RBI Stays Supportive

June 4, 2021

The RBI-led Monetary Policy Committee (MPC) met in the backdrop of a sudden & sharp decline in economic activities amid the raging 2nd wave of Covid-19 across the country and recent uptrend in industrial commodity prices. Based on the current and evolving economic conditions, the MPC made the following announcements today:

- MPC unanimously decided to keep policy rates unchanged (Repo Rate @ 4%, MSF & Bank Rate @ 4.25% and Reverse Repo Rate @ 3.35%)

- To continue with the current accommodative stance "*as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target.*"

That probably means that the RBI will keep policy rates lower for longer and banking system liquidity in surplus mode until scars of Covid-19's on the Indian economy are more-or-less healed and the economic growth is on solid footing on sustained basis, in our opinion. Therefore, the Repo Rate is unlikely to be hiked in FY22.

Apart from that, the RBI also made the following important adjustments:

- FY22 Average CPI projection has inched up to 5.1% from 5% in April meeting, in light of the recent upsurge in crude oil and key industrial commodity prices.

- FY22 GDP growth projection has been adjusted downwards to 9.5% from 10.5% in light of the slowdown in economic activities in Q1FY22.

The RBI has recognized that there is an upside risk to its CPI forecast due to disruptions in supply-side economy. However, the RBI remains optimistic on revival of rural demand amid expectations of normal monsoon this year. The RBI is also hopeful that recent increase in global economic activities should support nascent recovery in Indian exports going forward.

In order to ensure stability in the bond markets, the RBI Governor has proactively announced the following two measures:

- 3rd & final tranche of bond purchases worth to Rs. 40,000 cr. under G-SAP 1.0 to be conducted on June 17, 2021, out of which, Rs. 10,000 cr. will be for SDLs.

- RBI has announced G-SAP 2.0 for Q2FY22 under which the RBI will purchase bonds worth Rs. 1.2 trillion from the open market.

Apart from G-SAP 1.0 & prospective G-SAP 2.0, the RBI has also purchased IGBs worth Rs. 36,500 cr. from the open market so far. This has contributed to reduction in volatility in the bond market.

What does this mean for the bond market?

There is no doubt in our mind that the RBI wishes to see bond yields trending down. The RBI Governor's comments during the speech that "*We do expect the market to respond appropriately to this announcement of G-SAP 2.0*" highlights that point, in our opinion.

We believe that the RBI will continue in its efforts of some sort of yield curve control until there are clear signs of revival of economic growth while seeing through the recent increase in supply-side inflationary pressures. This could result in some reduction in term premiums on the long end of the sovereign yield curve and potential price appreciation in the medium-term.

The RBI has also noted tightening of credit spreads across the high-quality corporate bond yield curve in FYTD22. This can be attributed to sharp increase in demand for quality bonds and decline in supply due to reduction in economic activities and distribution of credit flows. We expect credit spreads to remain tight until H2FY22 when we expect economic activities to normalize.

What should bond investors do?

We reiterate that given the current term structure of rates, bond investors should expect low, single digit returns from the bond market in FY22. We foresee four distinct buckets of returns for investors to choose from:

- 3% bucket: Risk-averse investors focusing on up to 6M average maturity of assets may earn ~3% returns in FY22.
- 4% bucket: Bond Investors focusing in 6M to 1Y maturity bucket may earn ~4% returns in FY22.
- 5% bucket: Bond investors seeking ~5% returns in FY22 should focus on high quality bonds with residual maturity of 1 to 3 years.
- 6% bucket: Bond investors seeking ~6% returns in FY22 will need to increase the average maturity of their fixed income portfolios to 5 to 10 years.

Based on our expectations of continued RBI support and potential reduction in term premium, we reiterate investors to focus on AAA-rated CPSE bonds maturing in the 5-10Y segment for investment horizon of at least two years. This will help investors to earn better risk-adjusted returns in FY22 without any compromise in liquidity or credit quality.

Disclaimer

The information provided above is for information purpose only and do not construe to be any investment, legal or taxation advice or solicitation of business in schemes of Edelweiss Mutual Fund. Please note that Edelweiss Asset Management Limited (Investment Manager of Edelweiss Mutual Fund) / Edelweiss Trusteeship Company Limited (Trustee Company) / Edelweiss Financial Services Limited (Sponsor of Edelweiss Mutual Fund) or any of its Associate Company will not be liable in any manner for the consequence of any action taken by you on the information contained herein. Please note that the proposed Schemes and their features are awaiting SEBI approval and may undergo changes accordingly. Please consult your Financial / Investment Adviser before making any investment decision. Neither Sponsor / AMC/ Trustee Company and its associates nor Edelweiss Mutual Fund or any person connected with it, accepts any liability arising from the use of this information. Utmost care has been exercised while preparing the document, and Sponsor /AMC /Trustee Company and its associates or Edelweiss Mutual Fund does not warrant the completeness or accuracy of the information and disclaims all liabilities, losses and damages arising out of the use of this information.

MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.