MACRO PULSE

AUGUST 2021

Contents

From the desk of the Chief Analytical Officer

It is our pleasure to bring you the **eighth** edition of **Acuité Macro Pulse** (Aug 2021). We not only analyse a wide spectrum of macroeconomic indicators in this monthly publication but also endeavour to weave them all together to bring to you an insightful commentary on the emerging domestic and economic landscape.

The headwinds in the economy hopefully, seems to be on the wane with the risk of another disruptive wave of the Covid pandemic having reduced, though not eliminated. The needle hasn't moved much as regards daily caseloads and mortalities in Aug-21 remaining in a narrow range of 40,000-42,000 and 400-500 respectively, particularly given the intensity of infections in Kerala which is contributing to around 70% of the national aggregate. What is encouraging, however on the pandemic front is the steady progress in the vaccination rate with around 37.8% of the country's population having received the first dose by end of Aug-21. With higher production and availability, the momentum on vaccination is set to build up further over the next quarter and an 80% milestone by Dec-21 remains very much achievable, which will not only mitigate the risks of new waves of the pandemic but also provide a boost to the growth outlook. An expectation of a steady progress on vaccination and a revival in domestic private consumption along with strong support to exports from global economic growth facilitated by an accommodative policy backdrop (both monetary and fiscal) continue to underpin our FY22 GDP growth forecast of 10.0%.

Apart from the regular sections on the different facets of the economy, we also carry in this edition **a special section on Corporate Credit Quality**. Acuité has a partnership with Prime Database for ratings migration data across all CRAs and the availability of such data has enabled us to bring you a comprehensive picture of ratings upgrades vs downgrades in the aggregate corporate universe. What is noteworthy is that the rating upgrades have surged by 2.4 times in the Apr-Aug'21 period vis-à-vis the comparative period in the previous year whereas the downgrades have dropped by 40%, leading to a spurt in the Credit Ratio to 2.3 times for the 5 month period. The rating actions, therefore, also corroborate the optimism that is building up around the economy since the intense second wave of the pandemic.

Among the potential challenges to a steady revival in the economy, stands the spectre of inflation. While the headline CPI inflation continues remain around the upper range of the MPC tolerance band, the easing of supply constraints and moderation in commodity prices along with a gradual pickup in demand is likely to ensure that there is no material surprise in CPI print over the next few months. While any decline in kharif crop output in the current season may accentuate food inflation risks, it can be offset by measures such as tax rationalization that can potentially reduce food and fuel prices.

Hope you enjoy reading this edition, feel free to drop a line with your comments or suggestions.

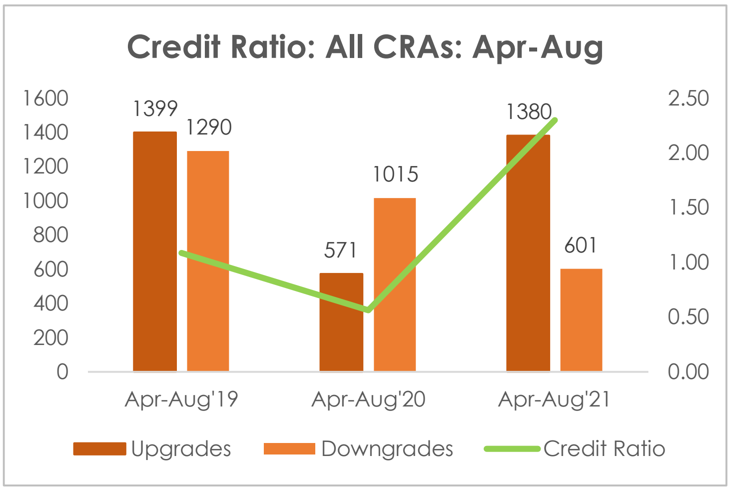
Suman Chowdhury
Chief Analytical Officer

Corporate Credit Quality

Sharp recovery in corporate credit quality

Gradual unlocking along with measures by RBI and Govt drive rating upgrades

Acuité has undertaken an analysis of the overall rating migration data for the April-Aug period over the last 3 years. What emerges is a sharp recovery in the [1]Credit Ratio (CR) of the CRA industry from 0.56x in the previous year to 2.30x in the current year which is significantly higher than the levels seen in the pre-pandemic year i.e. FY20.

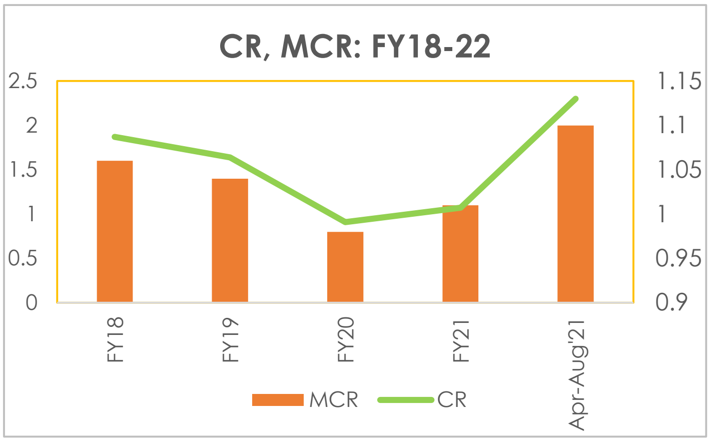


All CRAs	Apr-Aug19	Apr-Aug'20	Apr-Aug'21
Upgrades	1399	571	1380
Downgrades	1290	1015	601
Credit Ratio	**1.08**	**0.56**	**2.30**

Source: Prime-Acuité Rating Migration Database

The number of upgrades have increased by 2.4 times in the Apr-Aug'21 period vis-à-vis Apr-Aug'20 and the downgrades have almost reduced by 40%. Further, the number of upgrades during this five month period is almost similar to that in the pre-Covid year while the number of downgrades has almost halved from those levels.

[1] CR is the ratio of upgrades to downgrades in a given period, non-cooperative issuers excluded



	FY18	FY19	FY20	FY21	Apr-Aug'21
CR	1.87	1.64	0.91	1.07	2.30
MCR	1.06	1.04	0.98	1.01	1.10

Source: Prime-Acuité Rating Migration Database

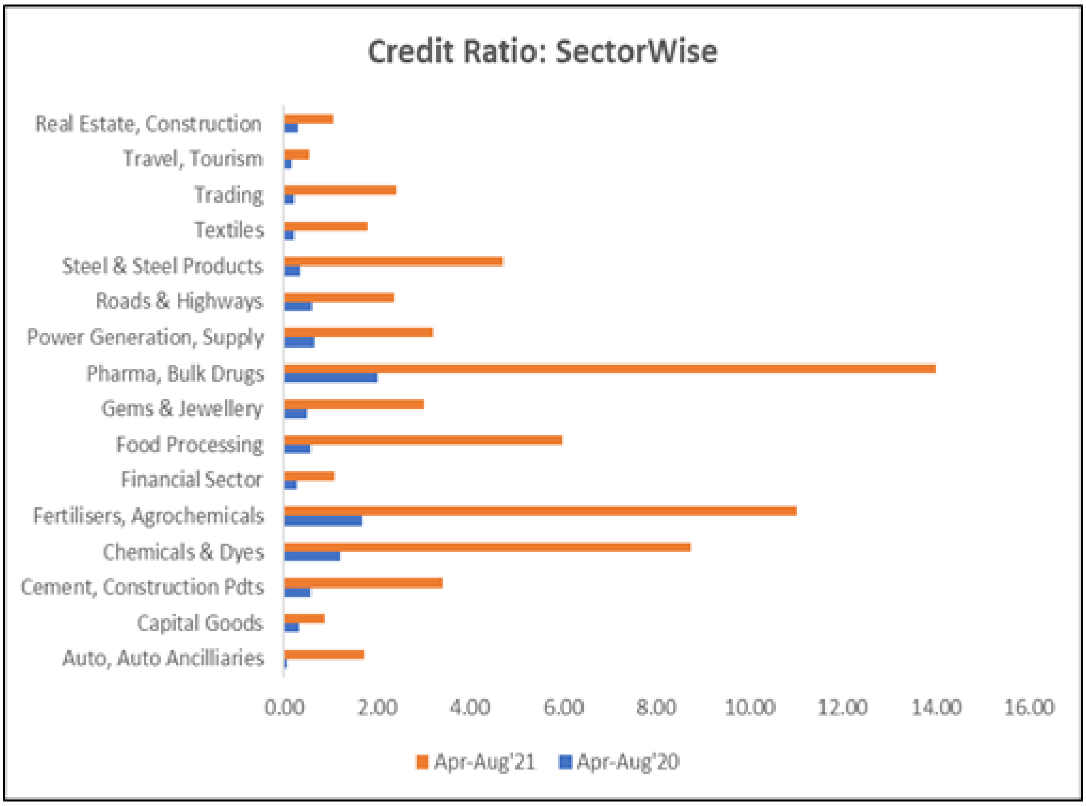
We have also looked at a longer time horizon since FY18 and analysed the movement of both Credit Ratio (CR) and [2]Modified Credit Ratio (MCR). While the volatility in the MCR is far less than the CR given the stability provided by addition of the reaffirmation cases, the trajectory in both the ratios first reflect the slowdown in the economy since FY19 which got severely aggravated by the Covid pandemic starting from the last quarter of FY20 and thereafter, the subsequent recovery that has been set in motion in the current year. Most of the downgrades that happened in the first half of FY21 had taken into account an actual or expected deterioration in the liquidity position and a severe impact on the business profile of the rated entity.

The sharp upsurge in the Credit Ratio in the first 5 months (Apr-Aug) of the current fiscal can be explained by the following:

- A resilient corporate performance in FY21 in a significant part of the manufacturing sector including lower debt levels vis-à-vis the apprehensions in the early part of the pandemic
- With a steady progress in vaccination and gradually declining risks of a third wave of the pandemic, private consumption demand is expected to revive from H2FY22 and the ratings have started to factor in such a scenario
- Significant number of monetary policy measures taken by RBI since the outbreak of Covid-19 which has helped the corporate and the financial sector to meet their funding requirements and stabilise their liquidity position
- Various relief measures announced by the Government of India importantly, the Emergency Credit Line Guarantee Scheme (ECLGS) with an initial amount of Rs 3 Lakh Cr which enabled banks to disburse additional funds to enterprises facing a working capital crunch
- Buoyancy in the export sector since H2FY21 which have largely offset the weak demand in the domestic sector
- Favourable monsoon conditions and healthy agricultural output since last year which has kept rural demand at steady levels though despite a moderate impact of the second wave of Covid

[2] MCR is the ratio of upgrades and reaffirmations to downgrades and reaffirmations

The credit ratio across the various sectors highlights the following aspects:



- There is a distinct recovery in the core infrastructure sectors with the focus on higher infrastructure investments leading to higher demand scenario in steel, cement and power
- With the removal of lockdown restrictions, the road sector has also started to see a recovery both in terms of project completion and toll collection
- There is also a significant revival in sectors such as auto, gems and jewellery and textiles with expectation of a pent up demand
- Few sectors such as chemicals, pharma and fertilisers were not only resilient to the economic disruption caused by the Covid pandemic but their business and financial position have strengthened over the last one year
- The improving credit ratio in the financial sector reflects a significant moderation in concerns on asset quality deterioration and liquidity impairment, given the monetary and the fiscal support measures; however, the credit ratio at 1.08x in Apr-Aug'21 indicates the continuing uncertainty particularly on retail asset quality
- The travel and the hospitality sector, understandably has been severely impacted during the pandemic and the persistent weak credit ratio indicates that recovery herein will take at least a few quarters; similar is the case for the real estate sector
- There appears to be an uptick in the capital goods sector although the number of downgrades is still slightly higher than that of upgrades

Annexure-1

Sector	Apr-Aug'20	Apr-Aug'21
Auto, Auto Ancilliaries	0.08	1.73
Capital Goods	0.33	0.89
Cement, Construction Pdts	0.57	3.40
Chemicals & Dyes	1.22	8.75
Fertilisers, Agrochemicals	1.67	11.00
Financial Sector	0.29	1.08
Food Processing	0.57	6.00
Gems & Jewellery	0.50	3.00
Pharma, Bulk Drugs	2.00	14.00
Power Generation, Supply	0.65	3.21
Roads & Highways	0.60	2.36
Steel & Steel Products	0.36	4.71
Textiles	0.23	1.81
Trading	0.23	2.41
Travel, Tourism	0.16	0.56
Real Estate, Construction	0.30	1.06

Source: Prime-Acuité Rating Migration Database

Growth

In recovery mode

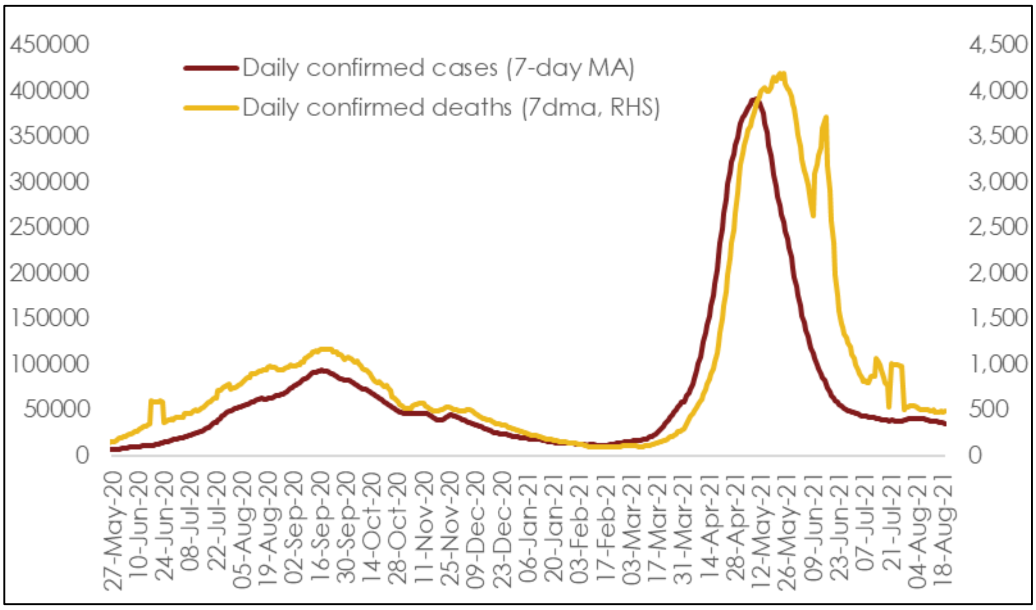
KEY TAKEAWAYS

- Economic activity continues to tread a gradual yet steady path of recovery post the second wave of the pandemic.
- After a strong pickup in Jun-21, growth momentum has continued to tick along well into the months of Jul-21 and Aug-21, albeit at a slower pace.
- High frequency indicators indicate that economic activity by mid Aug-21 have reverted to pre-second Covid wave peak.
- Although by a smaller magnitude, incremental data for the month of Jul-21 validates the sequential improvement in economic activity, with annualised readings continuing to find support in a low base from last year.
- Looking ahead into FY22, progress on vaccination remains the most critical monitorable. Amidst global support to domestic exports and catch-up in sowing, we continue to hold on to our FY22 growth forecast of 10% (with downside risks).
- We do acknowledge downside risks emanating from the possibility of another wave of Covid infections and longevity of pent-up demand, besides scarring seen in consumer sentiment, jobs and incomes.

On growth front, economic activity continues to tread a gradual, yet steady path of recovery post the second wave of the pandemic. After a strong pickup in Jun-21, growth momentum has continued to tick along well into the months of Jul-Aug-21, albeit at a slower pace. High frequency indicators indicate that economic activity by mid Aug-21 have reverted to pre-second Covid wave peak primarily on the back of decline in infections along with state-level easing of lockdown restrictions amidst progress on vaccination. As of Aug 31 2021, the number of daily confirmed Covid cases (7-DMA basis) has eased to close to 35k after averaging at ~37k over the last month; while the daily pace of vaccinations has picked up to 5.3 mn compared to 4.3 mn in Jul-21.

Amidst the unlocking, Google mobility indicator has also surpassed levels seen prior to the onset of the second wave of infections. While mobility for essentials i.e., Pharma and Grocery was the quickest to recover; the last few weeks have seen Google mobility associated with Retail and Recreation along with that for Transit Stations and Workplaces record a strong rebound.

Chart 1: Daily confirmed new cases have eased to ~35k

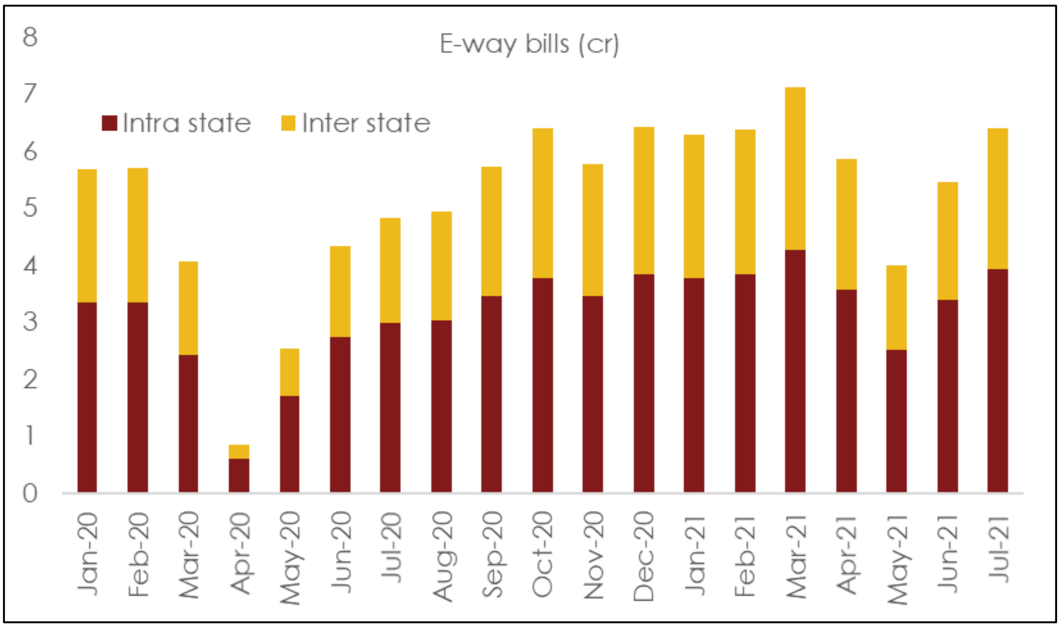


Although by a smaller magnitude, incremental data for the month of Jul-21 validates the sequential improvement in economic activity, with annualised readings continuing to find support in a low base from last year.

- Annualized IIP growth normalized further in Jun-21 to 13.6% compared to 28.6% in May-21; broadly in line with market expectations. While tapering of favorable base weighed on headline growth, it masked the jumpstart in sequential momentum after a gap of 2 months. To be precise, IIP index registered an expansion of 5.7% MoM in Jun-21 to partially reverse the lockdown driven cumulative contraction of ~21% over Apr-May.
- E-way bill collections rose to Rs 6.4 Cr in Jul-21, the highest level in the last four months, clocking a growth of 17.3% MoM (see chart 2).

- Fuel consumption rose by 2.9% MoM in Jul-21 to build on the previous months' gain of 8.1%, after contracting over the months of Apr-May-21, despite crude prices continuing to remain elevated.
- PMI manufacturing moved above the threshold of 50 in Jul-21, coming in at 55.3 compared to a contraction of 48.1 in Jun-21. The uptick was fairly broad-based with output and new orders recording a sharp rebound.
- On the other hand, services PMI remained in contraction at 45.4 for the third consecutive month; though the pace of moderation receded.
- Auto production recorded a sequential growth of 24% in Jul-21, reflecting the continued normalization of operations in the sector, higher dispatches to dealers and build-up of supplies ahead of the festive season.

Chart 2: E-way bills continue to recover, now at a 4-month high in Jul-21



Outlook

Q1FY22 double-digit GDP growth of 20.1% YoY must be viewed as a statistical surge, concealing the sequential deceleration of 16.9% owing to the staggered state-level restrictions imposed seen in the quarter. Having said so, the last week of May-21 saw economic activity bottom-out, with the momentum continuing to tick in the months of Jun-Aug 2021. This is validated by high frequency indicators such as E-way bill collections, Google mobility, Auto sales, Electricity generation, Rail Passenger movements among others, shifting into swift recovery mode with most of them now nearing or have already surpassed pre-second wave respective peaks.

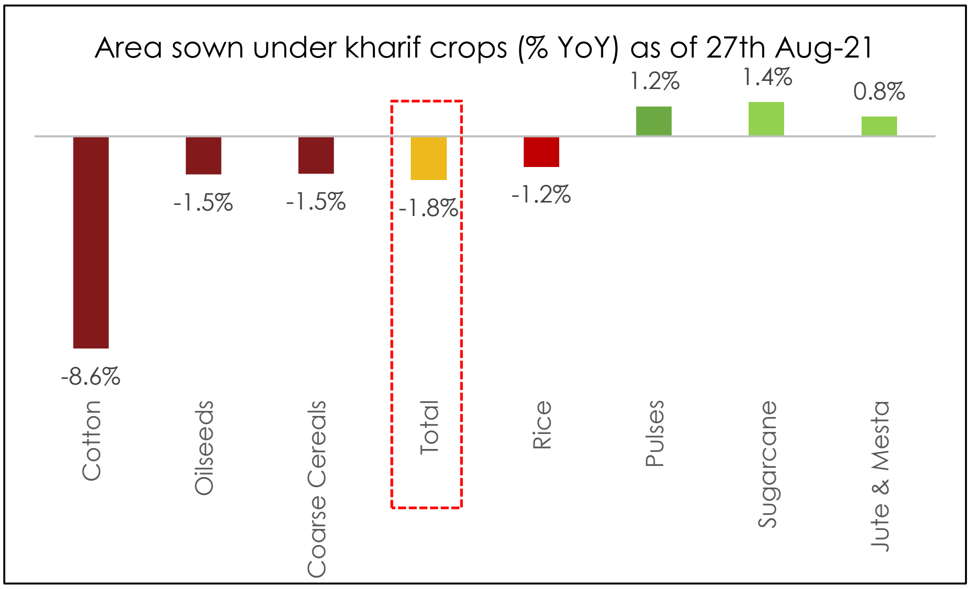
Looking ahead into subsequent quarters, while headline GDP/GVA growth is likely to increasingly 'normalize', one must keep an eye on sequential momentum which is expected to fare better Q2 onwards, owing to -

1) Strong V-shaped global growth recovery that is likely to be supportive of India's exports momentum

2) A stronger comeback in rural demand vis-à-vis urban, amidst above normal area sown for Kharif crops as of end Aug-21 and policy support.
3) Vaccination drive having gained momentum in the last one week. Not only did India achieve the highest ever daily vaccination pace of more than 10 mn doses on 29 th Aug-21 and yet again on 31 th Aug-21, it also set a record average daily pace of vaccination for that week. If vaccinations keep up this pace over the next 3 months, India can achieve inoculation of at least 80% of the population by the end of the calendar year.
4) As vaccinations approach critical mass, it could boost consumer sentiment and demand, with the festive season providing an added fillip. It is likely to also propel a lagged pickup in pent-up demand for services.

Possible risks to growth do remain on the table from the possibility of a third wave of infections, though the loss of economic momentum is expected to be much less in comparison to the second wave. In addition, a deficient monsoon possibly weighing on Rabi prospects and inflation remaining above RBI's target could be additional headwinds. As such, we continue to retain our FY22 growth forecast at 10.0% with downside risks. Looking beyond FY22, the recent Government announcement of deciding to roll back the retrospective taxation law and gradual progress on Production Linked Incentive Scheme, may mean that loss of potential industrial output can be made up for in the medium term.

<u>Chart 3: Kharif sowing has picked up pace, now ~2.0% lower versus last year</u>



Inflation

Offers some respite

KEY TAKEAWAYS

- After printing above the RBI's tolerance band for two straight months, CPI inflation slipped back into the RBI's target band of 2-6% in Jul-21, coming in at 5.59% YoY vs. 6.26% in Jun-21.
- Stretching this comfort, WPI inflation too moved to a 3-month low of 11.16% YoY in Jul-21 from 12.07% in Jun-21. It appears that for both the inflation series the peak is behind us for now.
- The moderation in both indices was largely on the back of a favorable base.
- While Jul-21 provided some respite to inflation concerns that had seen a build-up in recent months, risks have not abated completely and hence there is a constant need for policy vigil.
- Overall, we see balanced risks to our FY22 average CPI inflation forecast of 5.5%.

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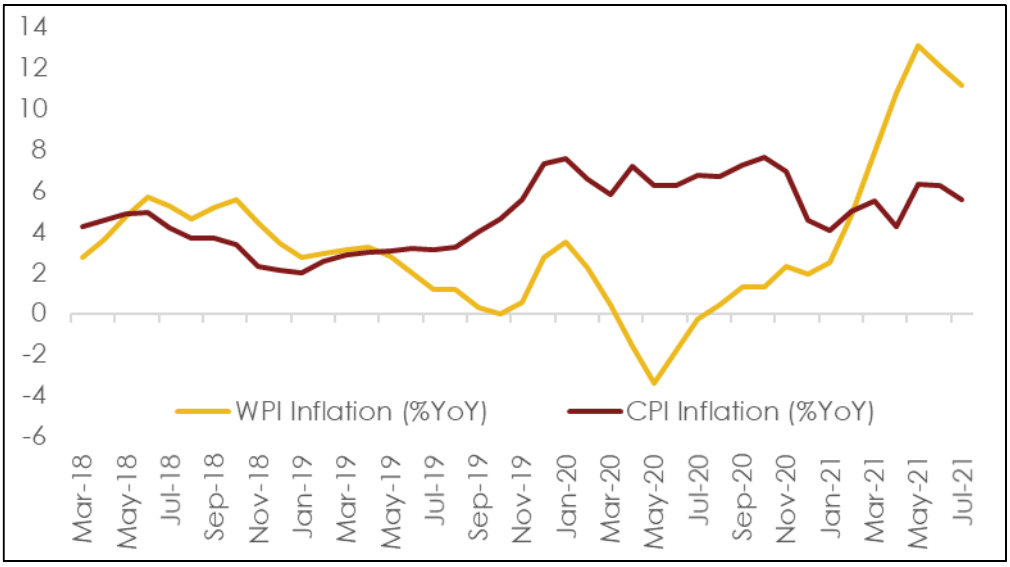
Chart 1: WPI and CPI inflation both ease in Jun-21



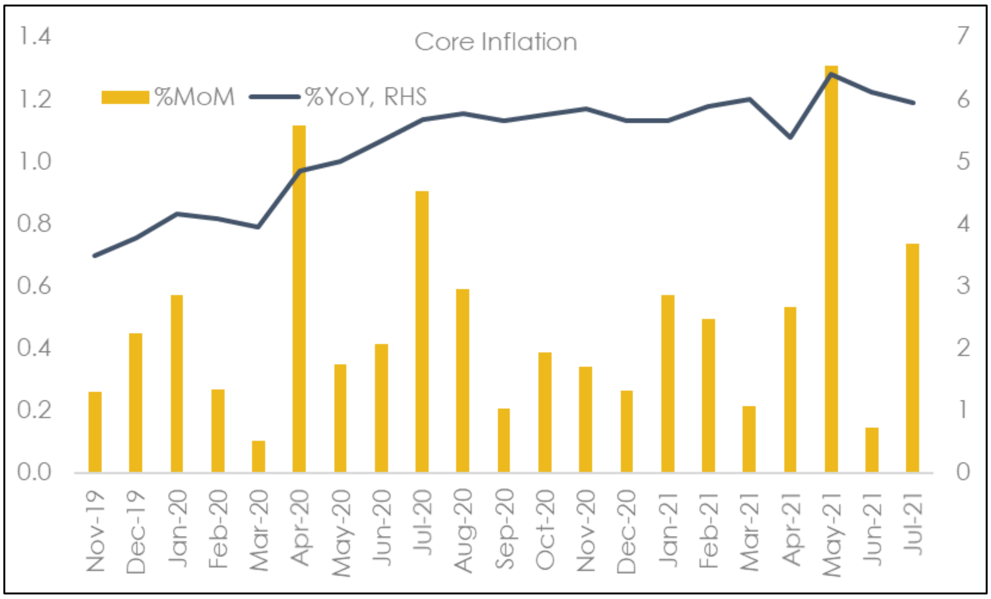
CPI inflation: Back in the tolerance band

- The CPI print came in somewhat below market consensus expectation of 5.6-5.7%
- The moderation in headline inflation was supported by a favourable statistical base. In fact, CPI rose sequentially by 0.74% MoM in Jul-21, higher than the previous month's momentum of 0.56%. All key sub-categories barring Food & Beverages depicted a pickup in sequential momentum in Jul-21 vis-à-vis the previous month.
- Food and beverages inflation registered a sequential increase of 0.86% MoM, lower than previous month's print of 1.18% MoM. Over the last 10-years, this is the second lowest sequential increase in the F&B index seen in the month of July.
    - Moderation in sequential price pressure was observed in case of Eggs
    - More importantly, prices registered a month-over-month decline in case of Cereals, Oils & Fats, Fruits, Pulses, Sugar, Spices, and Prepared Meals/Snacks. For Oils & Fats, this was the first month of sequential decline in prices after a protracted 13-month period of a continuous rise in monthly prices.
    - On the other hand, price pressure firmed up in case of Meat & Fish, Milk, Vegetables, and Non-alcoholic Beverages.

- Overall, the summer seasonality appears to be somewhat less severe so far on the Food and beverages index. In addition, government measures on incentivizing supplies in case of pulses and edible oils appears to be having some early impact.

- Fuel and Light index registered a sequential increase of 0.56% MoM in Jul-21, higher than previous month's momentum of 0.25%. Compared to Jun-21, price pressures accelerated in case of LPG and Firewood while it moderated for Kerosene, Diesel, Coke, and Charcoal. Overall, fuel inflation remained elevated at 12.38% MoM vs. 12.61% in Jun-21.
- Core index (CPI ex Food & Beverages and Fuel & Light indices) increased by 0.63% MoM in Jul-21, after remaining unchanged in the previous month. Sequential increase was led by Pan, Tobacco & Intoxicants, Housing, Household Goods & Services, Health, Education, and Personal Care items.
    - The pandemic has resulted in stickiness in core inflation due to supply disruption and some evidence of pass through of escalation in input prices. The FYTD (Jul over Mar) build-up in price pressure for core inflation has been at 2.7% in FY22, similar to 2.8% seen in FY21, this we note is much higher than the average build-up of 1.5% seen in the corresponding 5-year period between FY16-FY20.

Chart 2: Core inflation continues to remain sticky at elevated levels



WPI inflation: Remains in double digit despite deceleration

- WPI inflation eased to a 3-month low of 11.16% YoY in Jul-21 from 12.07% in Jun-21. Despite the moderation in the headline inflation, the sequential momentum remained unchanged at 0.60% MoM over Jun-21 and Jul-21.
- Consolidated food & beverages inflation ticked up to 0.44% MoM in Jul-21 from -0.13% MoM in Jun-21. Nevertheless, the uptick appears to be moderate compared to the average build-up of ~1.7% in F&B prices in the month of July (for series beginning 2011-2012).
- Consolidated fuel inflation posted another strong sequential print of 1.45% MoM in Jul-21 led by Crude Petroleum & Natural Gas (7.91% MoM) and Mineral

Oils (5.41% MoM). Meanwhile, drop in electricity prices (-11.61% MoM) provided a marginal respite.

- In contrast, momentum in Core WPI (Headline excluding food & beverages and fuel components) eased somewhat to 0.39% MoM in Jul-21 from 0.54% in Jun-21. Nevertheless, the annualized print of core WPI created a new series high of 11.65% YoY in Jul-21 on account of unfavourable base effect. High sequential pressure was observed in case of Primary-Non-Food (2.35% MoM), Tobacco (2.09% MoM), Fabricated Metal Products (1.90% MoM), Machinery & Equipment (1.27% MoM), and Printing and Reproduction of Recorded Media (1.17% MoM).

Outlook

The month of Jul-21 provided some respite to inflation concerns that had seen a build-up in recent months. However, risks have not abated completely, and hence there is a constant need for policy vigil.

- Food price pressures appear subdued basis historical comparison. Record Rabi output and a good start to monsoon has helped. However, rainfall performance has slipped in recent weeks – the cumulative rainfall up until 19 th Aug-21 stood 8% lower vis-à-vis the long period average. While area sown under Kharif crops has picked up, the monsoon performance remains on watch.
- After a strong runup, international commodity prices have started to show signs of plateauing amidst supply adjustments in case of oil, administrative actions on select commodities by China, and renewed threat of Covid infections (from the Delta variant) in few countries. This could potentially temper the price build-up in the coming months.
- Recently the central government took administrative steps to ease supply in case of pulses and edible oils. These include relaxing import restrictions and easing the stock limits for pulses with traders and millers. At the state level, Tamil Nadu announced a cut in petroleum tax at its recently unveiled budget. Such policy interventions, scope for which still exists, would be important to calibrate the fiscal-inflation balance.
- If India inoculates at least 80% of the population before the end of 2021 with a single dose of vaccine, then it could lead to an upbeat consumer sentiment (as seen in case of few developed economies currently) and fan demand side pressures in the near term. This could potentially provide temporary downward rigidity to core inflation.

Overall, we see balanced risks to our FY22 average CPI inflation forecast of 5.5%.

Government Finances

Slippage risks remain manageable

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Jul stood at 21.3% of budget estimates (BE) for FY22 compared to 45.1% of actuals over the corresponding period in FY21.
- The relatively lower accretion to fiscal deficit this year reflects better revenue collection (barring disinvestments) even as pace in overall expenditure appears similar.
- Quality of spending continues to remain healthy with capex growth outpacing revex growth.
- Budgeted expenditure in FY22 will likely overshoot on account of Covid relief packages, increase in fertilizer subsidy, higher outlay for vaccination, and hike in DA/DR.
- Further, there is an emerging likelihood of MGNREGS budget getting a Rs 250 bn hike in FY22 on account of strong demand for rural work.
- While fiscal slippage risks have been stacking up, it would be premature to extrapolate those risks into headline deficit due to strong tax and non-tax revenue collections.
- Having said so, the realization of record high disinvestment target of Rs 1750 bn would be crucial in managing the fiscal risks.

India's central government fiscal deficit for the period Apr-Jul stood at 21.3% of budget estimates (BE) for FY22 compared to 45.1% of actuals over the corresponding period in FY21. Prima facie, the relatively lower accretion to fiscal deficit this year reflects better revenue collection (barring disinvestments) even as pace in overall expenditure appears similar.

Receipts: Revenue collection momentum stays strong

Total receipts have been buoyed by robust tax as well as non-tax revenue accretion.

- On FYTD basis (Apr-Jul), gross tax revenue collection clocked a strong growth of 83.1% YoY despite COVID's second wave. However, it's not just the annualized growth that looks better (which is strongly aided by a favourable statistical base from last year), but gross tax revenue has already clocked 31.4% of BE for the full year (vs. 18.7% of actuals in the corresponding period in FY21), thereby providing a strong starting point.
    - Barring service tax collection that contracted on annualized basis in Apr-Jul FY22, all other key tax sources recorded robust growth in collection, with particularly impressive growth seen in case of customs, corporate tax, income tax, and excise.
- Net tax revenue on FYTD basis (Apr-July) recorded a robust growth of 161.0% YoY compared to a contraction of 40.1% seen in the corresponding period in FY21 on account of support from gross tax collections and relatively lower tax devolution to states.

Non-tax revenue also recorded a strong annualized growth of 468.6% YoY in Apr-Jul FY22 compared to a contraction of 43.9% seen during the corresponding period in FY21. Notwithstanding the favourable statistical base support, the key reason for robust performance under this category stems from the significantly higher than budgeted dividend from the RBI, transferred in the month of May this year vis-à-vis August last year due to the synchronization of RBI's financial year with that of GoI.

Non-debt capital receipts clocked a healthy expansion of 159.2% YoY in Apr-Jul FY22 vis-à-vis a contraction of 68.0% seen in the corresponding period in FY21. The government sold its SUUTI shares in Axis Bank, thereby garnering Rs 40 bn in the month of May-21. Despite low-ticket divestment activity so far, the robust growth rate reflects favourable statistical base effect from last year.

Expenditure: Pace still subdued, but quality remains healthy

Total expenditure contracted by 4.7% YoY in Apr-Jul FY22 vis-à-vis an expansion of 11.3% seen in the corresponding period in FY21. On BE basis, this translates into 28.8% of the full year target vis-à-vis 30.0% seen in the corresponding period in FY21. We note a divergence between the pace of revenue and capital expenditure by the government:

- Revenue expenditure contracted by 7.0% YoY (29.9% of BE) during Apr-Jul FY22 vis-à-vis an expansion of 12.2% (30.5% of actuals) seen in the corresponding period in FY21. The slower disbursal reflects the outsized impact of Covid relief work undertaken by the central government during the nationwide lockdown in Apr-May FY21. With the central government reinitiating some of the earlier programs under the Atma Nirbhar Bharat scheme from May-Jun 2021 onwards (along with DA/DR hikes to be paid from Jul-21 onwards), to provide relief from the second wave of Covid, revenue expenditure could pick up momentum in the coming months.

- On the other hand, it is encouraging to see a relatively healthy capital expenditure growth of 14.8% YoY (23.2% of BE) during Apr-Jul FY22 vis-à-vis an expansion of 3.9% (26.3% of actuals) seen in the corresponding period in FY21. Continued thrust on capex provides comfort and would be important for supporting the economy at a time when private sentiment could remain subdued, at least in the near term.

Outlook

The central government fiscal situation has an appearance of a strong performance backed by tax and non-tax revenue collections. However, as highlighted in the July edition of 'Acuite Macro Pulse', the need for additional spending has escalated post the second wave of Covid. As per our estimates, the combination of vaccination cost, Covid relief program, hike in DA/DR allowance, and higher fertilizer subsidy outgo could entail an additional spending of Rs 1.6-1.7 tn (0.7% of GDP) in FY22.

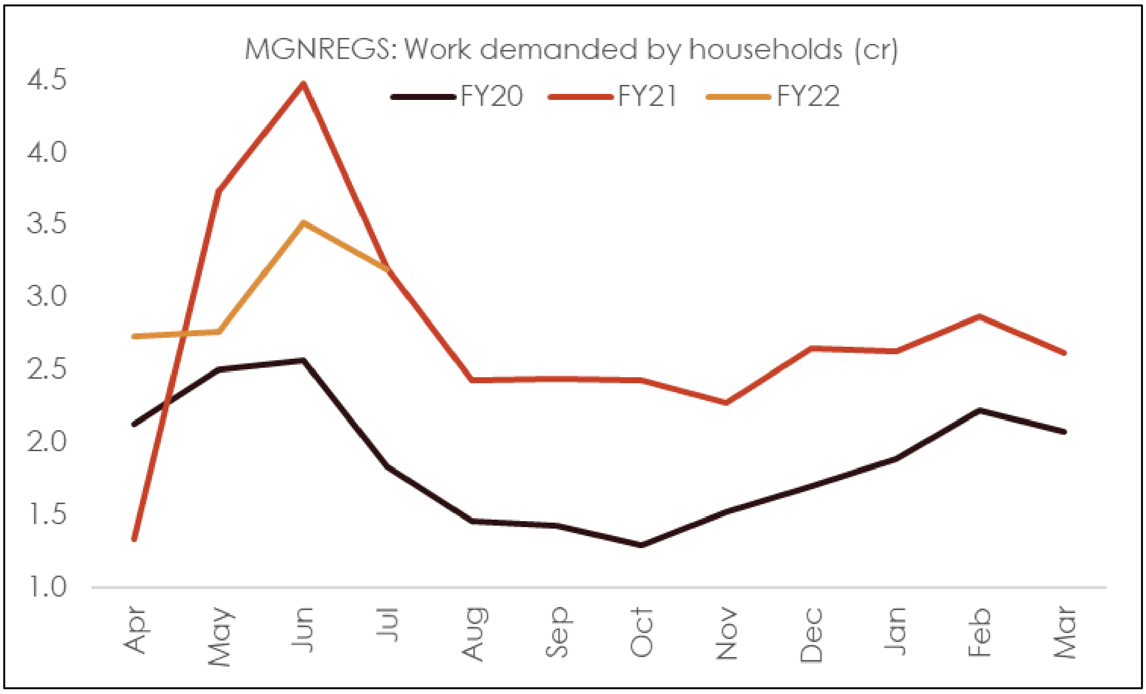
In addition, there is now a possibility of increasing the annual outlay for MGNREGS, budgeted at Rs 730 bn for FY22. As of Aug 19 th, the outgo under this scheme (including payments due) had touched ~81% of FY22 BE and ~53% of full year expenditure in FY21. Further, person days of work generated stand at 1.59 bn – approximately 41% of the 3.89 bn person days of work generated in FY21. As distressed labour continues to seek employment opportunities in rural parts of the country, the government is currently assessing the demand, with media reports highlighting the likelihood of a Rs 250 bn top-up to the budgeted MGNREGS outlay. This could further increase additional spending by 0.1% of GDP.

While fiscal slippage risks have been stacking up, it would be premature to extrapolate those risks into headline deficit for the year. Basis available trend, government's tax as well as non-tax revenue outturn could carry a positive surprise. Having said so, we continue to emphasize that the realization of record high disinvestment target of Rs 1750 bn would be crucial in managing the fiscal risks.

Table1: FYTD comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position as of Apr-Jul)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	13.9	37.4	-40.6	194.3
Net Tax	14.2	34.2	-40.1	161.0
Non-Tax	11.8	57.6	-43.9	468.6
Non-Debt Capital Receipts	9.5	7.5	-68.0	159.2
Total Receipts	13.8	34.6	-41.7	193.4
Revenue Expenditure	30.5	29.9	12.2	-7.0
Capital Expenditure	26.3	23.2	3.9	14.8
Total Expenditure	30.0	28.8	11.3	-4.7
Fiscal Deficit	**45.1**	**21.3**	**-**	**-**

Chart1: Demand for MGNREGS work remains strong



Rates

Elevated yields; shifting concerns

KEY TAKEAWAYS

- After increasing by 15 bps in Jul-21, India's 10Y g-sec yield consolidated further with a move towards the band of 6.20%-6.25%.
- Bonds have come under some pressure in last 1-2 months despite a propitious backdrop from factors like moderation in inflation, softening of UST yields, relief from concerns over additional market borrowing, and RBI's aggressive absorption of g-sec supply vis-à-vis last year.
- Repricing of higher inflation trajectory and the recent subdued monsoon performance are risks gradually getting internalized.
- In addition, the case for the eventual liftoff in monetary policy is slowly gaining currency along with a tapering of bond buying programme by the Federal Reserve.
- With progress on vaccination, we continue to expect the RBI to start normalizing policy corridor from Dec-21 onwards, followed by an eventual hike in the benchmark repo rate in Apr-22.
- We continue to stick to our 10Y g-sec yield forecast of 6.50% by Mar-22.

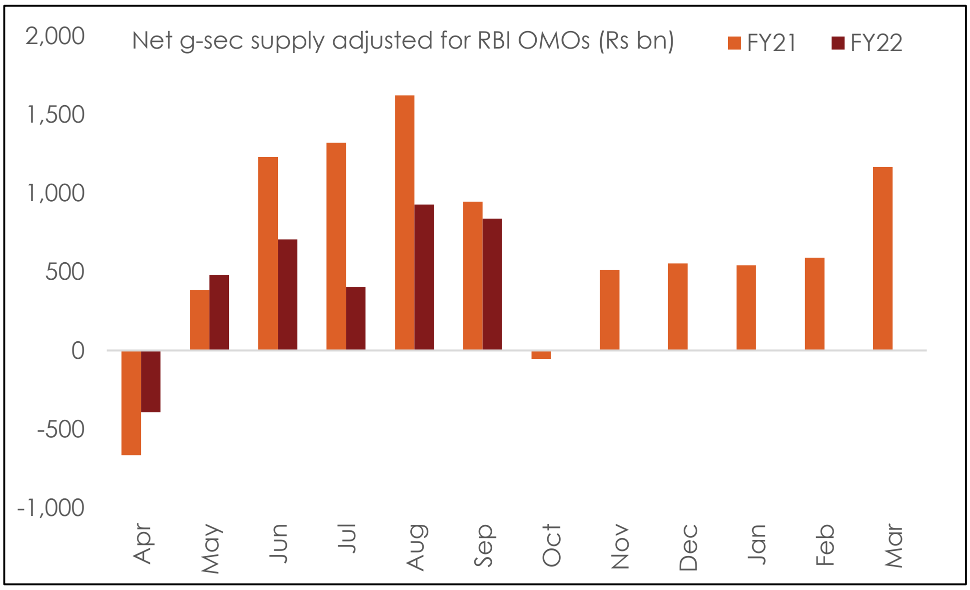
After increasing by 15 bps in Jul-21, India's 10Y g-sec yield has consolidated further with a move towards 6.20%-6.25%, thereby exceeding our near-term expectation of 6.15% for Sep-21. Nevertheless, the overall trajectory remains on course towards our Mar-22 expectation of 6.50%.

No mood to relent despite a propitious backdrop

Over the last one month, several factors came together to form a favorable setting for the bond market:

- CPI inflation reverted to RBI's target band in Jul-21 after remaining above the policy tolerance threshold over Apr-May 2021. In addition, CPI inflation has surprised on the downside for two consecutive months.
- Concerns over additional market borrowing due to GST compensation shortfall got allayed as the central government transferred Rs 750 bn (~50% of the total shortfall for the year) to states in Jul-21.
- 10Y UST yield softened by 24 bps in Jul-21, with almost range bound movement since then, despite elevated inflation in the US.
- Most importantly, RBI's participation in the g-sec market via partial supply absorption through OMOs (auction based as well as outright) has seen a significant leg-up. The central bank is set to absorb at least 52% of the net g-sec supply between Apr-Aug FY22 compared to the absorption of 24.4% of net g-sec supply in the corresponding period in FY21.

<u>Chart 1: RBI's aggressive g-sec purchases has lowered the supply pressure in FY22</u>



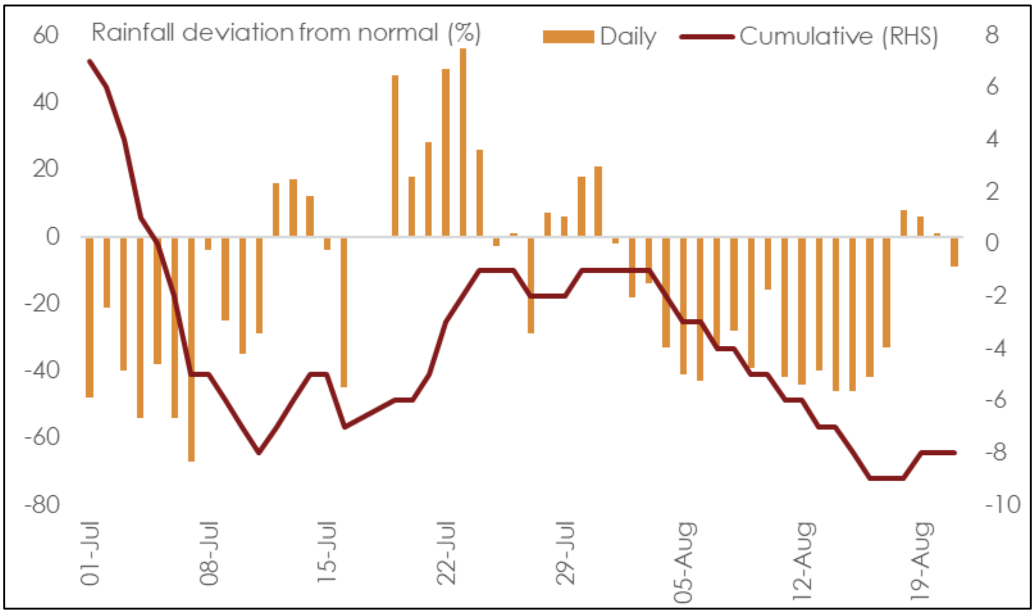
Despite the above, the 10Y g-sec yield moved from 6.05% in end Jun-21 to 6.21% currently. While the sell-off in bonds is not uniform across the yield curve, it was prominent in the 10-15Y segment, with short end of the curve deriving support from the surplus liquidity in money market along with MPC's continued reiteration of strong accommodative policy guidance.

What's holding back bonds?

We believe the concerns for the bond market are in a state of flux:

- As highlighted in the July edition of 'Acuite Macro Pulse', inflation risk is getting repriced amid elevated commodity prices.
    - Domestically, this prompted the RBI to revise up its average FY22 CPI inflation projection to 5.7% in Aug-21 policy review from 5.1% earlier.
    - Performance of south-west monsoon has been somewhat disappointing of late. The month of August has recorded a rainfall deficiency of 24%. Unless rainfall activity improves considerably in the next couple of weeks, this could result in a below normal monsoon outturn with potential for some upside risk for food inflation (although, historically, the correlation between monsoon performance and food inflation is poor).
- The anticipated normalization of monetary policy is getting closer.
    - The US Fed has started considering the possibility of tapering its USD 120 bn per month of bond purchases. While there is no consensus on the timing, the Fed chair has hinted at the likelihood of such an event taking place towards the end of 2021.
    - Few DM central banks like the Norges Bank, Reserve Bank of New Zealand, Reserve Bank of Australia, and the Bank of Canada have indicated their plan for monetary policy normalization. Among EMs, central banks in Brazil (+325 bps), Russia (+225 bps), Turkey (200 bps), Hungary (+60 bps), Czech Republic (+50 bps), Chile (+25 bps), Peru (+25 bps), and Mexico (+25 bps) have begun hiking interest rates in 2021.

Chart 2: Monsoon performance has been subdued over Jul-Aug 2021



    - Back home, while the RBI has not hinted at prospects of normalization of exceptionally accommodative monetary policy, there are early indications that the process might commence before the end of 2021.

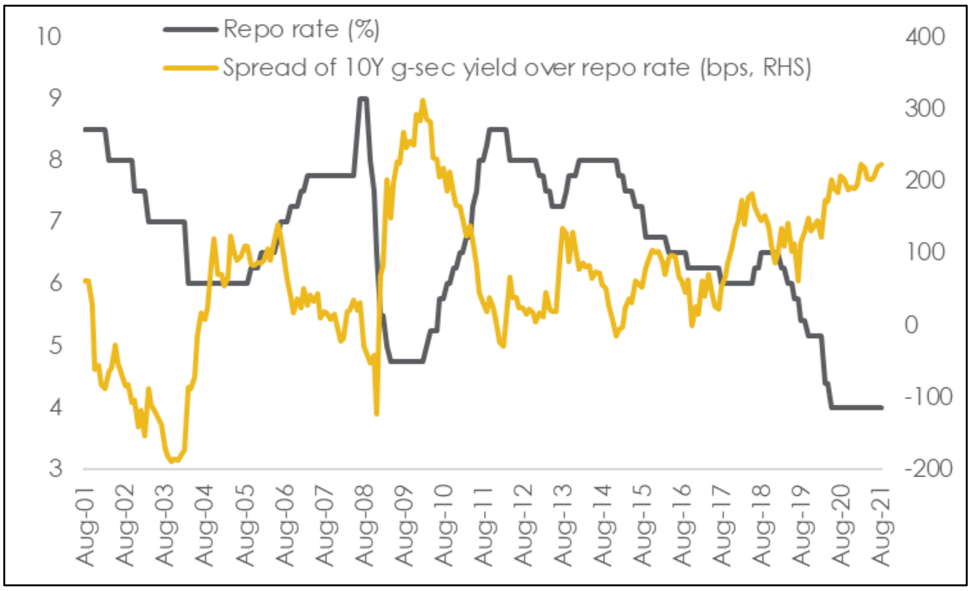
The MPC meeting in Aug-21 saw one of the members voting against continuation of the accommodative policy stance with few others hinting at the need for gradually restoring the policy corridor while maintaining the accommodative stance. We continue to expect the RBI to start normalizing its monetary policy setting by lifting the reverse repo rate from 3.35% currently to 3.75% between Dec-21 and Feb-22, while opting for a 25 bps repo rate hike in Apr-22.

Outlook

The uncertainty created by inflation risks and the likelihood of the lift-off in monetary policy rates has been weighing upon bond market sentiment off late despite the comfort provided by RBI's liquidity operations and g-sec purchases.

We note that the current term premium for 10Y g-sec (represented by the spread in yield vis-à-vis repo rate) is about 223 bps (see chart 3), the highest level since the aftermath of the Global Financial Crisis. We also note that the last time the term premium was this high, it culminated into the RBI hiking repo rate after a gap of 9-months. We believe the situation this time around could be somewhat similar, and hence continue to expect further hardening in the 10Y g-sec yield towards 6.50% by Mar-22.

Chart 3: Recent inflation prints have been higher across key countries



Rupee

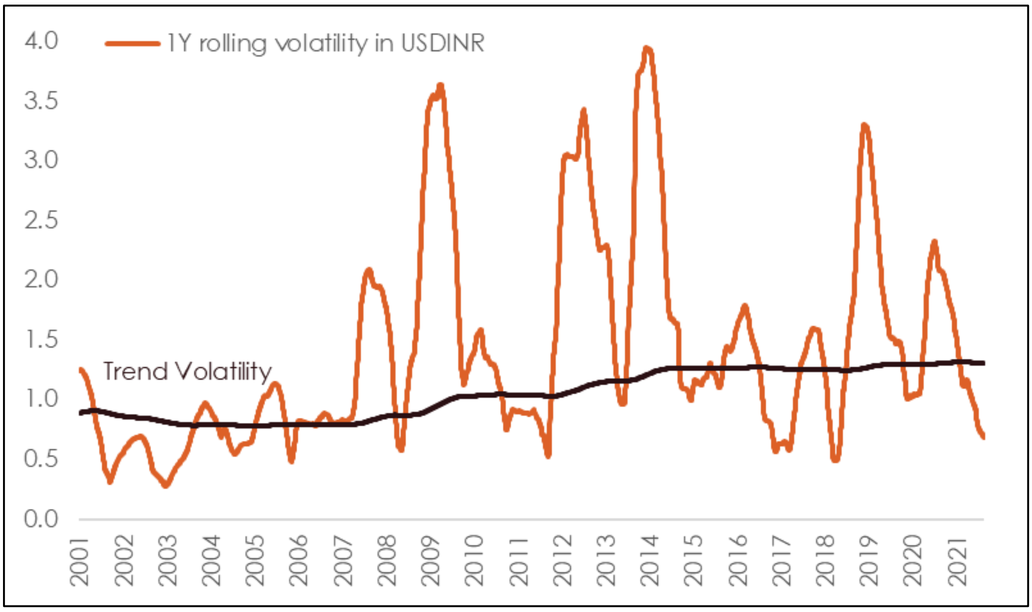
Uneasy calm

KEY TAKEAWAYS

- The Indian rupee has been exceptionally stable since last 2-months, resulting in a dip in trading volatility.
- Reasons for anticipated USD strength continue to persist with rapid spread of the Delta variant globally even as growth prospects for the US economy face upgrades.
- Domestically, the combination of gradual unlock and progress on vaccination would widen India's merchandise trade deficit.
- We continue to expect USDINR to move up towards 75.0 by Sep-21, and further towards 77.0 by Mar-22.
- The Fed chair at the Jackson Hole symposium hinted that the central bank could begin to withdraw its stimulus measures by year-end. This gradual taper could result in USD remaining strong in the near term, with adverse spillover on emerging market currencies.
- While INR would face depreciation pressures on account of Fed's taper, the intensity is likely to be moderate vis-à-vis the 2013 episode on account of relatively better domestic macros and strong FX Reserve cover.

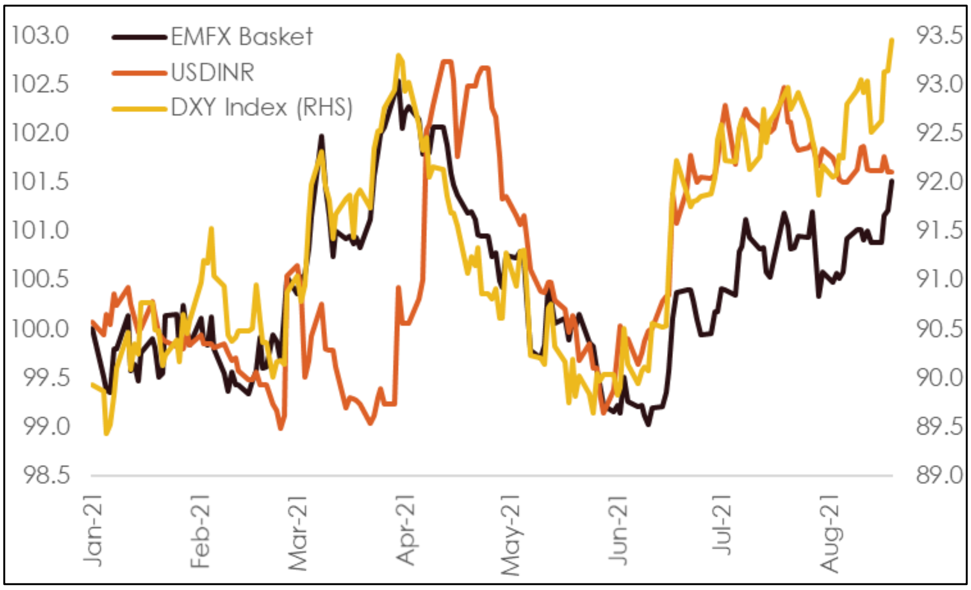
The Indian rupee has been stable since last 8-weeks with the currency pair moving from 74.33 in end Jun-21 to 74.41 in Jul-21, and further towards 73.3 currently. This tight range-bound trading has dampened USDINR volatility, which is currently at its lowest levels in last 3-years.

Chart 1: Volatility in rupee is at its lowest in last 3-years



The recent stability in rupee appears rather unique as the same as come about at a time when the dollar (DXY Index) has been gradually strengthening, while EM currencies have continued to lose ground.

Chart 2: In recent weeks, INR has been stable despite a strong USD/ weak EMFX backdrop



Note: Currency values indexed to 100 on 1-Jan-21; EMFX basket comprises of currencies of top 10 EMs (excluding India) weighted by the size of their 2020 $GDP

The factors driving USD strength continue to persist:

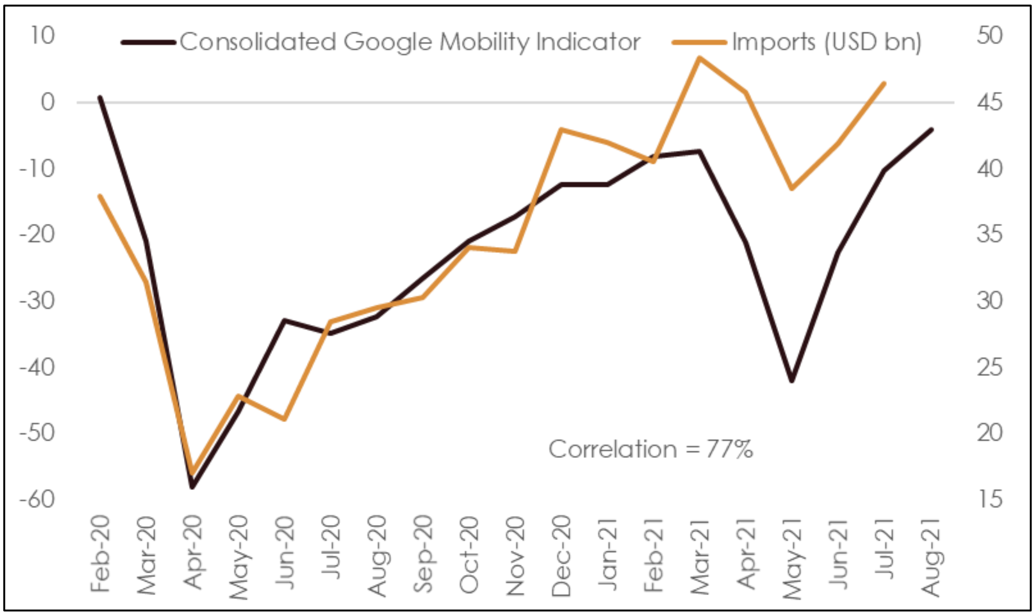
- Covid related concerns on account of the Delta variant continue to stoke global uncertainty. Incremental infections have been rising in many countries since the fourth week of Jun-21, with current daily global caseload ~82% higher than its Jun-21 lows (corresponding figure for daily mortality is ~27% higher than its Jul-21 lows).
- With continuing support from exceptionally accommodative policy mix that continues to persist, the US economic recovery is powering ahead vis-à-vis its DM peers. The IMF in its recently published World Economic Outlook (Jul-21) upgraded US GDP growth forecast for 2021 and 2022 by 60 bps and 140 bps to 7.0% and 4.9% respectively. This would make US the strongest growth center among DMs over 2021 and 2022. Recall, the US economy surpassed its pre Covid levels in Q2 2021.

Outlook

With INR remaining in a steady band, the narrative continues to remain unchanged. As such, we stick to our USDINR call of 75.0 by Sep-21 and 77.0 by Mar-22.

In the near term, the anticipated gradual normalization of domestic economic activity post the second wave of Covid will be one of the most important factors that would drive INR. With improvement in mobility indicators, demand for imports is seen to be picking up at a faster pace vis-à-vis exports (see chart 3). This would result in further widening of the merchandise trade deficit in the coming months, as progress on vaccination coverage would aid economic recovery. India has so far (as of Aug 31) inoculated 33.0% of its total population with one dose of Covid vaccine. Going forward, with centralized procurement and augmentation of supply via higher throughput and liberalized imports, the likelihood of covering at least 80% of the total population before the end of calendar 2021 appears plausible.

<u>Chart 3: With improvement in mobility, demand for imports is picking up</u>

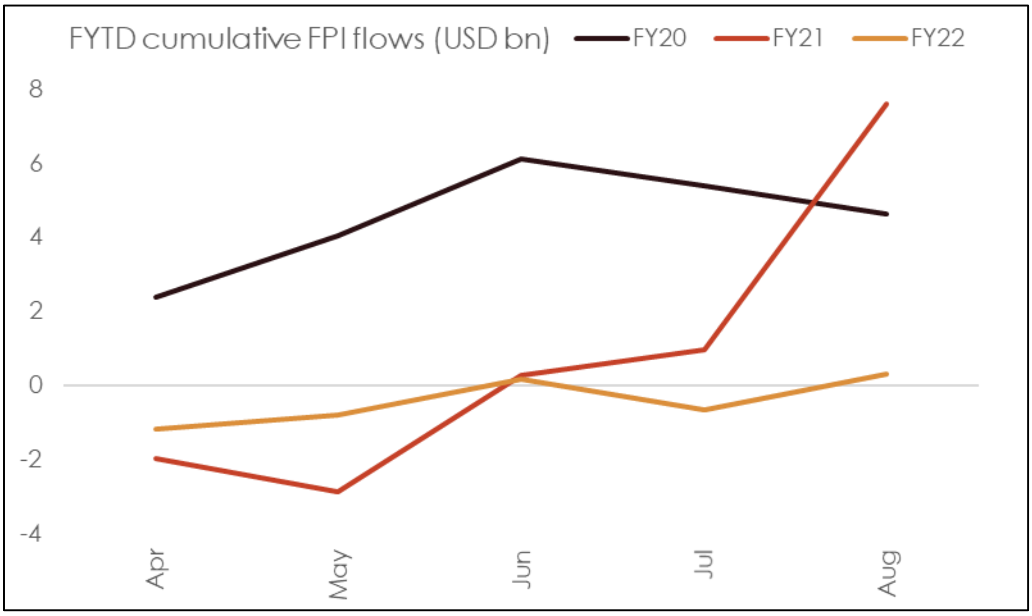


We continue to project FY22 current account deficit at USD 30 bn compared to a surplus of USD 24 bn in FY21. Even as current account balance would move towards normalization, the accompanying balance of payments is likely to result in a moderation in surplus from USD 87 bn in FY21 to USD 44 bn in FY22. While per se healthy, the lower BoP surplus could potentially increase INR's sensitivity to global FX volatility.

This will be critical as the fate of foreign portfolio flows could get determined by the Fed's policy stance on tapering its asset purchases. At the recently concluded Jackson Hole Symposium, Fed Chair Jerome Powell reiterated Fed's stance to reduce the pace of asset purchases this year , however, he refrained from providing an exact timeline. Further, he also stressed that there was no hurry to raise rates.

Fed's taper could result in USD remaining strong, at least in the near term, with adverse spillover on EMFX. As highlighted in previous 'Acuite Macro Pulse' reports, we do expect INR to face depreciation pressures on account of the beginning of normalization of US monetary policy. However, the intensity is likely to be moderate vis-à-vis the 2013 episode on account of relatively better domestic macros and strong FX Reserve cover.

Chart 4: FPI flows have been subdued in FY22 so far



Global Overview

The Delta stress test

KEY TAKEAWAYS

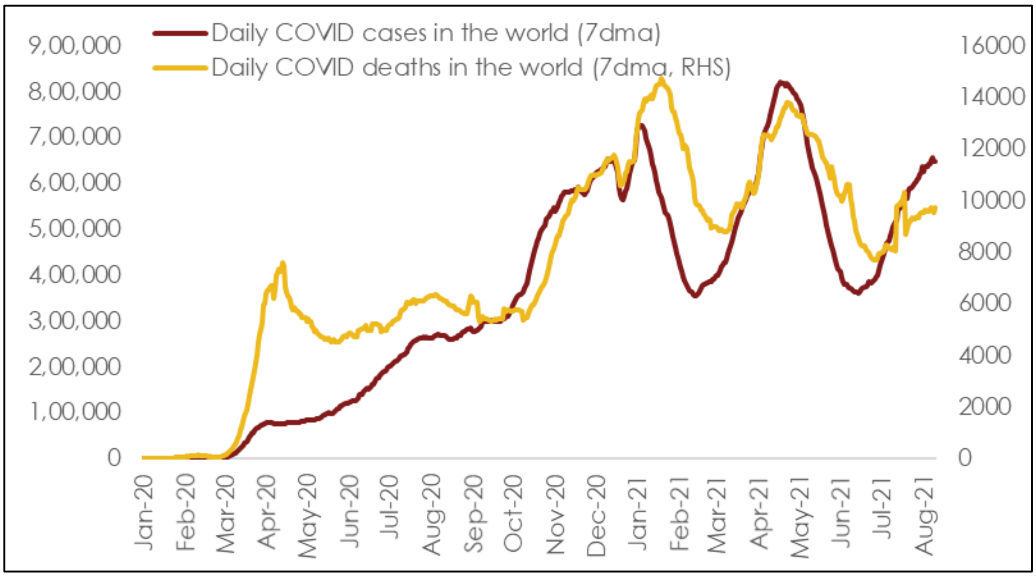
- Globally, COVID cases continued to rise for the second month in a row, with the Delta variant flare up causing renewed restrictions in few countries and turning investors jittery.
- Incoming data is pointing towards some slack in confidence levels, moderation in demand for services and plateauing of mobility in some regions.
- While the impact of Delta variant is expected to be brief and modest, downside risks to recovery from the virus remain alive.
- Notwithstanding the spread of the delta variant and continued inflation pressures, global economic growth continues to strengthen as vaccination programs gather pace and restrictions in many countries ease further.
- As per IMF's latest WEO report, global economy is expected to grow by 6.0% in 2021 unchanged from Apr-21. While growth forecast for EMDE were marked down those for advanced economies were revised up, notably for US and UK.
- These revisions reflect pandemic related developments and variations in policy support.

Overview

Globally, COVID cases continued to rise for the second month in a row, with the Delta variant flare up causing renewed restrictions in some countries and turning investors jittery. While early days yet, incoming data is pointing towards some slack in confidence levels, moderation in demand for services and plateauing of mobility in some regions. While the impact of Delta variant is expected to be brief and modest, but nevertheless downside risks to recovery from the virus continues to persist.

Notwithstanding the spread of the delta variant and continued inflationary pressures, global economic growth continues to strengthen as vaccination programs gather pace and restrictions ease further. Much of the recovery so far has been led by consumer spending in advanced economies, amidst considerable monetary and fiscal policy support, allowing global trade in goods to simultaneously post a strong revival.

Chart 1: COVID cases continue to rise globally in August



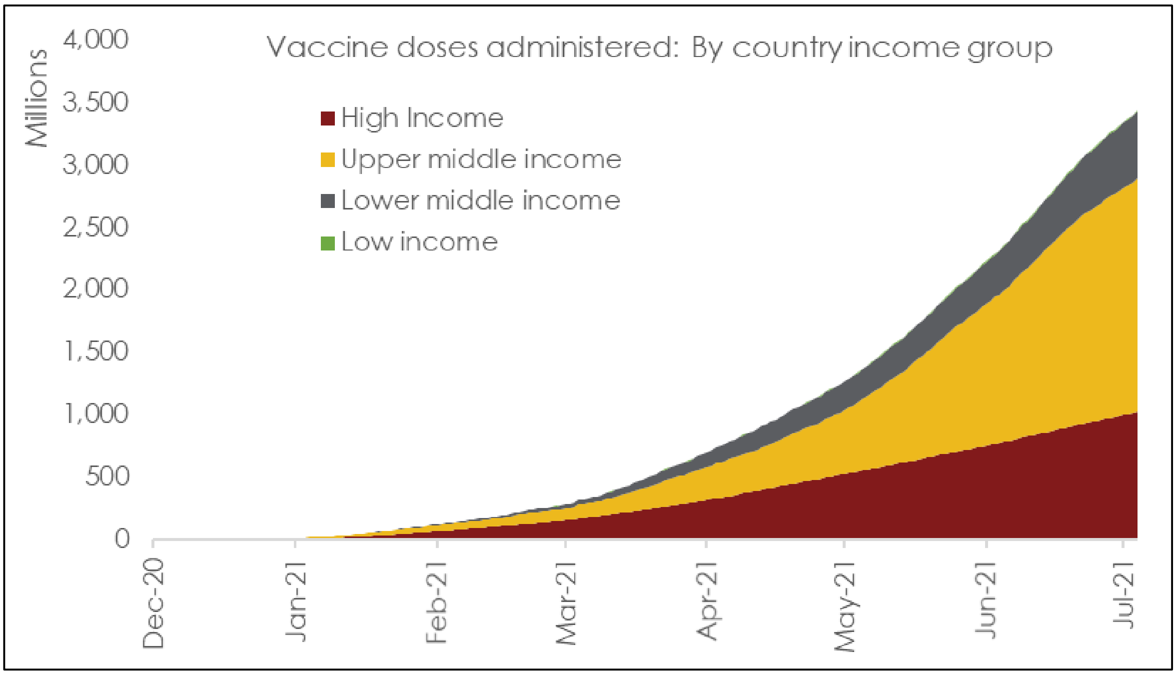
As per IMF's latest World Economic Outlook report released in Jul-21, global economy is expected to grow by 6.0% in 2021 and 4.9% (revised up by 0.5%) in 2022. While the 2021 headline growth forecast has remained unchanged from Apr-21, growth prospects for emerging market and developing economies (EMDE) were marked down especially for emerging Asia. On the other hand, forecast for advanced economies have been revised up, notably for US and UK. These revisions reflect pandemic related developments and variations in policy support.

The IMF also believes that economic prospects have diverged further across countries since the Apr-21 forecast. It points out that "vaccine access has emerged as the principal fault line along which the global recovery split into two blocs: those that can look forward to further normalization of activity later this year (almost all advanced economies) and those that will still face resurgent infections and rising COVID death toll. The recovery, however, is not assured even in countries where infections are currently very low so long as the virus circulates elsewhere".

Risks around the global baseline are pegged to the downside, for several reasons -

- The evolution of the coronavirus and the slower than anticipated vaccine rollout may allow the virus to mutate further
- Frictions in global supply chains and labour markets that may induce more lasting upward inflationary pressures
- Financial conditions could tighten rapidly, for instance, from a reassessment of the monetary policy outlook in advanced economies if inflation expectations increase more rapidly than anticipated.
- A double hit to emerging market and developing economies from worsening pandemic dynamics and tighter external financial conditions would severely set back their recovery
- Even as global merchandise trade remains buoyant, trade in services lags behind. As per WTO's latest release, global services trade plunged by 9.0%YoY in Q1-21, after declining by 21.0% in 2020. The persistent weakness in travel acts as the main drag on services trade.

Chart 2: Access to vaccines remains highly uneven



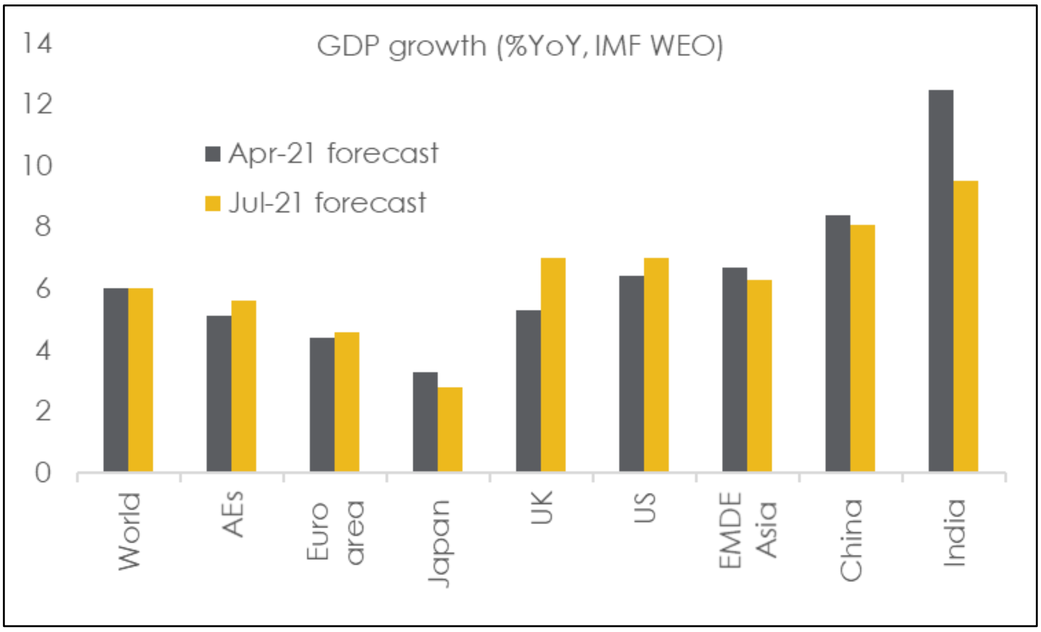
US

The US economy in Q2-21 expanded by a solid 6.5%YoY, albeit lower than consensus estimates of 8.5-9.0%, as massive government aid and vaccination progress fuelled spending on goods and services. Compared to consensus estimates, consumer spending showed some signs of fatigue along with inventory drawdown and lower residential investment. Nevertheless, the economy surpassed its pre-pandemic level of GDP in the quarter.

Following a steady economic rebound in H1-21, the pace of recovery is expected to moderate somewhat in H2-21 amidst the rise in Delta variant cases. New daily cases continue to move up and are at their highest level since Feb-21 along with a rise in hospitalizations. The impact of this on economic activity will be on close watch. Having said so, the large wave of government spending approved in Aug-21 in the form of the infrastructure investment package worth USD 1.0 tn, would boost growth over the next several years.

As such, at its last FOMC meeting in Jul-21, the Federal Reserve sounded more upbeat on the economy and flagged ongoing talks around the eventual withdrawal of monetary policy support. In the press conference following the release, Chairman Powell said that the job market still had "some ground to cover" before it would be time to pull back from the economic support. On inflation, Fed retained the thought that higher inflation was the result of "transitory factors" and was not an imminent risk to the economy. Assuaging some concerns, CPI inflation in Jul-21 remained unchanged at 5.4%YoY, with the sequential momentum easing to 0.5% from 0.9% in Jun-21.

Chart 3: IMF has revised 2021 US growth forecast up to 7.0%



Incremental data has been mixed. Industrial production rose 0.9%MoM, led by manufacturing which surged by 1.4%MoM after a contraction in Jun-21. The gains were broad based led by auto production, electrical equipment and aerospace. Non-farm payrolls rose 943k in Jul-21, above market consensus of 870k. At the sectoral level, leisure and hospitality recorded an addition of +380k along with trade and transport registering a gain of +47k. Despite an increase in worker participation, unemployment rate eased to 5.4% from 5.7% in Jun-21. Overall, non-farm payrolls remain more than 5.7 mn below the pre-pandemic level of Feb-20 – a point that Fed too has been harping about.

On the other hand, some of the consumer-oriented lead indicators moderated. Retail sales fell more than expected by 1.1%MoM in Jul-21, owing to weaker auto sales. Additionally, the University of Michigan sentiment plunged to its lowest levels since 2011, dropping by 11 points to 70.2 in Jul-21. The resurgence in COVID cases led build-up in anxiety amongst households, combined with nearing end of unemployment benefits and rising inflation perhaps have had a role to play.

The next important event for the markets would be the Jackson Hole symposium, scheduled between 26-28th Aug-21, where the Fed Chairman may possibly give some hint on the taper plans. As per a survey by Reuters, nearly 65% of economists polled expect the Fed to announce a plan to taper its asset purchases only in Sep-21.

UK

The number of Covid cases after rising in Jun-21 and Jul-21, have subsequently shown signs of falling back, although there has been a sharp increase in the number of people being asked to self-isolate temporarily. Clearly, mass vaccination strategy has paid off by blunting the impact of the virus in the UK economy.

With the majority of domestic Covid restrictions being lifted, leading economic and sentiment indicators have shown signs of improvement. In Q2-21, UK emerged as one of the fastest growing economies in the world at 22.2%YoY growth. In particular, private consumption and government spending were both strong, registering gains of 7.3% and 6.1%QoQ respectively. Consumer confidence surpassed pre-pandemic levels for the second month in a row, as consumers continued to spend their pent-up cash on beauty, clothes, and hospitality during the mid-summer months. GfK consumer index was -8 in Aug-21, a marginal fallback from -7 in July but still higher than Jan-20 levels. As of 20 Aug-21, UK had vaccinated 71.1% of its population with a single shot and nearly 61.6% of the population with both the doses.

Having said so, the spread of the Delta variant could disrupt the local recovery by turning consumers cautious and weigh on spending and demand in H2-21. The pace of recovery may take some breather in Aug-21 as large number of people self-isolate and travel related activities ease. Retail sales clocked an unexpected drop of 2.5%MoM in Jul-21. While a bit premature to draw inferences of a broad-based slowdown yet, but incoming data will remain on close watch.

CPI inflation rose to 2.5%YoY in Jun-21, above the MPC's 2.0% target. Core CPI inflation rose further to 2.3%, with higher global input costs being passed on to some consumer goods prices. The reopening of the economy has led to a pickup in price of select consumer goods and services.

The BoE in its last meeting held its benchmark interest rate at a historic low of 0.1%. However, the Committee judged that, "should the economy evolve broadly in line with the central projections in the August Monetary Policy Report, some modest tightening of monetary policy over the forecast period is likely to be necessary to be consistent with meeting the inflation target sustainably in the medium term". The central bank expects UK GDP to recover further over the remainder of the year, reaching its pre-pandemic level in Q4-21, with demand-led growth boosted by a waning impact of COVID. On inflation, the central bank projects CPI to rise in the near term to 4.0% owing largely to developments in energy and other goods prices. The price pressures need to be seen as transitory, before falling back to close to the 2% target.

EUROZONE

The Eurozone economy grew by a healthy 2.0%QoQ in Q2-21, as easing of pandemic related restrictions boosted economic activity in most large economies, barring Germany. On an annualised basis, GDP clocked a growth of 13.6%, aided by the favourable base from last year. The QoQ expansion followed two quarters of contraction, with sequential momentum likely to remain in positive in Q3-21, as vaccination distribution gathers further speed and restrictions are lifted off.

In incoming macro data, industrial production fell by 0.3%MoM in June, as supply chain issues due to input shortages continued to weigh. The auto sector continues to bear the brunt of semiconductor shortages, with Germany facing the largest issues. Inflationary pressures are rising as well, but so far, are mostly concentrated in volatile items (e.g., food and energy) and producer prices. It's unclear to what extent these price pressures will be passed on to consumers, but it is likely that core inflation will track higher in the coming months as service sector activity rebounds.

Amidst the flare up in Delta variant, in recent weeks, mobility in the region has come to a near halt. To a limited degree, some countries have put more restrictive measures in place again or delayed the easing of measures. Surveys are showing some impact on confidence for businesses and consumers, with optimism outlook declining. Looking ahead at Q3-21, so far, growth is expected to continue to tick at the same pace seen in Q2-21, as domestic and foreign demand continues to revive.

Japan

Japan's economy reported a positive growth in Q2-21 at 1.3%YoY to beat market consensus of 0.7%, recording a sharp turnaround from the contraction of 0.9% in Q1-21. The recovery was led by stronger than expected growth in private consumption, along with support from exports and business investment. The upside in the rebound was however dampened by the rise in COVID cases. The economy has been slower to bounce back from the pandemic compared to other advanced economies, with its vaccination program only recently picking up pace. As of 20th Aug-21, nearly 51.3% of the population has been administered a single dose of the vaccine, while 39.6% has been fully vaccinated.

Looking ahead, there remains a risk of contraction in Q3-21 as the Government has placed stronger restrictions across the country's big cities until the end of Aug-21 to control the spread of Covid infections. The recently concluded Tokyo Olympic games are unlikely to have materially supported growth as the event remained behind closed doors. For the year as a whole, the IMF forecasts Japan's economy to grow by 2.8% in 2021 from a year before, down 0.5pp from its Apr-21 estimate citing that the country continued to struggle to contain the spread of the coronavirus. Japan is the only country among the G7 industrialized nations whose growth was downgraded in the IMF's latest economic outlook.

About Acuité Ratings & Research Limited:

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Media Contacts:

Roshni Rohira Ph: + 91-9769383310 roshnirohira@eminenceonline.in	Neelam Naik Ph: + 91-9619699906 neelam@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