"A Change in the Air"

Note on April 2022 MPC outcome

Edelweiss MUTUAL FUND

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Key takeaways:

The Monetary Policy Committee (MPC) made the following announcements after today's meeting:

- The MPC left unchanged the key policy rate — Repo rate at 4% and the Reverse repo rate at 3.35%.
- However, the RBI introduced the Standing Deposit Facility (SDF) – an additional tool for absorbing liquidity – at an interest rate of 3.75%.
- The central bank retained its accommodative policy while focusing on withdrawal of accommodation in wake of elevated inflation levels
- The policy panel slashed the GDP growth to 7.2% and hiked the inflation forecast at 5.7% for the fiscal 2022-23.

Assessment:

As anticipated, the MPC set the ball rolling on the gradual exit from its post-pandemic easy monetary policy by tweaking the policy stance to "Accommodative while focussing on withdrawal of accommodation". That probably means the RBI has signalled potential hikes in policy rate in FY23 with first hike expected in Q2FY23.

While the MPC decided to keep all policy rates unchanged as expected, the RBI decided to revert to pre-pandemic liquidity management framework by narrowing the liquidity corridor to 50 basis points as follows

1. RBI introduced Standing Deposit Facility (the facility which will help RBI absorb surplus liquidity without giving any collateral to the lender) at 3.75% pa. This will form the lower bound of the liquidity corridor.
2. The Repo Rate remains unchanged at 4%.
3. The Marginal Standing Facility (MSF, the penal rate at which banks can borrow from RBI without any collateral) is kept at 4.25%, or Repo + 25 bp. This will form the upper bound of the liquidity corridor.

The RBI will continue to manage liquidity through a combination of Variable Rate Reverse Repo (VRRR) auctions to absorb surplus liquidity and inject liquidity through the Repo Rate.

While the Reverse Repo Rate was kept unchanged at 3.35%, we believe it has been made redundant with the introduction with SDF and ongoing VRRR auction.

Apart from that, the MPC made note of the tectonic shift in the global economy, ongoing geo-political crisis, imposition of sanctions and resultant volatility in commodities vital for India's economy. The RBI also observed that sustained increase in crude oil prices may have the potential to derail India's economic growth and disturb inflation outlook. That has prompted RBI to prioritise on inflation over economic growth. This is a change from their earlier stance to focus on economic growth. The RBI Governor did not mention the potential policy normalization by the FOMC and their impact on India.

As a result, the RBI has marked down India's FY23 GDP growth from 7.8% in Feb 2022 to 7.2% in April 2022 with downside risk to this forecast if average crude remains above $100 per barrel.

Sharp increase in commodity and energy prices have also forced RBI's hands in revising average inflation forecast for FY23 from 4.5% to 5.7% with upside risk to this forecast. This is one of the sharpest upward revisions in inflation by the RBI in just two months. That said, Market participants feel that RBI's Q2FY23 inflation forecast as being on the lower side.

The RBI Governor's tone was of cautious optimism. He observed that "the sky may be overcast with clouds but we will use all our energies, resolve and resources to let the sunlight illuminate India's future…". He also alluded that RBI was not hostage to any rulebook and no action is off the table when the need of the hour is to safeguard the economy. The Governor refrained from making any reference to RBI's direct support to FY23 GOI borrowing through OMO bond purchases like FY22.

What does this mean for the bond market?

IGB bond yield curve rose by 10 to 15 basis points across the curve after the RBI signalled potential rate hikes in future. The benchmark 10Y IGB yield crossed 7% level for the first time since May 2019 as market participants brace for upcoming supply of bonds amid subdued demand-supply dynamic.

We expect IGB yield curve to remain steep with short-end remaining anchored at the Repo Rate while the mid-end and long-end of the curve being impacted by supply pressure of 2-, 5-, 7-, 10-, 14-, 30- and 40-year benchmark bonds.

Bond market participants expect the RBI to intervene to ensure orderly evolution of the yield curve, in our view.

It is going to be tough being an investor in the bond market when monetary policy stance is normalizing, and bond yields are on the uptrend.

What should investors do?

Bond investors should brace for lower single-digit returns from the bond market in CY22, similar to CY21.

That said, we expect bond yields to peak in H1FY23. That will provide investors with opportunity to lock-in higher rates for their long-term fixed income allocation through bond ETF / bond index funds maturing in 5-10Y segment, in our view.

A Change in the Air.

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