MACRO PULSE

APRIL 2021

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From the desk of the Chief Analytical Officer

We are pleased to release the **fourth** edition of **Acuité Macro Pulse** for the month of **April 2021**. Apart from a comprehensive coverage of the key macro-economic variables, this report prepared by senior economists also has valuable insights on the emerging economic landscape which will be useful to not only bankers and investors but also to corporate planning and treasury teams.

Over the last few weeks, the optimism around the economic recovery in FY21 has been gradually replaced by a despondency arising from the intensity of the second Covid wave, the resultant containment measures and its significant implications on the nascent growth momentum. Clearly, the current intensity of infections is much higher than in the first wave with a more virulent mutant of the virus at play. The data points are indeed alarming; the daily cases have galloped from around 60,000 as on March 25, 2021 to almost six times at 3,45,000 cases over one month along with almost a tenfold rise in daily mortalities from Covid-19.

Unfortunately, FY22 has started on a gloomy note as did FY21; google mobility indicators have begun to moderate amidst the localized restrictions in several states. Over the last one month, mobility for retail and work have reduced to the levels last seen in early Jan-21 i.e., a set back by nearly 3 months. As per CMIE, unemployment rate has risen above 8% in the first two weeks of Apr-21, after a hiatus of 3 months.

However, not all is gloom and doom; most of the activity indicators have fared well in Mar-21 amidst powerful base effects from last year's lockdown that started in Mar-20, with the exception of IIP and core data (i.e., for Feb 2021). Exports and imports, both galloped to record highs in the previous month. Exports at USD 34.5 bn was a reflection of strong factory output amidst a stronger global recovery and imports at USD 48.4 bn echo a revival in consumption demand. Nevertheless, it is evident that the fresh containment measures will have a significant effect on the recovery of not only the services sector but also hit the industrial sector albeit the extent of the impact on the latter is not clear as of now. Our economic research team believes that the global V shaped recovery, the continuity in rural consumption growth due to another favourable monsoon forecast, the supportive monetary and fiscal policies and the steady progress in vaccination will still support a healthy growth in FY22 albeit the growth forecast has been moderated by the team to 10.0% with the assumption that the second Covid wave will peak by May 2021.

As regards inflation and bond yields, the upside risks are significant even though a favourable monsoon forecast for 2021 along with the RBI's new government bond buying programme (GSAP- 1.0) will help to contain them. One additional risk factor is the movement of the rupee which has suddenly turned adverse in the last one month primarily due to growth concerns triggered by the second Covid wave.

Hope you enjoy the read!

Best Regards,

Suman Chowdhury
Chief Analytical Officer

Growth

Lockdown led downside risks

KEY TAKEAWAYS

- From a growth perspective, FY21 ended on a sanguine note. However, the euphoria has proved to be ephemeral.
- A sharp rise in COVID infections since Mar-21 have led to reimposition of localized lockdowns which are becoming more stringent and pervasive with sharply rising numbers of daily infections.
- The major impact of lockdowns will expectedly be on services. While a negative impact on industry is obvious – the extent of it remains difficult to ascertain amidst many moving parts.
- Assuming that lockdowns have a finite life and are not extended beyond May-21, we revise our FY22 GDP growth forecast to 10.0% (from 11% earlier).
- Support to growth is likely to come from (in addition to a favourable base) –
  1) Synchronous V-shaped global recovery
  2) Progress on vaccine
  3) Supportive fiscal and monetary policies and
  4) rural demand that is likely to find support in a normal monsoon.

Overview

From a growth perspective, FY21 ended on a sanguine note as recovery further pushed its heels into the ground, amidst easing restrictions and declining COVID cases. Unfortunately, the euphoria has proved to be ephemeral. A sharp rise in COVID infections since Mar-21 has led to reimposition of localized lockdowns as we entered FY22, which are becoming more stringent and pervasive as the second wave of virus gets more severe than the first one. To put this in perspective, as of April 20, 2021, there were 2.0 mn active cases compared to India's first COVID wave peak of 1.0 mn in mid Sep-20. Clearly, the intensity of infections is twice as bad as the first wave with a more virulent mutant of the virus at play.

Pace of activity: All good up to Mar-21

Most of the activity indicators have fared well in Mar-21, with the exception of IIP and core data (i.e., for Feb 2021), amidst powerful base effects from last year's lockdown that started in Mar-20.

- PMI for both manufacturing and services eased (55.4 and 54.6 respectively) vis-à-vis Feb-21(57.5 and 55.3 respectively), but both indices remained well above the threshold of 50.
- Fuel consumption rose with sequential growth supported by an exceptionally favorable base, to catapult the annualized growth into double digits at 17.9%
- Exports and imports, both galloped to record highs. Exports at USD 34.5 bn was a reflection of strong factory output amidst a stronger global recovery and imports at USD 48.4 bn echo a revival in consumption demand.
- Auto production grew by 65.4% in Mar-21 amidst a broad-based recovery across segments, again finding support from a favorable base
- In contrast, India's industrial production contracted for second month in a row with Feb-21 print of -3.6% YoY, weaker compared to Jan-21 growth print of -0.9% YoY (revised up from -1.6% earlier). To be sure, market expectations were geared towards a negative print on the back of subdued high frequency indicators; however, the magnitude of contraction turned out to be higher, for second month in a row.

High frequency data for Apr-21: Some cracks in sight

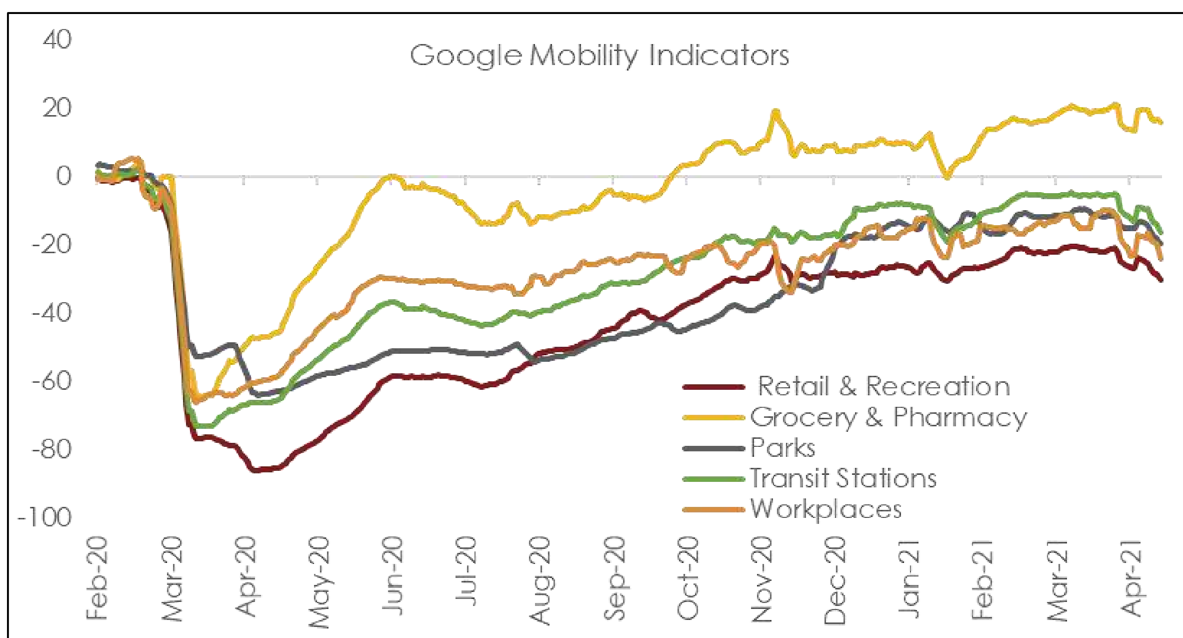
So far, some degree of weakness is visible in high frequency data especially those related to mobility and traffic.

- Google mobility indicators have begun to moderate amidst the localized restrictions in several states. Over the last one month, mobility for retail, work, transit stations have reduced by nearly 10 pp, to the levels last seen in early Jan-21 i.e., a set back by nearly 3 months.
- Traffic congestion, in similar vein too has seen a drop, by as much as 50% since mid-Mar-21, with more severe declines in cities of Mumbai and Pune.
- As per CMIE data, unemployment rate has risen above 8% in the first two weeks of Apr-21, after a hiatus of 3 months.

Looking ahead: Crystal ball gazing

The intensity of the current wave of virus is still unfolding, but it is amply clear that its much bigger than the first wave. Government steps to curb the virus are getting more stringent with initial night curfews becoming mini-lockdowns in cities such as Mumbai, Delhi. The major impact will expectedly be on services yet again with curbs on hotels, restaurants, retail and recreation activity, many of which had recently begun operations. While a negative impact on industry is obvious, the extent of it remains difficult to ascertain amidst many moving parts – labour mobility (with migrants returning to rural villages and towns), restriction on movement of goods, shutting down of factories producing non-essential goods, softening in consumer demand (of non-essentials), rise in global commodity prices and most importantly the duration of the lockdowns which remains unknown as of now.

Chart 1: Mobility indicators have taken a beating in Apr-21

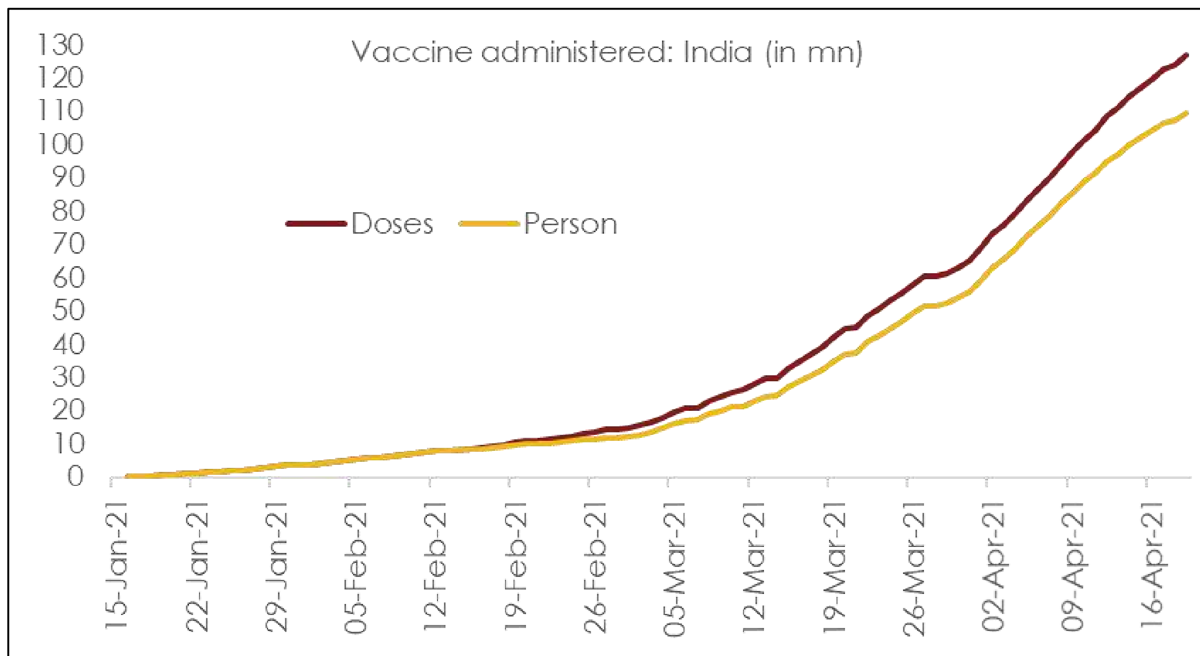


Having said so, we must acknowledge that there are reasonable positive factors (along with a favorable base) that will continue to support GDP growth in FY22 –

- A synchronous V shaped global recovery with the IMF recently upgrading its forecast for World GDP growth in 2021 to 6.0% from 5.5% earlier
- Rural demand remaining strong, likely to find support in a normal monsoon. In its early assessment, IMD expects 2021 monsoon to be normal at 98% of LPA.
- Supportive fiscal and monetary policies reinforced by countercyclical fiscal impulses in the FY22 Union Budget and an accommodative monetary and liquidity backdrop that RBI remains committed to.
- Progress on Vaccine: As of April 21, 2021, India has administered first vaccine dose to 8.2% of the population while 1.3% of the population stands fully vaccinated. Further, the latest Government directive of opening vaccination to all adults above 18 years of age from 1st May-21 is likely to quicken the process. At a pace of 5 mn doses/day (vs. current pace of 3 mn doses/day), India can inoculate close to 50% of its population by year-end.

Keeping all these factors in mind, we estimate the risks to growth being fairly balanced. But we do acknowledge the downside in industrial growth amidst ongoing lockdowns (assuming that lockdowns have a finite life and are not extended beyond May-21) and a delay in recovery of the services sector by a quarter (to Q4 FY22 now). As such, we revise our FY22 GDP growth forecast to10.0% (from 11.0% earlier).

Chart 2: Continued progress on vaccine offers comfort for growth outlook



Inflation

Fuel plays spoilsport

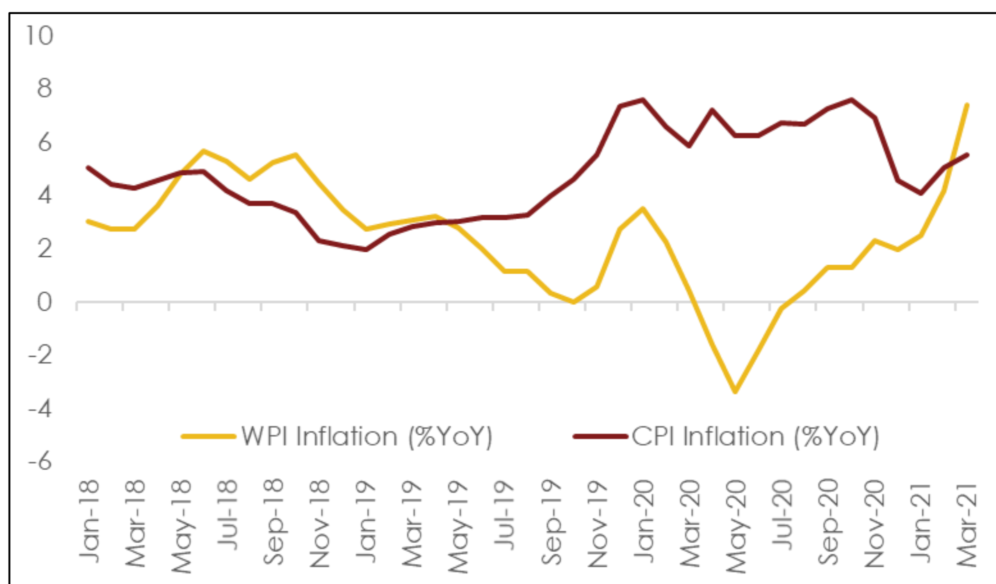
KEY TAKEAWAYS

- Consumer and wholesale inflation both rose further in Mar-21, with prices pressures led by fuel inflation along with an adverse base.
- After a gap of nearly 2 years, WPI inflation now stands above CPI inflation.
- For FY21, average CPI inflation stood at 6.2% - in line with our expectations, but nevertheless the worst outcome in 7 years and above RBI's upper threshold of comfort
- WPI inflation average stood at 1.2%, with a sharp monotonic increase seen over the 12 months.
- On inflation outlook, we retain our FY22 projection of 5.0% on continued comfort on food inflation amidst expectations of a normal monsoon in 2021.
- Upside in crude price remains a risk unless countered by fuel tax reductions by the center and state Governments.
- Impact of ongoing lockdowns remains unclear as of now amidst possible supply disruptions and demand moderation.

CPI and WPI inflation rise further in Mar-21

Consumer and wholesale inflation both rose further in Mar-21, with prices pressures led by fuel inflation reflecting lagged pass-through of higher global crude prices, along with an adverse base. After a gap of nearly 2 years, WPI inflation now stands above CPI inflation.

Chart 1: WPI inflation rises above CPI after a gap of nearly 2-years



Granularity of Mar-21 data

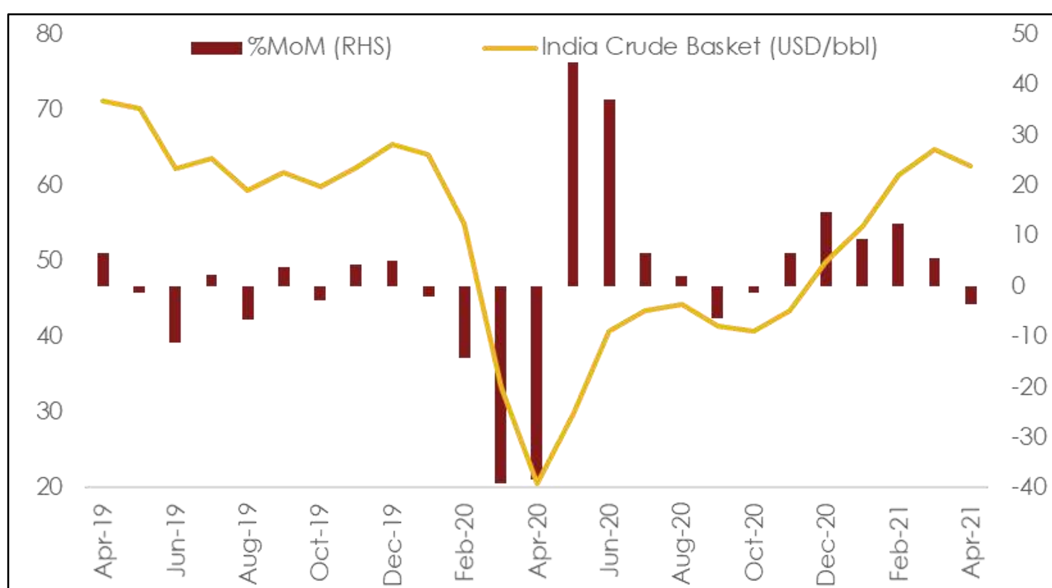
While CPI inflation quickened to a 4-month high of 5.52% (vs. 5.03% earlier), WPI inflation accelerated to a record high in the 2011-12 series, coming in at 7.39% (vs. 4.17% in Feb-21) in Mar-21.

- Notwithstanding a sequential correction in prices (driven by Vegetables, eggs, spices and cereals), CPI food inflation rose to a 4-month high amidst an unfavorable base. In addition, Fuel and Light inflation continued to ascend to a 12-month high with price pressures seen in LPG, Kerosene, Diesel, Petrol and Charcoal. In similar vein, inflation for Transport and Communication (within miscellaneous and captures petrol and diesel prices) rose to a record high. Recall, higher fuel prices are a manifestation of India crude basket hardening by ~18% cumulatively over the months of Feb-Mar-21.
- Core CPI inflation, i.e., headline ex food and fuel prices, rose marginally but neared a 2-1/2 year high of 5.96% in Mar-21 compared to 5.88% in Feb-21. While price pressures on a sequential basis were rather muted, the elevated and sticky core inflation is somewhat concerning.
- Within WPI, fuel inflation stood in double-digits at 10.25% vs. 0.58% in Feb-21 reflecting the lagged passthrough of global crude prices. Further, manufacturing too registered broad based price pressures led by sub-sectors of Chemicals, Pharma, Rubber & plastics, Basic metals, Non-metallic mineral products, Electrical equipment among others, amidst some degree of pricing power among producers. Separately, food prices continued to offer comfort owing to the sequential contraction led by vegetables.

Taking stock of the fiscal year gone by

- For FY21, average CPI inflation stood at 6.2% - in line with our expectations, but nevertheless the worst outcome in 7 years as it breached RBI's upper threshold of inflation band for the first time since the flexible inflation target regime was formally adopted in FY15. Perhaps keeping in mind, the idiosyncratic nature of FY21 inflation – an outcome of the pandemic, RBI's mandate of maintaining inflation in the 4% +/- 2% band was renewed by the Government further for a period of 5-years, up to FY26.
- Anatomy of annual CPI inflation indicates price pressures being led by categories of Pan, Tobacco & Intoxicants, Food and Miscellaneous in FY21 (see table).
- WPI inflation average stood at 1.20% in FY21 with a monotonic increase seen over the 12 months. In H1, WPI averaged at -0.9% followed by a significant increase in H2 to 3.27%, reflecting the hardening of manufacturing prices amidst higher commodity-based input prices.

Chart 2: Rise in India Crude Basket manifests as higher fuel inflation



Outlook

On inflation outlook, we retain our FY22 projection of 5.0% as we expect comfort on food inflation amidst expectation of a normal monsoon in 2021. IMD has forecast 2021 Southwest at 98% of LPA i.e., in the Normal range. In comparison, private weather forecaster SkyMet is a tad more positive projecting rainfall at 103% of LPA (Long Period Average). While crude oil prices have seen some softening in Apr-21 so far (-4% in USD terms), outlook on crude remains quite uncertain amidst global recovery, vaccine progress and OPEC geopolitics. Any upside in crude price (with Rupee weakness likely limiting the downside) will add to inflationary pressures, unless countered by fuel tax reductions by the center and state Governments.

Further, an added element of uncertainty has come on board with respect to a rapidly deteriorating situation on the COVID front with current number of active cases having surged past Sep-20 peak. Consequently, containment measures, so far, have

been localized in nature and are not as pervasive or stringent as Q1 FY21. From an inflation perspective, the impact of lockdowns remains unclear. On one hand, lockdowns can cause near term disruptions to supply, pushing prices higher (akin to Q1FY21), but on the other it can also extinguish some demand side price pressures in the economy.

Table 1: CPI Inflation

CPI Inflation: By sub-components (%YoY)				
	Q1FY21	Q2FY21	Q3 FY21	Q4 FY21
CPI headline	6.57	6.90	6.38	4.87
Food	8.92	8.86	7.62	4.05
Pan, Tobacco & Intoxicants	7.81	10.81	10.57	10.46
Clothing & footwear	3.19	2.84	3.32	4.15
Housing	3.72	3.06	3.22	3.32
Fuel & Light	1.66	2.88	2.22	3.97
Misc.	5.76	6.90	6.83	6.73
Core Inflation	5.06	5.70	5.75	5.83

Table 2: WPI Inflation

WPI Inflation: By sub-components (%YoY)				
	Q1FY21	Q2FY21	Q3 FY21	Q4 FY21
WPI Inflation	-2.25	0.5	1.9	4.7
Primary	-1.1	2.5	2.5	2.2
Food	*2.5*	*5.8*	*3.6*	*0.6*
Non-food	*-3.2*	*-3.0*	*4.9*	*6.7*
Mineral	*1.4*	*0.5*	*9.0*	*10.7*
Crude & natural gas	*-35.3*	*-19.5*	*-20.1*	*6.5*
Fuel and Light	-17.3	-9.2	-8.1	2.3
Manufacturing	0.0	1.3	3.3	6.2

Government Finances

FY21 fiscal deficit path appears reassuring

KEY TAKEAWAYS

- The relatively lower accretion to FYTD (Apr-Feb) fiscal deficit this year at 76.0% of RE compared to 110.8% over the corresponding period in FY20 reflects the sharp upward revision in fiscal deficit target for FY21 to 9.5% of GDP from 3.5% BE.
- With support from excise and custom duties, net tax collection growth has outpaced the previous year's run rate on FYTD basis
- However, non-tax revenue and disinvestments have contracted on year-on-year basis, owing to lower surplus transfer from the RBI and slow traction in disinvestments
- Total expenditure growth of 14.3% YoY on FYTD basis has improved moderately on the back of significant ramp up in capex even as growth in revenue expenditure has lagged
- We continue to believe that there could be scope for mild improvement in FY21 fiscal deficit ratio of 9.5% of GDP
- However, fiscal risks for FY22 needs close monitoring amidst the reimposition of lockdowns in select states

India's central government fiscal deficit for the period Apr-Feb FY21 stood at 76.0% of revised estimates (RE) for the full year compared to 110.8% over the corresponding period in FY20. *Prima* facie, the relatively lower accretion to FYTD fiscal deficit this year reflects the sharp upward revision in fiscal deficit target for FY21 to 9.5% of GDP as per RE vis-à-vis 3.5% as per initial budget estimates (BE).

Moving our attention to the current trend, we observe the following.

Receipts: Tax collections playing a supporting role

In recent months, the annualized growth in total receipts has shown strong momentum, particularly led by tax revenue.

- On FYTD basis (Apr-Feb), gross tax revenue collection has clocked a mild contraction of 0.7% despite COVID's adverse impact on the economy. This is surprisingly modestly better compared to the contraction of 0.8% seen in the corresponding period in FY20.
    - Support to gross tax revenue has emerged from excise and customs, which registered FYTD growth of 59.6% and 7.4% respectively compared to a growth of 1.9% and -10.0% seen in the corresponding period in FY20. While hike in excise duty on petroleum products earlier in the year continues to aid robust growth in excise collections, the recent pickup in imports appears to be providing a supportive backdrop for customs collection.
    - Beyond these two categories of taxes/duties, the disruptive impact of COVID is noticeable in case of drop in collections from corporate tax, income tax, and GST, which contracted by 16.2%, 4.2%, and 9.9% respectively on FYTD basis vis-à-vis a growth of -12.0%, 7.7%, and 4.5% seen in the corresponding period in FY20. Nevertheless, it is comforting to see that GST collections in the last 3-4 month have picked up with sequential recovery in GDP and aided by efficiency in tax administration.
- Net tax revenue on FYTD basis (Apr-Feb) clocked a healthy growth of 9.1% compared to a mild growth of 1.9% seen in the corresponding period in FY20, on account of lower tax devolution to states.

Non-tax revenue comprising of Interest receipts, dividends and profits, external grants etc. on FYTD basis (Apr-Feb) recorded a sharp contraction of 41.4% compared to an expansion of 53.2% seen in the corresponding period in FY20, primarily on account of moderation in transfer of surplus from the RBI. When seen with respect to the downwardly revised RE, the FYTD accretion under non-tax revenue stands at 73.2% of full year target vis-à-vis 80.7% seen in the corresponding period in FY20.

While the FYTD (Apr-Feb) contraction in non-debt capital receipts (primarily comprising of disinvestment receipts) of 16.2% appears better than the contraction of 28.7% seen in the corresponding period in FY20, it needs to be interpreted carefully. Government's disinvestment collection at Rs 257 bn between Apr-Feb FY21 is marginally lower than the figure of Rs 352 bn seen in the corresponding period in FY20. However, with respect to the significant downward revision in RE, the FYTD disinvestment revenue accretion stands at 80.2% of full year target vis-à-vis 70.1% seen in the corresponding period in FY20.

Expenditure: Significant improvement in quality of spending in H2 FY21 so far

Total expenditure on FYTD (Apr-Feb) basis recorded a growth of 14.3%YoY compared to 12.6% growth seen during the corresponding period in FY20. On RE basis, this translates to a figure of 81.7% of the full year target vis-à-vis 91.8% seen in the corresponding period in FY20. We note a divergence between the pace of revenue and capital expenditure by the government:

- Revenue expenditure stood at 80.1% of full year RE, lower than 92.0% seen in the corresponding period in FY20. While bulk of the spending under *Atmanirbhar Bharat Abhiyan* targeted towards immediate COVID relief/support is being carried out under this category, the slower pace of spending is on account of sharp increase in the RE for major subsidies (to Rs 6.0 tn from the BE of Rs 2.3 tn) to boost fiscal transparency.
- Encouragingly, FYTD (Apr-Feb) growth in capital expenditure has increased threefold to 33.0% from 11.4% seen in the corresponding period in FY20. On RE basis, this translates into a figure of 92.4% of the full year target vis-à-vis 90.5% seen in the corresponding period in FY20.

Since the beginning of H2 FY21, growth in government expenditure has picked up perceptibly. This possibly stems from recent comforting trend observed in tax collections as well as the need to support the economy amidst gradual phasing of lockdown restrictions.

Outlook

As highlighted in the Mar-21 edition of Acuite Macro Pulse, we continue to believe that recent performance on tax collection and expenditure trend supports the scope for a mild improvement in the revised fiscal deficit target of 9.5% of GDP for FY21. The optimism stems from (i) traction in tax collections (GST revenue has averaged at Rs 1.18 tn in last four months), (ii) higher than expected realization from the auction of telecom spectrum in Mar-21 (Rs 778 bn vs. expectation of Rs 450 bn), and (iii) higher than anticipated Nominal GDP base (on account of commodity price inflation) – in this context we note that while CPI inflation moderated to 4.9% YoY in Q4 FY21 from 6.4% in Q3 FY21, WPI inflation accelerated to 4.7% YoY in Q4 FY21 from 1.9% in Q3 FY21.

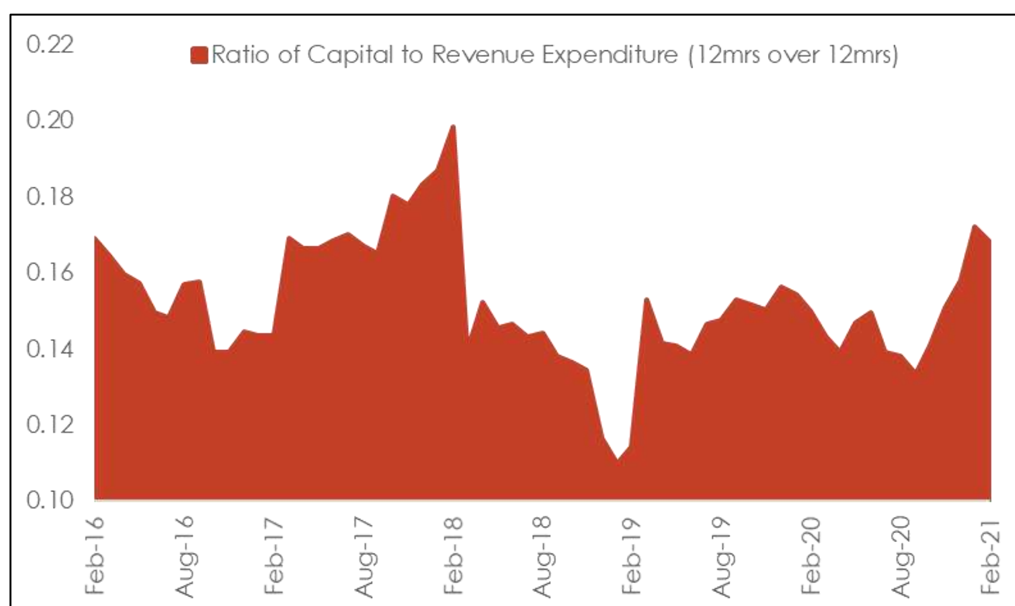
Having said so, we do note that any scope for improvement would be marginal as the government's on- boarding of subsidy expenditure from public sector entities has created large room for revenue spending in the final month of the fiscal year.

Nevertheless, the recent improvement in tax buoyancy is indeed comforting. If it sustains through FY22, then it could have a salubrious impact on next year's deficit arithmetic, provided other sources of receipts, (especially, the disinvestment target of Rs 1750 bn) play a complimentary role. We do, however acknowledge the emergence of early risks from sharp resurgence of COVID infections resulting in reimposition of lockdowns in select states. If these restrictions persist, or become stringent or pervasive in the coming months, then it could once again upset the fiscal arithmetic in FY22 via dampening impact on tax collections and obligations for continuing with expenditure support. We would closely monitor the developments in this space to assess the fiscal risks (if any) for FY22.

Table 1: FYTD comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative as of Apr-Feb)				
	% of FY Actual/Target		%YoY	
	FY20	FY21	FY20	FY21
Revenue Receipts	81.9	88.1	8.9	-0.5
Net Tax	82.2	90.4	1.9	9.1
Non-Tax	80.7	73.2	53.2	-41.4
Non-Debt Capital Receipts	74.5	92.1	-28.7	-16.2
Total Receipts	81.6	88.2	6.8	-1.1
Revenue Expenditure	92.0	80.1	12.8	11.7
of which, Major Subsidies	*119.1*	*61.4*	*0.7*	*37.5*
Capital Expenditure	90.5	92.4	11.4	33.0
Total Expenditure	91.8	81.7	12.6	14.3
Fiscal Deficit	**110.8**	**76.0**	**-**	**-**

Chart 1: Quality of central government spending has improved significantly in H2 FY21



Rates

Yields moderate; uncertainty increases

KEY TAKEAWAYS

- G-sec yields have moderated over the last four weeks despite buildup of inflationary pressures on account of input prices
- The combination of a mini rally in USTs, prospects of India's entry into the EM bond index, and RBI's formal attempt towards quantitative easing has supported bond market sentiment
- While we believe RBI's G-SAP program to be similar to the ongoing OMO purchases, it is however likely to maximize the positive impact on sentiment as a calendarized commitment from the central bank would significantly curb uncertainty, while boosting near term visibility over absorption of g-sec supply
- We continue to expect RBI to make gradual progress on policy normalization via liquidity, LAF corridor, and with an eventual 25 bps hike in the repo rate in Feb-22
- We continue to expect 10-year g-sec yield to increase towards 6.30% by Sep-21 and further towards 6.50% by Mar-22.
- Uncertainty on account of the second wave of COVID has clouded the near-term economic outlook, which could potentially have a bearing on monetary policy normalization

Since our last update in Mar-21, the 10Y g-sec yield has softened, dropping from 6.18% to 6.01%, before settling somewhat higher at around 6.08% levels currently. From a bond market perspective, the last four weeks saw four key drivers, out of which three played a supportive role.

1. Global rates pressure has eased somewhat

Over the last 4-weeks, global bond yields, led by US, have seen some moderation by approximately 15 bps on the 10Y sovereign segment. There does not appear to be a strong driver of the recent mild moderation in US yields – however, concerns over safety of J&J vaccine, short covering, and strong auction demand are likely to have triggered this.

2. India's potential tryst with global bond indices

In its semi-annual country classification, FTSE Russell placed the Indian and Saudi Arabian government bond markets on the watchlist for possible inclusion in its FTSE EMGB Index (that has representation from 16 EM countries). This development is an acknowledgment of India's efforts to gradually liberalize the sovereign bond market to include a wider investor base. As per FTSE Russell, global index users have evinced interest in Indian g-secs issued under FAR (fully accessible route – under this scheme, eligible investors can invest in specified g-secs without being subject to any investment ceilings).

While this is an encouraging and a welcome development for the domestic bond market, its near-term impact would be minimal as the scrutiny process and actual inclusion gets pushed beyond FY22. Nevertheless, it is a significant medium-term development with the potential of attracting USD 30-40 bn into domestic markets.

3. RBI's unrelenting support to the economy

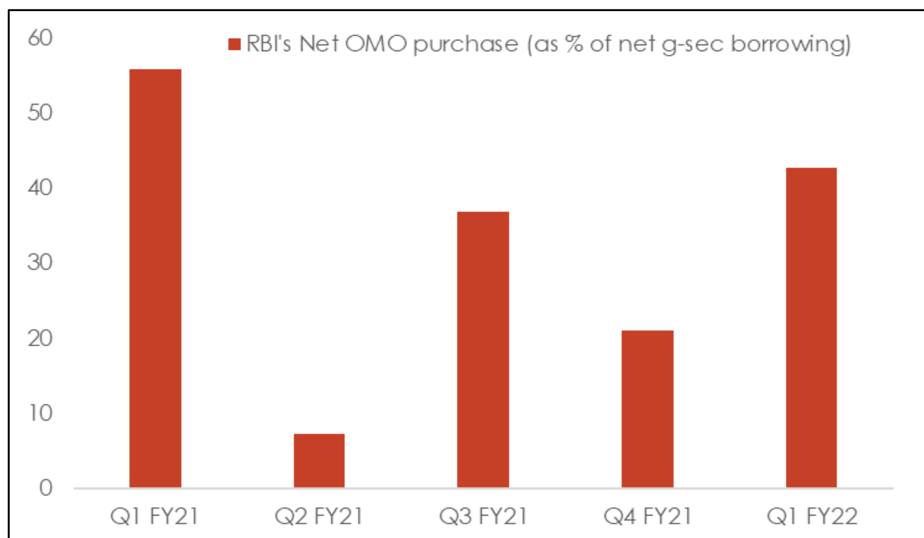
Despite widespread expectation of a status quo on monetary policy rates in Apr-21 policy review, which the RBI did stick to, the central bank continued to reiterate the need for maintaining accommodative policy stance "as long as necessary to sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward". Further, it boosted its liquidity support via extension of TLTRO On Tap Scheme, provision of special refinance window to AIFIs for incremental lending in FY22, besides others.

The most significant policy step however came with the announcement of G-SAP (a secondary market g-sec acquisition program), wherein the central bank will commit upfront a specific target for bond purchases to enable a stable and orderly evolution of the yield curve amidst comfortable liquidity conditions. For Q1 FY22, the target for G-SAP has been set at Rs 1 lakh cr.

We believe the G-SAP program to be similar to the ongoing OMO purchases (outright as well as via auctions) by the RBI. However, it is likely to maximize the positive impact on sentiment as a calendarized commitment from the central bank would significantly curb uncertainty, while boosting near term visibility over absorption of g-sec supply. As far as Q1 FY22 is concerned, we note that the G-SAP quantum of Rs 1 lakh cr would

help absorb ~43% of net g-sec supply. While this is an improvement over 21.0% g-sec absorption done by the RBI in Q4 FY21, it is comparatively lower than ~56% absorption done by the RBI in Q1 FY21.

Chart 1: RBI to continue absorbing substantial portion of g-sec supply

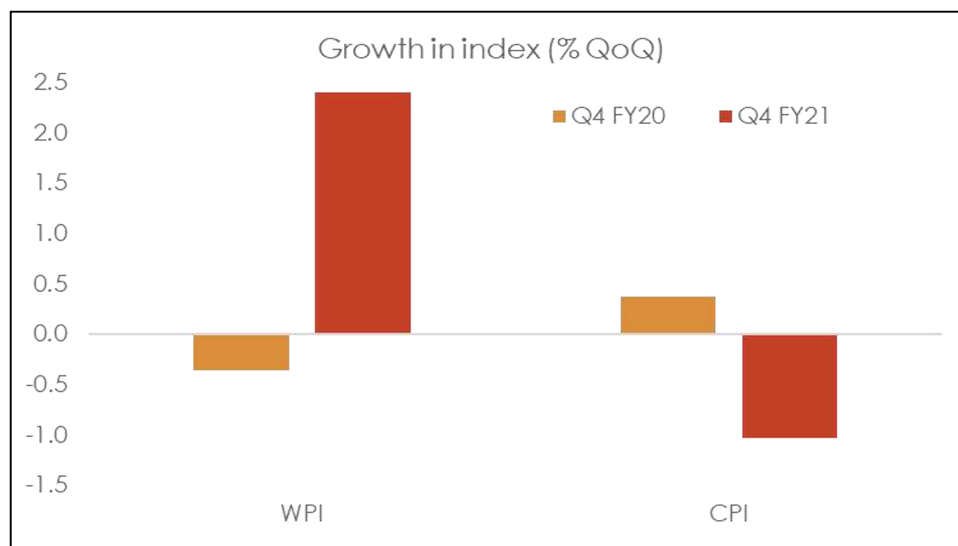


4. Inflation pressure rearing its head once again

Even as the above three factors have supported bond market sentiment, cautious undertone continue to exist amidst recent hardening of inflationary pressures:

- After averaging at 4.3% YoY over Dec-Jan FY21, CPI inflation accelerated to 5.3% over Feb-Mar FY21. While retail inflation pressures still seem moderate compared to the upper threshold of 6%, household inflation expectations continue to remain elevated (3-month ahead and 1-year expectations have predominantly been in double digits since May-20).
- WPI inflation touched a series high of 7.39% YoY in Mar-21, reflecting steep jump in input price inflation in recent months.

Chart 2: Input price pressures have hardened WPI inflation considerably



Outlook

As far as the global backdrop is concerned, we continue to expect the US Federal Reserve to start moving towards tapering of asset purchases sometime in the middle of 2022. Improvement in US growth outlook backed by record fiscal support has already been providing an upside bias to UST yields. The ongoing pace of vaccination in the US (one of the fastest in the world) is adding another layer of optimism. This was echoed by Fed's Bullard who recently said that Fed could consider tapering of its ongoing QE program when 75-80% of the population gets inoculated. While this isn't a line in the sand, it serves well to note that the US could very well achieve 100% coverage with respect to complete vaccination before the end of 2021. This could form a credible premise for tapering of QE in mid-2022.

While this would put pressure on EM assets, the impact is unlikely to be cataclysmic (a la 2013) as most EM countries have significantly improved upon their vulnerability parameters.

On the domestic front, we continue to expect RBI to maintain repo rate unchanged through 2021 and opt for a 25 bps hike in Feb-22 policy review. This would mark the formal act of interest rate normalization – a move backed by anticipated improvement in growth outlook (helped by at least 60% population coverage under the COVID vaccine program thereby boosting chances of herd immunity), need for steering the focus back on preserving the medium term inflation target of 4%, and preparing the economy and financial markets for the expected taper transition in mid-2022 (few EM central banks that saw significant FX pressure in 2020 like Brazil, Turkey, and Russia, have started resorting to interest rate hikes in 2021).

Hence, we continue to expect the 10-year g-sec yield to increase towards 6.30% by Sep-21 and further towards 6.50% by Mar-22. Having said so, we note that uncertainty on account of the second wave of COVID infection has clouded the near-term economic outlook, which could have a bearing on the beginning of anticipated normalization of monetary policy.

Rupee

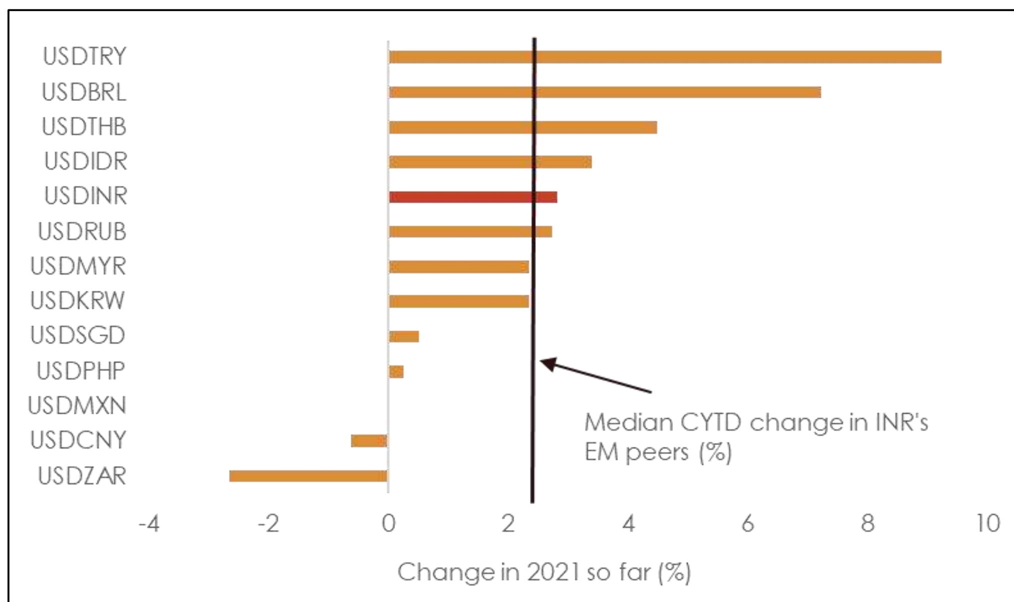
The tide has turned

KEY TAKEAWAYS

- After remaining on a steady path in Q4 FY21, INR has weakened considerably in the month of Apr-21 so far
- Normalization in trade deficit and reversal of equity portfolio flows appear to provide reasons for pressure
- We believe the G-SAP program to have a negligible impact on INR – however it could have triggered unwinding of short dollar positions in the market as a knee jerk reaction
- From a near term perspective, we now see the emergence of second wave of COVID as a risk factor for INR as this time the economy would be facing a commodity price headwind too
- We revise up our current account deficit forecast to USD 35 bn (from USD 30 bn earlier) and look for a lower BoP surplus of USD 40-50 bn vis-à-vis USD 55 bn earlier.
- We now revise our forecast for USDINR to 76.0 by Sep-21 (from 73.0 earlier) and further towards 77.0 by Mar-22 (from 75.0 earlier)

After remaining on a steady path in Q4 FY21, INR has weakened considerably in the month of Apr-21 so far. However, the depreciation on CYTD basis is still in line with EM peers' average performance, which suggests a catch up in case of INR.

Chart 1: INR's CYTD performance has been similar to the average of EM peer group

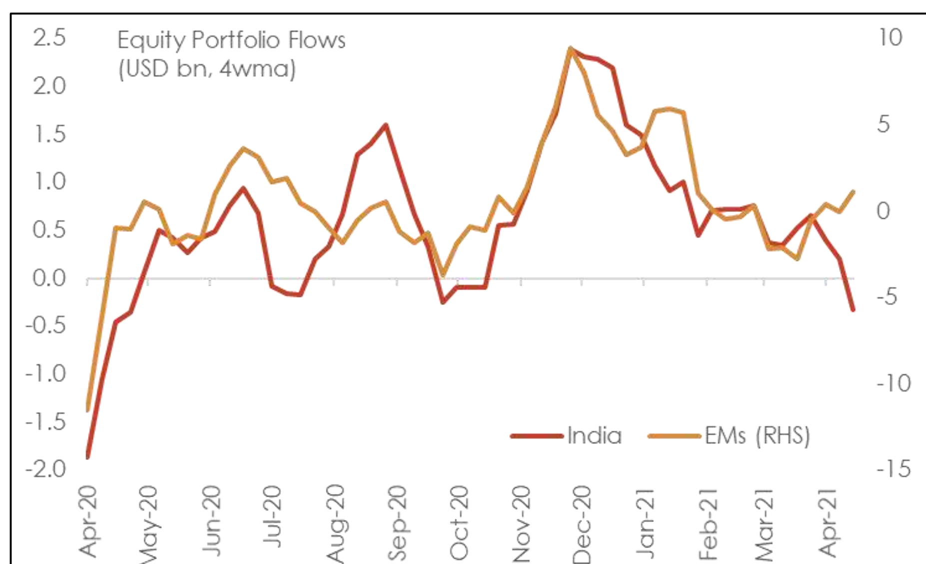


We are not surprised by the direction of the move as we had highlighted in last month's edition of the Acuite Macro Pulse about the possibility of factors gradually stacking up against INR in FY22. However, the speed of adjustment, and the concomitant volatility has materialized earlier than anticipated.

Surprisingly, the weakness in INR has happened in the backdrop of retracement in the dollar index from its recent peak of 93.3 seen in end Mar-21 towards 91.2 currently. We believe the following factors to have played a role in this regard:

- India's merchandise trade deficit has shown evidence of normalization on account of increase in global commodity prices and improvement in domestic demand conditions amidst gradual phasing out of lockdown restrictions hitherto. As such, the trade deficit jumped from a subdued level of USD 9.9 bn in Q1 FY21 and USD 14.1 bn in Q2 FY21 to USD 35.0 bn in Q3 FY21, and finally registered a seven-quarter high print of USD 41.1 bn in Q4 FY21.
- As pointed out earlier, we had flagged the possibility of some reversal in foreign investment flows. After the bunching up of IPOs towards the end of FY21, equity portfolio flows have reversed in the month of Apr-21 so far with an outflow of USD 0.9 bn, the largest since Mar-20, the month that marked the beginning of the COVID pandemic at a global level.

Chart 2: India's equity portfolio flows have reversed off late



Is India's version of QE weighing upon INR?

As highlighted in the rates section, with announcement of the G-SAP program, the RBI has made a formal attempt towards quantitative easing, similar to other major central banks. With bond yields cooling off post the announcement and INR weakening somewhat, there is a widespread perception that G-SAP program has added to depreciation pressures for INR.

While we acknowledge the presence of interest rate-currency channel, we would be skeptical of small movements in interest rates having an impact on FX, esp. for partially open (on the capital account) EM economies like India. Moreover, since the G-SAP program and the OMO purchases that were used extensively in FY21 to curb upside pressure on yields are similar, there is not enough reason to distinguish one from the other from FX perspective. Having said so, while a knee jerk reaction is inevitable, its impact is likely to fade away sooner rather than later.

Nevertheless, the knee jerk reaction could have precipitated the unwinding of short dollar positions in the market, which as per market estimates had seen a significant buildup in H2 FY21.

Outlook

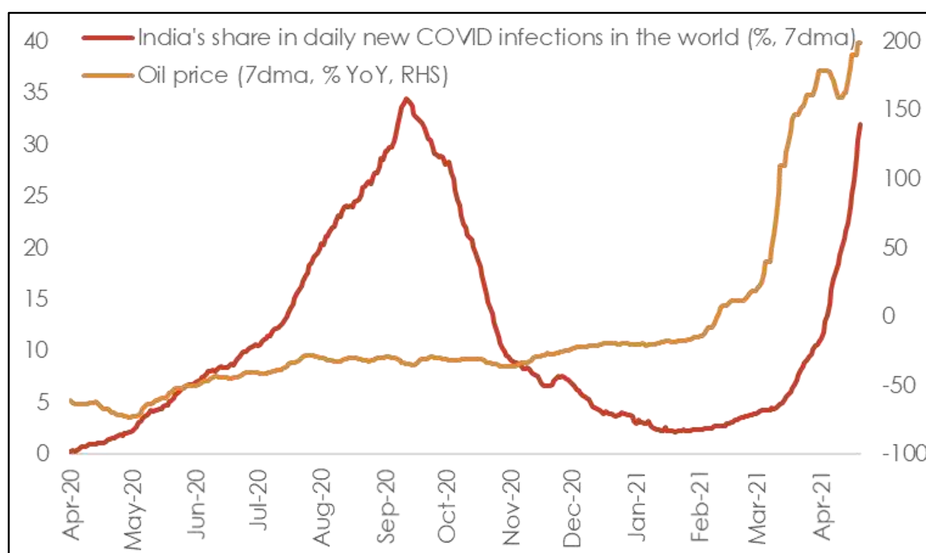
We continue to stick to our view of moderate weakness for INR during FY22 on account of strong reflationary push to the USD and normalization of India's current account balance.

From a near term perspective, we now see the emergence of second wave of COVID as an additional risk factor for INR. India is currently contributing close to 32% of the daily infections in the world – this is close to the peak of 34% India had in terms of daily infections in the world in Sep-20. One can argue that India never took the COVID brunt on FX (barring the initial global risk aversion in Mar-Apr 2020) and the current situation

should not be any different. We believe things have changed between Sep-20 and Apr-21, which amidst the strong second wave in India could have a short-term negative impact on INR:

- Commodity prices, which were extremely soft during Sep-20, have now recouped their pre pandemic levels, with some exceeding them. This shift in commodity prices from being a tailwind to a headwind will impact growth-inflation-current account balance for India in FY22.
- While India has been making progress in terms vaccinating its population, the coverage in percentage terms is lagging in comparison to DMs like US, UK, and Eurozone. We note that India will be liberalizing its vaccine eligibility (to 18+ years from May 1st from 45+ years currently). This is indeed a much-needed welcome step for boosting sentiment and stabilizing the economy – from FX perspective the benefits of this could accrue with a lag of 2-quarters.

Chart 3: Unlike the first Covid wave, India faces a commodity price headwind in the second wave



Looking beyond the near term, we now see risk of a higher current account deficit materializing in FY22 (for a detailed scenario outline, please refer to Mar-21 edition of the Acuite Macro Pulse). As such, we revise our FY22 current account deficit projection to USD 35 bn from USD 30 bn earlier (vs. an estimated current account surplus of USD 26 bn in FY21). This is likely to pull lower the anticipated BoP surplus towards USD 40-50 bn range vis-à-vis our expectation of USD 55 bn earlier.

As such, we now revise our forecast for USDINR to 76.0 by Sep-21 (from 73.0 earlier) and further towards 77.0 by Mar-22 (from 75.0 earlier). Risk to this view stems from further hardening of global commodity prices, which could potentially impart a larger depreciation bias to INR. On the other hand, a faster than anticipated growth recovery and government's execution of reforms agenda (esp. on listing on international bond indices) can potentially favor a stronger INR.

Acuite RATINGS & RESEARCH

Global Overview

The race between vaccine and

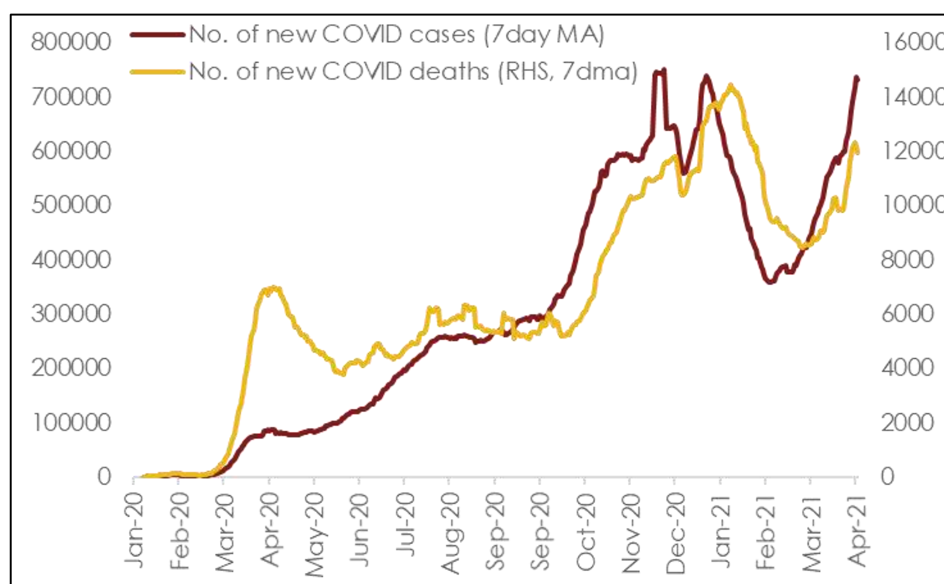
KEY TAKEAWAYS

- The global pandemic continues to worsen as the number of new COVID cases, after bottoming out in mid Feb-21, have been on a systemic rise once again.
- Despite the health crisis, mobility indicators globally are seeing an improvement with easing of restrictions, and so has economic data, finding support in a strong base from last year.
- Vaccination campaigns continue to be rolled out around the globe. At present (as of 21st Apr-21), 925 bn doses of the vaccine have been administered.
- From an economic perspective, the momentum in global recovery remains intact. IMF upped its 2021 global growth forecast to 6.0% from 5.5% earlier.
- On the ground, early indicator of global growth gaining ground came from the PMI data recording the fastest improvement in more than a decade in Mar-21
- Looking ahead, the strength of the global recovery is also contingent on the distribution pattern of the vaccine, which so far remains lopsided.

Overview

The global pandemic continues to worsen as the number of new COVID cases, after bottoming out in mid Feb-21 have been on a systemic rise. In the 2nd week of April, i.e., 8-15th more than 5.1 mn were reported, a 18% increase over the previous week's rise. Upside were observed in Europe (+1.7 mn), South East Asia, (+1.2 mn), and the Americas (+1.6 mn), up 3.6%, 55.5% and 17.9%, respectively. In Europe, clearly the growth rate of the new infections is on a declining trend as seen over the past 2-3 week. Despite the health crisis, mobility indicators globally are seeing improvement with easing of restrictions, and so has economic data, finding support in a strong base from last year. Vaccination campaigns continue to be rolled out around the globe. At present, 925 bn doses of the vaccine have been administered (as of 21st Apr-21) across 155 countries at the rate of ~17.2 mn doses a day. By country, Israel is still in the lead with 59% of its population having received at least one dose of the vaccine. The UK is in second place with 49.5% of its population having received at least one shot. Both countries have seen incremental easing of restrictions amidst a decline in new cases. US too has vaccinated close to 40% of its population. Further, European Union, despite a slow start, has recorded a swift acceleration in the pace of vaccinations, so far in the month of Apr-12.

Chart 1: Gloabally COVID cases continue to worsen

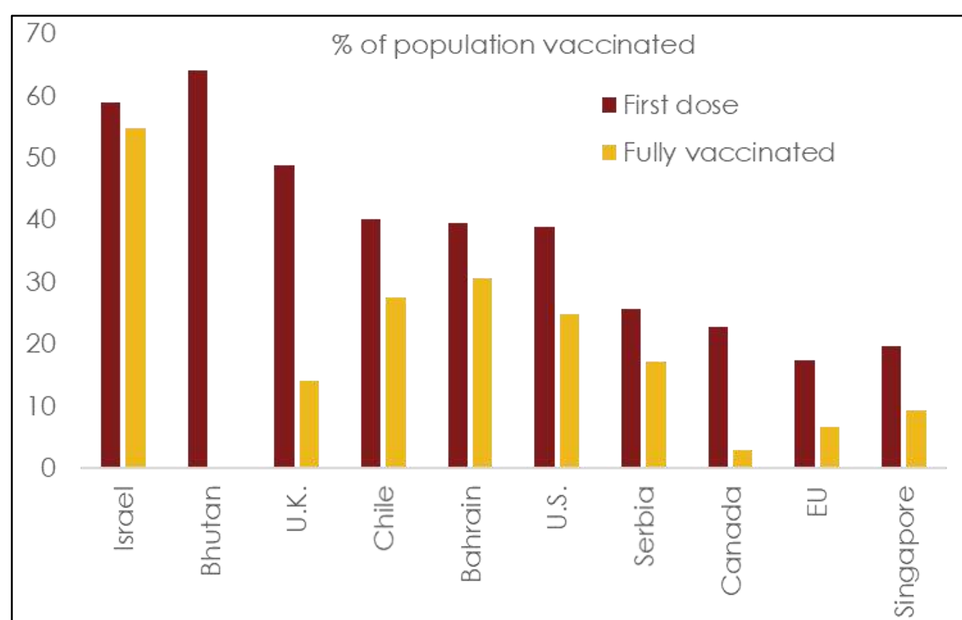


From an economics perspective, the momentum in global recovery remains intact. This was validated by IMF in its recently released update to the World Economic Outlook (WEO) report. The global agency upped its 2021 global growth forecast to 6.0% from 5.5% earlier. Advanced economies are now expected to grow at 5.1% (vs. 4.3% projected earlier) with EMDE (Emerging markets and developing economies) growth pegged at 6.7% (vs. 6.3% earlier). Among the revisions, the upward adjustment to US growth by 1.3% to 6.4% for 2021 stood out in magnitude, reflecting primarily the impact of USD 1.9 tn of stimulus implemented under the Biden administration.

On the ground, an early indicator of global growth gaining ground came from the PMI data. Mar-21 saw an outperformance with the index reporting the fastest improvement in more than a decade. This was led primarily by advanced economies (with the exception of Japan) – i.e., the US, UK and Eurozone. However, PMI data for

the month displayed significant growth disparities among regions contingent on the lingering containment measures and pace of inoculations. However, a more worrisome aspect of the PMI was the spike in input prices, which globally rose at the sharpest pace in over a decade – an outcome of supply delays and surging demand. The problem was exacerbated by the grounding of container ship in the Suez Canal (in late Mar-21) leading to extended delivery times in addition to input prices.

Chart 2: Vaccine progress among key countries



Rise in crude oil price saw some respite in Apr-21, with prices moving lower by 4.5% compared to a cumulative rise of ~30% since the start of 2021. However, the decline may prove to be short-lived, amidst strong recovery underpinned by incremental macro data coming from both US and China, along with global agencies such as IEA and OPEC reinforcing demand expectations remaining strong in H2 2021.

Despite increasing number of new coronavirus cases globally, there is a hope that as vaccines progress, several economies will be able to limit restrictions and curb rise in case numbers. However, the situation at best remains choppy. Underscoring the fluidity of the economic situation, despite upping its growth forecasts, IMF acknowledged that "*A high degree of uncertainty surrounds these projections, with many possible downside and upside risks. Much still depends on the race between the virus and vaccines. Greater progress with vaccinations can uplift the forecast, while new virus variants that evade vaccines can lead to a sharp downgrade*".

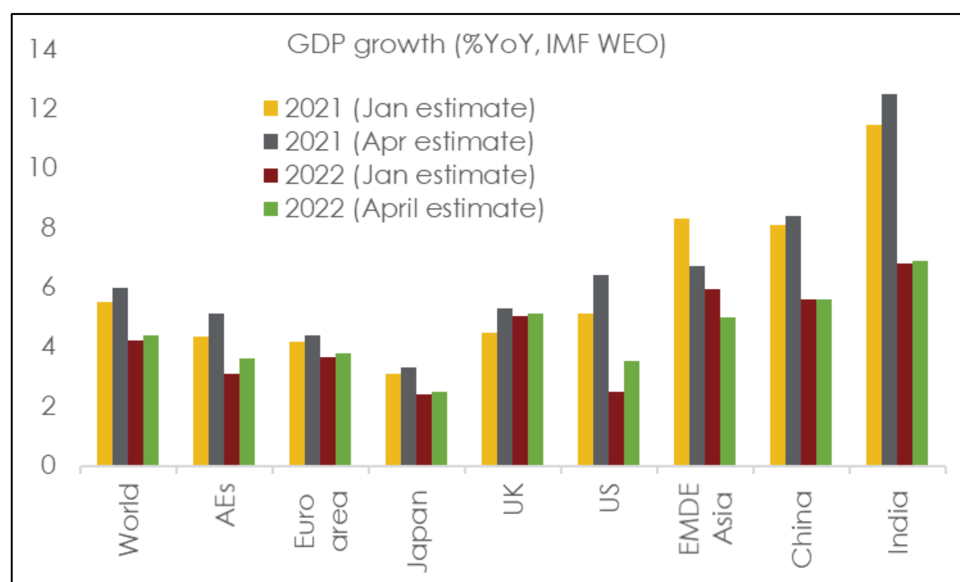
Having said so, the strength of the global recovery is also contingent on the distribution pattern of the vaccine, which so far remains lopsided. As per Bloomberg estimates, nearly 40% of the Covid-19 vaccines administered globally have gone to 27 wealthy nations that represent 11% of the global population. Countries making up the least-wealthy 11% have gotten just 1.6% of Covid-19 vaccines administered so far. This clearly needs to change. In the words of the WHO Director "*Global health security is only as strong as its weakest link – no one is safe until we are all safe*".

US Economy

Macro data for the month of Mar-21 reasserted the roaring recovery in the economy aided by warmer weather, aggressive vaccination efforts as well as a massive fiscal stimulus. Retail sales jumped by 9.8%MoM in Mar-21 to a 10-month high with gains being broad based with every single sub-segment registering an expansion. Non-farm payrolls rose more than expected, by 916k in Mar-21, with the unemployment rate falling to 6.0% from 6.2% earlier. Encouragingly, improved hiring was recorded in sectors such as hospitality and construction, reflecting the easing of social distancing restrictions. In yet another validation of recovery in services, US ISM surged to a record high of 63.7 in Mar-21 compared to 55.3 in Feb-21, amidst robust growth in new orders. The US economy is now expected to surpass its pre-COVID GDP level this year.

Supporting the domestic growth, as per the minutes of the Federal Open Market Committee meeting held on 16-17th Mar-21, Fed officials indicated that the easy policy will remain until it produces stronger employment and inflation outcomes. Further, while committee officials saw economy progressing on a recovery path, but they expect "*it would likely take some time for substantial further progress to be achieved*" before ultra-easy policy changes. In an attempt to give direction to markets regarding withdrawal of loose monetary conditions, Fed Reserve Chairman Jerome Powell outlined an exit strategy. He indicated that the Fed will reduce its monthly bond purchases before it commits to an interest rate increase, steps that are still months if not years in the future; despite the rise in inflation to 2.6%YoY - a 9 year high in Mar-21 (in line with Fed's symmetric inflation target of 2%).

Chart 3: IMF revised global and US growth upwards

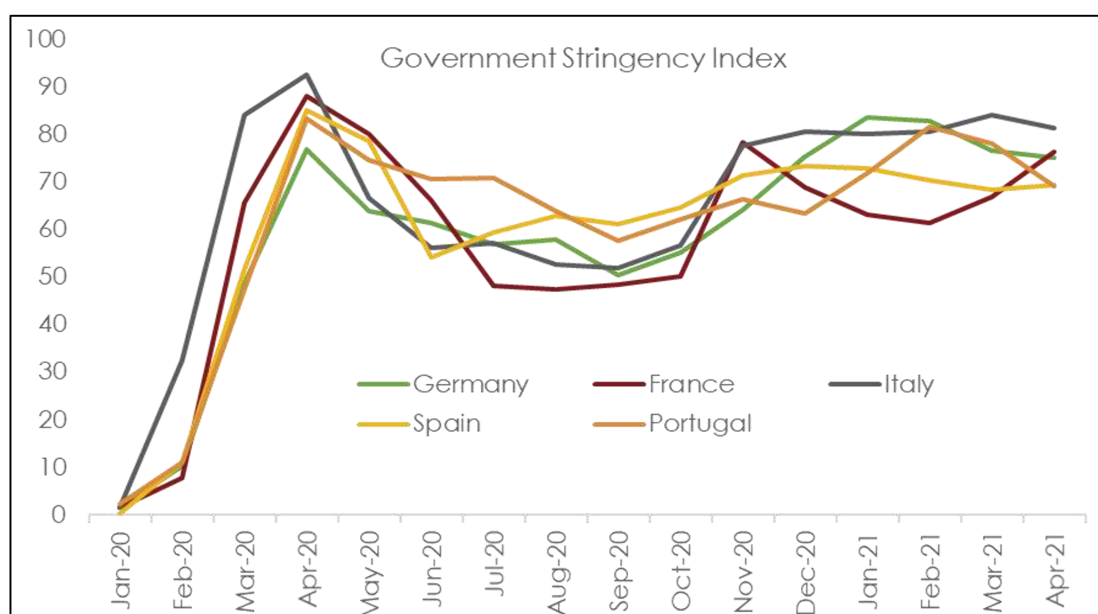


Eurozone

It appears that Eurozone's economy is growing more resilient to lockdowns, with macro data and mobility indicators continuing to pick up, despite renewed lockdowns in several countries such as Germany, France and Italy amidst a third wave of the virus that is brewing. As per IMF, the Euro area is expected to clock a growth of 4.4% compared to a contraction of 6.6% in 2020. Upside to this number remains limited, amidst delays to vaccination rollouts and a third wave of the virus.

Looking at incremental data, Markit Composite PMI bounced above the 50 mark to 52.5 in Mar-21 compared to Feb-21 level of 48.8, led by manufacturing index as services continued to remain in contraction. PMI for manufacturing at 62.5 in Mar-21 marks the highest level on record from 57.9 in Feb-21. Further, German ZEW index assessing economic situation improved by 12.2 points in Mar-21 compared to previous month, but the expectations for months ahead slipped amidst extended restrictions.

Chart 4 :Lockdowns renewed in several European countries amidst third wave of virus



UK

The UK economy grew by 0.4% in Feb-21 rebounding from a sharp drop of 2.2% in Jan-21. Among the subsectors, manufacturing and construction led the improvement, while services continued to see tepid growth. Amidst continued progress on vaccination and reducing case load, the third lockdown in the UK came to an end in early Apr-21 with several services such as gyms, hairdresser and non-essential shops getting opened. Even pubs and restaurants resumed operations but only for outdoor service. The economy despite signs of a turnaround remains on course to record a modest contraction in Q1. However, the actual growth outcome is expected to be far better compared to BoE's Feb-21 Monetary Policy Report, that had pegged economy to shrink by 4.2%QoQ in Q1. Attention will soon turn to the BoE monetary policy scheduled for 7th May-21.

Japan

The fragility of the recovery continues to be underpinned by incoming data, reflecting the drop in activity and sentiment during the state of emergency in Tokyo and some other areas to contain a renewed spike in coronavirus cases imposed for a period of 10 weeks over Feb-Mar-21.

Retail sales contracted for the third consecutive month in Feb-21, by 1.5%YoY following a degrowth of 2.4% in Jan-21 and 0.2% in Dec-20, with the broader decline led by fall in spending on items such as clothing, toiletries and general merchandise. Industrial production shrank by 2.6%YoY in Feb-21 dragged down by fall in production of cars, electrical machinery and information and communication equipment.

Despite visible weakness in the economy, jobless rate stood at 2.9% in Feb-21, unchanged from Jan-21. Adding to the positives, the popular corporate survey, known as Tankan, displayed growing optimism among businesses to levels seen in early 2020.

Looking ahead, the economy is still not out of the woods. The country is under threat of a likely fourth wave of spurt in COVID cases which has cast doubts on the 2021 Olympics, slated to begin from 23rd Jul-21. A strong call for postponing the event to next year is being made, though authorities are yet to take a decision. As per IMF, cancellation or postponing the Games would probably not hurt Japan's economy much but would have a larger effect on Tokyo's service sector.

In its assessment of the economy, Bank of Japan (BoJ) Governor Kuroda, recently acknowledged that the economy has been picking up but any recovery is likely to be modest due to lingering caution over the COVID-19 pandemic. However, growth is expected to find support in global demand and massive fiscal spending by the Government. Further, he has advocated benefits of a weaker Yen in helping manufacturers by inflating the value of profits earned overseas. From monetary policy perspective, BOJ is expected to continue monetary easing via Yield Curve Control in the foreseeable future.

China

China's GDP growth beat market expectations to expand by 18.3%YoY in Q1-21, expectedly driven by powerful base effects from last year. Fixed asset investments in Q1-21 (25.6%YoY in Mar-21) were dominated by railway infrastructure and technology-related investment. In other data, Industrial production (+14.1%YoY) was moderate compared to other activity measures due to slower export demand for clothing, lower production of smart devices (which could also be due to chip shortages) and tighter anti-pollution policies on commodity refineries. Reflecting revival in consumer sentiment, retail sales continued to recover well, clocking a growth of 34.2%YoY. Overall, after the economy rebounded to positive growth territory in Q2-2020, the recovery has gradually become more broadly-based.

The annual session of the National People's Congress (NPC) was held in Mar-21. The NPC is the highest body of state power in China with the ability to enact legislation, approve the government's budget and ratify development plans. While sustained fast economic growth continues to be important for China, however it set a modest goal for economic growth of "more than 6%" which is expected to be surpassed by a comfortable margin. The government is likely to maintain a proactive fiscal policy stance in 2021. The central government's budget deficit will marginally narrow this year to 3.2% of GDP from 3.6% in 2020, while the issuance of special local government bonds will remain sizable. However, the central government will not issue any additional Covid-related bonds this year, after selling 1 tn yuan of such instruments in 2020.

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