Dear Friends,

The month of January 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain around 3.9% and 4.6% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 7.4% during the same period.

On the global front, the US GDP grew 1.9% in the fourth quarter, a tad lower than consensus estimate even as the consumption growth remained robust. Meanwhile, the new administration in the US has shown intent to roll back regulations to facilitate business investment in order to spur job creation, revisit international trade deals and tighten immigration laws.

On the domestic front, the Union budget FY 2018 sought to provide a fine balance between reviving economic activity by increasing the spends on infrastructure, agriculture and rural development while maintaining fiscal prudence. The budget aims to deliver the fiscal deficit of 3.2% of GDP in FY 2018 as against 3.5% in FY 2017. The government has proposed a modest 7% increase in overall government expenditure.

The union budget doubled the credit target for the MUDRA scheme, increased allocation to the rural housing & rural roads as well as aimed to augment the skill development plan. The budget gave a boost to the digital drive of the government, reduced the corporate tax rate for small and medium enterprises with annual turnover up to ₹50 cr, thereby benefitting 96% of the companies and widened the tax holiday for start-ups. The budget initiated a slew of reforms on various fronts as it sought to abolish the Foreign Investment Promotion Board (FIPB) in order to transition towards a more liberalized FDI regime. In a move to promote payments for large transactions through the formal economy, the budget restricted any transaction above ₹3 lakhs in cash.

In a bid to continue to delink the farm sector from the weather related disruption, the budget provided a higher allocation to the crop insurance scheme with the coverage of the scheme increased from 30% of cropped area in FY 2017 to 40% in FY 2018. The government sought to improve the price discovery for agricultural products by expanding the National Agricultural Market and nudged states to remove perishables from the APMC Act. The budget planned to set up a dedicated micro irrigation fund in NABARD as well as proposed to double the corpus of the long-term irrigation fund.

The initial estimate for indirect taxes for the period April-December 2016 indicates a growth of 25% over the same period last year led by excise tax collection and service tax while customs duty collection growth was muted. The initial estimate for net direct taxes for the period April-December 2016 indicates a growth of 11% over the same period last year. Government spending was up 12% year on year during April–December 2016, broadly in line with the Budget Estimate (BE) of 11.5% year on year for FY 2017 led by the 14% year on year increase in revenue expenditure even as the capital expenditure declined 4% year on year.

India's trade deficit in the month of December 2016 was at USD10.4 bn, lower than USD13 bn in the prior month. December exports growth was at an acceptable 5.7% on a year on year basis as against 2.3% in November. Imports grew 0.5% year on year to USD 34.3 bn in December against 10.4% growth in November. For the period April-December 2016, export growth was at 1% on a year on year basis while imports contracted by 7.2%.

The Consumer Price Index (CPI) inflation for December 2016 came in at 3.4%, lower than the market expectation of 3.5% and lower than the 3.6% registered in the prior month. December CPI inflation print reflected sustained easing of inflationary pressures in the food category. Wholesale Price Index (WPI) inflation for December 2016 was at 3.39%, higher than the 3.15% in the prior month.

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 January 2017 saw the benchmark 10 year Government security (G-sec) close the month at 6.41%, easing by 11bps over the month even as the 30 year G-sec eased by 7 bps during the same period. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.30%, easing by 16 bps over the month. In the month of January, the Foreign Portfolio Investors (FPIs) were sellers of Indian debt.

The fiscal deficit was contained at 3.2% of GDP in the Union budget for FY 2018 as against the 3.5% in FY 2017, signaling the government's commitment towards fiscal consolidation even though it slipped against the fiscal deficit of 3% of GDP in FY 2018 projected earlier. The central government's net borrowing via government securities was pegged at ₹3.48 tn in fiscal year FY 2018, similar to the prior fiscal. A large part of funding the fiscal deficit has been assumed through small savings receipts, pegged at a net receipt of ₹1 tn.

In its sixth bi-monthly monetary policy review, the monetary policy committee (MPC) of the RBI kept the policy repo rates on hold at 6.25% while changing the stance from accommodative to neutral with the objective of achieving CPI inflation of 5% by Q4 FY 2017 and the medium-term target of 4% within a band of +/- 2%, while supporting growth.

The MPC projected the GVA growth for FY 2017 at 6.9% but expected the growth to recover sharply in FY 2018 on account of a pickup in discretionary consumer demand that was held back by demonetization and the expectation of a rapid restoration of the economic activity in cash-intensive sectors such as retail trade, hotels & restaurants, and transportation, as well as in the unorganized sector. Additionally, the MPC opined that a sharp improvement in transmission of past policy rate reductions into marginal cost-based lending rates (MCLRs) spurring an uptick in both consumption and investment demand and the emphasis in the budget on stepping up the capital expenditure, as well as boosting the rural economy and affordable housing were favourable for growth. Accordingly, the GVA growth for FY 2018 was projected by the MPC at 7.4%.

On the inflation front, the MPC was concerned that the decline in headline CPI inflation in the months of November and December, though larger than expected, was almost exclusively on the back of deflation in vegetables and pulses. The MPC expected the prices of pulses to remain soft with comfortable supply conditions while opined that vegetable prices could potentially rebound as the effects of demonetization wear off. The MPC was of the view that the persistence of inflation excluding food and fuel could set a floor on further downward movements in headline inflation and trigger second-order effects. The RBI projected the inflation in the range of 4 to 4.5% in the first half of FY 2018 and in the range of 4.5 to 5% in the second half of FY 2018.

In this context, the RBI noted the hardening profile of international crude oil prices, volatility in the exchange rate on account of global financial market developments imparting upside pressures to domestic inflation and the fuller effects of the house rent allowances under the 7th Central Pay Commission award as upside risks to inflation even as the government's fiscal prudence reflected in the union budget could limit some upside risks.

The MPC reiterated its commitment to bringing headline inflation closer to 4% on a durable basis in a calibrated manner and opined that this required further significant decline in inflation expectations, especially since the services component of inflation that was sensitive to wage movements had been sticky. The MPC's decision to change the stance from accommodative to neutral while keeping the policy rate on hold was to assess how the transitory effects of demonetization on inflation and the output gap play out.

The MPC was of the view that the transmission of policy rates to bank's lending rates will be considerably improved if the banking sector's NPAs were resolved more quickly and efficiently, recapitalization of the banking sector 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.

Given the neutral monetary policy stance of the RBI as well as stickiness of the core inflation there could only be a limited possibility of any reduction of the repo rate in the near term. We believe that the data points on growth and inflation in the coming months will remain key factors in shaping the monetary policy of the RBI.

EQUITY MARKET OUTLOOK

The month of January 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain around 3.9% and 4.6% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 7.4% during the same period. The FIIs were net sellers to the tune of USD 0.15 bn in the month of January while DII's were net buyers to the tune of USD 0.7 bn with insurance companies net sellers to the tune of USD 0.1 bn and mutual funds net buyers to the tune of USD 0.8 bn.

In the month of January, the Indian equity markets rallied on the expectation of an investor friendly Union budget as well as a better than expected third quarter earnings season despite the impact of demonetization, as seen by early results, even as the equity market had to navigate some sector specific disruptions from the possible actions of the new US administration.

In the third quarter FY 2017 earnings season, a slew of companies in a range of sectors such as financials, energy and building materials either beat or met the subdued expectations post demonetization. However, some companies in the consumer centric sectors such as the FMCG and consumer discretionary space have given cautious revenue guidance for the forthcoming quarters. IT sector continued to deliver muted results with tepid guidance.

The Union budget FY 2018 focused on reviving public investment for roads, railways and other infrastructure sectors. The budget planned to upgrade airports in Tier-II cities through public-private-partnership (PPP) route as well as raise resources through the effective monetization of land assets. The budget announced a specific programme to implement the development of multi-modal logistics parks accompanied by multi-modal transport facilities in a bid to improve port connectivity and benefit port logistics. The budget provided a boost to further digitization by seeking to expand the broadband connectivity in rural areas.

The budget proposed setting up of an integrated oil and gas public sector enterprise (PSE) to improve economies of scale, target overseas acquisition for higher energy security and increase the bargaining power for crude oil and LNG import over the long term. The budgetary allocation for further augmenting strategic petroleum reserves for crude oil in order to improve energy security was increased.

The government has set an ambitious target of ₹725 bn for resource mobilization from the sale of public sector enterprises (PSE's). The government hopes to list several profit making PSE's in a time bound schedule in the stock exchanges. The government also plans to launch a new diversified ETF in FY 2018 with a broader base of PSE's to reduce the sector concentration.

In an effort to revive the real estate sector, the budget provided higher allocation for housing for poor, beneficial policy changes for low cost affordable housing and lowering holding period for real estate to be eligible for long-term capital gains tax. The budget gave a boost to the affordable housing by providing it the infrastructure status which would reduce cost of borrowings and ease funding issues. This move along with the interest subvention scheme is expected to provide an impetus for affordable housing.

The budget has given a boost to textile infrastructure by increasing the allocation by almost three times to promote employment through building textile parks, incubation facilities, processing and development centers. The government plans to launch a scheme for the labour intensive leather and footwear sector to boost growth aimed at creating more jobs.

Going forward, government's continued reforms to improve the ease of doing business, the timely rollout of the GST, the increased formalization of the economy through the focus on digital transactions, the shift to financial savings as well as sustained period of low interest rates in the economy should catalyze the acceleration of corporate earnings growth.

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