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India's economy remains a diamond in the rough; strong domestic impulses supporting activity even as the global economy continues to slow

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- Global economic slowdown broadened in November amidst continued tightening of financial conditions by major central banks (particularly the US), persistently high inflation across the world, the weakest Chinese economy in decades, and ongoing negative spillovers from the conflict in Ukraine.
- Despite this generalized slowdown in economic activity, jobs growth has remained strong, particularly in developed economies potentially due to companies holding off on cutting staff to save costs owing to the difficulties they anticipate in rehiring.
- Although major central banks have started tapering the pace of rate hikes given the recent signs of inflation peaking, the central banks will need clearer signs of the labour market and demand weakness before considering a pause to the ongoing monetary tightening.
- The Indian economy continues to hold its ground amidst multiple global headwinds as real GDP grew by 6.3% in Q2 FY23 supported by a continued recovery in private consumption. High frequency indicators suggest continued recovery in private consumption boosted by services demand.
- However, the positive momentum is somewhat being offset by a weak industrial sector momentum and external trade owing to weak global demand.
- The government's favorable fiscal position in FY23 (till October) provides it with the flexibility to step up expenditure supporting growth in the rest of FY23 without jeopardizing the budget deficit target.
- Meanwhile, the RBI stepped down the pace of its rate hike to 35-bps in December. However, the tone was assessed to be hawkish with no change in stance and discomfort around the level of core inflation.
- Core inflation remained above the RBI's upper threshold of 6% even though the headline inflation moderated to 5.9% in November.
- We expect the RBI to hike rates by another 25-35 bps in February 2023. This would take the repo rate up to 6.5-6.6%, which given the central bank's inflation expectation of 5.9% for Q4 FY23 would attain real positive interest rates. We believe that the RBI will hold rates steady at that level and pivot further towards a neutral monetary policy stance.

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Global economic activity slowed further in November; central banks have begun tapering hikes

The global economic slowdown broadened in November amidst continued tightening of financial conditions by major central banks (particularly the US), persistently high inflation across the world, the weakest Chinese economy in decades, and ongoing negative spillovers from the conflict in Ukraine. The magnitude of slowing in the pace of economic activity varies by country and region but the generalized slowing in growth is unmistakable.

Ongoing weakness in the global composite PMI – capturing activity in both the manufacturing and non-manufacturing sectors – summarizes nicely the cooling in global economic growth. This index has been in contractionary territory for the past four months. Key contemporaneous and leading PMI indicators also continue to weaken. For instance, overall business output fell at the sharpest rate since the aftermath of the Global Financial Crisis (GFC) (excluding the government-directed halt in economic activity associated with COVID in 2020). Meanwhile, the rate of decline in new orders and backlogs gathered further pace, pointing to rising spare capacity as the demand environment weakens. Consistent with these developments, business optimism is at one of its lowest levels since the first compilation in mid-2012.

The slowing is broad based with only healthcare and technology showing resilience among the eight major sectors monitored by the global PMI data. Regionally, only India recorded an expansionary reading in November.

Global economic slowdown continued to broaden in November

Composite PMI (Value > 50 indicates expansion from previous month; <50 indicates contraction; 50 is no change)								
	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22
Global	51.2	51.3	53.5	50.8	49.3	49.6	49.0	48.0
US	56.0	53.6	52.3	47.5	44.6	49.5	48.2	46.4
China	37.2	42.2	55.3	54.0	53.0	48.5	48.3	47.0
Eurozone	55.8	54.8	52.0	49.9	48.9	48.1	47.3	47.8
Japan	51.1	52.3	53.0	50.2	49.4	51.0	51.8	48.9
Germany	54.3	53.7	51.3	48.1	46.9	45.7	45.1	46.3
UK	58.2	53.1	53.7	52.1	49.6	49.1	48.2	48.2
India	57.6	58.3	58.2	56.6	58.2	55.1	55.5	56.7

Source: IHS Markit

Despite this generalized slowdown in economic activity, jobs growth has remained strong, particularly in developed economies. Indeed, the latest global PMI survey marked the 27th consecutive month of job creation and country-specific indicators show few, if any, signs of a nascent weakening in employment conditions. To be sure, employment is a lagging indicator. But the degree of resilience in jobs is notable given that global economic activity has been easing for many months and historical patterns would suggest at least some visible signs of the labour market softening by now.

Various anecdotal reports hint that companies may be holding off on cutting staff to save costs owing to the difficulties they anticipate in rehiring as well as a legacy of labour shortages from the pandemic. Nevertheless, we judge it likely that evidence of a softer labour market will be visible in early 2023. Activity and/or prices in the most cyclical and/or interest rate sensitive parts of the economy have started to decline, a likely precursor to layoffs and business retrenchment in those areas. Central banks will need clearer signs of the labour market and demand weakness before considering a pause to ongoing monetary tightening.

Rate hikes tapered, but inflation still far above targets in the developed world

	Policy rate (%)									Cumulative hikes in 2022 (bps)	Inflation (deviation from target)
	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22		
US	0.50	1.00	1.75	2.50	2.50	3.25	3.25	4.00	4.50	425	7.1 (+5.1)
China	2.85	2.85	2.85	2.85	2.75	2.75	2.75	2.75	2.75	-10	1.6 (-1.4)
EU	0.00	0.00	0.00	0.50	0.50	1.25	2.00	2.00	2.50	250	10.1 (+8.1)
Japan	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0	3.6 (+1.6)
UK	0.75	1.00	1.25	1.25	1.75	2.25	2.25	3.00	3.50	325	10.7 (+8.7)
India	4.00	4.40	4.90	4.90	5.40	5.90	5.90	5.90	6.25	225	5.9 (+1.9)

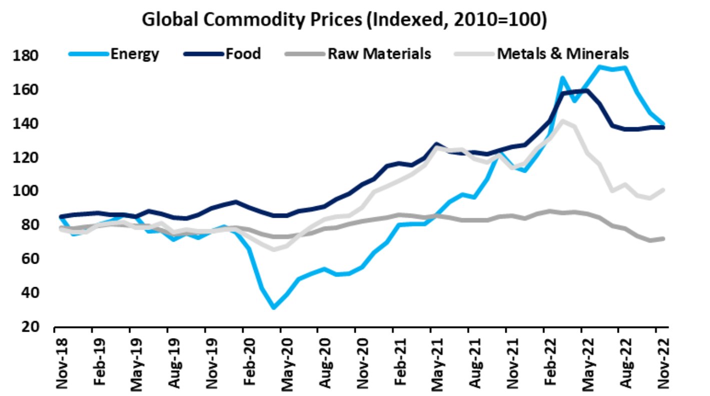
Source: US Federal Reserve, People's Bank of China, European Central Bank, Bank of Japan, Bank of England, Reserve Bank of India

Major central banks have started tapering the pace of rate hikes given the cumulative hikes put in place in 2022 plus recent signs that inflation rates likely have peaked. For instance, in the US where inflation has moderated to 7.1% in November from 7.7% in October and the Fed had put in place 375-bps of rate increases, the Fed hiked its policy rate by 50-bps in December, down from its prior 75-bps per meeting pace. The ECB and the Bank of England followed suit with a 50-bps hike as well. Major global central banks now seem to be moving on from "catch up" tightening where they sought to correct being massively late to increase interest rates to "calibrated" tightening. This new phase likely will involve a quarter, or half a percentage point rate increases each meeting but, importantly, will continue until underlying inflation trends are considerably lower than prevailing currently.

China, however, remains an outlier on this front. In recent weeks, China terminated its strictest-in-the-world Zero-COVID policy and has begun to prioritize economic recovery as underscored by various policy proclamations. Although there is no immediate-term policy bazooka coming like the one introduced in the aftermath of the 2008 financial crisis, policy support is beginning to be introduced and may be targeted to sectors most in need, such as real estate. We expect that easier monetary and credit conditions will be an integral part of that policy support, but that it may be the middle of 2023 before Chinese demand begins to respond meaningfully.

Against this backdrop, oil prices have continued their recent easing. In November, oil prices fell by around 3% MoM on weak global demand. Oil prices have remained low in December despite the imposition of the EU's oil price cap on Russian exports and China's dropping of the Zero-COVID policy. Oil prices had fallen to ~US$82/bbl by Dec 21st compared with ~US$95/bbl at the start of November. Meanwhile global food prices have remained more or less flat since early November but risks of food prices spiking again will remain high with La Nina's forecast to return for a third straight year and with cereal supply uncertainty from Ukraine for as long as the conflict continues. Metal prices increased by 6% MoM in November but remained far lower than the levels seen in 2021 and earlier this year.

Global commodity prices remained soft in November



Source: World Bank

Looking ahead, we expect global commodity prices to rise again with the reopening of China and associated release of massive pent-up demand, recognizing that the timing of a spike in pent up Chinese demand is very hard to ascertain.

The Indian economy continues to recover amidst global headwinds

The Indian economy continues to outperform. Despite tighter monetary policy – both domestically and globally – and the adverse effects of high inflation, persistent dislocations, and disruptions to supply chains tied to Chinese-COVID policies and the conflict in Ukraine, the outlook for India remains generally favourable, especially vis-à-vis the bulk of the rest of the world. Indian economic growth in Q2 FY23 rose by 6.3%, moderating from the double-digit pace recorded in Q1 but still indicating a solid footing. The latest quarter's moderation partly reflected the waning of a favourable base effect. Importantly, sequential economic growth in Q2 FY23 at 3.6% was much higher than the pre-COVID five-year average of 1.2% growth in Q2 reflecting still strong recovery momentum and was mainly driven by a continued recovery in private consumption. The recovery in private consumption was largely supported by urban demand. Even based on incoming data for the current quarter urban demand is showing signs of broad-based improvement while the rural demand seems to be lagging. However, the robust onset of the rabi sowing should bode well for the rural demand outlook.

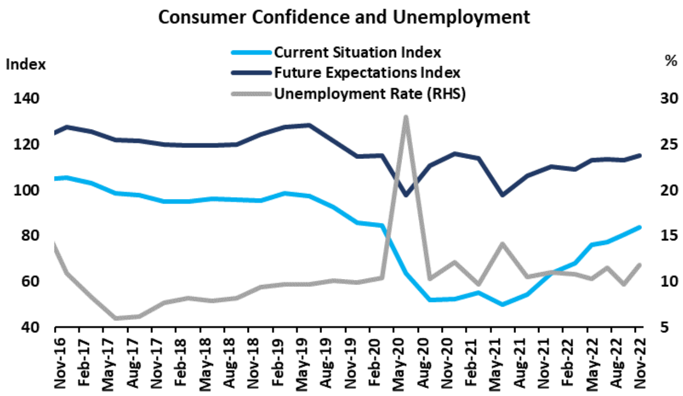
The services sector was a particularly bright spot in Q2 FY23 with the normalization of consumer spending – especially in contact-sensitive parts (Trade, Hotels, Transport, Communication etc.) of the economy where activity climbed above its pre-pandemic levels for the first time. Moreover, high-frequency indicators such as railway freight, air passenger traffic, business surveys – all potentially buoyed by festival-related travel and the continued release of pent-up demand – in the past two months (October & November) suggests that momentum in the services part of the economy has remained robust.

Improving consumer sentiment as measured by the RBI's consumer confidence survey are a source of continued cautious optimism for the consumer spending outlook, as upbeat consumer attitudes tend to correlate with solid consumer activity. Still, an enduring improvement in labour market conditions would strengthen the case for a sustained period of continued favourable consumer spending growth.

	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22
Industry indicators (% YoY)											
PMI Manufacturing*	54.0	54.9	54.0	54.7	54.6	53.9	56.4	56.2	55.1	55.3	56.3
Banks lending to Industry	6.4	6.5	7.5	8.1	8.7	9.5	10.5	11.4	12.6	13.6	
Industrial Production Index (IIP) ^	106.8	100.7	114.1	103.1	105.6	106.0	103.0	100.8	102.7	99.3	
IIP: Manufacturing ^	105.7	98.6	110.3	99.9	102.2	103.8	102.5	99.7	102.3	97.7	
IIP: Mining ^	115.3	113.8	133.3	107.6	111.1	104.9	93.3	91.9	92.3	103.8	
IIP: Electricity ^	105.0	101.9	121.1	123.3	126.7	124.8	119.7	121.3	118.8	107.3	
Coal output ^	133.9	133.6	161.5	113.2	119.8	113.4	101.7	97.7	97.7	111.5	
Steel output ^	112.4	106.3	117.5	105.7	110.8	101.9	107.5	109.3	109.3	112.4	
Cement output ^	119.4	113.6	134.6	115.7	112.0	120.1	105.2	102.6	107.5	104.9	
WPI Inflation- Manufactured goods	9.5	10.2	11.3	11.4	10.3	9.3	8.2	7.5	6.1	4.4	3.6

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

Consumer confidence survey remained upbeat; Labour market yet to see sustained recovery



Source: CMIE

Industrial activity, on the other hand, has been sluggish of late. The activity in Q2 FY23 declined by 0.8% YoY (after eight quarters of expansion) caused by a contraction in manufacturing and mining activity due to elevated input costs, tightening financial conditions and weakening external sector demand. Actual and proxy data for industrial activity thus far in the current quarter (Q3 FY23) have been mixed amidst the push and pull of slowing external demand weighing on manufacturing activity and domestic demand helping to support activity. The loss of working days due to Diwali and extended festival-related weekends may also be distorting activity to some degree. Looking ahead activity in the sector is likely to be supported by a continued capex push by the central government and return to work after the holiday-heavy festive season.

The external sector held back growth in the latest quarter but conditions on this front are nuanced. Exports slowed due to the global economic cooling, while the resilient domestic economy supported imports, affirming the solid consumption backdrop. Despite slight narrowing in the trade deficit in November, trade is expected to remain a drag on growth in the near term. Easing commodity prices could support a moderation in imports however, the export outlook remains weak with the slowdown becoming more broad-based.

The government's fiscal position stayed comfortable on the back of robust tax collections

The government's favourable fiscal position in the first seven months of the year provides it with the flexibility to step up expenditure for the remainder of the year – thereby helping to support economic growth -- without jeopardizing its fiscal target of 6.4% in FY23. This is aided by strong revenue collections which stood at 60.7% of the Budgeted Estimates (BE) supported by the robust tax collections indicating continuing economic recovery. Regarding the expenditure, while the capital expenditure for the first seven months has grown impressively by 61.5% YoY and has reached roughly 54.5% of the BE the growth in revenue expenditure so far has been rather modest increasing by 10% (April – October). For the current fiscal year, the central government has sought parliamentary approval for the additional expenditure over the budget worth Rs 4.4 lakh crores involving a net cash outgo of roughly Rs 3.3 lakh crores (details in below table). Added expenditure on the employment scheme and asset creation will help support the labour market, and hence consumption demand. This additional expenditure is unlikely to create any major impact on the fiscal deficit largely on the back of buoyancy in the tax collections.

Cash outgo proposed under the first batch of Supplementary Demand for Grants

Purpose	Expenditure (in crores)		
	Revenue	Capital	Total
Fertilzer Subsidy	1,09,289		1,09,289
Food Subsidy	80,348		80,348
LPG Subsidies to Oil Marketing Companies; LPG connections to poor household	29,944		29,944
Capital outlay on Indian Railways		12,000	12,000
Pradhan Mantri Awas Yojna - Rural	28,422		28,422
Mahatma Gandhi National Rural Employment Guarantee Scheme	16,400		16,400
Investment in National Highways Authority of India		13,500	13,500
Others	30,301	5,553	35,853
Total	2,94,704	31,053	3,25,757

Source: Department of Economic Affairs

The RBI stepped down the quantum of hike to 35-bps; inflation softened to below 6% for the first time in 11 months

CPI Inflation, YoY%											
Sub-groups	Weights	Pre-COVID average*	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22
CPI (headline)	100.0	4.24	6.95	7.79	7.04	7.01	6.71	7.00	7.41	6.77	5.88
CPI-Urban		4.20	6.12	7.09	7.08	6.92	6.49	6.72	7.27	6.50	5.68
CPI- Rural		4.28	7.66	8.38	7.08	7.09	6.80	7.15	7.56	6.98	6.09
Core-CPI	54.1	4.75	6.33	6.98	6.21	6.00	5.90	6.00	6.23	6.13	6.23
Food and beverages	45.9	3.69	7.47	8.10	7.84	7.56	6.71	7.57	8.41	7.04	5.07
Pan, tobacco and intoxicants	2.4	6.68	2.98	2.70	1.15	1.83	1.78	1.67	1.98	1.87	2.02
Clothing & footwear	6.5	4.25	9.40	9.85	8.85	9.52	9.85	9.91	10.17	10.16	9.83
Housing	10.1	5.57	3.38	3.47	3.65	3.93	3.90	4.06	4.57	4.58	4.57
Fuel & light	6.8	4.37	7.52	10.80	9.54	10.14	11.76	10.78	10.39	9.93	10.62
Household goods and services	3.8	4.49	7.67	7.97	6.79	7.49	7.45	7.53	7.68	7.58	7.66
Health	5.9	5.54	6.99	7.21	5.43	5.47	5.45	5.43	5.52	5.68	5.83
Transport and communication	8.6	2.75	8.00	10.91	9.47	6.90	5.55	5.20	5.39	4.62	5.30
Recreation and amusement	1.7	4.56	7.01	7.31	5.97	6.97	7.08	6.92	6.28	6.05	5.44
Education, stationery etc.	4.5	5.62	3.62	4.12	4.16	4.51	5.02	5.51	5.68	5.80	5.78
Personal care and effects	3.9	4.83	8.71	8.62	6.18	6.68	6.00	7.00	6.81	7.03	7.03

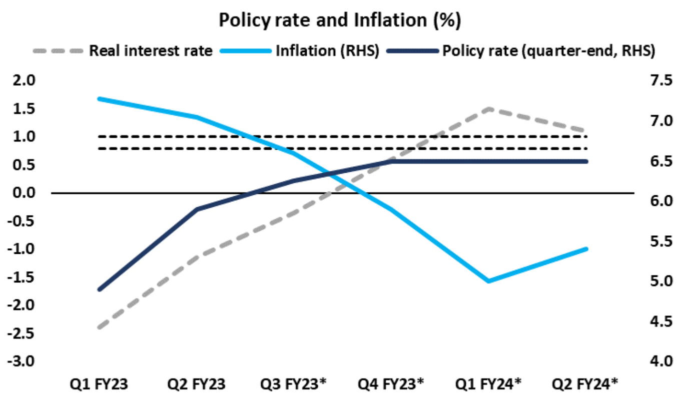
Source: CMIE

As was widely expected, the RBI stepped down the pace of its rate hike to 35-bps in December, following three consecutive 50-bps hikes in previous meetings. The decision was supported by all except one MPC member who voted for no rate hike. Even with a smaller rate hike, the tone of the governor's statement leaned hawkish – reflected in an unchanged policy stance and its clear discomfort around elevated levels of core inflation. The upshot being that the RBI is prepared to raise rates further if core inflation remains sticky.

On this front, core inflation in November remained above 6.0% even with headline inflation having fallen by nearly 2 percentage points since April to 5.9% in November. The moderation in headline inflation was led mostly by a softening of food price pressures following a period of seasonally high prices of fruits and vegetables. Core inflation was sustained at 6.2% by continued high price pressures in the household goods and services, health and transport and communication categories.

Going forward, we remain confident of further moderation in the headline rate of inflation, supported by a reduction in input price pressures (as reflected in a sharp moderation in the Wholesale Price Inflation over the past few months) and a further correction in food prices. However, services inflation is likely to prove to be sticky given the still strong pace of recovery in the sector, which likely will inhibit the desired softening in core inflation. While there is little doubt that the RBI is likely to continue to hike rates, the size of future rate hikes will depend crucially on the evolution of core inflation in December and January before the next RBI meeting in February. Currently, we expect the RBI to hike rates by another 25-35 bps in February 2023. This would take the repo rate up to 6.5-6.6%, which, given the central bank's inflation expectation of 5.9% for Q4 FY23 would attain real positive interest rates close to the RBI's estimation of natural interest rate (0.8-1%). At this point, we lean toward the view that the RBI will hold rates steady at that level and pivot further towards a neutral monetary policy stance.

Assuming a 25-bps hike in February, real interest rate is likely to reach close to the RBI's estimate of natural interest rate

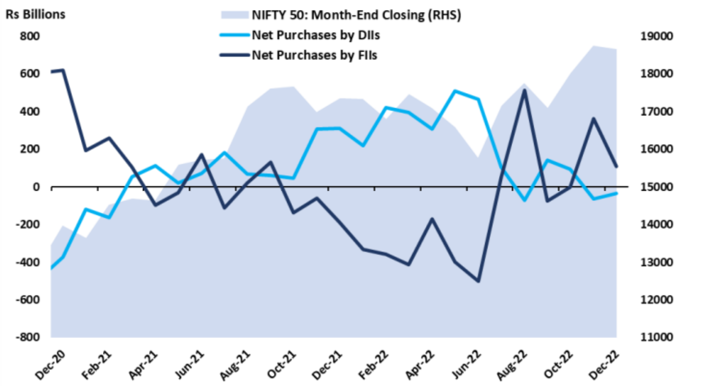


Source: CMIE, DMI calculations

Market update

The Indian Equity markets continued to see interest from foreign institutional investors in November – December as the country's economic fundamentals remain favourable amid a slowing global economy. Indeed, in November foreign investors poured in ~Rs 362.4 billion in the Indian equity markets. Foreign investor interest in the markets has sustained in December with FII inflow totaling Rs109 billion in the first 21 days of the month. Meanwhile, domestic investors pulled out investment worth Rs 63 billion in November and Rs 33.7 billion in the first 21 days of December respectively. As such the Nifty 50 index gained in value by 4.1% in November while the Sensex climbed by 3.9%. In December (data till 21st) the stock market has fallen ~3% owing to weaker global cues including an expectation of the Fed remaining hawkish for longer. We expect volatility in the capital markets to remain high amid a resilient domestic economy and negative external shocks.

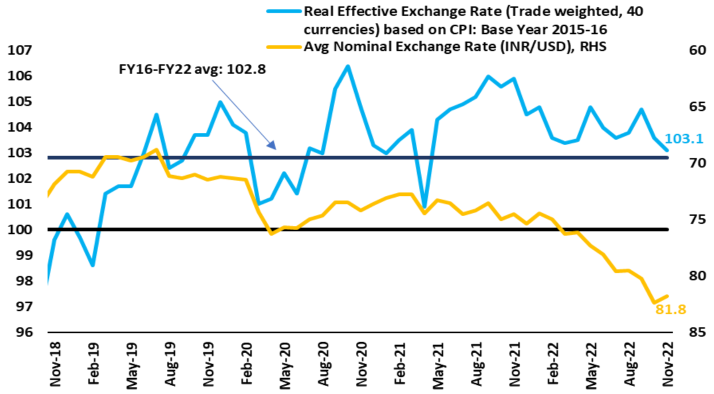
FII interest in the Indian equity market remained strong in Nov-Dec



Source: CMIE

The Indian Rupee appreciated smartly against the US Dollar in November as the signal by the US Fed that it might shift to smaller rate hikes from December led to a weakening of the dollar index. The exchange rate was further supported by low oil prices. The gains in November were reversed in December as the dollar rebounded on better-than-expected economic data from the US as well as the US Fed governor's hawkish comments, despite a step down to a 50-bps hike. Going ahead, the Indian rupee is likely to be impacted primarily by movements in the dollar as well as oil prices. In terms of the real effective exchange rate, the rupee moved slightly closer to its long-term average in October and November, as the US Dollar had started to weaken but a corresponding appreciation was not seen in the rupee. We believe that the rupee continued to inch closer to its fair value in December, which means that depreciatory pressure on the currency has eased, at least in the short term. Over the next couple of months, we expect the exchange rate to remain around 81-84 levels with primary factors affecting the exchange rate being movement in the dollar index, oil prices and a widening of the current account deficit. The RBI is likely to utilize the period of dollar weakening to build up its forex reserves which has fallen sharply in 2022, limiting the movement below 81 levels. Indeed, foreign currency reserves have increased from a trough of US$524 billion in mid-October to US$564 billion according to the latest data. This is equivalent to around nine months of import cover.

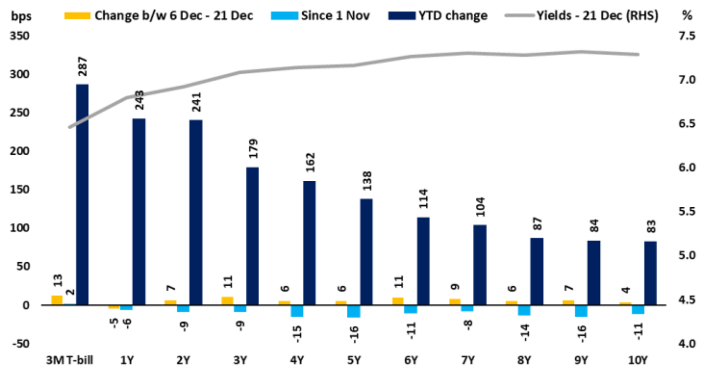
Real exchange rate corrected in October-November and is likely to have corrected further in December



Source: CMIE

Bond yields cooled across the maturity spectrum in November since the Fed policy meeting on November 2 with 10-yr G-Sec benchmark yields declining by 19-bps from 7.40% (on November 1) to 7.21% as of December 1. The easing of the yields was supported by anticipation of slower rate hikes by the Fed, a softer domestic inflation print, and a sharp fall in oil prices from ~US$95/bbl at the start of November to US$87 at the start of December. Following the RBI meeting on December 7, yields remained more or less unchanged. The 1-yr G-Sec yield closed 7-bps higher than its level on December 6 while the 10-yr G-Sec yield barely moved reflecting that the central bank's decision was in line with market expectations. However, yields have again jumped in the past few sessions with the hardening of the yields in the US and an apparent hawkish tweak to policy in Japan. Looking ahead, bond yields in India are likely to continue to face upward pressure due to rising yields around the world and a potential rise in oil prices due to China's optimism. Meanwhile, softening in the rate of inflation is likely to help keep yields in check.

Indian bond markets will remain under pressure from rising yields in the developed world



Source: Bloomberg, Investing.com

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