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Fed Policy Review

Fed finally abandons ZIRP, heading for a smooth normalisation

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The advent of the normalisation process of an over-accommodative Fed rate cycle with a 25bp hike to a range of 0.25-0.5% marks a beginning of a series of hikes in the coming years. This is an end to the 7 year of near zero interest rate policy (ZIRP). We expect 3-4 hikes during course of 2016 as Fed turns less accommodative. FOMC is more confident as compared to last policy that Fed rate to be at 1.4% in 2016 i.e. an hike of nearly 90bps. In the short term, we can expect markets to respond positively given that the anxiety around the much awaited lift-off is over now.

Strength of recovery justifies a lift-off, despite less than target inflation: As expected the FOMC statement recognized the strength of the US economic recovery including solid growth in private spending and improvement in the housing sector which have counterbalanced the soft net exports. However, from the growth angle concerns on energy and manufacturing continue to remain at a large. Underutilization of labor resources has diminished appreciably. However, inflation remains below fed's target of 2%, partly reflecting declines in energy prices and in prices of non-energy imports which Fed has highlighted that they are transitory in nature.

US economy to continue to improve along with gradual rate normalisation: Fed expects that along with gradual adjustments in the stance of monetary policy, economic activity will continue to expand and the labor market will continue to strengthen. Risks to the outlook for economic activity and the labor market are balanced. However, the wage inflation is still showing some signs of labour market slackness. Inflation is expected to rise to 2% over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further.

Rate hike reflects an element of preemptiveness to lessen the degree of accommodation: "Recognizing the time it takes for policy actions to affect future economic outcomes" the initiation of the normalisation process with a 25bp hike was appropriate. But the stance of monetary policy remains accommodative after this increase.

Further rate normalisation will depend on data dependent, market response and global development: In determining the timing and size of future adjustments the Committee will assess labor market conditions, inflationary pressures and readings on financial and international developments. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.

Fed will maintain its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction.

Changes in Fed's forecast table:

- The median real GDP growth projection for 2016 is kept mostly unchanged at 2.3-2.5% (2.2-2.6% earlier)
- Unemployment rate is expected to be lower than earlier at 4.6-4.8% (4.7-4.9% earlier)
- Core PCE inflation is expected to remain at 1.5-1.7% (1.5-1.8% earlier)
- Fed rate expectation at 0.9-1.4% from 1.1-2.1%; Long term neutral rate kept at 3-4%

Outlook:

We read the tone and tenor of the FOMC statement as neutral even through, as expected there is clear commitment towards sustaining an accommodative stance for some time. The liftoff reflects a big change in monetary policy perspective as the Fed abandons its earlier over-cautious stance despite "appreciable improvement in the labor market" and underplays the fact that the core inflation remains below its 2% target. The primacy is now given to lagged effect of monetary.

From the markets standpoint the liftoff seems to been achieved very smoothly with the equity markets continuing to gain after the announcement. DJIA 500 gained 1.5% at the close and also Asia opened positively this morning. Crude gained 0.5% even as USD strengthened 0.5% against the EUR.

In the short term the removal of anxiety over the Fed rate liftoff will help the markets given the short selling we saw earlier on.

Indian equities have undergone sharp correction and could respond positively and this short-term reaction could include ICICI bank, HDFC, Lupin, Tata motors, Concor, Coal India, HCL tech to name a few.

However, we maintain that Fed normalisation process will gain momentum over the course of 2016. The 25bp hike yesterday will be followed by 75bp (or may be 100bp) hike over the course of 2016.

Hence, we also maintain our core thesis that:

- **EMs flows vulnerable to Fed normalization and "reverse de-coupling":** Fed's exit can be a significant risk for EM flows, particularly portfolio flows, given the backdrop of the sharp deceleration in EM's GDP and earnings growths.
- **Global rebalancing could lead** to a) further depreciation in Chinese yuan and EM currencies, b) Decline in EM investments in US treasury resulting in upward impulse on yields and c) support US fed rate normalization. Declining global liquidity can erode India's Fx reserves and impact money supply.
- Retrenchment of excess global liquidity will realign asset market, especially those that have benefitted from prevalence of excess liquidity for a long time. EM equities will be exposed to complications arising from a) US rate normalization, b) Still exuberant valuations in India notwithstanding earning downgrades sustaining for six years, c) Growth sensitive EMs like India trading more expensive valuations (growth adjusted) than developed markets like US and d) Narrowing growth differential between EM and DMs.
- **Fed's normalisation will constrain RBI's rate easing cycle**. We expect no change in RBI's policy rate till after the Union Budget in Feb'2016 in line with our view that the current rate easing cycle will be a shallow one.
- **Strength in US dollar value** has continued on expected lines with USD major currency index rising beyond 100. This will continue to exert downside risk to EM currencies. We maintain INR/USD weakening bias with a near term target of 68-70.

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BUY	Expected total return (%) (Stock price appreciation and dividend yield) of over 25% within the next 12-18 months.
ACCUMULATE	Expected total return (%) (Stock price appreciation and dividend yield) of over 10% within the next 12-18 months.
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SELL	The stock is believed to underperform the broad market indices or its related universe within the next 12-18 months.

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