Update on RBI Policy- June 2022

In a much-anticipated meeting, the Monetary Policy Committee (MPC) decided to take the middle ground and made the following important announcements:

- The Repo Rate & Standing Deposit Facility Rate have been hiked by 50 basis points to 4.9% and 4.65% respectively. The MPC decision was unanimously.
- The monetary policy stance was switched to "focussed on withdrawal". The word "accommodative" was dropped.
- FY23 inflation forecast was increased to 6.7% y/y from earlier forecast of 5.7% y/y. The revised forecast considers average crude oil price of $105 / barrel.

While today's increase in the Repo Rate was along the expected lines, Governor's optimistic assessment of India's FY23 economic growth-inflation dynamics was comforting to market participants who were bracing for some tough measures in form of forward guidance on policy rates and further reduction in banking system liquidity.

On growth, RBI maintained their earlier FY23 GDP growth forecast of 7.2% assuming normal monsoon supporting rural demand and opening of contact-intensive services supporting urban consumption. RBI also noted the gradual improvement in capacity utilization in manufacturing sector and healthy improvement balance sheets of the corporate India and banking sector.

On inflation, Governor stressed that while current inflation was higher-than-expected due to multiple supply-side factors, he was hopeful that recent fiscal measures, expectations of normal monsoon and gradual improvement in supply-side constraints should ease inflationary pressures going forward. Based on that, RBI has increased its FY23 inflation forecast by 100 bp to 6.7%, which is in line with consensus estimates.

What does this mean for the bond market?

Bond market has reacted positively to today's policy measures as it was along the expected line and without any negative surprise. Consequently, there was a relief rally in the IGB market with yield of benchmark 10Y IGB declined by ~10 bp to 7.44%. OIS rates have also eased as market participants unwounded aggressive bets of forward rate hikes. Lighter investor positions have also helped.

While reiterating that RBI will be proactive and decisive in taming inflationary pressures going forward, Governor refrained from providing any further guidance on Terminal Repo Rate (Level of Repo Rate at the end of rate hiking cycle) as well as announcing any further liquidity reduction measures. This will keep the debate alive on the pace & path of future policy rate actions and level of surplus liquidity in the banking system. Bond market has interpreted this as a "dovish signal".

Governor has also reiterated his stance on completion of government borrowing program in a non-disruptive manner. This should help calm market fears on imbalance in demand-supply dynamics.

What should bond investors do?

With today's 50-bp hike out of the way, bond market participants will start the debate on the quantum of next hike in August MPC. Consensus Terminal Repo Rate is between 5.5% to 6% over next 12-15 months. Bond market will probably react positively in our view If RBI decides to maintain a 25-bp hike going forward.

Based on the expected Terminal Repo Rate at ~6%, we believe there is value in the 5-10Y segment of the yield curve. Investors with long-term investment horizons should consider Target Maturity Bond ETF / Bond Index Funds maturing between 5- to 10-year depending on their comfort. Risk-reward ratio is in favour of investors who remain invested till the maturity of these Bond ETF / Bond Index Funds. Investors should consider investing in in 3 to 4 tranches with a view to get fully invested by Dec 2022 in our view.