Global growth on an upswing; India's Q2 GDP validate nascent signs of recovery

2017 ended on a positive note, with the last set of the year's macro data continued to underpin the strength in global recovery. Global manufacturing PMI in December rose to a seven year high, led by faster growth in developed nations vis-à-vis emerging markets. In additional, growth continued to be broad based across the major advanced economies, with US, Eurozone, Japan and the UK seeing further improvement in Q3 2017 GDP growth. On the monetary policy front, US Federal Reserve raised its benchmark rate in line with expectations by 25 bps to 1.25-1.50% (7-2 vote), marking its third hike in the year. Indeed, 2017 has been the 'Year of Recovery Initiation' for the global economy.

In a validation of synchronized global recovery, IMF expects 2017 global GDP growth at 3.6% – the fastest pace of annual growth since 2014. While outlook for 2018 remains optimistic, with growth anticipated to improve further, led by both developed and EMEs.

On the domestic front, the ruling Government won the state elections in Gujarat and Himachal Pradesh, reflecting public endorsement of economic reforms over the last 4 years. In addition, domestic data released for the months of November-December was mostly upbeat, indicating normalization of macro conditions post implementation of GST.

On the growth front, after incorporating the latest CSO advanced estimates, we revise our FY18 GDP growth estimate marginally lower to 6.7% from 6.8% earlier (versus 7.1% in FY17). While the pace of annual growth marks a deceleration in FY18, it should be noted that the incremental momentum is expected to pick up in H2, with growth in H2FY18 accelerating to 7.3% YoY from 6.0% YoY in H1 on the back of support from consumption and normalization of business conditions.

On the inflation front, recent data has surprised on the upside led by food and fuel prices. This upward trajectory in CPI inflation is expected to continue till mid-2018, amidst an unfavorable base, ongoing on-boarding of rise in HRA rates and possible fiscal slippage both for Centre and the State. While the risks for monetary tightening have risen, we maintain our base case for RBI remaining on a prolonged pause in 2018, as upside risks to inflation are balanced by growth concerns, with the economy remaining in early stages of GST-transition. In the current scenario the inflation target breach does not warrant a rate hike as: it's partly due to statistical impact of HRA adjustment and not entirely reflective of domestic demand conditions.

On the fiscal front, we expect the government to breach fiscal deficit target of 3.2% of GDP, with a risk of fiscal slippage at 0.3% of GDP on the back of revenue shortfall from the following sources - lower surplus transferred by the RBI and lower collection from GST.

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Global Macro Developments

- US Q3 GDP growth was revised from 3.3%YoY to 3.2% YoY, though the print was lower than the previous estimate it represents a pickup from the previous quarter (Q2: 3.1%).
- US President, Donald Trump, signed the tax overhaul bill into a law. The law reduces corporate tax rate from 35% to 21% and reduces tax burden on individuals also. He also approved a short term spending bill which averts a Government shutdown.
- UK Q3 GDP growth printed at 1.7% YoY, higher than market estimates of 1.5% YoY (Q2: 1.9%). Despite the higher than anticipated growth, household spending grew at 1%, the slowest pace since 2012.
- Eurozone Manufacturing December PMI came in at a record-high (60.6, Previous: 60.1), amid record expansion of output in member countries of Austria, Germany and Ireland.
- Bank of Japan kept its monetary policy stable in its January 2018 meeting. The central bank revised up its forecasts of private consumption and capital expenditure.
- Japan Government raised its growth projections for 2017 and 2018 to 1.9% (previous: 1.5%) and 1.8% (previous: 1.4%), respectively.
- World Bank raised its growth forecast for China for 2017 from 6.7% published earlier in October to 6.8%. However, it kept its forecast for 2018 and 2019 unchanged at 6.4% and 6.3% respectively.
- German chancellor Angela Merkel, highlighted the need for a stable government stating that an EU without a strong Germany and a robust Franco-German alliance is unthinkable. The statement comes against the backdrop of ongoing coalition talks with SPD, which are moving at a slow pace almost 12 weeks since the national election results.
- European Central Bank kept its interest rate steady, in line with expectations. It also said that the tapering plans would remain unchanged and would start from January. ECB raised its growth and inflation forecasts till 2020, however the inflation forecast of 1.7% is still short of their intended target of 2%.
- Japanese business confidence of large manufacturing firms improved for the fifth consecutive quarter to reach at 11 year high.

Events and Data Calendar

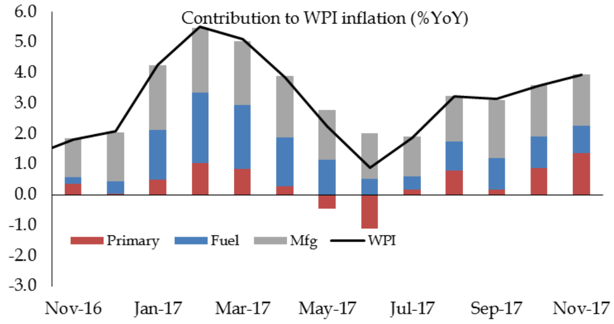
Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
Japan	21-Dec-2017	BoJ Interest Rate Decision	(DEC)	-0.10%	-0.10%	-0.10%	⇨
	26-Dec-2017	Jobless Rate	(NOV)	2.80%	2.70%	2.80%	⇩
US	13-Dec-2017	Consumer Price Index (YoY)	(NOV)	2.20%	2.20%	2.00%	⇧
	14-Dec-2017	Fed Interest Rate Decision	(DEC)	1.50%	1.50%	1.25%	⇧
	21-Dec-2017	GDP Annualized (QoQ)	(3QT)	3.30%	3.20%	3.30%	⇩
EA	14-Dec-2017	ECB Interest Rate Decision	(DEC)	0.00%	0.00%	0.00%	⇨
	18-Dec-2017	Consumer price Index (YoY)	(NOV)	1.50%	1.50%	1.50%	⇨
UK	14-Dec-2017	BOE Interest rate Decision	(DEC)	0.50%	0.50%	0.50%	⇨
	22-Dec-2017	GDP (YoY)	(3QF)	1.50%	1.70%	1.50%	⇧
China	9-Dec-2017	Consumer Price Index (YoY)	(NOV)	1.8%	1.7%	1.9%	⇩
	2-Jan-2018	Caixin PMI Manufacturing	(DEC)	50.70	51.50	50.80	⇧

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

COMMODITY

- Gold prices decreased 1.28% MoM in December (vs. an increase of 0.07% MoM in November) as market participants stayed optimistic over the progress of the US tax reform.
- Brent prices increased by 2.5% MoM in December (vs. 8.60% MoM in November); on the back of 1. Reports of an oil pipeline explosion in Libya, 2. More than expected inventory drawdown in the US, 3. Fall in the US crude stocks and 4. Geopolitical uncertainty in the Middle Eastern Region.

Domestic Market Macro Economics

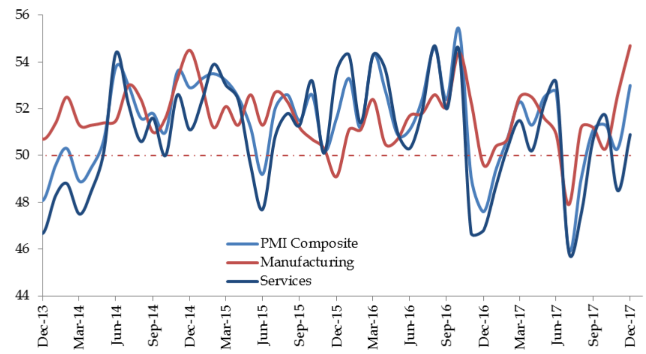


India November WPI: WPI inflation at 8-month high

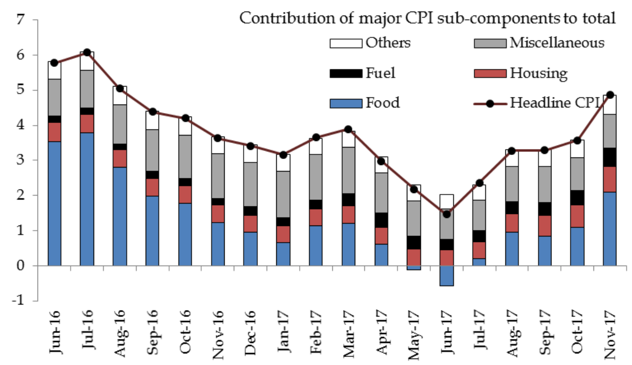
%YoY	Weights(%)	17-Aug	17-Sep	17-Oct	Apr-Oct FY17	Apr-Oct FY18
IIP	100	4.5	4.1	2.2	5.6	2.5
Sectoral Classification						
Mining	14.4	9.2	7.8	0.2	2.7	3.4
Manufacturing	77.6	3.4	3.8	2.5	5.9	2.1
Electricity	8	8.3	3.4	3.2	5.9	5.3
Use Based Classification						
Primary goods	34	7.1	6.6	2.5	5.1	3.5
Capital goods	8.2	5.2	8.2	6.8	4.6	0.8
Intermediate goods	17.2	-0.7	2.1	0.2	3.4	0.2
Infrastructure/construction goods	12.3	2.7	0.4	5.2	5.2	2.6
Consumer durables	12.8	3.4	-3.4	-6.9	6	-1.9
Consumer non-durables	15.3	7.3	10.3	7.7	9.5	7.5

October IIP: Seasonal factors impact momentum

- ✓ In a validation of continued gradual improvement in domestic manufacturing sector, India's survey-based gauge of PMI for the sector rose to a 5-year high of 54.7 in Dec-17, to close 2017 on an optimistic note.
- ✓ Core sector grew by 4.7%YoY in Oct-17, unchanged from Sep-17 level (revised downward from 5.2%). Robust growth in three of the sub-sectors of steel, refinery products and fertilizers was partly offset by de-growth in cement and crude oil output and a slowdown in growth of natural gas, electricity and coal output.
- ✓ India's industrial production slowed further to 2.2% YoY in October vs. 4.1% rise in September (upward revision from 3.8%), coming in lower than expectations (Bloomberg consensus: 2.9%; YBL estimate: 2.6%). The lower reading is likely to have been biased by the early timing of festive period which affects manufacturing schedules. IIP prints have tended to be weaker in the past due to the variation in timing of the festive period.
- ✓ The Centre's fiscal deficit for the period Apr-Nov FY18 clocked 112% of budgeted estimate (BE) up from 96.1% of BE from over Apr-Oct, and much higher versus 85.8% of BE over Apr-Nov FY17. The steep rise in fiscal deficit run rate versus last year has been on the back of higher expenditure outgoes and lower revenue receipts, mainly on the non-tax front.
- ✓ India's wholesale (WPI) inflation also rose to an 8-month high of 3.93% YoY in November from 3.59% in October (Bloomberg consensus: 4.0%; YBL expectation: 4.0%). The pickup in inflation (YoY) was primarily driven by rise in food inflation followed by rise in core inflation (non-food manufacturing).
- ✓ November CPI rose to a 15-month high of 4.88% YoY from 3.58% in the previous month, substantially higher than market expectations (Bloomberg Estimate: 4.29%, YBL: 4.57%).



PMIs: Manufacturing - At a 5 year best, Services - Back in Expansion



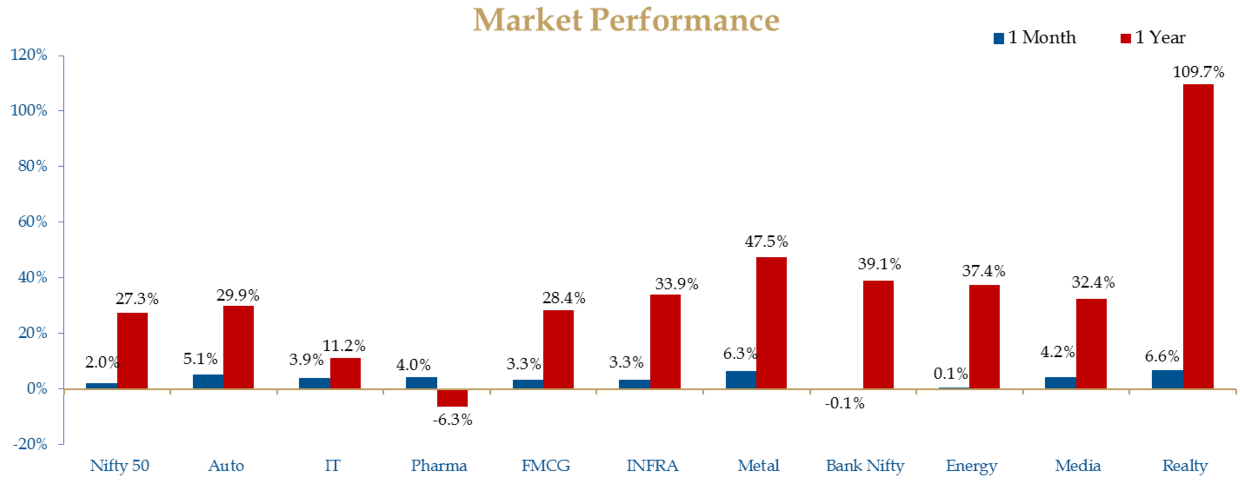
India November CPI - Food fuels upside trajectory

We expect:

- ✓ We estimate FY18 GDP growth at 6.7%, with growth conditions expected to pick-up in 2H FY18, supported by consumption growth and normalization of growth conditions.
- ✓ CPI inflation is expected to average at ~5% in Q4FY18 driven by staggered implementation of HRA, rise in crude oil prices and possible fiscal slippage.

Equity Market Insights

- December 2017 turned out to be a positive month for markets all across - domestic as well as global. In India, all sectoral indices closed the month on a positive note. The mid and small cap stocks continued their revelry with the Nifty Freefloat Midcap 100 and Nifty Freefloat Smallcap 100 rising ~6.2% and ~4.4% MoM, respectively. On the other hand, the Sensex and Nifty 50 rose by ~1.9% and ~2.0% MoM, respectively.
- Domestic mutual funds continued to pump in capital into equity markets (net inflow of Rs 83.3 bn), while foreign investors made a U-turn (with a net outflow of Rs 47.5 bn) in December after being net buyers in the preceding month.
- Gains were seen across the board with auto, realty and metal stocks being the most favoured in the month gone by. On a YoY basis, realty, metal and banking stocks stole the show with their respective indices rising by as much as 40-110%.



Factors to Watch

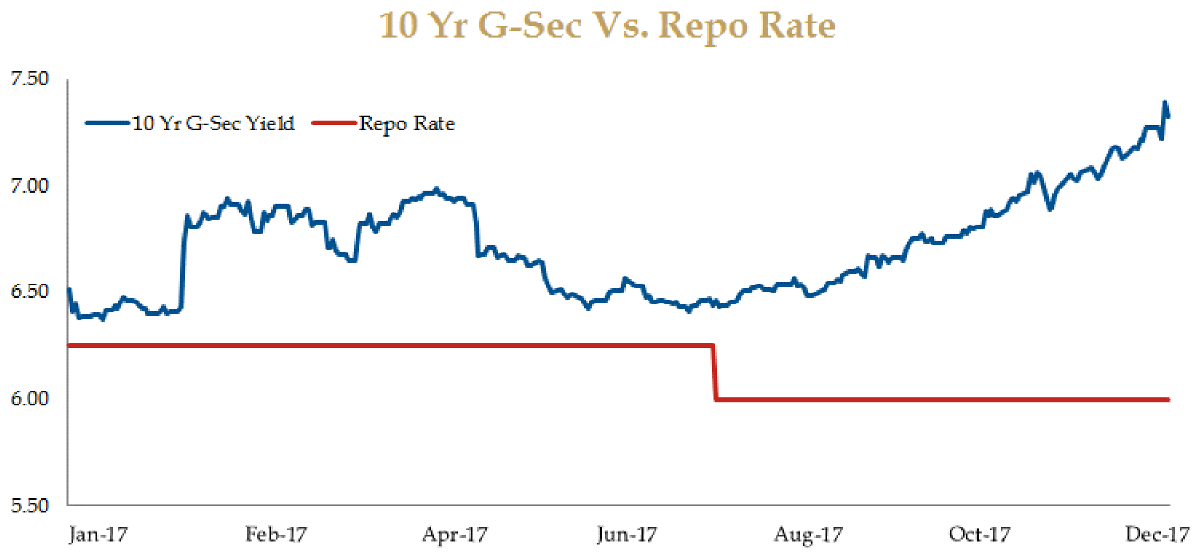
- Over the next few weeks, all eyes will be on the corporate earnings as the December 2017 quarter results will start to trickle in. Expectations would be high given the low base effect (due to demonetization) and stabilization of operations post implementation of GST about two quarters ago.

Outlook & Expectations

- With markets hovering around their all-time highs and valuations of the benchmark indices seeming elevated, the current environment does not seem conducive for broad based returns. A combination of poor fundamentals and high valuations has rarely made for good long term investments and thus, taking a stock specific approach would be the way to go.
- Broader fundamentals are expected to improve on the back of improving macroeconomic factors with recovery led by consumption, followed by public sector capex and external demand improvement, benefits of reforms percolating to the ground level and conducive inflation/interest rate environment. While we expect the markets to continue with their upward trajectory over the long term, there would be some aberrations due to global and other uncertain events. But as seen many times before, the Indian markets are quick to recover during such times as the domestic growth story remains intact.
- In terms of sectors, we remain positive on infrastructure (given the Government's focus towards the same), sectors linked to affordable housing, and consumption led sectors; we thus recommend investments in quality names in these spaces. We also like select names from the auto and auto ancillary sectors. The consumer durables sector is also an interesting space, particularly those companies which have a long runway of growth (due to lower penetration levels) and are slated to benefit from the lower share of the organized market (effect of GST implementation).
- We recommend equity investments through a Systematic Transfer route with a minimum investment horizon of 36 months.

Debt Market Insights

- The average systemic liquidity in the banking system reduced to a surplus Rs. 336 bn in December vs. of Rs. 779 bn in November, on the back on increased festival related demand for cash.
- Average 10 yr G-sec bond yield during December rose to 7.18% vs. 6.97% in November. Yields have been trading higher post the announcement of the bank recapitalization bonds, pick-up in crude oil prices and concerns regarding potential risks to FY18 Central Government Deficit target of 3.2% of GDP. During December, FII debt inflows were seen at USD 0.4 bn vs. outflows of USD 0.2 bn in November.
- November CPI rose to a 15-month high of 4.88% YoY from 3.58% in the previous month, substantially higher than market expectations (Bloomberg Estimate: 4.29%, YBL: 4.57%). Underlying inflationary momentum rose to a four-month high of 1.10% MoM (Previous: 0.67%), after moving into the positive zone last month (see Table 1). On an FYTD basis as well, inflationary pressures are now tracking higher than last year (April-November FY18: 0.63% MoM; April-November FY17: 0.51%).
- The RBI's Monetary Policy Committee published the minutes of its meeting held over December 5-6, 2017. This meeting was followed by the central bank's decision to keep repo rate unchanged at 6.00%. The overall tone appears neutral with a hawkish bias amidst ambiguity on durable price signals with respect to transient (monsoon related) and long lasting (GST, HRA, fiscal risks, etc.) factors, with majority members advocating a wait and watch mode to assess incoming trends.
- We expect RBI to stay on a prolonged pause in 2018 as concerns on inflation are balanced by growth conditions remaining suboptimal. On one hand, the recent uptick in inflation trend has limited the space available for further rate cuts, while the space for rate hikes is limited with the economy remaining in early stages of post-GST transition. While we expect RBI to maintain a neutral stance, its commentary could sound more hawkish with the rising trend in inflation.



Outlook and Expectations

- We estimate FY18 GDP growth at 6.7%, with growth conditions expected to pick-up in 2H, supported by consumption growth and normalization of growth conditions.
- On the inflation front, we expect CPI inflation which breached RBI's 4% target in Nov-17, to average at ~5% in Q4FY18, marginally higher than RBI's forecast of 4.7%. Inflation trend is expected to remain above the 4% mark for the majority of 2018 driven by staggered implementation of HRA, rise in crude oil prices, unfavorable base till H1 and possible fiscal slippage. The upside pressures will be partly mitigated by seasonal disinflation in foods prices, downward adjustment in GST rates on Nov 10th and presence of excess capacity which will keep core inflation pressures contained.
- 10 yr G-sec yield is expected to reach at 7.3% by Jun-18. Upside risks could dominate on fiscal risks, firm oil prices, structure of recap bonds and Fed rate hikes.

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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