MACRO PULSE REPORT

February 2022

Contents

From the desk of the Chief Analytical Officer

We are glad to release our **fourteenth edition** (Feb-22) of **Acuité Macro Pulse**, a monthly economic journal which provides a crisp analysis of both the domestic and the global economic developments.

Since the release of our last edition, there have been three key developments – the announcement of the Union Budget, the rapid taper down of the third Covid wave in India and last but not the least, the flare up of the conflict between Russia and Ukraine. While the budget didn't have any major surprises, it laid a platform for a sustainable capex cycle over the medium term with significant participation from both the public and the private sector. Higher capital investments should structurally push up the medium to long term growth prospects of the Indian economy. It also brought in a slew of policies that should not only induce fresh investments in clean energy, electric vehicles and digitization but take India forward towards its sustainability goals. Secondly, Omicron had a short peak with continuously declining severity of cases, that have led to almost a complete unlocking of the economy and a boost to the contact intensive sectors by Feb-22 end. As soon as the hopes of a permanent mitigation of the prolonged Covid risks were building up, unfortunately another risk has emerged in the horizon through the Russia-Ukraine conflict.

Clearly, the first casualty in any such geo-political strife is price stability which has already seen headwinds across the globe. The prolonged pandemic has left deep scars in the global supply chain which is set to get further aggravated by the latest conflict. Given the market share of Russia in the global oil and gas sector as well as the increasing breadth of economic sanctions, the crude oil prices have started to rocket and already breached the levels of USD 120 pb. Needless to say, persistently high crude oil prices will have far reaching impact on the domestic macro-economic contours.

While the domestic retail fuel prices have not been revised upwards in the last 3 months, it is already overdue and a significant pass through will start to have an impact on headline CPI inflation which has been supported so far by benign food prices. We believe that the MPC's forecast of a 4.5% CPI print in FY23 may not be realistic given the emerging ground realities unless we see a quick resolution of the geo-political conflict. Even if the government decides to absorb a large part of the crude price increase through further excise duty cuts, it may lead to a higher than budgeted deficit and consequently, higher borrowings which have already been projected to rise sharply in the next fiscal.

Not surprisingly, the latest geo-political developments have added to the increased volatility in the global capital and commodity markets due to the acceleration of the monetary normalization process in the developed economies. Despite the accommodative stance by RBI, domestic bond yields have continued to rise and the rupee has just breached the 76 mark. For corporates, bankers and investors, it is a time for caution for sure but not panic given the structural strength of the economy.

Suman Chowdhury
Chief Analytical Officer

Growth

Omicron recedes, geo-political risks arise

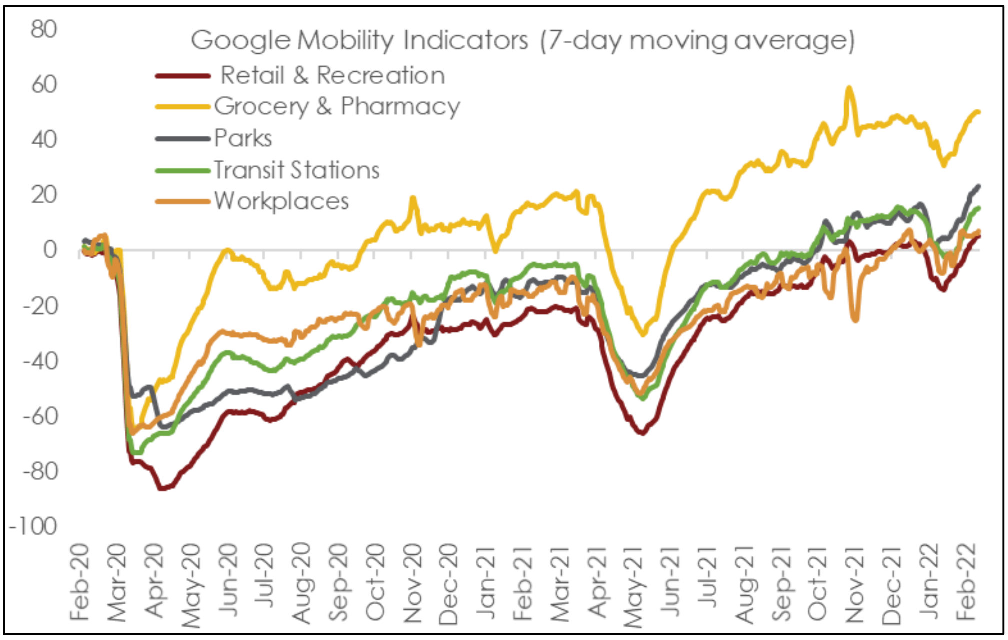
KEY TAKEAWAYS

- India Q3 FY22 GDP growth decelerated more than expected to 5.4% YoY from 8.5% in Q2 (consensus: 6.0%). On sequential basis, GDP however expanded by a healthy 6.4% QoQ, underscoring an unfavorable base weighing on annualized growth.
- Correspondingly, GVA growth eased to 4.7% in Q3 FY22 from 8.4% in Q2. The moderation was broad-based, across all three sectors and sub-components within i.e., Agriculture, Industry and Services.
- With Omicron cases peaking and receding swiftly, domestic growth has reverted to path of recovery in Feb-22 after a short pause last month. The mobility indicators have seen a healthy revival and touched post-pandemic highs. In addition, high frequency indicators such as E-way bills, rail freight, electricity generation and GST collections have continued to remain fairly resilient, with incoming data set to show a build-up of momentum in services for the month of Feb-22.
- While elevated commodity prices amidst the geopolitical tensions is likely to weigh on Q4 FY22 activity, the downside is likely to be offset by backloaded government expenditure, RBI remaining in accommodative mode along with further progress on vaccination.
- Given the revision to FY21 GDP data and consequently a less favourable base for FY22, our GDP growth estimate for FY22 stands revised lower to 9.2% which is slightly higher than the revised NSO estimate. For FY23, we currently expect GDP growth at 7.5%.

India Q3 FY22 GDP growth decelerated more than expected to 5.4% YoY from 8.5% in Q2 (consensus: 6.0%). On a sequential basis, however GDP expanded by a more healthy 6.4%QoQ, underscoring an unfavorable base weighing on headline growth. Along with Q3 FY22 GDP the National Statistical Office (NSO) published FY22 GDP second advance estimate which stands revised lower at 8.9% compared to 9.2% provided in its preliminary estimate. The downward revision reflects the upward adjustment to FY21 GDP (i.e., the base) along with a moderate impact of Omicron wave. Basis NSO's annual estimate, the implied Q4 FY22 GDP growth stands at 5.3% YoY i.e., almost the same as in Q3.

The spread of Omicron variant led to a dent in domestic economic activities last month which was clearly reflected in our proprietary AMEP (Acuité Macroeconomic Performance) easing marginally to 112.2 in Jan-22 from 115.0 in Dec-21. From growth perspective, the index contracted sequentially by 2.5% MoM in Jan-22 from an expansion of 3.3% in Dec-21. However, on an encouraging note, the magnitude of the adverse impact has been much lower as compared to the previous pandemic waves given less severity of infections amidst robust vaccination coverage, prevailing level of seroprevalence, improvement in medical and healthcare facilities and better management of supply chain logistics. With Omicron now cases peaking and receding swiftly, domestic growth has reverted to path of recovery in Feb-22 after a short pause in Jan-22. With easing of restrictions at the state level, mobility indicators have seen a healthy recovery, with sub-indicators showing a broad-based increase to not just above the baseline of 0 (i.e., pre-pandemic level) but have attained post-pandemic highs yet again. In addition, high frequency indicators such as E-way bills, rail freight, electricity generation, GST collections have continued to remain fairly resilient, with incoming data likely to show build-up of momentum in services for the month of Feb-22.

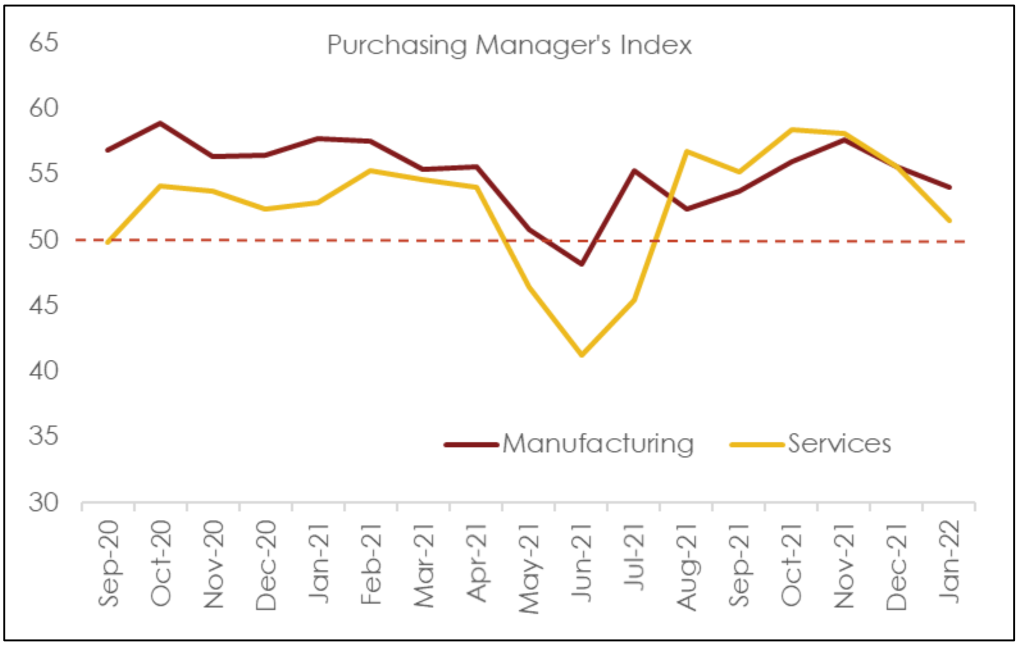
Chart 1: Google mobility, after dipping in Jan-22, has recovered swiftly in Feb-22



Recent data releases: A granular look at recovery

- India's IIP growth slipped to a 10-month low of 0.4% in Dec-21, compared to 1.3% in Nov-21. The moderation was largely owing to an adverse base, as sequentially the index expanded by a healthy 7.5%MoM. However, on annualized basis, capital and consumer goods continued to remain in contraction for the third consecutive month.
- India PMI, both manufacturing and services slipped in the month of Jan-22, reflecting the impact of Omicron wave. While downside in manufacturing was moderate from 55.5 in Dec-21 to 54.0 in Jan-22, services PMI saw a sizeable decline to 51.5 in Jan-22 from 55.5 previously. However, the PMI print has seen a marginal pickup in Feb-22.
- After hitting a 3-month low of Rs 1.29 Lakh Cr in Dec-21, GST collections bounced back to a record high of Rs 1.41 cr in Jan-22, registering a growth of 15% over Jan-21 and 25% over the comparable 2-year period.
- NONG (Non-oil-non-gold) imports, a key indicator of domestic demand, moderated by USD 1 bn, the overall magnitude of USD 37.6 bn recorded in Jan-22 is the second highest on record (with previous month level of USD 38.6 bn being the record high).
- Total acreage under rabi crops touched a new record of 700.8 lakh hectares, i.e., 1.5% above the previous year's acreage and 8.2% above the normal (5-year average) acreage. As per the second advance estimates of production for major crops, Government is estimating foodgrain production at a record 316.06 mn tonnes for FY22 (i.e., 5.32 mn tonnes higher than FY21)

Chart 2: Stronger moderation seen in services PMI vs manufacturing due to Omicron



FY21: A less severe contraction

National Statistical Office (NSO) also released the first revised estimate of national income for FY21, earlier this month. Key takeaways from the data were –

- The severity of pandemic on the economy was lower than initially estimated; with FY21 GDP growth contraction revised to 6.6% from 7.3% earlier. The GDP growth for FY20 was too lowered to 3.7% from the 4.0% estimated earlier.
- Savings and investment rates continued to decline. Gross savings as a % of gross national disposable income for FY21 stood at 27.8% vs. 29.4% in FY20.
- Gross fixed capital formation (GFCG) as % of GDP slipped to 26.6% in FY21 from 28.6% in FY20, underscoring the continued downsizing in private investment.

Outlook

Although not very significant, the Omicron wave dented the pace of growth recovery that posted a good run post the second Covid wave amidst a mix of pent-up, festive and some organic demand. However, the silver lining to the outlook comes from relatively lower severity of the Omicron wave with cases having peaked rather quickly amidst robust vaccination coverage, prevailing level of seroprevalence, improvement in medical and healthcare facilities and better management of supply chain logistics. In addition, vaccination coverage continues to power ahead with over 80% of the adult population being double vaccinated. Further, the monetary as well fiscal policy environment also remains conducive for overall economic growth.

That said, the pace of economic revival in the near term under risk on the back of ongoing conflict between Russia and Ukraine that has created an additional stress on already elevated commodity prices particularly crude oil prices and existing supply chain bottlenecks. As per RBI's assessment, a 10% sustained increase in crude oil price pulls down on average India's GDP growth by 0.2%. Additionally, the scale back of fiscal and monetary policy support in most developed economies, and the financial market volatility (amidst rising interest rates and prospects of quantitative tightening) could impact capital flows and weigh on overall growth momentum in the next couple of months.

Overall, given the revision to FY21 GDP data and consequently a less favorable base for FY22, our GDP growth estimate for FY22 has been revised lower to 9.2%, albeit marginally higher than the NSO estimate of 8.9%. We believe that the backloaded government expenditure in Mar-22, RBI remaining in accommodative mode along with further progress on vaccination may offset some of the downside risks. In addition, in nominal terms, FY22 GDP growth revised up to 19.4% from 17.2% projected earlier offers added support. The FY22 fiscal deficit estimate stands adjusted lower to 6.7% of GDP from 6.9%, thereby providing some fiscal buffer to the government to enhance spending or cut taxes amidst emergence of geopolitical risks.

For FY23, we expect GDP growth at 7.5% amidst government's strong thrust on infrastructure segment highlighted in the Union Budget FY23, healthy progress on vaccination, moderate recovery in rural consumption and the full play out of pent-up demand although it is likely to be partly offset by high crude oil prices and higher than expected inflationary pressures.

Inflation

Pulls and pressures

KEY TAKEAWAYS

- On inflation front, the year 2022 has begun with the manifestation of the anticipated upside in CPI inflation.
- Jan-22 retail inflation soared to a 7-month high of 6.01%YoY from upwardly revised 5.66% (by 7 bps) in Dec-21 amidst tapering of a favourable base, as incrementally the index contracted by 30 bps.
- With this, CPI inflation now sits at the upper threshold of 6.0% of the RBI's inflation target band.
- As per high frequency mandi prices, vegetable prices are continuing to witness further seasonal correction in early part of Feb-22, led by tomato prices. In further support, retail price of petrol and diesel in the four metros has remained unchanged over Jan-Feb-22, which could perhaps see upward adjustment in Mar-22 post the state elections.
- Looking at FYTD CPI inflation run rate, we continue to hold on to our FY22 forecast of 5.5% which may see only a mild downside.
- For FY23, we foresee the moderation in headline CPI inflation to continue in our base scenario, albeit at a weaker pace. The RBI's estimate of 4.5% of FY23 CPI inflation in this respect, appears under whelming owing to several upside risks lurking on the horizon.

Overview

On inflation front, the year 2022 has begun with the manifestation of the upside anticipated in CPI inflation. Jan-22 retail inflation soared to a 7-month high of 6.01%YoY from upwardly revised 5.66% (by 7 bps) in Dec-21 amidst waning of a favorable base, as incrementally the index contracted by 30 bps. With this, CPI inflation now sits at the upper threshold of 6.0% of the RBI's inflation target band.

Key highlights:

- The sequential decline was led by Food and Beverages prices that contracted by 1.1%MoM, building on 0.9% dip recorded last month. Leading this decline, were categories of vegetables (-7.4%), Oils and fats (-1.6%) and sugar and confectionary (-0.9%)
- Pan, Tobacco & Intoxicants prices too contracted for the second consecutive month, by 0.1% compared to 0.3% in Dec-21.
- Fuel and light index rose by a muted 0.1%MoM, driven by a 5.6% contraction in price of PDS Kerosene in the month and in absence of any upward revision to retail fuel prices by oil companies ahead of state elections.
- Among other movers, the index of Clothing & Footwear once again posted a strong momentum of nearly 1.0%MoM. Over the last three months, the category has registered an average price rise of 0.86%MoM compared to 0.60% over the previous three months. This reflects the hike in GST rate on footwear as well as the ability of producers to charge higher price for goods amidst increased retail mobility and strengthened demand.
- Telephone charges continued to surprise on the downside, with only a marginal upward revision of 1.6%MoM in Jan-22. Against nearly 20% hike in tariffs announced by telecom companies in Nov-21, the cumulative increase over Dec-21 and Jan-22 at around 6.5% appears incomplete, which could mean lagged adjustment continuing into the coming month/s.
- Core inflation (i.e., CPI ex Food & Beverages and Fuel & Light indices) increased by 0.5% MoM in Jan-22 vs. 0.2% MoM in Dec-21. While the annualized rate of core inflation moderated a tad, we note that it has averaged a little over 6% in last four months.

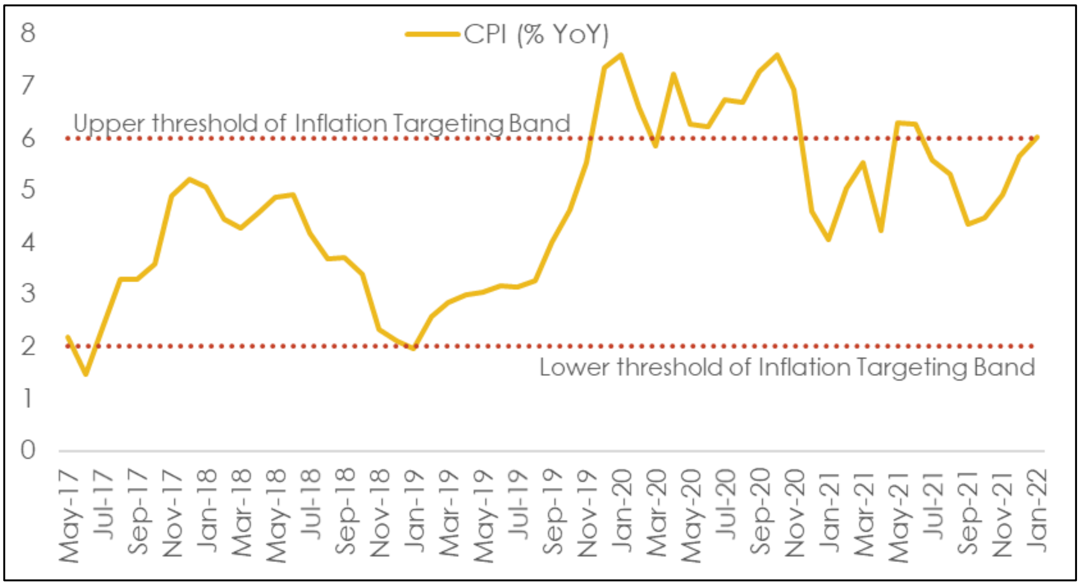
WPI inflation: A mild moderation

WPI inflation eased to 12.96%YoY in Jan-22 from 13.56% in Dec-21, marking the second consecutive month of moderation. Sequentially, the index rose marginally by 0.35% compared to a contraction of 0.90% in Dec-21.

- Looking at internals, annualized inflation for primary and fuel sub-components remained elevated, at 13.87% and 32.27% respectively with little change compared to previous month.
- Manufacturing inflation eased marginally into single-digits after a gap of 8 months to 9.42% from 10.62% in Dec-21

- On a sequential basis, primary articles' prices eased by 1.67% in the month, led by contraction in food prices by a sizeable 2.61% amidst winter seasonal downside in vegetable prices.
- Fuel and power index rose by 3.90%MoM after contracting by a sharp 5.74% (owing to fall in petrol and diesel prices post duty reduction) in Dec-21, led by upward adjustment in price of electricity, petroleum coke and Naphtha. With India Crude Basket having risen by over 25% since the beginning of 2022, fuel inflation is likely to remain elevated amidst lagged pass-through.
- In comparison, sequentially manufacturing prices saw a subdued uptick of 0.51% with lower month-on-month increment in price of chemicals, fabricated metals, paper and paper production vis-à-vis the last few months.
- On a FYTD basis, WPI inflation is clocking a run rate of 12.6% compared to 0.3% over the same period in FY21 fueling concerns of lagged pass-through to consumer prices, as demand recovery amidst progress on vaccination solidifies further, heading into FY23.

Chart 1: CPI inflation yet again at the upper threshold of inflation band



Outlook

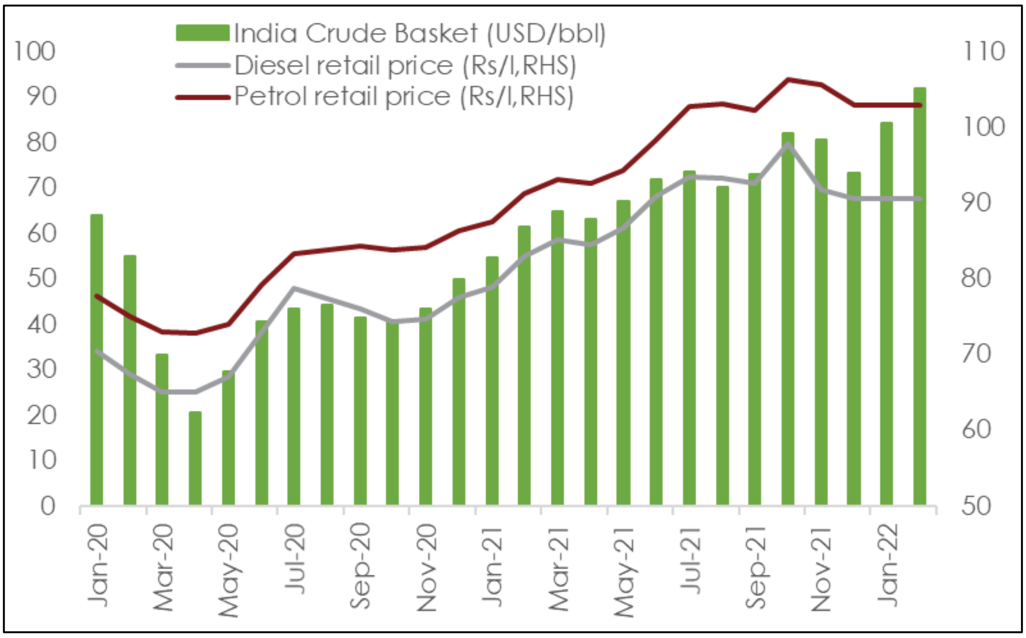
As per high frequency mandi prices, vegetable prices are continuing to witness further seasonal correction in early part of Feb-22, led by tomato prices. In further support, despite the sharp uptick in crude oil prices, retail prices of petrol and diesel in the four metros have been unrevised over Jan-Feb-22, which could perhaps see upward adjustment in Mar-22 post the state elections.

Looking at FYTD CPI inflation run rate, **we continue to hold on to our FY22 forecast of 5.5% with only a mild downside**. The decline in inflation from 6.2% in FY21, has primarily been a function of softer food prices (with third successive year of surplus monsoon), even though Fuel and Clothing & footwear sub-categories added to inflation pressures amidst reopening of economies (global and domestic respectively) in FY22.

For FY23, we foresee the moderation in headline CPI inflation to continue in our base case scenario, albeit at a weaker pace. The RBI's estimate of 4.5% of FY23 CPI inflation in this respect, appears under whelming owing to the following upside risks which could also keep core inflation elevated:

- CPI inflation is yet to fully represent the complete impact of sharp hike in telecom tariffs in Nov-21.
- India has currently vaccinated around 70% and 55% of its total population with first and second dose of vaccine. Continued progress on this front coupled with recovery in personal mobility post Omicron wave will continue to support pent-up or 'revenge' demand.
- The possibility of future Covid waves with milder spillovers on supply disruptions.
- As severe tail risks on account of Omicron have receded, global commodity prices have firmed up sharply over Jan-22 and Feb-22 (so far), with price of India Crude Basket at over USD 110 pb amidst flare up of geopolitical tensions between Russia and Ukraine. This could result in persistent rise of input price pressures.
- Additionally, with India importing significant amount of edible oils from Russia and Ukraine, prices for the same could surge in the next couple of months thereby impacting the currently benign food inflation levels.

Chart 2: Retail price of petrol and diesel have remained unchanged despite the rally in India Crude Basket



Government Finances

Hopeful of a positive fiscal surprise in FY22

KEY TAKEAWAYS

- India's central government's fiscal deficit for the period Apr-Jan FY22 stood at 58.9% of RE compared to 67.8% of actuals in the corresponding period of FY21.
- The relatively lower accretion to fiscal deficit in FY22 so far reflects strong revenue collection (excluding disinvestments), even as expenditure disbursal momentum showed some signs of pick-up.
- Although the central government has projected a minor slippage of 0.1% of GDP in FY22 (with RE of fiscal deficit getting re-pegged at 6.9% of GDP vis-à-vis the initial budget estimate of 6.8%), incoming signals from some of the indicators over Jan-Feb FY22 indicate a rather comfortable fiscal position.
- Therefore, for FY22, we believe there could be a reasonable likelihood of the central government's fiscal deficit coming in marginally better at 6.7-6.8% of GDP compared to the RE of 6.9%.
- For FY23, we are of the view that the credible (and perhaps conservative) arithmetic presented in the Budget would help in achieving the headline fiscal deficit target of 6.4% of GDP. If pandemic related risks do not resurface in FY23, then the possibility of some minor improvement (vs. BE) in fiscal metrics cannot also be ruled out.

The Finance Minister presented the FY23 Union Budget earlier on Feb 1. The Budget revised higher the estimate for FY22 fiscal deficit to 6.9% of GDP from the initial budget estimate of 6.8%. For FY23, the Budget displayed a fine balance between fiscal retreat and maintaining focus on growth facilitation. Continuing its path of moderate fiscal consolidation, the FM announced a 50-bps reduction in fiscal deficit ratio to 6.4% in FY23 (for details, please refer to our note on FY23 Union Budget https://www.acuite.in/research.htm).

Focusing on the current year, incremental information reveals that central government's fiscal deficit for the period Apr-Jan FY22 stood at 58.9% of revised estimates (RE) compared to 67.8% of actuals in the corresponding period of FY21. The relatively lower accretion to fiscal deficit this year continues to reflect strong revenue collection (barring disinvestments), even as expenditure disbursal momentum showed moderate signs of pick-up.

Receipts: Continue to power ahead

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

On FYTD basis (Apr-Jan), gross tax revenue collection clocked a robust growth of 38.5% YoY compared to a contraction of 1.0% seen in the corresponding period in FY21. It's not just the annualized growth that looks better (which is strongly aided by a favourable statistical base) – in fact, gross tax revenue has already clocked 83.4% of RE for the full year (vs. 74.8% of actuals in the corresponding period in FY21), thereby concluding the ten months of the fiscal year on a strong note. Further, vis-à-vis 2-years ago period (to avoid the pandemic related statistical distortion), gross tax revenue still clocks a healthy growth of 37% during Apr-Jan FY22 vs. the corresponding pre pandemic period in FY20.

- While strong momentum in tax collection is broad based, it is being powered by robust growth in customs (reflecting pickup in imports) and corporate tax (reflecting healthy earnings performance). We also note that total GST collections in the last four months have averaged above Rs 1.30 tn.

Non-tax revenue too recorded a strong annualized growth of 106.6% YoY in Apr-Jan FY22 compared to a contraction of 44.0% seen during the corresponding period in FY21. Notwithstanding the favourable statistical base support, the key reason for robust performance under this category stems from a significantly higher than budgeted dividend from the RBI.

Meanwhile, non-debt capital receipts contracted by 19.2% YoY in Apr-JanFY22 vs. an expansion of 23.3% seen in the corresponding period in FY21. The month of Jan-22 saw no accretion towards disinvestment revenue.

Expenditure: FYTD momentum gradually picking up

Expenditure disbursal moderated marginally in Jan-22, because of which the FYTD (Apr-Jan) run rate increased by only 11.6% YoY compared to 11.0% seen in the corresponding period in FY21. On RE basis, this translates to 74.5% of the full year target vis-à-vis 71.7% (of actuals) seen in the corresponding period in FY21. Few observations:

- While headline revenue expenditure expanded by 9.9% YoY (74.8% of FY22 RE) during Apr-Jan FY22 vis-à-vis an expansion of 7.7% (69.8% of FY21 actuals) seen in the corresponding period in FY21, bulk of the growth continues to be led by interest payments and subsidies. Excluding these, revenue expenditure stood at a subdued level of 2.8% YoY during Apr-Jan FY22 vs 4.9% in the corresponding period in FY21. However, the pace of revenue could gather momentum in the remaining months of the fiscal year to meet revised budget targets as well as extra budget expenses.
- While the thrust on investment continues, capital expenditure clocked a lower growth of 13.5% YoY (73.3% of FY22 RE) during Apr-JanFY22 vis-à-vis 35.2% (85.2% of FY21 actuals) seen in the corresponding period in FY21. Disbursals until Dec-21 continue to be led by the Ministry of Road Transport and Highways.

Outlook

Although the central government projected a minor slippage of 0.1% of GDP in FY22 (with RE of fiscal deficit getting re-pegged at 6.9% of GDP vis-à-vis the initial budget estimate of 6.8%), incoming signals from some of the indicators over Jan-Feb FY22 indicate a rather comfortable fiscal position.

- Fortunately, the Omicron wave is turning out to be relatively less severe, both from the perspective of lives as well as livelihood. With adverse spill over on economic activity being limited, GST E-way bills have quickly recouped their initial loss in momentum.
- Basis a reassessment of its surplus cash position, the central government cancelled two weekly g-sec auctions worth Rs 480 bn in Mar-22 so far. This could either signal a likelihood of actual tax collections exceeding the RE figures, or the government incrementally relying upon non-market sources of funding to fill the fiscal gap in the remaining months of FY22. Given how Covid risks have dissipated, at least in the near term, the former looks more probable at this juncture.
- On the other hand, while there are media reports stating that the public offering of shares by the LIC is expected to open for investors on Mar 11, the IPO could defer in the wake of the market jolt caused by the stand off between Russia and Ukraine. Nevertheless, if insurer lists its shares in FY22, the government could potentially raise Rs 600-700 bn.

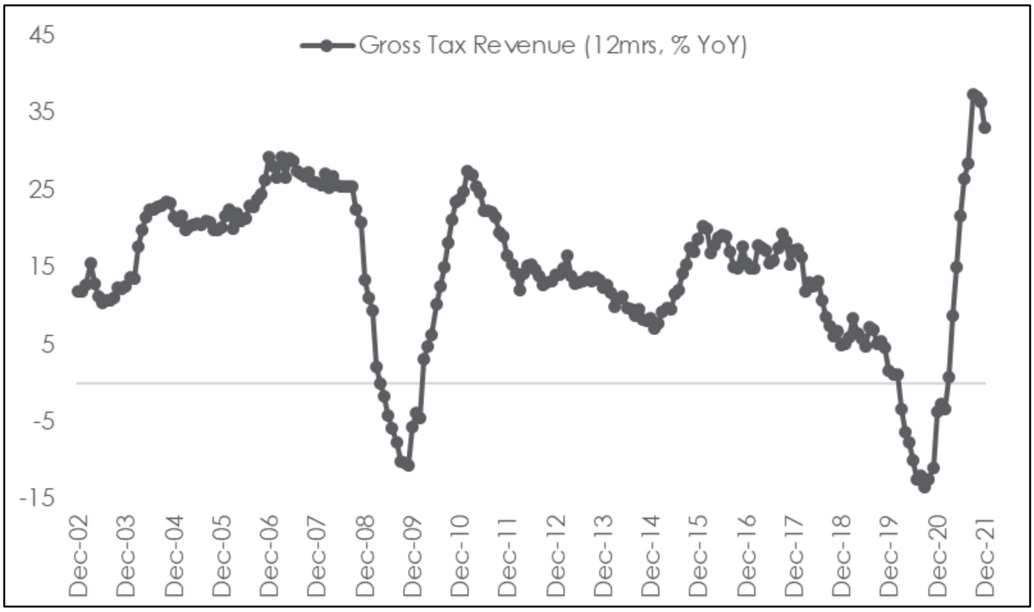
In addition to the above-mentioned factors, FY22 could also see a denominator support via higher than budgeted Nominal GDP, which per se could provide a fiscal buffer of 5-10 bps. Hence, we believe there could be a reasonable likelihood of the central government's fiscal deficit coming in marginally better at 6.6-6.8% of GDP compared to the RE of 6.9%.

Going into next year, we believe the credible arithmetic presented in the Budget would help in achieving the headline fiscal deficit target of 6.4% of GDP. In fact, if pandemic related risks do not resurface in FY23, then the possibility of a minor improvement (vs. BE) in fiscal metrics cannot be ruled out.

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

Key Fiscal Variables (Cumulative Position as of Apr-Jan)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	76.2	88.5	-0.6	47.9
Net Tax	77.4	87.7	10.4	40.4
Non-Tax	67.8	92.9	-44.0	106.6
Non-Debt Capital Receipts	70.1	32.6	23.3	-19.2
Total Receipts	75.9	80.9	0.0	37.3
Revenue Expenditure	69.8	74.8	7.73	9.86
Capital Expenditure	85.2	73.3	35.25	21.98
Total Expenditure	71.7	74.5	10.98	11.60
Fiscal Deficit	**67.8**	**58.9**	**-**	**-**

Chart 1: Gross tax revenue collection continues to remain robust



Rates

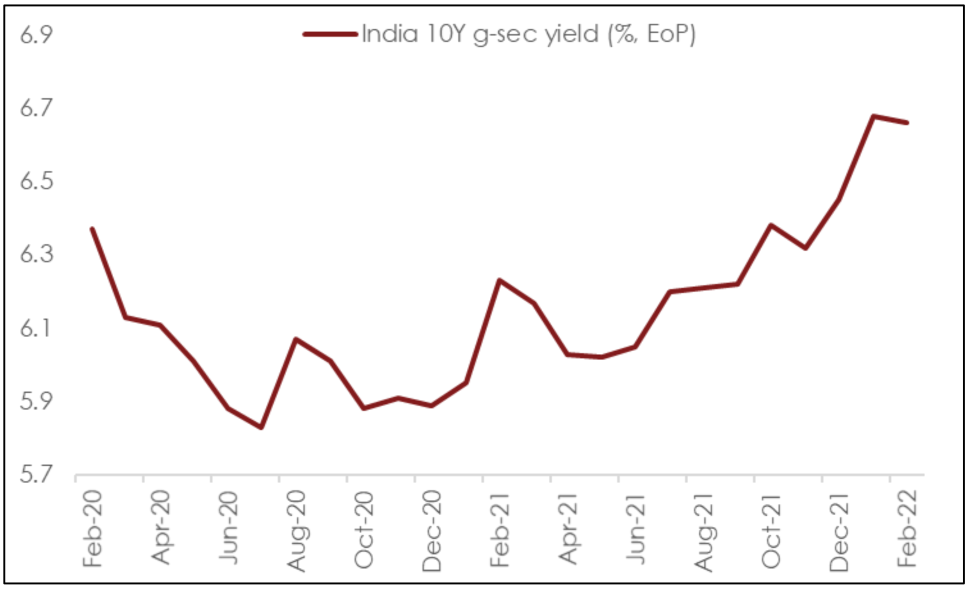
A volatile month

KEY TAKEAWAYS

- The 10Y g-sec bond yields remained jittery in the month of Feb-22 on the back of multiple domestic as well as global factors at play.
- While the supply pressure in FY23 amidst high government borrowing announced in the Union Budget is sizeable, yields had cooled down slightly with support from RBI's dovish monetary policy outturn in early Feb-22 and cancellation of two successive weekly g-sec auctions amounting to Rs 480 bn besides the cancellation of g-sec switch auction in Feb-22.
- However, the yields have again recorded a spike and currently trading at around 6.8% led by escalating geopolitical tensions involving Russia and Ukraine which have nudged crude oil prices above USD 110 pb. Increasing crude oil prices are also building up case for higher inflation with a likelihood of manifestation in official data in the coming months.
- Meanwhile, the expectation of systemically important central banks to move forward on monetary policy normalization in 2022 has strengthened.
- We now expect RBI to move forward on interest rate normalization in Apr-22 or Jun-22 as headwinds associated with Covid gradually begin to moderate.
- With our year-end target of 6.75% now achieved earlier than anticipated due to the geopolitical standoff, we expect 10Y g-sec yield to remain elevated at around 6.8% in Mar-22, and move further towards 7.25% by Mar-23.

The 10Y g-sec bond yields remained jittery in the month of Feb-22 on the back of multiple domestic as well as global factors at play. The announcement of significantly higher than expected government's borrowing program in FY23 coupled with lack of clarity on India's inclusion in the global bond indices weighed on market sentiment, with 10Y g-sec yield jumping sharply to 6.89% on Feb 3 rd. Encouragingly, the yield cooled off thereafter by 20 bps with support from RBI's dovish monetary policy outturn in early Feb-22 and cancellation of two successive weekly g-sec auctions amounting to Rs 480 bn besides the cancellation of g-sec switch auction in Feb-22. However, the geopolitical standoff between Russia and Ukraine has nudged the crude oil prices above USD 110 pb pushing the yields at around 6.8%.

Chart 1: 10Y yield exceeds its pre-Covid levels despite monetary policy status quo



In the Jan-22 edition of "Acuité Macro Pulse" report we had highlighted how factors responsible for providing upside risk to yields (inflation persistence and reversal in global monetary policy) had started to strengthen. The list has also got expanded to incorporate the larger than anticipated borrowing pressures from the central government in FY23.

Below we take stock of each of these factors in detail:

- **FY23 borrowing pressures**

  We had expected the central government to target fiscal deficit ratio at 6.3% in FY23. From bond market perspective, there were two key market expectations: (i) budgeting of about Rs 9.0-9.5 tn net g-sec financing (Acuité expectation: Rs 9.2 tn), and (ii) some clarity on progress of India's inclusion in the global bond indices. While the budget estimate pegs FY23 fiscal deficit ratio marginally higher at 6.4%, bond market disappointment emanated from:
    - Announcement of sharply higher net g-sec borrowing of Rs 11.19 tn (compared to FY22 revised estimate of Rs 7.76 tn). With this, the

    proposed net g-sec borrowing in FY23 will be 2.4x of its size compared to the pre pandemic year of FY20.
  - No provision or announcements made with respect to India's inclusion in global bond indices.

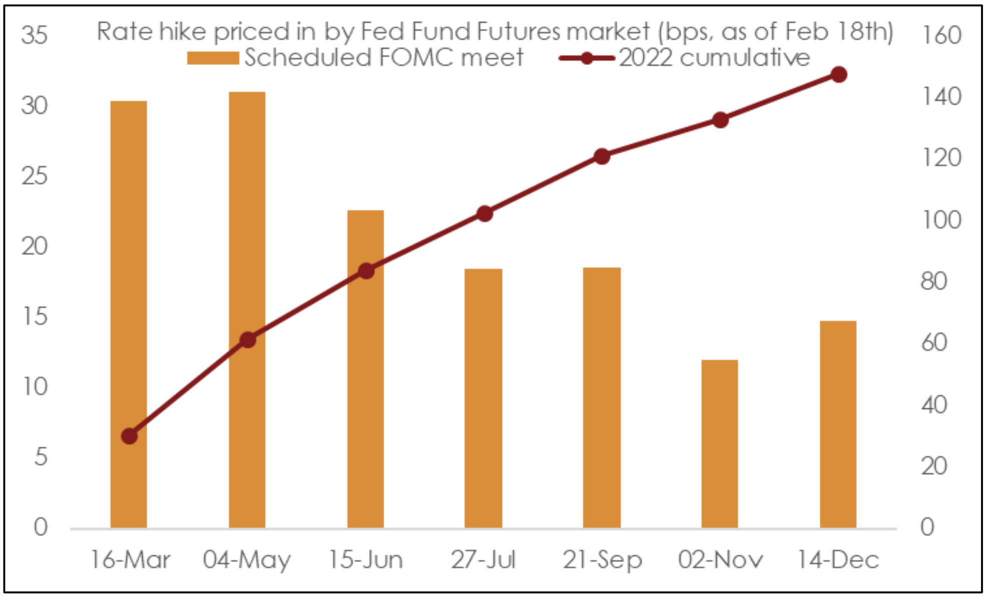
- **Emergence of inflation risks**

  Notwithstanding the substantial cut in petroleum taxes in Nov-21 along with support from seasonal decline in food prices, inflation risks continue to be tilted to the upside.
  - Even after two months, the passthrough of steep hike (20-25%) in telecom tariffs towards the end of Nov-21 appears to be partially effected, leaving space for further acceleration in core inflation (retail).
  - As severe headwinds on account of Omicron have receded, global commodity prices have firmed up sharply in 2022, with price of India Crude Basket crossing USD 110 pb in Feb-22 so far vis-à-vis USD 73 pb in Dec-21. While domestic retail prices have not been altered since Dec-21 in the wake of ongoing assembly election in five states, buildup of further pressure on input prices can be expected with oil marketing companies likely to start adjusting prices from Mar-22 onwards.
  - Continued progress on vaccination front coupled with recovery in personal mobility (except the temporary disruption on account of Omicron) will continue to support pent-up/revenge demand and could keep core inflation elevated.

- **The reversal in global monetary policy**

  Central banks across many countries have started to scale back pandemic era extraordinary monetary accommodation. Among developed countries, the US Fed and the BoE are major central banks who initiated their monetary policy normalization with a rather hawkish pivot in Dec-21 with an aim to start refocusing on inflation management. Meanwhile, several EM central banks appear to be ahead in terms of policy normalization, prompted by concerns on inflation and/or financial market stability.
  - Among key central banks tracked by the BIS who have seen rate action in the pandemic period, currently: i) 17 have their monetary policy rate below their pre pandemic levels, ii) 3 have their monetary policy rate at their pre pandemic level, and iii) 9 have their monetary policy rate above their pre pandemic levels.
  - The year 2022 is likely to see more central banks join the normalization bandwagon. Most importantly, with CPI inflation in US now remaining above 7% (4-decade high) for two consecutive months, market participants have started pricing in an aggressive 150 bps rate hike from the Fed in 2022, up from an expectation of 100 bps towards the end of 2021. Further, the expectation of quantitative tightening has now been brought forward to H2 2022 from 2023 earlier.

Chart 2: Market expects Fed to hike rates by 150 bps cumulatively in 2022



Outlook

Notwithstanding the growth supportive Union Budget and emergence of upside risk to inflation, the RBI continues to maintain accommodative stance while retaining the reverse repo rate at a record low of 3.35% (in contrast to our as well as consensus expectation of a 20 bps hike). The central bank has justified continuation of status quo as it expects CPI inflation to moderate to 4.5% in FY23 from 5.3% in FY22. The dovish policy outturn in Feb-22 relative to market expectations provided some support to the bond market. However, the comfort proved to be short-lived on account of the spike in crude oil prices which led bond yields to rise again, with this our year-end target of 6.75% now stands achieved earlier than anticipated.

Going forward, we continue to expect 10Y g-sec yield to move towards 7.25% by Mar-23 as supply pressures would dominate and the central bank might not be willing to deploy large scale OMO purchases as it did in FY21 and FY22 to infuse liquidity and support yields. Nevertheless, we do expect the RBI to partially curb the upside pressure on yields by conducting Operation Twist and providing temporary relaxation in regulatory dispensation of HTM holding for banks in FY23.

Rupee

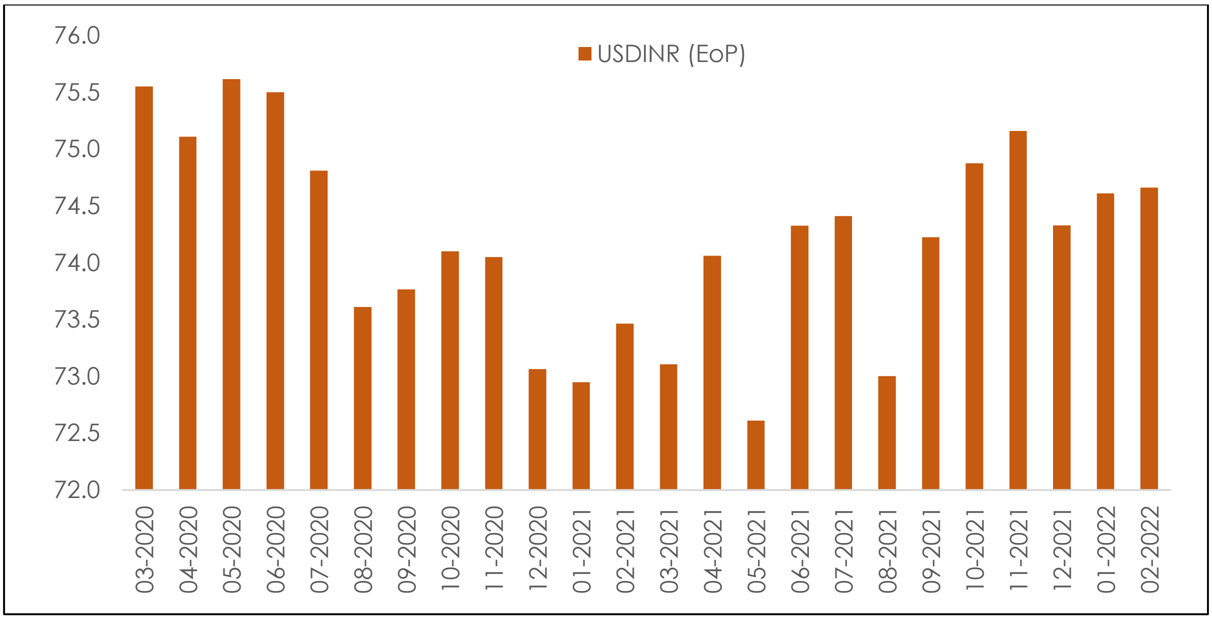
Consolidating amidst risks

KEY TAKEAWAYS

- After appreciating by 1.1% in Dec-21, the Indian rupee registered a mild depreciation of 0.4% in Jan-22 closing the month at a level of 74.61 vis-à-vis the US dollar.
- However, the ongoing geopolitical tensions between Russia and Ukraine have led rupee to depreciate by a significant 1.2% to 75.51 against the USD vs the level as of Jan-22 and in early March, the 76 level has been breached.
- The INR is likely to face depreciation pressures in the near term amidst the ongoing standoff between Russia and Ukraine, higher crude oil prices and fall in equity markets.
- In the near term, the dollar is likely to continue deriving support from its safe heaven appeal along with aggressive pricing of monetary policy normalization in the US.
- The combination of elevated global commodity prices, sequential improvement in domestic growth (notwithstanding the temporary disruption from Omicron), and gradually increasing vaccination coverage has resulted in expansion of trade and current account deficit.
- While foreign portfolio outflow has picked up in recent months, its impact is getting partly offset by the recent spurt in issuance of foreign currency debt by domestic corporates.
- We revise upwards our forecast for India's current account deficit to USD 50 bn in FY22 from our earlier expectation of USD 46 bn.
- We continue to expect rupee to depreciate moderately in the near term, and project USD-INR pair to trade in the range of 75-76 levels in Mar-22.

After appreciating by 1.1% in Dec-21, the Indian rupee registered a mild depreciation of 0.4% in Jan-22 closing the month at a level of 74.61 vis-à-vis the US dollar. The currency pair has further weakened from Jan -22 levels primarily due to geopolitical tensions, with all other economic factors taking a back seat. In the near term, the INR will likely continue to face some depreciation pressures amid significant jump in crude oil prices along with fall in equity markets.

Chart 1: INR broadly stable in last two months, but global factors likely to weigh



Global and domestic developments continue to point towards the likelihood of a moderate weakness in INR. In fact, the pipeline factors for moderate rupee depreciation have rather strengthened somewhat in the last one month.

On the global front, we continue to remain dollar bulls.

- The multi-decade high inflationary pressures in US have caused consternation among FOMC members. With most labor market indicators depicting comfortable degree of recovery, inflation mandate has gained prominence with the Fed making a sharply hawkish tilt in the Dec-21 policy meet.
- While the last Fed dot plot (as of Dec-21) projects three rounds of rate hike in 2022, two consecutive CPI inflation prints of 7%+ levels have caused consternation among FOMC members, resulting in hawkish commentary in recent weeks.
    - As per the Fed Funds Futures, market participants are currently pricing in about 150 bps rate increase by the FOMC in 2022, up from an expectation of 100 bps hike towards the end of 2021.
    - There is also an expectation that quantitative tightening could potentially commence earlier in H2 2022 compared to the previously held expectation of balance sheet unwind in 2023.

Table 1: Recent commentary increase likelihood of aggressive rate hikes in 2022

FOMC Member	Position	Recent Commentary
Lael Brainard#	Vice Chair	"It would be appropriate to "initiate a series of rate increases" beginning next month"
John Williams#	New York	"With today's strong economy and inflation that is well above our 2% longer-run goal, it is time to start the process of steadily moving the target range back to more normal levels"
James Bullard#	St Louis	Called for federal funds rate to be 1% higher from its near-zero level by Jul-22
Charles Evans^	Chicago	"The current inflation situation warrants a substantial repositioning of monetary policy"
Mary Daly^	San Francisco	Favors a "measured" approach to lifting the fed funds rate to a level consistent with slower economic activity

Voting member in 2022; ^ non-voting member in 2022

While the backdrop of receding economic risks from Omicron and sharp rise in global commodity prices have further raised concerns on inflation, the expectation of pricing in aggressive rate hike in US has caused a substantial flattening of the yield curve, with the 10-2Y spread currently down to about 46 bps in Feb-22 from its post pandemic peak of 158 bps in Mar-21. Further flattening in the UST yield curve could raise concerns over medium term growth prospects in US.

On the domestic front, the BoP comfort is expected to get shallower, driven by expansion of trade deficit while capital account could see a mild moderation.

- The moderation in India's merchandise trade deficit in Jan-22 to USD 17.4 bn vs. the average of USD 20.8 bn in the previous 4-months is a brief reprieve since it is likely to have happened in the backdrop of lower import demand amidst Omicron uncertainty. With the Omicron wave tapering at a rapid pace, states have begun to relax their lockdown restrictions. This will once again stoke pent-up demand in the economy, which would also find support from year-end seasonality. Combined with the impact from elevated global commodity prices (esp. crude oil, which has jumped by over 25% in 2022 so far), we anticipate the pressure on imports to strengthen. While a similar rationale would also benefit India's exports (which seems poised to exceed government's USD 400 bn target for FY22 comfortably), on net basis, the merchandise trade deficit could remain elevated as the recent surge in global commodity prices would have an adverse impact on India's terms of trade. Hence, we revise upwards our forecast for India's current account deficit to USD 50 bn in FY22 from our earlier expectation of USD 46 bn.
- The pressure on trade deficit is increasing at a time when portfolio outflows have been persistent since Oct-21. Compared to a net FPI inflow of USD 4.3 bn in H1 FY22, H2 has so far seen a net outflow of USD 12.6 bn from Indian equity and debt markets. Elevated domestic equity valuations, faster than anticipated normalization of US monetary policy, and lack of any firm

commitment from the FY23 Union Budget with respect to India's inclusion in global bond indices could keep foreign portfolio flows subdued in the near term.

- Additionally, we continue to remain watchful of the risks emanating from the standoff between Russia and Ukraine and its impact on India's economy.

Despite the buildup of depreciation bias, rupee appears to be broadly stable as:

- Improving medium-term outlook for India's economy (as per the IMF, India is projected to grow at an average pace of 7.1% in next 3-years) and the urge to lock-in rates before the commencement of monetary policy normalization by the US Fed has been prompting high quality corporates to tap the international market for funding. Growth in foreign currency loans (via ECBs, FCCBs, and RDBs) accelerated to 31.3% YoY in Q3 FY22 from 13.0% in Q2. Reflecting this strong momentum, few Indian companies are reported to have made bond offerings to raise up to USD 7-8 bn in Jan-22.
- India's FX Reserves appears comfortable at around 13 months of import cover, its highest in last 12-years. This provides the first line of defense against any excessive volatility.
- India's long term (10Y) sovereign real yield spread vis-à-vis the US has averaged close to 650 bps in last 4-months, the highest in nearly two decades. With adequate FX Reserves helping to curb volatility, the risk-adjusted carry will continue to favor rupee, thereby providing partial insulation from aggressive rate hikes in the US.

On net basis, we continue to stick to our expectation of USD-INR pair anchoring near 76 levels by Mar-22.

Global Overview

Geopolitics adds to the uncertainty

KEY TAKEAWAYS

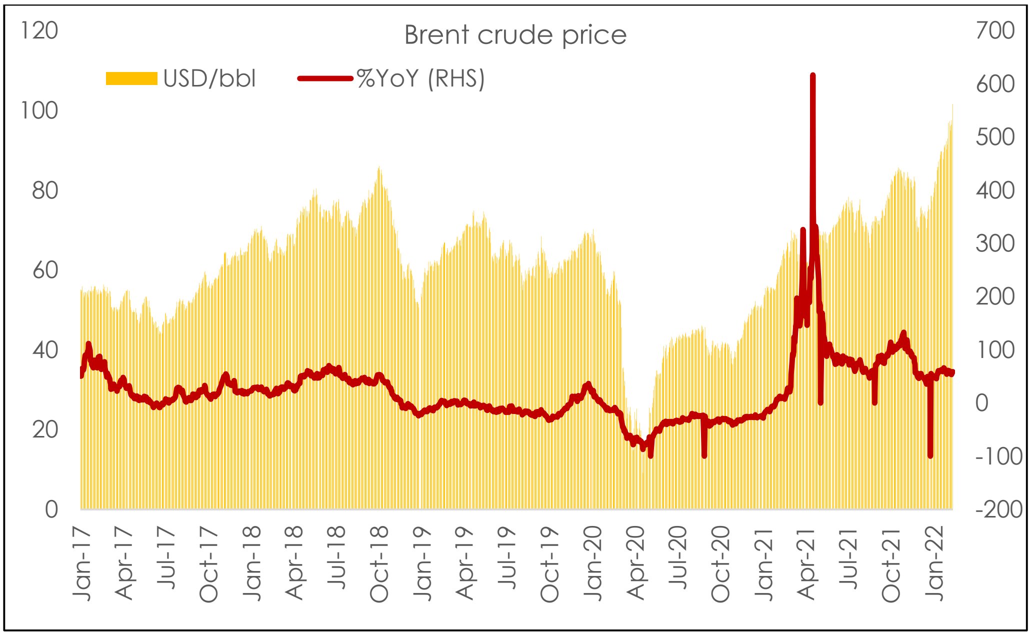
- Financial markets have had a volatile start to the year 2022. Sustained increase in inflation in advanced economies and a step up in expectation of tightening by US Federal Reserve have kept financial markets on tenterhooks.
- To this, geopolitical unrest between Russia and Ukraine and the possible response it could elicit from the US and NATO including the impact of economic sanctions has added to the uncertainty.
- Over the past few weeks, global equities, government bonds and currencies have all had a volatile ride as the situation continues to unfold.
- On a positive note, Covid storm appears to be receding, with global infections declining by nearly 44% since the third wave peak in fourth week of Jan-22, with the decline being broad-based across regions.
- Acknowledging these disruptions, IMF in its latest World Economic Outlook indicated that global economy has entered 2022 in a weaker position than anticipated earlier; with the agency revising lower its 2022 world GDP growth output estimate to 4.4% from 4.9% earlier.

Global overview

Financial markets have had a volatile start to the year 2022. Sustained increase in inflation in advanced economies and a step up in expectation of tightening by US Federal Reserve have kept financial markets on tenterhooks. To this, the geopolitical unrest between Russia and Ukraine has added to the uncertainty. Over the past few weeks, global equities, government bonds and currencies have all had a volatile ride as the situation continues to unfold. Ukraine's currency hryvnia has emerged as the worst performing emerging market currency on a year-to-date basis, with Russian Rouble not too far behind.

The current situation has led the financial markets to remain on the edge, with headlines and political rhetoric dictating market gyrations. The escalating tensions between the two countries will clearly have an adverse impact on global economy. Europe is likely to bear the biggest burden, as it is heavily dependent on Russia for natural gas. Russia is the second largest producer of natural gas, with nearly 70% of its natural gas exports sent to Europe via pipeline, with a significant part passing through Ukraine. The supply disruption of natural gas will logically put upward pressure on already elevated global crude oil prices. Amidst the brewing geopolitical tensions, crude oil price has already rallied over 30% since the start of 2022, crossing USD 100 pb mark in Feb-22. The crisis could also impact Europe's banking sector which has significant exposure to Russia along with its corporate sector. With the magnitude of events escalating, we expect the crisis to act as a near term downside risk for the global economic recovery.

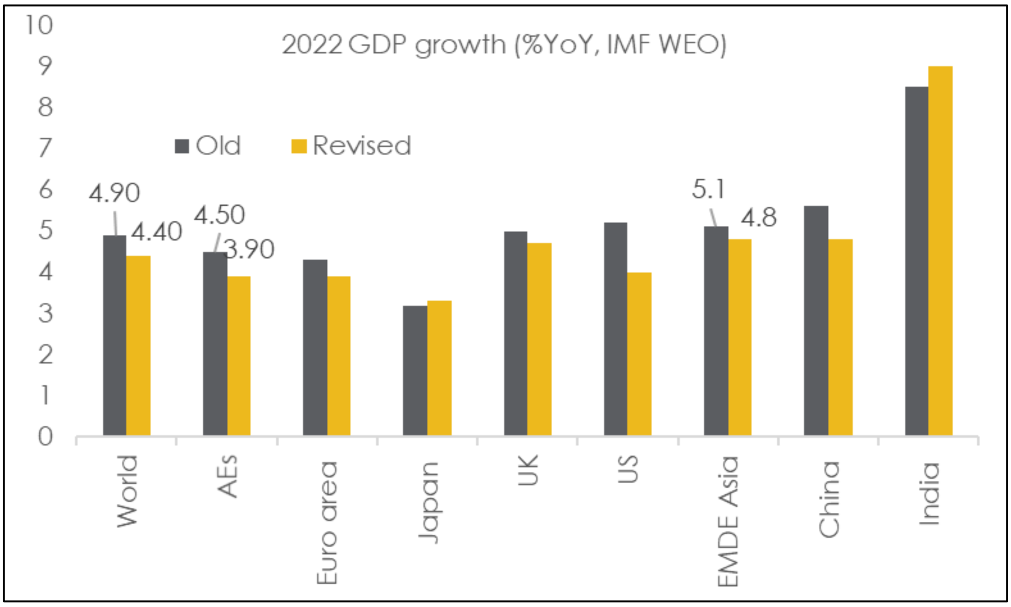
Chart 1: Crude oil has rallied by over 30% since start of 2022



On a positive note, the Covid pandemic appears to be receding, with global infections declining by nearly 44% since the peak in fourth week of Jan-22 (on a trend basis). This decline has been broad-based across all geographical regions. However, at a country level, situation still continues to differ. Slowdown in cases has been strong in India, Belgium, US, France, Spain, Italy among others. In contrast, Asian economies of Indonesia, South Korea and Japan are still seeing a rise in cases. On the vaccination front, the world achieved the milestone of administration of 1 bn booster shots. As of March 4 2022, 10.85 bn doses of vaccine have been administered with a little over 63% of the global population having received at least one dose.

Acknowledging these developments, IMF in its latest World Economic Outlook indicated that global economy has entered 2022 in a weaker position than anticipated earlier. It mentions Omicron impact, continued supply disruptions, higher and more broad-based inflation along with tightening of monetary conditions as forces having shaped the outlook. As such, IMF revised lower its 2022 global GDP growth output to 4.4% from 4.9% earlier and vs. 5.5% in 2021. At a disaggregated level, growth for advanced economies was reduced by 60 bps to 3.9% (led by US owing to removing the Build Back Better fiscal policy package from the baseline and earlier withdrawal of monetary accommodation) and that of Emerging economies by 30 bps to 4.8% (led by China). IMF views the balance of risks titled to the downside, depending on – 1) Path of the pandemic 2) Financial markets conditions as Fed begins to tighten 3) Longevity of supply disruptions 4) Impact of tight labour market and rising wages on inflation persistence and lastly, 5) China's real estate downside.

Chart 2: IMF lowers global growth forecast by 50 bps to 4.4% for 2022



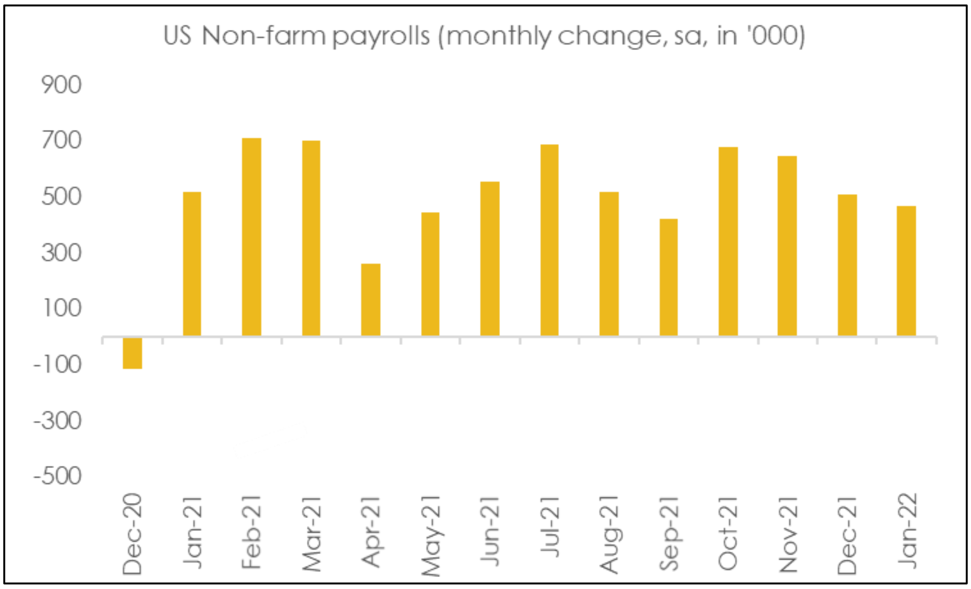
US

US CPI inflation surprised yet again on the upside in Jan-22, with both headline and core inflation up 0.6%MoM. As such, annualised inflation rose to 7.5% and core inflation to 6.0%. The upside was entirely driven by energy (+0.9%MoM), food (+0.9%MoM) and goods (+1.0%MoM) prices – underscoring the broad nature of inflation pressures. While momentum in goods prices appear to be waning somewhat, price pressures in services are on the rise.

With the Federal Reserve indicating its plan to tighten at its Mar-22 policy, the question no longer remains of timing, but rather the 'quantum of hike'. Post the latest CPI print, a larger section of the market was expecting a 50-bps hike in Mar-22, given hawkish comments from some of the Fed members in early Feb-22. This saw the yield on the two-year treasury paper jump by 26 bps to a level of 1.61% (on 10th Feb) – marking the biggest single day move since 2009. However, more recently commentary has seen Fed officials push back on rapid interest rate hikes. Federal Reserve Bank of New York President John Williams recently acknowledged that though Fed should start raising interest rates next month to help rein in too-high inflation, he added that "Personally, I don't see any compelling argument to take a big step at the beginning". Echoing similar views, Charles Evans, president of the Chicago Fed, said that the Fed needed to adjust its low-interest rate policies, which he called wrong-footed. But he also suggested that the central bank may not have to sharply raise rates this year. While a 25-bps hike in Mar-22 appears to be a base case, much rides on Feb-22 jobs report and inflation readings before the March meeting.

From macroeconomic perspective, incoming data suggests that the US economy held up well despite Omicron surge in Jan-22. Retail sales jumped 3.8%MoM in Jan-22 (prior: -1.9%), more than expected. The monthly increase was the largest since households received stimulus payouts in Mar-21. Industrial production also beat expectations and climbed higher in Jan-22, by 1.4%MoM (prior: -0.1%) during the month led by improvement in manufacturing and mining output both.

Chart 3: Rising inflaiton and tight labour markets may push Fed to hike rate in Mar-22



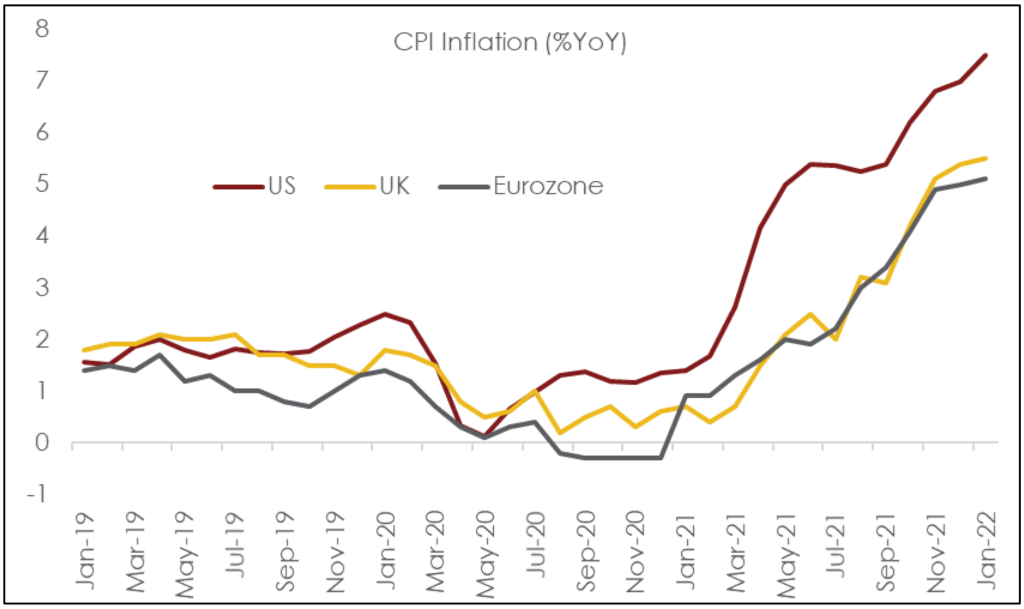
EUROZONE

After posting a 0.3%QoQ (4.6%YoY) growth in Q4-21, Eurozone economy is expected to witness a subdued expansion in Q1-22. Jan-22 had seen a record number of Omicron infections, which is likely to weigh on both production and consumption (especially of services) due to absenteeism from work and restrictions led lower mobility. Thankfully, the month of Feb-22 has seen Covid case load peak and restrictions are being relaxed in several countries. Beating Covid, IHS Markit PMI for Jan-22 rose to 58.7 from 58.0 in Dec-21, to its highest level since Aug-21 as manufacturing sector gained momentum led by production, new orders and employment.

Inflation, on the other hand, continues to remain a challenge for the region. The preliminary estimate for HICP inflation for Jan-22 stood at 5.1% (vs. consensus of 5.0%), even higher than Dec-21's 5.0%. This reading is worse than it appears, as it subsumes 50 bps of comfort from the completion of 1 year of German VAT introduction. The higher-than-expected inflation outcome has increased pressure on European Central Bank (ECB). The Feb-22 ECB press conference did sound more hawkish or perhaps one can say less dovish, with President Lagarde saying that inflation risks were "tilted to the upside" while refusing to rule out raising rates this year. More recently, Philip Lane, ECB's Chief Economist has changed his view on inflation by acknowledging that inflation looks unlikely to drop below 2.0% over the next 2 years citing higher expectations of investors, analysts and consumers, and structural changes in the economy.

Looking ahead, a section of the market believes that it is likely that net asset purchases may well end in Sep-22, creating room for deposit rate hike before the end of the year. However, it is too early yet to cement views on this. The downside risks to growth which is likely to find support from the European Recovery Fund this year, remain from prolonged supply disruptions (especially for Germany given its exposure to global supply chains) and high energy prices further aggravated by the latest geo-political conflict in Ukraine.

Chart 4: Inflation continues to escalate in advanced economies in Jan-22



UK

In UK, like elsewhere, inflation is continuing to surprise on the upside and prompting the Bank of England (BoE) to act. Annualised CPI inflation accelerated to a 30-year high of 5.5% in Jan-22, versus 5.4% in Dec-21 and 0.7% a year ago i.e., at more than double the BoE target of 2.0%. The MPC expects inflation to hit 7.0% in Apr-22 before it begins to recede. In response, the BoE has raised interest rates twice. From 0.1% during the pandemic, the base rate was raised to 0.25% in Dec-21 and then to 0.50% earlier in Feb-22. Further rate hikes are likely to follow as the MPC in its own assessment is aiming to increase the base rate to 1.50% by mid-2023.

On growth front, GDP data revealed that growth in Q4 as well month of Dec-21 was affected by the spread of the Omicron variant. In Q4, UK GDP expanded by 1.0% QoQ - i.e., marginally below consensus forecast of 1.1%. Household consumption and government spending were the primary drivers of growth, while due to government and voluntary restrictions, personal consumption slowed to contribute just 0.7 pp to overall growth in the quarter. Basis monthly data for Dec-21, UK economy contracted by 0.2%MoM. For the year as a whole, the economy rebounded by 7.5% in 2021 – to mark the strongest expansion in 80 years. Despite this solid recovery, the level of nominal GDP is still 0.4% below pre-pandemic level and UK remains a laggard in comparison to the US. Further, elevated inflation, tighter monetary policy, high energy prices and the Ukraine conflict all complicate the economic outlook for 2022. Nevertheless, growth is expected to be above-trend in 2022, which as per IMF latest WEO is pegged at 4.7% though risks are more to downside in case of more aggressive tightening by BoE or if the Ukraine led energy crisis is prolonged and disruptive.

JAPAN

Japan GDP rebounded, though less than expected, in Q4-21 to 5.4% annualised rate from a contraction of 2.7% in Q3. The lifting of the state of emergency that was in place in Tokyo and surrounding area, helped a revival in consumer and services related activities. Reflecting this, private consumption grew by 11.2% on annualised basis, supported by vaccine uptake that reached nearly 80%.

The overall outlook for Japanese economic growth remains solid for 2022, given the passage of fiscal stimulus late last year. IMF pegs Japanese economy to expand by 3.3% in 2022 compared to 1.6% in 2021. Having said so, the economy could stumble early this year as the Omicron variant reinstated some mild restrictions. Unlike most countries, inflation pressures in Japan remain moderate with the Jan-22 CPI up just 0.5%YoY. Further, growth recovery continues to lag other advanced economies. As a result, the Bank of Japan is likely to stay pat on rates for an extended period, but it could remain active to enforce yield-curve control as it did recently. The BoJ offered to buy an unlimited amount of 10-year bonds at a fixed rate of 0.25% in a bid to cap the recent rise in yields. The plan was the first of its type in more than three years. Japan's central bank remains an outlier, maintaining ultra-easy policy while its peers start to wind back stimulus.

About Acuité Ratings & Research Limited:

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