Bajaj Finserv Mutual Fund

Note on RBI's Monetary Policy

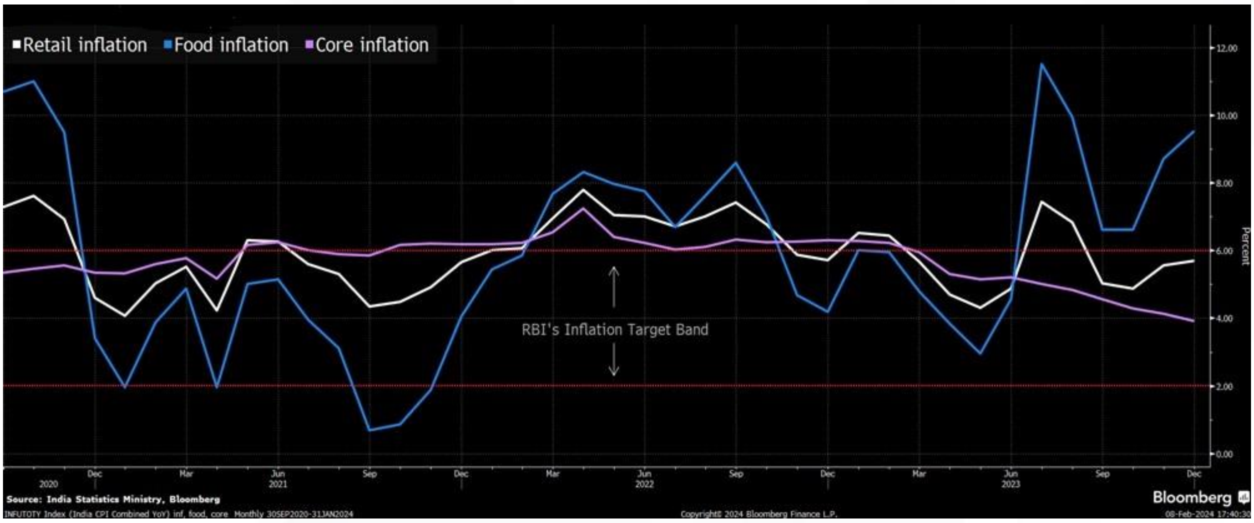
(February 2024)

The Monetary Policy Committee voted five is to one to keep the repo rate unchanged at 6.5% for a sixth 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. Dissenting member- First time since MPC stopped raising rates in Feb 2023 there is a dissent vote as one member voted for a 25-bps rate cut.

Our View: The Consensus expectation of Jan -24 CPI number is at 4.99% vs 5.7% print in Dec-23. The key gauge of inflation that RBI looks at is Core CPI is clocking at 3.9 pct, already below the 4% target. **Chart 1**: **CPI break up.**

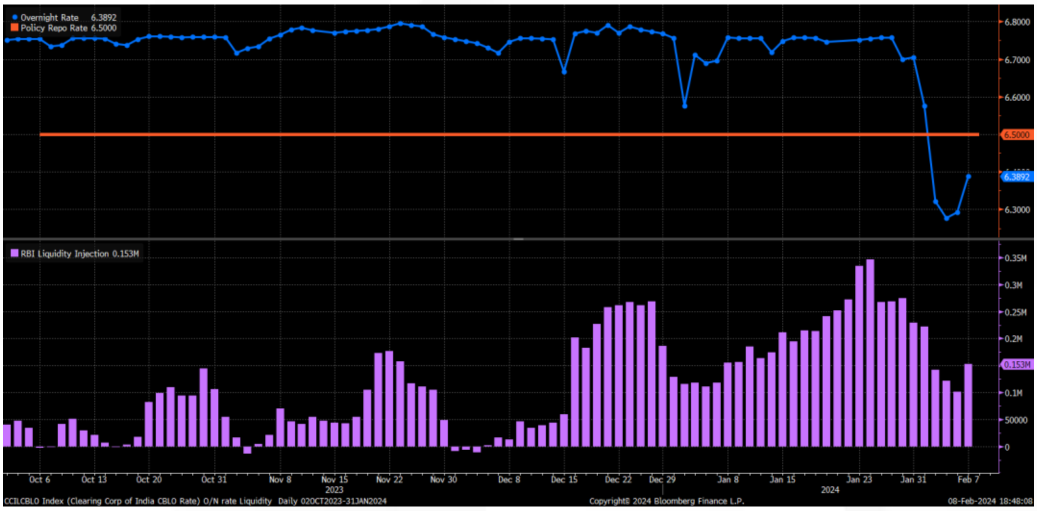


Source: Bloomberg

2. Decoupling stance and liquidity – RBI clarified that stance is linked to the course of future interest rates which in turn depends upon achieving a 4% inflation target on a durable basis. The liquidity feeds into transmission and thus is an important tool of monetary policy, **it is not directly linked to the stance.**

RBI committed **to remain nimble and flexible** in its liquidity management and indicated deploying an appropriate mix of instruments to modulate both **frictional and durable liquidity** to ensure that money market interest rates evolve in an orderly manner **(read overnight rates)**.

Our View: Read the above in context to serious signaling on liquidity starting October 2023 policy where RBI talked about Open Market Operations (OMO) Bond sales to manage liquidity and possibly create a deeper liquidity deficit. This view eased somewhat after the Governor pointed out in December policy that there has been no need till now for OMO sale of government bonds as liquidity has been in the negative zone. Markets took it as a reversal of the hawkish signal given previously. So, today's signaling is some turnaround after the banking system liquidity deficit widened to a decadal high of INR 3.46 trillion in January, largely due to frictional factors. In January/February though RBI has already been quite nimble in liquidity management. **Chart 2: Overnight rate vs Policy Rate and System liquidity.**

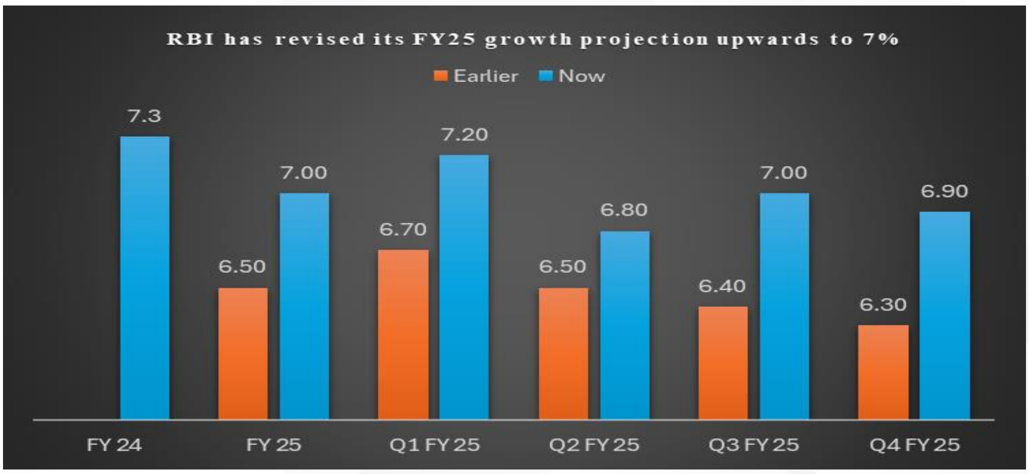


Source: Bloomberg

Note In December-January, the Reserve Bank proactively injected liquidity through both the main and the fine-tuning repo operations to ease liquidity tightness in the system. In February with government spending picking up and improving system-level liquidity, the Reserve Bank undertook six fine-tuning variable rate reverse repo (VRRR) auctions to absorb surplus liquidity.

Going ahead we can expect the RBI to continue with liquidity measures to help alleviate seasonally tight liquidity till March 24 and try to push down the overnight rates near the repo rate rather than operating at the MSF rate. Post-March 2024 the challenge will reverse, as government spending increases one can expect RBI to operate to push the overnight rate upwards toward the repo rate by absorbing liquidity.

3. **An upward revision to GDP forecast-** Given stronger-than-expected GDP readings in recent releases the RBI raised its growth forecast for the FY 2025 to 7 %.



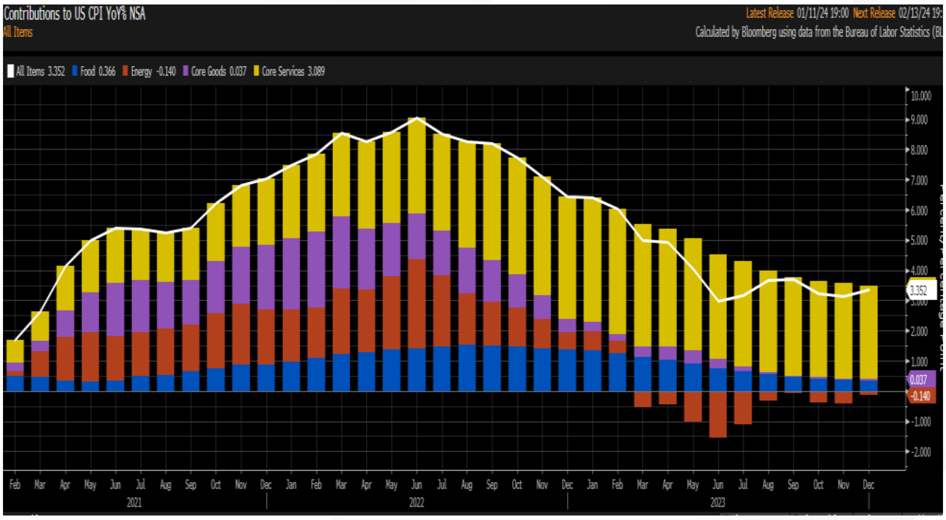
Source: RBI

Our View: The RBI's assessment of inflation-growth dynamics still points to a continued hold and the need to have a disinflationary policy to ensure that inflation eases back to its medium-term target of 4%

Interest Rate Outlook

The year 2023 witnessed the culmination of synchronized rate hikes by global central banks to address the unacceptably high inflation having origins in imbalances between supply and demand that have persisted since the pandemic.

Inflation in the US had surged to a 40-year high earlier in 2022 and with the highest reading for the year 2023 at 6.4 percent in January 23. Since then, we have seen the inflation rate fall to 3.4 percent. This is a significant decline though the headline number is still higher than the Fed's target of 2 pct.

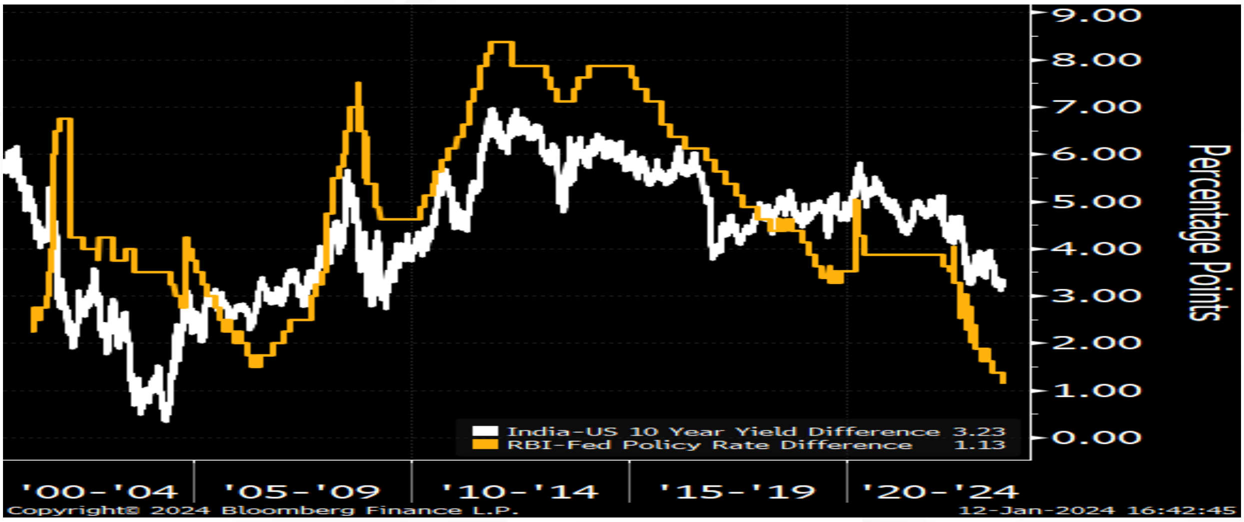


Source: Bloomberg

Core Services now account for all inflation now. As all other components net out to zero. Headline Inflation Excluding Shelter Inflation is below 2%. However, the Headline CPI disinflation stalled in June 2023. Last-mile disinflation, which was exceptionally fast by historical standards in 2023 may be slower and more complicated in 2024.

In line with our expectations in the US the positive surprise in the form of incoming soft data has pushed away expectations of any early rate cuts in the March Federal Open Market Committee (FOMC) meeting. The implied probability of a 25 basis-point cut in March which had gone at a high of 63% in December has now dropped to almost nil. The anticipated start date of cuts has moved forward to the First Qtr. of FY 2025

In domestic markets post interim budget the 10 y G-sec fell 18 bps from the monthly high of 7.24%. In the near term, we expect it to find some resistance at 7.00% levels in line with strong growth data in India. The rally in domestic Government bonds can be seen as tepid even though multiple positives have emerged in form of near target core inflation, reduced political risk, fiscally responsible budget, and expectation of FPI flows post-bond inclusion. This is because the growth rates remain strong (near to long-term potential), food inflation surprises possible and the rate gap with the US remains near the narrowest on record**. See Chart 5 below INDIA US 10Y and policy rate differential.**



Source: Bloomberg

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 is only expected to follow rate cuts by the Fed and to a lower magnitude. The longer-end yields are expected to be well-bid as 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 may have 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 advise investor with at least a 1 to 2-year Investment horizon to increase the duration of their Fixed-income portfolios in line with their risk appetite.