Dear Friends,

The month of June 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed around 0.7% and 1% respectively. However, the Mid-cap index, Nifty Free Float Mid-cap 100 gained around 1.3% during the same period.

On the global front, the FOMC of the US Federal reserve increased the Fed funds rate by 25 bps to the range of 1.0-1.25%, broadly on expected lines retaining the dot plot which indicated one more rate hike in CY2017 and three more in CY2018. Further, it outlined the roadmap of its balance sheet reduction plan without communicating any start date. Meanwhile, the European Central Bank (ECB) changed its forward guidance to make it marginally less accommodative, consistent with the improving growth outlook even as political risks in the Eurozone receded on the back of the decisive results in the French election.

On the domestic front, the landmark reform, the Goods & Services Tax (GST) was rolled out with effect from July 1st 2017 with the government stepping up its communication efforts to reach a large number of SMEs to address the initial concerns in order to ensure a smooth transition to the GST regime. The GST is expected to increase tax revenues by improving compliance and catalyze GDP growth by unifying the national market. Additionally, the productivity gains through efficient logistics as well as improving the ease of doing business would accrue in the medium term.

India's fiscal deficit in April-May 2017 was at an elevated 68.3% of the full fiscal 2018 budget estimate even though the gross tax collections grew 25%, higher than the 11.3% growth budgeted in FY2018. However, the frontloading of expenditure resulted in the total expenditure increasing 54% with capital expenditure growing 58.1% even as revenue expenditure grew 53.5%.

The Current account deficit (CAD) for the fourth quarter FY 2017 improved to USD 3.5 bn compared to USD 8 bn in the prior quarter. The fourth quarter FY17 capital flows was at USD10.4 bn and printed USD 36.5 bn in the fiscal 2017.The balance of payment swung to a surplus USD7.3bn in Q4FY17 from a negative USD1.2bn last quarter, on the back of an improvement in the current account and capital account balance. For the full year FY 2017, the surplus stood at USD 21.6bn.

CPI inflation printed a record low of 2.18% in the month of May on the back of a contraction of 1% in food inflation. The Core CPI inflation continued to slide down and registered 4.1% in May. The WPI inflation in the month of May fell sharply to 2.17% as against 3.85% in April. Core WPI inflation picked up marginally to 2.1%, largely owing to sharp sequential increase in basic metals.

The 7th Central Pay Commission (CPC) recommendations pertaning to allowances have been approved by the Union government and shall come in force from 1st July impacting 4.8 mn Central government employees. This would entail an increase of ₹307 bn per annum in the central government budget, roughly 0.18% of GDP.

The Cabinet Committee on Economic Affairs gave its 'in-principle' approval to the strategic disinvestment of Air India and five of its subsidiaries and proposed the creation of an group of ministers to guide the process on strategic disinvestment and decide on issues such as the treatment of unsustainable debt of Air India, hiving off certain assets, demerger and strategic disinvestment of three profit-making subsidiaries and quantum of disinvestment.

The south west monsoon has started on a robust note with the cumulative rainfall at 6% above normal till 2nd July on the back of weakened El Nino conditions. A large part of India has seen normal to excess rainfall thus far barring some states in the East. The water storage in 91 reservoirs increased to 19% of full capacity, lower than the 5 year average of 21% for the month of June.

The Kharif (summer crop) sowing has started on a strong note with the total Kharif acreage at 18.9% higher than the same period last year as on June 30th with the acreage of rice and oil seed sowing 0.4% and 8.6% lower even as acreage of pulses was 44.2% higher than last year. Acreages under coarse cereals and sugarcane ticked up while cotton acreage surged as compared to the prior year.

The government has set Minimum Support Prices (MSP) for the Kharif (summer) crop for the fiscal year 2017-18 with the average increase in MSP pegged at 6.2%, broadly similar to the last year's hike of around 5%. The government has also asked states to step up procurement to enforce MSPs as the anchor for the market prices.

With key macroeconomic indicators looking robust in the backdrop of the positive impact of far reaching reforms, 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 June 2017 saw the new benchmark 10 year Government security (G-sec) close the month at 6.51%, easing by 15 bps over the month. The 30 year G-sec eased by 23bps over the month to close at 7.12%. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.42%, easing by 22 bps over the month. In the month of June, the Foreign Portfolio Investors (FPIs) remained buyers of Indian debt. The Indian fixed income yields eased across the board in June as the CPI inflation print remained below market expectations in the month of May.

The minutes of the meeting of the Monetary policy committee (MPC) in the second bi-monthly monetary policy review for fiscal FY 2018, where it held the repo rate at 6.25%, indicated some signs of divergent opinion among members regarding the trajectory of inflation going forward and consequently the response of the MPC in its monetary policy review. The MPC had to effect a sharp downward revision of its earlier projected inflation trajectory, especially for the first half of fiscal FY 2018.

Many MPC members were surprised by the large fall in the CPI inflation in April and expected it to rebound in the coming months on the back of the risk of fiscal slippages on account of announcements of large farm loan waivers, global political and financial risks materializing into imported inflation and the disbursement of allowances under the 7th central pay commission even as they expected the implementation of the GST to have no material impact on overall inflation. They also expected the easing of inflation excluding food and fuel to be transient in view of its underlying stickiness in a situation of rising rural wage growth and strong consumption demand.

One member of the MPC expressed the need for a decisive policy action and recommended slashing the repo rate by 50 bps on the back of a sharp fall in the CPI inflation print, a declining trend of core inflation as well as the advance inflationary expectations as per the RBI survey of households declining to among the lowest levels observed in the history of such surveys. He opined that the capacity utilization had persistently remained below 75% for a long time indicating the existence of a large output gap and expected the recent policy reforms to increase the potential output and growth in the economy implying persistent if not widening output gap in the near to medium term. Additionally, the member highlighted the positive monsoon forecast, benign oil price outlook, stable exchange rate enabling FII and FDI flows into India in the backdrop of a high degree of political stability and robust GDP growth. He opined that under such circumstances, becoming cautious and not acting on the repo rate amounted to ignoring all costs associated with not supporting growth in terms of unemployment and poverty reduction.

On the other hand there was a view expressed in the MPC that there was a need to focus on steering the trajectory of inflation towards its target over the medium-term and dealing with the risks around it and not on conducting monetary policy by looking at the most recent inflation prints or deviations of recent outcomes from projections that cannot be presumed to be durable. The recent deflation of 15.9% in the prices of pulses and 8.6% in the prices of vegetables would not be the steady state that will define the medium-term food inflation path when the agricultural wages rose by 8.5%, farm input costs by 10%, bank credit to agriculture by 13.5% in the prior year and the output gap in agriculture was turning positive on rising rural income. In a situation in which transitory and structural factors impacting inflation were interlinked and difficult to decouple, it is possible to make policy errors that can be large and costly in the medium-term and hence the repo rate would have to be held at current level.

The RBI announced an Open market operation (OMO) sale of ₹100bn of G-secs, first since July 2015, to mop up excess liquidity in the system. The excess liquidity stands at an average of ₹4.7 tn in June and hence this OMO sale was a step towards moving the system to neutral liquidity. However, the RBI would need to balance the need to drain the surplus liquidity through continued OMO sale with the objective of no large distortion in the prices of G-secs.

Going forward, the fixed income market will be taking positive cues from the satisfactory onset and progress of the south west monsoon as well as the robust Kharif (summer crop) sowing seen across most major crops. A section of the market participants expect the RBI to nudge the repo rate downwards in the third bi-monthly monetary policy review in August. In the near term, the inflation prints in the first half of FY 2018 in the range of 2.0-3.5%, in line with RBI's revised projected trajectory, would be the key data point to shape the trajectory of the fixed income yields.

EQUITY MARKET OUTLOOK

The month of June 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed around 0.7% and 1% respectively. However, the Mid-cap index, Nifty Free Float Mid-cap 100 gained around 1.3% during the same period.

The Indian equity market in the month of June was weighed down by the concerns regarding GST implementation and its effect on the first quarter fiscal 2018 earnings, the RBI's directive to banks to increase provisioning on accounts referred for bankruptcy and the announcement of farm loan waiver by the states of Maharashtra, Punjab and Karnataka following the announcement by Uttar Pradesh earlier. On the economy front, the CPI and WPI inflation print fell sharply, surprising on the downside even as the growth in Industrial production was reasonable and the Current account deficit (CAD) was contained.

The first quarter FY 2018 earnings is expected to be impacted by the pre-GST roll-out uncertainties for companies focused on domestic consumption while a strong exchange rate could impact earnings of exporters. On a sectoral basis, many private sector banks as well as select industrials could deliver acceptable earnings growth while some companies in the telecom, oil & gas and pharma could be among the laggards.

The GST is expected to play a game changing role in many large sectors of the Indian economy such as apparels, consumer electricals and building materials by catalyzing the shift in market share from the unorganized to the organized segment. The GST will increase the cost competitiveness in the manufacturing sector by delivering productivity gains through pruning logistics and warehousing costs. The GST will eliminate the tax arbitrage between neighbouring states and reduce compliance costs. Moreover, the GST will improve transparency through automated processes for refunds and tax payments and is expected to reduce the public interface between the manufacturer and the tax administration.

The Financial Stability Report (FSR) released by the RBI stated that the GNPAs of banking sector rose even as the stressed advances as a percentage of total assets declined between September 2016 and March 2017 due to the fall in restructured standard advances. The Capital to Risk-Weighted Assets ratio (CRAR) improved marginally during this period while the share of large borrowers, both in bank's total loans portfolio as well as GNPAs showed a reduction between September 2016 and March 2017.

The RBI's Internal Advisory Committee advised banks to take twelve companies with exposure greater than ₹50 bn and contributing to around 25% of NPLs to the National Company Law tribunal to frame a resolution under the Insolvency and Bankruptcy Code (IBC). In addition, the RBI has given a broad guideline that accounts with outstanding greater than ₹50bn where at least 60% of the amount has been classified as NPA can be taken up for bankruptcy proceedings. Market experts opine that while referrals to IBC could accelerate the move towards large stress asset resolution, it will also trigger additional provisioning, and hence greater capital needs, particularly for the state owned banks.

An inter-ministerial panel has been set up by the government to address the issues pertaining to the financially distressed telecom sector. Earlier, the RBI had directed banks to create provisions for the telecom sector at a rate higher than the standard assets rate as interest coverage ratio had deteriorated.

The economic activity in recent months has signalled a recovery as seen by the robust fuel consumption, power generation, two-wheeler sales and domestic air passenger traffic. There could have been a rundown of the inventory of the trade channel in the month of June ahead of the GST rollout from July 1st though this is expected to be transient and could normalize in the September quarter itself. Moreover, the strong south west monsoon thus far as well as the initiatives taken by the government to increase the investment in irrigation, crop insurance and the thrust to rural housing could support rural incomes and catalyse a rural recovery in the medium term. The government's frontloading of public capex is another key driver of economic activity.

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