Economic Alert | 15 January 2015

India – RBI likely to ease further

- **RBI delivers a surprise inter-meeting repo rate cut of 25bps to 7.75%**
- **We expect two more rate cuts of 25bps, each in the February and April policy meetings**
- **Stay *Positive* on IGBs; Buy 10Y IGBs (current: 7.68%, entry: 8.08%, target: 7.40%, revised stop-loss: 8.00%)**

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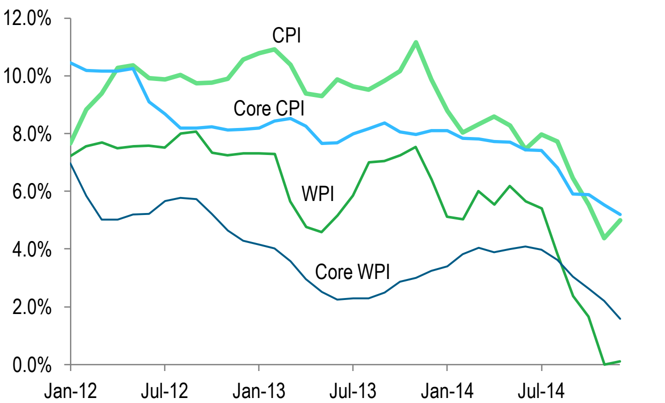
After today's inter-meeting repo rate cut by 25bps to 7.75%, we expect the Reserve Bank of India (RBI) to deliver two more rate cuts of 25bps each in the February and April 2015 policy meetings. Given the benign inflation outlook – we expect lower CPI inflation of 5.8% y/y in FY16, versus 6.6% in FY15 – we see room for the RBI to further ease monetary policy as most of its pre-conditions listed in the 2 December policy meeting are likely to be met.

The RBI set the following pre-conditions to a change in its monetary policy stance in the December 2014 policy meeting:

- Looking beyond base effects
- Some confirmation that disinflationary impulses are not transitory
- A change in inflation expectations
- The government's ability to keep the fiscal deficit within target

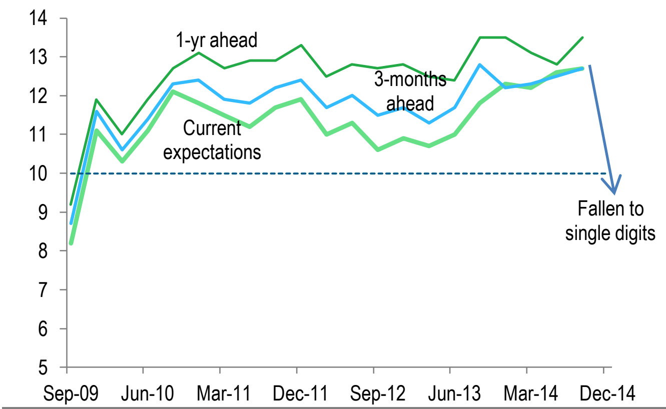
Despite the favourable base effect fading in December, CPI inflation of 5.00% y/y was a positive surprise versus consensus expectations, and also lower than the RBI's own projection of c.5.5%. A broad-based slowdown in price pressures, along with a slide in core CPI inflation to 5.2% in December for the 13th month in succession, confirms that the slowdown in inflation is not a temporary phenomenon. Even WPI inflation of 0.11% y/y in December, with core WPI inflation of 1.6% y/y, was the slowest inflation rate since December 2009. While we expect some upward price pressure from higher vegetable and fruit prices due to adverse weather conditions, CPI inflation is unlikely rise to uncomfortable levels. We expect January 2015 CPI inflation to come in at c.5.5%. However, given the sizeable downside surprises on CPI inflation in India and globally in the past few months, we cannot rule out further downside surprises.

Figure 1: RBI cuts repo rate on benign inflation
% y/y



Source: CEIC, Standard Chartered Research

Figure 2: Household inflation expectations have slipped to single digits, *% y/y*



Source: CEIC, RBI, Standard Chartered Research

The RBI noted that household inflation expectations slowed down to single digits for the first time since September 2009. This is a positive development, in our view, and represents a dramatic change from inflation expectations of 12.7% and 13.5% for the 3-month and 1-year ahead periods, respectively, as of end-September 2014. The results of the latest inflation expectations survey were largely expected by the market to come in by the end of January; as such, this news was not publicly available until today's announcement. Given our benign inflation outlook – we expect H1-FY16 (year-end March 2016) CPI inflation to average less than 5.5% before inching up marginally in Q3-FY16 – the RBI's January 2016 CPI inflation target of 6% looks achievable. Low inflation should also keep household inflationary expectations contained.

Despite market worries of fiscal slippage on the FY15 target of a fiscal deficit at 4.1% of GDP, the RBI appears to be reassured of the government's commitment to adhere to the target. We think this likely triggered today's rate cut, and should also support a rate cut in the February policy meeting.

While the RBI could have initiated a larger rate cut today, we believe it wants to move in a calibrated manner. In our view, the lack of indication of another inter-meeting action in today's press statement implies that waiting until the April policy meeting to cut rates further may be too long a pause, given the current benign inflationary environment.

If the RBI decides to hold off on a rate cut in the February meeting – contrary to our view – we expect it to re-insert the inter-meeting action clause in the statement. This would make a rate cut in March more probable, in our view, as the RBI gets more clarity on the fiscal consolidation measures from the government.

In all, we expect the RBI to front-load interest rate cuts of another 50bps, spilt equally over the next two meetings. Following these cuts, we expect it to pause to assess the impact of monetary policy easing on inflation.

Rates market cheers surprise rate-cut

We have a Positive outlook on IGBs; recommend buying 10Y IGBs

The timing of the rate-cut announcement surprised the rates market. The benchmark 10Y Indian government bond (IGB) yield opened lower by c.11bps and the OIS curve (1/5Y segment) bull steepened by c.5bps in response to the announcement. We remain *Positive* on IGBs, and continue to recommend buying 10Y IGBs (current: 7.68%, entry: 8.08%, target: 7.40%). We revise lower our stop-loss level for this trade recommendation to 8.00% from 8.30%. Given the dovish tone of the policy announcement, we expect rate-cut expectations to persist in the rates market and cap any substantial move up in IGB yields.

Material changes to our views

	Change	Period	Prior	New
Macro				
India	Policy Rate (%)	FY15E	7.75	7.50
India	Policy Rate (%)	1Q- FY15E	7.75	7.50

Disclosures appendix

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