The Bond Market Party Continues

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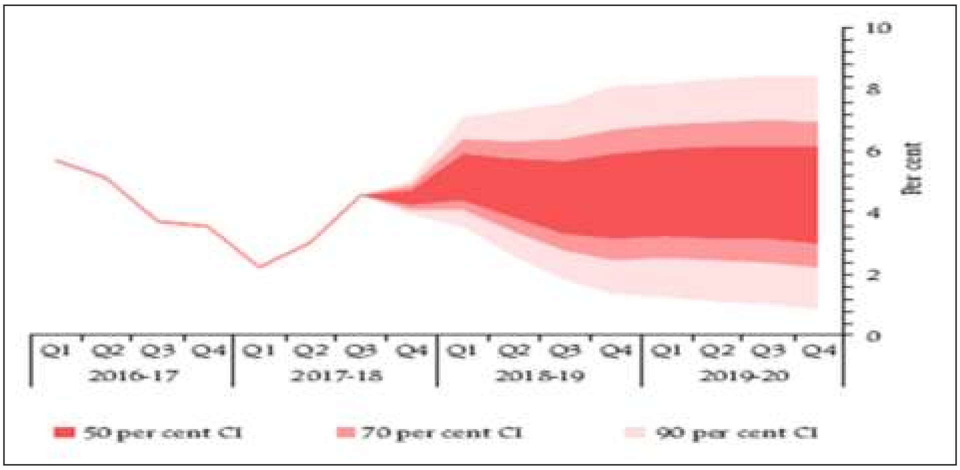
The Monetary Policy Committee (MPC) kept on hold all the rates in the review held on 5th April, 2018 as per expectations, but the biggest takeaway from the RBI Monetary Policy Review was the lowering of the Inflation projection for FY19. The lowering of average headline CPI projection by RBI to 4.5% (ex HRA) is important as it implies a real rate of 150 bps.

For H1 of FY19, RBI lowered the Inflation projection to 4.4% from 4.6% earlier and for H2 to a range of 4.7-5.1% from 5.1-5.6% earlier. CPI inflation had undershot RBI's projection for the first two months of this year. Beyond the headline numbers, RBI also mentioned the lower Core Inflation (ex HRA) of 4.4% in February.

Though RBI has lowered its Inflation target for FY19, it has flagged various upside risks to its forecast, which stem from higher oil prices, fiscal slippage and higher MSP.

Even keeping in mind the upside risks to Inflation flagged by RBI, the probability of a rate hike in this fiscal year has reduced substantially and it was reflected in the markets reaction post policy wherein the benchmark 10yr bond yield fell by 16 bps to end the day at 7.13%.

RBI's quarterly CPI inflation projection



On growth projection RBI shifted to GDP estimate (versus GVA growth earlier) this time. It sees GDP growth strengthening to 7.4% in FY19 from 6.6% in FY18 with growth at 7.3-7.4% in H1 and 7.3-7.6% in H2 – with risks evenly balanced.

RBI also said that it will allow non-residents to participate in the Interest Rate swap market and will also review the guidelines on STRIPS (Separate Trading of Registered Interest and Principal Securities). This will help develop the Fixed Income markets and are a positive development.

Our Outlook

The Bond market has rallied quite sharply over the last 10 days and is likely to take a breather now. Bond yields were looking quite attractive at 7.70% and the rally over the last fortnight has pushed the yields to more reasonable levels but we should be aware of the headwinds both domestically and internationally which the bond markets face. The probability of fiscal slippage and higher US rates is very much there and we continue to recommend short term income funds to investors.

The tactical play in duration is close to an end and will recommend any duration play through dynamic bond funds and medium term funds rather than through a long duration fund.