Monetary Policy

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A call for complementarity

- **The growth-centric budget has implied elevated market borrowings, further spooking the bond market which was already reeling under pressure since January on fears of an apparent liquidity withdrawal. The unintended financial tightening amid a nascent growth recovery is neither optimal nor desirable at current juncture. The upcoming RBI policy will likely to be vociferous on communication on being the heavy-duty balancing factor in Gsec demand-supply ahead. We reckon there seems much ado about fiscal dominance of the monetary policy in the current context and monetary policy complementarity is presently needed.**
- **In addition, on the liquidity management front, the (mis)communication loop between the RBI and markets needs to be broken. The policy intent has been to tackle the liquidity asymmetry than to tighten its state, and to fix misplaced risk bets in money markets. We watch out for actions - such as 1) defined OMO calendar and secondary market G-sec buying; 2) no increase in variable reverse repo (VRR) quantum; and 3) maintenance of adequate system liquidity - as strong policy signals. However, we reckon the RBI will continue to strive fixing the artificially skewed yield curve and maintain its preference for curve flattening. We also watch out for the introduction of tools such as MSS bonds and/or standing deposit facility (SDF) ahead.**

A growth-centric budget has come at a cost…

The FY22 budget has struck all the right chords, ensuring that the underlying fiscal impulse does not become pro-cyclical ahead. However, its cost has come in the form of elevated Net/Gross market borrowing at Rs9.25tn/Rs12.05tn. This has further soured G-sec yields, which have been reeling under pressure since the fear of supposed liquidity tightening by the RBI hit the markets in early January (*see "Liquidity normalization ≠ Liquidity tightening", Jan 12,2021*). The pressure is now felt across the yield curve unlike recent weeks where the pressure was shorter-tenor centric. The 10-yr yield has comfortably breached the psychologically crucial 6% mark. Against this backdrop, the upcoming MPC will assume importance to gauge the central bank's reaction function ahead.

"Need" to reverse unintended financial tightening but…

Honestly, there is no straight answer as to how to reverse the unintended financial tightening which started with shorter tenor and has now engulfed the whole curve. We are still far from that state which is neither optimal nor desirable at current juncture. With elevated borrowings and policy rates likely having bottomed out, the appetite for duration risk on G-sec will likely fade. Thus, RBI support in the form of vigorous OMOs will be required to maintain demand-supply balance and pressure on the longer end of the curve. Further, we believe that the liquidity withdrawal will be a gradual process. We reckon current liquidity deluge is not necessarily feeding into present inflation dynamics as the credit offtake remains sluggish. Any premature tightening of market rates could also be counter-productive and instead lead to more speculative FX flows and also hurt nascent growth recovery and credit offtake, while increasing the RBI's problem of plenty.

…"how" remains a challenge

We would watch out for a more vociferous RBI on OMOs/OTs in the upcoming policy. On the liquidity management front, we maintain that the policy intent was to tackle the liquidity asymmetry than to tighten its state, and to fix misplaced risk bets in money markets. *(see "That Taper Tantrum like feeling…", Jan 19,2021)*. Thus, the (mis)communication loop between the central bank and markets needs to be broken. Actions such as 1) not increasing the quantum of VRR and 2) maintenance of adequate system liquidity could send a strong signal to markets to align them back to the RBI's intent. However, we reckon that RBI will continue to strive fixing artificially skewed yield curve and maintain its preference for curve flattening. We watch out for possible action in the form of (including any delay) an expected 1% CRR normalization (which should withdraw Rs1.6tn from the system), MSS bonds and/or SDF introduction, among others.

Much ado about fiscal dominance of monetary policy

There is much ado about the fiscal dominance of monetary policy in the current context where the RBI may have to absorb more than 40% of market loans in FY22E. However, we believe that the countercyclical fiscal stance is indispensable at the current juncture to sustain demand and mitigate the long-term costs of the crisis. Monetary policy can complement these efforts, amid its current constraint effective lower bound of policy rates. In times like these, it may not be prudent to limit fiscal policies "today" to protect monetary dominance "tomorrow". On the contrary, using fiscal and structural policies more actively in the current environment may foster central bank independence. This is because such policies may boost potential growth and thereby increase the monetary policy space in the future. A lower welfare cost of public debt may be needed when public funds are used for investments addressing growing economic externalities. Although this should not be confused with modern monetary theory (MMT), which denies the government's intertemporal budget constraint. We reckon that once the sustainable growth path, the fiscal policy should take a backseat again and regain the policy room.

Please see our model portfolio (Emkay Alpha Portfolio): **Nifty (Page 3)**

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Key Highlights

- **The (mis)communication loop between the RBI and markets needs to be broken by strong market signalling by the central bank.**
- **Amid heavy supply and fading appetite for duration risk on G-secs, vigorous and pre-announced OMOs are needed in FY22.**
- **Liquidity management over time needs to be calibrated, ensuring finanical conditions do not tighten prematurely.**
- **The RBI's preference for curve flattening may remain. Watch out for possible action in the form of MSS, SDF introduction, etc.**

Exhibit 1: Spike in cost of sovereign and corporate borrowing

Security	Post Dec MPC	Post VRR auction	Post Budget (t+1)
	4-Dec	15-Jan	2-Feb
Gsec			
Gsec-3 Yr	4.40	5.01	5.24
Gsec-5 Yr	5.03	5.51	5.75
Gsec-10 Yr	5.82	5.95	6.13
Corporate Bonds (AAA)			
AAA - 3 Yr	4.56	5.10	5.25
AAA - 5 Yr	5.45	5.76	6.00
AAA - 10 Yr	6.57	6.72	6.85
Corporate Bonds (AA)			
AA - 3 Yr	5.47	6.01	6.10
AA - 5 Yr	5.45	5.76	6.00
AA - 10 Yr	7.36	7.45	7.66

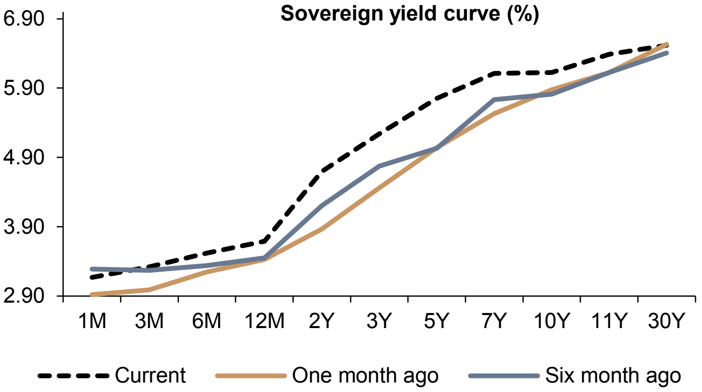
Source: Bloomberg, Emkay Research

Exhibit 2: Money market rates now aligning towards reverse repo

Money Market Rates (%)	Post Dec MPC	Post VRR auction	Post Budget (t+1)
	4-Dec	15-Jan	2-Feb
TREPS (Erstwhile CBLO)	2.69	2.86	3.21
Call money rate	2.64	2.75	3.20
3M- T bill	2.97	3.29	3.34
Net Banking liquidity (Rs. Tn)	6.98	6.33	7.44

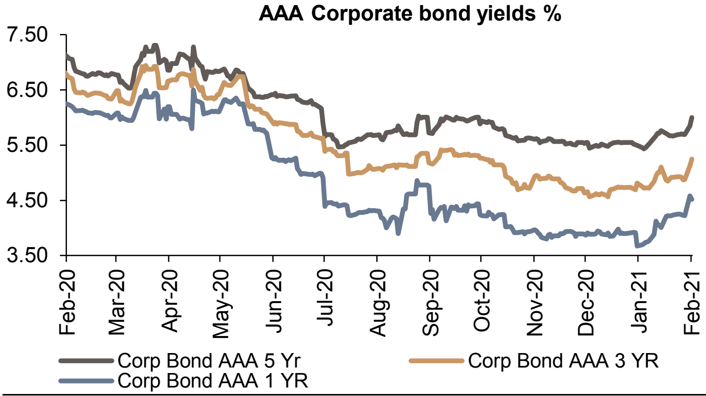
Source: Bloomberg, Emkay Research

Exhibit 3: Sovereign yields have seen surge across the curve



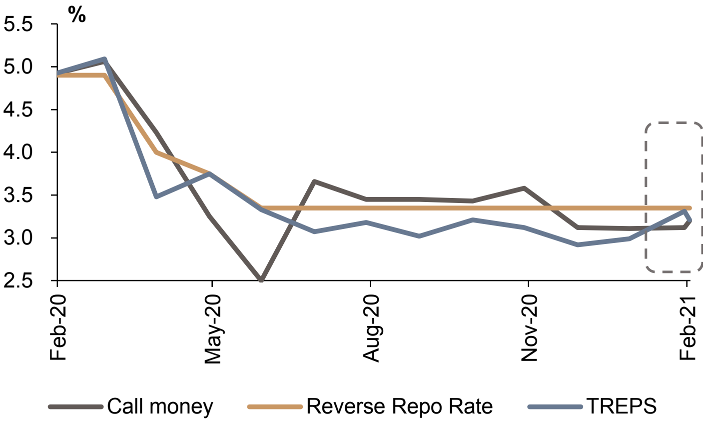
Source: Bloomberg, Emkay Research

Exhibit 4: …with corporate bonds also feeling the unexpected pinch



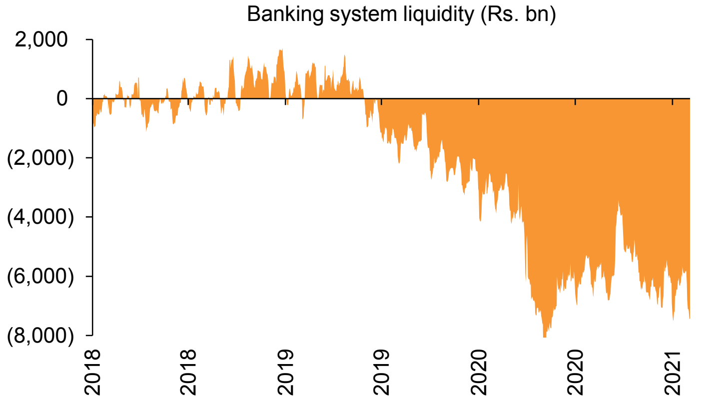
Source: Bloomberg, Emkay Research

Exhibit 5: Call money and TREPS rates are still trading below lower end of the policy corridor, albeit have gone up…



Source: Bloomberg, Emkay Research

Exhibit 6: …As easy liquidity (Rs7.4tn currently) finds its way out of the LAF to other avenues



Source: Bloomberg, Emkay Research

Emkay Alpha Portfolio – Nifty

EAP-Nifty (25 stocks)

Company Name	Nifty Weight	Nifty EAP Weight	OW/UW	OW/UW
Agri Input & Chemicals	**0.49**	**0.00**	**-100%**	**-49**
UPL	0.49	0.00	-100%	-49
Auto & Auto Ancillaries	**5.95**	**9.85**	**66%**	**390**
Bajaj Auto	0.87	1.85	114%	99
Eicher Motors	0.64	1.39	117%	75
Hero Motocorp	0.68	0.91	34%	23
Mahindra & Mahindra	1.24	0.00	-100%	-124
Maruti Suzuki India	1.61	2.86	77%	125
Tata Motors	0.91	2.84	211%	193
BFSI-Banks	**27.52**	**36.65**	**33%**	**913**
Axis Bank	2.80	6.70	139%	390
Bandhan Bank	0.00	2.55	NA	255
HDFC Bank	10.75	9.22	-14%	-153
ICICI Bank	6.75	8.71	29%	196
Indusind Bank	0.88	3.79	332%	291
Kotak Mahindra Bank	4.32	0.00	-100%	-432
State Bank of India	2.02	5.69	181%	366
BFSI-Insurance	**1.38**	**1.97**	**42%**	**59**
HDFC Life	0.85	0.00	-100%	-85
SBI Life	0.53	1.97	269%	144
BFSI-NBFCs	10.64	9.45	-11%	-120
Bajaj Finserv	0.91	0.00	-100%	-91
Bajaj Finance	2.17	0.00	-100%	-217
Cholamandalam Investment	0.00	1.94	NA	194
HDFC	7.57	7.51	-1%	-5
Cement & Building Materials	**2.41**	**4.41**	**83%**	**200**
Grasim Industries	0.73	2.24	207%	151
Shree Cements	0.56	0.00	-100%	-56
Ultratech Cement	1.12	2.17	94%	105
Consumer Goods & Retail	**10.54**	**6.30**	**-40%**	**-424**
Asian Paints	1.76	0.00	-100%	-176
Britannia Industries	0.65	0.41	-37%	-24
Hindustan Unilever	3.15	0.00	-100%	-315
ITC	3.02	1.52	-50%	-150
Nestle India	0.97	0.00	-100%	-97
Titan Company	0.98	2.42	147%	144
United Breweries	0.00	1.95	NA	195
Engineering & Capital Goods	**2.91**	**1.29**	**-56%**	**-162**
Larsen & Toubro	2.91	1.29	-56%	-162
Information Technology	**16.37**	**12.48**	**-24%**	**-390**
HCL Tech	1.64	3.12	90%	148
Infosys	7.46	6.93	-7%	-53
TCS	5.33	0.00	-100%	-533
Tech Mahindra	0.94	2.42	158%	148
Wipro	1.01	0.00	-100%	-101
Metals & Mining	**2.39**	**3.01**	**26%**	**62**
Coal India	0.44	0.68	56%	24
Hindalco	0.59	1.09	84%	50
JSW Steel	0.60	0.00	-100%	-60
Tata Steel	0.77	1.25	62%	48
Oil & Gas	**11.69**	**3.07**	**-74%**	**-862**
BPCL	0.52	2.54	390%	202
GAIL	0.38	0.00	-100%	-38
Indian Oil	0.40	0.00	-100%	-40
ONGC	0.54	0.53	-1%	0
Reliance Industries	9.86	0.00	-100%	-986
Pharmaceuticals	**3.28**	**6.50**	**98%**	**322**
Cadila Healthcare	0.00	1.97	NA	197
Cipla	0.66	1.91	188%	124
Divi's Lab	0.72	0.00	-100%	-72
Dr. Reddy's Lab	0.86	1.85	115%	99
Sun Pharma	1.04	0.78	-25%	-26
Ports & Logistics	**0.64**	**0.00**	**-100%**	**-64**
Adani Ports	0.64	0.00	-100%	-64
Power	**1.51**	**1.75**	**16%**	**24**
NTPC	0.72	0.72	-1%	0
Power Grid Corporation	0.79	1.03	31%	24
Telecommunications	**2.28**	**3.27**	**44%**	**99**
Bharti Airtel	2.28	3.27	44%	99
Cash		**0.00**		
Nifty	**100.00**	**100.00**		

*Source: Emkay Research; Note: *We have internally capped single stock exposure to 10% in our EAP*

Sector portfolio NAV

	Base					Latest
	1-Apr-19	4-Feb-20	4-Aug-20	3-Nov-20	1-Jan-21	2-Feb-21
EAP - Nifty	100.0	102.5	92.2	95.8	113.0	120.9
Nifty50	100.0	102.7	95.1	101.2	120.1	125.5

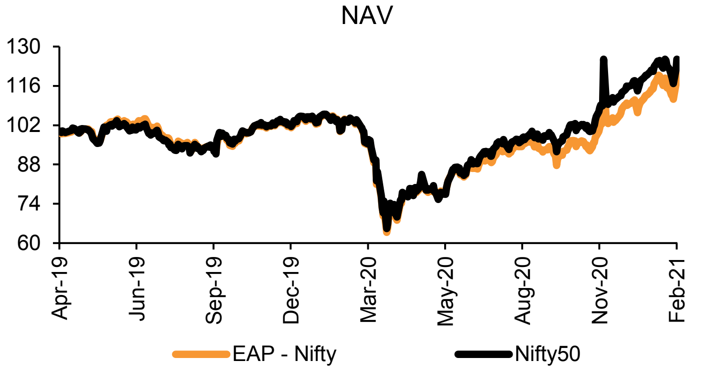
**Performance measurement base date 1st April 2019*
Source: Emkay Research

Price Performance (%)

	1m	3m	6m	12m
EAP - Nifty	7.0%	26.2%	31.1%	17.9%
Nifty50	4.5%	24.0%	32.0%	22.3%

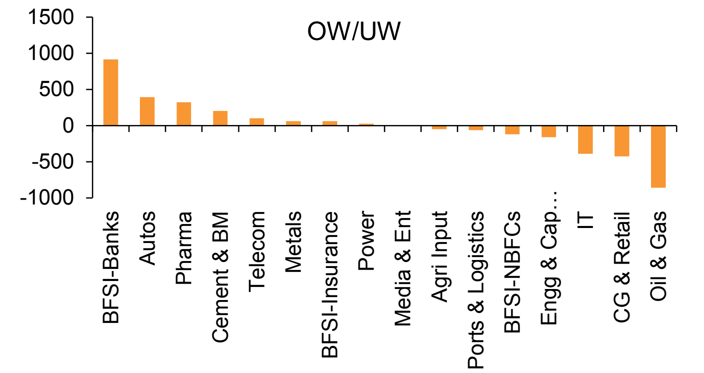
Source: Emkay Research

NAV chart



Source: Emkay Research

Sector OW/UW



Source: Emkay Research

Please see our model portfolio (Emkay Alpha Portfolio): SMID

"Emkay Alpha Portfolio – SMID and Nifty are a supporting document to the Emkay Alpha Portfolios Report and is updated on regular intervals"

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Ratings	Expected Return within the next 12-18 months.
BUY	Over 15%
HOLD	Between -5% to 15%
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