

April RBI Monetary Policy Preview

April 2017

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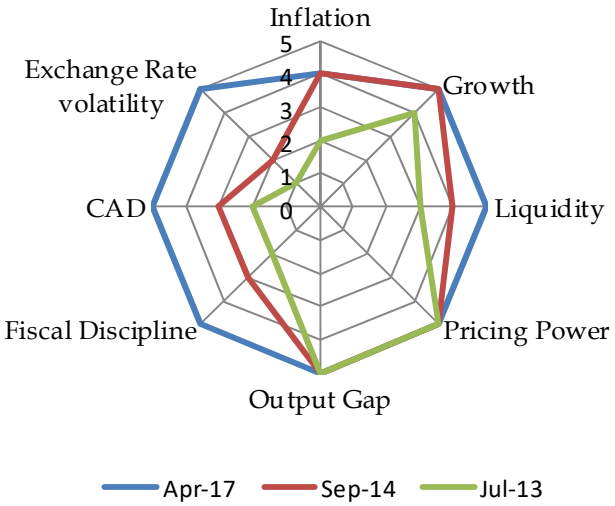
RBI Dashboard

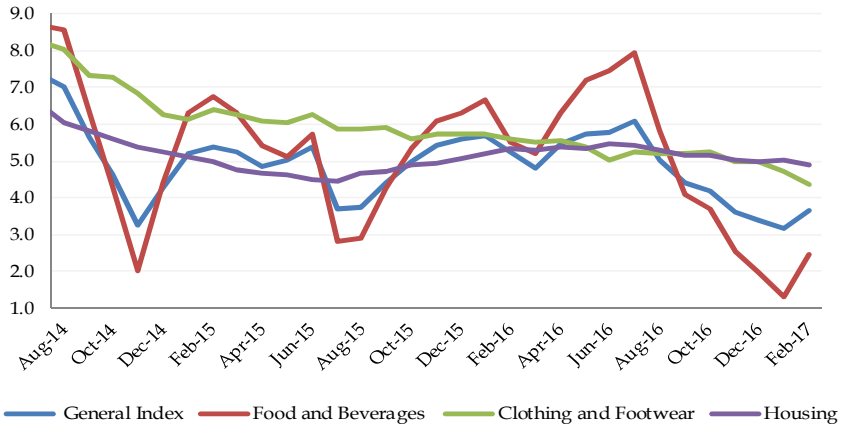
- RBI's objectives as set out in Urjit Patel Committee Report:
  - Headline CPI - nominal anchor for policy communication.
    - Target: 4% with a band of +/- 2% tolerance
  - Monetary Policy Committee (MPC) vested with Monetary Policy decision
    - Policy rule defined in terms of a real policy rate 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:
  - Current stance has been changed to neutral from accommodative. Current stance seems to be influenced by RBI's own perception of the number of U.S interest rate hikes and their implication for emerging markets.
  - There is been a dramatic improvement in all variables with inflation being the only worry

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

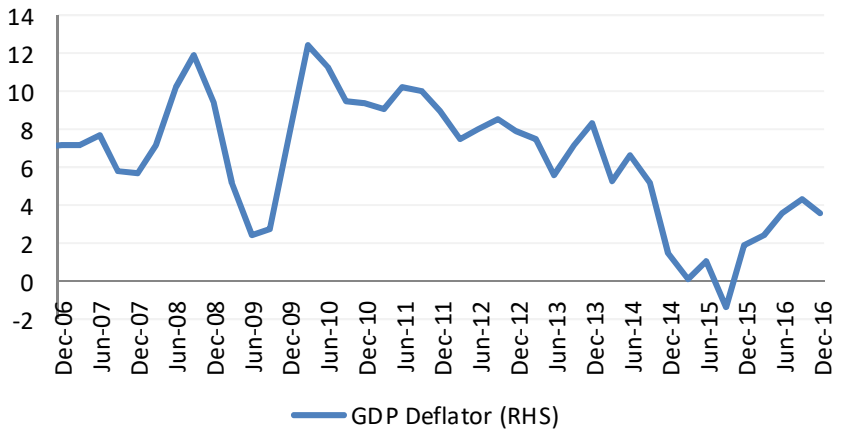


Inflation Picture: Significant pick up in WPI inflation

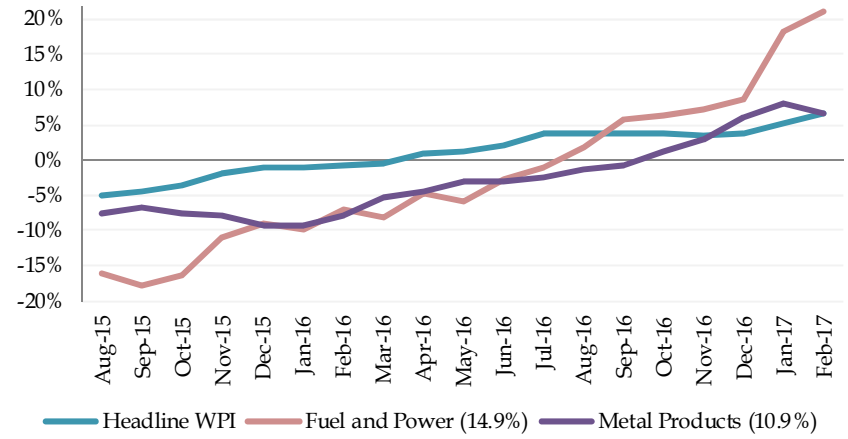
India CPI



GDP Deflator



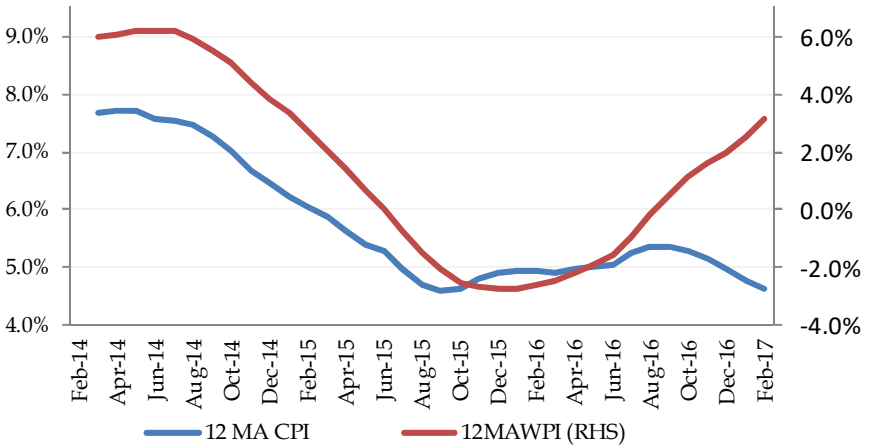
WPI



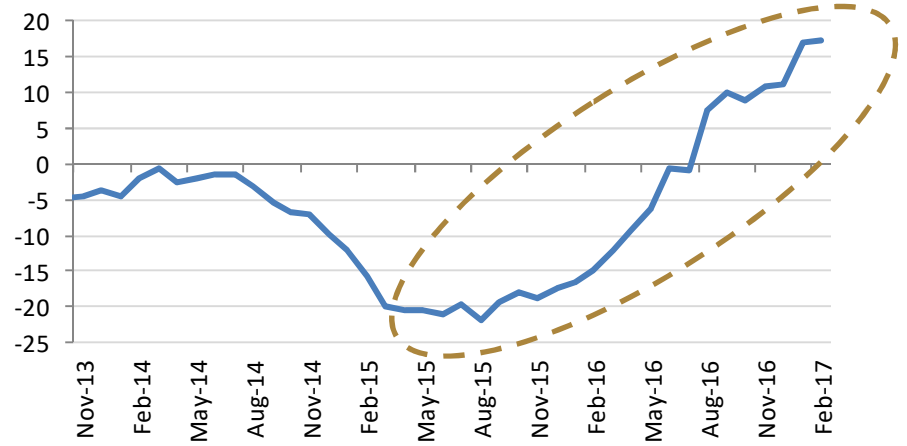
- CPI inflation remains within RBI's medium term trajectory although it picked up in the last reading
- Key drivers of CPI inflation remain manageable. Pulse prices which were the main drivers of the recent upticks have dropped significantly reflecting increased sowing and higher imports.
- However there are upside risks to WPI inflation. Metals, coal and petroleum products which in the past have kept WPI low have picked up in recent months and pulling the WPI index higher.
- With CPI remaining relatively low and WPI elevated, the change in policy stance it begs the question whether monetary policy stance is guided by WPI or CPI?

Inflation Picture: Global food prices have firmed up

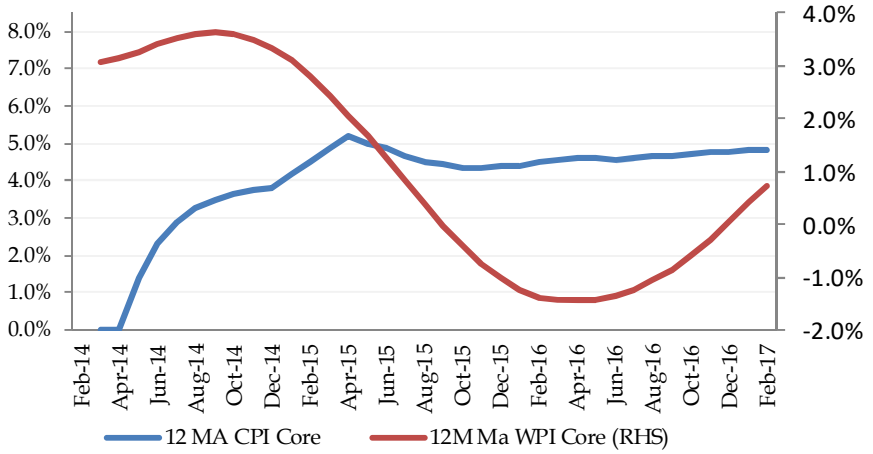
Twelve Month Moving Average Headline Inflation



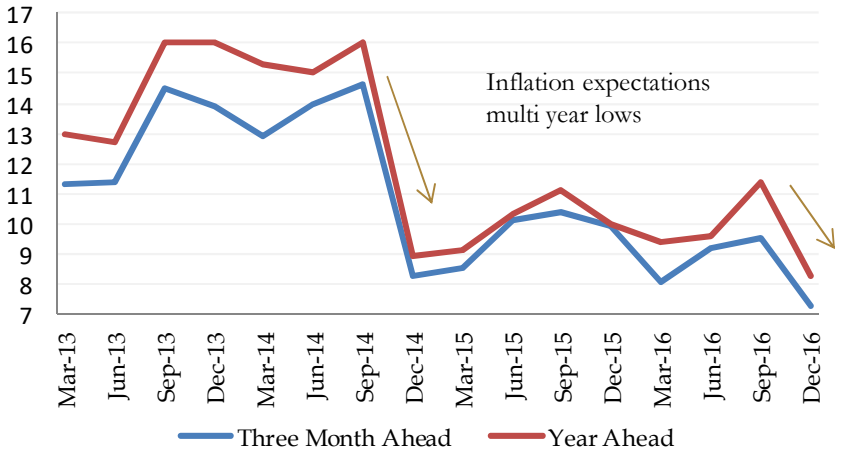
FAO Global Food Index (% Growth)



Twelve Month Moving Average Core Inflation

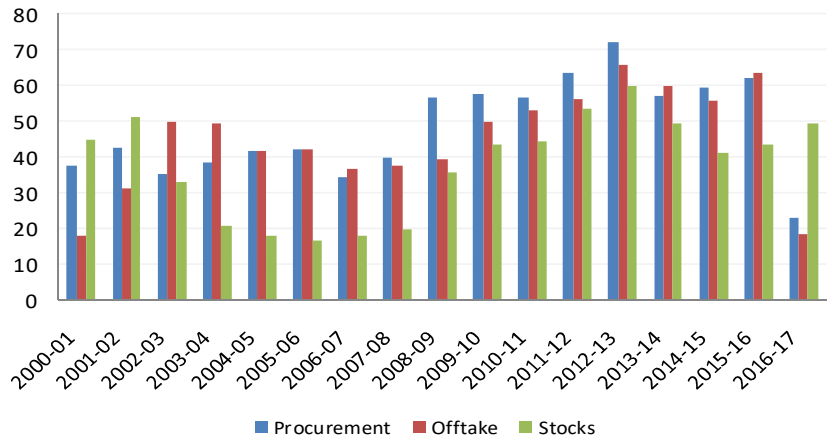


Inflation Expectations

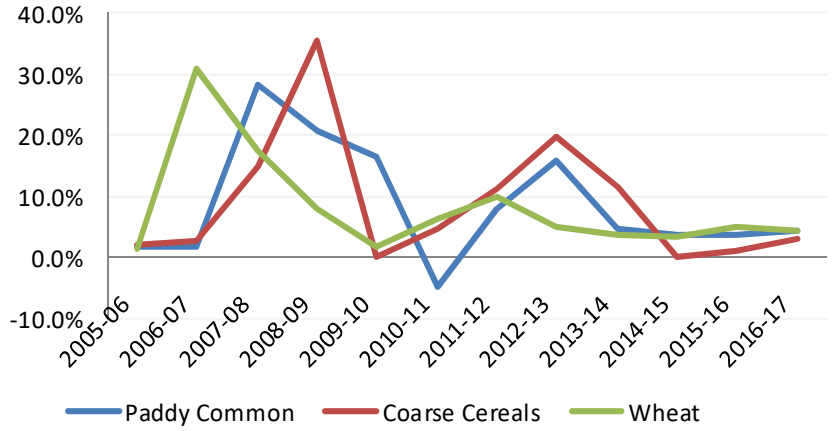


Inflation Picture: Adequate food stocks in conjunction with slower price growth and improved agricultural output

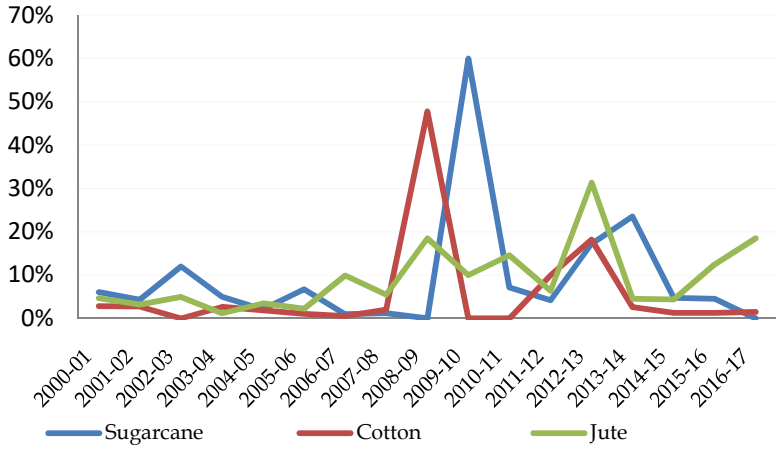
Public Distribution System (Million Tonnes)



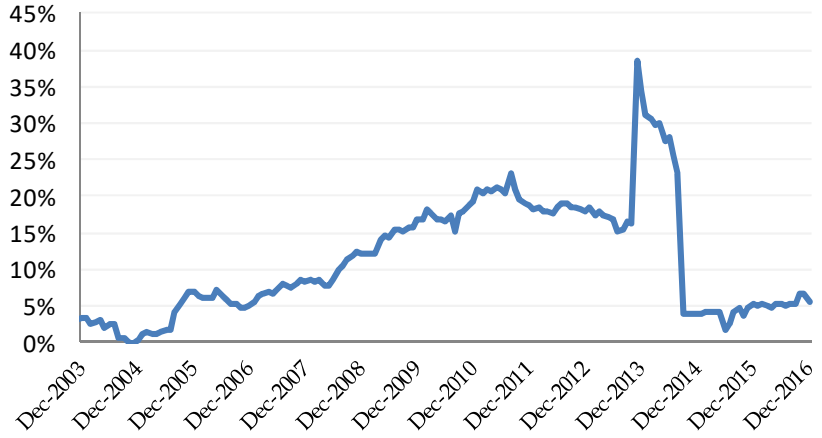
MSP Prices – Food Grains (%chg)



MSP Prices – Non Food Grains (%chg)

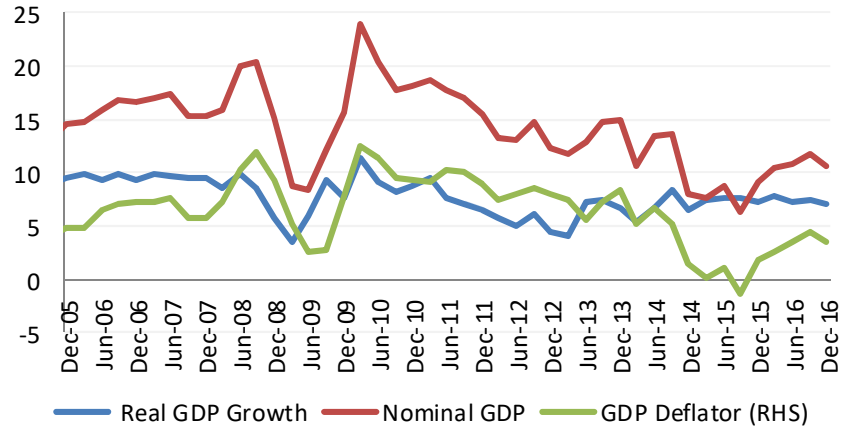


Rural Wage Growth

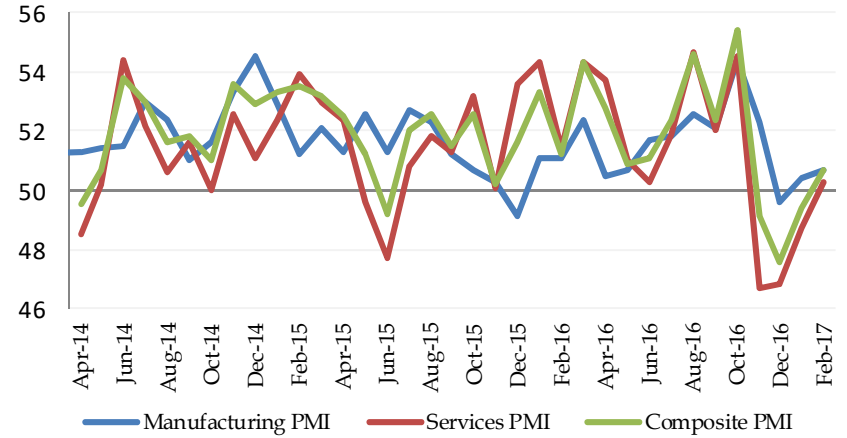


Growth Picture: PMI has recovered post the demonetisation slump

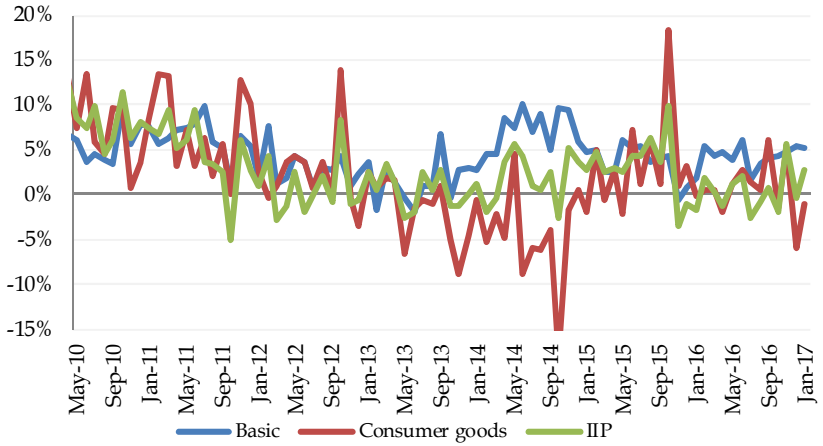
Real GDP Growth



India PMI



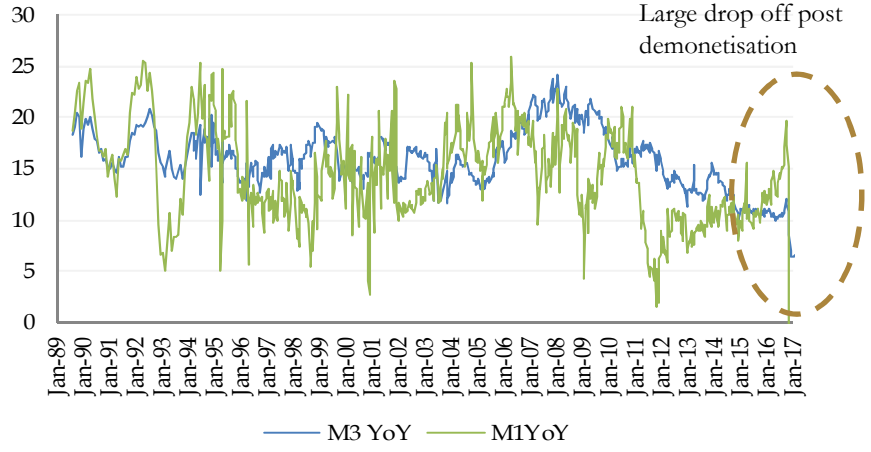
Index of Industrial Production



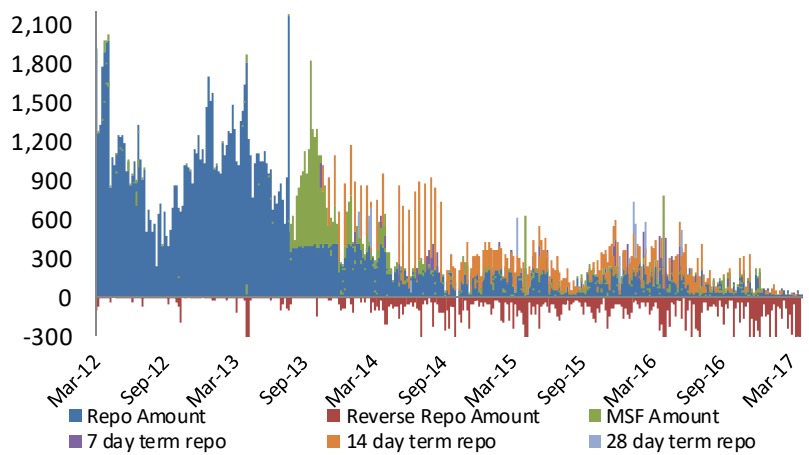
- The revised GDP figures indicate a higher growth trajectory but other indicators point to slack in the economy
- Muted industrial production across all sectors. The consumer sector had slumped after the demonetisation but is now showing signs of recovery.
- There also has been a sharp move up both in service and manufacturing PMI post demonetisation slump. Although it still remains below recent levels.

Liquidity Picture: Comfortable liquidity conditions

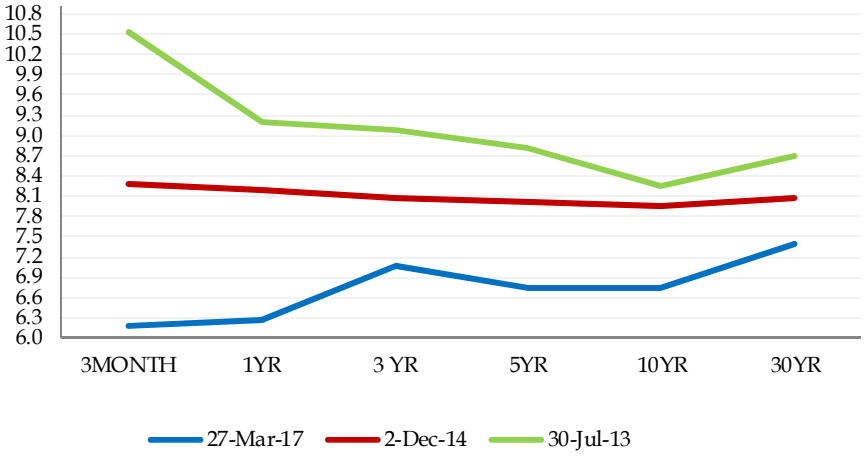
Money Supply Growth



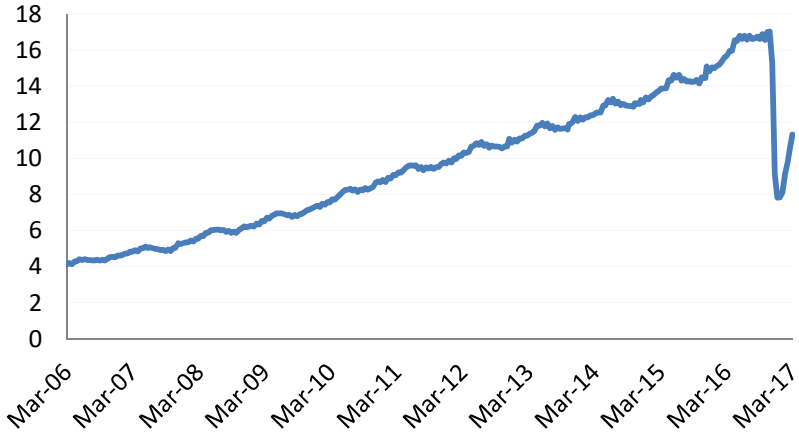
Liquidity Adjustment Facility (Rs. B)



Yield Curve

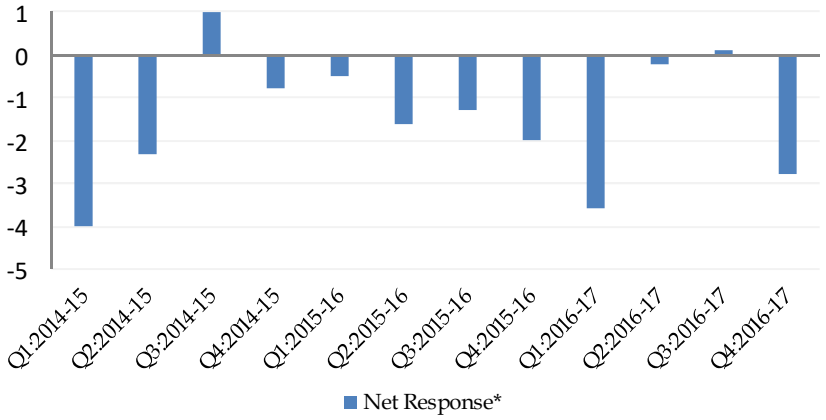


Currency in Circulation (Rs. TRN)

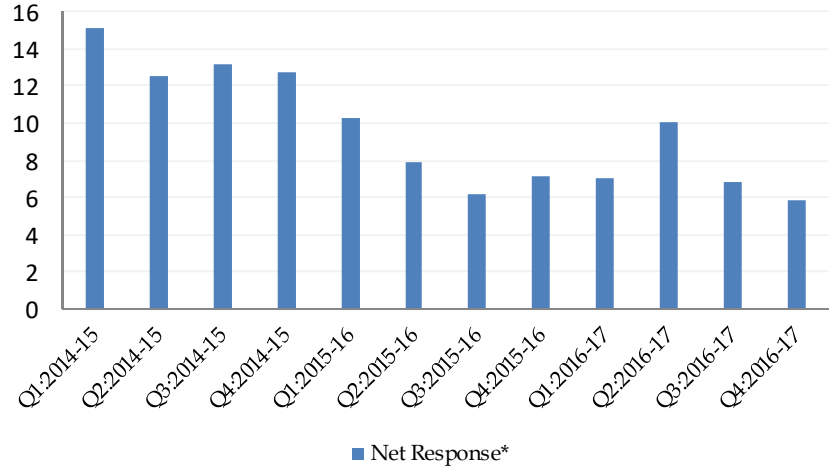


Pricing Power: Producer's pricing power compromised

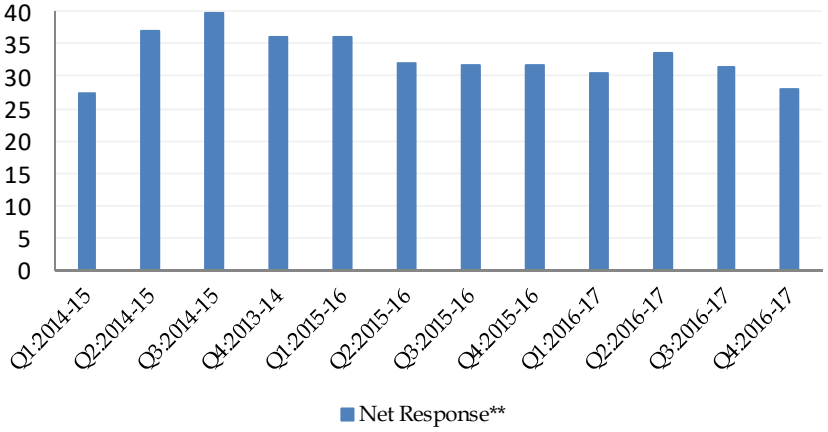
Expectations of Profit Margin – RBI Industrial Outlook Survey (% response)



Expectations of Selling Price– RBI Industrial Outlook Survey (% response)



Expectations of Overall Business Situation – RBI Industrial Outlook Survey

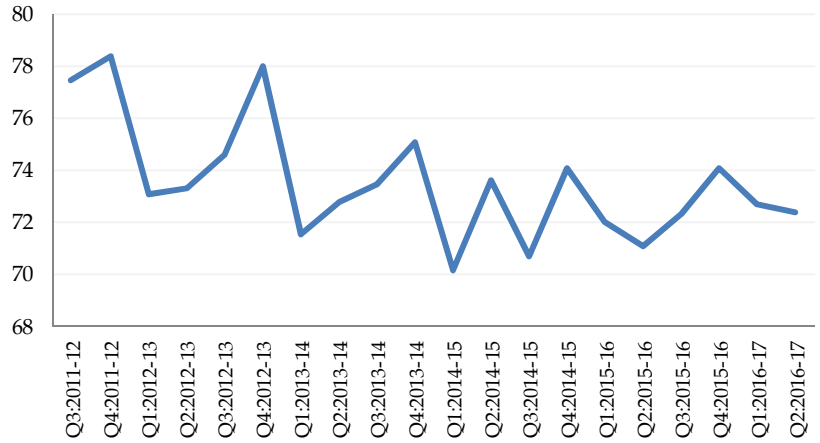


- FY16 saw a continued drop in operating profit growth indicating moderation in pricing power
- Companies highly impacted by high interest rates as interest costs as a percentage of operating profits increased
- RBI's Industrial Outlook indicates companies' expectation of selling price and profit margin remains muted
- Companies do not expect their pricing power to improve in the short term. However companies will want to pass on cost inflation at the earliest opportunity

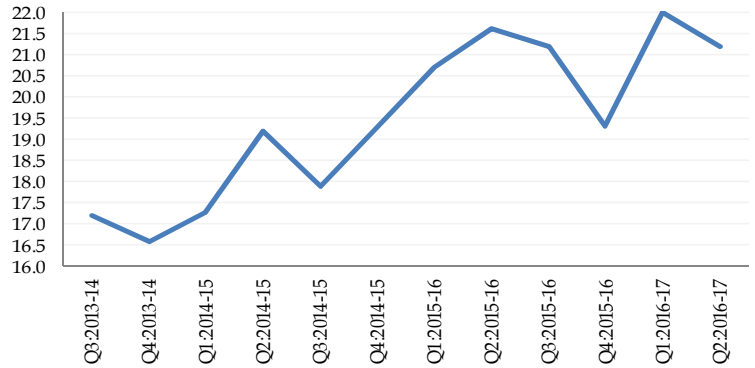
* The difference between % of respondents which indicated that profit margin and selling price will increase and those that answered it will decrease
** The difference between % of respondents which indicated that the overall business situation will improve and those that indicated it will worsen

Output Gap: Capacity Utilisation down, inventory build up

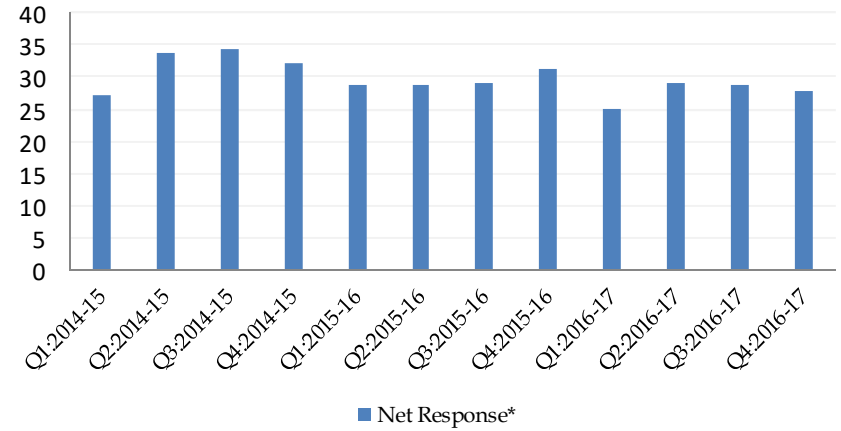
Capacity Utilization (OBICUS %)



Average Finished Goods Inventory / Sales Ratio (OBICUS)



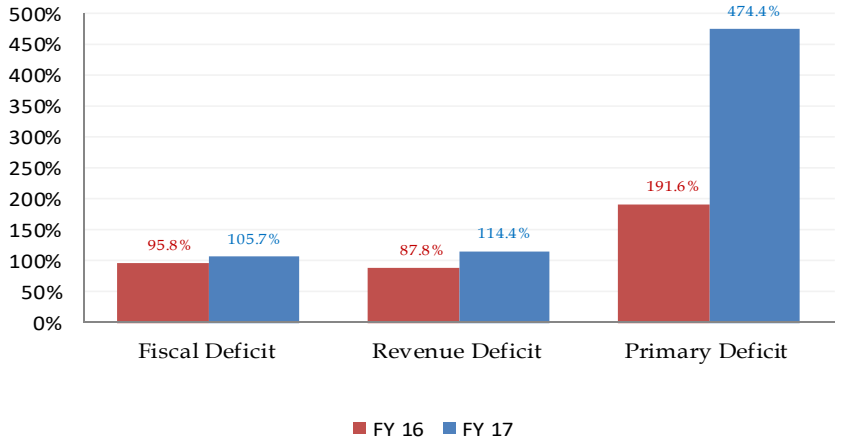
Expectation for Production (Industrial Outlook Survey %)



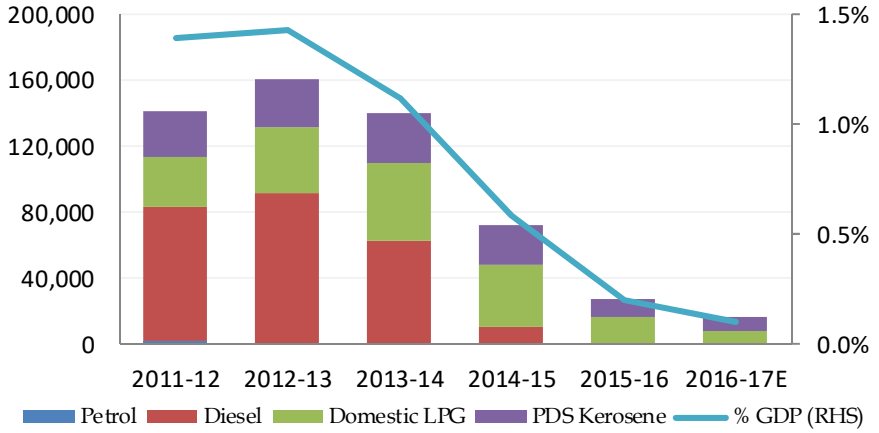
- The RBI's Order Books, Inventories, and Capacity Utilisation Survey (OBICUS) survey continues to show a decline in the level of capacity utilization
- The fall in capacity utilisation is visible across industry groups and especially pronounced in sponge iron and petroleum products
- Inventory levels have continued to remain elevated over the last several quarters.

Fiscal Discipline: Budget has outlined a prudent consolidation path

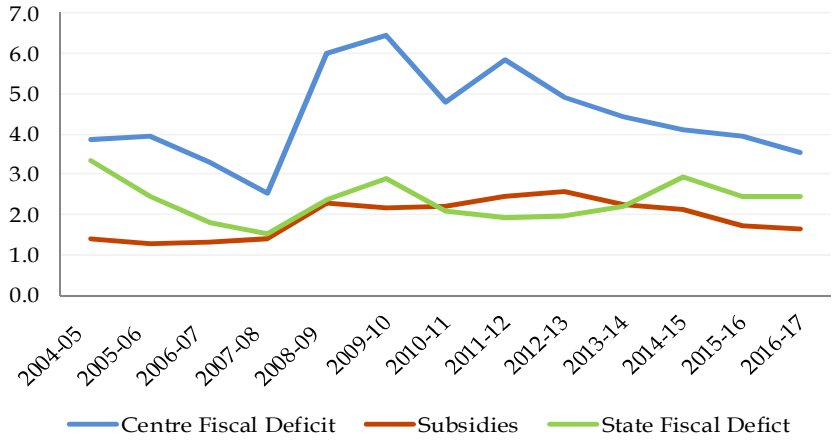
Fiscal Position up to January 2017 % actual to budget estimates



Public Sector Oil Marketing Companies Under recoveries



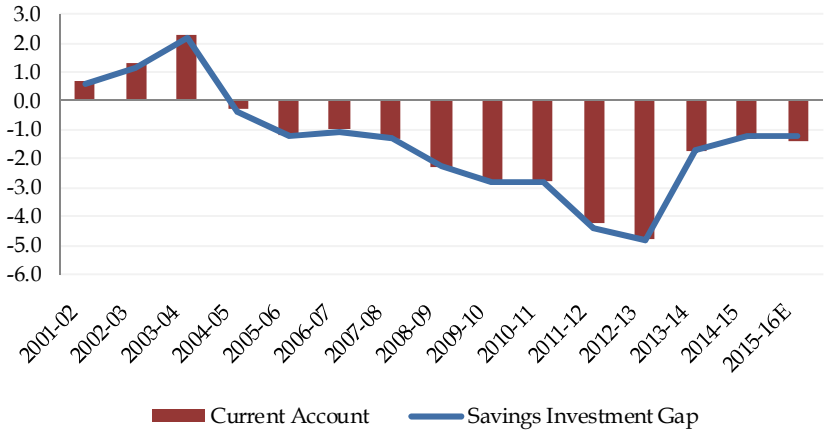
Fiscal Deficit (% of GDP)



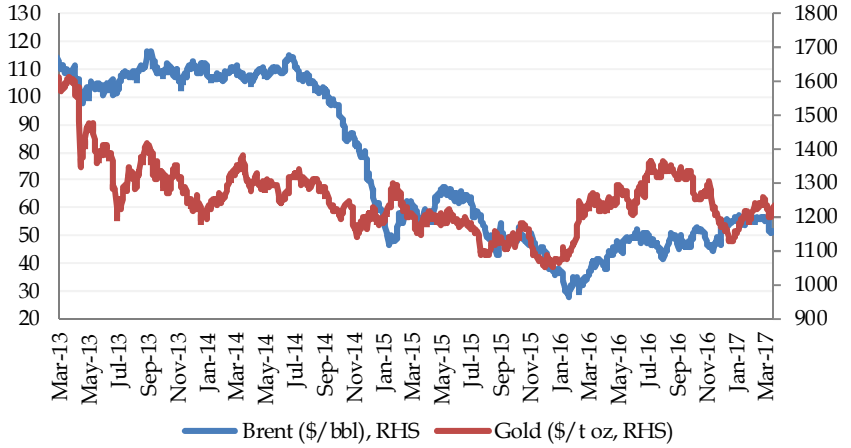
- The RBI has repeatedly stated that fiscal consolidation is very important.
- The government has made deep commitment to fiscal discipline at 3.5%, and lowered structural impediments to lower rate transmission by reducing PF, small savings and Kisan Vikas Patra rates. Moreover these rates are now revised more frequently to reflect market conditions.
- Given all the improvements the government will achieve its fiscal deficit target of 3.5% as forecasted by the budget for FY17 despite the current aggressive front-loaded infrastructure spending. We also expect next year's target of 3.2% will be achieved. The government is making a concerted effort to widen the tax base along with disciplined expenditure control.

CAD: Substantial improvement over the last two years

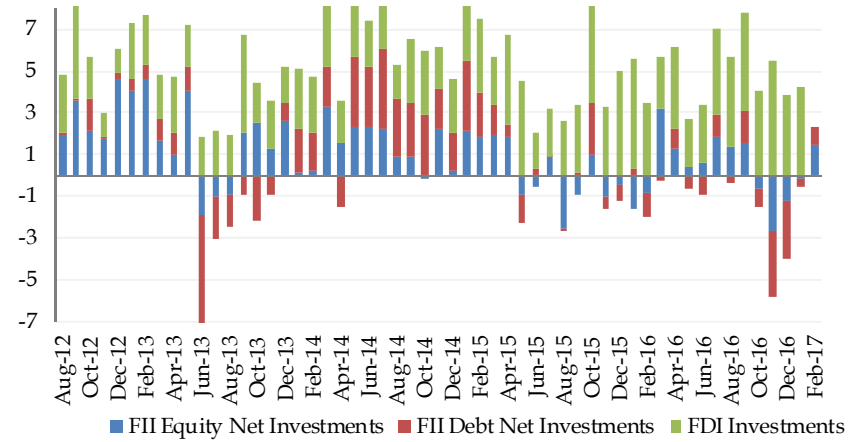
Current Account and Saving Investment Gap as % of GDP



Oil and Gold Prices



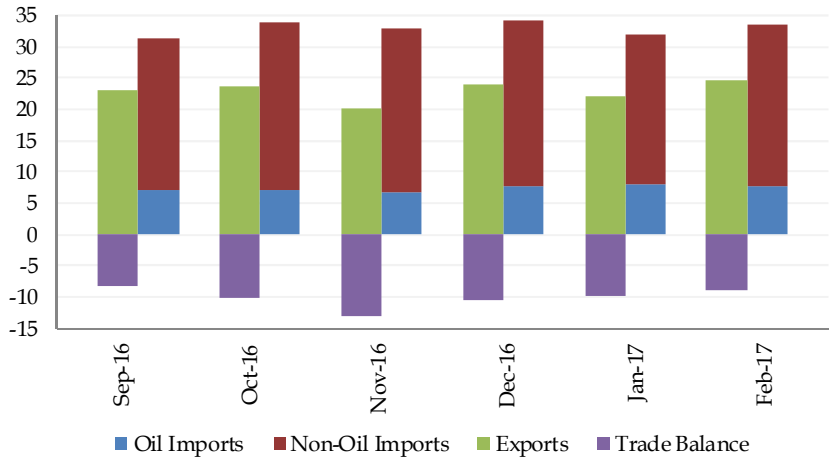
FII Investments



- The current account deficit (CAD) had emerged as a major source of concern for both monetary policy and financial stability
- The CAD has come in at 1.4% in Q3 FY17 vs 0.6% in Q2 FY17. The moderate 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 has reduced India's vulnerability to external shocks.

Trade: Export growth starting to recover

Trade ($B)



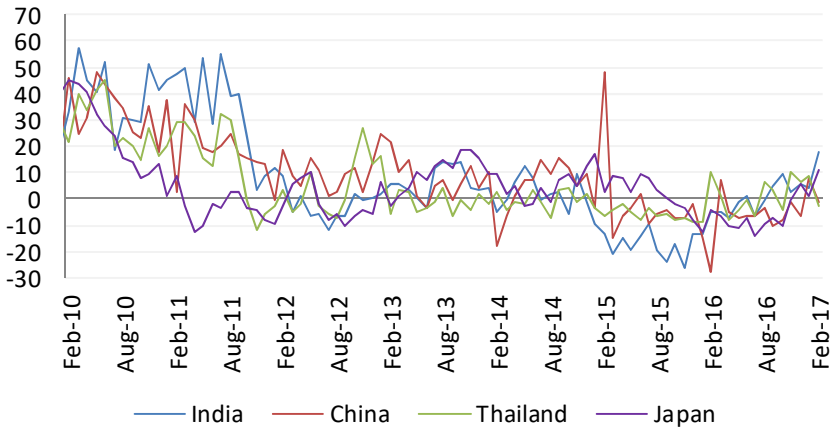
Top 10 Imports ($M)

Commodity Group	Apr-Jan 2016	Apr-Jan 2017(P)	%Growth	%Share
Pertoleum Crude & Products	73,322	69,310	-5	22
Gems & Jewellery	49,783	40,453	-19	13
Electoronics Items	33,439	33,880	1	11
Chemicals & Related Products	32,205	28,189	-12	9
Machinery	26,773	27,088	1	9
Base Metals	21,031	18,001	-14	6
Ores & Minerals	17,651	17,118	-3	6
Agri & Allied Products	17,712	18,691	6	6
Transport Equipments	12,457	13,570	9	4
Plastic & Rubber Articles	11,684	11,697	0	4
Total	**326,277**	**309,328**	**-5**	**100**

Top 10 Exports ($M)

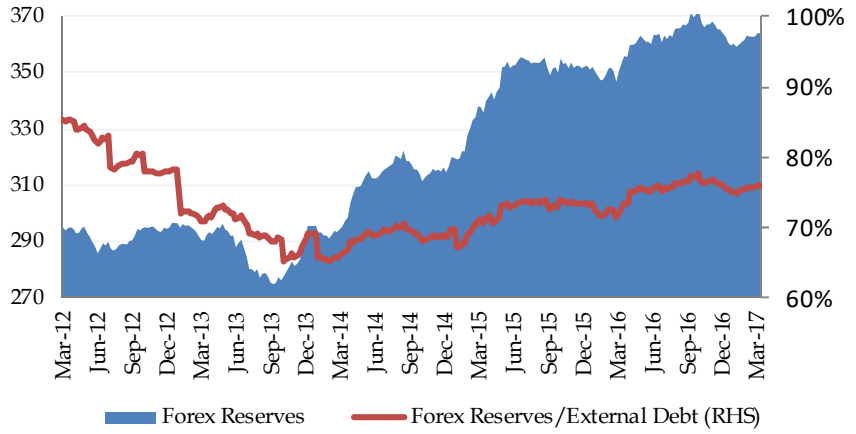
Commodity Group	Apr-Jan 2016	Apr-Jan 2017(P)	%Growth	%Share
Gems & Jewellery	31,709	35,291	11	16
Chemicals & Related Products	26,677	27,013	1	12
Pertoleum Crude & Products	26,461	25,282	-4	11
Agri & Allied Products	20,314	19,568	-4	9
Transport Equipments	17,920	17,896	0	8
Base Metals	15,688	16,782	7	8
Machinery	15,605	16,163	4	7
Plastic & Rubber Articles	5,397	5,233	-3	2
Leather & Leather Manufactures	4,695	4,451	-5	2
Electoronics Items	4,627	4,620	0	2
Total	**218,533**	**221,777**	**1**	**100**

Export Growth

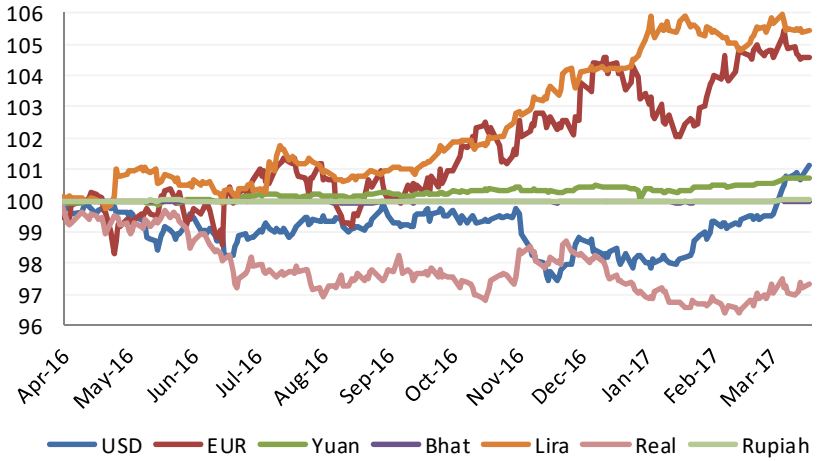


India's forex reserves have grown in absolute and relative terms

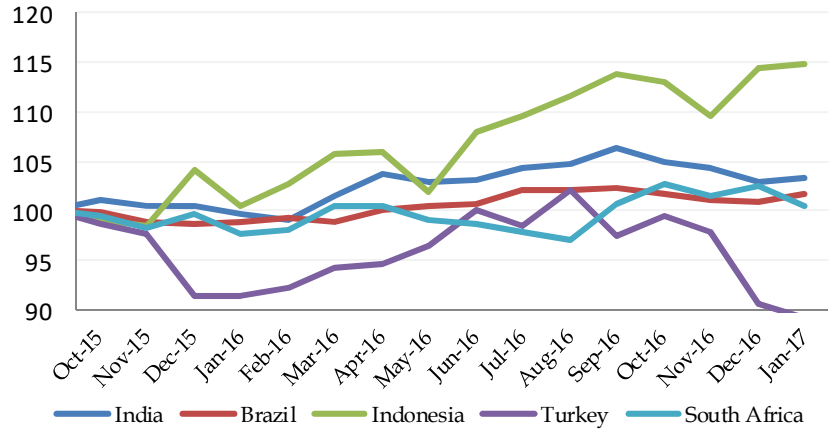
Foreign Exchange Reserves (SB)



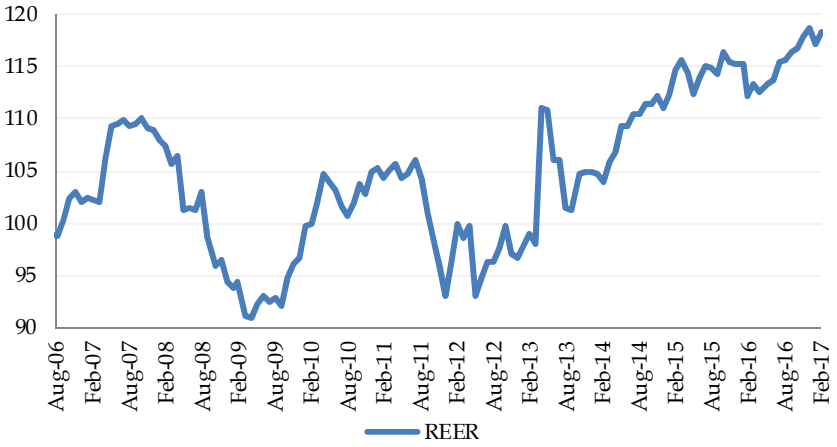
Rupee vs Selected Currencies



Foreign Exchange Reserve Additions

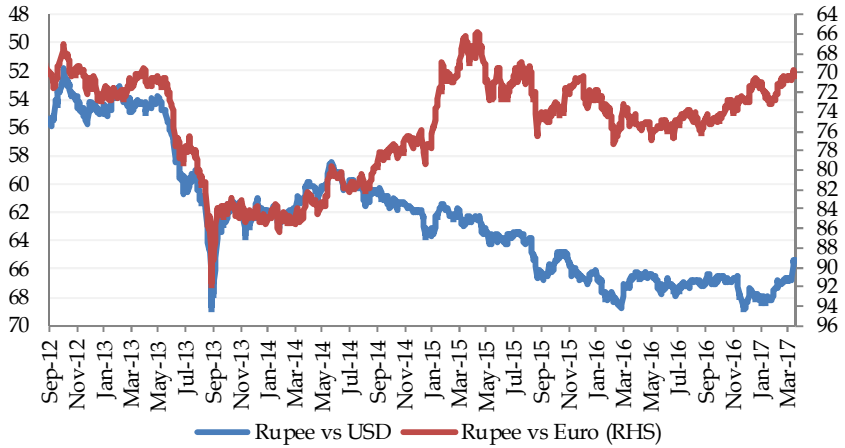


Real Effective Exchange Rate

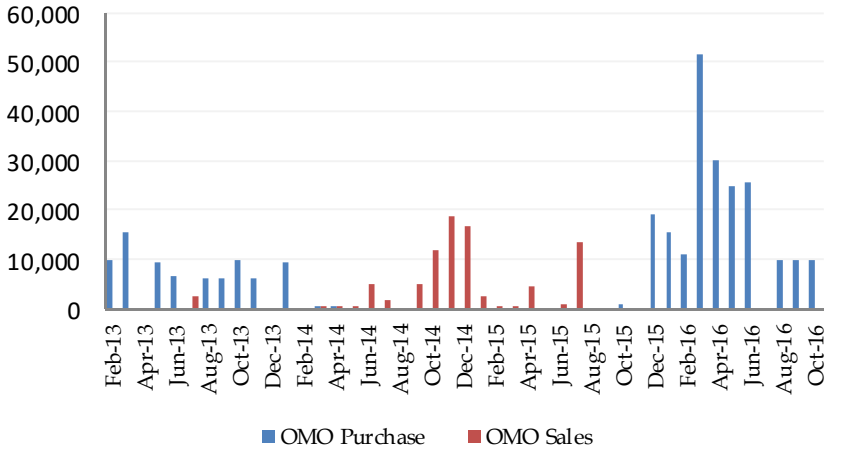


RBI Continues to intervene in currency and bond markets

Rupee Performance



Net RBI OMO Sale/Purchase



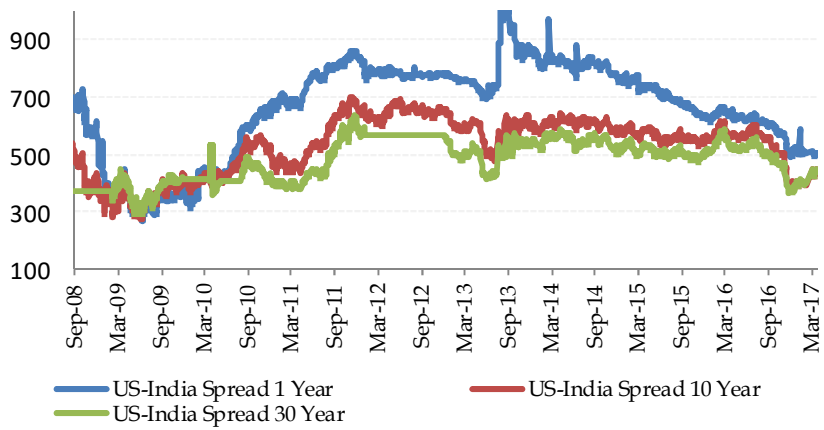
Sale/Purchase of Dollars by RBI

Period	RBI Gross Sale $	RBI Gross Purchase of $	RBI Net Purchase of $	Outstanding Forward Sales (-)/Purchase (+)
Jan-17	1,749	1,335	-414	501
Dec-16	4,534	4,997	463	586
Nov-16	21,845	19,127	-2,718	2,944
Oct-16	9,966	9,548	-418	5,632
Sep-16	4,392	9,041	4,649	4,890
Aug-16	4,220	5,070	850	94
Last 12 Months	**67,067**	**76,035**	**8,968**	

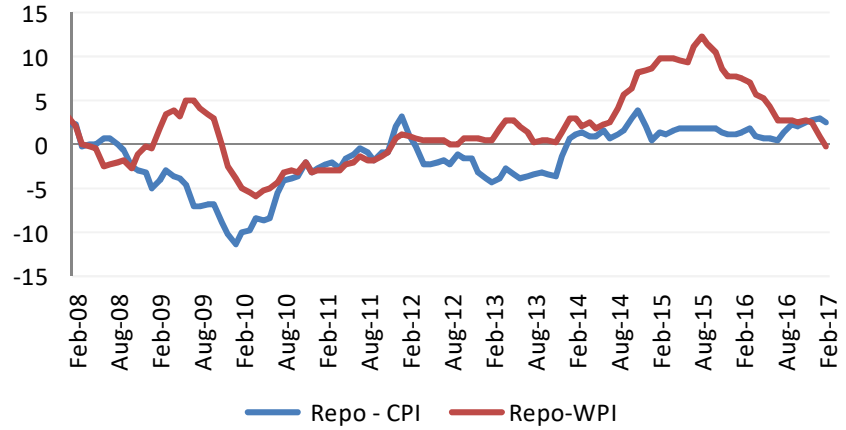
- The Rupee has actually appreciated against the dollar after the state assembly election to a 11 months high. The results of the election has increased the governments ability to carry out reforms.
- The RBI continues to intervene in FX and fixed income markets through the use of OMOs. After the April policy, the RBI approach is far more constructive in terms of providing adequate durable liquidity to the market as compared to previous years.
- RBI's net OMO purchases have been at historical highs. However with surplus in banking system OMO purchases have been scaled back

Real rates remain positive

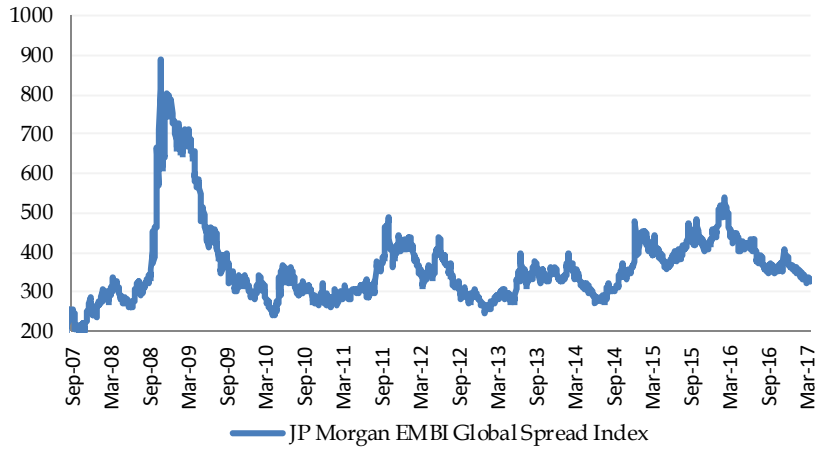
U.S Treasury-India G-sec Credit Spreads



Real Rates*



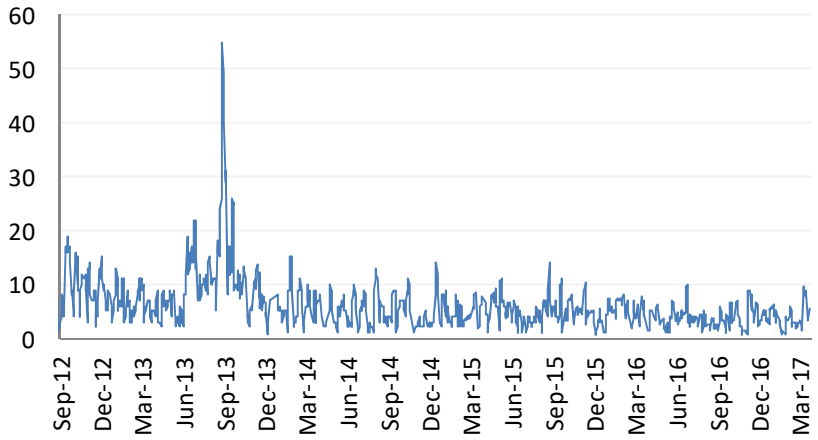
JP Morgan EMBI Spread Index



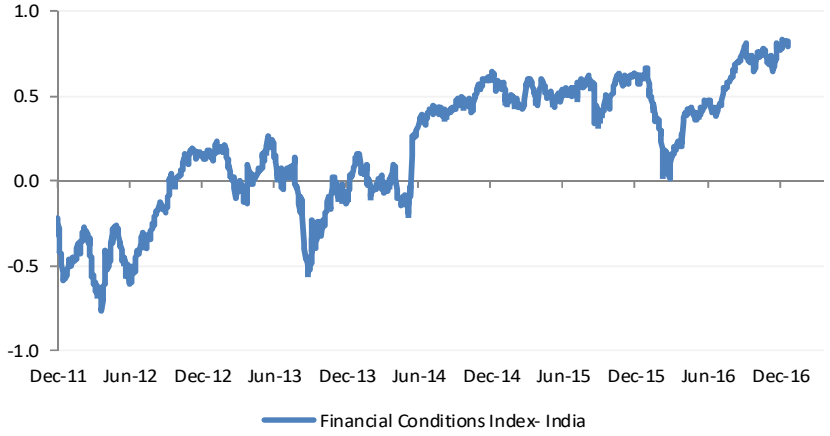
- As the U.S yields have risen and Indian yields moving down, the U.S India spread has come down from its recent highs
- India is also currently experiencing positive real rates. The real rate as measured by the Repo-CPI has moved down as the RBI has increased CPI has fallen faster than the policy rate. The real rates for producers has also come to zero as the WPI has increased.
- The wedge between real rates for borrowers and consumers has narrowed
- The RBI has indicated that a real rate around 1.25% is reasonable for India
- However rising commodity prices imply a drop in real rates for most other emerging economies.

Global financial conditions remain relatively stable

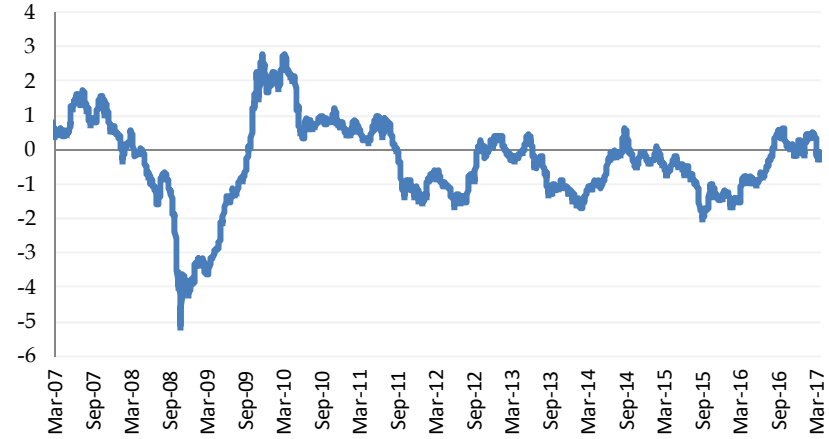
Rupee 5% day volatility



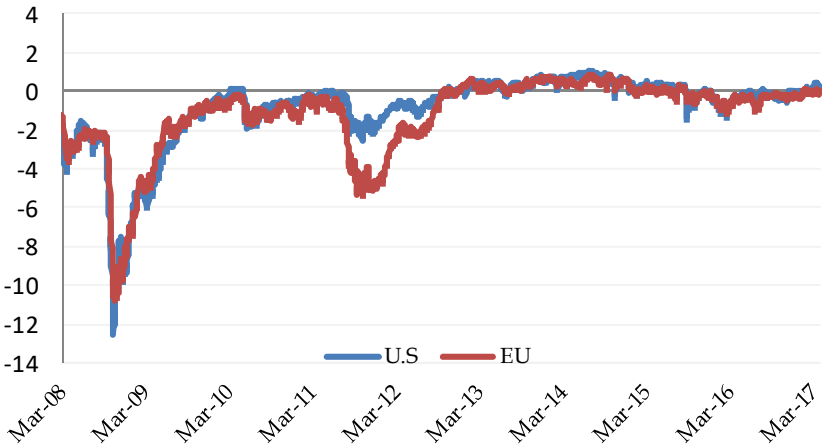
Trust India Financial Conditions Index



Bloomberg Asia Ex-Japan Financial Conditions Index

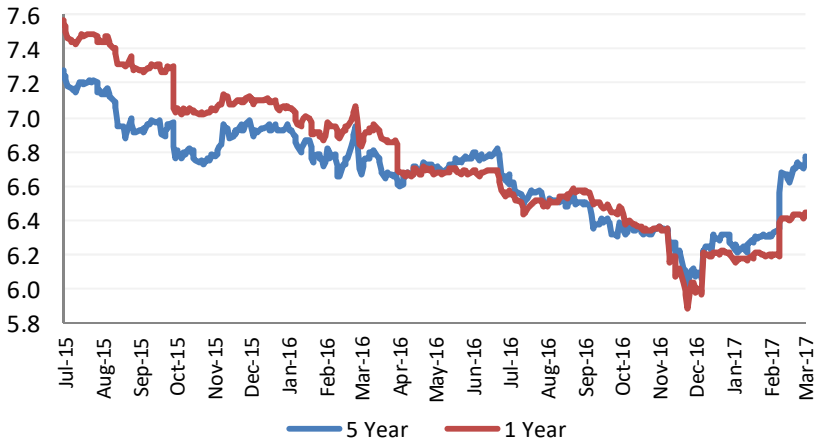


Bloomberg U.S EU Financial Conditions Index

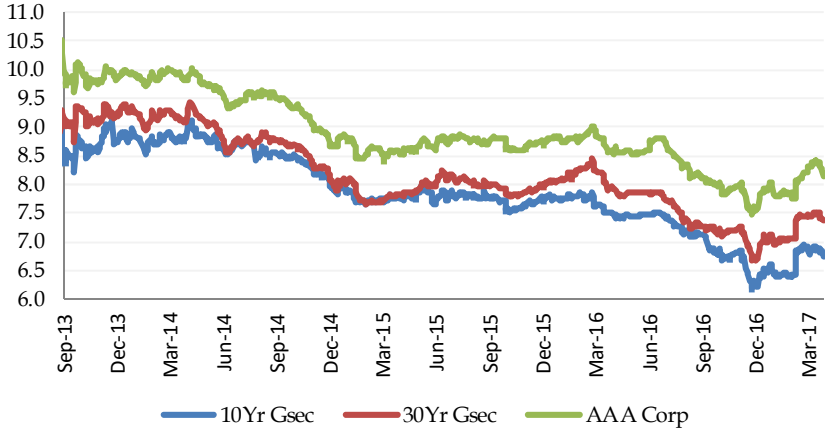


The rally in Indian bond markets was reversed with the change in stance

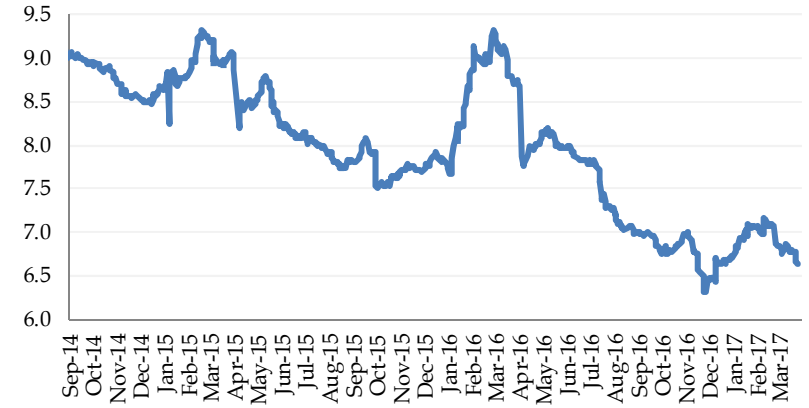
On-shore Swap Rates



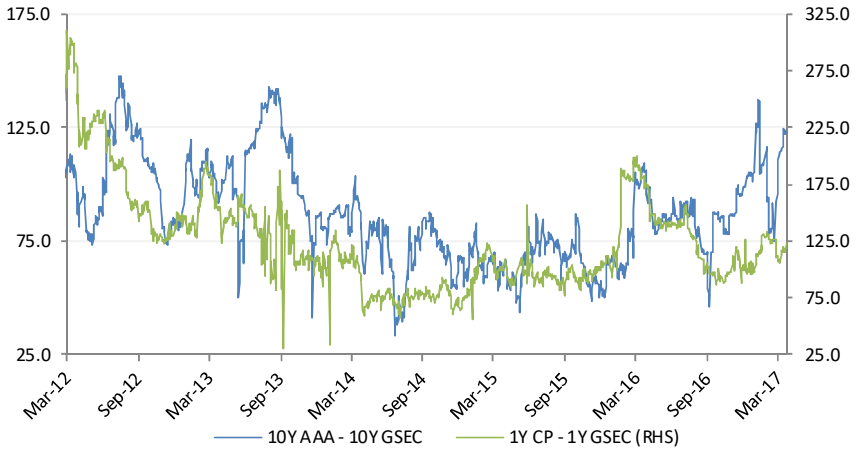
Selected Yields



3 Month CP Rates



10 Year and 1 Year Corp AAA Spreads (bps)



Our View: rates to remain on hold with change in stance

- In its February policy the RBI surprised the market by keeping the policy repo rate unchanged and shifting its monetary policy stance from accommodative to neutral.
- In its policy the RBI had highlighted volatility on the exchange rate on the account of global financial developments as an upside risk that could impart uncertainty on the baseline inflation path. However since the policy, the Rupee has appreciated to four year highs post the recent state assembly elections and relatively dovish FOMC statement.
- The RBI is actually in a corner in its efforts to stem the rapid appreciation of the Rupee. The Rupee appreciation reduces the risk of imported inflation however the RBI does not desire such a rapid appreciation. Intervention to weaken the Rupee ends up boosting domestic liquidity at a time where the banking system is awash with surplus liquidity. If the RBI does not intervene the Rupee could continue appreciating setting it up for future volatility of the currency.
- So the RBI may be forced to recalibrate its monetary stance given the diminishing expectations of three/four U.S interest rate hikes in the current year and persistent strength of the Rupee.
- However the RBI cannot flip flop on its monetary policy stance in consecutive meetings and hence will maintain the status quo while remaining data dependent.
- In terms of inflation, the trend in WPI is particularly worrying as it could lead to higher CPI with a lag. The rise in WPI partly represents a rise cost inflation and this cost inflation has so far not been passed on to end products. As the economy revamps post demonetisation this cost inflation will feed into headline CPI inflation.
- Despite the current surplus liquidity in the banking sector the RBI has reiterated that it is committed to conducting liquidity operations in pursuit of the objectives of restoring system level liquidity to a position of neutrality as the surplus liquidity pressures abate. The RBI expects that surplus liquidity should decline with progressive remonetisation. Nonetheless, the currently abundant liquidity with banks has persisted into the early months of 2017-18. In light of this the RBI is likely to initiate the process of adding the Standing Deposit Facility as an additional liquidity management tool.

Rates and Credit Research
Binyam Taddese
+91 22 42245000
binyam.taddese@trustgroup.in

Head of Equity
Naren Shah
+91 22 42245074
naren.shah@trustgroup.in

Institutional Sales
Pranav Inamdar
+91 22 40845031
pranav.inamdar@trustgroup.in

FII Sales
Sandeep Bagla
+91 22 42245143
sandeep.bagla@trustgroup.in

Equity Sales
Sriram Rangarajan
+91 22 42245216
sriram.rangarajan@trustgroup.in

Thank You

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109/110, 1st Floor, Balarama, Bandra Kurla Complex, Bandra (E), Mumbai -400 051, Maharashtra.

Ph: +91 22 4084 5000 • Fax: +91 22 4084 5052 • www.trustgroup.co.in