27 March 2024

India's FY25 outlook remains solid; global monetary policy will ease in 2024 but the pace will be gradual, and the scope limited

- The Fed officials kept the interest rate steady, in their Mar 20th meeting and sent the strongest signal in the direction of lower interest rates for 2024. While Powell refrained from providing a potential time frame for the first rate cut, we expect it to begin in June.
- However, we remain concerned about the stickiness of inflation for two main reasons: goods disinflation, which led to the bulk of disinflation in the US in H2 CY23, seems to have picked up in Jan-Feb; and services inflation continues to be high. Consequently, we believe the rate reductions will likely be gradual and the scope of reductions likely will be limited.
- Indian macroeconomic outlook remains favourable with continued solid, albeit somewhat moderating, economic growth and receding core inflationary pressures.
- High-frequency data for Jan-Feb 2024 suggest the pace of economic activity in Q4 FY24 is likely to have remained reasonably strong, albeit with some moderation in growth when compared to Q3. Agriculture sector is likely to remain weak in Q4. Meanwhile, the manufacturing sector seems to have sustained momentum.
- We also look at the themes that will likely shape the outlook for FY25 including policy continuity, the government's continued focus on investment growth, expectation of limited rate cuts in FY25 and continued uncertainties in the global economy.
- Headline inflation remained steady in February at 5.1%, as the support from a favourable base effect offset the rise in food inflation. Core inflation remained on a downward trajectory – printing at 3.4%.
- We expect inflation to ease in the coming months due to a supportive base effect, the announcement of LPG subsidy by the government and subdued input cost price pressures. We expect inflation to average ~4.6% in FY25 down from an estimated ~5.4% in FY24.
- We expect the monetary policy easing to begin in Q2 FY25 with a higher probability of a rate cut in August (vs June) as the central bank will have clarity on the progression of the monsoon. However, with food inflation expected to shoot up again in the second half of the year, the room for substantial cuts will be limited in FY25, especially if resurgent price pressures start to show up in the core component of CPI.

Christopher Wiegand
Group Head - Economics & Data
christopher.wiegand@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Sarthak Gupta
Economist
sarthak.gupta@dmifinance.in

Yuva Simha
Economist
yuva.simha@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

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Fed left the rates on hold in the March policy meeting; the first rate cut is expected in June

Many global central banks slowly are moving toward a recalibration of monetary policy post the pronounced monetary tightening that took place from late 2021 through 2023. Officials in most countries have been hesitant to guide definitively toward lower policy interest rates in 2024, providing instead highly conditional guidance and attempting to temper the degree by which rates might fall. Until this month, that description applied to most major Western central banks, including the US Federal Reserve.

However, Fed Chairman Powell in the past week sent the Fed's strongest signal yet in the direction of lower interest rates for the period not too far ahead. In the press conference following the Fed's Mar 20th policy meeting, Chair Powell emphasized that he and his fellow policymakers (1) viewed the current monetary policy as restrictive; (2) were not dwelling on the higher-than-anticipated core inflation readings for January and February; (3) still were reasonably confident that further disinflation lay ahead even if it does not unfold in a straight line; (4) had some concerns about the labour market weakening (even though when pressed he admitted that he did not see any such signs currently but was concerned that employment conditions could weaken ahead). Taken together, these points paint a clear picture that the US central bank is strongly inclined to reduce its policy rate in the coming months.

Chair Powell was careful not to signal a potential timeframe for the initial rate reduction, but we would posit June or July with a slight leaning toward June as the most likely starting date. Despite the Fed's seeming desire to move rates down from their current 5.25%-5.50% range, the next meeting in May likely is too soon for them to do so. While Chair Powell tried to deemphasize the January and February 0.4% (sequential) core CPI readings, core CPI inflation as of February is running in a 3.75% to 4% range on both a six-month and 12-month annualized basis. Officials almost certainly would prefer those rates to be lower when they make their initial reduction in the policy rate.

Rate reductions are likely to be gradual; the scope of reduction will likely be limited

We remain more concerned about the prospective stickiness of inflation than the Fed. The bulk of disinflation in US core inflation in H2 CY23 was concentrated in prices for consumer goods. This phenomenon reflected the steep hike in US interest rates and the corresponding dampening effect on goods demand. Some supply chain normalisation as the world returned to normalcy post-COVID also helped reduce goods prices. But with interest rates having peaked and consumer goods prices in both January and February perking up, that source of disinflation may be in the past.

Meanwhile, services sector inflation continues to run at levels that are far too high. CPI services excluding energy prices advanced at a 5.75% six-month annualized pace in the latest month and have not increased by a sub-5% pace on a year-on-year basis in two years. As has been the case for some time, we continue to believe that some weakening in labour market conditions will be necessary for services inflation to moderate in the manner the Fed seems to be expecting based on Fed officials' latest overall inflation forecasts.

Largely as a result of this anticipated inflation stickiness, rate reductions likely will be gradual – i.e. not happen at sequential meetings – and the scope of reductions likely will be limited. In many respects, we see a variety of similarities to the mid-1990s interest rate cycle, which often is characterized as having been a mid-cycle policy adjustment. That is, an adjustment in monetary policy against a backdrop of a solid economy that helped to smooth out some rough edges of the economy following the Fed's three percentage point (300bp) rate hiking campaign from Feb 1994 to Feb 1995.

Moreover, then like now there were hints of a strengthening in the economy's potential growth rate due to strengthening productivity. Nearly thirty years ago, that productivity pickup was due to the introduction of new technology and IT equipment; today, it appears due to the adaptation of existing/emerging technologies plus broad efficiency enhancements borne out of COVID disruptions.

The upshot is that the economy likely can withstand higher interest rates than is generally assumed. And monetary policy probably is nowhere near as restrictive as the Fed seems to judge it to be. Higher equilibrium interest rates due to faster potential economic growth – and thereby stronger real returns on capital – is an unambiguous positive.

Such environments, however, can be challenging for even the most adept central banks to navigate, as efforts to cushion the economy following a rate hiking campaign often result in too much monetary stimulus and ultimately a boom/bust cycle. To be sure, such a process is not in train – the first rate cut has not even happened – but the Fed has a far more challenging environment to navigate ahead in setting monetary policy than either it or the consensus seems to believe.

Indian economic activity resilient in Q3 FY24; moderation expected in Q4

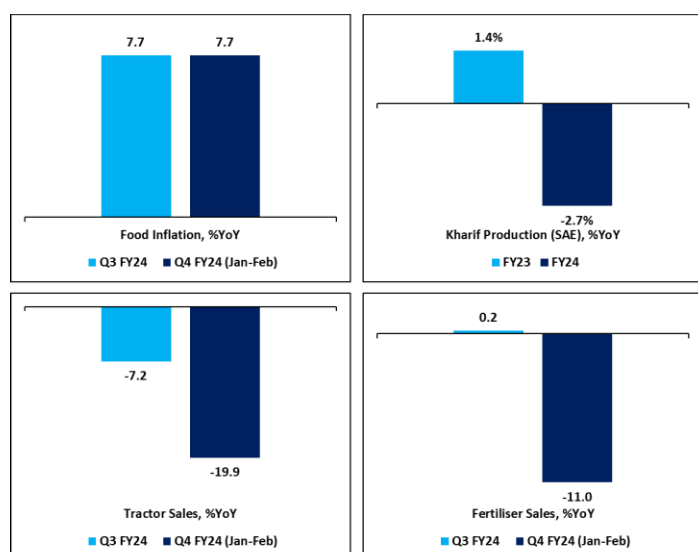
The Indian macroeconomic outlook remains favourable with

continued solid, albeit somewhat moderating, economic growth and receding core inflationary pressures.

In Oct-Dec 2023, the pace of economic growth (as measured by real gross value added) moderated slightly to 6.5% YoY, from 7.7% in Q2; real gross domestic product growth was more buoyant at 8.4% YoY, but this was due to higher growth net indirect taxes (less subsidies).

Based on data available for Jan-Feb 2024, the pace of economic activity in Q4 FY24 is likely to have remained reasonably strong, albeit with some moderation in growth when compared to Q3. The growth moderation reflects various fundamental factors and is relatively broad-based. The normalising impact of net indirect taxes growth will also lead to moderation in GDP print.

Agri indicators point to deepening contraction in Q4



Source: CMIE

Agriculture sector weakness deepened in Q3 with activity contracting by 0.8% YoY as a deficient monsoon, and extreme weather conditions significantly impacted the sowing and harvesting of Kharif season crops. With the second advance estimates of Kharif crop production trailing last year's levels by 2.7%, Q4 is unlikely to be a turning point for agriculture. Tractor and fertiliser sales have plummeted in Jan-Feb, pointing to a further slowdown in the agriculture sector.

Industrial activity lifted GVA (Gross Value Added) growth in Q3; Manufacturing is to remain strong in Q4 while construction is likely to slow

The industrial sector contributed handsomely to overall growth in Q2 and Q3 FY24, punching well above its weight (accounting for half the growth in GVA even though its weight in GVA is less than one-third), thanks to strong manufacturing and construction activity. Manufacturing sector growth was supported by strong domestic demand (and a favourable base effect) while construction activity was lifted by the government's push on infrastructure development. Both sectors saw some bit of normalisation in growth in Q3, which we believe continued into Q4. For manufacturing, this will mainly occur due to the waning of a favourable base effect as well as the waning of favourable support from the reducing input cost prices thereby affecting the profit margins of companies. IIP manufacturing slowed to 3.2% YoY in January, compared with 4.5% growth in December and 5% in Q3. However, improving PMI readings, increases in employment, higher non-oil exports and continuing deflation in the WPI manufactured goods signal continued strength of the manufacturing sector in Q4 FY24. For construction, a slowdown in activity is expected due to a reduction in the pace of capital spending by the government. Not only did government CAPEX plummet in January, but employment in the construction and real estate sector has suffered over the past few months. Other indicators like steel consumption and cement production have also slowed in Jan-Feb (compared with Q3).

Industry Indicators	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24
IIP: Mfg (% YoY)	10.6	1.2	4.5	3.2	
PMI: Mfg	55.5	56.0	54.9	56.5	56.9
Employment: Mfg (mn)	46.7	42.0	42.0	41.4	47.3
Non-Oil Non-Gold & Silver Imports (% YoY)	4.0	-4.4	-0.9	-1.9	3.8
WPI: Mfg Goods (% YoY)	-1.1	-0.8	-0.8	-1.1	-1.3
Govt CAPEX (% YoY)	-14.9	1.6	105.4	-40.5	
Employment: RE & Const (mn)	49.7	60.6	57.0	51.0	47.0
Steel Consumption (% YoY)	13.6	15.4	6.5	6.5	8.8
Cement Production (% YoY)	17.4	-4.1	3.9	5.7	

Source: CMIE, S&P Global

Services remained resilient in Q3; Q4 performance could be mixed

Services Indicators (% YoY)	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24
Air Cargo Handled	13.1	6.6	10.8	15.5	
Railway Freight	8.5	4.3	6.4	6.4	10.1
GST E-way Bills Generation	30.5	8.5	13.2	16.4	18.9
Air Passenger Traffic	10.7	8.7	8.1	5.0	5.8
NETC Volume	13.0	12.3	13.0	10.2	12.1
Hotel Occupancy (%)	63%	63%	70%	67%	
Services Exports	10.8	4.3	1.3	10.8	17.3
First Year Life Insurance Premium	7.6	-25.3	43.8	27.0	48.4
Govt Revenue Expenditure	-13.8	-16.1	-5.5	-6.2	

Source: CMIE, HVS Anarock

India's services sector remained resilient and was the largest contributor to growth in Q3. Growth was lifted by improving activity in the trade, hotels, transport, communication and broadcasting services, continued momentum in the real estate sector, rising insurance premiums and growth in other services like health and education.

Data available for the sector for Jan-Feb suggests that performance in Q4 will be mixed. Trade services indicators like cargo and freight traffic, and E-way bill generation remained strong, hotel occupancy has remained elevated, while transport indicators like air passenger traffic, and toll

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Key themes that will underpin the FY25 outlook:

Policy continuity: The BJP-led National Democratic Alliance is most likely to secure a third consecutive term in office in the general elections which are scheduled to be held in April-May 2024. Continuation of the rule of the current administration will support the recovery of investor and business confidence, which has remained tepid in the post-COVID period, through policy continuity. The government is likely to expand on its existing policy priorities related to improving the formalisation of the economy through digitisation and financial widening, simplifying the tax system, improving physical infrastructure with a focus on railways, roads and ports, housing for all, improving the competitiveness of India's manufacturing sector with schemes like Make in India and production-linked incentive. Strong leadership of the prime minister, Narendra Modi, will help increase India's visibility and influence on global and regional forums.

Investment will continue to be led by government CAPEX: The government has strongly pushed CAPEX to support the economy out of the COVID crisis. Indeed, government CAPEX has grown by a CAGR of 29.7% between FY24 and FY20. This is compared with a CAGR of 7.3% in the preceding four-year period. In effect the public sector has sustained investment growth in the country as private sector investor confidence still remains on the mend since the COVID crisis. In FY25, the government is planning to grow CAPEX further by 16.9% to Rs 11.1 trn, which should sustain investment growth for another year. Lately, there have been some signs of private sector investment revival, but these are patchy by industry (mostly related to renewable energy) and scattered by timing. Capacity utilisation of manufacturing companies has remained around 75% for the last two years, corporate profitability has improved, and leverage ratios are low. The banking system's non-performing assets and capital levels are at decadal best levels. Lower government borrowing should also help in creating space for corporate bond issues and could potentially lead to crowding-in of private investment. However, a weak global growth and high interest rate environment could act as deterrents to private sector investment revival.

Inflation will ease, but the room for rate cuts will be limited: FY24 was characterised by extreme weather events, deficient monsoon rainfall and persistently high food prices. Indeed, inflation is expected to average ~5.4% in FY24. In FY25, inflation is expected to ease to an average of 4.5% (according to the RBI) with headline inflation reaching the target of 4% on an average in Q2 FY25, assuming normal monsoon and moderate commodity prices. Furthermore, the chances of la Nina developing as per IMD in June-August period is supportive of a better monsoon season compared to the previous year. Low commodity prices and easing supply chain issues have facilitated disinflation in the core component throughout FY24. However, despite low core inflation below 4%, headline inflation has averaged 5.3% over the past three months owing to high food inflation.

Following the drop to 4% in Q2 FY25, the RBI too expects inflation to reaccelerate to 4.7% by Q4. This means that the room for rate cuts, in the second half of 2024 will be limited. While we expect the RBI to ignore the seasonal and temporary spikes in food inflation, it will be on guard to any signs of generalisation of food price pressures. The fact that inflation is expected to reaccelerate from Q3 also means that the policy loosening cycle this time could be much shallower. A reversal of disinflationary trend in the core component (not our base case) could even cause the RBI to keep the policy tighter for longer, delaying the start of the policy loosening cycle further.

Slow global growth and risk-off environment: Given that economic strength in most of the major global economies (except for the US) remains weak, we expect export growth to remain low while import growth will continue to remain high owing strong domestic growth and India's dependence on imports for its oil and industrial needs. Low global growth and geopolitical uncertainties will mean that risk averseness towards emerging markets will continue and could affect FDI flows into the country. That said, the inclusion of India in global indices is likely to more than offset the impact of lower FDI. The inclusion of India in JP Morgan EM bond index is expected to generate FPI inflows of ~US$30bn, spread over 10 months.

collection volume have slightly slowed. Insurance premiums continue to grow strongly but banks' profit margins continue to be squeezed due to narrowing bank spread, and there are signs of slowing growth in the real estate sector. On the other hand, service exports grew sharply in Jan-Feb and will help to offset some of the more mixed domestic picture.

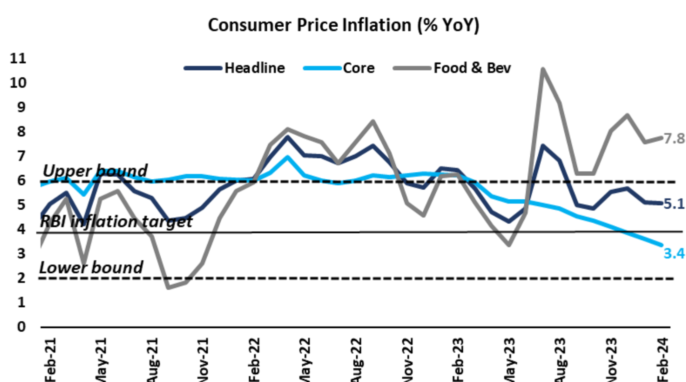
Based on the second advance estimate, the growth for real GVA is imputed at 5.3%. Overall, the economy is expected to sustain momentum in Q4 with the pace of expansion being more moderate.

Headline inflation steady in Feb; risk from food inflations remains

In February, headline inflation remained flat at 5.1% as the uptick in food inflation was offset by the continued softening in the core component. This was the sixth consecutive month of headline inflation printing within the RBI's tolerance band. Food & beverage inflation inched up to 7.8% in February from 7.6% in the previous month led primarily by a rise in prices of vegetables (30.2% YoY) and an abrupt increase in the prices of protein items (eggs, meat, etc.). Daily vegetable prices for the first three weeks of March are showing a

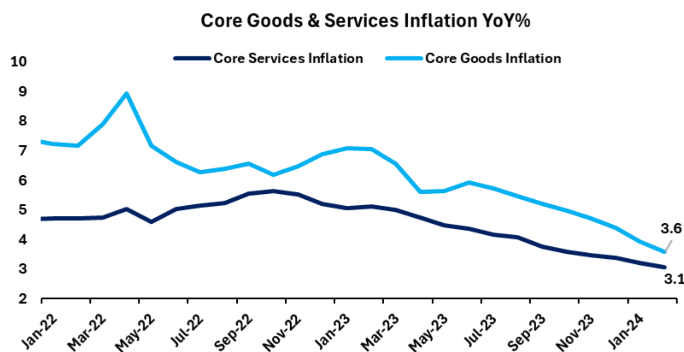
sequential pick-up due to prices of onions and potatoes, which will continue to exert upward pressure on food prices. Meanwhile, the cereal and pulses inflation, while moderated slightly from the previous month, continued to remain elevated and contributed 1/3rd to food inflation. Daily food prices till 19th Mar are indicating a decline in cereals prices reflecting the impact of central governments' initiatives including the Open Market Sale Scheme (OMSS) and export restrictions. The near-term outlook for food inflation continues to remain uncertain. As per second advance estimates of the Rabi crop, the food grain production is expected to decline by 1.7% led primarily by rice and pulses. However, on the bright side, the government's stock of rice is tracking higher than the norm (four times higher) which could help stabilize prices even if production turns out to be lower.

Headline inflation remained at 5.1% in February



Source: CMIE

Core inflation printed below 4% for the third consecutive month

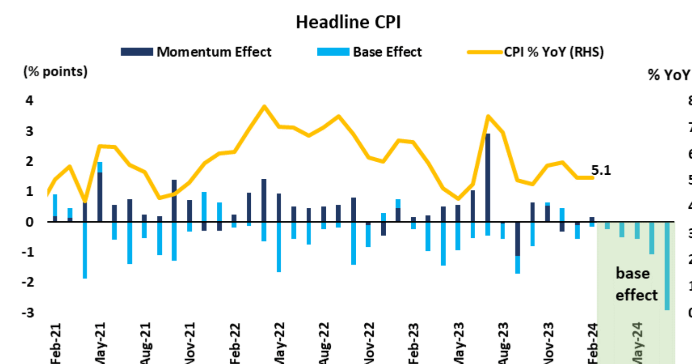


Source: CMIE; MoSPI

On a positive note, core inflation remained on a downward trajectory as it came in at 3.4% in February – marking the third consecutive month of staying below the 4% target and underscoring RBI's past monetary policy actions are proving effective. The moderation in the core component continues to be broad-based. Core goods inflation moderated to 3.6% led by a decline in clothing & footwear, household goods, gold, and silver. Meanwhile, the core services inflation declined to 3.1% led by a decline in household services, housing, health, and recreation services.

Going ahead, we are confident that inflation rates will ease further in the upcoming months for multiple reasons. Firstly, the base effect will remain favourable until July, supporting the moderation in annualized retail inflation. Secondly, the deflationary trend in the fuel category is expected to remain with the government announcing a 100 rupees cut in the LPG cylinder recently. Thirdly, input price pressures remained subdued with the WPI (Wholesale Price Index) reaching a four-month low of 0.2% in February, which should augur well for the headline print in the coming months. Based on the above factors and an expectation of no supply chain disruptions and a normal monsoon, inflation should move closer to the target of 4% by Q2 FY25 before potentially picking up again in the latter half of FY25. Overall, we expect inflation to average ~4.6% in FY25 down from ~5.4% in FY24.

Base effect to remain favourable in coming few months, supporting moderation in annualized inflation



Source: CMIE; Note: DMI Calculations

RBI expected to maintain status quo in April Meeting

The Monetary Policy Committee (MPC), in its last meeting conducted in February, maintained the status quo on stance and the policy rate. Based on the minutes of the meeting, a broad message from most of the members was that it is premature to reduce the policy rates at this juncture amidst upside risks from food inflation, robust growth, and incomplete transmission. Any signal of policy easing (change in stance) could fuel market expectations of a rate cut leading to easier financial conditions amidst still, at least as judged by MPC members, incomplete transmission.

The minutes were also awaited to gauge the reason behind one of the members voting in favour of a 25-bps rate cut in the meeting. Prof. Jayanth Verma was of the view that the current policy rate of 6.5%, implying a real rate of 2% (using the RBI's projection for FY25 of 4.5%), is higher than the desired range of 1-1.5% to bring down inflation and could

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pose a downside risk to the growth outlook. Secondly, he argued that robust economic growth should not be seen as a sign of overheating as it could also reflect a likely increase in potential output to 8%. Further, the continuation of fiscal consolidation in FY25 will reduce inflationary pressures.

Outlook: With inflation expected to glide down to 4% in Q2 FY25 and growth expected to moderate in FY25 due to waning support from the central CAPEX and continued uncertainties on the external front, the space for easing of policy will open. The US Federal Reserve's seeming desire to lower interest rates in the period ahead also helps to create space for the RBI to ease. As such, we believe that rate cuts could likely begin in mid-2024, with a higher probability of a rate cut happening in August (compared to June) as the central bank will have clarity on the progression of the monsoon. However, with food inflation expected to shoot up again in the second half of the year, the room for substantial cuts will be limited in FY25, especially if resurgent price pressures start to show up in the core component of CPI.

Market Update

- **Equity Market**: Indian equity market indices advanced over ~1% by the end of February, despite a heightened daily volatility. This was largely led by positive global cues and optimism surrounding the domestic growth prospects reflected in the remarkable GDP print of Q3 FY24. The positive momentum in the market continued in early March. On Mar 13th, comments by the SEBI chairman on stretched valuations in the SME segment led to a sharp correction of ~4% and ~10% in the mid-cap and small-cap segment (from February end). Further, the Bank of Japan's decision to raise the interest rates after 17 long years weighed on investor sentiment in India and the region at large and led to further correction of the domestic market indices. In tandem with a rally in global markets following the projections of three rate cuts by the Fed this year, Indian equity markets also closed in positive by Mar 22nd (0.5% over end-Feb).

- **Bond Market:** Domestic bond yields softened in February and early March supported by the foreign capital flows which have been rising since news of India's inclusion in global indices (JP Morgan Index in Sep and Bloomberg index in March), lower-than-expected borrowings announced in the budget and easing domestic inflation. Overall, the 10-year benchmark yield softened from 7.14% from the end of January to 7.03% by Mar 12th. Yields firmed up again, tracking the surge in US treasury yields following the release of the higher-than-expected US inflation print leading to concerns over the possibility of delayed/shallow rate cuts this year, announcement of record states' borrowing of Rs 60K crores and a fall in rupee in the last week. Overall, yields increased from 7.03% by Mar 12th to 7.09% by Mar 22nd.

- **Currency Market:** Domestic currency appreciated slightly in February as the USD/INR pair traded at an average of 82.98 compared to 83.12 in January. This is the first time the pair traded below the 83 level in the past five months propelled by the continued surge in foreign capital inflow in the debt market offsetting the impact of rising strength in the dollar and volatile crude oil prices. Foreign investors had an average net inflow of US $ 2.4bn in the debt segment in Dec-Feb which is much higher than the monthly average of US $0.3 bn in Jan-Oct 2023. However, the increased demand for dollars by corporates to make payments at the end of the financial year weighed on the domestic currency. Accordingly, the rupee fell by 0.6% by Mar 22nd. With generalized USD weakness probably awaiting greater clarity in the timing of the Fed's first rate cut or the magnitude of the US policy easing, the rupee is expected to remain range-bound with excessive volatility being curtailed by the central bank.

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