MACRO PULSE REPORT

June 2022

Contents

From the desk of the Chief Analytical Officer

We are happy to release our **eighteenth** edition of **Acuité Macro Pulse (Jun-2022).**

Over the last six months, the geo-political conflict in Ukraine had intensified the inflationary headwinds across the globe and induced a sharp reversal in the ultra-accommodative monetary policies of most nations. Alarmingly high commodity prices along with increasing interest rates have raised the risks of a global slowdown immediately after a brief recovery from the prolonged pandemic disruption. World Bank has been busy revising its global growth forecast for CY22 downwards, with its latest estimate at 2.9% vis-à-vis the earlier 4.1%.

Interestingly, the concerns of slowdown or even recession in some nations have started to have a counter effect on the commodity prices. While crude oil prices still continue to rule above USD 100 pb thanks to the limited access of Russian oil in the global markets, aluminium and copper prices are at a 12 month and 18 month low respectively. Further, global food prices have witnessed a moderation since May'22 and in India, the government has taken specific steps to cool down the prices of some of the food commodities through levy of export duties or lower import duties. What is noteworthy is that palm oil which had spurted in Apr'22 after a temporary export ban by Indonesia, has seen a subsequent price correction by 40% and this has already started to reflect in the retail prices of edible oil.

Although a bit early, it is plausible that food inflation and thereby, overall domestic headline inflation can surprise on the downside over the next few months. This might mean lesser quantum of incremental rate hikes in the current fiscal as against some market predictions of a terminal repo rate of 6.0% by Mar'23. While we have pegged our average CPI inflation forecast at 6.7% for FY23, we believe that RBI may pause to assess the macroeconomic landscape after another 75 bps hike, over and above the 90 bps hike that has already taken place over the last two months.

On the other hand, the high frequency indicators highlight a moderate momentum in economic recovery in Q1FY23 particularly driven by the pent up demand in contact intensive sectors. PMI, GST collections, core infra output, railway freight, port traffic along with bank credit continue to underpin the recovery in manufacturing activity underway. This along with a normal monsoon (at least going by the current trends after a late start in Jun'22) and a gradual recovery in rural consumption, makes us stick to our earlier GDP growth forecast of 7.5%, which is tinged with some optimism.

Clearly, the largest risk in the macro-horizon at this point is the depreciation of the rupee, an aspect that we have been talking about in **Acuité Macro Pulse** for the last few months. The rupee has already depreciated by 6% since Jan'22 and it is not only due to the capital outflows of USD 34 bn over the last nine months but also due to the sharply increased trade deficit given the mounting oil bills. While we continue to believe that the central bank will make efforts to stabilise the rupee, the sharpness of the decline has indeed caught us by surprise and can have a potential impact on overseas fund raising by corporates through both debt or equity in the short term.

Suman Chowdhury
Chief Analytical Officer

Growth

Global headwinds to weigh

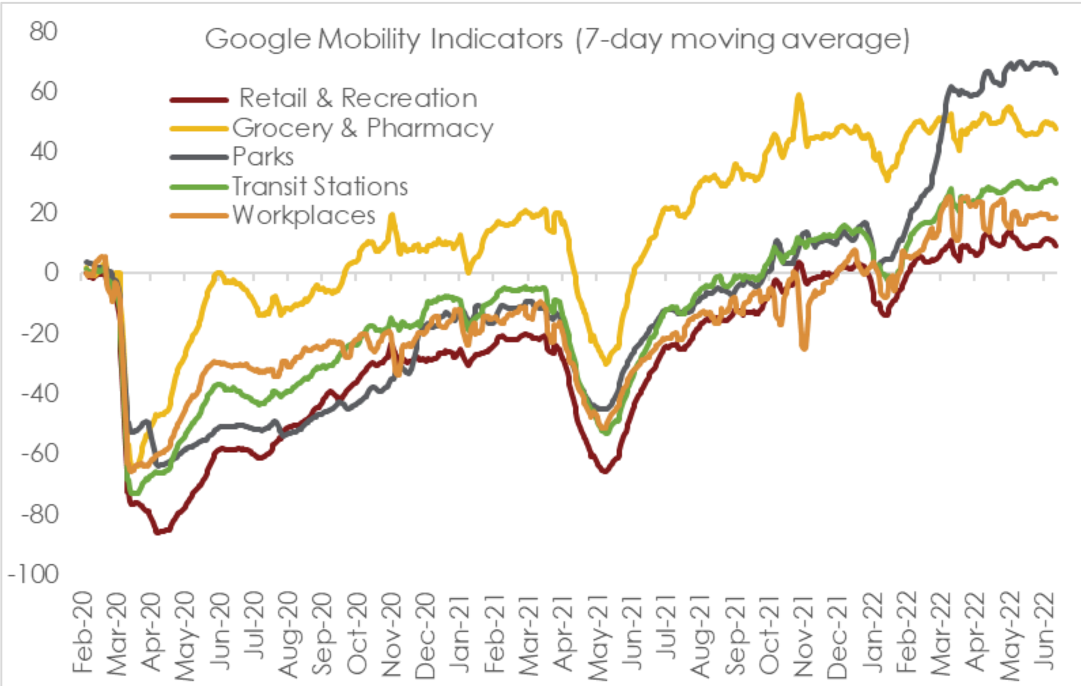
KEY TAKEAWAYS

- The month of May-22 was a testimony to domestic economic activity continuing to tread a path of modest recovery despite global headwinds getting stronger.
- The resilience in most of the lead indicators such as PMI, GST collections, core infra output, railway freight, port traffic along with bank credit continues to underpin the recovery in manufacturing activity underway. Services as a sector too continues to recuperate at a somewhat faster clip, gaining from complete opening up of the economy and nearly 66% of the population getting fully vaccinated.
- Google mobility consolidated near peak levels in Jun-22 for sub-categories of Retail & recreation, Parks and Transit stations.
- At a global level, geopolitics led surge in commodity prices, pass-through to domestic inflation, slowdown in world growth and prolonged supply disruptions are downside risks likely to make a dent on India's growth momentum, in addition to financial market volatility thst have arisen from global monetary policy tightening.
- Keeping in mind the support factors and downside risks, we retain our FY23 GDP growth at 7.5%.

The month of May-22 was a testimony to domestic economic activity continuing to tread a path of modest recovery despite global headwinds getting stronger. The resilience in most of the lead indicators such as PMI, GST collections, core infra output, railway freight, port traffic along with bank credit continues to underpin the recovery in manufacturing activity underway. Services as a sector too continues to recuperate at a somewhat faster clip, benefitting from complete opening up of the economy and nearly 66% of the population getting fully vaccinated. Google mobility has consolidated near peak levels in Jun-22 so far for sub-categories of Retail & recreation, Parks and Transit stations.

At a global level, geopolitics led surge in commodity prices, pass-through to domestic inflation, slowdown in world growth, prolonged supply disruptions are downside risks that are likely to make a dent on India's growth momentum, in addition to financial market volatility stemming from global monetary policy tightening now firmly underway.

Chart 1: Google mobility consolidates near peak levels in Jun-22

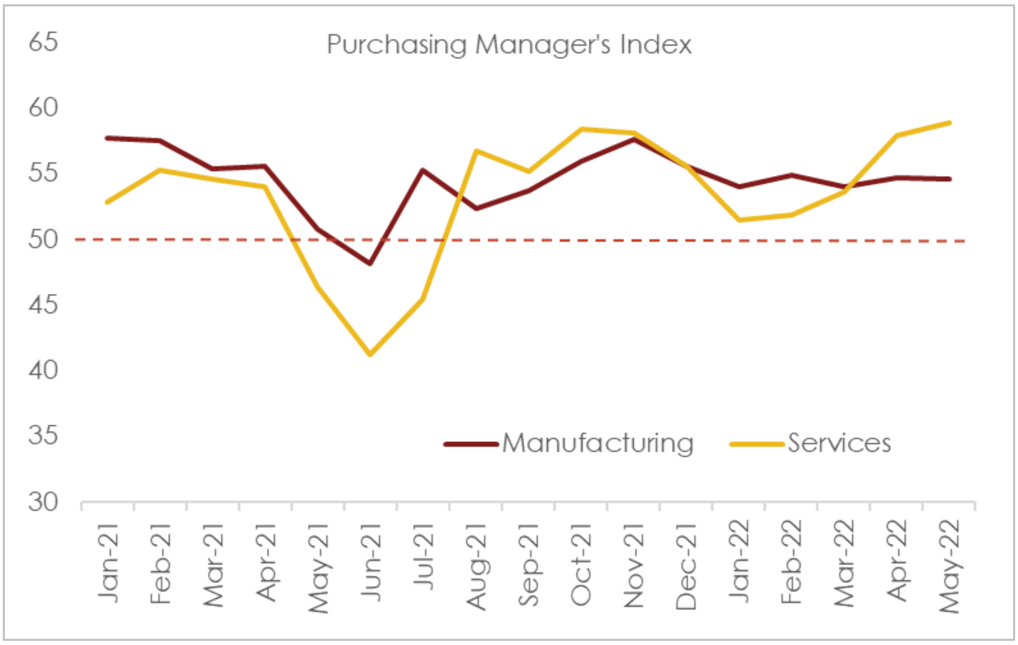


Recent data releases: A granular look at recovery

- India's industrial production growth picked up in Apr-22 to an eight-month high of 7.1%YoY compared to 2.2% in Mar-22. The annualised growth was however, supported by a favourable base from Apr-21 that saw the peak of Delta wave of Covid weigh on industrial activity. On sequential basis, the index contracted by 9.2%MoM in line with seasonal downside typically seen in the month of April, post the fiscal year-end ramp up in industrial activity (in March). Having said so, the contraction in Apr-22 was less than the average contraction of 11.7% usually seen in the month (ex. Covid lockdown in April 2020).

- Headline PMI manufacturing index eased a tad to 53.9 in Jun-22 compared to 54.6 in Apr-22. Nevertheless, it has continued to remain resilient in a tight range of 53-55.
- PMI services index rose to over an 11-year high of 59.2 in Jun-22 from 58.9 in May-22, supported by a substantial pick-up in contact intensive services
- While GST collections moderated in the month of May and June to INR 1.40 and INR 1.45 tn, after hitting a record high in Apr-22 (Rs 1.68 lakh cr), on an annualised basis, tax collections were 56% higher in June.
- In similar vein, after peaking at INR 7.81 cr in Mar-22, E-way bills have moderated over the last 2 months to INR 7.52 cr and 7.36 cr in Apr-22 and May-22 respectively.
- Merchandise exports moderated to USD 38.9 bn in May-22 from USD 40.2 bn in Apr-22. This translates into a sequential contraction of 3.1% MoM.
- NONG (Non-oil-non-gold) imports, a key indicator of domestic demand, moderated marginally to USD 38.0 bn in May-22 from USD 38.4 bn in Apr-22.

Chart 2: PMI indices underscore the faster recovery in services



Outlook

The pace of economic activity has so far withstood well in the face of the global adversities as well as the recent rise in domestic Covid infections.

In consumption trends, after witnessing a lull, fuel consumption and auto sales both indicated a pick up in the month of May-22 and Jun-22. Urban consumption has fared better as the economy opened up post the Omicron wave, with rural demand remaining somewhat subdued as validated by the weakness in 2-wheeler and FMCG sales in Apr-May'22. The expectation of a normal monsoon along with improvement in agriculture terms of trade and hike in MSPs, augur well for supporting agricultural incomes and rural demand in H2 FY23. On the other hand, rise in borrowing costs, elevated inflation and some waning of pent-up demand (for goods) could possibly weigh on urban demand, though a complete opening up of services could offset this downside.

The improvement in capacity utilisation (CU) in the manufacturing sector, as per RBI's latest survey to 74.5% in Q4FY22 from 72.4% in Q3 – to surpass the pre-pandemic levels, is positive for investment outlook. Historically, borrowing cost as a variable is found to be of low significance in explaining investment trends, while capacity utilisation and demand visibility are stronger determinants. While private investment could still wait for the current geopolitical uncertainty to wane before a palpable revival, the Government's capex push should prove supportive to FY23 growth.

Notwithstanding the support from factors outlined above, the global spill over from higher commodity prices, slowing world growth and a swift monetary policy normalisation (both global and domestic) are downside risks that are likely to manifest on incremental growth momentum.

- Though crude oil prices have corrected from above USD 120 pb levels in early Jun-22, they continue to average close to USD 117 pb for the month so far, a near 8% increase over May-22.
- World Bank became the latest global agency to pare 2022 global growth forecast to 2.9% from 4.1% earlier, highlighting the possibility of wider stagflation in several economies later this year. In its worst-case scenario (of prolonged supply chain disruptions, more aggressive Fed, and Ukraine-Russia geopolitics continuing) it estimates global growth to slip to as low as 2.1% in 2022.
- True to market expectations, US Fed increased its policy rate by 75 bps in Jun-22 – to mark the biggest incremental uptick in nearly 28 years. RBI too followed up its intermeeting rate hike of 40 bps in May-22 with an incremental 50 bps hike in the repo rate in Jun-22.

Keeping in mind the support factors and downside risks, we retain our FY23 GDP growth at 7.5% with some downside risk.

Inflation

Above comfort zone

KEY TAKEAWAYS

- On headline basis, India's inflation metrics were at divergence in May-22.
- CPI inflation moderated to 7.04%YoY in May-22 from 7.79% in Apr-22 while WPI inflation accelerated to more than a three-decade high level of 15.88% YoY in May-22.
- On a positive note, sequentially both metrics saw the momentum ease in May-22 vis-à-vis Apr-22.
- The moderation in sequential momentum in case of most items within CPI in May-22 offers some relief. Government has taken some steps over the last two months to reduce the prices of essential commodities through various tax cuts and bring down the inflationary expectations.
- Nevertheless, it would be premature to see this as a trend reversal as global crude oil prices continue to remain elevated aggravated by the depreciation of the rupee, economic normalization hasten pass through of higher input costs and late advancement of South west monsoon.
- With the balance of risk once again tilted to the upside, mainly on account of further hardening of crude oil prices and yet to reflect upward adjustment in electricity tariffs at the state-level, we revise our inflation forecast upwards to 6.7% in FY23.

On headline basis, India's inflation metrics were at divergence in May-22. CPI inflation moderated to 7.04%YoY in May-22 from 7.79% in Apr-22 while WPI inflation accelerated to more than a three-decade high level of 15.88% YoY in May-22 vis-à-vis 15.08% in Apr-22. On a positive note, sequentially both metrics saw momentum ease in May-22 vis-à-vis Apr-22.

Key highlights: CPI inflation

- May-22 CPI marked the second consecutive above 7.0% print and the fifth consecutive month of CPI inflation remaining above the 6.0% policy tolerance threshold.
- Sequential momentum moderated to 0.94% MoM in May-22 from 1.43% in Apr-22; but was moderately higher vis-a-vis the pre pandemic average of 0.67% MoM seen in the month of May.
- Food and Beverages index maintained its sequential momentum from last month (1.46% MoM in May-22 vs. 1.43% in Apr-22). The incremental price pressures were predominantly led by Vegetables (5.23% MoM), Meat & Fish (2.46% MoM), and Spices (1.99% MoM). While this partly reflects the impact of adverse summer seasonality, factors like elevated agricultural input prices and second order effect of the spillover of the ongoing conflict between Russia and Ukraine have also played a role. Having said so, there are also signs of partial respite from resumption of palm oil exports by Indonesia and imposition of domestic export ban on wheat.
- Sequential momentum in Fuel and Light index moderated to 1.39% MoM from 2.99% in Apr-22. The sequential drop in price of diesel, coke, and dung cake along with moderation in electricity, kerosene, and firewood momentum provides comfort. However, coal and charcoal depicted signs of increased price pressure while LPG continues to carry over relatively strong momentum.
- Core (i.e., CPI ex indices of Food & Beverages, Fuel and Light) inflation momentum moderated to a 4-month low of 0.5% MoM from 1.22% in Apr-22.
  - Moderation in sequential momentum in core inflation was on account of easing of pressure on Miscellaneous index (Recreation & Amusement services and Personal Care products) and the Housing index.
  - Meanwhile, sequential momentum in Clothing & Footwear index increased to a 12-month high of 1.04% MoM from 0.99% in Apr-22, manifesting the impact of hike in GST rate earlier in the year along with strong pickup in retail mobility in the post Omicron phase.

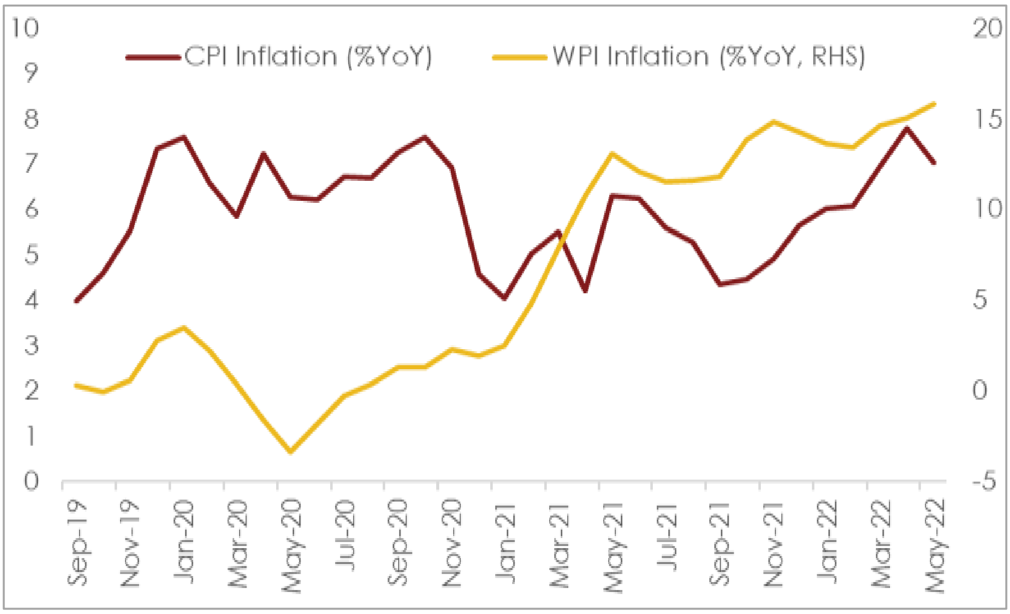
Key highlights: WPI inflation

WPI inflation touched more than a three-decade high level of 15.88% YoY in May-22 vis-à-vis 15.08% in Apr-22. Sequentially, while the increase in headline index moderated from 2.01% in Apr-22 to 1.38% MoM in May-22, it nevertheless remains strong.

- The sequential momentum in consolidated food prices eased somewhat to 1.87% MoM in May-22 from 2.70% MoM. Nevertheless, it remains elevated on the back of summer seasonality and persistent global supply disruptions. As such, annualized consolidated food inflation touched a 29-month high of 10.66% in May-22 vs. 8.63% in Apr-22.

- The trend is similar in case of consolidated fuel prices that saw a moderation in sequential momentum to 3.24% MoM in May-22 from 4.20% in Apr-22 largely on account of excise duty relief. Nevertheless, the annualized fuel (consolidate) inflation inched up to a 6-month high of 45.75% in May-22 from 42.64% in Apr-22.
- Core inflation (non-food manufacturing) moderated to 10.4% YoY in May-22 from 11.1% in Apr-22 on the back of easing of sequential momentum to 0.45% MoM in May-22 from 1.02% in Apr-22.

Chart 1: CPI and WPI inflation at divergence in May-22



Outlook

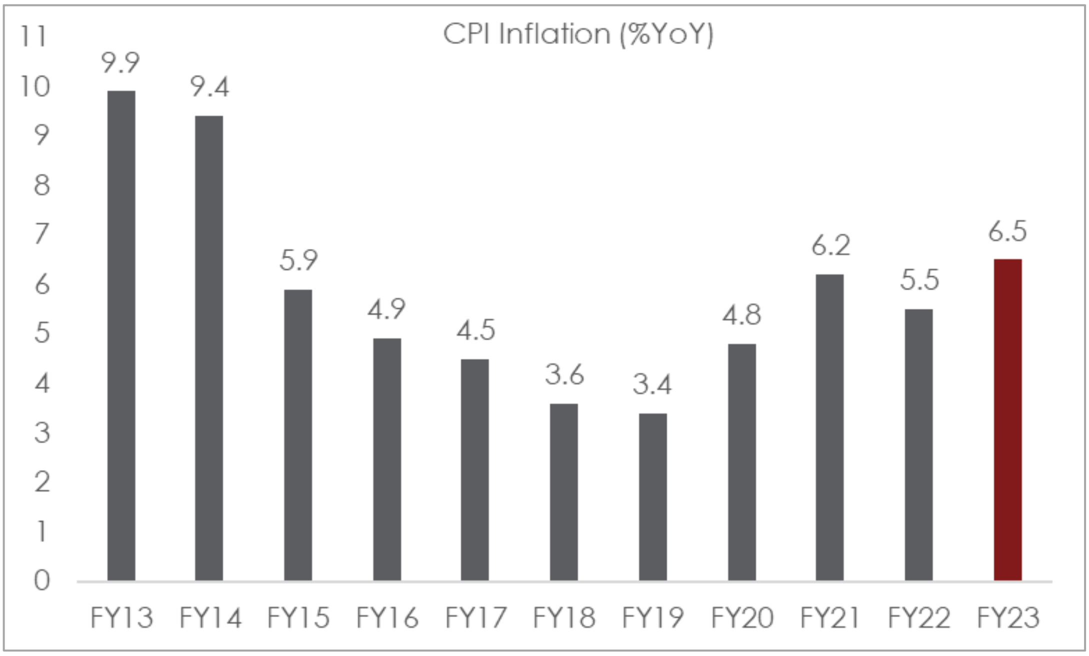
The moderation in sequential momentum in case of most items within CPI in May-22 offers some relief. Nevertheless, it would be premature to see this as a beginning of a trend reversal as overall sequential momentum continues to remain elevated.

- Post the cut in excise duty on petrol and diesel in May-22, international crude oil (India Crude Basket) price has jumped by nearly 8% in Jun-22 so far, aggravated by the rupee depreciation. Although retail prices have remained unchanged since then, incremental buildup of under recoveries could eventually result in upward adjustment in prices by oil companies or a further buildup in fiscal headwinds via subsidies.
- The opening up of the economy, strong pick-up in retail mobility (to its highest post pandemic levels currently), and vaccination attaining critical mass (with 66% of the population having adminstered two doses) is hastening the pass-through of elevated input prices. This is likely to provide stickiness to core inflation around 6% levels.
- IMD expects the ongoing south-west monsoon season to clock 103% rainfall vs. the long period average. After a slow advancement in first half of Jun-22, monsoon progress has improved since the third week of Jun-22. Rainfall progress in the coming months would be crucial for kharif sowing and overall food inflation.
- Some of the states have begun to adjust electricity tariffs higher, that is yet to get captured in CPI data as of now.

Having said so, the recently announced hike for kharif crops by an average of 6.1% (vs. last 3-year average of 4.0%) appears moderate amidst the backdrop of sharp pickup in agricultural input prices. This as per our estimates would provide subdued impact of 15 bps to FY23 CPI inflation.

Incorporating the recent upside in crude oil prices and also the rupee depreciation, we revise up our **FY23 CPI inflation estimate by 20 bps to 6.7% premised on crude oil averaging at USD 110 pb** (vs. USD 100 pb assumed earlier).

Chart 2: For FY23, we revise our CPI inflation estimate up to 6.7%



Government Finances

Risks cloud FY23 fiscal deficit outlook

KEY TAKEAWAYS

- India’s central government’s fiscal deficit for the period Apr-May stood at 12.3% of budgeted estimates (BE) for FY23 compared to 7.8% of actuals in the corresponding period of FY22.
- Despite continued traction in tax revenue collections along with some early disinvestment activity, higher expenditure led the deficit to expand as compared to the previous year.
- Although two month of data is insufficient to make any meaningful inference for the full year fiscal outlook, we nevertheless see congregation of fiscal headwinds via increase in expenditure commitments and revenue forgone for providing inflation relief.

India's central government's fiscal deficit for the period Apr-May stood at 12.3% of budgeted estimates (BE) for FY23 compared to 7.8% of actuals in the corresponding period of FY22. Despite continued traction in tax revenue collections along with some early disinvestment activity, higher expenditure led the deficit to expand as compared to the previous year.

Receipts: Apr- May22 witness favourable spill over of strong tax momentum

The first two months of FY23 saw strong receipt collection, led by healthy tax revenue and non-debt capital receipts.

- Gross tax revenue clocked 14.6% of FY23 BE in Apr-May'22 compared to 11.5% of actuals in the corresponding period in FY22.
    - Momentum in gross tax revenue was supported by corporate, income, and GST collections. We note that the impressive momentum in GST revenue continues to persist with total monthly collections averaging at Rs 1.5 tn during Q1 FY23 compared to the required monthly run rate of Rs 1.35-1.40 tn for meeting the BE.
    - Meanwhile, collections from customs and excise were moderately lower in comparison.
    - On annualized basis, growth in gross tax collections stood at 29.0% in Apr-May'22, reflecting a marked deceleration vis-à-vis a robust growth of 147.9% seen in previous year. This is a statistical aberration caused by the massive flux in the tax base on account of successive lockdowns in Apr-20 and Apr-21.
- Non-debt capital receipts came in at 31.5% of FY23 BE in Apr-May'22 vis-à-vis 12.3% of actuals in the corresponding period in FY22. This predominantly reflects the disinvestment proceeds from ONGC and LIC in Apr-22.

On the other hand, non-tax revenue (led by interest receipts) moderated to 18.3% of FY23 BE in Apr-May'22 from 33.4% of actuals in the corresponding period in FY22.

Expenditure: Disbursals show a moderate pick-up

Total expenditure disbursal picked up to 14.8% of FY23 BE in Apr-May'22 from 12.6% of actuals in the corresponding period in FY22.

- The increased momentum was led by capital expenditure that clocked 14.3% of FY23 BE in Apr-May'22 vis-à-vis 10.6% of actuals in the corresponding period in FY22. At a ministry wide level, traction was seen in case on Roads, Railways, and Food & Public Distribution.
- Revenue expenditure disbursals too firmed up moderately to 15.0% of FY23 BE in Apr-22 from 13.0% of actuals in the corresponding period in FY22.
    - Interest payments picked up to 11.2% of FY23 BE in Apr-22 from 9.4% of actuals in the corresponding period in FY22
    - However, subsidy disbursal decelerated to 10.0% of FY23 BE in Apr-May'22 from 14.1% of actuals in the corresponding period in FY22
- On annualized basis, growth in total spending stood at 22.6% in Apr-May'22, reflecting a substantial improvement over an annualized contraction of 0.2% seen in Apr-May'21. This is a statistical aberration caused by the massive flux in spending outlays on account of successive lockdowns in Apr-20 and Apr-21.

Outlook

Although two months of data is grossly inadequate to make any meaningful inference for the full year fiscal outlook, we nevertheless see congregation of fiscal headwinds. Despite a rollover buffer from FY22 (the LIC IPO garnering Rs 205 bn), likelihood of higher than budgeted tax revenue collections and the recent export duty on petrol and diesel along with windfall tax levied on crude oil production, slippage risks are gaining momentum. The fuel tax measures announced by the government are expected to partially offset the revenue slippage and expenditure hike from:

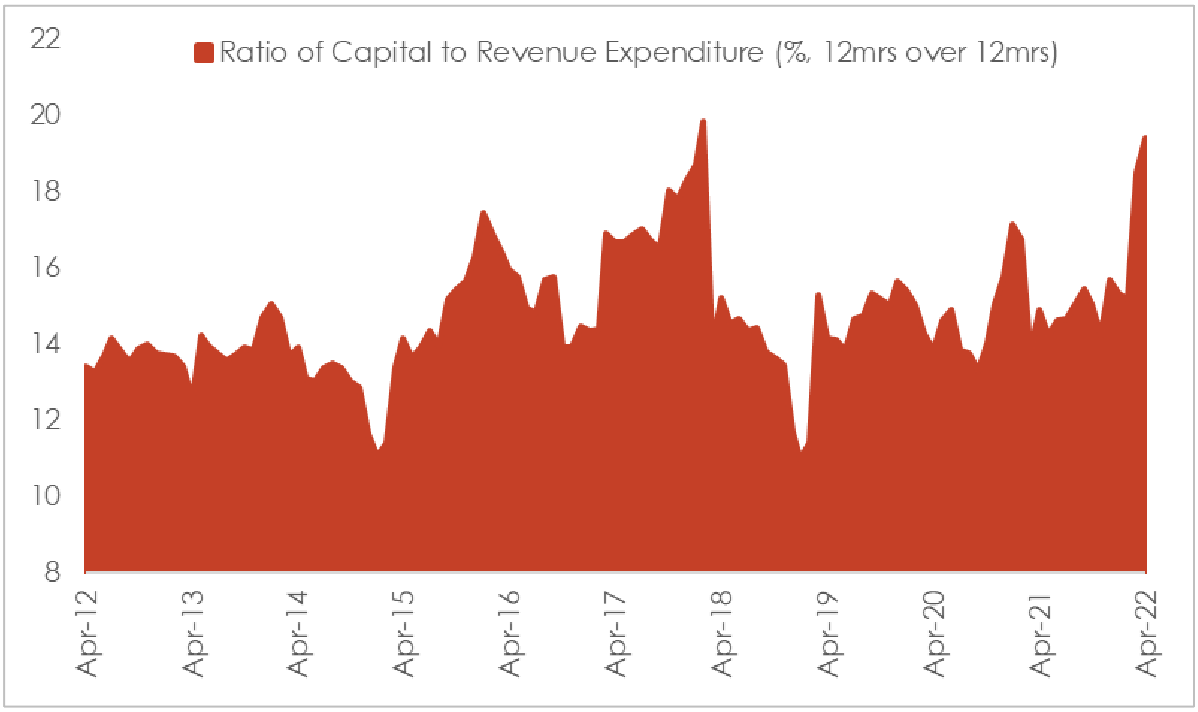
- Extension of PM Garib Kalyan Anna Yojana by 6-months till Sep-22 to continue providing relief for priority households, will cost Rs 800 bn.
- Higher than budgeted subsidy bill (on account of the recently announced top-up of Rs 1.1 tn), especially on account of fertilizers, which currently face supply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

As noted in the May-22 edition of Acuite Macro Pulse report, we continue to believe that it might be too early to quantify FY23 fiscal risks. While on standalone basis, FY23 fiscal deficit could potentially exceed the budgeted target of 6.4% of GDP by 30-40 bps, the latest comments from finance ministry officials indicate the likelihood of fiscal re-balancing via pruning of revenue expenditure.

Table 1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position for FY22)			
Fiscal Variables	% of Actuals	% of BE	Cumulative (INR bn)
	FY22	FY23	Apr-May'22
Revenue Receipts	16.1	16.2	3568.4
Net Tax	12.8	15.9	3075.9
Non-Tax	33.4	18.3	492.5
Non-Debt Capital Receipts	12.3	31.5	250.1
Total Receipts	16.1	16.7	3818.5
Revenue Expenditure	13.0	15.0	5857.74
Capital Expenditure	10.6	14.3	1054.22
Total Expenditure	12.6	14.8	6911.96
Fiscal Deficit	**7.8**	**12.3**	**2039.21**

Chart 1: Central government's capex spending picking up strong momentum



Rates

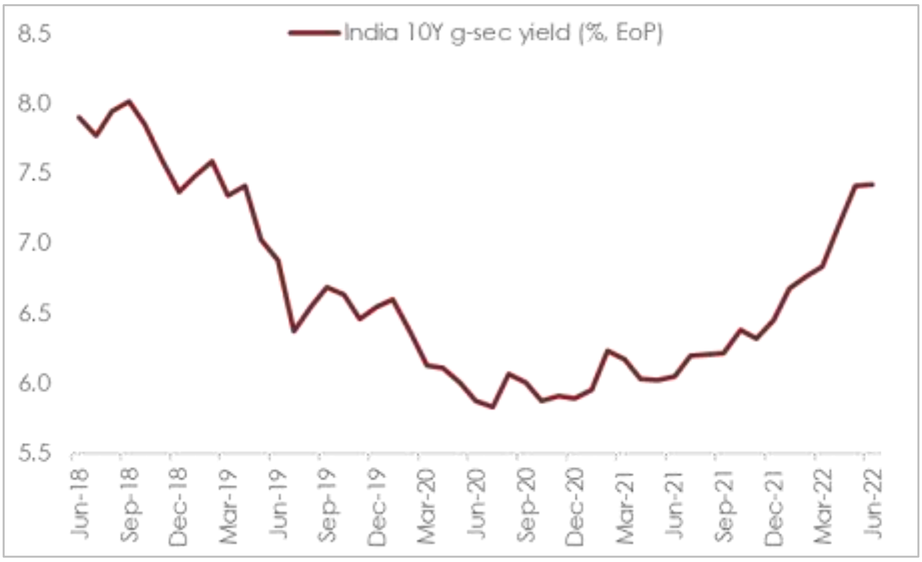
Monetary policy changes gear

KEY TAKEAWAYS

- After closing the month of May-22 at 7.41%, the 10Y g-sec yield hardened to an over 3-year high of 7.61% in the month of Jun-22, before retracing slightly to 7.42% levels currently.
- The turn in global monetary policy has gathered steam amidst further signs of persistence in inflationary risks, with US Fed leading the pack in normalizing interest rates aggressively.
- Following on the heels of a surprise 40 bps hike in repo rate announced in an off-cycle meeting in early May-22, RBI raised the policy rate further by 50 bps to 4.90% in its scheduled policy meeting in Jun-22, aggregating to 90 bps so far in this cycle.
- We expect an incremental 75 bps hike in repo rate between Aug-22 and Dec-22. This will take the repo rate to 5.65% i.e., 50 bps above the pre-pandemic level. We continue to see room for another 50 bps hike in the CRR.
- We fine tune our expectation of 10Y g-sec yield to 8.00% before the end of FY23, from 7.75-8.00% range earlier.

India's 10Y g-sec yield has been climbing up for the past seven months. After closing the month of May-22 at 7.41%, the 10Y g-sec yield hardened to an over 3-year high of 7.61% in the month of Jun-22, before retracing to 7.42% levels currently.

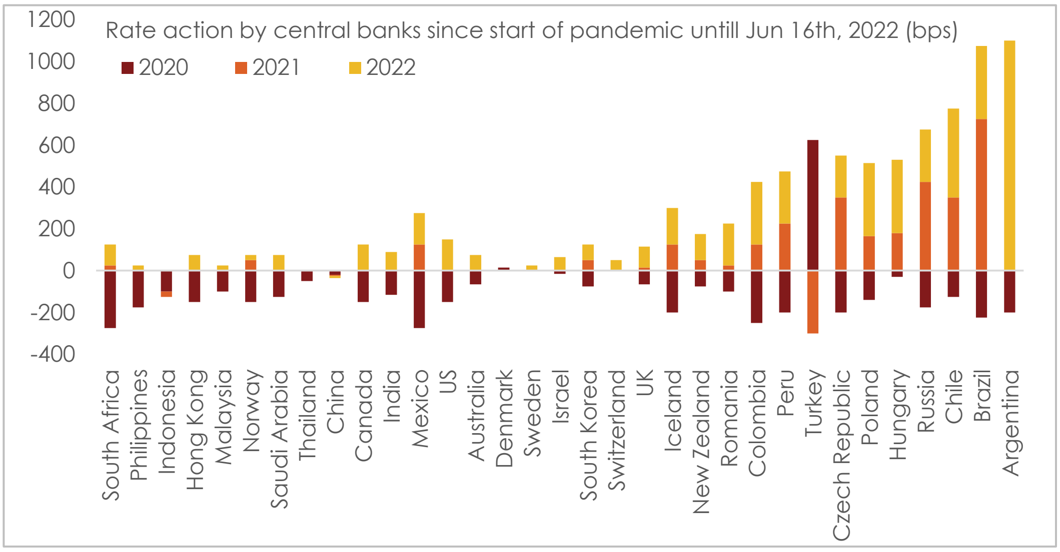
Chart 1: 10Y g-sec yield moves up to an over 3-year high level



Normalization of global monetary policy powers ahead in full steam

The turn in global monetary policy has gathered steam amidst further signs of persistence in inflationary risks. Central banks across many countries continue to scale back pandemic era extraordinary monetary accommodation. Among developed countries, the US Fed and the BoE (with 150 bps and 100 bps hike respectively in 2022 so far) have initiated their monetary policy normalization with an aim to emphatically address inflation risks even if it means a slowdown of the economy. Meanwhile, several EM central banks appear to be ahead in terms of policy normalization, prompted by concerns on inflation and financial market stability.

Chart 2: Global monetary policy normalization gathers steam in 2022



- Among key central banks tracked by the BIS who effected rate action in the pandemic period, currently: i) 13 have their monetary policy rate below their pre pandemic levels (with median at 50 bps below pre pandemic level), ii) 2 have their monetary policy rate at their pre pandemic level, and iii) 20 have their monetary policy rate above their pre pandemic levels (with median at 150 bps above pre pandemic level).

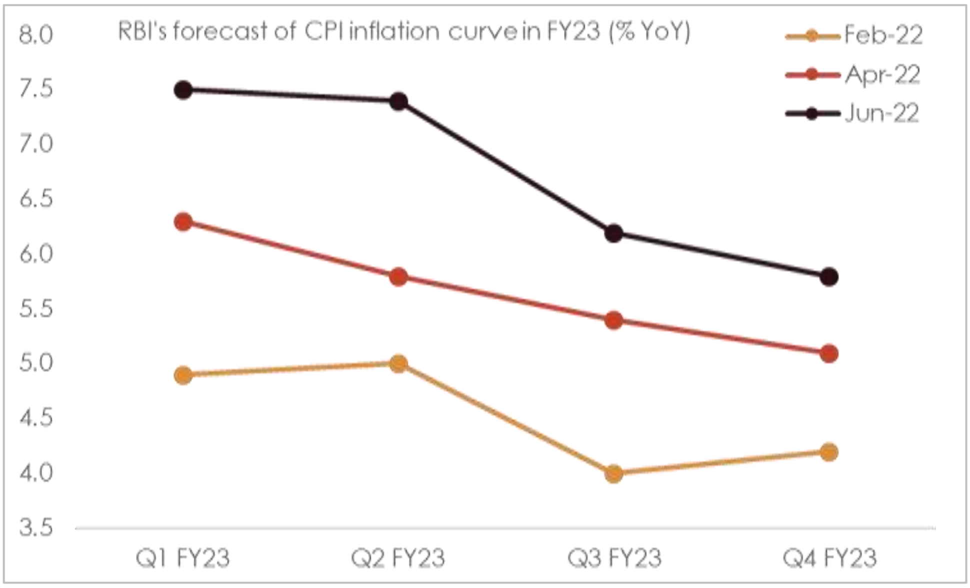
Domestic monetary policy normalization changes gear

Following on the heels of a surprise 40 bps hike in repo rate announced in an off-cycle meeting in early May-22, RBI raised the policy rate further by 50 bps to 4.90% in its scheduled policy meeting in Jun-22. The quantum of hike was marginally higher than market consensus expectation of 40 bps in Jun-22. The 50-bps rate hike was unanimous, backed by all members of the Monetary Policy Committee (MPC) who decided to "remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth". We note that this is the first time in the post pandemic phase that the MPC dropped the words "to remain accommodative" from its stated policy stance.

This strong pivot in the monetary policy stance has undoubtedly stemmed from a sharp upward movement in the expected inflation curve for FY23 by the central bank. Since the policy review in Feb-22, the RBI has raised its average FY23 inflation estimate by a whopping 220 bps to 6.7%. Further:

- The forecast indicates the likelihood of CPI inflation remaining above the 6% tolerance threshold for four consecutive quarters (including Q4 FY22), marking a clear breach of the inflation targeting mandate.
- In fact, the 1-year ahead projected inflation at 5.8% barely scrapes through the target band.

<u>Chart 3: RBI's expected FY23 inflation curve has progressively moved up</u>



The ongoing aggressive monetary policy normalization by key central banks globally along with the Ukraine-Russia crisis is creating pressure on EM currencies including INR. Rupee has depreciated by around 5.0% since the start of 2022. While FX reserves remain adequate, synchronous interest rate adjustment with rest of the world would help to rein in adverse external spillovers.

As such, we expect an incremental 75 bps hike in repo rate between Aug-22 and Dec-22. This will take the repo rate to 5.65% i.e., 50 bps above the pre-pandemic level. Post Dec-22, RBI could take a pause and reassess the evolving domestic growth-inflation scenario, in the global context. Having said so, rate increases are likely to get front loaded keeping in mind the elevated inflation risks in the near-term, fast evolving global monetary policy cycle and a weaker growth outcome anticipated in H2 vs. H1 FY23.

Meanwhile, we expect the central bank to continue to wean off excess liquidity from the system as core liquidity surplus remains close to 3.7% of NDTL as of Jun-22. This is quite high compared to RBI's own estimate of 1.5% level being non-inflationary (as per the Currency and Finance report). For liquidity withdrawal, while an additional CRR hike of 50 bps remains our base case in this fiscal year, alternate tools via fx intervention, sale of g-secs or issuance of short-term cash management bills can also be deployed to achieve the same objective.

Outlook

We fine tune our expectation of 10Y g-sec yield to 8.00% before the end of FY23, from 7.75-8.00% range earlier.

- MPC's unambiguous monetary policy pivot now indicates a stronger and swifter response to inflation risks.
- As per media reports, the government is expected to opt for additional borrowing of Rs 1.0 tn in FY23 to address higher than budgeted fiscal deficit.

Having said so, we do expect the central bank to rely on tools like Operation Twist and verbal suasion, to support yields and ensure an orderly completion of government's record high borrowing program in FY23.

Rupee

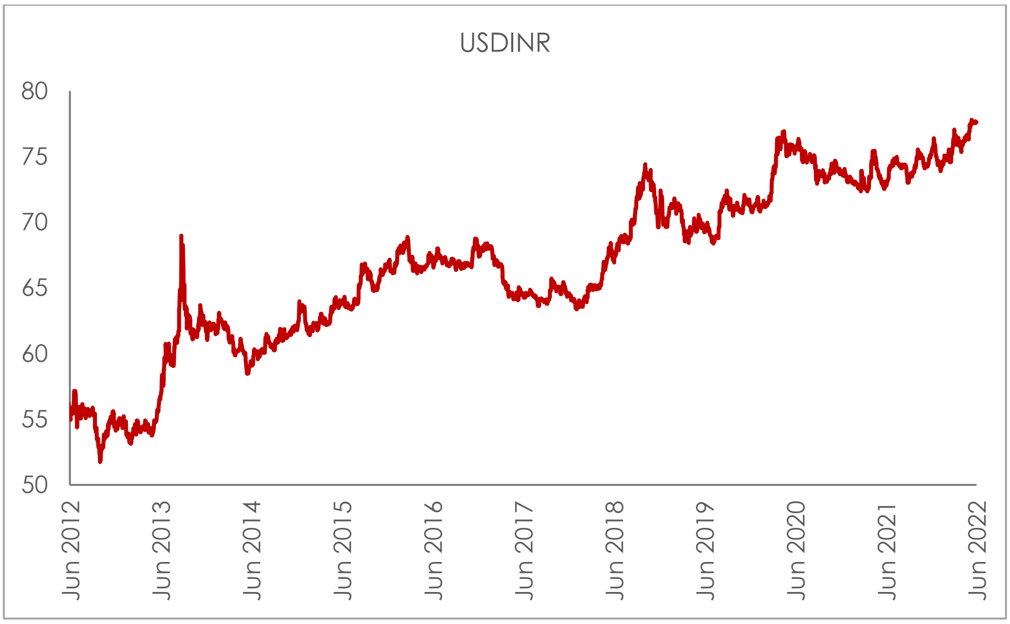
A new low even as pressure persists

KEY TAKEAWAYS

- The Indian rupee has weakened for six straight months culminating into a depreciation of around 6.0% in calendar 2022 so far.
- The dollar is expected to continue deriving support from aggressive interest rate hikes and monetary tightening in the US along with geopolitical led risk aversion.
- The combination of elevated global commodity prices, sequential improvement in domestic growth, and gradually increasing vaccination coverage is resulting in expansion of trade and current account deficit for India.
- Portfolio outflow continues to persist for ninth consecutive month with markets aligning to US monetary policy tightening and spike in commodity prices amidst ongoing geopolitical conflict between Russia and Ukraine.
- We revise our expectation of India's FY23 current account deficit to USD 105 bn from USD 90 bn earlier.
- A larger than anticipated BoP deficit would weigh on INR in FY23, in an environment of dollar bullishness.
- We continue to expect rupee to depreciate moderately, but extend our USD-INR call higher to 80.5-81.0 levels by Mar-23 vs. our earlier expectation of 79.

After closing Jun-22 at a level of 78.9, the Indian rupee weakened further towards 79.14 levels currently in Jul-22. With this, the Indian rupee has weakened for six straight months culminating into a depreciation of 6.0% in 2022 so far. The last time rupee saw six consecutive months of weakness was during the backdrop of the domestic NBFC crisis in 2018. Monetary policy tightening by the US Fed was nevertheless a common underlying factor between the 2018 episode of consistent weakness in rupee as well as the current ongoing phase of depreciation.

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

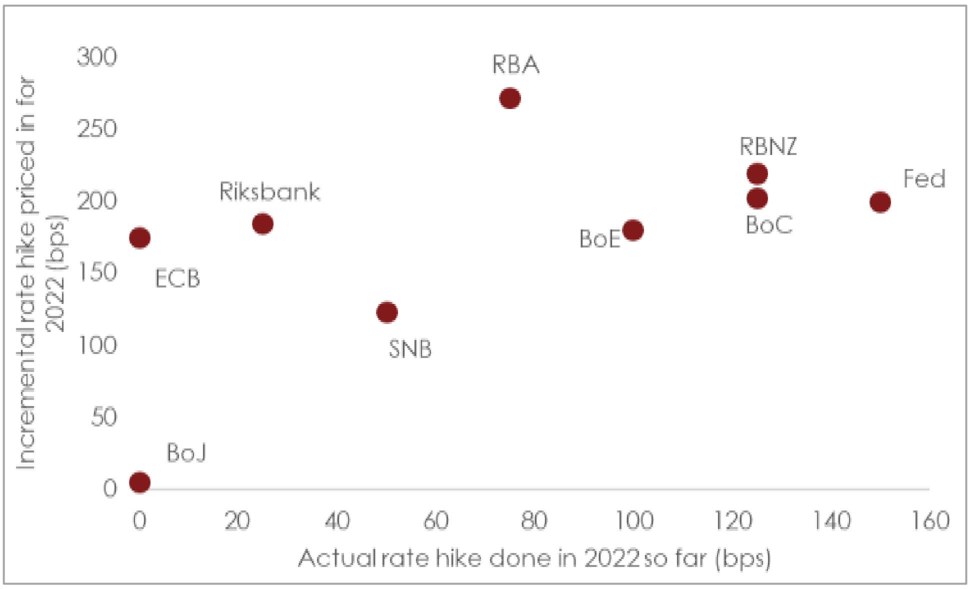


The theme driving rupee weakness continues to remain intact. In fact, the drivers have strengthened and continue to point towards the likelihood of further moderate weakness.

On the global front, dollar supportive environment continues to persist.

- High and persistent inflation has imparted a sense of urgency to monetary policy normalization by the US Fed. We note that post the 150 bps rate hike effected by the FOMC since Mar-22, the fed funds rate is now back to its pre Covid level, thereby completing the normalization exercise. Going forward, interest rate increase will tantamount to effective tightening of monetary policy in a nominal context. As per the recently revised dot plot, the FOMC could now increase policy rate by another 175 bps by the end of 2022 (and by a further 50 bps in 2023).
    - This will make the US Fed as one of the most hawkish DM central banks over the course of 2022 and 2023.
    - The Fed has also begun quantitative tightening from this month to further address inflation risks. The monthly pace of QT will involve USD 47.5 bn selling of securities (USD 30 bn USTs and USD 17.5 bn Agency MBS) before getting to a "max" of USD 95 bn in Sep-22 (USD 60 bn USTs and USD 35 bn Agency MBS). The unwinding of the Fed balance sheet will reinforce the message of monetary policy normalization and would provide a supplementary tailwind to the USD.

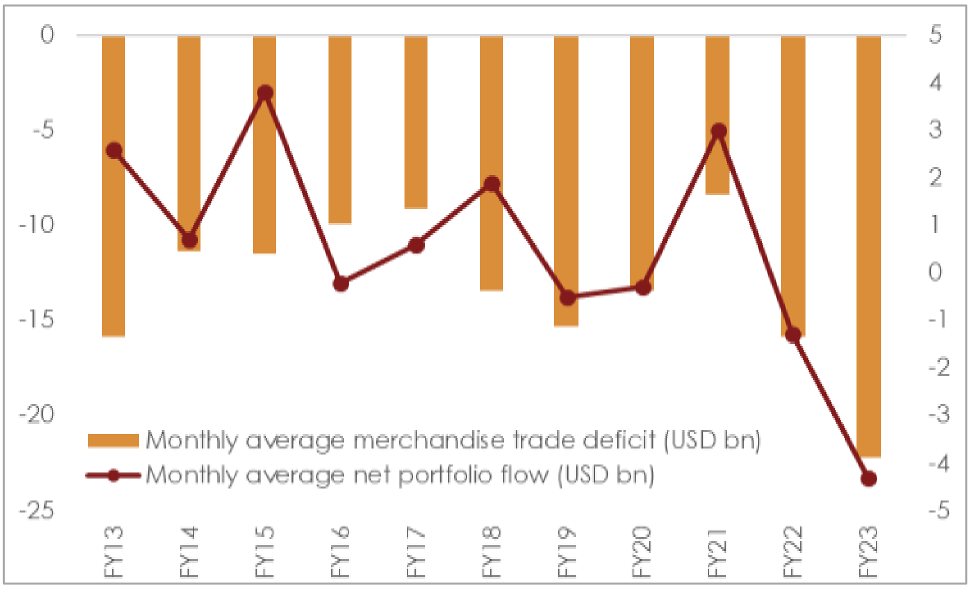
Chart 2: The US Fed comes across as the most hawkish DM central bank



On the domestic front, the BoP comfort is expected to moderate amidst the commodity price shock exacerbated by the ongoing Russia-Ukraine conflict.

- The price of Brent has averaged at USD 109 pb so far, in the first quarter of FY23. Since there is no near-term visible sign of resolution of the Russia-Ukraine conflict, we now assume prices to hold close to current levels and hence revise up our FY23 baseline oil price to USD 110 pb in FY23, up from USD 100 pb earlier.
- As such, we also adjust our expectation of FY23 current account deficit to USD 105 bn now vis-à-vis our earlier forecast of USD 90 bn. The expectation of expansion of current account deficit not just rests upon the likelihood of elevated global commodity prices, but is also contingent upon the following factors:
    - The ongoing geopolitical crisis would dampen world trade volume (recently the WTO scaled down its projection for merchandise trade volume growth for 2022 to 3.0% from 4.7% projected earlier).
    - Unlocking of the domestic economy post the Omicron wave along with vaccination drive gaining critical mass (with 66% of the population having received double dose) is expected to support domestic demand for imports.
    - In the very near term, a marginal adverse impact on exports can come from the recently imposed export restrictions by the government in case of select commodities.
- The pressure on current account deficit is increasing at a time when portfolio outflows have remained persistent since Oct-21. In the last nine months, Indian markets have seen a cumulative portfolio outflow of over USD 34 bn. Elevated domestic equity valuations, surge in global commodity prices, and aggressive normalization of US monetary policy could keep portfolio inflows subdued in the near term.
- As such, we now expect FY23 BoP to register a deficit to the tune of USD 33 bn vis-à-vis our earlier forecast of USD 8 bn deficit.

Chart 3: INR facing pressure from both wider trade deficit and portfolio outflows



While reserve buffer and rupee's carry appeal remain supportive, there has been some let up in both in the last one month:

- RBI's FX Assets (including net forward position) appears marginally better at 11.2 months as of May-22 vis-à-vis its pre pandemic level of 10.9 months. Although its still comfortable and provides the first line of defense against excessive volatility, it is slowly moderating (from its peak of over 19-months in early 2021) amidst widened current account deficit and persistent portfolio outflows.
- Compared to a peak of 670 bps in Nov-21, India's long term (10Y) sovereign real yield spread vis-à-vis the US has moderated to 601 bps in May-22 on the back of sharp rise in domestic inflation. Going forward, the spread could moderate further on faster pace of monetary tightening in the US vis-à-vis India.

As such, we now fine tune our expectation of further depreciation in rupee in FY23, with a potential move in USDINR towards 80.5 levels (vs. our earlier call of 79) before end Mar-23.

Global Overview

Race against inflation

KEY TAKEAWAYS

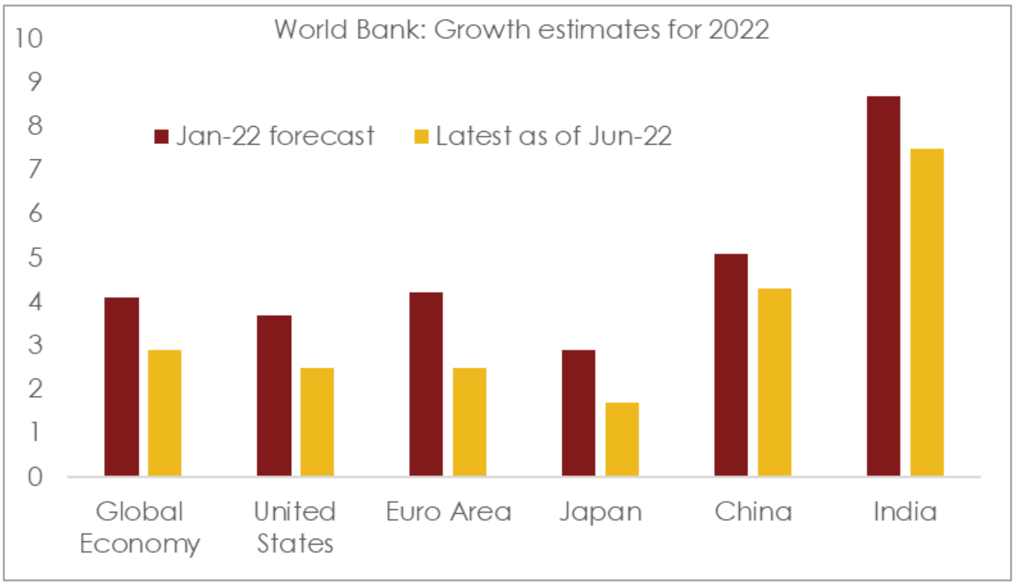
- Amidst unrelenting global price pressures, a concurrent monetary policy tightening remains the dominant theme across advanced and emerging economies.
- Central banks around the world over are battling a worse than anticipated upsurge in inflation, exacerbated by the disruptions in supply of goods, energy and food amidst the Russia-Ukraine war and lockdowns in China.
- In incremental monetary moves, US Federal Reserve hiked its policy rate by 75 bps, the biggest increase in 28 years along with BoE continuing to effect its fifth rate hike in this cycle. The Swiss National Bank too joined the hawkish camp by raising its policy rate in an unexpected move by 50 bps to -0.25%.
- On macroeconomic front, World Bank downgraded its global growth forecast by 120 bps to 2.9% for 2022. The global agency warned of several years of above-average inflation, having the potential to potentially destabilize low and middle-income countries. World Bank President, David Malpass said that "Even if a global recession is averted, the pain of stagflation could persist for several years, unless major supply increases are set in motion"

Global overview

Amidst unrelenting global price pressures, a concurrent monetary policy tightening remains the dominant theme across advanced and emerging economies. Central banks around the world over are battling a worse than anticipated upsurge in inflation, exacerbated by the disruptions in supply of goods, energy and food amidst the Russia-Ukraine war and lockdowns in China. More than 60 monetary authorities - including the Bank of England (BoE) and the Federal Reserve have raised interest rates this year, and the European Central Bank is slated to embark on a tightening path as early as next month.

In incremental monetary moves, US Federal Reserve hiked its policy rate by 75 bps – the biggest increase in 28 years along with BoE continuing to effect its fifth rate hike in this cycle. The Swiss National Bank joined the normalization camp by raising its policy rate in an unexpected move by 50 bps (the first rate hike in 15-years) to -0.25%. According to the central bank's accompanying press release, the rate hike is aimed at countering inflationary pressures, as inflation in Switzerland reached 2.9% (vs. target range of 0-2%) in May-22, its highest level since the summer of 2008. In contrast, Japan's central bank kept its ultra-low interest rates on hold in a bid to reinforce its support to the economy that is yet to recover to its pre-pandemic level. Markets however are likely to continue to price in policy change potential sometime later this year amidst the fast-normalising global monetary policy situation.

<u>Chart 1: World Bank lowered its 2022 global growth forecast by 120 bps to 2.9%</u>



On macroeconomic front, as per latest Global Economics Prospects report of the World Bank, global growth is expected to slow sharply this year, from 5.7% in 2021 to 2.9% in 2022. This is a downgrade of 120 bps since Jan-22 forecast of 4.1%. Growth in advanced economies is projected to decelerate from 5.1% in 2021 to 2.6% in 2022 – 120 bps below previous projection, with an equal magnitude of downgrade attached to EMDE growth now estimated at 3.4% vs. 6.6% in 2021. The World Bank joins other global agencies such as IMF and OECD who have already downgraded their global growth outlooks for 2022.

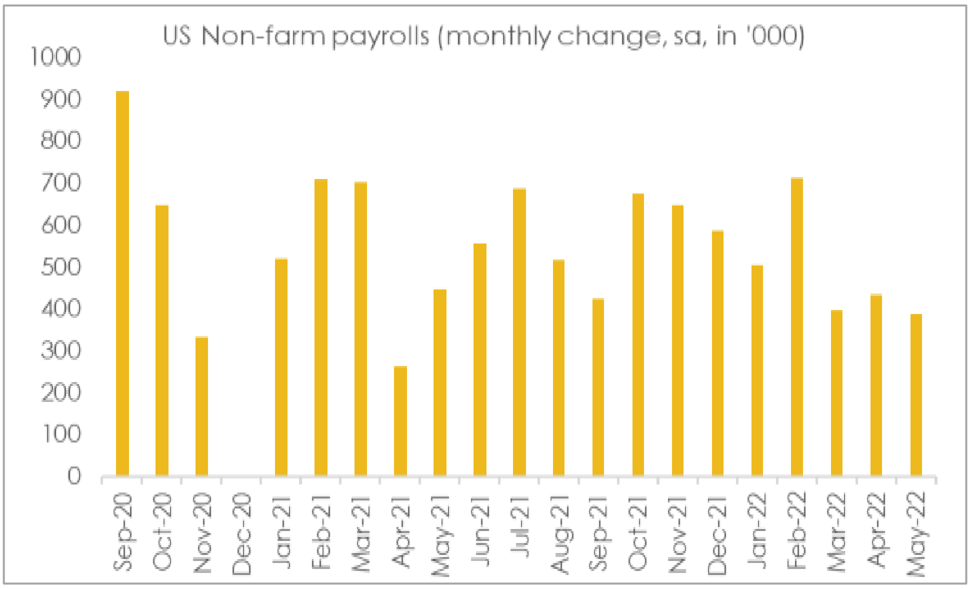
In addition to growth downgrades, the World Bank warned of several years of above-average inflation, having the potential to potentially destabilize low and middle-income countries. World Bank President, David Malpass said that "*Even if a global recession is averted, the pain of stagflation could persist for several years -- unless major supply increases are set in motion*"

US

On the data front, US industrial production grew at a slower pace in May-22 led by a decline in manufacturing output, adding to signs of slowing economic growth. The metric increased by 0.2% on a seasonally adjusted basis in May-22, down sharply from a revised 1.4% increase in Apr-22. Further, non-farm payrolls continued to see strong addition of 390K in May-22, though somewhat lower than 428K in Apr-22. Despite an upbeat NFP, unemployment rate remained steady at 3.6%, while the labour force participation rate rose slightly to 62.3% from 62.2% in Apr-22.

Meanwhile, consumer inflation reached its highest level in more than four decades in May-22, as rising energy and food prices pushed up prices. According to Bureau of Labor Statistics, CPI inflation increased 8.6%YoY in May to mark the highest reading since Dec-81. On a monthly basis, CPI index was up 1.0%MoM, while core index rose 0.6%MoM to push annualised core inflation to 6.0%.

<u>Chart 2: Addition to Non-farm payrolls continue to remain healthy</u>



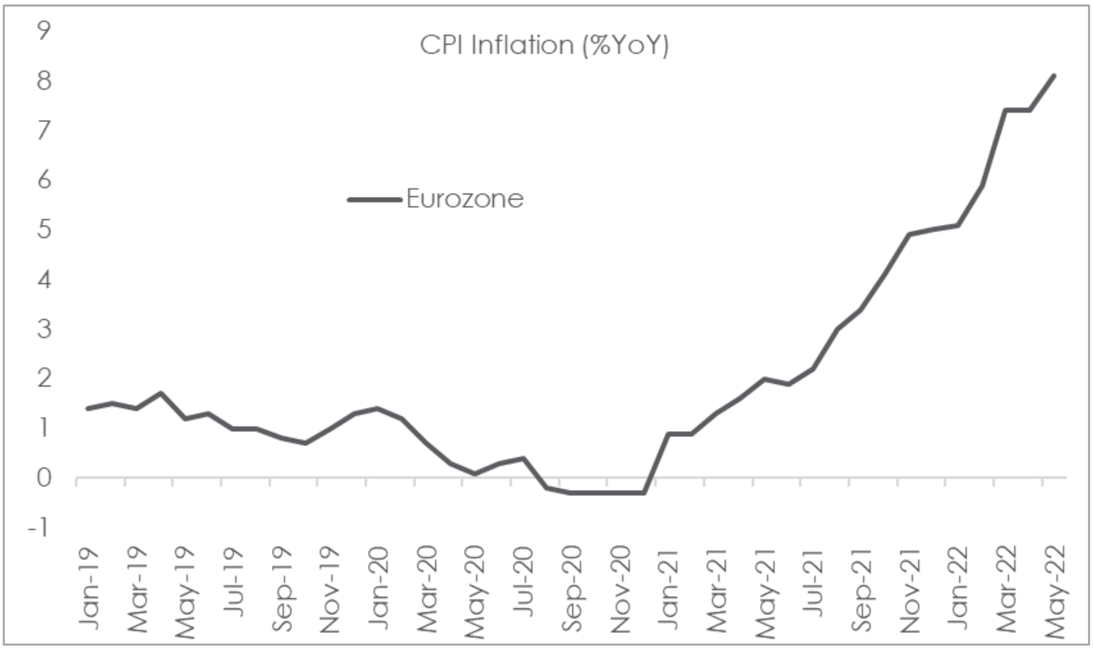
In line with market expectations, the Federal Reserve raised Fed Fund rate by 75 bps to a range of 1.5-1.75% at its Jun-22 meeting to mark the largest increase since 1994. The Fed officials now project median Fed funds rate at 3.4% by end of 2022 and 3.8% in 2023 – underscoring its commitment to bring CPI inflation back to its 2.0% target. Guiding market expectations, US Fed Chairman Powell said that the next meeting scheduled for 26-27th Jul-22 could see another 50-75 bps hike. The hawkish monetary policy was accompanied with a downgrade to the Fed's economic outlook, with the economy now seen slowing to a below trend growth of 1.7% in 2022 compared to 2.8% projected in Mar-22. Alongside, inflation projection was upped by 110 bps to 5.2%.

EUROZONE

The biggest development in Eurozone was the ECB's prominent step on its policy normalisation path at its Jun-22 meeting. While ECB kept its policy interest rate steady, it announced the decision to end its net purchases under the Asset Purchase Program (APP) by 1st Jul-22. More importantly, ECB sent very clear signals of forthcoming policy rate increases in Jul-22 and beyond. Specifically, the ECB indicated that -

- It intends to raise the key ECB interest rates by 25 bps at its Jul-22 monetary policy meeting.
- The Governing Council expects to raise the key ECB interest rates again in Sep-22. The calibration of this rate increase will depend on the updated medium-term inflation outlook. If the medium-term inflation outlook persists or deteriorates, a larger increment will be appropriate.
- Beyond Sep-22, based on its current assessment, the Governing Council anticipates that a gradual but sustained path of further increases in interest rates will be appropriate.

Chart 3: Sharp upside in inflation pushed ECB to guide markets for rate hike in Jul-22



The central bank also offered updated economic projections, again raising its CPI inflation forecast and lowering its GDP growth forecast for 2022.

- GDP was revised lower by 90 bps to 2.8% compared to its Mar-22 estimate
- Headline HICP inflation estimate was revised up by 170 bps to 6.8%

Given this commentary, market participants have begun to price in a 25-bps hike in Jul-22, 50 bps hike in Sep-22 and 25 bps each in Dec-22, Mar-23 and Jun-23 meetings of the ECB. This would lift the Deposit Rate from the current negative levels to +0.50% by the end of 2022, and +1.00% by mid-2023.

UK

The UK economy unexpectedly contracted by 0.3%MoM in Apr-22 after falling by 0.1%MoM in Mar-22, to mark the first back-to-back monthly decline since the COVID pandemic began in early 2020. In addition, the contraction was broad-based, seen across sectors of manufacturing, services and construction; prompting fears of a slowdown in the coming months. Reinforcing this, OECD in its latest economic update is predicting that Britain's economy will show no growth in 2023 (3.6% growth in 2022) - the weakest forecast for 2023 of any country in the G-20 (with the exception of Russia).

In line with slowdown in economic activity, unemployment rate in UK increased to 3.8% in the three months ending in April, up from 3.7% in the previous three months. Between Mar-22 and Apr-22, the unemployment rate rose from 3.5% to 4.2%. In May-22, the number of salaried workers increased by 90k - a lower pace compared to recent months. Separately, Industrial production rose 0.7%YoY in Apr-22, to miss market expectations of a 1.7% increase by a wide margin.

Economists polled by Reuters expect UK CPI inflation to hit yet another peak of 9.1%YoY in May-22 from 9.0% in Apr-22 – a 40 year high. Inflation, as per BOE is estimated to rise above 11% by Oct-22. The inflation surge is expected to be led by a mix of factors such as rising global crude and other commodity prices, a tight labour market and pass-through of higher input costs. Given the inflation backdrop, at its Jun-22 meeting, BoE policymakers raised policy rate by 25bps to 1.25% - the fifth consecutive increase to the highest level since the global financial crisis in 2009. While the decision was backed by 6 of the 9 members of the MPC, 3 voted for a sharper increase of 50 bps. This has led market participants to expect BOE to deliver a 50 bps of rate hike at its next policy meeting in Aug-22, given the near-term inflation pressures.

CHINA

China's latest data reinforced the bottoming-out of economic activity in Apr-22 amidst the broadening of lockdowns over Mar/Apr-22. Incremental and early data for May-22 reinforces a recovery underway, led by supply-side owing to gradual reopening of economy and measures taken to address bottlenecks in production and transport.

Industrial production fared better than expected in May-22, showing an annualised growth of 0.7%YoY led by the auto sector recovery compared to a contraction of 2.9% in Apr-22. Retail sales continued to contract albeit at a slower pace in May-22, by 6.7% in May-22 versus 11.1% in Apr-22; continuing to underscore weakness in consumer services especially contact-intensive services such as restaurants/catering. Meanwhile, reflecting the opening of the economy, unemployment rate eased to 5.9% from 6.1% in Apr-22. Overall, capturing this incremental improvement in economic activity Bloomberg's monthly GDP estimate too returned to positive territory, at 1.8%YoY vs. -0.7% in Apr-22.

Looking ahead, some improvement in growth momentum heading into H2 of 2022 can be expected, amidst the targeted easing and relaxation of macroprudential regulations for the real estate sector. Having said so, the re-imposition of Covid-19 restrictions in megacities such as Shanghai and Beijing over the past week shows that uncertainty remains high, with risks tilted to the downside.

About Acuité Ratings & Research Limited:

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