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Macro Pulse Report

June 2023

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Contents

Growth 4
Inflation 7
Government Finances 10
Rates 13
Rupee 16
Global Overview 19

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From the desk of the Chief Economist

Greetings from Acuité Ratings & Research!

This is the **twenty ninth** edition of **Acuité Macro Pulse (AMP)**, our monthly commentary on the global and the domestic economy.

While the global macroeconomic uncertainties are not behind us, there is a growing sense that CY2023 will not be as disappointing a year as it was initially projected to be. World Bank has recently revised its global growth forecast upwards to 2.1% in the current year from 1.7% earlier, reflecting particularly the resilience of the US and some other developed economies such as Japan to the intense global headwinds. Despite the moderation in commodity prices and the easing of prior supply chain bottlenecks, core inflation continues to be relatively high in most of these economies, reinforcing some level of resilience. This has already led to two central banks – Reserve Bank of Australia (RBA) and Bank of Canada (BoC) to hike rates by 25 bps in their last meeting even after announcing a pause. The global market is looking forward to Fed's stance in the coming meeting – a further rise or a pause? Whatever way it is, one thing that emerges clearly is that the uncertainty in the global interest rates will continue to be high in the current year and in our opinion, the theme of "higher for longer"(rates) will play out for a large part of the current calendar year. Some of you will recall that my introductory note on this report three months back, had harped on this likely scenario. Market participants who had predicted that there will be a quicker pivot and multiple rate cuts in the US in the current year itself, have realized that the likelihood of such a scenario has diminished.

In the case of India, the resilience of the domestic economy has already been talked about since last year when the geo-political crisis erupted in Ukraine. The higher inflation and the global slowdown notwithstanding, the latest data releases by NSO confirm that the real GDP growth for FY23 stood at 7.2% with a significantly higher than expected 6.1% print in Q4FY23. Of late, the sense of optimism around the economy has grown particularly among the policy makers. In the last MPC meet, RBI has held on to its optimistic GDP growth forecast of 6.5% vis-à-vis our figure of 6.0%. In our opinion, it is too early to be complacent about the risk factors to inflation and growth – namely the El Nino and its impact on the monsoon. The latter seems to be already delayed in the current season and a lack of adequate spatial as well as temporal distribution in rainfall can have a significant impact on agriculture which has seen healthy growth over the last three years. There is an upside to growth, however which can accrue from a step up in private sector capital expenditure but we would like to see more data points on that before coming to a conclusion.

India's macroeconomic stability, however, will continue to be a comfort factor. Interest rates have been kept on a pause since April by RBI MPC and it is likely to be that way for the next two quarters. The central bank is set to tread with caution and not indicate any easing of monetary policy till there are adequate signs of a drop in core inflation to near 4.0%. The rupee may see some moderate volatility in the current year but given the improving BoP position, we continue to believe in the possibility of a stronger currency by the end of the fiscal.

To conclude, we remain "cautiously optimistic" about the Indian macroeconomic outlook.

Let the rains now hit the parched lands! Cheers,

Suman Chowdhury
Chief Economist & Head – Acuité Research

Growth

Moderate slowdown likely despite optimism

KEY TAKEAWAYS

- The enthusiasm over the healthy pace of India's economic activity continues well into Q1 FY24.
- This has been somewhat reinforced by the upward surprise in GDP growth for Q4 FY23, which x`came in at 6.1%YoY, compared to market consensus pegged broadly between 5.0-5.5%.
- In its latest MPC report, RBI has continued to be optimistic on the growth prospects in FY24, pegging its forecast at 6.5%; while the World Bank has cut its forecast slightly, it also pegs it at similar levels at 6.3%.
- High frequency indicators for Apr-23 and May-23 largely display strength, notwithstanding the seasonal downside usually seen at the beginning of the fiscal year.
- Prominently, India's PMI manufacturing index expanded at the quickest pace in as many as 31 months to 58.7 in May-23 from 57.2 in Apr-23, amidst broad-based gains in output, orders and hiring. Services PMI held up well too in May-23.
- Looking ahead, challenges for domestic growth are expected to exacerbate in FY24 owing to – 1) Slowdown in global growth and trade 2) Possibility of El Nino and 3) downside in urban leveraged consumption owing to pass-through of higher borrowing costs.
- We do acknowledge that there are nascent signs of a more decisive shift in private sector capex intentions for FY24. As such, we maintain GDP growth forecast at 6.0% in FY24, but introduce the possibility of a minor upside.

The enthusiasm over pace of India's economic activity being healthy continues well into Q1 FY24. This has been somewhat reinforced by the upward surprise in GDP growth for Q4 FY23, which came in at 6.1%YoY - compared to market consensus pegged broadly between 5.0-5.5%. High frequency indicators for Apr-23 and May-23 display sustained momentum. Prominently, India's PMI manufacturing index expanded at the quickest pace in as many as 31 months to 58.7 in May-23 from 57.2 in Apr-23, amidst broad-based gains in output, orders and hiring. PMI services index in May-23 continued to remain robust, expanding at the second fastest pace in 13 years. This is against a global backdrop that remains uneasily calm amidst the recently concluded uncertainty on US debt ceiling impasse.

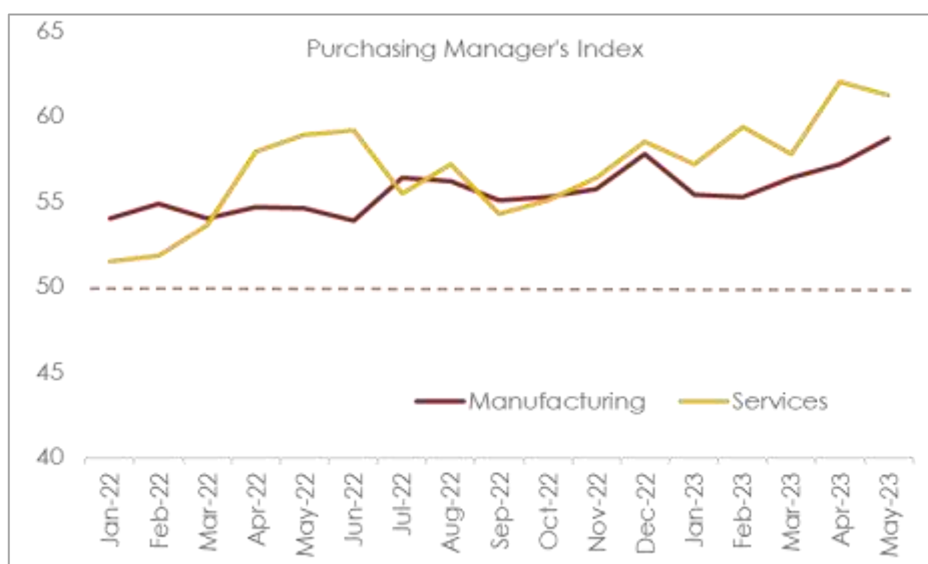
Q4 FY23 GDP: As good as it gets

- India's GDP growth accelerated sharply to 6.1% YoY from 4.5% in Q3. The upturn in headline was primarily driven by pent-up demand for services, healthy run-rate of investment, improvement in net exports, and robust capex-oriented government expenditure.
- The robust pace of economic activity in Q4 FY23 meant an upward revision to FY23 GDP growth, which is now pegged at 7.2% (up 20 bps vs. prior estimate).
- Government capex continues as a strong pillar of support, as it pushed investment ratio to 31.7% of GDP in Q4 FY23, the highest level in almost 9 years.

Here are the other recent data releases

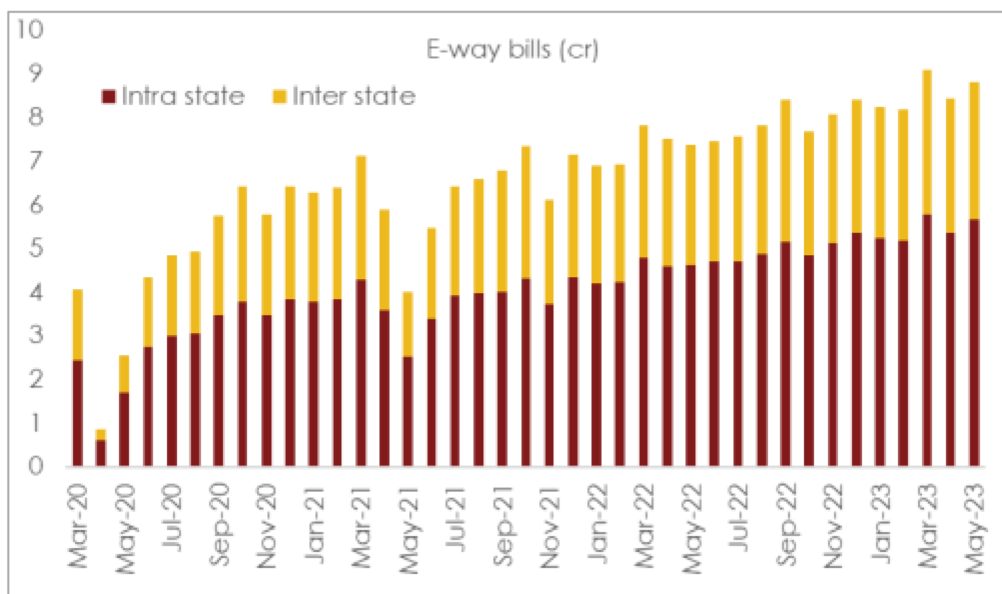
- Industrial activity moderated to a 5-month low of 1.1%YoY in Mar-23 from 5.8% in Feb-23. The moderation was driven by the manufacturing and the electricity sector, the drop in demand and output in the latter largely due to a relatively moderate summer in the current year.
- Gross GST collections maintained their growth at 11.5% YoY in May-23 (pertaining to transactions in Apr-23) vs. 11.6% in Apr-23.

<u>Chart 1: Both, PMI manufacturing and Services remained robust in May-23</u>



- The composite PMI remained unchanged in May-23 at 61.6, the strongest level in 13 years.
- Merchandise trade deficit, narrowed to a 20-month low of USD 15.2 bn in Apr-23 from USD 18.6 bn in Mar-23.

Chart 2: E-way bills generated bounced back in May-23



Outlook

Over the last few weeks, some defining features of recent pace of economic activity have stood out (both on domestic and global front):

- Momentum in domestic economic activity has continued well into Q1 FY24, as validated by several high frequency indicators.
- There are nascent signs of a perceptible shift in private sector capex intentions. Visible capex thrust in Q4 FY23 (though driven by one major deal in the aviation sector), has now found support from improving capex pipeline for FY24.
- The anticipated slowdown in global growth is moving at a slower pace than anticipated earlier. In fact, the World Bank upped its global growth forecast for 2023 by 40 bps to 2.1% (although it still signals a slowdown vs. estimated global growth of 3.1% in 2022).

However, challenges for economic growth are expected to exacerbate in FY24.

- Global trade is seeing a material slowdown amidst weaker demand and heightened protectionism.
- Urban consumption is likely to show some fatigue as pent-up demand wanes and monetary transmission gets completed. The pace of annualized growth of credit to consumer durables has moderated in the last 2-3 quarters.
- Downside risks could emanate from the possibility of El Nino weighing on monsoon performance which could dampen rural incomes.

Having said so, the ongoing recovery in rural demand, continued support from public capex along with nascent signs of revival in private capex are to be seen as growth anchors. Overall, we maintain FY24 GDP growth forecast at 6.0% at this stage (with a possibility of a minor upside).

Inflation

Comfortable within target range

KEY TAKEAWAYS

- India's CPI and WPI inflation moderated in Apr-23 to 4.70%YoY (18-month low) and -0.92%YoY (34-month low) respectively.
- Headline CPI inflation in Apr-23 remained within the RBI's target range (2-6%) for the second consecutive month.
- Headline CPI and WPI inflation eased by 96 bps and 226 bps respectively over the previous month.
- Notwithstanding the co-movement at the headline level, both inflation metrics diverged on sequential basis. While CPI index rose by 0.51% MoM, WPI index remained unchanged (0.00% MoM).
- Core retail and wholesale inflation moderated to an 11-month low of 5.48%YoY and 41-month low of -1.77%YoY in Apr-23 respectively, on account of incremental softness in most commodity prices amidst a slowing global economy.
- Moderation in headline inflation for both WPI and CPI can be attributed to easing food inflation, lower commodity costs, favourable statistical base effects and lagged impact of past monetary tightening.
- Upside risks to inflation, nevertheless, remain from El Nino conditions that could impact the performance of Southwest monsoon.
- We maintain our FY24 CPI inflation projection of 5.3%.

India's CPI and WPI inflation moderated in Apr-23 to an 18-month low and a 34-month low of 4.70%YoY and -0.92%YoY respectively. Other highlights include:

- Headline CPI and WPI inflation eased by 96 bps and 226 bps respectively over the previous month.
- Notwithstanding the co-movement at headline level, both inflation metrics diverged sequentially in Apr-23 with CPI rising to 0.51% MoM and WPI remaining unchanged (0.00% MoM) for the second consecutive month.
- Headline CPI inflation in Apr-23 remained within the RBI's target range (2-6%) for the second consecutive month.
- Headline WPI inflation in Apr-23 retreated to negative territory after a gap of 33-months.

Key highlights of CPI inflation

- The 0.51% MoM momentum in Apr-23 was stronger than Mar-23 momentum of 0.23%, but well below the pre-COVID average sequential increase of 0.69% usually seen in the month of April.
- Food and Beverages index rose by 0.56% MoM in Apr-23. The acceleration was due to unfavourable summer seasonality coupled with adverse impact arising from a heatwave followed by unseasonal rains/ hailstorms in certain parts of the country.
- Consolidated fuel inflation dropped to a 25-month low of 5.52%YoY in Apr-23 due to normalisation in energy prices, from 8.79%YoY in Mar-23.
- Sequential momentum in core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel items within Miscellaneous) rose to 0.45% MoM in Apr-23 from a 21-month low of 0.23% MoM in Mar-23. However, amidst a favorable base, inflation rate under this category moderated to an 11-month low of 5.48% in Apr-23 from 5.89% in Mar-23.
- Within core, Clothing and Footwear inflation moderated to a 19-month low of 7.47%YoY in Apr-23 from 8.18%YoY in Mar-23; while Personal, care and effects inflation rose to 9.0%YoY from 8.25% in Mar-23 owing to safe-haven run-up in gold prices globally.

Key highlights of WPI inflation

- At a granular level, gain in the Primary article index (1.31% MoM) was offset by moderation in Fuel and Power (-2.68% MoM) and Manufacturing indices remaining unchanged (0.00% MoM).
- Price pressures in the primary index were led by sequential increase across all sub-categories barring Non-food. Prominent sub-categories contributing to the sequential upturn were Crude & natural gas (+3.47% MoM), Minerals (+2.30% MoM), and Food (+1.45% MoM).
- Core WPI (WPI ex indices of Primary: Food, Mfg: Food, Mfg: Beverages, Fuel & Power, and Primary: Crude Petroleum & Natural Gas) rose by 0.06%MoM from a contraction of 0.21% in Mar-23. Despite the sequential pick-up, Core WPI inflation eased further to -1.77%YoY from -0.34% in Mar-23 amidst a favourable base at play.

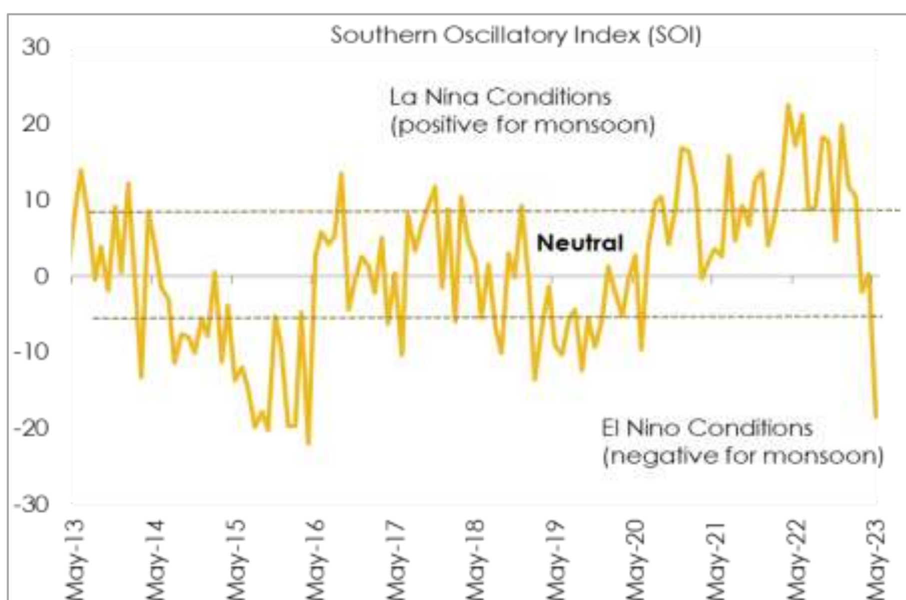
Outlook

Continued deceleration in headline inflation in Apr-23 at both the retail and wholesale level has been comforting. Moreover, core CPI and WPI inflation are exhibiting early signs of moderation on account of incremental softness in most commodity prices along with a slowdown in global demand.

Having said so, the possibility of El Nino conditions likely evolving during the summer months has risen. In its latest update (as of 8th Jun-23), the US based NOAA (National Oceanic and Atmospheric Administration) has officially announced the onset of El Nino, with expectations of its gradual build-up in strength. Any adverse impact on spatial and geographical distribution of rainfall could potentially push up domestic food prices. IMD, in its second range forecast for rainfall, continues to expect Normal rainfall at 96% of LPA for the Southwest monsoon. The onset of the monsoon in Kerala is delayed (against the expected date of 4th Jun-23) by 3-4 days and is forecasted to be 'Below Normal' at 92% of LPA for the month of Jun-23. While healthy water level in reservoir may help to tide the Jun-23 shortfall in rainfall, monsoon performance in July-23 will be critical from the perspective of Kharif sowing of crops.

CPI inflation may ease further and be in the band of 4.2%-4.6%YoY over the near term amidst a favourable base and softer momentum in both food and fuel. Potential risks notwithstanding from El Nino, we see a faster moderation in headline CPI inflation in FY24 than core inflation. The latter could prove somewhat sticky amidst strong growth momentum continuing in contact intensive ones. While RBI in its latest policy lowered FY24 CPI inflation forecast by 10 bps to 5.1%, we hold on to our projection of 5.3% for now despite the downward surprise in recent inflation prints as well as global crude prices remaining ranged. We await better clarity on El Nino and its possible impact on food prices, if any to cement any change to our FY24 inflation outlook.

Chart 1: The SOI has plunged in May-23 to officially mark the onset of El Nino



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Government Finances

Fiscal risks neutral at this stage

KEY TAKEAWAYS

- In line with our expectations, the central government met its FY23 fiscal deficit target of 6.4% of GDP.
- Focusing on incremental data for FY24, we note that fiscal deficit for the month of April stood at 7.5% of budget estimates (BE) for FY24, higher than 4.3% of actuals seen in the corresponding period in FY23.
- The higher accretion to fiscal deficit reflects relatively moderate pace of realization of revenue receipts even as revenue expenditure disbursal turned out to be faster than last year's momentum.
- Going forward, there are slippage risks on account of higher than budgeted fertilizer subsidy bill, potential upside to rural spending in case of El Nino disruption, and likelihood of lower than budgeted Nominal GDP growth weighing upon tax revenue collections.
- However, with creation of additional fiscal space from higher than budgeted dividend transfer from RBI, we believe the government would adhere to FY24 fiscal deficit target of 5.9% of GDP.

In line with our expectations, the central government has met its FY23 fiscal deficit target of 6.4% of GDP. Compared to revised estimates, total receipts turned out to be higher by Rs 238 bn led by positive surprise in both tax and non-tax sources of revenue – this helped to offset lower than budgeted disinvestment revenue. While total expenditure disbursal in FY23 was close to target, capex saw a minor positive surprise, which was offset by a minor negative surprise in revex (which incidentally helped in lowering the revenue deficit target to 3.9% of GDP compared to the RE of 4.0%).

Focusing on incremental data for FY24, we note that fiscal deficit for the month of April stood at 7.5% of budget estimates (BE) for FY24, higher than 4.3% of actuals seen in the corresponding period in FY23. The higher accretion to fiscal deficit reflects relatively moderate pace of realization of revenue receipts even as revenue expenditure disbursal turned out to be faster than last year's momentum.

Receipts: Start on a subdued note

Gross tax revenue collection started FY24 on a sombre note with Apr-23 clocking a contraction of 6.1% YoY (6.5% of BE for the full year compared to 7.6% of actuals in the corresponding year in FY23).

- The drag was primarily led by corporate tax collections, with signs of minor weakness seen in income tax and GST collections.
- Surprisingly, customs duty collection emerged as an outperformer amongst various category of taxes.

Non-tax revenue collections also started on a modest note, clocking 3.6% of BE in Apr-23 compared to 4.2% of actuals in the corresponding period in FY23. However, the higher than budgeted dividend transfer from the RBI to the central government (Rs 874 bn vs. BE of Rs 480 bn inclusive of dividend from PSU banks) in the month of May-23 would help in creating revenue buffers.

Non-debt capital receipts clocked just 0.8% of BE in Apr-23, much lower than 4.8% of actuals in the corresponding period in FY23. The divergence at the start of the year is on account of lack of divestment activity in Apr-23, in contrast to the ONGC disinvestment carried out in Apr-22. The FYTD disparity is likely to increase further as LIC and PPL divestments had helped the government to gain traction in May-22, in contrast to any such big-ticket divestment activity so far.

Expenditure: Revex disbursals start on a firm note

Total expenditure disbursal in Apr-23 stood marginally higher at 6.8% of FY24 BE, vs. 6.6% of actuals in the corresponding period in FY23.

- Revenue expenditure started on a firm note, clocking 6.4% of FY24 BE compared to 5.7% of actuals in the corresponding period in FY23.
    - Interest payments and subsidies accounted for ~32% of revex disbursals during Apr-23.
    - Excluding interest payments and subsidies, revex grew by 5.6% YoY in Apr-23 compared to 28.4% in Apr-22.
- Unlike the robust expansion seen in FY23, capital expenditure started FY24 on a moderate note with Apr-23 clocking 7.8% of FY24 BE vis-à-vis 10.7% of actuals in the corresponding period in FY23. These are early trends and should not be extrapolated for the rest of the year as there is often significant chunkiness in government spending.

Outlook

We continue to expect the central government to meet its FY24 headline fiscal deficit target of 5.9% of GDP with risks appearing neutral at this stage.

Key risks emanate from:

- The fertilizer subsidy bill is likely to a see a slippage of approximately Rs 500 bn.
- The BE are based on the assumption of 10.5% growth in FY24 Nominal GDP. Basis the second advance estimates of national accounts for FY23, the implied growth now stands at 10.8%. This could see some downside risk as per our estimates. This in turn could potentially lead to some slippage on tax revenues.
- Any significant monsoon disruption from El Nino in the coming months could potentially prompt the government to extend rural spending support measures beyond BE.

On a positive note, significantly higher than budgeted dividend transfer from the RBI has created some fiscal room for accommodating expenditure slippages.

Table1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position, as of Apr)				
	% of FY Actual/Target		%YoY	
	FY23	FY24	FY23	FY24
Revenue Receipts	8.2	6.5	33.1	-13.6
Net Tax	8.8	6.8	41.1	-13.9
Non-Tax	4.2	3.6	-29.0	-8.2
Non-Debt Capital Receipts	4.8	0.8	837.6	-81.6
Total Receipts	8.1	6.3	35.1	-14.7
Revenue Expenditure	5.7	6.4	9.1	15.2
of which, Interest Payment	4.4	4.4	39.2	16.1
of which, Major Subsidies	3.2	6.7	-72.8	147.9
Capital Expenditure	10.7	7.8	67.5	-0.6
Total Expenditure	6.6	6.8	21.2	10.6
Fiscal Deficit	**4.3**	**7.5**	**-**	**-**

Rates

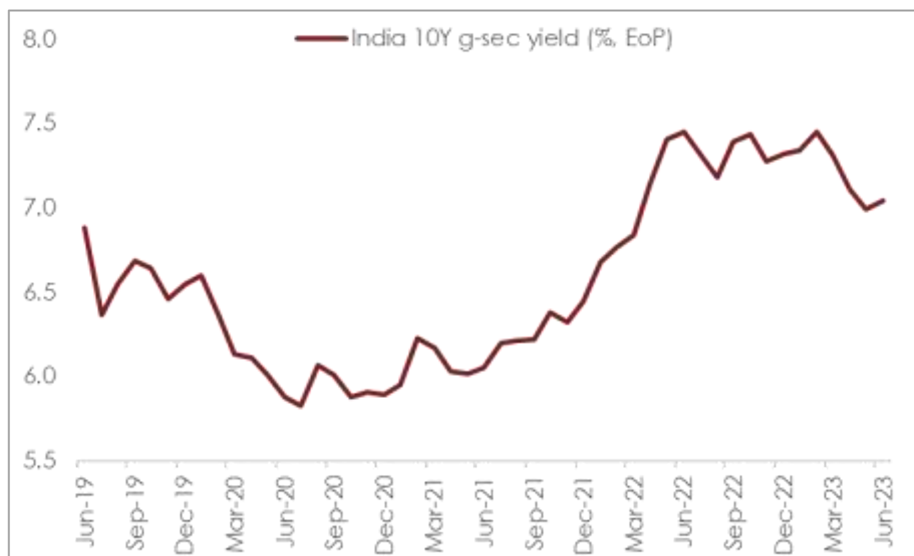
Downside bias persists despite upside risk

KEY TAKEAWAYS

- After closing Apr-23 at 7.11%, the 10Y g-sec yield touched a low of 6.96% towards the middle of May-23, before inching up to 6.99% by end May-23. Since then, bonds have shown range-bound trading with some bias for upward movement in yields – the 10Y g-sec yield is currently just above 7.0%.
- Quick dissipation of negative spill overs from banking sector turmoil in the US, stickiness in core inflation, and still healthy labour market conditions has prompted a reassessment of Fed rate trajectory with terminal rate expectations seeing a step-up for the near-term and projection of status quo getting stretched through 2023.
- While RBI maintained status quo on rates and stance in Jun-23, there seems to be some caution creeping in amongst MPC members.
- Record high net g-sec supply pressure in Q2 FY24 coupled with El Nino risks could potentially take 10Y g-sec yields towards 7.15% levels in the near term.
- However, we continue to expect 10Y yield to moderate towards 7.00% (with downside risk) by Mar-24 assuming lowering of inflation expectations for FY25 and beginning of actual monetary policy pivot by key central banks globally.

After closing Apr-23 at 7.11%, the 10Y g-sec yield touched a low of 6.96% towards the middle of May-23, before inching up to 6.99% by end of May-23. Since then, bonds have shown range-bound trading with some bias for upward movement in yields – the 10Y g-sec yield is currently at 7.04%.

Chart 1: India's 10Y g-sec yield has been consolidating post recent decline



A quick fading of negative spill overs from banking sector turmoil in the US (although it is likely to have a lagged gradual impact due to tightening of credit conditions), stickiness in core inflation, and still healthy labour market conditions have prompted a reassessment of Fed rate trajectory. In contrast to market pricing in of close to 3 rate cuts by end of 2023 (as of first week of May-23), the current status indicates pricing in of 1 rate hike by Jul-23 along with near pricing out of rate cuts in 2023. Market participants have now pushed out their expectation of a Fed pivot (i.e., the start of monetary policy easing) to Q1 2024.

Table 1: Market has pushed out Fed pivot expectations to Q1 2024

FOMC Meeting Date	Expected FOMC rate action with implied probability (%)
Jun 14, 2023	At least one rate cut (0); **Status quo (71)**; At least one rate hike (29)
Jul 26, 2023	At least one rate cut (0); Status quo (31); **At least one rate hike (69)**
Sep 20, 2023	At least one rate cut (2); Status quo (33); **At least one rate hike (65)**
Nov 1, 2023	At least one rate cut (14); Status quo (39); **At least one rate hike (47)**
Dec 13, 2023	At least one rate cut (28); **Status quo (38)**; At least one rate hike (34)
Jan 31, 2024	**At least one rate cut (48)**; Status quo (33); At least one rate hike (19)
Mar 20, 2024	**At least one rate cut (71)**; Status quo (21); At least one rate hike (8)

Note: (1) Current fed funds target range is at 5.00-5.25%; (2) Probability of FOMC rate action as implied by fed funds futures market shown in parenthesis (rounded off numbers).

With Fed terminal rate expectations seeing a step-up for the near-term and projection of status quo getting stretched through 2023, UST 10Y yield has increased by 44 bps since early part of Apr-23.

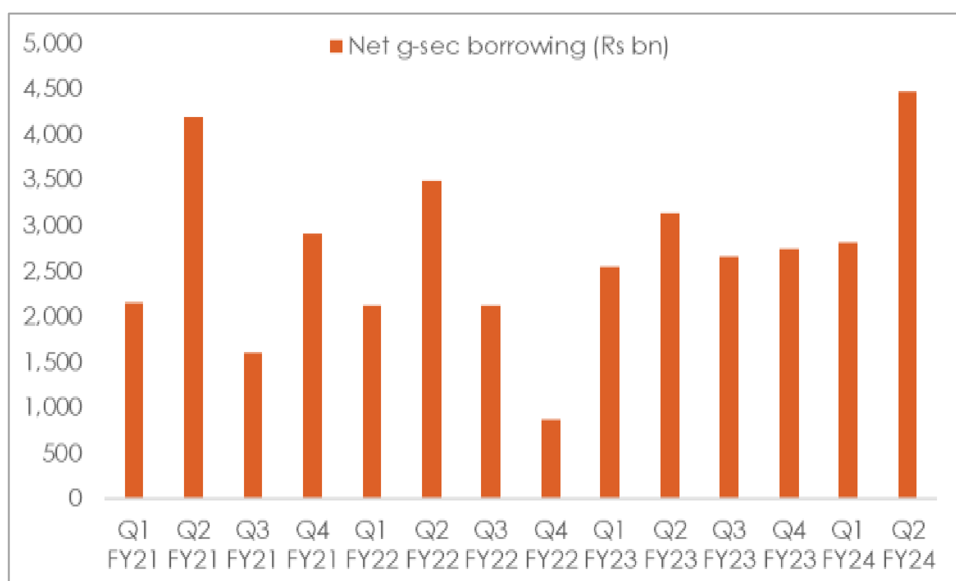
This complete turnaround in market expectations with respect to Fed pivot in last 1-2 months has sprung few surprises. In contrast to market expectation of status quo, the Reserve Bank of Australia and the Bank of Canada surprised with a rate hike in their Jun-23 policy reviews.

However, this did not permeate to India - the RBI, in line with market expectations, maintained status quo on rates as well as stance in its policy review in Jun-23. Nevertheless, there was some hint of caution in the monetary policy statement pertaining to inflation related risks (despite a 10 bps downward revision to its FY24 CPI inflation forecast to 5.1%). Moreover, with CPI inflation projected to remain firmly within the target range in FY24, the MPC now appears determined to align it with the policy target of 4.0% by FY25. This could potentially imply the need for keeping real policy rate in a relatively tight range.

From market pricing perspective, aggressive expectations by few with respect to start of RBI monetary policy easing from Dec-23 onwards now appears to have been unwound, with likelihood of first rate cut getting pushed to Feb-24/ Apr-24.

From g-sec perspective, we associate this backdrop for range-bound movement as CPI inflation is projected to stay in the comfortable range of 4.6-5.4% through FY24. However, there can be some upward pressure on yields in the near term (with 10Y potentially touching 7.15%) on account of record high net borrowing of Rs 4.5 tn in Q2 FY24. Although this will get partially offset by a comfortable liquidity backdrop owing to the impact of withdrawal of Rs 2000 banknote from circulation and higher than budgeted dividend transfer from the RBI to the GoI, supply pressure would eventually outweigh. In addition, risk of El Nino playing a spoilsport during Q2 FY24 is not trivial.

Chart 2: Q2 FY24 will see a record amount of net g-sec borrowing



However, over the medium term, we continue to expect yields to moderate and maintain our call of 10Y g-sec yield of 7.00% (with downside risk) by Mar-24 assuming this will coincide with lowering of inflation expectations for FY25 and more importantly, would also see actual monetary policy pivot by key central banks globally.

Rupee

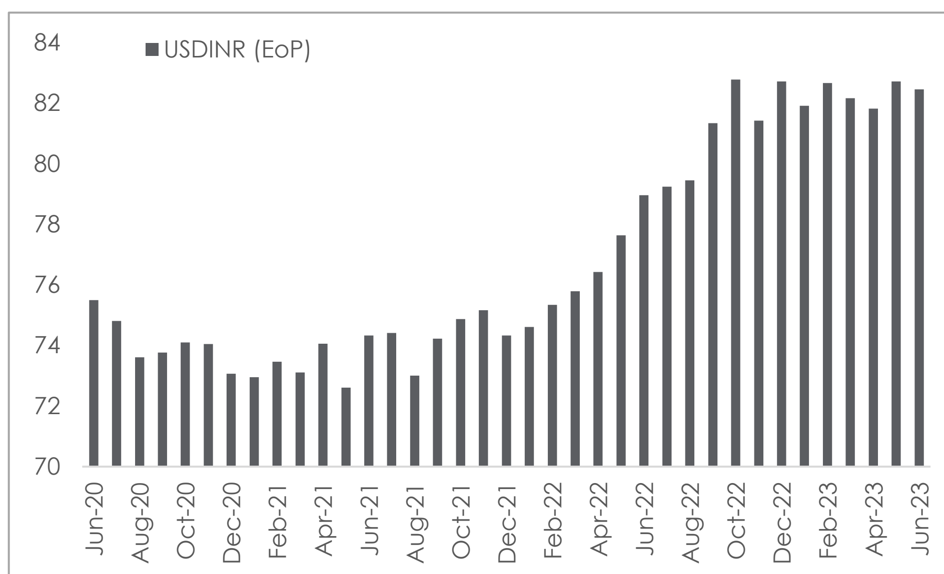
Backloaded strength in store

KEY TAKEAWAYS

- The INR closed May-23 at 82.72 after depreciating 1.1% against the USD. Since then, the currency has regained modestly, trading around 82.46 levels currently.
- Sharp turnaround in market expectations with respect to Fed rate trajectory over last one month has provided a leg-up to the USD – the DXY index has climbed up to 103.6 currently from 101.7 in end Apr-23.
- However, the anticipated Fed pivot in Q1 2024 will eventually weigh upon USD as there could be a lag with which other central banks begin their monetary policy easing.
- Meanwhile, INR is expected to benefit from gradually improving macroeconomic balance.
- With BoP projected to revert to surplus after estimated to have stayed in deficit territory in FY23, we continue to expect rupee to moderately strengthen in FY24, with forecast of USDINR touching 80.0 levels before end of FY24.

The Indian rupee closed May-23 at 82.72 after depreciating 1.1% against the US dollar. Since then, the currency has regained modestly, trading around 82.46 levels currently.

Chart 1: INR has been consolidating in the 81-83 range for last 10-months



As noted in the rates section, a quick dissipation of banking sector concerns in the US, stickiness in core inflation, and still healthy labour market conditions has prompted a reassessment of Fed rate trajectory. The sharp turnaround in market expectations with respect to Fed rate trajectory (from pricing in as much as 3 rate cuts before the end of 2022 as of early May-23 to near pricing out of any monetary easing in 2023 currently) in course of last one month has provided a leg-up to the USD – the DXY index has climbed up to 103.6 currently from 101.7 in end Apr-23.

This dollar strength has weighed upon EM currencies, with INR also facing depreciation pressures. Having seen that, we believe depreciation pressures for INR are unlikely to persist.

- The Fed is expected to attain its terminal policy rate range of 5.25-5.50% by Jul-23. The monetary policy advantage for the USD would dissipate thereafter as peer central banks like the ECB and the BoE are expected to continue to tighten their respective monetary policy through Q2 and Q3 of 2023.
- The Fed is now widely expected to begin easing monetary policy from Q1 2024. When the pivot happens, we expect the Fed to lead other key central banks in the rate cutting cycle. This will put the USD at a disadvantage to begin with.

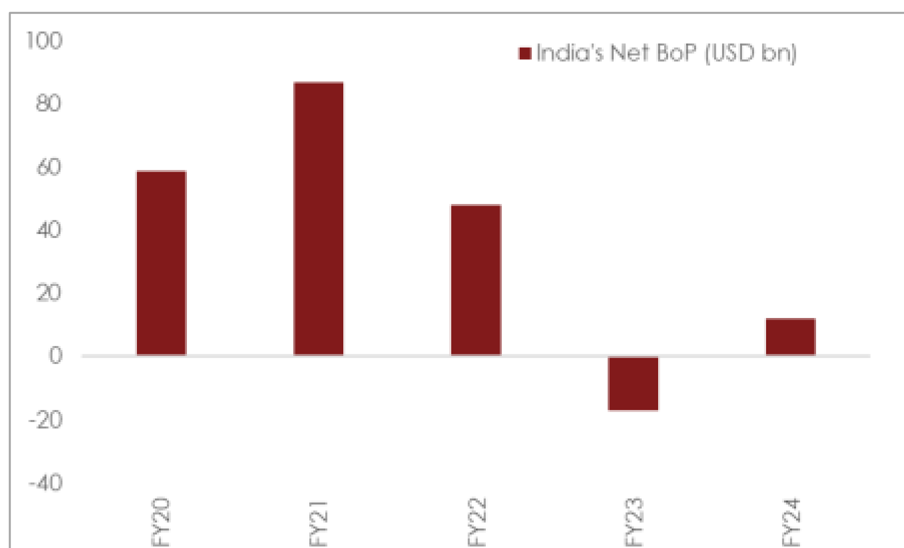
From INR perspective, this could result in some backloaded appreciation in our opinion as the domestic macro setting sequentially gets more comfortable.

- Despite expected moderation in GDP growth to 6.0% in FY24 from 7.2% in FY23, the slowdown in the rest of the world is likely to be deeper, thereby helping India to remain one of the fastest growing major economies in the world.
- We expect CPI inflation to get back to its target band in FY24 by averaging close to 5.3%, down from 6.7% in FY23.

- India's central government's fiscal deficit has been on a gradual correction path (budgeted at 5.9% of GDP in FY24) after hitting its post pandemic high of 9.2% of GDP in FY21.
    - Return towards macroeconomic stability is seen to be attracting portfolio flows (on FYTD basis India has received USD 8.9 bn FPI flows – the highest in 10-quarters).
- Last, but not the least, is the sharp improvement in India's current account position - the current account deficit is expected to narrow to 1.4% in FY24 from an estimated 2.0% in FY23.
    - Despite persisting geopolitical pressures, easing of COVID era associated supply chain bottlenecks and anticipation of global economic slowdown has suppressed commodity prices. India Crude Basket is currently trading at an average level of USD 75 pb in Jun-23, down ~29%YoY. This has led to India's petroleum trade deficit to reduce to USD 8.7 bn in Apr-23 from its recent peak of USD 14.8 bn in Jul-22.
    - Russia's share in India's import basket has steadily climbed from 2.1% in Jan-22 to 10.0% in Apr-23. Since most of this is on account of crude oil, which is procured at a discount of USD 25-30 pb compared to Brent, this is increasingly becoming an important source of saving for the current account deficit.
    - Structural improvement in services exports amidst post pandemic thrust on digitization/ cost optimization is helping to narrow the overall current account deficit. In addition, with threat of COVID ebbing at a global level, India is once again witnessing tourism related foreign inflows.

The relative attractiveness of India's macroeconomic stability accompanied by BoP surplus of USD 14 bn in FY24 (estimated) amidst a dollar negative backdrop towards end of FY24 should be supportive of a stronger rupee in the coming quarters. We maintain our USDINR forecast of 80.0 by Mar-24.

Chart 2: In contrast to FY23, India's BoP is expected to generate a surplus in FY24



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Global Overview

A complex landscape

KEY TAKEAWAYS

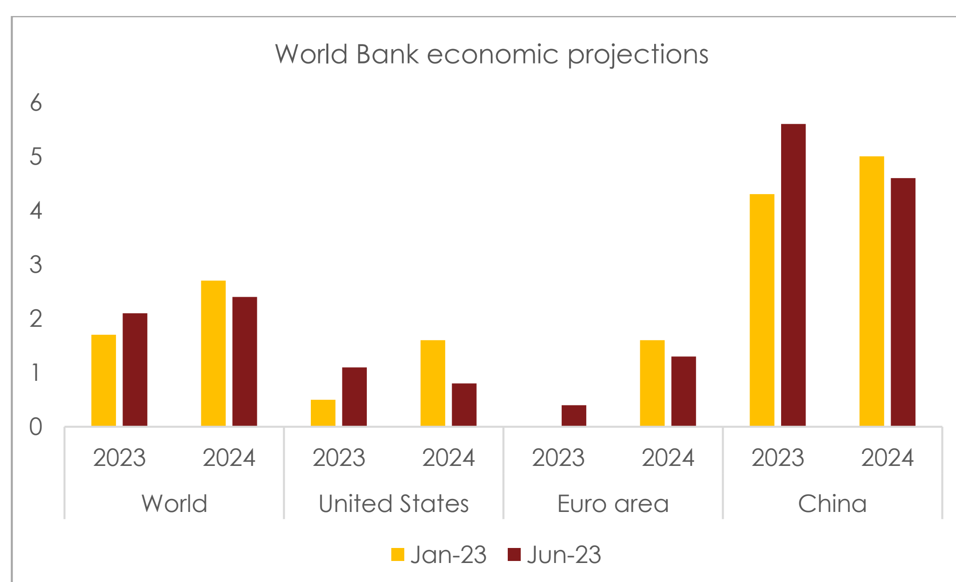
- Economic signal from most countries have been somewhat confusing. Most economies continue to show some degree of resilience despite record magnitude and pace of monetary tightening keeping intact the expectation of slowdown.
- It's not surprising that the World Bank in its Jun-23 Global Economics Prospects report upgraded its forecast for global growth in 2023 by 40 bps while simultaneously downgrading its 2024 forecast by 30 bps.
- From economic activity perspective, export power houses like China and Germany have started showing signs of strain, with the latter entering a technical recession in Q1 2023.
- While the global monetary policy tightening cycle is close to peaking, central banks are expected to tread the path ahead judiciously should inflation prove stickier and labour markets stay more resilient than expected.
- While the jury is still out regarding the timing of central banks beginning to cut rates, we believe it is unlikely in CY23.

Global overview

The anticipated global economic slowdown in 2023 has been fleeting so far, thereby providing room for key central banks to continue focusing on their unfinished task of fighting inflation. While the US Fed in its May-23 meeting, did indicate that it is likely to pause in Jun-23, debate over the need for further rate hikes continues to remain alive. In comparison, the ECB is likely approaching the peak rate with one more rate hike, while markets are pricing in two more rate hikes by the BoE. More recently, both the Reserve Bank of Australia and Bank of Canada surprised markets by delivering a 25-bps hike each, citing upside risks to inflation.

Meanwhile, economic signals remain confusing. Lagged impact of tight financial conditions has raised pockets of stress within financial markets (for e.g., US regional banks). Concerns over tighter credit conditions and slowing global trade were exacerbated by the US debt ceiling impasse. The true test of the impact assessment of these economic factors was seen on Germany that slipped into a recession in Q1-23. According to the latest Global Economics Prospects report by the World Bank, Global GDP growth for 2024 has been pared down by 30 bps to 2.4% from 2.7% projected in Jan-23, on account of the lagged effects of monetary tightening and restrictive credit conditions. However, global GDP is set to expand at a marginally stronger pace of 2.1% in 2023 (vs. 1.7% earlier) as major economies have proven more resilient than initially envisaged.

Chart 1: World Bank trims growth prospects for 2024 across key regions



Capturing the weakness in manufacturing, JP Morgan Global Manufacturing PMI registered contraction for the ninth successive month, to remain flat (49.6) in May-23. International trade volumes continued to weigh on demand, with new export orders dropping for the fifteenth consecutive month and declined at the fastest pace in 2023 so far. The US, Euro area, Japan, the UK and Brazil were among the key nations to see contraction, whereas China and India reported an expansion. Meanwhile, labour markets are still exceptionally tight, and parts of the services sector are still in post-pandemic recovery mode.

As such, a complex landscape has prompted central banks to slow the pace of rate hikes while remaining in a tightening mode as inflation shows signs of easing but remains higher than target. While the global monetary policy tightening cycle is close to peaking, central banks will tread the path ahead judiciously should inflation prove stickier and labour markets stay more resilient. While the jury is still out regarding the timing of central banks beginning to cut rates, we believe it is unlikely in CY23.

US

The combination of persistently elevated inflation, tight credit conditions and debt ceiling uncertainty continued to weigh on business investment and consumer spending in May-23. While tight labour market conditions are showing some signs of easing with unemployment rate climbing to 3.7% in May-23 from 3.4% in Apr-23, they remain relatively resilient. Nonfarm Payrolls rose by a robust 339k in May-23, well above market expectation (Refinitiv: 190k), accompanied by upward revision to both Mar-23 and Apr-23 payrolls.

US GDP growth was revised up to 1.3% YoY in Q1-23 from 1.1% reported earlier, driven by a stronger upward revision to private inventory investment and consumer spending. Government spending rose 5.2% on an annualised basis with federal non-defence outlays boosted by larger-than-usual social security payments. Residential investment though remained severely constrained, posting its eighth consecutive quarterly decline, down to 5.4%YoY in Q1-23 from its peak of 22.0% in Q1-22.

US headline CPI inflation continued to descend to 4.9%YoY in Apr-23 from 5.0% in Mar-23, slowing to below 5% for the first time in two years and broadly in line with market consensus. Core CPI (Excluding volatile food and energy) eased marginally to 5.5% YoY in Apr-23 from 5.6% YoY in Mar-23. Moreover, core PCE, the Fed's preferred gauge of inflation, softened to 4.7% YoY in Apr-23 from 4.6% in Mar-23, reinforcing that a gradual disinflationary process is well underway.

Manufacturing activity was soft with ISM manufacturing PMI falling to 46.9 in May-23, contracting for the seventh straight month as new orders continued to plummet. Momentum in the services sector (ISM non-manufacturing PMI) too eased from 51.9 in Apr-23 to 50.3 in May-23 but remained in expansion territory. Consumer spending was robust with core retail sales (headline excluding automobiles, gasoline, building materials, and food service) rising by 0.7%MoM in Apr-23, well above market expectation (Refinitiv: +0.3%), from a contraction of 0.4% in Mar-23.

The FOMC minutes revealed that committee members generally viewed inflation as being excessively high and perceived the current disinflationary trend as being much slower than expected. This, along with a tight labour market, pushed policymakers to proceed with a 25 bps rate hike in its 3rd May-23 meeting, bringing the federal funds rate range to 5.00%–5.25%. The minutes also indicated that "several" participants believed "*further policy firming after this meeting may not be necessary*" if the economy evolved along the lines of their current outlook. However, since then, some divergence in views has emerged, with some members expressing their bias for a 25 bps hike in Jun-23.

UK

UK Apr-23 CPI inflation eased but less than expected to 8.7%YoY (Refinitiv: 8.2%), from 10.1% in Mar-23. The largest upward contribution to the headline came from housing and household services, and food and non-alcoholic beverages. Core CPI (excluding energy, food and tobacco components) proved stickier, rising by 6.8% YoY in Apr-23, the highest rate since Mar-92, from 6.2% in Mar-23.

As per media reports, the UK government is planning to have retailers cap the price of basic food items such as bread and milk to tackle stubbornly high food prices. The government had already introduced relief measures including extending household energy subsidies by three months along with freezing the duty on pub alcohol and fuel prices.

Incoming data on other high frequency indicators has been mixed. The final S&P Global/CIPS UK manufacturing Purchasing Managers' Index (PMI) fell for the third consecutive month to 47.1 in May-23, from 47.8 in Apr-23. Consumer sentiment improved sharply with retail sales rising by 0.5% MoM in Apr-23, marginally above market expectation (Refinitiv: +0.3%), from a contraction of 1.2% in Mar-23.

According to estimates released by the Office for National Statistics (ONS), GDP edged up 0.1%QoQ in Q1-23 to match the tepid pace of Q4-22 and broadly in line with market consensus.

Factoring the elevated inflation, BoE raised interest rates by 25 bps to 4.5% in May-23 meeting, in line with market expectations. All but two BoE members, backed the rate action. The MPC now expects the UK economy to grow by 0.25% in 2023 and by 0.75% in 2024, an improvement vs. its previous estimates -0.50% and -0.25% respectively. Inflation is projected at 5.1% by Q4 2023 (previous forecast: 3.9%), and 3.4% in Q1 2024 (previous forecast: 3.0%). Governor, Andrew Bailey, said that he hoped the BoE was "*approaching the point when we should be able to ... rest in terms of the level of rates*", but added it was too soon to be sure. Market participants are pricing BoE to raise its policy rate at both its 22nd Jun-23 and 3rd Aug-23 meetings, bringing the peak policy rate at 5.00% for the current cycle.

Eurozone

The euro zone economy entered a technical recession in Q1 2023 with GDP growth dipping by 0.1%QoQ compared to a flash reading of 0.0% and a contraction of 0.1% in Q4 2022. The feared contraction in growth, after Germany became the first industrialised economy in the region to enter recession, was driven by a fall in government consumption expenditure (-1.6%) and consumption (-0.3%).

The downturn in euro zone manufacturing activity deepened in May-23 with the final manufacturing PMI falling to 44.8, well below the 50-mark for the eleventh consecutive month, from 45.8 in Apr-23. Investor morale, as measured by the Sentix index, fell to -13.1 in May-23, well below market expectation (Refinitiv: -8.0) and from -8.7 in Apr-23. Retail sales in the euro zone, on a sequential basis, were unchanged in Apr-23 compared with market consensus pegged at an expansion of 0.2% MoM. However, the labour market appears strong with unemployment rate falling marginally to 6.5% in Apr-23 from 6.6% in Mar-23.

Eurozone inflation though still elevated, eased to 6.1%YoY in May-23, to mark the lowest level in more than a year and marginally below market expectation (Refinitiv: 6.3%), from 7.0% in Apr-23. All broad categories trended lower, with core inflation (excluding food, alcohol, tobacco and fuel components) dropping to 5.3%YoY from 5.6% in Apr-23. ECB President Christine Lagarde, post CPI data release remarked that "*There is no clear evidence that underlying inflation has peaked*," and "*we have made clear that we still have ground to cover to bring interest rates to sufficiently restrictive levels*." Markets expect ECB to deliver one last 25 bps rate hike to a terminal rate of 3.50% on 15th Jun-23, before moving to a pause.

CHINA

Chinese economy appears to be losing momentum. Manufacturing activity shrank in May-23, as captured by the official manufacturing PMI falling to a five-month low of 48.8, staying below threshold of 50 for the second consecutive month. The deceleration was driven by production, new orders, new export orders, and employment. In contrast, services sector expanded but at the slowest pace in four months in May-23, with the official non-manufacturing PMI index falling to 54.5 from 56.4 in Apr-23.

On annualised basis, industrial activity grew by 5.6% in Apr-23, well below market expectations pegging a recovery of 10.9%, from 3.9% in Mar-23. Growth in retail sales at 18.4%YoY in Apr-23 too fell short of consensus forecast for a 21.9% gain. Trade activity indicates a grim outlook as well, with exports falling by 0.8% YoY in May-23, below market expectation (Refinitiv: -0.4%), after growing by 8.5% in Apr-23. Imports grew by 2.3% YoY in May-23, well below market expectation (Refinitiv: -8.0%), following a drop of 7.9% in Apr-23. The data reflects worsening global demand for goods, as also witnessed by other major Asian exporters, such as South Korea and Vietnam.

Retail inflation rose by 0.2%YoY in May-23, marginally below market expectation (Refinitiv: +0.3%) with easing price pressures seen across both food and non-food components. The PPI fell for the eighth consecutive month by 4.6%YoY, the fastest decline since Feb-16, over and above a contraction of 3.6% in Apr-23.

Nascent signs of economic recovery levelling off in China coupled with weak inflationary pressure have renewed expectation for the People's Bank of China (PBOC) to continue maintaining an accommodative monetary policy, following a 25bps cut in the Reserve Requirement Ratio (RRR) in effect since end Mar-23.

About Acuité Ratings & Research Limited:

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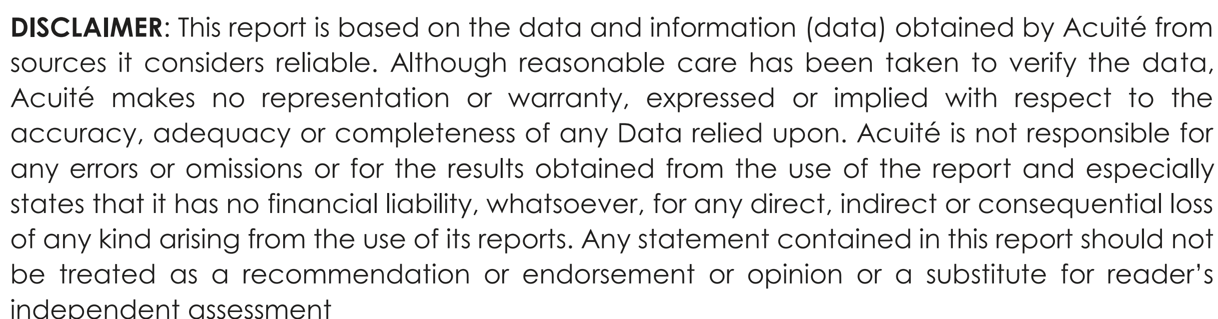

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