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Macro-economic developments

- As widely expected, the US Fed hiked rate by 25 bps to 125-150 bps in its December 2017 policy. Fed dot plot indicates that it expects 3 rate hikes in 2018. Fed revised US GDP growth estimate to 2.5% in 2018 from 2.1% earlier. Inflation expectations were broadly the same, with Core PCE inflation expected at 1.9% in 2018.
- Current Account Deficit (CAD) came in at USD7.2 billion (1.2% of GDP) in Q2 FY18, below market expectations of USD8.3 billion. Also, it was lower than 4-year high CAD of USD15 billion (2.5% of GDP) in Q1 FY18, but was higher than that in the year ago period (Q2 FY17). Lower CAD was helped by reduction in trade deficit, due to sharp fall in gold imports primarily.
- Balance of Payments (BoP) came in at a healthy USD9.5 billion in Q2 FY18, albeit a bit lower than previous quarter, but higher than that in the year ago period (Q2 FY17) primarily driven by FDI inflows
- Fiscal deficit for FYTD 18 (April - Nov) came in at 112% of Budgeted Estimate (BE), compared to ~86% in the year ago period. The elevated fiscal deficit was due to a combination of higher expenditure and lower revenue receipts, especially on the non-tax revenue front (due to lower dividend from RBI).
- Index of Industrial Production (IIP) fell to 2.2%YoY in Oct 2017 from 4.1%YoY in the previous month—led by Mining and Manufacturing sectors.IIP for FYTD 18 (April – October 2017) was sluggish at 2.5%, compared to 5.5% in the year ago period
- CPI headline inflation rose above expectations to 4.9%YoY in Nov 2017, from 3.6%YoY in Oct 2017. The rise was primarily contributed by pick-up in food inflation, along with housing and fuel inflation. Food inflation rose to 4.4%YoY in Nov 2017 from 1.9%YoY in Oct 2017—led by fruits & vegetables where inflation rose to 17.4%YoY in Nov 2017 from 6.8%YoY in Oct 2017.Core inflation (ex food & fuel) also rose to 4.9%YoY in Nov 2017 from 4.6%YoY in Oct 2017.
- Brent crude price rose by 5.2% in December to close at USD 66.87/barrel; versus USD 63.57/barrel at the end of November.
- INR appreciated by almost a percent in December to close at INR 63.87/USD.

Equity market developments and Outlook

- Equity markets did fairly well in the month of December, with the benchmark Nifty index returning 3.0%. Mid/small-caps stocks fared better during the month with the Nifty Midcap 50 index and the NSE Smallcap 100 index closing up 6.3% and 4.4% respectively.
- On the sectoral front, metals, telecom, real estate and auto outperformed, while PSU banks and banks underperformed. The Nifty PSU Bank index closed the month with a loss of 4.0%.
- Foreign portfolio investors (FPIs) registered net outflow of ₹. 5,354 crore in the month of December, after seeing a strong net inflow of ₹. 19,783 crore in November.
- Domestic Institutional Investors (DIIs) continued to see strong flows, and registered a net inflow of ₹. 8,143 crore in December. Within the DII segment, Mutual funds were net buyers to the tune of ₹. 6,114 crore in December, while Insurance funds also turned net buyers of ₹. 1,633 crore during the month.
- Global markets broadly fared well during the month of December. In the US, the S&P 500 index and Dow Jones Industrial Average index closed with a gain of around 1% and 2% respectively, with President Trump being able to pass the mega US tax reform bill. In Europe, the FTSE 100 index outperformed with a gain of around 5% in December. Within Asia, the India and Indonesia markets outperformed during the month.
- Going forward, we expect Corporate Earnings to drive markets in 2018, and not PE expansion. Corporate earnings in Q2 FY18 have shown some signals of bottoming out, and we expect earnings to recover in H2FY18, and pick-up more meaningfully in FY19. Any disappointment on the corporate earnings front may cause headwinds for the Indian equity markets.
- We expect economic growth to recover in the coming year, led by pick-up in consumption and a gradual recovery in investment. Although the capex cycle remains currently in doldrums, we expect the PSU bank recapitalization initiative to contribute to a pick-up in credit growth, which could trigger a capex recovery over the coming quarters.
- Commodity prices seem to have bottomed out and we could be seeing the start of a commodity up-cycle. Any further upward trajectory esp. in crude oil prices may cause some headwinds for an oil-importing country like India.

Fixed Income market developments and Outlook

- 10 year G-Sec benchmark yield closed higher at 7.33% in December v/s 7.06% in November, due to concerns regarding fiscal slippage, rise in CPI inflation, further pick-up in crude oil prices, and government announcement of additional market borrowing in FY18 (of ₹. 50,000 cr in Gilts and ₹ 23,000cr in T-Bills) towards the end of the month. However, an announcement of cancellation of two bond auctions by the RBI on the last trading day of December, provided some respite to bond yields.
- In its December 2017 monetary policy review, the RBI Monetary Policy Committee (MPC) voted (5 - 1) in favour of keeping the policy repo rate unchanged, while maintaining the 'neutral' stance of the monetary policy. The central bank highlighted upside risk to inflation, and also increased its inflation projection for second half of FY18 by 10 bps, from 4.2-4.6% in its October monetary policy to 4.3-4.7% in the December monetary policy, with risks evenly balanced.
- Foreign Portfolio Investors (FPIs) registered a net inflow of Rs. 2,240 crore in the debt segment during the month of December.
- With the rise in bond yields, we feel that most of the negatives have been priced in by the market, and therefore bond yields could remain range-bound in the near term.
- On the domestic monetary policy front, we feel that the interest rate easing cycle seems to have ended. The RBI MPC is expected to be on long pause, with a "neutral" stance. However, you could see a more hawkish RBI, if the upward trajectory in global crude prices and inflation continues, thereby putting more upward pressure on bond yields. Future policy stance of RBI MPC would continue to be data dependent.
- The upward movement in yields presents a good investment opportunity in the shorter to medium term end of the yield curve.
- Key factors to watch out for will be – fiscal deficit, Union budget, trajectory of growth and inflation going forward, RBI and US Fed policy decisions and indirect tax collections.