

Dear Friends,

The month of February 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain around 3.9% and 3.7% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 6.9% during the same period.

On the global front, the minutes of the FOMC of the US Federal reserve indicated that many members felt it appropriate to hike interest rates fairly soon if the inflation and employment data came in along expected lines. The minutes also reflected the uncertainty regarding the new US administration's economic program. Meanwhile the new US administration outlined its broad economic agenda pertaining to infrastructure spending, trade as well as tax cuts for corporates.

On the domestic front, the resilience of the Indian economy was evident as reflected by the limited impact of demonetization on the GDP growth numbers as GDP grew by 7% year on year in the third quarter FY 2017, well above the market expectation of 6.1% even as the growth measured on a GVA basis stood at 6.6% year on year. Agriculture and allied activities delivered an above par growth of around 6% on a year on year basis on the back of a robust production of food grains during the Kharif (summer crop) season.

The industrial growth was broad based as seen from the Mining segment growth of 7.5% while growth in the manufacturing and electricity segments accelerated to 8.3% and 6.8% respectively. However, the growth in the construction segment, decelerated further, to 2.7% on expected lines. Services growth decelerated sharply to 6.8% year on year on the back of a marked slowdown in the 'financial, real estate and professional services' segment, which registered an anemic growth of just 3.1%. However, the services growth was supported by robust government spending as growth in 'public administration, defense and other services' segment picked up to 11.9%.

While the GDP print has surprised on the upside, high frequency economic activity indicators need to be monitored to get a clearer picture of the impact of demonetization on the informal sector of the economy. Moreover, the impact of inventory stocking in the supply chains, will be evident in the fourth quarter GDP data.

India's fiscal deficit reached 106% of the government's budget estimate (BE) during the period April-January 2017 even though the gross tax revenue was marginally ahead of target on FYTD basis at 18% year on year as against the Revised Estimate (RE) of 17%. The direct taxes during April-January 2017, grew 10% year on year, lower than the RE of 14% year on year on the back of a sharp slowdown in the corporate tax collections even as the growth in personal income tax collections was robust, albeit lower than the revised estimates. Indirect taxes grew at a robust 25% year on year in the April-January 2017 period as against the RE of 20%, largely led by higher excise duty and service tax collections even as the customs duty collection lagged. This was mainly on account of hikes in excise duty on petrol and diesel as well as revision in the service tax rate. The government spending was up 13% year on year during April-January 2017, broadly in line with the RE of 12.5% year on year on the back of a surge in revenue expenditure even as the capital expenditure declined.

Trade deficit in the month of January 2017 was at USD 9.8 bn, lower than USD 10.4 bn in the prior month. Exports growth in January was at 4.3% on a year on year basis against 5.7% in the prior month. Imports grew 10.7% on a year on year basis to USD 32 bn in January against 0.5% in the prior month. For the period April-January 2017, export growth was at a muted 1.3% while imports contracted by 5.6%.

The Consumer Price Index (CPI) inflation for January 2017 came in at 3.17%, lower than the market expectation of 3.24% and lower than the 3.4% registered in the prior month reflecting sustained easing of inflationary pressures in the food category. Wholesale Price Index (WPI) inflation for January 2017 increased sharply to 5.25%, higher than the consensus estimate of 4.3% and higher than the 3.4% in the prior month led by a surge in fuel and power segment as it inflated by 18.1% on a year on year basis in January as against 8.7% in the prior month. Some market experts expect the divergence between the elevated WPI and still moderate CPI inflation to further widen led by higher WPI in Q4 FY 2017 owing to higher commodity prices and adverse base effects.

Given the positive impact of far reaching reforms on the macro economy in the long term as well as a fiscally prudent credible budget, we 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 February 2017 saw the benchmark 10 year Government security (G-sec) close the month at 6.87%, hardening by 46bps over the month even as the 30 year G-sec hardened by 39 bps during the same period. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.80%, hardening by 50 bps over the month. In the month of February, the Foreign Portfolio Investors (FPIs) turned buyers of Indian debt.

The minutes of the Monetary Policy Committee (MPC) meeting held prior to the RBI's sixth bi-monthly policy review highlighted the upside risks to inflation while reiterating that the impact of demonetization on economic activity was transient and medium term growth rate remained intact. The RBI had kept the rates unchanged in its monetary policy review and its change in stance from accommodative to neutral surprised the market participants leading to a sell-off in bond market over the month of February.

The MPC expressed concern over sticky core inflation as well as the rise in global commodity prices. The MPC believed that demonetization had led to a distortion in the price levels given the 'fire' sales of goods such as perishables like vegetables, which could reverse very quickly as re-monetization gathered pace. The MPC was of the view that achieving 4% inflation target on a durable basis called for a change in stance to neutral which gave the RBI the flexibility to move either way depending upon inflation outcomes.

MPC members were of the view that the impact of demonetisation on the economy is likely to be temporary and thus did not warrant a rate cut. In addition, the surplus liquidity with the banks had led to decline in lending rates. The MPC opined that with remonetisation progressing rapidly, transmission of further rate cuts was unlikely.

The MPC believed that the environment for timely transmission of policy rates to bank's lending rates would be considerably improved if the banking sector's non-performing assets (NPAs) are resolved more quickly and efficiently, recapitalization of the banking sector is hastened and the formula for adjustments in the interest rates on small savings schemes to changes in yields on government securities of corresponding maturity is fully implemented.

Since April 2016, the RBI had conducted market liquidity operations consistent with the liquidity management framework, progressively moving the systemic liquidity conditions to close to neutrality. They expect this stance to continue even as the surplus liquidity would decline with progressive re-monetization beyond the early months of 2017-18. The RBI has reiterated its commitment to ensuring efficient and appropriate liquidity management with all the instruments at its command to ensure close alignment of the weighted average call rate (WACR) with the policy rate, improved transmission of policy impulses to lending rates and adequate flow of credit to productive sectors of the economy.

While RBI's continued resolve to keep liquidity at comfortable levels is a tailwind for the fixed income markets, the neutral monetary policy stance of the RBI as well as stickiness of the core inflation limit the possibility of any reduction of the repo rate in the near term. Moreover, upside risks to inflation from the allowances part of 7th pay commission, higher crude prices and the impending trends of the next south west monsoon reinforce the view that the RBI is expected to keep interest rates on hold in the medium term too as it assesses the inflation trajectory in FY 2018. The positive surprise of the third quarter FY 2017 GDP growth has further reduced the scope of a rate cut as it has mitigated any growth concerns.

Going forward, we believe that the data points on growth and inflation continue to remain key factors in shaping the monetary policy of the RBI.

EQUITY MARKET OUTLOOK

The month of February 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain around 3.9% and 3.7% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 6.9% during the same period. The FIIs were net buyers to the tune of USD 1.5 bn in the month of February while DII's were net buyers to the tune of USD 0.14 bn.

In the month of February, the Indian equity markets rallied as the Union budget was perceived to be reform oriented, balancing the twin objectives of fiscal consolidation and growth. Moreover, the third quarter FY 2017 earnings was largely above expectations even as the expectations themselves were muted due to the impact of demonetization. The third quarter earnings season saw a slew of companies in the materials space deliver robust results while most private sector banks exceeded expectations even as some companies in the auto sector and the healthcare sector delivered subpar earnings.

The commentary from corporate India broadly signal a greater impact of demonetization in rural areas and on SME businesses while the momentum in modern retail segment was evident. The bank deposits surged while the credit growth collapsed and companies in the services sector bore the brunt of the adverse impact. In the medium term, it is expected that demonetization would catalyze a shift in market dynamics towards the organized sector from the unorganized sector in a broad range of product categories across the spectrum.

At a granular level, muted rural demand was reflected in the tepid volume growth in rural focused FMCG companies and the decline in demand for two-wheelers and tractors. However, the urban demand had areas of strength as seen by robust air passenger traffic growth, strong steel demand and robust petrol consumption while consumer durables and real estate demand were pockets of weakness. A section of market see the possibility of a faster-than-expected recovery on the back of re-monetization in both rural and urban markets as seen by the trend towards normalization in categories such as passenger vehicle sales, decorative paints and cement volumes.

The third quarter FY 2017 GDP growth signaled a sharp pick up in manufacturing sector and steep acceleration in private consumption despite a slowdown of several high frequency indicators, such as FMCG sales, two-wheeler sales and credit growth during the quarter. The acceleration in the GDP could be due to a possible nascent shift towards formalization in some sectors which were earlier dominated by the informal sector, some preponement of demand amid note-ban and a likely inventory buildup in the supply chain of manufacturers driven by credit.

The second phase of the budget session of parliament, slated to commence on March 9th could see the passage of the IGST and CGST bills as there has been a broad based consensus on most sticky issues. The government seems on track to roll out the GST from July 1st 2017 and usher in the biggest reform on the indirect tax front in decades.

The legislative agenda and the productivity of the second phase of the budget session of parliament as well as the results of the five state elections could be the domestic events which could shape the trajectory of the Indian equity market. The monetary policy stance of the leading global central banks such as the ECB, US Federal Reserve and BoJ in their policy review meet in March would also act as near term triggers for the Indian equity market.

Given the positive impact of far reaching reforms on the macro economy in the long term as well as a fiscally prudent credible budget, we believe that the equity market offers a reasonable entry point for a long-term investor with a 3-5 year view.

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