Treasury Report
The Daily Update

HDFC Bank Ltd.
HDFC Bank House,
Senapati Bapat Marg,
Lower Parel,
Mumbai - 400 013.
CIN:
L65920MH1994PLC080618

Inflation dips, IIP Up

Dec 13, 2018

- India's retail inflation plunged to a 17-month low level of 2.33% in November. The reading was lower than our and market expectations (HDFC Bank: 2.55%, Reuters Consensus: 2.8%), with the decline primarily coming on account of food items like vegetables, eggs and pulses.

- Meanwhile, industrial production growth was more than expected and touched a 11-month high of 8.1% YoY in October. Mining output went up by 7%, manufacturing output rose 7.9%, and the electricity generation growth stood at 10.8%. In terms of specific items, furniture, wood and wood products, plaiting materials, and computer, electronic and optical products showed maximum traction.

Inflation Trends (% YoY)	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18
Headline CPI	4.6	4.9	4.9	4.2	3.7	3.7	3.4	2.3
Food CPI	2.8	3.1	2.9	1.3	0.3	0.5	-0.8	-2.6
- Vegetable	7.5	8.0	7.8	-2.3	-7.1	-4.2	-8.1	-15.6
Clothing & Footwear	5.1	5.5	5.6	5.3	4.9	4.6	3.6	3.5
Housing	8.5	8.4	8.4	8.3	7.6	7.1	6.6	6.0
Fuel & Light	5.2	5.8	7.2	8.0	8.6	8.6	8.5	7.4
Fuel & Light inclu. Petrol & Diesel	5.8	6.9	8.6	9.7	9.6	10.0	10.4	7.8
Broad Core CPI	5.8	6.1	6.1	5.9	5.7	5.5	5.9	5.4
Core CPI excluding petrol & Diesel	5.7	5.9	5.9	5.5	5.4	5.2	5.5	5.3

Below 0%	0-4%	4-6%	6-8%	8-10%	>10%

Source: CEIC and HDFC Bank. NB: Food CPI excludes Non- alcoholic beverages, prepared meals. Core CPI excludes fuel & light, food, petrol & Diesel

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IIP Trends (% YoY)	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18
Overall	**3.8**	**7.0**	**6.5**	**4.7**	**4.5**	**8.1**
Mining	5.8	6.5	3.4	-0.5	0.1	7.0
Manufacturing	3.6	6.9	7.0	5.1	4.6	7.9
Electricity	4.2	8.5	6.6	7.6	8.2	10.8
Primary goods	5.7	9.2	6.8	2.5	2.6	6.0
Capital goods	6.4	9.7	2.3	9.3	6.5	16.8
Intermediate goods	0.1	1.5	1.3	2.8	1.5	1.8
Infrastructure and Construction goods	7.6	9.4	9.2	8.0	9.3	8.7
Consumer Durables	6.7	13.6	14.1	5.3	5.2	17.6
Consumer Non Durables	-1.6	0.2	5.3	6.5	6.1	7.9

Source: CEIC and HDFC Bank

Some key questions…

- Is the inflation trajectory likely to remain subdued? The next reading for the month of December is likely to be around 2.3%. For 4Q-FY19, we expect inflation to average at around 3% and for H1-FY20, we expect an average inflation of 4.0%. In a nutshell, the headline inflation is likely to remain sub-4% for the next eight months and thereafter too it is unlikely to be significantly different from the RBI's target.

- What are the major assumptions and the upside risks? We have assumed that oil prices are likely to be in the range of USD 60-70/barrel, the MSP hike that was announced this year (24% on average for the Kharif season) is unlikely to have any material impact on food prices, and that the rupee is unlikely to face any major depreciation pressures from the current levels of 72 against the dollar. Against such a backdrop, the biggest upside risk to our forecasts (and to the forecasts of the RBI as well) could be a reversal in food prices. This could come on the back of sub-par monsoon next year or a sudden ramp in procurement activity which in effect could lead to higher food prices on the ground (with support of the MSP policy).

- Can we consider the current growth trajectory as robust? While the IIP number was higher than market expectations, it was largely driven by a favourable base effect. During the same time last year, on account of Diwali holidays, there was sluggishness in the manufacturing activity. Last year, after a pre-festive bounce of 2.6% MoM in August and September, the manufacturing activity declined by 1.5% MoM in October. This year, the pre-festive bounce continued until October as Diwali was in the month of November. Meanwhile, not all high frequency indicators are suggestive of broad-based growth in the economy. The data is somewhat mixed. For example, while the overall credit growth is in the robust territory, there are pockets like consumer durables and auto loans, where there is some degree

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of moderation. Globally too, the growth momentum seems to be slowing for the US and China, which could have repercussions for world trade in general. In a nutshell, while the growth momentum is not worrisome, it is also not broad-based. Overall, we expect marginal slowdown in 2H-FY19, wherein GDP growth could edge lower to 6.8% from 7.7% in H1-FY19 (more so because of unfavorable base but also because of some moderation in the growth momentum).

- Given that inflation remains low, could the RBI cut policy rates to support the economy? We believe that the first step in this direction could come in the month of February, when the RBI is likely to change its stance from "calibrated tightening" to "neutral". However, it might be too early to expect a rate cut in February. For one, the food prices story is still not certain and it is best to adopt a wait-and-watch approach for some time to gauge any risk of a reversal in food inflation. For more details, read "India's benign inflation: The real story, 23rd October 2018". Two, core inflation continues to run at somewhat higher pace of 5.4% (despite moderation in November). This could be suggestive of gradual closing in the output gap and thus a cut in policy rates could come at a wrong time and lead to overheating risks in the economy. Again, it is important to be certain that core inflation is on a downward trend.

- Bottom-line: We are not ruling out the possibility of a rate cut. The likelihood of a rate cut seems to be rising with each inflation reading in our view. However, at this stage, it is important to watch the growth-inflation mix carefully. It is essential to gauge if the subdued trend in food inflation is sustainable or short-lived. In our view, it would be prudent to wait for further evidence to rule out any possibility of upside risks in inflation.

In the domestic currency and bond markets, uncertainty related to election results and Central Bank eased and led to some value-buying yesterday. Globally too, trade war tensions eased to some degree as US President Donald Trump in an interview with Reuters said that talks were taking place with Beijing and that he would not raise tariffs on Chinese imports until he was sure about a deal. This came as a relief for global market - the favourable impact of this could be felt today with more buying of EM assets.

The Brexit and uncertainty around the leadership of UK Prime Minister Theresa May was the main factor affecting sentiment in the global markets yesterday. On account of the uncertainty, the GBP dropped to 1.25 levels yesterday. However, there was some recovery thereafter, as Theresa May survived the confidence vote by her own MPs (winning the backing of 200 Conservatives against 117 votes to oust her).

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- After securing 63% of the total vote, she is now immune from a leadership challenge for a year. That said, uncertainty around the Brexit deal continues to be high and is unlikely to be passed by the parliament in the current form. Mrs. May is scheduled to meet EU leaders later this weak to discuss the deal further. The EU continues to maintain its stance that it is willing to provide further assurances to the UK (especially on the Irish

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backstop issue) but is unlikely to make changes to the Brexit deal. We expect the GBP/USD pair to remain close to 1.25-1.26 levels in the coming days as uncertainty continues to loom in the region.

Today, ECB's monetary policy decision is likely to drive the momentum in the global markets. The EUR could strengthen marginally if President Mario Draghi sticks to indications that monetary policy could be tightened next year, with at least one rate hike in 2019. Markets would also be watching out for clarity on the ECB's bond buying program. While the ECB is set to cap its asset-purchase program at EUR 2.6 trn euros ($2.97 trillion) by the end of this month, it is yet to announce how it will reinvest proceeds from maturing bonds.

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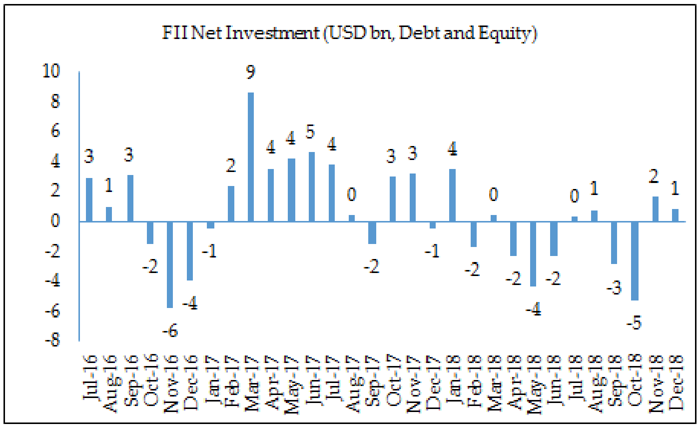
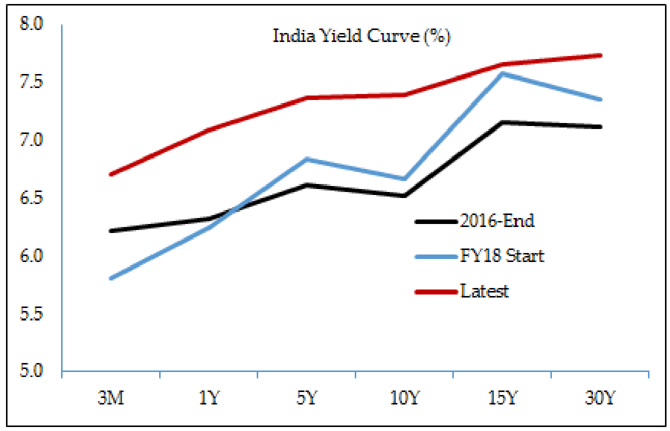
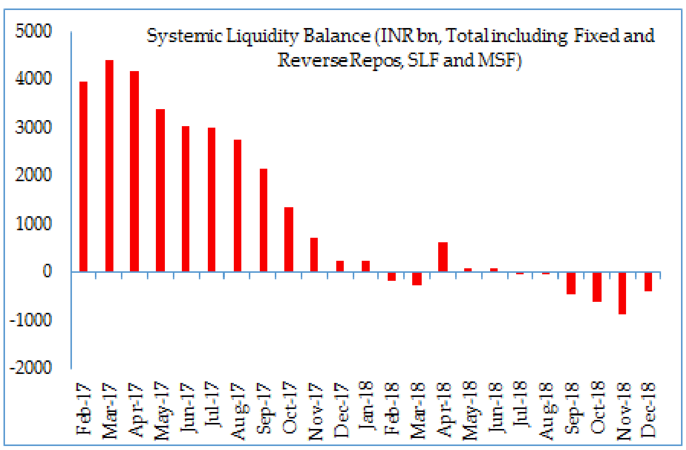
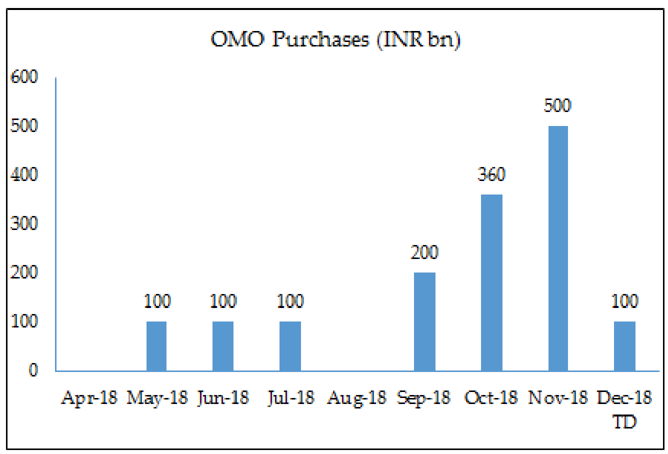
FX and Bonds Update









Bond Yields (Benchmark 10-Year)	Latest Level (%)	WTD (bps)	CYTD (bps)
US	**2.91**	3	**50**
Germany	**0.27**	4	**-16**
Japan	**0.05**	0	**0**
UK	**1.28**	3	**9**
Canada	**2.13**	4	**9**
Australia	**2.44**	-2	**-23**
China	**3.30**	-3	**-62**
India	**7.41**	-1	**9**

NB: For Bond yields, 2027 (6.79%) 10 year bond is used for latest levels.

FX Market (All vs. USD)	Latest	WTD (%)	CYTD (%)
Dollar Index	**97.09**	**0.6**	**5.4**
EUR	1.14	-0.1	-5.2
JPY	113	-0.6	-0.7
GBP	1.26	-0.9	-6.6
CAD	1.34	0.3	6.2
INR	**71.64**	**-1.1**	**-12.2**
CNY	6.87	0.0	-5.6

NB: positive change reflects appreciation against the dollar

FII Flows (USD mn)	Equity	Debt	Total
12-Dec-18	-403	-16	-419
FY19-till date	-6565	-7193	-13758
FY18	4019	18505	22524

Net Government market borrowings (INR trn)	Centre	State
Yearly		
FY17	4.08	3.43
FY18	4.48	3.41
FY19 TD	2.67	2.07