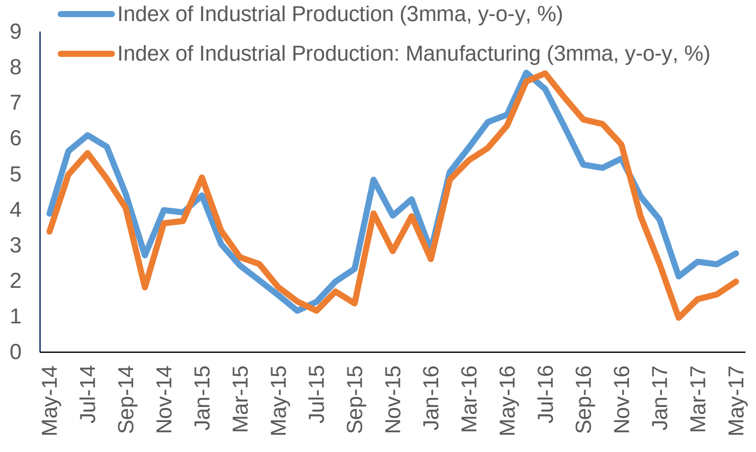
Wodehouse Capital Advisors
Monthly Economy and Investment Outlook

The Indian equity market will continue to remain supported by domestic as well as global liquidity. We maintain our neutral stance on Indian equities even as valuations continue to get stretched further. We maintain our overweight stance on Indian bonds. The latest rate cut by the RBI was largely expected and with inflation trending well below where the RBI would like it to be, we should see another rate cut coming through before the end of the year. The Indian rupee is expected to continue to strengthen in the months ahead, supported by foreign capital inflows as well as broad US dollar weakness.

Economy:

The RBI rate cut by 25 basis points to 6.00% was largely expected. Inflation has been trending lower for some time now and with the latest inflation figure coming in at around 1.6% y-o-y in June, it would have been very difficult for the RBI to have justified any other decision. The economy is expected to see a recovery further out – for now it continues to find its footing as it recovers from 'demonetisation'. Industrial production growth has been lacklustre for quite some time now, trending below 3.0% y-o-y on a 3-month moving average basis. More worrying is the trend in manufacturing that has seen production growth slow to less than 2.0% y-o-y as of May 2017.

Figure 1: Manufacturing production remains weak



Source: CEIC, Marketnomix

The implementation of GST and the uncertainty around it has seen activity slow – although this is expected to be only a temporary phenomenon. The monsoons have been good this year which bodes well for rural income and thereby rural demand – with more interest rate cuts possible over the coming months, the outlook for household consumption should remain upbeat in the months ahead. The government's push for affordable housing should also be positive for overall investment in the economy going forward.

The economy has continued to see large capital inflows into both the debt as well as the equity market – adding to the overall liquidity in the financial system. The Rupee has continued to strengthen against the USD dollar as a result. The rising FX reserves indicate that the RBI has continued to intervene in the markets to prevent the Rupee from strengthening very sharply. The country's FX reserves now stand at USD 385 billion – an indicator that is no doubt providing a lot of comfort to foreign investors. One of the pitfalls of the rupee strengthening, as it is currently doing, is that it will hurt India's export competitiveness while also making imports cheaper – which is a risk to the fortunes of the domestic industry.

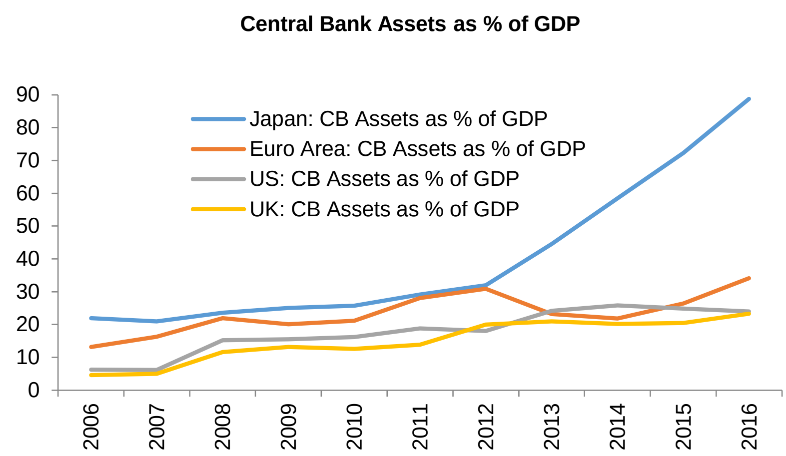
Table 1: Strong foreign and domestic institutional investments continue

Institutional Trading Activity				
	Domestic Instituional Investors		Foreign Institutional Investors	
	Equity (Rs Cr)	Debt (Rs Cr)	Equity (Rs Cr)	Debt (Rs Cr)
Year-to-date (YTD)	52972.68	223281.36	58935.47	113329.27
Total YTD Equity Investments (Rs Cr) :		**111908.2**		
Total YTD Debt Investments (Rs Cr) :		**336610.6**		

Source: SEBI

Even as the global economy prepares for an eventual normalising of interest rates in the US and eventually in Euro zone, the chart below clearly highlights the fact that global liquidity remains abundant and will remain supportive for global equity and debt markets. The pace of normalization of interest rates in the US and Euro zone are expected to be very gradual.

Figure 2: Abundant global liquidity to remain supportive for financial markets



Source: CEIC, Marketnomix

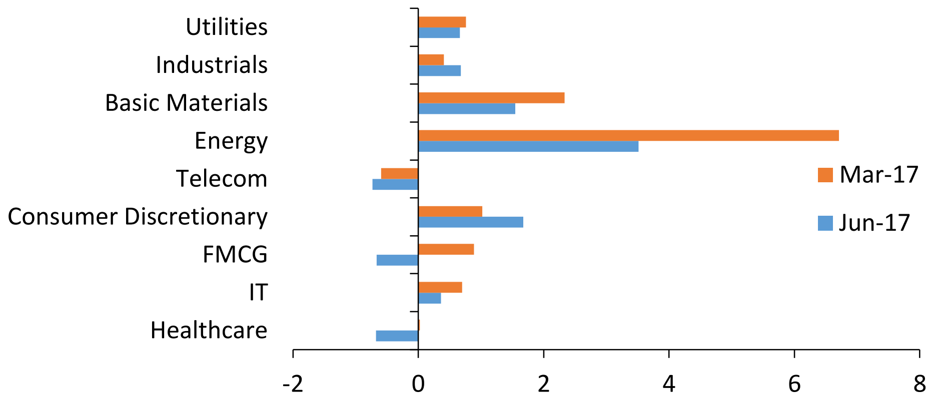
Equities:

The Indian equity market will continue to remain supported by domestic as well as global liquidity. We maintain our neutral stance on Indian equities even as valuations continue to get stretched further. The equity market has clearly shrugged off the initial uncertainty around GST and has continued to record new highs. The Indian market has been supported by strong foreign capital inflows as well as domestic institutional investments – July saw an additional inflow from foreign institutional investors of INR 5,161 Cr into the equity markets, taking the year to date total to over 55,000 Cr. Domestic institutional investors on the other hand poured in around INR 11,800 Cr in the month of July, taking the year to date total to around INR 52,000 Cr.

The positives for the equity market going forward apart from liquidity include the normal monsoons as well as the RBI's interest rate trajectory which is expected to head further south. Rural demand is expected to remain healthy and should provide support to overall consumption. While the FMCG sector as well as the Consumer Discretionary sector have both done exceedingly well on a year-to-date basis, rising 24% and 30% respectively in the BSE All Cap Index, the upbeat outlook for consumption should see these sectors continuing to remain in favour with investors. As the uncertainty surrounding GST fades and activity returns to normal, some of the subsectors within the Consumer Discretionary space that are likely to look attractive are possibly the auto companies that have a strong rural footprint.

Within the Basic Materials sector, cement and steel companies should benefit from the government's push for affordable housing. Inputs into steel such as coal and iron ore have been placed under the 5% tax bracket for GST and thus should benefit some of the larger steel companies. While the BSE Basic Materials Index has already rallied 36% on a year-to-date basis, lower input costs for steel as well increased demand from the real estate sector could see improved bottom lines for Steel companies further out.

Figure 3: Consumer discretionary providing a healthy contribution to overall sales growth



Source: Bloomberg

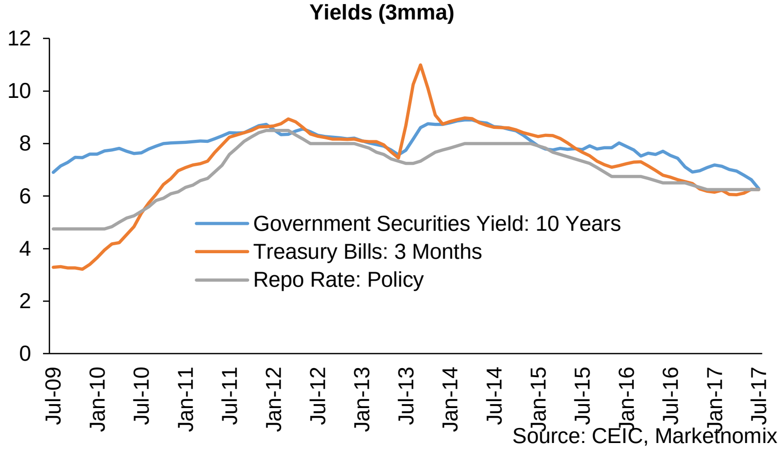
Accounting for around round 240 companies that have reported their earnings for the quarter ending June, overall sales growth has slowed and possibly reflects the post demonetisation slowdown in the economy. The main contributions have continued to come from the Energy and the Basic Materials sector. The Consumer Discretionary sector too has provided a healthy contribution to overall sales growth – in fact this is one sector that has seen its sales growth move higher compared to the previous quarter. The Energy sector remains vulnerable with global oil prices continuing to remain below USD 50 per barrel, and the impact of the earlier price increases likely to start fading.

Interest Rates:

We maintain our overweight stance on Indian bonds. The latest rate cut as mentioned earlier was largely expected and with inflation trending well below where the RBI would like it to be should see another rate cut coming through before the end of the year. The bond market has continued to register strong capital inflows, with foreign institutional investors pouring in nearly INR 19,000 Cr into the bond market in July – taking the year to date total inflows into the bond market to over INR 114,000 Cr.

The risk to the Indian bond market from rising Fed interest rates as well as any talk of gradual liquidity withdrawal by the ECB is minimal at present. Any risk of a sudden outflow from the debt market by foreign investors is likely to be mitigated by the strong presence of domestic institutional investors (DII) – on a year to date basis, DIIs have poured in over INR 232,000 Cr.

Figure 4: Yields to head lower as another rate cut by RBI likely before year end

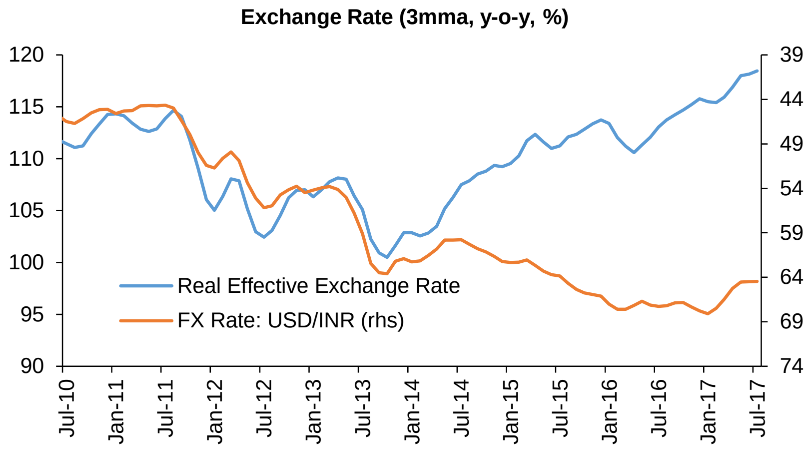


Source: CEIC, Marketnomix

FX:

The Indian rupee is expected to continue to strengthen in the months ahead. Strong foreign capital inflows mentioned earlier, into both the debt and equity markets, have been supportive for the rupee. Broad US dollar weakness since the beginning of 2017 too has contributed to overall rupee strength this year. As can be seen from the chart below, the real effective exchange rate has continued to trend higher and has been weighing on India's export competitiveness. A stronger rupee is also making imports cheaper to the detriment of domestic producers.

Figure 5: Foreign inflows and broad USD weakness to support rupee strength



Source: CEIC, Marketnomix

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