CANARA ROBECO Mutual Fund

RBI Policy Update

February 08, 2017

RBI's Sixth Bi-monthly Monetary Policy Statement, 2016-17

Last policy of the FY2016-17 – Surprisingly hawkish policy by the MPC

RBI maintains status- quo in this policy with changing stance to "Neutral" in a unexpected surprise to the market:

- keep the policy repo rate under the liquidity adjustment facility unchanged at 6.25%;
- keep the reverse repo rate under the LAF stands unchanged at 5.75% and the marginal standing facility (MSF) rate at 6.75%

Stands at
6.25%
5.75%
4.00%
6.75%
20.75%

Policy Stance & Rationale:

- In a major surprise, RBI's six-membered panel continued to keep the key policy rates unchanged in the sixth bi-monthly monetary policy on the back of volatility around the financial markets across the globe, inflation edging-up on the back of rising energy prices and rising global commodity price.
- The MPC reiterated that one of its prime objectives of getting retail inflation at 5% by Q4FY17 may be largely met, there were seeing risks to medium-term target of 4% within a band of +/- 2%. The committee noted that while headline CPI is down on lower food prices, core CPI has remained sticky at 4.9% since Sept'16 and accordingly necessitated a change from an accommodative to neutral stance to further access the effects of demonetisation on inflation.
- On the global front, financial conditions are likely to squeeze as central banks in advanced economies normalise exceptional accommodation in monetary policy. With recessionary conditions fading in Russia and Brazil, and China stabilising on policy stimulus, global trade which has remained subdued due to increasing political tensions and major central banks tightening monetary policies, is expected to improve in the near future.
- As an impact, GVA growth for 2016-17 was revised downward once again to 6.9% from 7.1% earlier projected, with risks evenly balanced around it. The reduction in estimates, is on the back of deceleration in the industrial sector activity mainly due to slowdown in manufacturing and mining. RBI expects growth to recover sharply in 2017-18 and accordingly, GVA growth for 2017-18 is projected at 7.4% primarily because of the following factors:
 - ✓ Bounce back of discretionary demand which was held back for the last couple of months by demonetisation of currency and limits on currency withdrawal.
 - ✓ Ease in bank funding conditions due to excess supply of currency notes has led to a sharp improvement in transmission of past policy rate reductions into marginal cost-based lending rates (MCLRs), which is expected to spur a pick-up in both consumption and investment demand.
 - ✓ The emphasis in the Union Budget for 2017-18 on stepping up capital expenditure, and boosting the rural economy and affordable housing is likely to contribute to growth.
- Domestically, CPI eased to nearly a fifth consecutive month of softening at 3.41% in Dec'16, following a reading of 3.63% in Nov'16. Reduction in food prices coupled with contained services inflation helped stem any upside pressure to the headline however, the inflation for fuel items and manufactured goods rose on the back of hardening commodity prices. The central bank made cash

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management bills (CMB) purchases to absorb the liquidity build-up due to the demonetisation and money market rates remained aligned with the policy reportate albeit with a soft bias.

Outlook:

- The unexpected stance of the RBI in its monetary policy from accommodative to neutral can be seen to be an indication that the while the Indian economy is on strong footing, global geo-political factors stemming from Trump presidency may be creating undue volatility. This may have forced RBI to go in a pause mode, in an increasingly vitiated global environment. However, the decision of shifting policy stance has put the market participants in dilemma as the government has presented a pro-growth budget a few days back.
- On the inflation front, joint efforts by RBI and the government to keep the inflation under check are commendable. Government adherence to its fiscal deficit target is seen as a positive by RBI. Going ahead we might see inflation being under pressure owing to hardening profile of international crude prices, volatility in the exchange rate on the back of global financial market developments and the impact of implementation of 7th CPC. With the last two inflation numbers near 3.5%, we expect the March 2017 inflation print to undershoot 5%. However, RBI expects CPI to be in the range of 4.0-4.5% in the H1FY2017-18.
- The panel also noted that transmission of rates can be further improved if the bad loan situation of Indian banks is resolved more quickly, there is better recapitalisation of banks and the formula for adjustments in the interest rates on small savings schemes to changes in government bond yields is fully implemented.
- Growth in the economy is expected to recover in medium to long term, on the back of improving discretionary consumer demand held back by demonetisation, economic activity in cash-intensive sector and sharp improvement in transmission of past policy rates translating in both consumption and investment demand. In addition to these factors, emphasis in the Union budget 2017-18, stepping up capital expenditure, and boosting the rural economy and affordable housing may boost the economy.
- While CPI inflation is falling, core inflation does not show a clear picture as the components other than food and fuel are seen to be sticky. However, we believe that effect of demonetization will have softening impact on some core inflation components i.e. housing. This could likely bring down core inflation in next few months. Going ahead, we expect RBI to closely watch global developments and decide its future course of action but expect volatility to remain an integral part of the markets. RBI is likely to be cognizant of the fact that with local investment cycle still recovering, higher interest could badly dent this incipient recovery. We expect RBI to focus more on growth (rather than inflation), once the global picture becomes a little clearer.
- The market has already responded very sharply to the unexpected action by RBI, by hardening of interest rates across the yield curve (10Y yield moving up by 32 bps). The longer part of the yield curve has retraced to a level of July'16 (before the Oct'16 policy cut when repo was 6.50%). A major up-move of yields from here in unlikely, though the market may take time to settle down and develop a trading range with repo at 6.25%. We are likely to see market trade in range of 6.60%-6.90% in the short term. The current volatility, however, gives another opportunity to long term investors to make fresh allocations, in a phased manner, with a 1 3 years' timeframe.

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