India Insights

March 2017

Monthly update on Indian markets

Summary

- Prime Minister Modi's Bharatiya Janata Party (BJP) pulled off one of the biggest electoral upsets in Indian politics in the recently concluded state elections
- February headline inflation rose to 3.65% yoy from 3.2% previously, primarily driven by firmer food and fuel prices. We expect food prices to undergo further normalisation as the favourable base effect and impact from demonetisaton wears off
- The rise in composite PMI above 50 – for the first time in 4 months – indicates a recovery in production and business activity, although the reading remains well below pre-demonetisation levels
- It's been a strong first quarter so far for Indian equity, which has emerged one of the best performing markets in Asia during the period, helped by the muted impact of demonetisation on corporate earnings and lack of big negatives in the FY18 budget
- We continue to be overweight in government bonds but have reduced duration by trimming holdings in the 15Y+ segment. Incrementally we would look to maintain our current level of low duration by investing in the belly of the curve

Why is a state election win the cause for a national celebration?

By Nilang Mehta,
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> These elections, along with municipal elections in the key states of Maharashtra and Orrisa, are being seen as a referendum of sorts on the Modi's government's controversial demonetisation plan

- Prime Minister Modi's Bharatiya Janata Party (BJP) pulled off one of the biggest electoral upsets in Indian politics in the recently concluded state elections. Belying exit poll results and forecasts from political analysts, BJP won the election in the state of Uttar Pradesh by bagging 80% of the seats and setting a record of sorts
- It did equally well in the adjoining state of Uttrakhand and will also form the government in Goa and Manipur where it rounded up the requisite number of seats by garnering support from smaller parties. At the same time, its loss in the state of Punjab was well anticipated
- Largely, there is a sense that the Indian electorate has placed higher emphasis on good governance in the latest polls, rewarding parties that performed well in their previous terms and ousting those that faltered
- These elections, along with municipal elections in the key states of Maharashtra and Orissa, are being seen as a referendum of sorts on the Modi's government's controversial demonetisation plan, and hence the BJP's recent spate of victories can be interpreted as an endorsement of that move

Source: HSBC Global Asset Management as of March 2017

HSBC Global Asset Management

Why is a state election win the cause for a national celebration? (cont'd)

> With these victories, states accounting for around 58% of India's population and 54% of its GDP, will be governed directly by BJP and its allies. This should help the Modi government push key reforms and improve implementation of Centre-backed schemes

- Against this backdrop let's analyse why these results matter. Uttar Pradesh (UP) is India's largest state but also its second poorest (by per capita GDP), making up 17% of the country's population but accounting for only 8% of its GDP
- Politically, UP is a key state as it represents 13% of the seats in upper house (Rajya Sabha) and 15% in lower house (Lok Sabha). Hence a victory of this magnitude could go a long way towards strengthening the BJP's position ahead of the national elections in mid-2019
- The election results also have a far-reaching impact on the reform front. With these victories, states accounting for around 58% of India's population and 54% of its GDP, will be governed directly by BJP and its allies. This should help the Modi government push key reforms and improve implementation of Centre-backed schemes
- These election results also auger well for improved Centre-State partnership on important issues such as, power reforms, labour/land reforms and implementation of the Goods and Service Tax (GST)
- Since winning the election, BJP pulled another surprise when it named Yogi Adityanath, a contentious political figure, as Chief Minister of Uttar Pradesh. In yet another unexpected move, BJP has appointed two deputy chief ministers to assist Adityanath in governing Uttar Pradesh, given the size of the state

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- If we take stock of the Modi government's performance half way through its tenure there are few notable hits and misses
- We have seen a significant improvement in the functioning of ministries such as railways, roads, power and defense. There has been a big thrust on increasing transparency in functioning of the government, leading to reduced corruption and rent-seeking by vested interests. And the focus on Aadhar- (India's biometric identification system) based distribution of social benefits has been a game changer
- However, there are many areas that need a lot more attention, including cleaning up government bank's balance sheets and divestment of government-owned assets
- We believe that the recent electoral win will improve the Modi government's chances of pushing through more hard-hitting structural reforms including the ones mentioned above

Source: HSBC Global Asset Management as of March 2017
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Equity market

- It's been a strong first quarter so far for Indian equity, which has emerged one of the best performing markets in Asia during the period, helped by the muted impact of demonetisation on corporate earnings and lack of big negatives in the FY18 budget. State election results in March came as another shot in the arm for the domestic market which has scaled new highs since shrugging off the demonetisation blues earlier this year

Cyclical recovery in India is gathering steam and will get a big boost from the fall in interest rates, the benefits of which are yet to percolate through the economy.

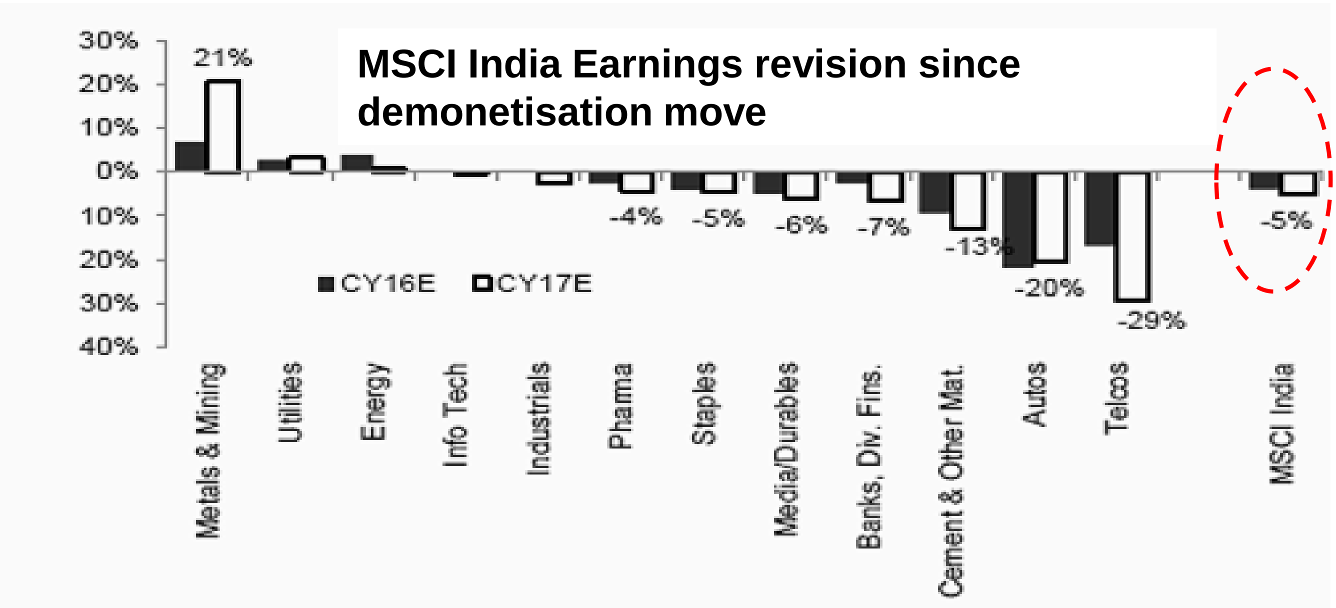
- December quarter earnings showed a surprising amount of resilience in many key sectors and industries that were expected to take a bigger hit from the demonetisation move (see related chart below)
- A number of consumer staples stocks were adversely impacted due to the currency replacement programme but the impact is estimated to be one-off and transitory in nature and expected not to extend beyond the January-March quarter
- On the other hand, some consumer discretionary names have held up very well during the impacted quarter, indicating that the unorganized to organized shift is already underway in some of these segments. Going ahead this shift to formal economy is likely to hasten, driven by policy focus on incentivising and stimulating digital transactions

Factors to watch include:

Elections in the key state of Uttar Pradesh, along with 4 others in February-March, 2017.

- The second half of the budget session of the Parliament which will conclude on April 12
- Updates on GST implementation schedule. The key bottlenecks related to GST legislations and implementation are expected to be cleared in current session of Parliament and the proposed July 1 rollout now seems achievable (see chart on Page 4)
- Comments / policy decisions from the RBI, especially those related to the monetary easing cycle

Muted impact of demonetisation on corporate earnings



Source: Goldman Sachs as of March 2017

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Sector Views

Sector	Weighting
Industrials	Overweight
Consumer Discretionary	Overweight
Financials	Overweight
Real Estate	Neutral
Information Technology	Neutral
Utilities	Underweight
Energy	Underweight
Consumer Staples	Underweight
Healthcare	Underweight
Telecom	Underweight
Materials	Underweight

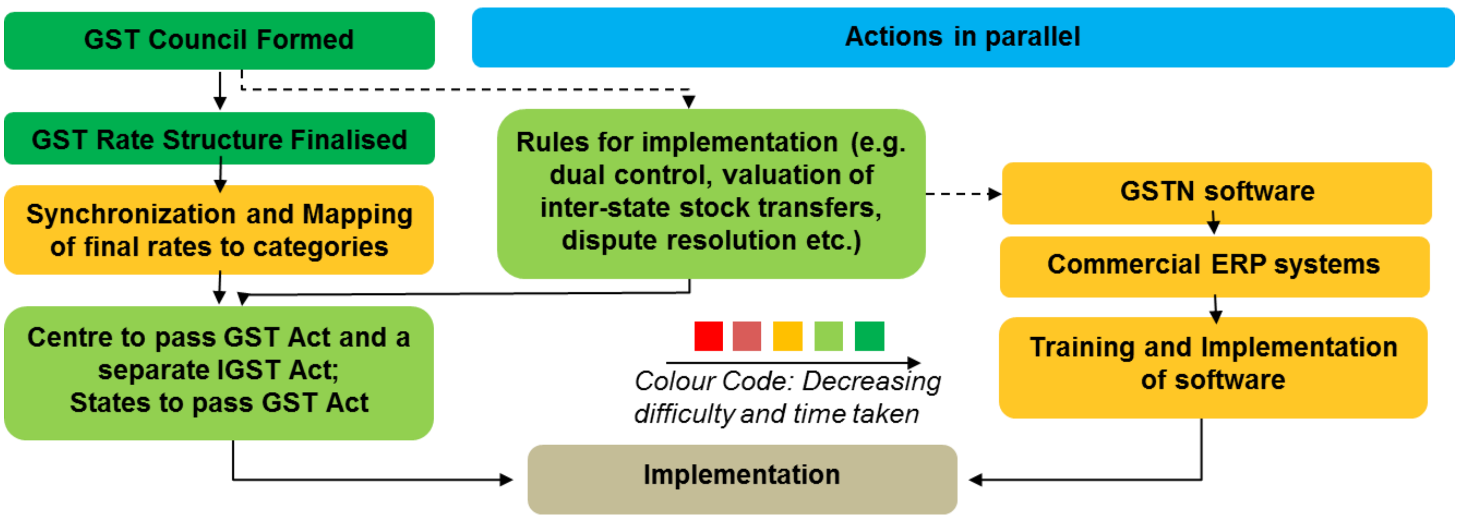
Source: HSBC Global Asset Management as of end-February 2017

Sector focus

- The **Information Technology** sector has been in the spotlight due to increased protectionist rhetoric following the US election, which is likely to weigh on its outlook. At the same time, an appreciating rupee is also seen as a headwind for margins of IT companies
- Top IT companies in India are dependent on revenues from US and European firms, and the growing backlash against immigration and outsourcing of jobs is likely to adversely impact their growth. Similarly increasing popularity of disruptive technologies including cloud computing and automation are also likely to take a toll on Indian tech companies
- On the other hand, the recent rate hike by the Federal Reserve is seen bolstering the banking sector in the US which could then translate to higher IT budgets and more orders for Indian IT companies
- Despite the potential challenges, the recent spate of buyback announcements, higher dividend payouts and supportive valuations have led us to assume a neutral stance towards the sector. We will continue to monitor developments and use significant corrections as opportunities to buy IT stocks

Chart in focus

GST implementation schedule seems achievable



Source: Credit Suisse as of March 2017
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Fixed income

> Higher supply of state government bonds has kept credit spreads at their wides and bond yields slightly pressured

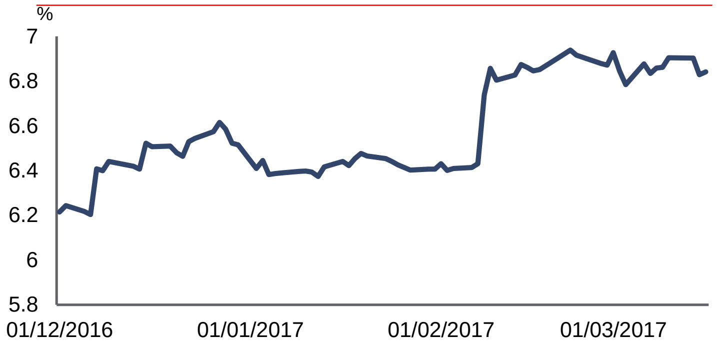
- India's February headline inflation rose to 3.65% yoy from 3.2% previously, primarily driven by firmer food and fuel prices. We expect food prices to undergo further normalisation as the favourable base effect and impact from demonetisaton wears off. Core inflation has eased to 4.83% yoy from 5.10% as other core items such as housing, clothing and footwear edged lower. Though this drop is somewhat comforting, the continued stickiness of core inflation has been one of the main reasons to hold back rate cut, and controlling inflation remains the key focus area for RBI
- Higher supply of state government bonds has kept credit spreads at their wides and bond yields slightly pressured. Since the jump after the last monetary policy in February, yields rose slightly but remained relatively stable in March and is expected to stay range bound
- Market expectations have been building up for the upcoming RBI monetary policy in April, which could see implementation of several structured measures such as CRR (cash reserve ratio) hike or the issuance of market stabilisation scheme bonds to reduce excess liquidity in the system. These expectations have kept the bond market from rallying. However, no government bond supply till end March has helped at the margin and yields have ground lower post RBI policy in line with the retracement lower in global bond yields. At the time of writing, there were headlines on the possibility of a standing facility with RBI but it is yet to be confirmed by further announcements
- From a strategy standpoint, we continue to be overweight in government bonds but have reduced duration by trimming holdings in the 15Y+ segment. Incrementally we would look to maintain our current level of low duration through investing in the belly of the curve. We will look to add more 3Y+ non banking financial companies for carry purpose given a stable rate environment, and continue to be underweight in USD bonds given expectations of Fed rate hikes

Currency

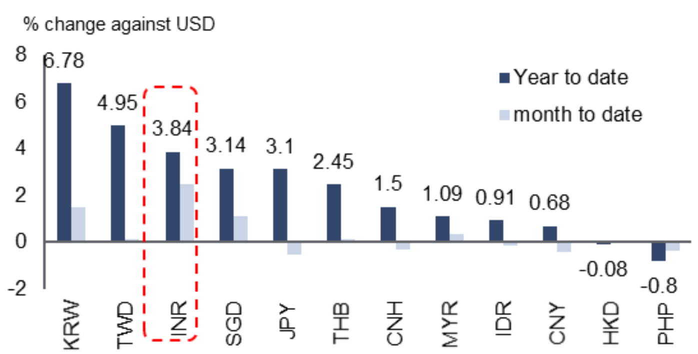
> We expect the INR to move in line with the Asian currencies and to remain range bound going forward given improving fundamentals and strong FX reserves

- The Indian stock market reacted positively to the recent state election results. The INR strengthened and appreciated by 3.84% against the USD (as of 17 Mar 2017). It has been one of the better performing Asian currencies year to date and over the month
- We expect the INR to move in line with the Asian currencies and to remain range bound going forward given improving fundamentals and strong FX reserves. Over the long term, INR continues to look attractive, as India's current account deficit is expected to remain relatively narrow and is well supported by increasing foreign direct investment inflows

Yields to remain range bound



INR is one of the better performing Asian currencies



Source: Bloomberg, HSBC Global Asset Management, as of 17 March 2017. Investment involves risks. Past performance is not indicative of future performance.
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Data watch

Indicator	Latest data	Consensus data	Previous data	Analysis
PMI (Composite) - Manufacturing - Services	50.7 (Feb) 50.7 (Feb) 50.3 (Feb)	NA	49.4 (Jan) 50.4 (Jan) 48.7 (Jan)	The rise in composite PMI above 50 – for the first time in 4 months – indicates a recovery in production and business activity, although the reading remains well below pre-demonetisation levels. New orders (manufacturing) and new business (services) sub-indexes improved. Inflationary pressures continue to build, as both input and output price indices rose further. The manufacturing input price index rose to a 30-month high of 57.5 (the highest level since August 2014) , while the output price index rose to a 40-month high (53.4).
Industrial Production (IP) (% yoy)	+2.7 (Jan)	+0.5	-0.1 (Dec)	The rebound in IP was driven by higher capital goods (partly led by the volatile cables/rubber-insulated category) and consumer durables (led by passenger cars and mobile phones) output. Overall, the data suggests normalisation in manufacturing activity and the impact from demonetisation is likely transitory.
Local passenger vehicle (PV) sales (units)	255,359 (Feb) (+9.0% yoy)	NA	265,320 (Jan) (+14.4% yoy)	Stocking by dealers in January was the main reason behind the slightly lower February sales. PV sales continued to recover from a dip in December 2016, driven by new launches and waning impact of demonetisation, although the impact is still being felt in rural areas where cash flow is yet to return to normal (as indicated by the modest rebound in two-wheeler sales). GST, expected to be implemented in July, would be positive for the auto sector mainly due to the removal of cascading effect of taxes embedded in cost of production/logistics.
Exports (USD) (% yoy)	17.5 (Feb)	NA	4.3 (Jan)	The pickup in export growth, driven by both price and volume gains, indicated better external demand.
Imports (USD) (% yoy)	21.8 (Feb)	NA	10.7 (Jan)	Gold imports soared 148% yoy, owing to restocking by jewellers ahead of the wedding and festive season, but we think this is likely to be one-off. Oil imports also jumped 60% on higher oil prices. Non-oil imports ex. gold also recovered, albeit modestly. This suggests some improvement in domestic demand after weakness in activity post demonetisation.
Trade Balance (USD)	-8.9bn (Feb)	NA	-9.8bn (Jan)	Higher commodity prices and an expected recovery in domestic demand into FY18 could widen the trade deficit but the deficit should remain manageable.
Inflation (% yoy) - CPI - WPI	3.65 (Feb) 6.55 (Feb)	3.60 6.10	3.17 (Jan) 5.25 (Jan)	The pickup in headline CPI inflation, following six straight months of decline, primarily, was driven by higher food inflation. Fuel price inflation also rose. Core CPI (ex. food, fuel and transport & communication) moderated to 4.8% from 5.1% in January, largely due to the base effect. While near-term inflation outlook remains benign, there are upside risks. Demand-pull pressures will likely increase going forward as remonetisation gathers pace. Elevated WPI inflation would impact CPI with a time lag, although pressures on WPI could ease somewhat from the recent correction in global commodity prices. Others include higher minimum support prices, firm rural wage growth, and the fuller effects of house rent allowances under the 7th Pay Commission award.
Policy repo rates (%)	6.25 (8 Feb)	6.00	6.25 (7 Dec)	The RBI changed the monetary policy stance to neutral from accommodative, given (1) its commitment to bringing headline CPI inflation closer to 4.0% on a durable basis; (2) its focus on core/underlying inflation, which has been sticky; and (3) global uncertainties (higher oil and commodity prices and FX volatility, etc.). A neutral policy stance still gives the RBI the flexibility in calibrating policy rates, but it caps the possibility of further easing unless inflation (and/or growth) slows significantly below the baseline scenarios.
GDP at market prices (quarterly, % yoy) Gross value-added (GVA) at basic prices (quarterly, % yoy)	7.0 (Oct-Dec) 6.6 (Oct-Dec)	6.1 6.0	7.4 (Jul-Sep) 6.7 (Jul-Sep)	The marginal growth slowdown implied a much more moderate impact from demonetisation than widely expected. The headline data likely understated the impact of demonetisation, given: (1) strong agricultural output (thanks to good monsoon) and government spending offset the demonetisation impact; (2) demonetisation likely hit the informal economy harder, but GDP/GVA is estimated using formal-sector economic indicators. For example, sales tax growth is used as a proxy for domestic retail and wholesale trade; and (3) remonetisation has boosted formalisation of the economy. Overall, we expect economic growth to recover in coming months, due to pent-up demand post remonetisation and the lagged effects of lower bank lending rates. The FY18 budget's focus on boosting infrastructure, the rural economy and affordable housing should also help growth.
Current Account Balance (CAB) (quarterly, balance in USD and % of GDP)	-USD3.4bn -0.6 (Jul-Sep)	+USD2.7bn +0.5	-USD0.3bn -0.1 (Apr-Jun)	Current account deficit widened in July-September from the previous quarter following an increase in core imports but it remained well below levels in 2015. Despite the recent rebound in oil prices and an expected wider trade deficit in H2 FY17, we expect the CAD to remain manageable at slightly below 1% of GDP in FY17, a mild improvement from -1.1% in FY16.

Source: Bloomberg, HSBC Global Asset Management, as of March 2017

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

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