PGIM
India Mutual Fund

RBI Policy View

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Long Pause….Pivot Later

The MPC meeting today was largely on expected lines as far as policy rates were concerned as the MPC maintained status quo on rates though it was a tad hawkish in its tone and guidance. All members of the MPC voted for a pause in rates while five of the six MPC members voted to retain the monetary policy stance at "withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth". The MPC lowered its inflation forecast for FY24 to 5.10% from 5.20% earlier taking into account the recent softness in inflation. The growth projection was retained at 6.50% for FY24. The RBI Governor, in his statement, reiterated that inflation coming down within the inflation targeting threshold was not enough and that RBI and MPC remain focussed on bringing inflation down towards the target of 4.00%. This statement added a touch of hawkishness in respect of the expectation of rate cuts as the swaps market was factoring in some expectation of rate cuts from December '23 which got pushed towards February '24 after the policy.

Market Reaction

Bond yields inched higher after the policy, as some sections of the market were expecting a change in monetary policy stance to "neutral", which did not happen. Further the reiteration of the 4% inflation target pushed out rate cut expectations, especially in the swaps market where the 1yr IOS Swap was higher by 6bps and the 5yr OIS was higher by 12bps. The benchmark 10yr Bond was trading 4 bps higher after the policy. This market reaction also has to be seen in the light of hardening global bond yields in response to the unexpected rate increases by the Reserve Bank of Australia and the Bank of Canada, both of which had paused earlier.

Our View

In our view RBI seems to have taken a nuanced view of the evolving scenario as the developed economies are still struggling to bring down inflation as evidenced from the unexpected rate increases done by RBA and BOC yesterday who had paused earlier in their rate hiking cycle. In fact the BOC statement stated that "major global central banks are signalling that interest rates may have to rise further to restore price stability" This was as explicit as it can come in terms of the global nature of the current monetary tightening cycle. In this context India is relatively well placed as inflation is under control and real rates are positive and expected to stay positive while growth is holding up and the current account deficit is expected to come around 1.20-1.30% of the GDP, which is easily fundable. Thus India is in a macroeconomic sweet spot and this is lending stability to India's markets with the benchmark 10yr bond yield hovering around 7% even as global bond yields have hardened by almost 50 bps in the last one month. In our view, the yield curve is likely to continue to take support from the stable macroeconomic variables and trade in a range. There is likely to be some steepening in the 2yr-10yr segment of the curve as rate cuts get pushed out and bond supply gets heavier on a net basis next quarter. We also think that India cannot cut rates until the global rate cycle has pivoted, the certainty of which can come only towards the end of the year. Thus RBI will be on a long pause. Another factor to consider is that the US real rates will turn positive as inflation in US is expected to fall towards 4% and below in the next couple of months and thus RBI will need to watch the real rate differential also.

We expect the benchmark 10yr bond to trade in a range of 6.95% to 7.20% over the next couple of months. We would recommend that investors take advantage of any retracement in yields and increase their allocation to fixed income if yields rise. We recommend investors should increase their investments in short duration category (upto 3 years) with predominant sovereign holdings while selectively looking at dynamic bond funds as per their risk appetite.

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