

FIXED INCOME -TIMES



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August and Everything After: Monetary Policy Review Aug 2021

The policy review was set against a market expectation of largely status quo on most things. The CPI forecast was expected to be raised, which would be mechanical given the higher than expected May print received in June. Additionally there was expectation around enhancement of the variable rate reverse repo (VRRR) amount from the current INR 2 lakh crores, although this expectation wasn't uniform across market participants. Given this, it *prima facie* delivered largely on expectation but with two caveats, as it were: One, a lone dissent on maintenance of accommodative stance from external member Prof. Varma. Two, RBI's average inflation forecast for the year at 5.7% which is higher than what most market participants were expecting (although this can be looked positively as well since the likelihood of policy setters being negatively surprised now is that much lesser). The following table summarizes the changes.

Growth and inflation projections

| | CPI (%y/y) | | | Real GDP (%y/y) | | |
|---------------------|------------------|------------------|------------------|-----------------|------------|------------|
| | 07-Apr-21 | 04-Jun-21 | 06-Aug-21 | 07-Apr-21 | 04-Jun-21 | 06-Aug-21 |
| Q1 FY22 | 5.2 | 5.2 | 5.6 | 26.2 | 18.5 | 21.4 |
| Q2 FY22 | 5.2 | 5.4 | 5.9 | 8.3 | 7.9 | 7.3 |
| Q3 FY22 | 4.4 | 4.7 | 5.3 | 5.4 | 7.2 | 6.3 |
| Q4 FY22 | 5.1 | 5.3 | 5.8 | 6.2 | 6.6 | 6.1 |
| FY22 | 5.0 | 5.1 | 5.7 | 10.5 | 9.5 | 9.5 |
| Q1 FY23 | | | 5.1 | | | 17.2 |
| Risk to projections | Broadly balanced | Broadly balanced | Broadly balanced | - | - | |

Source: RBI, IDFC MF Research. Note: 1) FY21 average CPI was 6.2% y/y and real GDP growth was -7.3% y/y. 2) Q1 FY22 CPI above is the actual number

The Assessment

Combining impressions from the Governor's statement as well as the monetary policy committee (MPC) resolution, domestic growth seems largely on track with June and July printing decent recovery as 2nd wave restrictions began getting rolled back. The prospects for all three components of aggregate demand (consumption, investments, and net exports) are found to be encouraging, although risks remain including from global commodity prices, financial market volatility, and from new waves of infection. However, even with these improvements in aggregate demand, the underlying conditions are still deemed to be weak with a large amount of slack in the economy persisting. The MPC also notes some moderation in the pace of global recovery with the resurgence in infections in parts of the world.

Recent inflation pressures are acknowledged but the assessment is that these are transitory and largely driven by adverse supply side factors. Thus aggregate supply is also lagging below pre-pandemic levels and this needs rectification through further government steps. Importantly, and lags in supply response notwithstanding, the assessment remains that policy support from all sides – fiscal, monetary and sectoral – is required to nurture the 'nascent and hesitant' recovery.

Recasting Into Framework

At an optimal level of aggregate supply (AS), monetary policy would ordinarily try and ensure that aggregate demand (AD) remains within this bound. Failure to do so would lead to generalized inflationary pressures. However, the current situation is much more complex. Even with improving prospects, AD lags much below pre-pandemic levels. But due to a variety of factors AS has fallen as well. This is leading to inflationary pressures even at a much lower than desired level of AD. Furthermore, this fall in AS is not uniform but varies sharply from one sector / industry to another. **One choice before the RBI / MPC is to already start to address the AD – AS imbalance via traditional monetary policy even though the imbalance is at a much weaker level of AD and is probably sector level. This would address potential perceptions of 'behind the curve' as well as help anchor inflation expectations now. However, it is also quite likely that AS is only temporarily depressed and comes back with a lag (adjusted for longer term scarring), thereby addressing the inflationary pressures currently being seen. RBI / MPC are clearly of the view that this indeed is likely to happen and therefore are unwilling to settle for a lower equilibrium (that is try to address the imbalance at a lower level of AD-AS). It is thus that the Governor re-emphasizes that RBI remains in 'whatever it takes' mode while also acknowledging that the 'MPC continues to be conscious of its mandate of anchoring inflation expectations as soon as the prospects for strong and sustainable growth are assured'.**

If the above framework sounds theoretical, then it is. But so is the discussion on a very small marginal change in monetary accommodation (which is what almost the entire spectrum of views on monetary policy encompasses currently) from standpoint of its effect on the actual economy; especially in the context of the 'K' shaped recovery where most entities that may actually benefit from very low levels of policy rates may already not be needing it (the problem is the lower arm of the 'K' where risk spreads and even availability of organized credit may be an issue). The argument then boils down only to whether the RBI/MPC perceived that the necessary conditions for a further step towards removal of accommodation have been achieved yet or not. And given the still subdued AD and risks from the next wave, the judgement clearly was that they haven't.

Remember also that **there is a multiple step process of unwind in this cycle as well, given the exceptional nature of accommodation that has had to be put in place. The first step of moving away from de-facto yield curve control to orderly evolution of the yield curve has already been implemented. The second of enhancing VRRR has been announced today but without step three yet of signaling change in stance. It can be reasonably argued that the time for signaling change in stance and actual adjustments to the effective policy rate has not yet come, with the risks highlighted and still unfolding when the system is already at a lower than desired level of AD currently.**

Market Implications

The enhancement in VRRR to double its current amount is being undertaken gradually and with explicit guidance that this shouldn't be read as a reversal of the accommodative policy stance. The so-called GSAP program is now reintroducing 'on-the-run' bonds (benchmark 5 year has already been announced for the next GSAP auction) which is on the margin positive for market participants. However, possibly the dissent in stance as well as a higher than expected revision to CPI may be leading some market participants to fear that we are that much closer to step three in the unwind cycle. This is getting reflected most particularly in the rise in swap rates post policy. While the fears are somewhat understandable, we can't help but observe that market bias seems quite one way. Put another way, **there seems to be extreme conviction that significant normalization is coming sooner rather than later despite what the RBI / MPC are saying. To clarify, it is quite logical to expect that the current emergency level of accommodation will expire soon. However, swap curves are pricing in not just an early exit from the current level of accommodation but also a fairly significant increase in overnight rates thereafter. Further, market is not fully considering the possibility that peak policy rates in this cycle may actually turn out to be lower than the last one. Not to extrapolate, but it may be noted that one way expectations with respect to US policy normalization have had serious cause for rethink over the past few weeks and months. Even in the Indian context given a relatively subdued fiscal response and with possibly a global peak on the reflation trade having been achieved, there is two-way risk to the above expectation even as RBI may have to move off the current emergency levels of overnight rate sometime soon (possibly first quarter of calendar 2022).**

From investors standpoint, we would reiterate our previous observations.

1. It isn't obvious that interest rate swaps are the best protection against future policy normalization given the sizeable rate hikes that they are already pricing and the fact that they don't get directly impacted by bond supply, which is the number one pressure point for Indian markets.
2. Intermediate duration points (4 – 6 years) seem well positioned to benefit from carry plus roll down even in an environment of gently rising bond yields.
3. Spreads on corporate bonds (including lower rated bonds) generally speaking for tenors beyond 3 - 4 years seem too shallow and such tenors are better played with sovereign assets.
4. While some amount of 'bar-belling' may be prudent, the cost of holding cash is large and only makes sense if one wants to hedge against tail risks that may entail sharp and short period rises in yields. In particular, a 'business as usual' gentle rise in yields is not enough grounds to sit on large amounts of cash given the extraordinary steepness even at intermediate duration points.

An additional point, and a recent thought, as expressed above is that if peak reflation is behind us it is likely that market discussions on peak policy rates in this cycle now start taking prominence. In the case of US, market price action recently seems to already be factoring in a lower than last cycle peak policy rate. We currently believe that this will likely be true in the Indian context as well.

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