PROSPERITY INSIGHTS

ECB June minutes less dovish; India implements GST from 1st July 2017

The month of July will see three key central bank policy meetings and on the domestic front overhauling of indirect tax architecture in India with GST launch. Global growth conditions held steady in June with composite PMI (Markit / J.P. Morgan) at 52.7 vs. 53.8 in May. Growth was led by Euro area which saw its best quarter in six years in June quarter. Rates of expansion improved in the US (4 month high), India (8 month high) and Australia. Softer increases seen in China, Japan, UK and Russia.

On the monetary policy front, June ECB minutes indicated lessening divergence between Fed and ECB policy stance, with the ECB sounding less dovish. The ECB members in the minutes discussed that its pledge to boost its asset purchase program if required, could be reviewed if confidence in the inflation outlook improved further. The ECB had removed its reference to the possibility of a rate cut if conditions warranted in its June statement as risks of deflation had diminished and growth conditions were expanding at a somewhat faster pace than expected. While the reference to asset purchases was kept unchanged in the statement. The next ECB meeting is on July 20 where it is expected to keep rates unchanged.

The Fed June meeting minutes showed increasing concern regarding inflation shortfall from target levels. While majority members viewed the recent softness as transitory, several members expressed concern that the recent soft patch might persist. The Fed had raised the target range for the Federal funds rate by 25 bps to 1.00%- 1.25% in the June meeting, in line with market expectations. The next Fed meeting is on July 25-26, where it is expected to keep rates unchanged.

In the first week of August monetary policy meetings of RBI (Aug 1-2) and BoE (Aug 3) will take place. The BoE meeting will be closely watch by the markets after the recent June MPC minutes revealed that 3 out of 8 members voted for a rate hike in light of the recent surge in inflation. However, we don't expect this to become a consensus decision any time in the near term and continue to stick to our expectation of no change in bank rate from the BoE in 2017. However internal debate within the MPC could intensify as inflation breaches 3% in the coming months.

On the domestic front, we expect RBI to opt for a 25bps rate cut in its August policy, as average CPI inflation is likely to move towards 4.0% in FY18 in line with the central bank's target. The minutes for the June meeting were relatively neutral compared to the somewhat hawkish April minutes, with the RBI revising down its inflation forecast and one of the members voting for a 50bps cut in June policy. The moderation in FY18 inflation to 4% (4.5% in FY17) is supported by the recent softness in food inflation, improved monsoon outlook, weaker crude oil prices and delayed implementation of 7 CPC. Implementation of GST is expected to have a very marginal impact on inflation in FY18.

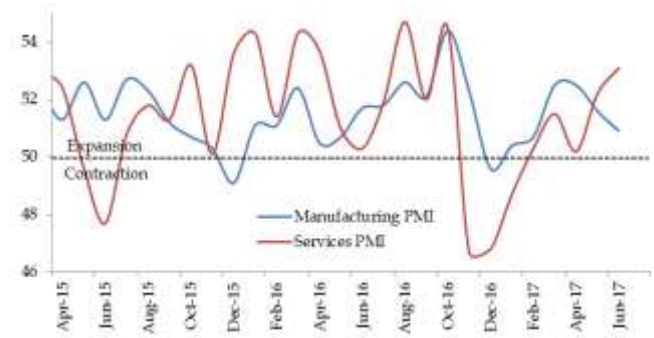
On the domestic policy front, the implementation of GST from July 1st took centre-stage as a multiplicity of indirect taxes at the Centre and state level were replaced. GST is expected to accrue significant gains in medium term through formation of unified market, removal of tax-on-tax cascading and higher compliance. However, in the near-term some disruption is expected as producers offload older inventories, consumers assess impact of GST and first time entry of many MSMEs into indirect tax net.

For the full year FY18, we expect India's GDP growth to accelerate to 7.4% in FY18 versus 7.1% in FY17, with recovery in growth led by consumption, public sector led capex and external demand improvement.

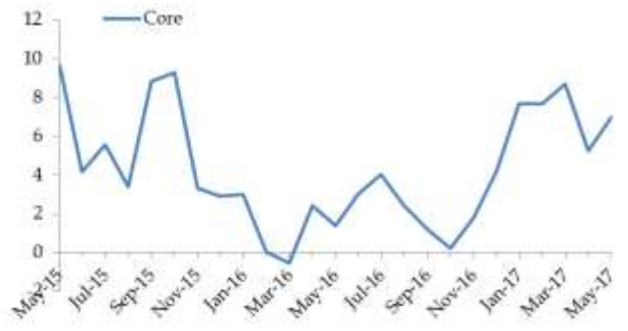
Shubhada M. Rao
Chief Economist

Kanwar Vivek
Senior President and Head - Wealth Management

Domestic Market Macro Economics

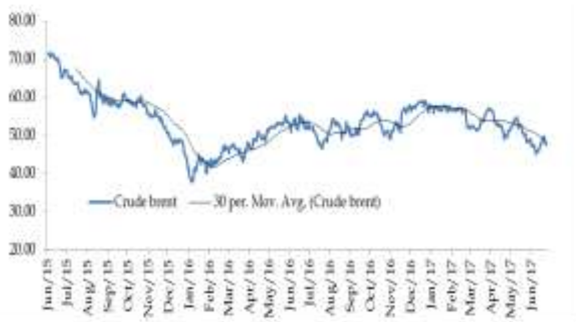


May India WPI: The great convergence

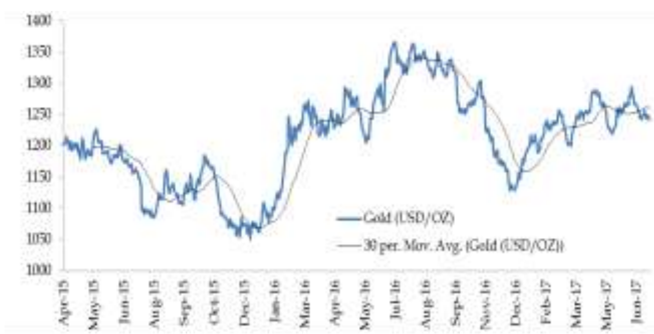


CORE - Growth picks up in May

- Manufacturing activity, as seen from the NIKKEI PMI, stayed in the expansion mode for the sixth consecutive month however, the pace of expansion eased to a fourth-month low of 50.9 in Jun-17 from 51.6 in May. Softer expansion in new orders and output weighed on the index
- India Services PMI increased to 53.1 in Jun-17 (Previous: 52.2), posting the highest reading in eight months driven by faster pace of rise in new business orders, supported by improved demand and marketing efforts. For Q1 FY18, the headline index averaged 51.8 vis-à-vis 50.2 in Q4 FY17.
- Core sector growth (40.27% of IIP) climbed to 3.6% YoY in May-17 (Previous: 2.8% and 5.2% corresponding period last year) led by expansion in electricity, natural gas and refinery production to more than offset contraction in coal and fertilizer production and moderation in steel production.
- India's industrial production, as measured by the IIP grew by 3.1%YoY, in line with our estimates (YBL: 3.0%; Bloomberg: 2.7%). The previous month growth rate was revised upwards to 3.8% as compared to the initial estimate of 2.7% The expansion however was broad based with 14 out of the 23 manufacturing groups registering positive growth as compared to only 9 in the previous month.
- CPI inflation slid further in May to touch a series-low of 2.18% YoY(Bloomberg Consensus: 2.40%, YBL: 2.33%, Previous: 2.99%). Monthly inflation momentum increased to 0.23% MoM(Previous: 0.15%), though on a cumulative basis, it continued to track significantly lower than the corresponding period of last year (Apr-May FY18: 0.19%, Apr-May FY17: 1.03%). Broadly, inflationary trends remain subdued, led by lower-than average increase in food prices.
- India 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, YBL estimate: 2.72%). Reinforcing the recent downward momentum in inflation, Mar-17 inflation was revised lower by 18 bps to 5.11% YoY.



Crude Brent (USD/ barrel)



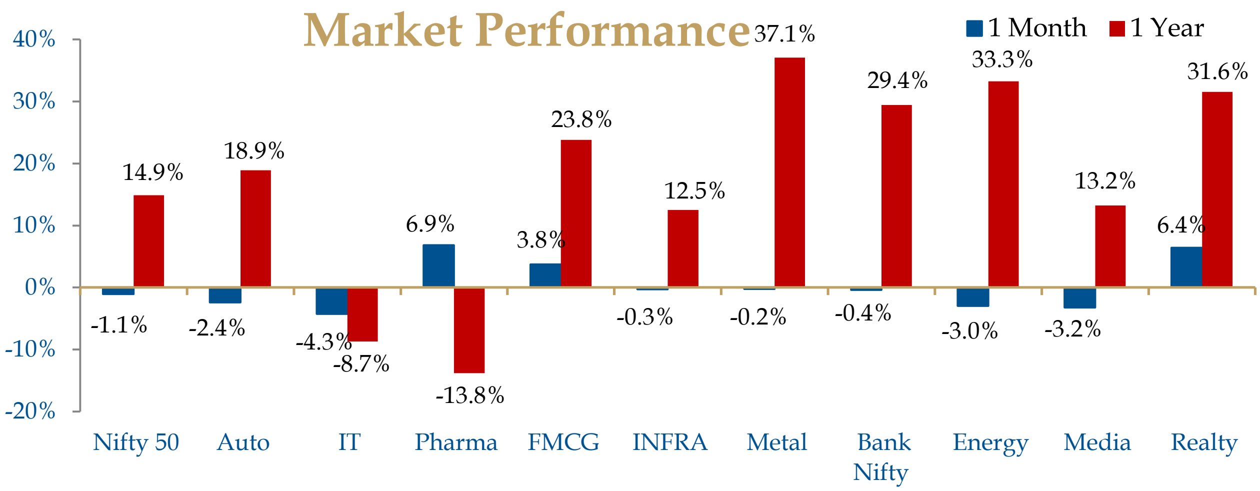
Gold Movement (USD /OZ)

We expect:

- We have fine-tuned our FY18 GDP growth estimate to 7.4% (vs. 7.1% in FY17), post series revision incorporating new base IIP and WPI. Growth to be led by consumption, public sector capex and export.
- USDINR may have moved to "lower-normal", amid somewhat lower global risks and positive domestic macros. We expect gradual depreciation to 66.0 by Mar-18

Equity Market Insights

- The Indian equity markets came under pressure during the latter part of June as investors booked profits ahead of the GST rollout. While the Nifty ended the month of at 9,520.90, the Sensex closed at 30,921.61; down 0.7% and 1.0% respectively. Midcaps and smallcaps outperformed their larger peers with the Nifty Free float Midcap 100 and the Nifty Free float Smallcap 100 indices up by 1.3% and 1.8% respectively during the same period.
- During June, foreign investors invested US$ 0.60 bn into the Indian equity markets and invested US$ 3.97 bn into the debt markets taking the total tally to a net inflow of US$ 4.57 bn during the month. DII's were net buyers and ~ $ 1.03 bn during the same period.



Factors to Watch

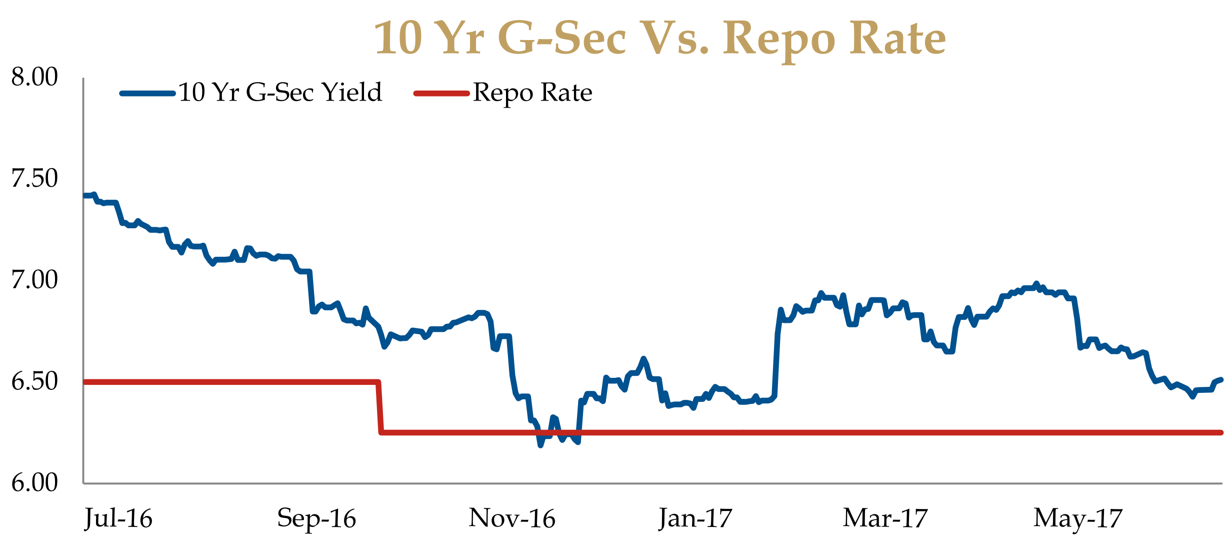
- Result announcements: The June quarter results are expected to be tepid for most sectors as destocking by dealers ahead of GST rollout would have a temporary impact on the consumption driven sectors. At the same time, export oriented sectors- IT and Pharma – are expected to be negatively impacted by the persisting structural issues and currency movements. However, it is expected that sectors like housing finance, cement, etc. that are directly or indirectly linked with affordable housing should post better numbers.
- Geopolitical developments particularly in the Eurozone and UK. Global investors would also be keeping a close watch on developments and policy announcements in US.
- Monetary policy announcement by RBI

Outlook & Expectations

- In terms of valuations, the Sensex and Nifty are trading at a forward PE multiple of 18.9 x and 18.2 x respectively, which is a tad bit stretched as compared to historical valuations. In our opinion, rather looking at the headline indices which do seem to be trending upwards and which do seem to be a little stretched if you are looking at on the valuation side, it would be more prudent to look at stocks instead. And even at current market levels, there are plenty of stocks that offer value in terms of valuations.
- As such, the markets are on an upward trajectory supported by an improvement in the country's fundamentals. This is clearly reflecting in the earnings growth too that has improved from the levels seen 3-4 quarters back. Although recovery is yet to be broad based, nevertheless earnings are on the path of improvement too.
- 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 do think that markets would continue to trend upwards over the long term, however there could be some aberrations due to global events.
- We recommend equity investments through a Systematic Transfer route with a minimum investment horizon of 36 months.

Debt Market Insights

- The average systemic liquidity surplus in the banking system reduced to Rs. 3137 bn in June vs Rs. 3404 bn in May.
- Average 10yr yield during June reduced to 6.5% vs. 6.8% in May. Yields have reduced due to due to market expectations of a rate cut in the August meeting and change in benchmark security.
- Taking into account the change in our monetary policy call, we revise lower our forecast for 10Y g-sec yield to 6.40-6.90%
- India's trade deficit widened for the third consecutive month, rising marginally to USD13.8 Bn vs. USD 13.2 Bn in Apr, rising to a 30-month high. The May deficit was higher than our estimate and consensus projections (YBL: USD 13.1 Bn, Bloomberg consensus: USD 12.5 Bn).
- The sequential widening in trade deficit in magnitude terms is driven by reduction in exports (petroleum products and ready-made garments), while imports marginally declined. The sequential contraction in export growth is partly driven by decline in crude oil prices and other commodity prices.
- The RBI's Monetary Policy Committee published the minutes of its meeting held over Jun 6-7, 2017. This meeting was followed by the central bank's decision to maintain status quo on the benchmark repo rate
- For the first time since the constitution of the MPC, the policy decision was not marked by complete unanimity. This time, the MPC voted 5-1 for keeping repo rate unchanged. One member voted for a 50 bps reduction in the repo rate.



Outlook and Expectations

- 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 commodity prices providing comfort on imported inflation.
- With average inflation likely to move towards 4.0% levels in FY18 from 4.5% in FY17, we expect RBI to opt for a 25 bps rate cut in the upcoming policy review in Aug-17.

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.

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

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YES BANK Ltd., Registered 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

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