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RBI policy: Bond yields will harden to 7.75%, Nifty to range 17,500-15,000

Breaking away from scheduled announcements, the Reserve Bank of India's May 4 decision to hike the repo rate by 40 basis points (bps) to 4.4 percent soon after unchanged rates in April is an indication that the RBI is making an early move to recalibrate its normalisation trajectory against higher-than-projected inflation and fast US monetary policy normalisation.

Two critical messages from the RBI are a) post the ebbing of Omicron worries, pent-up demand recovery is getting widespread, b) the demand recovery will likely aggravate the inflation scenario, which touched 7 percent in March 21; core inflation has averaged 6 percent in recent months.

The RBI has enumerated several factors for the higher-than-expected inflation, most of which were known beforehand.

These include high global food inflation, its spillover effect in India, persistently high core inflation, high crude prices, its second-order impact and high pipeline inflation from elevated input costs, reflected in WPI inflation at around 15 percent.

This out-of-turn rate hike contrasts with the RBI's earlier complacency on inflation, which indicates that the central bank has an inkling that the April print will likely be much higher, maybe in excess of 8 percent.

Hence, the repo rate hike announcement also comes with a CRR hike of 50bps to 4.5 percent. The governor also mentioned that the rate and CRR hikes embody a partial reversal of monetary accommodation introduced after the outbreak of the pandemic.

Pre-emptive strike

What the governor refrained from emphasising enough is that the out-of-turn rate and liquidity normalisation comes half a day ahead of the US Fed's FOMC announcement, which is widely expected to increase rates by 50 bps, following the 25 bps hike in March 2022.

There is a high likelihood of even a 75 bps hike along with the announcement of balance-sheet shrinkage of $95 billion per month. Hence, with the spread between the US Fed rate and the RBI repo rate narrowing to 300 bps (4 percent-1 percent), the Indian central bank may have decided to do a pre-emptive hike given that it has run down its forex reserves to $600 billion, down $42 billion since the October 2021 peak.

India's trade deficit has widened to $18-20 billion (March-April 2022) and capital flows have declined, especially FII flows ($20 billion since April 2021).

Hence, the rate hikes ahead of the Fed's announcement appear to be aimed at preventing a steep depreciation in INR-USD in the wake of continued strength in the US dollar index.

The RBI hopes that through a speedy normalisation, the adverse impact of tightening global financial conditions and build-up of inflation trends can be minimised, thereby preserving macro stability that is conducive for long-term growth.

Playing catch-up

In our view, the RBI has been quick in recognising that it has been falling behind the curve in recognising the inflationary impulses.

Rate hikes and withdrawal of surplus liquidity through CRR hikes will continue. The withdrawal of Rs 87,000 crore of liquidity is still less than the overall liquidity surplus of Rs 7.5 trillion (average for April) of which Rs 2 trillion is under the SDF mechanism.

After the 40 bps hike the real repo rate would still be -1.6 percent (4.4 percent-core inflation of 6 percent), significantly higher than an estimated neutral rate of 1 percent.

And if the RBI wants to achieve price stability through monetary policy normalisation, the real rate has to go above 1 percent. Thus, there is plenty of room for further rate hikes and liquidity normalisation.

What does it mean for the market?

Clearly, the RBI has tilted towards its price-stability objective, pushing behind the immediate focus on growth stimulus.

Given that real GDP growth on a two-year CAGR basis is just 2.9 percent and the RBI has to act to contain inflation and manage external sector balances, it is evident that the structural or potential GDP growth is much lower than the central bank's assumption of 7.5 percent.

Withdrawal of monetary accommodation when demand recovery is still modest and fiscal impulse negative (Union Budget spending growth at 4.6 percent in FY23 is negative in real terms) would impact the earnings trajectory of Indian companies.

In our view, the 16-17 percent consensus growth assumption for Nifty50 companies for FY23-FY24E after a post-COVID rebound of 40 percent in FY22E is very optimistic. Thus, our guidance of a 15-20 percent cut in estimates in the next 24 months appears realistic.

We continue to maintain that India's 10-year G-sec yield will harden further to 7.75 percent (CMP 7.38 percent), with an upside risk, expect INR/USD at 80 and the Nifty range at 17,500-15,000, with downside risk in the near term.

We have been guarding against rate-sensitive, cyclical sectors such as banks, capital goods and industrials, as they will be impacted by slower growth.

We have also been consistent in highlighting the valuation risks in small and mid-cap segments. We continue to favour a balanced portfolio, with higher weights on domestic non-cyclicals and other defensive components such as pharma, technology and utilities.