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Mutual Fund

RBI Policy Update

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An assessment of RBI's 2nd Bi-monthly Monetary Policy Statement, FY 2020-21

RBI's Policy Stance:
Based on evolving macroeconomic and financial conditions, the MPC has decided to keep the benchmark interest rate unchanged and continued to maintain its stance as "accommodative". This was broad market expectation post higher than expected inflation prints and 115 bps repo rate cut already delivered in the previous two policies. The monetary policy committee (**the MPC) reiterated its commitment to achieve the medium-term target for headline inflation of 4%within a band of +/- 2% while supporting growth and decided to**:

- **kept** the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4%;
- maintain the monetary policy stance as **accommodative**

Variable	Stands at
Repo	4.00%
Reverse Repo	3.35%
CRR	3.00%
MSF	4.25%
SLR	18.00%

Source: www.rbi.org.in

Policy Stance & Rationale:

- In the 2nd bi-monthly MPC meeting of FY21, chaired by the Reserve Bank of India governor Shri. Shaktikanta Das, the members voted unanimously to keep its benchmark interest rate unchanged, despite rising concerns over economic growth as inflation concerns came to forefront. The committee though, voted for keeping the stance at "accommodative", as growth is expected to contract in current fiscal and monetary policy has to continue to support revival. The MPC kept the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.0%. The reverse repo rate under the LAF too continues to stand at 3.35%, and the marginal standing facility (MSF) rate and the Bank Rate at 4.25%.

- On the global front, the economic activities remained fragile and in retrenchment in several geographies. Contractions in economic activity have been more severe in Q2 CY2020 than in Q1, with output in the US and the Euro area showed significant reduction in Q2 as compared to the previous quarter. Based on the high frequency indicators, Emerging market economies (EMEs) could contract in Q2. Crude oil prices have remained supported on supply cuts by oil producing countries (OPEC plus) and improved demand prospects on the gradual easing of lockdown restrictions since May'20. However, OPEC+ is likely to pull back from the extreme production cuts, tempering any sustained rise in prices.

- On the domestic front, the agricultural sector has shown sign of relief during the pandemic led crisis on the back of good spatial and temporal progress of the south-west monsoon. The committee highlighted that the transmission to bank lending rates has improved further, with the weighted average lending rate (WALR) on fresh rupee loans declining by 91 bps during March-June 2020. The transmission was most in money market and corporate bonds with the spreads of 3-year AAA rated corporate bonds over G-Secs of similar maturity declined from 276 bps on March 26, 2020 to 50 bps by end-July 2020.

- The MPC has also recognised that domestic financial conditions have eased substantially, and systemic liquidity remains in large surplus, due to the conventional and unconventional measures by the Reserve Bank since February 2020. Cumulatively, these measures announced injected liquidity of the order of ₹9.57 lakh crore or 4.7 per cent of GDP. Reflecting these developments, reserve money (RM) increased by 15.4 per cent on a year-on-year basis (as on July 31, 2020), driven by a surge in currency demand (23.1 per cent).In order to distribute liquidity more evenly across the term structure and improve transmission, the Reserve Bank conducted 'operation twist' auctions involving the simultaneous sale

and purchase of government securities for ₹10,000 crore on July 2, 2020.
Source: RBI

Outlook:

- From a macroeconomic perspective, growth is likely to be adversely impacted due to the pandemic induced lockdown, severely impacting aggregate demand in the economy. As per IMF estimates, global output is likely to be (-)4.9% in 2020, with advanced economies bearing the brunt with growth of (-)8%. India's GDP is likely to contract by 4.5% in CY2020, which could lead to GDP contraction for FY2021. Inflation has been high in past few readings. However, lower oil prices, good monsoons coupled with weak aggregate demand denting core inflation, overall inflation is likely to be lower in 2HFY2021. Globally, developed economies are likely facing recession in FY21, with a hard and slow road to recovery.

- Monetary policy remains at forefront in managing the economic crisis. 115 basis points repo rate, 155 bps reverse repo rate cut coupled with 100 basis points CRR cut, since pandemic induced lockdown, have supported the economy as well markets. RBI further announced long term repo operation (LTRO)to provide long term liquidity at repo rate, which pushed rates lower. Targeted LTRO (TLTRO) specifically aimed at corporate bond investments, further reduced cost of borrowings for corporate issuers.

- While the MPC expects the growth to contract in FY2021, the Governor noted that there was good transmission on past policy cuts and liquidity operations in terms of sharp fall in rates for money market and corporate bonds, with NBFC also able to take advantage of the low rate scenario and hence a pause at this juncture is justified. With good monsoons and resumption of supply lines, food inflation is likely to moderate. The MPC expects the inflation to fall in the 2HFY2021.

- G-Sec markets are likely to be driven by the borrowings in FY2021. With additional borrowings of Rs.4.2 lac crores already keeping G-Sec yields at elevated level, any further borrowings could materially pressure yields. Tight fiscal conditions, however, may prevent the government from deviating too much from revised numbers.

- Corporate bonds have been supported from RBI measures especially TLTRO aimed at investment in commercial papers and corporate bonds. Good flows in debt mutual funds have further helped rally in corporate bonds. This led to lower corporate bond rates with compression of spread vis-à-vis sovereign papers. Further with global recession imminent, local growth will likely be lower in FY21. This means the corporate demand for funds for capital expenditure will likely remain muted, and most of the demand is likely to be working capital related or refinancing. Less supply pressure is likely to be positive for bonds.

- In current scenario, growth will be likely to remain under pressure. Central Banks across the world have slashed rates and are pumping liquidity. In this scenario, rates are likely to go lower and remain low for prolonged period of time. RBI is likely to ease further as GDP growth is expected to contract in FY2021. While G-Sec market will feel pressure from government borrowings in the short term, corporate bonds will likely benefit from rate cuts and excess liquidity injected by RBI.

- Market yields rose on rate status quo as well as no RBI action on further liquidity measures to support market with the 10Y yields rising by ~5 bps. Market was not expecting any rate cut and hence the sell-off was limited. Market yields may inch up a little in near term. However, RBI has done ad-hoc OMO purchase / "twist" operations in the recent past, whenever yields have gone up and hence market participants would be wary of the same. Markets may remain in a narrow trading zone, as future policy action is not ruled out. We expect 10Y to remain within 5.75-5.95% range.