FIRST Insights

Monetary policy dominates global economic discourse

The month of September 2016 was dominated by monetary policy actions of key central banks in advanced economies. With output gaps still negative, wage pressures muted and risk of persistent low inflation, the need to remain accommodative persists, with growing reliance on unconventional strategies in these economies. Against this backdrop, the US Federal Reserve was unable to raise rates, while the Bank of Japan found itself unable to ease meaningfully, risking the credibility of both banks.

In a highly anticipated monetary policy meeting, US Federal Reserve kept its Fed funds rate on hold (at 0.25-0.50%) for the sixth consecutive meeting, following the spate of weak data points. Further, median economic projections of FOMC members were shaved-off to denote lower GDP growth, marginally higher unemployment rate, and most importantly, only a 25 bps rate hike in 2016. In its statement, the Fed while acknowledged that labor market has continued to strengthen and household spending had been strong, business fixed investment has softened and inflation has continued to remain below-target. Overall near-term risks to economic outlook appeared balanced, and even as case for increase in rates had strengthened, the Committee decided to wait "for the time being".

In the same week, Bank of Japan (BoJ) disappointed markets with much less-than-expected monetary policy stimulus, after having promised a complete overhaul of its monetary policy framework. Nevertheless, it introduced a "Quantitative and Qualitative Monetary Easing (QQE) with yield curve control" by essentially removing an explicit target for the monetary base and replacing it with yield curve control. While JPY 80 tn bond-buying will continue, the final target will be to maintain 10-year bond yields at around 0%. The guideline for average maturity of Japanese Government Bond (JGB) purchases which used to be 7-12 years was also abolished - essentially implying that BoJ will now concentrate its buying at the shorter end of the curve. Further, it committed to maintaining QQE with yield control until the 2% inflation target is achieved in "a stable manner".

On the domestic front, incremental data continued to remain mixed, a reflection of diverging consumption and investment trends. High frequency indicators more attuned to consumption such as personal loans growth, PMI services continued to uphold growth on trend basis. On the other hand, investment and manufacturing related indicators such as PMI manufacturing, core industry growth, industrial credit continued to display tepid momentum in their latest prints.

Going forward, we expect recovery to continue to be led by improvement in consumption, as the lagged impact of normal monsoon, 7th pay commission payouts and onset of festival season provide support. We expect FY17 GVA growth to improve to 7.8% from 7.2% in FY16. Reiterating our view, IMF in its latest World Economic Outlook update, too upped India's FY17 GDP growth forecast by 20 bps to 7.6%.

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Global Macro Developments

- Japan Markit/Nikkei manufacturing PMI returned to expansion in September (50.4, Flash: 50.3, Previous: 49.5), higher than preliminary estimates, as output and new export orders went up.
- Bank of Japan governor Kuroda said that the bank's new policy to target the yield curve would not result in tapering of ongoing bond purchases by the bank, and it was still possible to ease policy further by deepening negative interest rates.
- US ISM manufacturing PMI for September beat expectations to move back into expansion zone (51.5, Previous: 49.4, Forecast: 49.7), as both new orders and production rose, though the reading remained lower compared to the July high of 52.6.
- US Nonfarm payrolls for September came in at 156k from an upwardly revised 167k for August (earlier: 151k) keeping Fed on track for a likely rate increase in December 2016 as participation rate increased to 62.9%, despite unemployment rate increasing to 5.0%.
- Eurozone Markit manufacturing PMI rose to 52.6 in September 2016 (Previous: 51.7), reading at the highest in three months, with Germany, Austria and Spain growing at a faster pace and Italy moving back into the expansion category.
- Euro zone inflation could approach the ECB's target by late 2018 or early 2019 and so far there is no evidence that super-easy monetary policy is leading to asset price bubbles, European Central Bank President Mario Draghi said.

Events and Data Calendar

Region	Date	Event/Data	Period	Forecast	Actual	Prior	Change
Japan	21/09/2016	BOJ Policy Rate	(SEP)	-0.10%	-0.10%	-0.10%	⇨
EU	22/09/2016	ECB President Draghi Speaks	-	-	-	-	⇨
	30/09/2016	Consumer Price Index (YoY)	(SEP)	0.40%	0.40%	0.20%	⇧
US	9/15/2016	Advance Retail Sales	(AUG)	-0.30%	-0.10%	0.10%	⇩
	9/27/2016	Consumer Confidence	(SEP)	104.10	99.00	101.80	⇩
	9/28/2016	Durable Goods Orders	(AUG P)	0.00%	-1.50%	3.60%	⇩
UK	13/09/2016	Consumer Price Index (YoY)	(AUG)	0.60%	0.70%	0.60%	⇧
	15/09/2016	Bank of England Rate Decision	(SEP)	0.25%	0.25%	0.25%	⇨

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

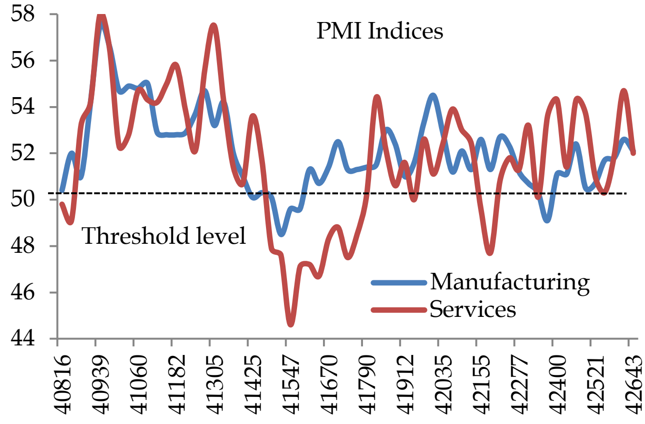
COMMODITY

- Gold prices contracted 0.8%MoM in Sep-16 (vs. 0.1%MoM in Aug-16) due to better than expected US macro data building expectations of a hike in US interest rates.
- Brent prices contracted 0.3%MoM in Sep-16 as compared to 0.4%MoM expansion in Aug-2016 due to press reports indicating that Saudi Arabia did not expect a decision on oil supply to be made at the meeting between OPEC and other major oil producers. Although prices rose by the end of the month following OPEC's decision to moderately cut output towards the end of the month.

Domestic Market Macro Economics

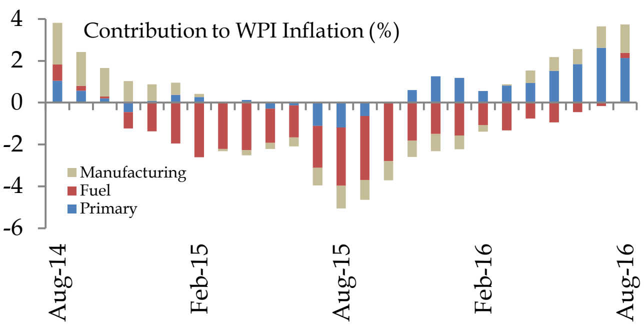
Snapshot of IIP Trend (% YoY)	Weight (%)	16-Jun	16-Jul	16-Aug	Apr-Aug FY16	Apr-Aug FY17
IIP	**100**	**2**	**-2.5**	**-0.7**	**4.1**	**-0.3**
Sectoral Classification						
Mining	14.2	5.3	0.9	-5.6	1.4	0.6
Manufacturing	75.5	0.7	-3.5	-0.3	4.5	-1.2
Electricity	10.3	8.3	1.6	0.1	3.2	5.8
Use-Based Classification						
Basic	45.7	5.8	1.7	3.2	4.6	3.9
Capital	8.8	-16.3	-29.5	-22.2	7.6	-21.2
Intermediate	15.7	5.7	3.7	3.6	1.9	3.9
Consumer	29.8	2.7	1.6	1.1	3	0.9
Durables	*8.5*	*5.6*	*5.9*	*2.3*	*8.2*	*6.3*
Non-Durables	*21.3*	*0.9*	*-1.4*	*0.1*	*-0.1*	*-2.7*

Weakness turning broad-based

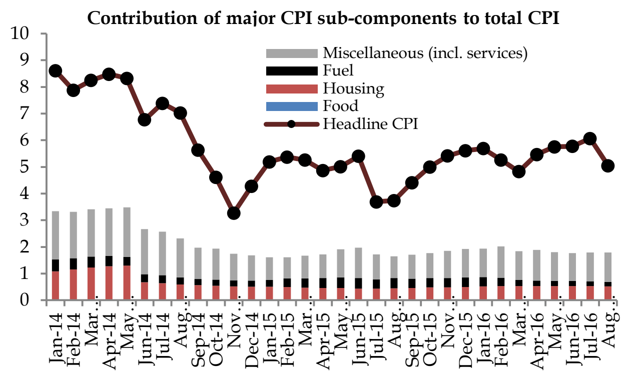


Sept PMIs suggest some moderation

- ✓ Pace of manufacturing activity eased in Sep-16 as Nikkei PMI manufacturing index moderated to 52.1 from 52.6 in Aug-16. This was led by slower increase in new orders.
- ✓ India's fiscal deficit stood at 76.4% of BE over Apr-Aug FY17 as compared to 66.5% in the corresponding period last fiscal year, driven by de-growth in non-tax revenue.
- ✓ Core sector output grew by 3.2%YoY in Aug-16 compared to 3.0% in Jul-16. Of the eight core sub-sectors, 3 sectors (Coal, Crude oil, Natural Gas) witnessed a contraction while electricity posted a near flat growth (of 0.2%YoY).
- ✓ Growth in Non-food credit came lower in Aug-16 to 8.2%YoY from 8.3% in Jul-16, owing to both a contraction in monthly credit off-take and an unfavorable base.
- ✓ August CPI came in at a 5-month low of 5.05%, expectedly led by food price disinflation.
- ✓ Headline IIP in July slipped into negative territory led by sharp de-growth in manufacturing index and weakness in mining and electricity production. The data continued to remain susceptible to sharp volatility as rubber insulated cable subtracted 4.24% from the headline index.



August WPI Inflation: The ascent continues



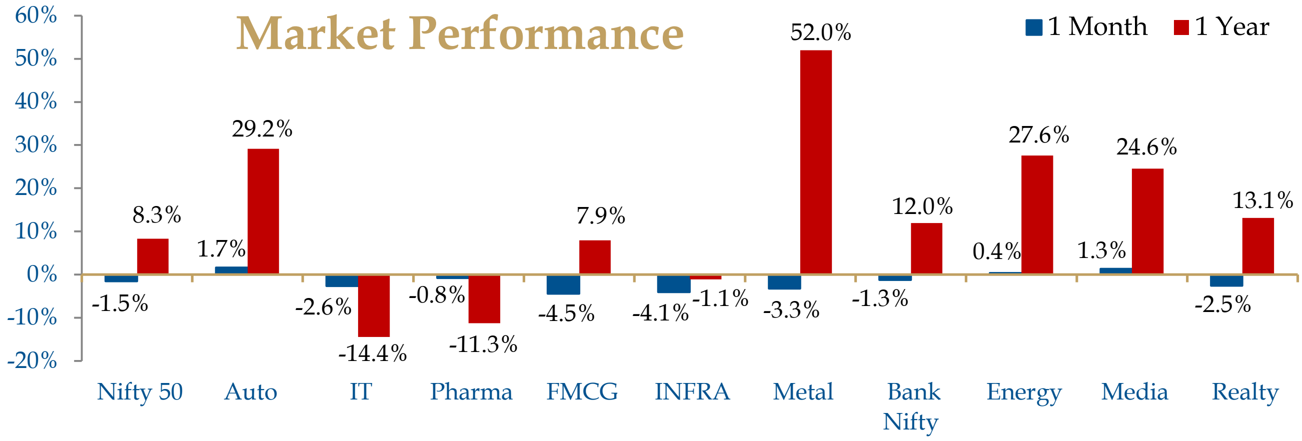
Food disinflation sets in

We expect:

- ✓ We continue to expect GDP growth to improve to 8.1% in FY17 from 7.6% in FY16 led by strong agriculture growth driven by normal monsoon.
- ✓ We expect FY17 CPI inflation to broadly track 4.8% vs. 4.9%YoY in FY16.
- ✓ With imports still in deep contraction, current account deficit dynamics are expected to remain supportive in FY17 (YBL estimate: 0.7% of GDP; USD 16 bn).
- ✓ We expect USDINR to trade in the range of 66-67 until Jun-17.

Equity Market Insights

- Indian markets were on a bumpy ride in the month of September and ended the month in losses. However, midcaps continued to shine with the Nifty Free Float Midcap 100 Index moving up by 0.27% during the month. BSE Sensex closed at 27,866, lower by 2.1% for the month while the Nifty closed at 8,611; down by 1.5%, during the same period. The Nifty Free Float Smallcap 100 Index was down by 0.6% during the month.
- During September, foreign investors pumped in USD 1.43bn in the Indian equity markets and USD1.58 bn in the debt markets taking the total tally to a net inflow of USD 3.01bn during the month. DII's were net buyers with an inflow of ~ USD 0.3bn during the same period.



Factors to Watch

- Fund flows: Escalation in geopolitical tensions led to the recent muted performance for the Indian stock markets. However, fund flows into the markets remained intact due to two factors – (i) Near zero interest rate environment in most of the developed economies makes high growth economies like India an attractive investment destination; (ii) abundant liquidity in the global system.
- In the near term there are a few risks to fund flows – (i) geo-political issues; (ii) trajectory of interest rates in the US and (iii) elections in the US. However, given the fundamental strength of our economy we do believe that in the long term our markets should continue to trend upwards and this would attract funds both from domestic as well as foreign investors.
- Corporate Earnings: The concern for investors till now has been on the corporate earnings side as earnings growth is yet to pick up in a meaningful way. Therefore, the key event to watch out for would be the July-September quarter earnings. We expect earnings to start improving in the second half of the year driven by (i) boost in consumption led by revival in the rural spending on the back of good rainfall and 7th Pay Commission related payouts; (ii) gradual pickup in economic activity; (iii) low base effect.
- Geopolitical developments across the world.

Outlook & Expectations

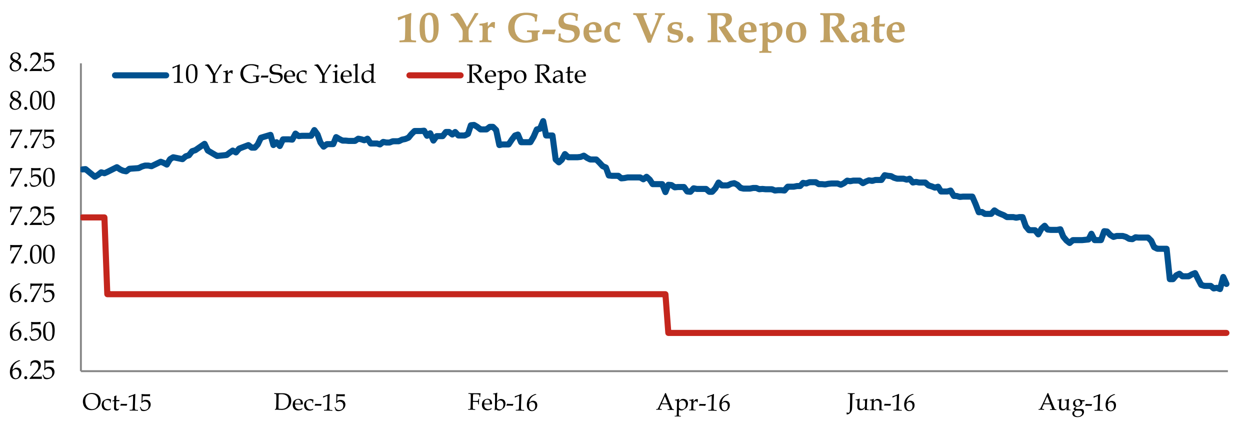
- The lackluster earnings growth has also resulted in valuations becoming expensive. Post the correction seen at the end of September, Sensex was trading at a forward PE multiple of 17.4x. If we factor in a possible recovery in earnings growth, valuations do not look expensive from a long term perspective. Any bigger fall due to global reasons can provide a good opportunity for investing in quality stocks for the long term.
- In terms of sectors, we believe that the continued traction in urban consumption and revival of the rural economy would have a multiplier effect on sectors that are driven by consumption. Revival in demand would eventually translate to revival in private capex as well. Additionally, pickup in crop acreage and sowing activity on the back of decent rainfall should bode well for stocks in the agri space. With this in mind we would recommend investing in infrastructure, consumption led sectors and agri sectors.
- 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 improved to a surplus of INR 474 bn from INR 305 bn previously. Government's spending, RBI's dividend payment and continued purchase of Gsecs by RBI through OMOs helped create durable liquidity surplus.
- ✓ Average 10 year yield during Sept declined to 6.91% from 7.13% amid comfortable liquidity and expectations of rate cut amid benign inflation print. OMO purchase worth INR 100 bn was conducted by RBI.
- ✓ In line with our expectations, the RBI's monetary policy committee cut the repo rate by 25 bps to 6.25%.
- ✓ For FY17, the RBI retained its:
  - ✓ CPI inflation forecast of 5% (for Mar-17). However, it noted that upside risks to inflation had reduced compared to earlier.
  - ✓ GVA growth estimate at 7.6% with risks evenly balanced.

Outlook and Expectations

- ✓ We continue to expect the RBI to remain in accommodative mode, expecting another 25 bps repo rate cut in the remainder of FY17, amid:
  - ✓ Downward trajectory of food inflation, in turn led by favorable outturn of the south-west monsoon.
  - ✓ Continued prudent supply management measures by the government, especially with regard to high-risk items such as pulses



Model Portfolios – October 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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