Managed Portfolios - Insights

Policy by Policy Guidance

Morningstar Investment Adviser India

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All members of the RBI's MPC unanimously voted to increase the policy rate by 50 bps to 5.4% and remain focused on the withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. Prof. Jayanth R. Varma expressed reservations on the stance. Consequently, the standing deposit facility (SDF) rate stands adjusted to 5.15%, and the marginal standing facility (MSF) rate and the Bank Rate to 5.65%.

Our Views

The debt market had, by and large, factored a 50 bps rate hike. But, in the last few days, post less hawkish commentary from the US Fed, the market had started to factor a 35 bps rate hike rather than 50 bps. As a result, the 10-year benchmark G-sec yield cooled off quite a bit and touched 7.11% before the policy announcement today. This was short-lived as the MPC decided to continue front-loading rate hikes and announced a 50 bps hike instead of 35 bps. The yield on the 10-year benchmark G-sec inched up by 19 bps post the announcement, closing at 7.30%.

With today's 50 bps rate hike, the RBI has surpassed the pre-pandemic policy rate. There's an expectation of another rate hike but the timing (Oct or Dec) and the quantum is extremely difficult to assess in this evolving dynamics. As the governor said in the press conference *"Difficult to provide any guidance at this point. It needs to be looked at policy by policy".* This is similar to what Jerome Powell, Governor of the US Federal Reserve, mentioned last week.

CPI is off its peak with a fall in the price of global commodities. June consumer prices were 7.01% higher than a year earlier with fuel inflation at 10.4% and lower than the recent peak of 7.8% for April 2022. Excluding food and energy prices, annual core CPI inflation is lower than the April figure of 7.05% but still sticky at 6%. Persistent high food and petrol prices are eating into people's spending. CPI inflation is expected to remain around 6.5% - 7% for the next few months before moving close to the RBI's upper band of 6% on the assumption on a normal monsoon and an average crude price (Indian basket) of US$105 per barrel. RBI retained its inflation forecast at 6.7% for FY 2023.

On currency, lately, RBI has been intervening in the forex market to support the Rupee and it may continue to do so in the near term. As deputy governor, Dr. Patra clarified in the press conference that intervention is based on RBI's assessment of the variance i.e. departure from the mean INR/USD rate, accordingly, actions will be taken. If they don't intervene and let the market determine a fair INR/USD rate – INR could depreciate further from here, a positive for exporters. However, it will increase the import bill given that we're a net importing nation and could further strain inflation.

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High-frequency indicators are seeing month-on-month improvement with urban consumption demand and a gradual increase in rural consumption demand – now slightly above pre-pandemic levels. Indian manufacturers signaled an increase in new orders and output with July manufacturing PMI coming in at 56.4 vs 53.9 in June. Service sector growth slowed down in July with Services PMI coming in at 55.5 in July vs 59.2 in June as slower sales growth and inflationary pressures restricted the upturn in activity. Both direct and indirect tax collection numbers continue to show strong growth with GST collection for July standing at INR 1.49 trillion. Capacity utilisation (75.3%) is now above its long-term average of 73.7%. Credit offtake shows improvement with non-food bank credit registering 14% y-o-y growth as of July 15, 2022, vs 5.4% a year ago, driven by the personal loans segment and medium, micro & small industries. Households are seeing improved affordability and better visibility on income growth which is an encouraging sign for higher credit offtake. RBI retained its GDP growth estimate for FY 2023 at 7.2%.

The recent surge in short-term rates amid absorption of surplus liquidity and RBI's intervention in the forex market by selling dollars and sucking out the rupee from the system on one hand, and, on the other hand, fall in long-term G-sec yields, tracking US treasury and crude oil prices – is reducing the yield curve steepness which was significant around the start of the year. The medium-long term segment continues to be relatively attractive over short-term and cash. However, the gap has narrowed down significantly in the recent past. The term spread (10-year – 3-month T-bill) is now ~1.7% vs 3% in March/April, although still slightly higher than the long-term average of ~1.5%. The money market and short-term rates for PSU and corporates have also moved up ~2.5% since the start of the year, although real rates remain low or negative.

India could experience a spillover effect in terms of exports and growth slowdown if the global economy goes through a slowdown or recession. The private consumption demand is just about sub 2% more than the pre-pandemic levels. Inflation is fuelled by high raw material and fuel prices and not by strong consumption demand. Also, increased interest burden (EMIs) with rising interest rates would impact discretionary spending. Global supply disruptions have eased recently but the heightened geo-political tensions could again worsen the global supply situation and a surge in various commodity prices could dampen consumption demand in the near term. This clubbed with aggressive rate hikes by major central banks poses downside risks to growth. The MPC would strive to strike a balance on growth-inflation rapidly evolving dynamics and may consider pausing once inflation expectations are anchored.

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