MACRO PULSE

MAY 2021

Contents

From the desk of the Chief Analytical Officer

It is my pleasure to bring to you the fifth edition of **Acuité Macro Pulse** (May 2021). This monthly publication on the economy has already attracted attention for its quality insights on the dynamic economic landscape through a comprehensive analysis of the key macro-economic variables.

The sentiments were fairly negative when we released our April 2021 edition as the country was taken by surprise at the intensity of the second wave of the pandemic. The daily cases continued to increase alarmingly and reached a peak of 4,15,000 in the first week of May with the mortalities touching the highest ever level of 4,500 by the third week. What has however, followed is a fairly quick taper down in reported cases in the last week of the month although mortality figures remain relatively high. Such a trend has raised hopes of a faster flattening of the Covid 2.0 curve and importantly, the likelihood of the removal of most lockdown restrictions by June. However, it is clear that the speed of the vaccination programme is the key to a sustainable unlocking of the economy. While 216 million doses have already been administered, it is still less than 20% of the doses required to vaccinate 50% of the country's population; expectations are that there will be a significant ramp up from June with higher indigenous production as well as launch of imported vaccines.

NSO has just released the GDP data for FY21 with a 7.3% contraction in real GDP which is pretty close to our forecast of 7.5%. But what caught our attention is the quarterly GVA print for Q4FY21. The manufacturing sector has delivered a 6.9%YoY growth in Q4 which despite the impact of the base factor, highlights the pickup in industrial activity; the construction sector recorded a growth of 14.5%YoY which indicates the impact of government capital expenditure. What is pleasantly surprising is that the financial, real estate and other services reporting a healthy growth of 5.4% in the last quarter. While the second wave of Covid is undoubtedly going to impact these segments in Q1FY22, it is clear that removal of lockdowns and movement restrictions by June should help the economy pick up the lost growth momentum by Q2/Q3 of FY22 unless we see a threat of third wave. We, therefore, continue to hold our forecast of 10.0% GDP growth for FY22 based on four key factors – (i) buoyancy in the export markets due to global growth recovery (ii) forecast of a timely monsoon that may bring back rural demand (iii) consistently supportive monetary and fiscal policies and (iv) steady progress on vaccination.

The current report has an interesting analysis on how RBI has managed to keep a downward bias in the Gsec yields despite the inflationary and the sovereign borrowing concerns. Further, it also gives insights into how the rupee quickly moved on from a depreciation phase to an appreciation phase vis-à-vis the dollar with the onset of the second Covid wave.

Hope you enjoy the read! We look forward to your feedback.

Best Regards,

Suman Chowdhury
Chief Analytical Officer

Growth

Slackening recovery

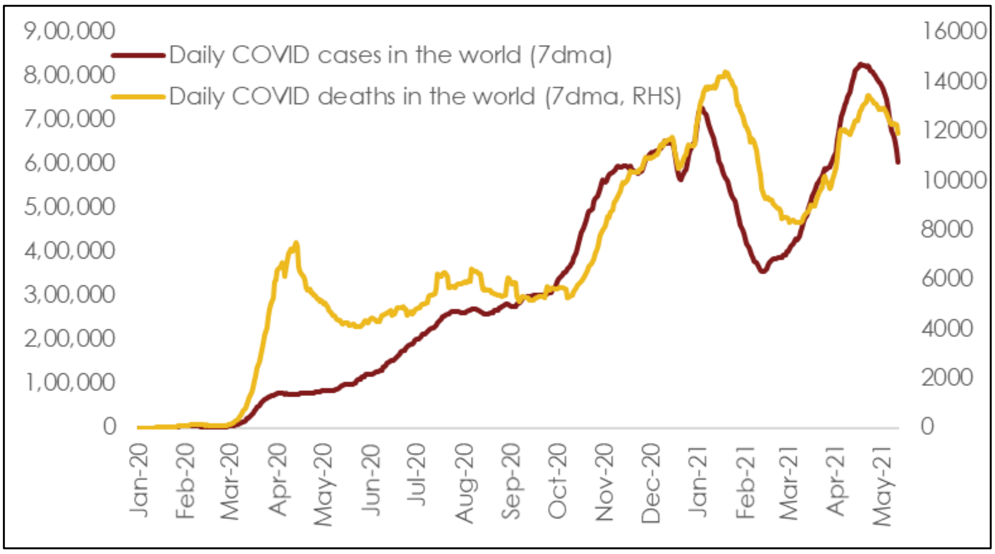
KEY TAKEAWAYS

- India's growth prospects for FY22 have suffered a setback amidst the second wave of COVID.
- Since early May-21, most states have veered away from partial restrictions to more stringent lockdowns in a bid to break the chain of transmission of infections.
- The latest high frequency data is however proving to be increasingly misleading; robust annualized readings amidst a powerful lockdown induced base from the initial months of FY21 are concealing the slack in the sequential growth momentum.
- The impact of second wave is broad based with contact-intensive services getting hit and industry too struggling to operate amidst labour migration, workforce safety concerns, supply chain disruptions and importantly weakening demand.
- Early signs of slippage in economic activity make us believe that there could be further downside risks to our FY22 GDP growth estimate of 10.0%.
- We do acknowledge the silver linings as well, from – i) Synchronous V-shaped global recovery ii) Anticipated progress on vaccinations iii) Supportive fiscal and monetary policies and iv) Rural demand that is likely to find support in a normal monsoon.

Overview

India's growth prospects for FY22 have suffered a setback owing to the second wave of Covid. In early part of May, amidst rising caseloads, most states had to veer away from partial restrictions to more stringent lockdowns in a bid to break the chain of transmission of infections. Since the third week of May, the infection curve appears to have flattened but the number of new positive cases still remain high at >2.5 lakh cases/day (as of May 22, 2021). This means that lockdown like conditions will certainly continue until the end of May and perhaps stretch into June in some states. Concomitantly, India's lockdown stringency index has risen from 73.6 in late Apr-21 to 81.9 in May-21 – i.e., the exact same level seen a year ago.

Chart 1: Covid 2.0 possibly past the peak levels



Need to look beyond the headline growth

In the current context, any economic data compared to the previous year is clearly misleading. The annualized reading for most indicators underscores a robust growth amidst a powerful lockdown induced base from last year. Worryingly, this is concealing the slack in growth momentum driven by the second Covid wave.

- India's industrial production swung wildly, posting a record expansion of 22.4% YoY in Mar-21 from a contraction of 3.4% YoY (revised up from 3.6%) seen in Feb-21. On sequential basis, IIP expanded by 10.6% MoM in Mar-21, marginally lower than the historical average of 11.2% in the month of March (i.e., for the current 2011-12 series excluding Mar-20). Nevertheless, it is largely in line with the seasonal trend of year-end ramp up in production activity. The data of April will be looked at more closely to gauge the impact of the containment measures on the industrial output trajectory.
- India's merchandise deficit widened to a 4-month high of USD 15.1 bn in Apr-21 from USD 13.9 bn in Mar-21. Both exports and imports registered their first triple digit annualized growth at 195.7% and 167.1% respectively, buoyed by an

exceptionally favorable base effect. On sequential basis, exports and imports contracted by 11.1% and 5.5%MoM in Apr-21, an outcome driven mostly by the calendar effect (sequential retracement is usually observed at the start of the FY following the March ramp-up).

- Fuel consumption volume rose by 81.9%YoY in April, masking the 9.4%MoM sequential decline led by industrial fuels.
- Domestic auto sales slipped by 30.2%MoM in Apr-21 as lockdown hurt both sales and demand.
- The sequential slowdown which has started to be visible in Apr-21 is expected to exacerbate in May-21, amidst more pervasive and stringent lockdown restrictions at the state level. The lead indicators of economic activity such as google mobility, traffic congestion, e-way bill registrations continue to weaken in May-21; this is likely to reflect in a moderation of both production and consumption volume data as well. It may be noted that semi urban and rural areas are seeing a much larger proliferation of cases vs. the first wave, which is bound to weigh on consumption in addition to the floundering urban demand.

Outlook

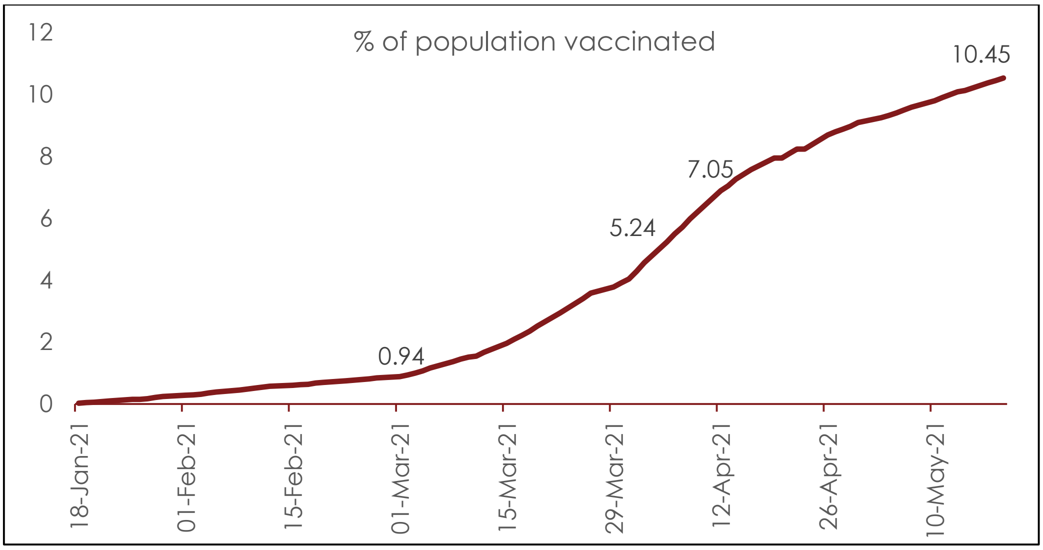
Notwithstanding the exceptionally strong annualized growth in indicators over Mar-Apr-21 and a likely double-digit Q1 FY22 GDP print, the sequential slowdown from the second wave of the pandemic is getting palpable across the board. The impact is expected to be most severe on contact-intensive services yet again with industry too struggling to operate amidst labour migration, workforce safety concerns, supply chain disruptions and importantly a slackening demand. As per media reports, key players in the auto as well as electronics segments have either temporarily shut or intentionally pared production. At this juncture, it is however important to caveat, that economic activity remains considerably above the trough seen in Q1 of FY21 at the time of complete national lockdown. Nevertheless, signs of slippages in economic activity make us believe that it could impart some downside risk to our FY22 GDP growth estimate of 10.0%.

Having highlighted the downside to near term growth prospects, we do acknowledge the silver linings as well:

- Global growth expectations have got marked up in the last few months led by strong doubling down of fiscal policy support in the US and continuation of extremely accommodative monetary policies by major central banks. A supportive global economic backdrop will support India's exports, which continue to show some degree of resilience despite the state level lockdowns.
- Although India's vaccination drive has lost momentum in May, it is expected to pick up pace in the next 2-3 months via augmentation of existing domestic capacity as well as possibility of greenfield vaccine production and imports. Currently, India has covered near 10% of its total population with a single dose of Covid vaccine. This could potentially move towards 50% before the end of 2021. This critical mass of vaccinated population would not just boost consumer confidence and enhance mobility, but it would also help in normalising a significant part of economic activity from Covid related disruptions.

- As the second Covid wave ebbs, rural consumption could find support from a normal monsoon, record level of food grain procurement and the Government schemes providing income or subsidy support to rural populace.
- Last but not the least is the supportive domestic policy environment characterized by countercyclical fiscal impulses reinforced by the FY22 Union Budget amidst an accommodative monetary and liquidity backdrop that RBI remains committed to.

Chart 2: India has vaccinated over 10% of its population



Inflation

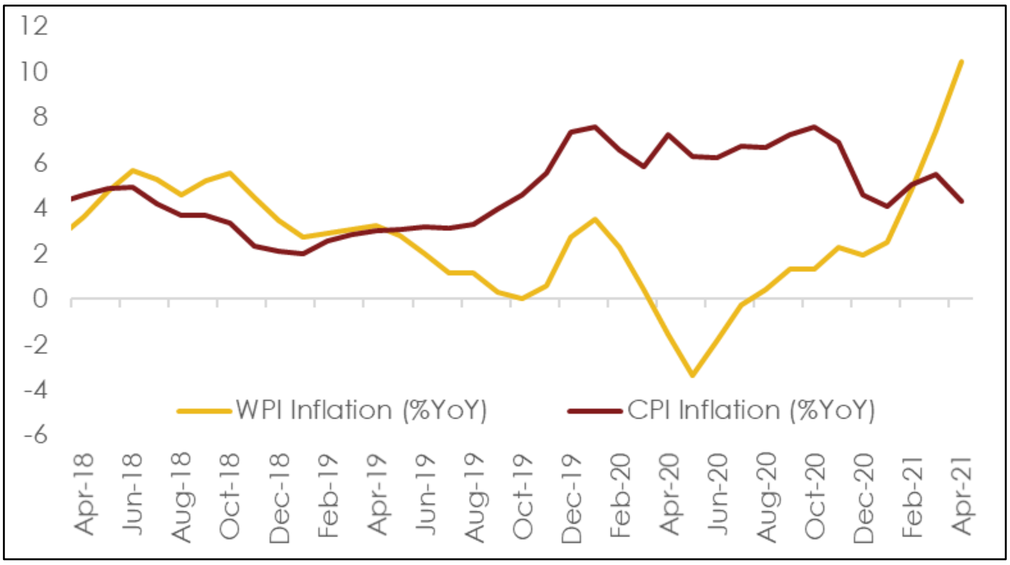
Sequential propulsion

KEY TAKEAWAYS

- The Apr-21 dichotomy of retail and wholesale inflation was an outcome of divergent base effects at play. Sequentially, both the inflation metrics however, had the same trajectory – i.e., of firming price pressures.
- CPI index rose by 0.7%MoM – the fastest pace in 6 months, while WPI index rose by 1.86%MoM – to beat all past records for the 2011-12 series.
- The passthrough from higher wholesale prices into retail prices is indeed a risk, but one that remains subdued as of now in the current environment of weak demand.
- On inflation outlook, we retain our FY22 CPI projection of 5.0%, down from 6.2% in FY21, as we expect comfort on food inflation to sustain amidst expectations of normal monsoon in 2021 and robust Rabi output.
- Upside risks nevertheless, remain from further rise in global commodity prices including crude oil and uncertainty with respect to still emerging impact of second wave of Covid on both supply and demand.

The Apr-21 dichotomy in retail and wholesale inflation was an outcome of separate base effects at play. To put this in perspective, while CPI inflation eased to a 3-month low of 4.29% (from 5.52% in Mar-21), WPI inflation quickened to a record high of 10.49% (from 7.39% in Mar-21). **Sequentially, both the inflation print however reflected firming price pressures.** CPI index rose by 0.7%MoM – the fastest pace in 6 months, while WPI index rose by 1.86%MoM – to beat all past records for the 2011-12 series. Over the last few months, WPI has risen at a much faster clip vs. CPI, not surprisingly amidst the sharp increase in global commodity prices.

Chart 1: WPI and CPI at sharp dichotomy



Granularity of CPI inflation

- On an annualized basis, CPI inflation at a 3-month low was dragged down by most sub-categories with the exception of Housing and Fuel and light, amidst a positive base at play.
- Food prices rose by a robust 0.9%MoM after a hiatus of 4 months, as the rise in mercury (with an early onset of summer), higher global passthrough of oil prices and lockdown induced mild disruptions weighed. Within food, once again 3 categories saw heightened price pressures – Meat & fish (+3.02%), Oils & fats (+3.78%) and Fruits (7.09%), compared to Mar-21. Providing some respite, prices of vegetables – the lone food category in decline, eased for the fifth consecutive month.
- Surprisingly, fuel prices remained unchanged from previous month, owing to a fall in LPG prices in Apr-21.
- Incremental momentum in core prices (i.e., CPI ex Food & Beverages and Fuel & Light indices) rose to 0.57% compared to 0.21% in the previous month, amidst broad-based price pressures seen in Housing (+0.94%), Clothing & footwear (+0.58%), Miscellaneous (+0.46%) and Pan, Tobacco, Intoxicants (+0.37%). Personal care & effects, within miscellaneous category, rose by 1.04%MoM as gold prices shot up in the month.

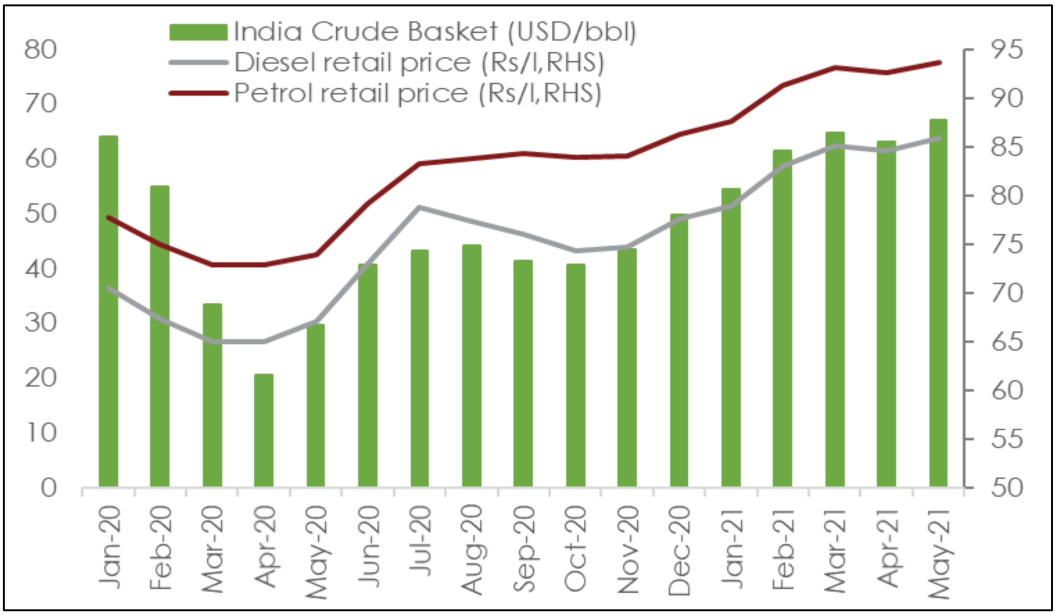
Granularity of WPI inflation

- On an annualized basis, the rise in WPI inflation was broad based, exacerbated by an adverse base.
- Manufacturing inflation rose to a record high of 9.01%, with strong price pressures seen in the sub-sectors of base metals, rubber & plastic, paper and chemicals.
- Fuel inflation galloped to a near record high of 20.94% owing to an unfavorable base from last year, even as sequentially fuel prices contracted by 1.0%MoM

Passthrough from WPI to CPI inflation?

The passthrough from higher wholesale prices into retail prices is indeed a risk, but one that remains subdued as of now. In the current environment of weak demand, the ability of producers to pass on higher input costs to final product will remain limited and perhaps work with a lag of 2-3 quarters, aided by more definite signs of a demand recovery in H2 FY22.

<u>Chart 2: Retail fuel prices have yet again started to move higher</u>



Outlook

CPI inflation marked a good start to FY22 with inflation moving close to mid-point of RBI's inflation target band of 2-6%. This comfort is however illusory and will prove to be ephemeral as it is driven solely by base effect. On inflation outlook, we retain our FY22 projection of 5.0%, down from 6.2% in FY21, as we expect comfort on food inflation to sustain amidst expectations of normal monsoon in 2021 and robust Rabi output.

However, upside risks remain from:

- Fuel inflation, already ruling at a 2-1/2 year high, could get intensified amidst further hardening of global crude oil prices (by 6.0% in May-21, so far). Retail price of petrol and diesel have resumed daily upward adjustments post the state elections, which will add to inflationary pressures, unless countered by fuel tax reductions by the center and state Governments.

- Pass through of higher global commodity prices other than crude, many of which such as copper, steel are near record highs and this could add to input costs, already visible in a record-high WPI inflation.
- Uncertainty with respect to second wave of COVID continues to linger. Daily confirmed cases while have eased over the last week, nevertheless continue to remain elevated. In a bid to control the infections, larger number of states have announced stricter lockdowns since beginning of May-21. While Apr-21 did not point to any strong supply side disruptions, May-21 data will be more relevant from this perspective. Further, with consumer demand expected to take a hit, the interplay of supply and demand side dynamics on inflation in this wave of Covid remains to be seen.

Chart 3: CPI Inflation: By Sub-Components

	(%YoY)			(%MoM)	
	Apr-20	Mar-21	Apr-21	Mar-21	Apr-21
CPI headline	7.22	5.52	4.29	0.13	0.70
Food	10.47	5.24	2.66	-0.13	0.89
Pan, Tobacco & Intoxicants	5.87	9.87	9.01	-0.11	0.37
Clothing & footwear	3.47	4.41	3.49	0.39	0.58
Housing	3.94	3.50	3.73	0.06	0.94
Fuel & Light	2.93	4.43	7.91	2.03	0.00
Misc.	5.43	6.95	6.19	0.26	0.46
Core Inflation	4.85	6.00	5.43	0.21	0.57

Government Finances

Comfort on FY21, discomfort on FY22

KEY TAKEAWAYS

- We continue to believe that there could be scope for mild improvement in FY21 fiscal deficit ratio of 9.5% of GDP.
- With support from excise and custom duties, net tax collection growth has outpaced the previous year's run rate on FYTD basis.
- 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 in FY21.
- Total expenditure growth of 14.3% YoY on FYTD basis has improved moderately on the back of significant ramp up in capital expenditure even as growth in revenue expenditure has lagged.
- However, fiscal risks for FY22 needs close monitoring amidst the pervasive state level lockdowns dampening tax collections in Q1 FY22 while raising the likelihood of extended expenditure support on account of additional Covid relief beyond the budgeted levels.

India’s central government fiscal deficit for the period Apr-Feb FY21 stood at 76.0% of revised estimates (RE) for the full year compared to 110.8% over the corresponding period in FY20. Prima facie, the relatively lower accretion to FYTD fiscal deficit this year reflects the sharp upward revision in fiscal deficit target that had taken place for FY21 to 9.5% of GDP as per RE vis-à-vis 3.5% as per initial budget estimates (BE).

Receipts: Tax collections playing a supporting role

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

- On FYTD basis (Apr-Feb FY21), gross tax revenue collection clocked a mild contraction of 0.7% despite the severe impact of Covid on the economy. This is surprisingly modest compared to the contraction of 0.8% seen in the corresponding period in FY20.
    - Support to gross tax revenue emerged from excise and customs, which registered FYTD growth of 59.6% and 7.4% respectively compared to a growth of 1.9% and -10.0% seen in the corresponding period in FY20. While the hike in excise duty on petroleum products earlier in the year aided robust growth in excise collections, the recent pickup in imports appears to be providing a supportive backdrop for customs collection.
    - Beyond these, the disruptive impact of Covid is noticeable in case of drop in collections from corporate tax, income tax, and GST, which contracted by 16.2%, 4.2%, and 9.9% respectively on FYTD basis vis-à-vis a growth of -12.0%, 7.7%, and 4.5% seen in the corresponding period in FY20.
- Net tax revenue on FYTD basis (Apr-Feb 2021) clocked a healthy growth of 9.1% compared to a mild growth of 1.9% seen in the corresponding period in FY20, on account of lower tax devolution to states.

Non-tax revenue on FYTD basis (Apr-Feb) recorded a sharp contraction of 41.4% compared to an expansion of 53.2% seen in the corresponding period in FY20, primarily led by moderation in transfer of surplus from the RBI. When seen with respect to the downwardly revised RE, the FYTD accretion under non-tax revenue stands at 73.2% of full year target vis-à-vis 80.7% seen in the corresponding period in FY20.

While the FYTD (Apr-Feb) contraction in non-debt capital receipts of 16.2% appears better than the contraction of 28.7% seen in the corresponding period in FY20, it needs to be interpreted carefully. Government’s disinvestment collection at Rs 257 bn between Apr-Feb FY21 is marginally lower than the figure of Rs 352 bn seen in the corresponding period in FY20. However, given the significant downward revision in RE, the FYTD disinvestment revenue accretion stands at 80.2% of full year target vis-à-vis 70.1% seen in the corresponding period in FY20.

Expenditure: Significant improvement in quality of spending in H2 FY21 so far

The total expenditure on FYTD (Apr-Feb) basis recorded a growth of 14.3%YoY compared to 12.6% growth seen during the corresponding period in FY20. On RE basis, this translates to a figure of 81.7% of the full year target vis-à-vis 91.8% seen in the corresponding period in FY20. We note a divergence between the pace of revenue and capital expenditure by the government:

- Revenue expenditure stood at 80.1% of full year RE, lower than 92.0% seen in the corresponding period in FY20. While bulk of the spending under "Atmanirbhar Bharat Abhiyan" targeted towards immediate Covid relief is being 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) to boost fiscal transparency – something that is expected to get disbursed and reflected in the accounts of Mar-21.
- Encouragingly, FYTD (Apr-Feb) growth in capital expenditure increased threefold to 33.0% from 11.4% seen in the corresponding period in FY20. On RE basis, this translates into a figure of 92.4% of the full year target vis-à-vis 90.5% 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 the improving trend observed in tax collections as well as the need to support the economy amidst gradual phasing of lockdown restrictions in the previous wave.

Outlook

As highlighted earlier, we continue to believe that recent performance on tax collection and expenditure trend supports the scope for a mild improvement from the revised fiscal deficit target of 9.5% of GDP for FY21. The optimism stems from (i) traction in tax collections, (ii) higher than expected realization from the auction of telecom spectrum in Mar-21, 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 on boarding of subsidy expenditure from public sector companies has created large room for revenue spending in the final month of the fiscal year.

Going into FY22, the fiscal arithmetic could once again encounter pressure points:

- Pervasive state level lockdowns over Apr-May FY22 have started to dent the nascent economic recovery momentum, which could dampen budgeted tax collections.
- In addition, if the situation continues to persist in the near term, then expenditure support programs (introduced earlier on account of Covid relief) could potentially get extended.
- The ambitious record disinvestment target of Rs 1750 bn could face execution risks with two months of the financial year already coming to an end.
- We note that the central government has recently increased the subsidy for DAP fertilizers from Rs 500 per bag to Rs 1200 per bag on account of rising fertilizer prices. This would mean an additional subsidy allocation of Rs 148 bn, over and above Rs 800 bn budgeted for fertilizer subsidies in FY22.

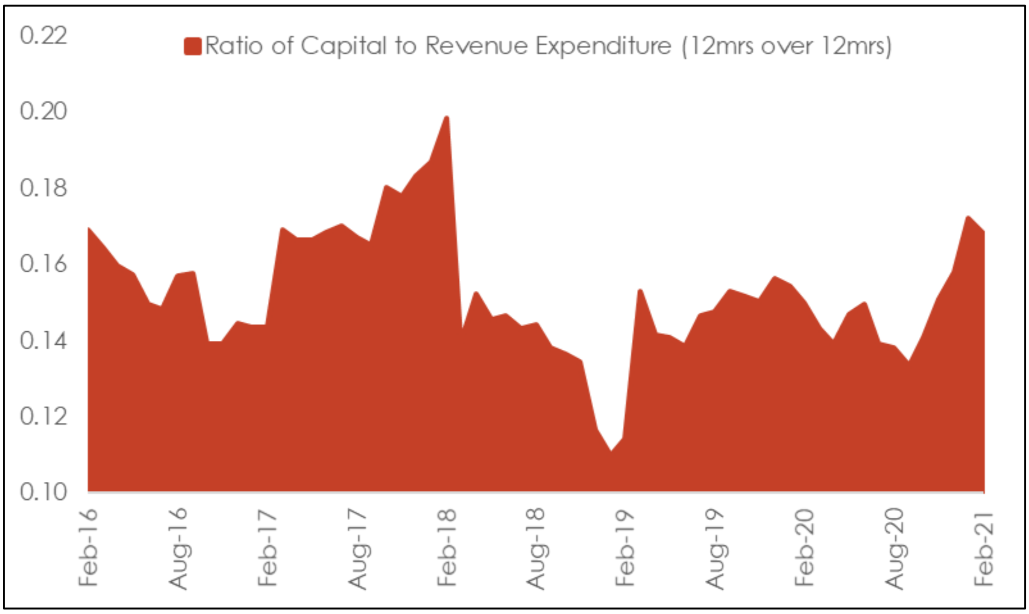
Having said so, there are also some mitigants that would partially offset the fiscal slippage risks:

- RBI has made a transfer of Rs 991 bn in dividend to the government in May 2021 which is close to double of the amount that was budgeted. This would indeed act as a buffer.
- FY22 Nominal GDP growth is likely to be higher than the budgeted growth of 13.8% on account of higher commodity price inflation. This will create a minor statistical wiggle room in projecting fiscal ratios.

Table 1: FYTD comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative as of Apr-Feb)				
	% of FY Actual/Target		%YoY	
	FY20	FY21	FY20	FY21
Revenue Receipts	81.9	88.1	8.9	-0.5
Net Tax	82.2	90.4	1.9	9.1
Non-Tax	80.7	73.2	53.2	-41.4
Non-Debt Capital Receipts	74.5	92.1	-28.7	-16.2
Total Receipts	81.6	88.2	6.8	-1.1
Revenue Expenditure	92.0	80.1	12.8	11.7
of which, Major Subsidies	119.1	61.4	0.7	37.5
Capital Expenditure	90.5	92.4	11.4	33.0
Total Expenditure	91.8	81.7	12.6	14.3
Fiscal Deficit	**110.8**	**76.0**	**-**	**-**

Chart 1: Quality of central government spending has improved significantly in H2 FY21



Rates

Downward bias in near term

KEY TAKEAWAYS

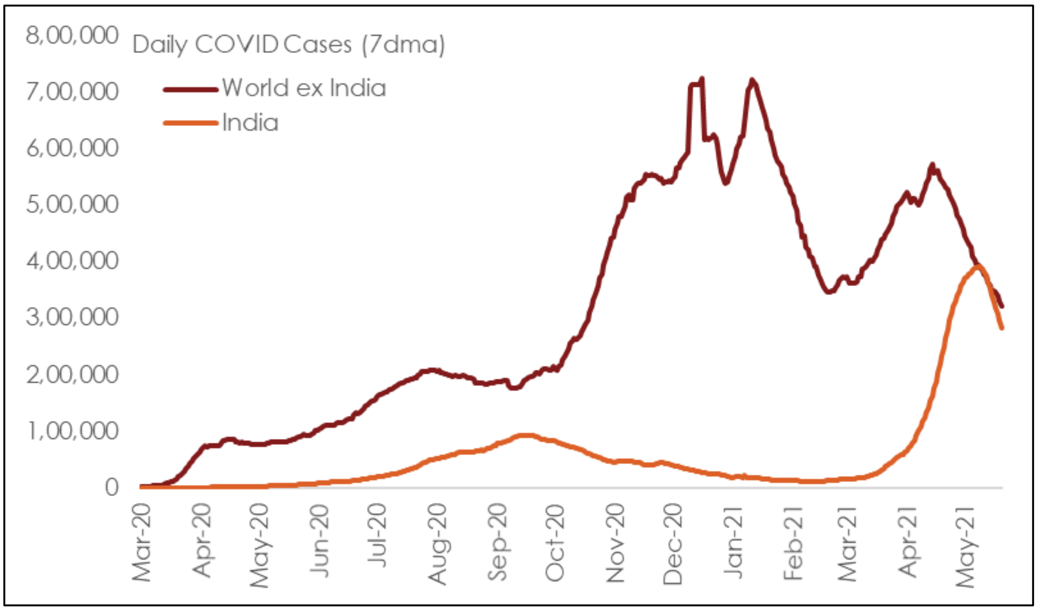
- Indian g-sec yields have moderated in last one month despite yields in developed countries inching up.
- For developed countries, receding Covid caseload coupled with rapid progress on vaccination has improved the outlook on economic growth, besides lifting inflation.
- In contrast, the severe second wave of Covid has dampened sequential growth momentum in India even as retail inflation remains somewhat moderate on favorable base effect.
- We now expect the anticipated hike in repo rate to get pushed to Apr-22 policy review from our earlier call of Feb-22.
- Despite pushing forward our repo rate hike call, we continue to stick to our 10Y g-sec yield forecast of 6.50% by Mar-22. However, we have tweaked our Sep-21 call to 6.15% from 6.30% earlier given the strong intervention of RBI through both G-SAP and OMOs to control the g-sec supply in the market.

Over the course of last month, the 10Y g-sec yield has softened, dropping from 6.07% to 5.97% currently. Surprisingly, this has happened at a time when long term yields in developed economies inched up; while 10Y US Treasury yields rose by a modest 7 bps in the last one month, the 10Y sovereign yield in Denmark, Germany, Norway, Switzerland, and UK rose by 10-17 bps.

The divergence between how yields have moved in India vis-a-vis developed economies in the last one month stems from the Covid situation. While India is currently going through an intense second wave of infections (that has off late started to show early signs of peak out), the rest of the world (led by Europe and US) has been going through a steady decline in incremental infections, with current daily caseload comparable to Oct-20 levels.

For developed economies, growing comfort on the Covid trajectory along with fast progress on vaccination in certain countries has reinforced the prospects of a strong V-shaped economic recovery. This juxtaposed with rising CPI inflation in most cases has led to upward pressure on bond yields in developed economies.

Chart 1: Divergence in recent Covid trajectory: India vs. rest of the world



In case of India, the situation is different in comparison. Rapidly escalating Covid caseload besides creating a severe healthcare challenge prompted most state governments to opt for lockdowns of various intensity. While the central government refrained from a national lockdown, the pervasiveness of state level lockdowns in the last six weeks has already dented mobility indicators and hence sequential economic activity. This is resulting in a reassessment of India's FY22 GDP growth prospects with downside risks becoming prominent despite relatively strong global undercurrents.

As far as inflation is concerned, India's status is somewhat mixed. The recent annualized CPI inflation print of 4.29% in Apr-21 provides comfort. Even if one accounts for upside pressures due to summer seasonality on food and surge in global commodity prices, it appears that CPI inflation is currently on track to be near RBI's estimate of 5.2% in H1 FY22.

We believe that with growth outlook changing on the margin, process of monetary policy normalization is now likely to get pushed ahead. Along with our recent downward revision in growth outlook, we now expect the anticipated hike in repo rate to get pushed to Apr-22 policy review from our earlier call of Feb-22.

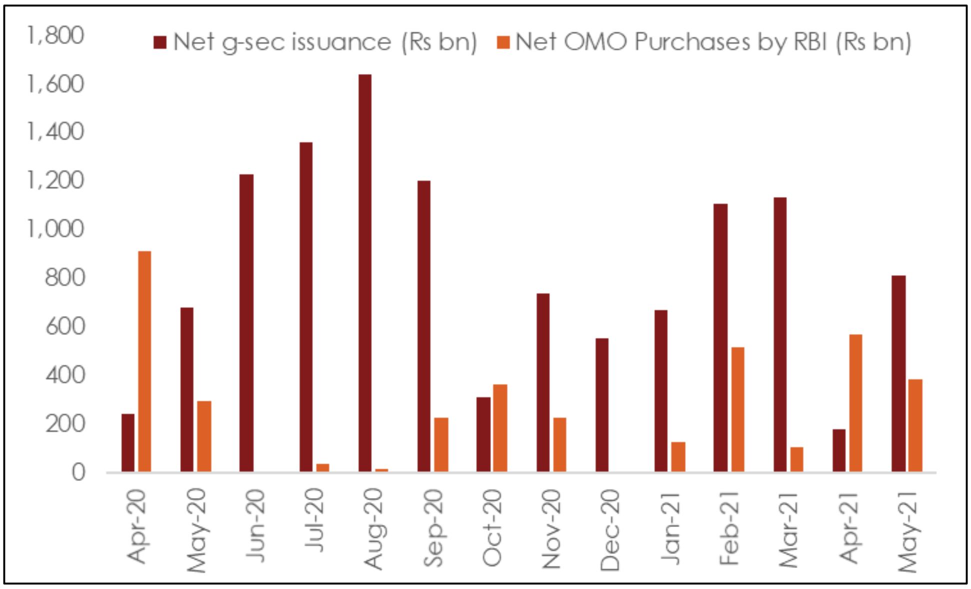
Outlook

Despite pushing forward our repo rate hike call, we continue to stick to our 10Y g-sec yield forecast of 6.50% by Mar-22. However, we have revised our Sep-21 call to 6.15% from 6.30% earlier. The rationale for the same is outlined below:

Short term drivers

- In the near term, while CPI inflation is expected to stay close to RBI's projected trajectory of 5.2% in H1 FY22, the downward revisions to growth will now provide a cap to yields.
- But more importantly, RBI's bond market intervention will continue to balance the supply pressure via active OMO purchase of g-secs. In this context, we had highlighted in the previous report that the central bank's formal attempt towards quantitative easing in the form of the G-SAP programme will have a salutary impact on bond market sentiment. We note that the in the last few weeks, the central bank has been supplementing its G-SAP auctions with Outright OMOs to support bond yields. In fact for the month of Apr-21, the magnitude of Outright OMO purchases (Rs 322 bn) exceeded the G-SAP quantum (Rs 250 bn). Together, they helped in creating a negative net supply outcome for g-secs in the month of Apr-21.

Chart 2: RBI to continue absorbing substantial portion of g-sec supply



While we do not espouse the persistence of negative g-sec supply situation in the coming months, the RBI could continue front loading its quantitative easing plan as long as downside risks to growth are prominent on account of Covid uncertainty.

Medium term drivers

Over the medium term, the drivers continue to remain unmoved.

- At a global level, the taper talk has started to gain momentum. Among developed economies, Canada (BoC) pared the amount of bonds it will purchase and also brought forward its estimate for the timing of rate hikes to late 2022. Meanwhile, Sweden (Riksbank) stands ready to wind down its asset purchases in 2021. Norway (Norges Bank) continues to stand apart as the most hawkish developed country central bank, which has signaled the possibility of a hike in interest rates in the latter half of 2021. With vaccination progressing fast in some of the key developed economies, we continue to expect larger central banks like the Fed, the ECB, and the BoE to opt for a taper of their respective QE programs by mid-2022. This is likely to lead to some degree of hardening in bond yields in these economies, with concomitant spill over in EM yields.
- Although the timing of repo rate hike is now expected to be pushed to early FY23, the RBI could use the Dec-Feb FY22 window to restore the width of the LAF corridor to 25 bps from 65 bps currently. This will involve a 40 bps hike in the reverse repo rate to 3.75%, with repo rate remaining unchanged at 4.00%. The need for normalization of the policy corridor would stem from potentially growing comfort on India's vaccination program and hence greater clarity on growth outlook. With vaccination gaining critical mass in the next 6-9 months, there could also be a possibility of a buildup in demand side inflationary pressures. In addition, it would also help the central bank to start preparing domestic financial markets for taper prospects by systemically important central banks.

Rupee

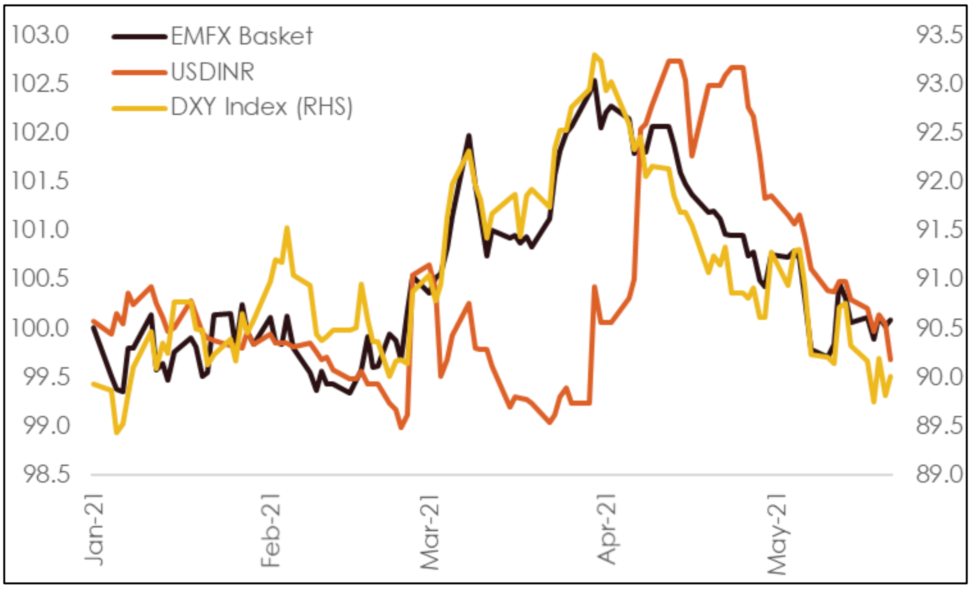
Unintended benefits of Covid second wave

KEY TAKEAWAYS

- After weakening considerably from 72.32 in the last week of Feb-21 to 75.06 in the last week of Apr-21, the Indian rupee managed to turnaround with the currency recovering in a big way within the recent span of 4-weeks.
- We continue to stick to our view of gradual depreciation in rupee with USDINR call unchanged at 77.0 for Mar-22. However, we have fine tuned our short-term call to 75.0, expected by Sep-21.
- The pervasive state level lockdowns have dampened sequential economic activity, which is likely to lower India's merchandise trade deficit and actually benefit INR in the near term.
- Although dollar has retraced from recent highs, vaccine led optimism and extended fiscal push in the US will support its reflationary appeal going forward besides the likelihood of taper talk by the Fed towards the middle of 2022.
- Amidst elevated commodity prices and expectation of ramping up of domestic vaccination drive in next few months, we continue to anticipate India's current account to post a deficit of USD 30 bn in FY22 vis-à-vis an estimated surplus of USD 26 bn in FY21.

After weakening considerably from 72.32 in the last week of Feb-21 to 75.06 in the last week of Apr-21, the Indian rupee managed to turnaround with the currency pair strengthening within the recent span of 4-weeks. Not surprisingly, this has happened at a time when the US dollar (DXY Index) has weakened by 1.3%.

Chart 1: Recent strength in INR appears to be a catch-up EM peers



Note: EMFX Basket consists of Top 10 EM currencies excluding India, weighted by their respective dollar GDP size in 2020.

The recent near term move in rupee appears in contrast to what we had outlined as a trajectory (with a forecast of 76.0 for Sep-21 and 77.0 for Mar-22) in our April edition of the Acuite Macro Pulse report.

Nevertheless, we continue to stick to our view of gradual depreciation in rupee with USDINR call unchanged at 77.0 for Mar-22. However, we would like to fine tune our short-term call to 75.0 which we still expect by Sep-21.

How we got the short-term call wrong for the right reason

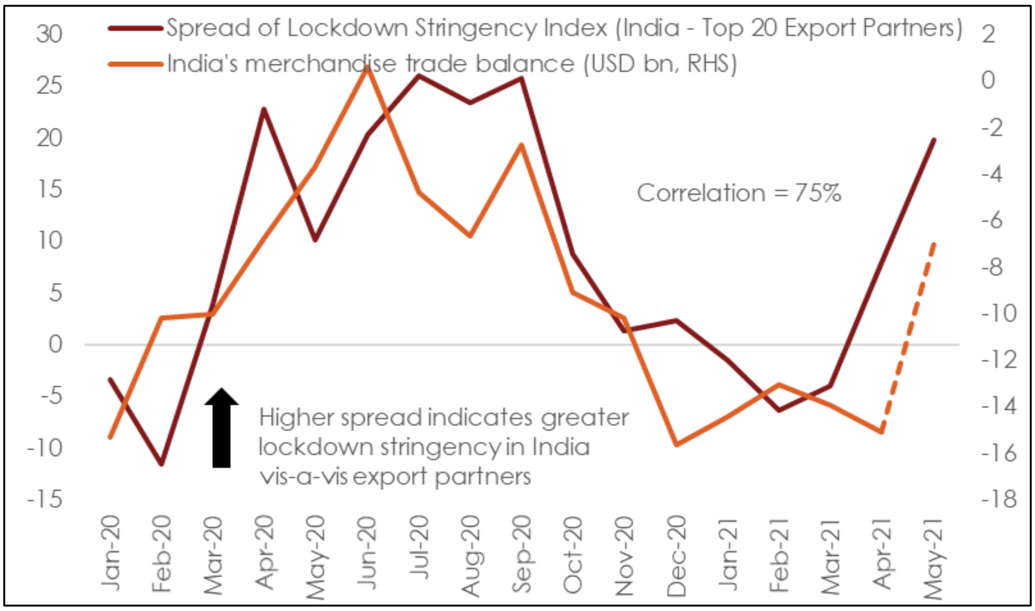
While it was still early, we had anticipated that the second wave of Covid in India could potentially be negative for the currency in an environment where global commodity prices are acting as a strong headwind.

Even though our assertion (still) seems to be on right track, the mechanics have turned out to be different. To elaborate, the second wave of infection intensified ferociously within a short time span, prompting several state governments to opt for lockdowns in their respective states. Although the cumulative impact of state level lockdowns is still somewhat less restrictive than the stringent nationwide lockdown in Apr-May 2020, it nevertheless has dampened the momentum in economic activity. Most high frequency mobility and economic indicators are manifesting a sizable loss in sequential growth momentum during Apr-May 2021. With consumer sentiment having turned extremely cautious amidst heightened medical and healthcare uncertainty, domestic demand is likely to see a sequential decline (notwithstanding the robust annualized growth numbers that would be supported by an extremely favorable statistical base).

From FX perspective, this becomes relevant as it would eventually reflect in lower demand for India's merchandise imports. More importantly, this outcome is likely to get juxtaposed with much lower impact on India's exports as 1) most of its key trading partners are gradually reducing lockdowns in their respective countries, and 2) state level lockdowns have permitted most industries and construction related work to commence with partial restrictions. On net basis, this would be tantamount to a short term shrinkage in India's merchandise trade deficit as had happened last year.

Preliminary figures announced by the Ministry of Commerce for the first week of May-21 indicates a merchandise trade deficit of USD 1.8 bn. Taking into account how the lockdown stringency has moved in India since then compared to its export partners, the entire month's merchandise trade deficit can be expected to halve vis-à-vis Apr-21 levels of USD 15.1 bn. This now pins one of the main the reasons behind recent rupee appreciation, which could potentially continue to persist in the near term.

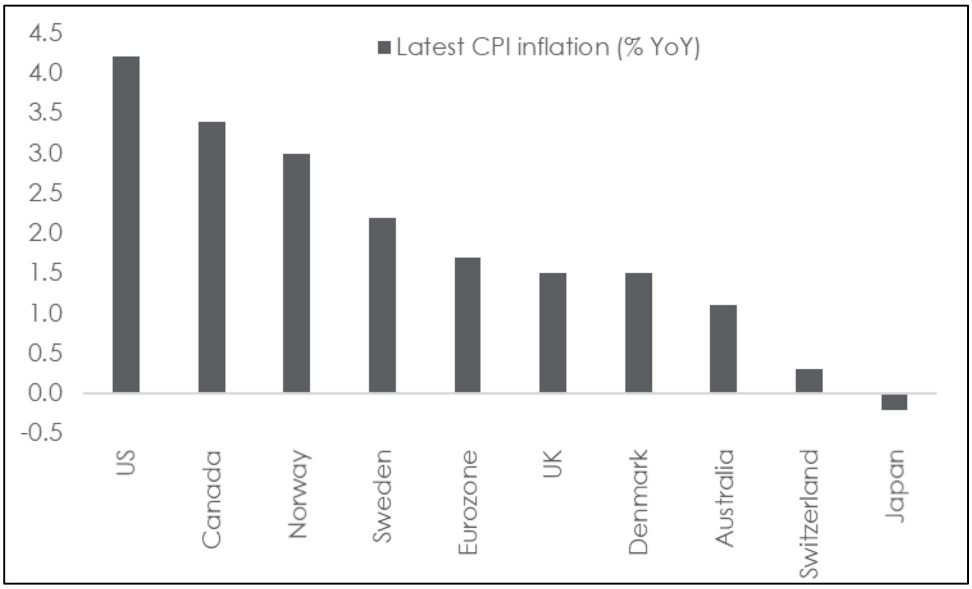
Chart 2: Strong second wave of COVID in India to narrow its trade deficit again



Outlook

The discussion on rupee would remain incomplete without considering the dollar trajectory and outlook. We had been anticipating the underlying strong reflationary theme to be supportive of the USD. However, recent price trajectory has outlined a modest weakening bias in the greenback, supported by soft labor market data and Fed's continued dovish rhetoric. We see the current patch as a transitory pullback and stick to our call of dollar strength over the course of next one year. Despite soft labor market data in Apr-21, the US economy continues to show signs of a strong V-shaped economic recovery amidst fast paced vaccination drive (47.4% of total population in the US has received at least one dose of Covid vaccine) and extended fiscal support from President Biden's second economic reform package, focused on social sector spending.

Chart 3: US currently has the highest inflation among key developed economies



From rupee perspective, while the compression in trade deficit in the near term is providing succor, over the medium term, moderate depreciation pressures could reassert themselves, taking USDINR towards 77.0 by Mar-22.

- As highlighted in April edition of Acuite Macro Pulse, the impact of G-SAP announcement has started to fade.
- The commodity price headwind would act as drag on India's current account when economic activity starts to normalize post the immediate shock from the second wave of Covid. For now, we continue to expect the current account to post a deficit of USD 30 bn in FY22 vis-à-vis an estimated surplus of USD 26 bn in FY21.
- India's vaccination drive has lost momentum during Apr-May 2021. While there is an expectation of ramp up in inoculation in the next 3-months form enhanced domestic capacity as well as imports, the country would continue to fall behind key developed economies.
- Last, but not the least, is the anticipated tapering of quantitative easing by the US Fed by mid-2022. This will not only provide a leg up to the dollar, but it would also weigh upon EM currencies.

Global Overview

From restraint to recovery

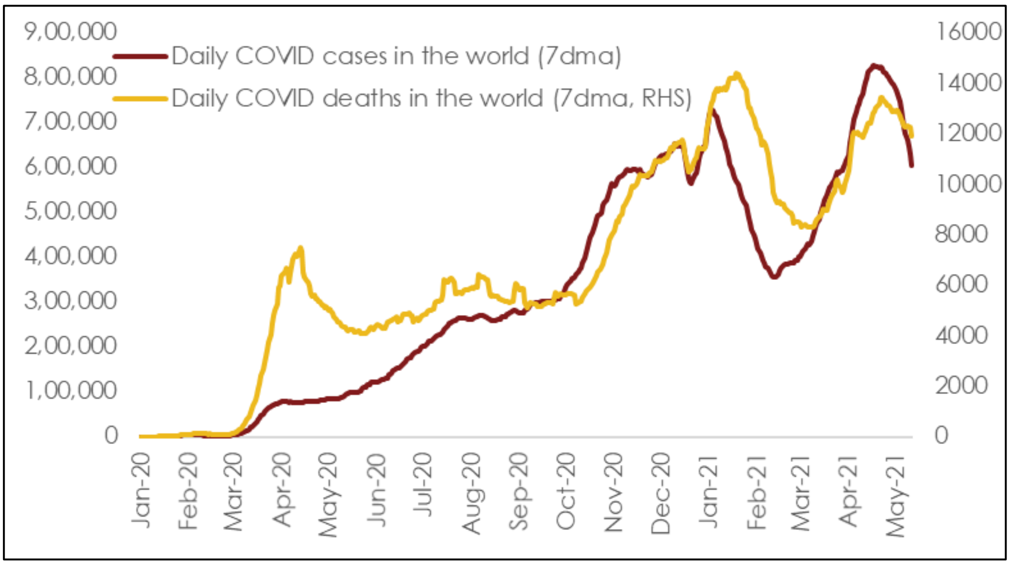
KEY TAKEAWAYS

- The global pandemic after worsening through most of Apr-21 finally appears to have moved past its peak in May-21.
- Vaccination campaigns continue to be rolled out around the globe. At present, more than 1.57 bn doses of the vaccine have been administered (as of May 21, 2021) across 176 countries at the rate of 27 mn doses a day.
- The continued progress on vaccines is buoying global consumer and business sentiment, as Governments' look to re-open economies in a progressive manner.
- Of the major economies, UK undoubtedly remains ahead of the pack, on track to completely open up next month, an event that is being closely watched the world over.
- With visibility of a stronger global recovery, commodity prices have continued to harden.
- In addition to commodity prices, improving demand is adding legs to domestic inflation in many countries. While price pressures may prove to be transitory, but nevertheless remain a risk on watch.

Overview

The global pandemic after worsening through most of Apr-21 finally appears to have moved past its peak, as new cases have declined by nearly 25% so far in the month of May (as of May 21, 2021). Despite the continuing global health crisis, economic data continues to underscore a gradually crystallizing economic recovery led by advanced economies and China. The continued progress on vaccines is buoying consumer and business sentiment, as Government's look to re-open economies in a progressive manner. Of the major economies, UK undoubtedly remains ahead of the pack, on track to completely open up next month – an event that is being closely watched the world over. Vaccination campaigns continue to be rolled out around the globe. At present, more than 1.57 bn doses of the vaccine have been administered (as of May 21, 2021) across 176 countries at the rate of 27 mn doses a day. The dark horse in the vaccine race has been the Eurozone, which after a slow start amidst supply shortages, has seen vaccinations rise at a fast pace, closing the gap with US and UK both over Apr-21 and May-21. As of 21st May, EU countries have administered close to 211 mn vaccines with nearly 33.5% of the population having received at least one dose (compared to 48.2% in US and 43.8% in UK). In addition to rising global commodity prices, improving demand is adding legs to domestic inflation in many countries. While price pressures may prove to be transitory, but nevertheless remain a risk - warranting a close watch for they could potentially upset the growth party.

Chart 1: Globally COVID cases turn a corner in May



UK

UK remains a beacon of hope in a Covid ravaged world, as it continues to gradually reopen amidst an incredibly fast pace of vaccination program that it has achieved since the beginning of 2021. Recall, back in Feb-21 PM Johnson had outlined a four-step plan to end restrictions by Jun-21, which remains well on track. After reopening of schools in early Mar-21, restrictions on outdoor gathering, opening of non-essential shops, indoor gathering and more recently travel have been progressively eased (albeit with riders). While risks remain from the new virus variant B.1.617, as of now it appears that the economy may well remain on track for a complete unlock by second half of June. This remains a closely watched event, a social experiment for all economies to assess if Covid cases remain low and how social behaviors evolve.

Incoming macroeconomic data displays the shift in gears in economic momentum from Q1-21 into Apr-21. Up to Mar-21, most economic indicators remained downbeat reflecting the third phase of lockdown in place. GDP growth expectedly posted a contraction of 1.5%QoQ in Q1 but the pace of degrowth was lower than anticipated. In contrast, data for the month of Apr-21 continues to surprise on the upside. GfK consumer sentiment increased marginally to -15 in Apr-21 from -16 in Mar-21 to mark its highest level since Mar-20. Retail sales posted a healthy increase of 5.4%MoM in Mar-21, signaling upbeat pent-up demand as consumers get ready to move out of social restrictions. Apr-21 has added near 97k jobs to payrolls driven by sectors of finance, insurance and administration, with the fall in hospitality being the least since the onset of the pandemic. On the business side, UK Composite PMI Index rose to 60.0 in Apr-21 from 56.4 in Ma-21, its highest reading since Nov-13, with new orders being exceptionally strong. Reflecting this stronger demand, CPI inflation for Apr-21 doubled to 1.5%YoY (from 0.7% earlier) with higher energy prices also at play.

The Bank of England (BoE), in its policy review earlier this month, maintained a status quo on expected lines with the guidance of a no rate hike expected until H2 2023. However, the central bank surprised markets by announcing a tapering of its weekly asset purchases from GBP 4.4 bn to GBP 3.4 bn over the Jun-Aug-21 period. The BoE however clarified that the decision was 'operational in nature' and that it should not be construed as a change in monetary policy stance. The BoE expects the economy to grow by 7.3% in 2021, the fastest pace since the second world war, compared to a contraction of nearly 10% last year.

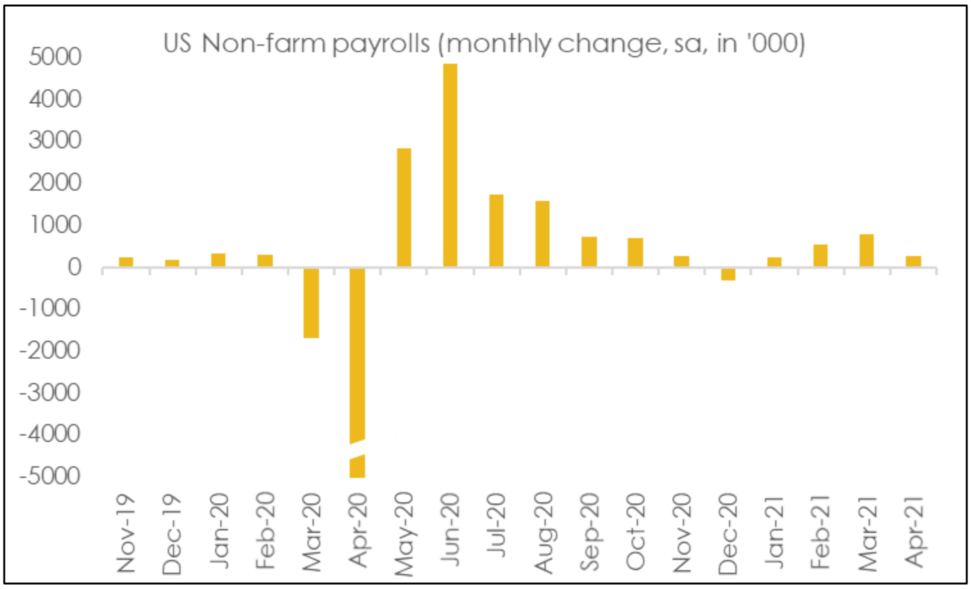
US

US economic recovery remains firmly on a growth track validated by the advance estimate pegging Q1 GDP growth at 6.4%YoY (higher than market consensus of 6.1%) following a 4.3% growth in Q4-20. A combination of progress on vaccines, a massive fiscal stimulus and a steady monetary policy support, have continued to support a faster rebound compared to its global peers.

In the month of May-21, amidst most economic indicators performing rather well aided by a powerful base from last year, two economic indicators stood out – in terms of performance and economic debate, both.

- US Non-farm payrolls unexpectedly slowed down in Apr-21, adding only 266k jobs compared to an expectation of 978k. Further, data for Mar-21 was revised lower to 770k job (from 916k earlier). The latest report has sparked a heated debate about the generosity of unemployment benefits which is perhaps keeping workers away from the labour force, despite improving public health and massive government aid fueling an economic boom. Treasury Secretary Janet Yellen though dismissed requests to scrap the weekly unemployment subsidy, stating that "It's clear that there are people who are not ready and able to go back into the labour force. I don't think the addition to unemployment compensation is really the factor that is making a difference."

Chart 2: US Non-farm payrolls surprised on the downside



- The other key data that remained under intense discussion, was the surge in Apr-21 CPI inflation to 4.2% on an annualised basis from 2.6% in Mar-21 – a near 12 year high. Booming demand amidst reopening of the economy and supply constraints have pushed prices northwards. The main drivers of the bigger than expected increase in Apr-21 were categories of hotels, airlines and used cars and trucks – a clear sign of vengeance demand (in addition to fuel inflation). While the uptick in inflation is expected to be temporary, in part pushed by an adverse base, investors continue to fret that surging inflation could force the Fed to raise interest rates sooner than anticipated.

The minutes of the Apr-21 FOMC meeting threw in another surprise. Some of the officials signaled "if the economy continued to make rapid progress toward the Committee's goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases". Further, concerns of upside risks to inflation with temporary factors turning out to be more persistent, were also alluded to by some participants. However, given the data surprises since the last policy, the minutes do appear a bit stale. Objectively, it is naïve to draw any strong conclusions basis one month of data, and as such we will await May-21 data to draw more meaningful inferences.

Eurozone

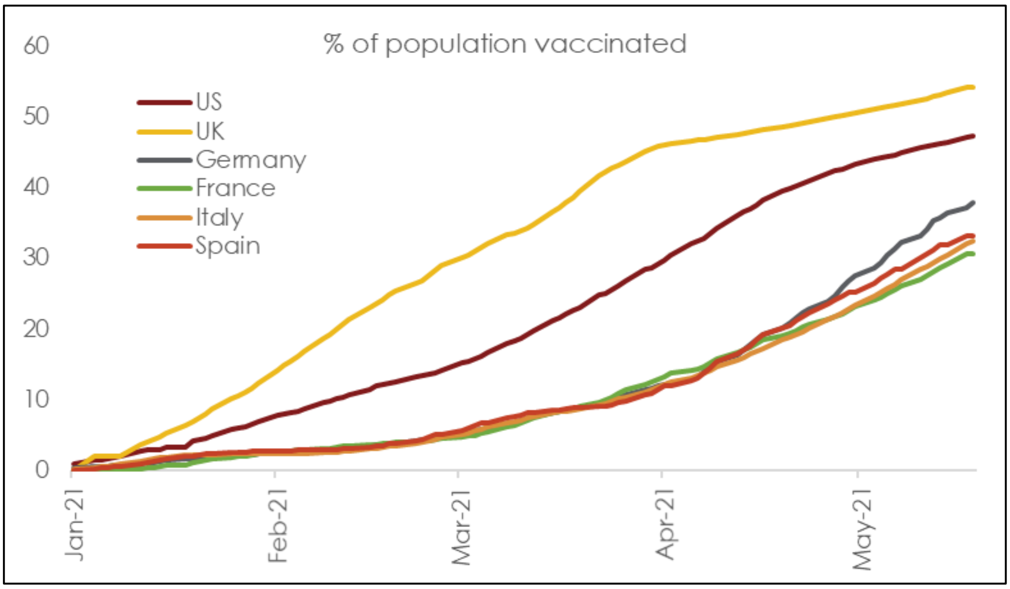
Expectedly, Eurozone's economy contracted yet again in Q1 by 0.6%QoQ (-1.8%YoY) making COVID crisis officially a double dip recession for the region. GDP contracted in all major economies with the exception of France. The vaccination roll out has finally started to gain momentum and is on course to achieve 50% of the population by Jun-21, which makes the outlook for 2021 optimistic. While sentiment indicators have already moved a notch up, recovery should start to reflect in real economic data for Q2 onwards. To clarify, Q2 still started on a weak footing with lockdown measures in place in many countries, but a gradual reopening is now foreseen this month onwards.

As such, the European Commission recently revised up sharply its 2021 growth forecast for Euro area to 4.3% compared to its previous estimate of 3.8%.

Capturing improving sentiment, German ZEW in May-21 rose to its highest level since the start of the COVID, at 84.4 pts from 70.7 in Apr-21. Eurozone industrial production grew in Mar-21 by 0.1% MoM from -1.2% in Feb-21. While the production of capital and durable consumer goods dropped once again, the production of intermediate and non-durable consumer goods rebounded. On an annualized basis, industrial production was up by almost 11% owing to a positive base. Further, manufacturing PMI rose to a record high of 62.9 in Apr-21 from 62.5 in Mar-21. HICP inflation rose, as expected, in Apr-21 to 1.6% YoY on the back of higher energy prices. Core inflation on the other hand fell back to 0.8%. However, there are clear signs of inflation building up amidst higher selling price expectations of producers and gradual opening up retail and services sectors.

As per the minutes of ECB's last policy meeting in Apr-21, policy makers indicated that growth and inflation in the Eurozone are more likely to overshoot expectations. Since then both growth and inflation outcomes have indeed moved up; intensifying a debate about whether ECB should start to slow its emergency bond purchases.

Chart 3: EU countries see a fast pick up in pace of vaccinations



Japan

The Japanese economy continues its battle with the Covid pandemic. Since the start of 2021, it has declared an emergency in some of the biggest cities, which recently has been extended until the end of May-21. Reflecting the impact on economic activity, preliminary GDP fell 1.3%QoQ to post the first decline in three quarters. With Covid related restrictions continuing in Q2 amidst a slow pace of vaccinations, the prospects for growth for the rest of 2021 are looking much weaker. So far, only about 3% Japan's the population has received a single dose. The inability to control infections has also fueled concern over the Tokyo Olympics, a decision on which is still pending. Cancellation of the Games would deal another blow to the economy.

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 8,600 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 BKC, Mumbai.

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