PROSPERITY INSIGHTS

Key events for 2017; Global growth conditions continue to improve

A number of significant events will play-out in 2017, which are expected to have an impact on macroeconomic conditions globally. The first key event will take place in January when new US President elect Donald Trump will officially take over from President Barack Obama. The markets have priced-in an expansionary fiscal policy with a sharp pick-up in the US dollar index and treasury yields. Further, the Federal Reserve's Federal Open Market Committee (FOMC) members expect three rate hikes in 2017 supported by a gradual recovery in growth and sustained improvement in the labour market conditions.

The new US policy towards international trade might set the tone for the rise in protectionism in developed economies. In this regard, the upcoming elections in three EU founding members Netherlands, France and Germany will also be key given the rise in Eurosceptic parties in Europe. This year will also provide more information on the contours of Britain's exit process from the EU and how much access UK will be able to maintain with EU which will have an important impact on its financial services sector.

The rise in crude oil prices will also play a key role in shaping global inflation dynamics. In 2016, importers benefitted from ultralow crude oil prices and other commodity prices, which is set to normalize this year. The OPEC and non-OPEC members such as Russia had agreed in Dec-16 to cut crude oil production by 1.8mn barrels a day starting from Jan-17. The news of the deal and unanticipated supply side disruption resulted in oil prices rising by 16% in Dec-16, with prices averaging at USD 54 per barrel. Oil prices in 2017 will be a function of producers sticking to the production cuts and recovery in global demand conditions. However, shale output which becomes profitable with a sustained rise in oil prices is expected to keep oil prices contained.

Data across major large economies paints a positive picture with continuing signs of recovery indicated by the December JP Morgan Global Manufacturing PMI rising to a 34-month high (52.7 in Dec-16 vs. 52.1 in Nov-16). The pick-up in manufacturing sector was led by US and Europe, with the US manufacturing Markit PMI rising to 21 month high and Euro Zone PMI rising to 68 month high. Growth conditions also improved in Asia with rise in PMI readings led by Japan, China and Taiwan.

Closer to home, the key events the market will be watching-out for will be the Union Budget on Feb 1 and proposed GST implementation. On the data front, in the second month of demonetization process, short term impact is seen in manufacturing and services sector as indicated by PMI, with the Nikkei manufacturing PMI declining to 49.6 in Dec-16 vs. 52.3 in Nov-16 and Nikkei services PMI at 46.8 in Dec-16 vs. 46.7 on Nov-16. Consumption demand conditions remain relatively better in urban areas as indicated by relatively better performance on passenger vehicles versus two wheeler sales. The influx of deposits in the banking system has resulted in a decline in lending rates, which is expected to support consumer demand going forward.

In agriculture, Rabi sowing remains in line with historical trends, with area under sowing expanding by 6.5%YoY till 6 Jan 2017. High frequency food prices indicate continued deceleration in food prices driven by seasonal factors, normal monsoon and short-term impact of demonetization. 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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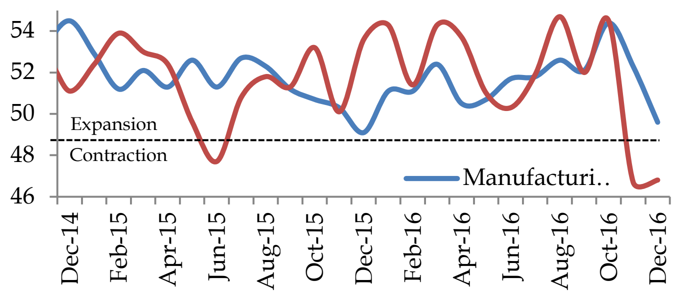
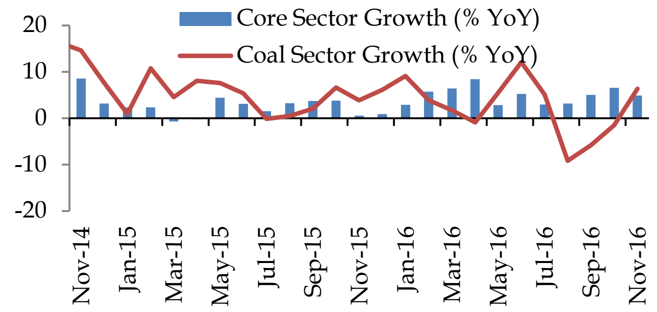
Domestic Market Macro Economics

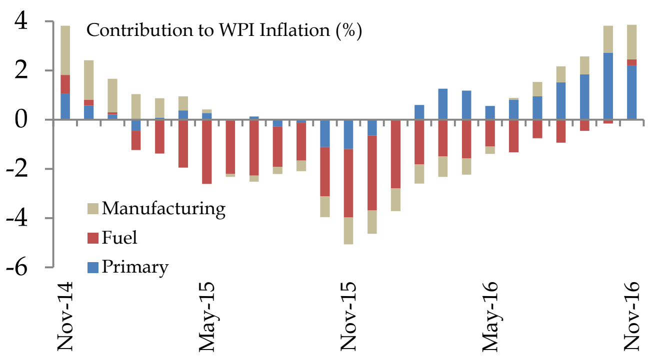


PMIs Contraction induced by cash shortages

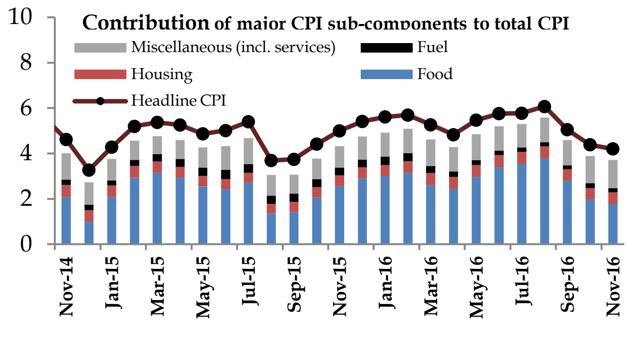


Deceleration in core sector output

- ✓ India's Manufacturing PMI recorded below the threshold level of 50 (49.6: Dec-16) posting first contraction in one year. Short-term cash shortages in the economy due to the demonetization resulted in fewer new orders. On a sectoral basis, consumer goods and intermediate goods were impacted the most.
- ✓ India's Services PMI showed a decline in service activity for the second consecutive month in Dec-16 (46.8; Nov-16: 46.7) reflecting subdued new business orders due to demonetization. Sub-sector; hotels and restaurants were impacted.
- ✓ Credit growth slumped to 5.1% YoY till 23 Dec (Nov: 5.8%YoY), the lowest in the series which started in Apr-97. Non-food credit expanded by 5.3%YoY till 23 Dec (Nov: 6.5%YoY) driven by lower working capital demand and focus of banking sector resources on implementation of demonetization drive.
- ✓ Growth in core sector output decelerated to 4.9%YoY in November (Previous: 6.6%; Nov15: 0.5%), driven by de-growth in the crude oil and natural gas and lower growth in refinery products, Steel and Cement.
- ✓ Fiscal deficit stood at 86% of Budget Estimates over Apr-Nov FY17 vis-a-vis 87% in the corresponding period last year, Gross tax revenue growth remained robust at 21.5% (Apr-Nov), supported by higher excise duty (46%YoY in Apr-Nov) and service tax revenue (27.1%YoY in Apr-Nov). Total expenditure is currently growth at 12.6%YoY (Apr-Nov) tracking higher than BE levels (11.5%)



Nov WPI Inflation: Primary articles driven moderation again



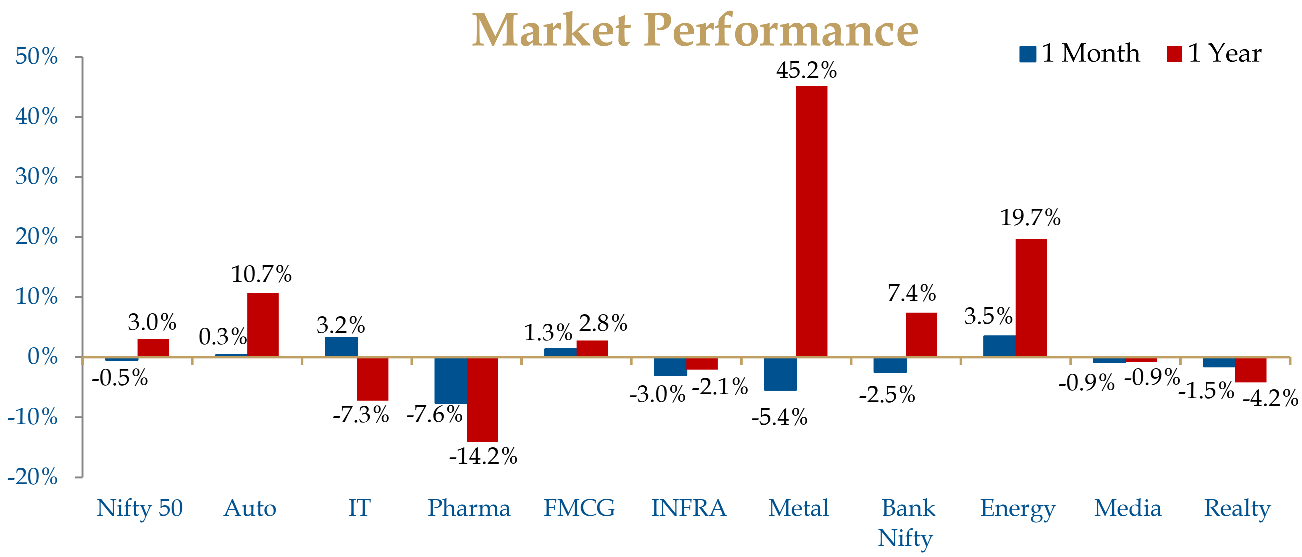
India Nov CPI Inflation at sub 4%; 24 month low

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, once 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 equity market fell marginally in the month of Dec-16. BSE Sensex closed at 26,626 while the Nifty closed at 8,186; down 0.1% and 0.5% respectively. Both midcap as well as smallcap underperformed with the Nifty Free Float Midcap 100 Index moving down by 3.7% while the Nifty Free Float Smallcap 100 Index was down 1.0% during the month.
- During Dec-16, foreign investors pulled out USD 1.05 bn from the Indian equity markets and USD 2.89 bn from the debt markets taking the total tally to a net outflow of USD 3.94 bn during the month. DII's were net buyers and ~ USD 1.35 bn during the same period.



Factors to Watch

- Quarterly earnings: The market would be closely tracking the quarterly results. In the current quarter, there could be an impact on earnings in sectors where cash transactions tend to be high such as consumer driven sectors, retail, autos, etc. However, as liquidity conditions improve, consumption driven growth would come back to support earnings and facilitate subsequent recovery in the equity market.
- Union Budget and developments on the rollout of GST.
- Geopolitical developments particularly in the Eurozone and UK. Global investors would also be keeping a close watch on developments in US as the new President elect resumes office.

Outlook & Expectations

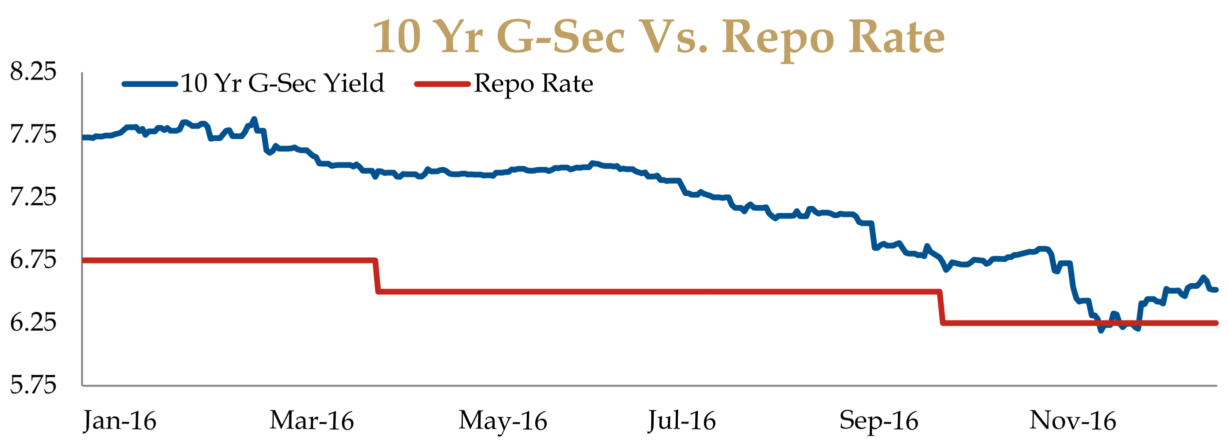
- Sensex and Nifty are trading a forward PE multiple of 18.6x and 18.3x respectively. The earning numbers in past few quarters have been revised downwards consistently. Nevertheless, the emerging trend suggests that there has been a definite improvement in indicators like vehicle sales, tractor sales, sale and prices of agri commodities, etc. At the same time, indicators like sale of commercial vehicles, credit to corporate, new investment projects, private sector capex, etc. are yet to show an uptick. We believe that it is just a matter of time before the reforms and structural steps taken by the Government start yielding results which in turn would support economic growth and consequently improve corporate earnings.
- 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 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 1,859 bn in Dec-16 from a surplus of INR 1,635 bn in Nov-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, Source: RBI).
- Average 10yr yield during Dec-16 declined to 6.4% from 6.5% in Nov-16 and 6.7% in Oct-16 due to surge in interbank liquidity post demonetization.
- India WPI Inflation eased for the third successive month in Nov-16 to 3.15%YoY from 3.39% in Oct-16 (YBL expectation: 3.21%, Bloomberg Consensus: 3.10%). The decline was led by primary articles inflation while both fuel and manufacturing inflation rose in the month.
- India Nov CPI Inflation reached a 24-month low at 3.63%YoY vs. 4.20%YoY in Oct-16. The Nov-16 print was lower than our and consensus estimate (YBL: 3.95% and Bloomberg: 3.9%), driven largely by lower than expected food prices.
- India's external debt as of Sep-16 stood at USD 484.3 bn, recording a contraction of 0.2% from the Mar-16 levels and a YoY increase of 0.8%.
- 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.
- We expect 50 bps cut in repo rate by Apr-17 on the back of weakness in growth in Oct-Mar FY17 and downside risk to inflation due to demonetization.
- 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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