



Key Highlights

1. All rates kept unchanged (Repo, Reverse Repo, CRR, Bank Rate)
2. Special refinance / liquidity windows instituted by the RBI which were earlier expiring on 30 June 2009 have been extended to 30 September 2009
3. Real GDP growth projection for FY09 has been revised to 7% with a downward bias from 7.5% - 8% earlier
4. WPI inflation projection by end March 2009 has been revised to 'below 3%' from 7% earlier
5. Projection of money supply (M3) growth for FY09 has been raised to 19% from 16.5 - 17% earlier
6. In line with above, aggregate deposit growth projection for FY09 has been raised to 19% from 17% earlier
7. Non food credit growth projection for FY09 has been revised to 24% from 20% earlier

Review

The RBI acknowledges worries about growth, especially in the context of sharp deterioration in global outlook since September 2008 and its corresponding impact on the local economy given stronger linkages than before through channels like trade, capital, and finance. It notes evidence of further domestic slowdown as reflected in slackening industrial production, negative export growth in October-November 2008, and deteriorating business sentiment.

On the inflation front, the RBI assesses the fall in domestic inflation to be broadly in line with global fall in commodity prices. Though, it notes that domestic demand slowdown has been a contributor as well. However, CPI inflation remains high due to elevated food prices although the RBI expects this to soften as well in the months ahead.

RBI's assessment, of government's finances, paints a bleak picture; given 1) lower direct and indirect tax collections on account of economic growth slowdown, 2) duty cuts coupled with a disproportionate growth in expenditure on account of subsidies, 3) 6th Pay Commission, 4) farm debt waiver, etc.

Assessment

The policy review reflects the heightened levels of uncertainty with regard to global and domestic outlook and hence the need to be able to act with policy tools as and when needed. Given that a host of measures have been taken since September 2008 and especially in context of 100 bps interest rate cuts each in December 2008 and January 2009, Governor Subbarao has decided to wait for measures to percolate before deciding upon further action. In particular, the RBI seems to be keenly watching credit growth numbers and the last 2 rate cuts in particular seem to have largely been triggered by fall in the credit growth number. Also, the RBI's assessment is that in emerging market economies, the transmission has been from real sector to financial sector. Therefore we would be keenly looking at incremental growth in credit numbers, in order to adjudge when the RBI is likely to act. In this context, the upward revision in M3 projection along with credit growth projection indicates willingness to implement additional monetary measures, to achieve desired credit growth rates.

Going forward, we would expect further cuts in policy rates in the range of 100 and 150 bps before we achieve cyclical bottom-on rates. At the same time we believe RBI will continue to provide for adequate liquidity so that the reverse repo rate remains the operative rate. The view is based on the expectation, that continued risk aversion may continue to

constrain widespread availability of credit. This would reflect in subdued credit growth numbers as well as in sharply deteriorating broad economic numbers. As a corollary, if risk perceptions were to recede and credit supply pick up, this would reflect in 1) improvement in credit numbers, 2) fall in credit spreads and 3) lesser need for the RBI to act aggressively incrementally. On the balance, however, we would expect continued role for monetary policy because risk aversion (and hence credit spreads) stabilises with a lag. A fall in CPI (as well as primary component of WPI) in the days ahead, and as assessed by the RBI, should give further room for incremental cuts.

Finally, the issue of broad based transmission of rate cuts remains. As we have highlighted earlier, the last cut has been largely lost in transmission primarily due to negative surprises on government borrowing. Indeed, the RBI flags-off persistence of large market borrowing programme of the government leading to hardening interest rate expectations and hence impeding transmission of policy cuts. Prospect of unexpected supply remains the single largest fear amidst bond market participants and given that the policy maker recognises the impediment caused by this factor, it is not unlikely that some measures would be taken in this regard (for instance, private placement of debt with RBI).

Overall, despite prospects of supply risk inducing intermittent volatility, we remain overall bullish on the bond market given the speed of deterioration of the underlying economic cycle. Lack of credit supply and hence elevated credit spreads will indicate that the RBI's work is incomplete while incremental ease in availability of credit will lead to compression in credit spreads. As a result, although a dynamic allocation between government securities and corporate bonds may be warranted, bond funds remain an attractive investment option for the longer term investor. Also, given the emphasis on provision of adequate liquidity, money markets should continue to be well bid with corresponding fall in rates.

We continue to recommend HSBC Flexi Debt Fund and HSBC Income Fund - Investment Plan to such long term investors. In our view, HSBC Floating Rate Fund - Long Term is also well positioned to benefit from this fall in rates.

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