RBI to support bond markets for next 3 years

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The Indian Debt Market rallied in the current financial year due to comfortable liquidity in the system of around Rs 6 Lakh crores, net inflows in mutual funds debt schemes crossing the Rs 1.50 Lakh mark. RBI also nudge interest rates down, by buying cutting repo and reverse repo rates by 40 basis points and 65 basis points, doing TLTRO of Rs 1.13 Lakh crores, open Market Operations and operation twist of above Rs 1.5 Lakhs crores. RBI intervention in the forex market till now, to control the currency appreciation is to 38.5 billion USD (approx. Rs 2.50 Lak crores). This neutralized the increase in currency in circulation of Rs 2.3 Lakhs crores as depositors withdrew currency from the banking system due to Covid related shutdown of business.

RBI at the start of the financial year was doing open market operations to support the bond market and keep liquidity in surplus mode, to aid transmission of policy rate cuts. However, RBI reduced OMO as it started mopping up the forex inflows coming due to increased Foreign Direct Investments (FDI). India has received FDI of 20 billion USD till date. CPI inflation number for the month of June was 6.09%, even though WPI for the month of June is negative 1.81 %, indicating high mark up in food items. We saw meaningful uptick in oil, gold inflation and food inflation component.

As the economy opens, food inflation due to bumper harvest should come down. Total rainfall has been 6 % above normal and acreage sowed is 69.2 million hectares higher by 21.2 % compared to last year. CPI inflation could converge towards WPI inflation in the coming months, however front loading of rate cuts and liquidity may pause for some time till CPI inflation cools down. We also feel RBI could go for more operation twist to control the yield curve rather than do outright open market operation and increase liquidity in the banking system, as CPI inflation is at the higher end of its mandated range of 2 %- 6 %.

Deposit growth in the banking system continue to grow at 10.1 % on a year on year basis, even though banks have reduced their deposit rates sharply in the absence of credit growth and liquidity induced by RBI due to Covid. Credit growth is growing at 6.1 % on a year on year basis. Credit growth of the NBFC sector is negative as they conserve cash and focus more on recoveries. Banks have been parking their excess liquidity into government securities and high-quality bonds, their total purchase of government securities has been around Rs 4.3 Lakh crores in the current financial year. This trend is expected to continue in this financial year also. Banks are busy raising equity capital to provide for expected credit loss caused due to Covid lockdown and maintain capital adequacy ratios.

Corporate and individual balance sheets continues to be under stress due to high debt levels. This was a problem even before Covid and is expected to aggravate as the moratorium is lifted. The government fiscal stimulus package is only around one percent of GDP, other countries have announced fiscal packages which are 7 % to 10 % of the GDP. Credit upgrade to downgrade ratio in value terms is 1:10 as per rating agencies, that is for everyone rupee of upgrade there is ten rupees of downgrades in the month of April 2020. The Indian economy recover will be slower than the advanced and other developing economies due to the countrywide lockdown and limited fiscal stimulus. We expect economic activity to normalize over a period of 3 years and come back to the original levels prevailing before Covid shock to the economy.

The potential trend rate of GDP growth which was around 7 %- 7.5 %, is expected to move down to 6% in the coming years due to changes in lifestyle and spending patterns which will emerge in the post Covid world order. We are already seeing countries becoming more inward looking and increase tariff and nontariff barriers to give protection to the domestic industry and jobs in their respective countries. World growth is expected to come down in the coming years as free trade gets restricted and investment activity remain muted. In the Indian context, Investment project commissioned was around Rs 5 trillion last year compared with Rs 6.5 trillion in 2018-19. This year is expected to be a wash out as most private companies have deferred commissioning of projects. The Government is also constraint as the borrowing programme is already Rs 12 Lakhs and debt to GDP ratio expected to move to 84 % of GDP in the current financial year. Further borrowing will lead to rating downgrades, the government debt to GDP ratio is expected to touch 84 % in this financial year. This is expected to remain at elevated levels for the next 2/3 years.

The Indian economy is expected to degrowth in the current financial year due to strict lockdown imposed. Industrial states like Maharashtra, Tamil Nadu and Gujarat imposing strict lockdowns should led to loss of output for the Indian economy. The Indian economy will

degrowth by 5 %- 6.5 % in the current financial year. Given high debt levels, the only way to stimulate growth is through structural reforms. However, reforms involves pain in the short run and the benefits accrue in the long run. RBI in this scenario, is expected to look through the CPI inflation number and concentrate on getting the economy on track, by keeping interest rates low. We expect RBI not be fetish on real interest rates and may cut the repo and reverse repo by 50 to 75 basis points in the current financial year. RBI has also shown an inclination to intervene in the debt market when the 10-year yield has gone towards 6 % levels. RBI is expected to keep liquidity easy, at the reverse repo rate for the next 3 year, till the economy growth moves above 6 % on a sustainable basis. With easy liquidity, the short end of the yield curve upto 5 years is a good buy for attractive carry available over the reverse repo rate. The ten-year yield due to unconventional measures followed by RBI should trade in the range of 5.25 % – 5.5%, in the current financial year.

Investors need to realistic in term of their return expectations. Majority of the rate cuts and liquidity measures are behind us. Rates are expected to move down in the coming months, but the movement may not happen at every monetary policy meeting of RBI. The investors may expect returns from duration products in the range of 6 %- 7 % over a 3-year time frame and 4.25 % – 4.75 % in the money market space over a one-year time frame. These returns must be seen from the context of low returns across asset classes due to low growth globally.

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