PROSPERITY INSIGHTS

Modest improvement in global activity; India embarks on demonization

The month of October 2016 was marked by optimistic set of data across most large economies, partially reversing the loss of momentum that was witnessed in last few months. Manufacturing PMIs recorded a broad-based improvement in second consecutive month suggesting that manufacturing sector may have finally bottomed out. While, China's Caixin manufacturing PMI rose to two year high signaling that economy was beginning to stabilize, US Markit manufacturing PMI was recorded at its best for the year and Eurozone improved to a three year high led by solid gains in Germany. Consequently, J.P. Morgan Global Manufacturing PMI rose to 52.0 in October 2016, its highest level since October 2014.

US Q3 2016 GDP growth was recorded at an annualized 2.9%, higher than expectation of 2.5%. Likewise, the first official growth figures from UK since the Brexit vote suggested that the economy avoided substantial shocks in the aftermath of the vote. Economy grew by 0.5% QoQ in Q3 beating market expectations of 0.3% growth. Similarly, EU inflation rose to a 2 year high providing some evidence that economy may have begun to stabilize.

The improved set of global data has been overall consistent with a nascent improvement in global trade indicators. World trade volume increased to an eight month high of seasonally adjusted 0.73% YoY in Aug-16 compared to a decline of 1.08% YoY in Jul-16.

On the domestic front, the government effective 9th Nov 2016, cancelled the legal tender of INR 500 and INR 1000. We believe government's move to de-monetize higher denomination currency would have a far-reaching impact on Indian economy. Apart from creating gush of liquidity in the banking system, de-monetization could create short-term disruption in consumption and lead to behavioural changes in household's saving and consumption demand. In the medium term, we expect there to be a support to growth through higher government spending, better transmission, greater financial inclusion and movement of household savings from physical to financial would be beneficial for boosting potential growth.

Additionally, domestic data for October 2016 showed marked improvement as compared to September 2016 as festive demand and 7th Pay Commission arrear payout boosted order inflows. Both manufacturing and services PMI registered robust gains suggesting consumption remained buoyant in the run up to festival. Higher output of steel and refinery products guided the infrastructure sector output to a three month high of 5.0%. The pickup in demand was also corroborated by the improvement in credit off-take on retail and services front. Likewise credit to NBFCs saw a spurt indicating increase in leverage consumption in run-up to festivities.

Going forward, while we expect recovery in consumption to gain traction as rural incomes improve analysis of early results of FMCG and auto companies for Q2FY17 suggest that the improvement in rural demand continues to remain tepid and incremental support to consumption over last two months has been urban led. As such we now see a delayed recovery in rural consumption prompting us to attach a marginal downward bias to our FY17 GVA growth expectation of 7.8%.

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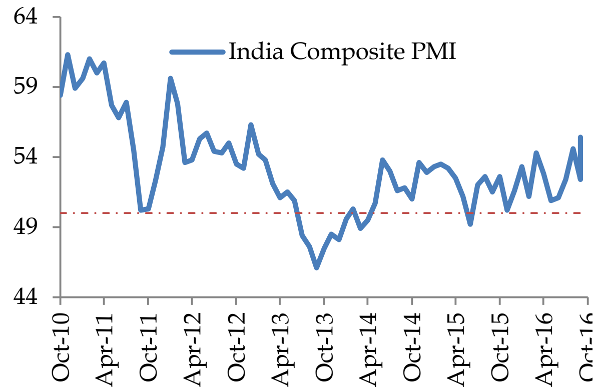
Domestic Market Macro Economics

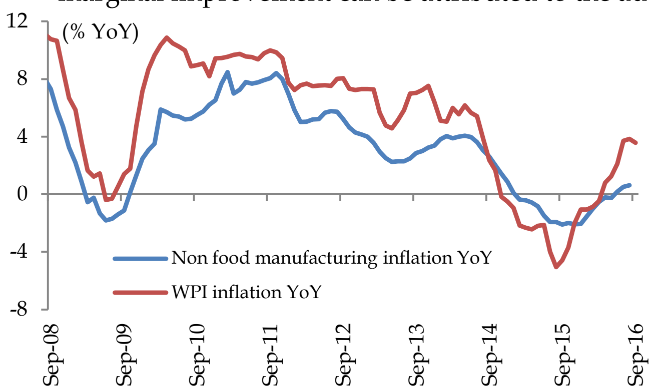
	Weight (%)	Jul-16	Aug-16	Sep-16	Apr-Sep FY16	Apr-Sep FY17
IIP	100	-2.5	-0.7	0.7	4.0	-0.1
Sectoral Classification						
Mining	14.2	0.9	-5.8	-3.1	1.7	0.0
Manufacturing	75.5	-3.5	-0.2	0.9	4.2	-0.8
Electricity	10.3	1.6	0.1	2.4	4.5	5.1
Use Based Classification						
Basic	45.7	1.7	3.5	4.0	4.5	4.0
Capital	8.8	-29.5	-22.1	-21.6	7.7	-21.4
Intermediate	15.7	3.7	3.5	2.2	1.9	3.6
Consumer	29.8	1.6	0.7	6.0	2.6	1.7
Durables	*8.5*	*5.9*	*2.2*	*14.0*	*7.7*	*7.6*
Non-Durables	*21.3*	*-1.4*	*-0.4*	*0.1*	*-0.6*	*-2.4*

IIP muted despite pre festival ramp-up

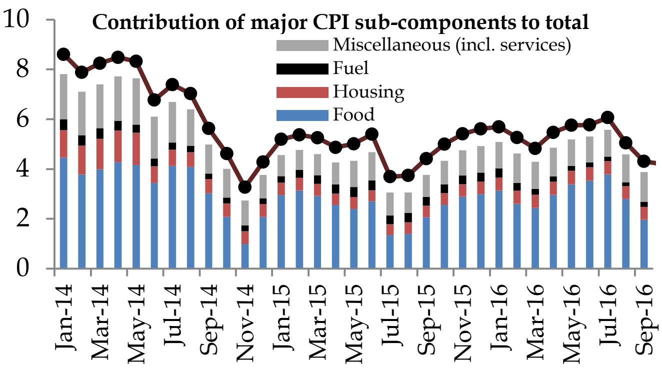


Sept PMIs suggest some moderation

- ✓ Manufacturing activity rose to a 22-month high in Oct-16 as index of new orders and output rose reflecting pickup in demand conditions boosted by festive season and 7th Pay Commission arrear payouts.
- ✓ India's fiscal deficit stood at 84% of BE over Apr-Sep FY17 against 68% in the corresponding period last year, driven by de-growth in non-tax revenue such lower spectrum auction receipts.
- ✓ Core sector output grew by 5.0%YoY in Sep-16 compared to 3.2% in Aug-16 as heavy weight refinery and steel sector recorded robust growth.
- ✓ Growth in Non-food credit improved to a 2 year high in Sep-16 to 10.8% YoY compared to 8.2% in Aug-16 despite an unfavorable base, owing to a sharp uptick in credit disbursed in the month.
- ✓ September CPI printed at a 13-month low of 4.31% led by the anticipated disinflation in food. Core CPI continued to rise for the third consecutive month to 4.88% from 4.72% in Aug. However, core inflation (after excluding impact of fuel and precious metals) moderated to 4.72% from 4.82% in Aug.
- ✓ September IIP growth printed in positive at 0.7%, reversing 2 consecutive months of de-growth. The marginal improvement can be attributed to the advancement of festive ramp up in production



Sep WPI Inflation: Non-core inflation pushes headline higher



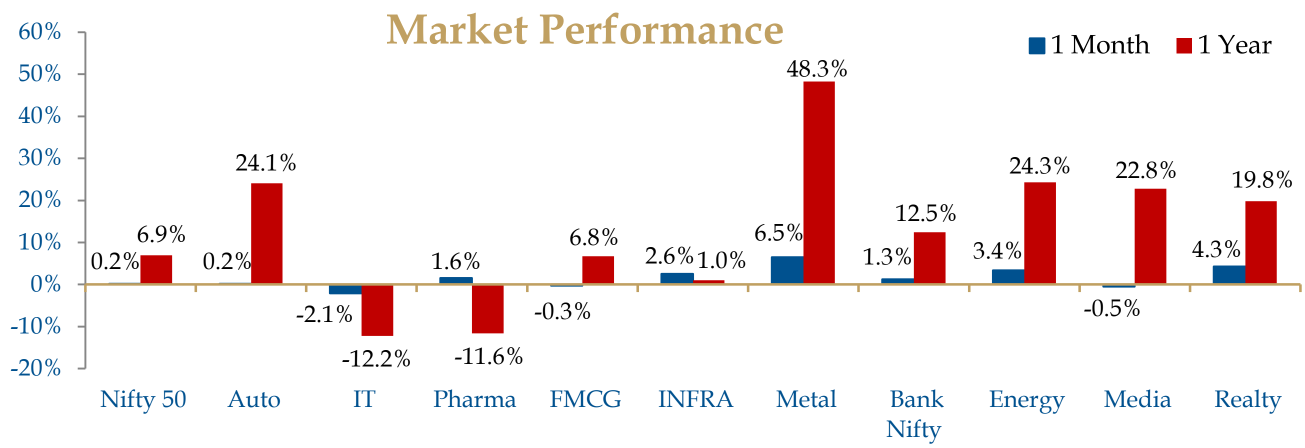
Food disinflation continues

We expect:

- ✓ In the near-term the shortage in cash is expected to impact cash based sectors and benefit banking and financial sector. On the basis of expected adverse impact of demonetization we have revised our growth expectation to 7.6% in FY17 – unchanged from FY16.
- ✓ 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. We expect banks to reduce deposit rates by ~75 bps over the next 6-9 months.

Equity Market Insights

- Indian markets remained under pressure during most of October 2016 and ended the month on a muted note. BSE Sensex closed at 27,942 while the Nifty closed at 8,638; up 0.3% each for the month. However, both midcap as well as small cap outperformed with the Nifty Free float Midcap 100 Index moving up by 2.8% while the Nifty Free float Small cap 100 Index was up 5.1% during the month.
- During October, foreign investors pulled out USD 0.75 bn from the Indian equity markets and USD 1.07 bn from the debt markets taking the total tally to a net outflow of USD 1.82 bn during the month. DII's were net buyers and ~ USD 1.2bn during the same period.



Factors to Watch

- Fund flows: In the near term there are a few risks to fund flows – (i) Geopolitical developments and (ii) trajectory of interest rates in the US. However, given the fundamental strength of our economy we do believe that in the long term our markets should continue to trend upwards and attract funds on account of (i) Near zero interest rate environment in most developed economies make high growth emerging economies like India an attractive investment destination; (ii) abundant liquidity in the global system.
- Corporate Earnings: The earnings season so far has been a mixed bag. Benefit of growth in consumption driven by revival in rural demand and 7th Pay Commission Payouts was visible in some sectors like 2-wheelers, tractors, etc. However, the FMCG sector did not see any benefit of this growth. In November PSU banks, infra and auto ancillary companies would declare their results. Although, we do expect both infra and auto ancillaries to see good traction, PSU banks could continue to see pressure on the asset quality front.
- Overall we expect earnings to start improving in the second half of the year driven by (i) boost in consumption led by revival in the rural spending on the back of good rainfall and 7th Pay Commission related payouts; (ii) gradual pickup in economic activity; (iii) low base effect

Outlook & Expectations

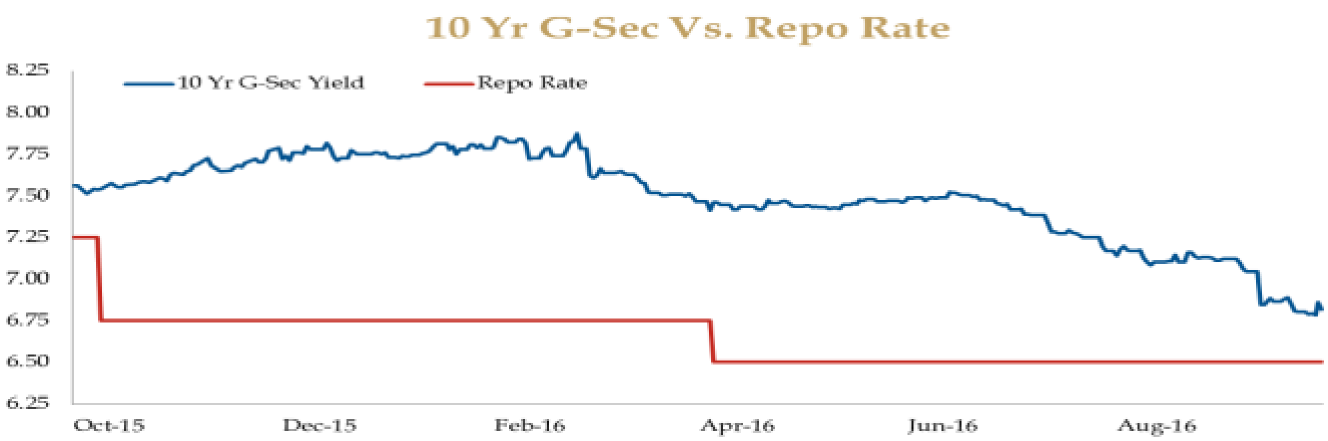
- Sensex and Nifty were trading at a forward PE multiple of 18.3 x and 18.6 x respectively. If we factor in a recovery in earnings growth (for reasons highlighted above) and continued momentum into FY18, valuations do not look expensive from a long term perspective. Some near term challenges such as developments on the geopolitical front, hike in interest rates by US Fed, and developments in Britain and EU region could keep market on 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 believe that the continued traction in urban consumption and revival of the rural economy would have a multiplier effect on sectors that are driven by consumption. This includes consumer goods, autos (2 wheelers in particular), etc. Revival in demand would eventually translate to revival in private capex as well. With this in mind we are optimistic on infrastructure (particularly road and ports) and consumption led sectors and would recommend investments in the quality stocks in the same.
- 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 reduced to a surplus of INR 95 bn from INR 474 bn previously mainly on account of increase in currency in circulation on account of festive season.
- Average 10 year yield during Oct-16 declined to 6.74% from 6.92% in Sep-16 following the repo rate cut by RBI in its Oct-16 meeting.
- In line with our expectations, the RBI's monetary policy committee cut the repo rate by 25 bps to 6.25%.
- 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 expect 50 bps cut in repo rate in Jan-June 2017.
- We expect 10 year G-sec to range between 6.25%-6.50% 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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