RBI Monetary Policy Review: Pauses as inflation concern return

HDFC Bank, December 2019

Monetary Policy Review: RBI keeps rates on hold against market expectations of a cut

Policy Announcement:

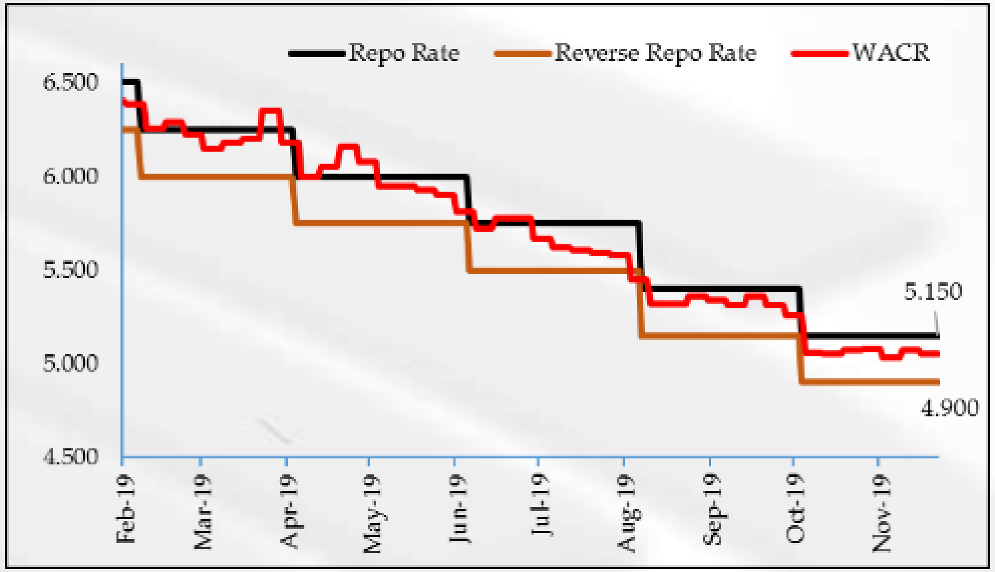
- In a surprise move, the central bank today kept the policy rate unchanged at 5.15%, citing higher headline inflation as a concern.

- All the members voted unanimously in the favor of the decision.

- Despite the pause, the MPC decided to keep the accommodative stance unchanged. **The MPC recognized that there is room for further easing, however paused at this juncture to analyze the inflation-growth dynamics, impact of already delivered rate cuts and of any fiscal measures announced in the upcoming budget.**

- **Growth revised down:** **As expected, the MPC revised down its FY20 GDP forecast to 5.0% from 6.1% previously**. The central bank now expects 2HFY20 growth in the range of 4.9-5.5% with a gradual recovery to 5.9-6.3% in 1HFY21.

- **Inflation revised up:** The MPC took into account recent upward swing in food CPI and revised its 2H FY20 inflation outlook to 4.7-5.1% from 3.5-3.7% previously.



What Changed between two meetings?		
	Oct-19 Meeting	Dec-19 Meeting
GDP Growth Risks	FY20: 6.1%, 2HFY20: 6.6-7.2% Q1FY21: 7.2% Evenly Balanced	FY20: 5.0%, 2H FY20: 4.9-5.5% 1H FY21: 5.9-6.3% -
CPI Inflation Risks	2H FY20: 3.5-3.7% 1Q FY21- 3.6% Evenly Balanced	2H FY20: 4.7-5.1%, 1H FY21: 3.8-4.0% Broadly Balanced

Source: RBI, HDFC Bank

Our View: Inflation, Growth & Rates

HDFC Bank Outlook:

- Going forward, we expect food CPI to keep the headline inflation elevated above 5% untill February. As such, we estimate FY20 retail inflation to range between 4.7%-5.3% in H2 FY20, coming in at 4.7% in March 2020. Higher inflation readings before the next policy meeting and any announcement of significant fiscal expansion in the budget could lower the possibility of a rate cut in February by the RBI.

- We expect some tightening in bond yields in response to this surprise. The markets had priced in a rate cut and a pause in the policy rate is likely to keep yields elevated in the near-term, within a range of 6.50-6.60%.

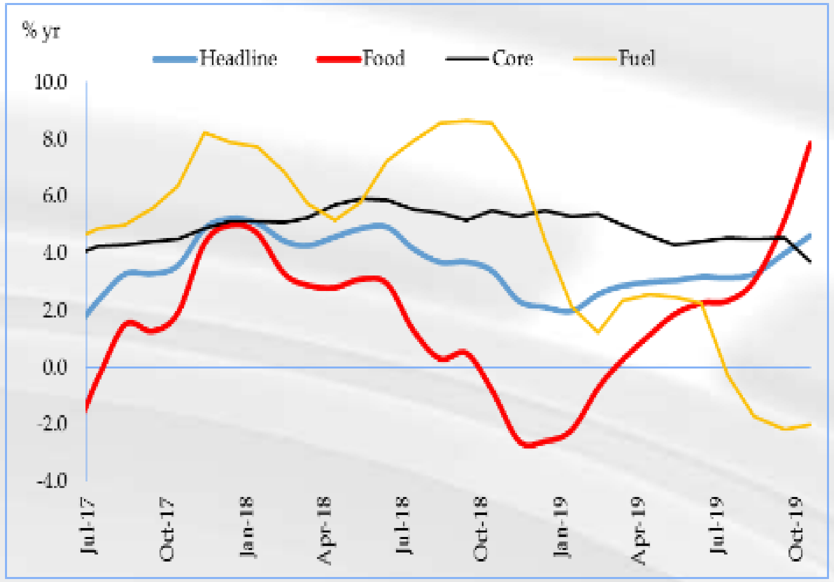
- That said, over the medium term, we expect yields to come down and trade in the range of 6.40-6.50% by March-end. The current level of the yield has significant fiscal slippage and consequently additional market borrowings in Q4 priced in. However, we believe that additional market borrowings by the government could be lower than the actual fiscal slippage (our estimate of Rs. 84,000 crore) as the government could tap into the small savings fund.

Forecasts RBI vs HDFC		
	2H FY20	FY20
GDP Growth		
RBI	4.9-5.5%	5.00%
HDFC	**5.2%**	**5.0%**
CPI Inflation		
RBI	4.7-5.1%	4.0%-4.2%
HDFC	**4.8%**	**4.1%**

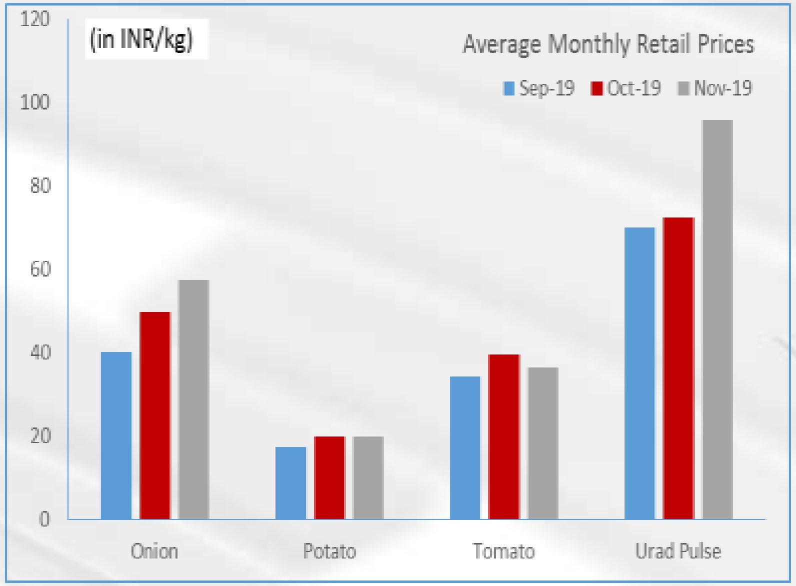
Source: RBI, HDFC Bank

Inflation expected to rise above 5% in November 2019…

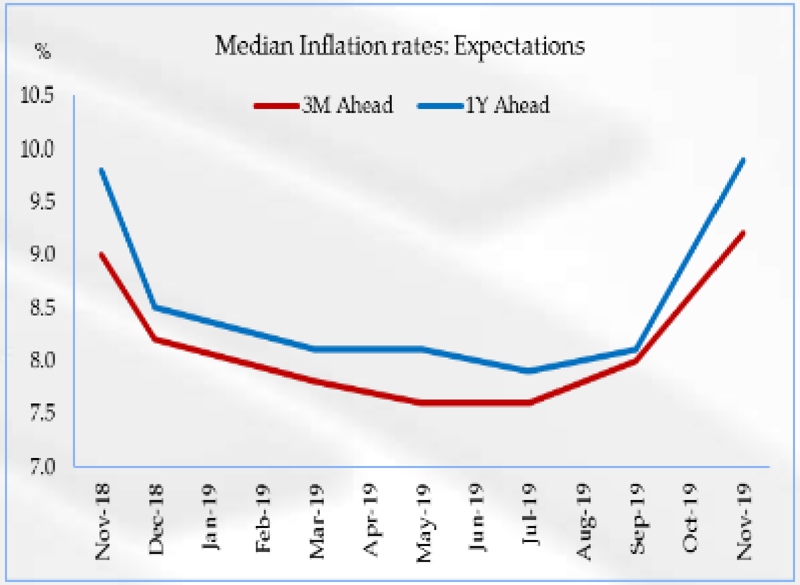
CPI Inflation expected to rise to 5.3% in November..



..driven by higher food inflation led by uptick in vegetable and pulses prices



Inflation expectations have risen in recent months



- Surge in CPI inflation likely to be driven by **higher food inflation** (in line with signals received from daily Mandi prices and data from the Department of consumer affairs) **and an unfavourable base effect.**
- The upward momentum in food inflation is expected to breach 8% level (from 7.8% in October) driven primarily by higher vegetable (especially onion) and pulses prices, amidst supply disruption.
- <u>**Core CPI Inflation (CPI ex food, fuel and light, petroleum and diesel)** is expected to moderate further to 3.5% amidst broad-based moderation in all sub-sectors, signalling weak demand conditions.</u>

Source: RBI, CEIC , HDFC Bank

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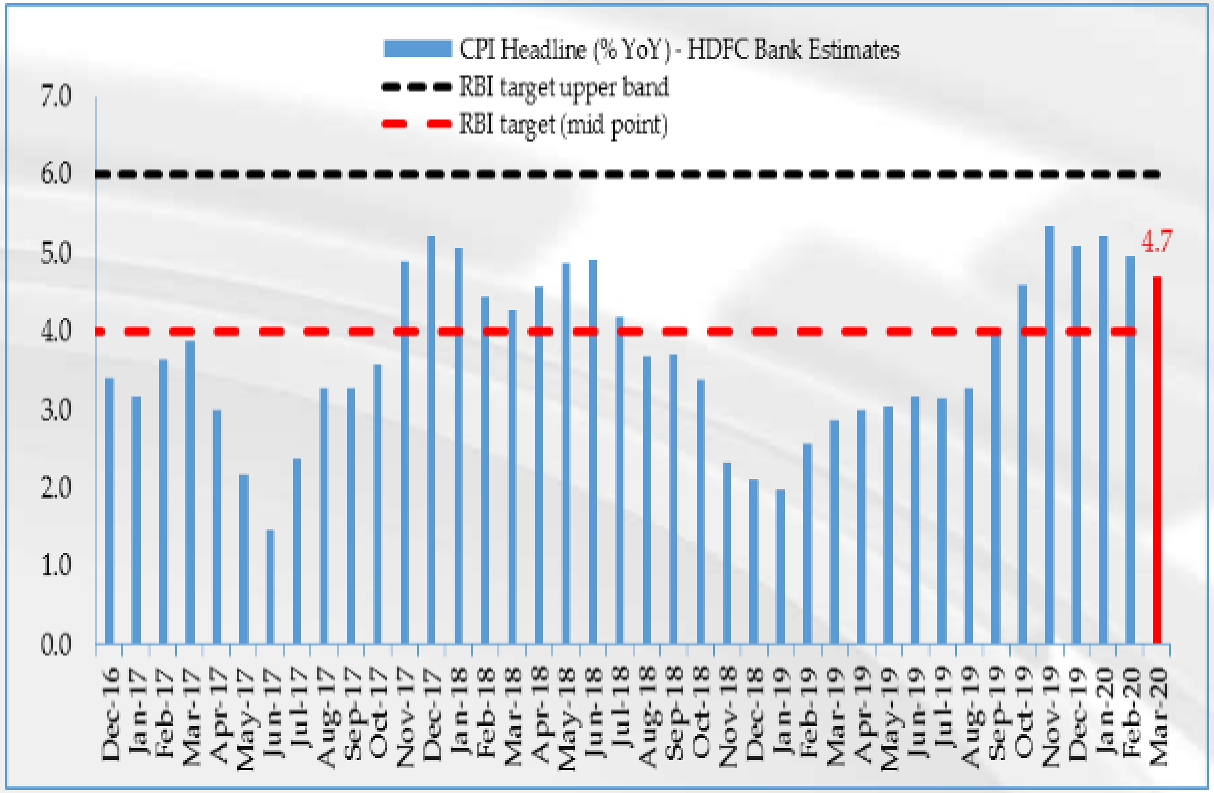
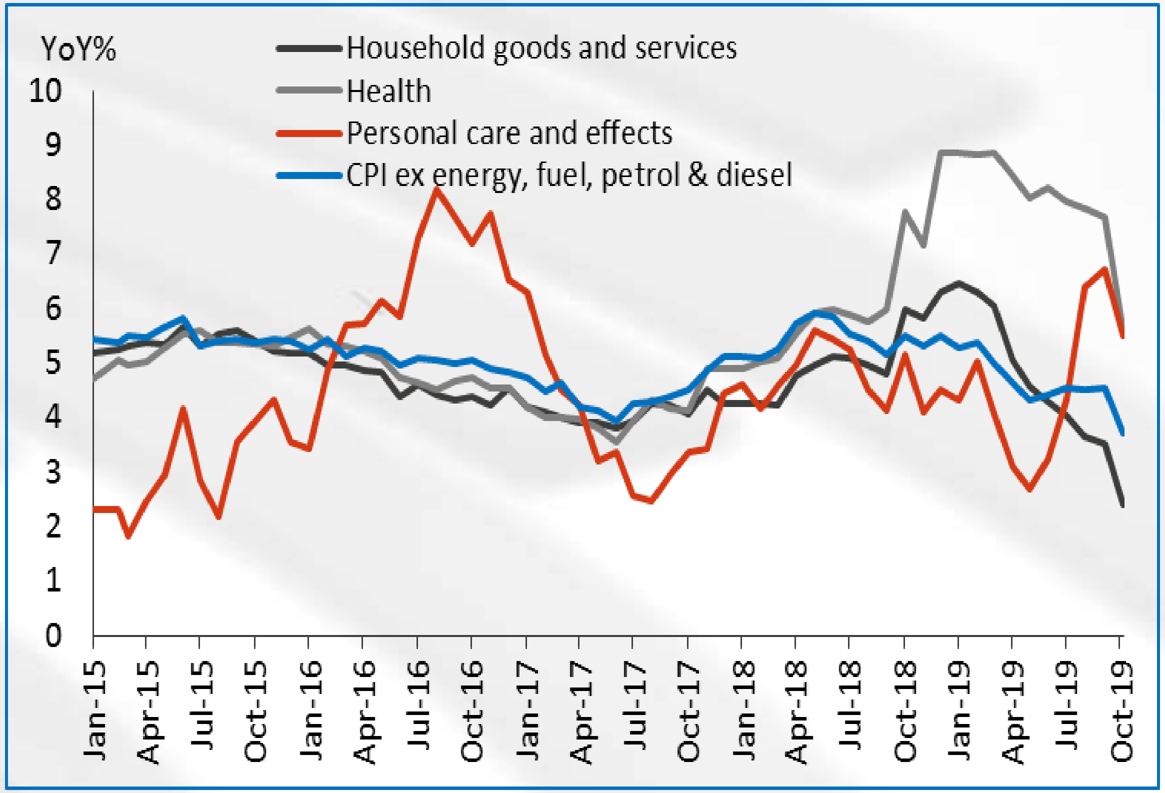
…and to remain elevated untill February 2020, raising uncertainty over further rate cuts

We expect inflation at 4.7% by March 2020 as food inflation continues to remain elevated and an unfavourable base effect pushes up the headline inflation numbers. For full year FY20, we expect inflation to average at 4.1%



That said, core inflation is expected to remain muted. It fell to 3.7% in October signalling that the output gap continues to expand.



Source: HDFC Bank forecast, IMF WEO outlook October 2019

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Transmission has picked up and could accelerate going forward…

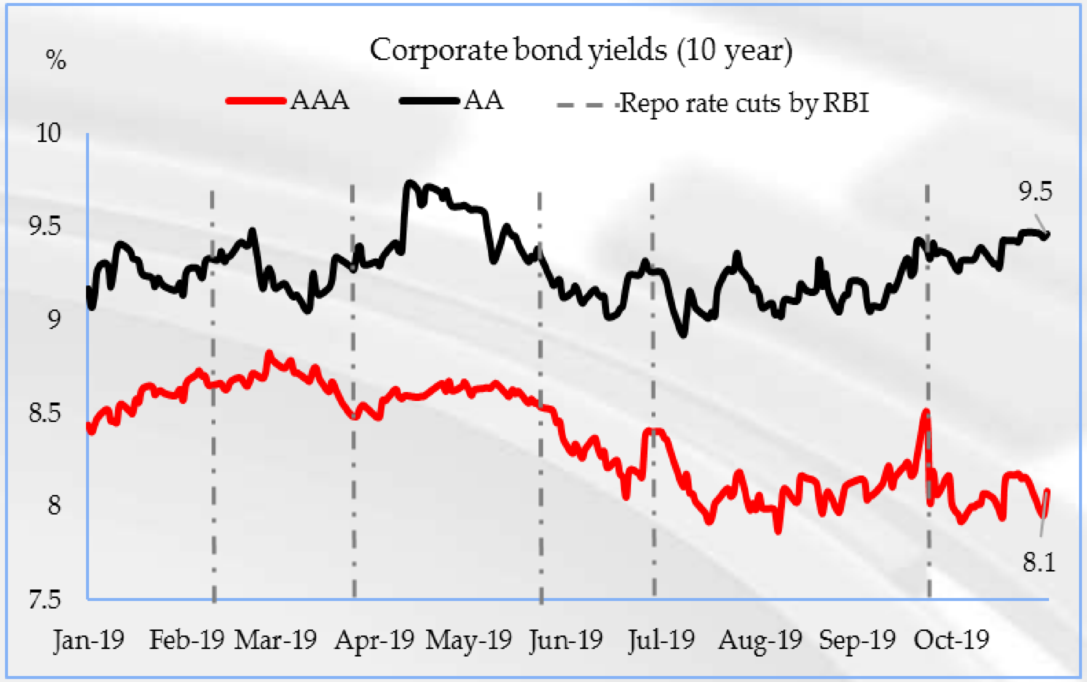
- Transmission to short term money market rates has been more than 100%. However, deposit rates, Weighted Average lending rates (WALR), and MCLR have dropped by only 40-45bps. Corporate bond yields have come off by 80bps since the beginning of the current rate cut cycle.
- CP rates (average of high and low) have dropped by 20bps on average. But this masks the rising variation in the highest and the lowest CP rates in the market. The lower bound of the CP rates across companies has fallen by 180bps while the upper bound has increased by 230bps signalling the significant variation in borrowing costs for corporates.

%	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Transmission (Jan-Latest) (bps)
Repo rate	**6.5**	**6.3**	**6.3**	**6.0**	**6.0**	**5.8**	**5.8**	**5.4**	**5.4**	**5.2**	**5.2**	**-135**
CPs (average of low, high)	9.2	9.5	8.9	9.1	9.9	9.1	9.8	9.4	7.6	9.6	9.0	-23
CBs (AAA, average yield)	8.5	8.7	8.6	8.6	8.6	8.3	8.3	8.1	8.2	8.0	7.8	-71
10 yr G-sec (avg)	7.3	7.4	7.4	7.4	7.3	6.9	6.5	6.5	6.7	6.7	6.5	-80
MCLR (1 year)	8.75	8.75	8.68	8.65	8.68	8.65	8.60	8.50	8.40	8.35	-	-40
WALR (Fresh loans)	10.0	9.8	9.7	9.8	9.9	9.7	9.8	9.7	9.6	9.5	-	-44
Term deposit (>1 yr)	6.9	6.9	6.9	6.9	6.9	6.8	6.8	6.7	6.6	6.6	6.4	-45
3-Month Tbill	6.6	6.4	6.3	6.3	6.3	6.0	5.8	5.5	5.3	5.0	5.0	-157
6 Month T-Bill	6.7	6.5	6.4	6.3	6.4	6.1	5.9	5.6	5.5	5.2	5.1	-161

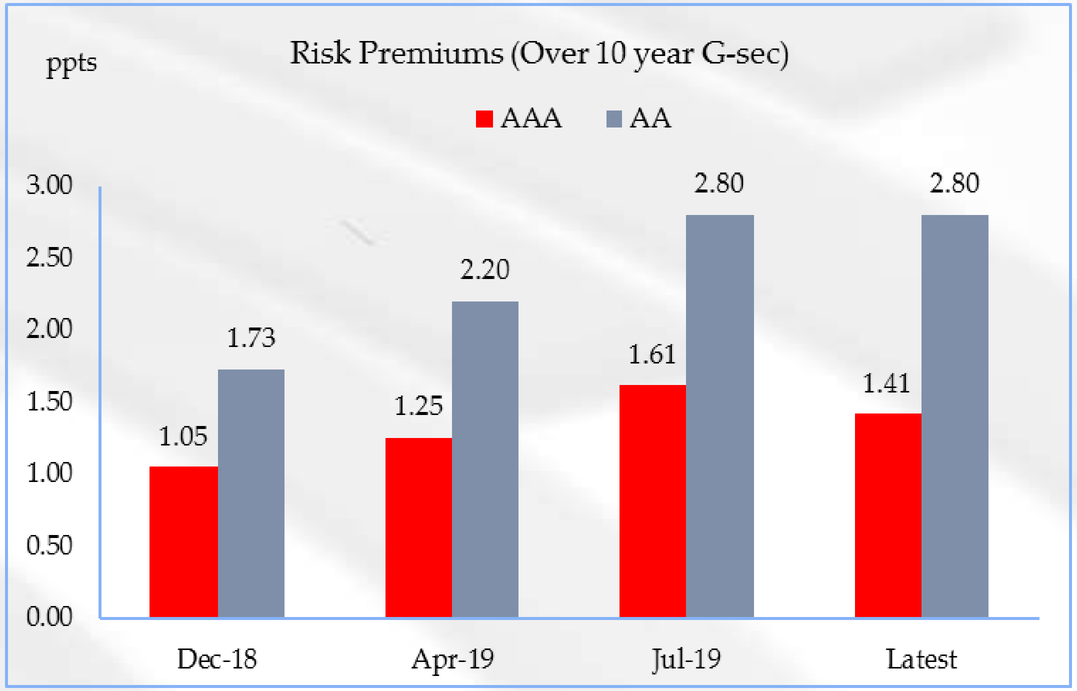
Source: RBI, CEIC, HDFC Bank

The flight to quality is visible in the higher AA corporate bond spreads over the 10 year G-sec. Even within the same rating bucket, there is considerable variation.

AAA 10 year corporate bond yields have fallen by 50bps while AA yields rose by 30bps since January 2019



Risk premiums have risen to 280 bps for AA bonds and 140bps for AAA corporate bonds



Source: Reuters, HDFC Bank

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