Dear Friends,

The month of October 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain 6.17% and 5.59% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 8.12% during the same period.

On the global front, the European central bank (ECB) announced that it will reduce its bond-buying to EUR30 bn per month from January 2018, down from the current level of EUR60 bn per month. The ECB highlighted that the recalibration of the asset purchases reflected growing confidence in the gradual convergence of inflation rates towards the inflation target on account of robust and broad-based economic expansion. The US real GDP grew 3% in the third quarter CY 2017, above market consensus of 2.6%, the second consecutive quarter of US growth around 3%, confirming that activity data had stayed strong despite the drag from hurricanes with consumption as the main driver of growth.

On the domestic front, the Union government announced a robust and credible PSU bank recapitalization plan of ₹2.11 tn over the next two years with the bulk of the recapitalization through the recapitalization bonds worth ₹1.35 tn. Further, the budgetary support will be to the tune of ₹181 bn, which is already part of the ongoing budgetary capital infusion plan and the remaining ₹580 bn to be raised by the banks from the market while diluting government equity.

India's ranking in the World Bank ease of doing business survey for 2018 climbed a record 30 notches to 100 on the back of regulatory and policy reforms as India improved its ranking on six out of the 10 parameters used to measure the ease of doing business. On the 'distance to frontier' metric, which measures the absolute improvement in the performance of a country against better-performing countries, India notched up an impressive performance signalling a steady shift towards the best practices in business regulation. The report highlights significant improvement made by India in the areas of access to credit, protection of minority investor interests and resolving insolvency even as enforcing contracts, registering property and dealing with construction permits remain areas of concern.

In a significant move to address the implementation bottlenecks in GST, the GST council focused on providing faster refunds to exporters, relief for small businesses, and rationalizing tax rates across certain goods and services. The GST council also decided to increase the limit under the composition scheme for small businesses and allowed small companies to file quarterly income returns and pay tax accordingly.

There was an improvement in the fiscal trend in the month of September on account of a sharp compression in government expenditure and buoyant indirect tax revenues as the cumulative fiscal deficit for H1 FY 2018 declined to 91.3% of full year budget estimate from the 96% registered in the April-August period. However, the level of the fiscal deficit in H1FY 2018 is still elevated as compared to the H1FY 2017 level of 84% of full year target. The government tax revenues rose by over 20% year on year in the first half FY 2018 as against the the budgeted growth of 13%. The direct taxes rose by a modest 13.5% year on year on the back of weaker corporate tax revenues even as the indirect taxes including GST collections increased by a robust 23% year on year in the first half FY 2018. Going forward, the volatility in GST collections and the extent of input tax credit refunds will determine the trajectory of indirect tax collections. While, the government has received just ₹197bn during the first half FY 2018 in divestment proceeds, around 27% of disinvestment target of ₹725bn budgeted for the entire fiscal FY 2018, there may not be much slippage on this front, given a robust divestment plan in the second half FY 2018.

Trade deficit in the month of September was at USD 9 bn, lower than USD 11.6 bn in August. September exports were at USD28.6 bn growing 25.7% against the growth of 10.3% registered in August with the non-oil exports growing 23.9% in September against 6.9% in August. Imports in the month of September were at USD 37.6 bn growing 18.1% in September against 21% in August with oil imports at USD 8.2 bn and non-oil imports at USD 29.4 bn.

The Consumer Price Index (CPI) inflation for September 2017 came in at 3.28%, lower than the market expectation of around 3.53% and similar to the downwardly revised August CPI inflation print of 3.28%. The September CPI inflation print reflected easing of inflationary pressures in some components in the food category. WPI inflation moderated to 2.6% in September compared to 3.24% in August. Core WPI inflation rose in September to 2.8% as against 2.5% in the prior month led by the adverse base effect and sequential increase in prices due to higher global commodity prices.

The recent high frequency data on a host of indicators signal a bottoming out of India's growth in the first quarter FY 2018 and a possible broadbased recovery in the second quarter. We continue to believe that the 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

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DEBT MARKET OUTLOOK

Debt market in the month of October 2017 saw the benchmark 10 year Government security (G-sec) close the month at 6.86%, hardening by 19 bps over the month. The 30 year G-sec hardened by 2 bps over the month to close at 7.31%. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.60%, hardening by 13 bps over the month. In the month of October, the Foreign Portfolio Investors (FPIs) remained net buyers of Indian debt.

The minutes of the Monetary Policy Committee (MPC) of the RBI in its fourth Bi-monthly monetary policy in October, which kept the policy repo rate unchanged at 6%, reiterated the cautious approach of most members as they expected CPI inflation to inch upwards. The MPC highlighted several upside risks to inflation from the surge in international crude oil prices, the impact of an expected decline in the production of foodgrains due to lower sowing during the Kharif (summer crop) season; the short-term GST related uncertainty; the effects of a possible central government stimulus; the likely fiscal slippages due to the farm loan waivers; and the introduction of the pay commission award by the states. Fiscal slippage concerns and possible volatility in global markets seem to worry a few members. Most members acknowledged some softening in inflation expectations in the recent period even as the downward rigidity of inflation was still a concern expressed by some members of the MPC.

On the output front, the MPC opined that the GDP growth slowed significantly in the first quarter of FY 2018, reflecting slower agricultural and manufacturing growth along with tepid consumption and investment demand. The muted first quarter FY 2018 GDP was explained by the the pre-GST destocking in the supply chain as well as the deleveraging underway in the heavily indebted parts of the corporate sector along with the poor credit growth of public sector banks given their inadequate capital relative to impending losses on legacy assets. Most MPC members expect growth to recover cyclically in the second half of FY 2018, but do acknowledge the structural constraints to growth in the form of low capacity utilization, debt overhang of corporate and stressed assets of the banking sector.

One member opined that there was a high cost of sacrificing output growth when inflation situation was practically under control in the near to medium term and believed that there was space for a reduction of about 40 bps at present with due consideration to any possible upward risk to future inflation. On the other hand, there was a view towards the other extreme as another member insisted on targeting 4% inflation on a durable basis and not shying to raise policy rates to quell the underlying drivers of inflation if they strengthen further.

The MPC noted the lower economic activity in the first quarter FY 2018 but opined that the growth would rebound as the impact of the GST fades. The MPC was of the view that the recapitalisation of PSU banks, infrastructure push, restarting stalled projects and faster rollout of affordable housing programme could drive investment activity.

The MPC opined that the future trajectory could be impacted by elevated global commodity prices, rupee depreciation and lower production of some of the Kharif crops. With the trajectory of headline CPI inflation close to the RBI projections and the core inflation sticky and elevated, the MPC noted that the RBI had limited room for further accommodation and any further reduction in the repo rate in the near term required a surprise in inflation on the lower side.

The Union cabinet approved a robust bank recapitalization plan to the tune of ₹2.11 tn for the state owned banks of which ₹1.35 tn would be funded through recapitalization bonds. While the specifics of the recapitalization bonds are yet to be finalized, these bonds are expected to be outside the fiscal deficit depending upon the issuing authority. If this plan is intended to be cash-flow neutral as well as deficit-neutral, it might not be disruptive for bond markets, especially as no additional government bond issuance would be required.

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, continued OMO sales and adverse global financial conditions & geopolitical risks. The support to the fixed income market is seen from the the continued inflows from 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 are expected to be broadly in the range of 4.2-4.6%, in line with the RBI's second half FY 2018 CPI inflation projection.

EQUITY MARKET OUTLOOK

The month of October 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 gain 6.17% and 5.59% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 surged 8.12% during the same period.

The Indian equity market in the month of October surged due to the robust and credible bank recapitalization plan of the government, the announcement of the big ticket road infrastructure project, improving macroeconomic fundamentals seen from a softer than expected CPI inflation, higher IIP growth, lower trade deficit as well as traction in a host of high frequency data-points signalling a broad based recovery. The FII's turned net buyers over the month of October after their net sell stance in August and September even as the DII's remained net buyers over nine out of ten months in CY 2017.

On an aggregate level, the second quarter FY 2018 earnings thus far, have been broadly in line with reasonable volume growth seen in many FMCG and automobile companies and robust realization in some companies in the cement sector. There were sectors such as consumer durables and pharmaceuticals where the GST related disruptions extended into the second quarter as well. The recent high frequency data in the month of September has been encouraging signalling higher economic activity post the transition into the GST regime. The extent to which an early festive season up fronted demand, the favourable base in the third quarter due to last year's demonetisation and the progress of the nascent capex cycle recovery would be key factors which could impact the earnings trajectory in the third quarter FY 2018.

The central government approved a large road building infrastructure program of around ₹6.92 tn, including the Bharatmala project of around 35,000 km with an investment of ₹5.35tn. The Bharatmala project would be an umbrella programme for the highways sector that focuses on enhancing effectiveness of the already built infrastructure through multi-modal integration, bridging infrastructure gaps and integrating the national and economic corridors. Of the ₹5.35 tn of capex envisaged over the next five years, market borrowing, cess funds, private funding, toll revenues as well as monetization of assets would be the key avenues of resource generation.

The Union government's bank recapitalization plan was seen as a credible exercise to enable state owned bank's meet the Basel III norms by improving their capital ratios. The capital would also help banks to provide for stressed assets on the back of the adoption of Insolvency and Bankruptcy Code accelerating the NPA resolution. Moreover, there is a possibility of the state owned banks lending to the ambitious infrastructure projects of the government crowding-in private investment.

The economic activity in the month of September accelerated, as an early festive season coincided with post-GST restocking in many consumer facing sectors. This is corroborated by the up-tick in several high frequency indicators such as tractor sales, diesel demand, two wheeler and passenger car sales, incremental currency demand, air traffic, tourist arrivals, nascent revival in exports and strong retail credit.

Some early signs of capex recovery can be seen from the robust commercial vehicle sales, a pick- up in non-food bank credit growth, surge in capital goods imports, increase in coal consumption, higher rail freight volumes though sluggish steel consumption in September is an area of concern. There is increasing evidence of the bottoming out of the Indian GDP growth in the first quarter FY 2018 and the possibility of a more broad-based recovery in the second quarter FY 2018 and beyond.

We continue to believe that the 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.

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