RBI does an encore

- ✓ **Drawing comfort from the ongoing disinflationary trend and improving quality of fiscal adjustment, the Reserve Bank of India in yet another unscheduled move lowered the benchmark policy rate by 25 bps to 7.50%**
- ✓ **A conflux of benign commodity prices, expected improvement in quality of government spending amid lingering weakness in domestic demand conditions is expected to keep CPI inflation well within RBI's targeted rate**
- ✓ **We expect Jan-16 RBI target of 6% to be over-achieved by 60 bps paving way for another 25 bps rate cut by June- 15, with the possibility of an additional 25 bps cut by Sep-15 if oil prices continue to remain soft and 2015 south-west monsoon presents a benign picture**
- ✓ **In our opinion, in the near term, government's actions would need to complement RBI's proactive step through;**
  - **Measures on food supply management to mitigate risks of food inflation**
  - **Timely execution of reform and expenditure plan set out in the Budget**
- ✓ **Going forward, we expect 10Y g-sec yield to trade close to 7.35% levels by end of FY16 with risks skewed to the downside**

The Reserve Bank of India in yet another unscheduled move lowered the benchmark policy rate by 25 bps to 7.50%.

Drawing comfort from the ongoing disinflationary trend and improving quality of fiscal adjustment as enunciated in the Union Budget FY16, the Reserve Bank of India in yet another unscheduled move lowered the benchmark policy rate by 25 bps to 7.50%. Consequently, the reverse repo and the MSF rates also got adjusted at 6.50% and 8.50% respectively, while the Cash reserve Ratio was left unchanged at 4%. Coming four days after the announcement of Union Budget 2015-16, the policy rate cut from RBI appears to suggest its focus towards growth, having adequately highlighted the risks associated with uncertainties around inflation trajectory.

Annualized inflation based on the new CPI data suggested broad-based disinflationary impulses in the economy

Rationale and key takeaways

RBI's action seems to have been guided by three evolving factors;

Inflation: Annualized inflation based on the new CPI data (rebased to 2012 with better representation of consumption trends in the economy) suggested broad-based disinflationary impulses in the economy. At 5.1%, headline inflation was well within the target of 8% by January 2016. Core inflation too moderated to a series low of 3.9%.

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Growth: Notwithstanding the upward revision to growth basis new GDP series, anecdotal evidence based on credit data, imports and capacity utilization, reflects subdued growth conditions. To quote "nevertheless, the picture of a steadily recovering economy appears right…it is appropriate for the Reserve Bank to be pre-emptive…to utilise available space for monetary accommodation".

Fiscal Policy: In our view, the incremental fiscal impulse in the form of Union Budget was most important factor behind today's move. Even though fiscal consolidation target of 3% was postponed by one year, there were other factors (like emphasis on quality of adjustment, tax reforms, investment push, fiscal rectitude, among others) that amply served as reassurance for the RBI.

The incremental fiscal impulse in the form of Union Budget was most important factor behind today's move

Besides the above mentioned factors, government's move to institutionalise the New Monetary Policy Framework proved to be an added impetus behind RBI's decision.

Policy outlook

For the near term, RBI has retained its guidance on policy action as highlighted in its fifth-bi-monthly policy statement of December 2014.

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Government's action on supply side in particular land, minerals and infrastructure, continuing progress on high quality fiscal consolidation amid outturn of South West monsoon and developments in international environment would continue to guide RBI's policy stance.

In this respect, notwithstanding the recent uncertainty towards passage of key bills such as Land Acquisition (given government's minority status in the Upper House of the Parliament) we expect government to adopt a consultative process to weed out differences and remain focused on the path of structural reforms. While Fed's imminent rate hike remains a key event risk, RBI's continued reserve accumulation amid India's improving growth-inflation fundamentals are likely to attenuate any possible undesirable impact.

A conflux of benign commodity prices and expected improvement in quality of government spending is expected to keep CPI inflation well within RBI's targeted rate

A conflux of benign commodity prices, expected improvement in quality of government spending amid lingering weakness in domestic demand conditions is expected to keep CPI inflation well within RBI's targeted rate. We expect CPI inflation to average ~5.5% in FY16 assuming average oil price of USD 65/bl. Likewise, we expect Jan-16 RBI target of 6% to be over-achieved by 60 bps paving way for another 25 bps rate cut by June-15, with the possibility of an additional 25 bps cut by Sep-15 if oil prices continue to remain soft and 2015 south-west monsoon presents a benign picture. We believe uncertainties with respect inflation outlook amid recovery in domestic demand would prevent RBI from undertaking aggressive easing.

In our opinion, in the near term, government's actions would need to complement RBI's proactive step. In this regard, two factors assume critcal importance,

- Measures on food supply management to mitigate risks of food inflation amid expected seasonal pickup in food prices.
- Timely execution of reform and expenditure plan set out in the Budget. This necessitates prioritising the disinvestment program so that there is no curtailment in capex spending on account of any undershooting of tax revenues.

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Implications

We expect 10Y g-sec yield to trade close to 7.35% levels by end of FY16 with risks skewed to the downside owing to a likelihood of 50 bps incremental policy easing vis-à-vis our base case of 25 bps cut

Bond markets reacted positively to the unexpected timing of the rate cut with the 10Y g-sec yield trading around 7.67% levels at the time of writing, down 8 bps from yesterday's close. Going forward, we expect 10Y g-sec yield to trade close to 7.35% by end of FY16.

Moreover, we believe while impending interest rate hike in the US in 2015 could provide some volatility, following downside risks could guide 10Y g-sec yield potentially to 7.15%:

- ✓ Likelihood of 50 bps incremental policy easing vis-à-vis our base case of 25 bps cut owing to continued disinflationary impulse
- ✓ Limited supply pressure on account of meagre increase in government borrowing for FY16. Gross and net market borrowing has been budgeted to grow by 1.3% and 0.7% in FY16 to INR 6.00 tn and Rs 4.56 tn respectively

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About YES BANK

YES BANK, India's new age private sector Bank, is the outcome of the professional commitment of its main Promoter, Rana Kapoor and his highly competent top management team, to establish a high quality, customer centric, service driven, private Indian Bank catering to "Emerging India".

YES BANK has adopted international best practices, the highest standards of service quality and operational excellence, and offers comprehensive banking and financial solutions to all its valued customers. A key strength and differentiating feature of YES BANK is its knowledge driven approach to banking and an unprecedented customer experience for its retail and wealth management clients.

YES BANK is steadily building corporate and institutional banking, financial markets, investment banking, business and transaction banking, retail and private banking business lines across the country. The Bank's constant endeavour is to provide a delightful banking experience expressed with simplicity, empathy and totality.