MACRO PULSE

JANUARY 2022

Contents

From the desk of the Chief Analytical Officer

Our **thirteenth** edition (Jan-22) of **Acuité Macro Pulse** comes just before the publication of the Union Budget 2022. Although the budget is meant to be an annual document of the revenues and the expenditure of the Centre, it has acquired a far larger significance for the Indian economic landscape as it provides an opportunity for the Government to articulate its fiscal and economic policies that has implications for the medium term growth trajectory of the country.

While 2022 hasn't exactly seen an auspicious start due to the continuing threat of the pandemic thanks to Omicron, the latest trends indicate that its severity has been moderate across the globe and the third wave that has risen in India is likely to have a shorter duration. While there is clearly an impact on the contact intensive sectors such as hospitality and transportation, we believe that the economy can still notch up a real GDP growth of 9.5% in FY22 provided the government expenditure in Q4 meets the budget targets. This expectation is also reinforced by the continuing progress on vaccination with almost 70% of the population having already received one dose of the vaccine and 50% having received both the doses. The production linked incentive (PLI) launched by the government in the current year has already covered 13 sectors with a gross outlay of Rs 1.97 tn which is set to trigger a fresh cycle of private sector investments starting from FY23.

We believe that the focus of the upcoming budget will be to rebuild the economy and to facilitate the durability of a healthy economic growth over the medium term. In that context, the government needs to take certain measures to incentivise private consumption demand particularly in the rural areas; rationalisation of GST for certain consumer durable goods such as two wheelers may help to improve affordability.

While the government has already increased its investment in infrastructure projects in FY22, public capital expenditure needs to move up to a higher scale to generate more jobs and give a greater push to the construction sector. We would expect a higher outlay for the infrastructure sector in this budget which is also likely to include the healthcare sector where there is a significant need to enhance capacity both by the government as well as through PPP route.

But the government has to walk the fiscal tightrope and ensure that it has adequate resources for the necessary social and capital expenditure. To revert to the fiscal consolidation path over the next 2-3 years, what will be the key is the ability to complete the disinvestment of the proposed PSUs along with other assets under NMP.

As we have been highlighting in our earlier reports, interest rates have begun their ascent not only globally but also in India despite the continuity of the accommodative policy stance by MPC. The acceleration in the monetary normalization in the developed economies, liquidity calibration by RBI and the expected inflationary pressures will not only continue to drive the firmness in the rates but also keep the capital and forex markets volatile. What will be keenly awaited now is the Union Budget and the narrative it sets for the economy.

Take Care,

Suman Chowdhury
Chief Analytical Officer

Growth

Moderate impact of Omicron headwinds

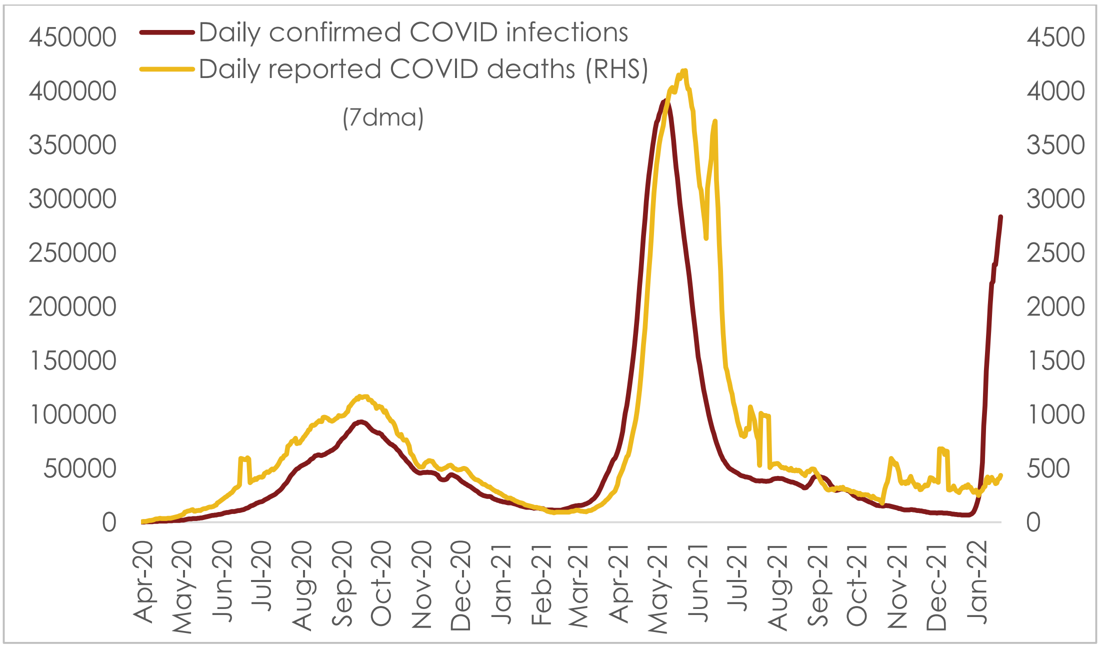
KEY TAKEAWAYS

- Domestic growth recovery, that was so far shaping well since the end of the second wave of COVID, is once again facing downside risks amidst the surge in Omicron cases in India.
- Since 1st Jan-22, nearly 3.4 mn confirmed cases have been recorded in the country, with as many as 321k cases on 23rd Jan-22 alone – the highest level since 15th May-21.
- The rapid rise in cases has been accompanied by states imposing restrictions, which though have been piecemeal in the form of weekend and night curfews predominantly.
- The consequent decline seen in consumer mobility is likely to have a disproportionate impact on high-contact intensive sectors.
- On the other hand, high frequency indicators such as E-way bills, rail freight as well as electricity generation have continued to remain resilient validating the relatively lower/milder restrictions on industrial and export sectors, so far.
- Reconciling the headwinds and tailwinds to growth in Q4 FY22, we cut our FY22 GDP growth forecast by 50 bps to 9.5%.

The domestic growth performance in Q3 FY22 has remained strong led by a confluence of several factors such as unwinding of lockdown restrictions supporting services sector, advancement in vaccinations along with festive season augmenting pent-up demand. This was also reflected in our proprietary AMEP index which averaged at 117.1, a quarterly high in the post-pandemic period. However, domestic growth recovery, that had been shaping well since the end of the second wave of Covid, started facing downside risks amidst the surge in Omicron cases in India from the end of Q3. The number of active cases stood at 2.2 mn as on Jan 25, 2022 which is a sharp increase over the levels in Dec-21, with the 7 day moving average at 312k cases as on the same day, the highest levels since the month of May-21. The rapid rise in cases has led many states to impose moderate and piecemeal restrictions in the form of predominantly weekend and night curfews. While the extent of hospitalisation and mortalities have increased, it is in much less proportion compared to the active cases than in the previous waves.

Nonetheless, the combination of restrictions and the surge in cases, have led to a decline in mobility indicators. In fact, Google mobility to retail and recreation, workplaces and transit stations, once again slipped below the baseline of 0 i.e., below the pre-pandemic level. This is likely to have a disproportionate downside on the high-contact intensive sectors which had started to see some green shoots. On the other hand, high frequency indicators more attuned to reflect industrial activity such as e-way bills, rail freight as well as electricity generation have continued to remain resilient until the third week of Jan-22. This underscores the milder impact of restrictions on industrial and export sectors, so far.

Chart 1: Omicron wave still unfolding in India but with less severity than in the past

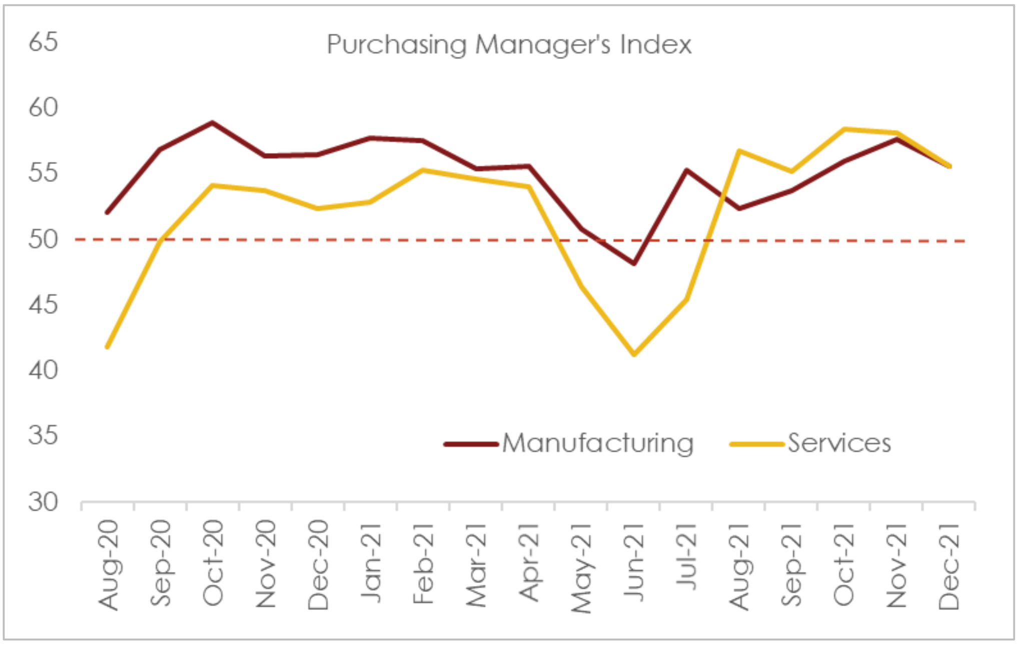


Recent data releases: A granular look at recovery

- India's IIP growth in Nov-21 slipped to the lowest level in 9-months, coming in at 1.4%YoY compared to 4.0% in Oct-21. The outcome was weaker than market expectations which were pegged at around 1.9% and can be attributed to the post festive fatigue along with lesser number of working days during Diwali month.

- India's PMI manufacturing and services slipped in Dec-21, coinciding at a level of 55.5 vs. 57.6 and 58.1 in Nov-21 respectively. Clearly, the sequential moderation was more pronounced in services.
- Total Goods and Services Tax (GST) collections hit a 3-month low in Dec-21 at Rs 1.29 tn but was 26% higher than the pre-pandemic levels of Dec-19 and 13% more than the same month a year ago.
- NONG (Non-oil-non-gold) imports, a key indicator of domestic demand, scaled a new peak of USD 38.6 bn in Dec-21 from USD 34.0 bn in Nov-21.
- Non-food credit, in the fortnight ending Dec 31, 2021 grew at the fastest pace in over 2 years at 9.3%YoY.

Chart 2: Both manufacturing and services PMI ease in Dec-21



FY22 GDP: First advance estimates

- As per the first advance estimate of national income for the year FY22 by NSO, India's GDP is projected to grow at 9.2% vis-à-vis a contraction of 7.3% in FY21.
- The FY22 GDP estimate represents a growth of 1.3% vis-à-vis the pre pandemic year of FY20. At an aggregate level, it reflects recouping of pandemic related GDP losses led by government consumption and exports.
- In contrast, private consumption is projected to remain below its pre pandemic level by 2.9%. This highlights the asymmetric nature of recovery amidst fragility of private consumption demand and the stress in the informal sector.
- From the supply side, FY22 GVA is projected to grow at 8.6% vs. a contraction of 6.2% in FY21. In comparison to the pre pandemic year of FY20, GVA shows a modest expansion of 1.9%. This recouping of pandemic related GDP loss is set to be supported by the sectors of i) Electricity, Gas, Water Supply, etc., ii)

Agriculture, Forestry, Fishing, etc., iii) Public Administration, Defense, & Other Services, iv) Manufacturing, and v) Mining & Quarrying.

- Meanwhile, Trade, Hotels, Transport & Communication is the only major broad sector that is projected to remain below its pre pandemic levels by 8.5%. This captures the lop-sided impact of the lockdown restrictions on high contact intensive services.

Outlook

From a growth perspective, we note that there are both upside and downside risks that need to be weighed.

On the downside, the high volume of Omicron cases (and the concomitant restrictions) is bound to lead to a slowdown in sequential growth momentum in Q4 FY22. However, given the experience of other countries of low hospitalization and mortality rates offers hope of a shorter tenure of the current wave. If cases in India were indeed to follow the same pattern, the impact of the ongoing Covid wave could very well be limited to Q4 FY22 itself or even for a lesser period, from a timeline perspective. Having said so, the adverse impact is largely to be borne by services and consumption-oriented sectors.

On the other hand, on the upside, a back-ended increase in government expenditure due to Covid related relief programs including vaccination, hike in DA/DR allowance, lagged pick-up in capex spending with relaxation of expenditure restriction in the last quarter will create a buffer that will likely cushion the impact of Covid downside in Q4 FY22. Further, India has currently inoculated 94% and 72% of the adult population with one and two dose of vaccine respectively. This is significantly ahead of the 70% and 26% corresponding milestone achieved by end of H1 FY22. More so, with vaccination now being open to younger population with selective administration of booster shots, enhanced coverage will hopefully help in improving labour participation, encourage mobility, bring on board pent-up demand, while also pushing ahead organic demand.

Further, RBI's reiteration of its growth supportive stance in Dec-21 policy review until the recovery becomes durable, strong, and inclusive remains in place. Assimilating all these factors, on balance, we have revised our forecast for FY22 GDP growth forecast lower by 50 bps to 9.5%.

Inflation

On an upward trajectory

KEY TAKEAWAYS

- CPI inflation accelerated to a six-month high of 5.59%YoY and WPI inflation remained firm at 13.56% in Dec-21. On a FYTD basis, CPI inflation average stands at 5.2%, while that of WPI at a lofty12.5%.
- On a sequential basis, both CPI and WPI showed a similar contraction by 0.36% MoM and 0.35% MoM respectively in Dec-21.
- The sequential decline in food and beverages inflation offered support to the sequential trajectory.
- However, upside risks persist on account of incomplete pass-through of telecom tariffs, persistence of elevated international commodity prices particularly crude oil, progress on vaccination, and temporary supply side disruption from Omicron.
- As such, we continue to expect CPI inflation to remain firm in the near term with likelihood of Q4 FY22 average number printing above RBI's estimate of 5.7%.
- Overall, we continue to maintain our FY22 CPI inflation forecast at 5.5%.

Overview
From inflation perspective, the calendar year 2021 ended on a dismal note. CPI inflation accelerated to a six-month high of 5.59%YoY and WPI inflation remained firm at 13.56% in Dec-21. On a FYTD basis (Apr-Dec), CPI inflation average stands at 5.2%, while that of WPI at a lofty12.5%.

CPI inflation: Headline gets close to upper threshold of policy tolerance
India's CPI inflation accelerated to a six-month high of 5.59% YoY in Dec-21 from 4.91% in Nov-21. While headline inflation continues to stay within the policy target band, with the latest print, it has now gotten closer to the upper threshold of RBI's inflation targeting band of 6%.

Despite a reduction in sequential price pressures versus previous month, the upside in headline print underlined the unfavorable base at play. To put this in context, incrementally CPI index fell by 0.36% MoM in Dec-21 despite the annualized rate of inflation rising by 0.7 percentage points.

Key highlights:

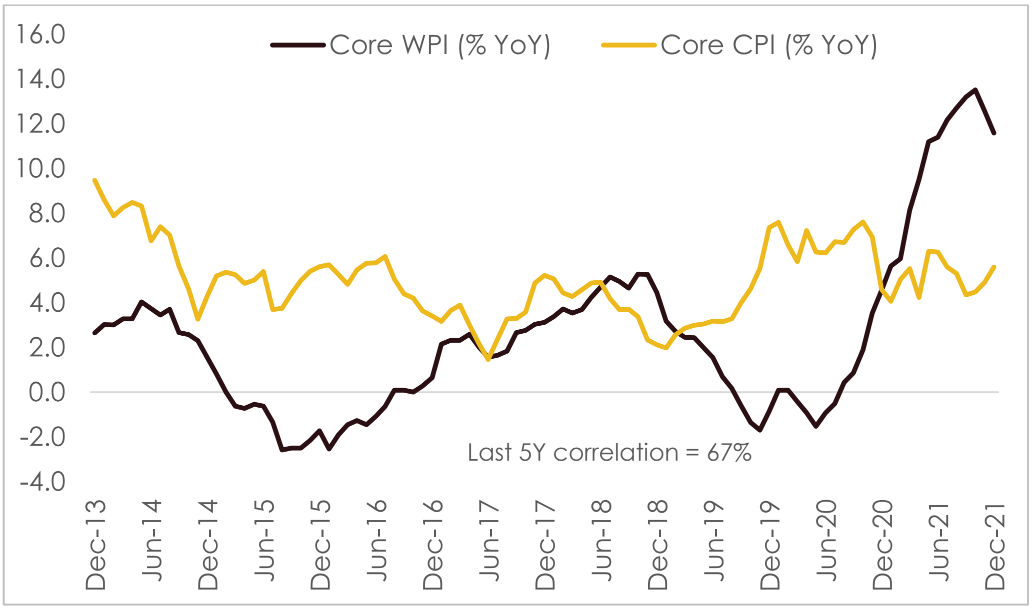
- The sequential decline was led by the Food & Beverages index that dipped by 0.88% MoM, following a 1.19% increase in Nov-21. Leading this decline in Dec-21 were Vegetables (-5.4%), Meat & Fish (-1.4%), Oils & Fats (-1.3%), Sugar (-1.1%), and Fruits (-1.0%). While that's comforting to note, the overall monthly decline appears to be somewhat weaker than the 1.1-1.5% decline usually seen in food inflation on account of winter seasonality in December.
- The other two sources of sequential decline in prices were Pan, Tobacco & Intoxicants (-0.2% MoM) and Housing (-0.5% MoM) indices. While it is difficult to ascribe a reason for the former, the latter is a bi-annual seasonal development, and hence not a surprise.
- Fuel & Light index rose, led by Coal (1.3% MoM), Kerosene (1.2% MoM), Dung Cake (1.1%), and Firewood & Chips (0.4% MoM). Meanwhile, fuel items in the Miscellaneous index i.e., Petrol and Diesel fell by 1.9% MoM and 2.7% MoM respectively, reflecting spill over impact of the reduction in petroleum taxes by the government during Nov-21.
- Among other movers, the index of Clothing & Footwear once again posted a strong momentum of 0.7%MoM, underscoring the ability of producers to charge higher price for goods amidst ramp-up in festive demand and increased retail mobility.
- Telephone charges saw a jump following upward revision in tariffs by telecom companies. However, the 4.8% MoM increase captured by the respective CPI sub index is much lower than the 20%+ actual increase in tariffs by key telecom companies. This in our opinion leaves the door open for lagged adjustment in the CPI in the coming month(s).
- Core inflation (i.e., CPI ex Food & Beverages and Fuel & Light indices) increased by 0.2% MoM in Dec-21 vs. 0.4% MoM in Nov-21. While the annualized rate of core inflation moderated a tad, we note that it has averaged a little over 6% in last three months.

WPI inflation: Decelerates from record high levels

WPI inflation moderated from its record high level of 14.23%YoY in Nov-21 to 13.56% in Dec-21. Sequentially, the headline index fell by 0.35% MoM in Dec-21, marking its first contraction in 19-months.

- Primary food prices fell by 1.07% MoM in Dec-21, led by Vegetables and Eggs, Meat & Fish. In addition, manufacturing indices for food and beverages also contracted by 0.25% MoM and 0.24% respectively.
- Fuel & Power index fell by 2.66% MoM in Dec-21, marking its first contraction in eight months. The down move was led by fall in petrol and diesel prices along with primary crude petroleum & natural gas. This reflects the sharp fall in price of India Crude Basket to USD 73 pb in Dec-21 from USD 81 pb in Nov-21.
- Core inflation (non-food manufacturing) moderated to 11.0% YoY in Dec-21 from 12.3% in Nov-21. While the monthly sequential momentum decelerated to 0.3% MoM from 1.2% in Nov-21, the core print remains in double digits, thereby reflecting persistence of pass-through pressures from input prices.

Chart 1: Both WPI and CPI accelerate in Nov-21



Outlook

The common thread emerging from both CPI and WPI inflation is the sequential moderation in price pressure, predominantly led by seasonal disinflation in food & beverages. Government policy interventions in case of edible oil and pulses along with reduction in petroleum taxes have also been supportive of an overall benign food inflation outturn. Moreover, healthy rabi sowing bodes well for food inflation in the coming months.

However, the upside risk to inflation continues to persist due to: '

- CPI inflation is yet to fully represent the complete impact of steep hike in telecom tariffs in Dec-21.

- As severe headwinds on account of Omicron have receded, global commodity prices have firmed up sharply in Jan-22, with price of India Crude Basket averaging at USD 83 pb vis-à-vis USD 73 pb in Dec-21 and set to be even higher in Jan-22. This will result in a persistence in input price pressure.
- Continued progress on vaccination coupled with recovery in personal mobility (barring the temporary disruption on account of Omicron) will continue to support pent-up/revenge demand and could keep core inflation elevated.
- In last 3-weeks, states have reimposed certain restrictions (not exactly lockdowns) to curb the rapid spread of Omicron. While the restrictions are moderate and could turn out to be of shorter duration compared to the second wave, there could be a mild spillover on inflation due to temporary supply disruptions.

As such, we continue to expect CPI inflation to remain firm in the near term with likelihood of Q4 FY22 average number printing above RBI's estimate of 5.7%. Overall, we continue to maintain our average FY22 CPI inflation forecast at 5.5%.

Table1: Key highlights of CPI inflation

CPI sub-components				
	Sequential (%MoM)		Annualized (%YoY)	
	Nov-21	Dec-21	Nov-21	Dec-21
CPI headline	**0.73**	**-0.36**	**4.91**	**5.59**
Food & Beverages	1.19	-0.88	2.60	4.47
Pan, Tobacco & Intoxicants	0.10	-0.21	4.05	3.22
Clothing & Footwear	0.91	0.72	7.94	8.30
Housing	0.37	-0.49	3.66	3.61
Fuel & Light	-0.18	0.12	13.35	10.95
Miscellaneous	0.25	0.37	6.75	6.65
Core CPI Inflation	**0.37**	**0.23**	**6.21**	**6.19**

Government Finances

All eyes on the FY23 Union Budget

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Nov'21 stood at 46.2% of budget estimates (BE) for FY22 compared to 59.0% of actuals in the corresponding period of FY21.
- The relatively lower accretion to fiscal deficit this year continues to reflect strong revenue collection (except disinvestments), even as expenditure disbursal momentum has been slow in the initial part of the year but has showed signs of a pick-up.
- Basis the second supplementary demand for grants, there is now a likelihood of additional spending (on net basis) of Rs 3.2 tn over and above the budgeted expenditure.
- Despite the expenditure slippage, the government could still meet the headline fiscal deficit ratio target of 6.8% of GDP in FY22 due to the positive surprise in tax and non-tax revenue collections, besides getting 0.3% additional fiscal adjustment room from higher than budgeted growth in the nominal GDP.
- We expect the upcoming FY23 Union Budget to target a moderate consolidation through a fiscal deficit projection of 6.0%-6.3% of GDP and net g-sec borrowing of Rs 9.2 tn.
- Beyond the projections for FY23, it would be critical for the Union Budget to lay out the medium-term fiscal consolidation roadmap under the revised FRBM framework including

India's central government fiscal deficit for the period Apr-Nov stood at 46.2% of budget estimates (BE) for FY22 compared to 59.0% 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 signs of pick-up from Q3FY22.

Receipts: Continue with their strong performance

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

On FYTD basis (Apr-Nov), gross tax revenue collection clocked a robust growth of 50.3% YoY compared to a contraction of 12.6% 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 69.5% of BE for the full year (vs. 50.7% of actuals in the corresponding period in FY21), thereby concluding first eight 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 clocked a healthy growth of 31.3% during Apr-Nov 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 a sharp pickup in imports) and corporate tax (reflecting healthy earnings performance for large corporate sector).
- We also note that total GST collections in the last three months have averaged around Rs 1.30 tn.
- Non-tax revenue too recorded a strong annualized growth of 79.5% YoY in Apr-Nov FY22 compared to a contraction of 46.6% 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.

Aided by favourable statistical base, non-debt capital receipts clocked an expansion of 14.1% YoY in Apr-Nov FY22 vs. a contraction of 37.5% seen in the corresponding period in FY21. The month of Nov-21 saw no accretion towards disinvestment revenue.

Expenditure: Despite moderation, FYTD momentum remains higher

Although expenditure disbursal slowed down in Nov-21, the FYTD (Apr-Nov) momentum remains higher at 8.8% YoY compared to 4.7% seen in the corresponding period in FY21. On BE basis, this translates to 59.6% of the full year target vis-à-vis 54.3% (of actuals) seen in the corresponding period in FY21. Few observations:

- While headline revenue expenditure expanded by 8.2% YoY (61.5% of FY22 BE) during Apr-Nov FY22 vis-à-vis an expansion of 3.7% (54.0% of FY21 actuals) seen in the corresponding period in FY21, bulk of the growth continues to be led by interest payments and subsidies particularly food and fertilisers. Excluding these, revenue expenditure stood at a subdued level of 2.8% YoY during Apr-Nov FY22 vs 4.9% in the corresponding period in FY21. However, the pace of revenue spending is likely to gather momentum in the remaining months of the fiscal year to meet budget targets as well as extra budget expenses.

- Pace of capex disbursal moderated for second month in succession. Nevertheless, the thrust on investment continues with capital expenditure clocking a comparatively higher growth of 13.5% YoY (49.4% of FY22 BE) during Apr-Nov FY22 vis-à-vis 12.8% (56.8% of FY21 actuals) seen in the corresponding period in FY21. Disbursals until Nov-21 have been led by the Ministry of Road Transport and Highways which has exhausted 68.3% of its budgeted allocation.

Outlook

The release of first advance estimate of national income for FY22 pegs nominal GDP growth at 17.6%. Since this is significantly higher than the FY22 budget assumption of 14.4%, the denominator impact will help to create additional fiscal space up to 0.3% of GDP for FY22.

In addition, the higher than budgeted revenues from tax and non-tax sources would enhance the fiscal safety net this year.

Nevertheless, additional expenditure items have also been stacking up. In the December edition of "Acuité Macro Pulse", we estimated the likelihood of government spending exceeding the budgetary target by approximately Rs 3.2 tn. Higher spending is due to vaccination cost, Covid relief program, hike in DA/DR allowance, higher subsidy outgo, capital infusion in Air India Assets Holding Company, and a potential top-up of the MGNREGS budget.

Despite the higher than anticipated net spending, the government could still meet the headline fiscal deficit ratio target of 6.8% of GDP in FY22 given buoyant revenue accompanied by higher than budgeted FY22 nominal growth. Additionally, if the disinvestment of LIC (expected to generate ~Rs 1 tn in revenue) gets concluded by Mar-22 the fiscal deficit could further moderate upto ~30 bps. The government would present the FY23 Union Budget on Feb 1, 2022. With output gap expected to remain negative for few years on account of the severe shock from the pandemic, the magnitude of fiscal consolidation in FY23 could be moderate as the budget is likely to preserve its focus on funding infrastructure asset creation, rural support along with adequate level of welfare expenditure and subsidies. As such, we expect the upcoming budget to present a fiscal deficit target between 6.0%- 6.3% of GDP, which we believe would strike a balance between supporting economic recovery and adhering to the need for gradual fiscal policy normalization.

- If the share of fiscal deficit financing via net g-sec borrowing remains close to the 4-year average of 55.5%, the budget could project FY23 net g-sec borrowing requirement at Rs 9.2 tn, similar to the FY22 budget estimate.

Beyond the projections for FY23, it would be important for the government to lay out the medium-term fiscal consolidation roadmap under the revised FRBM framework.

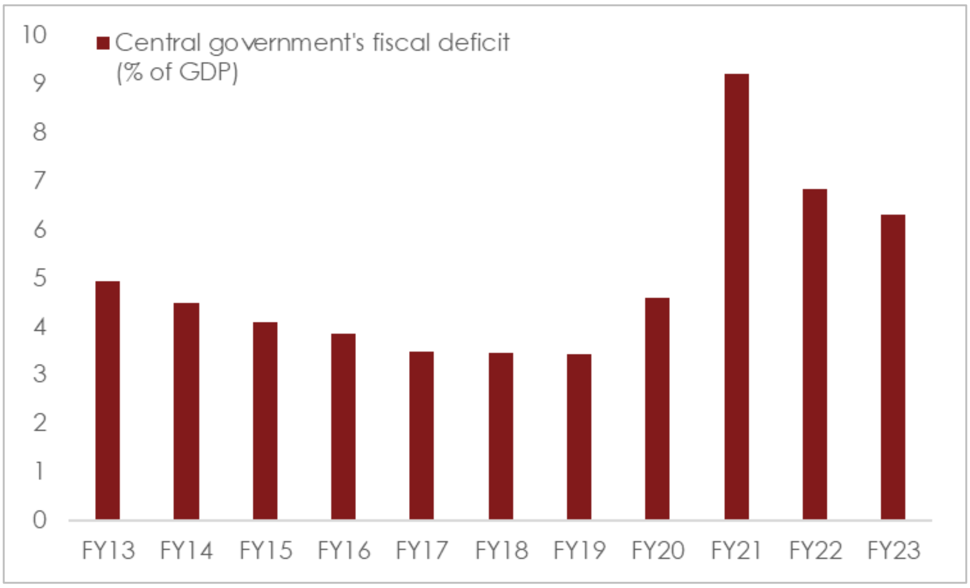
- The FY22 Union Budget had projected the glide path with fiscal deficit expected to drift lower towards 4.5% of GDP by FY26.
- This would imply an average fiscal consolidation of 0.6% of GDP over FY24-FY26.
- The government could retain this target to signal its resolve for policy normalization with emphasis on revenue augmentation and expenditure rationalization.

- What, however, will remain the key to fiscal consolidation is the ability to meet the disinvestment and the asset monetisation targets over the next 2-3 years.

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

Key Fiscal Variables (Cumulative Position as of Apr-Nov)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	**49.8**	**75.9**	**-17.3**	**67.1**
Net Tax	48.3	73.5	-8.3	64.9
Non-Tax	59.7	91.8	-46.6	79.5
Non-Debt Capital Receipts	31.5	11.0	-37.5	14.1
Total Receipts	**49.2**	**69.8**	**-17.9**	**66.0**
Revenue Expenditure	**54.0**	**61.5**	**3.7**	**8.2**
of which, Interest Payment	56.2	56.9	12.2	20.1
of which, Major Subsidies	33.9	68.5	-14.0	14.1
Capital Expenditure	**56.8**	**49.4**	**12.8**	**13.5**
Total Expenditure	**54.3**	**59.6**	**4.7**	**8.8**
Fiscal Deficit	**59.0**	**46.2**	**-**	**-**

Chart 1: We expect FY23 Union Budget to target a moderate consolidation by projecting fiscal deficit in a band of 6.0-6.3%% of GDP in FY23 vs. 6.8% in FY22



Rates

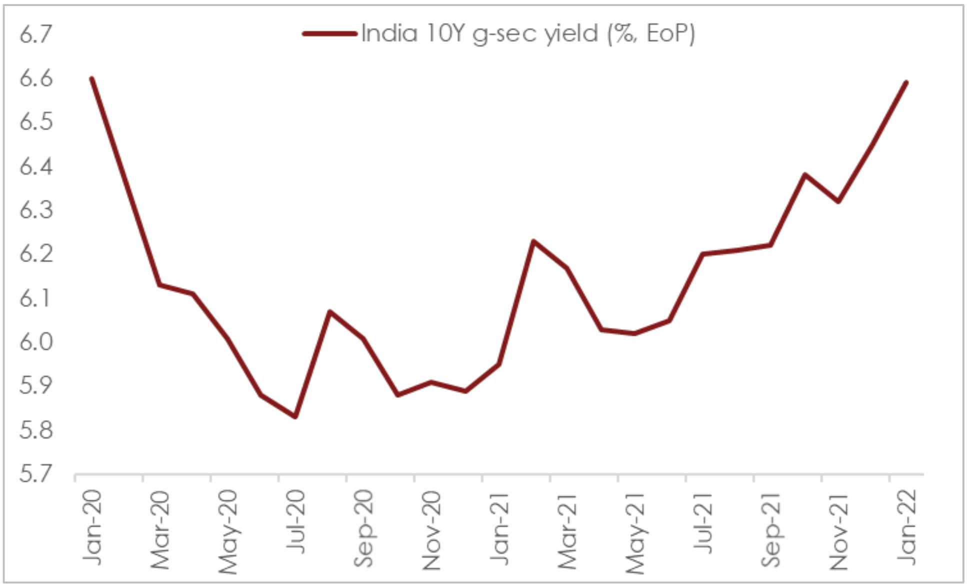
Attaining prepandemic levels

KEY TAKEAWAYS

- India's 10Y g-sec yield has hardened further and rose to 6.75% in Jan-22 so far, after inching up to 6.45% in Dec-21 (from 6.32% in Nov-21). It is currently trading at a 25 month high and at the highest level since the beginning of the pandemic.
- Pipeline inflation risks are building up, with likelihood of manifestation in CPI inflation in the coming months.
- Systemically important central banks like the US Fed and the BoE have made a hawkish pivot in Dec-21 and Jan-22 in a bid to scale back pandemic era monetary accommodation and initiate policy normalization.
- We expect RBI to move forward on interest rate normalization in Feb-22 as headwinds associated with Omicron have turned out to be moderate and could be receding soon.
- We expect FY23 Union Budget to project fiscal deficit in a band of 6.0%-6.3% of GDP along with a net g-sec funding requirement of Rs 9.2 tn.
- We now expect 10Y g-sec yield to remain over 6.50% in the current quarter and move further towards 7.25% by Mar-23.
- The upside risk could moderate if FY23 Union Budget lays the roadmap for India's inclusion in global bond indices, thereby increasing the demand for sovereign paper.

India's 10Y g-sec yield has hardened further towards 6.75% in Jan-22 so far, after inching up to 6.45% in Dec-21 (from 6.32% in Nov-21). It is currently trading close to the highest level since the beginning of the pandemic - with this our year-end target of 6.50% now stands achieved earlier than anticipated.

Chart 1: 10Y g-sec yield is now back to pre-pandemic levels



The bond yields have hardened despite the RBI maintaining reverse repo rate unchanged at 3.35% in its Dec-21 policy review (few market participants were expecting a token hike of 20 bps). The rapid spread of the Omicron variant of the coronavirus had led to uncertainty regarding growth taking precedence over uncertainty around inflation.

- The 10Y benchmark yield has risen by over 40 bps since the last policy review with upside pressure evident across the yield curve, especially at 5Y, 13-14Y, and the 30Y segments.

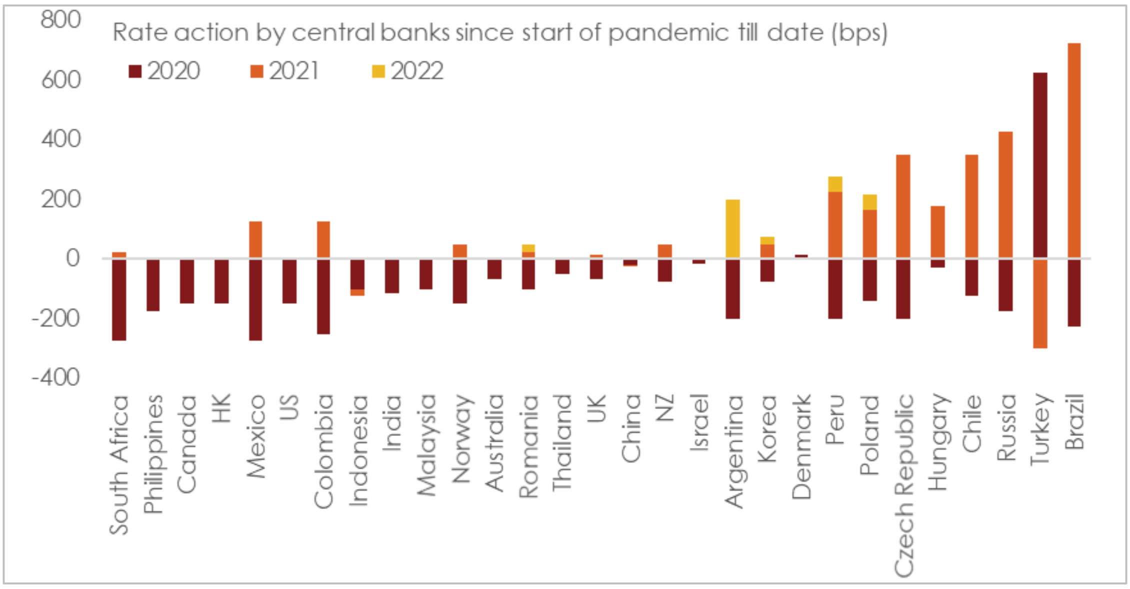
Upside pressures getting firmly in place

We had given a heads-up on the formation of two important upside risks for bond yields in the Dec-21 edition of "Acuité Macro Pulse". Since then, those risks have materialized with significant intensity.

- 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.
    - The passthrough of steep hike in telecom tariffs appears to be partially captured, 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 Jan-22, with price of India Crude Basket averaging at USD 83 pb vis-à-vis USD 73 pb in Dec-21 and perhaps further high in Jan-22. This will result in persistence of input price pressures.

- India has currently vaccinated 67% and 50% of its total population with first and second dose of vaccine as on Jan 27, 2022. Continued progress on this front coupled with recovery in personal mobility (barring the temporary disruption on account of Omicron) will continue to support pent-up or revenge demand and could keep core inflation elevated.
- There is likely to be a mild upside impact of the hike in GST rate for few items of footwear from Jan-22.

Chart 2: Policy rates have begun to normalize in many countries



- The turn 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 and Jan-22 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 (Bank of International Settlements) who have seen rate action in the pandemic period, currently: i) 18 have their monetary policy rate below their pre pandemic levels, ii) 2 have their monetary policy rate at their pre pandemic level, and iii) 8 have their monetary policy rate above their pre pandemic levels.
  - The year 2022 is likely to see more central banks join the normalization bandwagon, especially with the US Fed now projecting three round of rate hikes along with possibility of balance sheet run down later in the year (we note that the recent commentary from few Federal Reserve members has stoked market expectations for pricing in four rounds of rate increases in 2022, starting March).

Outlook

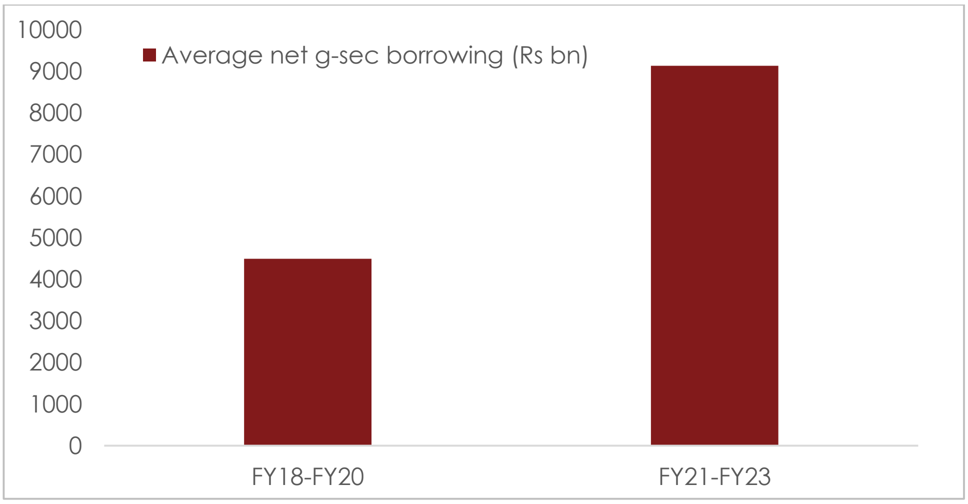
Although the RBI has resisted formal monetary policy normalization, the recent hawkish pivot from the Fed and the BoE could potentially alter its actions in 2022.

- As per RBI's Jan-22 Monthly Bulletin, "expectations that Omicron may turn out to be more of a flash flood than a wave have brightened near-term prospects". This is consistent with reports of lower mortality and relatively lesser pressure on the healthcare system vis-à-vis the previous two waves.
- With adverse spill over from Omicron expected to be limited, the likelihood of continuation of the recovery process remains broadly unaltered. As per the Jan-22 update of World Bank's Global Economic Prospects, India's GDP is projected to grow at 8.7% in FY23, up from 8.3% in FY22.
- As such, we believe the central bank could consider moving reverse repo rate up by 20 bps in the Feb-22 policy review to signal the start of interest rate normalization cycle and gradually shift focus towards inflation management.
- This will also be consistent with its ongoing emphasis on recalibration of liquidity surplus, which has pushed short term money market rates (barring overnight segment) towards the upper end of the policy rate corridor, marked by the repo rate, currently at 4.00%.

While the turn in domestic monetary policy trajectory is almost priced in by market participants, fiscal policy at this juncture will play an important role for the bond market. We expect the FY23 Union Budget to project fiscal deficit ratio moderately lower between 6.0%- 6.3% of GDP along with a funding requirement of Rs 9.2 tn via g-secs (on net basis). This will keep borrowing pressure at elevated levels, especially considering that the pre pandemic (FY13-FY20) level of net g-sec borrowing ranged between Rs 4.1-4.7 tn.

With our Mar-22 target of 6.50% for 10Y g-sec now achieved, we now expect 10Y g-sec yield to move towards 6.75% by Mar-22, and further towards 7.25% by Mar-23. The upside risk could moderate if FY23 Union Budget lays the roadmap for India's inclusion in global indices, thereby creating additional source of demand from FPIs.

Chart 3: Post pandemic, government's market borrowing requirement has doubled



Note: For FY23, we have included our net g-sec borrowing estimate of Rs 9.2 tn

Rupee

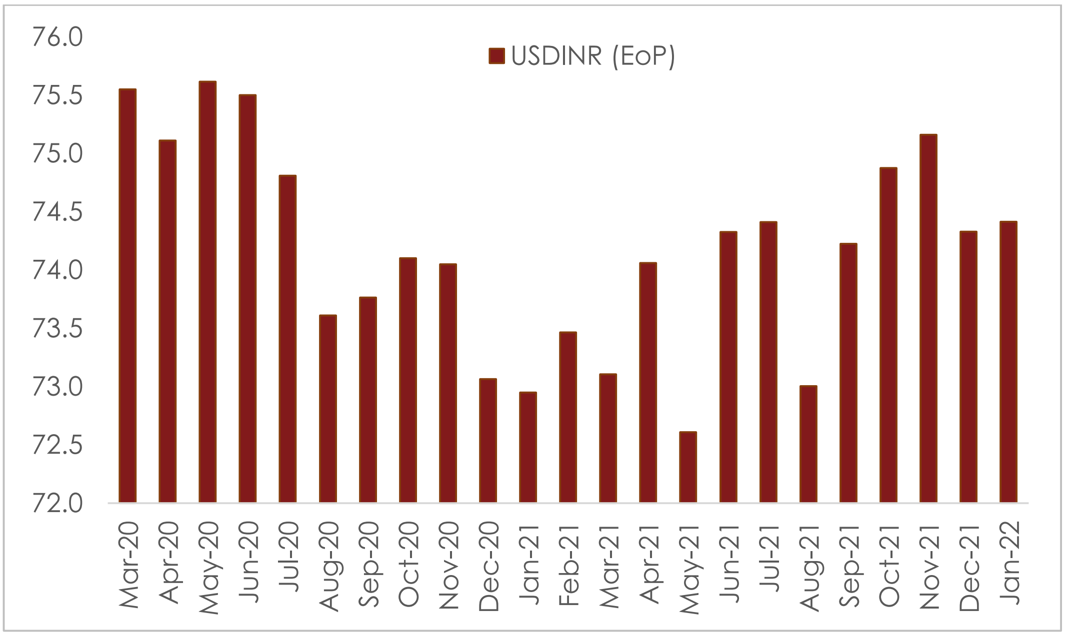
In consolidation phase

KEY TAKEAWAYS

- After 3-months of depreciation, INR made an impressive turnaround in the final week of Dec-21 but has continued to witness significant volatility thereafter.
- We continue to remain USD bulls on the back of constructive outlook on US growth, extremely high inflation, and the latest hawkish pivot displayed by the Federal Reserve in favor of faster pace of monetary policy normalization.
- The combination of elevated global commodity prices, sequential improvement in domestic growth (notwithstanding the temporary disruption from Omicron), and gradually increasing vaccination coverage is resulting in rapid expansion of trade and current account deficit.
- While portfolio outflow has picked up in recent months, its impact has been partially offset by the spurt in issuance of foreign currency debt by domestic corporates.
- Although we continue to expect rupee to depreciate in the near term, we tweak our expectations and project USD-INR pair to touch 76 levels by Mar-22 vs. our previous forecast of 77.

After depreciating for three consecutive months against the US dollar between Sep-Nov 2021, the Indian rupee made an impressive turnaround in the final week of Dec-21, with the currency pair closing the month at 74.33, stronger by 1.1% vis-à-vis the previous month. Nevertheless, it has continued to exhibit volatility in a range of 73.9-75.2 in the month of Jan-22 so far.

Chart 1: Post three consecutive months of weakness, INR has partly consolidated



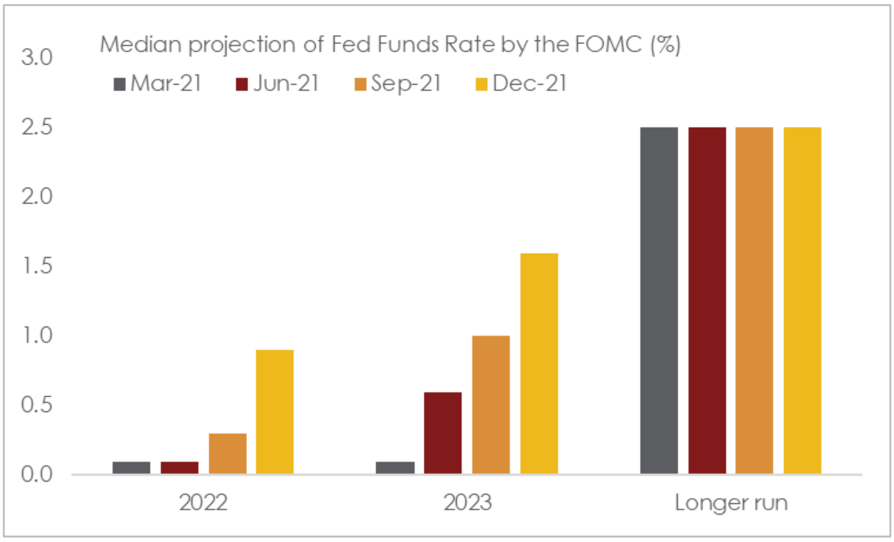
The sharp pullback from weakness, towards the end of Dec-21 was unanticipated. Equally surprising is rupee's relative stability thereafter despite strengthening of factors in favour of its depreciation.

Since the publication of the November edition of "Acuité Macro Pulse" report, global and domestic macro backdrop has tilted further towards rupee depreciation. On the global front, we continue to remain dollar bulls.

- Our optimism stems from economic outperformance of the US economy (averaged over 2021 and 2022, the IMF expects US GDP to grow by 5.6%, thereby making it one of the strongest growth centers among DMs).
- More importantly, with the US economy already attaining its pre Covid levels in Q2-21, multi-decade high inflationary pressures finally prompted the Federal Reserve to abandon the 'transitory' defense and refocus on inflation management. In a sharply hawkish tilt, the FOMC in Dec-21 and Jan-22 not only announced its intent to halt the bond purchase program by Mar-22, but more importantly, it now projects three round of rate hikes in 2022, up from just one hike projected in the Sep-21 policy review.
- The projection of three rate hikes as per the latest dot plot practically eliminates any major gap between end of taper and beginning of policy rate normalization as rate hikes can potentially now happen every quarter post the conclusion of the taper program in Mar-22. In fact, the first rate hike can be expected as early as Mar-22.

- Of late, few FOMC members have further highlighted their discomfort with the pace of inflation and have thrown in the possibility of four rate hikes in 2022 along with the possibility of running down the central bank's balance sheet (or in other words, quantitative tightening).

Chart 2: Latest FOMC sees a sharp hawkish pivot in favor of policy normalization



Even as a strong dollar backdrop is unsupportive of rupee, the short-term domestic macro-financial balance is rather adverse from currency perspective.

- Earlier this month, we revised higher our forecast for India's FY22 current account deficit to USD 46 bn from USD 38 bn estimated previously. Since then, price of India Crude Basket has jumped sharply by over 12% (to record a fresh post pandemic high) due to: i) receding global economic threat from the spread of Omicron, ii) monetary and credit policy turning accommodative in China, and iii) the role of geopolitical factors (recent tensions in Middle East and Central Asia) in curbing supply. While it would be early to say if the pressures would sustain, we would need to keep a close watch on global commodity prices, especially crude oil.
    - The FY22 merchandise trade deficit is estimated to be around 6.0% of GDP (assuming annual average oil price of USD 76-77 pb). If current level of oil price (~USD 85 pb) sustains in FY23, then the trade deficit would widen further. From historical perspective, FY15 that saw average oil price of USD 84 pb comes closest to the current level of oil price. This was the year in which trade deficit touched 7.1% of GDP. While not our forecast, this potentially highlights the upside levels for further expansion of trade deficit in FY23.
    - Pressure on trade deficit is also seen to be emerging from sequential recovery in domestic economic growth (which could see a short and mild disruption on account of Omicron related curbs on activities). With

gradually rising vaccination cover, pent-up demand is gradually getting unlocked.

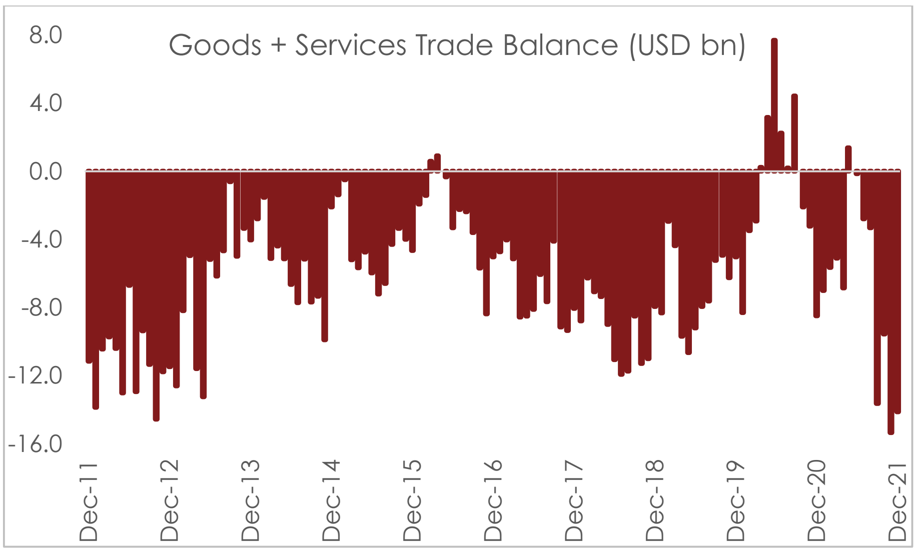
- The pressure on trade deficit is increasing at a time when portfolio outflows have been incessant for four months in a row with Jan-22 so far marking the worst FPI outflow (of USD 4.5 bn) from Indian markets in the last 22-months. Elevated domestic equity valuations and faster than anticipated normalization of US monetary policy could keep portfolio flows subdued in Q4FY22.

What then is the saving grace for rupee? We believe the silver lining in the current environment is coming from:

- 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 prompted high quality corporates to tap the international market for funding in Jan-22. One of India's largest conglomerates raised a record amount of foreign currency debt worth USD 4.0 bn. Reflecting strong momentum, some Indian companies are already in the international market with bond offerings in pipeline to raise up to USD 7-8 bn in Jan-22.
- The upcoming FY23 Union Budget could provide some roadmap for India's inclusion in global bond indices. If successful, this would have the potential to attract over USD 30 bn in FPI debt flow within 4-6 quarters.
- India's FX Reserves appears comfortable at ~13 months of import cover, its highest in last 12-years. This provides the first line defense against any excessive volatility on the foreign exchange front.

Considering the above factors, we continue to expect rupee to face mild depreciation pressures. However, with recent spate of foreign currency issuances providing tailwinds, we now fine tune our expectations and project USD-INR pair to touch 76 levels by Mar-22 vs. our previous forecast of 77.

Chart 3: India's trade deficit has widened significantly in recent months



Global Overview

Omicron clouds 2022 outlook

KEY TAKEAWAYS

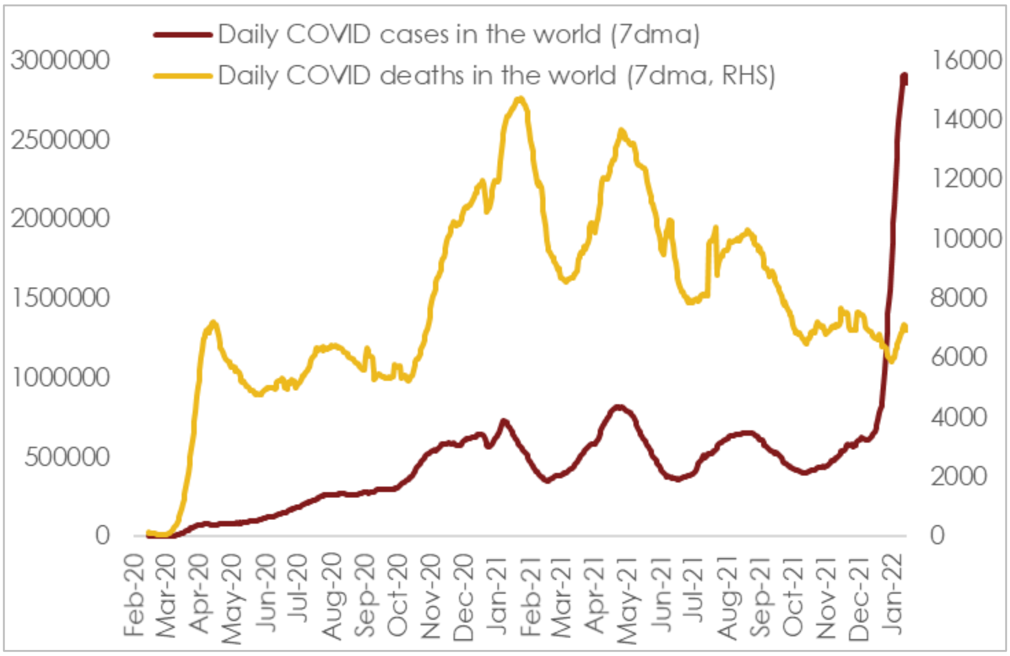
- The rise in Covid cases with the emergence of the Omicron variant continues unabated. Since the start of 2022, more than 45 mn cases have been confirmed globally.
- Encouragingly, on a weekly basis, the pace of increase has eased dramatically from 53% to 9.0% in the third week of Jan-22, offering hope that the peak may be nearer.
- Covid flare up has led to downside risks to near term economic prospects. The World Bank forecasts a slower global recovery in 2022 at 4.1% (revised lower by 20 bps) compared to 5.5% in 2021.
- From a macroeconomic perspective, incoming data from advanced economies is beginning to reflect some downside in activity owing to Omicron wave. Nevertheless, activity remains resilient validated by the continued improvement in labour demand. On the other hand, inflation upside remains relentless.
- Inflationary concerns has led central banks to hasten the withdrawal of monetary policy support, despite Omicron rage. Markets are poised for BoE's second rate hike in Feb-22 and Federal Reserve embarking on its rate tightening cycle as early as Mar-22.

Global Overview

The rise in Covid cases with the emergence of the Omicron variant continues unabated. Since the start of 2022, more than 45 mn cases have been confirmed globally. Although, on a weekly basis, the pace of increase has eased dramatically from 53% last week to 9.0% so far offering hope that the peak may be nearer. While the faster transmissibility of Omicron has led several countries to announce lockdowns and other travel related restrictions, UK once again has led the path for easing of restrictions with the recent drop in cases. PM Boris Johnson recently announced face masks to no longer be mandatory in public places and schools and Covid passports will be dropped for large events. On the vaccine front, countries continue to hasten administration with more than 10 bn doses being delivered globally till date. Italy, recently made vaccination compulsory for citizens aged 50 years and above.

The Covid flare up has led to downside risks to near term economic prospects. The World Bank, in its latest Global Economic Prospects (GEP) report, released earlier this month, forecast a slower global recovery in 2022 at 4.1% (revised lower by 20 bps) compared to 5.5% in 2021. While growth projections for both advanced and emerging economies were revised lower, prominent among those downgrades were that for US and China by 50 bps and 30 bps respectively. Further, World Bank highlights that emerging and developing economies are experiencing a weaker recovery, owing to slower vaccination progress, more muted policy support, and more pronounced scarring effects from the pandemic.

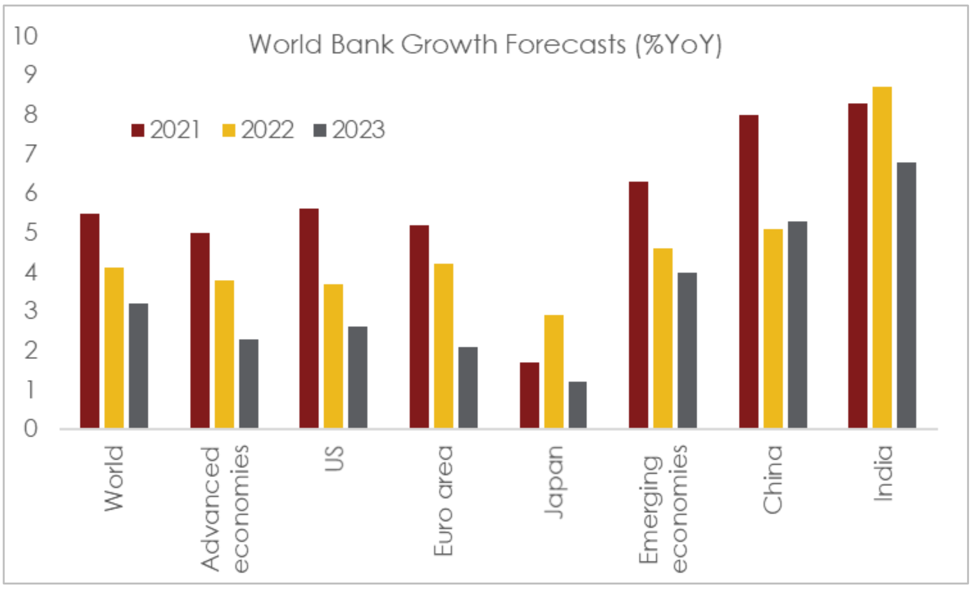
Chart 1: Omicron cases have dwarfed previous waves of the pandemic



From a macroeconomic perspective, incoming data from advanced economies is beginning to reflect some moderation in activity owing to Omicron wave. Nevertheless, activity remains encouragingly resilient validated by the continued improvement in labour demand across economies. On the other hand, inflation upside remains relentless. US CPI inflation surged to 7.0%YoY in Dec-21 – a 40 year high.

In UK, consumer prices rose by 5.4%YoY – to mark the highest level since Mar-92 while in Eurozone inflation was at a new high of 5.0%YoY. This has led central banks to hasten the withdrawal of monetary policy support. On a positive note, the shorter lifespan of Omicron effect along with lower hospitalisation rates offers hope. This has revived risk appetite, with Brent crude prices soaring to near 7 years high of USD 87 pb in Jan-22, an incremental MoM gain of nearly 12%.

Chart 2: World Bank has reduced 2022 growth forecast by 20 bps to 4.1%



US

For the US economy, the latest macroeconomic theme remains one of intensifying inflation amidst easing consumer activity as Omicron plays catch-up in its impact. CPI inflation in Dec-21 remained firm, coming in line with expectations at 7.0%YoY compared to 6.8% in Nov-21. Core inflation, though saw a bigger jump to 5.4% from 4.9% previously. While the decline in oil and gas prices helped to cap inflation upside, price pressures were broad-based and exceptionally strong in categories of used cards, new cards, apparels and shelter and eating out services.

On the real activity side, retail slipped by a sizeable 1.9%MoM in Dec-21, reflecting the impact of Omicron wave being more damaging than envisaged earlier. Not only store retail, but even non-store retail sales dropped by 8.7%MoM underscoring the broad-based nature of weakness, which was seen across categories of furniture, clothing, sporting goods, department stores among others. In other data, industrial production slipped 0.1% MoM in Dec-21, as the heavily weighted manufacturing index fell 0.3%.

On the other hand, labour market continues to tighten, with the latest data showing unemployment rate falling sharply to 3.9% in Dec-21 from 4.2% in Nov-21. This improvement was despite a marginal improvement clocked in the labour force participation rate (the denominator), and more importantly marked the unemployment rate easing below the level FOMC considers as full employment (i.e., of 4.0%).

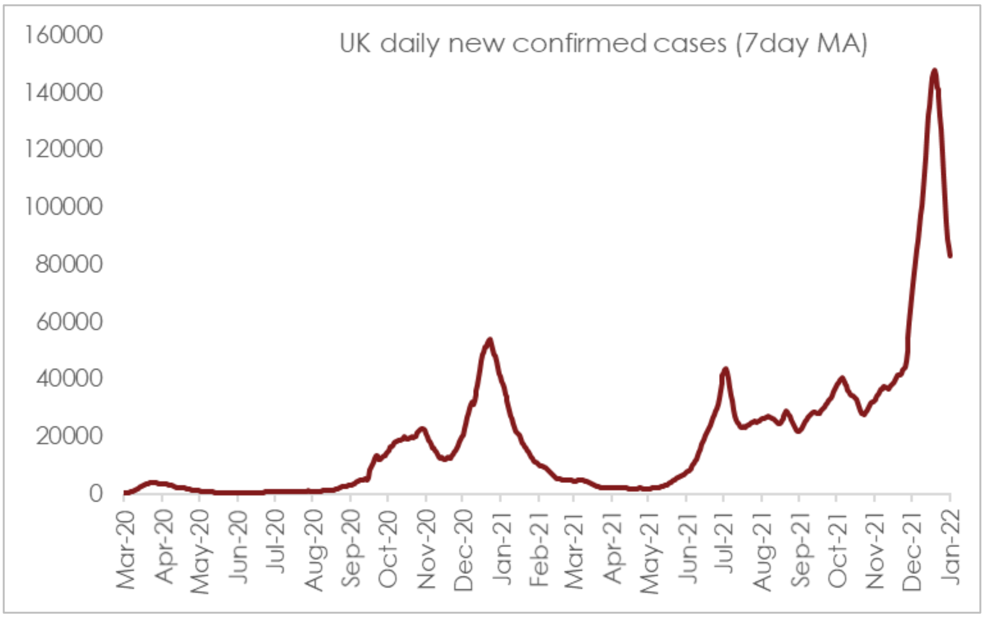
The US monetary policy expectations have shifted significantly in recent months, as inflation remains well above the Federal Reserve's 2.0% target and labor market recovery continues at a strong pace. At a congressional hearing recently, Chairman Powell indicated that "the economy should weather the current COVID-19 surge with only short-lived impacts and was ready for the start of tighter monetary policy". Markets are increasingly pricing in first hike in the Fed funds rate as early as in Mar-22.

UK

The monthly GDP for the economy grew by a strong 0.9%MoM in Nov-21, compared to a paltry 0.1% increase in Oct-21. With the improvement, which was led by services sector, the economy rose above its pre-pandemic peak. However, incoming Dec-21 data has begun to reflect the impact of Omicron wave and associated restrictions that were put in place in the month. Manufacturing PMI fell to 57.9 (from 58.1 previously), while the services PMI fell more sharply to 53.6 in Dec-21 (from 58.5 in Nov-21). However, the impact of the Omicron wave is likely to be shallow as Covid cases are seeing a sharp decline from a peak earlier this month. This should allow growth in economy to rebound more quickly. In fact, PM Johnson recently announced face masks no longer being mandatory in public places and schools and Covid passports being dropped for large events.

Consumer prices rose in UK by 5.4%YoY – to mark the highest level since Mar-92. The pickup was led by food along with services owing to higher transportation and storage prices. CPI inflation, as per official forecasts, is on track to peak at about 6.0% in Apr-22 i.e., three times the BoE's 2.0% target, before it begins to recede. Given the inflation trajectory, market participants are pricing in another 25 bps hike by the central bank at its upcoming meeting in Feb-22. Recall, with its first hike in Dec-21, BoE became the first major bank globally to embark on monetary tightening in the post pandemic phase.

<u>Chart 3: A sharp fall in COVID cases has led UK to begin easing restrictions</u>



EUROZONE

Incoming macroeconomic data for the Eurozone economy remains mixed while inflation hit yet another record high. Specifically, industrial production increased by 2.3%MoM in Nov-21, after a 1.3% contraction in Oct-21. However, the MoM gyrations were largely because of statistical issues in Irish production, which makes it difficult to interpret data. Unemployment rate eased marginally to 7.2% from 7.3% previously, despite COVID related restrictions. This underscores the strength in labour demand with vacancy rates breaking pre-pandemic highs. In a sign of business confidence remaining upbeat, the widely tracked German ZEW index unexpectedly rose sharply in Jan-22 to 51.7 from 29.9 previously, on expectations that incidence of cases will fall in the coming weeks.

Eurozone HICP inflation rose to 5.0%YoY in Dec-21 (vs. 4.9% in Nov-21), a record high. The acceleration was led by a combination of food and energy prices. While inflation is expected to begin to recede beginning Jan-22 (as Germany's tax cut completes a year and supply chain disruptions ease), it is nevertheless expected to remain above ECB's 2.0% inflation target through most of 2022. Despite this, ECB officials, including President Christine Lagarde, have indicated that they are in no hurry to raise interest rates, arguing that euro-area inflation will fall back to the bank's 2.0% target in due course.

CHINA

China's Q4 GDP data came in better than expected, on both sequential and annualised basis. The economy expanded by 1.6%QoQ (vs. 0.7% in Q3) with annualised growth coming in at 4.0% (vs 4.9% in Q3.). The recovery in sequential momentum in the last quarter of 2021 was owing to pick up in production, even as consumption and real estate sectors continued to display weakness. For the year as a whole, GDP growth stood at 8.1%YoY, to mark the fastest pace of expansion since 2011 vs. 2.2% in 2020.

However, headwinds to growth in 2022 remain amidst the spread of Omicron variant and China's zero-COVID policy. Several cities have gone into a lockdown beginning Jan-22 in a bid to control pockets of virus outbreak. This could lead to renewed supply chain disruptions, as the country heads towards the Lunar New Year holiday season beginning Feb-22.

In a bid to support growth, in its latest move, PBoC reduced its policy rate for 1-year Medium-Term Lending Facility (MLF) by 10 bps, to 2.85% - the first reduction since Apr-20. The PBoC also cut its 7-day reverse repo rate by 10 bps, to 2.10%. Recall, last month, the central bank had cut the Reserve Requirement Ratio (RRR) for banks by 50 bps, while the 1-year Loan Prime Rate was lowered by 5 bps, to 3.80%. Such piecemeal monetary easing can be expected to continue in the coming months in a bid to support the economy.

About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 9,000 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 Kanjurmarg, Mumbai.

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