

May, 2020

In the backdrop of the evolving domestic market conditions, the Reserve Bank of India (RBI) convened a surprise, unscheduled Monetary Policy Committee (MPC) meeting, the outcome of which was announced today.

Key Highlights

- The MPC voted by 5 votes to 1 to reduce the policy repo rate by 40 bps to 4.00%. Correspondingly, the reverse repo rate was reduced to 3.35% and the Marginal Standing Facility (MSF) rate reduced to 4.25%. The MPC decided to continue with the accommodative stance till growth revived and the economic impact due to COVID-19 mitigated
- The MPC showed concerns regarding collapse in domestic demand and investment activity. Barring agriculture, all other sectors showed considerable contraction
- As per the MPC, the outlook for inflation remained highly uncertain. The one-off spike in food inflation which was seen in April is expected to moderate with gradual lifting of lockdown. This in conjunction with softening in crude oil prices and commodities and weak domestic demand augers well to keep inflation under check. However, persistent supply side dislocations along with continued volatility in financial markets could add uncertainty to inflation. Taking all these factors into consideration and a favourable base effect, the MPC expects inflation to fall below the mandated 4% in H2 FY2021
- The MPC expects growth to languish for the first half of the financial year, with recovery expected only in Q3 and Q4. Given the uncertainty around how much time it might take post lifting of lockdown for normalcy to restore and economic activity to pick up, the risks to growth on the downside are fairly substantial. Although, the MPC did not give any guidance on the GDP growth number, they expect it to remain in negative territory for the financial year

The RBI Governor also announced measures pertaining to developmental and regulatory policies. The overall theme of these measures was to provide some flexibility to financial institutions to enable them to function efficiently, reduce burden on both borrowers and lenders and to avoid any disruptions that might have occurred due to COVID-19.

- The moratorium of 3 months by Banks and Financial Institutions on all outstanding loans, which was announced earlier, has been extended by another 3 months
- Similar extension of 3 months has been provided for interest payment on working capital facilities provided by lending institutions in addition to the 3 months announced earlier. The accumulated interest can be converted into a funded interest term loan
- The large exposure framework for Banks in terms of exposure to a group has been increased from 25% to 30% of their eligible capital base

The Governor reiterated that they will undertake all possible measures to help economic activity to get back on track and that they will remain proactive in their approach.

Market Impact

The surprise announcement of the unscheduled MPC along with the 40bps rate cut, expectedly led to a rally across the G-Sec and AAA curves. Money market rates (upto 1 year segment) rallied the most, with yields falling by 20-25 bps during the day.

Given the attractive yield pickup versus the money market rates, the other segment which performed very well, were 2-3 year AAA corporate bonds, which rallied by about 15-20 bps. While the medium to longer end of the G-Sec curve rallied sharply initially, some of the gains were given back and yields retraced higher as the market expectations regarding a solution to the demand –supply conundrum of the G-Sec market was left unanswered.

The RBI Governor chose to stay clear of any statements about the RBI's plans – either with regard to deficit monetisation or about its OMO strategies. The old 10-year G-Sec benchmark ended at 5.96% (vs 6.03% previous day), and the new 10-year G-Sec benchmark moved lower by just a few bps to 5.74%.

Outlook

The RBI continues to remain proactive, as shown by this surprise MPC meeting just 2 weeks before the scheduled June MPC. Given the significant downside to GDP growth on account of the virus spread and lockdown measures, the RBI has clearly signalled it stands ready to do more if needed, which does open up space for some more policy easing going forward.

With abundant liquidity in the system, and successive policy rate cuts (reverse repo at 3.35% and repo at 4% now), the bond market curve has been aligning itself accordingly, with sharp rallies across various segments over the past month.

We continue to see room for interest rates to move lower still, as the carry still remains fairly attractive. With overnight rates below 3% and 2-3 month CDs/CPs below 3.5%, AAA corporate bonds in the 2-3 year segment still offer sufficient yield pickup and carry, despite low absolute levels in an environment of limited bond supply.

The medium to longer end of the yield curve still remains elevated, caught in the crossfire of huge supply of G-Sec and State Development Loans (SDLs), while still awaiting clarity from RBI on the mechanism through which it plans to absorb a large part of this supply. Hopes of some clarity emerging today have been dashed, but markets remain hopeful of RBI delivering through on this, atleast by the time of the upcoming June MPC.

We believe it is essential for RBI to step in a very significant way to absorb the upcoming G-Sec supply, and that it is a matter of time before they come clean on their strategy to the market. Accordingly, ***we remain positive on our outlook for longer term interest rates to move lower over the coming weeks and months, both in Government security and AAA rated corporate bonds.***