

This pause should last a while



Ashish Agrawal
Local Markets Strategist
Merrill Lynch (Hong Kong)
ashish_agrawal@ml.com

+852 2536 3965

No rate action but no letting down the ante either

In their annual policy announcements, the RBI stayed pat, a pause after the accelerated tightening in recent months. However, the tone of the policy remained hawkish and doors remain open for inter-meeting hikes as price control remains a priority. RBI lowered their inflation band - to 'close to 5%' from '5-5.5%' and medium term inflation ceiling to 4-4.5% from 5% - a reinforcement of the lower tolerance for inflation.

Forecasts incorporate a marginal slowdown

RBI's forecasts slower GDP growth at 8.5% and credit growth of 24-25%. There were a few FX related measures, largely aimed at moderating inflows and spurring outflows. For fixed income the policy reiterates RBI's intention to keep liquidity tight while for FX, the immediate term positive is the absence of specific measures to curb inflows but over the medium term, markets will likely react to liquidity and RBI intervention.

Reinforcing their sterilization war chest

Last week, the RBI increased MSS limits from Rs800bn to Rs950bn and then further to Rs1100bn. The INR has appreciated around 7% against the USD since Feb 06 in nominal terms and 4% in REER terms. We think it is possible that easing headline inflation and relatively slower growth will allow the RBI to relax their hold on liquidity marginally to restrain the INR.

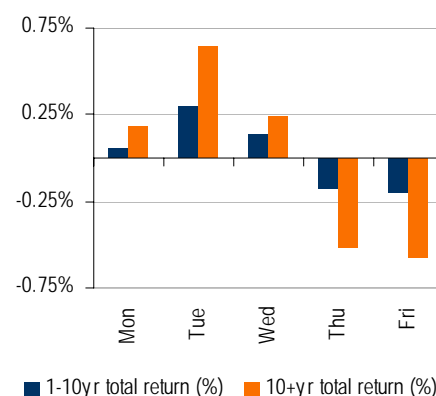
Strategy: Positive news-flow should support gilts

Going forward, we believe the favorable base effect on inflation is more sustained and continuous, 122bp over the next four weeks and an additional 103bp in the next four. While further liquidity sterilization measures can't be ruled out, we think this easing in inflation would give the RBI time to assess the impact of their tightening and the outlook on the monsoon. An SLR cut is unlikely in the short term and gilts should remain supported, at least for maturities upto 7yrs. Uncertainty on liquidity could keep the OIS curve bid. In the near term, a tight liquidity outlook and Rs100bn of supply next week should keep sentiment subdued.

A relief rally that did not last

Markets reacted positively to the announcements, indicating that they were positioning was for a hike. However, the move did not sustain and gilts weakened ahead of the auction and on expectations of tighter liquidity (Rs78bn outflows as CRR rises to 6.5%). The auctioned security was trading rich on the curve and was not aggressively bid, it cleared at 8.16% attracting a bid-cover of 2.15x. Overnight rates climbed once again to 14% levels and the short end of the OIS curve came under pressure. 1/5 OIS spreads inverted further, -46bp, the move likely getting exaggerated on account of position unwinding. Inflation came in line with expectations, showing little signs of easing.

Chart 1: Daily Gilt returns (%)



Source: Merrill Lynch India Government Bond Index

Table 1: Market Data

	Latest	Last week
Reverse repo rate	6.00%	6.00%
NSE MIBOR (%)	8.77%	9.88%
91-day T-bill (primary)	7.35%	7.48%
182-day T-bill (primary)	7.75%	7.99%
364-day T-bill (primary)	7.75%	7.70%
7.55% 2010	98.50	98.58
8.07% 2017	99.50	100.02
5yr OIS	8.33%	8.24%
5yr MIFOR swap	9.18%	8.89%
WPI (YoY)	6.09%	6.09%
10yr UST	4.69%	4.67%
Brent crude (US\$/barrel)	67.96	66.33

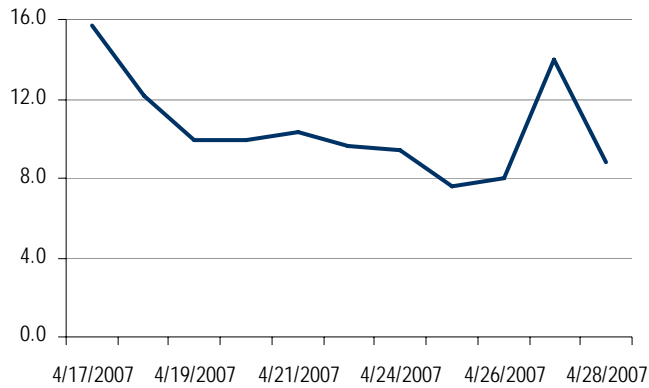
Source: RBI, Bloomberg, Merrill Lynch Research

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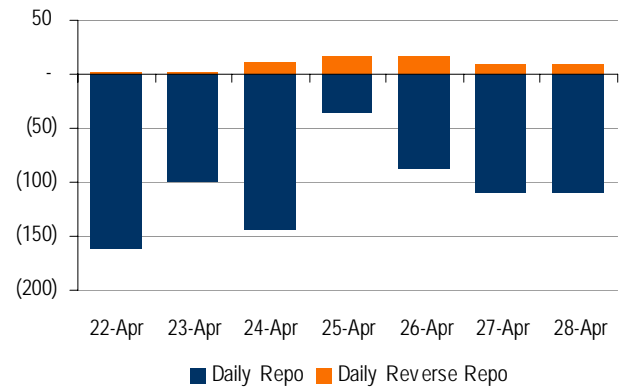
Refer to important disclosures on page 6 to 7. Analyst Certification on page 5.

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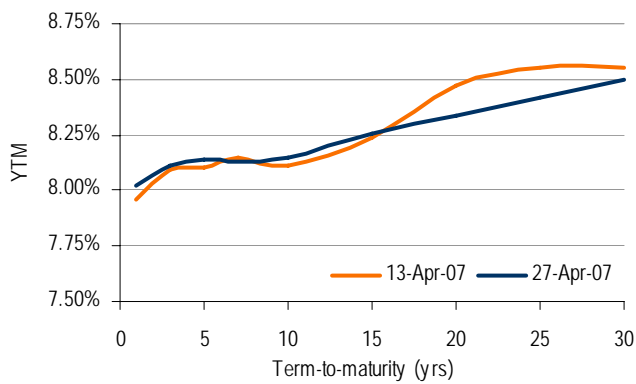
The week in charts

Chart 2: NSE MIBOR


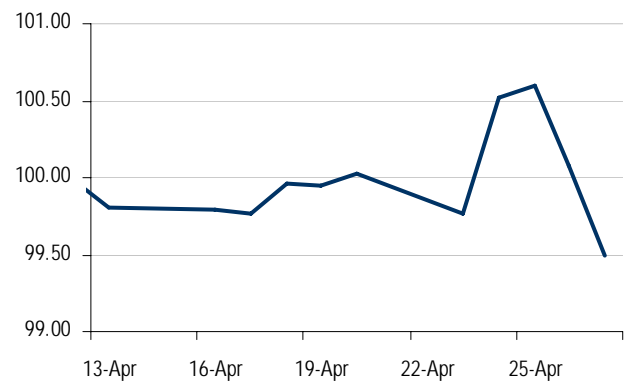
Source: NSE

Chart 3: Amounts Outstanding With RBI (Rsbn)


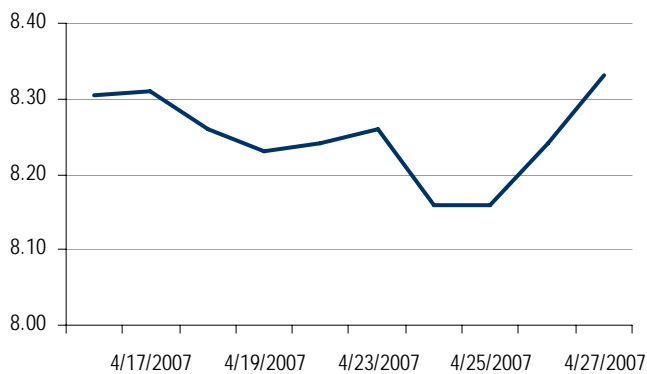
Source: RBI

Chart 4: Yield curve


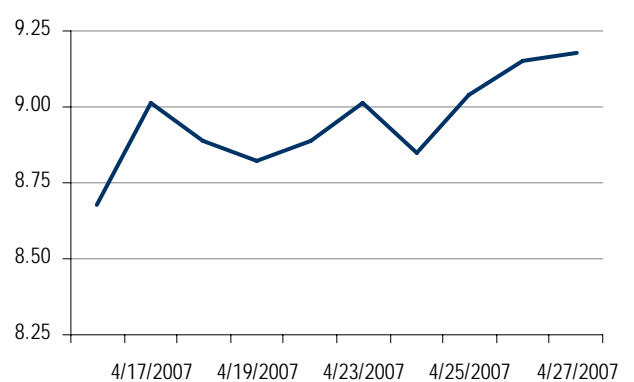
Source: Merrill Lynch Research

Chart 5: Secondary Price Movement of 8.07% 2017


Source: Merrill Lynch Research

Chart 6: 5yr OIS rate


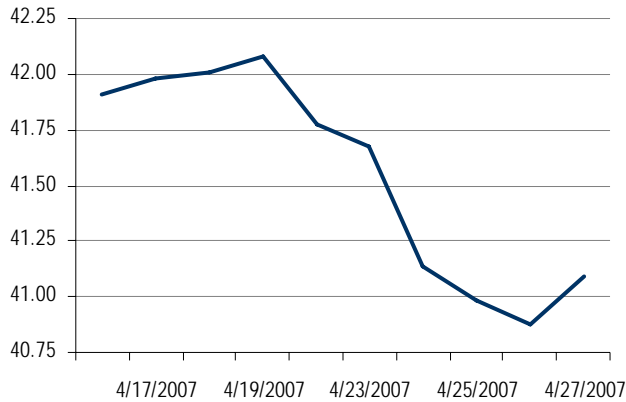
Source: Bloomberg

Chart 7: 5yr MIFOR Swap rate


Source: Bloomberg

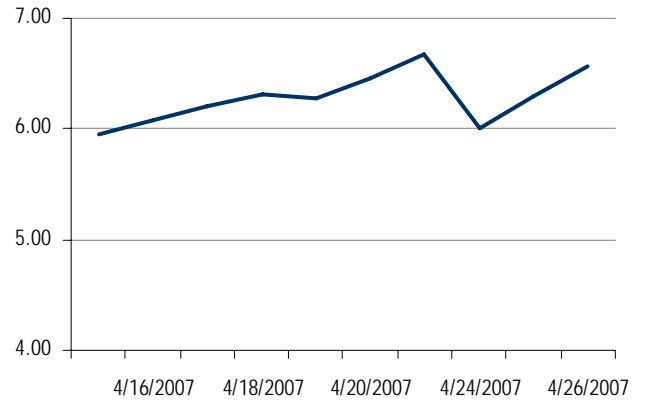
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Chart 8: INR/USD exchange rate



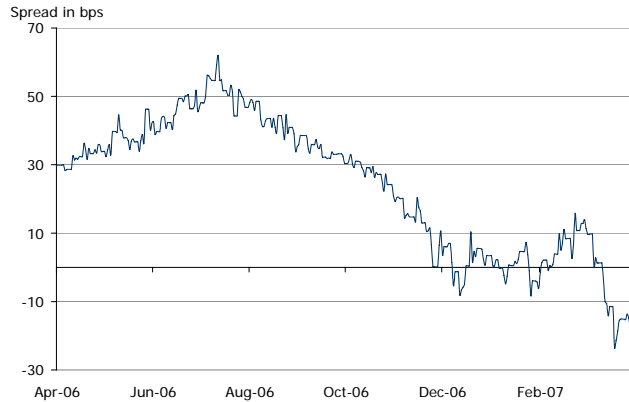
Source: Bloomberg

Chart 9: 6mth forward premium (%)



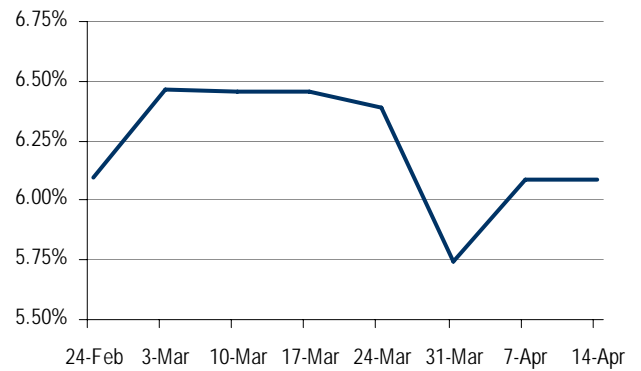
Source: Bloomberg

Chart 10: 5yr Bond-swap spreads



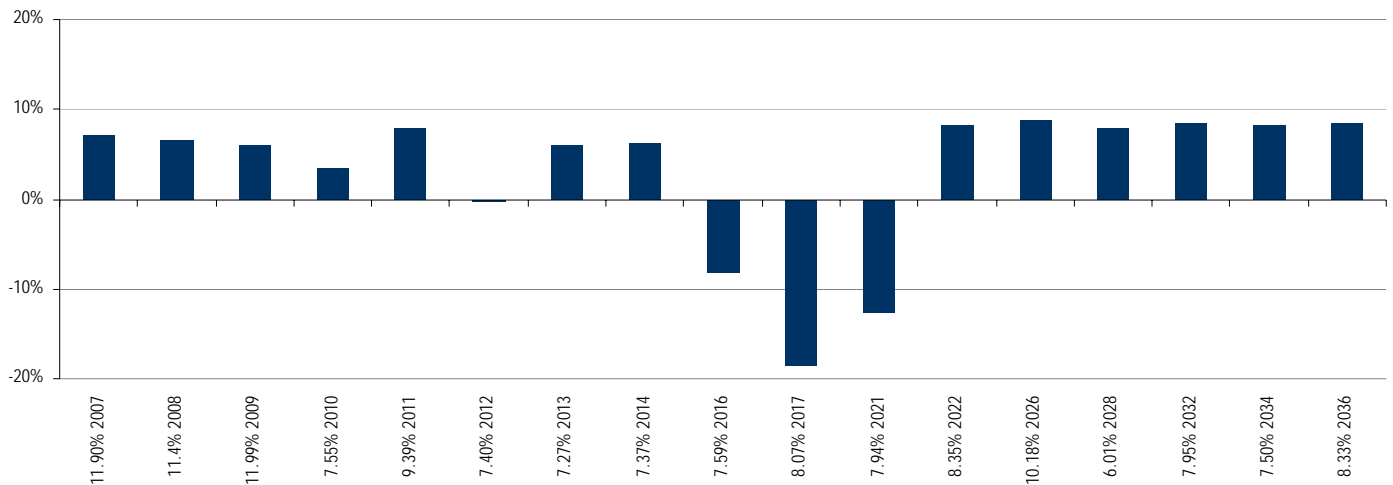
Source: Merrill Lynch Research

Chart 11: WPI YoY Change (Provisional)



Source: Min of Commerce & Industry, Govt

Chart 12: Annualized Total Return (For The Period Apr 20-27)



Source: Merrill Lynch Research

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