Invesco Mutual Fund

Insights – Monetary Policy Review

Monetary Policy Committee maintains status quo on interest rates, but attempts credibility by bringing inflation forecast lower

June 8, 2017

The Monetary Policy Committee (MPC) held the repo rate unchanged for the fourth consecutive review. The committee reiterated its commitment towards achieving the medium-term target of Consumer Price Index (CPI) inflation of 4% within a band of +/- 2%. Although the expectations of interest rate cut have been low, the committee has set the ball rolling by lowering its inflation projection. The CPI inflation is projected in the range of 2% – 3.5% (down from 4.50% earlier) in the first half of the year and 3.5% – 4.5% (down from 5% earlier) in the second half of the year. This is basis the sharp reversal in CPI inflation in April, which came in at a record low of 2.99%.

Interestingly, the revised CPI inflation forecast for the first 6 months is closer to inflation in developed markets. RBI attempts to bring some credibility back by lowering the inflation forecast, and tries to use this policy to change its stance for August'17 policy review. According to the policy document, the MPC members differed in opinion and there was a member who called for a rate cut.

While, deputy Governor of RBI Mr. Viral Acharya, mentioned to the reporters of being watchful of incoming data in the next few months and act for a 'broader accommodation through interest rate policy', few MPC members raised upside risks to inflation which could emanate from geo-political risk, domestic fiscal slippages due to large farm loan waivers and disbursement of allowances under the 7th central pay commission. According to the policy statement, risks are evenly balanced, although the distribution of the monsoon and the government staying the course in effective food management will play a critical role in the evolution of risks.

In another measure, separately, the RBI slashed the Statutory Liquidity Ratio (SLR) by 50 bps, from 20.50% of Net Demand and Time Liabilities (NDTL) to 20.00% from the fortnight commencing June 24, 2017. The move is expected to result in increased liquidity with the banks thereby leading to higher lending.

Market Outlook

We expect the RBI to course correct and induce a 50-75 bps rate reduction over the course of the calendar year; as has been our view in the past. Fixed income market is expected to remain positive, basis dovish RBI, surplus liquidity, benign inflation and stable rupee. The appreciation in rupee, stable macro-economic environment and higher forex reserves are bringing in foreign investors in the capital market and demand for Indian bonds are increasing rapidly.

As inflation in India moved below 3% and the differential inflation between India and US contracts to less than 1% we expect stability in Indian Rupee to continue. Additionally, the rupee may also appreciate in spurts as the Foreign Direct Investment (FDI) inflows are larger than the Current Account Deficit (CAD). That means the economy is getting more dollar flows than what it is spending.

In this environment, we encourage investors who have over 2 year investment horizon to invest in funds with fund duration longer than their investment horizon, given the higher probability of interest rates remaining lower in the medium term. Investors under 2 years of investment horizon is encouraged to choose credit focused funds to benefit from potential improvement in credit environment and individual risk appetite.

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