# India Insights

## Monthly update on Indian markets

June 2018

## Summary


- *In early June, the Reserve Bank of India (RBI) increased its policy rate for the first time in four years, citing the need to be pre-emptive amidst an acceleration in core inflation momentum*
- *The June rate hike spurred a slight pick-up in bond yields and pushed the benchmark bond yields to cross 8% for the first time since December 2014*
- *We believe aggressive tightening is not warranted given the relatively high real rates and tighter financial conditions*
- *Corporate earnings estimates for FY2019 have been revised down but consensus figures are still registering high growth – of about 20% year-on-year – indicating that the earnings recovery cycle is underway*
- *Domestic investors continued to anchor the Indian equity market, adding USD2.0 billion in May and USD9.1 billion in the first five months of 2018, even as foreign investors pulled back*


## In the spotlight

### So far, so good…so what next?

Emerging Asian economies and markets are facing an increasingly challenging external environment, amidst rising USD funding costs, more divergent economic trends across countries and markets, rising global trade concerns and higher crude oil prices. Since we are midway through 2018, this seems like a good time to stand back and analyse how India is positioned in the midst of these changing dynamics.

**Trade tensions**

- India got swept up in the ongoing trade disagreements between major economies following the recent tariff hike by the US on steel and aluminum products, which is expected to have a $241 million tariff impact on India. India has retaliated with increased duties on a range of agricultural and iron and steel products imported from the US in a tit-for-tat move
- This increase, which follows similar moves by China and the European Union (EU), would come into effect on August 4, according to an Indian Finance Ministry notification on June 20

HSBC

## So far, so good…so what next? (contd.)

> In our opinion, there is still room and time for negotiations between the US and India as the tariffs will only become effective in August

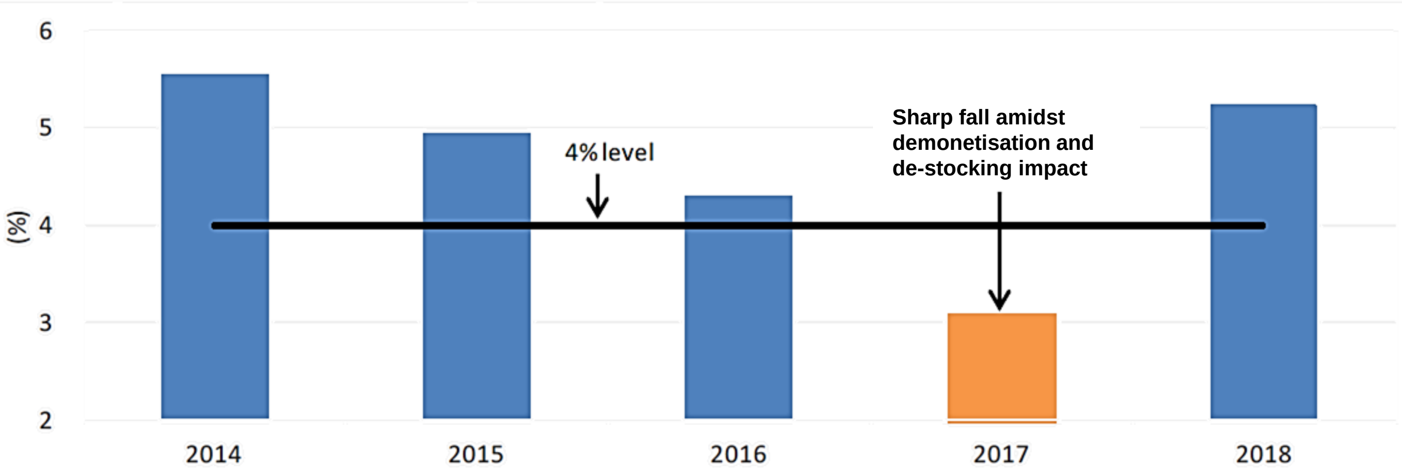
- The list of products on which import duty would be hiked includes - certain agricultural products, shrimps, apples, walnuts, boric acid, diagnostic reagents, and some iron and steel products
- In our opinion, there is still room and time for negotiations between the US and India as the tariff hikes will only become effective in August and officials from the United States Trade Representative (USTR) department are scheduled to visit India shortly, which will allow for further discussions between the two countries on tariffs
- Regardless of the outcome of these discussions the amount involved is rather insignificant (less than 0.01% of India's GDP), so the direct impact to the Indian economy is likely to be negligible. But trade tensions between the US and India may escalate further if no agreement is reached and the tariffs get implemented. The potential effect on business sentiment and investment decisions, especially amid already heightened concerns over global trade and growth, could pose a risk to India's economic outlook in the second half of 2018

**Inflation concerns**

- In early June, the Reserve Bank of India (RBI) increased its policy rate for the first time in four years, citing the need to be pre-emptive amidst an acceleration in core inflation momentum, rise in inflation expectations, higher oil and commodity prices - which have led to a build-up of input cost pressures, and a sustained revival in domestic economic activity
- While the timing of the rate increase was somewhat sooner than expected, with the central bank acting ahead of the curve, a hike in itself was not a surprise to the markets and both equity and bond investors brushed it off
- However there is some debate around whether the RBI's move was premature since the sharp increase in core inflation seems to be distorted by the low base-effect when it is juxtaposed against the demonetisation-induced weakness in prices in the previous year. The pace of disinflation was much higher in the post demonetisation phase compared to previous years, and the level of adjusted core CPI was relatively low at 3% annualised (see chart below).
- Additionally, transient factors such as rise in input prices have also lifted the core inflation higher in recent months. And finally, we believe that growth impulses (from wage, credit cycle, capacity utilisation) are still nascent and not supportive of sustained pricing power
- In our view, aggressive tightening is not warranted given the already relatively high real rates and tighter financial conditions, via higher market and bank lending rates, even without a change in the policy rates
- A sustained rise in crude oil prices can pose a risk to our outlook, but this is not our base case scenario. Oil is India's biggest import and rising prices is a threat not only to inflation, but also the country's sizable trade deficit

> Aggressive tightening is not warranted given the already relatively high real rates and tighter financial conditions

### Base effect: Adjusted core CPI fell in 2017 due to demonetisation and GST de-stocking




Source: CMIE, Edelweiss research; Note: Adjusted Core CPI is Core CPI ex commodities and housing

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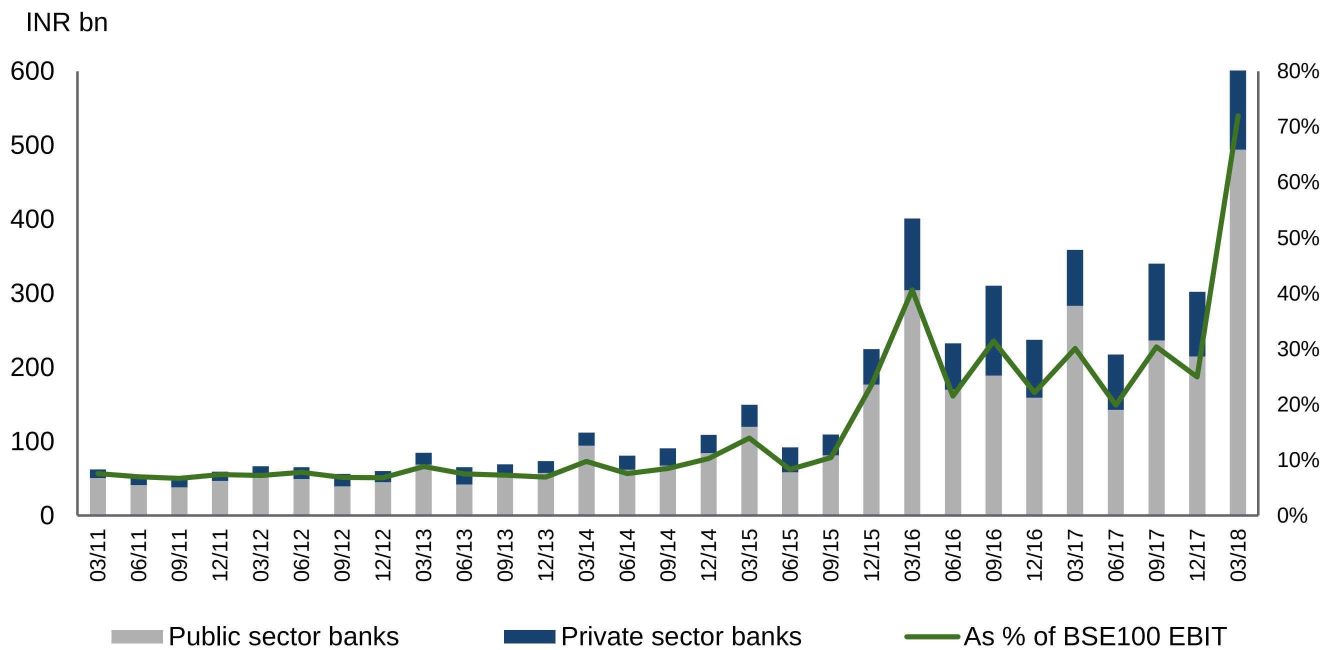
## Equity market

> Earnings estimates for FY2019 have been revised down but consensus figures are still registering high growth – of about 20% year-on-year – indicating that the earnings recovery cycle is underway

- Indian equities were more or less unchanged in June. This follows a correction in the market in the month of May, which saw the MSCI India Index fall by 2.5%, led by rising crude oil prices and the selloff in global and regional equities amidst increased geopolitical uncertainties. Consumer staples was the best performing sector in May, followed by utilities; meanwhile healthcare and telecommunications performed the worst
- The corporate results season for the fourth quarter of the previous financial year has concluded, with overall EPS for MSCI India increasing by 2% year-on-year, dragged down by higher provisions at corporate banks owing to regulatory norms on recognizing non-performing loans (see chart below)
- Earnings estimates for FY2019 have been revised down but consensus figures are still registering high growth – of about 20% year-on-year – indicating that the earnings recovery cycle is underway
- India's largest private bank has been in the headlines again, with its CEO going on leave amidst ongoing investigations surrounding her involvement over conflict of interest on loans made to a large corporate house. The market initially reacted positively to the news of this potential leadership transition
- Indian equities saw net inflows of USD590 million in May. Foreign investors continued to pull out of the market in May, turning into net sellers for the year-to-date period, although just marginally. Domestic participation, however, continues to be stable, as local investors added USD2.0 billion to Indian equities, in total pouring in USD9.1 billion year-to-date
- MSCI India is now trading at 16.8x forward P/E, which is right around its 5-year average. These valuations seem reasonable, since Indian corporate earnings are at a cyclical low at just 2.9% of GDP at present
- Risks for Indian equity investors to watch out for include upcoming state elections, progress of the monsoon rainfall, inflationary and oil price pressures

## Increase in provisions by BSE100 banks




Source: RBI, Credit Suisse, as of June 2018

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## Sector Views

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

Source: HSBC Global Asset Management as of end-May 2018

## Sector focus

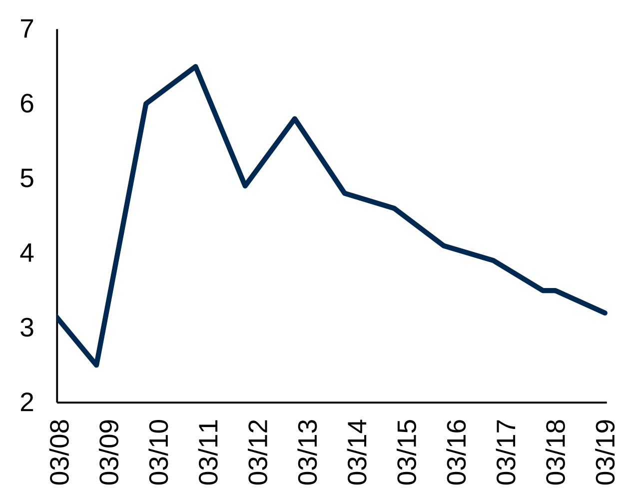
- The landscape of India's automobile industry is poised for change with the government is targeting a 30% **electric vehicle** (EV) penetration by 2030. The transition to electric is expected to help reduce air pollution, which has become a hot button issue in recent years, as well as decrease the nation's reliance on imported crude oil
- India's automobile market is the fifth largest in the world and the industry makes up about 7% of the nation's GDP. But India's EV market is still at a nascent stage, accounting for less than 1 % of total vehicle sales. Research group, Brookings estimates that 100 to 300 million EVs could be on the road in India by 2030
- The Indian government is running a Faster Adoption and Manufacturing of Hybrid and Electric Vehicles in India (FAME) scheme, which provides incentives on the purchase and usage of electric and hybrid vehicles. Phase I of the scheme was launched in 2015, and the rollout of Phase II is still in progress
- The EV market in India saw somewhat of a setback as the state-owned Energy Efficiency Services Ltd.'s (EESL) plan to roll out 10,000 EVs was delayed to March 2019. The original plan was to put out 500 cars by this November and the rest by June 2019. The delay was attributed to challenges surrounding charging points
- HSBC AMG have seen a pick up in demand for EVs in public transportation, with various companies rolling out EV buses in India. Most recently, the city of Patna announced plans to operate 30 e-buses under the Smart City Plan. Earlier this year, the Karnataka government announced the purchase of 640 EVs and Mumbai City Transport procured 40 e-buses
- Both domestic and foreign auto manufacturers seem to be keen on claiming a piece of this expanding market segment. The EV initiatives of key local players are in various stage of development. In the meantime, a number of international auto companies have announced plans leverage on their existing technology and launch electric vehicles in India in the short term

## Chart in focus

### Tackling the twin deficits

**Current Account Deficit (CAD) as % of GDP**


**Fiscal deficit as % of GDP**




Source: Bloomberg, as of 31 May 2018. Note: FY2018 and FY2019 are based on consensus forecast.

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## Fixed income

The additional LCR carve out from the SLR for banks should help improve liquidity for banks and help cool short term rates

We prefer liquid corporate bonds in the 1-5y space, based on spreads

- The MPC's rate decision in June spurred a slight pick-up in bond yields and pushed the benchmark bond yields to cross 8% for the first time since December 2014. Following the rate hike, the MPC adopted a 'neutral' policy stance allowing it to assume a flexible approach amidst enough uncertainty in the future inflation trajectory
- Liquidity in the system has generally remained in surplus during April-May 2018. While government spending and Open Market Operations (OMOs) had a positive effect on liquidity, GST and withdrawal of currency-in-circulation have had a negative effect.
- The additional Liquidity Coverage Ratio (LCR) carve out from the Statutory Liquidity Ratio (SLR) for banks should help improve liquidity for banks and help cool short term rates
- State Development Loans (SDL) supply in FY19 is well distributed. The recent change in valuation norms for banks, could impact spreads at the margin
- The market awaits the announcement on the Minimum Support Price (MSP) for its impact on headline inflation
- On the bond supply side, the high level of excess SLR securities and recent SDL valuation norms could impact appetite from banks at the margin
- From a strategy standpoint, HSBC AMG are marginally underweight in duration while on an incremental basis, have turned a bit defensive. Possibility of further rate hikes is however well captured in current market pricing of government bonds as well as the swap curve. They continue to like liquid Government bonds in the 5-10y space, given the relatively flat yield curve
- HSBC AMG continue to hold liquid credit names to maintain carry and could selectively add to bonds in the 1-5y space (post change in regulations) depending on spreads

### Yields touched 8% after RBI announced rate hike


## Currency

The INR weakened further to 68.13 (as of 20 June 2018) due to escalating US-China trade tensions

- The move up in oil prices and the impact on the current account deficit (despite being covered well by net FDI and capital flows) seem to have weighed to some extent on the Indian rupee (INR)
- The INR weakened further to 68.13 (as of 20 June 2018) due to escalating global trade tensions and concerns about oil prices
- Going forward, HSBC AMG expect the INR to move more in line with the USD, but improvement in growth and macro fundamentals as well as reasonably solid external fundamentals, should keep it relatively well supported. We expect the RBI to smoothen any volatility in the market

Source: HSBC Global Asset Management, Bloomberg data as of 20 June 2018

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## Data watch

| Indicator | Latest data | Consensus data | Previous data | Analysis |
|---|---|---|---|---|
| PMI (Composite)<br>- Manufacturing<br>- Services | 50.4 (May)<br>51.2 (May)<br>49.6 (May) | NA | 51.9 (Apr)<br>51.6 (Apr)<br>51.4 (Apr) | The drop in the composite PMI indicated softening of growth momentum. Forward-looking composite new-orders index declined in both manufacturing and services , while input costs increased, suggesting pressures on profit margins are building. |
| Industrial Production (IP) (% YoY) | 4.9 (Apr) | 5.7 | 4.6 (Mar) | April IP growth was driven by the volatile capital goods and infrastructure sectors. The higher YoY IP growth largely reflected the base effect, while the sequential growth momentum eased. While the economy continues to recover from the GST and demonetisation shocks, uncertainties over the growth outlook have increased. |
| Local passenger vehicle (PV) sales (units) | 301,238 (May) (19.7% YoY) | NA | 298,504 (Apr) (7.5% YoY) | The strong PV sales growth largely reflected new model launches and was partly due to a lower base effect due to transition from Bharat Stage (BS) III to BS-IV emission norms and GST-led destocking. A normal monsoon forecast is supportive, but higher fuel costs and tighter financing conditions could pose challenges. |
| Exports (USD) (% YoY) | 20.2 (May) | NA | 5.2 (Apr) | The rebound in yoy export and import growth was partly due to a lower comparison base. Manufacturing exports have recovered in recent months, largely reflecting a gradual recovery from supply-chain shocks after GST and demonetisation. Exports were also boosted by an unusual jump in crude oil exports in May. |
| Imports (USD) (% YoY) | 14.9 (May) | NA | 4.6 (Apr) | Higher oil imports and non-oil, non-gold imports, an indicator of domestic demand, led gains in total imports, while gold imports further contracted YoY. The smaller net jewellery imports could point to slowing post-demonetization capital flight. However, overall, import growth may remain supported by strength in domestic demand and a larger oil import bill in the coming months if crude stabilises at current levels. |
| Trade Balance (USD) | -14.6bn (May) | -14.3bn | -13.7bn (Apr) | The recent trend of widening deficit has been intact on account of higher oil prices, a recovery in domestic demand growth, and tepid export growth (albeit a recovery). |
| Inflation (% YoY)<br>- CPI<br>- WPI | 4.87 (May)<br>4.43 (May) | 4.90<br>4.00 | 4.58 (Apr)<br>3.18 (Apr) | The rise in headline CPI inflation was broad-based driven by higher food, fuel and core inflation. The combination of sticky core inflation and some easing of growth momentum suggests that inflation is more cosh-push than demand-pull, while some pricing power exists for firms to pass on a fraction of the input cost increases to retail inflation. However, growth impulses (from wage, credit cycle, capacity utilisation) are still nascent and not supportive of sustained pricing power. Benign food prices, which had undershot their typical summer rises, may provide some near-term relief. Inflation could peak in June or the September-quarter as the base effects reverse. The transitory rise in the housing component due to the centre gov't housing rent allowance hikes will likely fade off once the base effects reverse. However, crude oil prices and the INR, the increase in minimum support prices, monsoon rains, and the government's efficacy in raising food prices remain important factors for the inflation outlook, as well as the fiscal policy risk given a busy election calendar. |
| Repo rate (%)<br><br>Reverse repo rate (%)<br><br>Marginal standing facility (MSF) rate (%) | 6.25<br><br>6.00<br><br>6.50<br><br>(6 Jun) | 6.00<br><br>5.75<br><br>6.25 | 6.00<br><br>5.75<br><br>6.25<br><br>(5 Apr) | The RBI's decision to raise its policy rates for the first time in four years was driven by the need to be pre-emptive amidst an acceleration in core inflation momentum, rise in inflation expectations, higher oil and commodity prices leading to a build-up of input cost pressures, and a sustained revival in domestic economic activity. The RBI revised its CPI inflation forecast to 4.8-4.9% yoy in H1FY19 (from 4.7-5.1%) and to 4.7% in H2FY19 (from 4.4%). It maintained its 'neutral' policy stance, signaling future policy decisions remain data dependent. Further rate hikes are likely, in our views, if core inflation stays elevated and/or inflation risks rise further. However, we believe the Indian economy does not require or warrant any aggressive tightening given the already relatively high real rates and tighter financial conditions (via higher market and bank lending rates) even without a change in the policy rates. |
| GDP at market prices (quarterly, % YoY)<br>Gross value-added (GVA) at basic prices (quarterly, % YoY) | 7.7 (Jan-Mar)<br><br>7.6 (Jan-Mar) | 7.4<br><br>7.1 | 7.0 (Oct-Dec)<br><br>6.6 (Oct-Dec) | The acceleration in GDP growth was driven by a pickup in investment activity and government consumption expenditure, while private consumption also recovered. Manufacturing and construction activity was strong; agricultural output improved; and services GDP maintained steady growth. We expect private consumption – with a pickup in rural demand, higher public/infrastructure investment, nascent signs of a recovery in private capex and some stabilisation in exports to support an ongoing cyclical recovery. However, the tightening of global and domestic monetary/financial conditions, domestic banking sector issues with still fragile balance sheets, and the adverse terms-of-trade shock from higher oil prices pose challenges to the outlook |
| Current Account Balance (CAB) (quarterly, balance in USD and % of GDP) | -USD13.0b<br>-1.9 (Jan-Mar) | NA | -USD13.7b<br>-2.1 (Oct-Dec) | CAD widened to -1.9% of GDP in FY18 from -0.6% in FY17, due to a much larger goods trade deficit, which more than offset a larger services trade surplus and an improvement in the income account balance. We expect CAD to widen further to around -2.5% of GDP in FY19. Despite recent signs of a recovery in FDI, we think the basic balance (CAD+FDI) is likely to stay in deficit in FY19, leaving the balance of payments reliant on short-term trade credit and volatile portfolio flows. |

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

Source: Bloomberg, HSBC Global Asset Management, as of June 2018

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