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RBI MONETARY POLICY

DECEMBER 2019

HIGHLIGHTS

MPC in "temporary pause" on recent rise in risks to inflation and to evaluate effects of GOI measures and past easing – room to ease further still available, and to be used for maximum impact in coordination with fiscal policy

RBI's Fifth Bi-monthly Monetary Policy Review: 2019-20
MPC holds its benchmark repo rate steady at 5.15% in a surprise unanimous move, though maintains its accommodative stance. Door to further easing remains open, however reliant upon evolving economic data.

Policy Actions
Repo, reverse repo, MSF & Bank rate steady, CRR held constant at 4%.

GROWTH-INFLATION DYNAMICS

RBI raised inflation projections significantly to 4.7-5.1% for H2-FY20 (from 3.5-3.7% earlier) on high food prices (expected to soften on late Kharif arrivals). Meanwhile, projections for H1FY21 were at 3.8-4.0%.

Inflation risks broadly balanced, with vegetable prices expected to moderate following pick-up in late Kharif arrivals, and measures undertaken by the GOI to augment supply through imports. Potential for incipient price pressure seen across milk, pulses and sugar to remain sustained. Further, crude oil prices expected to remain range bound, barring any supply disruptions due to geo-political tensions. Household inflation expectation rose sharply by 120 bps for 3 month ahead period and by 180 bps for 1 year ahead, possibly responding adaptively to recent spike in food prices.

FY20 growth projection was lowered further to 5.0% from the earlier 6.1%, in line with weak domestic and global demand condition as suggested by various high frequency indicators. Improved monetary transmission and a quick US/China trade resolution were seen to have upsides to growth projections while a delay in revival of domestic demand, a further slowdown in global economic activity and geo-political tensions were seen as downside risks.

LIQUIDITY AND EXTERNAL SECTOR

Overall liquidity conditions were in surfeit during October and November despite rapid rise in currency in circulation. Comfortable liquidity was aided primarily by the RBI FX intervention. The weighted average call rate (WACR) traded below the policy repo rate (on an average) by 8 basis points (bps) in October and by 10 bps in November on surplus liquidity conditions.

Global economic trends continue to remain subdued with some signs of resilience becoming visible on perceived optimism over US/China trade resolution and a possibility of Brexit deal.

POLICY STANCE AND GUIDANCE

The MPC continued with an accommodative stance as long as it is necessary to revive growth while ensuring inflation remains within target. Further action is likely in February 2020, depending on evolution of the growth/inflation duality as well as the fiscal stance espoused in the budget.

MUTUAL FUND RECOMMENDATIONS

IMPACT ON THE MUTUAL FUND INDUSTRY:

Liquid Funds:

These schemes will continue to generate returns around the repo rate due to their portfolio composition i.e. being invested at the shorter end of the money market segment. Liquid funds have low average maturity as they concentrate more on high quality papers including CPs, CDs and other debt securities with residual maturity of upto 3 months. These funds may be considered for parking short term (up to 3 months) surplus money.

Ultra Short Term / Low Duration / Money Market Funds (Maturity Up to 1 Year):

These schemes predominantly invest in below 1 year maturity paper. The strategy adopted by these schemes is to hold the paper till maturity and capitalize on the running yield. Hence, returns in this category will continue to remain relatively attractive over liquid funds depending on the positioning of the fund.

Short Duration Funds:

Schemes in this category are predominantly invested in Corporate Bonds, CPs and CDs while a few of them also have some exposure to G-Secs. We continue to remain bullish at the shorter end of the curve. Investors may consider these funds (with a time horizon commensurate with the maturity profile of such funds) and gain from current accruals and capital appreciation in the event of yields coming off.

Medium Duration & Credit Risk Funds: We remain cautious on Medium Duration Funds (having a higher than category average allocation towards credit papers) and Credit Risk Funds going forward. We assume that there could be further erosion of NAVs and hence returns due to a mark-to-market impact (timing mismatches, further possible downgrades, etc) in the medium duration and credit funds space. It will also depend on the liquidity

MUTUAL FUND RECOMMENDATIONS

conditions in the market and redemption pressure on these funds. Thus, we think there is an elevated systemic risk in the market within credit / accrual space. Hence, it makes sense for one to stay away from these funds at the current juncture till the dust settles or risks in the credit markets shows signs of waning.

Long Term Income Funds / Gilt Funds / Dynamic Bond Funds: On the eve of December MPC meet, 10 year benchmark yield post the October policy is down from 6.69% to 6.47%, translating to 22 bps movement south. However, it has remained rangebound for a large part of the past 2 months (+/- 20 bps). Post today's policy announcement yield have hardened by 15 bps at 6.61%.

The announcement from government on corporate tax rate cuts has added pressure on fiscal numbers. However, government is sticking to its fiscal target, but prima facie we may see some slippages as the tax collection growth is slower than expected. Additionally, surplus amount transferred from RBI and aggressive divestment may to a certain extent curtail the fiscal. Given that, we may continue to see some pressure on the longer end of the yield curve, due to demand supply mismatch. Spreads of 1 – 3 year corporate bonds over repo and corresponding maturity government bonds are at an attractive level while providing certain degree of 'margin of safety'. The 10 year Gsec – Repo spread is currently at ~132 bps whereas 3 year AAA – repo spread is at ~160 bps (~230 bps for AA – repo spread). Hence, while they have come off markedly over the past few months, 1-3 year corporate bonds continue to look attractive from risk reward perspective as they can benefit from further spread compression and capital appreciation with further possible fall in yields over a 1-3 year period. Policy rate cuts and rally in yields have been front loaded, but the same has not yet been transmitted in the ecosystem in similar manner. Further rate cuts will be data-dependent and MPC would like to ascertain transmission of rate cuts and the impact of fiscal measures taken by the government, outlook for inflation and growth, interest rate spreads, shrinking credits, etc. Everything said, high duration funds including dynamic bond funds which are at the longer

MUTUAL FUND RECOMMENDATIONS

end of the yield curve, may see some volatility in returns over the near term. Given this background, one may look at select dynamic bond and long term funds which are a play on roll-down strategies with a slightly longer term (3+ years) view. 10 year AAA spreads over the repo and g-sec continues to remain elevated and to that extent, is an attractive play given a 3 year plus investment tenure assuming that spreads will eventually shrink to their long term averages.

Conservative Hybrid Funds-CHF *(Erstwhile: Monthly Income Plans (MIPs)*: With between 10% to 25% allocation to equity, returns of CHFs are largely determined by the vagaries of the equity markets as against the debt markets. These funds are therefore suitable for investors who have a reasonably long time horizon and are comfortable with taking exposure to equities.

OUTLOOK

IMPACT ON THE MUTUAL FUND INDUSTRY:

The MPC held off from further easing in a surprise unanimous move, despite continued and accelerated weakness in growth conditions. Though the stance remains accommodative, extent of further easing looks limited going forward and depends largely on the evolution of growth and inflation conditions, as well as the government's fiscal stance. The liquidity stance officially remains one off neutrality, but in practice, a surfeit of liquidity has been tolerated and even added to by heavy intervention by the RBI in FX markets. The MPC has elected to watch for evolution of conditions, including the effects of GOI measures and past easing, so as to be able to act in a way as to maximize impact in the future.

We remain constructive **on the shorter end of the yield curve. Short Duration funds, Corporate Bond funds, Banking & PSU Debt funds, Low Duration funds, Money Market funds and Ultra Short Duration funds** can be considered by investors with an investment horizon commensurate with the maturity and duration of the schemes, due to their steady accrual profile and possible capital appreciation in case of a fall in yields. **One can also additionally look at dynamic bond and corporate bond funds with roll-down strategies selectively with a medium term (3 years+) view.** Having said this, one should consider aspects such as exit load, capital gains tax and asset allocation amongst others while evaluating their investment options.

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