October 2018

Key highlights:

- The Monetary Policy Committee (MPC) surprised beyond anyone's expectations today by holding rates unchanged (5-1 vote), against market expectations of atleast a 25bp (if not 50bps) hike.
- The policy stance was however changed from "neutral" to "calibrated tightening", thereby adding somewhat to the confusion in the markets over what the RBI was trying to signal, as their own CPI forecasts for H2 FY19 as well as for Q1 FY20 were marked lower by 60 and 20bps respectively versus the prior MPC meeting.
- The MPC document itself hardly had any meaningful references to the recent sharp weakening in the INR or the impact on India's current account dynamics from the sharply rising crude oil prices – which was hard to digest as it was precisely these two factors which had led to markets' expectations of potential RBI rate hikes.
- The MPC has taken comfort from the recent downward trend in CPI readings, surprisingly benign food inflation, and its own models which suggest that the trajectory of future CPI readings is likely to be lower than earlier expected.

What spooked the markets?

While the status quo on rates with a stance change (instead of 25 bps hike with possibility of stance change expected by the market) – although surprising – should have been taken positively by all markets, what ended up rattling currency and equity markets were a couple of statements made by the RBI Governor and Deputy Governor during their media press conference.

- The RBI Governor made it very clear that the exclusive mandate of the MPC is inflation targeting, implying therefore that currency weakness was not an issue which necessitated any kind of action on their part. In a world where currencies across emerging markets are getting brutally hammered and central banks are doing their best to protect it through various measures (trade related as well as interest rates), reiteration of a complete hands-off approach by the RBI MPC with regard to INR immediately sent the currency into a tailspin with INR breaching 74 per USD in just a few seconds thereafter.
- With INR moves getting unhinged, equity markets too started falling sharply, led primarily by NBFCs. This can be attributed to the absence of any special liquidity measures by the RBI to help NBFCs tide through this challenging period. On the contrary, the RBI DG further clarified that the RBI is likely to come out with changes to the regulations governing NBFC's ALM guidelines as well as high CP dependence, so that ALM mismatch of NBFCs which has caused the recent turmoil does not get repeated in the future. While the details of this are awaited, RBI's intent of the need to slow down NBFCs rapid growth and funding mismatch was enough to hammer this entire sector.

Market reaction and our takeaway:

While the currency and equity markets reacted very negatively to the MPC press conference, the bond markets did experience a small relief rally, with 10-year government security yield moving lower by 8bps to 8.03%. The short end of the curve also witnessed a sharp rally, with a few deals happening almost 30-50bps lower in the 2-3 month segment.

While the bond and money markets did react positively, we expect the rally to be short lived, especially if the global macro situation continues to deteriorate with US T yields and oil prices continuing to move higher, thereby keeping pressure on various EM currencies. In such a scenario, the INR would probably start exhibiting a much higher beta to the rest of EM and FPIs in both equity and debt markets would be more likely than before to unwind some of their long positions. Also, we continue to expect that CPI in Q4FY19 and Q1FY20 is likely to overshoot RBI's downwardly revised forecasts, and hence would necessitate rate hikes of atleast 50bps later during the year, something that could have been front-ended thereby giving more certainty to market participants.

Accordingly, we prefer not to chase this move lower in yields, but to maintain our cautious stance in terms of duration positioning and risk across various fund categories. What would change our view and stance would be any significant and sustainable signs of a reversal in the global macro situation viz. US Fed Rate trajectory, US T yields, oil prices and EM FX weakening trends, in which case this MPC would end up being an amazingly fortuitous move and timed to perfection to calm down the Indian markets!

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