India Insights

November 2017

Monthly update on Indian markets

Summary

- On November 17 Moody's unexpectedly raised India's sovereign rating by a notch from Baa3 to Baa2 and revised its rating outlook to stable from positive
- The vote of confidence from Moody's is a vindication of the reform process and our conviction in the India story which we have consistently highlighted to investors
- October CPI accelerated on the back of an unexpected increase in food prices as food inflation came in stronger than expected at 2.3% YoY from 1.8% previously
- Equity markets surged higher in the month of October and scaled fresh highs in November, driven by a string of reform announcements locally and stable global cues
- The RBI's recent withdrawal from Open Market operations (OMO) sales along with the Moody's upgrade should bring about consolidation around current levels in the bond market

Moody's upgrade is an endorsement of Modi's reforms and resolve

By Nilang Mehta,
Investment Director,
HSBC Global Asset Management

India received an early Christmas present on November 17 when Moody's unexpectedly raised its sovereign rating by a notch from Baa3 to Baa2. This is the first upgrade from the rating agency since 2004. Along with the upgrade, the rating outlook has also been revised to stable from positive and Moody's rating now stands one notch above those granted by Fitch and Standard & Poor's.

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While investors have hoped for an upgrade for a long time and priced higher rating/lower risk premium into all the major asset classes (currency, bonds and equities), the timing of the upgrade did come as a surprise. Especially since a few recent data points including - increasing trend in current account deficit, inflation picking up from the lows and the impact of GST implementation on growth and government revenues – have caused concern amongst investors. This also coincided with a recent spike in oil prices and a clearer view of the US rate hike trajectory.

Against this backdrop, the 10 year government bond yield had spiked 60bps and the Indian rupee (INR) lost 2.2% against the US Dollar (USD) since mid-September. Lower than expected growth rates also led to doubts about the economic policies of the government, with local and international media highlighting the negative news flow.

Markets reacted positively to the announcement. The rupee has strengthen in the days following the announcement while equity markets have been pushed to new highs. The 10 year government bond yields fell following the announcement *(please refer to pages 3 and 5 for charts and further details on the market reaction)*

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Moody's upgrade is an endorsement of Modi's reforms and resolve (contd)

The rating upgrade from Moody's is underpinned by consistent progress on the Modi government's reform agenda since it came to power in May 2014. The government has pursued structural reforms, focused on formalising the economy, improving transparency in the operation of government agencies and staying on the path of fiscal and monetary prudence to bring the cost of debt and equity capital lower.

Here are a few examples of moves made by the government to :

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- The implementation of GST and the controversial demonetisation move were aimed at increasing the tax base over the long run which will help the government reduce tax rates and spend money on public infrastructure, health and education
- Opening up sectors, such as defence and railways, that were hitherto off limits to foreign investments was path breaking
- Plugging the leakage of subsidies by adopting Direct Benefit Transfers (DBT) and utilising the JAM trinity (JanDhan Aadhaar Mobile - an initiative to enable financial inclusion by linking bank accounts to biometric identification numbers i.e Aadhaar and mobile numbers) was a game changer
- The recently instituted bankruptcy law in itself has the potential to change the corporate lending landscape in India in coming years
- In October the government announced a record capital injection of USD32 billion into public sector banks, in an effort to tackle their asset quality and capital adequacy issues. This much-needed recapitalisation package (equivalent to about 1.3% of 2017-18 GDP) is significantly larger than the previous commitment from the government and the amount is greater than the total capital infusion into public sector banks over the past decade

The rating upgrade is a delayed reaction to the changes that have been happening (and have been priced in by investors) on reform front over the past three and a half years. While India has long way to go before it achieves its promised potential, the vote of confidence from Moody's is a vindication of the reform process and our conviction in the India story which we have consistently highlighted to investors.

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The recent 30 spot jump in India's ease of doing business ranking by World Bank may seem less impressive when we note it's still ranked 100th among 190 countries, but what is commendable is focus and desire of the government to keep improving on this.

While it took nearly 14 years for India to achieve this rating upgrade, there is a chance that the country can move up the ranks a lot sooner the next time around if it delivers on its growth potential and sticks to its chosen path of fiscal consolidation.

In the meantime, we will wait to see if the other rating agencies follow suit and upgrade India. An endorsement from two out of the three major rating agencies should significantly improve India's ability to attract fund flows from global investors.

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

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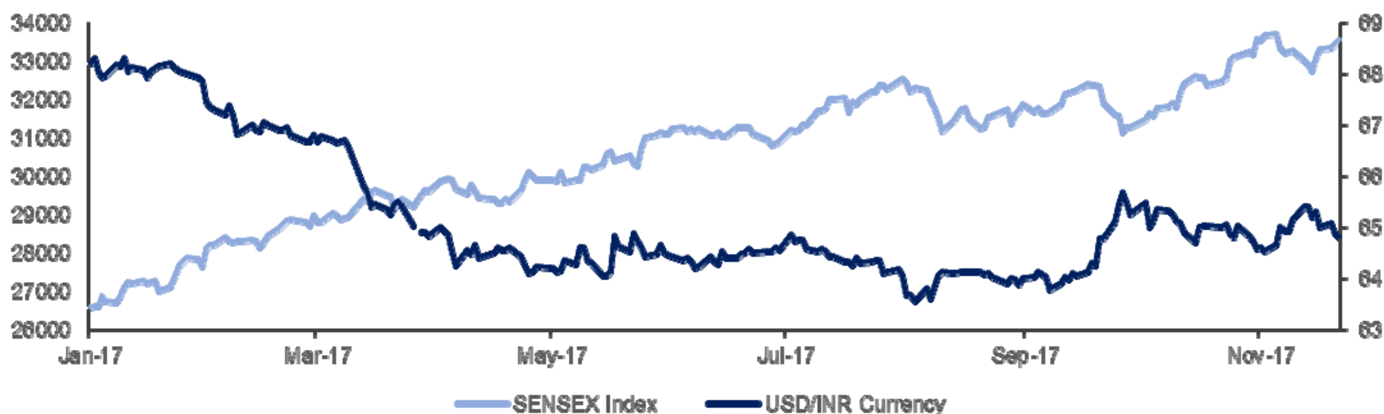
Equity market

> Equity mutual funds saw net inflows of $2.7 billion in September, as strong domestic interest continues

> GST impact, second quarter earnings and the direction of the US dollar are some of the key drivers of market sentiment in the short term

- Equity markets surged higher in the month of October and scaled fresh highs in November, driven by a string of reform announcements locally and stable global cues. The announcement of mega recapitalisation package for public sector banks, unveiling of ambitious road construction project, improving macro data indicators and more recently, the endorsement from Moody's buoyed investor sentiment
- Also helping sentiment, were a host of relaxation measures from the GST council to ease the compliance burden of Small and Medium Enterprises (SMEs) and provided a relief package for exporters. Additionally, the Council also decided to reduce the tax rate on 27 items
- Equity markets saw net inflows of $1.85 billion from domestic and foreign institutional investors in October. In the January to October period, flows from domestic institutions more than doubled that from foreign investors at $11.35 billion. Domestic interest in the stock markets can be attributed to a shift in India's savings structure from physical savings to financial savings, with financial savings now making up about 41% of total household savings as compared to 31% in FY 2012
- The quarterly earnings season trends at an aggregate level have been broadly on expected lines so far, while the sector wise trends have been mixed. However, the key aspect to monitor towards the end of the quarter would be whether the trend of earnings downgrades is close to bottoming out or not
- Risks to short term market performance comes from valuations trending above historical averages and a weaker than expected delivery in corporate earnings going forward
- Other factors to watch include the upcoming state assembly election outcomes, particularly that of the state of Gujarat will be keenly followed. External news flows related to geopolitical tensions (the Korean peninsula tensions) and other eco-political events could also influence market performance going forward, as the recent rally in the markets have supported by strong flows from domestic investors

INR has stabilised on equity inflows



Source: Bloomberg, HSBC Global Asset Management data as at 30 September 2017
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Sector Views

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

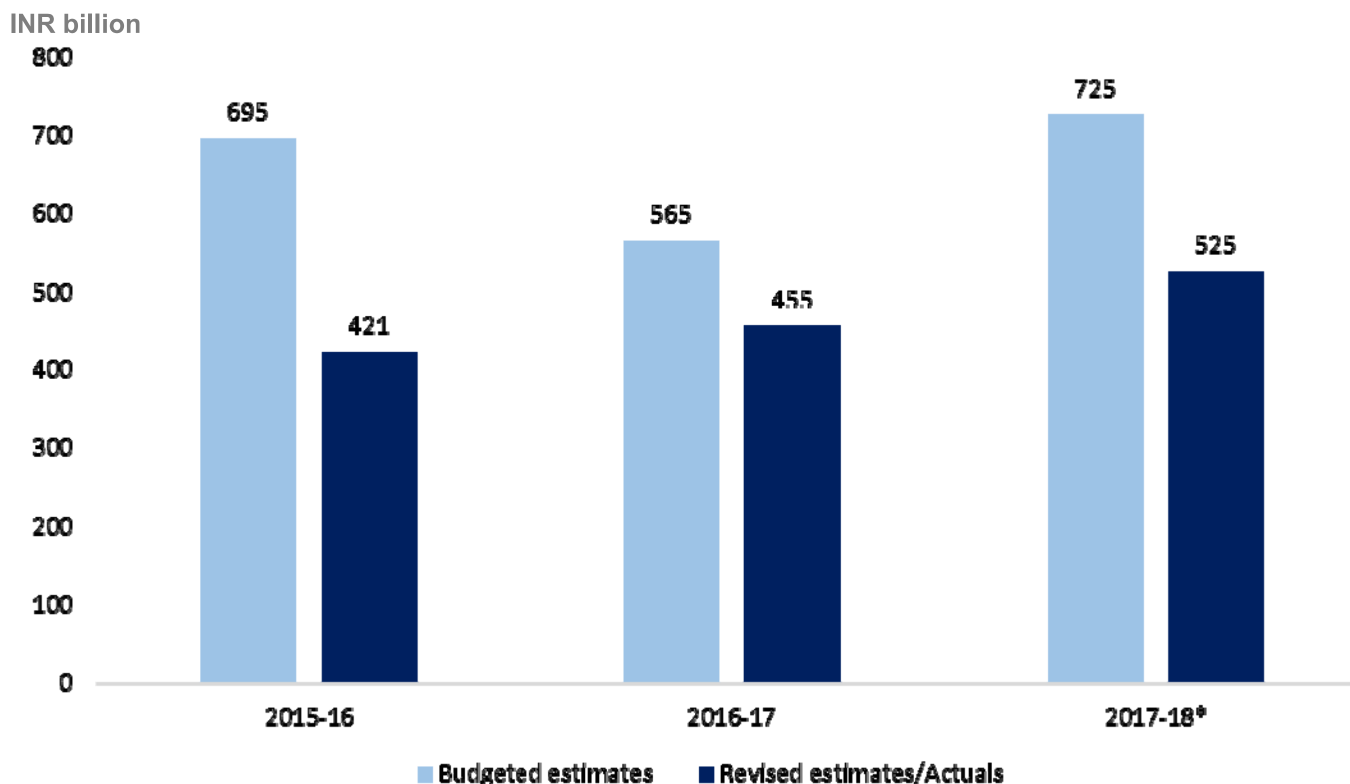
Source: HSBC Global Asset Management as of end-October 2017

Sector focus

- **Banking** stocks have rallied sharply in the weeks following the announcement of the record capital injection into public sector banks in October. The bank stock index, S&P BSE Bankex, has risen around 8% in the four weeks since the plan was made public
- Within financials, we are overweight attractively valued private sector banks. These banks have best-in-class retail deposit franchises, but trade at a discount because they hold a high level of non-performing assets (NPAs) that were a result of corporate lending between 2010-2013. We believe the market will start to appreciate their deposit franchise as bad debt resolution speeds up for these banks, and their valuation discounts, which are currently at historical highs, should narrow
- We also like select government-owned banks with strong balance sheets and where NPLs have peaked. Our portfolio has directly benefited from the bank recapitalisation announcement
- We've been talking about a government plan for the banking system for a while and we held on to positions in government banks, which hurt our performance in past periods, but this announcement was a vindication of our long-term belief

Chart in focus

Disinvestment in first eight months of 2017-18 has surpassed total amount for 2016-17



Source: indiabudget.nic.in as of November 2017.
*denotes that the actuals for 2017-18 have been measured as of mid-November 2017
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Fixed income

- October CPI accelerated on the back of an unexpected increase in food prices. Food inflation came in stronger than expected at 2.3% y-o-y from 1.8% previously, while fuel grew quickly at 6.4% from 5.6% a month ago. Core inflation (ex food, fuel, petrol and diesel) rose 4.5% y-o-y, a tad higher than the previous reading of 4.4%.
- Exports contracted in October for the first time in FY18, largely reflecting a payback after shooting up in September. Oil import bill continued to increase strongly on the back of higher crude prices and weaker currency, while gold and core imports moderated
- Uncertainty on the fiscal front coupled with an already heavy bond supply and ongoing Open Market Operations (OMO) sales have contributed to a reduced buying appetite from bond investors. The RBI's recent withdrawal from OMO sales should relieve pressure in the bond markets to a certain extent
- In addition to upgrading the sovereign rating, Moody's also revised the short-term local currency rating to P-2 from P-3. The upgrade confirms the positive direction of government reforms and their benefits over the medium term
- Together with the OMO withdrawal decision, these two positive triggers should bring about consolidation around current levels in the bond market
- From a strategy standpoint, we have maintained a marginal overweight duration through INR government bonds given a balanced inflation outlook and fiscal uncertainty. State Development Loans (SDLs) have been added and have seen some spread compression. We look to maintain carry in a stable interest rate environment. We continue to be underweight USD corporate bonds

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Currency

- The recent upgrade from Moody's brings positive change to the INR and India in the medium term, as it lends credibility to the ongoing reform agenda which should support inflows, which in turn should relieve concerns over current account-deficit financing
- October trade data was an aberration given that exports were subdued due to GST related teething problems. Oil price increase has seen an uptick in the import bill. For 1QFY18, the BoP surplus rose to USD 11.4bn from USD 7.3bn the previous quarter. This was led by an increase in both FDI and portfolio flows
- Current account deficit for FY18 is expected to come in at 1.6-2% of GDP, depending on oil prices, which is the broad market consensus. FX reserves meanwhile remained in the USD 400bn range which is 11months of import cover and provides a strong external debt cover. Given improving economic fundamentals, narrowing inflation differentials and healthy FX reserves, we expect the INR to be resilient and to remain range bound going forward

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India 10 year government bond yield on a steady rise

Source: Bloomberg, data as of 22 November 2017. Investment involves risks. Past performance is not indicative of future performance.

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Non contractual document

Data watch

Indicator	Latest data	Consensus data	Previous data	Analysis
PMI (Composite) - Manufacturing - Services	51.3 (Oct) 50.3 (Oct) 51.7 (Oct)	NA	51.1 (Sep) 51.2 (Sep) 50.7 (Sep)	The PMI data showed some improvement in services sector business, while manufacturing activity softened. Overall business sentiment remained below pre-GST and pre-demonetisation levels, but recovered from July-August lows.
Industrial Production (IP) (% YoY)	+3.8 (Sep)	+4.1	+4.5 (Aug)	The lower IP growth followed a strong August reading and on the back of an unfavourable base effect. The underlying momentum remained solid, amid festival demand and fading impact of demonetization and GST rollout.
Local passenger vehicle (PV) sales (units)	279,837 (Oct) (-0.3% YoY)	NA	309,955 (Sep) (+11.3% YoY)	The MoM decline was largely due to pre-buying ahead of the festive season, and to evade GST-related cess hikes announced on certain segments of vehicles in September. PV sales may remain subdued in November post the festival season.
Exports (USD) (% YoY)	-1.1 (Oct)	NA	25.7 (Sep)	The contraction of exports largely reflected GST-related distortions: e.g. the front-loading of shipments to September due to expiry of the old duty drawback rates; and working capital constraints due to delayed tax refunds. The GST council (at its 6 October meeting) indicated that it would pay July and August tax refund claims in October; allow duty-free sourcing of materials for export production until March 2018; and introduced a GST rate of 0.1% for merchant exporters, etc. These relief measures/the resolution of these GST-related issues could lead to an export revival in the coming months.
Imports (USD) (% YoY)	7.6 (Oct)	NA	18.1 (Sep)	A higher base, partly due to the festival timing distortions, was behind import growth slowdown. On a sequential basis, import value was supported by gold and oil imports owing to the festival demand and higher crude prices. Non-oil, non-gold imports (a proxy for domestic demand) slowed.
Trade Balance (USD)	-14.0bn (Oct)	NA	-9.0bn (Sep)	The wider trade deficit was consistent with our view of a larger current account deficit, though FDI inflows have been robust. Oil prices remain one key risk.
Inflation (% YoY) - CPI - WPI	 3.58 (Oct) 3.59 (Oct)	 3.43 3.01	 3.28 (Sep) 2.60 (Sep)	The acceleration in CPI inflation was driven mainly by higher food/vegetable prices and housing inflation (due to the house rent allowance hike under the 7th Pay Commission), and partly reflected a lower base. Core inflation (ex. food, fuel and transport) rose, while the cuts to excise duties helped lower petrol and diesel prices. Recent rationalisation in GST rates (tax rates were lowered for 213 items) is disinflationary at the margin. The negative output gap is likely closing only gradually, helping to curb demand-pull inflationary pressures. However, recent rises in oil prices pose upside risks, while fiscal slippage risks linger. Inflation is likely to rise above 4% in coming months.
Repo rate (%) Reverse repo rate (%) Marginal standing facility (MSF) rate (%)	6.00 5.75 6.25 (4 Oct)	6.00 5.75 6.25	6.00 5.75 6.25 (2 Aug)	The RBI kept its policy stance neutral. It slashed its GVA growth forecast for FY18 to 6.7% from 7.3%, acknowledging the recent growth slowdown and potential widening of the output gap but would wait for more evidence to assess whether the trend is transitory or structural. It noted that the adverse impact of the GST, coupled with stressed bank and corporate balance sheets, could further delay the revival of private capex. The RBI remained cautious on the inflation outlook and revised up its inflation forecast for H2 FY18 to 4.2-4.6% from 3.5-4.5%. Future policy action remains data dependent. While inflation may remain within the RBI's projected range, the focus on keeping inflation at 4% on a durable basis suggests rates may be more likely on an extended pause. Greater clarity on the fiscal policy is also needed.
GDP at market prices (quarterly, % YoY) Gross value-added (GVA) at basic prices (quarterly, % YoY)	5.7 (Apr-Jun) 5.6% (Apr-Jun)	6.5 6.2	6.1 (Jan-Mar) 5.6% (Jan-Mar)	Growth slowdown likely partly reflected the lagged impact of demonetisation**.** The cash shortage led to a contraction of construction GVA and a drop in real estate and manufacturing GVA growth on the supply side. On the demand side, it led to a contraction in fixed investment growth and slowdown in private consumption, despite a rise in government spending. However, nominal GDP growth picked up to 12.5% YoY from 10.4% in the December-quarter. The GST implementation pose some risks to post-demonetization growth recovery, but the impact is likely to be transitory and not broad-based. High-frequency data suggest consumption, public investment, and exports still drive growth.
Current Account Balance (CAB) (quarterly, balance in USD and % of GDP)	-USD14.3b -2.4 (Apr-Jun)	-USD15.4bn	-USD3.4bn -0.6 (Jan-Mar)	The significant widening of the CAD was driven by a larger goods trade deficit, despite a slight improvement in remittance inflows and services trade surplus. However, strong FDI and portfolio (debt) inflows more than offset the CAD, resulting in an increase in the surplus of the balance of payments. We expect CAD to normalise in the coming quarters amid fading distortions from the GST and demonetisation. CAD is likely to widen in FY18 on a larger goods trade deficit, but it should stay within sustainable levels of below/around 2% of GDP.

Source: Bloomberg, HSBC Global Asset Management, as of November 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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