Monetary policy to take center stage; India gears-up for GST implementation

The month of Jun-17 so far has been a busy month both on the policy and political front. The UK election on June 8, resulted in the incumbent PM Theresa May losing her majority in parliament. The snap election had been called to strengthen her party's position ahead of the Brexit negotiation which will start on June 19. The result of the election are likely to further complicate the negotiations. In France, the position of recently elected President Macron is expected to strengthen further with his party expected to win 3/4 of the seats in the National Assembly. In the US, rising political risks are clouding implementation of policies under the new administration.

On the policy front, Jun-17 is an important month for monetary policy with meetings of RBI (June7), ECB (June 8), Fed (June 13-14), BoE (June 15) and BoJ (June 15-16). The ECB kept policy rates unchanged in line with consensus expectation. The key change in the statement was the removal of the reference to the possibility of a rate cut and the statement that rates will remain at current levels for an extended period, reflecting the assessment that risks to growth are broadly balanced. As expected, the Fed hiked rates by 25bps, the second rate hike in 2017. The rationalization of its balance sheet will begin this year, with a path outlined by the central bank. While the balance sheet will be gradually reduced it will remain larger than pre-financial crisis levels. Meanwhile, the BoE and BoJ kept rate unchanged in line with expectations, however in the case of BoE the number of members calling for a rate hike rose to three from one previously.

As expected, the RBI kept policy rates unchanged in its Jun-17 meeting. The tone of the policy statement was less hawkish with the central bank significantly revising down its CPI inflation forecast, reflecting the recent subdued inflation momentum. Indeed, CPI inflation has surprised on the downside for the third consecutive month, registering a fresh series low at 2.81%YoY in May-17, on the back of low momentum of food prices. The May-17 CPI print further reaffirmed our call for a 25bps cut in policy rate in the Aug-17 meeting.

On the domestic policy front, focus has been on implementation of GST, with the government targeting implementation from 1 July 2017. The tax rate for goods and services has been finalized and is expected to have a minimal impact on inflation. In the near term we could see some increase in inflation to due higher compliance cost and partial pass-through of tax rate changes. On the growth front, GST is expected to enhance efficiency by removing the cascading impact of tax on tax and creation of unified market by removing barriers across states.

India's GDP Q4FY17 growth slowed to a series low of 6.1%YoY from 7.0%YoY in Q3FY17, led by construction and manufacturing. If we exclude volatile components of agriculture and government services, core GDP growth slowed to 3.8%YoY in Q4, a sustained slowdown from 10.6%YoY growth in late-2015. As the re-monetization progress, we expect growth conditions to gradually normalize. Indeed, a significant part of re-monetization has already been undertaken with the currency in circulation reaching more than 80% of pre-demonetization levels. As a result, we have seen a pick-up in high frequency indicators such as car sales, cargo, steel consumption and PMI indicators for services and manufacturing remaining in expansion zone.

Going forward, we expect India's GDP growth to accelerate to 7.3%-7.5% in FY18 versus 7.1% in FY17, with recovery in growth led by consumption, followed by public sector led capex and improvement in external demand conditions. Consumption is expected to be supported by 7th CPC payouts, lower interest rates and rural demand recovery. Higher capital expenditure by governments is expected to support public capex.

Shubhada M. Rao
Chief Economist

Kanwar Vivek
Senior President and Head, Wealth Management

FIRST Insights

Global Macro Developments

- In the snap UK elections Prime Minister Theresa May lost her majority in parliament with the Conservation Party winning 317 seats down from 330 seats earlier. The opposition Labour party improved its performance securing 262 seats, a gain of 30 seats.
- In its 8 June meet, the ECB dropped its reference to possible rate cut if required, judging the economy to be rebounding. However, the bank refrained from discussing winding down the ongoing monetary policy stimulus, amid still-low inflation. ECB's inflation projections were cut to 1.5%, from 1.7% for 2017.
- China CPI rose to a four-month high of 1.5% in May-17 (Apr-17: 1.2%), as cost of non-food articles rose. On the other hand, producer prices recorded their slowest growth in five-months (5.5%, Apr-17: 6.4%), driven by persistent declines in iron ore and coal prices amid concerns over cooling demand.
- The World Bank has maintained its projections of global growth forecasts for 2017 (2.7%, 2016: 2.4%), led by a pickup in manufacturing and trade, improving market sentiment and commodity price recovery.
- Eurozone PMI was recorded at a 6-year high in May-17 (57, Apr-17: 56.7), rising for the ninth month, reaffirming signs of broadening economic recovery in the region.
- OPEC and non-members led by Russia agreed to extend the current cuts (1.8mn bpd) in oil production till March 2018.
- Japan's GDP beat consensus estimates (1.7%), rising by 2.2%YoY in Q1 vs. a rise of 1.4% in Q4, marked the 5th quarter of expansion.
- UK inflation rose to 2.7% in Apr-17, highest since Sept 2013, vs. 2.3% in Mar-17, driven by higher air fares, clothing, vehicle excise duty and electricity.

Events and Data Calendar

Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
Japan	17/05/2017	Industrial Production (MoM)	(APR)	4.20%	4.00%	-1.90%	↑
	08/06/2017	GDP (YoY)	Q1	2.40%	1.00%	2.20%	↓
US	12/05/2017	Core Consumer Price Index (YoY)	(APR)	2.00%	1.90%	2.00%	↓
	02/06/2017	Trade Balance	(APR)	-46.10B	-47.60B	-45.30B	↓
	02/06/2017	Unemployment Rate	(MAY)	4.40%	4.30%	4.40%	↑
EA	17/05/2017	Consumer price Index (YoY)	(APR)	1.90%	1.90%	1.90%	→
	31/05/2017	Unemployment Rate	(APR)	9.40%	9.30%	9.40%	↑
	08/06/2017	ECB Interest Rate Decision	(JUN)	0.00%	0.00%	0.00%	→
UK	16/05/2017	Consumer Price Index (YoY)	(MAY)	2.70%	2.90%	2.70%	↑
	17/05/2017	Unemployment Rate	(MAR)	4.70%	4.60%	4.70%	↑
China	01/06/2017	Caixin PMI Manufacturing	(MAY)	50.10	49.60	50.30	↓
	09/06/2017	Consumer Price Index (YoY)	(MAY)	1.50%	1.50%	1.20%	↑
	09/06/2017	Trade Balance (USD)	(MAY)	46.32	40.81	38.05	↑

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

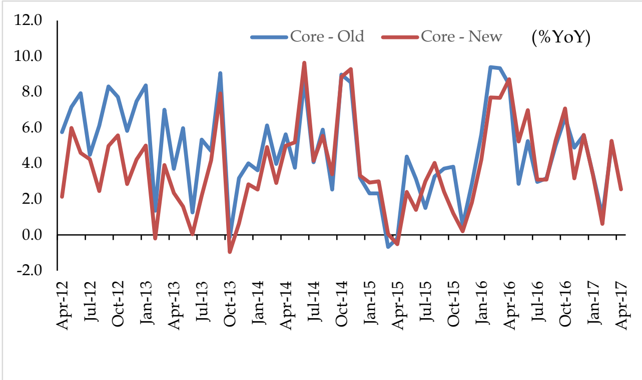
COMMODITY

- Gold prices fell 2.2% MoM in May-17 (vs. an increase of 3.24% MoM in Apr-17) amid higher expectations of a Fed rate hike in Jun-17.
- Brent prices fell 4.2% MoM in May-17 as compared to an increase of 2.3% MoM in Apr-17; after OPEC and non-members led by Russia agreed to extend the current cuts (1.8mn bpd) in oil production till March 2018. Further, signs of resurgent in Libya also weighed on the sentiment.

Domestic Market Macro Economics

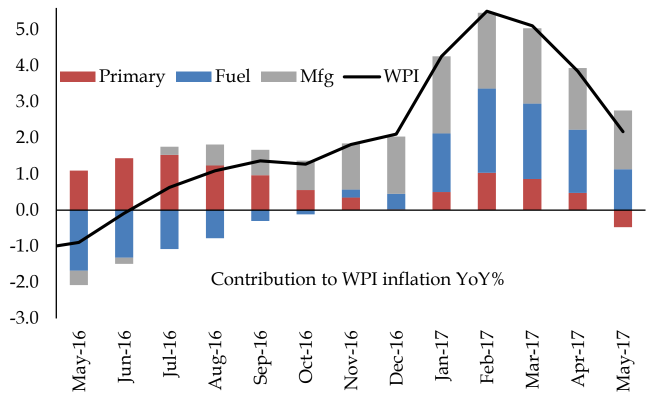
	Weights(%)	Jan-17	Feb-17	Mar-17	Apr-17	Apr-16
IIP (new base)	100	3.0	1.9	3.8	3.1	6.5
Sectoral Classification						
Mining	14.4	8.6	4.6	10.3	4.2	6.7
Manufacturing	77.6	1.9	1.4	2.4	2.6	5.5
Electricity	8.0	5.1	1.2	6.2	5.4	14.4
Use Based Classification						
Primary goods	34.0	3.8	0.8	5.9	3.4	12.6
Capital goods	8.2	-0.2	-3.1	9.8	-1.3	8.1
Intermediate goods	17.2	3.3	2.2	2.8	4.6	0.0
Infrastructure/ construction goods	12.3	2.6	-2.0	0.9	5.8	0.8
Consumer durables	12.8	-5.0	-2.9	-3.9	-6.0	13.8
Consumer non-durables	15.3	9.3	12.4	6.2	8.3	0.1

New-base IIP: Refurbishing the series

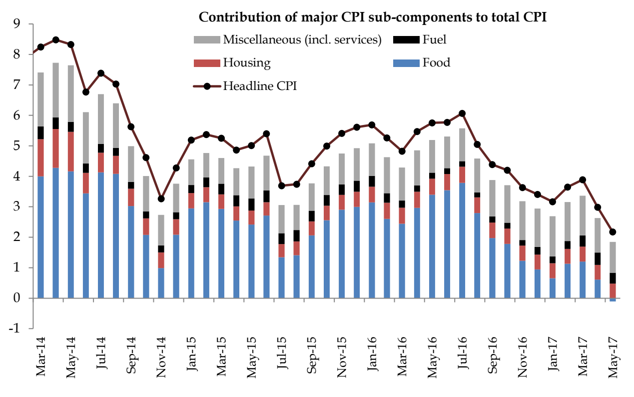


CORE - New vs Old Series Growth

- ✓ Manufacturing activity, as seen from the NIKKEI PMI, stayed in the expansion mode for the fifth consecutive month. However, the pace of expansion eased to a three month low of 51.6 in May-17 from 52.5 in Apr-17. The moderation was on the back of softer expansion in both new orders and production.
- ✓ India Services PMI increased to 52.2 in May-17 (Apr-17: 50.2), posting the highest reading since Oct-16 on the back of rise in new business orders – both domestic and foreign. However, the headline number remained below long period average of 54.8, indicating moderate pace of growth recovery so far.
- ✓ Total credit growth eased in Apr-17 to 4.3%YoY compared to 8.1% in Mar-17 and 8.6% in Apr-16. In line with recent past trend, growth was driven by Non-food credit while Food credit continued to contract by a steep 45% on an annual basis.
- ✓ Core sector growth slipped to 2.5%YoY in Apr-17 (Mar-17: 5.3% and Apr-16: 8.7%) dragged by contraction in coal, crude and cement production, in addition to an unfavorable base.
- ✓ The much awaited GDP growth for FY17 after incorporating the new IIP and WPI series, came in at 7.1%YoY unchanged from the advance estimate of 7.1% (announced in Feb-17). However, closer look at quarterly trends indicates – (i) moderation in GDP growth beginning in Q2FY17 and, (ii) sharper slowdown in H2 FY17 vis-à-vis H1 FY17 (of 110 bps).
- ✓ India's IIP grew by 3.1%YoY in Apr-17 and Mar-17's growth rate was revised upwards to 3.8% as compared to the initial estimate of 2.7%. Decline in the annualized growth rate is likely to be influenced by one less working day. The expansion however was broad based with 14 out of the 23 manufacturing groups registering positive growth as compared to only 9 in Mar-17.



May-17 WPI Inflation: The great convergence



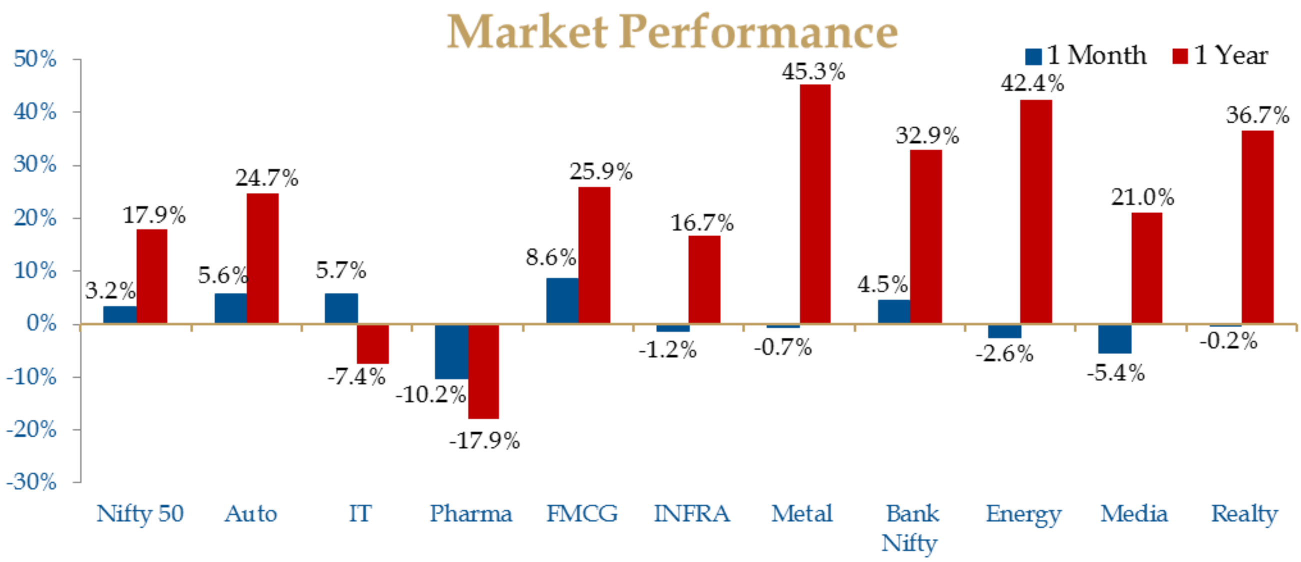
CPI: Third downside surprise reaffirms case for repo cut

We expect:

- ✓ We expect FY18 GDP growth at 7.3%-7.5% vs. 7.1% in FY17, with recovery led by consumption, followed by public sector capex and external demand improvement.
- ✓ We expect average FY18 CPI inflation at 4.0% in FY18 (vs. 4.5% in FY17), on the back of normal monsoon, minimal impact from GST, rupee appreciation and lower commodity prices.

Equity Market Insights

- The Indian equity markets continued its upward journey in the month of May-17 with Nifty and Sensex ending the month at 9,621 and 31,146; up 3.4% and 4.1% respectively. Mid and small caps underperformed large caps with the Nifty Free Float Midcap 100 and the Nifty Free Float Small cap 100 indices down by 3.2% and 3.5% respectively during the same period.
- During May-17, foreign investors invested USD 1.39bn into the Indian equity markets and invested USD 2.84bn into the debt markets, totally investing USD 4.23bn during the month. DII's were net buyers to the tune of ~ USD 0.66bn during the same period.



Factors to Watch

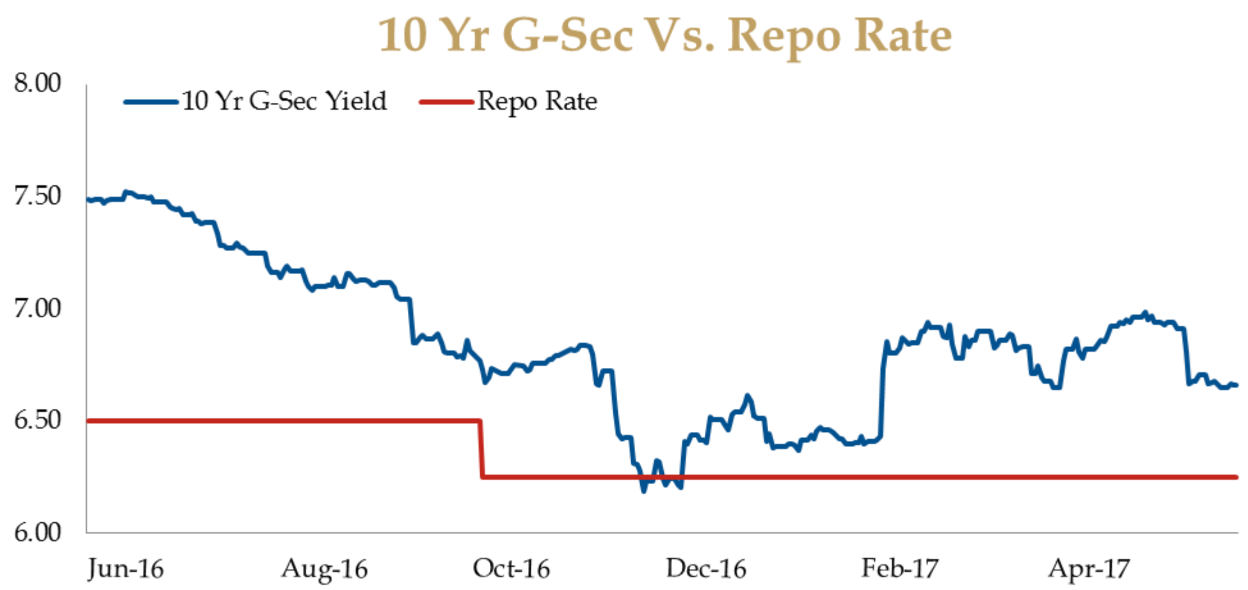
- Geopolitical developments particularly in the Eurozone and UK. Global investors would also be keeping a close watch on developments and policy announcements in US.
- Trajectory of interest rates in US.
- Progress on GST in India.

Outlook & Expectations

- In terms of valuations, the Sensex and Nifty are trading at a forward PE multiple of 18.9x and 18.4x respectively, which is a tad bit stretched as compared to historical valuations. However, there are many companies which offer value in terms of valuations.
- The markets are on an upward trajectory supported by an improvement in the country's fundamentals. This is clearly reflecting in the earnings growth which has improved compared to 3-4 quarters earlier. Although recovery is yet to be broad based, earnings are on the path of improvement.
- Fundamentals are further 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 do think that markets would continue to trend upwards over the long term, however there could be some aberrations due to global events. But as seen earlier too, our markets are quick to recover during such times as the domestic growth story remains intact.
- In terms of sectors, we remain positive on autos and auto ancillaries given that they enjoy a multiplier effect to economic growth. We also like stocks from the infrastructure and capital goods spaces given the Government's focus in that space; consumer durables is also an interesting space, particularly those companies that stand to benefit from the early onset of summers in most parts of the country.
- 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 moderated to a surplus of INR 3,404bn in May-17 vs. INR 4,199bn in Apr-17, as liquidity conditions begin to normalize and deposit growth normalizes post demonetization induced surge of deposits in the banking system.
- Average 10yr yield during May-17 held steady versus Apr-17 at 6.8%. Yields have risen post the change in stance of RBI to neutral from accommodative in Feb-17 and in the Apr-17 meeting when the central bank narrowed the policy rate corridor.
- India's WPI inflation, as per the new series, eased further for the fourth consecutive month and more than anticipated to 2.17%YoY in May-17 from 3.85% in Apr-17. Reinforcing the recent downward momentum in inflation, Mar-17 inflation was revised lower by 18 bps to 5.11%YoY.
- India's CPI inflation slid further in May-17 to touch a series-low of 2.18% YoY (Apr-17: 2.99%). Monthly inflation momentum increased to 0.23%MoM (Apr-17: 0.15%), though on a cumulative basis, it continued to track significantly lower than the corresponding period of last year (April-May FY18: 0.19%, April-May FY17: 1.03%). Broadly, inflationary trends remain subdued, led by lower increases in food prices
- In line with expectations, the RBI kept repo rate on hold in its monetary policy meeting on 7th June 2017. With inflationary risks not materializing to the extent expected, the central bank reduced its CPI forecasts, even as it continued to sound cautious on the several fronts.
- On FY18 growth, the central bank continued to sound sanguine. On our part, we have been highlighting that inflationary risks are on the wane. Notably, while our FY18 CPI forecasts were tracking above RBI in the last policy meeting; on receiving favorable news on inflation drivers, our forecasts are now below the RBI trajectory. Basis our CPI projections and the less-hawkish tone of the RBI in the monetary policy statement, we change our repo rate call from status quo in FY18 to 25 bps repo cut in the next RBI policy meeting.



Outlook and Expectations

- We expect RBI to cut rates by 25bps in the Aug-17 meeting, on the back of downside surprises in CPI inflation in the recent months and less hawkish tone of Central Bank in the Jun-17 meeting.
- We will be revising down our FY18 10Y g-sec yield forecast of 6.70-7.20%, to incorporate our change RBI repo rate call from status quo in FY18 to 25bps cut in Aug-17 meeting.

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.

YES BANK Limited

Regd. & Corporate Office: Nehru Centre, 9th Floor, Discovery of India, Worli, Mumbai 400018. | Tel: + 91 22 6669 9000 Fax: + 91 22 6669 9018
Northern Regional Corporate Office: 48 Nyaya Marg, Chanakyapuri, New Delhi 110 021. |Tel: + 91 11 5556 9000 Fax: +91 11 5168 0144

Contact Details

Gaura Sengupta
Economist
gaura.sengupta@yesbank.in

Shubhada M. Rao
Chief Economist
shubhada.rao@yesbank.in

Kanwar Vivek
Senior President and Head
Wealth Management
kanwar.vivek@yesbank.in