## Dear Friends,

***The month of September 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed 1.41% and 1.30% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 shed 0.93% during the same period.***

On the global front, the US Federal Reserve (Fed) announced its plan to reduce its balance sheet from October 2017 onwards by USD10 bn in a staggered manner until it reached a cap of USD50 bn per month. The Federal Funds rate expectations for 2017 remained unchanged at 1.4%, signalling one more rate hike in the calendar year while the median dot chart in 2018 implied three hikes next year. The positive macro indicators in the US on growth, manufacturing activity and consumer sentiment has increased the Fed's confidence in adhering to another hike in December 2017 even as lower than expected inflation has been characterized as just a transient factor by many Fed members .

On the domestic front, the Monetary Policy Committee (MPC) of the RBI kept the policy repo rate unchanged at 6%. The decision of the MPC is consistent with a neutral stance of monetary policy in consonance with the objective of achieving the medium-term target for CPI inflation of 4% within a band of +/- 2 %, while supporting growth.

The Central government's fiscal deficit for the period April-August 2017 reached an elevated 96.1% of the full year budget estimate. The total expenditure increased by 18.6% with the capital expenditure growth at 20.1% while the revenue expenditure grew 18.4%. The government had collected ₹907bn as Goods and services tax (GST) for the month of August, lower than the ₹941bn collected in July. The compliance levels seems to have moderated in the month of August as 55% of assesses paid the GST for August as compared to 64% for July.

India's current account deficit (CAD) widened to USD 14.3bn or 2.4% of GDP in the first quarter FY 2018 from 0.6% of GDP in the prior quarter. Despite the surge in the level of CAD, the balance of payment surplus rose to USD 11.4bn in the first quarter from USD7.3bn in the prior quarter on account of stronger FDI and portfolio investments. Moreover, further comfort was provided by India's robust forex reserve at around USD 400bn. The trade deficit in August was at USD 11.6 bn, in line with USD 11.4 bn in July as the August exports at USD 23.8 bn grew by 10.3% against 3.9% in July. Imports in the month of August were at USD 35.5 bn growing 21% in August against 15.4% in July.

The CPI inflation accelerated to 3.4% in August from 2.4% in July as the food inflation rose to 2% compared to 0.4% in July. The core inflation picked up to 4.5% in August from 3.9% in July even as the inflation in the housing sub-component picked up sharply to 5.6% in August from 4.9% in July. The WPI inflation in August surged to 3.24% from 1.9% in July on the back of adverse base effect along with higher food and commodity prices.

India's South west monsoon for 2017 registered around 95% of Long Period Average (LPA) with around 83% of the country receiving excess to normal rainfall while 17% area received deficient rainfall. The output of the kharif (summer crop) is expected to decline by 2.8% year on year as per the first advance estimate, mainly based on cropping area, on account of floods and erratic rainfall in different parts of the country. The output is expected to be marginally lower across most major Kharif crops barring sugarcane, which is expected to see robust production.

The recent data suggests a weakening in India's macroeconomic position with higher CAD, higher inflation and lower GDP growth. However, we 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**

# DEBT MARKET OUTLOOK

Debt market in the month of September 2017 saw the benchmark 10 year Government security (G-sec) close the month at 6.67%, hardening by 14 bps over the month. The 30 year G-sec hardened by 14 bps over the month to close at 7.29%. On the corporate bond side, the 10 year AAA corporate bond closed the month at around 7.47%, hardening by 9 bps over the month. In the month of September, the Foreign Portfolio Investors (FPIs) remained buyers of Indian debt.

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

The MPC opined that actual inflation outcomes so far had been broadly in line with projections, though the extent of the rise in core inflation had been higher than anticipated. They expected the inflation path for the rest of FY 2018 to be shaped by the assessment of food prices which had been largely favourable, despite the first advance estimates of kharif production posing some uncertainty. However, prices of pulses, which had declined significantly to undershoot trend levels in recent months, had now begun to stabilize. Moreover, there had been a firming up of crude oil prices in September. The MPC projected the inflation to rise from its current level and range between 4.2-4.6% in the second half of FY 2018, including the HRA increase by the centre.

The MPC noted the upside risks to this baseline inflation trajectory from the implementation of farm loan waivers by the states resulting in possible fiscal slippages as well as the implementation of the salary and allowances award by the states similar to that of the centre, which could push up headline inflation by about 100 bps above the baseline over 18-24 months. However, the MPC expected adequate food stocks and effective supply management by the government to keep food inflation more benign than assumed in the baseline.

The MPC was concerned with the loss of growth momentum in Q1 FY 2018 and the muted first advance estimates of kharif food grains production. They noted that the implementation of the GST thus far appeared to have had an adverse impact, rendering prospects for the manufacturing sector uncertain in the short term, thereby delaying the revival of investment activity, already hampered by the stressed balance sheets of banks and corporates. Consequently, the MPC revised the projection of real GVA growth for FY 2018 down to 6.7% from 7.3%, with the risks evenly balanced.

To summarize, the MPC observed that the CPI inflation had risen by around 2% since its last policy meet with price pressures coinciding with an escalation of global geo-political uncertainty and heightened volatility in financial markets. The MPC opined that the outlook to the domestic food prices remained largely stable with generalized momentum building in prices largely emanating from crude oil. They also noted the possibility of fiscal slippages adding to this momentum in the future. On a dovish note, the MPC acknowledged the likelihood of the output gap widening but opined that it would require more data to better ascertain the transient versus sustained headwinds in the recent growth prints. Accordingly, the MPC decided to keep the policy rate unchanged and its policy stance neutral. The MPC reiterated its commitment to keeping headline inflation close to 4% on a durable basis.

The overall gross borrowing by the central government for FY 2018 was pegged at ₹5.8 tn with the first half FY 2018 gross borrowings at ₹3.72 tn. As a result, the government targets to borrow ₹2.08 tn in the second half FY 2018 with the net borrowing at ₹1.92tn. The weekly dated securities auction size is ₹50-180 bn, spread over 17 weeks. On the tenor side, borrowings are expectedly concentrated in the 10-14-year bucket at around 51% of gross borrowings in the second half FY 2018.

RBI notified the exclusion of masala bonds from the overall Foreign Portfolio Investment (FPI) ceiling, freeing up ₹440 bn additional limits, thereby providing greater room for flows into corporate bonds and masala bonds.

The key risks to the market stems from 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 robust 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 is expected to be broadly in line with the second half FY 2018 projection in the range of 4.2-4.6%.

# EQUITY MARKET OUTLOOK

The month of September 2017 saw the benchmark indices S&P BSE Sensex and Nifty 50 shed 1.41% and 1.30% respectively. The Mid-cap index, Nifty Free Float Mid-cap 100 shed 0.93% during the same period.

The Indian equity market in the month of September was under pressure from a range of factors such as the continued global geo-political tensions, the sharp acceleration of August inflation prints from the June lows, the deterioration of the current account deficit, tepid July IIP numbers, higher crude oil prices and uneven progress of the south west monsoon. Increasing activity in the primary market during the month also contributed to the tepid equity market performance. The FII's remained net sellers over the month of September even as the DII's were net buyers.

There were some early indicators of economic revival in India as seen from the robust growth in passenger vehicles, two wheelers, tractors and commercial vehicles for the month of September. The data pertaining to PMI manufacturing and retail loans have also signalled a rebound in growth.

The second quarter earnings season is expected to benefit from the tailwinds of restocking post the destocking seen prior to the rollout of the GST in sectors such as consumer goods even as the supply chains of some companies may be still grappling with the GST implementation issues. The margins of companies in a slew of sectors which are dependent on commodities as key inputs such as the cement sector could be under pressure on account of firming up of global commodity prices. The metal sector is expected to continue to register robust results in the second quarter.

The government, in an effort to catalyse economic activity, has nudged state-owned companies to spend an additional ₹250bn as capital expenditure in FY 2018, above the budgeted combined capital spending target. The "Saubhagya" programme launched by the government aims to provide power to all households in the country by December 2018 and cater to the needs of 40 mn households who have no access to electricity. The scheme is expected to cost ₹160bn, with the Central government's contribution pegged at 60% of the funding. This initiative from the government is expected to be positive for the transmission sector.

The government decided to reduce the excise duty on diesel and gasoline by ₹2/litre effective October 4th. The reduction in excise duty will lower fiscal receipts by about ₹130 bn for the second half fiscal FY 2018. The Oil marketing companies (OMCs) have reduced retail prices accordingly, passing on the entire benefit to end-consumers.

Fitch Ratings, reiterated its negative outlook on Indian banks highlighting the challenges of capital infusion even as it lowered its estimate of capital requirements on the back of balance sheet rationalization and tepid loan growth. Fitch also highlighted its concerns about asset quality over the next twelve months, and sees risks from the power sector, farm loan waivers, and SME lending. The negative outlook from Fitch contrasts with stable outlook from Moody's on the Indian banking sector.

Going forward, the rural sector is expected to see higher economic activity on the back of farm loan waivers, increased allocation for MNREGA and a thrust to rural housing. The JAM framework will be a catalyst to expand the ambit of the direct benefit transfer scheme by bringing most of the state government schemes into its scope over the next few months by cash transfers directly deposited into the beneficiaries' bank accounts.

The RBI's Monetary Policy Committee was of the view that the various structural reforms introduced by the government would likely be growth augmenting over the medium to long term by improving the business environment, enhancing transparency and increasing formalization of the economy. The RBI continues to work towards the resolution of stressed corporate exposures in bank balance sheets which should start yielding dividends for the economy over the medium term.

The recent data suggests a weakening in India's macroeconomic position with higher CAD, higher inflation and lower GDP growth. However, we 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.