PROSPERITY INSIGHTS

Protectionist measures on the rise; India unveils FY18 Union Budget

The key policy frameworks which will impact the global economy have begun to take shape at the start of 2017 with President Trump pulling out of the TPP and signaling his intention to renegotiate NAFTA and the UK government providing the blue print outlining the Brexit process. The UK parliament is in the process of approving a bill which authorizes the government to initiate exiting from EU. The spread of protectionist policies in the rest of Europe will be determined by the outcome of elections in three founding members of EU – France, Germany and Netherlands, which have seen a rise in Eurosceptic parties.

Against this backdrop of rising protectionism, global macros continued to improve with JP Morgan Global Manufacturing PMI rising to a 34-month high led by improving growth conditions in US, Euro Area and UK. Global trade indicators show an improvement in Nov-16 with world exports rising by 5.8% (vs. -3.7% in Oct-16). Pick-up in commodity and oil prices is expected to further support the pick-up in commodity exports. OPEC and key non-OPEC producers which had agreed to cut production levels from 2017 onwards, have implemented majority of the agreed cuts as per Reuter's survey.

On domestic front, the FY18 Union Budget was unveiled outlining the government's policy vision for the next one year. The Budget balanced the need for fiscal prudence (FY18 fiscal deficit target pegged at 3.2% of GDP) and the need to support growth by focusing on capex and consumption.

The RBI in its first meeting post the budget and the second meeting post the demonetization drive, opted for a status quo in monetary policy. The key change is the policy stance moving from 'remaining accommodative' to a 'neutral'. The inflation target was unambiguously emphasized at 4% versus previous statements indicating 4% with a band of ± 2%.

Domestic growth conditions show nascent signs of recovery as the re-monetization process progresses. Indeed passenger car sales have rebounded sharply in Jan-17 post the dip seen in Dec-16, expanding by 14.4%YoY. Two wheeler sales which is driven more by rural demand and hence relatively more impacted by the demonetization, also showed some signs of recovery with a more moderate decline. Manufacturing PMI also saw a rebound in Jan-17 with the index entering the expansion zone at 50.4 (vs. 49.6). The pick-up was led by rise in new orders and output. Even services sector which has been impacted relative more than the manufacturing sector saw an improvement in growth momentum, with services PMI rising to 48.7 vs. 46.8 in Dec-16. Core index which represents primary industries such as electricity, steel, coal etc. saw an acceleration in growth, with the index rising by 5.6%YoY in Dec-16 vs. 4.9%YoY in Nov-16.

For the full year FY17 we expect growth to moderate to 6.7% from 7.6% in FY16 on the back of short-term impact of demonetization on cash intensive sectors. We expect growth momentum to normalize as the re-monetization process progresses. Growth is expected to be supported by normal monsoon, 7th CPC and lower interest rates.

In agriculture, Rabi sowing remains in line with historical trends, with area under sowing expanding by 6.5%YoY till 6 Jan 2017. We expect economic activity to normalize from Q1FY18 onwards as the re-monetization process is completed. 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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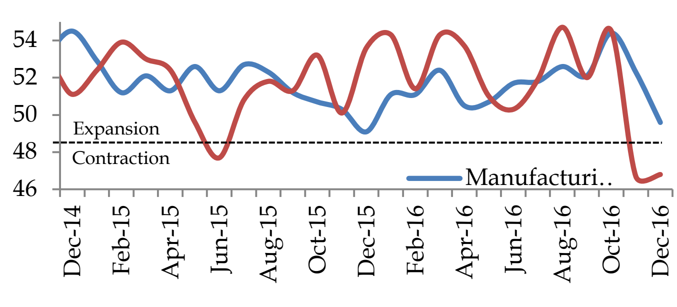
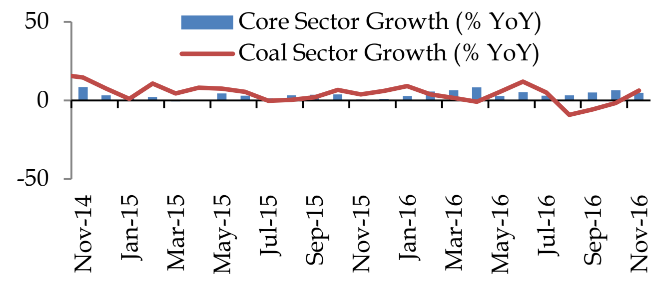
Domestic Market Macro Economics

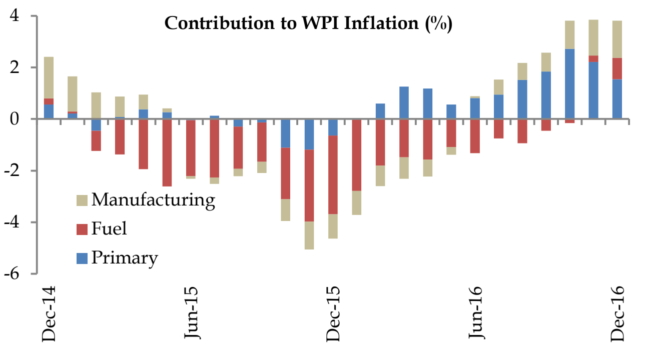


PMIs Contraction induced by cash shortages

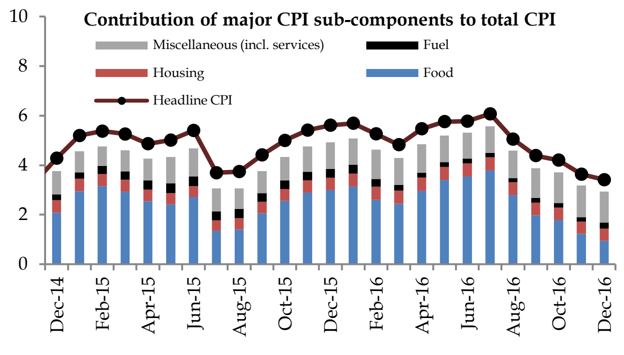


Deceleration in core sector output

- India's manufacturing activity rebounded from the contraction zone on the back of rise in both new orders and output in Jan-17. Manufacturing PMI increased to 50.4 (Dec-16: 49.6). As opposed to upturn in total new business, export orders eased in the month of Jan-17
- India Services PMI contracted for the third consecutive month in Jan-17 (48.7; Dec-16: 46.8), however; the pace of downturn in the service sector softened, due to lesser contraction in new business inflows
- Credit growth slumped to 3.3% YoY in Dec-16 (Nov-16: 4.0%), registering a fresh historical low. Non-food credit decelerated to 4.0% in Dec-16 vs. 4.8% in Nov-16, driven by third consecutive month of contraction in credit to industry
- Growth in core sector output accelerated to 5.6% YoY in Dec-16 (Nov-16: 4.9%; Dec-15: 2.9%), driven by healthy output recorded in steel, electricity and refinery products
- Fiscal deficit stood at 94% of BE over Apr-Dec FY17 as compared to 89% in the corresponding period last year driven by lower revenue receipts, mainly on non-tax revenue due to shortfall in spectrum auction. On the tax revenue front, the gross revenue growth stood at 18.3% YoY lower than 21.1% in the same period last year due to tepid pace in growth in collections from corporate and custom tax as compared to the last year levels



Nov WPI Inflation: Primary articles driven moderation again



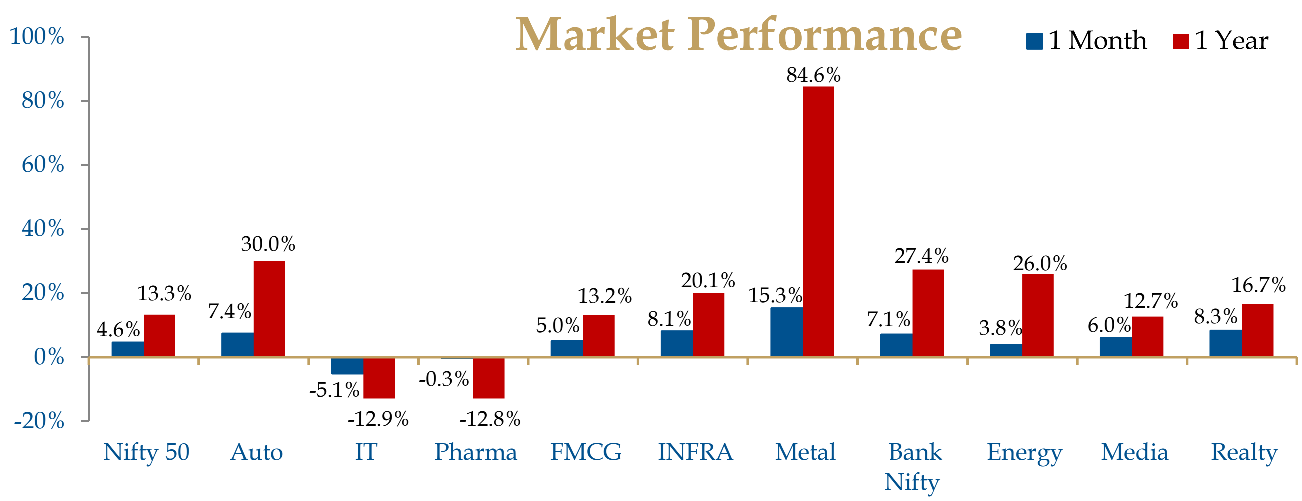
India Nov CPI Inflation at sub 4% (24 month low)

We expect:

- We expect FY17 GDP growth at 6.7% versus 7.6% in FY16, with growth in 2HFY17 decelerating to 6.2%YoY from 7.2%YoY in 1HFY17 due to demonetization. From Q1FY18 we expect growth conditions to start normalizing as the re-monetization process is completed.
- Demonetization has resulted in a surge in deposits with banking system, resulting in a decline in lending rates. We expect durable increase in deposits at INR 2-3 trn, as the limits on withdrawals are removed. The rise in liquidity with the banking system is expected to enhance the transmission of monetary policy.
- We expect USDINR to trade in the 68-70 range, amid adverse global factors including USD strength post US elections. However, Strong domestic fundamentals are expected to limit the downside.

Equity Market Insights

- Indian markets ended the month of Jan-17 on a positive note. BSE Sensex closed at 27,656 while the Nifty closed at 8,561; up 3.9% and 4.6% respectively. Both midcap as well as small cap outperformed with the Nifty Free Float Midcap 100 Index moving up by 7.4% while the Nifty Free Float Small cap 100 Index was up 9.0% during the month.
- During Jan-17, foreign investors pulled out USD 0.1 bn from the Indian equity markets and USD 0.4 bn from the debt markets taking the total tally to a net outflow of USD 0.5 bn during the month. DII's were net buyers with USD 0.66 bn invested during the same period.



Factors to Watch

- Quarterly earnings: The stock markets would be closely tracking the earnings announcements. In the current quarter, there could be an earnings impact particularly in sectors that wherein cash transactions tend to be high including consumer driven sectors, retail, autos, etc. However, as liquidity conditions improve, consumption driven growth would come back to support earnings and would lend support to the upward movement in the capital markets as well.
- Geopolitical developments particularly in the Eurozone and UK. Global investors would also be keeping a close watch on developments and policy announcements in US.

Outlook & Expectations

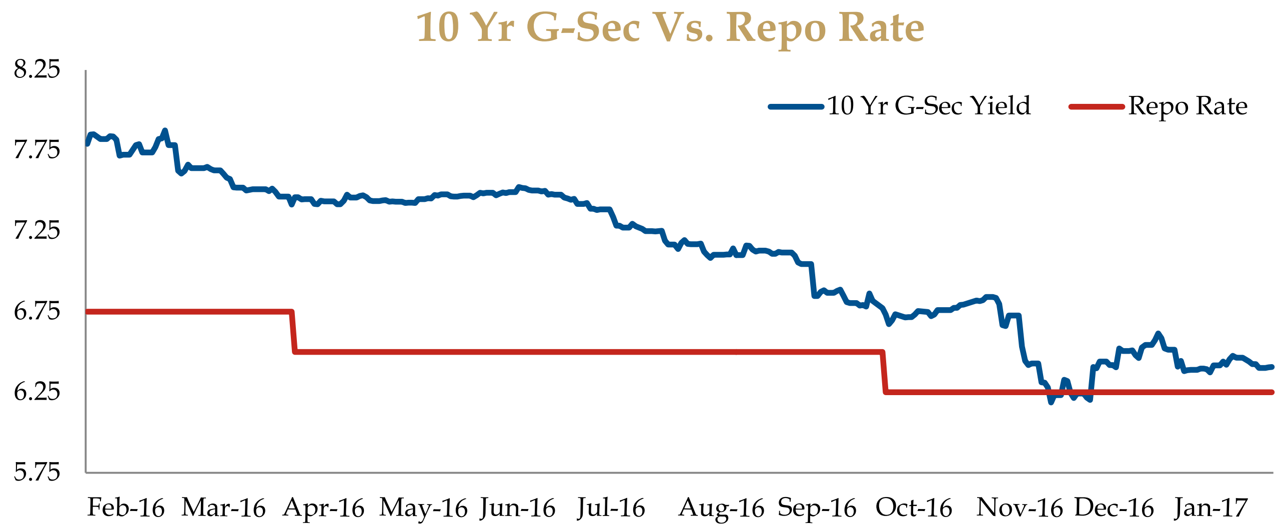
- Sensex and Nifty are trading at a forward PE multiple of 19.5 x and 19.2 x respectively pricing a growth of 10-11% in earnings over a 1 year horizon. There are 4 key themes that have emerged from the Budget, which in our opinion would drive sectoral performance from an equities perspective. These include focus on rural and agri; continued focus on infrastructure particularly towards roads and railways; drive for affordable housing and measures to boost consumption.
- We believe that it is just a matter of time before the reforms and structural steps introduced by the Government start yielding results which in turn would help the laggard indicators to turn around and support growth both for the economy and consequently for the corporate earnings.
- If we factor in a recovery in earnings growth and 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 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 that area 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 2017bn from INR 1859bn surplus in Dec-16 as banks continue to park excess funds at the reverse repo window. Demonetization has resulted in rise in deposits of INR 12.1tn (till Dec 10, RBI).
- Average 10yr yield during Jan-17 held steady at 6.4% vs. pre-demonetization level of 6.7% in Oct-16 due to surge in interbank liquidity post demonetization.
- India WPI inflation rose 3.39% YoY in Dec-16 (Nov-16: 3.15%), largely in line with expectations (Bloomberg Consensus: 3.50%, YBL: 3.56%). Sequentially, WPI fell 0.16% MoM (Previous: +0.11%), led by negative momentum in food prices and slower growth in fuel and manufacturing prices.
- India's retail inflation (CPI) for the month of Dec-16 printed at a 25-month low of 3.41% (Bloomberg consensus: 3.51%; YBL estimate: 3.49%) vis-à-vis 3.63% in Nov-16. The deceleration is led by food prices. Core inflation (i.e., stripping out items volatile items like food, fuel, and jewellery products from the headline index), printed at 4.62% in Dec-16, its lowest level since the beginning of the new inflation series.
- We expect demonetization to lead to an incremental increase in durable deposits worth INR 2-3 trn. 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.

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. Decline in food prices reflecting seasonal factors in addition to demonetization impact.
- Demonetization has resulted in a surge in deposits with banking system, resulting in a decline in lending rates. We expect durable increase in deposits at INR 2-3 trn, as the limits on withdrawals are removed. The rise in liquidity with the banking system is expected to enhance the transmission of monetary policy.
- We expect policy rates to remain unchanged in FY18 as RBI has changed its stance to neutral from accommodative.



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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