February, 2020

Sixth RBI MPC meeting Feb, 2020: Imparts significant downward thrust to short end of yield curve

Key Highlights

RBI Monetary Policy Committee (MPC) maintained status quo with a 6-0 unanimous vote, both on policy rate and on its accommodative stance. While the bond market was not expecting a rate move at this policy, there were some worries about the possibility of a stance change to neutral.

With December CPI at 7.35%, way above RBI MPC's 4% target, and inflation over the next few months likely to remain elevated, the decision to stay on hold and monitor incoming data is well justified. While stating that there was space to lower interest rates further, the statement highlighted various data points to be monitored for further clarity, before deciding on the timing of any rate cuts.

The MPC has revised its Q4 FY20 CPI to 6.5% versus its range of 4.7-5.1% for H2 FY20 in its December meeting. Similarly, CPI for H1 FY21 has been moved up to 5.0-5.4% from 3.8-4.0% earlier, and that for Q3 FY21 has now been pegged at 3.2%.

GDP growth for FY21 has been projected at 6%, with H1 FY21 GDP growth at 5.5-6%, versus 5.9-6.3% projected in its previous meeting, reflecting the sharp downward trend in the growth trajectory.

The MPC has noted various risk factors which make the evolution of CPI quite uncertain, with risks of CPI remaining elevated in H1 FY21, viz.

- Spike in onion prices, which has recently started to ebb
- Hardening in prices of pulses and proteins
- Adjustments in telecom charges, impacting core CPI
- Increase in prices of drugs and pharmaceuticals
- Impact of new emission norms

While underscoring the need to stay vigilant, the MPC clearly has ascribed more weightage to the severe growth slowdown and consequent negative output gap. Accordingly, the statement has continued with its forward guidance of retaining an accommodative stance "as long as necessary to revive growth".

Our Takeaway And Outlook

Overall, the MPC statement can clearly be seen as fairly dovish versus market expectations, especially given that the 6 member MPC's reaction, function to CPI being above 7%, was not clearly known before this MPC. The policy would give a fair amount of comfort to the market, that rather than just the headline CPI, the committee is focused on the underlying drivers of inflation and that demand side worries are still unfounded at a time when growth is so anemic.

The real action was much more in the accompanying "statement on Development and Regulatory Policies", which had some huge impactful announcements. Taking off from where the Union Budget had left off, the RBI has taken several well-targeted initiatives to impart a positive stimulus to growth.

Most importantly, the move on Long Term Repo Operations (LTRO) for improving monetary transmission, in our view, is a hugely significant one. Starting February 15, 2020 – the RBI shall conduct term repos of one year and three year tenors upto total amount of Rs. 1,00,000 crore, at the policy repo rate of 5.15%. This essentially gives very cheap three year repo funding to banks, thereby having the potential to bring down short term rates very significantly over the coming months. ***The 1-5 year part of the government security and AAA corporate bond curve are both likely to see a significant rerating downwards, of which 10-15 bps has already been witnessed today itself.***

Apart from this, targeted measures to incentivize bank credit to specific sectors were also announced, through CRR benefit for incremental retail lending to autos, housing and MSMEs up to July 31, 2020. In a bid to help banks and NBFCs to deal with the stress in certain sectors, extension of one-time restructuring scheme for MSME advances and a similar move of permitting extension of date of commencement of commercial operations of project loans for real estate by one year, were also provided.

Overall – the RBI MPC delivered much more than what the markets had bargained for, and has imparted a ***significant downward thrust to yields, especially at the shorter end of 1-5 year segment.*** Also, risks of a knee jerk reaction by MPC to the elevated CPI readings are now unlikely to materialize over the coming quarters and that should provide a huge comfort to various market participants and investors, to play out their long Fixed Income strategies, in a backdrop of reduced risks of a sharp upward move in interest rates.

Source: RBI Press Release, Internal

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