No change in interest rates and neutral liquidity stance. Inflation trajectory to guide next policy move

Policy at a glance

The Reserve Bank of India (RBI), maintained status quo on interest rates and decided to watch inflation trajectory, before effecting the next policy move. The policy was in line with market expectations with fairly low probability of the rate cut, ahead of the onset of the monsoon and better clarity on the US Federal Reserve's further policy rate moves.

Even as, RBI cited concerns about the upside risks to inflation, the policy statement clearly highlighted that accommodative stance of monetary policy would continue. The RBI would monitor macroeconomic and financial development, and remains cognizant of the fact that more monetary transmission is pivotal for supporting the revival of growth.

The trend of inflation, after moving down in two consecutive months to March, reversed in April, with Consumer Price Index (CPI) based inflation rising sharply to 5.4% YoY in April versus 4.8% in March. The rise in inflation in April was broad-based, but was primarily led by higher food prices. Further, the upside risks to inflation emanated from higher food prices, firming international crude oil prices and implementation of the 7th Central Pay Commission awards. Nonetheless, risks to inflation are expected to be balanced by good monsoon (Indian Metrological Department has forecasted above normal monsoon this year) and various supply management measures undertaken by the government to tackle inefficiency in food supply. The average international crude oil prices are also expected to hover in the range of USD 50-55 a barrel, at which higher oil production will resume and will help address the demand supply imbalance, and stabilize imported inflation from crude oil prices.

In such a backdrop, the RBI chose to adopt a wait and watch stance, given the uncertain outlook on the inflation. It retained the CPI inflation projections given in the April policy statement at around 5% for 2016 -17, but with an upward bias for the near term. Meanwhile, on the growth front, the Gross Value Added (GVA) growth projection for 2016-17 has been retained at 7.6% with risks evenly balanced around it.

Moreover, the liquidity measures, which were unveiled in last policy review in April, and overhauled the RBI's liquidity framework, continued with RBI remaining committed to progressively neutralize the liquidity deficit in the banking system. Accordingly, the RBI injected liquidity through purchases under Open Market Operations (OMOs) of Rs. 700 billion during April-May in pursuance of the revised liquidity management framework and address tight liquidity conditions since mid-May. Additionally, liquidity was injected through variable rate repos of various tenors, in addition to the regular 14-day term repos, overnight fixed rate repo and Marginal Standing Facility (MSF). The move helped to reduce volatility in the fixed income market and helped weighted average call money rate to remain anchored to the policy rate within a narrow corridor of +/- 50 basis points.

Outlook

We had not anticipated any rate action in this policy review, but remain optimistic that accommodative stance of monetary policy will continue. In our view, interest rates are expected to move lower over 6 to 9 months period, due to benign inflation. The risks to inflation, are likely to be offset by progress of monsoon, efforts of government to address the supply side inefficiencies and range bound uptick in international crude oil prices amid demand-supply dynamics.

Further, the liquidity, which plays a significant role in governing the trajectory of fixed income market, remains favorable on the back of RBI's new liquidity management framework. The liquidity which broadly has been in deficit for around 5 years now, and was recorded at Rs. 1 lakh crore in deficit on April 5, 2016, improved significantly to under Rs. 10,000 crore deficit by early June, attributed to astute liquidity infusion by RBI through OMOs and reduction in currency with public (seasonal factor during monsoon).

Given improving liquidity and reduction in volatility, we expect higher demand for short term bonds in the near term. The additional liquidity through purchase of government bonds by OMOs, will also lead to higher demand for government securities, with supply expected to remain constant amid government's intention to contain fiscal deficit. This will eventually translate into lower yields for medium to long term bonds.

In our opinion, currently fixed income markets are in sweet spot, supported by presence of liquidity and benign interest rates over a longer period. Further, with increased monetary policy transmission on the back of reduction in small savings rate by the government and RBI's liquidity management, leading rates should soften. The availability of cheaper credit will help in improving the balance sheet of leveraged corporates. Though, we do not rule out further downgrades, but expect that corporate balance sheets should improve over a period, albeit slowly due to availability of cheaper credit and pick-up in consumer demand. This should help in improving the overall outlook of the credit market.

Given, the favorable outlook of both interest rate and credit market, investors are encouraged to choose across duration and credit funds based on their individual suitability. Investors are urged to select funds with portfolio duration longer than their investment horizon as yields are expected to move lower swiftly with the pace of durable liquidity infusion.