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In line with our expectations, RBI moderated the policy rate hike to 35 bps and continued with “withdrawal of accommodation” stance signaling further room for rate hike. Resilient domestic growth provides flexibility to maintain tight vigil on inflation trajectory amidst global as well as domestic uncertainty. Global factors remain critical for policy action. Overall, marginally hawkish commentary than the market expectations. Future rate actions to be more data dependent with a possibility of reaching towards an end of rate hike cycle.

Key decisions/Highlights

Five out of six members of Monetary Policy Committee (MPC) voted to **increase the policy rate by 35 bps at 6.25%**.

The **standing deposit facility (SDF) rate** stands adjusted to **6.00 %** and the **marginal standing facility (MSF) rate** and the **Bank Rate** to **6.50%**.

MPC by a majority of 4 out of 6 members voted to continue with “**withdrawal of accommodation**” to ensure that inflation remains within the target going forward, while supporting growth.

Consumer Price Index (CPI) inflation projection is retained at **6.7% in 2022-23 with Q3 at 6.6% (up from 6.5%); and Q4 at 5.9% (up from 5.8%), with risks evenly balanced. CPI inflation for Q1FY24 is projected at 5.0% (retained) and for Q2FY24 at 5.4%.**

Real GDP growth projections for **2022-23 at 6.8% (down from 7%), with Q3 at 4.4% (down from 4.6%) and Q4 at 4.2% (down from 4.6%), with risks evenly balanced. Real GDP growth for Q1:2023-24 is projected at 7.1% (down from 7.2%) and Q2 at 5.9%.**

MPC **restored the market hours - from 9.00 am to 5.00 pm** - in respect of call/notice/term money, commercial paper, certificates of deposit and repo in corporate bond segments of the money market as well as for rupee interest rate derivatives in a move towards normal liquidity operations.

The dispensation of enhanced **Held-to-maturity (HTM) limit of 23% for banks has been extended up to March 31, 2024**. The HTM limits would be restored from 23% to 19.5% in a phased manner starting from the quarter ending June 30, 2024.

MPC lowers the quantum of rate hike to 35 bps; a welcome re-confirmation to market expectations

December MPC is setup in the backdrop of relatively benign global backdrop with many Global Central Banks shifting away (or expected to) from jumbo rate hikes to a moderate one, lowering global interest rates as well as commodity prices and most critically, relatively stable currency market with USD weakening to an extent. MPC's rate hike of 35 bps was in line with market expectations and is the lowest quantum in the current rate hike cycle (40-50 bps rate hike in last four policies). The policy statement and subsequent media interaction provided a welcome re-confirmation on returning to a more normal market state from the unprecedented rate hikes over last few policies. This policy announcement was a critical one as market participants keenly awaited to know the direction of future course of rate action as major central banks are shifting to a more calibrated and data driven pace of tightening. The MPC so far has hiked Repo rate by cumulative 225 bps since April 2022 in order to reign in inflation taking the rates back to the level seen in February 2019.

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Inflation commentary more hawkish than market expectation is marginally negative

Market participants were expecting a balanced commentary from RBI on inflation given the recent softening of global commodity & crude oil prices and the likely moderation in domestic food inflation in winter season. However, RBI continued to maintain its caution on inflation highlighting the sticky core inflation, higher pricing power with companies to pass on the cost as domestic demand remain healthy and global uncertainties that can pose upside risks to the inflation trajectory. Retaining FY23's inflation projection at 6.7% and 1HFY24's inflation projection at 5.2% reflects that the inflation may take longer to reach closer to the long-term inflation target of 4% and hence a caution. We believe RBI would maintain its tight vigil on inflation (including core inflation) and try to bring it below 6% as a first step and then reach closer to the long term target of 4% over a period of time.

Resilient domestic growth provides flexibility to RBI to maintain tight vigil on inflation

RBI has toned down the FY23 growth forecast marginally from 7% to 6.8% largely on the concerns of global growth slowdown while the domestic factors remain healthy. Near term headwinds can come from extended geopolitical tensions and tightening global financial conditions which can pose downside risks to growth. Nonetheless, RBI Governor sounded confident about India's growth story and mentioned that India will still be among the fastest growing major economies in the world. The acceleration in non-bank food credit, flow of credit to commercial sector, improvement in manufacturing & service PMI (Purchasing Managers' Index), traction in investment activity indicate broadening of economic activities and supports the case for economic growth. In our view, healthy domestic growth provides flexibility to RBI to maintain a tight vigil on inflation trajectory without getting too worried about growth slowdown as of now.

Liquidity remains benign for now; expected to moderate over the medium term

Liquidity has remained in surplus mode in recent months though to a lesser extent as also pointed out by the Governor that average total absorption under Liquidity Adjusted Facility (LAF) during October-November was down to Rs. 1.4 lakh crores from the average of Rs. 2.2 lakh crores during August-September. While we expect the liquidity to remain adequate till the year end especially on the back of moderation in currency in circulation, pickup in government expenditure and healthy Foreign Portfolio Investors (FPI) inflows in recent months, RBI's pre-emptive warning to market participants stating "to wean themselves away from the overhang of liquidity surpluses." is a precursor to a gradual moderation in systemic liquidity over the medium term. Nonetheless, RBI has stated its readiness to act on two-sided liquidity operations and smoothen the volatility if arises.

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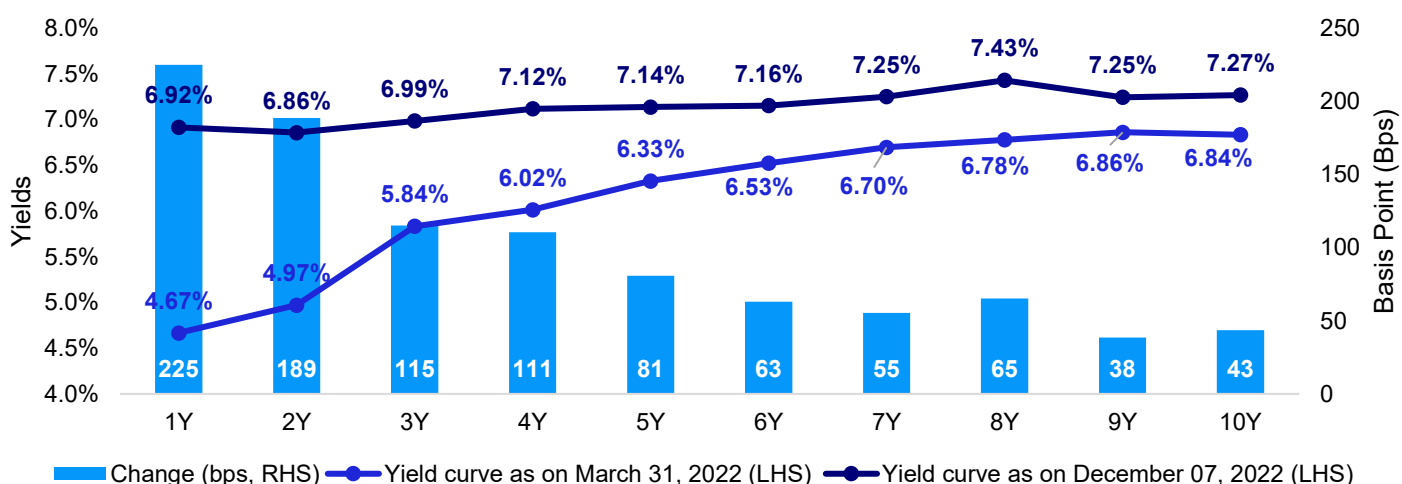
Global factors get the spotlight again; needs to be monitored closely

The governor highlighted that India cannot remain decoupled from global slowdown. The geopolitical tensions, global slowdown and tightening of global financial conditions is likely to have a bearing on India as well. We believe that further rate actions will be a function of not only the domestic inflation trajectory but also the global factors like global recessionary fears, tightening of policy rates by key central banks, relative currency movement, commodities prices in the wake of China opening up, etc. that would continue to influence domestic policy direction.

Stance maintained as “Withdrawal of accommodation”, indicating possibility of further rate hike; although closer to an end of current rate hike cycle

MPC decision to continue with “withdrawal of accommodation” stance indicates that the rate hiking cycle is not over yet and there is further room for rate hike. We expect the future rate actions would be data dependent and they will be watchful of evolving global & domestic environment. Given the current global as well as domestic indicators, we expect MPC to further moderate its rate hike to 25 bps in Feb 2023 to reach a policy rate of 6.5%. This may provide a safety cushion to absorb the global spillovers to an extent. India’s Foreign Exchange (Fx) reserve has also improved over past month by ~USD 35 bn which has also provided some relief. Any further rate hikes beyond a policy rate of 6.5% would be more determined by the global factors than the domestic factors. As of now, we expect MPC to deliver another 25 bps rate hike and reach a terminal policy rate to be ~6.50% by early 2023 before a prolonged pause reflecting that the current rate hike cycle is towards the final leg.

G-Sec Yield Curve change since March 2022



Source: Bloomberg

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Market Movement

Segment	Broad movement of yields in bps (as on December 07, 2022)	
	G-Sec	AAA Corporates
3 Months	+5bp	+3 to 5bp
6 Months	+7bp	+3 to 5bp
1 year	+10bp	+5 to 7bp
2 -3 years	+3-5bp	+3 to 5bp
4 - 5 years	+3bp	+5 to 7bp
10 years	+2bp	+3 to 5bp

Source: Bloomberg

Rate volatility may moderate compared to earlier; flattened yield curve gives opportunity to investors to benefit from high accrual

As global and domestic rate hike cycle reach towards the end over next few months, we believe interest rate volatility would also get reduced compared to the heightened volatility witnessed over past few months. At the same time, impact of future rate hikes has already been largely factored in specifically in the 2 – 5 years segment. However, the long end may remain under pressure as the fiscal supply overhang is expected to continue for next year as well.

Our fund positioning will be guided by evolving market dynamics as well individual fund's mandates. At the current juncture, we believe investors should look at the fixed income investments more constructively and benefit from the elevated & flattened yield curve to maintain high accrual without taking excessive market risk. More specifically, 2 to 5 years segment of the yield curve remains well placed on a risk-reward metrics from absolute carry perspective (~ 7.25% to 7.50% yield) for medium to long term investors and one could look to spread out the investments in this segment over next few months. 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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