

August 8, 2024



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*On expected lines, status quo on policy rates and stance “withdrawal of accommodation” as growth – inflation dynamics remain in a fair balance. Food inflation remains persistent & elevated and needs monitoring even as core inflation has been benign. Divergence across global central banks rate cycle and 1QFY26 GDP / Inflation projections at 7.2% / 4.4% could mean more wait for domestic first rate cut. No specific concern shown on current banking liquidity surplus and no mention of OMO sales provides immediate relief to market worries. Strength of external factors provides resilience against any global spillovers. Overall, a non-event policy. Market sentiments expected to remain positive amidst comfortable banking liquidity and favorable demand – supply dynamics.*

## Key decisions/Highlights

Four out of six Monetary Policy Committee (MPC) members voted **to keep the policy rate unchanged at 6.50% while 2 members voted to reduce the policy rate by 25 bps.**

The **standing deposit facility (SDF) rate remains unchanged at 6.25%** and the **marginal standing facility (MSF) rate and the Bank Rate at 6.75%.**

MPC by a majority of four out of six members voted to remain focused on **“withdrawal of accommodation”** to ensure that inflation progressively aligns to the target, while supporting growth. Two members voted for change of stance to neutral.

Consumer Price Index (CPI) **inflation projections for FY25 retained at 4.5%** with 2QFY25 at 4.4% (up from 3.8%), 3QFY25 at 4.7% (up from 4.6%) and 4QFY25 at 4.3% (down from 4.5%) assuming a normal monsoon. **Q1FY26 inflation is projected at 4.4%** with risks evenly balanced.

Real GDP growth projections for **2024-25 at 7.2% (retained)** with 1QFY25 at 7.1% (down from 7.3%), 2QFY25 at 7.2% (retained), 3QFY25 at 7.3% (retained) and 4QFY25 at 7.2% (retained). **Q1FY26 GDP is projected at 7.2%** with risks evenly balanced.

## Status quo on policy rates for the ninth consecutive policy review and stance maintained as “Withdrawal of accommodation”

With current fiscal year’s Budget positively setting the undertone for the economy and clearly laying a roadmap for fiscal consolidation, all eyes shifted to monetary policy for further direction. Today’s monetary policy was set in the backdrop of concerns about uneven global growth, growing possibility of early rate cuts by US Federal Reserve amid weak job data and escalating geopolitical tensions. Back home, economic growth remained resilient, however elevated food prices posed a challenge and kept headline inflation higher. Given the fact that economic growth is holding well and MPC remains focused on bringing inflation towards the 4% target on a sustained basis, the decision to hold policy rates steady and retain its “Withdrawal of accommodation” stance came on expected lines.

The MPC vote split on rate cut and stance, however, suggests continued divergence in policy views. However, six-member MPC comprising of three central bank officials and three external members, is recast every four years and will see a reshuffle before next policy review. This could again change the differing policy views.

## Maintaining price stability remains a key priority. Volatility in food inflation is expected to subside with healthy progress in Monsoon

In June’24, Consumer Price Index (CPI) based inflation breached the 5% mark led by higher food prices, which has 46% weightage in the index. Food inflation remained high at 8.36% YoY in June led by high vegetable, cereal and pulses inflation. Vegetable prices have remained elevated even in the month of July and August so far. The volatility in food inflation is expected to subside given above-average Monsoon and healthy Kharif crop sowing so far.

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While the next few prints will come lower due to favorable base effect & healthy monsoon but will then inch up again. Core inflation, on the other end, continued to remain soft & came at 3.15% in June'24 vs 3.12% in May'24 and helped offset the higher food inflation.

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## **Upbeat growth outlook with projection for FY25 retained at 7.2%**

The MPC sounded optimistic on growth with real GDP growth projections retained above 7% across time periods. Q1FY26 GDP is projected at 7.2%. Indian economy continues to demonstrate strength from healthy investment cycle, strong bank lending, green shoots in rural demand, supportive urban consumption on the back of sustained buoyancy in services activity. The healthy growth momentum gives room to RBI to remain resolute on its commitment of anchoring inflation.

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## **A swift and flexible approach to liquidity management is positive for debt markets**

System liquidity turned from deficit in June to surplus conditions in July. The policy was critical with respect to further guidance on liquidity measures given that the recent banking liquidity has surged to more than Rs. 2.5 lakh crores and RBI's Variable Reverse Repo Rate (VRRR) auctions to suck liquidity is not yielding much results as the overnight Tri Party Repo (TREPS) continue to hover below the policy rate. Also, since RBI had undertaken Open Market Operation (OMO) sales in previous 3 weeks, no mention of OMO sales in policy review and no specific concern shown on current surplus banking liquidity, provides immediate relief to market worries. However, RBI Governor acknowledged that liquidity management challenges could arise due to gap between deposit growth and credit expansion. We feel that lesser T-bill supply and budgeted cash drawdown of Government's cash balance as indicated in FY25 Budget, will help in aiding banking liquidity. Even as the systemic liquidity is expected to improve, it may stay within RBI's comfort zone i.e. within 1.5% of Net demand and time liabilities (NDTL) in FY25. However, intermittent systemic liquidity may increase till festival season and is expected to neutralize thereafter.

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## **Current growth-inflation dynamics provide room to RBI to stay focused on inflation control; wait for rate cut to get longer**

Many Key Central banks have already commenced the rate cut cycle and US is also highly likely to begin the rate cuts in next policy meet due in September 2024. At the same time, Bank of Japan, has started the much-awaited rate tightening, repercussions of which may be felt by global markets. Global commodity prices both industrial as well as agricultural have declined by 10% - 20% from their recent highs and bodes well for global inflation trajectory. However, domestic inflation continues to remain elevated with food inflation imparting upward pressure on headline inflation. Even as the monsoon has picked up well and is expected to be normal, Governor clearly articulated that the current elevated food inflation has a risk of becoming persistent, thereby de-anchoring household's inflation expectations. As the headline inflation may remain above the targeted 4% even till 1QFY26, we expect RBI to stay cautious on inflation and continue with its data dependent approach. We believe that RBI will be able to get better clarity by CY2024 end in terms of monsoon and the domestic food inflation, and if the global uncertainties recede by then, MPC may look to pivot towards the commencement of rate cut cycle.

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## Market Movement

Segment	Broad movement of yields in bps (as on August 8, 2024)	
	G-Sec	AAA Corporates
3 months	0 bps	0 bps
6 months	0-1 bps	0-1 bps
1 year	0-1 bps	0-1 bps
2 -3 years	+2 bps	+1 to 2 bps
4 - 5 years	+1 bps	+1 to +2 bps
10 years	+1 bps	+1 to +2 bps
14 years	+1 bps	NA
30 years	+1 bps	NA

Source: Bloomberg

## Fixed Income Market remains in a Sweet spot

With fiscal metrics at their most favourable levels and inclusion of Indian sovereign bonds to JP Morgan's EM Bond Index, the convergence of monetary policy outcome with market expectations will add to the positive sentiments for Fixed Income market. We believe that both short end and long end of the yield curve remain attractively placed. Investors can look to invest in fixed income funds for stability and building a diversified portfolio. We feel that current elevated short-term yields provide an opportunity to benefit from higher carry. With reduction in T-bill supply, the net T-bill supply is negative Rs. 50,000 crores in FY25, thereby lowering the supply by Rs. 1 lakh crores. Further, Government has budgeted to draw down Rs. 1.37 lakh crores from its cash balance which is largely on account of the fiscal saving achieved in FY24. This will help in releasing banking liquidity and will drive down the short end yields.

Long dated bonds look attractive on demand-supply dynamics and as India will also enter rate cut cycle. We believe investors can look at increasing allocation, depending on the risk appetite, toward funds like Gilt fund, Medium duration fund, Corporate bond fund, Banking & PSU fund etc. Markets, being forward looking will react much in advance to the expected policy stance change followed by rate cut cycle thereby upfronting the returns through spread compression over policy repo rate. Active fund management is critical as uncertainties may emanate from domestic inflation, volatility in global crude oil prices and geo-political risks which may influence various yield curve segments differently.

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