RBI Policy Update- Sept 2022

As widely expected, the Monetary Policy Committee (MPC) **voted 5:1 to raise the Repo Rate by 50 bp to 5.90% with immediate effect**.

This is the 3rd consecutive 50 basis-point hike and comes on the heels of hawkish policy actions from DM central banks, unabated global inflation, upsurge in global FX volatility and tightening of global financial conditions.

Ahead of today's policy meeting bond market participants have raised their expected Terminal Repo Rate to 6.5% by Q4FY23 amid super hawkish FOMC and other factors.

The MPC voted 5:1 & to keep monetary policy stance unchanged as **"withdrawal of accommodation".** A section of market participants expected MPC to shift to "neutral" stance.

The MPC trimmed by FY23 GDP growth by 20 bp to 7% amid weakness in Q1FY23. India's GDP growth is expected to decelerate to 6.3% y/y in Q2FY23, 4.6% in Q3 & Q4 each. Indian economy is expected to growth at around 6% y/y in FY24.

On inflation, the MPC expects food inflation to ease amid above-average monsoon season this year and reduction in crude oil & other commodity prices. The MPC has maintained their FY23 inflation forecast to 6.7%. This is based on average crude oil price of $100 per barrel in the second-half as against $104/barrel in H1FY23.

That said, a section of market participants expects India's CPI to remain sticky at 5.5- 6% y/y level in H1FY24, higher than RBI's current projection of ~5% inflation in Q1FY24. This should keep RBI vigilant on inflation front.

On recent volatility in the USD-INR, the RBI governor comforted that India's FX reserves were over $537 billion and over 2/3rd of the fall in FX reserves was due to valuation changes amid surging USD. He also reiterated that RBI would intervene to contain FX volatility.

The MPC noted that **banking system liquidity has turned into a deficit mode** – first time after June 2019. This should help contain inflationary pressures and aid in efficient transmission of monetary policy.

Reaction of Bond Market:

IGB prices reacted positively amid "a relief rally" and no negative surprises in the policy. Yield of the benchmark 10Y IGB fell from its pre-policy level of 7.39% to 7.31% before giving up some of its gains. Sentiment remains buoyant amid slight reduction in H2FY23 GOI borrowing, robust growth in tax collections and undiminished expectations of inclusion in global bond indices.

We expect 10Y IGB to remain range-bound between 7.27% and 7.47% from a technical perspective. The belly of the IGB yield curve (3-7Y segment) should benefit amid a relatively lower primary supply in H2FY23. This should help widen yield gap between 5Y and 10Y IGB, in our view. That said, we expect IGB yield curve to remain flat in the near-term.

What should investors do?

We see value in sovereign yields across the curve after the recent hardening of yields. Investors looking for long-term fixed income allocation should consider investing in Target Maturity bond ETFs / index funds maturing in 3 to 7-year maturity bucket with predominant exposure to IGB & SDLs with a view to hold them till maturity to benefit from attractive tax-adjusted returns.