RBI Monetary Policy Review

L&T Financial Services
Mutual Fund

June 6, 2018

RBI rate hike and the changes to come

- India's Monetary Policy Committee (MPC) voted 6-0 to hike policy rates by 25 bps at today's review, taking the Repo Rate to 6.25%.
- Interestingly, however, the RBI did not formally tighten its monetary policy stance from "neutral" to a "withdrawal of accommodation" as had been expected and hinted at in the April MPC minutes.
- Inflation forecast for H2 FY19 was hiked by a somewhat lower than expected 30 bps from 4.4% to 4.7%, while growth projection was retained at 7.4% for FY19.
- Negative output gap had been cited as one of the main reasons why rates were kept on hold over the past 6 months, even though inflation ruled above their medium-term 4% target. This time, the MPC clearly noted a lot more comfort from recent growth indicators, with the governor stressing repeatedly that the output gap as per RBI's estimate had almost closed.
- On the inflation front – the MPC noted various upside risks:
  - Most significantly, oil prices having moved up by 12% since the last MPC, and which seems to be "durable".
  - Also, the compositional shift towards acceleration in core CPI, instead of food and vegetables as expected in the earlier projections.
  - The household inflation expectations survey of May 2018 reporting a significant rise of 90 bps and 130 bps for the 3 month and 1 year ahead horizon respectively.
- Apart from the monetary policy announcements, there were two key surprise elements:
  - On the positive side - RBI has allowed 2% more SLR carve out to meet Liquidity Coverage Ratio (LCR), taking the total SLR carve out to 13%. This potentially releases a significant amount of liquidity, especially for the large private sector banks.
  - The other announcement (medium-term positive, albeit painful near term) - SDL valuation norms have been changed to reflect market traded prices for that particular issuing state, and not the hitherto system of G-Sec + 25 bps spread across all SDLs.

Key takeaways and market impact

- Rate hike of 25 bps, while a bit earlier than expected, has been widely anticipated – and hence not a shock for the market.
- The neutral stance was a bit of a surprise, as markets were discounting a change to "withdrawal of accommodation". However, this failed to have any calming effect on the market. Possibly, the markets do realise that this should not be read as an indication that the MPC would stop at only one rate hike, and risk persists that we may see another two or three rate hikes over the next year or so. Also, from the last MPC experience, the markets are worried that the MPC minutes of this meeting could later show a more hawkish bias for future trajectory of rate moves by the individual MPC members.
- With no comfort being given by Deputy Governor Viral Acharya with regard to OMO purchases going forward, market worries around demand-supply mismatch for Government securities continue with zero visibility of the "RBI hand" to prevent further sell-off.
- Yields moved higher post policy, with 10 year G-Sec closing at 7.92%, just 2 bps shy of the intra-day high of 7.94% seen in mid-May. We expect upward bias to continue with yields likely to breach 8% soon.

- Short end rates cheered the LCR announcement, with a rally of almost 15-25 bps in the 3 month segment (CDs & CPs) and about 10-20 bps in the 6-12 month segment. We expect some more relief at the shorter end over coming days.
- The effect of the SDL valuation announcement will be fully felt in the upcoming SDL primary auction. This, to our mind, is the more worrying take-away from this MPC – as SDL spreads could start widening meaningfully from current 50-55 bps over G-Sec. This could have a negative spill-over effect on longer end of the corporate bond curve as well.

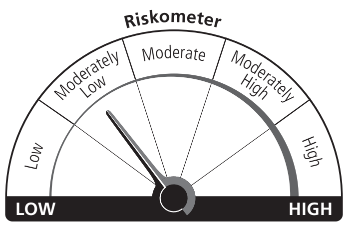
Like in our previous communication, we would recommend investors to be cautious and maintain fund allocations strictly within their risk appetite and limits, as this year we are likely to see wild swings in market expectations from one extreme to the other. From a medium term perspective, we believe the 10-year G-Sec yield is likely to hover in the 7.5-8.25% range.

Funds such as L&T Ultra Short Term Fund (positioned in the conservative 3-6month duration space) and L&T Short Term Bond Fund offer attractive carry with high credit quality portfolios, while keeping interest rate risk on the lower side of their respective categories. In the accrual fund segment, we believe the sweet spot continues to be the AA space (where the L&T Low Duration Fund is positioned), where yields are still quite attractive and credit risks well contained. We expect bank MCLRs to move up over the next few months, which should result in yields for A rated issuers to move up in the bond market as well. Till that happens, we prefer keeping less exposure to A rated bonds in the L&T Credit Risk Fund, while deploying mainly in the AA segment.

This product is suitable for investors who are seeking*

L&T Ultra Short Term Fund
(An open-ended pure income scheme)
- Generation of reasonable and stable income and liquidity over short term
- Investments predominantly in highly liquid money market instruments, government securities and corporate debt

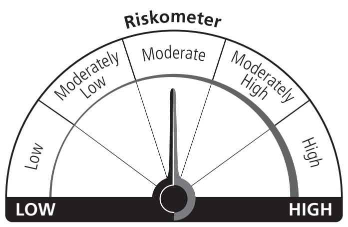
L&T Short Term Bond Fund
(An open-ended debt scheme)
- Generation of regular returns over short term
- Investment primarily in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions in India



Investors understand that their principal will be at moderately high risk

L&T Low Duration Fund
(An open-ended income scheme)
- Generation of reasonable returns over short to medium term
- Investment in xed income securities and money market instruments

L&T Credit Risk Fund
(An open-ended income scheme)
- Generation of regular returns and capital appreciation over medium to long term
- Investment in debt instruments(including securitized debt), government and money market securities



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***Investors should consult their financial advisers if in doubt about whether the product is suitable for them.**

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.