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Monetary Policy Update

Repo Rate Hiked to 6.5%, Policy Tone Maintained Neutral

The Reserve Bank of India today decided to hike the policy repo rate by +25 bps from 6.25% to 6.5% in a 5:1 vote in what was the RBI's first 3-day MPC (vs. prior 2-days). The MPC maintained its neutral stance on monetary policy and commitment to achieving a medium-term target for CPI of $4\% \pm 2\%$, while supporting growth.

Key highlights of the RBI's Monetary Policy

Global Growth Has Become Uneven

The RBI in its assessment flagged off choppy global growth and mounting trade tensions as key global concerns, citing a moderation in growth in Europe, Japan and China, an intensification of trade wars and uncertainty around Brexit as concerns. Emerging economies also showed mixed growth patterns with due to volatility in oil. China, South Africa and Brazil's economies did not perform well in Q2CY18/Q1CY18/Q1CY18 respectively, though Russia picked up in Q1CY18. Global trade also moderated on intensifying trade wars and uncertainty in Brexit negotiations. Crude oil prices eased off during the quarter, as did metals prices. The RBI further cited market declines in advanced economies. The ten year sovereign bond has come off its peak slightly, and highlighted the flight to liquidity and away from emerging markets on flows.

Indian Economy in Sustained Momentum

The monsoons have been recovering after a brief spell of deficiency in the second half of Jun-18. The live storage in major reservoirs was at 41% of the full reservoir level compared with 36% a year ago, which portends well for the rabi sowing season.

Macro indicators such as IIP (strengthened in Apr-May-18 vs. yoy), output of eight core industries (accelerated in Jun-18 on higher petroleum refinery production, steel, coal and cement), RBI's BEI (business expectation index remained optimistic for Q1FY19), manufacturing and services PMIs, tractor, 2W, PV and CV (though slight deceleration in growth here) and domestic air passenger growth showed encouraging trends.

Mounting Inflation Expectations & Inflation in the Pipeline

CPI increased in Jun-18 to 5.0% vs. 4.9% in May-18 driven mainly by an **increase in fuel (pulled up by liquefied petroleum gas and kerosene) and items other than food and fuel. Food inflation itself though was muted.** The Jun-18 round of the RBI's survey of households reported a rise in households' inflation expectations of +20bps, for both 3-month and 12-month ahead horizons. The RBI's industrial outlook survey (IOS) reported higher input costs and selling prices in Q1FY19. Input costs for companies polled in Services PMI in June also stayed elevated.

Market Reaction

G-Sec yields initially **spiked intra-day on the RBI announcement to 7.85%** (up ~12bps) but eased shortly thereafter to 7.74% levels (flat). The benchmark NIFTY50 index was largely unchanged during the trading session and closed the day down -0.31%.

The INR initially depreciated post the announcement on increasing concerns related to rising rates leading to a growth slowdown, but at the time of writing **had** settled at 68.5 levels vs. the USD.

Outlook

The MPC guided for a **slight hardening of headline inflation** (incl. HRA) particularly towards H2FY19:

- 4.6% for Q2FY19 (vs. 4.8-4.9% for H1FY19 as at Jun-18) and
- 4.8% for H2FY19 (vs. 4.7% earlier)

This was mainly because of the hike in MSPs for kharif crops which is much larger than the average increase seen in the past few years, elevated levels of crude oil prices, broad-based inflation in items excluding food and fuel reflecting pass-through of rising input costs and improving demand conditions.

While the RBI did hike the repo rate, it simultaneously also expects FY19 GDP growth to **remain robust at 7.4%, with growth being more front-ended at 7.5-7.6% in H1FY19 and 7.3-7.4% in H2FY19** (as forecasted in Jun-18 policy as well). GDP growth for Q1FY20 is projected at 7.5%. The major drivers for the reiteration in GDP growth were: robust corporate earnings especially from FMCG companies, thus reflecting buoyant rural demand, firm investment activity despite tightening financial conditions and increasing FDI flows in recent months.

We continue to view this as a shortened rate hike cycle. The rise in input cost pressures have been largely due to crude oil, which has moderated in recent days. While the possibility certainly exists that crude could spike higher, we continue to expect crude prices to stay steady in current ranges and head lower next year. Equity markets will take the rate hike in stride pending additional data; generally, it takes at least three hikes in a rate hike cycle for the impacts to start to be felt by consumers and

businesses. The rise in repo relative to G-sec is a catch-up on the part of the RBI to the market rate. Our interest rate expectation remains range bound, with no clear impetus of a meaningful change in the rate level or curve structure.

Sanctum Wealth Management

Investment & Advisory

Sunil Sharma

Chief Investment Officer & Executive Director

97177 19898,

sunil.sharma@sanctumwealth.com

Ashish Chaturmohta

Chief Advisor – Technical Strategies

77386 48833

ashish.chaturmohta@sanctumwealth.com

Viraj Vajratkar

Investment Analyst, Investment Office

98334 95395

viraj.vajratkar@sanctumwealth.com

Hemang Kapasi

Portfolio Manager

983322 7605

hemang.kapasi@sanctumwealth.com

Rohit Laungani

Investment Analyst, Investment Office

93241 68860

rohit.laungani@sanctumwealth.com

Anway Bhujbal

Technical & Derivative Analyst

98702 12498

anway.bhujbal@sanctumwealth.com

Offices

Mumbai

Sanctum Wealth Management Private Limited

Unit 1501, Tower 2B, One Indiabulls Centre, 841, Jupiter Mills, Off Senapati Bapat Marg, Lower Parel, Mumbai – 400013

Telephone: +91 22 61064800

Bengaluru

Sanctum Wealth Management Private Limited

Unit 1102, 11th Floor, HMG Ambassador, 137, Residency Road, Bengaluru – 560025

Telephone: +91 80 67427900

Kolkata

Sanctum Wealth Management Private Limited

Regus Business Centre Office no. 131, The Legacy, 1st Floor 25-A, Shakespeare Sarani Kolkata – 700017 West Bengal

Telephone: +91 33 44000509

Delhi

Sanctum Wealth Management Private Limited

812 – 816, 8th Floor, Narain Manzil, 23, Barakhamba Road, New Delhi – 110001

Telephone: +91 11 6612 5713

Chennai

Sanctum Wealth Management Private Limited

Level 4, Suite no. 503, Apeejay Business Centre, 39/12, Haddows Road, Nungambakkam, Chennai - 600006

Telephone: +91 44 28224949

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