From the CIO's Desk

June 2019

ENAM ASSET MANAGEMENT

Dear Investor,

It gives me great pleasure to share with you an update for the quarter ended 30th June 2019. The last quarter has been a historic one for our nation. The results of the general elections were declared on 23rd May 2019 with an unprecedented victory for the Bhartiya Janata Party (BJP) led by the honorable Prime Minister, Mr. Narendra Modi. The expectations of the BJP coming back with a majority were very slim and no one had expected this sort of a victory for them. The BJP managed to get 303 seats in a total of 543 seats thus coming home victorious with a better tally than in 2014 where it had won 282 seats. This is the second consecutive term where the BJP has won a majority vote as a single party. This spells huge political stability for India and once again helps formulate a decisive policy framework without any coalition partners blocking progressive reforms.

This mandate signals that the people of this nation, including the first-time voters, are wanting to bring in dramatic changes in the political and socio-economic landscape of this country. Never has India and its Government acted so boldly to end crony capitalism. In their last term, this Government has provided the country with a scam free environment. There was a dramatic clean-up of India's banking system with an all-time high recognition of non-performing loans. This Government has also attempted to change the business landscape with some major reforms like the Goods and Services Tax (GST). India has for the first time experienced a corruption free environment in the high offices of the Government.

While the outgoing Government had presented its interim budget in February 2019, before the general elections, the full budget for 2019-20 was presented in the parliament by the newly appointed Finance Minister Ms. Nirmala Sitharaman on 5th July 2019. Even though the relevance and impact of the budget on the markets has been on a secular decline over the last few years, the first budget of the newly elected Government hasn't evoked a positive response with both domestic and global investors. There is a lack of growth initiatives and a hope for higher growth without much impetus being provided by the Government. The budget has imposed a surcharge on the super-rich and hit the rich class of tax payers with a tax rate of over 42%. Further, imposition of higher taxes has spoiled the sentiment amongst the market participants as there is a feeling that the Government is trying to tax the rich to benefit the poor. One of the things that need further clarity is the imposition of an extra surcharge payable by non-corporate Foreign Institutional Investors (FIIs). The profits made by these FIIs, who are not operating under a corporate structure, will now be taxed a little over 42% as compared to a little over 35% earlier. This issue has now been taken up with the Central Board of Direct Taxes (CBDT) without any resolution so far. These are some of the issues that have led to a sell off in the markets post the Union Budget for FY 2019-20.

Turning to the Indian economy, last year has been one of the slowest years in the recent past. India's GDP growth has slowed down to 5.72% for the quarter ended 31st March 2019. The GDP for the year ended 31st March 2019 is estimated to have grown by about 6%, one of the lowest growth rates in the recent past. The IIP growth rate is now trailing at around 3%. There is very little activity for new capital expenditure on the ground. The economy is reeling under pressure of slowing growth. In fact, in the absence of much job creation and large job losses in a few sectors, the economy is now witnessing a slowdown in its only growth engine–private consumption. The environment continues to be very challenging. The last quarter has seen most of the companies struggling to record volume growth. The discretionary consumption has taken a severe beating with the largest impact on the automobile industry. Passenger cars and two wheelers sales have de-grown and a lot of unsold inventory is still lying with the dealers. Every category of consumption has been affected by this severe slowdown.

The three major building blocks for the nation are savings, consumption and infrastructure. So far savings was seeing a steady accretion. The financialization of savings happened post demonetization in 2016 post which investors moved from physical to financial assets. In the last fiscal, there was a record inflow of US$ 10.22 Billion in the equity market from domestic investors. The quarter ended 30th June 2019, witnessed an inflow of just US$ 674 Million by the domestic investors into equity markets. This slowdown in inflows to the equity markets were due to a lacklustre stock market where the broader market has declined dramatically. The good news is that FII inflows into equity markets were very strong at approximately US$ 3.20 Billion for the quarter ended 30th June 2019. In fact, the FII inflows in CY 2019 stood at a record US$ 11.42 Billion. The FIIs have been net sellers post the latest union budget 2019-20.

A combination of factors such as global slowdown, lower rural incomes and continued tightness in liquidity, have all led to a persistent slowdown in the Indian economy. There is a lot of weakness in consumer demand with decline in auto sales now into its third quarter. Broad indicators such as industrial production and rail freight movement continue to grow in low single digits. This is the year in which discretionary consumption demand will be severely affected. There is still a lot of unsold inventory of every item in the system. This year the corporates will record lower sales growth but will clean up the supply chain with a sharp correction of the unsold inventory in the market place. This will form a bottom for the next year in which we expect much better growth over this year's lower base.

As far as India's infrastructure story is concerned, we haven't seen much playing out except for the road constructions which have been growing impressively over the last few years. In the last budget, the Finance Minister has expressed her intention to spend INR 100 lac crores on infrastructure over the next few years. While this is very good, there are no specific details of how the Government will mobilize such large resources. The plan to open the infrastructure creation to the private sector has not evoked much response as the private sector does not have the adequate resources to do so. The creation of infrastructure must be led by the Government which we believe will start happening from the second half of this fiscal.

It is in the above context, that the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) unanimously reduced the policy rate by 25bps to 5.75% in June 2019. It also changed its stance to "accommodative" after previously maintaining it at "neutral" despite earlier rate cuts. This is the third rate cut of 2019, representing a cumulative 75 bps of rate cuts so far. The MPC also lowered its FY 2019-20 GDP growth projection to 7.0% y-o-y (from 7.2% earlier). The accommodative stance suggests that the MPC is now more concerned about the growth slowdown and is expecting inflation to remain capped despite its ongoing easing. The change to accommodative stance suggests the possibility of further rate cuts of at least 50 to 75 bps and reinforces monetary policy transmission. The RBI would be keen to see the transmission of these cuts by the banks and Non-Banking Finance Companies (NBFC) to their borrowers. Inflation remains benign and is no more a concern for the RBI. We are in a low inflation low growth environment which will need hand holding by the Government and the RBI.

The economy is limping because of the crisis in the NBFC sector. The NBFCs play a very important role in reaching out to fund segments of the industry and sections of the society that do not have access to credit from the formal banking channels. The current NBFC crisis has led to non-availability of funds for various sectors and various sections of society. This has dramatically slowed down consumption in various pockets of the economy leading to a contraction in demand. In the NBFC sector, only the companies having a stressed balance sheet are facing problems. Well-capitalized NBFCs with transparent reporting standards are not finding it difficult to raise resources. So, the Government and the RBI seem to be of the view that the NBFC crisis is not a systemic risk and is transient. This crisis is surely an eye opener that the NBFC sector is a very important segment that funds growth within our economy. All NBFCs are a lifeline of our economy and we cannot survive without them. The Government in its recent budget has extended credit to the sector by allowing banks to buy pools of assets for INR 1,00,000 crores from various sound NBFCs providing them with the support they need. Further the Government has agreed to bear a loss of INR 10,000 crores in case of any defaults from the NBFC pool of assets purchased by the banks. This measure will play out towards the second half of 2019-20. Further, the Government has also agreed to infuse INR 70,000 crores into public sector banks so that they can help kick start the economy by lending further.

Global commodity prices have remained soft thus easing cost pressures on corporates. Prices of crude oil have remained very stable and have declined by approximately 3% QoQ. With global growth outlook being muted, crude oil prices are expected to remain soft in the foreseeable future. This spells good news for the economy which imports nearly 80% of its crude oil requirements. Though crude oil prices are lower, the Current Account Deficit (CAD) is still high at 1.8% of the GDP. The Government has raised import duty on gold from 10 to 15% to discourage gold imports. The Indian Rupee (INR) has remained in a stable range between 68 and 69 to the US$. Given the macro-economic headwinds, the INR seems to be a bit over valued. The INR could witness a further devaluation in case the economy does not bounce back in the near term.

The markets are still very polarized with large cap and select growth stocks quoting unreasonably high valuations. This trend has been persistent over the last few months. The small and mid-cap stocks have witnessed a massive de-rating. Some of the small and mid-cap stocks are at historical lows with very compelling valuations and are offering very good value to investors. While the Nifty 50 has corrected marginally from its highs, the broader market continues to reel under tremendous pressure. The broader market will take some more time to recover and will surely give patient investors huge returns from the current valuations. The margin of safety is very high across several small and mid-cap stocks and there is more upside than downside from hereon.

Due to a slowing US and global economy, the US Federal Reserve has taken a dovish stance and will surely cut interest rates in the months ahead. Europe too is struggling with lower interest rates. It is said that bonds worth approximately US$ 13 Trillion are yielding zero to negative interest rates. It is getting more and more difficult to deploy capital at attractive rates of return. India is one of the only large emerging economies that is still witnessing relatively good growth of 6-7% in a world that is sharply slowing down. We do believe that India will attract a lot of FDI and FII money in the year ahead. The PE multiples should witness a re-rating as interest rates decline and the Indian economy revives.

India is a structural story with immense long-term visibility. The current down turn is more cyclical in nature and not structural which means the Indian economy should revive in the next 6-9 months. Generally, markets always discount what lies ahead and hence we believe that the economy will reset and start growing after 2-3 quarters and the stock markets will bottom out earlier in the next 1-2 quarters. India remains a preferred investment destination due to its long-term growth story being intact. There is still enough visibility for India growing at 7% in the coming decade. This growth presents a very promising opportunity for investors in the equity markets.

All the above trends are leading us to believe that we will witness better times in 2-3 quarters as most of the pain is already in the current valuations and from hereon it could be more of a time rather than price correction. We expect a sharp recovery in earnings towards the last quarter of FY 2019-20 with a more back ended recovery resulting in a sharp rebound in select stock prices that have already borne the brunt of this downturn. While there are positive trends shaping up in the country, we do not expect any immediate revival in the economy. A gradual pick up is possible after the festive season. If India is to realize its full potential, then the new Government being sworn in 2019 will have to take quick measures to revive the economy and bring back growth to its previous levels of 7-8%.

Headline indices are reporting stable returns but a well-diversified portfolio, which is well positioned to capitalize on the various emerging opportunities within our economy, has seen a year full of pains with valuations in select sectors correcting to multi year lows. We believe this is a temporary phase that will correct itself going forward.

We continue to position your portfolio to benefit from deep value that the markets are offering today. We remain confident that the Indian economy will be resilient to some of these challenges and will continue to grow in the long-term. Your portfolio is well positioned to capitalize on the next phase of growth and should deliver superior sustainable returns over the next 3-5 years. My team and I, continue to focus on a bottom-up approach for stock selection with well researched and deep conviction ideas. We continue to ensure that any new addition to your portfolio complies with our approach of investing in high quality businesses that are structurally well positioned and are led by able management teams with strong execution capabilities to deliver superior returns on a sustainable basis. We are convinced that the Indian market will continue offering many good opportunities that will be highly rewarding.

I have attached a detailed portfolio summary and performance for the year ended on 30th June 2019. In case you require any further information on your portfolio our team will be available to attend to the same.

Warm Regards,
Jiten Doshi
Co-Founder & CIO