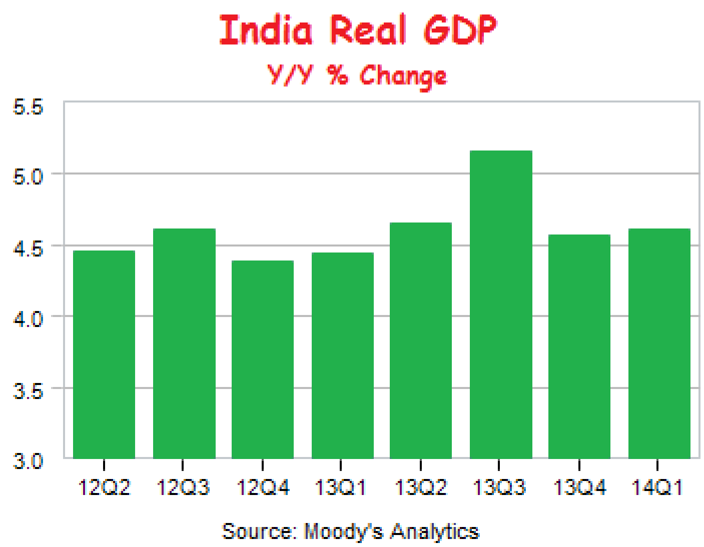
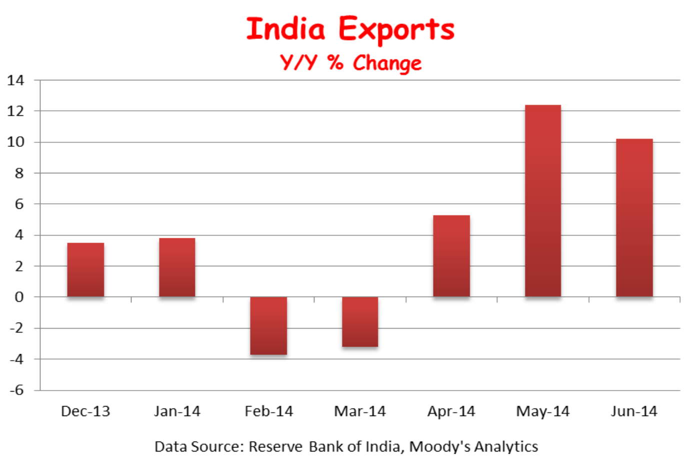
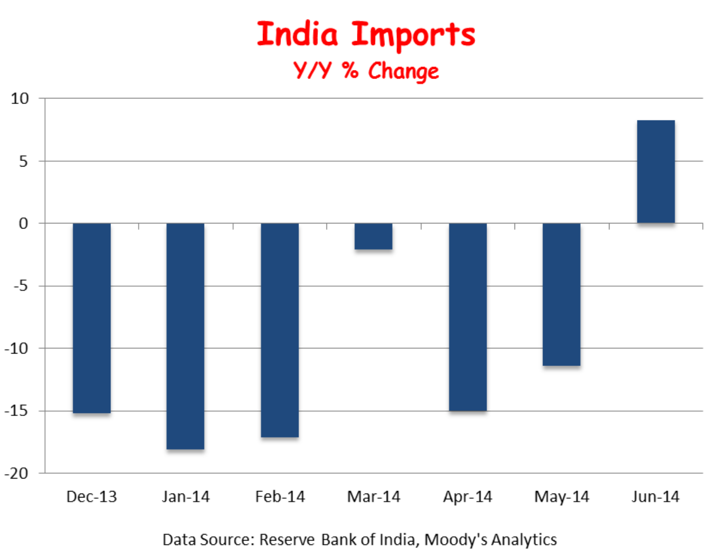
India's Economic Outlook







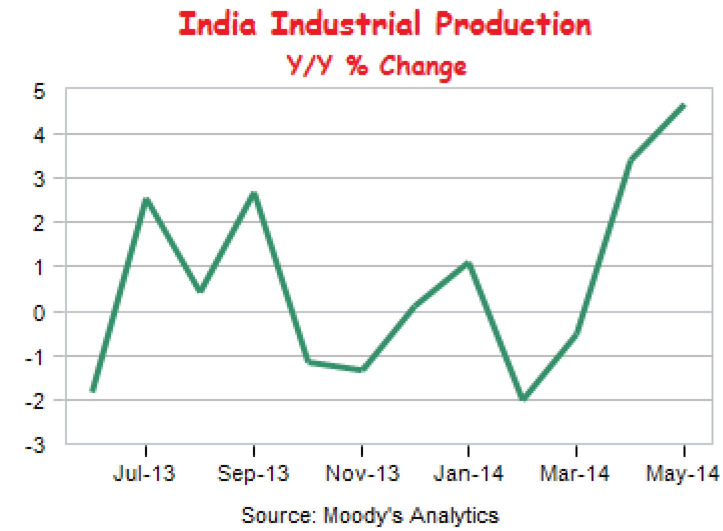
India, Asia's third-largest economy, is showing signs of improvement after growing at the same rate for two years. The economy is expected to have passed its trough and growth should pick up through the rest of the year. While the economy appears to have stabilized, it is still growing at a rate below its potential of around 7%. It is also experiencing a significant slowdown compared to its growth in early 2010, when growth rates reached over 12%.

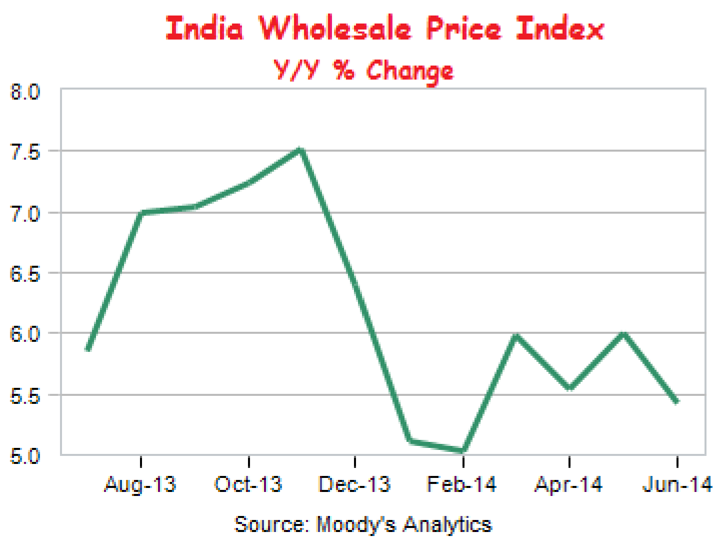
There is hope that the new administration, with Narendra Modi as the prime minister, will boost economic growth. The government has identified foreign investment as a key area of focus as a way to reduce the economy's current account deficit and improve its infrastructure. The administration's opening of foreign investment in defense and insurance is expected to help achieve this goal.

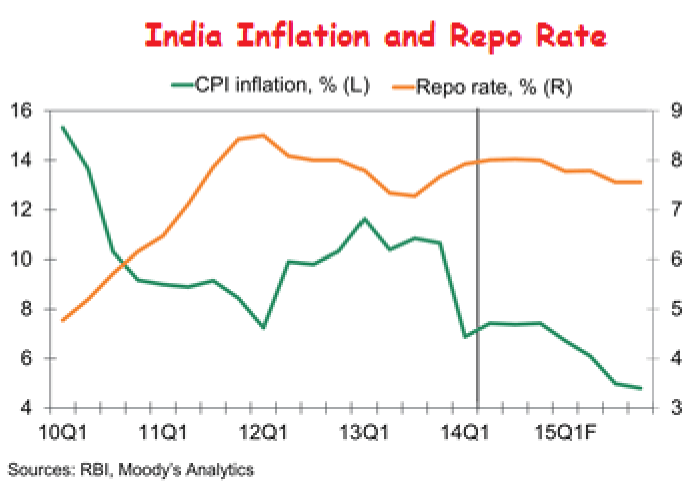
The government has also announced that it will spend over a billion dollars to build 100 new cities that will include the latest technology and infrastructure. These "smart cities" are where the government plans for most economic development to take place.

India's exports, which account for about a quarter of the country's GDP, are growing at a solid rate due to improved demand from India's key export markets. Demand has picked up particularly from Europe and the U.S., which together make up about a third of India's total export market. Export growth is expected to remain strong as global demand gains momentum.

In an effort to reduce India's trade imbalance, the government increased taxes on gold imports, causing imports to fall. Since the trade imbalance has narrowed, the government has now lifted these taxes, leading to an increase in jewelry imports. As a result, India's imports recently experienced positive annual growth for the first time in about a year. As the economy sees more improvement and domestic demand builds momentum, India's imports are expected to gain steam.







The majority of the weakness in India's economy in recent years has been in the corporate sector. As a result of tax policies implemented in 2012 which retroactively taxes India's firms, business sentiment has been weak. While there was hope that this tax policy would be removed after Prime Minister Modi took office, we have yet to see the new administration make this change. However, Modi has promised to make moves to help boost investment and reduce regulations for businesses.

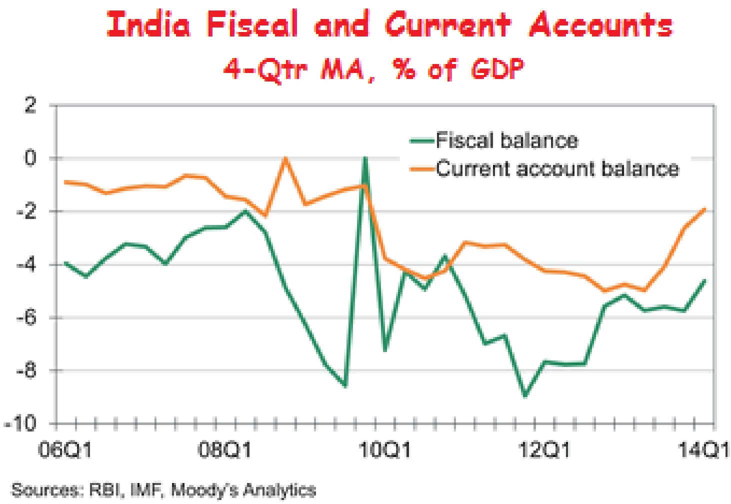
Thankfully, manufacturing in India has seen a turnaround due to improved external and domestic demand. Since manufacturing dominates India's industrial production, overall industrial output has risen over the last few months and recently experienced its fastest growth in over a year. This trend should continue in the coming months since global demand is expected to remain steady and continued improvements in India's economy boost domestic demand.

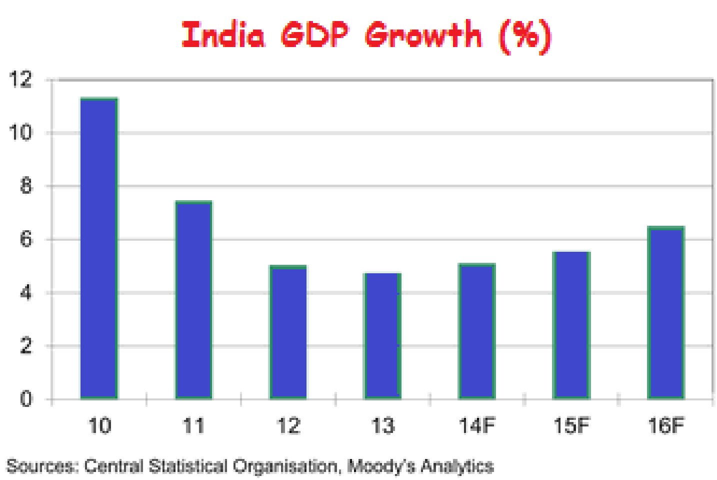
While India's inflation rate has eased from its previous double-digit rates, inflation still remains relatively high. India's inflation has been driven mainly by high food prices. High food prices pose a threat to social stability, since according to the World Bank, approximately three-quarters of India's population live on less than $2 a day.

Elevated inflation levels are also largely due to the government's large fiscal deficit, which is mainly the result of heavy subsidies on fuels, fertilizers and food. This is fueling demand and keeping prices from falling. The weak rupee has also been a source of inflation since a weak currency makes imported goods relatively more expensive.

Persistently high inflation prevents the Reserve Bank of India from cutting policy rates further to stimulate growth. Persistently high inflation and interest rates have stubbed spending by households, which makes up over half of India's GDP. The new administration has vowed to make improvements in India's agricultural sector and supply chain in an effort to reduce food inflation; however, it will take a while to see the results of these efforts.

Unfortunately, inflation is expected to pick up even more in the coming months as a result of below-average monsoon rains that will reduce supply and increase food inflation. The lower crop output is very serious, since India's agricultural sector contributes to 15% of the economy's GDP and is a source of income for over two-thirds of the nation's population.





While there has been some improvement recently, India is still experiencing a large fiscal deficit, mainly the result of heavy subsidies on fuels, fertilizers and food. A tighter government budget is expected with the new government, which should help narrow the fiscal deficit.

In an effort to reduce India's trade imbalance, the government increased taxes on gold imports, causing imports to fall. As a result, India's current account deficit has narrowed and reached a four year low. However, since the current account has narrowed, the government has recently lifted the taxes on gold imports and imports have now seen gains. This may cause the current account deficit to edge higher in the coming months. Thankfully, stronger external demand and the government's efforts to boost foreign investment should help keep the current account deficit in check.

As a result of the improved current account balance, the Indian rupee has strengthened as well. The rupee experienced persistent weakening from early 2010 to mid-2013. The fall in the currency was mostly driven by the threat of a global economic downturn which led investors toward safe-haven assets and away from risk-sensitive currencies. The rupee has been among the most risk-sensitive currencies in Asia. Government efforts to reduce the current account deficit, along with a more stable global outlook, are expected to help keep the rupee steady.

Overall, we see that India's economy is showing signs of improvement. Government efforts to reduce the current account deficit, stem the weakening of the rupee, and reduce inflation have been successful. Manufacturing has rebounded and exports have enjoyed gains due to improved global demand.

While the Indian economy appears to have stabilized, it is still growing at a rate below its potential of around 7%. The economy is also still suffering from persistently high inflation and large current and fiscal account deficits. High inflation is impeding on the ability of India's central bank to cut interest rate further to spur growth.

The Indian economy appears to have hit the bottom of the current business cycle. A gradual recovery is expected to take place from here as rising sentiment and a more stable global outlook help to boost the economy. The new administration also offers hope for improved economic growth. GDP growth is expected to reach around 5% this year and the government hopes to return it to its potential rate within three to four years.