FIRST Insights

On Watch: Trade tensions

The rout in EMs re-emerged in August, with most currencies taking a strong beating. The confluence of concerns from several economic corners means that the fears of an EM contagion continue to remain alive.

US data was upbeat, suggesting that the economy remains strong in the early third quarter after logging robust performance in Q2. Retail sales rose more than expected by 6.4%YoY in July led by higher purchases of motor vehicles and clothing. Further, industrial production too rose in July aided by higher manufacturing output. Continued robust data has increased the odds of rate hike(s) by the Federal Reserve (Sept and Nov hike probability now stands at 93% and 96% respectively).
The trade war fears continues to remain in focus. So far, while China has matched tariffs dollar-for-dollar, its bandwidth to do so going forward seems to be limited. Further, data from China has begun to display nascent signs of moderation which will be closely assessed to gauge the impact of trade wars. China Caixin PMI manufacturing moderated to a 14-month low of 50.6 while services sector activity grew at its slowest pace in 10 months in Aug.

Amongst the EMs, macro concerns continued to remain elevated, especially in the economies of Argentina, Turkey and South Africa, reflected in their respective currency depreciation of 42%, 28% and 15% in August. Turkey announced measures to attract long term deposits, while the banking regulatory temporarily suspended mark-to-market calculations on capital adequacy ratios until prices of securities normalize. The volatility spilled over to other EM peers, with the MSCI EM index of currencies weakening by 2.2% in Aug-18, for the fifth consecutive month.

Adding to the market gyrations, price of Brent crude escalated to above USD 78/bbl recently, a rally of close to 8% since early Aug-18. Concerns that the fall in Iranian output may impact the supply (once US sanctions come into effect from Nov-18) and commencement of the hurricane season in the US, pushed prices higher.

On the domestic macroeconomic front, incremental data released for the months of July-August painted a mixed picture with some of the indicators faring better, indicating normalization in growth condition post GST-transition. PMI for manufacturing and services both moderated in Aug-18, while core sector grew by 6.6%YoY in Jul-18 vs. an upwardly revised 7.6% in the previous month. The moderation in the reading can also be partly attributed to waning of a favorable base. On the consumption front, auto sales posted a downbeat growth in Aug on account of high base effect and muted consumer sentiment due to heavy rainfall, and floods in Kerala. Non-food credit growth continues to improve to 12.9%YoY as of 17th Aug compared to 12.4% as of 20th Jul, remaining significantly higher than last year's comparable single digit growth of 6.0%.
Encouragingly, Q1FY19 GDP growth accelerated to 8.2%YoY vs. 7.7% in Q4 FY18, marking the first quarter with 8% plus growth after Q1 FY17, indicating normalization in economic condition post GST-transition and demonetization. We expect FY19 GDP growth to pick up pace at 7.3% (vs. 6.7% in FY18) with incremental growth likely to be supported by consumption and gradual capex recovery.

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Global Macro Developments

- ECB kept policy rates unchanged in line with consensus expectations, and also kept its inflation forecast unchanged, but lowering the growth projections slightly.
- BoE kept interest rates on hold, in line with consensus expectations and highlighted greater financial market concerns about Brexit.
- Turkey's central bank raised its benchmark rate by 625 bps to 24%, against the backdrop of sharp depreciation in the Lira and elevated CPI inflation at 17.9%, highest level since late 2003.
- South Africa entered into recession for the first time since 2009. Its GDP fell by 0.7% in June quarter after contracting by 2.6% in the previous quarter due to weakness in agricultural sector and the country was also affected by a major drought earlier this year.
- Euro Area Q2 2018 GDP growth was revised up to 0.4% QoQ from previous estimate of 0.3%. Europe's largest economy Germany's GDP rose by 0.5% QoQ in Q2, beating consensus forecast of 0.4% driven by higher household and state spending.
- Eurozone CPI inflation rose to 2.1% YoY in July (above ECB's target of 2.0%) vs. 2.0% in June led by higher energy costs. On a country by country basis, highest inflation was recorded in Estonia, Latvia and Belgium.
- Japan's CPI inflation rose 0.8% YoY in July. Core-core CPI (excludes energy and food costs), closely watched gauge used by BoJ, rose by 0.3% YoY vs. 0.2% YoY in June.
- US Q2 GDP (second estimate) rose by 4.2% up from 4.1% in the advance estimate, near a four-year high. H1 2018 growth stood at 3.2% amidst strength in business investment that more than offset slightly slower consumer spending.
- Argentina's central bank raised policy rates to 60% (15 percentage point increase), which is the second increase this month, as policy makers attempt to defend the currency (depreciated by 91.3% since Apr 2018. Argentina had secured the biggest IMF loan in history, a USD 50 bn credit package agreed in June.

Events and Data Calendar

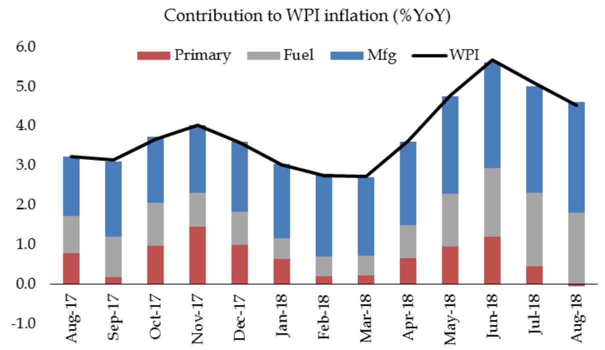
Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
Japan	4-Sep-2018	Manufacturing PMI	Aug	52.50	52.50	52.50	⇨
	14-Sep-2018	PPI (YoY)	Aug	3.00%	3.10%	3.00%	⇧
US	14-Sep-2018	Industrial Production	Aug	0.40%	0.30%	0.40%	⇩
	14-Sep-2018	Initial Jobless Claims		204k	210k	205k	⇧
	14-Sep-2018	CPI (YoY)	Aug	2.70%	2.80%	2.90%	⇩
UK	14-Sep-2018	BoE rate Decision	Aug	0.80%	0.80%	0.80%	⇨
	12-Sep-2018	ILO Unemployment Rate	Jul	4.00%	4.00%	4.00%	⇨
	10-Sep-2018	Industrial Production	Jul	0.20%	-	0.40%	⇧
China	14-Sep-2018	Industrial Production	Aug	6.10%	6.00%	6.00%	⇨
	6-Sep-2018	Caixin PMI Services	Aug	52.60	51.50	52.80	⇩

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

COMMODITY

- Gold prices decreased by 3.1% MoM in August vs. a decline of 3.4% MoM in July amid stronger dollar.
- Brent prices decreased by 1.7% MoM in August vs. a decrease of 1.1% MoM in July, on the back of a stronger dollar and escalating trade tensions.

Domestic Market Macro Economics



India August WPI

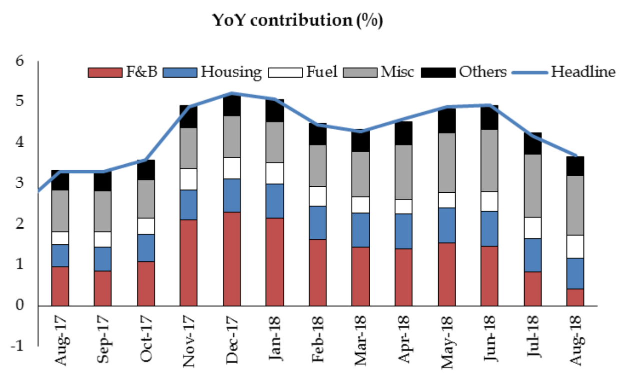
%YoY	Weights(%)	Apr-18	May-18	Jun-18	Jul-18
IIP	100	4.5	3.9	6.9	6.6
Sectoral Classification					
Mining	14.4	3.8	5.8	6.6	3.7
Manufacturing	77.6	4.9	3.7	6.7	7.0
Electricity	8.0	2.1	4.2	8.5	6.7
Use Based Classification					
Primary goods	34.0	2.7	5.7	9.3	6.9
Capital goods	8.2	9.8	6.9	9.8	3.0
Intermediate goods	17.2	0.4	0.8	1.5	1.2
Infrastructure/construction goods	12.3	8.5	7.4	8.2	8.4
Consumer durables	12.8	3.9	6.4	13.4	14.4
Consumer non-durables	15.3	7.5	-2.1	0.2	5.6

July IIP: Consumption cushions slowdown in core

- ✓ PMI for manufacturing and services both moderated in Aug-18. As such, Composite PMI eased to a three-month low of 51.9 from 54.2 in the previous month.
- ✓ India's industrial production growth eased to 6.6% YoY in July compared to a downwardly revised 6.9% in June (from 7.0% earlier, YBL expectation of 6.7%; consensus expectation: 6.5%). The moderation was in line with lead indicators such as core sector growth, automobile production, exports, along with survey based PMI manufacturing – all of which saw some loss of momentum at the start of Q2FY19.
- ✓ The nation-wide cumulative rainfall remains below normal at 93% of LPA (as of 6th Sep), albeit closer to IMD's forecast of 96% of LPA. Withstanding the vagaries of monsoon, total area sown under Kharif crops as of end Aug is only 0.4% lower compared to the same period last year.
- ✓ GST collections average run rate for FYTD19 stands at Rs 966 bn. It's lower than the Government's target of Rs 1 tn per month for FY19 but is above the average monthly collection of Rs 898 bn in FY18. That said, GST collection for Aug-18 stood at Rs 940 bn (vs. Rs 965 bn in July). The dip can be attributed to the delay of sales of items for which GST rates were cut.
- ✓ India's August merchandise trade deficit printed at USD 17.4 bn, a sequential moderation from the five-year high of USD 17.9 bn in July. The latest print surprised positively, albeit modestly, coming lower than ours and consensus expectations of USD 18.0 bn and USD 18.5 bn respectively.
- ✓ Retail inflation in India moderated in August, printing below the 4% target of RBI for the first time in 10-months. Headline CPI inflation decelerated to 3.69% YoY (Bloomberg consensus: 3.77%; YBL estimate: 3.62%) from 4.17% in July. This also happens to be the fourth consecutive downward surprise in CPI inflation data.

%YoY	Jul-17	May-18	Jun-18	Jul-18
Overall	**2.9**	**4.3**	**7.6**	**6.6**
Coal	0.6	12.2	11.8	**9.7**
Crude Oil	-0.6	-2.9	-3.4	**-5.4**
Natural Gas	6.6	-1.4	-2.7	**-5.1**
Refinery Products	-2.6	4.9	12.1	**12.3**
Fertilizers	0.2	8.4	0.9	**1.3**
Steel	9.4	0.7	3.4	**6.0**
Cement	1.1	13.0	13.3	**10.7**
Electricity	6.6	4.2	8.5	**4.8**

CORE – Growth remains strong



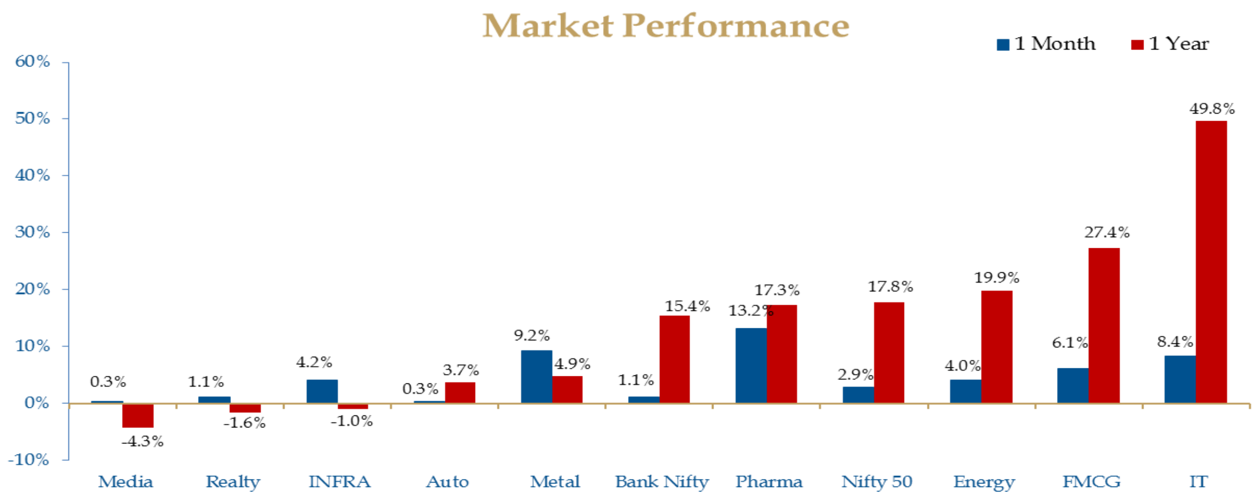
India Aug CPI - Present perfect, future tense

We expect:

- ✓ FY19 GDP growth to accelerate to 7.3% with a broad-based recovery led by consumption and modest capex cycle revival.
- ✓ FY19 CPI inflation at 4.5% assuming normal monsoon, average crude oil price at USD 75 per barrel and recalibration of kharif MSP. Upside risks like kharif MSP recalibration, closing of negative output gap, weaker currency, are likely to be partially offset by global food deflation, stabilization in commodity prices, tighter domestic money supply, and improvement in capacity augmentation.

Equity Market Insights

- August 2018 was a mixed month for global markets. While gains were seen in the US; China and UK fared weakly. Sensex rose by 2.8% during the month. On a YoY basis, all major markets have done well, except China which came in marginally lower.
- Within India, gains were seen in stocks across the board with the indices ending higher by ~2.7 to ~5.5%. Midcaps however stood out in the month gone by, with the representative index rising by 5.5%.
- Large caps however continue to outperform their small counterparts by a wide margin. In the year gone by, the Sensex and Nifty 50 rose by ~22% YoY and ~18% YoY respectively as compared to the ~9% YoY gain in midcaps and ~1% YoY decline in smallcaps.
- Foreign investors remained net sellers to the tune of INR 20 bn in August. In July 2018, FPIs were net buyers to the tune of INR 4.9 bn. Domestic funds (DIIs) continued to be net buyers, investing a net amount of ~INR 40.9 bn in August 2018. In the calendar year till date, DIIs invested a net of INR ~733 bn versus the net inflow amount of INR ~29 bn of FPIs.



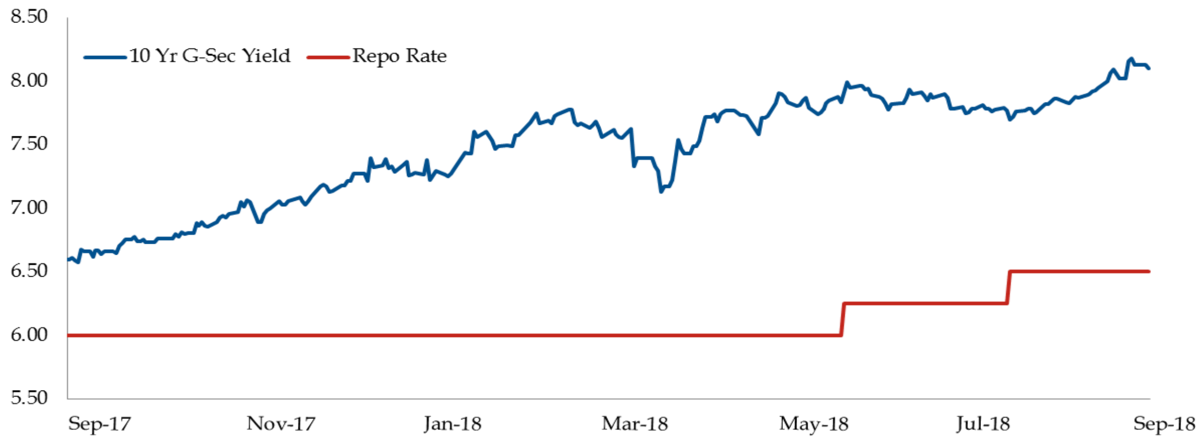
Outlook & Expectations

- Historically, whenever a handful of companies have contributed to a sharp rise in frontline index, it has led to situations of the market being fairly heated. The trend seems to be similar this time around.
- After months of underperformance, midcaps finally outperformed their larger counterparts in August 2018 by a wide margin, indicating the possibility of the above mentioned trend this time around.
- This is occurring at a time when the fund flow dynamics seem to be changing. While FPIs have turned net buyers, the amount being invested is fairly low (in the range of INR 5-10 bn per month in last two months.
- DII net flows have slowed down. In the year till date, the average monthly inflows stood at INR 110 bn (during 1HCY18). In the months of July and August 2018, the same averaged to INR 39 bn per month.
- The changing dynamics of fund flows is one concern that could impact markets - especially considering that higher inflows (read liquidity) has been a key reason behind the upward movement in recent times.
- We continue to believe that the problem of housing shortage is real and that the need for quality infrastructure in the country is strong. Not to mention that the story of higher consumption and discretionary spends very much remains intact. The government's push towards improving the livelihood of the rural and agri space does remain. We prefer looking at the entire gamut of options to play on a sector.
- The aim for long term investors is to build wealth. And to do so, one would essentially need to do as well or better than the broader market in both, rising or falling environments. And to do so, investors largely have two options - sit on cash or invest into companies where the downside seems capped (read favourable valuations) - or a mix of both. Notwithstanding the dull market sentiments in the past few quarters, we believe this should work well for investors over the short to medium term.

Debt Market Insights

- ✓ The average systemic liquidity surplus increased in August to INR 30 bn from a deficit of INR 125 bn in July.
- ✓ 10yr G-sec bond yield during August remained elevated at 7.8% (unchanged from July), due to depreciation pressures on the INR countering moderation in crude oil prices.
- ✓ In line with our expectations, Q1FY19 GDP growth accelerated to 8.2%YoY vs. 7.7% in Q4 FY18, marking the first 8% plus growth after Q1 FY17, indicating normalization in economic condition post GST-transition and demonetization.
- ✓ Retail inflation in India moderated in August, printing below the 4% for the first time in 10-months. Headline CPI inflation decelerated to 3.69% YoY from 4.17% in July. This also happens to be the fourth consecutive downward surprise in CPI inflation data.

10 Yr G-Sec Vs. Repo Rate



Outlook and Expectations

- ✓ We expect RBI to remain on hold in the remainder of FY19, as the transmission of two back-to-back rate hikes plays-out and CPI is expected to remain in comfortable range of 4.0%-4.5%. Neutral stance indicates future policy course remains data dependent.
- ✓ In the second half of August, yields have firmed-up with INR weakness and rise in crude oil prices. We expect 10-year g-sec yields to trade between 7.5-8.2% in FY19. OMO purchases and an expected 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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