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RBI MONETARY POLICY

OCTOBER 2019

HIGHLIGHTS

RBI cuts rates for fifth consecutive time on deteriorating growth, benign inflation outlook

RBI's Fourth Bi-monthly Monetary Policy Review: 2019-20
RBI cut its benchmark repo rate by 25bps to 5.15% and maintained its accommodative stance. Door to further easing remains open, however it will be reliant upon evolving economic data.

Policy Actions
Repo, reverse repo, MSF & Bank rate cut by 25 bps, CRR held constant at 4%.

GROWTH-INFLATION DYNAMICS

RBI raised inflation projections fractionally to 3.4% for Q2FY20 on elevated vegetable prices (which is expected to moderate post arrival of winter supplies). Meanwhile, projections were retained at 3.5-3.7% for H2FY20 and 3.6% for Q1FY21.

Inflation risks are evenly balanced, with vegetable prices expected to moderate as winter supplies enter the market, and with indications of output prices softening in Q3, core CPI should be muted. Crude oil and financial markets could remain volatile. Household inflation expectation have risen by 40 bps for the 3 month ahead period and by 20 bps for 1 year ahead, possibly responding adaptively to rise in food prices.

FY20 growth projection was lowered further to 6.1% from the earlier 6.9%, with risks evenly balanced. The revision is on the backdrop of weak demand condition as suggested by various high frequency indicators and continued weakness in global trade. Impact of monetary easing since February and slew of fiscal measures is expected to boost output and investment activity which may provide some fillip to the economy in later half of this fiscal.

LIQUIDITY AND EXTERNAL SECTOR

Overall liquidity conditions were in surplus during August and September despite rise in currency in circulation and RBI forex operations. Comfortable liquidity was aided primarily by government spending. Though mid September saw slight moderation in surplus liquidity conditions owing to advance tax payments.

The external sector currently looks gloomy, with elevated trade tensions and escalating geo-political uncertainty posing downside risks. Perceived trade worries and increased risk aversion might cap overseas fund flows into emerging market economies despite accommodation by central banks across advanced economies.

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. This indicates that the next move is likely to be a rate cut or status-quo, guided by incoming data, evolving growth-inflation dynamics and financial conditions.

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 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 conditions and redemption pressure in the market on these funds. Thus, we think

MUTUAL FUND RECOMMENDATIONS

there is an elevated systemic risk in the market within this credit / accrual space. Hence, it makes sense for one to stay away from these funds over the next few months till the dust settles or risks in the credit markets shows signs of waning.

Long Term Income Funds / Gilt Funds / Dynamic Bond Funds: Longer term bonds have seen an extended rally on the back of RBI policy action and hopes of further rate cuts. That said, we are unsure of how long the rally will last. 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 Repo – 10 year Gsec spread is currently at 78 bps whereas AAA – repo spread is at 170 bps (~230 bps for AA – repo spread). Hence, 1-3 year corporate bonds continue to look attractive from risk reward perspective as they can benefit from spread compression and capital appreciation with further fall in yields. 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. Recent spike in bond yields was over fear of fiscal slippages post reduction in corporate tax rate announced by FM. 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 on inflation and growth before going in for a deeper cut in policy rate. Everything said, duration may yield results in the near term and hence tactical allocations towards the longer end may be considered by investors who would want to take an opportunistic call. To that extent, dynamic bond funds, Gilt funds and select long duration funds can be considered by investors.

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 added to easing efforts for the fifth consecutive meeting to address the growth concerns. Below target inflation trajectory provided the policy space to act, and continue with the accommodative stance 'as long as necessary to revive growth'. RBI sees recent measures announced by the Government to help strengthen private consumption and spur private investment activity. The extent of further easing possible will be gauged from high frequency indicators , especially on growth, and will continue to guide the outlook on the rates markets, in conjunction with liquidity and other trends.

We remain constructive **on the shorter end of the yield curve. Short Duration funds, Corporate Bond funds, Banking & PSU Debt funds, Money Market funds, Low Duration 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. 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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