Acuité
RATINGS & RESEARCH

MACRO PULSE

JUNE 2021

Contents

From the desk of the Chief Analytical Officer

We are glad to bring you the sixth edition of **Acuité Macro Pulse** (June 2021). This monthly publication on the economy is being disseminated since January 2021 and has differentiated itself for its quality insights on the volatile economic landscape being witnessed both in India and across the world.

The economic environment has clearly turned positive since the end of May with a steady reduction in daily case loads and mortalities along with the unlocking measures taken by almost all the states in June. The daily cases and deaths as on June 30, 2021 at 48,600 and 1,000 respectively have been nearly one third of the figures as on May end, confirming the taper down of the second Covid wave. While the vaccination figures at 336 million doses as on end of Q1FY22 sounds encouraging, we have still a far way to go with only 20.7% of the population having been administered the first dose. Meanwhile, the state governments continue to be cautious on a complete unlocking of the economic activities particularly in the contact intensive services given the risks of a third wave amidst a low proportion of vaccinated people.

The dent to Q1 growth made by Covid 2.0 has meant downward revisions to FY22 growth forecasts, with RBI paring its estimate to 9.5% from 10.5% previously. Since the beginning of Jun-21, however ultra-high frequency lead indicators have started to show a marginal turnaround in economic activity. The mobility indicators have seen a pick-up (after hitting a trough) coinciding with the decline in nationwide cases and opening up of businesses in most states. The silver linings in the form of a strong support from global economic growth, likelihood of a normal monsoon outturn, and continued support from an accommodative policy backdrop should aid sequential recovery in industrial activity. Nevertheless, the pace of vaccination would play a key role in boosting confidence in the economy and bringing back 'vengeance' demand in the services sector that is necessary to rebuild the momentum in the economy from Q3/Q4. While we stick to our 10.0% GDP forecast for FY22, we believe there are downside risks to that figure and will continue to track the growth prospects closely.

We have talked about the incipient risks on the inflationary front in our previous editions and the data for May clearly indicates that it is "the elephant in the room" that can disrupt the potential growth momentum. Steadily rising prices of crude oil along with that of other commodities and the pass through of increased input costs by manufacturers additionally with supply challenges in some sectors such as passenger vehicles (semiconductors) doesn't augur well for a strong economic recovery. What is comforting, however is the regularity of the monetary and fiscal measures that are being taken to address some of the emerging risks like for example the difficult liquidity position in smaller NBFCs and MFIs. These measures should ensure that the funding risks in non-banks and the delinquency risks in retail loan portfolios arising from Covid 2.0 are suitably addressed.

While we wait for better times ahead, we will keep deciphering the dynamic economic and credit signals for our readers.

Happy Reading & Best Regards,

Suman Chowdhury
Chief Analytical Officer

Growth

Turning a corner

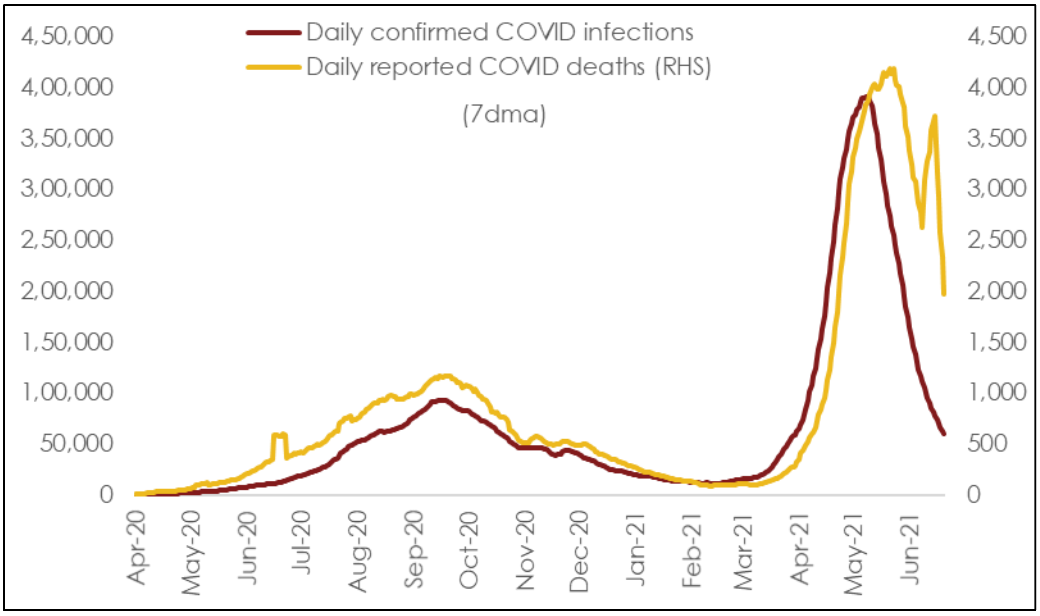
KEY TAKEAWAYS

- With ebbing of the second wave of infections, growth impulses are beginning to show nascent signs of a turnaround.
- Enabled by a gradual and staggered easing of restrictions, led by major cities of Mumbai and Delhi; with a likelihood of a more pervasive easing of curbs Q2 onwards.
- Nevertheless, the dent to Q1 growth has meant downward revisions to FY22 growth forecasts, with the RBI too paring its estimate to 9.5% earlier this month (from 10.5% previously).
- The silver linings in the form of a strong support from global economic growth, likelihood of a normal monsoon outturn, and continued support from an accommodative policy backdrop should aid sequential recovery in industrial activity.
- Having said so, we also believe that the pace of vaccination would play a key role in reducing the severity of the threat from future waves of Covid while boosting economic confidence and a broader revival in growth H2 FY22 onwards.
- We continue to monitor these developments closely while sticking to our FY22 GDP growth forecast of 10.0% with some downside risk.

With ebbing of the second wave of infections, growth impulses have started to show nascent signs of a turnaround. The gradual and staggered easing of restrictions, led by major cities of Mumbai and Delhi is likely to lead to a more pervasive easing Q2 onwards. Nevertheless, the significant dent to Q1 growth has meant downward revisions to FY22 growth forecasts, with the RBI too paring its estimate to 9.5% earlier this month (from 10.5% previously).

Looking back, NSO released the final growth estimates for FY21. Real GDP contracted by 7.3% in FY21, with Q4 FY21 growth faring better than expected at 1.6% on an annualised basis. The latter however was distorted by onboarding of food subsidy bill on Government's balance sheet; concealing the relatively higher GVA growth of 3.7% in the quarter.

Chart 1: Confirmed cases now lower than the first peak



Incremental data for the months of Apr-21 and May-21 continue to reflect the impact of lockdown restrictions, albeit with annualised readings finding support in a low base from last year's nationwide lockdown. We had in the previous issue of "Acuite Macro Pulse", highlighted the possibility of exacerbated slowdown in May-21 amidst more pervasive and stringent lockdown restrictions at the state level.

- After remaining unscathed in Apr-21, PMI indices slipped sharply in May-21. On the manufacturing side, the reading dropped to a 10-month low of 50.8 vs. 55.5 in the previous month. Expectedly so, PMI services slipped below the threshold of 50; coming in at 48.1 vs. 55.4 in Apr-21 bearing the brunt of more stringent lockdown restrictions.
- The annual growth in IIP accelerated sharply to a record high level of 134.4% in Apr-21 from 24.1% YoY (revised up from 22.4%) in Mar-21 understandably due to the complete national lockdown last year. On a sequential basis, 24 out of 25 sub-industries within IIP registered a contraction in Apr-21 over Mar-21, depicting a broad-based decline in industrial production activity (lockdown effect and seasonal unwinding being the culprits). On seasonally adjusted

sequential basis, the headline IIP de-grew by 1.5% MoM in Apr-21, marking its first contraction in 5-months. This momentum is likely to decline further in May-21 coinciding with the peak of the healthcare crisis.

- India's merchandise deficit narrowed to an 8-month low of USD 6.3 bn in May-21 from USD 15.1 bn in Apr-21. The moderation in trade deficit was led by a sequential increase in exports (+5.4% MoM) along with a sequential decline in imports (-15.7% MoM). The sharp compression in May-21 trade deficit is yet again a by-product of state-level lockdowns getting pervasive even as India's key export partners progressively relaxed lockdown restrictions in their respective countries.
- Despite a favorable base, fuel consumption contracted by 1.5% on an annual basis in May-21 with widespread lockdowns and record high retail prices yet again weighing on consumption.
- E-way bills, capturing the movement of goods in the country, contracted at a faster clip in the month of May-21 by 32.0%MoM vs. 17.5%MoM in Apr-21.

Since the beginning of Jun-21, however ultra-high frequency lead indicators have started to show a marginal turnaround in economic activity. Mobility indicators such as Google mobility and Apple driving trends, both have seen a pick-up (after hitting a trough) coinciding with the decline in nationwide cases and opening up of businesses in select cities and states. In addition, e-way bills, railway passenger movement, rail freight, traffic congestions – all appear to be bottoming out after a significant dip over the months of Apr-May-21, albeit more contained compared to a year ago.

Outlook

After a dismal phase in Apr-May 2021, most lead indicators have begun to show some degree of stabilization and normalization in the month of Jun-21. The peaking of the second wave of Covid in the first half of May-21 has gradually resulted in tapering of lockdown restrictions by states. Meanwhile, most annualised growth data continues to be misleading with exorbitant growth figures primarily due to the national lockdown over most of Q1FY21. Hence, one needs to look through Q1 FY22 data not only from an annualised perspective but also in terms of the underlying sequential momentum.

The silver linings in the form of a strong support from global economic growth, likelihood of a normal monsoon outturn, and continued support from an accommodative policy backdrop should aid sequential recovery in industrial activity. Having said so, we also believe that the pace of vaccination would play a key role in reducing the severity of the threat from future waves of Covid while boosting confidence in the economy. As of Jun 28, India had covered 20% of its population with one dose of vaccine. While the coverage appears to be slow in comparison to some of the developed countries (US, Eurozone, UK, etc.), expectation of enhancement of domestic vaccine manufacturing capacity along with sourcing from imports would help to speed up the process within the next 2 months. This would allow a backloaded recovery in services led by 'vengeance' demand. We continue to monitor these developments closely while sticking to our FY22 GDP growth forecast of 10.0% with some downside risk.

Chart 2: Monsoon progress remains satisfactory, so far (as of 20 Jun-21)

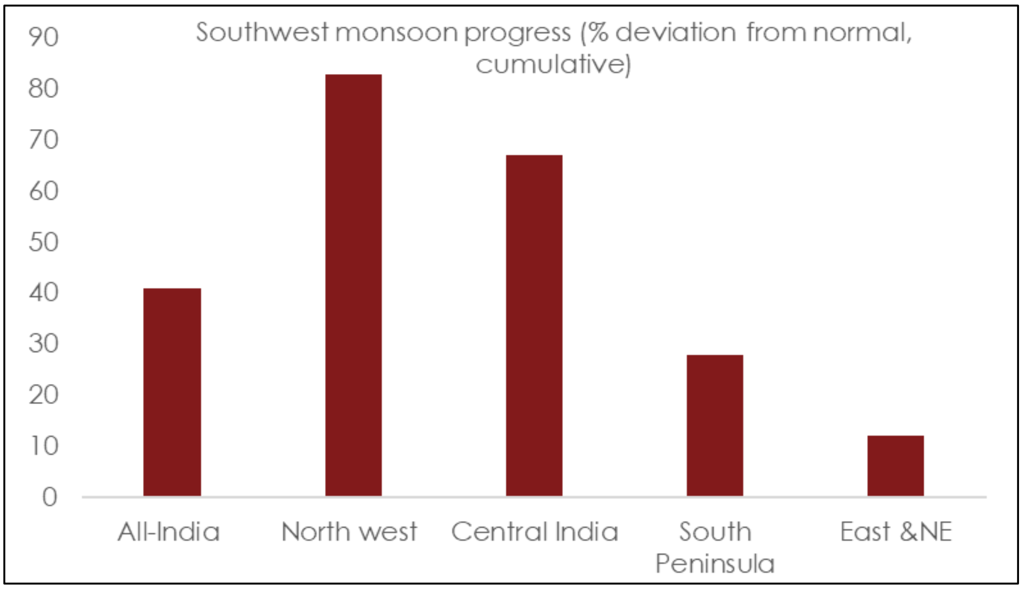
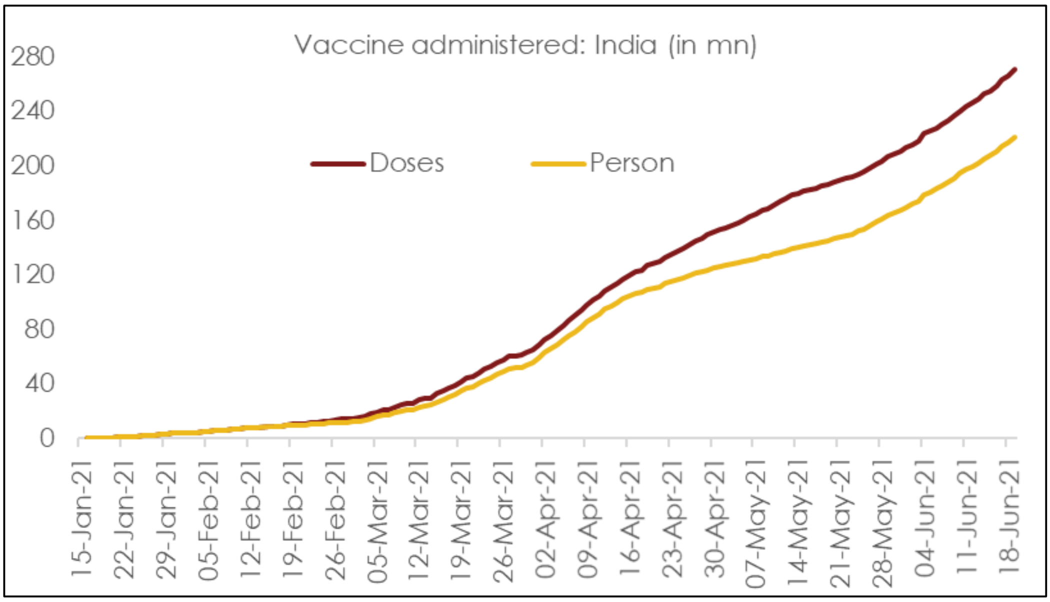


Chart 3: Vaccinations have seen better traction over the last one month



Inflation

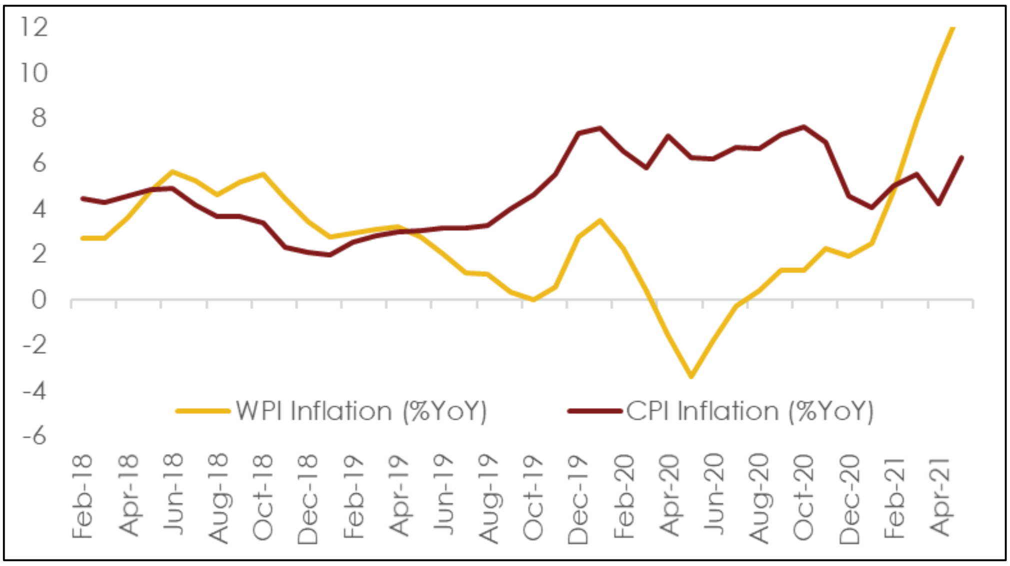
Overstepping comfort

KEY TAKEAWAYS

- May-21 was testimony to uncomfortable data on inflation front.
- Headline CPI inflation accelerated to a 6-month high of 6.30%, above RBI's upper threshold of inflation targeting band.
- WPI inflation continued its ascent to a new series high of 12.94% in May-21 vs. 10.49% in the previous month.
- Current household inflation expectations rose by150 bps to a 3-year high of 10.2%.
- In addition to supply disruptions from the second wave of Covid, a mix of pass-through of higher input prices along with surge pricing by bigger players amidst curtailed competition may have also been factors responsible behind the strong sequential momentum in May-21 CPI index.
- This upward adjustment to May-21 CPI index has added a material upward bias to the entire FY22 inflation trajectory.
- Accordingly, we revise our CPI inflation estimate up to 5.5% for FY22 from 5.0% earlier.

The month of May-21 was testimony to uncomfortable data on inflation front. Headline CPI inflation accelerated to a 6-month high of 6.30%, above RBI's upper threshold of inflation band from a downwardly revised 4.23% in Apr-21 (from 4.29% earlier). Further, WPI inflation continued its ascent to a new series high of 12.94% in May-21 vs. 10.49% in the previous month. In addition, RBI released the May 2021 round of the Inflation Expectations Survey of Households (IESH), which saw current median inflation perception to have risen by 150 bps to a double-digit level of 10.2%, marking a 3-year high. Further, expectations for 3-months and 1-year ahead period increased by 70 bps each to settle at 10.8% and 10.9% respectively.

Chart 1: WPI and CPI move higher in tandem in May-21



CPI inflation: Broad based price pressures

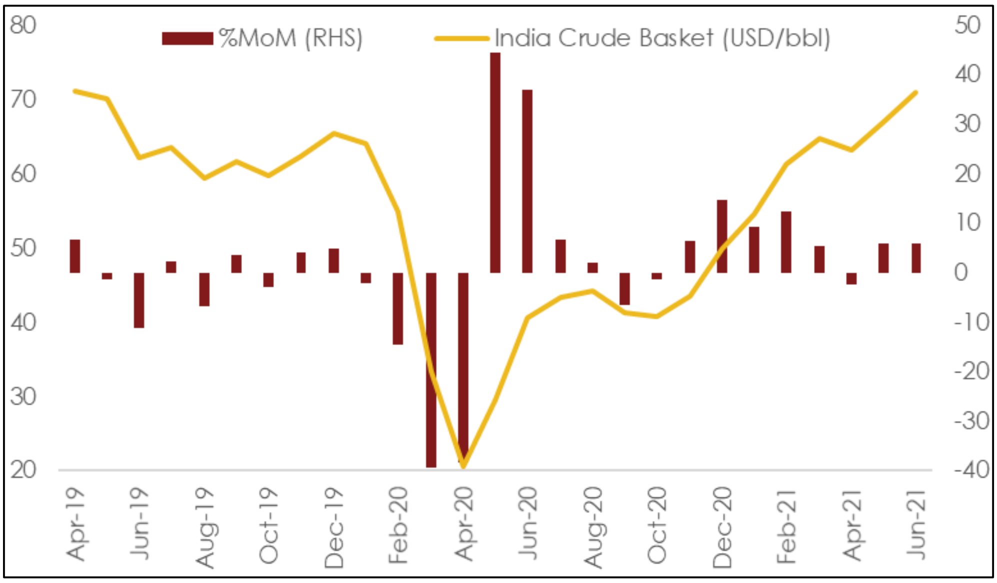
- CPI momentum was broad based, with price pressures escalating across food, fuel and core inflation categories with the exception of housing. The inflation outcome came as a strong surprise versus market consensus expectation in the range of 5.3-5.4%.
- Reflecting a combination of supply side disruption and onset of summer, food prices rose by 1.7%MoM in a near pervasive rise across sub-categories. Price pressures were exceptionally strong (compared to recent past trend) for edible oils & fats, pulses, cereals, eggs, spices and sugar – i.e., for staples, cumulatively accounting for nearly 40% of the food basket. Mercifully, momentum in price of perishables of fruits and vegetables though in positive, remained muted in comparison to past sharp gyrations.
- Fuel and light prices registered a strong uptick of 2.2%MoM, driving annual fuel inflation into double-digits at 11.58%. Yet again, price pressures were broad based, not limited to only expected offenders viz. petrol and diesel. Two other heavy weights i.e. Firewood and chips and Electricity explained nearly 75% of the fuel upsurge.
- Core index (CPI ex Food & Beverages and Fuel & Light indices) jumped by 1.5%MoM, to mark the fastest sequential uptick since 2013. On annualised basis,

core inflation climbed to a 7-year high of 6.5% amidst near broad-based price pressures.

WPI inflation: Respite on momentum

- o While headline WPI inflation rose further to a new series high of 12.94%, on sequential basis May-21 reading saw some respite. WPI index rose by 0.76% MoM i.e., nearly half the pace of increase recorded in previous three months averaging at 1.35%.
- o In another silver lining, primary prices contracted after a gap of 3 months by 0.86%MoM led by food prices compared to a significant build-up of 3.0% in Apr-21.
- o Fuel inflation soared further to clock at 37.6%YoY but more so an outcome of an adverse base than a sequential uptick in prices. To put this in perspective, an unchanged fuel index in May-21 vis-à-vis Apr-21 would have translated into a fuel inflation print of 35.24%.
- o Manufacturing prices rose by 1.24%MoM, almost in line with previous month's increase of 1.17% and last 6 months average momentum of 1.21% reflecting the passthrough of escalating global commodity prices. The annual inflation for the category moved higher into double-digits at 10.83% compared to 9.01% in Apr-21 led by sub-categories of basic metals, furniture, fabricated metal products and electrical equipment.

Chart 2: India crude basket continues to trend upwards



The Big Picture

May-21 CPI inflation is reminiscent of inflation prints from the first lockdown. Last year, not only did inflation spike owing to supply side disruptions but data collection also remained sub-par amidst the pandemic. The latest CPI reading is a deja-vu experience on both these counts. On a conjectural basis, in addition to supply disruption from Covid, a mix of pass-through of higher input prices (i.e., from WPI to CPI) along with surge pricing by bigger players amidst curtailed supply/competition (especially from MSME sector) may have also been factors responsible behind the strong sequential momentum in May-21.

Looking ahead, while we do expect a normal monsoon to help keep food prices in check, upside risks from fuel inflation and its second order impact remain material. Recently, crude prices have once again risen above USD 70 pb, with ICB trading nearly 6.0% up so far in Jun-21. Objectively, some of the price pressures can be quelled by Government measures on both food and fuel categories via 1) Supply side interventions in specific items such as pulses, cereals, and/or 2) reduction in excise duty on petrol and diesel.

The pulls and pushes discussed above notwithstanding, the upward leap in May-21 CPI index will materially add an upward bias to the remaining FY22 inflation trajectory. **As such, we revise our CPI inflation estimate up to 5.5% for FY22 from 5.0% earlier.** Being supply-side and cost-push in nature, the current price pressures will however, continue to allow RBI to focus on growth revival. As faster pace of vaccination with a possible target of 60% of population getting inoculated by end of the year allows a faster normalization of the economy, demand side pressures especially in services can perhaps begin to takeover.

CPI Inflation: By sub-components (%YoY)				
	Apr-20	May-20	Apr-21	May-21
CPI headline	**7.22**	**6.27**	**4.23**	**6.30**
Food	10.47	8.37	2.60	5.24
Pan, Tobacco & Intoxicants	5.87	6.28	9.01	10.03
Clothing & footwear	3.47	3.39	3.49	5.32
Housing	3.94	3.66	3.73	3.86
Fuel & Light	2.93	1.57	7.98	11.58
Misc.	5.43	5.79	6.12	7.52
Core Inflation	4.84	5.00	5.39	6.55

Government Finances

Managing the fiscal purse strings in FY22

KEY TAKEAWAYS

- For the month of Apr-21, India's central government fiscal deficit stood at 5.2% of BE for FY22 compared to 15.3% over the corresponding period in FY21.
- The relatively lower accretion to fiscal deficit this year reflects better revenue collection amidst somewhat lower pace of expenditure incurred during the month.
- While FY21 fiscal deficit print of 9.2% of GDP turned out to be marginally better than RE of 9.5%, there are few additional risks that have emerged for FY22.
- The budgeted expenditure in FY22 is expected to overshoot on account of Covid relief packages with the latest one announced in June end, the proposed increase in fertilizer subsidy and a higher outlay for vaccination.
- However, tax revenue collection is likely to be on track while non-tax revenue could witness a significant increase amidst RBI's dividend support.
- In order to minimize the risk to fiscal slippage, it would however, be critical for the government to ensure that it meets the record high budgeted divestment target.

For the month of Apr-21, India's central government fiscal deficit stood at 5.2% of the budget estimate (BE) for FY22 compared to 15.3% over the corresponding period in FY21. Prima facie, the relatively lower accretion to fiscal deficit this year reflects better revenue collection and somewhat lower pace of expenditure incurred during the month.

Receipts: Strong start to the year

The first month of FY22 saw robust receipt collection, led by healthy tax as well as non-tax revenues.

- Aided by a favourable statistical base, gross tax revenue collection clocked a record high annualised growth of 151.8% in Apr-21 vis-à-vis a contraction of 44.3% seen in Apr-20.
    - Barring service tax collection that contracted on YoY basis in Apr-21, all other key tax sources recorded robust growth in collection, with particularly impressive growth seen in case of customs and GST.
    - It is important to note that some taxes reflect claims on past economic activity and hence did not see any impact of the strong resurgence in Covid infections during the month. However, they are likely to moderate in May-Jun due to lagged impact of the intensification of the second Covid wave.
- Net tax revenue clocked a strong annualized growth of 510.9% in Apr-21 compared to a contraction of 70.1% seen in Apr-20, on account of lower tax devolution to states.

Non-tax revenue also recorded a strong annualized growth of 191.2% YoY in Apr-21 compared to a contraction of 75.2% seen during Apr-20. While it is too early to comment on the trend in non-tax revenue looking at just one month of data, we note that growth figures are going to accelerate for this category in May-21 on account of the significant jump in dividend transfer from the RBI.

Non-debt capital receipts clocked a meagre expansion of 1.9% YoY in Apr-21 vis-à-vis a contraction of 86.5% seen in Apr-20. Similar to Apr-20, the month of Apr-21 saw nil divestment of stake from the central government.

Expenditure: Slow start, but likely to accelerate

Total expenditure de-grew by 26.2% YoY in Apr-21 vis-à-vis an expansion of 20.6% seen in Apr-20. On BE basis, this translates to a figure of 6.5% of the full year target vis-à-vis 8.7% seen in the corresponding period in FY21. We note a divergence between the pace of revenue and capital expenditure by the government:

- Revenue expenditure contracted by 35.6% YoY (6.1% of BE) in Apr-21 vis-à-vis an expansion of 24.4% (9.0% of FY actuals) seen in Apr-20. The slower disbursal reflects the outsized impact of Covid relief work undertaken by the central government during the nationwide lockdown in Apr-20. With the central government extending some of the earlier programs under "Atma Nirbhar Bharat" scheme from May-21 onwards to provide relief from the second wave of COVID, revenue expenditure is expected to pick up in the coming months.
- Encouragingly, capital expenditure growth increased to 66.5% YoY (8.5% of BE) in Apr-21 from a contraction of 7.5% (6.7% of FY actuals) seen in Apr-20. The

thrust on capex provides comfort and would be important for supporting the economy at a time when private sentiment could remain subdued.

Outlook

As anticipated and highlighted in our May edition of the "Acuite Macro Pulse", the central government's FY21 fiscal deficit ratio printed marginally better at 9.2% of GDP vis-à-vis the RE of 9.5%. The sprint in tax revenue collection seen in Q4 FY21was the primary reason behind the same.

This clearly had a positive spill over into the first month of FY22 with a broad-based expansion in tax revenue collection. However, as noted above, the next 2-3 months could see deceleration in the pace of tax collection as economic activity took a sequential hit from the severe resurgence in Covid during Apr-May FY22. While the second wave peaked in early May-21, state level lockdowns continue to prevail in Jun-21, as differentiated spread of Covid has evoked a calibrated unlock response so far with most services still facing restrictions of some form. Having said so, we do not see this as a risk factor from fiscal deficit perspective as the supportive base from previous year and higher than budgeted Nominal GDP growth (led by higher inflation) would support tax collections in FY22. The higher excise duty collections from retail fuels also continues to be supportive of tax revenues.

Nevertheless, there is some concern on the possibility of fiscal slippage in FY22 amidst rising economic uncertainty post the second wave of Covid. As a result, the central government promptly provided incremental expenditure support for FY22 via

- Rs 148 bn increase in fertilizer subsidy
- Rs 939 bn via extension of "Pradhan Mantri Garib Kalyan Yojana"
- Rs 150 bn for boosting public health emergency preparedness with emphasis on paediatric care

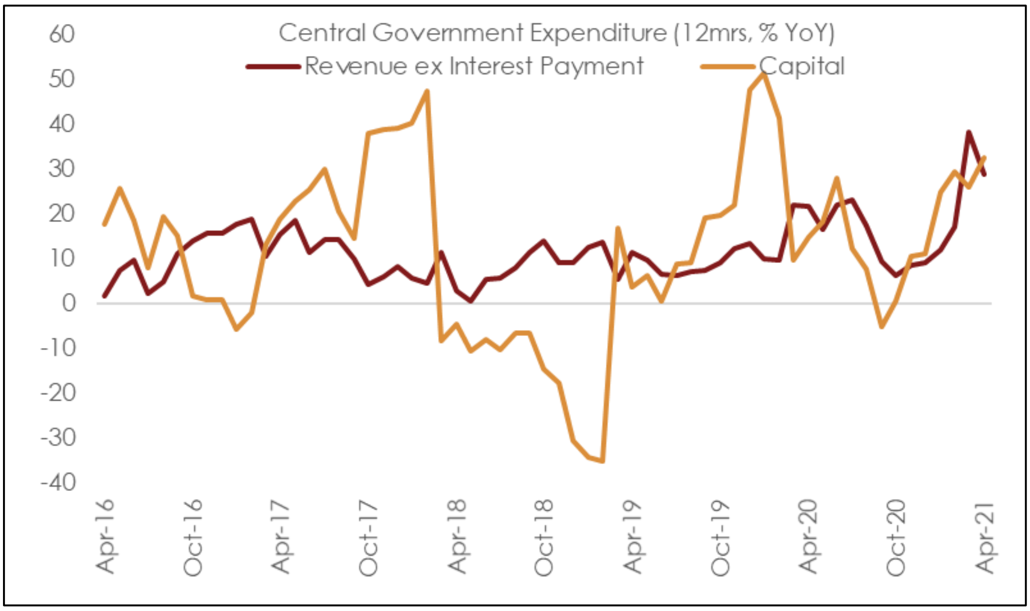
The outgo on these, along with a whole host of wide-ranging relief measures announced by the Finance Minister on Jun 29, 2021 are estimated to have a direct fiscal cost of around 0.6% of GDP in FY22. In addition, budgetary allocation for vaccination could see an upside to the extent of Rs 120-150 bn post the centralization of public procurement and disbursal along with the decision to provide Covid vaccine free of cost to every adult citizen.

To conclude, while slippage risks have begun to stack up, it is still early to take a call on the headline fiscal risk at this juncture – hence we continue to expect FY22 fiscal deficit ratio to come at the budgeted level of 6.8% of GDP. However, we would monitor the expenditure risks closely along with the realization of the record high disinvestment target of Rs 1750 bn.

Table1: FYTD comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position as of Apr)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	1.7	8.3	-71.4	443.1
Net Tax	1.5	8.5	-70.1	510.9
Non-Tax	2.8	6.9	-75.2	191.2
Non-Debt Capital Receipts	0.6	0.2	-86.5	1.9
Total Receipts	1.6	7.5	-71.8	437.2
Revenue Expenditure	9.0	6.1	24.4	-35.6
of which, Interest Payment	3.9	3.7	36.5	11.1
of which, Major Subsidies	19.3	11.1	-36.1	-15.2
Capital Expenditure	6.7	8.5	-7.5	66.5
Total Expenditure	8.7	6.5	20.6	-26.2
Fiscal Deficit	**15.3**	**5.2**	**-**	**-**

<u>**Chart 1: Government's capex thrust gaining prominence**</u>



Rates

Anchored in the near term

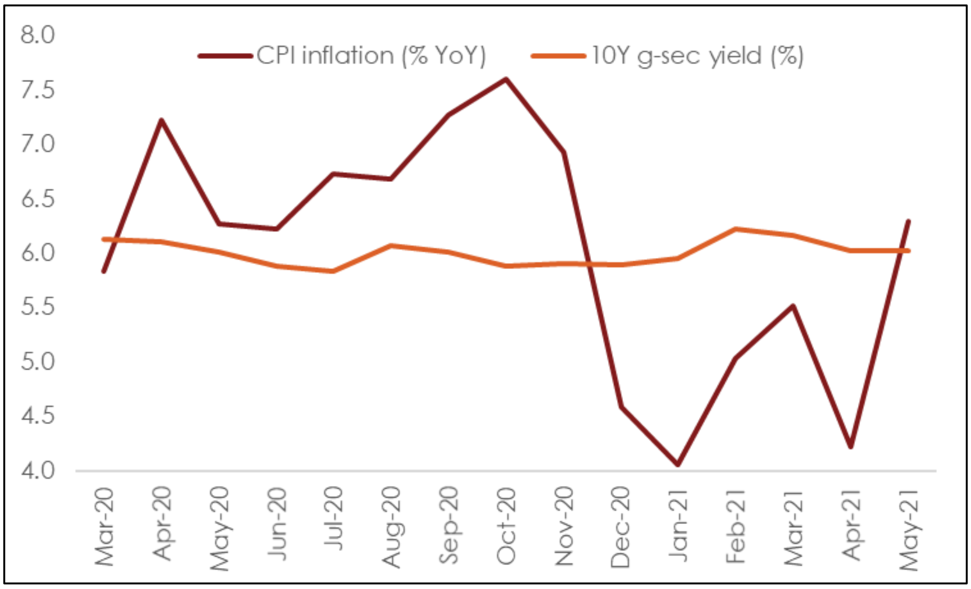
KEY TAKEAWAYS

- Despite the emergence of upside risk on inflation, domestic bond yields have not seen any runaway pressure.
- Re-emergence of growth concerns post the second wave of Covid and RBI's sizeable bond market interventions have clearly provided an anchor to bond yields in the near term.
- However, vaccine led global recovery, especially in DMs, would open the door for sooner than anticipated monetary policy normalization.
- We continue to expect the RBI to start normalizing policy corridor from Dec-21 onwards, followed by an eventual hike in the benchmark repo rate in Q1FY23.
- We continue to stick to our 10Y g-sec yield forecast of 6.15% by Sep-21 and 6.50% by Mar-22.

On a monthly basis, the 10Y g-sec yield has been coming off since its recent high of 6.23% in Feb-21 to 6.02% as of end May-21 and has been rangebound since that time.

From a near term macro perspective, concerns over inflation have risen in the backdrop of series high WPI inflation (12.94% YoY in May-21) along with CPI inflation overshooting the upper threshold for policy tolerance and printing at a 6-month high level of 6.30% YoY in May-21. Sharp rise in international commodity prices, particularly for crude oil, metals, and certain food products in 2021 so far, has raised the spectre of inflation globally, as well as in India. In addition, idiosyncratic factors like pervasive state level lockdowns in India during the months of Apr-May 2021 (spilling over to Jun-21 in some cases) did seem to have caused supply side disruptions, thereby adding another factor for upside in domestic inflation.

Chart 1: Bond yields have remained anchored despite gyrations in inflation



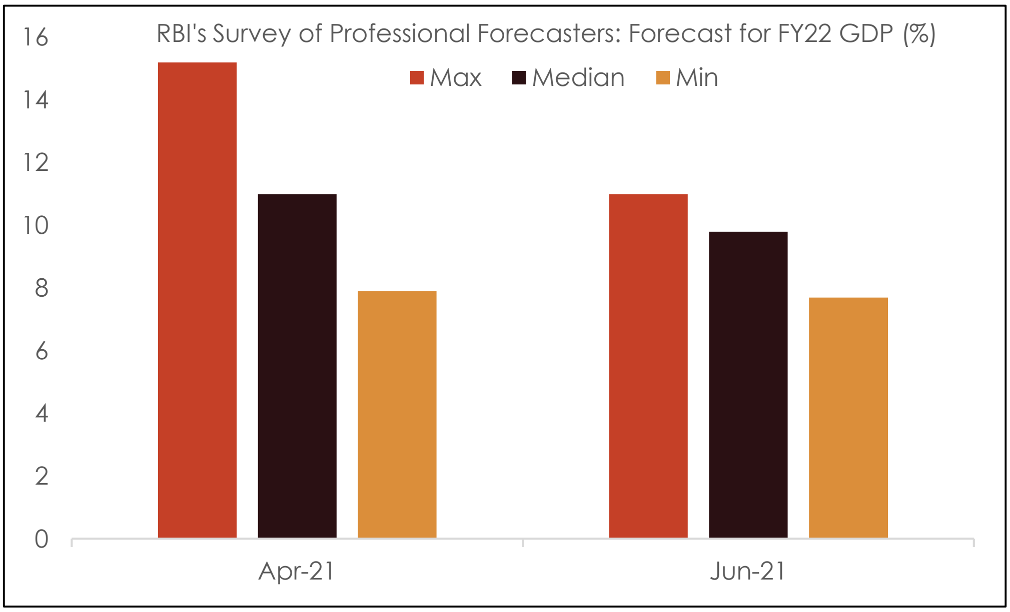
Despite the emergence of upside risk on inflation, bond yields have not seen any runaway pressure. There are two key reasons for the same, which we believe are also likely to persist in the near term.

- Growth concerns have risen once again. To be sure, there is still an expectation of a V-shaped economic recovery with consensus as per the RBI's Professional Forecasters Survey expecting FY22 GDP growth to come at 9.8% vis-à-vis a contraction of 7.3% in FY21. However, a significant part of this V-shaped recovery would be supported by an exceptionally strong statistical base. The severe second wave of Covid seen in Apr-May 2021 has adversely impacted sequential activity due to which the FY22 GDP outlook of market participants has undergone a downward revision over the last one month. The RBI too slashed its forecast for FY22 GDP growth to 9.5% in Jun-21 policy review from 10.5% provided earlier.
    - The minutes of the Jun-21 MPC meeting suggests that all the six members appear to have taken the downside risk to growth into serious

consideration and prioritized the continuation of accommodative monetary policy stance amid heightened economic uncertainty. This reinforcement of dovish bias has provided the fundamental backdrop for yields to remain somewhat anchored.

- RBI's bond market intervention has continued to ease the elevated g-sec supply pressure via active OMO purchases. In this context, we had highlighted earlier that the central bank's formal attempt towards quantitative easing in the form of the G-SAP program will be key in anchoring sentiment in the bond market. On cumulative basis in the current fiscal year, the RBI as of Jun 18, 2021 bought bonds worth Rs 1380 bn (via G-SAP and Outright OMOs), thereby absorbing approximately 43% and 66% of gross and net g-sec issuances respectively in the corresponding period. This has played a very significant role in curbing upside pressures on domestic bond yields.

Chart 2: Market consensus has seen a downgrade in growth view



Outlook

We continue to stick to our 10Y g-sec yield call of 6.15% for Sep-21 and 6.50% for Mar-22. We believe that near term growth concerns and RBI's quantitative easing along with its forward policy guidance would keep yields relatively anchored in the near term despite the buildup of inflationary risks.

However, going forward, yields could carry an upside bias on account of the following factors:

- The recently concluded monetary policy review by the Federal Reserve in Jun-21 appears to be the first tentative step towards interest rate normalization in the US. While the Fed left its policy rate unchanged along expected lines, it significantly upped its forecast for 2021 GDP growth (by 50 bps to 7.0%), PCE inflation (by 100 bps to 3.4%), and Core PCE inflation (by 80 bps to 3.0%). This was followed by an upward revision to the projected Fed Funds Rate trajectory, with the FOMC median now expecting a cumulative of 50 bps rate hike in 2023 vis-à-vis none earlier. Market participants have construed this as the first sign of FOMC members beginning to consider the possibility of tapering of its existing quantitative easing of USD 120 bn monthly asset purchase program. We had highlighted in the May edition of "Acuite Macro Pulse" that some of the developed countries central banks like the BoC and Riksbank have already signaled their intent to wind down asset purchases while Norges Bank appears ready to hike policy rate before the end of 2021. The rapid pace of ongoing vaccination in some of the developed countries has resulted in their central banks starting to account for inflation risks and guiding the markets accordingly. This is likely to lead to some degree of hardening in bond yields in these economies, with concomitant spill over on to EM yields.

Table1: US Fed has signaled the beginning of policy rate normalization in 2023

Expectation of Fed Funds Rate (%) by the FOMC Members						
	Range			Median		
	2021	2022	2023	2021	2022	2023
As of Mar-21	0.1	0.1-0.6	0.1-1.1	0.1	0.1	0.1
As of Jun-21	0.1	0.1-0.6	0.1-1.6	0.1	0.1	0.6

- Although we have rolled forward the likely timing of repo rate hike to Q1FY22 from Feb-22, the RBI could use the Dec-21 to Feb-22 window to restore the width of the LAF corridor to 25 bps from 65 bps currently. This will involve a 40 bps hike in the reverse repo rate to 3.75%, with repo rate remaining unchanged at 4.00%. The need for normalisation of the policy corridor would stem from
    - Gradually growing comfort on India's vaccination program (as of Jun 30, 2021, 20.7% of the total population had received one dose of Covid vaccine), providing greater clarity on growth outlook
    - Policy focus slowly getting back to inflation management as vaccine led herd immunity towards the end of FY22 could potentially stoke demand side pressures
    - It would also help the central bank to start preparing domestic financial markets for taper prospects by systemically important central banks.

Rupee

Moderate weakness in store

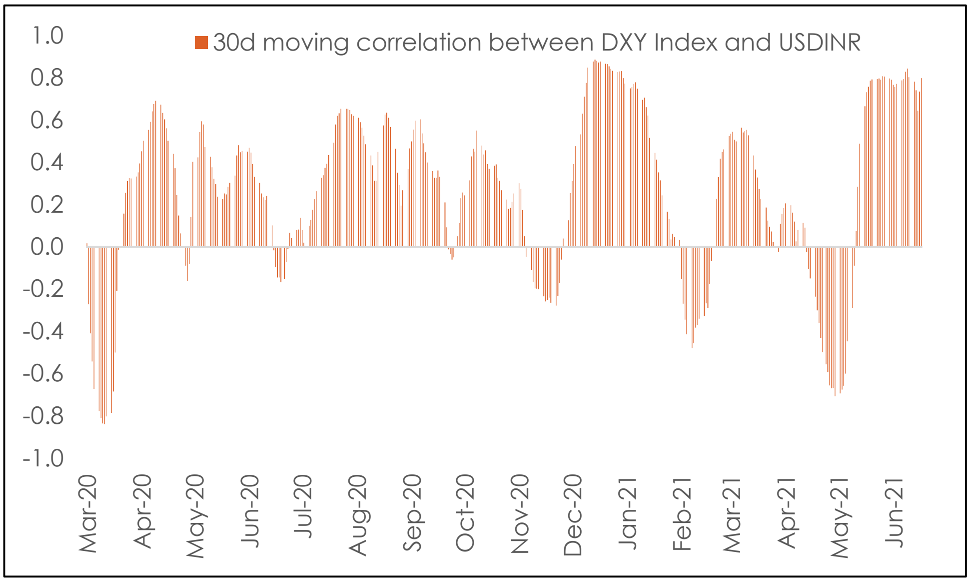
KEY TAKEAWAYS

- After closing at its strongest level since the beginning of the pandemic at 72.61 in May-21, the Indian Rupee has been on a weak turf in the month of Jun-21.
- The recent weakness in INR appears to be in sync with strengthening bias creeping in for the USD, which seems to have received a shot in the arm post Federal Reserve's Jun-21 monetary policy review.
- The combination of gradual unlock, elevated commodity prices, and progress on vaccination would tend to weigh on India's trade deficit and support its normalization over the next few months.
- Meanwhile the relatively strong economic performance of US vis-à-vis other developed economies would create tailwinds for the US dollar.
- We continue to expect USDINR to move up towards 75.0 by Sep-21, and further towards 77.0 by Mar-22.
- Unlike the aftermath 2013 "Taper Tantrum" episode, however the anticipated weakness in INR would be relatively moderate, buffered by recovery prospects for the Indian economy, and further insulated by record high FX Reserves.

After closing at its strongest post pandemic level of 72.61 in May-21, the Indian Rupee has been on a weak turf in the month of Jun-21, with the currency trading at close to 74.3 levels currently – that reflects significant volatility in a span of 3-weeks.

The up move in USDINR appears to be in sync with strengthening bias creeping in for the US dollar (DXY Index has gained 2.4% in Jun-21 so far), which seems to have received a shot in the arm post Federal Reserve's Jun-21 monetary policy review. In fact, the 30-day rolling correlation between DXY Index and USDINR is currently close to its strongest level in the post COVID period.

Chart 1: Recent moves in INR tracking the dollar index



Outlook

This is broadly along our expectation of a moderate depreciation in INR, which we anticipate would continue to play in the coming quarters. As such, we stick to our USDINR call of 75.0 by Sep-21 and 77.0 by Mar-22.

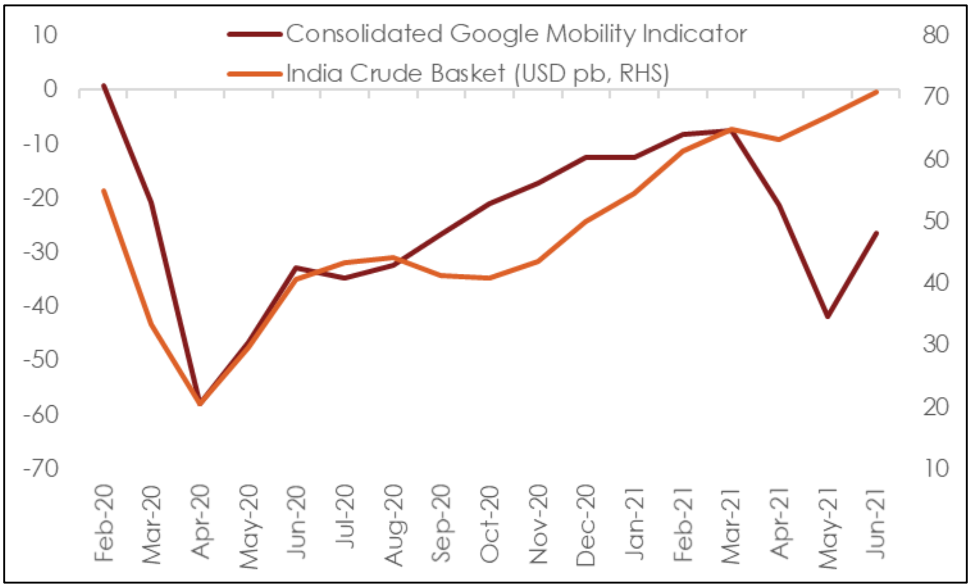
In the near term, the anticipated gradual normalisation of economic activity post the second wave of COVID will be one of the most important factors that would drive INR. We had highlighted in the May edition of the "Acuite Macro Pulse" the dampening impact of the severe resurgence of Covid on domestic demand in India. This resulted in a substantial compression of the monthly merchandise trade deficit to USD 6.3 bn in May-21 from USD 15.1 bn in Apr-21.

We believe this would form a "local minima" for the goods trade deficit for India.

- With the second Covid wave having ebbed, state level lockdowns have begun to ease, albeit gradually. The impact is visible in the turnaround in high frequency mobility indicators – Google Mobility Indicator for Grocery & Pharmacy has in fact turned normal (to pre pandemic levels) even as the recovery in other categories of mobility is somewhat moderate. As the process of unlock gains further momentum in Jul-21, the recovery in domestic demand should also follow suit, thereby widening the trade deficit due to rise in imports.

- Supported by the expectation of a strong V-shaped global economic recovery, international commodity prices continue to carry an upside bias, surpassing their pre pandemic levels in most cases. On FYTD basis (since Mar-21) for India, crude oil price is up by 9%, precious metals up by 8%, and key industrial metals up by 7-20%. This will continue to amplify the price impact on India's merchandise trade deficit in the coming months.

Chart 2: Elevated commodity prices and gradual recovery in activity levels will weigh on India's trade deficit

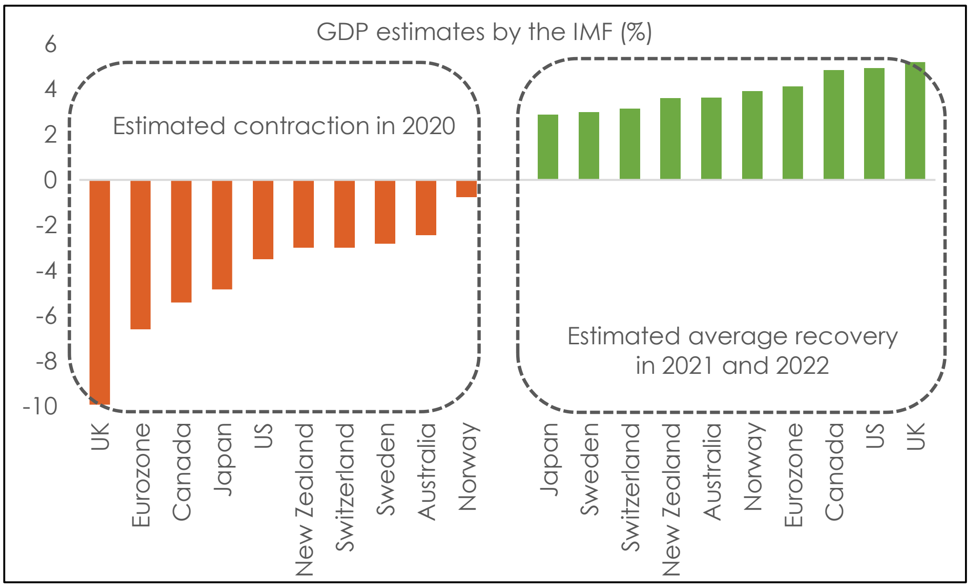


Besides, the gradual progress on vaccination would also act as a medium-term factor for economic recovery, and thereby lead to a wider current account deficit. India has so far (as of Jun 30, 2021) inoculated 20.7% of its total population with one dose of Covid vaccine. Going forward, with centralized procurement and augmentation in availability via higher throughput and liberalized imports, the likelihood of covering close to 60% of the total population before the end of 2021 appears plausible. Hence, despite the temporary narrow down of the merchandise trade deficit in May-21 (which could also see a partial spillover into Jun-21), we continue to stick to our FY22 current account deficit forecast of USD 30 bn compared to the estimated surplus of USD 26 bn in FY21.

Meanwhile, the global FX backdrop will continue to be dictated by the reflationary theme. Few of the developed country central banks have already signaled their intent to start normalizing their respective monetary policies before the end of 2021. In this context, the latest FOMC outcome becomes relevant. As highlighted in the chapter above, the sizeable upward revision to growth-inflation forecasts for 2021 by the Federal Reserve along with the introduction of a cumulative 50 bps rate hike in 2023 (vis-à-vis none earlier) appears to be the first tentative step towards interest rate normalization in the US. Market participants have construed this as the first sign of

FOMC members beginning to consider the possibility of tapering of its existing quantitative easing of USD 120 bn monthly asset purchase program. While the actual tapering could still be 2-3 quarters away (earlier than our previously communicated view of mid-2022), adjustment in financial markets would in most likelihood lead to the actual event. We see the recent run up in the USD in this context and anticipate further buildup of appreciation pressure in the DXY Index in coming quarters. The leg up to USD would not just come from the anticipated taper by the Federal Reserve in isolation, but would rather stem from the heads-up that US monetary policy would have with respect to normalization vis-à-vis monetary policies in other key advanced economies like Eurozone, Japan, and UK.

<u>Chart 3: Relatively strong performance of US among G10 economies to bring about an earlier monetary policy normalization</u>



Having acknowledged the support that the USD could potentially have, any sharp run up in a short span of time could have an adverse spillover on EM currencies, including INR. With India's fiscal and debt metrics appearing on the weaker side among key EMs, this could push USDINR towards our forecast level of 77.0 by Mar-22. However, the impact on INR is likely to be lower in comparison to the earlier "Taper Tantrum" episode of 2013 that saw significant weakening on the back of an unhealthy macroeconomic combination of subdued growth, high inflation, and wide current account deficit. In the current context, the expected GDP-CPI-CAD combined performance over 2021/ 2022 appears sustainable. More importantly, RBI's holding of FX Reserves continues to scale new highs. As of June 25, 2021, reserves stood at USD 609 bn, adequate enough to provide pre pandemic merchandise import cover of 14-15 months.

Global Overview

A diverging recovery

KEY TAKEAWAYS

- Global economic recovery is seeing a divergent narrative.
- On one hand, there is new sense of hope and optimism in the US, UK and Europe that freedom from pandemic induced restrictions is just around the corner.
- For rest of the world, Covid continues to remain a dominant force to reckon with as pace of vaccinations remain slow amidst constrained supplies.
- Collectively, Asia has administered around 21.7 doses of Covid vaccines per 100 people, compared to North America's roughly 40.7 doses per 100 people and European Union's 46.6 doses per 100 people.
- The delta variant of the virus remains on watch, with UK pushing back the final leg of its reopening by 4 weeks, amidst rise in cases.
- Strong annualised inflation readings (low base and rise in commodity prices led) amidst a still recovering growth has put central banks in a tough spot.

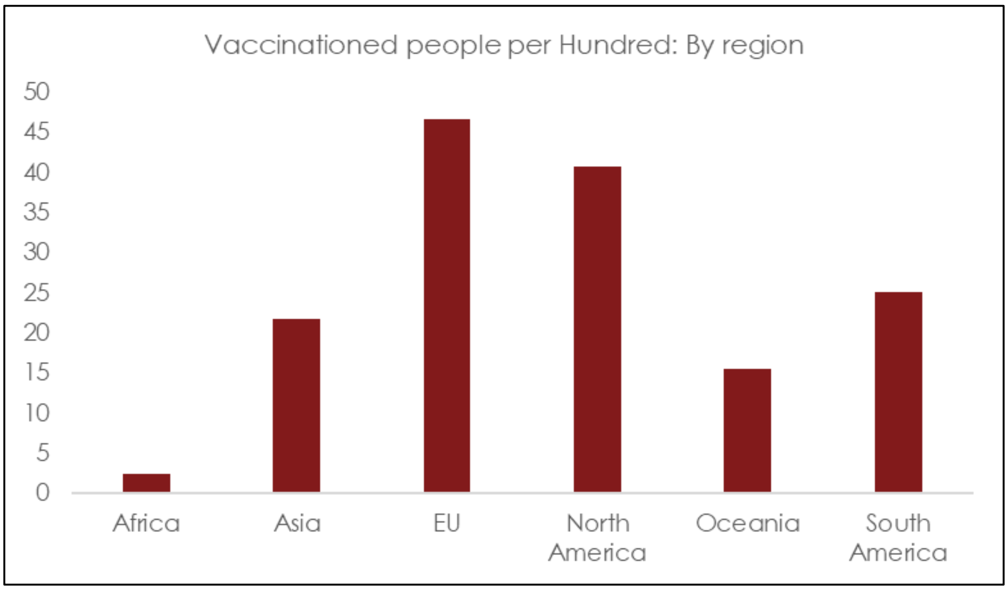
Overview

With nearly half of this year behind us, the global economic recovery is seeing a divergent narrative. On one hand, there is new sense of hope and optimism in the US, UK and Europe that freedom from pandemic induced restrictions is just around the corner. On the other hand, for rest of the world, COVID continues to remain a dominant force to reckon with as pace of vaccinations remain slow amidst constrained supplies.

For developed economies, the near-term outlook remains bright. As vaccinations attain critical mass, the gradual opening up of economy is paving way for a strong growth turnaround in 2021. Having said so, central banks will need to keep a close watch on labour markets. This is because, low participation rates and higher unemployment compared to pre-pandemic levels still indicate insignificant and weak core inflation outcomes. But even if the current inflation readings driven by an abysmally low base from last year were to ease off (i.e., read as temporary), prices could remain elevated amidst higher commodity prices and an impending demand recovery. This would imply perhaps a faster than anticipated normalisation in monetary policy, as also depicted by the Fed's recent dot plot indicating a cumulative 50 bps rate hike in 2023 (vis-à-vis none earlier).

In comparison, bucking the trend in economic re-opening, Asia has seen restrictions on movements in several countries via lockdowns of varying degrees. With China's pace of recovery also displaying some signs of exhaustion, any further unanticipated downside could have repercussions on rest of the region. Vaccine rollouts remain slow in most countries. To put this in perspective, countries in Asia have collectively administered around 21.7 doses of covid vaccines per 100 people, compared to North America's roughly 40.7 doses per 100 people and European Union's 46.6 doses per 100 people.

<u>Chart1: Progress on vaccine slow in Asia compared to EU and North America</u>



This was well highlighted by the World Bank's latest 'Global Economic Prospects' report. The international agency now expects world growth to expand by 5.6% in 2021, i.e., the strongest post-recession pace in 80 years. However, this exceptional growth masks highly uneven recovery underpinned by unequal access to vaccines. As such, "growth is expected to be concentrated in a few major economies notably the United States owing to substantial fiscal support, with most EMDEs lagging behind. In addition, despite the strong pickup, the level of global GDP in 2021 is expected to be 3.2% below pre-pandemic projections". In terms of outlook, World Bank believes that "there are significant downside risks which include the possibility of large COVID-19 waves in the context of new virus variants and financial stress amid high EMDE debt levels. Controlling the pandemic at the global level will require more equitable vaccine distribution, especially for low-income countries".

Echoing almost similar views, OECD raised its global growth forecast to 5.8% in 2021 and 4.4% next year from 5.6% and 4.0% respectively in its latest forecasts released in Mar-21. As per their assessment "Amid renewed virus outbreaks, while there is relief that economic outlook is brightening, but with discomfort of doing so in a very uneven way. The global economy remains below its pre-pandemic growth path and in too many OECD countries living standards by the end of 2022 will not be back to the level expected before the pandemic"

At the global level, in a consequential accord, Group of Seven (G7) nations agreed to back a minimum global corporate tax rate of at least 15% for large MNCs to reduce their incentive to shift profits to low-tax offshore havens. With this deal, significant monies could flow to governments which are left cash-strapped by the pandemic; termed as a "30-year race to the bottom on corporate tax rates" by US Treasury Secretary Janet Yellen.

Reflecting the optimism on global demand, crude oil prices continue to harden to near 2-year high levels, on expectations that oil inventories will fall further in the months to come. At its latest meeting, OPEC+ oil producers agreed to stick to the existing pace of gradually easing supply curbs through Jul-21, as they sought to balance expectations of a recovery in demand against a possible increase in Iranian supply.

Table1: World Bank updates its 2021 global growth outlook

GDP growth projections: World Bank				
	2020	2021	Change from Jan-21	2022
World	-3.5	5.6	1.5	4.3
Advanced Economies	-4.7	5.4	2.1	4.0
US	*-3.5*	*6.8*	*3.3*	*4.2*
Euro area	*-6.6*	*4.2*	*0.6*	*4.4*
Japan	*-4.7*	*2.9*	*0.4*	*2.6*
EMDE	-1.7	6.0	0.8	4.7
China	2.3	8.5	0.6	5.4
India	-7.3	8.3	2.9	7.5

US

Economic activity continues to remain incredibly robust with the US economy on course to recover to its pre-pandemic output level in Q2-21; thereby leading the recovery among the major developed economics. Reflecting this optimism, the US Fed, in its Jun-21 policy upped full year growth forecast to 7.0% from 6.5% earlier.

CPI Inflation hit 5.0% mark in May-21 as it accelerated at the fastest pace since 2008, with core inflation at 3.8%. However, the market looked past the rise in inflation as it seems to be convinced that inflation is likely to be transitory and that the central bank will keep the support intact. Indeed, in its Jun-21 policy, Fed inflation projection for 2021 was raised to take on account the current uptrend, accompanied by an indication that inflation may be more "permanent" in nature than expected.

As such, amidst upside revisions to growth and inflation both, the Fed as widely expected kept interest rates and the QE program unchanged at its Jun-21 FOMC. But more members now expect a cumulative 50bps rate hike in 2023 compared. The dot plot showed that 7 (minority) Fed officials expect hikes in 2022, while 13 (majority) expect hikes in 2023. Market participants have construed this as the first sign of FOMC members beginning to consider the possibility of tapering of its existing quantitative easing of USD 120 bn monthly asset purchase program. In the accompanying policy statement, Fed dropped longstanding language that the health crisis "continues to weigh" on the economy and instead said the influence of vaccinations would "continue to reduce the effects" of the pandemic.

Most of the key economic data barring labour market continues to perform better than estimated. Retail sales though down 1.3%MoM in May-21 but not surprisingly, as Apr-21 growth was revised up to 0.9% (from flat earlier) and when compared to stimulus fueled 11.3%MoM surge in Mar-21. Flash manufacturing PMI increased to 61.5 in the first half of May-21, highest since the survey was expanded in Oct-09 to cover all manufacturing industries. In contrast, labour market continues to experience supply and demand imbalances. Non-farm payrolls in May-21 missed expectations for the second month to add 559k jobs (vs. market consensus of 650k). The unemployment rate fell to 5.8% from 6.1%, but largely an outcome of the contraction in the Labor Force Participation Rate from 61.7% to 61.6%. According to the Fed's Beige Book the economic recovery continued to pick up pace, but the dearth of skilled labor and rising input prices are expected to continue in the months ahead.

US President Biden unveiled a USD 6 tn budget with focus on economic agendas including large new investments in education, transportation and fighting climate change among others. US Treasury Secretary Janet Yellen said that while Biden's fiscal 2022 budget request will increase the US federal debt-to-GDP ratio above its current level of about 100% over the next decade; the plans were fiscally responsible, partly because the real interest burden to finance the federal debt is currently negative.

UK

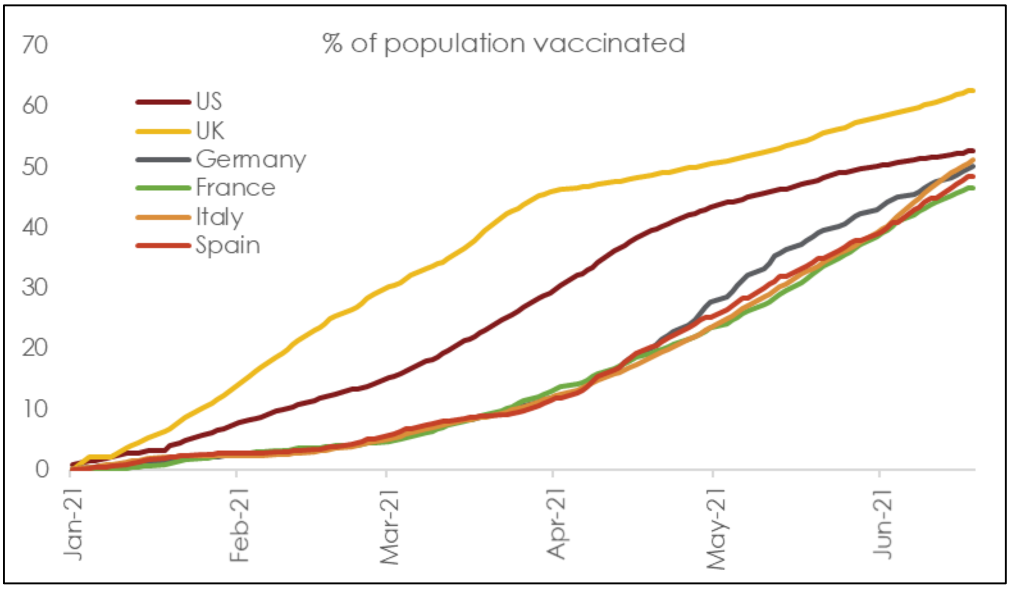
The final leg of reopening in the UK stands delayed amidst rising COVID cases. The push back to complete opening is by a limited number of four weeks until 19th July (vs. earlier target of 21st June earlier) i.e., until greater number of people are fully vaccinated. At present, 46.5% of UK's population stands fully vaccinated with 63.9% having received one dose.

Annualized inflation rose above BoE's 2.0% target for the first time in nearly 2 years, rising to 2.1% in May-21 from 1.5% a month ago. However, Finance Minister Sunak indicated that inflation expectations in the economy are well anchored around the BoE's target and said there was no sign that expectations for higher inflation were becoming entrenched as the economy bounces back from lockdowns. As per the Bank of England (BoE), inflation is likely to ease through 2022, suggesting less imminent pressure to move towards tightening.

Continued economic recovery is reinforced by monthly GDP data of 2.3%MoM in Apr-21, which marks the fastest pace of increase since Jul-20, amidst easing lockdown measures and opening up of non-essential retail, hospitality businesses and schools. Retail sales however unexpectedly contracted by 1.4%MoM (vs. consensus of +1.6%) in May-21 as a lifting off of lockdown restrictions encouraged spending in restaurants rather than shops. Overall, the economy remains on recovery track, with the pushback in opening likely to have a minimal impact. Having said so, the recent increase in number of cases owing to the Delta variant remains on close watch.

Eurozone
The region is heading for a stronger performance backed by accelerated reopening of the economy. This has been enabled by vaccination rates steadily rising across the major economies of the Eurozone, nearly closing the gap versus the US. The EZ economy also contracted by lesser than expected in Q1-21, by 0.3%QoQ and 1.3%YoY compared to estimates of -0.6% and -1.8% from three weeks earlier. However, a sharp spike in energy prices and more expensive services boosted CPI inflation in the region to 2.0%YoY (vs. 0.3%MoM) in May-21 as expected, taking the inflation rate to ECB's target.

Chart 2: EU countries have nearly closed the vaccination gap with the US



At its Jun-21 policy, the ECB kept its interest rates unchanged and decided to continue with its stimulus measures. The central bank said bond purchases under the EUR 1.85

tn pandemic emergency purchase programme (PEPP) would continue in the three months to Sep-21. Meanwhile, the bank raised its growth and inflation projections. It now sees 2021 GDP growth at 4.6%, above the 4.0% projected in Mar-21, while 2022 forecast was lifted to 4.7% from 4.1%. Inflation projections were raised for the next several years and the ECB now sees inflation at 1.9% this year, in line with its target and above its last projection for 1.2%. ECB members including its chief Christine Lagarde indicated that the surge in inflation is temporary and have vowed to keep its monetary policy loose because the drivers of price growth will fade early next year and inflation will be below target for years to come.

Amongst key data prints, industrial production varied across the region. While Italian production jumped to pre-pandemic levels, Germany's industrial production dropped by 1.0% MoM in Apr-21 from 2.2% MoM in Mar-21, indicating that supply chain disruptions such as the blockage of the Suez Canal and ongoing semiconductor delivery problems continue to weigh. Retail sales for the region fell more than expected in Apr-21, driven by lower sales of non-food products, but were 23.9% higher than a year earlier.

China

China is experiencing slower than anticipated normalization in ongoing economic recovery. Most incoming data such as retail sales, industrial production and investment data have disappointed bullish market expectations. Lingering caution among consumers remains the key dampening factor.

Looking ahead, a stronger economic recovery is premised on a more meaningful turnaround in demand side of the economy. It is expected that domestic investment and household consumption will continue to recover, albeit on a slower path, taking longer to reach pre-pandemic levels than anticipated earlier. On the other hand, China's central bank governor Yi Gang played down concerns over inflation assuring that it is under control after data showed the fastest rise in producer prices in 12 years. Further he added that monetary policy would be kept steady until the economy fully recovers.

Japan

Japan remains the only G7 country where the composite PMI is below the threshold of 50 i.e., at 48.8 in May-21 indicating continued contraction in economic activity in the region. Tokyo and several other prefectures' formal state of emergencies are set to lift on 20th Jun-21, but reports suggest lighter restrictions may be imposed ahead of the start of the Olympics and Paralympics scheduled for the third week of Jul-21. Holding the games during Covid has been unpopular in Japan, though public opinion appears to have softened off late. Nevertheless, the G7 statement recognized the importance of holding the event safely and securely "as a symbol of global unity in overcoming Covid-19".

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