Investment Strategy Note

17 November 2016

بنك أبوظبي التجاري
ADCB

India remains an island in troubled emerging market waters

- **This note restates our relatively positive outlook on India and constitutes an update on our earlier note in June of this year.**
- **India's macro-economic cycle is still on the upside and inflation is well-behaved**
- **Looking at the longer term, we believe that India remains a structural growth story based on the demographic dividend and productivity enhancing economic reforms**
- **The rate cut cycle is, however, coming to an end, whilst there are some temporary risks related to a breach of the country's fiscal deficit and rising rates in the US. As such we remain neutral on the local currency bond market.**
- **India's relatively high valuation can be justified when put in perspective, also of the country's enormous long term structural growth potential. We believe that the current turnaround in the revenue- and earnings growth will support the market this year. Growth expectations for the coming year are also sound.**

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India looks least vulnerable among its EM peers

As we wrote in our latest general strategy note, the prospect of reflationary Trumpenomics is putting upward pressure on US yields and the green back and, as a result, downward pressure on emerging market assets and currencies. Needless to say, it's the countries with larger current account deficit, as well as those with large US dollar-denominated debts that stand to suffer the most. This time, however, there is an added dimension of risk to emerging markets troubles, namely the threat of increased protectionism against the goods they produce and export.

One of the reasons why we have been favouring India for a long time is the fact that its larger, mainly domestically driven economy, is much more insulated from external shocks such as downturns in global growth. This critical difference with other emerging markets is now being exacerbated.

It is also important to point out that the remarkable improvement in structural factors such as current account imbalance, fiscal deficit and inflation over the last two-three years, have bolstered even more the country's economy's resilience against external shocks. This is not the case for many of its peers. Indeed, India's foreign asset and liability mismatch is one of the lowest among the major EM. Absence of commodity export dependence is another advantage for the country. We have not been surprised by the relative stability of its currency over the last few years and in particular since the US election result last week.

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Demonetization impact will be temporary

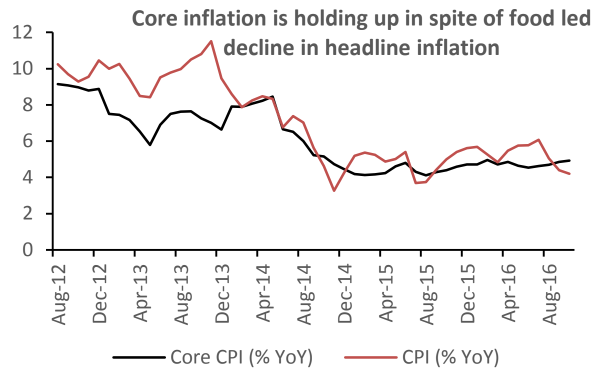
Government decision to demonetize the higher denomination currency notes (Rs. 500 and Rs. 1000) and replace them with new currency notes over the next few weeks has temporarily impacted the economic activity, largely in the unorganized sectors and smaller industries where usage of currency notes was prevalent for wage payments and purchase of materials. This will reflect in a slower economic growth in the current quarter. We believe that the impact will be limited to the period when currency notes are being replaced. As enough new currency notes will be in the market over the next few weeks, economic activity in these sectors will turn back to normal. Moreover, the lack of currency notes in circulation has impacted prices of perishable food items such as vegetables, which will have a transient moderating impact on inflation.

The structural story remains intact

Beyond the short-term negative impact of demonetization, the structural growth story for India remains intact. Domestic consumption will remain solid over the next months. The most important positive impulse will come from the wage hike for central government employees, which will be followed by wage hikes for state governments' employees next year. Add to that the good monsoon season this year, which has enhanced the households' income, and one can see that consumption will remain sustained. We think that this solid consumption story, combined with improving financial conditions - declining interest rate, resolution of high nonperforming assets in the banking sector- will inevitably lead to a revival of the investment cycle over the coming quarters. Beyond the next few quarters, the demographic dividend and productivity enhancing economic reforms will continue to support growth.

Need to be cautious on inflation, only limited room for monetary easing in our view

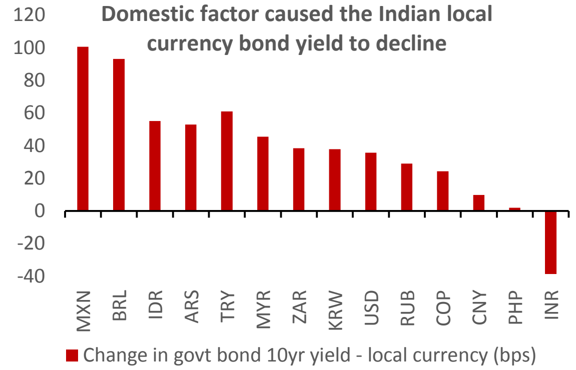
The recent drive on demonetization has reduced the money supply significantly as a large portion of currency in circulation has been rendered illegal tender. Whilst this is going to have a moderating impact on inflation, it will be transient, such that the central bank should be able to cut interest rates further in December, however unlikely beyond. Indeed, core inflation (excluding food and fuel) has been trending up after bottoming out in June this year. Indeed, consumption-driven growth, along with the lower base effect for many commodities continue to provide upside risk to inflation once the temporary factors fade away.



Source: Bloomberg

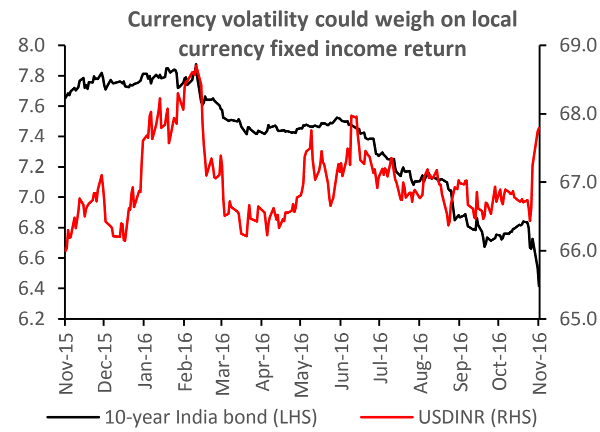
Indian local currency bond rally on demonetization, we remain neutral

Indian bond markets have proven their insularity to the global volatility which was sparked by the Trump electoral win. The 10-year Indian Government Bonds have outperformed their emerging market peers, as yields have dipped by 35bp over the past week, driven by domestic factors. The government's recent demonetization move proved positive for the bond market as it has attracted large amount of deposits with limitation on withdrawal and increased the probability of another policy rate cut in December. Banks are estimated to have received approximately INR 20trn of deposits following the ban on the old currency notes. At the same time, with an improvement in banking system liquidity, we could see a slowdown in the momentum of the RBI's open market operations (OMO) purchases of government bonds.



Source: Bloomberg

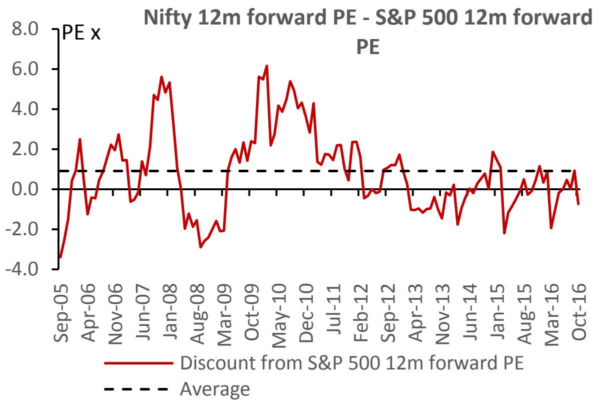
Going forward, it is prudent to stay neutral on local currency government bonds given the backdrop of emerging currency volatility and the risk of rising US interest rates. Although we expect that the Indian rupee is unlikely to come under any significant pressure, it is also not likely to be completely untouched by the dollar strength. Whilst the case for a December RBI rate cut has increased, most of it has been priced in by the market in the past weeks, limiting the downside in bond yields. Thus, potential on capital gains seems to be capped due to the rising risk of a breach of government fiscal deficit target, as well as an upside surprise in inflation following the current moderation.



Source: Bloomberg

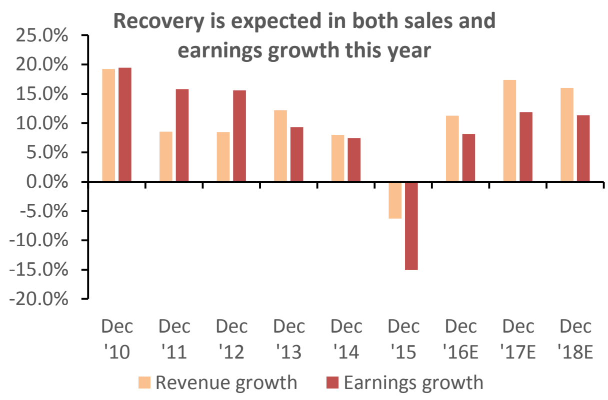
Equity market derives strength from a structurally strong economy

India's structural economic advantages are reflected its equity market's valuation premium over other emerging markets. Whilst the current valuation versus both its own long term average, as well as most of its emerging market peers, it trades at a discount compared to its long-term valuation versus the S&P 500. This discount makes us feel comfortable that the overall valuation is not stretched.



Source: Bloomberg

Critically also, revenue and profit growth have turned around. A sustainable rise in the wholesale price this year suggests that companies have been able to push through a moderate price rise after two years of deflation. Market expectations of EPS growth of 11.5% in the next four quarters seem to be reasonable, with an economy growing at close to 7.5% in real terms. A further pick-up in earnings growth in 2017 also is plausible as economic growth consolidates and accelerates following the persistent reforms, and the feed-through of the recent cuts in interest rates.



Source: Bloomberg

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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