MPC surprises bond market by front-loading of rate hikes

In an off-cycle policy meeting, the monetary policy committee (MPC) surprised market participants by announcing the following:

- Repo Rate hiked by 40 bp to 4.4% with immediate effect
- Cash Reserve Ratio increased by 50 bp to 4.5% from May 21, 2022. This should reduce banking system liquidity by ~Rs. 85,000 crores

The RBI governor attributed these measures to the evolving growth-inflation dynamic and decided to maintain the accommodative stance.

The timing of the RBI's announcement is also quite important as the FOMC is widely expected to raise the Fed Fund rate by 50 bp later today.

Although government bond prices experienced a steep decline, today's decision has helped RBI maintain their credibility among investors. This should also help provide some stability in the FX market.

After today's hike, the June MPC rate hike is very much alive. Odds of a similar of higher hikes have increased considerably. Bond market participants expect the RBI to raise the Repo Rate to 5.15%, a pre-pandemic level, quickly and aim to complete the policy rate normalization process. We believe that Repo Rate will reach there by Dec 2022.

IGB yield curve flattened in response to this move. Benchmark 2-, 5-, 10- and 14-year yields inched up by ~32 bp, ~37 bp, ~26 bp and ~22 bp as on 3:25 pm with significant widening in bid-offer spreads as market participants digest this unscheduled move. An overhang of just concluded Rs. 33,000 crore T-Bill auction may weigh on market participants as these securities are out-of-money due to rate hike.

What should investors do?

Honestly, we are surprised by today's move. But at the same time relieved that RBI has finally thrown in the towel on Repo Rate normalization. Bond market will experience some volatility in the next few sessions as market participants go back to the drawing board and reassess RBI's potential hikes in next 12 months and their implications of other financial assets.

After crossing important levels such as 7.26% and 7.36%, we expect the benchmark 10Y IGB to trend towards 7.53% from a technical perspective.

Investors with long-term fixed income allocation should probably wait till June MPC policy and allocate a portion of their surplus (25%) after the June MPC outcome and keep allocating 25% each after subsequent MPC policy outcomes in Target Maturity Bond ETFs / Bond Index Funds maturing in five to 10-year residual maturities depending on their comfort. This should help them average out their investments and earn attractive tax-adjusted returns if they remain invested till the maturity of these funds.

Happy investing.

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