Global economy losing steam

Global disruption propounded by geopolitical turmoil and restrictive monetary policies became the talk of 2018. Italy's Budget headache, US President Donald Trump's trade curbs and the recent threat of a Federal shutdown - all set against a backdrop normalizing of US interest rates presented an uncertain backdrop for the global economy and financial markets.

However, there was some solace as the purported escalation of US-China trade conflict was defused with both nations opting for a temporary trade truce. Italy also reached an accord with EU on its 2019 Budget proposal as it reduced its deficit target to 2.04% from 2.4% of GDP thereby avoiding penalties from EU.

The cracks in the EU deepened with "yellow vests" protests threatening the leadership of French President Emmanuel Macron, who also survived a "no confidence" vote over the protests and took a populist route to raise the budget deficit to 3.4% (Previous 2.8%) by announcing a monthly hike of USD 114 in the minimum wages along with abolishing a tax on pensions, defying the EU rules of the excessive budget deficit.

Amidst all these geopolitical tensions, volatility in the markets was amplified by the withdrawal of support by the central banks. With ECB ending its QE program despite concerns of slow-down in the Euro Zone with a pledge to step in whenever required and utilize other tools such as long-term loans to commercial banks to stabilize the economy. However, BoJ remained accommodative and reaffirmed its ultra-loose monetary policy by maintaining the short-term rate at -0.1% to provide soft landing to the economy after the proposed sales tax hike (to 10% from 8%) comes into effect in Oct-19.

Meanwhile, US Fed proceeded with its fourth rate hike of the year by increasing the target range for the federal funds rate to 2.25%-2.50% at its December meeting.

The signs of global slowdown were evident as FOMC lowered expectations for real GDP growth in 2018 and 2019, and its headline PCE projection to 1.9% for both 2018 and 2019. Although the statement and projections were more dovish, Fed Chairman Jerome Powell's comments were relatively hawkish vs. market expectations.

Meanwhile, disappointing data from China also fueled the concerns of slowdown with China's IIP falling to 5.4% YoY in November, from 5.9% YoY in October. The concern led to a sell-off in Asian markets which spilled over into a global market rout.

These factors have deepened the trend towards a plausible stagnation in the global economy. However, with a likely trade deal between the US and China along with favorable developments on Italy's budget plan, possibility of extreme downside risk to the global economy can be expected to attenuate.

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Global Macro Developments

- World Bank in its semi-annual update of global outlook cut the world economic growth for 2019 to 2.9% from 3.0%, along with lowering of its 2020 growth forecast to 2.8% from 2.9% citing 1) acute downside risks emanating from slowdown in global trade due to trade wars, 2) fall in investments due to rising interest rates, and 3) significant financial stress in developing and emerging market economies.
- Bank of England kept interest rates on hold at 0.75% as expected. The central bank stated that the Brexit uncertainty had "intensified considerably" over the last month but falling oil prices were likely to push inflation below its 2 percent target which will support the economy.
- US Fed Chairman Jerome Powell stated that Fed will patiently adjust its policy on the basis of how the economic situation evolves amid muted inflation. Chairman Powell assured that there weren't any signs of recession but suggested the need for the central bank to reduce its balance sheet.
- US Fed raised its benchmark overnight lending rate to a range of 2.25% to 2.50% unanimously. Fed Chairman Jerome Powell indicated a reduction in the balance sheet by USD 50 bn each month along with two more rounds (revised lower from three earlier) of rate hike in 2019. Chairman Powell asserted a cautious approach from policy makers as the economy was growing at a strong rate along with sound labor market conditions amidst slowing global economy.
- PBoC (People's Bank of China) left short-term interest rates unchanged with 7-day reverse repo at 2.55%, and 14-day reverse repo rate at 2.7%, amidst growing concern of slowdown of the Chinese economy.
- BoJ kept its monetary policy steady maintained its stance to keep interest rates extremely low for an extended period of time.

Events and Data Calendar

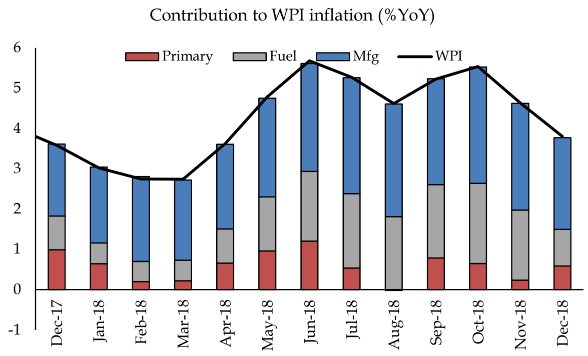
Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
China	10-Jan-2019	CPI (YoY)	Dec	2.10%	1.90%	2.20%	
	14-Dec-2018	IIP	Nov	5.90%	5.40%	5.90%	
	31-Dec-2018	Manufacturing PMI	Dec	50.00	49.40	50.00	
UK	19-Dec-2018	CPI YoY	Nov	2.30%	2.30%	2.40%	
	21-Dec-2018	GDP QoQ	3Q F	0.60%	0.60%	0.60%	
US	11-Jan-2019	CPI YoY	Dec	1.90%	1.90%	2.20%	
	4-Jan-2019	Unemployment Rate	Dec	3.70%	3.90%	3.70%	
Japan	28-Dec-2018	Industrial Production YoY	Nov P	0.01	1.40%	4.20%	

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

COMMODITY

- Gold prices increased by 2.4% MoM in December vs. an increase of 0.4% MoM in November due to safe haven asset demand amid rising global uncertainty and a weaker dollar.
- Brent prices contracted by 13.56% MoM in December vs. a decline of 18.54% MoM in November as global growth concerns along with supply glut weighed on oil demand.

Domestic Market Macro Economics



India December WPI

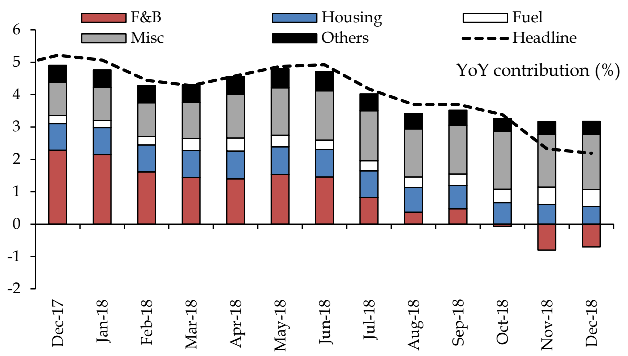
%YoY	Weights(%)	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18
IIP	100	6.5	4.7	4.5	8.4	0.5
Sectoral Classification						
Mining	14.4	3.4	-0.5	0.1	7.0	2.7
Manufacturing	77.6	7.0	5.1	4.6	7.9	-0.4
Electricity	8.0	6.6	7.6	8.2	10.8	5.1
Use Based Classification						
Primary goods	113.1	6.8	2.5	2.6	6.0	3.2
Capital goods	93.4	2.3	9.3	6.5	16.8	-3.4
Intermediate goods	115.4	1.3	2.8	1.5	1.8	-4.5
Infrastructure/construction goods	119.6	9.2	8.0	9.3	8.7	5
Consumer durables	120.6	14.1	5.3	5.2	17.6	-0.9
Consumer non-durables	113.5	5.3	6.5	6.1	7.9	-0.6

Nov IIP: Barely grows in November

- ✓ Composite PMI stood at 53.6 in Dec-18 vs. 54.4 in Nov-18, marking second best reading in 2018. Activity in both manufacturing and services sectors expanded, albeit at a slower pace.
- ✓ Core sector industries slowed to a 16-month low of 3.5% YoY in November-18 vs. 4.7% YoY in the previous month, led by contraction in crude oil and fertilizer output and slowdown in the growth of cement production and electricity output. The moderation in the reading can also be attributed to unfavourable base effect.
- ✓ India's industrial production growth decelerated sharply to a 17-month low of 0.5% YoY in Nov-18 from an upwardly revised print of 8.4% in Oct-18. Notably, the IIP data has posted its first negative surprise in 6-months. The deceleration was led by the heavy weight manufacturing sector, which recorded a contraction of 0.4% on annualized basis, the lowest since Jul-17.
- ✓ GST revenues for Dec-18 stood lower at INR 947 bn vs. INR 976 bn in Nov. GST collections average run rate for FYTD19 stood at INR 968 bn, lower than the Government's monthly target of INR 1 tn, is likely to put pressure on Government finances. GST revenue shortfalls for FYTD19 stands at INR 290 bn.
- ✓ India's merchandise trade deficit moderated to USD 13.08 bn in Dec-18 from USD 16.67 bn in Nov-18. Export growth came in at 0.3%, down from 0.8% growth seen in the previous month. Growth in imports contracted to 2.4% from 4.3% in the previous month.
- ✓ India's retail inflation weakened in December to 2.19% YoY from 2.33% YoY in November (Bloomberg consensus: 2.20%; YBL estimate: 2.11%). The headline inflation, which happens to be the lowest reading since June 2017, undershot RBI's medium term target of 4% for the fifth consecutive month.

%YoY	Aug-18	Sep-18	Oct-18	Nov-18
Overall	4.1	4.3	4.7	**3.5**
Coal	2.5	6.5	11.3	**3.7**
Crude Oil	-3.7	-4.2	-5.0	**-3.5**
Natural Gas	1.0	-1.9	-1.0	**0.6**
Refinery Products	5.0	2.5	1.3	**2.3**
Fertilizers	-5.2	2.6	-11.6	**-8.1**
Steel	4.0	3.2	2.6	**6.0**
Cement	14.4	11.9	18.5	**8.9**
Electricity	5.4	8.2	10.8	**5.4**

CORE Sector



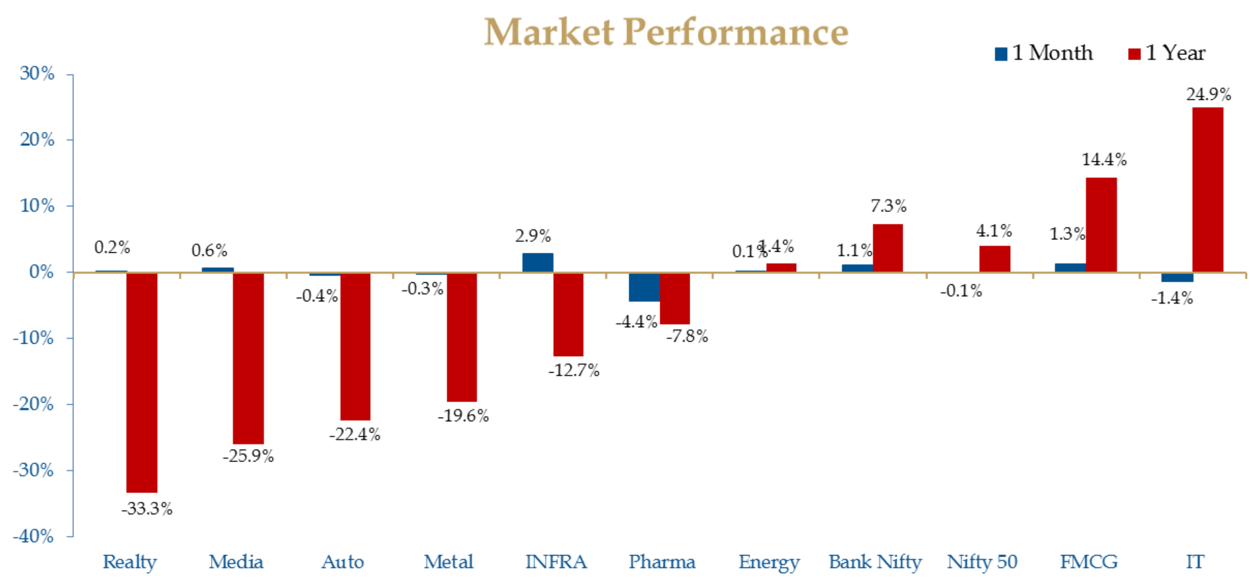
India Dec CPI - Lowest in 18 months

We expect:

- ✓ FY19 GDP growth to accelerate to 7.3% (vs. 6.7% in FY18) aided by twin-engines of consumption (supported by 7th CPC and state commission payouts, rural oriented government expenditure) and capex recovery.
- ✓ We expect the inflation trajectory to remain broadly benign with annual inflation for FY19 in the band of 3.5-3.7%, below RBI's 4% target. However, some upside risks that could potentially disturb the trajectory include the likelihood of inferior fiscal adjustments and the impact of farm debt waivers fuelling demand.

Equity Market Insights

- Flat returns of the headline Nifty in the month of December does not convey the real action on Dalal Street. In a roller-coaster ride, index marked a low of 10,334 before rallying towards the December peak of 10,985. Indian markets dealt with plethora of news flow which resulted in wild swings in December.
- The high voltage drama on the political front (i.e. state elections in Rajasthan, Madhya Pradesh & Chattisgarh) kept indices on tenterhooks during the start of the month. However, markets chose to overlook BJP's loss in key state assembly election results as equities rebounded and even Rupee recovered significantly from day's low post the disruption events.
- Apart from domestic issues, global economic worries also weighing heavily on Indian markets. Dow Jones registered its worst December, recording a drop of ~9%, following a negative reaction to Fed's interest rate hike and suggestion that two more increases in 2019. Market participants were spooked on concerns that continued rise in borrowing costs will cause the economy to slow.
- In terms of institutional activity, DII buying slowed down with an inflow of INR 27 bn as against inflow of INR 48 bn in November. FPIs on the other hand, bought equities worth INR 23 bn during the month.



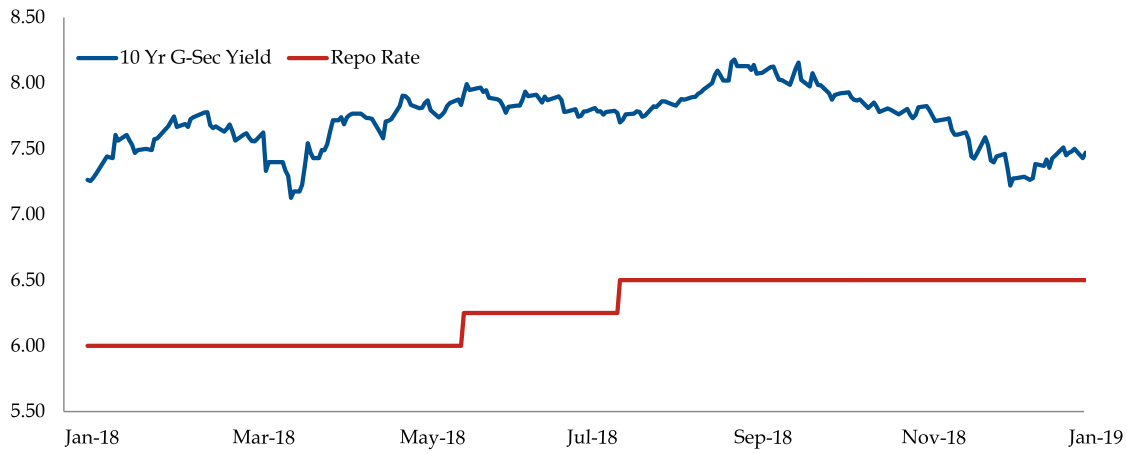
Outlook & Expectations

- The lower trajectory of crude price, low inflation regime, softening of sovereign yields, relatively stable currency and signs of recovery in domestic earnings are healthy signals for the market.
- On the fiscal front, while revenue-expenditure trends haven't been optimal so far, the government has reiterated its commitment to meet the Budget target.
- Correction in stock prices, especially in the midcap and small-cap space, in the last many months, has cleaned-up excesses from the secondary market to a large extent.
- Globally, some issues remain – part of yield curve inverting, trade rift between US and China and so on. But our sense is that the trade war issue is unlikely to dramatically escalate anytime soon given the renewed inclination of Beijing and Washington to find a common ground and avert a long-lasting destabilizing impact on the global economy. Moreover, a flattening curve between US 10 to 2yr yields can be deemed positive for emerging markets as an impending slowdown in the US economy can hard-press Fed to pause or probably reverse the monetary tightening process.
- Indian equity attractiveness is high, vis-à-vis fixed income, gold and property. An investment from 3 to 4 years perspective would prove rewarding. Sectors like capital goods, chemicals, consumption oriented themes and select financials look appealing. However, largely we prefer a bottom-up approach to stock selection.

Debt Market Insights

- The average systemic liquidity maintained a deficit in December of INR 944 bn from a deficit of INR 794 bn in November.
- The average 10yr G-sec bond yield during December moderated to 7.4% from 7.7% in November because of decline in oil prices and favourable surprise in November CPI data. RBI's announcement of INR 500 bn OMO purchase for Jan-18 along with increasing the total OMO purchase for Dec-18 to INR 500 bn from INR 400 bn indicated earlier, supported sentiment. Speculation of new RBI Governor being more accommodative on interest rates and liquidity as inflation remains under control led to yields ending lower.
- As the inflation trajectory is to remain broadly benign with average annual inflation for FY19 expected in the band of 3.5-3.7%, below RBI's 4% target. We reiterate our view that the MPC will revert to neutral stance in the forthcoming policy review from the current calibrated tightening stance. Importantly, the current and near term inflation trajectory paves way for the MPC to mull over a possible rate cut in February thereby partly addressing the high real interest rate factor impeding the investment appetite.

10 Yr G-Sec Vs. Repo Rate



Outlook and Expectations

- The central bank has done INR 1,560 bn OMO purchases in 2018, while it has provided a calendar for another INR 800 bn OMO purchases by Jan-19. We expect an incremental increase of INR 1,000 bn in currency in circulation between Dec-18 and Mar-19, which needs to be provided for via RBI's purchase of domestic assets in the absence of adequate foreign inflows. If the RBI intends to guide core liquidity towards zero, then it will need to provide liquidity infusion to the extent of INR 1900 bn (assuming that the CRR related liquidity demand is also incorporated) between Dec-18 and Mar-19. This would then take the total OMO count for FY19 towards INR 3.2-3.3 trillion, higher than our previous estimate of INR 2.4-2.6 trillion.
- From a bond market perspective, this will act as a favorable supply shock with net G-sec supply remaining negative for a considerable period of time. For FY19, this could tantamount to RBI absorbing 82% of net G-sec borrowing. While such high degree of OMO purchase could distort the yield curve, the evolving supply outcome would nevertheless help domestic bonds outperform its peers even without the support of monetary policy.
- As such, we revise lower our forecast of 10Y G-sec yield to 7.1-7.2% for Mar-19 from 7.7% earlier. Upside risk to this view could potentially stem from a reversal in crude oil prices, fiscal slippage by the central government, escalation in global trade war, and competitive populism with respect to announcing farm loan waivers in the upcoming election season. Downside risk to this view could potentially stem from monetary easing from the MPC by Apr-19.

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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