View on Monetary Policy & Equity markets

Is the Change in stance by MPC conveying a long pause in rate action?

By changing its monetary stance from accommodative to neutral the Monetary Policy Committee (MPC) has signaled an important inflection point in its pursuit of achieving medium-term target of 4% consumer price inflation (CPI). By highlighting the persistence of core inflation (excluding the volatile food & fuel component) at 4.9% since September 2016 and discernable stickiness in items like housing, education, heath etc; MPC may well be conveying a long pause before any further rate cut. The view gets buttressed by the Governor's admission in the press conference that excluding the effects of sharper than usual drop in vegetable prices during winter as a result of some distress sales by farmers in the wake of demonetization, the CPI would have been 1.4% higher than CSO estimate. With ample liquidity in the banking system and further scope for banks to lower their lending rates (Repo rates have dropped by 1.75% since January 2016 while weighted average bank lending rates are down by just 0.8 to 0.9%), RBI would prefer a faster transmission.

Heightened upside risks to global inflation warrant caution

Heightened upside risks to inflation in both advanced and emerging economies (EM) have weighed on the MPC's decision. Fiscal stimulus by Trump administration leading to spike in US bond yields and stronger dollar, gradually strengthening economic outlook in US & rising international commodity prices especially crude have injected a measure of caution. With its massive dependence on crude imports India can ill-afford to lower its guard. Any sharper than expected rise in US rates has the potential to trigger FII exodus from EMs including India putting downward pressure on Rupee and causing rise in imported inflation and worsening trade deficit. Domestically the full effect of house rent allowances under 7th Pay Award are not fully reflected in the projected inflation trajectory.

MPC placing high confidence in sharp bounce-back in economic growth

MPC is placing high confidence that sharp dip in aggregate demand due to demonetization will sharply bounce-back & growth will recover sharply in FY 18. It expects deferred discretionary consumer demand to stage smart recovery as cash levels resume normalcy in the closing months of FY 17, demand in cash-intensive sectors like retail trade, hotels etc & unorganized sectors to be rapidly restored, lowering of borrowing costs as a result of banks cutting rates due to surge of liquidity to spur both consumption & investment demand and lastly a fiscally-prudent, capital expenditure focused Union Budget to aid growth impulses in the economy. If the restoration of aggregate demand falls short of the MPC's rosy outlook then it may have to recalibrate its stance & consider providing a monetary stimulus.

Recovery in earnings still fragile and not broad based warranting caution to be exercised

Although equity markets have shrugged off the hawkish overtone of the policy we remain cautious in the wake of sharp rally underpinned by a surge in domestic inflows and reversal of FII outflows. Although the earnings season is not reflecting the doomsday scenario feared by many investors in the wake of demonetization, the recovery in earnings is still fragile and not broad-based. Negative volume growth trends in fast moving consumer goods sector, anemic credit growth in the banking system, aggressive stuffing of channel inventory by many companies to buoy primary sales and whispers of some amount of future purchases by channel partners using older currency notes are all grim reminders to exercise abundant caution before rejoicing that the damage to aggregate demand was not substantial. Valuations particularly in some sections of small & mid-cap space, interest rate sensitives like NBFCs & some global cyclicals need to take a breather as commensurate earnings growth is not visible.

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