Mid-Quarter Monetary Policy Review

Inflation continues to be RBI's priority

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RBI hikes repo (25bp) and reverse repo rates (50bp)

- Hikes repo rate by 25bp to 6.0%
- Hikes reverse repo rate by 50bp to 5.0%
- Keeps cash reserve ratio unchanged at 6.0%

Inflation RBI's priority in FY2011

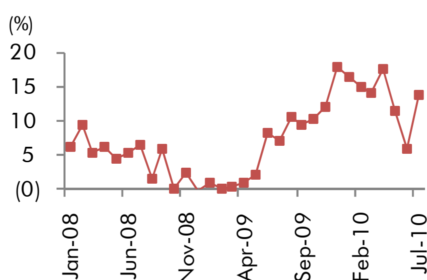
The Reserve Bank of India in its maiden mid quarter monetary policy review raised interest rates for the fifth time since mid March 2010 with an objective to control inflationary expectations. It raised the repo rate (the rate at which it lends to banks) and reverse repo (the rate at which it accepts surplus liquidity from banks) by 25bp and 50bp to 6.0% and 5.0%, respectively. Effectively, this reduced the Liquidity Adjustment Facility (LAF) corridor to 100bp after a reduction of 25bp in July 2010 policy as well. The Central Bank has maintained status quo on Cash Reserve Ratio (CRR) at 6.0%.

Monetary Policy - Key takeaways

- Inflation remains the dominant concern for hiking the rates.
- Expectation of rate hike not disrupting growth.
- GDP and IIP growth rates indicate that the recovery is consolidating and the economy is rapidly converging to its trend rate of growth.
- Monetary tightening that has been carried out since October 2009 has taken the monetary situation close to normal.
- Central fiscal deficit to be contained at targeted 5.5% on account of higher than expected realizations from 3G and BWA auctions coupled with buoyant tax revenues.

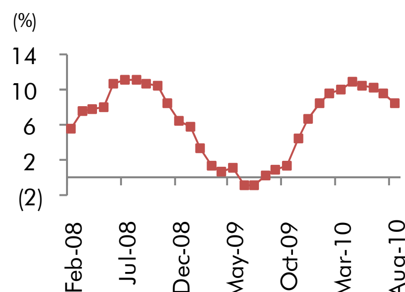
The growth momentum in the Indian economy continued to be strong and was largely broad based, with IIP registering robust growth of 13.8% yoy in July 2010 coupled with healthy credit growth of 19.4% yoy in August 2010. On the other hand, continuing food inflation (14.6% yoy) has kept the overall WPI (8.5% yoy as per 2004-05 series) above RBI's tolerable levels. Thus, with the headline inflation clearly above the RBI's target of 6.5% as well as sustained healthy uptick in credit growth in the last few months, we expect gradual monetary tightening to continue.

Strong Industrial growth continues



Source: RBI, MOSPI, Bloomberg, Angel Research

Inflation tapering off



Source: MOSPI, Angel Research

Focus on anchoring inflationary expectations

Until February 2010 (as per the 2004-05 WPI series), food and textiles contributed as much as 63% of the overall 9.7% WPI inflation on account of the drought-driven increase in the prices of food grains, sugar and cotton, among others. By August 2010, their contribution to the 8.5% WPI, though still high at 46% was on a downward trend. Oil's contribution to overall inflation increased to 18% from 13%. Contribution of other items (having 55% weightage in the WPI index) increased to 37% in August 2010 due to the increased prices of coal, metals, electricity and wood products among others, indicating that inflation is becoming more broad-based. Therefore, monetary tightening by the RBI to anchor inflation expectations is appropriate at this juncture.

Over the next few months, we expect inflation to continue to moderate from the peak levels seen in the recent months. However, the RBI has noted certain upside risks to inflation such as:

- International commodity prices, particularly oil, have started to increase again. In several commodities, the import option for India to contain domestic inflation is limited because of the higher international prices.
- The revival in private consumption demand and the bridging of the output gap will add to inflationary pressures.
- It is important to guard against the risks of hardening of inflation expectations conditioned by near double-digit headline WPI inflation.

However, it should be noted that interest rates are well below peak levels, leaving ample scope for gradual monetary tightening, without adversely affecting the growth outlook.

Exhibit 1: WPI (food v/s non-food) August 2010

	Inflation yoy (%)	Weightage in WPI Index (%)	% contribution to current WPI
Food & textiles	10.8	36	46
Oil	16.0	9	18
Others	5.7	55	37
Current WPI	8.5		

Source: MOSPI, Angel Research; Note: Data as per 2004-05 series

Exhibit 2: WPI (food v/s non-food) June 2010

	Inflation yoy (%)	Weightage in WPI Index (%)	% contribution to current WPI
Food & textiles	14.0	36	49
Oil	17.1	9	16
Others	6.7	55	35
Current WPI	10.3		

Source: MOSPI, Angel Research; Note: Data as per 2004-05 series

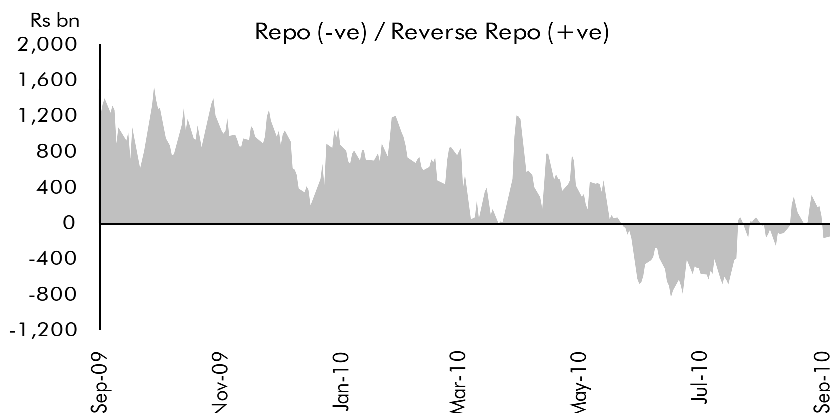
Liquidity management may also become important going ahead

The liquidity situation has improved considerably compared to June-July 2010 (when the banks had borrowed as much as Rs82,490cr through LAF from the RBI) as the government spending has started and the 3G and BWA money makes its way back into the system. In August 2010, banks on an average borrowed only around Rs1,100cr compared to borrowings of Rs45,700cr on an average in July 2010. In the last 2-3 days, the banks have borrowed in excess of Rs15,000cr, which is mainly on account of advance tax payments by the corporates and will get balanced in the immediate short term.

G-sec yields have also remained range-bound since the previous monetary review. They have fallen to 7.89% levels after touching a high of 8.08% on August 25, 2010, and a low of 7.70% on July 27, 2010.

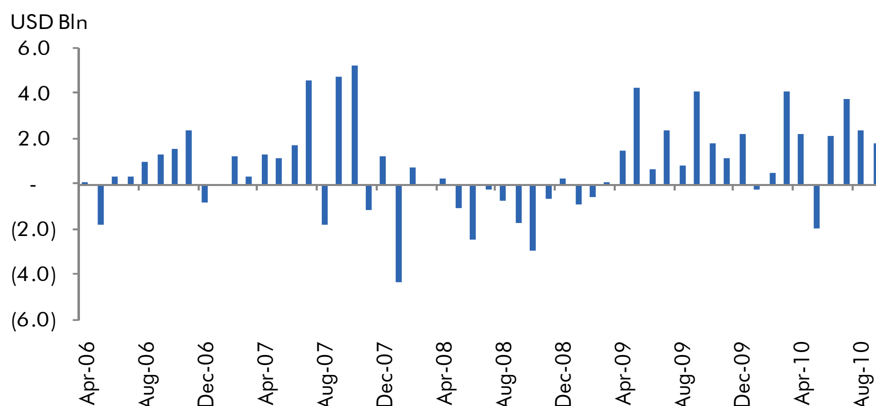
In the past few months, capital inflows have been relatively strong. Going ahead, with the global central banks holding their rates steady, the rising interest rate differential along with India's relatively stronger GDP growth outlook, capital inflows may increasingly exceed the large current account deficit. This could once again require the RBI to manage forex liquidity through sterilisation tools, as seen in CY2007 and also take into account risks of asset inflation going forward.

Exhibit 3: Moderately tight liquidity situation



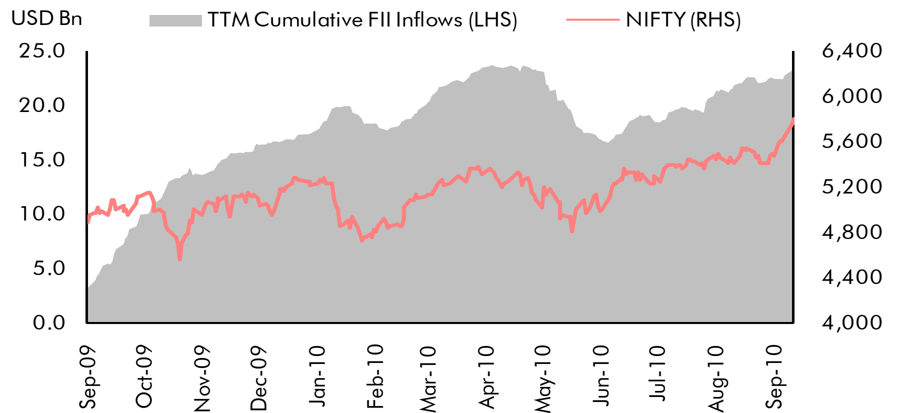
Source: RBI, Angel Research

Exhibit 4: FII flows continue to remain strong



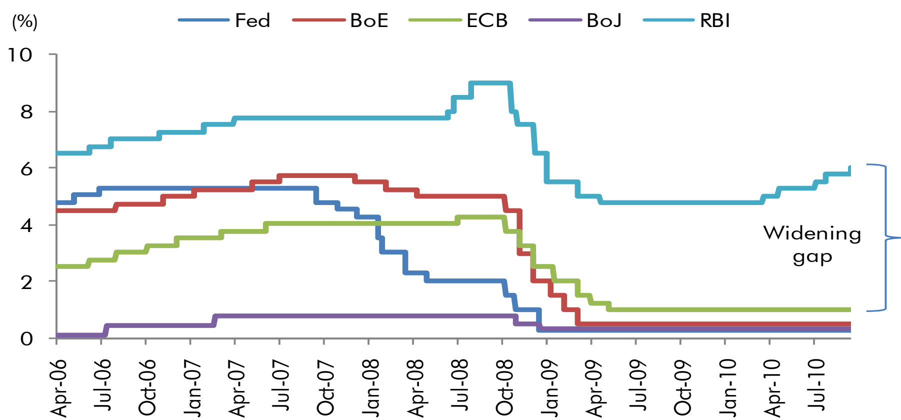
Source: Bloomberg, Angel Research; Note: Data till September 14, 2010

Exhibit 5: TTM FII flows and S&P CNX Nifty



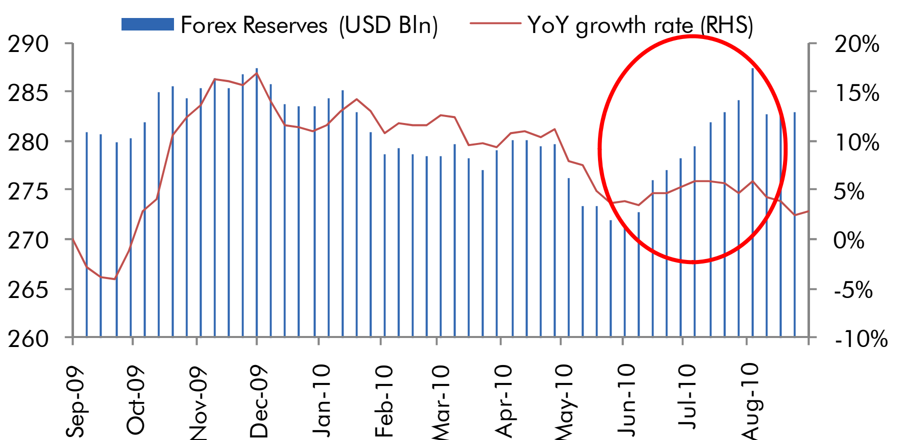
Source: Bloomberg, Angel Research

Exhibit 6: Discount rates of various central banks



Source: Bloomberg, Angel Research

Exhibit 7: Forex reserves position



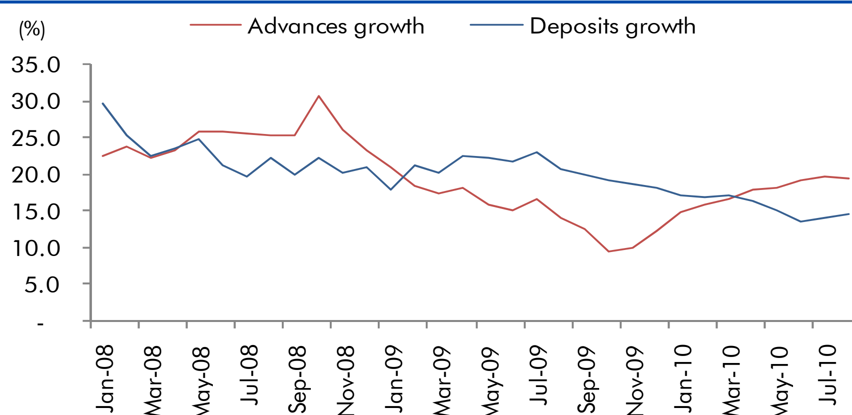
Source: RBI, Bloomberg, Angel Research

Domestic interest rates to increase faster though unlikely to hurt growth momentum

As on August 27, 2010, the yoy growth rate in credit stood at 19.4% compared to 10% in October 2009. Looking at the inelasticity of credit demand in the last cycle, we believe calibrated monetary tightening over the next couple of years is unlikely to slow down economic growth or credit demand until it reaches an advanced stage (at least 250–300bp above the current level).

At the same time, deposit growth has declined to 14.4% yoy compared to 20.5% yoy during the corresponding period last year. Though almost all the banks increased their retail fixed deposit rates (in most cases between 25-50bp) in August-September 2010, they continue to be unattractive for depositors, leading to a gap between savings and investments, which is being plugged by the high current account deficit at present. Accordingly, over the course of the year, we expect deposit and lending rates to be on an upward trajectory. That said, the potential increase in forex reserves going forward may provide much needed respite on the M1 front, improving the liquidity situation. Moreover, the increasing availability of foreign risk capital would also provide a thrust to investment-led credit demand and M3 growth.

Exhibit 8: Deposits growth still lagging despite increase in FD rates



Source: RBI, Angel Research

Banking sector outlook - Set to outperform

We expect the banking sector to be amongst the strongest performers over the next two years, with at least 20% credit growth for the sector as a whole, driven by strong GDP prospects, reasonable (albeit rising) domestic interest rates and increasing risk capital inflows from abroad. In our view, the expected increase in interest rates will not affect the banking sector negatively, as it will be outweighed by the acceleration in core earnings growth on the back of improvement in credit growth and fee income coupled with a sharp reduction in NPA losses.

Data from the last cycle indicates that the banking stocks gave negative returns, on an absolute basis, when the interest rates were falling post the Lehman crisis, since the interest rates were merely symptomatic of a declining economic environment when markets as a whole were falling. On the other hand, the banking sector gave

handsome returns during the up-cycle from 2003, even though the interest rates were rising - concomitant to strong GDP growth.

Large banks better placed

Rising interest rates however, affect individual banks relatively - banks that have locked in more funds than the sector's average at low yields for a longer duration will experience lower profitability in terms of relatively higher MTM losses and pressure on NIMs. Mid-size banks outperformed towards the early part of the up-cycle when the interest rates had not started rising. However, once the interest rates bottomed in December 2003 following the one-year lag for deposit and loan re-pricing, from March 2005 the larger banks conclusively outperformed the mid-size banks. During 1QFY2005–3QFY2008, large private banks registered 2.4 x increases in net interest income, while the PSU banks saw a mere 1.1x increase due to the negative impact of declining CASA market share in a rising interest rate environment. Stock returns reflected this, with private banks recording 311% increase in market capitalisation, while mid-size PSU banks registered a mere 141% increase during the period.

Exhibit 9: Banking stock returns over interest rate cycles

	Net Interest Income		Stock Returns	
	Start date	End Date	Start date	End Date
Period 1: GDP up-cycle, impact of bottomed G-sec yields (Dec 2003) transmitted through bank P/Ls				
	1QFY2003	3QFY2005	1QFY2003	3QFY2005
Large private banks	100	234	100	444
Large PSU banks	100	149	100	325
Mid-sized PSU banks	100	163	100	497
Period 2: GDP up-cycle, 10-yr Gsec yields rise from ~ 5% to 8%				
	4QFY2005	2QFY2008	4QFY2005	2QFY2008
Large private banks	100	236	100	311
Large PSU banks	100	110	100	247
Mid-sized PSU banks	100	109	100	141
Period 3: 2008 global crisis, 10-yr Gsec yields fall from 9.5% to 5.5%				
	3QFY2008	3QFY2009	3QFY2008	3QFY2009
Large private banks	100	118	100	53
Large PSU banks	100	138	100	71
Mid-sized PSU banks	100	140	100	46
Period 4: GDP up-cycle, impact of bottomed G-sec yields transmitted through bank P/Ls				
	4QFY2009	1QFY2011	4QFY2009	Current
Large private banks	100	118	100	278
Large PSU banks	100	132	100	248
Mid-sized PSU banks	100	162	100	292

Source: C-line, Angel Research; Note: Excludes banks for which comparable data for the entire period was unavailable due to later listing, etc.

Hence, on a relative basis, we prefer banks with a high CASA ratio and lower-duration investment book given the rising interest rate scenario. Broadly, this combination is available in large banks, viz. HDFC Bank, ICICI Bank, Axis Bank and SBI. We expect these banks to outperform on account of their stronger core competitiveness and likelihood of credit and CASA market share gains, driven by strong capital adequacy and robust branch expansion. Generally, we expect mid-size banks to underperform on the net interest income front from 2HFY2011 and expect stock returns to reflect the same.

Taking into account valuations, our top picks are ICICI Bank among the large-cap banks and Federal Bank among the mid-caps. Amongst PSU banks, we like Union Bank and Indian Bank on account of their relatively better deposit franchise compared to peers.

Exhibit 10: Recommendation summary

Company	Reco	CMP (Rs)	Tgt. price (Rs)	*Upside (%)*	FY2012E P/ABV (x)	FY2012E Tgt P/ABV (x)	FY2012E P/E (x)	FY10-12E CAGR in EPS (%)	FY2012E RoA (%)	FY2012E RoE (%)
AxisBk	Accumulate	1,484	1,688	*13.7*	2.8	3.2	14.7	27.4	1.6	20.5
FedBk	Buy	367	425	*16.0*	1.1	1.3	7.9	30.7	1.4	14.4
HDFCBk	Accumulate	2,395	2,514	*5.0*	3.8	4.0	20.0	36.5	1.7	20.6
ICICIBk	Buy	1,103	1,350	*22.4*	2.2	2.9	17.8	31.0	1.4	15.5
SIB	Neutral	207	-	-	1.2	-	7.2	17.4	1.0	17.9
YesBk	Neutral	330	-	-	2.6	-	16.6	18.7	1.3	17.1
BOI	Neutral	486	-	-	1.5	-	7.7	38.0	0.9	20.5
CorpBk	Neutral	671	-	-	1.2	-	6.4	13.4	1.0	20.5
DenaBk	Neutral	112	-	-	1.0	-	5.4	7.2	0.8	19.1
IndBk	Accumulate	262	277	*5.9*	1.2	1.3	6.4	7.6	1.3	21.0
IOB	Accumulate	139	151	*9.0*	1.0	1.1	6.9	24.9	0.7	14.8
OBC	Neutral	456	-	-	1.2	-	6.8	21.6	0.9	18.3
PNB	Neutral	1,289	-	-	1.8	-	8.7	9.5	1.2	22.0
SBI	Neutral	3,100	-	-	1.9	-	13.1	26.5	1.1	20.1
UcoBk	Neutral	117	-	-	1.1	-	4.8	15.1	0.8	25.5
UnionBk	Accumulate	369	389	*5.4*	1.5	1.6	6.5	17.1	1.1	24.1

Source: Company, Angel Research; Note: We have increased our target multiple for the banks under coverage; Prices as on September 16, 2010

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