

October RBI Monetary Policy Preview

October 2017

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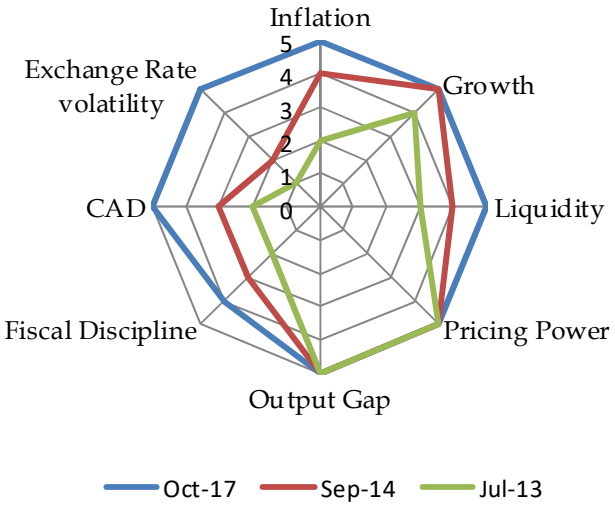
RBI Dashboard

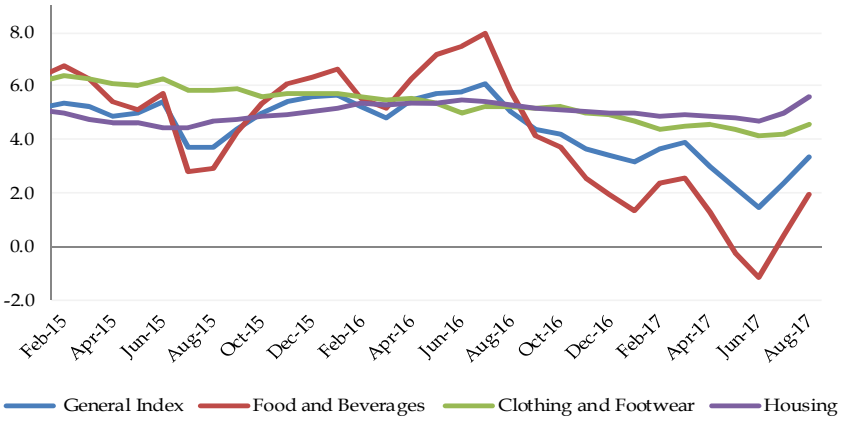
- RBI's objectives as set out in Urjit Patel Committee Report:
  - Headline CPI - nominal anchor for policy communication.
    - Target: 4% with a band of +/- 2% tolerance
  - Monetary Policy Committee (MPC) vested with Monetary Policy decision
    - Policy rule defined in terms of a real policy rate 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. The RBI has indicated the neutral stance gives it more flexibility to respond to changing economic conditions.
  - Inflation has ticked up but still remains below RBI's medium term target

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

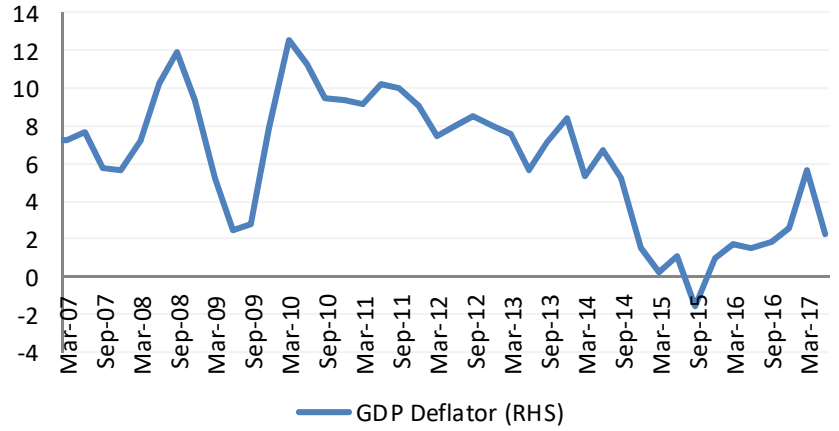


Inflation Picture: CPI has ticked up from record lows

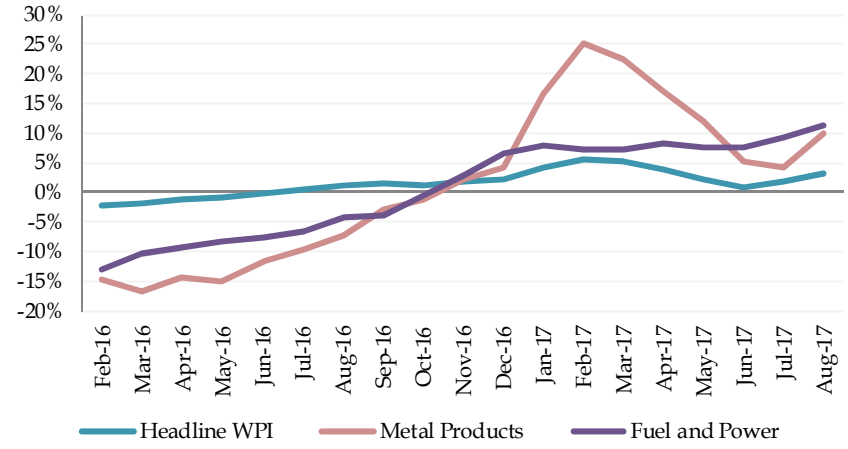
India CPI



GDP Deflator



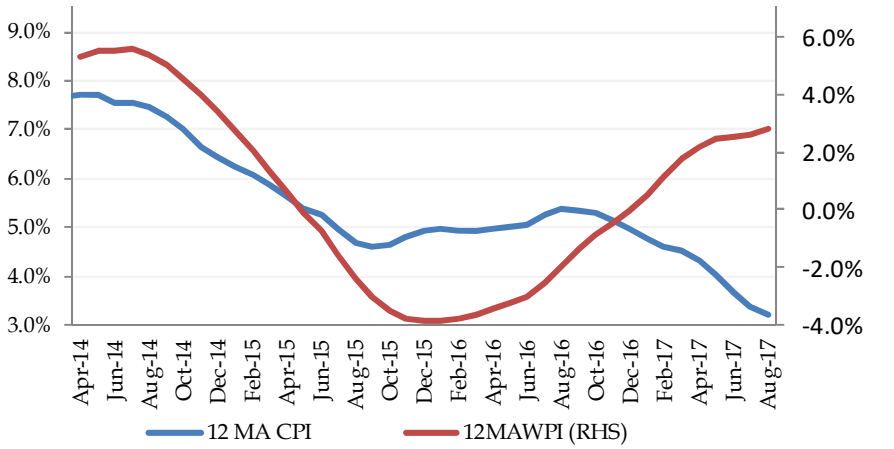
WPI



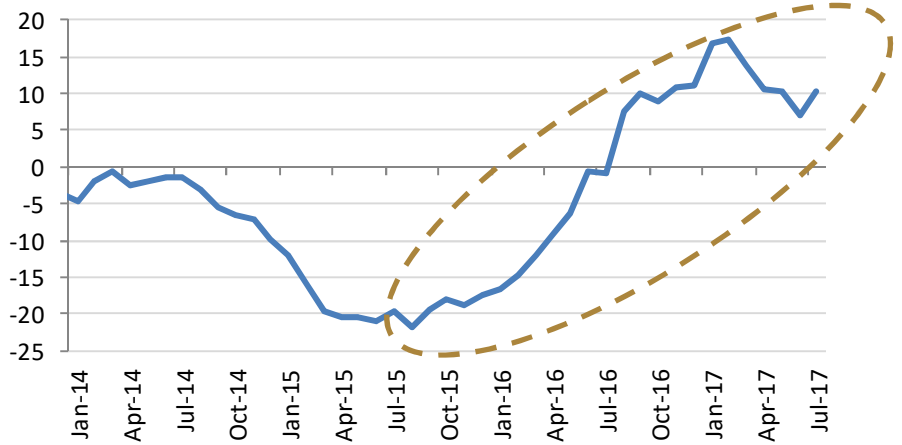
- After falling to record lows up to June, CPI inflation has picked up in the last few readings, although it remains below the RBI's medium term trajectory
- Key drivers of CPI inflation remain manageable. Pulse and vegetables prices which were the main drivers of the past upticks have dropped significantly reflecting increased sowing, better supply management and higher imports.
- WPI had risen in the recent past driven by metal and petroleum products, however even those factors have now stabilized . The WPI and CPI divergence has reduced since the base revision to 2011-12.
- Furthermore the outlook for food inflation remains stable as the monsoon was considered normal.

Inflation Picture: Global food prices have firmed up but domestic prices mostly stable

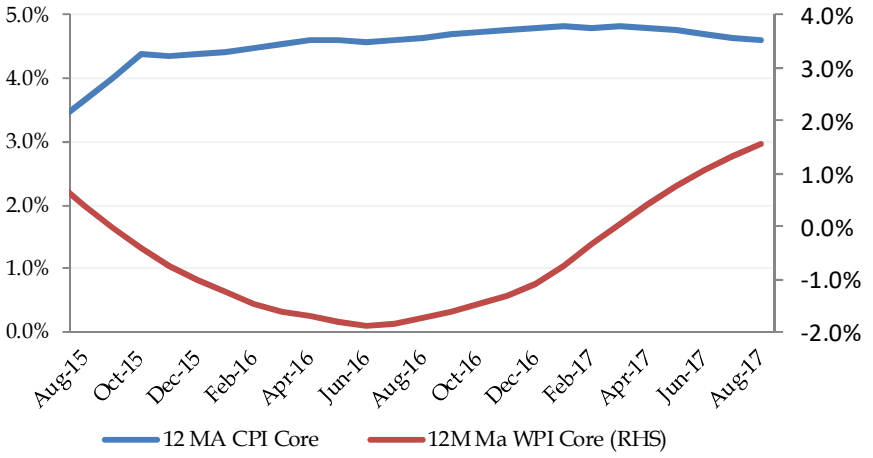
Twelve Month Moving Average Headline Inflation



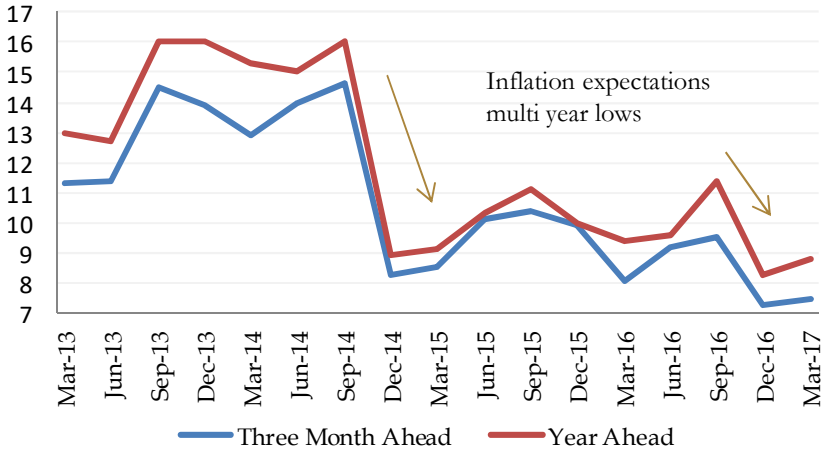
FAO Global Food Index (% Growth)



Twelve Month Moving Average Core Inflation

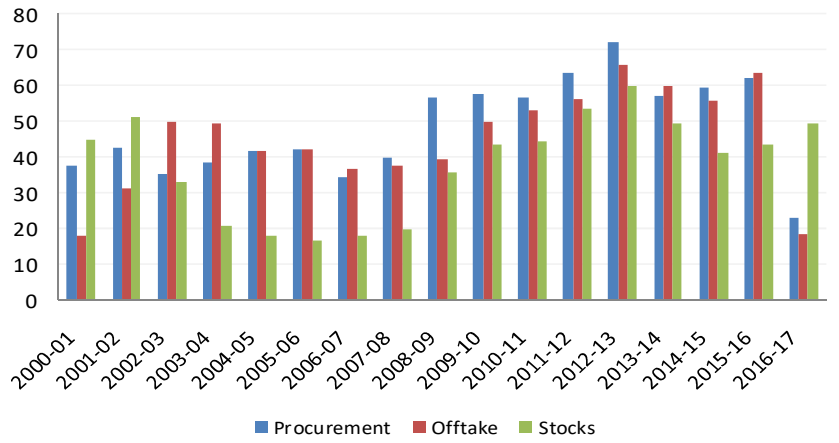


Inflation Expectations

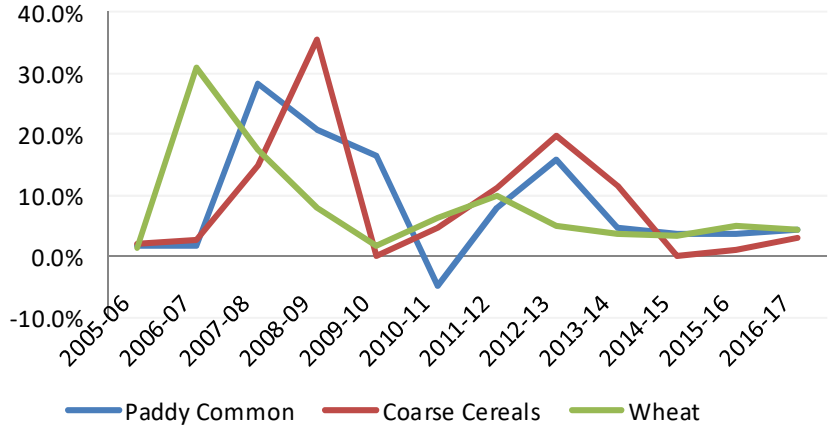


Inflation Picture: Adequate food stocks in conjunction with slower price growth and improved agricultural output

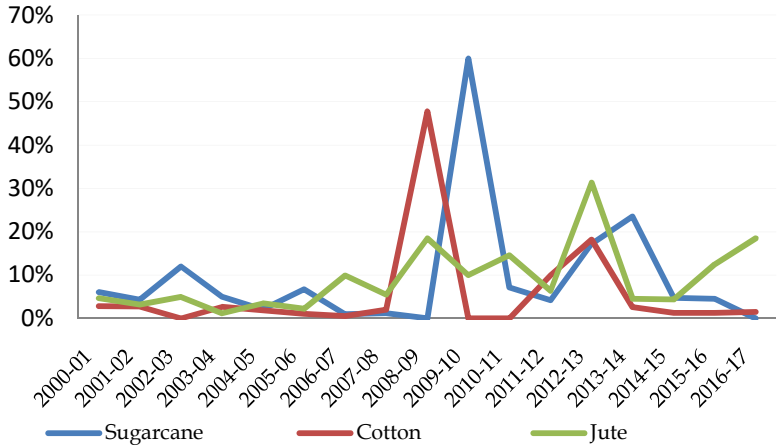
Public Distribution System (Million Tonnes)



MSP Prices – Food Grains (%chg)



MSP Prices – Non Food Grains (%chg)

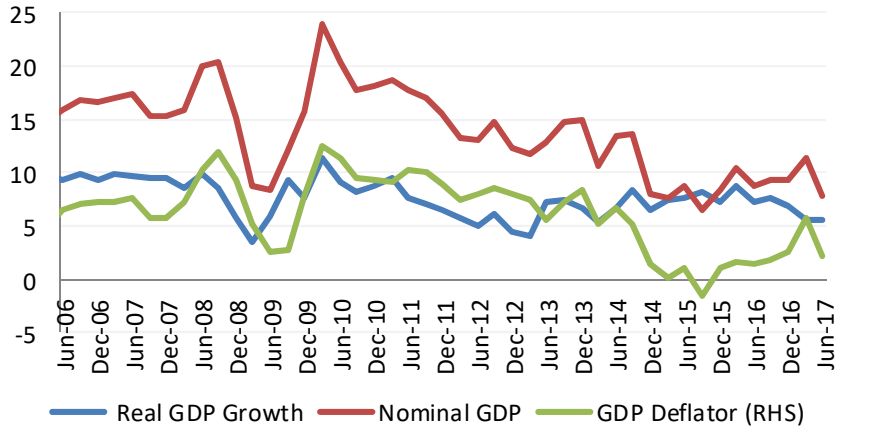


Rural Wage Growth

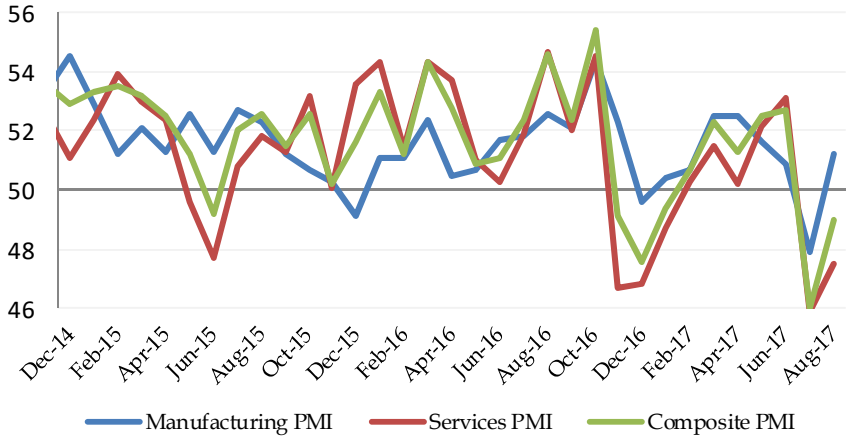


Growth Picture: economy working through multiple transitions

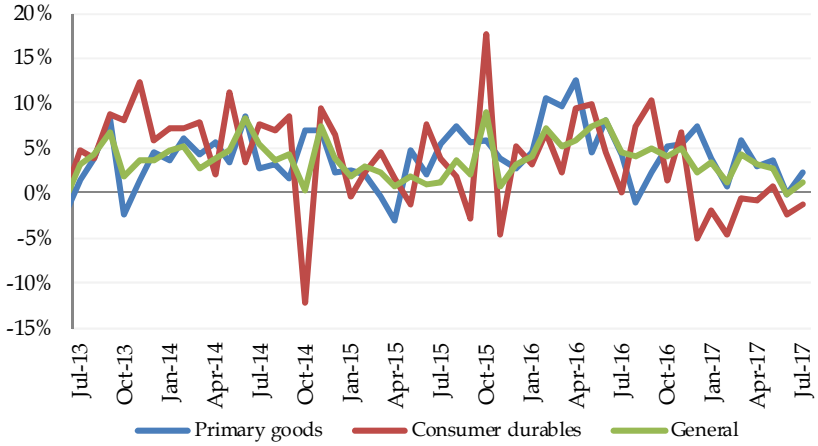
Real GDP Growth



India PMI



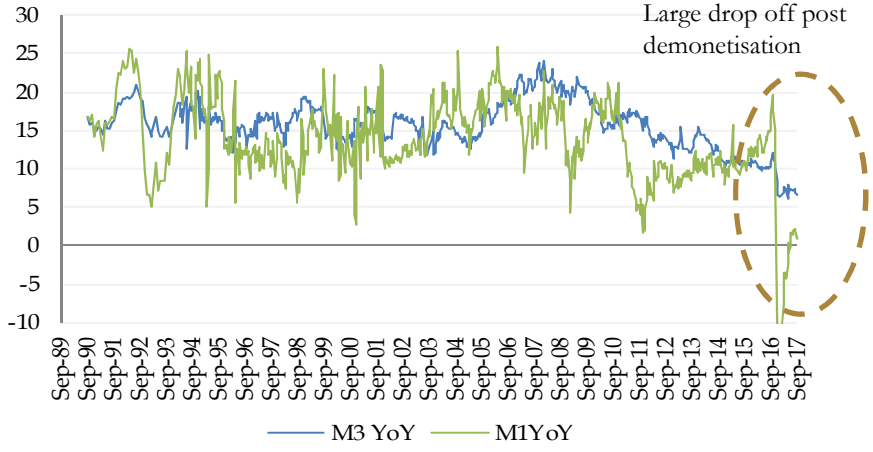
Index of Industrial Production



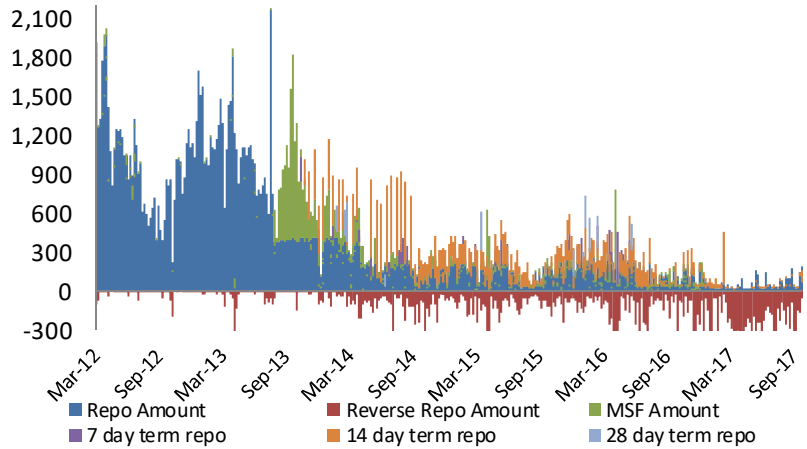
- The revised GDP figures indicate there has been a slowdown in GDP as the market has suspected all along and the economy works through multiple transitions including the introduction of the GST.
- This transition is visible in the industrial production data where the latest readings suggest that industrial production has been impacted by the uncertainty surrounding the introduction of GST and remaining residual impacts that arose out of the demonetisation exercise.
- We expect the IIP to be less volatile under the new series and track other indicators closely

Liquidity Picture: Comfortable liquidity conditions

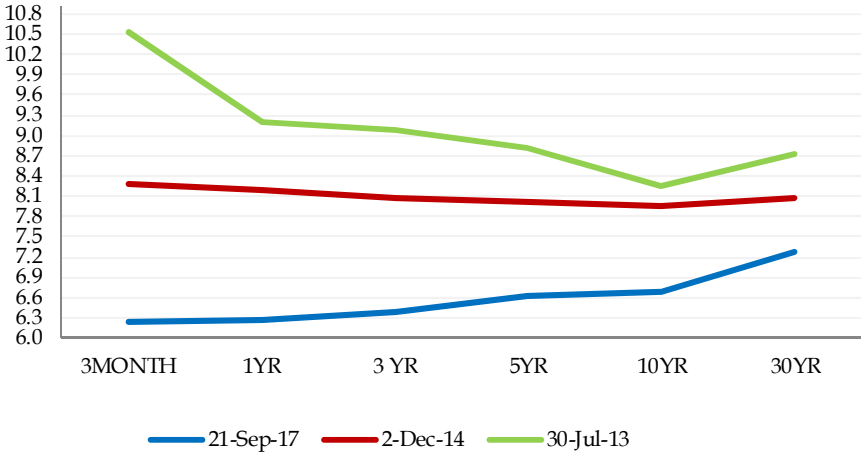
Money Supply Growth



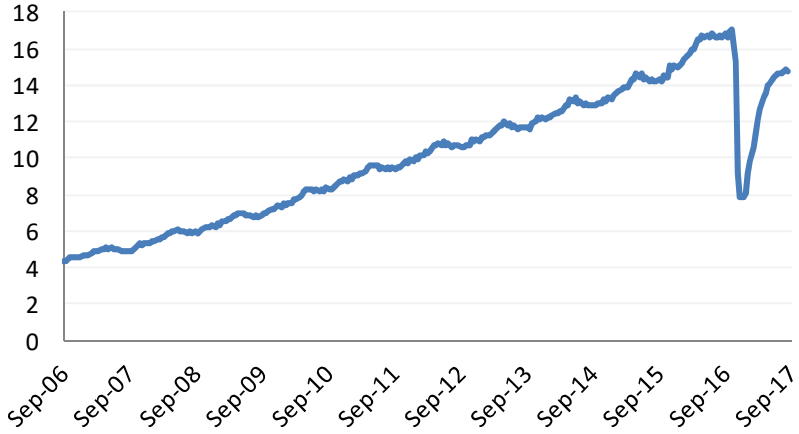
Liquidity Adjustment Facility (Rs. B)



Yield Curve

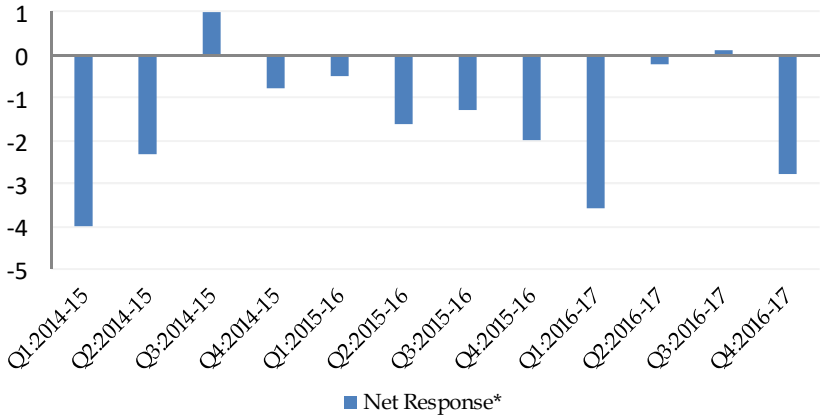


Currency in Circulation (Rs. TRN)

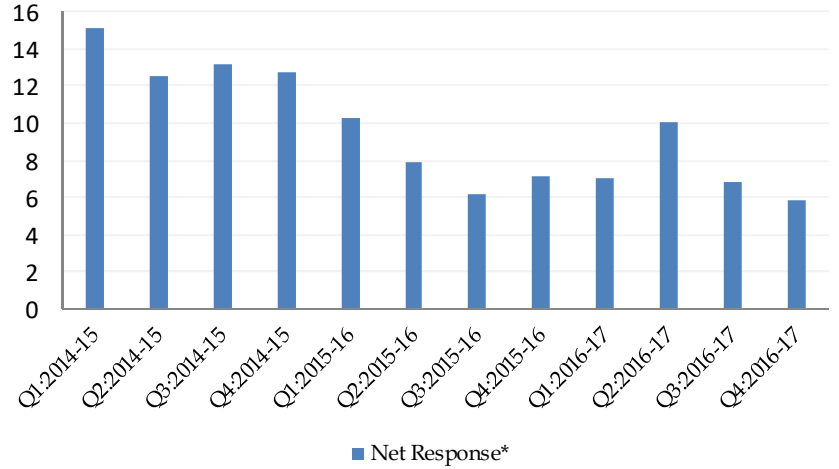


Pricing Power: Producer's pricing power compromised

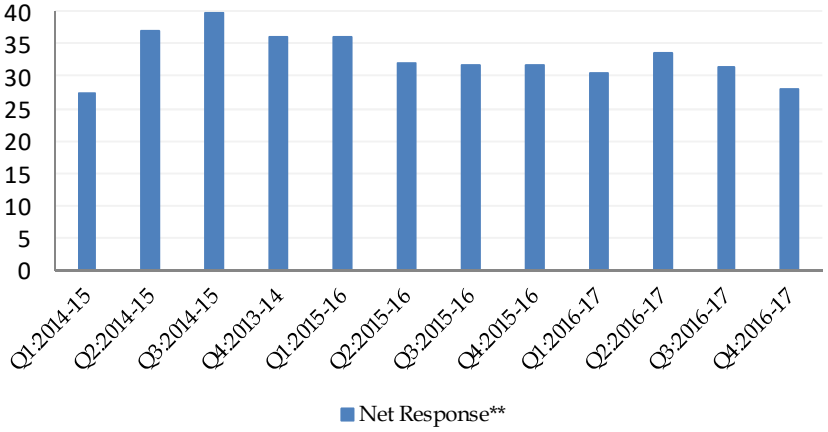
Expectations of Profit Margin – RBI Industrial Outlook Survey (% response)



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



Expectations of Overall Business Situation – RBI Industrial Outlook Survey

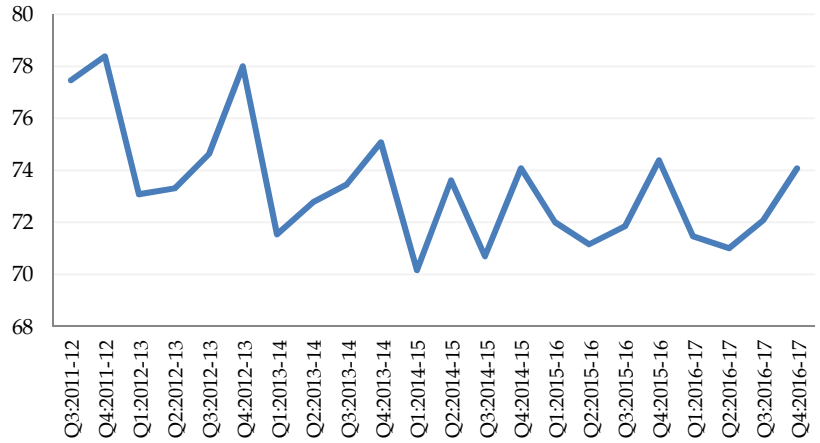


- FY16 saw a continued drop in operating profit growth indicating moderation in pricing power
- Companies highly impacted by high interest rates as interest costs as a percentage of operating profits increased
- RBI's Industrial Outlook indicates companies' expectation of selling price and profit margin 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

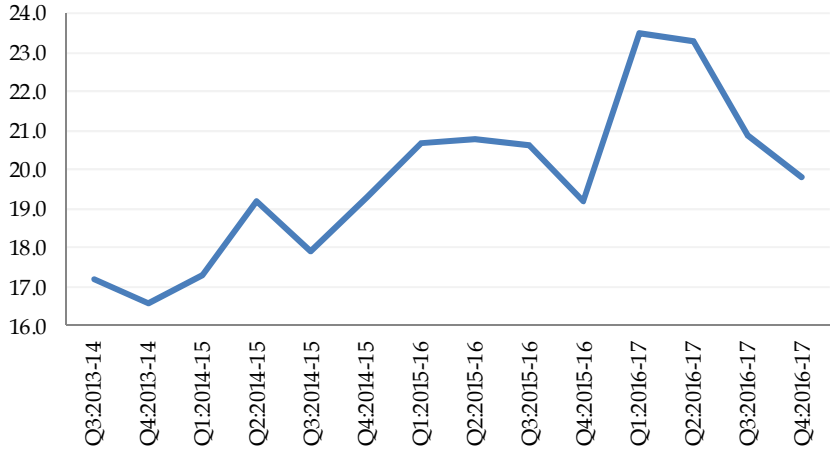
* The difference between % of respondents which indicated that profit margin and selling price will increase and those that answered it will decrease
** The difference between % of respondents which indicated that the overall business situation will improve and those that indicated it will worsen

Output Gap: Capacity Utilisation down, inventory build up

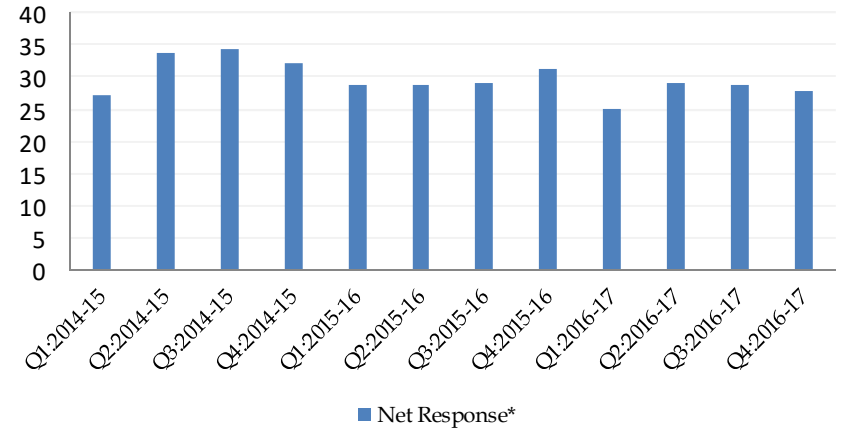
Capacity Utilization (OBICUS %)



Average Finished Goods Inventory / Sales Ratio (OBICUS)



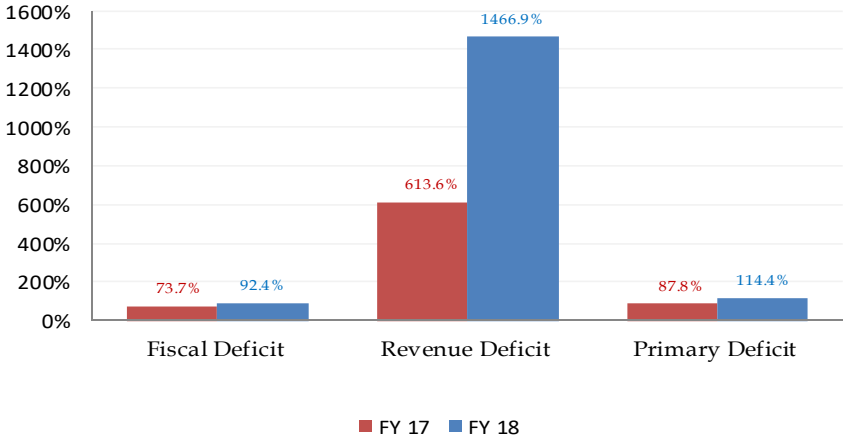
Expectation for Production (Industrial Outlook Survey %)



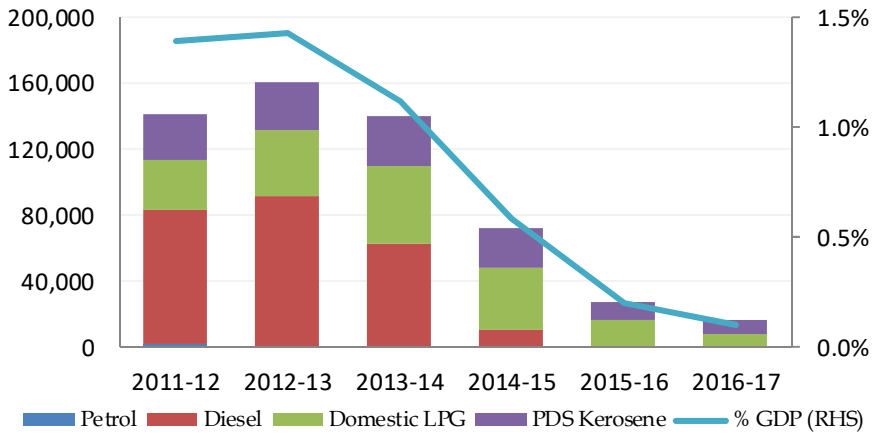
- The RBI's Order Books, Inventories, and Capacity Utilisation Survey (OBICUS) survey continues to show a decline in the level of capacity utilization
- The fall in capacity utilisation is visible across industry groups and especially pronounced in sponge iron and petroleum products
- Inventory levels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

Fiscal Discipline: Meeting fiscal deficit target may be difficult

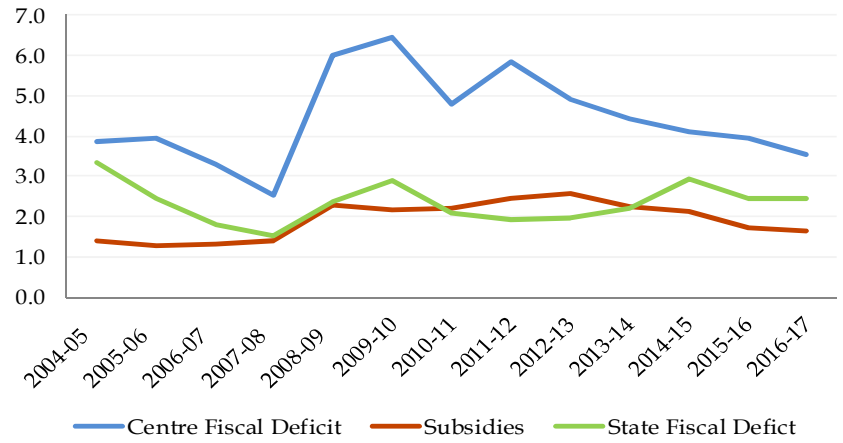
Fiscal Position up to July 2017 % actual to budget estimates



Public Sector Oil Marketing Companies Under recoveries



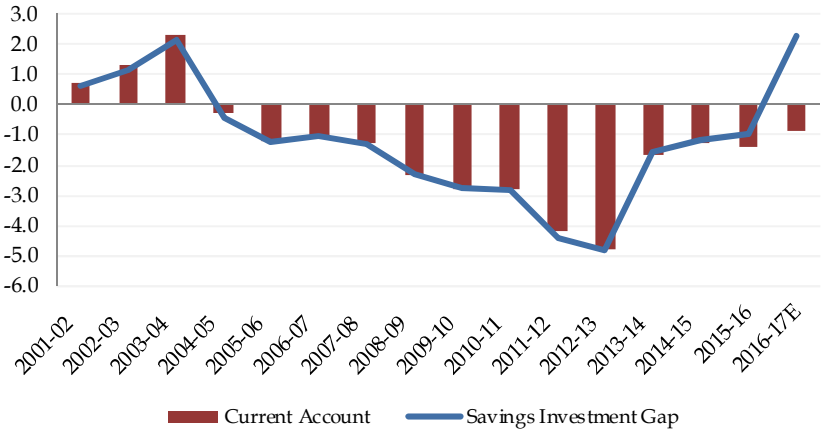
Fiscal Deficit (% of GDP)



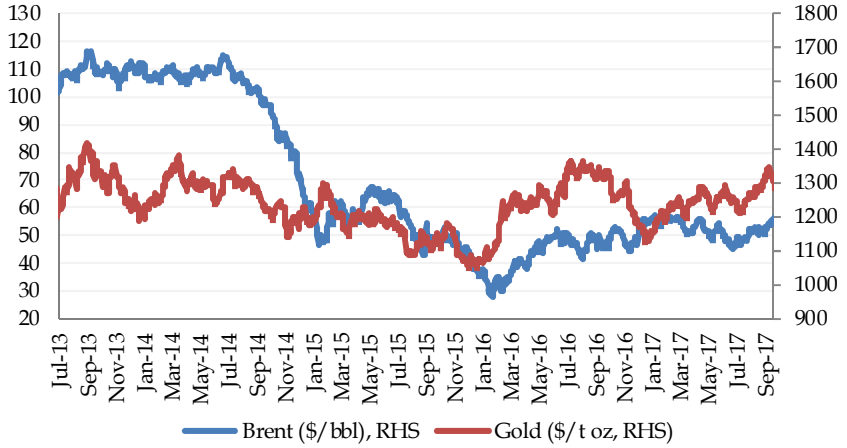
- The RBI has repeatedly stated that fiscal consolidation is very important.
- Last year the government has achieved its fiscal deficit target of 3.5% as forecasted by the budget for FY17 despite the aggressive front-loaded infrastructure spending.
- However for this year, while the government is making a concerted effort to widen the tax base, risks have arisen that could disrupt the fiscal math.
- Key risks that need to be monitored for fiscal targets are the pay commission increases, farm loan waivers, the success of GST implementation and any impulses to loosen fiscal targets.
- At this point in the fiscal year, the deficit as a percentage of the budgeted deficit is alamrming.

CAD: Substantial improvement over the last two years

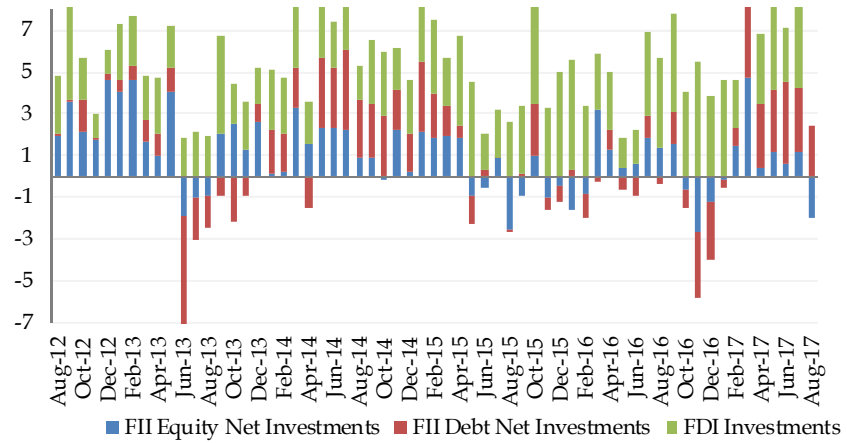
Current Account and Saving Investment Gap as % of GDP



Oil and Gold Prices



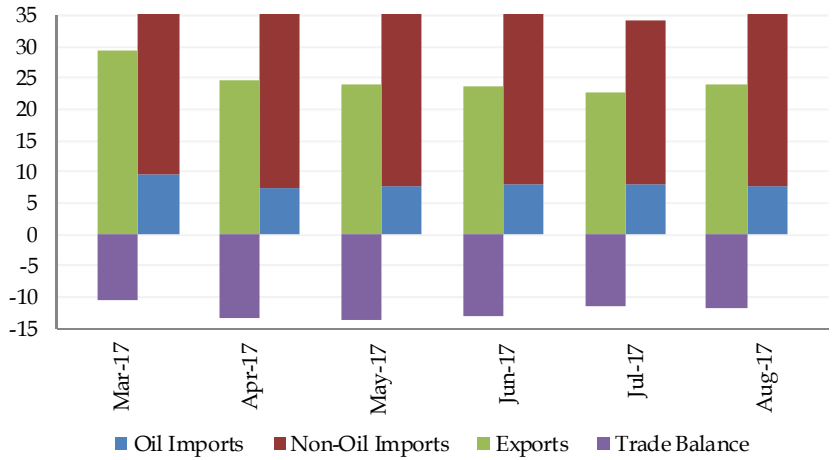
FII Investments



- The current account deficit (CAD) had emerged as a major source of concern for both monetary policy and financial stability
- The CAD for Q4FY17 came in at 0.6% of GDP and for FY17 as a whole at 0.7% of GDP, a significant improvement over the last several years.. Financing of the deficit has also become easier due to significant FII inflows.
- An improving CAD situation has reduced India's vulnerability to external shocks.
- However the trade deficit is widening in the latest readings and should be monitored closely.

Trade: Trade deficit higher than recent lows

Trade ($B)



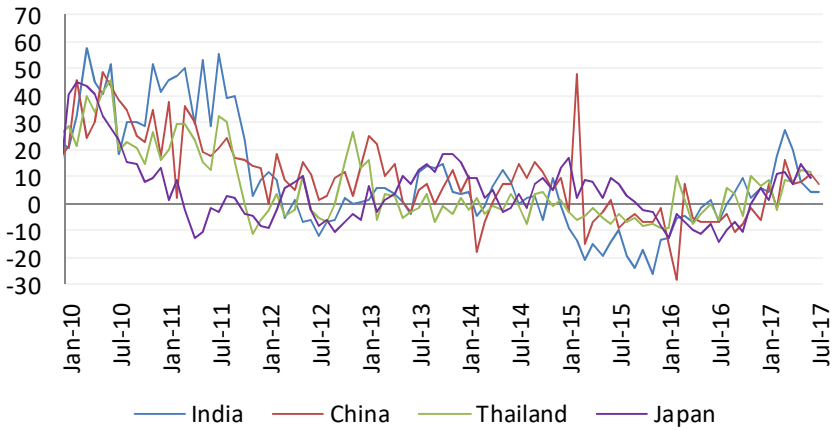
Top 10 Imports ($M)

Commodity Group	Apr-Aug 2016	Apr-Aug 2017(P)	%Growth	%Share
Gems & Jewellery	16,916	33,157	96	18
Pertoleum Crude & Products	32,616	38,325	18	21
Electoronics Items	15,557	21,021	35	11
Machinery	12,923	15,061	17	8
Chemicals & Related Products	14,835	16,260	10	9
Ores & Minerals	7,544	11,733	56	6
Base Metals	8,903	10,935	23	6
Agri & Allied Products	8,223	10,012	22	5
Plastic & Rubber Articles	5,960	7,063	19	4
Transport Equipments	5,877	5,908	1	3
Total	**143,501**	**182,977**	**28**	**100**

Top 10 Exports ($M)

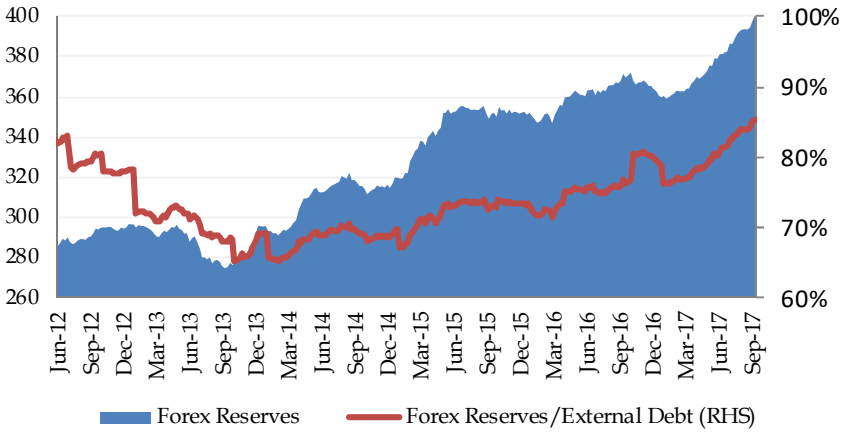
Commodity Group	Apr-Aug 2016	Apr-Aug 2017(P)	%Growth	%Share
Gems & Jewellery	17,757	16,561	-7	14
Pertoleum Crude & Products	11,836	13,943	18	12
Chemicals & Related Products	13,274	14,093	6	12
Agri & Allied Products	9,822	10,989	12	9
Base Metals	7,372	10,418	41	9
Machinery	8,283	9,174	11	8
Transport Equipments	9,463	9,611	2	8
Plastic & Rubber Articles	2,629	2,875	9	2
Electoronics Items	2,333	2,376	2	2
Leather & Leather Manufactures	2,312	2,307	0	2
Total	**109,215**	**118,057**	**8**	**100**

Export Growth

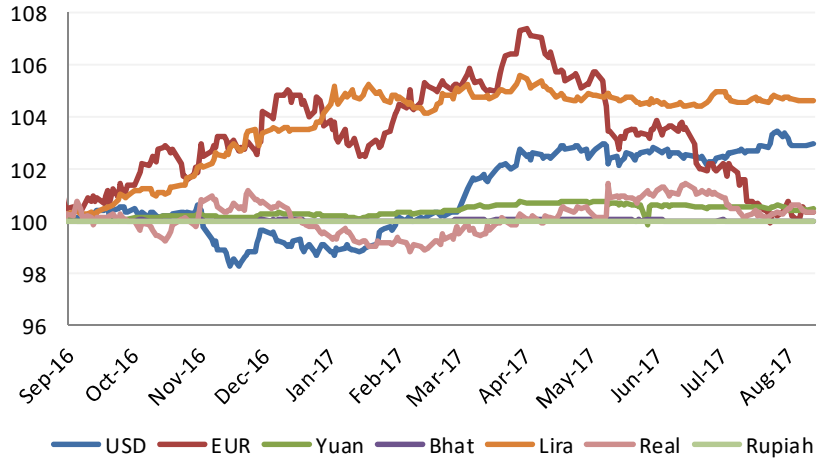


India's forex reserves have grown in absolute and relative terms

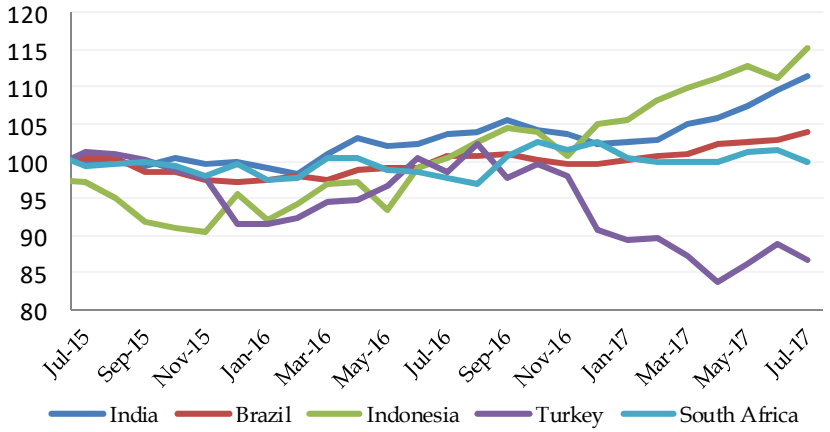
Foreign Exchange Reserves (SB)



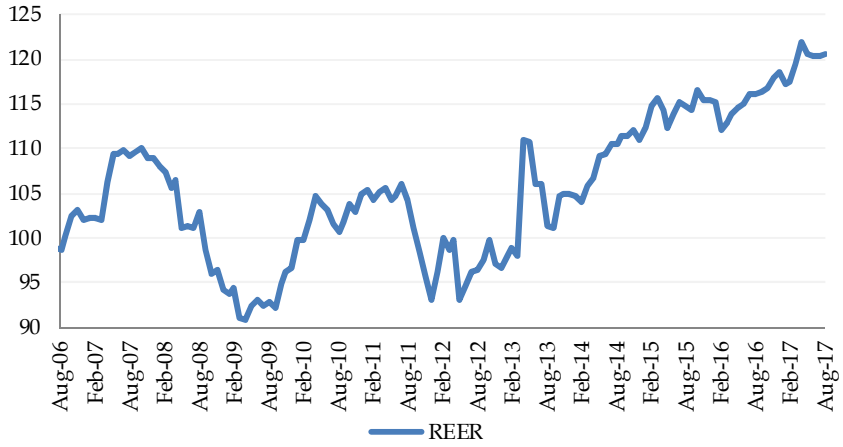
Rupee vs Selected Currencies



Foreign Exchange Reserve Additions

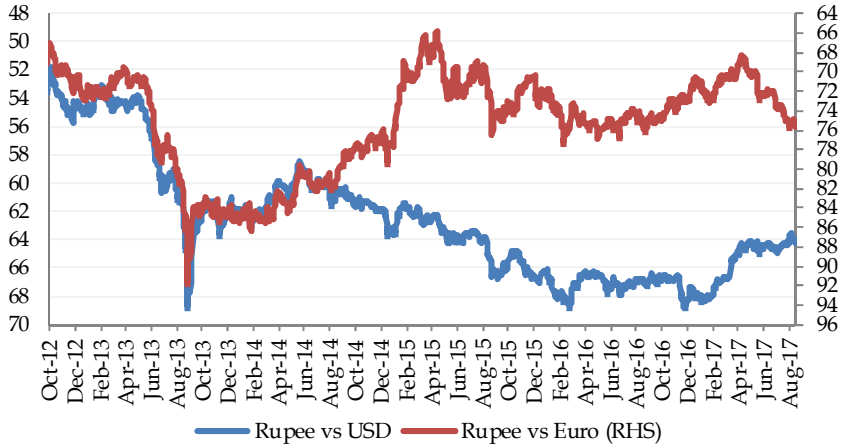


Real Effective Exchange Rate

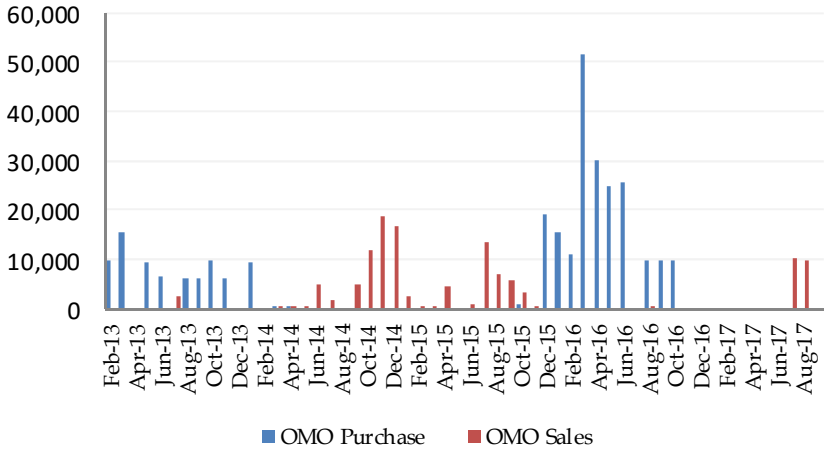


RBI constrained by excess liquidity in intervening in FX markets

Rupee Performance



Net RBI OMO Sale/Purchase



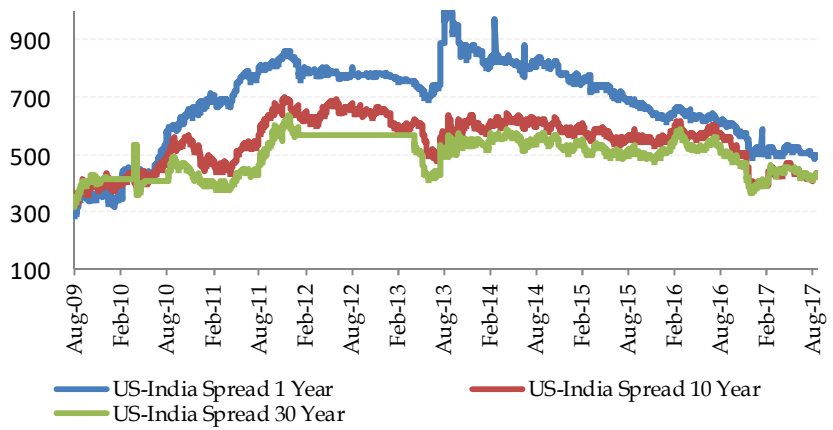
Sale/Purchase of Dollars by RBI

Period	RBI Gross Sale $	RBI Gross Purchase of $	RBI Net Purchase of $	Outstanding Forward Sales (-)/Purchase (+)
Jul-17	1,940	4,893	2,953	26,450
Jun-17	1,680	4,971	3,291	17,081
May-17	2,014	7,020	5,006	13,601
Apr-17	1,185	1,751	566	13,553
Mar-17	1,486	5,024	3,538	10,835
Feb-17	1,011	2,201	1,190	2,842
Last 12 Months	**56,022**	**74,978**	**18,956**	

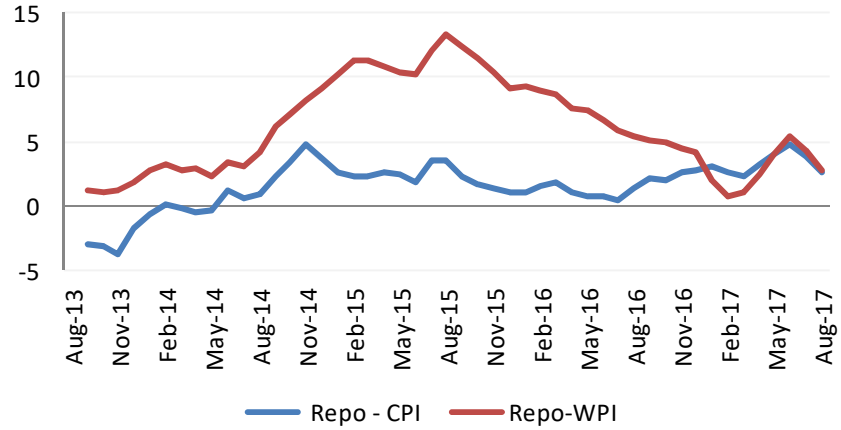
- The Rupee has had an appreciating bias as FII interest in INR assets has been very strong and macro economic fundamentals have been performing well relative to other Asian markets.
- While the RBI continues to intervene in FX markets ,its ability to slowdown the INR appreciation has been constrained by the surplus liquidity in the banking sector
- Even as it works to reduce the surplus liquidity in the banking system, the RBI has reiterated its approach of providing adequate durable liquidity to the market as compared to previous years.

Real rates remain positive

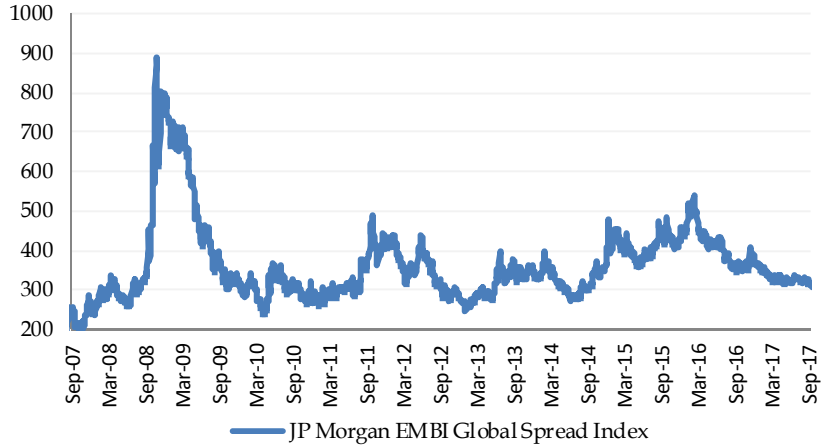
U.S Treasury-India G-sec Credit Spreads



Real Rates*



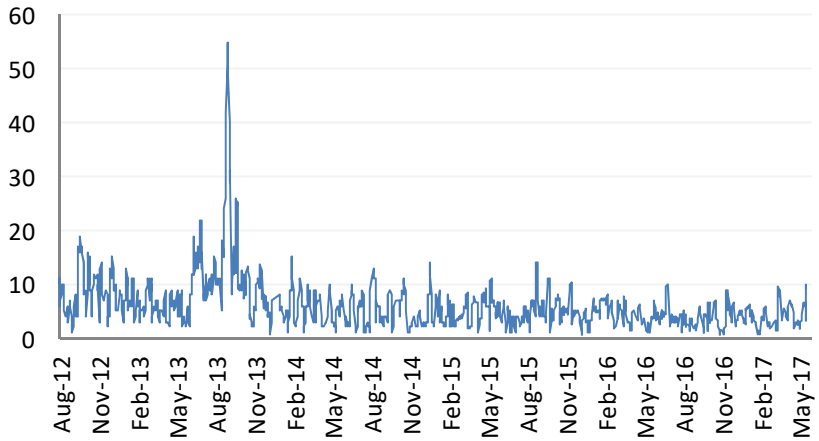
JP Morgan EMBI Spread Index



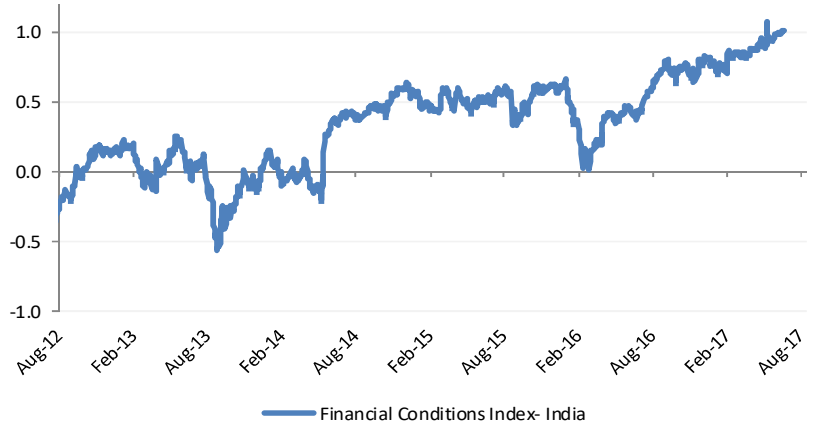
- As the U.S yields have risen and Indian yields moving down, the U.S India spread has come down from its highs
- India is also currently experiencing positive real rates. The real rate as measured by the Repo-CPI has moved up CPI has fallen faster than the policy rate. The real rates for producers is also positive as the WPI has also moved up.
- 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



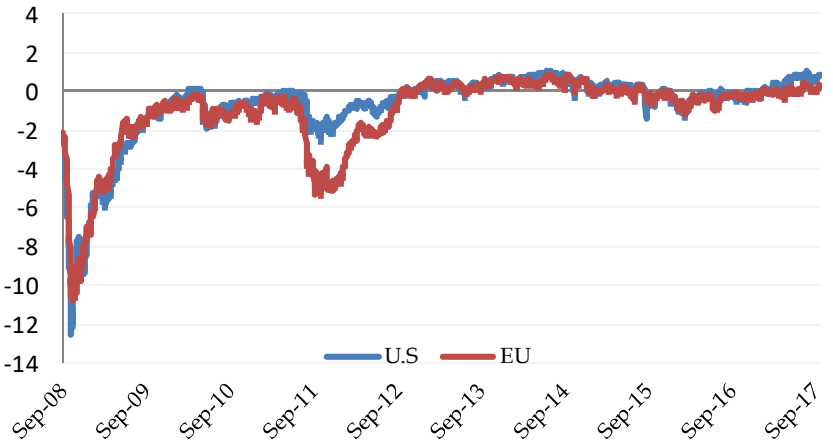
Trust India Financial Conditions Index



Bloomberg Asia Ex-Japan Financial Conditions Index

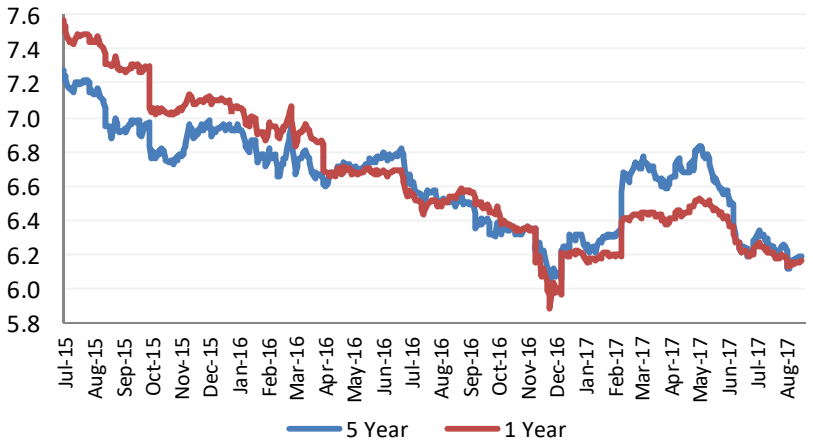


Bloomberg U.S EU Financial Conditions Index

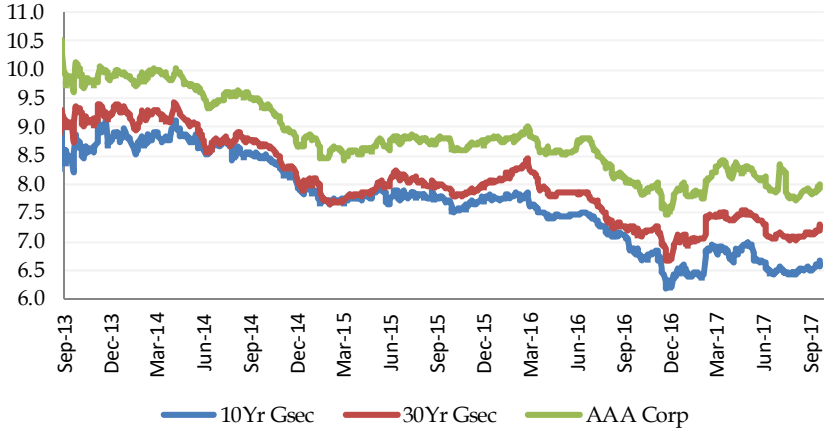


The Indian bond markets remain stable

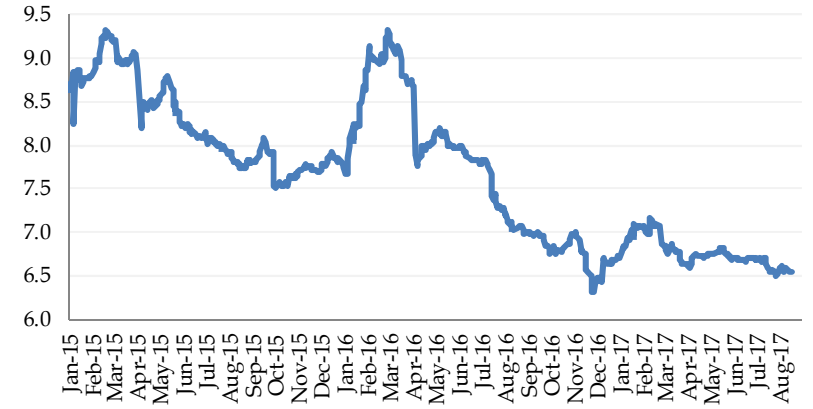
On-shore Swap Rates



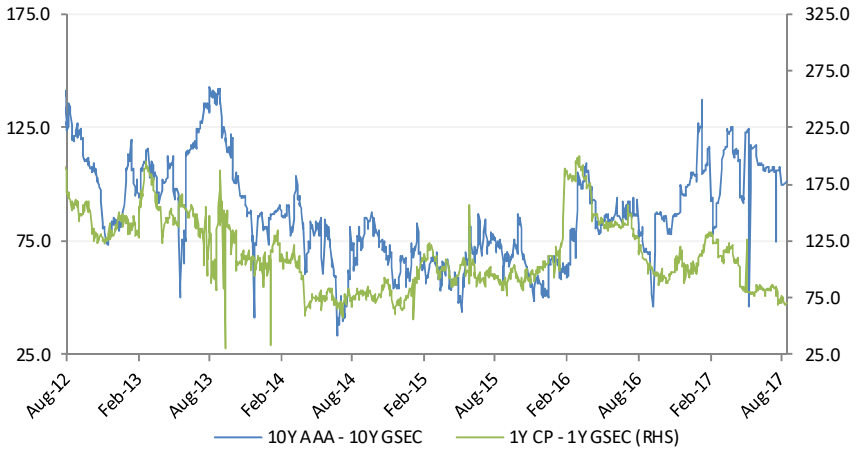
Selected Yields



3 Month CP Rates



10 Year and 1 Year Corp AAA Spreads (bps)



Our View: On hold for now

- After the observing the deceleration in the inflation trajectory over the last several months the RBI in its August policy meeting finally decided there is room for policy rates to come down. However in that policy, the RBI maintained its neutral policy stance and stated that it remains concerned with various upside risks to inflation. The RBI has always maintained the neutral stance gives it flexibility to respond to incoming data.
- In the August policy the RBI has highlighted several factors contributing the uncertainty around inflation projections including:
  - Implementation of farm loan waivers by States may result in possible fiscal slippages and undermine the quality of public spending, entailing inflationary spillovers.
  - The timing of the States' implementation of the salary and allowances award. For example if States choose to implement salary and allowance increases similar to the Centre in the current financial year, headline inflation could rise by an additional estimated 100 basis points above the baseline over 18-24 months.
  - Price pressures are building up in vegetables and animal proteins in the near months.
  - A conclusive segregation of transitory and structural factors driving the disinflation is still elusive.
- Since the last policy decision, the inflation readings have moved up due to vegetable and protein items, although it remains below the RBI's medium term target of 4%.
- Moreover the latest slowdown in GDP readings have led to speculation that the government may want to increase fiscal spending to counter the growth slowdown. In addition the farm loan waivers the implementation of HRA increases continue to put pressure on the fiscal math.
- Given this backdrop, with the RBI's neutral stance, inflation moving up in the last few readings, and possible fiscal slippages the RBI is likely to feel the room for more monetary accommodation is limited. We therefore expect the RBI to keep its policy Repo rate unchanged while maintaining its neutral stance and remaining data dependent.

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

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

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

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