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Rates and Credit Research



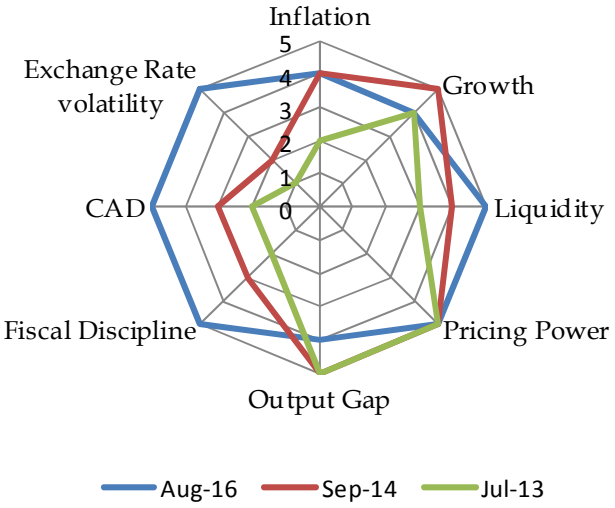
August RBI Monetary Policy Preview

August 6, 2016

RBI Dashboard

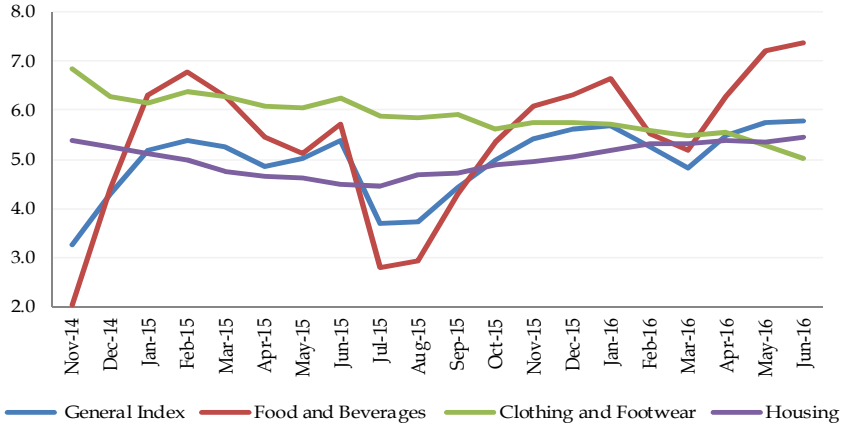
- RBI's objectives as set out in Urjit Patel Committee Report:
  - Headline CPI - nominal anchor for policy communication.
    - Target: 4% with a band of +/- 2% tolerance
  - Monetary Policy Committee (MPC) vested with Monetary Policy decision
    - Policy rule defined in terms of a real policy rate that is expected to be positive when inflation is above nominal anchor
    - Monetary policy to be consistent with sustainable growth and financial stability
  - Stable exchange rate with minimal volatility
- In assessing these objectives the RBI has and will continue to focus on certain key variables:

Note: Scale 1-5 refer to conditions for monetary easing, 5 being most favorable

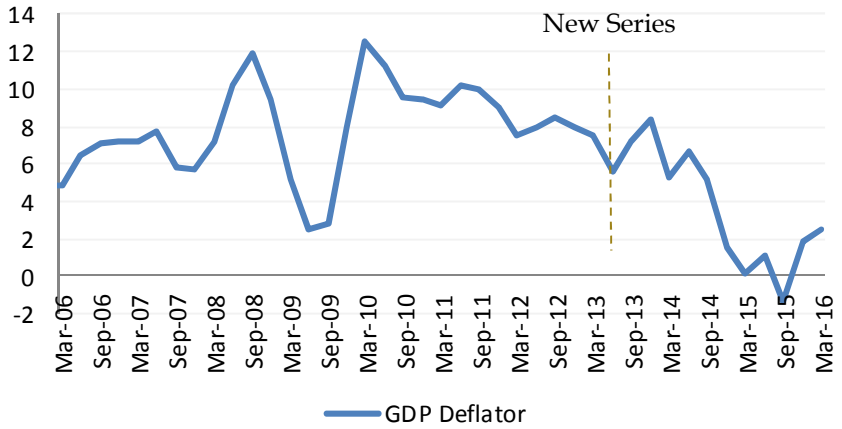


Inflation Picture: Within RBI trajectory

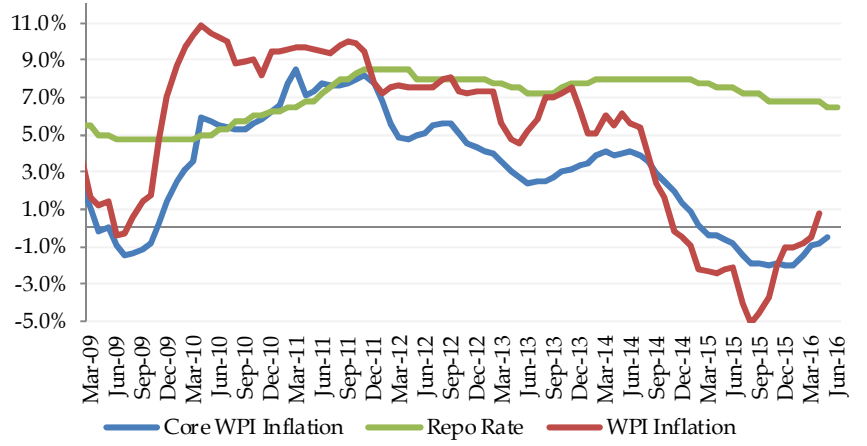
India CPI



GDP Deflator



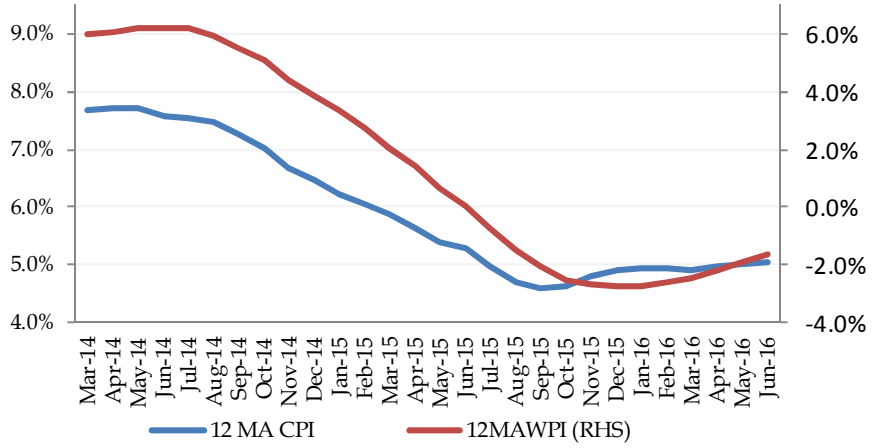
WPI and Repo Rate



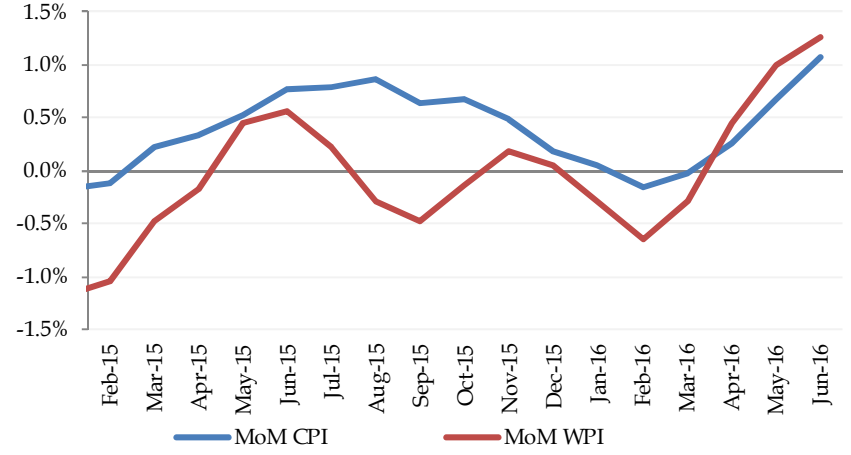
- Despite some recent upticks, CPI inflation remains within RBI's medium term trajectory
- The spread between the WPI inflation rate and the policy interest rate remains very high
- Key drivers of inflation have also subsided. Pulse prices which were the main drivers of the recent upticks have remained flat for the last six months and agricultural productivity has improved over the last several years.
- Going forward, we expect inflation pressures to continue to ease in the medium term helped by the removal of supply side constraints and a normal monsoon

Inflation Picture: Gradual move down over time

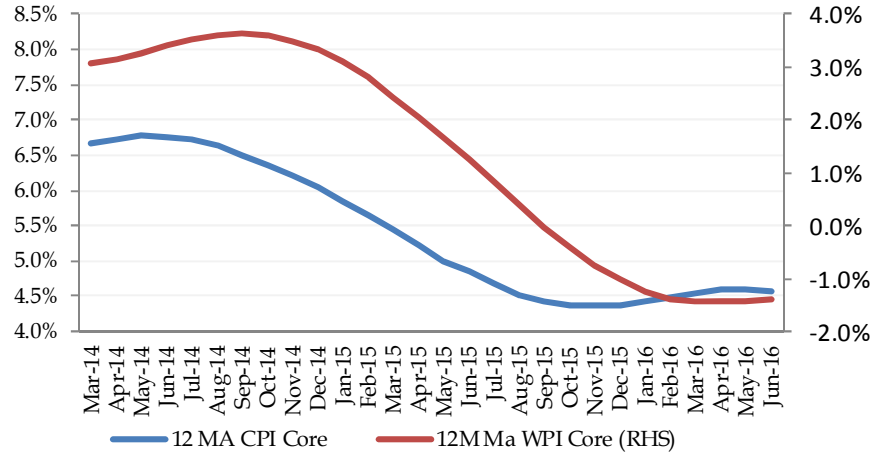
Twelve Month Moving Average Headline Inflation



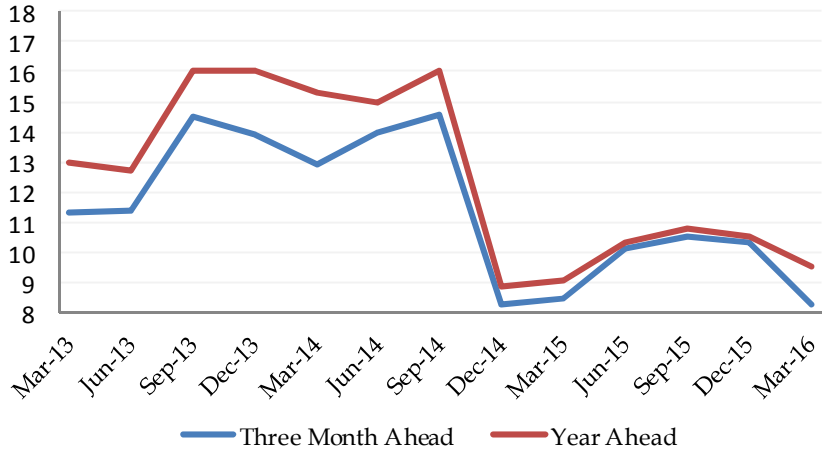
Three Month Moving Average MoM Inflation



Twelve Month Moving Average Core Inflation

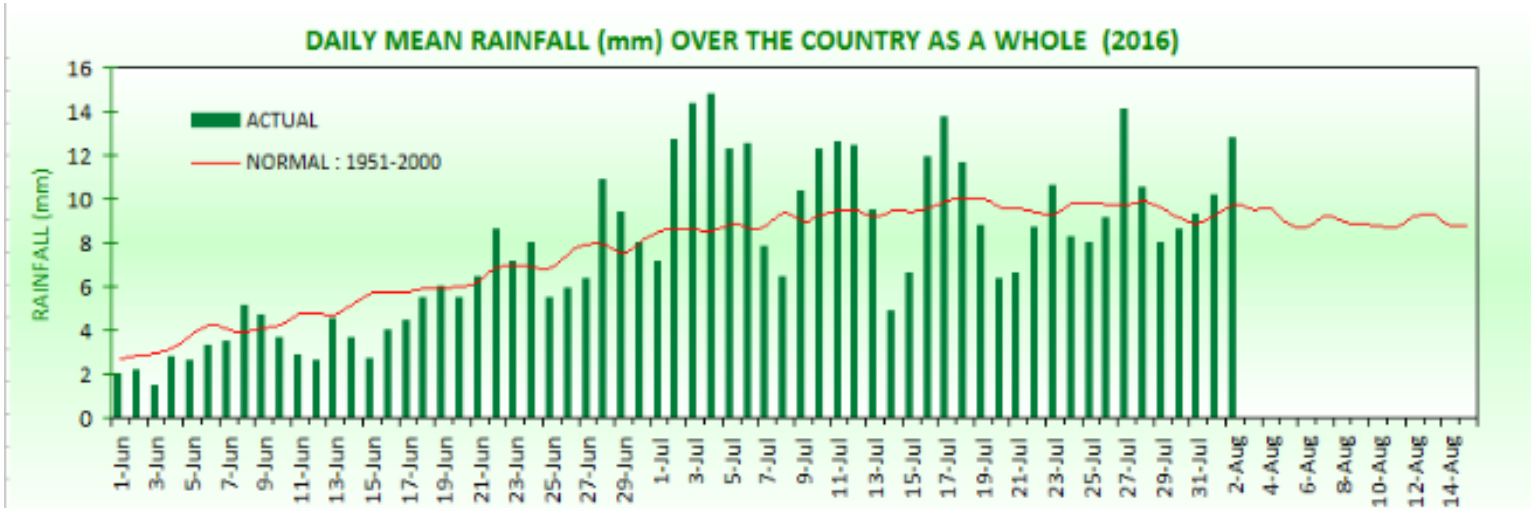


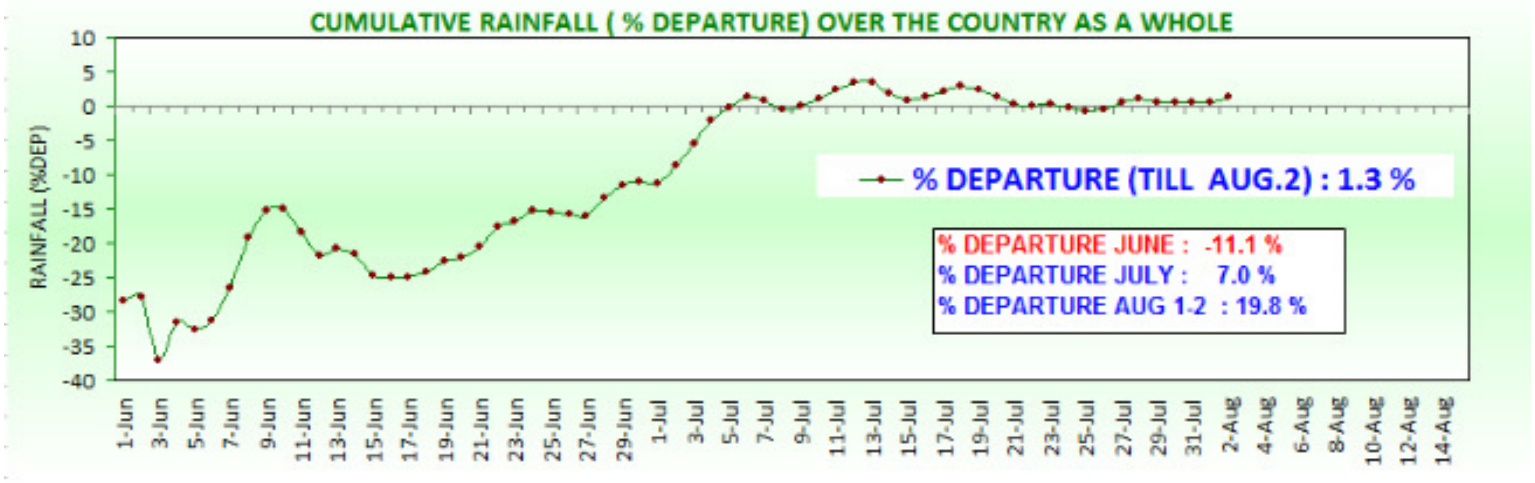
Inflation Expectations



Monsoon : July has seen a large pick up in the progress of the monsoon

Daily Rainfall

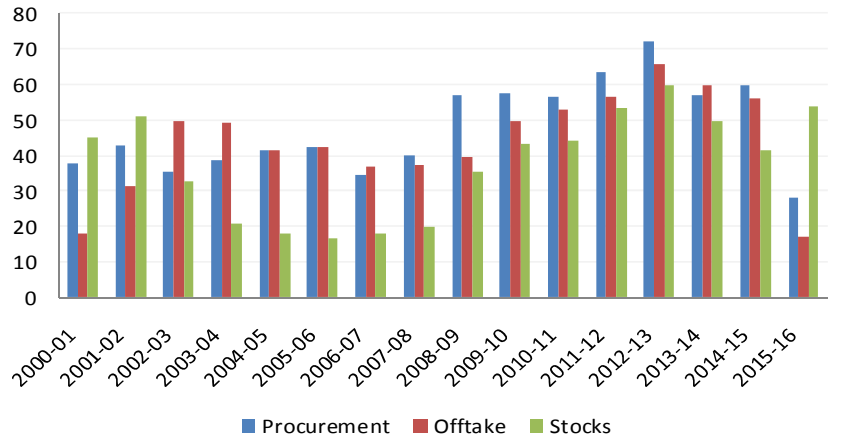




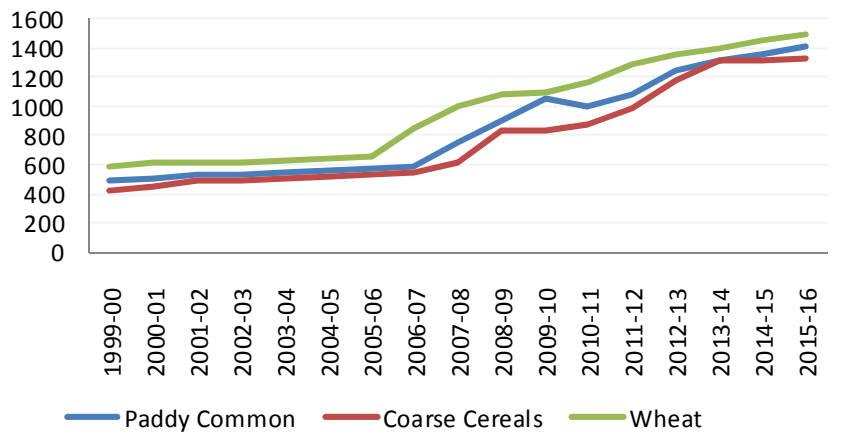
Source: India Meteorological Department,, Trust Research

Inflation Picture: Adequate food stocks in conjunction with slower price growth

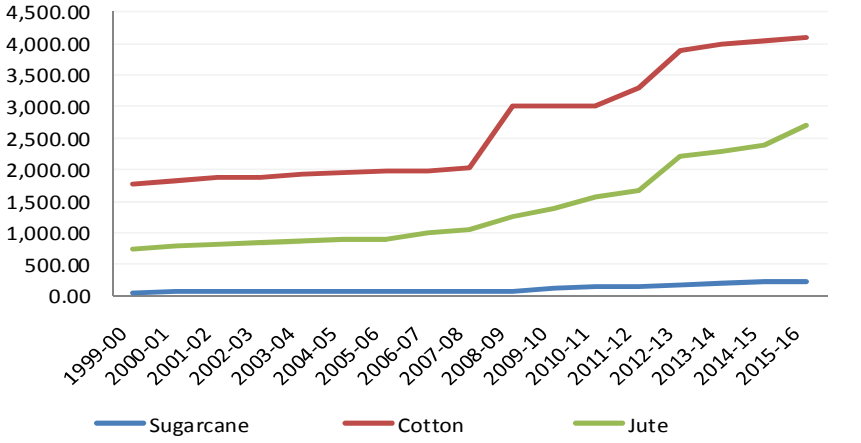
Public Distribution System (Million Tonnes)



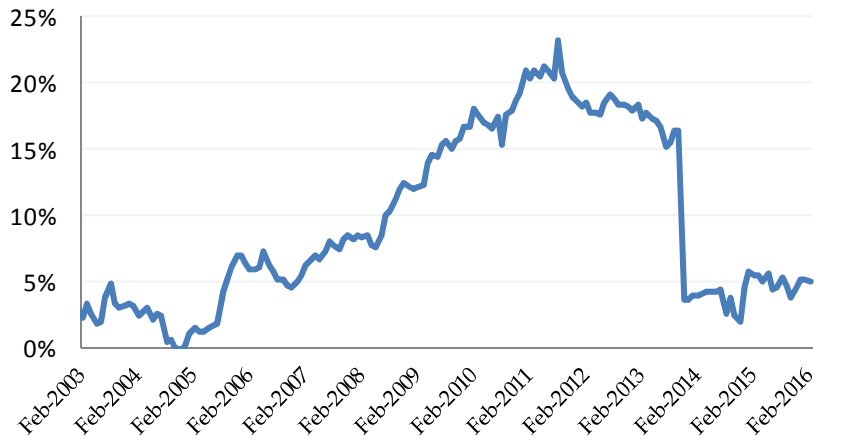
MSP Prices – Food Grains (Rupees/ Quintal)



MSP Prices – Non Food Grains (Rupees/ Quintal)

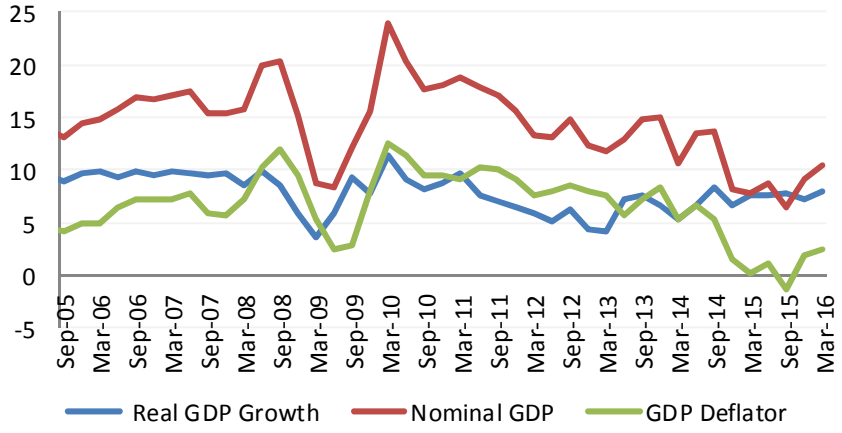


Rural Wage Growth

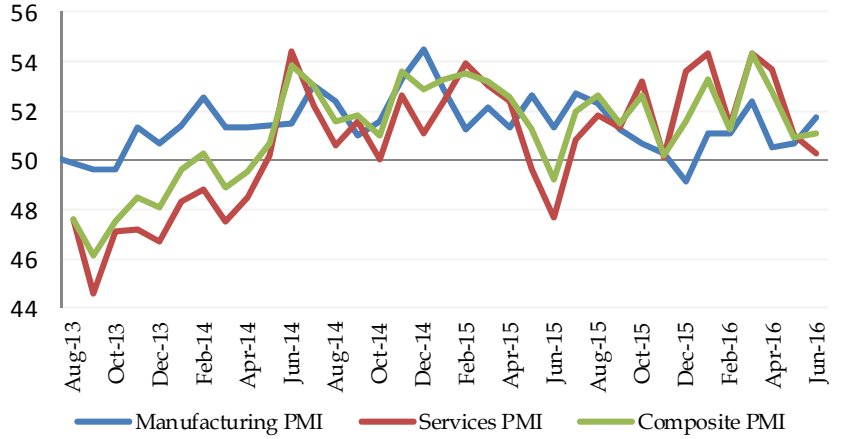


Growth Picture: IIP muted

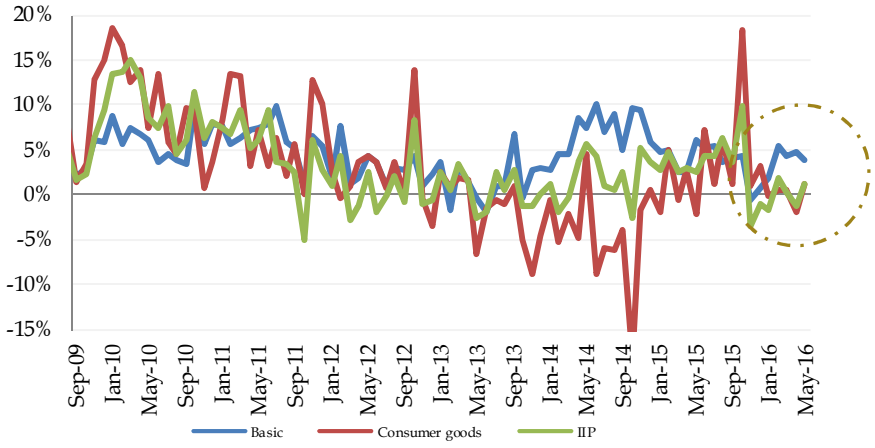
Real GDP Growth



India PMI



Index of Industrial Production

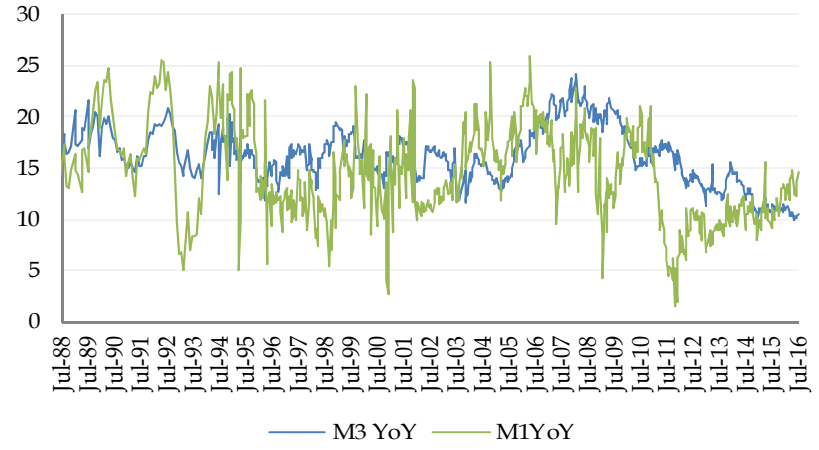


- The revised GDP figures indicate a higher growth trajectory but other indicators point to slack in the economy
- Muted industrial production across all sectors. The consumer sector has continued to struggle.
- Services PMI has slowed down in the last few months. The manufacturing PMI has moved up but the series has been volatile
- These muted demand conditions suggest that policy rates can come down further without inflationary impact

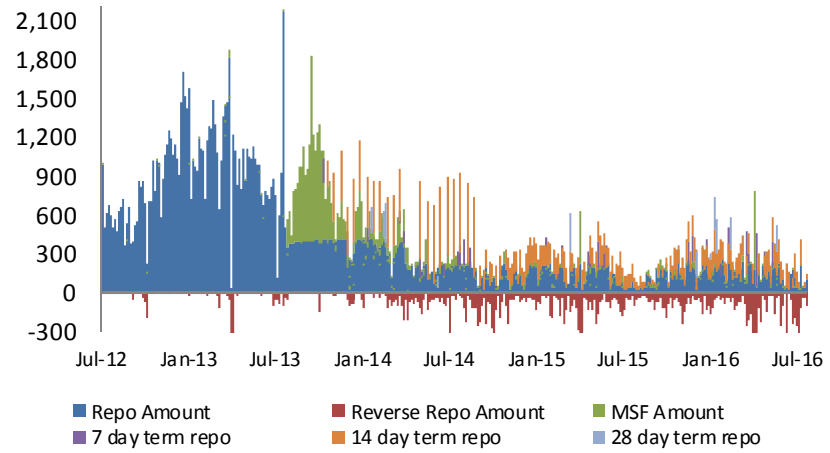
Source: Bloomberg, CMIE, Trust Research

Liquidity Picture: Yield curve no longer inverted

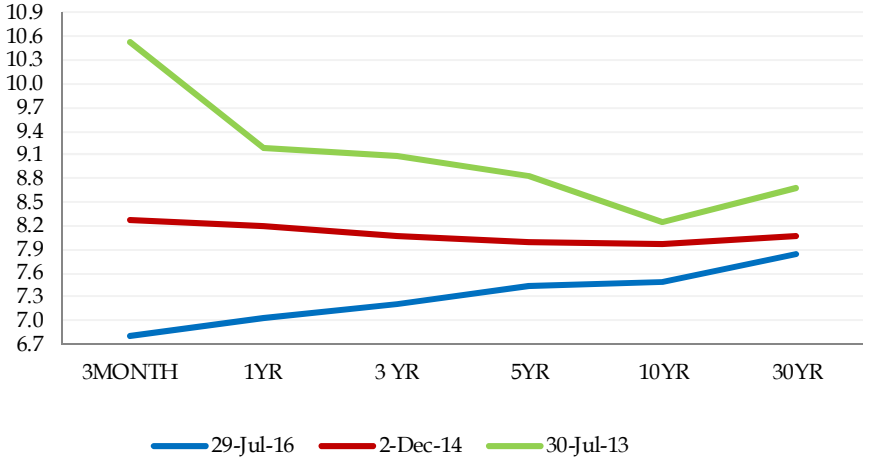
Money Supply Growth



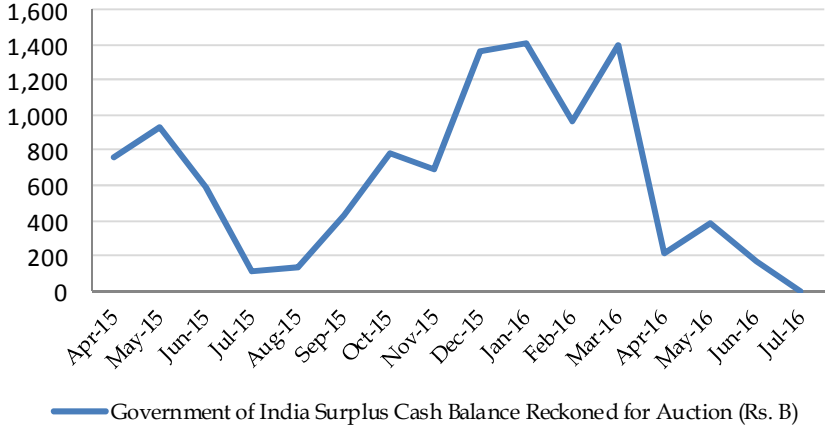
Liquidity Adjustment Facility (Rs B)



Yield Curve



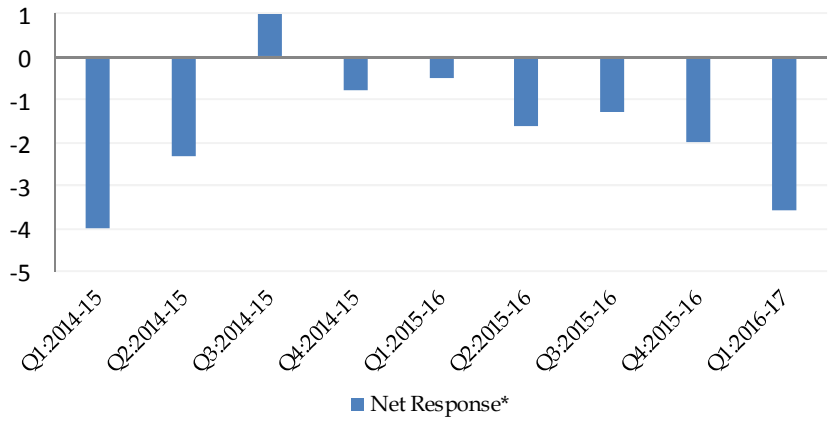
Government Cash Balances with RBI



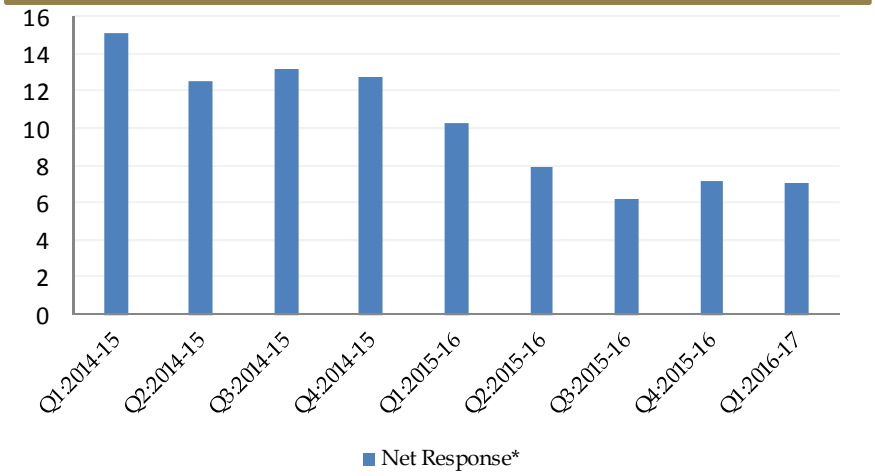
Source: RBI, Bloomberg, Trust Research

Pricing Power: Producers' pricing power compromised

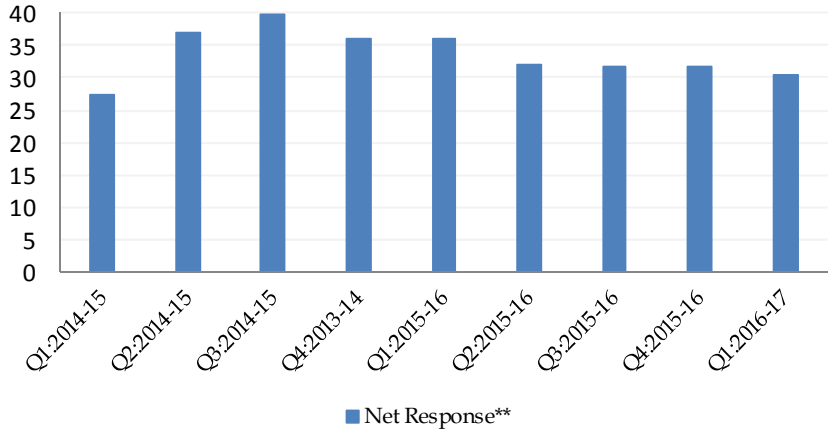
Expectations of Profit Margin – RBI Industrial Outlook Survey (% response)



Expectations for Selling Price – RBI Industrial Outlook Survey (% Response)



Expectations of Overall Business Situation – RBI Industrial Outlook Survey



Source: Bloomberg, RBI, Trust Research

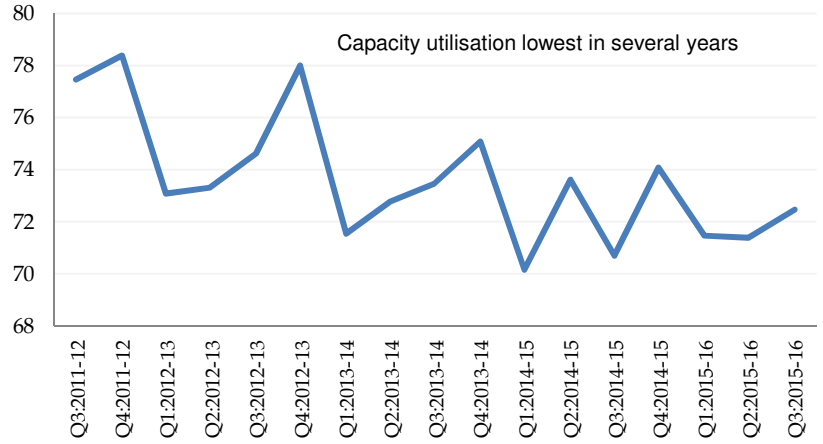
- FY16 saw a continued drop in operating profit growth indicating moderation in pricing power
- Companies highly impacted by high interest rates as interest costs as a percentage of operating profits increased
- RBI's Industrial Outlook indicates companies' expectation of selling price and profit margin remains muted
- Companies do not expect their pricing power to improve in the short term.
- Given this lack of pricing power, inflation should continue to remain moderate even in a rate easing environment

* The difference between % of respondents which indicated that profit margin and selling price will increase and those that answered it will decrease

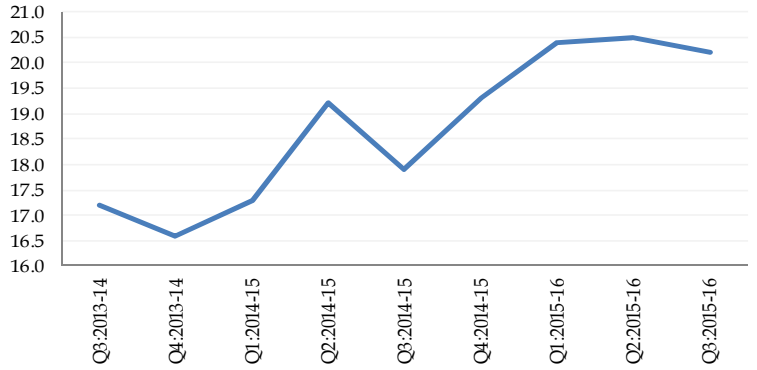
** The difference between % of respondents which indicated that the overall business situation will improve and those that indicated it will worsen

Output Gap: Capacity utilisation down, inventory build up

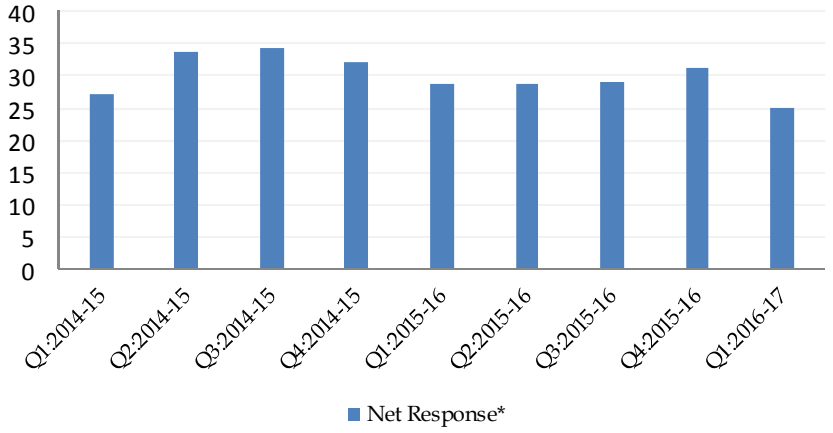
Capacity Utilization (OBICUS %)



Average Finished Goods Inventory / Sales Ratio (OBICUS)



Expectation for Production (Industrial Outlook Survey %)

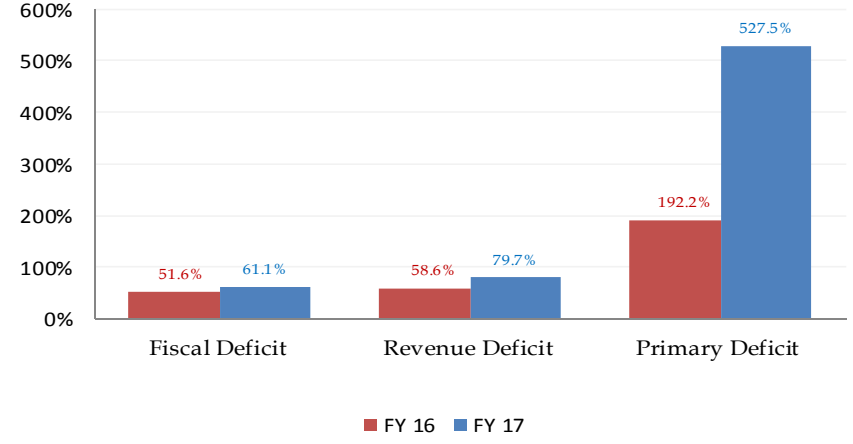


Source: RBI, Trust Research

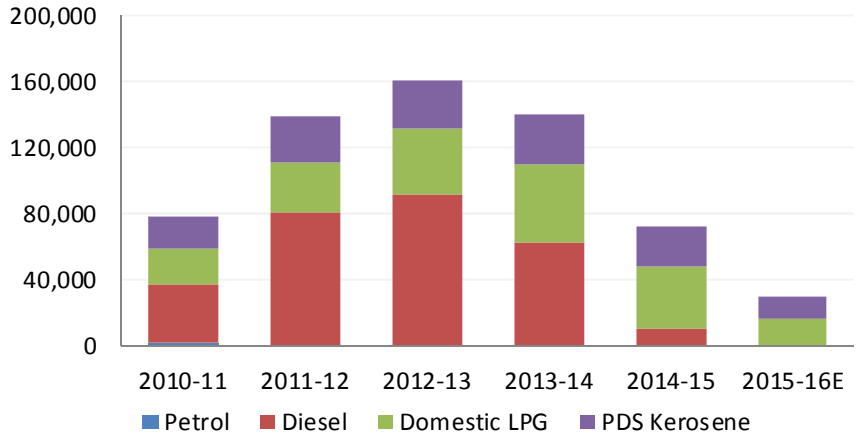
- The RBI's Order Books, Inventories, and Capacity Utilisation Survey (OBICUS) survey continues to show a decline in the level of capacity utilization
- The fall in capacity utilisation is visible across industry groups and especially pronounced in sponge iron and petroleum products
- Inventory levels have continued to remain elevated over the last several quarters.
- Under this environment easing rates will not lead to higher prices

Fiscal Discipline: Budget has outlined a prudent consolidation path

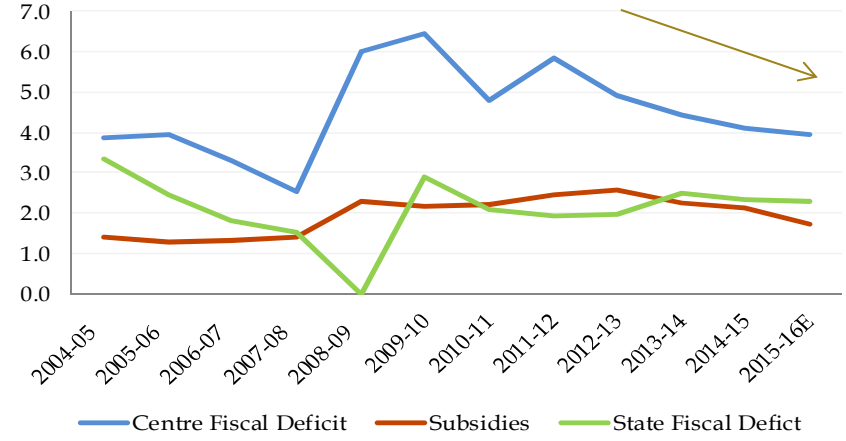
Fiscal Position Up to June 2016 % Actuals to Budget Estimates)



Public Sector Oil Marketing Companies Under Recoveries



Fiscal Deficit (% of GDP)

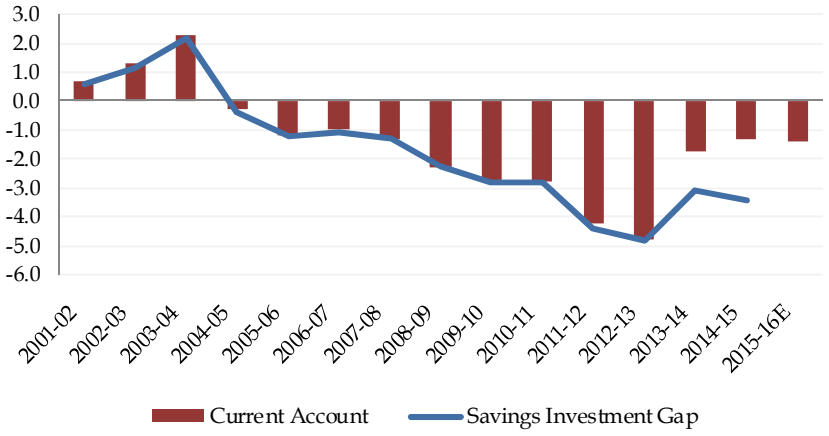


- The RBI has repeatedly stated that fiscal consolidation is very important.
- The government has made deep commitment to fiscal discipline at 3.5%, and lowered structural impediments to lower rate transmission by reducing PF, small savings and Kisan Vikas Patra rates.
- Given all the improvements the government has been able to easily achieve its fiscal deficit target of 3.9% as forecasted by the budget for FY16 despite the current aggressive infrastructure spending. We also expect next year's target of 3.5% will be achieved despite challenges due to the expected increase in salary costs of government employees.

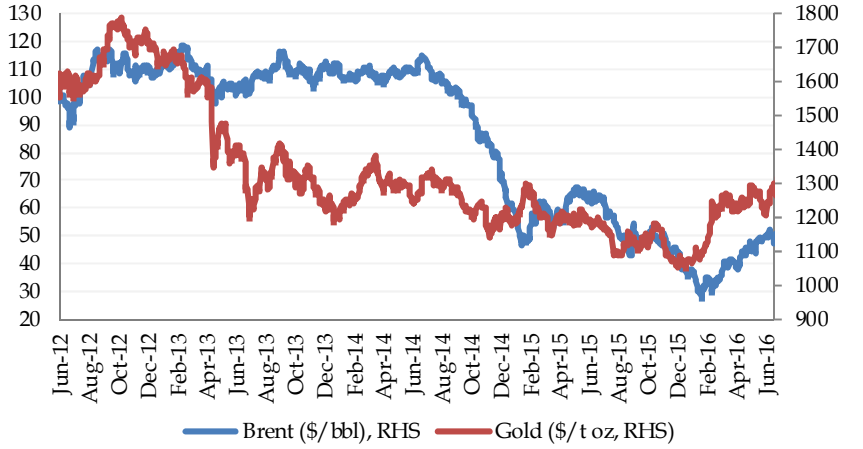
Source: Ministry of Finance, Ministry of Petroleum and Natural Gas, Bloomberg, Trust Research

CAD: Substantial improvement over the last two years

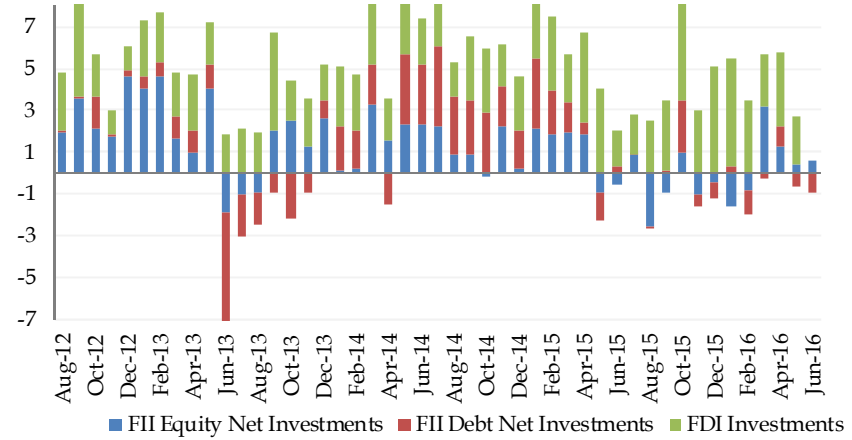
Current Account and Saving Investment Gap as % of GDP



Oil and Gold Prices



FII Investments*



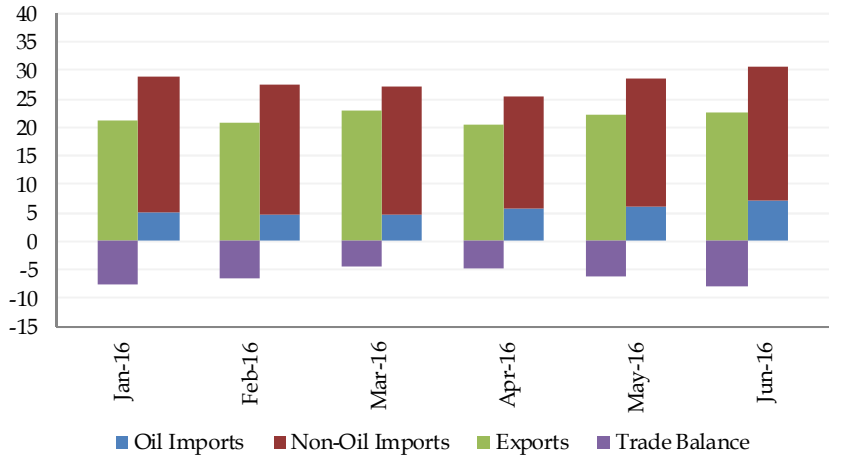
*FDI data available until May 2016

- The current account deficit (CAD) had emerged as a major source of concern for both monetary policy and financial stability
- The fall in prices of oil and gold, the two commodities India imports in large quantities, will ensure that CAD will remain manageable.
- Financing of the deficit has also become easier due to significant FII inflows
- The improving CAD situation create space for rates to come down further

Source: Bloomberg, Trust Research

Trade: Export growth lagging historical averages and regional peers

Trade ($B)



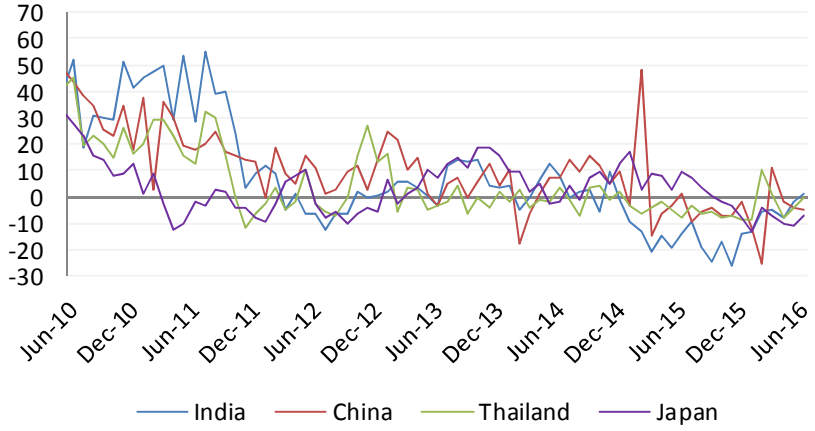
Top 10 Imports ($M)

Commodity Group	Apr-May 2015	Apr-May 2016(P)	%Growth	%Share
Pertoleum Crude & Products	16,045	11,596	-28	22
Gems & Jewellery	10,043	7,612	-24	14
Electoronics Items	6,132	5,481	-11	10
Chemicals & Related Products	6,409	5,165	-19	10
Machinery	5,351	4,913	-8	9
Base Metals	4,197	3,389	-19	6
Ores & Minerals	4,340	3,048	-30	6
Agri & Allied Products	3,072	2,779	-10	5
Transport Equipments	2,256	1,689	-25	3
Plastic & Rubber Articles	2,578	2,350	-9	4
Total	**66,341**	**53,518**	**-19**	**100**

Top 10 Exports ($M)

Commodity Group	Apr-May 2015	Apr-May 2016(P)	%Growth	%Share
Gems & Jewellery	6,186	7,282	18	17
Chemicals & Related Products	5,426	5,136	-5	12
Pertoleum Crude & Products	5,351	4,114	-23	10
Agri & Allied Products	4,190	3,904	-7	9
Transport Equipments	4,507	4,595	2	11
Base Metals	3,448	2,505	-27	6
Machinery	3,108	3,185	2	7
Plastic & Rubber Articles	975	1,039	7	2
Leather & Leather Manufactures	916	843	-8	2
Electoronics Items	888	932	5	2
Total	**44,621**	**42,924**	**-4**	**100**

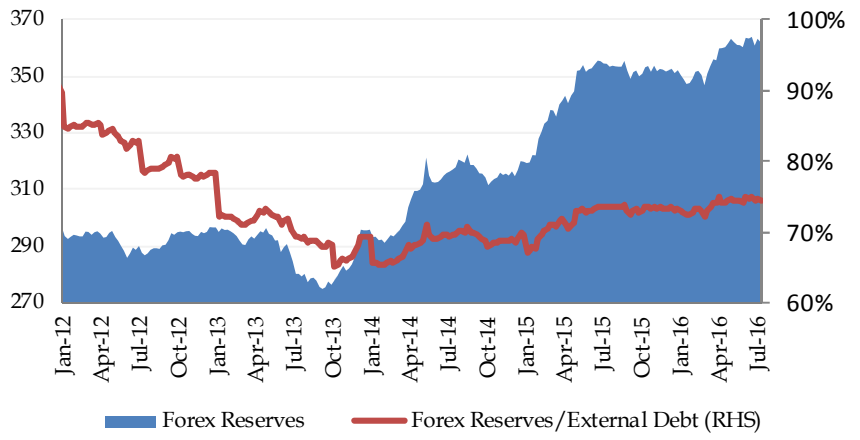
Export Growth (YoY %)



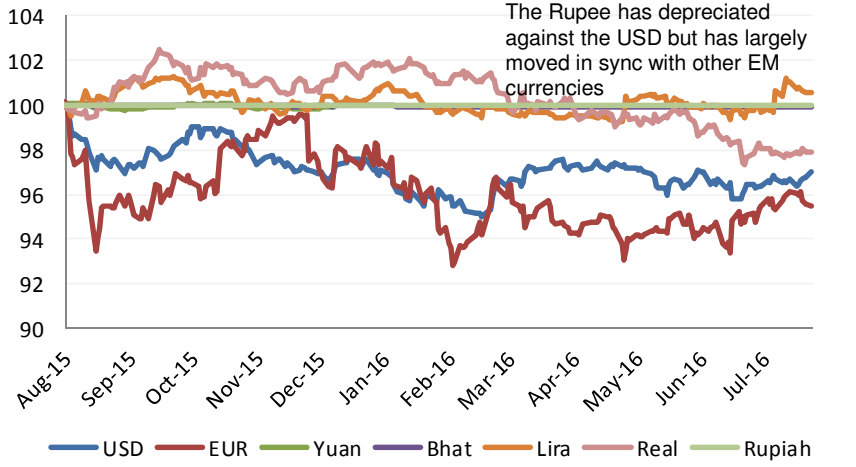
Source: RBI, DGCI&S, Bloomberg, Trust Research

India's forex reserves have grown in absolute and relative terms

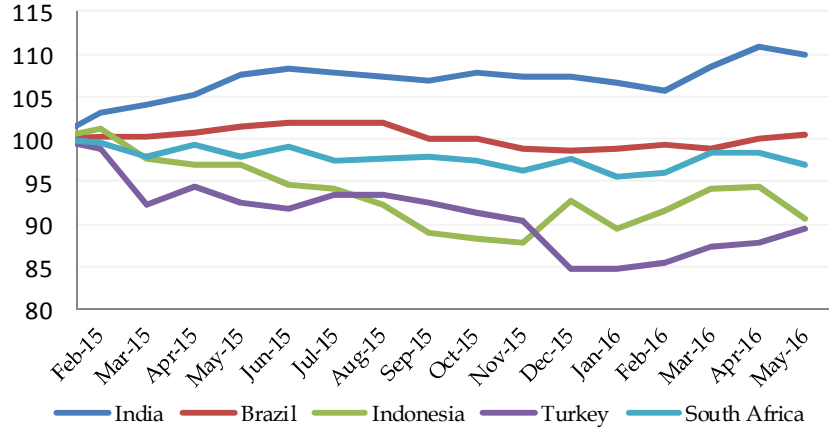
Foreign Exchange Reserves ($B)



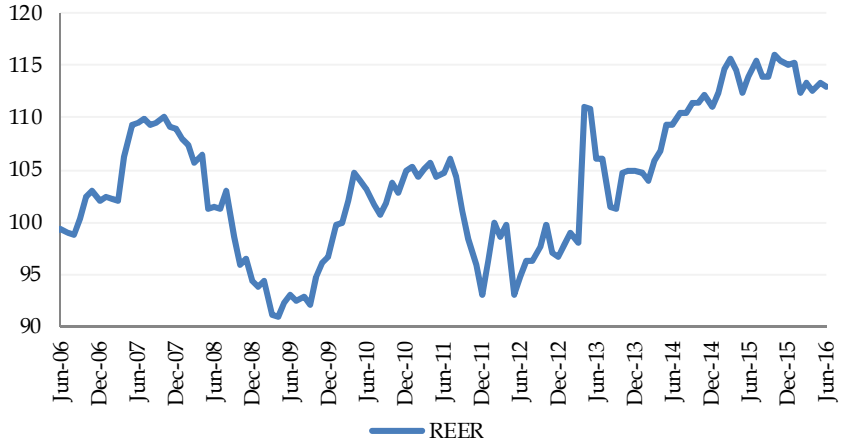
Rupee vs Selected Currencies *



Foreign Exchange Reserve Additions *



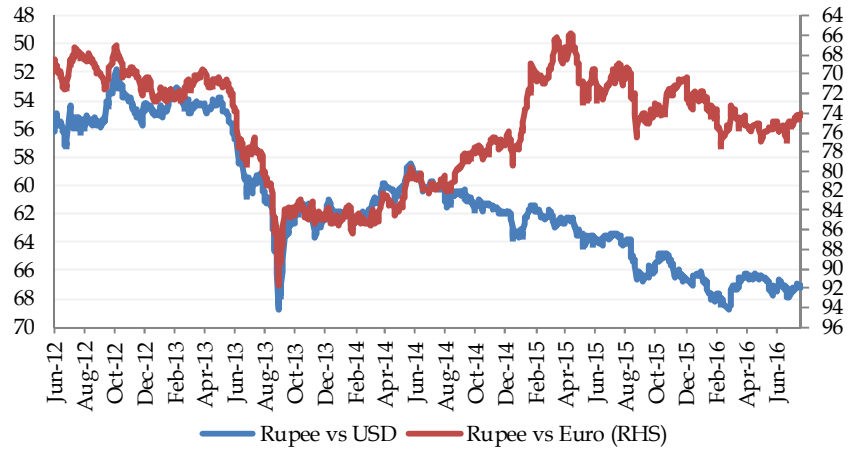
Real Effective Exchange Rate



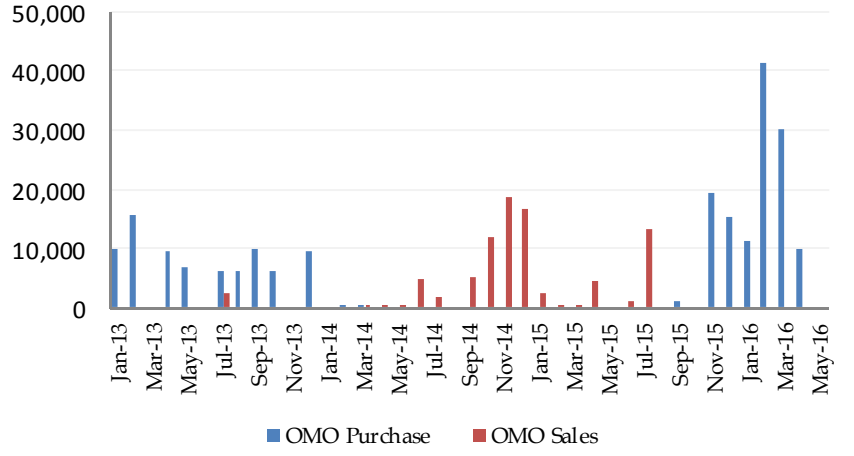
*Values have been indexed to 100 as of Aug 1, 2014

RBI continues to intervene in currency and bond markets

Rupee Performance



RBI OMO Sale/Purchase



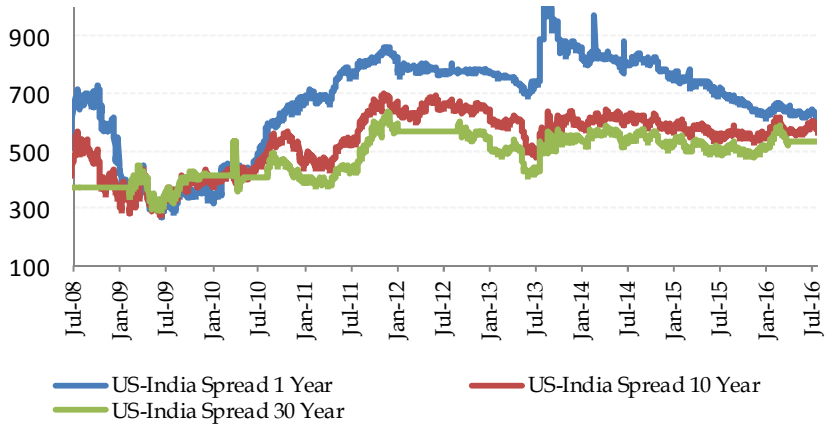
Sale/Purchase of Dollars by the RBI

Period	RBI Gross Sale $	RBI Gross Purchase of $	RBI Net Purchase of $	Outstanding Forward Sales (-)/Purchase (+)
May-16	3,815	4,369	554	-5,748
Apr-16	1,300	2,639	1,339	-4,003
Mar-16	3,348	8,034	4,686	-4,253
Feb-16	6,803	3,462	-3,341	-2,410
Jan-16	3,270	3,240	-30	-318
Dec-15	2,799	2,620	-179	1,987
Last 12 Months	**50,445**	**54,538**	**4,093**	

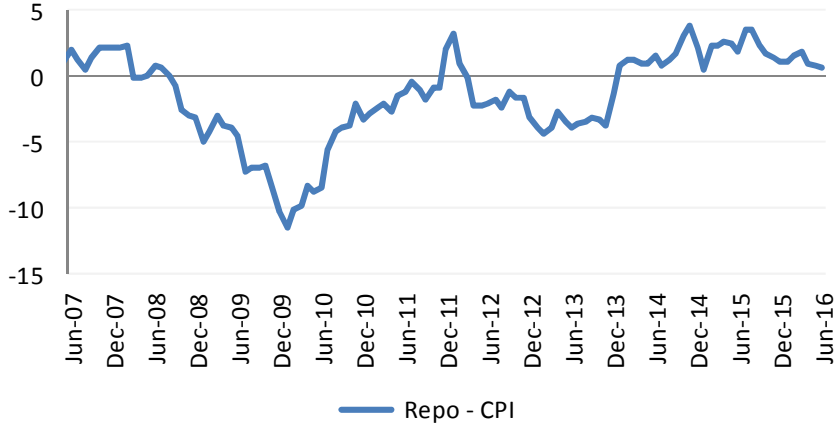
- The Rupee has depreciated against the dollar , however the Rupee continues to fare much better than the fall experienced by other currencies reflecting India's progress in reducing its external vulnerabilities.
- The RBI continues to intervene in FX and fixed income markets through the use of OMOs. After the April policy, the RBI approach is far more constructive in terms of providing adequate durable liquidity to the market as compared to previous years.
- Upcoming swap redemption of more than $30b by December 2016 will put pressure on foreign reserves and liquidity.

Real rates remain positive but have come down

U.S. Treasury- India G-Sec Credit spreads (bps)

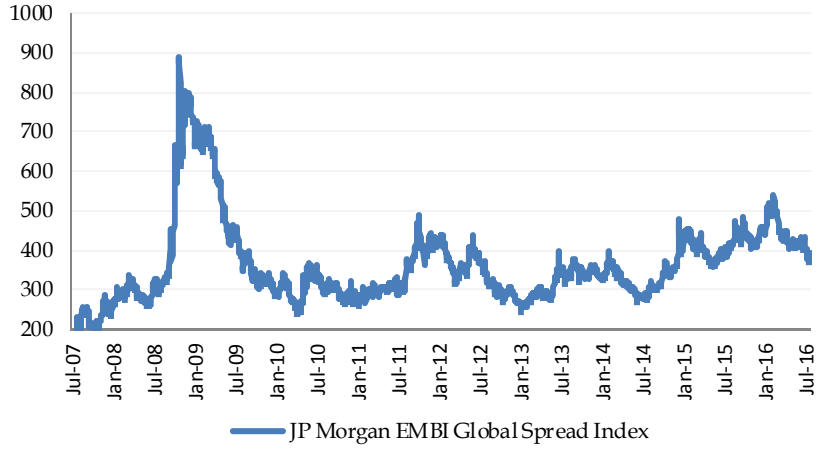


Real Rates*



*Prior to Jan 2012, the CPI for industrial workers is used.

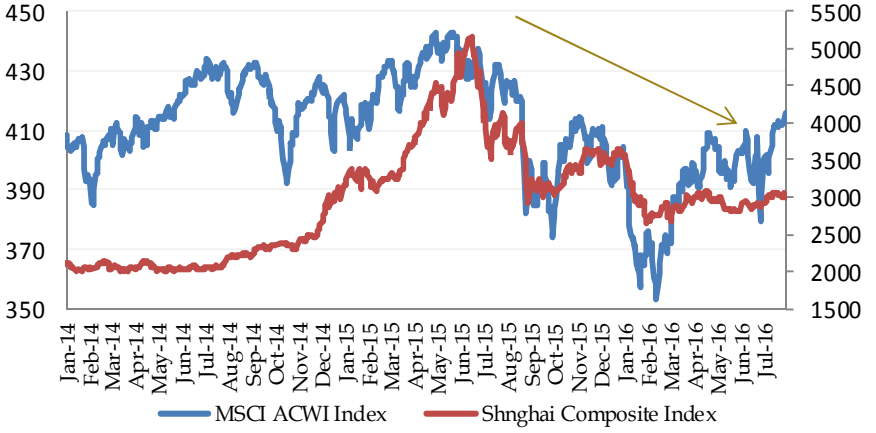
JP Morgan EBMI Spread Index



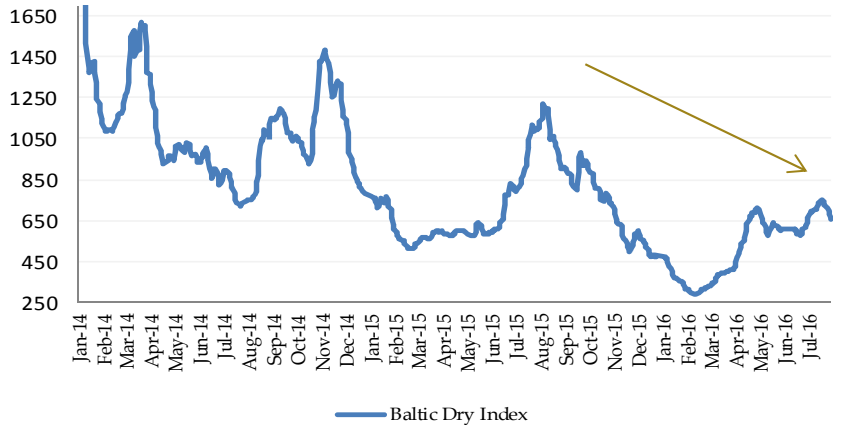
- Low yields in the U.S combined with rates remaining at elevated levels in India has led to the Indian G-Sec treasury spread to remain at elevated levels
- India is also currently experiencing positive real rates. The RBI has indicated that a real rate around 1.5% is reasonable for India
- However rising commodity prices imply a drop in real rates for most other emerging economies.

A confluence of several trends playing out simultaneously in global markets

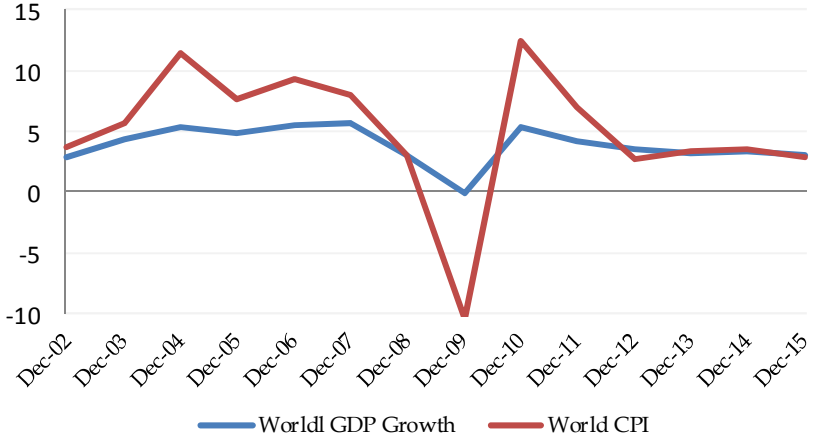
MSCI ACWI Index has fallen sharply



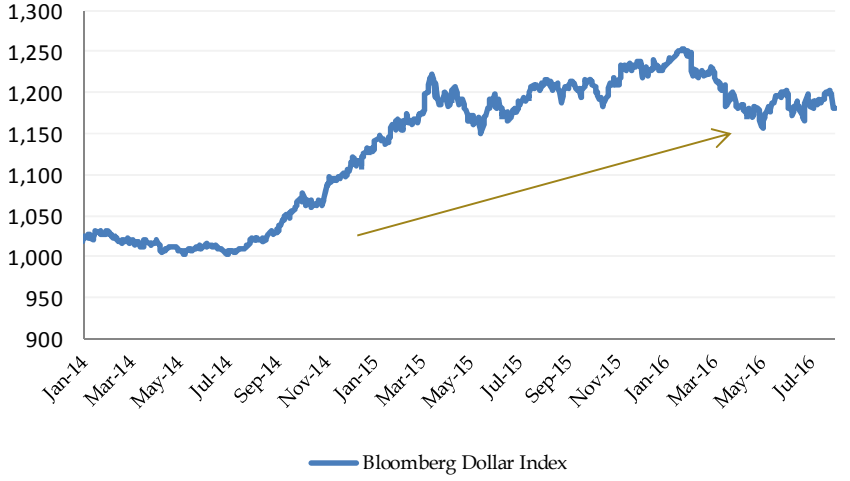
Freight Rates have fallen sharply indicating slowdown in global trade



Global GDP growth has fallen gradually over the last several years



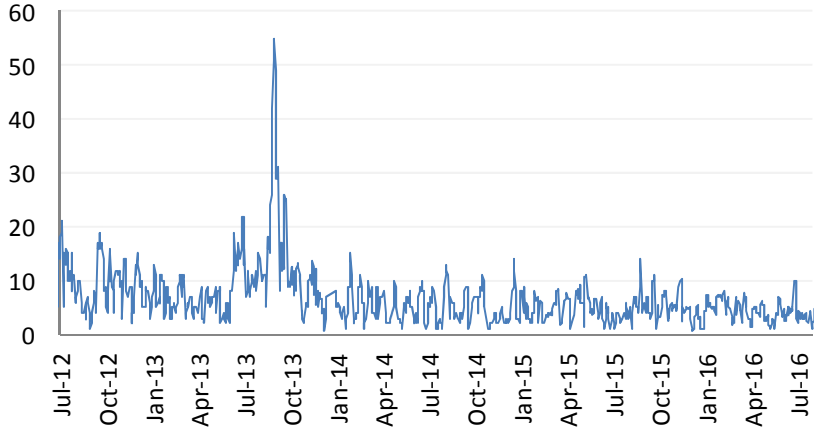
While the Dollar has strengthened against other currencies



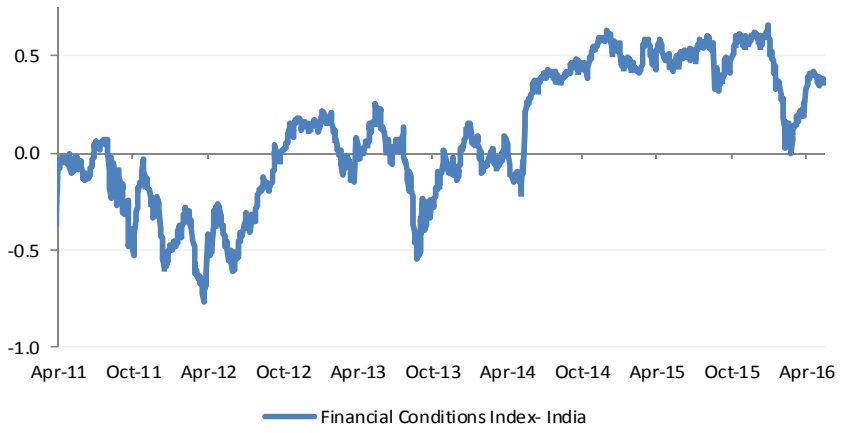
Source: Bloomberg, Thomson Reuters, Trust Research

Global financial conditions remain relatively stable despite Brexit vote

Rupee 5 day Volatility (%)



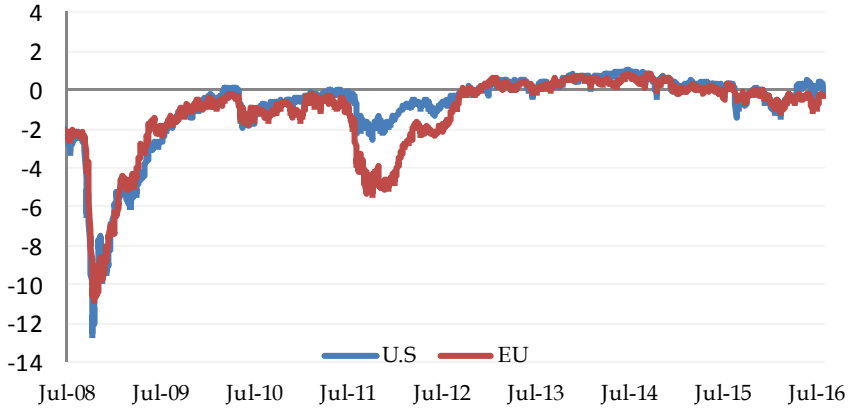
Trust India Financial Conditions Index



Bloomberg Asia Ex-Japan Financial Conditions Index



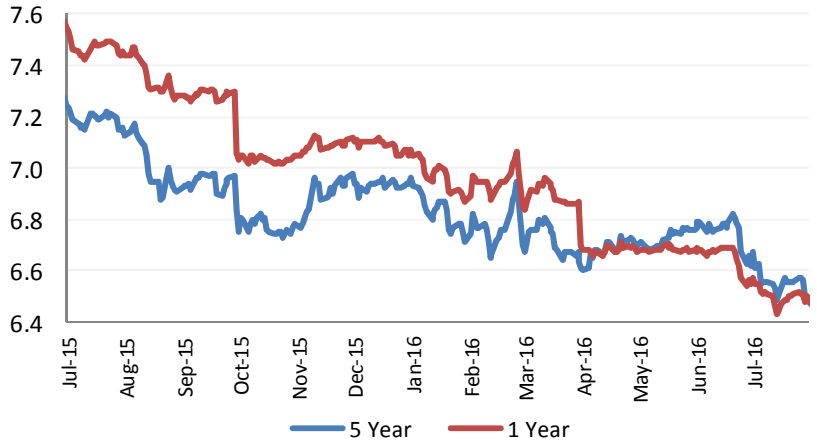
Bloomberg U.S and EU Financial Conditions Index



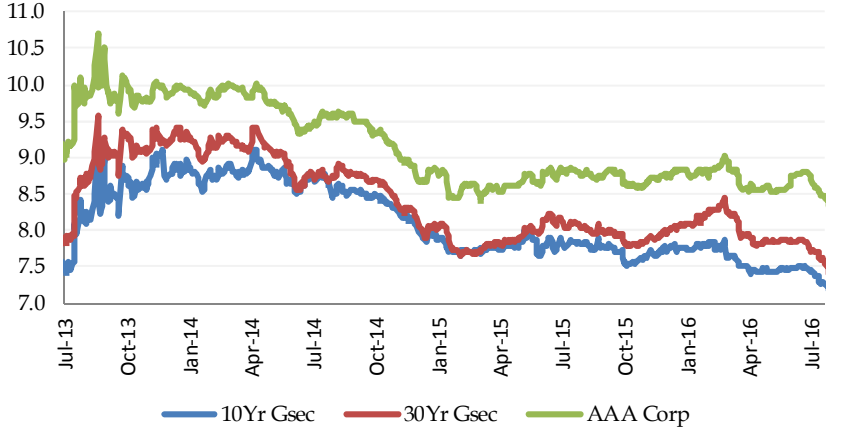
Source: Bloomberg, Thomson Reuters, Trust Research

Markets have rallied since May

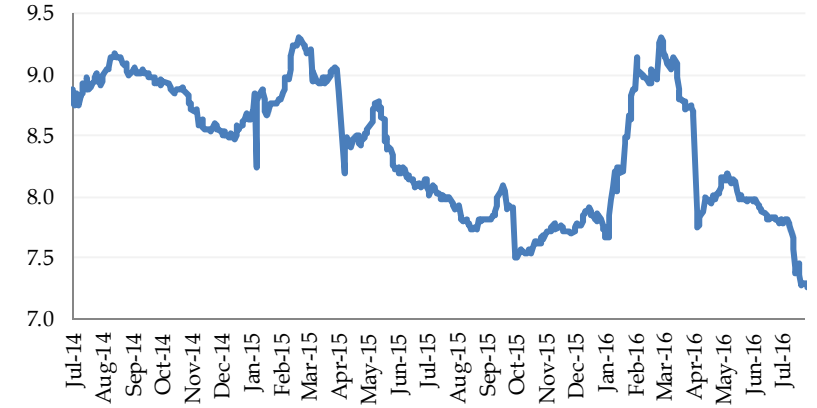
Onshore Swap Rates



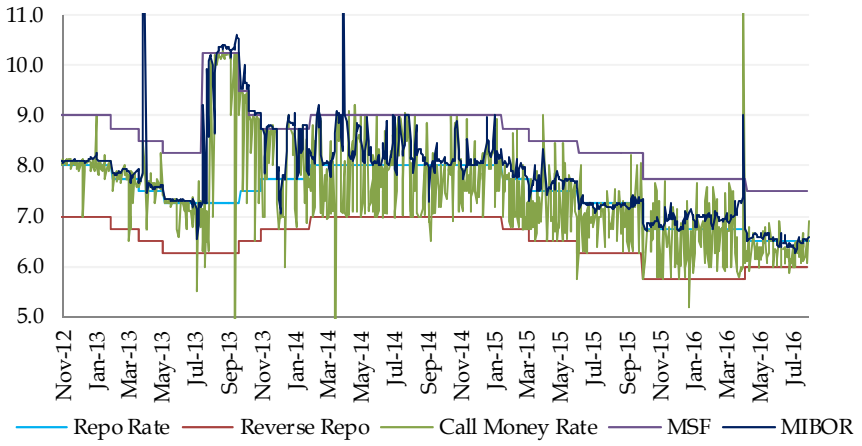
Selected Yields



3 Month CP Rates



Policy Rates and MIBOR



Source: Bloomberg, Thomson Reuters, Trust Research

Our View: On hold for now

- As the RBI prepares to announce its August policy statement we note that there has been key paradigm shifts in the monetary policy regime including:
  - Move away from keeping liquidity in deficit to keeping it at a neutral level
  - New base rate setting mechanism based on marginal costs
- These key shifts have allowed better monetary policy transmission and have led to a dramatic fall in short-end yields which has allowed the yield curve to get normalized.
- Moreover a series of fault lines identified by the RBI as key concerns have been faced by the market and the economy remains resilient. These fault lines have included the outcome of the monsoon, health of banking sector, twin deficits, U.S rate hike, Brexit and other geopolitical risks, trajectory of commodity prices and the European crises.
- Given this backdrop the market has re-priced the Indian yield curve lower indicating that there is room for policy rates to come down. This market outlook is also supported by the dramatic fall in inflation expectations.
- Nonetheless, per the June policy guidance the RBI is still wary of the inflation trajectory and other global risks. Based on its June guidance we expect the RBI to leave the policy Repo Rate unchanged in its August policy meeting. We also expect the August policy will highlight the achievements under the current monetary policy regime and emphasize the need to sustain focus on containing inflation. Focus on containing inflation will also continue beyond the current Governor given the very recent formal adoption of the 4%+/2 target by the government.
- We can expect policy action once there is some clarity on the above mentioned uncertainties after the monsoon. However if the RBI waits too long in bringing rates down, it risks falling behind the curve. Other policy moves may include a reduction in SLR consistent with previous RBI actions. The RBI may argue that this is required to increase credit growth. However such a move may lead to a hardening of short term rates.

Thank You

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