

THIRD BI-MONTHLY MONETARY POLICY STATEMENT, 2018-2019

Monetary Measures

- Monetary Policy Committee (MPC) increased the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points to 6.50%.
- Consequently, the reverse repo rate under the LAF stands adjusted at 6.25 %, and the marginal standing facility (MSF) rate and the Bank Rate at 6.75 %.
- Neutral stance of monetary policy maintained.

Analysis & Outlook

- The tone of the policy remained cautious with adequate focus on the upside risks to inflation. The MPC observed that even as overall food inflation remained under check, upside pressures from hike in MSP prices and improvement in domestic demand will remain. We see inflation for 2HFY19 to be in the range of 4.6-4.8% and 4.8-5.0% in Q1FY20.
- The MPC also noted that domestic economic activity has continued to sustain momentum and the output gap has almost closed. Normal monsoon, positive outlook on rural income and robust corporate earnings suggests demand will continue to remain buoyant. Investment activity remains firm even though there is some tightening of financial conditions. Geo-political risks, global financial market volatility and the threat of trade protectionism pose headwinds to the domestic and global growth.
- Q2FY19 inflation is estimated in the range of 4.6% (earlier estimate 4.8-4.9%), including House Rent Allowance (HRA) impact and 2HFY19 inflation at 4.8% (earlier 4.7%), Q1FY20 inflation at 5% with risks evenly balanced. Excluding the impact of HRA revisions, CPI inflation is projected at 4.4% in Q2FY19, 4.7-4.8% (earlier 4.7%) in 2HFY19 and 5% in Q2FY20.
- FY2019 GDP growth estimate retained at 7.4%, ranging 7.5-7.6 per cent in H1FY19 and 7.3-7.4 per cent in H2FY19, with risks evenly balanced; GDP growth for Q1FY20 is projected at 7.5%.
- RBI noted that the liquidity in the system continues to be in moderately surplus mode, but it is moving steadily towards neutrality.
 - Yields at the longer end of the curve moved down by 4-5 bps with the benchmark 10-year paper yield at 7.73% at the time of writing.
 - Yields at the shorter end of the curve (up to one year) moved up by 5-10 basis points after the policy.
- As MPC has maintained the monetary policy stance neutral, we expect MPC to move towards gradual rate hike depending upon evolving inflationary and growth conditions.
- MPC has cited the following as reasons for increasing the repo rate.
 - The MPC observed that CPI inflation was projected at 4.6 per cent in H1 and 4.7 per cent in H2. Actual inflation outcomes have been slightly below the projected trajectory as the seasonal summer surge in vegetable prices has remained somewhat muted in comparison with its past behaviour and fruits prices have declined. The inflation outlook is likely to be shaped by several factors. 1) Hike in MSP prices will have a direct impact on food inflation and second round effects on headline inflation. Full impact of MSP on inflation will only resolve in the next several months once the price support schemes are implemented 2) The overall performance of the monsoon so far

augurs well for food inflation in the medium-term. 3) Crude oil prices have moderated slightly, but remain at elevated levels. 4) The central government has reduced GST rates on several goods and services. This will have some direct moderating impact on inflation, provided there is a pass-through of reduced GST rates to retail consumers. 5) Inflation in items excluding food and fuel has been broad-based and has risen significantly in recent months, reflecting greater pass-through of rising input costs and improving demand conditions. 6) Financial markets continue to be volatile. 7) In case there is fiscal slippage at the centre and/or state levels, it could have adverse implications for market volatility, crowd out private investment and impact the outlook for inflation. 8) The staggered impact of HRA revision by state governments may push headline inflation up.

- The MPC noted that various indicators suggest that economic activity has continued to be strong. The progress of the monsoon so far and a sharper than the usual increase in MSPs of kharif crops is expected to boost rural demand by raising farmers' income. Robust corporate earnings also reflect buoyant rural demand. Investment activity remains firm even as there has been some tightening of financing conditions in the recent period. Increased FDI flows in recent months and continued buoyant domestic capital market conditions bode well for investment activity. The Reserve Bank's Industrial Outlook Survey (IOS) indicates that activity in the manufacturing sector is expected to remain robust in Q2FY19, though there may be some moderation in pace.
- The MPC remains focused on its commitment to keeping headline inflation close to 4 per cent on a durable basis.

Position of Funds

Duration funds:

- The policy statement has hiked the policy rates while maintaining the neutral stance and flagged upside risks to inflation. We believe that there could be one more rate hike of 25 basis points in current financial year based on evolving inflation and growth dynamics.
- Any up move in bond yields provides an excellent opportunity for investors to enter the fixed income market, especially into products focussed on the short to mid end of the yield curve.

Money market funds:

- The yields at the shorter end of the curve may move in tandem with the liquidity in the system. With RBI expected to continue to move towards liquidity neutrality, short end rates are expected to be anchored to repo rate.

The next meeting of MPC is scheduled to be held on October 03 to 05, 2018.

MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.

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