



# Surprise, Surprise, Another Hike!!

**RBI has hiked the Cash Reserve Ratio by 50 bps to 6.50% (in two tranches of 25 bps each)**

**RBI has hiked the Repo Rate from 7.50% to 7.75% with immediate effect**

**The incremental interest on CRR deposit has been reduced from 1% to 0.5%**

## What has changed?

Growth has been galloping as reflected by the GDP and IIP numbers. Inflation continues to be unabated despite various measures taken by the government to cool the same. Non food bank credit, money supply continue to be higher than the RBI's target thereby implying that the previous measures taken by the RBI have not been able to stem the underlying growth.

In a bid to **reign in a growing economy** and to **especially curb inflation**, the RBI has indicated that it will hike the Cash Reserve ratio (CRR) by 50 basis points to 6.50% in two tranches. The first hike of 25 basis points will be implemented on the 14<sup>th</sup> of April and the next one on the 28<sup>th</sup> of April. Furthermore, to **stem the burgeoning credit growth** the repo rate has been hiked by 25 basis points to 7.75% with immediate effect.

## Impact of these hikes

- ✓ The RBI has indicated that a sum of close to Rs 15,500 cr will be sucked out of the banking system, thereby further tightening liquidity (Call touched a high of 80% during the day) in the system.
- ✓ Banks will witness a marginal interest loss in their CRR deposit as the interest paid on CRR has been reduced from 1% to 0.5% whilst the CRR has been hiked by 25 bps.

## Stance of the Credit Policy – 31<sup>st</sup> January 2007

- ✓ To **reinforce** the **emphasis** on **price stability** and well **anchored inflation expectations** while ensuring a monetary and interest rate environment that **supports** the **growth continuation** of the economy.
- ✓ To **re-emphasis credit quality** for **securing macroeconomic** and in particular **financial stability**.
- ✓ To **respond swiftly** with all **possible measures** to the evolving global and domestic situation – especially on the **inflation** and the **growth momentum** front.

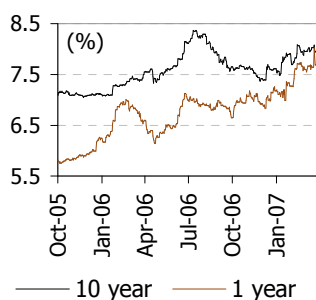
## Macro Numbers

	Current	Target for 2006-07
GDP Growth (%)	9.1	8.5-9.0
Inflation (WPI) (%)	6.5	5.0-5.5
Money Supply (M3) (%)	22.0	15.0
Non Food Bank Credit (%)	29.5	20.0

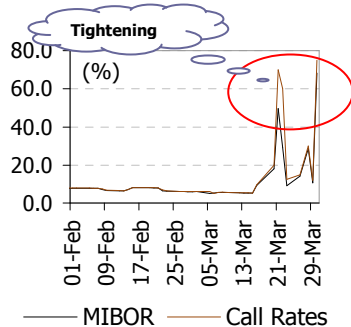
## Overnight Interest Rates (worldwide)

Central Banks	Interest Rates (%)
US FED	5.25
ECB	3.75
BOJ	0.25
BOE	5.25

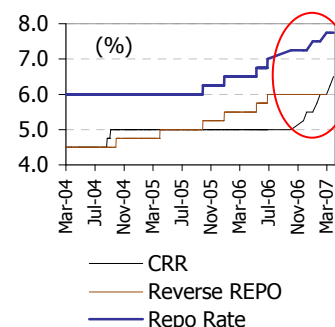
## 10 yr bond yield vs 1 yr bond yield



## Overnight MIBOR vs Call Rates



## Key policy rates



CRR & Repo Hike

Source: Bloomberg

## Mutual Fund Recommendations

	Liquid	Liquid Plus	Floating Rate Funds	Short Term Income	Income/ Bond	Gilt Funds	Derivative/ Arbitrage
Impact	Positive	Positive	Neutral	Negative	Negative	Negative	Neutral

**Note:** These recommendations are based on the overall market expectations and the taxation aspect has been ignored.

### Impact on the Mutual Fund Industry

- ✓ **Liquid Funds:** These schemes will continue to generate superior returns due to the tightening of liquidity as CBLO and overnight MIBOR rates were trading at highs of 50% and 68% during the day. Schemes which are exclusively dedicated to call or cash plans should continue to generate superior in the coming week.
- ✓ **Liquid Plus Funds:** These schemes are predominately invested into 6 – 12 month CPs and CDs which are giving a net yield of around 11.5%. The strategy adopted by these schemes are to hold the paper till maturity and capitalize on the running yield.
- ✓ **Short Term Floating Rate Funds:** Very few short term floating rate funds have sizeable exposure to MIBOR linked papers as most of them have moved into INBMK linked papers. Selective allocation can be meted out to schemes within this category which have sizeable exposure to MIBOR linked assets.
- ✓ **Long Term Floating Rate Funds:** There is no change in the status of these schemes as INBMK papers reset once in 6 months and most of these schemes have minor allocation to MIBOR linked papers. Most of the fund houses are restructuring this category whereby the portfolio mimics that of a liquid fund whilst offering the dividend distribution tax of 14.16% and 22.66% for individuals and corporates respectively.
- ✓ **Short Term Income Funds:** These schemes are predominately invested into 6-24 month CPs and CDs and they are exposed to mark to market risk. We expect a blemish in their performance during the coming week due to their portfolio constituents.
- ✓ **Long Term Income Funds / Gilt Funds:** These schemes present more a trading opportunity in the short run as against an investment opportunity. Better avoided until some clarity comes regarding various issues like the SLR reduction and the MSS issuance etc.
- ✓ **Monthly Income Plans:** Status quo being maintained for these schemes as the returns of the monthly income plans are mostly determined by the vagaries of the equity markets as against the debt markets. We recommend this style of investing to investors who have a sufficiently long time horizon and are comfortable with taking exposure to equities.
- ✓ **Derivative/Arbitrage Funds:** The debt portfolios of these schemes are usually invested at the shorter end of the yield curve and they will continue to benefit from the overall tightening of liquidity. The recommended time horizon for these schemes is a minimum of six months.

Investors willing to capitalize on the steepness of the short end yield curve should maintain allocation to liquid plus funds and to liquid funds maintaining sizeable allocation to CBLO and MIBOR linked assets.

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