Acuite
RATINGS & RESEARCH

Macro Pulse Report

December 2022

Contents

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

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From the desk of the CAO

Hope all of you had a great start to the year 2023! The release of our **twenty fourth** edition of **Acuité Macro Pulse** marks the completion of **two years** since we started the publication of this monthly commentary on the domestic and the global economy.

One word that defines 2023 or at least the beginning of it is "uncertainty". Since the early part of 2022, the global macroeconomic horizon had been clouded by uncertainty and with the passage of time, they have only got darker. This uncertainty can be split into three components.

The first is the duration of the global tightening cycle and how much more residual rates are there on the way for the major central banks in the world. This has implications for global capital flows, asset allocations, currency depreciation and finally, global economic growth. While the quantum of rate hikes have started to taper down due to a slackening inflation trajectory, the end game is difficult to predict at this stage. Many market participants have started to believe that even if the rate hikes pause in the near term, they are likely to stay high for a relatively longer period.

The second element are the vestiges of what we have already witnessed over the last three years – the Covid pandemic. No, it is not done yet as the high level of mortalities in China indicate – reported 60,000 over the last one month with high underestimation risks. Although global mobility have almost normalized with even China having lifted the lockdowns, the likelihood of potent new variants can't be wished away. As regards the domestic scenario, the data is yet to suggest any disturbing trend and we can only hope that the vaccination coverage as well as the herd immunity will help India to remain insulated from any fresh scare.

The third is the geo-political conflict in Ukraine that is now set to complete a year and doesn't show any signs of abatement. With the continuing economic sanctions on Russia, the energy prices are unlikely to come down significantly despite the ongoing global slowdown. Brent crude oil prices have moved back to USD 85 pb supported by the supply restrictions announced by OPEC+ in Dec-22. Higher oil prices may not allow global inflation to subside at a quicker pace despite the relatively benign outlook in the food category.

On the other hand, the state of the domestic economy permits us to be more optimistic. NSO has pegged the first advance estimates of GDP growth in FY23 at 7.0% which is in line with our forecasts. We believe that the strength of domestic demand particularly in the services sector may still surprise us on the upside. However, the narrative has now shifted to FY24 and while we are yet to formalize our forecast, we believe the economy is capable to deliver a growth print of 6.0% next fiscal. Lower inflation, a pickup in rural demand and the emergence of private sector capex along with higher level of public capex are likely to be the growth drivers in FY24. The impact of interest rate hikes on consumer demand will remain a concern but given that we are almost at the end of the rate hike cycle in India, it is likely to remain moderate. What will be closely watched are the fiscal policies of the government announced either through the upcoming Union Budget or otherwise to incentivize growth. While we don't expect any radical changes in the taxation front given the need for fiscal consolidation, measures to expedite private sector capex through PLIs or other forms can push the needle on investments.

Wishing you and your family the very best in 2023,

Suman Chowdhury
Chief Analytical Officer

Growth

Resilient despite slowdown headwinds

KEY TAKEAWAYS

- While we enter the new calendar year with some uncertain steps, the Indian economy has managed to withstand a tough global environment rather well over the last two quarters.
- Growth impetus in the domestic economy has been driven by pent-up and festive demand for goods, alongside a sharp recovery seen in contact-intensive services especially in tourism, hospitality and travel with complete normalization of the economy.
- India's GDP growth print in Q2 FY23 decelerated sharply to 6.3% YoY from 13.5% in Q1 FY23. The downslide in headline economic growth was broadly along expected lines (market consensus: 6.2%) due to the absence of a favorable statistical base in Q2, in contrast to the significant boost it provided to Q1 data.
- Looking at recent data releases, high frequency indicators suggest that domestic economic activity remained broadly resilient in Nov-22 and Dec-22. Recall, Oct-22 had recorded a dip in some of the indicators amidst lesser number of working days in the festive heavy month.
- For Q3 and Q4, growth is likely to dip closer to 4.0%-4.5%. This factors in incremental external risks (tightening global financial conditions, heightened geopolitical uncertainty, lingering Covid related supply disruptions in China) despite support from factors such as strength in services demand, upside in rabi sowing, capex-oriented government expenditure and the softness in global commodity prices.
- We have held to our FY23 GDP growth estimate of 7.0% which is in line with the first advance estimates of GDP growth released by NSO.

The Indian economy has managed to withstand a tough global environment rather well over the last two quarters of calendar 2022. The geopolitical uncertainty amidst the Ukraine Russia crisis that broke out in Feb-22, followed by the run up in commodity prices (up-to Jun-22), a synchronized and aggressive monetary policy rate tightening cycle and more recently the slowing momentum in global growth, meant that the external environment remained largely antagonistic in the past one year. On the other hand, a growth impetus was visible in the domestic economy, driven by pent-up and festive demand for goods, alongside a fast resumption seen in contact-intensive services especially in tourism, hospitality and travel sectors.

Q2 FY23 GDP and FY23 AE NSO: In line with expectations

India's GDP growth in Q2 FY23 decelerated sharply to 6.3% YoY from 13.5% in Q1 FY23. The downward slide in headline economic growth was broadly along expected lines (market consensus: 6.2%) due to the absence of favorable statistical base in Q2, in contrast to the significant boost it provided to Q1 data.

Sequentially, GDP expanded by 3.6% QoQ, better than the pre pandemic seasonal average (over a 10-year period) of 0.6% observed in Q2. This sequential expansion is in sync with the signals derived from other leading activity indicators, including our monthly Acuite Macroeconomic Performance Index.

NSO has released the advance estimates (AE) of FY23 GDP which pegs the growth at 7.0%. While this is slightly higher than the forecast of RBI (6.8%), it is currently in line with the forecast of Acuité.

Recent data releases

Looking at recent data releases, high frequency indicators suggest that domestic economic activity remained broadly resilient over the month of Nov-22 and Dec-22. Recall, Oct-22 had recorded a dip in some of the high frequency indicators amidst lesser number of working days in the festive heavy month.

- Growth in India's industrial activity retreated into negative territory with Oct-22 IIP contracting 4.2%YoY vis-à-vis an expansion of 3.5% in Sep-22. However, the latest IIP data release indicate India's industrial activity has reverted to expansionary territory with Nov-22 IIP posting an annualized growth of 7.1%YoY.
- Despite the slowdown fears, PMI manufacturing has interestingly seen an increasing trend with a print of 55.7 in Nov-22 and further sharply up to 57.8 in Dec-22 which is the highest figure since Oct-20. This is led by expansion in both new domestic and export orders along with a substantial easing of input cost pressures.
- PMI services has also seen a consistent uptrend since Sep-22 and has logged a multi-year high of 58.5, led by strong pent-up demand for services and upside in employment after the normalization of the economy.
- Gross GST revenue collections in Nov-22 (i.e., for transactions in Oct-22) dipped to Rs 1.46 Lakh Cr compared to Rs 1.52 Lakh Cr in Oct-22 but it has seen a quick recovery to Rs 1.50 Lakh Cr in Dec-22, with the annualized growth at 15%.

- E-way bills continued to show an upward trend in Q3FY23, rising to 8.4 Cr in Dec-22 on the back of 8.1 Cr in Nov-22 and 7.7 Cr in Oct-22.
- Fuel consumption accelerated in Nov-22 on a low base of contraction a year ago. Growth was led by increase in consumption of diesel and ATF with agri harvesting in full swing and continued uptick in demand for air travel.
- After an annualized contraction of 12.1% in Oct-22, merchandise exports registered a modest growth of 0.6% YoY to USD 32.0 bn in Nov-22 from USD 31.4 bn in Oct-22 to mark the first sequential expansion (1.9% MoM) in 5-months. Sequential growth was led by Machinery Items, Petroleum Products, Agri & Allied Products, Electronic Items, Chemicals and Textiles.

Chart 1: Both Manufacturing and Services PMIs hit a high in Nov and Dec-22

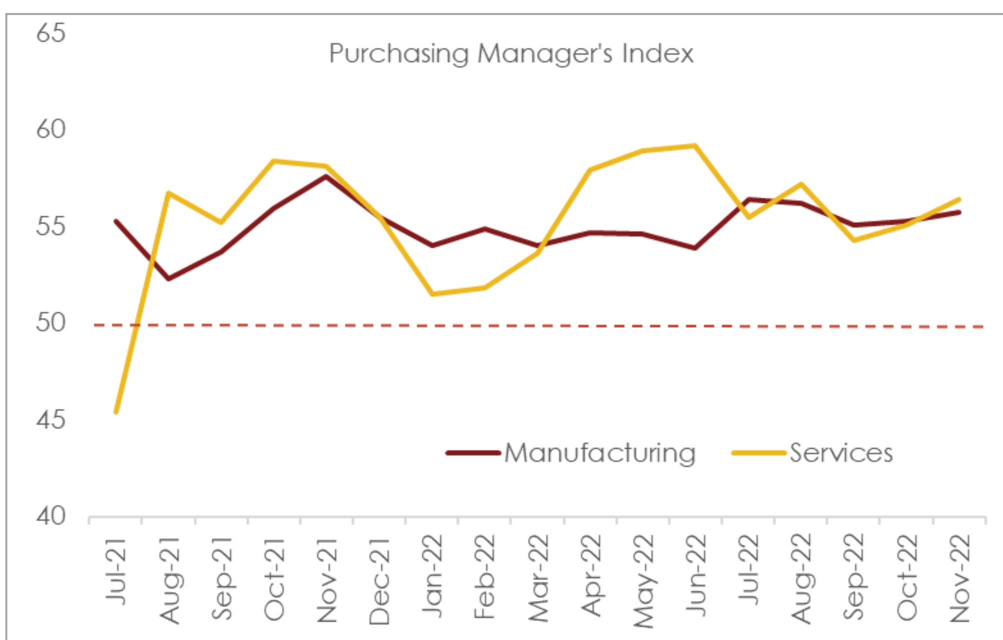
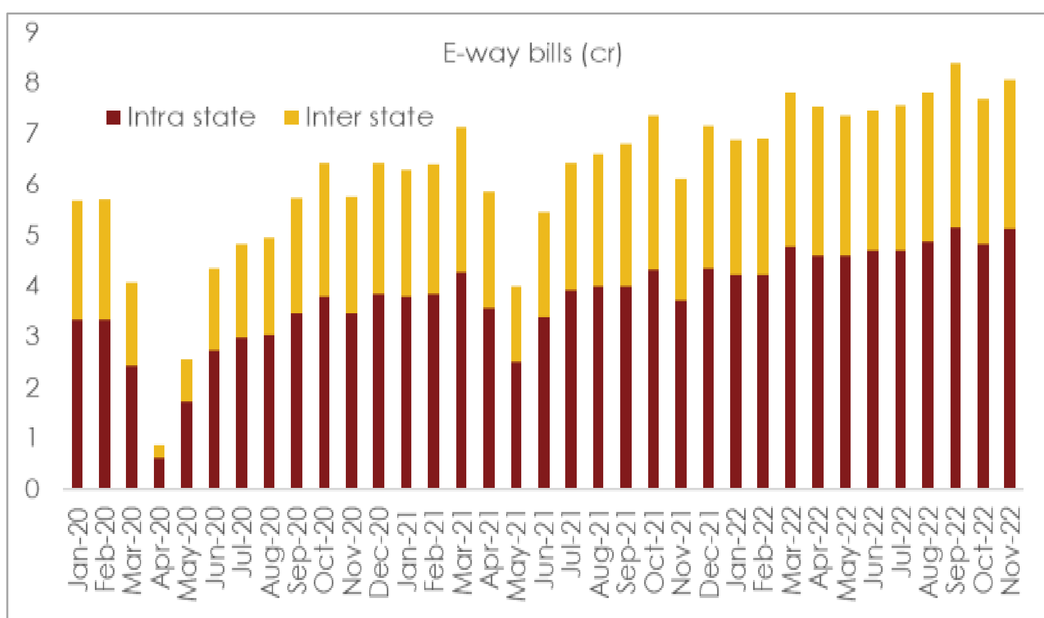


Chart 2: E-way bills generated bounce back in Nov-22 and Dec-22



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Outlook

Broadly, domestic economic activity continues to display strength with several indicators shrugging off the weakness seen in Oct-22. Having said so, global growth conditions remain hostile amidst tightening financial conditions and lingering geopolitical uncertainties.

On the sectoral side, agriculture continues to offer support amidst a healthy pick up in Rabi sowing seen so far this year. This has been aided by the late withdrawal of monsoon, adequate water level in reservoirs along with a moderate hike in MSPs especially for wheat. Services continue to outperform manufacturing, benefitting from a fully reopened economy and vengeance demand. With the moderation in inputs costs (validated by both WPI inflation and PMI input prices), manufacturing GVA growth could turn positive in Q3 FY23 after contracting by a sharp 4.3%YoY in Q2 FY23.

On the expenditure side, domestic consumption recovery is being led by urban demand (pent-up/festive demand), while rural demand recovery remains on a weaker track. Tractor sales slipped to a 3-month low in Nov-22, along with moderation seen in two-wheelers and motorcycles. In contrast, credit card spends, air travel and discretionary spends underscore strength in urban demand. While completion of Kharif harvest/procurement and a good Rabi output can potentially provide support to rural demand amidst easing inflation over the next two quarters, urban demand is likely to simultaneously feel the pinch of the lagged impact of over 200 bps of rate tightening undertaken by RBI so far. Investment activity continues to recover as validated by improving capacity utilization levels, domestic production and imports of capital goods. Offering added support is Government's capital expenditure, having risen by a strong strong 49.5%YoY during H1 FY23, though states appear to be lagging on this front.

Having said so, external support to exports remains on a weaker turf amidst slowing global demand conditions. In its last World Economic Outlook report, the IMF slashed its growth forecast for 2023 World GDP and World Trade by 20 bps and 70 bps to 2.7% and 2.5% - this marks a sharp loss of momentum vis-à-vis IMF's 2022 growth estimates of 3.2% and 4.3% earlier.

On an annualised basis, as the favourable statistical effect tapers, incremental GDP growth is bounded to be on decelerating path. In Q3 and Q4, growth is likely to dip to a range of 4.0-4.5%, compared to a robust expansion of 9.7% in H1 FY23. **We hold on to our FY23 GDP growth estimate of 7.0%.**

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Inflation

Relief after the overheating

KEY TAKEAWAYS

- India's CPI and WPI inflation had converged in Nov-22 with a print of 5.88% YoY (11-month low) and 5.85% YoY (21-month low) respectively. The latest CPI print for Dec-22 has come as a further relief to the market and the policymakers at 5.72%.
- From their respective monthly peaks in FY23, headline CPI and WPI inflation are now lower by 208 bps and 1078 bps respectively.
- After a long hiatus, headline CPI inflation has printed within the target range (2-6%) for successive two months.
- While favorable statistical base effect helped both WPI and CPI inflation drift lower in Nov-22 and Dec-22, it is noteworthy that both inflation indices also registered a sequential fall.
- Basis favorable winter seasonality, ongoing decline in global food prices, and pick-up in domestic rabi sowing, we are hopeful of a relatively benign near-term outlook on food inflation.
- Concerns on core CPI inflation, however, continue to persist, with services inflation exhibiting stickiness given the increased demand strength. However, incremental softness in commodity prices and some moderation in domestic demand would gradually help to ease the pressure going forward.
- We continue to maintain our FY23 CPI inflation forecast at 6.7%.

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Overview

India's CPI and WPI inflation metrics converged in Nov-22 with a print of 5.88% YoY (11-month low) and 5.85% YoY (21-month low) respectively. CPI print hit a further low of 5.72% in Dec-22. More importantly:

- Both metrics exhibited sharp deceleration, with headline CPI and WPI inflation easing by 16 bps and 254 bps respectively over the previous month.
- From their respective monthly peaks in FY23, headline CPI and WPI inflation are now lower by 208 bps and 1078 bps respectively.
- The convergence has happened after a gap of nearly 2-years
- Last, but not the least, CPI inflation, after a hiatus of 11-months, printed within the target range (2-6%) for two successive months.

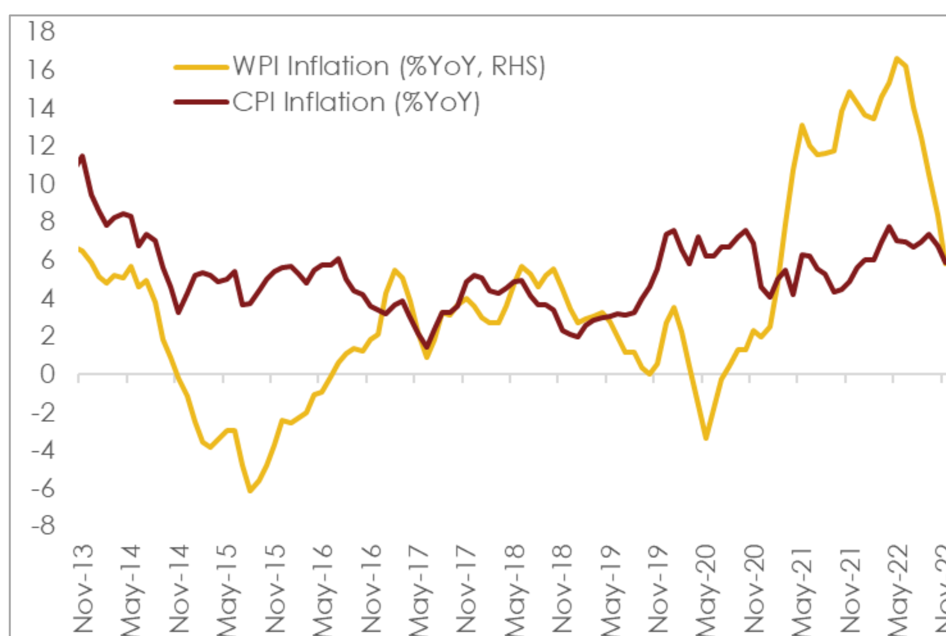
Key highlights of CPI inflation

- On sequential basis, CPI declined by 0.11% MoM in Nov-22 and further by 0.45% MoM in Dec-22, this trend of a sequential decline in inflation has happened in successive months after a 10 month period.
- Food and Beverages index fell by 0.72% MoM in Nov-22, marking its first decline in last 9-months. The downside was led by Vegetables (-8.3% MoM), Fruits (-2.0% MoM), and Meat & Fish (-0.7% MoM). On the other hand, price pressures were seen to persist in case of Cereals (+1.3% MoM) and Spices (+1.4% MoM). The latest print highlights a further fall in food inflation by 1.35% MoM in Dec-22, diluting the concerns on food prices.
- Respite on food inflation was driven by perishables, which appear to have benefitted from fresh mandi arrivals post the erratic rainfall in Oct-22. In addition, (i) edible oils saw its first price increase after a 5-month hiatus, and (ii) milk prices continue to march ahead at a somewhat elevated pace. We note that the lagged spillover impact of elevated agri input prices and extension of PM Garib Kalyan Yojana (until Dec-22) can keep food inflation pressures arising mainly from cereals, on the table. However, the arrival of incoming kharif produce and ongoing healthy rabi sowing would help to neutralize some of these risks.
- Consolidated fuel prices rose by 0.35% MoM in Nov-22, with bulk of the increase coming from hike in kerosene prices along with hardening of coal and charcoal prices.
- Sequential momentum in core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel items within Miscellaneous) moderated to 0.40% MoM in Nov-22 and further to 0.27% in Dec-22 from 0.69% in Oct-22. The annualized rate of inflation under this category posted a mild moderation to 6.4% in both Nov-22 and Dec-22 from its post pandemic peak of 6.5% in Oct-22 but still remains a matter of concern for the central bank, given that it is consistently above 6%.

Key highlights of WPI inflation

- Sequentially, WPI fell by 0.26% MoM vs. an increase of 0.39% seen in Oct-22.
- Sequential fall was led by consolidated food & beverages index that declined by 1.71% MoM in Nov-22.
- Support also came from core WPI, that saw its third consecutive sequential decline (-0.28% MoM in Nov-22). Significant easing of sequential price pressures was observed in case of textiles, basic metals, paper products, rubber, electronic & optical products, etc.
- In contrast, consolidated fuel index rose by a strong 2.41% MoM, led by jump in price of bitumen, wholesale diesel, pet coke, ATF, naphtha, kerosene, and wholesale petrol.

Chart 1: CPI and WPI inflation converge after a gap of nearly 2 years in Nov-22



Outlook

While a favourable statistical base partly helped both WPI and CPI inflation drift lower in Nov-22 and Dec-22, it is noteworthy that they also registered a sequential fall. Importantly, on annualized basis, they continue to underscore disinflationary tendencies, with the latest prints showing a pick-up in the pace of deceleration.

Easing of food inflation is comforting as it now symbolizes kicking in of favorable winter seasonality (with arrival of kharif produce) at both wholesale and retail levels. Juxtaposed with the ongoing decline in global food prices and healthy domestic rabi sowing, one is hopeful of a build-up of relatively benign near-term outlook on food inflation.

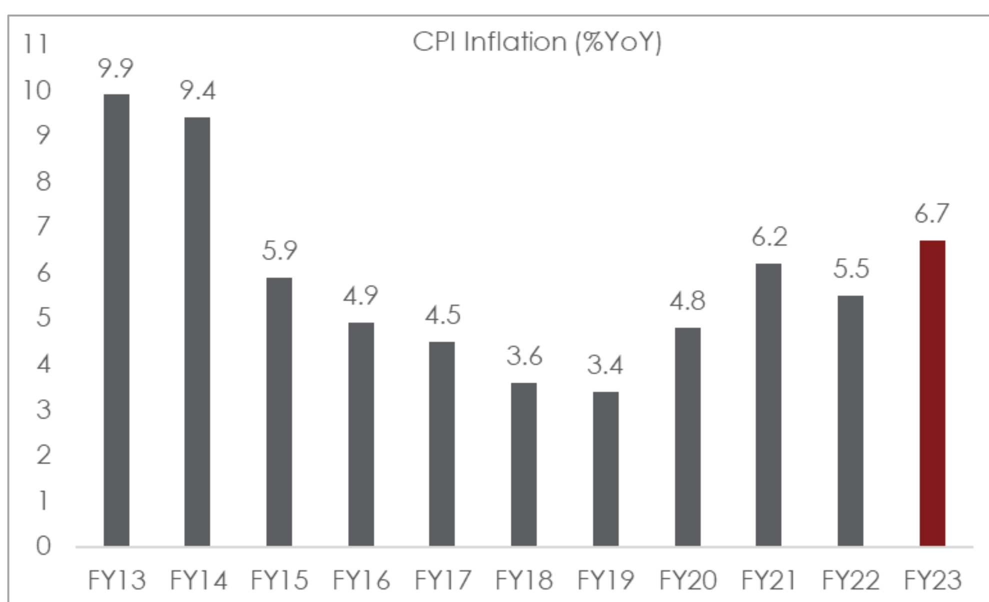
Having said so, incipient concerns, primarily in the form of elevated core retail inflation and stickiness in services inflation, continue to persist. We note that core retail inflation has persisted above 6.0% for the last 6 months - a concern that RBI too had highlighted

in its recent policy commentary in Dec-22. In addition, services inflation clocked its third consecutive monthly increase in Nov-22.

However, the silver lining emerges from the sharp deceleration in core wholesale inflation (that printed at a 2-year low of 3.8% in Nov-22). Incremental softness in most commodity prices (including crude oil) bodes well for further easing of input price pressure, which should start getting partially reflected in core retail inflation with a lag. Even with PMI manufacturing, input cost inflation receded to the weakest rate in 28 months in Nov-22.

While we continue to maintain our FY23 CPI inflation forecast of 6.7%, a downside risk to this estimate has emerged post the Nov-22 and the Dec-22 data print.

Chart 2: We hold on to FY 23 inflation estimate of 6.7% with increased downside risks



Government Finances

Despite risks, deficit target achievable

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Nov stood at 58.9% of budget estimates (BE) for FY23, slightly lower than the level of 61.7% of actuals in the corresponding period in FY22.
- The FYTD fiscal theme continues to rest upon strong revenue receipt collections and prioritization of capex over revex.
- Fiscal headwinds continue to persist in the form of additional subsidy burden, cut in excise duty and customs on select items to provide relief from inflation, deferment of big-ticket divestment, and lower than budgeted dividend transfer by the RBI.
- Nevertheless, we continue to believe that the central government has buffers that would enable it to attain the budgeted target on account of persistence of tax buoyancy, recent upward adjustments in some of the indirect tax rates, expenditure savings and rationalization, and significantly higher than budgeted Nominal GDP base.

India's central government fiscal deficit for the period Apr-Nov stood at 58.9% of budget estimates (BE) for FY23, slightly lower than the level of 61.7% of actuals in the corresponding period in FY22.

While the pace of expenditure disbursals had been faster in H1FY23, it seems to be slowing down in the second half of the year given the tighter control on revex.

Receipts: Despite adverse base for growth, value of collection remains strong

Total receipts in the first eight months of FY23 continue to be buoyed by strong tax collections.

- On FYTD (Apr-Nov) basis, gross tax revenue has grown by 15.5% YoY.
    - Momentum so far is supported by healthy collections under income tax, corporate tax, and GST. The impressive momentum in GST revenue continues to persist with total monthly collections averaging at Rs 1.49 tn during Apr-Nov FY23 compared to the anticipated monthly run rate of Rs 1.35-1.40 tn for meeting the BE. While the recent hike in GST rates for select goods and services and the festive heavy H2 FY23 are seen to be key enablers, moderation in imports could weigh upon the momentum in the coming months.
    - Meanwhile, collections from customs and excise were lower in comparison. This is reflective of relaxation in duties on select import items (including retail fuel) to provide relief from elevated inflation.
    - We had highlighted early signs of moderation in gross tax revenue growth in the October edition of Acuite Macro Pulse report. The second half of FY23 would present unfavourable statistical base, besides the anticipation of easing of nominal growth momentum. While we are confident of tax collections exceeding budget targets by a fair margin, we would nevertheless keep an eye on incremental developments in this space.

Non-tax revenue collections accelerated to 73.5% of BE during Apr-Nov FY23.

- Pick-up in last few months appears to be led by telecom spectrum revenue from 5G auction and increased dividend pay-out from PSEs.
- Having said so, RBI's dividend for FY22 (transferred in May-22) that stood at Rs 303 bn, a sharp drop from Rs 991 bn done in the previous financial year, would continue to leave a hole in non-tax revenues.

Non-debt capital receipts clocked 52.3% of BE during Apr-Nov FY23. While disinvestment proceeds from LIC in May-22 (that fetched Rs 205 bn) provided a strong start, lack of divestment activity in last four months led to petering of gains.

Expenditure: Capex disbursals see further build-up

On FYTD (Apr-Nov) basis, total expenditure disbursal stood at 61.9% of BE, significantly higher than 54.7% of actuals in the corresponding period in FY22.

- Momentum continues to be led by capital expenditure that clocked 59.6% of BE during Apr-Nov FY23 vis-à-vis 46.2% of actuals in the corresponding period in FY22. Bulk of this was incurred on defence, railways and urban housing. In

addition, to facilitate capex by states, the FY23 Union Budget had made provision for disbursing Rs 1.1 tn as 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 whopping 115.6% YoY during Apr-Oct FY23 vis-à-vis a contraction of 19.8% in the corresponding period in FY22.

- Revenue expenditure too firmed up to 62.5% of BE during Apr-Nov FY23 from 56.3% of actuals in the corresponding period in FY22.
    - Interest payments and subsidies have accounted for 41.5% of revex disbursals in the seven months of this fiscal.
    - Excluding interest payments and subsidies, revex grew by a modest pace of 5.4% YoY during Apr-Oct FY23.

Outlook

As highlighted in our last month's edition of Acuite Macro Pulse, fiscal headwinds continue to persist in the form of additional subsidy burden (primarily on account of extension of PM Garib Kalyan Anna Yojana and adverse spill over of Russia-Ukraine war on prices of fertilizers and crude oil), cut in excise duty and customs on select items to provide relief from inflation, deferment of big-ticket divestments and lower than budgeted dividend/surplus transfer by the RBI.

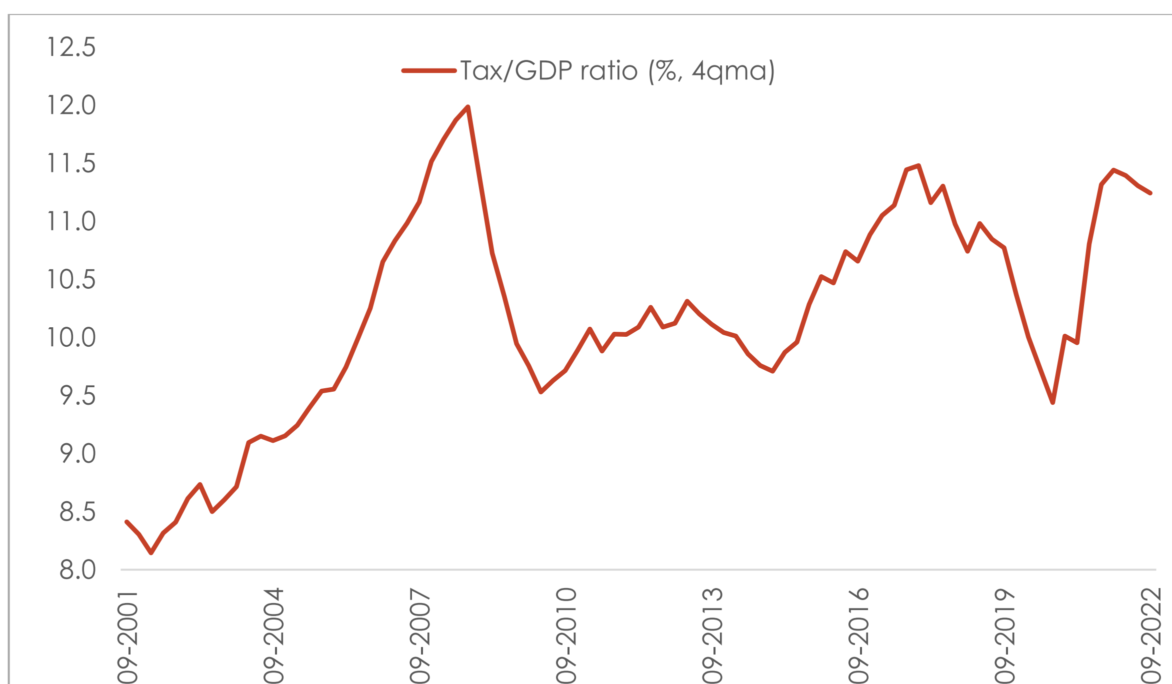
However, we continue to believe that the central government would be able to scrape through and attain the budgeted fiscal deficit target of 6.4% of GDP due to multiple factors:

- Tax buoyancy continues to remain healthy with 4-quarter trailing Tax/GDP ratio of 11.2% in Q2 FY23 vis-à-vis the pre pandemic level of 10.8% in Q2 FY20.
- The rollover of LIC IPO (garnering Rs 205 bn) has generated some divestment buffer.
- The government is likely to have saved Rs 200-300 bn due to lower than targeted procurement of wheat.
- Recently concluded 5G telecom auction has generated about Rs 150 bn in additional revenue vis-a-vis BE.
- Following the historical pattern, the government could potentially rationalize revenue spending towards the end of FY23 to make ends meet if required.
- As per the first advance estimates of GDP for FY23, Nominal GDP, which becomes a critical input for Budget arithmetic, is estimated at Rs 273.1 Lakh Cr – translating into annualised growth of 15.4% compared to 19.4% in FY22. Against the budgeted growth of 11.1%, this growth upside gives the Government an added fiscal headroom of nearly Rs 95000 Cr in FY23 (or 30 bps cushion to FY23 fiscal deficit to GDP ratio of 6.4%).

Table 1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position, Apr-Oct)				
	% of FY Actual/Target		%YoY	
	FY22	FY23	FY22	FY23
Revenue Receipts	58.1	61.2	82.1	7.1
Net Tax	57.9	60.5	82.9	11.2
Non-Tax	59.4	66.3	78.0	-13.6
Non-Debt Capital Receipts	50.3	45.0	20.3	81.0
Total Receipts	58.0	60.7	80.7	8.3
Revenue Expenditure	49.1	54.3	7.5	10.2
of which, Interest Payment	49.8	51.2	20.3	19.9
of which, Major Subsidies	48.5	75.2	13.2	13.8
Capital Expenditure	42.7	54.6	28.3	61.5
Total Expenditure	48.1	54.3	9.9	17.4
Fiscal Deficit	**34.5**	**45.6**	**-**	**-**

Chart 1: Despite moderation, tax buoyancy remains above pre pandemic quarter



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Rates

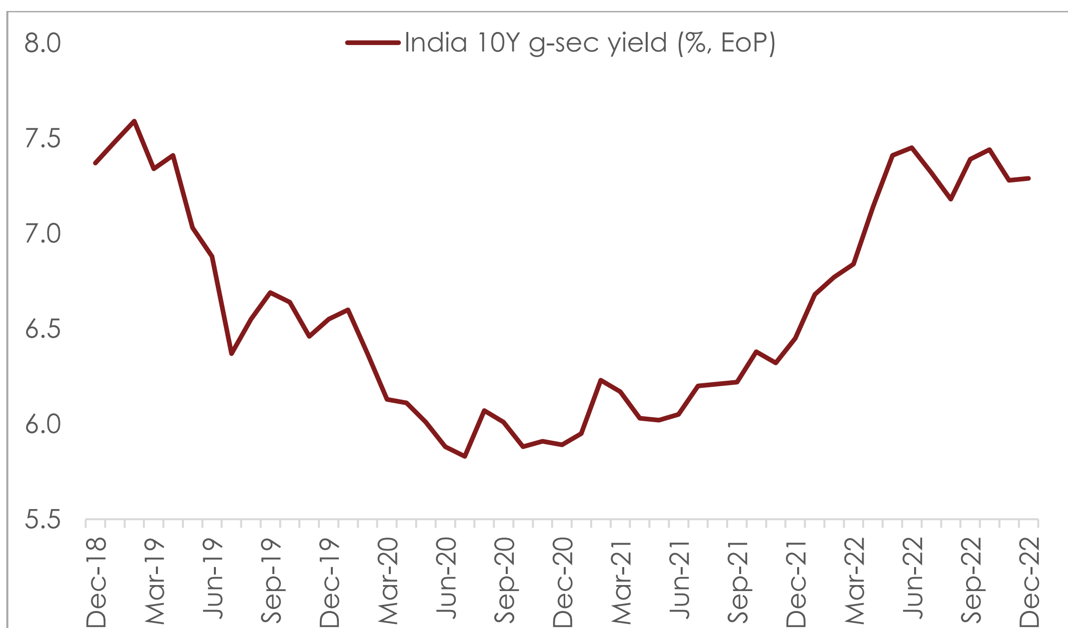
Emergence of a mild downside bias

KEY TAKEAWAYS

- After closing the month of Nov-22 at 7.28%, India's 10Y g-sec yield has been trading in a narrow 11-12 bps range of 7.21-7.32%.
- Over the last 2-3 months, the peak out of inflation has emerged as a dominant macro theme across many countries.
- Some of the central banks have acknowledged the declining trend in consumer inflation and has started calibrating their respective monetary policy actions.
- After moderating its pace of rate increase, we expect the RBI to announce its final hike of 25 bps in the next policy review in Feb-23 and get into a pause thereafter.
- Of late, a mild downside bias to long term interest rates has emerged.
- We finetune our near term (by Mar-23) 10Y g-sec yield range call from 7.20-7.60% to 7.10-7.50%.

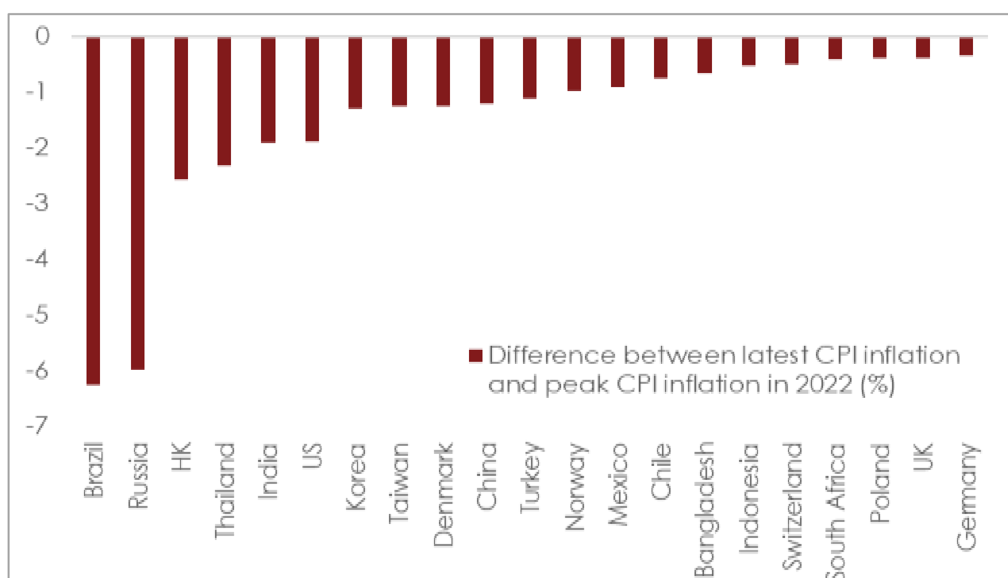
After closing the month of Nov-22 at 7.28%, India's 10Y g-sec yield has been trading in a narrow 11-12 bps range of 7.21-7.32%.

Chart 1: India's 10Y g-sec has moved sideways in last 6 months



Over the last 2-3 months, the peak out of inflation has emerged as a dominant macro theme across many countries. Moderation in commodity prices since Jun-22, ongoing gradual easing of global supply chain disruptions, and lagged impact of monetary policy tightening is beginning to have the desired impact on inflation. US CPI inflation is expected to drop below 7.0% in Dec-22 after touching a high of 9.1% in Jun-22.

Chart 2: Inflation pressures showing signs of easing in key economies



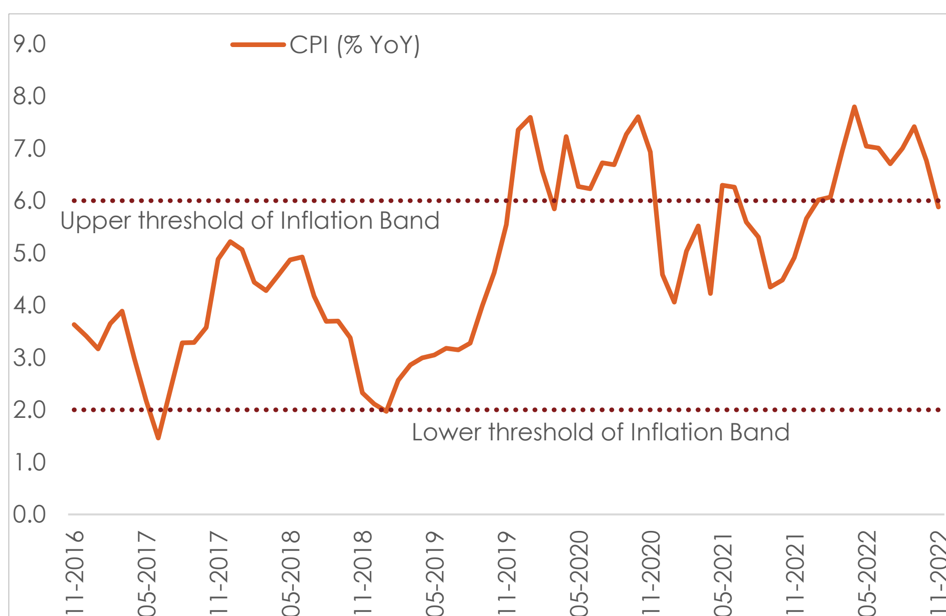
Although success in taming inflation is still far away (as inflation continues to persist much above policy targets in several countries), these are undoubtedly encouraging signs. Some of the central banks have acknowledged this and started calibrating their respective monetary policy actions.

- The US Federal Reserve moderated its pace of rate hike to 50 bps in Dec-22 policy review from 75 bps in previous four occasions.
- In last 2-months, most central banks (taking cue from Fed's well telegraphed step down in pace of monetary aggression) have moderated their pace of monetary tightening. Prominent countries/economies witnessing this outturn include Eurozone, UK, Australia, Canada, Switzerland, Chile, Denmark, South Korea, Mexico, Norway, Romania, Sweden, etc.

A similar outturn is evolving at the RBI. In the last policy review in Dec-22, one out of six MPC members voted for no rate hike vs. the consensus decision of 35 bps hike. In addition, two out of six members are likely to have voted for a neutral stance, i.e., in contrast to the 'withdrawal of accommodation' policy stance adopted by the consensus. With near term inflation trajectory following the central bank's projected glide path with a downward bias (average CPI inflation for Q3 FY23 is currently tracking 6.2-6.3% vs. RBI's forecast of 6.6%), there is a likelihood of more members within the MPC joining the pivot bandwagon. While we continue to expect the RBI to increase repo rate by 25 bps in its next policy review in Feb-23, we also believe that the MPC could pause thereafter for an impact assessment.

From a bond market perspective, the moderation in inflation from peak levels is encouraging. Importantly for the Indian economy, the return of CPI inflation to the policy target band of 2-6% after a gap of 10-months in Nov-22 is comforting. This is in line with MPC's policy objective (communicated towards the beginning of the current rate hike cycle) of gradual disinflation towards the point target of 4%.

Chart 3: CPI inflation back in range



From a near to medium term perspective, the following factors would hold importance for domestic bond yields:

- Post the step down in monetary policy aggression by key central banks, market focus will now shift towards the peak rate in the current tightening cycle. We expect Jan-Mar 2023 to be the quarter wherein most central banks would be either close to or would have achieved their respective terminal policy rate. From g-sec yield perspective, we expect the RBI and the Fed to achieve terminal policy rate in Feb-23 and Mar-23 respectively.
    - Near term visibility of terminal policy rate is historically associated with moderation of pressure on long term yields. We note that the spread of 10Y g-sec yield vis-à-vis policy repo rate has narrowed from its post pandemic high of 314 bps to 104 bps currently. Going forward, the spread could moderate further post the MPC review in Feb-23 (assuming policymakers signal a pause).
- Expectation of a marked slowdown in global growth in 2023 should keep commodity prices ranged, with possibility of a downward pull getting offset by likelihood of easing of Zero Covid policy in China.
    - The impact of this is increasingly getting captured by the headline WPI inflation that decelerated to a 21-month low of 5.85% YoY in Nov-22 (Core WPI inflation has meanwhile seen a faster pace of deceleration to 3.76% YoY, a 24-month low). We believe this trend to partially get transmitted to retail inflation in the coming quarters.
- Rupee has shown some stability in Dec-22, albeit underperforming most EM currencies. However, depreciation pressures seen so far (~9% on FYTD basis) would provide a mild upside to inflation.
    - As per RBI's Monetary Policy Report (published in Sep-22), 5% depreciation in rupee on an average provides 20 bps upside to CPI inflation.
- Rabi sowing is progressing well (up ~2.2% YoY as of mid-Dec'22 led by oil seeds, coarse cereals, and pulses) backed up by good northeast monsoon rainfall and reservoir water storage levels. This would lower food inflation risk in the coming quarters.
- Last, but not the least is the evolving fiscal policy scenario. Likelihood of government sticking to the FY23 fiscal deficit target remains high amidst strong tax buoyancy.
    - Market participants have started to focus towards FY24 Union Budget and its implications for the bond market

On net basis, we finetune our near term (by Mar-23) 10Y g-sec yield call from 7.20-7.60% to 7.10-7.50%.

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Rupee

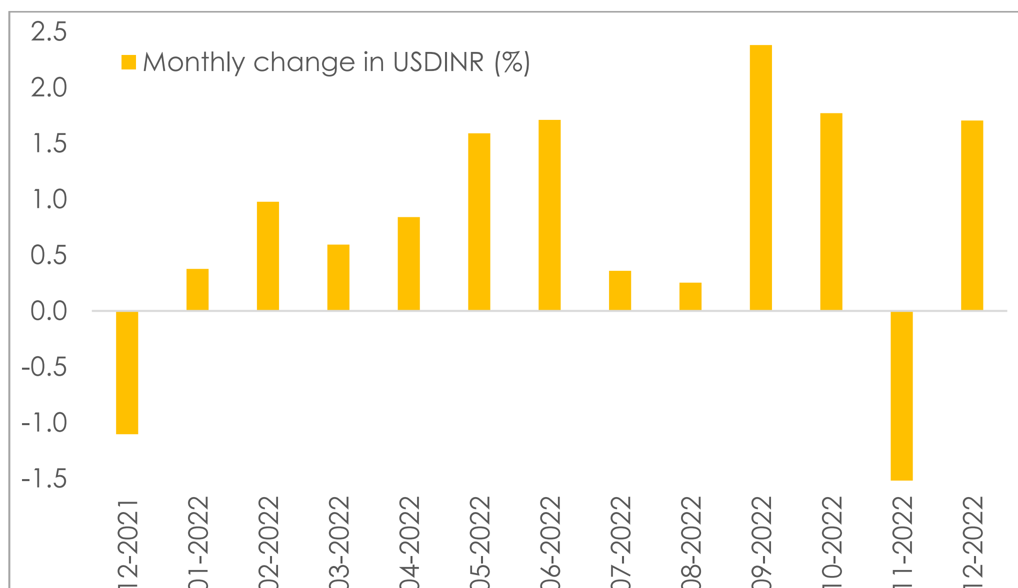
Moderation in volatility

KEY TAKEAWAYS

- The rupee continues to exhibit a moderate degree of volatility given the multiple factors at play. While the month of Nov-22 had turned out to be favourable for INR, which strengthened by 1.6%, marking its first appreciation in 11-months. this could not sustain, with INR once again back to the depreciation path in Dec-22. The latest trend, however, suggests that the pressure on the INR has eased for now.
- Surprisingly, INR's weakness in Dec-22 transpired despite support from a near broad based decline in the USD.
- We suspect that the recent source of weakness in INR potentially lies with its capital account along with RBI's efforts to recoup some of the lost FX Reserves.
- INR's relative underperformance vs. its trading partners is helping to correct the REER based overvaluation.
- On the domestic front, we believe BoP deficit has likely remained elevated in Q2 FY23. It could start to moderate in H2 FY23 on account of the softness in global commodity prices, some respite from persistent portfolio outflows, and recent series of macroprudential steps undertaken by the RBI.
- Meanwhile expectation with respect to consolidation in USD could continue to provide a bias for weakness. While the likelihood of a further depreciation of the INR is moderate, we don't expect it to breach the level of 84 by end March 2023.

The month of Nov-22 turned out to be favourable for the Indian rupee, which strengthened by 1.6%, marking its first appreciation in 11-months. However, the strength could not sustain, with rupee once again back to the depreciation path - in the month of Dec-22, rupee has so far weakened by 1.7%, offsetting the entire gain seen in the previous month.

Chart 1: INR-USD continues to display a moderate level of volatility



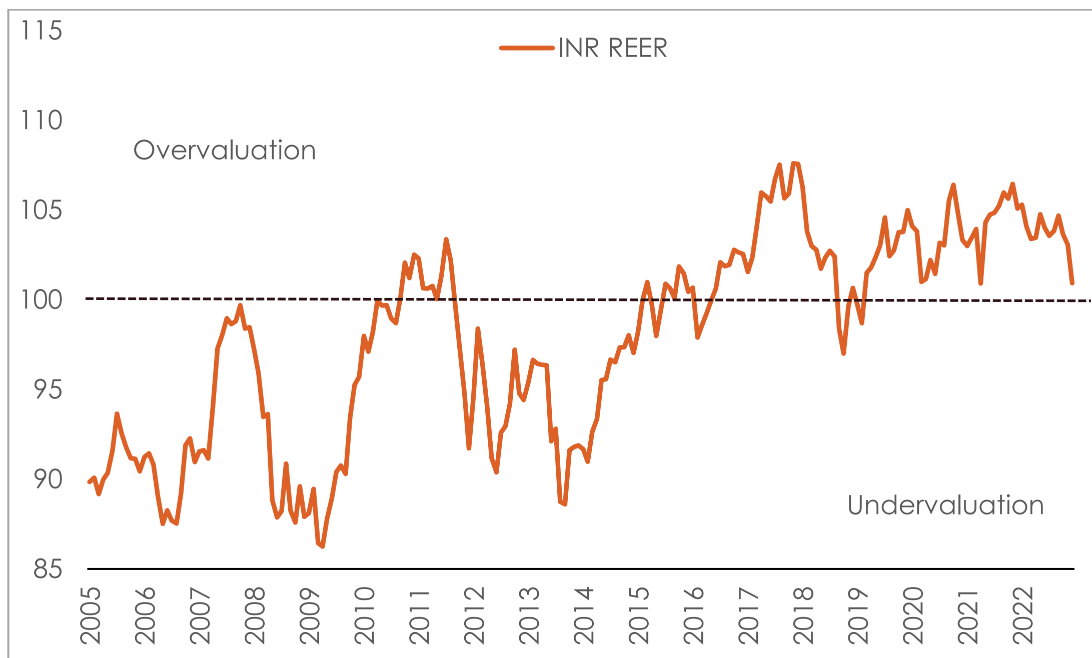
Surprisingly, INR's weakness in Dec-22 transpired despite support from a near broad based decline in the USD (the DXY index has fallen by 1.7% in Dec-22). The diagnosis for this divergence is challenging as India's "Achille's Heel", commodity prices have sequentially softened in Dec-22 by a fair magnitude (importantly, the average price of Brent has dropped from USD 91 pb in Nov-22 to USD 80 pb in Dec-22 so far). In fact, the monthly merchandise trade deficit had moderated to a 5-month low of USD 23.9 bn in Nov-22 and could potentially remain ranged in Dec-22 with a lower bias emanating from the softness in crude oil prices.

As such, we suspect that the source of weakness potentially lies with the capital account. High frequency data on portfolio flows point toward this possibility – compared to net buying activity worth USD 4.1 bn by FPIs in Nov-22, the month of Dec-22 saw a much lower net quantum of USD 1.1 bn due to sporadic outflows. It is likely that non-portfolio capital flows also could be the softer side (official data that will be published with a lag of 2-3 months could confirm this conjecture).

The weakness in INR appears to be broad based. With reference to RBI's 40-currency REER basket, INR has weakened against 35 of them in the month of Dec-22 so far. On relative cross currency basis, this is turning out to be INR's worst month since Apr-21, when INR had weakened against 38 of its trading partners (while depreciating by 2.3% against the USD on monthly average basis). The upshot of this would reflect in further

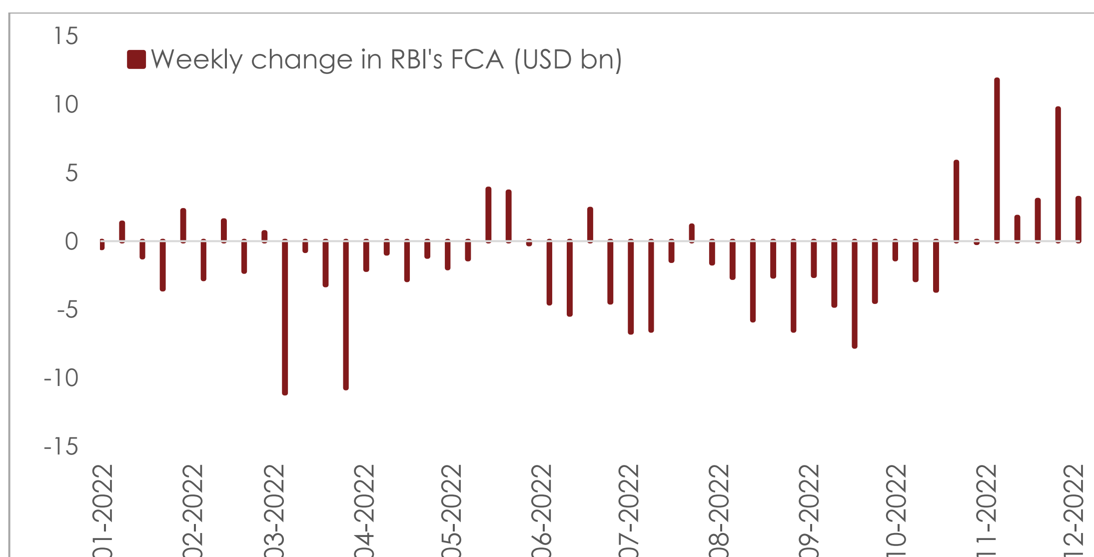
correction in INR's overvaluation (the REER index has moderated from its 2022 peak of 105.3 in Jan-22 to 103.1 in Nov-22).

Chart 2: INR's overvaluation has seen a correction



Having said so, RBI's efforts to recoup some of the lost FX Reserves is also seen to be playing a role here. Since its recent low of USD 465 bn registered for the week ending Oct 21, 2023, RBI's foreign currency assets have jumped to USD 500 bn (as of week ending Dec 9). While part of this change is on account of FX revaluation (gains on account of dollar weakness) and running down of RBI's forward reserves (resulting in a switch from forward reserves to spot reserves), spot purchases done by the central bank is also one of the explanatory factors behind this surge in reserves.

Chart 3: India's FX Reserves has seen sequential gains in Nov-Dec'22



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Going forward, we continue to expect a bias for mild weakness in INR. While the down move in DXY index has been swift, we are not convinced of its durability yet. Despite the correction seen in Oct-Dec 2022, the DXY index is up by 8.6% in 2022 so far, driven by:

- US Fed's aggressive tightening of monetary policy. Notwithstanding Fed's moderation in the pace of rate hikes to 50 bps in Dec-22 from 75 bps in previous four consecutive policy reviews, FOMC's projection of the terminal fed funds rate in the current cycle has now moved up to 5.00-5.25% (to be achieved by Mar-23) from 4.50-4.75% in Sep-22. In addition, the Fed has projected rates to remain unchanged thereafter in 2023 – in contrast to market expectation of at least one round of 25 bps rate cut before the end of 2023. This 'higher for longer' monetary policy thrust will continue to provide an anchor to the USD.
- Going into 2023, the Fed will further reduce its balance sheet by a further USD 1.1tn, way ahead of any other major central bank. A gradual mop up of global dollar liquidity would continue to support the USD.
- Build-up of recessionary conditions in Europe and pressure on international commodity prices would weigh upon other trade dependent currencies.
- Last, but one of the least predictable, is the unsettled geopolitical risk premium. This could sporadically boost safe haven status of the USD.

On the domestic front, while pressure on India's BoP has been persisting since Q4 FY22, the peak discomfort is now likely to be behind us.

- Basis decline in international commodity prices, India's merchandise trade deficit has so far averaged at USD 25.7 bn in Q3 FY23, down from an elevated level of USD 28.0 bn in Q2 FY23.
- India's services trade surplus touched a record high of USD 11.9 bn in both Sep-22 and Oct-22 compared to an average level of USD 10.1 bn seen during Apr-Aug 2022.

Hence, we foresee some downside risk to our FY23 current account deficit projection of USD 130 bn. We also believe that the incremental risks of a further depreciation of INR in the remaining quarter of FY23 is moderate. Nevertheless, we maintain our USD-INR peak forecast of 84 (before end Mar-23), given the nature of volatility in the global markets.

Global Overview

Braking into 2023

KEY TAKEAWAYS

- As we step into the new calendar year, it is perhaps apropos to define the year gone by as intensely challenging on the economic front with complexities arising from geopolitical tensions, but amidst a dissipating pandemic (albeit with vestiges in China) that allowed the global economy to revert to normalcy.
- The Ukraine-Russia crisis which continues to linger, elevated inflation and aggressive synchronized monetary policy tightening was seen to be counterbalanced by easing supply chain bottlenecks, commodity prices losing steam in H2 and US economy holding strength better than envisaged.
- Looking ahead into 2023, it is likely to be a year of weaker growth outcomes. The tightening of financial conditions will unleash its full impact, pushing some economies into a recession. But the year will also hopefully see lower inflation and a near-end to rate hikes.
- Three inflection points, witnessed in the last few weeks are likely to have a strong bearing on economic outcomes in 2023 –1) Inflation 3appears to have most likely peaked and 2) Lower magnitude of interest rate hikes, but to continue for longer and 3) A display of strength in the US economy.

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Global Overview

As we step into 2023, it is perhaps apropos to define the concluded year as intensely challenging on the economic front with complexities arising from geopolitical tensions, but amidst a dissipating Covid pandemic that allowed social lives to revert to normalcy (in most countries sans perhaps China). The Ukraine-Russia crisis which continues to linger, elevated inflation and aggressive synchronized monetary policy tightening was seen to be counterbalanced by easing supply chain bottlenecks, commodity prices losing steam in H2 and US economy holding strength better than envisaged.

Looking ahead into the new year, it is likely to be a year of weaker growth outcomes. The tightening of financial conditions will unleash its full impact, pushing some economies into a recession. But the year is likely to see lower inflation and a near-end to rate hikes. Below we take stock of three inflection points, we have witnessed in the last few weeks which will have a strong bearing on economic outcomes in 2023.

- **Lower magnitude of rate hikes, but may continue for longer**

In the last few weeks, the US Fed, ECB and BoE all have slowed down their pace of interest rate increase but have also indicated that the hiking cycle may continue for longer than indicated earlier.

- On 14 Dec-22, the US Fed hiked its policy rate by 50 bps to 4.25-4.50%, following four consecutive 75 bps hikes. Despite the step down, it appears that the Fed is likely to keep rates 'higher for longer.' In the accompanying quarterly Summary of Economic Projections, the policy rate is now expected to reach 5.1% by the end of 2023. The Fed said that it plans to tighten policy until it is "sufficiently restrictive" to bring inflation down. It is getting "close" to this, but Chairman Powell added that "it is not there yet"
- The ECB raised its interest rate on 15th Dec-22 by 50 bps, marking a step down from rate hikes of 75 bps in the last two meetings. However, the central bank indicated that it expects rates to rise further, based on the substantial upward revision to its inflation outlook. The inflation in the Euro Zone has dropped from a high of 10.6% in Oct-22 to 9.2% in Dec-22. The Bank sees inflation at 6.3% next year, compared with expectations of 5.5% as of Sep-22. Its forecast for 2024 was raised to 3.4% from 2.3%, while its first estimate for 2025 has pegged inflation at 2.3%, indicating an expectation of a gradual decline in inflation.
- On the same day, BoE too raised its key interest rate by 50 bps to 3.5% - its ninth successive rate hike. While this was a step down from 75bps hike in Nov-22, but further rate hikes are likely. "The labour market remains tight and there has been evidence of inflationary pressures in domestic prices and wages that could indicate greater persistence and thus justifies a further forceful monetary policy response," the Bank said. As regards, the inflation print had reached a peak of 11.1% in Oct-22 and has since dropped to 10.7% in Nov-22 and is likely to decline further in Dec-22.
- Among other central banks, Bank of Canada raised its policy rate by 50 bps but signaled further rate hikes will be increasingly data dependent. Meanwhile, the Reserve Bank of Australia raised its policy rate by 25 bps without offering any clear indication of an end to rate hikes.

- **Inflation appears to have most likely peaked**
  - US inflation appears to be slowing. In Nov-22, consumer prices posted their smallest annual increase in nearly a year, rising by less than expected for a second straight month. The consumer price index increased by 0.1% in Nov-22 after advancing by 0.4% in Oct-22 and contracted on a sequential basis for the first time by 0.1% in Dec-22.
  - Japanese wholesale prices rose by 9.3%YoY in Nov-22, almost unchanged from the previous month. This appears to indicate initial signs of inflation peaking amid easing global commodity prices.
  - UK inflation fell more than expected in Nov-22, after hitting a 41-year high in Oct-22. The annual rate of consumer price inflation dropped to 10.7% from 11.1% in October.
  - In Eurozone, Nov-22 prices cooled for the first time in over a year. Headline CPI slowed to a 10%YoY, down from 10.6% in Oct-22 and further to 9.2% in Dec-22. While prices for energy and services are still elevated, they rose at a slower pace in Nov-22, driving the slowdown.

- **US economy remains a tough one to predict**

While there is a near consensus on a likely slowdown in US in 2023, there still seems to be a fair degree of divergence in the view on whether the economy will slip into a recession or not. Despite Fed hiking aggressively this year, economy has proven to be resilient as consumers still hold on to their jobs and spending. The US economy has added more than 4mn new jobs in 2022 so far and the unemployment rate at 3.7% currently is just above its historic pre-pandemic low. Against these pockets of strengths, it remains to be seen if the resilience can continue for longer than anticipated, well into 2023.

US Economy

Fresh macroeconomic data coming in from the US economy, underscored the divergence in the performance of goods vs. services sectors. While both have been on a moderating path, the slowdown in service sector activity has been more muted compared to manufacturing. The Nov-22 release of ISM services, saw the index rising by 2.1 points to 56.5 to defy expectations of a decline. The upside was led by a strong increase in business activity index, which rose to a year high. The labour market too continues to remain strong, with non-farm payrolls rising by 263k in Nov-22 led by services-oriented sectors of leisure and hospitality, health among others. The gains, though modest compared to a year ago, nevertheless remain strong vis-à-vis historical standards. The unemployment rate was unchanged at 3.7% in Nov-22 but dropped slightly to 3.5% in Dec-22.

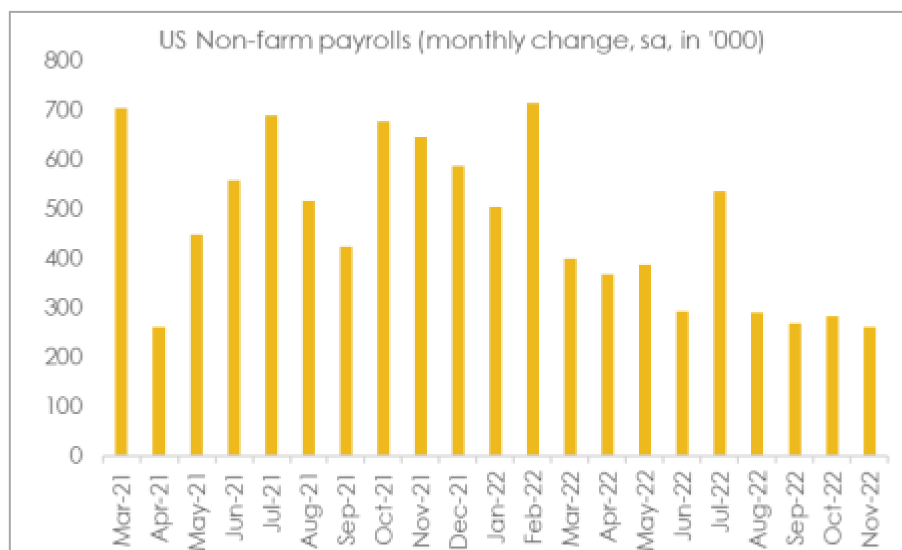
In contrast, retail sales (which capture consumer purchases of goods) slipped by 0.6%MoM in Nov-22, to mark the biggest drop in last 1 year. Eight of the twelve industry groups registered a decline, led by building material stores, motor vehicles & parts dealers and furniture stores. Still elevated goods prices along with rising interest rates are weighing on leveraged consumption of goods. This slowdown in demand for goods does not bode well for manufacturers as validated by industrial production

falling to 0.2% in Nov-22, to mark the decline in last 1 year and the fifth negative print in last 7 months.

US headline CPI inflation had risen by just 0.1%MoM in Nov-22 and it further surprised on the downside in Dec-22 by contracting by 0.1%. On annualized basis, this translated to inflation softening to 6.5% from 7.1% in Nov-22. Energy prices pulled down the overall index, as gasoline prices slipped sharply by 9.4%. In addition, food prices showed signs of moderation with Dec-22 increase of 0.3% being the slowest in last 1 year. Core CPI, which excludes food and energy, came in slightly higher in Dec-22, increasing by 0.3%MoM; but on an annualized basis, it stood at 5.7% vs 6.0% in Nov-22. Core goods prices fell for the second consecutive month, led by sub-categories of used vehicles, education and communication and recreation goods. Meanwhile, core services prices rose – yet another indicator of diverging performance of goods vs. services sectors.

On the monetary policy front, FOMC raised the fed funds rate by 50 bps in Dec-22 to a range of 4.25-4.50%, a step down from the 75 bps increases seen at the previous four meetings. In terms of its monetary policy outlook, FOMC signaled that it is not done hiking yet. The statement maintained that "ongoing increases in the target range will be appropriate" with the Fed funds rate target upped to 5.1% for end 2023 and 4.1% for 2024 compared to 4.6% and 3.9% previously. This sits in contrast to market participants expecting a peak in interest rates in 2023 followed by rate cuts in the forecast timeline.

Chart 1: US non-farm payrolls though have trended lower, continue to remain strong



The divergence in views between the Federal Reserve and market participants, lies in inflation expectations. The softer than anticipated Nov-22 and Dec-22 print has boosted confidence of a firmly lower inflation trajectory. However, Fed officials seem to believe that inflation has become more entrenched. As per the quarterly Summary of Economic Projections, the median estimate for core PCE in Q4 2023 was upped to 3.5% from 3.1% earlier. This upward adjustment could perhaps be an outcome of two possible factors weighing on Fed's mind – 1) labour costs remaining somewhat stubborn along with 2) growth holding up well in general with economy possibly

avoiding a GDP contraction in 2023. Indeed, Fed is predicting only a modest downturn in activity next year with the unemployment rate rising to 4.6% from the current level of 3.7% and the economy is likely to continue expanding, albeit at just 0.5%YoY between the Q4 of 2022 and 2023.

UK

In UK, inflation dropped to 10.7% YoY in Nov-22 after it hit a 42-year high of 11.1% YoY in October. The headline print was below market expectations as well as BoE's forecast of 10.9%. At a granular level, the moderation in consumer prices in Nov-22 was driven by price changes in the transport sector, particularly for motor fuels and second-hand cars. There was also downdraft from tobacco, accommodation services, clothing and footwear, and games, toys and hobbies. The largest, partially offsetting, upside pressure came from price rises for alcohol in restaurants, cafes and pubs, as well as from Energy costs (electricity, gas and other fuel categories).

To tackle the soaring energy prices, the government had announced an energy price cap for all households for a period of at least six months starting from Oct-22, but higher wholesale energy prices nonetheless are still expected to be at least partly passed on to consumers. Meanwhile, core inflation dropped to 6.3%YoY in Nov-22 from 6.5% in October, but nevertheless remains stubbornly elevated. BoE Governor Andrew Bailey said that the moderation in consumer prices gave "*the first glimmer*" that inflation could fall sharply next year but indicated that persistent labour market pressures meant it was too soon for the BoE to let down its guard.

Despite the looming risk of a deep recession and hopes that inflation has passed its peak, the BoE's Monetary Policy Committee voted 6-3 to raise Bank Rate by a further 50 bps to 3.5% - its ninth consecutive rate rise and the highest policy rate since 2008. While 1 member wanted to match Nov-22's bigger 75 bps increase, two MPC members voted not to raise rates at all. The Bank's statement also said there were several indicators showing the economy had weakened since the summer. It expects a 0.1% contraction in GDP in the last quarter of 2022, which would put the UK economy officially in recession after a 0.2% contraction in the third quarter. Considering the policy communication from the central bank and the growing divergence among the MPC members, it appears that the BoE remains inclined in favour of incremental tightening, albeit at a slower pace.

According to the monthly estimates, GDP grew by 0.1% MoM in Nov-22 vs. 0.5% in Oct-22 and a contraction of 0.8%MoM in Sep-22. The services sector grew by 0.2% in Nov-22 after growth of 0.7% in Oct-22, while production dropped by 0.2%, and construction was flat. However, on a trend basis, the economy remains on a weakening path with GDP declining by 0.3% in three months to Oct-22 compared with the previous three-month period - the biggest fall since Covid onset of Mar-21.

Eurozone

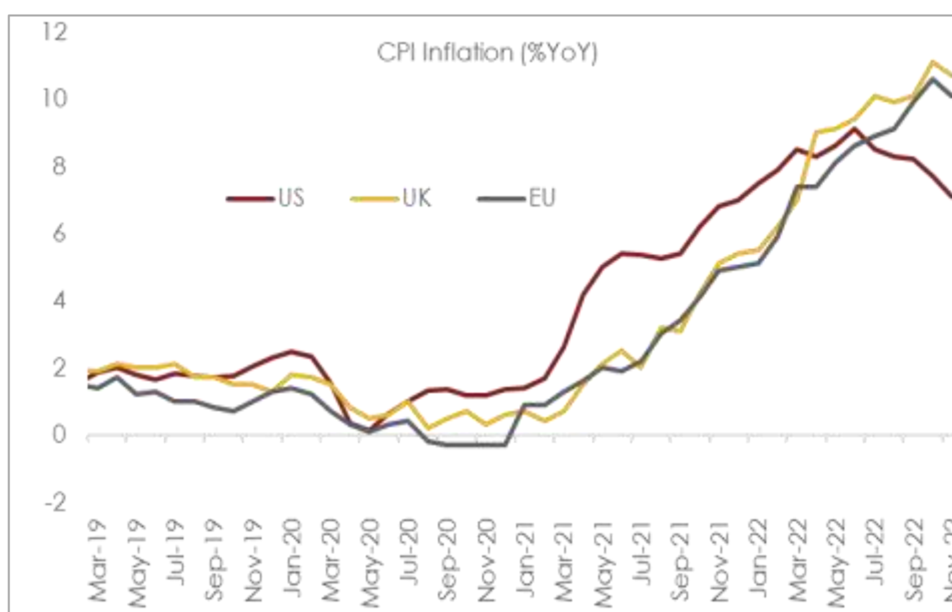
In Eurozone, Inflation dropped further to 9.2% in Dec-22 from 10.1% YoY in Nov-22 and 10.6% in Oct-22 - the first slowdown in a year and a half. Energy inflation continue to account for the bulk of the sequential slowdown in the headline print, while inflation in the price of food, alcohol & tobacco continues to trend up. Compared with Oct-22, annual inflation fell in sixteen Member States, remained stable in three and rose in eight. The lowest annual rates were registered in Spain (6.7%), France (7.1%) and Malta (7.2%). The highest annual rates were recorded in Hungary (23.1%), Latvia (21.7%),

Estonia and Lithuania (both 21.4%). However, core inflation continues to exhibit stickiness as it actually increased to 5.2% in Dec-22. Despite the moderation in the headline inflation, ECB President Christine Lagarde said she does not believe "that we've reached peak inflation and that it's going to decline in short order". She added that ECB economists still saw clear "upside" risks to inflation.

In its Dec-22 monetary policy, ECB eased its pace of rate hikes by raising the deposit rate and refinancing rate by 50 bps each and stepping down from 75 bps increases. Contrary to previous rate hike decision, the size of the 50-bps hike was not unanimous with nearly a third of ECB policymakers voting in favour of a larger quantum (i.e., 75 bps). However, to secure a majority, ECB President Christine Lagarde had to offer dissenters a pledge that rates will be increased back-to-back by 50 bps along with a hawkish commentary at the press conference, as per sources. The ECB also laid out plans to stop replacing maturing bonds from its EUR 5 tn portfolio, reducing monthly reinvestments from its Asset Purchase Programme by 15 bn euros starting in Mar-23 and revising the pace of balance-sheet reduction from Jul-23. Consequently, yield on Italy's 10-year bonds rose by 31 basis points to 4.19%, the biggest single-day change since the pandemic-induced market rout of March 2020. The ECB's new projections showed inflation above the ECB's 2% target through 2025, justifying the sharpest and most aggressive hiking cycle in history of 250 bps in slightly more than 4 months.

Incoming macroeconomic data was mixed from the region. The composite PMI for the region, fell to 48.8 in Dec-22 but was above market expectations of 48.0. This marked the sixth month of composite PMI below the 50-mark separating growth from contraction, the longest streak of a downturn since Jun-13. In contrast, European Commission's economic sentiment indicator rebounded to 93.7 in Nov-22 from 92.7 in Oct-22, rising for the first time since the Russian invasion of Ukraine in Feb-22 and marginally beating market expectations. Recessionary fears continue to linger, but the economy seems to have gathered pace, perhaps suggesting a likely recession ahead will be shallower than previously thought.

Chart 2: Inflation has peaked in G3 economies, with print coming lower fo EU and UK



CHINA

In Nov-22, activity data from the Chinese economy confirmed yet another weak outcome, as Covid restrictions remained in place given the rebound in cases. Services activity, as captured by retail sales fell more than expected by 5.9%YoY in the month, with all categories recording a yearly contraction except for essentials of medicines and food. The manufacturing sector was also affected, as growth in industrial output slipped to 2.2% in Nov-22 from 5.0% in Oct-22. The slowdown was led by export-oriented sectors of integrated circuits, smartphones, and micro computing equipment, while domestic consumption-oriented industries such as new energy vehicles and metals continued to register an expansion.

Looking ahead, activity data in Dec-22 is likely to be only marginally better, as restrictions have been eased amidst still climbing COVID cases in the country. While port activity could be somewhat smoother, labour shortages could weigh, nevertheless. Retail sales could see a recovery with travel activity picking up over the Chinese New Year.

In its Central Economic Work Conference in Dec-22, Government's focus remained on fueling growth via domestic consumption heading into 2023. Preferential policy support to sectors such as new-energy cars and elderly services was indicated, along with an overarching focus on developing technology. The main support tools for growth were indicated to be an expansionary fiscal stimulus along with a stable monetary policy.

In its Dec-22 policy, People's Bank of China kept its key lending rates unchanged for a fourth consecutive month, as it struggles to maintain a balance between shoring up a COVID-stricken economy and keeping the Yuan strong. The PBoC maintained its one-year loan prime rate (LPR) unchanged at 3.65%, while the five-year LPR, which is used to determine mortgage rates, was maintained at 4.30%.

Keeping in mind the easing of Covid restrictions, the economy it appears to be slowly picking up, but growth outlook remains somewhat somber over the next two quarters of Q4-22 and Q1-22. Reflecting this, the World Bank recently slashed its growth outlook for China for 2022 to 2.7% from 4.3% in Jun-22, citing nearly three years of 'zero-Covid curbs and a real estate slump. For next year, the international agency pegs growth to recover to 4.3% amidst reopening of the economy.

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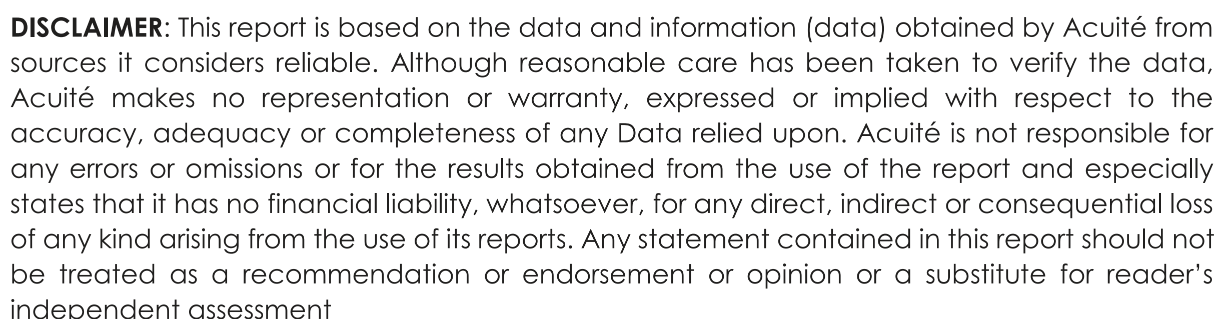

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