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November 2022

Macro Pulse Report

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From the desk of the Chief Analytical Officer

The **twenty third edition** of our monthly publication, **Acuité Macro Pulse** is being released as we come almost to the end of calendar 2022, a year which will be known in history as the year when the world got relief from a once in a century pandemic but also got embroiled in a geo-political conflict. Given the unusual complexity in the global macroeconomic landscape, we have put in our best efforts to simplify the developments for our readers while also ensuring a reasonable level of depth in our perspectives.

Beyond the 35 bps rate hike by RBI MPC in early Dec-22, which was largely expected, we believe that RBI has taken a moderately hawkish stance at this point in time with continuation of its stance of "withdrawal of accommodation" which implies that further rate hikes may take place in the upcoming policy meets if the inflation print continues to be above RBI's expectations.

Essentially, the MPC has kept faith on the resilience of the domestic economy and has only marginally revised its GDP growth forecast to 6.8% in FY23 despite the increased global headwinds. This is consistent with our view that domestic demand has seen a healthy momentum in the current year and is likely to sustain given the expected recovery in rural demand. India's GDP growth in Q2FY23 at 6.3% YoY has been largely in line with our forecast and expectedly, has been driven by a strong recovery in the services sector. What is noteworthy is the growth in private consumption expenditure which stood at 9.7% YoY in Q2; this was corroborated by our proprietary **AMEP index** print which on an average grew by 12.7% in Q2FY23 over Q2FY22. Further, credit growth stood at 17.5% YoY as on the start of Dec-22 and incremental credit of Rs 12.1 lakh cr has been disbursed in Apr-Nov'22, reflecting the underlying strength of domestic demand. However, the manufacturing sector may continue to see a lack of momentum due to the decline in exports and impact the overall growth print for FY23. Balancing the continuing global risks and domestic support factors such as festive season demand, healthy outlook in agriculture, capex-oriented government expenditure and softness in global commodity prices, we have revised our FY23 GDP growth forecast only slightly to 7.0%.

Given the moderately healthy growth momentum, RBI remains cautious on the headline inflation print and will keep an "Arjuna's eye" on it, highlighting its intent to bring it sustainably down to below 6% within the next two quarters. This opens up the possibility of a further round of rate hike in Feb-23 and a potential terminal rate 6.5% by the beginning of FY24. RBI has also made it clear that liquidity calibration will continue to take place and market participants have to get used to a lower level of liquidity surplus in the system.

The cloud in the horizon, however, continues to be the uncertainty in the global financial environment i.e. the extent to which interest rates will rise in the developed nations particularly the US and its timeframe. The US fed rate is currently at 4.25-4.50% after the 50 bps raise in Dec'22 and may be closer to 5.0% in another three months. Given the shrinkage of the interest rate differential between India and US, the risks of capital outflows will continue to remain, leading to persistent pressures on the rupee which have already touched a high of 83/USD.

Acuité expects a further rise in bank deposit rates over the next two quarters to the extent of 50-100 bps given the narrative from MPC and the continuing momentum in credit growth. The pass through of higher rates to home loans may start to impact the demand for housing particularly in the mid to high ticket segment.

Wishing you a very merry Christmas,

Suman Chowdhury
Chief Analytical Officer

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Growth

Poised for a moderation in H2FY23

KEY TAKEAWAYS

- India's annualized GDP growth in Q2 FY23 expectedly, expanded at a slower pace of 6.3% YoY vs. 13.5% in Q1 FY23, the latter led by easing of favourable base impact created by the second Covid wave in the previous year.
- Nevertheless, India's growth impetus driven by domestic demand as judged by high frequency lead indicators continues to remain resilient, withstanding the uncertain and an increasingly antagonistic global environment.
- While pent-up as well as festive demand has had a positive role to play in keeping up this momentum, there is a possibility of a moderation in some of the lead indicators in the second half of the fiscal unless there is a sustainable and consistent uptick in rural demand.
- While loss of working days in a festive heavy month may have caused a scare on the IIP in Oct-22, a sharper slowdown in global growth is likely to have a stronger bearing on growth Q3 FY23 onwards.
- This factors in incremental external risks (ongoing tightening of global financial conditions, persistent geopolitical uncertainty, and lingering Covid related supply disruptions in China) and their impact on domestic growth, despite support from factors such as strength in services demand, upside in Rabi sowing, capex-oriented government expenditure and the softness in global commodity prices. We hold our FY23 GDP growth estimate of 7.0%.

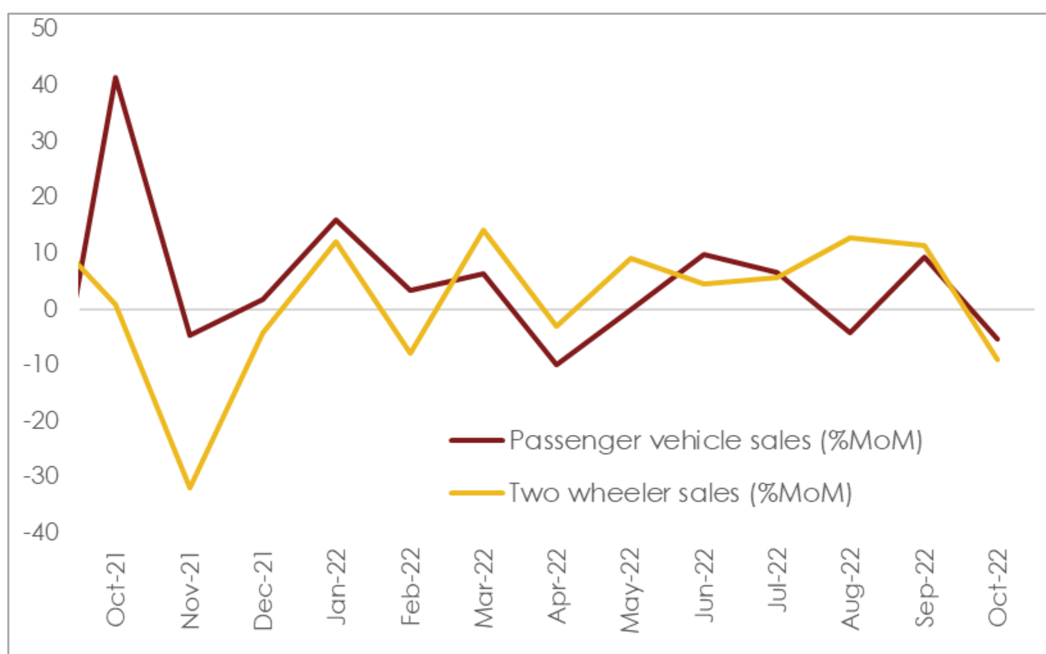
India's annualized GDP growth in Q2 FY23 expanded by a slower pace of 6.3% YoY vs. 13.5% in Q1 FY23, the latter led by easing of favourable base impact created by the second Covid wave in the previous year. Nevertheless, the sequential momentum expanded by 3.6% QoQ, vs. a contraction of 9.6% recorded in the previous quarter. Domestic tailwinds supported by the pent up demand, complete recovery of mobility after the prolonged pandemic, pre-festive enthusiasm on the back of the first normalized celebrations in nearly 3 years, and restocking demand have been key drivers in Q2 FY23 which led the economy to expand by 7.2 % over the pre-Covid levels (i.e. Oct-Sep'19). India's growth impetus as judged by high frequency lead indicators continues to remain resilient, withstanding the uncertain and an increasingly antagonistic global environment. Having said so, while the recovery in domestic demand has had a positive role to play in keeping up this momentum, we do see early signs of petering out of growth in some of the lead indicators. For instance, the IIP has contracted by 4.0% YoY in Oct-22, reflecting an underlying weakness in the manufacturing sector. While the loss of working days in a festive heavy month may be a possible reason for the latter, a sharper slowdown in global growth is likely to have a stronger bearing on growth Q3 FY23 onwards.

Recent data releases

Deep diving into recent data releases, a slowdown was seen broadly in case of auto sector sales along with exports and select transport indicators within the services sector.

- Sales growth of both passenger vehicles and two-wheelers contracted sequentially in Oct-22, by a sizeable 5.3%MoM and 9.1%MoM compared to previous month's growth rate of 9.3% and 11.4% respectively. However, this may be partly attributed to seasonal inventory holding pattern with dealers.
- Rail freight traffic earnings decelerated by 1.4%YoY in Oct-22 compared to a growth of 9.1% in Sep-22, led by slowdown recorded in case of cement and coal; however, it has recovered to 5.4% YoY in Nov-22.
- IIP growth had moved into positive territory in Sep-22, clocking an annualized expansion of 3.1% vis-à-vis a contraction of 0.7% in Aug-22 but again in Oct-22, there has been a contraction on both annualized and sequential basis, highlighting an underlying weakness in the industrial sector.
- Merchandise exports slipped to USD 29.8 bn in Oct-22 to mark the first monthly reading below USD 30 bn in last 20 months, compared to USD 35.4 bn in Sep-22. This translated into a contraction of 16.0% on a MoM basis and 16.7% on an annualized basis. However, the latest trade data for Nov-22 shows a modest recovery with a 6.5% YoY and 7.5% MoM growth.
- Gross GST revenue collections in Nov-22 (i.e., for transactions in Oct-22) eased to Rs 1.46 Lakh Cr compared to record high collection of Rs 1.52 Lakh Cr in Sep-22. Nevertheless, it marks the ninth month of the collections remaining above INR 1.4 Lakh Cr mark.

Chart 1: Sales of PVs and 2-wheelers exhibit a mixed trend



Most other lead indicators continue to paint a positive growth story -

- PMI for both manufacturing and services held ground in Oct-22 and Nov-22. PMI manufacturing rose marginally to 55.3 in Nov-22 from 55.1 in Sep-22, reflecting stronger gains in employment and stocks of purchases. Services PMI rose at a faster clip to 55.1 in Oct-22 and further up to 56.4 in Nov-22 from a 6-month low of 54.3 in Sep-22, led by new domestic orders.
- Sowing for Rabi season has begun on a strong note. As of mid Dec'22, Rabi sowing has recorded a growth of 2.2% over the same period last year. Late withdrawal of Southwest monsoon, healthy water level in reservoirs and a higher (compared to recent past) hike in wheat MSP announced by the Government appear to be supportive.

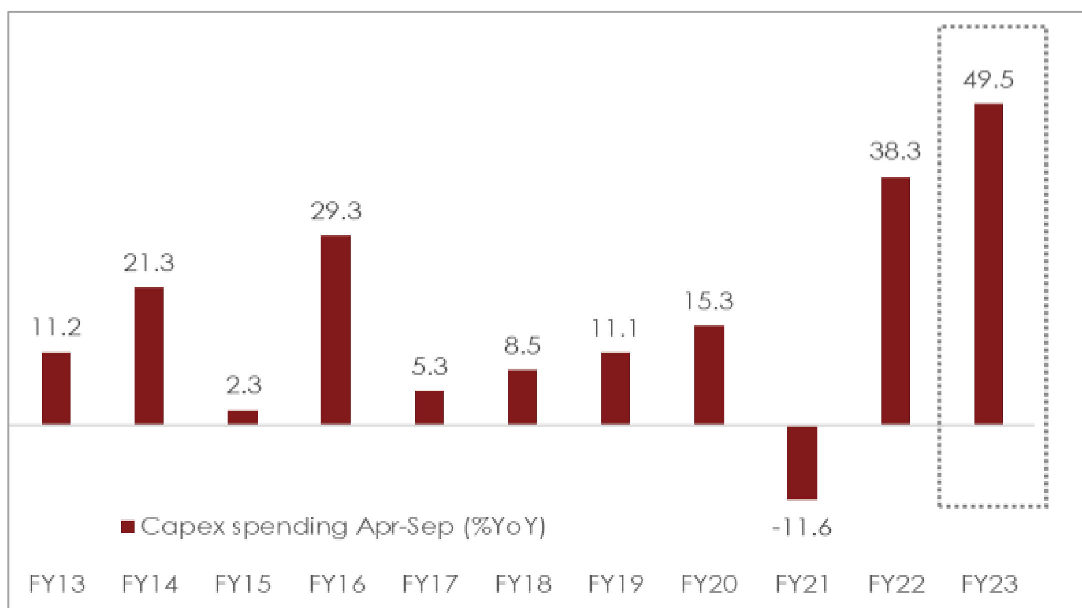
Outlook

So far, the domestic economic activities continue to display resilience though we do see some of the indicators faring weaker in the month of Nov-22. At a granular level, domestic consumption recovery is primarily being led by urban demand (pent-up/festive demand), while rural demand remains on a relatively weaker track. While kharif harvest and a good rabi output can potentially provide support to rural demand amidst easing inflation over the next two quarters, urban demand is likely to simultaneously feel the pinch of the lagged impact of the 225 bps of repo rate tightening undertaken by RBI so far. Investment activity is expected to maintain its buoyancy as also validated by improving capacity utilization levels, domestic production and imports of capital goods. What has provided added support is Government's capital expenditure, having risen by a strong strong 49.5%YoY during H1 FY23, though states appear to be lagging on this front.

Having said so, global growth conditions remain fragile amidst confluence of factors such as synchronized monetary policy tightening on the back of high price pressures and lingering geopolitical uncertainties that have been reverberating across economies. The adverse impact of slowing global growth, has now started manifesting in India's export performance. While overall exports have been easing since the start of FY23, for the month of Oct-22, merchandise exports slipped to USD 29.8 bn coming below USD 30 bn mark for the first time in the last 20 months although there has been a modest recovery to USD 32.0 bn in Nov-22. Nevertheless, the outlook on exports remains clouded. IMF in its latest update to the World Economic Outlook report, slashed its growth forecast for 2023 World GDP and World Trade by 20 bps and 70 bps to 2.7% and 2.5% - this marks a sharp loss of momentum vis-à-vis IMF's 2022 growth estimates of 3.2% and 4.3% earlier.

Looking ahead, on annualised basis, as the favourable statistical effect tapers further, incremental GDP growth is expected to be on decelerating path. For Q3 and Q4, growth is likely to slip closer to 4.0-4.5%. This factors in incremental external risks and their impact on domestic growth, despite support from factors such as strength in services demand, upside in rabi sowing, capex-oriented government expenditure and the moderation in global commodity prices. Taking into account these upside and downside factors, we had revised the GDP growth forecast only marginally to 7.0% in FY23.

Chart 3: Strong run-rate in gov capex expenditure offers support to growth



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Inflation

Lower print a relief but needs to be on watch

KEY TAKEAWAYS

- India's CPI and WPI inflation both moderated in Oct-22 and Nov-22 and has almost converged. While CPI inflation slipped to an eleven month low of 5.88% and within the MPC target range for the first time since Dec-21, WPI inflation was down to a twenty one month low of 5.85% in Nov-22.
- From their respective monthly peaks in FY23, headline CPI and WPI inflation are now lower by 192 bps and 1078 bps respectively.
- While a favourable statistical base effect helped both WPI and CPI inflation drift lower in Nov-22, it is noteworthy that both inflation indices also registered a sequential fall.
- Basis favorable winter seasonality, ongoing decline in global food prices, and pick-up in domestic rabi sowing, we have a relatively benign near-term outlook on food inflation. We continue to peg our FY23 CPI inflation forecast at 6.7%.
- Concerns on core CPI inflation, however, continue to persist, with services exhibiting stickiness, given the pent up demand. However, incremental softness in commodity prices and some moderation in domestic demand would gradually help to ease the pressure.
- While moderation in headline retail inflation is welcome, there are uncomforting factors that continue to lurk - the broad-based increase in food prices especially cereals, some of the recent electricity tariff hikes at the state level starting to get reflected in data in a calibrated manner. In addition, rupee weakness could impart a degree of imported inflation upside along with the bounce-back in demand for services keeping core inflation elevated.

Overview

India's CPI and WPI inflation converged in Nov-22 with a print of 5.88% YoY (11-month low) and 5.85% YoY (21-month low) respectively. More importantly:

- Both metrics exhibited sharp deceleration, with headline CPI and WPI inflation easing by 89 bps and 254 bps respectively over the previous month.
- From their respective monthly peaks in FY23, headline CPI and WPI inflation are now lower by 192 bps and 1078 bps respectively.
- Last, but not the least, CPI inflation, after a hiatus of 11-months, printed within the target range (2-6%).

Food prices on watch

- Food and Beverages index fell by 0.72% MoM in Nov-22, marking its first decline in last 9-months. The downside was led by Vegetables (-8.3% MoM), Fruits (-2.0% MoM), and Meat & Fish (-0.7% MoM). On the other hand, price pressures were seen to persist in case of Cereals (+1.3% MoM) and Spices (+1.4% MoM).
- Respite on food inflation was driven by perishables, which appear to have benefitted from fresh mandi arrivals post the erratic rainfall in Oct-22. Vegetable inflation has been volatile and in high double digits in the first half of the current fiscal but from Oct-22 onwards, the winter seasonality has kicked in, bring the much needed relief in vegetable prices. The fruit inflation has also been relatively benign in comparison and reflects the increased investment in horticulture and storage infrastructure apart from higher imports.
- The animal protein inflation (egg, fish, and meat) has also been largely stable from Sep-22 onwards although egg prices have seen a sharp uptick in Nov-22. However, price pressure in other parts of the food basket, namely cereals and spices continues to persist. In addition, (i) edible oils saw its first price increase after a 5-month hiatus, and (ii) milk prices continue to march ahead at a somewhat elevated pace.
- We note that the lagged spillover impact of elevated agricultural input prices and extension of PM Garib Kalyan Yojana (until Dec-22) could keep food inflation pressures on the table. However, the arrival of incoming kharif produce and ongoing healthy rabi sowing would help to neutralize some of these risks.

CPI Inflation: Other key highlights

- While crude oil prices have been on a downtrend, there has been a modest rise in the fuel and light inflation to 10.6% in Nov-22 from 9.9% in Oct-22 with a sequential uptick of 0.35%. The uptick in sequential momentum was primarily on account of the revision in electricity tariffs, coal, firewood and chips as well as kerosene. It may be noted that inflation in this basket is not directly related to the transportation fuel prices and more linked to the electricity tariffs and LPG/CNG prices used in households.
- While housing inflation continues to be stable at 4.6% YoY, clothing and footwear and miscellaneous category inflation continue to be relatively high

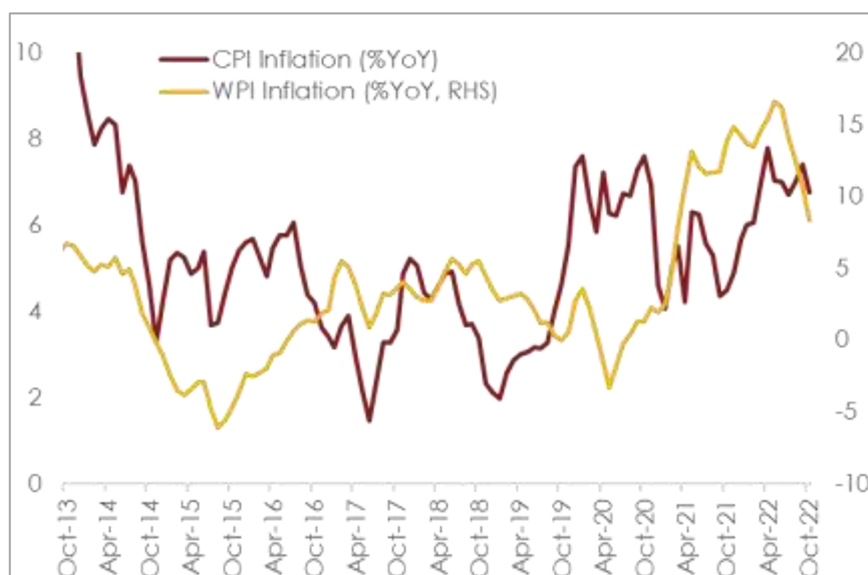
at 9.8% YoY and 6.1% YoY respectively in Nov-22. The sequential inflation in both the latter categories continue to be positive throughout the current year, reflecting the transmission of higher food and fuel prices to the other goods and services consumed by households. The steady inflation print of around 6.0% in the miscellaneous category in the current fiscal reflects a broad based increase in the charges for household services, healthcare, transport, communication, recreation, education, and personal care. Clearly, the demand in these segments have seen a significant recovery after the prolonged pandemic and has allowed the pass through of higher operating costs by the service providers.

- Sequential momentum in core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel items within Miscellaneous) moderated slightly to 0.40% MoM in Nov-22 from 0.69% in Oct-22. But the annualized rate of inflation under this category has continued to be above 6.0% for over a year although it posted a mild decline to 6.3% in Nov-22 from its post pandemic peak of 6.5% in Oct-22.

WPI Inflation: Key highlights

- Sequentially, WPI fell by 0.26% MoM vs. an increase of 0.39% seen in Oct-22.
- Sequential fall was led by consolidated food & beverages index that declined by 1.71% MoM in Nov-22.
- Support also came from core WPI, that saw its third consecutive sequential decline (-0.28% MoM in Nov-22). Significant easing of sequential price pressures was observed in case of textiles, basic metals, paper products, rubber, electronic & optical products, etc.
- In contrast, consolidated fuel index rose by a strong 2.41% MoM, led by jump in price of bitumen, wholesale diesel, pet coke, ATF, naphtha, kerosene, and wholesale petrol.

Chart 1: Sharp deceleration in WPI inflation from its recent peak



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Outlook

While favourable statistical base effect helped both WPI and CPI inflation drift lower in Nov-22, it is noteworthy that both inflation indices also registered a sequential fall. Importantly, on annualized basis, they continue to underscore disinflationary tendencies, with Nov-22 prints showing a pick-up in the pace of deceleration.

The easing of food inflation while expected, is comforting as it now symbolizes kicking in of favourable winter seasonality (with arrival of kharif produce) at both wholesale and retail levels. Juxtaposed with the pick-up in domestic rabi sowing, one is hopeful of a build-up of relatively benign near-term outlook on food inflation.

We could see some further moderating impact coming from –

- The anticipated slowdown in global economic growth in 2023 and its disinflationary impact on international commodity prices.
- The FAO Food Price Index fell further to 135.7 in Nov-22 from 135.9 in Oct-22 sharply below a record high of 159.7 hit in March.
- Easing of global supply chain pressures could gather steam with China showing inclination for gradually curbing COVID restrictions.

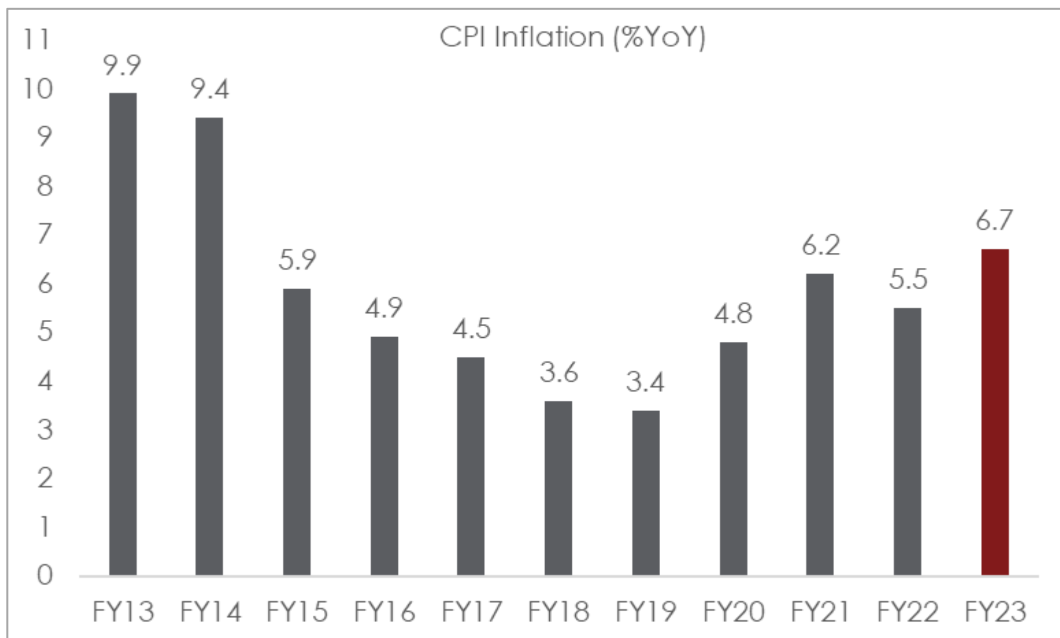
Having said so, incipient concerns, primarily in the form of elevated core retail inflation and stickiness in services inflation, continue to persist. We note that core retail inflation has persisted above 6.0% for the last 6 months - a concern that RBI too had highlighted in its recent policy commentary in Dec-22.

However, the silver lining emerges from the sharp deceleration in core wholesale inflation (that printed at a 2-year low of 3.8% in Nov-22). Incremental softness in most commodity prices (including crude oil) bodes well for further easing of input price pressure, which should start getting partially reflected in core retail inflation with a lag.

The quarterly CPI inflation print in the current fiscal suggests a gradual moderation from 7.28% in Q1 to 7.04% in Q2 and going by the data points of Oct-22 and Nov-22, we expect the Q3 print to be between 6.20%-6.30% which is still above the upper band of RBI MPC; our Q4 forecast stands at 5.8%, slightly lower than limit. Taking into consideration the above-mentioned factors, we continue to maintain our FY23 CPI inflation forecast of 6.7%. Although it is early to opine, a mild downside risk to this estimate seems to have emerged post the Nov-22 data.

From monetary policy perspective, we continue to expect the MPC to hike by 35 bps in the upcoming policy review in Dec-22, before opting for a pause for reassessment.

Chart 2: We hold on to CPI inflation estimate @6.7% in FY23 with risks evenly balanced



Government Finances

Despite risks, likelihood of fiscal slippage is low

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Oct stood at 45.6% of budget estimates (BE) for FY23, higher than the level of 34.5% of actuals in the corresponding period in FY22.
- The overall fiscal theme continues to rest upon strong receipt collections and prioritization of capex over revex.
- Fiscal headwinds have gathered momentum and can potentially cause a slippage in the FY23 budgeted fiscal deficit ratio of 6.4% of GDP.
- Nevertheless, we continue to believe that the central government has buffers that may enable it to get close to the budgeted target on account of persistence of tax buoyancy, recent upward adjustments in some of the indirect tax rates, expenditure rationalization, and strong likelihood of higher than budgeted nominal GDP base.

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India's central government fiscal deficit for the period Apr-Oct stood at 45.6% of budget estimates (BE) for FY23, higher than the level of 34.5% of actuals in the corresponding period in FY22. While both revenues and expenses have been outperforming last year's pace, the higher accretion to FYTD fiscal deficit this year is on account of relatively faster pace of expenditure disbursal vis-à-vis budget estimates.

Receipts: Remain strong

Total receipts in the first seven months FY23 continue to be buoyed by strong tax collections.

- On FYTD (Apr-Oct) basis, gross tax revenue clocked 58.3% of BE compared to 50.4% of actuals in the corresponding period in FY22.
    - Momentum so far is supported by healthy collections under GST, corporate tax, and income tax. The impressive momentum in GST revenue continues to persist with total monthly collections averaging at Rs 1.49 tn during Apr-Oct FY23 compared to the anticipated monthly run rate of Rs 1.35-1.40 tn for meeting the BE. While the recent hike in GST rates for select goods and services and the festive heavy H2 FY23 are seen to be key enablers, ongoing moderation in imports could weigh upon the momentum in the coming months.
    - Meanwhile, collections from customs and excise were lower in comparison. This is reflective of relaxation in duties on select import items (including retail fuel) to provide relief from elevated inflation.
    - We had highlighted early signs of moderation in gross tax revenue growth in the October edition of "Acuite Macro Pulse" report. The second half of FY23 would present unfavourable statistical base, besides the anticipation of easing of nominal growth momentum. While we are confident of tax collections exceeding budget targets by a fair margin, we would nevertheless keep an eye on incremental developments in this space.

Non-tax revenue collections accelerated to 66.3% of BE during Apr-Oct FY23 vs. 59.4% of actuals in the corresponding period in FY22.

- Pick-up in last two months appears to be led by telecom spectrum revenue from 5G auction and increased dividend pay-out from PSEs.
- Having said so, RBI's dividend for FY22 (transferred in May-22) that stood at Rs 303 bn, a sharp drop from Rs 991 bn done in the previous financial year, would continue to leave a hole in non-tax revenues.

Non-debt capital receipts clocked 45.0% of BE during Apr-Oct FY23 vis-à-vis 50.3% of actuals in the corresponding period in FY22. While disinvestment proceeds from LIC in May-22 (that fetched Rs 205 bn) provided a strong start, lack of divestment activity in Q2 FY23 has led to petering of gains.

Expenditure: Disbursals seen picking up

For Apr-Oct'22, total expenditure disbursal stood at 54.3% of BE, higher than 48.1% of actuals in the corresponding period in FY22.

- Momentum continues to be led by capital expenditure that clocked 54.5% of BE during Apr-Oct'22 vis-à-vis 42.7% 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 robust 115.6% YoY during Apr-Oct'22 vis-à-vis a contraction of 19.6% in the corresponding period in FY22.
- Revenue expenditure too picked up to 54.3% of BE during Apr-Oct FY23 from 49.1% of actuals in the corresponding period in FY22.
    - Revex is being led by interest payments and subsidies, which cumulatively had a share of ~57% in total revex disbursal in Oct-22.
    - Excluding interest payments and subsidies, revex moderated to 1.6% YoY during Apr-Oct'22.

Outlook

As highlighted in our last month's edition of "Acuite Macro Pulse", fiscal headwinds continue to gather momentum.

- Extension of "PM Garib Kalyan Anna Yojana (PMGKAY)" by a cumulative of 9-months till Dec-22 for continuation of relief for priority households will cost the exchequer an additional Rs 1.25 tn.
- Higher than budgeted subsidy bill (on account of the top-up of Rs 1.1 tn), especially on account of fertilizers, which currently faces supply as well as price disruption from the ongoing conflict between Russia and Ukraine.
- Likelihood of government providing state run OMCs with an additional Rs 200 bn as compensation for under-recoveries in FY23.
- Cut in excise duty on petroleum products that will have a revenue implication of close to Rs 850 bn over the remainder of FY23.
- Some rationalization in select custom/import duties on raw materials used for steel and plastics industries to share the burden of the sharp spike in global commodity prices.
- Deferment of the big-ticket BPCL divestment due to subdued interest from bidders amidst volatile market conditions, as per media reports.
- Lower than budgeted dividend/surplus transfer by the RBI (at Rs 303 bn vs. the FY23 budget estimate of Rs 650-700 bn).

Nevertheless, we continue to believe that the central government might be able to scrape through and get close to the budgeted fiscal deficit target of 6.4% of GDP due to the following factors:

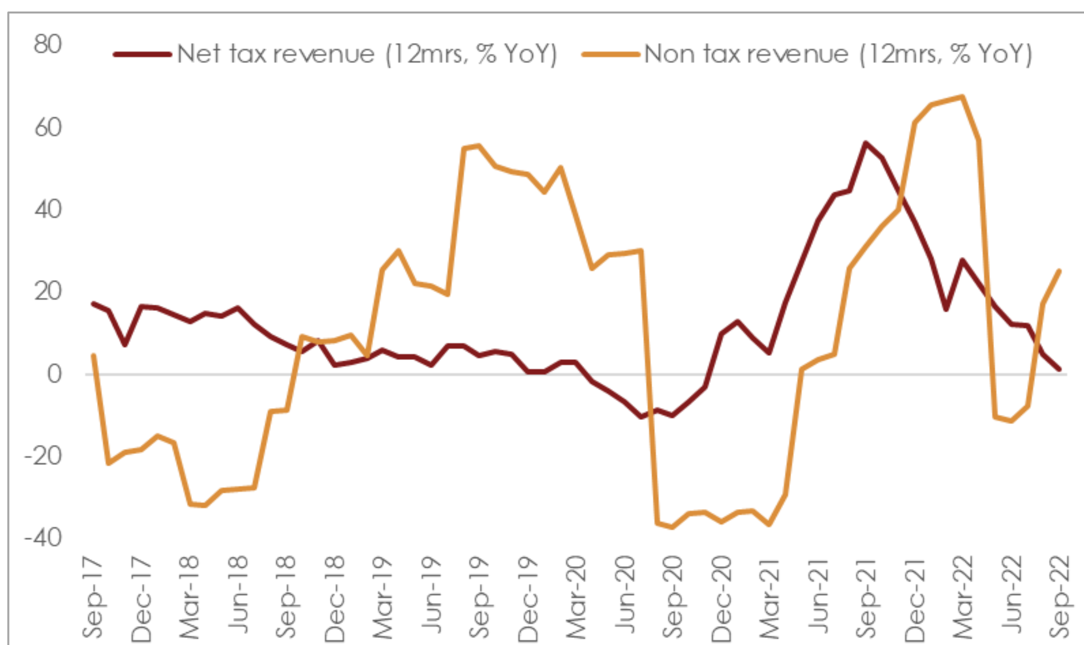
- Tax buoyancy continues to remain healthy. In addition, the recent increase in GST rate for select items, customs duty on gold imports, imposition of a windfall tax would offset some of the revenue loss from cut in excise duty on retail fuel items.
- The rollover of LIC IPO (garnering Rs 205 bn) generated some divestment buffer.
- The government is likely to have saved Rs 200-300 bn due to lower than targeted procurement of wheat.
- Recently concluded 5G telecom auction has generated about Rs 150 bn in additional revenue vis-a-vis BE.

- Similar to FY22, led by a surge in inflation, once again a higher probability of Nominal GDP growth exceeding the budgeted assumption of 11.1% has emerged. We note that in the likely scenario of Nominal GDP growth touching 15.5% in FY23, the generation of fiscal buffer could be to the extent of ~30 bps.

Table1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position for FY22)			
Fiscal Variables	% of Actuals	% of BE	Cumulative (INR bn)
	FY22	FY23	Apr-Sep'22
Revenue Receipts	58.1	61.2	3568.4
Net Tax	57.9	60.5	3075.9
Non-Tax	59.4	66.3	492.5
Non-Debt Capital Receipts	50.3	45.0	250.1
Total Receipts	58.0	60.7	3818.5
Revenue Expenditure	49.1	54.3	5857.74
Capital Expenditure	42.7	54.5	1054.22
Total Expenditure	48.1	54.3	6911.96
Fiscal Deficit	**34.5**	**45.6**	**2039.21**

Chart 1: While growth in tax revenue eased, that of non-tax revenue has picked up



Rates

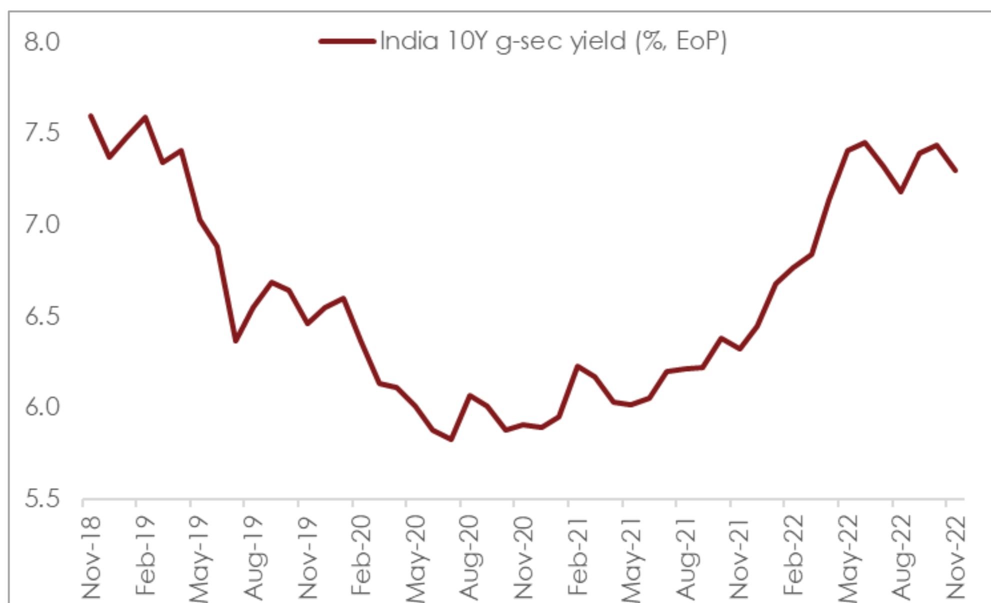
Range bound movement to persist

KEY TAKEAWAYS

- After closing the month of Nov-22 at 7.28%, India's 10Y g-sec yield moderated further to 7.21% in the first week of Dec-22.
- Recent inflation prints in key economies are encouraging and point towards the likelihood of concerns peaking out over the next few months.
- This is prompting key central banks to dial down their accelerated pace of rate hikes. Fed has raised the funds rate by 50 bps in the last meet in Dec-22 after four rounds of 75 bps hike.
- RBI MPC has already taken the path of moderation by reducing its rate increase to 35 bps in Dec-22 from 50 bps in last three policy reviews although it has maintained a moderately hawkish stance and has decided to continue on the path of "withdrawal of accommodation".
- Upside and downside risks to inflation are offsetting each other with market consensus expecting inflation in the 5.0-5.5% range by Q1 FY24.
- We maintain our 10Y g-sec yield forecast range of 7.20-7.40% in the remaining months of FY23.
- However, we believe that there is a strong likelihood of another 25 bps hike in the repo rate in the Feb-23 MPC meet before a possible pause to assess the lagged impact of the aggregate rise in interest rates.

After closing the month of Nov-22 at 7.28%, India's 10Y g-sec yield eased marginally to 7.21% in the first week of Dec-22.

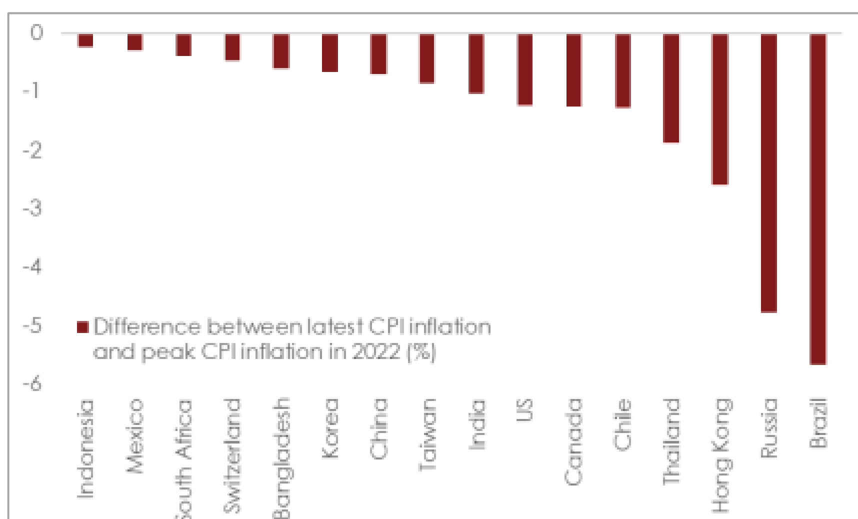
Chart 1: India's 10Y g-sec has moved sideways in last few months



The October edition of "Acuite Macro Pulse" had highlighted that multi decade high inflation in key economies is yet to show signs of easing. We had noted that while headline CPI inflation was showing some tentative signs of a peak out in select economies, relief appears to be inconspicuous as either the inflation data surprises are still in positive territory, or core inflation continues to march ahead.

The month of Nov-22 has ushered in some welcome news on this front. Most notably, CPI inflation eased in US (to a 4-month low of 7.7% YoY in Oct-22) while also springing a downward surprise vis-à-vis market consensus (a similar outturn was seen in case of

Chart 2: Inflation pressures showing signs of easing in key economies



core inflation). In fact, the trend of moderating inflation was also seen in case of few other economies like Hong Kong, Russia, Chile, China, Brazil, and India.

Although success (in taming inflation) is some distance away, these are encouraging signs. Moderation in international commodity prices and gradual de-clogging of global supply chains is helping to lower sequential price pressures. Some of the central banks have acknowledged this and started calibrating their respective monetary policy actions. In last two months, central banks in Australia, Canada, Norway, Denmark, Chile, and Romania have moderated their pace of rate hikes. Most importantly, the US Fed has already dialled down the pace of rate increases from 75 bps to 50 bps in the last Fed meet held in Dec-22.

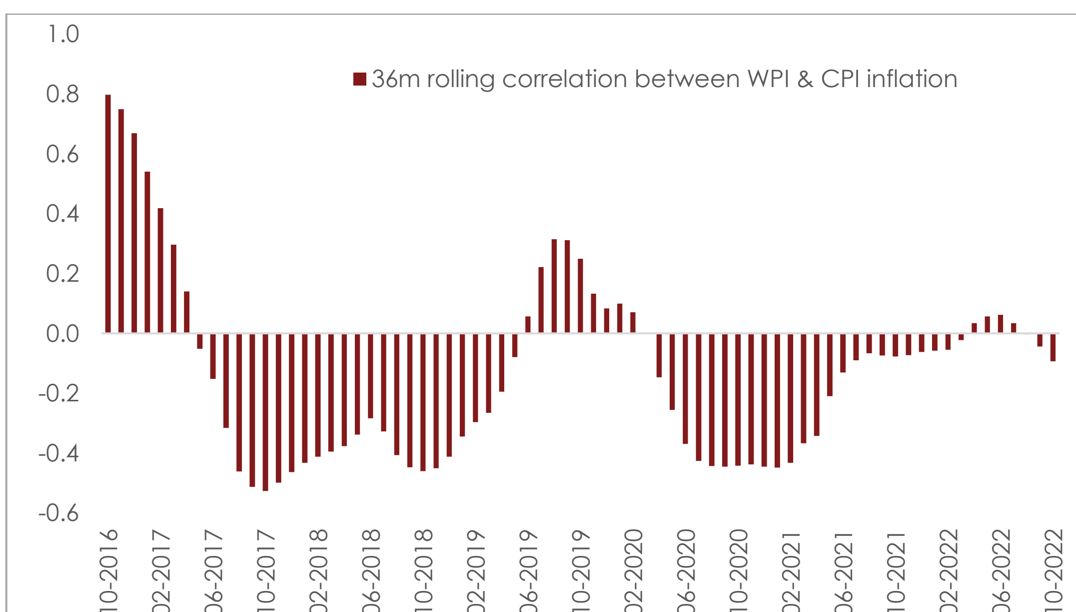
RBI MPC has already taken the path of moderation with the 35 bps rate hike in early Dec-22 vs the three preceding rounds of 50 bps hike. In the last policy review, two out of six MPC members revealed their preference for a pivot in India's monetary policy trajectory. With inflation trajectory broadly following the central bank's projected glide path, there is a likelihood of more members joining the pivot bandwagon. Given the hawkish stance however, maintained by MPC, we believe that another 25 bps rate hike may be on the cards in Feb-23, after which the MPC could pause for impact assessment.

From a bond market perspective, we continue to maintain our peak 10Y g-sec yield forecast range of 7.20-7.40% in the remaining months of FY23.

Stickiness in CPI inflation at elevated levels despite swift deceleration in WPI inflation remains a concern and would continue to act as an important factor pushing the 10Y g-sec yield towards the upper end of our forecast range.

- While WPI inflation has declined substantially by 8.2% from its 2022 peak, CPI inflation has seen a modest decline of 1.0% from its 2022 peak

Chart 3: Correlation between WPI and CPI inflation is negative over the last 3-years



In the near term, the transmission of disinflationary signal from WPI would be partial and subdued as:

- Corporates did not pass on the complete build-up of input price pressure seen in FY22 and hence would use this opportunity to preserve margins.
- In contrast to WPI basket that comprises of tradable commodities, the CPI basket is predominantly characterized by non-tradables. This makes CPI inflation less sensitive to international commodity price moves (which in the current scenario is a key driver of disinflation in WPI).
- Price of items linked to international commodity prices like retail petrol and diesel within the CPI basket have not been revised since Aug-22 despite ~8% fall in international price for crude.

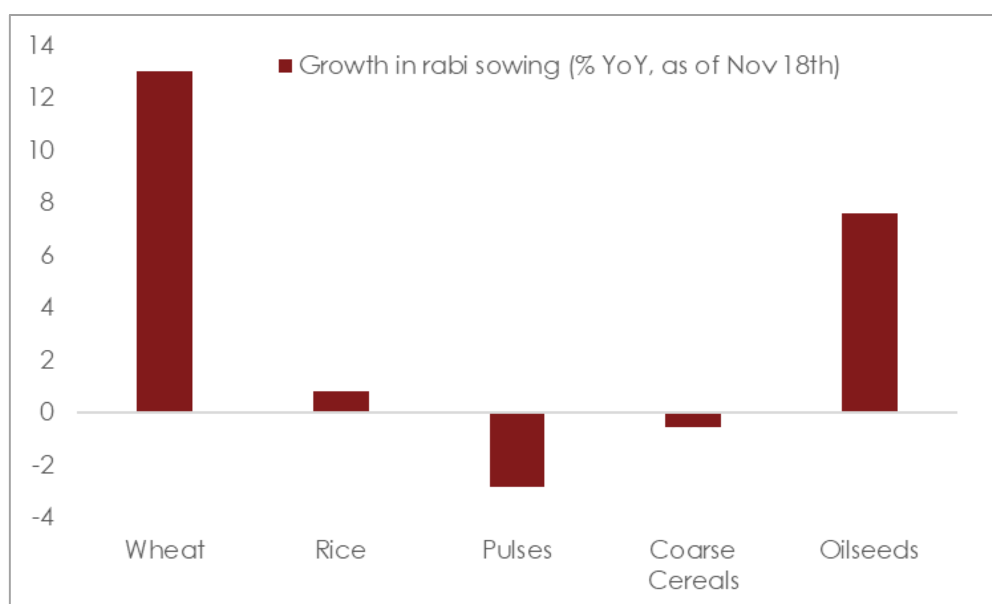
Although rupee has seen lower depreciation pressures in Nov-22, in line with most EM currencies, depreciation seen so far (9% on FYTD basis) would provide some upside to inflation, and thereby on bond yields. As per RBI's Monetary Policy Report, 5% depreciation in rupee on an average provides 20 bps upside to CPI inflation.

Having said so, we also acknowledge the emergence of factors that could push g-sec yields towards the lower end of our forecast range.

- Rabi sowing is progressing well backed up by good northeast monsoon rainfall and reservoir water storage levels. This would lower food inflation risk in the coming quarters.
- Central government's H2 FY23 borrowing calendar projected net borrowing requirement of Rs 6.18 tn, marginally lower than the implied budgeted target of Rs 6.28 tn. While modest, the improvement in the calendar rules out any additional dated borrowing towards the end of FY23.

Overall, we expect the upside and downside risks enumerated above to offset each other – as such, we see range bound movement to prevail in the remaining months of FY23, with 10Y g-sec yield expected to trade between 7.20-7.40%.

Chart 4: Pickup in rabi sowing augurs well for food inflation



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RATINGS & RESEARCH

Rupee

No respite from volatility yet

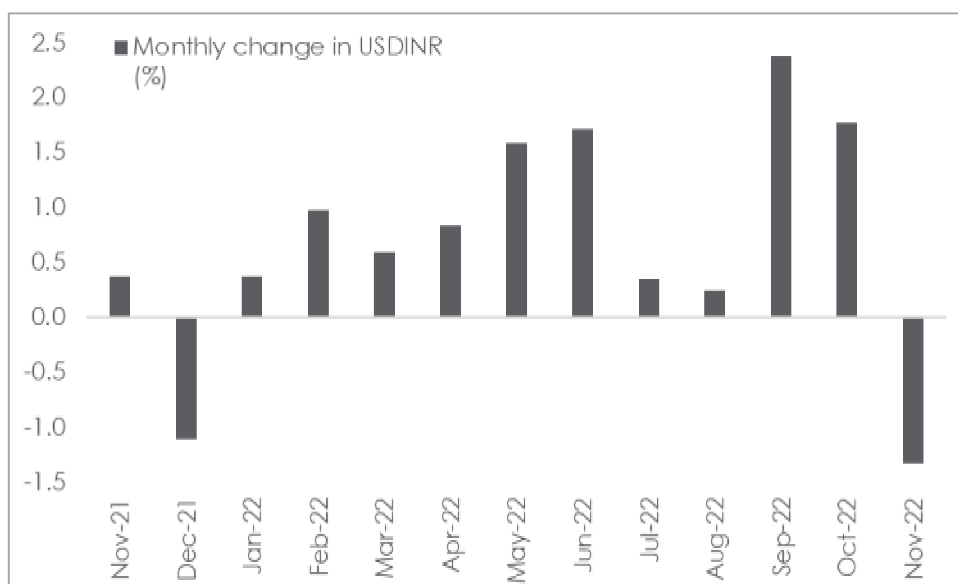
KEY TAKEAWAYS

- The rupee like most other currencies, continue to exhibit strong volatility.
- After depreciating to 82.78 in Oct-22 the Indian rupee had strengthened somewhat in Nov-22 but has again reverted to 82+ levels, highlighting the underlying pressure on the currency due to increased current account deficit.
- Key FX outcome of the current and the previous month is the tumble in the US dollar driven by expectations of Fed dialing down the pace of rate hikes which is reflected in the steady decline in the dollar index.
- For the near term, we suspect the durability of the correction in the dollar as expectations of terminal fed funds rate have moved up, QT continues to get rolled out in the US, and geopolitical risk remains elevated.
- On the domestic front, we believe BoP deficit could remain elevated in Q2 FY23 before it starts to moderate in H2 FY23 on account of recent softness in global commodity prices, respite from persistent portfolio outflows, and recent series of macroprudential steps undertaken by the RBI.
- While INR could continue to carry a moderate bias for weakness, we do ascribe a downside risk to our USDINR forecast of 84 before end Mar-23, given the expectation of a stability in a capital flows .

After depreciating to 82.78 in Oct-22, the Indian rupee had strengthened somewhat in Nov-22 but has again reverted to 82+ levels, highlighting the underlying pressure on the currency due to increased current account deficit.

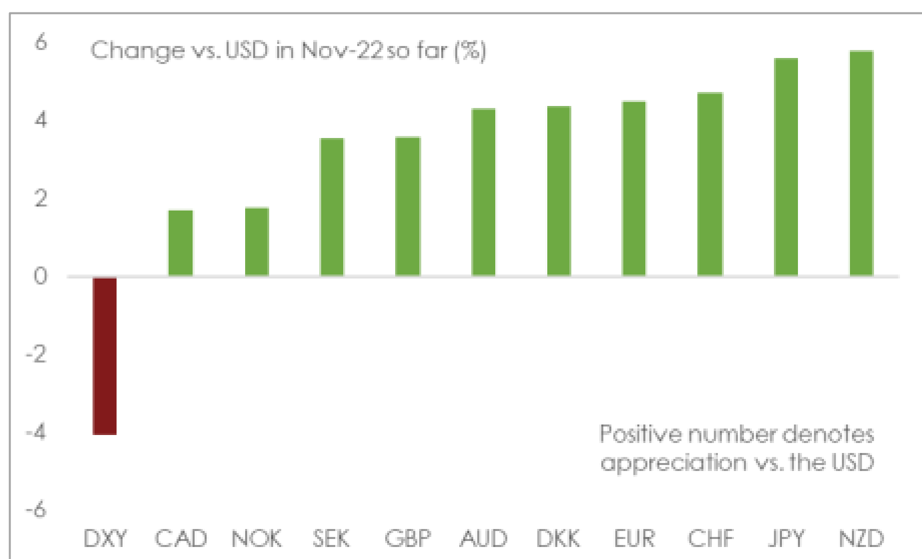
Indian rupee has cumulatively weakened by 11.3% in calendar 2022 so far (and by 8.9% on FYTD basis).

Chart 1: INR recorded its first monthly gain in 11-mths but gains reversed in Dec-22



Key FX outcome of the ongoing month is the tumble in the US dollar. To be sure, the DXY Index had started to ease somewhat post the Nov 2 FOMC outcome that gave a mixed signal. However, the release of softer than expected inflation print later in the month (for Oct-22) accelerated the selling pressure, with the US dollar emerging as the worst performing currency in G10 space.

Chart 2: USD has suffered a broad-based decline in G10 FX space



While the down move in DXY index has been swift, we are not convinced of its durability yet. Despite the correction seen in Nov-22, the DXY index is up by 11.5% in 2022 so far, driven by:

- US Fed's aggressive tightening of monetary policy via jumbo rate hikes (last 50 bps preceded by 4 consecutive FOMC meetings with 75 bps rate increase). Although market participants anticipate the Fed to prune its aggression further, expectations with respect to the terminal fed funds rate have moved up to 5.00-5.25% from 4.50-4.75% (as per the last dot plot provided in Sep-22).
- Going into 2023, the Fed will reduce its balance sheet by a further USD 1.1tn, way ahead of any other major central bank. A gradual mop up of global dollar liquidity would continue to support the USD.
- While a softer Fed profile will likely emerge towards the end of Mar-23, it would act as a necessary condition for a turn in dollar sentiment, rather than a sufficient one. Build-up of recessionary conditions in Europe and pressure on international commodity prices would weigh upon other trade dependent currencies.
- Last, but one of the least predictable, is the unsettled geopolitical risk premium. This could sporadically boost safe haven status of the USD.

On the domestic front, pressure on India's BoP has been persisting since Q4 FY22. Cumulative trade data for Apr-Nov of FY23 shows a significant expansion of the merchandise deficit to USD 198.4 bn vs. USD 115.4 bn seen in the corresponding period in FY22. The rising pressure on merchandise trade deficit is due to a confluence of four factors:

- Ongoing sequential recovery in domestic growth along with pent-up demand is supporting imports.
- The geopolitical crisis continues unfettered dampening world trade volumes. This has been manifesting in marked slowdown in India's exports in recent months.
- In the near term, a marginal adverse impact on exports is also on account of the recently imposed restrictions by the government in case of select commodities. We note that some of these have started to get reversed (the government scrapped export duty on steel and iron ore) and would benefit exports in the coming months.
- Individual cases of persistent supply disruption (in case of import of Vegetable Oils, Coal, etc.) and sudden spurt in demand (in case of import of Silver on account of substitution effect vis-à-vis gold and its rising demand on for green infrastructure) is also seen to be playing a role.

Having said so, we do foresee some moderation to our FY23 current account deficit projection of USD 130 bn after taking into account continued softness in commodity prices and some traction in services exports (India posted its largest services trade surplus of USD 11.9 bn in Sep-22).

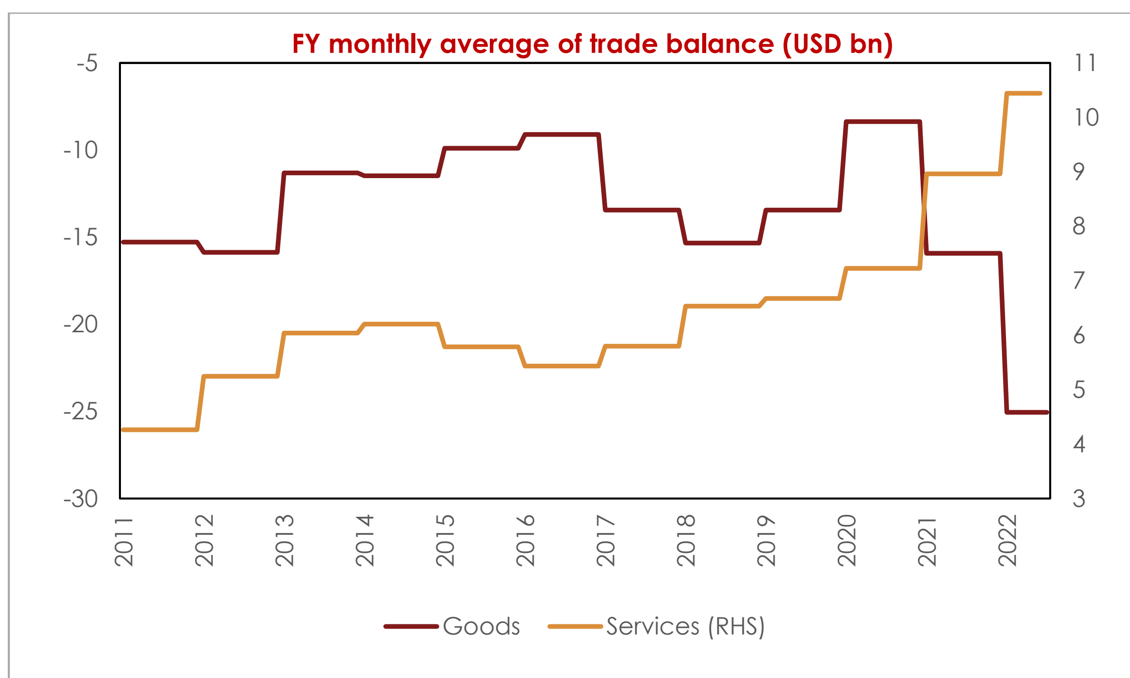
As such, the size of BoP deficit could sequentially moderate in H2 FY23 vs H1 FY23.

- Prospects of a global hard landing coupled with Zero Covid policy in China would keep a lid on commodity prices.
- Portfolio flows seem to have turned positive after consistent selling over Q3 FY22 and Q1 FY23. After recording a net inflow of USD 7 bn in Q2 FY23, portfolio flows have clocked USD 3.3 bn in Q3 FY23 so far.
- Recently announced macroprudential measures by the RBI to augment capital inflows in the near term could offer a mild reprieve (NRI deposit inflow improved somewhat to USD 2.4 bn in Q2 FY23 from USD 0.4 bn in Q1).

While this could help in moderating the pressure in BoP deficit in the coming quarters, INR could continue remain to carry a depreciation bias as (i) exchange rate adjustment would be a natural stabilizer for widening of current account deficit, and (ii) excessive use of FX reserves to curb depreciation pressures amidst the backdrop of broad-based dollar strength would increase INR's real effective overvaluation vis-à-vis peers.

Having said so, we do ascribe a downside risk to our USDINR forecast of 84 (before end Mar-23) as the recent strength in USD and CNY has improved FX risk appetite supported by signs of a peak out of inflation in US as well as in India.

Chart 3: While monthly trade deficit rate is widest on record, so is the services surplus



Global Overview

A difficult year lies ahead

KEY TAKEAWAYS

- Lingering geopolitical hostilities, aggressive and synchronized rate tightening in a bid to lower inflation to tolerable levels, are clearly weighing on global growth incrementally.
- This deepening slowdown was captured by Oct-22 PMI, with both manufacturing and services indices contracting at a faster pace in the month. The JP Morgan Global Composite Output Index slipped further to 48.0 in Nov-22 and 49.0 in Oct-22 compared to 49.6 in Sep-22.
- In its latest report prepared for the G-20, IMF highlighted that recent high frequency indicators confirm that the global outlook is gloomier. The challenges that the global economy is facing are immense and weakening economic indicators point to further challenges ahead.
- Consumer price inflation remains high across economies, though early signs of easing have emerged in some economies especially in the US and select EMEs such as Brazil, Russia, Thailand and China.
- Given these growth-inflation dynamics, central banks have already started to dial down on rate hikes. It may not be an end to the rate hiking cycle, but more like 'taking stock' of the impact of cumulative past hikes on the economy.

Global overview

Lingering geopolitical hostilities, aggressive and synchronized rate tightening in a bid to lower inflation to tolerable levels, are clearly weighing on global growth incrementally. This deepening slowdown was captured in Oct-22 PMI, with both manufacturing and services indices contracting at a faster pace. As such, the JP Morgan Global Composite Output Index slipped to 49.0 in Oct-22 compared to 49.6 in Sep-22. This marked the third consecutive month of contraction at its fastest pace since Jun-20 i.e., post COVID outbreak. A faster contraction in demand in Oct-22, weighed on global private sector output even as both input and output price inflation eased to 19-month lows. Additionally, the Global PMI manufacturing eased to a 29-month low of 48.8 in Nov-22 with contraction recorded in China, US, Euro area and Japan. On the other hand, India once again remained the top country to have recorded highest PMI manufacturing reading at 55.7 in Nov-22.

In its latest report prepared for the G-20, IMF highlighted that recent high frequency indicators confirm that the global outlook is "gloomier". The challenges that the global economy is facing are immense and weakening economic indicators point to further challenges ahead.

Consumer price inflation remains high across economies, though early signs of easing inflation have emerged in some economies especially in EMEs such as Brazil, Russia, Thailand and China (owing to easing global commodity prices and supply chain bottlenecks). US CPI inflation too softened to 7.1% YoY in Nov-22 and 7.7%YoY in Oct-22 from 8.2% in Sep-22. The inflation in Eurozone as well as UK has also moderated albeit it remains relatively high at 10.1% and 10.7% on annualized basis in Nov-22 respectively. Global commodity prices traded in a tight band in Oct-22 and Nov-22 as slowing global growth dampened demand despite war in Ukraine providing an upside.

Given these growth-inflation dynamics, central bankers have initiated a dial down on pace of rate hikes. It may not be an immediate end to the rate hiking cycle, but more like 'taking stock' of the impact of cumulative past hikes on the economy. As growth slowdown increasingly becomes more palpable, slipping into a recession for some economies in 2023, terminal rates may well be in near sight perhaps hitting a peak in Q1-23. However, all in all, trajectory of inflation and its persistence will remain a major determinant of central bank moves.

US

The most encouraging macroeconomic development in the US, was the relief on consumer inflation in Nov-22 for both consumers and policymakers. The headline CPI inflation rose only 0.1%MoM, below consensus expectation of 0.3%, allowing annualized inflation to ease to 7.1% from 8.2% in Sep-22 – to mark the lowest pace of inflation in three quarters. Core inflation, also rose a more muted 0.3% as core goods prices eased amidst waning supply chain constraints but were offset by core services prices rising at a faster clip. On the heels of CPI, headline PPI prices also rose less than expected in Nov-22, with headline PPI inflation easing for the fifth consecutive month, albeit at a still elevated level of 7.4%.

On the activity side, underscoring the resilience in consumer demand, total retail sales increased more than expected by 1.3%MoM in Oct-22, though boosted in part by a strong jump in motor vehicles & parts and gasoline. Nevertheless, stronger growth augurs well for the upcoming holiday season demand, with Atlanta Fed GDP Now model currently forecasting Q4 GDP growth at a healthy 4.2%YoY. Nov-22 Non-farm payrolls employment was also a strong report yet again, with the US economy continuing to add workers at a rapid pace. Employers added 263K net new jobs in Nov-22 to beat consensus expectation of 200K gain by a wide margin. Job gains were fairly broad-based across sectors, and the report underscores a tight labor market.

In contrast, industrial production slipped 0.1%MoM in Oct-22, as muted rise in manufacturing was offset by decline in mining and utilities output. Manufacturing activity remains on a somewhat weaker footing amidst waning global growth backdrop, rising interest rates and a stronger Dollar. In addition, housing market too displayed tardiness, with housing starts recording yet another drop in Oct-22.

On balance, recent economic indicators support resilience in the US economy so far in Q4, though headwinds from elevated inflation, tightening monetary policy and heightened global uncertainty remain in place. This stronger-than-expected economic performance makes the Fed's job of taming inflation that much more difficult. In its Nov-22 FOMC policy, in addition to the widely anticipated decision of lifting the target range by 75 bps, for the first time the Fed indicated that it will consider cumulative degree of tightening and its lagged impact on future course of rate actions. This has led to expectations of Fed going somewhat slower on rate hikes (and in magnitude too) in the near future.

UK

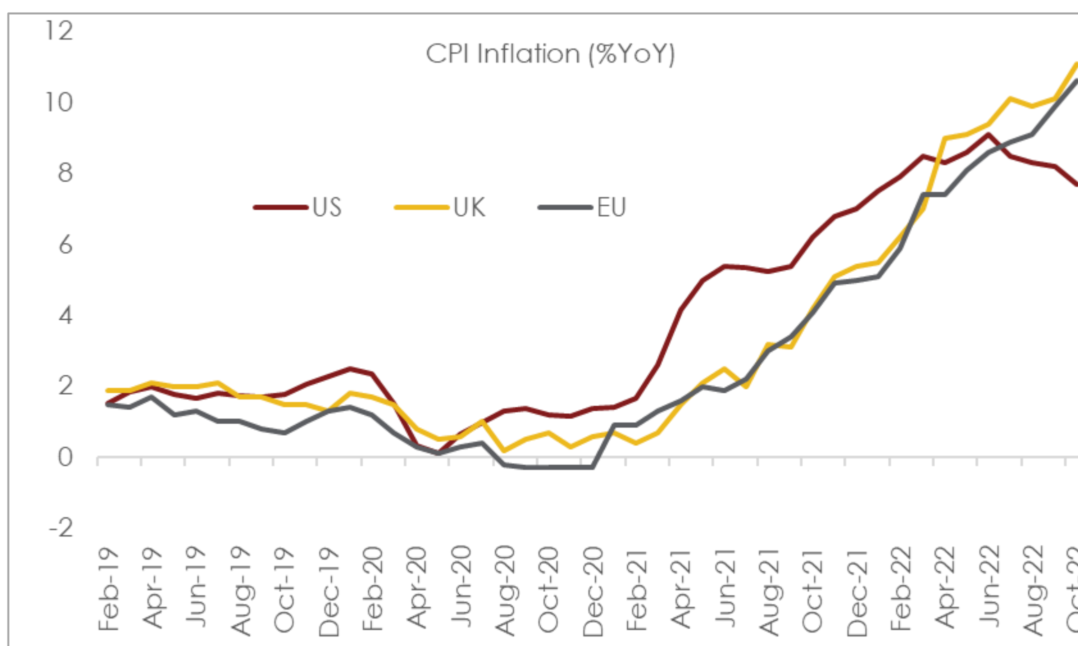
In UK, inflation moderated slightly to 10.7% YoY in Nov-22 after soaring in Oct-22, to a level of 11.1% YoY i.e., the highest in 42- years. At a granular level, energy costs remained the culprit, with electricity, gas and other fuel categories (put together) contributing to the rise. While the government has announced an energy price cap for all households for a period of at least six months starting from Oct-22, higher wholesale energy prices will nonetheless still be at least partly passed on to consumers. Meanwhile, core inflation reduced somewhat to 6.3%YoY, but nevertheless stubbornly elevated.

According to the preliminary estimate by the Office for National Statistics (ONS), Q3 GDP growth fell by 0.2%QoQ – to mark the first contraction after five quarters of consecutive growth. This contraction was mainly owing to higher levels of destocking in manufacturing and retail sectors. The decline in household consumption due to the rise in the cost of living, was fully offset by the strong upturn in public spending. Also seen was a recovery in gross fixed capital formation, driven single-handedly by public investments while private investment contracted in the quarter. In addition, external trade contributed positively to GDP growth owing to a drop in imports while exports grew strongly.

In his recent Autumn statement, Jeremy Hunt, UK's finance minister acknowledged the possibility of the economy slipping into a recession in 2023. As per the Office of Budget Responsibility (OBR), UK GDP growth is now projected to contract by 1.4% in

2023 compared to a projection of 1.8% growth in its previous outlook published in Mar-22. In his statement, Hunt unveiled a plan for "stability, growth and public services" which is intended to support household purchasing power with targeted support of GBP 26 bn. The plan also includes a budget consolidation of GBP 55 bn by 2027-2028, split between tax hikes and public spending savings to ensure the sustainability of public finances.

Chart 2: US leading the moderation in consumer inflation with Eurozone and UK lagging



Eurozone

Eurozone registered an unexpected 0.2% QoQ expansion in Q3 GDP. Upside was led unsurprisingly by Spain, Italy and France as tourism rebounded, accompanied by stronger growth recorded in Germany as well.

However, the strength in economic activity has not continued into Q3. The composite PMI for the region, fell to 47.1 in Oct-22 to mark the lowest level in nearly 2 years. In addition, European Commission's economic sentiment indicator fell in Oct-22 for the eighth consecutive month. Recessionary fears for the economy have gathered pace, with likely contraction in GDP in Q4 itself, amidst soaring energy prices, ECB tightening and dimming global growth outlook.

Inflation in the region moderated only slightly to 10.1% in Nov-22 after a peak of 10.6%YoY in Oct-22. CPI core inflation also rose to 5.0%YoY, up 20 bps compared to Sep-22 level. The highest contribution to headline inflation came from an outsized magnitude of energy price increase, along with price pressures in food, alcohol & tobacco, services and non-energy industrial goods.

On the consumer side, high frequency indicators have been somewhat holding up, though likely to see moderation in the coming months. Despite budgetary support to alleviate energy bills in most countries, higher interest rates and inflation remain non-supportive of consumption. Eurozone retail sales rose 0.4%MoM in Sep-22, to match market expectations while sales from prior month were revised upwards. On a country

level basis, sales rose in Germany (0.9%), France (0.2%) and Spain (0.2%), but dipped in Italy (-0.1%). Despite the rise in Sep-22, for the quarter retail sales dipped by 0.7%QoQ.

In its Oct-22 monetary policy, ECB hiked by 75 bps. Contrary to previous two hikes in Jul-22 and Sep-22, the size of the rate hike was supported by all ECB members. Additionally, ECB announced changes to the current TLTRO (Targeted long term refinancing operations) in terms of applied interest rate and earlier repayment dates. This marks the sharpest and most aggressive hiking cycle in history of 200 bps in slightly more than 3 months.

The ECB is likely to maintain the pace of rate increases amidst likely inflation upside. In his recent comments, Robert Holzmann, head of the National Bank of Austria and member of the ECB's governing council, backed a third straight 75 bps rise in the deposit rate at the next rate-setting meeting in mid-December. Echoing similar sentiment, Christine Lagarde, at the European Banking Congress recently said that "We expect to raise rates further and withdrawing accommodation may not be enough." She added that the Bank intended to bring inflation down "in a timely manner", adding that "how far we need to go, and how fast, will be determined by the inflation outlook".

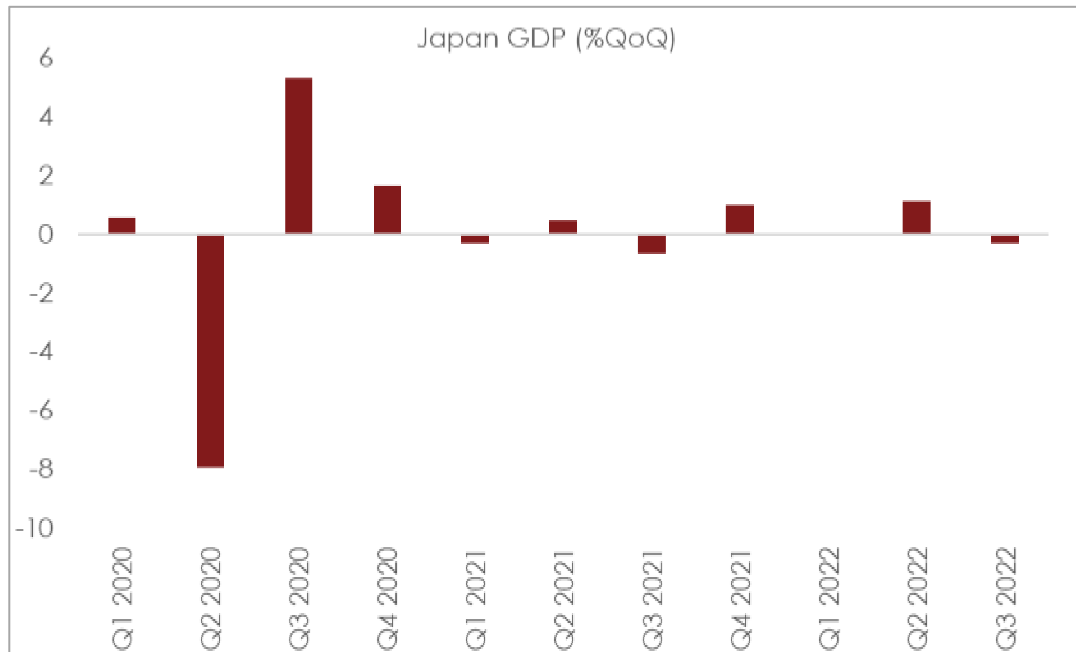
JAPAN

Japan's economy shrank for the first time in four quarters in Q3-22, hit by higher inflation and a weaker yen. The quarter had also witnessed a sizeable Covid wave, that too is likely to have weighed on growth momentum. As such, GDP growth shrank by 0.3%QoQ, translating into a contraction of 1.2% on an annualized basis compared to a growth of 4.6% in Q2. This was in contrast to consensus expectations pegging GDP to grow by over 1.0%QoQ in the quarter. Higher prices for commodities, a moderate increase in Japanese inflation along with a weaker yen weighed on consumption while driving imports higher in the quarter.

In comparison to most other advanced economies, Japan's inflation is much more contained, although local inflation is elevated by recent historical standards. National headline CPI inflation quickened to 3.7%YoY in Oct-22. Meanwhile, core inflation accelerated to 3.6%YoY. This metric of inflation has been above the Bank of Japan's target of 2% for seven months now. After the data release, BoJ Governor Kuroda said the recent acceleration in inflation is significant and prices could rise further. However, the BoJ expects price growth to fall back below 2% next fiscal year, which means raising rates is not appropriate for the time being.

Looking ahead, Japanese government's proposed stimulus package should help support the economy in the coming quarters and absorb some of the higher energy costs for households and firms. The reopening of economy to tourism should also be an added support, while there do remain downside risks from rising price of goods and fear of another COVID wave. After seeing a lull in infections in mid Oct-22, COVID case numbers are once again on a rebound in recent weeks with nationwide daily tally of ~85k (7-day moving average).

Chart 4: Japan's economy witnessed an unexpected sequential contraction in growth in Q3-22



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