

Insights- Monetary Policy Review

April 08, 2022

Key decisions/Highlights



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Status quo on policy rates as expected, but a reality check with RBI acknowledging the increasing inflation fears with a 120 bps increase in FY23 inflation. Covid-19 led disruption behind us leading to further monetary policy normalization with restoring of LAF corridor to 50 bps, introduction of SDF at 3.75%, revision in market timings, focusing on withdrawal of accommodative stance and a reduction in size of liquidity surplus over a multi-year time frame. Overall, **a more realistic & data-driven monetary policy with a shift towards the conventional order of criticality** - inflation over growth from the earlier growth over inflation. We expect RBI to start a gradual rate hike cycle in 2HCY22.

All Monetary Policy Committee (MPC) members unanimously voted to **keep the repo rate at 4%**.

MPC members unanimously voted to **maintain accommodative stance while focusing on withdrawal of accommodation** to ensure that inflation remains within the target going forward, while supporting growth.

Marginal Standing Facility (MSF) rate and Bank rate stands unchanged at 4.25%.

The RBI restored the **Liquidity Adjustment Facility (LAF) corridor to 50 basis points**, as it was pre-pandemic.

RBI introduced **Standing Deposit Facility (SDF)**. **SDF would be the floor of LAF corridor and would be used as liquidity absorption tool**. The SDF rate would be 25 basis points below the repo rate, i.e., **at 3.75%**.

The **MSF would be the upper end of the LAF corridor and would be used as liquidity injection tool**. The MSF rate would be 25 basis points above the repo rate, i.e., **at 4.25%**.

The access to SDF and MSF will be at the discretion of banks, unlike repo/reverse repo, Open Market Operations (OMO) and Cash Reserve Ratio (CRR) which are available at the discretion of the RBI.

The **fixed rate reverse repo rate (FRRR)** is retained **at 3.35%** and will remain as part of RBI's toolkit and its operation will be at the discretion of the RBI for purposes specified from time to time.

Liquidity management to continue through variable rate reverse repo (VRRR) auctions of varying maturities to absorb liquidity; and **variable rate repo (VRR)** auctions to meet transient liquidity shortages and offset mismatches.

On the assumption of normal monsoon in 2022 and average crude oil price (Indian basket) of US \$ 100 per barrel, **Consumer Price Index (CPI) is projected at 5.7% for FY23** (revised upwards from 4.5%), with Q1FY23 at 6.3% (up from earlier 4.9%); Q2FY23 at 5.8% (up from earlier 5.0%); Q3FY23 at 5.4% (up from earlier 4.0%); and Q4FY23 at 5.1% (up from earlier 4.2%).

Real Gross Domestic Product (GDP) growth for FY23 is projected at 7.2% (down from earlier 7.8%) with Q1FY23 at 16.2% (down from earlier 17.2%), Q2FY23 at 6.2% (down from earlier 7%), Q3FY23 at 4.1% (down from earlier 4.3%) and Q4FY23 at 4% (down from earlier 4.5%).

Enhancement of **the limit under Held to Maturity (HTM)** category from 22% to **23%** of Net Demand and Time Liability (NDTL) till March 31, 2023. The HTM limits would be restored to 19.5% in phased manner from the quarter ending June 30, 2023.

On the face of it, MPC maintained status quo on all policy rates & continued to maintain an accommodative stance with unanimous vote, as widely expected by the market. However, reality is quite distant from the policy actions as critical changes have been announced on various fronts.

April 2022 policy was setup against a backdrop of significant upside inflationary risks due to further flare up on global commodity prices largely led by geo-political risks. While the market was expecting an upward revision in RBI's inflation projections, it was expected to be accompanied with a dovish narrative citing the supply side factors. MPC on a contrary has not attributed the upward sharp revision in inflation to any supply side disruptions either due to Covid-19 or geo-political factors and has highlighted the risks on either side.

With Covid-19 led disruption behind us and still evolving global war situation, MPC has clearly made a pivotal shift from a non-conventional growth supportive approach to a more conventional data driven inflation targeting framework and has indicated the order of priority as **inflation – growth – financial stability**, which upto Feb 2022 used to be *“growth recovery on sustainable basis and mitigating impact of Covid-19 taking precedence over inflation”*. MPC has reiterated that its forward guidance on policy signals a shift away from ultra-accommodative policy adopted during pandemic.

Further normalization of the monetary policy; introduction of SDF - effectively raising reverse repo by 40 bps

MPC surprised the market negatively by introducing the Standing Deposit Facility (SDF) at 3.75% thereby effectively raising the lower threshold policy rate from 3.35% (Reverse Repo) by 40 bps. This also brings back the LAF corridor (difference between MSF at 4.25% & SDF at 3.75%) to a normal 50 bps as it used to be before the pandemic. SDF would also be used as financial stability tool in addition to liquidity absorption tool. The SDF rate will be 25 bps lower than repo rate i.e. 3.75% and replace the fixed rate reverse repo rate (FRRR) as the floor of the LAF corridor. With SDF becoming operative rate, banks will be able to deploy funds at a higher rate even for a short tenure of as low as 1 day which signals an increase in overnight rate.

“The MPC also decided unanimously to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth”. Further, reduction in the size of liquidity surplus over a multi-year time frame in a non-disruptive manner is in line with the objective of restoring liquidity to a level consistent with prevailing stance of monetary policy. Revision of market timings also point towards normalization as Covid-19 led disruptions are receding.

This forward looking narrative is in line of RBI's earlier stated stance that MPC would take a well telegraphed approach and will spell out in advance about the future policy actions to avoid any surprises or suddenness.

Inflation revised upwards by 120 bps in FY23 to a more realistic levels; still upside pressure exists

RBI has revised its inflation projection for FY23 sharply to 5.7% from 4.5% earlier, factoring in the crude prices for FY23 at USD 100 per barrel. While it is a steep rise of 120 bps, earlier projection of 4.5% itself was an un-realistic number. We believe there could be upside risks to the RBI's inflation projection led by the elevated global commodity prices including food related and also the services related inflation with contact intensive services resuming. Further, the growth projections have also revised downwards by 60 bps to 7.2%. A lot will depend on how the war in Ukraine plays out and its effects on global energy markets. Escalation of the geopolitical situation, surge in international crude oil and other commodity prices, tightening of global financial conditions, persistence of supply-side disruptions and significantly weaker external demand pose risks to the inflation and growth outlook.

Existing approach to liquidity management to continue

The governor has stated that RBI will engage in a gradual and calibrated withdrawal of this liquidity over a multi-year time frame in a non-disruptive manner beginning this year. RBI would maintain adequate liquidity to support the financial markets.

Not much on higher fiscal supply in FY23. No mention of inclusion in global bond indices; negative for high fiscal supply

RBI did not provide much insights either on its stance on supporting huge fiscal supply of government securities in FY23 or on the prospects of inclusion of sovereign bonds in global bond indices, something which was keenly watched by the market participants. While the Governor re-iterated the availability of various policy tools to complete the G-Sec borrowing in an orderly manner, absence of any specifics will make it difficult to absorb huge supply of ~INR 32,000 crs of weekly G-Sec auction in 1HFY23. Upward revision in HTM limit for banks will provide an incentive for banks to buy G-Secs but it alone may not be sufficient.

Market will keenly watch for the support of RBI in the form of Open Market Purchase Operations (OMOs) or Operation Twists to establish a threshold level for 10 yr G-Sec benchmark and till then, high fiscal supply may continue to put upward pressure in the longer end of yield curve.

RBI re-iterated the monetary policy to be driven by domestic growth-inflation dynamics; Geo-political risks to be managed by external balances

RBI again highlighted that Indian monetary policy will be more driven by the domestic growth-inflation dynamics and not by the approach taken by the Global Central Banks, supported by strong external balances. The geo-political risks may put pressure on balance of payment and current account deficit; however RBI has shown confidence in managing the same through healthy forex reserves.

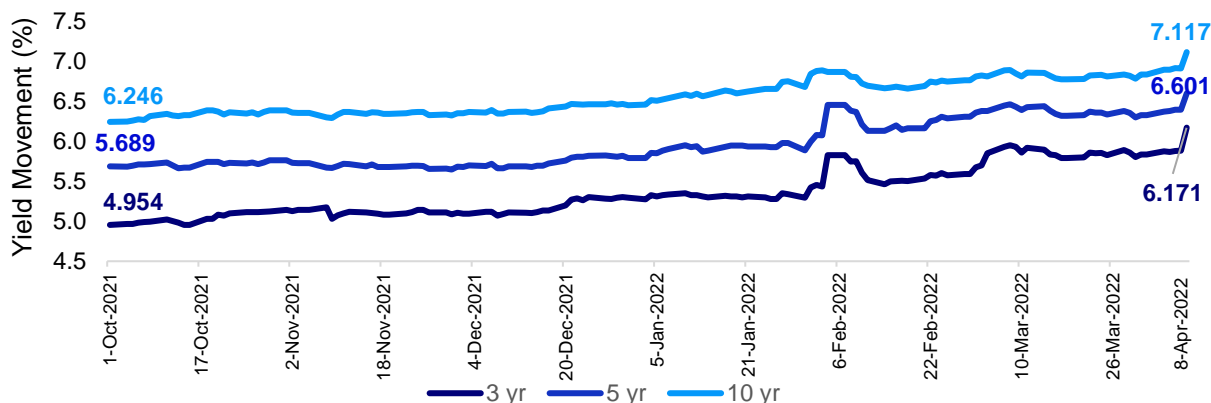
We expect a gradual withdrawal of loose monetary policy

We believe that MPC has clearly articulated its forward guidance on rate policy and with the current state, we expect MPC to change its accommodative stance to 'Neutral' in next June MPC policy and begin with a gradual rate hike cycle beginning August policy onwards. While the policy actions are expected to be more data driven, without factoring in any tail risk on inflation-growth dynamics, we continue to believe that RBI will undertake ~50 bps rate hike in the 2nd half of CY2022 which is more than factored in already by the market. Having said that, with MPC's focus shifting to inflation control, any negative surprise on inflation front can prompt MPC to go for more aggressive rate hikes even at an expense of growth impact, something we don't expect as of now.

Interest rate volatility may remain high in 2022, with an upward bias

Year 2022 is expected to remain volatile for financial assets as the world adjusts to lesser availability of fiscal, monetary and most crucially the liquidity support for economic recovery, as the normalcy gathers pace & controlling of inflation becomes a key task for Central Banks. Yet another record high G-Sec borrowing in FY23 in the absence of RBI's stated support, we expect interest rates to remain volatile, especially at the longer end. While the RBI has also articulated the withdrawal of accommodative monetary policy and surplus liquidity, we believe it would still be done in a gradual way.

Interest rate movement of 3 yr G-sec, 5 yr G-sec and 10 yr G-sec



Data from October 1, 2021 to April 08, 2022. Source: Bloomberg

Market reaction post policy announcement

Segment	Broad movement of yields today in bps	
	G-Sec	AAA Corporates
3 Months	+15	+15
6 Months	+15	+15
1 year	+20	+20-25
2 -3 years	+20-25	+20-25
4 - 5 years	+25-30	+20-25
10 years	+20	+15-20

Source: Bloomberg

Fund Positioning

Against the backdrop of heightened volatility, one of the biggest challenges in 2022 will be to manage the return vs. the volatility expectations. Extreme steepness of the yield curve may provide merit to go up the curve, however, longer end may remain volatile as the global backdrop further becomes negative with relatively tighter monetary policies for tackling inflation and continued high domestic fiscal supply. While we expect a general hardening of interest rates across the curve in 2022, we believe that gradual policy rate hikes by RBI and already steep yield curve provides investment opportunity at the short end of the curve.

We feel that 6 months to 1 year segment of the yield curve provides opportunity to risk-averse investors amidst expectations of gradual repo rate hike going forward. Our funds like **Invesco India Ultra Short Term Fund, Invesco India Money Market Fund and Invesco India Treasury Advantage Fund** with a defensive positioning are suited for such investors.

For investors looking at the core allocation, the 1 to 3 year segment of the yield curve looks well placed from carry perspective, given the current steepness of the yield curve. To us, it is a sweet spot on the yield curve – neither too short which gets impacted by low gross yields, nor too long that can get impacted by the rate volatility. Our funds such as, like **Invesco India Short Term Fund, Invesco India Corporate Bond Fund, and Invesco India Medium Duration Fund** having a large proportion deployed in this segment can be looked at by such investors.

Invesco India Short Term Fund

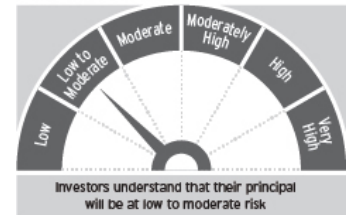
(An open ended short term debt scheme investing in instruments such that the Macaulay duration[^] of the portfolio is between 1 year to 3 years. A moderate interest rate risk and relatively low credit risk.)

Suitable for investors who are seeking*:

- Income over short to medium term
- Investments in short term debt and money market instruments

***Investors should consult their financial advisers if in doubt about whether the product is suitable for them.**

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Invesco India Corporate Bond Fund

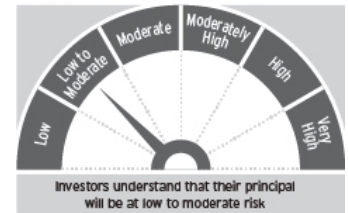
(An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds. A relatively high interest rate risk and relatively low credit risk.)

Suitable for investors who are seeking*:

- Income over medium to long term
- Investments in AA+ and above rated corporate bonds

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RISKOMETER



Invesco India Treasury Advantage Fund

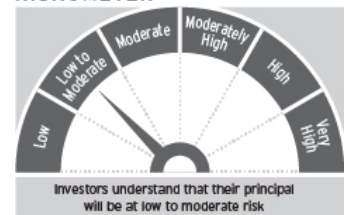
(An open ended low duration debt scheme investing in instruments such that the Macaulay duration[^] of the portfolio is between 6 months to 12 months. A relatively low interest rate risk and relatively low credit risk.)

Suitable for investors who are seeking*:

- Income over short term
- Investment in debt and money market instruments

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[^]Please refer to the heading 'C. Asset Allocation Pattern' under Section 'II. Information about the Scheme' of Scheme Information Document where the concept of Macaulay duration has been explained.

Note - Macaulay duration of a bond is the number of years taken to recover the initial investment of a bond. It is calculated as the weighted average number of years to receive the cash flow wherein the present value of respective cash flows is multiplied with the time to that respective cash flows. The total of such values is divided by the price of the security to arrive at the duration.

Invesco India Medium Duration Fund

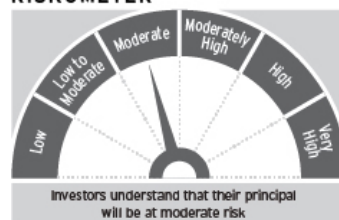
(An open ended medium term debt scheme investing in instruments such that the Macaulay duration[^] of the portfolio is between 3 years and 4 years. A relatively high interest rate risk and moderate credit risk.)

Suitable for investors who are seeking*:

- Income over medium term
- Investments predominantly in debt and money market instruments with portfolio Macaulay Duration of 3 – 4 years

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Invesco India Ultra Short Term Fund

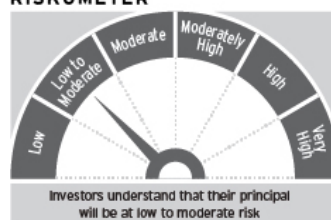
(An open ended ultra-short term debt scheme investing in instruments such that the Macaulay duration[^] of the portfolio is between 3 months to 6 months. A relatively low interest rate risk and moderate credit risk.)

Suitable for investors who are seeking*:

- Income over short term
- Investments in a portfolio of short term money market and debt instruments

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RISKOMETER



Invesco India Money Market Fund

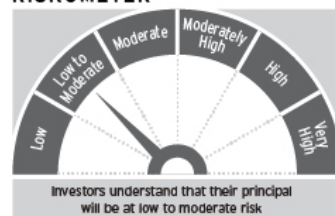
(An open ended debt scheme investing in money market instruments. A relatively low interest rate risk and relatively low credit risk.)

Suitable for investors who are seeking*:

- Income over short term
- Investment in money market instruments

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RISKOMETER



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Potential Risk Class Matrix

Scheme Name Invesco India Treasury Advantage Fund Invesco India Money Market Fund	Potential Risk Class			
	Credit Risk →	Relatively Low (Class A)	Moderate (Class B)	Relatively High (Class C)
	Interest Rate Risk ↓			
	Relatively Low (Class I)	A-I		
	Moderate (Class II)			
	Relatively High (Class III)			

Scheme Name Invesco India Short Term Fund	Potential Risk Class				
	Credit Risk	→	Relatively Low (Class A)	Moderate (Class B)	Relatively High (Class C)
	Interest Rate Risk				
	Relatively Low (Class I)				
	Moderate (Class II)		A-II		
	Relatively High (Class III)				

Scheme Name <hr/> Invesco India Corporate Bond Fund	Potential Risk Class			
	Credit Risk →	Relatively Low	Moderate	Relatively High
	Interest Rate Risk↓	(Class A)	(Class B)	(Class C)
	Relatively Low (Class I)			
	Moderate (Class II)			
	Relatively High (Class III)	A-III		

Scheme Name	Potential Risk Class				
	Credit Risk	→	Relatively Low (Class A)	Moderate (Class B)	Relatively High (Class C)
	Interest Rate Risk				
	Relatively Low (Class I)			B-I	
	Moderate (Class II)				
	Relatively High (Class III)				

Scheme Name	Potential Risk Class			
	Credit Risk	Relatively Low (Class A)	Moderate (Class B)	Relatively High (Class C)
	Interest Rate Risk			
	Relatively Low (Class I)			
	Moderate (Class II)			
	Relatively High (Class III)		B-III	

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