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Domestic demand strong amidst continuing disinflation; RBI likely to remain on pause

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- Global central banks on balance are likely to hold rates at prevailing levels for some time to help to cement the moderation in underlying inflation taking place in many countries.
- The probability of additional policy tightening has reduced due to a host of factors – the pace of wage growth has moderated, global supply chains have normalized facilitating moderation in goods inflation and credit conditions have become challenging.
- However, we are not prepared to conclude that the war against above-target inflation is over - as a pause in policy meeting could lead to gradual easing in financial conditions that could stimulate economic growth and therefore could circumvent any additional moderation in core inflation. Additionally, the services inflation is still uncomfortably high.
- High-frequency indicators for the domestic economy indicate that momentum in demand conditions continued in October amidst festive season demand.
- Downside risks to the outlook persist from the weaker agricultural output, slowing global demand and tentative signs of softness in labour market conditions.
- In this report we also look at the progress of central finances in H1 FY24. We assess that risk to fiscal slippage remains from lower than budgeted nominal GDP growth and potential increase in subsidies and welfare spending ahead of general elections.
- Consumer price inflation eased in October to its four-month low of 4.9% YoY, down from 5.0% YoY in September led by the moderation in core inflation and fuel inflation even as price pressures in the food category remain elevated.
- Continued moderation in core inflation gives the confidence that underlying price pressures are receding.
- For the outlook, we could see inflation picking up due to the waning of favourable base effect, a potential decline in Kharif food grain production exerting pressure on food prices and expected pick-up in wholesale price index. Overall, we expect inflation to be in range of 5.3%-5.5% for FY24. With inflation expected to remain above 5%, we expect the central bank to maintain status quo on policy rate in the December meeting.

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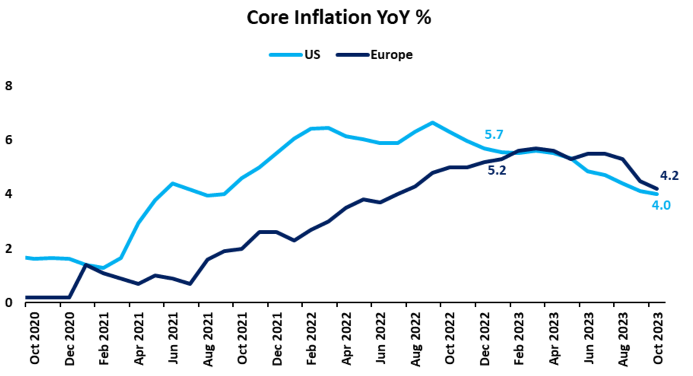
Global central banks likely to hold rates at prevailing rates

Barring a pronounced and sustained reacceleration in core inflation, the global monetary policy tightening that began two years ago likely is finished in most, if not all, of the world's major economies. However, the prospective end of central bank policy tightening does not imply that monetary policymakers in short order will be lowering interest rates, as often has been the ebb and flow of interest rate cycles in the past 25 years. Rather, global central banks on balance are likely to hold rates at prevailing levels for some time to help to cement the moderation in underlying inflation taking place in many countries.

We wrote last month that the hurdle was high for any additional policy tightening in 2023 and early 2024 given the prevailing economic backdrop and that hurdle has increased substantially based on recent data and events. The latest updates on wage and price trends across the bulk of the world's largest economies have extended prior months' generally favourable readings on these fronts, boosting the likelihood that tighter monetary policy plus long-hoped-for normalization in global supply chains are ameliorating the most intense inflationary pressures experienced in decades.

Although core inflation has moderated it is still above the desired levels



Source: Bloomberg

To be sure, current core inflation rates in nearly every major economy still are too high and above their respective target/desired level. But the rate of core inflation has been decelerating steadily and, in some countries, sharply in recent quarters. For instance, core inflation as measured on a YoY basis in the United States and Europe has moderated by 1.7 and 1.0 percentage points (pp), respectively from year-end 2022 to October 2023. In absolute terms, YoY core inflation in the US has moderated to 4.0% in October 2023 from 5.7% in December 2022, while in Europe YoY core inflation stood at 4.2% in October 2023, down from 5.2% in December 2022. Notably, this moderation has occurred in these – and other – economies absent pronounced economic weakness, much less recession.

More importantly, the mix of forces that propelled inflation sharply higher in 2021 and 2022 has shifted substantially and should be a bulwark against a meaningful acceleration in inflation in 2024.

- The labour market is the most balanced it has been since the start of 2020 prior to the COVID shock. Businesses no longer are seeking to hire workers at nearly any price with the flip side of that being workers are less willing to take a chance on a new opportunity because the compensation hike for doing so no longer is 10% to 20%. Meanwhile, labour force participation steadily has increased with prime-age participation rates generally back at pre COVID levels, thereby increasing the pool of labour available to employers. Together, these developments have moderated the pace of labour compensation increases from multi-decade highs toward rates more consistent with 3% inflation, a vast improvement from compensation gains consistent with 5%+ inflation.
- Global supply chains have normalized. China's termination of its Zero COVID policy has been an important development helping to facilitate the normalization of global supply chains, especially pertaining to goods production. Despite China's current visible economic struggles, the country remains the key locale of production (in whole or part) of an outsized portion of the global economy's goods and the return to more normal production in China has helped to quash price pressures in the goods sector. Indeed, prices for goods in many countries are deflating (i.e., falling outright), which is helping to moderate underlying inflationary measures.
- Credit conditions, as judged by both the cost of credit and its ease of availability, have shifted from super easy to challenging. Interest rates on new borrowing by both businesses and consumers are four to seven pp higher (depending on the economy and type of borrowing) than they were just two years ago. Moreover, it has become considerably more difficult to obtain new credit. High quality borrowers are still able to obtain credit, but the process and documentation sought by lenders has toughened; more marginal borrowers face an uncertain and perilous credit approval process and, if approved, meaningfully tougher terms and standards on their loans. Accordingly, demand for large-ticket goods

typically financed such as homes and autos has cooled. In select economies the cooling in large-ticket goods purchases has been considerable.

While this backdrop has curtailed the degree of upside risk to core inflation in the year ahead, we still are not prepared to conclude that the war against above-target inflation is over. Economic growth throughout much of the world has proved resilient to the dampening effects of high inflation and monetary tightening. With major central banks indicating a pause in their policy tightening cycle, the prospect of a gradual easing of financial conditions is becoming increasingly likely. This easing could manifest in lower market interest rates, improved credit availability, and higher equity valuations, all of which could stimulate economic growth. Such an event could circumvent any additional moderation in core inflation.

Separately but related, services inflation remains uncomfortably high in nearly every major economy, and this has been papered over to some degree by the magnitude of disinflation / deflation in goods prices. Given the strong linkages between services inflation and labour income, we remain of the judgement that it will be necessary for some labour market weakness – i.e., a rise in unemployment – to secure the necessary moderation in services inflation to reduce overall core inflation rates back down to their targets. Accordingly, we expect the central banks to hold interest rates at prevailing levels.

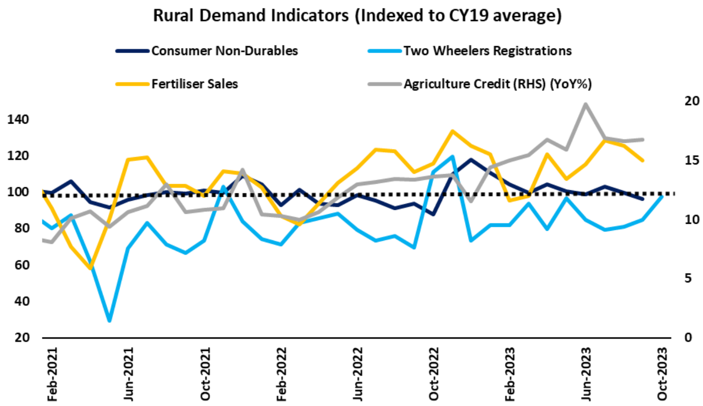
Indian Economy: Growth in Q2 remained healthy; High-frequency indicators for Oct suggests momentum continues ahead of festive season

Overall demand conditions in the Indian economy have likely remained upbeat, while core inflation has moderated. Domestic demand continues to recover, potentially boosted by festive season sales and the government's push on capital expenditure. Meanwhile, the external trade remains a drag on overall demand. Downside risks to the outlook persist from the weaker agricultural output and slowing global demand in response to the past two years' global monetary policy tightening.

Festive demand to provide much needed boost in Q3; downside risks from surge in unemployment rate persist

Indicators of consumption demand suggest that growth momentum has continued in Q2 FY24 on the back of the robust urban demand while some moderation was observed in rural demand potentially due to the impact of the deficient monsoon. The extent of the slowdown in rural demand has potentially been arrested due to a decline in food inflation and the LPG subsidy announced by the government. High-frequency data for rural demand including a strong two-wheeler registration and an uptick in the reported sales volume in rural areas of FMCG companies attest to the same.

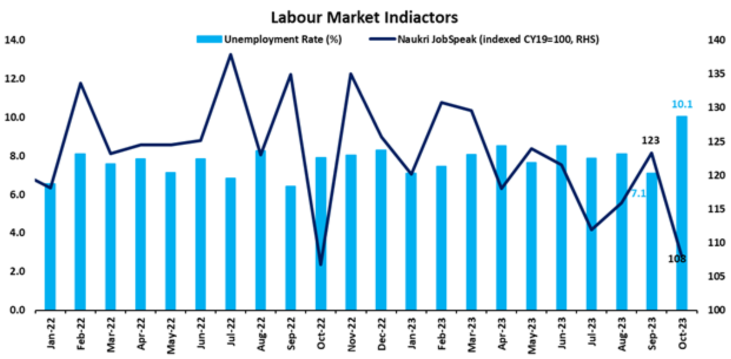
Impact of sub-par monsoons on rural demand has been limited so far



Source: CMIE

Looking ahead, the outlook for Q3 appears bright with the festive and wedding season providing a much-needed boost to the consumer demand. Lead demand indicators for October including passenger-vehicle sales, two-wheeler sales, domestic air passenger traffic etc. remained upbeat. This is likely due to strong demand for both goods and services. Indeed, the services related indicators have posted robust growth. The optimism around improving demand conditions is further confirmed by the early estimates of the Diwali sales published by the Confederation of All India Trade (CAIT). As per the data released by the CAIT, the retailers clocked a record high sale of Rs 3.75 lakh crores up until Diwali.

Unemployment surged in October; Hiring for white collar jobs has slowed

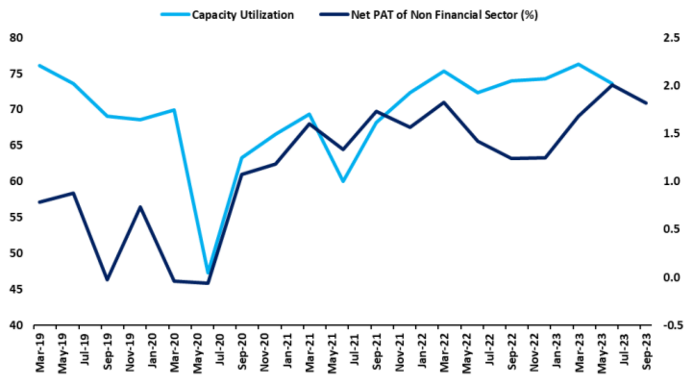


Source: CMIE

While the recent data does sound encouraging, it is hard to say whether the momentum in consumer demand will sustain. A primary reason for our cautious assessment is the volatile labour market conditions as visible in the jump in unemployment rate to 10.1% in Oct from 7.1% in Sep. Such an outsized one-month jump is unusual and may be overstated and/or a bad data print. Nonetheless, separate data from Naukri.com also suggest that white collar hiring has slowed in recent months so, in our judgment, there is some degree of moderation taking place in labour market conditions with potential implications for future consumer demand. Further, the recent uptick in consumption is also due to easing of the food inflationary pressures, however if food inflation rises again, we could see moderation in the pace of consumer demand.

On the investment front, the recovery so far has been led by the government with no meaningful pick-up observed in private investment. This has supported industrial sector growth which continues to be led by infrastructure and construction materials as consumer output lags. However, ahead of the general elections in (Apr'24-May'24), the subsidies and welfare spending could increase (based on past trends). To achieve the fiscal deficit target for FY24, this would imply a reduction in the government's CAPEX spending. As a result, private investments will have to pick-up to compensate for the same.

The corporate sector posts strong profitability in Q2; bodes well for the investment revival



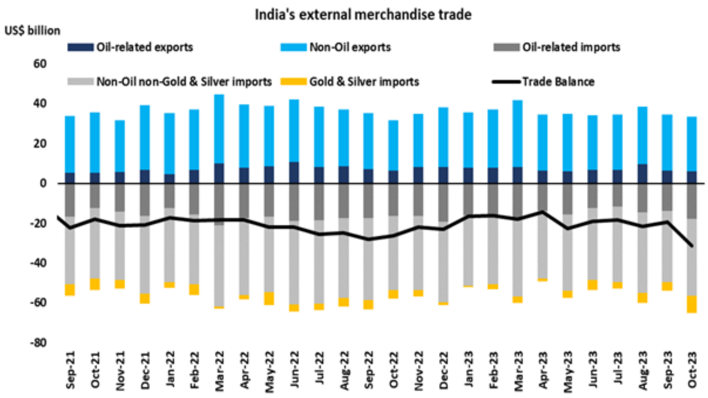
Source: CMIE

Listed companies' Q2 FY24 earnings reports indicate continued strong profitability. As per the CMIE, based on the financial results of 3.2K companies released so far, the net profit adds up to Rs 1.82 tn which is only slightly lower than Rs 2.01 tn reported in the June quarter by 3.4K companies. The addition of remaining companies should bring the profit closer to a record high profit in June. This along with rising capacity utilization should bode well for the strengthening of a private investment activity revival.

Drag from external sector continues in October

The drag from the external sector continued in October with trade deficit touching record highs of US $31.5 bn up from US $19.4bn in the prior month. This was led by a sharp uptick in imports as exports continued to moderate on a sequential basis. Within imports, the increase was led by gold & silver ($4.3 bn MoM) and petroleum imports ($3.7 bn MoM). A large increase in gems & jewellery is likely due to the festive and wedding season demand and is expected to normalize going ahead. On the other hand, the services surplus slightly improved from US $13.8 bn in the previous month to US $14.4 bn in October. With global demand expected to remain subdued, the drag from the external sector is likely to persist.

Import growth surged in October; expected to normalize going ahead



Source: CMIE

Outlook for the agriculture sector tilted towards downside owing to sub-par monsoons

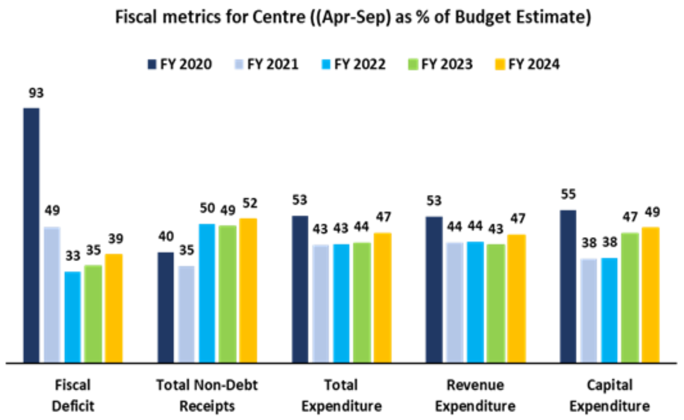
While activity in services and industrial sector have likely remained healthy, we could see some deceleration in the agriculture sector due to the subpar monsoons. As per the first advance estimate, the Kharif food grain production for FY24 is expected to be 4.6% lower than the final estimate for FY23. The outlook is expected to be tilted on downside with sub-par monsoon impacting the rabi sowing season - as due to deficient rainfall the reservoir levels are tracking below their decadal averages – which are crucial for the winter crop. As of November 16, the total live storage in 150 important reservoirs was tracking ~6% lower than the decadal average.

Inflation and Monetary Policy

Consumer price inflation eased in October to its four-month low of 4.9% YoY, down from 5.0% YoY in September, printing comfortably below the RBI's upper tolerance threshold (6%) for a second consecutive month. The softening in headline print is primarily attributed to the favourable base effect and was led by the moderation in core inflation and fuel inflation even as price pressures in food category continues to remain elevated.

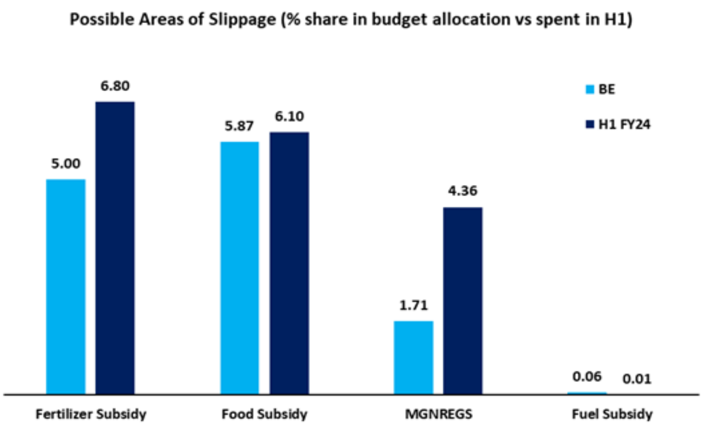
Focus section: Progress of Central Government Finances in H1 FY24

The central government's fiscal deficit in the first half of FY24 reached 39% of the full year budgeted estimates, slightly higher than the average in the previous two years but much lower than the pre-COVID five-year average of 86%. The pace of both collection and spending have improved in FY24 compared with the past two years.



On the receipts side, the improvement was led by the surge in non-tax revenue and is attributed to the larger than expected surplus transfer from the RBI (Rs 87k crore against budgeted amount of Rs 48k crore for RBI and PSU banks' surplus). Indeed, non-tax revenue until September 2023 had reached 78.5% of the budgeted amount. On the tax side growth has been healthy apart from excise duty collection which was down slightly compared with the corresponding period of the previous year owing to a reduction in excise duty related to export and production petroleum-related products. Non-debt capital receipts are expected to underperform due to poor progress on divestment (until September only Rs 7k crores out of the budgeted Rs 51k crores have been realized). Overall receipts were a healthy 52.2% of the budgeted estimates in H1 FY24.

On the expenditure side, an improved pace of spending was seen on both revenue and capital accounts. Growth in CAPEX continued to remain high at 43.1% YoY for the first half of the financial year in line with the government's focus on infrastructure development to support economic recovery out of COVID-19. Indeed, the capital spending of the ministry of road and transport, and ministry of railways (ministries with the highest CAPEX allocation in FY24 with over ~25% each) in H1 FY24 had already reached ~60% of their full year allocation showing front loading of expenditure.



Revenue expenditure growth has been higher than expected for H1 FY24 at 10% YoY, especially when compared to the budgeted growth which is only 1.2%. While part of this is attributed to a low base effect (revenue expenditure growth in H1 FY23 was only 6%), the main drivers of growth were increase in expenditure on interest payments, defense (including pensions and services), fertilizer subsidy, food subsidy, and rural development (or specifically Mahatma Gandhi Rural Employment Guarantee Scheme). Although growth will come down in the second half of FY, revenue spending is likely to breach the target. With 63% of the budgeted fertilizer subsidy already exhausted, we believe that this could be an area of fiscal slippage for the government. Further slippage could come in the form of the need to allocate additional funds to the MGNREGA. Indeed, until end-October, expenditure under the scheme was already ~115% of the allocated Rs 60k crores. Furthermore, the announcement of LPG price cut in August by Rs 200 per cylinder is expected to have a fiscal impact of close to ~Rs 7.5k crores.

Despite the better-than-expected progress of receipts in H1 FY24, risk of fiscal slippage remains. Lower-than-expected growth in nominal GDP in the rest of the fiscal year could exert a drag on receipts growth and ultimately lead to some fiscal slippage. Our current estimates are based on the assumption of 10.5% growth in nominal GDP (as per the budget). Nominal GDP growth in Q1 FY24 was 8% YoY. Additional risk factors that could lead to a higher fiscal deficit include the announcement of further subsidies by the government in the view of the upcoming general election or the possibility of higher oil prices due to a rise in geopolitical risk around the globe (which would increase the petroleum subsidy burden).

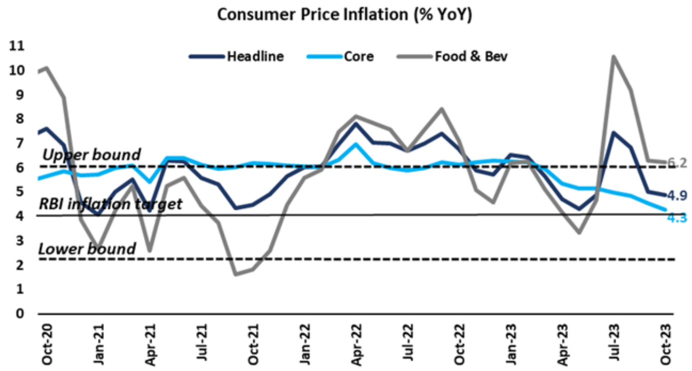
	Fiscal Metrics (Rs Lakh Crore)				As % of GDP				%YoY			
	FY23 RE	FY23 A	FY24 BE	FY24 E	FY23 RE	FY23 A	FY24 BE	FY24 E	FY23 RE	FY23 A	FY24 BE over FY23 RE	FY24 E over FY23 A
Revenue Receipts	23.48	23.84	26.32	27.49	8.6	8.7	8.7	9.1	8.2	9.8	12.1	15.3
Net Tax Revenues	20.87	20.97	23.31	23.97	7.6	7.7	7.7	7.9	15.6	16.2	11.7	14.3
Gross Tax Revenues	30.43	30.54	33.61	35.53	11.1	11.2	11.1	11.8	12.3	12.7	10.4	16.3
Non Tax Revenues	2.62	2.86	3.02	3.52	1.0	1.1	1.0	1.2	-28.3	-21.6	15.2	23.0
Non Debt Capital Receipts	0.84	0.72	0.84	0.47	0.3	0.3	0.3	0.2	112.1	83.3	0.6	-34.3
Total Receipts	**24.32**	**24.56**	**27.16**	**27.96**	**8.9**	**9.0**	**9.0**	**9.3**	**10.1**	**11.2**	**11.7**	**13.9**
Total Expenditure	**41.87**	**41.89**	**45.03**	**45.66**	**15.3**	**15.4**	**14.9**	**15.1**	**10.4**	**10.4**	**7.5**	**9.0**
Revenue Expenditure	34.59	34.53	35.02	35.65	12.7	12.7	11.6	11.8	8.1	7.9	1.2	3.3
Capital Expenditure	7.28	7.36	10.01	10.01	2.7	2.7	3.3	3.3	22.8	24.2	37.4	35.9
Fiscal Deficit	**17.55**	**17.33**	**17.87**	**17.70**	**6.4**	**6.4**	**5.9**	**5.9**				

Note: E- Estimates; BE - Budget Estimates; RE - Revised Estimates; A - Actuals;

Source: CMIE; Note: DMI Calculations

Food & beverage inflation, moderated marginally from 6.3% in September to 6.2% in October. However, the yearly improvement masks that on a sequential basis food & beverage inflation quickened to 1.0% from deflation of 1.8% in the prior month. This was due to the sharper increase in vegetable prices potentially reflecting the impact of increase in the onion prices in the second half of October. The full impact of the surge in onion prices is expected to be felt in November with retail price for onion tracking over 55% above the October prices (data till 20th Nov). While we expect the vegetable prices to correct going ahead owing to multiple harvest seasons, the inflationary pressure in other food categories continues to persist with 50% of the subcomponents by weight in food category posting inflation above 6%. These items include cereals, pulses, spices, eggs and milk.

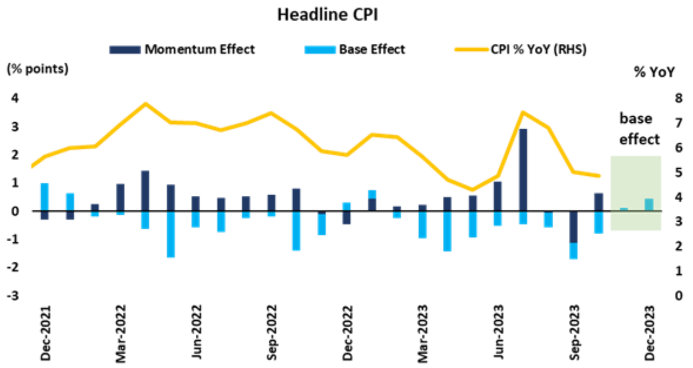
Core inflation continues to moderate while food inflation remains elevated



Source: CMIE

Positively and more importantly, the core inflation rate which has a bearing on the monetary policy decision has softened further to 4.3% in October from 4.5% previously. This marks the lowest print since the pandemic. The moderation in the core inflation was broad-based across all sub-components which gives confidence that underlying price pressures continue to recede.

Base effect to turn unfavourable in Nov-Dec



Source: CMIE

Going ahead, the headline inflation is expected to pick up again due to multiple factors. Firstly, the favourable base effect will wane in the coming months. Secondly, as per the first advance estimates the Kharif food grain production is estimated to be 4.6% lower than last year's final estimates. If the final production remains closer to the current projection, it will exert upward pressure to food prices. Thirdly, the lower reservoir levels also add to the upside risks to the food inflation. And lastly, WPI inflation is expected to turn mildly positive with the tapering of the favourable base effect, which could lead to a slight increase in core inflation. Keeping in mind the upside risks to inflation, we expect the full year FY24 inflation to be in the range of 5.3%-5.5%, slightly lower than our previous forecast of 5.5%-5.8%, owing to the faster correction in vegetable prices in Sep-Oct.

From the policy perspective, with the expectation that inflation will stay above 5% for FY24 and the MPC's commitment to align inflation to the 4% target and not be complacent with bringing it in the target range, the central bank is likely to maintain status quo on policy rates in the December meeting. Furthermore, the stance is expected to be retained at withdrawal of accommodation to contain second-round impact of surplus liquidity on inflation and to aid the transmission of the previous rate hikes.

Market Update

- Equity Market: Indian equity markets staged a sharp recovery in November (data till 22nd Nov), recouping the losses of the previous month as the benchmark index – the NIFTY50 was up by 3.8% from the previous month's closing. This was led by positive global cues after softer-than-anticipated U.S. inflation data which strengthened hopes of an end to the rate-hiking cycle, and a resilient domestic economy. As a result, FII's capital inflows turned mildly positive at Rs 8.9 bn (data till 20th Nov) after two consecutive months of capital outflows. Going ahead, with continued global uncertainty the volatility in the equity market is likely to persist.

- Bond Market: The Indian bond market remained under pressure in October as the average 10-year G-sec yield was up by 13 bps to 7.32%. This was led by a host of factors including the central bank's statement to possibly use Open Market Operations (OMO) sales if the surplus banking liquidity were to increase and the surge in US treasury yields to decadal highs. However, the bond market took a breather in November as the 10-year benchmark yields retreated from 7.38% on October 23rd to 7.25% on November 22nd amidst cooling of the US treasury yields due to an unchanged Fed policy and lesser-than-expected refunding announcement; and easing of the oil prices. Volatility in the 10-year yields was also imparted from the chatter about the inclusion of India's bonds in Bloomberg indices after JP Morgan included domestic bonds in its emerging market index – this could potentially be deferred. The near-term catalyst therefore for the bond market will be the upcoming monetary policy meeting and the movement in the US treasury yields.

- Currency Market: In the currency market, the USD/INR pair depreciated by 0.2% sequentially in October to trade at an average of 83.2 from 83.07 in September as sustained foreign capital outflows, elevated crude oil prices and the rising dollar strength amidst the increasing demand for safe-haven weighed on the domestic currency. Heading in November, the rupee has continued to trade above 83 levels, despite a moderation in dollar strength (2.6% decline till 22nd Nov) amidst an unchanged Fed policy and softer inflation print; and retreating oil prices. This is likely due to increased domestic dollar demand by the importers. Looking ahead, the depreciatory bias is likely to be limited as easing in the dollar index and crude oil prices should offer some support to the domestic currency.