PROSPERITY INSIGHTS

Pro-EU centrist Macron wins French election; NPA resolution takes center stage

The month of May-17 is important from election front, with presidential elections in France, South Korea and regional elections in Germany. In France, Centrist Emmanuel Macron was voted French president beating far-right Eurosceptic candidate Marine Le Pen, giving a boost to Eurozone. In South Korea, liberal Moon Jae-in has been elected as the new president. In Germany, regional elections will take place in North-Rhine Westphalia, which is the most populous state in Germany. It is an important election in the run-up to the Federal elections to be held in Sep-17, providing an early indication on voter support. Chancellor Merkel is seeking a fourth term in the Sep-17 election and is in the lead. Germany is the largest economy in Eurozone and the outcome of the Federal election will have an important bearing on the future of the European Union.

On the monetary policy front, the US Federal Reserve opted for a status quo in May-17 policy review after delivering a 25 bps hike in Mar-17. However, robust labour market reports (rise in Apr-17 payroll employment and fall in unemployment) and inflation nearing 2% goal, reinforced expectations that Fed is on track to hike rates in Jun-17 (with Fed Funds future factoring in a 100% probability).

On the domestic policy front, attempt towards NPA resolution took center stage with the Government amending the Banking Regulation Act to give the RBI more power over NPA resolution. The amendments allow RBI to direct banks to resolve specific stressed assets by initiating insolvency and issue other directions for resolution. RBI revised the Prompt Corrective Action by tightening thresholds for capital ratios, NPLs, profitability and leverage. The RBI also strengthened the Joint Lenders Forum by reducing the threshold required to reach an agreement.

A key policy development in May-17 will be the fitment of GST rates, with the council expected to decide allocation of goods and services across four indirect tax brackets on May 18-19. The government aims to implement GST by 1st July 2017. While the president has approved four GST bills in Apr-17, at the state level eight states have approved State GST so far.

On the currency front, the USDINR may have moved to a lower normal amid some reduction in global risks and strong domestic macros, trading between 64.12 and 65.03 in Apr-17. The appreciation was driven by a confluence of factors – the state election results, change in RBI monetary policy stance to neutral from accommodative since Feb-17 and dollar weakness driven by uncertainty on US policy implementation. FII inflows which had exhibited bunching-up in Mar-17 ahead of GAAR implementation has moderated in Apr-17 to USD 2.7bn net inflows (vs. USD 9bn in Mar-17) driven by debt market.

Lead indictors continued to point towards a modest recovery with India's PMI manufacturing and services index remaining in expansion zone. Industrial index posted a significant increase from Feb-17's growth, as output increased across sector. On the consumption front, auto sales continue to accelerate in Apr-17 and personal loans growth has picked-up in Mar-17. Going forward, we expect India's GDP growth to accelerate to 7.3% in FY18 versus 6.9% 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 Centre and state governments is expected to support public capex.

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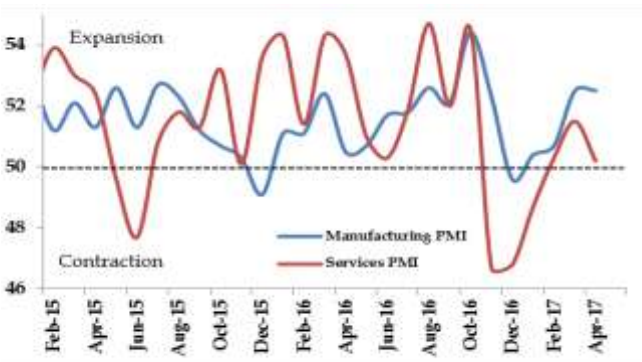
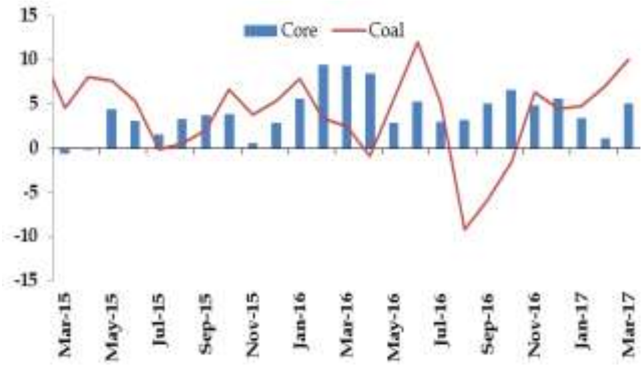
Domestic Market Macro Economics

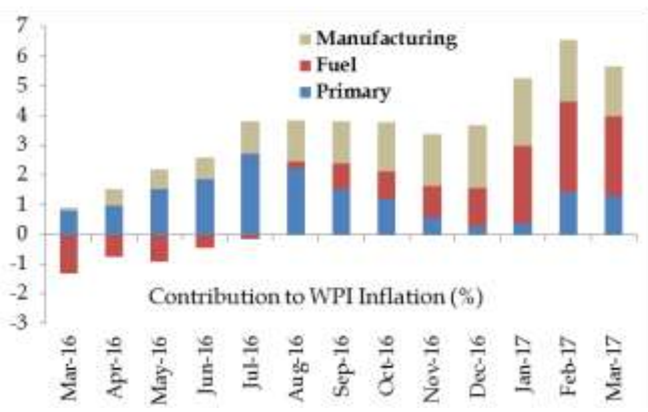


PMIs: remains in the expansion zone

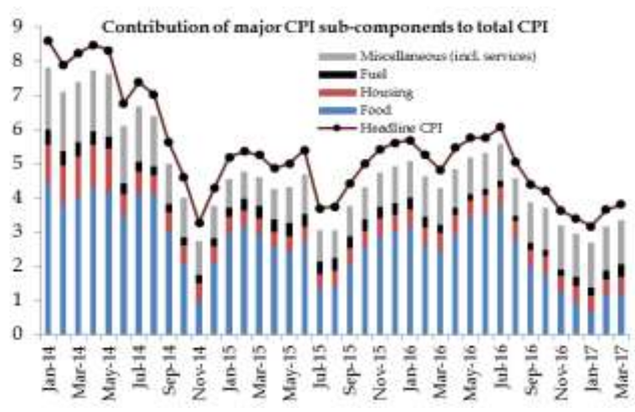


CORE - Coal and Steel drives growth

- Manufacturing activity, as seen from the NIKKEI PMI, continued to be in the expansion zone for the fourth successive month in Apr-17 (52.5), however, it remained unchanged from Mar-17. Stronger growth of new orders were offset by slower pace of increase in output, stocks of purchases and employment.
- Credit growth improved to 5.1% in Mar-17 (Feb-17: 4.8%) amid expansion in credit to non-food sector. Within non-food credit growth, credit offtake to agriculture and allied sector, services and personal loans improved considerably. However, credit offtake to industry sector continued to remain weak.
- Core sector grew by 5% in Mar-17 (Feb-17: 1.1%) recording the fastest pace in three months, led by coal and steel production. Favorable base and a positive sequential momentum added to the upside.
- India's trade deficit rose unexpectedly in Mar-17, coming in at USD 10.4bn (Feb-17: USD 8.9bn), much-above the projections. Both exports (27.6% YoY) and imports (45.3% YoY) rose sharply, with monthly momentum also showing a double-digit pickup (exports: 19.4% MoM, imports: 18.8% MoM). Overall, the broad-based increase in imports was higher than exports, leading to the increase in trade deficit.
- India's industrial production, as measured by the IIP contracted by 1.2%YoY in Feb-17 contrary to expectations. A key factor driving the decline in YoY growth rate is an adverse base from Feb-16 which had an extra working day on account of the leap year. The drop can also be seen on a sequential basis as the index fell by 4.7% MoM vs. an expansion of 4.0% MoM.



March India WPI: A fine closing act



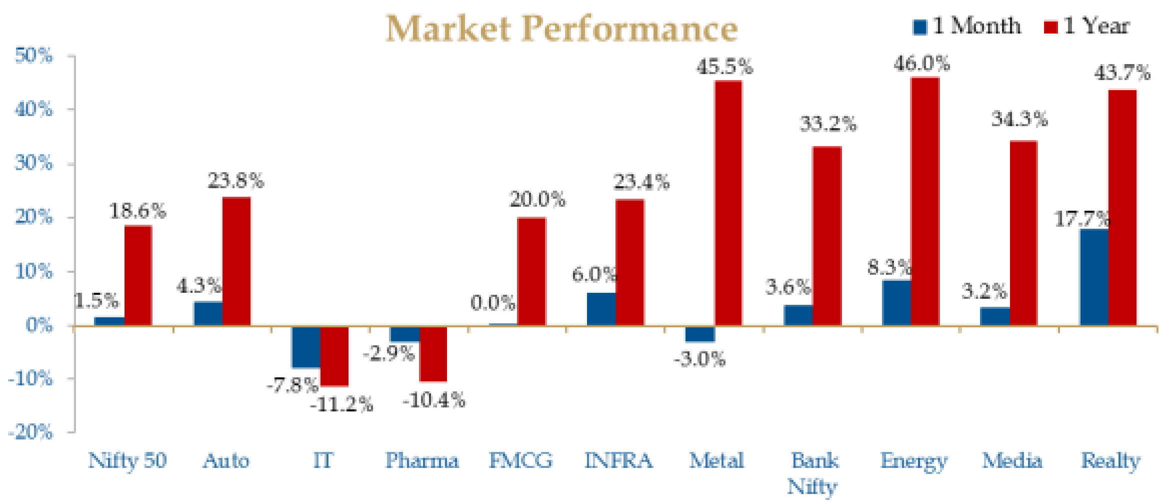
India March CPI Inflation - Remains below 4%

We expect:

- We expect FY18 GDP growth at 7.3% vs. 6.9% in FY17, with recovery led by consumption, followed by public sector capex and external demand improvement. We see upside risks to FY18 forecast if export growth momentum strengthens significantly.
- We expect average FY18 CPI inflation at 5.2% in FY18 (vs. 4.5% in FY17), pick-up led by rise in commodity prices, 7th CPC allowances and slight impact due to GST.
- We expect 10Y g-sec yield to trade in the range 6.70-7.20% in FY18.

Equity Market Insights

- The Indian equity markets soared during the month of Apr-17 and touched record highs, Nifty was up 1.01% and Sensex was up 1.42%. Midcaps and small caps outperformed large caps with the Nifty Free float Midcap 100 and the Nifty Free float Small cap 100 indices went up by 5.17% and 6.57% respectively. The run up was on the back of positive news related to French elections, tax policies in US and BJP's landslide victory in New Delhi municipal elections.
- During Apr-17, foreign investors pulled out USD 0.17bn from the Indian equity markets and invested USD 2.9bn into the debt markets taking the total tally to a net inflow of USD 2.73bn during the month. DII's were net buyers to the tune of ~ USD 1.43bn 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.
- Quarterly earnings announcements.

Outlook & Expectations

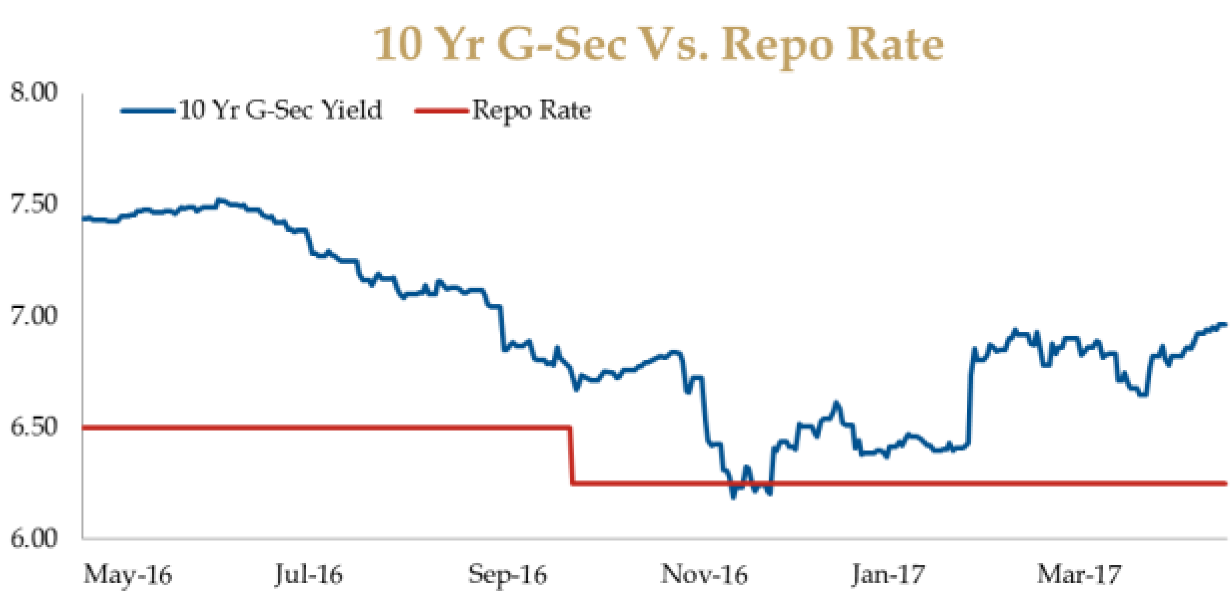
- In terms of valuations, the Sensex and Nifty are trading at a forward PE multiple of 17.9x and 17.8x respectively, which is a tad bit stretched as compared to historical valuations. However, there are many companies which offer value in terms of valuations.
- The markets are on an upward trajectory 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 4,199bn in Apr-17 vs. INR 4,524bn in Mar-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 Apr-17 held steady versus Mar-17 at 6.8%. Yields have risen post the change in stance of RBI to neutral from accommodative in Feb-17. In the Apr-17 meeting, the central bank narrowed the policy rate corridor to 50bps from 100bps, with a 25bps hike in reverse repo and 25bps cut in MSF, which further supported yields.
- India's wholesale price inflation (WPI) eased from a 29-month high of 6.55% in Feb-17 to 5.70% in Mar-17. WPI inflation for Jan-17 was revised upwards to 5.53% from 5.25% reported earlier. On a sequential basis, the headline WPI index contracted by 0.11% MoM, depicting a weak momentum as opposed to historical seasonal trends seen in the month of Mar-17 (more often driven by Budget related announcements).
- Marginally lower than expectations, CPI inflation rose to 3.81%YoY in Mar-17 vs. 3.65% YoY in Feb-17. The Mar-17 print marks the fifth consecutive month of sub-4% inflation. On a sequential basis the index was up by 0.15%, which is lower than the usual monthly momentum seen in Mar-17. Core-core inflation was steady at 4.35%YoY in Mar-17.
- The N.K Singh led FRBM Review Committee recommends adoption of a medium term anchor to fiscal policy in the variable of public debt to GDP ratio to be achieved via the operational target of fiscal deficit/GDP. Basing analytic underpinnings, it suggests a ceiling of 60% of GDP for General Government debt, with Central Government debt at 40% and the balance of 20% of GDP as prudent for States (versus current levels of 49.4% and 21% respectively).

Outlook and Expectations

- We expect average FY18 CPI inflation at 5.2% in FY18 (vs. 4.5% in FY17), pick-up led by rise in commodity prices, 7th CPC allowances and slight impact due to GST.
- We expect monetary policy to remain on a prolonged pause (through FY18) so as to work towards achieving the 4% inflation target by Mar-19.
- We expect 10Y g-sec yield to trade in the range 6.70-7.20% in FY18.



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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