RBI chooses to play by the script

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Mutual Fund

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As broadly expected by us and majority of the market participants, the RBI MPC in a 5-1 vote decided to hike rates by 25bps, keeping the stance unchanged at neutral. The accompanying language has been kept deliberately balanced, highlighting two sided risks to future projections and actions, and hence the choice of a neutral stance allowing flexibility on either side to react to global and domestic developments.

Key highlights:

- The ***global growth scenario is a lot more asynchronous*** than in the recent past, with Europe, Japan and China showing signs of slowdown, unlike the US where growth continues to be robust
- ***Intensification of trade wars*** could take a further toll on global growth, and is a key factor which could derail global growth projections and influence policy action globally and in India as well
- On the domestic front, growth indicators remain robust across manufacturing as well as services, with RBI retaining its GDP growth projection at 7.4% for FY19 and noting that the ***output gap has virtually closed.***
- On the inflation front, the RBI highlighted the continued ***increase in inflation expectations*** in its survey of households. The RBI has moved up its CPI forecast for H2 FY19 by 0.1% to 4.8%, while also introducing its forecast of 5% for Q1FY20 for the first time, signifying a 1% gap versus their CPI target.
- The usual laundry list of risks have been highlighted, which include volatile oil prices, protectionist trade policies, rising household inflation expectations, hardening input prices for firms, fiscal slippage at centre / state level, and finally the actual manner of MSP hike implementation.

Market impact:

- With markets already discounting the rate hike and the RBI governor ensuring that the rate hike was accompanied by neutral commentary in his post policy media interactions, there was ***limited impact across various debt market*** segments.
- Slight moderation in yields at the longer end by 4-5 bps took the 10 year G-Sec down to 7.72%, although the intra-day fall in oil prices probably had more to do with the rally than the MPC itself.
- The markets still have very limited clues on ***how the RBI will tackle the liquidity deficit*** that is sure to hit us in H2, when currency in circulation invariably tends to pick up. Hence, the uncertainty continues around the extent of RBI OMOs that the market can expect during the second half of the year, when supply is going to be heavy – not just from the centre, but also states and other corporates.
- In conclusion, the RBI has understandably stuck to a predictable line, thereby ensuring continuing ***credibility on its inflation targeting framework***, while also ensuring that ***markets cannot take future policy direction for granted***, given various developments in the global as well as domestic macros.

Key take-aways:

- We believe investors, who want to keep their MTM volatility relatively lower, should take advantage of the carry that the front end of the curve (upto 2 years) provides, in an environment where risks of violent sell-off have materially diminished. Accordingly, ***ultrashort term funds, short term funds and accrual oriented funds*** offer attractive risk adjusted returns and can be considered by such investors depending on their investment horizon.
- However, from a ***longer term perspective***, we believe interest rates are at the upper end of the range, and price in a majority of the negative factors currently at play. From a 3-5 year perspective, we believe investors who can absorb near term volatility, could gradually allocate a portion of their long term savings to debt products which invest in the ***longer end of the AAA corporate bond curve***, which is attractively priced. We believe such a strategy should do quite well, especially compared to investing in tax free bonds or long term FDs where current yields are quite unattractive.