On Watch: Trade tensions

The month of July was significant from monetary policy perspective. One overarching forward looking thesis that remains unchanged is that monetary policies across the globe would continue to diverge over the course of next year. In terms of rate action, while US Fed, BoJ and ECB kept rates on hold, BoE hiked by 25 bps. However, it was the accompanying commentary which was more pertinent. US Fed sounded more optimistic on US economy, as it described economic activity as "strong" (Recall, Q2 GDP came in at a 4-year high of 4.1%YoY) – for the first time since 2006, amidst continued strength in the labour market and robust growth in household spending and business fixed investment. As such, it retained its call of two more rate hikes by the end of CY 2018. On the other hand, while ECB too sounded upbeat about the economy, it reinforced its commitment to keep policy rates on hold till summer of 2019. Meanwhile, accompanying the 25 bps hike, BoE tone sounded hawkish, with MPC members agreeing that "future rate hikes are likely to be at a gradual pace and to a limited extent" amidst buildup in inflationary pressure.

The other global theme that continues to remain dynamic and on close watch for its impact assessment is that of trade wars. US and EU last month committed to work towards zero tariffs, zero non-tariff barriers and zero subsidies for the non-auto industrial goods. While nothing specific was mentioned on car tariffs, Jean-Claude Juncker (the European commission president) stated that no further tariffs will be implemented during the negotiation period. He also mentioned that existing tariffs on steel and aluminum will be reassessed, and EU imports of US liquefied natural gas and soybeans will be expanded. On US-China front, President Donald Trump asked the IS trade representative to explore the possibility of imposing a 25% tariff on USD 200 bn of Chinese imports as compared to the initial proposal of a 10% tariff. In response, China's finance ministry proposed tariffs on US goods worth USD 60bn worth, with import duties ranging between 5% and 25%. Back home, India has deferred the imposition of retaliatory tariffs on some U.S. imports to Sept 18 from Aug 4, opening the door to an agreement that would avert a trade war between the two nations. The higher import duties were on goods like almonds, chickpeas and bengal gram (chana).

On the domestic front, lead domestic indicators released for the month of June-July mostly fared well. Both PMI manufacturing and services remained in the expansion zone, core sector growth expanded at its fastest pace in 7 months led by healthy performance of cement, refinery and coal sub-sectors in addition to favourable base effect. On the hard data front, auto sales posted a somewhat downbeat growth in July, albeit on account of high base effect. Decline was majorly led by passenger cars and UVs. Average FYTD19 (Apr-July) gross GST collections stood at Rs 973 bn, slightly lower than the Government's target of Rs 1 tn per month for FY19 through higher than average monthly collection of Rs 898 bn in FY18.

On the monetary policy front, RBI hiked policy rates by 25 bps in its third bi-monthly monetary policy review for FY19. It also marks the first instance since May 2013 where policy rates were raised in two consecutive meetings. Overall tone of the statement was neutral, in-line with our expectations. The neutral tone indicates that the future policy course remains data dependent and despite back to back rate hikes, it doesn't imply the start of an aggressive rate hiking cycle.

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Global Macro Developments

- Turkey's FM Berat Albayrak stated that an economic action plan has been drafted to avert financial volatility. Albayrak also stated that measures have been prepared for banks and the real economy sector, including small to mid-sized businesses which are most affected by the foreign exchange fluctuations.
- PBoC in its quarterly monetary policy report said that it won't use the Yuan as a tool to cope with external issues and trade tensions. The bank said that it will flexibly use a combination of several monetary policy tools and further enhance macro prudential management of the economy.
- UK's GDP picked up to 0.4% in Q2 2018 after a slowdown in Q1 led by higher retail sales and construction activity aided by a good weather.
- BoE unanimously voted to hike rates by 25 bps to 0.75% in its monetary policy decision, however, it signaled that it was in no hurry to hike rates further amidst Brexit related uncertainty. BoE said that the economy was operating at its "speed limit", thus raising the prospects of inflation pressure going ahead.
- BoE’s McCafferty said that there is a need for 2 more rate hikes in next 1.5-2 years as wage growth may accelerate to 4% next year, on account of labor shortages thereby pressuring inflation.
- China retaliated to the additional tariffs by the US, announcing 25% tariffs on an equivalent amount of US imports of USD 16 bn, on products ranging from fuel, steel products to autos and medical equipment.
- ECB in-line with consensus expectations kept policy rates on hold. It maintained its commitment to keep rates unchanged through the summer of 2019 and kept its QE unwind schedule unchanged- starting in Oct and ending by Dec 2018. The central bank continued to maintain that an ample degree of monetary accommodation is still necessary for the continued sustained convergence of inflation to levels that are below, but close to 2% over the medium term.
- IMF in its annual External Sector Report stated that U.S. dollar is over-valued and China's yuan is in-line with fundamentals. On the current account front, the report stated that surpluses and deficits are becoming increasingly concentrated in advanced economies. Countries with excessive current account surpluses include – China, Germany, South Korea, the Netherlands, Sweden and Singapore. Countries with excessive current account deficit include - United States, Britain, Turkey and Argentina.

Events and Data Calendar

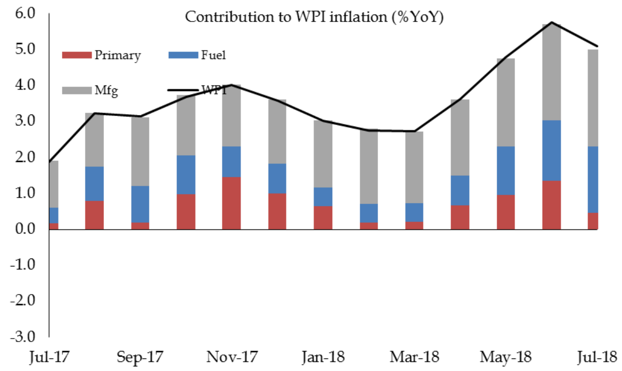
Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
Japan	31-Jul-2018	BoJ Interest rate Decision		-0.10%	-0.10%	-0.10%	→
	8-Jun-2018	GDP Annualized (YoY)	Q2	1.40%	1.90%	-0.90%	↑
US	1-Aug-2018	Fed Interest Rate Decision		2.00%	2.00%	2.00%	→
	3-Aug-2018	Unemployment Rate	JUL	3.90%	3.90%	4.00%	↓
	10-Aug-2018	CPI (YoY)	JUL	3.00%	2.90%	2.90%	→
UK	2-Aug-2018	BoE rate Decision	AUG	0.75%	0.75%	0.50%	↑
	12-Aug-2018	GDP (QoQ)	Q2	0.40%	0.40%	0.20%	↑
	15-Aug-2018	CPI (YoY)	JUL	2.50%	2.50%	2.40%	↑
China	31-Jul-2018	Caixin PMI Manufacturing	(JUL)	51.40	51.20	51.50	↓
	9-Aug-2018	CPI (YoY)	(JUL)	2.00%	2.10%	1.90%	↑

P* – Provisional Estimates F* - Final Estimates A* - Advanced Estimates T*- Third Estimates

COMMODITY

- Gold prices decreased by 3.41% MoM in July vs. a decline of 1.63% MoM in June amid a stronger dollar.
- Brent Crude prices decreased by 1.12% MoM in July vs. a decline of 1.78% MoM in June amidst easing concerns over supply disruptions as Libyan ports resumed export activities.

Domestic Market Macro Economics



India July WPI

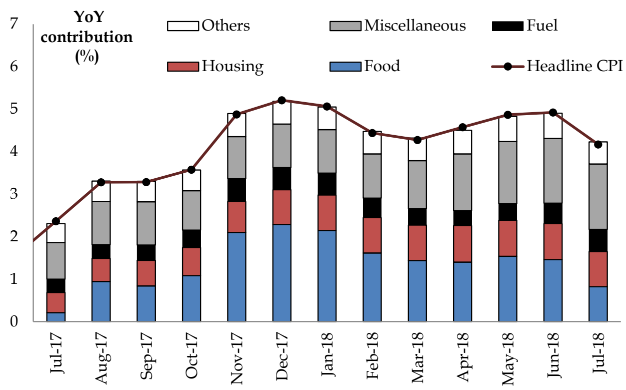
%YoY	Weights(%)	May-18	Jun-18
IIP	100	3.9	7.0
Sectoral Classification			
Mining	14.4	5.8	6.6
Manufacturing	77.6	3.7	6.9
Electricity	8.0	4.2	8.5
Use Based Classification			
Primary goods	34.0	5.7	9.3
Capital goods	8.2	6.9	9.6
Intermediate goods	17.2	0.8	2.4
Infrastructure/construction goods	12.3	7.4	8.5
Consumer durables	12.8	6.4	13.1
Consumer non-durables	15.3	-2.1	0.5

June IIP: Regains momentum

- Manufacturing PMI moderated to 52.3 in Jul-18 vs. a seven month high of 53.1 in June, marking 12th consecutive month of expansion (a reading above 50 indicates expansion). The moderation was led by output and new orders
- The PMI services index remained in the expansion zone for the second consecutive month in July, hitting the highest level since Oct-16 to 54.2 vs. 52.6 in June. The expansion in the service activity was led by output and new business orders that rose at their strongest pace since Oct-16 and Jun-17 respectively amidst strong demand conditions.
- Core sector growth expanded at its fastest pace in 7 months to 6.7% YoY in June vs. an upwardly revised 4.3% in May. The expansion was driven by healthy performance by cement, refinery and coal sub-sectors.
- As per RBI's latest data, Non-food credit growth stood at 12.4%YoY as of 20th July-18, marginally lower versus 12.8% nearly a month ago (as of 22nd Jun-18) but significantly higher than 4.8% a year ago.
- India's industrial production picked up in June, clocking a growth of 7.0% YoY, (in line with our expectation of 7.1%; consensus expectation 5.5%) compared to an upwardly revised reading of 3.9% in May-18 (from 3.2% earlier). This marks the fastest pace of growth in five months. IIP detail reveals that the acceleration in growth was broad-based.
- July CPI Inflation reading printed marginally below our expectations (YBL: 4.25%, consensus: 4.49%) at 4.17%YoY from 4.92%YoY (revised lower from 5%) in June, driven by continued muted food inflation and moderation in core inflation. The biggest positive in the recent prints has been the consistent softness in food inflation.

%YoY	Jun-17	Apr-18	May-18	Jun-18
Overall	1.0	4.6	4.3	6.7
Coal	-6.8	16.0	12.2	11.5
Crude Oil	0.6	-0.9	-2.9	-3.4
Natural Gas	6.5	5.7	-1.4	-2.7
Refinery Products	-0.2	2.7	4.9	12.1
Fertilizers	-2.7	4.6	8.4	0.9
Steel	6.0	3.8	0.7	4.4
Cement	-3.3	16.4	13.0	13.2
Electricity	2.1	2.1	4.2	4.1

CORE – Growth at a 7-month high



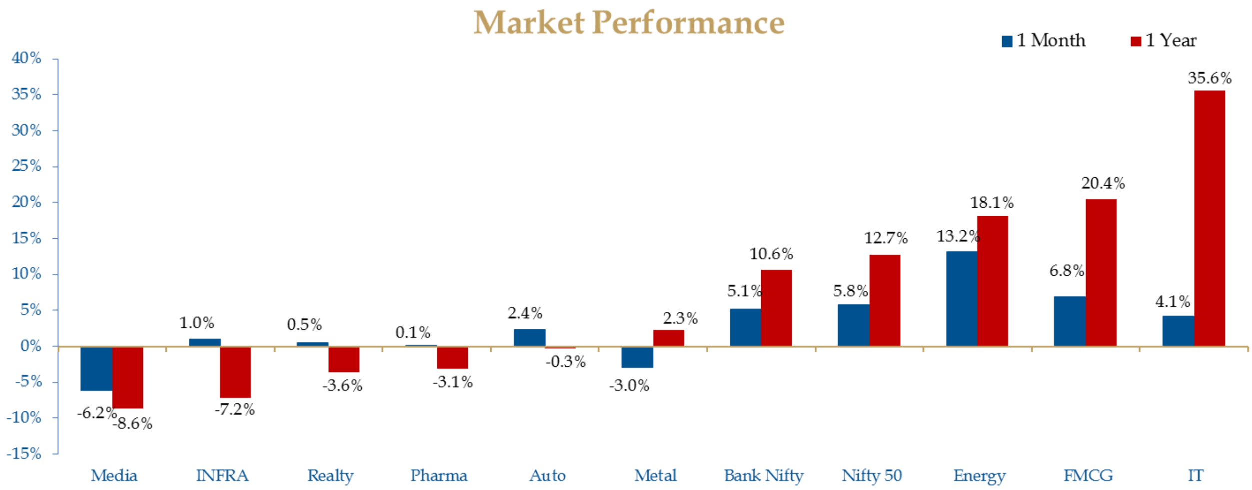
India July CPI - Third consecutive downward surprise

We expect:

- FY19 GDP is expected to accelerate at 7.3% with a broad-based recovery led by consumption and modest capex cycle revival. Gains from structural reforms such as GST, insolvency resolution and bank recapitalization will begin to flow through.
- We retain our FY19 average CPI inflation forecast at 4.9% vs. 3.6% in FY18 amidst the recent softer than seasonal momentum in food prices (assume a normal monsoon and average crude oil price at USD 75 pb).

Equity Market Insights

- July 2018 was a positive one for global markets with gains seen across the major markets (barring China). Indian markets led the gains with the Sensex rising by 6.2% during the month. On a YoY basis, all major markets have done well, rising in the range of ~5% to 21%. In the calendar year till date, the Sensex is up by ~10%.
- Within India, gains were seen in stocks across the board with the indices ending higher by ~4 to 6%. However, when gauged over a period of one year, smallcaps continue to remain in the red (down 4.3%) while midcaps have gained by ~2%. Largecaps on the other hand continue to steal the show with the Nifty and Sensex gaining by 12.7% and 15.7% respectively.
- Barring media and metal stocks, all other sectoral indices ended on a positive note in July 2018. Energy, banking and FMCG stocks were particularly in favour with their respective indices up in the range of ~5% to ~14%.
- Foreign investors have been net buyers after three consecutive months of selling. DIIs continued to be net buyers investing a net amount of ~INR 40 bn in July 2018. Foreign investors had net inflow of ~INR 4.9 bn during the month. In the calendar year till date, DIIs have invested ~INR ~710 bn versus the net inflow of INR ~20 bn of FPIs.



Outlook & Expectations

- A key reason for the sharp decline seen in the mid and small cap stocks since the start of the year has been the valuation and earnings growth remaining out of sync. For instance, the trailing 12-month price to earnings ratio of the midcap index expanded by more than 2x over the past three years, eventually leading to a sharp divergence between the earnings growth and index movement. Such situations rarely turn out to have favourable outcomes.
- The lack of investment options and abundance of liquidity in the system (post demonetization) have been one of the main factors driving the broader markets over past few years. But while one may believe this is a structural change, we would instead like to believe that its human nature that came out on top.
- A busy political calendar (state elections) towards the end of the year as well as the news related sentiments leading up to the general elections will also keep the market on its toes; the stock market is bound to swing to developments and news flow emanating from the political arena. In the interim, all eyes will be on the results for the quarter ended June 2018 which have already started to flow in.

Debt Market Insights

- The average systemic liquidity moved to a deficit of INR 125 bn in July from a surplus of INR 134 bn in June.
- While the average 10 yr G-sec bond yield during July moderated to 7.8% vs. 7.9% in June, with moderation in crude oil prices.
- RBI hiked rates by 25 bps in its third bi-monthly monetary policy review for FY19. It also marks the first instance since May 2013 where policy rates were raised in two consecutive meetings. Overall tone of MPC's policy statement was neutral, in line with our expectations as the central bank acknowledged the recent developments, both global as well as domestic. The neutral tone indicates that the future policy course remains data dependent and back to back rate hikes may not imply the start of an aggressive rate hiking cycle.

10 Yr G-Sec Vs. Repo Rate

Outlook and Expectations

- On the monetary policy front, following the two back to back 25 bps hike each since June, we expect RBI to stay on hold for the rest of FY19 as lagged transmission of rate hikes plays out and headline CPI inflation moderates in H2-2018.
- We expect the 10Y g-sec yield to be trading in a range of 7.5%-8.2% in FY19 with moderation in crude oil prices and US Treasury yields while OMO purchases and a likely status-quo of RBI may provide some relief.

Glossary:

- **Consumer Price Index (CPI):** A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.
- **Wholesale Price Index (WPI):** An index that measures and tracks the changes in price of goods in the stages before the retail level.
- **Open Market Operations (OMO's):** is the buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite.
- **Cash Management Bills (CMB):** A short-term security sold by RBI to meet any temporary shortfalls.
- **Purchasing Managers Index (PMI**) is based on surveys on private sector service /manufacturing companies. An index level of 50 denotes no change since the previous month, while a level above 50 signals an increase or improvement and below 50 indicates a decrease or deterioration.
- **Net Demand and Time Liabilities (NDTL):** It is the sum of demand and time liabilities (deposits) of banks with public and other banks wherein assets with other banks is subtracted to get net liability of other banks.
- **Current Account Deficit (CAD):** A measurement of a country's trade in which the value of goods and services it imports exceeds the value of goods and services it exports. A current account deficit represents negative net sales abroad. A country can reduce its current account deficit by increasing the value of its exports relative to the value of imports.
- **West Texas Intermediate (WTI)**: also known as **Texas light sweet**, is a grade of crude oil used as a benchmark in oil pricing. This grade is described as light because of its relatively low density, and sweet because of its low sulfur content.

For Further Information on Model Portfolios, Kindly contact your Relationship Manager.

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About YES BANK

YES BANK, India's new age private sector Bank, is the outcome of the professional & entrepreneurial commitment of its Founder, Rana Kapoor and its top management team, to establish a high quality, customer centric, service driven, private Indian Bank catering to the future businesses of India. YES BANK has adopted international best practices, the highest standards of service quality and operational excellence, and offers comprehensive banking and financial solutions to all its valued customers.

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