RATINGS & RESEARCH

MACRO PULSE REPORT

Aug 2022

Contents

From the desk of the Chief Analytical Officer

Amidst the onset of the great Indian festive season, we publish the **twentieth edition of Acuité Macro Pulse**, our comprehensive monthly publication on the Indian and global macroeconomic scenario which has been appreciated by bankers, corporate treasurers, policy makers and researchers over the last two years.

As I pen down the foreword of this Aug-22 edition, I sense an optimism around the domestic economy driven by the festive mood. Private consumption has ticked up fairly well so far in the fiscal with increased dilution of the Covid threat and normalization of mobility supported by the high vaccination coverage. The transport and the hospitality sector are expected to witness heightened activity in the current year, as reflected by the data on airline passenger load factor and the hotel occupancy rates. The PMI print for manufacturing and services continue to be buoyant and reflect the positive sentiments of the corporate sector. As on the first week of September, the banking system credit growth YoY stood at a multi-year high of 15.5% which indicates two factors (i) inventory buildup for consumer goods in expectation of a 3 yr high festive demand (ii) increased capacity utilization leading to a gradual pickup in corporate capital expenditure for capacity expansion.

All these bode well for the economic outlook but strong global headwinds still persist. The global slowdown signals have intensified and is reinforced by the declining monthly export volumes; although to an extent, the decline in exports is also to do with the imposition of duties or ban on certain commodities with an aim to cool down domestic inflation. While the overall monsoon rainfall has not been a concern, the geographical distribution of precipitation has been uneven and can impact crop output in some agriculture based states in the North and East. Nevertheless, we continue to believe that the resilience in the Indian economy is capable of delivering a GDP growth of over 7.0% in FY23.

As we highlighted in our earlier edition, the narrative on inflation has got a little less intense over the last 1-2 months with the concerns on global slowdown and the moderation in commodity prices. What is a matter of comfort on the inflation front is the willingness of the Government to take proactive steps to cool down prices of commodities of mass consumption. Nevertheless, RBI is expected to remain hawkish till the CPI headline print sustainably drops below 6.0% i.e. the MPC upper tolerance limit. We hold on to the expectation that the repo rate will get close to 6.0% by the third quarter before MPC takes a pause.

The global headwinds have continued to keep the pressure on the external front and have led to a moderate depletion of India's foreign exchange reserves over the last few months. But any further major depreciation in the INR is unlikely with the capital flows witnessing some reversal in the last one month. The 10 yr govt bond yields also seem to have found some stable levels at around 7.2%. While the overall macroeconomic landscape looks better than at the end of Q1FY22, it is perhaps a bit early to pronounce a clear judgement on the matter.

Let's cheer for the upcoming festivities,

Suman Chowdhury
Chief Analytical Officer

Growth

Recovery continues well into Q2 FY23

KEY TAKEAWAYS

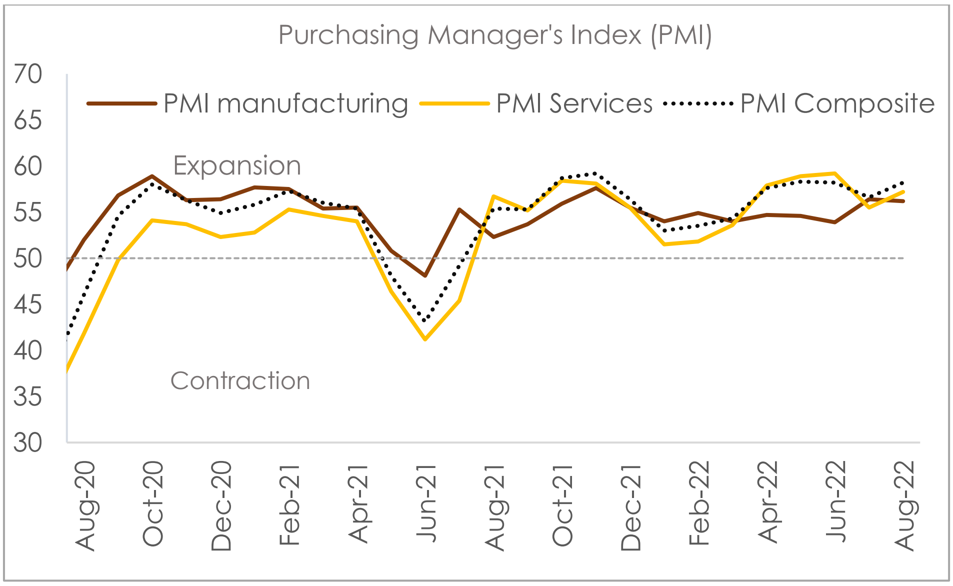
- India's GDP growth in Q1 FY23 accelerated sharply to 13.5% YoY from 4.1% in Q4 FY22.
- The combination of the favourable statistical base due to the destructive second Covid wave last year, complete unlocking of economic activity, spill-over of pent-up demand particularly in the contact intensive services sector, and the high vaccination coverage have helped India to post a double-digit expansion in Q1 FY23 GDP.
- The global economy continues to grapple with the ongoing shocks from the Ukraine-Russia war that is now in its seventh month, elevated global inflation pressures leading to aggressive monetary tightening, lingering supply chain disruptions, currency depreciations and more recently a slackening demand.
- Domestic high frequency indicators, nevertheless, continue to display incremental strength, well into Q2 FY23, with services leading the recovery aided by non-dissipating pent-up demand (especially in sectors such as tourism, hospitality), normalising personal mobility and an expansive vaccination coverage.
- The softness in global commodity prices and the pick-up in southwest monsoon at an all-India level have provided some comfort. Having said so, in recent months, global growth prospects have turned bleaker. IMF in its Jul-22 World Economic Outlook update revised lower its 2022 global growth forecast to 2.9% from 3.2% earlier. This could have a stronger bearing on India's exports in the coming months.
- While we continue to remain cautiously optimistic about the domestic growth scenario, the dip in the external demand due to weakening global growth and rising interest rates could offset these gains.
- Considering the lower-than-expected GDP print in Q1 FY23 (13.5%), we see a downside risk of 30-40 bps to our full-year GDP growth projection of 7.5%. We, therefore, revise our FY23 growth forecast to 7.2%.

India's GDP growth in Q1 FY23 accelerated sharply to 13.5% YoY from 4.1% in Q4 FY22. However, the sequential momentum appears soft with GDP contraction by -9.6% QoQ, worse than the pre pandemic seasonal average (over a 10-year period) of -4.6% observed in Q1. A weak seasonally adjusted print coupled with a high annualized growth number underscores the role of a favorable statistical base in the headline GDP, given the disruptive second Covid wave in Q1FY22.

The combination of the favourable statistical base, complete unlocking of economic activity, spill-over of pent-up demand, and high vaccination cover helped India to post a double-digit expansion in Q1 FY23 GDP. The trajectory is commendable amidst the current backdrop of global headwinds namely heightened geopolitical uncertainty, tightening of global financial conditions, and persistence of supply chain disruptions in certain commodities. When we compare the Q1GDP with the pre-pandemic period of FY20, the print stands 3.3% higher with private consumption followed by government expenditure supporting the recovery momentum.

The global economy grapples with the ongoing shocks from the Ukraine-Russia war now in its seventh month, elevated global inflation pressures leading to aggressive monetary tightening, lingering supply chain disruptions and more recently a slackening demand. However, domestic high frequency indicators continue to display incremental strength, well into Q2 FY23, with services leading recovery aided by non-dissipating pent-up demand (especially in sectors such as tourism, hospitality), normalising personal mobility and an expansive vaccination coverage.

Chart 1: PMI manufacturing and services remain resilient despite global headwinds



Recent data releases: A granular look at recovery

- Acuité Macroeconomic Performance index (AMEP index) has recorded a double digit albeit slower growth rate of 12.0% YoY in Jul-22 vs 20.4% in Jun-22 (Chart 3) which reflects a healthy momentum and resilience in the domestic economy despite the continuing strong global headwinds. The moderation in the annualised growth needs to be seen in the context of a taper in the favourable base factor in Q1FY22 due to the second Covid wave. However, the index also eased to a 5-month low of 121.4 in Jul-22 from 130.1 in Jun-22 leading to a contraction of 6.7% on a sequential basis which partly arises from the seasonality associated with the monsoon months.

- India's annualised industrial production eased in Jun-22 but remained in double-digits at 12.3%YoY (compared to 19.6% in May-22) owing to a favourable base even as sequentially the index eked out only a marginal growth of 0.1%MoM.
- India PMI manufacturing activity eased a tad from an 8-month high of 56.4 in Aug-22 to 56.2 in Jul-22 led by rise in new orders. On the other hand, services PMI recouped some of the lost momentum in Aug-22, rising from 55.5 in Jul-22 to 57.2 in Jun-22.
- GST collections came in marginally lower to Rs 1.43 lakh Cr in Aug-22 compared to Rs 1.49 lakh Cr in Jul-22, to mark the sixth consecutive month of the print remaining above Rs. 1.4 lakh cr.
- NONG imports, a key indicator of domestic demand, also eased to USD 40.5 bn in Aug-22 from USD 42.7 bn in Jul-22. Notwithstanding the marginal easing, the print remained above USD 40 bn for the third consecutive month with coal, machinery, electronic goods, vegetable oil remaining the top import commodities.

Outlook

Going forward, as the favourable statistical effect tapers, headline GDP growth would clearly decelerate in the coming quarters. However, incremental support would nevertheless come from:

- The festive heavy H2 FY23 in combination with pent-up demand (esp. for services) and further traction in vaccination coverage would drive domestic demand recovery. Expectation of moderation in inflation, along with likely bonus pay-outs and expected hike in dearness allowance for government employees, could further support discretionary consumption.
- At an aggregate level, kharif harvest beginning late Sep-22 onwards would offer support to agriculture output and farm incomes.
- Capex oriented public expenditure continues to offer the much-needed fiscal impulse, and would hopefully benefit manufacturing capacity utilisation further, which has recovered to above pre-pandemic levels, at 74.5% as of Mar-22.
- The recent moderation in global commodity prices, with the CRB index nearly 11% lower vis-à-vis Jun-22 peak will offer reprieve to producers, and the likely pass-through to consumers (with a lag) would support consumer sentiment.

Having said so, we also acknowledge growing downside risks of 30-40 bps to our FY23 GDP growth estimate of 7.5% on account of:

- Disruption in rice acreage on account of uneven rainfall distribution, especially in states of Uttar Pradesh, Bihar, Jharkhand, and West Bengal.
- More importantly, buildup of adverse global factors (like tightening of global financial conditions, elevated geopolitical uncertainty, etc.) would constrain external demand significantly in H2 FY23. The IMF in its Jul-22 World Economic Outlook update had slashed its 2022 global growth forecast by 40 bps to 3.2% and trade volume growth by 90 bps to 4.1%.
- Likelihood of government resorting to some degree of back-loaded expenditure rationalization in order to stick to the FY23 fiscal deficit target of 6.4% of GDP.

Therefore, Acuité Ratings has revised its GDP growth forecast for FY23 downwards to 7.2%.

Chart 2: Govt. Capex in Q1 FY23, strongest run-rate seen in nearly a decade

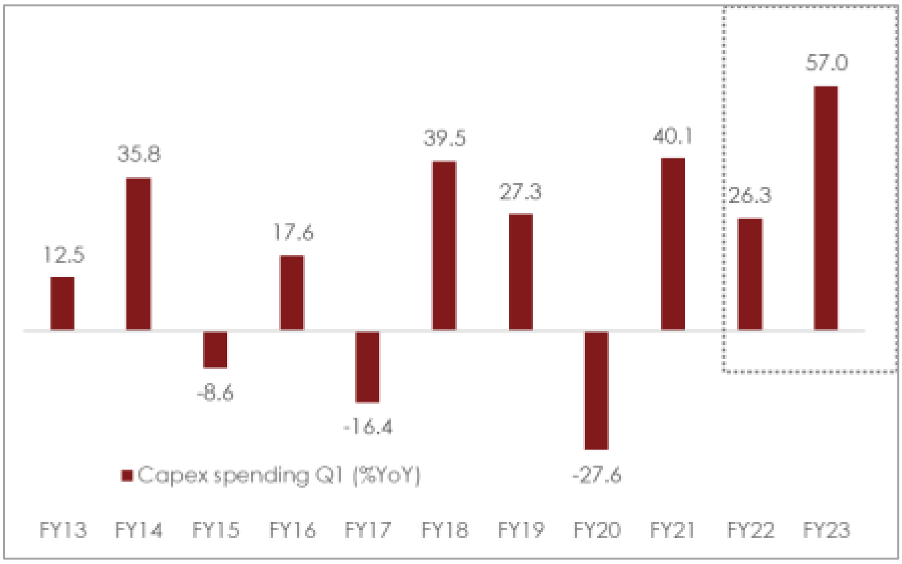
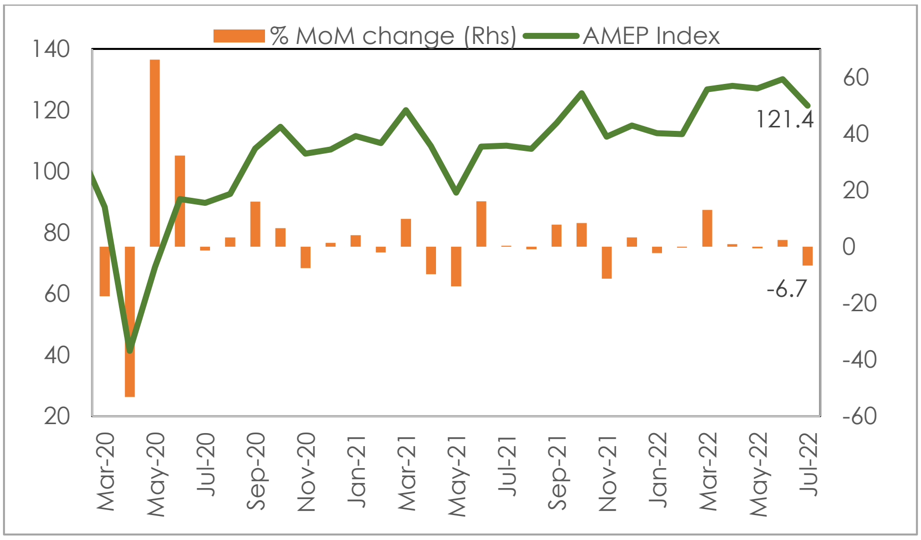


Chart 3: AMEP index eases from a record high level in Jul-22



Source: CMIE, Acuité Ratings and Research

Inflation

Softens in Jul-22, but still elevated

KEY TAKEAWAYS

- Both metrics of inflation – CPI and WPI moderated in Jul-22 on an annualized basis to offer reprieve, given the last few elevated readings.
- CPI inflation moderated in Jul-22, to 6.71%YoY from 7.04% in Jun-22. This marked the first below 7.0% print in four months and was broadly in line with market expectations.
- WPI inflation eased to the lowest level in 5-months in Jul-22, coming at 13.93% YoY compared to 15.18% in Jun-22. For the second month in a row, sequential momentum remained in contraction, the impact of which on the headline was exaggerated by a favorable base.
- The softening in global commodity prices and the recovery in Southwest monsoon along with the latest inflation readings, do underscore the possibility of inflation having already peaked in FY23.
- In terms of trajectory, after averaging at 7.3% in Q1FY23, we expect CPI inflation to display some downside in the ongoing quarter, notwithstanding a marginal upward bias that months of Aug-Sep-22 carry owing to an adverse base.
- H2 FY23, is likely to see a more favorable inflation outturn with Kharif harvest coming onboard, winter seasonality in perishables kicking-in and a lagged pass-through of commodity price softening amidst a favorable base.

Overview

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Key highlights: CPI inflation

- Sequential CPI momentum eased further to the lowest level in 5 months of 0.46%MoM in Jul-22 compared to 0.52%MoM in Jun-22 and an average of 1.11%MoM over months of Mar-May-22.
- Momentum for Food and beverages was substantially lower, at 0.06%MoM in Jul-22 compared to an average momentum of 1.28%MoM between Mar-Jun-22. The downside was led by a deceleration in price of Vegetables (-0.1%MoM, led by Tomatoes), along with Edible oils (-2.54%MoM) and Meat & fish (-2.92%MoM).
- In contrast, cereals momentum remained strong for the fifth consecutive month i.e., since the outset of the Ukraine-Russia war primarily led by wheat and wheat products. As such, cereals inflation in Jul-22 stood at a near 2-year high of 6.90%YoY in Jul-22, nearly double of 3.46% from earlier this year in Jan-22.
- Consolidated fuel prices climbed up by a strong 1.53%MoM in Jul-22, reflecting the waning impact of excise duty cut announced in May-22 completely. While petrol and diesel prices eked small declines in Jul-22, sharp upward adjustment was seen in price of other fuel items such as Kerosene, Coke, and LPG.
- Core inflation (CPI ex indices of Food & Beverages, Fuel & Light) momentum rose to 0.6%MoM in Jul-22, owing to a mean-reversion in Housing prices (after a seasonal dip in June), strong momentum in Clothing & Footwear along with a sizeable correction in gold and silver prices. As such, the annualized rate of core inflation remained above 6.0% at 6.04% in Jul-22 from 6.22% YoY in Jun-22.

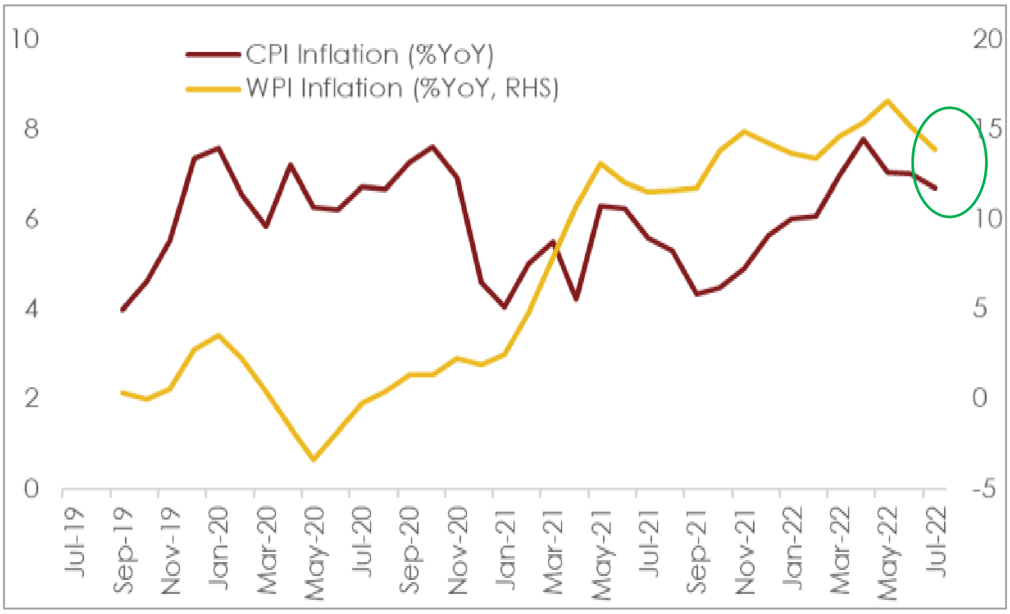
Key highlights of WPI inflation

- At a granular level, momentum for both Primary articles (-2.69%MoM) and Manufacturing (-0.42%MoM) registered a deceleration, partially offset by a sharp increase in case of Fuel and power (+6.56%MoM).
- Within Primary articles, the decline was almost broad-based with the exception of minerals, as moderation in price of vegetables and other commodity prices (such as cotton, oilseeds etc.) aided food and non-food prices lower.
- Index heavy-weight manufacturing WPI contracted by 0.42%MoM in Jul-22, building on the deceleration of 0.90%MoM recorded in Jun-22. The decline was broad based with 12

of the 22 sub-sectors registering a correction in price, led by Wood (-3.57%MoM), Food (-1.53%MoM), Paper (-1.22%MoM) among others.

- In contrast, Fuel and power registered a strong sequential momentum of 6.56%MoM in Jul-22, more than reversing the 5.01%MoM correction recorded in the previous month. The upside was led by Diesel (+18.4%MoM), Kerosene (+17.4%MoM), ATF (8.6%MoM) and Petrol (+7.6%MoM).

Chart 1: CPI and WPI inflation both moderated in Jul-22



Outlook

In our CPI report in Jul-22, we had highlighted the abatement of two risks – one, moderation in global commodity prices and two, recovery in Southwest monsoon. Both these factors continue to remain in favor of a declining inflation trajectory, so far in Aug-22. To put this in perspective, CRB Reuters commodity index has eased by nearly 12% in Aug-22 since its peak in early Jun-22 while cumulative rainfall in Aug-22 continued to remain in a surplus of 6.2% versus the long period average.

Despite this, we continue to maintain our CPI inflation estimate at 6.7% for FY23, owing to the following reasons –

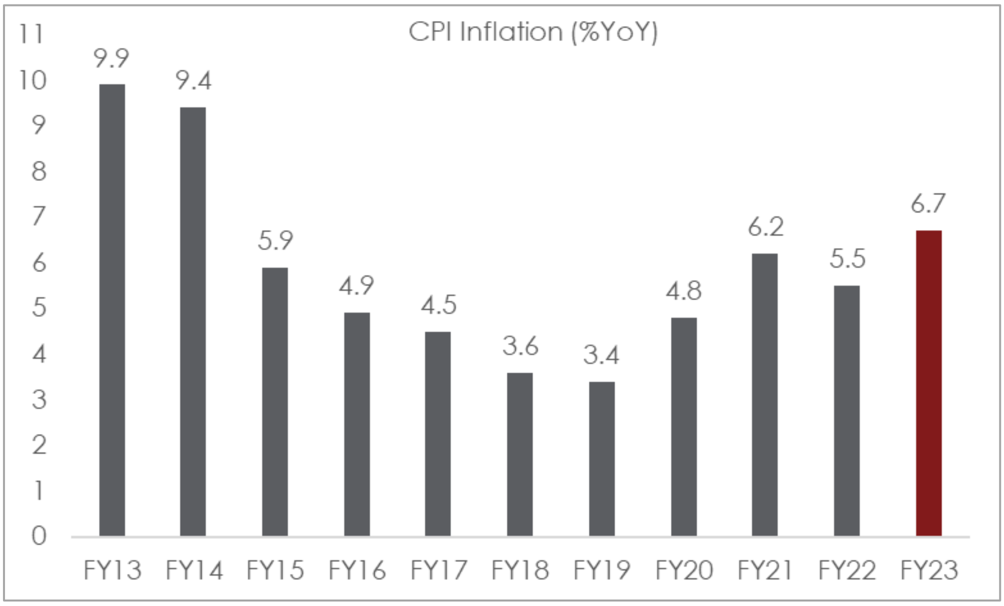
- Impact of GST rate hikes on several food items of mass consumption (effective Jul-22), along with hike in electricity tariffs by several states is yet to get captured completely in CPI data.
- Pass-through of global commodity price correction on to CPI inflation is likely to be gradual and lagged. Further, the depreciation in Rupee to the tune of 5.3%MoM on a FYTD basis stands to offset marginally some of these gains.
- Sowing of paddy in the ongoing Kharif season, as per Government sources has been lower compared to last year (as of early Aug-22) owing to sizeable rainfall shortfall in key rice-producing states of Uttar Pradesh (-44%), Bihar (-40%) and Jharkhand (-26%). While Government's rice stocks continue to remain significant and well above buffer norms, any

shortfall in paddy production could put upward pressure on prices. It may be also noted that the Government has announced a 20% duty on non-basmati rice exports in Sep-22 to stem any spikes in domestic prices.

- Services inflation could see an upside, amidst strong demand especially for contact-intensive services amidst complete normalization of economic activity.

In terms of trajectory, after averaging at 7.3% in Q1FY23, we expect inflation to display some downside in the ongoing quarter, notwithstanding a marginal upward bias that months of Aug-Sep-22 carry owing to an adverse base. H2 FY23, is likely to see a more favorable inflation outturn with Kharif harvest coming onboard, winter seasonality in perishables kicking-in and a lagged pass-through of commodity price softening amidst a favorable base.

<u>Chart 2: For FY23, we hold on to CPI inflation estimate of 6.7%</u>



Government Finances

Risks galore, but target still achievable

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Jul stood at 20.5% of budget estimates (BE) for FY23 compared to 20.2% of actuals in the corresponding period of FY22.
- Slightly higher accretion to FYTD fiscal deficit this year is on account of larger expenditure disbursal while non-tax revenue has lagged on account of lower than budgeted RBI dividend payout.
- Fiscal headwinds have gathered momentum and are cumulatively sufficient to potentially cause a slippage in the FY23 budgeted fiscal deficit ratio of 6.4% of GDP.
- Nevertheless, we continue to believe that the central government has buffers that may enable it to get close to the budgeted target on account of persistence of tax buoyancy, recent upward adjustments in some of the indirect tax rates, and strong likelihood of higher than budgeted Nominal GDP base.

India’s central government fiscal deficit for the period Apr-Jul stood at 20.5% of budget estimates (BE) for FY23 compared to 20.2% of actuals in the corresponding period of FY22. The slight accretion to FYTD fiscal deficit this year is on account of faster pace of expenditure disbursal while non-tax revenue accretion has lagged.

Receipts: Comfort on tax buoyancy continues

Total receipts in the first four months of FY23 were buoyed by strong tax collections and disinvestment revenue.

- On FYTD (Apr-Jul) basis, gross tax revenue clocked 31.5% of BE compared to 25.7% of actuals in the corresponding period in FY22.
    - Momentum was supported by collection from income tax, corporate tax, and GST. We note that the impressive momentum in GST revenue continues to persist with total monthly collections averaging at Rs 1.51 tn during Apr-Aug FY23 compared to the required monthly run rate of Rs 1.35-1.40 tn for meeting the BE. Recent revision in GST rates for select goods and services would help in maintaining the healthy run rate in the coming months as well.
    - Meanwhile, collections from customs and excise were lower in comparison. Moderation in customs and excise is reflective of relaxation in duties on select import items (including retail fuel) to provide relief from elevated inflation.

On the other hand, non-tax revenue (led by dividend transfer from the central bank) moderated to 33.2% of BE during Apr-Jul FY23 from 40.2% of actuals in the corresponding period in FY22.

- RBI’s dividend for FY22 (transferred in May-22) stood at Rs 303 bn, a sharp drop from a high of Rs 991 bn done in the previous financial year. Lower dividend was on account of escalation in provisions due to MTM losses on foreign currency assets from rise in bond yields globally.
- Going forward, the conclusion of the 5G telecom spectrum auction that generated close to Rs 1.5 tn would also provide some buffer (approximately Rs 150 bn is expected to accrue to the government in the first year).

Non-debt capital receipts clocked 38.0% of BE during Apr-Jul FY23 vis-à-vis 36.1% of actuals in the corresponding period in FY22.

- This predominantly reflects the disinvestment proceeds from LIC in May-22 that fetched Rs 205 bn to the central exchequer. The month of Jun-22 saw revenue generation of Rs 5 bn from GAIL buyback.

Expenditure: Disbursals show a pick-up on continued emphasis on capex

On FYTD (Apr-Jul) basis, total expenditure disbursal stood at 28.6% of BE, up from 26.5% of actuals in the corresponding period in FY22.

- The increased momentum was led by capital expenditure that clocked 27.8% of BE during Apr-Jul FY23 vis-à-vis 26.5% of actuals in the corresponding period in FY22. To facilitate capex by states, the FY23 Union Budget had made provision for disbursing Rs 1.1 tn interest-free loans to states with attached conditionalities for targeted spending. In this context, we note that loans disbursed under central government’s capex grew by a staggering 106.4% YoY (aided by a favourable statistical base effect) during Apr-Jul FY23 vis-à-vis 72.6% in the corresponding period in FY22.
- Revenue expenditure too firmed up to 25.7% of BE during Apr-Jul FY23 from 18.2% of actuals in the corresponding period in FY22.
    - Expenditure on subsidies however moderated on account of lower disbursal on food subsidy.

Outlook

As highlighted in our last month's edition, fiscal headwinds have gathered momentum and are cumulatively sufficient to cause a slippage in the FY23 budgeted fiscal deficit ratio of 6.4% of GDP.

- Extension of "PM Garib Kalyan Anna Yojana" by 6-months till Sep-22 to continue providing relief for priority households will cost additional Rs 800 bn.
- Higher than budgeted subsidy bill (on account of the top-up of Rs 1.1 tn), especially on account of fertilizers, which currently faces supply as well as price disruption from the ongoing conflict between Russia and Ukraine.
- Cut in excise duty on petroleum products that will have a revenue implication of close to Rs 850 bn over the remainder of FY23.
- Some rationalization in select custom/import duties on raw materials used for steel and plastics industries to share the burden of the sharp spike in global commodity prices.
- Deferment of the big-ticket BPCL divestment due to subdued interest from bidders amidst volatile market conditions, as per media reports.
- Lower than budgeted dividend/surplus transfer by the RBI (at Rs 303 bn vs. the FY23 budget estimate of Rs 650-700 bn).

Nevertheless, we continue to believe that the central government might be able to scrape through and get close to the budgeted target due to the following factors:

- Tax buoyancy continues to remain strong as reflected in GST collections. In addition, the recent increase in GST rate for select items, customs duty on gold imports, imposition of a windfall tax could offset some of the revenue loss from cut in excise duty on retail fuel items.
- The rollover of LIC IPO (garnering Rs 205 bn) will generate some divestment buffer.
- Similar to FY22, led by the surge in inflation, there is once again a high possibility of Nominal GDP growth turning out to be higher than the budgeted assumption of 11.1%. We note that in the likely scenario of Nominal GDP growth touching 16.5% in FY23, the generation of fiscal buffer could be to the extent of ~40 bps.

Table1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position for FY22)			
Fiscal Variables	% of Actuals	% of BE	Cumulative (INR bn)
	FY22	FY23	Apr-May'22
Revenue Receipts	30.9	34.3	3568.4
Net Tax	29.1	34.4	3075.9
Non-Tax	40.2	33.2	492.5
Non-Debt Capital Receipts	36.1	38.0	250.1
Total Receipts	31.0	34.4	3818.5
Revenue Expenditure	27.4	28.7	5857.74
Capital Expenditure	21.7	27.8	1054.22
Total Expenditure	26.5	28.6	6911.96
Fiscal Deficit	**20.2**	**20.5**	**2039.21**

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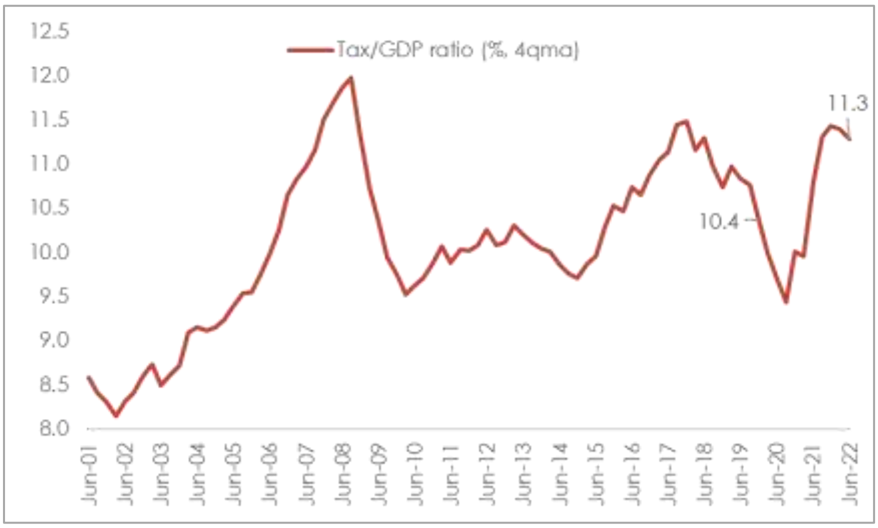
	FY22	FY23	Apr-May'22
Revenue Receipts	30.9	34.3	3568.4
Net Tax	29.1	34.4	3075.9
Non-Tax	40.2	33.2	492.5
Non-Debt Capital Receipts	36.1	38.0	250.1
Total Receipts	31.0	34.4	3818.5
Revenue Expenditure	27.4	28.7	5857.74
Capital Expenditure	21.7	27.8	1054.22
Total Expenditure	26.5	28.6	6911.96
Fiscal Deficit	**20.2**	**20.5**	**2039.21**

Chart 1: CG tax buoyancy above pre pandemic levels for 5-quarters in a row



Note: We have assumed Nominal GDP growth of 27.6% YoY for Q1 FY23

Rates

Peak in yields behind us

KEY TAKEAWAYS

- After closing the month of Aug-22 at 7.19%, India's 10Y g-sec yield has remained in the band of 7.15-7.20% in early Sep'22.
- Accelerated monetary policy tightening by key central banks (led by the US Fed), elevated geopolitical uncertainty, and resurgence of Covid infections in few countries (esp. China) has raised the possibility of a material slowdown in global economic growth, thereby resulting in a correction in global commodity prices from their June peak levels.
- On the domestic front, while improvement in south-west monsoon bodes well for food inflation in the coming months, deficiency in kharif sowing (although gradually catching up) for rice could pose some risk.
- We expect RBI to hike repo rate by a cumulative of 50 bps between Sep-22 and Dec-22.
- We revise lower our 10Y g-sec yield expectation (from hardening towards 8.0%) and don't expect it to breach the FYTD high of 7.6% seen in Jun-22. The 10Y g-sec yield is now likely to have peaked out with possibility of range bound trading between 7.2-7.6% levels in the remaining months of FY23.

After closing the month of Aug-22 at 7.19%, India's 10Y g-sec yield has remained in the band of 7.15-7.20% in early Sep'22.

Chart 1: The 10Y g-sec yield has depicted a softening bias in recent weeks

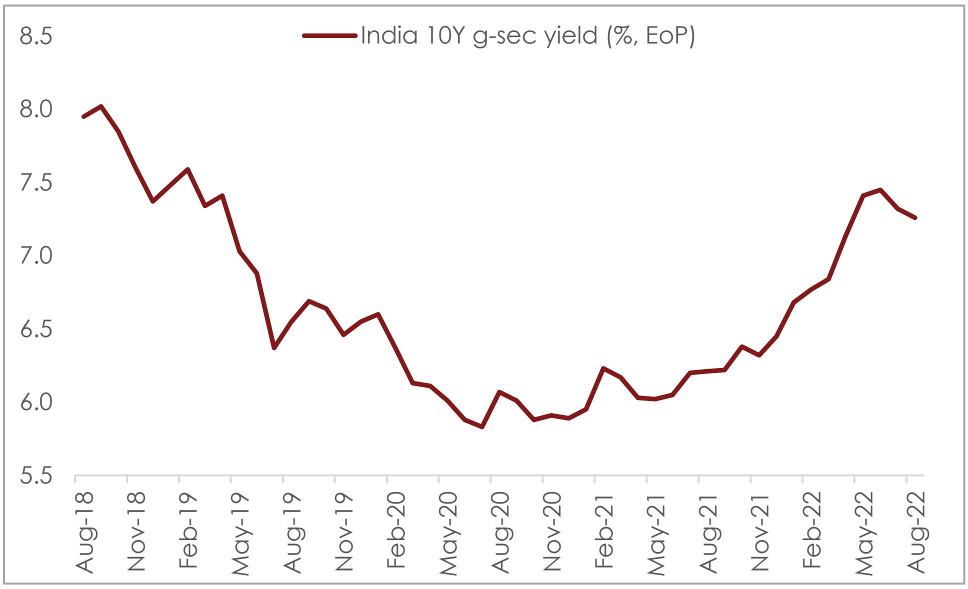
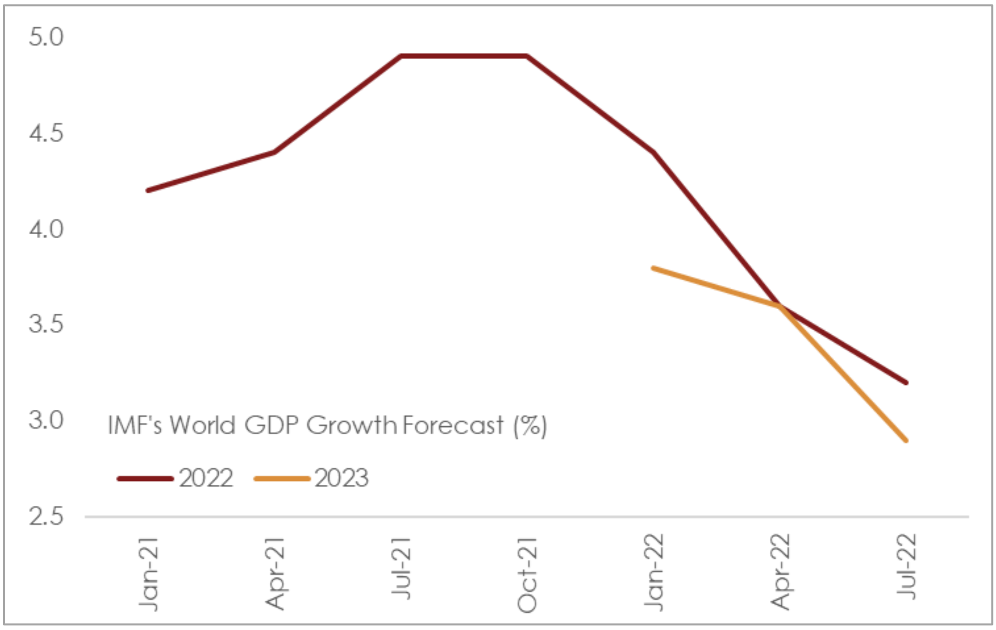


Chart 2: Global growth expectations are getting scaled back



Global growth concerns dominating market sentiment

In the Jul-22 edition of the Acuité Macro Pulse report we had noted that concerns over global growth expectations had started to come together on account of an accelerated pace of monetary tightening in key economies, persistence of elevated geopolitical uncertainty, and resurgence of Covid infections in few countries (esp. in China, which continues to stick to a zero COVID policy).

Since then, these concerns have gained currency. Notably, the IMF in its Jul-22 update to the World Economic Outlook report slashed its forecast for 2022 and 2023 World GDP growth by 40 bps and 70 bps to 3.2% and 2.9% respectively vis-à-vis 6.1% in 2021. We also note that:

- From its peak (in Oct-21), the forecast for 2022 World GDP growth now stands lower by 170 bps
- From its peak (in Jan-22), the forecast for 2023 World GDP growth now stands lower by 90 bps

These sizeable downward shifts in global growth expectations is having a sobering impact on most global commodity prices, thereby offsetting the support from geopolitical uncertainty led disruptions seen in earlier months.

The correction in global commodity prices for second month in succession is having a salubrious impact on India's wholesale inflation. The index for Core WPI (headline index excluding items of fuel, food and beverages) has seen two consecutive months of price decline with the annualized rate of inflation under this category easing off to a 16-month low of 8.86% in Jul-22. If the price moderation sustains, then it could reduce the burden of pass-through to retail consumers.

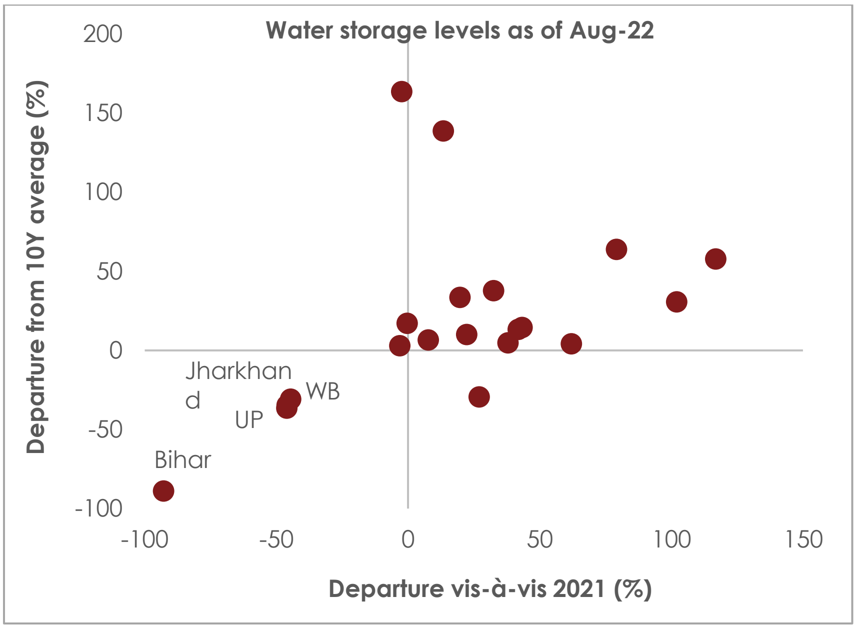
Monsoon progress bodes well, but distribution is a concern

On the domestic front, notwithstanding the disappointing start, south-west monsoon did an impressive catch-up registering a cumulative rainfall of 6.2% above the long period average (as of Aug-22).

However, because of uneven distribution of monsoon (with state level cumulative deficits of 44% in Uttar Pradesh, 38% in Bihar, 26% in Jharkhand, and 13% in Kerala), the kharif sowing activity continues to show a lag, especially in case of pulses and paddy. In case, monsoon rain fails to catch up with the LPA in case of deficient states, irrigation support would become critical for paddy. Although irrigation is accessible in more than 50% of the rice sown area in these states (except for Jharkhand at 4.6%), water availability might be subnormal on account of current low reservoir levels in the eastern regions of the country.

This poses some risk to food inflation, esp. coming from rice and related products (cumulative weight of ~5% in CPI basket).

Chart 3: Low reservoir storage levels could pose risk to paddy output in 4 key states



Outlook

Amidst the unfolding of the above-mentioned global and domestic factors, buildup of excessive risk for g-sec yields no longer appears threatening. However, upside risks do persist. One of the foremost is the pressures on US Federal Reserve to persist with its monetary policy tightening (although market participants are now pricing in slower pace of rate hikes in the future post two successive dose of 75 bps rate increase).

Post the 50 bps rate hike in Aug-22, the RBI has now taken the policy rate above the pre pandemic level. This is in sync with MPC's "withdrawal of accommodation" stance. With CPI inflation expected to remain above the tolerance threshold of 6% until Q3 FY23, we now see scope for another 50 bps cumulative rate hike spread between Sep-22 and Dec-22 policy reviews.

This would nudge 'ex ante' real monetary policy rate in the positive territory and should hopefully provide some anchor to INR as well. We note that since the central bank has been playing an active role in managing rupee volatility, the expected FX intervention on account of sizeable BoP deficit would obviate the need for any CRR hike – as such we roll back our expectation of 50 bps hike in reserve requirement. This would offer some comfort to bond yields. However, a bigger relief comes from the expectation of ebbing of commodity price risks and fast deceleration in global growth momentum. This would help to anchor long term yields by pushing the term premium lower amidst continued emphasis on the gradual transition towards meeting the inflation targeting mandate. As such, we now revise lower our 10Y g-sec yield expectation (from hardening towards 8.00%) and don't expect it to breach the FYTD high of 7.6% seen in Jun-22. The 10Y g-sec yield may have peaked out with possibility of range bound trading between 7.2-7.6% levels in the remaining months of FY23.

Rupee

Possibility of mild weakness persists

KEY TAKEAWAYS

- After closing Aug-22 at a level of 79.49, the Indian rupee weakened further and is currently trading close to the 80.0 levels.
- The dollar is expected to continue deriving support from aggressive pricing in of monetary tightening in the US, ongoing quantitative tightening, along with geopolitics led risk aversion.
- On the domestic front, pressure on India's BoP has been escalating since Q4 FY22. We believe BoP deficit could remain elevated in H1 FY23 before it starts to moderate in H2 FY23 on account of the correction in global commodity prices, reversal in portfolio outflows, and the recent series of macroprudential steps undertaken by the RBI.
- Nevertheless, INR could continue to carry a mild depreciation bias as (i) exchange rate adjustment would be a natural stabilizer for expansion of current account deficit, and (ii) excessive use of reserves to curb depreciation pressures amidst the backdrop of broad-based dollar strength would increase INR's real effective overvaluation vis-à-vis peers.
- We expect moderate depreciation in rupee in FY23 with USDINR moving towards 81 levels before end Mar-23.

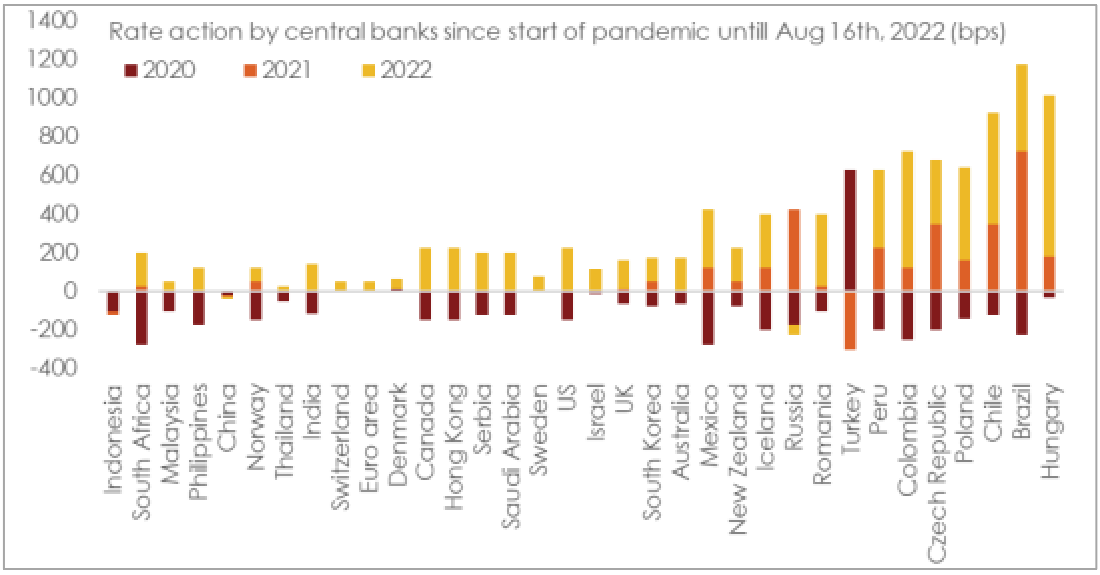
After closing Aug-22 at a level of 79.49, the Indian rupee weakened further and is currently trading close to 80.0 levels. With this, the Indian rupee has weakened for eight straight months culminating into a depreciation of 7.3% in 2022 so far.

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

The broad theme driving rupee weakness has continued to remain intact for the last 7-8 months. We continue to believe that there is room for further weakness, albeit to a moderate extent.

On the global front, dollar supportive environment continues to power ahead.

Chart 2: Following a hawkish Fed, most central banks have accelerated their monetary tightening in 2022



- After hiking monetary policy rate by 225 bps so far in 2022, the US Federal Reserve is expected (as per the FOMC dot plot) to hike interest rates by another 100 bps in the remaining three policy reviews in 2022. Cumulatively, this would tantamount to about 350 bps rate hike during the calendar year 2022, making it the most aggressive rate hike cycle since the Volcker era. The Fed chief Jerome Powell in the recent Jackson Hole speech also clearly stated that the Fed won't stop raising rates until the inflation is under control. As per, the latest statements from FOMC members, the Fed is willing to tolerate some pain on the growth front to bring inflation down to 2% target levels.

  - Meanwhile, the Fed has also commenced quantitative tightening from Jun-22 to further combat inflation risks. The monthly pace of QT will involve USD 47.5 bn selling of securities before getting to a "max" of USD 95 bn in Sep-22. The unwinding of the Fed balance sheet would curb global dollar liquidity and thereby provide a supplementary tailwind to the USD.

In fact, with the DXY Index (at 109 levels) currently trading at its strongest since 2002, has managed to offset the moderate comfort that would have ideally accrued to major EM currencies from the recent correction in global commodity prices.

On the domestic front, pressure on India's BoP has been escalating since Q4 FY22. Monthly trade data for the first five months (Apr-Aug) of FY23 shows a significant widening of the merchandise deficit to USD 125.2 bn vs. USD 53.8 bn seen in the corresponding period in FY22. The increasing pressure on merchandise trade deficit is a confluence of five factors:

- Complete normalization of retail mobility post the Omicron wave along with vaccination drive gaining critical mass (with ~67% of the population having received double dose) is supporting domestic demand for imports.
- The geopolitical crisis continues unfettered for the sixth consecutive month. The ongoing conflict has started to dampen world trade volume (the IMF in its Jul-22 update of the World Economic Outlook report slashed its projection for growth in 2022 and 2023 world trade volume (goods and services) by 90 bps and 120 bps to 4.1% and 3.2% respectively. This has started to manifest via moderation in India's exports.
- In the very near term, a marginal adverse impact on exports is also on account of the recently imposed export restrictions by the government in case of select commodities. This could get reversed in the coming months.
- While most international commodity prices eased considerably in Jul-Aug 2022 on concerns over global slowdown, the impact is yet to get completely manifested in India's trade numbers.
- Individual cases of persistence of supply disruption (in case of like import of Vegetable Oils, Coal, etc.) and sudden spurt in demand (in case of import of Silver on account of substitution effect vis-à-vis gold and its rising demand on for green infrastructure) is also seen to be playing a role.

While the monthly trade deficit prints could moderate in the coming months as impact of somewhat lower commodity prices trickle down and global supply chain pressures ease, overall, increasing risks to exports and relatively robust demand for imports has strengthened the upside risk to our FY23 current account deficit projection of USD 105 bn prompting us to revise it upwards to USD 130 bn. Post this revision, our FY23 BoP estimate would now stand adjusted to a deficit of USD 55 bn.

The size of BoP deficit could however moderate in H2 FY23 vs H1 FY23 as:

- Most commodity prices have corrected significantly in last 2-months on account of growing concerns of a global hard landing (led by the US and Chinese economy). This could provide moderate relief to India's trade deficit in the coming months.
- Amidst expectation of moderation in the pace of hikes by the US Fed, portfolio flows into India have turned around registering an inflow of USD 5.7 bn in Aug-22 so far, marking the highest inflow in last 20-months.
- Recently the RBI announced a series of macroprudential steps to augment capital inflows in the near term.
    - To incentivize NRI deposits, the central bank granted CRR and SLR exemption to banks (on incremental FCNR(B) and NRE term deposits) up to Nov 4, 2022. In addition, banks have also been permitted to raise fresh deposits (FCNR(B) and NRE) without reference to extant regulations on interest rates - this relaxation will be available up to Oct 31, 2022.
    - To incentivize debt investment by FPIs, the central bank has now expanded the FAR basket to include all new issuances of 7Y and 14Y g-secs. In addition, limits on short term investments (in securities with residual maturity of less than 1Y) in g-secs and corporate bonds have been exempted until Oct 31, 2022. Further, investment in corporate money market instruments with original maturity of up to 1Y can now be done (up till Oct 31, 2022), with such investments to be treated as outside reckoning for considering the short-term limit for investments in corporate securities.
    - Unlocking of the domestic economy post the Omicron wave along with vaccination drive gaining critical mass (with ~66% of the population having received double dose) is expected to support domestic demand for imports.
    - In the very near term, a marginal adverse impact on exports can come from the recently imposed export restrictions by the government in case of select commodities.
    - Foreign currency borrowing by banks and corporates (for ECBs) will see relaxation in end-use restrictions, enhancement of automatic route limit, and all-in-cost celling. This dispensation will be available for banks and corporates up till Oct 31, 2022 and Dec 31, 2022 respectively.

While this could help in moderating the pressure in BoP deficit in the coming quarters, INR could continue to carry a mild depreciation bias as (i) exchange rate adjustment would be a natural stabilizer for widening of current account deficit, and (ii) excessive use of reserves to curb depreciation pressures amidst the backdrop of broad-based dollar strength would increase INR's real effective overvaluation vis-à-vis peers.

As such, we expect further moderate depreciation in rupee in FY23 with USDINR moving towards 81 levels before end Mar-23.

Global Overview

Growth outlook turns bleaker

KEY TAKEAWAYS

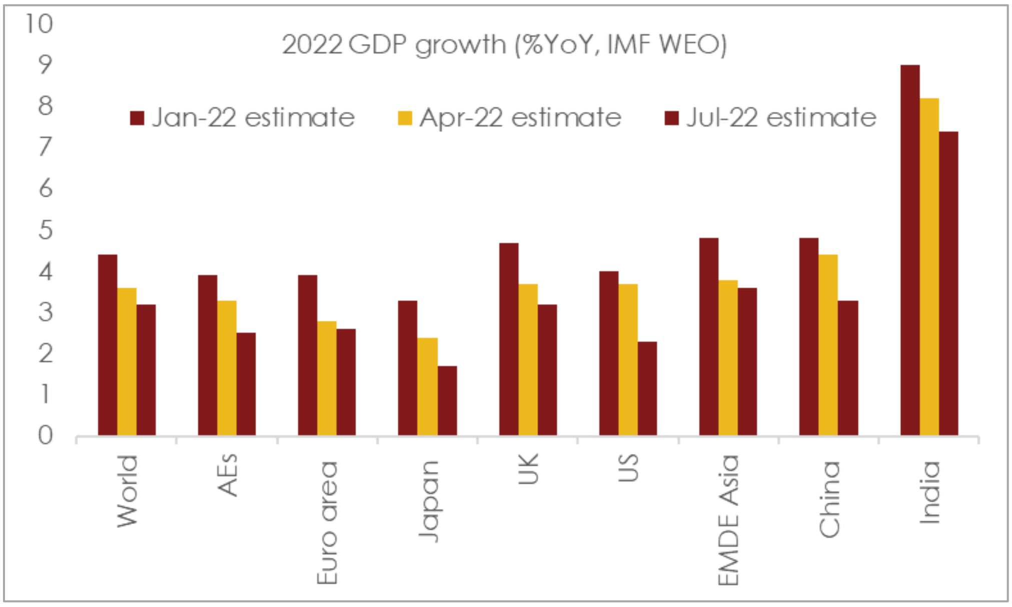
- Over the last one-month, global economic outlook has turned bleaker. Incoming data points to slower growth momentum, even as central banks continue to dial hawkish tones as labour markets' strength remains intact and inflation elevated.
- A sliver of good news on the inflation front was the moderation seen in Jul-22 US CPI inflation. The perpetuating downside in global commodity prices amidst a gloomier growth outlook, has fostered hopes of inflation possibly having peaked in the US.
- In its Jul-22 World Economic Outlook update, IMF assessed the global growth outlook as having turned more 'gloomy and uncertain'. It reduced its 2022 global growth forecast down by 40 bps from 3.6% to 3.2%.
- US growth was downgraded by 140 bps to 2.5% owing to lower growth in H1, reduced household purchasing power, and tighter monetary policy.
- For China, further lockdowns and the deepening real estate crisis has pushed this year's growth estimate lower by 110 bps to 3.3%.
- Global inflation was revised up due to food and energy prices as well as lingering supply-demand imbalances, and is anticipated to average 6.6% in advanced economies and 9.5% in EMDEs this year.

Global overview

Over the last one-month, global economic outlook has turned bleaker. Incoming data points to slower growth momentum, even as central banks continue to dial hawkish tones as labour markets strength remains intact and inflation elevated. The sliver of good news on the inflation front, was the moderation seen in US CPI inflation in Jul-22. The perpetuating downside in global commodity prices amidst a gloomier growth outlook, has fostered hopes of inflation possibly having peaked in the US.

Reaffirming this, in its Jul-22 World Economic Outlook update, IMF had assessed the global growth outlook as having turned more '*gloomy and uncertain*'. As such, it reduced its 2022 global growth forecast down by 40 bps from 3.6% to 3.2% and that for 2023 by 70 bps from 3.6% to 2.9%. On a country wise base, US growth was downgraded by 140 bps to 2.5% owing to lower growth in H1, reduced household purchasing power, and tighter monetary policy. For China, further lockdowns and the deepening real estate crisis has pushed this year's growth estimate lower by 110 bps to 3.3%. In Europe, regional downgrades were an outcome of perpetuating Ukraine-Russia war and tighter monetary policy. On the other hand, global inflation was revised up due to food and energy prices as well as lingering supply-demand imbalances, and is anticipated to reach 6.6% in advanced economies and 9.5% in emerging market and developing economies this year i.e., an upward revision of 90 and 80 bps respectively.

<u>Chart 1: IMF downgraded it's 2022 global growth estimate further by 40 bps to 3.2%</u>

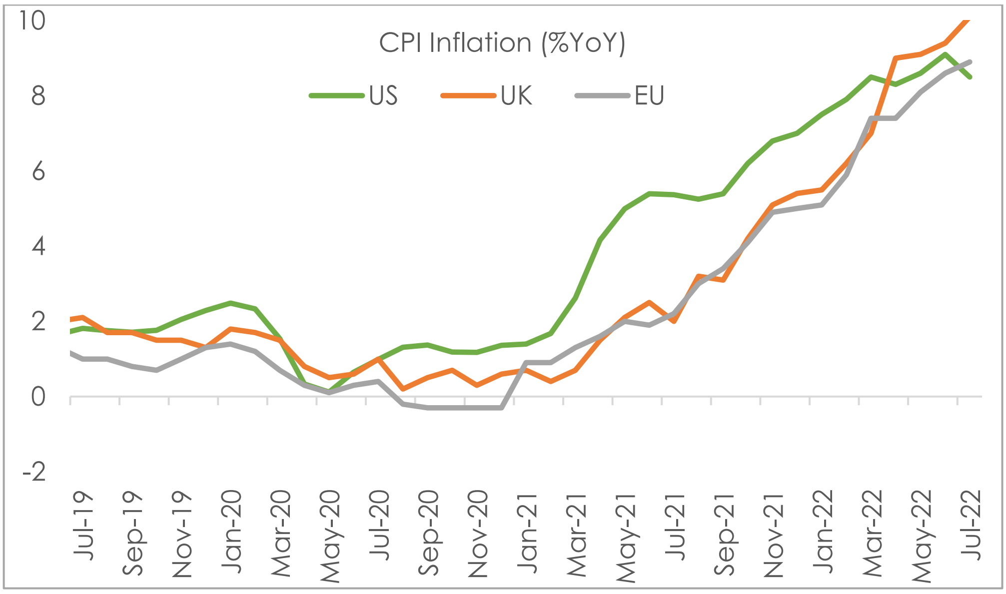


More so, IMF pegged risks to growth outlook to be "*overwhelmingly tilted to the downside*" owing to the possibility of a sudden stop of European gas imports from Russia, tighter than expected labour markets making inflation harder to correct, and tighter global financial conditions inducing debt distress in emerging economies. In addition, renewed COVID outbreaks and geopolitical fragmentation remain risks on watch.

PMI across developed and emerging markets for Jul-22 underscored the slowing global growth momentum. After having remained fairly stable in first few months, global manufacturing PMI index dropped further to 50.3 in Jul-22 from 51.1 in Jul-22, to mark the weakest reading in nearly 2 years. The aggregate index for developed markets, fell more sharply by 1.2 points to 51.3 with indices for several economies slipping below the threshold of 50 (i.e., into a contraction). On the other hand, index for emerging economies dropped 0.9 points to 50.8. At a granular level, the sub components of PMI reflected a weakening of both demand and supply side indicators.

On inflation, key data was Jul-22 US CPI that moderated to 8.5%YoY (i.e., below consensus of 8.7%) from 9.1% in Jun-22. On a sequential basis, an unchanged index in the month for the first time in nearly 2 years offered added relief. The downside was owing to a decline in prices of lodging, airfares, rental cars along with gasoline. The latest inflation print has reinforced the possibility of inflation having peaked in the US economy; which might allow the US Federal Reserve to slow the pace of increase in policy rate when it meets in Sep-22 (i.e., 20-21st Sep-22).

Chart 2: US CPI dips in Jul-22 leading to hopes of inflaiton possibly peaking out



US

Incremental data from the US economy continues to remain exceptionally intriguing – especially the latest prints on CPI inflation and non-farm payrolls. On one hand, the marginal dip in CPI inflation has fuelled hopes of a possible peak out in inflation, but the exceptionally strong addition to payrolls and wage growth points to the possibility of a perpetuating wage-price spiral.

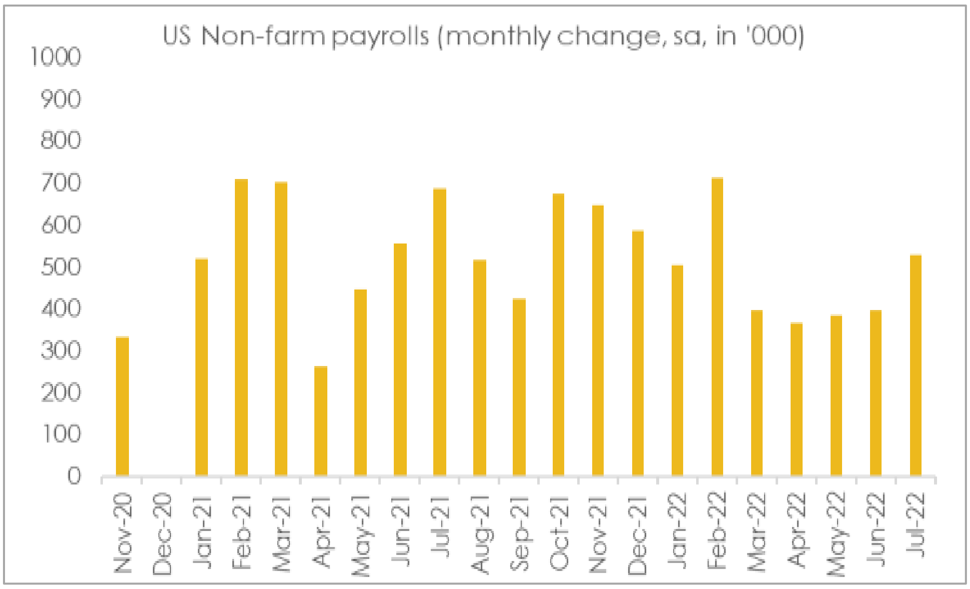
To put this in perspective -

- US CPI rose by 8.5%YoY in Jul-22 (vs. consensus of 8.7%), down from 9.1% in Jun-22. On a sequential basis, prices remained unchanged in the month for the first time in nearly 2 years. Inflation relief came from a decline in price of lodging, airfares, rental cars along with gasoline.
- Jul-22 non-farm payrolls saw an increase of 528k – more than double of market consensus of 250k. In addition, there were upside revisions to past data, with US payrolls having made up completely for all the COVID related job losses in 2020.
- In addition, wage growth also surged, as average hourly earnings jumped 0.5%MoM and 5.2%YoY, higher than estimates.

In other key data, US GDP growth remained in contraction for the second consecutive quarter in Q2-22 coming at -0.9%YoY, though lower than 1.6% drop recorded in Q1; fuelling concerns of a recession.

From FOMC's perspective, inflation needs to see a more sustained easing to warrant a pivot from the current stance. In this spirit, the latest minutes of the FOMC do somewhat suggest that the Fed will remain on a tightening path, but there were signs of some nervousness building up among some of the members. To quote from FOMC minutes - "*Ongoing increases in the target range for the federal funds rate would be appropriate*" with policy needing to move to a "*restrictive stance*", but that "*it likely would become appropriate at some point to slow the pace of policy rate increases*".

Chart 3: Additions to non-farm payrolls beat market expectations by a strong margin in Jul-22, underscoring the continued strength in labour markets



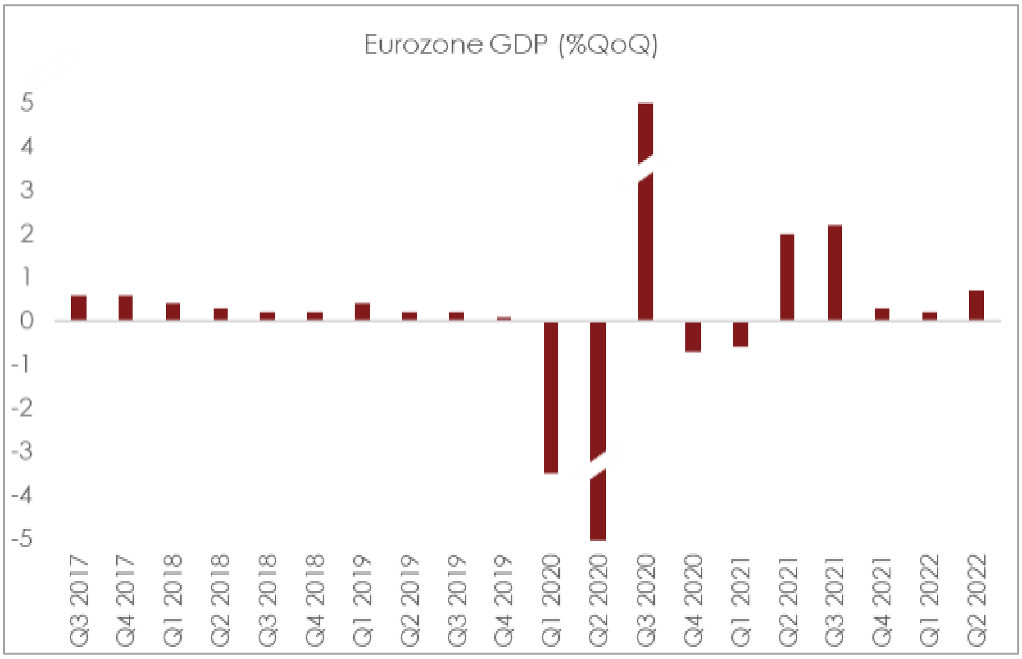
EUROZONE

Q2 GDP for the Eurozone held up well, aided by reopening of the economy and a strong rebound in tourism related services. As such, Q2 GDP clocked a growth of 0.6%QoQ (3.9%YoY) led by countries such as Italy and Spain. Growth not only fared better than market consensus pegged at a more sober 0.1%QoQ, but more than offset the stagnation recorded in German GDP.

Incremental data has however been more disappointing, indicating the region is losing economic momentum. The German ZEW index fell to -55.3 in Aug-22 – near an all-time low, from 53.8 in Jul-22. The current assessment also weakened from -47.6 from -45.8 in Jul-22. The low water levels and a gas levy have added to the downside risks to economic growth in Germany, already grappling with high energy and commodity prices, ongoing supply chain frictions and the war in Ukraine. Eurozone retail sales contracted by 1.2%MoM in Jun-22 with broad-based slowdown especially in the non-food segment. The contraction was pervasive also on a geographical basis, with the sharpest decline seen in Germany and Netherlands. The seasonally adjusted flash Eurozone Composite PMI Index fell from 52.0 in Jun-22 to 49.4 in Jul-22, signalling a contraction of business output for the first time since Feb-21.

On inflation, the region continues to face soaring price pressures, with latest CPI print coming in at 8.9%YoY in Jul-22 compared to 8.6% in the previous month. This meant inflation has hit a record high for the third straight month in a row. In its last policy meeting in Jul-22, ECB announced a 50-bps hike to surprise some sections of the market. Forward guidance was changed to a 'meeting by meeting' approach keeping the door open for incremental rate action in line with evolving economic situation. Still, the ECB did indicate, that 'further normalisation of interest rate will be appropriate'; which the latest CPI inflation print reinforces.

Chart 4: Eurozone Q2 GDP better than expected amidst reopening dynamics



UK

Unlike the US, price pressures in UK have not yet abated. CPI inflation jumped to 10.1%YoY in Jul-22, the highest since Feb-82 compared to 9.4% in Jun-22. This marked the first double digit inflation led by surging food costs, with the print exceeding market forecasts. Earlier this month, despite warning about an impending recession, the BoE raised the key policy rate by 50 bps to 1.75% - its first 50 bps hike since 1995. The central bank now sees inflation peaking at 13.3%YoY in Oct-22, i.e., when regulated household energy prices are set to rise against 11% earlier. However, price pressures cannot only be attributed to more volatile components like food and energy, as core CPI also quickened to 6.2%YoY. Elevated inflation is likely to pressure real household incomes, consumer purchasing power and overall GDP growth going forward. As per its assessment, the MPC projects the UK economy to enter a recession from the Q4-22, and the recession to last nearly 5 quarters. Reading into these growth-inflation dynamics, markets continue to expect the BoE to hike by another 75 bps but in a front-loaded manner.

CHINA

Incremental data shows signs of further weakening of the Chinese economy has shown signs of weakness. The biggest disappointment came from retail sales, with annualised growth slowing to 2.7%, much below consensus expectations of an improvement to 4.9% and when compared to 3.1% in the previous month. In comparison, industrial production growth was more or less stable compared to Jun-22, at 3.8%YoY but yet again below market expectations pegged at 4.3%. While unemployment rate marginally dropped further to 5.4% in Jul-22 from 5.5% in Jun-22, youth employment rose to a new high of 19.9%. From a broader perspective, growth recovery in China appears to be getting constrained in the aftermath of the drag from virus flare-ups earlier in the year and related policies, along with the property sector remaining on a weaker footing. Reinforcing this, IMF in its Jul-22 update of the World Economic Outlook, cut its growth forecast for the Chinese economy by 110 bps to 3.3% for 2022.

Reacting to the macroeconomic environment, the PBoC cut its 1-year rate on its Medium-Term Lending Facility to 2.75%, from 2.85% earlier this month, for the second time this year. While CPI is rising, at 2.7%YoY in Jul-22, it remains well below central bank's target rate of 3.0% and anchored when compared to global inflation. Further, the decline in global commodity prices has softened producer price inflation to a 17-month low of 4.2%YoY in Jul-22. However, the rate cut needs to be seen not so much from an inflation perspective, but rather as a means to support the economic recovery from the lockdown led slump earlier this year.

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 9,200 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.

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