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MACRO PULSE REPORT

July 2022

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From the desk of the Chief Analytical Officer

As we are about to celebrate the 75th independence day of our country, it is a pleasure to release the **nineteenth edition of Acuité Macro Pulse**, a comprehensive monthly publication on the Indian macroeconomic landscape which has proved to be valuable to bankers, corporate treasurers, policy makers and researchers.

Needless to say, high global inflation has been driving the narrative in macro-economic analysis for quite a while now. The consumer inflation print in developed economies had reached dangerously close to double digits, levels that they haven't seen in several decades. The story hasn't been very different in the emerging economies except in the extent of the rise. And it is not very difficult to understand the underlying reasons for such an unprecedented inflation wave just immediately after the Covid pandemic, which disrupted the global economy in 2020 and 2021. The prolonged pandemic had already damaged supply chains across the world and before they could recover, the geo-political conflict in Ukraine crippled supplies from Russia and Central Asia. To add to it, China went into intermittent lockdowns to adhere to its zero Covid policy.

There are indications, however, that the global inflation wave is gradually subsiding thanks to fears of a global recession that has led to a moderation in commodity prices. While we await the CPI print for the current quarter to get a clearer picture on the inflation trajectory in India, the latest data on consumer inflation from US raises hopes that prices may have already peaked in that country. In this context we should also recognise the important roles that governments are playing world-wide to address inflation. US has reportedly released some quantity from its strategic oil reserves to cool down crude oil prices and the Indian government have been taking steps from time to time such as imposition of export duty or reduction of import duty to moderate domestic food and commodity prices.

There is therefore, a case emerging for lower interest rate hikes globally than previously expected. Interest rates across most of the economies have already reverted to levels before the pre-pandemic and in some cases, even higher through several rounds of hikes by their respective central banks. Going ahead, one can expect that central banks would examine the inflation-growth dynamics closely before considering the next round of hikes. In India, the increased repo rate stands currently at 5.4%, 25 bps higher than what it was before the pandemic hit in Mar-20. RBI MPC may hit the hike button perhaps a couple of times more to take the repo rate closer to 6% by the third quarter before taking a pause.

Our AMEP (Acuité Macroeconomic Performance) Index has highlighted the resilience in the Indian economy by reaching a post pandemic record high in Q1FY23. While the base factor will distort the growth print for the previous quarter, we continue to hold on to our FY23 GDP forecast of 7.5%, slightly higher than the market average. A recovery in rural demand on the back of a reasonably healthy monsoon, the ongoing public sector capex and the catch up efforts of the contact intensive services sector are the likely engines of growth in the near term. Having said that, we can't wish away the risks off the table. The conflict in Ukraine continues to remain at a moderate level but what has started to bother analysts is the one emerging between China and Taiwan where there is also a strong involvement of US. Hope we don't get to see this one get escalated, fingers crossed. Happy independence day!

Suman Chowdhury
Chief Analytical Officer

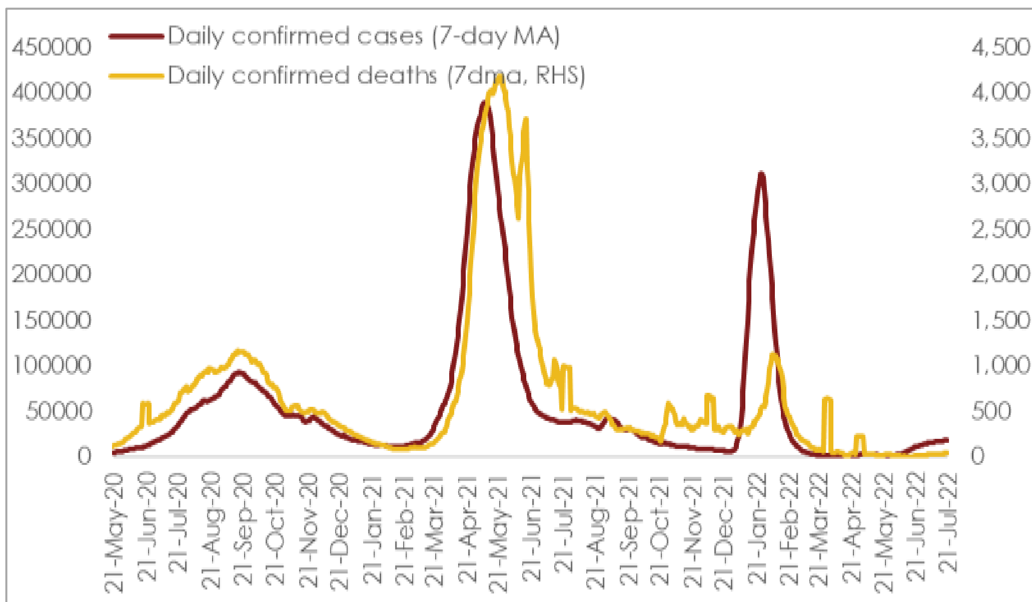
Growth

Cautious optimism prevails

KEY TAKEAWAYS

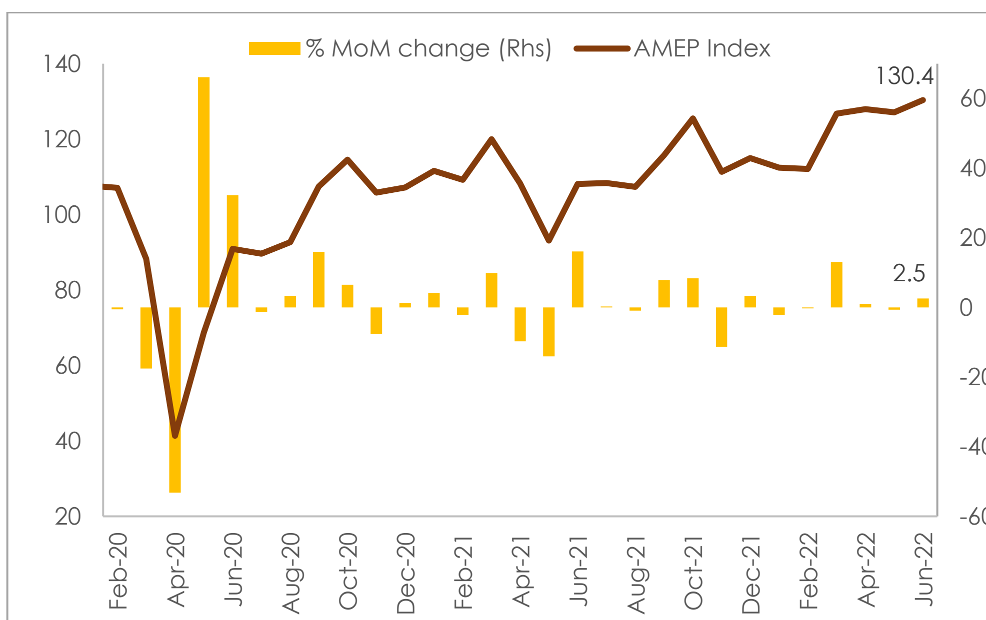
- Domestic economic activity continues to remain broadly resilient so far in FY23 notwithstanding the global headwinds. This is reflected in our **Acuité Macroeconomic Performance index (AMEP index)** which has hit a post pandemic high of 128.5 in Q1 FY23 from 117.1 in Q4 FY22.
- High frequency indicators continue to paint a largely positive story, with services outperforming amidst a complete normalization of economy and the high vaccination coverage in India.
- While Covid infections have again resurfaced and risen by nearly 25% over Jul-22, this has not affected personal mobility in a material way, especially for the purpose of retail and recreation.
- The moderation in global commodity prices definitely comes as support for the growth outlook in the current year. The softness is likely to provide producers some respite in the face of a sharp rise in input costs experienced in the last one year and improve their margins. In addition, the economic recovery fortunately has allies in the form of the ongoing revival in south-west monsoon activity in Jul-22 and Aug-22 and the expectation of a revival in rural demand as well as the capex focused central government expenditure.
- Given the highly favourable base factor of Q1FY22 when the economy faced the highly disruptive Delta wave of the Covid pandemic, GDP growth is set to be in double digits in Q1FY23. Assuming risks to be broadly balanced at this stage, we retain our FY23 GDP growth forecast at 7.5%.

Chart 1: Fresh rise in Covid cases but limited impact on mobility



Domestic economic activity continues to remain broadly resilient so far in FY23, holding its pace in the face of global geopolitics, elevated inflation, rapid global monetary tightening and a slowdown in demand across the world. For Q1 FY23, our AMEP index has remained resilient averaging at a post pandemic high of 128.5 in Q1 FY23 from 117.1 in Q4 FY22 with services sector indicators outperforming amidst a complete normalization of economy and high vaccination coverage. Although Covid infections have reported a sizeable increase, rising by nearly 25% over Jul-22, the rise in cases has affected personal mobility albeit marginally, especially for movement to parks and for the purpose of retail and recreation.

Chart 2: AMEP index treads a path of modest recovery



Recent data releases: A granular look at recovery

- India's industrial production surged to 19.6% YoY in May-22, compared to 6.7% in Apr-22 to mark the highest pace of growth in the past one year. The upside was clearly supported by a favourable base owing to the Delta wave of Covid concentrated over the months of Apr-May in 2021. Sequentially, while the index expanded by 2.3%MoM, it was lower than historical momentum of 5.5% usually seen in the month of May.
- India manufacturing PMI in Jul-22 hit an eight-month high of 56.4 from 53.9 in May-22. At a granular level, output and new orders strengthened leading companies to step-up input purchases.
- PMI for the services sector had expanded at the fastest pace in 11 years in Jun-22, rising 59.2 from 58.9 in May-22. However, it lost some momentum moderating to 55.5 in Jul-22 led by weaker revenue growth and still higher prices confining the uptick in business activity.
- Accordingly, the Composite PMI Output Index dropped in Jul-22 to 56.6 from 58.2 in Jun-22.
- GST collections for Jul-22 remained above Rs 1.4 lakh Cr for the fifth consecutive month coming in at 1.49 lakh Cr, clocking an annualised growth of 35% largely due to the base factor. This marked the second highest level of collection since the rollout of the new tax regime in Jul-17.
- Merchandise exports increased to USD 40.1 bn in Jun-22, a 3-month high and the second highest level on record. This translates into an annualized growth of 23.5%YoY and a sequential expansion of 3.1%MoM. However, early data indicates that exports have dropped significantly in Jul-22 due to not only the impact of the global slowdown but also due to imposition of export duty on several commodities.
- NONG (Non-oil-non-gold) imports, a key indicator of domestic demand, picked up to USD 42.3 bn in Jun-22 from USD 38.0 bn in May-22 but it is estimated to have slipped again in Jul-22.

Outlook

Despite unrelenting global headwinds, India's economic activity remained fairly resilient with a moderate momentum in Q1 FY23. Most of the lead indicators have been able to better their performance (also owing to a favorable base at play due to last year's Delta wave), despite elevated domestic inflation and some slowdown in external demand coming to the fore. With RBI firmly on a monetary tightening path, the rise in domestic borrowing costs by 140 bps since May-22 (with incremental tightening of 50-60 bps anticipated in this CY), is likely to weigh on growth impulses in H2 FY23.

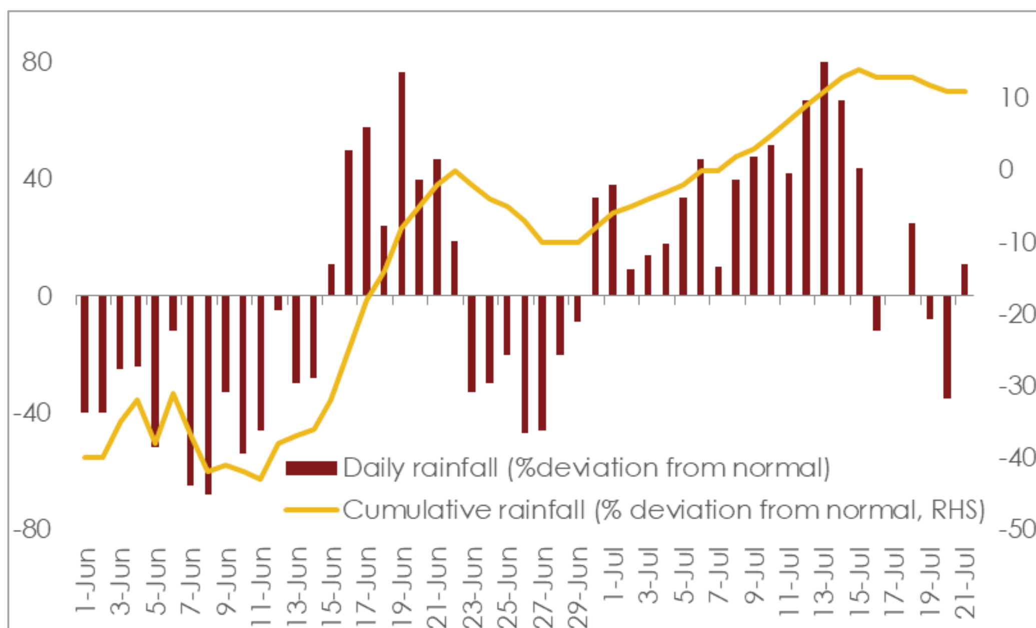
Having said so, the recent correction in global commodity prices definitely comes as a support for the domestic growth outlook. The softness is likely to provide producers some respite in the face of a sharp rise in input costs experienced in the last one year and encourage them to increase output. In addition, the economic recovery fortunately has allies in the form of:

- Revival in the south-west monsoon activity after a weak Jun-22 with cumulative rainfall between Jun 1, 2022 and Aug 9, 2022 clocking an 7.0% surplus vis-à-vis the long period average.

- Capex focused public expenditure with capex disbursal by the central government growing by 70.1%YoY over Apr-May FY23 compared to 14.0% growth in the corresponding period in FY22.
- High vaccination coverage (with around 70% of the population covered by two doses) that supports pent-up demand, especially for contact intensive services.

GDP growth is set to be in the range of 12%-16% YoY in Q1FY23, given the highly favourable base factor of Q1FY22 when the economy faced the highly disruptive Delta wave of the Covid pandemic. However, the growth trajectory for the current fiscal will be shaped by the momentum in the subsequent quarters. Assuming risks to be broadly balanced at this stage, we retain our FY23 GDP growth forecast at 7.5%.

Chart 3: Strong recovery in SW monsoon, cumulative rainfall currently 7% above LPA



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Inflation

Remains elevated, but has it peaked?

KEY TAKEAWAYS

- While inflation in the month of Jun-22 continued to remain elevated, the lack of sequential momentum in WPI inflation and the flattish CPI inflation print offered some comfort.
- A sizeable decline in the momentum of food prices along with the full impact of the cut in excise duties on petrol and diesel effected in May-22, getting reflected on retail side, were two broad positives.
- India's CPI inflation stabilized in Jun-22 at near 7.0% levels coming in at 7.01%YoY compared to 7.04% in May-22. With this, for Q1 FY23, CPI inflation averaged at 7.3%, that is 20 bps lower than RBI's projection of 7.5%, raising hopes that such a trend may be repeated for the coming quarters.
- Looking ahead, while the sharp decline in global commodity prices in recent weeks, a pick-up in monsoon in Jul-22 and steps from the government to rein in inflation bode well for inflation outlook, we believe it is still early to change our FY23 average inflation call of 6.7%.
- The sharp depreciation in Rupee, along with yet to reflect pipeline inflationary pressures (upward revision in electricity tariffs, GST rate hikes etc.) are upside risks that remain on watch.

Overview

While inflation in the month of Jun-22 continued to remain elevated, the lack of sequential momentum in WPI inflation and the flattish CPI inflation print offered some comfort. A sizeable decline in momentum of food prices along with full impact of cut in excise duties on petrol and diesel getting reflected on retail side, were two broad positives. While a sharp decline in global commodity prices in recent weeks along with a pick-up in monsoon in Jul-22, bode well for inflation outlook, it is not enough to warrant a change to our FY23 call just yet. The depreciation in Rupee, along with yet to reflect pipeline inflationary pressures (upward revision in electricity tariffs, GST rate hikes etc.) are upside risks that remain on watch.

Key highlights: CPI inflation

India's CPI inflation stabilized in Jun-22 at near 7.0% levels coming in at 7.01%YoY compared to 7.04% in May-22. While in line with consensus expectation (basis Reuters poll), headline inflation continues to remain elevated above the 7.0% mark for the third consecutive month and above RBI's upper threshold of inflation targeting band (i.e., 6.0%) for the sixth consecutive month. Having said so, there were two broad positives accompanying this CPI print:

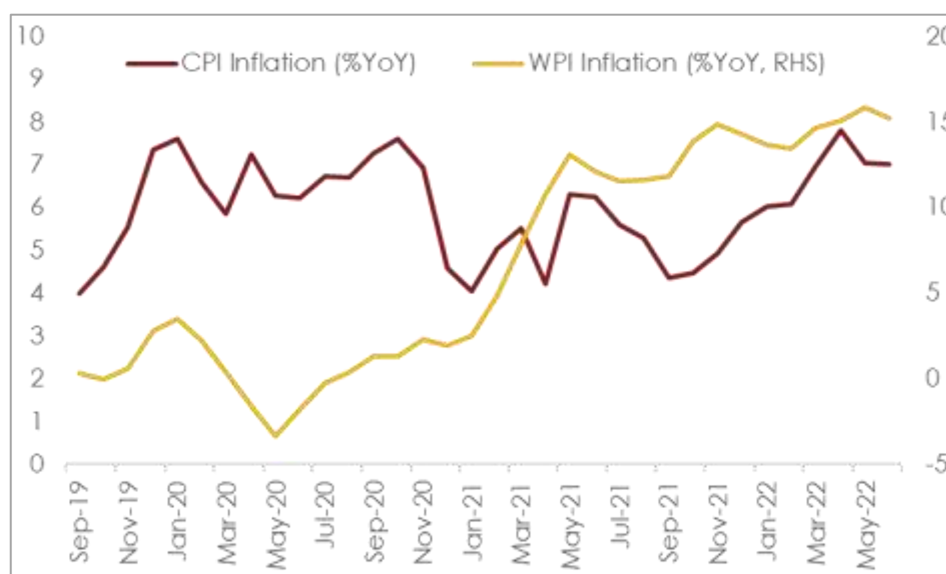
- One, for Q1 FY23, CPI inflation averaged at 7.3%, that is 20 bps lower than RBI's projection of 7.5%.
- Second, a broad-based slowdown in momentum was seen across food, fuel and core components of inflation due to the Government measures like the export ban on wheat and sugar along with the cut in excise duty on petrol and diesel announced in the month of May-22.
- Importantly, sequential CPI momentum halved to 0.52%MoM in Jun-22 from an average run rate of 1.1% over the months of Mar-May-22.
- Food and Beverages momentum led the downside as it eased to 0.92%MoM after remaining in the range of 1.3-1.4% over the previous three months. While prices of Vegetables, Meat & Fish and Eggs continued to see a sizeable increment in Jun-22, the decline in price of Fruits, Edible Oils (for the first time in five months) and pulses capped the upside.
- Consolidated fuel prices declined by 0.59% MoM, marking the first drop in last six months. This was owing to a downward adjustment in retail price of petrol and diesel (post the excise duty reduction in third week of May-22) along with sequential decline in price of other fuel items such as Coke, Charcoal, and Electricity.
- Core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel in Miscellaneous) momentum eased to 6.22% YoY in Jun-22 from 6.41% YoY in May-22, backed by seasonal contraction in Housing, continuing subdued price pressures in Pan, Tobacco & Intoxicants, and marginal moderation of momentum seen in case of Clothing & Footwear, Health, and Recreation & Amusement.

Key highlights of WPI inflation

WPI inflation too eased marginally in Jun-22 to 15.18%YoY from 15.88% in May-22, with the index remaining unchanged from previous month. This marked the lowest sequential momentum in as many as six months.

- The sequential momentum in consolidated food prices eased for the second consecutive month to 1.25%MoM in Jun-22 from 1.91% in May-22. This was largely driven by a strong correction in price of manufactured food items in the month. Nevertheless, the momentum remains elevated on the back of summer seasonality in vegetable prices and late arrival of monsoon (price spike seen in case of Onions and Potatoes) and persistent global supply disruptions. As such, annualized consolidated food inflation touched a near 8-1/2 year high of 12.36% in Jun-22 vs. 10.97% in May-22.
- The trend is similar in case of fuel and power prices, that saw sequential momentum moderate to 0.65%MoM in Jun-22 compared to 2.25% in May-22 on account of moderation in price of LPG, Naphtha, Bitumen and Furnace Oil. Nevertheless, the annualized inflation for the category remained elevated at 40.38% in Jun-22 from 40.62% in May-22.
- Manufacturing WPI registered its first sequential contraction in six months, with prices dropping by a sizeable 0.75%MoM. The decline was led by index-heavy weights of Base metals and Food, along with that of Furniture and 'Other manufacturing'.

Chart 1: CPI and WPI inflation both edged lower in Jun-22



Outlook

In our last report, we had highlighted some upside risks to the overall sequential momentum in CPI inflation. Given the global and domestic developments since then, two of these risks have abated materially:

- Global commodity prices have seen a sharp correction in recent weeks as risk of a pronounced global growth slowdown amidst aggressive monetary policy tightening in several countries has gained ground. India crude basket, after averaging at USD 109 pb and USD 116 pb in May-22 and Jun-22 respectively, has moderated to USD 105 pb in Jul-

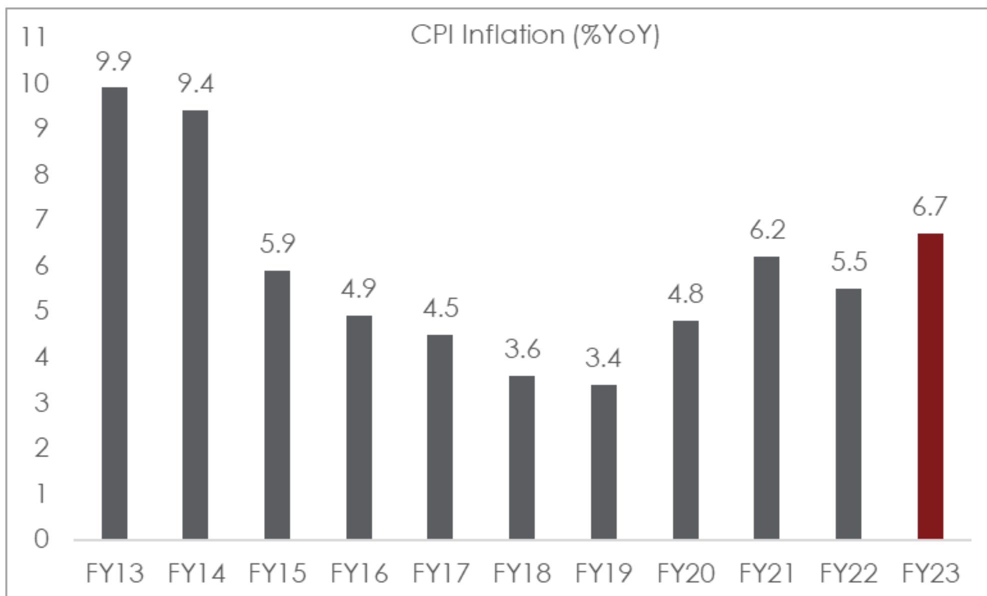
22. The CRB Commodity Index has declined by 13% in Jul-22, marking its first monthly fall in 2022. The pass-through of this correction could offer some reprieve to domestic price pressures.

- Owing to a slow advancement, the country received less than normal rainfall in the month of Jun-22 at 8% below LPA (Long Period Average). However, since the start of Jul-22, rainfall activity has picked up pace with cumulative rainfall for the season swinging into a 7% surplus (as of Aug 9, 2022). Despite this, sowing of rice continues to lag, though a delayed catch-up has been seen for other crops. The intertemporal and geographical spread of monsoon remains on watch, as a pick-up in Kharif sowing will be critical to assuage food price pressures especially in the post-harvest season i.e., Sep-22 onwards.

Negating these positives somewhat, is the increased risk of imported inflation with the depreciation in the Rupee. While INR has outperformed vis-à-vis many peers, it nevertheless has depreciated by 5.5% in FY23 so far. On balance, it appears that the correction in global commodity prices could outweigh the impact of Rupee depreciation, going forward from an inflation perspective.

Overall, we see the upside and downside risks balancing each other and hence maintain our FY23 CPI inflation forecast of 6.7%.

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



Government Finances

FY23 fiscal risks on watch

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Jun stood at 21.2% of budget estimates (BE) for FY23 compared to 17.3% of actuals in the corresponding period of FY22.
- Higher accretion to FYTD fiscal deficit this year is on account of larger expenditure disbursal while non-tax revenue has lagged on account of lower than budgeted RBI dividend payout.
- Fiscal headwinds have gathered momentum and on a cumulative basis, they can potentially cause a slippage in the FY23 budgeted fiscal deficit ratio pegged at 6.4% of GDP.
- Nevertheless, we continue to believe that the central government might be able to scrape through and get close to the budgeted target on account of persistence of tax buoyancy, recent upward adjustments in some of the indirect tax rates, disinvestment rollover buffer, and strong likelihood of higher than budgeted Nominal GDP base.

India's central government fiscal deficit for the period Apr-Jun stood at 21.2% of budget estimates (BE) for FY23 compared to 17.3% of actuals in the corresponding period of FY22. The higher accretion to FYTD fiscal deficit this year is on account of larger expenditure disbursal while non-tax revenue has lagged so far.

Receipts: Comfort on tax buoyancy continues

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

- On FYTD (Apr-Jun) basis, gross tax revenue clocked 23.5% of BE compared to 19.6% of actuals in the corresponding period in FY22.
    - Momentum in gross tax revenue was supported by GST, income, and corporate tax collections. We note that the impressive momentum in GST revenue continues to persist with total monthly collections averaging at Rs 1.5 tn during Apr-Jul FY23 compared to the required monthly run rate of Rs 1.35-1.40 tn for meeting the BE. Recent revision in GST rates for select goods and services would help in maintaining the healthy run rate in the coming months.
    - Meanwhile, collections from customs and excise were moderately lower in comparison. Moderation in customs and excise could be reflective of relaxation in duties on select import items to provide relief from elevated inflation.
- Non-debt capital receipts clocked 35.3% of BE during Apr-May FY23 vis-à-vis 18.9% of actuals in the corresponding period in FY22. This predominantly reflects the disinvestment proceeds from LIC in May-22 that fetched Rs 205 bn to the central exchequer.

On the other hand, non-tax revenue (led by dividend transfer from the central bank) moderated to 23.1% of BE during Apr-Jun FY23 from 36.1% of actuals in the corresponding period in FY22.

- RBI's dividend for FY22 (transferred in May-22) stood at Rs 303 bn, a sharp drop vis-à-vis a high of Rs 991 bn of transfer done in the previous financial year. Lower dividend was on account of escalation in provisions on the back of MTM losses on foreign currency assets from rise in bond yields globally.

Expenditure: Disbursals show a pick-up

On FYTD (Apr-Jun) basis, total expenditure disbursal stood at 24.0% of BE, up from 21.7% of actuals in the corresponding period in FY22.

- The increased momentum was led by capital expenditure that clocked 23.4% of BE during Apr-Jun FY23 vis-à-vis 18.8% of actuals in the corresponding period in FY22. In order to facilitate capex by states, the FY23 Union Budget had made provision for disbursing Rs 1.1 tn interest-free loans to states with attached conditionalities for targeted spending. In this context, we note that loans disbursed under central government's capex has grown by a staggering 364.1% YoY (aided by a favourable statistical base effect) during Apr-Jun FY23 vis-à-vis a contraction of 77.2% in the corresponding period in FY22.
- Revenue expenditure increased to 24.2% of BE during Apr-Jun FY23 from 22.2% of actuals in the corresponding period in FY22.
    - Expenditure on subsidies declined on account of a fall in expenditure on food subsidies.

Outlook

Fiscal headwinds have gathered momentum and may cause a slippage in the FY23 budgeted fiscal deficit ratio of 6.4% of GDP.

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

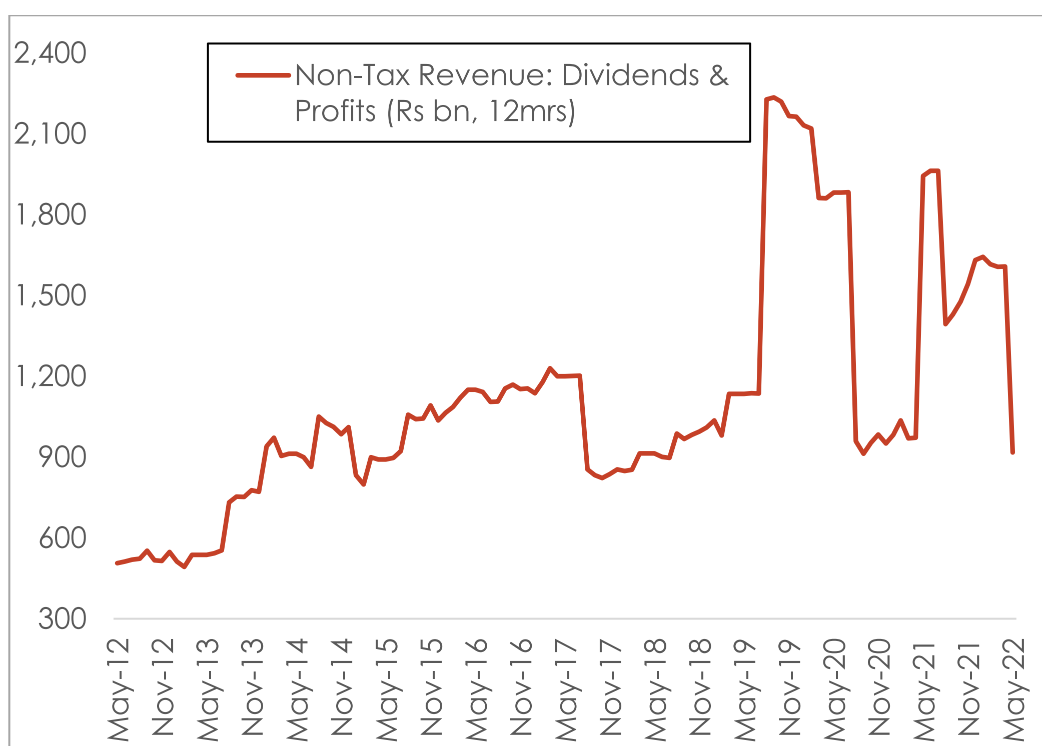
Nevertheless, we continue to believe that the central government might be able to scrape through and get close to the budgeted target due to the following factors:

- Tax buoyancy continues to remain strong as reflected in GST collections. In addition, the recent increase in GST rate for select items, customs duty on gold imports and imposition of a windfall tax on oil producers could offset some of the revenue loss from cut in excise duty on retail fuel items.
- The rollover of LIC IPO (garnering Rs 205 bn) has already generated some divestment buffer
- Similar to FY22, led by the surge in inflation, there is once again a high possibility of Nominal GDP growth turning out to be higher than the conservative budgeted assumption of 11.1%.

Table1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position for FY22)			
Fiscal Variables	% of Actuals	% of BE	Cumulative (INR bn)
	FY22	FY23	Apr-May'22
Revenue Receipts	24.9	25.8	3568.4
Net Tax	22.7	26.1	3075.9
Non-Tax	36.6	23.1	492.5
Non-Debt Capital Receipts	18.9	35.3	250.1
Total Receipts	24.8	26.1	3818.5
Revenue Expenditure	22.2	24.2	5857.74
Capital Expenditure	18.8	23.3	1054.22
Total Expenditure	21.7	24.0	6911.96
Fiscal Deficit	**17.3**	**21.2**	**2039.21**

Chart 1: CG revenue from dividends and profits seen a sharp decline in FY23 so far



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Rates

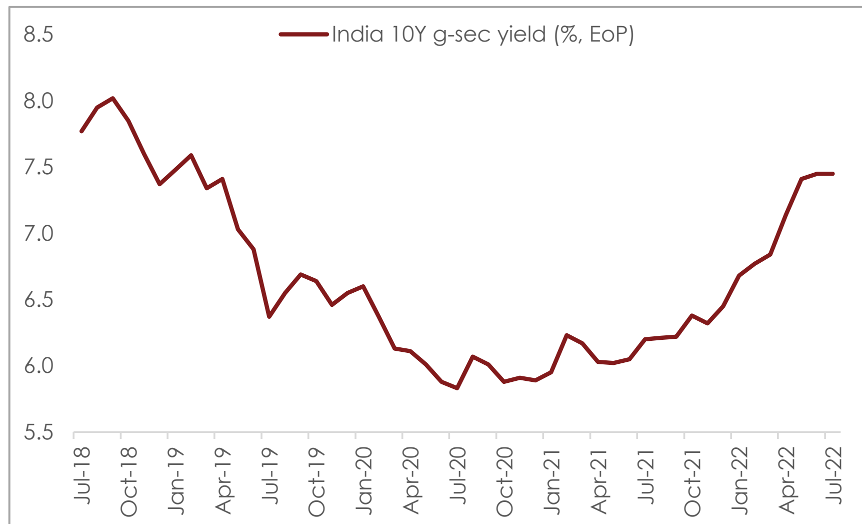
Continue the path of ascent

KEY TAKEAWAYS

- After closing the month of Jun-22 at 7.4%, India's 10Y g-sec yield has settled down to a range of 7.2%-7.3% in Jul-22 and early Aug-22 albeit with moderate volatility.
- Accelerated monetary policy tightening by key central banks (led by the US Fed) and resurgence of Covid infections in few countries (esp. China) has raised the possibility of a material slowdown in global economic growth, thereby resulting in a correction in global commodity prices from their June peak levels.
- On the domestic front, improvement in south-west monsoon and kharif sowing bodes well for food inflation in the coming months and raises hopes that headline inflation may have peaked for the current fiscal.
- RBI MPC, largely in line with expectations has hiked the benchmark repo rate for the third time in the current cycle by 50 bps, taking the total hike to 140 bps. We believe that such an action is not only driven by continuing concerns on inflation but also by the visible pressures on the external front and the rupee.
- We also believe that the 10Y g-sec yield has peaked out with possibility of range bound trading between 7.20-7.60% levels in the remaining months of FY23.

After closing the month of Jun-22 at 7.4%, India's 10Y g-sec yield has settled down to a range of 7.2%-7.3% in Jul-22 and early Aug-22 albeit with moderate volatility.

Chart 1:10Y g-sec yield remained broadly stable in 7.3-7.5% range in last 2 months



Emergence of supportive global developments

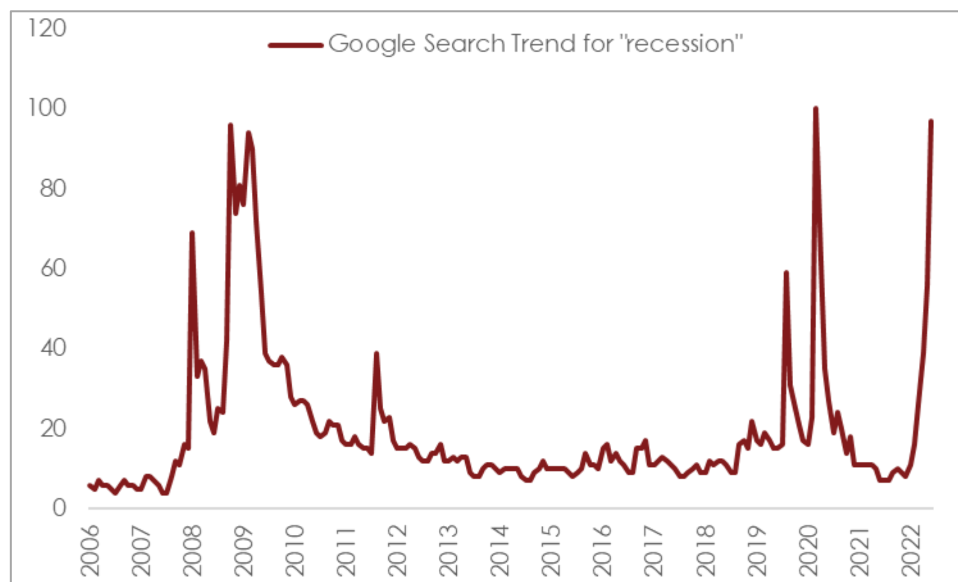
The month of Jun-22 and Jul-22 turned to be important for the global economy with crucial shifts in market sentiment.

- Prompted by yet another multi decade high inflation print of 8.6% and 9.1% YoY in May and Jun-22, the US Federal Reserve hiked its fed funds rate by 75 bps for two consecutive times, the last being in late July. This aggressive move by the Fed, imparted pressure on many DM and EM central to up the pace of monetary tightening in their respective countries resulting in market participants pricing in higher monetary policy trajectory across the globe. There is expectation of another 75 bps hike by the Fed in Sep-22 although the latest inflation print released for Jul-22 at 8.5% indicates that inflation may have peaked in US.
- Covid cases resurfaced in many countries (China in particular), with daily cases recording a 70-71% monthly jump in both May-22 and Jun-22 respectively. But the scenario seems to be improving from Jul-22 with removal of most travel restrictions in China.

Both these factors have led market participants to reassess their expectation of global economic growth even as the geopolitical uncertainty from Russia-Ukraine war continues to linger on. The IMF also in its latest World Economic Outlook report has revised lower its global growth forecast by 40 bps to 3.2% in 2022.

The Global PMI-Manufacturing slipped to 52.2 in Jun-22, its lowest level since Aug-20 with its sub-component of new export orders remaining below the 50 mark (indicating contraction) for third consecutive month. While we are not in the camp of forecasters projecting a global economic recession in 2023, the risk of a material slowdown has increased with most central banks opting for suppression of demand (to curb inflation pressures) even as global supply disruptions are yet to get normalized completely.

Chart 2: Recession concerns have picked substantially up in last 2-months



The growing risk of a material slowdown in global demand has weighed upon most global commodity prices (with price of Brent oil along with key industrial metals falling by 17% and 11-33% from Jun-22 peak respectively).

This has muted the upside risks to India's inflation to some extent. Although the annualized headline WPI inflation is still elevated (at 15.2% in Jun-22), sequential momentum has weakened considerably.

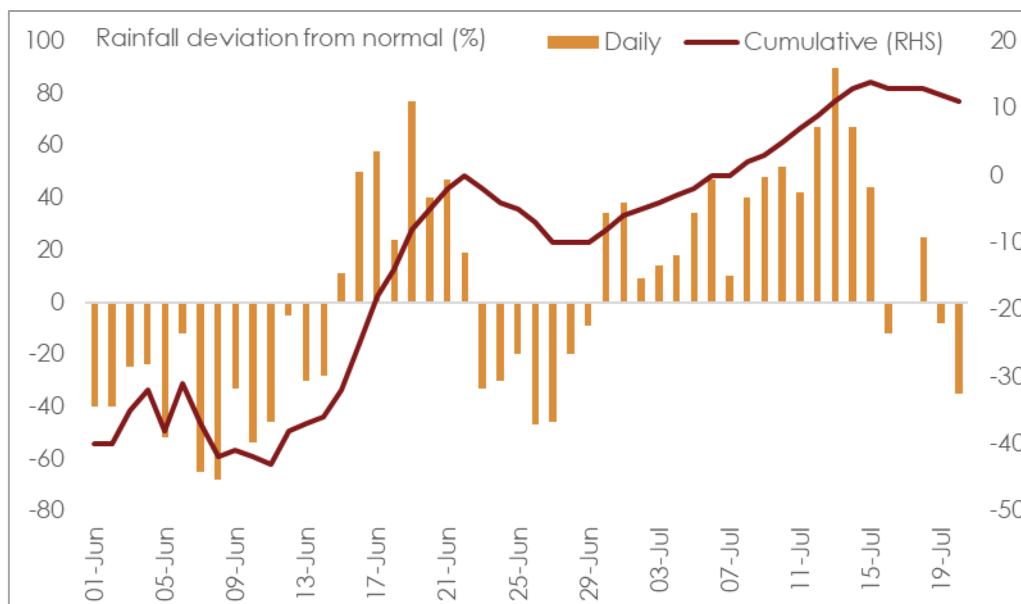
Monsoon progress bodes well

On the domestic front, after a disappointing start, the south-west monsoon did an impressive catch-up registering a cumulative rainfall of 7% above the long period average (as of the first week of Aug-22).

As such, kharif sowing activity has started to pick up with acreage improving to 592.1 lakh hectares (0.1% growth as of Jul 15) compared to 591.3 lakh hectares in the corresponding period in 2021. There is considerable traction in sowing of pulses (+9.0% YoY), coarse cereals (+7.9% YoY), oilseeds (+7.4% YoY), and cotton (+6.4% YoY). Among major crops, paddy sowing (-17.4% YoY) however continues to lag due to relatively poor rainfall in UP and Bihar.

If this trend is maintained, then it could have a salubrious impact on domestic food inflation in the coming months, especially in H2 FY23, when the kharif output comes to the market.

Chart 3: Monsoon performance has picked up post a delayed onset



Outlook

Amidst the unfolding of the above-mentioned global and domestic factors, the buildup of excessive risk for g-secs yields no longer appears threatening. However, upside risks do persist. With Fed in its latest policy review increasing interest rates by another 75 bps in late July-22, many central banks have started to reposition their respective monetary policy trajectory amidst increasing pressure on currency (with few EM central banks announcing rate hikes in unscheduled meetings). While INR's 5.5% FYTD depreciation against the USD appears moderate compared to other DM and EM peers, risk of further weakness is likely amidst pressure on current account deficit and portfolio outflows.

As such, the RBI would be under moderate pressure to normalize interest rates – India is now one of the few economies where the cumulative hike in interest rates (140 bps) is still moderate compared to some of the developed economies. With CPI inflation still remaining above 7% levels, we expect the MPC to go for additional hikes of 50-60 bps over the next 2 quarters. Given the expected moderation in the headline inflation print by that time, we expect a temporary pause thereafter to assess the pass through and its impact.

As such, our 10Y g-sec yield expectation has been revised to a band of 7.2%-7.6% over the remaining part of FY23. We continue to expect the central bank to rely on tools like Operation Twist and verbal suasion, to support yields and ensure an orderly completion of government's record high borrowing program in FY23.

Rupee

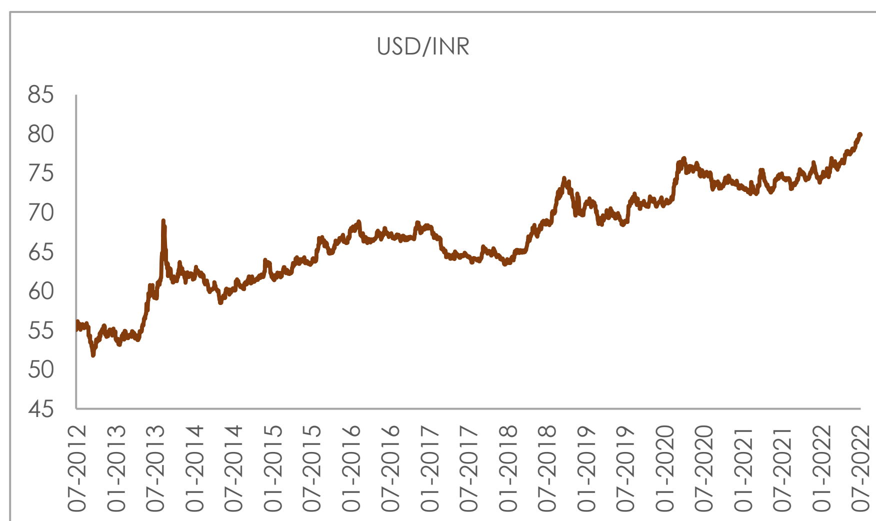
Still in the vulnerable zone

KEY TAKEAWAYS

- After closing Jun-22 at a level of 79, the Indian rupee weakened further breaching the 80 level currently in Jul-22 before retreating partially to the band of 79.0-79.5 levels.
- The dollar is expected to continue deriving support from aggressive pricing in of monetary tightening in the US, ongoing quantitative tightening, along with geopolitical led risk aversion.
- On the domestic front, while pressure on India's BoP has been escalating since Q4 FY22, the coming quarters could see a moderate degree of deficit vis-à-vis Q1 FY23 on account of the correction in global commodity prices, tapering of portfolio outflows, and the series of macroprudential steps undertaken by the RBI.
- Nevertheless, INR could continue to carry a mild depreciation bias as (i) exchange rate adjustment would be a natural stabilizer for expansion of current account deficit, and (ii) excessive use of reserves to curb depreciation pressures amidst the backdrop of broad-based dollar strength would increase INR's real effective overvaluation vis-à-vis peers.
- Nevertheless, we expect INR to stabilize in the band Rs 79-81 by March 2023 with the moderation in commodity and crude oil prices and the prospects of some reversal of the sharp capital outflows seen over the last six months.

After closing Jun-22 at a level of around 79, the Indian rupee weakened further breaching the 80 level currently in Jul-22. With this, the Indian rupee has weakened for seven straight months culminating into a depreciation of 7.7% in calendar 2022 so far. The last time rupee saw seven consecutive months of weakness was against the backdrop of the domestic NBFC crisis in 2018.

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



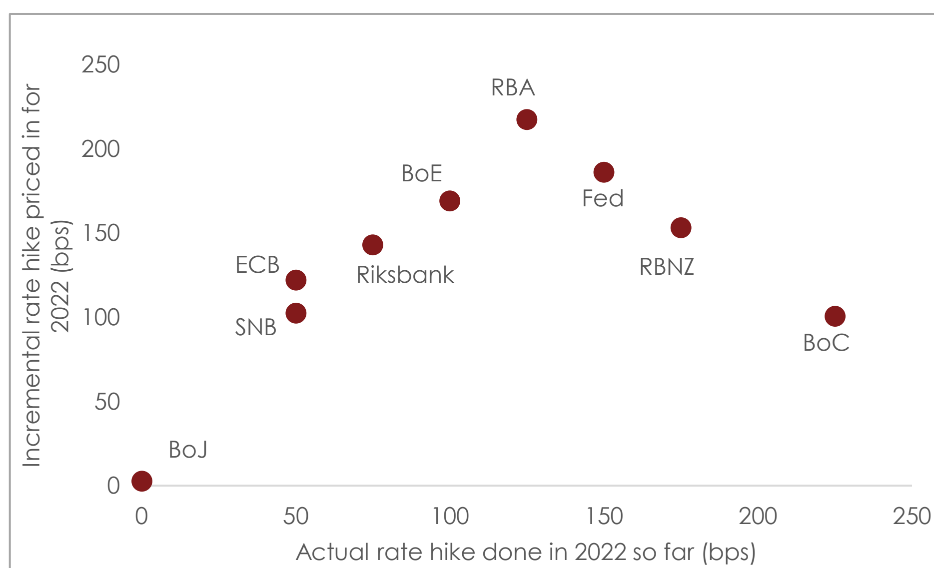
The broad theme driving rupee weakness has continued to remain intact for the last 6-7 months. We continue to believe that there is room for further weakness, albeit to a moderate extent.

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

- After hiking monetary policy rate by 225 bps so far in 2022 to 2.25-2.5%, the US Federal Reserve is expected to hike interest rates at least by another 100 bps during the remaining months of 2022. Cumulatively, this would tantamount to about 350 bps rate hike during the calendar year 2022, making it the most aggressive rate hike cycle since the Volcker era.
    - Meanwhile, the Fed has also commenced quantitative tightening from Jun-22 to further combat inflation risks. The monthly pace of QT will involve USD 47.5 bn selling of securities before getting to a "max" of USD 95 bn in Sep-22. The unwinding of the Fed balance sheet would curb global dollar liquidity and thereby provide a supplementary tailwind to the USD.

The dollar (DXY) Index (at 105-106 levels) currently trading at its strongest since 2002, has managed to offset the moderate comfort that would have ideally accrued to major EM currencies from the recent correction in global commodity prices.

Chart 2: The US Fed comes across as the most hawkish DM central bank



On the domestic front, pressure on India's BoP has been escalating since Q4 FY22. Monthly trade data for Q1 FY23 shows a significant expansion of the merchandise deficit to a record high level of USD 70.9 bn. Together with USD 14.4 bn portfolio outflow during the quarter, the Net BoP position could turn out to be in the USD 15-20 bn deficit range.

Annualized projection of this quarterly BoP trend for the remaining three quarters would make the full year (FY23) picture appear ominous. While we continue to expect FY23 BoP to post a sizeable deficit of USD 33 bn, the size of the deficit could potentially moderate in the coming quarters:

- Most commodity prices have corrected significantly in last 3-4 weeks on account of growing concerns of a global hard landing (led by the US and Chinese economy). The Reuters CRB Commodity Index has fallen by 10% on monthly average basis in Jul-22, registering its first monthly decline in 2022 so far. This could provide moderate relief to India's trade deficit in the coming months.
- While portfolio outflow has persisted for tenth consecutive month, the magnitude has tapered considerably with Jul-22 registering a meagre inflow of USD 0.5 bn. We believe that the sentiment could further stabilize somewhat in the coming months as inflation peaks out in US and correction in asset prices provide opportunities for churning the investment portfolio.
- Recently, the RBI has also announced a series of steps to augment capital inflows in the near term.
    - With an aim to incentivize NRI deposits, the central bank granted CRR and SLR exemption to banks (on incremental FCNR(B) and NRE term deposits) up to Nov 4, 2022. In addition, banks have also been permitted to raise fresh deposits (FCNR(B) and NRE) without reference to extant regulations on interest rates - this relaxation will be available up to Oct 31, 2022.

- Further, to incentivize debt investment by the FPI and to increase the choice of G-secs available for investment by NRI, the central bank has now expanded the FAR (Fully Accessible Route) basket to include all new issuances of 7Y and 14Y g-secs from an access of just 5,10 and 30 year tenors earlier. In addition, limits on short term investments (in securities with residual maturity of less than 1Y) in g-secs and corporate bonds have been exempted until Oct 31, 2022. Further, investment in corporate money market instruments with original maturity of up to 1Y can now be done (up till Oct 31, 2022), with such investments to be treated as outside reckoning for considering the short-term limit for investments in corporate securities.
- In a move to promote global trade and to support increasing global interest in rupee, the RBI announced a mechanism to settle tractions in rupee terms. While in the short run this reform is not expected to lead to any immediate surge in rupee trade settlement, in the long run internationalization of INR could help to reduce the demand for dollars, cap large-scale depreciation pressures for the rupee and help preserve forex reserves.

That said, we believe that INR could continue to carry a mild depreciation bias as (i) exchange rate adjustment would be a natural stabilizer for expansion of the current account deficit, and (ii) excessive use of reserves to curb depreciation pressures amidst the backdrop of broad-based dollar strength would increase INR's real effective overvaluation vis-à-vis peers.

To conclude, Acuité believes that the INR may stabilize in the band Rs 79-81 by March 2023 with the expected moderation in commodity and crude oil prices and the prospects of some reversal of the sharp capital outflows seen over the last six months.

Global Overview

War against inflation

KEY TAKEAWAYS

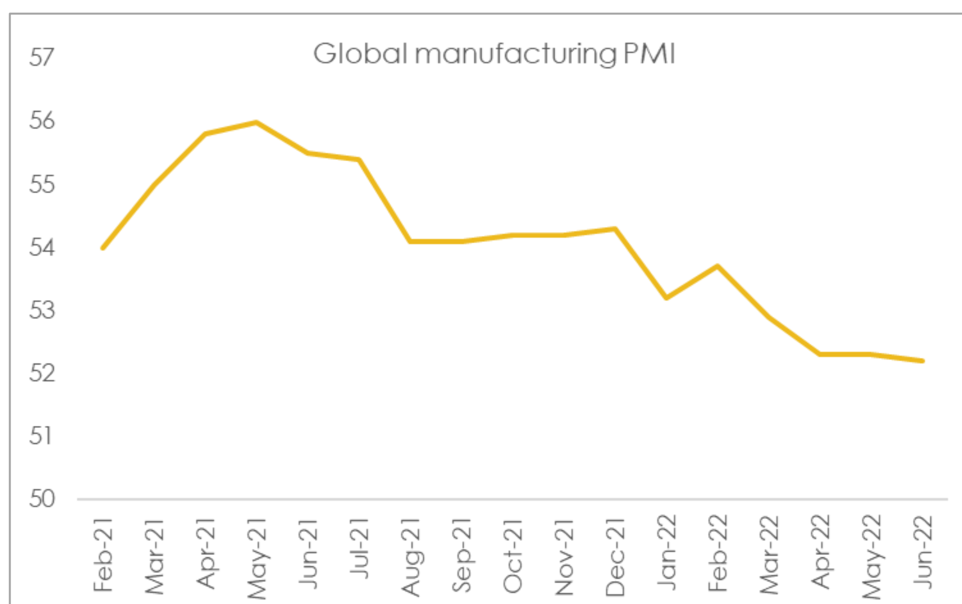
- Global macroeconomic and financial market commentary in the month of Jun-22 was dominated by two themes – both of which gained further strength in Jul-22.
- First, the cool down in commodity prices, and second, central bank monetary policy tightening becoming more pervasive and aggressive (on the heels of Fed's latest 75 bps hike).
- Concerns of still elevated inflation, resilience in labour markets, and exchange rate pressure in some countries have wielded central bank to act more aggressively, overlooking downside risks to growth and in turn raising concerns of an imminent hard landing or even recession in several economies.
- On the monetary policy front, a string of sizeable rate increases by the Federal Reserve, including 75 bps in both Jun-22 and Jul-22, have put pressure on central banks around the world to follow suit to counter soaring inflation and the strong dollar.
- In a little over three months since Apr-22 to date, of the nearly 76 instances of policy rate increases made by 36 key central banks we track, close to about 58 were of 50 bps quantum or higher. This marks the biggest number of large rate moves in the history of monetary policy tightening.

Global Overview

Global macroeconomic and financial market commentary in the month of Jun-22 was dominated by two themes – both of which gained further strength in Jul-22. First, the cooling off in commodity prices, and second, central bank monetary policy tightening becoming more pervasive and aggressive (on the heels of Fed's latest 75 bps hike). Concerns of still elevated inflation, resilience in labour markets, and exchange rate pressure in some countries have wielded central bank to act more aggressively, overlooking downside risks to growth and in turn fuelling concerns of an imminent hard landing/recession in several economies.

Reinforcing the downside in growth, global manufacturing PMI dropped further to a 2 year low of 51.1 in Jul-22 from 52.2 in Jun-22 and 52.3 in May-22. The deterioration was driven by DMs, primarily US and Eurozone. Meanwhile, the aggregate index for EMs rose above 50 mark for the first time since Feb-22; mainly driven by lesser lockdowns in China. Overall, the global picture appears to be one of improving supply side coupled with an orchestrated weakness on the demand side arising from higher interest rates.

Chart 1: Global manufacturing PMI dropped to a near 2-year low in Jul-22



On the commodities front, the Reuters CRB index has eased by nearly 12% by first week of Aug-22 since its peak in early Jun-22, in a reflection of a tighter monetary policy, looming recession concerns, Europe's impending energy crisis (as Russia restricts supplies) along with China's strict zero-Covid policy amidst a rise in local cases. Copper recorded the biggest drop with prices falling to USD 7,000/tonne for the first time since Nov-20. Copper prices are now 24% lower than those recorded in early June and 34% lower than the record high seen in Mar-22. In similar vein, Brent crude oil prices slipped briefly below USD 95 pb in Jul-22 for the first time since the onset of the Ukraine-Russia crisis, though currently are trading near USD 100 pb. Reflecting this softness, global manufacturing PMI sub-indices for input and output prices eased in Jun-22. The aggregate component for input prices dropped to a 4-month low of 68.6 from 70.3 in May-22, while the component for output prices fell to a 6-month low of 60.5 from 61.5 in May-22. This moderation is likely to get more pronounced in the Jul-22 readings.

On the monetary policy front, a string of sizeable rate increases by the Federal Reserve, including a 75 bps hike for the second consecutive time in Jul-22, has put pressure on central banks around

the world to follow suit to counter soaring inflation and the strong dollar. After lagging the rest of the world, including Emerging Markets in particular, Asian central banks are playing catch-up now. In Jul-22, monetary authorities of both Singapore and Philippines (75 bps hike) surprised markets with unscheduled tightening announcements, underlining the growing urgency among policymakers to act. South Korea’s central bank too made its first 50 bps increase in Jul-22. The BoK sent a strong signal to the market that it is willing to do what is necessary to meet its inflation target mandate, with the 50 bps hike being a pre-emptive response to avoid locking in high inflation.

Among the DM central banks, ECB after a hiatus of 11 years, hiked its policy rate by 50 bps, beating market expectations of a 25 bps increase. Canadian policymakers too earlier this month had surprised markets with a bigger than expected rise i.e., opting for a 100-bps increase - the largest by any G7 economy since 1998. In addition, Norges Bank i.e., Norway's central bank too delivered a larger monetary policy increase, as it raised its policy rate by 50 bps to 1.25% in a hawkish surprise. Norges Bank cited strong activity, limited spare capacity within the economy, and inflation that is above target and with prospects that it will remain so for some time. With respect to policy, Norges Bank said it expects to raise interest rates by 25 bps at its Aug-22 meeting but did not rule out further 50 bps hikes. Last month, the Swiss National Bank (SNB) raised its policy rate for the first time in 15 years as inflation hit a 29 year high of 3.4% in Jun-22.

In a little over three months since Apr-22 to date, of the nearly 76 instances of policy rate increases made by 36 key central banks we track, close to about 58 were of 50 bps quantum or higher. This marks the biggest number of large rate moves at any time since the turn of the millennium and definitely surpassing the pace and magnitude of increase seen in the last global monetary tightening cycle i.e., in the run-up to the global financial crisis.

US

After an above trend growth last year, the US economy is clearly on a moderating growth trajectory in 2022 the signals of which have mounted over the last one month. In its third estimate, US GDP growth fell by 1.6% on an annualized basis in Q1, revised down from 1.5% earlier. This marked the first drop in GDP since the onset of the pandemic led recession. For Q2-22, the USD GDP contracted for the second consecutive quarter by 0.9% thereby entering a technical recession (two consecutive quarters of negative growth). However, the slowdown in growth has coincided with a labour market which is at full employment. US labour markets continue to remain tight. Nonfarm payrolls increased by 528k in Jul-22, continuing to reinforce a strong year for jobs growth in the US. The unemployment rate reduced marginally to 3.5%. An alternative measure of unemployment that accounts for discouraged workers and people who hold part-time jobs dropped significantly, from 7.1% in May-22 to 6.7% in Jun-22.

The most critical economic indicator on watch i.e., of CPI inflation increased to 9.1%YoY in Jun-22, to exceed the consensus estimate of 8.8% - marking the fastest rate of inflation since Nov-81. Excluding volatile food and energy prices, core CPI rose 5.9%YoY, compared to a forecast of 5.7%. On a monthly basis, headline CPI rose by a strong 1.3%MoM while core CPI rose by 0.7 %MoM.

Nevertheless, the latest data released for Jul-22 highlights that the CPI print has slowed more than expected to 8.5% in July of 2022 below market forecasts of 8.7%. Compared to the

previous month, the CPI was unchanged, after hitting a 17-year high of 1.3% in Jun-22. Core inflation was steady at 5.9% and offering some support that inflation has finally peaked.

Looking ahead, further relief on the inflation front looks set to come from lower global

commodity prices. Gasoline prices have retreated a little over 7% since mid-June. Lower shipping costs, shorter delivery times and rising inventories also suggest price pressures easing for core goods. Having said so, the moderation in inflation to the 2% target is likely to be only gradual and over a prolonged period.

Strong employment data and higher than expected Jun-22 CPI inflation, has led Fed to increase interest rates by another 75 bps taking it to 2.25%-2.50%. With 225 bps of rate increase in the current interest rate cycle so far, the Fed continues to have material concern on inflations. The current dot plot projection indicates to another 100 bps rate hike to 3.25%-3.50% by Dec-22.

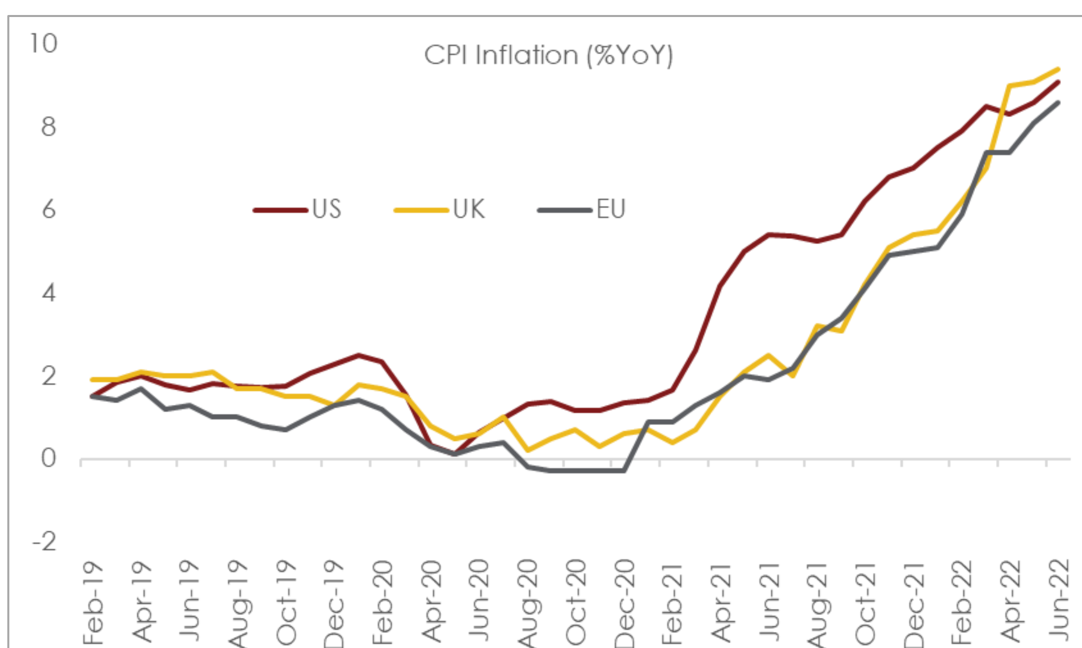
EUROZONE

The European Central Bank (ECB) raised interest rates for the first time since 2011, by delivering a 50 bps hike in a bid to tackle inflation against expectations of a 25-bps hike. The central bank now joins the US Fed and BoE in tightening monetary policy. The ECB's president, Lagarde said that "We expect inflation to remain undesirably high for some time, owing to continued pressures from energy and food prices, and pipeline pressures in the pricing chain."

From incremental data, there is increasing evidence of a gradual growth slowdown across the region. The Eurozone services PMI was little changed in Jun-22 vs. May-22, but both Spain and Italy services PMI registered sizeable declines. The Eurozone manufacturing PMI also stagnated near 52.0 in Jun-22. However, while there is evidence that a more noticeable slowdown in growth may be coming, the surveys point to ongoing inflation pressures, with the input and output prices indices still near record highs.

Amidst the continuing war between Ukraine-Russia lending an uncertainty to energy supplies and a growing risk of recession, the consistent pressure on the Euro saw the common currency briefly attain parity with the USD. This happened for the first time since Dec-02 which was in the early years of the currency's existence. In addition, annualized inflation for the region rose to a record high of 8.6%YoY in Jun-22 and is estimated to have risen even further to 8.9% in Jul-22, up from 8.1% in May-22; led by a spike in price of energy and food costs. Both these factors are likely to have moulded ECB's 50 bps rate hike decision.

Chart 3: Inflation continues to soar to a record high in key G3 economies



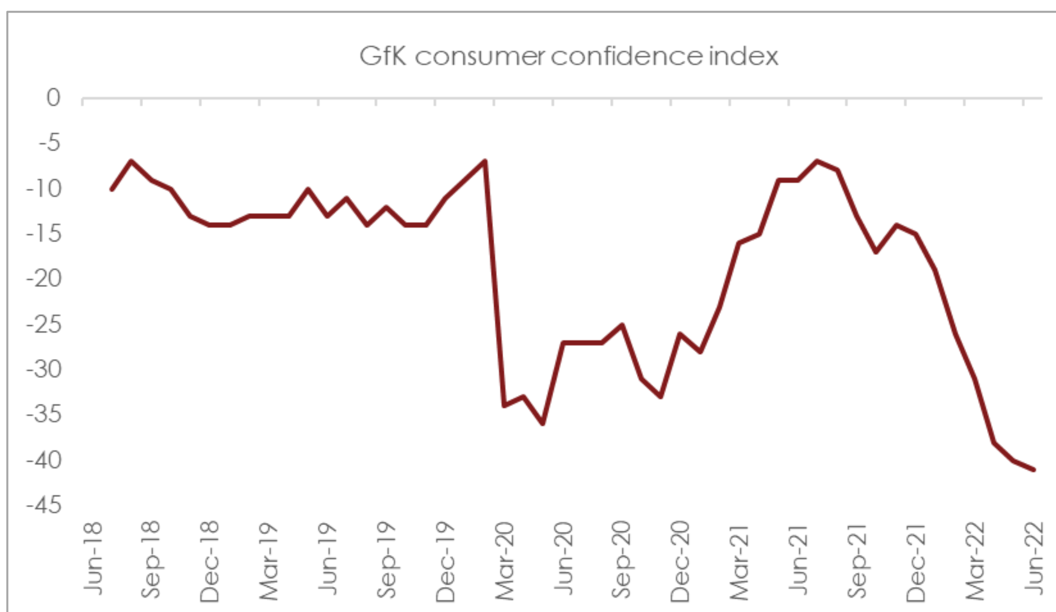
UK

UK economic growth surprised on the upside in May-22, as it grew by 0.5%MoM compared to a 0.2% decline in Apr-22. The gains were broad-based, across all three major production sectors of manufacturing, construction, and services. At the sectoral level, services sector was the predominant driver of growth, led by health care as people made more appointments with general practitioners after COVID-19 restrictions were relaxed.

However, since May-22, there are nascent signs of economy beginning to slow, especially the consumer sector. Elevated inflation is beginning to pinch consumers, as reflected in retail sales that contracted by 0.5%MoM in May-22 compared to a sequential expansion of 0.6% in Apr-22. In addition, confidence levels among British consumers fell to new record low in Jun-22, with the GfK index slipping to -41 in Jun-22 from -40 in May-22. Adding to the negative data, unemployment rate too rose from 3.5% in Mar-22 to 4.2% in May-22.

UK consumer inflation hit yet another record high of a 40-year high, coming in at 9.4% on an annualized basis in Jun-22, as food and energy costs continued to soar. The print was higher than market consensus expectations pegged at 9.1% and a full 100 bps above May-22 print of 8.4%. The Jun-22 inflation print has upped BoE's ante in its fight to rein in prices. Accordingly, BoE has effected a 50 bps hike in its early Aug-22 policy meeting, which is the biggest single increase in interest rate in the British economy in nearly 30 years.

Chart 4: Consumer confidence has plunged to a record low in UK



CHINA

In Q2, the Chinese economy grew by a somber 0.4%YoY albeit to beat market expectations (as some analysts estimated a contraction) but marking a sharp slowdown from 4.8% growth recorded in Q1. Recall, Q2 had captured the extensive lockdowns in Mar-22 and Apr-22, and the subsequent slump in economic activity.

Looking beyond Q2, incremental data however appears to be pointing towards possible bottoming out of the economy. Jobless rate declined to 5.5% in Jun-22 compared to 5.9% in

May-22, as per the latest round of survey. In addition, retail sales recovered in Jun-22, clocking an expansion of 3.1%YoY in Jun-22 compared to -6.7% in May-22. This improvement was led by car sales, owing to subsidies granted for consumption of new energy cars. In addition, industrial production rose by a healthy 3.9%YoY in Jun-22 compared to 0.7% in May-22, once again supported by new energy cars along with solar power batteries and telecom stations. Adding to the spate of indicators underscoring an economic recovery, China's Caixin/Markit manufacturing PMI rose to 51.7 in Jun-22 from 48.1 in May-22. This marked the fastest pace of growth in 13 months and also the first expansion in 4 months.

China's central bank, the PBoC kept the 1Y Medium Lending Facility policy rate unchanged at its last meeting while rolling over the facility amount. It appears that the central bank is in a wait and watch mode assessing pace of the economic recovery because of the uncertain development of the recent Covid situation in Shanghai, and also against the background of aggressive rate hikes in the US and other developed economies.

Notwithstanding the current recovery, headwinds to growth for the Chinese economy do persist in the form of virus flare-ups combined with strict anti-Covid policies, problems in the real estate sector, and the likely slowdown in China's main export markets in late 2022/early 2023. As such, GDP growth is likely to undershoot government target of 5.5% for this year.

About Acuité Ratings & Research Limited:

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