Outlook 2017: The Year Ahead

2016: Year Gone by...

	31-Dec-15	27-Dec-16	% Change
USDINR	66.15	68.06	2.88%
Dollar Index	98.631	103.02	4.45%
CAD (Mar-Sep) USD Billion	-21.8	-4.09	-81.24%
BoP (Mar-Sep) USD Billion	40.724	18.68	-54.13%
CPI Inflation (Nov)	5.41%	3.63%	-1.78%
GDP Growth (Sept)	7.60%	7.30%	-0.30%
US Fed Funds Rate	0.25%-0.5%	0.5%-0.75%	0.25%
US 10Y Yield	2.27%	2.56%	0.29%
RBI Repo Rate	6.75%	6.25%	-0.50%
India 10Y Yield	7.76%	6.62%	-1.15%
Nifty	7946.51	8032.85	1.09%
MSCI EM Index	794.41	844.66	6.33%
MSCI World USD	1662.79	1760.56	5.88%
Brent Crude	37.28	56.09	50.46%
CRB Commodity Index	176.14	192.75	9.43%

Source: Bloomberg, RBI, MOSPI

Markets across the world had a rutted year and India fared no better, though debt markets in 2nd half gave investors lots of reason to cheer. The wobbly start for global financial markets in 2016 did not detract the investors' attention from the fact that the fundamental situations in EMs especially in India were significantly better. India stood out among the EMs, as the macro-economic landscape viz. inflation and fiscal continued to improve and external sector remained benign, despite global angst.

The globe was swamped by anti-globalisation and anti-immigration wave, causing a lot of turmoil and is likely to remain a top issue in 2017 as well. "Brexit" and Donald Trump winning the US presidential elections were events which caught markets off-guard, increasing uncertainty in markets already hit by slow growth and dis-inflation. While most developed economies struggled to fight dis-inflation / deflation, US still managed to grow, albeit at a slower pace. Strong Dollar and positive data on employment and housing were the main themes driving US growth recovery and FED rate hike (just one out of the planned four rate hikes). OPEC finally reached an agreement to cut crude oil production while other commodities showed a mixed trend. Recover in Emerging economies was mixed. Countries dependent on exporting commodities (especially oil) like Russia, Indonesia, and Brazil recovered, while countries like China, Malaysia, Turkey and Philippines, dependent on non-commodity exports, continued to suffer due to slowdown in global demand.

Domestically, 2016 was a year that saw India doing well on all grounds. With the growth oriented government at the centre, India's fiscal policy remained prudent as the government stuck to its budgeted numbers in 2016-17. The implementations of seventh pay commission and the passage of the GST Bill were some of the bright spots in the previous year. Inflation dropped (now below 4%) on back of good monsoons and prudent policy measures despite strong US Dollar and recovery in commodities; especially crude oil. Falling inflation & RBI's policy directed towards liquidity prompted RBI to cut rates by 50bps during the year. While most of the currencies around the world depreciated largely against the US Dollar, INR was seen to be fairly robust, despite maturing FCNR deposits and recent FPIs outflows (INR depreciation was much slower than appreciation in dollar index). RBI's liquidity targeting was supported by the Government's exercise of banning specified bank notes of high denomination. The initiative led to a sudden spurt in the liquidity thereby impacting the yields across the yield curve. While demonetisation is expected to reduce inflation further, the move has resulted in impacting growth across various sectors especially in labour/cash intensive and unorganised markets while impacting discretionary demand. Cash crunch further hit exports of labour intensive sectors like gem/jewellery and textiles. While Indian fixed income markets moved relative to market sentiment on account of positive data, equity markets generated lacklustre returns.

Debt Outlook 2017:

Global events are expected to drive market sentiments as geo-political environment continues to be disruptive on wave of anti-globalisation and immigration issues .This could negatively affect the global growth whilst creating political uncertainty in parts of the world. President-elect Trump's protectionist trade policies could further add fuel to this fire whilst opening up a confrontation with its largest trade partner, China. Trump's stated foreign policies, lower US intervention in global matters, could see rise of Russia and China expand their sphere of influence in Europe and Asia respectively.

While FED may continue with rate hike cycle, it will be extremely data dependent with eye on global events. Dollar strength may continue to make export oriented economies more competitive whilst hurting EMs with high external debt and weak macro-economic conditions. For US economy, dollar strength is typically accompanied with weaker growth with disinflationary impact. With rest of the world growing slowly, a strong dollar may eventually hurt US growth and stop FED from aggressive hikes. The US FED has shown concerns on dollar strength impacting growth in its assessment in its previous policy statements.

The Euro zone could be a region of budding negative sentiments. Number of countries in Europe like Netherlands, Italy and France are displaying strong anti-Euro sentiments. More referendums forcing countries to move out of European Union could lead to more global weakness and uncertainty. The ECB is likely to continue with its quantitative easing stance for more time as it grapples with fresh challenges arising out of right wing politics.

The recent OPEC deal has propelled oil prices upwards. The compliance to their respective quotas by OPEC/non-OPEC countries would closely be tracked by the markets to determine the trajectory of oil prices. Increased output of shale oil from the US, on increased prices, is likely to cap any significant rise in oi prices. Further output increase from Libya and Nigeria, which are not part of the agreement, could add further downward pressure on prices.

Despite the weak global conditions and extremely volatile markets, India continues to stand tall within EM space on back of strong macros. Global investors who are currently shying away from most emerging markets are likely to favor countries / currencies where local macro conditions are strong and local demand drives economic growth. Strong Indian macros are expected to keep Indian fixed income markets buoyant.

Retail inflation has been largely under control and thanks to a good monsoon season, it is expected that March'17 inflation is likely to undershoot RBI's target of 5% by a considerable margin. This has been possible due to prudent policy measure both by government in managing fiscal, and RBI is adopting the inflation targeting framework.

INR has been relatively stable, though there have been bouts of volatility. However the currency has prevailed below its life high of 68.80/$^, though it has touched it twice post 2013. While marginally higher oil prices may impact INR a little, RBI has built considerable reserves to weather any storm. In terms of REER (real effective exchange rate), index of 36-currency based on trade weights is 115.39^ in Nov'16 vs 114.03^ in Nov'15, indicating that INR overvaluation has gone up in last one year. While INR may continue to depreciate gradually, it should continue to outperform other EM currencies as the macro-economic conditions remain strong.

Demonetisation exercise is likely to lead to "formalization" of a significant part of the "cash economy" which when coupled with the implementation of GST is likely to lead to a "wider" tax base and consequent increase in government revenues. One-time tax/penalty on undisclosed cash deposits in banks is further likely to add to government coffers in the short term. Economic impact of demonetisation is likely to persist for 2-3 quarters and overall growth may only stabilize by H2FY18.

Apart from the short term increase in bank deposits, continual efforts by government to reduce "cash in circulation" and increase "digitization" is likely to lead to increased flow in bank deposits / other financial assets as public reduces its cash holdings. With credit growth being in low single digits, and increase in deposits, banks will likely lower deposit rates further which will translate into lower lending rates in the medium term. This is likely to bring the overall interest rates in the economy down.

In an environment of slow growth and low inflation, there is room for RBI to reduce rates further in the coming year. While global volatility may continue to impact the timing of RBI rate moves, growth concerns and falling inflation may prompt RBI to reduce rates in 2017. Consequently, Indian Fixed Income markets are likely to continue to remain a preferred investment avenue from a long term perspective.

Equity Outlook 2017

Going forward, global growth looks to be at an inflection point and India will remain no different, albeit is expected to continue to grow faster than most other economies. Traditional economic indicators combined with insights and expectations from many market participants point to an uptick in the year ahead. The fixed income market is expected to take the center stage in 2017 and is expected to be the primary driver of markets on account of better governance and a stringent control by the Reserve Bank. Having said that, equity markets are also expected to recover from the sluggish 2016 and perform better in the coming year. The recent activity of demonetisation of currency by the Indian government is likely to create demand disruptions over the next couple of quarters. This will impact the earnings of the Indian corporates and the estimates for FY17 and H1FY18 with a downward bias. However, the market seems to be discounting the reduced earnings currently. From a broader perspective, Indian economy is fairly resilient to internal and external shocks and hence is likely to recover from the impact of the demonetisation exercise by H2FY18.

Going ahead, the macro indicators like fiscal deficit and inflation are expected to be hugely positive and likely to impact the direction of the interest rates in the country. Lower interest rates could be the next big trigger for equity markets positively impacting the balance sheet of many corporates. The only risk other than the slowing corporate earnings in the near term could be from the uncertainty surrounding the trade policies of US President elect Donald Trump, which could throw up some negative surprises for the Indian export story. This however could impact the markets only in the shorter run and is unlikely to sustain in the long term. Volatile crude oil prices, currently do not pose a threat to the Indian economy. Energy prices inching upwards, above USD 60/bbl, could have a negative impact on the Indian Equity & Fixed income markets. The government would try to address the concerns in the upcoming finance budget. The finance budget is likely to be growth oriented and market participants expect tax rationalization. Overall, the Indian Economy could be considered to be in one of the bright spots in the slowing global world.

India is expected to be one of the fastest growing Emerging Market economies the coming year. Many economic indicators are already positive or are showing signs of recovery. While one cannot conclude that the full-fledged economic rebound is underway, but the signals are surely positive. The government seems to be on the right track and most importantly to find out permanent solutions for some of the structural issues prevailing in the country. The building blocks required for a sustainable economy seem to be in place. We believe that at this juncture, market recovery is more of a' when' rather than 'if'.

^Source: RBI, Bloomberg