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MACRO PULSE

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Contents

Growth

At Breakout Junction

KEY TAKEAWAYS

- Amongst a whole host of leading activity indicators now either close to above pre-COVID levels, the countercyclical fiscal stance of the Union Budget has further cemented expectations of recovery continuing well into FY22.
- Various agencies, domestic and global, have amply quantified the FY22 growth rebound - a near certain double-digit expansion
- Growth prospects remain positive amidst gradual easing of lockdown restrictions, supportive fiscal and monetary policy environment, global recovery, and pent-up demand.
- Further traction in roll-out of COVID vaccine will boost sentiment. Pace of commodity price increase, however needs to be watched.
- Expect FY22 GDP to show a record expansion of 11%

Amongst a whole host of leading activity indicators now either close to above pre-COVID levels, the countercyclical stance of the Union Budget has further cemented expectations of growth recovery continuing well into FY22.

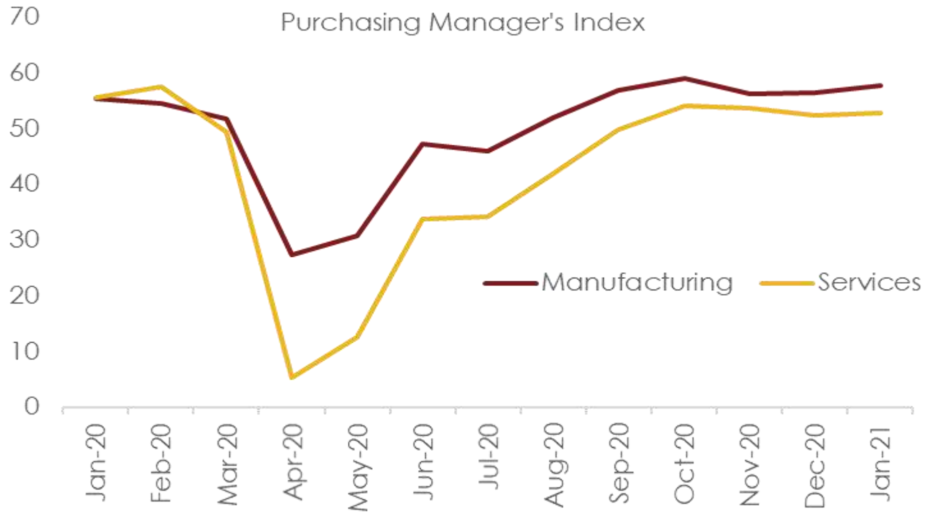
As such, over the last few weeks, various agencies, domestic and global, have amply quantified the FY22 growth rebound. Economic Survey pegged real GDP growth for FY22 at 11.0%, followed by the RBI's estimate of 10.5% in the Feb-21 Monetary policy meeting. As per IMF, India is expected to be the fastest growing economy in the world, slated to expand by 11.5%. In similar vein, global rating agencies Fitch and S&P have pinned FY22 GDP growth at 11% and 10% respectively. In nominal terms, Union Government based its budget calculations on a GDP growth of 14.4% and the other key ratings agency of Moody's expects India to grow by 17%. **While the range of real GDP growth prognosis varies between 10-15% broadly, a double-digit expansion looks almost a certainty in FY22.**

High frequency signals corroborate sequential improvement in activity

- Among the recently released high frequency indicators, IIP growth **ended CY20 in the positive territory, as it registered a modest expansion of 1.0% in Dec-20 on an annualized basis** compared to a contraction of 2.1% in Nov-20 (downwardly revised from -1.9% earlier). Looking beyond the headline, on a sequential basis, not only the performance was much stronger (+7.8%MoM) but also broad based in nature.
- PMI for Manufacturing rose from 56.4 in December to a 3-month high of 57.7 in January, led by output amidst stronger sales and new export orders.
- Services Business Activity Index rose from 52.3 in December to 52.8 in January, pointing to a quicker expansion in services output.

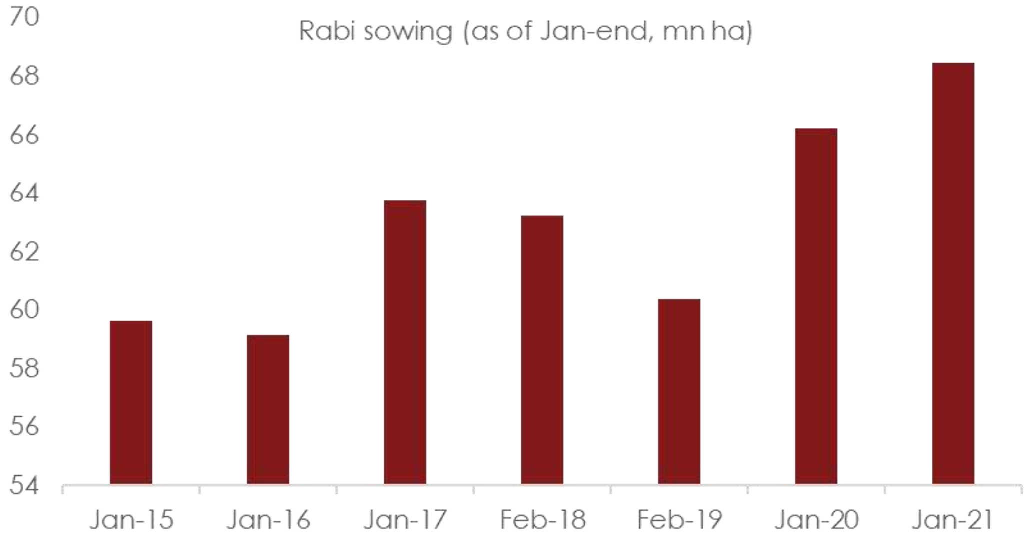
Economic recovery that commenced from Q2 FY21, gathered further steam in Q3 with progress on unlock, festive led and pent-up demand support, and rebound in global economic recovery from subdued levels. The corporate earnings validate this, with listed companies seeing a marginal uptick in net sales accompanied by a strong growth in net profits in Q3 FY21. In fact, the soon to be released GDP estimate for the quarter is likely to post a mildly positive growth after a hiatus of 2 quarters; technically ending a period of recession for India.

Chart 1: PMI for manufacturing surpasses pre-COVID level, services PMI trails



Looking ahead, in Q4, growth is expected to find further support in strong rural demand in the backdrop of Rabi sowing at a record high (see chart), government's year-end spending push, and relatively less COVID penetration. This is getting manifested in healthy performance in case of production of fertilizers, 2-wheeler sales, tractor sales, consumer non-durables, etc.

Chart 2: Rabi sowing at a record high to support rural incomes



On the other hand, urban demand continues to remain weak and uneven. While mobility indicators show activity levels reverting close to pre-pandemic levels, select consumption sectors such as hospitality, recreation, retail, aviation continue to bear the brunt of the pandemic. Further, loss of jobs and incomes, elevated retail fuel prices and sluggish credit growth, suggest a more gradual return to normalcy.
Encouragingly, labor markets displayed a nascent sign of a turnaround at the start of CY21. As per CMIE, the unemployment rate in Jan-21 fell to 6.5% from 9.1% in Dec-20 and the employment rate rose to 37.9% from 36.9%. This marks the first increase in jobs

after Sep-20. In similar vein, PMI manufacturing survey indicated that while manufacturers cut jobs in Jan-21, but at the slowest pace in the current ten-month stretch of contraction. It remains to be seen if jobs keep up pace in the coming months.

Outlook

Looking ahead, on balance, we expect the economic recovery to gather momentum as:

- With ongoing tapering of lockdown restrictions, mobility indicators are now only 10-15% below pre-COVID levels
- The policy environment, characterized by a countercyclical fiscal outturn reinforced in the Union Budget FY22 amidst an accommodative monetary and liquidity backdrop that RBI remains committed to, continue to remain supportive of economic recovery.
- Sustained progress on rollout of vaccine in India, with 0.7% of the population getting inoculated so far, will be a boost to consumer and business confidence both. Urban demand and demand for contact-intensive services are expected to see a fillip as vaccine administration picks up.
- A synchronous V-shaped global recovery

On the downside, rise in input costs amidst hardening global commodity prices remains a risk to business sentiment and pace of recovery. As per RBI's industrial outlook survey, while manufacturers expect expansion in production volumes, new orders and jobs along with an ability to pass on higher selling prices in Q4FY21, but the sentiment on profit margins remains subdued on the back of higher possible input cost pressures.

We continue to expect GDP to post a V-shaped recovery in FY22 with a record high growth print of 11.0%. This anticipated growth would be front loaded as H1 FY22 would benefit from a significantly favorable base effect.

Inflation

The going gets good

KEY TAKEAWAYS

- Inflation outturns in the last two months have turned out to be better than expected.
- In Jan-21CPI inflation softened further to near striking distance of the 4.0% target after a gap of 15 months. In contrast, WPI inflation in Jan-21 climbed to the highest level in 11 months essentially on account of hardening of global commodity prices
- Urban inflation continues to remain above 5.0% with 1-year ahead inflation expectations of urban households seeing no respite
- For FY22, we expect CPI inflation to average close to 5.0%, a significant moderation versus likely FY21 average of close to 6.0%
- The recent moderation in inflation should allow the Government to continue to retain the current inflation mandate of 4% +/-2%

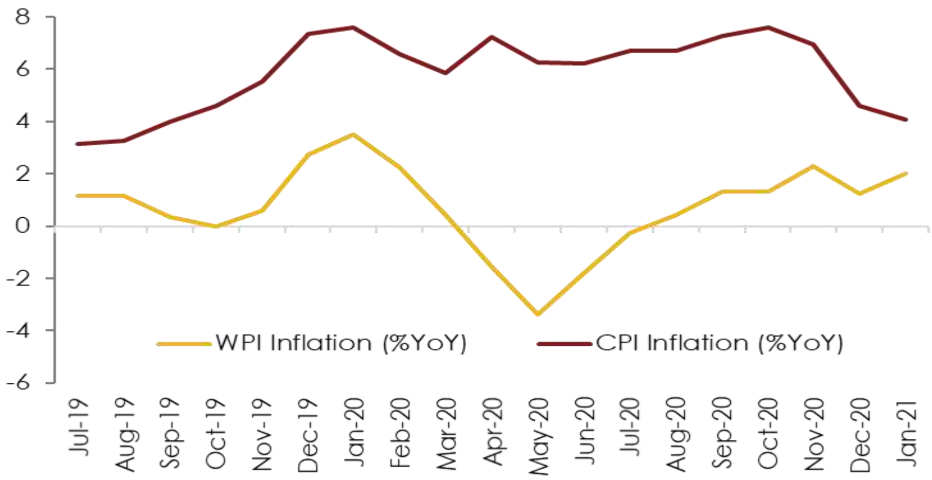
Inflation outturns in the last two months have turned out to be better than expected. While a softening in inflation was largely anticipated, the actual CPI prints surprised market consensus by nearly 40 and 30 bps on the downside in Dec-20 and Jan-21 respectively. So, while Dec-20 saw headline CPI return to RBI's inflation target band (after a gap of 8 months), in Jan-21 it softened further to near striking distance of the 4.0% target (after a gap of 15 months). This is comforting, as for much of the current fiscal year inflation continued to rein above RBI's comfort level, averaging at 6.9% over Apr-Nov.

Anatomy of Jan-21 CPI inflation

- Jan-21 CPI inflation eased to 4.06%YoY compared to 4.59% in Dec-20.
- **Moderation was once again led by food prices**, of which, vegetables drove the downside primarily. The near 15%MoM drop in vegetable prices came on the heels of an equal magnitude of correction recorded in Dec-20. Accompanied by modest moderation in prices of Meat, Eggs (amidst the avian flu outbreak) and Pulses, the sequential rise in price of Oils & fats and Non-alcoholic beverages remained underwhelming.
- On the other hand, **rise in fuel prices** continued to cap the inflation downside. Combined fuel inflation (i.e., fuel and light along with transport within miscellaneous) rose to 5.66% in Jan-21- a near 2 year high, reflecting the steep rise in global crude oil prices. In USD terms, since Nov-20, India crude basket has risen by nearly 40%, exacerbating further, the pressure on already elevated retail fuel prices carrying the burden of excise duty hikes effected in May-20.
- **Core inflation,** i.e., Headline ex. Food and Fuel, reflecting underlying demand conditions in the economy, remained unchanged from previous month at 5.65% in Jan-21.

WPI Inflation: A jump up

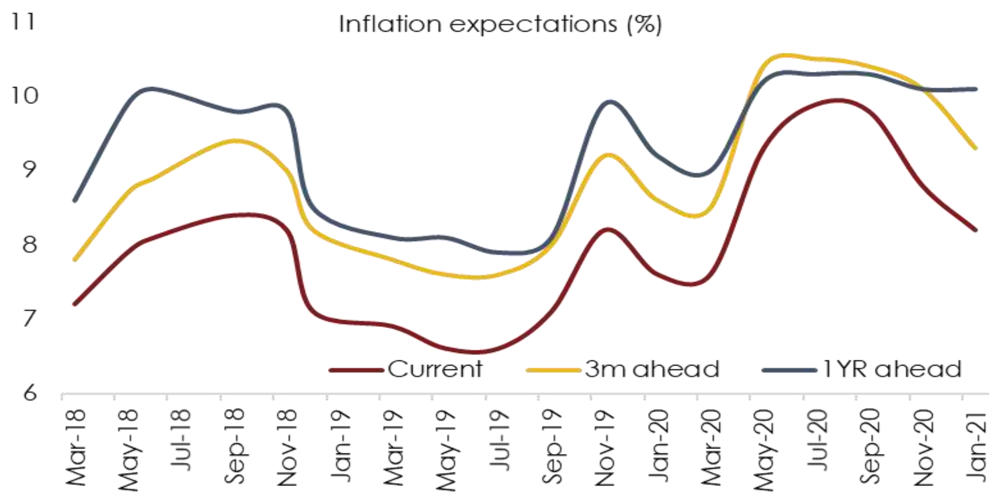
WPI inflation in Jan-21 climbed to the highest level in 11 months, at 2.03%YoY from 1.22% in Dec-20, essentially on account of hardening of global commodity prices led by metals followed by rubber and plastic products, textiles and chemicals and chemical products. The shallower contraction in fuel & power inflation reflects the sequential build in crude prices since Nov-20. However, a large cushion to headline WPI was provided by primary food articles led by vegetables - a seasonal behavior, akin to retail inflation. Going forward, gradual improvement in pricing power combined with global recovery led hardening of commodity prices suggests an upward trajectory for the WPI inflation.



Urban inflation: Downside capped?

Given the disproportionately higher share of food, the decline in rural CPI continued to outpace urban inflation for the second consecutive month. While Rural inflation eased by nearly 85 bps in Jan-21, urban inflation in comparison moderated by only 10 bps, continuing to remain above 5.0%.

In addition, as per the latest round of RBI inflation expectations, urban households display uncertainty about future inflation outcomes. Broadly they expect inflation to remain elevated over the 1-year horizon, led by rising fuel prices and anticipated increase in price of services.



Inflation targeting: Reiteration of 4.0% target?

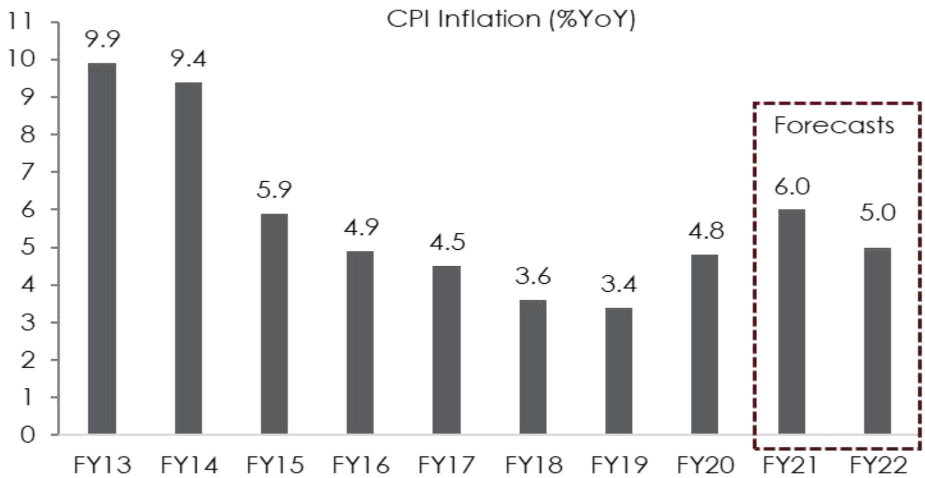
One area that has been subject of intense debate recently, is with respect to RBI's inflation targeting regime, given that the current mandate of maintaining CPI inflation within the 4% +/-2% range is slated for review by Mar-21. Recall, India had officially adopted flexible inflation targeting (FIT) in Jun-16 to place price stability as the primary objective of the monetary policy.

The recent comfort drawn from Dec-20 and Jan-21 inflation prints should provide solace to the RBI as well as the Government – to continue to retain the current mandate as is. In a recent paper, RBI in fact argued that given that the trend inflation in India has steadily declined to 4.1-4.3%, maintaining the inflation mid-point target at 4.0% seemed appropriate.

Outlook

CY21 has begun on a sanguine note at least on CPI inflation front. We expect this comfort to continue in the coming months amidst a salubrious impact on food prices from winter seasonality, Kharif output, good progress on Rabi sowing, along with a positive statistical base. RBI in its recent MPC statement, anticipating this softness, had revised lower its Q4 FY21 CPI inflation forecast to 5.2% from 5.8% earlier. On the non-food prices, upside risks remain from a higher pass-through of the rise in global commodity prices of oil and other industrial metals to domestic inflation, along with demand-side pressures as a vaccine-led economic recovery gradually gains impetus in FY22.

For FY22, we expect CPI inflation to average close to 5.0%, a significant moderation versus likely FY21 average of close to 6.0% - largely a fallout of COVID idiosyncrasies.



Government Finances

Fiscal push to growth

KEY TAKEAWAYS

- Fiscal deficit for FY21 was revised to 9.5% of GDP compared to budgeted target of 3.5%.
- For FY22, fiscal deficit is expected to consolidate to 6.8% of GDP, premised on a nominal GDP growth of 14.4%.
- Health, Infrastructure and Finance emerge as three focus areas.
- Improvement in quality of spending and fiscal transparency are commendable steps, besides the credible arithmetic.
- The sine quo non for achieving the headline deficit target will be the realization of disinvestment and asset monetization target in FY22
- Overall, the Budget is expected to pave way for a V-shaped real GDP growth recovery to 11.0% in FY22.

The FY22 Union Budget overdelivered versus expectations despite an extremely challenging economic backdrop. The growth inducing nature of the increased budgetary expenditure, transparency with respect to off balance sheet funding along with a durable push to investments, infra financing and the new institutions of a Bad bank and DFI were all noteworthy features of the Budget.

Fiscal arithmetic: Realistic

Fiscal deficit for FY21 was revised up to 9.5% of GDP compared to the budgeted target of 3.5%. While the sharp increase, driven by a severe shortfall in revenues amidst the pandemic and an expansion in spending to support the flailing economy was not unanticipated, the magnitude of the upward revision did catch the markets by surprise. At a closer look, a part of the upside (1.4% of GDP) was driven by transfer of food subsidy 'on budget', which earlier was largely met via NSSF loan to the FCI.

For FY22, fiscal deficit is expected to consolidate to 6.8% of GDP, premised on a nominal GDP growth of 14.4%. Tax revenue projections appear realistic and no major change in tax rates came as a relief. However, predictably, the Budget banks on disinvestment and asset sales on a large scale to raise incremental resources to the tune of 0.8% of GDP. On the expenditure side, while revenue spending is budgeted to contract by 2.7%YoY, capital spending is pegged to increase by 26.2% in FY22 over and above the 30.8% in FY21, leading to a sharp improvement in quality of spending.

Transparency

The FY22 Union Budget also scores big on transparency. In recent years, 'off balance sheet' spending had proliferated with central government shedding a part of subsidy as well as capital expenditure to project a leaner headline fiscal deficit. However, the FY22 Union Budget has significantly downsized dependence on off balance sheet spending. This has resulted in a sharp fall in extra budgetary resources mobilized via GoI serviced bonds as well as in the financial support extended via NSSF loans. As such, the off-balance sheet spending (as a ratio to total budgetary expenditure) is slated to fall to 0.9% in FY22 from its peak of 7.0% in FY19. This is a welcome cleanup exercise, which would help boost overall fiscal credibility.

Chart1: Quality of spending to undergo a sharp improvement in FY22

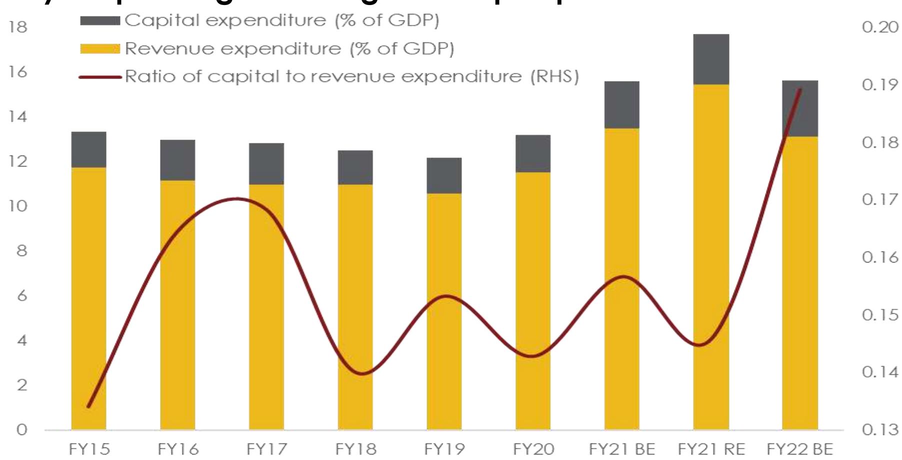
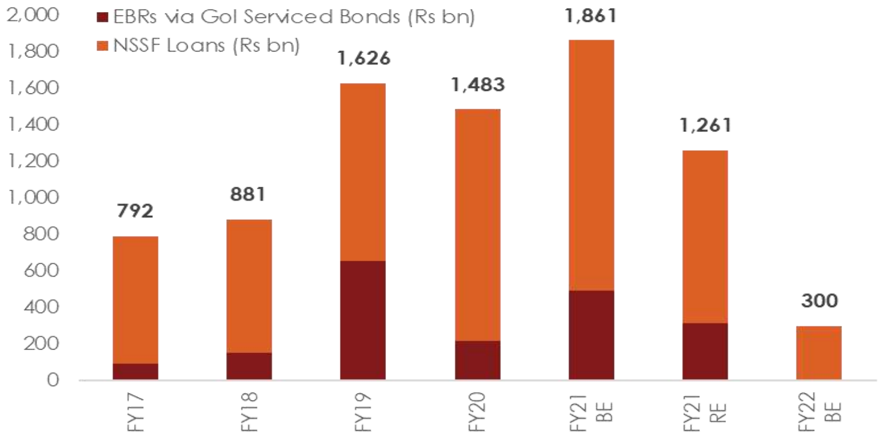


Chart 2: Sharp fall in off balance sheet spending



Fiscal responsibility and the FRBM objective

The envisaged fiscal consolidation in FY22 notwithstanding, the Budget remains silent on explicitly codifying the 15th Finance Commission recommendations on fiscal consolidation. We expect this to take a formal shape when the currently void FRBM Act gets operationalized from FY23 onwards.

- It has been recommended by the 15th Finance Commission to bring down fiscal deficit from 7.4% of GDP in FY21 to 6.0% in FY22. The Budget has chosen to exceed the recommended deficit targets in the short term.
- In the long term, the Commission recommends bringing down fiscal deficit to 4.0% of GDP by FY26, compared to an earlier target of 3.0% by FY23. If actualized, this fiscal leeway will provide the government an opportunity to spend aggressively over the next 4-years.

From a longer-term perspective, it is critical to acknowledge that this extra space of 1% of GDP, if actualized by the revised FRBM Act, is used judiciously, primarily via healthy capex outlays to enhance the growth potential of the economy without generating inflationary pressures. This we believe will help in preserving debt sustainability in the long run. Further, it is also important to safeguard fiscal discipline by establishing an independent Fiscal Council with requisite statutory powers (as recommended by the 15th Finance Commission) that can play the role of advising the Union and States on short as well as long term fiscal adjustments.

Chart 3: The Budget is yet to formalize the FRBM glidepath

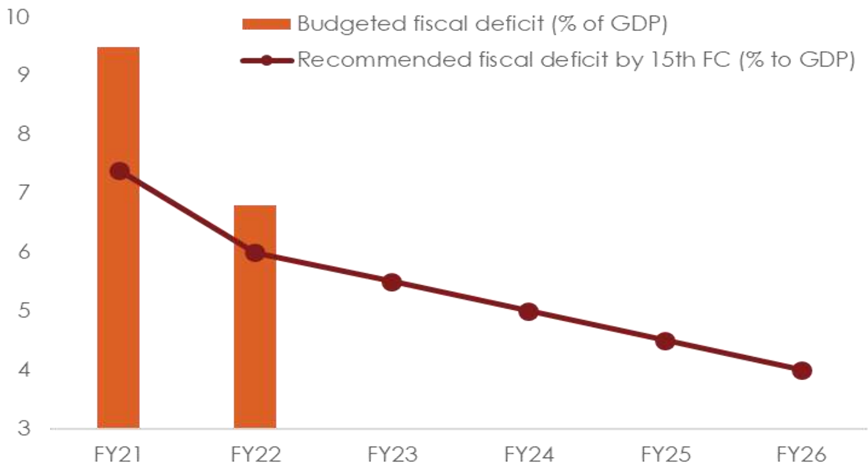


Table1: Focus areas of the Budget

Infrastructure	Finance sector reforms	Health spending
Enhanced outlay on capital spending across infra sectors of roads, ports, railways, urban infrastructure, in line with the National Infrastructure Pipeline (NIP). To meet infrastructure funding needs, the Budget proposed – 1) Creation of a new Development Financial Institution (DFI) with an initial capital of Rs 200 bn 2) Thrust on utilization of funds raised by monetizing operating public infra-asset under the Asset Monetization Program.	Create a Bad Bank, via an Asset Reconstruction and an Asset Management Company. A well-timed measure given large overhang of banking sector NPAs subsequent to the AQR by RBI in 2015 and risks of a further rise as highlighted by RBI in the latest Financial Stability Report. To divest stake in 2 PSBs Capital infusion of Rs 200 bn in PSBs in FY22. FDI limit in Insurance sector increased to 74% from 49%	Spending on 'Health and wellbeing' budgeted to rise by 137%YoY in FY22 Rs 350 bn earmarked towards the COVID vaccine along with significant portion of extra spending as 'transfers' to States. A new centrally sponsored scheme, PM AtmaNirbhar Swasth Bharat Yojana launched, with an outlay of Rs 641bn over next 6 years to strengthen healthcare infrastructure.

Financing of higher Fiscal Deficit

Understandably, the onus of funding the higher than anticipated fiscal deficit lies on market borrowing through both dated securities and short-term bills.

- Gross and net borrowing via g-secs in FY21 got revised up sharply to Rs 12.8 tn and Rs 10.5 tn from the initial budget estimate of Rs 7.8 tn and Rs 5.5 tn respectively. In similar fashion, net funding via T-Bills got scaled up to Rs 2.3 tn vis-à-vis the initial budget estimate of Rs 250 bn.
- For FY22, gross and net borrowing via g-secs has been budgeted at Rs 12.1 tn and Rs 9.2 bn, marginally lower vs. FY21, but considerably higher vs. FY20.
- The reliance on small savings is expected to increase significantly from Rs 2.4 bn in FY20 to Rs 4.8 tn in FY21 and Rs 3.9 tn in FY22. This reflects clean financing

via NSSF with major part of off-balance sheet spending now being met by the Budget.

Table 2: Funding of fiscal deficit

(In Rs bn)	FY20	FY21 BE	FY21 RE	FY22
Fiscal Deficit	**9337**	**7963**	**18487**	**15068**
External Financing	87	46	545	15
Domestic Financing	9250	7917	17941	15053
Dated Securities (Net)	4740	5449	10528	9247
T-Bills (Net)	1501	250	2250	500
Small Savings	2400	2400	4806	3919
Cash Drawdown	50	-530	-174	714
Others*	906	559	348	531

*Includes State Provident Funds, Internal Debts and Public Account

Conclusion

The FY22 Union Budget does a good job of managing the current macro challenges by maximizing fiscal impulse in an inflation neutral manner. With credibility on its side, we expect the headline deficit targets to be met in FY21 and FY22. This would provide a supportive backdrop for India's V-shaped GDP growth recovery.

The sine quo non for achieving the headline deficit target is the realization of disinvestment and asset monetization target of Rs 1750 bn, which stands at a record high in rupee terms. While past performance on this front is dominated by slippages, current buoyant equity market sentiment (aided by the global liquidity glut) can get supportive provided the government spaces the dilution and sale exercise in a prompt and timely manner. Amidst the additional borrowing for FY21 and higher than expected market borrowing for FY22, we revise upwards our view on the 10Y g-sec yield. For details see our Rates section.

Table 2: Budget at a glance

(As % of GDP)	FY20	FY21 BE	FY21 RE	FY22
Revenue Receipts	**8.3**	**10.4**	**8.0**	**8.0**
Net Tax Revenue	6.7	8.4	6.9	6.9
Non-Tax Revenue	1.6	2.0	1.1	1.1
Non-Debt Capital Receipts	0.3	1.2	0.2	0.8
Total Expenditure	**13.2**	**15.6**	**17.7**	**15.6**
Revenue Expenditure	11.6	13.5	15.5	13.1
Capital Expenditure	1.6	2.1	2.3	2.5
Revenue Deficit	3.3	3.1	7.5	5.1
Fiscal Deficit	**4.6**	**4.1**	**9.5**	**6.8**
Primary Deficit	1.6	0.5	5.9	3.1

Rates

The fiscal overhang on bonds

KEY TAKEAWAYS

- The RBI is expected to continue with its accommodative monetary policy through the remaining part of FY21 as well as for a major part of FY22 to ensure economic recovery is sustainable
- With growth conditions likely to stabilize in the next 2-4 quarters, we expect the central bank to start normalizing monetary policy by raising repo rate by 25 bps in Feb-22
- As a prelude to interest rate normalization, the RBI is also expected to calibrate liquidity conditions by curbing the current state of liquidity glut
- With fiscal deficit remaining high in FY21 and FY22, RBI's role (via bond purchases) in ensuring non disruptive conclusion of government's borrowing plan would be critical
- We expect India's 10Y sovereign yield to rise from 6.00% in Mar-21 to 6.40% by Mar-22

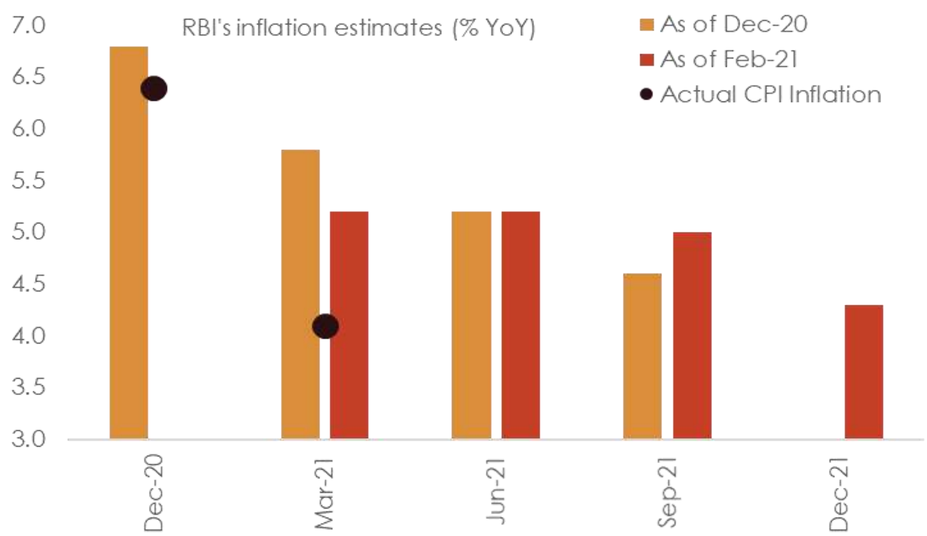
The 10Y g-sec yield bottomed out at an average level of 5.82% in Jul-20. Since then, it has been gradually creeping up, with over 16 bps of up move happening in 2021 so far. The hardening of yield has played out despite the continuation of status quo on policy rates along with reiteration of accommodative policy stance, and sharp deceleration in CPI inflation.

The tailwinds for bonds…

The monetary policy setting continues to remain conducive for lower rates, both globally, as well as domestically.

- Despite 41 bps increase in 10Y UST yield in 2021 so far, the 2Y UST yield has eased by 2 bps during the same period. This signifies the impact of Federal Reserve's commitment towards average inflation targeting and strong forward guidance on lower rate environment.
- In India, while the MPC of the RBI has maintained status quo since May-20, the forward guidance on continuing with the accommodative stance as long as necessary – at least during the current financial year and into the next financial year – to revive growth on a durable basis and mitigate the economic impact of COVID, got unanimously reiterated in the last policy review in Feb-21.
- With CPI inflation decelerating sharply over Dec-Jan FY21, there is a strong likelihood that average inflation in FY22 would trend lower to 5.0% (from an estimated level of 6.0% in FY21) despite increase in global commodity prices and some demand led inflation from the anticipated strong V-shaped economic recovery. This is likely to provide some comfort to the MPC, which saw inflation remaining above their tolerance threshold (at 6.0%) for major part of CY 2020.

Chart 1: CPI inflation has undershot RBI's forecast in Q3 FY21; on course for an encore in Q4 FY21



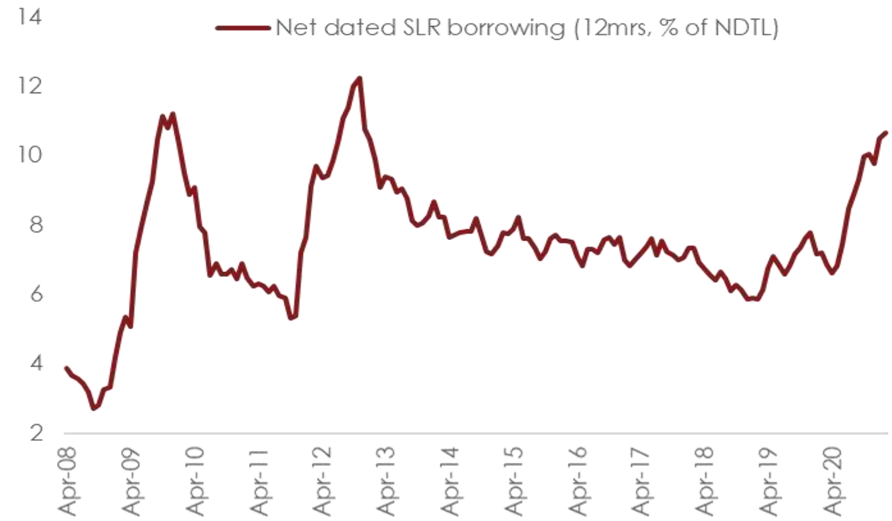
Note: Actual CPI inflation for Mar-21 quarter is represented by the actual print for the month of Jan-21

…are being suppressed by fiscal headwinds

The pressure on g-sec term premium has been building up during the course of FY21 as the effective monetary policy rate switched to reverse repo amidst excess liquidity conditions, while market participants factored in risks of COVID led substantial fiscal slippage.

Chart 2: The g-sec term premium is currently at its highest level in last 11-years

Chart 3: Net dated SLR borrowing has seen a sharp rise in FY21



With COVID adversely impacting both revenue and expenditure side of the fiscal equation, the fiscal deficit for FY21 has now got revised sharply upwards to 9.5% of GDP from the initial budget estimate of 3.5%. Despite efforts towards consolidation in the next financial year, the budgeted fiscal deficit ratio of 6.8% in FY22 would still be significantly higher than previous 10-year average of 4.8%.

- Hence, despite net g-sec borrowing requirement budgeted to moderate somewhat to Rs 9.3 Lakh Cr in FY22 from Rs 10.5 Lakh Cr in FY21, it nevertheless remains 2.0x of the net g-sec borrowing concluded in FY20.

Outlook

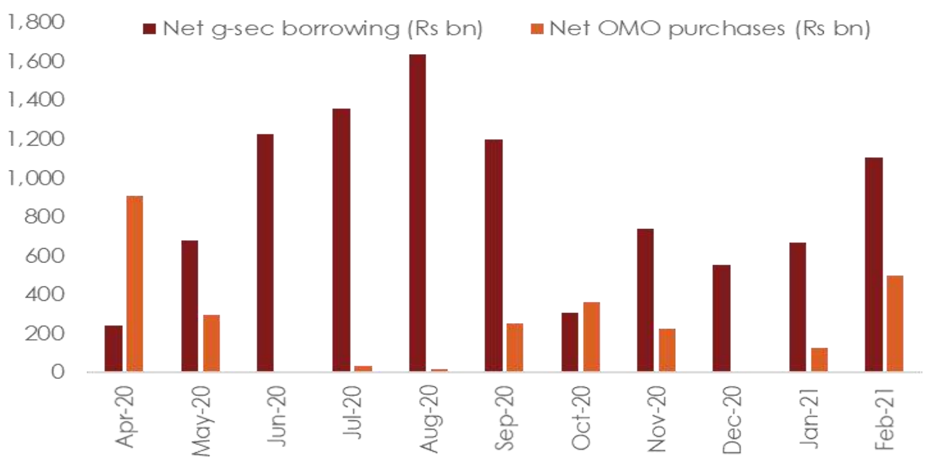
With FY21 coming to a close, we now expect the 10Y g-sec yield to trade close to 6.00% levels (vis-à-vis our earlier estimate of 5.85%) by Mar-21 on account of wider than anticipated fiscal deficit in FY21 and FY22.

Going into FY22, we expect the following factors to play an influential role:

- Although CPI inflation is expected to moderate to 5%, it would continue to remain above the 4% target for the third consecutive year. This would trigger the beginning of policy normalization once growth conditions stabilize. As a prelude to interest rate normalization, the RBI has already initiated the first leg of liquidity calibration through the variable rate term reverse repo auction and the rollback of CRR cut. The central bank would rely on both frictional tools (like the VRRR auction and SDF) and permanent tools (like CRR and MSS) to calibrate liquidity conditions depending upon the overall BoP outturn.
- Liquidity calibration is likely to lead to normalization in monetary policy amidst the expectation of a strong V-shaped recovery coupled with the above target inflation. At this juncture, we expect the MPC to hike repo rate by 25 bps in Feb-22. This is likely to get preceded by upward adjustment in reverse repo rate to 3.75% in H2 FY22 so as to restore the width of the policy rate corridor at 25 bps.

With borrowing requirement remaining high, we expect the RBI to continue supporting the bond market via OMO purchases and Operation Twist. In FY21 so far, the RBI has absorbed 28% of the net g-sec supply. A similar response would be warranted from the central bank in FY22 to ensure non disruptive conclusion of government's borrowing program. Taking all the above into account, we expect the 10-year g-sec yield to increase towards 6.15% (vis-à-vis our previous estimate of 6.00%) by Sep-21 and further towards 6.40% (vis-à-vis our previous estimate of 6.20%) by Mar-22.

Chart 4: The RBI has been regularly purchasing g-secs to anchor long term yields



Rupee

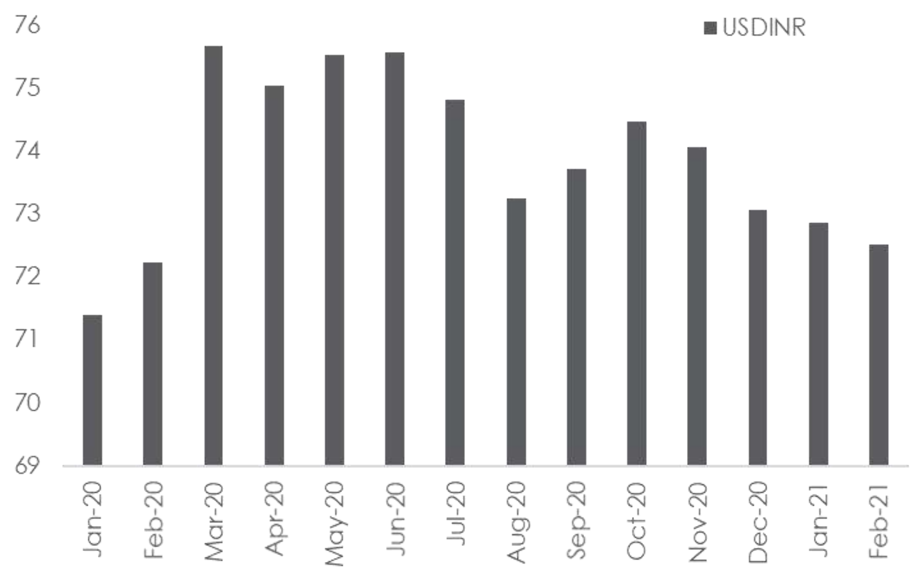
So far so good

KEY TAKEAWAYS

- 2021 has begun with two headwinds for INR: i) recent strength in the USD, and ii) sharp widening of the merchandise trade deficit
- Nevertheless, INR has strengthened in 2021 so far on i) healthy portfolio inflows, and ii) sharp downward adjustment in inflation
- We expect India to post record BoP surplus of USD 105 bn in FY21, followed by a healthy surplus of USD 55 bn in FY22
- While FX intervention from the central bank will continue in FY22, the pace is likely to ease with moderation in inflation
- We expect gradual appreciation in the currency to play out with USDINR at 73.0 (with downside risk) in Mar-20 to 71.0 by Mar-21

The monthly appreciation in the Indian rupee continued for three successive months through Jan-21, with the currency gaining 2.1% vs. the US dollar between Oct-20 and Jan-21. The trend continues to assert in the ongoing month with INR gaining 0.5% in Feb-21 so far to 72.5 levels, the strongest in the post COVID period.

Chart 1: INR has attained its strongest level so far in the post COVID period



Recent strength in INR, especially seen in 2021 so far, has come about despite the backdrop of mild strength in USD and sharp deterioration in India's merchandise trade deficit.

- The USD (as represented by the DXY Index) has strengthened by 0.5% in 2021 so far, supported by a sharp 41 bps jump in the 10-year UST yield. While the hardening of long-term rates has not resulted in change in market expectations from the Federal Reserve in terms of policy action in 2021, it nevertheless captures the recent pickup in inflation and inflation expectations in the US.
- India's merchandise trade deficit has risen sharply to USD 14.5-15.4 bn range over Dec-20 and Jan-21 vis-à-vis the monthly average of USD 5.3 bn seen between Apr-Nov 2020. The deterioration in merchandise trade deficit indicates the impact from i) increase in global commodity prices, especially crude oil and metals and ii) continued normalization in domestic demand conditions amidst gradual phasing out of lockdown restrictions.

What's driving INR strength despite these moderate headwinds?

Despite the recent turn in USD sentiment and the trajectory of trade deficit, INR has managed to eke out gains in 2021 so far due to:

- Foreign investment inflows, especially portfolio flows have remained healthy despite some moderation vis-à-vis recent months. Net FPI inflows have clocked about USD 5.4 bn in Q4 FY21 so far vis-à-vis USD 21.4 bn of inflow recorded in Q3 FY21. Record low monetary policy rates in advanced economies along with unprecedented quantitative easing by systemically important central banks continue to provide a supportive backdrop for capital inflows into emerging market economies, including India.

- Inflation trajectory has seen a sharp downward adjustment from an average of 6.9% YoY seen between Apr-Nov FY21 to an average of 4.3% seen during Dec-Jan FY21. While moderation in inflation was anticipated, the extent of softening has turned out to be greater than expectations of market participants as well as the RBI. With CPI inflation now getting close to the medium-term target of 4%, the need for maintaining aggressive buy side intervention stance by the RBI could see some relaxation as the inflation led misalignment in currency's fair value would now correct. The pace of incremental buildup of foreign currency assets by the RBI has started showing signs of moderation (notwithstanding the impact from recent strength in USD).

Chart 2: Fall in inflation will help narrow INR's overvaluation on REER basis

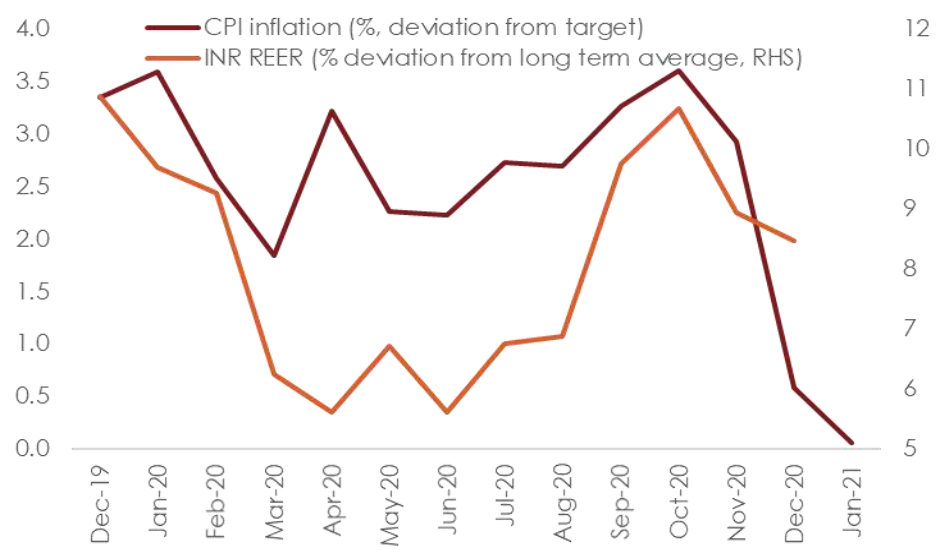
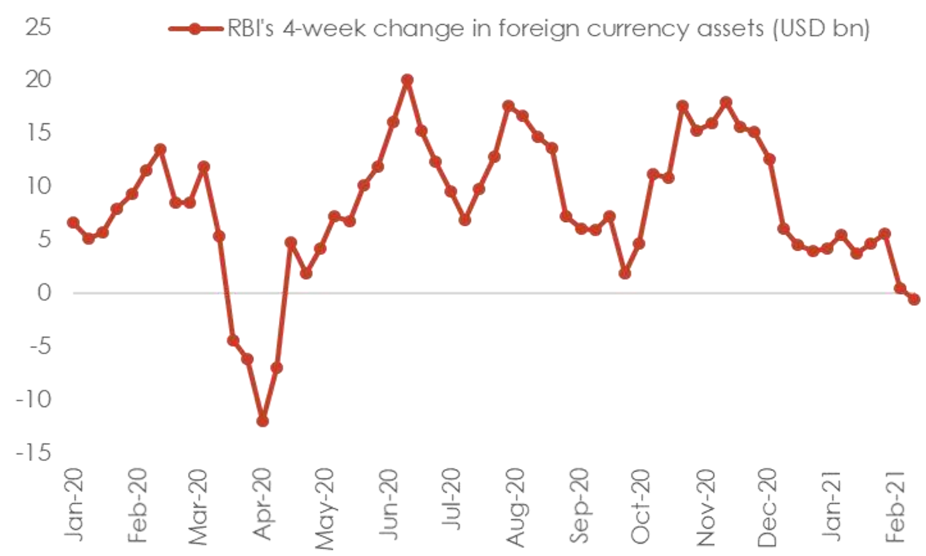


Chart 3: Incremental buildup of RBI's FCA sees some moderation



Outlook

Recent dynamics in the FX market along with macroeconomic developments now provide a downside bias to our forecast of 73.0 for USDINR by end Mar-20.

For FY22, we continue to expect weakening bias in the USD to persist amidst the adoption of relatively stronger reflationary policies. This would provide a supportive backdrop for EM currencies, including the INR.

Moreover, India specific factors would also turn favorable for INR:

- India is likely to be one of the front runners of the global V-shaped recovery with a strong double-digit expansion in GDP. Compared to World Bank's forecast of expansion in World GDP by 3.8-4.0% over calendar years 2021-2022, we expect India to post a substantial outperformance with a GDP growth of 11.0% in FY22.
- Inflation pressure is expected to moderate towards 5.0% from the estimated 6.0% in FY21.

With improvement in growth prospects and hardening of global commodity prices, India is also likely to revert to the usual current account deficit position. We expect current account balance to post a deficit of USD 30 bn in FY22 vis-à-vis a surplus of USD 32 bn in FY21. Despite the deficit outturn on current account, India's financial and capital account are expected to remain healthy, thereby generating a BoP surplus of USD 55 bn in FY22 vis-à-vis a surplus of USD 105 bn in FY21.

As such, while we expect INR to appreciate once again in FY22, the pace would get interspersed by central bank's actions in the FX market resulting in INR's underperformance vis-à-vis peers. We expect USDINR at 72.0 by Sep-21 and 71.0 by Mar-22. Risk to this view stems from an appreciation in the dollar, which could potentially impart a depreciation bias to INR. On the other hand, a faster than anticipated growth recovery, stability in commodity prices, and government's execution of reforms agenda can potentially favor a stronger INR.

Global Overview

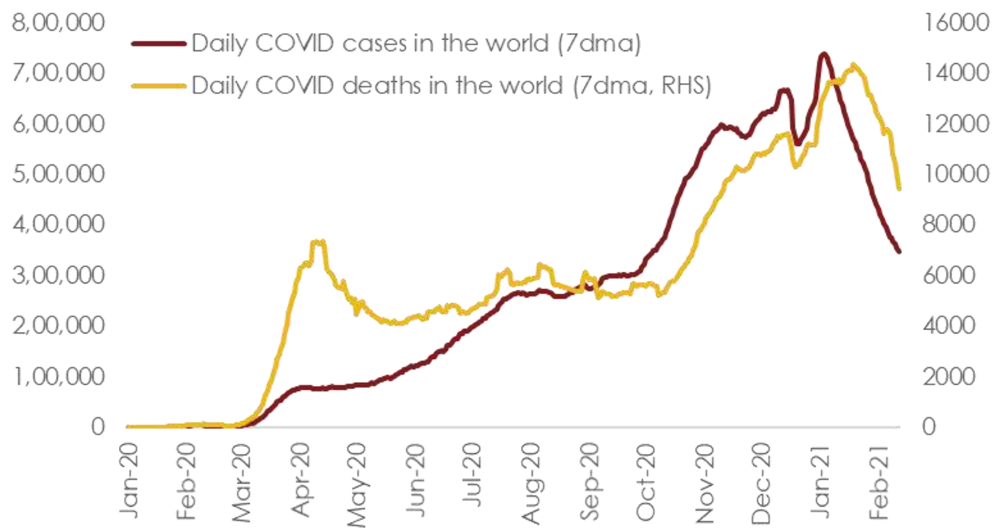
Rays of Hope

KEY TAKEAWAYS

- Developments in month of Feb-21 on three fronts reinforced expectations of global economic recovery gaining traction in 2021.
- Foremost, the COVID curve at the global level showed a decisive retreat for the first time ever, with daily new infections seeing a steady drop for nearly a month since its peak in mid Jan-21
- Second, vaccine rollouts which began at a slow pace, gathered momentum.
- Third, IMF underpinned a faster global recovery in 2021 amidst sustained fiscal and monetary policy support, although it expects regional variations to persist.
- In a positive sign, GDP released across major economies indicated continued sequential recovery in Q4 2020, despite stricter containment measures.

Overview

Developments in month of Feb-21 on three fronts reinforced expectations of global economic recovery gaining traction in 2021. Foremost, the COVID curve at the global level showed a decisive retreat for the first time ever, with daily new infections seeing a steady drop for nearly a month since its peak in mid Jan-21 (see chart). Second, vaccine rollouts which began at a slow pace, gathered momentum. As of 21st Feb-21, 205 million COVID vaccine shots have been administered globally. Countries that have shown scale in terms of population covered for the first dose include Israel (47.0%), UK (26.3%), Bahrain (18.3%) and US (13.1%). Third, IMF underpinned a faster global growth in 2021 amidst sustained fiscal and monetary policy support, although it expects regional variations to persist. Concurrently, reflecting the recovery underway, oil and other commodity prices continued to harden which is somewhat worrisome as a sustained rise could possibly derail the still nascent recovery that is taking shape.

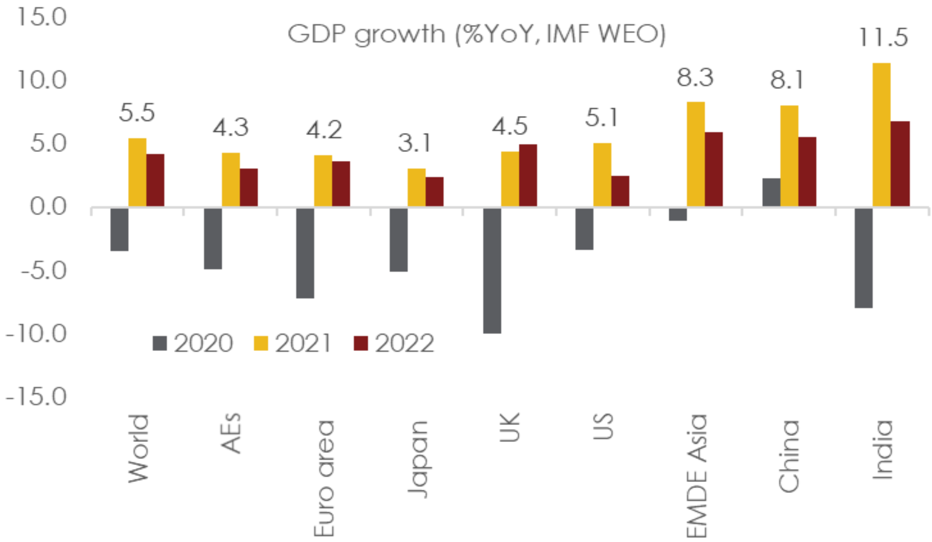


IMF's World Economic Outlook

As per the IMF's World Economic Output (WEO) report, released in Jan-21, "Amid exceptional uncertainty, the global economy is projected to grow 5.5% in 2021 versus a contraction of 3.5% in 2020. The 2021 forecast is revised up 0.3pp relative to the previous forecast, reflecting expectations of a vaccine-powered strengthening of activity later in the year and additional policy support in a few large economies. The strength of the recovery is projected to vary significantly across countries, depending on access to medical interventions, effectiveness of policy support, exposure to cross-country spill overs, and structural characteristics entering the crisis".

IMF's improved 2021 growth outlook was based on an upward revision to both advanced and emerging market and developing economies (EMDEs) growth forecasts. The former is expected to grow by 4.3% (revised up +0.4ppt vs Oct-20) while EMDE are expected to grow by 6.3% (revised up +0.3ppt).

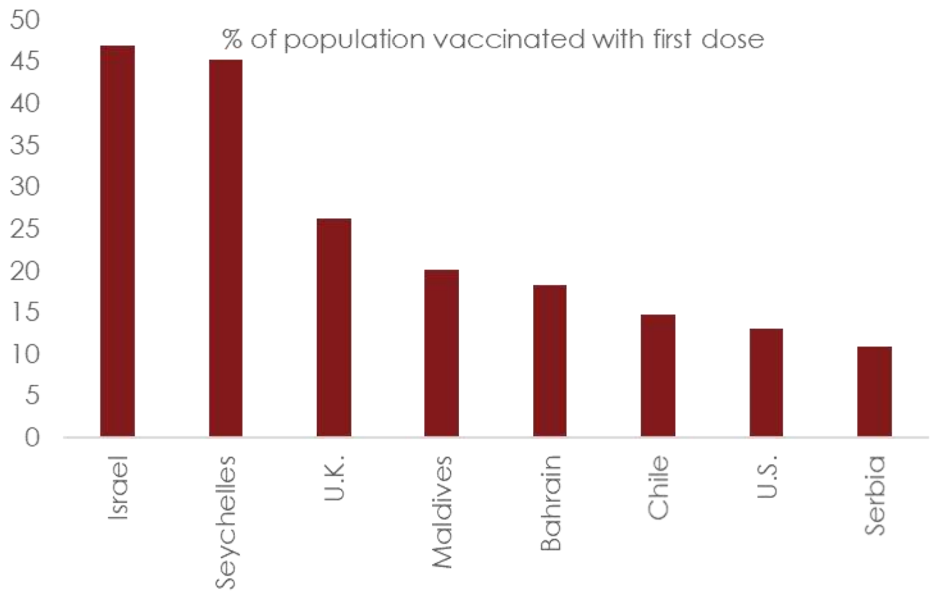
- Within AEs, recovery paths vary with US and Japan projected to regain end-19 activity levels by H2-21, while in euro area and UK activity is expected to remain below end-19 levels into 2022.
- Within EMDEs, considerable differentiation is expected between China - where effective containment measures, a forceful public investment response, and central bank liquidity support have facilitated a strong recovery, versus other economies.



US Economy

US Q4 GDP grew by 4.0%YoY after a steep rise of 33.4% in Q3, broadly in line with market expectations. Despite the rebound in H2, for the year as a whole, GDP contracted by 3.5% following an expansion of 2.2% in 2019. Growth in consumer spending stood at 2.5%YoY in Q4, affected by the imposition of containment measures as COVID infections saw a surge. The passage of fiscal package of USD 600 bn in Dec-20 however should prove to be supportive of consumption Q1-21 onwards.

On the vaccine front, US has administered approximately 54.6 mn doses, inoculating close to 12.0% of the population with the first dose and 4.5% with the second dose. The country has significantly ramped up pace of doses administered to 1.6 mn doses a day. As pace of vaccine accelerates, it should allow a faster reopening of the economy and growth in 2021. As per IMF WEO, US economy is expected to clock a growth of 5.1% in 2021; revised up from 3.1% as of Oct-20. Stronger growth is expected to be function of – 1) Strong carry over of momentum for H2-20, 2) Traction in vaccine administration and 3) Additional support from Dec-20 fiscal package, as per IMF.



In other major development, at the confirmation hearing before the Senate, the then nominated treasury Secretary Janet Yellen (now appointed), made some incisive comments on China, currency and US fiscal stimulus. From her communique, it appears that US' hard stand against China's abusive unfair and illegal practices will continue into the Biden era, reflecting a continuity from Trump regime. On the domestic currency, while pledging that the value of US Dollar should be market determined, Yellen indicated that US will take a strong stand against countries who artificially manipulate currency levels to their advantage. Most importantly she backed Biden's proposed USD 1.9 tn of fiscal stimulus, urging lawmakers to 'Act Big'. She argued that benefits of the stimulus will far outweigh the costs (esp. higher debt levels in the near term). Separately, Congressional Democrats continue to push forward President Biden's USD 1.9 tn corona virus relief bill, ahead of a mid-Mar-20 deadline when enhanced unemployment benefits expire.

On the data front, latest releases continue to fare well -

- ISM services index in Jan-21, defying expectations of a dip, rose to a 23-month high of 58.7, led by new orders and business activity.
- ISM manufacturing dipped marginally, to 58.7 in Jan-21 from 60.5 in Dec-20, but continued to post an expansion for the 8th consecutive month.
- Non-farm payrolls increased by +49k in Jan-21, after a downward revision of 227k decline in Dec-20, with unemployment rate falling to 6.3% from 6.7% previously.

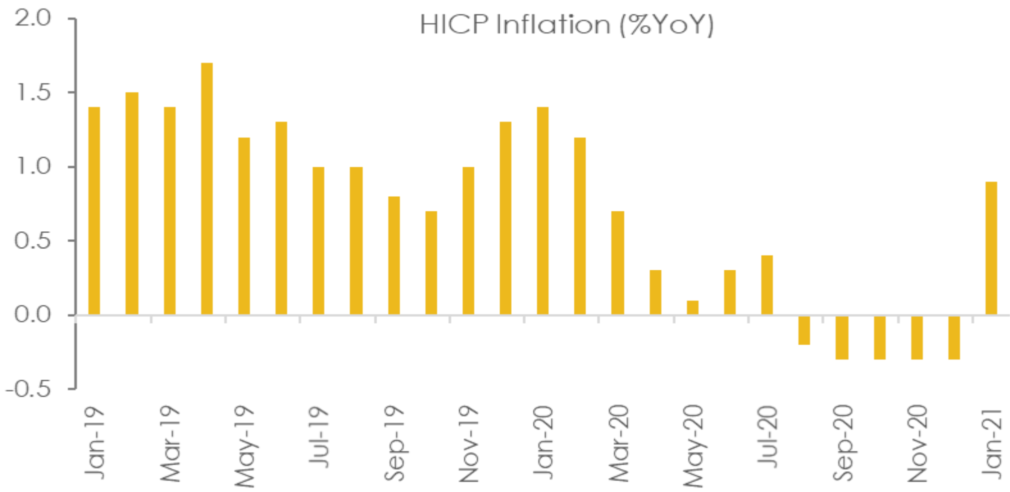
Eurozone

Eurozone GDP expectedly contracted by 0.6%QoQ and by 5.1%YoY in Q4, but the pace of contraction was shallower than anticipated despite the imposition of containment measures. Contraction was led by France and Italy, while Spain (+0.4%) and Germany (+0.1%) managed to post marginal growth. Looking ahead, the region is likely to remain in recession, with GDP growth expected to contract even in Q1-21 due to extended lockdowns. The European Commission expects the region to record a slower growth of 3.7% in 2021 from an earlier estimate of 4.2% on account of second wave of the pandemic. For 2022, the economy is expected to growth by 4.2% from an earlier estimate of 3.0%.

Eurozone inflation saw a sharp increase in Jan-21, moving into positive territory for the first time since Jul-20. As such, prices rose by 0.9%YoY from a contraction of 0.3% in the previous month, with the uptick being led by a combination of one-off factors, such as, reversal of temporary reduction in German VAT, higher energy prices and supply chain disruptions amidst the renewed lockdowns that continue to remain in place.

Private sector too saw an enduring start to 2021, with output declining for both manufacturing and the services sector. PMI manufacturing eased, albeit marginally to 54.8 from 55.2 in Dec-20, while services saw a sharper decline to 45.4 from 46.4 in Dec-20. Services sector activity continues to remain in contraction for the 5th consecutive month, bearing a disproportionately higher burden of the containment measures.

On the vaccine front, the region has faced unprecedented delays, with the European Union pushing forward its COVID-19 vaccination target date by three months. The bloc now aims to vaccinate 70% of the adult population by the end of the summer instead of the beginning of the season, which appears as a setback for growth recovery.



UK

The Bank of England's (BoE) MPC at its Feb-21 policy voted unanimously to hold rates steady and maintain its quantitative easing program at current levels (GBP 895 tn) as the economy progresses to emerge from the pandemic led slowdown. More importantly, the BoE indicated that domestic banks would need at least a preparation time of 6 months for a shift to negative interest rates, to avoid risks to safety and soundness. Recall, that central bank had indicated last year in Sep-20 that it was considering the possibility of negative interest rates. As such, the probability of lowering interest rates to negative territory has decreased for now.

On the growth front, outlook still remains uncertain, with nationwide lockdown measures likely to continue till early Mar-21 and as the country races ahead with vaccine rollout amidst new strains of virus. It has so far administered close to 15.8 mn doses, with 22.9% of the population receiving the first jab. GDP grew by 1.0%QoQ in Q4-20, with the full year growth contraction at 9.9%YoY – the largest decline on record. In its latest growth assessment, BoE cut this year's GDP growth forecast to 5.0% from 7.3% in Nov-20; but lifted guidance for 2022 to 7.3% from 6.3%.

Japan

Amidst rising COVID infections, Japanese Government extended the state of emergency covering Tokyo and other major metropolitan areas to 7th Mar-21, which is expected to weigh on economic activity that showed a healthy recovery in the last quarter of 2020. GDP growth in Q4-20 beat market expectations to expand by 3.0%QoQ (seasonally adjusted). For the full year, GDP shrank by 4.8%, to mark the first contraction since a 5.7% plunge seen during the global financial crisis. The recovery is expected to continue into 2021, despite state of emergency due to lighter restrictions, robust global demand and vaccine rollout that is about to begin.

The Bank of Japan (BoJ) in its last meeting, maintained its target under the yield curve control at -0.1% for short term rates and around 0% for 10-year bond yields. In its latest quarterly projections, the BOJ upgraded growth forecast for 2021 to 3.9% from 3.6% earlier on expectations that the Government's spending spree will help to arrest the pandemic induced slowdown. But it offered a bleaker view on consumption, warning that services spending will remain under "strong downward pressure" due to recently imposed containment measures.

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 8,000 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in BKC, Mumbai.

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