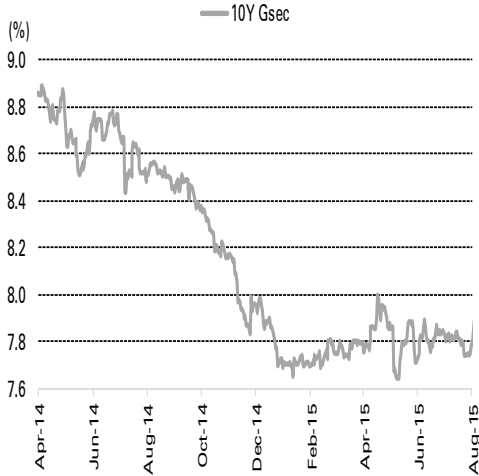


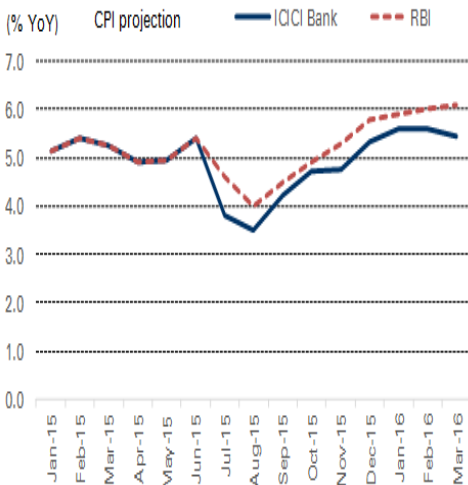
India Fixed Income: Ranged markets await Fed and RBI triggers

Benchmark bond yield has traded ranged in recent weeks



Source: Bloomberg, ICICI Bank Research

Our CPI projection is 40-50 bps lower compared to RBI's glide path



Source: CEIC, ICICI Bank Research

September 16, 2015

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- The global market volatility driven by China and US Fed has led to ~USD 30-40 bn FII outflows from EM, ~70-80% of the magnitude observed during taper tantrum
- August CPI reinforces our view of rate cut by RBI in September; further rate cuts are likely to be contingent upon RBI's adoption of medium term CPI goalposts
- We maintain our 10Y bond yield range of 7.50-7.70% by end-Dec FY2016. The risk to the view is from rise in global market volatility while FII debt limit hike would provide downward bias

EM outflows have persisted amid heavy global volatility

According to the latest report by Institute of International Finance, "Total (FII) outflows (from EMs) are estimated at ~USD 30-40 bn since August 10 (Yuan devaluation period), about 70-80% of the magnitude observed during the 2013 taper tantrum. Portfolio equity flows have been exceptionally weak over the past month, while bond flows seem to have suffered less". India though has been relatively cushioned given the significant improvement in fundamentals since Fed taper tantrum.

Benign CPI reinforces our 25 bps rate cut view by RBI in September

August CPI slipped to 3.66% YoY (July print of 3.69% YoY), due to favourable base. The reading was lower than RBI's projection of 4% for Aug-2015 thereby building case for further policy easing. Weak commodity prices as well as policy steps have helped keep price pressures under control. We believe that in spite of a poor monsoon (16% below long period average), food price pressures are likely to be capped on Government's contingency plan and healthy crop sowing trend.

Fiscal dynamics currently under control; however, concerns remain

During April-July FY2016, fiscal deficit was 69.3% of budgeted versus 61.2% in FY2015. The widening in deficit is attributable to sharp rise in spending amid strong indirect tax collections though we believe that higher focus on capex is a positive trend. However, we are worried about the following issues: a) Direct tax collections remain weak (0.7% YoY) b) disinvestment receipts lag (INR 127 bn vs INR 695 bn target); c) uncertainty regarding spectrum auction receipts; d) increase in spending due to defence pension and DA hike (INR 110 bn required between July-Feb FY2016) and e) PSU bank recapitalisation (INR 250 bn vs budgeted of INR 79.4 bn). While the Government has already announced some reallocation of budget to accommodate recapitalisation, however we are worried that further reduction in spending may be required, even after adjusting for ~INR 100-150 bn savings on fuel subsidy. Moreover, in FY2017, the 7th Pay Commission will increase fiscal burden significantly, thereby raising need to step up revenues.

Fed likely to maintain pause; "dot-plot" could be revised downward

We expect the Fed to maintain status quo tomorrow. Further, the official "dot-plot" for median Fed funds rate projection is likely to be revised downward.

Maintain view of fall in 10Y yield to 7.50-7.70% range by December

After hitting a peak of 7.89% in end August-2015 amid excessive volatility, the benchmark bond yield continue to trade in a tight range of 7.75-7.80% in recent weeks. Given our monetary policy view, we continue to project a decline in 10-year bond yield to 7.50-7.70% by end-December 2015.

The upside risk to our view is from rise in global volatility (if Fed turns hawkish in September meeting) which could possibly lead the RBI to defer policy easing. Meanwhile, downside risk to yields remains from a FII debt limit hike on conversion into Rupee terms.

Aug-2015 CPI came out in line with expectations

Inflation (new base 2011-12=100)			
(% YoY)	Weight (%)	Jul-15	Aug-15
Headline	100.0	3.7	3.7
Food	45.9	2.8	2.9
of which:			
Cereals	9.7	1.1	1.2
Protein	13.0	6.2	5.4
Vegetables	6.0	-8.0	-6.4
Fuel and light	6.8	5.4	5.7
Core	47.3	4.3	4.1
of which:			
Pan, tobacco & intoxicants	2.4	9.8	9.3
Housing	10.1	4.4	4.7
Clothing	6.5	5.9	5.8
Services	28.3	3.4	3.1
of which:			
Transport	8.6	-0.4	-1.0
ex-transport	19.7	5.1	4.8

Source: CEIC, ICICI Bank Research

Food stocks for cereals remain adequate and will continue to support disinflation in cereals

FCI stocks		
(lakh tonnes)	as on Sep 1-2015	Buffer norm*
Rice	139	115
Wheat	345	246

*excluding the strategic reserve requirement

Source: FCI, ICICI Bank Research

EM outflows have persisted amid heavy global volatility

According to the latest report by Institute of International Finance, "Total (FII) outflows (from EMs) are estimated at ~USD 30-40 bn since August 10 (Yuan devaluation period), about 70-80% of the magnitude observed during the 2013 taper tantrum. Portfolio equity flows have been exceptionally weak over the past month, while bond flows seem to have suffered less".

In the Indian context, FII outflows have totaled USD 4.2 bn since August 10-2015, of which debt and equity outflows have been USD 0.4 bn and USD 3.8 bn respectively. This implies that the domestic markets have been relatively cushioned from global market volatility. This is attributable to a sharp improvement in our fundamentals since Fed taper tantrum when FII outflows totaled ~USD 12.5 bn, primarily from debt markets.

August CPI eased to 3.66% YoY versus RBI projection of 4.0%

The domestic retail inflation reading slipped to 9-month low of 3.66% YoY in Aug-2015 as against revised prior of 3.69% YoY. The data came out in line with our and market expectation of 3.60% YoY. The easing trend in CPI was supported by a favourable base effect.

Food CPI remained benign at 2.9% YoY despite price pressures being witnessed in vegetables and pulses. Government is taking steps to correct elevated pulses inflation through imports. However, the elevated inflation in fruits & vegetables led by onions will possibly come under control only after fresh supply hits markets in the coming months.

Core CPI also eased to 4.1% on weak crude prices. The fall in core CPI is primarily attributable to drop in services inflation to 3.1% YoY from 3.4% YoY. Transport services inflation, which is affected by movement in petrol and diesel prices remained in negative territory amid benign international crude prices.

The domestic inflation dynamics are likely to provide comfort to the RBI. The August reading was lower than RBI's projection of 4% thereby building case for further policy easing. On balance, we expect 25 bps repo rate cut in the September policy meeting. Beyond that, further rate cuts will be contingent upon RBI's adoption of medium term CPI goalposts (Jan-2017: 5% & Jan-2018: 4%).

The risk to our view is that if the Fed hikes rates later this week, it could increase market volatility and possibly lead the RBI to defer policy easing.

Poor monsoon remains a cause for concern

While impact of drought on inflation will be watched, we believe that Government's contingency plan and healthy crop sowing trend are expected to help limit food price pressures. The good start to monsoon in June led to improved crop sowing especially in pulses, coarse cereals and oilseeds, which are short in supply and are imported. Meanwhile, the weakness in cereals sowing is likely to be partially offset by adequate food stocks.

Region	% departure from Long Period Average (LPA)	
	1 June - 1 July	1 June - 14 Sep
North-west	28.0	-20.0
Central	20.0	-21.0
South peninsula	15.0	-15.0
East & north east	-1.0	-7.0
All India	13.0	-16.0

Source: IMD, PIB, ICICI Bank Research

Kharif crop	Crop sowing (as of 11 th September 2015)		
	(lakh hectares)	(% YoY)	
	2014	2015	2015
Rice	367	368	1
Coarse cereals	171	181	6
Pulses	99	110	11
Oilseeds	176	181	3
Sugarcane	49	49	0
Cotton	125	115	-8
Jute	8	8	-4
All Crops	994	1012	2

Fiscal dynamics (April-July FY2016)

Fiscal component	FY2016 (BE)	FY2016 (BE) over FY2015	April-July FY2016	
	(INR bn)	(% YoY)	(INR bn)	(% YoY)
Receipts	12110	7.2	2158.7	20.6
Gross taxes	14495	15.8	3051.1	17.9
of which:				
States' share	5240	55.1	1497.0	35.1
Total taxes (Net to Centre)	9198	1.9	1538.5	4.8
Non taxes	2217	12.5	551.3	91.6
Non-debt capital receipts	695	60.1	68.9	103.7
of which:				
Disinvestment	695	131.7	33.8	-
Expenditure	17775	8.1	6009.8	19.3
of which:				
Revenue	15360	5.4	5150	16.5
Capital	2415	29.1	860	39.0

Source: CEIC, ICICI Bank Research

Strong tax collections led by indirect taxes while direct tax growth lags

Tax component	April-July FY2016	
	(INR bn)	(% YoY)
Gross Tax Revenue	3051.1	17.9
of which		
Direct Tax	1282.7	0.7
of which		
Corporate Tax	663.2	6.1
Income Tax	619.5	-4.6
Indirect Tax	1729.7	35.4
of which		
Excise duty	580.3	79.9
Custom duty	664.0	23.2
Service tax	485.4	16.6

Source: CEIC, ICICI Bank Research

Fiscal dynamics indicating positive trends though concerns remain

During April-July FY2016, the Government registered fiscal deficit of 69.3% of budgeted levels vis-à-vis 61.2% during same period in FY2015. The widening in deficit is attributable to sharp rise in spending amid strong indirect tax collections though we believe that higher focus on capex is a positive trend.

- **Indirect tax collections rising at a healthy pace:** Gross tax revenues have increased by 17.9% YoY during April-July FY2016. In addition, this increment is higher than a budgeted increase of 15.8% YoY for the entire year. The growth in revenues was primarily driven by indirect taxes especially excise.
- **Spike in expenditure growth with focus on capex:** Expenditure growth increased to 19.3% YoY exceeding a budgeted rise of 8.1% during FY2016. The good news is that the quality of spending has improved since capital expenditure has risen at a higher rate (39.0% YoY) relative to revenue spending (16.5% YoY). In particular, the focus is on plan capital expenditure, which is likely to stimulate growth trajectory.

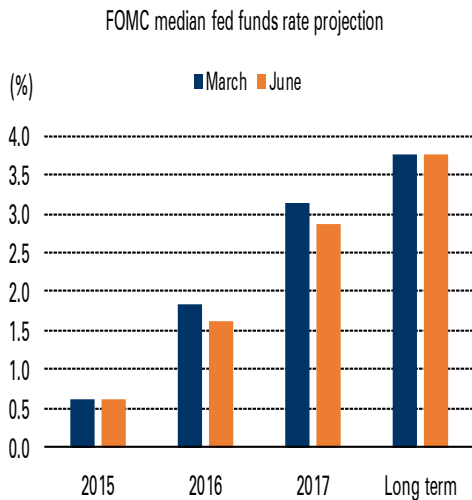
However, we believe that there are some causes for concern in the fiscal dynamics which need to be addressed.

- **Divestment revenues lag:** The divestment revenues remained weak at ~INR 33.8 bn during April-July as against budgeted target of INR 695 bn. As per media reports, Government entities were the major subscriber of the Indian Oil corporation stake sale (~INR 93.7 bn) in August given the weak equity market conditions. Hence, volatile global markets could limit the Government's ability to achieve the elevated stake sale targets.
- **Direct tax collections remain weak:** Direct tax collection (which accounts for 40% of total tax collection) grew by only 0.7% YoY during April-July FY2016, sharply lower than the budgeted 11.7% YoY. This is a cause for concern and could offset the impact of strong indirect tax revenues.
- **Uncertainty regarding spectrum auction revenues:** We believe that after participating in large spectrum auctions for 2 consecutive years, the telecom companies are focusing more on rollout of infrastructure in the current fiscal. We do not expect any big ticket spectrum auction in this fiscal.
- **New defence pension scheme and plans to hike Dearness Allowance (DA) likely to raise spending requirements:** Earlier this month, the Government took two steps which could step up revenue expenditure, i.e. 6% hike in dearness allowance (DA) of over 1 crore employees and pensioners along with a new pension scheme for the armed forces i.e. one rank one pension scheme (OROP). The announced cost for DA hike is ~INR 110.92 bn during July-Feb FY2016 while the Defence Minister has indicated additional spending for OROP to be ~INR 70-80 bn in the current fiscal.

While the Government has already announced some reallocation of budget to accommodate recapitalisation, however we are worried that further reduction in spending may be required, even after adjusting for ~INR 100-150 bn savings on fuel subsidy.

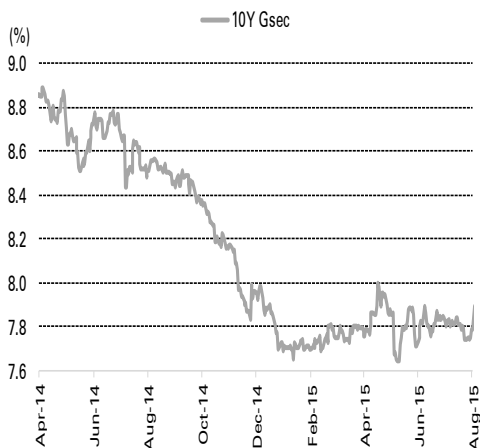
On balance, the Government is required to step up efforts in order to meet the strict fiscal consolidation target of 3.9% of GDP in the current fiscal. Moreover, in FY2017, the 7th Pay Commission will increase fiscal burden significantly, thereby raising need to step up revenues.

Focus to be on the Fed funds rate projection



Source: Federal Reserve, ICICI Bank Research

Ranged markets await Fed and RBI triggers



Source: Bloomberg, ICICI Bank Research

Fed likely to maintain status quo; "dot-plot" could be revised downward

The FOMC meeting due later this week will be a key market event, which would be closely watched.

- We expect the Fed to maintain zero interest rate policy (ZIRP) in this meeting. This is primarily attributable to weak inflation pressures in the economy, with CPI remaining well below the 2% comfort level for the Fed, on the back of subdued wage growth.
- Meanwhile, GDP growth has provided a sharp positive surprise in the last quarter and the annual projection is likely to be revised upwards by the FOMC.
- Interestingly, the minutes of the July FOMC minutes were dovish and stated that "Most participants agreed that the conditions for monetary tightening had not been met but noted that the conditions were approaching that point".
- On balance, although September cannot be completely ruled out, we believe that conditions currently tilt the scales towards an end-2015 hike.
- Markets have reduced bets of a policy move in September as well. The market-implied probability of a September lift-off has fallen to 28% currently from 48% recorded in mid-August.
- The official "dot-plot" indicating median Fed funds rate projection is likely to be revised downward.

(For details, please refer to our report, dated 15th September-2015, "US FOMC preview: Likely to maintain rate pause")

Maintain view of fall in 10Y yield to 7.50-7.70% range by December

After hitting a peak of 7.89% in end August-2015 amid excessive volatility, the benchmark bond yield has traded in a tight range of 7.75-7.82% in recent weeks. Given our monetary policy view, we continue to project a decline in 10-year bond yield to 7.50-7.70% by end-December 2015.

The upside risk to our view is from rise in global volatility (if Fed turns hawkish in September meeting) which could fuel depreciation pressures on Rupee and risk a delay in RBI rate easing. The downside risk to our yield view is from a FII debt limit hike on conversion into Rupee terms.

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