

India - Case for Further Monetary Easing

September 2016

We had, in March '14, opined that the RBI, while targeting inflation, will soon begin its accommodative stance on the interest rates citing India's improving macro economic situation, including moderation in headline inflation. (*Refer Viewpoint, Time for Duration, March 2014*). Most of those macro-economic parameters have visibly improved since then.

	March 2014	March 2015	March 2016
Current Account Deficit	\$ 32.4 bn	\$ 26.8 bn	\$ 22.1 bn [@]
Fiscal Deficit	4.60%	4.10%	3.90%
Gross Value Add (GVA)	5.80%	6.70%	7.10%*
Headline CPI Inflation	8.25%	5.25%	5.05% [#]
Forex Reserves	\$ 304 bn	\$ 342 bn	\$ 366 bn [#]
Repo Rate	8.00%	7.50%	6.50% [#]

(Source: Bloomberg. For Current Account Deficit, Source: RBI. Notes - @ Provisional. * as at June '16. #as at August '16.)

The reasons for an accommodative stance in 2014 are well 'live' even today and we expect easy monetary policy to continue.

The trigger for RBI to start the rate reduction has been mainly:

- Dropping inflation and inflationary expectations
- Fiscal prudence from government

Inflation continues to be moderate over the years and the government remains committed in achieving fiscal deficit target of 3.5% for FY17.

Positive Triggers for the Economy

Monsoon

After two consecutive 'drought-like' years in the past, the monsoon rains in the current year have been reasonably good thus far.

- Cumulative rainfall during this year's monsoon season (June – August '16) is 3% below the Long Period Average (LPA), which is within the normal range.

- Monsoon has spread evenly throughout the country.
- The reservoir levels have risen to 105.248 billion cubic meters i.e.67% of their total live storage capacity.

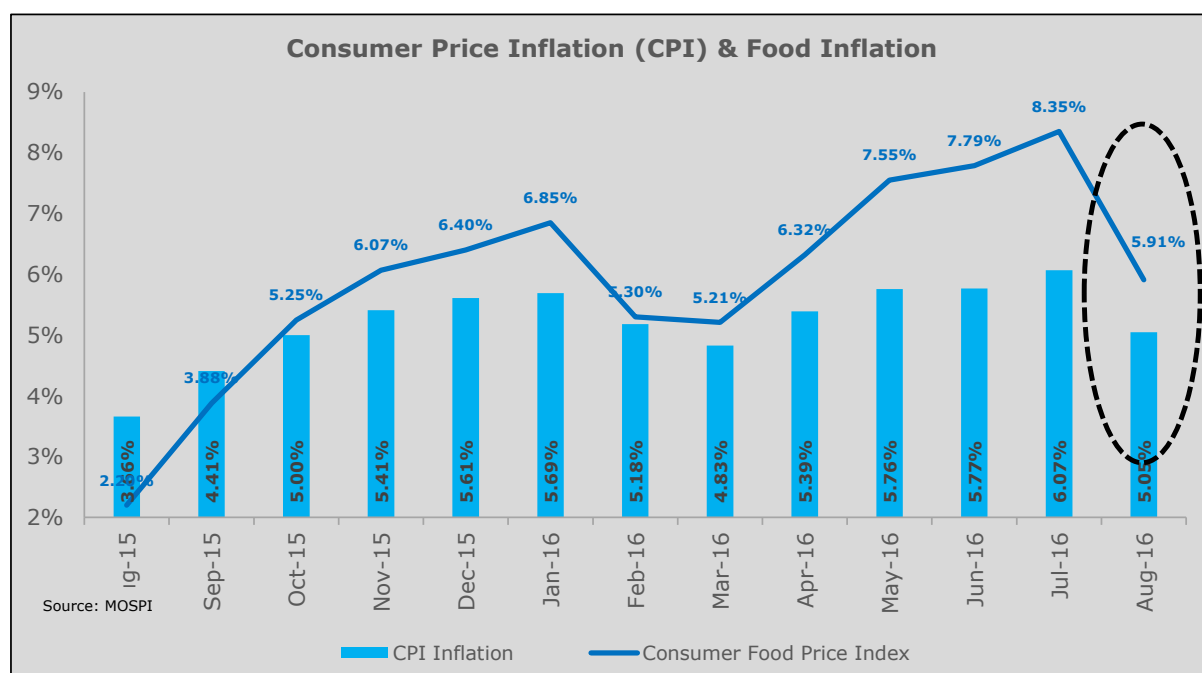
(Source: IMD. Data as at September 1, 2016)

Food Inflation

The deficient monsoon of past two consecutive years impacted the food prices that rose exponentially in the recent past. The RBI, however, has retained its 5% inflation target of Consumer Price Inflation (CPI) by the end of FY '17, with a possible upward bias owing to surge in food prices (the effect of monsoon just beginning to play out); the potential impact of reversal in commodity prices as well as that of implementation of the 7th Central Pay Commission awards.

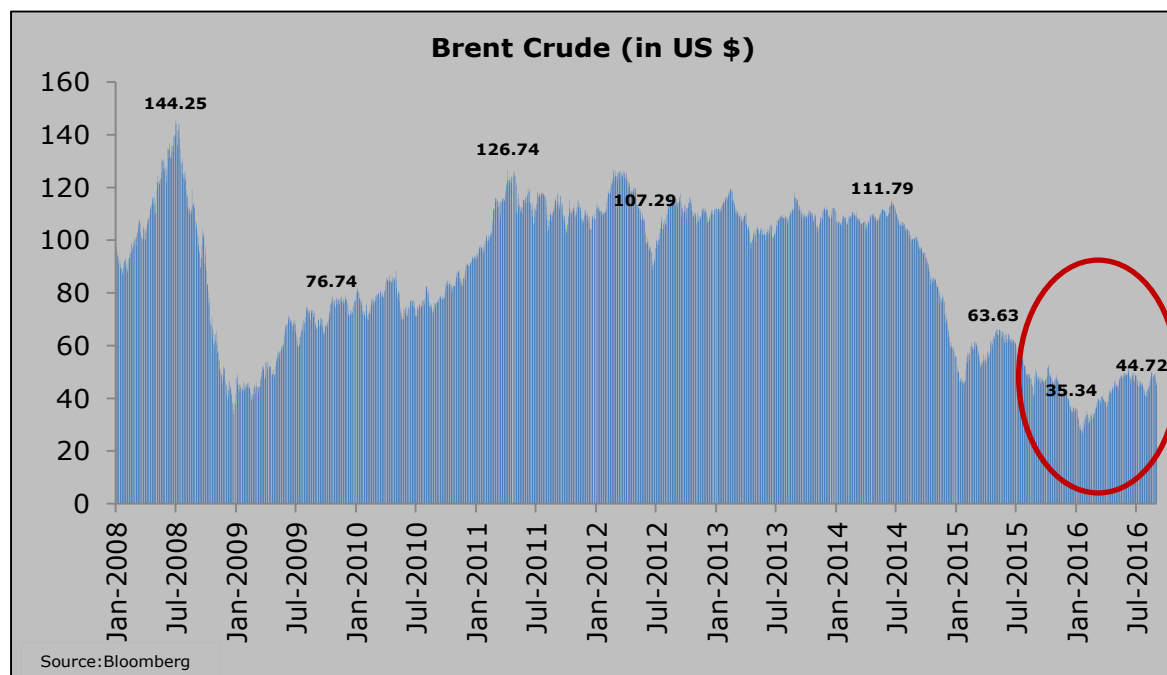
Food accounts for 45.86% of the inflation basket and any progress therein enormously impacts the inflation index.

Now that there has been a reasonably good monsoon season, the food prices, which have started to moderate (as is reflected in the latest Consumer Food Price Index for the month of August '16); are expected to remain low with increased food production in the coming months.

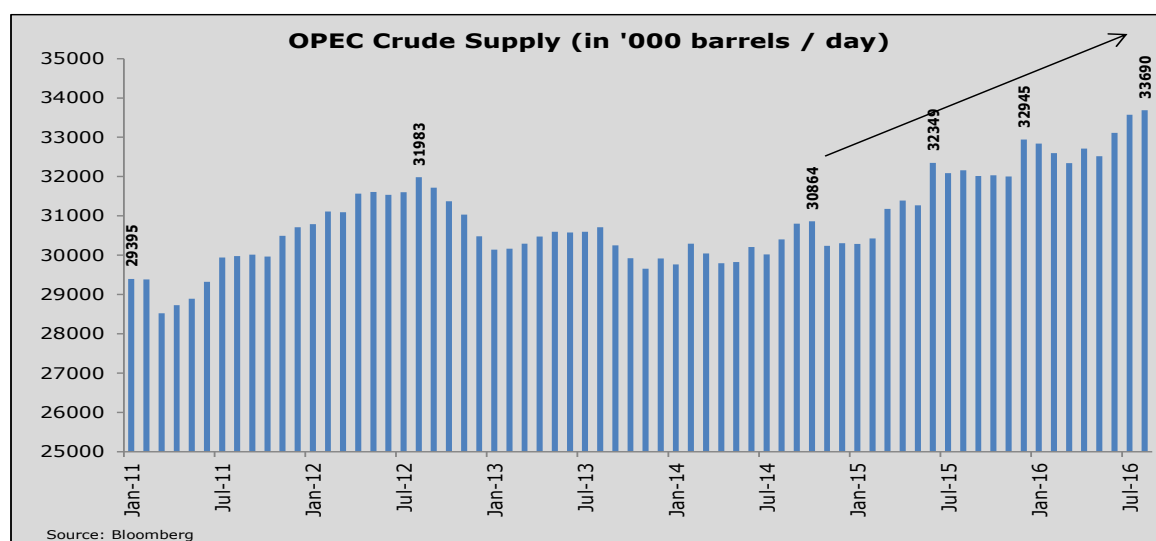


Fuel Inflation

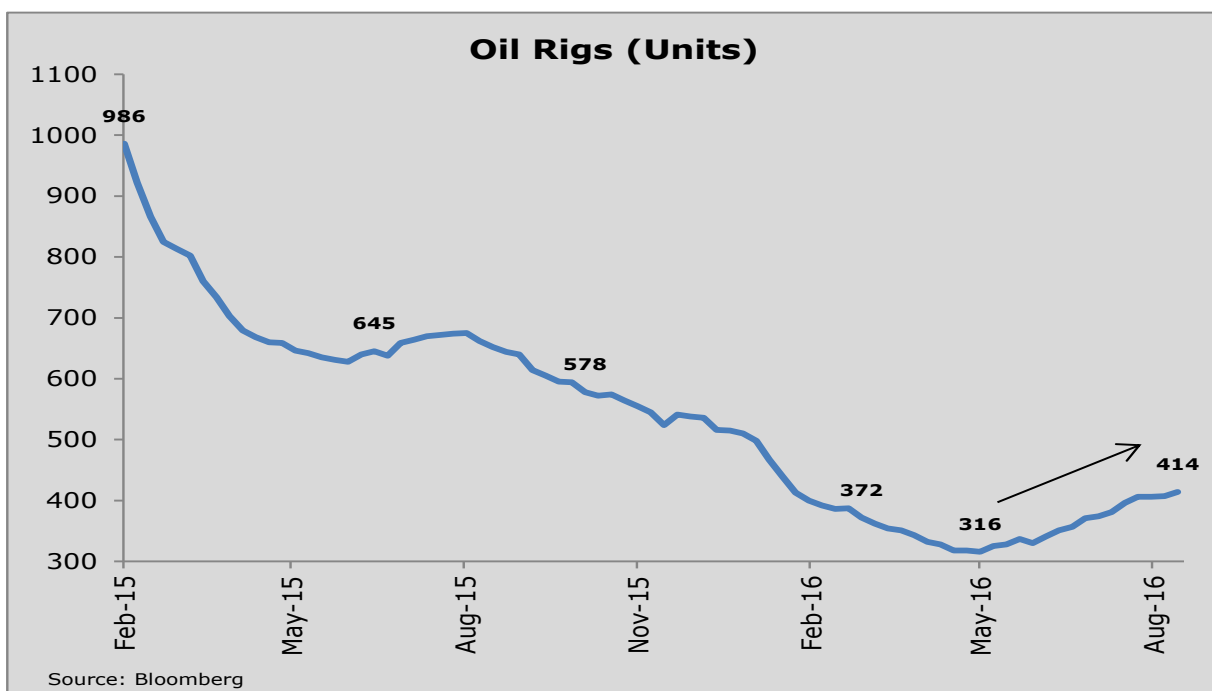
Fuel inflation has been positive for the Indian economy as prices of crude oil, which constitutes 6.84% of our inflation basket, have come off drastically over the past couple of years. We expect the oil prices to continue to stay moderate as **supply outstrips demand for oil**.



Additionally, low oil prices can be primarily attributed to the fact that despite a relatively low demand for oil globally, the oil producing nations continue to maintain their supply of oil, thereby maintaining the downward pressure on oil prices.



Further, the recent change in the oil rig count suggests potential pick-up in supply of oil **at current prices**. The healthy oil inventory in the US and in China has also put a lid on any near term appreciation in the oil prices.



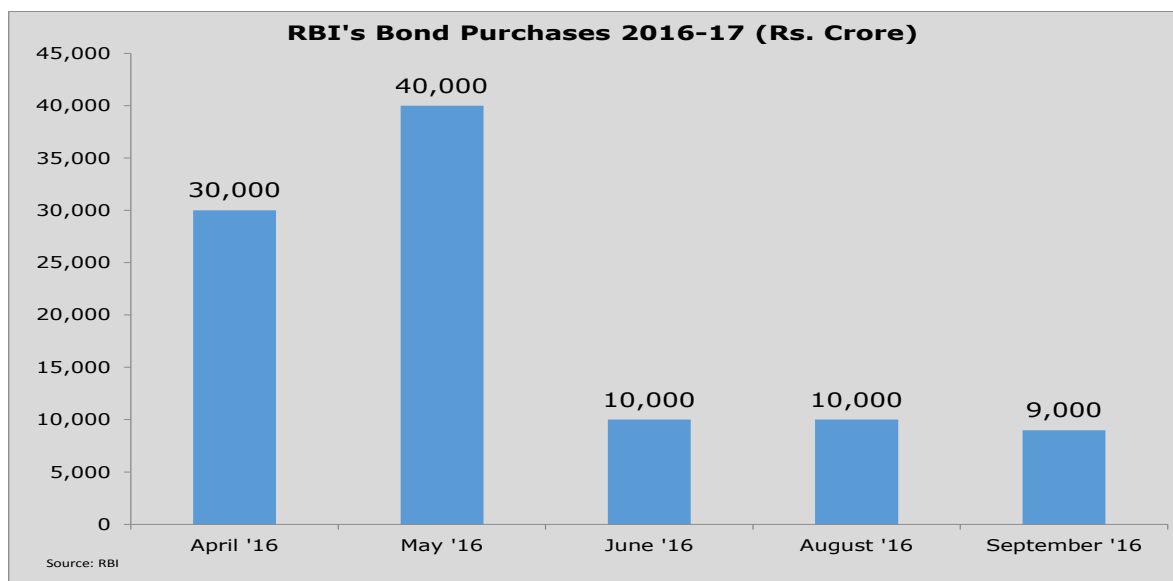
Lower oil prices bode well for India, which is the net oil importing country, and has immensely helped in moderating the imported inflation.

With oil prices holding at these levels or being within a moderate range, the upside risk to inflation on account of any reversal in commodity prices is lower.

Liquidity

Liquidity has also been an area of concern for the economy with deficit liquidity conditions having prevented banks from lowering interest rates. However, beginning April '16, the RBI has resolved to maintain liquidity neutrality in the system through Open Market Operation (OMO) i.e. bond purchases.

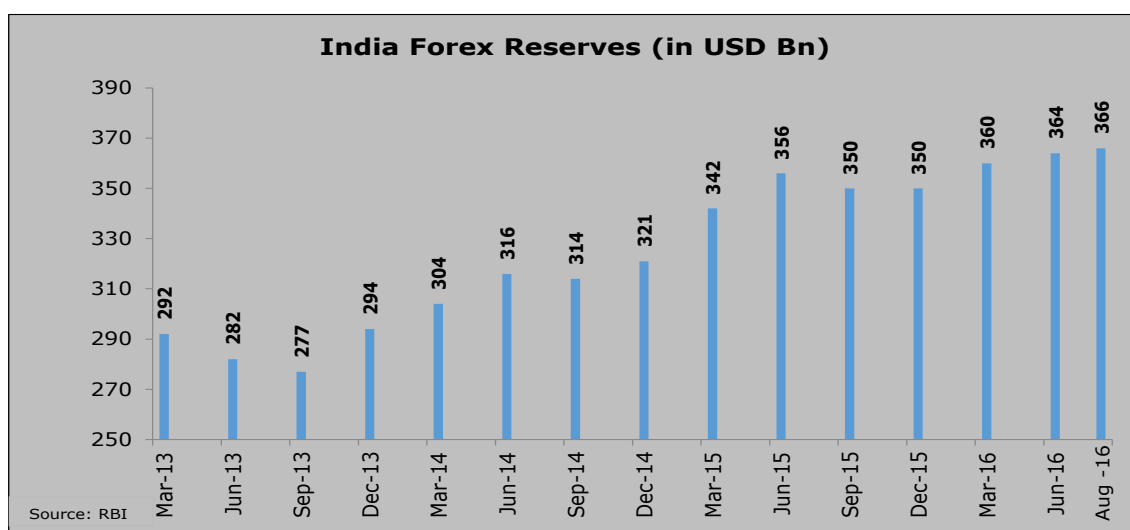
- The RBI has infused Rs 99,000 crore of liquidity into the system through bond purchases through April – September '16.
- The move is aimed to help ease the transmission of monetary policy i.e. to help commercial banks pass on the benefits of rate cut to the consumers.
- This will help bring down the rates further in due course of time.



The liquidity infusion gives additional comfort that RBI can be expected to neutralise any potential liquidity related stress, such as that arising from the upcoming maturity (September – November '16) of Foreign Currency Non Resident (FCNR) Deposits. RBI estimates that around US\$ 20 billion may potentially be paid out.

Forex Reserves

India's foreign exchange reserves have surged to over US\$ 366 billion (as at August 26, '16) backing RBI's assertion to support liquidity requirements. The RBI has time and again reiterated its preparedness as well as intention to intervene in the market and reduce any volatility or strain as the situation may demand.



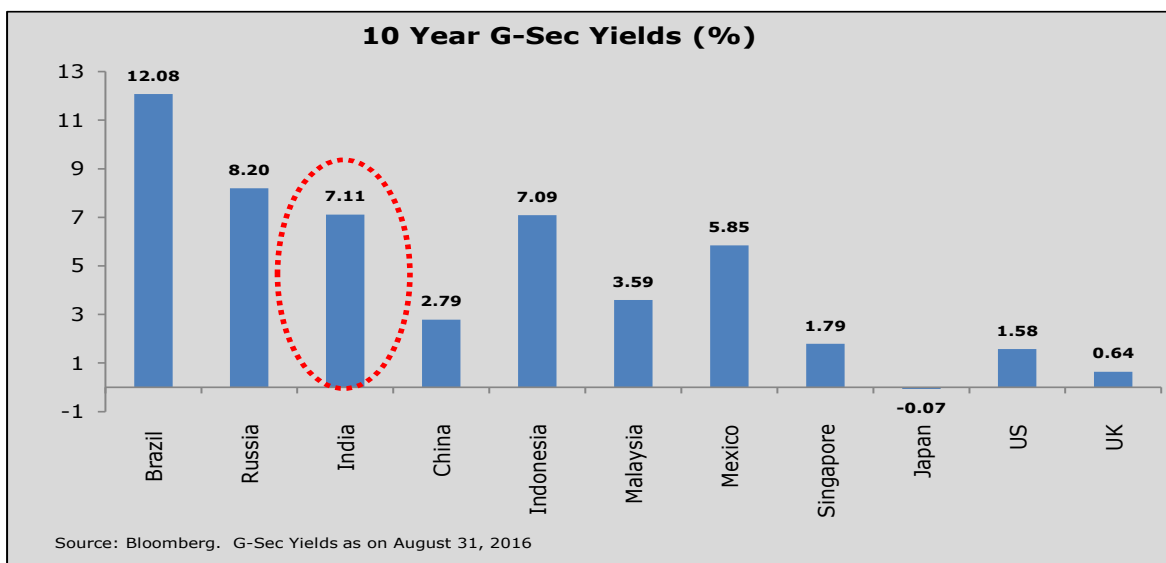
US Interest Rates

Global investors, have time and again, been apprehensive about the quantum and pace of rate hike in the US. The recent chain of global events, such as Brexit, that has brought in some additional uncertainty on the prospects of revival of the global growth story and in the absence of any convincing positive triggers of strong economic growth and inflation in the US (despite drop in unemployment) it seems that the much anticipated next interest rate hike in the US by the Federal Reserve may still be some time away.



Inflation in the US remains lower than target of 2% and has eluded reasoning for successive rate hikes in US. Prices globally remain low due to overcapacity across markets and particularly in China.

The Federal Reserve's (Fed) extension of its dovish stance on US interest rates favours Indian bonds given the differential interest rates.

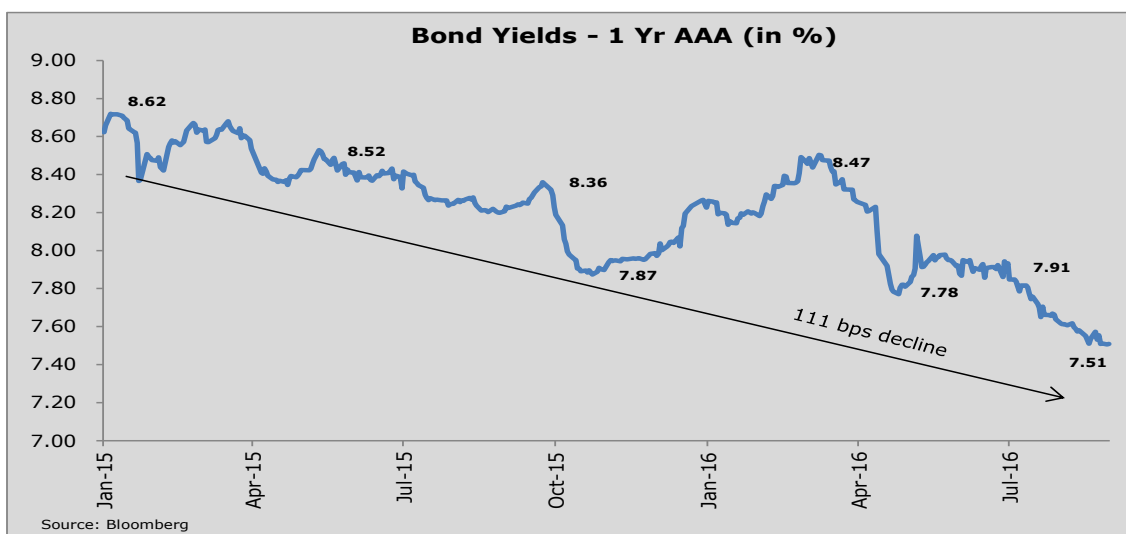
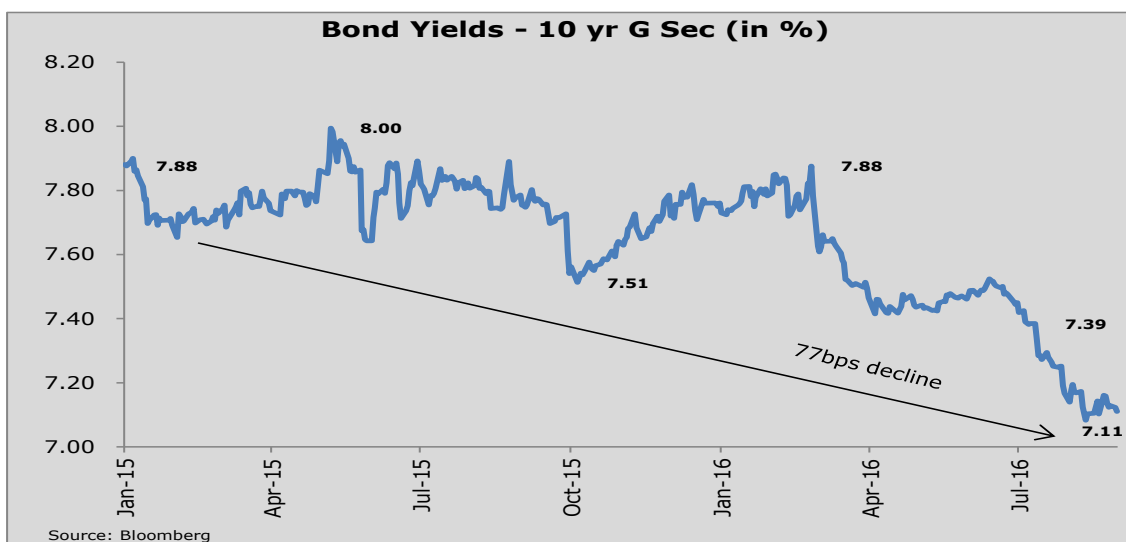


- The yields presently offered by India are superior to most other economies of the globe; barring Brazil and Russia.
- Brazil is currently marred in Political Crisis and Russia is still to get a breather from its ongoing Currency Crisis.
- India's key strength, on the other hand, lies in its reform oriented stable Government as well as fairly stable currency.
- India presently enjoys a 'BBB-' sovereign rating with 'Stable Outlook'.
- The sovereign rating for Brazil presently stands at 'BB' with 'Negative Outlook' and that for Russia at 'BBB-' with 'Negative Outlook'

Fitch Ratings as on August 31, 2016. Source: Tradingeconomics.com

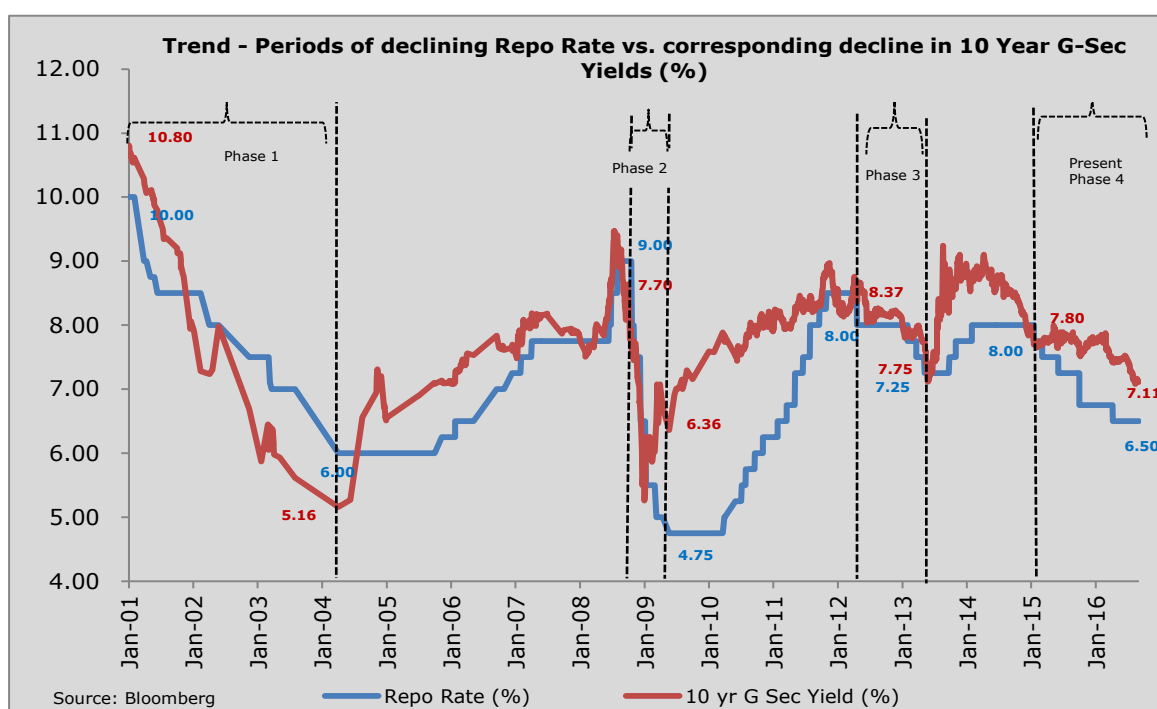
Indian Bond Market

Present Yields in the Indian Bond Market



- The bond yields have softened since the beginning of the rate reduction cycle in early 2015.
- The drop in yields at the shorter end has been higher as compared with the drop in the 10 year point.
- Liquidity inflow has resulted in the curve turning steep.

Recently some flattening of the curve is also seen beyond the 10 year point. Flattening of the yield curve at the longer end is generally observed as investors gain comfort with the declining trajectory of inflation.



In the above chart –

Phase 1 (Jan '01 – Mar '04): Average spreads = 30 bps

Phase 2 (Oct '08 – May '09): Average spread = 12 bps

Phase 3 (Apr '12 – May '13): Average spread = 21 bps

Present Phase 4 (Jan '15 – August '16): Average Spread = 66 bps

The spreads have been calculated to understand the potential drop in sovereign 10 year yield over repo rate during the Present Phase 4 of accommodative rate cycle. Over a period of time, we expect the 10 year benchmark to move down to the historical spreads over the repo rate as witnessed in the past.

We are positive on the Indian Sovereign and Corporate Bonds and expect the 10 year bond to trade close to 25bps average spread over the Repo Rate (historical average) from the present average spread of approx. 66bps.

Viewpoint

Our Medium Term View

We believe;

- Achieving inflation target of 4% in 2 years time remains a possibility, amidst moderating domestic inflation, lower food and energy inflation and low price pressures in global markets
- RBI may target a lower real rate of 1% over inflation in this scenario of slackening industrial growth
- Expect repo rate to drop down towards 5-5.50% in 2 years time frame

Reasoning

- Improving macro fundamentals are leading to overall stability. These being;
 - Lower Current Account Deficit (CAD) – marginal possibility of turning positive in near months
 - Lower fiscal deficit – further consolidation possible
 - Increasing forex reserves – presently over 12 months of import cover
 - Lower headline inflation – good monsoon leading to higher production and moderation in food prices
 - Moderation in trade deficit – drop in import bill due to moderation in crude oil prices. Oil fundamentals suggest stabilisation of prices around current levels with occasional volatility. Overall demand for oil remains lower than supply. Higher inventory of oil in US and China to maintain a lid on prices
 - RBI's Open Market Operations (OMO) to infuse liquidity and neutralise the deficit liquidity position within banking system, leading to an increased risk appetite among investors. This will also help in transmission of lower rates to borrowers.

We thus expect -

- Sovereign bond yields to move down over time due to net lower supply of securities
- Systemic liquidity to improve with pickup in economic activity, credit growth and money multiplier (*Money Multiplier – a measure of the extent to which creation of money in the banking system causes the growth in the money supply*)
- Masala bond issuance in global markets to reduce primary bond supply in domestic market
- Differential rates to remain attractive amidst dropping rupee volatility and lower hedging cost

- India to remain attractive given high real GDP growth and moderating inflation amidst low levels of growth and inflation in most global economies

Risks to our Medium Term View

- Volatility in currency market due to altering global scenario and US rates. Fed hiking rates in the absence of inflation
- Volatility in flows as global liquidity moves from lower yielding assets to higher yielding assets
- Threat from Chinese exports and altering trade balance due to overcapacity in China.

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