Dear Friends,

The month of December 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain 2.74% and 2.97% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 6.22% during the same period.

On the global front, the US Federal Reserve (Fed) in its FOMC meet in December raised the benchmark Fed funds target rate by 25 bps in line with expectations, and guided three additional hikes for CY 2018. The minutes from the monetary policy meeting confirmed that the Fed remained on a gradual interest rate hike path so long as inflation remains subdued, even if the boost to growth from the fiscal stimulus is taken into account. Meanwhile, the Bank of England and the European Central Bank held rates steady and announced no new changes to their respective asset purchase programs.

On the domestic front, as per the CSO's FY2018 advance estimates, the real GDP growth was pegged at 6.5% in FY2018, lower than the 7.1% registered in the prior fiscal. Real GVA growth for FY2018 is estimated at 6.1% against the 6.6% registered in FY2017. The estimates indicate moderation in growth of agriculture & allied activities to 2.1% in FY 2018 from 4.9% in the prior fiscal while the growth in the manufacturing sector is estimated to have slowed in FY2018 to 4.6% against 7.9% in the prior fiscal. Services sector growth is estimated to improve to 8.3% in FY2018 compared to 7.7% in the prior fiscal.

The RBI announced an additional borrowing plan for ₹500 bn through Government Securities indicating a likely slippage in the FY 2018 fiscal deficit. Earlier, the FRBM review committee report provided an escape clause from the fiscal consolidation path if there were far-reaching structural reforms with unanticipated fiscal implications. On the positive side, this possible slippage indicates that the government may not be inclined to curtail its capital expenditure significantly in order to meet the fiscal deficit target.

The central government's fiscal deficit in the April-November period widened to an elevated 112% of the budgeted fiscal deficit target for FY 2018. The revenue expenditure grew 13.1% on a year on year basis while the capital expenditure grew by 29.3% in the first eight months of the current fiscal. Some of the frontloading of the government spend this year has been on account of higher fuel subsidy as well as increased spend on rural development and defence. In the month of November 2017, total GST collected was at a muted ₹808bn as against ₹833bn in the prior month even as the GST collections have been trending down in recent months compared to the range of ₹900-940 bn registered in the second quarter FY 2018. Of the 9.9mn registered assesses under GST, around 5.3mn have filed returns for November 2017 while another 1.6mn assesses are slotted in the composition scheme, filing returns quarterly. Another reason for the tepid GST revenues in November has been the early impact of the lowering of rates for commonly used household items from 28% to 18%, effective November 15th.

India's current account deficit (CAD) improved to USD 7.2 bn in the second quarter FY 2018 from USD 15 bn in the prior quarter on the back of a reduction in non-oil imports to USD 85.2 bn in the second quarter FY 2018 from USD 92.3 bn in the prior quarter. The Foreign Portfolio Investors (FPI's) net inflows in the second quarter FY 2018 were tepid at only USD 2.1 bn against the robust inflows of USD 12.5 bn in the prior quarter. The Net FDI inflows were at an impressive USD12.4 bn in the second quarter FY 2018 as against USD7.2 bn in the prior quarter. Overall balance of payments surplus in the second quarter FY 2018 was at USD 9.5 bn, slightly lower than USD 11.4 bn in the prior quarter.

Trade deficit in November was at USD 13.8 bn compared to USD14 bn in October. November exports at USD 26.2 bn registered an impressive growth of 30.5% against a contraction of 1.1% in the prior month. Non-oil exports grew at 28.2% in November against a contraction of 3.3% in the prior month. Imports at USD 40 bn grew 19.6% in November against 7.6% in the prior month. Oil imports in November were at USD 9.6 bn and non-oil imports were at USD 30.5 bn with gold imports at USD 3.3 bn.

The Consumer Price Index (CPI) inflation for November 2017 came in at 4.88%, higher than the market expectation of around 4.3% and significantly higher than the October CPI inflation print of 3.58%. Wholesale Price Index (WPI) inflation for November 2017 increased to 3.93% on a year on year basis, higher than the 3.58% registered in the prior month. Going forward, the fixed income market expects a pause in interest rates in the near term as the CPI inflation print is expected to overshoot the RBI's second half FY 2018 projection in the range of 4.3-4.7%.

The Union budget FY 2018-19 is expected to focus on key areas such as rural development, infrastructure creation and stimulating economic growth to accelerate job creation. The budget could address the agriculture sector with an objective of improving farmer incomes with specific initiatives for irrigation, quality seeds and crop insurance. It could catalyze rural infrastructure by improving road connectivity and power availability in villages. The budget could also enable acceleration in logistics and transportation sector through improving quality of infrastructure and connectivity in highways, ports and railways. The government could facilitate more job creation opportunities by focusing on skill development initiatives in large labour intensive sectors in the economy and the tourism sector. Overall, the government has to deliver a fine balancing act of stimulating the economic growth, addressing the rural aspirations as well as accelerating jobs without slipping too much from its path of fiscal consolidation. The adherence to the path of fiscal consolidation over the last three years has paid rich dividends in the form of macro-stability, lower inflation and the sovereign rating upgrade.

With the domestic growth outlook improving, we believe that further benefits of the far reaching reforms will accrue in the medium term and that the equity market offers a reasonable entry point for a long-term investor with a 3-5 year view.

Team Investment

TATA AIA LIFE

DEBT MARKET OUTLOOK

Debt market in the month of December 2017 saw the benchmark 10 year Government security (G-sec) close the month at 7.32%, hardening by 26 bps over the month. The new 10 year has been issued at 7.17%. The 30 year G-sec hardened by 16 bps over the month to close at 7.64%. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.86%, hardening by 14 bps over the month. In the month of December, the Foreign Portfolio Investors (FPIs) turned net buyers of Indian debt.

The Indian fixed income market has been under pressure in the month of December on the back of rising CPI inflation in November, the announcement of additional G-sec borrowing, the possibility of fiscal slippages and the sustained rise in global crude oil prices.

The minutes of the Monetary Policy Committee (MPC) of the RBI in its fifth Bi-monthly monetary policy which kept the policy repo rate unchanged at 6% noted a cautious approach as most members expected inflation to inch upwards. Upside risks to inflation highlighted by the members include higher MSP announced for wheat in addition to stagnant agri-productivity and lopsided temporal rainfall, higher crude oil price on account of extention of OPEC production cuts, the possibility of fiscal slippages, global financial stability risks on account of monetary policy normalization, the HRA impact of the 7th central pay commission, lesser-than-expected seasonal fall in vegetable prices, firming up of inflation expectations and lower Rabi (winter crop) output. Offsetting factors include the reduction in GST rate of several commodities & services that may translate into lower retail prices for consumers, a more proactive supply management by the government, and a downward trend in prices of pulses.

Some members noted the weakness in growth drivers despite the rebound in the GVA and GDP growth. Tepid investment demand, volatile exports and the contraction in the November 2017 PMI in services were other signals of anemic growth. However, the MPC expected the growth process to be supported by GST restocking, favourable impact of global growth, incipient turnaround in credit growth and bank recapitalization. Going forward, RBI's surveys indicated an improvement in the performance in services and infrastructure sectors in the fourth quarter on account of increase in demand, improvement in the financial conditions and the overall business situation. Moreover, eventhough output gap remains somewhat negative as reflected in present low capacity utilisation and high inventory, gradually improving credit metrics in several distressed sectors should pave way for improved investment over the next year. This process is expected to be further supported as cases referenced to Insolvency and Bankruptcy Code (IBC) resolve, facilitate consolidation, and restore pricing power. As public sector banks raise capital as well as deploy the capital from recapitalization, credit is expected to flow to the productive sectors of the economy.

One member argued for a 25 bps rate cut as he believed that the range of the RBI forecasts of both the headline and core CPI inflation showed the relevant inflation rate hovering around 3.9 to 4.3% over the rest of the year if the statistical impact of HRA revisions of the pay commission were ignored. He cautioned against keeping the real policy rate substantially higher than most other countries in the world and if the situation were not to be corrected soon, it had the potential to destabilize the financial markets at home by discouraging domestic investments and encouraging foreign investment in the debt market. On the other hand, he noted that by cutting the policy rate, the domestic corporate bond market, stock market and hence investment demand could be encouraged and growth can be accelerated to bridge the output gap.

At the other end of the spectrum, another member highlighted that the upside risks to inflation cited in previous resolutions were materializing with the price pressures no more confined to vegetables alone and was getting diffused across petroleum products, services and into underlying inflation. He noted that the projections indicated that the inflation prints were likely to stay above target from here on and that the pressure of input costs may soon force corporations to reflect them in selling prices. He argued that the current phase of accommodation in the monetary policy stance was one of the deepest barring the easing associated with the global financial crisis and has been almost fully transmitted in the economy. He stated that it was time now to signal its end and commence the withdrawal of accommodation, consistent with the evolving stance of liquidity management.

The government has announced additional market borrowing to the tune of ₹500 bn via government securities, higher than market expectations. The gross G-sec issuances in the fourth quarter FY 2018 stood at ₹930 bn as against ₹430 bn budgeted earlier and the gross T-bill issuances is to the extent of ₹1.79 tn. Consequently, the Gsec auction size has increased to ₹150 bn for the last five auctions of FY2018.

The fixed income market is under pressure from the higher than expected additional borrowing and the expectation of an elevated CPI inflation print for the month of December. Moreover, tightening domestic liquidity, normalization of the global monetary policy, the possibility of fiscal slippage in FY 2018 and the uncertainity regarding the fiscal consolidation trajectory in FY 2019 are additional headwinds.

Going forward, the fixed income market expects a pause in interest rates in the near term even as the CPI inflation prints could trend higher. Moreover, the CPI inflation print is expected to overshoot the RBI's second half FY 2018 CPI inflation projection range of 4.3-4.7%.

EQUITY MARKET OUTLOOK

The month of December 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain 2.74% and 2.97% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 6.22% during the same period.

The Indian equity market in the month of December 2017 rose despite weaker domestic macro-economic fundamentals such as rising CPI inflation registered in November, heightened geo-political tensions and elevated global crude oil prices. The robust domestic liquidity and the removal of the overhang of the uncertainties in the state election results supported the equity markets. The FII's turned net sellers in December even as the DII's continued to remain net buyers.

The robust returns of the Indian equity market in the month of December concluded CY 2017's stellar market performance on the back of expectations of strong earnings recovery in FY 2019 and beyond. The strong inflows from DII's has extended into the third consecutive year as well and has supported the market levels.

The government reviewed its Foreign Trade Policy and incentivised labour intensive MSME and agriculture exports benefiting sectors such as textiles, leather & footwear, handmade carpets of silk, handloom, coir and jute products, agriculture and marine products.

The RBI's financial stability review (FSR) expected the Gross NPA in the Indian banking system to increase from 10.2% in September 2017 to 10.8% by March 2018 and 11.1% by September 2018 in the base case scenario. RBI highlighted that, while slippages had been moderating, headline NPA levels are expected to remain high due to lower growth in advances and lower recoveries.

The government sought the parliamentary approval for an additional spend of ₹800bn towards recapitalization of public sector banks. This might not entail any cash outgo for the government as the additional spend is expected to be matched by the additional receipts on issue of securities, namely recapitalization bonds to public sector banks. This is the first tranche of the ₹1.35 tn bank recapitalization bonds that are planned to be issued as part of the overall ₹2.11 tn capital infusion plan for state owned banks.

The month of November saw a further acceleration in consumption and a pick-up in foreign trade. There was a surge in auto sales, albeit on the back of a favourable base, and higher engineering exports. The growth in freight was largely on account of the acceleration in Ports traffic even as the railway freight moderated. Moreover, the core sector data indicated a sharp acceleration in cement and steel output in November on a year on year basis. Other high frequency indicators such as airport passenger traffic and oil consumption registered robust growth. There was also increased hiring activity in November as well as robust PMI in manufacturing registered in December. However, the capex announcement and capex completion were at tepid levels.

The equity market, in the medium term is expected to be supported by improved earnings in FY 2019 on the back of a revival in the rural economy, higher levels of formalization in a slew of sectors, increased shift in household savings towards financial assets, higher discretionary spends, an up-tick in the global growth outlook enabling Indian exports, government's initiatives around affordable housing and higher commodity prices. The increasing premiumization in many product categories, positive wealth effects and implementation of the pay commission recommendation by states as well as early expectations of a normal monsoon could drive consumption. The nascent revival of the private sector capex, the PSU bank recapitalization plan and the initiatives of the government in the housing as well as the power sector could boost investments.

There has been a nascent revival of rural demand boosting private consumption which in turn could spur private sector investment momentum as capacity utilization rises. The policy initiatives for increasing rural incomes, promoting infrastructure and increased thrust on affordable housing is expected to remain favourable in the coming months. The risks to the Indian equity market stems from the possibility of deterioration of global factors such as higher crude oil prices and geo-political tensions as well as domestic factors such as a possibility of higher inflation and higher fiscal slippage.

With the domestic growth outlook improving, we believe that further benefits of the far reaching reforms will accrue in the medium term and that the equity market offers a reasonable entry point for a long-term investor with a 3-5 year view.

TATA AIA LIFE