India Strategy

Decoding the Trump policy mania

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INDIA | STRATEGY

There is little doubt now that the largest economy of the world will turn inwards. The President of the USA, Donald Trump, has assembled a remarkable crew of protectionists in his cabinet, which is indicative of the direction of his policy framework. With republicans in control of both the houses, a major overhaul of tax and trade policies is on the cards. Significant income-tax rate cuts are likely to be combined with imposition of trade tariffs, which could be implicit or explicit. Even as the impact of these policies on the US economy remains uncertain, the huge amount of distortion in trade will have far-reaching consequences on economies across the world. Indian sectors that will be impacted the most are – pharmaceuticals, IT, auto ancillaries, textiles, and gems and jewellery. Apart from a big overhaul of the tax structure, policy changes in healthcare, immigration, and regulation, are likely to have mixed consequences.

As policy uncertainty has risen to an all-time high (as measured by the Global Economic Policy Uncertainty Index), we reduce our weights for pharmaceutical stocks that will be significantly impacted by changes in the US tax policy and regulations. Our stance on the IT sector (will be impacted by policy changes in the US) is already significant underweight because of the structural headwinds. We add weight in commodities with the addition of JSW Steel and Vedanta to our model portfolio, as we see the demand environment improving. Our key ideas are as follows:

BAT income tax might be the 'better way', but VAT is more acceptable: Currently, the only credible policy framework before the US congress is from the Speaker of the United States' House of Representatives – Paul Ryan's 'Border Adjustment Tax'. While the President does not favour this tax framework much (he has expressed his displeasure publicly), it provides a very effective mechanism to achieve his long-term election manifesto goals. Border-adjustment tax could deal a big blow to global trade and supply chains across the planet, as it would make imported goods in cost of goods sold inadmissible for tax deduction. The biggest impact would be on manufactured goods, with pharmaceutical companies taking the worst hit. An alternative is the VAT, which is considered trade neutral by the WTO, but requires a much bigger overhaul of the US tax system. Imposition of VAT would affect global exporters and make US companies more competitive, but the punitive damages would be much less severe vs. BAT. Companies in our coverage that are most vulnerable to the BAT regime include Dr Reddy's Lab, Aurobindo, and Tata Motors.

Protectionist trade reform to follow tax cuts (given the Navarro-Ross plan): Trump's trade policies have been heavily influenced by his economic advisors – Wilbur Ross and Peter Navarro – who are openly critical of China's and trade practices and of other major trading partners. Their plan is to offset any federal revenue loss from tax cuts through increases in revenue from trade, energy, and regulatory reforms. As trade reforms form the biggest part of this revenue structure (US$ 1.74tn of US$ 2.37tn), we believe these would quickly follow (possible) tax cuts. Navarro-Ross' plan focuses on increasing manufacturing jobs and reducing the trade deficit by taking on currency manipulators, countries with unfair trade practices, and renegotiate past trade deals (NAFTA, 2012 South Korea deal).

Dodd-Frank modifications positive for global banks... and commodities? Repealing the Dodd-Frank Act could provide the biggest boost to the financial services sector, as it would free up a lot of capital for banks, which is very likely to seep into the equity and commodity markets. While we don't see a complete repeal of the act, any modifications that allow excess capital to flow into the system, combined with the infrastructure spending discussed by the Trump administration, could kick-start a multi-year investment cycle in the US – a positive for commodity prices. Rising interest rates serve as a risk to our thesis, but we think rising inflation expectations, global growth revival, and reducing overcapacity should mitigate these risks. Stocks positioned to benefit – Hindalco, Vedanta, and Tata Steel.

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Trump's A-Team carefully designed to "Make America Great Again"...

Trump's cabinet is remarkably aligned with the pro-US, anti-trade, and anti-immigration theme that dominated President Trump's entire campaign trail. His mostly male, mostly white, and mostly super-rich cabinet is a powerful indicator of the nature of the future policies that are likely to impact the world's largest economy. Notables among his cabinet include Former CEO of Exxon, Rex Tillerson, the first Secretary of State with absolutely no prior government experience, who shares a relatively warm relationship with Russian President Vladimir Putin. Secretary of Treasury Steven Mnuchin is a former Wall Street Banker and Goldman Sachs alum, while the Administrator of the Environmental Protectionist Agency, Scott Pruitt, does not believe in climate change. The United States Trade Representative, Robert Lighthizer, is a vocal trade protectionist.

Another notable inclusion is Peter Navarro as director of the National Trade Council, a newly created entity in the executive branch of the US federal government. Peter Navarro has authored several books including Death by China. His views are often espoused by the president and he is likely to play a key role in framing policies on trade.

Trump's economic doctrine, as outlined in his economic plan dated September 29, 2016, focuses on a four-point agenda that includes tax cuts, reduced regulations, lower energy costs, and eliminating America's trade deficit. Since these US policies are unlikely to not have a profound effect on the broader world economy (US attributed to about 16% of the world GDP), we deep-dive into Trump's proposed economic plan to understand the anticipated policies and its impact back home. Based on Trump's economic plan, and without reading too much into the complexities of how these policies will pan out in the Congress, we see a high probability of the following proposals turning into reality soon:

1. A modified version of the border adjustment tax looks likely, with exemptions for critical items like Pharma, etc; corporate- and income-tax cuts look more certain
2. Trade reforms will follow tax-cuts and could involve punitive measure for country with a history of prolonged trade deficit with the US (eg. China). Trade incentives could also be dished out to return manufacturing to the US
3. Wall Street reforms will focus on the Volcker rule appeal, although amidst significant opposition from Democrats

Trump cabinet's assessment

	Name	Office	Male	White	Govt Exp.	Expect pro-US, anti-trade, anti-immigration policies	Background
Cabinet Members	Mike Pence	Vice President	✓	✓	✓	Yes	Former Indiana Governor that makes up for Trump's lack of government experience
	Rex Tillerson	Secretary of State	✓	✓	×	Yes	Former CEO of ExxonMobil. Has a decade-long relationship with Vladimir Putin. First Secretary of State with no government experience
	Steve Mnuchin	Secretary of the Treasury	✓	✓	×	Yes	Former Goldman Sachs Banker, Hedge Fund Manager, and Hollywood Producer. Essentially another successful businessman
	James Mattis	Secretary of Defence	✓	✓	×	Yes	Forty one years in the military, none in civil positions. Straight shooter and thankfully not a supporter of torture
	Jeff Sassions	Attorney General	✓	✓	✓	Yes	Failed at Federal Judgeship in 1986 due to racist remarks. Supported President Bush on tax-cut packages, Iraq war, and proposed amendment to ban same-sex marriages. Staunch support of curbing illegal immigration and legal migration
	Ryan Zinke	Secretary of the Interior	✓	✓	✓	Yes	Former Navy Seal. Found strong support from Donald Trump Jr. Environmentalists denounced his nomination given his support for mining and drilling and his scepticism about climate change
	Sonny Perdue	Secretary of	✓	✓	✓	Yes	Former governor of Georgia, having served two terms

		Agriculture					ending in 2011. An immigration hawk, he grew up on a farm and earned a doctorate in veterinary medicine
	Wilbur Ross	Secretary of Commerce	✓	✓	✗	Yes	Billionaire investor and founder of the investment firm W.L. Ross and Co. Described as the "King of Bankruptcy" for his work restructuring failed companies. Was a key economic adviser to Trump during his run for the presidency
	Andrew Puzder	Secretary of Labour	✓	✓	✗	Yes	Former CEO of fast food chain Hardee's and Carl's Jr. Conservative and critic of minimum-wage laws
	Tom Price	Secretary of Health and Human Services	✓	✓	✓	Yes	Long-time Obama critic. Staunch supporter of Trump's policies
	Ben Carson	Secretary of Housing and Urban Development	✓	✗	✗	Can't Say	A retired neurosurgeon. Was once Trump's rival in the 2016 Republican primaries and now serves as the vice-chairman on Trump's transition team
	Elaine Chao	Secretary of Transportation	✗	✗	✓	Can't Say	Given her government experience and obvious qualifications for the post, Chao might be the least controversial of any of Trump's choices so far
	Rick Perry	Secretary of Energy	✓	✓	✓	Can't Say	Former Texas Governor. Was one of the strongest critics of Trump's policies during the Republican nominations
	Betsy DeVos	Secretary of Education	✗	✓	✗	Yes	Billionaire and major GOP donor. She's been a major advocate for education reform centered on expanding charter schools and private-school vouchers
	David Shulkin	Secretary of Veterans Affairs	✓	✓	✓	Can't Say	The only Trump pick currently serving in the Obama administration, Shulkin is now the under-secretary for health at the VA
	John F. Kelly	Secretary of Homeland Security	✓	✓	✗	Yes	Retired general with 40 years of military experience. In charge of building the 'wall' across Mexico's border
Cabinet-level officials	Reince Priebus	White House Chief of Staff	✓	✓	✗	Yes	Head of Republican National Committee
	Nikki Haley	Ambassador to the UN	✗	✓	✓	Can't Say	Served six years as South Carolina Governor. Rising Republican Star
	Scott Pruitt	Administrator of the EPA	✓	✓	✓	Yes	Served as the Attorney General for Oklahoma, and like Trump, he doesn't believe in climate
	Robert Lighthizer	United States Trade Representative	✓	✓	✓	Yes	Former Trade Lawyer and a vocal protectionist
	Mick Mulvaney	Office of Management and Budget	✓	✓	✓	Yes	Hard-line conservative. Opposing views with Trump on social security and defence programs
	Linda McMahon	Administrator of the Small Business Administration	✗	✓	✗	Yes	Wrestling Entrepreneur
	Dan Coats	Director of National Intelligence	✓	✓	✓	Yes	Served as the US Ambassador to Germany under the Bush administration
	Mike Pompeo	Director of the Central Intelligence Agency	✓	✓	✓	Yes	Pompeo was elected to his fourth term in the House in November and served on the Intelligence Committee.

Source: https://www.theatlantic.com/politics/archive/2017/02/trump-cabinet-tracker/510527/

Uncertainty looms over border-adjustment tax; but, broader tax cuts more certain

With the Republicans now in control of both houses of the Congress (House of Senate and House of Representative), a comprehensive tax reform is all but certain in America. Based on President Trump's tax proposals, we would watch out for two big tax reforms:

1. Reduction in the corporate tax rate to 15% or 20% from the current 35%
2. 'Border-adjustment' tax or as House Speaker Paul Ryan puts it – the "Better Way" tax reform

Border-adjustment tax – better for whom? The current income-tax regime in the US is based on "direct tax", which essentially means that companies can claim cost of goods sold (purchased or manufactured), SG&A, and other expenses – to get to taxable income, which is then subject to a blanket 35% corporate tax rate. This tax rate is the third-highest in the world (behind only Chad and UAE), and encourages US companies to move operations to lower tax destinations. With the objective of encouraging corporations to stay in the US, discouraging manufacturing from leaving the US, and raising additional tax revenue, House Speaker Paul Ryan introduced border-adjustment.

The current proposed border-tax will treat domestically produced inputs and imported inputs differently, and corporations would no longer be able to deduct the cost of imported goods from their taxable income. On the other hand, companies receive export subsidies as export-sales will be exempted from taxes. The US is the only country amongst the OECD nations that does not impose federal VAT leading to some advantage for importers over exporters. While this form of taxation could potentially curb imports, leading to dollar appreciation, it could also lead to higher investments and lesser offshoring as domestic income tax rates would be lower.

However, the disruptions to global supply chains will be unprecedented. Off shoring to on-shoring are rather long-gestation projects, but medium term trade disruptions will significantly dent global trade and growth. This tax scheme is very high-risk high-reward, as many economists point to a resultant higher inflation regime ensuing, without a commensurate increase in GDP growth – which would knell a *stagflation-type scenario* in the USA that would obviously be undesirable. However, we still wouldn't press the panic button just yet, as the details of this tax system are still under review and even President Trump has described it as "too complicated."

In his interactions with the media, President Trump has (several times) alluded to the imposition of VAT by other countries that puts US exporters in a disadvantageous position. He seems to prefer a simpler tariff on imports (probably a similar VAT structure, but VAT cannot be categorised as a tariff).

Proposed border-adjustment tax

What is border adjustment tax? (Simplified)

Current US corporate tax plan	Proposed House of GOP Border-Tax Adjustment
Worldwide profits	Domestic revenue - domestic costs
x 0.35	x 0.20
Taxes	Taxes

Source: PhillipCapital India Research

Proposed lower corporate tax rate

Heated Debate around Border Adjustment Tax

	The debate
Arguments for	1. Reduces incentives for US originated MNCs to move base abroad, outsource, and move business income to lower-tax destinations (transfer pricing) 2. Address US trade disadvantage under WTO rules. WTO allows adjustment for indirect taxes (e.g., VAT on sales) at borders, but not direct taxes 3. Reduction in US trade deficit, given expectations of larger US exports and lower US imports 4. Increase in tax revenues for treasury, if the revenue gained from import adjustments exceed losses due to export subsidies 5. Changes in US taxation (to consumption from production) may discourage consumption, leading to an eventual increase in household savings
Arguments against	1. Significant opposition from net importers such as major retailers, oil refiners, and auto companies 2. Increase in average household spend, especially for medium-to-lower income households that rely heavily on imported goods (think: cheap Chinese imports) 3. Opposition from the WTO, as it doesn't allow VAT rebates on corporate taxes 4. Any increase in demand of US goods could lead to dollar appreciation that is high enough to offset any potential gain in US competitiveness

Source: Peterson Institute of International Economics, PB 17-3 Border Tax Adjustments: Assessing Risks and Rewards by Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, January 2017

Border-tax potential scenarios: Our base-case assumes a partial border-adjustment with some exemptions

	Best Case	Base Case	Worst Case
Proposal	Hybrid VAT structure similar to other countries. COGS will be tax deductible but an import type tariff maybe imposed. Expect VAT to be in the range of 15%-25%	Partial border adjustment with exemption for certain critical items such as pharma	Trump supports the tax reform in its current form and goes ahead with it irrespective of WTO approval
Benefits	→ Puts US on the same stage as other OECD countries → Less likely to draw any opposition from the WTO → Easier policy to design and implement	→ Likely to attract less opposition than a complete border adjustment	→ US companies move manufacturing back to the US (unlikely and even if it does, it could take years for set up and reaping any potential benefits) → lower US trade deficit → Higher GDP growth, especially if dollar appreciates high enough to have no effect on inflation
Challenges	→ Another layer of taxation that will be undesirable → Still offers loopholes for US companies → Will not have the same effect politically	→ Adds more complexity → Most imports will still be expensive leading to some inflation (if dollar doesn't appreciate)	→ Likely to lead to some adverse reactions from major trading partners such as China → If dollar appreciation cannot offset the impact of higher prices of goods and services, inflation could rise faster than expected → Higher inflation with lower growth on lower consumption could lead to a "stagflation" in the world's largest economy

Source: PhillipCapital India Research

Impact on Indian markets: Based on the border-adjustment-tax discussions, we see some risks to Indian sectors that have higher exposure to US markets (IT, pharma, auto ancillaries). Here is a list of stocks in our coverage that are most vulnerable to these changes.

Stocks within PC coverage that have significant US export exposure and are most vulnerable to the proposed border-tax regime

Company	Sector	PC Reco	US exposure % of revenue (9MFY17)	Impact of tax on PL* FY19 EPS impact	Observation
Infosys	IT	BUY	62	20%	H1B to be increased to US$ 130000 fromUS$60000
TCS	IT	NEU	56	27%	H1B to be increased to US$ 130000 fromUS$60000
HCL Tech	IT	NEU	61	10%	H1B to be increased to US$ 130000 fromUS$60000
Tech Mahindra	IT	NEU	48	23%	H1B to be increased to US$ 130000 fromUS$60000
Wipro	IT	SELL	55		
Aurobindo Pharma	Pharma	BUY	48	2%	Sensitivity to import duty of 1%
Cadila Healthcare	Pharma	NEU	45	1%	Sensitivity to import duty of 1%
Cipla Ltd	Pharma	NEU	18	1%	Sensitivity to import duty of 1%
Divis Labs	Pharma	BUY	30	1%	Sensitivity to import duty of 1%
Dr Reddy's Lab	Pharma	SELL	51	3%	Sensitivity to import duty of 1%
Glenmark Pharma	Pharma	BUY	36	2%	Sensitivity to import duty of 1%
IPCA Labs	Pharma	NEU	4	0%	Import duty of 1%
Lupin	Pharma	BUY	43	2%	Import duty of 1%
Sun Pharma	Pharma	BUY	45	2%	Import duty of 1%
L&T	Cap Goods	NEU	6%	NA	L&T Infotech & Technology services effective share
KECI	Cap Goods	BUY	3%	Insignificant	SAE Towers USA, loss making
Thermax	Cap Goods	SELL	2%	Insignificant	Thermax INC USA
Cummins	Cap Goods	NEU	3%	Not very significant	
Tata Motors	Auto	NEU	20%	2%	Sensitivity to imposition of 1% import tax
Bharat Forge	Auto	NEU	25%	0.5%	Sensitivity to imposition of 1% import tax

Source: PhillipCapital India Research

Income taxes deep dive: Broadly, President Trump's tax plan aims to significantly slash income and corporate taxes, and eliminate estate taxes, with an objective to widen the tax base and boost the long-run economy. According to the Tax Foundation's report, "Details and Analysis of the Donald Trump Tax Reform Plan, September 2016" by Economist Alan Cole, major changes to the individual income tax include: (1) consolidating the current seven tax brackets to three with tax slabs of 12%, 25%, and 33%, (2) eliminating the net investment income tax, and (3) increasing the standard deduction for singles and married couples among other things. Key changes to corporate tax include: (1) reducing taxes to 15% from 35%, (2) eliminating corporate alternative-minimum tax, and (3) allowing firms manufacturing in the US to fully expense capital investments or deductibility of interest paid.

Cole also highlights that this plan has the potential to reduce federal revenue anywhere between US$ 4.4tn and US$ 5.9tn over the next decade, and after accounting for a larger economy and broader tax base, the ***net reduction in tax revenue would be between US$ 2.6tn and US$ 3.9tn***. However, the long-run benefits to the economy include a 6.9-8.2% increase in GDP at the end of a 10-year period (2016-2025). It also estimates 5.4-6.3% higher wages, an additional two million full-time equivalent jobs, and a 24% increase in capital stock. However, we acknowledge the limitation of this analysis, given that it does not take into account the fiscal or economic effects of the interest on debt nor does it require budgets to be balanced over the long term.

Return of manufacturing jobs, or currency wars?

Trump's trade policies have been heavily influenced by those of his economic advisors Wilbur Ross and Peter Navarro. Navarro is a Professor of Economics at UC Irvine and has authored books such as *Death by China,* in which he openly criticised China as a 'trade cheater' and 'currency manipulator'. Wilbur Ross, the billionaire 'King of Bankruptcy' has vehemently supported Navarro's views and is frequently called for quick action against poorly negotiated US trade deals. President Trump recently named Navarro the director of a newly created National Trade Council, serving within the executive branch of the US federal government.

Navarro-Ross' trade plan: In their September 2016 Economic Plan, the co-authors built on Alen Cole's base-case that federal revenue will reduce by US$ 2.6tn (highlighted above) and propose that comprehensive trade, regulatory, and energy reforms will actually translate into a conservative revenue-neutral scenario as described below.

Expected increase in federal tax revenues from policy reforms

	Cumulative federal tax revenue increases (2017-2026, Nominal US$, tn)
Trade Policy Reforms	1.740
Regulatory Policy Reforms	0.487
Energy Policy Reforms	0.147
Total	**2.374**

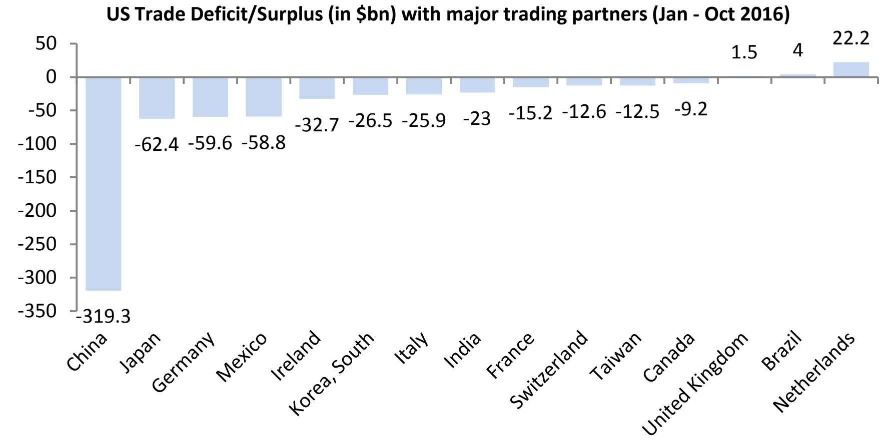
Source: Scoring the Trump Economic Plan: Trade, Regulatory, & Energy Policy Impacts, by Peter Navarro and Wilbur Ross

According to their analysis, the US$ 2.37tn of additional revenue, when combined with the spending cuts, will offset the reduction of US$ 2.6tn from tax cuts; but, a large part of this (US$ 1.74tn) hinges on trade-policy reforms over the next decade. They plan to achieve these additional benefits by: (a) bringing back manufacturing jobs, and (b) taking coercive action (if necessary) to reduce trade deficit with major trading partners. According to the National Association of Manufacturers (NAM), "For every one worker in manufacturing, there are another four employees hired elsewhere." In addition, "For every dollar spent in manufacturing, another US$ 1.81 is added to the economy", creating the highest multiplier effect.

On trade deficit, Trump's advisors have recommended taking on currency manipulators, countries that engage in unfair trade practices, and renegotiating bad deals. They advise using the Treasury Department to brand any country than manipulates its currency a "currency manipulator" and impose defensive/countervailing tariffs if such manipulation is not reversed. For countries engaging in unfair trade practices (sweat shops, pollution havens), they have suggested using tariffs as a negotiating tool. If these don't work, they recommend imposing appropriate defensive tariffs as a punitive measure. Finally, Trump has also pledged to renegotiate any trade deal that does not increase US GDP growth, reduces the trade deficit, and strengthens the US manufacturing base.

While several economists have offered opposing views to Peter Navarro's plan, we note that Trump's comments so far have been in line with his views. Hence, any action by President Trump in this direction will obviously not bode well for countries that have a history of running a trade deficit with the US (China, Japan, Germany, Mexico, South Korea). The seriousness of trade actions by the US can be evaluated from the fact that during his campaign, Trump frequently said that he would impose 45% tariff on Chinese-made goods in response to China's alleged currency manipulations and a 35% tariff on Mexican-made goods. He also withdrew from the Trans-Pacific Partnership (Trade pact signed by 12 countries in 2015, the terms of which were promoted by Washington itself under Obama's rule) within the first week of his presidency. He has also expressed his intent to renegotiate the North American Free Trade Agreement (NAFTA – signed by USA, Mexico, and Canada, to create a free trade zone in North America) and the South Korean deal signed by Hillary Clinton in 2012.

US trade deficit with top trading partners (in USD bn)



Source: United States Census Bureau

Impact on India: We think India is relatively immune to targeted trade actions from the US, given its more service-oriented exports. However, the largest goods that India exports to the US (precious stones, pharma, textiles) are likely to see some topline headwinds (reduced demand).

India's top exports to the US (in $mn)

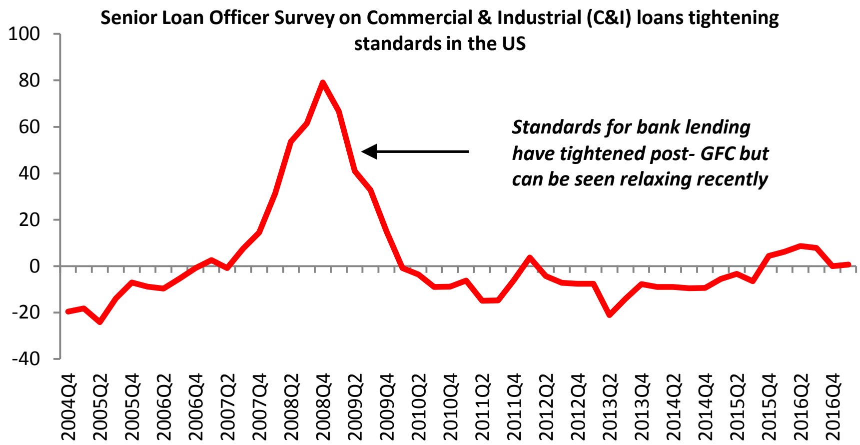
	2015-16	% of Total
Precious Stones	8,673.33	21.5%
Pharmaceutical Products	5,026.46	12.5%
Miscellaneous Textile Articles	6,151.84	15.3%
Mineral Fuel (oil)	2,073.04	5.1%
Electrical & Other Machinery	3,264.04	8.1%
Organic Chemicals	1,413.41	3.5%
Articles of Iron or Steel	1,232.58	3.1%

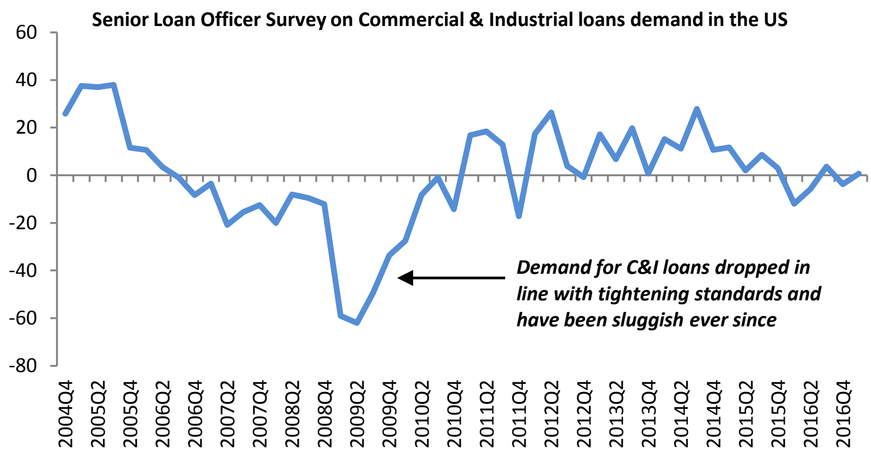
Source: Ministry of Commerce & Industry

Dodd-Frank modifications – Bankers delighted, but Democrats unhappy

A key aspect of Trump's campaign has been his focus on dismantling the Dodd-Frank act in its current form; hence, not surprisingly, on Friday, February 3rd 2017, President Trump signed an executive order instructing agencies to begin work on loosening regulations. The Dodd-Frank Wall Street Reform and Consumer Protection Act (commonly known as Dodd-Frank) was signed into Federal law by the Obama administration in 2010, in response to the financial meltdown seen in the 2007-08 Great Financial Crisis. While a complete repeal of the act is very unlikely, Wall Street lobbyists have been focusing their efforts on the repeal of the Volcker rule that prevents banks from making speculative trades on their own books and curbing the power of the Consumer Financial Protection Bureau. Banks have frequently argued that the excessive regulatory burden from this act has led to limited credit growth in the post financial crisis era, which has in turn has led to potential losses in job creation, as businesses looking for loans aren't able to get them. President Trump has described this act as a "disaster" and recently promised, "We're going to be doing a big number on Dodd-Frank."

Senior Loan Officers Survey in the US support Trump's claims on negative effect of tightening standards on commercial loan activity





Source: Senior Loan Officer Opinion Survey on Bank Lending Practices, https://www.federalreserve.gov/boarddocs/SnloanSurvey/

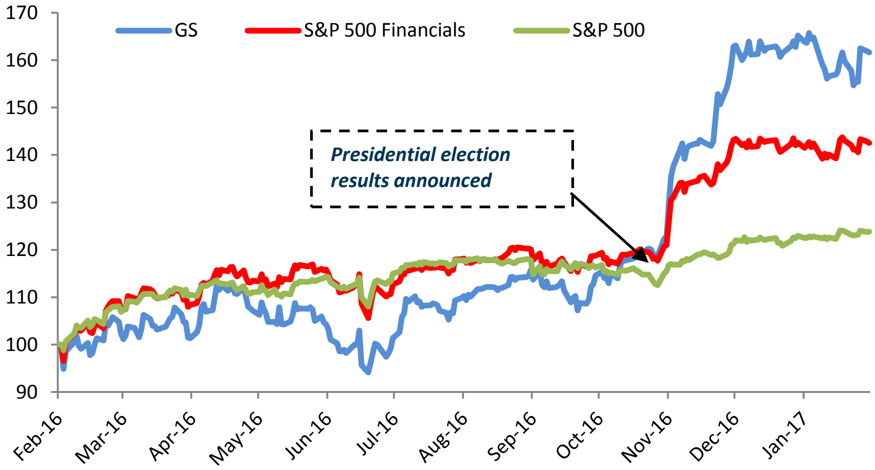
A look at Trump's cabinet composition is indicative that Wall Street reforms may come in sooner rather than later. Gary Cohn, ex-president of Goldman Sachs, and now Trump's director of the National Economic Council, recently commented that post-crisis capital levels in banks were enough to withstand big shocks, reflecting his loosening bias. Other notable Wall Street bankers that form part of Trump's administration include Treasury Secretary Steve Mnuchin (former Goldman Sachs Trader and Chairman of OneWest Bank), Stephen Bannon and Anthony Scaramucci, both ex-Goldman investment bankers, and Dina Powell, former president of Goldman's charitable foundation.

However, economic experts and Democrats remain strongly opposed to the proposition of any changes to the Dodd-Frank, given that these changes threaten the interests of the minority shareholders for whom the act was created in the first place. While changes to Dodd-Frank could happen at a pace faster and easier than the proposed Obamacare repeal, we think President Trump will be very careful in choosing his next steps, as any benefits to Wall Street that are detrimental to minority shareholders will be perceived as against the 'anti-elite' theme that won him the election.

US Banks best positioned to benefit: Look for spill over effects on commodity prices

The expectation of lower tax rates, higher interest rates, and loosening financial regulations has created a favourable environment for the US financials sector – the S&P 500 Financials has rallied 12% since the November 2016 election results. While the path for financials outperformance/recovery is unclear, we think it's noteworthy the potential impact on a further recovery in commodity prices. Increased availability of capital combined with Trump's focus on fiscal spending, especially on infrastructure, could kick-start an investment cycle in the US, in our view. This investment cycle would be a key positive for broader commodity prices, which we imagine could see another rally, given that banks would also have the ability to hedge positions in their proprietary books (i.e., if the Volker rule is repealed).

GS, S&P 500, and S&P 500 Financial performance since the November 2016 elections (rebased to 100)



Source: Bloomberg

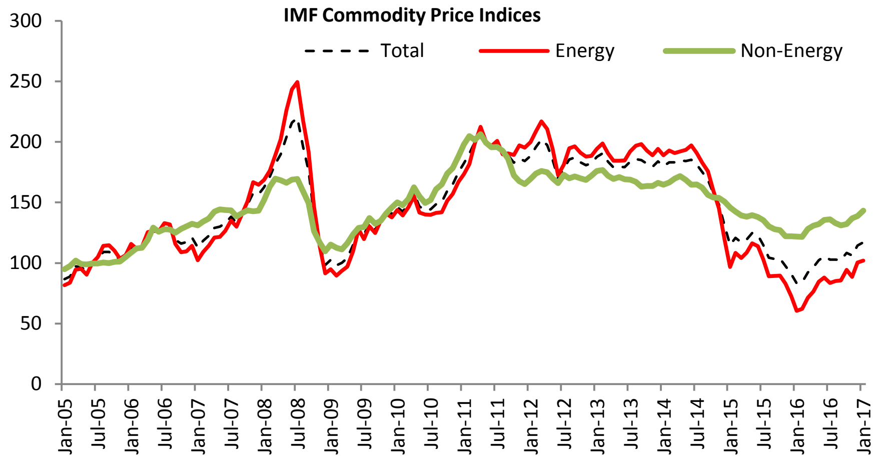
Of course, it is impossible to make any arguments about future commodity prices without taking into consideration the impact of interest rates. Historically, there has been a strong negative correlation between interest rates and commodity prices, so expectations of a rise in commodity prices are negated by expectations of Fed rate hikes (Fed Chair Yellen also recently indicated that the Fed will consider raising rates in coming months). We think the distinction between 'nominal' and 'real' interest rates is the key here. Rising interest rates, because of an overheated economy and rising expectations of inflation, would be considered nominal rather than real. With US inflation expectations at their highest level since 2016, we could consider rate hikes by the Fed as nominal in nature, and hence, any impact on commodity prices will not be that straightforward.

US 5-year, 5-year-forward inflation expectation rate

Source: Federal Reserve Bank of St. Louis

Against this backdrop, we focus more on broader economic growth and commodity-specific demand-supply factors as important drivers of commodity prices, rather than real interest rates. With global growth expectations rising, fiscal spending in the US picking up, and overcapacity in most commodities bottoming out, we believe Dodd-Frank modifications could serve as a trigger for more capital availability, driving a favourable demand-supply dynamic for a further rally in commodity prices. Stocks positioned to benefit: Hindalco, Vedanta, and Tata Steel.

US fiscal spending and Dodd-Frank modifications could fuel another rally in commodity prices



Source: IMF, Bloomberg

Model portfolio

In light of the possible changes in US tax and regulatory policies, we reduce our weights in the pharmaceutical sector. We also delete Praj Industries from our Model Portfolio because of the changes in management.

We add commodity plays Vedanta and JSW Steel.

Model portfolio

Company	Weight	EPS (Rs)			EPS Growth (%)			P/E (x)		
Company	**Weight**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**	**FY16**	**FY17E**	**FY18E**
FMCG	**10.0%**									
HUL	2.0%	18.9	19.4	22.1	4%	2%	14%	45	44	39
Colgate Palmolive India Ltd	2.0%	22.3	22.1	25.5	9%	-1%	15%	39.5	40.0	34.6
ITC	6.0%	7.8	8.6	9.6	2%	10%	11%	34.6	31.5	28.3
Automobile	**8.5%**									
Maruti	3.0%	151.3	243.2	273.1	23%	61%	12%	38.9	24.2	21.6
Tata motors	3.0%	34.3	48.7	71.6	-21%	42%	47%	12.8	9.1	6.2
Bajaj Auto	2.5%	126.2	137.3	159.3	16%	9%	16%	22.2	20.4	17.6
IT	**6.0%**									
Infy	6.0%	59.0	63.2	71.9	9%	7%	14%	16.9	15.8	13.8
Pharmaceuticals	**6.0%**									
Sun Pharma	4.0%	24.1	29.7	34.3	12%	24%	15%	26.0	21.1	18.2
Aurobindo	2.0%	35.0	42.5	51.2	24%	21%	20%	18.2	15.0	12.5
Cement	**4.0%**									
Ultratech	3.0%	83.3	104.5	108.3	9%	25%	4%	43.7	34.9	33.6
Dalmia Bharat	1.0%	21.5	59.1	65.8	25%	175%	11%	17.9	6.5	5.9
Metals , Mining & Utilities	**12.3%**									
Tata Steel	3.0%	9.5	36.2	66.6	-	279%	84%	48.7	12.8	7.0
JSW Steel	2.0%	6	15	18	-25%	160%	24%	32	12	10
Hindalco	2.0%	3.8	14.6	16.2	-72%	285%	12%	48.9	12.7	11.4
NTPC	3.3%	12.4	12.1	13.6	21%	-2%	12%	13.7	14.0	12.5
Vedanta	2.0%	10.6	16.3	22.5	4%	54%	38%	23.7	15.4	11.1
Industrial	**4.0%**									
L&T	2.0%	44.9	62.1	72.1	-5%	38%	16%	33.0	23.9	20.6
NCC	2.0%	4.3	5.0	6.7	112%	17%	33%	19.0	16.2	12.1
Finance	**33.3%**									
Axis bank	4.0%	34.5	12.7	18.9	11%	-63%	49%	14.2	38.6	26.0
IndusInd bank	3.0%	38.4	49.7	64.0	13%	29%	29%	34.3	26.5	20.6
SBI	4.5%	14.9	5.0	11.8	-35%	-66%	136%	18.5	55.1	23.3
Cholamadalam Fin	2.5%	36.4	47.9	63.9	20%	32%	33%	27.3	20.7	15.5
HDFC Ltd	5.0%	44.9	46.6	51.3	16%	4%	10%	31.1	30.0	27.2
LIC Housing Finance	2.0%	32.9	38.9	46.4	20%	18%	19%	16.7	14.2	11.9
HDFC bank	6.0%	48.6	58.0	69.5	19%	19%	20%	27.2	22.8	19.0
ICICI Bank	6.3%	16.7	14.6	12.2	-13%	-13%	-16%	16.8	19.3	23.0
Oil & Gas	**5.0%**									
Reliance Industries	5.0%	92.3	96.3	78.3	15%	4%	-19%	11.4	10.9	13.5
Telecom & Media	**9.5%**									
Bharti Infratel	2.0%	12.6	14.3	15.4	19%	13%	8%	25.7	22.7	20.9
Bharti Airtel	3.0%	9.8	9.4	14.4	-35%	-4%	54%	37.1	38.7	25.2
Dish TV	2.0%	6.6	2.6	3.6	-	-61%	41%	13.0	33.7	23.9
Zee Entertainment	2.5%	9.5	11.2	15.9	10%	18%	42%	54.4	46.1	32.5
Others	**1.5%**									
Tata Comm	1.5%	8	5	14	105%	-36%	177%	95.9	149.0	53.8

Source: PhillipCapital India Research Estimates

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15	Target price is equal to or more than 15 of current market price
NEUTRAL	-15 > to < +15	Target price is less than +15 but more than -15
SELL	<= -15	Target price is less than or equal to -15.

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