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MACRO PULSE REPORT

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From the desk of the Chief Analytical Officer

Happy festive greetings! Our **twenty first edition** of **Acuité Macro Pulse** is being released as we move into the festive heavy third quarter of the fiscal year.

India's social and cultural milieu is dominated by festivals across diverse communities and they are undoubtedly a driver for shaping private consumption demand. Particularly so in the current year which is the first opportunity for unbridled celebrations after a prolonged pandemic which held back festivities for almost two years. B2C players are placing a lot of expectations on a healthy pickup of demand for consumer goods in the current season and the auto sales in Sep'22 is an indicator of that optimism. On the other hand, the increasing public sector capex and the sharp rise in credit growth are set to strengthen investment demand.

While such domestic factors do give a shield of resilience to the Indian economy, the intensified global headwinds have exposed some of its vulnerabilities. Fed has already hiked the interest rates by 300 bps in the current cycle and the global markets are in a tizzy in anticipation of the additional rate hikes which are pegged upto another 150 bps, making it the sharpest hike since the Volcker period. Clearly, such a tightening of the global monetary conditions continues to have a severe impact on both the developed and the developing economies, not to speak of the underdeveloped nations that have already experienced extreme stress on their sovereign debt serviceability. Needless to say, the expected slowdown in the global economy will have ramifications for India's exports with the impact already visible in H1FY23.

The other worrying aspect of the global tightening storm (the 'third storm' as termed by the RBI governor in his MPC statement after the pandemic and the geo-political conflict) is the stability of the currency. While the 10%+ depreciation of the INR since the start of calendar 2022 is understandable given the unprecedented strength of the USD and the weakness in other currencies, the continuing uncertainty on its equilibrium level is giving sleepless nights to corporate treasurers and bankers. While we believe that the rupee has already weathered the peak of the global hurricane, the latter's tail can still lead to a further depreciation of the currency. Nevertheless, capital flows are set to revive within a few quarters given India's differential growth dynamics in the global order and some of the losses in the rupee are likely to be recovered.

The worsening global scenario has led to a downward revision in the growth forecasts for the domestic economy, some of which like that of the World Bank being very significant. However, we have still retained our forecast at 7.2% given the ability of the domestic consumption engine to surprise us. Interest rates, however, are set to rise further in Dec'22 given the intransigent inflation trajectory that refuses to come down in a hurry from the 7% levels and importantly, the massive global monetary tightening operations.

While the hike in the benchmark repo rates are gradually leading to an increase in lending rates and bond yields, what is noteworthy is the modest rise in bank deposit rates so far. The deposit rates have increased modestly by around 50-60 bps as against the 190 bps hike in the repo rate in the current tightening cycle. We, however, believe that this is set to change in the upcoming quarters as banks exhaust their excess SLR cushion and credit growth sustains the momentum it has shown in the last quarter. The good news for risk averse bank depositors therefore, is that rates are set to increase rapidly by 100-150 bps over the next two quarters.

Wishing you and your family the best in advance on the occasion of Deepavali !

Suman Chowdhury
Chief Analytical Officer

Growth

Growing downside risks

KEY TAKEAWAYS

- India's growth has held up well in FY23 so far, against the current backdrop of persistent geopolitical uncertainty, rapid tightening of global financial conditions and the ensuing market volatility, along with continuing supply chain disruptions in certain commodities.
- The latest print of most high frequency indicators reinforces the resilient nature of the recovery in the domestic economy which is also reflected in our AMEP (Acuite Macroeconomic Performance index) that has continued to record a double-digit growth rate for the fifth consecutive month at 12.4% YoY in Aug-22 despite the dilution of the favorable base, with services sector leading the overall economic recovery.
- Looking ahead, as the favourable statistical effect tapers further, headline GDP growth is expected to decelerate in the coming quarters. However, incremental support would nevertheless come from – festive season onset, back ended rainfall in monsoon deficit states, capex-oriented government spending along with the moderation in global commodity prices.
- Having said so, we also acknowledge downside risks to our FY23 GDP growth estimate of 7.2% largely on account of the build-up of adverse global factors such sharp tightening of global financial conditions, elevated geopolitical uncertainty, likelihood of recession in developed economies and the resultant impact on the export sector.

India's Q1 GDP growth accelerated sharply to 13.5% YoY from 4.1% in Q4 FY22. While the spring in annualized growth was along expected lines due to the base factor of the previous year, the actual print came in lower than street expectations (consensus estimates were in the range of 15-16%). More importantly, sequential momentum dipped (-9.6%QoQ) in line with seasonal downside seen in Q1, and by a higher margin than past years (of -3.7%QoQ over a 10-year period pre-COVID). A weaker seasonally adjusted print coupled with a high annualized growth number underscores the role of the favorable statistical base in the headline GDP.

Nevertheless, India's growth has held up well in FY23 so far, against the current backdrop of heightened geopolitical uncertainty, rapid tightening of global financial conditions and the ensuing market volatility, along with persistence of supply chain disruptions in certain commodities. The latest print of most high frequency indicators reinforces this at a broad-based level.

Table 1: India's GVA and GDP: Sectoral break-up

	Q1 FY22	Q2 FY22	Q3 FY22	Q4 FY22	Q1 FY23
GVA	**18.1**	**8.3**	**4.7**	**3.9**	**12.7**
Agri and allied activities	2.2	3.2	2.5	4.1	**4.5**
Mining and Quarrying	18.0	14.5	9.2	6.7	**6.5**
Manufacturing	49.0	5.6	0.3	-0.2	**4.8**
Electricity, Gas, Water Supply etc.	13.8	8.5	3.7	4.5	**14.7**
Construction	71.3	8.1	-2.8	2.0	**16.8**
Trade, Hotels, Transport, Communication	34.3	9.6	6.3	5.3	**25.7**
Financial, Real Estate & Professional Services	2.3	6.1	4.2	4.3	**9.2**
Public Administration, Defence	6.2	19.4	16.7	7.7	**26.3**
	Q1 FY22	**Q2 FY22**	**Q3 FY22**	**Q4 FY22**	**Q1 FY23**
GDP	**20.1**	**8.4**	**5.4**	**4.1**	**13.5**
Private Final Consumption Expenditure	14.4	10.5	7.4	1.8	**25.9**
Government Final Consumption Expenditure	-4.8	8.9	3.0	4.8	**1.3**
Investments	62.5	14.6	2.1	5.1	**20.1**
Exports	40.8	20.7	23.1	16.9	**14.7**
(Less) Imports	61.1	41.0	33.6	18.0	**37.2**

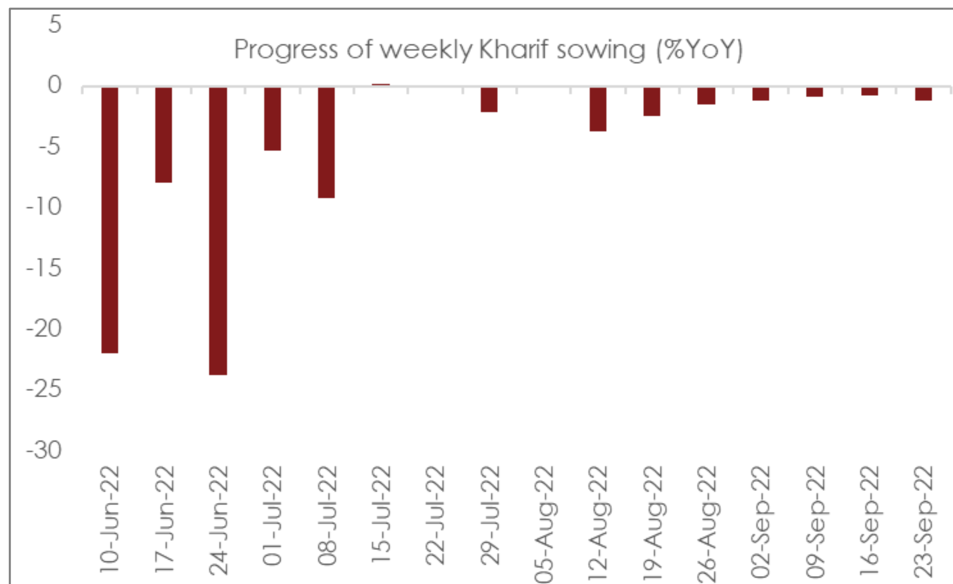
Recent data releases: A granular look at recovery at sectoral level

Agriculture

- Southwest monsoon has seen a late revival in deficit regions aiding a lagged pick up in Kharif sowing. As of Sep-22, area sown under Kharif crops stood at 1102 lakh ha, having exceeded the normal area sown by 1.16% and lower vis-à-vis last year's level by a marginal 1.23%.
- While the downside in projected foodgrain output is still primarily driven by Rice and Pulses, there has been a fair degree of catch-up with the shortfall in acreage getting restricted to 4.8% and 4.0% for the two crops in the current kharif season respectively.

- Demand for work under the MGNREGS continued to ease in Aug-22, clocking a significant annualized contraction of 40% over the months of Jul-Aug-22, indicating availability of gainful employment opportunities in agriculture sector or elsewhere due to the normalization of the economy.

Chart 1: Late monsoon pick-up in deficit states helped close the sowing gap



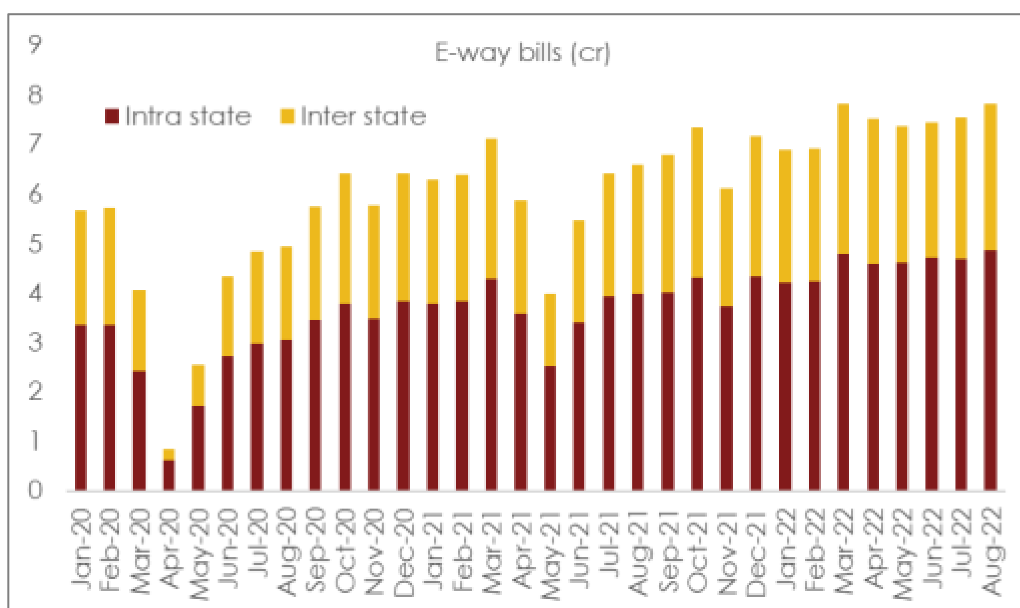
Industry

- Growth in India's industrial production decelerated sharply to 2.4% YoY in Jul-22 from 12.7% (revised upwards from 12.3%) in Jun-22. While the dilution in the favourable statistical base in Jul-22 contributed to easing of the headline growth print, the overall impact got exacerbated by a sequential contraction in momentum – the index dropped by -2.7% MoM, worse than the pre pandemic historical average expansion of 0.1% seen in the month of July.
- On the other hand, PMI manufacturing moderated marginally, coming in at 55.1 in Sep-22 compared to 56.2 in Aug-22. The average PMI manufacturing index stood at 55.1 for the manufacturing sector in H1FY23, reflecting a material momentum in the sector.
- GST collections rose to Rs 1.47 tn for Sep-22, sequentially marginally higher than Rs 1.43 tn for the previous month.

Services

- PMI Services eased to a six-month low of 54.3 in Sep-22 from 57.2 in Aug-22 led by some easing in demand amidst high inflation. However, the average PMI for services stood at 57.2 for H1FY23, highlighting the robust recovery of the services sector after the taper of the pandemic.
- E-way bills generation picked up pace in Aug-22 to rise to 78 mn compared to 76 mn in Jul-22, led by higher intra-state movement of goods. This marked a record number of E-way bills generated in a month, matching the same level last seen in Mar-22.

Chart 2: E-way bills rose to a record high in Aug-22, matching that in Mar-22



Outlook

Looking ahead, as the favorable statistical effect continues to taper, headline GDP growth is set to decelerate in the coming quarters. Incremental support would come from:

- The festive heavy H2 FY23 in combination with pent-up demand for both goods and services. Expectation of moderation in inflation, along with the likely bonus pay-outs and hike in dearness allowance for government employees, could further support discretionary consumption.
- At an aggregate level, kharif harvest beginning Oct-22 onwards would offer support to agriculture output and farm incomes.
- Late withdrawal of monsoon and healthy reservoir levels augur well for Rabi sowing.
- Capex oriented public spending continues to offer the much-needed fiscal impulse, and would hopefully benefit manufacturing capacity utilization further, which has recovered to above pre-pandemic levels, at 75.3% as of Mar-22.
- The recent softness in global commodity prices, with the CRB index nearly 18% lower vis-à-vis Jun-22 peak will offer reprieve to producers, and the likely pass-through to consumers (with a lag) would support consumer sentiment.

Having said so, we also acknowledge the growing downside risks to our FY23 GDP growth estimate of 7.2% on account of:

- Continuous buildup of adverse global factors (like tightening of global financial conditions, elevated geopolitical uncertainty, etc.) would constrain external demand significantly in H2 FY23.
- Likelihood of government resorting to some degree of back-loaded expenditure rationalization in order to stick to the FY23 fiscal deficit target of 6.4% of GDP.

Inflation

Headline print shows rigidity at 7.0% levels

KEY TAKEAWAYS

- India CPI inflation rose in line with expectations in Aug-22, to 7.0%YoY from a 5-month low of 6.71% in Jul-22. This marked the eighth consecutive month of CPI inflation remaining above RBI's upper threshold of 6.0%.
- On sequential basis, CPI momentum in Aug-22 was largely in line with recent trend at 0.52%MoM compared to 0.49% over Jun-Jul-22.
- However, compared to previous month, there was significant difference in drivers of the sequential momentum; with Food & beverages seeing a strong build-up and Fuel prices offering respite.
- WPI inflation eased to an 11-month low of 12.41%YoY in Aug-22 from 13.93% in Jul-22. The downside was led primarily by fuel and other commodity prices. On sequential basis, prices contracted for the second consecutive month.
- The risks to our FY23 CPI inflation estimate of 6.7% appear to be somewhat balanced at the current juncture.
- Supportive factors include – a good run in Southwest monsoon, moderation in global commodity prices along with government's administrative measures including a ban on exports of broken rice and imposition of 20% tax on export of non-basmati rice.
- On the other hand, uneven distribution of rainfall, rupee depreciation and pent-up demand for goods and services could add to upside pressures, along with the hike in GST rates on select items and electricity tariffs, that is yet to reflect completely.

Overview

Inflation readings for the month of Aug-22 diverged on the consumer and wholesale fronts. While CPI inflation resumed its upward ascent led by food prices, WPI inflation eased to an 11-month low capturing the moderation of global commodity prices since Jun-22.

- CPI inflation rose in line with expectations in Aug-22, to 7.0%YoY from a 5-month low of 6.71% in Jul-22 (Reuters consensus: 6.9%). This marked the eighth consecutive month of CPI inflation remaining above RBI's upper threshold of inflation band i.e., of 6.0%.
- WPI inflation eased to 12.41%YoY in Aug-22 from 13.93% in Jul-22. The downside was led primarily by fuel and other commodity prices.

Key highlights: CPI inflation

- On a sequential basis, CPI momentum in Aug-22 was largely in line with recent trend at 0.52%MoM compared to an average of 0.49% over Jun-Jul-22.
- However, compared to previous month, there was significant divergence in the drivers of sequential momentum.
- The momentum of Food and beverages saw a sizeable jump to 0.74%MoM in Aug-22 compared to a subdued 0.06% in Jul-22. The upside was led by a strong buildup in price of Cereals (+2.43%MoM), Vegetables (+2.47%MoM), Spices (+1.89%MoM) and Pulses (+1.70%). This could be attributed to uneven distribution of rainfall weighing on rice acreage, GST hikes on select food items along with global spillovers. The upward price pressure more than offset the moderation seen in Meat & fish (-3.1%MoM), Eggs (-3.42%MoM) and Oils & fats (-1.74%MoM) in the month.
- After registering a strong build-up of 2.04%MoM in Jul-22, momentum in Fuel and light contracted by 0.45% in Aug-22, led primarily by PDS Kerosene (-7.83%MoM) along with Coke and Charcoal.
- The sequential momentum in core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel items within Miscellaneous) eased marginally to 0.52% MoM in Aug-22 from 0.64% in Jul-22. The annualized rate of core inflation remained nearly unchanged at 6.26% YoY in Aug-22 vis-à-vis 6.23% in Jul-22, with strong price pressures seen in case of Clothing & footwear, Personal care and effects, Housing and Household goods & services.

Key highlights of WPI inflation

The Aug-22 downside in headline WPI was led primarily by fuel and other commodity prices. On sequential basis, prices contracted for the second consecutive month, by 0.46% in Aug-22 compared to -1.03% in Jul-22.

- At a granular level, consolidated food saw a strong sequential momentum, at 0.9%MoM owing to escalation in price of rice, pulses, wheat, and fruits, compared to a contraction of 1.69% in the previous month.

- On the other hand, fuel and power registered a sharp decline of 4.83%MoM mainly on account of a fall in mineral oils (-7.8%MoM). At a granular level, with the exception of lubricant oils that grew by 6.5%MoM, all the other major fuel components registered a price contraction on a sequential basis. Of these, prominent decline was registered in Kerosene (-13.7%MoM), ATF (-12.5%MoM) and Furnace oil (-12.3%MoM).
- Index heavy-weight manufacturing saw a subdued price increase by 0.07%MoM, in contrast with the contraction seen in previous two months. The strong upward adjustment in price of Non-metallic mineral products, wearing apparels, electrical equipment was offset by correction seen in case of Rubber, Furniture and Textiles.

Table 1: Sowing of rice and pulses has seen a delayed catch-up this year

Crop	Area Sown (in lakh ha)		
	2022	2021	%YoY
Rice	401.56	425	-5.5
Pulses	132.8	138.3	-4.0
Coarse cereals	181.43	174.05	4.2
Oilseeds	191.75	193.28	-0.8
Sugarcane	55.66	55.22	0.8
Jute & Mesta	6.95	6.97	-0.3
Cotton	127.39	118.56	7.4
Total	**1097.57**	**1111.36**	**-1.2**

Outlook

The risks to our FY23 CPI inflation estimate of 6.7% appear to be somewhat well balanced at the current juncture.

Supportive factors for CPI outlook include –

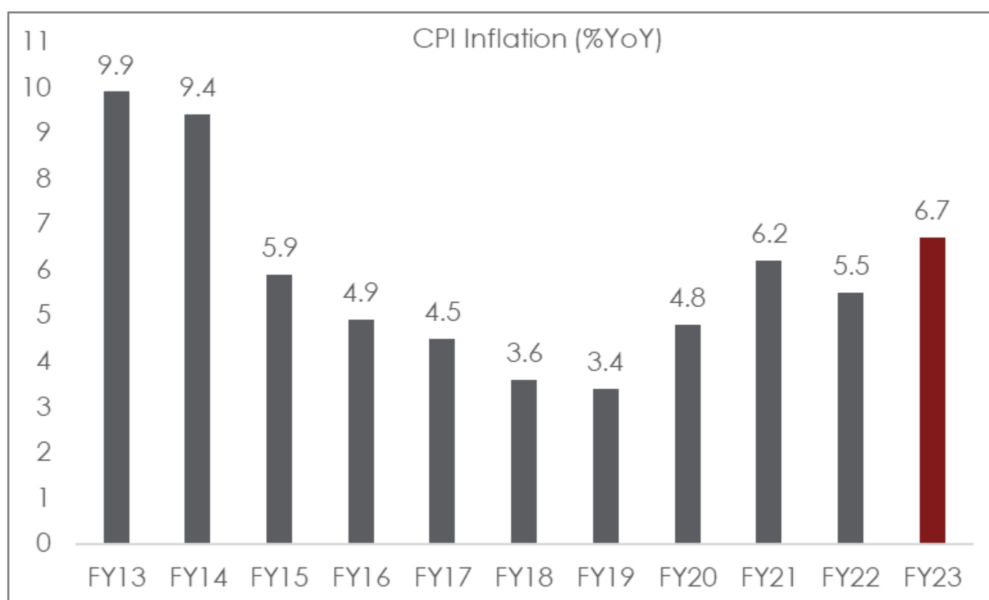
- A good run in Southwest monsoon, with cumulative rainfall up to Sept 27, 2022 clocking a surplus of 7% over LPA (long period average). A delayed catch-up in rainfall deficit states has helped bridge the sowing gap in rice and pulses, vis-à-vis last year (as of 23rd Sep-22)
- Moderation in global commodity prices to the tune of ~18% since the peak in early Jun-22, as measured by Reuters CRB Index.
- Administrative measures of the Government including the recent ban on exports of broken rice and imposition of 20% tax on export of non-basmati rice.

On the other hand,

- The lower acreage for rice and an anticipated decline in production (6% as per the first advance estimate of Kharif production), has led to upward pressure on domestic prices. Government action of a ban on export of broken rice and the imposition of a 20% export duty on non-basmati rice exports is likely to offer some reprieve.

- High frequency mandi data from the department of consumer affairs, indicates a continued rise in prices of cereals – primarily Rice and Atta. Speculative trading and festive season demand are both conjectured to be weighing on prices.
- Rupee weakness could impart a degree of imported inflation upside.
- Removal of all Covid related restrictions along with the progress on vaccination has led to a strong revival of contact-intensive services along with non-dissipating pent-up demand for goods. This could keep pressure on core inflation intact.
- Impact of hike in GST rates on some items of mass consumption along with hike in electricity tariffs by state discoms remains yet to be fully captured.

Chart 1: For FY23, we hold on to 6.7% CPI inflation forecast with risks evenly balanced



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Government Finances

Capex prioritization amid tax buoyancy

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Aug stood at 32.6% of budget estimates (BE) for FY23, marginally higher than the level of 29.5% of actuals in the corresponding period in FY22.
- The FYTD fiscal theme continues to rest upon buoyancy in tax 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 the persistence of tax buoyancy, recent upward adjustments in some of the indirect tax rates, expenditure savings and rationalization, and also a strong likelihood of higher than budgeted Nominal GDP base.

India's central government fiscal deficit for the period Apr-Aug stood at 32.6% of budget estimates (BE) for FY23, higher as compared to 29.5% of actuals in the corresponding period in FY22.

Receipts: Comfort on tax buoyancy continues

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

- On FYTD (Apr-Aug) basis, gross tax revenue clocked 37.0% of BE compared to 31.7% of actuals in the corresponding period in FY22.
    - Momentum was supported by collection from income tax, corporate tax, and GST. We note that the impressive momentum in GST revenues continue to persist with total monthly collections averaging at Rs 1.49 tn during Apr-Sep FY23 compared to the required monthly run rate of Rs 1.35-1.40 tn for meeting the BE. Recent revision in GST rates for select goods and services and the upcoming festive season would further help in maintaining and perhaps buoying further, the healthy run rate in the coming months.
    - The latest data from CBDT indicates that gross direct tax collections rose by 24% YoY till Oct 8, 2022.
    - Meanwhile, collections from customs and excise were lower in comparison. The moderation in customs and excise is reflective of relaxation in duties on select import items (including retail fuel) to provide relief from elevated inflation.

On the other hand, non-tax revenue improved marginally to 43.3 % of BE during Apr-AugFY23 vs. 42.7% of actuals in the corresponding period in FY22.

- RBI's dividend for FY22 (transferred in May-22) stood at Rs 303 bn, a sharp drop from Rs 991 bn done in the previous financial year. Lower dividend was on account of the escalation in provisions on the back of MTM losses on foreign currency assets from the sharp rise in bond yields globally and the depreciation in non-dollar currencies.
- Going forward, the conclusion of the 5G telecom spectrum auction that generated close to Rs 1.5 tn would provide some buffer (approximately Rs 150 bn is expected to accrue to the government in the first year).

Non-debt capital receipts clocked 39.8 % of BE during Apr-Aug FY23 vis-à-vis 38.7% 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. The month of July and August did not see any revenue generation from disinvestment activity by the central government.

Expenditure: Subdued revex accompanied by robust capex

On FYTD (Apr-Aug) basis, total expenditure disbursal stood at 35.2% of BE, marginally higher than 33.6% of actuals in the corresponding period in FY22.

- Momentum continues to be led by capital expenditure that clocked 33.6% of BE during Apr-AugFY23 vis-à-vis 29.0% 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 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 staggering 106.4% YoY (aided by a favourable statistical base) during Apr-Jul FY23 vis-à-vis a contraction of 43.9% in the corresponding period in FY22.

- Revenue expenditure too firmed up to 35.6% of BE during Apr-Aug FY23 from 34.5% 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 69% in total revex disbursal in Aug-22.
    - Excluding interest payments and subsidies, revex contracted by 1.0% YoY during Apr-AugFY23.

Outlook

As highlighted in our last month's edition, fiscal headwinds have gathered momentum and are cumulatively sufficient to cause a slippage in the FY23 budgeted fiscal deficit ratio of 6.4% of GDP.

- Extension of "PM Garib Kalyan Anna Yojana" by 9-months till Dec-22 to continue providing relief for priority households will cost 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.
- 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 target due to the following factors:

- Tax buoyancy continues to remain. 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 205 bn) will generate 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 is expected to have 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 conservative budgeted assumption of 11.1% has emerged. We note that in the likely scenario of Nominal GDP growth touching 16.5% in FY23, the generation of fiscal buffer could be to the extent of ~40 bps.

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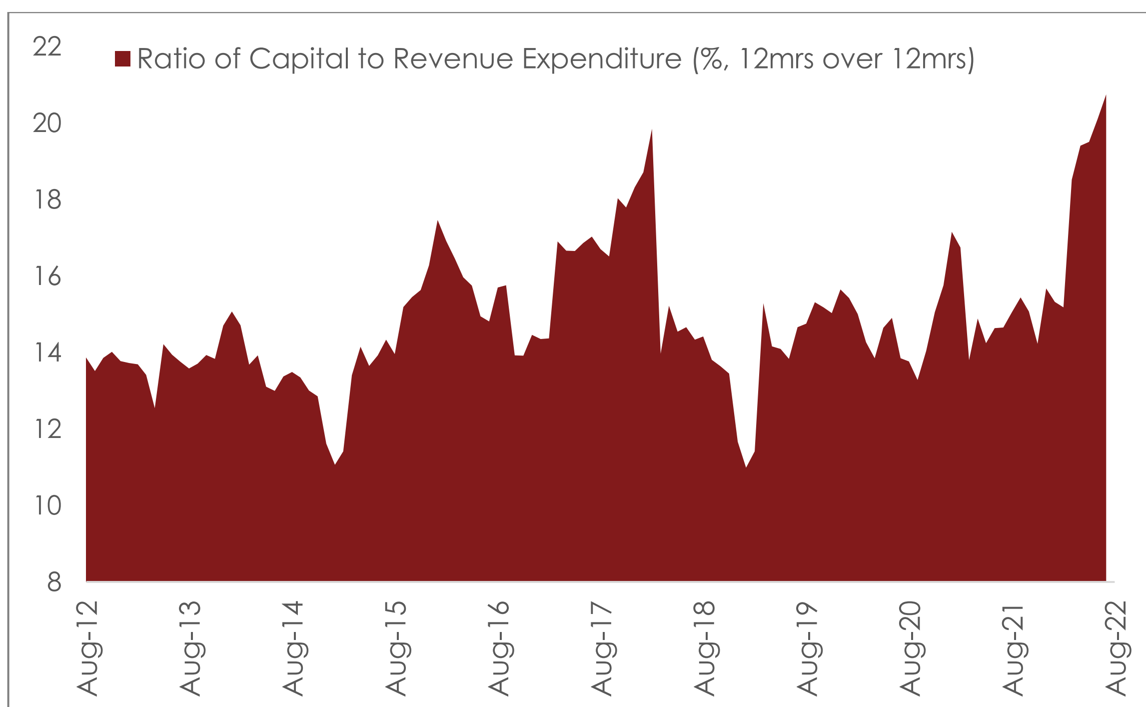
Table1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position for FY22)			
Fiscal Variables	**% of Actuals**	**% of BE**	**Cumulative (INR bn)**
	FY22	**FY23**	**Apr-May'22**
Revenue Receipts	36.6	37.1	3568.4
Net-Tax	35.4	36.2	3075..9
Non-Tax	42.7	43.3	492.5
Non-Debt Capital Receipts	38.7	39.8	250.1
Total Receipts	36.6	37.2	3818.5
Revenue Expenditure	34.5	35.6	5887.74
Capital Expenditure	29.0	33.6	1054.22
Total Expenditure	33.6	35.2	6911.96
Fiscal Deficit	**29.5**	**32.6**	**2039.21**

Chart 1: Central government continues to prioritise capex over revex in FY23 so far



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Rates

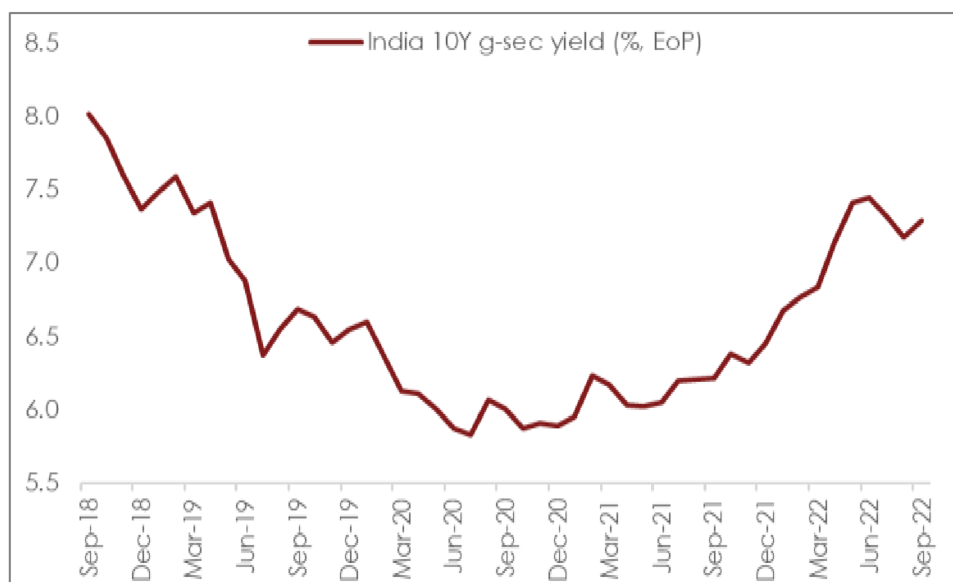
Despite risks, yields remain range-bound

KEY TAKEAWAYS

- After closing the month of Sep-22 at 7.40%, India's 10Y g-sec inched up further towards 7.48% levels in Oct-22 so far amidst deferment of India's bond inclusion in global bond indices.
- As inflation continues to ratchet up 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.
- Global rates market is reeling under pressure with yield curve inversion becoming a central theme.
- Concerns over global slowdown, however, continues to weigh upon commodity prices.
- Unevenness in monsoon has led the government to estimate 3.9% decline in kharif foodgrain production vis-à-vis last year.
- We continue to expect 10Y g-sec yield to trade in the 7.20-7.60% range in the remainder of FY23 given continued monetary tightening by the RBI (after a cumulative 190 bps rate hike in FY23 so far, we expect the RBI to raise repo rate by another 35 bps in Dec-22).

After closing the month of Sep-22 at 7.4%, India's 10Y g-sec yield inched up further to 7.48% amidst deferment of India's bond inclusion in global bond indices.

Chart 1: India's 10Y g-sec yield continues to remain ranged bound



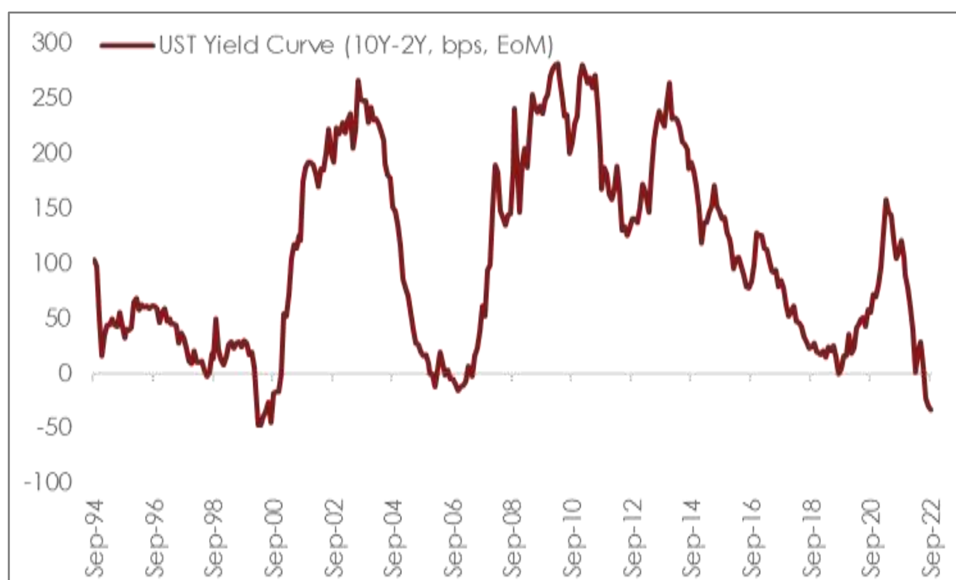
Global headwinds and tailwinds

For domestic bond markets, the global backdrop over the last one month provided a mixed picture.

- At one end, as inflation continues to ratchet up 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 developed and emerging economies.
  - The Jackson Hole Summit in the US followed by the release of monthly inflation numbers for Aug-22 (in Sep-22) reignited market sentiment with respect to pricing in of larger quantum of rate hikes in US, Euro area, and UK.
  - However, a bigger jolt to market sentiment came from the step-up in hawkishness by the US Fed in its Sep-22 policy review. While the FOMC delivered the expected 75 bps rate hike (from 50 bps earlier, market expectations saw a reset post the Jackson Hole Summit in Aug-22) for third time in a row, the accompanying 'dot plot' surprised the markets. The terminal fed funds rate as implied by the median FOMC dot plot moved up from 3.8% in Jun-22 to 4.6% in Sep-22. This points towards the likelihood of incremental 150 bps rate hike by the Fed by Mar-23, thereby taking the federal funds rate to the highest level since 2007.
  - Fed's renewed hawkishness has spilled over to other central banks. Post the FOMC outcome on Sep 21,2022 most central banks have raised their monetary policy rate, with size of hike ranging between 50-125 bps.
  - With aggressive monetary policy in the US supporting the dollar, the implied exchange rate pressures for other countries could force further monetary tightening in response.
- As such, rates market globally is reeling under pressure. Among DMs (barring Japan), the 10Y sovereign yield has jumped by 166-353 bps in 2022 so far. While

the 10Y UST has increased by 246 bps this year, the increase at the shorter end (2Y) is far more at 358 bps, resulting in a sharp inversion of the yield curve. A similar trend is observed in most DMs.

Chart 2: UST yield curve has been inverted for last three months



- Inversion of the yield curve across major economies is signalling concerns over a slowdown in growth, something which we have been highlighting since last two editions of the Acuite Macro Pulse report. For domestic bond market, the ramification of this is somewhat positive in terms of downward pressure on international commodity prices.
    - Brent crude is currently trading at sub USD 90+ pb levels, lower than the levels that existed before the start of the Russia-Ukraine war.
    - On monthly average basis, the broader CRB Commodity Index is down 10% from its peak in Jun-22.
    - Although most commodity prices continue to remain higher in 2022 vis-à-vis 2021, the recent softness bodes well for lowering inflationary pressures. We note that the domestic non-food WPI index has seen three consecutive months of decline over Jun-Aug 2022, with annualized rate of inflation under this category moderating from its record high level of 19.36% in May-22 to 13.45% in Aug-22. Taking on board the drop in commodity prices in recent weeks, the annualized non-food WPI inflation can be expected to fall below 10% in Oct-22. This is likely to spill over to retail inflation, albeit with a lag.

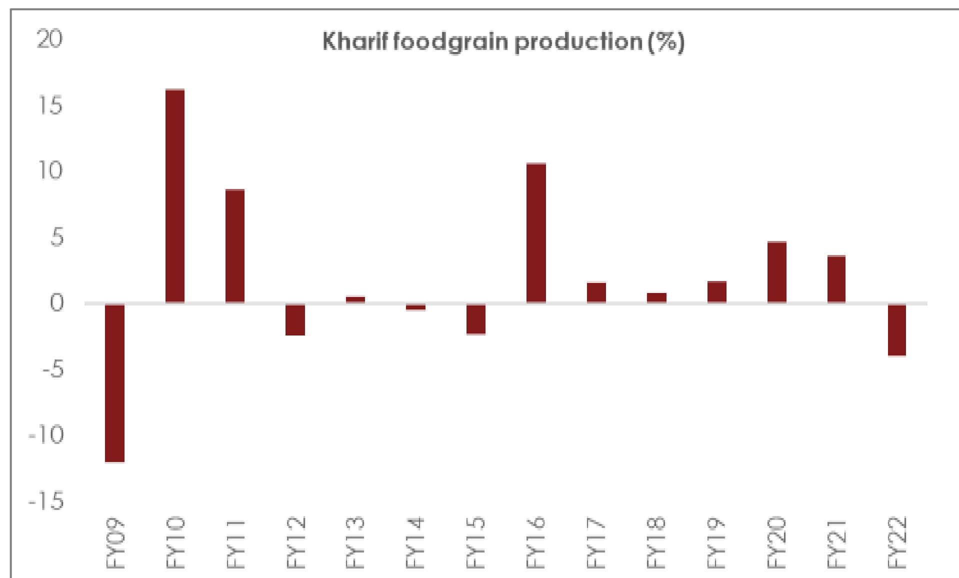
Monsoon did a late flourish, but its distribution has remained a concern

On the domestic front, notwithstanding the disappointing start, south-west monsoon did an impressive catch-up thereafter, with a cumulative rainfall of 7% above the long period average (as of Sep-22).

However, because of uneven distribution of monsoon (with state level cumulative deficits of 47% in Manipur, 31% in Bihar, 28% in Uttar Pradesh, 23% in Tripura, 22% in

Mizoram, and 21% in Jharkhand), the first advance estimate of kharif production for foodgrains has been estimated to show a contraction of 3.9% vis-à-vis last year. This poses some risk to food inflation, esp. coming from rice and related products (cumulative weight of ~5% in CPI basket).

Chart 3: Low reservoir storage levels could pose risk to paddy output in 4 key states



Outlook

With global environment providing a mixed backdrop, we don't see any pressure on either side of our forecast range (for remainder of FY23) of 7.20-7.60% for the 10Y g-sec yield.

Having said so, we do acknowledge two potential significant risks which could put upward pressure on bond yields

- Pressure on rupee (~10% weakness in 2022 so far) could result in adequate response from the RBI. Since the divergence of inflation vis-a-vis target is relatively moderate in case of India, the response from the central bank is unlikely to mimic the high degree of hawkishness currently displayed by most DM and few EM central banks. Nevertheless, we do expect the MPC to now opt for an additional 35 bps rate hike between Sep-22 and Dec-22 policy reviews. This will take repo rate to 6.25% by Dec-22.
- Additionally, expectation of India's inclusion in the global bond indices has been deferred again amid certain investment hurdles which is a negative from the perspective of bond market sentiments.

Rupee

Still vulnerable due to global head winds

KEY TAKEAWAYS

- After closing Sep-22 at a level of 81.0, the Indian rupee has weakened further and reached a high of 82.8 levels before witnessing a moderate slide in early Oct-22.
- The dollar is expected to continue deriving support from aggressive pricing in of the ongoing interest rate hikes in the US along with quantitative tightening, apart from 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 H1 FY23 before it starts to moderate in H2 FY23 on account of the recent correction in global commodity prices, respite from persistent portfolio outflows, series of macroprudential steps undertaken by the RBI, and positioning related flows ahead of India's likely inclusion in global bond indices in early FY24.
- 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 reserves to curb depreciation pressures amidst the backdrop of broad-based dollar strength would increase INR's real effective overvaluation vis-à-vis peers.
- With USD-INR having breached our earlier target of 81, there is a likelihood of rupee further moving towards 83-84 levels before end Mar-23 in the short term, but once the tightening pauses, a partial reversal is expected by Mar'23.

After closing Sep-22 at a level of 81.0, the Indian rupee weakened further and is currently trading close to 82.4 levels. With this, the Indian rupee has weakened for ten straight months (something that has not happened since 1995) culminating into a depreciation of 10.8% in calendar 2022 so far.

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

Surprisingly, the recent weakness in rupee has played out in the backdrop of correction in international commodity prices (especially crude oil) and moderate revival in sentiment of portfolio investors. Both these factors had weighed upon INR in the first half of 2022.

	2021		2022	
	Jan-Jun	Jul-Dec	Jan-Jun	Jul-Sep
Brent Crude (% change)	45.0	3.5	47.6	-24.9
Cumulative portfolio flows (USD bn)	7.7	-0.8	-29.8	7.8
USDINR (% change)	1.7	0.0	6.2	3.8

This clearly points towards the overwhelming impact of the broad-based dollar strength and expansion of India's trade deficit. While we had been pointing to these two factors as key reasons for keeping rupee on a weaker turf, the magnitude of impact (especially in recent weeks) is turning out to be greater than earlier envisaged.

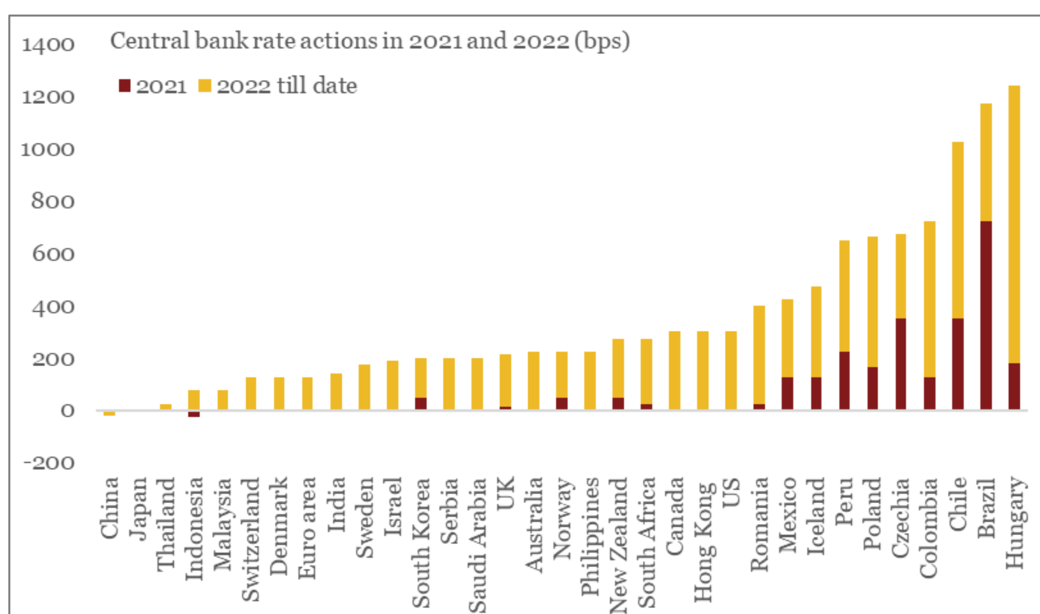
On the global front, dollar supportive environment continues to power ahead in an unprecedented manner:

- After hiking monetary policy rate by 300 bps so far in 2022, the US Federal Reserve is expected (as per the recently revised FOMC dot plot in Sep-22) to hike interest rates further by at least 150 bps incrementally by Mar-23. Cumulatively, this would be tantamount to 450 bps rate done in a span of approximately a year, thereby making it the most aggressive rate hike cycle since the Volcker era. Inflation fighting resolve is further getting a boost from the ongoing quantitative tightening. The unwinding of Fed's balance sheet

would curb global dollar liquidity and thereby provide a supplementary tailwind to the USD.

- While renewed monetary policy aggression in US is spilling over to other economies, the combination of war related uncertainty with the sharp tightening of global financial conditions is threatening to expose currencies associated with higher debt/deficit levels in their respective economies. As such, the DXY Index (at around 112 levels) 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.

Chart 2: Following Fed, most central banks accelerated monetary tightening in 2022



On the domestic front, pressure on India's BoP has been escalating since Q4 FY22. Cumulative trade data for the first five months (Apr-Aug) of FY23 shows a significant widening of the merchandise deficit to USD 124.5 bn vs. USD 53.8 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 however, 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.
- 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 reserves to curb depreciation pressures amidst the backdrop of broad-based dollar strength would increase INR's real effective overvaluation vis-à-vis peers.

With USD-INR having breached our earlier target of 81, there is a likelihood of rupee further moving towards 83-84 levels before end Mar-23 in the short term, but once the tightening pauses, a partial reversal is expected by Mar-23.

Acuite RATINGS & RESEARCH

Global Overview

A gloomy outlook for 2023

KEY TAKEAWAYS

- Leading indicators point to weakening of momentum with global PMI indices sliding into contractionary territory.
- Unsurprisingly, OECD in its latest economic update cut global growth forecast for 2023 to 2.2% from 2.8% earlier. It projects a slowdown in growth in US to 0.5%, Eurozone to 0.3% and zero growth in UK.
- Downside to global growth is expected to become more pronounced in the coming quarters.
- On the global monetary policy front, the month of Sep-22 witnessed the pace of hikes becoming even more synchronised and aggressive. Leading the pack, US Federal Reserve raised its key policy rate by 0.75% to a range between 3.0-3.25%.
- This was followed by the Swedish Riksbank 100 bps increase in its interest rate to 1.75%. Switzerland, Saudi Arabia and the UAE also announced a 75-bps increase each, with Switzerland ending its period of negative rates since in 2015. The Bank of England too raised its policy rate by 50 bps to 2.25%.
- The ongoing monetary policy tightening led by US and global macroeconomic outlook are both impinging on currency markets strongly. The dollar index has gained by nearly 3.7% in Sep-22– to hit a 20-year high and is currently hovering close to 112 levels

Global Overview

Leading indicators point to weakening of momentum with global PMI indices sliding into contractionary territory. Unsurprisingly, OECD in its latest economic update cut global growth forecast for 2023 to 2.2% from 2.8% earlier. It projects a slowdown in growth in US to 0.5%, Eurozone to 0.3% and zero growth in UK. Downside to global growth is expected to become more pronounced in the coming quarters. The US is likely to face repercussions from an aggressive monetary policy tightening in response to elevated inflation and Europe's slowdown will reflect surging energy prices and rationing. The dimmer global outlook is despite a boost in activity as COVID-19 infections drop worldwide.

Table 1: OECD's latest growth projections for 2022 and 2023

	Latest growth projection for 2022	Downgrade vs Jun-22	Growth Projection for 2023	Downgrade vs. Jun-22
World	3.0	0.0	2.2	-0.6
US	1.5	-1.0	0.5	0.7
Euro area	3.1	0.5	0.3	-1.3
UK	3.4	-0.2	0.0	0.0
Japan	1.6	-0.1	1.4	-0.4

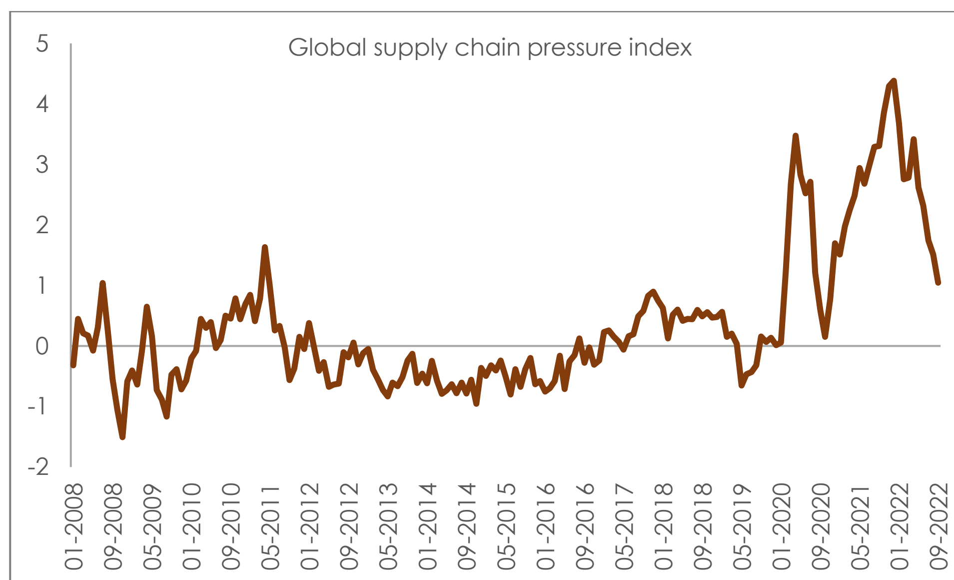
As per the latest PMI survey, global manufacturing PMI contracted in Sep-22-22 for the first time since Jun-20. The composite index fell though marginally, from 50.3 in Aug-22 to 49.8 in Sep-22 – the downturn marked a broad-basing of deterioration of output and demand conditions. In addition, for the first time since the onset of the pandemic, the four largest developed economies reported falling output. While the Eurozone, UK and Japan all slipped into minor downturns, a steeper contraction was recorded in the US.

Encouragingly, price pressures have abated for both goods and services. Measured globally, average prices charged for services rose at the slowest rate for a year in Sep-22, while goods prices rose at the slowest rate for a year-and-a-half. While 2021 was testimony to demand running ahead of supply, with the latter constrained by pandemic-related raw material and labour shortages, 2022 is now seeing demand ease and supply conditions improve. The New York Federal Reserve's supply-chain pressures index has fallen significantly since the beginning of the year to reach its lowest level in 22 months in Sep-22 (see chart). Further, global maritime trade flows are facing lower disruption, with congestion largely eliminated at ports on the US west coast.

On the global monetary policy front, the month of Sep-22 witnessed the pace of hikes becoming even more synchronised and aggressive. Leading the pack, US Federal Reserve raised its key policy rate by 0.75% to a range between 3.0-3.25%. This was followed by the Swedish Riksbank's 100 bps increase in its interest rate to 1.75%, its biggest interest rate increases in three decades. Switzerland, Saudi Arabia and the

UAE also announced a 75-bps increase each, with Switzerland ending its Zero Interest Rate policy since 2015. The Bank of England too raised its policy rate by 50 bps to 2.25%, the highest since the financial crisis, with a near promise of further rate rises to come. Even in Japan, which has long adopted negative interest rates, the authorities of late have felt the need to act to tame inflation. Its finance ministry intervened in currency markets to prop up the yen and limit the rise in import prices.

Chart 1: Global supply chain pressures have eased considerably



The ongoing monetary policy tightening led by the US and evolving macroeconomic outlook are both impinging on currency markets strongly. The dollar index has gained by nearly 3.7% so far in Sep-22 (as of 29th Sep-22) – to hit a 20-year high, with a concomitant decline in EUR by 4.2%, GBP depreciating by 6.3% to near parity and host of other currencies displaying weakness of varying degrees. The already elevated inflationary pressures from food and energy, are getting intensified by imported inflation.

US

The Fed in its Sep-22 FOMC meeting raised the Fed funds rate by 75 basis points, third on the trot, to raise the upper bound of the policy rate to 3.25%. The accompanying dot plot (a key indicator of future Fed policy) shows that the Fed is expected to continue raising the policy rate to 4.4% by the end of this year, and to 4.6% in 2023 versus previous expectations of 3.8%. This implies 150 bps of incremental rate increase. On macro-economic front, the Federal Reserve sharply downgraded its economic forecast, with its median expectation of growth in Q4 GDP now at 0.2%, down from 1.7% in Jun-22. Unemployment is expected to reach 3.8% by end of this year, up from 3.7% earlier, and rise to 4.4% by the end of 2023. The Fed also raised PCE inflation projections by 20 bps each for Q4-22 and 2023 to 5.4% and 2.8% respectively.

In the post policy interaction, Fed Chairman Jerome Powell while noting a slowdown in economic activity, particularly in housing and business investment, indicated that

labour market remained "out of balance" with demand for workers outstripping supply. "We are taking forceful and rapid steps to moderate demand," he said, and "We will keep at the job until we are done."

On the data front, the US economy continues to send mixed signals. After two quarters of contraction, Q3-22 GDP is estimated at 0.3% - as per the most recent data from Atlanta Fed's GDP Now model. Further, the Conference Board consumer confidence index rose to 108 in Sep-22 from 103.6 in Aug-22, helped by a drop in gasoline prices. On the other hand, US industrial production fell 0.2% in Aug-22 while Jul-22 reading was revised lower by 10 bps to 0.5%. Retail sales in Aug-22 though surprised on the upside, rising by 0.3%MoM compared to a contraction of 0.4% in July-22. On a three-month moving average, sales were up 9.3 per cent YoY.

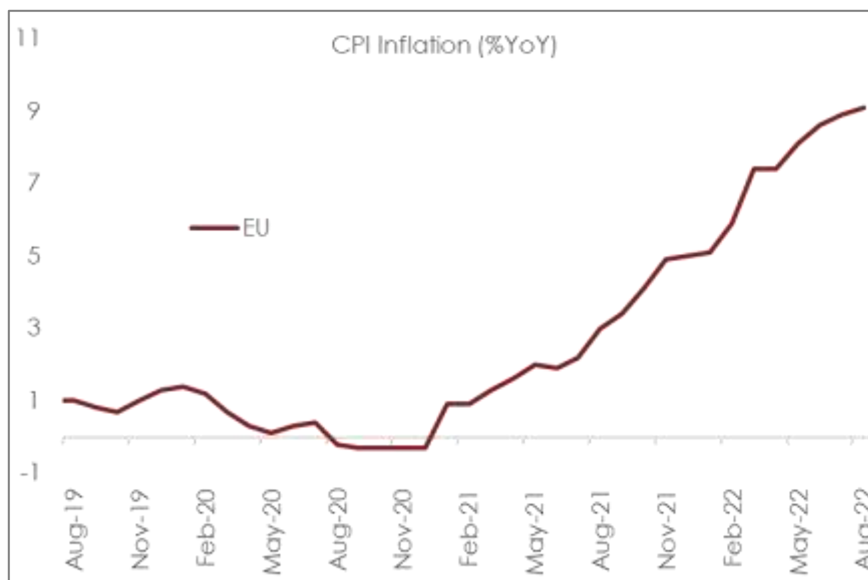
EUROZONE

The OECD in its latest economic outlook, projects Eurozone growth to slow down from 3.1% in 2022 to 0.3% in 2023. This implies that the region is likely to see a part of the year in a recession. This marks a dramatic downgrade from OECD's latest economic outlook in Jun-22 when the economy was forecast to grow by 1.6% in 2023. The international agency presented a gloomy outlook for the German economy, forecasting it to contract by 0.7% in 2023 from its Jun-22 estimate of a growth of 1.7%.

Reinforcing this, ECB president Christine Lagarde in her recent remarks to the European Parliament recently said that the economic outlook "is darkening" and she expects business activity to "slow substantially" in the coming months, as high energy and food prices pushed up by the war weigh on consumer's spending power. She also mentioned that next year would be "*certainly, a difficult year*" and that the first three months of 2023 "*will most likely be negative, as we believe that the fourth quarter of 2022 will be negative as well*."

Earlier this month, the European Central Bank raised its key interest rates by an unprecedented 75 bps and promised further hikes, prioritising the fight against inflation. Inflation jumped to yet another record high of 9.1% in Aug-22 compared to 8.9% in Jul-22 and the ECB's new projections predict a peak near this level just before the end of the year, even if some market analysts see it over 10% soon. As per ECB's own assessment, inflation will remain over the Bank's 2% target for several years to come.

Chart 2: Eurozone CPI inflation rose further to a fresh record high of 9.1% in Aug-22



UK

UK economy is showing clear signs of a slowdown in growth as inflation hit a 40-year high of 9.9%YoY in Aug-22. According to the monthly GDP estimate, UK growth was flat in Jul-22, marginally below expectations of a marginal growth of +0.1%. On a sequential basis, after rising in May-22 by +0.4%MoM, GDP fell in Jun-22 by 0.6%MoM before recovering slightly in Jul-22. In Jul-22, growth in services sector was largely offset by contraction in industry and construction.

The slowdown in growth notwithstanding, the labour market continues to operate at full employment levels. The unemployment rate has continued to fall by 0.2 points between May-22 and Jul-22, to 3.6% to mark its lowest level since 1974. Amidst a decline in labour force participation, vacancies were at 4.2% in Jul-22 – the highest level since 2001, especially in services-oriented sectors of – accommodation, healthcare and financial services.

Although inflation slowed slightly in Aug-22, coming in at 9.9%YoY compared to 10.1% in Jul-22, mainly reflecting a drop in fuel prices, it continues to be widespread. Core inflation rose to 6.3%YoY in Aug-22 from 6.2% in the previous month. At its monetary policy meeting, the Monetary Policy Committee decided on a seventh consecutive hike in the key interest rate by +50 bps, bringing the policy rate to 2.5%. In addition, and as expected, the MPC announced that it would sell EUR 80 bn of its portfolio of bonds over a twelve-month period starting from Oct-22.

More recently, UK Government in a bid to support growth, unveiled the country's biggest tax cut package in 50 years which has sparked fears of higher government borrowing along with rising interest rates and inflation. The IMF has responded to the fiscal measures critically as they run the risk of pushing inflation higher. The ensuing financial market turmoil has pushed the BoE to commit to buying as many long-dated government bonds as needed up to 14th Oct-22 in a bid to calm nerves. This remains a developing story on watch.

CHINA

China's economy continues to struggle in 2022. The difficulties in the real estate sector and the tough zero-tolerance COVID measures have hurt economic recovery. The People's Bank of China (PBoC) has loosened monetary policy and lowered interest rates in an effort to promote economic activity, in defiance of the global monetary policy tightening trend. In recent developments, the metropolis of Chengdu was placed under complete lockdown because of an increase in COVID cases.

August activity data surprised favourably with retail sales and industrial production data rising more than consensus expectations. While food and auto sales continued to record sizeable increase, catering sales too recovered from a Covid induced slowdown to increase by 8.4%YoY in Aug-22. As a result, retail sales increased 0.5%YoY in Aug-22. Industrial production increased by 4.2%YoY, exceeding the forecast of 3.8%. Notwithstanding slowdown in industries of cement and steel, the automotive production once again emerged as a bright spot.

On the currency front, the Chinese yuan breached the psychologically significant 7.00 mark earlier this month, and more recently has slipped further to a 14-year low (7.23 as of 29th Sep-22) against the dollar despite central bank efforts to stem the slide. On 15th Sep-22, to shore up the exchange rate, Beijing cut the amount of foreign currency deposits Chinese banks are required to hold as reserves to 6% from 8%. Reflecting the evolving macroeconomic and financial market developments, the World Bank cut its forecast for the Chinese economy to 2.8% in 2022 from 5.0% earlier.

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About Acuité Ratings & Research Limited:

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