RBI Monetary Policy Review

L&T Financial Services
Mutual Fund

Aug, 2020

The Reserve Bank of India (RBI) Monetary Policy Committee (MPC) decided unanimously (6-0 vote) to hold all policy rates unchanged, broadly as expected by a majority of the market. Consequently, ***the reverse repo and repo rate stand at 3.35% and 4% respectively.***

Key Highlights

- The MPC chose not to give a projection for the GDP growth for the year, instead just saying it expects FY21 GDP to be negative
- Despite only moderate increase in Minimum Support Price (MSPs) and a good monsoon so far, the MPC noted that upside risks to food inflation remain, especially in vegetables and protein based food items such as pulses. On the non-food side, higher taxes on petroleum products may lead to cost push pressures. Similarly, hike in telecom charges, rising gold prices and hikes in prices of steel (driven by higher raw material costs) all pose upside risks to inflation outlook
- The MPC also mentions volatility in the financial markets and rising asset prices as upside risks to inflation
- The MPC noted that various measures taken so far are working their way through the economy and have resulted in significant easing of financial conditions, lowering interest rates in money, bond and credit markets, and narrowing down spreads
- Given the unprecedented stress experienced by the economy, the stance of the MPC remains accommodative as long as necessary to revive growth. While space for further rate cuts is available, the MPC noted that it is important to use it judiciously and opportunistically to maximize beneficial impact on economy
- Probably, the most important measure that was announced along with the MPC statement was the much needed special window for restructuring those corporate loans that have been a victim of COVID-19 related stress. With the ongoing loan moratorium ending in August, it was critical to have such a timely restructuring scheme announced, in order to keep banking sector NPA worries in check. An expert committee (under KV Kamath) will lay out the financial parameters and sector specific benchmarks for this restructuring window

Key Takeaways

- While the status quo on rates wasn't a surprise, the tone of the MPC document was slightly more hawkish than expected, flagging upside risks to inflation (albeit supply side driven factors) and the need to see CPI move decisively lower (durable reduction) within the inflation targeting band, before the MPC thinks about using any additional space for further rate cuts. ***This effectively implies that markets may need to wait till the December policy for any potential rate cut, which also would be dependent on the CPI trajectory over the coming months***
- The other important point to note is that despite the unprecedented growth impact on account of the pandemic, ***the MPC recognizes its primary mandate is to achieve medium term target for CPI*** of 4% within a band of +/-2% and not diluting or rationalizing non-achievement of this target
- Lastly, there was no mention about future course of action with regard to the huge supply of Government bonds, either through OMOs or via monetization of deficit, which effectively means that ***the market would need to continue digesting the upcoming supply,*** while the uncertainty about the scale and timing of RBI's OMO strategy continues to be an overhang.

Market Reaction

Markets were slightly disappointed by the RBI's focus on inflation control, despite the collapse in growth. However, ***continuation of the accommodative stance, adequate liquidity surplus in the system and expectation that RBI will not allow a significant sell-off in bond markets,*** *meant that the negative reaction was quite muted and yields were up by only about 3-5bps across the medium to longer end of the curve.*

Outlook and Strategy Recommendations

Flush liquidity in the system, good demand for bonds by banks in absence of meaningful credit growth and healthy flow trends in mutual funds are all likely to remain positive drivers, ensuring that yields remain low, especially with the RBI backstop at play.

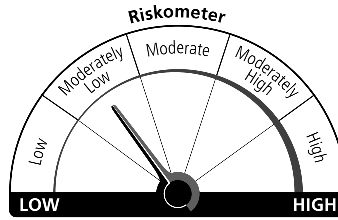
Thus, ***on a risk-adjusted basis, the yield curve continues to remain steep, with carry remaining attractive*** as we move longer on the yield curve. Accordingly, in our view, ***the AAA curve remains attractive both on the 3-year space (where our L&T Short Term Bond and L&T Banking & PSU Debt Fund are invested), and also at the longer end (where L&T Triple Ace Bond Fund is positioned).***

For investors looking to make additional alpha, a good alternative is to play duration actively. The current bond market environment is a tricky one, where rates are likely to stay low or rally over the coming year, with potential for normalization (upward movement) of rates in late 2021/2022 as and when the economic situation in the post COVID era improves. Active management of duration, to capture the ongoing rally, while limiting losses in later years through well timed duration reduction – may offer an optimal strategy. We believe, ***L&T Flexi Bond Fund and L&T Gilt Fund, both have a demonstrated track record of active duration management in past such cycles, and are well suited in the current market conditions.***

The other alternative for alpha generation that is slowly catching investor attention is good quality, but less liquid securities in the AAA/AA+/AA rating buckets. While the credit environment surely remains extremely challenging and warrants abundant caution, we do believe that funds which can offer access to good quality issuers in these higher rating buckets could be considered by investors willing to move up a notch in the risk-reward chain. We believe that ***L&T Resurgent India Bond Fund is well positioned in this space., with a pickup of around 300 bps over 3-year AAA PSU yields.***

This product is suitable for investors who are seeking*

L&T Short Term Bond 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 in fixed income securities of shorter term maturity.



Investors understand that their principal will be at moderately low risk

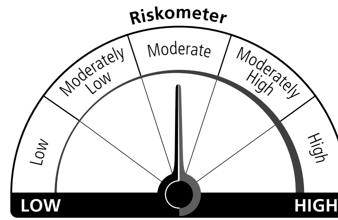
L&T Banking and PSU Debt Fund
An open ended debt scheme primarily investing in debt instruments of banks, public sector undertakings, public financial institutions and municipal bonds:
• Generation of reasonable returns and liquidity over short term
• Investment predominantly in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions and municipal corporations in India

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

L&T Flexi Bond Fund
An open ended dynamic debt scheme investing across duration:
• Generation of reasonable returns over medium to long term
• Investment in fixed income securities

L&T Gilt Fund
An open ended debt scheme investing in government securities across maturity:
• Generation of returns over medium to long term
• Investment in Government Securities

L&T Resurgent India Bond Fund
An open ended medium term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 3 years to 4 years
• Generation of income over medium term
• Investment primarily in debt and money market securities



Investors understand that their principal will be at moderate risk

***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. CL07349