Status quo on rates – Liquidity stance remains accommodative

Kumaresh Ramakrishnan
CIO - Fixed Income

The Monetary Policy Committee (MPC) unanimously (6-0) decided to maintain all policy rates at status quo while also retaining the liquidity stance as "accommodative". Further liquidity management and normalisation is now likely to be graded and gradual to prevent any market disruption or impair financial stability. Cash Reserve Ratio (CRR) which was to be reinstated back to 4% from the temporary 3% introduced in March 2020, is proposed to be restored in a 2 phased manner by 50 bps each in March 2021 and May 2021. RBI has reiterated the availability and keenness to use all policy tools to met liquidity gaps if necessary to allay any yield spike fears.

Relaxation in Held To Maturity (HTM) limits on Statutory Liquidity Ratio (SLR) securities which was raised to 22% (in March 2020) for banks from 19% earlier will now continue for another year until March 2023. This should help RBI in managing the Govt's record borrowing program smoothly. RBI's clear recognition that yield is a 'public good' benefitting everyone, is a positive which is likely to be an actively managed curve especially given the expansion in government borrowing program.

Other policy measures include Foreign Portfolio Investors (FPI) in debt to invest in defaulted securities and treating this outside of their short term investment limit. Besides there will be no minimum residual maturity requirement for such investments. This is a positive and will help free up limits for FPIs to look at attractive opportunities in the distressed asset space which has seen activity in the last couple of years as credit stress has piled up. This will also help widen and deepen the distressed asset space enabling further entrants. On Targeted Long Term Repo Operations (TLTRO), banks will now be able to provide funds to NBFCs on tap for onward incremental lending to specified stressed sectors. Since NBFCs operate in many of the sectors with a distinct last mile advantage unlike banks, this step will help in dispensing credit to small borrowers (SMEs and micro SMEs) in many sectors that were seriously impacted by the pandemic.

The other step was to allow retail investors to open direct accounts with RBI to buy/invest in Govt bonds, should also help in improving and creating sticky demand over time. This is notable as it offers one additional investment avenue for retail investors. India would also be one of the very few countries that would permit retail investors such an access. Retail money is sticky and less volatile. Further details are awaited but the initiative from RBI is revolutionary.

RBI in the policy today raised marginally its inflation forecasts for Q4 -FY 2021 and for the first half of FY 2022 and Q3 -FY 2022 referring to escalation in cost pressures and the stronger than expected growth rebound seen higher petroleum prices and high industrial raw material prices are also seen feeding into services and other manufactured products in recent months leading onto a more broad base inflation. CPI is forecast at 5.2% in Q4-FY 2021, falling only marginally to 5.2%-5.0% band in H1-FY 2022.

Markets expectation for an Open Market Operation (OMO) calendar did not come through which is causing some nervousness in the backdrop of an all time high borrowing program for the next financial year. The context for borrowing shifts now to the next financial year, wherein the overall supply is daunting. Net Govt issuance (only Central) will be over INR 9 trillion with the gross at INR 12 trillion. State Govts are likely to close the current financial year with about INR 8.7 trillion of borrowing. Gross borrowing of Centre and States would touch INR 20 trillion. Given the daunting number, RBI will need to be actively involved to manage the curve and prevent market fears of supply absorption translate into higher rate expectations.

In this backdrop of a record borrowing program for next year besides likely gradual steps from RBI to drain out the excess liquidity likely at some time in the next 6-9 months, we prefer maintaining a shorter bias in our products. We would hence prefer shorter products viz. Banking & PSU Fund and the Premier Bond Fund for investors with a 1-3 year horizon. Investors with some risk appetite and higher carry from longer products could have some allocation in the Dynamic Bond fund. For investors with shorter time frames, we would recommend the Ultra Short Term Fund and the Money Market Fund.