Dear Friends,

The month of November 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed 0.2% and 1.1% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 gained 1.6% during the same period.

On the global front, the minutes of the FOMC of the US Federal reserve (Fed) indicated another rate hike in December but concern over low inflation might delay the Fed's tightening schedule in CY 2018. The Fed Chairman nominee Jerome Powell represented consistency in monetary policy even as the regulatory policy could be more relaxed. The third quarter US GDP growth was revised up from 3% to 3.3%, above consensus of 3.2% growth reflecting the broad basing of growth to business investment.

On the domestic front, Moody's upgraded India's sovereign rating to Baa2 from Baa3 after a gap of almost 14 years on the back of significant reforms and policy measures such as implementation of GST, demonetization, an effective monetary policy framework as well as the rollout of the Unique identification and Direct benefit transfer framework. Moody's highlighted that the challenges remain in certain areas such as land and labour market reforms, private sector investments, and resolution of the banking sector's asset quality issue. Meanwhile, Standard & Poors (S&P) kept India's ratings unchanged at 'BBB-' with a 'stable' outlook expressing concern over relatively high government debt and low per capita income,. However, S&P expects the rising private consumption, the public infrastructure investment program and the bank restructuring plan to help revive investment and consequently deliver a higher trajectory of GDP growth.

The Monetary Policy Committee (MPC) of the RBI in its fifth Bi-monthly monetary policy decided to keep the policy repo rate unchanged at 6%, consistent with a neutral stance 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.

India's GDP growth rebounded to 6.3% on a year on year basis in the second quarter FY 2018 after decelerating for five quarters, led by manufacturing sector which grew by 7% from 1.2% registered in the prior quarter on the back of an early festival season and re-stocking of the supply chain. Mining output increased by 5.5% compared with a decline of 0.7% in Q1FY18 due to higher coal production. The GVA growth in the electricity also strengthened on higher demand. Construction output remained tepid with a growth of 2.6% in Q2FY18 as against 2% in the prior quarter due to transitory effects of the RERA and GST implementation. Agriculture growth at 1.7% was expectedly lower as the kharif (summer crop) production declined year on year. Services growth decelerated to 7.1% in the second quarter FY 2018 from the impressive 8.7% in the prior quarter. Among the services, growth in 'trade, hotels, transport, communication' was robust at 9.9% in the second quarter. 'Financial, insurance, real estate and professional services' performance was muted at 5.7% as real estate has been facing significant regulatory headwinds. However, the biggest dip in growth was seen in public administration and defence on the back of relatively lower general government spending.

Central government's fiscal deficit widened to around ₹5.3tn or 96.1% of the full year target during April-October 2017. Revenue expenditure grew 10.1% in April-October 2017 period as against the budgeted growth of 5.9% while the capital expenditure grew 30.3% in April-October17 period against the budgeted growth of 10.7%. A major part of the expenditure thus far this year, has been on account of frontloading payment for food subsidy, higher fuel and fertilizer subsidy, higher expenditure for rural and urban development and roads. Non tax revenue has been impacted by the lower dividend transfer from the RBI to government even as robust disinvestment proceeds has cushioned the impact to an extent. Direct tax collections grew by 13.8% year on year in April-October 17, lower than the budgeted 15.7% growth rate for the year on the back of a moderate rise in personal income tax even as the corporate tax collections has exceeded budget expectations thus far.

Trade deficit in October was at USD14 bn, higher than USD 9 bn in September. October exports at USD 23.1 bn contracted 1.1% against the robust growth of 25.7% seen in September. Non-oil exports contracted 3.3% in October against a growth of 23.9% in September. A sustained increase in exports of engineering goods, petroleum products and chemicals during the month was outweighed by a sharp fall in shipments of gems and jewellery, ready-made garments, and drugs and pharmaceuticals. Imports at USD 37.1 bn grew 7.6% in October against 18.1% growth in the prior month with the oil imports at USD 9.3 bn and non-oil imports at USD 27.8 bn. Although gold imports rose sequentially in October, they moderated from their level a year ago.

The Consumer Price Index (CPI) inflation for October 2017 came in at 3.58%, higher than the market expectation of around 3.4% and higher than the September CPI inflation print of 3.28%. The October CPI inflation reflected the higher level of inflation in some components in the food category. Wholesale Price Index (WPI) inflation for October 2017 increased sharply to 3.6% on a year on year basis, higher than the 2.6% registered in the prior month. The CPI inflation is expected to inch up further in the near term on the back of adverse base effect, higher global commodity prices and the continuing impact of the HRA revisions in the 7th central pay commission.

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

DEBT MARKET OUTLOOK

Debt market in the month of November 2017 saw the benchmark 10 year Government security (G-sec) close the month at 7.06%, hardening by 20 bps over the month. The 30 year G-sec hardened by 17 bps over the month to close at 7.48%. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.72%, hardening by 12 bps over the month. In the month of November, the Foreign Portfolio Investors (FPIs) turned net sellers of Indian debt.

The Indian fixed income market has been under pressure in the month of November on the back of rising inflation, fear of fiscal slippages, rising oil prices and OMO sales by the RBI even as the sovereign rating upgrade and the recent cancellation of the OMO sale provided some support to the yields.

The Monetary Policy Committee (MPC) of the RBI in its fifth Bi-monthly monetary policy decided to keep the policy repo rate unchanged at 6%, consistent with a neutral stance with the objective of achieving the medium-term target for CPI inflation of 4% within a band of +/- 2%, while supporting growth.

On the inflation front, the MPC noted that the headline inflation outcomes had evolved broadly in line with their projections even as the moderation in inflation excluding food and fuel observed in the first quarter FY 2018 had largely reversed. Moreover, while the impact of HRA by the central government was expected to peak in December, the staggered impact of HRA increases by various state governments could push up housing inflation further in 2018, with attendant second order effects. The MPC highlighted the risk of a sustained rise in international crude oil prices on account of the OPEC's decision to maintain production cuts through next year accompanied by a possibility of an adverse supply shock due to geo-political developments. On the other hand, some seasonal moderation in the prices of vegetables expected in near months on the back of winter arrivals, continued downward bias in the prices of pulses and the reduction of the the GST rates of several retail goods and services to lower tax brackets thereby translating into lower retail prices could mitigate some inflationary pressures. On the whole, the MPC estimated inflation in the range 4.3-4.7% in the second half of fiscal FY 2018, including the HRA effect of up to 35 bps, with risks evenly balanced

The MPC highlighted that the evolving inflation trajectory needed to be carefully monitored as two of the key factors determining the cost of living conditions and inflation expectations, food & fuel inflation, edged up in November. Inflation expectations of households surveyed by the RBI had already firmed up and any increase in food and fuel prices might further harden these expectations. The rising input cost conditions as reflected in various surveys pointed towards higher risk of pass-through to retail prices in the near term. The MPC opined that the implementation of farm loan waivers by select states, partial roll back of excise duty and VAT in the case of petroleum products, and decrease in revenue on account of the reduction in GST rates for several goods and services might result in fiscal slippage with implications for inflation. The MPC was concerned that the global financial instability on account of the uncertainty over monetary policy normalisation in the advanced economies and the fiscal expansion in the US carried risks for inflation.

Accordingly, the MPC decided to keep the policy repo rate on hold. However, keeping in mind the output gap dynamics, the MPC decided to continue with the neutral stance and watch the incoming data carefully. The MPC remained committed to keeping headline inflation close to 4% on a durable basis.

Surplus liquidity in the system continued to decline during October and November. The RBI managed surplus liquidity through the conduct of regular variable rate reverse repo auctions of various tenors, ranging from overnight to 28 days. Net average daily absorption of liquidity under the LAF declined from ₹2.23 tn in September to ₹1.4 tn in October and further to ₹718 bn in November. The RBI conducted open market sales of ₹300 bn in October-November, taking the total absorption of durable liquidity during the financial year FY 2018 so far to ₹1.9 tn, comprising ₹900 bn in the form of open market sales and ₹1 tn of long-term treasury bills under the market stabilisation scheme.

Despite the Moody's upgrade,the RBI is expected to be focused on the trajectory of inflation, especially as the growth has seen an uptick in the second quarter FY 2018. The support to the fixed income market is seen from the offshore investors as the real rates in India have remained attractive as compared to its Asian peers.

Going forward, the fixed income market expects a pause in interest rates in the near term as the CPI inflation prints could trend higher in the next few months. However, the CPI inflation prints is expected to be broadly in the range of 4.3-4.7%, in line with the RBI's second half FY 2018 CPI inflation projection. The key risks to the fixed income market remains the prospect of an overshoot of CPI inflation limiting RBI's accommodation, the possibility of fiscal slippage and adverse global financial conditions & geopolitical risks.

EQUITY MARKET OUTLOOK

The month of November 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed 0.2% and 1.1% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 gained 1.6% during the same period.

The month of November was volatile on the back of geopolitical tensions, rising crude oil prices and concerns of fiscal slippage even as there was a slew of positive domestic news flow such as an impressive increase in ranking in the World Bank's ease of doing business survey for 2018, Moody's upgrade of India's sovereign rating to Baa2 from Baa3 and an expectation of an economic recovery in the second quarter GDP numbers, which supported the Indian equity market. The FII's remained net buyers over the month of November and the DII's remained net buyers over ten out of eleven months in CY 2017.

The second quarter FY 2018 earnings saw the companies making up the Nifty 50 universe deliver an aggregate revenue growth of 10% even as their PAT grew 12% on a year on year basis.The second quarter earnings also saw the impact on higher commodity prices on gross margins of manufacturing firms in a slew of sectors such as cement, two-wheelers and agro chemicals. There was some sign of a GST led restocking catalysing volume growth of rural-oriented companies in agrochemical, FMCG, and two wheelers. Order book growth of infrastructure companies remained robust.

In a landmark reform, the government passed an ordinance debarring promoters with a greater than 1 year old NPA accounts and wilful defaulters from bidding for assets under the insolvency and bankruptcy code (IBC) process and from buying assets in case of sale by the liquidator, thereby removing the moral hazard being faced by creditors regarding assessment of promoter bids. This move in the long term should entail better borrower discipline though in the short term, the resolutions might suffer from larger haircuts as the number of incremental bidders reduces.

The GST Council reduced the rates for 211 items across various tax slabs led by 178 items in the 28% tax slab in a range of categories such as food, grooming, personal accessories, wood, rubber, stone & ceramics and kitchen appliances. Only around 50 items are now in the 28% slab which are mostly demerit, sin, and luxury goods. The government appointed the chairman and members of the Anti-profiteering authority tasked with ensuring that the benefit of reductions in the tax burden under the GST in the form of lowering the tax rates as well as input tax credits reached the end consumers. It is also expected to lay out the methodology to determine what constitutes profiteering in various businesses.

The sovereign rating upgrade from Moody's is expected to be positive for companies in the infrastructure and finance space which have routinely borrowed from the overseas market as better rating should lead to lower risk premium and hence lower funding costs. While the large companies in the financial sector are seen as proxies to the Indian economic growth outlook, the infrastructure sector would have access to larger pools of cheaper funds to fund the large capex for the Infra sector over the next five years.

In an effort to boost affordable housing, the central government has increased the area of a unit on which a first time buyer can avail benefits under the Credit link subsidy scheme (CLSS) under the Pradhan Mantri Awas Yojna (PMAY). This increase in area will offer buyers greater choice of housing projects and also help the sale of ready flats in the affordable housing segment.

The high-frequency indicators suggest a mixed picture of economic activity. In the month of October, growth in some high frequency indicators such as auto sales, trade, fuel consumption and power generation had slowed even as services related indicators like domestic and international air passenger & freight traffic and railway traffic had improved. Also, according to the RBI's Industrial Outlook Survey (IOS), production is expected to pick up in the third quarter as order books are rising. The RBI's survey suggested that sentiments on service sector activity for the third quarter were upbeat and auto sales have rebounded in November. On the other hand, PMI for services moved into contraction zone in the month of November.

The RBI highlighted that there had been several significant developments in the recent period which augur well for growth prospects, going forward. The capital raised from the primary capital market has increased significantly and would be deployed to set up new projects, thereby augmenting demand in the short run as well as boosting the growth potential of the economy over the medium-term. The improvement in the ease of doing business ranking should help sustain foreign direct investment in the economy. Moreover, large distressed borrowers were being referenced to the IBC and public sector banks were being recapitalized, which should enhance allocative efficiency.

Going forward, growth numbers of many high frequency indicators will benefit from the low base and the withdrawal of the GST transition impact and this would translate into a recovery of corporate earnings as well. 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.