RBI shocks markets with a surprise rate hike

The Monetary Policy Committee (MPC) in a surprise move today, hiked rates outside of the bi-monthly policy meeting. Some of the key announcements are as follows:

- The MPC members unanimously voted to increase the policy repo rate under the Liquidity Adjustment Facility (LAF) by 40 bps to 4.40% with immediate effect
- Consequently, the Standing Deposit Facility (SDF) rate was changed to 4.15% and the Marginal Standing Facility (MSF) rate and Bank Rate changed to 4.65% each
- The MPC unanimously decided to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remained within the target going forward while supporting growth
- Additionally, the RBI also decided to increase the Cash Reserve Ratio (CRR) by 50 basis points to 4.50% of Net Demand and Time Liabilities (NDTL), effective from the fortnight beginning May 21, 2022. This would result in the withdrawal of liquidity to the tune of INR 87,000 Crs

Market Movement:

Markets reacted sharply to the unanticipated move today. Short assets of 1-2 months moved up by 40-45 bps, while up to 1-year assets moved higher by 50-60 bps. Corporate bonds up to 3-years moved up by around 50 bps while the movement beyond that was 30-40 bps. G-Sec in the 4-year segment moved by 45 bps and movement in the longer end was 20-30 bps.

Our Take

The MPC has stunned the markets with its inter-meeting 40 bps rate hike, coupled with the 0.50% CRR hike. One of the key reasons for this surprise rate hike has been attributed to the significant upside risk to the inflation trajectory set out by the MPC in the April policy. The March CPI print was higher than RBI and market expectations and clearly, the April CPI Inflation is likely to be upwards of 7.50%. Amid this backdrop, elevated inflation for too long might de-anchor inflation expectations and impact growth and financial stability, necessitating such an aggressive move.

The entire sequence of gradual rate normalization assumed by the markets so far now needs to be recalibrated to factor in a policy repo rate of 5.15% (policy rate before MPC began easing to allay growth fears due to the pandemic) within the next two policy meetings, with a mounting risk that it could happen at the June MPC itself. Apart from the accelerated timing of rate hikes, markets are grappling with the uncertainty around where the terminal rates are headed. So far, RBI has been tightlipped about this, especially given the various uncertainties on the global, geopolitical and domestic front. But markets are now likely to price in a terminal rate above 6.00%, which would imply further upside in yields before we can expect some consolidation to happen.

We continue to remain cautious in our duration across various actively managed funds while keeping a keen eye on when the balance of risks starts tilting in favor of adding duration.

L&T Financial Services
Mutual Fund

Source: RBI Press Release, internal