PGIM
India Mutual Fund

RBI Policy View

October 06, 2023

Puneet Pal
Head - Fixed Income

As Hawkish as it gets…

The MPC policy today was as hawkish as it could get even as the MPC kept the policy rates unchanged. Flagging inflation as still the "Major Risk", the RBI governor emphatically reiterated that the inflation target is 4% and not 2% to 6%. This along with the announcement that RBI will be nimble in managing liquidity by conducting OMO bond sales spooked the bond markets and the benchmark 10yr bond yield rose by 13bps to 7.34%. The MPC voted unanimously to keep the policy rates unchanged while the monetary policy stance was retained at "withdrawal of accommodation" with a 5-1 majority with Prof Varma dissenting.

The MPC left its GDP growth and inflation forecast unchanged at 6.5% and 5.40% respectively for FY2024. Clearly RBI's focus is on liquidity management as RBI does not seem to be comfortable with the overnight lending rates going below the policy repo rate of 6.50% when the banking system liquidity is in surplus. They seem to be fine with the overnight lending rates staying between the repo rate and the MSF rate or at the MSF rate. RBI also highlighted the resilience of Indian growth and the macroeconomic stability. Though sounding hawkish, RBI acknowledged the drop in core inflation and also the fact that the rate hikes done so far were still working their way through the system. The RBI Governor in his statement highlighted the unsatisfactory transmission of lending and deposit rates pointing out that both lending and deposit rate increases so far have lagged the increase in the policy rates.

Market Reaction

In the run up to the policy, bond markets were expecting a hawkish but status quo policy. As RBI had rolled back the incremental CRR (I-CRR), market was not expecting any direct action to drain liquidity but were expecting RBI to continue with its FX intervention and VRRR operations to manage liquidity. The announcement of the possibility of bond sales through open market operations caught the bond market by surprise and the benchmark 10yr bond yield rose by 13bps to end the day at 7.34%. The curve steepened as the OMO sales will in all probability be at the longer end of the curve though the yields were higher across the curve.

Our View

In our view RBI, by formally announcing OMO sales, is giving a yield signal to the market. Though the RBI governor categorically denied in the post policy press conference that this was a yield signal saying that this was meant to manage liquidity, we think that this is very much a yield signal as there are many tools available to RBI for draining liquidity such as FX swaps and issuing bonds under MSS. Given the surge in global bond yields, especially US and the higher for longer rates narrative in the developed markets, RBI probably is nudging the Indian bond markets to a higher yield level to maintain yield differential. To put things in perspective, the benchmark US Bond yield has risen by 100 bps in the last quarter whereas the Indian 10yr benchmark bond yield had risen by just 20 bps till yesterday. Also the fact that Indian growth is holding up quite well in face of moderating global growth has probably led RBI to focus on protecting Macroeconomic stability. The Dollar Index (DXY) has been strengthening and INR has come under pressure of late and nudging yields higher without an explicit rate hike may be RBI's tactical tool to ensure INR and macroeconomic stability.

Our current interest rate differential with US is close to historically low levels and this dichotomy of narrowing rate differentials between the developed market economies and the emerging market economies is a much discussed and debated theme currently. Brazil, one of the key emerging markets has cuts rates and China is also pursuing an accommodative monetary .

Given the current growth inflation dynamic in India we think that RBI will be on a long pause with no pressing need to cut rates at least till this fiscal year end. Going ahead we expect the curve to steepen with the longer end underperforming the shorter end of the curve and expect the 10yr benchmark bond to trade in a range of 7.25% to 7.60% over the next couple of months.

Given the recent rise in yields both domestically and globally, yields are entering attractive territory and we believe it is the right time for investors to start increasing their allocation to Fixed Income especially at the longer end of the curve.

Investors with medium to long term investment horizon can look at funds having duration of 3-4yrs with predominant sovereign holdings as they offer a better risk reward currently. Investors having an investment horizon of 6-12 months can look at money market funds as yields are attractive in the 1yr segment of the curve.

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