

RBI Mid Quarter Policy - Review & Implications

Highlights:

- All rates (repo, reverse repo, CRR, SLR) kept unchanged
- Commitment to do OMOs to address higher than threshold liquidity deficit. However, no explicit calendar for OMOs as expected by sections of the market.

The RBI's tone is now decidedly dovish with explicit concerns with respect to growth, especially in context of a deteriorating global environment. It cites various indicators like falling IIP and investments growth, as well as declining pricing power with corporates. On inflation, while non-food manufactured inflation remains elevated, momentum indicators are showing continuing signs of moderation. Concerns on fiscal deficit remain, however, and the RBI notes that likely slippage on the same has inflationary expectations. With regard to money markets, while the central bank observes that there are no significant signs of stress, in view of the fact that LAF borrowings are persistently above RBI's comfort zone, further OMOs will be conducted as and when seen to be appropriate.

Implications:

The RBI has officially flagged a reversal in monetary policy stance by its explicit guidance that **'from this point on, monetary policy actions are likely to reverse the cycle, responding to risks to growth'**. We would like to reiterate our view that we expect the first rate cut in the half year starting April 2012; with the risk that a rise in global uncertainties may bring forward that action. With the change in stance now underway, CRR as a tool for money infusion may re-enter RBI's consideration set; apart from OMOs.

November was most likely the last print above 9% in the current inflation trajectory; with December likely to bring a number lower than 8% given falling primary articles' prices and the substantial base effect from here on. Barring a new commodity shock, inflation looks set to comfortably fall to below the RBI's expectation of 7% by March. This should allow the central bank the desired headroom to act in favour of growth going forward.

Even as signs of relief on monetary policy become definitive, concerns on the fiscal side continue to rise. It is likely that the government may make an official acknowledgement of deficit breach over the next month or so. December quarter advance tax collections are likely to be a critical input into this assessment. At the time of writing, media reports suggest there has been virtually no growth in tax collections over same quarter last year. Hence, it is likely that bond supply to the mid – long end of the curve will be substantial in the quarter going forward. This may be partly due to excess borrowing from the central government, and partly owing to more borrowings from state governments as well given slowdown from receipts under small savings, among other things.

We think conditions are falling in place for the yield curve to steepen over the next 6 months or so. Shorter end rates may be quicker to react to falling growth and change in RBI stance, whereas long term rates, though likely to maintain an easing bias over the medium term, may still have to face headwinds from excess bond supply as fiscal pressures mount.

In the context of the above we reiterate our following product recommendations and also reiterate the urgency to participate sooner rather than later given the mounting opportunity costs of delaying participation

- **IDFC Super Saver Income Fund-Short Term-** Is a Short Term Income Fund, the portfolio is a mix of short duration corporate bonds and money market instruments. The residual maturity of any instrument bought will not ordinarily exceed 3 yr. Average portfolio maturity will not ordinarily exceed 24 months.
- **IDFC Super Saver Income Fund-Medium Term-** Is a fund in the short to medium term income category. The portfolio is a mix of good quality debt instruments including corporate bonds and money market instruments. The fund shall invest upto 75% in corporate bonds with 2 – 5 years residual maturities. The fund strategy states that it can take upto 25% exposure in Government Securities of not more than 11 years tenor, subject to fund manager's view. This upto 25% will be invested in gilts opportunistically (The same will be parked in upto 1 yr bank CD's if the fund is not running any gilt positions). The overall average maturity of the fund will ordinarily not exceed 4 years. The fund will endeavor to maintain its objective to generate stable long term returns through a mix of accrual income and capital appreciation.

- **IDFC Dynamic Bond Fund-** Is positioned in the income fund category to take exposure across the curve depending upon the fund manager's underlying interest rate view where we employ the majority of the portfolio. The fund plays the trade of the season which we think will sustain for a longer period of time. The fund will move dynamically between cash, government bonds, money market and corporate bonds to optimize performance. However, a part of the fund can be used to opportunistically play trading opportunities.
- **IDFC Super Saver Income Fund-Investment Plan-** Is a long income fund, run slightly passively, the fund is predominantly invested in a mix of corporate bonds and government bonds. The fund will actively monitor the dynamic interest rate and credit spread environment to optimize performance.

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