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*One of the trickiest policies amidst the global rate cut cycle, slowing down global & domestic growth, moderating inflation but elevating geopolitical risks & food inflation. MPC finds a fine balance with the status quo on rates but changes the stance to 'Neutral'. Despite the recent moderation, FY25 growth–inflation projections retained at 7.2% / 4.5% reflecting a caution on inflation. Strong commentary on healthy external factors provides comfort on resilience against global spillovers from Middle East tensions. Overall, a sentiment-boosting policy with a high likelihood of commencement of rate cut cycle over the next few months, though data dependent. Recently hardened yields provided an opportunity to add duration as already favourable demand-supply dynamics get supplemented by increased expectations on the rate cut cycle*

## Key decisions/Highlights

Five out of six Monetary Policy Committee (MPC) members voted to **keep the policy rate unchanged at 6.50% while 1 member 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 **unanimously voted to change the stance** from “withdrawal of accommodation” to “**Neutral**” and to remain unambiguously focused on a durable alignment of inflation with the target, while supporting growth.

Consumer Price Index (CPI) **inflation projections for FY25 retained at 4.5%** with Q2FY25 at 4.1% (down from 4.4%), Q3FY25 at 4.8% (up from 4.7%) and Q4FY25 at 4.2% (down from 4.3%). **Q1FY26 inflation is projected at 4.3%** (down from 4.4%) with risks evenly balanced.

Real GDP growth projections for **2024-25 at 7.2% (retained)** with Q2FY25 at 7.0% (down from 7.2%), Q3FY25 at 7.4% (up from 7.3%) and Q4FY25 at 7.4% (up from 7.2%). **Q1FY26 GDP is projected at 7.3% (up from 7.2%)** with risks evenly balanced.

## One of the trickiest policy announcements in recent times given the mixed global and domestic dynamics but MPC finds a fine balance by maintaining status quo on rates and changing the stance to 'Neutral'

MPC's earlier few policies had come out to be more hawkish than market expectations as RBI maintained its close watch on headline inflation due to elevated food prices, even as the core inflation remained confined at 3.2% - 3.3% for many months. Robust domestic growth & evolving global monetary policies had given room to RBI to stay focused on inflation controlling measures.

A lot of developments have taken place since the last monetary policy announcement in August'24. US Fed joined the rate cutting bandwagon by delivering an outsized rate cut of 50 bps with the guidance of more rate cuts over next few policies. The start of easing cycle by US clearly reflects shift in focus to support job market and economic growth as inflation expected to gradually recede to targeted levels and does not warrant any further tightening measures. While almost all other developed market Central Banks have already taken such shift and commenced upon the rate cut cycle, US rate cut is the most critical one and paves way for emerging markets to kickstart the easing cycle. Amongst emerging markets, China, Philippines and Indonesia have recently surprised with rate cuts in order to support domestic growth. Even Bank of Japan, which was the only bank on tightening side, has taken a dovish stance on future rate hikes. In essence, global Central Banks have turned their focus on growth supportive measures as inflation no longer remains a worry.

On domestic front, growth which had been holding high has shown some signs of moderation as the recent high frequency indicators like falling PMIs, auto sales, GST collections, core industry growth turning negative, etc. point towards a slowdown. Inflation data for past two months has been below 4% however risks to food inflation continue to persist.

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Today's monetary policy announcement was set up in the backdrop where the domestic growth – inflation dynamics has turned more favourable for an easing monetary policy, in line of the global direction which could have nudged the MPC to turn dovish and signal an easing rate cycle going forward. However, at the same time, few factors like a) recent escalation in middle east tension has put pressure on energy prices, b) China's recent measures to kick start its economy has flared up the industrial commodity prices, c) US elections due in November 2024 and d) US's recent robust report on non-farm payroll may give enough reasons to MPC to stay cautious and maintain a hawkish narrative.

This policy decision was one of the trickiest as RBI had to find a balance between domestic dynamics while being cognizant of the global factors and geopolitical risks. It was also a first MPC meeting with 3 new external MPC members. The RBI delivered on this front by opting to keep interest rates unchanged while shifting its stance to neutral.

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### **Growth projections retained at 7.2% for FY25, despite recent slowdown; H2FY25 becomes critical to meet the projections**

Domestic growth has been robust on the back of strong Government capex and required no monetary support as such. In fact, the whole of FY24 saw multiple upgrades in growth projections as FY24 GDP clocked 8.2% against the initial RBI's projection of 6.4%. Given this, some growth slowdown was apparent. Q1FY25 GDP came in at 6.7% against the RBI's projection of 7.1% - possibly a first miss. One can still give it a benefit of doubt that it was due to lesser Government capex during election season, but even the recent high frequency indicators like falling PMIs, auto sales, GST collections, core industry growth turning negative, etc. point towards a slowdown. Despite the recent slowdown, RBI retained the growth projections at 7.2% on back of increased Government's capex spends post election, expected improvement in rural demand owing to above normal monsoon, supportive urban consumption and healthy investment cycle. It would be critical to be watchful of incoming data to gauge the growth trajectory going ahead.

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### **Inflation momentum moderating, food inflation worries recede to an extent**

The CPI based inflation for July'24 and August'24 eased sharply to 3.54% and 3.65% respectively from 5.1% in June'24 owing to favourable base effect & low core inflation. Food inflation also softened in these two months to an average 5.5% from 8.4% in June'24. Since the last MPC, monsoon has come out to be better (5% above long term average), higher Kharif crop sowing (1.9% y-o-y) and higher reservoir level (18.3% y-o-y) which bodes well for next Rabi crop sowing. While some excess rainfall in September has put pressure on tomato & onion prices and next few CPI readings may come above 5% mainly due to unfavorable base effect. The headline inflation trajectory is expected to sequentially moderate from Q4FY25 onwards. Monetary Policy Report has indicated that FY26 average inflation may turn out to be 4.1% - very close to long term target. Having said that, the ongoing global turmoil would have an impact on energy and commodity prices which in turn could have a bearing on headline inflation and warrants close monitoring.

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## RBI to stay nimble on liquidity management; banking liquidity has turned surplus

System liquidity remained in surplus during August-September'24 and early October'24, with a pickup in Government spending and decline in currency in circulation. Further, a bond buyback of Rs. 25,000 crore is scheduled on October 10, 2024, targeting securities maturing in FY26. This is expected to release further liquidity in the system. This coupled with strong Foreign Portfolio Investment (FPI) inflows and G-sec maturities in November'24 is expected to keep liquidity in surplus over the next two months. RBI is expected to continue managing liquidity through both main and fine-tuning operations as necessary to uphold favourable money market conditions.

## "Actions speak louder than words" – The market reaction indicates that RBI action of stance change was more dovish than the commentary

G-Sec yields had hardened sharply over last few days before the policy as the Israel – Iran tensions worsened & as crude prices surged in fear of oil supply destruction from Iran. Despite the recent moderation in growth and upside risks to inflation due to geo-political events, the growth – inflation projections were maintained for FY25. However, the change in stance from "Withdrawal of accommodation" to "Neutral" came as a surprise to market and triggered a rally across the curve.

| Segment     | Broad movement of yields in bps (as on October 9, 2024) |                  |
|-------------|---|------------------|
|             | G-Sec   | AAA Corporates   |
| 3 months    | -2 bps to -4 bps  | -2 bps to -4 bps |
| 6 months    | -2 bps to -4 bps  | -2 bps to -4 bps |
| 1 year      | -3 bps to -5bps   | -3 bps to -5 bps |
| 2 -3 years  | -4 bps  | -5 bps to -7 bps |
| 4 - 5 years | -4 bps  | -4 bps to -5 bps |
| 10 years    | -4 bps  | -2 bps to -3 bps |
| 14 years    | -4 bps  | NA               |
| 30 years    | -1 bps  | NA               |

Source: Bloomberg

## Strong external factors provide resilience against global spillovers

India's external sector indicators have remained resilient with manageable current account deficit (CAD), strong FPI flows (~USD 15 billion in this fiscal till October 7, 2024) and robust forex reserves of more than USD 700 billion. These strong external factors are expected to provide cushion to absorb global spillovers. The Middle East tensions between Israel & Iran have led to a quick surge in brent crude prices from the recent low of below \$ 70 per bbl to now close to \$ 80 per bbl. While we keep a close watch upon evolving situation, any further sharp increase in crude prices is expected to be limited given that Iran accounts for only 3%-4% of global crude supply and crude demand itself is expected to taper with global growth slowdown. Interestingly, brent crude prices were at similar levels during last MPC meeting in August'24 and Government had last cut down the diesel / petrol pump prices in March'24 when brent crude was ~ \$ 85 per bbl.

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## **Fiscal demand – supply dynamics remain favourable**

Fiscal demand – supply dynamics has remained buoyant in FY25 so far on the back of fiscal consolidation and huge demand from foreign as well as domestic investors. Foreign investors have pumped in more than Rs. 75,000 crore in domestic debt in H1FY25 with a monthly average of ~Rs. 20,000 crore since G-Sec inclusion in JP Morgan global debt index in June'24 - far exceeding the market expectations. Even including the State Development Loan (SDL) supply, overall Statutory Liquidity Ratio (SLR) demand is expected to outstrip the net supply in FY25. Additionally, Central Government has been able to utilize only 27% of budgeted FY25 fiscal deficit till August'24 as against ~36% last year. While Government's capex spend is expected to pickup post election, it may still be a tall task for Government to meet the budgeted capex spend of FY25 which will require ~40% y-o-y growth in remaining months of FY25 (as against budgeted capex growth of ~17% in FY25). With higher cash accumulation, Government in consultation with RBI is prudently reducing the borrowing through reduced T-bill supply (Q3FY25 T-bill calendar came lesser than expected) and recently Government announced buy back of Rs. 25,000 crore of G-Sec maturing in FY26.

Recent announcement of G-Sec inclusion in Financial Times Stock Exchange (FTSE) Russell Emerging Market Debt index also adds to the overall positive momentum. Now G-Sec is included in all the three major Emerging market indices – JP Morgan, Bloomberg & FTSE Russell and inclusion is staggered over next 1.5 years which will keep up the foreign investors buying momentum.

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## **Recent hardening in domestic yields seems to be overdone; provides entry opportunity**

G-Sec yields had hardened sharply by 10-12 bps across the curve after the escalation in Middle-east rift as crude prices surged in fear of obstruction of Iran crude supply. We believe it was an over-reaction as domestic demand-supply dynamics continue to remain extremely healthy. Now with MPC's dovish narrative for easing of rate cycle, yields are expected to moderate, and we believe current elevated yields provide an entry opportunity for investors across the yield curve. Short end of the yield curve is expected to get the benefit of surplus banking liquidity and reduced T-bill supply while the long end of the yield curve is expected to reap the benefit of robust demand from investors like insurance companies, National Pension System (NPS), Employees' Provident Fund Organisation (EPFO) etc. 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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