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CANARA ROBECO Mutual Fund

RBI Policy Update

October 09, 2020

Assessment of 'Monetary Policy Committee's (MPC) Third Bi-monthly Monetary Policy, FY 2020-21

RBI's Policy Stance:

Based on the current and evolving macroeconomic and financial conditions, the MPC has decided to keep the benchmark interest rate unchanged and continued to maintain its stance as "accommodative" for as long as necessary to revive growth while ensuring inflation remain within the MPC's target going forward. MPC noted that the Indian economy is entering into a decisive phase in the fight against the coronavirus and focus should be on reviving the economy. **The MPC has continued to display its commitment to achieve the medium-term target for headline inflation of 4% within a band of +/- 2% while supporting growth and decided to**:

- **keep** 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 3rd bi-monthly policy meeting of FY21, chaired by the RBI governor Mr. Shaktikanta Das, the members voted unanimously to keep its benchmark interest rate unchanged and continued to remain accommodative, focusing on the need to revive growth on a durable basis and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward. **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%.**

- The RBI further announced several liquidity measures to fulfil liquidity needs in the system and encourage growth as well support the financial markets. **An on tap TLTRO (targeted long term repo operations) with tenors of up to three years for a total amount of up to ₹1,00,000 crore at a floating rate linked to the policy repo rate is to be conducted.** The scheme will be available up to March 31, 2021 with flexibility in terms of enhancement of the amount and period. Liquidity availed by banks under the scheme has to be deployed in corporate bonds, commercial papers, and non-convertible debentures issued by entities in specific sectors to which bank loans can be extended. Also, banks that had availed of funds earlier under TLTRO and TLTRO 2.0 can reverse these transactions before maturity.

- The RBI increased the investments permitted to be classified as Held to Maturity (HTM) on September 1, 2020 from 19.5% to 22% of NDTL in respect of SLR securities. **In order to provide certainty to banks for their investments and to ensure orderly market conditions, the RBI has decided to extend the enhanced HTM limit of 22% to March 31, 2022** for securities acquired between September 1, 2020 and March 31, 2021.

- **Open Market Operations (OMOs) issue size is being increased to Rs.20,000 cr. Further OMOs in State Development Loans (SDLs) are to be conducted as a special case during the financial year in order to**

improve liquidity and facilitate efficient pricing. This will aim to improve secondary market activity and rationalize spreads of SDLs over central government securities of comparable maturities.

- Globally, economic activity was seen to recover in Q3 of 2020 however remained uncertain due to the renewed surge in infections which could impact the global trade; however, global financial markets remain supported by highly accommodative monetary and liquidity conditions. With the reduction in crude price and sluggish aggregate demand, inflation remained below target in advanced economies (AEs), although in some emerging market economies (EMEs), supply disruptions have pushed price pressures upward.

- On the domestic front, economic activity is indicated to be stabilising in Q2 FY 2021 after the 23.9% (Y-o-Y) decline in real GDP in Q1 and is expected to improve as economic activities normalise. **Government spending and rural demand has enabled sectors such as manufacturing, consumer non-durables and services (especially passenger vehicles and railway freight) to gradually recover in Q2.** However, the trade deficit widened in Q2 FY 2021 amidst marginal increase in imports and export in merchandise slowly catching up to pre-COVID level. The MPC expects real GDP on FY2021 to show negative (-) 9.5% growth but expects a sharp rebound by 20.6^ in Q1 FY 2022.

- The MPC recognised the continued systemic liquidity surplus and easing domestic financial conditions. Reserve money increased by 13.5% on a Y-o-Y basis (as on 2nd Oct'20), driven by a surge in currency demand (21.5%). However, the headline CPI inflation increased to 6.7% during Jul-Aug'20 as pressures accentuated across food, fuel and core constituents on account of supply disruptions, higher margins and taxes. The MPC sees the high food inflation as transient and expects inflation to be near 4% by end of current fiscal

Source: RBI

Outlook:

- On the global front, the economic growth is likely to remain sluggish in the near term, amidst COVID-19 led pandemic hovering in the danger zone for major economies. Post COVID-19, growth related macroeconomic indicators declined sharply, although there has been some recovery in the last quarter which comes as a hope in the ongoing crisis. The measures taken by major central banks would continue to remain extremely accommodative to support incipient economic activity.

- Domestically, with good monsoon, the rural economy is expected to strengthen while the urban share in the economic growth could lag and take time to rebound. For sectors, especially which are contact-intensive, the gain in the business activity could get delayed due to the elevating infection numbers. With uncertainty in the COVID-19 trajectory, weak global demand is likely to impact export and private investments would continue to remain submissive for short to medium term. However, with India's GDP growth declining by 23% in Q1 FY 2021, expectations of sharper full year contraction in the financial year is widely expected.

- The MPC meeting unveiled a plethora of measures for bond markets. The rate action was on expected lines with the Committee deciding to maintain "status quo" on rates in the light of high inflation in recent times, as well the stance being maintained as accommodative. In a first, forward guidance for stance was spelled out. The MPC said that the stance is likely to "*...continue with the accommodative stance at least during the current financial year and into the next financial year*". This reinforces RBI's resolve to continue to support the economy in post pandemic recovery.

- There were more surprises in store in terms of liquidity measures viz. OMO size increase to ₹20,000 crore (already announced for next week), special OMOs in state development loans (first time it is happening), on tap TLTRO for up to ₹1,00,000 crore for specific sectors. The TLRTO can be used for investing in corporate papers as well as for giving loans and advances. Further this facility will be exempt from large exposure framework and can be classified in HTM category over and above 25% limit. This is likely to give boost to bank lending. The RBI's measures clearly point towards its desire to maintain adequate liquidity as well as keep yields low in an environment on elevated government borrowings.

- The markets reacted positively with 10 year yields dropping by ~8 bps post policy announcement. The announcement of OMO stocks further consolidated the rally with good participation expected in today's auction. Whilst near term inflation prints are likely to keep markets cautious, yields should soften on the back of RBI's measures. Increase in OMO purchase size to ₹20,000 crore should go a long way in helping the smooth passage of government borrowings. In the short term 10 year bonds are likely to trade in a range of 5.80-5.95% with a downward bias.

- The MPC expects that once the business restrictions get normalised and economic activity improves, the supply side support to the economy would progress and expand. Ongoing fiscal expansion combined with an accommodative monetary policy could keep the fixed income market volatile in the near term. Going forward, the increased level of inflation combined with recent uptick in unemployment is likely to influence consumption and consumer confidence. In addition, yields on G-Sec papers as well as the long duration corporate bonds (especially 3 years and above) fell during Sept'20. However, yields on the short to medium duration corporate bonds increased. As the uncertainties continue to prevail, we recommend investments in high quality Short Duration Funds and Corporate Bond Funds depending on the investment horizon of investors as well as Gilt Funds for investors with high risk appetite.