PGIM
India Mutual Fund

RBI Policy View

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A Wait and Watch Approach

The MPC policy meeting today was on expected lines as status quo was maintained on the policy rates and the monetary stance. The **decision on policy rates and the monetary policy stance was taken with a 4-2 majority just like in the previous policy meeting. Prof. Varma and Dr Ashima Goyal voted for a rate cut of 25bps along with the change in monetary policy stance to "Neutral".**

The RBI Governor, in his statement, while acknowledging the moderation in Inflation highlighted the uneven nature of the disinflationary process citing the volatility in food prices. The RBI governor also sought to address the ongoing debate between the "core" and food Inflation and that how much importance the MPC should give to food inflation.

The Governor's statement mentioned that the MPC's target is the headline inflation wherein the weight of food inflation is 46% and with such a high weight, food inflation cannot be ignored. Further, the governor's statement highlighted that "public at large understands inflation more in terms of food inflation than the other components of headline inflation. Therefore, we cannot and should not become complacent merely because core inflation has fallen considerably". It further stated that "high food inflation adversely affects household inflation expectations, which have a significant impact on future trajectory of inflation.

Household inflation expectations, after witnessing a moderating trend between May 2022 and September 2023, have edged up on the back of high food inflation since November 2023. Persistently high food inflation and unanchored inflation expectations – if they materialise – could lead to spillovers to core inflation through pick-up in wages on cost-of-living considerations. This, in turn, could be passed on by firms in the form of higher prices for services as well as goods, especially in a scenario of strong aggregate demand.

Third, these behavioural changes can then result in overall inflation becoming sticky, even after food inflation recedes. The MPC may look through high food inflation if it is transitory; but in an environment of persisting high food inflation, as we are experiencing now, the MPC cannot afford to do so. It has to remain vigilant to prevent spillovers or second round effects from persistent food inflation and preserve the gains made so far in monetary policy credibility".

Apart from this, the MPC statement also mentioned that "The MPC reiterates the need to continue with the disinflationary stance, until a durable alignment of the headline CPI inflation with the target is achieved. Enduring price stability sets strong foundations for a sustained period of high growth. Hence, the MPC also considers it appropriate to continue with the disinflationary stance of withdrawal of accommodation to ensure that inflation progressively aligns to the target, while supporting growth".

Thus RBI seems to be pushing back on suggestions of relooking at the monetary policy framework in the context of limited influence of monetary policy on food inflation which is mostly supply driven. This assumes important in the context of the trajectory of the future monetary policy decisions.

RBI's Inflation forecast for FY25 was upped marginally to 4.57% from 4.50% earlier while retaining its growth forecast for FY25 to 7.20% assuming normal monsoons.

On financial system stability, RBI voiced some concerns regarding the elevated credit deposit ratio which can have structural implications on banking sector liquidity and asset-liability- management. The central bank also voiced concerns on certain segments of loans, like retail loans for consumption, and top-up housing loans, which need to be better assessed and monitored in certain cases.

The undertone of the policy remains cautious and is being read as relatively hawkish compared to bond market expectations going into the policy.

Market Reaction

In the run up to the policy, bond yields had trended lower taking cognisance of the global developments where expectations of monetary easing had gone up over the past couple of weeks. The benchmark 10yr bond yield had traded earlier in the week to a low of 6.84% in response to the fall in global bond yields amidst recalibration of expectations of more rate cuts from the US Fed. Bond yields were stable after the policy. The benchmark 10yr bond yield ended the day at 6.88%, almost flat from pre policy levels.

Our View: Rate cuts in CY2025

We think today's policy is a continuation of the cautious approach taken by RBI over the last couple of policies with continued emphasis on macroeconomic stability. Given the current growth/ inflation dynamics and RBI's concern on growth in unsecured and certain other segments of banking credit, we think that RBI will be on a pause till the end of the calendar year 2024.

Normal monsoons can ease the concerns on food Inflation to a large extent and given the backdrop of high real rates and the start of the global monetary easing cycle, the rate cutting cycle in India can start from Q1 of CY 2025.

The possibility of monetary easing, favourable demand supply dynamics, steady PFI Inflows after the JP Morgan EM- Bond inclusion and a fair probability of India's sovereign rating upgrade over the next couple of years places Indian Bonds in a sweet spot. Bond yields tend to react ahead of expected monetary action and we continue to be constructive on long duration bonds. Investors can look at increasing their fixed income allocation.

Investors with medium to long term investment horizon can look at funds having duration of 6-7yrs with predominant sovereign holdings as they offer a better risk-reward currently. Investors having an investment horizon of 6-12 months can look at the Money Market Funds as yields are attractive in the 1yr segment of the curve. We expect the benchmark 10yr Bond yield to gradually drift lower towards 6.50% by Q3/ Q4 FY2025.