Sanctum Wealth Management

Sanctum View

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Monetary Policy Update

RBI Surprises the Street With Status Quo

Contrary to street expectations, the Reserve Bank of India today decided to maintain the policy repo rate to 5.15% with a unanimous vote in favour of keeping rates unchanged. The MPC also kept the monetary policy stance unchanged at "accommodative", with an objective of achieving a medium-term target for CPI of 4% within a band of ± 2%, while supporting growth.

Key highlights of the RBI's Monetary Policy

The MPC's inflation expectations have been revised up:

- 4.7-5.1% for H2FY20 (vs. 3.5-3.7% earlier)
- 3.8-4.0% for H1FY21 (vs earlier guidance of 3.6% for Q1FY21)

The GDP growth rates expectations were trimmed down again as various high frequency indicators suggest weak demand:

- 4.9-5.5% for H2FY20 (vs 6.6-7.2% earlier)

- 5.0% in FY20 (vs 6.1% earlier)
- 5.9-6.3% in H1FY21 (vs. earlier guidance of 7.2% for Q1FY21)

Global Economy at Bottom but Not Worsening

The RBI flagged weakness in global economic activity, elevated trade tensions and geo-political uncertainty. Among advanced economies, GDP growth in the US picked up marginally in Q3. In the Euro area, GDP growth remained stable in Q3 relative to the previous quarter on improved household consumption and government spending, although manufacturing activity continued to struggle with lingering geo-political uncertainties. With weak global demand pulling down exports, the Japanese economy lost momentum in Q3.

The Chinese economy's growth also continued to remain tepid in Q3, due to weak industrial production and contraction in exports. In Russia and Brazil, GDP growth accelerated in Q3 on the back of an upturn in agricultural output and industrial activity, while in South Africa, economic activity contracted in Q3, pulled down by slowing mining and manufacturing activity.

Slowing Domestic Activity

Domestically, GDP growth decelerated for a sixth consecutive quarter to 4.5% in Q2FY20. Real GDP growth was weighed down by a sharp slowdown in gross fixed capital formation, cushioned by a jump in government final consumption expenditure.

IIP continued to decline in October for a second consecutive month. Production of coal, electricity, natural gas, crude oil and cement contracted in October. However, output of fertilisers rose sharply, reflecting expectations of robust sowing activity in the rabi season. The manufacturing purchasing managers' index improved MoM in November, driven up by an increase in new orders and output.

High frequency indicators present a dull picture with contraction across segments. Tractor and motorcycle sales – indicators of rural demand – continue to contract but at moderate pace. Amongst indicators of urban demand, passenger vehicle sales growth moved to positive territory after 11 months of decline. Railway freight and sales of commercial vehicles, a key indicator for the transportation sector, continued to contract.

Retail inflation, measured by CPI, shot up to 6.9% in October, a 39 month high pushed up by a sharp increase in prices of vegetables due to heavy unseasonal rains. Inflation in CPI excluding food and fuel softened further from 4.2 per cent in September to 3.4 per cent in October.

While the rate cuts have been significant, with cumulative rate cuts of 135bps since Feb 2019, the concern remains slow transmission of rate cuts to the end consumer. Transmission has gained some momentum in recent weeks, with the weighted average lending rate on fresh rupee loans sanctioned by banks declining 44 basis points.

The trade deficit narrowed during the quarter despite weak exports as both oil and non-oil imports contracted. Net FDI inflows rose to USD20.9bn in H1FY20 from USD17.0bn a year ago. On the FPI side, there have been sharp inflows post the corporate tax rate cut in September. India's foreign exchange reserves stood at a very healthy USD451.7 bn as on Dec 03, 2019.

Market Reaction

- The yield on the 10 year government bond shot up 10bps. The yields had fallen ~20bps in the last two months.

- The Indian rupee depreciated marginally to 71.55 per Us dollar.

Outlook

Global growth appears to have bottomed out and pockets of recovery have come forward. The domestic economy seems to have bottomed as well and the government is likely to continue to come forward with additional stimulus and policy measures to help revive growth.

Transmission remains slow. However, the cut in corporate tax rates, a lower cost of borrowing and a slowly steadying picture on the credit front suggest a gradually improving economic scenario as the most likely path forward.

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