22 December 2014 | 11 pages

Emerging Markets
Asia

India Macro View

US Trip Tales – Stay Invested in the India Story

- **India still a favorite: Consensus view** — We recently met ~50 institutional investors in the US. Unsurprisingly, India remains a consensus favorite both as an 'absolute' and 'relative' play due to a trinity of factors i.e. (1) Business-friendly Modi govt; (2) Pro-active RBI Governor Rajan; and (3) Commodity tailwinds. Following a strong market performance in 2014 (equity +30%, bond ~13-14%, INR outperformed by 4-5%), most investors were of the view that the on-going cyclical and structural upturn could result in India continuing to outperform in 2015, albeit at a modest pace. (See pg. 2 for a summary on the trinity of factors aiding India)

- **Not immune to risk-off, but relatively better-off** — While dollar strength was largely expected due to divergent global monetary policies, the sharper-than-expected fall in crude and recent Ruble depreciation have led to a mild risk-off environment, with investors preferring to stay away from 'the energy space' and companies with Russian exposure. India, despite its improving fundamentals is clearly not insulated (INR down 2% in last 1m), however it is relatively better-off considering (1) India is a net importer of crude; (2) Improving macro fundamentals; and (3) Rising FX reserves and forward positions. (see pg. 6 for markets)

- **Common question: What could go wrong?** Interestingly, despite high expectations, memories of the 2013 taper tantrums have resulted in investors remaining on guard and watching out for potential risks. The common concerns were largely around (1) Growth not coming-in as fast as markets have priced them, especially in the context of another large market move; (2) NPA issues in the banking sector; (3) Potential standoffs in the upper house thereby denting the reform momentum; and (4) Limited space on the fiscal side. Many feel that the first full budget of the BJP govt in Feb-2015 will provide useful insights on the path ahead.

- **Commodity fall a relief, but it's not a one-way street** — Our commodity team notes that the global hydrocarbon industry could see cuts in capex on account of lower crude prices and productivity gains. India too is not immune. Low commodity prices could delay the investment upturn and/or result in import substitution in the hydrocarbon as well as the mining space. However, at this juncture, we believe that for India, the benefits in falling commodity prices out-weigh the negatives. (pg 4 & 5)

- **Bottom-line: Re-iterate no room for complacency** — Unlike the 2013 taper tantrums, when India had a high current account deficit, elevated inflation and weak growth, India's fundamentals have improved. However, we re-iterate there is no room for complacency as generalized EM risk aversion could result in reversal in portfolio flows and external debt de-leveraging. None-the-less, we remain positive on the India story with growth likely to edge back to 7% and lower inflation. For more details on our 2015 outlook please see India Macroscope – Surprises in Store.

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With thanks to
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WHAT's INSIDE

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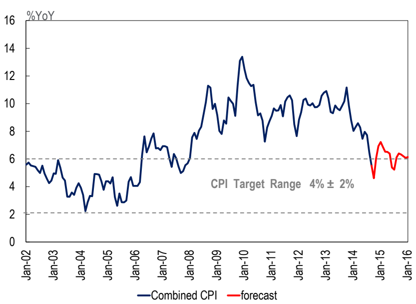
Modi, Rajan Effect and Commodity Boost

Figure 1. Modi Reforms Agenda– Announced and Pending

ANNOUNCED	
Energy	Diesel price has been de-regulated; Gas price increased to US$5.6 per mmBtu from US$4.2 per mmBtu on GCV basis and to US$6.2 on NCV basis Rollout of modified direct benefit transfer for LPG in 54 districts in Nov and all India from 1st Jan
FDI	Railways: 100% FDI in railway infrastructure; Defence: Increase in limit to 49% from 26% Make in India: aggressive campaign to get FDI
Labor	Presidential assent for labor laws in Rajasthan, thereby providing some flexibility ; Shram-Suvidha Portal to allow single online return for 16 laws; Transparency in Labor inspection – decided by computer draw, reports to be uploaded within 72 hrs; Universal account number for EPF accounts
Mining	Govt frames draft rules of coal ordinance, plans to allot 74 of 200+ cancelled coal blocks through auctions and allocations by 16th March
Finance	Banking Financial Inclusion plan; Expenditure management commission
IT	1bn enrollment target for Adhaar (UID)
Rural Development	Integrated project-based infrastructure development
Environment	Clearance process (environment and forest) online
Food Inflation	Hoarding made non-bail able offense. Rs5bn price stabilization fund; Continued moderation of MSPs and offloading food stocks
PENDING	
Finance	GST; Amendments to retrospective tax laws; Increase in FDI limit in insurance sector to 49%
Energy	Modification in incentive regime for hydrocarbon exploration (from cost-recovery to revenue-sharing model)
Land acquisition	Making the recent law less onerous
Economic planning	Planning commission scrapped
Food	National common market for agricultural produce
Investments	Single-window clearance for capital intensive steel, coal and power projects

Source: Govt, media reports and Citi Research

Figure 2. CPI – the New Nominal Anchor (%)



Source: CSO, Citi Research

Figure 3. Rajan's Five Pillars – A Status Update

Pillars	Objective	Progress So Far…
Monetary Policy	Clarifying and strengthening the monetary policy framework.	RBI proposes Flexible Inflation Targeting Nominal Anchor moved from WPI to CPI Changes in Liquidity Framework
Banking Expansion	New entry, branch expansion, encouraging new varieties of banks	New bank license awarded to IDFC, Bandhan On-tap issue of licenses; Payment Bank Norms
Market Broadening	Broadening /deepening financial markets for better liquidity, pricing of risks	Long term bank Infra bonds CPI indexed bonds Proposed International Settlement of bonds
Financial Inclusion	Expanding financial access to SME, unorganized sector, remote areas	Draft norms for small and payment banks Push for mobile-based banking
Restructuring/Distress management	Mechanism to deal with corporate/FI distress and debt recovery	Refinancing infra loans under take out financing not construed as restructuring Norms for Distress asset management

Source: RBI, Citi Research

CRUDE PRICES FALL 40% SINCE JUNE

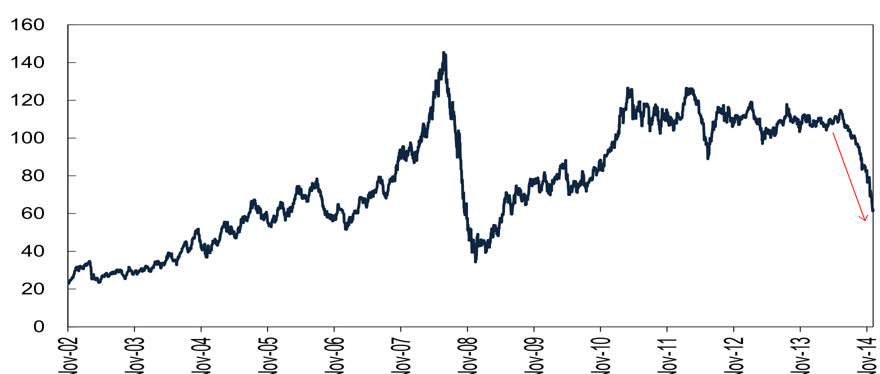
There has been a ~40% decline in crude prices since June from US$115/bbl to ~US$60/bbl. This bodes well for:

Inflation: RBI study indicates a 10% change in the price of crude could alone affect CPI inflation by 20bps.

CAD: Crude accounts for 30% of imports; $1/bbl change in oil price impacts CAD by US$900mn.

Fisc: $1/bbl change impacts losses by US$700mn.

Figure 4. Trends in Crude Prices (US$/bbl)



Source: Bloomberg

What Could Go Wrong?

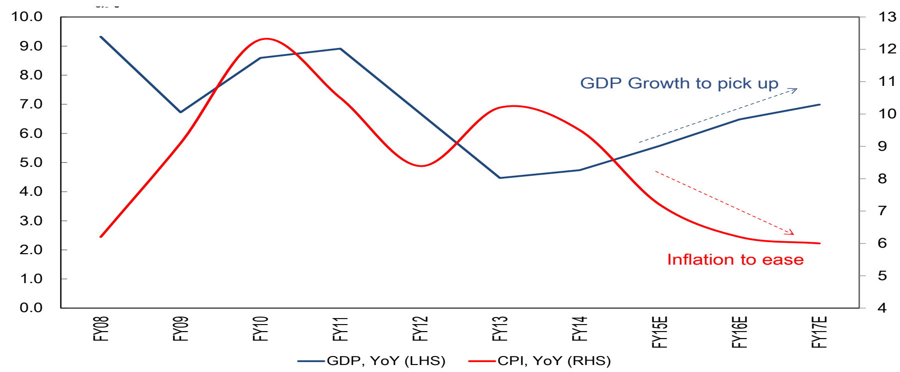
IF GROWTH-INFLATION IMPROVES SLOWER THAN OUR BASELINE

Following a period of slowing growth and elevated inflation seen during FY11-FY14, trends have reversed.

GDP: We expect growth to pick up to 5.6% in FY15, and 7% in FY17 from sub-5% levels before.

CPI: We expect CPI to ease towards 6%, in-line with the RBI's glide path, from double-digit levels before.

Figure 5. Trends & Projection in GDP & Inflation



Source: CSO, Citi Research estimates

OPPOSITION IN RAJYA SABHA

Ruling BJP government continues to have a minority status in the Upper house. This could potentially cause delays in major reforms.

As BJP gains strength in state assemblies – as seen recently in Haryana and Maharashtra – its numbers could increase in the Rajya Sabha.

But, this may take 2-3 years. In the interim, passing legislation through multi-party dialogues or joint sessions remains an alternative.

Figure 6. Rajya Sabha Retirement Schedule – Party Wise

	2014	2015	2016	2017	2018	2019	2020	Total
INC		4	21	3	19	2	19	69
BJP	1		12	2	16		12	43
BSP	6		6		2			14
AITC				4	4		5	13
JD(U)			5		4		3	12
AIADMK			3			4	4	11
SP	1		3		6			10
Total	**10**	**10**	**72**	**10**	**69**	**8**	**63**	**241**

Source: Rajya Sabha

Figure 7. Pending Reforms

Finance	GST; Retrospective amendments to tax laws; Increase in FDI limit in insurance sector to 49%
Energy	Modification in incentive regime for hydrocarbon exploration (to revenue-sharing model)
Land acquisition	Making the recent law less onerous
Econ planning	Planning commission scrapped
Food	National common market for agricultural produce
Investments	Single-window clearance for capital intensive steel, coal and power projects

Source: Media Reports, Citi Research

GLOBAL MARKET TURBULENCE

USD strengthening was widely expected on divergence in global monetary policies.

The recent fall in crude and Ruble depreciation has led to a mild risk-off environment.

As a result, USD has strengthened further against most currencies.

Figure 8. Dollar Strengthens on EM Risk Aversion

Source: Bloomberg

Lower Commodities – Windfall for India

CURRENT ACCOUNT DEFICIT TO NARROW

We expect the CAD to remain in-check at 1.6% and 1.3% of GDP in FY15 and FY16 as the impact of a ~40% drop in crude prices is likely to offset higher gold imports.

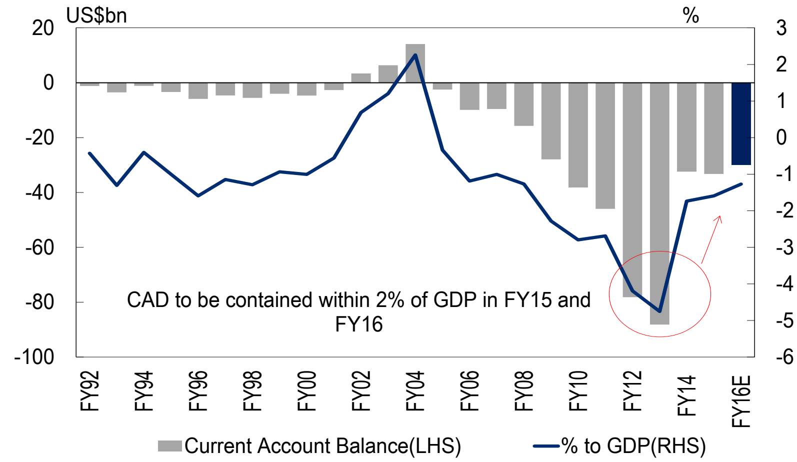
ASSUMPTIONS

Exports: US$358bn up 6.5%; Imports: US$504bn up 5%; Non-oil/non-gold: 12%

Gold: 800 tonnes, priced at US$1220/oz

Oil price: US$80/bbl (Every US$1/bbl change in prices = US$900mn on CAD)

Figure 9. Trends in Current Account Deficit



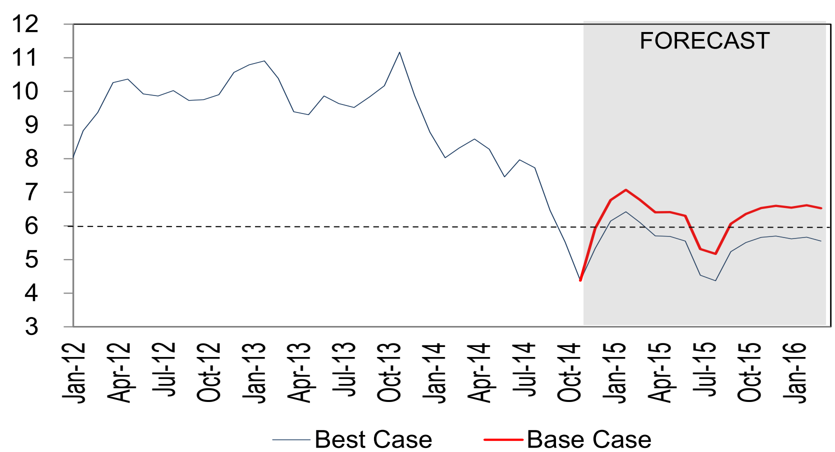
Source: RBI, Citi Research estimates

Figure 10. Fuel Sensitivity of Inflation

	WPI weight	CPI weight
Crude Petroleum	0.90%	0%
Diesel	4.67%	0.01%
Petrol	1.09%	1.66%
other mineral oil	2%	0%
Bus/Tram/Taxi/auto fare	0	1.31%
Total	**8.66%**	**2.98%**

Source: Office of Econ Advisor, NSSO, Citi Research

Figure 11. Trends in CPI (%)



Source: CSO, Citi Research estimates

FUEL SUBSIDY

The de-regulation of diesel and lower crude prices bodes well for lower under recoveries for oil companies.

Our team's current assumption for FY16 / 17 is based on crude at US$97/bbl

It is noteworthy that every US$1/bbl change in oil prices would impact under-recoveries by US$700mn.

As a result, the fuel subsidy cost for government could decline by 0.4%-0.5% of GDP in FY 16/17.

Figure 12. Trends in Oil Under-recoveries / Subsidies (Rs bn)

Year Ending Mar 31	FY11	FY12	FY13	FY14	FY15E	FY16E	FY17E
Gross Under-Recoveries	**782**	**1,385**	**1,610**	**1399**	**837**	**681**	**675**
- Diesel	347	812	921	628	125	0	0
- LPG	218	300	396	465	410	402	413
- Kerosene	195	274	294	306	302	279	262
Less: Upstream sharing	**303**	**550**	**600**	**670**	**649**	**506**	**497**
% of total	39%	40%	37%	48%	77%	74%	74%
Less: gov't compensation	**410**	**835**	**1,000**	**708**	**188**	**175**	**178**
% of total	52%	60%	62%	51%	23%	26%	26%
Crude Prices (US$/bbl)	87	114	111	108	103	97	95
INR/US$	45.6	47.9	54.4	60.4	61.0	62.0	62.0
Diesel losses (Rs / ltr)	(3.4)	(8.9)	(9.9)	(6.9)	(1.7)	0.0	0.5
LPG losses (Rs/cylinder)	(248)	(331)	(448)	(471)	(435)	(398)	(393)
Kerosene losses (Rs / ltr)	(16.6)	(25.8)	(30.5)	(35.0)	(33.8)	(32.6)	(31.4)

Source: PPAC, OMCs, Citi Research estimates

The Flip side of Lower Commodities

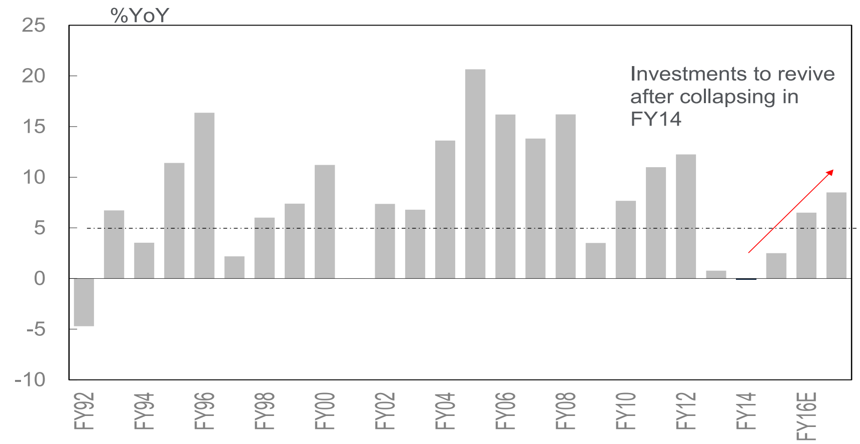
COULD IMPACT CAPEX IN THE AREA OF HYDROCARBONS

We expect investments to pick up to 2.5% in FY15 and further to 6.5% in FY16.

Low commodity prices could delay the investment upturn and/or result in import substitution in the hydrocarbon as well as the mining space.

However, at this juncture, we believe that for India, the benefits in falling commodity prices out-weigh the negatives.

Figure 13. Trends in Investments (%YoY)



Source: CSO, Citi Research estimates

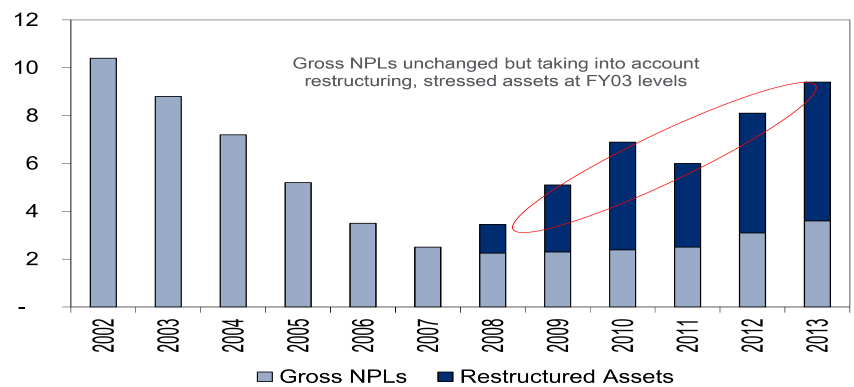
FINANCING REMAIN A CONCERN DUE TO NPA ISSUES

Gross NPAs+ restructured assets in infra sector are ~20% of total advances.

This has led to risk aversion from the borrower and the lender (e.g., avg lending rate for power sector is 13.7% vs. policy rate of 8%).

Solution lies in wider financing options, e.g., bonds, enabling environment for infrastructure, e.g., pass through of costs, dispute resolution.

Figure 14. Stressed Assets (% of advances)



Source: RBI, Citi Research

LOW CAPEX TO KEEP DOMESTIC CRUDE PRODUCTION SLUGGISH

Crude production has remained stable in the last three years. The growth in crude production could moderate given slower capex.

Crude production was 39mn tonne in FY14 and is expected to rise to 41mn tonne in FY15 and 43 mn T in FY16E.

Figure 15. Trends in Oil Production and Imports

	FY13	FY14	FY15E	FY16E
A. Crude prodn (Mn T)	37.9	38.9	41.1	43.4
B. Crude Imports(Mn T)	184.8	189.6	195.0	212.1
Crude Oil Req (A+B)	**222.7**	**228.6**	**236.1**	**255.5**
Volume Terms (Mn T)				
Cons of Petrol Products	157.1	158.2	165.8	172.4
Petro Product Exports	63.4	68.4	68.8	80.2
Value Terms (US$bn)				
C. Total Imports	164.0	165.2	143.9	129.4
D. Petro Product Exports	60.9	62.7	56.9	57.1
Net Oil Import Bill (C-D)	**103.2**	**102.5**	**87.0**	**72.3**
Avg Oil Price	108.0	105.5	93.0	80.0

Source: PPAC, DGCI&S, Citi Research estimates

Indian Markets – Still Attractive

STOCKS RETURN 35% in 2014

Improving growth inflation dynamics makes India markets attractive.

Positive investor sentiment could continue to favor Indian markets.

Figure 16. Trends in Sensex

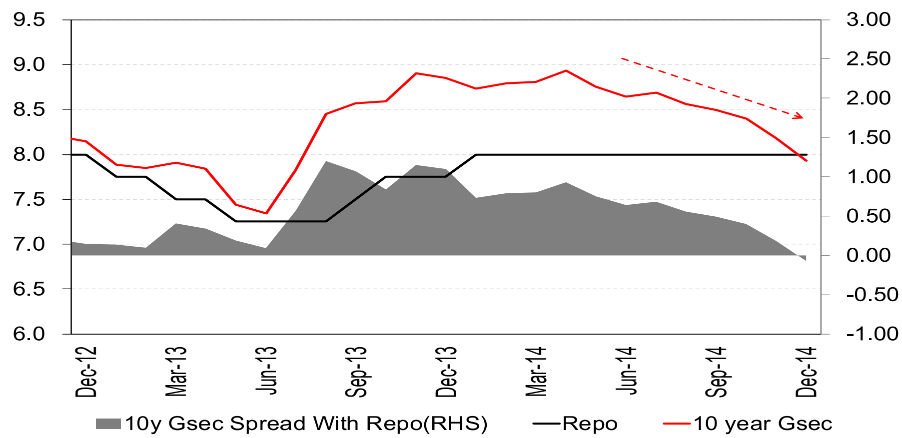
Source: Bloomberg

BONDS RETURN 13-14% in 2014

Slowing Inflation and improving rates outlook helped 10 year bond to ease from 9% to ~8% currently.

We expect RBI to cut rates by 100bps by FY16, thus resulting in bond yields softening towards 7.5-7.75%.

Figure 17. G-Sec Yields with Repo (%)



Source: Citi Research

INR TRADING RANGE WIDENS TO 61-64

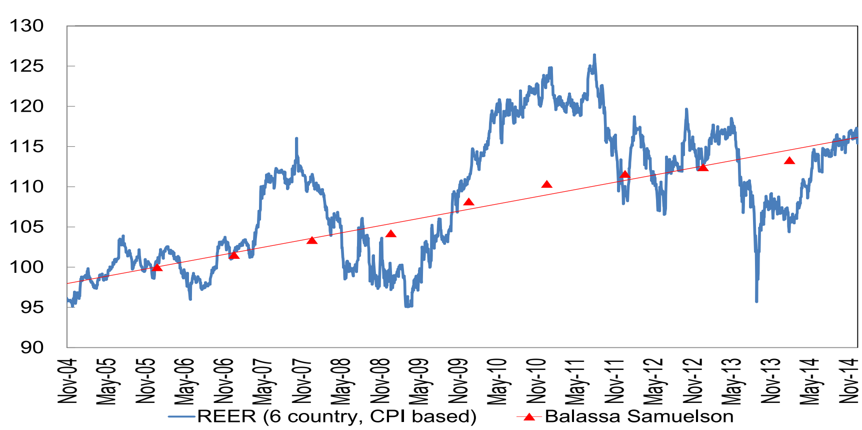
While India remains better positioned due to lower crude, the trading range could likely widen on EM weakness.

Figure 18. Trends in Fx Reserves (US$bn)

	Fx Reserves	O/S Forwards		
		<1yr Mat	>1yr Mat	Total
Sep-13	277.2	-7.7	-1.9	-9.6
Oct-13	281.5	-5.9	-8.5	-14.5
Nov-13	290.7	-6.4	-26.1	-32.5
Dec-13	293.9	-6.6	-26.0	-32.6
Jan-14	291.1	-5.9	-26.0	-31.8
Mar-14	304.2	-5.1	-26.0	-31.0
Apr-14	311.0	-6.1	-26.0	-32.1
May-14	312.2	14.5	-26.0	-11.5
Jun-14	316.1	25.8	-26.0	-0.2
Jul-14	319.8	31.4	-26.0	5.4
Aug-14	318.4	31.8	-26.0	5.8
Sep-14	313.8	34.4	-26.0	8.4
Oct-14	315.9			
Nov-14	314.9			

Source: RBI, Citi Research

Figure 19. INR-REER Close to Fair Value



Source: RBI, Citi Research

Statistical Snapshot

Figure 20. India Macroeconomic Summary FY04 – 17E

Fiscal Year to 31 March	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15E	FY16E	FY17E
National Income Indicators														
Nominal GDP(Rs bn)	28,617	32,422	36,934	42,947	49,871	56,301	64,778	77,841	90,097	101,133	113,551	128,312	146,276	165,467
Nominal GDP (US$ bn)	623	720	834	950	1,241	1,224	1,367	1,708	1,873	1,873	1,880	2,070	2,359	2,805
Per Capita GDP (US$)	582	662	754	847	1,090	1,061	1,168	1,440	1,558	1,539	1,499	1,651	1,854	2,171
Real GDP growth (%)	**8.1**	**7.0**	**9.5**	**9.6**	**9.3**	**6.7**	**8.6**	**8.9**	**6.7**	**4.5**	**4.7**	**5.6**	**6.5**	**7.0**
Agriculture growth (%)	9.0	0.2	5.1	4.2	5.8	0.1	0.8	8.6	5.0	1.4	4.7	0.5	3.0	3.0
Industry growth (%)	7.3	9.8	9.7	12.2	9.7	4.4	9.2	7.6	7.8	1.0	0.4	3.9	5.9	7.0
Services growth (%)	8.1	8.1	10.9	10.1	10.3	10.0	10.5	9.7	6.6	7.0	6.8	7.5	7.5	7.8
By Demand (%YoY)														
Consumption	5.4	1.9	8.7	7.7	9.4	7.7	8.4	8.2	8.9	5.2	4.7	5.6	6.8	6.8
Pvt Consumption	5.9	1.7	8.6	8.5	9.4	7.2	7.4	8.7	9.3	5.0	4.8	5.5	7.0	7.0
Public Consumption	2.6	3.4	8.9	3.8	9.6	10.4	13.9	5.8	6.9	6.2	3.8	6.0	6.0	6.0
Gross Fixed Capital Formation	13.6	20.7	16.2	13.8	16.2	3.5	7.7	11.0	12.3	0.8	-0.1	2.5	6.5	8.5
Cons; Invst, Savings * (%GDP)														
Consumption	75.0	70.1	69.2	68.0	67.2	68.6	69.1	67.5	68.5	68.8	68.9	69.2	68.9	68.9
Gross Capital Formation	26.9	32.8	34.7	35.7	38.1	34.3	36.3	36.5	36.4	34.7	31.4	31.7	31.7	31.4
Gross Domestic Savings	28.7	32.4	33.4	34.6	36.8	32.0	33.7	33.7	31.3	30.1	30.5	30.8	31.0	31.0
Real Indicators (%YoY)														
Commercial vehicle sales	36.2	22.4	10.1	33.3	4.2	-21.4	39.2	27.0	19.5	-1.9	-20.2	-4.5	11.6	15.0
Car sales	27.2	17.8	7.7	20.7	12.1	0.3	25.7	29.2	3.9	2.4	-6.7	1.7	10.6	19.0
Two-wheelers	11.3	15.7	13.6	11.5	-7.8	2.7	25.9	25.8	13.9	2.9	7.3	10.0	10.0	15.0
Diesel consumption	1.2	6.9	1.4	6.7	11.1	8.5	8.9	6.5	8.0	6.7	-1.0	4.0	4.0	
Mobile Tele density	3.1	4.8	8.2	14.1	22.0	33.0	48.5	66.8	75.1	79.0	87.9	78.0	80.0	
Monetary Indicators (% YoY)														
Money supply	13.0	14.0	15.9	20.0	22.1	20.5	19.2	16.2	15.8	13.4	17.0	16.0	17.0	17.5
Inflation – WPI (Avg)	5.5	6.5	3.7	6.5	4.8	8.0	3.6	9.6	8.8	7.5	5.9	4.0	4.0	4.0
CPI (Avg)	3.8	3.9	4.2	6.8	6.2	9.1	12.3	10.5	8.4	10.2	9.5	7.2	6.2	6.0
Bank credit growth	15.3	30.9	37.0	28.1	22.3	17.5	16.9	21.5	17.0	14.1	15.0	14.0	15.0	16.0
Deposit growth	17.5	13.0	24.0	23.8	22.4	19.9	17.2	15.9	13.5	14.2	13.5	14.0	14.0	14.0
Fiscal Indicators (% GDP)														
Centre's fiscal deficit)	-4.3	-3.9	-4.0	-3.3	-2.5	-6.0	-6.5	-4.8	-5.7	-4.9	-4.6	-4.1	-4.0	-3.6
State fiscal deficit	-3.9	-3.4	-2.5	-2.1	-1.4	-2.3	-2.9	-2.1	-2.4	-2.3	-2.2	-2.6	-2.5	-2.6
Combined deficit (Centre+State)	-8.2	-7.2	-6.5	-5.4	-4.0	-8.3	-9.3	-6.9	-8.1	-7.2	-6.9	-6.7	-6.5	-6.2
Off Balance Sheet Items			-0.5	-0.9	-0.6	-1.7	-0.2							
Combined liabilities (dom+ext)	90.0	88.8	84.6	79.9	76.1	76.8	75.5	70.2	69.6	69.8	69.6	68.5	66.2	64.7
External Sector (% YoY)														
Exports (US$bn)	66.3	85.2	105.2	128.9	166.2	189.0	182.4	250.5	309.8	306.6	318.6	336.1	358.0	393.8
% YoY	23.3	28.5	23.4	22.6	28.9	13.7	-3.5	37.3	23.7	-1.0	3.9	5.5	6.5	10.0
Imports (US$bn)	80.0	118.9	157.1	190.7	257.6	308.5	300.6	381.1	499.5	502.2	466.2	480.2	504.2	549.6
%YoY	24.1	48.6	32.1	21.4	35.1	19.8	-2.6	26.7	31.1	0.5	-7.2	3.0	5.0	9.0
Trade deficit (US$bn)	-13.7	-33.7	-51.9	-61.8	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-147.6	-144.1	-146.2	-155.8
Invisibles (US$bn)	27.8	31.2	42.0	52.2	75.7	91.6	80.0	84.6	111.6	107.5	115.2	110.8	116.3	121.4
Current Account Deficit (US$bn)	14.1	-2.5	-9.9	-9.6	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-32.4	-33.2	-30.0	-34.4
% to GDP	2.3	-0.3	-1.2	-1.0	-1.3	-2.3	-2.8	-2.7	-4.2	-4.7	-1.7	-1.6	-1.3	-1.3
Capital Account (US$bn)	16.7	28.0	25.5	45.2	106.6	7.4	51.6	62.0	67.8	89.3	48.8	80.5	84.5	82.5
% GDP	2.7	3.9	3.1	4.8	8.6	0.6	3.8	3.6	3.6	4.8	2.6	3.9	3.6	3.0
Forex Assets (incl gold) (US$bn)	110.3	140.9	151.6	199.2	309.2	252.3	277.0	303.5	294.4	292.6	303.7	350.9	405.5	453.6
Months of imports	16.5	14.2	11.6	12.5	14.4	9.8	11.1	9.6	7.1	7.0	7.8	8.8	9.7	9.9
External Debt (US$bn)	112.7	134.0	139.1	172.4	224.4	224.5	260.9	317.9	360.8	409.4	442.2	450.1	465.1	480.1
Short Term Debt (US$bn)	4.4	17.7	19.5	28.1	45.7	43.3	52.3	65.0	78.2	96.7	89.2	87.9	92.9	97.9
Exchange Rate														
US$/INR - annual avg	45.9	45.0	44.3	45.2	40.2	46.0	47.4	45.6	48.1	54.0	60.4	62.0	62.0	62.0
% depreciation	-5.2	-2.0	-1.6	2.0	-11.1	14.4	3.0	-3.8	5.5	12.3	11.9	2.6	0.0	0.0

* At current prices.
Source: CSO, RBI, Ministry of Finance, Citi Research estimates

Appendix A-1

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