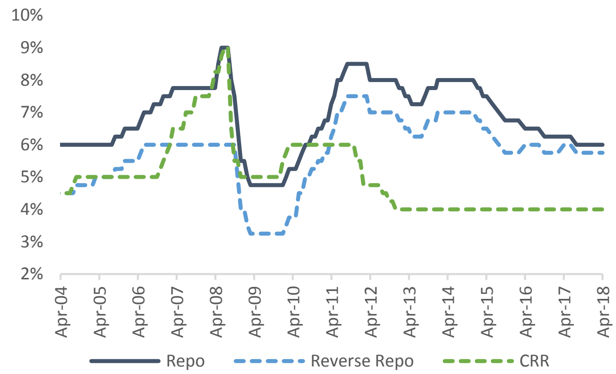
First RBI Bi-Monthly Monetary Policy Review FY19

FRANKLIN TEMPLETON INVESTMENTS

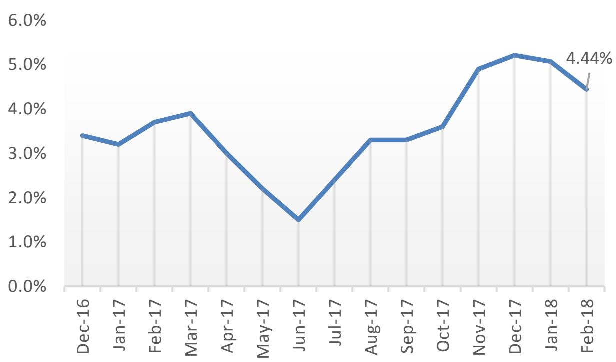
April 5, 2018

RBI Policy Rates Trend



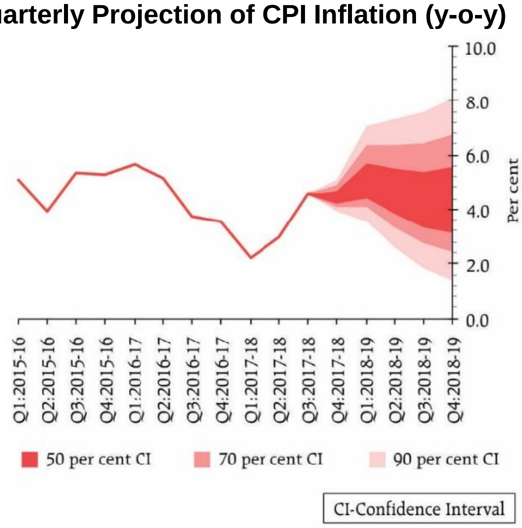
Source: RBI, April 2018

Headline CPI Inflation Trend (% YoY);
Fall led by food price inflation; Core inflation unchanged



Source: Morgan Stanley, April 2018

Quarterly Projection of CPI Inflation (y-o-y)



Source: RBI, April 2018

Following are the key points of first RBI bi-monthly monetary policy statement 2018-19 announced on 5th April 2018:

RBI policy highlights:

- RBI kept Repo rate unchanged at 6.00%.
- Consequently, Reverse repo rate stands unchanged at 5.75% and Marginal Standing Facility (MSF) as well as Bank rate stand unchanged at 6.25%.
- CRR is unchanged at 4%
- SLR is unchanged at 19.5%

Economic forecast:

- GDP growth is projected to strengthen from 6.6% in 2017-18 to 7.4% in 2018-19 with risks evenly balanced.
- The projection for CPI inflation for H1FY19 revised downward to 4.7-5.1% from earlier 5.1-5.6%. Headline CPI inflation for Q4FY18 revised lower to 4.50% against earlier projection of 5.10%.

Inflation:

- Headline CPI inflation eased to 4.44% (YoY) in February (compared to 5.07% in January), primarily due to decline in food and fuel inflation. Core inflation (excluding food and fuel) remained unchanged at 5.20% in February.
- Meanwhile, WPI inflation further eased for the third consecutive month to 2.48% (YoY) in February from 2.84% (YoY) in January, led by sharp fall in food price inflation. However, core inflation inched up to 3.90% in February against 3.40% in January.
- The RBI expects sharp moderation of food prices to continue in March as well. It also expects the overall food inflation to remain contained.
- Households inflation expectation is seen to have marginally hardened (Reserve Bank's survey, March 2018) indicating that households are discounting the current low inflation numbers.

Domestic market assessment:

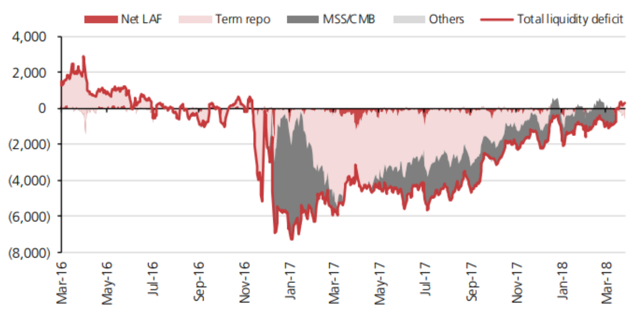
- Normal monsoon has led to higher Kharif production, as reflected in the second advance estimates released in February. Good season augurs well for the agricultural and allied sectors and could support the rural demand, going forward.
- Industrial performance remained in an expansionary mode for the eighth consecutive month in March. However, it moderated in Q4FY18. Capital goods production registered a 19-month high growth in January 2018, indicating traction in investment demand.
- Capacity utilization levels are showing signs of improvement in cement, automobile ancillaries, engineering, casting and sheet metals segment. These are early signs of an uptick in capacity utilization, which could be a precursor to an investment revival.
- High frequency indicators show strengthening of demand trends. Private consumption is improving on the back of

strong domestic air passenger traffic, foreign tourist arrivals, rising sales growth of passenger vehicles and a strong upturn in the production of consumer durables. Growth in sales of two-wheelers and tractors reflect buoyant rural consumption.

Global economy assessment:

- Global demand and steady commodity prices supported global trade in the recent months. The MPC noted that a broad-based strengthening of global economic activity has gained further strength in recent past. Eurozone expanded at a robust pace. The US and Japanese economies showed robust manufacturing activity.
- Major Developed Markets (DMs) continued on the path of recovery over last quarter. US unemployment rate remained low with hiring around multi-month highs. Euro region's falling unemployment rate and elevated consumer confidence continued to underpin the strength of the economy. Japanese economy expanded steadily due to improvement in exports growth. Among the emerging markets, while China registered a robust growth in Q4FY18 led by higher consumption and better industrial production; others including Brazil, Russia and South Africa also saw momentum gaining in economic activities.

Systemic Liquidity movement Jan-Mar 2018 (INR bn)

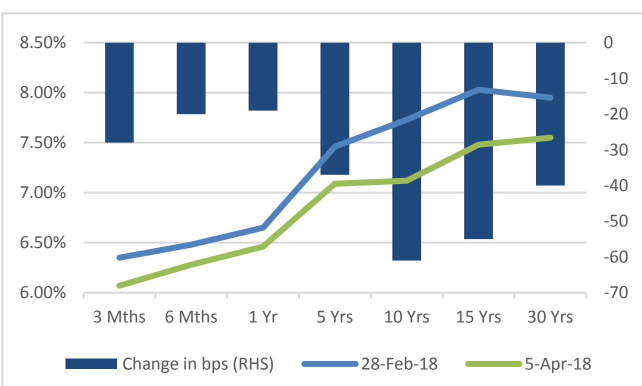


Source: CEIC, RBI, Kotak Institutional Equities

Liquidity:

- Systemic liquidity oscillated between surplus and deficit during February and March. Slowdown in government spending and large tax collection moved the liquidity in deficit. However, the RBI injected liquidity into the system in March-end to ensure the seasonal tightening had lower impact.
- Weighted average call rate inched closer to the policy repo rate. From a 12 basis points below the policy rate in January to 7 bps in February, and 5 bps in March.

Government Yield curve movement Feb to Apr 2018



Source: Reuters, April 2018

G-Sec bond movement:

- The bond yields eased across the curve post the announcement of government borrowing calendar for 1HFY19. It surprised the market positively with its quantum, tenure and nature of the borrowing. The borrowings composition, as desired by market, has tilted towards short-end securities.
- The tenure of g-sec issuances are also favorable, as the government, for the first time has planned to issue securities in the 1-4 years maturity bucket.
- Post policy announcement, the g-sec yields eased across the curve. The short-end, 1-4 years witnessed a drop of 2-12bps, 5-10 years were down by 12-16bps.

Policy stance:

The policy maintained a neutral stance. The inflation trend for Q4FY18 is lower (at 4.5%) than the projected trajectory of 5.10%. It has also revised H1FY19 inflation projection downwards to 4.7-5.1% from 5.1-5.6%. The Monetary policy Committee (MPC) maintains that there are upside risks to inflation, emanating primarily due to higher MSP prices announced in the budget, staggered impact of HRA revision by various states, fiscal slippages and volatility in crude oil prices. The committee also mentioned that inflation outlook will hinge upon upcoming monsoon. The policy highlighted economic recovery and signs of investment activity as reflected in improving credit offtake, large resource mobilisation from the primary capital market, and improving capital goods production and imports.

Outlook:

In the backdrop of softening inflation over last few months, the MPC maintained status quo on policy rate and a neutral stance. Rising crude prices, fiscal slippage along with higher MSP prices continue to be the areas of concern. The MPC would closely monitor whether the current drop in inflation trend is structural. The RBI's reaffirmation of a neutral policy stance and reducing inflation forecast may indicate a prolonged pause on the policy rates.

Improving consumption demand and expansion of industrial activity augurs well for the growth of the economy. Higher capacity utilization in select sectors, along with better demand conditions show improvement in the economic condition. This is also reflected in higher GDP growth projections for FY19. The MPC assesses that capital raised from the primary capital market has increased which may be deployed to set up new projects. Therefore, it will add to demand in the short run and boost growth potential of the economy, over the medium-term.

Going forward, we expect bond yields to trade lower in the near term on account of lighter borrowing calendar in H1FY19, expected enhancement of quota for FPIs and dispensation provided by the RBI to banks for spreading their mark-to-market losses on g-sec holdings over four quarters.

Improvement in the credit environment (upgrade to downgrade ratio) augurs well for the Indian corporate bond market segment.