PROSPERITY INSIGHTS

Global activity continues to improve; domestic growth impacted by Demonetization

The month of Nov-16 has witnessed significant events unfolding globally with republican candidate Donald Trump becoming US President and the demonetization exercise carried out by India. Data across major large economies paint a positive picture with signs of recovery indicated by the JP Morgan Global Manufacturing PMI rising to a 27-month high (52.1 in Nov-16 vs. 52.0 in Oct-16). Signaling an expansion in 22 out of 30 nations in November. US manufacturing Markit PMI rose to 54.1 in Nov-16 from 53.4 in Oct-16, with the fastest rise in output in 20 months driven by improving order books.

In Eurozone manufacturing PMI reached a high since Jan 2014, at 53.7 in Nov-16 (vs. 53.5 in Oct-16). The growth was driven by Netherland, Austria, Spain and Germany. In Asia, China's Caixin manufacturing PMI fell to 50.9 in Nov-16 from 51.2 in Oct-16 (a 27 month high reached in Oct-16), due to weakness in new orders.

US recovery remains on firm footing with improving labour market indicated by better than expected non-farm payroll print and unemployment rate falling to a 9-yr low. The markets have priced in a 25bps rate hike in the US Fed Dec-16 meeting due to the improving macro data. US President-elect has indicated to implement expansionary fiscal policies, resulting into an expectation of steeper pace of Fed rate hikes. Indeed, post the election results we have seen surge in treasury yields and dollar strength.

In Europe, ECB kept its monetary policy rates unchanged in line with consensus expectation and extended its asset purchase programme while reducing the quantum of purchase. Post the decision bond yields increased on both sides of the Atlantic and the Euro depreciated versus the USD.

Domestically, one month into the demonetization process we are beginning to see the first signs of the impact, with a moderation in India's manufacturing PMI (52.3 in Nov-16 vs. 54.4 in Oct-16) due to softer rise in order books. However, encouragingly despite the slowdown the index remains in the expansionary zone. In contrast, the services sector has seen a sharper impact, sliding into contraction zone (46.7 in Nov-16 vs. 54.5 in Oct-16) due to contraction in new business inflows and output. Rabi sowing which had been initially impacted post demonetization has recovered with the latest estimates showing an 8.5%YoY growth. Retail and wholesale food prices remain subdued due to curtailment in demand caused by the cash shortage, combined with the increased supply post Kharif harvest. Nov-16 auto sales which is one of the first indicators of discretionary consumption contracted by 5.5%YoY (vs. +8.1%YoY in Oct-16), with greater impact on two wheelers as rural areas are impacted more than urban.

The re-monetization process is only partly complete with 28% of the withdrawn currency (INR 500 and INR 1000) replaced. We expect the re-monetization process to take at least three months, proceeding gradually from urban to rural. The impact on growth is expected to be limited over the next two quarters with a transient negative impact on economic activity in cash intensive sectors. Taking into account the short-term negative impact, we revise down our FY17 GDP forecast to 6.7% from 7.6% previously.

Economic activity is expected to normalize from Q1FY18 onwards as the re-monetization process is complete. Significant benefits are expected to accrue in the medium-term with the expansion of the formal economy reinforced by the GST architecture, rise in more productive financial savings and enhanced monetary policy transmission.

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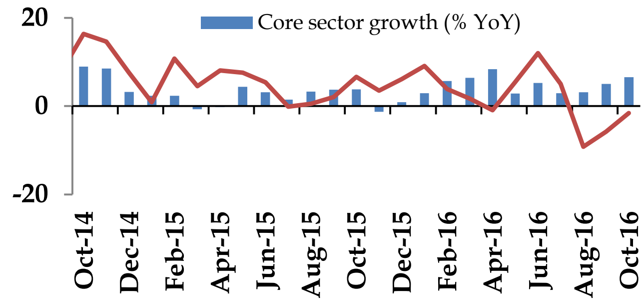
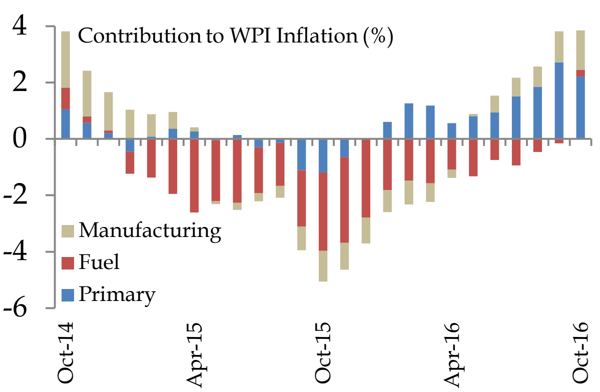
Domestic Market Macro Economics

PMIs fell on the back of demonetization-induced cash shortage

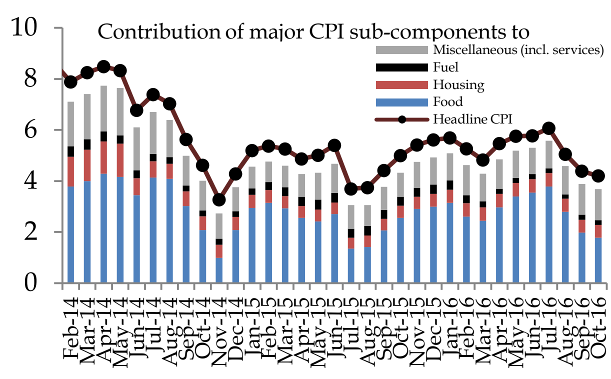


Core sector output improving

- India's manufacturing PMI continued to expand in Nov-16 but at a slower pace (Nov-16: 52.3; Oct-16: 54.4). Withdrawal of high denomination notes decelerated manufacturing growth as shortage of cash hampered buying and production. On a sectoral basis, consumer goods were impacted the most.
- After 16th consecutive months of expansion, India Services PMI showed a decline in Nov-16 (46.7; Oct-16: 54.5) reflecting subdued new business orders due to demonetization. Output declined in three of the six sectors namely (1) financial intermediation, (2) hotels and restaurant and (3) renting business activities.
- Growth in core sector output improved to 6.6%YoY in Oct-16 (Sep-16: 5.0%), driven by robust growth in the refinery products, steel and cement.
- WPI inflation moderated for the second consecutive month, reaching a four-month low at 3.39%YoY in Oct-16 vs. 3.57%YoY in Sep-16. The downside was due to lower primary food and non-food inflation.
- Fiscal deficit stood at 79% of Budget Estimates over Apr-Oct FY17 vis-a-vis 74% in the corresponding period last year, on account of (1) lower non-tax revenue receipts and (2) higher revenue expenditure. Standalone, the month of October recorded a fiscal surplus.



Oct WPI Inflation: lower primary inflation



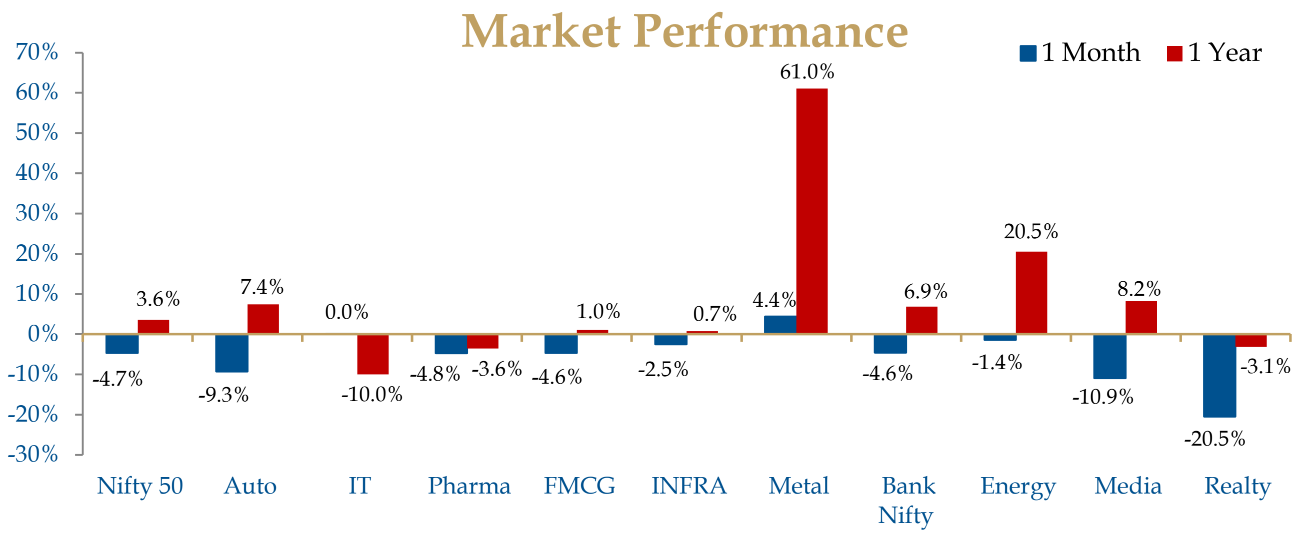
Food disinflation continues

We expect:

- We have lowered our FY17 GDP forecast to 6.7% from 7.6% previously, taking into account the short-term negative impact of demonetization over the next two quarter. Sectors which are dependent on cash based tractions are expected to be negatively impacted in the near-term, while a beneficial impact is expected on banks deposits and NBFCs. From Q1FY18 we expect growth conditions to start normalizing as the re-monetization process is completed.
- We expect demonetization to lead to an incremental increase in durable deposits worth INR 2-3trn. A rise in deposit base will allow banks to lower the blended cost of funds as higher CASA deposits help to replace the high cost of borrowing and lower overall cost of funds. We expect banks to reduce deposit rates by ~75 bps over the next 6-9 months. The new regime of MCLR will immediately take into account the lower cost and will thereby lead to a decline in lending rates and improved transmission.
- We expect USDINR to reach 68.5 by Dec-2016, moving to 68.0 by Mar-17.

Equity Market Insights

- Indian equity market fell in the month of November 2016 with BSE Sensex closing at 26,652 while the Nifty closing at 8,224; down 4.6% and 4.8% respectively. Midcap and Small cap underperformed the broader market with the Nifty Free float Midcap 100 Index and Nifty Free float Small cap 100 Index moving down by 5.9% and 9.4% respectively during the month. The fall was largely on account of outflow of FII funds from emerging markets including India as investors turned cautious ahead of US Fed meet to be held in December 2016, resulting in further strengthening of US dollar and increasing US Bond yields. Additionally, the domestic market was impacted by demonetization and expected economic slowdown post demonetization.
- During November, foreign investors pulled out USD 2.46bn from the Indian equity markets and USD 2.79bn from the debt markets, taking the total tally to a net outflow of USD 5.25bn during the month. DII's were net buyers with an inflow of ~ USD 2.7bn during the same period.



Factors to Watch

- Interest Rates: Investors would be keeping a close eye on the trajectory of interest rates both in India as well as in the US. Though the market has been pricing in a 25bps rate hike in US in its December 2016 Fed meet, it would be important to understand their statement on possible future rate hikes. Back home, The Reserve Bank of India Monetary Policy Committee kept the repo rate on hold in its bi-monthly monetary policy review meet held in early December.
- Geopolitical developments particularly in the Eurozone and UK.

Outlook & Expectations

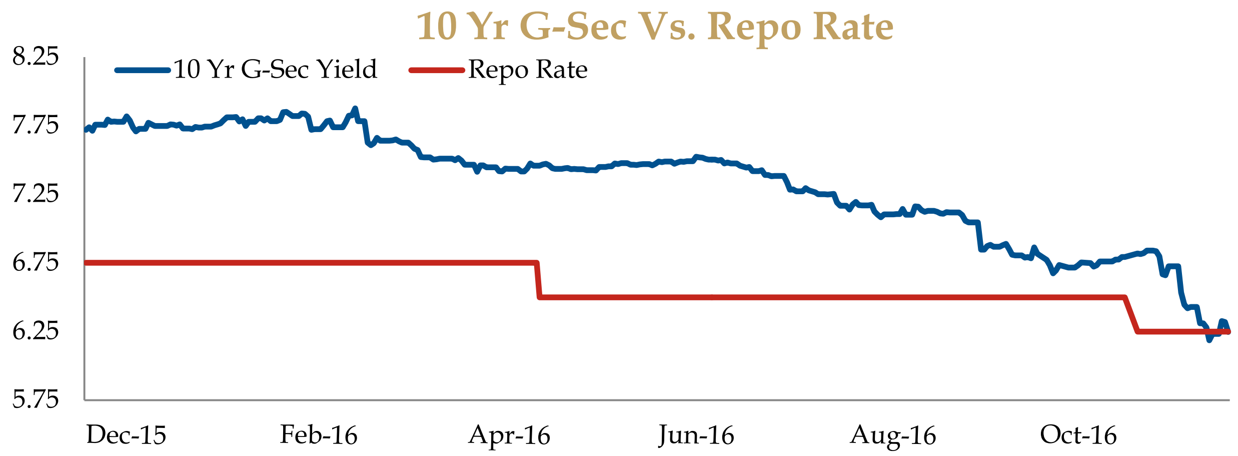
- Sensex and Nifty are trading a forward PE multiple of 17.8x and 18.0x respectively. If we factor in a recovery in earnings growth and expect a continued momentum into FY18, valuations do not look expensive from a long term perspective. However, in the near term there are some risks which could keep markets in check. These include developments on the geopolitical front, hike in interest rates by US Fed, and developments in Britain and EU region. These events could lead to near term dips which in turn provide a good opportunity for picking up quality stocks for the long term.
- In terms of sectors, we remain positive on autos and auto ancillaries given that they enjoy a multiplier effect to economic growth; infrastructure and capital goods given the Government's focus in infrastructure development and agri stocks which would see a growth in demand on the back of good monsoons.
- 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 increased to a surplus of INR 1,635bn in Nov-16 from a surplus of INR 95bn previously as banks parked excess funds at the reverse repo window. Demonetization has resulted in rise in deposits of INR 10.2trn (till Dec 4, YBL estimate).
- Average 10 yr yield during Nov-16 declined to 6.24% from 6.79% in Oct-16 due to surge in interbank liquidity post demonetization.
- The Reserve Bank of India Monetary Policy Committee kept the repo rate on hold in its fifth bi-monthly monetary policy review in Dec-16, against our and consensus expectations of a 25 bps cut. All members voted in favor of the decision, in a 6-0 vote. Demonetization resulted in a surge in systemic liquidity. RBI initially absorbed the excess liquidity using reverse repo, however due to the surge in liquidity it announced incremental CRR effective from Nov 26 at 100% of increase in NDTL between 16 Sep and 11 Nov. This measure absorbed INR 3200bn in liquidity and effective from 10 Nov it will be replaced with a combination of MSS issuances and liquidity adjustment facility operations. The MSS limit has been expanded to INR 6trn from INR 300bn earlier. The RBI has issued INR 1.6trn under MSS via Cash Management Bills (CMB) of tenor ranging from 28 to 35 days. The cut off yield on the latest CMB auction was at 6.8% versus 6.19% in the previous CMB auction.
- We expect demonetization to lead to an incremental increase in durable deposits worth INR 2-3 trillion. A rise in deposit base will allow banks to lower the blended cost of funds as higher CASA deposits help to replace the high cost of borrowing and lower overall cost of funds. We expect banks to reduce deposit rates by ~75 bps over the next 6-9 months. The new regime of MCLR will immediately take into account the lower cost and will thereby lead to a decline in lending rates and improved transmission.

Outlook and Expectations

- We expect FY17 CPI inflation to broadly track 4.8% vs. 4.9%YoY in FY16. We believe demonetization could add a marginal downside bias to our estimates.
- We expect 50 bps cut in repo rate by April 2017.
- We expect 10 yr G-Sec to decline to 6.25% by Mar-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.

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