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RBI MONETARY POLICY

MARCH 2020

HIGHLIGHTS

MPC cuts rates in an unscheduled meeting, announces liquidity & macro prudential measures

RBI's Seventh Bi-monthly Monetary Policy Review: 2019-20

MPC cut its benchmark repo rate by 75 bps to 4.40% in an unscheduled move with a 4-2 vote and maintained its accommodative stance as long as necessary to maintain growth and combat impact of COVID-19 on the economy while ensuring that inflation remains within the target.

Policy Actions

- Repo rate cut by 75 bps to 4.40%
- Reverse repo rate cut by 90 bps to 4.00%,
- MSF & Bank rate reduced by 25 bps to 4.65%
- CRR lowered by 100 bps to 3% of NDTL for a year
- Daily CRR maintenance now at 80% of requirements as opposed to 90% earlier as long as maintained 100% on a fortnightly average basis (for 3 months)
- MSF availability increased to 3% of NDTL from 2% (for 3 months)

LIQUIDITY & MACRO PRUDENTIAL MEASURES

- TLTRO of Rs 1 trillion available for deployment in investment grade bonds, NCDs and CPs.
- Lower CRR (up to next 1 year) to inject liquidity worth Rs 1.4 trillion & lower maintenance threshold to insure banks against disruptions that can see rapid outflows.
- All lending institutions being permitted 3-month moratorium on payment of interest on all loans outstanding on 1 March, 2020.
- Working capital facilities under cash credit and overdraft: Deferment and drawing power increase without asset classification downgrade.
- Implementation of net stable funding ratio deferred by 6 months to 1st October, 2020 intended to ease pressure on banks to raise funding from long term liabilities.
- Deferment of last tranche of capital conservation buffer by a year to March 2021, which postpones increase in tier 1 capital requirement by Rs 652 bn for the banking system.
- Banks permitted to participate in NDF markets through foreign branches for better price discovery.

GROWTH-INFLATION DYNAMICS

Current inflation numbers are likely to see a spike in prices of essential items, but longer term inflation trends will likely remain subdued given weak growth trends and expectations of good agricultural output. Sharp fall in oil prices is likely to sustain for a time, also limiting any upside inflation impulse. Interestingly, household inflation expectations eased by 20 bps in March 2020.

Despite continuing resilience of agriculture and allied activities, most other sectors of the economy are seen to be adversely impacted by the pandemic, depending upon intensity, spread and duration. Deepening of the global slowdown will also likely have adverse implications. Upside 'risks' are presented by monetary, and fiscal easing measures. Still, growth for FY21 is likely to print around 4% as a base case with deep contraction in Q1.

RBI refrained from giving projections on growth and inflation as the outlook is heavily dependent upon spread and containment of the virus.

LIQUIDITY AND EXTERNAL SECTOR

Domestic financial conditions tightened on account of massive sell-off by FPIs, while redemption pressure, thin trading activity and risk aversion kept yields on CPs, corporate bonds and other fixed income elevated. System liquidity surplus was at an average of Rs 2.86 trillion this month (as on 25 March). RBI undertook unconventional operations by selling short term securities and buying long term securities, conducting 5 LTROs across 1-yr and 3-yr tenors and 3 OMO purchase auctions in March.

Global financial markets were highly volatile from January due to COVID-19 outbreak and saw panic sell-off in equities across DMs and EMs. Also, global risk aversion saw sharp depreciation in currencies. International crude oil prices softened on weak demand outlook and disagreements in production cuts among key oil producers. Central banks and governments responded with several conventional and unconventional measures to ease financial conditions & avoid a demand collapse and to prevent financial markets from freezing up due to illiquidity.

POLICY STANCE AND GUIDANCE

The MPC continued with an accommodative stance and said that all tools (both conventional and unconventional) were on the table. Further action, if any, will depend on duration and intensity of economic disruption as well as the overall growth strategy.

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. At the current juncture though, they look especially attractive due to extreme pressure at the shorter end of the yield curve (<3 month securities) and hence should be considered for investments.

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 (especially since current running yields are higher than long term averages).

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

MUTUAL FUND RECOMMENDATIONS

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.

Long Term Income Funds / Gilt Funds / Dynamic Bond Funds: Capital markets across the globe have been very volatile over the past month owing to concerns relating to Covid-19 pandemic, resultant fear of economic slowdown, currency depreciation and a recent fall in global crude oil prices. These tensions have led to a sharp selloff in risky assets globally. Risk aversion and flight towards liquidity has led to the rise in Indian debt yields by approx. 200 bps across the yield curve in a month. The spread of 3 year AAA rated bond over 3 year government securities also had jumped to a more than four-month high of 195 points.

As the Coronavirus has spread rapidly in major parts of the world, with the relative intensity now seemingly shifting away from China to other geographies, global monetary easing is now in full swing with the lead being taken by the US Federal Reserve. Other central banks have acted as well, both in provisioning of liquidity as well as in reducing policy rates. There are emerging signs of government fiscal responses also picking up, over and above the first reactions via emergency packages.

Recent large sell-offs in the domestic equity, bond and forex markets have intensified redemption pressures. Liquidity premia on instruments such as corporate bonds, CP and debentures have surged. Financial conditions for these instruments, which are used, inter alia, to access working capital in the face of the slowdown in bank credit, have also tightened. To mitigate the adverse effects

MUTUAL FUND RECOMMENDATIONS

on economic activity leading to pressures on cash flows across sectors, the RBI will conduct auctions of targeted term repos of up to three years tenor of appropriate sizes.

To summarise, as local bond markets are today hostage to the panic selling pressures as investors (both local and global) scramble to create liquidity, we believe that volatility might continue for some more time given the impact of coronavirus outbreak and its impact on growth. Thus, with today's rate cut and other liquidity measures, the RBI is actively removing pressure on deposit rates to rise by providing much cheaper long term money at its repo rate. We remain constructive on the shorter end of the yield curve. This is also considering that yields at the shorter end have spiked upwards and are now close to the longer term bond yields, thereby creating attractive opportunities (though at the time of writing this, they have eased considerably today by anywhere between 150-200 bps for the very short term securities). Short Duration funds, Corporate Bond funds, Banking & PSU Debt funds, Low Duration funds, Money Market funds, Liquid 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.

10 Year benchmark closed at 6.13% a gain of 16 bps, during the day it rallied by 31bps.

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 stance remains accommodative, as long as necessary, to revive growth and mitigate effects of COVID disruptions, but at the same time will ensure that inflation remains within target. Governor Das emphasised that all tools, both conventional and unconventional, will be used to achieve the above. It is likely that muted inflation trends and weak growth will allow RBI to cut rates a little further going forward, especially if growths weakens below our baseline GDP growth of 4%. More important, however, is the RBI's use of its toolkit to cover the near end of the sovereign, FI and corporate yield curves. This will be nominally used to ensure adequate transmission and prevent disruptive moves, but will have the effect of keeping near end rates pinned at lower levels. The longer end of the yield curve is freer to move, and will likely to continue to be impacted by fiscal and borrowing implications.

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, Liquid 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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