# Escalating geopolitical concerns could moderate growth prospects

Following the weak first quarter, global economy continued to gain strength although the pace of recovery remained uneven. Based on weak prospects in certain emerging market economies and post sluggish growth in US economy in first quarter, IMF marked down its global growth projection for 2014 by 30 bps to 3.4%. However, incoming data from advanced and emerging economies over last couple of months suggests that economic growth is gaining traction.

In US, growth rebounded in the second quarter supported by business investment and labour market continued to show improvement. US GDP growth expanded at an annual pace of 4% following a sharp 2.1% contraction during first quarter. Total nonfarm payroll employment increased by 209,000 in July, the same as its average monthly gain over the prior 12 months. Meanwhile basis improving underlying strength in the US economy, Federal Reserve decided to further scale back its bond-buying stimulus, cutting its monthly asset purchases to USD 25 bn from USD 35 bn while maintaining a dovish tone on interest rate outlook to support labour market.

Manufacturing data from Euro zone suggested that economy seemed to show some semblance of stability with manufacturing PMI remaining steady at 51.8 in July supported by expansion in Germany and other smaller economies. However, the concerns on low inflation continued to persist as annual inflation rate fell to its lowest rate in five years in July at 0.4% from 0.5% in June, well below ECB target of 2%.
Meanwhile, among Asian economies, moderation in consumer spending and weak export growth prompted Japan to trim its economic forecast by 20 bps points to 1.2% for the current fiscal. Data from China showed its economy grew by 7.5% in the second quarter suggesting that the economy has stabilized, supported by government stimulus. PMI manufacturing also strengthened to an 18 month high of 51.7 in July.

Despite perceptible improvement in global economy, downside risks on account of increased geopolitical stress leading to sharply higher oil prices poses significant downside risk. While escalating militant insurgency in Iraq has prompted US to initiate air strikes, stand-off between Ukraine and Russia post the shooting down of the Malaysian passenger jet by Russian rebels has intensified the conflict. The continuing geopolitical stress could keep the global economy volatile and may hurt the risk appetite in the days to come.

On the domestic front, Indian economy exhibited signs of strong recovery during the first quarter of the current financial year. Industrial output grew by a healthy 4.1%YoY during April-May 2014 after remaining stagnant during FY14, while inflation at retail and wholesale level moved lower.
In line with expectations, Reserve Bank of India kept the policy repo rate unchanged at 8% in its third bi-monthly monetary policy review. Monetary policy status quo was driven by the expectation of CPI inflation moving towards the immediate glide path target of 8% in Jan-15 with risks remaining balanced. We continue to expect RBI to keep repo rate unchanged at 8% for the rest of FY15. As growth-inflation balance improves driven by policy support from the government in the area of food management and facilitation of project clearances, some room for monetary easing could emerge in H1 FY16.

**Shubhada M. Rao**
**Chief Economist**

**Kanwar Vivek**
**Senior President and Head**
**Wealth Management & Global Indian Banking**

# FIRST Insights

## Global Macro Developments

- China's official Purchasing Managers' Index (PMI) climbed to a 27-month high in July; signaling that the economy is re-gaining momentum
- Japanese industrial output declined at highest pace since March 2011 in June highlighting the amplifying impact of the April sales tax increase
- UK economy continued to remain strong rising by 3.1% YoY in Q2 2014 as compared to 3% YoY in previous quarter

## Events and Data Calendar

| Region | Date | Event/Data | Period | Forecast | Actual | Prior | Change |
|---|---|---|---|---|---|---|---|
| US | 07/03/2014 | US ISM Manufacturing | Jun | 55.9 | 55.3 | 55.4 | ↓ |
| | 07/03/2014 | US Change in Non-farm Payrolls | July | 215K | 209K | 298K | ↓ |
| | 07/07/2014 | US Unemployment Rate | June | 6.30% | 6.10% | 6.30% | ↓ |
| | 07/09/2014 | Fed Releases Minutes from June 17-18 FOMC Meeting | Jun | - | - | - | → |
| | 7/22/2014 | US Consumer Price Index (YoY) | June | 2.10% | 2.10% | 2.10% | → |
| | 7/25/2014 | US Durable Goods Orders | Jun | 0.50% | 0.70% | -1.00% | ↑ |
| | 7/30/2014 | USD Gross Domestic Product Price Index (2Q A) | 2Q A-2014 | 1.80% | 2.00% | 1.30% | ↑ |
| | 7/30/2014 | US Federal Open Market Committee Rate Decision | Jul-30 | 0.25% | 0.25% | 0.25% | → |
| UK | 07/01/2014 | UK Markit UK PMI Manufacturing s.a. | Jun | 56.8 | 57.5 | 57 | ↑ |
| | 07/10/2014 | Bank of England Rate Decision | Jul-10 | 0.50% | 0.50% | 0.50% | → |
| | 7/25/2014 | UK Gross Domestic Product (YoY) | 2Q A-2014 | 3.10% | 3.10% | 3.00% | ↑ |
| Japan | 7/14/2014 | Japan Industrial Production (YoY) | May F | - | 1.00% | 0.80% | ↑ |
| | 7/25/2014 | Japan National Consumer Price Index (YoY) | Jun | 3.50% | 3.60% | 3.70% | ↓ |
| | 7/29/2014 | Japanese Retail Trade (YoY) (Jun) | Jun | -0.50% | -0.60% | -0.40% | ↓ |
| EU | 07/03/2014 | EU ECB Marginal Lending Facility (JUL 3) | Jul-03 | 0.40% | 0.40% | 0.40% | → |
| | 07/03/2014 | EU ECB Deposit Facility Rate | Jul-03 | -0.10% | -0.10% | -0.10% | → |
| | 7/24/2014 | EU Markit Eurozone Composite PMI | Jul P | 52.8 | 54 | 52.8 | ↑ |
| | 7/31/2014 | Euro-Zone Consumer Price Index Estimate (YoY) | Jul | 0.50% | 0.40% | 0.50% | ↓ |

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

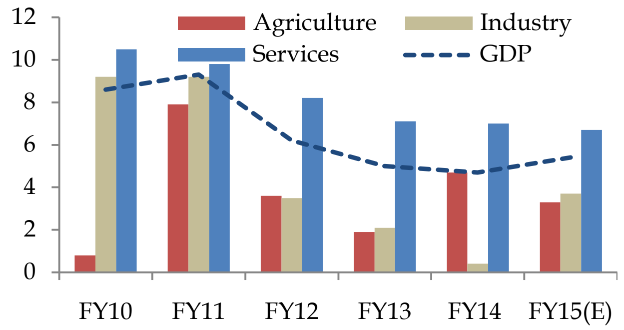
**COMMODITY**

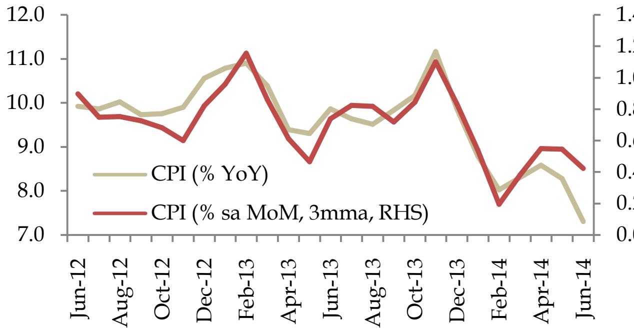
- Gold registered a 2.3% MoM gain during July vs. a 4.4% MoM decline during June as geopolitical tensions over the Gaza strip, continued militant insurgency in Iraq and the face-off between Russia and Ukraine edged up the metal's safe haven appeal.

- WTI declined 1.9% MoM in July as compared to a 4.3% MoM gain in June as a government report showed that US gasoline supplies expanded.

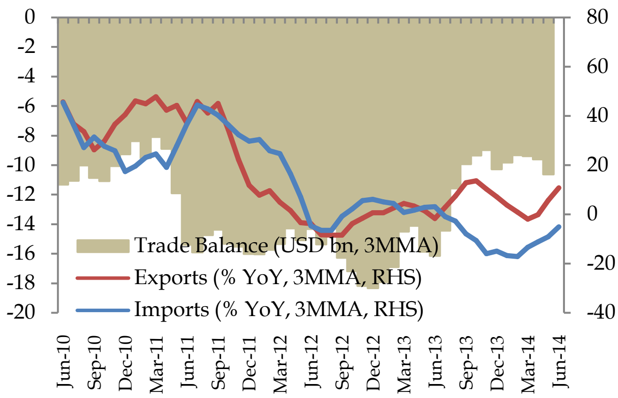


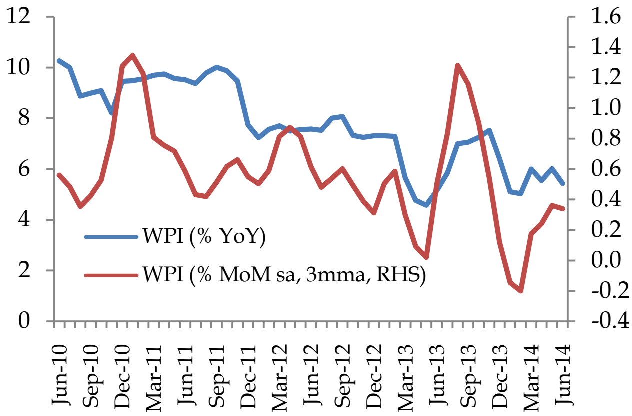
## Domestic Market Macro Economics




- HSBC India PMI manufacturing rose to 53 in July from 51.5 in June , rising to a 17-month high.
- HSBC PMI Services Business activity index moderated to 52.2 in July from June's 54.4; but continued to be in the expansion zone for three months in succession.
- Trade deficit during Q1FY15 stood at USD 11.1bn as compared to USD 16.2bn in Q1-FY14 as imports contracted by 5.1%YoY while exports grew by 10.8%YoY.
- CPI inflation for the month of June inched lower to 7.31%YoY as compared to 8.28%YoY as food and fuel inflation eased. Core CPI also moved lower to 7.39%YoY in June from 7.71%YoY previously.
- WPI inflation eased to 5.43%YoY in June as compared to 6.01% in May supported by benign food inflation. However, core WPI inched up to 3.91%YoY from 3.82%YoY as manufacturing inflation perked up.
- Core sector output during June jumped to 7.2%YoY from 2.3%YoY during May led by broad based improvement. Core output grew by an average 4.6%YoY during Q1FY15 from 3.6% in Q1FY14.
- Reserve bank kept the policy repo rate unchanged at 8% in the third bi-monthly monetary policy review.
- In its forward guidance, the RBI reiterated that the need for further monetary tightening will be prevented if CPI inflation continues along the intended glide path towards 8% by Jan-15 and 6% by Jan-16.



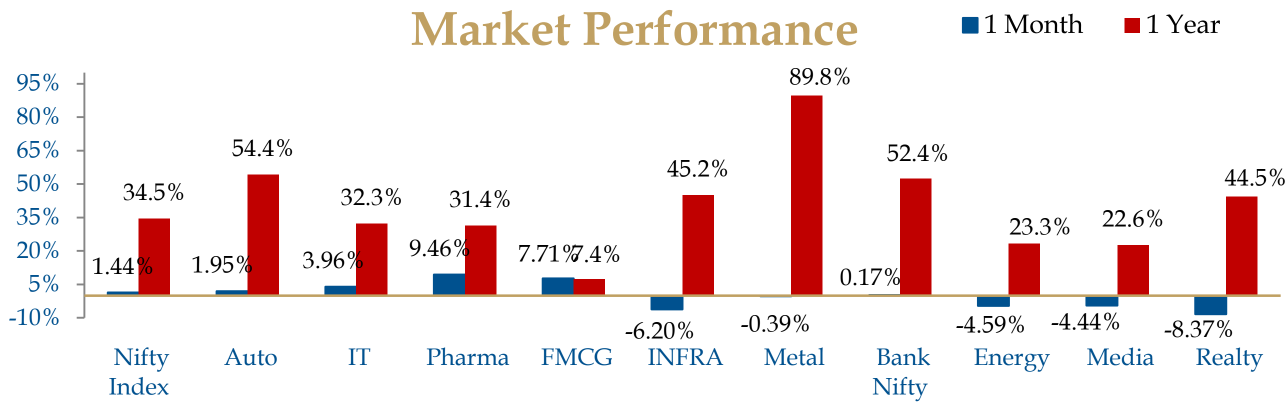




**We expect:**

- We expect Indian economy to grow by 5.4% in FY15, led primarily by improvement in industrial sector which is estimated to grow at 3.5% in FY15 as compared to 0.4% in FY14. Consumption, Exports and government's policy initiatives in Budget would provide boost to growth in FY15.
- We expect average CPI inflation to decline to 7.8% in FY15 from 9.5% in FY14.
- We expect CAD to increase marginally to 2% in FY15 from 1.7% (of GDP) in FY14 assuming merchandise exports to grow by 7-8 % and imports to clock a growth of 8.0%. In absolute terms, CAD is expected to go up marginally from USD 32bn in FY14 to USD 42bn in FY15.
- Going forward, assuming CPI inflation follow the projected glide path as set out by RBI, we believe monetary policy rates are set for a prolonged pause with repo rate staying at 8% for the rest of the current fiscal year.
- We expect INR to move towards 59 by Mar-15 encouraged by improving external sector fundamentals and stable policy regime.

# Equity Market Insights

- The month of July saw the Indian stock markets enter a phase of consolidation. The benchmark BSE Sensex closed at 25,895, up 1.89% for the month while the Nifty closed at 7,721, giving a monthly return of 1.44%. As seen during phases of consolidation, both the CNX Mid-Cap index and the CNX Small- cap index underperformed the broader indices with negative returns of 2.3% and 6.1% respectively.
  - The Budget did deliver in terms of providing broad based themes that outline the government's plans and policies with the focus on fiscal consolidation. Budget set the tone that the government is focused on creating an environment that will boost business growth, create jobs and drive economic growth.
  - The 'hope' of reforms and a subsequent economic recovery that had driven market gains for a large part of this year, seems to have found firm ground now with the new Government setting a positive tone with its maiden budget. This has led to an increase in the institutional activity as well.
- FIIs were net buyers in equity markets by ~ $ 1.9bn while, DII's were net sellers by ~ $0.5bn during July.




**Factors to Watch**

- A key event that is being tracked closely by the markets is the data related to the monsoons. This year there have been reports and forecasts that the El-Nino weather phenomenon could have an adverse impact on the monsoons. The month of June saw a 43% deficit in rainfall. While July has seen better data, however there are indications of poor rainfall in some parts of the country. Headwinds related to this could hurt the GDP growth and pose as an upside risk to inflation and could therefore lead to some near term consolidation in the markets.
- Quarterly earnings: The 1QFY15 earning season kick started in the second week of July and will continue through most part of August as well. We believe that earnings for most companies have bottomed out. Though 1QFY15 earnings are unlikely to be spectacularly high for most companies but it is commentaries on the future trends and expectations that will be keenly watched by the investors.
- Other key events that would be watched closely especially by the FIIs would be the geo-political events surrounding Ukraine, domestic political developments and commodity prices.

**Outlook & Expectations**

- With the key events of general elections and Union Budget behind us, we believe that the next leg of rally for the markets would be driven by the earnings growth of the companies.
- Rolling our earnings estimates to FY15, we had pegged the EPS growth to be around 11%. This is arrived at by applying a multiple of 2x (historic average) to the expected GDP growth rate for FY15. Using this estimate, the SENSEX is currently trading at a forward earnings multiple of 17.6 times which is slightly higher than its 16 year historic average. This suggests that we could either see prices coming down and/or earnings going up for the markets if we are to expect valuations to correct to historic levels. On a fundamental basis, stocks are trading at attractive valuations. But on a technical basis, we could see some amount of correction largely driven by profit booking.
- We believe that this correction 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.
- For a near term horizon we continue to have a positive view on the IT sector. Select stocks in the auto and auto ancillary space too would see their earnings grow due to their focus on exports. We believe that the recent correction in prices offers a good entry point for investors to pick up the good stocks in these sectors.

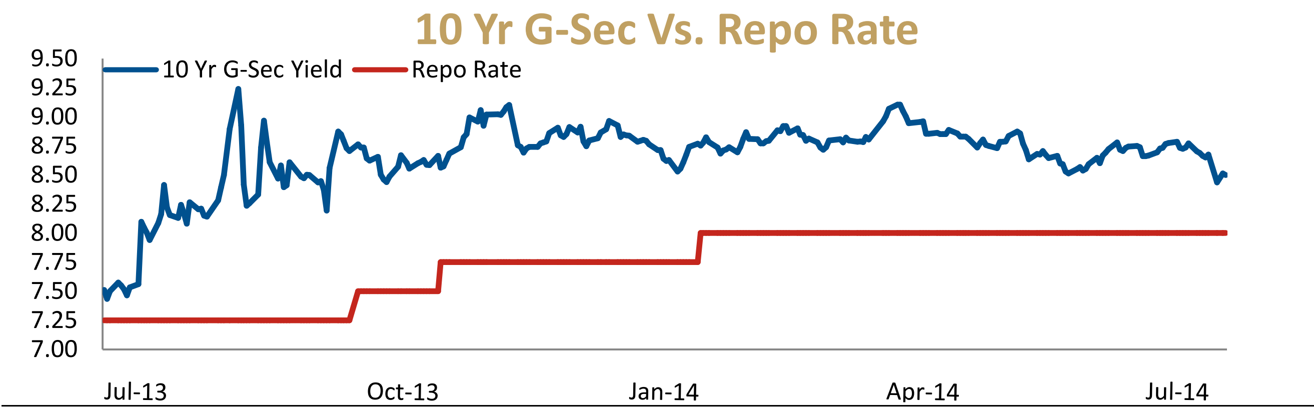
- ✓ From a longer term perspective, i.e. from a 2 to 3 years' horizon, investors could look at picking up stocks in sectors that stand to benefit from a revival in the economy, like power, infrastructure and banks.

## Debt Market Insights

- ✓ The average systemic liquidity deficit in July was reported at an average INR 1119bn as compared to INR 1024bn in June.
- ✓ Average 10 yr yield during July remained largely unchanged at 8.67% as compared to 8.64% in June.
- ✓ In line with expectations, the RBI left repo rate unchanged at 8.0% in its third bi-monthly review of monetary policy. However, SLR was reduced by 50 bps to 22.0% of NDTL along with a 50 bps reduction in the HTM ceiling for banks to 24.0% of NDTL
- ✓ Monetary policy status quo was driven by the expectation of CPI inflation moving towards the immediate glide path target of 8% in Jan-15 with risks remaining balanced. We expect RBI to keep repo rate unchanged at 8% for the rest of FY15.
- ✓ Going forward, we expect improvement in the growth-inflation balance driven by complementary policy support from the government in the area of food management and facilitation of project clearances to create room for monetary easing in H1 FY16.

**Outlook and Expectations**

- ✓ The 10 Yr G sec yields were ranged within 8.51% to 8.78% levels for the month of July.
- ✓ We continue to expect RBI to maintain status-quo, realigning its stance more in favor of growth while waiting for previous rate hikes to have an impact on inflation expectations.
- ✓ 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.




## Model Portfolios – August 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** |

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## 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</u>** <u>(WTI):</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.**


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

**Garima Kapoor**
**Economist**
garima.kapoor@yesbank.in

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

**Kanwar Vivek**
**Senior President and Head**
**Wealth Management & Global Indian Banking**
kanwar.vivek@yesbank.in