Acuité RATINGS & RESEARCH

October 2022

Macro Pulse Report

Contents

From the desk of the Chief Analytical Officer

As we step into the winter months (literally), the **twenty second edition of Acuité Macro Pulse (Oct-22)** is ready for release. We highly recommend this comprehensive monthly publication on the Indian and global macroeconomic scenario to bankers, corporate treasurers, policy makers and researchers, given the depth of its coverage.

Indian economy stands at an inflexion point today. The high frequency economic indicators provide mixed signals, leading to differences in near term economic outlook among economists. While private consumption has picked up fairly well in H1FY23 with increased dilution of the Covid threat, normalization of mobility and pent-up demand in the transport and the hospitality sector, FMCG and two-wheeler volumes continue to reveal an underlying weakness which is linked to fragile rural demand. PMI print in both manufacturing and services have remained well entrenched in the expansion zone although exports have seen a slowdown due to the global headwinds. As on the third week of October, the banking system credit growth YoY continued to move to higher levels and stood at 17.9% YoY which indicates a clear pickup in retail and SME loans apart from higher working capital requirements in corporate segment.

Balancing the continuing global risks and domestic support factors such as festive season demand, an expected healthy kharif output despite an inconsistent monsoon, capex-oriented government expenditure and softness in global commodity prices, we have revised our FY23 GDP growth forecast only slightly to 7.0%.

The biggest uncertainty before not just the Indian but the global economy is 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 4.0% after the 75 bps raise in early Nov'22 and may be closer to 5.0% in another three months. On the domestic interest front, MPC is expected to raise rates again in Dec'22 although the quantum of hike is uncertain and can be between 35-50 bps, taking the repo rate to 6.5%. The headline CPI inflation print is however set to moderate in the current and the next quarter, given the seasonal dip in food prices and the steps that the Government has continued to take to address overheating of commodity prices. Therefore, a pause in rate hikes is the most likely scenario after Dec'22. 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.

The transmission of higher interest rates to the end borrowers in India has only taken place to a partial extent. Bank deposit rates have seen an increase of 60-100 bps since the start of the rate upcycle whereas the repo rate hike stands at 190 bps and is set to go up further. Further, the incremental credit ratio has reached very high levels and the liquidity in the banking system has clearly become tighter. This implies that banks will need to raise deposit rates by another 100-150 bps over H2FY23 to address the funding gap that has started to arise in the banking system.

So banks have to start preparing for the intensifying competition for deposits…some ads offering special rates are already visible.

Cheers,

Suman Chowdhury
Chief Analytical Officer

Growth

FY23 growth revised slightly lower to 7.0%

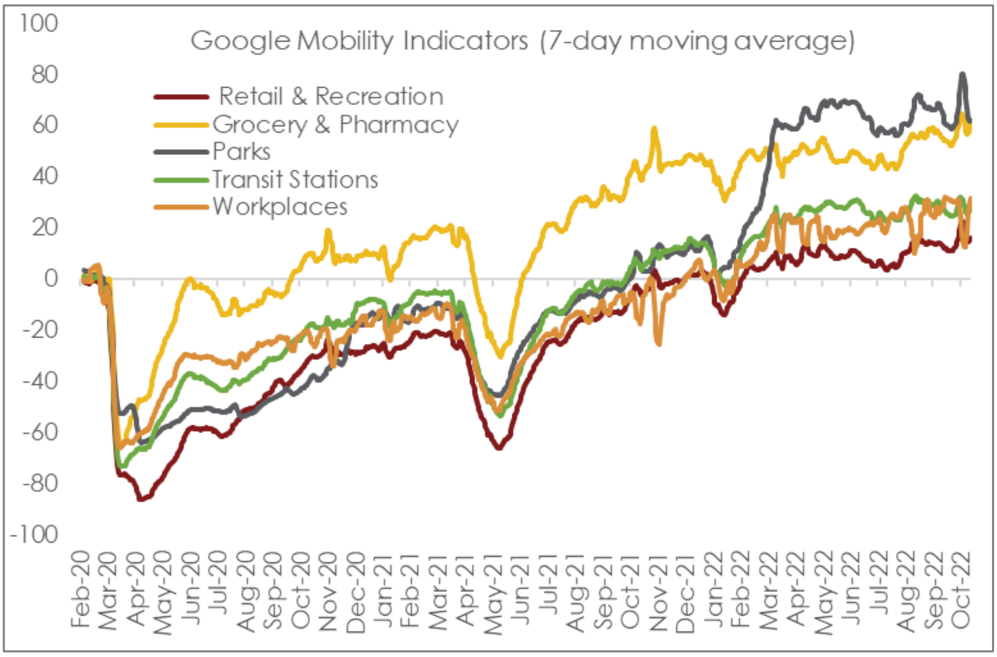
KEY TAKEAWAYS

- India's growth impetus continues to remain somewhat supported, by the onset of the festive season – the first normalized celebrations in nearly 3 years.
- This offers a positive fillip to economic activity which is looking increasingly at risk in a global backdrop marred by geopolitical uncertainty, tight financial conditions, and persistence of supply chain bottlenecks.
- However, not all lead indicators reflect the same narrative. At a granular level, there is a growing divergence in the pace of incremental performance of various high frequency indicators of economic activity.
- Looking ahead, on annualised basis, as the favourable statistical effect tapers, incremental GDP growth is expected to decelerate over Q3 and Q4 of FY23.
- Balancing the continuing global risks and domestic support factors such as festive season demand, an expected healthy kharif output despite an inconsistent monsoon, capex-oriented government expenditure and softness in global commodity prices, we have revised our FY23 GDP growth forecast only slightly to 7.0%.

India's growth impetus continues to remain somewhat supported, more recently by the onset of the festive season – the first normalized celebrations in nearly 3 years. This offers a positive fillip to economic activity which is looking increasingly at risk in a global backdrop marred by geopolitical uncertainty, tight financial conditions, and persistence of supply chain bottlenecks.

However, not all lead indicators reflect the same narrative. At a granular level, there is a growing divergence in the pace of incremental performance of various high frequency indicators of economic activity.

Chart 1: Google mobility in Oct-22 rose to the highest levels amid the festive season



Latest data releases

At the sectoral level, despite the uneven distribution of monsoon, the Kharif season closed with near normal acreage. While we do not rule out a modest shortfall in the crop production and the resultant price pressure especially for cereals (i.e., wheat and rice), the downside in agriculture output is likely to be capped. A late withdrawal of monsoon and bountiful reservoir levels, along with the higher than previous year's hike in wheat MSP for 2022-23 season, augurs well for Rabi sowing and output.

The data on industrial activity is somewhat mixed with weak IIP data but relatively steady PMI data which continues to be in the expansion zone for the last 15-16 months. GST collections have also remained somewhat robust. Having said so, while the anticipated downside in exports amidst rising headwinds to global demand is likely to shave off some incremental GDP growth, the moderation in commodity prices stands to offer some respite to producers.

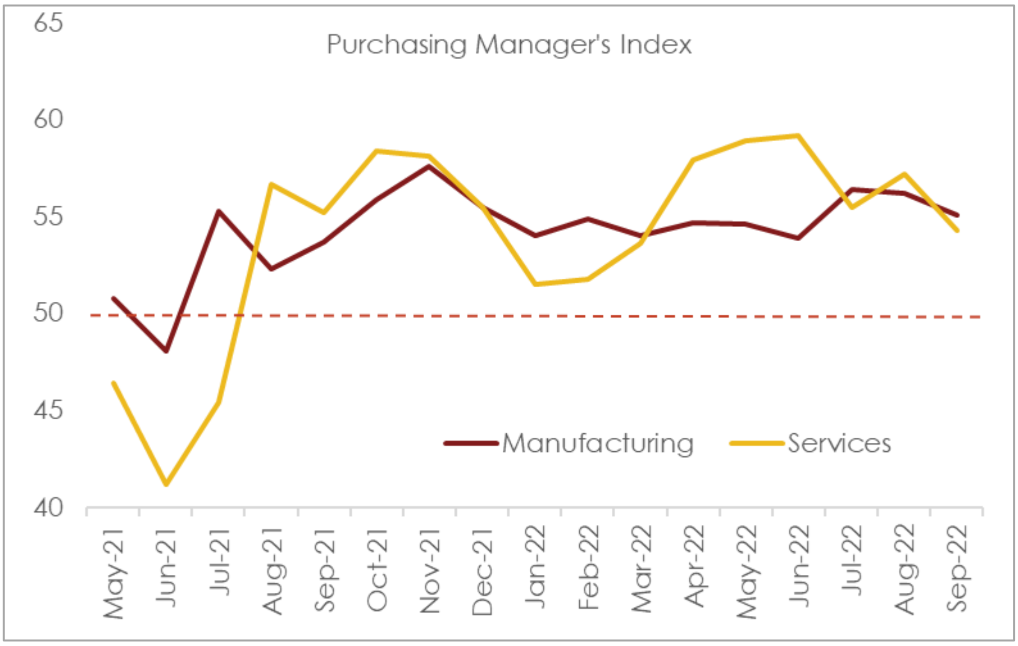
- Industrial production growth slipped into contraction of 0.8%YoY in Aug-22, to surprise market consensus expecting a positive outturn on growth (of 1.7%). This marked the first negative print in close to a year and a half. More so, growth for Jul-22 was revised lower by 20 bps to 2.2%. The deceleration was broad-based with significant drag seen in production of consumption-oriented sectors.

- Oct -22 PMI manufacturing remained broadly unchanged at 55.3 vs. 55.1 in Sep-22 moderating from 56.2 in Aug-22.
- On the other hand, GST collections recorded a robust growth of 26.2%YoY and stood at Rs 1.48 lakh cr in Sep-22, surpassing Rs 1.4 lakh cr for the seventh consecutive month.

In comparison, recovery in services sector continues to remain somewhat strong, though there are early signs of pent-up demand possibly on the wane. The withdrawal of the southwest monsoon has aided travel, hospitality and construction sectors. The onset of the festive season has pushed domestic mobility to a yet another post pandemic high, continuing to support the recovery in contact intensive services.

- E-way bills generation recorded an all-time high of 8.4 cr in Sep-22, on the back of increased economic and trading activity, compared to previous high of 7.8 cr matched in Aug-22 and Mar-22.
- PMI Services index improved to 55.1 in Oct-22 from 54.3 in Sep-22. As per the survey participants, sustained increase in new business boosted overall output.

Chart 2: PMI for both manufacturing and services eased in Sep-22



Outlook

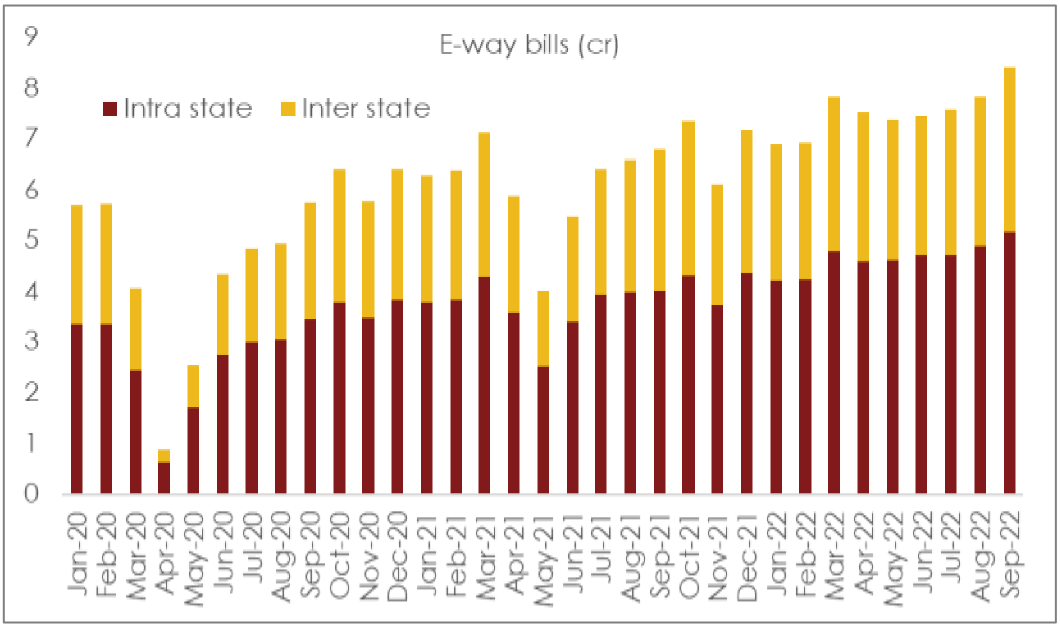
Some of the recent data adds do indicate a slowdown in the momentum of domestic growth, amidst the escalation of downside risks to overall economy owing to global factors.

On the expenditure side, the festive season led surge in urban demand seen in many sectors as per anecdotal evidence (air traffic, auto sales), along with the onset of Kharif harvest, extension of free foodgrain under the PMGKY up to Dec-22 and some price reductions announced for FMCG products augur well for a pickup in rural demand and overall consumption. Separately, Government's capital expenditure, having risen by a strong 49.5%YoY during Apr-Sep FY23 also remains supportive of investment growth.

Having said so, external support from exports is deteriorating as global demand conditions wane. Domestic exports in Sep-22 slipped further to USD 35.5 bn i.e., 16% lower compared to the recent peak of USD 42.2 bn in Jun-22. In its latest update to the World Economic Outlook report, the IMF 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 favorable statistical effect tapers, incremental GDP growth is expected decelerate over Q3 and Q4 of FY23. Considering the support from factors outlined above (such as festive season demand, delayed catch-up in Kharif sowing, expectation of a late withdrawal of monsoon, capex-oriented government spending, correction in global commodity prices) we continue to forecast FY23 GDP growth forecast at 7.0%, slightly moderated from the earlier 7.2% given the impact of incremental external risks.

Chart 3: E-way bills generated rose to a record high in Sep-22



Inflation

Is the worst behind?

KEY TAKEAWAYS

- India's retail and wholesale inflation showed a divergent trend in Sep-22. While CPI inflation inched up to a 5-month high of 7.41% YoY (from 7.00% in Aug-22), WPI inflation eased to an 18-month low of 10.70% YoY (from 12.41% in Aug-22).
- On annualized basis, the increase in CPI inflation was led by food & beverages, while the deceleration in WPI inflation was broad based.
- The ongoing disinflation in most international commodity prices is getting captured by WPI inflation – if the current trend persists, then WPI inflation could briefly touch negative territory in Q1 FY24.
- This makes us hopeful of expecting a decelerating trend in CPI inflation in H2 FY23 and beyond with support from gradual easing of global supply chain disruptions, a normal monsoon outturn, and imposition of price and quantity control measures by the government in case of select food items.
- However, depreciation in rupee, lower acreage in case of paddy and pulses, erratic rainfall in Oct-22, further extension of PMGKY, and a complete reflection of changes in electricity prices could impart upside risks.
- Overall, we see limited risks surrounding our FY23 CPI inflation average forecast of 6.7%.

Overview

India's retail and wholesale inflation showed a divergent trend in Sep-22. While CPI inflation inched up to a 5-month high of 7.41% YoY (from 7.00% in Aug-22), WPI inflation eased to an 18-month low of 10.70% YoY (from 12.41% in Aug-22). Notwithstanding the substantial drop of 593 bps in WPI inflation since its peak in May-22, CPI inflation has averaged close to 7% mark in the last 8-months. More importantly, since it has stayed above the policy threshold of 6% for three consecutive quarters now, the inflation targeting mandate has for the first time triggered a formal explanation (along with steps for course correction) from RBI to the Central Government.

Key highlights: CPI inflation

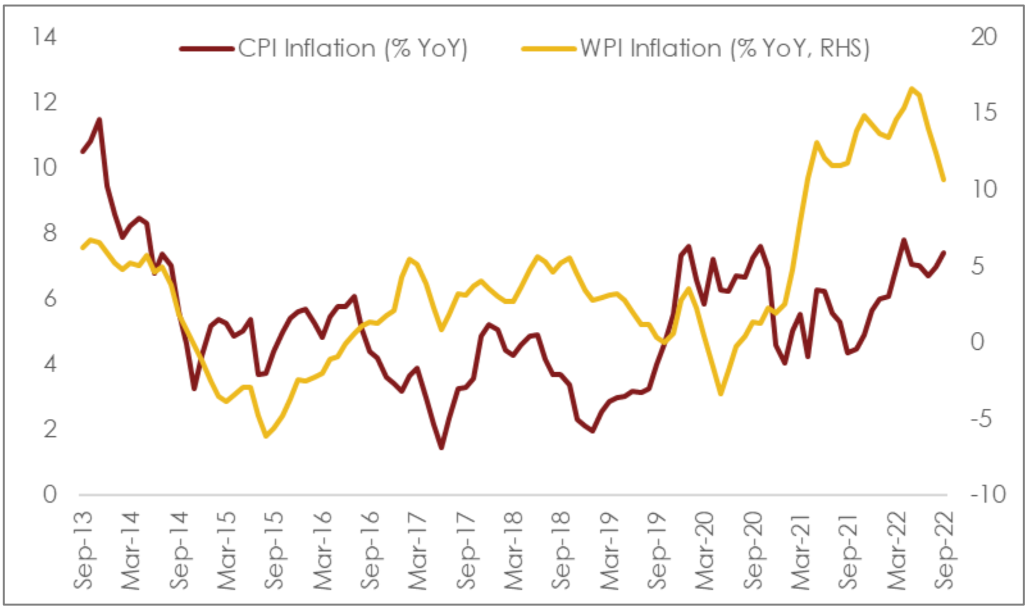
- On sequential basis, CPI momentum slightly firmed up in Sep-22 to 0.57% MoM, from 0.52% in Aug-22 and 0.18% in Sep-21.
- Momentum of Food and Beverages rose to 0.85% MoM in Sep-22 from 0.74% in Aug-22 and 0.06% in Sep-21. The upside was led by persistence of sequential price pressures in case of Vegetables (+2.62% MoM), Cereals (+2.00% MoM), Spices (+1.91% MoM), and Milk (+0.95% MoM), all of which saw a similar increase in the previous month. In addition, fresh build-up of price pressures was seen in case of Meat & Fish (+1.31% MoM) and Pulses (1.14% MoM).
- The near broad based nature of sequential price pressures in case of food reflects the impact of (i) lingering of wheat inflation due to a combination of a severe heat wave at the end of FY22/start of FY23 and global disruptions on account of Russia-Ukraine war, (ii) lower sowing in case of paddy and pulses in the current kharif season, (iii) 3-month extension of PM Garib Kalyan Yojana (Central Government's free foodgrain scheme), (iv) late withdrawal & unseasonal rains and (iv) spillover impact of elevated agri input prices.
- Consolidated fuel prices rose by a moderate 0.29% MoM, with bulk of the increase coming from 1.61% monthly increase in electricity prices even as retail prices for LPG, petrol, and diesel remained unchanged.
- Core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and pan tobacco and intoxicants) rose at a slower pace of 0.41% MoM in Sep-22 from 0.51% in Aug-22. Nevertheless, the annualized rate of core inflation continued to remain firm and range bound at 6.33% levels. .

Key highlights of WPI inflation

- On sequential basis, WPI posted its third consecutive monthly contraction, with Sep-22 index contracting by -0.65% MoM compared to -0.58% in Aug-22.
- The consolidated food & beverages index saw a sequential contraction in momentum, with a print of -0.46% MoM in Sep-22 vs. 1.04% in Aug-22. While cereals and vegetables saw buildup of price pressure, the same got offset by a decline in price for fruits and manufactured food items (likely on the back of the moderation in price of edible oils).

- The consolidated fuel & power index saw its third consecutive monthly fall with a print of -0.83% MoM in Sep-22 vs. -5.76% in Aug-22. At a granular level, the fall was led by decline in prices of Crude Petroleum & Natural Gas, Pet Coke, Naphtha, LPG, Kerosene, Furnace Oil, ATF, etc.
- Core inflation (non-food manufacturing) eased to a 19-month low of 7.0% YoY in Sep-22 from 7.9% in Aug-22 on the back of drop in sequential momentum to -0.23% MoM vs. -0.14% in Aug-22. The decline was led by drop in prices of Non-food Articles and Minerals within Primary Articles, and Basic Metals and Textiles within Manufacturing Items.

Chart 1: The sharp deceleration in WPI inflation bodes well for CPI inflation



Outlook

The ongoing disinflation in most international commodity prices is getting captured by WPI inflation – if the current trend persists, then WPI inflation could briefly touch negative territory in Q1 FY24.

This makes us hopeful of expecting a decelerating trend in CPI inflation in H2 FY23 and beyond. We also take comfort from the following factors:

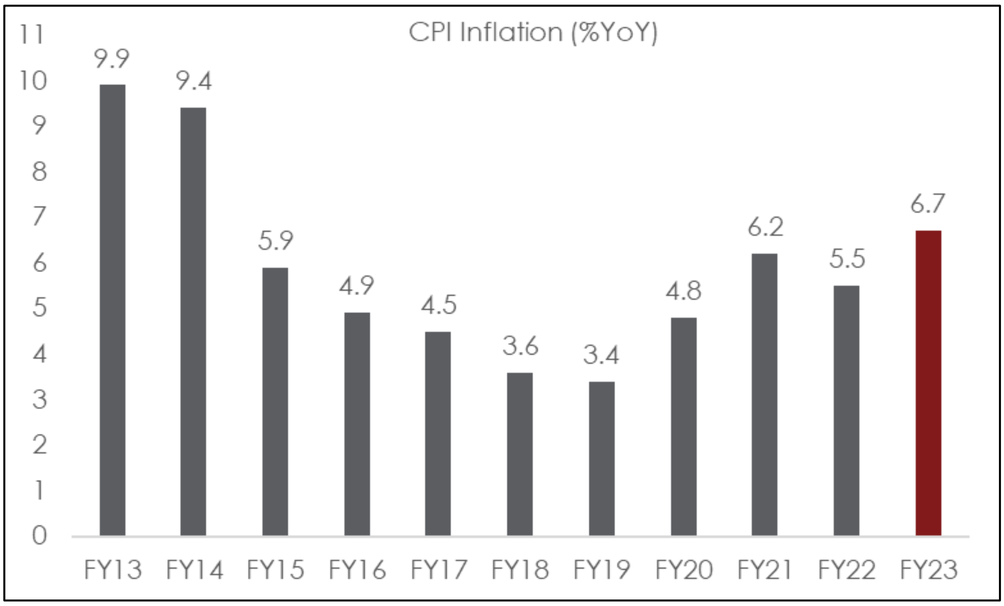
- The New York Fed's Global Supply Chain Pressure Index (GSCPI) moderated for the fifth consecutive month in Sep-22 to move closer to normal Levels vis-à-vis its history.
- At a headline level, southwest monsoon ended the season with a 6% surplus rainfall vis-à-vis the long period average. Barring lower acreages in paddy and pulses, this should be broadly supportive of food inflation.
- Government's administrative measures including the ban on exports of broken rice and imposition of 20% tax on export of non-basmati rice should help curb price pressures on the margin.

However, there are also risk factors that need a close watch:

- Erratic rainfall in the month of Oct-22 so far poses some challenges for arrival of early kharif produce. In addition, the extension of PMGKY (government's free foodgrain program for the rural poor) by another 3-months until Dec-22 could provide ancillary pressure on foodgrain inflation.
- Rupee weakness would increase the burden of imported inflation
- Impact of hike in GST rates on some items of mass consumption along with hike in electricity tariffs by state discoms is yet to be fully captured.

Overall, we believe risks surrounding our FY23 CPI inflation forecast of 6.7% are evenly balanced.

<u>Chart 2: For FY23, we hold on to CPI inflation estimate of 6.7%</u>



Government Finances

Capex prioritization amid tax buoyancy

KEY TAKEAWAYS

- India's central government fiscal deficit for the first half came in at Rs. 6.2 tn or 37.3% of budget estimates (BE) for FY23, slightly higher than the level of 33.2% of actuals in the corresponding period in FY22.
- The current fiscal theme continues to rest upon strong revenue receipt and prioritization of capital over revenue expenditure.
- Some fiscal headwinds have gathered momentum and are cumulatively adequate to potentially cause a modest slippage in the FY23 budgeted fiscal deficit ratio of 6.4% of GDP.
- Nevertheless, we continue to believe that the central government has fiscal 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 savings and rationalization and strong likelihood of higher than budgeted Nominal GDP base.

India's central government fiscal deficit for the first half of FY23 stood at 37.3% of budget estimates (BE) for FY23, higher than the level of 33.2% of actuals in the corresponding period in FY22. Higher accretion to H1 FY23 fiscal deficit this year is on account of faster pace of expenditure disbursal relative to the mobilisation of total receipts.

Receipts: Collection gathers momentum

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

- On FYTD (Apr-Sep basis, gross tax revenue clocked 50.5% of BE compared to 43.7% of actuals in the corresponding period in FY22.
  - Momentum was supported by healthy collection from income tax, GST, and corporate tax. We note that the impressive momentum in GST revenue continues to persist with total monthly collections averaging at Rs 1.49 lakh cr during Apr-Oct FY23 compared to the required monthly run rate of Rs 1.35-1.40 lakh cr for meeting the BE. Recent hike in GST rates for select goods and services and the festive heavy H2 FY23 would further help in maintaining the healthy run rate in the coming months.
  - Meanwhile, collections from customs and excise were lower in comparison. This is reflective of the relaxation in duties on select import items (including retail fuel) to provide relief from elevated inflation.
  - Although, looking at monthly fiscal data for signals could be misleading at times, we nevertheless note that gross tax revenue collection in Sep-22 rose to its highest level since Mar-19 recording a growth rate of 14.5% YoY after contracting by -7.7% YoY in Aug-22. While we are confident of tax collections exceeding budget targets by a fair margin, we would keep an eye on incremental developments for any signs of easing.

After lagging budget estimates for the first five months on account of lower than budgeted transfer of surplus by the RBI, non-tax revenue collections accelerated to 58% of BE during H1FY23 vs. 46.1% of actuals in the corresponding period in FY22.

- The government was able to generate Rs 1.5 tn from auction of 5G telecom spectrum. Out of this, the DoT received Rs 179 bn in the month of Aug-22. This provided a leg up to overall non-tax revenue collections.
- 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 sizeable hole in non-tax revenues.

Non-debt capital receipts clocked 43.1% of BE during H1 FY23 vis-à-vis 46.2% of actuals in the corresponding period in FY22. This predominantly reflects the disinvestment proceeds from LIC in May-22 that fetched Rs 205 bn to the central exchequer. In fact, the second quarter did not see any sizeable revenue generation from disinvestment activity by the central government.

Expenditure: Subdued revex accompanied by robust capex

Total expenditure disbursal stood at 46.2% of BE in H1 FY23, higher than 42.9% of actuals in the corresponding period in FY22.

- Momentum continues to be led by capital expenditure that clocked 45.7% of BE during H1FY23 vis-à-vis 38.7% 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.
- Revenue expenditure too firmed up to 46.3% of BE during H1 FY23 from 43.6% of actuals in the corresponding period in FY22.
    - Bulk of the heavy lifting in revex is being borne by interest payments and subsidies, which cumulatively had a share of ~87% in total revex disbursal in Sep-22.
    - Excluding interest payments and subsidies, revex contracted by 0.8% YoY during H1 FY23.

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" 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 lakh cr.
- Higher than budgeted subsidy bill (on account of the top-up of Rs 1.1 lakh cr), 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 20,000 cr as compensation for under-recoveries in FY23.
- Cut in excise duty on petroleum products that will have a revenue implication of close to Rs 85,000 cr 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 30,300 cr vs. the FY23 budget estimate of Rs 65,000-70,000 cr).

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:

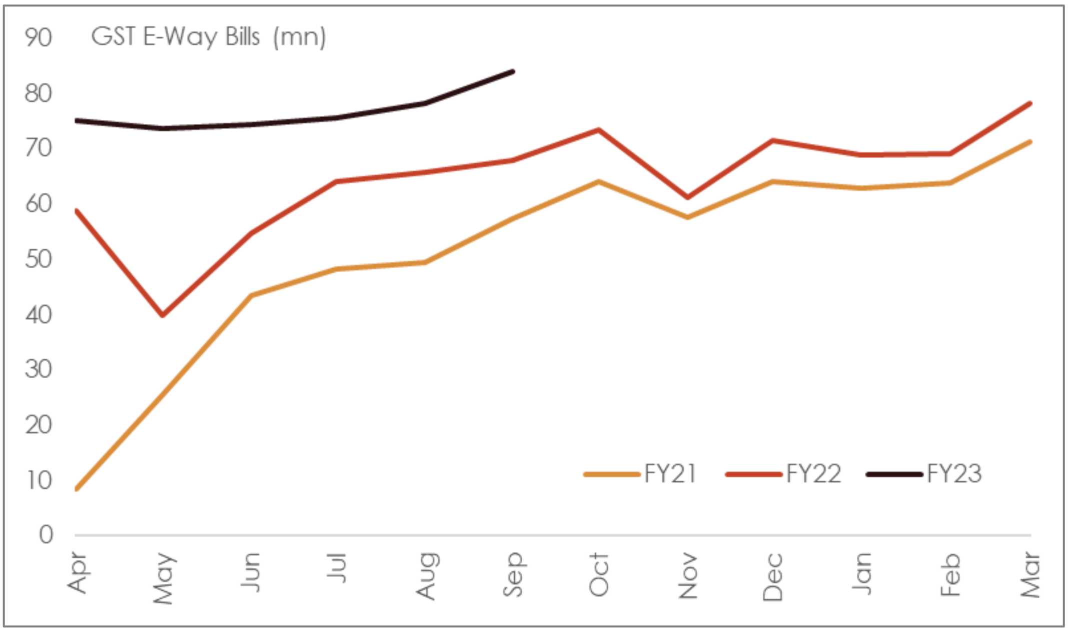
- Tax buoyancy continues to remain healthy. In addition, the recent increase in GST rate for select items, customs duty on gold imports, imposition of a windfall tax could offset some of the revenue loss from cut in excise duty on retail fuel items.
- The rollover of LIC IPO (garnering Rs 20,500 cr) has generated some divestment buffer.
- The government is likely to have saved Rs 20,000-30,000 cr due to lower than targeted procurement of wheat.
- Recently concluded 5G telecom auction has generated about Rs 15,000 cr 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)			
	% of Actuals	% of BE	Cumulative (INR bn)
Fiscal Variables	FY22	FY23	Apr-Sep'22
Revenue Receipts	49.9	53.1	3568.4
Net Tax	50.6	52.3	3075.9
Non-Tax	46.1	58.4	492.5
Non-Debt Capital Receipts	46.2	43.1	250.1
Total Receipts	49.8	52.7	3818.5
Revenue Expenditure	43.6	46.3	5857.74
Capital Expenditure	38.7	45.7	1054.22
Total Expenditure	42.9	46.2	6911.96
Fiscal Deficit	**33.2**	**37.3**	**2039.21**

Chart 1: GST E-Way bill generation continues to maintain a healthy momentum



Rates

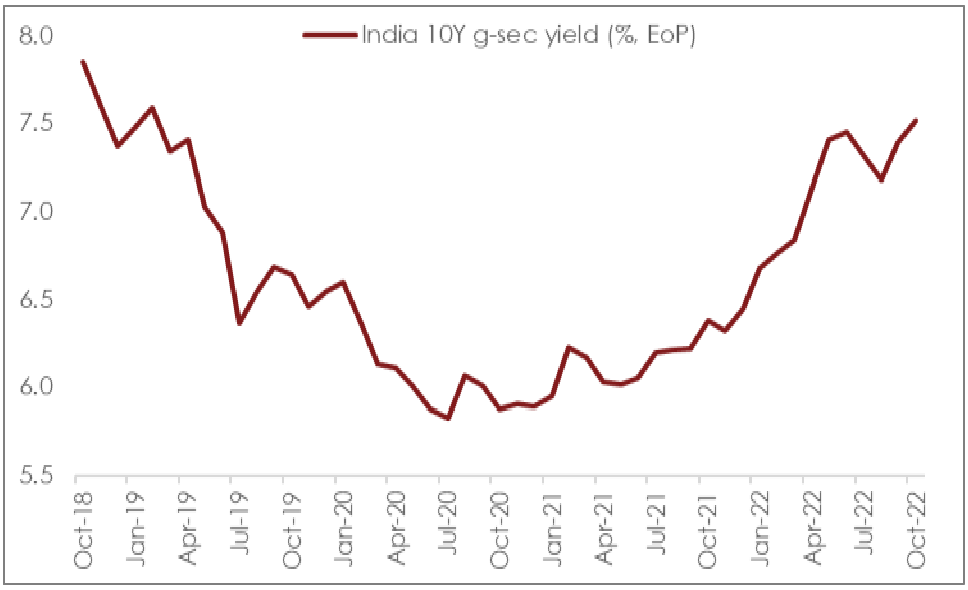
Despite risks, pressure seems moderate

KEY TAKEAWAYS

- After closing the month of Oct-22 at 7.45%, India's 10Y g-sec yield ticked-up further to 7.48% before moderating to 7.3%-7.4% by first week of Nov'22.
- With inflation yet to offer any sizeable relief in most countries, central banks persist with tightening of monetary policy with alacrity. Barring China, Japan, Russia, and Turkey, the tightening of monetary policy is not just accelerating, but it is also ubiquitous across DMs and EMs.
- The deferment of India's likely inclusion in global bond indices came as a mild sentiment dampener with erratic rains in Oct-22 fueling concerns over persistence of food inflation.
- Notwithstanding these pressures, rise in sovereign yields in case of India appears moderate compared to most other countries.
- Expectation of headline inflation reverting to the target band after two quarters, a potential split in MPC in favor of a likely pause, and a minor pleasant surprise in the H2 FY23 borrowing calendar seems to be partially offsetting the upside risks to yields.
- We, nevertheless, continue to expect RBI to deliver 35-50 bps hike in Dec-22 before opting for a pause.
- While we maintain our peak 10Y g-sec yield forecast of 7.6% for now, some upside risk cannot be ruled out on account of INR weakness and continued hawkish pivot of the Fed.

After closing the month of Oct-22 at 7.45%, India's 10Y g-sec yield ticked-up further to 7.48% before moderating to 7.3%-7.4% by first week of Nov'22. If yields sustain at these levels by the end of month, then it would be the highest level (on EoP basis) in last 44 months.

Chart 1: India's 10Y g-sec yield inching towards a 44-month high



The adverse global backdrop in the form of multi decade high inflation is yet to show signs of easing.

- Within the top 10 developed economies (by size of GDP), the median of latest annualized retail (CPI) inflation is currently at 7.6%, with three economies, viz., UK, Sweden, and Denmark, having double digit inflation at the moment.
- Inflationary pressures are far more acute at the producer level. Within the top 10 developed economies, the median of latest annualized PPI inflation is currently at 12.8%, with four economies, viz., Euro area, Sweden, Norway, and Denmark, having PPI inflation in excess of 25% at the moment.

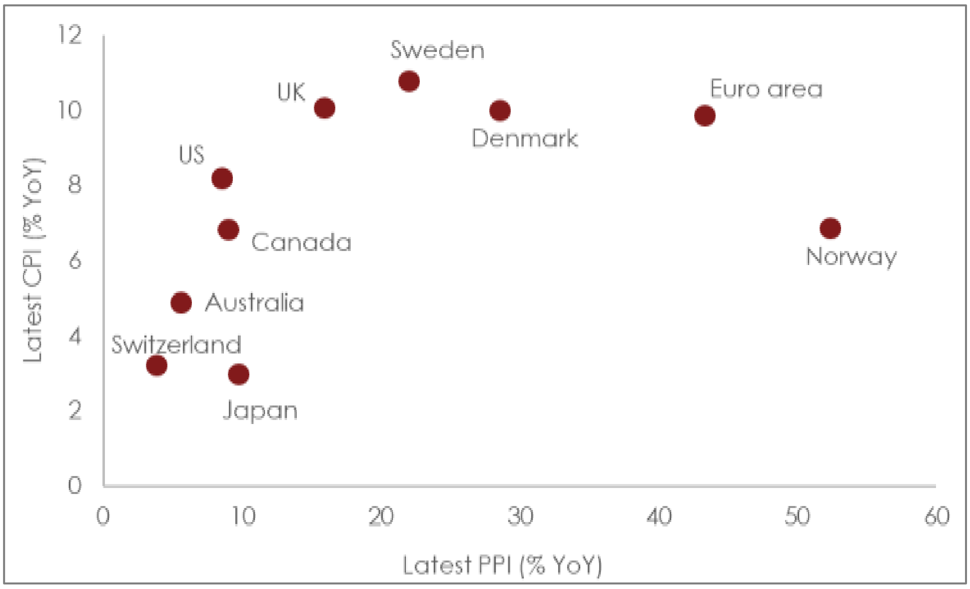
While headline CPI inflation has shown some tentative signs of peaking out in few economies, relief appears to be inconspicuous as either the inflation data surprises are still lying in positive territory, or core inflation continues to march ahead reflecting the pass-through impact and the runaway pressure on services inflation in general in almost every part of the world.

Given this alarming backdrop, central banks continue to tighten monetary policy with alacrity. Barring China, Japan, Russia, and Turkey, the tightening of monetary policy is not just accelerating, but it is also ubiquitous across developed and emerging economies.

- The Fed recently hiked the policy rate by 75 bps for the fourth consecutive time in the Nov-22 policy amidst the backdrop of high inflation and tight labour market. Importantly, the terminal Fed Fund rates are expected to be higher than Sep-22 policy projection of 4.6%. As such, we expect at least 50 bps rate hike by the Fed in Dec-22 policy review and wouldn't rule-out a 75-bps rate hike if inflation remains entrenched.

- With aggressive monetary policy in the US supporting the dollar (the DXY index is up ~18% in 2022 so far and close to its highest level since 2002), the implied exchange rate pressures for other countries could force further monetary tightening in response (Sweden, Norway, and UK being a prime examples in DM economies, where the krona, kroner, and pound have weakened by record 25%, 21%, and 17% on CYTD basis).

Chart 2: Inflation raging across economies



While the global inflation-cum-monetary policy headwind is undoubtedly providing an extreme adverse backdrop, recent specific developments have also not gone in favour of India's bond market.

- As highlighted in previous editions of Acuite Macro Pulse report, the months of Aug-Sep 2022 had seen significant frenzy with respect to market expectations regarding the possibility of India's inclusion in global bond indices. In fact, the 10Y g-sec yield had touched a low of 7.10% in the second week of Sep-22 on heightened expectations driving some degree of front running of market positioning. With maintenance of status quo (India on watch) by both FTSE and JPM indices, and the likelihood of the decision getting pushed to FY24, unwinding of market positioning drove the initial spike in domestic yields.

- The upward pressure on g-sec yields got compounded by:
    - Higher than expected print on CPI inflation for Sep-22 pointing towards likelihood of persistence of food price pressures due to erratic rains in Oct-22, which can also potentially disrupt the expected moderation in food inflation (on MTD basis, October has so far clocked an excess rainfall of 73% vs. the long period average, making it the most wet October in last 9-years).
    - Depreciation pressures making its forceful presence felt in case of rupee, especially since the breach of 80 levels (against the US dollar). We note that since USDINR breached 80 levels and weakened by 3.5% thereafter in a span of approximately four weeks, the 10Y g-sec yield rose by 28 bps in the interim. Sudden depreciation in rupee tends to impact domestic yields as it raises the spectre of imported inflation. As per RBI's

Monetary Policy Report (published in Sep-22), 5% depreciation in rupee on an average provides 20 bps upside to CPI inflation.

Outlook

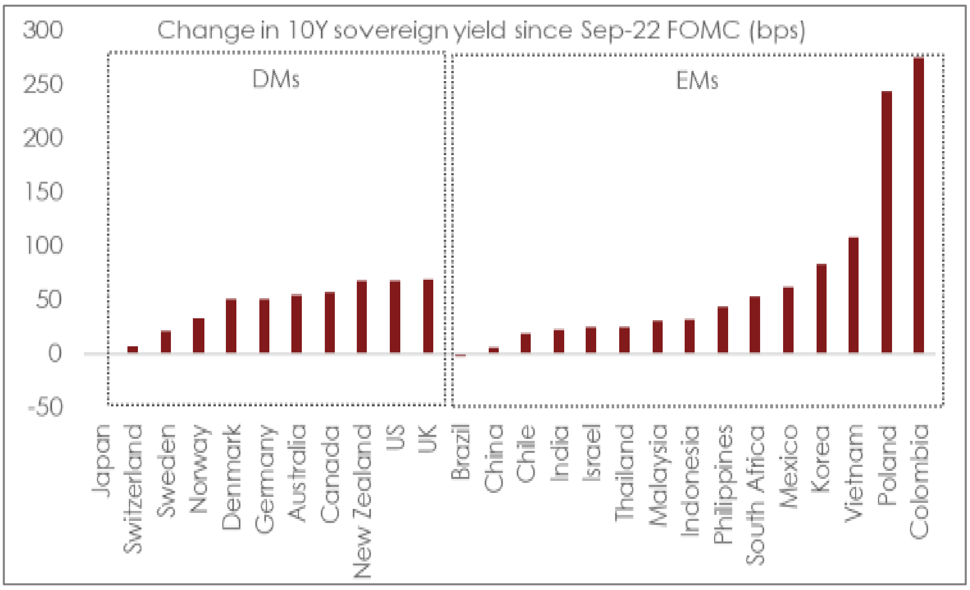
Notwithstanding the global as well as specific domestic pressures, the 10Y g-sec yield has risen moderately compared to moves seen in case of other countries. Since the Sep-22 FOMC announcement, 10Y sovereign yields in DMs have risen in the range of 0-70 bps, while in case of EMs, the range is between -2 bps to 275 bps – in comparison, India's 10Y g-sec yield has risen by 23 bps over the same period.

We believe the following factors are providing a partial offsetting impact:

- There is a general belief among policymakers and market participants that India's CPI inflation has peaked and is expected to revert to the target band soon. Estimates by the central bank and professional forecasters put retail inflation at 5.8% and 6.0% respectively for Q4 FY23 – the path thereafter seems to project further moderation. The anticipated comfort on inflation is stoking expectations of India's current monetary policy cycle being close to peak (a view shared by two external MPC members).
- Central government's H2 FY23 borrowing calendar projected net borrowing requirement of Rs 6.18 lakh cr, marginally lower than the implied budgeted target of Rs 6.28 lakh cr. While modest, the improvement in the calendar rules out any additional dated borrowing towards the end of FY23.

We continue to expect the RBI to hike repo rate by 35-50 bps in its upcoming policy review in Dec-22 and take a pause thereafter. While we maintain our peak 10Y g-sec yield forecast of 7.6% for now, some upside risk on account of INR weakness cannot be ruled out.

Chart 3: Despite multiple pressures, domestic yields have risen moderately



Rupee

Peripheral weakness to persist

KEY TAKEAWAYS

- After closing Oct-22 at a level of 82.77, the Indian rupee has marginally strengthened and is currently trading close to 81.70 levels.
- The dollar is expected to continue deriving support from aggressive monetary tightening in the US, ongoing quantitative tightening, along with geopolitical led risk aversion.
- On the domestic front, pressure on India's BoP has been escalating since Q4 FY22. We believe BoP deficit could remain elevated in Q2 FY23 before it starts to moderate in H2 FY23 on account of recent correction in global commodity prices, respite from persistent portfolio outflows, and recent series of macroprudential steps undertaken by the RBI.
- Nevertheless, INR could continue 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.
- We continue to expect further depreciation in rupee in FY23 with a potential peak of 84 to the USD in H2FY23 before a partial reversal by end Mar-23.

After closing Oct-22 at a level of 82.77, the Indian rupee has moderately strengthened to sub 81 levels. Overall the Indian rupee has weakened for ten straight months (something that has not happened since 1995) culminating into a depreciation of over 11.2% in 2022 so far.

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

The breach of the big figure 80 in case of USDINR happened soon after the Sep-22 FOMC that saw renewed monetary policy aggression by the US Fed, with revised dot plot projecting a higher path for terminal fed funds rate.

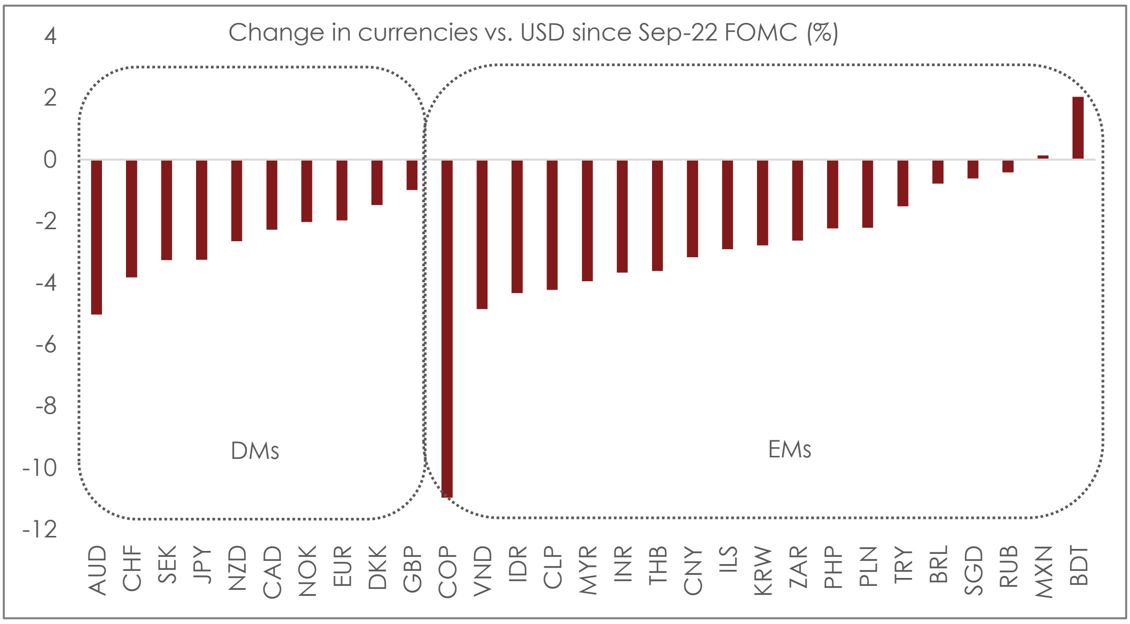
The concomitant sharp up move in the dollar spawned further volatility in the global currency market with monetary policy divergence vis-à-vis the US playing an active role. While we had been calling for broad based dollar strength for months in succession, the magnitude of impact is turning out to be greater than envisaged earlier.

- The FOMC in the Nov-22 policy review, raised the interest rates by 75bps for the fourth consecutive time to 3.75%-4.00%. Given the excessive tightness in the labour market along with persistently higher inflation, likelihood of terminal fed fund rates breaching the 4.6% (as per the dot plot Sep-22) has moved up considerably. Clearly, this is turning out to be the most aggressive rate hike cycle by the Fed since the Volcker era. Meanwhile, the ongoing unwinding of Fed's balance sheet is curbing global dollar liquidity and providing a supplementary tailwind to the USD.
- While monetary policy aggression in the US is spilling over to other economies, the combination of war related uncertainty with tightening of global financial conditions is threatening to expose currencies associated with higher debt and deficit levels in their respective economies. As such, the DXY Index (at around 110-112 levels) is currently trading at its strongest since 2002, has managed to offset the moderate comfort that would have ideally accrued to major EM currencies from the recent correction in global commodity prices.

FX spillover concerns for INR have unfortunately not been limited to the USD. Weakness in Chinese economy (on account of stress in real estate sector, policy interventions in certain new age service sectors, and continuation of Zero Covid policy) has prompted the PBoC for a calibrated monetary policy and liquidity easing, thereby creating additional pressure on CNY – which in turn amplifies the pressure on most other currencies having sizeable trade flow with China.

Seen from this perspective, the breach of 80 for USDINR, and the weakness thereafter does not seem excessive.

Chart 2: Despite record weakness, INR a moderate performer at a global level



On the domestic front, pressure on India's BoP has been persisting since Q4 FY22. Cumulative trade data for the first half (Apr-Sep) of FY23 shows a significant expansion of the merchandise deficit to USD 148.5 bn vs. USD 76.3 bn seen in the corresponding period in FY22. The rising pressure on merchandise trade deficit is a confluence of five factors:

- Ongoing sequential recovery in domestic growth along with pent-up demand is supporting demand for 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 very near term, a marginal adverse impact on exports is also on account of the recently imposed export restrictions by the government in case of select commodities. This could get reversed in the coming months.
- While most international commodity prices eased considerably in Jul-Sep 2022 on concerns over global slowdown, the impact is yet to completely show in India's trade numbers.
- 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.

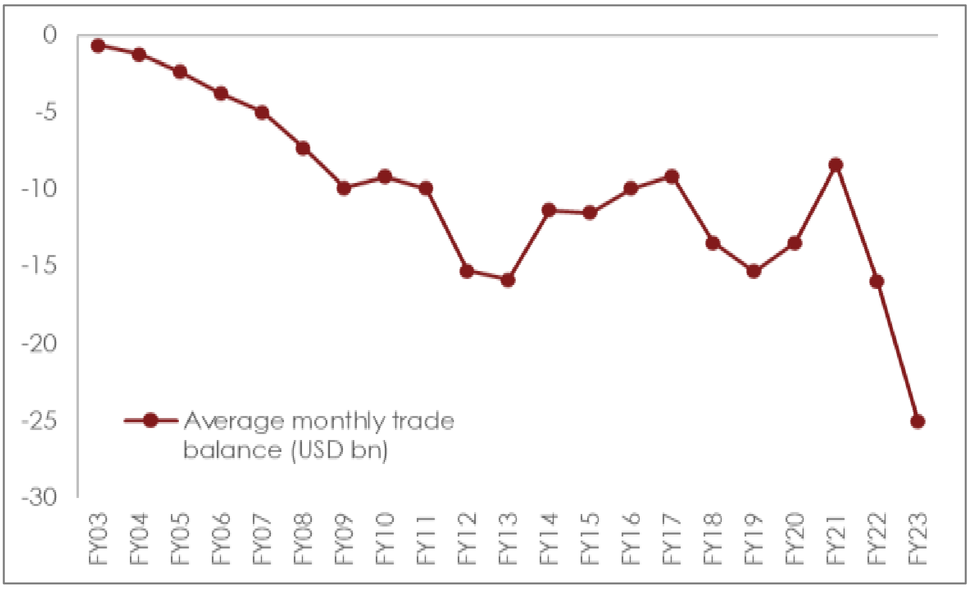
The monthly trade deficit prints could moderate in the coming months as impact of somewhat lower commodity prices (with CRB Index down 10% since its Jun-22 peak) trickle down and global supply chain pressures ease. Amidst buildup of exchange rate pressure, the government could also consider easing some of the administrative restrictions imposed on exports this year. This could pose a mild downside risk to our FY23 current account deficit projection of USD 130 bn, especially if rising global growth risks further weigh upon commodity prices. We also believe that the size of BoP deficit could sequentially moderate in H2 FY23 vs H1 FY23 as:

- 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 somewhat neutral after consistent selling over Q3 FY22 and Q1 FY23 (Q2 FY23 recorded an inflow of USD 7 bn).
- Recently announced macroprudential measures by the RBI to augment capital inflows in the near term could offer mild reprieve.

While this could help in moderating the pressure in BoP deficit in the coming quarters, INR could continue 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.

As such, we continue to expect further moderate depreciation in rupee in FY23 with a potential peak at 84/USD before end Mar-23. Having said so, the central bank can announce temporary steps (like oil swap window for oil importers, tightening of money market liquidity, etc.) to curb the pace of depreciation cannot be ruled out.

Chart 3: Monthly trade deficit is tracking 57% higher on average basis



Global Overview

Entered a slow lane

KEY TAKEAWAYS

- Global manufacturing PMI, contracted for the third consecutive to a 28-month low of 49.4 in Oct-22 from 49.8 in Sep-22 led by weaker intakes of new business, deteriorating international trade flows and lower business confidence. Reinforcing the possibility of impending slowdown in global growth, IMF in its latest WEO harped on three lingering effects – the Russian invasion of Ukraine, a cost-of-living crisis caused by persistent and broadening inflation pressures, and the slowdown in China.
- As per IMF's revised outlook, GDP growth for 2022 was left unchanged at 3.2%, but that for 2023 was lowered by 20 bps to 2.7% compared to Jul-22 forecasts.
- On the monetary policy front, following on the heels of the fourth 75 bps hike effected by the US Federal Reserve, Oct-Nov'22-22 have active months for EM and DM central banks. However, it appears that the pace of tightening is headed for a somewhat slower track given the worsening global growth outlook.
- Recent weeks have been testimony to heightened bout of volatility in global treasury markets. This has been on the back of fears of a recession, aggressive rate hikes from Fed and the intensification of market intervention in UK and Japan.

Global overview

Global manufacturing PMI, contracted for the third consecutive to a 28-month low of 49.4 in Oct-22 from 49.8 in Sep-22 led by weaker intakes of new business, deteriorating international trade flows and lower business confidence. The weakness was broad-based geographically with 18 of 31 economies tracked reporting a fall in production. The slowdown was however concentrated within emerging markets. Encouragingly, India's PMI manufacturing recorded the highest expansion amongst the 31 economies tracked by IHS Markit The downside in PMI reflects the impact of the energy crisis and the tightening of financial conditions on activity and expectations in DMs.

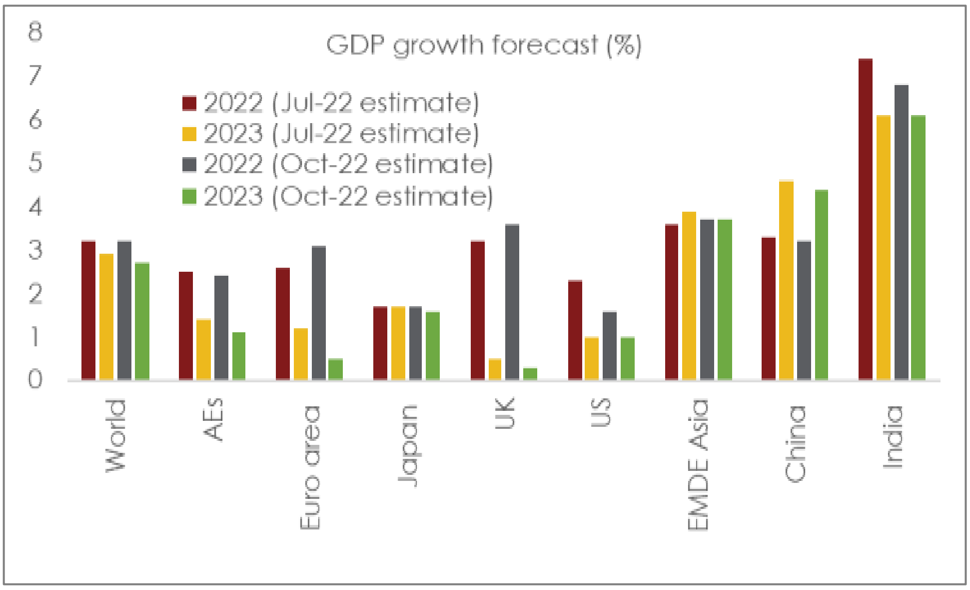
In addition, the demand side of PMI too painted a sombre picture. The global new orders index dropped further to 46.9 in Oct-22 from 47.7 in Sep-22, accompanied by a weakness in global new export orders.

Reinforcing the possibility of impending slowdown in global growth, IMF in its latest World Economic Outlook (WEO) harped on three lingering effects – the Russian invasion of Ukraine, a cost-of-living crisis caused by persistent and broadening inflation pressures, and the slowdown in China. The GDP growth for 2022 was left unchanged at 3.2%, but that for 2023 was lowered by 20 bps to 2.7% compared to Jul-22 forecasts. IMF projects more than a third of the global economy will contract this year or next, while the three largest economies—the United States, the European Union, and China—will continue to stall. The international agency also highlighted several downside risks to global growth outlook from – higher oil prices, further worsening of the crisis in the Chinese property sector leading to a decline in real estate investments, lower potential output from persistent disruptions in the labour market and a further tightening of financial conditions. If these risks were to materialize, in a worst-case scenario the global growth could slow down to 1.1% in 2023.

On the monetary policy front, following on the heels of the fourth consecutive 75 bps hike effected by the US Federal Reserve, Oct-Nov'22 have been active months for EM and DM central banks. However, it appears that the pace of tightening is headed for a somewhat slower track given the worsening global growth outlook. In the month of Oct-22 and Nov-22 so far, nearly 13 banks out of 38 central banks tracked by the BIS, have raised their interest rates in a bid to bring the price pressures down.

Recent weeks have been testimony to heightened bout of volatility in global treasury markets. This has been on the back of fears of a recession, aggressive rate hikes from Fed and the intensification of market intervention in UK and Japan. Recently, yield on the US 2-year and 10-year Treasury notes hit the highest level since 2007, currently trading at 4.66% and 4.15% respectively.

Chart 2: Global growth forecasts have seen a sizeable downgrade for 2023 (IMF)



US

Rising more than expected, US CPI inflation came in at 8.2% on annualized basis in Sep-22, although a tad lower than Aug-22's 8.3% and off its Jun-22 peak. However, core CPI surprised on the upside as it rose by 0.6%MoM to offset downside pressures on headline from falling fuel prices; taking annualised core inflation to 6.6%. Worryingly, services price growth hit a new 40 year high of 0.8%MoM, driven by a pickup in shelter inflation along with continued strength in medical services and transportation. Looking ahead, conditions do seem to support the moderation in inflation based on – commodity price softening, correction in house prices on the back of surge in mortgage rate.

On the other hand, despite efforts from the Fed to cool labour market, the latest Job Openings and Labor Turnover Survey (JOLTS) registered a rise in job openings in Sep-22 indicating nearly 1.9 job openings for every available worker. Further, the widely tracked, Non-farm payrolls rose by 261k in Oct-22 –higher than the market expectations. The tight labour market along with rigid inflationary pressures led the US Fed to hike interest rates for the fourth consecutive time by 75 bps to 3.75%-4.00%. Going forward, the upcoming inflation and the labour market prints will be the deciding factor for the quantum of future rate hikes in the US. Nevertheless, taking into consideration Fed's view- the cost of not tightening policy enough, outweighs the risk of overtightening hikes, there is a likelihood of the terminal rate surpassing the 4.6% (as per the dot-plot) peak rate anticipated in Sep-22 policy meeting.

In other macroeconomic indicators, higher interest rates and inflation appear to be weighing on some of the lead indicators. The pace of US retail sales was unchanged in Sep-22 compared to a downwardly revised sequential growth of 0.4%MoM in Aug-22. Further, ISM manufacturing index slipped to 50.2 in Oct-22 from 50.9 in Sep-22 to mark the slowest pace of expansion since the pandemic. Additionally, Conference Board Consumer Confidence Index fell to 102.5 in Oct-22 from 108 in Sep-22. Consumer sentiment improved both for the current state of the labour market and business conditions.

UK

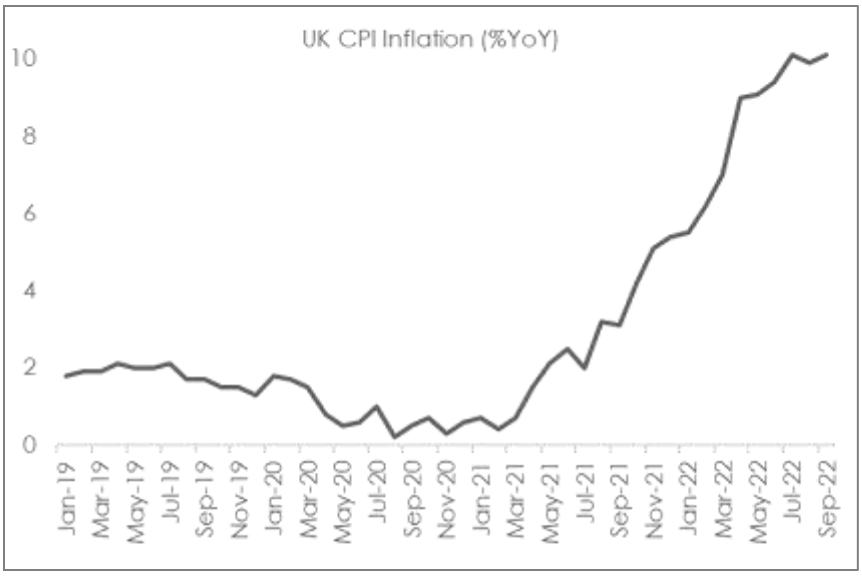
In addition to the recent turmoil in UK's political situation and Government bond markets, latest economic data offers increasing evidence of a slowing UK economy. Monthly GDP for Aug-22 unexpectedly fell by 0.3%MoM while Jul-22 growth was revised lower to a paltry 0.1% expansion. At the sectoral level, there was weakness in manufacturing sector as industrial output fell by 1.8% along with services sector that eased by 0.1%. Output for consumer facing services such as retail trade, entertainment, sports etc too fell by 1.8% suggesting high inflation is taking a toll on consumer purchasing. Anticipated fall in economic activity in Sep-22 as well, given the extra holiday due to the funeral of Queen Elizabeth II, UK GDP is clearly on track to contract in Q3-22.

UK PMI remained in contraction for the fourth consecutive month, at 46.2 in Oct-22 compared to 48.4 in Aug-22, as ordered declined for the fifth consecutive month. Retail sales too tumbled by 1.4% in Sep-22, building on the 1.7% decline recorded in Aug-22. UK CPI inflation rose to 10.1% in Sep-22 to surpass consensus estimates pegged at 10.0% - to mark the highest level of inflation in 40-years. Recall, inflation had unexpectedly dipped in Aug-22 to 9.9% from 10.1% in Jul-22, on the back of fuel price decline.

To counteract the runaway inflation, the Bank of England raised the interest rates by 75 bps to 3.0%- the highest in nearly 14 years. Further, The BOE warned the UK economy faces a 'very challenging outlook." Its forecasts imply the UK is already in recession, and that GDP will fall for eight straight quarters till mid-2024.

On the political front, British PM Liz Truss quit on 20th Oct-22, bringing an end to her 45 days in office marred by unpopular economic policies that roiled financial markets and upset members of her own party. On 25th Oct-22, the former chancellor of the exchequer Rishi Sunak became the United Kingdom's new prime minister after winning the ruling Conservative Party's leadership contest. This remains a developing story on watch, as the choice of a new leader who can unify political factions and impart confidence to the overall economic recovery remains critical.

Chart 3: UK CPI inflation rose once again in Sep-22 after a drop in the previous month



Eurozone

As per the IMF, growth slowdown in Euro area is less pronounced than that in the US in 2022 but is expected to deepen in 2023. Projected growth is 3.1% in 2022 and 0.5% in 2023 i.e., an upward revision of 0.5% since Jul-22 update for 2022, on account of a stronger than projected Q2 outturn in most euro area economies, and a downward revision of 0.7% point for 2023. Weak 2023 growth across Europe reflects spillover effects from the war in Ukraine, and tighter financial conditions, with the European Central Bank (ECB) having ended net asset purchases and rapidly raising policy rates by 50 basis points in Jul-22 2022, 75 basis points in Sep-22 and Oct-22 to 3.0% currently.

After seeing recovery take shape in Q2, the weakness in recent data points towards a likely QoQ contraction in the region. Aug-22 retail sales fell 0.3%MoM to clock a contraction of 2.0% on an annualized basis. German industrial production continues to remain weak, with production in real terms down by 0.8% YoY in Aug-22.

Despite downside risks to growth, ECB action will be in reaction to the domestic inflation continuing to remain elevated in the region, as it rose to 9.9% in Sep-22 from 10.0% in Aug-22. Energy prices remain the key reason, but core inflation too has firmed up from 5.5% in Aug-22 to a record high of 6.1% in Sep-22. Cementing rate hike expectations further, in his latest comments, chief of Germany's Bundesbank Joachim Nagel, said that "Further interest rate hikes will be needed to bring the inflation rate back to 2% in the medium term - not just at the monetary policy meeting at the end of Oct-22".

CHINA

China's economy has made only modest progress towards economic stability in Q3. Earlier in the quarter, there was a semblance of economic conditions improving however Sep-22 data suggests otherwise. Leading indicators of economic activity point to weaker outcomes than consensus estimates for recent data releases. The official manufacturing PMI contracted to 49.2 in Oct-22 from 50.1 in Sep-22 while

Caixin manufacturing rose to 49.2 in Oct-22 from a 4-month low of 48.1 in Sep-22. On the services side, PMI dipped to 48.4 in Oct-22 from 49.3 in Sep-22 pointing towards a sharp consumer slowdown amidst sporadic COVID related restrictions.

From a policy perspective, both fiscal and monetary policy remain expansionary and supportive in a bid to support the economy. Real estate sector continues to remain a weakling, with continuing decline in home prices weighing on loan demand and overall sentiment in the economy. Additionally, several Chinese key political figures have reiterated the commitment to zero-COVID policy, which could remain in place in the foreseeable future. This is likely to weigh on growth, both in 2022 and 2023. Against this slowing growth backdrop, China recently concluded the 20th National Party Congress. As background, the National Party Congress is held once every five years and is a platform for the Chinese Communist Party (CCP) to provide an assessment of China's evolution over the past five years and highlight primary objectives the CCP has for the next five years. Xi Jinping clinched his third five-year stint in charge, breaching the established custom of a two-term rule. In his opening remarks, Xi Jinping spoke about China's fight against COVID-19, the party's safeguarding of national security, maintaining social stability, protecting people's lives and taking control of the situation in Hong Kong, which was rocked by anti-government protests in 2019. He also called for accelerating the building of a world-class military.

About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 9,200 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

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