RBI Policy- August 2022

As widely expected, the RBI-led Monetary Policy Committee (MPC) unanimously **raised the Repo Rate by 50 bp to 5.4%** today with immediate effect. Consequently, the **Standing Deposit Facility (SDF) rates and Marginal Standing Facility (MSF) rates have also moved up by 50 bp to 5.15% and 5.65% respectively**.

The MPC also voted 5-1 to maintain the policy stance as "focused on withdrawal of accommodation while supporting growth." In that regard, the MPC noted that banking system liquidity surplus has declined by Rs. ~3T to Rs. 3.8T in June/July 2022 while economic growth remained resilient.

The RBI governor refrained from providing any forward guidance on policy rates in his policy speech. That said, bond market participants expect the RBI to raise Repo Rate to 6% by March 2023 and take a pause from there.

The MPC noted the recent fall in crude oil & key commodity prices and their potential positive impact on the headline inflation since Q1FY23 as well as improvement in key macro-economic indicators. However, the MPC decided to play safe and maintained their FY23 average CPI forecast at 6.7% as well as FY23 GDP growth forecast at 7.2%.

Judging by the RBI governor's emphasis on the rupee's relative performance FYTD amid surge in volatility in global currencies, improving capacity utilization ratios & growth conditions and challenging external business environment, it is clear that the MPC has prioritized their focus from containing inflation & inflationary expectations to managing the INR and managing India's economic growth amid rising global uncertainties.

Rate hike and its Impact on bond yields

IGB yields hardened as bond market participants found RBI governor's comments and body language a bit hawkish. Bond market participants went into policy with upbeat tone hoping for a dovish guidance on the terminal Repo Rate. As a result, the benchmark 10Y IGB yield had declined by ~11 bp between yesterday and today to touch an intra-day low of 7.12% ahead of the policy announcement.

However, the bond market gave up all their gains after the policy announcement and pushed yields of benchmark 10Y IGB higher at 7.25% - closer to technically important level of 7.27%. We expect IGB yields to remain volatile amid higher supply pressure, lack of immediate positive trigger and subdued sentiment. In case if 10Y IGB yields convincingly cross 7.27% level, then it will likely settle in its next trading range of 7.27-7.47% based on technical factors, in our view.

What should bond investors do?

Long-term investors should rejoice the back up in IGB yields, in our view.

Based on expected terminal Repo Rate of 6% amid declining liquidity surplus and imbalance in demand-supply dynamics of IGBs this year and beyond, we continue to expect the IGB yield curve to remain steep and IGB yields to remain elevated in the medium-term. This may provide an excellent opportunity for long-term investors to consider investing in Target Maturity Bond ETFs / Bond Index Funds maturing in 5 to 10-year segment for superior tax-adjusted returns, in our view.

That said, it will be prudent for investors to stagger their investments in 2-3 tranches, preferably after each MPC policy outcome, with a view to average-cost investing and mitigate policy-related uncertainties.

We also ask investors to choose suitable Target Maturity Bond ETFs / Bond Index Funds based on their investment horizon. This should result in superior investment experience.