Monetary Policy Review – Make no mistake; “normalization” started; Carry is King!

ASK WEALTH ADVISORS

RBI kept its key policy rates unchanged through a unanimous vote of the Monetary Policy Committee (MPC). Thus Repo, Reverse Repo rate & MSF rate stands at 4.00%, 3.35% and 4.25%. The MPC in its meeting today decided (unanimously) “to continue with an accommodative stance of monetary policy till the prospects of a sustained recovery are well secured while closely monitoring the evolving outlook for inflation”. CPI inflation has been revised to 5.2 per cent in Q4:2020-21, 5.2 per cent to 5.0 per cent in H1:2021-22 and 4.3 per cent in Q3: 2021-22, with risks broadly balanced. Real GDP growth is projected at 10.5 per cent in 2021-22 – in the range of 26.2 to 8.3 per cent in H1 and 6.0 per cent in Q3The following supportive measures were announced too.

- **TLTRO on Tap Scheme – Inclusion of NBFCs**: Given that NBFCs are well recognised conduits for reaching out last mile credit and act as a force multiplier in expanding credit to various sectors, it is now proposed to provide funds from banks under the TLTRO on Tap scheme to NBFCs for incremental lending to these (*identified*) sectors.
- **Restoration of CRR in two phases beginning March 2021**: To help banks tide over the disruption caused by COVID-19, the cash reserve ratio (CRR) of all banks was reduced by 100 basis points to 3.0 per cent of net demand and time liabilities (NDTL) effective from the reporting fortnight beginning March 28, 2020. Banks would now be required to maintain the CRR at 3.5 per cent of NDTL effective from the reporting fortnight beginning March 27, 2021 and 4.0 per cent of NDTL effective from fortnight beginning May 22, 2021.
- **MSF - Extension of Relaxation**: It has now been decided to continue with the MSF relaxation for a further period of six months, i.e., up to September 30, 2021.
- **SLR Holdings in Held to Maturity (HTM) category**: On September 1, 2020, the Reserve Bank increased the limits under Held to Maturity (HTM) category from 19.5 per cent to 22 per cent of net demand and time liabilities (NDTL) in respect of statutory liquidity ratio (SLR) eligible securities acquired on or after September 1, 2020, up to March 31, 2021. It has now been decided to extend the dispensation of enhanced HTM of 22 per cent up to March 31, 2023 to include securities acquired between April 1, 2021 and March 31, 2022. The HTM limits would be restored from 22 per cent to 19.5 per cent in a phased manner starting from the quarter ending June 30, 2023.
- **Allowing Retail Investors to Open Gilt Accounts with RBI:** Encouraging retail participation in the Government securities market has been the focus area of the Government of India and the RBI. Accordingly, several initiatives viz. introduction of non-competitive bidding in primary auctions, permitting stock exchanges to act as aggregators/facilitators for retail investors and allowing odd-lot segment in the NDS-OM secondary market, have been taken in the past. As part of continuing efforts to increase retail participation in government securities and to improve ease of access, it has been decided to move beyond aggregator model and provide retail investors online access to the government securities market – both primary and secondary - along with the facility to open their gilt securities account (‘Retail Direct’) with the RBI. Details of the facility will be issued separately.
- **Integrated Ombudsman Scheme**: To make the alternate dispute redress mechanism simpler and more responsive to the customers of regulated entities, it has been decided to implement, inter alia, integration of the three Ombudsman schemes and adoption of the ‘One Nation One Ombudsman’ approach for grievance redressal.

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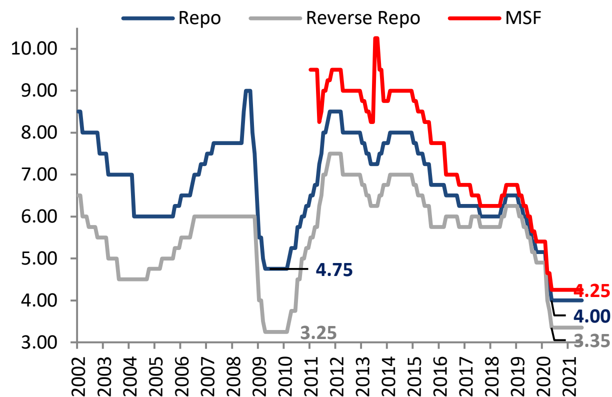
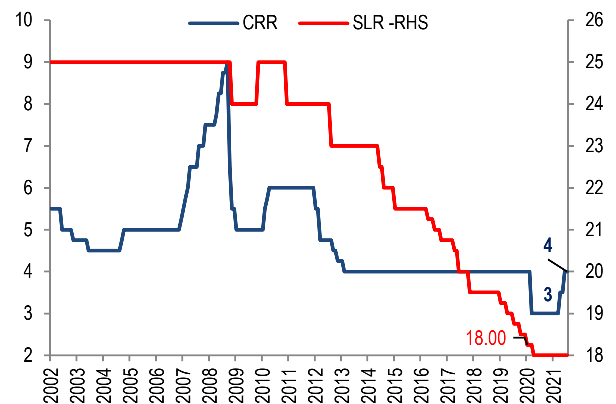
RBI keeps rates unchanged but indicates gradual liquidity withdrawal

Exhibit 1: RBI keeps policy rates unchanged for the time being in accordance with accommodative stance



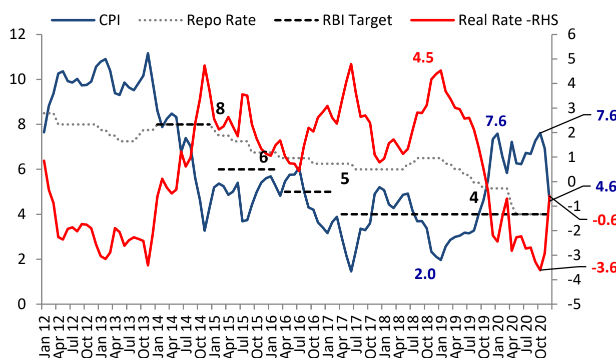
Source: RBI, ASKWA Research

Exhibit 2: CRR to be restored back to 4% level in two phases



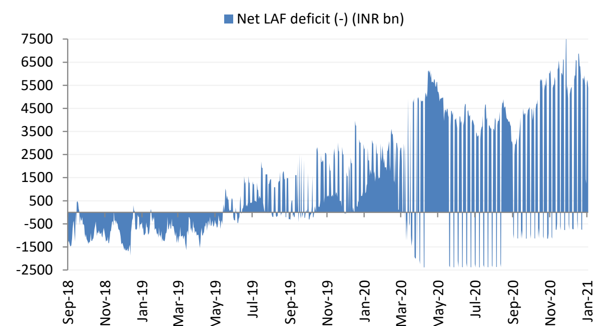
Real rates nearly positive; liquidity support continues but have seen early signs of normalisation

Exhibit 3: Real rates are close to positive now



Source: CMIE, RBI, ASKWA Research

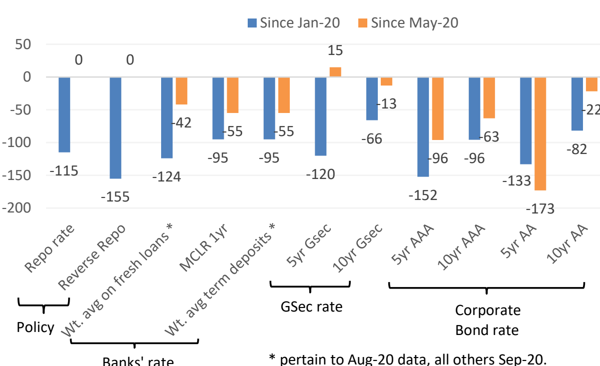
Exhibit 4: Huge liquidity support (INR6tn+) continues



Source: CMIE, RBI, ASKWA Research

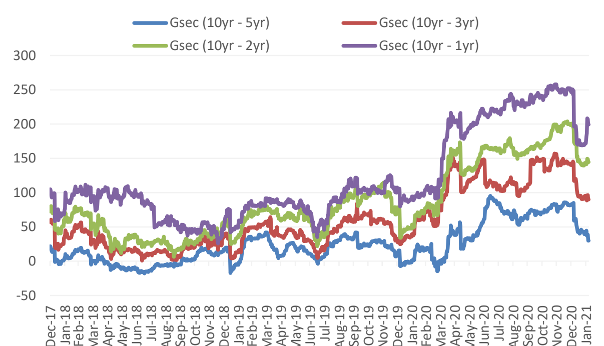
The transmission continued despite RBI’s no change for nine months, term spreads have started moderating

Exhibit 5: Rate transmission when RBI does nothing



Source: CMIE, RBI, ASKWA Research

Exhibit 6: The term spread has started moderating



Source: CMIE, RBI, ASKWA Research

Implication and outlook:

On rates and liquidity

Make no mistake. RBI has started "normalizing" extraordinary monetary policy that was provided as part of Covid-19 response. There are many pointers in the policy to this effect.

i) A missed opportunity for rate cut: Given the sharp and more than expected drop in inflation and its own inflation assessment staying within the tolerance band of 4%(+/- 2%) for coming three quarters of FY22 and expressed acknowledgement that "The recovery, however, is still to gather firm traction and hence continued policy support is crucial" – RBI choose not to cut rates.

ii) MPC omitted the reference "**to maintain status quo on the policy rate and** continue with the accommodative stance as long as necessary…" in favour of "to continue with the accommodative stance as long as necessary…" (Bold added). This can be viewed as a significant alteration of the stance.

iii) Restoration of CRR cut albeit with a revised deadline by May-21.

Takeaways: RBI has chosen to give it a miss of what was pretty much the last opportunity to cut rates in the current cycle, effectively signaling bottoming out of the rate cycle. The imperative for a rate cut in the current policy emanated from the fact that yields in the G-sec market has already started reversing despite the huge excess liquidity support that at the margin had become ineffective to bring down the yields. Moreover, the Union Budget FY22 has lined up huge borrowing for FY22 and even for Q4FY21 which would be difficult to conduct smoothly if credit growth too starts picking up as expected. Hence a stronger rate signal was needed to cool off the market. It must be mentioned that RBI can claim to maintain accommodative policy even in case of limited rate hike, as long as such rate hikes are limited to what it considers as lesser than "neutral rate". Thus, both on rate as well as stance there have been an effective hardening.

On the liquidity front too, normalization has clearly started. The fact that RBI fettered about short term rates going below Reverse Repo rate signals both limitations of transmission that is impeded by heavy government borrowing as well as its own discomfort of weathering through temporary and largely inconsequential but perceived market distortions. CRR restoration would further reduce excess liquidity no matter RBI's assurance that the measure "opens up space for a variety of market operations to inject additional liquidity". We might just note that such space and instruments exist as at present too and it is certain to reduce flexibility at the banks' end. Moreover, if credit growth picks up it may not take long for the surplus to dramatically reduce or evaporate in a short period of time with possibilities of faster than expected policy rate normalization. We think transmission that has indeed been very significant across market segments even since no rate action by RBI from May-20 onwards, would now come to a halt as a result of the rate action (or lack thereof) and liquidity measures of RBI.

Retail participation on Government securities market:

Takeaways: This is a significant measure that provides additional avenue for channelizing savings for retail investors directly to the Gsec market and providing them with a truly risk-free alternative. While the details of the scheme would be released in due course it raises a few concerns.

i) This may divert a part of financial savings to this channel and to that extent may have an adverse impact of the fixed deposit mobilization of the banks – so far taken as a risk-free alternative by retail customers at least of public sector banks.

ii) Those investors going direct would need to bear the MTM consequence in their portfolio. They may not get the benefit of liquidity, aggregation, maturity transformation and yield enhancements done by intermediaries, particularly mutual funds.

Strategy for Fixed Income investment

As RBI abstained from further directional measure on rates and indicated only what we perceive a more arduous course of yield management, we have revised our 10 year forward guidance to 5.75 to 6.75% (from 5 to 6.5% earlier). This indicates our revised expectation in view of the combined impact of Union Budget FY22 and RBI’s Feb-21 policy as well as incoming signs of consolidating recovery. Fixed income strategies need to be recalibrated accordingly.

I) Bottoming of rate cycle

While RBI maintained its earlier stance to pursue an accommodative policy stance, incremental and supportive measures including communication to moderate yields further, were missed. It is clear that possibilities of faster than expected hardening of market yields and earlier than expected exit of ultra-loose policy exist.

ASK reco implication – Carry is King! Term structure remains steep, and value remains at the medium range of the curve. While the extreme long-end (10 year+) could have some enhanced volatility, the risk-reward is best for the 5-6 year average maturity profile. Extreme low duration remains devoid of carry and hence wouldn’t be optimum for long term allocations. While emphasis on higher grade (AAA + sovereign) stays, selective credit opportunities need to be explored for yield enhancement. Opportunities that provide protection against rising yields such as Inflation Indexed Bond (IIBs) or Floating Rate Bonds (FRBs) should be explored too.

II) Extension of TLTRO scheme to NBFCs:

Positive for banking system, NBFCs and the real economy to revive the credit flow. Remain positive on sub-AAA (but still high quality) corporate bond yields – a collapse 5yr AA corporate bond yields provide evidence of this.

ASK reco implication – Positive for our hi-grade, sub-AAA recommendation like Shriram Transport Finance

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