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RBI: More confident of a Feb rate cut

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Bottom line: Dovish in December, 1st RBI rate cut February

We are increasingly confident about our call for a Reserve Bank of India (RBI) repo rate cut in February. While the December policy should turn more dovish, Governor Raghuram Rajan may want to await further clarity on the inflation peak-off. In our view, of course, the RBI is set to achieve its inflation targets (assuming normal rains) of 8% for January 2015 and 6% for January 2016.

The case for lower rates looks increasingly compelling. First, September growth will likely slow to ~5% from 5.7% last quarter, buttressing our view that recovery will need lending rate cuts. Second, "imported" inflation is coming off, with oil prices stabilizing on Fed rate hike expectations and Rs58-62/USD holding with the RBI recouping FX reserves. Third, our US economists have pushed their first Fed rate hike to September from June. It is another matter that we believe the RBI should be able to cut even if the Fed hikes, so long as it recoups FX reserves to stabilize INR expectations. Fourth, the Indian government has announced expenditure cuts to achieve FY15 fiscal deficit target of 4.1% of GDP. We, of course, do not lose sleep over fiscal slippage, as the government's Rs1,284bn surplus with the RBI will buffer its borrowing program. Fifth and last, the RBI is turning more accommodative of the ongoing G-Sec rally. Do read our last February rate cut report here.

#1. Sep GDP growth ~5%: Lending rate cuts key to recovery

We are now more confident of our call that lending rate cuts are key to a recovery. September quarter growth will likely come off to about 5% from 5.7% last quarter on November 28 (Table 1). Production at core industries (37.9% of IIP) has slowed to 1.9% in September from 5.8% last year. September industrial growth will likely print an anemic 1.5% on November 12, *albeit* higher than the 0.4% in August. Do read our last growth report here.

#2. "Imported" inflation coming off; RBI holding Rs58-62/USD

"Imported" inflation is moderating, as expected, with oil prices stabilizing on Fed rate hike expectations and Rs58-62/USD holding with the RBI recouping FX reserves. While our numbers are based on our US$100/bbl forecast, Brent is actually down to US$82/bbl. A 5% swing in petrol and diesel prices reduces CPI inflation by about 45bp. Meanwhile, the incoming autumn *kharif* harvest has continued to pull down vegetable price inflation (Table 2). We estimate that CPI inflation (out on November 12th) should drop to 5.7% in October from 6.5% last month (Chart 1). While base effects should reverse after November, CPI inflation should lie well within the RBI's 8% January 2015 target. A bit of good news is that winter *rabi* oilseed and pulses sowing are doing well (Table 3). Do read our last inflation report here.

Our call that the RBI should hold Rs58-62/USD – with falling oil prices and gold import curbs offsetting the strong US Dollar – is holding good so far. As a consequence, inflationary pressures from depreciation are ebbing. Chart 2 shows that on a YoY basis, as the INR's depreciation turned to appreciation in August 2014, the CPI inflation has come off in line with an appreciating INR, with a lag of 2 months.

We continue to expect Gov Rajan to recoup FX reserves via forwards to guard against contagion in this uncertain environment (Table 4). Of course, further USD strengthening could force the RBI to temporarily allow the INR to weaken beyond Rs62/USD. Do read our last INR report here.

#3. Fed hike pushed back to September; FX reserves key

Our US economists now see the first Fed rate hike only in September (pushed out from June). This should assuage concerns that the RBI would have to protect the INR from an EM sell-off by higher rates. In fact, we believe that the RBI should be able to cut even if the Fed hikes, so long as it recoups FX reserves to stabilize INR expectations. A closer look at July 2013 suggests that the 10y spiked only after the RBI hiked the MSF rate by 300bp on July 15th. The 10y had come-off to 7.1% by end-May from 8% in March, even though the US 10y increased to 2.1% from 1.8%. Although fears of tapering did lead to FII debt outflows of US$8.4bn between the announcement on May 22nd and the MSF hike on July 15th, this did not impact the 10y significantly because of the limited exposure to FIIs. It is only after the RBI hiked the MSF rate 300bp to block FII debt outflows and support the INR that the 10y spiked to 8.1% on July 16th and kept increasing to touch 9% in August. In fact, the resulting MTM hit led to further FII debt outflows of US$2.2bn, pushing the INR to Rs68/USD. Once Gov Rajan launched the FCNRB-cum-concessional swap scheme on September 4th and began cutting the MSF rate, the 10y began to subside.

#4. Delhi tightening fiscal belt; RBI surplus buffer

We welcome the Center's decision to cut non-Plan expenditure by 10% to meet the FY15 fiscal deficit target of 4.1% of GDP. (This, however, excludes interest payments, repayment of debt, defence capital, salaries, pension and Finance Commission grants to the states.) In any case, we do not lose sleep over the fact that the Center's April-September fiscal deficit has climbed to 82.6% of Budget estimates from 76% last year, as the Center has a buffer in the form of a Rs1,284bn surplus with the RBI (as of March 31st) to protect net borrowing. In fact, we have long been of the view that the 10y should come off, as supply concerns are overdone. Do read our last report here.

#5. RBI more comfortable with lower yields

In our view, the RBI is now relatively comfortable (as expected) with lower yields. This supports our standing call that the 10y should settle at 8-8.25%. After all, lending rates cannot fall unless the 10y rate itself eases, as banks typically price their prime rate 400bp above the benchmark riskless rate (Chart 3). Although it did announce another OMO for this week, the RBI explained that this was driven by "…a review of current and evolving liquidity conditions…" rather than falling yields. We, of course, feel that there is little need for OMO with reserve money expansion at barely Rs32.5bn since April. Do read our RBI OMO report here.

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Table 1: September GDP growth to disappoint at ~5%

	June (% yoy)	September (% yoy)
Agriculture	3.8	0
Rabi harvest (food grains)	5.0	-
Kharif harvest (food grains)	-	-7.0
Industrial production	4.0	0.1
Construction	4.8	6.4
Cement	9.5	9.8
Steel	1.6	3.1
Trade, hotels, transport & communication	2.8	5.0
Railway goods traffic	4.2	4.1
Commercial vehicles sales	-13.0	-1.9
Cellular subscribers	9.8	11.1
Trade (industrial production)	4.0	0.1
Imports	2.2	6.9
Finance, Insurance & other services	10.4	9.6
Credit growth	13.1	11.1
Deposit growth	13.3	13.1
Social services	9.1	7.7
Fiscal deficit	13.3	-5.6
Government expenditure	8.2	5.1

Source: BofA Merrill Lynch Global Research Estimates, RBI, MoSPI, Bloomberg, CEIC

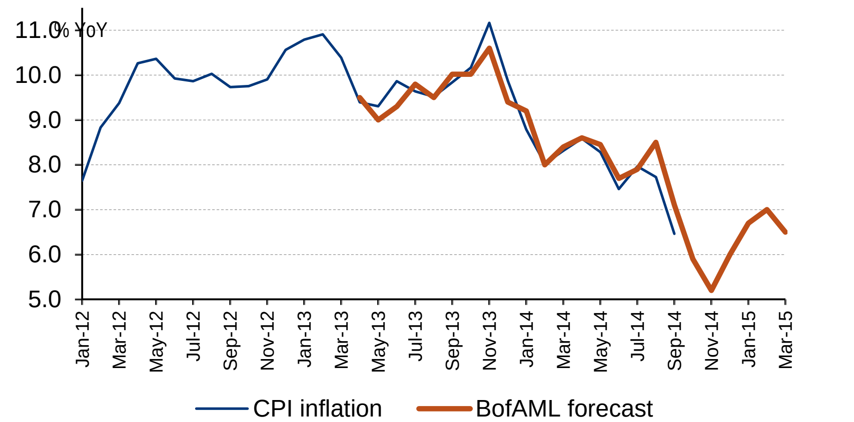
Table 2: Late rains, base effects and seasonality reversing food inflation

Retail food price inflation (% yoy)	Weight in CPI	Jul'14	Aug'14	Sep'14	Oct'14	Nov'14*
Rice	7.1	7.4	6.5	7.0	5.6	0.3
Wheat	5.5	4.0	3.1	7.1	5.2	0.4
Atta	1.9	3.2	3.6	5.0	4.0	0.1
Gram dal	0.4	-11.8	-9.6	-10.1	-10.0	-12.9
Tur/Arhar dal	1.5	2.3	4.8	7.0	6.6	5.7
Urad dal	0.1	24.7	29.4	31.4	25.6	18.4
Moong dal	0.5	16.7	19.8	21.7	20.5	18.8
Masoor dal	0.2	14.3	16.3	18.2	19.6	18.9
Groundnut oil	1.9	-6.5	-6.2	-7.0	-5.6	-5.5
Mustard oil	0.1	-1.6	-0.2	0.8	1.5	-4.4
Vanaspati	0.1	8.7	7.7	4.0	2.7	-0.1
Soyaoil	0.7	-0.4	0.6	-0.4	-0.3	-2.5
Sunflower	0.3	-2.1	-3.4	-5.4	-4.7	-6.2
Palm oil	0.8	4.8	1.7	-5.2	-3.6	-5.3
Potato	1.8	35.6	49.7	62.8	54.5	15.0
Onion	1.8	-2.4	-36.6	-51.2	-55.1	-52.7
Tomato	1.8	-13.2	52.4	23.9	-7.2	-38.6
Sugar	1.8	0.7	0.7	0.2	0.5	0.6
Gur	0.1	-0.5	-0.8	0.2	1.6	-2.7
Milk	7.7	10.1	11.6	9.4	9.8	10.6
Tea loose	1.8	0.7	0.9	3.5	3.2	4.4
Salt pack	0.2	6.3	7.6	7.4	6.8	7.3
Vegetables inflation	5.4	0.2	9.7	-10.4	-22.2	-34.2
Total/ Weighted Avg.	38.2	2.5	3.8	2.1	0.7	-2.0
CPI food inflation	49.7	9.1	9.1	7.6	-	-

*Avg prices until November 3rd

Source: BofA Merrill Lynch Global Research Estimates, Department of Consumer Affairs, PMC

Chart 1: CPI to fall towards RBI's 12-month 8% target in February



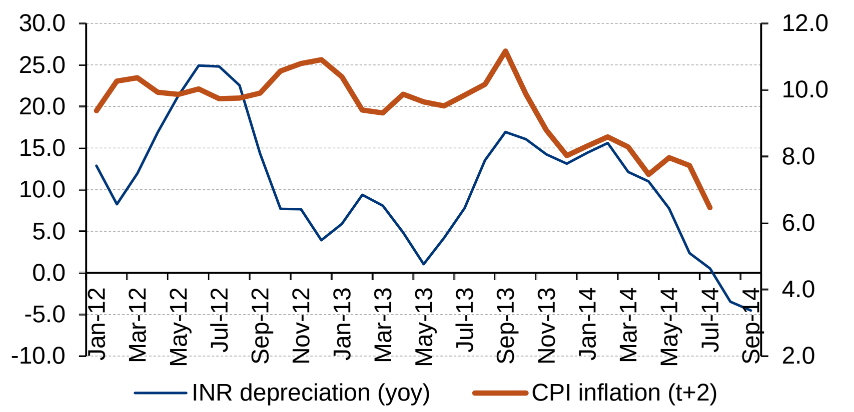
Source: BofA-ML Global Research Estimates, MoSPI

Table 3: Oilseeds, pulses sowing off to a good start

Rabi crops sown till 24 October	FY15 YTD (lakh hectare)	FY14 YTD (lakh hectare)	FY 14 YTD (% yoy)
Total Pulses	7.8	6.7	17.7
Coarse Cereals	14.1	21.6	-34.4
Oilseeds	20.3	17.9	13.2
Total Rabi Area	42.3	46.2	-8.4

Source: BofA Merrill Lynch Global Research Estimates, Ministry of Agriculture

Chart 2: INR depreciation fears ebbing away and lowering CPI inflation



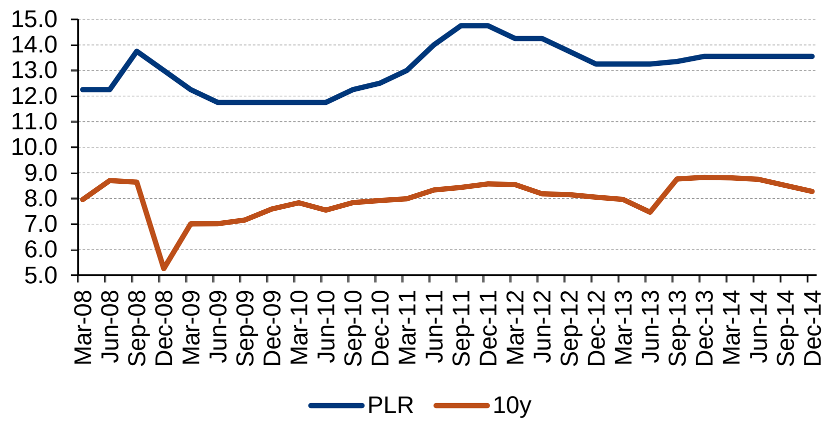
Source: BofA Merrill Lynch Global Research estimates, Bloomberg

Table 4: RBI's continues buying in forwards market (US$26bn net fwds in September)

	Short term O/s		Long term O/s	Total O/s
	Short	Long	Short	Net Fwd Sales O/s
US$bn	(1)	(2)	(3)	(4) = (1)+(2)+(3)
Jun-13	-7.16	2.25	0.00	-4.91
Jul-13	-6.93	2.20	0.00	-4.74
Aug-13	-10.84	1.79	0.00	-9.05
Sep-13	-14.46	6.80	-1.92	-9.58
Oct-13	-16.80	10.88	-8.54	-14.46
Nov-13	-18.50	12.05	-25.96	-32.40
Dec-13	-18.34	11.70	-25.96	-32.60
Jan-14	-17.51	11.63	-25.97	-31.85
Feb-14	-16.98	11.63	-25.97	-31.32
Mar-14	-16.90	11.84	-25.97	-31.03
Apr-14	-16.11	10.02	-25.97	-32.06
May-14	-14.65	29.16	-25.97	-11.46
Jun-14	-12.47	38.28	-25.97	-0.15
Jul-14	-9.89	41.25	-25.97	5.40
Aug-14	-9.15	40.94	-25.97	5.82
Sep-14	-7.45	41.84	-25.97	8.42

Source: BofA Merrill Lynch Global Research Estimates, RBI

Chart 3: 10y coming-off on rate cut expectations, PLR to follow



* Dec-14 quarter data is taken as on Oct. 31. Source: BofA Merrill Lynch Global Research Estimates, RBI

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