



Key Highlights

The Reserve Bank of India (RBI) today announced its 'Second Quarter Review of Monetary Policy 2011-12'. The key highlights were as follows:

- ▶ The RBI increased benchmark repo rate (rate at which RBI lends to banks) by 25 bps making it 8.50%
- ▶ In addition, the RBI has revised its GDP growth projections for FY12 downward to 7.6% (from 8%)
- ▶ Maintained its Wholesale Price Inflation (of 7% by March 2012), M3 growth (15.5%) and non-food credit growth (18%) projections

Surprisingly, the RBI has provided guidance of a low probability to the likelihood of a rate action in the December 2011 mid-quarter review.

Overall Assessment and Outlook

The RBI has provided rate guidance, thus providing due consideration to the significant risks to growth and its expectation of inflation to start tapering in December 2011 (to 7% by March 2012) and moderate further in FY13. We find the timing of such guidance a bit surprising as even though there is some moderation in growth due to previous rate actions and the current global environment. However, many factors negatively influencing inflationary expectations persist and the direction of some factors remain uncertain.

The RBI stated:

"Going forward, the inflation path will be shaped by both demand and supply factors:

First, it will depend on the extent of moderation in aggregate demand. Some signs of demand moderation are evident, although the impact is being felt more on the investment side.

Second, the behaviour of crude prices will be a crucial factor in shaping the outlook of domestic inflation in the near future. Despite the sluggish growth prospects of the global economy, crude prices have moderated only marginally. Also, the benefit of decline in global crude prices in the recent period so far has been more than offset by the depreciation of the rupee in nominal terms. Thus, the exchange rate will also have some impact on the behaviour of domestic petroleum prices.

Third, the inflation outlook will also depend on the supply response in respect of those commodities where there are structural imbalances, particularly protein items. Therefore, concerted policy focus to generate adequate supply response in respect of items such as milk, eggs, fish, meat, pulses, oilseeds, fruits and vegetables will play a major role in shaping the behaviour of food inflation in the near term.

Fourth, there is still an element of suppressed inflation as domestic prices of administered petroleum products do not reflect the full pass-through of global commodity prices. As the decline in crude prices has been offset by the depreciation of the rupee, under-recoveries continue to occur in respect of administered petroleum products. In addition, there are already large accumulated under-recoveries. Therefore, an increase in administered petroleum prices cannot be ruled out even in a scenario of stable or declining global crude prices. In addition, there are other items such as coal whose current prices do not reflect the underlying market conditions. Since coal is an input for electricity, coal prices, as and when raised, will also have implications for electricity tariffs."

It appears that inflation concerns are diminishing and the policy stance is now being calibrated toward stimulating growth, particularly investments, albeit in a low and stable environment. The RBI also appears to be softening its stance on systemic liquidity "to ensure that it remains in moderate deficit, consistent with effective monetary transmission."

Fiscal concerns continued to loom with fiscal imbalances widening during April - August 2011. Shortfall in other financing sources and lower revenues has led the government to announce an increase in its budgeted borrowings. Given the FII outflows due to volatility in global markets, the current account deficit may be higher compared to last year.

The RBI has also deregulated interest rates on Savings Bank Deposits with immediate effect. Banks are now free to set their own rate on savings account deposits, which is likely to put pressure on very short-end rates and consequently their base rates.

Going Forward

The RBI appears to be softening its anti-inflationary stance and clearly guiding the markets to a pause, given a build-up of significant risks to growth - indicating that we are near the peak in the current interest rate cycle. Government securities and corporate yields should move lower progressively, albeit capped by increased issuances pressure.

From a portfolio perspective, bond funds and Monthly Income Plans will continue to focus on selectively building duration. Short end funds would benefit due to easing of yields in short maturities.

Disclaimers

Expressions of opinion are those of HSBC only and are subject to change without notice. It does not have regard to specific investment objectives, financial situation and the particular needs of any specific person who may receive this document. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies that may have been discussed or recommended in this report and should understand that the views regarding future prospects may or may not be realised. Neither this document nor the units of HSBC Mutual Fund have been registered in any jurisdiction. The distribution of this document in certain jurisdictions may be restricted or totally prohibited and accordingly, persons who come into possession of this document are required to inform themselves about, and to observe, any such restrictions.

© Copyright. HSBC Asset Management (India) Private Limited 2011, ALL RIGHTS RESERVED.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted, on any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of HSBC Asset Management (India) Private Limited.

Investors may obtain Scheme Information Document and Statement of Additional Information and Key Information Memorandums along with application forms from the Investor Service Centre of HSBC Mutual Fund. **Statutory Details:** HSBC Mutual Fund has been set up as a trust by HSBC Securities and Capital Markets (India) Private Limited (liability restricted to the corpus of Rs 1 lakh). The Sponsor/associates of the Sponsor/Asset Management Company (AMC) are not responsible or liable for any loss or shortfall resulting from the operation of the Schemes. The Trustees of HSBC Mutual Fund have appointed HSBC Asset Management (India) Private Limited as the Investment Manager.

Risk Factors: All investments in mutual funds and securities are subject to market risks and the Net Asset Value (NAV) of the Scheme(s) may go up or down depending on the factors and forces affecting the securities markets. There can be no assurance that the objectives of the Scheme(s) will be achieved. Past performance of the Sponsor, AMC, Mutual Fund or any associates of the Sponsor/AMC does not indicate the future performance of the Scheme(s) of the Mutual Fund. The names of the Schemes do not in any manner indicate the quality of the Schemes or their future prospects or returns. Please read the Scheme Information Document and Statement of Additional Information carefully before investing.