The consequences of oil price decline

OPEC's decision to refrain from cutting oil production in its November meeting deepened the glut in oil supply and prompted a sharp decline in the crude oil prices (~40% since June-14). The decline in prices has changed the dynamics of the global economy significantly. While the oil price slump is likely to adversely affect oil exporting countries such as Russia, Nigeria and Venezuela among others, it is likely to fortify recovery in countries such as US and India which are already witnessing green shoots. Cheaper oil is also likely to grease the wheels of global growth. According to the IMF, a 30% decline in crude oil prices translates into 0.8% boost for most advanced economies.

Declining oil prices are likely to accelerate the pace of revival in US economy. Being a significant energy consumer, US is likely to gain from lower gas and gasoline prices which would eventually boost real incomes leading to higher consumption expenditure. This, in conjunction with the underlying improvement in jobs growth bodes well for the US growth. Non-farm payrolls in US surged to 321k in Nov-14 from 243k in Oct-14, marking the 10th consecutive month in which employment rose by at least 200k.

However, falling oil prices are likely to have a mixed impact on Eurozone. While disposable incomes would be supported on account of oil price decline, deflationary fears are likely to get intensified, posing a test for the European Central Bank. Consumer prices rose by 0.3% YoY in Nov-14 slipping from 0.4% increase reported in Oct-14. While, so far the ECB has refrained from announcing quantitative easing, continued softness in global oil prices may eventually compel the ECB to act more boldly to ward off deflationary risks. Declining oil prices are also likely to be beneficial for Asian giants Japan and China which continue to face headwinds on growth front. While GDP in Japan shrank by an annualized 1.9% in Q32014; manufacturing PMI in China fell to a six-month low of 50.0 with the output index falling into a contractionary zone. While Japanese PM Shinzo Abe responded by delaying scheduled sales tax increase and announcing snap elections, Central Bank in China eased monetary policy by cutting its benchmark one year loan rate by 0.4%.

On the domestic front, declining oil prices are likely to have multi-fold positive impact through channels of inflation, trade deficit and fiscal deficit. Incoming data suggests that recovery in the economy is gradually taking hold, despite moderation in Q2FY15 GDP to 5.3%YoY from 5.7% in previous quarter. Private sector activity surged in Nov-14 led by strong readings on PMI manufacturing (53.3 vs. 51.6 in Oct) and services (52.6 vs. 50.0 in Oct). Meanwhile, in line with expectations, Reserve Bank of India kept the policy repo rate unchanged at 8% in its fifth bi-monthly monetary policy review, although it signaled possibility of a rate cut in early next year, if inflation continued to fall.

Looking ahead, we expect growth-inflation mix to improve as economic activity gains traction and inflationary pressures moderate. Recent sharp decline in oil prices amid moderation in domestic food prices and ease in services inflation has increased the visibility of attainment of RBI's inflation target. We expect Jan-15 CPI inflation to undershoot RBI's 8% target by at least 150 bps. Likewise, we expect RBI to comfortably achieve its Jan-16 target of 6% given the current dynamics.

As such, we now expect the RBI to ease monetary policy by a cumulative of 75 bps (earlier expectation: 50 bps) during the course of 2015 with the first cut happening in Feb-15 policy review (earlier expectation: Apr-15).

Kanwar Vivek
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Wealth Management & Global Indian Banking

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Chief Economist

Global Macro Developments

- On the global front, the J.P.Morgan Global Manufacturing PMI stood at a 14-month low of 51.8 in November as compared to 52.2 in October.
- ECB kept its key policy rates unchanged in its monetary policy meeting, in line with consensus. ECB President Draghi specified that unanimity is not required for quantitative easing, saying that the ECB policymakers would review measures next year. GDP and inflation were revised down for this year.
- The Euro zone economy showed risks of a renewed slowdown. As Purchasing Managers Index for factories and services activity unexpectedly fell to 51.4 in November, the lowest in 16 months, from 52.1 in October.
- Japan's economy contracted to an annualized 1.9% in Q32015, more than a preliminary 1.6% decline, as capital expenditure was revised downward to -0.4%, compared with a reading of -0.2%.
- US consumer sentiment rose in November to its highest level in more than seven years on improvements in the current economic condition, including lower gas prices and improving job prospects.
- China's HSBC manufacturing PMI fell to an eight-month low in November (50.3, October: 50.8) suggesting the world's second largest economy continues to slow and more policy easing could be in the anvil.
- PBoC unexpectedly cut benchmark lending rates by 40 bps; highlighting that downside risks to Chinese growth are intensifying.

Events and Data Calendar

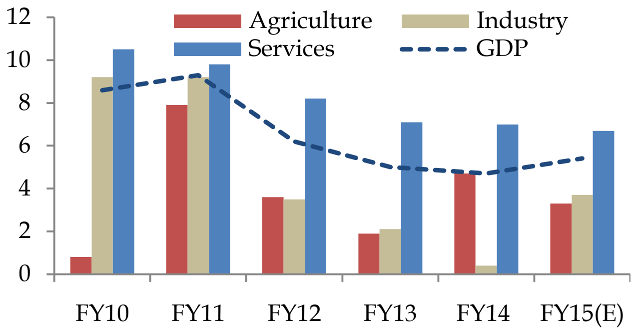
Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
US	11/03/2014	ISM Manufacturing	(OCT)	56.1	59	56.6	↑
	11/07/2014	Change in Non-farm Payrolls	(OCT)	235K	214K	257K	↓
	11/14/2014	US U. of Michigan Confidence	(NOV P)	87.5	89.4	86.9	↑
	11/20/2014	US Fed Minutes from Oct. 28-29 FOMC Meeting	(NOV)	-	-	-	→
	11/20/2014	Consumer Price Index Ex Food & Energy (YoY)	(OCT)	1.70%	1.80%	1.70%	↑
	11/25/2014	US Gross Domestic Product (Annualized)	(3Q S)	3.30%	3.90%	3.50%	↑
	11/25/2014	US Consumer Confidence	(NOV)	96	88.7	94.5	↓
	11/26/2014	US Durable Goods Orders	(OCT)	-0.60%	0.40%	-0.90%	↑
UK	11/06/2014	Bank of England Rate Decision	-	0.50%	0.50%	0.50%	→
	11/18/2014	Consumer Price Index (YoY)	(OCT)	1.20%	1.30%	1.20%	↑
	11/26/2014	Gross Domestic Product (YoY)	(3Q P)	3.00%	3.00%	3.00%	→
Japan	11/17/2014	Gross Domestic Product Annualized	(3Q P)	2.20%	-1.90%	-7.30%	↑
	11/28/2014	JPY National Consumer Price Index (YoY)	(OCT)	3.00%	2.90%	3.20%	↓
EU	11/14/2014	Euro-Zone Gross Domestic Product s.a. (QoQ)	(3Q A)	0.10%	0.20%	0.10%	↑
	11/18/2014	German ZEW Survey (Economic Sentiment)	(NOV)	0.5	11.5	-3.6	↑
	11/27/2014	German Unemployment Change	(NOV)	-1K	-14K	-23K	↓
	11/28/2014	Euro-Zone Consumer Price Index - Core (YoY)	(NOV A)	0.70%	0.70%	0.70%	→
	11/30/2014	CHF Swiss Gold Referendum	(NOV)	-	-	-	→

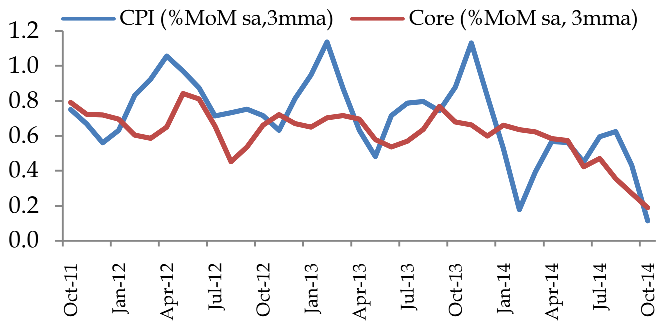
P* – Provisional Estimates   F* - Final Estimates   A*- Advanced Estimates   T*- Third Estimates

COMMODITY

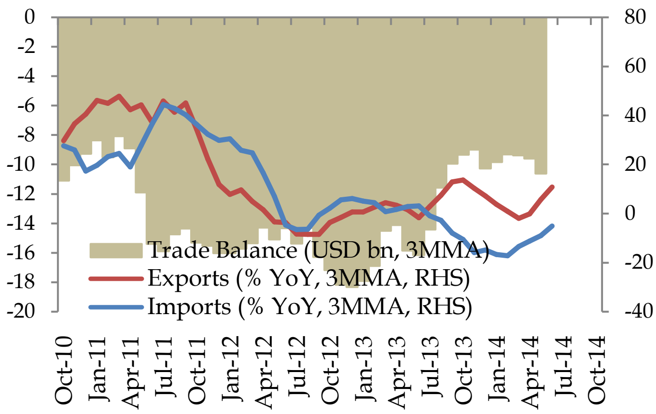
- Gold prices contracted 3.7% MoM in November, as compared to a 1.2% MoM decline in October as Swiss voters overwhelmingly rejected proposals to boost gold reserves in the a Swiss referendum on central bank bullion assets. Further, expectations that plunging oil prices could deplete inflationary pressure curbed the metal's appeal as a hedge.
- WTI contracted 9.07% MoM in November as compared to 8.8% MoM decline in October as OPEC decided to maintain its production at 30 mbpd. Given weak global demand, sufficient non-OPEC supply and a strengthening Dollar, oil market is likely to find a new 'lower' equilibrium in the coming months.

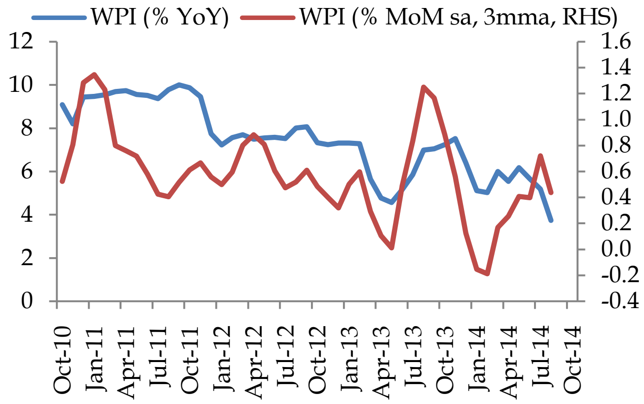
Domestic Market Macro Economics





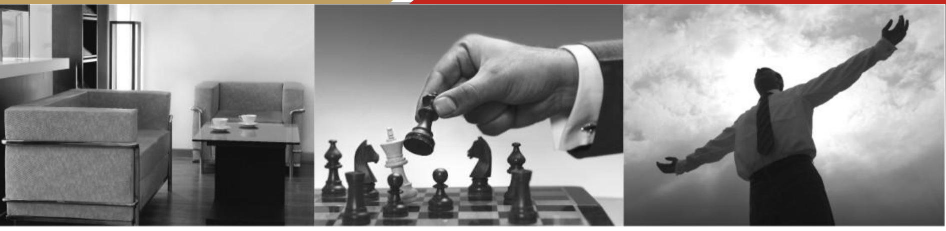
- India's Q2FY15 GDP growth moderated to 5.3%YoY from 5.7%YoY recorded in Q1FY15 as industrial growth moderated to 2.2%YoY from 4.2%YoY in Q1FY15
- Oct-14 trade deficit improved marginally to USD 13.4 USD (vs. USD 14.2bn in Sep-14) as moderation in exports (USD 26.1bn in Oct-14 vs. USD 28.9bn in Sep-14) was outpaced by decline in imports (USD 39.5bn vs. USD 43.2bn in Sep-14)
- CPI inflation for the month of Oct-14 declined to 5.52%YoY as compared to 6.46%YoY on account sharp fall in food and fuel prices. Core CPI moved lower to 5.86%YoY in Oct from 5.90%YoY previously.
- WPI inflation eased to 1.77%YoY in Oct-14 as compared to 2.38% in Sep-14 supported by favorable base, sharp decline in international crude and domestic food prices. Encouragingly, core WPI moderated to 2.55%YoY in Oct-14 from 2.81% previously
- HSBC manufacturing PMI surged to 53.3 in Nov-14 from 51.6 in Oct-14 as new order index surged.
- HSBC PMI Services Business activity index rose to 52.6 in Nov-14 from Sept's 50.0 led by new orders.
- Core sector output during Oct-14 rose to 6.3%YoY from 1.8%YoY in Sep-14, primarily driven by favorable base effect.
- Reserve bank kept the policy repo rate unchanged at 8% in the fifth bi-monthly monetary policy review, while signaling monetary easing in early 2015 if the current moderation in inflation continues.





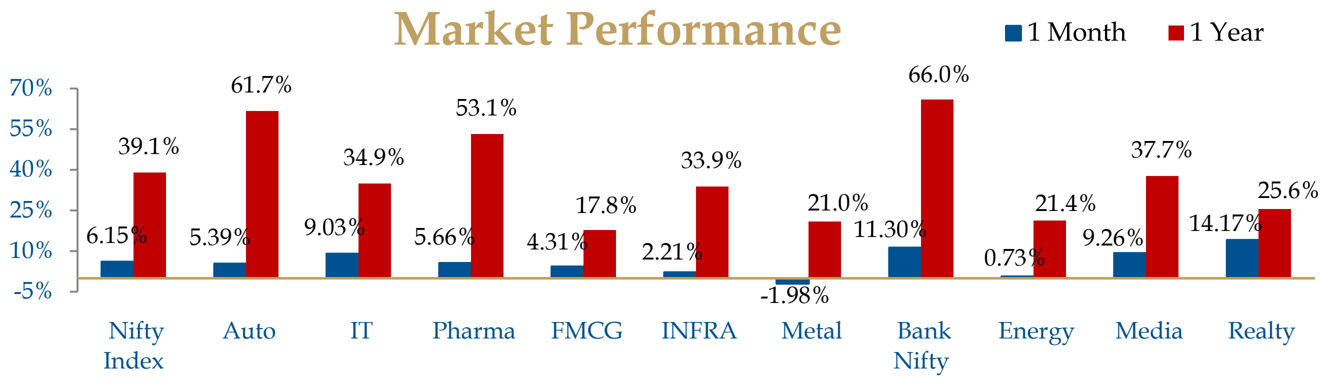
We expect:

- We expect Q3FY15 growth to moderate from 5.3% of Q2FY15 as impact of less than normal monsoon plays through. Thereafter a gradual recovery in industrial sector amid moderate expansion in services sector would steer full year growth towards our projection of 5.4% for FY15.
- Following a sharp decline in crude prices and moderation in food inflation, we expect FY15 average CPI inflation at 6.7-6.8% vis-a-vis our earlier expectation of 6.9%. Jan-15 CPI inflation is now likely to undershot RBI's target by 150 bps. For FY16, we expect CPI inflation estimate to 5.9% from 6.4% earlier. We also expect the Jan-16 CPI target to be met comfortably.
- We expect the RBI to ease monetary policy by a cumulative of 75 bps (previous call: 50 bps) during the course of 2015 with first cut likely in Feb-15 policy review (previous call: Apr-15).
- Our FY15 CAD estimate of USD 35bn may see some downside risk to the extent of USD 2-4bn.
- While we continue to stick to our USDINR call of 62-64 for 2015, but we now expect 10Y g-sec yield to trend lower towards 7.90% in Mar-15, vis-à-vis our previous call of 8.10%



Equity Market Insights

- The month of November saw the Indian stock markets reach record highs. The benchmark BSE SENSEX closed at 28,694, up 6.75% for the month while the Nifty closed at 8,588, up by 6.98% during the same period. The CNX Mid-Cap and CNX Small-cap indices too delivered robust returns of 7.4% and 3.9% respectively.
- The hope of a recovery in economic growth continues to fuel interest from institutional investors.
- FIIs & DII's were both net buyers in equity markets by ~ $ 1.9bn & ~$270mn in November.



Factors to Watch

- On the domestic front, market participants will now be watching out for the trends in inflation, which are already suggesting a cool off. This in turn has started to fuel expectations of an interest rate cut by the Reserve Bank of India.
- The markets are now focused on the Union Budget which is scheduled to be delivered in February. Close watch would be kept on policy measure announcements which would strengthen the faith in an impending economic recovery. Any policy measure announcements outside of the Budget would provide further impetus to the markets.
- Market participants would also keep a close eye on the global commodity prices particularly that of crude, which has come down sharply in recent times.
- Other key events that would be watched closely especially by the FIIs would be the geo-political events in Greece, developments in Japan and China and policy announcements in the Euro zone.

Outlook & Expectations

- The quarterly earnings season saw a growth of about 4% in the top line for companies forming a part of the CNX 100 Index on a year-on year (YoY) basis. Growth in net profits was higher at 19% YoY during the same period. On a sector wise basis, the sectors that reported a negative growth in topline were energy, mining and power. In terms of EBITDA margins, most sectors reported an improvement suggesting that cost pressures seem to be easing off. The exceptions to this were the autos, pharma and power sectors that saw margins remain relatively flat on a YoY basis. In terms of growth in the bottom-line the results were mixed. On one hand sectors like autos, cement, BFSI, and IT saw their net profits increase significantly on a YoY basis. On the other hand sectors like metals, mining and power saw bottom lines decline. The overall results seem to suggest that the worst maybe over for India Inc., however, the signs of recovery are still feeble.
- In terms of valuations, the SENSEX is trading at a trailing twelve month PE multiple of 19.6 times which is slightly higher than its long term historic average of 18.2 times. However on a forward earnings basis (assuming an 11% growth in earnings), the SENSEX is trading at a multiple of around 17.7 times, which suggests that valuations are not expensive even at these levels. However based on technicals, we could see some near term consolidation in the markets. We believe that any correction in the market should be viewed as an ideal time to pick up quality stocks.
- We recommend equity investments through a Systematic Transfer route with a minimum investment horizon of 36 months.
- We continue to have a positive view on the IT sector, though some of the top tier companies are trading close to the higher valuation bands. Therefore corrections could be viewed as good opportunities to buy into these stocks. Select stocks in the auto and auto ancillary space too would see their earnings grow based on a recovery in the domestic markets as well as better performance of the export markets.

- From a longer term perspective, i.e. from a 2 to 3 years' horizon, investors could look at picking up stocks in sectors that stand to benefit from a revival in the economy. These would be consumer durables, infrastructure and banks.

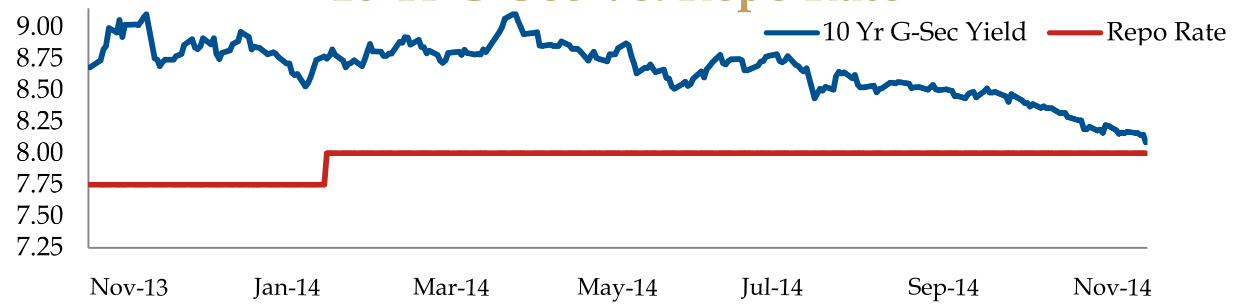
Debt Market Insights

- The average systemic liquidity deficit in Nov was recorded at INR 429bn vs. an average of INR 512bn in Oct.
- Average 10 yr yield during November declined to 8.18% from 8.39% in October.
- The decline in yields for month of Nov was led by sharp correction in global commodity prices in particular crude oil. Price of Indian crude basket declined by 10.6% MoM in Nov supporting moderation in inflation.
- In line with expectations, the Reserve Bank of India in its fifth bi-monthly review of monetary policy left repo rate unchanged at 8.00%.
- Basis support from the sharp decline in global commodity prices, and seasonal disinflation in food, along with policy restraint on upward adjustment in government's procurement prices, the RBI now expects Mar-15 CPI inflation at 6.0% vis-à-vis its earlier projection of ~7.8%. Similarly, the RBI now expects Jan-16 CPI inflation at 6.0% (with balanced risks) vis-à-vis its earlier projection of ~7.0%.
- In its forward guidance, the RBI enumerated that "if the current inflation momentum and changes in inflationary expectations continue, and fiscal developments are encouraging, a change in monetary policy stance is likely early next year, including outside the policy review".

Outlook and Expectations

- The 10 Yr G sec yields were ranged within 8.09% to 8.26% levels for the month of November.
- We expect RBI to announce its first rate cut in the Feb-15 policy review. Over the course of 2015, we stick to our call of cumulative monetary easing of 75 bps.
- We continue to believe that short term rates are attractive at current levels and suggest investing in short term funds and dynamic bond funds for an investment horizon of 12 to 18 months and for certain aggressive clients strategic allocation in long term income / gilt funds.

10 Yr G-Sec Vs. Repo Rate



Model Portfolios – December 2014

Asset Class	Conservative	Cautious	Moderate	Growth	High Growth
I) Debt (%)	95	70	50	25	10
Ultra Short Term Funds	20	15	15	5	-
Dynamic /Income Funds	35	30	20	15	5
NCD/ Bank Deposit	40	25	15	5	5
II) Equity (%)	-	15	30	45	55
Large Cap	-	15	25	30	35
Mid cap	-	-	5	10	15
Sector/ Thematic	-	-	-	5	5
II) Alternate (%)	5	15	20	30	35
Gold ETF	5	5	10	10	10
Structured Products	-	10	10	10	10
PE/ Real Estate Funds	-	-	-	10	15
Total (%)	**100**	**100**	**100**	**100**	**100**

Glossary:

- **<u>Consumer Price Index (CPI):</u>** A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.
- **<u>Wholesale Price Index (WPI):</u>** An index that measures and tracks the changes in price of goods in the stages before the retail level.
- **<u>Open Market Operations (OMO's):</u>** 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.
- **<u>Cash Management Bills (CMB):</u>** A short-term security sold by RBI to meet any temporary shortfalls.
- **<u>Purchasing Managers Index (PMI</u>**) 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.
- **<u>Net Demand and Time Liabilities (NDTL):</u>** 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.
- **<u>Current Account Deficit (CAD):</u>** 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.
- **<u>West Texas Intermediate (WTI)</u>**<u>:</u> 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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