Resolution of the Monetary Policy Committee (MPC) June 6 and 8, 2022

On the basis of an assessment of the current and evolving macroeconomic situation, the Monetary Policy Committee (MPC) at its meeting today (June 8, 2022) decided to:

- Increase the policy Repo rate under the liquidity adjustment facility (LAF) by 50 bps to 4.90% with immediate effect.

- Consequently, the Standing Deposit Facility (SDF) rate stands adjusted to 4.65% and the Marginal Standing Facility (MSF) rate and the Bank Rate to 5.15%.

- The MPC also decided to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.

These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2%, while supporting growth.

The RBI also announced measures on Developmental and Regulatory Policies relating to (i) Regulation and Supervision; (ii) Financial Markets; and (iii) Payment and Settlement Systems.

MPC's Outlook:

The monetary policy actions announced today were largely in line with the general market expectations. The RBI highlighting the persistence of the upside pressures on inflation and the urgency to act, in order to contain inflation as well as inflation expectations. The lack of Cash Reserve Ratio (CRR) hike was also in line with expectations, as the liquidity surplus has declined sharply over the past couple of months. Currently inflation seems to be the focal point of the RBI's monetary policy as highlighted by the governor's closing remarks where he said that "preserving price stability is the best guarantee to ensure lasting growth and prosperity".

The RBI upped its inflation forecast sharply, wherein it now expects Consumer Price Index (CPI) inflation to be at 6.7% YoY in FY23, with Q1FY23 at 7.5%; Q2FY23 7.4%; Q3FY23 at 6.2%; and Q4FY at 5.8%, with risks evenly balanced. Thus, the RBI expects that the CPI inflation will remain above its medium-term inflation for three quarters of FY23. In the April monetary policy, the RBI had forecasted inflation at 5.7% in FY23, with Q1 at 6.3%; Q2 at 5.8%; Q3 at 5.4%; and Q4 at 5.1%. The governor highlighted that there is considerable uncertainty to the domestic inflation outlook on account of global geopolitical situation and the consequent elevated commodity prices. The several factors that will continue to put upside pressure on inflation that the RBI highlighted included, elevated crude oil prices with risks of further pass-through to domestic pump prices; upside risks from revisions in the prices of electricity; and expectations of further input and output price pressures going forward. The RBI also highlighted that that continuing shocks to food inflation could also sustain pressures on headline inflation. That said the RBI added that the supply side measures taken by the government would help to alleviate some cost-push pressures on inflation.

The RBI continued to sound optimistic on domestic economic growth as it is seeing the domestic economic activity gathering strength. And thus, the RBI retained real GDP growth projection for FY23 at 7.2% YoY, with Q1FY23 at 16.2%; Q2FY23 at 6.2%; Q3FY23 at 4.1%; and Q4FY23 at 4.0%, with risks broadly balanced. In RBI's opinion, the factors that are likely to support economic growth include, likely normal south-west monsoon and the expected improvement in agricultural prospects benefiting Rural consumption; rebound in contact-intensive services which may bolster urban consumption; expected improvement in investment activity supported by improving capacity utilisation, government's capex push, and strengthening bank credit; and growth in exports.

Impact on the Bond Market and outlook:

Bond markets were neutral, as the Repo rate hike and the lack of CRR hike was in line with expectations. However, bond yields turned volatile wherein yield on the 10 year benchmark G-sec rose during the announcement of the monetary policy, but later declined sharply and then was trading near its previous closing level of 7.52% at the time of writing this note. The RBI also did not announce any further measures to withdraw the surplus system liquidity, while indicating that the several tools at the RBI's disposal will be used depending upon the evolving liquidity conditions. The RBI reiterated that it would remain focussed on orderly completion of the government's borrowing programme, which also aided market sentiments. **The RBI acknowledging that inflation is likely to remain above its target for longer, is important, as we believe that the RBI could undertake a series of rate hikes to contain inflation. Also, as per the inflation forecast, the RBI believes that inflation could decline below the upper band of its medium term target (2%-6%) by the end of FY23. Therefore, the terminal Repo rate at the end of the current financial year could follow the incoming inflation trajectory.** While there is clarity on the possible monetary policy path of the RBI in the near term, a lot of uncertainties are likely to impart volatility to bond markets. These uncertainties emanate from geopolitical tensions that are impacting the global growth and inflation dynamics thereby prompting strong actions from policy makers of various nations, which in turn is further exacerbating global macro-economic scenario. Faster monetary policy tightening by the major global central banks is also threating to throw off guard, the financial market and forex market stability in the emerging markets including India. Additionally, a rising trade deficit on account of higher commodity and input prices could put further pressure on Rupee thereby resulting in imported inflation. Any further deterioration in the macro-economic variables that impact fixed income markets, is likely to push bond yields higher from here on. Domestically with the government also having to intervene in the fight against elevated inflation, brings in the risk of higher than budgeted fiscal deficit and government borrowings. This could put further pressure on bond yields in the absence of appropriate and timely support from RBI. Going forward bond yields are likely to remain volatile and trade with an upward bias.

Fixed Income Mutual Fund Investment Strategy:- Investors who have relatively longer investment horizon could look at Target Maturity Index Funds that invest in a mix of high credit quality securities. Investors with an investment horizon of 12 months and above can look at Short Duration Funds, Money Market Funds, Ultra Short Duration and Low Duration Funds. Investors with a horizon of 15 months and above can start looking at Corporate Bond Funds and Banking & PSU Debt Funds. With the rise in yields at longer end of the yield curve, investors who are comfortable with volatility and have a longer investment horizon could gradually start looking at Dynamic Bonds for a horizon of 24 months and above. For a horizon of 3 months and above Arbitrage Funds can be considered. Whereas, for a horizon of upto 3 months investors can consider Overnight Funds and Liquid Funds. Investors should invest in line with their risk profile and product suitability.

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