RBI Monetary Policy Review

February 2019

The Monetary Policy Committee (MPC) decided to reduce the policy ***repo rate*** by ***25 bps*** to ***6.25%*** from ***6.50%*** and changed the stance from "calibrated tightening to "neutral". While the change in stance was unanimous, the rate cut was voted 4-2 in favor of the cut.

Our key takeaways

- On the CPI front, the RBI has further lowered its inflation forecasts, down to 2.8% in Q4FY19. For ***H1FY20***, CPI projections have been revised downwards to ***3.2-3.4%*** from ***3.8-4.2%*** and ***3.9%*** in ***Q3FY20*** with risks balanced around the central trajectory. While core inflation continues to be high, food inflation has continued to surprise on the downside. The Reserve Bank's surveys show that inflation expectations of households as well as input and output price expectations of producers have moderated significantly. Inflation expectations of households, measured by the December 2018 round of the Reserve Bank's survey, softened by ***80 basis points*** for the three-month and by ***130 basis points*** for the twelve-month ahead horizon.
- On the growth front, the ***GDP growth*** for ***2019-20*** is projected at ***7.4%*** – in the range of 7.2-7.4% in H1, and 7.5% in Q3 – with risks evenly balanced.
- The MPC has flagged upside risks to inflation due to volatile vegetable and Oil prices and sharp uptick in education and health components in core CPI. Other risks highlighted are volatile financial markets, trade tensions and geo-political uncertainties, implications of budget and monsoon.
- After assessing that output gap had virtually closed in the previous policies, the MPC in this policy notes that the output gap has opened up as actual output has inched lower than potential.

Market Impact

While the market was at consensus in predicting the change in stance back to "neutral", it was divided with the rate cut as the budget preceding the policy was viewed by certain sections of the market as fiscally expansionary and MPC could have waited for further data on the evolution of the higher core inflation before cutting rates. Also to cut rate while the stance of the policy was still "calibrated tightening" would not have bode well with the MPC. However, the MPC chose to act with both the stance change and cutting repo rate by 25 bps in this policy itself.

The G-Sec and corporate bond market has broadly rallied by 5 to 15bps. The 4-5 year Gilts yields are trading at 7.08 to 7.20% lower by 10-15 bps and the 10 year G-Sec yield is trading at 7.33-7.50% lower by 5 bps. Corporate bonds in the 1-3 year segment are lower by 15-20 bps whereas 5 year and 10 year corporate bonds are lower in sync with the G-Secs by 15 bps and 10 bps respectively.

Outlook & Investment Strategy post RBI MPC

While another rate cut in the April policy will depend on the future inflation readings, the market will have to absorb Rs 7.1 trillion of government bond supply for FY20 alongwith Rs 5 trillion of state loans. In absence of higher OMO purchases going forward and possible front-ending of the G-Sec supply, the yields on the longer end of the curve will remain under pressure. We expect the 10 year Gilts to trade in the range of 7.15% to 7.60%.

With the steepening G-Sec yield curve, 1 to 4 years corporate bonds are still available at attractive spreads and conservative investors can benefit by investing in short term bond fund. 1 year CDs are trading in the range of 7.75% to 8.10% offering a 150 to 200 bps carry over the repo rate which investors can benefit by investing in ultra short term bond fund.

The L&T MF approach of keeping high quality funds such as L&T Ultra Short Term, L&T Short Term Bond Fund, L&T Banking and PSU Fund invested only in the top quality AAA papers ensures that credit risks in these funds are kept at a minimum, and we would advise investors to start looking at these segments gradually, given the attractive carry they offer.

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 such as the L&T Triple Ace Bond Fund. 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.

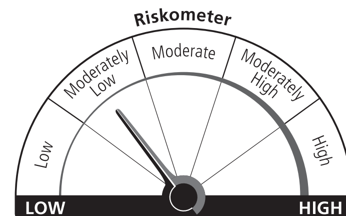
This product is suitable for investors who are seeking*

L&T Ultra Short Term Fund
(An open ended ultra-short term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 3 months to 6 months.)

- Generation of reasonable and stable income and liquidity over short term
- Investments predominantly in highly liquid money market instruments, government securities and corporate debt

L&T Short Term Bond Fund (Formerly known as L&T Short Term Opportunities Fund)
(An open ended short term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 1 year to 3 years.)

- Generation of regular returns over short term
- Investment primarily in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions in India



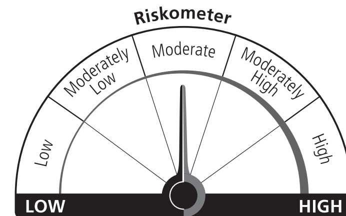
Investors understand that their principal will be at moderately high risk

L&T Banking and PSU Debt Fund
(An open ended debt scheme pre dominantly investing in debt instruments of banks, public sector undertakings, public financial institutions and municipal bonds)

- Generation of reasonable returns over short to medium term
- Investment in xed income securities and money market instruments

L&T Triple Ace Bond Fund
(An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds)

- Generation of regular and stable income over medium to long term
- Investment predominantly in AA+ and above rated corporate bonds and money market instruments



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***Investors should consult their financial advisers if in doubt about whether the product is suitable for them.**

Source: RBI Press Release, Internal

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.