09th Aug 2024

Monetary policy divergence among G4 central banks was the key theme driving sharp volatility in domestic and global markets this week. On one hand, Bank of Japan raised benchmark rates while on the other, Fed is sending strong signals for lowering rates in Sep-24. These divergent directions on interest rate especially the rate hike by BoJ sent markets on a roller coaster this week as YEN carry trades started to unwind. Meanwhile, recession concerns in US led the markets to price stee rate cuts in succession which has normalized after the US Fed did not respond to market overreaction. It was pointed out in our last FI weekly report that "fate of flows" shall be decided by 2 Central Banks (BoJ and Federal Reserve) which created mayhem in equity and rally in Bonds. Domestically, RBI has held the repo rate and remained consistent with the "withdrawal of accommodation" stance while still sounding hawkish. Meanwhile, we stick to our call of staying long on 10-year or below IGBs as highlighted in our recent research.

Monetary policy divergence in G4 was key driver of investor sentiment this week:

- Bank of Japan (BoJ) for only the second time in 2 decades, in an attempt to curb rising inflation in the economy raised policy rates last week to 0.25%, up from a range of 0 to 0.1%. This rate was last hiked 17 years ago in Mar-2007.
- The NFP data of July (at 114k) infused recessionary fears in the US and World markets leading to selling in US Dollar on increased probability of rate cut. The US 10year benchmark softened and touched a low of 3.67% on 5th Aug'24 as probability of rate cut in Sep-24 touched to 98%.
- These divergent directions on interest rates has led to immediate unwinding of YEN carry trades across the world creating mayhem in equities and rally in Bonds. However, a sense of stability emerged after Black Monday as investors realized that central banks are not responding to overreaction in markets and that the US recession fears may be overblown.

RBI August MPC decision looks like a Hawkish pause:

- In line with our expectations, the Monetary Policy Committee (MPC) voted for status quo on repo rate at 6.5% and withdrawal of accommodation policy stance. This was again a 4:2 decision with dissenters Dr. Varma and Dr. Goyal voting for a 25bps rate cut and change in stance to neutral in their last policy meeting as tenor for the three government nominees ends by Oct'24.
- The most important statement from the Governor was that "food inflation pressures cannot be ignored as the public at large understands inflation more in terms of food inflation than the other components of headline inflation". This is a clear assertion that the RBI stays focused on elevated food inflation (above 8% consistently since Nov'23) as it endangers a spillover impact on record low core CPI of c.3%.
- Financial stability was stressed upon by the RBI governor who cautioned banks about potential asset-liability mismatches if they rely too heavily on short-term bulk deposits and emerging credit excesses in some retail loan segment. He noted that as households shift their savings to alternative investments, banks face challenges in funding, with deposit growth lagging behind loan growth.
- Overall, while the MPC kept FY25 inflation projection unchanged at 4.5% even as Q2 forecast was revised up by 60bps to 4.4% (*Fig 1*). This was a hawkish signal from the MPC which stays focused on lowering the headline CPI inflation towards 4% target.
- The RBI's hawkish signaling is in line with our expectations of no rate cuts in this fiscal year. We have been assertive on the argument that US Fed has made more rate hikes relative to India RBI, thus, even if Fed starts cutting rates, we (India) may not follow the suit.

Liquidity in strong surplus zone, RBI market operations aligning with the curve:

- As of 08th Aug, the system liquidity was in surplus, to the tune of Rs.1.65 lakh crore, easing from the peak of Rs.2.86 lakh crore earlier this week on adverse impact of tax outflows and probable USD outflows which also drove Rupee to fresh record lows.
- It is to be highlighted here that RBI has conducted OMO sales worth Rs.1,570 Crore during 29th Jul to 03rd Aug 2024 taking the total to c.Rs 11,675 Crore. Further, in the latest MPC meeting, the RBI Governor asserted that they would continue to manage liquidity by use of fine-tuning operations (VRRRs / VRRs) to help align overnight call rate with repo rate, even as some sections of the market were fearing about liquidity announcements like OMO sale auction calendar etc. In alignment to this, RBI has conducted VRRR auction on 09th Aug'24 worth Rs.75,000 Crore of which Rs. 45,236 Crore bids were accepted at a cut off of 6.49%.
- Post MPC, the weighted average call rate, which was trading at 6.44% on Monday, moved back above the repo rate to 6.65% as liquidity normalized.

Fig-1: CPI Q2FY25 projection hiked by 60bps to 4.4% from 3.8%

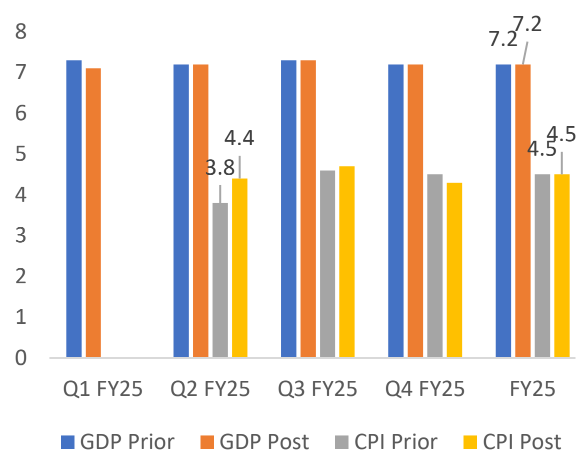
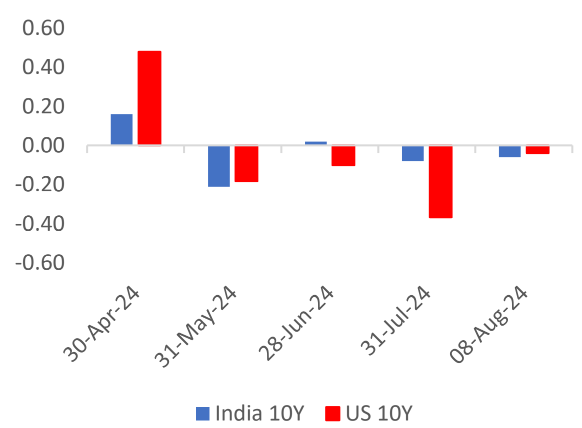


Fig.2: US 10Y benchmark outperformed in Jul-24 on rate cut expectations (Change in bps vis-à-vis previous month close)



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