FIRST Insights

Global Volatility likely to intensify, focus shifts to domestic macros

Global financial markets have been unsettled since the start of 2016. Increased concerns about global economic recovery have dominated the global risk sentiment. The weak May PMI readings globally have suggested that the tepid onset to the year has penetrated into the second quarter. While emerging market growth continues to be sluggish, the developed economies have been stuck in a low growth trap since February.

OECD downgraded its growth forecasts by 0.3 percentage point for both this year and the next. Among the risks identified were a potential British exit from the European Union, volatility in financial markets, and Europe's inability to find a common response to its refugee flows. Further, weak jobs data from US has exacerbated fears of disruption in global growth, which is expected to result in weaker consumption demand, feeding back into pessimism into investor sentiment and private sector activity; and thus creating a vicious cycle.

Meanwhile on domestic front, the incremental lead indictors released on the heels of robust Q4-FY16 GDP data reflect a gradual and uneven improvement in growth. While personal loans continued to outperform (reflecting relatively resilient urban demand), moderation in credit growth to large industries and contraction in MSME segment weighed on the headline print. Further, while India's May-16 manufacturing PMI and services print highlighted an expansion in business activity, the uptick remained modest.

On the upside, Apr-16 core sector activity rose to a near four year high. Notwithstanding the favorable base, the expansion in underlying seasonally adjusted momentum remained robust (post a contraction in Mar-16). Moreover, auto sales continued to post strong numbers, reflecting gradual uptick in domestic demand conditions.

On monetary policy front, taking cognizance of the recent build up in domestic inflation and the increased uncertainty globally, the Reserve Bank of India maintained status quo in its second bi-monthly policy review while suggesting that its stance continues to remain accommodative.

Going forward, India's economic recovery is expected to gain traction as increase in disposable incomes following 7th CPC implementation, an above-normal monsoon, and continued monetary policy accommodation are expected to engender both urban and rural demand, which in turn are expected to strengthen profitability of Indian companies, kick-starting a virtuous cycle of growth. We expect FY17 GVA to improve to 7.8% from 7.2% in FY16 with GDP growth moving towards 8.1% from 7.6% in FY16.

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Global Macro Developments

- US nonfarm payrolls dropped to its weakest pace since 2010 in May 2016 as payrolls rose by a modest 38k compared to an expectation of 160k. The data for March and April was also revised downwards. The weak payrolls data pushed forward expectation of a rate hike in June.
- Service sector activity in the US in May at the slowest pace in more than two years as non-manufacturing purchasing managers index fell to 52.9 last month from 55.7 in April.
- The European Central Bank maintained status quo on interest rates while making only small adjustments to its forecasts for growth and inflation. It revised its inflation forecast for 2016 up to 0.2% from 0.1% before, and growth to 1.6% from 1.4% earlier.
- Growth in Germany's private sector accelerated in May to reach its highest level since January as composite PMI rose to 54.5 from 53.6 in April
- Japan's Finance Minister Taro Aso said that he would not comment on Japan's response in the currency market if the yen were to rise further in the wake of bleak US payroll data.

Events and Data Calendar

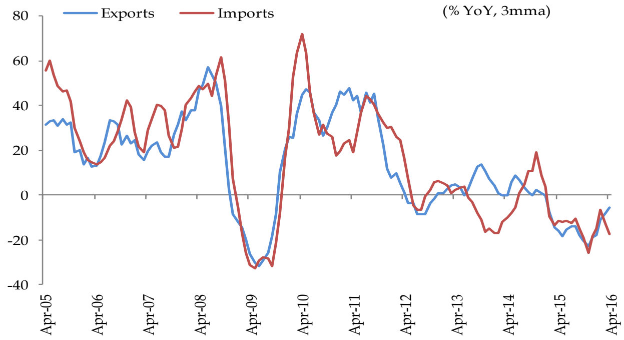
Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
Japan	5/13/2016	Gross Domestic Product Annualized	(1Q P)	0.30%	1.70%	-1.70%	↑
US	5/31/2016	Consumer Confidence	(MAY)	96.1	92.6	94.7	↓
EU	06/03/2016	Change in Non-farm Payrolls	(MAY)	160K	38K	123K	↓
	06/03/2016	ISM Non-Manufacturing Composite	(MAY)	55.4	52.9	55.7	↓
	5/30/2016	German Consumer Price Index (YoY)	(MAY P)	0.10%	0.10%	-0.10%	↑
	06/02/2016	European Central Bank Rate Decision	(JUN 2)	0.00%	0.00%	0.00%	→
UK	5/26/2016	Gross Domestic Product (YoY)	(1Q P)	2.10%	2.00%	2.10%	↓

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

COMMODITY

- Gold prices increased 1.14%MoM in May-16, following a 0.14%MoM contraction in April-16, as fears of a rate hike by the US Federal Reserve subsided following the release of disappointing employment data for May.
- Brent prices expanded 10.3%MoM in May-16, after expanding 5.4% MoM in April-16, after a report from the Energy Information Administration showed crude stockpiles had fallen by 1.4mn barrel for the week ended May 27.

Domestic Market Macro Economics

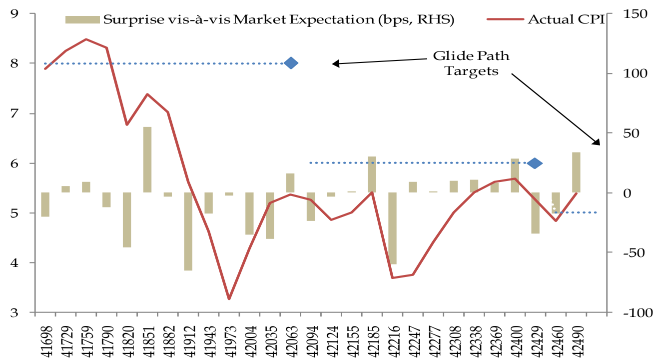


Trade metrics improve

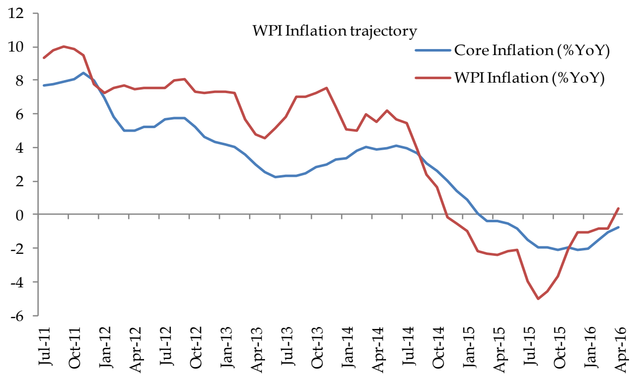
GDP Growth (% YoY)				
	Q1 FY16	Q2 FY16	Q3 FY16	Q4 FY16
Private Consumption	6.9	6.3	8.2	8.3
Government Consumption	-0.2	3.3	3	2.9
Gross Fixed Capital Formation	7.1	9.7	1.2	-1.9
Exports	-5.7	-4.3	-8.9	-1.9
(less) Imports	-2.4	-0.6	-6.4	-1.6
GDP*	**7.5**	**7.6**	**7.2**	**7.9**

Q4 GDP growth comes in strong

- ✓ GDP growth for Q4 FY16 came in at a strong 7.9%YoY topping Bloomberg and our estimate of 7.5%. As such, full year GDP growth for FY16 stood at 7.6% - the same as pegged by advance estimates, while GVA stood marginally lower (10 bps) at 7.2%YoY.
- ✓ In line with the moderation in most other lead indicators in April (PMI, exports, auto sales), IIP growth slipped into negative territory, contracting by 0.8% on an annualized basis compared to a near flat albeit upward revised growth of 0.3% in March (earlier 0.1%).
- ✓ NIKKEI India Manufacturing PMI stood at 50.7 in May (vs. 50.5 in April), highlighting an overall improvement in operating conditions for the fifth consecutive month; albeit at the margin.
- ✓ The headline CPI inflation in April came in line with our expectations at 5.39%YoY led mainly by rise in prices of food. Halting the disinflationary momentum witnessed since Dec-15, food & beverages index rose by 1.46%MoM – the fastest pace of monthly uptick since Aug last year.
- ✓ Post the 25 bps monetary easing along with the introduction of a phased transition towards a neutral liquidity framework in the month of April, the RBI adopted caution in June amidst the emergence of some upside pressure on inflation. Repo rate was retained at 6.5%.



CPI accelerates, led by food and miscellaneous category



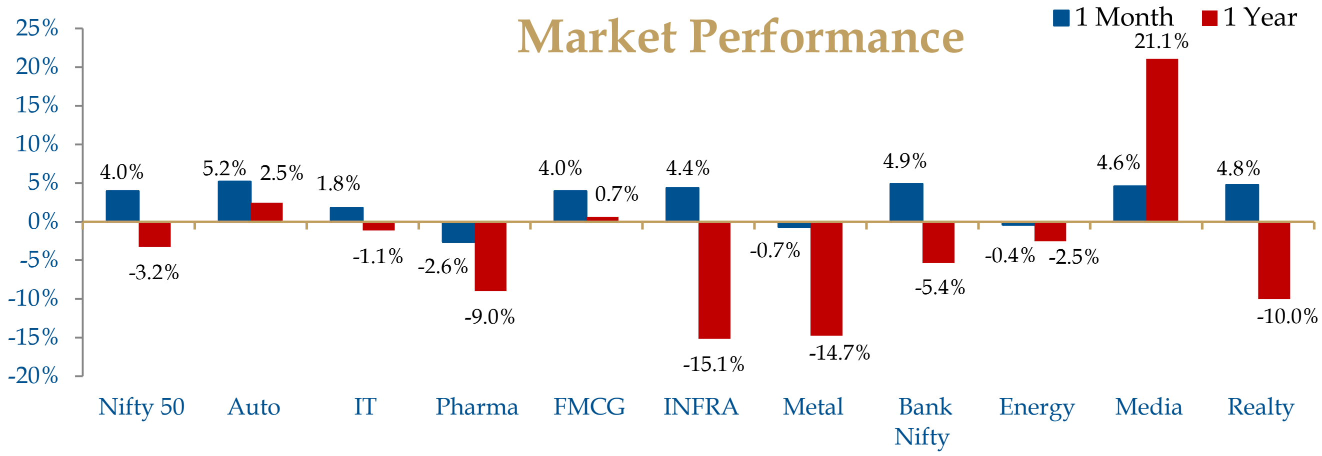
WPI inflation turns positive after 17 months

We expect:

- ✓ For FY17, we foresee an upside to our earlier 7.8%YoY GDP estimate. We estimate GDP growth in FY17 could stand closer to 8.1%YoY as –
  - A surplus monsoon outturn (assuming a favorable spatial and inter temporal distribution) is likely to support agriculture output and rural demand to a greater extent.
  - Impetus to consumption gets further entrenched with anticipated revision in wages for govt. employees.
  - Visible return in investment appetite by the end of the year
- ✓ We expect USDINR to remain weak in the range 67-69 due to continued global headwinds such as monetary policy uncertainty from central bank actions and financial volatility; though strong domestic macros would keep sharp depreciation pressures contained. Medium-term INR direction would depend on the execution and pace of domestic reforms.

Equity Market Insights

- Indian stock markets were amongst the best performing markets globally, during the month of May. BSE Sensex closed at 26,668, higher by 4% for the month while the Nifty closed at 8,160; recording similar levels of gains during the same period. The CNX Mid-Cap and CNX Small-cap indices relatively underperformed with returns of 0.7% and 0.3% respectively during the month.
- During May, foreign investors remained optimistic on the equity markets but were net sellers in the debt markets. There was an inflow of US$ 0.05 bn in the equity markets and an outflow of US$ 0.12 bn in the debt markets taking the total tally to a net outflow of US$ 0.07 bn during the month. DII's were net buyers and bought $ 1.0 bn during the same period.



Factors to Watch

- The March quarter result season saw an improvement in earnings. The Sensex companies (ex BFSI and Energy) saw net profits go up by 12.2% QoQ while the topline improved by 5.5% sequentially. This seems to suggest that earnings have bottomed out and should start improving going forward.
- We base the assumption of recovery on 3 important factors – 1. Monsoons: As of now the estimates and indications as given by both Skymet as well as IMD are that the monsoons this year would be better. This in turn would have a positive impact on the rural economy and therefore on the rural driven consumption. 2. Project clearance and orders data: The data on projects getting cleared and awarding of orders has gone up in recent times. For instance there is traction on awarding orders on the metro side. 3. Pick up in industrial activity.
- Global events: Key global events which investors would be watching out for include the outcome of the referendum related to Britain's continuance/exit from EU and the course of interest rate hikes by the US Fed.
- Investors would also be keeping a close eye on commodity prices particularly that of crude. In the near term, global issues are the major risk to Indian stock markets particularly from the point of view of foreign fund flows.

Outlook & Expectations

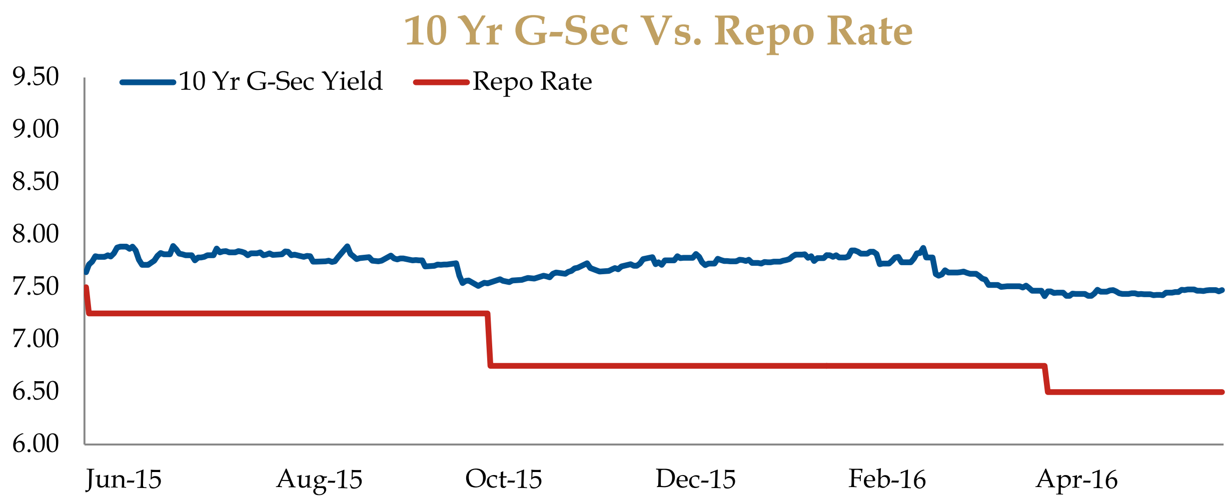
- In terms of valuations, the Sensex is trading at a trailing twelve month PE multiple of 20.1 times which is slightly above its long term historic average of 18.2 times. On a forward earnings basis the Sensex is trading at a multiple of around 16.4 times, which suggests that markets are not expensive at current levels. Building an assumption of a robust improvement in earnings in FY17, we believe that the markets are still attractive from a longer term perspective, i.e. for 2 to 3 years.
- Going forward, we continue to remain optimistic on the agri sector. Revival of the rural economy would have a multiplier effect on sectors that are driven by consumption. This includes consumer goods, FMCG, autos (2 wheelers in particular), etc. Revival in demand would eventually translate to revival in private capex as well. With this in mind we are optimistic on infrastructure, consumption led sectors and agri sectors and would recommend investments in the quality stocks in the same.

Debt Market Insights

- The average systemic liquidity deficit in May reduced to an average INR 961 bn as compared to INR 1021 bn in April as government spending accelerated and cash leakage eased.
- Average 10 yr yield during May remained more or less unchanged at 7.45% compared to 7.44% in April.
- Amid emergence of upside pressure on inflation, RBI introduced an upside bias to its CPI inflation forecast, even though the forecast of 5% inflation by end of FY17 has been retained.
- Unlike the April policy review where the RBI highlighted a timeline of close to 2-years for complete transition to the neutral liquidity framework, the central bank now eschewed from mentioning a specific timeframe.

Outlook and Expectations

- With inflation adjusted for the first round impact of 7th CPC expected to broadly track the 5% target, we continue to anticipate another 25 bps monetary easing from the RBI. This is likely to happen in the forthcoming policy review in August
- We expect average CPI (ex housing) inflation to moderate towards 5.0% in FY17 from our estimated level of 5.1% in FY16
- Our FY16 current account forecasts remain at a comfortable 1.1% GDP. For FY17, we see a higher but still subdued CAD of 1.3% of GDP translating into USD 29bn



Model Portfolios – June 2016

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:

- **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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