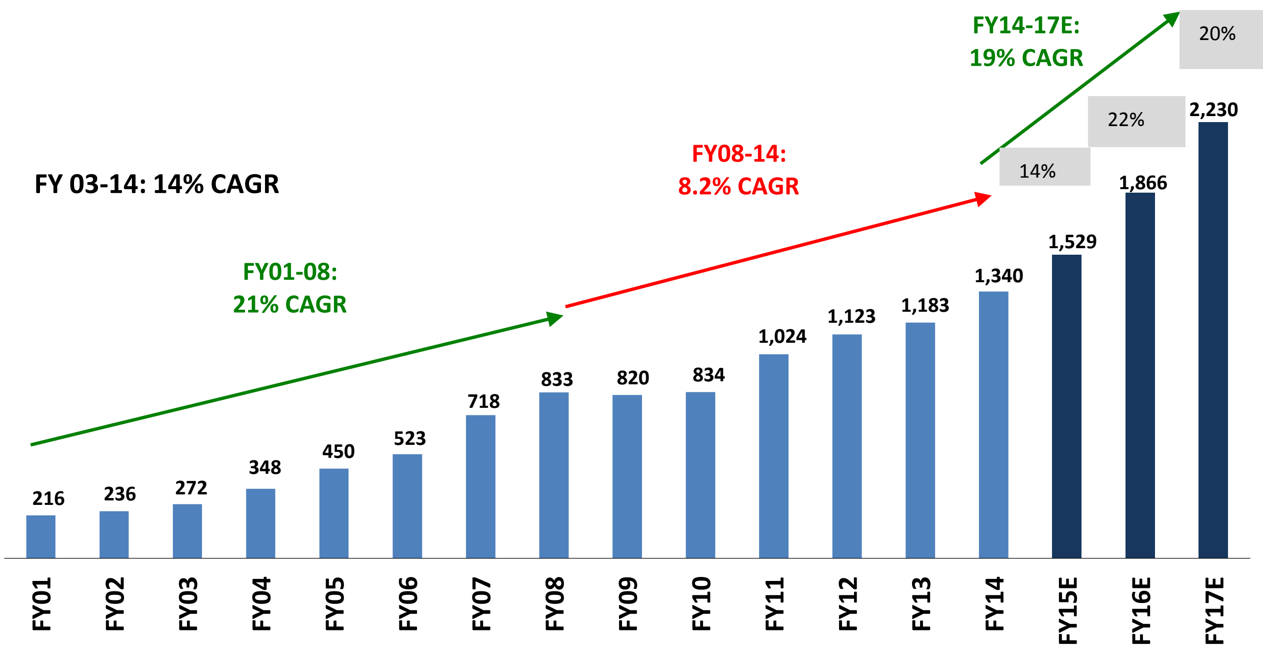


Source: Bloomberg, 23rd December, 2014

EQUITY OUTLOOK 2015

It will be difficult to predict the movement of indices but we believe 2015 could continue to be a good year for Indian equities. Some of the factors that make Indian Equity attractive are

1. Earnings & Valuations the Pillars for Equity Market Growth:



Source: MOSL, November 2014

Post 8.2% CAGR earnings growth during FY08-14, there is revival in earnings growth (estimated 19% CAGR in FY14-17E). The strong earnings growth is expected to drive P/E ratings and markets.

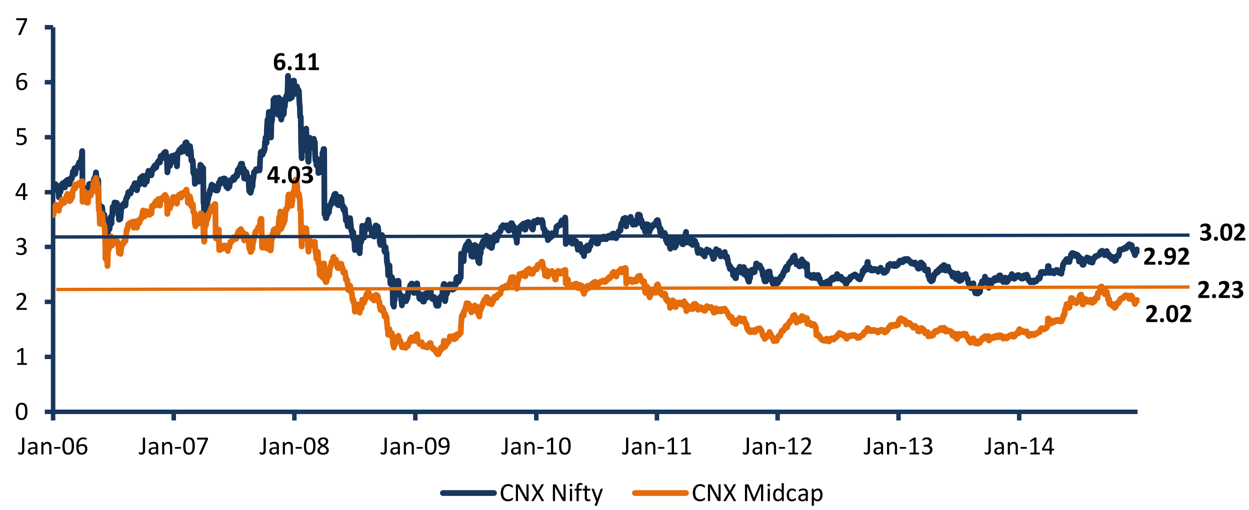
Price Equity Ratio:

Source: Bloomberg, 23rd December, 2014

The markets still very attractive as the indices are trading close to their 8 year average, but still are way below their peak.

- **CNX Nifty is currently trading at PE of 18.91x, which is at around 33% discount to its peak**
- **CNX Midcap is trading at PE of 18.56x, which is at around 35% discount to its peak**

Price to Book Ratio

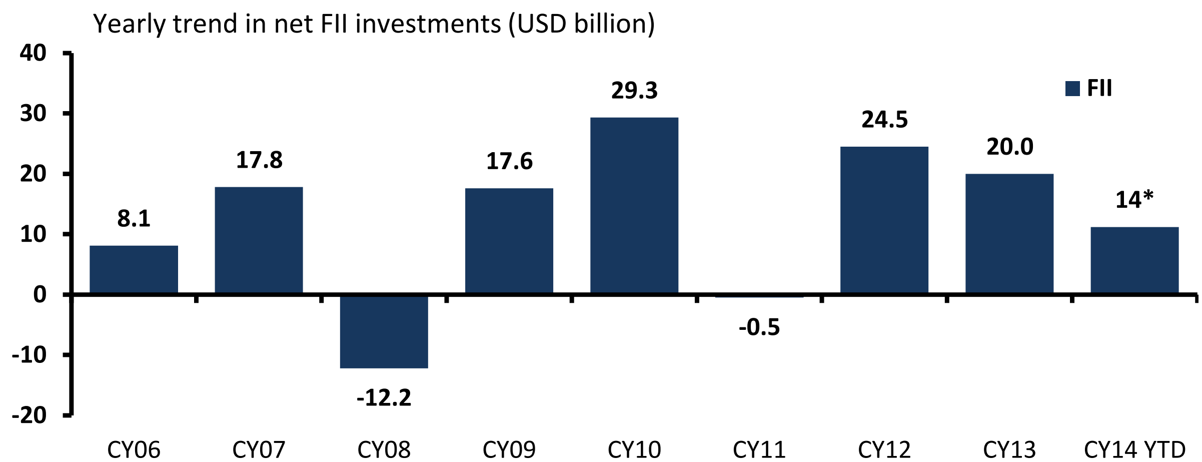


Source: Bloomberg, 23rd December, 2014

The markets still very attractive as the indices are trading close to their 8 year average, but still are way below their peak.

- **CNX Nifty is currently trading at PB of 2.92x, (compared to peak of 6.11x in 2008)**
- **CNX Midcap is trading at PE of 2.02x, (compared to peak of 4.03x in 2008)**

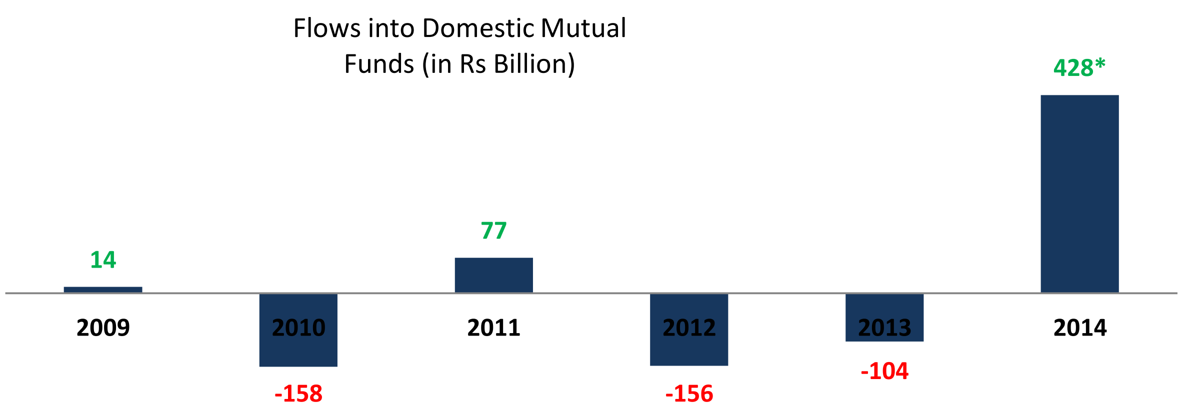
2. FII & Domestic Flows will add zing to the markets:



Source: Bloomberg, 29th December, 2014

FII's continue to be positive on India, with highest flows amongst emerging markets. However FII flows into equity were modest compared to last couple of years. A key reason could be that FII's also purchased 26 billion USD of Indian Fixed Income securities this calendar year. In the past six years (FY10-FY15E), Indian households will have invested an estimated US $ 40 billion into equities at an average annual rate of $ 6.7 billion (includes direct equity purchase, purchases through mutual funds and life insurance). During the same period, FIIs inflows amounted to US $ 106 billion at an average annual rate of close to $ 18 billion.

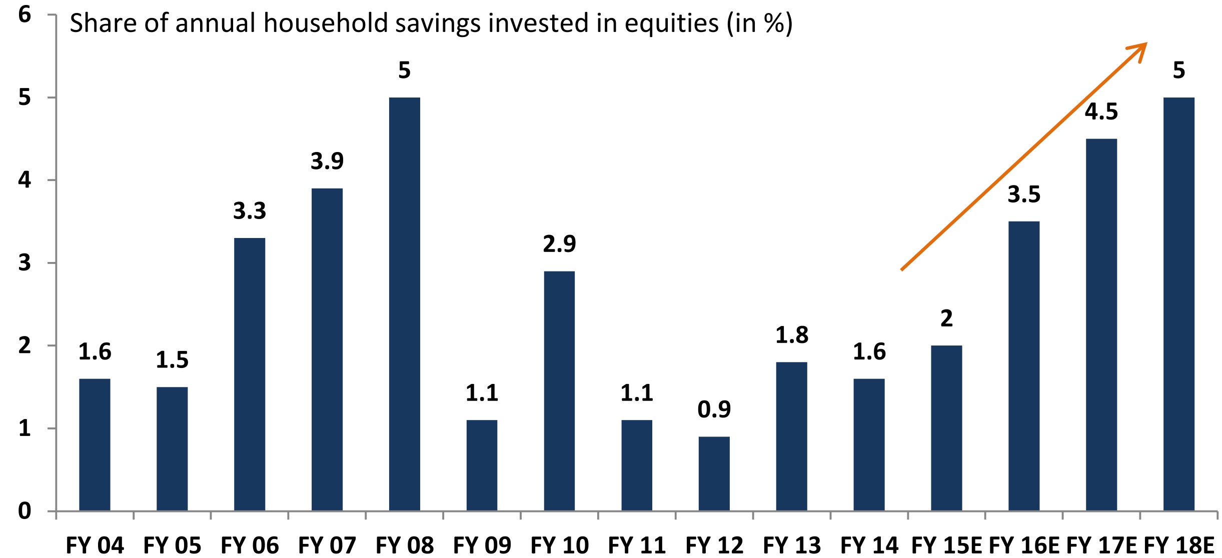
Significant jump in flows into domestic equity mutual funds since May-14



Source: Bloomberg, 29th December, 2014 (till November, 2014)

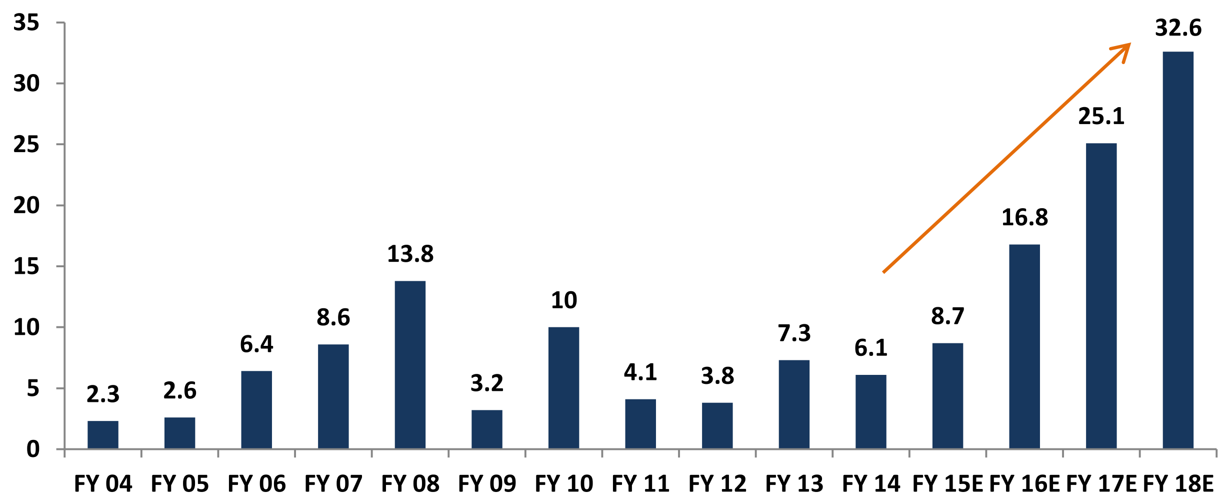
Domestic mutual funds are witnessing robust inflows since May 2014. We expect this to accelerate in the coming years.

The last time Indian households were bullish on equities was in FY08. In that year, 52% of household savings went into financial assets (they have since fallen to 35% in FY14) and an estimated 5.0% of total savings went into equities (they fell to 1.6% in FY14).



Source: IIFL India Strategy, 2015

Estimated equity investments by households (US $ billion)



Source: IIFL India Strategy, 2015

IIFL estimates that households could invest $ 74 billion over the next three years (FY16-FY18E), at an average annual rate of nearly $25 billion.

Our View:

Indian Retail Investors have been underweight on equities over the last few years and reversion to mean will add domestic flows to the markets.

3. Market Cap to GDP

Market Cap to GDP is a long-term valuation indicator that has become popular in recent years, thanks to Warren Buffett. Back in 2001 he remarked in a Fortune Magazine interview that "it is probably the best single measure of where valuations stand at any given moment."

The value of Indian listed companies as a percentage of the country's economic output is at its highest in a little over three years, an indication that market valuations are at least fairly valued. The figure is still off its all-time high in December 2007, when it crossed 100% of GDP. It is also lower compared to global average of 82%.

India's Market Cap in the global context

Country	M Cap (US$ billon)	2014 GDP (US$ billon)	M Cap/GDP %
U.S	23400	17416	134
China	4938	10465	47
Japan	4392	4670	94
Hong Kong	3873	293	1324
U.K	3568	2815	127
Canada	1987	1785	111
France	1930	2868	67
Germany	1846	3775	49
Switzerland	1596	672	238
India	**1474**	**2115**	**70**
South Korea	1175	1434	82
Australia	1164	1464	80
Taiwan	940	503	187
brazil	737	2202	33
Spain	731	1384	53

Source: IIFL Research. Based on 2014 GDP estimates of IMF and market data as on 16-Dec-2014

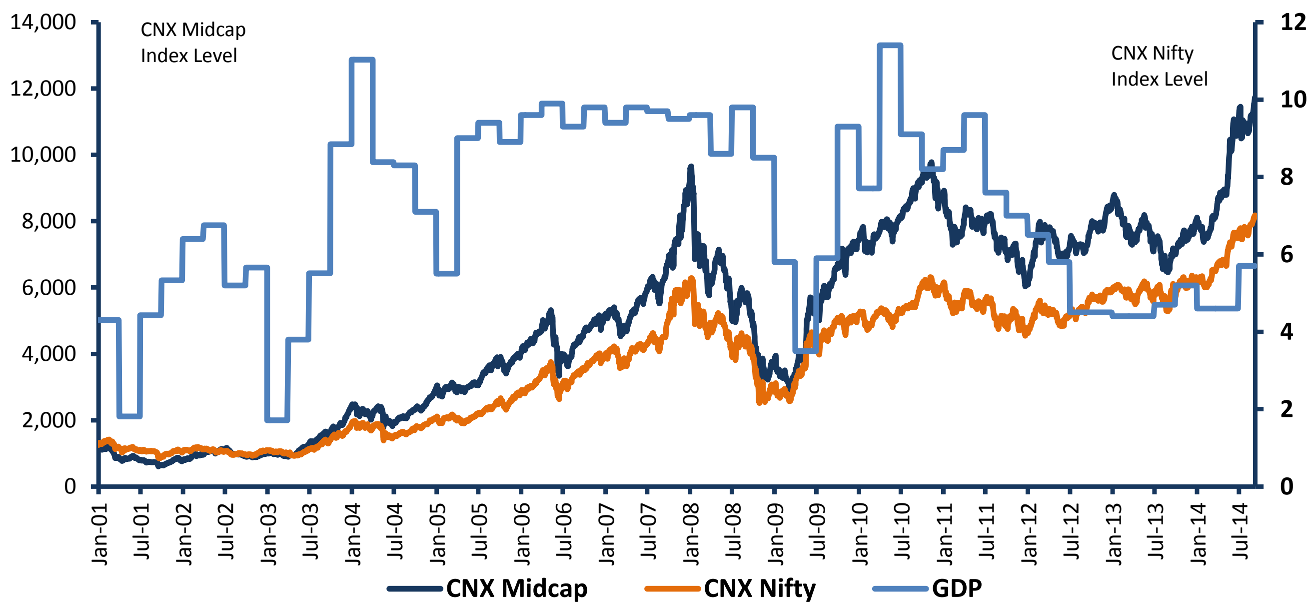
4. GDP and Earnings Growth

The equity markets generally tend to do well when both the GDP growth and Earnings growth are robust (a sample period of 2003-2007 bull period shown below). In the long run, one can reasonably expect average equity returns to at least track the nominal growth of the economy.

Year	GDP Growth	Earnings Growth	Sensex Return
2003	8.10%	20.60%	73%
2004	7.00%	36.50%	13%
2005	9.50%	27.70%	42%
2006	9.60%	25.50%	47%
2007	9.30%	19.00%	47%

Source: Bloomberg, 23rd December, 2014

Market Performance and GDP Growth



Source: Bloomberg, 23rd December, 2014

As growth starts to look up and earnings outlook will improve, the market can continue to perform well.

5. Economic Reforms

We expect the central and progressive state governments to implement more meaningful reforms in 2015. Fiscal reforms are underway with the government focusing on implementation of **GST**; direct cash transfer schemes, etc. Introduction of GST and DTC will have a huge impact as it will removes the tax anomalies and increases GDP by over 1% and help generating better revenues which is the need of hour. Investment reforms in areas related to labor, land and power reforms may ease the business conditions.

India continues to rank poorly in the World Bank's Ease of Doing business survey at No. 134 of 180 countries. Government "Make in India" initiative should over time help improve the ranking as it creates congenial environment which facilitates investments.

Coal sector reforms – Auctioning of 72 coalmines de-allocated by Supreme Court in Sep'14 is expected to be completed by Mar'15. Auctioning of the balance 140 odd mines would happen in phases. The government has set a target to raise Coal India's production from 462MT in FY14 to 925MT in FY20 (12% CAGR) and India's total production from 565MT in FY14 to 1200MT in FY20 (12% CAGR). Mine-wise plans are being drawn. Government is seeking to modify the Coal Nationalization Act to allow third-party sales by the private sector.

Labour reforms - Stringent labour laws, are a major constraint for the manufacturing sector. The government has initiated labour reforms process

Manufacturing Reforms

- Increase manufacturing sector growth to 12-14%p.a. over the medium term.
- Increase the share of manufacturing from 16% of GDP to 25% by 2022.
- To create 100 million additional jobs by 2022 in manufacturing sector.
- Enhance the global competitiveness of the Indian manufacturing sector.

Source: www.makeinindia.com

The concerns at this point would be more related to execution, i.e., political risk as lot is driven by one-man. Also, the government's ability to implement reforms may be constrained by its minority status in the upper house of parliament and its limited influence over states.

INVESTMENT STRATEGY:

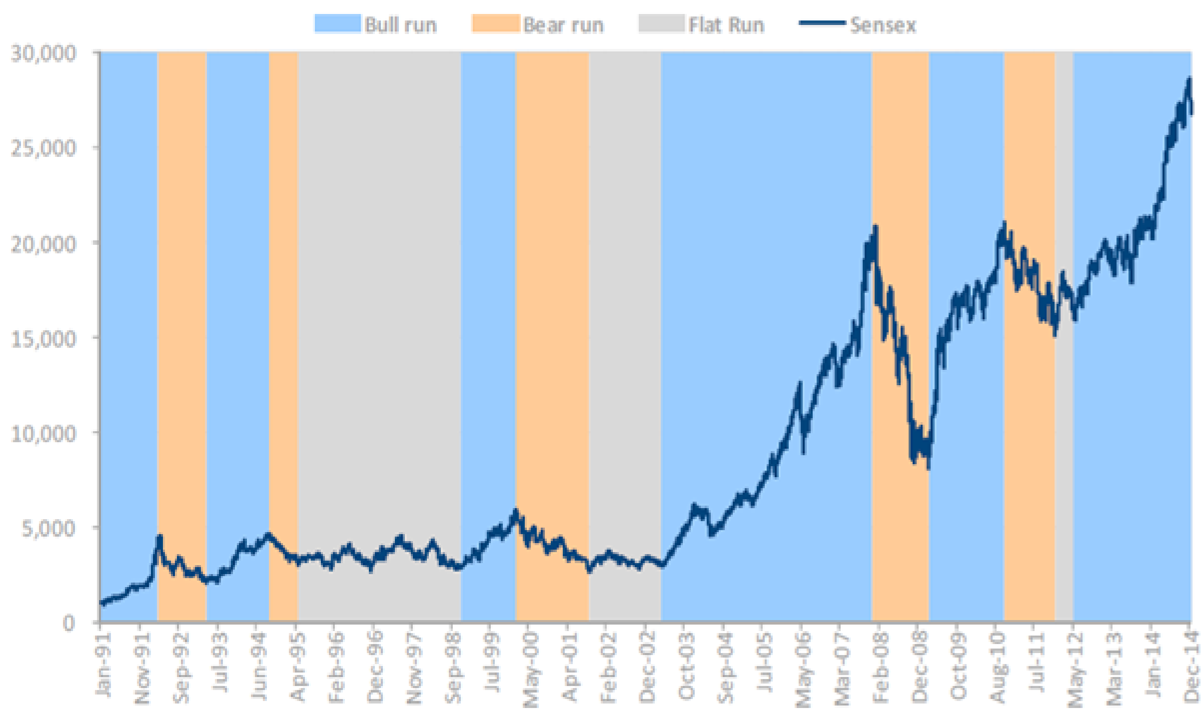
Overall, we believe that 2015 will be another good year for Indian equities. With transformation in macros driven by stable government, and low commodity prices, India is a multi-year theme – in this context, we believe that investors should take a long term view while investing in equities. In the short term (only 2015), there could be possibility of moderation in returns after significant re-rating in 2014, and thus sector/stock selection is crucial. Possible strong reforms in various sectors will drive the market hereon.

Introduction of GST and DTC will have a huge impact as it will removes the tax anomalies and increases GDP by over 1% and help generating better revenues which is the need of hour. We believe the historical verdict paves the way for strong growth over the next few years. Potential improvement in the growth outlook will be dependent on the Government's ability to bring in reforms. Aside from the sector specific reforms, the potential macro reforms which mentioned above - like simplifying project approval and land acquisition processes, labor reforms, federal reforms, tax reforms and lowering of subsidies.

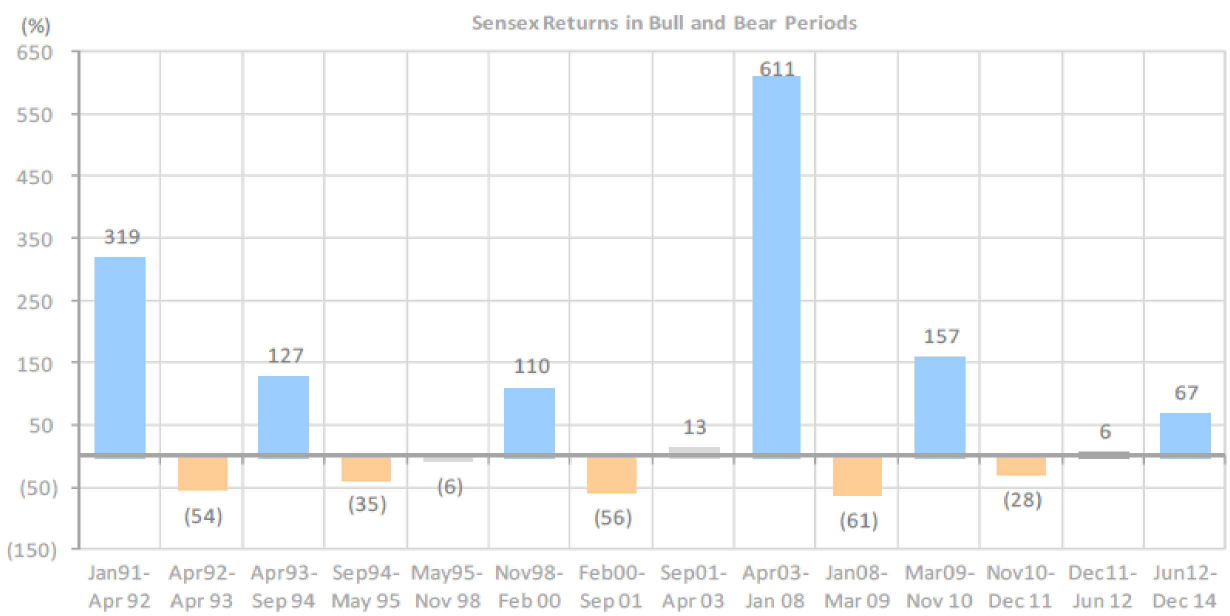
We are running a fairly balance portfolio skewed towards growth oriented quality companies. We are positive on both domestic themes as well as export oriented businesses like Pharma. Within domestic sectors, we like businesses which will benefit from the likely reduction in interest rates, margin expansion owing to fall in commodity prices, and reforms like GST, etc. Among the key overweight position in our portfolios are Private sector banks, Consumer discretionary (like Autos, Auto ancillaries, Building materials, etc.), and businesses which will benefit from the revival in the Manufacturing sector.

ANNEXURE - HISTORY OF BULL MARKETS- WHERE ARE WE?

BSE Sensex – History of Bull and Bear phases



BSE Sensex returns in Bull and Bear periods



The BSE Sensex has risen by 67% since its bottom in June 2012, versus 611% in the biggest bull-run of Apr'03-Jan'08, and between 100-300% in other previous bull runs

In the last three bull runs, which ended in Feb'00, Jan'08 and Nov'10, the BSE Sensex peaked at trailing PE of 24-28x, versus its current trailing PE of 18x. That leaves enough upside through a combination of higher earnings growth and further expansion in PEx.

Period	% Returns	Duration (mths)	Start trailing PEx	End trailing PEx
Jan91-Apr 92	319	15	17.8	55.8
Apr92-Apr 93	(54)	13	55.8	25.3
Apr93-Sep 94	127	17	25.3	47.0
Sep94-May 95	(35)	8	47.0	26.8
May95-Nov 98	(6)	43	26.8	11.2
Nov98-Feb 00	110	15	11.2	25.5
Feb00-Sep 01	(56)	20	25.5	13.5
Sep01-Apr 03	13	19	13.5	12.8
Apr03-Jan 08	611	57	12.8	28.5
Jan08-Mar 09	(61)	14	28.5	11.6
Mar09-Nov 10	157	20	11.6	24.2
Nov10-Dec 11	(28)	14	24.2	16.2
Dec11-Jun 12	6	6	16.2	15.7
Jun12-Dec 14	67	30	15.7	18.0

Source for all 3 graphs above: IIFL India Strategy, 2015

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The data mentioned are as on 29th December, 2014.

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