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## Insights – Monetary Policy Review

Monetary Policy Committee maintains status quo on policy rates citing upside risks to inflation, policy stance remains neutral

October 5, 2017

With inflation inching up and surge in inflationary risks since last monetary policy review in August'17, the decision to keep key policy rates unchanged was on the expected lines. The repo rate was held steady at 6% and reverse repo rate at 5.75%. The policy decision was voted 5-1 in the Monetary Policy Committee (MPC) meeting. The room for lowering interest rates in this policy review has narrowed as headline inflation, measured by Consumer Price Index (CPI) reversed its downward trend and rose to a 5-month high of 3.36% in August. The inflation hardened as favourable base-effect waned and food inflation rebounded after witnessing a decline in Q1 of April-June. Core inflation excluding food and fuel also edged higher in July and August. The rise in inflation in recent months was more broad-based accompanied by price increase in both goods and services.

As upside risks to inflation emanated, the committee revised upwards its inflation projection for second half of FY18 to range between 4.2%-4.6%. Medium term target for CPI inflation was retained at 4% (within a band of +/- 2%). Expectations of uncertainty in Kharif production amid slightly deficient and uneven monsoon, rising global crude oil prices, impending price revision due to implementation of Goods and Services Tax (GST), the possible fiscal slippages due to farm loan waivers by States and likely increase in salaries & allowances by State Governments posed inflationary risks. In terms of downside risk, policy statement highlighted that adequate food stocks and effective supply management measures by the government will help to keep food inflation lower than expected. Accordingly, the committee retained its neutral policy stance citing uncertainties surrounding inflation.

Whilst inflation quickened, economic growth remained subdued. The growth slowdown concerns were further compounded by short term disruptions amid demonetization and implementation of GST. Acknowledging the latest data trend and projections, the MPC lowered its growth forecast. The Gross value added (GVA) projection for 2017-18 is revised down to 6.7% from the August 2017 projection of 7.3%, with risks evenly balanced around it.

In another measure, the RBI slashed the Statutory Liquidity Ratio (SLR) by 50 bps, from 20% of Net Demand and Time Liabilities (NDTL) to 19.5% from the fortnight commencing October 14, 2017. The move is expected to result in increased liquidity with the banks thereby leading to higher lending.

On another front, systemic liquidity remained in surplus. The RBI from time to time conducted Open Market Operations (OMOs) to balance liquidity conditions.

## Market Outlook

The factors playing into the inflation dynamics will decide the future trajectory of interest rates. Whilst, inflationary risks have gone up, we feel that hardening of inflation is likely to be transient. The inflation will be contained by favourable assessment of food prices (which will help keep food inflation in check) and limited upside of global crude oil prices. From here on, if CPI remains anchored and well within the MPC's medium term target, there could be a rate reduction before it hits a long pause, in order to address the economic woes.

From the fixed income market standpoint, macro-economic environment continues to remain stable. The government's commitment to stick to its borrowing and fiscal deficit targets for this fiscal so far, are bond market positive. In such a scenario, demand for fixed income securities is likely to remain high. Concurrently, the RBI hiked Foreign Portfolio Investors (FPI) investment limits for October-December 2017. The limit has been raised by Rs. 8,000 crores in central government securities and Rs. 6,200 crores in State Development Loans (SDLs). RBI's indication of new set of rules on corporate bonds for foreign investors from April'18 is also viewed bond positive as the appetite for Indian bonds are high amongst foreign investors.

Further, reform measures undertaken by the government may support the economic recovery in the long term. The credit outlook is likely to improve as economic activity gains momentum. Corporate bonds will continue to find demand amid increasing risk appetite and expectations of economic recovery.

In this environment, we encourage investors who have over 2-year investment horizon to remain invested in funds with fund duration longer than their investment horizon, given the higher probability of interest rates remaining lower in the medium term. Investors with a horizon of less than 2 years can consider short term funds. Short horizon investors may consider credit focused funds to benefit from potential improvement in credit environment and in line with individual risk appetite.

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