Union ASSET MANAGEMENT
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Yield

SPECIAL UPDATE – October 4, 2019

FOURTH BI-MONTHLY MONETARY POLICY STATEMENT, 2019-2020

Monetary Measures

- Monetary Policy Committee (MPC) cut the policy repo rate under the liquidity adjustment facility (LAF) by 25 bps from 5.40% to 5.15%
- Consequently, the reverse repo rate under the LAF stands adjusted to 4.90%, and the marginal standing facility (MSF) rate and the Bank Rate to 5.40%. Five members voted for a 25 bps rate cut while one member voted for 40 bps rate cut.
- MPC maintained its 'accommodative' stance of monetary policy and also indicated that it would continue as long as necessary to revive growth.

Analysis & Outlook

- Reduction in repo rate by the MPC was in line with expectations of a rate cut; along with an accommodative stance. These expectations were based on the slowing economic growth, stable inflation levels and dovish outlook of central banks of major developed and emerging economies.
- RBI's policy statement highlighted the consistently reducing GDP growth rates due to slowdown in consumer demand in both rural and urban areas. Service sector is also witnessing signs of slowing down as several high frequency indicators are suggesting. Consequently, RBI has revised its GDP forecast for FY2020 downward to 6.1% from its August forecast of 6.9%. GDP is now forecasted to grow at 5.3% in Q2FY20 and 6.6-7.2% in H2FY20 against its previous estimate of 7.3-7.5% for H2FY20.
- MPC has taken into consideration the weak global growth outlook with developed economies such as USA, Euro, UK and Japan witnessing slowing economic activity. USA effected a second consecutive rate cut of 25 bps in September 2019 following a similar rate cut in July. Emerging economies like China, Russia, Brazil and South Africa are also seeing similar signs of slowdown; and hence central bankers globally have turned dovish in their latest monetary policy statements.
- MPC expects inflation to remain below its 4% target; Q2FY20 inflation is projected to inch up slightly to 3.4% against its previous estimate of 3.1% whereas H2FY20 and Q1FY21 inflation projection is in line with its earlier estimates of 3.5-3.7% and 3.6% respectively with risks evenly balanced. Factors that effected the change in Q2FY20 inflation projection are 1) elevated vegetable prices, 2) volatile crude oil prices and 3) uptick in household inflation expectation. RBI in its statement has highlighted the above average monsoon and hence is positive in its outlook towards agriculture output and subsequently on the rural demand.
- RBI has once again highlighted the concerns on lack of rate cut transmission to the borrowers, despite adequate liquidity in the system. Against four policy rate cut aggregating to 110 bps between February and August 2019, weighted average lending rate on fresh rupee loans of banks has dropped by 29 bps only.
- The MPC notes that the negative output gap has widened further. While the recent measures announced by the government are likely to help strengthen private consumption and spur private investment activity, the continuing slowdown warrants intensified efforts to restore the growth momentum. With inflation expected to remain below target in the remaining period of 2019-20 and Q1:2020-21, there is policy space to address these growth concerns by reinvigorating domestic demand within the flexible inflation targeting mandate. It is in this context that the MPC decided to continue with an accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.
- The change in stance and tone of the policy opens up room for further rate cuts.

- Yields at the longer end of the curve moved up by 4-5 bps with the benchmark 10-year paper yield at 6.65% at the time of writing.
- Yields at the shorter end of the curve (up to one year) remained flat as the rate cut expectation was already built-in over the last couple of days.

- The MPC remains focused on its commitment to keeping headline inflation close to 4 per cent on a durable basis.

Position of Funds

Duration funds:

- With slowing economy and benign inflation, interest rates are expected to come down further and credit spreads are likely to narrow.
- Therefore, it represents an opportunity for investors to invest in fixed income duration funds with a medium to long-term horizon.

Money market funds:

- The yields at the shorter end of the curve are expected to move in tandem with the liquidity in the system. With RBI likely to keep liquidity neutral to surplus, short end rates are expected to be anchored to repo rate.

The next meeting of MPC is scheduled to be held on December 03 to 05, 2019.