December, 2020

November continued to see a rally in yields across various segments, with the rally being most pronounced at the shorter end of the curve on the back of a huge liquidity surplus in the system and the continued surge of inflows into various short to medium categories of mutual funds.

Short dated Government and corporate bonds rallied by 10-15 bps. Longer end bonds were however flattish, as the buildup in expectations around RBI's OMO support met with some disappointment. CPI for October came higher at 7.61%, although markets chose to treat the reading as transient as guided by the RBI MPC members.

With RBI's relentless FX intervention leading to a further surge in liquidity surplus, short end rates crashed to well below reverse repo rates. 3M T-bill slumped to a low of 2.91%, and overnight rates hovered in the 2.70-2.90% range, pulling down the yields on short CDs and CPs also significantly below the reverse repo rate.

Key announcements on policy rates

MPC December 2020: Status Quo…

Some of the key announcements of the Monetary Policy Committee (MPC) are summarized below.

Policy Rates:

- The MPC members unanimously voted for keeping the policy rates unchanged
- The MPC also unanimously decided to continue with an accommodative stance as long as necessary (at least during FY2021 and into FY2022) to revive growth on a durable basis

The MPC continues to provide forward rate guidance as an effective tool to ensure monetary transmission and enable stability to bond yields in an environment of higher fiscal borrowing. This was broadly in line with market expectations, given that RBI has repetitively emphasized the importance of reviving growth while keeping inflation within the targeted band.

Inflation Outlook: The MPC acknowledged the fact that the inflation outlook has turned adverse over the last couple of months owing to supply-side bottlenecks, and with economic activity picking up and crude prices moving higher, core inflation might remain sticky. However, with a good kharif harvest, cereal prices might soften and vegetable prices may ease with the onset of winter. But this relief might only be transient and the MPC will close monitor any threats to price stability. With this backdrop, the MPC is constrained currently to use any monetary policy space available. Keeping these factors in mind, the MPC revised its inflation outlook upwards. CPI inflation is projected at 6.8% for Q3 FY2021, 5.8% for Q4 FY2021 and 5.2% to 4.6% in H1 FY2022, with risks broadly balanced. This is against an expectation of 5.4%-4.5% for H2 FY2021 and 4.3% for Q1 FY2022 in the October policy.

GDP Outlook: The MPC recognized that growth has picked up in pockets, with rural demand strengthening further and urban demand gaining some momentum. The optimism around the business sentiment is improving and the progress on a possible vaccine is encouraging. However, private investment has still not picked up and capacity utilisation is far from optimal. With fears around a second wave of the pandemic building up, growth recovery might still require further support. Under this backdrop, the MPC has revised its growth forecast. Real GDP growth for FY2021 is projected at -7.5% (against -9.5% in the October policy). GDP growth is expected to reach positive territory in Q3 FY2021 (0.1%) and to be in the 21.9% to 6.5% band in H1 FY2022, with risks broadly balanced.

Other significant non-policy related announcements were related to the expansion of the ontap TLTRO to more sectors and allowing Regional Rural Banks (RRBs) access to the liquidity windows of the RBI as well as Call/Notice money market.

Market Impact

The MPC maintained status quo in today's policy reiterating the fact that growth is of paramount importance while ensuring that inflation remains within the mandated band.

Markets were worried that given the excess surplus systemic liquidity and with short term money market rates having fallen below the Reverse Repo, the MPC might come out with some measures pertaining to removing the excess liquidity to bring short end rates to more acceptable levels. However, the MPC decided not to tamper with the excess liquidity currently and assured market participants that ample liquidity will be provided. They were mindful of the evolving macroeconomic and domestics factors, and reiterated that all tools at their disposal will be used at the appropriate time with the objective of supporting growth and financial stability

The Governor also emphasized that it is important to ensure that fiscal borrowing goes through with minimal disruptions, thereby giving signals to market participants that liquidity is here to stay and the 'RBI PUT' is still intact.

Government Securities across the curve moved down by 3-8 bps, with yields in the 4-7 year point falling the most. The new 10-year G-Sec moved down by about 3 bps. Corporate bond yields also fell correspondingly, with the 2-5 year curve moving down by 5-10 bps and a lesser impact on the 10-year curve. Rates at the very short end which had earlier moved higher on fears of possible liquidity removal measures retraced lower in relief.

Outlook

While market participants were a bit cautious ahead of today's policy, given the higher inflation prints and excess surplus liquidity, the MPC has made it clear that the need to support growth trumps these concerns at present.

- Given that the MPC has continued to provide forward rate guidance, it clearly indicates that we are likely to remain in a low interest rate environment for some more time to come
- Although, any further rate cuts look less likely with the likely CPI trend over coming months, the MPC stands committed to ensuring that financial markets will be provided with ample liquidity and all measures will be taken to ensure financial stability, reinstating the RBI PUT option and the one-sided risk play.
- **Thus, the carry earned by moving longer on the yield curve (compared to the very short end) is still very attractive, especially in a protracted era of 'low for longer' interest rate policy.**
- Inflation trends over the coming months need to be monitored closely, as both food and core inflation need to start moving lower, in order to give RBI enough space to continue with their accommodative policies. If this were not to happen, the next few MPC meeting could again lead to some uncomfortable questions around their commitment to inflation targeting and MPC credibility.

Overall, while the absolute yield levels continue to trend lower, we do see the risks as one –sided as any upside in yields is likely to be capped by the RBI measures, especially given the forward time-based guidance of accommodative policies by the MPC till early next fiscal year. **We continue to recommend investors to earn the extra carry provided by the still steep yield curve.**

Source: RBI Press Release, Internal

Mutual Fund investments are subject to market risks, read all scheme related documents carefully. CL07689