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RBI MONETARY POLICY

OCTOBER 2020

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HIGHLIGHTS

MPC holds rates with ECB style calendar guidance, assumption of inflation returning to 4% allows for continued focus on growth

RBI's Third Bi-monthly Monetary Policy Review: 2020-21

The MPC unanimously voted to maintain its benchmark repo rate at 4.00% and continue with an accommodative stance as long as necessary - at least through FY21 and into FY22 – to revive growth on a durable basis and mitigate the impact of pandemic on the economy.

Policy Actions

Repo, Reverse repo, MSF & Bank rate also kept steady, CRR held constant at 3%.

GROWTH-INFLATION DYNAMICS

CPI inflation is projected to ease to 4.5% - 5.4% in H2, 4.3% in Q1FY22 and range of 4.1% - 4.4% in FY22. Risks were seen as broadly balanced, with upside risks from elevated import duties on pulses and oilseeds, higher domestic fuel prices, COVID-19 related supply disruptions, labour shortages and high transportation costs were offset by downside risks from progressive easing of lockdowns and removal of restrictions on inter-state movements. Besides these vegetable inflation was expected to ease by Q3 with Kharif arrivals.

GDP growth for FY21 was seen at -9.5%, with Q2 at -9.8%, Q3 at -5.6% and Q4 at +0.5%. Growth for FY22 was projected at 10.1%. The recovery in rural economy was expected to strengthen further while rebound in urban economy was seen to be delayed on account of social distancing norms and elevated number of COVID-19 infections. Besides these, private investment and exports were likely to remain subdued, with the external demand remaining weak.

LIQUIDITY AND EXTERNAL SECTOR

Domestic systemic liquidity remained in large surplus on account of conventional and unconventional tools adopted by the RBI since February 2020.

Global financial markets have remained supported by highly accommodative monetary and liquidity conditions. However, downside risks to global growth have increased on renewed surge in infections in many countries. Besides these, inflation conditions in advanced economies have remained below targets on softer fuel prices and weak demand conditions, whereas for emerging market economies, supply side disruptions have imparted upward price pressures.

POLICY STANCE AND GUIDANCE

The MPC continued with an accommodative stance as long as it is necessary to revive growth and mitigate impact of pandemic on economy while ensuring inflation remains within the target.
The accommodative stance is to be held at least through FY21 and into FY22.

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KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order since lockdown.

Date	Measures Announced
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 upto 3 years • MSF window extended to 3% from 2% of NDTL, • 3-month moratorium on payment of interest of all term loans, • 3-months deferment 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.

KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order since lockdown.

Date	Measures Announced

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.

October 9, 2020	• Policy Rates Unchanged • WMA limit for the Centre has been kept at Rs.1.25 lakh crore compared to Rs.35,000 crore in H2FY20. The 60% WMA limit for states has been extended till March 31, 2021. • RBI to up the size of the OMO Purchases to Rs.20,000 crore from Rs. 10,000 crores. • To conduct on tap TLTRO with tenors upto 3 years for upto Rs.1 Lakh crore at floating rate linked to policy rate available up to March 31, 2021. • TLTRO funds availed by banks to be deployed in corporate bonds, commercial papers and non convertible debentures issued by entities in specific sectors. • To conduct OMOs in State Development Loans (SDL) to rationalize spreads over G-sec.

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Measures announced in chronological order since lockdown.

Date	Measures Announced

October 9, 2020	• Enhanced SLR holdings in HTM category (increased from 19.5% to 22% in September 2020) of NDTL of banks, acquired between 1st September 2020 to 31st March 2021, will be applicable till 31st March 2022.
	• To discontinue system-based automatic caution listing of Exporters.
	• Allowed banks to increase exposure to retail individuals or small business (with turnover of upto Rs 50 crore) from Rs.5 crore to Rs.7.5 crore.
	• To rationalise the risk weights and link them to LTV ratios only for all new housing loans sanctioned up to March 31, 2022.
	• To extend scheme for Co-lending to all NBFCs including HFCs.
	• Other Measures
	    • Round-the-clock availability of RTGS on all days from December 2020.
	    • To grant authorisation for all PSOs (new applicants as well as existing PSOs) on a perpetual basis from earlier limited periods of up to five years.

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-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 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.

IMPACT ON THE MUTUAL FUND INDUSTRY:

Long Term Income Funds / Gilt Funds / Dynamic Bond Funds:
The downward trend in the bond yields has taken a U-turn, the 10-year G-Sec benchmark yield rose by around 15 bps to 6% more than a month back, spiked further up to 6.23% towards the end of August and currently has stabilized at around 6%. The upward movement in the G-Sec yield curve has been lower at the shorter end (around 5-10 bps) and higher at the longer end (around 25-30 bps). The 10-year benchmark yield traded in a tight range of 15 bps (5.90% – 6.05%) during the month of Sept-20, as market participants awaited the outcome of the monetary policy review. Covid brought a nation-wide lockdown that stalled economic activity and led to the sharpest contraction in India's GDP in Q1FY21. Since June 2020 post the ease in lockdown restrictions, there has been a gradual improvement in various high frequency indicators of the economy, though they are still not at par with pre-Covid levels. The spread of Covid in certain pockets of the country prompted localized lockdowns since July 2020, which slowed down the resumption of activity to some extent.
Due to the elevated level of retail inflation with CPI remaining above the upper band of RBI's inflation target for five consecutive months, the MPC's primary concern has been to keep a check on inflation. Although retail inflation is likely to abate in H2FY21 supported by a favorable base effect, but elevated retail inflation in Q2FY21 will be a key factor in the MPC's decision making process. The net FDI flows have recorded a noteworthy fall from $17.5 bn during April – July 2019 to $2.7 bn during April-July 2020. On the other hand, FPI flows so far this year (01st April – September 30th) has been robust at around $7.46 bn compared with $4.9 bn during the corresponding period last year. Inflows by the FPIs have largely been in the equity segment ($10.7 bn) during the year with outflows in the debt segment ($5.7 bn).
The growth outlook has turned weaker and the Centre's tax collection is running far below the February budget numbers, suggesting that the additional borrowings announced in May will largely cover the tax revenue shortfall. And, it is not just the Central government, but State governments are also facing increasing pressure to borrow more. Moreover, fiscal support is likely to be needed, given the rising growth headwinds worsening the fiscal outlook. Given that, H2FY21 gross borrowings which were announced last week, have been pegged at an unprecedented Rs.12tn (unchanged from earlier), but space has been retained to increase it later. Yields slipped 2-3 bps as market participants were not entirely convinced (as they assume government may, in all probability, increase the borrowing number in the fourth quarter).
Additionally, uncertainty about the US Presidential elections, the lingering India-China border tensions, US-China trade war, concerns around Brexit, second

IMPACT ON THE MUTUAL FUND INDUSTRY:

wave of Covid cases and the re-imposition of lockdowns and its impact on financial markets will have to be closely monitored.

Currently, the yield curve is steep where the spread between 1 Yr & 10 Yrs AAA corporate bonds is above ~300 bps. Massive liquidity has brought down yields at the shorter end of the curve, while fiscal fears / higher Government borrowing / slower than expected recovery have kept longer maturity rates high and is likely to compress over a period of time. Having said that, an unexpected sustained spike in inflation and substantially higher government borrowing could pose as risk.

India's debt picture is marked by multiple policy challenges with RBI trying hard to balance between yields, inflation and forex markets. Having said that, inflation is likely to head lower from hereon and may decelerate in Q4FY21. Also, the RBI is likely to ensure surplus liquidity in the banking system predominantly via OMOs, on tap TLTROs and various other measures with a dual objective of improving financial conditions and managing the yield curve. We believe rates are expected to remain benign, however, volatility might continue for some time given the impact of the Covid 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 benchmark saw a sharp intraday rally of 10 bps (5.9154%) and managed to close with majority of gains at 5.94%. The fall in yield was on the backdrop of measures announced by the central bank to keep a check on yields and provide comfortable liquidity via OMOs, TLTROs, OMOs in SDL and other measures).

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, placing revival of the economy from pandemic at the highest priority at current juncture. Members looked through elevated inflation readings, expecting conditions to normalise as Covid related restrictions are eased further over the coming months. RBI guidance leaves the door open for another rate cut, but only if inflation comes off along RBI's fan chart – this is below Axis Banks' own forecast on inflation.

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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