Investment Report August, 2017

Dear Friends,

The month of August 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed 2.41% and 1.58% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 shed 1.28% during the same period.

On the global front, the major central banks affirmed that the withdrawal of monetary stimulus would be gradual and slow. They cautioned against the possible dismantling of the financial regulations implemented since the global financial crisis and highlighted the perils of protectionism impacting global trade. The European Central Bank President suggested that its asset purchases would continue until there was an up-tick in the underlying inflation. Meanwhile, the US economy registered a robust GDP growth of 3% in the second quarter CY 2017 as against the 2.6% growth estimated earlier in the month of July for the second quarter.

On the domestic front, India's real GDP growth slowed to 5.7% in the first quarter FY 2018 compared to 6.1% in the prior quarter even as the real GVA growth remained unchanged from the prior quarter at 5.6%. The manufacturing sector growth was muted at 1.2% while the services sector growth was an impressive 8.7%. The GST related destocking has impacted the manufacturing sector due to the inventory drawdown in the first quarter FY 2018 even as there was a pick up in trade services on account of advanced consumption. Exports momentum has slackened in recent months.

The RBI, in its annual report highlighted the positive effects of demonetization such as higher financial savings, rapid disinflation, faster monetary transmission on account of the banks nudging lending rates downwards and the increase in electronic payments. Moreover, demonetisation had led to a higher tax base as seen from a 24.7% increase in the number of income tax returns filed as on August 5th, 2017 to register 28.3 mn against 22.7 mn filed during the corresponding period last year. The RBI also highlighted that FY2017 household financial savings as proportion of GDP increased to 8.2% from 7.9% in FY2016.

The rollout of the GST has been smooth and has registered a collection of ₹923 bn for the month of July. The government noted that around 6 mn tax payers were eligible to pay taxes in July, comprising around 70% of the expected total tax base and 64.4% or around 3.8 mn of the eligible 6mn tax payers had filed their returns in July. The government had a total of 9.12m GST assesses wherein 21% were new tax payers registered on the GST system. Robust GST collections for the month of July gives early signals on the expected trends in GST collections through improved compliance levels on account of formalization of the economy.

The fiscal deficit in April-July 2017 was at an elevated 92.4% of the FY2018 budget estimate. Some improvement in this is expected as the final GST collections for the month of July are yet to be factored in The gross tax collections grew 17.1%, higher than the 11.3% growth budgeted in FY2018 with the Indirect tax collections growing 13.9% and direct taxes growing 21.5%. Total expenditure increased 23.1% with capital expenditure growth at 33.4% even as revenue expenditure grew 21.8%.

Trade deficit in July was at USD 11.4 bn, lower than USD 13 bn in the prior month. The exports in July were at USD 22.5 bn registering a growth at 3.9% against 4.4% in June. Imports were at USD 34 bn as it grew 15.4% in July against 19% in June. Oil imports in July were at USD7.8 bn and gold imports were at USD 2.1 bn.

The Consumer Price Index (CPI) inflation for July 2017 came in at 2.4%, higher than the market expectation of around 2% and higher than the 1.5% registered in the prior month. Wholesale Price Index (WPI) inflation for July 2017 printed 1.9% on a year on year basis, higher than the 0.9% registered in the prior month. The rise in CPI and WPI inflation prints in July was largely on expected lines after the steep fall in inflation in the prior month.

As of August 24th, 2017, the total Kharif (summer crop) acreage was 0.6% lower than the same period last year. The sowing acreagaes of rice, oilseeds, pulses and coarse cereals were 0.8%, 8.1%, 3.8% and 2.1% lower respectively. Sugarcane and cotton registered impressive increase in their sowing acreages.

The key macroeconomic indicators reflect a mixed picture regarding the health of the economy in the near term even as the benefits of the far reaching reforms will accrue in the medium term. We continue to believe that the equity market offers a reasonable entry point for a long-term investor with a 3-5 year view.

Team Investment

DEBT MARKET OUTLOOK

Debt market in the month of August 2017 saw the new benchmark 10 year Government security (G-sec) close the month at 6.53%, hardening by 6 bps over the month. The 30 year G-sec hardened by 5 bps over the month to close at 7.15%. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.38%, hardening by 7 bps over the month. In the month of August, the Foreign Portfolio Investors (FPIs) remained buyers of Indian debt.

The minutes of the Monetary policy committee's views which shaped the RBI's monetary policy in August signaled its mildly dovish stance with almost all members acknowledging the recent fall in inflation and the receding near term upside risks. However, the MPC members were of the view that the present level of headline CPI inflation was unusually low and was set to rebound even as they differed in their year-ahead forecast of inflation. The Monetary Policy Committee (MPC) had reduced the policy repo rate under the liquidity adjustment facility (LAF) by 25 bps from 6.25% to 6% while retaining its neutral stance of monetary policy in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 % within a band of +/- 2 %, while supporting growth.

A member of the MPC proposed a 50 bps reduction in the policy rate on the back of benign inflation for the months of May and June and the downward revision of RBI's base forecast of inflation. Moreover, the member noted that the core inflation was on a declining path and expected the headline inflation to show a converging trend over the long term. He opined that the HRA impact of the 7th central pay commission (CPC) was just a transient influence likely to persist for 18-24 months because of sequential implementation of the HRA hikes by different states. He expected the trend of a normal monsoon, reforms in the agricultural sector and improvements in the logistics enabled by the introduction of GST to help keep the food inflation under control. Moreover, he was of the view that low capacity utilization, below 75%, declining manufacturing purchasing managers' index (PMI) and weak exports required the support of lower interest rates and urged the MPC to consider changing the neutral policy stance in favour of the accommodative stance.

On the other extreme, a MPC member argued for a status quo on the interest rate maintaining that the inflation targeting framework had to be forward-looking and not based on inflation prints of the recent past and a reduction of the policy rate at the juncture when the inflation was set to rise in a couple of months would be inconsistent and could undermine the MPC's credibility. The member highlighted that the rising households' inflation expectations completely discounted the June CPI inflation's historic low. Moreover, the increase of HRA of the 7th CPC would feed into the CPI inflation cumulatively, starting from July and likely reach its maximum effect in December. The member opined that the uncertainty around the inflationary impact of the roll-out of the GST as well as restocking after clearance sales would add to inflationary pressures. The reversal of base effects and an unfavourable base from August would raise the trajectory of inflation over the next few months. He noted the seasonal spikes in inflation-sensitive food prices as an added concern as the member favoured status quo on interest rates.

Most members seemed concerned about the weaker potential growth prospects owing to debt overhang of companies and banks as well as other infrastructure bottlenecks. One member maintained that there would only be a limited impact of further rate cuts to address the symptoms of twin balance-sheet problems and this could even backfire by misallocating investments and fueling asset price inflation.

The RBI had notified that it was paying a dividend of around ₹306bn to the government for FY 2017, down from ₹658 bn for FY2016, possibly indicating that the cost incurred in absorbing excess liquidity through reverse repo operations, especially post demonetization, might have affected the RBI's surplus. Moreover, reduced foreign earnings on the back of rupee appreciation, higher currency printing and freight costs and an increase in provisioning towards contingency reserve fund would be other likely reasons for the lower dividend from the RBI to the government.

Going forward, the fixed income market expects a pause in interest rates in the near term as the CPI inflation prints are expected to be higher over the next few months. However, the CPI inflation prints are expected to be broadly in line with the first half of FY 2018 projection in the range of 2-3.5%. Some market experts are of the view that the RBI had limited monetary space to nudge the interest rate in the near term.

EQUITY MARKET OUTLOOK

The month of August 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed 2.41% and 1.58% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 shed 1.28 % during the same period.

The Indian equity markets in the month of August were under pressure from the heightened geo-political tensions across the globe, the acceleration of July inflation prints from the June lows, the neutral monetary policy stance of the RBI and tepid June IIP numbers.

The first quarter FY 2018 earnings season saw the large sectors of corporate India under pressure weighed down by structural issues such as the digital transition in the IT sector and pricing pressures in the US pharmaceutical market. Moreover, these export led sectors had to grapple with the cyclical headwind of stronger INR as well. A slew of companies in the Metals sector saw strong quarterly earnings on the back of higher global commodity prices. The Oil marketing companies saw some tailwinds on account of a positive outlook for their refining business as well as the possibility of the removal of subsidy for Kerosene and LPG in a calibrated manner.

Domestic consumption was impacted by the Goods & Services Tax (GST) led de-stocking on account of the uncertainty around the implementation of GST. Moreover, the revival in the raw material prices remains a headwind for the manufacturing sector while the pass through of higher input costs by the manufacturing companies has only been partial due to the weak demand conditions. Going forward, the early onset of the festive season and demand revival in the second half FY 2018 can act as drivers for a consumption led increase in economic activity in the next few months.

The RBI's annual report highlighted that the FY2017 household financial savings as a proportion of GDP increased to 8.2% from 7.9% registered in FY2016. Moreover, compared to FY2016, savings in currency as a proportion to GDP in FY 2017 fell by around 350 bps contracting by 2.1% even as the deposits picked up by 250 bps to 7.4%.Shares and debentures allocation increased by 90 bps to 1.2% and insurance funds allocation picked up by 100 bps to 2.9%. This trend of higher financial savings of households is expected to sustain and would help catalyze domestic inflows into the Indian equity market.

In an effort to speed up the consolidation among PSU banks, the Union cabinet gave an in-principle approval to delegate to a select panel of ministers the task of overseeing the bank mergers. The aim is to create this alternative mechanism which would facilitate the consolidation among the nationalised banks taking into account the asset quality, capital adequacy ratio, profits and location of banks. The process would be initiated by the boards of the banks post which the RBI and the government would study and approve the proposal.

The month of July saw a sharp rebound in economic activity after a moderation in the prior month due to destocking in response to the imminent GST rollout. Many consumption indicators as well as railway freight picked up and there was a sharp acceleration in the sale of two wheelers and passenger vehicles. Moreover there was an uptick in electricity and diesel consumption and acceleration of commercial vehicle sales. However, there was a moderation in foreign trade and consequently port traffic. Some high frequency indicators such as credit growth as well as the stamp duty collections of states, a proxy for real estate, are yet to pick up.

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