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Indian economy's resilience story continued in Q2; heightened global uncertainty continues to pose risks; RBI to maintain status quo

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- Events over the past few weeks have heightened global economic uncertainties. Conflict in the Middle East has boosted the price of oil and risk of further consequences remains.
- Meanwhile, the relentless march higher in long-term interest rates in many countries, most notably the United States, has continued apace, pushing borrowing costs to 20+ year highs in some cases. Despite such policy tightening, core inflation rates remain well above their medium-term desired/targeted level.
- We remain of the judgment that inflation is more likely to prove stickier than expected. As such, interest rates will remain at or above prevailing levels for considerably longer than anticipated. A resumption of a monetary tightening cycle where a major central bank(s) increases rates by another 100bp (or more) seems a low probability but not one that can be ruled out.
- India's economic activity in Q2 remained healthy thanks to sustained demand for both goods and services, government's push to capital expenditure, recovery in real estate and boost in manufacturing sector likely due to festive season.
- On the other hand, the impact of uneven monsoon on agriculture and consequently on the rural demand and slowing external sector demand likely weighed on GDP growth for Q2.
- Headline inflation moderated to a 3-month low of 5.0% in September (after remaining above the RBI's threshold of 6% in the previous two months) owing to a decline in vegetable prices along with the impact of the LPG price cut announced in August.
- Continued moderation in core inflation suggests that there was no spillover from the spike in food inflation to the core components. However, the risk to inflation from recurring weather-related disturbances and the rise in global energy prices remains.
- From the policy perspective, we believe the central bank is likely to hold the policy rate at the current level in FY24 to align inflation to the target of 4%.
- Future policy actions are likely to keep liquidity in tightening mode to keep it consistent with the policy stance. Accordingly, the central bank hinted the use of OMOs (Open Market Operation) sales, but we expect with the higher currency leakage amidst the festive season, the quantum of the OMOs sales is likely to be limited and the timing could coincide with the redemption of the G-Sec bonds in November.

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Global Economy: Heightened uncertainty due to conflict in the Middle East; despite policy tightening inflation rates remain elevated and economic activity remains resilient

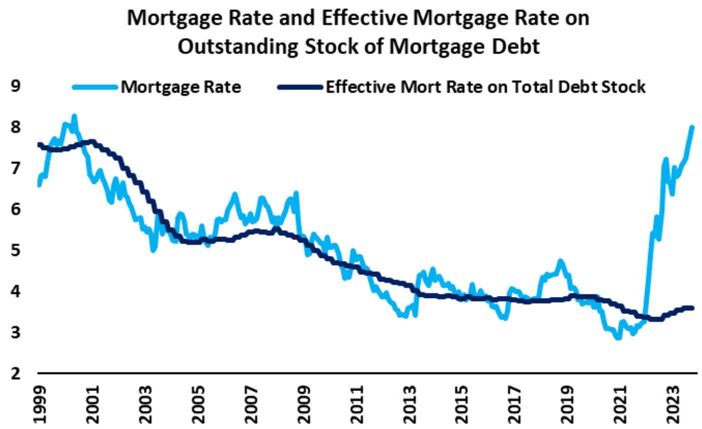
Events in recent weeks have brought new uncertainties to bear on the global economic outlook. Escalating tensions in the Middle East while the conflict in Ukraine continues have raised the spectre of sustained armed conflict on multiple continents. Moreover, geopolitical tensions in the Middle East have boosted the price of oil with the possibility – especially in the event the conflict widens – of oil supply disruptions with attendant consequences for global oil and broad energy prices. Meanwhile, the relentless march higher in long-term interest rates in many countries, most notably the United States, has continued apace, pushing borrowing costs to 20+ year highs in some cases.

These developments are taking place against what already was one of the most complex and uncertain global economic settings in decades. In many of the world's largest economies, central banks have hiked interest rates at the fastest pace in decades, have used other tightening tools (liquidity, quantitative tightening) and generally maintain a hawkish policy bias. Despite such policy tightening and recognizing inflation is a lagging indicator, core inflation rates, nonetheless, remain well above their medium-term desired/targeted level. And, many economies show few, if any, signs of having entered the type of sustained economic slowdown that history would suggest is necessary to lower underlying inflation rates back to target in the next 18 to 36 months. Indeed, economic growth in the United States, for instance, appears to have accelerated since midyear with some estimates of third-quarter growth near 4% (annualised QoQ rate).

Against this backdrop, it is challenging to disentangle the reasons for the relentless rise in longer-dated government bond yields. Are rising yields a by-product of a still favourable economic growth outlook despite monetary tightening to date? Are they rising due to a concern that central banks' desire to be finished with tightening will prevent further progress on inflation? Or might it be the case that rising yields reflect a return to a more normal pricing of long-term interest rate risk – a return of the so-called term premium – given that the era of zero interest rates and massive balance sheet expansion likely are being confined to the annals of history? In our judgment, all these factors are contributing to the rise in longer-term interest rates.

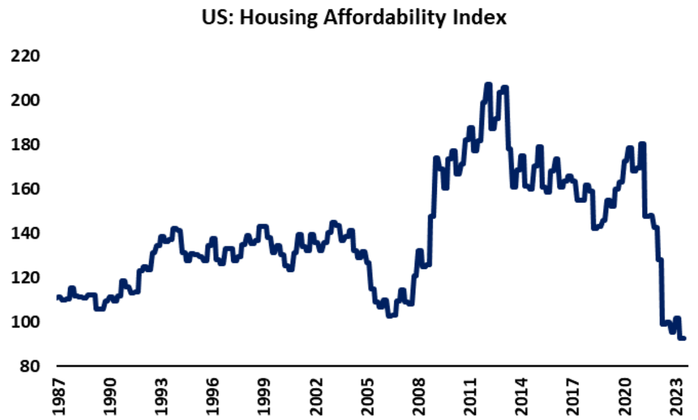
More importantly, the speed and magnitude of the rise and the now prevailing level of longer-term borrowing costs are poised to exert their greatest degree of restraint on the economy this cycle. In the United States, for instance, mortgage rates are 8% versus the 3.6% effective rate on mortgage debt outstanding, an unprecedented gap (see Figure 1) in decades. The upshot is the most challenging degree of housing affordability on record (see Figure 2). Meanwhile, the business sector in many advanced economies has been somewhat insulated from the move up in interest rates due to the terming out and lengthening of debt in 2020-21, but that is on the verge of changing as corporate liabilities from those years are starting to mature and will need to be refinanced at rates four to six percentage points higher.

Gap between mortgage rate on new and existing debt has widened significantly from a historic standard



Source: Bloomberg

Housing affordability has dropped to a historically-low level



Source: Bloomberg

Nonetheless, economies throughout out much of the world have been remarkably resilient since the start of 2022 when interest rates began their historic rise. Moreover, economies withstood substantially higher energy prices during the middle of 2022 than prevailing currently.

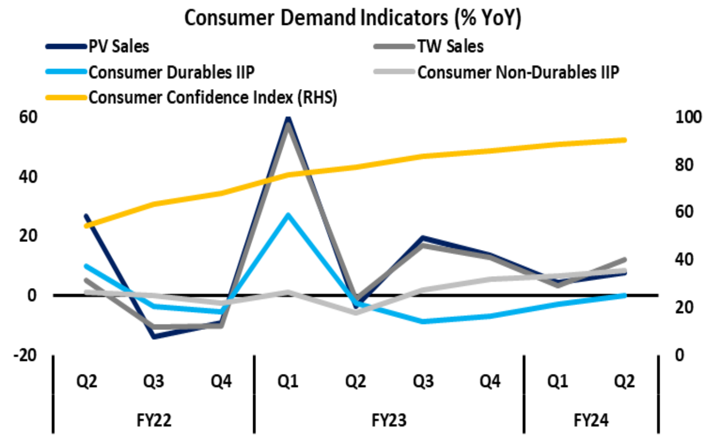
Fundamentals in many of the largest countries remain on balance reasonably favourable, buoyed by healthy consumer and business balance sheets and continued solid income and profit growth. Importantly, forward-looking indicators of labour demand generally remain strong, suggesting that – as of now at least – businesses are not looking to shed employees be it due to increased uncertainty, margin pressure and/or waning demand.

These various countervailing forces are likely to persist through year-end and into early 2024 and the hurdle is quite high for major central banks to hike interest rates again this calendar year. On a longer-term basis, though, we remain of the judgment that inflation is more likely to prove stickier – owing in part to economic resilience and factors outlined in prior monthly reports – than either the consensus or major central banks anticipate. Accordingly, it is our judgment that at a minimum – barring an exogenous shock – interest rates will remain at or above prevailing levels for considerably longer than anticipated. A resumption of a monetary tightening cycle where a major central bank(s) increases rates by another 100bp (or more) seems a low probability but not one that can be ruled out should recently surfaced headwinds to the outlook abate in relatively short order.

Economic activity remained healthy in Q2

India's economy in Q2 FY24 continued to exhibit signs of resilience. Consumer demand was supported by sustained demand for both goods and services, investment continued to be driven by the government's CAPEX push and recovery in residential real estate while manufacturing growth was supported by the anticipated boost in demand in the festive season. Agriculture growth and consequently rural demand growth likely weakened in Q2 given extreme weather events and high food inflation. Despite a narrowing of net exports (deficit) in nominal terms, based on volume net exports likely remained a drag on real GDP growth.

Consumer demand for goods is resilient



Source: CMIE; Note: IIP for Q2 FY24 is based on Jul-Aug data

Consumer demand indicators for Q2 FY24 present a mostly positive picture. Automobile sales improved in Q2 after being hit by price increases in Q1 as the industry transitioned to new emission norms while consumer demand indicators of the IIP continued to signal improvement. Furthermore, healthy growth in air passenger traffic, GST, E-way bills generation, railway freight, and bank credit signal that services demand remained strong in Q2. The consumer confidence index improved to its highest level in four years in September further indicating that consumption growth remains strong. However, all is not rosy. Given the agriculture sector had struggled in Q2 owing to extreme weather events, and the jump in food inflation (which dampens consumption) there is a possibility that rural demand (which was the main driver of consumption growth in Q1) turns out to be weak in Q2 dragging down overall private consumption growth. While lower kharif production will remain a risk for consumption in Q3, anecdotal evidence suggests a strong start to retail sales in the ongoing festival season which should positively impact private consumption growth.

Most services demand indicators point to improvement in the Sep quarter

Services Indicators (% YoY)						
	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23
Domestic Air Passengers	206.2	64.1	18.5	52.2	19.1	23.3
Air Cargo Traffic	9.8	1.5	-8.1	-0.8	-0.4	2.1
Railway Freight	11.8	8.4	3.2	3.8	1.1	4.8
Port Cargo Traffic	9.3	12.9	5.1	6.7	0.9	5.0
CV Sales	100.4	34.7	11.5	7.1	-5.1	4.2
GST E-way Bills	45.6	20.1	17.2	18.1	15.8	15.0
Services Exports	35.4	30.2	24.5	22.8	5.9	5.4
Life Insurance First year Premium	39.7	36.6	19.1	-7.0	-0.9	-21.2
Banking Net Interest Margin (%)	3.3	3.3	3.5	3.7	3.8	3.7
Services PMI	58.7	55.7	56.7	58.1	60.6	61.1

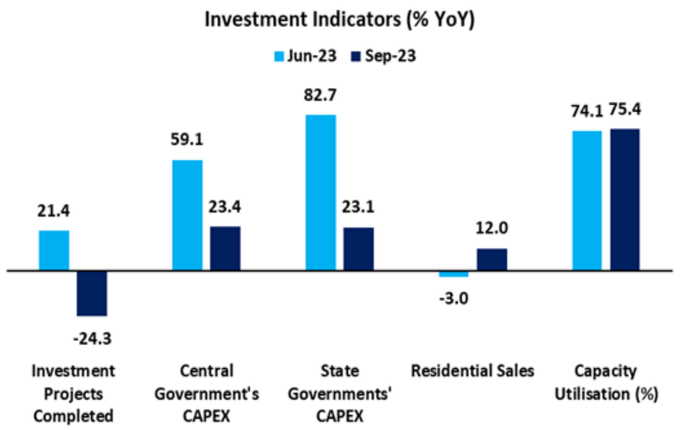
Source: CMIE, S&P Global; Some data for Q2 FY24 is based on Jul-Aug data

Investment indicators for Q2 suggest a slight slowdown in growth compared with Q1. There was a sharp drop in investment project completions for both the private and public sectors. Overall, investment projects completed fell by 24.3% YoY in Q2 compared with a growth of 21.4% in Q1. There is a high chance that as more data flows in over the next month or so, this number will be revised up, but it is clear that there was a slowdown in growth compared with the previous quarter.

Despite the mellowing impact of weakness in corporate investment, we assess overall investment growth to have remained healthy owing to continued strong central and state governments' thrust on CAPEX. In the two months of Q2 for which data are available, central government CAPEX grew by 23.4% YoY (down from 59% in Q1) while that for the state governments was up by 23% (down from 82% in Q1). Trade deficit widened in August due to slowing external demand.

A pickup in residential real estate is also likely to have supported investment activity. According to Knight Frank Research, housing sales improved by 12% YoY in Q2, reaching a six-year high in terms of volume, and improving 7% compared to the previous quarter. Furthermore, continuous improvement in the capacity utilisation of manufacturing companies and strong corporate profitability means that conditions for private sector investment remain conducive.

Investment indicators point to continued growth, but the pace has moderated



Source: CMIE, Knight Frank Research, RBI; refers to quarters ended in Jun-23 and Sep-23; government CAPEX data for Sep-23 quarter is based on Jul-Aug data

Looking specifically at the performance of the manufacturing sector, strong demand from the domestic market for manufactured goods is supporting the sector. Based on high frequency indicators like the PMI and the two months of IIP data available for Q2 manufacturing sector output improved supported by primary goods, infrastructure and construction related goods, and consumer non-durables. The RBI's latest industrial outlook survey for the manufacturing sector remains optimistic on prospects of the sector as the expectations score continued to improve for Q3 on top of Q2's already impressive score.

Manufacturing sector growth remained robust in Q2 FY24

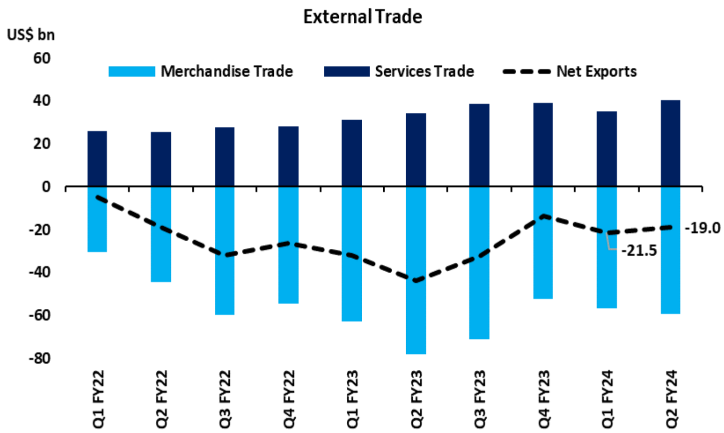
Production Growth in Top Manufacturing Sub-Sectors (% YoY)		
	Jun-23	Sep-23
Basic Metals	12.6	14.0
Coke and Refined Petroleum Products	1.4	8.2
Chemicals and Chemical Products	-0.5	-5.1
Food Products	0.6	4.8
Pharmaceuticals, Medicinal Chemical and Botanical Products	15.9	14.3
Motor Vehicles, Trailers and Semi-Trailers	8.4	10.2
Machinery and Equipment	7.8	6.0
Non-Metallic Mineral Products	7.4	10.2
Textiles	-3.8	2.0
Electrical Equipment	11.9	8.5

Source: CMIE; Note: IIP for Sep-23 quarter is based on Jul-Aug data

However, we remain cautious of demand sustaining at the current levels post Q3 when the festive season is over. Already, export-oriented sectors like wearing apparel, computer and electronics have seen a contraction. Indeed, in Q2, the merchandise trade deficit widened for the second consecutive quarter. Given uncertainty in the global economy once the spike in demand from the festive season fizzles out, manufacturing sector activity could see some moderation again.

Despite the highest ever surplus in the services trade account in Q2, overall net exports are likely to remain a drag on overall GDP growth. Although, on a BOP basis, overall goods and services trade deficit in Q2 was smaller compared to a year ago; on the basis of volume, it is likely to have widened. India has benefited from lower commodity price environment over the past couple of quarters which have allowed narrowing of the trade deficit in nominal terms but net exports by volume continue to exert a drag on growth.

Goods and services trade balance improved in Q2 in nominal terms



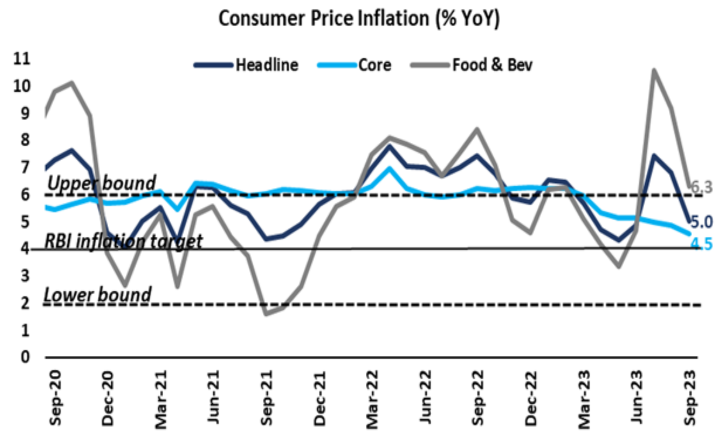
Source: CMIE

Headline inflation declined to three-month low in September

Headline retail inflation moderated to a 3-month low of 5.0% in September after remaining above the RBI's threshold of 6% in the previous two months owing to a decline in vegetable prices along with the impact of the LPG price cut announced in August. With September observing lower than expected inflation, the average for Q2 FY24 stands at 6.4%, aligning with the RBI's latest inflation projections.

Food inflation, which had been the primary culprit for the uptick in the headline print in the last two months declined from 9.2% in August to 6.3% in September on account of a drop in vegetable prices. While vegetable inflation has come down the inflationary pressure in other food categories continues to persist with 50% of the subcomponents by weight in food category posting inflation above 6% with cereals, pulses, eggs, milk, and spices being the major pain points. Moreover, the drop in sowing of pulses and oilseeds compared to last year and the lower reservoir levels due to uneven monsoon, do not bode well for the food inflation outlook. Positively, fuel inflation slipped in deflationary trajectory for the first time since December 2019 thanks to the LPG cut announced by the government. While the intervention is likely to keep fuel inflation in check, the upside risk persists from any sustained increase in global oil prices owing to the ongoing geopolitical uncertainties.

Food inflation moderates from the peak with the decline in vegetable prices



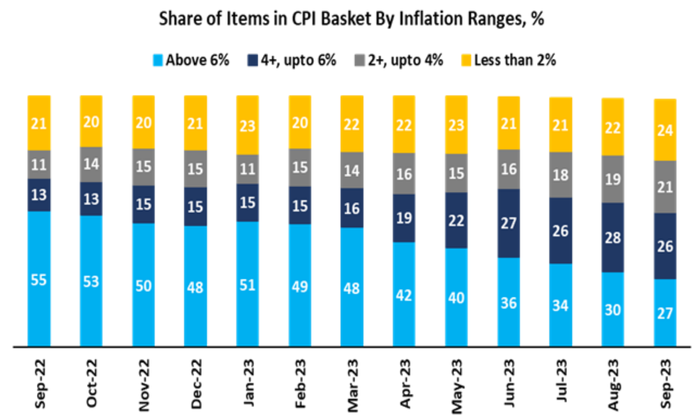
Source: CMIE

The core inflation has also moderated to a two-year low of 4.5% in September due to a decline in all components barring personal care & effects which could be due to rising gold prices amidst the volatile global environment and festive season. Within core inflation, the only component which noted sequential decline was the housing which is rather surprising given the rising rentals in urban cities and more companies implementing the work from office model. Hence, we do expect this to correct in the months ahead. Overall, the decline in the core inflation suggests that there was no spillover from the food inflation to the core components. Still, progress on continued disinflation of the core component of CPI will need to be watched carefully given vulnerability to recurring weather related events and rise in global energy prices.

An analysis of 299 items of the CPI basket revealed that the share of items with inflation above 6% has declined from 51% in the beginning of 2023 to 27% in September reflecting a broad-based moderation in price pressures. Further, the WPI continued in the deflationary zone in September (-0.26% in September) which augurs well for the inflation outlook. However, as stated earlier the risks from resurgent food prices and an uncertain global environment remains.

From the monetary policy perspective, the latest data should not have considerable implications. Continued decline in the rate of core CPI inflation, moderation in services inflation and deflation in manufactured goods gives confidence that underlying price pressures are receding. However, with the expectation that inflation will stay above 5% for the FY24 and the MPC's commitment to further align inflation to the 4% target and not be complacent with bringing it in the target range, the central bank is likely to maintain status quo on policy rates. Furthermore, the stance is expected to be retained at withdrawal of accommodation to contain second-round impact of surplus liquidity on inflation and to aid the transmission of the previous rate hikes.

Price pressure has moderated across the board



Source: CMIE; DMI Calculations

Future policy actions are likely to keep liquidity in tightening mode to keep it consistent with the policy stance Accordingly, the central bank hinted the use of OMOs to absorb excess liquidity in the October meeting even though liquidity was already tracking in the deficit mode thanks to the advance tax and goods and services tax payment. Apart from keeping liquidity consistent with the current stance, the move could have also been influenced due to the central bank's consistent intervention in the FOREX market to contain volatility in the domestic currency. However, with the higher currency leakage amidst the festive season, the quantum of the OMOs sales is likely to be limited and the timing could very well coincide with the redemption of the G-Sec bonds in November.

Market Update

- Bond Market: The Indian bond market recorded volatility in September even though the average 10-year G-Sec yield remained unchanged on a sequential basis at around 7.19%. The pressure on the domestic bond yields renewed at the end of the September with benchmark yields tracking above 7.2% towards the end of September on account of surging treasury yields and rising oil prices. The yields hardened further to 7.34% on October 6th after the governor hinted the RBI's intention of conducting open market bond sales in the latest policy announcement. Since then, the negative impulse from hardening treasury yields amidst concerns surrounding mounting government debt and elevated interest rates for longer, rising crude oil prices, and potential bond sale by the RBI has outweighed the positive impulses from the moderation in domestic inflation. Consequently, the 10-year g-sec yields are tracking above 7.35% (data till 23rd) and the upward pressure is likely to persist going forward.

- Equity Market: After scaling fresh highs in mid-September, the Indian equity markets came under pressure amidst the negative global cues, higher US treasury yields, concerns about elevated interest rate and weaker IT earnings. Consequently, the FIIs turned net seller after 6 months of sustained buying, recording outflow of ~Rs 147 bn. However, the market remained supported by domestic institutional investors and remained in green. In October, the risk-off sentiment continued amidst intensifying geopolitical conflict in the Middle east, rising global crude oil prices and elevated US treasury yields. Consequently, the benchmark index NIFTY 50 has shed 2.0% MoM by October 23rd. The market is expected to remain under pressure with an uncertain global environment and commodity prices weighing on the investor sentiment.
- Currency Market: The domestic currency depreciated for the second consecutive month in September as the USD/INR pair traded at an average of 83.07 compared to 82.8 in August as strengthening dollar currency (DXY index gained 2.1%) amidst the hawkish remarks by some of the Fed officials coupled with rising crude oil prices and foreign capital outflows weighed on the rupee. However, the extent of depreciation has likely been capped due to the RBI intervention. As such, the FX reserves have declined to the tune of Rs ~8 bn in the month of September (although part of the decline is also explained due to valuation losses). The depreciating trend has continued in the month of October as well with USD/INR trading at an average of 83.2 (data till October 23rd). Going forward, the rising geopolitical tensions is likely to keep the depreciatory pressures on the rupee while the central banks' intervention is expected to keep the volatility in check.

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