EQUITY REVIEW

Commentary on Equity Markets

The MSCI India Index started the month at 19.23 and closed at 17.68, decreasing by 8.1% over the month. As per latest data, FIIs were net sellers in Equity with outflow of USD 1.33 Bn and in Fixed Income with outflow of USD 1.45 Bn. Domestic Institutions were net buyers in equities with net buying of USD 1.09 Bn in the month.

Commodities and Inflation

NYMEX Crude Oil prices rose by ~4.9% from the previous month levels, ending at 73.25 per barrel; the prices were higher by ~41.7% yoy. LMEX closed at 2994.8 higher by 2.27% over the month (lower by ~4.1% yoy). Gold prices closed at USD 1182.87/oz lower by ~1.98% over the previous month (lower by ~8.2% yoy). The USD Index was flattish vs. other currencies with USD falling marginally by ~0.01% over the month; over the year the USD Index was higher by ~2.21%.

August CPI at 3.69% (vs 4.17% in July) came in lower tracking a steep base effect and lower food inflation. Inflation details indicate softening in daily consumption food items albeit a sharp jump in retail fuel prices. Inflation internals reveal higher food index with moderating daily consumption items, higher fuel index given the rising global crude oil price and depreciating INR and a core momentum led by higher rentals. Core inflation stood at 5.87% (vs 6.27% in July). Core inflation ex-Transport & Communication stood at 5.35%. YTD core inflation has average 6.1% while headline CPI has averaged 4.45% (both above RBI's 4% comfort). Headline readings are likely to moderate in the near-term and inch up going into Q4FY19. Core inflation rate is likely to remain upwards of 5%.

Markets & Real Economy

July IIP at 6.6% gained from a weak base (GST implementation in July 2017). YTD FY19 production stands higher at 5.4% vis-à-vis 1.7% seen in April - July FY18. Mining, Manufacturing and Electricity grew 3.7%, 7% and 6.7% respectively. Primary goods (+6.9% YoY) gained support from heavyweight items such as Electricity, Diesel & Mining. Capital goods (+3.0%) moderated, with some strength from items such as Commercial vehicles. Performance of Intermediate goods (+1.2%) remains lackluster indicating no conviction of an uptrend in future production. Infrastructure goods (+8.4%) remained supported by a healthy growth seen in cement. Items such as Stainless Steel utensils and a weak base supported Consumer Durables (+14.4%). Non-durables (+5.6%) rose tracking items such as vaccines.

As per the latest RBI data, Forex reserves position increased marginally to USD 401.79 Bn over the month. The Rupee weakened over the month closing at 72.533 Rs/USD vs. 70.925 Rs/USD last month.

Sector-wise Performance

Key outperforming sector during the month was Information Technology. Positive momentum in IT stocks continues driven primarily by INR depreciation which helps in higher realizations and profitability for IT companies. Even in terms of underlying performance, a number of IT companies, both large as well as mid tier, have shown pick-up in growth momentum in the previous quarter results. Management commentary by the IT companies about future demand outlook has also been positive across the board. Indian companies have been investing in developing capabilities in new technologies like digital and automation and the same shall start delivering results as momentum picks up and proof of concept is established. We believe that with global growth picking up, demand for IT Services shall improve, especially driven by the Banking and Financial Services segment which is a significant portion of revenues for all IT companies. We continue to remain positive on the sector.

Key underperforming sector during the month was Automobiles. The current panic in the financial market has given rise to concerns that system wide liquidity is likely to come under pressure leading to poor availability of funds. This may drive interest rates higher which will be passed on to the consumers leading to higher borrowing costs. In addition, rise in oil prices and adoption of higher safety and insurance norms will lead to a further rise in cost of ownership. As such, the demand for automobiles may get impacted in the near term. While these disruptions may lead to stocks being under pressure, the long term potential is significant as the penetration levels in India are much lower than global levels. Also, given that automobile sector is a play on consumption demand, valuations within the sector are attractive as compared to consumer staples. We continue to remain positive on the sector.

Key Stock Movements

Tata Consultancy Services Ltd – Stocks within the Information Technology sector have outperformed driven by weakness in INR as well as improving growth outlook. Tata Consultancy Services Ltd has been leading in terms of growth amongst the large-cap IT companies, and hence benefitted the most from the current rally in the sector. As mentioned in the sector comments above, we believe that the Indian IT companies shall continue to benefit from revival in global growth, especially US, and we maintain a positive outlook on the company.

Yes Bank Ltd – Yes Bank stock has corrected sharply due to the RBI restricting the term of its current MD & CEO Mr Rana Kapoor till 31st January 2019. Yes Bank, in a release to the stock exchanges, has re-iterated that the bank will maintain credit cost at 50-70 bps for FY19 which communicates the management's confidence on asset quality and provides comfort that there shall not be any slip-ups post Mr Rana Kapoor's exit, as is being feared by the market. The bank has also established a Search & Selection Committee to identify a new MD & CEO and is taking measures to ensure a long term succession plan. We have been observing the developments closely since the time this issue has emerged and shall continue to monitor the developments going forward. Any further call on the exposure will be taken only after more clarity emerges. While Mr Rana Kapoor has been instrumental in the growth of Yes Bank, in our opinion the bank has developed over the years into a stable and process driven high quality financial institution. We believe that the recent fall in the stock price is an over-reaction which shall correct in due course of time

Market Outlook

Indian equity market corrected sharply during the month driven primarily by stocks within the Non Banking Financial Services segment following concerns of a liquidity crisis in the system borne out of the default by IL&FS Ltd and its subsidiaries. The situation quickly got extrapolated by market participants to all NBFCs leading to concerns that these entities will have to compromise on growth as availability of funds gets restricted due to a liquidity crisis. The panic also spread to other sectors like Automobiles, Real Estate, etc where demand is interest rate sensitive. These developments, together with the continued news-flow on US-China trade tariffs, kept the market under pressure. We believe that the recent sharp fall, especially in Financial Sector companies, is an over-reaction to an event which is related to just one entity and not representative of a system-wide crisis. Both GoI and RBI have stepped in to assuage the situation and are taking requisite measures to prevent the issue from escalating. In our opinion, this is a temporary disruption and shall have no long term bearing on the liquidity in the system or the growth potential of the economy

FIXED INCOME REVIEW

India's consumer prices (CPI Inflation) moderated considerably to 3.69% in August 2018 from 4.17% in July 2018 primarily on account of low food inflation and a favourable base. Food inflation moved lower to 0.29% vs. 1.3% YoY last month on the back of sequential fall in prices across most food groups. The core-CPI inflation also moved lower to 5.9% in August 2018 from 6.3% in July 2018. However, the inflation related to fuel and light hardened to 8.5% in August 2018 from 8.0% in July 2018 on the back of high petrol and diesel prices. The Wholesale Price Index (WPI) came off to 4.5% in August 2018 from a level of 5.1% in July 2018 primarily on account of disinflation in primary food articles.

The Government announced its borrowing calendar for second half of financial year 2019 (H2FY2019), pegging gross borrowing at INR 2.47 trillion (USD 34 bn) which was lower than the markets expectation. With this, the Government's total gross borrowing for FY2019 stands at INR 5.35 trillion (USD 73 bn), which is INR 700 bn less than initially budgeted amount of INR 6.05 trillion (USD 83 bn). The Government also mentioned its intention to stick to its fiscal deficit target of 3.3% of GDP in FY2019.

Outlook

With two back to back rate hikes, we had expected RBI to pause in the near to medium term. However off late emerging market (EM) contagion has progressed sharply which has put a huge pressure on the currencies of those emerging market countries which run a current account deficit and because of which we have seen a sharp depreciation in local currency INR during last one month. In light of this recent rapid fall in INR which has fallen by around 14% YTD against USD, the local fixed income markets are forced to re-evaluate the chances of a rate hike in next RBI policy due in October, the probability of a rate action from central bank has gone up significantly.

We believe the unfolding of various global and domestic events would keep the markets volatile in the near term. On the global front, fixed income markets will remain watchful on uncertainty in oil prices, any further developments on trade-related negotiations between the US and China, US mid-term elections in November, and pace of unwinding of quantitative easing by central banks. Domestically, commitment towards fiscal discipline and consolidation, in an election year, needs to be monitored closely given that the GST collections have not been too buoyant. Also the fixed income markets will remain vigilant of any central bank action to shore up the currency in light of recent rapid fall versus dollar.

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