PGIM
India Mutual Fund

Dove Turning Hawk

Puneet Pal
Head - Fixed Income

RBI sprang a major surprise on 4th May, by doing an unscheduled MPC meeting over 2-4th May and raising the policy repo rate by 40 bps and CRR by 50 bps. Although we had expected RBI to hike repo rate starting June meeting, the 4th May repo rate hike of 40bps along with the CRR hike of 50 bps was unexpected.

The key highlights of the announcement were:

- MPC voted unanimously to raise repo rate by 40 bp in an unscheduled meeting
- MPC maintained the accommodative stance while focusing on withdrawal of accommodation
- RBI raises CRR by 50 bp to 4.50% effective May 21, 2022
- MPC expects inflation to rule at elevated levels, warranting resolute and calibrated steps to anchor inflation expectations and contain second round effects

MPC Statement:

MPC noted the surge in headline CPI in March to 7%, along with the rapid rise in inflationary pressures across the world. Thus, there is a significant upside risk to the inflation trajectory set out in the April statement. Since April meeting, disruptions, shortages and escalating prices induced by the geopolitical tensions and sanctions have persisted. Global commodity price dynamics are driving the path of food inflation in India, including prices of inflation sensitive items that are impacted by global shortages. The risks to the near-term inflation outlook are rapidly materializing, as reflected in the inflation print for March and the developments thereafter. Thus, the MPC expects inflation to rule at elevated levels, warranting resolute and calibrated steps to anchor inflation expectations and contain second round effects

While prioritizing Inflation over Growth in the April Policy, RBI had set the stage for normalization of monetary policy but nobody expected that words will pave way for blunt action so soon, less than a month after the April 8th MPC meeting.

Deciphering this surprise action from RBI, it seems to us that RBI has got concerned about inflation domestically after the March inflation print, as highlighted in their statement. In all likelihood the April CPI print is also going to be much higher than market anticipation and the trajectory of inflation will stay elevated, which in our view, led to this surprise rate action by RBI. Moreover in the last one month we have seen some aggressive communication from central banks in developed markets regarding the need for an appropriate response to inflation. Worldwide yields have surged as markets started to factor in monetary tightening amid sticky and elevated inflation levels.

Market Reaction & Outlook

The curve flattened significantly even as yields rose across the curve. 1yr Overnight Index Swap (OIS) has risen 100 bps with the 5yr OIS rising by 45 bps. The yield on the benchmark 10yr Bond has risen 30 bps to 7.40%

We expect 10yr yield to be rangebound between 7.25%-7.50% in the next few weeks as the sharp up move in yields to 3 year highs is likely to generate some demand.

We expect RBI to continue to frontload rate hikes and see the policy repo rate at 5.75-6% by March 2023.

We expect widening of corporate bond spreads over sovereign over the next 3/6 months as they have fallen to historically low levels led on the back of lack of supply and surplus liquidity and now as the RBI is becoming proactive in liquidity management, we expect corporate spreads to widen.

We would recommend Investors to stay invested in actively managed short duration funds and can look to increase their investment as yields rise. We would also recommend investors with longer investment horizon (> 3yrs) to start investing in actively managed long duration funds as yields are becoming attractive from a long term perspective.