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India’s economic recovery strengthens as uncertainty shrouds the global economic outlook

- Uncertainty about the global economic outlook has risen given the persistence of supply chain disruptions, jump in energy prices and inflationary pressures, and repricing of the pace of policy normalization by major central banks.
- India's economic recovery continues to gain traction, as indicated by higher frequency indicators.
- Demand conditions strengthened aided by the contained COVID situation, vaccination progress, and festival demand. However, broader input cost pressures and supply-side constraints may curtail the pace of economic recovery.
- Listed companies' Q2 FY22 earnings reports showed strong profitability and broadening of recovery to smaller-size firms and contact-intensive industries.
- As per the corporates' earnings reports, there are also signs of a pick-up in investment activity, though input cost pressures and supply-side constraints may weigh on revival in the near term.
- Governments, both center and states, are stepping up spending supported by strong revenue collections. Prospects of higher fiscal spending in H2 FY22 have improved, supporting the economic recovery outlook.
- Recent consumer inflation prints provide the RBI comfort to maintain an accommodative policy stance and plan a gradual policy normalization.
- There are, however, risks of inflation rising faster than anticipated due to elevated commodity prices, including energy prices, which may require the RBI to recalibrate its gradual policy normalization approach.
- The RBI is laying the groundwork for policy normalization by stepping up measures to adjust the liquidity overhang.
- We expect the RBI to hike reverse repo rate in the December/February policy meeting, with the possibility of two-stage hikes in the range of 10bps to 20bps, one in December followed by another in the February meeting in line with the RBI's gradual policy normalization approach.

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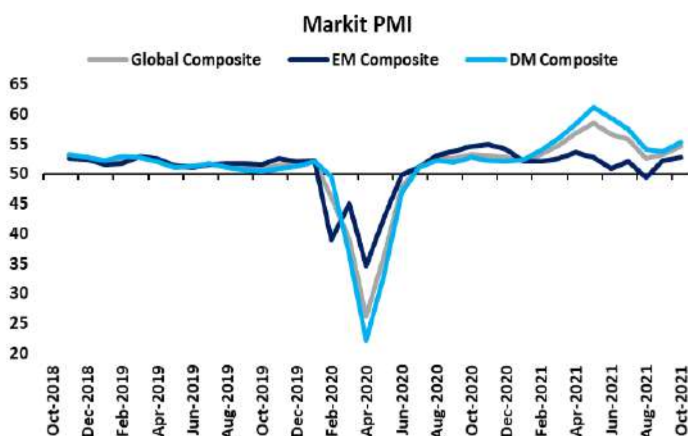
Uncertainty over the global economic outlook grows

Uncertainty about the global economic outlook has risen in view of the persistence of supply chain disruptions longer than previously anticipated, jump in energy prices and inflationary pressures, and repricing of the pace of policy normalization by major central banks. COVID cases have also started to inch up, driven by some of the European countries. These could weigh on the global economic activity momentum, which had already weakened in Q3 CY 2022. The world's two largest economies, the US (due to rise in COVID cases, supply-side issues, and fall in government assistance payout) and China (due to several factors including energy shortages and troubles in the property sector), posted slower economic growth in the September quarter. Economic recovery in the Euro area, on the other hand, managed to gain traction in Q3. Early data for Q4 indicates attempts to regain lost momentum amidst continued supply-side constraints and elevated energy prices. The rising vaccine coverage (more than 50% of the world population has received at least a single vaccine dose), especially among developed economies (fully vaccinated nearly 2/3rd of their population), enabled countries to relax restrictions on movement and other contact intensive services, including international travel. This was reflected in the global composite PMI, which jumped to a 3-month high of 54.5 in October, driven primarily by an improvement in the services PMI. In addition, the improvement in the composite PMI was mostly noted in developed economies, indicating the boost in economic activity due to the relatively higher vaccine coverage compared to emerging economies.

Global economic recovery led by advanced economies



Source: IHS Markit

However, the traction in business activity has been stymied with rising input cost pressures and continued supply chain disruptions that pose headwinds to the global economic outlook. According to the global PMI survey, the average vendor delivery time increased to its highest level since survey inception, and input prices rose at their fastest pace in over 13 years due to rising commodity prices. Consequently, inflationary pressures continue to build in major developed and several emerging economies. This, coupled with country-specific factors, is leading to a shift towards faster than previously anticipated policy normalization by some countries' central banks, as reflected by the Bank of Canada ending its assets purchase program, the Monetary Authority of Singapore tightening its monetary policy, and central banks of Brazil, Russia, Czech Republic, Poland, Hungary, and Chile raising the respective policy rates. But some other central banks, like the Bank of England, held back from raising policy rates despite markets' expectations. Meanwhile, after ECB announced the tapering of its assets purchase program in the September meeting, the US Fed followed and announced the start of tapering of its assets purchase program in its November meeting. Markets are increasingly focused on the timing and the pace of the US Fed rate hike. With US CPI inflation for October surging to the highest levels in over 3 decades, US bond yields have risen as market participants are now pricing in more than two rate hikes in 2022, a faster pace than indicated by Federal Open Market Committee's members "dot-plot". Central banks have an arduous task of supporting fragile and uneven economic recovery while ensuring ongoing inflationary pressures don't become entrenched, weighing economic outlook by forcing disruptive policy moves later.

India's economic recovery remains on track; supply-side issues and higher input costs may pose risks to the recovery momentum

India's economic activity remains on the recovery path as demand conditions improve, aided by the contained COVID situation, progress on the vaccination front, and festival demand. India's COVID situation remains contained despite pick up in mobility during the festival season. Daily COVID cases (7-dma) continued to hover around ~11K by November 16 compared to 20K on October 9. Other COVID indicators also remained benign as the daily positivity rate (7-dma) dropped below 1% for the first time by November 16. The daily recoveries continue to outpace the daily cases, bringing the active caseload (7-dma) to around 1.2 lakhs at present from around 2.3 lakhs as of October 9. On the vaccination front, India has administered close to 114 crores of vaccine doses as of November 17, and as a result, inoculated ~80.5% of the adult population with at least one dose and ~40.6% with both doses.

While demand conditions improved, there are signs of supply-side issues weighing on certain industries such as auto, electronics, and power generation, leading to demand-supply mismatches. How quickly and effectively supply-side

constraints can be addressed will have an important bearing on the economic recovery momentum in H2-FY22. Potential pick-up in the pass-through of elevated input costs to final consumers may also weigh on the pace of economic recovery. This follows a quick economic recovery in Q2 FY22 from the second COVID wave impact in Q1. With most high-frequency indicators such as PMIs, industrial production, credit growth, E-way bills, GST collections, exports, fiscal CAPEX spending, and employment, etc. showing recovery in Q2, we reiterate our view of economic growth to be around 9% YoY in Q2 FY22, putting Q2 real GDP above its pre-COVID level.

The agriculture sector continues to offer bright prospects after a record Kharif harvest, a strong start of rabi sowing, and current reservoir conditions. As of November 11, the sowing of Rabi crops was 1.4% higher than the last year, and the total live storage in 130 important reservoirs of ~80.1% of the full reservoir level was 6.6% higher than the decadal average. Other indicators, however, depicted mixed trends, with tractor sales continuing to increase while fertilizer sales declined (possibly due to supply issues). Nonetheless, with the government announcing a subsidy for DAP (Di-ammonium Phosphate) and taking measures to boost the fertilizer supply, the robust performance of the agriculture sector is expected to continue.

The Industrial Index of Production (IIP) slid below pre-COVID levels (taken as an average for 2019) at 98% after two consecutive months of staying above its pre-COVID levels, with electricity being the only sub-head managing to stay above its pre-COVID levels at 106%. With supply-side disruptions weighing on the industrial activity and the waning of the base effect, the IIP noted a growth of 3% YoY in September compared to 12% YoY in August. On a sequential basis, the IIP index momentum registered a decline of 2.6% MoM, with moderation in all major sub-heads, following a marginal decline of 0.1% in the prior month. Mining activity was constrained by an extended monsoon season, electricity generation by coal shortages (which intensified in late September and early October), and manufacturing by chip shortages (motor vehicles output down by 9%YoY and other transport equipment by 18.5% YoY). While mining and electricity generation (coal stocks with power plants rose to 8 days by mid-November from 4 days in mid-October) issues should be alleviated in the coming months, the semiconductor chips shortage may persist longer. Despite supply-side issues, the lead indicator for manufacturing depicts a strong momentum as the manufacturing PMI reached its 8-month high level of 55.9 compared to 53.7 in September as companies reported increased production and new orders both domestically and internationally, amidst improving demand conditions. However, the input cost pressures continued to remain a concern as input prices surged substantially to a near eight-year high in October as per the survey. Other high-frequency indicators like E-way bills (15% YoY/8% MoM) and second-highest GST collections on record (24% YoY/11% MoM) showed robust growth in October on an annualized and sequential basis, indicating a further upswing in industrial activity amidst the festival season. Petrol consumption surpassed its pre-COVID levels, whereas diesel consumption inched closer to pre-pandemic levels (110% and 94% of the respective pre-pandemic levels). Continuing robust exports performance (42.5% YoY in October and 54.5% YoY during April-October'21) also remain supportive of industrial and agriculture sectors growth.

Meanwhile, the services sector is staging a strong and broad-based recovery thanks to the contained COVID situation and rapid progress on the vaccination front. The services PMI reached its decadal high of 58.4 in October compared to 55.2 in the previous month. Despite increased input cost pressures, companies reported a notable increase in sales, production, and employment. However, the international demand continued to weigh on the recovery of the services sector as new export orders declined, but the rate of contraction remained weakest in FY22. Domestic air traffic passengers continued to recover sequentially in October amidst the easing of travel restrictions and festival season. Other high-frequency indicators also suggest an uptick in the services sector as rail freight, port cargo, etc. showed a sequential improvement in October. We expect the services sector recovery to gather further momentum with receding concerns of a third COVID wave and the continued vaccination pace.

Demand conditions strengthened, supported by the festival season and a labour market recovery

Incoming high-frequency indicators suggest a strengthening of consumption demand conditions. Amidst the festival season, google mobility for grocery and pharmacies reached 53.3% above baseline levels in early November. Google mobility for retail and recreation inched closer to its pre-pandemic levels as it averaged 4.9% below baseline in October and reached 1.25% above baseline in the early days of November (data till November 8). Retail credit also increased sequentially in September by 0.9% MoM vs 1.2% MoM in August. As per IIP data, consumer durables noted a sequential improvement in September, whereas the non-durables noted marginal moderation. Auto sales, both retail and wholesale, of Passenger Vehicles, Two-Wheelers, and Three-Wheelers combined showed a sequential pick up by 5.7% MoM and 4.8% MoM respectively in October amidst the festival season; however, the global chip shortages

impact was visible in terms of 24.7% YoY fall in wholesale dispatches

Broad-based recovery in demand indicators

Consumption Indicators, Index Averaged to 2019								
	Apr-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Oct-21
Google Mobility - Grocery & Pharmacy	-52	-2.5	-4.9	9.5	18.5	3.2	32.7	42.8
Google Mobility - Retail & Recreation	-81.5	-59.8	-41.9	-27.5	-22.1	-40.4	-13.0	-4.9
Petrol Consumption	38.8	91.1	97.8	108.0	109.4	96.2	103.7	109.8
Diesel Consumption	46.4	89.9	78.3	102.6	103.1	88.4	78.7	94.4
Personal Loans	108.5	108.2	113.2	115.8	123.7	121.1	126.9	
Passenger Car Sales	1.4	38.3	97.1	95.5	95.5	81.6	52.1	68.1
Two Wheeler sales	2.5	66.0	119.2	81.5	101.0	76.4	102.8	104.4
Tractor Sales	18.6	147.2	173.4	107.1	142.1	179.8	156.9	190.8
IIP: Consumer Durables	4.4	63.0	104.0	100.7	107.2	80.7	101.9	
IIP: Non-Consumer Durables	49.0	99.5	99.4	108.6	106.0	95.6	98.9	

Source: CMIE, Google mobility reports

The optimism around improving demand conditions is further confirmed by the early estimates of the Diwali sales published by the Confederation of All India Trade (CAIT). As per CAIT, the retailers logged a decadal high sale of Rs 1.25 lakh crores (i.e., 73% YoY increase) driven by the release of pent-up demand and additional festival demand. Another bright sign of resumption in demand is reflected in an extraordinary surge in e-commerce sales during the festive season as the combined sales (gross merchandise value) of e-commerce firms increased by ~Rs 68,000 cores, 84% above its pre-COVID levels, as per RedSeer.

The economic environment remains supportive for continued recovery in the demand conditions. Two measures of hike in Dearness Allowance and Excise cuts on diesel and petrol by the center and several states will provide further impetus to the consumption demand by supplementing households' disposable income. Moreover, labour market conditions improved in Sept-October'21, which should aid consumption spending recovery. As per the CMIE data, the employment level remained above 400 million for a second consecutive month in October. It, however, showed some moderation from the recent peak in September with jobs losses concentrated in two sectors viz agriculture (reporting a decline of 2.5 million jobs in October) and construction sector (7.7 million jobs lost in October), mainly in the rural areas. Nonetheless, the employment level was the second-highest since the start of the pandemic. With a decline in jobs and a rise in labor force participation in rural areas, the rural greater unemployment rate edged from 9.3% in September to 11.9% in October, pushing the national greater unemployment rate from 9.9% to 11.1% during the same period. With a pick-up in the rabi sowing season, we could expect some improvement in rural employment conditions in the coming months. Broadening of economic recovery and expectations of additional funds for the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) should also support the rural jobs market.

In contrast to deterioration in rural unemployment numbers, the urban job markets continued to mend as urban areas noted a moderation in the greater unemployment rate from 11.3% in September to 9.3% in October. This was further reiterated by the hiring trends in the organized sector. In October, the Naukri Jobs index registered a growth of 43% YoY and 19% above the October 2019 level. The hiring activity remained supported by professional services like IT services, employment firms, medical services, etc., and pick up in contact intensive services such as hotels, media, etc. Moreover, the recovery observed in the urban job market is also noted in the Q2 FY22 corporate earnings reports. According to a sample of over 3,000 companies in the non-financial sector sourced from CMIE, despite the second COVID wave, the wage cost increased by 14.4% YoY in Q1 FY22, with smaller firms being the only exception (53% YoY decline in bottom decile). With the resumption of economic activity after the ebbing of the second wave, salaries and wage costs grew by 14.5% YoY in Q2. The bottom decile noted a growth of 3% YoY for the first time since the onset of the pandemic, reflecting a broad-based recovery in the urban employment conditions.

Listed companies report a rise in wage costs indicating improved jobs conditions.

Non-Financial Sector - Salaries and Wages % YoY							
	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
Total	**3.9**	**-3.6**	**-1.6**	**3.4**	**5.8**	**14.4**	**14.5**
Decile 1	4.5	-0.8	0.1	4.6	5.9	13.1	13.3
Decile 2	3.7	-10.4	-5.9	2.5	8.1	19.7	19.8
Decile 3	-1.2	-17.7	-12.3	-5.1	5.1	21.9	19.9
Decile 4	0.2	-21.1	-9.9	-4.8	1.4	20.3	17.8
Decile 5	-3.3	-21.9	-10.7	-5.4	0.9	23.9	15.7
Decile 6	1.7	-24.4	-11.4	-5.8	3.3	26.6	16.0
Decile 7	-9.8	-23.1	-24.9	-10.2	-7.6	14.0	13.2
Decile 8	-6.8	-29.0	-17.4	-19.3	0.8	25.6	17.6
Decile 9	-10.3	-22.4	-25.0	-12.7	-0.4	21.0	8.5
Decile 10	-7.7	-18.3	-32.4	-29.6	-26.8	-52.7	2.9

Source: CMIE

The corporate sector posts record-high quarterly profits in Q2; investment activity shows signs of revival

Listed companies' Q2 FY22 earnings reports indicate continued strong profitability and broadening of recovery to smaller-size firms and contact-intensive industries. This should bode well for the strengthening of investment activity revival. Based on the financial results of 2603 companies as per the CMIE, the non-financial sector reported an increase

in profit before taxes (PAT) to a record high in Q2 FY22. The sharp rise in expenditures (led by operating expenses and fuel & power) was matched by increases in total incomes in line with the recovery in sales and some price adjustments. The pace of profit growth, however, moderated due to the base effect. Corporate sales rose to their highest ever in Q2 FY22, surpassing its pre-COVID levels by ~25% (vs September 2019) and increasing by 39% YoY. The traction in sales was broad-based across sectors with manufacturing, mining, services (other than financial), and real estate & construction sales growing by ~29%, ~17%, ~14%, and ~8%, respectively, above their respective pre-COVID (vs September 2019) levels. The contact-intensive services that had reeled under the first and second COVID waves also noted a healthy recovery in demand as restrictions eased further, signaling a broad-based turnaround. Sales for the Hotels & restaurants and transportation services improved to ~15% and ~20% below their pre-COVID levels (from ~52% and ~37% below their respective pre-COVID levels in the previous quarter). Meanwhile, tourism sales noted a modest improvement over the quarter; however, we expect this to normalize further as travel restrictions are lifted progressively.

Sales recovery broadens to the services sector

Non-Financial Sector Sales Performance							
Sector-Wise Break-up	% YoY					% 2YoY	
	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Jun-21	Sep-21
Non-Financial	**-10.3**	**-0.6**	**18.8**	**58.9**	**38.9**	**2.3**	**25.2**
Manufacturing	-10.3	-0.2	22.7	80.2	41.7	2.1	28.8
Mining	-27.3	-19.0	16.0	98.3	61.4	0.5	17.2
Electricity	-0.6	1.7	-3.1	-33.4	39.7	5.7	48.2
Services*	-9.2	-0.7	10.3	32.3	30.3	3.6	13.9
Hotels & Restaurants	-68.6	-52.2	-28.8	106.9	136.2	-52.4	-15.0
Tourism	-93.8	-88.3	-72.2	5.4	30.7	-96.4	-92.7
Transport Services	-41.5	-31.5	-12.6	69.4	46.7	-36.7	-19.7
Construction & Real Estate	-14.5	0.1	18.0	61.3	24.0	-4.0	8.1

Source: CMIE; *Services is excluding the financial sector

It is also heartening to note that the recovery is well-rounded when accounting for firm size. In our Economic monitor report (July edition), we had noted the divergence in the performance recovery of firms that were skewed in favor of the larger firms while smaller firms had reported sub-optimal sales. In the September 2021 quarter, corporates across firm size (split as per deciles) reported their highest ever sales that were comfortably above their pre-COVID levels, with firms in the 10th decile posting a 53% YoY jump in sales after a 22% YoY contraction in Q2.

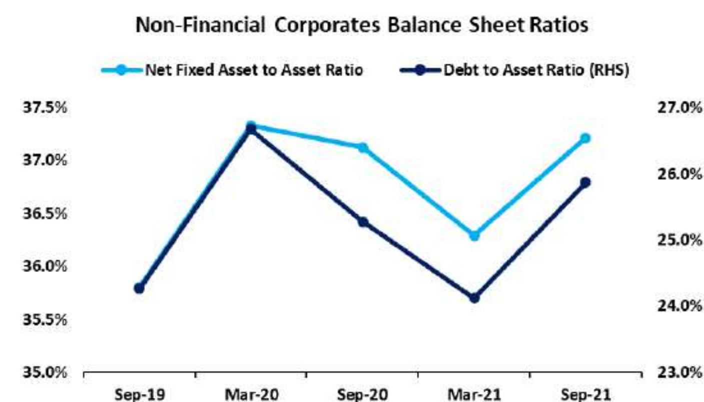
Listed companies by firm size show a broad-based turnaround in sales

Non-Financial Sector Sales Performance							
Size Wise Break-up	Net Sales (in Millions)				% YoY		
	Dec-20	Mar-21	Jun-21	Sep-21	Mar-21	Jun-21	Sep-21
Decile 1	1,18,60,975	1,34,31,292	1,23,41,557	1,40,17,138	6.9%	1.8%	22.2%
Decile 2	12,23,497	14,67,706	12,70,895	15,39,835	17.2%	5.2%	35.2%
Decile 3	5,07,423	5,99,125	5,25,431	7,17,481	9.0%	4.9%	45.6%
Decile 4	2,60,995	2,99,691	2,51,104	3,49,209	10.9%	1.6%	47.4%
Decile 5	1,31,680	1,58,675	1,36,774	1,89,671	14.1%	7.1%	51.7%
Decile 6	75,091	85,883	66,823	1,05,073	12.5%	4.7%	65.4%
Decile 7	35,861	41,171	32,169	53,082	13.6%	0.7%	68.2%
Decile 8	14,244	17,178	12,151	22,183	12.0%	5.6%	64.4%
Decile 9	3,558	5,012	3,404	6,522	23.9%	-0.7%	80.7%
Decile 10	383	508	253	603	9.9%	-22.3%	52.9%

Source: CMIE

The healthy recovery in overall corporate sector activity has boosted business confidence, with the RBI business assessment index (BAI) indicating the strongest expansion of business activity in the manufacturing sector since FY2011. The RBI's services outlook survey also reported a rebound in the overall services business situation in Q2 FY22 after a sharp decline in the previous quarter. Meanwhile, private surveys such as the NCAER business confidence index also pointed towards the highest business sentiment in over two years. The turn in sentiments appears to be translating into a pick-up in capital raising activity by corporates. With the buoyant stock market, funds raised through public offerings remained robust, with a record fundraising of ~Rs 414 billion in the September quarter (88% YoY). Bank credit to industries noted a tentative turnaround in the September 2021 quarter. While this was muted at 2.5% YoY, it was the fastest quarterly growth pace since Q1 FY20. Meanwhile, funds raised through the primary debt market (increased by 5.6% YoY in Q2 FY22 vs a 40% YoY contraction in the previous quarter) improved in Q2. Overall, total borrowings by the sample of listed companies increased by ~21% YoY in the September 2021 quarter (vs 4.3% YoY decline in Q1 FY22).

Rise in corporate debt utilized for investment purposes



Source: CMIE

Accordingly, the total debt to asset ratio of sample companies rose to ~26% as of September 2021, its highest since March 2020. It is encouraging to note that this was matched by an increase in fixed assets, indicating tentative signs of revival in the investment cycle. This contrasts with last year, where corporates were primarily raising funds at relatively cheaper rates to deleverage their old and more expensive debt. The net fixed assets and investment by non-financial corporates rose by over 14% YoY in Q2 FY22, which was its highest pace of growth in more than four years. Accordingly, the net fixed asset to total asset ratio inched back near its March 2020 levels at 37.2% in September 2021. The total investment projects completed (as per CMIE) also increased by 34.2% YoY in September 2021, although new investment projects announced remained low. It is worth noting that companies raised concerns about higher inputs costs and pressures on margins. Any sustained elevated input prices/supply-side bottlenecks could pose risks to the investment revival and will have to be monitored.

Government spending gains traction supported by strong revenue collections

Economic recovery is likely to benefit from expected higher government expenditure in H2 FY22. With the reopening of the economy, the government has stepped up its spending to boost economic recovery momentum. The government spending rose by 21.2% YoY in Q2 FY22, up sharply from 0.7% YoY in Q1 FY22 as the finance ministry lifted expenditure curbs on select ministries and departments in line with robust tax collections. This continued to be led by higher capital expenditure, which increased by ~52% YoY in Q2 FY22 (vs ~26% in Q1 FY22), with revenue expenditure also rebounding to increase by ~17% YoY (vs contraction of ~2.4% in Q1 FY22). Accordingly, government spending stood ~10% YoY higher for the first half of the fiscal year. State governments also maintained their pace of spending, with total expenditure (based on data available for 22 states) increasing by ~17% in H1 FY22 over H1 FY21. Incentivized by the push from the central government – states also prioritized capital spending, which stood higher by 76% YoY, while revenue expenditure increased by ~12% YoY in H1 FY22. Capital expenditure by Central Public Sector Enterprises (CPSEs) also picked up as they achieved ~37% of their aggregate capital expenditure target in H1 FY22 (according to government officials), which stands ~30% higher over the previous fiscal year. These are likely to keep investment demand robust even as we note nascent signs of a pick-up in the private investment cycle. Moreover, the stronger revenue expenditure is expected to percolate into higher government consumption expenditure in the Q2 FY22 GDP release later this month.

The robust pick-up in spending has come on the back of strong tax collections by both the center and state governments. The net tax collections by the center rose by ~101% YoY in H1 FY22, driven by both direct and indirect taxes, indicating a strong recovery in the economy and base effect. Corporate taxes rose by 105% YoY in H1 FY22, while income tax was higher by 64.7% YoY. Meanwhile, GST collections crossed the Rs 1 lakh crore mark for the fourth consecutive month and scaled to their second-highest ever collection in October 2021. As a result - total central government receipts achieved ~56% of its budgeted target until September 2021, far exceeding the past trend rate (average of ~41% of budgeted revenue collected during FY2016-20) during the first half of the fiscal year. State revenues also remain robust, with tax receipts ~32% higher YoY (data for 22 states) in the first half of the fiscal year. Moreover, seven states have received the centre's approval to borrow an additional amount of Rs 16,691 crores after achieving the capital expenditure target for Q2 FY22. This is likely to aid states in continuing to maintain their pace of expenditure.

Government spending picks pace buoyed by strong revenue collections

Fiscal Metrics			
Central Government			
	H1 FY2022 % YoY	Aug 2021 %YoY	Sep 2021 %YoY
Total Receipts	**94.4**	**-13.2**	**54.4**
Net TaxRevenues	100.8	41.5	58.5
Non Tax Revenues	73.8	-85.9	91.1
Total Expenditure	**9.9**	**40.7**	**50.7**
Revenue Expenditure	6.3	33.9	45.7
Capital Expenditure	38.3	92.2	83.1
State Governments*			
Total Revenue Receipts	**26.2**	**42.9**	**34.7**
Total Expenditure	**17.2**	**11.6**	**35.1**
Revenue Expenditure	11.9	8.5	28.2
Capital Expenditure	76.1	54.0	113.0

Source: CMIE; *data based on 22 states

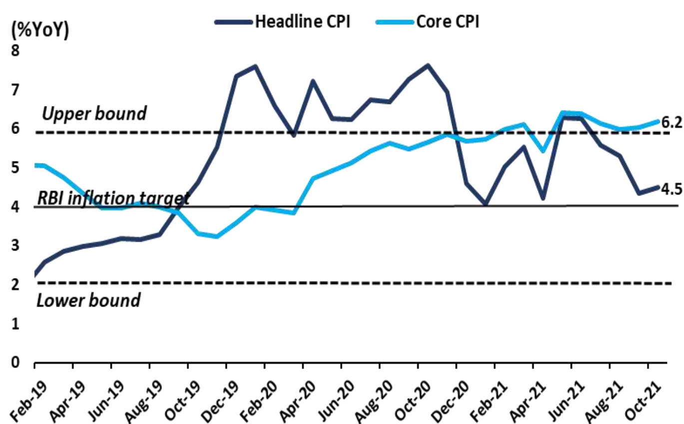
Strong revenue collections have resulted in a benign fiscal position for the government, supporting prospects for higher spending in the rest of FY22. The fiscal deficit for the center stood at just ~35% of its budgeted estimates in H1 FY22. This compares favorably against the previous year's trends when the fiscal deficit had reached ~86% (5-year average FY2016-20) of their respective BE in the first half of their respective fiscal years. This bodes well for the government to boost expenditure beyond the budgeted amounts. Utilizing the fiscal space, the central government announced a cut in excise duties on petrol and diesel by Rs 5 per litre and Rs 10 per litre, respectively, in early November. Following this, 25 states and union territories announced a

reduction in their respective Value-added Taxes (VAT) for petrol and diesel by ~Rs 6 per litre and ~Rs 5 per litre, respectively, on average. The announced excise duty cut is estimated to result in a revenue loss of ~Rs 44,000 crores (~0.2% of GDP) for the remaining 5 months (November-March) for the central government, and states' VAT reduction could result in a revenue loss of ~Rs 32,000 (~0.14% of GDP) for the above 25 states/UTs. Given that VAT by states is levied on an ad valorem basis, the final loss on state revenues could be higher. These excise/VAT cuts are expected to be easily covered by the ongoing strong revenue collections, thus not unduly impacting the fiscal deficit targets.

RBI setting the stage for policy normalization

Recent consumer inflation prints presently provide the RBI comfort to maintain an accommodative policy stance and plan a gradual policy normalization approach. There are, however, risks of inflation rising faster than anticipated due to elevated commodity prices, including energy prices. It is thus imperative for the central bank to continue to prepare the ground for the start of policy normalization.

Headline CPI inflation inched higher but well below RBI's upper bound; core inflation remains sticky

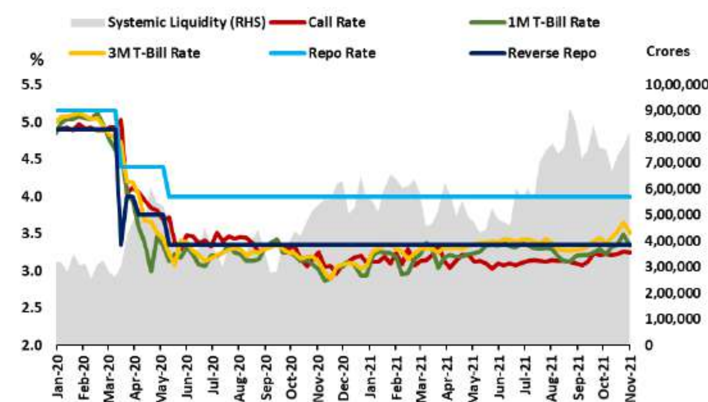


Source: CMIE

After four consecutive months of easing, the CPI headline inflation edged slightly to 4.5% YoY in October from 4.3% YoY in September, despite a favourable base. Despite the increase, inflation remains well within the RBI target range of 2% to 6%. The marginal increase in CPI is led by an all-time high fuel inflation rate of 14.3% and a pick-up in food inflation (from 0.68% YoY in September to 0.85% YoY in October). Core inflation remained sticky at around 6.2% YoY, thanks to the broadening of inflation in clothes and footwear, miscellaneous items, personal care, etc. With a broad-based surge in input prices, the WPI inflation for October accelerated to a five-month high of 12.5% YoY. As economic activity continues to revive, we could see producers passing on the input cost pressures to consumers, leading to a convergence of headline and core inflation. This will partly be curtailed by the recent excise/VAT cuts for petrol and diesel price, supply-side measures by the government for edible oil and pulses, and continued good agriculture output prospects.

With ongoing sequential economic recovery and continuing inflationary pressures risks (in core CPI and elevated WPI countering contained headline CPI), the RBI is expected to start the policy normalization in its upcoming meeting. It is already laying the groundwork for policy normalization by stepping up measures to adjust the liquidity overhang. In the October policy meeting, the RBI increased the quantum of the fortnightly VRRR auctions and announced suspension of the market G-Sec Acquisition Programme (GSAP) operation. It also announced complementing the 14-day VRRR auctions with 28-day VRRR auctions, a sign to address the durable liquidity in the system. Accordingly, it conducted the first 28 days VRRR auction on November 2, with a cut-off rate of 3.97% and the weighted average rate of 3.95%. The surplus liquidity has come down thanks to RBI measures; however, it remains elevated, raising the possibility of additional longer-tenor VRRR auctions. Higher-cut offs at VRRR auctions have led to short-term rates drifting upward. Accordingly, money market rates such as the call rate, 1month T-bill, and 3month T-bill increased by 1 bps, 9 bps, and 11 bps, respectively, as of November 12 compared to the beginning of October. This sets the stage for the potential reverse repo hike in the December/February policy meeting, with the possibility of two-stage hikes in the range of 10bps to 20bps, one in December followed by another in the February meeting, in line with RBI's gradual policy normalization approach.

Short-term rates inched up following long term repo auctions



Source: CMIE

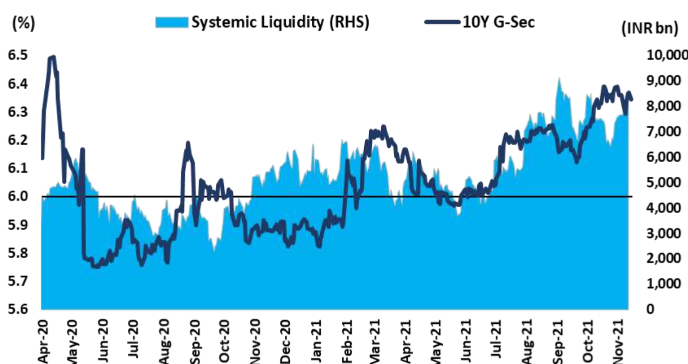
Market Section

Indian bond markets came under pressure in October, with yields rising across the curve driven by a combination of higher global energy prices, RBI's measures to address

liquidity overhang, and markets pricing of US Fed's policy normalization. Bond yields on the benchmark 10Y inched higher by 15 basis points in October to trade at 6.33% on average vs 6.18% in September. Meanwhile, the shorter end of the curve noted a sharper increase with yields on the 1Y and 2Y papers rising by 24 basis points, respectively, as the RBI increased its quantum of VRRR auctions and introduced a longer tenor of 28 days for the VRRR auctions in addition to the fortnightly tenors. The measures to normalize the surplus liquidity resulted in a flattening of the yields curve, with the 10Y-2Y spread narrowing by ~8 basis points in October. In addition, bond yields also came under pressure with the elevated crude oil prices (Brent increased to its highest levels in seven years) as the Fed started with the tapering of its asset purchase programme in November. This was further exacerbated by rising inflationary pressures in the US, which have led markets to reprice their expectations of the US Fed's rate hikes as early as next year.

Consequently, the Indian 10-year yields have increased moving into November (averaging 6.35% until mid-November). We expect bond yields to increase further from hereon as RBI embarks on policy normalization, although we expect the central bank to ensure a gradual normalization that is likely to curb any excessive volatility. Higher than expected inflation, fueled by elevated global commodity prices, may pose risks to this outlook.

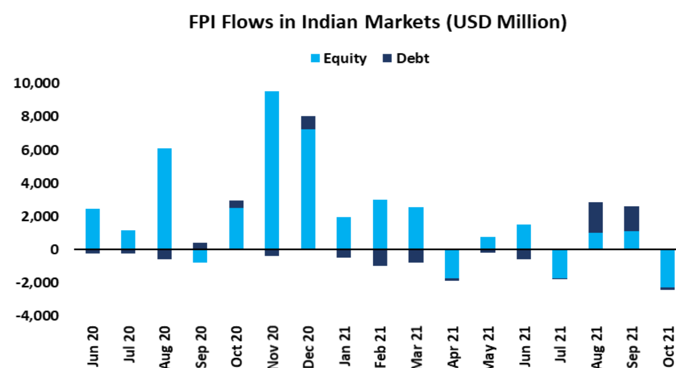
Indian bond markets come under pressure on expected policy normalization



Source: CMIE, Bloomberg

Indian equity markets managed to extend gains in the month of October as the NIFTY and SENSEX indices reported a modest increase of 0.3% MoM each. The indices scaled to record highs around mid-October buoyed by the ongoing economic recovery, corporates' robust earnings report for Q2 FY22, and optimism around the increasing vaccine coverage and falling COVID cases. However, concerns around the elevated valuations of the Indian stock market that has given 26% returns in this fiscal year until its peak in mid-October (on the back of 71% returns in FY21) resulted in some correction in the second half of October. Some global financial institutions downgraded Indian equities due to valuation concerns. The P/E multiples fell marginally to ~26.2 on average in October compared to 28.1 (average) in September. Meanwhile, the beginning of the tapering of liquidity by the US Fed and concerns around a sooner than expected normalization of interest rates nudged FPIs to pull out ~$2.3 billion of capital from the Indian equity markets in October, partly reversing the flows from the previous two months. Meanwhile, mutual funds continued to plough capital in Indian equities for the eighth consecutive month in October, although it was the lowest investment since May 2021. Going into November, Indian equities have inched higher by ~2.4% again as of mid-November, supported by ongoing economic recovery and robust earnings reports by corporates. However, we do not rule out possible volatility due to repricing of timing and pace of US Fed policy normalization and higher commodity prices.

Foreign investors pull out capital from equity and debt markets amidst global markets volatility



Source: CMIE

The Indian rupee came under pressure as it depreciated by nearly 2% against the dollar in the month of October. The strengthening of the Dollar Index as the US Fed embarked on tapering its asset purchase program weighed on emerging markets, including India, as FPIs pulled capital from both Indian equity and debt markets, reversing their trends from the past two months. The elevated oil prices also weighed on the domestic currency as Brent prices increased by another 7.5% MoM in October and stood almost 125% above the previous year's levels. This, along with the general recovery in import demand, weighed on the trade deficit in October, which widened to its second-highest print ever (highest being in September) and weighed on the rupee. Meanwhile, the RBI also continued to intervene and build on its FX reserves (~$5 billion in October) that weighed on the currency. Moving into November, the Indian Rupee has somewhat stabilized. However, going ahead, we do not rule out volatility with the changing global macro-economic landscape and global inflationary pressures. Although the RBI is well equipped with significant FX reserves to curb any sharp volatility in the currency.

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