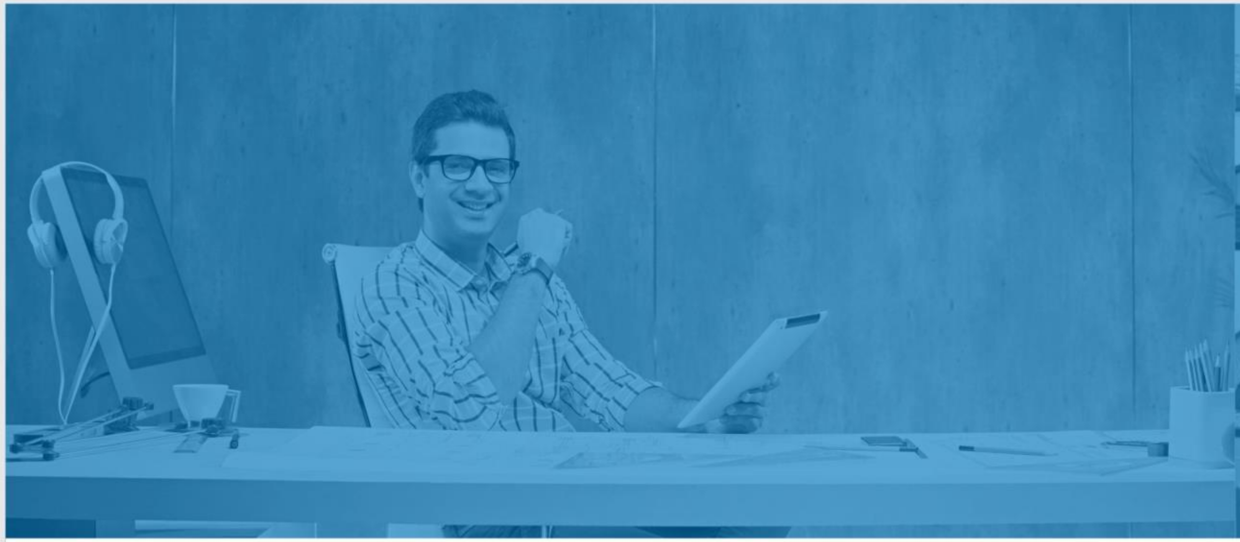

Quarterly Market & Macro Review & Outlook

July 2018

LIFE GOALS. **DONE.**

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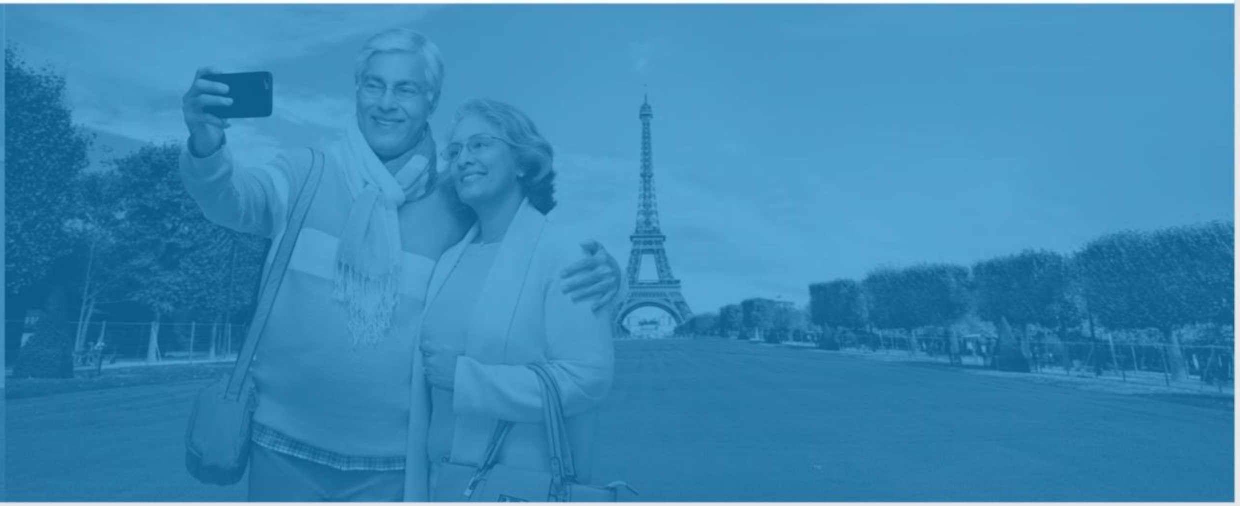


Equity Markets & Flows

Globally, India has been among the top performing markets, amidst the global correction that we have seen over the past 3 and 6 months

Performance of International Indices (ended June 2018 in %)				
Index Name	**Country / Region**	**3 months**	**6 months**	**1 Year**
Shanghai Composite	China	-10.1	-13.9	-10.8
FTSE SET All Share	Thailand	-10.4	-9.8	-0.1
JSX Composite	Indonesia	-6.3	-8.8	-0.5
MSCI Emerging Markets PR USD	Emerging Markets	-8.7	-7.7	5.8
FTSE Bursa Malaysia KLCI	Malaysia	-9.2	-5.9	-4.1
MSCI AC Asia Ex Japan PR USD	Asia Ex-Japan	-6.2	-5.8	7.5
KOSPI	South Korea	-4.9	-5.7	-2.7
BOVESPA	Brazil	-14.8	-4.8	15.7
FSE DAX TR	Germany	1.7	-4.7	-0.2
FTSE/SGX STI	Singapore	-4.6	-3.9	1.3
Hang Seng	United States	-3.8	-3.2	12.4
MSCI World PR USD	World	1.1	-0.7	9.0
FTSE 100	UK	8.2	-0.7	4.4
RTS RTSI PR USD	Russia	-7.6	0.0	15.3
Euronext Paris CAC 40	France	3.0	0.2	4.0
S&P 500	US	2.9	1.7	12.2
Nifty 50	**India**	**5.9**	**1.7**	**12.5**
TSEC TAIEX	Taiwan	-0.8	1.8	4.3
S&P/ASX 200 PR	Australia	7.6	2.1	8.3

Source: Morningstar Direct. Returns are absolute and in local currency of index.
Date sorted on the basis of 6 mth return in descending order

- **Over the past 3 months and 6 months, we have seen a substantial correction in Asia Ex-Japan and some emerging markets due to large outflows from these funds, but India managed to fare much better.**

Over past 6 months or CYTD (ended June 2018)

- **Underperformers**: China has been one of the bottom performing markets due to trade war concerns. Regionally, MSCI EM and MSCI Asia Ex-Japan indices registered large losses. Other Asian countries like Thailand, Jakarta, Malaysia and Korea were among the bottom performers.
- **Outperformers:** Australia, Taiwan, India and the US were among the top performing markets. Generally, developed markets fared better.

Over past 3 months or quarter (ended June 2018)

- **Underperformers:** Brazil, Thailand China and Malaysia were among the bottom performing markets
- **Outperformers:** UK, Australia, India and France were among the top performing markets. In this period too, developed markets fared better, generally.

Domestically, small / mid-cap stocks and sectors like PSU, Realty, Power, Oil & Gas and Metal have witnessed significant correction over the past 6 months. Meanwhile, IT & FMCG has outperformed

Performance of Domestic Indices (ended June 2018 in %)			
Index Name	**3 months**	**6 months**	**1 Year**
NIFTY Smallcap 100	-7.9	-21.1	-1.8
S&P BSE PSU	-7.2	-20.5	-10.1
S&P BSE Realty	-7.0	-20.5	1.5
S&P BSE Power	-8.4	-18.3	-12.5
S&P BSE Oil and Gas	-6.5	-16.1	3.5
S&P BSE Metal	-1.9	-12.5	14.9
Nifty Midcap 50	-2.5	-12.4	7.3
S&P BSE Consumer Durables	-9.2	-10.9	26.2
S&P BSE Auto	-0.9	-10.9	1.8
S&P BSE Capital Goods	-5.4	-8.6	2.4
S&P BSE Healthcare	6.4	-5.4	-1.3
Nifty 500	2.8	-3.5	10.0
S&P BSE BANKEX	7.5	1.4	11.3
Nifty 50	5.9	1.7	12.5
S&P BSE SENSEX	7.4	4.0	14.6
S&P BSE FMCG	9.0	4.8	7.5
S&P BSE IT	15.0	23.4	41.6

Source: Morningstar Direct. Returns are absolute.
Date sorted on the basis of 6 mth return in descending order

Over past 6 months or CYTD (ended June 2018)

- **Underperformers**: Small / Mid-cap stocks and sectors like PSU, Realty, Power, Oil & Gas and Metal
- **Outperformers:** IT and FMCG sectors

Over past 3 months or quarter (ended June 2018)

- **Underperformers:** Consumer durables, Power, Small-Cap, PSU & Realty
- Outperformers: IT, FMCG, Banking and Healthcare

Indian equity markets have seen outflows from FIIs, but registered strong inflows from DIIs

Source: SEBI, BSE	Rs in Crore			
Year	**FIIs**	**DIIs**	**MFs**	**Insurance**
FY2008	52,572	47,794	15,948	31,846
FY2009	(48,250)	60,040	6,962	53,078
FY2010	110,752	24,211	(10,235)	34,446
FY2011	110,121	(18,709)	(19,974)	1,265
FY2012	43,738	(5,347)	(1,384)	(3,963)
FY2013	140,032	(69,069)	(22,008)	(47,061)
FY2014	79,709	(54,161)	(21,069)	(33,092)
FY2015	111,445	(21,446)	40,087	(61,533)
FY2016	(14,171)	80,416	66,143	14,273
FY2017	60,196	30,787	56,209	(25,422)
FY2018	21,074	113,258	140,517	(27,259)
FY2019 (upto June)	(18,705)	37,712	33,820	3,893

	Rs in Crore			
Month-end	**FIIs**	**DIIs**	**MFs**	**Insurance**
30 April 2017	(2,209)	9,248	11,244	(1,996)
31 May 2017	9,957	4,277	9,358	(5,081)
30 June 2017	2,485	5,333	7,853	(2,520)
31 July 2017	2,488	4,786	11,800	(7,013)
31 August 2017	(11,108)	16,205	17,941	(1,736)
30 September 2017	(10,759)	21,026	17,457	3,569
31 October 2017	1,923	10,091	9,991	100
30 November 2017	19,783	9,243	12,080	(2,837)
29 December 2017	(5,350)	8,143	8,333	(190)
31 January 2018	12,984	399	9,023	(8,624)
28 February 2018	(12,492)	17,813	16,181	1,632
31 March 2018	13,372	6,694	9,256	(2,562)
30 April 2018	(6,468)	8,511	11,294	(2,782)
31 May 2018	(9,660)	15,055	13,619	1,436
30 June 2018	(2,577)	14,146	8,907	5,239

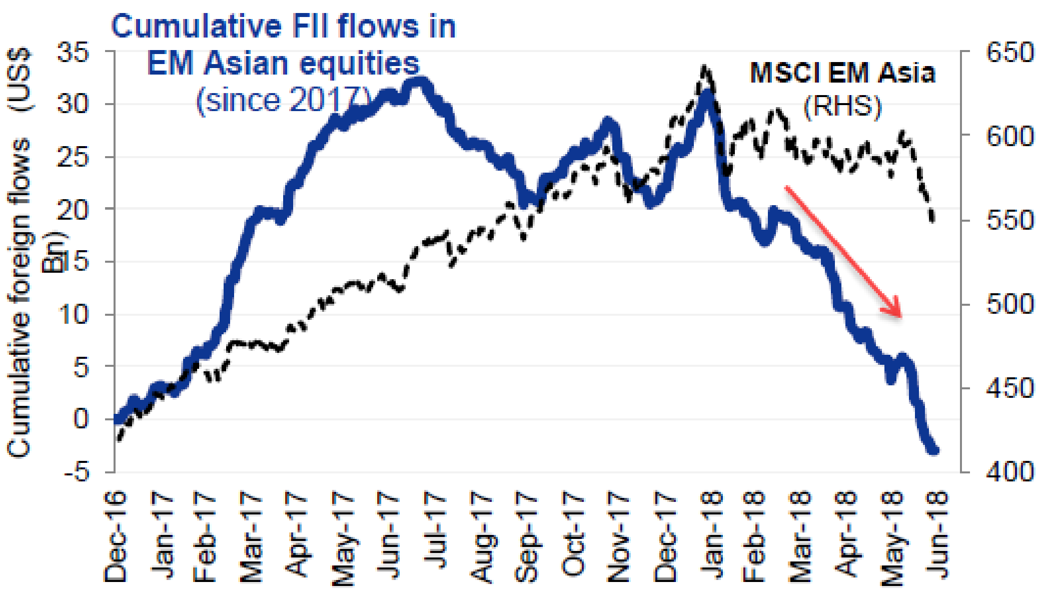
- FIIs have registered a net outflow of Rs. 18,705 crore over the past quarter (ended June), and a net outflow of Rs. 4,841 crore CYTD in 2018, in Indian equities.
- However, DIIs have registered strong inflows of Rs. 37,712 crore over the past quarter (ended June), and a net inflow Rs. 62,618 crore of CYTD in 2018, with most of it being contributed by mutual funds.
- Insurance funds registered a net buying of Indian equities to the tune of Rs. 5,239 crore in the month of June 2018—which is the highest monthly net purchase in equities by insurance funds since the month of January 2016.

Asian Emerging Markets have seen large foreign outflows YTD in 2018

Foreign Equity Flows within Emerging Asian region ($ in bln)

Country	2016	2017	YTD	since late-Jan'18 peak
India	2.9	8.0	(0.8)	(2.9)
Korea	10.4	8.1	(3.9)	(6.8)
Taiwan	11.0	6.1	(8.9)	(11.8)
Philippines	0.1	1.1	(1.2)	(1.4)
Indonesia	1.2	(3.0)	(3.4)	(3.7)
Thailand	2.2	(0.8)	(5.7)	(5.7)
Malaysia	(0.6)	2.5	(1.7)	(2.6)
ASEAN	2.9	(0.2)	(12.1)	(13.4)
Emerging Asia	$27.2	$22.0	-$25.7	-$34.8

Cumulative FII inflows into EM Asian Equities Vs EM Asia Index

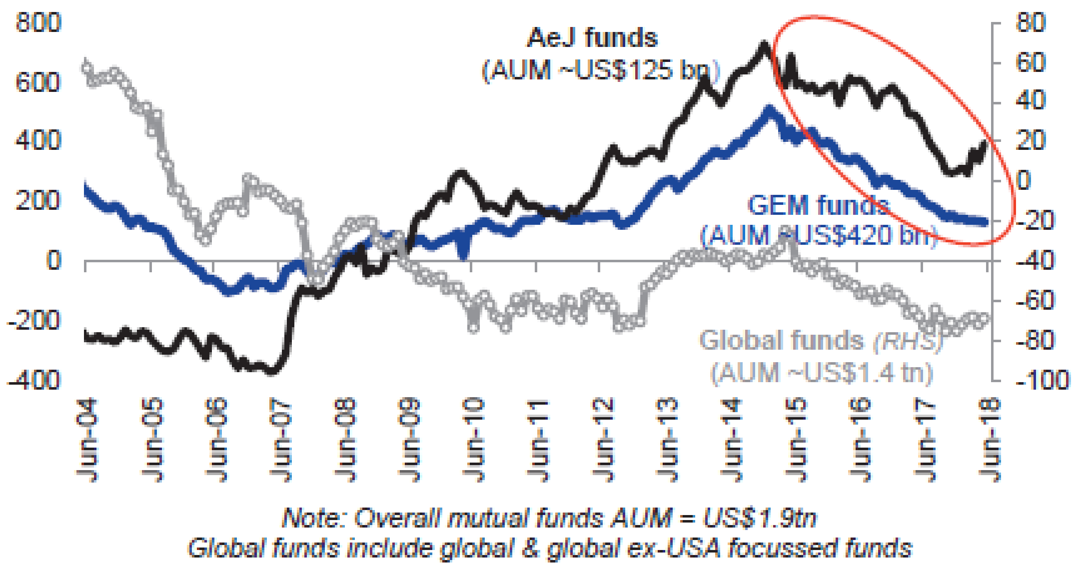


Source: Goldman Sachs, Bloomberg

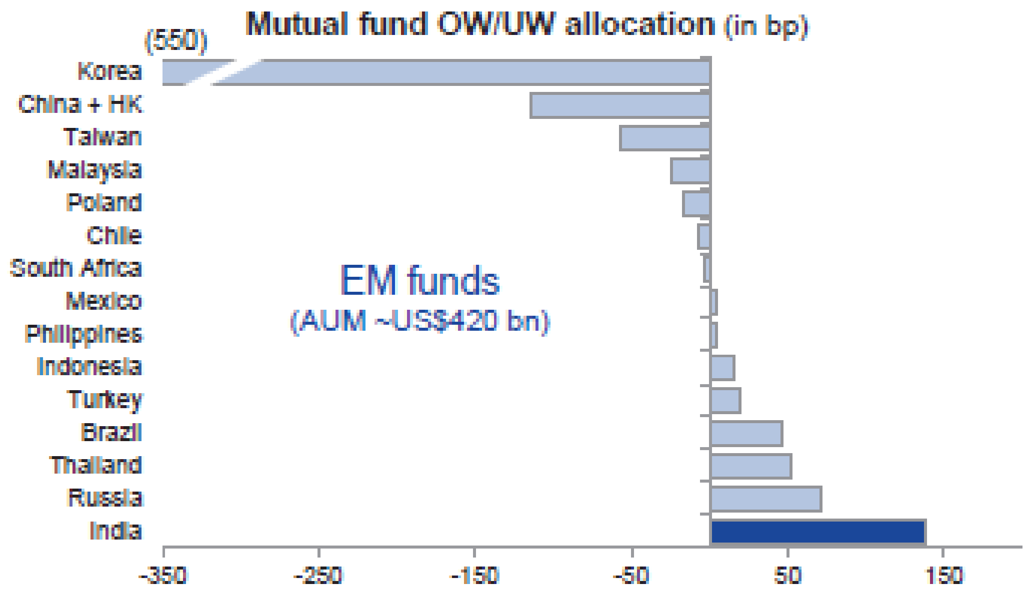
- Emerging Asia equity markets have seen large outflows to the tune of $35 billion from FIIs since late-Jan 2018 peak, and a net outflow of $26 billion CYTD in 2018 (up to June). This has been caused due to large outflows from Asia ex-Japan and Emerging Market Equity funds.
- The large FII outflows from these Asian markets, have led to a sharp correction in some of these markets.
- YTD in 2018, India has seen relatively less FII outflow compared to some of the other Asian emerging markets. This, along with strong DII equity flows have helped the Indian market to relatively outperform YTD in 2018.

India still has overweight allocation in portfolios of EM & Asia ex-Japan equity funds; albeit it has come down gradually over the past few years

India's allocation in mutual funds globally (OW / UW in bps)



Allocation to various countries in Emerging Market Funds (OW / UW in bps)

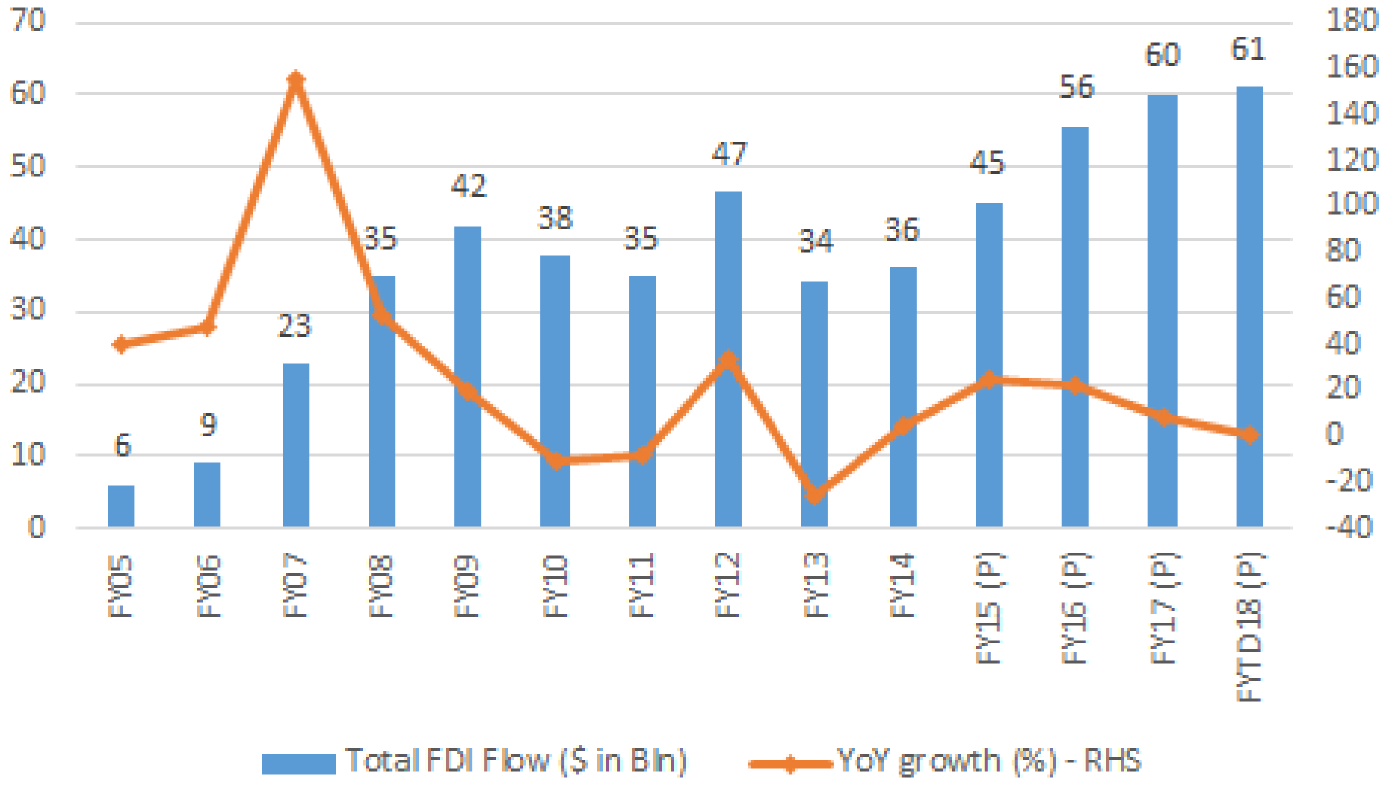


Source: Goldman Sachs, EPFR. GEM = Global Emerging Market Funds, AeJ = Asia ex Japan funds

- India still has an overweight (OW) allocation of 130 bps in Emerging Market Equity Funds, and ~400 bps in Asia ex-Japan equity funds, when compared to it weight in the respective MSCI index. Albeit the allocation has come down gradually over the past few years.
- However, India has an underweight (UW) allocation in Global Equity Funds.
- India has the highest overweight allocation in portfolios of emerging market equity funds. Korea and China / HK are biggest underweight positions in emerging market fund portfolios.

Fiscal Year-Wise Total FDI Trend for India

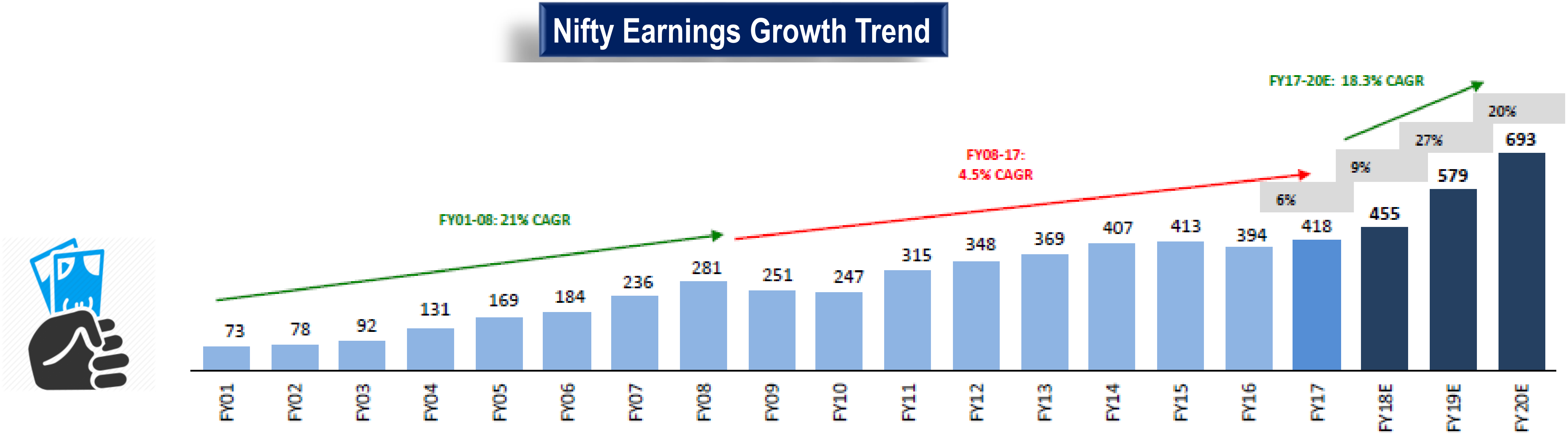
FDI Flows growth was flat in FY18; but it was still healthy at $61 bln



Source: DIPP. P = Provisional. Total FDI flows includes re-invested earnings and other capital.

Earnings growth is recovering & Forward valuations near long term average

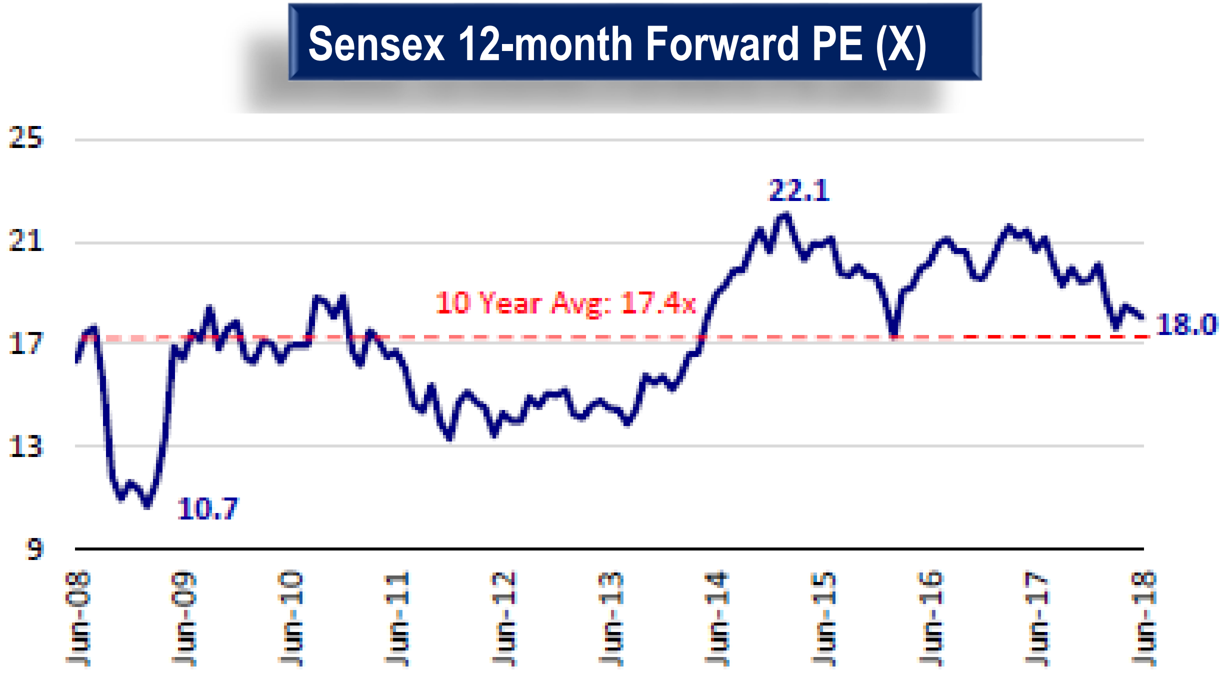
Signs of revival in Corporate Earnings Growth

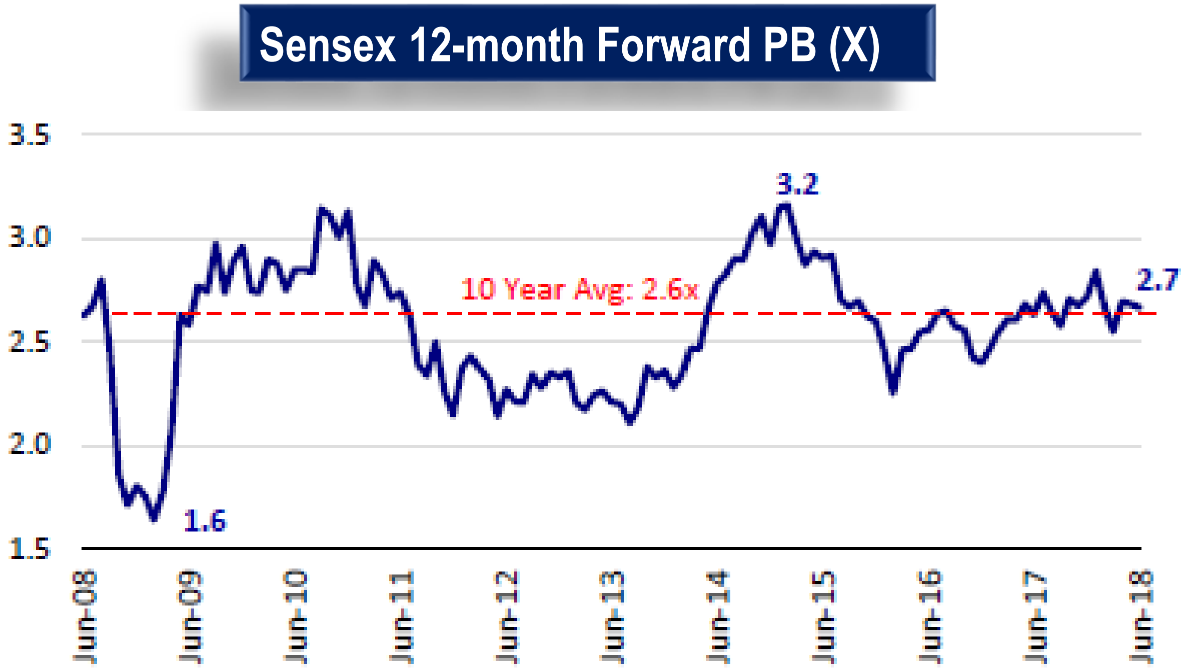


Source: Motilal Oswal Research

- ✓ Nifty earnings growth between FY01-08 was very robust at 21% CAGR.
- ✓ However, earnings growth slowed down to 4.5% CAGR between FY08-17. Last 4 years earnings growth was dismal.
- ✓ Corporate earnings for Q4 FY18 have been above or in-line with expectations in majority cases; but at an aggregate level has been below expectations, mainly dragged down by PSU and Corporate banks.
- ✓ Nifty EPS growth rose to 9% in FY18 from 6% in FY17. But expected to recover meaningfully going forward, esp. in FY19-20.
- ✓ The sectors which would drive earnings growth, would be: Metals Private Banks & Consumption related themes.

Market Fwd P/E is now close to the long term average

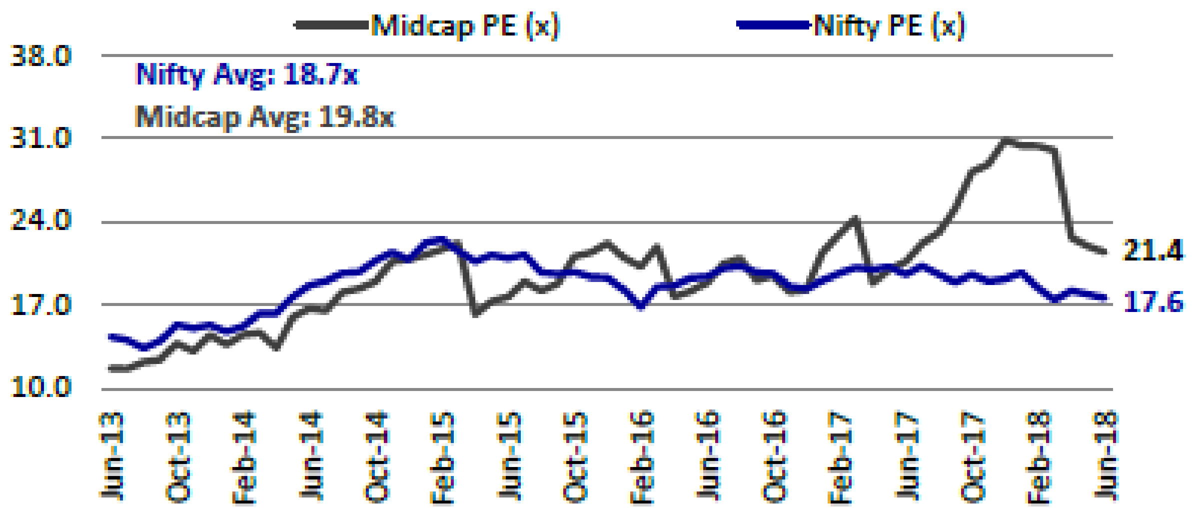




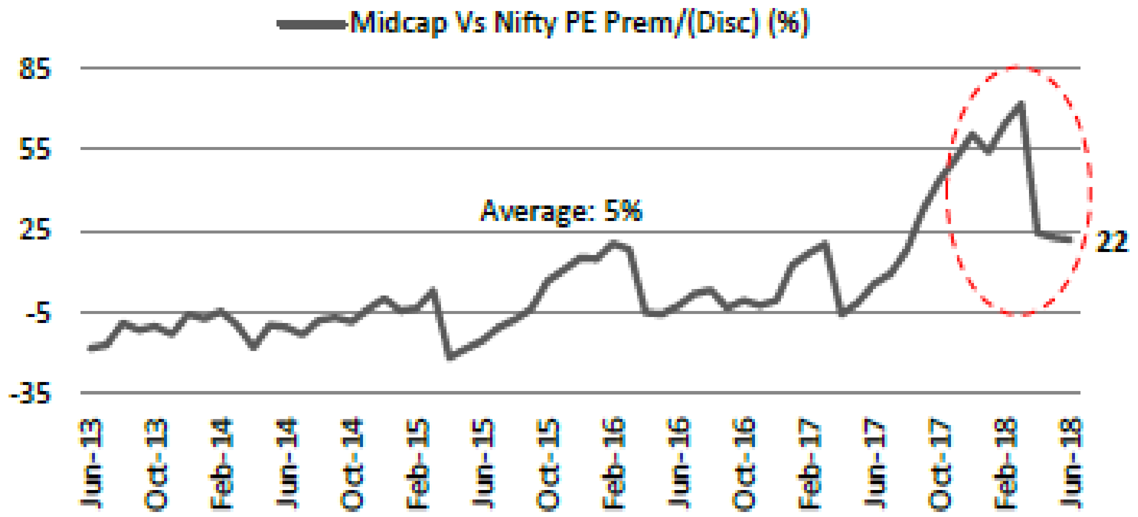
Source: Motilal Oswal & Bloomberg

Midcap companies have seen their valuation premium fall considerably, amidst the correction

12-month Forward PE of Nifty Vs Midcap Index (X)



Midcap Vs Nifty Premium (in %)



Source: Bloomberg, Motilal Oswal

- ✓ Even with the fall in valuation premium of mid-caps, we continue to prefer large-cap companies: Risk-reward more favorable
- ✓ Historically, large caps have traded at premium, but now it is the reverse.

Economic growth is recovering

GDP & GVA growth came in above expectations in Q4 FY18

GDP Growth Trend (in %)

	YoY growth rate				
	Q2FY18	Q3FY18	Q4FY18	FY17	FY18
Private Final Consumption Exp.	6.6	5.6	6.7	7.3	6.6
Government Final Consumption Exp.	2.9	6.1	16.8	12.2	10.9
Gross Capital Formation	8.9	13.0	14.9	4.7	9.6
Gross Fixed Capital Formation	6.9	12.0	14.4	10.1	7.6
Change in Stock	5.8	7.0	7.8	-61.2	4.5
Valuables	56.5	40.8	29.1	-13.9	58.8
Exports of Good & Services	6.5	2.5	3.6	5.0	5.6
Imports of Goods & Services	5.4	8.7	10.9	4.0	12.4
GDP	6.5	7.2	7.7	7.1	6.7

GVA Growth Trend (in %)

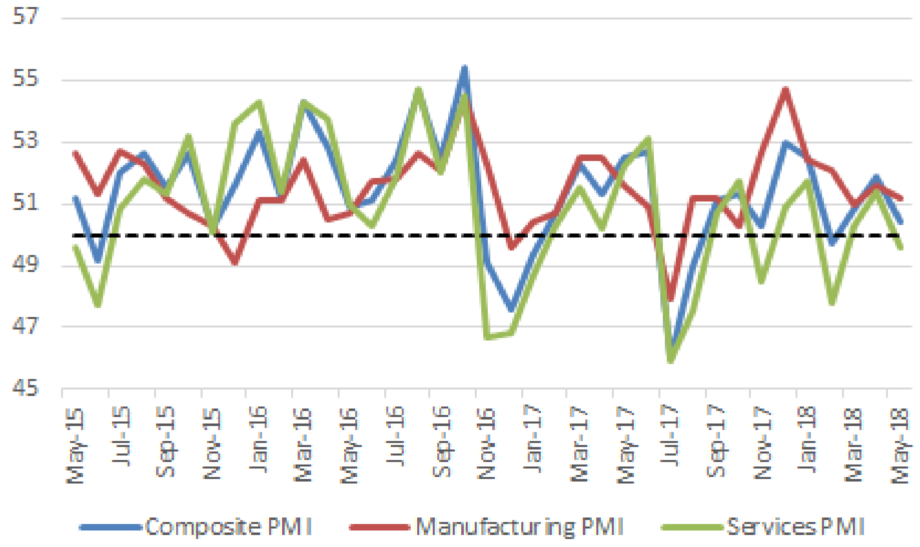
	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	FY17	FY18
Agriculture	4.3	5.5	7.5	7.1	2.7	2.7	4.1	4.5	6.3	3.4
Industry	10.2	7.8	8.8	8.1	-0.4	7.0	6.8	8.0	8.7	5.5
Mining and Quarrying	10.5	9.1	12.1	18.8	1.8	7.1	-0.1	2.7	13.0	2.9
Manufacturing	9.9	7.7	8.1	6.1	-1.8	6.9	8.1	9.1	7.9	5.7
Electricity, gas and water supply	12.4	7.1	9.5	8.1	7.1	7.7	6.1	7.7	9.2	7.2
Services	8.5	7.4	6.0	4.9	8.6	6.6	7.6	8.2	6.7	7.6
Construction	3.0	3.8	2.8	-3.9	1.5	2.8	6.8	11.5	1.3	5.7
Trade, hotels, Transport, & Communication	8.9	7.2	7.5	5.5	8.4	9.3	9.0	6.8	7.2	8.0
Financing, Insurance, Real Estate& business services	10.5	8.3	2.8	1.0	8.9	6.4	6.7	5.0	6.0	6.6
Public administration, defence, & other services	7.7	8.0	10.6	16.4	13.2	5.6	7.2	13.3	10.7	10.0
GVA at Basic Price	8.3	7.2	6.9	6.0	5.6	6.2	6.7	7.6	7.1	6.5

Source: MOSPI, Philip Capital

- GDP growth for Q4 FY18 came in above expectations at 7.7%YoY, on the back of gross fixed capital formation (or investments), which registered a growth of more than 14.4%YoY in Q4FY18, compared to negative growth YoY in the corresponding quarter a year back (Q4 FY17). Private consumption growth also picked up to 6.7%YoY in Q4 FY18.
- GVA growth for Q4 FY18 picked up to 7.6%YoY, helped by strong growth in manufacturing and construction sectors.
- With that, GDP and GVA growth for full FY18 came in at 6.7% and 6.5% respectively, compared to CSO's GDP and GVA forecast for FY18 at 6.6% and 6.4% respectively. **RBI forecasts GDP growth to pick-up to 7.4% in FY19.**

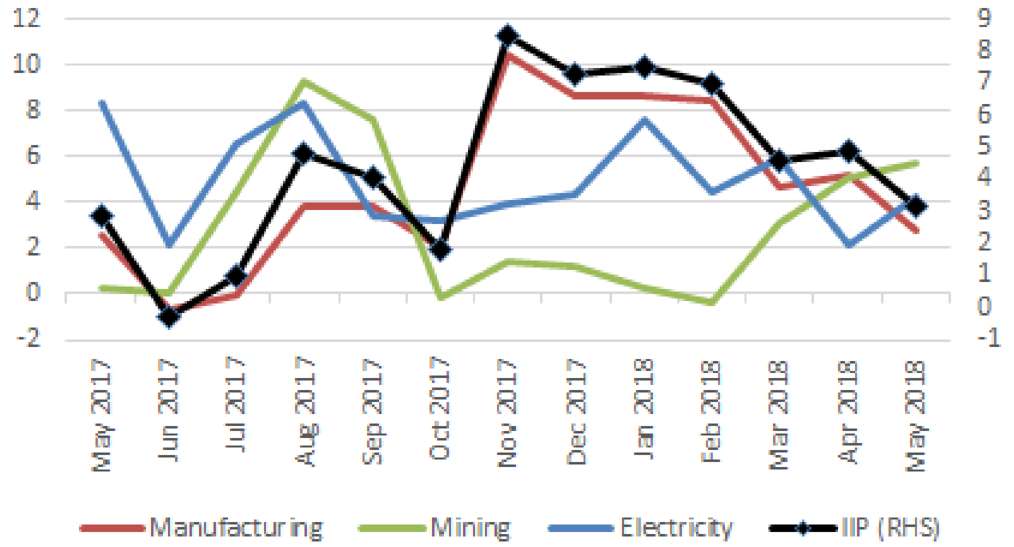
Manufacturing sector is mixed

Movement of PMI Components



Source: Bloomberg. Above 50 indicates expansion and below 50 indicates contraction

IIP & Industry Components Growth (%YoY)

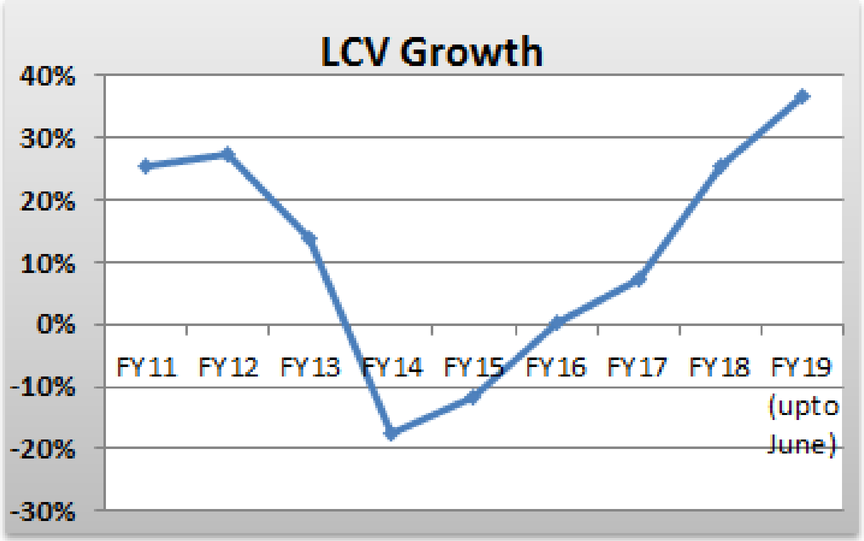


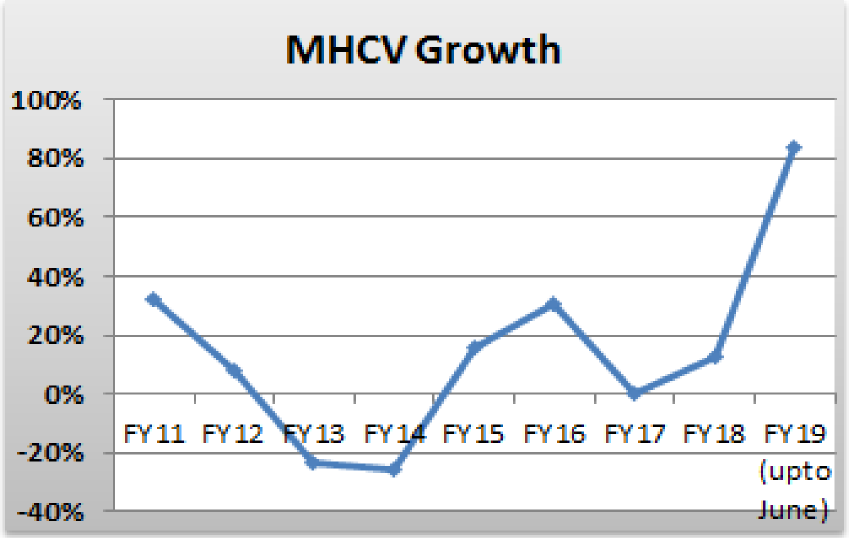
Source: Bloomberg

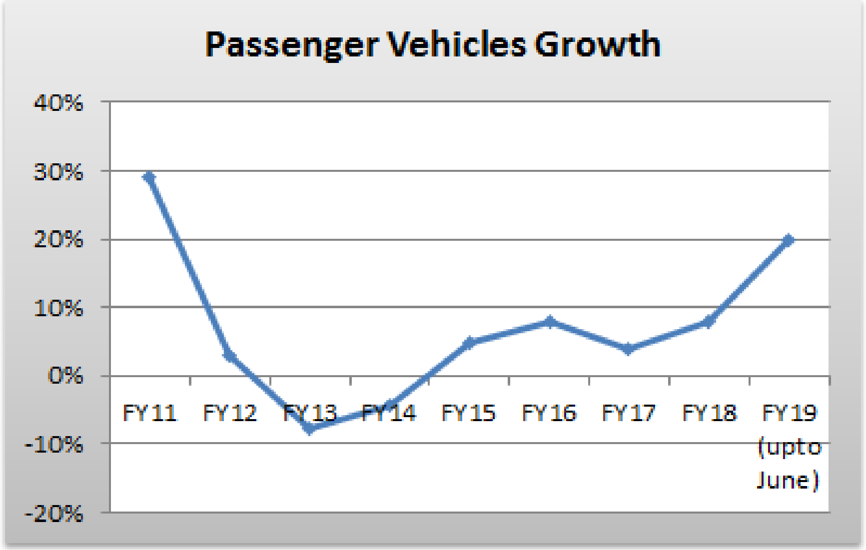
- The Nikkei India Manufacturing Purchasing Managers Index (PMI) rose to its highest level this calendar year at 53.1 in the month of June 2018 from 51.2 in May 2018, helped by sharpest gains in output and new orders since last December.

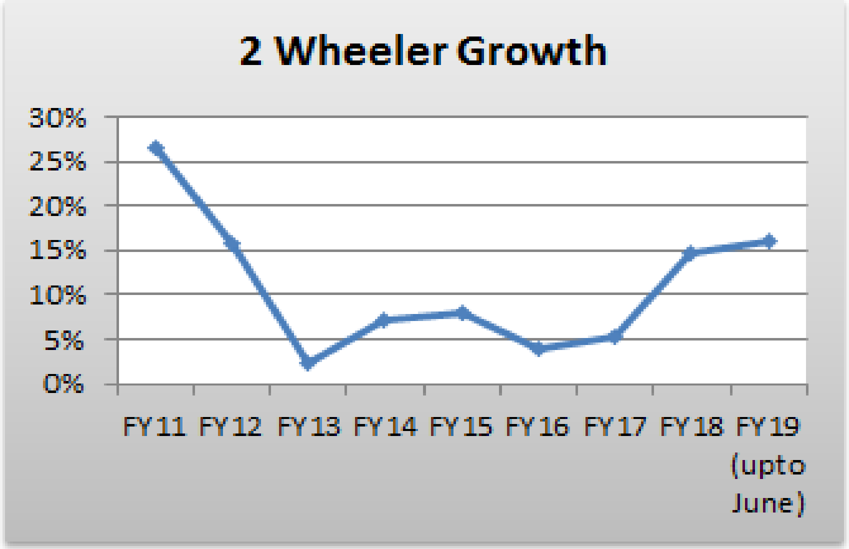
- However, Index of Industrial Production (IIP) growth came in at 3.2%YoY in May 2018 from 4.9%YoY in the previous month—led by Manufacturing sector (78% weight in index), where growth fell to 2.8%YoY in May 2018.

High Frequency Indicators: 2-wheeler & commercial vehicle growth has been robust in Q1 FY19, and passenger vehicles also saw a decent recovery in growth, after some time. M&HCV growth saw a sharp % increase in Q1 FY19, due to lower base effect in corresponding period last year, due to tight emission norms introduced then.



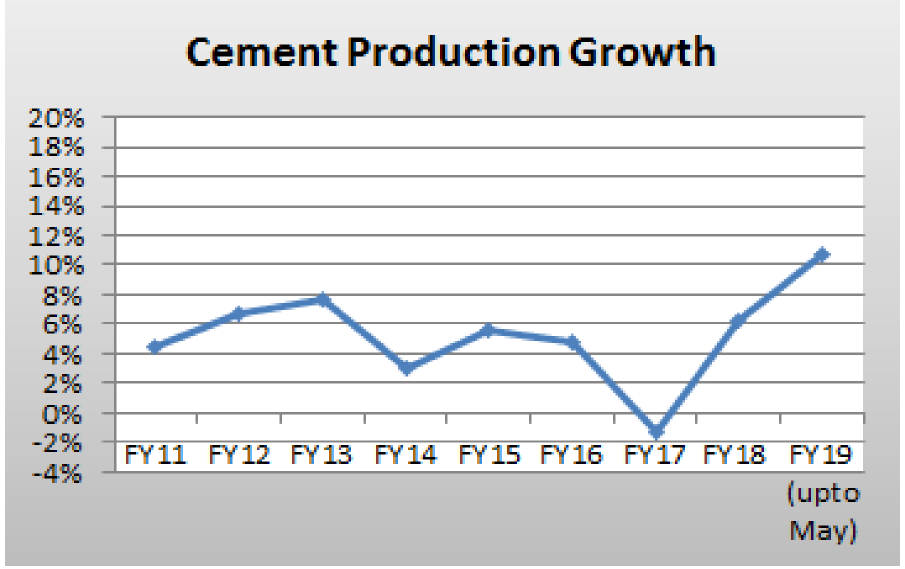


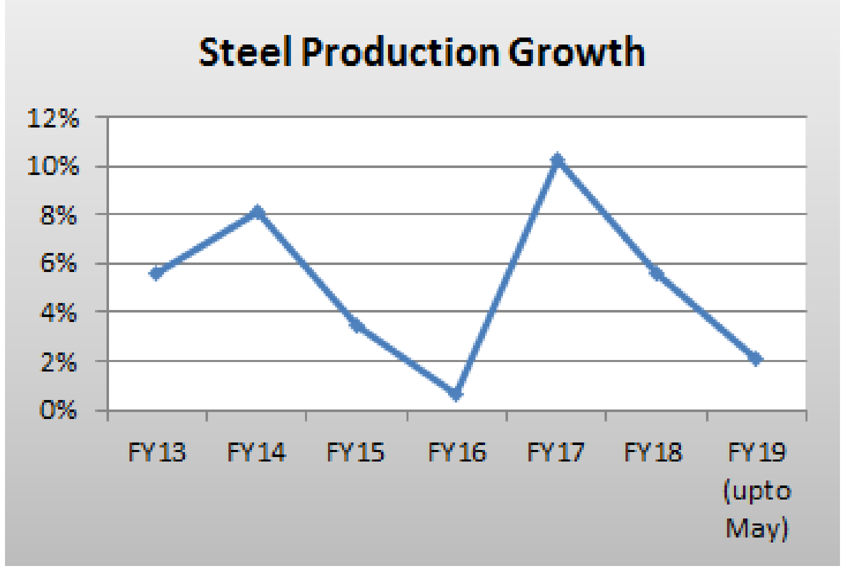


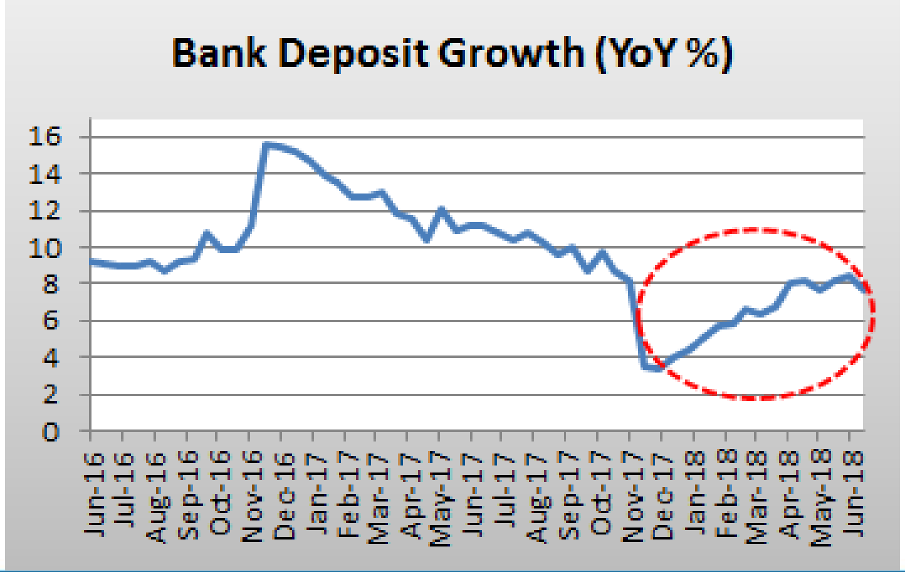


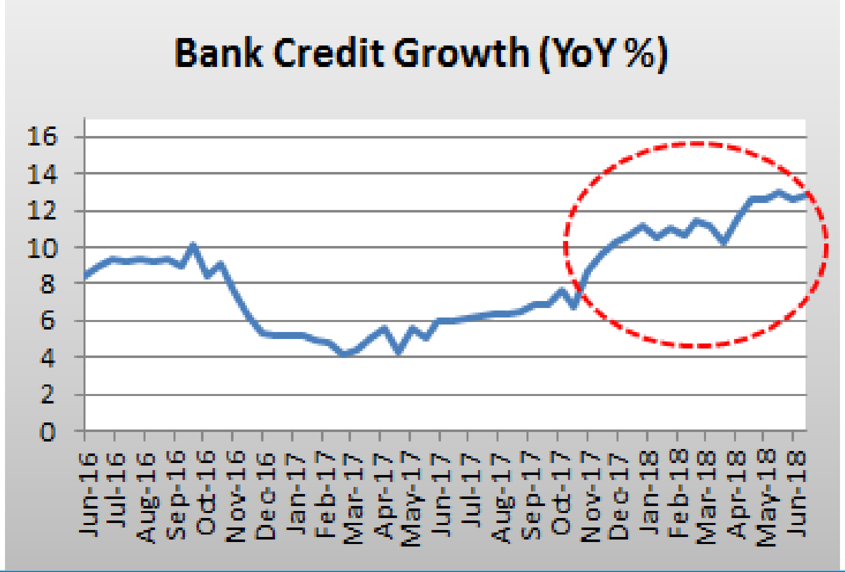
Source: SIAM, Bloomberg. LCV = Light Commercial Vehicles, MHCV = Medium & Heavy Commercial Vehicles

High Frequency Indicators: Cement production picks-up strongly in FYTD 19, but steel production remains sluggish. Bank credit and deposit growth continues to recover.







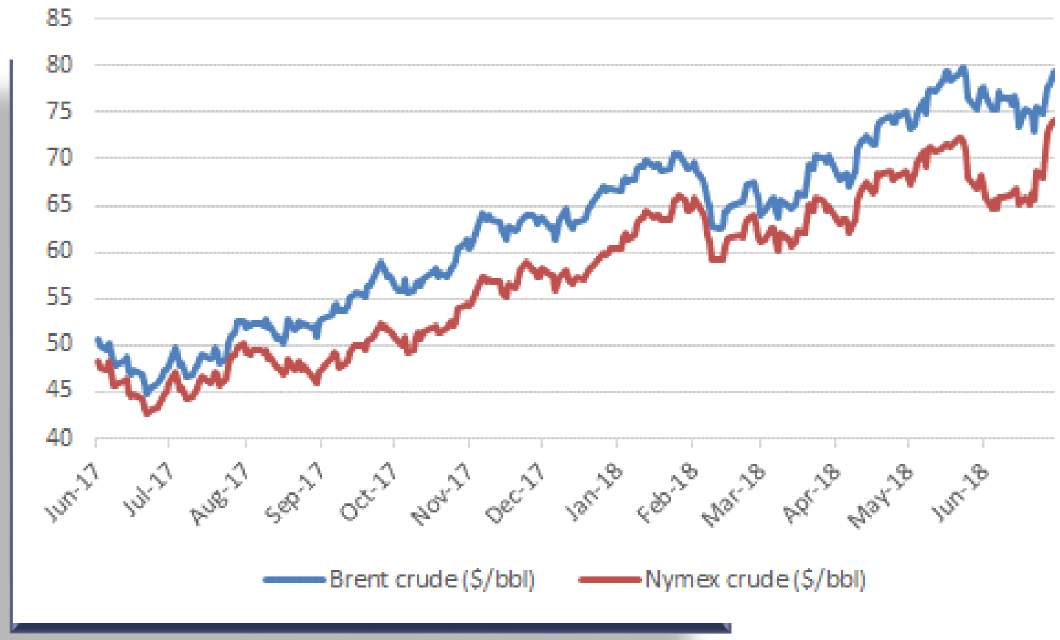


Source: RBI, Bloomberg

But there are some macro-headwinds as well

Brent crude breached the psychological barrier of $80 / bbl intra-month in May

Brent & Nymex Crude Price ($/bbl.)



Source: Bloomberg

Impact of $10 / bbl. increase in Brent Crude on various macro-economic indicators

Macro-economic Indicator	Impact
Consumer Price Index (CPI) Inflation	+0.6 – 0.7%YoY
Wholesale Price Index (WPI) Inflation	+1.3 – 1.4%YoY
Current Account Balance	-0.4% of GDP

Source: Nomura

- Brent crude price breached the $80/barrel psychological barrier intra-month in May 2018, and finally closed the month of June at USD 79.44/ barrel. With that, brent crude is up 13% over the past quarter, and up 19% CYTD in 2018
- Pose inflation and current account deficit (CAD) challenges, if it doesn't stabilize.
- Recently in July 2018, crude oil prices have corrected, with Libya opening up its ports & increasing production, and with Saudi Arabia & Russia promising to increase output.

CAD widens due to widening trade deficit; BoP remains healthy

India CAD & BOP Trend ($ in billion)

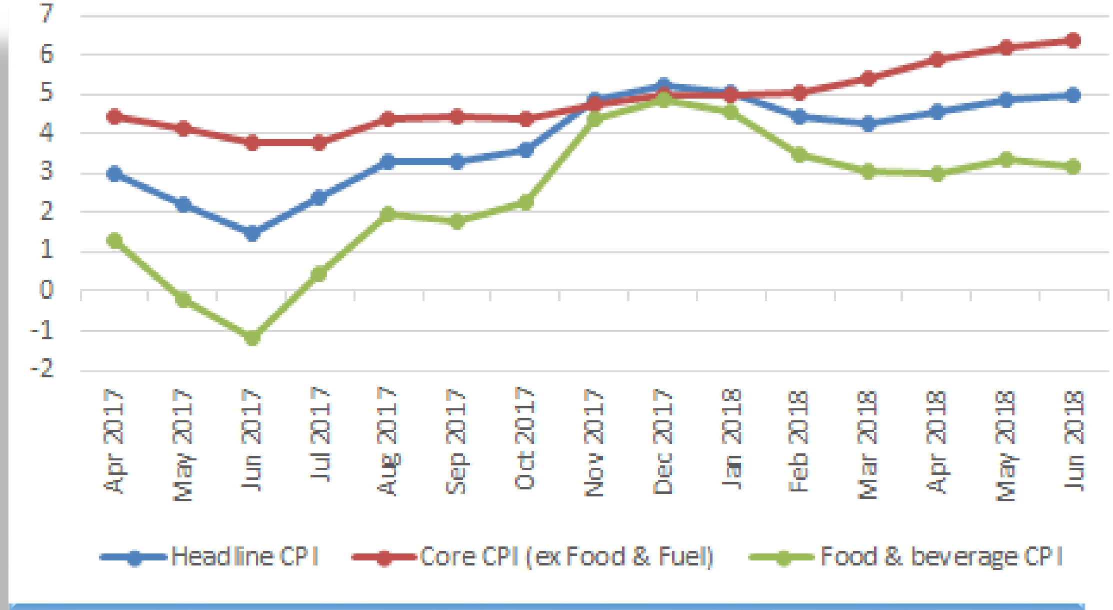
India Current Account Balance & Balance of Payment Trends ($ in billion)										
	FY15	**FY16**	**FY17**	**FY18**	**Q3FY17**	**Q4FY17**	**Q1FY18**	**Q2FY18**	**Q3FY18**	**Q4FY18**
Current Account (CA)	**-26.8**	**-22.2**	**-14.9**	**-48.7**	**-7.9**	**-3.4**	**-15.0**	**-7.2**	**-13.5**	**-13.1**
CA as % of GDP	**-1.3**	**-1.1**	**-0.7**	**-1.9**	**-1.4**	**-0.6**	**-2.5**	**-1.2**	**-2.1**	**-1.9**
Trade Balance	-144.9	-130.1	-112.1	-160.0	-33.2	-29.7	-42.0	-32.8	-44.1	-41.6
Invisibles	118.1	107.9	97.2	111.3	25.4	26.3	27.0	25.6	30.6	28.6
Capital Account	**89.3**	**41.1**	**36.5**	**91.4**	**6.1**	**10.4**	**25.8**	**16.4**	**22.1**	**25**
FDI	31.3	36	35.6	30.3	9.7	5.0	7.2	12.4	4.3	6.4
FPI	42.2	-4.1	7.6	22.1	-11.3	10.8	12.5	2.1	5.3	2.3
Balance of Payments (BOP)	**61.4**	**17.9**	**21.6**	**43.6**	**-1.2**	**7.3**	**11.4**	**9.5**	**9.4**	**13.2**

Source: RBI

- India's current account deficit (CAD) widened to $13 billion (1.9% of GDP) in Q4 FY2018 from $3.4 billion (0.6% of GDP) in the corresponding quarter a year back, but remained marginally lower than the preceding quarter (Q3 FY18) at $13.7 billion or 2.1% of GDP. .
- The YoY increase in CAD was primarily due to rising trade deficit, as imports (both oil & non-oil imports) grew at a faster pace than exports. **For the full FY18, CAD rose to $49 billion (1.9% of GDP) from $15 billion (0.7% of GDP) in FY17.** As per recent data, trade deficit hit a 5-year high in the month of June 2018.
- However, if oil prices remain elevated or rise further, **CAD could increase to 2.5-3% of GDP in FY19**, as per market expectations.
- On the positive side, balance of payments (BoP) rose to $43.6 billion in FY18, compared to $21.6 billion in FY17. This was primarily due to rise in Capital Account balance, on the back of strong FPI flows (esp. on the debt side), healthy FDI inflows and pick-up in NRI deposits and foreign loans.

CPI headline inflation continued to rise, primarily due to rise in core inflation

CPI Inflation & its Components



Source: Bloomberg

- CPI headline inflation continued to rise to 5.0%YoY in June 2018 primarily due to rise in core inflation, and also contributed by rise in fuel, and housing inflation. CPI headline inflation at the end of the previous quarter (March 2018) was at 4.3%.
- Food inflation, which has the highest weight in CPI inflation remains benign at 2.9%YoY in June 2018.
- Core inflation (ex food & fuel) rose to a multi-year high of 6.4%YoY in June 2018. It was ~5.2% at the end of March 2018.

MSP hikes on kharif crops will also add to rising inflation to some extent

Fiscal Year-wise increase in Kharif & Rabi crops with CPI Inflation Weightage

Season	MSP	CPI weight (%)	FY16 (% y-o-y)	FY17 (% y-o-y)	FY18 (% y-o-y)	FY19 (% y-o-y)
Rabi	Wheat	2.7	5.2	6.6	6.8	
Rabi	Barley	0.0	6.5	8.2	6.4	
Rabi	Gram	0.3	10.2	14.3	10.0	
Rabi	Lentil	0.3	10.6	16.2	7.6	
Rabi	R&M	1.3	8.1	10.4	8.1	
Rabi	Safflower	0.0	8.2	12.1	10.8	
Kharif	Paddy	4.7	3.7	4.3	5.4	12.9
Kharif	Maize	0.1	1.1	3.0	4.4	19.3
Kharif	Jowar	0.2	2.6	3.5	4.6	42.9
Kharif	Bajra	0.1	2.0	4.3	7.1	36.8
Kharif	Ragi	0.0	6.5	4.5	10.1	52.5
Kharif	Arhar	0.8	6.3	9.2	7.9	4.1
Kharif	Moong	0.3	5.4	7.7	6.7	25.1
Kharif	Urad	0.3	6.3	8.1	8.0	3.7
Kharif	Groundnut	0.3	0.8	4.7	5.5	9.9
Kharif	Soybean	0.6	4.0	6.7	9.9	11.4
Kharif	Sunflower	0.6	1.3	3.9	3.8	31.4
Kharif	Sesamum	0.0	2.2	6.4	6.0	17.9
Kharif	Nigerseed	0.0	1.4	4.8	5.9	45.1
Kharif	Cotton	0.0	1.2	1.5	3.8	26.2
	Rabi	4.7	6.7	8.8	7.4	6.6
	Kharif	8.2	3.8	5.2	6.1	14.8
	Rabi + Kharif	12.8	4.8	6.5	6.6	11.8

Source: CACP, Nomura

- India's As promised in the budget, the govt. hiked minimum support price (MSP) for kharif (summer) crops to at least 1.5 times the production cost in order to boost farm incomes.
- Paddy (which the highest weightage of 4.7% in CPI inflation) saw its MSP registering a 12.9% hike in FY19, while other increases range from 3.7-52.5%
- **On a weighted average basis, MSPs were hiked by ~15%YoY in FY19 versus 6%YoY in FY18.**
- The MSP hikes are **expected to have +0.3 to +0.5% impact on CPI headline inflation,** although food inflation is benign presently. The effect will also depend on how effective the procurement is by the government.

Emerging Market Currencies have been under pressure, and Indian rupee has been the bottom performer within the Asian pack

Performance of Various Currencies Versus USD (in %)			
Name of Currency	3 mths	6 mths	1 Year
Japanese Yen	-4.0	1.7	1.4
Malaysian Ringgit	-4.2	0.2	6.3
Hong Kong Dollar	0.0	-0.4	-0.5
Thai Baht	-5.6	-1.6	2.5
Chinese Yuan	-5.0	-1.7	2.3
Swiss Franc	-3.6	-1.9	-3.6
Singapore Dollar	-3.8	-2.0	1.0
Pound Sterling	-5.9	-2.4	1.6
Euro	-5.1	-2.8	2.4
Indonesian Rupiah	-3.9	-5.3	-7.0
Australian Dollar	-3.7	-5.5	-3.7
Philippine Peso	-2.2	-6.5	-5.4
Indian Rupee	-4.8	-6.8	-5.7
Russian Ruble	-8.3	-8.2	-5.5
South African Rand	-13.6	-9.7	-4.4
Brazilian Real	-13.6	-13.8	-13.9
Turkish Lira	-13.5	-17.2	-23.1

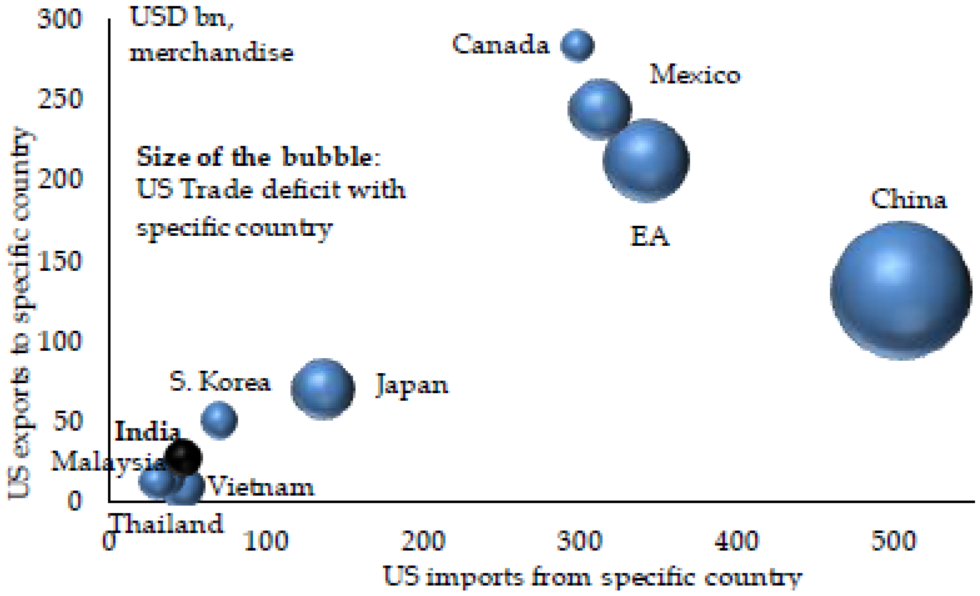
Source: Morningstar Direct.
Data sorted on the basis of 6 mths return

- Indian rupee has been under pressure, and been one of the bottom performers within the Asian pack over the past 6 months (-6.8% vs the USD).
- This has been due to large foreign outflows, rising oil prices, widening current account deficit, and also global strengthening of the US dollar.
- Some of the Asian currencies also have seen depreciation over the past 3 months due to foreign outflows and strengthening dollar.
- Other Emerging market currencies like Turkish Lira, Brazilian Real, South African Rand, and Russian Ruble also have been under considerable pressure over the past 3 and 6 months and seen significant depreciation, due to economic issues in some of these countries and also outflows from global emerging market funds (due to some global risk aversion).

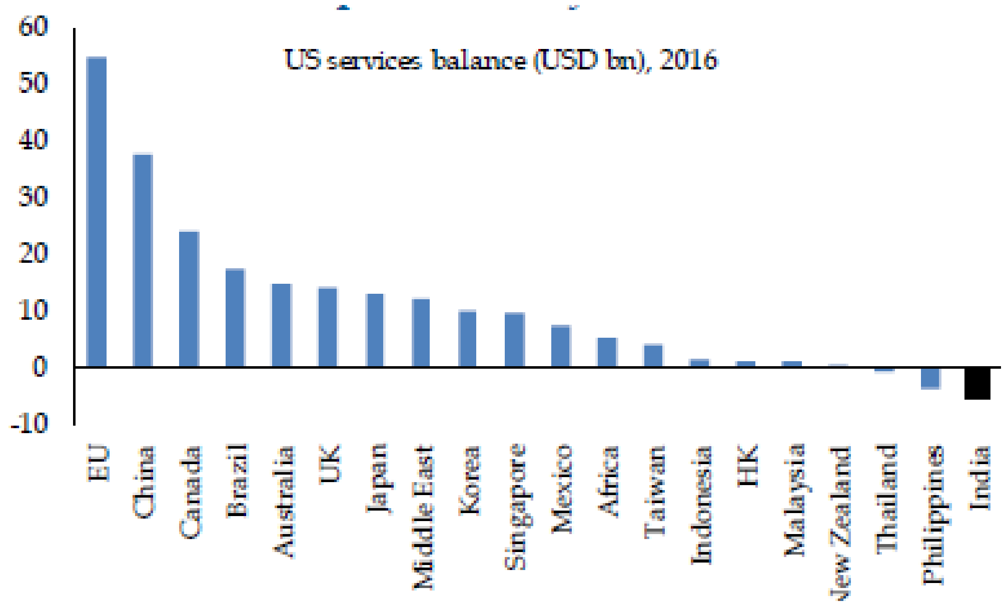
Globally also there is uncertainty, due to escalating trade wars and tightening of monetary policy

Trade war escalates, but India's exposure to US is limited, on the merchandise front

US Goods Trade Deficit & Imports / Exports with various countries ($ in bln)



US Services Balance with various countries ($ in bln)

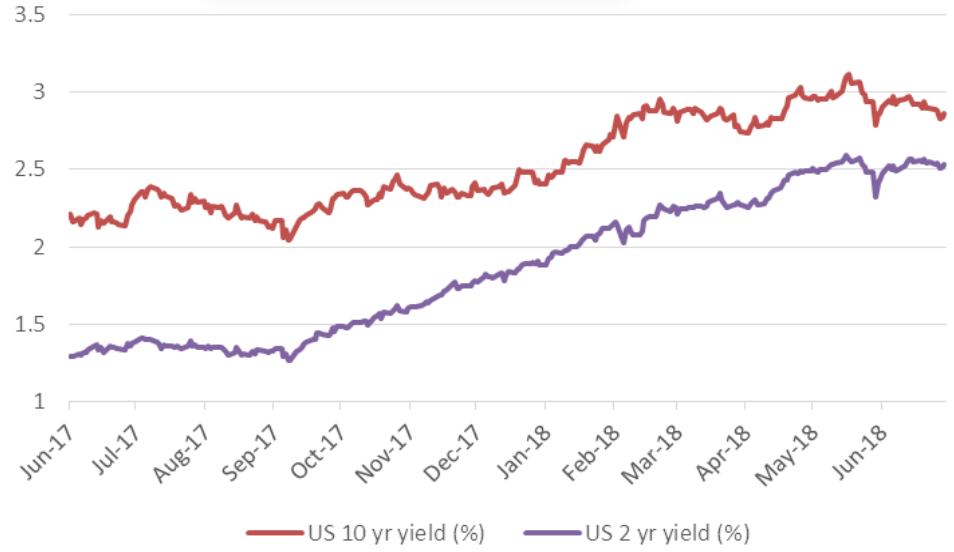


Source: Yes Bank

- **Trade war is escalating, and has led to volatility in global markets and currencies**. The US has an overall trade deficit on goods (merchandise) of $800 bln with the world, of which China accounts for $375 bln, as of 2017. However, on services side, US has positive balance with most countries.
- US started off, by implementing a 25% import tariff on steel and 10% on aluminum effective June 1, 2018. Effective June 6, US has imposed a tariff of 25% on $34 bln of Chinese goods, and China imposed retaliatory tariffs of a similar quantum on US goods. Later, President Trump announced that there could be further tariffs of 10% on additional $200 bln of Chinese goods, which is due for hearing in August. Europe has imposed tariffs on $3.4 bln of US goods, so far. President Trump threatened a 20% tariff on imports of automobiles from Europe, if they don't remove the existing import tariff of 10% on US automobiles.
- India's impact is limited, with merchandise exports to US at ~15% of overall exports. However, 60% of India's software service exports go to US & Canada.

US bond yields have hardened significantly, and the Fed has indicated 4 rate hikes this year

US 10 Yr Bond Yield



Source: Bloomberg

US Fed Projections – June 2018 meeting

Percent

Variable	Median[1]			
	2018	2019	2020	Longer run
Change in real GDP	2.8	2.4	2.0	1.8
March projection	2.7	2.4	2.0	1.8
Unemployment rate	3.6	3.5	3.5	4.5
March projection	3.8	3.6	3.6	4.5
PCE inflation	2.1	2.1	2.1	2.0
March projection	1.9	2.0	2.1	2.0
Core PCE inflation[4]	2.0	2.1	2.1	
March projection	1.9	2.1	2.1	
Memo: Projected appropriate policy path				
Federal funds rate	2.4	3.1	3.4	2.9
March projection	2.1	2.9	3.4	2.9

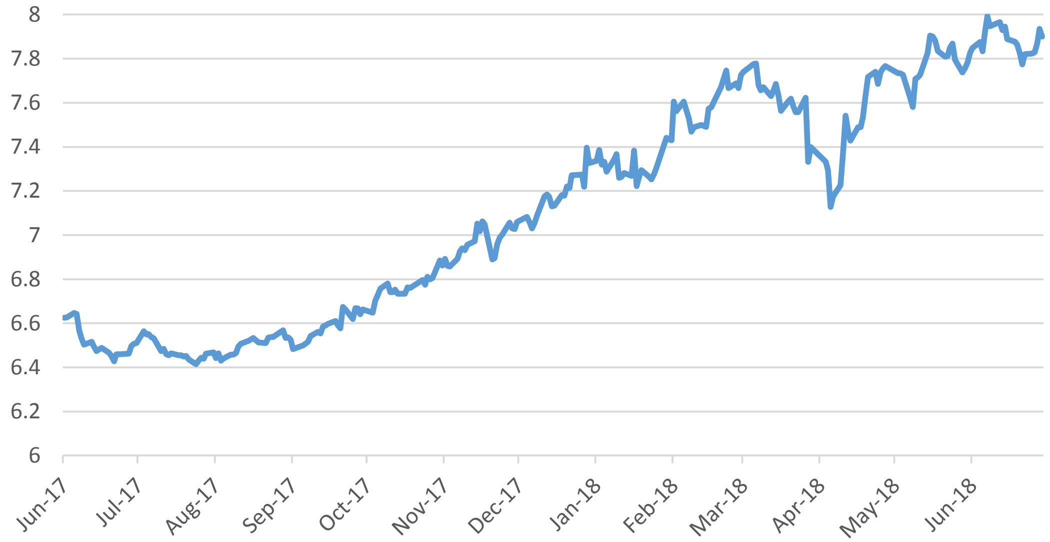
Source: US FOMC

- US 10 year bond yield has hardened sharply by since the start of 2018, and breached the 3% mark in April 2018 and touched a high of 3.13% in May 2018 (highest since 2012), and US 2 year yield touched a 10-year high. This has been contributed by inflationary concerns, strong jobs data, cut in corporate taxes (which is expected to boost US corporate earnings and spur the economy), and higher probability of rate hikes by the US Fed.
- Fed hiked it's rate by 25bps in it's June meet, and has signaled a total of 4 rate hikes for 2018 (the Fed has so far hiked 2 times this year).
- The Fed revised the US 2018 GDP forecast to 2.8% (up 10 bps from March projection), and it reduced the unemployment rate forecast for 2018 to 3.6% (from 3.8% in March projection).

Domestic Bond yields have also hardened significantly, and have been volatile

Bond yields have been volatile; fell sharply in March, and again hardened April onwards

India 10 Yr Bond Yield Movement (%)



Source: Bloomberg

- Bond yields have been volatile, and hardened on the back of rising crude oil prices, higher inflation, depreciating rupee, and some tightening of liquidity. The Indian 10 year G-Sec bond yield had breached the 8% psychological barrier intra-month in June, and finally closed the quarter at 7.90% - up by a significant 50 bps over the quarter.

- Long term bond yields have hardened post the June 6th policy hike announcement, with market consensus of at least one additional hike in this fiscal year.

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RBI hikes rates in June, but maintains status quo on policy stance

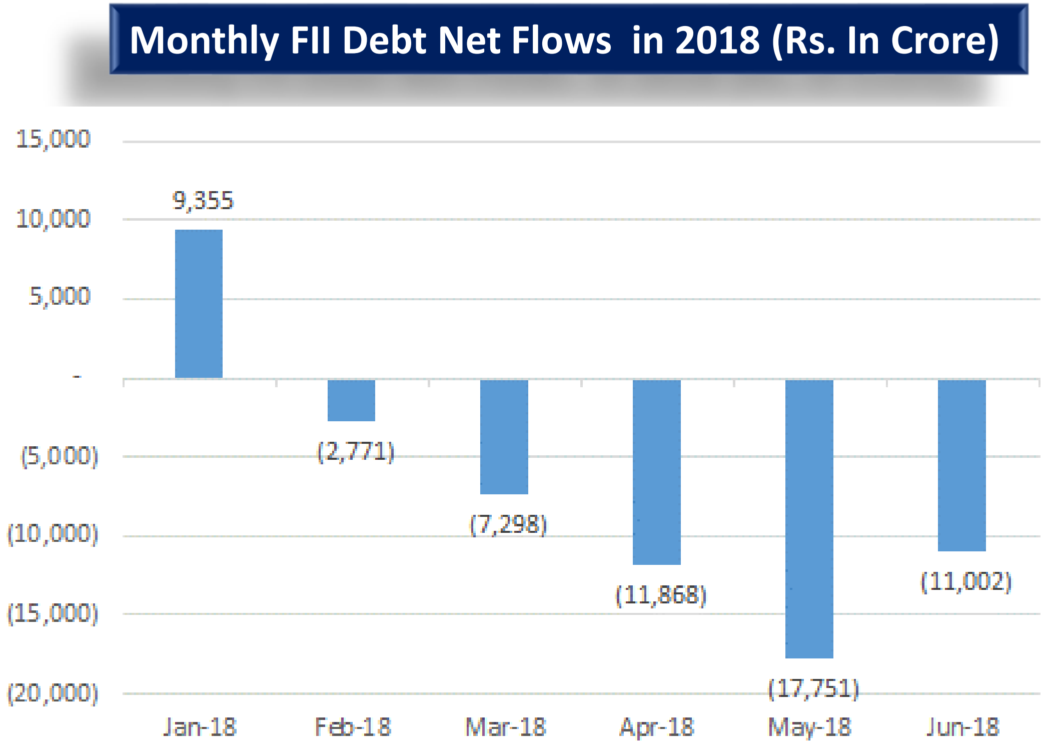
- As expected, RBI hikes policy rates by 25bps in its June policy review.
- RBI revised the CPI headline inflation forecast for H1FY19 to 4.8-4.9% (from the earlier forecast of 4.7-5.1% in April policy review), and for H2 FY19 to 4.7% (from April forecast of 4.4%)—with risks tilted to the upside.
  - ✓ The key reasons for the revision in inflation forecast was attributed to rise in crude oil and commodities prices, and pick-up and persistence in core inflation along with increase in inflation expectations.
- On the economic front, the RBI has retained the April GDP forecast of 7.4% (with risks evenly balanced), after the robust Q4 FY18 GDP growth of 7.7%YoY reported recently.

Outlook: With the RBI keeping its policy stance unchanged at 'neutral', we feel that future rate action and policy stance will continue to be data dependent, and especially track the course of inflation & oil price trajectory, and global monetary policy events. It also remains to be seen what impact the recent MSP hike announcement will have on RBI's inflation trajectory.

Repo Rate Vs 10 Yr Bond Yield Movement (%)

Source: Bloomberg

We have seen large foreign outflows in the debt markets this calendar year



Source: Bloomberg

- CYTD in 2018 (up to June) we have large FII net outflows from the Indian debt markets to the tune of Rs. 41,335 crore.
- In CY 2017 we had seen record high FII net inflows in the Indian debt markets cumulating to Rs. 1,48,484 crore.

Outlook

Market Outlook & Strategy

- **Earnings growth to recover:** We expect earnings growth to recover meaningfully in FY19 & FY20 and that will drive the direction of markets. Earnings growth to be led by revival of earlier under-performing sectors and also by lower base effect to some extent. Certain sectors we are positive on presently are Technology, Pvt. Financials, and Consumption. Pharma also seems to be bottoming out.

- **Risk-Reward in Large-Cap equities still more favourable:** YTD in CY 2018 we have seen a large correction in mid and small cap segment. As a result, the valuation premium of small/mid-cap to large-cap stocks has reduced considerably, but the risk-reward for large-caps is still more favourable. Investors can continue to invest systematically in equities, but should temper down their return expectations this year, when compared to 2017.

- **The micro picture is good, but some headwinds on the macro-side:** Broad macro-economic data and high-frequency data point to a recovery in economic growth. However, some macro headwinds remain like elevated and rising crude oil prices and its impact on the twin deficits, rising interest rates and inflation.

- **Some uncertainty on the global front as well:** Global trade war, tightening of monetary policy by major central banks, and risk aversion in emerging markets are some uncertainties on the global front.

- **RBI's rate action will be data-dependant:** We feel that RBI's rate action and policy stance will be data dependent, and especially track the course of inflation (especially food & oil price trajectory), global monetary policy, and fiscal deficit. We expect at least one additional rate hike in this fiscal year.

- **On the debt side, we continue to prefer the shorter end:** With the yield curve being flat, we continue to prefer the shorter end of the yield curve, and have positioned our portfolios accordingly.

THANK YOU

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