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**MPC stays on course with a 50 bps repo rate hike maintaining its tight vigil on inflation. Retaining FY23 inflation projection at 6.7% highlights global uncertainties. Continuation of “withdrawal of accommodation” signals more rate hikes to come as healthy economy provides space. Overall, a more hawkish policy than the recent market expectations and reiterates the need to anchor inflation expectations. We expect market volatility to remain high with fast evolving global backdrop.**

## Key decisions/Highlights

All Monetary Policy Committee (MPC) members unanimously voted to **increase the policy rate by 50 bps at 5.40%.**

The **standing deposit facility (SDF) rate** stands adjusted to **5.15%** and the **marginal standing facility (MSF) rate** and the **Bank Rate** to **5.65%.**

MPC decided to remain **focused on withdrawal of accommodation** to ensure that inflation remains within the target going forward, while supporting growth.

On the assumption of a normal monsoon in 2022 and average crude oil price (Indian basket) of US\$ 105 per barrel, Consumer Price Index (CPI) inflation projection is retained at **6.7% in 2022-23 with Q2 at 7.1% (down from earlier 7.4%); Q3 at 6.4% (up from 6.2%); and Q4 at 5.8% (retained), with risks broadly balanced. CPI inflation for Q1:2023-24 is projected at 5.0%.**

Real GDP growth projections have been **retained at same levels, for 2022-23 it is projected at 7.2%, with Q1 at 16.2%; Q2 at 6.2%; Q3 at 4.1%; and Q4 at 4.0%, with risks broadly balanced. Real GDP growth for Q1:2023-24 is projected at 6.7%.**

## MPC remains ahead of curve maintaining its tight vigil on inflation; hikes repo rate by 50 bps

Today's repo rate hike of 50 bps to 5.40% by MPC came in line with our expectations and towards the higher end of 35-50 bps of market expectations. With the current increase, the repo rate is now higher than the pre-pandemic levels of 5.15%. So far, the MPC has hiked the repo rate by cumulative 140 bps in a span of 3 months. Elevated inflation trajectory which continues to remain above RBI's medium-term target and the aggressive tightening by major central banks would have prompted the MPC to raise policy interest rates towards the higher end of market expectations.

Another parameter to watch out for was the future guidance and direction of rate moves. Recent market expectation built up was that MPC would indicate a pause or a data dependent approach for future rate hikes as the global commodities including food items have come off sharply since last MPC meeting and also as the global rates rallied with expectations of less aggressive global rate hike amidst recession fears. MPC on the contrary continued with its last policy narrative and sounded hawkish on global uncertainties & inflation trajectory thereby signaling more front-loaded rate hikes to continue in upcoming policies.

August 05, 2022

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## **FY23 inflation projections retained at 6.7% despite Q1FY23 inflation lower than projected; highlights global uncertainties**

RBI has retained the inflation projection despite the recent correction in commodity prices & has delivered a cumulative rate hike of 140 bps indicating uncertain environment. The committee acknowledged that domestic inflationary factors have softened to some extent, however global uncertainties still persist and can put upside pressure on local inflation prints. RBI has factored in an average crude oil price (for Indian basket) at USD 105 per bbl which as of now seems reasonable given that the crude oil prices have fallen below USD 100 per bbl. However, household inflation expectations remain elevated and there could be a risk to domestic inflation as pass-through of higher inputs costs picks up translating into possible wage price pressures.

Given the volatile global environment, we expect MPC to be watchful of how long the fall in commodity price would sustain before revising the inflation forecast downwards. Going ahead, we feel that RBI would be closely monitoring the geopolitical developments, commodity prices and global financial market developments as it would play a key role in the inflation trajectory in coming months. On domestic front, once the economy comes back to normal, risk of demand side factors may also play out on inflation.

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## **Growth projection maintained at 7.20% for FY23; resilient to external factors**

RBI sounded confident on the growth recovery across the segments and retained the real GDP projection at 7.20% for FY23. This stems from that fact that capacity utilization in manufacturing sector is above the long-run average and needs additional capacity creation. Further, uptick in bank credit growth, improving urban demand and likely pick-up in rural demand on the back of improvement in agricultural prospects, should help the economic growth.

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## **RBI assures adequate liquidity; without stoking inflationary fears**

The liquidity surplus has reduced to Rs. 3.8 lakh crore in June-July 2022 from Rs. 6.7 lakh crore during April-May 2022. This is on expected lines given the lower forex inflows and capital outflows and is not concerning. The governor indicated that RBI would continue to maintain adequate liquidity in system by conducting two-way fine-tuning operations as and when warranted through variable rate repo (VRR) and variable rate reverse repo (VRRR) operations of different tenors.

August 05, 2022

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## **India may not remain unscathed in fast changing global environment; currency needs to be watched closely**

Besides the inflationary pressures, another key monitorable to keep a watch on is the Balance of Payment situation which can also influence RBI's decision for pre-emptive rate hikes. Aggressive rate hike expectation in US has triggered a significant USD strength against many currencies. Even the other safe heaven currencies like Euro & Yen have come under huge pressure for different reasons. INR has also depreciated in line with other Emerging market currencies even as RBI has actively intervened to smoothen the volatility. Though not alarming as of now, as supported by healthy forex (Fx) reserve of ~USD 573 bn, but incremental drag due to high current account deficit which is expected to be ~3.0% of GDP in FY23 and FPI's sell off can add to the complications for RBI for maintaining healthy Fx cushion & currency stability.

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## **Current domestic growth-inflation dynamics & global uncertainties prompt us to move our rate hike timeline expectations from ~6% earlier by April 2023 to December 2022 / February 2023 now.**

MPC has clearly articulated its concern on inflation which is reflected in retention of inflation forecasts for FY23. We believe supply side disruptions, geopolitical tensions and commodity prices pose risks to inflation outlook, while the growth seems to be fairly supported by domestic factors. We expect inflation trajectory to be key priority for MPC and given the current inflation trajectory, we expect MPC to continue to front-load the rate hikes. Additionally, with the narrative in this MPC on external global factors, we now expect a policy repo rate to reach ~6% by December 2022/ February 2023, faster than our earlier expectations by April 2023. Further rate hikes, if any, will depend upon the expected inflation trajectory in FY24 which is still evolving & dependent upon geo-political uncertainty.

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## **Rate volatility may remain high; significantly flattened yield curve gives opportunity to investors to cut down on risk without compromising on accrual**

Record high fiscal supply in FY23 remains a challenge in the absence of RBI's Open Market Purchase Operations & any meaningful FPIs inflow in debt segment. Central government's recent fiscal expansionary measures to partly absorb the high prices in few global commodities have been largely compensated by higher taxes on energy products thereby reducing the overhang to an extent. Notwithstanding, any further flareup in inflationary pressure may prompt central government to take more such fiscal measures thereby putting additional pressure on overall G-Sec borrowing program.

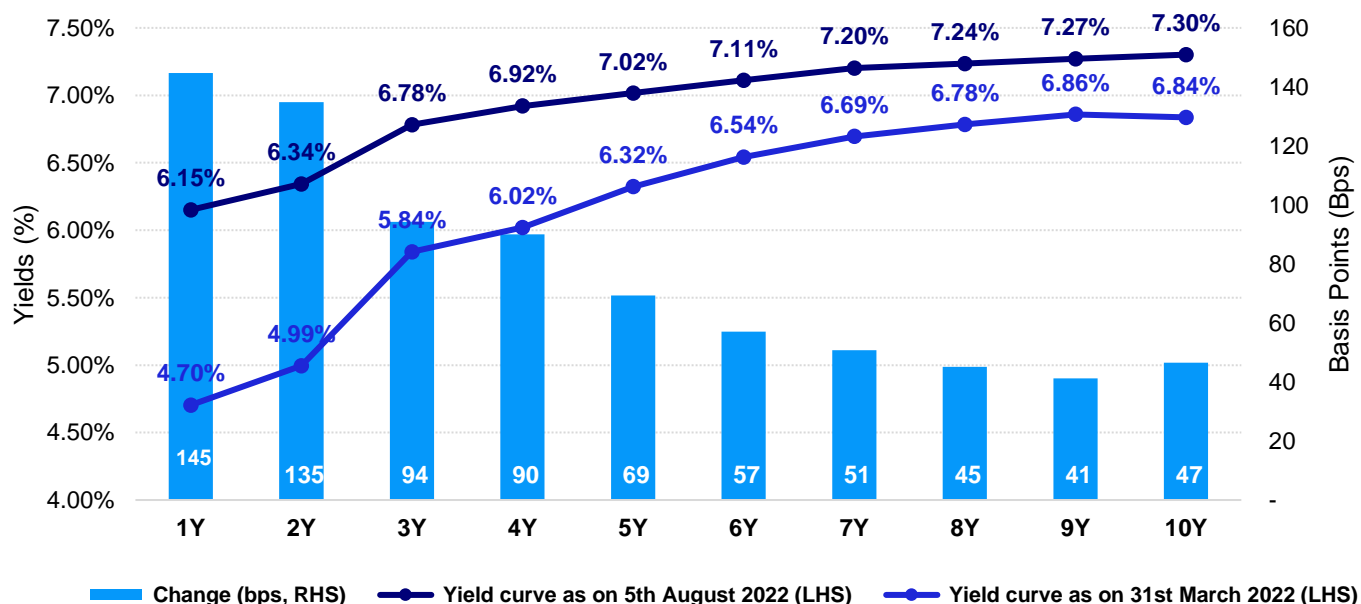
With challenging global backdrop as many Central Banks tighten the monetary policies to tame inflationary pressures, huge fiscal supply and RBI expected to front load rate hikes, we expect domestic interest rates to remain volatile with an upward bias. Inflation trajectory is uncertain on geo-political risks & quantum of rate hike by US Federal Reserve and is expected to remain elevated especially over next few months due to energy prices.

August 05, 2022

Against the backdrop of many such uncertainties, we prefer using the **conventional wisdom to contain interest rate risk with a moderate overall duration of debt investment portfolio**. Yield curve has already flattened sharply since March 2022 with 1-2 years segment hardening by ~140 bps while the 5 years+ segment has hardened by much lesser ~50 – 60 bps. A much flatter yield curve gives an opportunity to investors to cut down on duration risk and continue to maintain high accrual.

Source: Internal, Bloomberg, Monetary Policy Statement

## G-Sec Yield Curve change since March 2022



Source: Bloomberg

## Market Movement

Segment	Broad movement of yields in bps (as on August 05, 2022)	
	G-Sec	AAA Corporates
3 Months	0	+3 to 7
6 Months	+2	+5 to 7
1 year	+3	+5 to 10
2 -3 years	+10	+10 to 12
4 - 5 years	+12	+10 to 12
10 years	+15	+10 to 12

Source: Bloomberg

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