

## India Update – Opting for the New Ball

The Reserve Bank of India (RBI) cut the base rate by 25bp to 7.75% yesterday morning in a surprise move two weeks in advance of a scheduled policy meeting. The interest rate cycle has now turned following a five year tightening trend (Chart 1). The December meeting stated that *“once the monetary policy stance shifts, subsequent policy actions will be consistent with this stance”*. Although the market was expecting interest rates to come down at some point in Q1 CY15, we believe the timing is a positive signal with regards to the Central Bank’s inflation expectations and growth outlook.

*“[T]he government has reiterated its commitment to adhering to its fiscal deficit target... Households’ inflation expectations have adapted, and both near-term and longer-term inflation expectations have eased to single digits for the first time since September 2009... These developments have provided headroom for a shift in the monetary policy stance.”* RBI Governor Dr Raghuram Rajan, 15 January 2015

### 1. Why interest rates have been reduced earlier than expected

- Since July 2014, inflation has been below its expected trajectory
- RBI’s January 2015 CPI 8% target comfortably met, 2016 6% target also breached (Chart 2)
- Inflation expected to rise slightly in the short term, but downward pressure remains strong
  - Brent crude oil down 30% since the last RBI policy meeting
  - Weak demand across multiple sectors
  - Muted industrial activity
- Lower volatility from the Rupee despite strong US Dollar performance (Chart 3)
- RBI assuaged by Government’s commitment to fiscal prudence and supply side reform

### 2. The impact of more accommodative monetary policy

- Sentiment boost from RBI’s transition away from inflation fighting towards growth; market expectations of 50-75bp cuts in 2015
- Lower borrowing costs for corporate India, asset quality relief in the banking sector (Chart 4)
- Banks have already started to cut deposit rates, lending rates should follow aiding recovery in credit growth (Chart 5)

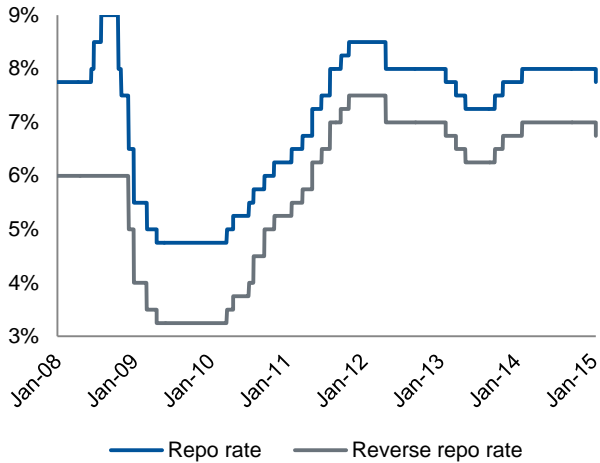
### 3. Outlook

- Despite a lower interest rate differential, INR appreciated 0.6% yesterday vs US\$. The RBI has the market’s confidence
- Easing to be measured ensuring real rates are positive to encourage financial savings (gold import restrictions now lifted)
- In the short term, lower interest rates will lead to lower NIMs for the banking sector, but should be offset by the sharper fall in bond yields leading to higher trading gains
- Lower cost of capital will accompany fiscal consolidation and structural reform to underpin economic recovery
- Revival in corporate profitability will take time as the economy cleanses itself
- Earnings growth for FY17 is forecasted at 17.5%, looks conservative if rates continue to fall

### 4. Market and portfolio implications

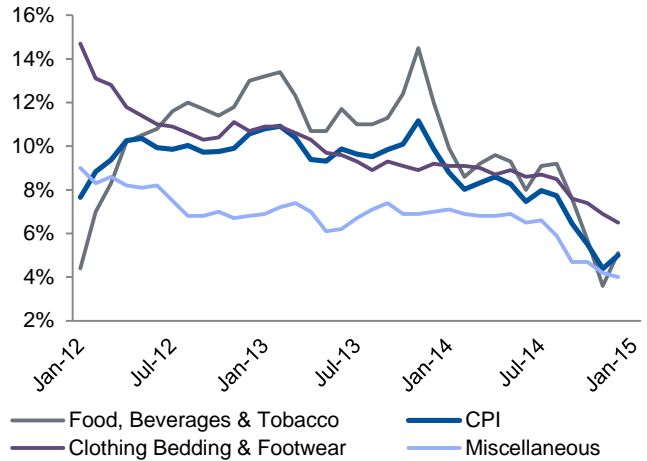
- Turn of interest rate cycle can keep market multiples elevated until the earnings recovery
- Remain cautious on pure infrastructure, positive on indirect beneficiaries; financial services, capital goods, industrials, where management quality and balance sheets are robust
- Risks to the downside for India are mainly global and geopolitical. FX reserves now at US\$320bn, the RBI has a buffer should they materialise

Chart 1: RBI base rate



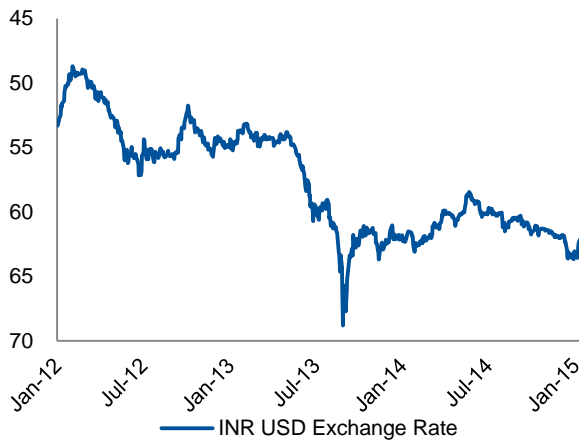
Source: Bloomberg

Chart 2: CPI and its components



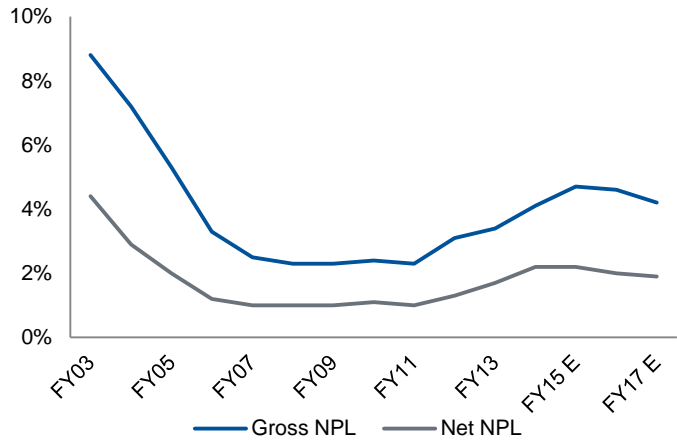
Source: Bloomberg

Chart 3: INR/US\$



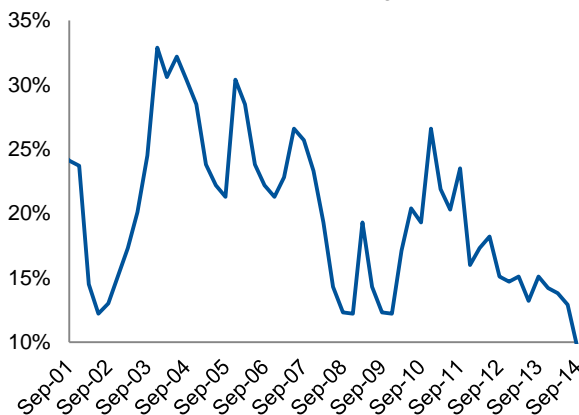
Source: Bloomberg

Chart 4: Asset quality in the banking sector



Source: BoA Merrill Lynch

Chart 5: India credit growth



Source: Bloomberg

Chart 6: Government of India 10 year bond yield



Source: Bloomberg

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