Acuite
RATINGS & RESEARCH

Macro Pulse
Report

May 2023

Contents

From the desk of the Chief Economist

Greetings from Acuité Ratings & Research!

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

As I write the preface to this edition, the data on GDP for Q4FY23 along with provisional estimates for the whole year just trickles in and it is indeed a pleasant surprise! Hardly any market participant or economist expected a growth of 6.1% in Q4 which took the overall growth print for FY23 to 7,2%. This data reinforces the resilience of the domestic economy like no other. We have been talking about the primary movers of such growth in our earlier editions – the buoyancy in the services sector including the continuing pent up demand in the travel and tourism sector along with the gains from higher government expenditure on capital projects. What can also be added to the list now is the 4.0% robust growth in the agriculture sector for the whole year and 5.4% particularly in Q4 despite the reports of some impact of untimely rainfall on the rabi crop.

The last data point augurs well for the rural economy where demand has been fragile and inconsistent throughout FY23. While we hope to see a healthy revival in rural demand for consumer goods in the current year, we should also be cognizant of the downside risks that can emerge from the El Nino phenomenon. The agricultural sector has seen steady growth over the last 4 years i.e. 3.5%-6.2% which presents additional statistical risks of a downturn in the sector in the current year. Even if the monsoon obliges, we believe the impact of the global slowdown and the lagged impact of the higher interest will show up in a moderation of the GDP growth print which we continue to peg at 6.0% for FY24. Interestingly, many organisations including the RBI have put forward forecasts of higher growth in the current year which in our opinion, are aspirational at this stage.

On the other side, inflation is on a moderation path and in the near term, there doesn't seem to be any upward drivers. RBI is likely to be on a "pause" mode for the next two quarters and in all likelihood, the current repo rate of 6.5% is set to be the terminal rate in the current cycle. As regards the timelines for a pivot or a cut in interest rates in India, we believe that the MPC will not act in haste on the matter unless there is a large negative surprise on growth in the ensuing quarters.

Another comfort factor in the macro landscape is the improving position on the twin deficits – fiscal and current account (CAD). While central elections are not that distant away, we believe that the government will have enough wherewithal to hold the fiscal deficit at less than 6.0% in FY24 and that was well demonstrated in FY23 where there has been virtually no slippages on the fiscal side. The CAD is likely to slip down to 1.4% and BoP is set to return to surplus given the buoyancy in services exports and the price advantages in increased crude sourcing from Russia. These factors will hold the economy relatively steady despite the persistent global headwinds. The rupee may actually appreciate from the current levels unless there are new "risk-on" factors.

Let's now hope for a good and timely start to the monsoons – a key factor in our economy.

Cheers,

Suman Chowdhury
Chief Economist & Head – Acuité Research

Growth

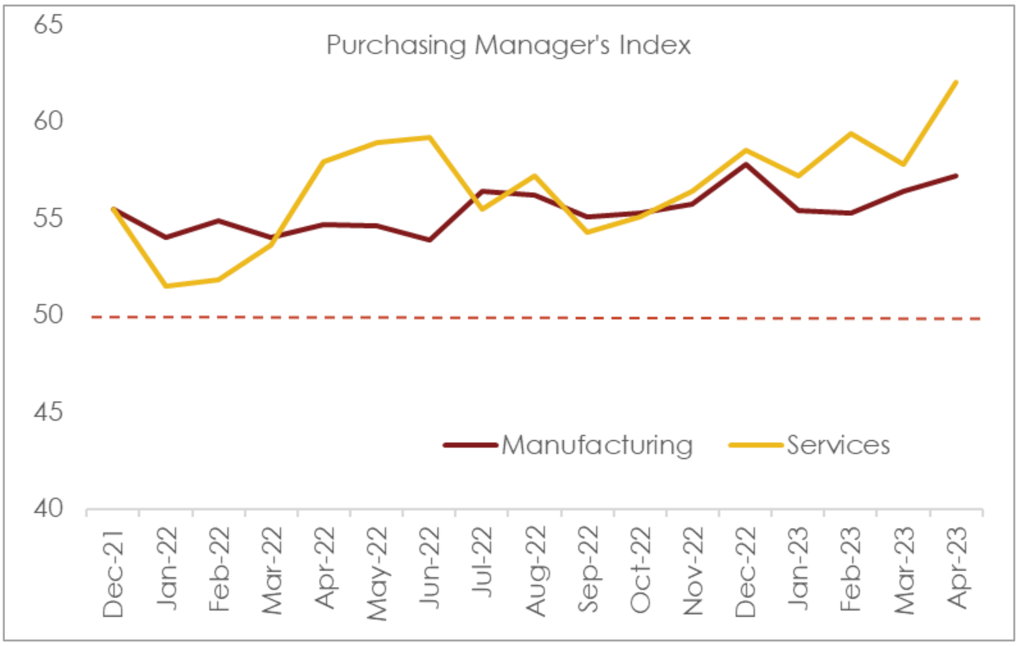
Global environment to weigh

KEY TAKEAWAYS

- In comparison to global economic conditions that remain besieged by heightened uncertainty, Indian economy continues to display resilience, well into FY24.
- The latest GDP figures released for Q4FY23 highlight that the Indian economy has grown by 6.1% in that quarter and the overall GDP growth for FY23 has also inched upwards to 7.2%.
- Most lead indicators for the domestic economy for the months of Mar-23 and Apr-23 display persistent strength. Prominently among those, PMI index for services in Apr-23 soared to the highest level in 13 years, at a robust 62.0.
- The delayed normalization of the services sector post the pandemic has kept demand from both domestic and international market buoyant.
- Having said so, the effects of the ongoing moderation in global demand is already seen in contraction of India's merchandise goods exports on a YoY basis, yet again in Mar-23. As a banking crisis joins the global macroeconomic backdrop that was already at risk from aggressive rate hikes from central banks across the world, the tightening of credit conditions is bound to have its impact on economic activity beyond US.
- Looking ahead, challenges for domestic growth are expected to emerge in FY24 owing to – 1) Slowdown in global growth and trade 2) Timely rainfall risks despite the prediction of a normal monsoon given the likelihood of El Nino event 3) Private capex remaining uneven and sluggish and 4) downside in urban leveraged consumption owing to pass-through of higher borrowing costs
- We continue to anticipate GDP growth to moderate to 6.0% in FY24.

In comparison to global economic conditions that remain beset by heightened uncertainty, Indian economy continues to display resilience, well into FY24. Most lead indicators for the domestic economy for the months of Mar-23 and Apr-23 display persistent strength. Prominently among those, PMI index for services in Apr-23 soared to the highest level in 13 years, at a robust 62.0. The delayed reboot of the services sector post the pandemic has kept demand from both domestic and international market buoyant. Having said so, the effects of the ongoing moderation in global demand is seen in annualized contraction of India's merchandise goods exports, yet again in Mar-23. As a banking crisis joins the global macroeconomic backdrop that was already at risk from aggressive central bank rate hikes, the tightening of credit conditions is bound to have its impact on economic activity beyond US shores.

Chart 1: Apr-23 PMI services at 62.0, marked the strongest reading in 13 years



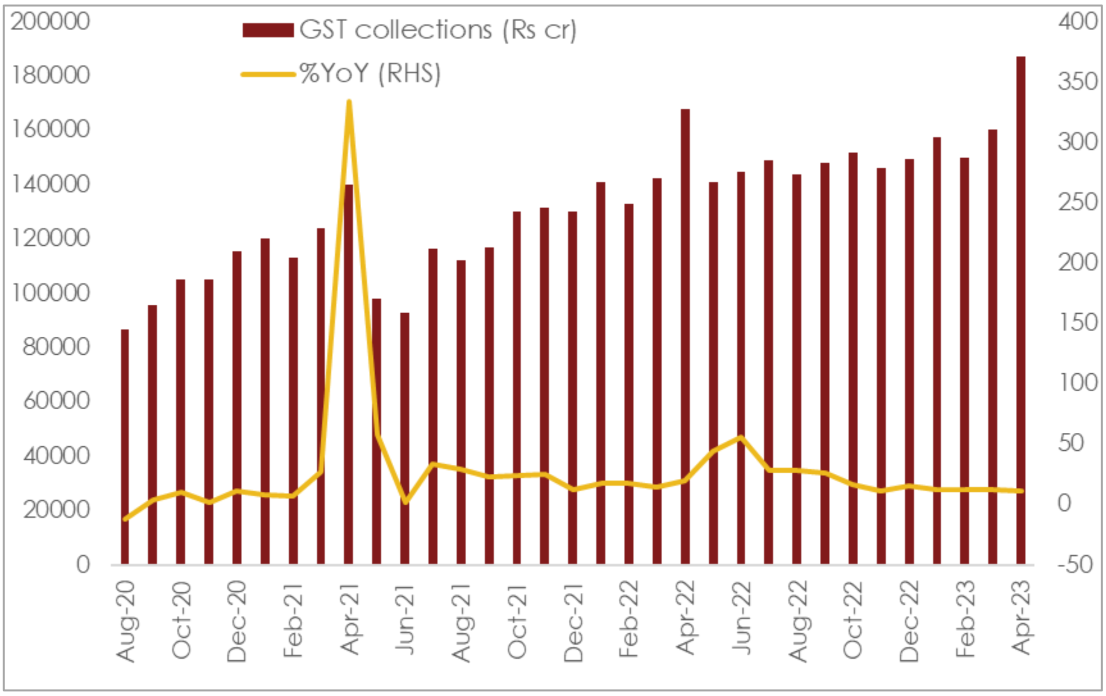
Recent data releases

Turning our attention to other recent data releases-

- India's industrial activity moderated to a 5-month low of 1.1% YoY in Mar-23, well below market consensus, from 5.8% in Feb-23. On an annualized basis, 2 of 3 sub-sectors, viz. Manufacturing and Electricity showed moderation, with Electricity registering a contraction of 1.6%.
- The deceleration in India's industrial production in Mar-23 was driven by lingering weakness in manufacturing exports, moderating global growth impulses due to monetary tightening by key central banks, uneven recovery in domestic private consumption, continuing geopolitical uncertainty and the waning impact of pandemic era stimulus of the central government. Nevertheless, we expect continued support to industrial activity arising from government's continuing focus on capex and gradual recovery in rural demand.

- Gross GST revenue collection in Apr-23 (i.e., for transactions for Mar-23) rose to a record high of Rs 1.87 lakh Cr. On an annualised basis, this translated into a growth of 12%. For the first time since inception, GST collections crossed Rs 1.75 lakh Cr mark.
- Robust GST collections were underscored by E-way bills generated, which too had risen to a record high of 9.1 Cr in Mar-23. Continued traction in domestic economy along with seasonal year-end bump up appear to have been at play. However, the figure has subsequently moderated to 8.4 Cr in Apr-23.
- In a broad-based expansion, headline PMI manufacturing index rose to a 4-month high of 57.2 in Apr-23 from 56.4 in Mar-23. New orders (both domestic and international) led the gains, with softer input prices also supporting at the margin. As such, firms resumed hiring after a decline in the previous month.
- Led by Services PMI that soared to a 13-year high of 62.0 in Apr-23 from 57.8 in Mar-23, Composite PMI Output Index also jumped to 61.6 in Apr-23 – the highest level since Jun-10.
- India's merchandise trade balance started FY24 on a comforting note, with the deficit narrowing to a 20-month low of USD 15.2 bn in Apr-23 from USD 18.6 bn in Mar-23.
- Services trade surplus is estimated to have eased marginally in Apr-23, to USD 13.9 bn from USD 14.2 bn in Mar-23.
- We expect the comfort on the monthly trade deficit prints to continue, despite the persistence of adverse global geopolitics, given the normalization of supply chains, correction in global commodity prices including crude oil and slowdown in domestic growth weighing on core imports.

Chart 2: GST collections had soared to a record high in Apr-23



Outlook

Domestic economic activity continues to maintain strength into the month of Apr-23 as validated by early data such as PMI for both manufacturing and services. The pace of momentum is however expected to moderate heading into FY24 owing to –

- Slowdown in global growth and trade volumes in 2023. WTO, in its Apr-23 update to 'Global Trade Outlook and Statistics' report, pared 2023 world merchandise trade growth forecast to 1.7% compared to 2.7% in 2022. Reasons for downgrade include continued effects of the war in Ukraine, stubbornly high inflation, tighter financial conditions, and financial market uncertainty.
- Sentiment related to global financial conditions, post the recent failure of some mid-sized banks in certain advanced economies (AEs), remains somewhat fragile though central banks and financial regulators have been able to restore confidence and financial stability for now.
- Pace of domestic private capex recovery could remain somewhat sluggish and uneven amidst global uncertainties and higher interest rates. Having said so, the ongoing improvement in Capacity Utilisation (CU) is aiding nascent investment turnaround in some of the infrastructure-oriented sectors. As per RBI's latest OBICUS Survey, CU in the manufacturing sector slightly improved to 74.3 in Q3 FY23 from 74.0 in Q2.
- Urban goods consumption, which is holding up well so far, could experience some moderation as pent-up demand fades and transmission of cumulative past rate hikes by RBI weighs more materially. We already do see the pace of annualised growth of credit to consumer durables coming-off sizeably over the last 2-3 quarters.
- In addition, downside risks emanate from possibility of El Nino weighing on Southwest monsoon performance. As per IMD's first long-range estimate, rainfall is expected to be normal at 96% of LPA, though we await the updated forecast to be released by end May-23 for better clarity.

As such, we continue to anticipate GDP growth to moderate to 6.0% in FY24. This happens to be in line with most global agencies who have revised their India growth outlook in recent weeks –

- IMF pared India growth outlook for FY24 to 5.9% from 6.1% (as of 11th Apr-23)
- World Bank cut its India FY24 growth forecast by 30 bps to 6.3% (as of 4th Apr-23)
- In contrast, RBI in its last policy in Apr-23, upped India's FY24 growth forecast by 10 bps to 6.5% - remaining at the top-end of the forecaster's range.

On balance, domestic economy is likely to find support in –

- Recovery in rural demand – an outcome of improving wage growth, easing agri-input costs, Rabi harvest and ongoing procurement (especially of wheat) along with continued support of Government spending towards the sector. Among the high frequency indicators, we find that sales of two-wheelers continue to recover and tractor sales have soared in the recent months.

- Government's capex support, seen in FY23 and reinforced in the Union Budget for FY24.
- Continued traction in services still benefiting from a delayed opening and pent-up demand especially in contact-intensive sectors of tourism, hospitality etc.

Inflation

Now on a moderating path

KEY TAKEAWAYS

- India's CPI and WPI inflation moderated in Apr-23 to 4.70%YoY (18-month low) and -0.92%YoY (34-month low) respectively.
- Headline CPI inflation in Apr-23 remained within the RBI's target range (2-6%) for the second consecutive month.
- Core retail and wholesale inflation moderated to an 11-month low of 5.48%YoY and 41-month low of -1.77%YoY in Apr-23 respectively, on account of continuing softness in most commodity prices amidst a slowing global economy.
- Moderation in headline inflation for both WPI and CPI can be attributed to easing food inflation, lower input costs, favourable statistical base effects and lagged impact of past monetary tightening.
- Easing of food inflation seems encouraging amidst IMD's prediction of a 'normal' monsoon outturn in the upcoming Jun-Sep season. Upside risks to inflation, however, remain from El Nino conditions evolving during the later summer months.
- Potential risks notwithstanding, we see a faster moderation in headline CPI inflation in FY24 than core inflation. The latter could display some degree of downward rigidity amidst continuing recovery in services and upward price adjustments in the sector. We maintain our FY24 CPI inflation projection of 5.3%.

Overview

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

More importantly:

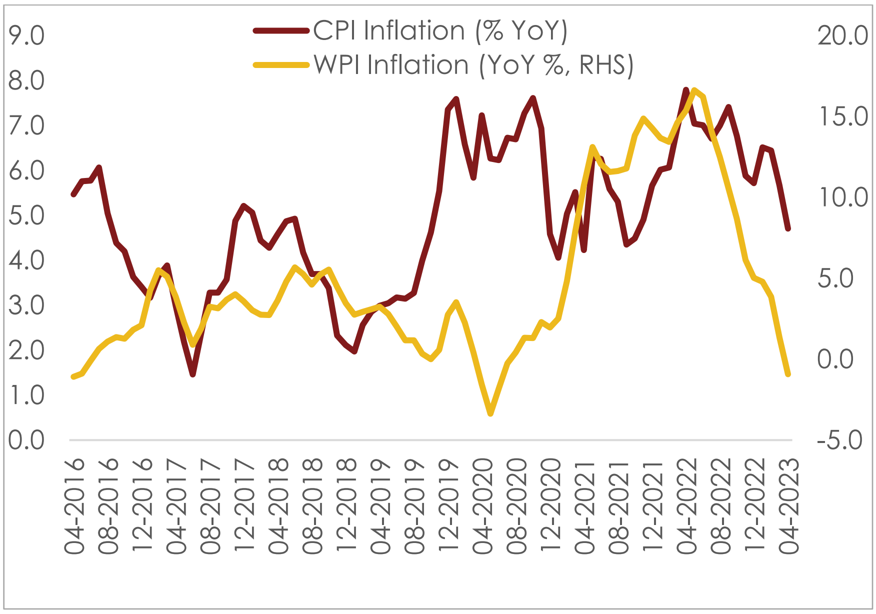
- Headline CPI and WPI inflation eased by 96 bps and 226 bps respectively over the previous month.
- Notwithstanding the co-movement at headline level, both inflation metrics diverged sequentially in Apr-23 with CPI rising to 0.51% MoM and WPI remaining unchanged (0.00% MoM) for the second consecutive month.
- Headline CPI inflation in Apr-23 remained within the RBI's target range (2-6%) for the second consecutive month.
- Headline WPI inflation in Apr-23 retreated to negative territory after a gap of 33-months i.e almost three years.
- Core retail and wholesale inflation moderated to an 11-month low of 5.48%YoY and 41-month low of -1.77% YoY in Apr-23 respectively.

Key highlights of CPI inflation

- Annualized Headline CPI of 4.70% YoY in Apr-23 was below market expectations (Refinitiv: 4.80%).
- The 0.51% MoM momentum in Apr-23 was stronger than Mar-23 momentum of 0.23%, but well below the pre-Covid average sequential increase of 0.69% usually seen in the month of April.
- Food and Beverages index rose by 0.56% MoM in Apr-23 from 0.23% MoM in Mar-23 and 1.43% in last April. The acceleration in food prices was due to unfavorable but expected summer seasonality coupled with adverse impacts arising from a heatwave followed by unseasonal rains/ hailstorms in certain parts of the country. The top 3 sub-categories contributing to the sequential upturn were Fruits (3.95% MoM), Vegetables (1.70% MoM), and Spices (1.53% MoM). On the other hand, the bottom 3 sub-categories contributing to easing price pressures were Eggs (-3.20% MoM), Edible Oils (-2.40% MoM), and Cereals (-0.34% MoM).
- On sequential basis, comfort can be found in easing price pressures in cereals for the second consecutive month, due to open market sales conducted by the Food Corporation of India and healthy output in the Rabi harvest season.
- On annualised basis, fuel and light inflation dropped to a 25-month low of 5.52%YoY in Apr-23 due to normalisation in energy prices, from 8.79%YoY in Mar-23.
- Sequential momentum in core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel items within Miscellaneous) rose to 0.45% MoM in Apr-23 from a 21-month low of 0.23% MoM in Mar-23. However, amidst a favourable base, inflation rate under this category moderated to an 11-month low of 5.48% in Apr-23 from 5.89% in Mar-23.

- Within core, Clothing and Footwear inflation moderated to a 19-month low of 7.47%YoY in Apr-23 from 8.18%YoY in Mar-23; while Personal, Care and Effects inflation rose to 9.0%YoY from 8.25% in Mar-23 owing to the safe-haven run-up in gold prices globally during the previous month.

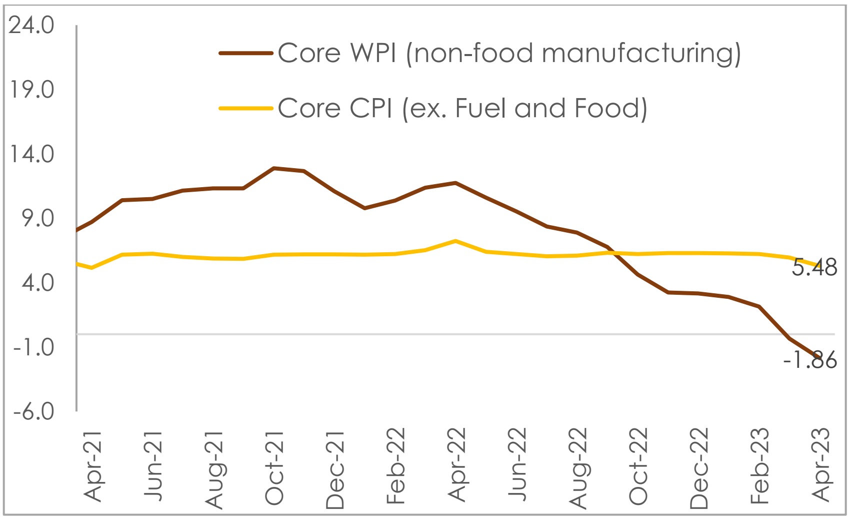
Chart 1: CPI and WPI inflation have been decelerating after peaking out in Q1 FY23



Key highlights of WPI inflation

- WPI inflation moderated to a 34-month low of -0.92%YoY in Apr-23, retreating to negative territory after a gap of 33-months, from 1.34% in Mar-23.
- Sequentially, WPI remained unchanged (0.00% MoM) in Apr-23 for the second consecutive month.
- At a granular level, gain in the Primary article index (1.31% MoM) was offset by moderation in Fuel and Power (-2.68% MoM) and Manufacturing indices remaining unchanged (0.00% MoM).
- Price pressures in the primary index were led by a sequential increase across all sub-categories barring Non-food. Prominent sub-categories contributing to the sequential upturn were Crude & natural gas (+3.47% MoM), Minerals (+2.30% MoM), and Food (+1.45% MoM).
- Core WPI (WPI ex indices of Primary: Food, Mfg: Food, Mfg: Beverages, Fuel & Power, and Primary: Crude Petroleum & Natural Gas) rose by 0.06%MoM from a contraction of 0.21% in Mar-23. Despite the sequential pick-up, Core WPI inflation eased further to -1.77%YoY from -0.34% in Mar-23 amidst a favourable base at play.

Chart 2: Core retail inflation finally seems to be taking a downward trend



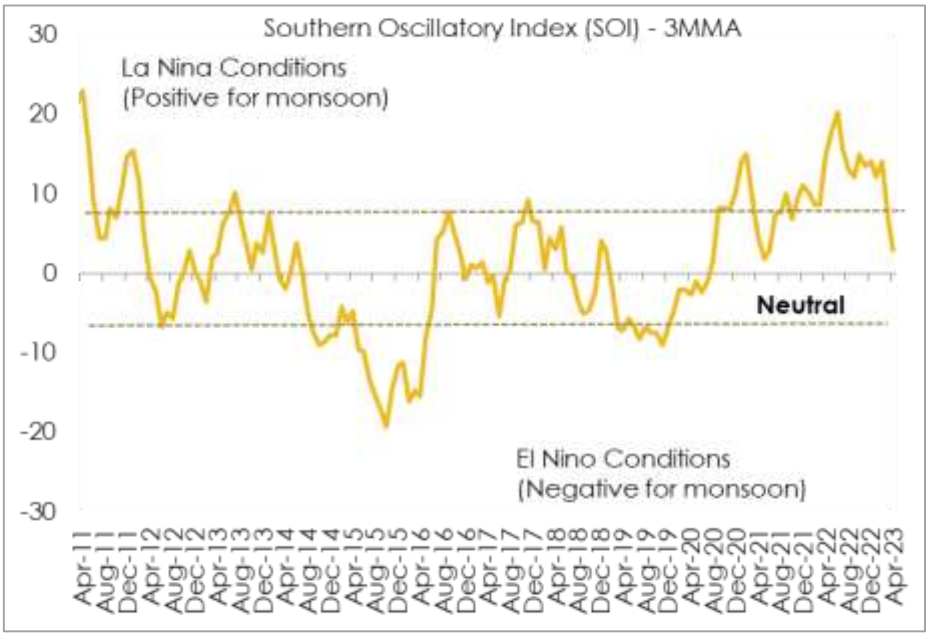
Outlook

The continued deceleration in headline inflation in Apr-23 at both the retail and wholesale level has been comforting. For both the metrics, in addition to a favourable base, easing of food price pressures amidst the moderation of global food prices and the impact of Government's administrative measures were in evidence particularly with respect to cereal prices. Moreover, core CPI and WPI inflation are exhibiting signs of moderation on account of further softness in most commodity prices along with a slowdown in global demand. Accompanied by the unchanged level of fuel prices in the CPI basket, it is comforting that headline CPI inflation remained within the RBI's target range (2-6%) for the second consecutive month.

Having said so, the possibility of El Nino conditions likely evolving during the later summer months could potentially push up food prices. While IMD in its First Range forecast had predicted a 'normal' rainfall at 96% of LPA for Southwest monsoon, we await the Second Range forecast to be released later this month for an updated view. Another private forecaster, Skymet has predicted a 'below normal' monsoon at 94%. In addition, firmness in crude oil prices if any, amidst a stronger than expected recovery in China, production cuts by OPEC+ and escalation of geopolitical uncertainty could serve as an added potential upside risks to CPI inflation.

From a monetary policy perspective, we expect the central bank to maintain a pause and gradually scale back liquidity surplus to push monetary policy transmission. Potential risks notwithstanding, we see a faster moderation in headline CPI inflation in FY24 than core inflation. The latter could prove somewhat sticky amidst the strong growth momentum continuing in services, especially contact intensive ones. For now, we maintain our FY24 CPI inflation projection of 5.3%.

Chart 3: Basis SOI index, El Nino conditions may develop in the late summer months



Government Finances

No slippage risks for now

KEY TAKEAWAYS

- India's central government fiscal deficit for FY23 as a whole at 98.7% of revised estimates (RE), reflects tighter expenditure control in the last quarter of the financial year.
- Total revenue receipts have been higher by 1.5% as compared to the revised estimates during the presentation of the Union Budget.
- Interestingly, total expenditure has almost matched with the estimates with minimal deviation; while the capital expenditure has been marginally higher, it has been offset by a slight reduction in revenue expenditure.
- The latest fiscal data confirms that there are no fiscal slippages from the RE levels and the fiscal deficit is estimated to stand at 6.36% in FY23 vs. the target of 6.40% primarily due to the control on revenue expenditure and lower subsidy payouts as compared to the budgetary estimates.
- For FY24, the fiscal deficit target of 5.9% of GDP appears achievable, with risks appearing neutral at this stage.

India's central government fiscal deficit for the period Apr-Feb stood at 82.8% of revised estimates (RE) for FY23, marginally lower than 83.0% of actuals seen in the corresponding period in FY22. The marginally lower accretion to fiscal deficit this year reflects relatively stronger pace of realization of tax and non-tax revenues, even though expenditure disbursal too remains somewhat higher than last year's momentum.

Receipts: Signs of moderation

- On FYTD (Apr-Feb) basis, gross tax revenue clocked 83.7% of RE, marginally lower than 84.0% of actuals in the corresponding period in FY22.
    - Compared to RE up to Feb, customs duty collection is the only category that is maintaining momentum ahead of last year's collections corresponding to the same period (90.0% of RE vs. 83.0% of actuals).
    - Nevertheless, GST collections continue to remain healthy with total monthly collections averaging at Rs 1.51 trillion during FY23 vis-à-vis the average monthly collection of Rs 1.24 trillion seen in FY22. This implies a growth of 21.5% in total GST collections in FY23.

Non-tax revenue collections accelerated to 95.0% of RE during Apr-Feb FY23 from 89.1% of actuals in the corresponding period in FY22. Pick-up in dividend pay-out from PSEs along with support from telecom spectrum revenue has managed to offset the drag on account of lower dividend transfer from the RBI in FY23.

Non-debt capital receipts clocked just 70.5% of RE during Apr-Feb FY23, lower than the level of 92.5% of actuals in the corresponding period in FY22 on account of slow pace of disinvestment activity in FY23. There was no realization of disinvestment revenue in the month of Feb-23.

Expenditure: Superior quality of spending being maintained

On FYTD (Apr-Feb) basis, total expenditure disbursal stood at 83.4% of RE, higher than 82.9% of actuals in the corresponding period in FY22.

- Capital expenditure clocked 81.0% of BE during Apr-Feb FY23 vis-à-vis 81.8% of actuals in the corresponding period in FY22. Bulk of this was incurred on defence, railways and urban housing. In addition, to facilitate capex by states, the FY23 Union Budget had made provision for disbursing Rs 1.1 tn as interest-free loans to states with attached conditionalities for targeted spending. In this context, we note that loans disbursed under central government's capex grew by a whopping 67.8% YoY during Apr-Feb FY23 vis-à-vis a contraction of 64.7% in the corresponding period in FY22.
- Revenue expenditure firmed up to 83.9% of RE during Apr-Feb FY23 from 83.0% of actuals in the corresponding period in FY22.
    - Interest payments and subsidies have accounted for 43.3% of revex disbursals in 11-months of this fiscal.
    - Excluding interest payments and subsidies, revex grew by a modest pace of 1.9% YoY during Apr-Feb FY23.

Outlook

The central government had used available levers to ensure adherence to FY23 fiscal deficit target of 6.4% of GDP.

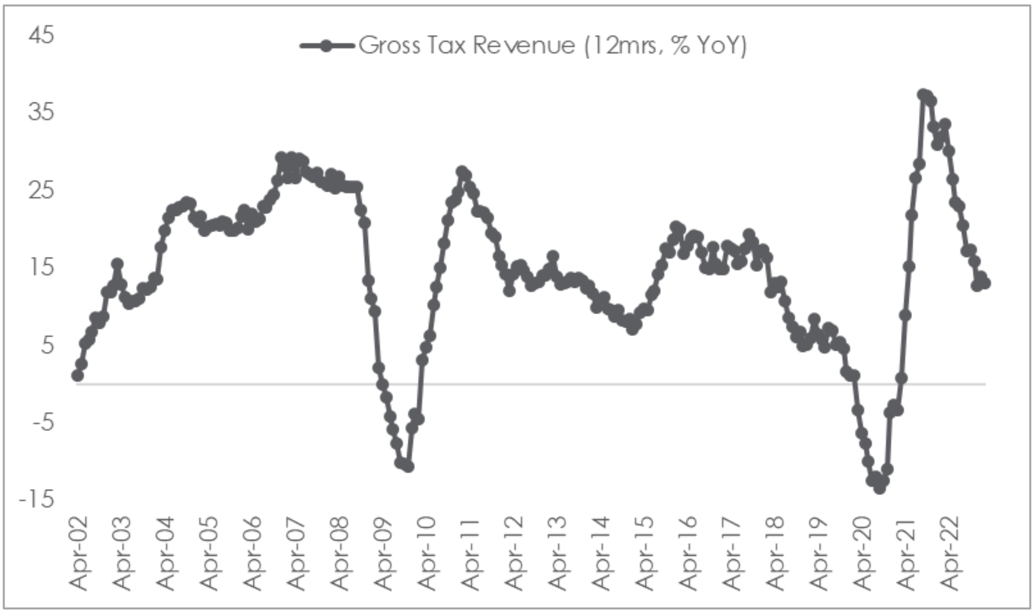
As for the FY24 outlook, the budget arithmetic appears credible with reasonable growth assumptions for Nominal GDP (10.5%) and gross tax collections (10.4%). The disinvestment target is not lofty (at Rs 510 bn) and could be achieved if traction is maintained through the year. Total expenditure is budgeted for a moderate growth of 7.5% as revex is slated for a subdued expansion of 1.2% (on account of savings generated from cut in subsidy budget). Encouragingly, the government doubled down on its focus for capex, which saw the total outlay increasing by 37.4% (with continued emphasis on railways, roads, and defence).

Overall, we expect the headline fiscal deficit target of 5.9% of GDP for FY24 to be met with risks appearing neutral at this stage.

Table1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position, Apr-Feb)				
	% of FY Actual/Target		%YoY	
	FY22	FY23	FY22	FY23
Revenue Receipts	82.6	84.3	30.7	10.6
Net Tax	81.4	83.0	21.8	17.0
Non-Tax	89.1	95.0	101.1	-19.8
Non-Debt Capital Receipts	92.5	70.5	-15.3	62.4
Total Receipts	**82.8**	**83.9**	**29.3**	**11.6**
Revenue Expenditure	83.0	83.9	10.2	9.2
of which, Interest Payment	83.4	84.9	20.1	18.9
of which, Major Subsidies	86.0	88.1	1.8	23.4
Capital Expenditure	81.8	81.0	19.7	21.7
Total Expenditure	**82.9**	**83.4**	**11.5**	**11.1**
Fiscal Deficit	**83.0**	**82.8**	**-**	**-**

Chart 1: Growth in gross tax collection has been moderating



Rates

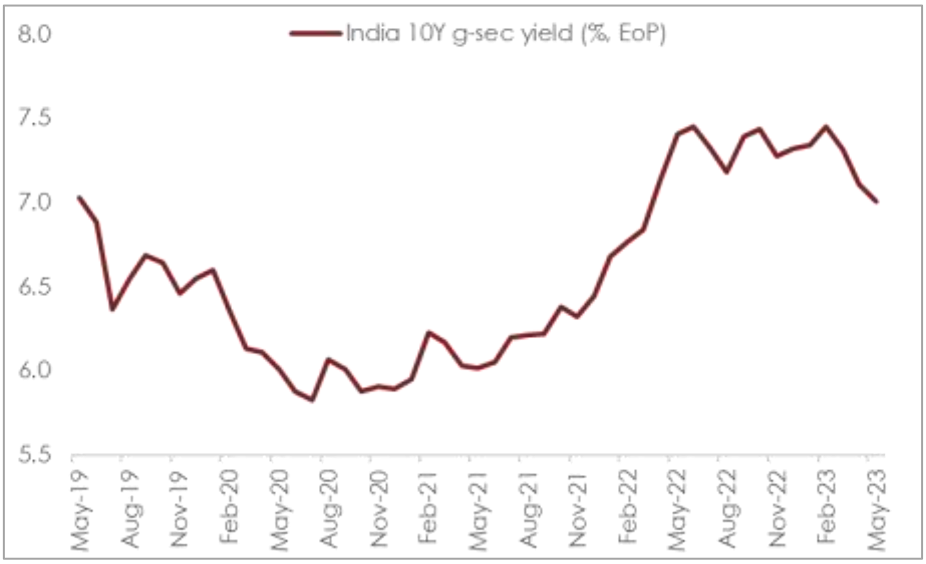
Downside bias persists despite pressure

KEY TAKEAWAYS

- After touching a high of 7.31% in early part of Apr-23, India's 10Y g-sec yield has eased considerably to 7.01% currently – the lowest level seen in the last 14 months.
- Banking sector turmoil in US and Europe coupled with market expectation of a 75 bps cut by the US Fed before the end of 2023 provides strong cue to the domestic bond market.
- RBI's surprise pause vis-à-vis market expectation of 25 bps hike in Apr-23 is likely to result in current repo rate of 6.50% to mark the cyclical peak.
- This takes away the uncertainty on terminal rate with record high g-sec supply concern and some likelihood of El Nino led disruption to monsoon being the only major sentiment dampener.
- Nevertheless, the broader anticipated macro backdrop of moderation in growth and inflation would help pull yields lower during the course of FY24.
- We maintain our 10Y g-sec view of 7.00% before Mar-24 with possibility of some downside bias.

After touching a high of 7.31% in early part of Apr-23, India's 10Y g-sec yield has eased considerably to 7.01% currently – the lowest level seen in the last 14-months. The decline in yields is on account of both global and domestic factors.

Chart 1: India's 10Y g-sec yield has fallen to 14-month low levels

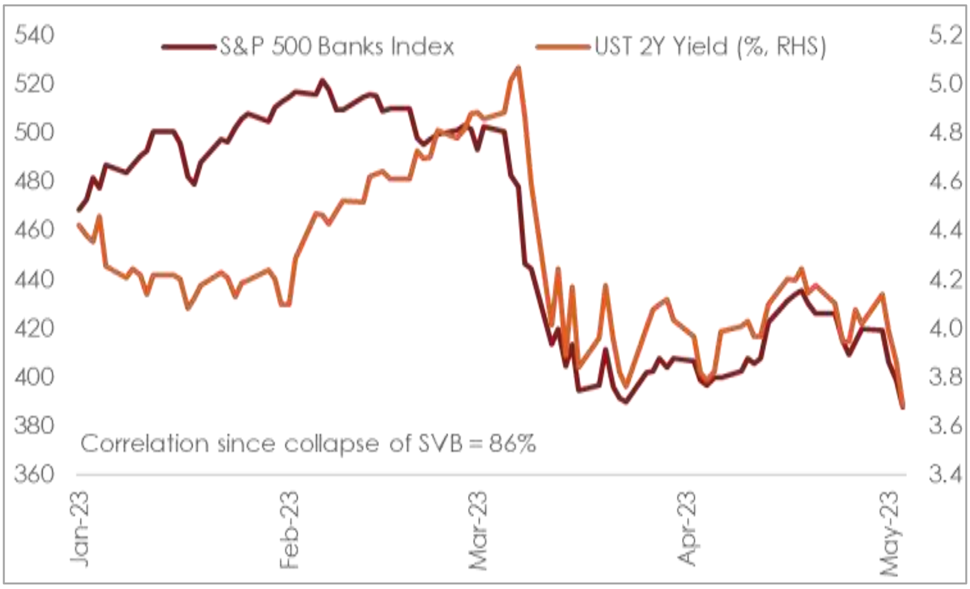


Global factors remain benign

Aggressive monetary tightening by the Federal Reserve in last 15-months has started having unintended consequences with US regional banks reeling under pressure.

- Silicon Valley Bank, Signature and First Republic have all collapsed since Mar-23, raising investor concerns about the health of some other regional banks.
- As such, the S&P 500 Regional Banks Index is currently down 51.5% from its 2023 peak, marking a significant underperformance vis-à-vis the benchmark S&P 500 Composite Index that lost just 2.8% from its respective 2023 peak.

Chart 2: Banking sector concerns pulling down US yields



In response to the banking sector turmoil and the concomitant risk aversion led tightening in credit markets, US sovereign yields have eased considerably from their 2023 peak levels (the 2Y UST yield has fallen from its 2023 peak of 5.07% on Mar 8th to a low of 3.66% on May 4th before recovering to 4.4%). The nervousness has manifested across other asset classes, with sell-off in equities, widening of credit spreads, and slump in crude oil prices accompanied by a jump in gold prices.

- Post the anticipated 25 bps hike by the FOMC in May-23 (which we believe will now mark the terminal rate in the current cycle), we note that the interest rate futures market is expecting the commencement of easing cycle by the Federal Reserve from Jul-23 onwards, while aggressively pricing in up to 75 bps of cumulative rate cut before the end of 2023.

Although the banking sector turmoil appeared to be US and Europe centric, the second order contagion impact for India appears relatively contained due to reduced external vulnerabilities and improvement in domestic banking sector's balance sheet in recent years. The g-sec yields have moderated (India's 2Y yield has declined by 50 bps between March and May) in an environment of heightened global risk aversion marked by lower commodity prices (esp. crude oil prices, which are trading at their lowest levels in last 17-months despite persistence of geopolitical uncertainty and OPEC's recent supply cut) in general.

Table 1: Market is pricing in up to three rate cuts by the US Fed by Dec-23

FOMC Meeting Date	Expected Fed Funds Target Range with Probability (%)
Jun 14, 2023	5.00-5.25 (95.5) and 4.75-5.00 (4.5)
Jul 26, 2023	5.00-5.25 (48.8) and 4.75-5.00 (49.0)
Sep 20, 2023	4.75-5.00 (48.9) and 4.50-4.75 (40.1)
Nov 1, 2023	4.75-5.00 (58.0) and 4.50-4.75 (42.0)
Dec 13, 2023	4.50-4.75 (55.7) and 4.25-4.50 (44.3)

Note: (1) Current fed funds target range is at 5.00-5.25%; (2) Implied probability of fed funds target range by fed funds futures market shown in parenthesis.

Domestic factors providing comfort

From India's perspective, the surprise pause by the MPC of the RBI in its Apr-23 policy review (against market consensus of a 25 bps hike) can be contextualized in the backdrop of US banking sector uncertainties along with its potential spill over impact on global demand conditions.

However, global factors provide just the operative backdrop for policymakers, with domestic factors having a larger weight on decision making. On this count, the MPC now seems to be taking a collective view on the following:

- The MPC has now adopted a data dependent approach instead of signalling continued tightening in a bid to assess the impact of the aggressive monetary tightening done since Apr-22 (the effective monetary policy rate has jumped sharply from 3.35% at the beginning of Apr-22 to 6.50% currently).

- Projection of Mar-24 quarter CPI inflation at 5.2%, down from 5.6% earlier, appears to have increased the comfort on real interest rates.
    - Recent correction in commodity prices since the Apr-23 MPC review (Brent down by 14.6% and CRB Index down by 5.4%) if sustained, could potentially provide some downside to inflation estimates.
- Further, the bi-annual Monetary Policy Report projects FY25 CPI inflation at 4.5%, down from RBI's forecast of 5.2% inflation in FY24. Although FY25 estimate is not yet an official forecast from the RBI, the projection by its Monetary Policy Department of inflation gradually aligning with the 4% target provides additional comfort.

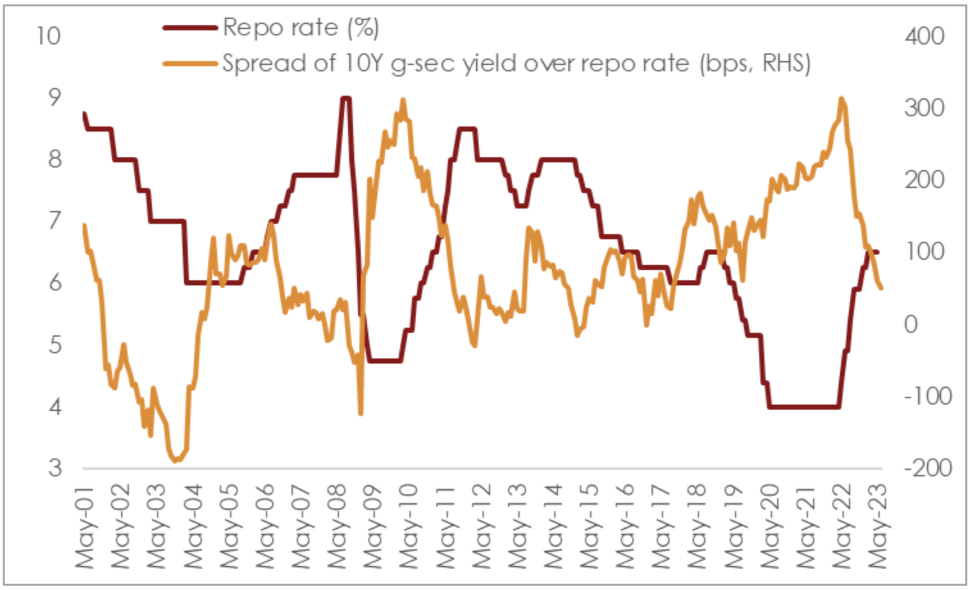
G-sec view

Post the surprise pause in Apr-23 policy review, the bar for incremental rate hikes has got reset at a higher level despite MPC emphasizing in its post policy press conference that the pause need not get extrapolated as core inflation risks still persist.

Nevertheless, we believe that repo rate at 6.50% can be taken as the terminal rate in the current cycle – thereby taking away the uncertainty with respect to the peak of monetary policy cycle. This would be comforting for bonds.

Going forward, the only thing that would continue to weigh on sentiment is the record high g-sec borrowing program in FY24 and risk of emergence of El Nino later in the year. While this would partially offset the comfort from status quo on monetary policy rate, the broader anticipated macroeconomic backdrop of moderation in growth and inflation would help pull yields lower during the course of FY24. We maintain our 10Y g-sec view of 7.00% before Mar-24. However, there could be some downside risk to our forecast if (i) softness in international commodity prices persist, and (ii) credit market uncertainty in the US prompts the Federal Reserve to commence monetary policy easing cycle earlier than currently anticipated by the FOMC.

Chart 3: Attainment of terminal rate by the RBI to be comforting for bond yields



Rupee

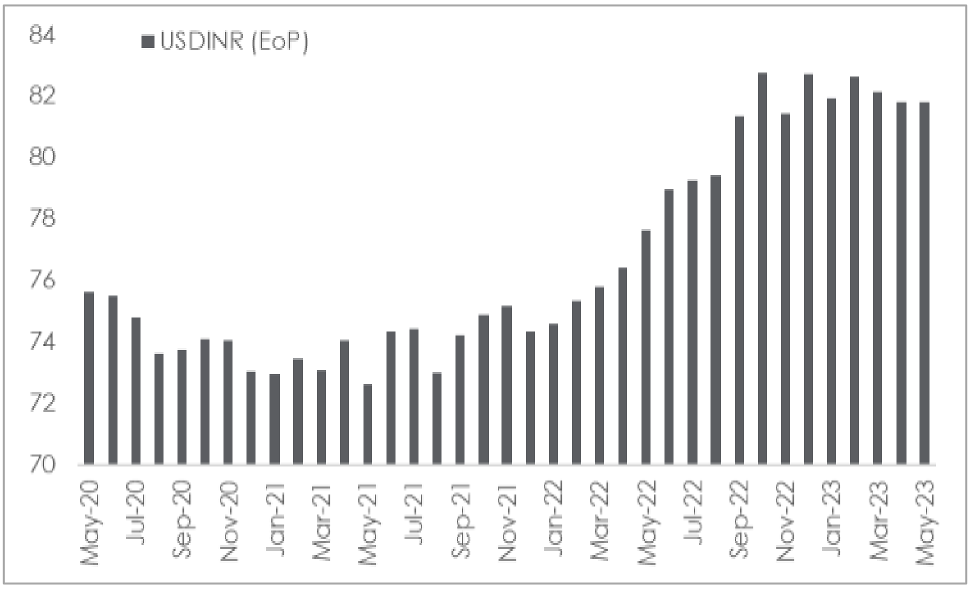
High volatility but gathering strength

KEY TAKEAWAYS

- After closing FY23 at 82.17, the Indian rupee appreciated 0.4% against the US dollar in Apr-23, closing the month at 81.83. However, there has been a fresh bout of pressure on the currency thereafter which pulled it down beyond 82.50.
- Credit market uncertainty in the US has led market participants to expect an early turnaround in the Fed rate cycle, in contrast to FOMC's dot plot projection of status quo through the remaining months of 2023
- With 75 bps of cumulative rate cut priced in by market participants, the US Fed could potentially lead the monetary policy easing cycle among DM central banks, thereby maintaining downward pressure on the USD.
- Meanwhile, INR is expected to benefit from gradually improving growth-inflation balance as well as a stronger twin deficit position.
- With BoP projected to revert to surplus after estimated to have stayed in deficit territory in FY23, we continue to expect rupee to moderately strengthen in FY24, with forecast of USDINR touching 80.0 levels before end of FY24.

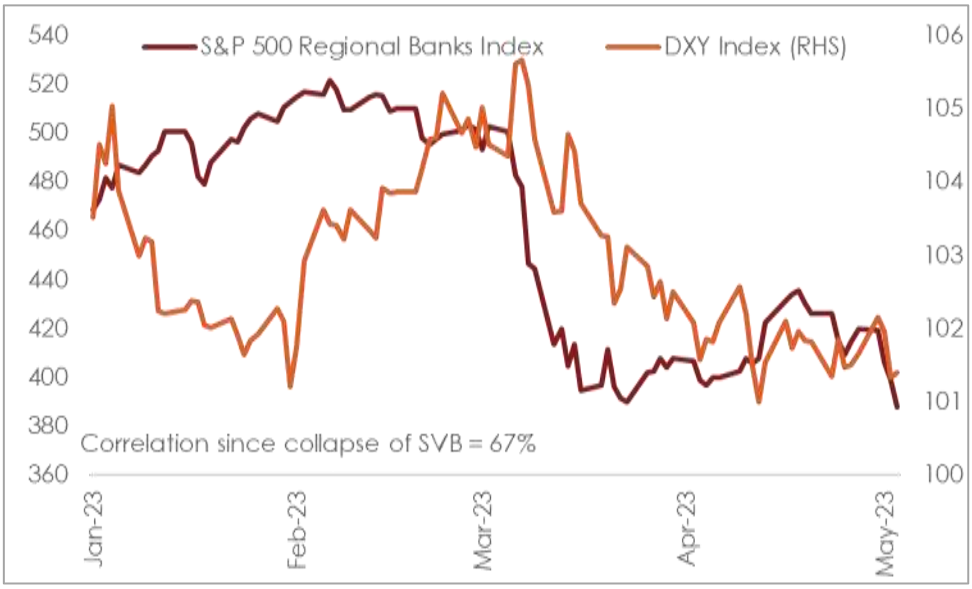
After closing FY23 at 82.17, the Indian rupee appreciated 0.4% against the US dollar in Apr-23, closing the month at 81.83. However, there has been a fresh bout of pressure on the currency thereafter which pulled it down beyond 82.50.

Chart 1: INR traded at its strongest in early May over a 6-month period



The episode of global risk aversion triggered by the banking sector turmoil in the US since Mar-23 seems to be weighing upon the USD. Although the spillover of confidence crisis from credit market to other parts of the financial market has been averted to some extent post prompt liquidity injection by key central banks like the Fed and the ECB, the mini credit crisis will nevertheless turn small and medium sized banks cautious while expanding their balance sheets. This could eventually accentuate the anticipated economic slowdown, especially in the US.

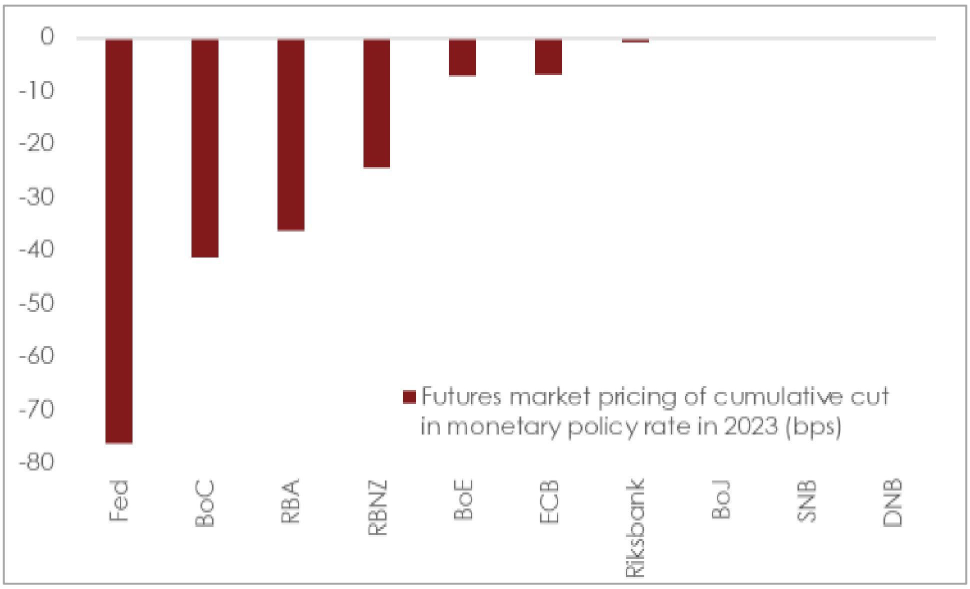
Chart 2: After the initial spike, dollar has lost ground amidst banking sector uncertainty



From FX market perspective, the implication of this would be in central banks turning dovish in near future, thereby reversing the interest rate cycle and start of monetary policy easing.

In sharp contrast to the recent Fed dot plot projection (in Mar-23) of a status quo through the remaining months of 2023, market participants are pricing in as much as 75 bps rate cut from the Fed before the end of 2023. From consensus expectations perspective, this would make the US Fed lead the monetary policy easing cycle among DM central banks.

Chart 3: US Fed may lead the monetary easing cycle among DM central banks



Although most other central banks might start following the US Fed with some lag in the rate cutting cycle, this would nevertheless weigh upon the USD in the interim. This in turn would offer support to most emerging market currencies, including the INR.

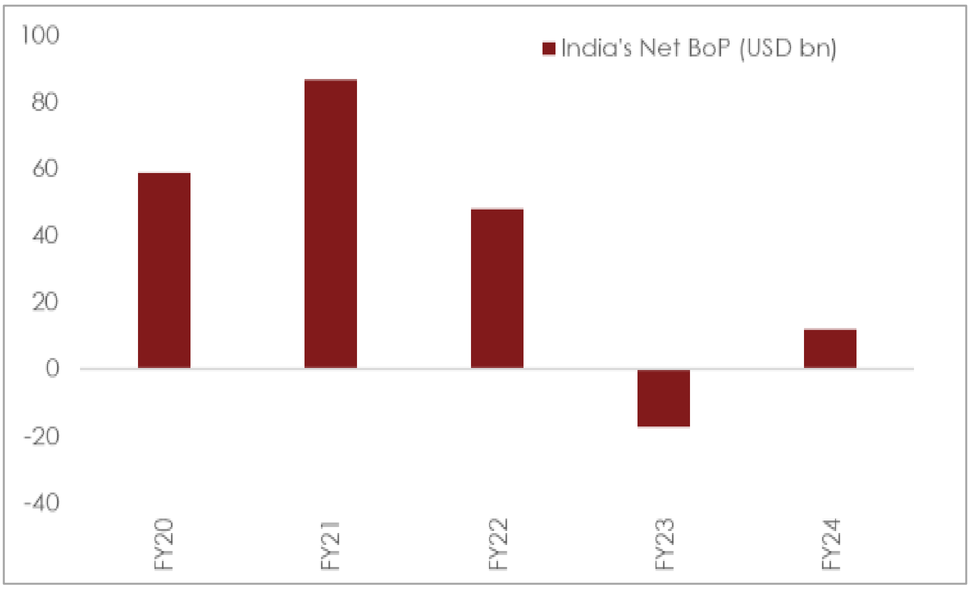
While global FX backdrop for INR is getting conducive, the domestic setting too is providing comfort.

- Despite an expected moderation in GDP growth towards 6.0% levels in FY24 from 7.0% in FY23, the slowdown in the rest of the world is likely to be deeper, thereby helping India to remain one of the fastest growing major economies in the world. IMF's projection of long-term growth path indicates likelihood of India's GDP growth remaining between 6.0-6.3% between 2024 and 2028.
- We expect CPI inflation to get back to its target band in FY24 by averaging close to 5.3% from 6.7% in FY23. Further, the recent Monetary Policy Report of the RBI estimates FY25 CPI inflation at 4.5%. This is comforting as it signals alignment of current elevated inflation with the 4% target gradually over a period of two years.
- India's central government's fiscal deficit has been on a gradual correction path after hitting its post pandemic high of 9.2% of GDP in FY21. The revised

estimates for FY23 indicate fiscal deficit to be at 6.4%, which is budgeted for further consolidation towards 5.9% levels in FY24.

- Last, but not the least, is the sharp improvement in India's current account deficit profile. We expect the current account balance to briefly turn into a mild surplus in Q4 FY23 compared to an average deficit of 2.7% of GDP during Q1-Q3 FY23. Going forward, the current account deficit is expected to narrow to 1.4% in FY24 from an estimated 2.0% in FY23.
    - Despite persisting geopolitical pressures, easing of COVID era supply chain bottlenecks and anticipation of global economic slowdown has helped to keep a lid on commodity prices. Price of India Crude Basket is currently trading at an average level of USD 76 pb in May-23, down ~31% on YoY basis.
    - Russia's share in India's import basket has steadily climbed from 2.1% in Jan-22 to 10.0% in Jan-23. Since most of this is on account of crude oil, which is procured at a discount of USD 25-30 pb compared to Brent, this is increasingly becoming an important source of saving for the current account deficit.
    - There is a structural improvement in services exports amidst post pandemic thrust on digitization and cost optimization globally. In addition, with threat of COVID ebbing at a global level, India is once again witnessing tourism related foreign inflows.

<u>Chart 4: India's BoP is expected to get back into surplus in FY24 after the deficit in FY23</u>



On net basis, the expected improvement in BoP to a surplus of USD 14 bn in FY24 along with a dollar negative backdrop, we expect rupee to strengthen moderately, with USDINR forecast of 80.0 by Mar-24.

Global Overview

An uncertain outlook

KEY TAKEAWAYS

- The month of Apr-23 can be viewed as intensely challenging on the economic front characterised by decelerating growth, still elevated inflation, interest rates at record high levels and credit conditions continuing to tighten. The banking turmoil and chances of a debt default in the United States has injected additional uncertainty into an already complex economic landscape.
- IMF's latest World Economic Outlook cut global GDP projections for 2023 and 2024 by 10 basis points each to 2.8% and 3.0%, respectively, given heighted recessionary risks.
- Capturing the weakness in sentiment, the JP Morgan Global Manufacturing PMI contracted for the eighth successive month in Apr-23, coming in at 49.6 and unchanged from Mar-23.
- Central bankers have continued to tighten monetary policy, albeit at a slower pace, and held rates at an elevated level in the face of persistent inflation.
- While the global monetary policy tightening campaign is nearing its end, central banks will want to preserve the flexibility to raise rates further should inflation prove stickier and labour markets more resilient than expected.

Global overview

The month of Apr-23 can be viewed as intensely challenging on the economic front with decelerating growth, still elevated inflation, interest rates at record high levels and credit conditions continuing to tighten. The banking turmoil and chances of a debt default in the United States have injected additional uncertainty into an already complex economic landscape. Major economic indicators have already started to show signs of concerns even as the full effect of the accelerated pace of pervasive monetary tightening and the recent banking-sector turmoil in the US and Europe is yet to be felt. The IMF's latest World Economic Outlook cut GDP projections for 2023 and 2024 by 10 basis points each to 2.8% and 3.0%, respectively given heighted recessionary risks.

Capturing the weakness in sentiment, the JP Morgan Global Manufacturing PMI registered contraction for the eighth successive month, to remain flat (49.6) in Apr-23. Global manufacturing new orders continued to fall due to shrinking demand for goods on account of rising cost of living, a post-pandemic switch towards spending on services and a preference for lower inventory holdings. Moreover, worldwide factory jobs growth came nearly to a halt in Mar-23, with the JP Morgan Global PMI's Employment Index holding barely above 50 and down from an eight-month high in Feb-23. The broadly flat employment picture is commensurate with a marked increase in the number of companies reporting reduced employment amidst pressure to cut costs. However, labour market conditions still appear relatively strong with US nonfarm Payrolls rising to 253k in Apr-23, better than the market expectation (Refinitiv: 180k), from 165k in Mar-23 (Prelim: 236k).

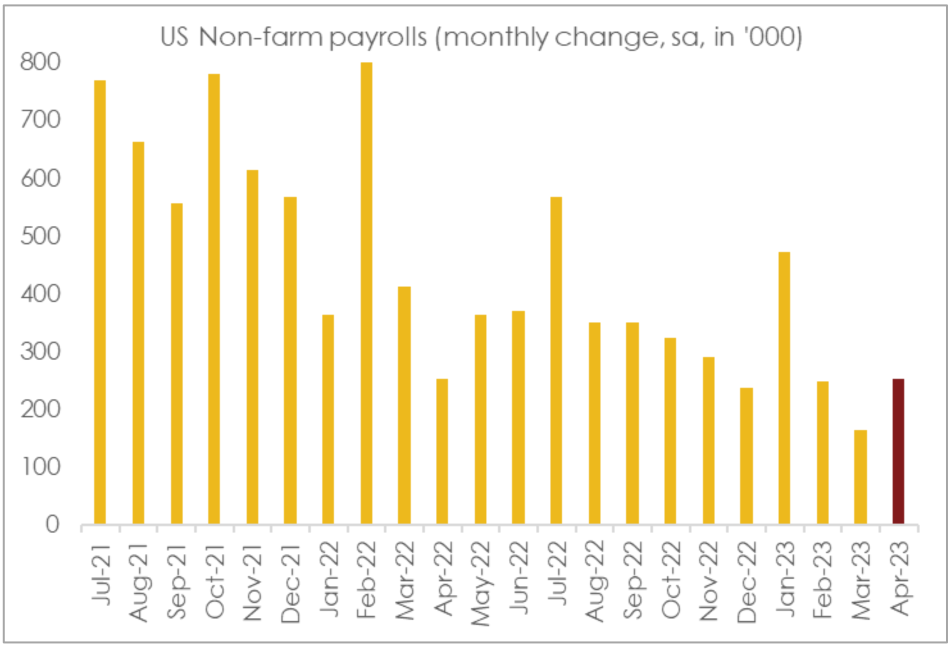
Central bankers have continued to tighten monetary policy, albeit at a slower pace, and have held rates at an elevated level in the face of persistent inflation. The US Fed raised its policy rate by 25bps on 3rd May-23 and signalled a likely pause to its rate hiking campaign, while the ECB pared down its pace of rate hike to 25bps on 4th May-23 meeting to balance sluggish growth and persistent inflationary pressures. The Bank of England is likely to raise interest rates by 25bps during its MPC meeting scheduled for 11th May-23, before pausing its rate hiking campaign, according to market expectations.

While the global monetary policy tightening campaign is nearing its end, central banks will want to preserve the flexibility to raise rates further should inflation prove stickier and labour markets more resilient than expected. However, rate cuts are unlikely to take place until next year, as the full effect of the tightening campaign is yet to be felt on financial conditions and consumer sentiment.

US economy

The combination of persistently elevated inflation, high interest rates and now tightening credit conditions continued to weigh on business investment, consumer spending and growth in Apr-23. While the labour market is showing definite signs of loosening with a slower pace of employment growth across several districts in Apr-23, as reported in the Fed's latest Beige book, it remains relatively resilient. Nonfarm Payrolls rose by 253k in Apr-23, better than the market expectation (Refinitiv: 180k), from 165k in Mar-23 (Prelim: 236k).

Chart 1: US non-farm payrolls at +253k in Apr-23 surprised considerably on the upside



US GDP growth moderated to 1.1% QoQ in Q1 2023 from 2.6% in Q4 2022, weighed down by the combination of slower business spending, declining private inventories and weaker than expected consumption expenditure. Residential investment remained severely constrained, posting its eighth consecutive quarterly decline, down to 4.2% YoY in Q1 2023 from its peak of 22% in Q1 2022. Moreover, core personal consumption expenditures (PCE), the Fed's preferred measure of inflation, rose to 4.9% QoQ in Q1 2023, the highest in a year, from 4.4% in Q4 2022.

US headline CPI inflation continued to descend to 5.0% YoY in Mar-23 from 6.0% in Feb-23, the lowest reading since May-21 and broadly in line with market consensus. Core CPI (Excluding volatile food and energy) proved to be stickier, rising marginally to 5.6% YoY in Mar-23, exceeding the headline CPI print for the first time since Jan-21, from 5.5% YoY in Feb-23. However, on sequential basis, core index eased to 0.4% MoM in Mar-23 from 0.5% in Feb-23, reinforcing that the disinflationary process is well underway.

Factoring the below-trend GDP growth and elevated inflation, the FOMC voted unanimously to raise policy rates by 25 bps in May-23, in line with market expectations, bringing the federal funds rate range to its highest level since Sep-07 to 5.00%–5.25%. The Fed also reiterated its commitment of reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities. In terms of its monetary policy outlook, the FOMC dropped the words stating, "in determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time", the Committee would factor the 500bps of rate hikes so far and the long and variable lags of monetary policy effects on economic activity and inflation. US Federal Reserve Chairperson, Jerome Powell, remarked that the central bank will be adopting a purely data-dependent approach and examine the case for further tightening on a meeting-by-meeting basis. The change in language certainly opens the possibility of a pause to the rate hiking campaign, but the FOMC will want to preserve the flexibility to raise rates further should inflation prove stickier and labour markets more resilient than expected.

UK

Britain was the only country in western Europe with double-digit inflation in Mar-23 even as CPI eased less than expected (Refinitiv: 9.8% YoY), to 10.1% YoY, from 10.4% in Feb-23. The largest upward contribution to the headline came from housing and household services (esp. from electricity, gas and other fuels), and food and non-alcoholic beverages. Core CPI, which strips out volatile energy and food components, remained unchanged at 6.2% YoY in Mar-23, vs. Feb-23.

UK finance minister, Jeremy Hunt, remarked that inflation running above 10% was "destabilising for the economy and the government had a plan to bring it down". To tackle the cost-of-living crisis, the government had introduced a raft of measures including extending household energy subsidies by three months along with freezing the duty on pub alcohol and fuel prices. However, the average household energy bill remains ~ 120% higher than over 2019-21, according to a Reuters report. While household energy costs could fall in Jul-23 when the Ofgem price cap is expected to fall due to lower wholesale prices, they would still remain around 93% higher than prior to Russia- Ukraine war.

More timely indicators have been mixed. The final S&P Global/CIPS UK manufacturing Purchasing Managers' Index (PMI) fell to a three-month low of 47.8 in Apr-23, from 47.9 in Mar-23. However, activity in Britain's construction sector increased in Apr-23 with the S&P Global/CIPS UK Purchasing Managers' Index for the construction industry coming in at 51.1, up from 50.7 in Mar-23. Business confidence, measured by the Lloyds Business Barometer, rose to 33% in Apr-23, well above its long-running average of 28%, from 32% in Mar-23,

According to estimates released by the Office for National Statistics (ONS), GDP was flat in sequential terms in Feb-23, against market consensus pegged at a 0.1% MoM expansion, as widespread industrial strikes hit economic output. The services sector output fell by 0.1% MoM in Feb-23, after growing by 0.7% MoM in Jan-2023 (revised up from 0.5% MoM). Against the current-growth dynamics, the Bank of England is likely to raise interest rates by 25bps in the May-23 meeting, before pausing its rate hiking campaign, according to market expectations.

Eurozone

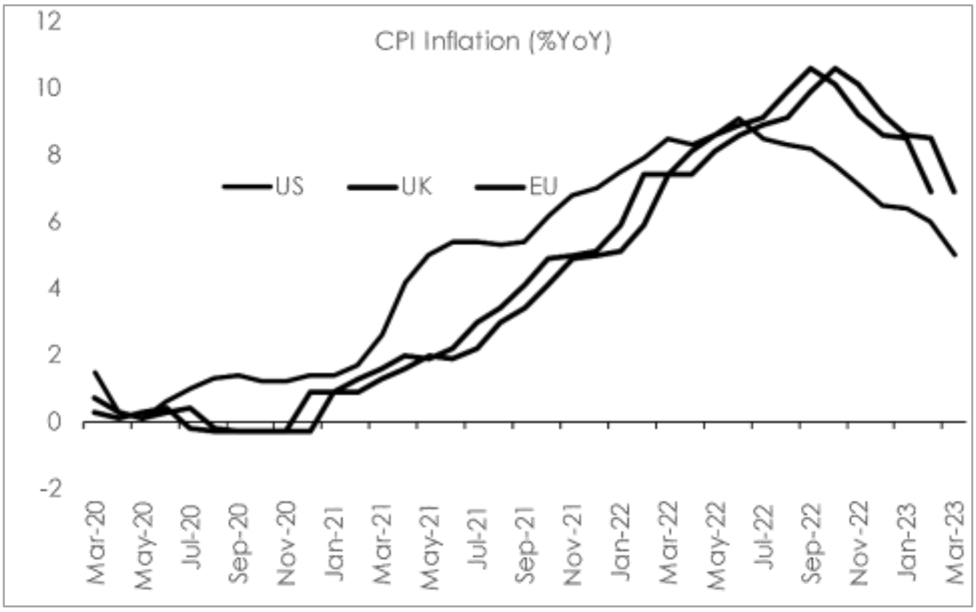
In Eurozone, inflation accelerated to 7.0% in Apr-23, in line with market expectations, from 6.9% in Mar-23 as a fall in food, alcohol and tobacco prices was offset by a price surge in energy and services costs. Energy prices remained the biggest driver, rising by 2.5% YoY in Apr-23 from a contraction of 0.9% in Mar-23. Stripping off volatile food and fuel components, core inflation slowed to 7.3% YoY in Apr-23 from 7.5% YoY in Mar-23, while an even narrower measure, which excludes alcohol and tobacco, slowed to 5.6% in Apr-23 from 5.7% in the prior month.

GDP growth in the euro zone moderated to 1.3% YoY in Q1 2023, as domestic consumption stagnated in many economies, from 1.8% in Q4 2022. Growth was primarily driven by exports, the result of a revival in global trade as China re-opened for business after the pandemic. Among the Member States for which data are available for Q1-23, Portugal (+1.6% QoQ) recorded the highest quarterly increase, followed by Spain, Italy and Latvia (all +0.5% QoQ). Contractions were recorded in Ireland (-2.7% QoQ) as well as in Austria (-0.3% QoQ). In annualised terms, growth rates were positive for all countries except for Germany (-0.1% YoY).

Taking into account the slowdown in GDP growth and persistently elevated inflation, ECB hiked rates by 25 bps in early May-23 to bring the deposit rate to 3.25%. This marked the smallest rate increase since the ECB started its current tightening cycle in Jul-22. All ECB policymakers but one, Austria's Robert Holzmann, backed the 25-basis-point increase. The opening statement of the accompanying press release clearly showed the ECB's rationale behind the downshift from 50bps to 25bps, stressing that "past rate increases are being transmitted forcefully to euro area financing and monetary conditions". Indeed, the central bank expects headline inflation to overshoot its 2% target through 2025. The latest decision was accompanied with limited guidance regarding the future policy path, against the backdrop of financial stability concerns. ECB President, Christine Lagarde, remarked that upside risks to inflation continue, notably from recent wage deals and high corporate profit margins, adding that financial conditions were still not sufficiently tight. Investors now see the terminal rate at around 3.65%, indicating that one more hike is fully priced in, but opinion is split on a second move.

Composite PMI for the region jumped to an 11-month high of 54.4 in Apr-23 from 53.7 in Mar-23. Services PMI soared to 56.6 in Apr-23, well above market expectations (Refinitiv: 54.5), from 55.0 in the prior month. However, manufacturing PMI contracted for the tenth straight month to 45.5 in Apr-23, marking the steepest fall since May-20 on declining production and orders, from 47.3 in Mar-23. Persistently elevated energy prices and inflation, compounded by monetary policy tightening, will continue to impact business confidence, consumption and economic growth in the region.

Chart 2: Inflation peaked in G3 economies, though sequential moderation slower



Japan

Japan's economy is characterized by "extremely high" uncertainty, according to Bank of Japan's Assistant Governor Tokiko Shimizu, as slowing global growth and recent financial market stress cloud its outlook. Manufacturing activity contracted for the sixth straight month in Apr-23 due to weak domestic and global economic trends, with manufacturing PMI coming in at 49.5 in vs. 49.2 in Mar-23.

The bigger macro challenge will be on the inflation front, which in the Japanese economy remains stubbornly elevated. As of Mar-23, core CPI inflation, which excludes volatile fresh food, stood at 3.1% on an annualised basis, well above the BoJ's 2% target and unchanged from Feb-23. An index stripping out the effect of both fresh food and energy, which is closely watched by the BoJ as a better gauge of underlying price trends, accelerated for the 10th straight month to 3.8% YoY in Mar-23, the highest since Dec-81, from 3.5% YoY in Feb-23.

A combination of weak business activity and persistent inflationary pressures have pushed the new BoJ Governor, Kazua Ueda, to retain the same monetary policy stance as his predecessor at the Monetary Policy Meeting (MPM) in Apr-23. But the central bank modified its guidance on the future policy path and removed a pledge to keep interest rates at "current or lower levels." Having said so, monetary policy is likely to remain ultra-loose until there is more evidence that inflation has become entrenched and driven by strong demand rather than supply pressures.

About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 9,600 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

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