HSBC Mutual Fund

RBI Monetary Policy

October 6, 2023

Announcement

The Monetary Policy Committee (MPC) came out with their bi-monthly policy statement today. Some of the key announcements are as follows:

- The MPC unanimously decided to keep the policy Repo Rate unchanged at 6.50%
- Consequently, the Standing Deposit Facility (SDF) rate remains unchanged at 6.25% and the Marginal Standing Facility (MSF) rate and Bank Rate at 6.75%
- The MPC also decided by a majority of 5 out of 6 members to remain focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth

The growth forecast for FY2024 has been retained at 6.5%, with quarterly projections remaining unchanged. Q1 FY2025 growth is projected at 6.6%. Inflation forecast has also been retained for FY2024 at 5.4% with at Q2 FY2024 revised marginally upwards to 6.4% (from 6.2% earlier) while Q3 FY2024 inflation forecast is revised slightly lower to 5.6% (from 5.7%). Consumer Price Index (CPI) inflation for Q1 Fy2025 remains unchanged at 5.2%.

On liquidity, the governor continued to mention that the liquidity distribution in the banking system remains skewed with elevated levels of MSF borrowings co-existing with substantial funds parked under the standing deposit facility. Going forward, the RBI noted that the release of impounded I-CRR funds along with a pick up in government spending may ease liquidity conditions further, though this would be offset by increase in currency demand in festive season. **The governor mentioned that while remaining nimble, the option of OMO Sales (Open market operation sales) may be resorted to in order to manage liquidity, with timing and quantum of such operations dependent on evolving liquidity conditions.**

On the external front, the governor expressed confidence in meeting external financing requirements, noting India's relatively lower vulnerability in comparison with emerging market peers as well as strong foreign portfolio flows in recent months

The policy statement mentioned that unprecedented food price shocks are impinging on evolving trajectory of inflation and recurring incidence of such overlapping shocks can lead to generalization and persistence. The MPC noted that core inflation is easing and easing vegetable prices and recent reduction in LPG prices should improve the near-term inflation outlook and mentioned that inflation expectations as measured by RBI's consumer surveys have seenfurther anchoring. However, with dip in area sown under pulses, dip in reservoir levels, persistence of El Nino conditions and volatile global energy and food prices, the statement noted that there remains risk to the future trajectory and hence the MPC mentioned that it would remain on "high alert" in terms of monitoring these risks.

The governor's statement mentioned that monetary policy must be in readiness to take appropriate and timely action to prevent any spillovers from food and fuel price shocks and risks to anchoring of inflation expectations. **The governor further reiterated that "the inflation target is 4 per cent and not 2 to 6 per cent" and the need to align inflation to this target of 4 per cent on a durable basis.** With inflation ruling above this target band, the statement mentioned that monetary policy would need to remain actively disinflationary

Market Movement Post RBI Policy

While the unchanged rate and stance were in line with consensus, the key surprise was the reference in the governor's statement to Open Market Operations (OMO) sales, which imparted a hawkish tinge to the policy. As a result of this, markets reacted negatively with the G-Sec yields moving higher by 8-14 bps across the yield curve. Corporate bond yields were higher by 5-8 bps. Money market yields have remained broadly stable with movement up to only 2 bps.

Outlook

Global bond yields have continued to move higher in the past month with the narrative moving towards higher for longer on the US rates front. Growth and employment indicators in the US continue to indicate an economy far from recession. This has re-ignited fears that inflation may remain stubbornly above the Fed's target of 2% and higher for longer policy rates may be required by the Fed over the coming 3-4 quarters before the fight against inflation can be declared as over.

Indian bond markets have so far been less volatile relative to global bond markets. While the RBI monetary policy was on expected lines, the reference to OMO sales in the Governor's statement was not anticipated by the market, thereby leading to a negative reaction post the MPC meeting.

On the other hand, the inclusion of IGBs in global bond index remains the biggest positive for domestic markets. Additionally, with the Government sticking to their borrowing program in conjunction with a low net supply (given substantial G-Sec maturities over the next few months) for second half of this financial year, the demand supply equation for G-Sec remains favorable in the near term. However, this would temper to some extent if RBI were to resort to OMO sales going forward as mentioned by the Governor.

Globally, rates could remain volatile going forward. Against this backdrop and given the overhang of potential OMO sales, our bond markets could see further correction with yields moving higher in the immediate term. However, **we have seen in the past that reversal from such points can be sharper than the move up. Hence, we believe that any further correction can provide an opportunity to add duration and provide a good entry point into longer duration bond funds. In our view, the risk–reward has turned in favor of careful deployment into certain areas.**

Past performance is not an indicator of future returns. Source: RBI Policy Statement, HSBC MF. Data as of Feb 8, 2023

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