Third Quarter Review of Annual Monetary Policy Statement – 2007-08

The US economy has been undergoing turbulent times after the subprime meltdown last year leading to liquidity crisis followed by an overall slowdown in the economy. The jitters have been felt in the equity markets around the globe in the past two weeks as concerns about the fallout of US slowdown looms large. This was followed by an emergency rate cut of 75 bps by the US Fed ahead of the scheduled FOMC meeting on Jan 30 giving mixed indications about the intensity of the problem as well as the intention of the Central Bank to arrest it before it becomes uncontrollable.

Indian economy has fared reasonably well during these times with GDP growing in excess of 9% during the first half of 2007-08. The monetary and liquidity tightening measures taken by RBI in 2007 has borne results with headline inflation cooling off from 6% and above levels to sub 4% levels.

Also as a result of the tightening the pace of economic growth has moderated as evidenced in the slowdown in retail consumption (reflected in the slowdown of non food credit offtake of SCBs to 21% yoy as on Jan 4, 2008 from 30.8% yoy year ago) and the industrial activity. The IIP growth slowed down to 9.2% during April-November 2007 as compared with 10.9% a year ago. Private corporate sector activity has also exhibited some moderation during this time.

While the economic pace is moderating, inflationary pressures have remerged. The persistence of high food prices, oil prices sustained at elevated levels and continued high prices of other commodities pose significant inflation risks and challenges for monetary policy. With the large liquidity overhang, aggregate demand pressures persist fueling the inflationary risks further.

On one hand the Central Bank was faced with the challenge of moderation in economic growth and rising differential against the US interest rates, while on the other hand it faced the risks of rising inflationary pressures. Amid the uncertainties in the global markets, the RBI governor adopted the safer approach to wait for the uncertainties to unfold before taking a decision to cut the rates. The key highlights of the policy were

- Bank Rate kept unchanged at 6%
- Reverse repo rate and the repo rate kept unchanged at 6% and 7.75% respectively.
- CRR kept unchanged at 7.5%

Some of the other interesting observations from the policy which are worth noting are

- Domestic economic activity continued to be steered by investment demand, with gross fixed capital formation (GFCF) increasing by 15.5% in real terms in the first half of 2007-08 (14.5% a year ago); on the other hand, private final consumption expenditure (PFCE) increased by 5.6% (6.4 %).
- The continued buoyancy of investment demand was reflected in the growth in capital goods production at 20.8 per cent (17.4 per cent) while consumer non-durable goods output rose by 7.8 per cent (8.9 per cent), the production of consumer durables goods declined by 1.7 per cent (increased by 12.4 per cent)
- Private corporate sector activity exhibited some moderation in the first half of 2007-08. Overall sales of sampled non-financial private companies increased by 17.4 per cent as compared with 27.4 per cent in the first half of 2006-07.
- Deficit rainfall for the rabi crop - The cumulative rainfall during the North-East monsoon season (October-December 2007) was 32% below normal. The major rabi producing regions like Punjab, Haryana, Himachal Pradesh, western Uttar Pradesh and eastern Madhya Pradesh had received deficient rainfall in the 2007 South-West monsoon season as well.
- Non-food credit extended by scheduled commercial banks (SCBs) increased by 11.8 per cent during the current financial year up to January 4, 2008 as compared with the increase of 17.5 per cent in the corresponding period of 2006-07 indicating a slowdown in credit growth. There was a decline of Rs.5,237 crore in food credit as compared with an increase of Rs.2,392 crore in the previous year.
- Adjusted for LAF collateral securities and the outstanding issuances under the market stabilisation scheme or MSS, investment in Government and other approved securities by SCBs are placed in the range of 23.0 per cent to 24.0 per cent of NDTL.
- Globally, inflationary pressures have re-emerged as a key risk to global growth. In the global foodgrains market, prices of major crops such as corn, soyabeans and wheat have increased by 22.4 per cent, 75.2 per cent and 87.7 per cent, respectively, from a year ago in response to surging demand. The rally has swept up prices of other food items as well

The RBI re-emphasized liquidity management by highlighting "liquidity management will continue to assume priority in the conduct of monetary policy". Although early last year this phrase was synonymous with a tighter liquidity backdrop, it is far more subtle in the current context. Also, the tone of the policy seemed to be less hawkish in comparison to the earlier policies.

Our Recommendation to the Investors is to continue to invest in Long Term Gilt Funds and Income Funds at a 10 year Gilt Yields of 7.50% (around Current Level) with a Three to Six months view.

Statutory Details

ICICI Prudential Mutual Fund (erstwhile Prudential ICICI Mutual Fund) (the Fund) was set up as a Trust sponsored by Prudential plc (through its wholly owned subsidiary namely Prudential Corporation Holdings Ltd) and ICICI Bank Ltd.

ICICI Prudential Trust Limited (erstwhile Prudential ICICI Trust Limited) (Trust company) is the Trustee to the Fund and ICICI Prudential Asset Management Company (erstwhile Prudential ICICI Asset Management Company Limited) (AMC) is the Investment Manager to the Fund. ICICI Bank Ltd (ICICI Bank) and Prudential Plc (acting through its wholly owned subsidiary namely Prudential Corporation Holdings Ltd) are the promoters of the AMC and the Trust Company. ICICI Bank currently holds 51% stake in both the companies and the balance 49% stake in both the companies is held by Prudential plc (acting through its wholly owned subsidiary namely Prudential Holdings Corporation Ltd). Prudential Plc (acting through its wholly owned subsidiary namely Prudential Corporation Holdings Ltd) transferred 6% of its shareholding in both the companies to ICICI Bank w.e.f 26th August 2005.Subsequently in accordance with the approval granted by the Board of Directors and the shareholders of the AMC and the Trust Company the name of the AMC has been changed to ICICI Prudential Asset Management Company Limited and the name of the Trust Company has been changed to ICICI Prudential Trust Limited. SEBI has vide its letter no IMD/PM/84968/07 dated January 23, 2007 conveyed its no objection to the said change of names of the AMC & the Trust company. The said change of names has also been approved by the Registrar of Companies, NCT of Delhi & Haryana, Ministry of Company Affairs, Govt of India. The Board of Directors of the Trust company have at their meeting held on 20th February 2007 accorded approval for the change of name of the Mutual Fund to ICICI Prudential Mutual Fund as well as of the various schemes /plans/options there under. SEBI has vide its Letter Nos IMD/PM/90168/07 & IMD/PM/90170/07 dated 2nd April 2007 accorded approval for the same.

Risk Factors: Mutual Funds and securities investments are subject to market risks and there is no assurance or guarantee that the objectives of the Schemes will be achieved. As with any securities investment, the NAV of the Units issued under the Schemes can go up or down, depending on the factors and forces affecting the capital markets. Past performance of the Sponsors, AMC/Fund does not indicate the future performance of the Schemes of the Fund. The Sponsors are not responsible or liable for any loss resulting from the operation of the Schemes beyond the contribution of an amount of Rs.22.2 lacs, collectively made by them towards setting up the Fund and such other accretions and additions to the corpus set up by the Sponsors. Please read the Offer Document carefully before investing.

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1 Datasource: Reserve Bank of India