HDFC Bank Research

December 5, 2019

Fifth Bi-monthly Monetary Policy 2019-20

Monetary and Liquidity Measures:

On the basis of an assessment of the current and evolving macroeconomic situation, the Monetary Policy Committee (MPC) decided to:

- Keep the policy repo rate under the Liquidity Adjustment Facility (LAF) unchanged at 5.15%.
- Consequently, the reverse repo rate under the LAF remains unchanged at 4.90%, and the Marginal Standing Facility (MSF) rate and the Bank Rate at 5.40%.
- The MPC also decided to continue with the accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

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.

MPC's Outlook:

Surprising the markets, the RBI's Monetary Policy Committee (MPC) kept the Repo rate unchanged at 5.15%, against the market expectation of a 25 bps cut. The interest rates were kept unchanged citing evolving growth-inflation dynamics. To that effect the monetary policy statement highlighted that while the rise in inflation is likely to moderate below its target by Q2FY21, it is prudent to carefully monitor incoming data to gain clarity on the inflation outlook. On the growth front the RBI stated that forthcoming union budget will provide better insight into further measures to be undertaken by the Government and their impact on growth. While the RBI paused on interest rates in the monetary policy, it stated that the MPC recognizes, that there is monetary policy space for future action.

On inflation forecast, the MPC revised it upwards in line with expectations. The MPC revised the inflation forecast to 5.1-4.7% for H2FY20 and 4.0-3.8% for H1FY21, with risks broadly balanced; from a forecast of 3.4% for Q2FY20, 3.5-3.7% for H2FY20 and 3.6% for Q1FY21 given in October 2019 monetary policy. As per the MPC, the factors that may influence the trajectory of inflation would include, upsurge in prices of vegetables which is likely to continue in immediate months (however vegetable prices are expected to soften due to pick-up in arrivals from the late kharif season along with measures taken by the Government to augment supply through imports); incipient price pressures seen in other food items such as milk, pulses, and sugar which are likely to be sustained; rise in inflation expectations of households; volatility in domestic financial markets; slowdown in demand, which is being reflected in the softening of inflation excluding food and fuel; and lastly expectations of range bound crude oil prices. On the economic growth projections, again in line with expectations, the MPC revised the same downwards from 6.1% in the October 2019 policy to 5.0% – 4.9-5.5% in H2FY20 and 5.9-6.3% for H1FY21. The MPC stated that, while improved monetary transmission and a quick resolution of global trade tensions are possible upsides to growth projections, a delay in revival of domestic demand, a further slowdown in global economic activity and geo-political tensions are downside risks. The RBI seemed optimistic about the impact of the several measures taken by the government and RBI as it highlighted that, these measures are gradually expected to further feed into the real economy. The RBI stated that "Data on corporate finance and on projects sanctioned by banks and financial institutions suggest some early signs of recovery in investment activity, though its sustainability needs to be watched closely."

Impact on the Bond Market and outlook:

Government securities reacted negatively to the MPC's decision to keep the Repo rate unchanged and rightly so, as the markets were expecting a cut in the Repo rate, given that incoming data on economic growth continued to remain muted. Post the release of the monetary policy outcome, the 10 year benchmark bond yield rose by about 10 bps. However, is it just the pause in the interest rate cut that has led the markets to react negatively? Probably not. Firstly, while in the RBI governor stated that the MPC is not worried about the fiscal deficit of the government, the monetary policy statement "…forthcoming union budget will provide better insight into further measures to be undertaken by the Government and their impact on growth…" may lead to expectations that the RBI could be wanting to see how the government's fiscal deficit pans out and the quality of the same as well. This further increases the focus of the markets on fiscal deficit. Thus, any further reforms announcement by the government and its possible impact on the fiscal situation is likely to be tracked very closely by the markets participants. Secondly, while the RBI expects the inflation to moderate below its medium term inflation target by Q2FY21, it also highlighted that price pressures seen in some food items are likely to be sustained. Also, the RBI added that it is prudent to carefully monitor incoming data to gain clarity on the inflation outlook. This could mean that while the RBI recognizes that there is monetary policy space for future action (as mentioned in the policy statement) it is also cautious about the trajectory of inflation and has thus kept the room open to pause further if inflationary pressures continue to persist on a sustained basis. That being said, the tone of the monetary policy was dovish, as the RBI governor stated that combined efforts (by both RBI and government) are being undertaken and would continue to be taken in order to bring about economic growth recovery. Thus, the interest rate trajectory is expected to remain on the lower side for longer until meaningful economic growth recovery takes place. However, future interest rate cuts may happen in a gradual manner as opposed to pace of the rate cuts seen so far.

Investors who are looking to benefit from relatively better accruals can look at Corporate Bond Funds and Banking and PSU Funds for a horizon of 15 months and above. Investments in Medium Duration Funds can be considered with a horizon of 15 months and above. Investments into Short Duration Funds can be considered with an investment horizon of 12 months and above. Investors, who are comfortable with intermittent volatility, can also look at strategies that have allocation to the longer end of the yield curve, through Dynamic Bond Funds with an investment horizon of 24 months and above. Investors looking to invest with a horizon of up to 3 months can consider Liquid Funds, while Ultra Short Duration Funds and Arbitrage Funds can be considered for a horizon of 3 months and above.

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