December 18, 2020

The beginning of the end of the pandemic – Vaccine progress brightens prospects for economic recovery

DMI FINANCE

A turnaround in the COVID-situation has improved the trajectory of economic recovery for the Indian economy in the current financial year. Moreover, the economic outlook for next year has received a shot in the arm thanks to a faster than anticipated timeline for the COVID-vaccination drive.

- Proactive virus containment steps are showing promising results in major European nations even as the United States (US) continues to face the third COVID wave.
- A quicker-than-expected roll-out of the COVID-vaccine with a high degree of reported efficacy and start of inoculation in some western countries such as the US and the United Kingdom (UK) bodes well for global economic recovery next year.
- India looks comfortably placed with regard to the COVID vaccine availability, considering the pre-orders are sufficient to cover around 80% of the population. Prospects for indigenous vaccine availability could bolster potential vaccination coverage in FY22.
- Distribution challenges will need to be addressed where private sector participation will help. Meanwhile, keeping a lid on COVID cases remain necessary for an uninterrupted economic recovery.
- We believe that India's ongoing economic recovery is likely to gain traction in the second half of the fiscal year and receive a further push into FY22 from the vaccine availability.
- Accordingly, we project real GDP to contract by 7.8%YoY in the FY21 compared to our earlier estimate of 9.8%YoY. For FY22, we project real GDP growth of 9.9%YoY compared to 7.8%YoY previously.
- An improved economic trajectory is expected to help the fiscal position. The fiscal deficit for the central government is projected to be in the range of 7.7% to 8.3% of GDP down from 7.9% to 8.9% of GDP previously.
- We expect inflation, presently driven by supply-side constraints, to ease in the coming months. This will support the continuation of RBI's accommodative stance into the next year.

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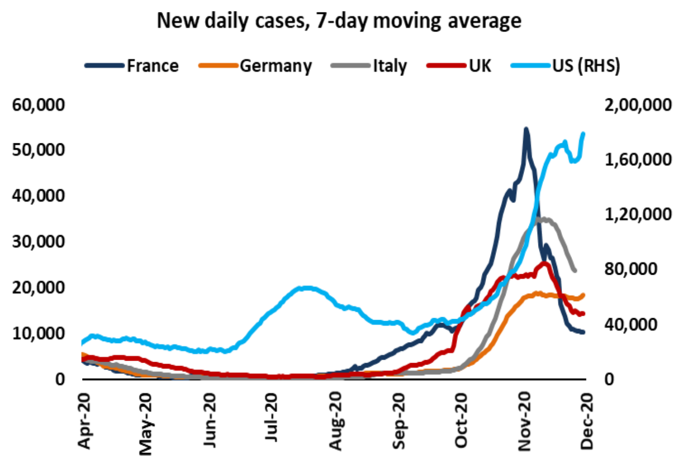
Global economic outlook receives a vaccine boost

The resurgence of COVID-19 cases in the western hemisphere in October and November had raised risks to the global economy's nascent recovery in the near-term. The number of daily global COVID cases rose from a high of ~5 lakh daily cases at the end of October to ~6 lakh daily cases during its peak in November. However, proactive virus containment measures, especially in the EU region, seem to be bringing the COVID situation under control. On the other hand, the US is still reporting more than 2 lakh daily cases (contributing ~1/3rd of total global cases) and is pushing the needle on daily cases further up. While this could weigh on near-term global economic recovery, risks have subsided compared to the last month with other major western countries witnessing a turnaround in daily cases. Moreover, a positive surprise on the vaccination timeline offers hope for an improved global economic outlook next year.

Proactive measures stem the COVID curve in major EU countries while the US's third wave continues



Source: CEIC

Select advanced economies in recent days have begun to inoculate health care workers and select high-risk individuals with the Pfizer-BioNTech COVID-19 vaccine, an important marker for the world's eventual return to normalcy from the now nearly year-old pandemic. Moderna's COVID vaccine – which uses similar technology as Pfizer-BioNTech's and has shown similar effectiveness in clinical trials – is likely to be the next vaccine approved for use in countries such as the US, the UK, and Europe. Vaccines created by other pharmaceutical and biotech companies using various technologies seem very likely to follow in the period not too far ahead based on preliminary publicly released results.

Vaccines have been developed on a faster timeline than many health officials thought likely, a development that is a testament to human ingenuity and effective government-private sector partnerships and resource sharing. Both stakeholders will need to continue to cooperate closely in the year ahead with the focus shifting from successful development and approval of vaccines to distribution. Fortunately, governments of most large economies, where vaccines are beginning to be administered, have spent months planning for distribution, and these plans will help provide a blueprint for other countries that begin distribution in 2021.

While the precise percentage is indeterminable in advance, health experts and select studies suggest that approximately 70% of the population will need to receive a vaccine or have contracted COVID for a population to achieve so-called herd immunity.[1] In this context, the reported roughly 95% effectiveness in trials of the Pfizer-BioNTech vaccines and roughly 70% effectiveness of the Oxford-AstraZeneca vaccine – all of which exceed the threshold many health officials had hoped for in statements made throughout the year – bode favourably for containing the virus as inoculation ramps up around the globe. Like any medication, a vaccine's efficacy at the individual level will vary, depending on idiosyncratic factors and thereby, actual results for a population – especially when those being inoculated initially - may not match the tested population sample and may differ from clinical trials.

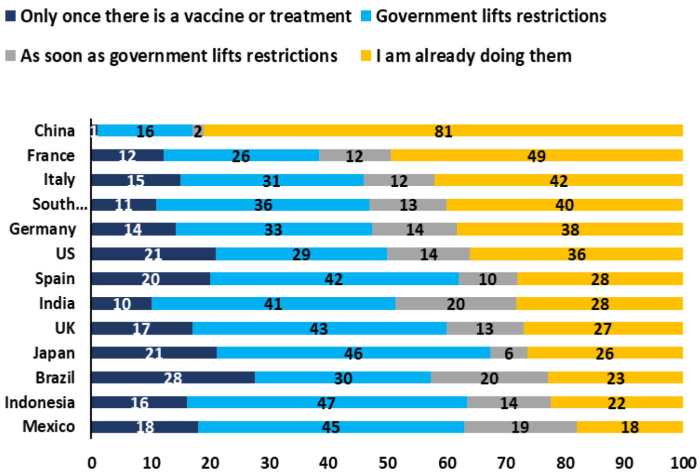
As COVID immunity builds throughout a population, depressed sectors of the economy will begin to normalize, boosting economic activity. Normalization in currently depressed sectors has the potential to be considerable, given the degree to which such activity is still being held back. For example, in the US, where the economy has been relatively open since April in both absolute terms and on a comparative basis, economic activity such as dining outside the home and travel continue to operate at historically low levels. Moreover, as measured by a McKinsey study, fewer than half of consumers in the bulk of the world's largest economies are engaging in out-of-the-home activities. In contrast, in China, where COVID has been squelched (at least for now while the country remains mostly closed to the inflow of foreigners), a disproportionate share of households have returned to 'normal' activities, and the economy is close to operating on all cylinders.

Economies around the world are likely to follow the China experience qualitatively in the period ahead. While the

[1] See, for instance, *Vaccine Efficacy Needed for a COVID-19 Coronavirus Vaccine to Prevent or Stop an Epidemic as the Sole Invention,* American Journal of Preventative Medicine, https://www.ajpmonline.org/article/S0749-3797(20)30284-1/fulltext.

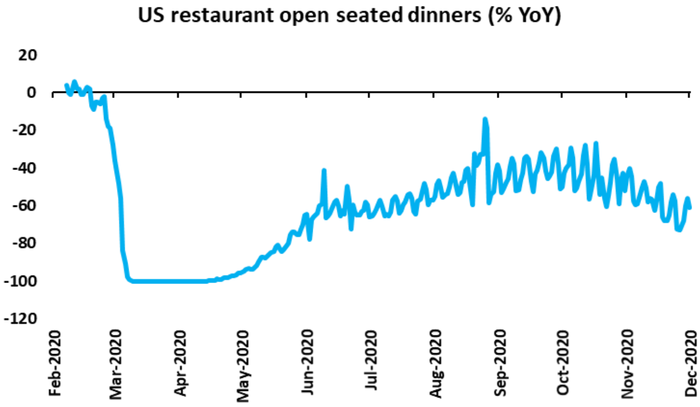
speed of normalization will depend on myriad country-specific factors and thus vary across economies, the direction is unambiguous. The upshot will be a rebound in activity in depressed sectors, notwithstanding the alterations to consumer and business behaviour that are likely to persist beyond the epidemic's end.

Consumers across the globe are at vastly different stages of returning to 'normal activities'



Survey question: What best describes when you will regularly return to stores, restaurants, and other out-of-home activities? % of respondents awaiting each milestone before engaging;
Source: Mckinsey & Company, COVID-19 Pulse surveys conducted globally, September 18-30th, 2020

Outside dining continues to witness historic lows

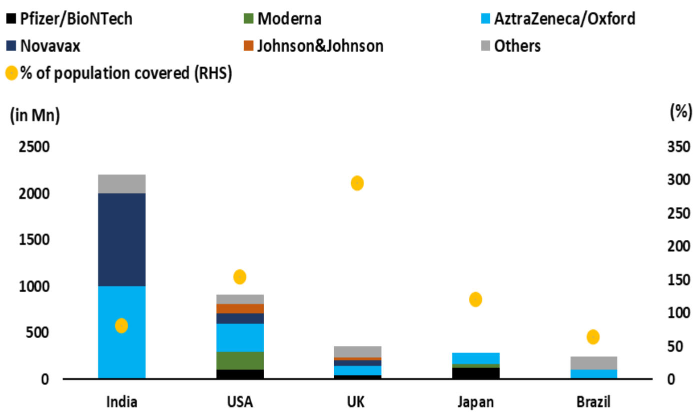


Source: Bloomberg

COVID and vaccine landscape in India

India is among the front runners in the vaccination drive across the globe. It is aptly placed in terms of having secured vaccine doses for the public. With various kinds of COVID vaccines on the verge of getting approved for use - India is relying on eight potential vaccines (including three indigenous ones) that are in different stages of trials. Based on available data, India has already pre-ordered 2.2 billion doses of three different vaccines (1 billion doses of Oxford-AstraZeneca and Novavax and 200 million of Gamaleya) securing around 80% coverage for its population. Given that children below a certain age, pregnant women and those who have already recovered from COVID are not likely to get vaccine shots, the coverage ratio could be even higher. Taking into consideration even the least effective vaccine (Oxford-AstraZeneca with a 70% efficacy rate) a successfully delivered vaccination drive at this scale would suffice in creating herd immunity. Prospects for indigenous vaccine availability could bolster potential vaccination coverage in FY22.

India is aptly placed with the highest vaccine pre-orders



Source: Bloomberg vaccine tracker; updated as on December 12***, 2020***

Eight potential vaccines (including three indigenous) are at various stages of trial in India

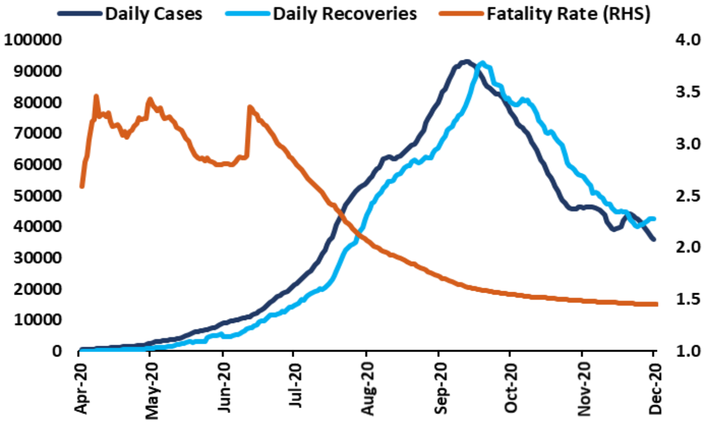
Landscape of COVID vaccines in India			
Product	**Indian Manufacturer**	**Collaborator**	**Current stage**
Covishield (Chimpanzee Adenovirus)	Serum Institute of India	Astra Zeneca	Phase II/III Applied for EUA
Covaxin (Inactivated Virus)	Bharat Biotech International	Indian Council of Medical Research, India	Phase III Applied for EUA
ZyCoV-D (DNA vaccine)	Cadila Healthcare Ltd, Ahmedabad (Zydus Cadila)	Dept of Biotechnology, India	Phase II
Sputnik V (Human Adenovirus vaccine)	Dr. Reddy's lab., Hyderabad	Gamaleya National Center, Russia	Phase-II over, Phase-III to start next week.
NVX-CoV2373 (Protein Sub-unit)	Serum Institute of India	Novavax	Ph III under consideration in India
Recombinant Protein Antigen based vaccine	Biological E Ltd	MIT, USA	Phase I plus II human clinical trials started.
HGCO 19 (mRNA based vaccine)	Genova, Pune	HDT, USA	Clinical trials (Phase I and II) to start.
Inactivated rabies vector platform	Bharat Biotech International	Thomas Jefferson University, USA	Pre-clinical (Advanced)

Source: Ministry of Health and Family Welfare; Progress of vaccines as on December 8, 2020

The next challenge is with vaccine distribution. The Indian government has released its initial guidelines for inoculating 300 million people identified on priority (healthcare workers, frontline workers, and prioritized age groups) in the first phase. According to the head of India's COVID-19 vaccine task force committee, it could take around 6-8 months to inoculate these 300 million people. However, infrastructural limitations pose a challenge as the current cold chain infrastructure is capable of storing the additional COVID vaccines only for 30 million people from the first phase of the inoculation. The Ministry of Health and Family Welfare noted that additional supplies would be made available for states and Union Territories (UTs) starting December 10. However, despite this, the cold storage infrastructure will need rapid augmentation for the success of distribution. The participation of the private sector is likely to aid in this process. Given logistical challenges and the size of the population, the process of vaccination might continue through 2021 and into the following year.

In the interim, developments around COVID cases will continue to remain a focus area. Fortunately, in contrast to other parts of the world, the COVID situation in India has remained under control. There has not been a major or a widespread spike in daily cases in the post festive period, except in some cities. Overall, daily cases dropped below 30,000 (7dma) by December 14 from an average of 62,000 and 43,000 daily cases in October and November, respectively. Meanwhile, the positivity rate reached a fresh low of 3.3% (7dma) while the death rate fell to 1.45% in comparison to the global average of 2.3%. Active cases stood below 3.5 lakhs vis-à-vis a total of more than 99 lakh confirmed cases, as daily cases continued to trail daily recoveries. However, some pockets of risk remain within states such as Kerala, Maharashtra, Delhi, West Bengal and Rajasthan that together account for more than 50% of the daily case count and warrant some caution. Overall, continued improvement in the national level COVID situation bodes well for ongoing economic recovery.

India's COVID cases witness sustained improvement

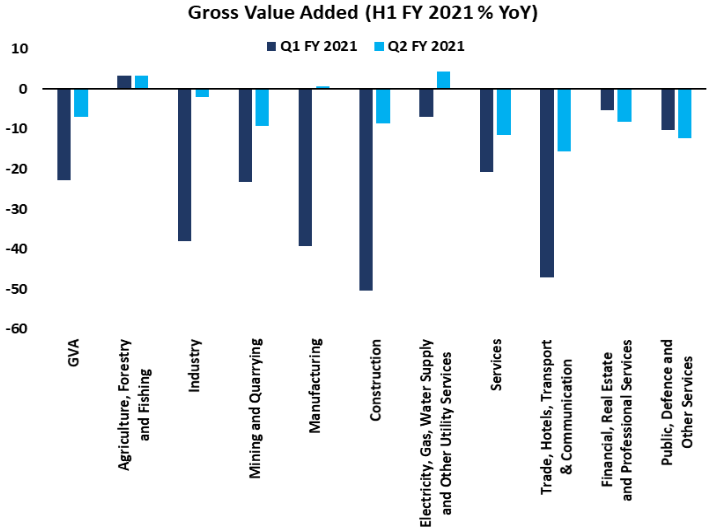


Source: CEIC

Indian economy surprises with remarkable sequential recovery in Q2

After a deep contraction in Q1-FY21 due to a strict nation-wide lockdown, few would have expected the Indian economy to stage a remarkable sequential recovery in the subsequent quarter. Dark clouds loomed over recovery in the early part of the second quarter when COVID cases were on the rise and spreading from urban centers to the hinterland, leading to the imposition of local lockdowns. However, tentative signs of recovery started to emerge in September when India registered a dramatic turnaround in the COVID situation as daily cases peaked. As the COVID situation began to abate, economic recovery gathered steam and received a further boost from pre-festive activities. These factors helped real GDP contraction to narrow significantly to 7.5% YoY compared to -23.4% YoY in the previous quarter. The recovery was even more striking as it came despite government expenditure contracting during the quarter. A narrower contraction in private consumption and investment coupled with net export growth helped the economy claw back some lost ground in the quarter. Sector wise, agriculture continued its positive momentum, posting a solid 3.4% YoY growth. The key surprise, however, was faster-than-expected recovery in industrial sector output, primarily led by electricity and manufacturing. Meanwhile, the services sector posted a relatively gradual recovery, as contact intensive sectors such as Trade, Hotels, and Transport continue to endure the disproportionate impact of social distancing measures.

GVA performance of Indian sectors in H1-FY21

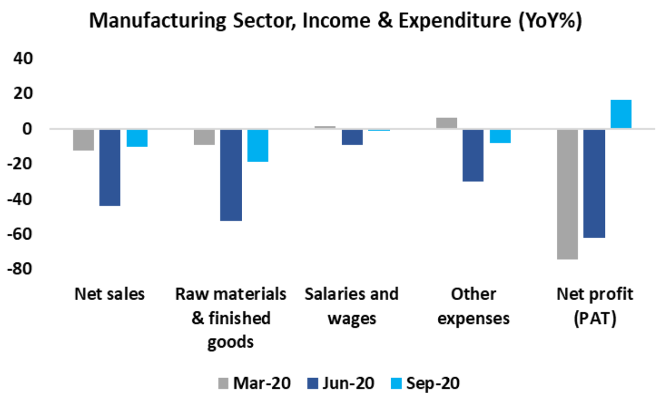


Source: MOSPI

At first glance, the manufacturing sector's expansion, albeit minor, appears at odds with the IIP-Manufacturing contraction of 6.8% YoY in Q2-FY21. However, this variance could be explained by strong corporate earnings during this period. Net profit for the manufacturing sector increased to 16.2% YoY in Q2-FY21. This was led by cost rationalizations and low raw material expenses due to the run down of inventories. Raw materials to sales ratio dropped from ~70% in March '20 to 60.4% in the September quarter. As such, profitability improved significantly to 16.2% YoY in Q2-FY21 from the sharp contractions in the previous two quarters (-73.5% YoY and -62.4% YoY in Q4-

FY20 and Q1-FY21 respectively). While strong corporate performance bodes well for the economy, the cost advantages of the last quarter might be offset in subsequent quarters with inventory build-up and increase in the cost of raw materials as demand improves and margins narrow.This makes demand pick up crucial for the sustainability of corporate profit growth and for maintaining economic momentum into the second half of the financial year.

Cost rationalization helps the manufacturing sector post sizeable profit growth in Q2-FY21



Source: CMIE, based on financial data of 1708 manufacturing firms

Outlook for H2-FY21 indicates a revival in growth

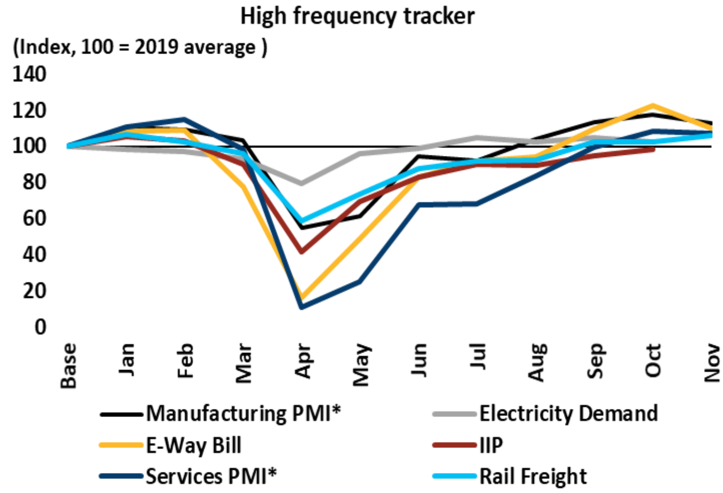
Luckily, the second half of the financial year started on a positive note. India finally bent its COVID curve. This permitted a pick up in mobility, the release of pent up demand, and resumption of economic activities. The onset of the festive season also provided an additional boost to demand conditions. As a result, the nascent shoots of recovery, first seen in September, started to bloom further in October and November. With optimism around COVID containment, google mobility improved to 15% below the baseline in November, its highest ever since February 2020. Mobility saw a dip after Diwali but has resumed recovery in recent weeks.

Industrial and services sector activity data also point to a continuation in the recovery process. The IIP index reported a robust growth of 3.6% YoY in October (up from a revised print of 0.5% YoY in September) though it was partly driven by the favourable base effect. The manufacturing sector drove expansion with a 3.5% YoY growth, after a gap of 7 months, while electricity continued to show robust growth of 11.2%. However, mining activity slipped into a contraction (-1.5% YoY).

Apart from gathering pace, there are also signs that economic recovery is becoming broad based. After lagging in the first quarter of the year, the services sector is showing early signs of a turnaround. Lead indicators for services such as e-way bill collections (21.4% YoY and 8.1% YoY), rail freight traffic (11% YoY and 8.4% YoY), automobile sales (10.5% YoY and 7.2% YoY) noted strong growth in October and November respectively. Credit to the service sector also expanded sequentially in October, improving to 9.5% YoY v/s 9.1% YoY in the previous month. Government spending also picked up in October which is expected to continue. PMIs for manufacturing and services continue to stay in the expansion zone in November despite some moderation from the highs of October, indicating a promising outlook for recovery. Pockets of weakness such as travel, entertainment and restaurant industries will take time to recover.

Given the sustenance of recovery as seen in October and November indicators along with the better-than-expected Q2 data, we are revising our real GDP forecast for FY21. We now expect a real GDP contraction of -7.8% YoY in FY21 compared to -9.8% YoY previously. Real GDP YoY % change is projected to turn positive in Q4-FY21. Besides a favourable base, a vaccination-led boost is expected to further aid domestic economic conditions as well as external demand next year. Accordingly, we expect India's economic growth to recover to +9.9% YoY in FY22 from the previous estimate of +7.8% YoY.

High frequency indicators point towards sustained growth in November



Source: CMIE, *Manufacturing and PMI services have indexed to 100 based on their monthly survey values

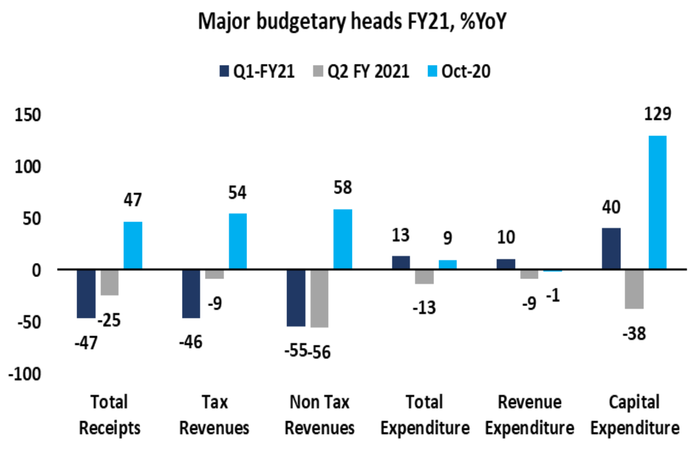
Government support to balance the momentum of the economy

The government has adopted a calibrated approach in lending support to the economy so far while maintaining a close watch on its fiscal parameters. After front-loading its spending in Q1-FY21 (13% YoY), government spending saw curtailment in Q2-FY21 (-13% YoY). Although a strained fiscal position has limited government spending, the rationale for extending budgetary support at the appropriate time has also received credence from government officials. To this effect, as the economy has started reviving and treading back to normalcy, the government is likely to extend more support and speed up recovery.

The latest monthly government expenditure numbers for October already portends to this effect as total spending increased by 9% YoY, driven primarily by capital expenditure. Meanwhile, the fiscal stimulus delivered in early November (Atmanirbhar 3.0) saw a relatively larger share of direct outlays vis-a-vis previous rounds which mostly had non-fiscal resource draining measures such as credit schemes guarantees, etc. Thus, the latest round of stimulus could translate into an economic boost relatively quickly.

Meanwhile, the revival in the economy has also buttressed government revenue collections as total receipts turned to report a growth in October for the first time since February this year. Both tax and non-tax heads showed higher collections compared to last year and are likely to free up space for government spending to take place. As such, we expect government spending to accelerate in the upcoming quarters and aid growth. In line with better collections and update to our growth forecast, we also revise our fiscal deficit projection from 7.9-8.9% of GDP to 7.7-8.3% of GDP in FY21.

Government's fiscal spending picks up with a rise in revenues in October



Source: CGA

RBI continues to support growth in the economy

As fiscal flexibility started to improve with an uptick in revenue collections, the RBI began to face constraints to further monetary easing. In its December meeting, RBI's monetary policy committee (MPC) acknowledged that elevated inflation was constraining monetary policy at the current juncture from using the space available to act in support of growth. CPI inflation has remained above the upper bound of RBI's inflation target range of 4% +/- 2% since Dec'19 (except in March'20). It has risen above 7% in September and October 2020, due to higher vegetable prices and cost push factors. Consequently, the RBI assessed that the inflation outlook had turned adverse relative to expectations in the last two months. The RBI still erred on the side of caution to support economic recovery, thereby reinforcing its dovish leaning. Accordingly, the MPC maintained status quo on key policy rates and decided 'to continue with the accommodative stance of monetary policy as long as necessary'. It also expanded on-tap LTRO to cover more sectors. (Please refer to our report - *A dovish RBI maintains a status-quo on rates and forward guidance; projects a V-shaped economic recovery* Report link). We believe this stance is appropriate at present as we shall discuss below.

Firstly, any changes in the policy stance would have impinged on the credibility of the enhanced forward guidance introduced in the October meeting. Further, a premature withdrawal of liquidity would have risked impairing policy transmission (as was witnessed following a relatively hawkish August policy and minutes which had led to an increase in rates across the spectrum). Moreover, the extension of the ultra-dovish policy is primarily backed by the concern that growth recovery remains reliant on policy support, and inherent demand remains weak. The RBI revised its real GDP projection for FY21 to -7.5% YoY from -9.5% previously. While this is a positive development, the revised projection still shows a deep contraction in the economy, warranting continued policy support.

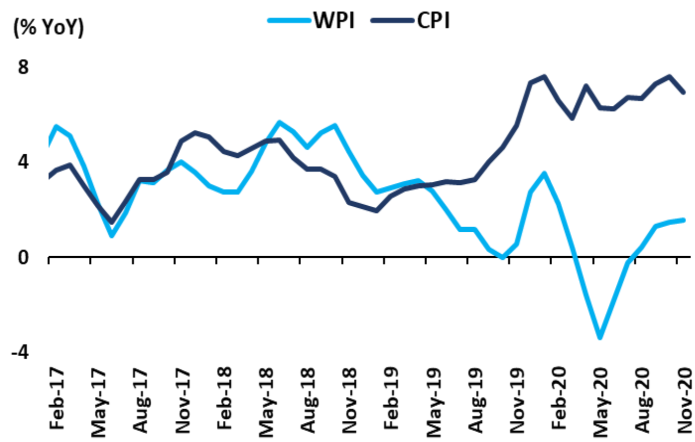
Further, elevated inflation is a concern, but the monetary policy is not an appropriate tool to address what mostly is a supply side and logistic issue at present. A large part of the elevated inflation continues to be supply driven as opposed to demand push inflation. Using the spread between the retail and wholesale prices as seen in the Consumer Price Index (CPI) and the Wholesale Price Index (WPI), we try to capture cost push and logistical pressures. Given that WPI does not have price levels for services, we make comparisons strictly for goods between the two indices exes, while noting that product groups are likely to be close and not exact matches. For our analysis, we choose products that account for around 54% of the total weight in CPI.

Our analysis shows that across product groups, change in WPI stood significantly below that of its CPI counterparts in this fiscal year so far (April-November). The food component, which has a weight of 39% in CPI and frequently remains affected by supply side pressures, has remained above its WPI counterpart by 5.3 percentage points on average in the April-November period. Other non-volatile components such as motor vehicles, furniture, and beverages in the CPI also remain above their equivalent in WPI. Some sub-components in WPI such as clothing and computers, and electronic & optical products, also point to a deflation (as seen in the table below) in sharp contrast to higher prints in CPI. Accounting for the difference in these price levels across the two indices, the CPI would be lower by around 274 basis points on average in the eight months so far in this fiscal year.

Supply side pressures cause CPI to diverge sharply from WPI

CPI vs WPI comparision (Apr-Nov 2021)			
	CPI % YoY	WPI % YoY	Diff ppt
Food	9.9	4.6	5.3
Cereals	5.8	-0.7	6.5
Vegetables	14.3	9.1	5.2
Milk & milk products	6.7	5.2	1.5
Egg	12.9	2.5	10.4
Spices	12.2	6.3	5.9
Pulses	17.8	12.4	5.4
Beverages	4.4	1.1	3.3
Motor Vehicles*	10	2.8	7.2
Clothing	3.1	-2.7	5.8
Furniture*	3.7	0.1	3.6
Computer,electronic and optical products*	3.4	-0.2	3.6

*Does not include April and May months as sub-components of the miscellaneous category was not released due to COVID



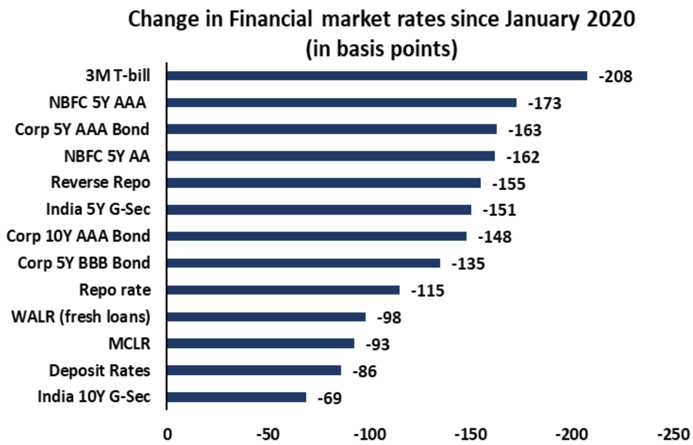
Source: CMIE

As supply side constraints ease and the base effect kicks in, we are likely to see a drop in CPI inflation. Food inflation is also likely to ease with the arrival of bumper Kharif harvest and a drop in vegetable prices with the winter crop. An initial sign of this could be seen in the CPI print for November, where inflation dropped to 6.9% YoY, its lowest level in the last three months. We expect this downward trend to continue in the coming months.

Market update

Financial conditions eased in November and December, supported by the RBI's extension of an accommodative policy stance and the system's surplus liquidity conditions (systemic liquidity averaged INR 5.3 million in November). The India 10-year benchmark yield continued to trade below the 6% mark. It eased further from an average of 5.92% in October to an average of 5.89% in November. Spreads across the spectrum also narrowed with AAA 10Y Corporates and NBFC AAA 5Y bond yields falling by 10 and 17 basis points respectively in November. Meanwhile, the transmission in the shorter tenors has been more than successful with money market instruments, including the call rate, tri-party repo rate (TREPs) and3M T-bill, falling even below the reverse repo rate – the floor of the policy corridor. Recently, the flux of liquidity (enhanced due to forex interventions by the RBI in response to large dollar flows) also started to make its impact in the risk segment of the credit curve as commercial papers for corporates started falling below the repo rate in November. This had raised concern over the mispricing of financial instruments. However, based on RBI's statement, it appears as though this is not seen as a threat to financial stability and will be dealt with at the appropriate time. We believe the RBI may consider measures to adjust surplus liquidity after the announcement of the budget for FY22 and the GDP data for Q3-FY21, which will give it more confidence about the economy's path of recovery ahead. The RBI could then adopt different instruments such as a standing deposit facility or market stabilization scheme bonds to park excess money with the RBI or allowing nonbanks (Mutual Funds) the option of parking surplus funds with the RBI.

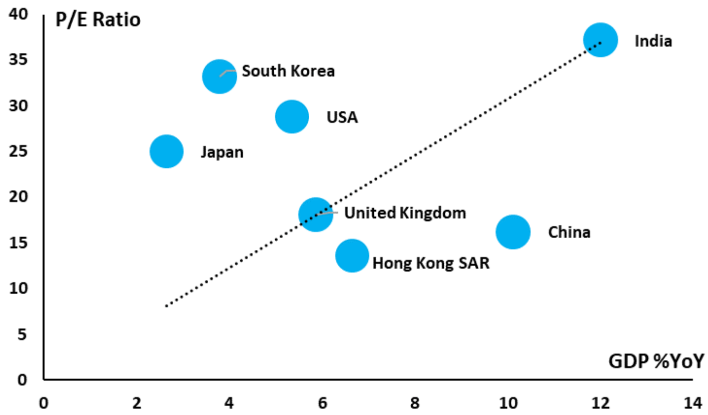
Transmission of interest rates across the spectrum



Source: RBI, Bloomberg; Change calculated from January 31, 2020 – November 30, 2020

Equity market share moved to record highs supported by the economic recovery underway and the influx of liquidity injected by central banks across the globe. Foreign portfolio investors turned to Indian equity markets and reported its highest monthly flows in over a decade of close to USD 8 billion in November. As such, the Nifty 50 index surged by 11.4% in November which was one of its best monthly performances since 2012 (excluding the rebound in April 2020). A similar uptrend is visible across indices of other countries. Moreover, the recent optimism around the release of the vaccine has further extended the rally and is supporting current levels. However, fundamentals remain dwarfed in comparison to price levels. From the price to earnings ratio perspective, India remains one of the highest in comparison to its global peers. The nominal GDP growth rate to PE multiple for India (based on its FY22 forecast from the IMF) stands at more than 3 at present compared to a historical average of 1.8. This raises the risk of market correction once vaccine related news normalizes.

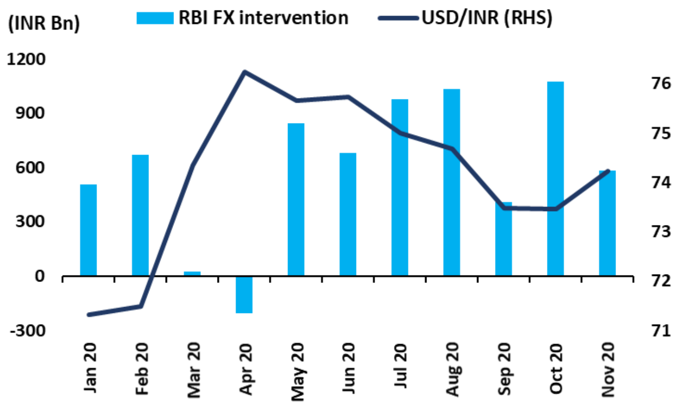
Indian equity markets appear to be among the most inflated in terms of their P/E ratio



Source: Bloomberg, exchanges of respective countries for P/E ratio as of December 9. Growth forecasts are nominal GDP forecasts from the IMF

The Indian Rupee continued to trade with an appreciating bias as the strong flow of capital from Foreign Portfolio Investors (FPI) lent strength to the Rupee. Moreover, news around the vaccine along with the global reflation trade is likely to augur well for EM currencies such as the Rupee, and we see a conducive environment for further appreciation. However, aggressive intervention by the RBI has kept a lid on the domestic currency. As such, it added another ~USD 15 billion to its forex reserves chest, taking the total reserves to a high of USD 574.8 billion as of November 27. Considering continued foreign capital inflows and RBI's intervention, we expect the USD/INR to trade in a narrow range of 72.5-74.5 in the near-term, athough with an appreciating bias.

Rupee gains get capped due to aggressive intervention by the RBI



Source: RBI, daily averages taken for monthly USD/INR, FX interventions are based on own estimates

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