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Amidst a challenging backdrop of elevated global rates & volatile commodity prices, MPC maintains a 4th consecutive pause on policy rates as domestic inflation trajectory moderates. Stance still maintained as “withdrawal of accommodation” to keep a guard high against any domestic inflation worries. Indication of G-Sec OMO Sales for liquidity management has spooked the market and clearly indicates MPC’s resolute to reach 4% inflation target. Q1FY25 projected inflation at 5.2% points to a delayed rate cut cycle. Overall, a more hawkish policy than expected although the likelihood of any more rate hike still remains remote.

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 **5.4% (retained)** in **2023-24** with, **Q2 at 6.4% (up from 6.2%)**, **Q3 at 5.6% (down from 5.7%)**, **Q4 at 5.2% (retained)** and **Q1: 2024-25 at 5.2% (retained)**

Real GDP growth projections for **2023-24 at 6.5% (retained)** with **Q2 at 6.5% (retained)**, **Q3 at 6% (retained)**, **Q4 at 5.7% (retained)** and **Q1: 2024-25 at 6.6% (retained)**

RBI may consider **OMO-sales** (Open Market Operation sales) **to manage liquidity**, the timing and quantum of such operations will depend on the evolving liquidity conditions

MPC maintained status quo on policy rates in line with market expectations but spooked the market on indication of OMO sales for liquidity management

Today’s MPC was setup amidst more challenging global as well as domestic backdrop. On global front, treasury yields hardened sharply across developed markets with US 10-year treasury yield hitting 16 years high and breaching 4.85% mark. The spike in treasury yields led dollar strengthening against major currencies with dollar index trading above 107 (a fresh peak for the current year) compared to ~100 few months ago. The crude oil prices remained elevated on back of tighter supply outlook due to OPEC’s extended oil production cut. On policy front, the global central banks of US, UK and eurozone have hinted that they will keep interest rates high in order to tame inflation and have adopted a “Higher for longer” stance.

Domestically, FPIs inflows which were positive from April to August’23 turned negative in month of September owing to rising bond yields in the US and a stronger dollar. Current account deficit (CAD) widened to \$9.2 billion (1.1% of GDP) in Q1FY24, from \$1.3 billion (0.2% of GDP) in the previous quarter, with further widening expected on elevated crude oil prices coupled with weak global growth.

Despite these headwinds, we had expected MPC to maintain a pause on policy rate as inflation is likely to moderate in H2FY24 and fall in line with RBI’s projections.

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The status quo on interest rate and policy stance was in line with expectations, but policy statement sounded more hawkish amid indications of open market operation (OMO) sales in order to manage liquidity and strong emphasis on bringing inflation to target of 4% (and not only 2% to 6%). This took the market participants by surprise as it indicates RBI's preference on maintaining tighter liquidity conditions. Meanwhile, MPC decided to maintain the stance as "withdrawal of accommodation" given the incomplete transmission of past 250 bps rate hikes to bank lending & deposit rates and to guard against any negative surprises on domestic inflation front.

Inflation projections retained for FY24; Q1FY25 inflation at 5.2% remains elevated

The CPI inflation for month of August eased more than expected to 6.83% from 7.44% in July. The headline inflation is expected to cool down further in near term on back of correction in vegetable prices and reduction in LPG prices. The MPC also took comfort from declining core inflation which has seen easing of 140 bps from its peak in January 2023. Further, the past policy actions coupled with supply side interventions by the government have helped ease inflation over time and is expected to further moderate going ahead. Owing to these factors, MPC lowered its near-term inflation projections while retaining its FY24 projections at 5.4% and Q1FY25 at 5.2%. The MPC has attributed inflationary risks due to volatile energy and food prices amidst lingering geopolitical tensions and adverse weather conditions. The Governor emphasized close vigil on incoming data and readiness to take actions to prevent any spillovers from food and fuel price shocks to underlying inflation trends.

Growth dynamics holding well; giving room to MPC to focus on inflation

India's growth momentum continues to remain resilient on back of strong domestic demand. The growth outlook remains strong and draws strength from revival in rural demand, healthy balance sheet of corporates and banks, buoyant service sector, expanding manufacturing purchasing managers' index (PMI), robust investment activity and healthy services exports. The upcoming festival season is also expected to provide further support to economic growth. The downside risks to growth outlook may emanate from geopolitical tensions, global economic slowdown, volatile global financial markets and uneven monsoon. The healthy growth momentum gives room to RBI to remain resolute on its commitment of anchoring inflation to 4% target.

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Liquidity management through OMO sales spooked market participants

Amongst all the key monitorable, MPC's actions on liquidity management was possibly the most critically watched by market as liquidity had turned deficit over last few weeks with incremental cash reserve ratio (I-CRR) and advance tax / GST outflows. While the liquidity conditions were expected to ease going forward as Central Government spending kicks in and last tranche of I-CRR is withdrawn. RBI surprised the market by the announcement of using G-Sec OMO-sales as a liquidity tool to actively manage the systemic liquidity. This indicates RBI's preference to tighter liquidity conditions going ahead which has lead to hardening of yields across the curve. It has left the market guessing for the quantum of OMO-sales, tenor of securities to be sold as well as the timing of such OMO-sales.

While any rate hikes are less likely, rate cut cycle gets further pushed down

Global factors have worsened over last month as market rates in many developed countries remain on upward trajectory, putting pressure on currencies. Elevated crude prices have further added to the concerns. US FOMC's future policy action is data dependent and incoming data on growth/inflation/jobs continues to stow mixed trends. Domestic rate environment has also become relatively more challenging with inflation concerns led by volatile food prices, incrementally higher current account deficit and slowdown in FPIs inflow due to global uncertainties.

Amidst a challenging backdrop, MPC in its October policy maintained a pause on policy rates while still retaining stance as "withdrawal of accommodation" to keep its guard high against any domestic inflation worries. Q1FY25 projected inflation at 5.2% points to a delayed rate cut cycle, pushing the possibility of rate cuts to H2FY25. While the MPC was more hawkish than expected, we believe MPC will maintain a long pause at current policy levels as Inflation is expected to maintain its downward trajectory over next few months. Instead, MPC may actively use its liquidity tool including OMO sales to anchor inflation expectations.

Market Movement - Yields have jumped by 10-15 bps across the curve on anticipation of tight liquidity and OMO sales overhang

Segment	Broad movement of yields in bps (as on October 06, 2023)	
	G-Sec	AAA Corporates
3 Months	+0 bps to +2 bps	+2 bps to +4 bps
6 Months	+0 bps to +2 bps	+2 bps to +4 bps
1 year	+0 bps to +2 bps	+0 bps to +2 bps
2 -3 years	+15 bps	+10 bps to +12 bps
4 - 5 years	+15 bps	+10 bps to +12 bps
10 years	+13 bps	+10 bps to +12 bps
14 years	+12 bps	NA

Source: Bloomberg

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Active management better suited as many uncertainties may unfold and as rate cut cycle is still far away

With the negative market reaction of 10-15 bps across the yield curve post MPC due to OMO sale overhang, domestic rates have surged back to the 2023 beginning levels with 5 – 10 year G-Sec now in the range of 7.35% - 7.40%. We believe, India's current fundamental situation is much better than that in early 2023 and the recent surge in market rates provide an attractive entry point to investors, especially in 2 to 5 year duration segment. Near-term volatility may remain high as market waits for a direction on RBI's liquidity management coupled with global rate & currency movement. Nonetheless, any large upside on yields is expected to be limited on the back of resilient domestic economy, India's inclusion in global bond indices. Inclusion in JP Morgan index alone can prompt inflow of more than USD 25 bn over next 2 years thereby lowering market yields and also support the currency. It may also open doors for inclusion in other global debt indices. Timing couldn't have been better as the global backdrop has become more challenging with elevated rates, surge in crude prices and currencies under pressure. However, active fund management is critical as uncertainties may emanate from domestic inflation, fiscal supply and global backdrop which may influence various yield curve segments differently. Credit environment remains healthy and selective AA / AA+ rated exposure can be explored at fair credit spreads.

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