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Moderation in India's Growth Expected, Positive Outlook Prevails; Rate Cuts Likely in H2 CY24

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- Economic resilience and stubborn inflation in major economies, particularly the US, have upended financial markets' expectations and, in many cases, central bankers' guidance for lower interest rates in the first half of the current calendar year.
- A pushed-back timeline for any easing in the US monetary policy and a strengthening US Dollar could make it considerably more difficult for select countries, especially those outside the G7 and those with current account shortfalls, to conduct a monetary policy based solely or primarily on domestic economic fundamentals. This likely includes India.
- High-frequency indicators suggest tempered yet strong growth of industrial activity in Q4. Among major sub-sectors, growth continues to be driven by manufacturing and construction. Meanwhile, consumption-related indicators of IIP suggest that rural demand continues to lag urban demand.
- That said, the expectation of a normal monsoon and development of La Nina conditions augur well for agriculture sector prospects, and in turn for rural demand. Additionally, the broadening scope of private sector investments, rising capacity utilization and healthy balance sheets of corporates bode well for the revival of private sector investment which has remained weak until now.
- The above high-frequency indicators suggest the economic momentum has continued in Q4 and the prospects for FY25 also look bright at the current juncture however we are cognizant of potential downside risks. These loom in the form of lower global growth impacting exports, high geopolitical uncertainty affecting oil prices, potential food price increases, and an increase in GDP deflator which will lower real GDP growth.
- Headline inflation continues to ease despite elevated food inflation caused mainly by a seasonal rise in vegetable inflation. While we expect inflation to continue to ease going ahead, durable progress on this front will be contingent on normal rainfall from the southwest monsoon and an absence of extreme weather events.
- Based on the minutes of the latest monetary policy meeting we believe that the MPC will wait and watch the progress of the southwest monsoon to judge its likely impact on the trajectory of food price inflation. As such we retain our view that the rate cuts, if any, would happen in the second half of CY24. However, also given that headline inflation is expected to accelerate again towards the end of the year, we continue to believe that the room for substantial cuts will be limited.

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Economic resilience and sticky inflation in the US could lead to potential delays in rate cuts by the Fed

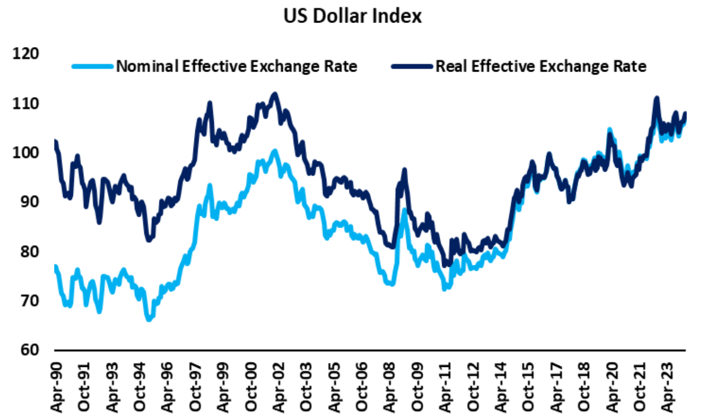
At the start of this calendar year, we highlighted that while chances were good that the monetary policy would be loosened somewhat in many economies in 2024, the path to that outcome probably would be an uneven one. Four months into the calendar year 2024, that judgment very much remains the case, as economic reality has collided with various central banks' – most notably the US Federal Reserve – desire to lower interest rates following the policy tightening of late 2021 through mid-2023.

Persistent economic resilience and/or hotter-than-anticipated inflation rates year-to-date in many of the world's largest economies have upended financial markets' expectations and, in many cases, central bankers' guidance for lower interest rates in the first half of the current calendar year. Nowhere has this development been more pronounced than in the United States. As the calendar turned from 2023 to 2024, markets anticipated six to seven quarter percentage point (pp) interest rate reductions (150bp to 175bp in total) by the Federal Reserve in 2024 and while senior Fed officials never endorsed an easing cycle of such magnitude, neither did they discourage expectations of a decent-sized recalibration of the US interest rate policy.

In the first three months of the year, US core inflation consistently increased at a faster than anticipated and/or desired pace, threatening the improving core inflation trend that had seemed to have taken root in 2023H2. Indeed, the six-month annual percent change in core CPI climbed to 3.9% as of March (latest data) from 3.25% at year-end 2023, placing the year-on-year percent change in core CPI at an unacceptably elevated rate of 3.75% to 4%. Fed officials repeatedly have stated they require "greater confidence" that core inflation is continuing to move lower for them to begin to reduce interest rates. In our judgment, that likely means core CPI year-on-year inflation falling to about 3.25%. To achieve such an outcome in the next six months, core inflation would need to increase by a roughly 2.5% annualized pace (roughly 1.5 pp below its prevailing pace), something that has not happened since the post-COVID recovery took hold.

As a result, the prospect for lower interest rates by the Fed is being curtailed in terms of prospective magnitude and pushed out in terms of prospective timeline. There likely is some small probability that the US monetary policy still could be eased this summer should monthly core inflation readings for April and May turn out similar to those of 2023H2 given that key Fed officials continue to characterize the monetary policy as "restrictive." Moreover, the Fed would prefer to be out of sight / out of mind during this autumn's Presidential campaign, making the September monetary policy meeting an unlikely one at which to start a monetary easing cycle.

Strengthening dollar due to the delay in the Fed rate cut could weigh on monetary easing in other economies, particularly outside the G7



Source: Bloomberg; Note: Citi Broad Nominal Effective Exchange Rate Index and Citi Broad Real Effective Exchange Rate

A pushed-back timeline for any easing in US monetary policy has underpinned the US Dollar (USD) strength. The USD has appreciated steadily so far this year and on a (real and nominal) broad trade-weighted basis is near its strongest level in the past 30 years (see chart). Dollar strength of this sort has important ripple effects throughout the global economy: Most notably, this type of USD strength makes it considerably more difficult for select countries, especially those outside the G7 and those with current account shortfalls, to conduct monetary policy based solely or primarily on domestic economic fundamentals. The result will be a hesitance to adjust interest rate and/or liquidity policy ahead of the Fed due to concerns of abrupt and substantial FX depreciation, and the financial and economic perils that such a move could produce. This likely includes India.

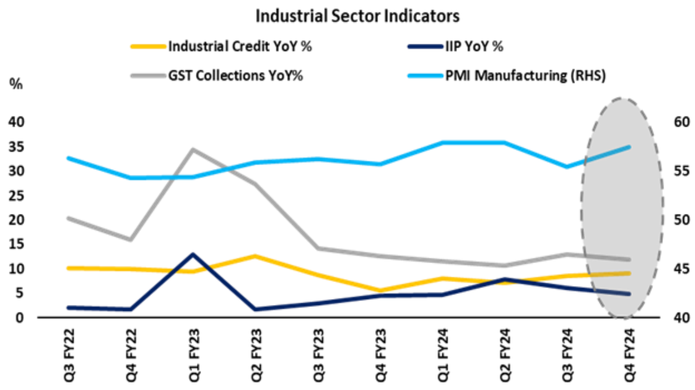
Monetary policy in Europe is expected to diverge from the US

Europe now seems likely to be the first major economic region to adjust monetary policy, probably starting in June. The European economy has been weaker than other major economies – partly due to the spillover effects of the Ukraine-Russia conflict, partly due to issues in the German industrial sector and partly due to the European economy being not particularly innovative or dynamic. Such factors have helped to contribute to inflationary pressures being ameliorated in Europe to a greater degree than elsewhere, paving the way for the European Central Bank (ECB) to likely be the first major central bank to begin reducing interest rates. The global ramifications of such a development are likely to be limited although a somewhat weaker Euro might bolster somewhat US Dollar's strength. Albeit not in a way that on its own has meaningful implications globally.

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

India's macroeconomic outlook remains generally favourable. India has been one of the best-performing economies in the world in recent years both on an absolute and relative basis and that trend likely will continue in the quarters ahead. To be sure, the most recent quarter's economic growth rate (8%+) is not sustainable and some downside risks are emerging from rising geopolitical tensions and the possibility of higher food prices. But the economy's fundamentals remain quite healthy with growth potentially receiving support from stronger rural demand and private sector CAPEX.

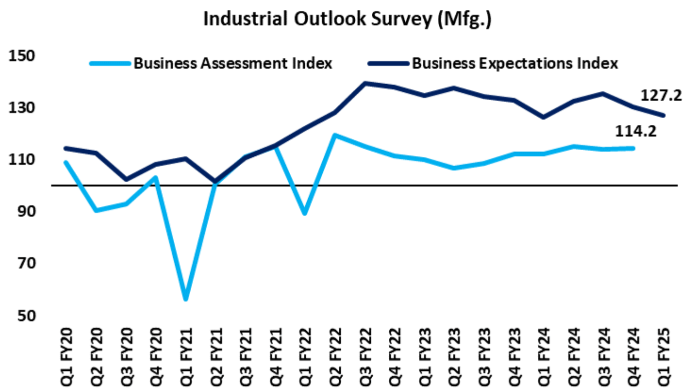
High-frequency indicators suggest tempered yet strong growth of industrial activity in Q4



Source: CMIE, S&P Global; Note: IIP data for Q4 FY24 is based on Jan-Feb average

Industrial growth improved in February 2024 as the Index of Industrial Production (IIP) grew at a four-month high of 5.7% YoY driven by a favourable base effect and the addition of an extra day due to the leap year. Broad-based improvement was noted across all the three sub-indices – mining, manufacturing, and electricity. However, quarterly growth seems to be moderating with the average growth for Jan-Feb tracking at 4.9% compared with 6.0% in the previous quarter. Despite slight moderation in the growth of IIP, the pace of the industrial activity in Q4 looks strong given double-digit growth in GST collections, E-way bills generation, and decadal high PMI readings. A similar optimism was also observed in the RBI's quarterly 'Industrial Outlook Survey of the Manufacturing Sector' where most of the respondents assessed improved business activity in Q4 FY24. The respondents were also optimistic about the current quarter (Q1 FY25), with over half of them expecting an improvement in production, order books, and the overall business situation.

Survey indicates a positive assessment of the business conditions in the manufacturing sector

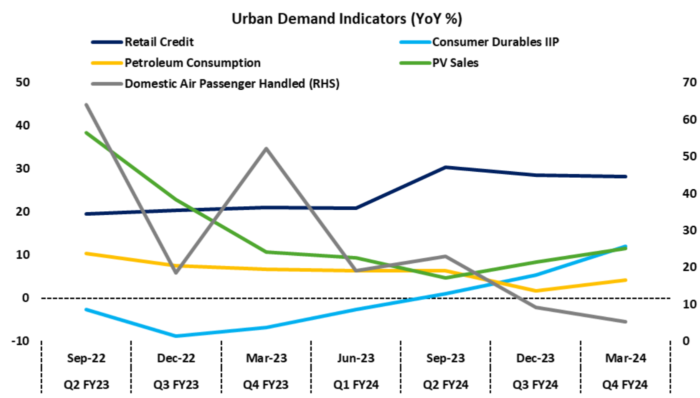


Source: RBI

For the first two months of the final quarter of FY24, the growth in industrial activity was led by consumer durables, which grew in double digits (12.1%), while non-durables output posted a contraction. Such a divergence suggests that consumption growth likely is being driven by urban demand. The same is exhibited in robust retail credit growth, double-digit passenger vehicle sales, and increased petroleum consumption, etc. However, rural consumption indicators were a mixed bag. On the one hand, double-digit growth in two-wheeler sales and a reduction in demand for employment under NREGA in Q4 compared to the previous quarter signal improvement. On the other hand, indicators such as lower domestic tractor sales and fertilizer sales potentially reflect the continuing woes of the agricultural sector.

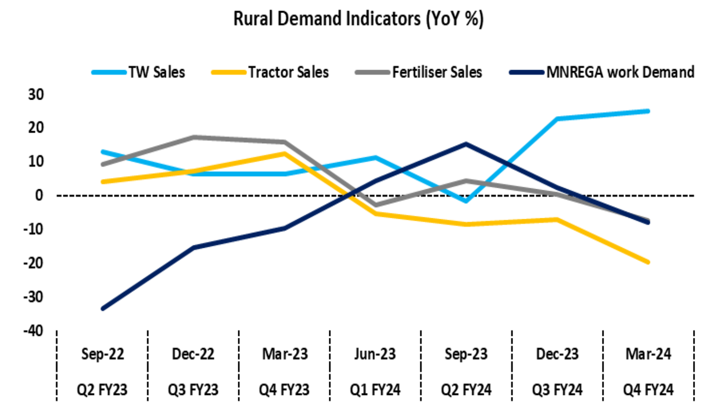
Having said that, the outlook for the agricultural sector, which directly impacts the rural demand, has improved for FY25 with the development of La Nina conditions that should lead to normal rainfall this year. The optimism in outlook is also reflected in the improvement in the future expectations index of the RBI consumer confidence survey in the latest round.

Lead demand indicators suggest continued momentum in urban demand



Source: CMIE

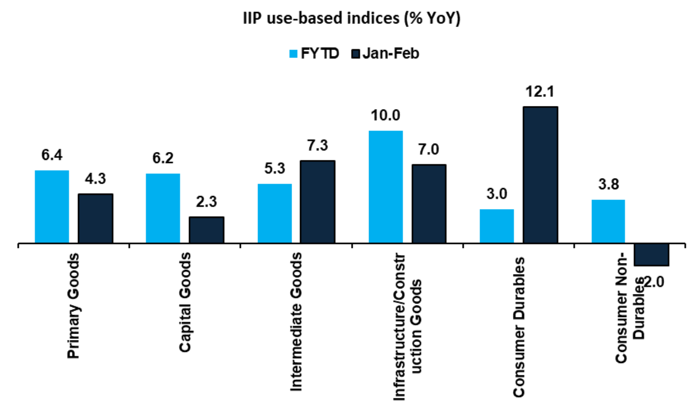
Indicators for rural demand point towards continued weakness in Q4



Source: CMIE

The industrial output was also supported by the continued expansion of the infrastructure and construction goods. In FYTD so far, infrastructure/construction goods and capital goods have contributed significantly to the growth of industrial output given the government's commitment towards infrastructure development by pushing CAPEX and the upbeat real estate sector. Accordingly, the growth of central government CAPEX continues to remain elevated at 32% YoY in Jan-Feb (up from 24.4% in Q3). However, we expect the pace to have moderated in the final month of FY24 owing to the implementation of the model code of conduct.

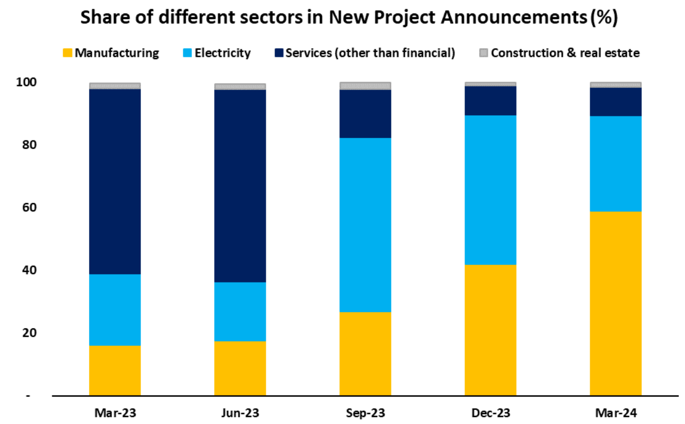
Infrastructure and construction have led growth in FY24 so far



Source: CMIE

The government has been doing the heavy lifting in supporting investment growth as private investments still have not picked up meaningfully. Based on the data of new projects completed, sourced from CMIE, the private sector's share remains relatively low in Q4 at 39%, with the government sector accounting for the rest. For FY24, the private sector accounted for 36% of total investment projects completed compared to a 50% average in the three-year pre-pandemic period.

Share of manufacturing and electricity has increased in new project announcements

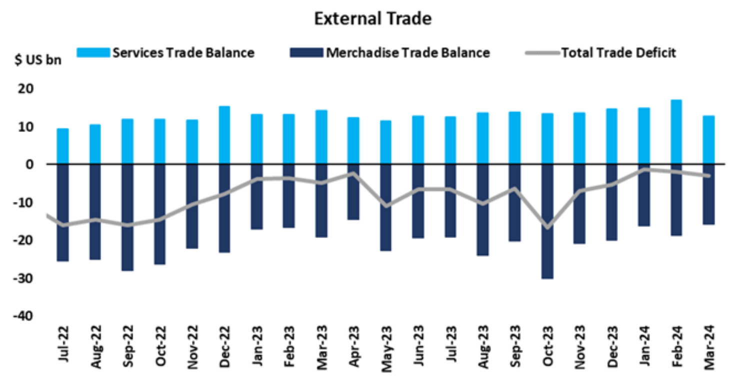


Source: CMIE

Importantly, however, there are some tentative signs of a revival of private-sector investment. Until now, private sector CAPEX announcements have been narrowly focused (e.g. the aviation sector). However recent data suggest a broadening out in private sector CAPEX. For instance, there have been announcements in diverse sectors such as manufacturing, electricity, and chemicals, which hint at a broader uptick in private investment. Further, the rising capacity utilization and healthy balance sheets of corporates augur well for the same. A durable revival in private CAPEX will have to navigate elevated interest rates and prevailing geopolitical uncertainties and we will be monitoring closely company announcements on this front.

On the external sector front, the combined trade deficit – merchandise and services – is tracking lower at US$ 9.7 bn compared to US$ 12.1 bn in the same quarter of FY23. This is being led by a lower trade deficit supported by the decline in oil and non-gold imports and the continued robust performance of the services export. Based on the current account details till Q3, the strong services export is led by the software and other business services.

Trade deficit moderated in Q4 on both annualised and sequential basis

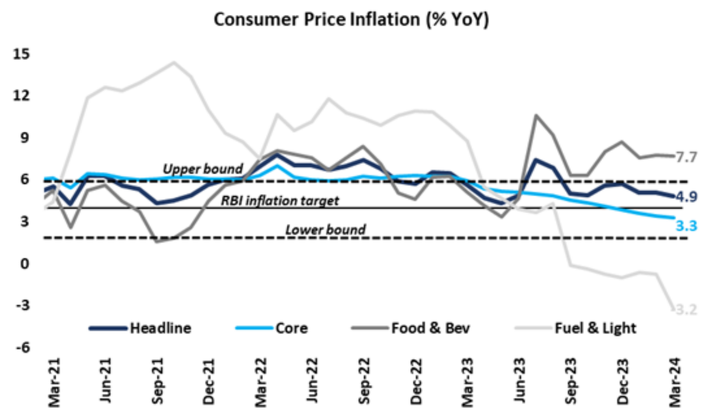


Source: CMIE

The above high-frequency indicators suggest the economic momentum has continued in Q4 and the prospects for FY25 also look bright at the current juncture with improvement expected in rural demand due to a favourable agriculture outlook on the back of expectation of normal monsoon and a potential pick-up in the private sector investment amidst healthy balance sheets of the corporates.

At the same time, we are cognizant of potential downside risks. Firstly, global growth is expected to remain subdued, which could negatively impact net exports. For FY24, the total exports (goods & services) were flat (0.5%), lower from ~14% in FY23. Secondly, the risks from the geopolitical turbulences remain. While the recent events in the Middle East have not caused any dramatic impact on commodity prices, the future tenor of geopolitical tensions in the region (which no one can predict with confidence) could negatively impact the rest of the world, including India, especially if oil prices were to surge. Thirdly and somewhat technically, support to GDP growth from a low deflator is likely to be missing in FY25. The WPI was tracking in negative territory for a major part of FY24 and this is likely to reverse in FY25 owing to the base effect and is expected to weigh on real GDP growth.

Headline inflation continues to ease despite elevated food inflation



Source: CMIE

Consumer price inflation in India continues to ease and was recorded at 4.9% in March although, it remains still higher than the RBI's target of 4%. Inflation in Q4 FY24 averaged 5%, compared with 5.4% in Q3 and 6.4% in Q2. High food inflation (especially in the vegetables category) has kept headline inflation elevated even as core inflation eased. Indeed, food and beverages inflation averaged 7.7% in Jan-Mar (same as the average in Q3) whereas core inflation eased to an average of 3.5% (compared with 4.1% in Q3). Deflation in the fuel and light basket (due to LPG price cuts announced in August 2023 and March 2024) has also contributed to an overall easing of price pressures.

The main contributor to elevated food inflation over the past five months is the vegetables category. Indeed, vegetable inflation jumped from 2.8% in October 2023 to 28.3% in March 2024. Still, the reading in March was marginally lower when compared to February's number of 30.2%. Seasonal spikes in prices of garlic, potato, onion, tomato and ginger have led to elevated vegetable inflation since November. Furthermore, high inflation in this category is partly attributed to an unfavourable base effect. In Q1 FY25, inflation in vegetables is likely to remain elevated as prices remain high in the summer months and the base effect stays unfavourable. Other groups within food which need to be watched closely are cereals and pulses. According to the second advance estimate of agricultural production, production of cereals in FY24 was around 6% lower compared to last year, whereas that of pulses was around 10% lower. This could lead to demand-supply mismatches in the coming months and contribute to food price pressures.

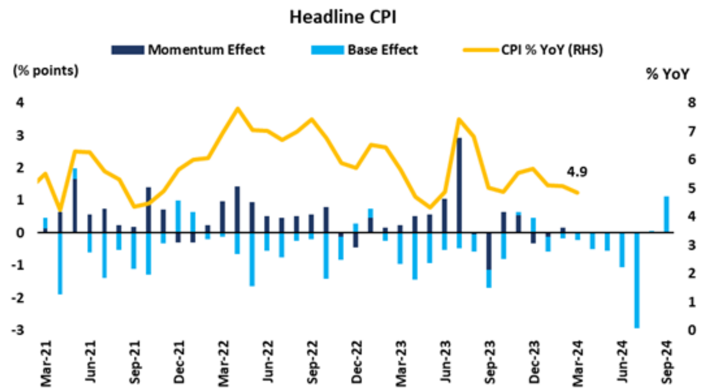
Inflation in major food items continues to remain at multi-month highs in April

Inflation in Major Food Items (%)								
	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24
Cereals	2.8	3.4	4.1	3.7	2.4	2.2	7.4	8.5
Pulses	12.0	14.4	15.7	16.5	15.9	15.8	15.6	14.2
Oil	-15.0	-13.9	-14.9	-14.1	-13.6	-12.3	-10.7	-8.3
Potatoes	-12.6	-13.7	-13.2	-7.7	-1.7	5.3	22.0	34.8
Onions	29.5	36.6	90.6	82.6	41.3	28.9	40.1	42.7
Tomatoes	-3.9	-35.4	3.6	28.4	31.8	38.2	36.2	40.1
Vegetables	2.6	-9.9	26.1	35.1	24.8	24.9	33.4	39.4

Source: CMIE; Note: April data is based on daily prices until the 16th from the Ministry of Consumer Affairs

While we expect inflation to ease going ahead, driven by a favourable base effect and easing of price pressures in some food categories as the Rabi crops harvest eases shortages, durable progress on this front will be contingent on normal rainfall from southwest monsoon and the absence of extreme weather events. Rising crude oil prices will also lift imported inflation through input prices and need to be watched.

Inflation to ease until July driven by a large favourable base effect



Source: CMIE; Note: DMI Calculations

Rate cuts, if any, will happen in the second half of 2024

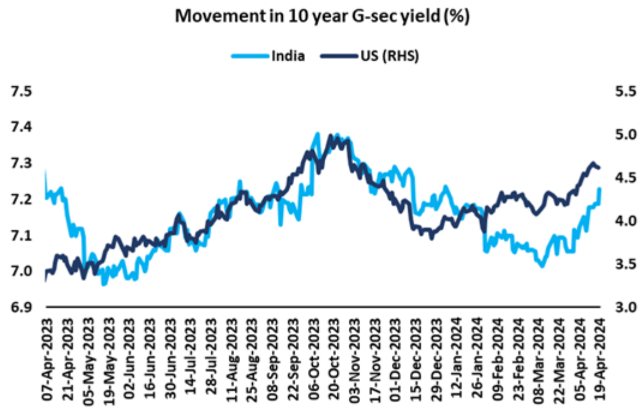
In line with market expectations, the RBI kept the repo rate, unchanged in its last MPC meeting in April. The repo rate has remained unchanged since February last year. Although in the latest meeting, the RBI gently nudged down its inflation forecast and maintained a strong GDP forecast of 7% for FY25, the tone of the governor's statement remained cautiously hawkish. The central bank's focus remains very much on price stability, bringing inflation down and aligning it to the target of 4% on a durable basis. This was reiterated many times in the governor's statement with emphasis on ensuring the anchoring of inflation expectations and fuller transmission of past actions. The minutes of the meeting suggest that while the MPC members agree that there has been meaningful progress made on lowering inflation, they remain concerned about shocks arising from volatility in food inflation and other supply-side related disruptions (commodity prices, most notably oil). The MPC will likely wait and watch the progress of the southwest monsoon to judge its likely impact on the trajectory of food price inflation. Given that economic growth remains robust and is expected to remain strong, and based on the central bank's current inflation projections, we retain our view that the rate cuts, if any, would happen in the second half of CY24. However, also given that headline inflation is expected to accelerate again towards the end of the year, we continue to believe that the room for substantial cuts will be limited. This means that the next rate cut cycle could be much shallower than the rate cutting cycles of the past where 110-200 bps of cuts were implemented.

Market Update

- **Equity Market**: Despite heightened volatility during the month, Indian equity market indices advanced by 1.6% MoM by the end of March. Equity valuations continued to grow on the back of positive domestic growth prospects and a continued strong flow of funds by both domestic as well as foreign institutional investors. The NIFTY fell by 2.7% since April 10 (till 19th) when higher-than-expected inflation in the US tempered expectations for interest rate cuts in 2024. This along with negative market sentiments amid escalating tensions in the Middle East caused the FIIs to pull out around Rs178 bn from the equity markets over the past one week. Looking ahead, volatility in the stock market is expected to continue amid heightened geopolitical tensions in the world but a resilient domestic economy should provide support.

- **Bond Market**: Domestic bond yields traded in the narrow range of 7.06-7.10% in the second half of March. Bond yields jumped in April, tracking higher yields in the US, following the release of stronger-than-expected economic data in that country. The outcome of the RBI meeting on April 5 was on expected lines and did not move the markets. However, stronger than expected inflation data in the US coupled with strong retail sales sent the bond yields surging, which was reflected in domestic yields as well. The increase in oil prices has also contributed to upward pressure on yields. However, positive domestic factors like lower government borrowing in H1 FY25, the continuation of disinflation, and the impending inclusion of some Indian government bonds in global bond indices have provided a downward counterpressure on yields. In effect, yields on Indian 10Y G-Sec rose by 17bps in April (until the 19th) while the yields on US 10Y treasury bonds increased by 42bps at the same time.

Domestic bond yields are tracking the US treasury yields



Source: Bloomberg

- **Currency Market:** The exchange rate has remained remarkably stable in 2024 compared with major currencies. Indeed, the exchange rate averaged Rs83/US$1 for the first three months of 2024 compared with an average of Rs83.3/US$1 in Oct-Dec 2023. Meanwhile, the US dollar index (DXY, which is used to measure the value of the dollar against a basket of six foreign currencies, the Euro, Swiss Franc, Japanese Yen, Canadian Dollar, British Pound, and Swedish Krona.) depreciated from an average of 104.5 to 103.5 as expectations of rate cuts by the US Fed in the second half of 2024 rose. The stability of the rupee is attributed to tight management of the exchange rate by the RBI. In April, the US dollar gained as higher-than-expected inflation readings, strong economic data and cautious comments made by some regional Fed governors pushed back rate cut expectations. As of 19th April, the USD/INR pair averaged 83.4 compared with 83 in March. Looking ahead, higher oil prices are likely to cause some depreciating pressure on the rupee, but we expect these pressures to be more than offset by a weaker dollar and strong FPI inflows given the country's strong economic fundamentals. Strong forex reserves of the RBI mean that the exchange rate will continue to be tightly managed to smoothen any excess volatility.