CIO Memo

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India: RBI maintains hawkish tone while hiking by a smaller 25 bps

Key takeaways

- The Reserve Bank of India (RBI) hiked its repo rate by 25 bps to 6.5% – its slowest pace in this cycle.
- Fixed income markets were firm with this rate decision largely priced in, while equities continued their recent gains.
- As real interest rates turn positive, fixed income offers attractive opportunities for investors to lock in yields with a 3-year perspective.

1. What happened?

Following 5 hikes in higher quantum's (starting with 40 bps in May 2022, three 50 bps and then 35 bps), the Reserve Bank of India slowed its pace of hiking to 25 bps, taking the repo rate to 6.50%. The Standing Deposit Facility rate went up to 6.25% and the Bank Rate to 6.75%.

The RBI's Monetary Policy Committee (MPC) voted 4-2 for the hike, and a similar majority for the policy stance to stay 'focused on withdrawal of accommodation'. Cumulative rate hikes in this cycle now amount to 250 bps.

GDP growth target for the financial year ending March 2024 was set at 6.4%, high enough to keep India as the fastest growing major economy. The Consumer Price Inflation (CPI) target for the same period was projected at 5.3%, down from 6.5% in the current period. All quarterly projections are above 5% for FY24, well above the RBI's target of 4%.

Mentioning that the easing of inflation in the past two months was largely due to deflationary vegetable prices, it focused on core inflation which continued to remain stickily high above 6%. More importantly, they stated that 'further calibrated monetary policy action is warranted to keep inflation expectations anchored, break core inflation persistence and thereby strengthen medium-term growth prospects', keeping the window open for any further monetary action.

Downside risks to domestic output were listed as protracted geopolitical tensions, tightening global financial conditions and slowing external demand.

The central bank also announced a proposal to allow lending and borrowing of Government bonds for participants like insurance companies, to enable greater liquidity and depth in the domestic USD1tn debt market.

2. How did markets react?

Government bonds traded on the weaker side with the 10-year benchmark yield trading higher by +3 bps to 7.34%, while the shorter end of the curve hardened with the 5-year moving up by +7.5 bps to 7.25%.

The INR closed +0.38% stronger at 82.48.

Equity markets held onto their pre-meeting gains and closed positive with the NIFTY 50 Index up +0.85%, while the financial benchmark Bank NIFTY Index was marginally up.

3. What does it mean for investors?

While RBI's tone remains hawkish, like that of other central banks, the Governor's comments ('we are optimistic') run contrary to the statements, also in line with others. Though it is highly likely that this was the last rate hike in this cycle, data-led policy repricing has led RBI to keep a window open for any future course of action.

Largely unsaid, but the differentials in interest rates with the Fed will need to be kept at attractive levels to prevent any currency stress. Thus, if inflation continues to remain high globally and the Fed does not stop, RBI may have its hand forced to hike further.

The RBI showed its awareness of higher core inflation, which is attributed more to demand, rather than the headline CPI which is affected by supply side factors. The monthly momentum for core inflation has remained stuck at 0.5%.Thus, rather than wait for monetary policy lags of hikes so far and for the impact of these to play out, the overall consideration seemed to be of a smaller hike.

With CPI projected at 5.3% for the next fiscal year, and the repo rate already at 6.5%, real interest rates will remain in positive territory and above 1%. This bodes well for savers and reduces financial repression. Higher rates can also lead to more allocation of assets towards fixed income, rather than to equity.

Global events and actions remain key monitorables for the future course of the RBI. Even though India's economy remains on a solid footing, the external sector and currency considerations will likely keep rates higher for longer.

Also, as the economy continues its acceleration, credit demand is likely to bring corporates back to the bond market, increasing spreads from the current lows of 20-30bps (vs. government securities). The flat yield curve may also see some steepening.

Yields continue to look highly attractive for fixed income investors to lock in with a 3-to-4-year horizon in the government securities space, while corporate yields can harden over the next few months.

Glossary

The Bank rate is the rate at which RBI lends money to banks without any security.

The Bank NIFTY includes the biggest-capitalised and most liquid Indian banking stocks.

Core inflation refers to a measure of inflation which excludes some volatile components.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Federal Reserve (Fed) is the central bank of the United States.

The Indian rupee (INR) is the currency of India.

The NIFTY 50 Index is a benchmark Indian equity index representing the weighted average of 50 stocks over 12 sectors.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

The Repo rate is the interest rate at which commercial banks can borrow money from the RBI

The Reserve Bank of India (RBI) is India's central bank and regulatory body under the jurisdiction of the Government of India.

The Standing Deposit Facility Rate (SFDR) is used as a policy tool to encourage overnight deposits by banks at the RBI.

Unified Payments Interface (UPI) is an instant real-time payment system developed by National Payments Corporation of India.

USD is the currency code for the U.S. Dollar.

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