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Against the backdrop of challenging global monetary policy outlook, MPC delivers second consecutive pause on policy rate indicating increasing comfort on external resilience as well as domestic growth - inflation dynamics. Stance still maintained as “withdrawal of accommodation” to keep flexibility against any negative surprises on global front and monsoon; only to be changed to Neutral later. Overall, a pause as expected with lesser likelihood of further rate hikes. Nonetheless, a long wait for rate cut cycle as inflation remains higher than the 4% target.

Key decisions/Highlights

Monetary Policy Committee (MPC) members unanimously decided to **keep the policy rate unchanged at 6.50%**.

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 five out of six members voted to remain focused on **“withdrawal of accommodation”** to ensure that inflation progressively aligns with the target, while supporting growth.

Consumer Price Index (CPI) inflation projected at 5.1% (down from 5.2%) **in 2023-24 with Q1 projected at 4.6% (down from 5.1%), Q2 at 5.2% (down from 5.4%), Q3 at 5.4% (retained) and Q4 at 5.2% (retained).**

Real GDP growth projections for **2023-24 at 6.5% (retained) with Q1 is projected at 8% (up from 7.8%), Q2 at 6.5% (up from 6.2%), Q3 at 6% (down from 6.1%) and Q4 at 5.7% (down from 5.9%).**

MPC keeps the policy rates unchanged in line with expectations; Policy stance maintained at “withdrawal of accommodation” – largely a non-event policy

Today's MPC was setup in the backdrop of a sharp change in global monetary policy outlook with rising likelihood of further rate hike by US Federal Reserve, European Central Bank (ECB) and unexpected rate hikes recently undertaken by Bank of Australia & Canada to tame the inflation. However, in line with our expectations, India's increasing strength on external factors and moderation in domestic inflationary factors has provided comfort to MPC to maintain a pause.

It was a much debated issue whether MPC would revise the policy stance to Neutral in this policy. The policy statement sounded a little more hawkish than expected and comes with a note of caution as committee constantly emphasized that current easing in inflation is not enough, and uncertainty prevails on future trajectory as inflation continues to remain above its medium-term inflation target of 4%. Accordingly, MPC maintained the stance as “withdrawal of accommodation” given that uncertainties on global front & monsoon might have a bearing on growth-inflation trajectory.

Inflation projections lowered further by 10 bps factoring in recent downward trend

The effect of monetary tightening (repo rate hike by cumulative 250 bps since May 2022) along with moderation in global commodity prices in the past year is now becoming evident on the inflation trajectory. The CPI inflation fell to an 18-month low of 4.7% in April, owing to decline in food inflation and favourable base effect. Further, core inflation has also eased from 5.9% in March to 5.3% in April with broad based moderation.

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Today's inflation commentary was more comforting than last time citing recent downward trend, health rabi crop, moderation in global commodity prices and RBI marginally revised down the inflation projection by 10 bps to 5.1% for FY24. However, caution was maintained on monsoon which can impact the inflation trajectory, though a bit early to start getting jittery on that front as of now.

Growth dynamics remain resilient to global backdrop

India's economic activity continues to remain stable and resilient. The FY23 real GDP came in at 7.2% which was better than the earlier projection of 7%. For FY24, growth dynamics remain strong and draws strength from various factors such as improving household consumption & investment, expanding purchasing managers' index (PMI) and high frequency indicators, strong passenger vehicle sales figures, buoyant credit growth, continued focus of government on infrastructure, and revival in corporate investments. The economic growth gains momentum from its macroeconomic fundamentals, however, downside risks to growth outlook may emanate from geopolitical tensions, weak external demand, volatile global financial market and possible impact of El Nino.

Healthy growth indicators gives room to RBI to stay cautious on inflation trajectory and look towards achieving a targeted 4%.

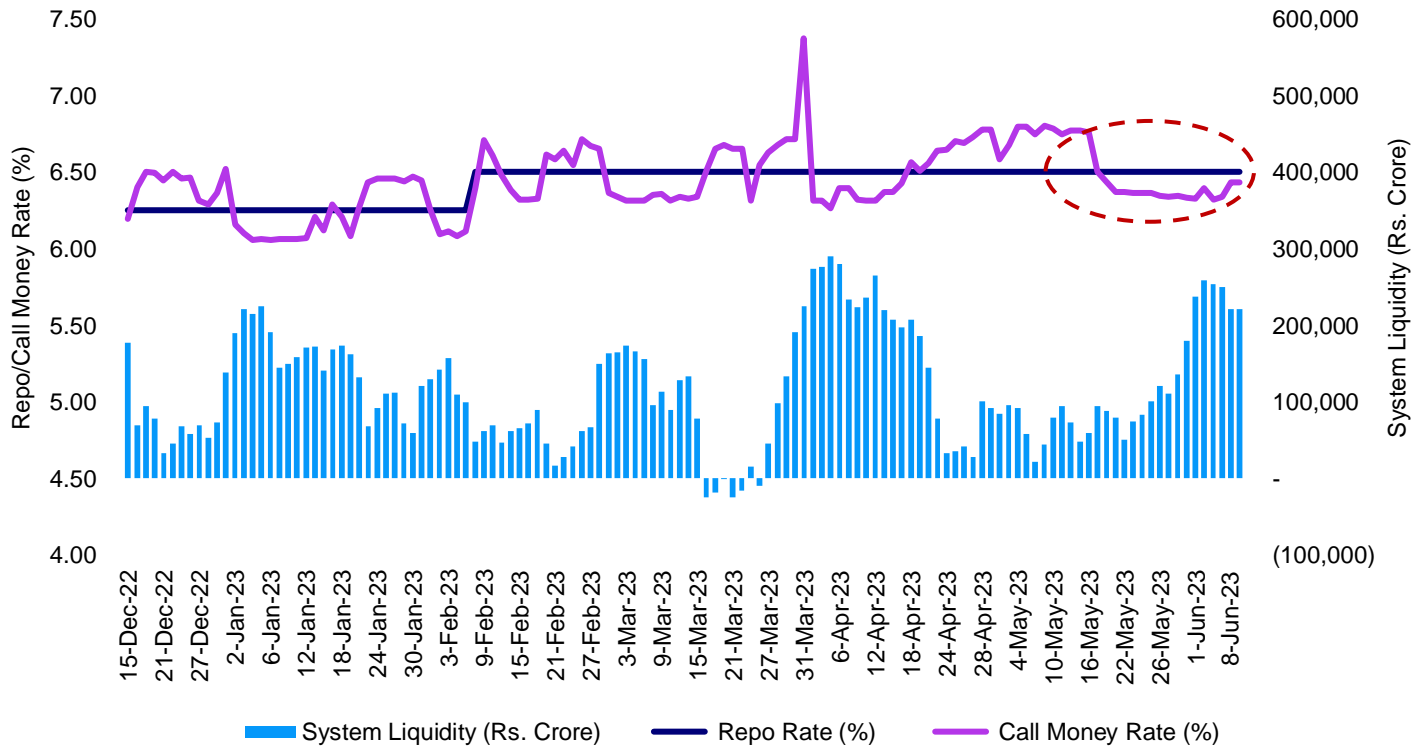
Comfortable liquidity as of now; RBI stands ready to avoid any extremes

Liquidity has improved over last month with increasing foreign portfolio investment (FPI) inflows, higher government expenditure on back of RBI's dividend and aided by deposits of Rs. 2,000 currency notes. Going forward also, liquidity is expected to remain comfortable despite upcoming advance tax and GST outflows as liquidity will be aided by further deposits of Rs. 2,000 currency notes (~50% of outstanding notes deposited so far) and upcoming monsoon months which traditionally reverses the currency in circulation leakages.

Governor's statement and his comments later in press conferences made it sufficiently clear that RBI will continue to keep a vigilant eye on liquidity and remain nimble in its liquidity management operations. In past RBI conducted both variable rate repo (VRR) & variable rate reverse repo (VRRR) auctions to smoothen the system excess & deficit and we anticipate it will continue to do so going forward. RBI conducted a 14-day VRR auction amounting to Rs. 50,000 crore on 19th May when some banks were resorting to borrow from MSF window, which led to cooling of overnight rates.

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Subsequently, RBI also took swift and continuous set of VRRR auctions this week when liquidity shot up sharply. In the press conference, Governor has specifically indicated that RBI would undertake liquidity operations through VRR & VRRR to ensure that overnight call money market rates stay close to the policy repo rate at 6.5%. This provides clarity & also stability to the short end of rates as TREPs is expected to remain in a narrow range close to repo rate.



Source – Bloomberg

Stance maintained as “Withdrawal of accommodation”, to maintain flexibility against any negative surprises; we expect no more rate hikes as external situation improves considerably; domestic monsoon holds the key

MPC has kept the rates unchanged but has continued to maintain “withdrawal of accommodation” stance which indicates possibility of further rate hike. We believe RBI has maintained the stance to retain the flexibility against any negative surprises from global monetary policy actions and to gauge the impact of monsoon on domestic inflation trajectory. Through this stance, RBI is signaling the market that they will maintain its constant vigil on inflation & other macro-economic indicators and not get complacent with the expected moderation in inflation over next few months.

India’s external strength remains healthy given the improving current deficit, increasing FPI inflows, growing services export, stable INR, comfortable forex reserves etc. If this sustains, India is in a good place to withstand global pressures, and this should provide comfort to MPC on monetary policy front. The current policy rate at 6.5% and future CPI inflation projection at ~5.1% gives a healthy ~1.4% positive real interest rate for now which should provide cushion to an extent.

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Going forward, the future rate actions would be driven by domestic inflation especially food inflation prints on back of success or failure of monsoon. The El Nino concerns can be seen from the inflation projections made by RBI, where they have retained the projections for Q3 and Q4 while significantly lowering it in H1FY24. We believe, efficient food supply management by government and moderation in global commodity prices should provide some comfort to inflation path. Given this backdrop, we believe RBI is unlikely to hike rates any further and has now moved to an extended pause. We feel that future rate action will remain data-dependent and any negative surprises from global macros/domestic inflation may push rate cuts to distant future. Accordingly, policy rates are expected to remain **“Higher for Longer”** as domestic growth-inflation dynamics may not provide any room for rate cuts in 2023.

Market Movement - Upward movement in yields with flattening bias

Segment	Broad movement of yields in bps (as on June 08, 2023)	
	G-Sec	AAA Corporates
3 Months	0 to +3 bps	+3 to +5 bps
6 Months	0 to +1 bps	0 to +1 bps
1 year	0 to +1 bps	0 to +1 bps
2 -3 years	+ 5 bps	+4 to +5 bps
4 - 5 years	+ 5 bps	+3 to +4 bps
10 years	+ 4 bps	+3 to +4 bps
14 years	+ 3 bps	NA

Source: Bloomberg

Post the policy, market rates hardened across the curve as some part of market was expecting a policy stance change to “Neutral” and also as Governor re-instated severally the intention to achieve 4% inflation target thereby delaying the rate cut expectations. Today’s market movement should also be seen in the backdrop of sharp overnight upward movement in developed market rates by ~10 – 15 bps across the curve as Bank of Canada carried out an unexpected rate hike.

Over last month or so, a clear divergence in rate movements has emerged with Developed Countries rate hardening by ~50-60 bps as their Central banks are expected to continue with rate hikes to rein in inflationary pressures while the Emerging Market countries like India, Indonesia and many others have seen a moderation in rates with cooling down inflation & improving external stability.

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With the peaking of policy interest rates, investors can benefit from opportunities across the curve; active management better suited as rate cut cycle is still away

We believe policy rates have peaked out which opens the space for entire yield curve. This gives investors an opportunity to look at various points of rate curve to meet their asset allocation requirements. Having said that, active management across the yield curve is critical as other uncertainties may emanate from global backdrop, domestic inflation, & more critically fiscal supply and these may influence various yield curve segments differently.

Our fund positioning will be guided by evolving market dynamics as well as individual fund's mandates. At the current juncture, we feel that policy rates are expected to remain "Higher for Longer" given the current growth-inflation dynamics. Thus, we believe investors should look at the fixed income investments more constructively and benefit from the elevated yield curve to maintain high accrual without even taking excessive market risk. Risk averse investors may look at the 6 months to 1 year segment of the yield curve amidst expectations of neutral liquidity & peak policy rates. Investors may look at the 2 to 5 years segment as their core allocation, as this part of the yield curve remains well placed from carry perspective. To us, it is a sweet spot on the yield curve –as it provides opportunity to capture prevailing high yields while getting less impacted by the volatility at the longer end. Credit environment remains healthy, however current narrow spreads of AA / AA+ over AAA bonds do not provide favorable risk adjusted reward opportunities and accordingly high credit quality-oriented debt funds should be a preferred choice as of now.

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