Monetary and Liquidity Measures:

On the basis of an assessment of the current and evolving macroeconomic situation, the Monetary Policy Committee (MPC) decided to:

- Reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points (bps) to 5.15 per cent from 5.40 per cent with immediate effect.

- Consequently, the reverse repo rate under the LAF stands reduced to 4.90 per cent, and the marginal standing facility (MSF) rate and the Bank Rate to 5.40 per cent.

- The MPC also decided to continue with an accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 per cent within a band of +/- 2 per cent, while supporting growth.

MPC's Outlook:

In line with expectations, the RBI in its fourth Bi-Monthly Monetary Policy on 4 October 2019 reduced the Repo rate for the fifth time in a row, since February 2019. The RBI reduced Repo rate by 25 bps to 5.15% from 5.40%; a cumulative reduction of 135 bps since February 2019. While the rate cut was largely expected, the market participants were keenly looking for some clarity on the future course of monetary policy from the RBI; and to that effect the monetary policy’s forward guidance could not be clearer in this policy meet. The RBI's monetary policy statement mentioned that, “…the continuing slowdown warrants intensified efforts to restore the growth momentum…” The policy statement also mentioned that “…there is policy space to address the growth concerns by reinvigorating domestic demand within the flexible inflation targeting mandate…” In case of inflation, the RBI revised the inflation projections upwards for Q2FY20 to 3.4%, from the earlier projections of 3.1%. Inflation projection for H2FY20 and Q1FY21 were retained at 3.5%-3.7% and 3.6% respectively, with risks evenly balanced. Some of the factors that the RBI highlighted influencing the inflation trajectory included the following: - improved outlook for food inflation; price pressures in CPI excluding food and fuel likely to be muted; and volatile crude oil prices.

On economic growth projections, the real GDP growth projections for FY20 were revised downwards by the RBI. GDP growth forecast was revised down from 6.9% in the August 2019 policy to 6.1%, with 5.3% in Q2FY20 and in the range of 6.6%-7.2% for H2FY20 – with risks evenly balanced; GDP growth for Q1FY21 was also revised downwards to 7.2% from 7.4% projected in the August 2019 monetary policy. The RBI's policy statement highlighted, that on the negative side the factors affecting growth included, high frequency indicators suggesting domestic demand conditions have remained weak; the business expectations index of the Reserve Bank’s industrial outlook survey showing muted expansion in demand conditions in Q3FY20; and export prospects being impacted by slowing global growth and continuing trade tensions. On the factors that may have a positive impact on growth, the RBI highlighted factors like, expectation of monetary easing, feeding into the real economy and boosting demand; and expectations of revival in sentiment and domestic demand, especially private consumption due to measures announced by the government.

Impact on the Bond Market and outlook:

The G-sec yields had rallied in the run up to the monetary policy as the expectations of a rate cut were already priced into the yields. However, on the day of the monetary policy the G-sec yields rose despite a rate cut as well as dovish commentary, as market participants resorted to profit booking. Yield on the existing 10 year benchmark
bond the 7.26% 2029 G-sec closed higher at 6.69% on 4 October 2019 as against its previous close of 6.61%. Going by the monetary policy statement, it is clear that the priority of the RBI at this juncture is to ensure economic growth revival, given that inflation has remained well behaved so far, and is also expected to remain within its 4% medium term target. This clearly indicates that there could be more interest rate reduction by RBI. However, the quantum and timing of further rate cuts may be data dependent and also on how the transmission of the rate cuts done so far pans out. What does this mean for the yield curve? The shorter end of the yield curve may see further decline and stay anchored tracking the Repo rate reduction as well as liquidity staying in the surplus zone. On the other hand, the longer end of the yield curve may continue to remain volatile as caution still prevails on the fiscal deficit of the government.

Investments in Medium Duration Funds can be considered with a horizon of 15 months and above. Investments into Short Duration Funds can be considered with an investment horizon of 12 months and above. Investors, who are comfortable with intermittent volatility, can also look at strategies that have allocation to the longer end of the yield curve, through Dynamic Bond Funds. Investors looking to invest with a horizon of up to 3 months can consider Liquid Funds, while Ultra Short Duration Funds and Arbitrage Funds can be considered for a horizon of 3 months and above.

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