PGIM
India Mutual Fund

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RBI Policy: An Unexpected Twist

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The Monetary Policy Committee (MPC) today kept the benchmark Policy rates on hold against the consensus and our expectation of a 25bps rate cut. The MPC decision was a unanimous one with all the members voting to hold rates. The MPC maintained an accommodative stance while reiterating that there is further policy space for need based intervention. The pause in the rate cutting cycle comes in the backdrop of slowing GDP growth, the Q2 GDP growth (YOY) came in at 4.5%, a multiyear low. Inflation on the other hand has picked up over the last one month primarily driven by food prices.

The CPI projection has been revised upwards to 5.1-4.7% (vs 3.5-3.7%) for H2 FY20 and 4.0-3.8% for H1 FY21 with risks broadly balanced.

The GDP growth projections were revised downwards to 5.0% in FY20 as compared with 6.1% projected earlier. The economy is estimated to grow by 4.9-5.5% in H2 FY20 and 5.9-6.3% in H1 FY21.

The MPC noted that economic activity weakened further and the output gap remained negative. However, it stated that measures already initiated by the Government and the monetary easing undertaken by the Reserve Bank since February 2019 will feed into the real economy and there are some early signs of recovery in investment activity,

On Monetary Transmission, it stated that the introduction of external benchmarks is expected to strengthen monetary transmission. It also mentioned the need for greater flexibility in the adjustment of interest rates on small saving schemes.

Giving the rationale for not cutting the policy rates, the MPC statement stated that with the evolving growth-inflation dynamics it is appropriate to take a pause at this juncture. MPC decided to keep the policy repo rate unchanged and continue with the accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

Market Outlook:

The market backdrop in the run up to the policy was positive though cautious given the uncertainty on the fiscal front but the market clearly was taken aback by the unchanged policy rates as the benchmark 10yr Bond yield went up by 15bps. Yields went up across the curve with the 5yr yields also going up by 20bps.

Going forward, we expect further uptick in yields given the uncertainty on the fiscal side. The short end of the curve (1-3yr) will be supported by the huge liquidity surplus in the system and attractive carry with respect to the overnight rate. The bar for a rate cut in the February Policy has risen and a lot will depend upon how the government manages its finances. The outlook on the belly and the long end of the curve will be influenced a lot by the management of the fiscal deficit by the government, though we believe that closer to 6.75% yield the 10yr benchmark will become attractive.

We would advise Investors to stay invested in short duration funds and use any further uptick in yields at the shorter end of the curve as an opportunity to increase their exposure to high credit quality Banking PSU and Corporate Bond Funds of short to medium duration.