Bajaj Finserv Mutual Fund

Note on RBI's Monetary Policy

(April 2024)

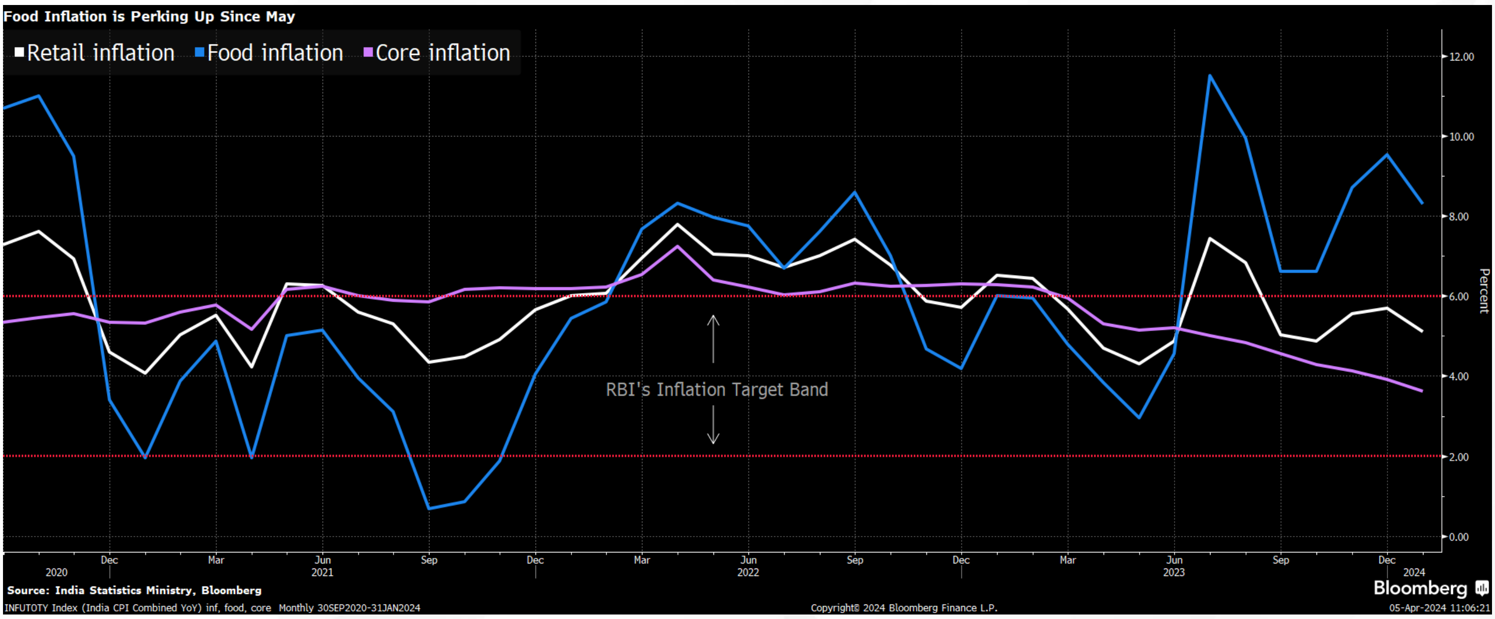
The Monetary Policy Committee (MPC) voted 5-1 to keep the repo rate unchanged at 6.5% for a seventh straight meeting. The committee members voted in the same ratio to keep the stance as withdrawal of accommodation. This is in line with our view and the market consensus.

Three key takeaways from today's MPC

1. **Downward revision inflation forecast -** The Q1 and Q2 FY25 Consumer Price Index (CPI) inflation is revised to 4.9% and 3.8% from 5% and 4%respectively, while FY 2025 CPI forecast is maintained at 4.5%.

   Our View - Core CPI number from the last policy is already running below 4% and it has dropped from 3.90% to 3.35% between the two policy dates. The recent momentum in growth has given headroom to MPC to focus more on the 4% target for headline inflation. However, one can argue that given the benign inflation forecast the longer MPC keeps rates elevated, the greater the growth sacrifice as indicated by latest Gross Value Added (GVA) numbers. We believe this cautious approach is warranted given the risk to food inflation due to forecast of harsher summer temperatures and crude prices due to escalating geo-political tensions.

Chart 1: CPI break up.



Source: Bloomberg

2. **Focus on Indian Rupee (INR) stability-** Governor pointed out the relative stability of the INR reflecting India's sound macroeconomic fundamentals, financial stability, and improvements in the external position.

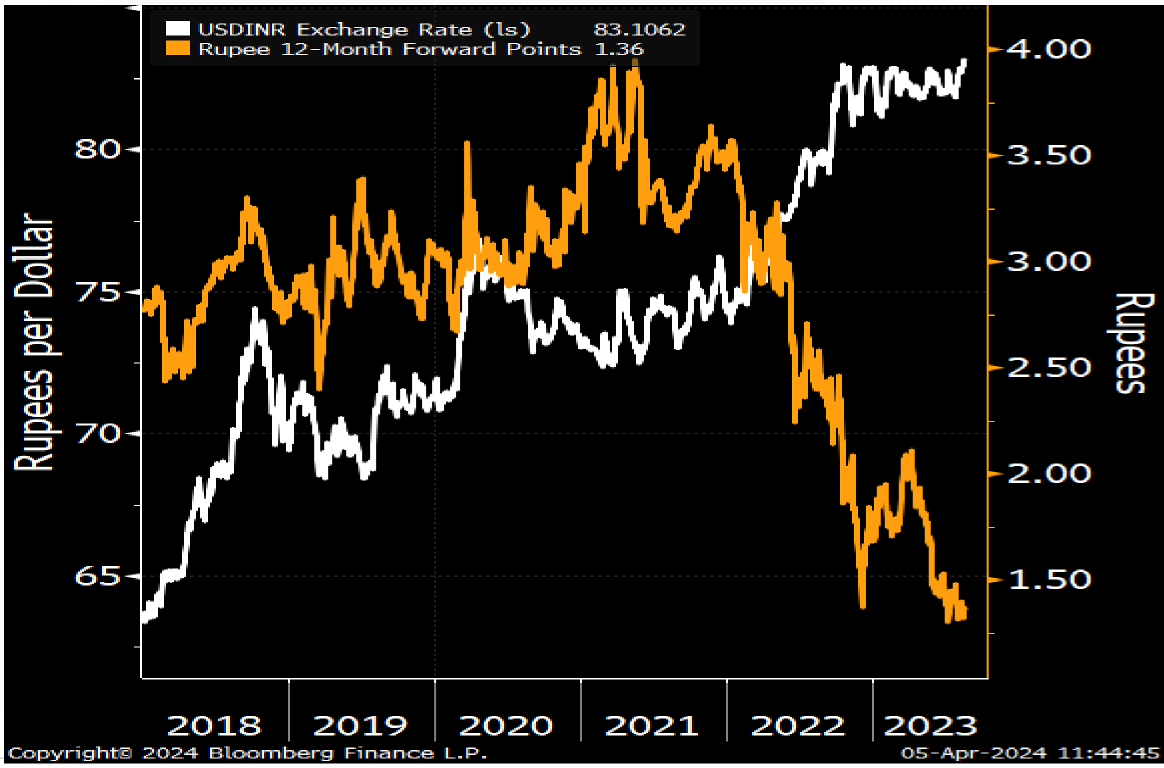
Our View

The RBI has done a great job of managing currency volatility in recent years. India's foreign exchange reserves have come long way to reach an all-time high of US$ 645.6 billion as of March 2024. But managing volatility would not have been possible if overall macroeconomic factors had not been in good shape.

Going ahead, we believe that the US Fed's inclination to ease rates in 2024 should work to limit any sharp uptrend in US yields but as we have seen how quickly and sharply market forecast deviates from Federal Open Market Committee (FOMC) forecast given any data surprise; one can expect bullish bias in the US Dollar (USD) to remain intact. Also it is important to note that :-

(a) Relative monetary policy and growth differentials support the case for a strong USD in the near-term.
(b) The weakness in the Chinese Yuan Renminbi (CNY) could weigh on regional Asian currencies.
(c) Geo-political tensions could ensure that global energy prices trade with an upside bias.

USD/INR and INR 1 Y Forwards



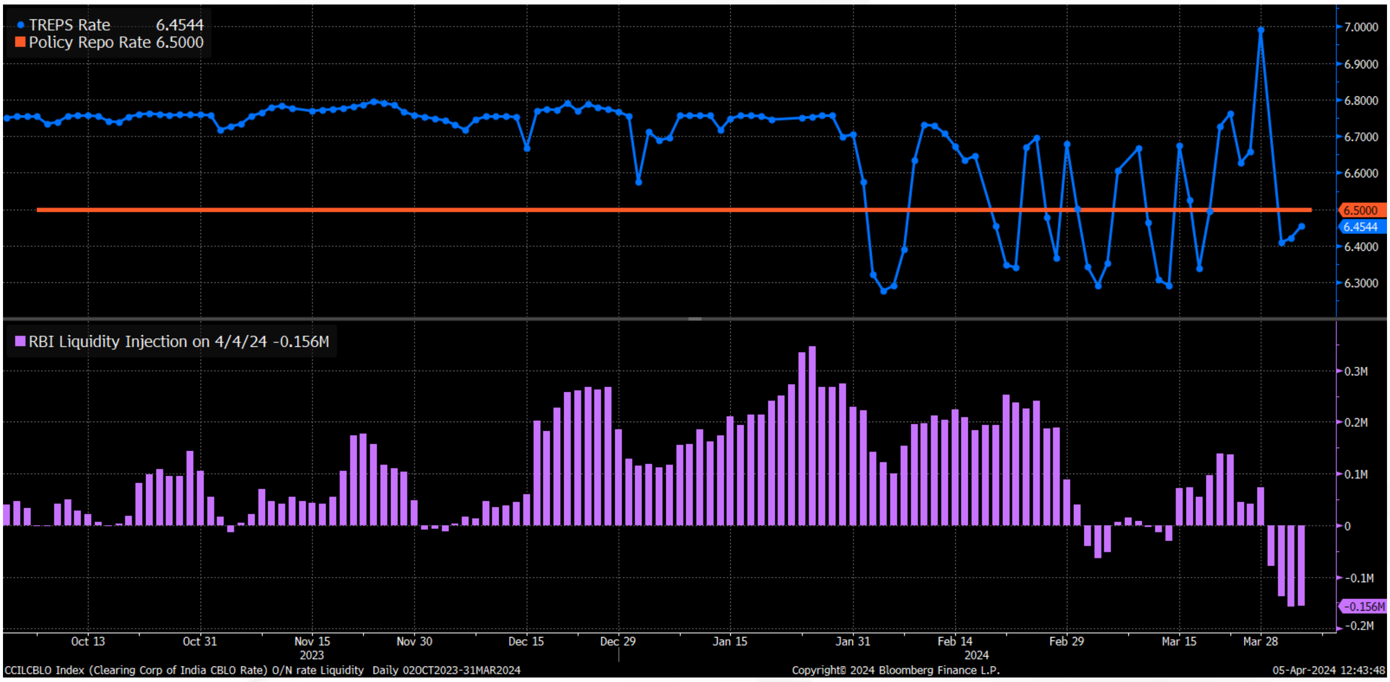
Source: Bloomberg

3. **Focus on Liquidity management-** The Reserve Bank again committed to be nimble and flexible in its liquidity management through main and fine-tuning operations in both excess and deficit situations. Further committed to deploying an appropriate mix of instruments to modulate both frictional and durable liquidity so as to ensure that money market interest rates evolve in an orderly manner that preserves financial stability.

Our View

We have already seen this in action during the month of March and in the first few days of this month. Anticipating the seasonal tightening of liquidity at end-March, the Reserve Bank injected liquidity through Variable Rate Repo (VRR) operations. Consequently, the average borrowings under the Marginal Standing Facility (MSF)window moderated. Liquidity conditions have again turned surplus from March 30 followed by Variable Rate Reverse Repo (VRRR) auctions from April 2. We expect Overnight rates to hover around repo rates most of the times in current month.

Overnight rate and Liquidity



Source: Bloomberg

Interest rate Outlook

Our view largely remains unchanged. We believe the timing and depth of the Fed rate cut cycle will have a bearing on the probable rate cuts in India. Considering the low policy rate differential, RBI may choose to follow the rate cuts by the Fed; and too, to a lower magnitude. The longer-end yields are expected to be well-bid as Foreign Portfolio Investment (FPI) flows are expected to continue ahead of the start of indices-related passive flows in June 2024.

Over the next year the possibilities of a synchronized global growth downturn, a resultant slowdown in India's exports along with contained inflation in the 4.0-4.5% range, may shift the policy focus from inflation control to supporting growth gradually creating space for a shallow rate cut cycle of 50-75 bps.

The rate cycle has peaked, and we may be nearer to the point where the visibility of the reversal of the interest rate cycle has improved but there are always potential risks to the view. **We believe that investors with at least a 1 to 2-year Investment horizon can increase the duration of their Fixed-income portfolios.**