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India's economic recovery back on track as third COVID wave abates; global headwinds keep up the uncertainty

DMI FINANCE

- The global economic outlook faces downside risks amidst several headwinds, including geopolitical tensions and policy normalization by major central banks, even as the COVID wave shows signs of abating.
- India's third COVID wave is past its peak, with a clear downward trend in daily cases.
- In line with our expectations, the impact of the third wave on the economy so far has been lesser than the previous waves, given better adaptability, higher vaccine coverage, and milder restrictions.
- High-frequency data indicates that the economic recovery is back on track after a brief disruption caused by the third wave. The deteriorating external environment, including the impact of geopolitical tensions, could pose downside risks.
- The Union Budget for FY23 carried forward the government's stance of prioritizing investment-driven economic growth revival with CAPEX projected to rise to 2.9% of GDP in FY23 from its pre-COVID average of 1.7% of GDP.
- For FY23, the government has set a budget deficit target of 6.4% of GDP, implying a fiscal consolidation of 0.5 percentage points over FY22 RE in line with our expectations.
- The RBI continued its focus on economic growth revival over inflation risks in its February meeting. It kept key policy rates and the accommodative policy stance unchanged while continuing with steps to adjust liquidity.
- Based on the RBI's dovish stance and its optimistic inflation projection, the RBI is expected to adopt a gradual policy normalization approach with a hike in reverse repo likely to start in Q1FY23 and the repo rate in H2FY23.
- The RBI envisaged an optimistic inflation outlook as it projects CPI inflation to ease from 5.3% in FY22 to 4.5% in FY23.
- We see upside risks to inflationary pressures given elevated global crude oil prices and domestic price pressures (which are reflected in a high WPI of 12.9% YoY and a CPI of over 6% YoY in January).
- If these risks were to materialize, the RBI would have to adjust policy at a faster pace in the future than presently anticipated.

Pramod Chowdhary
Chief Economist
pramod.chowdhary@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

www.dmifinance.in

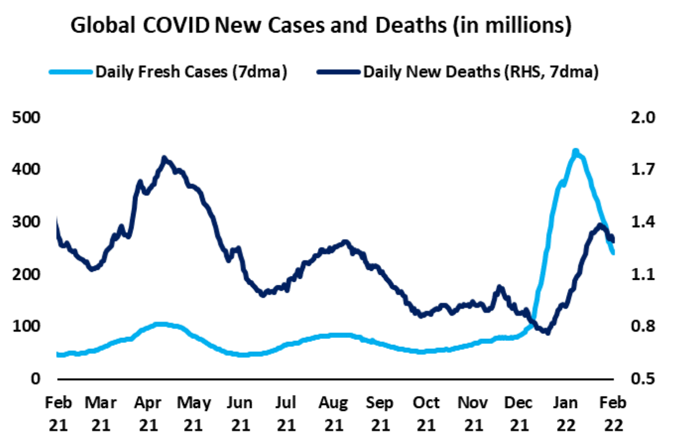
+91 11 4120 4444

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

The global economic outlook remains marred with high-level uncertainty amidst several headwinds, even as the COVID wave shows signs of abating

The global economic outlook faces downside risks given the persistence of several headwinds. The impact of the Omicron led new COVID wave and its associated disruptions (including through mobility restrictions and supply-side bottlenecks) are starting to get revealed in the economic data. Weighed down by both the manufacturing and the service sectors, the Global Composite PMI slipped to an 18-month low of 51.4 in January. Meanwhile, the Global Supply Chain Pressure Index (GSCPI)[1] remained elevated near multi-decade highs, although it appeared to cool from its peak in October 2021. An encouraging development has been the moderation in the number of daily cases across the globe, from a peak of ~34 lakh cases per day to ~19 lakh per day as of February 18, 2022. This, tied with the growing confidence around a low severity of the Omicron variant, has resulted in several western countries lifting restrictions that were brought in response to the current wave. On the other hand, China's strict zero-COVID strategy has seen the imposition of stringent restrictions in the country, weighing on its economic growth and thereby on the global growth prospects. The International Monetary Fund (IMF) revised its global growth forecast for 2022 lower by 0.5 percentage points to 4.4% YoY, citing pandemic related disruptions, among other reasons.

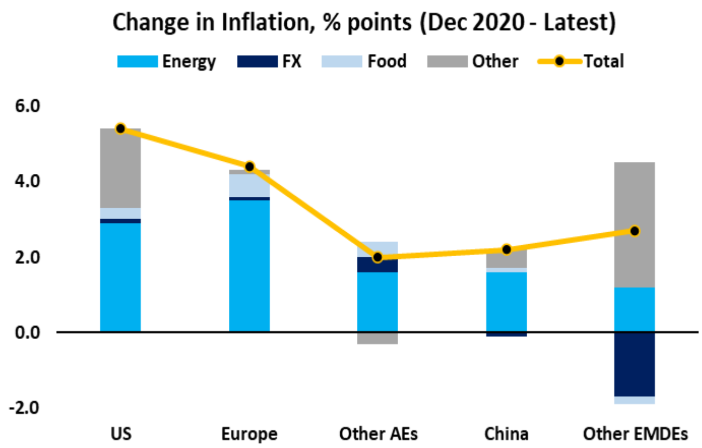
Global COVID cases moderate in February



Source: OurWorldindata.com

Besides the pandemic, geopolitical tensions between Russia and Ukraine have also been thrown in the mix of rising headwinds, resulting in heightened global uncertainty and financial market volatility. The oil market showed high sensitivity to news related to the Russia/Ukraine stand-off, with Brent prices rising to a seven-year high of ~$96.5/bbl by mid-February before easing to ~$93.5/bbl on news of the revival of talks to ease tensions. Oil prices also corrected due to speculation over the possibility of revival of Iran's 2015 nuclear agreement, which could eventually lead to the granting of waivers on oil sanctions and thereby add about 1 million barrels a day of oil from Iran to the global markets. Even after some moderation seen in recent days, Brent oil prices remain ~20% higher (as of February 18) than the 2021 end level. Elevated energy prices are accentuating inflation risks that add to the risks of an aggressive tightening by central banks worldwide.

Elevated energy prices driving higher inflation



Source: IMF; AEs = advanced economies; EMDEs = emerging market and developing economies; FX = import weighted nominal effective exchange rate depreciation

Responding to the continuing increase in inflation prints, major central banks are turning incrementally hawkish as they find themselves falling behind the curve in achieving their mandate of price stability. The most recent inflation print in the US, which rose to a 40 year high of 7.5% in January, has led to a recalibration among market participants about the number of interest rate hikes the US Federal Reserve will deliver. The market consensus seems to be converging towards the expectation of around 7 hikes by the US central bank in 2022 (compared to 3 rate hikes in 2022 according to the median dot plot in the latest December Fed policy), with some market participants expecting a 50-basis points (bps) hike in the March 2022 policy meeting. The Bank of England has already embarked on its path of raising policy rates and delivered its second consecutive interest rate hike earlier this month for the first time since 2004, in response to the near 30 years high inflation print. Meanwhile, the European Central Bank, which remains accommodative, noted upside risks to inflation and delivered relatively hawkish guidance, keeping the door open for rate hikes in 2022. The Bank of Japan kept its policy rate unchanged, though it noted inflationary pressures. Among EM central banks, South Africa, Russia, Brazil, Hungary,

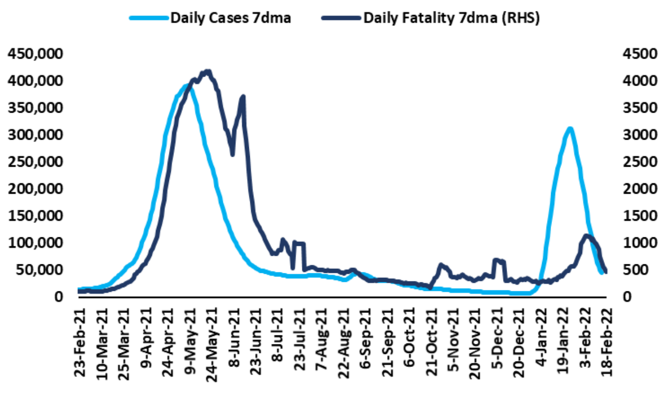
[1] a barometer for global supply chain pressures created by the New York Federal Reserve

and Chile raised their respective policy rates in January-February '22. In contrast, China's central bank cut select policy rates, given pressures on economic activity. While policy divergence prevails with major economies such as China and Japan, an aggressive tightening by the US Federal Reserve and other major western central banks could strong-arm emerging economies to pull the plug on domestic support as well. As such, an aggressive tightening by the US Fed is likely to lead to increased financial market volatility, especially in emerging economies and could also risk the global economic healing process.

India's third COVID wave pasts its peak

The COVID third wave is past its peak, with a clear downward trend in daily cases. After a rapid rise in daily cases in the first three weeks of January, the COVID curve showed an equally quick turnaround, with daily cases peaking by January 25. Not only was the peak of daily cases (7dma) ~20% lower than the peak during the second wave; it was also reached much sooner than in previous waves. The peak of daily cases was reached in ~30 days during the third wave, as compared to ~80 days during the second wave. Further, the number of fatalities has also been much lower than previous waves, with daily fatalities (7dma) peaking at a level nearly 73% lower than the peak during the second wave. With the ebbing of the third wave, India's daily new cases (7dma) have fallen sharply from the peak of 3.1 lakh cases on January 25 to ~31K by February 18. The daily positivity rate (7dma) has dropped from 16.5% to 2.6% during the same period. Meanwhile, with daily recoveries exceeding the daily new cases, the active caseload has declined sharply from over 22 lakh cases on January 25 to 2.5 lakh cases on February 18.

India's third COVID wave is less severe and short-lived compared to the second wave



Source: CMIE, PIB

On the vaccination front, India has administered over 173 crores of vaccine doses as of February 15 and consequently has managed to inoculate 94.2% of its eligible population (15+ years) with at least one dose and 74.7% of the eligible population with both doses. Given the improved COVID situation and vaccination coverage, states have started relaxing virus containment measures, allowing the resumption of economic recovery.

Economic recovery shows signs of a quick rebound following a brief disruption caused by the third wave.

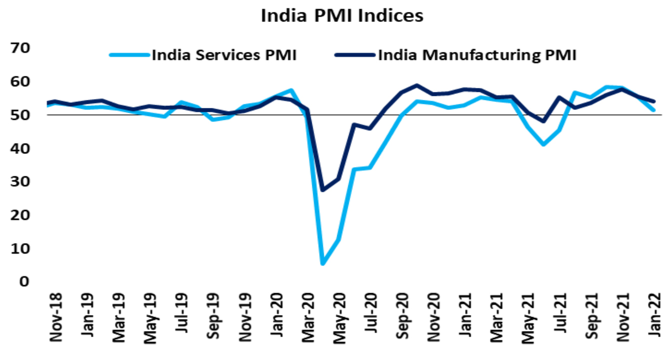
India's economic recovery is back on track after a brief disruption caused by the third COVID wave. In line with our expectations, the impact of the third wave on the economy so far has been lesser than the previous waves, given better adaptability, higher vaccine coverage, and milder restrictions. Incoming high-frequency data, on balance, are showing some moderation in the pace of economic activity in January, which has been less than compared to previous waves. This has also been followed by tentative signs of a quick rebound in February. With the ebbing of the third wave, we expect the economic recovery to gain traction in the coming months; however, global headwinds could weigh on the pace of economic recovery.

The agricultural outlook continues to look optimistic, given a good rabi crops sowing season. As the rabi sowing season comes to an end, the total area sown crossed 70 million hectares and stood 1.5% higher than the previous year and 12.1% higher than India's normal rabi acreage, primarily driven by oilseeds where the total area sown remained over 30% higher than the normal area. Complementing the performance of the rabi harvest is the current reservoirs' level in India, as the water storage in the 135 important reservoirs stood at 62.4% of the full reservoir level, which is 13.5% higher than the decadal average (as of February 10). Banks' credit growth to the agriculture sector accelerated to 14.5% YoY in December (vs 10.4% YoY in November), its fastest pace since September 2016, underscoring robust farm sector activity. In the Union Budget FY2023, the government has also announced a slew of measures like promoting chemical-free farming, augmenting farmers' income, financing of agriculturally oriented start-ups, etc., to promote sustained growth in the agricultural sector which are likely to bode well for the rural demand.

In the industrial sphere, the impact of the third wave has been limited, based on early high-frequency indicators. The manufacturing PMI eased to 54 in January, a four-month low, from 55.5 in December as companies reported a weaker pace of expansion in output, new orders, and input purchases. However, the index managed to stay in the expansionary territory compared to a fall into the contraction zone during the second wave. Further, e-way bills noted a mild sequential decline of 4% MoM in January (v/s 17.1%

MoM increase in Dec), while GST bills registered an increase of 6.6% MoM (v/s 1.3% MoM decline in Dec). Additionally, as per the RBI's Industrial Outlook Survey (IOS), businesses remained optimistic, although the optimism waned marginally as the Business Expectation Index moderated from 139.3 in Q3 FY22 to 137.8 in Q4 FY22. Heading into the third wave, industrial activity had shown a surprisingly robust pickup in December. The Industrial Index of Production (IIP) gathered momentum on a sequential basis, with the index noting a jump of 7.5% MoM in December compared to 4.7% MoM contraction in the prior month. All three sub-sectors noted an expansion reflecting the broad-based recovery. Thanks to sequential pickup, the IIP surpassed its pre-COVID levels (taken as an average of 2019) at 105.8% in December vs 98.4% of its pre-COVID levels in November. However, on an annualized basis – the IIP noted its slowest growth in the last ten-month at 0.4% YoY in December, primarily on account of the waning of the favourable base effect. While mining and electricity posted expansion, the manufacturing sector noted a contraction of 0.1% YoY in December. Supporting sequential pickup in industrial activity, banks' credit to the industrial sector noted a strong turnaround in the month of December, growing by 7.6% YoY, the fastest pace of growth since October 2014, double the rate of 3.8% YoY seen in November. The sharp acceleration in industrial credit was visible across its major sub-components, with credit to MSMEs growing by 86.5% YoY in December, significantly up from 48.7% YoY registered in the previous month, and credit to large industries notching a growth of 1.3% YoY, its highest since July 2020. With COVID related restrictions weighing on economic activity in January, we expect some sequential moderation before a rebound from February onwards.

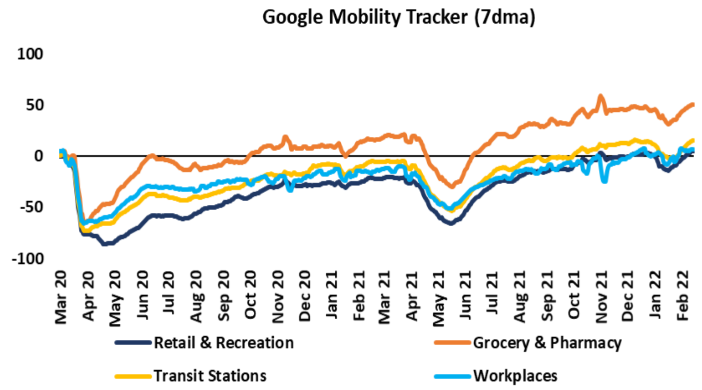
PMI Indices remained in the expansionary zone despite sequential moderation



Source: CMIE

Compared to agriculture and industry, the COVID third wave seems to be having relatively more impact on the services sector, especially the contact-intensive services. However, it seems to be lesser in magnitude compared to the last COVID wave. India's services PMI index moderated to 51.5, a six-month low, in January compared to 55.5 in December in light of the surge in COVID cases and reimposition of restrictions. Companies noted the slower pace of expansion in aggregate sales and output amidst elevated input price pressures. Despite moderation in the services sector activity, the PMI index remained in the expansionary zone and fared better than a sharp fall in its value to 41.2 (in June '21) during the second wave. Other high-frequency indicators painted a mixed picture with port traffic, domestic air passengers, and toll collections declining sequentially in January, while freight traffic noted a sequential rise. With the third wave being rather short-lived, we could expect the recovery of the services sector to gain traction in the coming months. Rapid credit growth before the third wave also suggests a possibility of a quick rebound. Banks' credit to the services sector rose sharply in December, increasing by 10.8% YoY, its fastest pace of growth since August 2020. Pick-up was broad-based, led by credit to trade (~15% YoY) and NBFCs (13.4% YoY). Credit to Tourism, Hotels & Restaurants also noted a strong growth of 6.3% YoY vs 2.8% in November, reflecting the increased demand for this segment during the end of the year season. RBI's lending survey also indicates an optimistic outlook for the demand for loans by the sector.

Mobility data shows a quick rebound of economic activity in February



Source: OurWorldindata.com

Demand conditions showed signs of some resilience in the wake of the third COVID wave, with ultra-high-frequency indicators suggesting a quick recovery. With states reimposing curfews in response to the flaring up of the cases, Google mobility for retail & recreation on average slipped 9.2% below its baseline levels in January from 2% above the baseline in the previous month. However, this was far better than ~18 percentage points sequential deterioration to 40.4% below baseline in the second wave impacted June '21 quarter. Similar resilience was shown by Google mobility related to grocery and pharmacy. Further, these mobility indicators have already surpassed their respective pre-third wave levels by mid-February, indicating the impact of the recent wave is likely to be limited and short-lived. This is positive for revival in consumer demand and retail credit growth from the expected impact of the third wave.

Consumption indicators show some moderation in January

Consumption Indicators, Index Averaged to 2019									
	Apr-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Jan-22
Google Mobility - Grocery & Pharmac	-52.0	-2.5	-4.9	9.5	18.5	3.2	32.7	47.5	36.8
Google Mobility - Retail & Recreation	-81.5	-59.8	-41.9	-27.5	-22.1	-40.4	-13.0	2.0	-9.2
Petrol Consumption	5.4	12.6	13.6	15.0	15.2	13.3	14.4	15.6	13.7
Personal Loans	108.1	107.9	112.8	117.1	123.8	120.7	126.4	133.8	
Passenger Vehicle Sales	9.8	65.4	102.3	131.3	134.1	90.7	110.9	117.9	119.9
Two Wheeler Sales	23.4	58.5	76.0	105.4	88.3	68.4	67.3	84.5	74.8
Tractor Sales	8.7	124.9	145.7	144.5	117.3	83.4	68.5	86.2	66.8
Domestic Air Passenger Traffic	0.0	8.5	16.9	31.4	33.5	13.0	29.6	30.4	
IIP: Consumer Durables	4.4	63.0	104.0	100.7	107.2	80.7	105.6	98.0	
IIP: Non-Consumer Durables	49.0	99.5	99.4	108.6	106.0	95.6	99.3	108.0	

Source: CMIE, Google mobility reports

With the increase in the cases, there has been a decline in the labor force in January, leading to a drop in the greater unemployment rate from 11.3% in December to 9.7% in January. However, within the sectoral contribution, the job quality seems to be improving, with salaried individuals noting job gains (~5.7 mn), whereas the small trader and wage labourers witnessed job losses of a similar magnitude. Validating the improvement in the job quality is the increase noted in hiring activity in the organized sector, with the Naukri Jobs Index registering a sharp expansion of 42% on a sequential basis, to above pre-COVID level, after three consecutive months of contraction. Consumer confidence, on the other hand, remained somewhat mixed, with the Current Situation Index increasing marginally in January to 63.7 from 62.3 in November 2021, while the Future Expectations Index noted moderation from 109.6 in November to 103 in January but continued to stay in the optimistic territory (value above 100 level shows optimism and below indicates pessimism). Households reported improved sentiment on spending driven by the higher spending on essential commodities, whereas spending on non-essential items remained subdued. This is in line with sluggish spending on consumer durables in recent months. As per IIP data, the consumer durables output stayed below the pre-COVID level for the second consecutive month (98% in Dec v/s 86.2% in Nov) despite the sequential improvement, whereas non-durables managed to stay above pre-COVID levels for the third consecutive month (108% in Dec v/s 101% in Nov). Within durables, auto sales remained sluggish, with global semi-conductor shortages adding to the sector's woes. Accordingly, passenger vehicle sales contracted for the fourth consecutive month (-10.41% YoY in Jan v/s -9.9% in Dec). Meanwhile, rural demand continues to be a laggard, as reflected in the sustained moderation in the two-wheeler segment. Sustained improvement in labor markets conditions is needed for consumption recovery to gain traction beyond the pent-up demand.

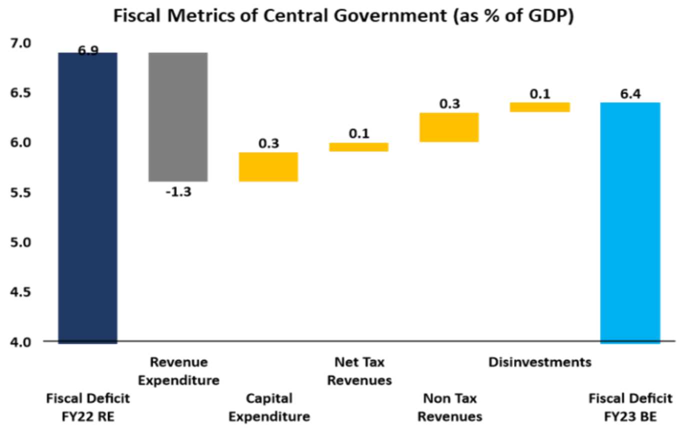
Meanwhile, the central government expenditure rose by ~19% YoY in December, after tepid spending noted in the prior two months. It was driven by a 74% YoY increase in capital spending (after a contraction of 54% in November), while revenue spending noted a relatively slower growth of 7.3% YoY in December. On a fiscal year-to-date basis (first nine months of the fiscal year), central government spending shows a 10.6% YoY rise. In the FY23 budget, the government continued its focus on CAPEX to crowd-in private investment and create jobs. Prospects for broadening of revival in private investment beyond select industries such as metals, chemicals and pharma are improving. As noted above, there are tentative signs of revival in credit demand by large industries. Further, companies continue to tap alternate sources of funding as well. Companies have raised a record Rs 1.05 lakh crore through IPOs during the current financial year till the end of December, more than the total of Rs 0.70 lakh crore raised in the previous three years. More IPOs are lined up for Q4 FY22. Moreover, capacity utilization (CU) for the manufacturing sector recovered to 68.3% in Q2 FY22 after the waning of the second wave, which had caused plummeting of CU to 60.0% in the previous quarter. As manufacturing companies maintained a broadly similar level of inventories in Q1 and Q2, improvement in sales led to a sequential decline in the inventory to sales ratio by 18 percentage points to 60.5% in Q2 FY22. Both indicators bode well for a pickup in credit demand and investment by industries.

Exhibiting resilience to headwinds from the Omicron variant, India's merchandise exports remained robust during January, although it noted some sequential moderation. Accordingly, the exports expanded by 25.3% YoY in January 2022 v/s 44.2% YoY in December 2021. Despite the sequential moderation of 12.1% MoM in January, exports remained 128% of their pre-pandemic level. India's imports also held strong as they remained above the $50 billion mark for the fifth consecutive month despite a sequential moderation of 13.2% MoM in January. Nonetheless, imports registered a growth of 23.5% YoY compared to 39.3% YoY in the preceding month and remained 128% of their pre-pandemic level. With imports registering a slower pace of growth than export, India recorded the lowest trade deficit in the last five months at $17.4 billion vs $21.7 billion in December. Moving ahead, the surging global commodity prices amidst rising geopolitical tensions could weigh on the trade balance. Policy normalization by major central banks is also likely to create volatility in global financial markets, weighing on the pace of economic recovery. These external headwinds coupled with domestic uncertainty related to future COVID variants continue to pose downside risks to our projection of 9.3% YoY growth in FY22.

The government continues to prioritize investment-driven economic growth revival; announces gradual fiscal consolidation

Recognizing the need to nurture the nascent economic recovery, the government's FY23 budget continued its focus on investment-induced economic growth revival strategy while moving ahead with the gradual fiscal consolidation. Given the preference for growth over fiscal prudence, the government revised the fiscal deficit target to 6.9% of GDP, close to our expectation and the budgeted estimate of 6.8% in FY22. The slight slippage comes from the higher than budgeted socio-economic welfare-related expenditure in response to the successive pandemic waves during the year, settlement of past Air India dues, and a shortfall in meeting the disinvestment target. This was partly offset by higher than budgeted revenue collections. For FY23, the government has set a fiscal deficit target of 6.4% of GDP, implying a fiscal consolidation of 0.5% of GDP and putting itself on track to attain a fiscal deficit target of 4.5% of GDP by FY26. (For more details, please refer to our Report on the FY23 budget).

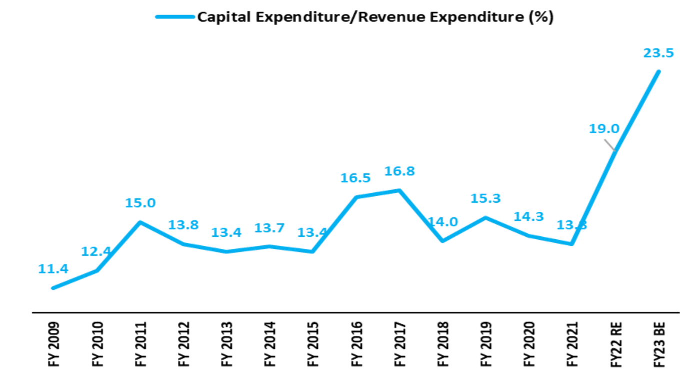
Gradual fiscal consolidation aimed for FY23



Source: Budget documents, CMIE

Building on the FY22 budget's approach to step-up capital spending to accelerate economic growth, the government continued to provide thrust to the capital expenditure via a push to the PMGatiShakti National Master plan. The plan involves the development of seven sectors, including Roads, Railways, Airports, Ports, Mass Transport, Waterways, and Logistics Infrastructure. The focus on expanding public infrastructure is expected to crowd in private investments and strengthen employment in the long run via the multiplier effect. Accordingly, capital expenditure is estimated to rise by 24.5% over FY22 Revised Estimate (RE) and 35.4% over the FY22 Budget Estimate (BE). The centre has announced an increased allocation from Rs 15,000 crore to 1 lakh crore under the 'Scheme for Financial Assistance to States for Capital Investment' to encourage states to enhance their capital investments. However, the increase in the CAPEX plan looks less impressive when we consider that some of the increase in the CAPEX budget is due to the reallocation from internal and extra-budgetary resources (IEBR) to budgetary allocation. The combined IEBR and center's CAPEX gross budgetary is estimated to rise by 10.4% compared to the revised estimate for FY22, though still much higher than the 3.1% increase projected for FY22 over FY21. On the other hand, the revenue expenditure is budgeted to grow by a mere 0.9% over FY22 RE as the government shifts its focus from relief measures to growth-oriented measures. The space created from moderation in revenue expenditure has been utilized by increasing capital expenditure. As such, the capital to revenue expenditure ratio increased to 23.5% - its highest in 15 years, indicating an improvement in the quality of expenditure. The reduction in revenue expenditure is led by a lower subsidy expenditure which declined to 1.2% of GDP in FY23 BE from 1.9% of GDP in FY22 RE. Expenditure on welfare schemes like MNREGA has been estimated at Rs 73,000 crore in FY23 despite a revised estimate of Rs 98,000 crore in FY22. However, with economic growth being in the initial stages of recovery, revenue expenditure could very well overshoot the budgeted estimate in a bid to provide relief to the disproportionately affected segments.

Capital-Revenue expenditure ratio jumps to highest in more than 15 years



Source: Budget documents, CMIE

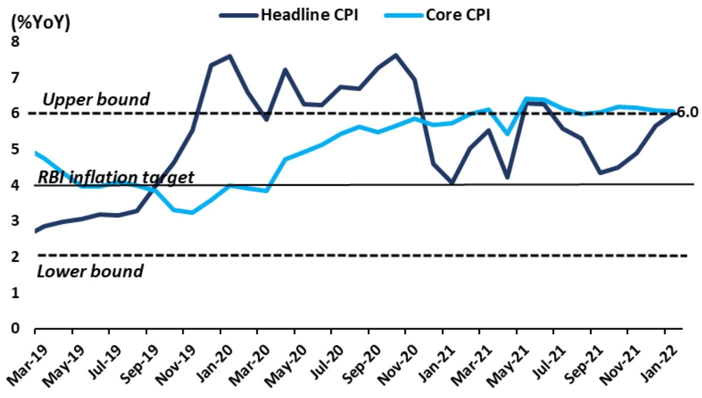
On the receipts side, the budget assumptions look a bit conservative. With the tax buoyancy of 0.9, the net tax revenue is budgeted to rise by 9.6% in FY23 over FY22 RE, primarily led by the direct taxes, which is estimated to increase by 13.6% in FY23. On the other hand, indirect taxes are estimated to grow by only ~5.6% over FY22 RE, due to a ~15% decline in excise duties as the government announced a reduction in excise duty on petrol and diesel in November 2021. However, the government has considered the nominal GDP growth of 11.1% for FY23, with a GDP deflator of 3.0-3.5% and an implied real GDP growth of ~8% YoY. Given inflationary pressures, the deflator could be higher than 3.5%, which may help achieve the nominal GDP growth in the range of 12%-13% and thereby provide an additional boost to the tax collection. Meanwhile, non-debt capital receipts for FY22 have been revised downwards as the government slashed the disinvestments target from Rs 1.75 lakh crore to Rs 78,000 crores assuming the LIC IPO is completed by March 2022. To date, the government has raised Rs 12,000 crores from divestment receipts. For FY23, the government has further reduced the disinvestment target by ~17% over FY22 RE to Rs 65,000 crores. Given that the government often missed its divestment targets, the FY23 budgeted disinvestment proceeds seem realistic. However, the government may garner higher divestment proceeds in FY23 than budgeted given the existing pipeline for divestment, including Bharat Petroleum Corporation, Public sector banks, etc. These potentially additional funds may help the government absorb any surprise on the expenditure front and help contain the budget deficit target around the target of 6.4% of GDP in FY23.

The government surprised the markets by announcing higher than expected market borrowing for FY23. Gross and net borrowings are budgeted to increase to Rs 14.95 lakh crore (~Rs 14.3 lakh crore after adjusting for switch operations) and Rs 11.2 lakh crore, given higher redemptions of Rs 3.76 lakh crores. Net borrowings are expected to finance ~67% of the fiscal deficit for FY23, given a lower reliance on the NSSF fund at Rs 4.2 lakh crore and limited space from cash drawdown. The RBI, which has been buying government bonds on a large scale in the past three years, is unlikely to generate any demand given the policy normalization process this year and therefore, we could see pressure on bond yields.

The RBI remains dovish all the way; focusing on economic growth revival over inflation risks

The RBI met for the first monetary policy event of the calendar year in February 2022 and delivered an ultra-dovish policy, continuing its focus on economic growth revival over inflation risks. As expected, the RBI kept the repo rate unchanged and maintained an accommodative policy stance. However, it surprised markets by keeping the reverse repo rate unchanged and further postponing the formal policy normalization process. The Monetary Policy Committee was of the view that continued policy support is warranted for a durable and broad-based recovery. The RBI governor broadly held on to his previous policy remarks as he continued to flag downside risks to economic growth due to the perpetuating uncertainty from the Omicron variant, a spike in inflation in several countries that are resulting in divergent monetary policies, persisting supply disruptions, recent geopolitical tensions, and global financial market volatility. Alongside, the RBI also envisaged an optimistic inflation outlook as it projects CPI inflation to ease from 5.3% in FY22 to 4.5% in FY23. While the January inflation print came in at 6.01% YoY (up from 5.7% YoY in Dec) and breached the upper tolerance band of the RBI, the central bank had factored in some temporary spikes in inflation in Q4 FY22 due to the base effect and expected inflation to moderate going into FY23. While the RBI notes upside risks from the hardening of crude oil prices and elevated core inflation prints, it expects the continued softening of food prices (assuming normal monsoons in FY23), supply-side interventions by the government and the pass-through of tax cuts to petrol and diesel (in November 2021) to balance the risks to inflation. Moreover, perceiving the continued slack in demand, the RBI expects input cost pressures to remain muted and envisages a softening in core inflation as risks from the Omicron variant wane and supply chain pressures also ease. The improved inflation outlook remains a key factor in providing the MPC space to remain accommodative. However, we see upside risks to these projections given the elevated global crude oil prices and domestic price pressures (reflected in elevated WPI inflation, averaging 12.6% YoY, and core CPI inflation, averaging 6.1% YoY, in FY22 till Jan'22). Household inflation expectations also remain elevated (though eased moderately from the previous round of the survey), and the assumption of normal monsoons could be fluid. We expect inflation to average around 5.3% in FY23, with upside risks. Despite recent moderate easing, oil price also remains high, with geopolitics posing upside risks. If these inflation risks were to materialize, the RBI would have to adjust policy at a faster pace than presently anticipated.

Inflation touches the RBI's upper bound target in January driven by the base effect



Source: CMIE

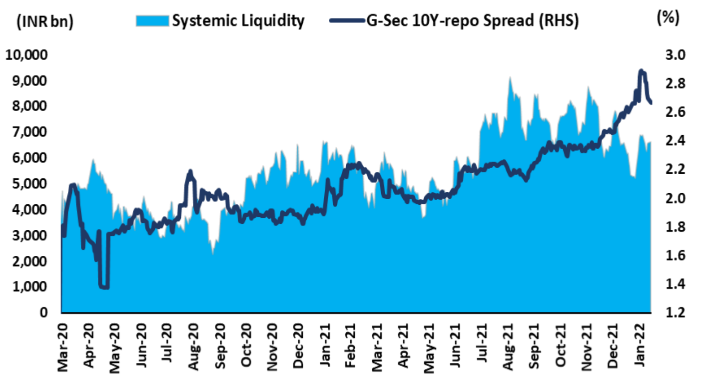
While the RBI extended its accommodative policy stance and postponed the formal policy normalization process, it maintained its liquidity stance via a rebalancing and gradual normalization of the unprecedented liquidity rolled out in response to the pandemic. Since the commencement of the rebalancing of liquidity in August last year, the RBI has focused on migrating from the fixed-rate overnight reverse repo window to the VRRR auctions of longer maturity (supported by fine-tuning auctions of various tenors). Consequently, the effective reverse repo rate (weighted average rate of fixed-rate reverse repo and VRRR of longer maturities) has increased from 3.37% at the end of August 2021 to 3.87% as of February 2022. The RBI also announced some tweaks in the liquidity operations with an aim to restore the revised liquidity management framework.

The February policy was devoid of any explicit assurance/guidance from the RBI in terms of the possibility of a calendar for OMOs/Operation twists, etc., to support the longer end of the curve that market participants were eagerly awaiting. However, the governor provided implicit assurance by stating that the RBI will deal with the new borrowing calendar when they enter the new financial year and execute the government borrowing smoothly and in a non-disruptive manner. The RBI's participation in the absorption of government supply is going to be challenging in FY23 as it works towards normalizing the surplus liquidity in the system and with no clear communication around the sovereign bond inclusion in global debt indices. However, we could see some respite from the increased limit in the Voluntary Retention Route (VRRR) by Rs 1 lakh crore, alternate sources of borrowing such as NSSF and some space for OMOs being created on the back of likely foreign capital outflows (given US Fed's projected rate hikes) in FY23. (For more details, please refer to our Monetary Policy Report).

Market Section: Volatility abound

Indian bond markets experienced a volatile start to the new calendar year. For the past few months, bond yields have been inching up on the back of RBI's liquidity withdrawal measures, rising oil prices, and policy normalization by major central banks. These factors have continued, and some even accentuated moving into the months of January and February. Inflation surged to a multi-decade high in many advanced western economies and has altered the initial pace of policy tightening towards a more aggressive pace of interest rate hikes expected in 2022. Elevated oil prices have added to these pressures. Accordingly, India's GSec 10-year bond yield rose to an average of 6.60% in January compared to the 6.40% average in December. Bond markets came under further pressures following the Budget FY23 on February 1, wherein the government announced higher than expected market borrowings for FY23. Consequently, the Indian 10Y yields surged by ~15bps on the day of the budget. This uptrend continues in subsequent days, with yield closing highs of 6.89% (even touching an intra-day high of ~6.95% on February 4) during the first week of February. However, yields have cooled since then, following the ultra-dovish RBI monetary policy. The RBI has also cancelled two G-sec auctions in February, reducing the supply of government debt and showing its discomfort about higher yields. Consequently, yields on the India 10Y G-sec fell by nearly 22 bps from the post-budget high to 6.66% by February 18. While the RBI has managed to placate bond yields, for the time being, the central bank's role in absorbing the record government debt supply will become challenging in FY23 as it continues to curtail surplus system liquidity and is expected to embark on the policy normalization process. This becomes even more critical with no update around the inclusion of India's sovereign bonds in the global debt index. Moreover, with an aggressive tightening by the US Federal Reserve throughout 2022, the RBI is likely to face pressure to raise interest rates itself, and as a result, going ahead, we could see bond yields rising. The oil price outlook will also significantly bear the yield movement, where geopolitical tensions pose upside risks to prices.

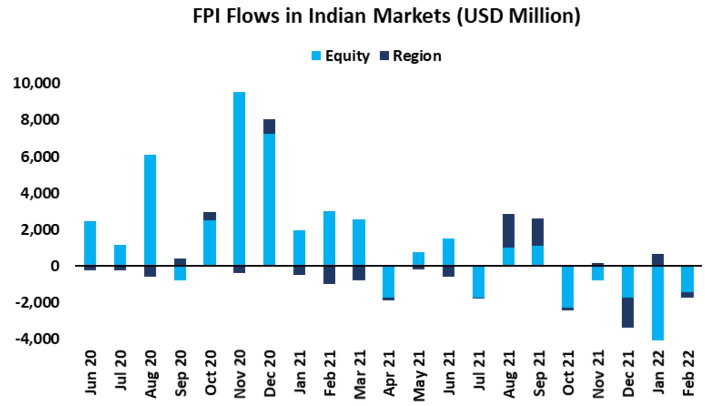
Bond yields cool after increasing to the highest levels in two years



Source: CMIE, Bloomberg

Indian equity market indices showed some resilience in January amidst increased volatility, with NIFTY and SENSEX down by 0.1% and 0.4%, following a 2.2% and 2.1% increase in December, respectively. Domestic investors continued to support India's equity flows with Domestic institutional investors investing ~Rs 531 billion in the last two months (Dec & Jan), partly offsetting the withdrawal by Foreign Portfolio Investors (who withdrew Rs. 620 billion from equity markets from December 2021 until mid-February now). The union budget provided a fillip to Indian markets as the expansionary budget doubled down on capital spending and infrastructure development, raising prospects for medium growth for the Indian economy. Indian indices increased by more than 1.4% on the budget day. The dovish RBI policy also aided the momentum until the first week of February. However, markets have endured high volatility in the subsequent weeks, with a sharp 3% correction on geopolitical concerns on February 14, followed by a sharp recovery on the next day by the same magnitude on easing geopolitical tensions. Overall, the NIFTY and SENSEX fell by ~0.4% and 0.3% respectively by February 18 compared to the end of January levels. Given global headwinds in the form of hawkish US Fed and geopolitical tensions, we expect increased volatility to continue, with bouts of corrections.

Foreign investors continue to pull out capital from Indian markets amidst bouts of global markets volatility



Source: CMIE

The Indian Rupee strengthened against the Dollar in January and offset losses from the previous month. The USD/INR appreciated by 1.26% in January to trade at 74.4 levels on average vs 75.4 in December. In January, a relatively benign trade deficit, which moderated to a 3-month low of $17.4 billion, supported the domestic currency. However, the rupee has been trading under pressure on the back of consecutive monthly capital outflows by foreign investors. Since the US Fed's pivot towards tapering of its asset purchase program around the end of September, ~$12 billion of foreign capital has been withdrawn from debt and equity markets until mid-February. Elevated oil prices also weigh on the currency market. Accordingly, the USD/INR pair has come under pressure again moving into February, and the rupee has depreciated by ~0.8% on average until February 18, ending the week at 74.66 versus the dollar. We continue to expect a depreciating bias for the rupee as the external environment remains under pressure, with a more hawkish stance by the Fed in 2022, geopolitical tensions and elevated oil prices. However, RBI's intervention, supported by its significant FX reserves of $630 billion, and in the near-term foreign capital inflows related to upcoming IPOs, including LIC IPO, could provide support to the currency.

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