

# Insights – Monetary Policy Review

Status quo on policy rates as expected. Accommodative stance maintained as long as necessary to revive growth on a durable basis and ample liquidity policy supportive for short term rates in the near term.

February 5, 2021

## Key Decisions / Highlights:

- **Policy Repo rate unchanged at 4%** and Reverse repo rate at 3.35%.
- No change in other policy rates; Marginal Standing Facility (MSF) rate and Bank rate stands unchanged at 4.25%.
- Monetary Policy Committee (MPC) retained its accommodative stance on policy rates and **to continue with accommodative stance as long as it is necessary**, at least during the current financial year and into the next financial year. The growth revival on a durable basis takes precedence in order to mitigate the impact of COVID-19, while ensuring that inflation remains within the target going forward.
- All MPC members **unanimously voted in favor of maintaining status quo** on rates with accommodative stance as long as necessary.
  - The projection for Consumer Price Index (CPI) inflation has been revised downwards to **5.2% in Q4 2020-21 from earlier 5.8%** while **CPI inflation range for H1 2021-22 has been revised upwards to 5.2% to 5.0%** from earlier 5.2%- 4.6%. Q3 2021-22 CPI is projected to be 4.3%.
  - Medium-term target for CPI inflation remains unchanged at 4% within a band of +/- 2%, while supporting growth. The government to review the inflation target for the next five years by March 2021.
- **Real Gross Domestic Product (GDP) growth projected at 10.5% in 2021-22** – in the range of 26.2% to 8.3% in H1 and 6% per cent in Q3
- The **stance of liquidity management continues to be accommodative** and in line with the stance of monetary policy with an aim to enhance liquidity support to targeted sectors.
  - The RBI remains **committed to ensure availability of ample liquidity**.
- **To gradually restore the Cash Reserve Ratio (CRR)** to its pre-covid era levels in two phases i.e. 3.5% effective from March 27, 2021 and 4% effective from May 22, 2021.
  - The CRR normalization would open up space for a variety of market operations to inject additional liquidity.

- **Under on tap Targeted Long-Term Repo Operations (TLTRO), banks can provide credit to NBFCs for incremental lending to the specified stressed sectors.**
- Marginal Standing Facility (MSF) relaxation extended for six more months i.e. upto September 30, 2021.
- **Gross market borrowing of the government for 2021-22 which is budgeted at Rs. 12 lakh crores to be completed in a smooth & non-disruptive manner.**
- In respect of statutory liquidity ratio (SLR) eligible securities, the **RBI will extend the dispensation of Held to Maturity (HTM) of 22% up to March 31, 2023.** This will be applicable to the securities acquired between April 1, 2021 and March 31, 2022.
  - The HTM limits would be restored from 22% to 19.5% in a phased manner starting from the quarter ending June 30, 2023.
- **In a major structural reform** with a view to broaden the investor base and provide retail investors with enhanced access to participate in the government securities market, **the RBI will provide retail investors with online access to the government securities market both primary and secondary** directly through the RBI.

### **Our Views**

Today's RBI monetary policy was a very critical one as it followed the two major events that happened over last few days. First, the RBI's liquidity measure to suck out Rs. 2 lakh crores of liquidity from the market through the variable Reverse Repo auction which caught the market off-guard and led to sharp rise in yields especially in the short end of the curve. Second, the Union Budget, where the Finance Minister delivered a growth-oriented budget amidst unprecedented disruption caused by the pandemic. Whilst, the budget will be a medium term positive in supporting growth, it also resulted in a substantially higher fiscal deficit for FY21 / FY22 at 9.5% / 6.8% respectively with a fiscal gliding path to 4.5% by FY26. For the debt market participants, another record year of around Rs. 12 lakh crores of Central Government's gross borrowing in FY22 & an additional Rs. 80,000 crores in rest of FY21 was a negative surprise and the rates reacted negatively across the curve.

In this backdrop, the market was looking for guidance from RBI on liquidity stance, and Open Market Operations (OMO) to absorb high G-Sec borrowings especially as the credit growth also picks up, while getting a re-affirmation on the continuation of accommodative policy stance.

Broadly, the policy statement delivered on two off the three asks of the market. First, the policy statement sounded dovish as last policy review and reaffirmed its accommodative

policy stance into FY22 giving precedence to growth revival on a durable basis while remaining watchful of the inflation trajectory. This is the fourth policy review in a row when MPC maintained status quo on interest rates while retaining its accommodative stance.

Second, the MPC delivered on liquidity front by indicating continued ample systemic liquidity and also by delaying the restoring of CRR. We see the RBI's earlier liquidity measure more as a routine operation in line with the restoration of the revised liquidity framework on managing Frictional/Transient liquidity and in our view, it should not be construed as a big reversal in RBI's liquidity stance. While we believe that RBI may gradually reduce the excess liquidity in a market non-disruptive way, we expect RBI to continue to maintain surplus liquidity over the medium term to ensure conducive rate environment for borrowers to recover from Covid-19 led disruption.

On the third ask, however, the MPC fell short on the market expectations of providing visibility on its OMOs for longer tenor G-Sec, although the Governor assured during the press conference that the FY22 G-Sec borrowing program will be completed in a smooth and a non-disruptive way.

Yield movement over last few months can be broadly divided into 3 phases – 1) abundance liquidity over Oct 2020 to early Jan 2021; 2) post Variable Reverse Repo (VRR) announcement till budget; 3) post budget till the MPC review. Phase 1 of abundance liquidity witnessed a sharp rally of interest rates especially in the short end upto 5 years, large part of which got reversed out during phase 2 of RBI's liquidity withdrawal leading to the flattening of the curve. Phase 3, post budget has seen a parallel shift upwards of the entire curve as below -

Instrument	Yield movement in basis points			
	Phase 1	Phase 2	Phase 3	Cumulative movement
	Abundance Liquidity (1st Oct 2020 to 8th Jan 2021)	Post VRR till Budget (9th Jan 2021 to 29th Jan 2021)	Post Budget till MPC (1st Feb 2021 to 5th Feb 2021)	
<b>2Y G-Sec</b>	-26	31	21	26
<b>3Y G-Sec</b>	-26	28	22	24
<b>5Y G-Sec</b>	-14	23	29	38
<b>10Y G-Sec</b>	-14	3	19	8
<b>15Y G-Sec</b>	-22	12	22	12

In the absence of a concrete action from RBI on absorbing record high G-Sec supply, we expect the yield curve to steepen going forward and the short term rates especially in 2 to 4 year segment to remain more attractive from risk-reward perspective on the back of surplus systemic liquidity and favorable demand-supply dynamics.

Direct participation of Retail investors in G-Sec can have a potential of addressing higher G-Sec supply to an extent, however one will have to wait for the actual participation levels of retail investors.

### **Market reaction post policy announcement-**

Segment	Broad movement of yields today	
	G-Sec	AAA Corporates
3 Months	flat	2- 3 bps lower
6 Months	flat	flat
1 year	~7-8 bps higher	flat
2 -3 years	~ 6-8 bps higher	Flat – 5 bps higher
4 - 5 years	~ 8-9 bps higher	~8-10 bps higher
10 years	~3-4 bps lower	~9-11 bps higher

Basis points- bps.

### **Fund positioning**

The policy stance to maintain ample liquidity augers well for short end of the yield curve. The short end also looks attractive given relatively high carry as RBI's liquidity measure to suck out Rs. 2 lakh crores of liquidity from the market has already led to the hardening of short-term yields. Favorable demand supply dynamics in short end segment with lack of issuances will also support the levels.

**Our funds such as Invesco India Treasury Advantage Fund, Invesco India Corporate Bond Fund, and Invesco India Short Term Fund largely positioned in 1-4 years space are in a sweet spot amid RBI's continued stance on surplus liquidity.**

Longer end of the curve will be more dependent on RBI's OMOs both in terms of quantum and timeliness. 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 Foreign institutional investors (FIIs) demand for domestic fixed income securities. Any such development will create a favorable demand – supply dynamics for bonds especially in the longer segment.

**Investors with long term horizon and ability to absorb short term volatility may consider Invesco India Banking & PSU Debt Fund which is positioned at longer-end of the curve.** Some allocation at the longer end finds merit on the back of conviction that RBI will manage the yield curve and may support the long-term yields.

Besides, we believe credit dispersion will continue, with very high-quality credits benefitting from RBI's benign liquidity policy but the lower quality credits continuing to be avoided for the time being. 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).

**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.**

#### **RISKOMETER**



### **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.**

#### **RISKOMETER**



### **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.**

#### **RISKOMETER**



## **Invesco India Treasury Advantage Fund**

(An open ended low duration debt scheme investing in instruments such that the Macaulay duration<sup>^</sup> 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.**

### **RISKOMETER**



<sup>^</sup>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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**Disclosure of Risk-o-Meter** - Risk-o-meter disclosed in the product label of the Scheme is based on the Scheme portfolio as on December 31, 2020. The AMC will evaluate the Risk-o-Meter on a monthly basis and shall disclose the same along with the portfolio disclosure. Any change in the risk-o-meter will be communicated by way of Notice-cum-Addendum and by way of an Email /SMS to the Unit holders of the Scheme.

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