HSBC Mutual Fund

RBI's policy bonanza amid global uncertainty

May, 2025

After immense chaos and volatility witnessed in April, by end May there was a bit of calm with the US administration retracting and putting on standby some of its aggressive measures on its trading partners. While US-China meet in Geneva led to a 90-day halt on tariffs on Chinese goods, the uncertainties linger on even as bilateral negotiations between countries & the US are ongoing, however, the world may never be the same as the baseline tariffs continue. The last of the three major credit rating agencies downgraded the US sovereign rating by one notch to Aa1 which further rattled markets; straining the dollar and the US treasury yield movements driven by concerns around US debt and fiscal situation, tariff-related inflation worries and consequently leading to a higher rate regime weighed on investor sentiments. The spillover was visible across asset classes and across geographies.

During May, due to escalation in cross border tensions for India market sentiments were jittery and following the initial knee jerk reaction and volatility, the situation and markets returned to normalcy.

The soft data esp. the PMI Manufacturing and consumer sentiments continue to reflect weaker outlook, the ISM data for the US has been weak as well. The hard data is awaited to see the possible impact of global policy uncertainty. The 90-day tariff relief by the USA to China and the US-UK trade deal provided temporary relief, but the surveys show that the business optimism is fading. For now, world over, businesses, investors, migrants, and even the governments await the final reckoning on the trade tariffs and related policies – a mission that has turned out to be impossible to achieve, so far!

After a chaotic April 2025, May has been calmer and more responsive to domestic developments of course, while being influenced by global developments and in sync with global sentiments. The US administrations' policy around trade and their own fiscal standing as well as clamor around capital tax has all culminated into investors asking whether it is the end of US exceptionalism. One of the interesting ways to look at it has been a weaker dollar and higher US yields which in an otherwise situation of risk averse or uncertain environment would strengthen both. The rising risk premia on US treasury reflects the same. Gold prices soared to fresh highs during May to US$ 3431/ounce and as trade negotiations were underway prices eased to close at US$ 3289/ounce on 30-May. Crude oil prices too remained volatile and softened to US$ 60.2/barrel and ended somewhat higher at US$ 64/barrel as demand concerns eased. This coupled with production hikes by the OPEC+ has kept prices anchored ~US$ 65/barrel.

May saw sharp FX swings with the G10 currencies gaining against the greenback. On the rates front, sovereign yields especially on the longer end of curve saw a spike amid fiscal (for Germany) and central bank purchases (for Japan) and for US it was concerns around fiscal, global demand and overall rising risk premia catapulted yields higher. The spillover to India has been limited owing to domestic factors and expectations of accommodative monetary policy stance by the RBI.

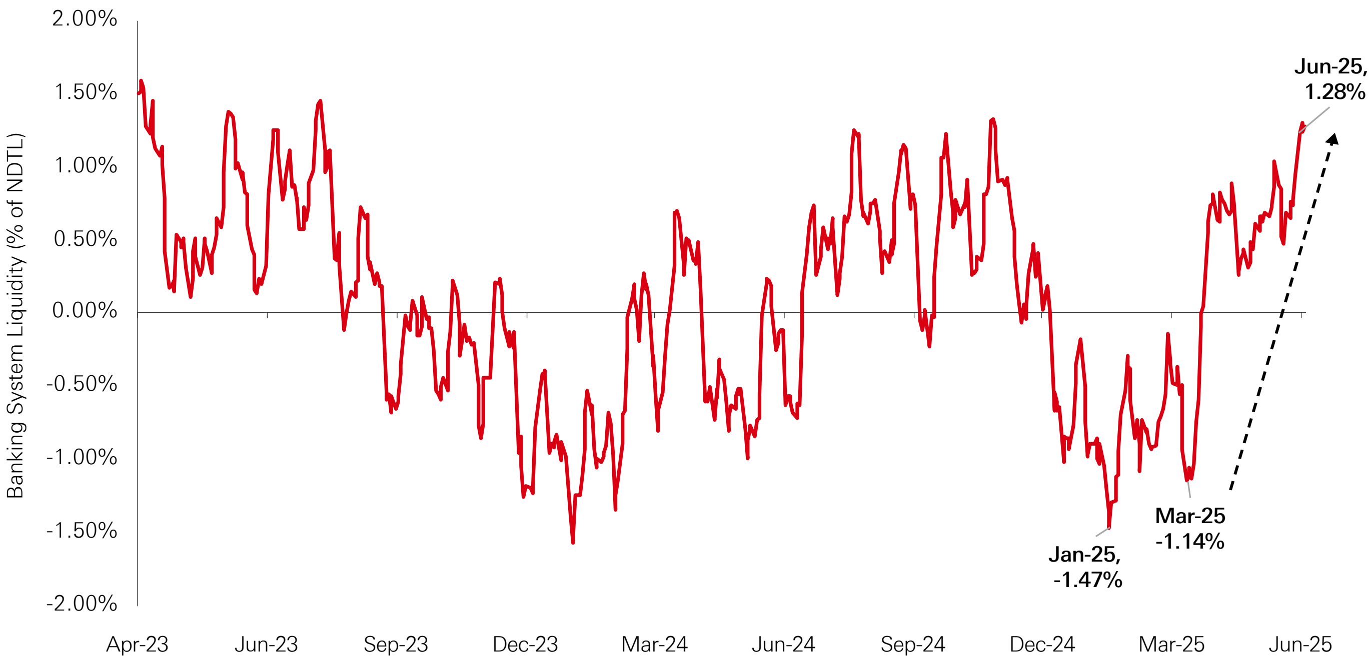
In the milieu of all the global developments and India's cross border tensions soured investor sentiments. However, India bounced back and has demonstrated resilience. India's strong defence standing as well as India-UK trade deal pared losses and anticipation of a phase-I completion in India-US trade deal by July 2025 has further bolstered sentiments.

India's growth remains resilient while inflation soft: Economic growth momentum has been resilient, at least till 4QFY25 – with GDP growth at 7.4% and a better metric to track activity viz. the GVA growth coming in at 6.8%. For FY25 GDP growth, was at 6.5% YoY vs 9.2% in FY24. The lead indicators are suggesting subdued activity and the global development continue to remain key headwinds to growth. India's retail inflation has softened swiftly and clocked 3.16% YoY in April, the May print is expected to be soft too at ~3% YoY largely driven by a fall in food inflation. The growth-inflation dynamics have thereby opened-up the space for the RBI-MPC to focus on growth by reducing policy rates. With Credit growth also languishing at 9.7% YoY as of mid-May, the focus would clearly be on supporting growth.

RBI a steady hand: Moreover, the RBI's proactiveness in injecting substantial liquidity and decisive monetary policy easing to support growth has boosted sentiments. In May, the RBI approved transfer of INR 2.69 lakh crore as surplus to the central government for FY25 compared to street expectations of a bumper transfer of INR 3.0-3.5 lakh crore. While RBI's income did shoot up, an increase in the Contingent Risk Buffer (for provisioning) by 1% reduced the transferable surplus. Nevertheless, the transfer still translates into 0.1% of GDP, slightly better than budgeted. The transfer augurs well from fiscal earnings as well as keeping durable liquidity in deep surplus. As of end-May, banking system liquidity surplus was about INR 2.3 lakh crore and with the RBI Dividend total liquidity, the so-called core liquidity, is expected to see a surplus of INR 5.5-6.0 lakh crore.

The RBI-MPC rate cut of 50bps to 5.50% have softened the rates across the curve and the yield curve remains steep. The third rate cut of 50bps today now takes the cumulative rate cuts of 100bps in a span of nearly 6-months along with RBI's active liquidity infusion. The chart below evinces how RBI's liquidity steps, starting from reserve requirement cut in Dec'24 to OMO Purchases of ~INR 5 lakh crore since Jan-May 2025, has augmented system liquidity from -1.5% of NDTL to +1.3% of NDTL so far in Jun'25.

The Swift Response: Liquidity surplus sharply, swiftly and substantially swung into surplus



Source: Bloomberg & HSBC MF Research estimates as on 5 June, 2025

Our Take:

Amid all the tariff uncertainty, India's macros remain on a strong foothold. Due to the tariff war and global outlook, demand for safe-haven assets has led to capital outflows and weighed on EM currencies, incl. India. With a 90-day pause on reciprocal tariffs and scope of reaching bilateral agreements and the dollar softening, the EM currencies by end-May pared losses. India's exposure to the US, its trade diplomacy and the RBI's steady hand & its policy approach have put India on the leaderboard amid the tariff concerns that has eclipsed business and growth outlook, globally.

India's cooling inflation has provided the RBI-MPC to focus on supporting growth by way of front-loaded policy easing. The MPC's shift to a neutral stance implies that the scope for future cuts might be limited and also, that it will remain data dependent. The RBI will continue to focus on keeping system liquidity into the surplus for faster monetary policy transmission to rates.

Our Take (Contd):

Following the RBI-MPC policy action, we believe liquidity will be the main driver of softer yields domestically, going forward. Currently, corporate bonds in the 3-5 year segment seem to offer favourable spreads of 50-70 bps over IGBs. This we believe is the sweet spot on the corporate yield curve. Given liquidity is expected to remain in surplus for the foreseeable future, we believe corporate bond spread compression story can continue and may provide for an opportunity for further compression in corporate bonds. While the corporate bond spread has compressed by ~15-20 bps on the shorter end, lower absolute levels in IGBs, lower differential with US treasuries point towards a gradual reallocation towards corporate bonds to chase the carry.

Abbreviations:

OMO: Open Market Operations
GDP: Gross Domestic Product
CPI: Consumer Price Index
MPC: Monetary Policy Committee
RBI: Reserve Bank of India
FII: Foreign Institutional Investors
EM: Emerging Markets

Note: Views provided above are based on information in public domain and subject to change. Investors are requested to consult their financial advisor for any investment decisions.

Source: Bloomberg & HSBC MF Research estimates as on May 31, 2025 or as latest available