PGIM India Mutual Fund

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A dovish and pro growth policy, reiterating support to liquidity and yields

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The MPC meeting outcome was along expected lines with RBI leaving all key policy rates unchanged. At the same time, RBI committed to support yields and liquidity as in the previous meetings using the entire array of tools at its disposal.

The MPC remained pro-growth in its orientation and committed to keep the stance accommodative and system liquidity in surplus for "as long was needed" to ensure a return to durable growth. Unlike in the past, RBI refrained from specifying a time limit to maintaining easy liquidity conditions, rather linking it purely to a "need based" manner.

The policy tone was clearly dovish, with the RBI acknowledging upward impulses to both headline and core inflation. However, the deputy Governor clarified that most of the recent contribution to inflation has happened in RBI's judgement from "pandemic related disruptions" rather than "demand pull".

The policy stood out for departing from RBI's hitherto orthodox stance and probably leaning on the style of other large Central Banks. RBI announced a Open market Operations (purchases of G Secs in the secondary market) calendar for the first time. This has been a long standing request of the bond market, given the massive back to back borrowing program in the last and current fiscals. Terming it as a Govt Security Acquisition Program (GSAP 1.0). Under the program, RBI plans to buy INR 1 trillion of G secs in the current quarter. We expect RBI to outline its proposed buying quantum at the start of every quarter.

RBI was quick to add that the GSAP is separate from the ongoing OMOs which are more adhoc and market linked. Hence GSAP is not a replacement for OMOs. The GSAP program ties in well with RBI's narrative of recognizing the yield curve as a "public good" and how all corporate debt is also priced off G secs. Keeping in mind the massive borrowing for FY 22 (of over INR 22 trillion) and rising stock of debt (debt / GDP now at over 85%), RBI is certainly getting more active in managing yields relative to the past.

Besides, the RBI is also probably trying to deliver on its previous assurance of filling in the liquidity gap that could be caused by reversal of CRR. With 50% having already happened in March, the residual CRR reversal is scheduled for May. Also RBI used the policy to announce continuation of its liquidity normalization, with planned introduction of longer term variable rate reverse repo (VRRR) operations. Hence, short term liquidity being sucked out should be getting infused through longer term operations (under GSAP). This could lead to a compression in term spreads and some flattening in the yield curve.

The combination of the GSAP, which is committed and known to the market in advance and can also potentially be scaled up and the OMO, which is ad-hoc and more reactionary in nature should help RBI exercise stronger "yield curve control" compared to the past.

RBI's deft moves on liquidity normalization is also aimed to absorbing excess liquidity without spooking markets or yields. Hence, this is likely to be timed in a manner that front end yields do not over-react even as RBI achieves its end objective of reducing the crisis level liquidity.

RBI made no major changes to either inflation or growth forecasts. RBI maintained its + 10.5% GDP growth for FY 2022 with a big jump in Q1, given the significant base effect for this period last year. Inflation was nudged up just a bit, though not materially.

For now, RBI appears to want growth back in a more irreversible manner and hence avoid any action that can negatively impact the incipient recovery or green shoots. However, rather than wait for a full blow recovery and probably picking from the actions post the GFC 2008, RBI prefers to initiate baby steps towards normalization.

For the next few quarters, we expect long end yields to remain range bound with a hard limit around 6.5%, though yields should reign much lower in and around 6.10-6.25% for most period. Very short end yields are unlikely to rise sharply given that the reverse repo has not been moved and neither is there any actions around compressing the repo-reverse repo corridor for now.

Recommendation

Given that yields have hit the low point, despite the proposed actions and display of new tools in its armory, there is no case at this point for yields to decline structurally. RBI has displayed an ability to cap yields successfully in the face of a record borrowing in fiscal 2021, which will be tested yet again in FY 22. We expect tactical opportunities to play the long end yields. For most the short and mid segments of the curve would be preferred operating zones.

As such we prefer the short / mid products such as the Corporate bond, Banking & PSU and Dynamic bond fund categories. For investors with a shorter and less than 1 year horizon, we recommend Ultra Short and Low Duration Funds.