HDFC MF Yearbook 2019

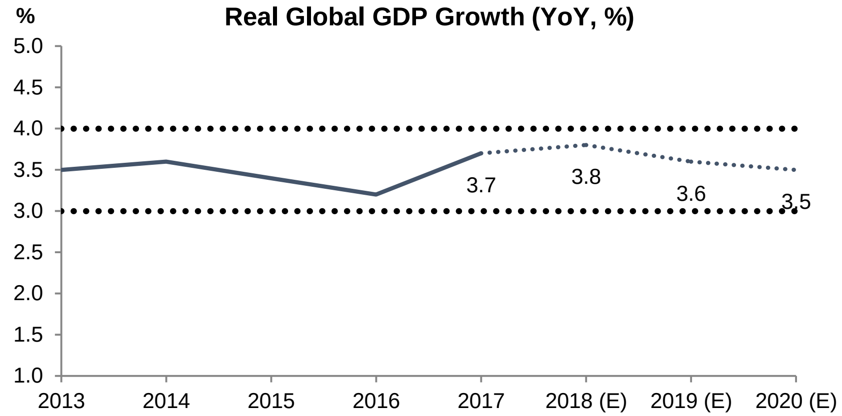
Contents

Global Economy and Markets

“There are two kinds of forecasters: those who don’t know, and those who don’t know they don’t know” --- Economist John Kenneth Galbraith

Range bound global growth continues

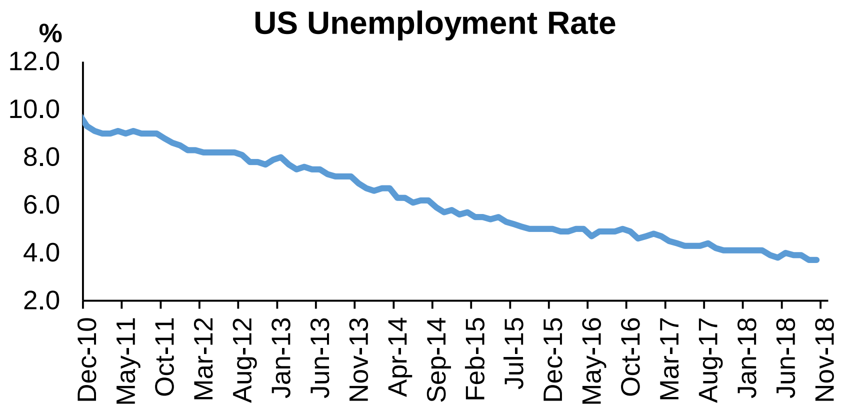
- **Global growth**
  - In 2018 was supported by robust US (fastest growing G10 economy) and stable Emerging Markets (EMs) growth
  - Normalisation of accommodative monetary policies poses risk going forward
- **United States (US)**
  - Impact of rate hikes and tapering of bonds purchase program was offset by fiscal stimulus/tax cuts
  - Effect of rising rates and unwinding of monetary stimulus need to be monitored
- **Euro Area**
  - Growth slowed down in major economies in 2018
  - As QE has ended in 2018, its impact needs to be monitored
- **China**
  - Economy is maturing after rapid growth over last 20 years, hence growth rates are moderating
  - Deleveraging efforts moderated economic growth in 2018
  - Trade war, monetary easing and tax breaks are key events to watch out for in 2019

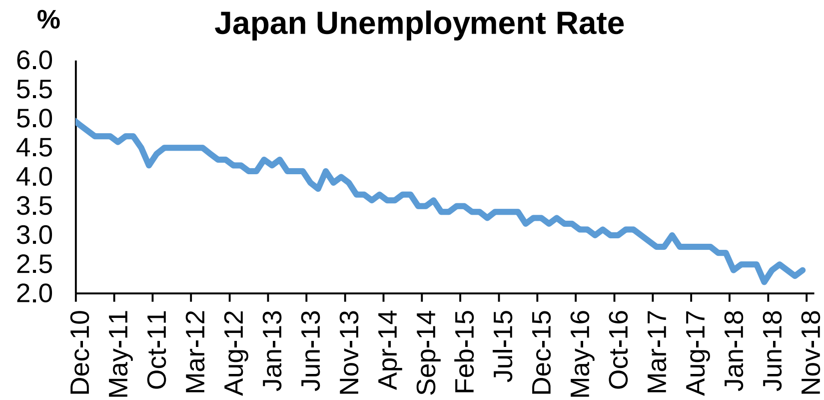


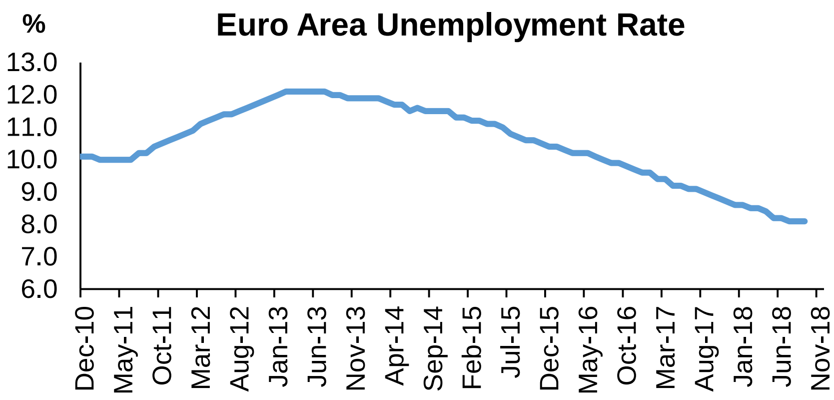
Growth in GDP (%)	2012-16	2017	2018E	2019E	2020E
G10	**1.7**	**2.2**	**2.2**	**1.9**	**1.6**
United States	2.2	2.2	2.9	2.3	1.9
Euro Area	0.9	2.5	1.9	1.6	1.5
United Kingdom	2.1	1.7	1.2	1.3	1.6
Japan	1.2	1.7	0.8	1.3	0.6
Emerging Markets	**4.8**	**4.8**	**4.8**	**4.7**	**4.8**
Brazil	(0.3)	1.0	1.3	2.3	2.5
Russia	0.7	1.5	1.6	1.5	1.6
India	6.7	6.2	7.7	7.6	7.5
China	7.3	6.9	6.6	6.3	6.1
South Africa	1.7	1.3	0.7	2.0	1.5

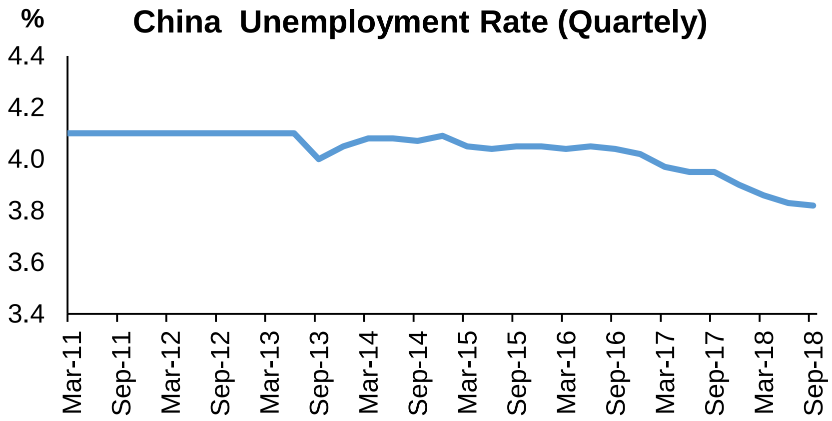
Source: Morgan Stanley estimates

Falling unemployment rates









Source: Bloomberg; Data updated till Nov’18 for US, Euro Area and Japan. Data for China available till Sep’18

Global Liquidity – Background of Quantitative Easing

US Federal Reserve (US Fed)

- Post Global Financial Crisis (GFC) in 2008, US Fed embarked on Quantitative Easing (QE) to support economic growth
- Over 2010-15, US Fed Balance sheet grew by ~USD 3.0 trillion
- With US economy strengthening, US Fed began unwinding its Balance sheet in 2017 and is likely to continue in 2019

European Central Bank (ECB)

- ECB embarked on asset purchase program in March 2015
- ECB purchased bonds worth ~EUR 2.6 trillion
- Though bond purchases have ended in 2018, rollover of bonds on maturity is likely

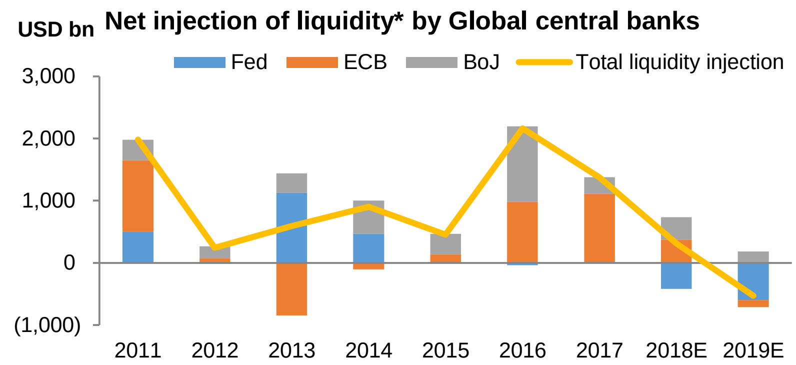
Bank of Japan (BoJ)

- Commenced asset purchase program in 2012
- BoJ is estimated to have bought bonds worth USD 3 trillion
- Likely to continue this program in 2019, though pace might reduce

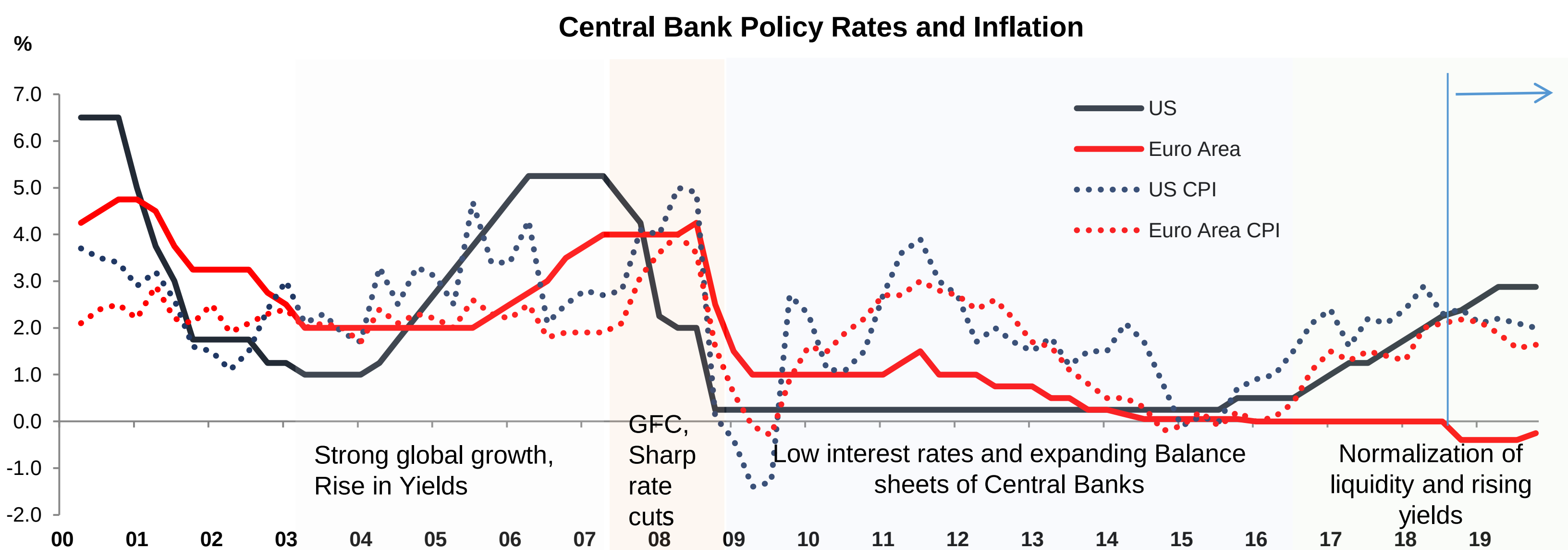
Since 2010, combined balance sheet of these 3 Central banks increased by ~USD 8 trillion, which supported global growth. *This phase is now ending and may impact growth*

Global liquidity – Likely to tighten in 2019; Policy rates might go up

- US Fed to continue unwinding and shrinking its balance sheet
- EU stopped QE in Dec’18, though likely to roll over bonds on maturity
- Japan expected to continue QE, albeit at slower pace
- In 2019, combined balance sheets of these central banks likely to shrink
- This may impact interest rates, capital flows and global growth

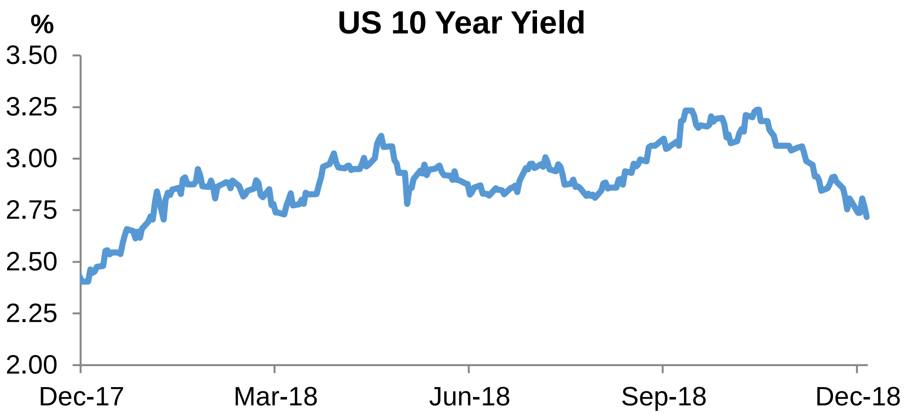


*change in assets
Source: Kotak Economics Research estimates

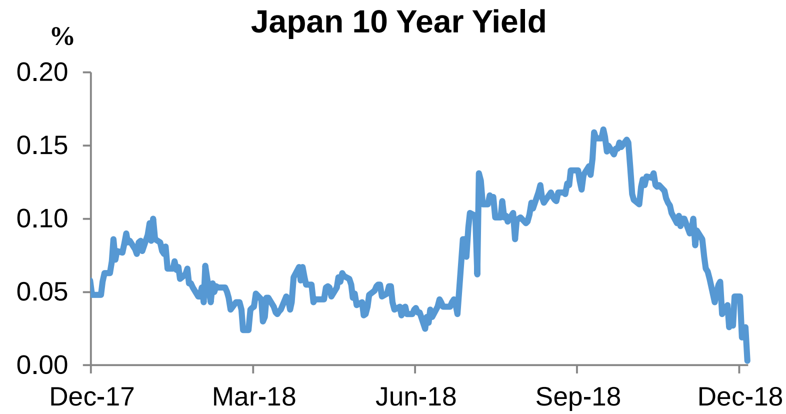


Source: Bloomberg, Data beyond Sep 18 is Morgan Stanley estimate

Yields across major economies declined in 2018, except US

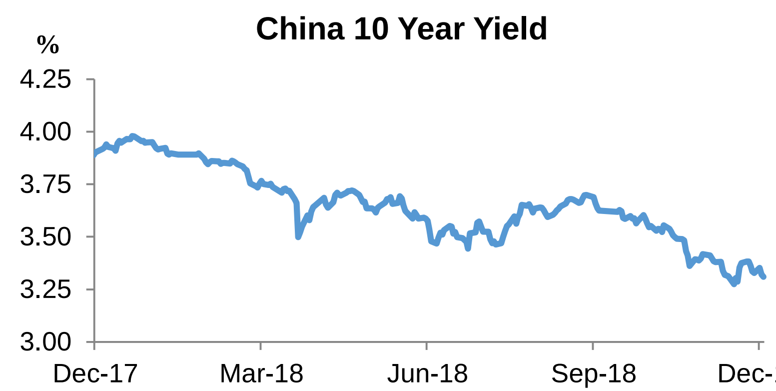


US 10Y yields increased on the back of increase in fed rate, steady growth, historically low unemployment and unwinding of asset purchase program



Japan's 10Y Yields remained range bound with benign inflation outlook. BoJ adjusted QE to allow yields movement within wider range

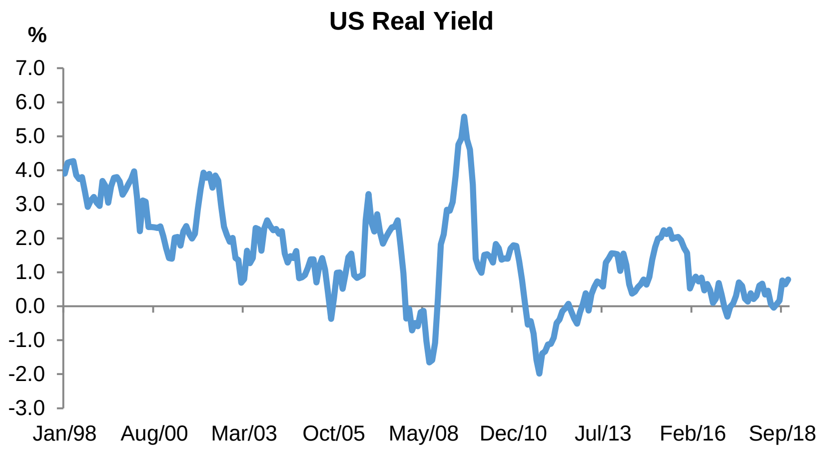
Growth and Inflation in Europe remained muted. Uncertainty over Brexit and concerns in Italy led to fall in yields

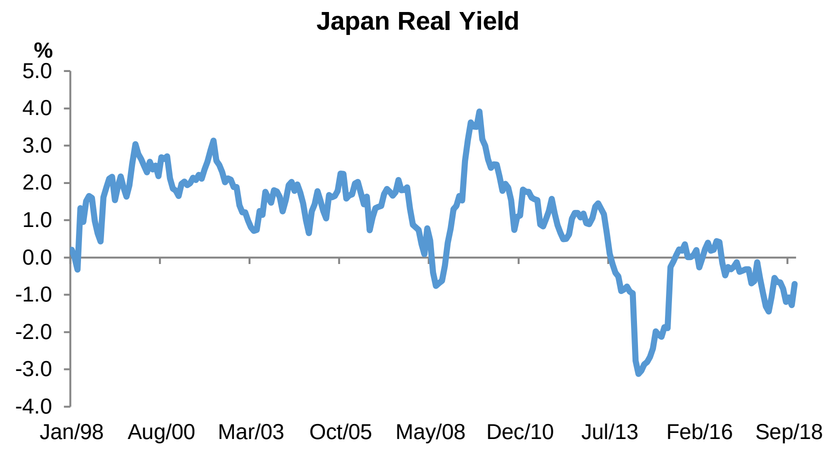


Escalation of trade wars & slow down in domestic growth resulted in PBoC easing monetary policy with Reserve Ratio Requirement cut

Source: Bloomberg. Data updated till 31st December 2018

Real Yields for major economies near two decade lows





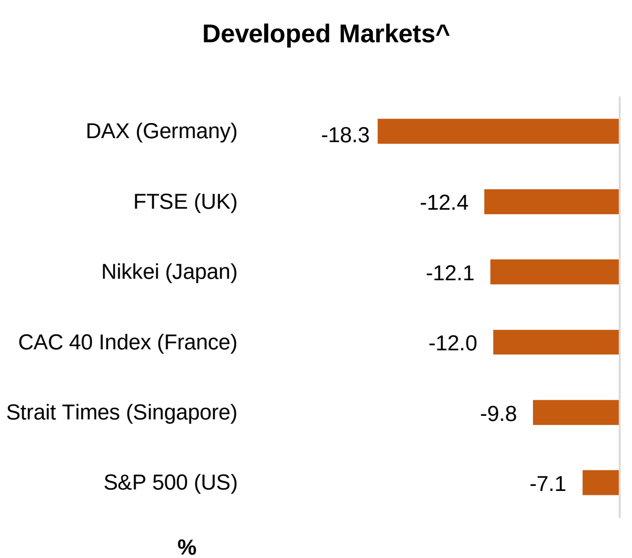
Low real yields create uncertainty for future interest rates

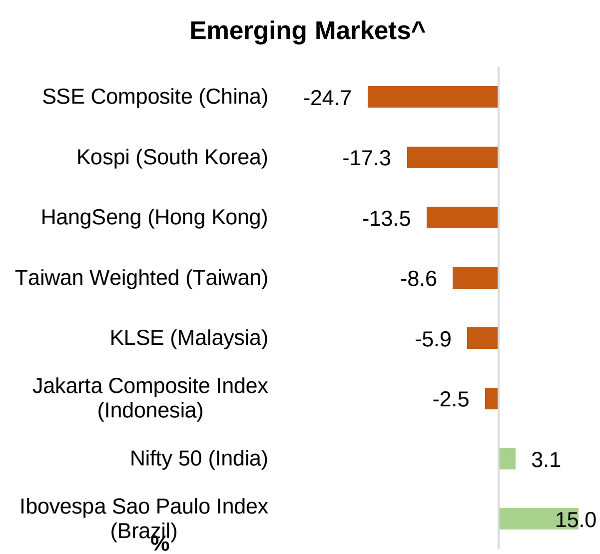
Real Yields = Month-end 10Y GSec Yield and CPI; Source: Bloomberg. Data updated till 30th Nov'18

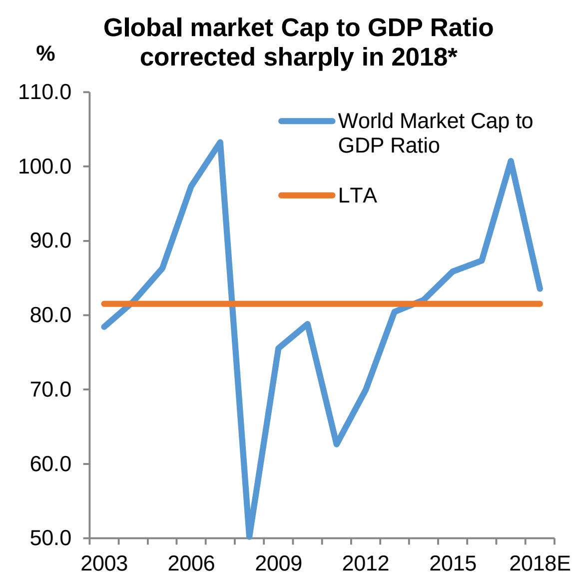
Global Equity Markets deliver negative returns in 2018

Major equity markets delivered negative returns

- Impact of high base given the strong returns of past 2 years
- Escalation of Trade war between China and US
- Emerging markets faced capital outflows on strong USD and unwinding of QE







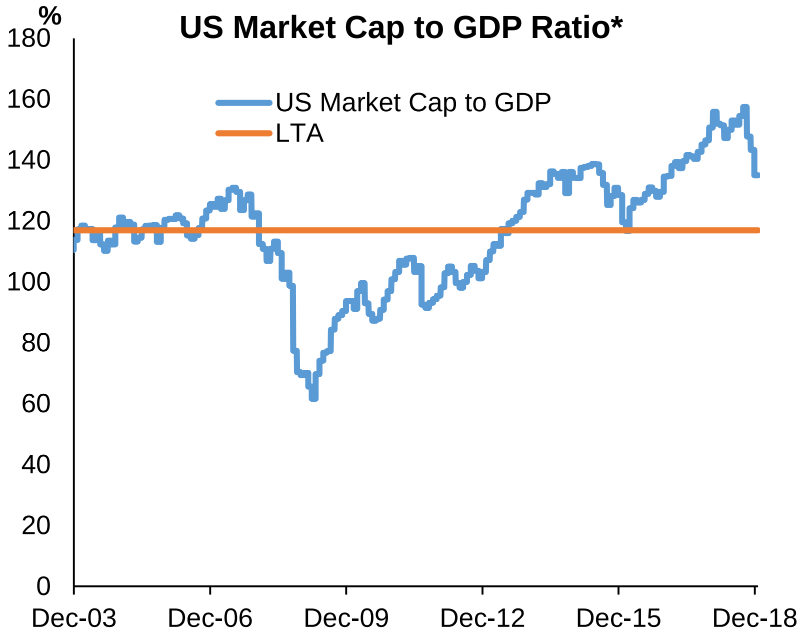
India's equity market (Nifty 50) significantly outperformed despite delivering low returns

* Global Market Cap to GDP ratio is calculated using world market cap from bloomberg and GDP from world bank. For 2018, current market cap is divided by world bank's estimated global GDP.

^Returns for Calendar year 2018; Returns as on 31st Dec 2018. All returns are calculated in local currency. Source: Bloomberg, World Bank, MFI;; LTA – Long term average

US Marketcap/GDP & Profits/GDP are above long term average

- US market cap to GDP remains higher than the long term average; though corporate profits to GDP is also high

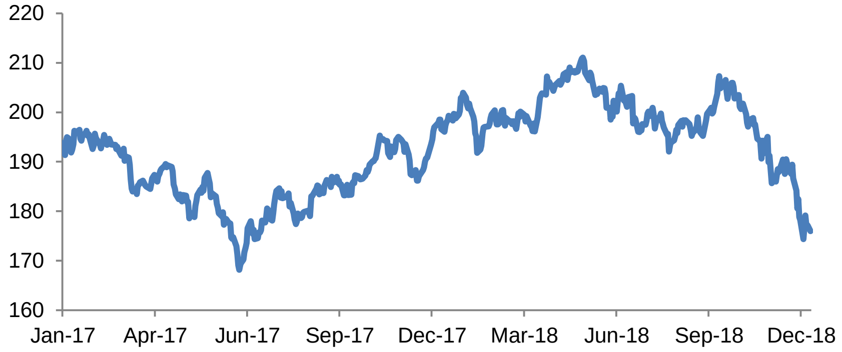


Recent correction in US equity markets should be viewed in the context of US Market Cap to GDP ratio being above long term average and bottoming out of yields in US

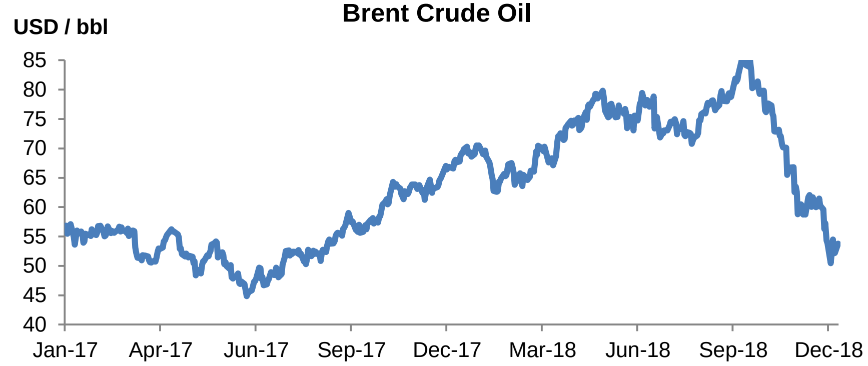
Source: Bloomberg, Morgan Stanley. * Data updated till 31st December 2018

Global commodity prices softened in 2018

CRY Index*

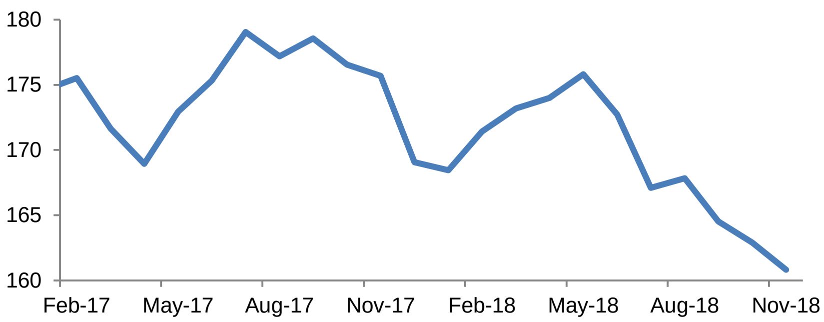


Brent Crude Oil



*** CRY index i.e. Thomson Reuters/CoreCommodity CRB Commodity Index acts measures the aggregated price direction of various commodity sectors.**

FAO Index#



 # UN Food and Agriculture World Food price index – Tracks the change in prices consumers pay for food at the retail level

JOC-ECRI Industrial Price Index^

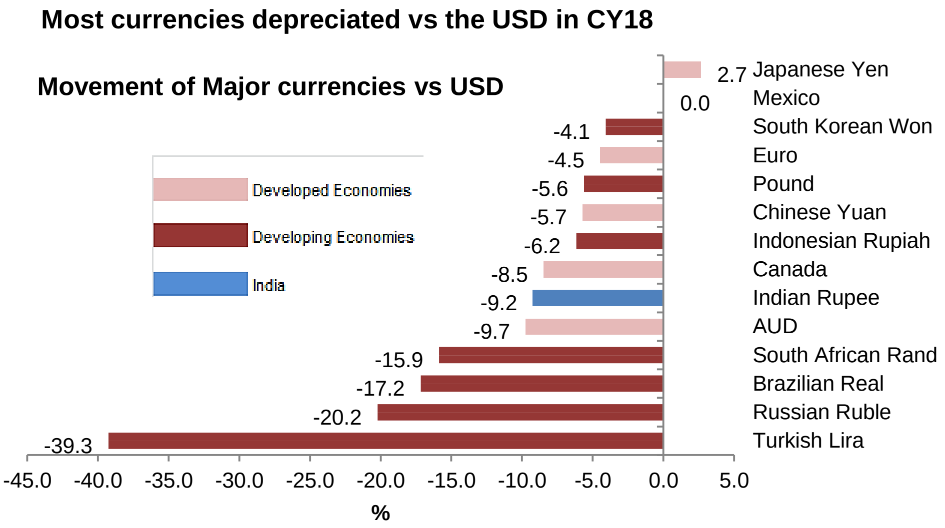
^ index indicating weighted price movement of industrial materials like cotton, burlap, steel, aluminum, zinc etc.

Softening in global commodities is positive for net commodity importers like India

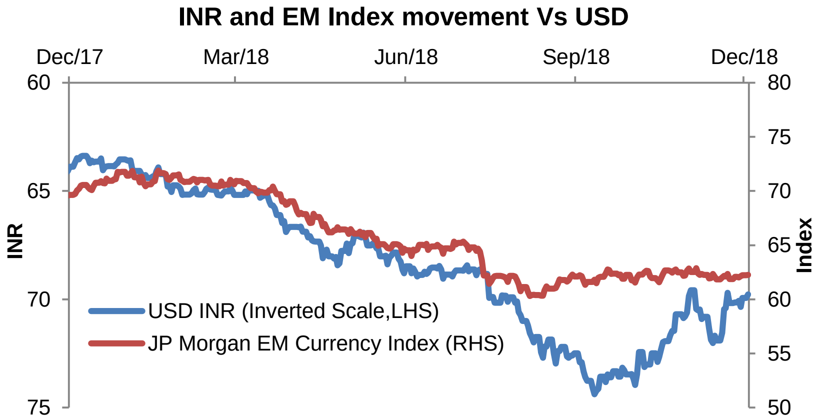
Source: Bloomberg. CRY Index, Brent Crude oil prices and JOC-ECRI Industrial Price index updated till 31st Dec 2018. FAO Index is updated till 30th Nov 2018.

USD strengthened against most currencies in 2018

- USD appreciation is due to:
  - Rising interest rates in the US
  - Strong US economic growth
  - Repatriation of USD 570 bn in 9MCY18 & more expected in 2019 under Tax Cuts and Jobs Act of 2017



- INR fall has been largely in line with other EM currencies



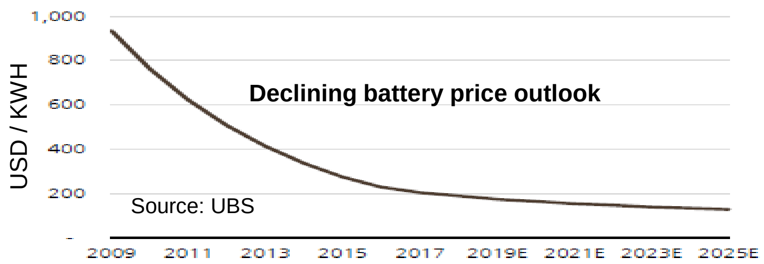
Source: Bloomberg, Data updated till 31st Dec, 2018

Key Future Trends

1. Electric Vehicles
2. Solar energy
3. Changing supply dynamics of Oil

Electric Vehicles (EVs), fully charged

- EV growth drivers:
  - Policy push led by environmental concerns
  - Declining battery prices
- ICE costs are expected to move up due to tightening environment norms
- Global EV sales are projected to grow at a CAGR of 40% between 2016-2025 with sales crossing 17.5 million vehicles in 2025 (Source:UBS)
- China is taking the lead, penetration (in PVs) to reach 9% in next 3 years (Source:UBS)



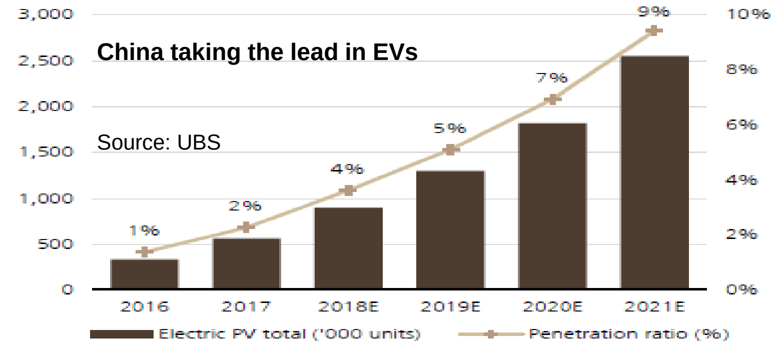
% of new car sales	2015	2020E	2025E
China	1.0%	6.7%	27.4%
US	0.7%	2.5%	5.3%
Europe	1.0%	4.1%	28.5%
World	0.6%	3.4%	16.6%

Source: UBS

Electrification is one of the key pillars of the Group's Strategy, By 2025, BMW Group will have 12 all-electric models *BMW CEO Harald Krüger^*

Company will help electric cars go mainstream using its new MEB platform, which is developed for the mass market. *Volkswagen's CEO Herbert Dies**

Toyota envisions to sell 5.5 million traditional hybrids, EVs and hydrogen fuel vehicles by 2030. *Toyota EVP Shigeki Terashi +*



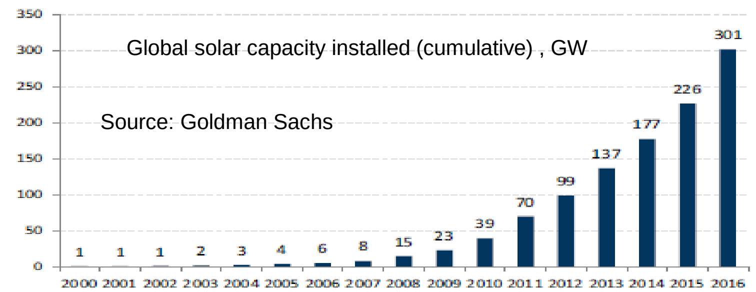
Success of EVs is positive for India. Net oil Imports in India are 4% of GDP and CAD is 2%. As EV penetration increases in India, oil imports should moderate in long term

Global growth in EVs should also keep pressure on oil prices, benefitting India

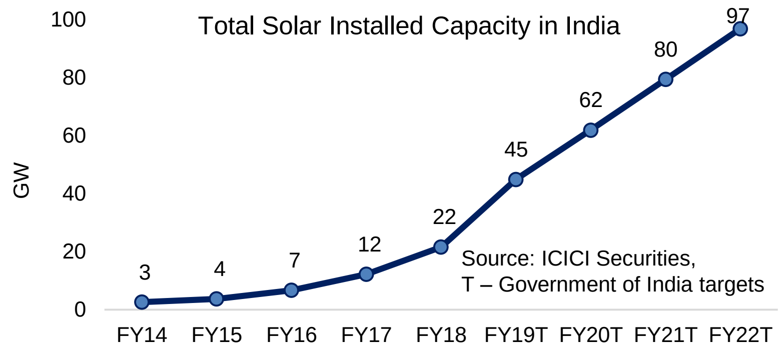
PV – Passenger vehicle, ICE - Internal combustion engine, ^dated Nov 07, 2018, *dated Oct 10, 2018, + dated Dec 25, 2017

Solar energy is emerging as a key power source

- Global solar capacity has been growing 50% CAGR since 2000



- Solar energy installed capacity in India has grown at CAGR of ~70% between FY14 and FY18. Target to reach ~97 GW by 2022
- Share of Solar energy in India
  - Rose from 8% to 33% in renewal energy capacities
  - Stands at ~7% of total power capacity

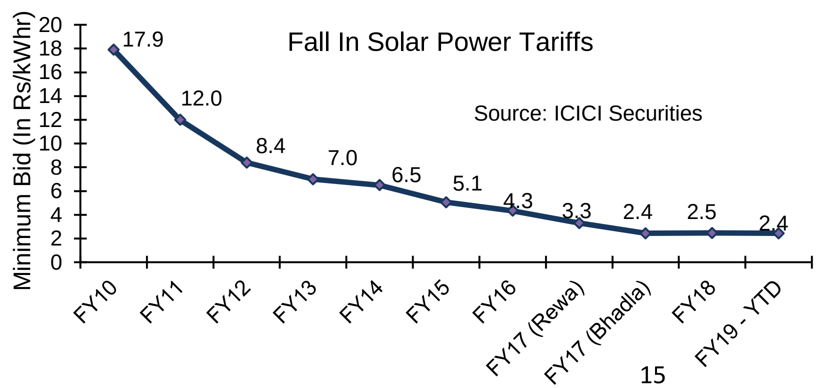


- Key Drivers for the rise in Solar energy
  - Fall in the solar panels costs

Total Capital Costs per MW	Unit	FY14	FY15	FY16	FY17	Current
	Rs lakh	806	691	606	501	391

Source: ICICI Securities

  - Policy push from Government and tax incentives/subsidy
  - Easy Implementation and higher certainty of power / costs



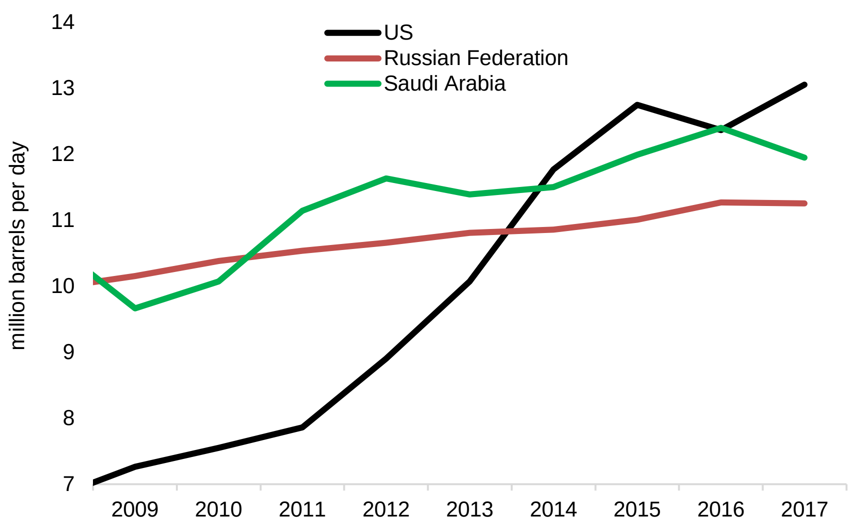
India has an estimated potential of about 750 GW of solar power (Source: MNRE). To put things in perspective India's total capacity from all sources is 350 GW

1 GW (Gigawatt) = 1000 MW (Megawatt)

Oil – Changing Demand / Supply Dynamics

US becomes largest oil producer

- US, on the back of increase in shale oil production, has become largest oil producer in the world
- US share in world supply has increased from 9% in 2009 to 14% in 2017



Oil demand to peak by 2030 as per BP^

- Demand has peaked in developed markets like the US, EU and Japan
- EV push, slowing demand growth in India / China should lead to global oil demand peaking by 2030

Million Barrels Per Day	United States	EU	China	India	World
1990	17	14	2	1	**66**
1995	18	14	3	2	**70**
2000	20	15	5	2	**77**
2005	21	15	7	3	**84**
2010	18	14	9	3	**87**
2016	19	13	12	4	**94**
2020	19	12	14	5	**99**
2025	18	11	16	6	**103**
2030	18	10	16	8	**106**
2035	16	9	17	9	**106**
2040	15	8	16	10	**105**
1990-2016 (CAGR)	0.3%	-0.4%	6.7%	5.2%	**1.4%**
2016-2040 (CAGR)	**-0.8%**	**-1.9%**	**1.0%**	**3.5%**	**0.5%**

Source: ^British Petroleum (BP), above chart Includes crude oil, shale oil, oil sands and NGLs (natural gas liquids)

Rising shale oil production, peaking global demand driven by EVs indicates moderate long term trends for oil prices. **Positive for India**

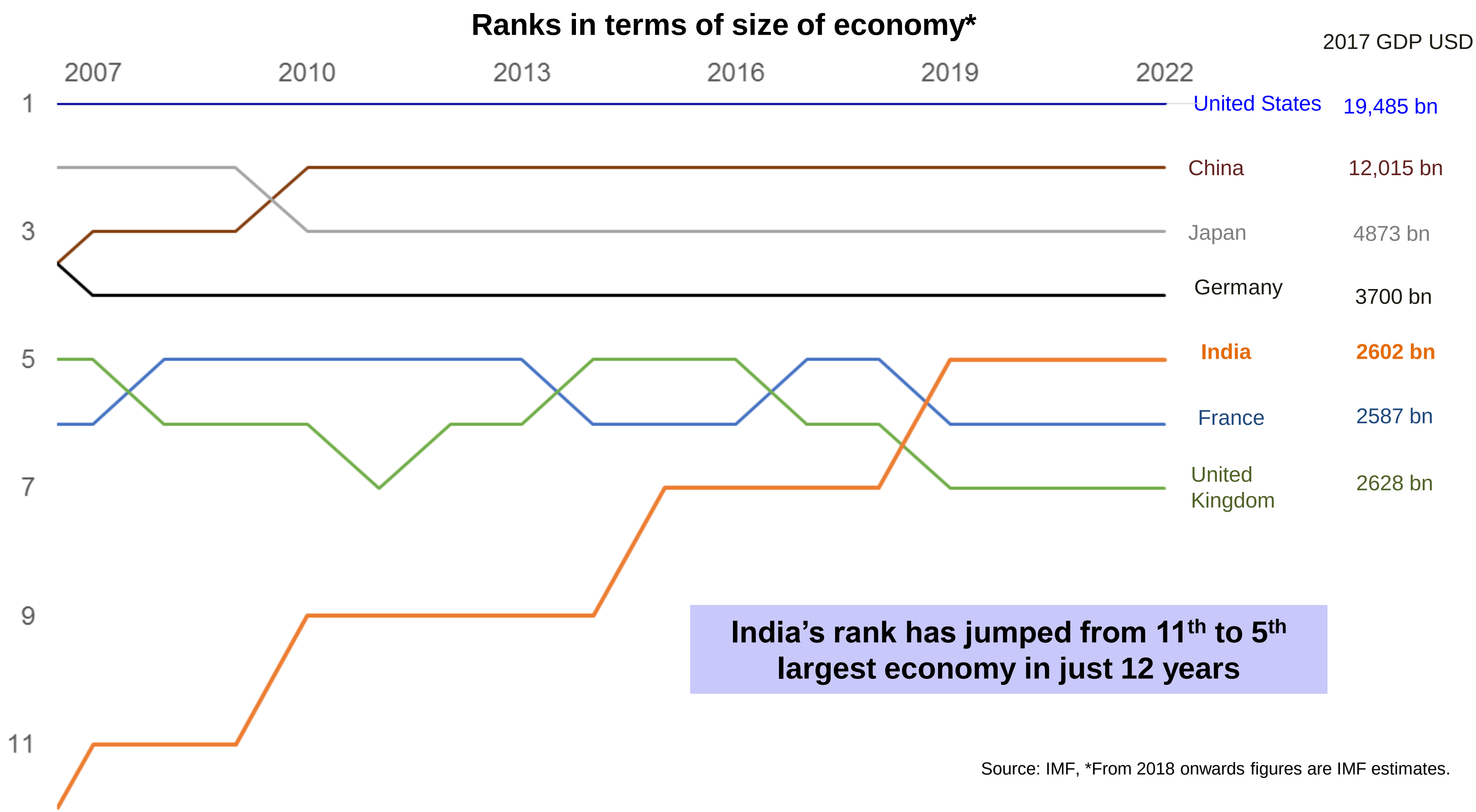
Indian Macro Economy Outlook

– India remains a long term secular growth story

India set to become world's third largest economy in 2028 – Bank of America Merrill Lynch*

*Report "India 2028: The last BRIC in the wall" dtd 10th Nov 2017

Indian economy –Breaking into top 5 economies



India's rank has jumped from 11th to 5th largest economy in just 12 years

Source: IMF, *From 2018 onwards figures are IMF estimates.

India's Ease of Doing Business ranking - Targets to be in top 50

Parameters	2016 ranking	2017 ranking	2018 ranking
Overall	**130**	**100**	**77**
Starting a business	155	156	137
Construction permits	185	181	52
Getting electricity	26	29	24
Registering property	138	154	166
Getting credit	144	29	22
Protecting minority investors	13	4	7
Paying taxes	172	119	121
Trading across borders	143	146	80
Enforcing contracts	172	164	163
Resolving insolvency	136	103	108

Key reforms that have made this possible

- Replacement of majority of state and central sales taxes with **one nationwide Goods & Services Tax (GST)**
- Faster and less expensive to obtain a **construction permit.**
- Strengthening legal rights and access to credit by amending **insolvency law**
- **Reduction in the time and cost to export and import**
  - Upgradation of port infrastructure
  - Electronic submission of documents
- Reduction in procedures / documentations and time for starting new business

World Bank has recognized India as one of the top improvers for the year 2018

Source: World Bank, Economic times article dtd. 2nd Nov 2018; DIPP Department of Industrial Policy and Promotion

Steady economic growth, stable macro economic parameters

Improving macros	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
Real GDP at market price (% YoY)	5.5	6.4	7.5	8	7.1	6.7	7.1	7.2
Centre's fiscal deficit (% GDP)	4.8	4.4	4.1	3.9	3.7	3.5	3.5	3.3
Current Account Deficit (CAD) (% GDP)	4.7	1.7	1.3	1.1	0.7	1.9	2.7	2.6*
Balance of Payment	0.2	0.8	3.0	0.9	0.9	1.7	(0.8)	(0.2)
Net FDI (% of GDP)	1.1	1.2	1.5	1.7	1.6	1.2	1.2	1.1
Consumer Price Inflation (CPI) (Average)	9.9	9.4	6.0	4.9	4.5	3.6	3.6	4.1
Foreign Exchange Reserves (USD bn)	292.6	303.7	341.4	359.8	370.0	424.4	393.3^	na

Source: CEIC, Kotak Institutional Equities; Economic Survey, E-Estimates, ^ as of 21st Dec'18. na – not available

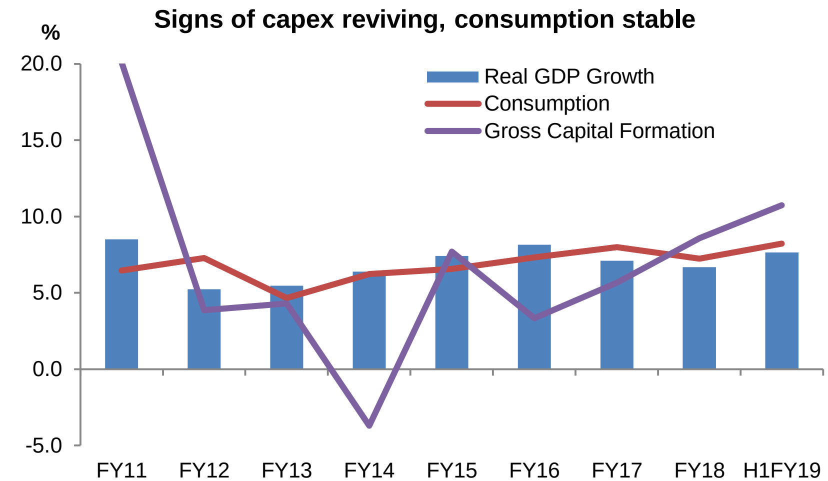
*** Calculated by assuming crude prices at USD 72.5 per barrel. With oil at USD 60 / barrel, CAD is estimated to be ~2.0% of GDP**

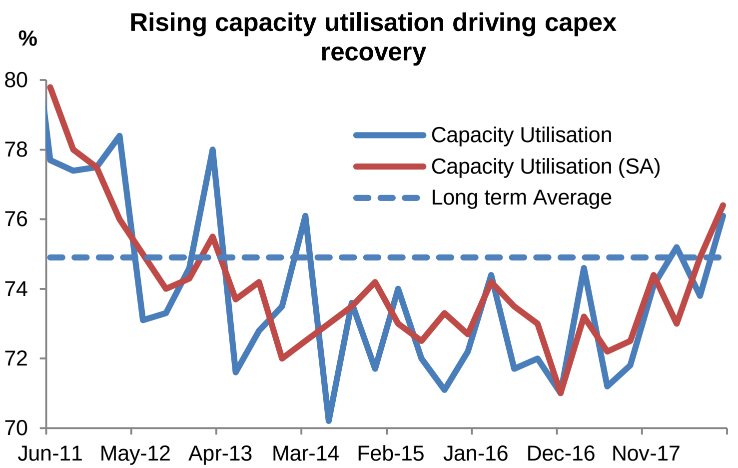
Key Reforms / Initiatives taken over past 4 years have created a favourable economic environment

- Introduction of Goods & Services Tax (GST)
- Introduction of Indian Bankruptcy Code (IBC)
- RERA and Housing for all
- Liberalisation of FDI in various sectors including railways, defense, coal mining, construction, aviation, pharma etc.
- Direct Benefit Transfer (DBT), UJJAWALA – LPG for poor households
- Power - Focus on Transmission and Distribution, Target 24*7 electricity, Saubhagya scheme
- Make in India - Focus on domestic manufacturing and design
- Transparent auctioning of natural resources

Revival in capex to support growth

- Consumption expenditure grew faster than capex in FY16 & FY17
- Capex grew faster than consumption in FY18
  - It should further accelerate in FY19
  - This should be positive for economic growth
- Infrastructure capex has improved over last few years led by roads etc.
- Signs of private capex recovery with capacity utilisation increasing
- Cement and Steel majors have announced significant capex

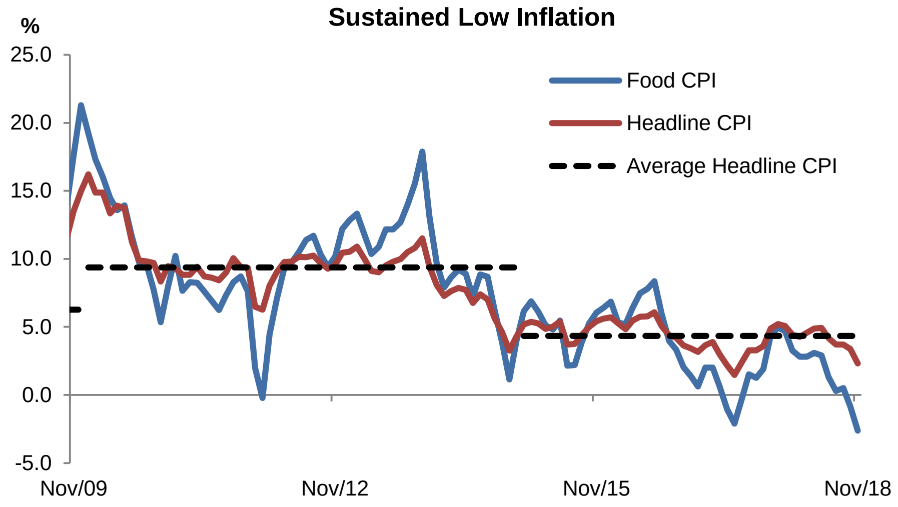




Source: CMIE, RBI, SA: Seasonally Adjusted

Sustained low inflation led by benign food prices

- Over the past 4 years, average inflation has been less than 4.3% as compared to 9.4% in 5 earlier years
  - Food inflation has fallen significantly to 3.4% from 9.7%
  - Driven by high agriculture growth in India and low global food prices (refer slide 11) , food inflation in India has been low over past 4 years as compared to previous10 years
- Average non-food inflation over past 4 years has been ~5%, significantly lower than 9% in earlier 5 years



Average inflation for the period

%	2000 - 2004	2005 – 2009*	2010 – 2014	2015 - 2018
Headline CPI	3.9	6.3	9.4	4.3
Non -Food CPI*	4.8	5.6	9.3	5.0
Food CPI*	2.6	9.4	9.7	3.4
Real Agriculture growth	1.7	3.2	4.1	3.3

*details of 2006 not available. Hence Food and non-food CPI is calculated using average of 2005, 2007-09.
- CPI-IW is used for the period before 2012

Low food inflation has adversely impacted farmers incomes

Source: CMIE, Bloomberg, World Bank

Summary of Indian Economic Outlook

- India remains a secular long term growth story driven by
  - Excellent demographics and rich natural resources
  - Large availability of skilled, young, English speaking and competitive manpower
  - Low penetration of consumer goods and improving affordability
  - Large unmet needs of infrastructure and strong reforms momentum
- Spate of reforms in past 4 years (refer slide 20) has created a favourable economic environment for sustained growth over medium to long term
- Macro economic indicators are stable and healthy
- Infrastructure capex continues to gain momentum; Definite signs of revival in industrial / private capex
- By 2028, India is likely to become the third largest economy in the world*

Source: *Bank of America Merrill Lynch Report "India 2028: The last BRIC in the wall" dtd 10th Nov 2017

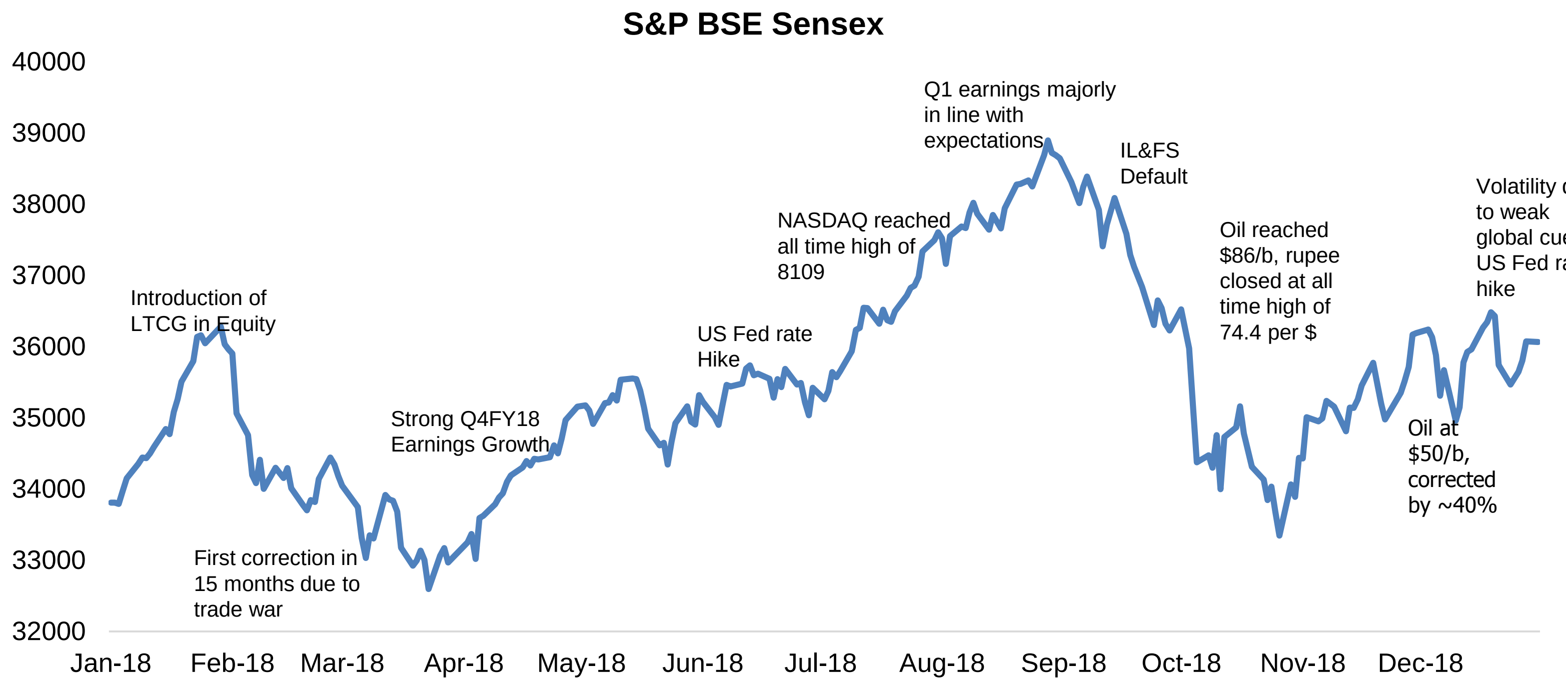
Equity Markets

“What the wise man does in the beginning, the fool does in the end.”

Warren Buffett

2018 – An eventful year for Indian Equities

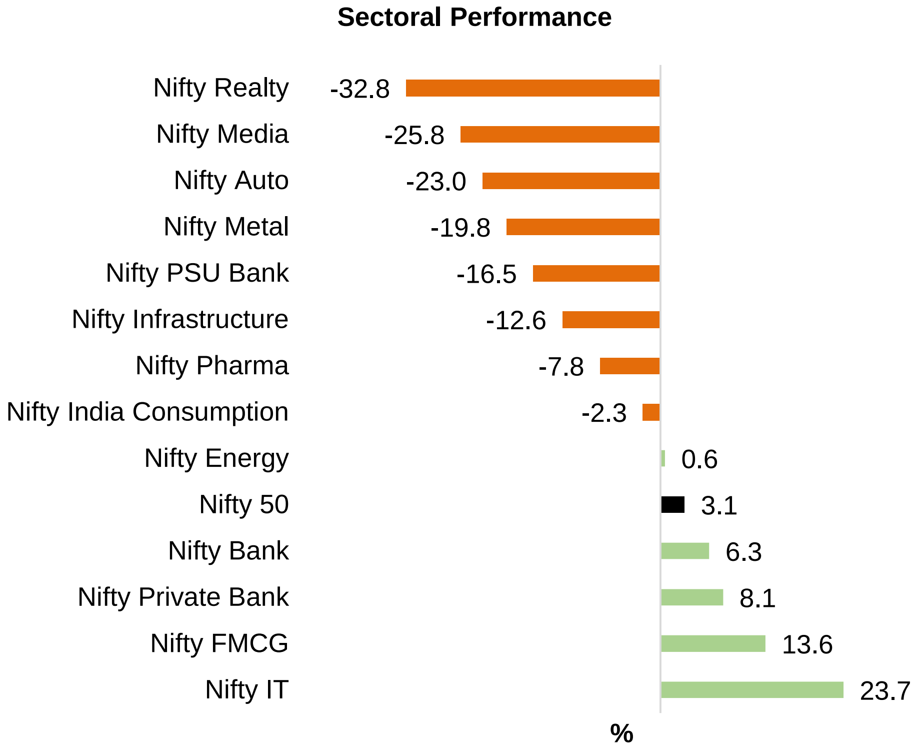
Markets end flat despite volatility

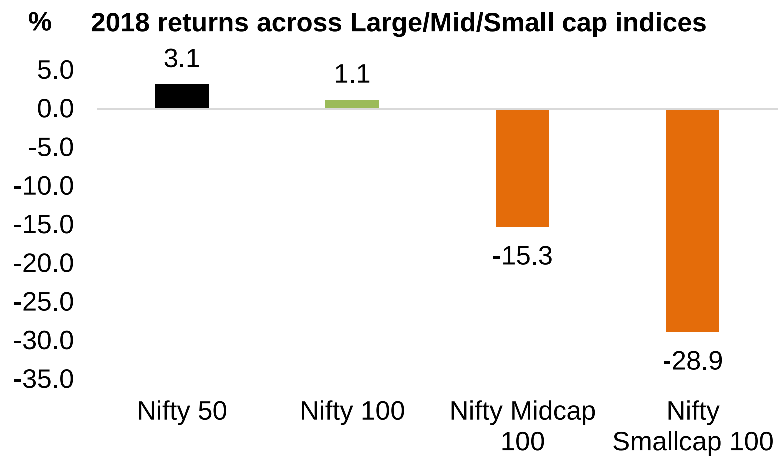


Indian equity markets outperformed global markets in 2018 (slide 9)

Source: Bloomberg. Data updated till 31st December 2018

Sharply Divergent Performance across sectors and Large / Mid / Small caps





	Absolute Returns %		
As on December 31, 2018	1 year	3 years	5 years
Nifty 50	3.1%	36.7%	72.3%
Nifty Midcap	-15.3%	33.4%	121.5%
Nifty Smallcap	-28.9%	14.1%	89.5%

- IT, FMCG and Private banks outperformed while Auto, Metal & PSU Banks underperformed
- IT was the top performing sector driven by weak INR, while Realty was the worst performing sector.

- Large caps outperformed mid and small caps; Performance of small and mid caps indices should be viewed in the context of strong performance over past 3 and 5 years

Source: MFI; Returns for Calendar year 2018. Data updated till 31st Dec 2018

2018 – A watershed year for Indian Equity markets

The Power of Retail investors

- Strong domestic flows have reduced impact of FII selling and thus volatility
- Since Jan 17, FII were net sellers (greater than USD 2.5 bn on 90 days cumulative basis) on three occasions but unlike in the past, Indian equity markets held up well on each of these three occasions as seen in table below

90 Days Period ending	FII Outflows (In USD Bn)*	Indian Market capitalization (USD bn)	FII outflows as % of Market cap	Fall in Sensex #
03-Apr-08	-4.5	1,270	0.4%	-10.9%
03-Dec-08	-5.7	543	1.1%	-43.6%
24-Oct-11	-2.5	1,208	0.2%	-13.5%
04-Sep-13	-3.9	917	0.4%	-5.7%
22-Jan-16	-3.1	1,362	0.2%	-13.1%
05-Jan-17	-5.1	1,589	0.3%	-1.2%
24-Oct-17	-4.2	2,154	0.2%	8.9%
14-Nov-18	-5.6	1,956	0.3%	-0.7%

Source: Bloomberg

* Maximum outflow on a 90 day rolling period and greater than USD 2.5 bn
# 6 months returns till date

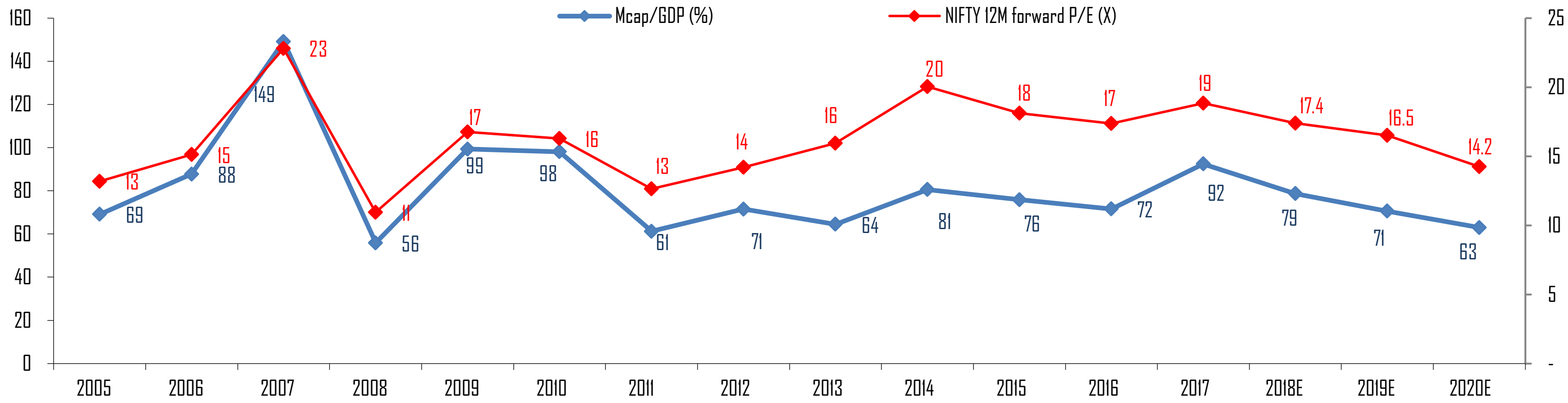
- This was due to sustained domestic flows into equity funds – currently (Rs 10,000-12,000 crs a month)^, of which SIPs flows itself are Rs 7,000-8,000 crores (25 million SIPs of Rs 3,000 each on an average)

A shift in power in capital markets from offshore players to domestic individual investors !

Source: AMFI; ^considering the average flows in past 6 months ending Nov18

Equity Markets – Valuations

India market cap to GDP ratio, calendar year-ends 2005-20E (%)



- Market Cap to GDP for 2018E to 2020E are based on current market cap and GDP estimate by Kotak Institutional Equities
- Marketcap to GDP at 63% is attractive, specially at a time when NIFTY EPS growth is estimated at 17% CAGR over FY18-21E (slide 29)
- Markets are trading at CY20(E) P/E of ~14x, which is reasonable, especially given improving earnings outlook

Given depressed earnings, Marketcap to GDP is a better valuation parameter

Data Source: Kotak Institutional Equities, updated till 30th Dec, 2018, From 2005-18, NIFTY50 PE is based on 12 month forward estimated EPS. For 2019E, by Kotak Institutional Equities has calculated PE based on EPS numbers as of Mar-20 end and for 2020E based on EPS of Mar-21 end

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Strong earnings growth ahead

NIFTY EPS growth of 17% CAGR expected between FY18 and FY21

Earnings - The worst is behind, strong improvement ahead

	FY13	FY14	FY15	FY16	FY17	FY18	NIFTY EPS CAGR 13-18	FY19E	FY20E	FY21E	NIFTY EPS CAGR 18-21E
NIFTY EPS	377	410	398	384	439	448	3.5	513	629	722	17.2
Growth %		8.8	-2.9	-3.5	14.4	2.0		14.2	22.7	14.8	

Source: Kotak Institutional Equities, E: Estimates

Reasons for weak NIFTY Earnings growth in FY13-18

Metals & Mining

Low prices in China and rest of the World

Low demand growth & large imports in India

Corporate Banks & Financials

Significant increase in stress in steel, power & infra sectors

Higher provisioning on NPAs impacted profitability sharply

Utilities

Change in CERC (Central Electricity Regulatory Commission) regulations

Earnings growth in FY18-21E should be driven by

Metals & Mining

- Higher prices led by MIP (Minimum Import Price) in steel and higher global prices across metals & INR depreciation
- Growing Infra / Housing spends / improving volume growth

Corporate Banks & Financials

- Recognition phase of NPAs is largely over, GNPA provisioning is at 54% as on Sep 18
- With falling slippages and increasing resolution of NPAs, provisioning costs are expected to fall sharply

Utilities

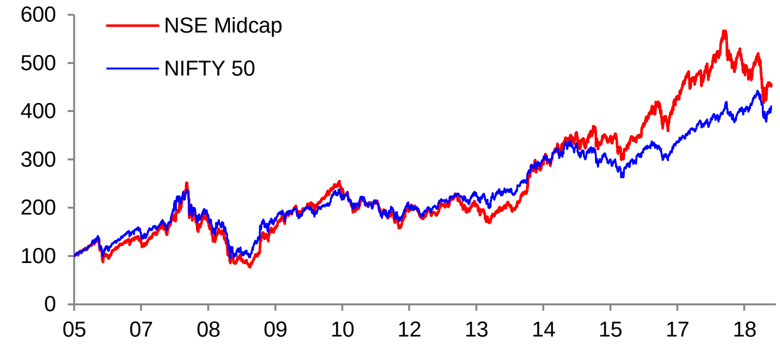
- Capacity led growth

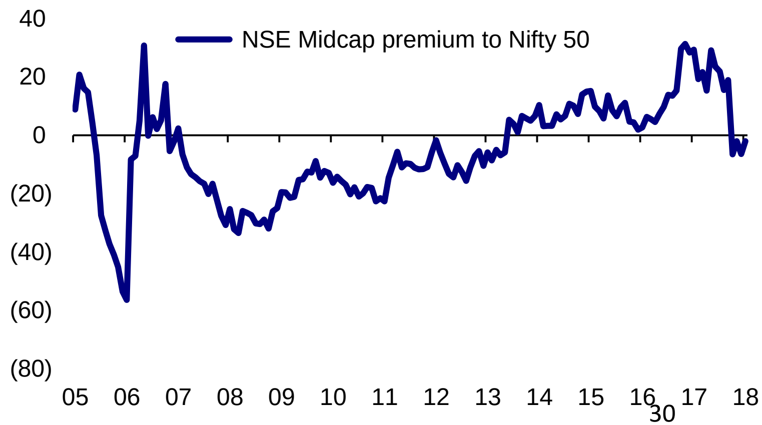
Interestingly, most of the sectors that witnessed weak profit growth / declining profits are the ones expected to witness healthy growth going ahead

Convergence of Largecap and Midcap Indices and valuations

Revenue growth	5 year CAGR	10 year CAGR
NIFTY Midcap	4.7	11.6
NIFTY 50	5.6	9.7

- No material difference in revenue growth of largecaps and midcaps
- Large caps underperformed midcaps in last few years due to weak NIFTY EPS growth (refer slide 29)
- With improving prospects of NIFTY EPS growth and correction in Mid Cap stocks, Largecaps and Midcap indices have now converged
- After correction in 2018, midcaps valuations have also converged with largecaps





Source: CLSA, Bloomberg, Midcap refers to NIFTY Midcap 100 . Largecap refers to NIFTY 50, data updated till Dec 29, 2018

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Worried about elections ?

Elections and equity returns
Spot the pattern* !

Represents year of elections

*As can be noticed there is no pattern in S&P BSE Sensex returns during the year in which elections were held or in years before or after the elections

**The base year of S&P BSE Sensex is 1978-79 and the base value is 100

Source: Sensex : www.bseindia.com, Election Commission of India for election years, Returns computation internal

HDFC Mutual Fund / AMC is not guaranteeing or promising or forecasting any returns on investments

Above chart is illustrative and for general information. Historical performance indications and financial market scenarios are not reliable indicators of current or future performance. HDFC Mutual Fund/AMC is not guaranteeing any returns on investments made. In view of the individual circumstances and risk profile, each investor is advised to consult his / her professional advisor before making a decision to invest

Year Ending	BSE S&P Sensex**	1 year absolute returns
Mar-79	100	
Mar-80	129	29
Mar-81	173	35
Mar-82	218	26
Mar-83	212	-3
Mar-84	245	16
Mar-85	354	44
Mar-86	574	62
Mar-87	510	-11
Mar-88	398	-22
Mar-89	714	79
Mar-90	781	9
Mar-91	1168	50
Mar-92	4285	267
Mar-93	2281	-47
Mar-94	3779	66
Mar-95	3261	-14
Mar-96	3367	3
Mar-97	3361	0
Mar-98	3893	16
Mar-99	3740	-4
Mar-00	5001	34
Mar-01	3604	-28
Mar-02	3469	-4
Mar-03	3049	-12
Mar-04	5591	83
Mar-05	6493	16
Mar-06	11280	74
Mar-07	13072	16
Mar-08	15644	20
Mar-09	9709	-38
Mar-10	17528	81
Mar-11	19445	11
Mar-12	17404	-10
Mar-13	18836	8
Mar-14	22386	19
Mar-15	27957	25
Mar-16	25342	-9
Mar-17	29621	17
Mar-18	32969	11

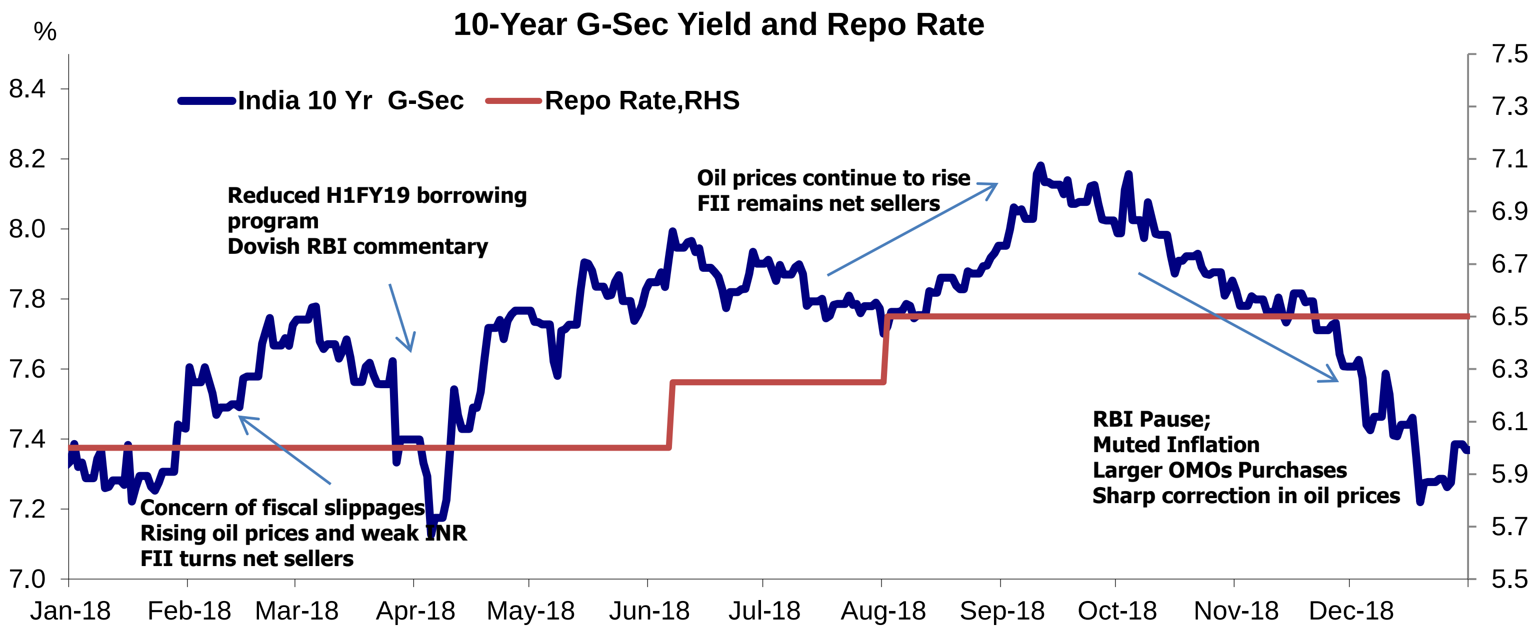
Equity Markets Summary

- Strong outlook for economic growth and earnings growth (NIFTY EPS growth estimated at 17% CAGR over FY18-21E (Slide 29)
- Markets are trading at CY20(E) P/E of ~14x and Marketcap to GDP ratio of 62% CY20E (Slide 28)
- Strong profit growth outlook, steady local flows and reasonable valuations lead to a positive view of markets
- Post correction in 2018, midcaps valuations have converged with largecaps
- Trade wars, rise in oil prices , sharp increase in US rates, sharp deterioration in local / FII flows, setback to NCLT etc. are key risks in near term

Fixed Income Markets

“It doesn’t matter how slow you go so long as you do not stop”

2018 Fixed Income markets – Flat ending to a volatile year



- G-Sec yields remained volatile - High sensitivity to INR & Oil, RBI OMO purchases and FII outflows
- RBI hiked policy rates twice by 25 bps each in 2018 and also changed its stance from neutral to calibrated tightening
- US yields remained at elevated level for most part of the year
- Headline CPI remained lower than RBI's forecast led by benign food prices

Source: Bloomberg

Build-up of risks in NBFC Sector; Increased reliance on MFs for funding

- 15% CAGR growth in NBFCs/HFCs asset book over past 3 years. NBFCs' share in total credit increased to 21% in FY18 from 18% in FY14

HFC & NBFC's ex PFC/REC (Borrowing)	Mar-14	Mar-16	Mar-18	Aug-18
Bank Funding (Rs bn)	4,333	5,504	7,197	7,602
MF Funding (Rs bn)	939	1,792	3,938	4,678
Insurance/Pension/Deposit (Rs bn)	2,073	3,243	4,101	4,226
Total	7,345	10,539	15,236	16,506
Bank Funding %	59	52	47	46
MF Funding %	13	17	26	28
Insurance/Pension/Deposit (%)	28	31	27	26
MFs Non Equity AUM	4,542	7,213	11,986	13,443
MF Funding as % of MFs non equity AUM	21	25	33	35

- Banks exposure to NBFCs/HFCs has also increased to 13.8% in FY18 from 11.7% in FY14
- MF's exposure to NBFCs has increased to 35% in Aug18 from 21% in Mar14
- Sharp increase in share of CPs in the borrowing mix of NBFCs and HFCs (ex- PFC and REC) – from 5.3% in FY14 to 16.3% in Aug18 leading to Asset Liability mismatch (ALM) concerns

HFC & NBFC's ex PFC/REC	Mar-14	Mar-16	Mar-18	Aug-18
Commercial Papers (INR bn)	392	830	1,685	2,691
% of total borrowing	5.3	7.9	11.1	16.3

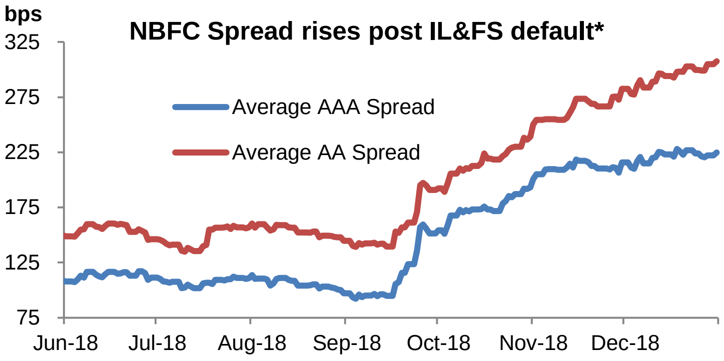
MFs contributed 40% of incremental funding since Mar 14

Source: Nomura , Global Markets Research , Sept 2018 , RBI
PFC- Power Finance Corporation Limited; REC – Rural Electrification corporation Limited
Refer disclaimer on slide 41

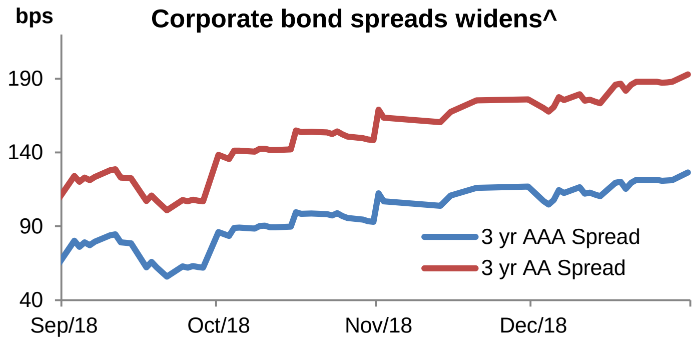
Liquidity concerns for NBFCs addressed, outlook is mixed

- Liquidity concerns post IL&FS default addressed by
  - Timely actions by RBI and Government
  - Securitisation / asset sale, unutilised bank lines etc.

- Growth expected to moderate for NBFCs
  - Cost of funds rising with widening of spreads
  - Risk aversion amongst lenders



- Corporate bond spreads have also widened during this period



* AAA Average spread is average spread of 10 large AAA rated NBFCs 3 Yr. bond yields over 3 Yr benchmark Gsec. AA Average spread is average spread of 5 large AA rated NBFCs 3 Yr. bond yields over 3 Yr benchmark Gsec

^ AAA spread is spread of 3 Year AAA rated corporate bond yields over 3 Yr benchmark Gsec yields. AA spread is spread of 3 Year AA rated corporate bond yields over 3 Yr benchmark Gsec yields

Source: Daily valuation provided by ICRA/CRISIL; Bloomberg; Data is updated till 31st Dec 2018. Refer disclaimer on slide 41

Interest Rates Outlook – Conflicting Forces at Play

Positives

- High Real yields in India
- Healthy real rates differential between India & US
- Soft oil, commodity and food prices (refer slide 11)
- Low rural wages growth
- Expectation of large OMO purchases by RBI
- Headline CPI outlook remains benign

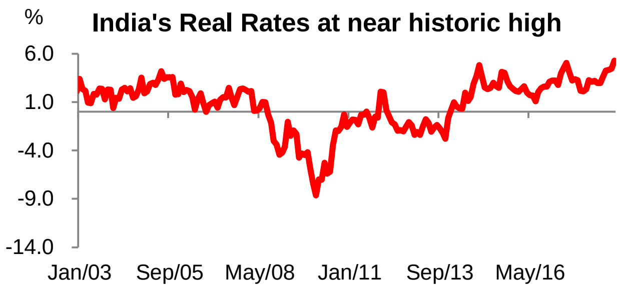
Negatives

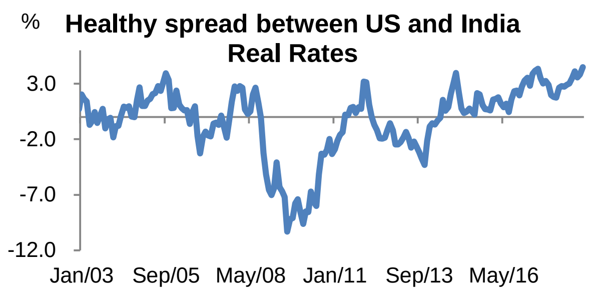
- Higher Credit growth vs Deposit growth
- Capex recovery should boost credit demand
- Excess SLR securities holding of PSU banks
- Concerns over fiscal slippages
- Global liquidity tightening & increase in yields
- Core inflation sticky at elevated level

Yields likely to fall at the short end

Interest Rates Outlook - Forces favouring lower Interest rates

- Real Yields in India at historical high
  - CPI outlook remains benign led by food inflation
- Healthy Differential with US Real yields



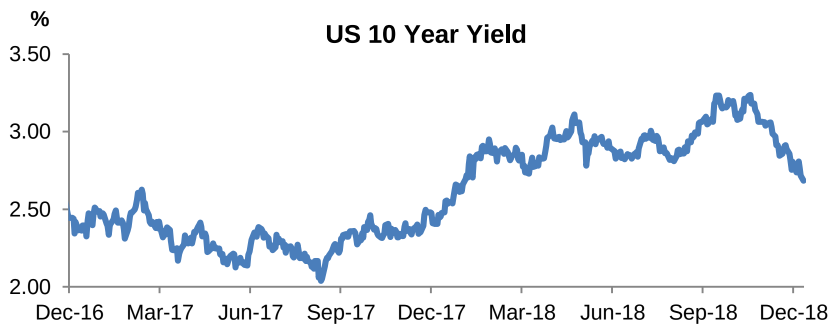


Real Yields = Month-end 10Y GSec Yield and CPI; Updated till 30th Nov'18. CPI-IW is used to calculate real yields for period before 2012

- Sharp fall in oil prices eases pressure on CAD
  - Fall in oil prices beneficial for CAD and INR outlook
  - Every USD 10 per barrel fall in crude prices results in CAD falling by ~0.4% of GDP

	FY16	FY17	FY18	H1FY19
Crude prices (USD /bbl)	50.2	48.8	56.7	75.0
CAD as % of GDP	-1.1	-0.7	-1.9	-2.7

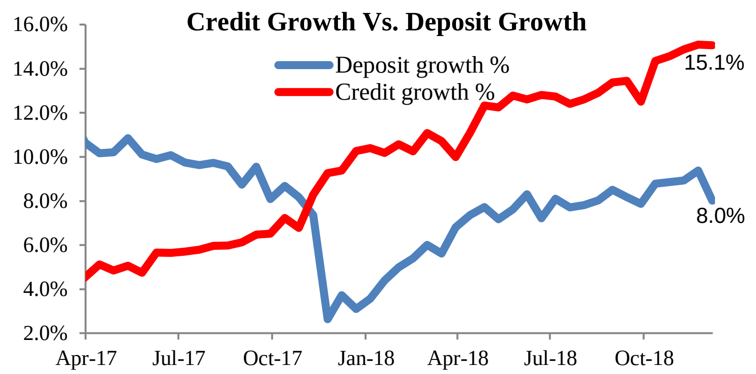
- US Federal Governor's comment that rates are "just below" neutral rate indicates benign outlook for rise in Fed rates
  - US 10Y yields have come off materially from the high made in Nov'18



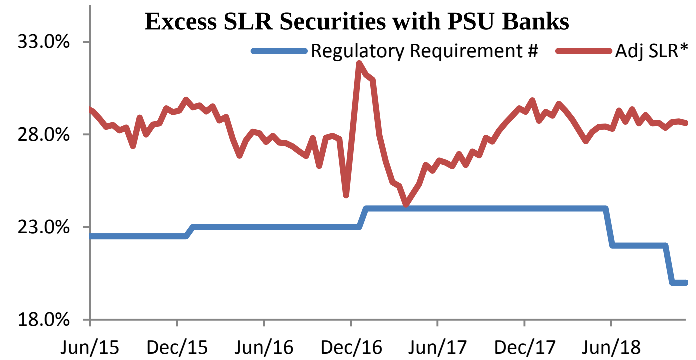
Source: Bloomberg, RBI, Kotak Institutional research.

Interest Rates Outlook - Forces adversely impacting interest rate outlook

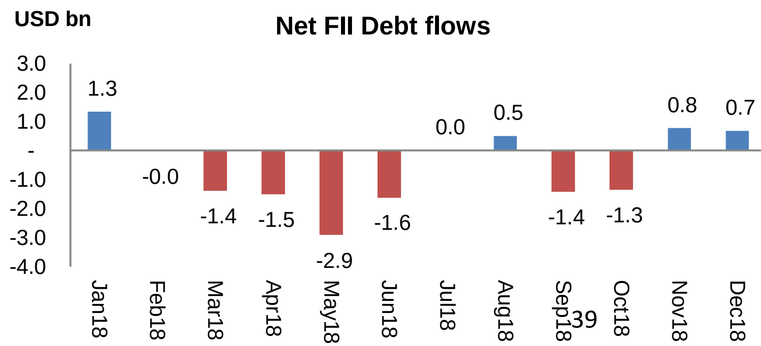
- Bank credit growth accelerating
  - Outpacing the deposit growth
  - Recovery in capex cycle likely to accelerate credit growth further



- Excess SLR Investments, especially with PSU banks
  - Incremental demand for G-sec could remain muted



- Debt FII Flows remain volatile on back of rising USD and global liquidity unwinding
  - Net FII Debt Outflows CY18 stood at USD 6.9 bn



* Adj SLR = Investments in Statutory Liquidity Ratio (SLR) Securities adjusted for securities under LAF
\# Regulatory Requirements = SLR + Liquidity coverage requirement requirements (~15-17% of NDTL) – carve out allowed from SLR

Source: RBI, Kotak Institutional research, NSDL

Fixed Income Summary

- Some factors support lower yields, while others don't (refer slide 37)
- Yields likely to fall at the short end (upto 3-5 years)
- Immediate liquidity concerns of NBFCs reduced; ALM mismatch still remains a challenge
- Asset quality of NBFCs needs to be monitored
- Cautious approach on credit and duration recommended
- Key risks to yields
  - Sharp rise in global yields & oil prices
  - FII flows remain uncertain

Wish you and your family a very Happy New Year

- HDFC Mutual Fund

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