MACRO PULSE

MARCH 2021

Contents

From the desk of the Chief Analytical Officer

We are pleased to release the third edition of **Acuité Macro Pulse** for the month of March 2021. Apart from having a comprehensive coverage of the key macro-economic variables, this report prepared by senior economists also provides valuable insights on the emerging economic landscape which will be valuable to not only bankers and investors but also to corporate planning and treasury teams.

While the Indian economy continues to chug along the track of economic recovery in the current quarter, a resurgence of Covid-19 cases in some of the states over the last one month has raised concerns of fresh lockdowns at least of a local nature. While this has the potential of slowing down the ongoing recovery, the steady progress in the vaccination drive with around 50 million people having received the first dosage, may mitigate the risk of a second wave to a significant extent. Acuité continues to believe in the continuation of the V shaped recovery given the healthy rural demand, improved mobility indicators, the supportive fiscal and monetary policy environment and finally the favourable base effect in H1FY22.

The latest CPI and WPI data for Feb 2021 have reinforced the concerns on the incipient inflationary pressures in the economy. Rising retail fuel prices along with increased commodity prices have the potential to push up the core inflation further which has already seen an increasing trend over the last 3 months. Nevertheless, inflation is unlikely to be a major challenge over the next 1-2 quarters due to a record Rabi crop and the flexibility that the Government has to reduce fuel taxes in case of any sustained rise in global crude prices.

Another risk factor in the current landscape is the rising bond yields in the global bond markets particularly in the US. While the major central banks are unlikely to abandon the strongly accommodative monetary policy amidst a fragile global recovery in the near term, the risks of normalisation over the next one year has clearly increased. This will make the management of bond yields by RBI even more challenging in the current scenario where the 10 year gsec yields have risen by 30 bps over the last one month. We, however, don't expect significant sharp upward revision in yields unless the growth momentum in the economy is firmly put in place.

While we remain positive on the growth trajectory for FY22, we would remain vigilant on some sectors of the economy such as real estate, hospitality and particularly the financial sector. The latest data from the NBFCs indicate that 90 dpd delinquencies have climbed up significantly as on Dec-2020 from the Mar-2020 levels particularly in asset classes such as CV, SME, microfinance and unsecured personal loans. Unless collections pick up in the current quarter, the increased delinquencies will translate to profitability challenges for NBFCs.

Happy reading!

Best Regards,

Suman Chowdhury
Chief Analytical Officer

Growth

Wheels continue to churn

KEY TAKEAWAYS

- The latest GDP data for Q3FY21 validated Indian economy finally exiting the recession after two quarters
- For Q4, while Jan-21 IIP disappointed, most other lead indicators continue to recover. The current quarter will also bear the burden of higher commodity prices which may shrink operating margins in several sectors
- Growth prospects remain sanguine amidst progress on vaccine, improved mobility, robust rural demand, supportive fiscal and monetary policy environment and a V-shaped global recovery
- The recent rise in COVID cases along with further strength in commodity prices could nevertheless, pose as downside risks and remain on watch
- We continue to estimate FY22 GDP expansion at a record 11.0%, which is expected to find support in a favorable base in H1 and a more meaningful recovery in services in H2.

The latest GDP data for Q3FY21 validated Indian economy finally exiting the recession after two quarters, to clock a growth of +0.4% versus a contraction of 7.3% in Q2. We draw attention to two aspects of the data:

- One, for the year as a whole, FY21 GDP growth is expected to be marginally weaker, at -8.0% (vs. -7.7% earlier) accompanied by a shallower contraction of 6.5% in GVA (vs. -7.0% earlier). This wider wedge between GDP and GVA is owing to Net Indirect Taxes (NIT, i.e., Indirect taxes – subsidies) which are expected to record a sharper contraction of 23% (vs. -13% earlier), amidst low tax collections but more importantly higher on-budget food subsidies.
- Two, looking at the granular data, on the sectoral side, GVA growth was driven expectedly by manufacturing, but positive growth surprise in Construction (within Industry) and Finance, real estate (within services) sub-sectors underscored the continued normalization in economic activity and labour mobility. On the use-based side, investment growth turned positive after a hiatus of three quarters to expand by +2.5% in Q3, possibly led by the spike in central government capital expenditure.

Table 1: India's GVA: Sectoral Growth Break-Up

	GVA	Agri / Allied	Industry	Mining	Mfg	Electricity/ Water/Gas	Constr.	Services	Trade/ Hotels/ Comm	Financial Services Etc.	Govt. Services
Q1FY20	**5.0**	**3.3**	1.7	-1.3	0.6	6.9	3.7	**7.2**	6.2	8.8	5.6
Q2FY20	**4.6**	**3.5**	-1.8	-5.2	-3.0	1.7	1.0	**8.2**	6.8	8.9	8.8
Q3FY20	**3.4**	**3.4**	-2.6	-3.6	-2.9	-3.1	-1.3	**7.0**	7.0	5.5	8.9
Q1FY21	**-22.4**	**3.3**	-35.9	-18.0	-35.9	-9.9	-49.4	**-21.4**	-47.6	-5.4	-9.7
Q2FY21	**-7.3**	**3.0**	-3.0	-7.6	-1.5	2.3	-7.2	**-11.3**	-15.3	-9.5	-9.3
Q3FY21	**1.0**	**3.9**	2.7	-5.9	1.6	7.3	6.2	**-1.0**	-7.7	6.6	-1.5

Q4 growth: Amidst pulls and pressures

Moving from Q3 to Q4 FY21, industrial production disappointed in Jan-21 as it contracted by 1.6%YoY compared to an expansion of an equal magnitude in the previous month. The deterioration belied market expectations of an improvement built on revival seen in several lead indicators and was somewhat surprising. The slowdown definitely raises questions on the sustainability in pent-up and festive demand that supported consumption in Q3 FY21. Objectively, we would tag Jan-21 data more as an aberration, and given IIP's inherently volatile nature, refrain from extrapolating the weak signal from Jan-21 data onto the coming months.

In key surveys underscoring pickup in business sentiment, PMI manufacturing while was little changed in Feb-21, at 57.5 compared to 57.7 in Jan, the index continued to remain above the pre-COVID level for the fourth consecutive month in a row. In similar vein, PMI services while expectedly below pre-COVID levels, climbed to a 1 year high of 55.3 in Feb-21.

The recovery in manufacturing and services sectors continues in line with high frequency indicators on a mend, such as - railway freight traffic, toll collection, e-way bills, and steel consumption among others. However, Q4 will also bear the burden of higher commodity prices (especially crude and metals) which may shrink operating margins in several sectors where pricing power continues to remain relatively constrained.

Visible factors in support of growth

- India has seen sustained progress on vaccination, with 2.7% of the population getting inoculated within a short span of two months. As of March 20, 2021, close to 43 mn doses of the vaccine have been administered and at the current pace of 2.1 mn doses daily, India marks the second fastest pace of inoculations in the world, after the US.
- Mobility indicators, as released by Google, continue to improve and are now <10% below pre-COVID levels. The mobility for the purpose of Grocery and Pharma is in fact now 20% above pre-COVID levels.
- Rural demand as seen in sales of two wheelers, tractors, non-durables continue to remain sturdy amidst lesser penetration of COVID in hinterlands along with the support measures and direct spending towards the sector by the Government.
- The policy environment characterized by a countercyclical fiscal outturn reinforced in the Union Budget FY22 amidst an accommodative monetary and liquidity backdrop that RBI remains committed to.
- A synchronous V-shaped global recovery led by the US.

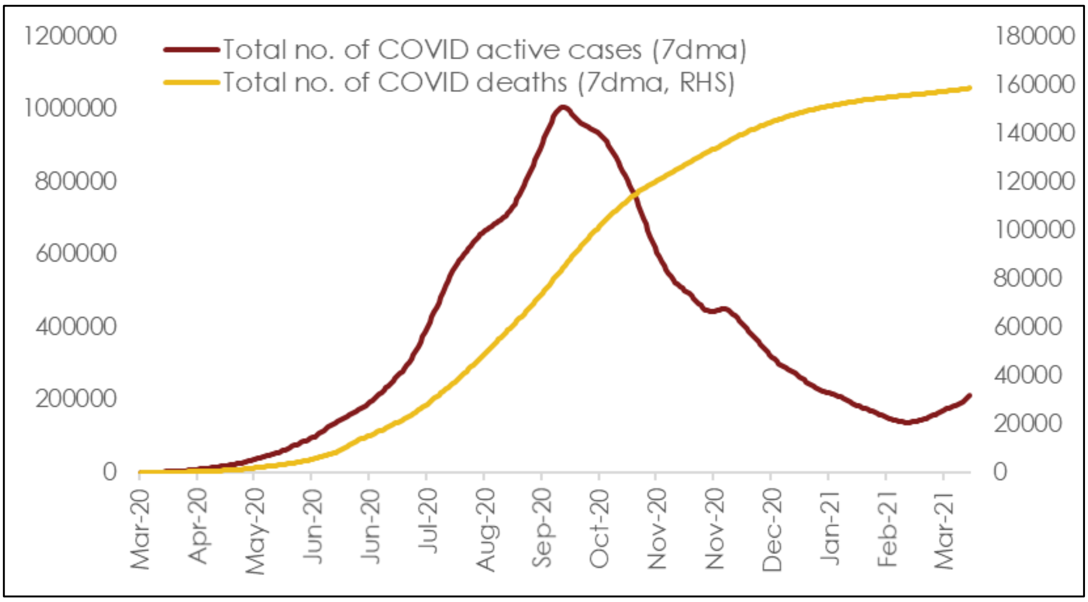
Possible headwinds

- Over the past 2-3 weeks, India has witnessed a resurgence in COVID infections, albeit it is currently limited to a few states. Counter containment measures as such currently have been restricted to select areas or states. Nevertheless, a faster than anticipated rise in case load can again trigger more broad-based restrictive measures, which can weigh down on the pace of recovery. Having said so, we believe the tradeoff between mobility and Covid cases may continue to remain a recurrent theme in 2021 until vaccination attains critical mass.
- Global commodity prices continue to ascend upwards, led by crude oil. An anticipated recovery in global demand amidst vaccine proliferation and OPEC's renewed commitment to supply cuts has seen India crude basket firm up by close to 8% in Mar-21 alone. This adds to the near 40% rise seen over Nov-20 to Feb-21.

FY22 Outlook

In continued global validation of India's growth rebound in FY22, Moody's has upped growth projection for FY22 to 13.7% from 10.8% estimated earlier on the back of normalization of activity and the steady rollout of Covid-19 vaccines. In similar vein, the OECD projects Indian economy to bounce back to growth at 12.6% in FY22, the highest among G-20 countries, aided by additional fiscal support.

Chart 1: Recent rise in COVID cases still localized in nature



Acuité continues to expect GDP to post a V-shaped recovery, with FY22 growth estimated at a record high of 11.0%. This anticipated recovery would be front loaded as H1 FY22 would benefit from a significantly favorable base effect arising from the nationwide lockdown in the previous year. As such, growth could be in high double digits between 15-20% in H1 which is expected to sober down in H2. In addition to the support factors enumerated above, we expect a faster recovery in services to take shape in H2 FY22. Having said so, downside risks as enumerated above will be closely watched as they could temporarily put a spoke in India's growth wheel.

Inflation

A quick recoil

KEY TAKEAWAYS

- After averaging at 4.3% over Dec-20 and Jan-21, CPI inflation saw a broad-based acceleration to 5.03% YoY in Feb-21
- Annualized food inflation jumped to 4.25% in Feb-21 from recent low of 2.67% in Jan-21, as sequential easing in price of vegetables waned.
- Consolidated fuel inflation accelerated to a 2-year high of 6.94% YoY in Feb-21 from 5.67% in Jan-21.
- Core inflation also hardened to a near 2-year high of 5.36% YoY in Feb-21 from 4.90% in Jan-21. This is somewhat of a concern and needs to be kept under watch as COVID related disruption in supply could result in inflationary pressures as the economy moves towards fast normalization in the backdrop of ongoing vaccination and increase in raw material prices.
- For FY22, we expect CPI inflation to average close to 5.0%, a significant moderation versus likely FY21 average of close to 6.2%.

After averaging at 4.3% over Dec-20 and Jan-21, CPI inflation accelerated sharply to 5.03% YoY in Feb-21. On sequential basis, while the jump in CPI at 0.19% MoM in Feb-21 appears modest, it is relatively much higher in comparison to a contraction of 0.73% MoM seen in Feb-20. This explains the exaggerated impact coming from the adverse base effect in Feb-21.

Drivers of CPI inflation

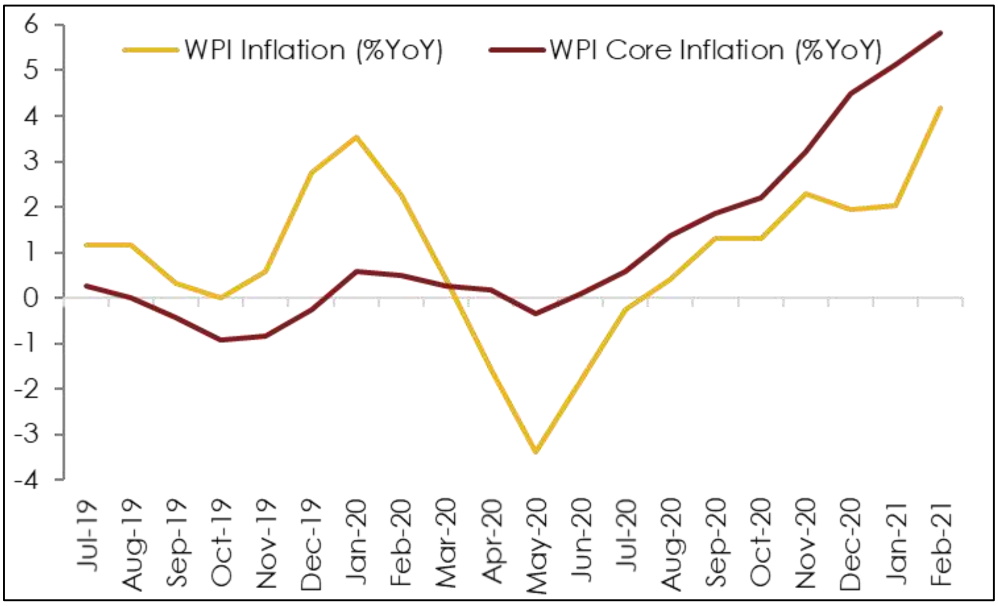
- Annualized food inflation jumped to 4.25% in Feb-21 from recent low of 2.67% in Jan-21. At a granular level, Oils & Fats and Non-Alcoholic Beverages, with cumulative weight of 4.8% in the CPI basket, are two sub-categories currently facing record high levels of annualized inflation (20.8% YoY and 13.9% YoY respectively). Moving on to heavyweight and volatile items like Vegetables, we note that the seasonal sequential easing is at its end with possibility of fresh buildup in prices during the month of Mar-21, aided by the early onset of summer and upward revision in transportation charges.
- Consolidated fuel inflation (fuel and light index along with fuel items within miscellaneous index) accelerated to a 2-year high of 6.94% YoY in Feb-21 from 5.67% in Jan-21. Continued ascent in consolidated fuel inflation in the last 3-quarters manifests the steep rise in price of international crude oil, with India Crude Basket moving from an average of USD 21 pb in Apr-20 to USD 61 pb in Feb-21. Expectation of a strong V-shaped recovery in global growth along with supply management by OPEC has led to further build-up of price pressures, with India Crude Basket climbing up to USD 66 pb levels in the month of Mar-21 so far.
- Core inflation (headline ex. food and fuel items such as petrol, diesel), reflecting underlying demand conditions in the economy, also hardened to a near 2-year high of 5.36% YoY in Feb-21 from 4.90% in Jan-21. This is a threat and needs to be kept under watch as COVID related disruption in supply could result in inflationary pressures as the economy moves towards fast normalization in the backdrop of ongoing vaccination and increase in raw material prices.

WPI Inflation: Quickens further

The pace of rise in WPI in Feb-21 also doubled to 4.17% vs. 2.03% in Jan-21, to mark the highest level in more than 2 years amidst a broad-based increase in food, fuel and core items.

- On annualized basis, while consolidated fuel & light inflation is still subdued, running at under 1.0%, the rise has been sharp vis-à-vis trough of -11.1% in Nov-20. Looking ahead, an adverse base effect and recent run up in international crude oil prices will push it into double digit territory by Apr-21.
- Meanwhile, manufacturing inflation rose further from 5.1% in Jan-21 to 5.5% in Feb-21, to remain at a series high for the second consecutive month. While it does reflect the hardening of commodity prices but also underscores the manufacturing led V-shaped economic recovery.

Chart 1: Both headline and core WPI inflation move northwards in Feb-21



Inflation target: Likely to be retained

It is likely that the Government leaves the inflation target range of 4%+/- 2% intact at its upcoming review. Recall, India had officially adopted flexible inflation targeting (FIT) in Jun-16 to place price stability as the primary objective of the monetary policy. Expectedly though, it is considering changes to the framework to include safeguard options that offer leeway in exceptional situation such as the COVID pandemic.

Outlook

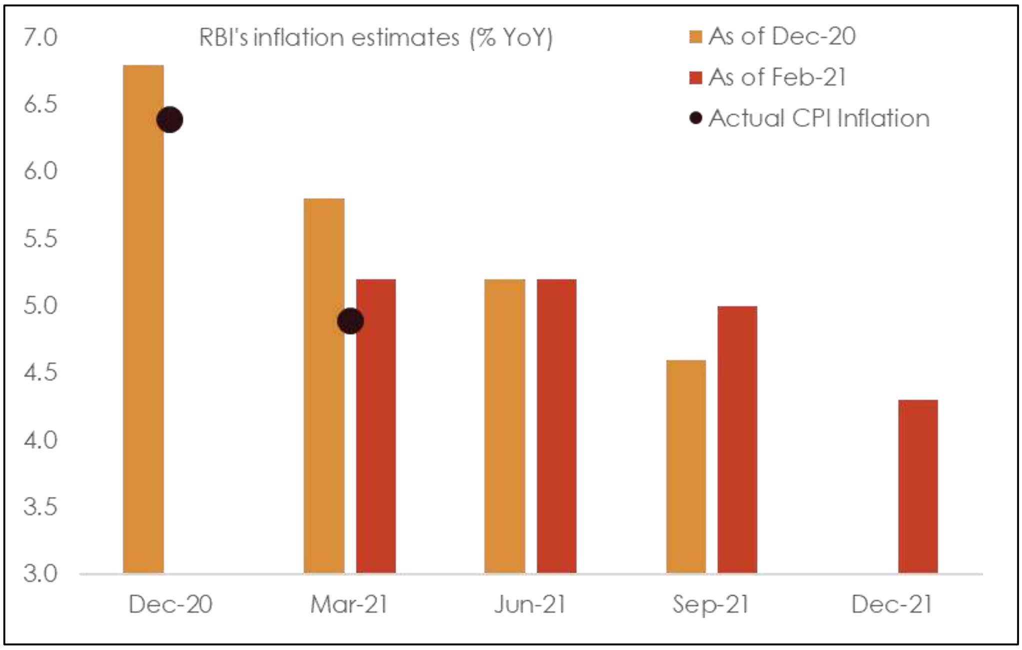
Despite the acceleration in price pressures, we note that CPI inflation is currently tracking at 4.9%, below RBI's forecast of 5.2% for Q4 FY21 (see chart below). This indeed offers a mild solace. In addition, record rabi sowing also provides comfort as it is likely to keep food price pressures somewhat under check in the coming summer months.

Going forward beyond the near term, the south-west monsoon outturn, strength of demand recovery, pace of supply restoration, and trajectory of commodity prices would determine the overall inflation trajectory. Also, any government action on cut in fuel taxes will require a careful balancing of fiscal consideration and inflation/sentiment impact.

Assuming a normal monsoon, strong V-shaped recovery in growth and range-bound commodity prices vis-à-vis current levels, we continue to expect headline inflation to moderate towards 5.0% levels on average basis in FY22 from an estimated level of 6.2% in FY21.

While this would be comforting, it would also mark the third successive year of overshooting of the mandated target (which we expect to be retained at 4.0% by the government in its upcoming review of the existing flexible inflation targeting framework in Mar-21).

Chart 2: Despite fast acceleration, inflation in Q4 FY21 is tracking below RBI's estimates



Government Finances

Scope for mild improvement in fiscal deficit

KEY TAKEAWAYS

- The relatively lower accretion to FYTD (Apr-Jan) fiscal deficit this year at 66.8% of RE compared to 105.3% over the corresponding period in FY20 reflects the sharp upward revision in fiscal deficit target for FY21 to 9.5% of GDP from 3.5% BE.
- With support from excise and custom duties, the FYTD gross tax revenue collection has clocked a mild contraction of 1.0% despite COVID's adverse impact on the economy.
- However, non-tax revenue and disinvestments have contracted on year-on-year basis, owing to lower surplus transfer from the RBI and slow traction in disinvestments.
- Total expenditure growth of 11.0% YoY on FYTD basis is lower in comparison to previous year's run rate despite significant ramp up in capex as growth in revenue expenditure has lagged.
- There could be scope for mild improvement in FY21 fiscal deficit on account of recent improvement in tax collection, higher than expected revenue from auction of telecom spectrum, and likelihood of somewhat higher Nominal GDP.

India's central government fiscal deficit for the period Apr-Jan FY21 stood at 66.8% of revised estimates (RE) for the full year compared to 105.3% over the corresponding period in FY20. The relatively lower accretion to FYTD fiscal deficit this year reflects the sharp upward revision in fiscal deficit target for FY21 to 9.5% of GDP as per RE vis-à-vis 3.5% as per initial budget estimates (BE).

Nevertheless, lets analyse the drivers of fiscal deficit to discern the near-term trajectory.

Receipts: Improvement in momentum is led by taxes

In recent months, the annualized growth in total receipts has shown strong momentum, particularly led by tax revenue.

- On FYTD basis (Apr-Jan), gross tax revenue collection has clocked a mild contraction of only 1.0% despite COVID's adverse impact on the economy. This is significantly better compared to the contraction of 2.0% seen in the corresponding period in FY20.
    - Support to gross tax revenue has emerged from excise and customs, which registered FYTD growth of 57.8% and 1.8% respectively compared to a contraction of 0.1% and 10.9% seen in the corresponding period in FY20. Hike in excise duty on petroleum products earlier in the year along with recent pickup in imports appears to be providing a supportive backdrop in this case.
    - Beyond these two categories of taxes, the disruptive impact of Covid is manifested, especially in case of GST and Income Tax collections, which contracted by 8.6% and 5.5% respectively on FYTD basis vis-à-vis an expansion of 4.6% and 6.9% seen in the corresponding period in FY20. Nevertheless, it is comforting to see that in the last 3-months, both GST as well as Income Tax collections have started improving, in line with the sequential recovery in GDP and aided by efficiency in tax administration.
- Net tax revenue on FYTD basis (Apr-Jan) clocked a healthy growth of 10.4% compared to a contraction of 2.1% seen in the corresponding period in FY20, mainly due to delay in required tax devolution to states.

Non-tax revenue comprising of Interest receipts, dividends and profits, external grants etc. on FYTD basis (Apr-Jan) recorded a sharp contraction of 44.0% compared to an expansion of 55.5% seen in the corresponding period in FY20, primarily on account of a significant reduction in transfer of surplus from the RBI which had been particularly high last year given the special dividend from RBI. When seen with respect to the downwardly revised RE, the FYTD accretion under non-tax revenue stands at 67.0% of full year target vis-à-vis 77.3% seen in the corresponding period in FY20.

While FYTD (Apr-Jan) growth in non-debt capital receipts (primarily comprising of disinvestment receipts) at 23.3% has massively outpaced the contraction of 33.6% seen in the corresponding period in FY20, it needs to be interpreted carefully. Government's disinvestment collection at Rs 195 bn between Apr-Jan FY21 is only marginally higher than the figure of Rs 184 bn seen in the corresponding period in FY20. However, with respect to the significant downward revision in RE, the FYTD disinvestment revenue accretion stands at 76.7% of full year target vis-à-vis 36.5% seen in the corresponding period in FY20.

Expenditure: Expected to be ramped up in remaining two months of FY

Total expenditure on FYTD (Apr-Jan) basis recorded a growth of 11.0%YoY compared to 13.3% growth seen during the corresponding period in FY20. On RE basis, this translates to a figure of 73.0% of the full year target vis-à-vis 84.4% seen in the corresponding period in FY20. The marginally lower pace of expenditure has happened despite the onus of stabilizing the economy falling on counter cyclical expenditure stance adopted by the government. We note a divergence between revenue and capital expenditure by the government:

- Revenue expenditure stood at 71.6% of full year RE, lower than 85.1% seen in the corresponding period in FY20. While bulk of the spending under **Atmanirbhar Bharat Abhiyan** targeted towards immediate Covid relief/support was undertaken under this category, the slower pace of spending is on account of sharp increase in the RE for major subsidies (to Rs 6.0 tn from the BE of Rs 2.3 tn arising due to transfer from other heads) to boost fiscal transparency.
- Encouragingly, FYTD (Apr-Jan) growth in capital expenditure has more than doubled to 35.2% from 16.5% seen in the corresponding period in FY20. On RE basis, this translates into a figure of 82.6% of the full year target vis-à-vis 79.5% seen in the corresponding period in FY20.

Since the beginning of H2 FY21, growth in government expenditure has picked up perceptibly. This possibly stems from recent comforting trend observed in tax collections as well as the need to support the economy amidst gradual phasing of lockdown restrictions.

Outlook

Considering both the FYTD performance as well as the recent performance in fiscal deficit drivers, it appears that there could be scope for a mild improvement in the revised fiscal deficit target of 9.5% of GDP in FY21. The optimism stems from (i) recent traction in tax collections (GST revenue has exceeded Rs 1.13 tn for three months in a row), (ii) higher than expected realization from the auction of telecom spectrum in Mar-21 (Rs 778 bn in aggregate vs. expectation of Rs 450 bn with around 25% expected to be received upfront), and (iii) higher than anticipated Nominal GDP base (on account of commodity price inflation).

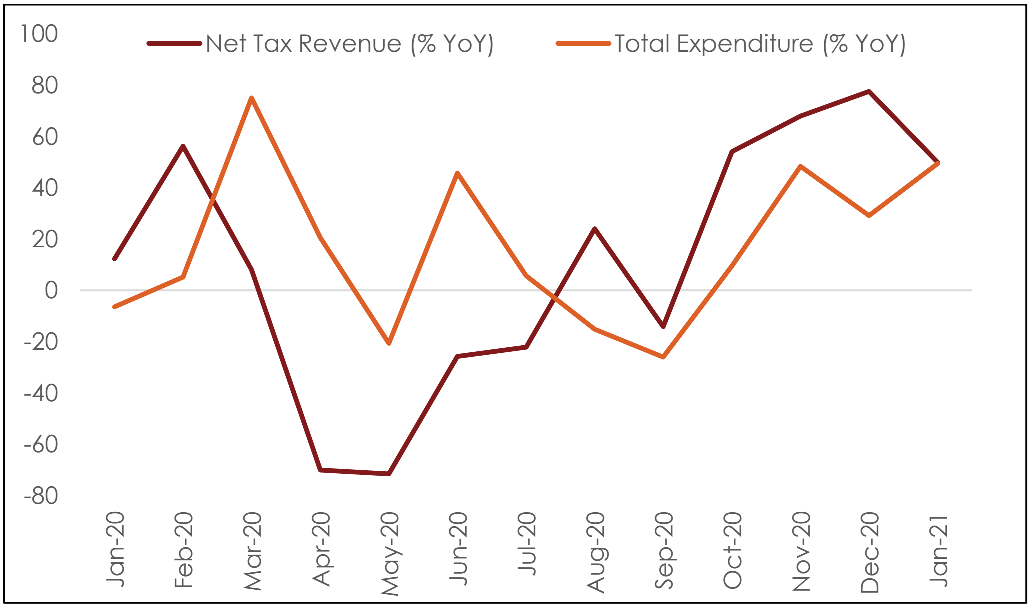
Having said so, we do note that any scope for improvement would be marginal as the government's transfer of subsidy expenditure from public sector companies has created large room for revenue spending in the remaining two months of the fiscal year.

Nevertheless, the recent improvement in tax buoyancy is indeed comforting. If it indeed sustains through FY22, then it could have a salubrious impact on next year's deficit arithmetic, provided other sources of receipts, (especially, the disinvestment target of Rs 1750 bn) play a complimentary role.

Table 1: FYTD comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative as of Apr-Jan)				
	% of FY Actual/Target		%YoY	
	FY20	FY21	FY20	FY21
Revenue Receipts	74.3	79.9	5.8	-0.6
Net Tax	73.6	82.0	-2.1	10.4
Non-Tax	77.3	67.0	55.5	-44.0
Non-Debt Capital Receipts	47.7	86.8	-33.6	23.3
Total Receipts	73.3	80.1	4.2	0.0
Revenue Expenditure	85.1	71.6	12.9	7.7
of which, Major Subsidies	*115.2*	*42.0*	*1.2*	*-3.9*
Capital Expenditure	79.5	82.6	16.5	35.2
Total Expenditure	84.4	73.0	13.3	11.0
Fiscal Deficit	**105.3**	**66.8**	**-**	**-**

Chart1: H2 growth in expenditure rising on the back of improvement in tax revenue



Rates

Bond anxiety springs in spring

KEY TAKEAWAYS

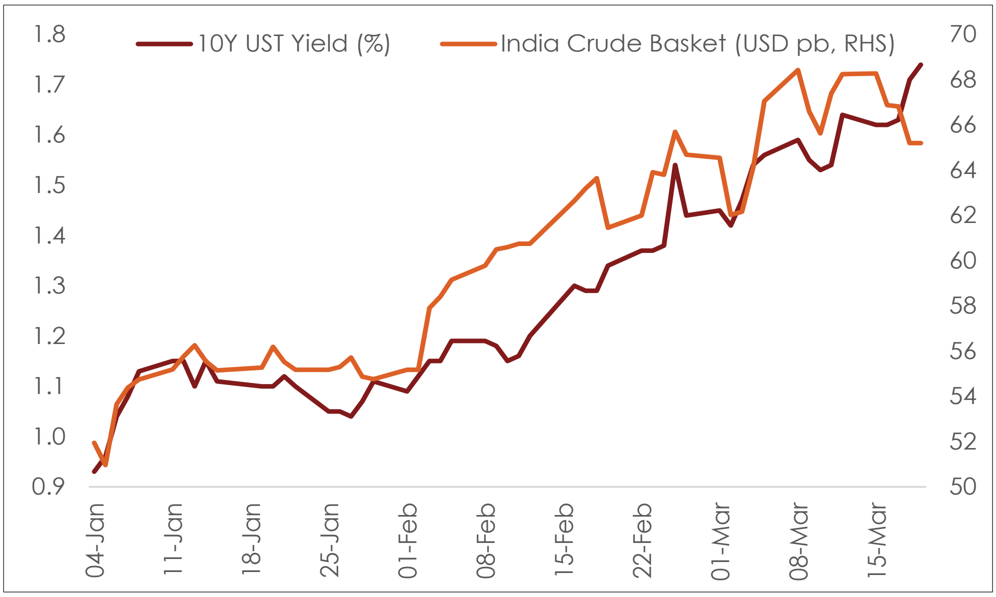
- While domestic fiscal overhang for bonds was already seen to be weighing on sentiment, global developments in the form of a further rise in oil prices and US Treasury (UST) yields intensified the headwinds in the last two months.
- Global V-shaped recovery amidst progress on vaccination besides geopolitics could keep an upside bias for both oil prices and UST yields in the coming quarters.
- Although the anticipated Fed taper program in 2022 would be less cataclysmic for EMs including India compared to 2013 on account of reduced macro vulnerabilities, some volatility from reverse flows of global liquidity would be unavoidable.
- We continue to expect RBI to make gradual progress on policy normalization via liquidity, LAF corridor and with an eventual 25 bps hike in the repo rate by Feb-22.
- We fine tune our forecast for India's 10Y sovereign yield to 6.30% (vis-à-vis 6.15% earlier) by Sep-21 and further towards 6.50% (vis-à-vis 6.40% earlier) by Mar-22.

After bottoming out at 5.82% (monthly average) in Jul-20, the 10Y g-sec yield has gradually crept up, with 30 bps of an uptick in 2021 so far. This hardening has played out despite the continuation of status quo on record low policy rate along with reiteration of accommodative stance and moderation in CPI inflation from elevated levels (notwithstanding some upside seen in the latest print for Feb-21).

Why is the bond market anxious?

Taking a closer look, the hardening of domestic yields is a phenomenon, which has begun to play out visibly since Feb-21. The beginning of the month saw the announcement of the FY22 Union Budget that also carried the revised estimates for FY21 fiscal numbers. The higher than anticipated fiscal deficit for FY21 and FY22 along with higher sovereign borrowings requirement caught market participants off guard. This led to the initial leg of the sell-off in the bond market (discussed earlier in Acuite Macro Pulse, Feb-21). While prompt response from the RBI (via extension of the HTM dispensation relief and stepped up OMO purchases) managed to provide relief to a great extent by mid Feb-21, two global developments (not mutually exclusive) thereafter threw a spanner in the works.

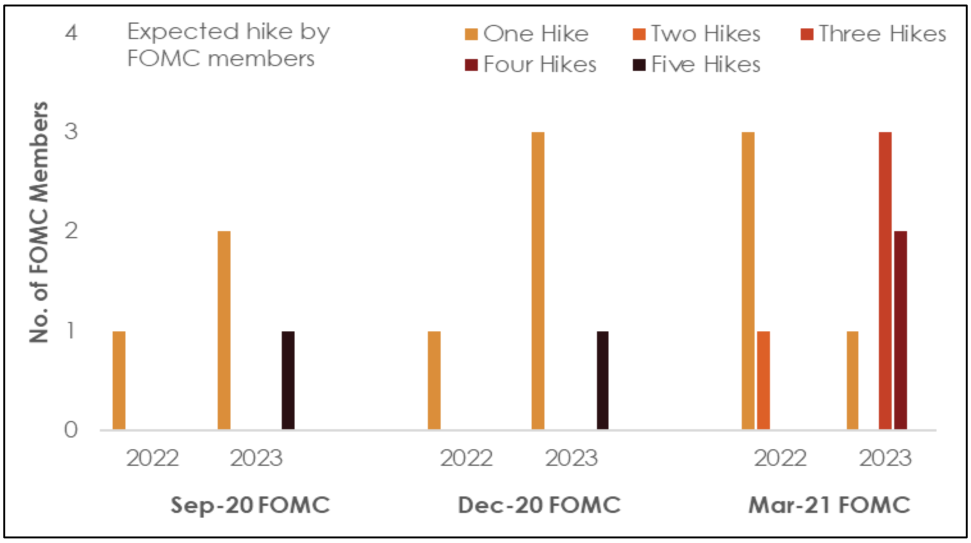
Chart 1: Since Feb-21, both oil price and UST yields have hardened considerably



- International crude oil prices started firming up. While the price for India Crude Basket has been moving up after bottoming out at USD 21 per barrel (pb) in Apr-20, it gained momentum from Nov-20 onwards. The month of Feb-21 holds importance as it saw India Crude Basket completely recouping its pre COVID levels (of USD 55 pb in Feb-20), piercing through the big figure level of USD 60 pb and in fact coming close to the psychological discomfort level of USD 70 pb in quick succession. As per RBI's simulations provided in the Monetary Policy Report (Oct-20), this is likely to provide 22 bps upside to CPI inflation in FY21. If India Crude Basket stays at current levels of USD 66 pb through FY22, then it would provide 151 bps of further upside to inflation in the coming year.

- Similarly, while the UST yields have been rising gradually after bottoming out in Jul-20, hardening picked up pace around mid Feb-21 on the back of pickup in US break-even rates and subdued response to primary auctions. The backdrop of fresh fiscal stimulus (worth USD 1.9 tn) and fast rollout of COVID vaccines in the US further stoked inflationary concerns. Although the Federal Reserve has painstakingly reiterated its continued stance of accommodation through strong forward guidance on unchanged monetary policy rate through 2023, market expectations seem to be running ahead of the median Fed dot plot. Although the latest dot plot presented in Mar-21 continues to show unchanged policy rate (on median basis) through 2023, we note that:
  - 4 FOMC members (up from 1 in Dec-20) now expect at least one rate hike in 2022
  - 7 FOMC members (up from 5 in Dec-20) now expect at least one rate hike or more in 2023

Chart 2: Despite a status quo median, few Fed members have started to drift towards rate hikes in 2022 and 2023



Outlook

Besides the two adverse global developments highlighted above, we note that the rise in UST yield has already started to have a tightening impact on emerging market economies via outflows from debt markets, rise in bond yields, and pressure on exchange rates.

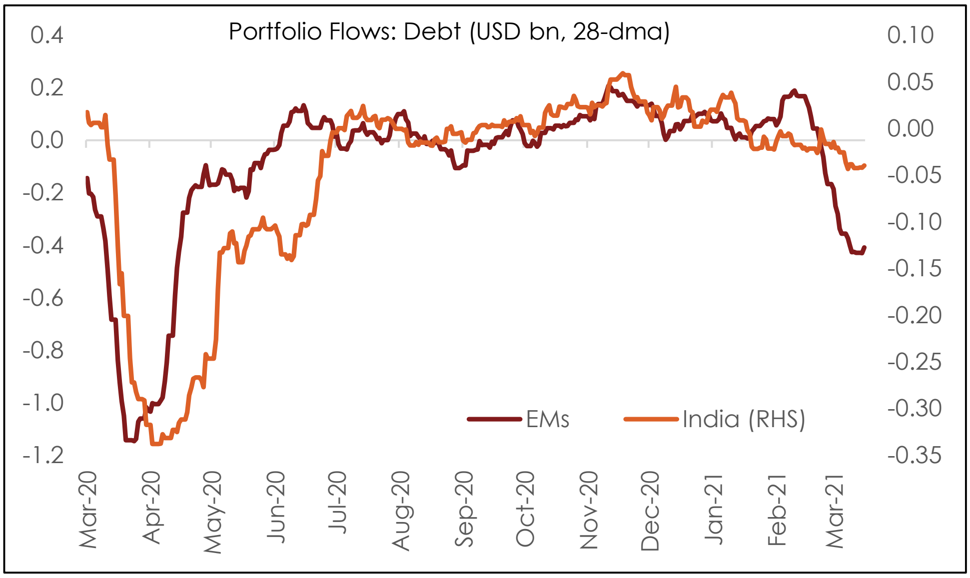
It is tempting to say that this looks like a déjà vu situation a la the 2013 Taper Tantrum episode. While adverse spillovers of scaling back of global liquidity is bound to create some pressure on EM financial markets, we believe the situation in 2021 or in 2022 (when the actual taper by the US Fed could potentially take place) would be relatively better as most EMs including India now have comfortable inflation, current account balance, reserve cover, and FX valuation. Hence, during the run up to the actual taper episode, EMs including India, appear favorably placed now vis-à-vis 2013 episode, barring the COVID led deterioration in fiscal balances and debt profile, which could become one of the potential macro yardsticks for assessing future vulnerabilities. Nevertheless, on balance we believe, the expected taper episode in 2022 would not be as cataclysmic for EMs including India, as it was during 2013.

On the domestic front, we continue to expect RBI to support bond yields till stance is accommodative (via bond purchases and verbal intervention/ moral suasion) make gradual progress on normalization of liquidity conditions as well as monetary policy through the course of FY22. We expect the reverse repo rate to be gradually adjusted upwards to 3.75% from 3.35% currently to restore the pre COVID level of the policy rate corridor width of 25 bps by Dec-21 possibly along with a 25 bps hike in the repo rate by Feb-22. The need to normalize monetary policy and liquidity conditions would stem from:

- Inflation being higher than the current mandated target of 4.0% despite the expectation of some moderation going into FY22. We expect the mid-point of the inflation target band to be retained at 4% by the government in its review of the flexible inflation targeting framework later this month. However, possibility of some tweaks exist on the lines of stipulation of escape clause under specific conditions etc.
- Preparing the economy and financial markets for the expected taper transition in 2022. In this context, we note that few EM central banks that saw significant FX pressure in 2020 (Brazil, Turkey, and Russia) have already started resorting to interest rate hikes in 2021. With oil price and US yields showing an upside bias, few more central banks in EM could be joining this space before the commencement of the anticipated Fed taper program in 2022.

Taking all the above into account, we expect the 10-year g-sec yield to increase towards 6.30% (vis-à-vis our previous estimate of 6.15%) by Sep-21 and further towards 6.50% (vis-à-vis our previous estimate of 6.40%) by Mar-22.

Chart 3: Portfolio debt outflows have started from EMs



Rupee

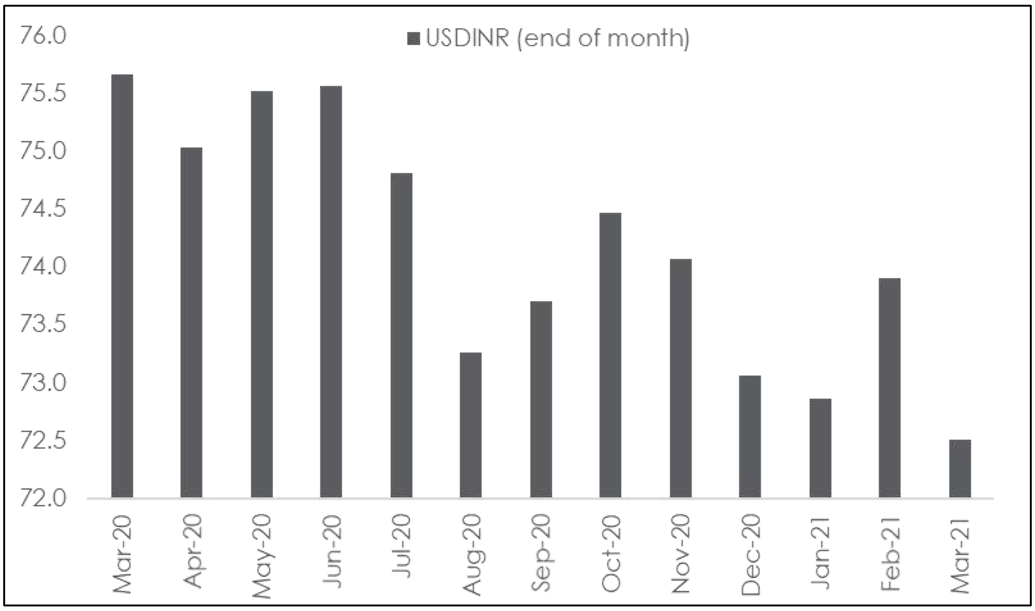
Can the tide turn?

KEY TAKEAWAYS

- Despite the headwinds from rising commodity prices and a strengthening of the US dollar, the INR continues to maintain an appreciating bias in 2021 so far amidst record high foreign investment inflows.
- While global liquidity glut and expectation of a strong V-shaped recovery in India continues to be supportive of flows, the situation may change on relentless rise in domestic asset valuations and possibility of tapering of Fed's QE program, which we believe could happen in early 2022.
- The recent surge in commodity prices would impart an upside risk to our FY22 current account deficit forecast of USD 30 bn while also providing a downside risk to our BoP surplus forecast of USD 55 bn.
- We revise our USDINR forecast to 73.0 by Sep-21 (from 72.0 earlier) and to 75.0 by Mar-22 (from 71.0 earlier).

Barring the weakness seen in Feb-21, appreciation in the Indian rupee continues in the month of Mar-21 (so far), with the currency registering a CYTD gain of 0.8% vs. the US dollar, and thereby standing out as one among the few emerging market currencies to have strengthened in 2021 so far. In fact, this would be INR's strongest level seen in the post COVID period.

Chart 1: INR has attained its strongest level so far in the post COVID period



As highlighted in our last month's Macro Pulse Report, the recent strength in INR has come about despite the backdrop of a mild strength in USD and significant deterioration in India's merchandise trade deficit.

- The USD (as represented by the DXY Index) has strengthened by 1.7% in 2021 so far, supported by a sharp 69 bps jump in the 10-year UST yield (despite repeated assurances from the Federal Reserve on unchanged monetary policy trajectory through 2023) as investors price in prospects of higher inflation from strong reflationary policies.
- India's merchandise trade deficit has risen sharply to USD 12.6-15.4 bn range over Dec-20 and Feb-21 vis-à-vis the range of USD 2.7-9.8 bn seen between Apr-Nov 2020 (barring the one-off trade surplus in Jun-20) on account of increase in global commodity prices and continued normalization in domestic demand conditions amidst gradual phasing out of lockdown restrictions.

This brings forth the role of foreign investment (especially FDI and FPI-Equity) inflows that have not only insulated INR from global FX volatility seen since the onset of the pandemic but have also been imparting it some degree of relative strength and outperformance vis-à-vis EMFX, notably since Nov-20.

- As per our estimates, the 12-month rolling sum of FDI and FPI-Equity flows have touched a record high of approximately USD 79 bn as of Feb-21. Since this has predominantly coincided with a rare instance of current account surplus for India, the salubrious impact on INR can be rationalized.

Can the tide turn?

Despite the show of relative strength by INR in recent months, we believe one needs to be cautious in extrapolation of this trend in the coming quarters. In fact, we would argue that the tide could turn against INR later in FY22 on account of:

- The expectation of a V-shaped global recovery amidst the backdrop of highly supportive policy environment in several countries (besides geopolitical factors and COVID related idiosyncrasies) has led to sharp rise in global commodity prices. The IMF's Commodity Price Index rose to a 4-year high growth of 26.8% YoY in Feb-21. As per preliminary estimates for Mar-21, the overall commodity index is likely to attain a 51% YoY growth, the highest in the post Global Financial Crisis period. While the increase is led by energy prices, it is nevertheless broad based with extended participation from metals and food items.
- While one could argue that the expected normalization in global economic activity is resulting in most commodities either attaining their pre pandemic levels (or even exceeding it in most cases), this development and more importantly its likely persistence in FY22 holds significance for the Indian economy. The futures market is expecting Brent and Gold price to average close to USD 66 pb (vs. FY21 average of USD 45 pb) and USD 1750 price per ounce (poz) in FY22 (vs. FY21 average of USD 1831 poz). Looking at India's recent history of merchandise trade performance under different levels of oil and gold prices, a baseline scenario characterized by the average monthly merchandise trade deficit of USD 14.5 bn can be conceived for FY22 compared to the estimated average monthly deficit of USD 8.0 bn in FY21. The risk if at all could lie on the upside given the manufacturing led revival and role of pent-up demand (especially for items like precious metals and electronic goods in India). As such, we now attach an upside risk to our current account deficit forecast of USD 30 bn for FY22. This in turn would lower the FY22 BoP surplus from the existing estimate of USD 55 bn.

Chart 2: India's average monthly trade deficit under different commodity prices

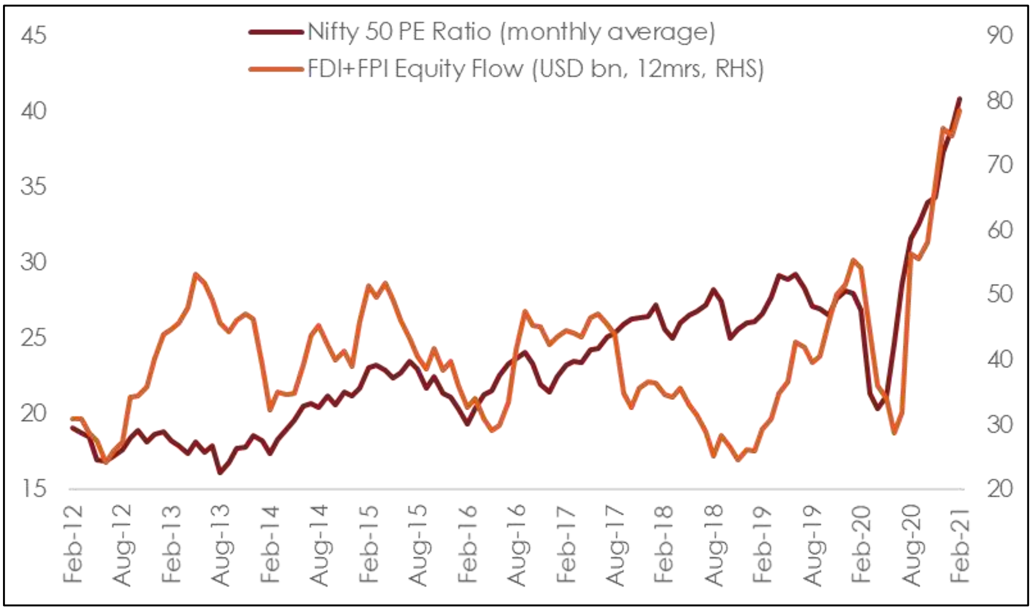
			FY16	FY17	FY18	FY19	FY20	FY21
			Oil Price (USD pb)					
			46	48	56	70	60	44
FY16	Gold Price (USD poz)	1,151	-9.9					
FY17		1,260		-9.1				
FY18		1,285			-13.4			
FY19		1,262				-15.3		
FY20		1,463					-13.5	
FY21		1,831						-8.0

Note:

- Unshaded box represents average monthly value (in USD bn) of the merchandise trade balance for India
- Prices shown for oil and gold represents the average for the financial year

- As stated above, since Q2 FY21 India has been an important recipient of foreign capital chasing growth prospects (FDI and FPI-Equity) in an environment of global liquidity glut. The magnitude of inflow has been overwhelming and it is partly responsible for driving domestic equity valuations to record high levels. While it is difficult to ascertain at what point high valuation in equities would hit a roadblock, prospects of a turn in sentiment attached to tapering of quantitative easing program by the US Fed (expected by us before mid-2022) could be an important event risk in this context.

Chart 3: Foreign investment inflows driving equity valuations to record high



Outlook

While we continue to stick to our near-term forecast of 73.0 (with some downside bias) for USDINR for end Mar-21, we now believe that FY22 prospects for the currency have turned somewhat adverse on account of wider current account deficit (and narrower BoP surplus) and likelihood of some strength in the dollar led by current strong pace of vaccination in the US and 'taper talk' in early part of 2022.

Therefore, we now revise our USDINR forecast to 73.0 by Sep-21 (from 72.0 earlier) and to 75.0 by Mar-22 (from 71.0 earlier). The weakness in case of INR is likely to be moderate (on account of record high reserve cover and relatively healthier growth-inflation dynamics vis-à-vis the previous episode of 'Taper Tantrum' in 2013) and backloaded, and linked to the evolution of the taper trajectory by the US Fed.

Risk to this view stems from further hardening of global commodity prices, which could potentially impart a larger depreciation bias to INR. On the other hand, a faster than anticipated growth recovery and government's execution of reforms agenda (esp. gsec listing on international bond indices) can potentially favor a stronger INR.

Global Overview

The return of reflation

KEY TAKEAWAYS

- The recent weeks have seen the resurgence of the reflation theme in global financial markets.
- The continued progress on vaccine administration, especially in the US and UK, higher headline inflation and prospects of its further rise amidst improving growth, have pushed up bond yields.
- While it began with a sell-off in the USTs, however globally sovereign bond yields too have risen. This has grabbed attention of key central banks as it could potentially upset the nascent recovery.
- From the perspective of central banks, reacting with tighter monetary policy amidst higher inflation runs the risk of choking off the recovery prematurely.
- But central banks will need to cap yields, perhaps with more verbal intervention and forced easing, as long as the pandemic still remains a threat to the fragile economic recovery.

Overview

The recent weeks have seen the resurgence of the reflation theme in global financial markets. The continued progress on vaccine administration, especially in the US and UK, higher headline inflation and prospects of its further rise amidst improving growth, have pushed up bond yields. The current increase in inflation comes on the back of rise in global crude prices (up over 100% on an annualised basis), which are expected to linger at least through Q1-21 on the back of rising demand and some production cuts. Looking beyond Q1, inflation drivers are expected to become more demand driven, led especially by services as the sector gradually come back to life. In addition, latest round of fiscal support of USD 1.9 tn introduced by Biden has the potential to add another leg to inflation.

While it began with a rally in the UST yields (up from 0.9% at the beginning of 2021 to 1.7% currently), however globally sovereign bond yields too have risen (see chart1). This has grabbed attention of key central banks as it could potentially upset the nascent recovery. From the perspective of central banks, 2021 will perhaps be as challenging (if not more) as 2020. Reacting with tighter monetary policy amidst higher inflation runs the risk of choking off the recovery prematurely. But central banks will need to cap yields, perhaps with more verbal intervention and forced easing, as long as the pandemic still remains a threat to the fragile economic recovery.

As such, expectedly initial reactions were rhetorical in nature, but recently central banks have begun to act. The European Central Bank (ECB) has indicated that it could step up purchases under the Pandemic Emergency Purchase Program over the next quarter following a similar action from the Reserve Bank of Australia (RBA) earlier.

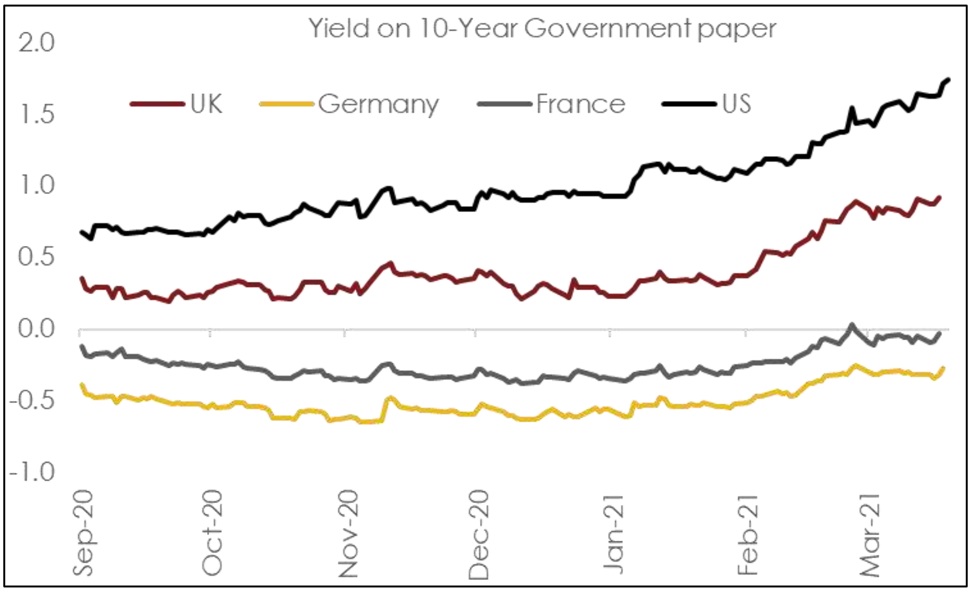
Another factor adding to the complexity of recovery is the sustained rise in global crude oil prices. Saudi Arabia and its OPEC allies surprised markets in early Mar-21 with their decision to keep supply cuts intact. Of the 1.5 million barrel per day (mbpd) that it could restore, OPEC+ only granted modest increases to Russia and Kazakhstan. Further, the additional 1 mbpd voluntary cut in output by Saudi Arabia last month, is now believed to be "open ended", implying upward pressure on prices in a global economy which is firmly on a path of a gradual recovery.

Underscoring the recovery, OECD revised up its global growth forecast amidst deployment of vaccines and the huge US stimulus program. For 2021, it expects world GDP to expand by 5.6% and further by 4.0% in 2022. For the US, OECD more than doubled its growth projection to 6.5% for 2021.

US Economy

Earlier this month, President Biden signed the USD 1.9 tn coronavirus aid package. Along with the stimulus approved at the end of Dec-20, this translates into a combined stimulus of close to 13% of GDP in 2021. The first tranche of direct support of USD 1400 to most US citizens (with income riders) saw a quick rollout. Among other measures, the package extends USD 300/week jobless aid supplement until Sep-21, allocates USD 350 bn to state and local governments and USD 130 bn to schools and includes grants for small businesses as well as more targeted funds, towards restaurants and bars, airlines, airports, transit, Amtrak rail and aerospace manufacturing.

Chart1: Global yields have followed the rise in USTs higher



Among the macro data, NFP rose more than expected in Feb-21 with addition of 379k jobs. Encouragingly, data for Jan-21 was also revised higher at 166k along with a fall in the unemployment rate by 0.1pp to 6.2%. ISM manufacturing survey rose 2.1 points to 60.8 in Feb-21, marking the ninth consecutive reading above the threshold of 50, marking a near 1-year high level. On the other hand, industrial production fell 2.2% MoM in Feb-21, worse than expected amidst winter storms that weighed on production. Separately, retail sales fell more than expected by 3% MoM in Feb-21 but some payback was expected from the upwardly revised 7.6% sequential growth in Jan-21, following the USD 600 stimulus-payment doled out at the end of 2020.

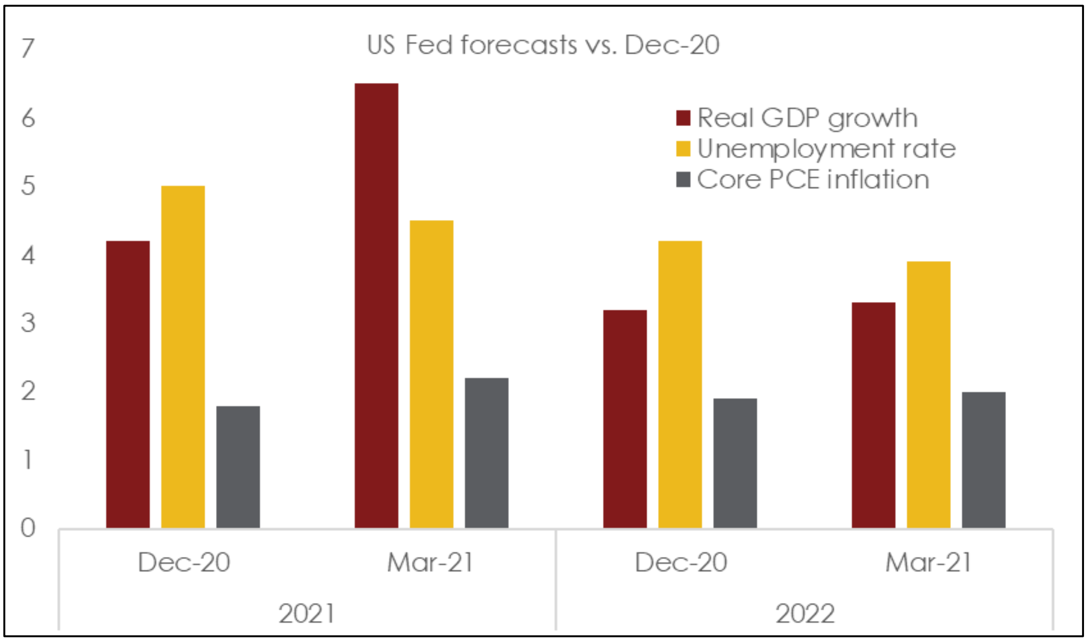
In the much-awaited FOMC meeting, the Federal Reserve offered no surprise as it unanimously left the target range unchanged at 0-0.25% and also the quantitative easing program. More importantly, US Fed officials reiterated that they continue to project near zero rates at least through 2023, while they upgraded their growth and inflation outlook to reflect faster recovery in both activity and prices (see chart2). On the rising UST yields, Governor Powell reiterated his views saying - "*The stance of monetary policy we have today we believe is appropriate. I would be concerned by disorderly conditions in markets or by persistent tightening of financial conditions that threaten the achievement of our goals.*"

Eurozone

The sluggish pace of vaccine rollout continues to remain a headwind to growth recovery in the region. As of 19th Mar-20, 8.1% of the EU population had been administered one dose of COVID vaccine compared to 22.7% in US and 38.5% in UK. While this could receive a leg up with the Johnson & Johnson vaccine from Apr-21 onwards, in the interim, it is not surprising that most of the countries have extended lockdowns or imposed stricter restrictions in place till end Mar-21/early Apr-21 at least.

On the data front, strong demand for manufactured goods helped the factory PMI soar to a near 2-year highs of 57.7 (vs. 54.8 previous), while PMI services industry fell to 44.7 from 45.4 in Jan-21, indicating that services continue to remain heavily affected by restrictions. In similar vein, Jan-21 retail sales underwhelmed with a contraction of

Chart2: Fed FOMC upped its growth and inflation forecast for 2021 vs Dec-20 policy



6.4%YoY while industrial production fared better than expected to post a marginally positive growth of 0.1%YoY in Jan-21. As such, while the economy is likely to clock a double dip recession, manufacturing is set to lessen the GDP contraction for Q1-21 as it did in last quarter of 2020.

From monetary policy perspective, the latest ECB meeting was being looked at closely to gauge the central bank's reaction function to the rise in domestic yields. While the ECB kept its policy rate and stance unchanged it stated that it "*expects purchases under the Pandemic Emergency Purchase Program (PEPP) over the next quarter to be conducted at a significantly higher pace than during the first months of this year*," imparting an overall dovish tone. The ECB's tweak comes after several policymakers in the run up to the policy had commented on monitoring bond markets closely and indicated concern about a premature rise in bond yields, tracking the upside in USTs. To put this in context, German bund yields had risen to the highest level in a year in Feb-21 while French 10-year bond yields climbed above zero for the first time since Jun-20.

UK

In its Budget announced in early Mar-21, the British FM committed that he will be doing whatever it takes to rescue the country out of the pandemic. Despite the near-term recovery in sight, with the Office for Budget Responsibility (OBR) pegging growth in 2021 and 2022 at 4.0% and 7.3% respectively, the FM alluded to long term scarring that the UK has witnessed with more than 7 lakh people losing jobs and economy shrinking by 10% last year. Put together, the FM outlined GBP 65 bn of new Covid support, bringing the total stimulus since start of the pandemic to GBP 352 bn.

The effect of renewed restrictions in the UK was seen in Jan-21 GDP which fell by 2.9% MoM, albeit lesser than anticipated. Weakness was driven expectedly by services sector which shrank by 3.5% compared to -1.5% in industrial sector. It appears that the economy is on its way to record a contraction in Q1-21, but with months of Feb-21 and Mar-21 faring incrementally better in terms of recovery.

Having said so, the near-term future for the UK economy looks bright. The country has made reasonable advance on vaccine administration, with nearly 39% of the population receiving at least one jab. The PM has announced a target of achieving full coverage of the adult population by Jul-21 and also a cautious timetable for re-opening the economy over the next several months. Further, in an added dimension of support to recovery, UK has delayed the introduction of a range of post-Brexit import checks on goods from the EU by 6 months. In its latest policy meeting, the BoE too acknowledged the growth recovery as it stated - "*Covid-related restrictions and people's health concerns would weigh on activity in the near term, but that the vaccination programme would lead to those easing, such that UK GDP was projected to recover strongly over 2021 towards pre-Covid levels*". The BoE maintained a status quo on both rates and quantitative easing.

China

Economic data emerging out of China has underscored a strong recovery underway at the start of 2021. Across a gamut of indicators tracking economic activity, growth has seen a sharp rise over the depressed COVID induced base of 2020. To put this in context, in the first two months of 2021, China's industrial production rose 35.1%YoY, compared with a contraction of 13.5% during the same period last year. As such, the economy is expected to see a strong double-digit growth in Q1-21, which obviously will be more optical due to a favourable statistical base at play.

In a further boost to near term activity, China relaxed COVID restrictions by removing control policy in multiple entertainment places. It also relaxed its borders for foreigners inoculated with Chinese vaccines such as Israel and Hong Kong. Separately, the National People's Congress (NPC) released their five-year plan for the economy with a target GDP growth rate of above 6% for 2021. Compared to estimates from other global agencies, NPC's estimate appears conservative. While the plan envisages continued fiscal support to the economy, it also acknowledges the need to reduce leverage overtime.

Despite robust data, China saw a selloff in equity markets amidst warnings from China's financial regulator on asset bubbles in foreign markets as well as local property markets, which has raised expectations of a possible policy tightening from authorities.

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