RBI's Fifth Bi-Monthly Monetary Policy Review (2018-19)

05 Dec 2018

Keeps Interest rates unchanged.. Stance: Calibrated Tightening

RBI cuts SLR by 25 basis points starting January 2019 quarter.

MPC retains FY19 GDP growth projection at 7.4 percent

- MPC keeps repo rate unchanged at 6.5%.
- The reverse repo rate stands unchanged at 6.25%.
- The rate for Marginal Standing Facility stands at 6.75%.
- MPC keeps stance at 'calibrated tightening'.
- MPC votes 6-0 to keep repo rate on hold.
- RBI cuts SLR by 25 basis points starting January 2019 quarter.
- SLR is to be brought down to 18%.
- The cut in SLR is to happen in a phased manner.
- MPC retains FY19 GDP growth projection at 7.4 percent
- MPC pegs H1 FY20 inflation at 3.8-4.2 percent
- MPC cuts H2 FY19 inflation forecast to 2.7-3.2 percent from 3.9-4.5 percent earlier
- MPC voted 5-1 to keep stance at 'calibrated tightening'; Dholakia voted for neutral stance
- CRR has remained unchanged at 4%.
- Although, MPC maintained their growth forecast for FY19 at 7.4% YoY, we estimated it a bit lower at 7.2% YoY, mainly due to moderation in private consumption. Private consumption slowed down possibly on account of moderation in rural demand, subdued growth in kharif output, depressed prices of agricultural commodities and sluggish growth in rural wages.
- So, we believe if food inflation do not increase, growth decelerate and Fed lowers its hawkish stance (as indicated by fed president Powell), given the decline in commodity prices which may lower inflation in U.S., RBI may give a soft stance in its next policy meeting.

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India's GDP Story

However, growth in government final consumption expenditure (GFCE) strengthened, buoyed by higher spending by the Central Government.

India's GDP growth slowed down to 7.1% YoY in Q2of FY19, weighed down by moderation in private consumption and a large drag from net exports. Private consumption slowed down possibly on account of moderation in rural demand, subdued growth in kharif output, depressed prices of agricultural commodities and sluggish growth in rural wages. However, growth in government final consumption expenditure (GFCE) strengthened, buoyed by higher spending by the Central Government. Gross fixed capital formation (GFCF) expanded by double-digits for the third consecutive quarter, driven mainly by the public sector's investment on national highways and rural infrastructure, which was also reflected in robust growth in cement production and steel consumption. Growth of imports accelerated at a much faster pace than that of exports, resulting in net exports pulling down aggregate demand. On the supply side, GVA growth too decelerated to 6.9% YoY in Q2, reflecting moderation in agricultural and industrial activities. Slowdown in agricultural GVA was largely the outcome of tepid growth in kharif production. Within industry, growth in manufacturing decelerated due to lower profitability of manufacturing firms, pulled down largely by a rise in input costs, while that in mining and quarrying turned negative, caused by a contraction in output of crude oil and natural gas. Growth in electricity, gas, water supply and other utility services strengthened. Services sector growth remained unchanged at the previous quarter's level. Growth in public administration and defence services accelerated sharply.

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Outlook: According to MOC, going forward, lower rabi sowing may adversely affect agriculture and hence rural demand. Financial market volatility, slowing global demand and rising trade tensions pose negative risk to exports. However, on the positive side, the decline in crude oil prices is expected to boost India's growth prospects by improving corporate earnings and raising private consumption through higher disposable incomes. Increased capacity utilization in the manufacturing sector also portends well for new capacity additions. There has been significant acceleration in investment activity and high frequency indicators suggest that it is likely to be sustained. Credit off take from the banking sector has continued to strengthen even as global financial conditions have tightened. FDI flows could also increase with the improving prospects of the external sector. The demand outlook as reported by firms polled in the Reserve Bank's IOS has improved in Q4. As a whole, GDP growth for FY19 has been projected at 7.4% YoY (7.2-7.3% in H2) same as in the October policy, and for H1 of FY20 at 7.5% YoY, with downside risk.

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Inflation update

India's CPI inflation declined from 3.7% YoY in September to 3.3% YoY in October. A large fall in food prices pushed food group into deflation and more than offset the increase in inflation in items excluding food and fuel. Within the food and beverages group, deflation in vegetables, pulses and sugar deepened in October. Among other items, there was a broad-based softening across food items, especially cereals, milk, fruits and prepared meals. Inflation, however, showed an uptick in meat and fish, and non-alcoholic beverages. Inflation in the fuel and light group remained elevated, driven by liquefied petroleum gas prices in October, tracking international petroleum product prices.

CPI inflation excluding food and fuel accelerated to 6.1% YoY in October; adjusted for the estimated HRA impact, it was 5.9% YoY. Transport and communication registered a marked increase, pulled up by higher petroleum product prices, transportation fares and prices of automobiles. A broad-based increase was also observed in health, household goods and services, and personal care and effects. However, inflation moderated significantly in clothing and footwear, as also housing on waning of the HRA impact of central government employees.

Outlook: According to MPC, there have been several important developments since the October policy which will have a bearing on the inflation outlook. First, food group is slipping into deflation. At a disaggregated level, deflation in pulses, vegetables and sugar widened, while cereals inflation moderated sequentially. The broad-based weakening of food prices imparts downward bias to the headline inflation trajectory, going forward.

Secondly, in contrast to the food group, there has been a broad-based increase in inflation in non-food groups.

Thirdly, international crude oil prices have declined sharply; the price of Indian crude basket collapsed to below US$60 a barrel by end-November after touching US$85 a barrel in early October. However, selling prices, as reported by firms polled in the Reserve Bank's latest IOS, are expected to edge up further in Q4 on the back of increased demand.

Fourthly, global financial markets have continued to be volatile with EME currencies showing a somewhat appreciating bias in the last one month.

Finally, the effect of the 7th Central Pay Commission's HRA increase has continued to wane along expected lines. Taking all these factors into consideration and assuming a normal monsoon in 2019, MPC projected that inflation will be at 2.7-3.2% YoY in H2 of FY19 and 3.8-4.2% YoY in H1 of FY20, with an upside risks.

Key Notes from Monetary Policy

- Since the last MPC meeting in October 2018, global economic activity has shown increasing signs of weakness on rising trade tensions. Among advanced economies (AEs), economic activity appears to be slowing in the US in Q4:2018, after a buoyant Q3. The Euro area growth lost pace in Q3, impacted by weaker trade growth and new vehicle emission standards. The Japanese economy contracted in Q3 on subdued external and domestic demand.

- Crude oil prices have declined sharply, reflecting higher supplies and easing of geo-political tensions. Base metal prices have continued to decline on selling pressure following weak demand from major economies. Gold price has risen underpinned by safe haven demand triggered by political uncertainty in some geographies, though a strong dollar may stem the rise. The inflation scenario has remained broadly unchanged in the US and the Euro area. In many key EMEs, however, inflation has risen, though the recent retreat in energy prices, tightening of policy stances by central banks and stabilizing of currencies may have a salutary impact, going forward.

- Retail inflation, measured by y-o-y change in CPI, declined from 3.7 per cent in September to 3.3 per cent in October. A large fall in food prices pushed food group into deflation and more than offset the increase in inflation in items excluding food and fuel. Adjusting for the estimated impact of an increase in house rent allowance (HRA) for central government employees, headline inflation was 3.1 per cent in October.

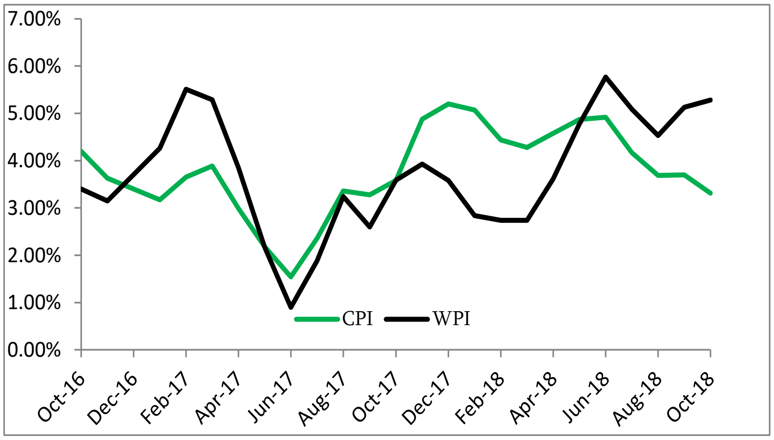
- Inflation in the fuel and light group remained elevated, driven by liquefied petroleum gas prices in October, tracking international petroleum product prices. Kerosene prices also edged up, reflecting the calibrated increase in their administered price. However, electricity prices softened in October. Inflation in rural fuel items such as firewood and chips and dung cake also moderated.

- In the fourth bi-monthly resolution of October 2018, CPI inflation was projected at 4.0 per cent in Q2:2018-19, 3.9-4.5 per cent in H2 and 4.8 per cent in Q1:2019-20, with risks somewhat to the upside. Excluding the HRA impact, CPI inflation was projected at 3.7 per cent in Q2:2018-19, 3.8-4.5 per cent in H2 and 4.8 per cent in Q1:2019-20. The actual inflation outcome in Q2 at 3.9 per cent was marginally lower than the projection of 4.0 per cent. However, the October inflation print at 3.3 per cent turned out to be unexpectedly low.

- India's merchandise exports rebounded in October 2018, after moderating in the previous month, driven mainly by petroleum products, engineering goods, chemicals, electronics, readymade garments, and gems and jewellery. Imports also grew at a faster pace in October relative to the previous month, contributed mainly by petroleum products and electronic goods. Consequently, the trade deficit widened in October 2018 sequentially as also in comparison with the level a year ago. Provisional data suggest a modest improvement in net exports of services in Q2:2018-19, which augurs well for the current account balance. On the financing side, net FDI flows moderated in April-September 2018. Portfolio flows turned positive in November on account of a sharp decline in oil prices, indications of a less hawkish stance by the US Fed and a softer US dollar. However, during the year, there were net portfolio outflows of US$ 14.8 billion (up to November 30). Non-resident deposits

Indian Government 10 Year Bond Yield

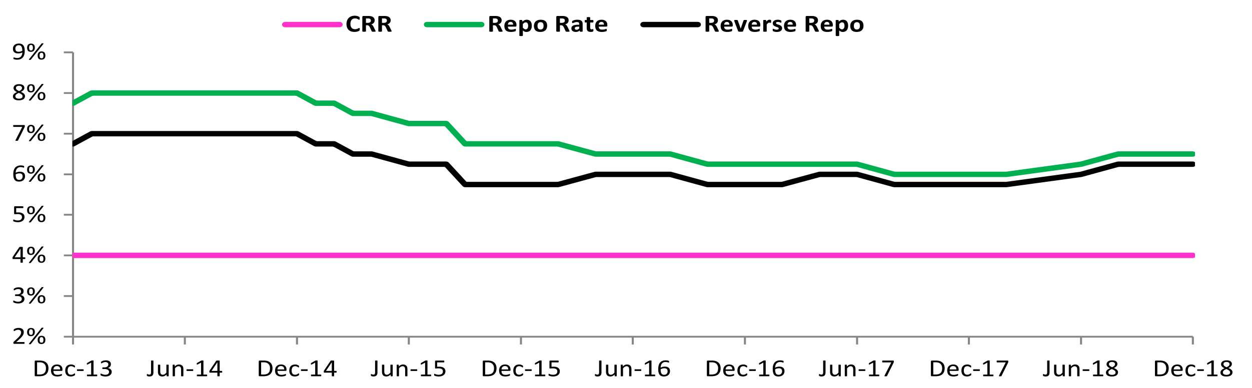
India's CPI and WPI Trend



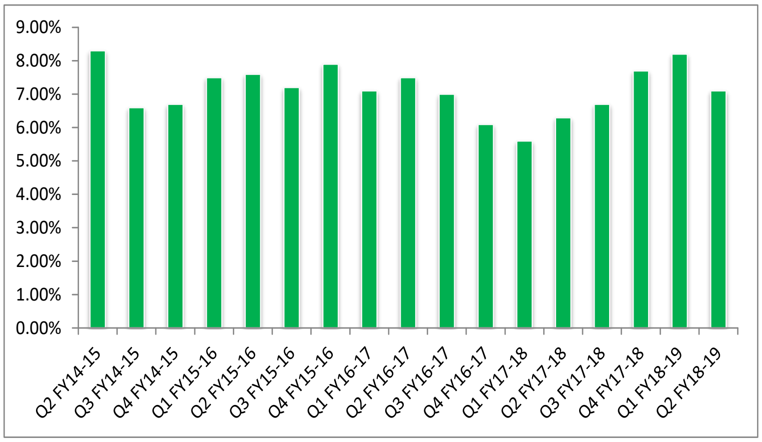
Key Quotes by MPC

- Risks to the revised inflation forecast titled to upside, although recent prints have surprised on the downside.
- Retained stance of calibrated tightening to buy time to pause , reflect and undertake future policy action with more robust inflation signals.
- Expect increased frequency and quantum of OMO to last till March.
- Intend to conduct additional long term repo operations to meet transient liquidity demand arising from third tranche of advance tax outgo.

RBI's Monetary Policy Stance

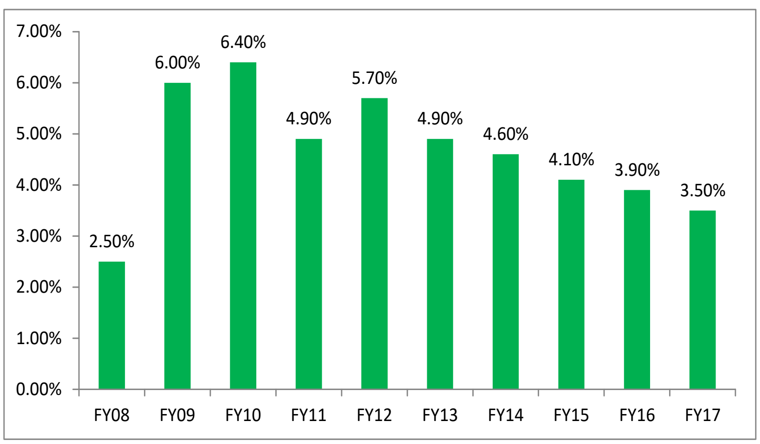


India's GDP Growth Trend

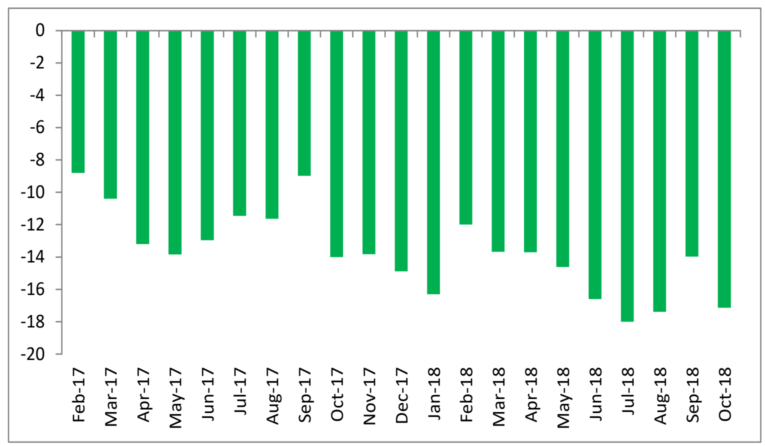


INR Vs US Dollar

India's Fiscal Deficit Trend

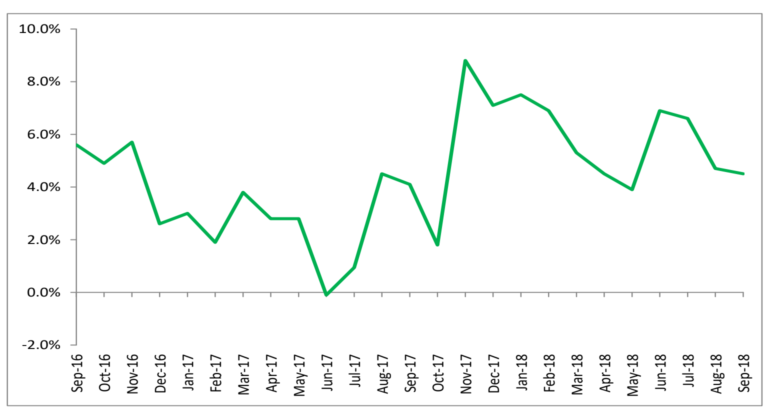


India's Trade Deficit Trend



Brent Crude Price Trend (In $/bbl)

India's Industrial Production Trend



Source: RBI, Bloomberg, SMIFS Research

Market Impact

The market had been anticipating the RBI to hold rates and things have turned out as per expectations.

MPC decision to bring down SLR from 19.5% to 18% in a phased manner by reducing 25 bps from January—March quarter will be positive for the markets specially for banks & NBFC, as it would improve the current liquidity crunch which is going on in the economy.

The halt in rate hike by the RBI, will bring in positive cheer for the Banks, NBFC & Auto Industry. Currently the auto industry is facing a de growth across all categories due to rise in costs led by rising interest rates and insurance costs.

This move by the RBI will bring in some relief for the auto industry and the NBFC space which is facing liquidity crisis.

Intraday Indian Government 10Y Bond Yield Chart

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Stock Recommendation	Expected absolute returns (%) over 12 months
Strong Buy	>20%
Buy	between 12% and 20%
Accumulate	between 6% and 12%
Hold	between 0% and 6%
Sell	0 to <-10%
Neutral	No Rating
Stock Recommendation	Expected absolute returns (%) over 12 months

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