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CANARA ROBECO Mutual Fund

RBI Policy Update

October 05, 2018

An assessment of RBI's 4th Bi-monthly Monetary Policy Statement, FY 2018-19

RBI's Policy Stance:

Surprising markets and against consensus, the MPC decided to keep the policy rates unchanged, though the stance was changed to "calibrated tightening". **The MPC reiterated its commitment to achieve the medium-term target for headline inflation of 4% while supporting growth and decided to**:

- **repo rate unchanged at 6.50%** under the liquidity adjustment facility;
- accordingly, keep the reverse repo rate under the LAF unchanged to **6.25%** and the Marginal Standing Facility (MSF) rate to **6.75%**

Variable	Stands at
Repo	6.50%
Reverse Repo	6.25%
CRR	4.00%
MSF	6.75%
SLR	19.50%

Source: www.rbi.org.in

Policy Stance & Rationale:

- The Monetary Policy Committee (MPC) voted 5-1 to remain status quo, which was against market expectations considering pressure on the rupee and kept the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.5%. Consequently, the reverse repo rate remained at 6.25%, and the marginal standing facility (MSF) rate and the Bank Rate at 6.75%. The monetary policy committee took note of decline in retail CPI inflation on the back of declining food price, which became the focal point for the rate decision.

- On the global front, activities related to the emerging economies continued to face headwinds on the back of global as well as country specific factors with growth in global trade weakening due to drop in export orders. Crude oil prices eased during the first half of August on concerns of reduced demand from EMEs due mainly to the spill-over from country-specific turmoil and accentuated by rising supplies. In the US, inflation remained firm reflecting tightening labour market and elevated energy prices, while it persisted much below the central bank's target in Japan. In the Euro area, inflation pressures have been sustained by elevated crude prices. Inflation in key EMEs remained impacted due to surge in crude prices and currency depreciations, caused by a firm dollar and domestic factors.

- On the advanced economy front, uncertainties continued to remain intact affected majorly by monetary policy stance. The US 10-year Treasury traded sideways, falling on dovish Fed guidance which is expected to improve on robust economic data. Among other advanced economies, bond yields in the Euro area hardened in Sept'18 on risk aversion following the sharp rise in financial market volatility in the last month. However, bond yields in Japan moved in a narrow range, driven by the central bank's yield curve management policy. In most EMEs, yields rose due to domestic factors and/or contagion effects from the stress in other EMEs.

- On the domestic front, MPC noted the improvement in economic growth on the back of increase in private final consumption expenditure which was accelerated to 8.6%, reflecting rising rural and urban spending, supported by retail credit growth. In addition, the growth of exports of goods and services jumped to 12.7%, powered by non-oil exports on the back of strong global demand. On the supply side, GVA at basic prices accelerated in Q1FY19 amidst expansion in manufacturing activity including the enhancement in agricultural growth, supported by improved production of rice, pulses and coarse cereals.

- Retail inflation eased significantly majorly due to reduction in food inflation. Prices of food and beverages group declined sharply in the absence of seasonal uptick in prices of fruits and vegetables. Substantial softening of inflation in items other than food and fuel also contributed to the decline. Inflation in the fuel and light group continued to rise on the back of a significant increase in liquefied petroleum gas prices, tracking international product prices.

- The central bank also highlighted the contrast in nature of the low by FDI and FPIs. While FPIs are getting jittery over the short term economic performance of Indian. FDI believes that the long-term story of Indian market is here to stay. By contrast, foreign portfolio investors have been net sellers amidst higher US interest rates, risk-off sentiment in EMEs and escalation of trade wars.

Outlook:

- The Monetary policy repeated its commitment in achieving the medium-term target for headline inflation of 4% on a durable basis. The MPC highlighted risks in near term arising from volatile international trade, rising crude oil prices and increase in minimum support prices (MSPs).

- Global headwinds in the form of escalating trade tensions, volatile and rising oil prices, and tightening of global financial conditions pose substantial risks to the growth and inflation outlook of the country and is expected to keep the rupee movement under check.

- Improving capacity utilisation, larger FDI inflows and increased financial resources to the corporate sector augur well for investment activity and with private consumption remaining robust which is likely to be sustained even with oil prices rise are factors that have helped RBI retain the GDP growth estimated at 7.4% in FY 19 and the economic growth accelerated to 7.6% in FY20. Going forwards, this could benefit the economy and increase confidence among market participants.

- Rising crude oil prices and other input costs may also drag down investment activity and could impact the profit margins of corporates. In addition, depreciating rupee and trade related conflict could impact the export growth which could lead to a further widening of India's CAD in FY19.

- With the MPC maintaining the status quo, it projected Retail inflation at 4.6% in Q2FY19, 4.8% in H2FY19 and 5.0% in Q1FY20, with risks evenly balanced. Going forward, inflation trajectory could be impacted by factors such as food price due to uneven rainfall, volatile crude price, depreciating EM currency and dissipating effect of HRA.

- The Government has announced a sharp decrease in H2 borrowing program. On the other hand, RBI announced OMO calendar for the month of October worth Rs 36,000 cr which has helped to support the yields. Post policy market rallied as the rate hike did not materialise. In the short term 10Y yield is expected to remain rangebound. We believe it will be difficult for the yields bond to breech 8.50% and sustain in an environment where INR is deprecating, and crude is rising. Hence, it presents the investors with a good opportunity to invest at such levels.