From the CIO's Desk

December 2019

ENAM ASSET MANAGEMENT

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Dear Investor,

It gives me great pleasure to share with you an update for the quarter ended 31st December 2019. India is passing through the most challenging phase with the lowest GDP growth in recent times. The economy has slipped to a growth of sub 5% which takes us back to the period of "Hindu rate of growth" witnessed before India started its journey of liberalizing its economy. There seems to be a sense of hopelessness even amongst the most optimistic persons. People seem to have lost hope after what they are witnessing on the ground. The last quarter was a quarter of continuing pain with most of the economic indicators showing signs of a severe slowdown.

Even though the economy was struggling in the last quarter, there was no sign of gloom or pain in the stock market which recorded a sharp up move with every segment - Large, Mid and Small Cap stocks participating in the rally. One always wonders how there is a such a big disconnect between the real economy and the stock market. The answer to that is simple – markets look ahead and discount the future much ahead than what is happening presently.

The slowdown in India had begun from the last quarter of CY 2018, post the ILFS debacle – this was India's Lehman crisis! Since then, the economic slowdown has been accelerating quarter after quarter. We believe that there are two parts of this slowdown – one with a decline in primary sales at the producers end and the other where there is a slowdown in consumption at the consumers end. Most companies had pushed large inventories into the system during the last quarter of FY 2018-19. With a slowing demand and lack of finance due to the severe cash crunch faced by banks and NBFC's, this slowdown gathered further momentum in FY 2019-20. While demand at the consumer end was tepid, demand from the trade channels witnessed a sharp downturn as they were liquidating excess inventories of the past and coping up with challenges of nonavailability of finance. Corporates were slashing production to cope up with this massive challenge.

This trend of de-stocking was most visible in the auto industry which was bracing another challenge. The transition from BS IV to BS VI vehicles wherein the industry had to upgrade to the new emission norms. The Government has refused to register BS IV vehicles after 31st March 2020. This has led to the industry having to compulsorily liquidate inventory of all BS IV vehicles. The transition to BS VI from BS IV has led to an increase in prices of all vehicles by 5-10%. This has also cautioned dealers from building inventories of BS IV vehicles.

This leads us to believe that most corporates have realized just ten or eleven months of sales, due to inventory clearance from previously billed sales lying with dealers as carried forward inventories. The slowdown was not as severe at the consumer end and every rise in demand helped clear up past inventories. This slowdown has taken its toll on the economy with a lot of small businesses struggling to survive.

The other big challenge faced by the economy is the banking system crisis which we believe is still not over. Though necessary, the Government's actions for chasing willful defaulters as well as going after fraudulent and unscrupulous businessmen has affected the business environment. Many such businesses have resulted in downsizing or closure. This has further aggravated the already alarming situation of large unemployment faced by the youth of this country. With no new capex from the Government or the private sector, there is a grave situation building up. This unemployment is resulting in lack of incremental demand and hence a slowdown.

A few sectors are witnessing an overall shrinkage in demand but with one positive rider – this demand is shrinking for the unorganized sector with the organized sector increasing its market share. In the short term a few companies will gain market share due to this shift. In a slowing economy there are a few companies that are shining bright and beating the current trend.

The slowdown which has engulfed the Indian economy for the last few quarters is now showing some signs of bottoming out. While we aren't witnessing any big uptick, similarly we aren't witnessing any further deterioration. There could be one or at best two more quarters of pain after which the economy will see the base effect playing out. Further, a good monsoon is likely to accelerate the already low rural demand. From hereon the destocking seems to be a thing of the past as the trade is already on very low inventory and there is very little room for further destocking. This is something that inspires us to believe that the worst may be behind us and we may witness some green shoots in the coming months.

As money managers our job is to find out whether the impact of the slowdown is fully priced into the markets. We believe that not only is the slowdown fully priced in to the valuations but the pessimism has overshot on the negative side. Most mid and small cap stocks are at historically low valuations with most of them quoting at 1 or 2 standard deviations lower than their 5 years average. This leads us to believe that small and mid-cap stocks are in the oversold territory giving investors an opportunity to make huge gains in the year ahead.

Further, the last quarter witnessed a very supportive trend for small and mid-caps. For the nine-month period ended 30th September 2019, the BSE Sensex rose by 7.21%, the Nifty 50 rose by 5.63%, the Nifty Mid Cap index declined by 10.35% and the Nifty Small Cap Index declined by 13.26%. While small and mid-cap indices underperformed the Sensex and Nifty for the nine months period ended 30th September 2019 it was a different story for the last quarter ended 31st December 2019. In the last quarter, the markets witnessed a divergent trend with the BSE Sensex up by 6.69%, Nifty 50 up by 6.05%, Nifty Mid Cap up by 6.72% and Nifty Small Cap up by 4.31%. This tells us that the worst seems to be over for the small and mid-cap indices which have bottomed out. A lot of smart money could be bottom fishing at these levels.

We believe that most of the small and mid-cap stocks are quoting one or two standard deviations below their long-term averages with a potential recovery in earnings around the corner. This effectively vindicates our stand that a sharp rotation is around the corner with an earnings recovery being seen in the select sectors that have borne the brunt of the economic slowdown over the past 2 years.

Despite political stability in the centre there is surely concern amongst investors about BJP losing state elections. The big blow was BJP was the end of its partnership with Shiv Sena and losing out in the state of Maharashtra which is one of the most important states. The launch of the Citizens Amendment Act (CAA) is another political milestone that seems to have backfired for the Government. Nation wide riots and closures have taken its toll on an already slowing economy. The BJP now faces a serious challenge as it has been voted out of most of the key states which helped it to win the Lok Sabha elections. This trend will not reverse till the economy turns begins to grow at 7% and more jobs are created. The Government very well realizes the seriousness of their survival and is now working round the clock to present a growth-oriented budget that should help kick start the economy.

There is a sharp decline in the direct and indirect tax collections in 2019-20. It is very unlikely that the Government would be able to meet its fiscal deficit target for the year. Given that growth is the need of the hour, the Government might choose to differ meeting its fiscal targets in the FRBM (Fiscal Responsibility and Budget Management Act), by another one or two years. The need of the hour is growth over maintaining the fiscal deficit target. We only hope the Government goes for growth in the forthcoming budget that it will present on 1st February 2020.

The Reserve Bank of India (RBI) has cut its repo rate by 1.35% in CY 2019. Though the entire rate cut has not been transmitted by the banks. The banking system has seen a lot of stress which continues to accelerate with its NPA's rising every quarter. If the economy picks up in the next 2 to 3 quarters, then we could see the stress coming off for the banking sector. The CPI inflation as 7.35% in December 2019 which is now above the RBI's comfort level of 4-6%. The RBI has paused in its rate cuts but has indicated a dovish stand. We believe that the repo rate which stands at 5.15% today can go down to 4.50 to 4.75% in CY 2020. The prices of all commodities continue to remain soft especially crude oil which is in a comfort zone of less than US$ 70. This is favorable for India's economy whose dependency on external supply continues to remain as high as 70%+.

In the meanwhile, the Indian market has witnessed strong inflows especially in the quarter ended 31st December 2019. The total FII inflow into the stock market during CY 2019 was US$ 14.47 Billion of which the last quarter accounted for US$ 6.31 Billion. The total DII inflow into the stock market during CY 2019 was US$ 5.87 Billion of which the last quarter accounted for an outflow of US$ 0.65 Billion. The US federal Reserve is following a very dovish monetary policy which is helping flood the markets with a lot of liquidity. We believe that in 2020 there will be a sharp improvement in the performance of emerging markets over the developed markets _ India should stand to gain the most with an upturn in its corporate earnings which should grow handsomely in FY 2021.

We re-iterate that the best is still to come with 2020-21 being a year of strong recovery in earnings compared to FY 2019-20. The year 2021-22 will be a year of strong growth for the Indian economy. 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 period ended on 31st December 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