Invesco Mutual Fund

Insights – Monetary Policy Review

Third consecutive rate cut with policy stance changing to accommodative

June 7, 2019

With government securing a powerful electoral mandate, the focus has shifted back to slowing economic growth and other challenges faced by the economy. The economic growth as measured by Gross Domestic Product (GDP) slipped to a five-year low of 5.8% in January-March quarter of FY19. Since high real rates act as a barrier to investment & GDP growth, the probability of rate action was high and reaffirmed our views of tighter real rates for efficient allocation of capital and savings/investment. Further, benign inflation and slowdown in global growth made it easier for Monetary Policy Committee (MPC) to change its policy stance from 'neutral' to 'accommodative'. With this rate cut of 25 basis points, the repo rate now stands at 5.75%, lowest in around 9 years (since September 2010). It is a third consecutive rate cut by MPC, so far in the calendar year. The six-member MPC unanimously voted for reducing the repo rate and changing the policy stance to accommodative.

Given that MPC follows inflation targeting regime, which has remained well below its 4% medium-term target, gave policy makers ample room to ease. The headline inflation, measured by Consumer Price Index (CPI), has stayed in the range of 2%-3.7% in last 9 months, with latest inflation recorded at 2.9% in April. The MPC's recent assessment of factors that could have bearing on inflation led it to marginally revise its inflation trajectory for 2019-20. The CPI inflation is now projected at 3.0% - 3.1% for H1 2019-20 and at 3.4% - 3.7% for H2 2019-20, with risks broadly balanced. Its previous policy statement had projected inflation to be in the range of 2.9% - 3.0% in H1 2019-20 and 3.5%-3.8% in H2 2019-20. The policy statement cited various risks to its inflation prognosis, which include uncertainties relating to the monsoon, unseasonal spikes in vegetable prices, international fuel prices & their pass-through to domestic prices, geo-political tensions, financial market volatility and the fiscal scenario.

In a scenario of controlled inflation, the MPC continued to accommodate growth concerns. Recent data suggested weakened economic activity and last two policy rate cuts did not help much to stimulate growth. Various growth projections also came muted in line with the deceleration on the economic front. The MPC revised its GDP growth estimates downwards for 2019-20 to 7.0% from 7.2% in the April policy, in the range of 6.4%-6.7% for H1 2019-20 and 7.2%-7.5% for H2 2019-20 with risks evenly balanced.

Meanwhile, the liquidity conditions within the banking system which had posed concern, showed marked improvement post election results. Liquidity in the system turned into an average daily surplus of Rs. 66,000 crores in early June, after remaining in deficit during April and most of May due to restrained government spending. To address liquidity deficit, the RBI injected liquidity of Rs. 70,000 crores in April and Rs. 33,400 crores in May on a daily net average basis under the Liquidity Adjustment Facility (LAF). Further, it conducted two Open Market Operation (OMO) purchase auctions in May amounting to Rs. 25,000 crores and a US dollar buy/sell swap auction of US$ 5 billion (Rs. 34,874 crores) for a tenor of 3 years in April to inject durable liquidity into the system. The RBI will also conduct an OMO purchase auction of Rs.15,000 crores on June 13, 2019.

On another front, in order to mitigate risks of excessive leverage and with a view to move further towards harmonization with Basel III standards, the RBI has set minimum leverage ratio at 4% for Domestically Systematically Important Banks (DSIBs) and 3.5% for other banks.

Market Outlook

The policy decisions came in line with expectations, although more measures were anticipated from MPC to address the liquidity woes within the Banking, Non-Banking Financial Company (NBFC) and Housing Finance Companies (HFCs) as well. In our view, such measures would have helped in transmission of lower rates for the borrowers which in turn helps in capacity expansion and viability of projects. The decline in interest rates should also help in balancing the overall leverage across sectors and in attracting equity capital as cost of savings & investments move lower.

Taking cues from evolving macro-economic dynamics and accommodative monetary policy stance, we feel that interest rates are expected to remain benign. Inflation, a key determinant of policy action, in our view is expected to stay well within 4% for CY 2020 due to benign oil prices, drop in core inflation and soft food prices. However, drop in repo rate do not always guarantee lower borrowing cost and hence we feel RBI will continue to infuse liquidity so as to help lower the deposit rates of the banks and enabling them to price their loans cheaper.

As the market reposition to a strong political mandate and chances of further repo rate reduction amidst widespread slowdown, we urge investors to start selecting funds in alignment with their investment horizon and selectively longer depending on their individual risk appetite. Hence, an additional duration over the investment horizon should work favorably as the risk return matrix is tilted towards lower rates. The bond yields have already headed lower with 10-year G-sec coming off by 40-45 basis points from last policy review.

The risks to this view emanate from higher government borrowing calendar of FY20. However, it may get neutralized through creation of higher demand for gilts and bonds by infusing liquidity into the system by RBI and or from higher demand from foreign investors amidst global slowdown. The uncertainty around attaining fiscal targets in a general election year had weighed on the market sentiment so far and now the investors look forward to the annual budget next month from the new Finance Minister.