

Insights – Monetary Policy Review

No policy action, in line with our expectations. Accommodative stance maintained and dovish policy is positive for rates over the medium term. RBI looks keen to ensure ample liquidity which augurs well for the bond market.

December 4, 2020

Key Decisions / Highlights:

- Policy Repo rate maintained at 4% and Reverse repo rate at 3.35%.
- Other policy rates remain unchanged. Marginal Standing Facility (MSF) rate and Bank rate at 4.25%.
- Monetary Policy Committee (MPC) maintained its accommodative stance on policy rates and to continue with accommodative stance as long as it is necessary, at least in the current financial year and into the next financial year. The growth revival takes precedence in order to mitigate the impact of COVID-19, while ensuring that inflation remains within the target going forward.
- Unlike last policy review when there was a dissent of one MPC member on maintaining long term accommodative stance, this time all MPC members unanimously voted in favor of it.
- Consumer Price Index (CPI) based Inflation projections revised higher at 6.8% for Q3 2020-21, 5.8% for Q4 2020-21 and 5.2%- 4.6% in H1 2021-22, with risks broadly balanced. In last policy review, inflation was projected at 6.8% for Q2 2020-21, at 5.4%-4.5% for H2 2020-21 and 4.3% for Q1 2021-22.
- Medium-term target for CPI inflation remains unchanged at 4% within a band of +/- 2%, while supporting growth.
- Real Gross Domestic Product (GDP) growth projections for FY21 revised upwards at (-)7.5% against (-)9.5% estimated earlier, (+)0.1% in Q3 2020-21 and (+)0.7% in Q4:2020-21 and (+)21.9% to (+)6.5% in H1 2021-22, with risks broadly balanced.
- No change in liquidity management approach despite excessive systemic liquidity. To ensure ample liquidity is available and prepared to take more measures, if required.
- On tap Targeted Long-Term Repo Operations (TLTRO) has been expanded to cover other stressed sectors, proposes to bring the 26 stressed sectors within the ambit, in synergy with the credit guarantee available under the Emergency Credit Line Guarantee Scheme (ECLGS 2.0) of the government.
- To extend the Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) to Regional Rural Banks (RRBs). RRBs are now allowed to participate in the Call/Notice money market, both as borrowers and lenders.

- To review the existing guidelines on Credit Default Swaps (CDS) in order to facilitate the development of credit derivatives market and a liquid and vibrant market for corporate bonds, especially for lower rated issuers.

Our Views

Today's RBI monetary policy was set in the backdrop of excessive market liquidity which had caused the short-term rates to fall sharply over last 2 months, higher than expected inflation trajectory and relatively better economic growth in 2QFY21. In our view, this monetary policy can well be defined as the continuation of the previous monetary policy with the revision in inflation and growth projections factoring in the recent data.

The policy statement sounded almost as dovish as last policy review and broadly remained supportive of creating conducive conditions for growth revival. Even as persistently high inflation remained a cause of concern and MPC acknowledged that outlook for inflation has turned adverse and accordingly revised its inflation projections upwards, the present negative growth output prompted MPC to maintain status quo and support growth recovery. This is the third consecutive policy review when MPC maintained states quo on interest rates while retaining its accommodative stance.

Another key parameter to be watched in today's policy was RBI's response to influx of liquidity which had caused short term rates to plunge recently. While a segment of the market was expecting some measures to be taken by the RBI on liquidity front in the light of increasing inflationary pressures, RBI alleviated those fears by abstaining from taking any specific liquidity measures to withdraw liquidity and once again re-iterated that they would like to maintain ample systemic liquidity to ensure the financial stability.

RBI also mentioned that it has taken measures for reducing the INR volatility amidst record foreign direct investment (FDI) / foreign portfolio investment (FPI) inflows through Forex intervention and the consequent INR liquidity has been sterilised through the Reverse Repo operations. This provides comfort to the yields on short tenor papers - the segment which had witnessed a correction of 15 – 20 bps this week before the monetary policy in anticipation of liquidity tightening measures by RBI. Consequently, the market reacted positively to policy review and short-term bond yields declined.

RBI has once again reiterated that it will continue to make sure that the government's borrowing program is completed in a smooth way without disrupting the market. We expect RBI to continue with its Open Market Purchase Operations so as to be able to clear huge G-Sec supply scheduled in rest of FY21. This will provide a support to the yields in the longer tenor segment.

The policy decision has further affirmed our views and overall, we remain positive on duration. With the growth recovery still in nascent stage & Covid-19 concerns, we expect RBI to keep rates on hold and maintain its accommodative policy stance for the foreseeable future. At the shorter end, we feel that bond yields will be supported by RBI's stance on liquidity and favorable demand-supply dynamics due to the lack of issuances in shorter tenor segment. On the longer end, we expect interest rates to drift lower as the term spreads still remain high relative to the historical levels and we expect RBI to continue with its Open Market Purchase Operations / Operation Twist.

On the key watchlist items, we continue to watch the way inflation trajectory pans out and especially core inflation which has continued to remain stubbornly high led by supply side disruptions and elevated food inflation. While the inflationary pressures are expected to subside going forward, we expect the policy rate cuts to be more dependent on the growth – inflation trajectory and if the inflation moderates and fall within the RBI's comfort zone, it may open up a window for a policy rate cut in the later part of 1HFY22.

Additionally, we believe global macro conditions with risk-on trade on hopes of Covid-19 vaccination and a benign global liquidity led by central banks have set the stage for a sustained outperformance of emerging market (EM) assets over the next few years. The expected weakening of the US dollar and the relatively higher accrual offered by Emerging Countries like India can create a strong FIIs demand for domestic fixed income securities. Any such development will create a favorable demand – supply dynamics for bonds especially in the longer segment and can expedite the compression in the currently elevated term spreads.

Further, we continue to remain credit averse. Weak economic conditions and challenges faced by banks (led by rise in NPA, drop in capital adequacy) poses hurdles for immediate pickup in credit growth. We believe credit dispersion will continue, with very high-quality credits benefitting from this but the lower quality credits continuing to be avoided for the time being. From a credit quality perspective, we have and will continue to stick to high quality credits – primarily Public Sector Undertaking (PSUs) and blue-chip AAA credits¹.

¹The above strategy is based on current views and is subject to change from time to time.

Market reaction post policy announcement-

Segment	Broad movement of yields today	
	G-Sec	AAA Corporates
3 Months	1-2 bps lower	2-4 bps lower
6 Months	~1-2 bps lower	flattish
1 year	~4-5 bps lower	7 – 9 bps lower
2 -3 years	~ 3 bps lower	5 - 7 bps lower
4 - 5 years	~ 9 - 10 bps lower	4 – 5 bps lower
10 years	~3-4 bps lower	~3 bps lower

Basis points- bps.

Fund positioning²

Amid expectations of sustained benign interest rates, our several debt schemes are expected to reap the benefits of capital gains over next few months. More specifically, Invesco India Banking & PSU Debt Fund and Invesco India Gilt Fund with positioning in longer tenor segment are expected to be benefitted by current attractive term spreads. As the excessive liquidity has impacted the yields at the short end, RBI is expected to drive the liquidity operations towards the longer end of the yield curve, which may drive yields at 5-10 years segment to move lower. Similarly, Invesco India Short Term Fund, largely positioned in 3-5 years space, also looks to benefit from tactical opportunities at the longer end of the yield curve.

Invesco India Corporate Bond Fund and Invesco India Treasury Advantage Fund positioned in 1-3 years space provides attractive carry over the alternative products like FDs as we continue to see stable to declining interest rates at the short end amid benign liquidity conditions. All the above funds have maintained highest asset quality and as of now are deployed in 100% AAA rated assets (on long term rating basis).

²**Disclaimer-** The above fund positioning is based on current views and is subject to change from time to time. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy. It should not be construed as investment advice to any party.

Invesco India Banking & PSU Debt Fund

(An open-ended debt scheme predominantly investing in Debt instruments of banks, Public Sector Undertakings, Public Financial Institutions and Municipal Bonds)

Suitable for investors who are seeking*:

- Returns over short to medium term
- Investments primarily in debt & money market instruments issued by Banks, PFIs, PSUs and Municipal Bonds

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



Invesco India Gilt Fund

(An open ended debt scheme investing in government securities across maturity)

Suitable for investors who are seeking*:

- Credit risk free returns over medium to long-term
- Investments primarily in securities issued and guaranteed by the Central and the State Government across maturities

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



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)

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.**



Invesco India Corporate Bond Fund

(An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds)

Suitable for investors who are seeking*:

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

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



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)

Suitable for investors who are seeking*:

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

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



[^]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.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.