



بنك الإمارات دبي الوطني
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Aditya Pugalia
Analyst
+971 4 230 7802
adityap@emiratesnbd.com

India Monitor

India is the best performing economy among emerging market peers. The steady road of continued economic reforms, reduced political risk premium, stability on both the fiscal as well as the monetary policy front seems to have enthused investors. The positive sentiment received a further boost from a dovish Fed and a hesitant Donald Trump. While India remains an attractive destination in the medium term with most factors going in its favour, we would remain slightly cautious in the short term given the recent run-up and impending monsoon season.

Goods & Services Tax (GST) – Impact

With India set to shift to the GST regime on July 1 2017, we look at the wide impact it will have on the Indian economy. For starters, the GST will subsume at least ten types of indirect taxes which are collected at the state and central government levels. Effectively, the implementation of GST will eliminate the compounding effect of multi-layered tax system and progressively make goods cheaper for the consumer.

The impact of the shift over the medium term is likely to be multi-fold. At the starting point, lower effective taxes at a single point will lead to greater compliance and limit possibilities of evasion. This should help the government to increase its tax base and revenues which in turn provides it with greater flexibility to stimulate the economy. Additionally, lower prices should ideally boost consumption which in turn will provide incentive to manufacturers and thereby create a virtuous cycle. For corporates, a single point simplified tax system should lower logistics and manufacturing costs and improve efficiency across the supply chain.

While most analysts' have said that the GDP can receive a boost of as much as 2% in the medium term, the Federal Reserve in a research paper said that growth could grow by as much as 4% in the long term from the measure.

However, it is worth noting that for all its positive impact over the medium to long term, there are likely to be disruptions in the short term as businesses adapt to the system and the government fine tunes the background IT systems. Additionally, the government is yet to categorize goods in different tax brackets. This exercise could well impact the actual benefit of the GST as larger number of goods in the top tax bracket of 28% could well negate a lot of positives from this shift.

Indian equities rally hard in Q1 2017



Source: Bloomberg, Emirates NBD Research

Sector Focus – Banking

Banks in India have been under intense scrutiny given the issues of non-performing assets and weak credit growth plaguing the sector. The credit growth in FY 2017 slowed down to 5.1% y/y from 10.3% in FY 2016. This was the slowest credit growth in the last sixty years. Demonetization seems to have been an important factor as between October and December credit growth declined by 2.3%. Deposits on the other hand grew by 11.8% y/y and again demonetization seems to have played a big part.

As a result of slowing credit growth, non-performing asset ratios for banks increased. The latest available data as of September 2016 showed that stressed loans made up of 11.3% of outstanding loans. The data for absolute non-performing shows that the situation has deteriorated further. For public sector banks, NPAs increased by 20.9% in nine months of FY 2017 while for private sector banks it jumped by 45.3% in the same period. In this context, it is worth noting that a research paper published on BIS showed that one percentage point increase in loan growth in India is associated with an increase in NPLs over total advances of 4.3% in the long run.

The data from IMF's global financial stability report indicates that Indian banks remain in the lower quartile in terms of asset quality as well as capital ratios. The Tier 1 capital ratio as a percent of RWA for Indian banks is 10.6%, second lowest among emerging market countries after Colombia.

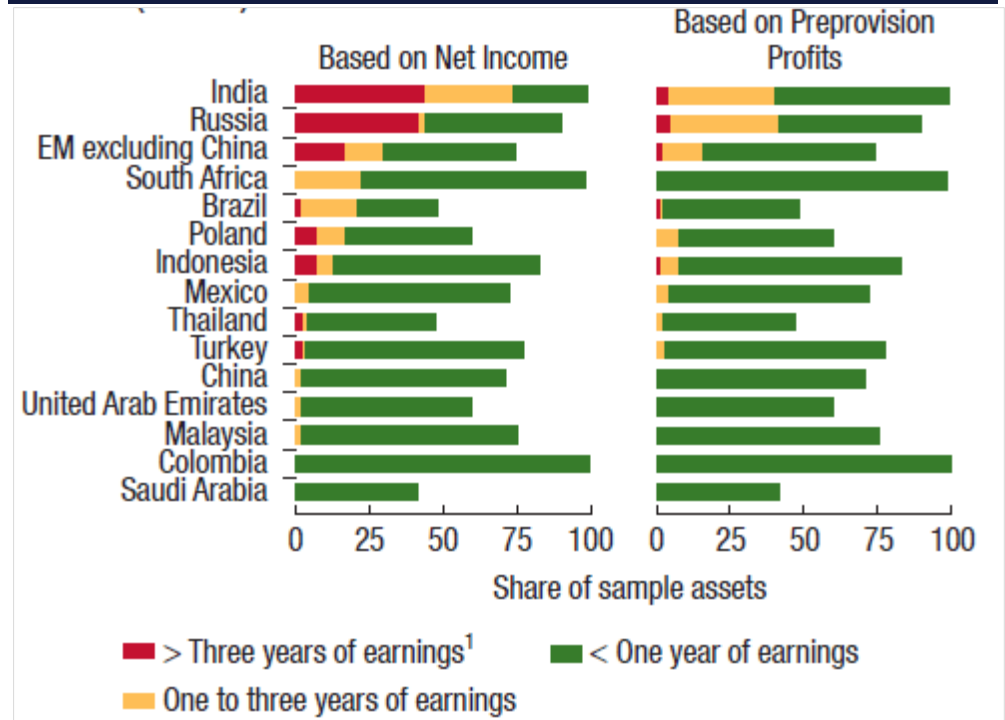
Banking sector indicators

Country	Number of Banks	Tier 1 Capital Ratio (percent of RWA)		NPL and Problem Loan Ratio (percent of gross loans)	NPLs and Problem Loans over Buffers (percent)	Banks with Provision Needs in Excess of Profits (percent of assets)	Provision Needs Divided by Profits: Weakest Quartile (multiples)	Share of Banks with Tier 1 Ratio below 10 Percent	
		Sample	FSI					Current (percent of assets)	After Provisions (percent of assets)
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	
India	64	10.6	10.6	11.3	79	73	> 3	43	77
Russia	24	11.6	8.8	15.6	76	43	> 3	21	49
South Africa	8	12.8	14.2	7.1	51	22	1.4	0	74
Brazil	22	12.9	13.1	9.5	48	20	0.9	20	21
Poland	14	14.8	15.7	7.6	44	16	1.4	2	7
Indonesia	32	19.5	20.6	8.0	36	12	1.7	1	7
Mexico	12	14.9	13.2	2.5	13	4	0.9	0	5
Thailand	12	14.1	14.8	6.5	34	3	0.9	0	3
Turkey	15	12.1	13.2	6.6	36	2	0.4	13	14
China	42	11.0	11.1	4.8	30	1	0.4	45	45
United Arab Emirates	22	17.1	16.9	6.6	26	1	0.6	0	0
Malaysia	12	14.2	14.4	3.7	27	0	0.7	0	0
Colombia	3	8.4	11.9	7.1	55	0	0.4	100	100
Saudi Arabia	12	17.6	16.8	3.0	12	0	0.2	0	0

Source: IMF Global Financial Stability Report, April 2017

Other data points from the same report suggests that situation remains dire. For example, nearly 80% of Indian banks have provision needs in excess of their net profit. According to IMF estimates, about one-third of Indian banks need to set aside at least three years of earnings to provision adequately for non-performing loans.

Provisions exceeding annual profits



Source: IMF Global Financial Stability Report, April 2017

Hence it is not surprising to see the focus of the government on reducing the NPA ratio. According to CARE Ratings, 24 public sector banks accounted for 88.2% of the total NPAs in the banking system as of December 2016. This suggests that the situation is unlikely to result in a systemic crisis and could be improved should the government come up with a credible roadmap. As part of that roadmap, the government has approved plans to amend the country's banking regulation law to give more powers to the RBI to resolve the NPAs. This should kick-start the process and enable faster resolution with the RBI giving specific solutions for specific cases.

RBI – Surprisingly hawkish

In a surprising change, the Reserve Bank of India at the start of 2017 shifted its stance to neutral from accommodative. This did catch a lot of market participants by surprise as most (including us) had expected the RBI to retain an easing bias in light of disruptions in the economy on account of demonetization. In fact, at its last meeting, the RBI narrowed the policy gap by increasing the reverse repo rate to 6% from 5.75%. The commentary from the central bank was also slightly hawkish as they upped the inflation projection for FY 2018 to 4.5% - 5% (from 4%-5%).

Notwithstanding the concern of the RBI, the inflation trajectory continues to remain benign and well within the target of the RBI. The consumer price inflation data for March 2017 came in at 3.81% y/y compared to 3.65% y/y. The wholesale price index came in 5.7% y/y, lower than previous month's 6.55% y/y.

Heading into FY 2018, we now expect the RBI to remain on a prolonged pause as the change in stance and subsequent commentary suggests that the easing cycle in India has come to a rather premature end. The RBI continues to remain wary of the stickiness of core inflation, the impact of upward revision to government employee salaries and spike in food prices ahead of the monsoon season.

Economic data– Hard to read

At the end of last year, there were a lot of apprehension and anecdotal evidence suggesting that demonetization may have had a crippling impact on the economy. The actual data bears out that the effect was short-lived with the economy gearing towards normal levels sooner than expected. Having said that, the data continues to remain mixed which makes it hard to decipher. Moreover, the implementation of GST from Q2 FY 2017 will add another layer of disruption in the immediate term given the complexity and magnitude of change.

The Nikkei PMI data suggests that economic activity is back to pre-demonetization level with manufacturing PMI jumping to 52.5 at the end of April 2017 from 49.6 at the end of December 2016. The Nikkei Services PMI has also improved to 51.5 at the end of March 2017 from 46.8 at the end of December 2016.

However, it does appear that the impact of demonetization is taking longer to dissipate in certain sectors like consumer non-durables of the economy. The same is borne out by the industrial production data which showed a contraction of -1.2% y/y in February 2017. The consumer non-durables sub index (-1.7%) which is considered a proxy for rural economy declined for a third consecutive month.

Markets – Solid performance

Indian equity markets shrugged off the impact of disruptive factors including demonetization to deliver a solid performance. The Nifty index has rallied +13.7% ytd in local currency terms on the back of solid budget from the government of India, decline in political risk premium and continued momentum in economic reforms. In terms of relative performance, India has marginally underperformed its emerging market peers but outperformed developed market peers. The MSCI India index has added +12.7% ytd compared to a gain of +13.4% in the MSCI Emerging Markets index and +6.6% ytd rally in the MSCI G7 index. Volatility has declined in line with broad equity markets. The INVIXN index has declined -29.8% in the first four month of 2017.

The sectoral performance since the start of 2017 not only reflects the confidence of investors in India as an investment destination but also the anxiety around Donald Trump's protectionist policies. All sectors, with the exception of Technology and Health Care, have delivered positive returns. Oil & Gas and Financials have delivered +28.9% ytd and +23.8% ytd respectively which Technology and Health Care have returned -3.6% ytd and -9.3% ytd respectively.

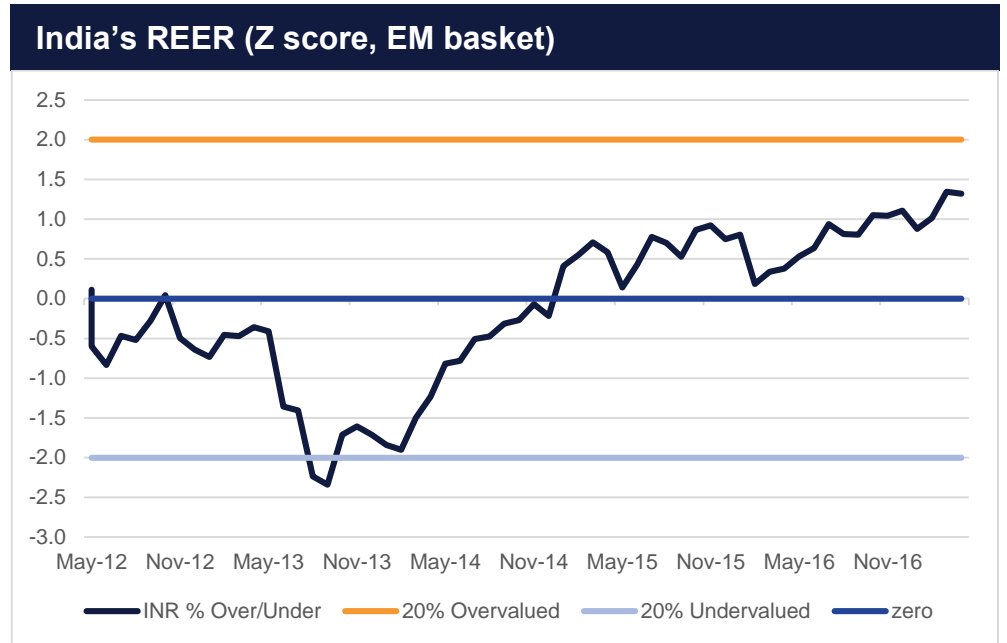
It is no surprise to see strong fund flows from foreign institutional investors (FIIs) in both the debt as well as equity markets. In fact, the flows in the first four month of 2017 are at multi-year highs. FIIs have bought stocks worth USD 6.5bn so far in 2017 while they have invested USD 7.5bn in debt markets. It is worth noting here that a rather ingenious use of ETFs by the government to sell stake in public sector companies could have boosted inflows. According to Bloomberg, Indian ETFs have received USD 1.8bn ytd, the fifth highest in the world and the largest among its EM peers. The government's CPSE ETF (Central Public Sector Enterprise) has received the maximum inflow so far this year.

INR – Surprise moves

The moves in INR has caught a lot of market participants unaware as the general consensus at the start of the year was for it to depreciate to levels closer to 70.0. Instead the currency has actually appreciated by +5.7% to levels below 65.0. The move has been in line with our expectation albeit at a quicker pace. It appears that the move accelerated on back of surprisingly strong inflows from FIIs and a more hawkish RBI. The excess liquidity in the system on account of demonetization seems to have mitigated the impact of RBI's intervention in the market.

The recent appreciation in the INR has brought into focus the fact that India's Real Effective Exchange Rate (REER) has been in the overvalued zone since the start of 2015. The

overvaluation essentially implies limited correction in inflation and productivity dynamics between India and its trading partners. Hence, we believe that it would be a mistake to read too much into the REER as a minor appreciation over the last two years does not mean overvaluation. Moreover, if the market two years ago did not believe that the INR was overvalued, nothing has changed in the interim to suggest otherwise.



Source: Bloomberg, Emirates NBD Research

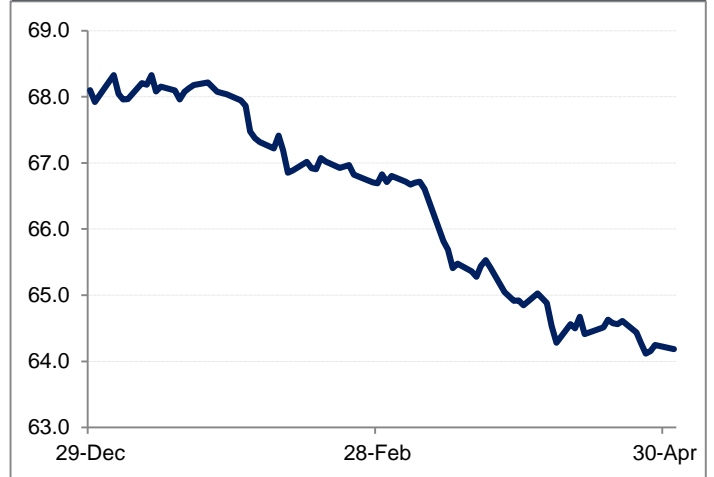
Having said that, we believe that the INR remains on a strong footing at least in the short term because of its limited dependence on external trade, shift in the RBI's stance and continued fiscal prudence from the government. In light of the recent moves, we have revised our Q2 2017 forecast to 64.5 level and Q4 2017 forecast to 66.0 levels. We have factored in the possibility of some outflows from foreign investors and a more hawkish Federal Reserve in 2H 2017 in our forecast.

Market watch and flows

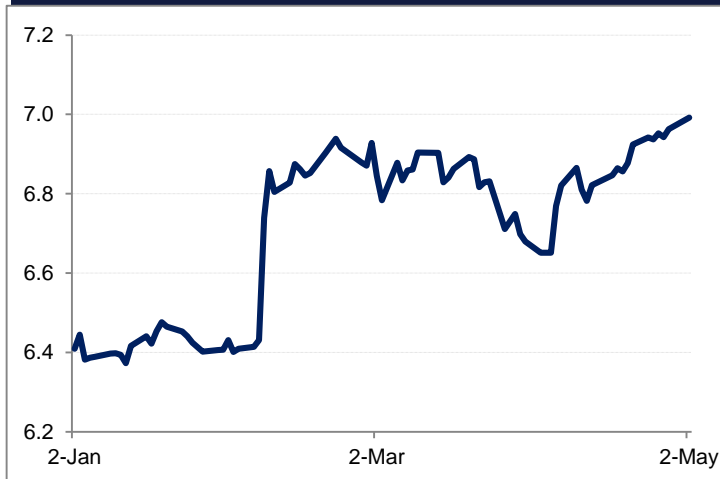
Nifty (1y)



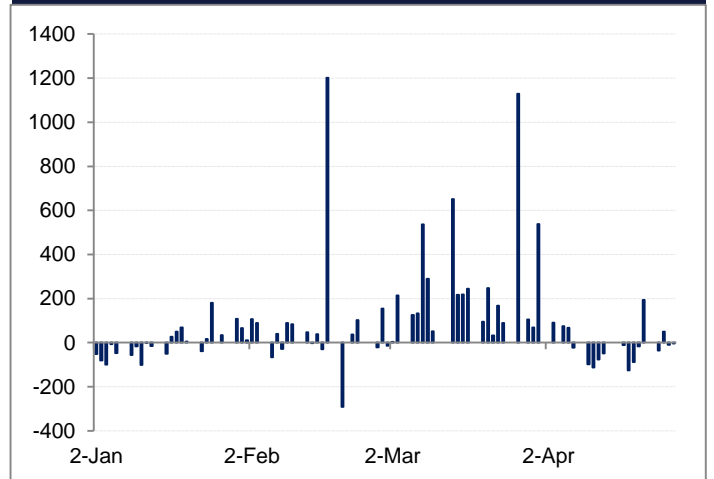
USD INR (ytd)



10y Gol yields (% ytd)



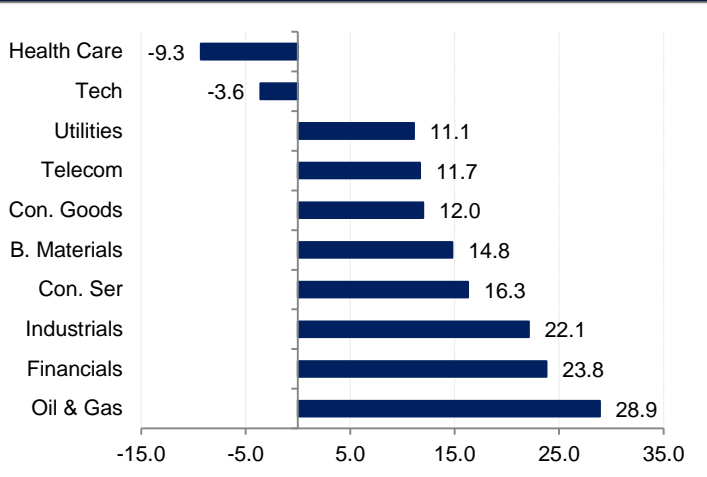
FII flows (USD mn, ytd)



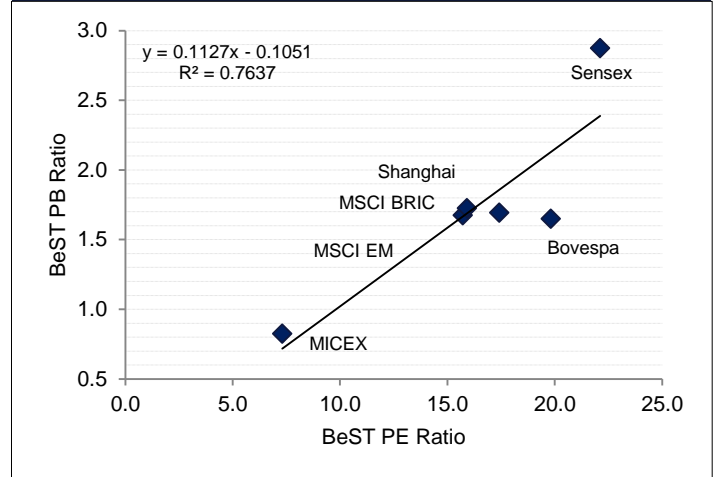
Source: Bloomberg, Emirates NBD Research

Performance and Valuations

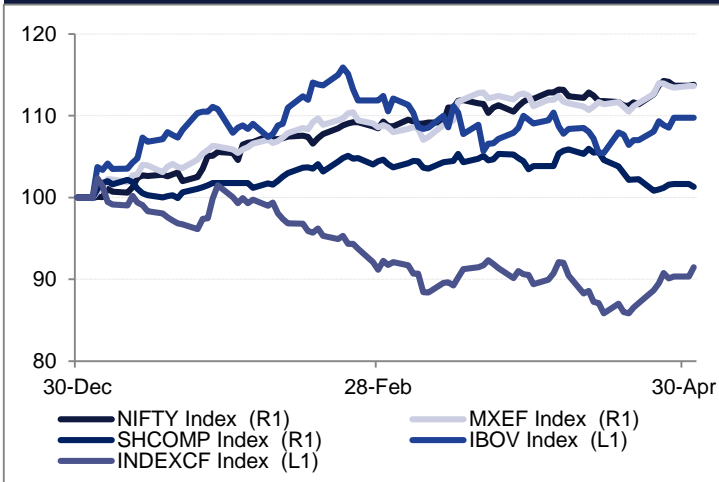
Nifty Sector Breakdown (ytd total return, %)



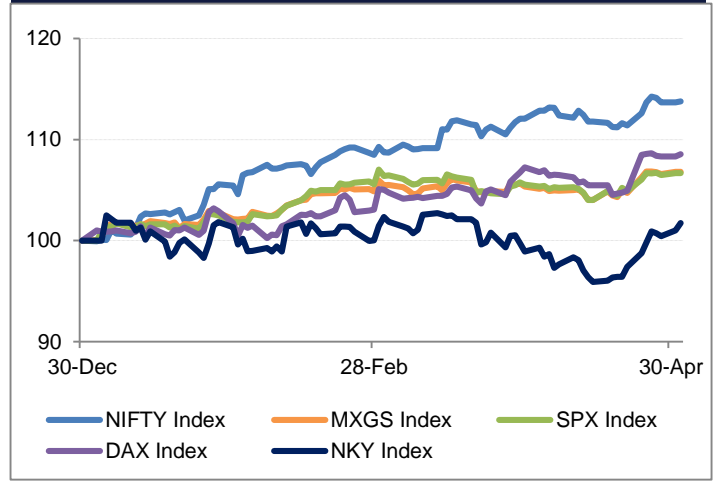
Sensex continues to command premium



Nifty outperforms emerging market peers (ytd)



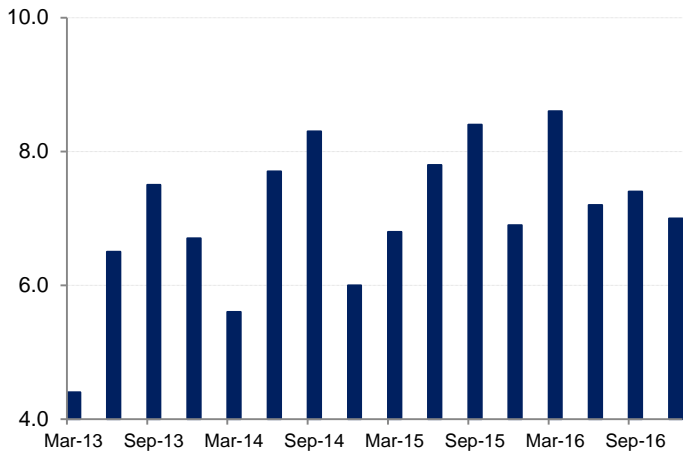
Nifty outperforms developed market peers (ytd)



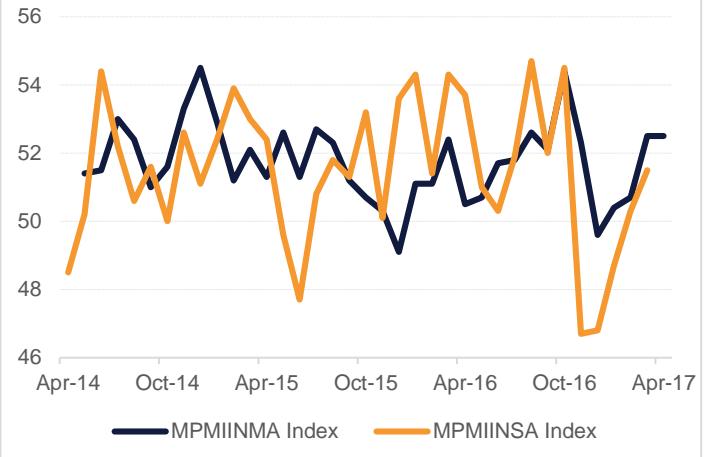
Source: Bloomberg, Emirates NBD Research

Economics

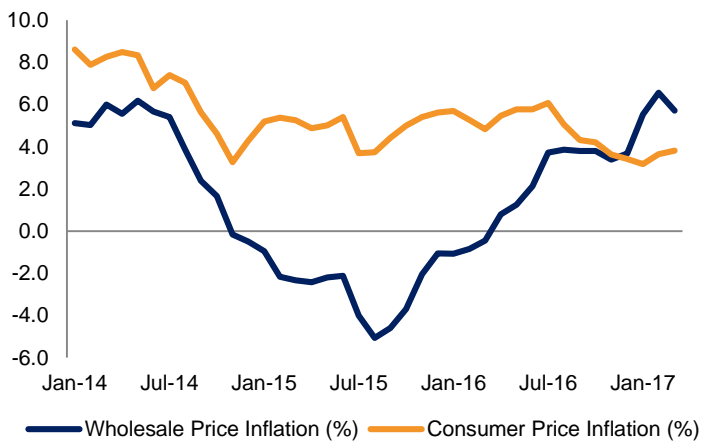
GDP growth remains steady (y/y, %)



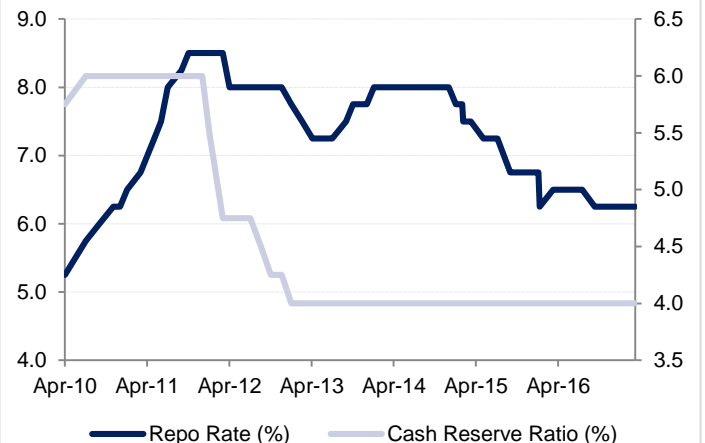
PMI rebounds (y/y, %)



Inflation remains benign (y/y, %)



RBI changes stance to neutral



Source: Bloomberg, Emirates NBD Research

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Emirates NBD Research & Treasury Contact List

Emirates NBD Head Office
12thFloor
Baniyas Road, Deira
P.O.Box777
Dubai

Aazar Ali Khwaja
Group Treasurer & EVP Global Markets &
Treasury
+971 4 609 3000
aazark@emiratesnbd.com

Tim Fox
Head of Research &
Chief Economist
+9714 230 7800
timothyf@emiratesnbd.com

Research

Khatija Haque
Head of MENA Research
+9714 230 7803
khatijah@emiratesnbd.com

Shady Shafer Elborno
Head of Macro Strategy
+9714 2012300
shadyb@emiratesnbd.com

Aditya Pugalía
Analyst
+9714 230 7802
adityap@emiratesnbd.com

Anita Yadav
Head of Fixed Income Research
+9714 230 7630
anitay@emiratesnbd.com

Athanasios Tsetsonis
Sector Economist
+9714 230 7629
athanasiost@emiratesnbd.com

Edward Bell
Commodity Analyst
+9714 230 7701
edwardpb@emiratesnbd.com

Mohammed Al-Tajir
Analyst
+9714 609 3005
mohammedtaj@emiratesnbd.com

Sales & Structuring

Group Head – Treasury Sales
Tariq Chaudhary
+971 4 230 7777
tariqmc@emiratesnbd.com

Saudi Arabia Sales
Numair Attiyah
+966 11 282 5656
numaira@emiratesnbd.com

Singapore Sales
Supriyakumar Sakhalkar
+65 65785 627
supriyakumars@emiratesnbd.com

London Sales
James Symington
+44 (0) 20 7838 2240
jamess@emiratesnbd.com

Egypt
Samy Safwat
+20 22 726 5050
samysafwat@emiratesnbd.com

Group Corporate Affairs

Ibrahim Sowaidan
+9714 609 4113
ibrahims@emiratesnbd.com

Claire Andrea
+9714 609 4143
clairea@emiratesnbd.com

Investor Relations

Patrick Clerkin
+9714 230 7805
patricke@emiratesnbd.com