Acuite
RATINGS & RESEARCH

MACRO PULSE REPORT

April 2022

Acuite RATINGS & RESEARCH

Contents

Growth 4
Inflation 8
Government Finances 12
Rates 16
Rupee 20
Global Overview 24

From the desk of the Chief Analytical Officer

We are happy to publish the **sixteenth** edition of **Acuité Macro Pulse (Apr-2022)** which is also the first edition of the monthly journal for the current financial year**.** We have consistently made efforts to make this publication useful and meaningful to our stakeholders which includes bankers, investors, corporates, as well as researchers.

The global and the domestic economy hasn't made an entry to FY23 on a great note with the gloomy shadows of the Ukraine-Russia conflict in the background. Shortly, the war will get into the fourth month and there are no major signs that the conflict will get resolved soon. The supply chain challenges that have arisen due to the resultant logistical bottlenecks and economic sanctions against Russia are set to play out over a prolonged period and this may keep energy and some other commodity prices elevated despite some moderation in demand due to weaker global growth prospects. After the prolonged pandemic, central banks across the world including that in India have to deal with a virulent strain of inflation that has spread all over the world and has gathered further strength from the geo-political crisis. Consumer inflation in the developed economies is at a three decade high and at alarming levels in some of the smaller nations, leading to political instability. This has led to a sudden urgency among the advanced economies to tighten their ultra-accommodative monetary policies and raise interest rates.

Clearly, India is not insulated from such inflationary attacks, as reflected from the surge in the headline CPI inflation over the last few months that averaged 6.3% in Q4FY22 and threatens to breach 7.0% in Q1FY23. What is important for us to understand is that the inflation is not just fed by the spike in crude oil, coal and metal prices but also a range of food commodities that includes edible oil and cereals. India is particularly vulnerable on the edible oil front with nearly 50% of the requirements sourced from imports that are currently threatened by shortages and bans in the exporting nations. We enjoyed a period of benign food inflation in the first three quarters of FY23 before it started seeing a steady pickup in the last quarter (7.5% - Mar'22) due to the early onset of summer that impacted the output of wheat apart from vegetables and fruits and while we hope for a timely monsoon, any irregularity in rainfall can further increase the inflationary pressures.

So what does this imply for the Indian markets? Lots of volatility in the bond and the forex markets that is already in evidence! RBI signalled a turnaround in its monetary stance only in Apr'22 by normalising the policy corridor to 50 bps and then surprised the market by raising the repo rate by 40 bps in early May, given the sharply escalating inflationary headwinds. Additionally, higher sovereign borrowings and monetary tightening in the developed markets have also contributed to a spurt in the 10 yr g-sec yields to over 7.4% in May'22. RBI's actions have also triggered a rise in bank lending and deposit rates; we have projected a cumulative rate hike of over 100 bps in FY23. This will translate into a steady increase in banks' lending and deposit rates in tranches which may affect the sentiments in the consumer loan business. On the other hand, higher trade deficit and FII outflows induced by higher rates in AEs have led to the rupee breaching the mark of 77.0 (INR/USD) in the current month. Nevertheless, we remain fairly optimistic on the growth prospects for FY23 amidst government's strong thrust on infrastructure segment, solid coverage on vaccination, moderate recovery in rural consumption and the full play out of pent-up demand.

Happy reading,

Suman Chowdhury
Chief Analytical Officer

Acuite
RATINGS & RESEARCH

Growth

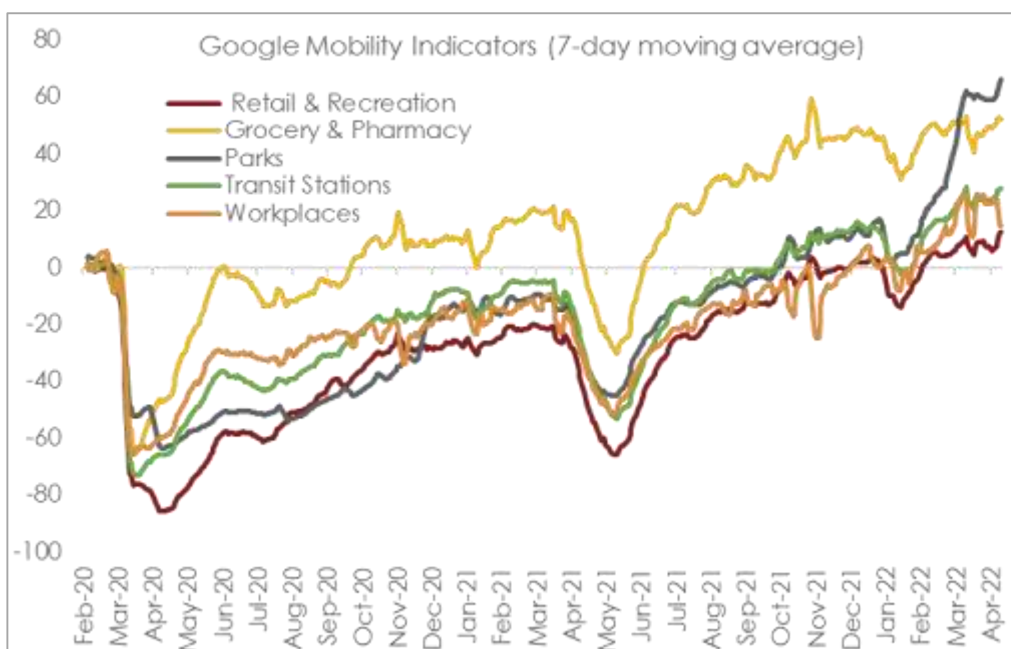
Amplifying headwinds to FY23 outlook

KEY TAKEAWAYS

- Domestic economic activity continues to remain in recovery mode, with Omicron wave behind us and mobility indicators continuing to normalize, as over 62% of the population now stands fully vaccinated.
- Most of the high frequency indicators have continued to improve on a sequential basis over the months of Feb-22 and Mar-22.
- Having said so, downside risks to FY23 growth prospects have mounted owing to the continuing geopolitical conflict between Russia and Ukraine. The sharp escalation in commodity prices, upside to domestic retail inflation and the concomitant slowdown in global growth are expected to weigh on the pace of growth recovery, especially in H1 FY23.
- In addition, resurgence of Covid in certain countries, particularly China, could further compound uncertainties on the demand as well as supply front. We also remain watchful of domestic Covid cases, which have shown a marginal uptick in some of the metros (such as Delhi and Mumbai).
- Taking on board the commodity price impact of the ongoing war, we expect FY23 GDP growth at 7.5% with moderate downside risk.

After the temporary setback from Omicron wave, domestic economic activity continued to remain in recovery mode, amidst improvement in mobility indicators and robust vaccination coverage (over 62% of the population now stands fully vaccinated). The complete removal of lockdown restrictions along with the heightened activities in the year-end have led to most of the lead indicators to improve significantly in Mar-22. This was clearly reflected in our proprietary Acuité Macro Economic Performance Index (AMEP) that rose to a post pandemic high of 126.1 in Mar-22 from 120.0 in Mar-21. While there is no visible and direct impact of the geo-political crisis in Ukraine as of now, a moderate impact due to spurt in some commodity prices and higher supply side bottlenecks can be expected from Apr-22. Having said so, overall downside risks to FY23 growth have mounted owing to the geopolitical conflict. The sharp escalation in commodity prices, upside to domestic retail inflation and the concomitant slowdown in global growth is expected to weigh on the pace of growth recovery, especially in H1 FY23. In addition, resurgence of Covid in certain countries, esp. China, could further compound uncertainties on the demand as well as supply front. We also remain watchful of domestic Covid cases, which have shown a marginal uptick in some of the metros (such as Delhi and Mumbai).

Chart 1: Google mobility across sub-categories higher than pre-pandemic levels



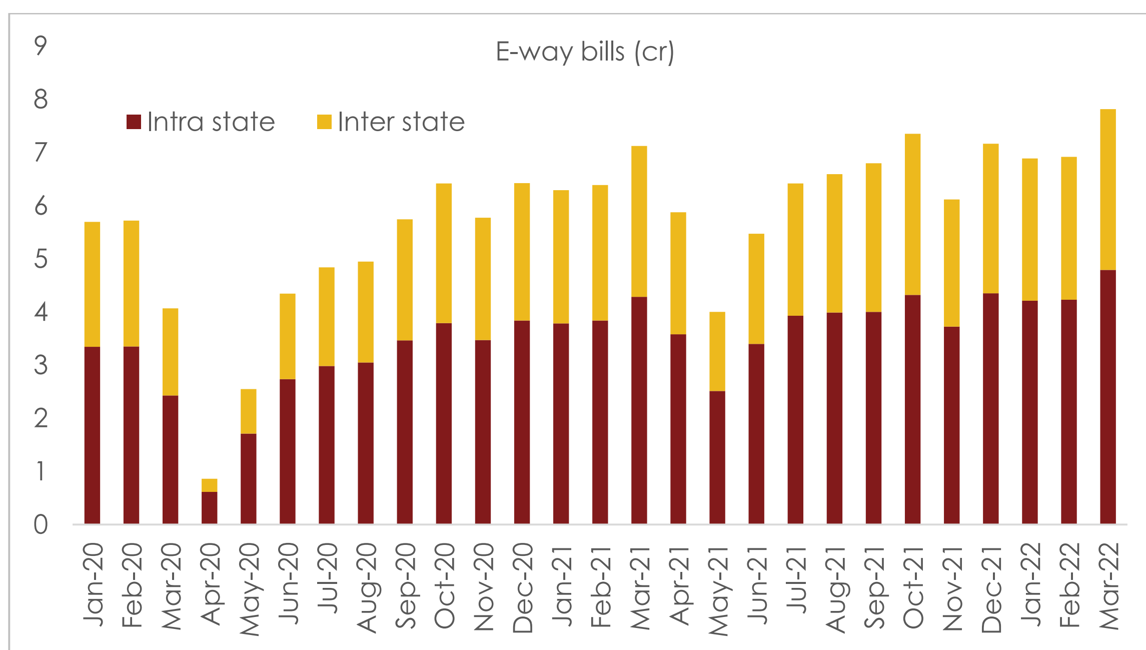
Recent data releases: A granular look at recovery

- India's IIP growth rose marginally to 1.7% YoY in Feb-22 from an upwardly revised print of 1.5% in Jan-22. On sequential basis, IIP contracted by 4.7% MoM in Feb-22, posting a deeper contraction than the seasonal average of 3.8% for the month of February. The sequential slowdown was led by manufacturing sector, and on the use-based side by consumer goods (i.e., both durable and non-durables). The latest data released on the eight core sector, however,

reflect a growth of 4.3% YoY in Mar-22 and it is likely that the IIP print will also improve further due to year-end spurt in economic activity.

- Interestingly, PMI manufacturing in Apr-22 improved marginally to 54.7 from 54.0 in Mar-22, reflecting an expansion in new orders and production. Following a marginal contraction in Mar-22, new export orders rebounded in Apr-22.
- PMI services rose to a 3-month high of 53.6 in Mar-22 compared to 51.8 in Feb-22, aided by the relaxation of Covid restrictions. The full opening up of the services sector post the Omicron wave allowed expansion in new businesses to take shape, even though input costs spiked to the highest level in 11 years.
- GST collections in Apr-22 rose to a record high of Rs 1.68 lakh Cr, capturing revenues for the month of Mar-22. The collection has surpassed the Rs 1.5 lakh Cr mark for the first time since the introduction of tax regime.
- NONG (Non-oil-non-gold) imports, a key indicator of domestic demand, increased sequentially to USD 37.1 bn in Apr-22 vs. USD 36.2 bn in Mar-22.

<u>Chart 2: E-way bills generated soared to a record high in Mar-22</u>



Outlook

After a short disruption in Jan-22 owing to the Omicron wave, most domestic high frequency indicators of economic activity have been in a recovery mode, although the pace has been subdued.

For FY23, the ongoing geopolitical crisis between Russia and Ukraine could potentially act as a dampener for certain sectors, esp. on account of sharp acceleration in input prices, trade related supply disruptions, and a slowdown in the global growth momentum. IMF in its latest edition (Apr-22) of World Economic Outlook, downgraded its global growth forecast to 3.6% in 2022 from 4.4% earlier. In addition, resurgence of Covid led disruptions in certain countries, especially China, could further compound uncertainties on the demand as well as supply front.

Reflecting these uncertainties, optimism in the manufacturing sector for Q1 FY23 marginally moderated in RBI's latest round of industrial outlook survey "due to an ebb in sentiments on inventory of raw materials and finished goods". Recent surveys conducted by other agencies (NCAER, CII, and FICCI) also indicate a sequential moderation in business expectations.

On the consumption side, the rise in retail fuel (including administered petroleum products such as Kerosene and LPG) and food prices are likely to weigh on household disposable income. The upward revision to FY23 inflation expectations could have a greater bearing on consumption recovery in FY23 than anticipated earlier.

Meanwhile, support continues in the form of thrust on public capex (which is helping overall investment activity and exports to hold up despite headwinds), reforms under the 'Atmanirbhar Bharat Abhiyan', and the expectations of a favourable monsoon for the third consecutive year. IMD has pegged rainfall for the country as a whole at 99% of LPA with a margin error of +/-5% in 2022. In addition, improvement in manufacturing capacity utilization to 72.4% in Q3 FY22 (higher than its pre pandemic level of 68.6% in Q3 FY20) corroborates the gradual easing of domestic supply side constraints and bodes well for future activity. High vaccination coverage should also prove supportive for a broader pick-up in contact intensive services.

The prolonged nature of the ongoing war in Ukraine and its adverse impact on commodity prices, will nevertheless, weigh on economic recovery and therefore, we forecast FY23 GDP growth at 7.5% with moderate downside risk.

Acuite
RATINGS & RESEARCH

Inflation

Looks ominous as it gathers steam

KEY TAKEAWAYS

- India's CPI inflation surged to a 17-month high of 6.95% YoY with WPI inflation firming to a 4-month high of 14.55%YoY in Mar-22.
- Price pressures on both wholesale and retail metrics were broad-based, reflecting primarily the run-up in global commodity prices and its pass-through to domestic prices.
- Sequentially, CPI upside was led by index-heavy weight food and beverages, though price pressures were visible in all other sub-categories with the exception of housing.
- Food inflation soared to a 16-month high of 7.47%YoY with nearly a third of the increase (i.e., 248 bps) on account of global spill over impact of ongoing conflict between Russia and Ukraine manifesting in the prices of edible oils and wheat.
- For FY22 CPI inflation averaged at 5.5%, in line with our estimate.
- For FY23, we stick to our upwardly revised estimate of 5.9% with upside risk, premised on the assumption of crude oil price averaging at USD 97-100 pb, adverse global spill overs on food and other commodity prices and core inflation remaining firm amidst reopening up of the economy.

India's inflation on both wholesale and retail side picked up in Mar-22 which primarily reflects the impact of ongoing war between Russia and Ukraine. While WPI inflation hardened to a 4-month high of 14.55% YoY, CPI inflation surged to a 17-month high of 6.95% YoY in Mar-22. Price pressures were broad-based, reflecting primarily the run-up in global commodity prices and its pass-through to domestic prices.

Key highlights: CPI Inflation

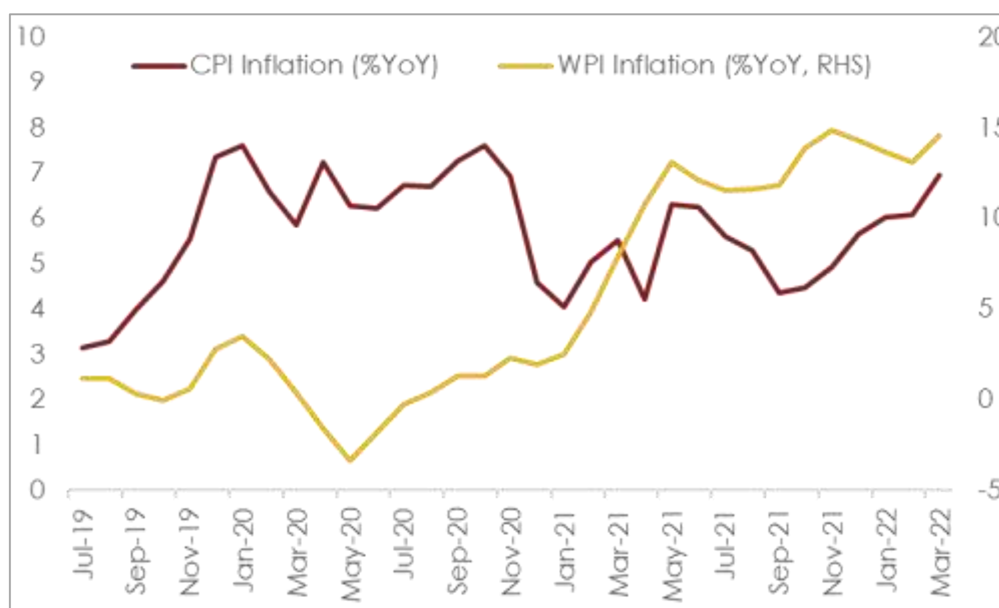
- CPI inflation surged to a 17-month high of 6.95% YoY in Mar-22 vs. 6.07% in Feb-22. While market participants had expected a firming up of price pressures (Market consensus: 6.40%) in Mar-22, the upside surprise was sizeable.
- With this, Mar-22 marked the third consecutive month of CPI inflation remaining above the 6.0% threshold, averaging at 6.3% for Q4 FY22.
- Sequential momentum rose to 0.96% MoM in Mar-22 vs. 0.24% in Feb-22 to mark the highest pace of increment since Oct-21.
- The upside was led by index-heavy weight Food and beverages, though price pressures were visible in all other sub-categories too with the exception of housing.
- Food and beverages index rose by 1.32% MoM in Mar-22, reversing the three consecutive months of decline over Dec-21 and Feb-22. Within food, price pressures were seen across the board in sub-categories of Oils & Fats, Meat & Fish, Fruits, Spices, Milk, Prepared meals & snacks, and Cereals.
- As such, food inflation soared to a 16-month high of 7.47% YoY compared to 5.93% in Feb-22. Nearly a third of the increase in food inflation (i.e., 248 bps) was on account of global spill over impact of ongoing conflict between Russia and Ukraine manifesting on edible oil and cereal prices.
- Fuel and light rose by 0.91% MoM in Mar-22 to match the incremental pace of Feb-22. Once again, the stronger momentum was led by Kerosene prices that saw a double-digit upward adjustment.
- Core inflation momentum (i.e., CPI ex indices of Food & Beverages, Fuel and light, and petrol and diesel in Miscellaneous) quickened to a 10-month high of 0.53% MoM in Mar-22, pushing annualized inflation to 6.53%. Price pressures were strong in both Clothing & Footwear and Miscellaneous sub-categories.
    - Annualized inflation for Clothing & Footwear spiked to 9.40%, a record high, led by hike in GST rate on footwear along with higher demand for summer clothing with the rise in temperatures, in addition to mobility getting restored.
    - Miscellaneous inflation too rose to a 9-month high of 7.02% YoY, led by higher petrol and diesel prices within Transport & communication, Gold within Personal care & effect along with a generalized rise in demand for goods and services amidst reopening up of the economy after the Omicron wave.

Key highlights: WPI Inflation

- WPI inflation remained in double-digits for the 12 th consecutive month in Mar-22, coming in at 14.55% YoY compared to 13.11% in Feb-22.

- Price pressures were broad-based, with primary, fuel and light and manufacturing indices sequentially firming up by 2.10%, 5.68% and 2.31%MoM respectively. Mar-22 marked the sharpest monthly jump in manufacturing index on the 2012 WPI series.
- Within manufacturing, strong price pressures were seen in sub-sectors of Basic metals, Paper & paper products, and Manufactured food.
- Within fuel and light category, double-digit price revisions were seen in Naphtha (+17.7%MoM), ATF (17.3%MoM), Kerosene (+15.7%MoM) and Pet. Coke (11.9%MoM) in the month.

Chart 1: CPI and WPI inflation both end FY22 at multi-month highs



Outlook

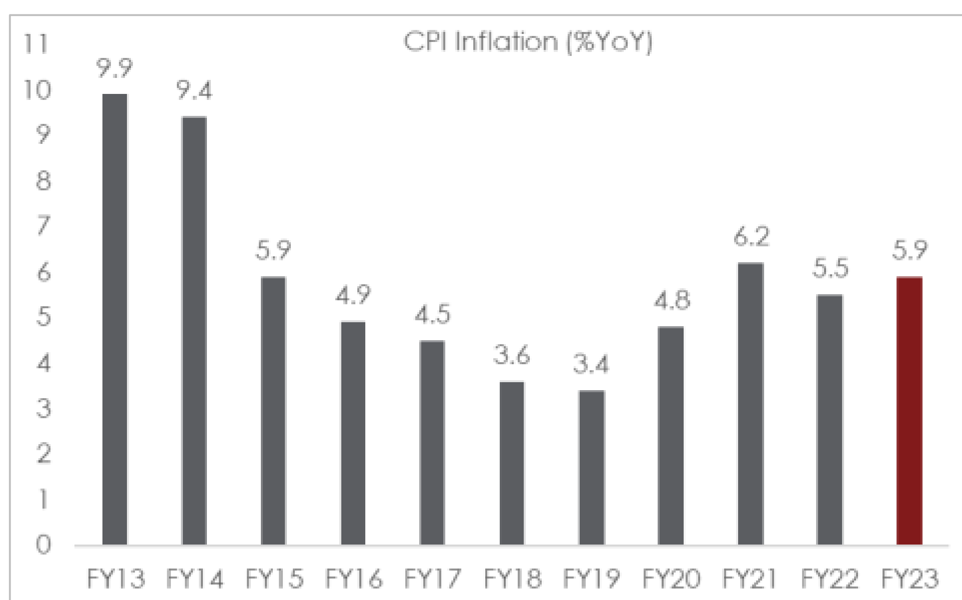
For the fiscal year as a whole, CPI inflation averaged at 5.5%, in line with our estimate. On the other hand, WPI which remained in double-digits throughout the year, averaged at 12.9%.

For FY23, we stick to our upwardly revised estimate of 5.9% for CPI inflation, premised on the assumption of crude oil price averaging at USD 97 pb, adverse global spillovers on food and other commodity prices and core inflation remaining firm amidst reopening up of the economy. Our estimate though includes a fiscal buffer in the form of an additional cut in excise duty of Rs 5 each on petrol and diesel each. Taking on board the adverse impact of the Russia-Ukraine war, RBI has revised upwards its FY23 inflation forecast to 5.7%, sizably close to our estimate in its policy statement in Apr-22. There is a strong possibility that the forecast may be revised further in the next policy meeting in Jun-22.

Looking ahead, Apr-22 CPI inflation reading is likely to remain elevated amidst non-core price pressures from:

- Stronger pass-through of crude oil prices to retail consumers in Apr-22. Recall, price adjustments had begun towards the end of Mar-22, with incremental upward adjustment amounting to close to 1.0% in the month. In comparison, so far in Apr-22 (as of 20th Apr), diesel and petrol price have been adjusted up by 9.2% and 8.1% respectively.
- Food price pressure from perishables especially fruits and vegetables are likely to mount with the onset of the summer season, adding to the global price pressures already escalating in case of edible oils and cereals. India has recorded the warmest month of Mar-22 in over 100 years.
- The imminent price pressures on food could potentially warrant government intervention in the form of draw-down of excess buffer stock/export restrictions in case of wheat. Having said so, manifestation of the anticipated normal monsoon will be critical to keep domestic price pressures manageable. As per IMD's Long Range Forecast for the 2022 Southwest Monsoon Season Rainfall released on 14th Apr-22, for the country as a whole, rainfall is likely to be normal at be 99% of the Long Period Average (LPA) with a model error of ± 5%.

Chart 2: For FY23, we expect CPI inflation to average at 5.9% albeit with upside risk



Government Finances

FY22 fiscal deficit target likely to be met

KEY TAKEAWAYS

- India's central government's fiscal deficit for the period Apr-Feb (data for the months of March and April will be released in May) stood at 82.7% of revised estimates (RE) for FY22 compared to 77.2% of actuals in the corresponding period of FY21.
- Although the central government projected a minor slippage of 0.1% of GDP in FY22 (with RE of fiscal deficit getting re-pegged at 6.9% of GDP vis-à-vis the initial budget estimate of 6.8%), incoming data signals indicate a mixed fiscal position.
- While higher than budgeted tax and spectrum fee collections along with an upward revision to FY22 Nominal GDP (denominator support) provide a positive surprise, the deferment of LIC IPO to FY23 may drag the actual FY22 receipts lower than the budgeted print.
- We expect the risks to broadly offset each other helping the government to stick to the revised fiscal deficit target of 6.9% of GDP in FY22.

India's central government fiscal deficit for the period Apr-Feb stood at 82.7% of revised estimates (RE) for FY22 compared to 77.2% of actuals in the corresponding period of FY21(data for the month of March and April will be released in May). The FYTD accretion to fiscal deficit picked up sharply in Feb-22 largely on account of depletion of net tax revenue on the back of a substantial one-off transfer to states.

Receipts: Continue to provide comfort

Barring the large one-off tax revenue shared with states in Feb-22, total receipts have been buoyed by robust tax as well as non-tax revenue accretion so far.

On FYTD basis (Apr-Feb), gross tax revenue collection clocked a robust growth of 36.6% YoY compared to a contraction of 0.7% seen in the corresponding period in FY21. It's not just the annualized growth that looks better (which is surely aided by a favourable statistical base), the year-to-date gross tax revenue has already achieved 90.4% of the full year RE (vs. 82.2% of actuals in the corresponding period in FY21). Further, vis-à-vis 2-years ago period (to avoid the pandemic related statistical distortion), gross tax revenue has posted a healthy growth of 35.6% during Apr-Feb FY22 vs. the corresponding pre pandemic period in FY20.

- While strong momentum in tax collection is broad based, it is being powered by robust growth in collections of corporate tax, customs, and income tax. We also note that total GST collections in the last six months have averaged above Rs 1.34 tn.

Non-tax revenue too recorded a strong annualized growth of 101.1% YoY in Apr-Feb FY22 compared to a contraction of 41.4% seen during the corresponding period in FY21. Notwithstanding the favourable statistical base support, the key reason for robust performance under this category stems from a significantly higher than budgeted dividend from the RBI. Collection under non-tax revenue is reported to have seen a further spurt in Mar-22 with key telecom companies prepaying their spectrum fee, taking advantage of the current low interest rate regime.

Meanwhile, non-debt capital receipts contracted by 15.3% YoY in Apr-Feb FY22 vs. a contraction of 16.2% seen in the corresponding period in FY21. As per incremental information post Feb-22, the government closed FY22 with a disinvestment revenue of Rs 135 bn. This is significantly lower vis-à-vis the downwardly revised estimate of Rs 780 bn mainly due to the deferral of LIC IPO from Mar-22 to early part of FY23 (the exercise concluded in early May-22).

Expenditure: Momentum slows down

Expenditure disbursal moderated somewhat in Feb-22 resulting in the FYTD (Apr-Feb) run rate slowing down to 11.5% YoY compared to 14.3% seen in the corresponding period in FY21. However, on RE basis, this nevertheless translates to a higher disbursal of 83.4% of the full year revised target vis-à-vis 80.3% (of actuals) seen in the corresponding period in FY21. Few observations:

- Bulk of growth in revenue expenditure continues to be driven by interest payments and subsidies. Excluding these, revenue expenditure stood at a subdued level of 8.6% YoY during Apr-Feb FY22.

- The disbursal of capital expenditure remained subdued for second month in a row. As such, the FYTD run rate for capex disbursals moderated to 19.7% YoY in FY22 (as of Feb) compared to 33.0% in the corresponding period in FY21. Disbursals until Feb-22 continue to be led by the Ministry of Road Transport and Highways. While utilization of capex budget is trailing at 80.5% of RE during Apr-Feb FY22 compared to 95.4% of full year actuals achieved in the corresponding period in FY21, there is still a likelihood of government having achieved the RE for FY22 capex before the end of Mar-22. There have been talks about huge funds which have been released to the defence and the railways towards the end of Mar-22, which has likely enabled capex to record an outlay of ~Rs. 5.9 trn via-a-vis revised estimate of Rs. 6.0 trn.

Outlook

Although the central government projected a minor slippage of 0.1% of GDP in FY22 (with RE of fiscal deficit getting re-pegged at 6.9% of GDP vis-à-vis the initial budget estimate of 6.8%), incoming data signals a mixed fiscal position.

On the positive front:

- Fortunately, the Omicron wave turned out to be relatively less severe for India, both from the perspective of lives as well as livelihood. As such, this is unlikely to have dented the strong momentum in tax collections. In fact, recent media commentary suggests government exceeding its FY22 gross tax collections vis-à-vis RE by around Rs 1.9 tn. Despite the significant positive surprise on gross tax revenue, net collections could end up close to RE due to the record one-off tax devolution of Rs 2.4 tn in Feb-22 (vs. the monthly average of Rs 545 bn seen in the first 10-months of the fiscal).
- The NSO has substantially revised up its FY22 Nominal GDP. As such, the FY22 nominal growth is now projected at 19.4% vs. 17.6% estimated earlier. This will provide a favourable denominator support of 0.2% of GDP.

On the flip side, volatility in equity markets on account of ongoing geopolitical conflict between Russia and Ukraine and the normalization of monetary policy by the US Fed has led to a deferment of the budgeted LIC disinvestment to FY23. As far as the impact on FY22 fiscal position is concerned, the combination of an upside to tax collections (vis-à-vis RE), buffer provided by higher than budgeted Nominal GDP, and some mild pruning of expenditure would help in sticking to the revised fiscal deficit target of 6.9% of GDP.

Having said so, the potential for a pleasant surprise to FY22 fiscal deficit outturn would now shift to FY23 as the LIC IPO would add an additional receipt. Although it is early to conjecture on FY23 fiscal prospects, we can nevertheless conclude that this additional buffer from LIC IPO along with the strong likelihood of higher than budgeted tax revenue collections would be useful in mitigating the slippage risks from:

- extension of PM 'Gareeb Kalyan Anna Yojana' by 6-months till Sep-22 to continue providing relief for priority households at a cost of Rs 800 bn.
- higher than budgeted subsidy bill, especially on account of fertilizers, which currently face supply as well as price disruption from the ongoing conflict between Russia and Ukraine. Recently, the government approved an enhancement in subsidies on non-urea fertilisers for the upcoming Kharif crop to Rs 60.9 bn. The subsidy will be Rs 2,501 per bag on Di-ammonium phosphate

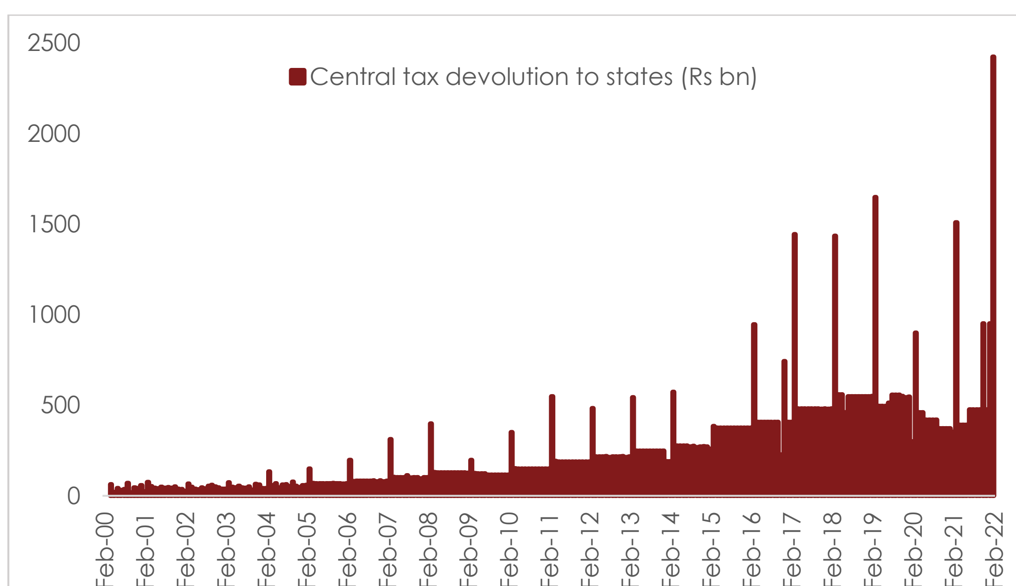
(DAP), instead of the existing subsidy of Rs 1,650 per bag, which is a 50% increase over last year's subsidy rates.

- likely cut in excise duty on petroleum products and some rationalization in select custom duties to share the burden of the sharp spike in global commodity prices.

Table1: FYTD (Apr-Feb) comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position as of Apr-Feb)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	84.0	86.2	-0.5	30.7
Net Tax	85.4	83.9	9.1	21.8
Non-Tax	74.1	98.8	-41.4	101.1
Non-Debt Capital Receipts	74.3	36.3	-16.2	-15.3
Total Receipts	83.6	83.9	-1.1	29.3
Revenue Expenditure	78.2	83.9	11.7	10.2
of which, Interest Payment	82.0	82.4	9.1	19.8
of which, Major Subsidies	61.4	86.0	37.5	1.8
Capital Expenditure	95.4	80.5	33.0	19.7
Total Expenditure	80.3	83.4	14.3	11.5
Fiscal Deficit	**77.2**	**82.7**	**-**	**-**

Chart 1: Central Govt. shared record amount of tax revenue with states in Feb-22



Rates

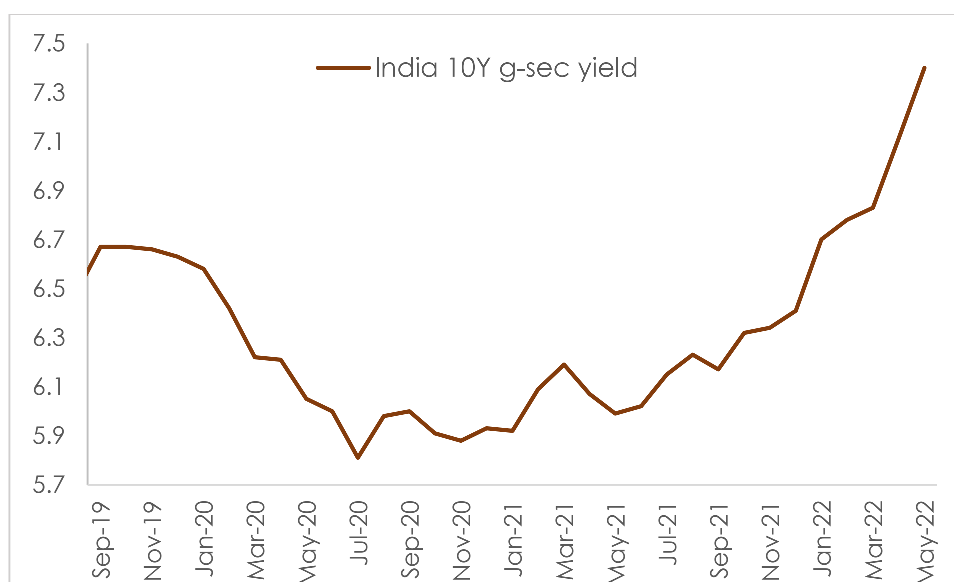
The last bastion falls

KEY TAKEAWAYS

- India's 10Y g-sec yield hardened to a 3-year high, closing at 7.11% in the month of Apr-22 and is currently trading sharply higher at 7.4%.
- Amidst escalating inflation risks, the domestic monetary policy made a hawkish pivot in Apr-22 by restoring the width of the policy rate corridor from 90 bps to 50 bps in one shot using a new floor rate viz., SDF in lieu of the reverse repo rate.
- Further, in a completely surprising move and in an unscheduled MPC meeting in early May, the RBI announced emergency rate hikes with repo rate moving up by 40 bps to 4.40% and CRR climbing up by 50 bps to 4.50%.
- Meanwhile, led by the US Fed, monetary policy normalization by other central banks continues to gather momentum.
- We continue to expect the RBI to hike repo rate by another 60 bps in the rest of FY23.
- However, worsening of inflation risks could potentially make a case for additional rate hike, thereby taking the repo rate to its pre pandemic level of 5.15% or higher by end FY23.
- We also see 10Y g-sec yield moving higher towards 7.50-7.75% range before the end of FY23.

India's 10Y g-sec yield has been climbing up for the past five months. After closing the month of Apr-22 at 7.11%, the 10Y g-sec yield has hardened to 7.4% in the month of May-22 so far. The March 2022 edition of the 'Acuité Macro Pulse' report had cautioned on the stability in Indian g-sec yields amidst mounting of global and domestic risk factors. All the key risks either continue to persist or have become somewhat emphatic in the last one month. Local rates market has now started to reflect these risks with a one-shot sharp adjustment in Apr-22.

Chart 1: 10Y g-sec yield moves up to a 3-year high level



Domestic monetary policy pivot

After maintaining a prolonged pause on monetary policy for nearly two years, India's central bank finally embarked upon the journey of normalizing policy rates. We had expected the RBI to start the process of policy rate normalization in Apr-22 with narrowing of the policy rate corridor (Liquidity Adjustment Facility) in a two-step process involving a 20 bps hike in the reverse repo rate in each of the Apr-22 and Jun-22 policy review meets. However, the central bank surprisingly showed urgency in restoring the width of the policy rate corridor from 90 bps to its pre pandemic level of 50 bps in one shot. Further, the RBI replaced the lower bound of the policy rate corridor – the reverse repo rate – by the overnight Standing Deposit Facility. Unlike the reverse repo window, the SDF will be uncollateralized, and hence enhance central banks' flexibility in managing surplus liquidity situations. The revised policy rate corridor now comprises of the MSF rate at 4.25% (unchanged), repo rate at 4.00% (unchanged), and SDF rate at 3.75% (new).

The surprise factor escalated further in early May-22 when the Monetary Policy Committee in an inter-meeting move raised repo rate by 40 bps to 4.40%, thereby resulting in the MSF and SDF rates to adjust upwards to 4.65% and 4.15% respectively.

In addition, the RBI also announced a 50 bps increase in the CRR to 4.50% of bank's NDTL (net demand and time liabilities).

It appears that the following factors could have prompted the central bank for an emergency rate hike:

- The RBI appears to have reassessed inflation risks and now expects "strengthening of inflationary impulses in sync with the persistence of adverse global price shocks" to pose "upward risks to the inflation trajectory presented in the April MPC resolution". While the central bank refrained from sharing its revised assessment on inflation (to be updated in Jun-22 policy review), the risk of 6%+ number on inflation now seems likely vis-à-vis RBI's Apr-22 forecast of FY23 CPI inflation at 5.7%.
- Escalation of inflation risks are expected to play out even as growth conditions remain stable in accordance with the Apr-22 projection of FY23 GDP growth of 7.2%. The central bank believes that emerging downside risks from deceleration in global growth, elevated input prices, and tightening of global financial conditions would get offset with support from domestic factors like normal monsoon, unlocking of the economy, and supportive fiscal policy backdrop.
- The timing of rate action, pre-empting the announcement of the US Federal Reserve's policy (in line with consensus expectations, the FOMC delivered a 50 bps hike in the fed funds rate while also announcing its plan for quantitative tightening beginning Jun-22) makes us believe that the RBI also incorporated financial stability concerns into its decision making.
    - Post the cumulative 75 bps hike by the Fed in 2022 so far, market pricing suggests likelihood of another 200 bps rate increase from the FOMC before the end of 2022.

We also note that among the 37 central banks tracked by the Bank of International Settlements (BIS), 15 have adjusted their monetary policy rate above pre pandemic levels. With Fed tightening expected to commence at an aggressive pace, more central banks are likely to push ahead with monetary policy normalization.

Given the tone of urgency in RBI's statement to support the altered inflation-growth dynamics, we now revise our call and expect the RBI to hike repo rate by an additional 60 bps in the rest of FY23. However, if inflation pressures continue to mount there is a likelihood of additional hikes thereby taking the rate to its pre pandemic level of 5.15% or even higher in FY23 (vis-à-vis our previous forecast of repo rate at 4.50% with risk of 4.75% before the end of FY23). The rate increase is likely to get front loaded keeping in mind the elevated inflation risks in the near-term and the fast-evolving global monetary policy cycle.

Outlook

Domestic fiscal pressures (in the form of record high central government borrowing in FY23) and global rates environment have been playing an adverse role in the domestic bond market in last two months. While g-sec yields did come under pressure on account of these factors, the upside was restrained on account of the accommodative domestic monetary policy till Apr-22.

With that lone bastion of support now beginning to fade, g-secs have come under pressure. We had been maintaining our call of 10Y g-sec yield drifting higher towards 7.5% before end FY23. However, there is now a probability of upside risk to this forecast as market expectations align with RBI's hawkish policy pivot. As such, we now revise up our 10Y g-sec yield forecast to 7.75% before the end of FY23.

Notwithstanding the upside risk to yields, we do expect the central bank to rely on tools like Open Market Operations (OMO), Operation Twist (OT) and verbal suasion, to facilitate an orderly evolution of the yield curve and to support a smooth completion of government's FY23 borrowing program.

Rupee

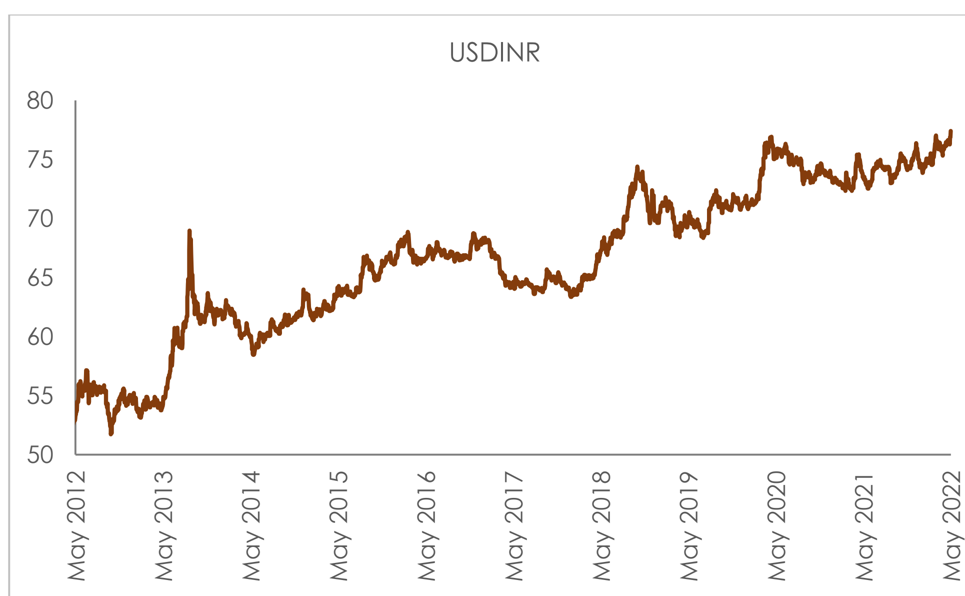
Under Pressure

KEY TAKEAWAYS

- The Indian rupee has weakened for four straight months culminating into a depreciation of 4.1% in 2022 so far, with rupee hitting a record low of 77.4 in May-22 amidst strengthening USD and FPI outflows.
- The dollar is likely to continue deriving support from aggressive pricing in of monetary policy normalization in the US along with geopolitical led risk aversion.
- The combination of elevated global commodity prices, sequential improvement in domestic growth, and gradually increasing vaccination coverage is resulting in widening of trade and current account deficit for India.
- Portfolio outflow has picked up momentum with markets aligning to US monetary policy normalization and spike in commodity prices amidst ongoing geopolitical conflict between Russia and Ukraine.
- We expect India's current account deficit to widen to USD 85 bn with upside risk in FY23 from an estimated level of USD 47 bn in FY22.
- While anticipated BoP deficit would weigh on INR in FY23, the support from real yield spread and FX reserve cover would soften the blow.
- With extreme depreciation pressures faced by the INR currently, we expect USDINR pair to cross our year end forecast of 78 levels in the next 1-2 months.
- Nevertheless, RBI's likely intervention in the forex market amidst strong FX reserves is expected to provide first line of defense against any excessive volatility.

The Indian rupee has weakened for four straight months culminating into a depreciation of 4.1% in 2022 so far, with rupee hitting a record low of 77.4 in May-22 amidst strengthening USD and FPI outflows. On fiscal year basis, rupee weakened by 3.7% in FY22, closing the year at 75.79 (close to our target of 76 for end Mar-22). The currency pair has lost further ground since then and is currently trading close to its record low of 77.41 levels.

Chart 1: INR is currently trading close to its weakest levels



Global and domestic developments continue to point towards the likelihood of further weakness in INR. In fact, the pipeline factors for moderate rupee depreciation have strengthened in the last two months with surge in global commodity prices amidst the ongoing geopolitical conflict between Russia and Ukraine.

On the global front, dollar supportive environment continues to persist.

- High inflation is not just prompting the US Fed to start scaling back exceptional monetary policy accommodation provided since the onset of the pandemic in Mar-20, but it has also imparted policy aggression and urgency to tame inflation by projecting fed funds rate above the neutral rate by the end of 2023. To begin with, the FOMC have raised policy rates cumulatively by 75 bps so far, joining its DM peers (BoE, BoC, RBNZ, and Norges Bank) in taking a formal step towards interest rate normalization.
- The ongoing geopolitical crisis between Russia and Ukraine has also cast its shadow on European currencies like the EUR, GBP, CHF, and SEK (comprising ~77% share in the DXY Index), which have weakened by 0.6-11.1% since the start of the conflict. Europe's greater economic linkage with Russia-Ukraine vis-à-vis US is acting as a supplementary source of dollar strength in the current environment. The dollar index is at a record high since 2003.

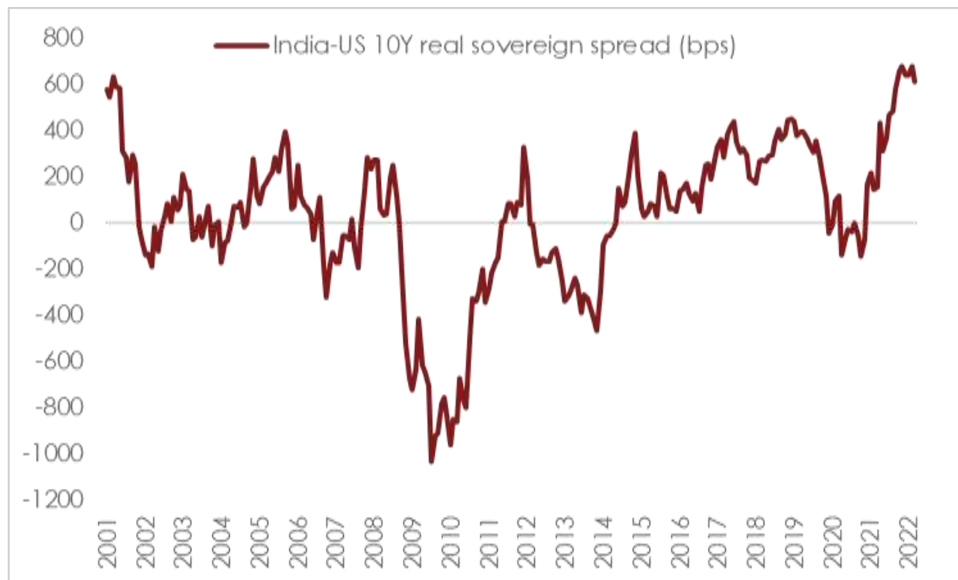
On the domestic front, the BoP comfort is expected to peter out completely amidst the commodity price shock from the ongoing conflict between Russia and Ukraine.

- Assuming an average price of Brent oil at USD 100 pb levels, we project current account deficit to widen to more than USD 85 bn in FY23 from an estimated level of USD 47 bn in FY22. The expectation of widening of current account deficit not just rests upon the likelihood of elevated global commodity prices, but is contingent upon the following factors:
    - Unlocking of the economy post the Omicron wave has begun to revive pent-up demand.
    - Improving vaccination cover (62% of the population has so far received two doses) will limit future Covid led disruptions and also aid organic recovery, which continues to find support from accommodative monetary policy and capex focused fiscal policy.
    - While PLIs would start accreting to export buoyancy in a gradual manner from FY23 onwards, we also need to be cognizant of continued disruption due to Covid (of late there is resurgence in infections in South Korea, Vietnam, Japan, China, Germany, etc.).
- The pressure on trade deficit is increasing at a time when portfolio outflows have remained persistent since Oct-21. Compared to a net FPI inflow of USD 4.3 bn in H1 FY22, H2 FY22 saw a net outflow of USD 23.3 bn from Indian equity and debt markets (FPI selling has continued thereafter with Apr-22 recording a net outflow of more than USD 2 bn so far). Elevated domestic equity valuations, surge in global commodity prices on account of geopolitical conflict, aggressive normalization of US monetary policy, and lack of any commitment from the FY23 Union Budget with respect to India's inclusion in global bond indices could keep portfolio flows subdued in the near term.
- As such, we expect FY23 BoP to register a moderate deficit to the tune of USD 8 bn.

Despite the buildup of depreciation bias, rupee appears to be broadly stable as:
- India's FX Reserves (including net forward reserves) appears comfortable at ~12 months of import cover, its highest in last 12-years. This provides the first line of defense against any excessive volatility. The reserves, however, have witnessed a moderation over the last months due to higher trade deficit and capital outflows.
- India's long term (10Y) sovereign real yield spread vis-à-vis the US has remained over 600 bps in last 6-months, the highest in nearly two decades. With adequate FX Reserves helping to curb volatility, the risk-adjusted carry will continue to favor rupee, thereby providing partial insulation from aggressive rate hikes in the US.

Overall, with extreme depreciation pressures faced by the INR in the near term, we expect USDINR pair to cross our year end forecast of 78 levels in the next 1-2 months.

Chart 2: Real yield spread continues to favor INR over USD



Global Overview

Deteriorating economic prospects

KEY TAKEAWAYS

- Global economic prospects continue to deteriorate amidst the ongoing and now somewhat prolonged geopolitical conflict between Russia and Ukraine.
- The crisis is unfolding at a time when the global economy had not yet fully recovered from the impact of the pandemic. The economic effects of the war are being felt across both advanced economies and EMDEs via elevated commodity prices, slowdown in trade and financial sector reverberations.
- Specifically, price pressures in food items such as wheat and corn, along with crude oil are having an adverse impact on energy intensive sectors and cost of living in several economies.
- In addition, the resurgence of Covid infections in China and the concomitant lockdowns too are exerting an adverse impact on port activity and leading to bottlenecks in global supply chains.
- Estimating economic damage from the conflict, IMF in its latest World Economic Outlook lowered 2022 global growth projection by 80 bps to 3.6% and upped CPI inflation estimate higher to 5.7% for advanced economies and 8.7% for EMDEs – an upward revision of 180 bps and 280 bps vis-à-vis Jan-22 estimates.

Global Overview

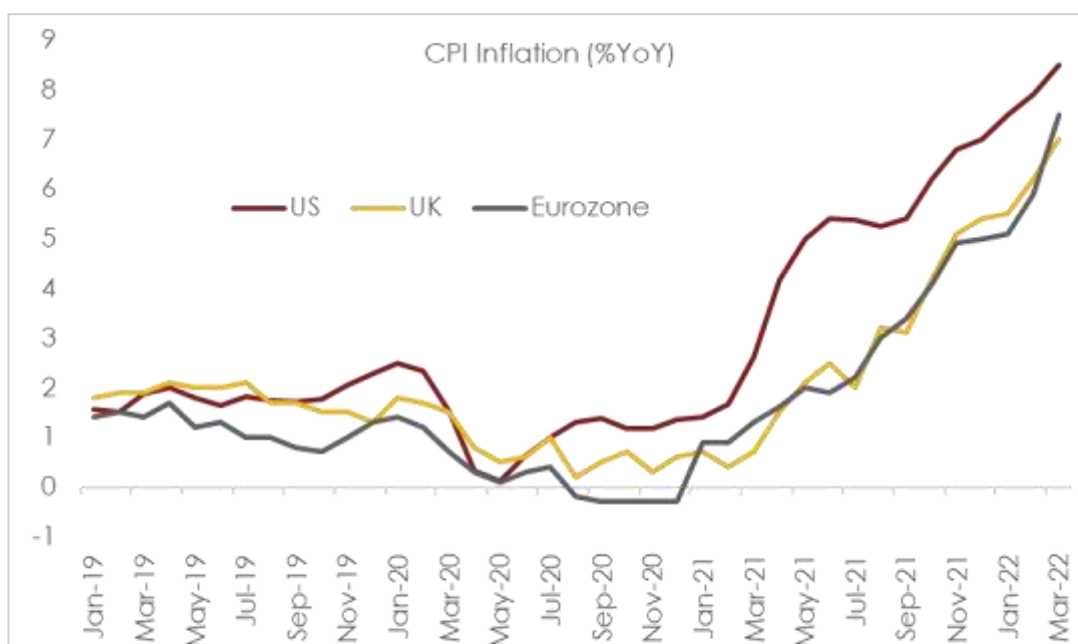
Global economic prospects continue to deteriorate amidst the ongoing and now somewhat prolonged geopolitical conflict between Russia and Ukraine. The crisis is unfolding at a time when the global economy had not yet fully recovered from the impact of the pandemic. The economic effects of the war are being felt across both advanced economies and EMDEs via elevated commodity prices, slowdown in trade and financial sector reverberations. Specifically, price pressures in food items such as wheat and corn, along with crude oil are having an adverse impact on energy intensive sectors and cost of living in several economies. The FAO Food Price Index averaged 159.3 points in Mar-22, up 12.6% from Feb-22 when it had already reached its highest level since its inception in 1990. In addition, the resurgence of COVID infections in China has hampered activities in key manufacturing hubs such as Shenzhen and key port such as Shanghai aggravating the already strained global supply chains.

The economic damage from the conflict, as per International Monetary Fund's (IMF) latest World Economic Outlook (Apr-22 edition) will contribute to a significant slowdown in global growth and add to inflation in 2022. Global growth is projected to moderate from 6.2%YoY in 2021 to 3.6% in 2022 – a downward revision of 80 bps for 2022 outlook compared to IMF's Jan-22 estimate. Additionally, war-induced commodity price rally is anticipated to push CPI inflation higher to 5.7%YoY in advanced economies and 8.7%YoY in EMDEs in 2022 – an upward revision of 180 bps and 280 bps vis-à-vis Jan-22 estimates. In a more pessimistic assessment compared to IMF's, the United Nations Conference on Trade and Development (UNCTAD)'s Trade and Development Report released in Mar-22 downgraded global growth projection by 100 bps to 2.6% from its Oct-21 forecast of 3.6%, on the assumption that the sanctions and supply chain disruptions will last through 2022 even if the war ends.

Chart 1: IMF in its Apr-22 outlook, has downgraded global growth for 2022 to 3.6%

On the macroeconomic front, the global composite PMI moderated to 51.0 in Apr-22 from 52.7 in Mar-22, owing to escalation of geopolitical tensions, tightened supply chains, dampened demand and business confidence amidst soaring energy and other input costs. In addition, the pass-through of higher commodity prices saw headline inflation in key advanced economies spike further to new record highs in Mar-22. US and Eurozone annualized inflation accelerated further to near four-decades high of 8.5% and 7.5% respectively in Mar-22, while UK inflation soared to a three decade high of 7.0%YoY. This significantly higher inflation vis-à-vis central bank inflation targets has hastened the withdrawal of accommodative monetary policy stances despite rising risks to growth.

Chart 2: CPI inflation continues to scale to newer highs in key advanced economies



US

US GDP growth unexpectedly declined coming at -1.4% YoY vs. 6.9% in Q4making an abrupt reversal at the start of the year. Currently, the pace has seen some further amidst onslaught of Russia-Ukraine war that has prolonged supply chain bottlenecks and added to an already elevated inflation. CPI index rose at a strong pace yet again in the month of Mar-22, at 1.2% MoM to push the headline rate of inflation to a near four decades high of 8.5%YoY. Of this, energy prices soared by 11%MoM led by crude oil, while food prices increased by 1.0%MoM. Other components, such as shelter, apparel and medical care too posted solid gains, with some respite coming from a decline in price of used cars and trucks along with education costs.

On the production side, ISM manufacturing index eased to 55.4 in Apr-22 vs. 57.1 in Mar-22, defying expectations of an uptick. The setback reflects lingering supply chain strains owing to recent COVID containment measures in China, with both new orders and output weakening to levels last seen in May-20

On the other hand, labour market continues to remain tight. As per Apr-22 jobs report, economy added 428k non-farm payrolls. The gains though moderated a tad from the previous month, they continue to remain strong and fairly broad-based across key

services sectors of retail, trade & transport, leisure & hospitality among others. With this, the unemployment rate remained unchanged at 3.6% in Apr-22.

On the monetary policy front, in line with expectations the US Fed hiked policy rates by an additional 50 bps, pushing the benchmark in the range of 0.75%-1.0%. This is Fed's biggest hike in over two decades that shows its aggressive approach to tame mounting inflationary pressures. The Fed also decided to start monetary tightening from June onwards with monthly cap of USD 30bn for treasuries and USD 17.5bn for mortgage-backed securities (MBS) till August. Post that the monthly cap will be increased to USD 60bn for treasuries and USD 35bn for MBS. The focus of the central bank remains of reigning-in high inflation. Looking ahead, Fed Chair indicated 50bps hikes for the next couple of meetings and stated that the FOMC wasn't actively considering 75bps hikes. The need for further policy tightening is driven by labour markets remaining extremely tight with 1.9 job vacancies for every unemployed person. Monetary policy tightening is aimed at aligning demand with reduced labour supply. The Fed Chair remained hopeful of engineering a soft landing given the strong balance sheets of households and businesses.

EUROZONE

The Eurozone economy, expanded at a slower pace of 0.2% QoQ in Q1 2022 from 0.3% in Q4 2021, owing to pandemic related restrictions and the impact of the Russia-Ukraine war. The IMF in its latest WEO revised down its growth forecast for the region for 2022 to 2.8% from 3.9% as per its Jan-22 estimate, with the region's biggest economy Germany, taking a heavy hit. German GDP growth for 2022 stands revised lower by a sizeable 170 bps to 2.1%. "*The main channel through which the war in Ukraine and sanctions on Russia affect the euro area economy is rising global energy prices and energy security*," the IMF said in the report.

While consumer confidence in the eurozone continued to decline in double digits to -16.9 in Apr-22 from -18.7 in Mar-22. Additionally, retail sales declined in Mar-22 by 0.2% MoM from an 0.3%MoM increase in Feb-22.

Soaring energy and food prices, pushed annualized inflation in the region to a fresh four decade high of 7.5% in Apr-22 from 7.4% in Mar-22. While higher energy costs were the main culprit, price pressures have become more broad-based. On the other hand, labour market continues to improve, with unemployment falling to a historical low of 6.8% in Mar-22. Job postings across many sectors still signal robust demand for labour, yet wage growth remains muted overall.

In its Apr-22 policy, the ECB retained the pace of reducing net asset purchases remains unchanged at EUR 40 bn per month in Apr-22, EUR 30bn in May-22 and EUR 20 bn in Jun-22. However, the announcement to end net asset purchases in the third quarter was slightly firmer than at the last meeting. President Lagarde confirmed in the post policy press conference that rates could be increased "*some time after*" the end of net asset purchases, clarifying that "*some time after*" could range from one week to several months. However, momentum is building for the ECB to raise interest rates in July to fight soaring inflation, after dovish policymakers indicated they are ready to accept an end to almost eight years of negative borrowing costs.

UK

Economic growth strengthened further over the months of Jan-22 and Feb-22 in UK, but the ongoing conflict between Russia and Ukraine has clouded the outlook. As per the monthly data, GDP grew by 0.1% in Feb-22 following a 0.8% growth in Jan-22. Growth in Feb-22 has been primarily driven by services sector, which offset the fall in industrial production and construction sectors. Strong growth within services was seen in tourism related industries with increases in both travel agency, tour operator and other reservation service and related activities (33.1%MoM) and accommodation (23%MoM). However, the strength in services sector eased in Apr-22 with PMI services index moderating to 58.9 in Apr-22 from 62.6 in Mar-22. In comparison, PMI manufacturing index expanded marginally to 55.8 in Apr-22 from 55.2 in Mar-22. The survey's gauge of new orders dropped to a level last seen in Jan-21 owing to a slowdown in domestic demand and export orders.

On the inflation front, UK's CPI inflation posted yet another upward surprise, as it came in at 7.0%YoY in Mar-22 (a 30-year high) compared to 6.2% in Feb-22. Unsurprisingly, the acceleration in large part was driven by fuel prices that increase by 10%MoM along with price pressures seen in furniture and hospitality services. It is expected that Apr-22 will mark the peak of inflation before it begins to descend lower. Reflecting the impact of higher inflation, retail sales fell further by -1.4% MoM in Mar-22 from -0.5% in Feb-22 and GfK consumer confidence deteriorated more markedly to a 16-month low. In a support to households, labour market continues to remain robust, with a further small fall in the unemployment rate which dropped by 0.1% to 3.8% in Mar-22 to equal the mutli-decade low seen just before the pandemic.

Reflecting the impact of geopolitical cross currents, IMF cut its forecast for UK GDP growth for this year to 3.7% from Jan-22's forecast of 4.7%, while for 2023 the growth rate was almost halved to 1.2% from 2.3%. In a widely expected move, the Bank of England rose interest rates to the highest level in 13-years. The Bank's Monetary Policy Committee approved a 25-basis point increase by a majority of 6-3, taking the base interest rate up to 1.0% in a bid to tackle soaring inflation. The Bank further expects UK inflation to rise to roughly 10% this year as a result of the Russia-Ukraine war and lockdowns in China. It has also warned prices are likely to rise faster than income for many people, deepening the cost of living crisis.

CHINA

China's GDP grew by 4.8%YoY in Q1-22 compared to 4.0% in Q4-21, faring better than expected especially given that the quarter had an adverse base from last year's 18.3%YoY growth in Q1. In other data, retail sales contracted by 3.5%YoY in the quarter, as consumer spending remained subdued amidst local travel restrictions during Beijing Winter Olympics and lockdowns in Shenzhen and Shanghai in Mar-22 as Covid cases soared. Industrial production expanded by 5.0% YoY in Mar-22, faring better than the sentiment captured by PMI survey that had slipped into contraction in the month. Having said so, manufacturing activity did suffer a setback as the lockdown hampered movement of logistics and led to port disruptions. Unsurprisingly, jobless rate rose yet again to 5.8% in Mar-22 from 5.5% in Feb-22. Looking ahead, further impact from lockdowns is imminent as delivery services and port disruptions have begun to wane only at a gradual pace in Apr-22. While Shanghai has

announced a plan for a phased lifting up of lockdown restrictions, it lacks a timeline and remains contingent on reduction in COVID cases.

In a bid to support flailing growth, the People's Bank of China (PBoC) announced a 25 bps cut in Reserve Requirement Ratio (RRR) effective 25 Apr-22, releasing about 530 bn yuan in long term liquidity. This was followed up by a set of 23 financial measures announced by the Central bank in a bid to boost lending and support industries impacted by the recent lockdowns. These measures including lending guidance for banks, credit guarantees, targeted lending for the MSME sector among others. Reinforcing the downside to growth, IMF in its Apr-22 WEO cut China's 2022 GDP growth forecast by 40 bps (from its January forecast) to 4.4% compared to 8.1% in 2021.

About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 9,000 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

Media Contacts:

Roshni Rohira Ph: + 91-9769383310 roshnirohira@eminenceonline.in	Sahban Kohari Ph: + 91-9890318722 sahban@eminenceonline.in

Investor Outreach: **Analytical Contact:**

Rituparna Roy Deputy Vice President Ph: + 91-7506948108 rituparna.roy@acuite.in	Suman Chowdhury Chief Analytical Officer Ph: + 91-9930831560 suman.chowdhury@acuite.in

DISCLAIMER: This report is based on the data and information (data) obtained by Acuité from sources it considers reliable. Although reasonable care has been taken to verify the data, Acuité makes no representation or warranty, expressed or implied with respect to the accuracy, adequacy or completeness of any Data relied upon. Acuité is not responsible for any errors or omissions or for the results obtained from the use of the report and especially states that it has no financial liability, whatsoever, for any direct, indirect or consequential loss of any kind arising from the use of its reports. Any statement contained in this report should not be treated as a recommendation or endorsement or opinion or a substitute for reader's independent assessment.