Debt markets

The Monetary Policy Committee in its fourth Monetary Policy for FY '19 decided to keep rates unchanged after two consecutive rate hikes. This was against the market expectation of a 25bps rate hike. MPC also changed the policy stance from neutral to calibrated tightening. This resulted in a relief rally in bond yields and benchmark yield came down by 10-12bps from its pre-policy levels.

The 10-year Government benchmark bond was trading in the band of 7.99% to 8.18% during the month. The benchmark yield touched intraday high of 8.23% tracking higher oil prices and a depreciating currency. However, the expectations of Open Market Operations (OMO) and lower than budgeted borrowing for second half of FY '19 the benchmark yield cooled off from the peak and closed the month at 8.02% compare to 7.95% in August

Banking system liquidity generally becomes tight due to Advance Tax outflows at the end of the quarter. Along with that increase in currency circulation resulted in rise in money market yields. Three month CD rates which were around 7.00% to 7.10% in August increased to 7.40% to 7.50% levels. Six month and one year CD rates also moved up by 50-60 bps in the second half of the month. However, in the last week Money market rates retreated by 20-30 bps from the peak due ease in liquidity.

Liquidity turned negative in the month of September and averaged Rs -0.41 trillion from previous month's average of positive Rs 0.05 trillion (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo) mainly due to advance tax outflows.

Domestic Macro Factors

Industrial Production

Growth in Industrial production moderated to 6.6% y-o-y in July vs. 6.9% (revised from 7%) in June. This was higher than market expectation of 6.5%. Growth in consumer non-durables was 5.6% in July vs. 0.2% in June. Infrastructure and Intermediate goods growth increased to 8.43% and 1.2% in July vs 8.22% and 1.5% respectively in June. Manufacturing activity growth increased to 7% y-o-y in July from 6.7% in June. Mining and electricity growth decelerated to 3.7% and 6.7% in July from 6.6% and 8.5% respectively in June. Primary goods also declined to 6.9% in July vs. 9.3% in May. In terms of use-based classification, Capital goods production increased to 3.0% in July vs 9.8% in June. The consumer durables category rose at 14.4% in July from 13.4% in June.

External Trade

India's external trade deficit narrowed to $ 17.39 bn in August vs. $ 18.02 bn in July. This was closer to market expectation of a deficit of $ 17.25 bn. Exports growth jumped to 19.2% y-o-y in August vs. 18% in July. Exports printed at $ 27.84 bn in August from $ 25.7 bn in July. Imports rose to 24.4% in August vs. 28.8% in July. Imports printed at $ 45.24 billion in the month of August. Oil imports grew at 51.6% in August from 57.5% in July. Gold imports rose to 92.6% In August vs 40.9% in July.

INR continued to remain under pressure during the month of September and traded in the range of 71.20/$ to 72.96/$ and finally closed the month at 72.49/$ in September vs 70.99/$ in August. India's forex reserves were at $ 401.7 bn as on 21st September from $ 401.2 bn in last week of August.

GST collection for the month of September increased to Rs 94,442 crore, from previous months collection of Rs 93,690 crores. GST collection in September witnessed an uptick but however it is much lower than the high of Rs 1.03 lakh crores collected in April. The break-up of the Rs 94,442 crore is as follows - Central GST of Rs 15,318 crore, State GST of Rs 21,061 crore, Integrated GST of Rs 50,070 crores and Cess of Rs 7,993 crore.

Current Account & BOP

The Current Account deficit widened to $ 15.8 bn in Q2 which is 2.4% of GDP, from $ 13.1 bn (1.9% of GDP) in Q1. This was better than expected deficit of $ 17.2 bn. Primary reasons for broadening were wider merchandise trade deficit, which increased to $ 45.7bn in Q2 from $ 41.6 bn in Q1 due to heavy imports, mainly oil. However, the wider trade deficit was somewhat balanced by a 17.5% y-o-y rise in payments, lifted by a weaker rupee and a moderation in investment income outflows. The Balance of Payments recorded a deficit of $ 11.3 bn.

Inflation

Headline CPI inflation fell to 3.69% in August from 4.17% in July. This was slightly below market expectation of 3.77%. It is the lowest inflation rate since October 2017. Lower food price inflation and slight fall in core inflation remained the main reasons for the decline in headline inflation. However, elevated level of core inflation remains a concern. Food inflation moderated to 0.3% in August vs 1.3% in July. Core CPI (i.e. CPI ex food & fuel) softened to 6.0% in August from 6.2% in July. Fuel & Lighting inflation increased to 8.47% August from 7.96% in July. Housing inflation moderated to 7.59% in August vs. 8.30% in July. Other miscellaneous inflation also moderated to 5.52% in August vs. 5.80% in July.

WPI inflation softened to 4.53% in August from 5.09% in July. This was below market expectation of 4.62%. It is the lowest wholesale inflation since April 2018. This was largely due to softer increase in food prices. Primary articles inflation declined to -0.15% in August vs. 1.73% in July. Fuel and power inflation combined also moderated to 17.7% in August from 18.1% in July. Core WPI Inflation (manufactured product ex food inflation) hardened slightly to 5% in August from 4.8% in July. Coal mining inflation remained constant at 4.7% in August vs. 4.7% in July. Electricity inflation increased 8.9% in August vs. 7.5% in July.

Outlook

The emerging market currencies are facing extreme pressures and the policy makers have to make difficult choices. External situation, liquidity management and financial stability have come to fore as key objectives for policy makers. Locally GOI had tried to stem the deteriorating external situation by a slew of measures like increasing tariffs on non-essential imports, easing ECB borrowings and abolishing withholding tax on Masala bonds. RBI had to announce that it will inject liquidity of Rs 360 bn in the month of October through purchase of Government Securities under OMO, citing assessment of durable liquidity going forward and the seasonal growth in currency in circulation due to the festive season. This comes just after the Government announced its borrowing calendar for the second half of FY '19. Government officials have decided to cut the borrowing by Rs 70,000 crores which concludes that the borrowing will come down to Rs 2.47 trillion. So with the borrowing of Rs 2.88 trillion in the first half, the total borrowing for the year would now be Rs 5.35 trillion as against the budgeted amount of Rs 6.05 trillion. Officials also mentioned that revenues are as per budget and no slippage in fiscal deficit is expected as the collection under small saving scheme is expected to fill the gap.

Globally, The Federal Reserve Committee increased interest rates for by 25 bps the third time this year and suggested three further rate hikes in 2019. So the policy rates would range between 2% to 2.5%. Officials also indicated that growth and job gains have been strong and inflation is closer to the target of 2%.

ECB in its Monetary Policy left the benchmark rates unchanged. It also announced plans to end bond purchases at the end of the year and keep the interest rates at present low levels through the summer of 2019. It would also reduce the bond purchases to 15 billion Euros from 30 billion Euros from the month of October. Similarly, The Bank of Japan also kept its Monetary Policy rates unchanged. The Central bank also maintained its new stance which was adopted in July which pledges to keep interest rates extremely low for an extended period.

Locally MPC acknowledges that food inflation has remained unusually benign which has kept CPI under control. Going ahead it is expected to remain the same as production of major Kharif crops for 2018-19 is higher than last year's record and baseline inflation projection factors in MSP hikes. The upside risk to inflation comes from rising crude oil and imported inflation due to weakening emerging market currencies. Taking all these factors into consideration, inflation is projected at 4.0 per cent in Q2 of FY '19 and 3.9% - 4.5% in H2 of FY '19 and 4.8% in Q1 of FY '20, with risks somewhat to the upside. This is around 20-30 bps below the previous projections.

MPC statement sounds confident on growth as Q1 growth was significantly higher than that projected in August. However it acknowledges both global and domestic financial conditions have tightened, which may dampen investment activity. Rising crude oil prices and other input costs may also drag down investment activity.

It looks like for now MPC's main concern is inflation and recent benign trend has given it some room to keep rates unchanged even at the cost of letting local currency depreciate. Markets expectation of rate hike was largely from the point of view of defense of the Rupee though that may not have been enough. We believe RBI has reckoned that rate hikes alone may not be effective to stem the fall in Rupee. Hence we may see more measures to improve external situation outside monetary policy like we have seen last month.

More importantly policy stance has been changed from "Neutral" to "Calibrated tightening". This gives clear indication that if inflation deviates from its projected trajectory MPC will be swift to hike the rates.

We believe that RBI will not waver from its durable 4% inflation target and tighten monetary policy exceptionally until and unless there is some adverse global event. Our base case still remains a further 25 bps hike this year and a total of 50 bps hike till March 19. However adverse developments on the currency front may force RBI to take measures to ring fence the economy from any contagion.

We continue to recommend Liquid, Money market and Low duration funds for shorter holding periods. Short duration funds with accrual focus for investors with 9 to 12 months focus while we recommend mid duration and systematic deployments in long duration funds for investors with 36 months and greater investment horizon.