ICRA

Interest Rate Outlook

Rate cuts to be delayed to H2 FY2025; quantum limited to 50 bps

MARCH 2024

Highlights - I

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With the latest GDP data revealing growth in excess of 8% in 9M FY2024, ICRA expects the onset of the rate cut cycle to be pushed to H2 FY2025, with the quantum of cuts limited to 50 bps at best

After remaining elevated during Oct-Feb FY2024, the WACR dipped below the repo rate in early-Mar 2024, owing to a sharp easing of liquidity conditions

Given the upward revision in the GDP growth estimates for Q1-Q2 FY2024, three successive quarters of 8% plus GDP expansion, and the stable CPI print for February 2024, ICRA expects the Monetary Policy Committee (MPC) to maintain a status quo on the rates and stance in the April 2024 meeting. We believe that the policy stance is unlikely to be changed until the August 2024 MPC review, after there is visibility on the monsoon turnout as well as on the sustenance of the growth momentum, and greater clarity on the US Fed's rate actions. Consequently, the earliest rate cut now appears likely in the October 2024 meeting, unless growth posits a negative surprise in the intervening quarters; ICRA now foresees the rate cut cycle to be limited to 50 bps at best. However, the 10-year G-sec yield is set to dip below the 7.0% mark in Q1 FY2025, amid favourable demand-supply dynamics, although rate cuts would need to be imminent for shorter term rates to moderate. Overall, the yield curve may shift downwards slightly in the near term, albeit only steepen once the rate cuts from the MPC become imminent. Nevertheless, this would augur well for corporate bond yields, while constraining banks' ability to raise lending rates.

- **Rate cuts unlikely to begin before Q3 FY2025; expect a shallow cycle of 50 bps at best:** ICRA expects the average CPI inflation to ease to 4.6% in FY2025 from 5.3% in FY2024, amid an expected softening in food inflation based on the assumption of a normal and well-distributed monsoon. However, the robust growth outcomes in 9M FY2024, suggest that a change in policy stance is likely to be pushed forward to the Aug 2024 MPC review, after there is visibility on the monsoon turnout as well as on the sustenance of the growth momentum, and clarity on the US Fed's rate decisions. ICRA foresees the earliest rate cut in the Oct 2024 meeting, unless growth posits a negative surprise in the intervening quarters, and the rate cut cycle to be limited to 50 bps at best.
- **Liquidity conditions eased substantially by end-Feb 2024, auguring well for short term rates:** The systemic liquidity deficit nearly doubled to Rs. 2.0 trillion in Jan-Feb 2024 (-1.0% of NDTL) from Rs. 1.1 trillion in Dec 2023 (-0.5% of NDTL). However, it dipped significantly by end-Feb 2024, before turning to a small albeit transient surplus during Mar 4-6 and Mar 11-14, 2024, attributed to a pick-up in the GoI's spending, a likely redemption of T-bills, and

Highlights - II

Systemic liquidity deficit doubled to 1.0% of GDP in Jan-Feb 2024 from 0.5% of NDTL in Dec 2023, before easing sharply in early-Mar 2024

Durable liquidity remains in surplus, implying that the tightness in systemic liquidity has been driven by unusually high cash balances of the GoI

10-year G-sec yield is expected to dip to sub-7.0% in Q1 FY2025, aided by favourable demand-supply dynamics

the RBI's decision to take delivery of the USD/INR buy-sell swap. This helped in bringing down the weighted average call rate (WACR) from an average of 6.54% in Feb 2024 to 6.39% in Mar 2024 (till Mar 15, 2024), ruling below the repo rate after a gap of six months. Interestingly, durable liquidity remained in the surplus mode during Dec-Feb FY2024, touching Rs. 1.6 trillion as on Feb 23, 2024 (0.8% of NDTL), implying that the systemic liquidity deficit during this period was driven by a build up in the GoI's cash balances.

- **Systemic liquidity conditions to tighten in the second half of March 2024:** The tightening will be driven by GST payments and advance tax outflows; the RBI has already conducted a 7-day VRR amounting to Rs. 0.8 trillion on Mar 15, 2024, to provide a leg up to liquidity. Thereafter, easing is likely in early-FY2025, on account of the onset of the lean season as well as potential dollar purchases aided by expectations of modest current account deficit along with sizeable and steady capital inflows aided by the Bond Index inclusion. Given the unusually large GoI cash balances (Rs. 4.1 trillion as on Feb 23, 2024), there is a possibility that a sizeable quantum may be carried forward into FY2025, which may augur well for G-sec supply and such yields in the next fiscal.
- **10-year G-sec yield expected to trade between 6.8-7.0% in H1 FY2025:** An additional source of demand owing to the Global Bond Index inclusion amid lower supply of G-secs would aid in financing the fiscal deficit and dampen such yields. ICRA expects the 10-year G-sec yield to dip below the 7.0% mark in Q1 FY2025, in the run up to the inclusion in the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Index suite. Overall, ICRA expects the 10-year to trade between 6.8-7.0% in H1 FY2025; however, yields could inch up towards the latter part of the period, if there is a build up of expectations of a further delay in rate cuts by the RBI beyond Q3 FY2025.
- **Yield curve to remain flattish over next few months**: The G-sec yield curve has shifted downwards between end-Sep 2023 and Mar 15, 2024, and has also flattened with the longer end witnessing a steeper moderation vis-à-vis the shorter end, amid tight liquidity conditions. Going ahead, the shorter-tenure yields are likely to ease slightly

Highlights - III

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Cooling in G-sec yields is also expected to augur favourably for corporate bond yields in early-FY2025

Despite the lag in transmission, the ability of banks to raise lending rates is likely to remain constrained given the anticipated softening in bond yields in early-FY2025 and expectations of rate cuts in latter part of the fiscal

amid expectations of moderation in the systemic liquidity deficit in early-FY2025. Given this, and ICRA's expectations of the 10-year G-sec yield easing below the 7.0% mark in Q1 FY2025, the yield curve may shift downwards slightly, while remaining flattish in the near term. Once the rate cuts from the MPC become imminent, the shorter-tenure rates may display a correction, steepening the curve to some extent.

- **Cooling in G-sec yields to augur well for corporate bond yields:** Largely in line with the dip in 10-year G-sec yields, the 10Y AAA and AA+ corporate bond yields have eased by 23-27 bps during FY2024 so far (till Mar 15, 2024). Additionally, the 5Y AAA and AA+ bond yields have softened by 8-17 bps, relative to the 9 bps decline seen in the 5-year G-sec yield during FY2024 so far. Going forward, the cooling off in G-sec yields, owing to the favourable demand-supply scenario for such securities is also expected to augur favourably for corporate bond yields in the first half of the next fiscal.
- **Bank deposit and lending rates unlikely to be raised materially in near term:** The weighted average term deposit rates on fresh and outstanding deposits of banks have risen by 240 bps and 182 bps, respectively, in the current tightening cycle (May 2022-Jan 2024). Moreover, the transmission of rate hikes to banks' lending rates has been incomplete, with the weighted average lending rates on fresh loans and o/s loans rising by 194 bps and 111 bps, respectively, while also lagging the increase in market-based borrowing costs. Notwithstanding the lag in transmission, the ability of banks to hike lending rates is expected to remain constrained given the expected softening in bond yields in the near term, as well as expectations of rate cuts commencing from Q3 FY2025.
- **Small savings rates may remain unchanged for Q2 FY2025:** The interest rates on all small savings schemes have been kept unchanged for Q1 FY2025. As per ICRA's analysis, such rates for most small savings schemes are either at fair levels or are only mildly lower than such levels. Based on this, and the expected near-term trends in G-sec yields, the interest rates on small savings schemes are unlikely to be revised upwards for Q2 FY2025.

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Thank You!