**Market Outlook**

Equity Market ended the quarter in an upbeat mood with Sensex now up 12% on year-to-date basis. Mid-cap (+4% in March) and small-cap indices (+5%) outperformed the Sensex for the third consecutive month.

Increased appetite for emerging market assets (lured by the prospects of better growth and less-hawkish US Fed), prudent monetary and fiscal policy domestically, favorable state elections outcome led India to receive the highest ever monthly FII flow. Foreign funds inflows in equity and debt market aggregated to US$ 8.5 billion in March vs. previous high of US$ 8 billion in September, 2010). Domestic investors continue to pour money into equity funds.

Favorable FII flows, robust FDI and growing exports have had a telling on the rupee. The currency strengthened 4.7% this year (vs. 2.4% depreciation in 2016) and out-shined most emerging market peers. Excess systemic liquidity post demonetization constrained RBI's ability to intervene and prevent rupee appreciation as absorbing excess dollars would mean further adding to the rupee liquidity.

Looking ahead, ebbing of the Trump related euphoria (in Dollar index) and strength in emerging markets (EM) economic activity since start of 2017, had led the investors to steer away from US to EM assets. Emerging Market economic surprise index has seen one of the sharpest up-moves since the Lehman crisis.

India has depicted persistent growth, reform bent in policy thinking, stability and strength in its macro-fundamentals. This provides a fundamental support to the currency. Nevertheless, the currency may still show some vulnerability from choppy portfolio flows. RBI's policy in past has been to contain volatility. On a REER basis, the currency already looks appreciated and it is unlikely that RBI would be willing to accommodate an out-performing rupee for long.

In sum, Indian Rupee's fundamentals look good but remain vulnerable to undependable FII flows, which in turn depend on things like execution of Trump's economic plans, strength of EM recovery and gradual unwinding from ultra-loose monetary policy in Europe. And even a small FII outflow from India due to global reasons could trigger depreciation. To reiterate, RBI has not intervened this time and built-up their reserves when currency was appreciating and hence should not disallow the currency to retrace its recent rally. We expect rupee to depreciate by 4-5% in FY18 (same as before) but on a new base of 65 Rs./ US$ (March 2017 end).

On the growth and policy front, government continued its focus on executing the planned reform. Aadhaar is getting increasingly integrated with government's social spending, tax collection and other administrative services.

The preparation for rolling out the GST is happening at a rapid pace. Parliament approved the four necessary bills last week, finance ministry is ironing out the tough issues related to GST and both government and private sector are working towards the adoption of IT infrastructure required in this new taxation regime. Passage of the SGST (State-GST) bills in respective state assemblies and laying down the detailed final rates for each goods and services are expected to be achieved by the month of May.

While a large part of NPAs in the bank books have been recognized and recorded, the process of resolution has been slow. This is one key stumbling block in India's growth story. While the twin deficit challenge (Fiscal and current account deficit) have been addressed, the twin balance sheet (excessive leverage in corporate balance sheet and Bank NPA) problem persist. Private capital expenditure is hampered due to low capacity utilization and excessive leverage. Banks are weighed down by bad loans which come in the way of credit growth. Both government and RBI realize that this is one of the biggest pain points for the economy and hopefully additional tough steps are likely to be seen in coming months.

While the Indian growth drivers are primarily domestic (led by private consumption and public sector investment), the improving global trade cycle provides the additional tailwind. India's share in world trade has stabilized at 1.7% in last 5-6 years. In other words, India did not lose its market share despite the overall poor performance and should stand to benefit from the rising global trade activity. Further, structural strength of Indian exports lies in the fact that exports from India has progressively diversified, both in terms of products and countries. This reduces the vulnerability of Indian exports to any negative development in one part of the world (such as proposed Border tax adjustment in US or sudden drop in demand of 'a particular commodity').

Despite the optimistic earnings projections (in high teens), equity markets are already trading at upper end of the valuation curve (18 times FY18 earnings) primarily helped by liquidity in the market. Positive global (growth related), domestic (reform related) developments and robust liquidity can keep valuations at the higher end. Hopefully supply (equity issuance) should catch up to absorb part of the strong flows. While we feel nervous about the valuations, we remain positive from medium to longer term perspective owing to inherent structural strengths of the economy, bottoming of corporate profitability and prospects of domestic flows.

NIFTY crossed 9000 levels early last month. The index has been flirting with those levels for 2 years now (NIFTY touched 8,952 in January 2015 and once again at 8953 in September 2016) only to actually cross 9000 in March 2017. While the market has been flat, so to speak, for 2 years now, there had been wide dispersion in its constituents from -43% (Idea) to +75% (Yes Bank); there are more than 10 stocks within NIFTY that have delivered 30% plus returns and almost equal number that have lost over 20% in the same period. This reinforces our belief in the strength of active bottom up stock picking.

Domestic Bond markets have been rallying recently on the back of strengthening rupee and carry buffer which led to FII inflows, attractive valuations even for domestic investors and (financial) year-end nuances. 10 year G-sec yields fell by 19bps to 6.68% by March end. The shorter-end of the curve (91 day Treasury bill) fell by 19bps during the month, thus leading to yield curve steepening.  FIIs have bought nearly US$ 4 billion in Indian bonds in March compared with an inflow of USD$ 550million during the first two months of the year.

RBI is unlikely to change its monetary policy stance in the upcoming April meeting as the broad narratives that dictated the adoption of neutral stance still holds. That said, the next trigger for the yield market is likely to be liquidity management tools that the RBI uses to suck out the liquidity overhang in the system.

For FY18 as a whole, supply-demand dynamics of the government bonds, liquidity situation of the banks once the pace of currency withdrawal normalized, bank credit outlook and global outlook will take prominence in guiding the bond markets trajectory. We remain constructive, but with a slightly longer term approach as average CPI settle lower and government's measures to widen the tax base leads to structural improvement in the fiscal balance.  Accordingly, we keep taking tactical calls in duration at the opportune time (like last month).

**Navneet Munot, CIO – SBI Funds management Private Limited**
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