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India's economic activity rides on festive demand even as signs of a global economic slowdown intensify

- Global economic activity continues to moderate amid persistently high inflation globally and the corresponding broad-based monetary policy tightening, China's ongoing COVID Zero policy, and spillover from the Russia-Ukraine conflict.
- Despite signs of cooling economic activity in many places around the world, inflation remains elevated, and labour markets are also resilient, meaning that the generalized trend of monetary tightening is far from over. However, the pace of rate increases is likely to slow.
- Notwithstanding recent moderation, commodity prices remain elevated by historical standards. With the expected continued tightening of policy in the developed world, developing countries likely will remain prone to fast-materializing external risks.
- Domestic demand continues to recover, boosted by festive season sales, services sector recovery, and the government's push on capital spending. Prospects for the agriculture sector seem bright.
- However, the positive momentum is being offset to a degree by continued soft private investment and weak industrial sector momentum. External trade remains a drag amid slowing global growth.
- India's consumer price inflation cooled to 6.8% YoY in October primarily due to a favourable base effect and simmering of food price pressures. Meanwhile, the wholesale price inflation reached its nineteen-month low of 8.4% YoY in October from its peak of 16.6% YoY in May 2022.
- The softening of inflation in October along with an expectation of further moderation in inflation could lead to a softer rate hike by the RBI in December. Accordingly, we continue to retain our view of the terminal rate being at 6.5% by end of FY23.
- In line with a moderation in the inflation rate, continued optimism about domestic economic growth and improvement in global investor sentiment towards EMs the Indian equity markets scaled fresh highs in November. This has supported the local currency.
- Bond markets also saw some respite in November due to the expectation of smaller rate hikes going forward as well as a softer domestic inflation print. Overall, we expect volatility to persist, with some firming up in yields.

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Global economic activity momentum slowed to a 2½-year low

Global economic activity continues to moderate amid persistently high inflation globally and the corresponding broad-based monetary policy tightening, most notably by the US Federal Reserve, China's ongoing COVID Zero policy, and a spillover from the protracted Russia-Ukraine conflict. The degree of cooling in the pace of economic activity varies by region and country but the generalized slowing in growth is unmistakable.

Consistent with tighter monetary policy and higher interest rates, the global economic slowdown is most pronounced in the most cyclical economic sectors. Manufacturing activity, for instance, in October contracted for the second consecutive month based on the global manufacturing PMI. In the month, the manufacturing PMI fell to a 28-month low. Forward looking PMI indicators are consistent with additional softening ahead: new orders – an indicator of future activity – declined in 25 of the 32 countries comprising the index. Higher interest rates also are souring sentiment globally toward large purchases such as those for real estate and automobiles, which probably is not fully reflected in the slumping global manufacturing PMI.

Activity in sectors less sensitive – but by no means immune – to higher interest rates is also beginning to show visible signs of cooling. Broad services sector activity as measured by the global services PMI indicated a mild contraction in activity globally in October. Echoing the weakening in activity, service sector business confidence for the year ahead continued to decline and now is at its worst reading since September 2020 when COVID continued to be a considerable uncertainty.

The generalized slowing in growth is unmistakable

	Composite PMI (Value > 50 indicates expansion from previous month; <50 indicates contraction; 50 is no change)									
	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22
Global	51.1	53.5	52.8	51.2	51.3	53.5	50.8	49.3	49.6	49.0
US	51.1	55.9	57.7	56.0	53.6	52.3	47.5	44.6	49.5	48.2
China	50.1	50.1	43.9	37.2	42.2	55.3	54.0	53.0	48.5	48.3
Eurozone	52.3	55.5	54.9	55.8	54.8	52.0	49.9	48.9	48.1	47.3
Japan	49.9	45.8	50.3	51.1	52.3	53.0	50.2	49.4	51.0	51.8
Germany	53.8	55.6	55.1	54.3	53.7	51.3	48.1	46.9	45.7	45.1
UK	54.2	59.9	60.9	58.2	53.1	53.7	52.1	49.6	49.1	48.2
India	53.0	53.5	54.3	57.6	58.3	58.2	56.6	58.2	55.1	55.5

Source: IHS Markit & Bloomberg

To date, the weakening trend in global economic activity has had little effect on labour market conditions even when accounting for the fact that employment conditions historically lag trends in broad economic activity. Resilient labour markets are helping to blunt the adverse effects on economic growth from tighter monetary policy and the erosion of purchasing power due to inflation. That resilience is proving to be a double-edged sword in that continued strength in labour markets is helping to sustain inflation rates globally that are much too high. The upshot is that despite signs of cooling economic activity in many places around the world, inflation remains much too high and labour markets too resilient to conclude with confidence that the generalized trend of monetary tightening is on the verge of concluding.

Despite significant tightening, inflation in the majority of economies remains manifolds above the target

	Policy rate (%)											Cumulative hikes in 2022 (bps)	Inflation (deviation from target)
	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22		
US	0.25	0.25	0.50	0.50	1.00	1.75	2.50	2.50	3.25	3.25	4.00	375	7.7 (+5.7)
China	2.85	2.85	2.85	2.85	2.85	2.85	2.85	2.75	2.75	2.75	2.75	-10	2.1 (-0.9)
EU	0.00	0.00	0.00	0.00	0.00	0.00	0.50	0.50	1.25	2.00	2.00	200	10.6 (+8.6)
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0	3.6 (+1.6)
UK	0.25	0.50	0.75	0.75	1.00	1.25	1.25	1.75	2.25	2.25	3.00	275	11.1 (+9.1)
India	4.00	4.00	4.00	4.00	4.40	4.90	4.90	5.40	5.90	5.90	5.90	190	6.8 (+2.8)

Source: US Federal Reserve, People's Bank of China, European Central Bank, Bank of Japan, Bank of England, Reserve Bank of India

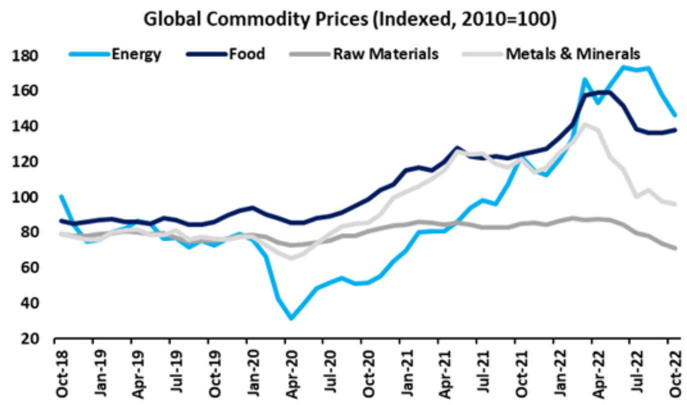
Tightening frenzy continued amid record high inflation prints

Despite persistently high inflation – especially in the US where core inflation remains the highest in decades – many central banks globally appear to be on the verge of attempting to more finely calibrate their ongoing monetary policy campaigns. With interest rates having moved higher throughout 2022 and in some cases such as in the US the central bank having engaged in the fastest pace of rate hikes in more than 40 years, monetary policymakers' focus on future policy tightening is starting to shift away from the speed of rate increases toward the ultimate level at which interest rates are likely to plateau. The US will garner the bulk of attention on this front as it shifts from 75bp increases to a likely 50bp increase in December but the US likely will be far from alone in shifting to a more modest pace of rate increases each meeting and/or reducing the frequency of rate increases given tightening done to date and the lagging nature of inflation. Nonetheless, these shifts are highly unlikely to signal a near-term end to many central banks' tightening campaigns. In most countries, more tangible signs of underlying inflation pressures easing and/or labour markets softening are prerequisites for monetary policymakers to debate seriously pausing or halting their tightening.

China is the notable outlier on this front. Economic activity in China is the weakest it has been since at least the early 1990s, owing in large part to its COVID Zero policy. The

Chinese leadership in recent days has begun to signal the prospect of an end to that policy and with-it greater support for the economy. There is no immediate-term policy bazooka coming like the one introduced in the aftermath of the 2008 financial crisis. Rather, policy support will be more targeted. But easier monetary and credit conditions will be an integral part of that policy support.

Notwithstanding recent moderation, commodity prices remain elevated by historical standards



Source: World Bank

Against this backdrop, there has failed to be much in the way of moderation in commodity prices. Global oil prices in October averaged ~3.3% higher than the previous month following the production cuts announced by OPEC+, although they have been a bit softer in recent days. Global food prices also continue to increase, having risen by 0.8% MoM in October. Meanwhile, prices of basic metals (excl. iron ore) fell by 0.9%. With the battle against inflation far from over, economic activity is likely to moderate further in the period ahead as central banks in the developed world attempt to bring inflation back to levels they are comfortable with. Developing countries likely will remain prone to potentially fast-materializing risks in the form of capital flight, currency depreciation, imported inflation, and escalating debt burdens.

Demand conditions improved but recovery yet incomplete

Overall demand conditions in the Indian economy continue to improve. Domestic demand continues to recover, boosted by festive season sales and the government's push on capital spending. Strength in these areas was offset to a degree by continued soft private investment in the wake of profitability headwinds, rising interest rates and a weak industrial sector momentum due to elevated commodity prices plus seasonal monsoon weakness. External trade remains a drag on overall demand amid slowing global growth.

A spurt of consumer spending in Q2 FY23 and into Q3 as the festive season began has been a key contributor to the trend in domestic demand. Both online and offline sales have been strong during the festive season. Online sales climbed by 28% YoY in the first phase of the festive season according to data compiled by RedSeer, while offline sales during the Diwali period are expected to have grown by over 40% YoY based on data from the Confederation of All India Traders. Relative to pre-COVID levels e-commerce festival sales are likely to be roughly double this year. Despite the sales strength, we are keeping a watchful eye on the prospects for consumer demand in the period ahead, as interest rates continue to rise, and inflation rates remain elevated. Indeed, the latest consumer confidence measure remained in pessimistic territory although it did improve somewhat from its prior month's reading. Unevenness in the labour market is a key factor curbing consumer demand. Better labour market conditions are essential to support continued recovery in the consumer sector. Should inflation moderate and the RBI policy turn somewhat less hawkish – as we expect – consumer demand would benefit.

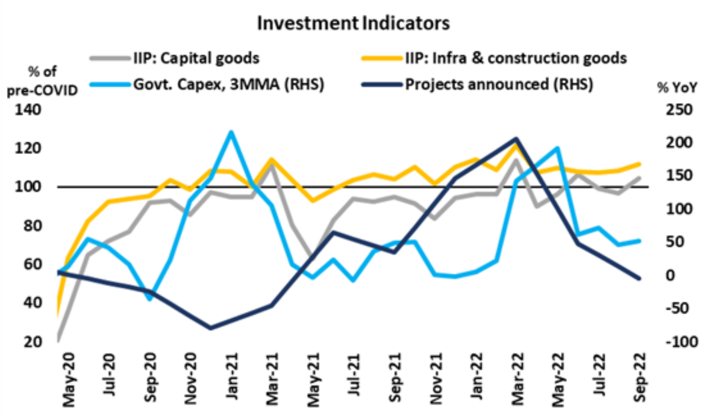
The government's revenue expenditure growth slowed in Q2 FY23 to 3.1% YoY from 8.8% in the previous quarter. Indeed, the government has budgeted negligible growth in revenue expenditure in FY23 (0.9% over FY22 RE) as it tries to rein in fiscal deficit to 6.4% of GDP in FY23 after it had jumped to 9.2% of GDP in FY21. That being said, the extension of the food security scheme until December and the payment of the recently announced dearness allowance are likely to prop up growth in revenue expenditure over the next few months. Fiscal slippage risks for FY23 have eased, with higher-than-

	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22
Consumption Indicators (% YoY)										
Personal credit	11.6	12.3	12.6	14.7	16.4	18.1	18.8	19.5	19.6	
Passenger Vehicle registrations ^	118.7	109.1	125.3	117.3	117.9	118.5	115.8	122.1	119.8	148.9
IIP: Consumer non-durable goods ^	104.1	92.8	101.4	93.7	92.7	98.5	95.6	90.5	92.3	
IIP: Consumer durable goods ^	95.5	91.0	103.9	89.2	91.8	100.9	97.9	95.6	100.9	
Petrol consumption ^	99.9	97.2	109.7	100.6	101.0	103.4	97.4	98.5	95.2	101.6
Unemployment rate (%)	9.7	11.5	11.1	11.8	10.3	11.3	11.5	11.7	9.7	11.1
Employed persons ^	99.9	98.5	98.2	100.0	100.2	96.9	98.5	97.9	100.3	98.3
Central Govt revenue expenditure	29.5	12.7	-19.1	9.1	20.1	-0.3	-12.4	-4.0	17.5	
Consumer confidence: current conditions*	64.4		71.7		75.9		77.3		80.6	
Consumer confidence: future expectations*	103.3		115.2		113.0		113.3		113.0	
Rural demand indicators (% YoY)										
Two wheeler registrations ^	74.4	71.7	84.2	87.1	88.7	80.5	74.8	80.0	76.1	121.4
Tractor sales	-27.8	-26.4	-11.6	38.1	47.7	-10.9	-12.2	-1.0	18.9	3.6
Agriculture credit	10.4	10.4	9.9	10.6	11.8	13.0	13.2	13.4	13.4	

Source: CMIE; ^ indicates % of CY19 average; * consumer confidence index value above 100 indicates optimism while a value below 100 indicates pessimism

expected revenue growth and broadly on-target expenditure growth.

Investment activity remained sluggish, outlook cloudy owing to global headwinds

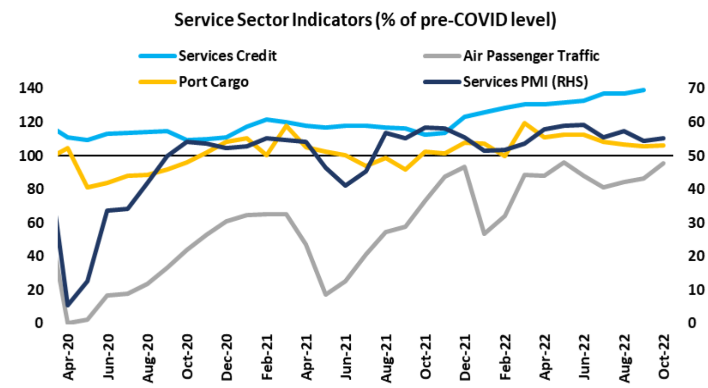


Source: CMIE

Investment activity was mixed in Q2 FY23 and the outlook for such spending is becoming more cautious. On the one hand, the government's push on CAPEX continues to help to support economic recovery out of COVID. In the first half of FY23, capital expenditure grew by almost 50%. Furthermore, investment indicators of the IIP showed a slightly better picture with both capital goods and infrastructure/construction goods sub-indexes improving when compared with the previous quarter. On the other hand, private investment activity has improved slightly sequentially but continues to moderate on a trend basis. New investment project announcements have fallen by 4% YoY while projects completed were more or less flat. Moreover, corporate profitability (an important pre-cursor to investment activity) dropped in Q2 FY23 as the non-financial sector reported a sharp contraction of nearly 24% YoY in net profits. Input costs and other expenses are outstripping revenue growth and rising interest rates are also adversely affecting profitability. As with consumer outlays, private investment growth likely will strengthen in the period ahead should inflationary pressures ease up and monetary policy turns somewhat less hawkish. However, tepid global investor sentiment owing to slowing growth in systemically important economies could dampen overall investment activity.

Services sector remains a bright spot in the Indian economy. Various measures of services sector activity are consistent with a solid current activity in the sector and, more importantly, a favourable outlook. The services sector continues to experience an accelerating rate of MoM increases in new work intakes and has seen employment grow consistently for the past five months. Data on air passenger and cargo traffic remain in an upward trend, consistent with healthy services sector activity. Meanwhile, credit demand continues to grow briskly with NBFC lending gathering pace.

Service Sector Ongoing Bright Spot



Source: CMIE; IHS Markit * PMI value above 50 indicates expansion over previous month while a value below 50 indicates contraction

Industrial momentum impacted by monsoon weakness and high commodity costs

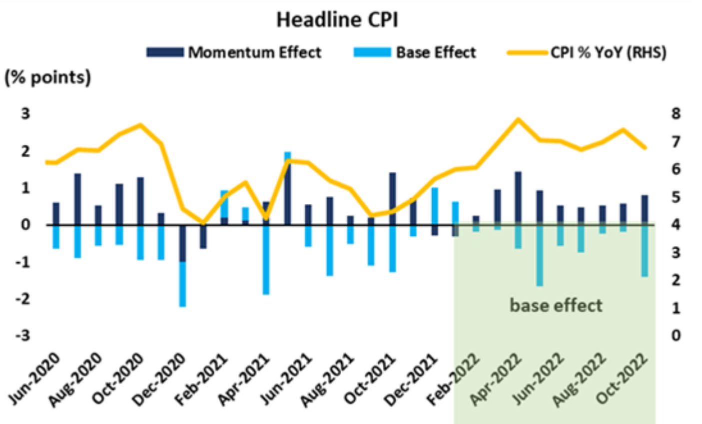
Industrial production growth moderated to 1.5% YoY in Q2 FY23 from 12.9% in the previous quarter owing to a normalizing base effect as well as seasonal monsoon weakness. The impact of the monsoons was seen particularly in mining and electricity production while manufacturing production was affected by high global commodity and raw material prices. Nevertheless, an increase in manufacturing employment (the strongest rate of increase since March 2005) and waning of inflationary pressures bodes well for manufacturing sector activity in the months ahead. Looking ahead, the activity in the industrial sector is expected to be supported by a resilient domestic demand. However, a weaker global environment could put a dampener on the overall demand conditions for the sector.

	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22
Industry indicators (% YoY)										
PMI Manufacturing*	54.0	54.9	54.0	54.7	54.6	53.9	56.4	56.2	55.1	55.3
Banks lending to Industry	6.4	6.5	7.5	8.1	8.7	9.5	10.5	11.4	12.6	
Industrial Production Index (IIP) ^	106.8	100.7	114.1	103.1	105.6	106.0	103.0	100.8	102.3	
IIP: Manufacturing ^	105.7	98.6	110.3	99.9	102.2	103.8	102.4	99.7	101.9	
IIP: Mining ^	115.3	113.8	133.3	107.6	111.1	104.9	93.3	91.9	91.8	
IIP: Electricity ^	105.0	101.9	121.1	123.3	126.7	124.8	119.7	121.3	118.8	
Coal output ^	133.9	133.6	161.5	113.2	119.8	113.4	101.7	97.7	97.7	
Steel output ^	112.4	106.3	117.5	105.7	110.8	101.9	106.1	109.3	110.4	
Cement output ^	119.4	113.6	134.6	115.7	112.0	120.1	105.0	102.6	107.1	
WPI Inflation- Manufactured goods	9.5	10.2	11.3	11.4	10.3	9.3	8.2	7.5	6.3	4.4

Source: CMIE; IHS Markit ^ indicates % of CY19 average; * PMI value above 50 indicates expansion over previous month while a value below 50 indicates contraction

Meanwhile, the agriculture sector continues to offer bright prospects with a strong start of rabi sowing and current reservoir conditions. As of November 18, the sowing of Rabi crops was 7.2% higher than the last year, and the total live storage in 143 important reservoirs of ~86% of the full reservoir level was ~14% higher than the decadal average.

Inflation eased in October aided by the base effect; The RBI likely to moderate the pace of rate hike in the upcoming policy meeting



Source: CMIE

In line with our expectation, consumer price inflation eased in October to its three-month low of 6.8% YoY, down from 7.4% YoY in September aided by a favourable base effect. A large base effect of 141 bps (up from 18 bps in September) more than offset the positive momentum of 80 bps in October (up from 57 bps in September). Despite the easing of the headline print, inflation remained well above the RBI's upper threshold of 6% for the tenth straight month. The softening of the headline YoY CPI was driven by the food and beverage component, which moderated by nearly 1.5 percentage points to 7.0%. However, the yearly improvement masks that on a sequential basis food & beverage inflation quickened to 1.0% from 0.9% in the prior month, reflecting the impact of the unseasonal rains on vegetable prices. Meanwhile, fuel and light inflation continued to moderate reaching a five-month low of 9.9% YoY.

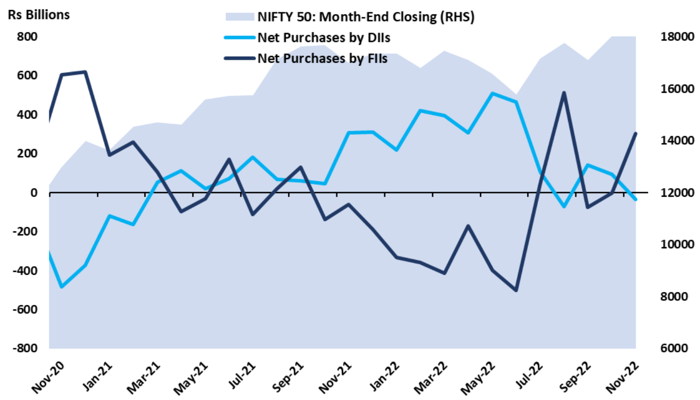
Core inflation, on the other hand, remained at elevated levels (6.1% in October v/s 6.2% in September), reflecting the firming up of inflation in the services sector. This is a function of the services sector continuing to be a bright spot in the overall economy. Given the relatively high bearing of services inflation on core inflation, the elevated services inflation will be an area of monetary policy concern.

We expect inflation to ease over the coming months based on several factors. These factors include (i) favourable base effect, (ii) easing of input cost pressures as reflected in the sharp moderation in the WPI to its nineteen-month low of 8.4% in October from its peak of 16.6% in May 2022, (iii) softening of daily food prices as reflected in the first two weeks of November. How these factors intersect with services inflation will be key in shaping inflation outlook in the quarters ahead. Overall, we expect inflation to be in the vicinity of ~6.8% for FY23. From the RBI's perspective, the softening of the domestic inflation print in October along with an expectation of further moderation in inflation could lead to a softer rate hike by the RBI. Accordingly, we continue to retain our view of the terminal rate being at 6.5% by end of FY23.

Market Update

Indian equity markets rebounded in October, recouping the losses suffered in the previous month despite a challenging global environment including the hawkish Fed, rising crude oil prices, protracted Russia-UK war, and stringent COVID measures in China. Accordingly, the benchmark indices – NIFTY50 and SENSEX gained 5.4% MoM and 5.8% MoM, respectively, in October. Amidst the broader market, the MidCap and SmallCap traded lower than the benchmark index, increasing by 4.3% and 1.0%, respectively. The upward rally in the market was supported by the domestic buyers as the domestic institutional investors (DIIs) pumped Rs 93 billion into equities, while foreign investors noted an outflow of just Rs 0.08 billion. In line with the softening domestic inflation print, an expectation of a lesser hawkish stance by the Fed due to moderation in US inflation, relaxation of some of the pandemic measures by China and continued optimism about the domestic economic growth the Indian equity markets scaled fresh highs in November. As such, both the NIFTY50 and SENSEX surged by 1.6% and 1.5% respectively (data as of 18th November) supported by the foreign investors as after two consecutive months of exodus, foreign institutional investors poured ~Rs 304 bn into domestic equities. Going ahead, with ongoing uncertainty on the global front, we expect volatility to continue in the Indian equity markets.

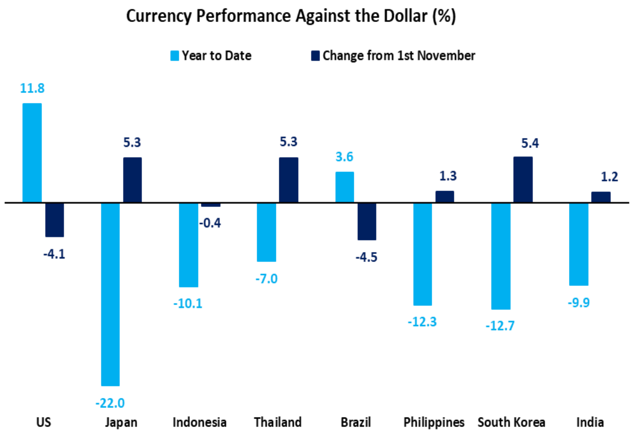
Foreign investors poured capital into equity markets in the first half of November as risk-on sentiment returns



Source: Bloomberg; Data for November is till 18th November

In the foreign exchange market, the Indian Rupee remained under pressure against the dollar as the USD/INR pair depreciated by 2.6% to an average of 82.4 in October compared to 80.3 in the preceding month. Sustained foreign capital outflow, elevated crude oil prices, broader strengthening of the dollar amidst global risk-off sentiment and a burgeoning trade deficit of the country (overall trade deficit widened to $81.4 bn in Q2 FY23 v/s $ 65.2 bn in Q1) weighed on the domestic currency. However, India's performance has been in line with other emerging market peers and better compared to some other currencies such as Japan, the Philippines, South Korea, Indonesia, etc. that have noted a more sizeable depreciation against the dollar since the beginning of the calendar year. Moving into November while the domestic currency continued to depreciate in the early days potentially led by the hawkish policy stance by the Fed, the recent renewed optimism on the part of foreign investors amid a softening inflation print and cooling off the dollar index has provided strength to the Indian currency. As such, since the beginning of November, the domestic currency has appreciated by ~1.2% (data till 18th November). The recent appreciation of the domestic currency if sustained could provide some breather for the depleting foreign exchange reserves. Overall, the forex reserves import cover has reduced at ~9 months (October '22) compared to over 12 months at the beginning of the year but continues to remain higher than the taper tantrum low of 6.5 months. As a result, the RBI is likely to be cautious while using the FX reserves to limit the exchange rate volatility. Going ahead, we do expect the depreciatory pressures to continue amidst the risk-off sentiment and dollar strength.

The Indian currency has performed better than most of its peers



Source: Bloomberg; Data for November is till 18th November

Bond yields hardened across the maturity spectrum in October led by a combination of factors including a 50-bps rate hike by the RBI in the last meeting, an expectation of the hawkish Fed policy, tightening liquidity conditions, elevated crude oil prices, and postponement of the Indian government bonds inclusion in the JP Morgan emerging market bond index. As such, the 10-year benchmark yields rose by ~21 bps from an average of 7.23% in September to 7.44% in October. Meanwhile, the 1-year benchmark yield increased by a larger magnitude of ~37 bps from 6.44% to 6.81% leading to a narrowing of the 10-yr and 1-yr spread from 79 bps in the prior month to 63 bps in October. Moving into November, the 10-year benchmark yield surged briefly by 7 bps to 7.48% (data as of 3rd November) following a 75-bps hike announced by the Fed. Yields cooled off later reaching 7.31% (data as of 18th November) tracking a decline in the US treasury yields due to an anticipation of slower rate hikes by the Fed as well as a softening of the domestic inflation print. The near-term outlook is guided by the upcoming monetary policy meeting. Overall, we expect volatility to persist, with some firming up in yields.

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