MPC holds rates after two rounds of emergency rate cuts: uncertain outlook, available space to be used judiciously when confirmed by inflation

RBI’s Second Bi-monthly Monetary Policy Review: 2020-21
The MPC unanimously voted to maintain its benchmark repo rate at 4.00%; policy guidance indicates limited room for further easing which is to be used judiciously and opportunistically when allowed for by confirmation on the inflation front.

Policy Actions
Repo, Reverse repo, MSF & Bank rate also kept steady, CRR held constant at 3%.
GROWTH-INFLATION DYNAMICS

Inflation outlook continued to remain highly uncertain despite bumper Rabi harvests and moderate increase in Minimum Support Price (MSP) for Kharif crops. The upside risks were seen from late abatement of vegetable inflation and tight demand and supply conditions in pulses. Also, for the non-food category, cost push pressures were seen arising from higher taxes on petroleum products, hikes in telecom charges, rising raw material costs with upward revision in steel prices and rise in gold prices. Lastly, favorable base effect was expected to keep CPI inflation moderated in H2-FY21 after remaining elevated in Q2-FY21.

GDP Growth was expected to remain in contraction territory given weak global economic conditions and highly pessimistic consumer confidence. However, there were upside risks to growth from an early containment of the pandemic while prolonged spread of the virus, deviations from normal monsoon and global financial market volatility were key downside risks to growth. On a positive note, rural economy was expected to be robust, buoyed by progress of Kharif sowing.
LIQUIDITY AND EXTERNAL SECTOR

Domestic systemic liquidity remained in large surplus on conventional and unconventional tools adopted by the RBI since February. Average daily net absorptions under the LAF eased from Rs 5.3 trillion in May to Rs 4 trillion in July, government balances were build up on heavy borrowing. Transmission to bank lending rates also improved further with WALR on fresh rupee loans declining by 91 bps during March-June, 2020. Spreads between 3-yr ‘AAA’ corporate bond and G-sec of comparable maturity declined from 276 bps from end-March to 50 bps by end-July. Similar moderation in spreads were reported for lowest investment grade bonds.

With sharp correction reported in Q1 2020, global financial markets rebounded post March shrugging off the volatility. Portfolio flows returned to EMEs in Q2 reversing the sharp sell-off, though July saw some moderation and EME currencies also appreciated mainly due to weak USD. Crude oil prices remained supportive on global supply cuts, better prospects for recovery with reopening of economic activities. Though gold prices rose to record high on fears over second wave of infections.

POLICY STANCE AND GUIDANCE

The MPC continued with its accommodative stance as long as necessary to revive growth and mitigate the impact of the pandemic on the economy while ensuring that inflation remains within the target.
# KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order since lockdown.

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| March 27, 2020     | • Repo Rate cut by 75 basis points to 4.4%;  
|                    |   • Reverse Repo Rate cut by 90 basis points to 4%;  
|                    |   • Cash Reserve Ratio (CRR) cut by 1% to 3% for a period of 1 year;  
|                    |   • TLTRO (Targeted Long-Term Operations) for Rs 1 tn, for up to 3 years;  
|                    |   • MSF window extended to 3% from 2% of NDTL,  
|                    |   • 3-month moratorium on payment of interest of all term loans,  
|                    |   • 3-months deferral of interest on working capital facilities,  
|                    |   • NFSR implementation delayed by 6 months and banks permitted to trade in NDF from 30 June.                                                     |
| March 27, 2020     | First TLTRO for Rs. 250 bn                                                                                                                          |
| April 3, 2020      | Second TLTRO for Rs. 250 bn                                                                                                                          |
| April 7, 2020      | RBI increased tenor allowed for states/UTs overdraft to 21 consecutive working days from 14 days previous, and to 50 working days in a quarter from 36 days previous |
| April 9, 2020      | Third TLTRO for Rs. 250 bn                                                                                                                          |
| April 17, 2020     | • Reverse repo cut by 25 bps to 3.75%;  
|                    |   • TLTRO 2.0 of Rs 500 bn, for small and mid-sized NBFC and MFIs;  
|                    |   • LCR requirements of SCBs cut from 100% to 80%,  
|                    |   • Special refinance of Rs 500 bn to NABARD, SIDBI and NHB,  
|                    |   • Hike in WMA (Ways & Means Advances) limit for states by 60% over and above the levels as on 31 Mar until 30 Sep.  
|                    |   • NPA classification will exclude 3-month moratorium period till May end  
|                    |   • NBFCs' loans to delayed commercial real estate projects can be extended by a year without restructuring;                                          |
| April 20, 2020     | RBI enhances WMA limit for remaining part of H1-FY21 to Rs 2 trillion.                                                                             |
| April 27, 2020     | Announces special 90-day repo liquidity facility for MFs up to Rs 500 bn.                                                                        |
| May 22, 2020       | • Repo Rate cut by 40 basis points to 4%;  
|                    |   • Reverse Repo Rate cut by 40 basis points to 3.35%;  
|                    |   • Extends moratorium on term loan repayments for 3 months.  
|                    |   • To support exports/imports, RBI has increased pre and post-shipment credit facility and extended line of credit for Rs 150 bn to EXIM bank for 90 days.  
|                    |   • Rs 150 bn facility created for SIDBI to be extended by another 90 days.  
|                    |   • Permits banks to extend margins on working capital facilities to original levels by 31 March 2021 and group exposures of banks to be increased from 25% to 30% of eligible capital base by 30 June, 2021. |
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| August 6, 2020  | • Policy Rates Unchanged  
                  • Rs. 10,000cr at repo rate to NABARD and NHB  
                    • Rs. 5,000cr to NHB to support HFCs (after the Rs. 10,000cr already given),  
                    • Rs. 5,000cr to NABARD (after the Rs. 25,000cr already given) to refinance small NBFCs and MFIs  
                    • The RBI to amend priority-sector lending guidelines to remove regional disparity -- a higher weight would be accorded to districts with lower credit flows.  
                    • To provide a window under the ‘prudential framework on resolution of stressed assets’ dated 07 June 2019 to enable lenders to implement a resolution plan for eligible corporate exposures (without change in ownership) and personal loans, while classifying such loans as standard and subject to specific conditions.  
                    • Restructuring MSME debt so that stressed MSMEs can utilise this provided their accounts with the concerned lender were classified as standard as on 01 March 2020 but this will have to be implemented by 31 March 2021. (Already in place if account was standard as on 01 Jan 20).  
                    • Maximum loan-to-value of loans sanctioned by banks against gold ornaments & jewellery for non-agricultural purposes, which is currently 75%, has been increased to 90%.  
                    • Banks investment in debt MFs and debt ETFs will be treated consistently with direct debt investments in terms of capital allocation. |
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 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-Seccs. 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 conditions in the market and redemption pressure on these funds. Thus, we think there is an elevated systemic risk in the market within the 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.
MUTUAL FUND RECOMMENDATIONS

**Long Term Income Funds / Gilt Funds / Dynamic Bond Funds:** Bond markets continued to trade on positive bias on the expectation of further easing from the RBI. The outbreak of Covid-19 pandemic worldwide has changed the complete math of the central bankers as well as governments across the globe. It had not only added to the ongoing concern of lower growth but had also brought economic activity to a standstill in various countries, including India. It is hard to predict the trajectory of Covid-19 cases. The world economy entered the second half of 2020 still deeply weighed down by the pandemic with a recovery now ruled out for this year. The global spread of the virus led to sharp movements in the equity & debt markets. Fixed income markets worldwide experienced strong shocks and India was no exclusion. To fight this, globally, governments and central banks are collectively taking requisite steps to ensure that the growth is not hampered due to Covid-19, including India. The measures to support economies across the globe has led to historic levels of monetary & fiscal stimulus and in effect liquidity, flushed into the system. The impending economic slowdown will be painful and revival of the economic activity is critical. India was combating a slowdown from 2016 where GDP growth had slowed from 8.30% in 2016-17 to 4.2% (final estimates) in 2019-20 and now, the extended lockdowns (full as well as partial region wise) has massively impacted end user consumption and private sector investments/capacity expansions. The pain is severe and widespread and the real reflection of it will be clearer in the coming quarters. Currently, market participants expect that the economy could contract anywhere between 5-10%. This points to a massive demand destruction.

RBI Governor Shaktikanta Das said in a recent speech that the need of the hour is to restore confidence, preserve financial stability, revive growth and recover stronger. Thus, fiscal stimulus by Government, sectoral policy measures and monetary actions by the RBI is the trinity that will be the likely way out. With a proactive Central Bank, we expect that, ‘COVID-19 necessitated’ higher Government borrowing is likely to be managed innovatively and successfully without any substantially sustained spike in borrowing costs and thereby manage the funding equations for sovereign as well as private sector successfully. Front end rates are already trading meaningfully below the reverse repo rate reflecting the excess liquidity in the system. Currently, we are witnessing one of the steepest yield curves where the spread between 1 Year & 10 Year G-Sec is...
Above 200 bps. Massive liquidity has brought down yields for shorter end of the curve, while fiscal fears / higher Government borrowing / worsening macros have kept longer maturity rates high. With increased risk off, continuation of accommodative stance in the future monetary policy is also expected. Long end of the curve will compress over a period of time. Any sporadic rise in yields shall be a good opportunity to invest in the shorter end of the curve. Having said that, a substantially higher government borrowing and unexpected sustained spike in inflation could pose as a risk to this downward journey of yields and hence one needs to continuously monitor the macros. However, we expect the RBI to use all the unconventional measures, including but not limited to, OMO calendar, debt monetization, cutting reverse repo rate, maturity switching amongst others.

We think yield curve management will continue amid current steepness, implying outright OMO purchases and operation twist will continue. We believe rates are expected to remain benign, however, volatility might continue for some time given the impact of the Covid-19 outbreak and its impact on growth, fiscal dynamics and government borrowings. 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 & possible capital appreciation in case of a fall in yields. All said, duration funds including dynamic bond funds which are at the longer end of the yield curve, may see some volatility in returns over the near term.

(P.S.: The 10 Year g-sec is stabilizing at current levels after a rally since the lockdown announced in India (March 2020). The 10Y Benchmark (5.79 GS 2030) yield opened the day at 5.83% and traded between 5.808% - 5.887% during the day and close the day at 5.86% vs 5.83%).

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 rates unchanged after two consecutive emergency rate cuts, while remaining in wait and watch mode given heightened uncertainty. Also, the inflation and growth outlook continues to remain highly uncertain, with lack of clarity over intensity and duration of the virus, and associated measures to control its spread. Governor Das reiterated that real GDP growth in FY21 was expected to remain in negative territory, with further improvement dependent upon pace at which virus curve was flattened. Policy guidance showed compressing space for further easing as primacy of inflation taking over growth.

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. Having said that, 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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