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From the CEO's desk – September 2018

Private capex growth - a structural game changer?

Rajesh Iyer
Chief Executive Officer

GDP growth at 8.2% for 1Q FY 18-19 is indeed positive - best quarterly number during the last 2 years - thanks to an all round performance by manufacturing, construction and agriculture.

GDP growth is thanks to private consumption and government expenditure. Sustainability of these numbers also depends upon when will the private sector capex fire. This is because the other metric to assess sustainability of this trend is growth in investments as measured by gross fixed capital formation (GFCF). Currently the GFCF is healthy but as a percentage of GDP is 28.8% which is way lower than for fiscal year ending March 2015.

The good news is purely from an economic perspective various data points suggest a strong possibility of revival in private capex. The capacity utilisation now stands at 75%+ compared to 70% in 1Q 2015. Primarily the sectors that are already seeing an uptick is chemicals, cement & process industry. The multiple of debt to equity ratio of BSE 500 companies has fallen to 75% from 92% in 2015 - duly supported by improved financial strength of the companies. The availability of capital for growth should not be a big challenge with strong capital markets and the corporate lenders witnessing slowdown in new NPA creations and improved recovery thanks to the Indian Bankruptcy Code. The only other factor which can add a leg to this hypothesis, will be clarity on the political front with the national elections scheduled in 2019.

So if we get a private capex kicker driven GDP momentum then one can expect an increase in demand for money which in turn could potentially lead to rising asset prices, inflation and rising rates. As of today already the cost of equity - risk free rate in terms of 10 year government securities - has been rising and has spiked by 150 bps to 7.7% post demonetisation. This means Equity as an asset class remains the only reasonable weapon available to deal with this potential structural change.

But the dilemma one faces in allocating to equities today:

1. Forward Price to Earnings ratio at 18.3x is highest since 2008
2. Price to Book ratio at 3.2x is highest since 2010
3. Market cap to GDP crosses 90% last seen in 2010
4. Bond – earnings yield spread at 223 bps (last observed in 2010 and 2013 - means reducing relative attractiveness of equities)
5. Large cap stocks discount to mid cap on a P/E basis is at 2007 levels

Given all the above should one postpone investment decisions?

No. Postponing the decision to purchase the desired asset may not work out to be the best option in a potentially inflationary but a growth oriented environment. Household expenditure planning needs to take into account possibility of increase in EMIs.

The takeaway is Asset allocation and Disciplined investing now becomes more critical than ever.

A systematic investment plan towards equities is highly recommended.

We continue to recommend Large Cap, Diversified Portfolios and selective exposure to quality Midcaps with low leverage. Short term and Accrual funds continue to be our picks on the fixed income side.

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