22 July 2022

Global recession concerns rise; India's economic recovery holding up in the face of external headwinds

- Synchronized global monetary policy tightening to quell elevated inflation, spillover from the Russia-Ukraine war, and China's strict COVID containment strategy have raised global recession concerns.
- On a positive note, there are signs of easing global supply constraints and commodity prices, which, if continue, may lead to moderation in global inflationary pressures. Geopolitical developments continue to pose risks.
- Over the last month, India's economic recovery continued to hold up in the face of negative spillovers from external developments.
- As per high-frequency data, strong momentum in the services sector, pick-up in rainfall and crops sowing, and resilient industrial activity supported the economic recovery.
- On the demand side, the situation is mixed, given tentative signs of investment pick-up, strong pace of government spending, continued uneven private consumption recovery, and slowing export growth.
- The risk of fiscal slippage, which had risen due to additional subsidies and fuel excise cut announced post-budget, has reduced as the government imposed "windfall" taxes on the energy sector.
- Amidst the weakening currency, the RBI announced several measures to support the rupee, including steps to boost foreign capital inflows via non-resident deposits, FPI investment in the debt market, and ECBs, and an additional arrangement for invoicing, payment, and settlement of trade in INR. More measures are expected in the coming months.
- Inflation continues to remain at an elevated level of over 7%, even though it has come off the eight-year high of 7.8% in April '22.
- With the elevated inflation print, depreciating domestic currency, and the synchronized monetary policy tightening by the major central banks, the RBI is expected to continue the front-loading of the rate hikes as growth remains resilient.

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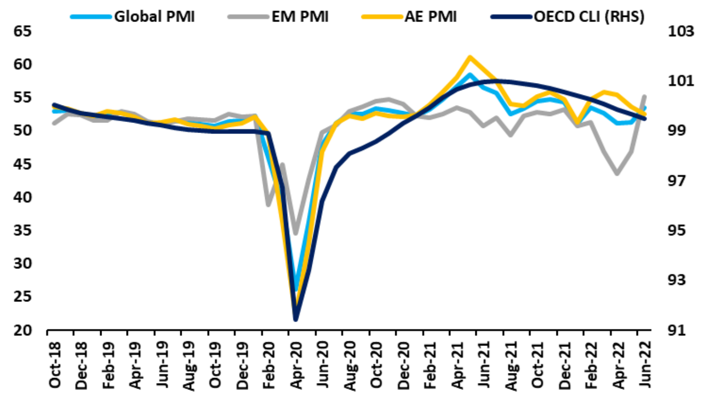
Global recession concerns rise; easing in global commodity prices and supply chain pressures offer some respite

Synchronized global monetary policy tightening to quell elevated inflation, continued spillover from the Russia-Ukraine war, and China's strict COVID containment strategy have raised global recession concerns. The latest high-frequency data is mixed, though directionally, it points to slowing global economic growth. The global PMI indices for June indicated a loss of momentum in manufacturing while the services sector activity gained traction. Global manufacturing PMI slipped to a 22-month low of 52.2 in June from 52.3 in May, with recovery in China (post relaxation in COVID-related restrictions, some of which have been reimposed since then), preventing a sharper fall. The catch-up in the services sector continued, with the Global Services PMI rising to 53.9 in June from 51.9 in May. This helped the Global Composite PMI climb to 53.5 in June from 51.3 in the previous month. It is interesting to note that improvement in the composite index in June came from the emerging economies while developed economies' output growth slowed to the second weakest since January 2021, led by worsening performances in the US and Eurozone. The OECD Composite Leading Indicator also suggests a loss of economic momentum, with the index falling further in June to 99.5, remaining below the 100 level for the third consecutive month. Considering these developments, an IMF official indicated that the agency would downgrade the global growth forecast "substantially" in the next review. In the last review in April '22, the IMF had already downgraded its outlook for the global expansion in 2022 to 3.6%, from 4.4% before the war in Ukraine.

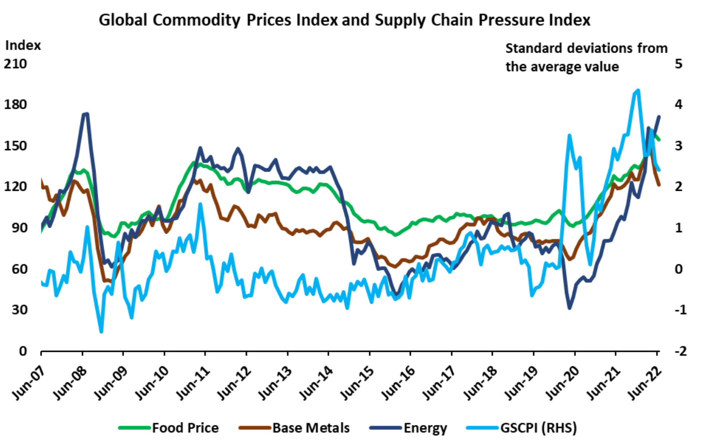
Global economic activity is losing momentum, dragged by advanced economies



Source: IHS Markit, OECD. EM: Emerging markets, AE: Advanced Economies, PMI: Purchasing Managers' Index: value above/below 50 indicates expansion/contraction. CLI: Composite Leading Indicator, where a value above/below 100 indicates expansion/contraction in activity.

Meanwhile, most central banks continue to tighten monetary policy decisively as inflation reached multi-decade highs in several countries. The latest month's inflation data showed a further escalation in inflationary pressures in major economies. Headline CPI inflation rose to a fresh 4-decade high of 9.1% YoY (v/s 8.6% in May) in the US, a new record high of 8.6% in June (v/s 8.1% in May) in the Euro area, and a new 4-decade high of 9.4% in June (v/s 9.1% in May) in the UK. Inflation in China rose to a 22-month high of 2.5% in June (v/s 2.1 in the prior month) but remained below the target of "around 3%". A sharp jump in the US inflation raised the market pricing of the odds of a 75-100 bps rate hike in the next policy meeting, compared to the previous guidance of 50-75 bps from the US Fed Chairman Powell. Meanwhile, the ECB hiked its policy rate by 50 bps in the July meeting compared to the previously indicated magnitude of 25 bps. The Bank of England will likely raise the rate again in the next policy meeting, having already hiked it to 1.25% by June. On the other hand, the Bank of Japan maintained its accommodative policy stance, and the Bank of China kept the policy rate unchanged since its last rate cut in May '22. Major central banks in the emerging economies continue to tighten policy rates to control inflation. As per the IMF, 75 central banks have raised interest rates since July '21. For emerging and developing economies, where policy rates were lifted sooner, the average total rate increase has been 3 percentage points—almost double the 1.7 percentage points for advanced economies. Aggressive monetary tightening by major central banks has led to sharp corrections in the world's equity markets and a rise in bond yields. Given the outlook for US Fed's policy tightening and safe-haven demand, the US Dollar rose to a near 2-decade high of ~108.65 by mid-July, putting pressure on EM currencies and fuelling imported inflation, thereby complicating EM central banks' inflation fight.

Global supply pressures continue to ease; tentative signs of moderation in global commodity prices



Source: FAO, World Bank, New York Fed

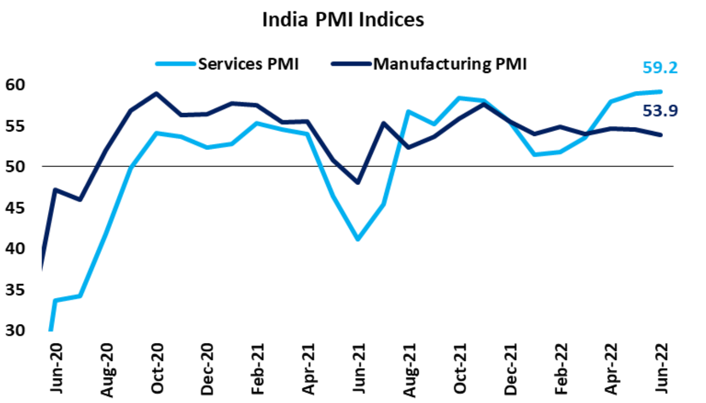
Fortunately, there are some tentative signs of moderation in global commodity prices supported by the easing of supply constraints, the pull-back in firms' expectations of growth prospects, and global growth concerns. As per the New York Fed, global supply chain pressures further eased in June, supported by an improvement in Chinese supply delivery times. This was also corroborated by the IHS Markit data, which showed that the number of companies (globally) reporting any items in short supply has been trending lower over the past year and fell further in June to hit the lowest since January 2021. Further, global commodity prices have also cooled off in recent weeks. In June, food price and base metal prices indices were 3.7% and 18.8% down compared to the highs of March '22. Brent oil prices have also fallen to around $100/bbl by mid-July, down from an average of $120/bbl in June. As per IHS Markit, the global input cost PMI index, which tracks changes in costs among manufacturing and service sector companies worldwide, fell from 71.5 in May, its highest since July 2008, to a four-month low of 69.3. As changes in firms' costs tend to feed through to CPI with a lag, CPI inflation in the coming months may show moderation from recent peaks. If these trends continue, the inflation pressures may moderate in the second half of 2022, reducing the extent of monetary policy tightening central banks might have to ultimately do to tame inflation. Downside risks, however, persist, given the risk of escalation of geopolitical tensions and retaliatory actions in terms of sanctions/disruption to energy supplies, at a time when spare capacity with major oil producers is limited.

India's economic recovery remained resilient despite spillover from external factors

India's economic recovery continued to hold up in the face of negative spillovers from external developments, including protracted geopolitical tensions, weakening global economic activity, elevated commodity prices, and tightening global financial conditions. We expect economic growth to be ~7% in FY23 (with downside risks), as the impact of negative external factors is offset by a catch-up in services and continued robust growth in the agricultural sector.

The pace of rising domestic COVID cases seems to be stabilizing, supporting the normalization of economic activity. India's daily COVID cases (7dma) increased from 15.3k on 30th June to 19.1k on 19th July. While cases at the aggregate level have increased, they have come down in the states that were the biggest contributors to total cases (Kerela and Maharashtra) at the end of June. Still, Kerela, West Bengal, Tamil Nadu, Maharashtra and Karnataka continue to account for 57% of the total caseload. Cases are generally not severe, and daily fatalities have remained contained despite inching up to 44 from around 26 at the end of June. High vaccination coverage should prevent any major spike in fatality rates. India has administered more than 200 crores of vaccine doses as of 18th July and, as a result, inoculated ~91% of the eligible population with both doses. On 15th July, the government also announced a free booster dose for all adults in a move to improve uptake of the third (precautionary) dose of the vaccine.

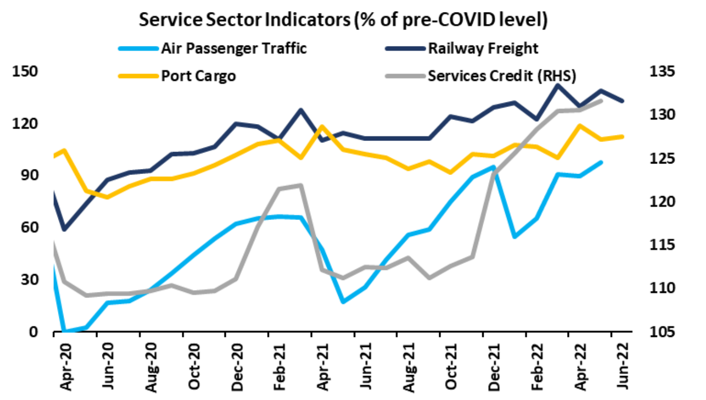
Services PMI at fresh 11-yr high; Manufacturing remained resilient



Source: IHS Markit, S&P Global

The recovery in the services sector continues to gain traction, boosted by the release of pent-up demand given the absence of COVID-related restrictions even as cases rose in June-July. The services PMI index rose to a fresh 11-year high of 59.2 in June from 58.9 in May. Companies reported the fastest increase in new work intakes in almost 11 years. Overall, the services PMI averaged 58.7 in Apr-Jun 2022 compared with 52.3 in the preceding quarter, indicating a strong pick-up in services sector activity in Q1 FY23.

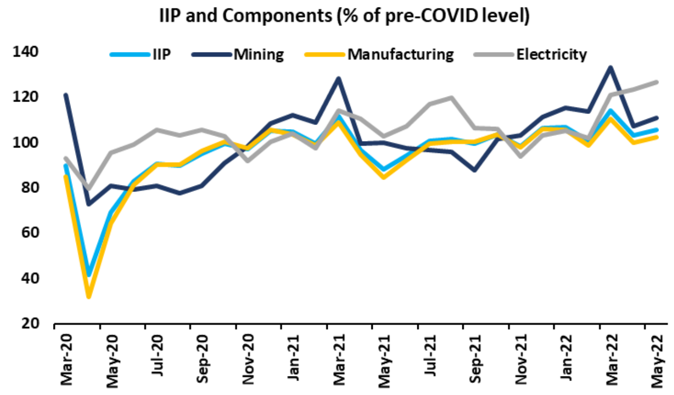
The services sector continued to benefit from a delayed release in pent-up demand



Source: CMIE. CY19 averages are taken as pre-COVID levels

Moreover, other high-frequency indicators like railway freight and port cargo traffic also continued to recover, growing by double digits in June. Domestic air passengers also noted robust growth in May and early June but could moderate going ahead given the sharp rise in fares. Looking at credit data, banks' lending to the services sector accelerated further in May to 12.9% YoY, up from 11.1% in April. This is much stronger than outstanding credit growth to the sector recorded at the end of March at 8.7%, signalling that momentum is building up in services activity. Encouragingly, credit growth in tourism, hotels and restaurants, and trade sub-sectors continued to recover and remained above their respective pre-COVID five-year averages. Going ahead, the services sector recovery is likely to continue as it benefits from a release of pent-up demand, especially in the travel, tourism, and hospitality sub-sectors.

The industrial sector shows signs of resilience

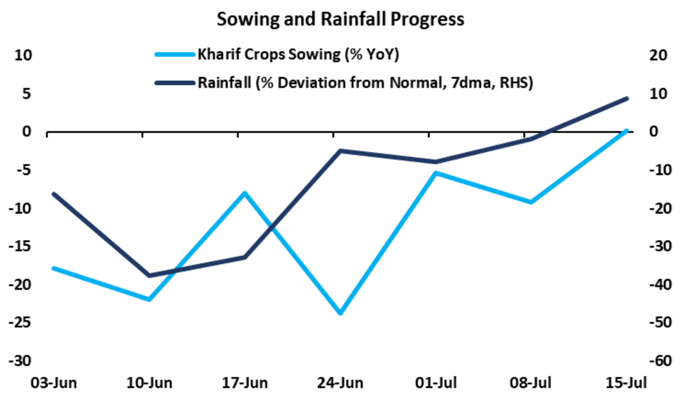


Source: CMIE. CY19 averages are taken as pre-COVID levels

The industrial sector has shown resilience in the face of input cost pressures and global supply chain issues. As such, the Index of Industrial Production (IIP) noted a double-digit growth of 19.6% YoY, aided by a favourable base effect. The IIP also noted a sequential pick-up of 2.3% in May v/s a contraction of 9.5% in the prior month, indicating a recovery in momentum. On average, industrial activity in the first two months of FY23 was ~104% of CY19 average, only marginally lower than the 107% in Q4 FY22. Within sectors, electricity and mining were at ~127% and ~111% of their pre-COVID levels, led by the boost in energy requirements which have been rising due to economic recovery, demand in the agricultural sector due to delayed rainfall, and weather conditions. On the other hand, the manufacturing sector remained a laggard (~102% of pre-COVID levels), dragged down by weakness in leather, textiles, other transport equipment, pharmaceuticals, electronics and electrical equipment, and paper and paper products, partly offset by robust growth in beverages, coke and refined petroleum products, chemical and chemical products, and base metals. Thankfully, the forward-looking PMI manufacturing index continues to show resilience. The index remained in the expansionary zone for the 12th consecutive month at 53.9, though moderating marginally from 54.6 in April as inflation concerns continue to dampen the overall business sentiment. In Apr-Jun 2022, manufacturing PMI averaged 54.4 compared with 54.3 in the preceding three months. Both domestic and external orders continued to increase, although at a softer pace. Cement and steel sub-indices of the eight core industries index clocked double-digit growth in May, reaching ~11%-12% above pre-covid levels (vs CY19 average). Furthermore, finished steel consumption grew by a robust 13.3% YoY in June, indicating strong momentum in the construction sector. Meanwhile, credit to the industrial sector continued to grow at a healthy pace of 8.7% YoY in May compared with the previous quarter-end growth of 7.5% YoY. Other high-frequency indicators like E-way bills and GST collections also noted robust growth in both annual and sequential terms. There are early signs of easing in global supply chain constraints. However, global economic slowdown, elevated commodity prices (though moderating), higher input costs, and tightening monetary policy are likely to put pressure on industrial activity in the coming quarters.

In the agriculture sector, the delayed monsoon and its impact on Kharif sowing raised some concerns about the sector's growth last month. In June, the cumulative rainfall was 8% lower than normal. This weighed on sowing, with the actual area sown for all crops combined being ~9% lower compared with the same period last year as of 8th July. Delayed sowing also weighed on employment in the agriculture sector. Fortunately, things have taken a positive turn in recent weeks. As the monsoon covered the entire country and gathered pace, the cumulative rainfall was 13% higher than normal as of 16th July. Accordingly, Kharif sowing has also picked up, with area sown at ~0.1% higher than last year by 15th July. Other indicators such as tractor sales (up 17.4% YoY in Q1-FY23 despite the contraction in June) and credit to the agriculture sector (11.8% YoY in May) indicate a robust agricultural activity. With a catch-up in rainfall and sowing, the outlook for the sector has improved, though monsoon progress and its spatial distribution will remain key variables to watch in July-August.

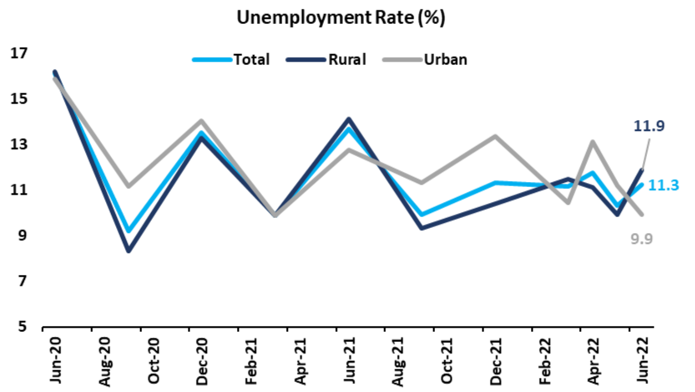
Kharif sowing picked up with the catch-up in monsoon rains



Source: CMIE

On the demand side, the situation is rather mixed, given a continued uneven recovery in private consumption and slowing export growth, tentative signs of investment pick-up, and a strong pace of spending by the government. The private consumption recovery is facing challenges from a high inflationary environment, tightening monetary conditions, and uneven labour market recovery. The IIP consumer index (weighted average of consumer durables and non-durables) remained flat at ~92% of the CY19 average in April and May. This is lower than the average of ~98% in Q4 FY22. Encouragingly, retail credit growth continued to improve in May, growing by 16.4% YoY, up from 14.7% in April. However, other demand indicators showed a disappointing picture. Passenger vehicle sales improved slightly in June but remained more or less flat in Q1 FY23 compared with the previous quarter, indicating an uneven recovery in the urban demand. Meanwhile, two-wheeler sales weakened in June, reflecting the continued weakness of rural demand. On average, two-wheeler sales in Q1 FY23 improved compared with Q4 FY22 but remained weak at ~86% of the CY19 average. Furthermore, the unemployment rate jumped to 11.3% in June from 10.3% in May despite a drop in the labour force participation rate. Total job losses in June were ~13.1 million, attributed to the rural sector, driven by the agriculture sector, where delayed sowing weighed on the activity. This is likely to weigh on private consumption growth in the coming quarter. On a positive note, the Naukri JobSpeak Index, a proxy for organized sector hiring activity, continues to post robust growth (holding steady at 125% of the pre-COVID level in June), led by a pick-up in services sector employment. Sustainable improvement in labour market conditions remains critical for private consumption recovery.

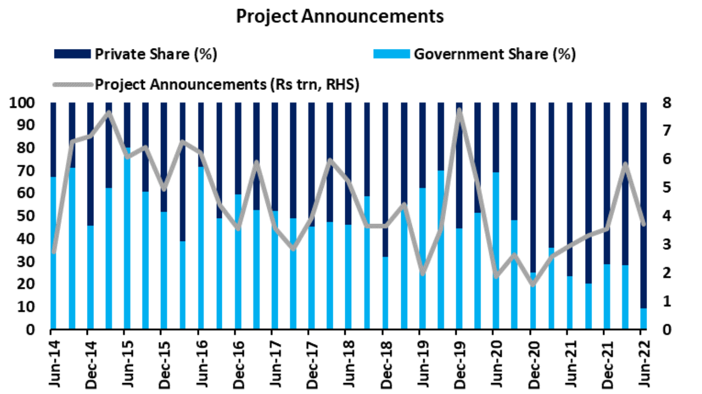
Rural sector deterioration in employment dragged labour market recovery in June



Source: CMIE

On the investment front, incoming data continues to suggest tentative signs of revival. According to the CMIE investment announcements data, around Rs 3.7 trillion worth of new projects were announced in the June quarter, noting a growth of over 25% YoY, though slowed sequentially. Encouragingly, over 90% of the new project announcements (by value) were by the private sector. For perspective, the private sector's share in new project announcements averaged ~40-50% pre-COVID. Meanwhile, credit growth to the infrastructure sector remained strong at 10.5% YoY in May and was led by roads, power, and telecom infrastructure. However, the investment revival is not broad-based, with other indicators suggesting a mixed picture. The investment-related indicators of IIP noted a slowdown when compared to the prior quarter. The sub-indices of capital goods and infrastructure and construction goods of IIP have slowed in the first two months of FY23 compared with Q4 FY22. As a percentage of CY19 average, the capital goods index in Q4 FY22 averaged ~102%, while the infra and construction index averaged 115%. These numbers have come down to ~94% and ~109% respectively in April-May. Given the heightened global economic uncertainty, financial market volatility, higher input costs, and monetary policy tightening, businesses may adopt a wait-and-watch strategy that could delay the broader pick-up in private investment.

Private sector leads in new project announcements



Source: CMIE

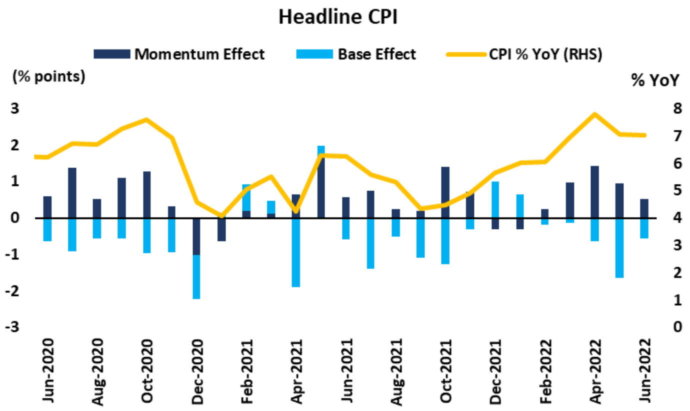
The government will have to continue to take the lead in driving investment. Early data for FY23 shows government CAPEX rising in line with the focus in the budget. The central government's CAPEX grew by a staggering 70.1% YoY in the first two months of FY23, indicating the government's strong focus on infrastructure spending to support economic recovery. CAPEX in the first two months of FY23 reached 14.3% of the budgeted CAPEX for the whole year, compared with just 11.4% for the same period last year, reflecting front-loading of CAPEX by the government. Meanwhile, revenue expenditure grew by 20.1% YoY in May, up from 9.1% YoY in April. In the first two months of FY23, central government expenditure reached 14.8% of the full-year budgeted estimate (BE), compared with 13.7% last year, but lower than the pre-COVID five-year average of 17.8%. Meanwhile, total receipts in the first two months of FY23 reached 16.7% of the full-year BE, lower than last year's 18% but much higher than the pre-COVID five-year average of 5.7%. Accordingly, the central government's fiscal deficit stood at 12.3% of the BE until May, compared to 8.2% of BE in the same period last year and an average of 51% of BE in the five years pre-COVID. The risk of fiscal slippage, which had risen due to additional subsidies and fuel excise cut announced post-budget, has also reduced as the government imposed "windfall" taxes on the energy sector. The government imposed a special additional excise duty (SAED) of Rs 13/ltr, Rs 6/ltr, and Rs 6/ltr, respectively, on diesel, petrol, and ATF exports and SAED of Rs 23,250/mt on domestic crude oil sales. In the third week of July, the government reduced the export tax on diesel and ATF shipments by Rs 2/ltr each. The export tax of Rs 6/ltr on petrol has been withdrawn completely. Windfall tax on domestically produced crude has been reduced by 27% to Rs 17,000 per tonne. These taxes can still fetch additional revenues of ~0.2% of GDP in the remaining part of FY23, reducing the fiscal slippage risk, which bodes well for continued spending support from the fiscal policy side.

On the external front, export growth has been slowing, reflecting weakening global growth momentum. Exports recovered partially by 2.8% MoM in June after falling consecutively for two months. They continued to post double-digit growth (23.5% YoY in June) and crossed the $40 bn mark for the first time in FY23. Still, in Q1 FY23, exports growth fell to 1.7% QoQ and 24.4% YoY from 9.5% QoQ and 29.4% YoY in the previous quarter, respectively. Further, the import bill continued to escalate given elevated oil prices and recovery in domestic demand (driving up non-oil imports). As such, the imports increased by 4.9% MoM and 57.6% YoY in June, leading to the widening of the trade deficit to the highest monthly level of $26.2 billion. In Q1 FY23, India recorded the highest quarterly trade deficit of ~$71 billion. The current account deficit is expected to be elevated in FY23 (~3% of GDP, up from 1.2% in FY22) amidst high oil prices, ongoing domestic demand recovery, and slower export growth.

Inflation sticky above 7%, remaining above the RBI's upper threshold for the sixth consecutive month

Inflation continues to remain at an elevated level, even though it has come off the eight-year high of 7.8% in April '22. Some of the moderation last month was driven by the base effect and the government's interventions. The risk of inflation stickiness at an elevated level persists as expected moderation in food inflation could be countered by a pick-up in service inflation and pass-through from exchange rate depreciation and recent GST tax measures. In June, the headline inflation showed a marginal decline to 7.01% YoY (v/s 7.04% YoY in May), remaining well above the RBI's upper tolerance threshold for the sixth consecutive month. As shown in the table, of the 11 main sub-components of the CPI basket, only food and beverages and transport and communication categories saw a slight reduction in their inflation rates while the rest saw an increase. In Q1 FY23, the headline inflation averaged 7.3% YoY, slightly lower than the RBI's estimate of 7.5% YoY. Food and Beverage inflation eased from the highs of 8.1% YoY in April to 7.6% YoY in June but remained much higher compared with the pre-pandemic five-year average of 2.9% for June. The food inflation trajectory will benefit from the pick-up of the Kharif sowing and the monsoon rainfall. Additionally, the steps taken by the government (including import duty cuts on edible oil, restrained hikes in MSP for Kharif crops) and a fall in global edible oil prices will also help rein in the upside risks for food prices. Fuel inflation stiffened to 10.4% YoY in June from 9.5% YoY in May. LNG and kerosene inflation rose while petrol and diesel fell sequentially. On the other hand, the core inflation eased to 6% YoY in June from 6.2% YoY in May and from a high of 7% YoY in April. A large part of the improvement in the core inflation is coming from the transportation and communication index, reflecting the impact of the fuel excise cuts done by the government. Rural inflation remained flat at 7.1% YoY in June (compared with May), while urban inflation eased slightly to 6.9% YoY in June from 7.1% YoY a month ago.

The base effect has kept inflation from rising over the past two months



Source: CMIE

Inflation for most of the sub-groups remained above the pre-COVID averages

CPI Inflation, YoY%								
Sub-groups	Weights	Pre-COVID average*	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22
CPI (headline)	100.0	4.24	6.01	6.07	6.95	7.79	7.04	7.01
CPI-Urban		4.20	5.91	5.75	6.12	7.09	7.08	6.92
CPI- Rural		4.28	6.12	6.38	7.66	8.38	7.08	7.09
Core-CPI	54.1	4.75	6.01	6.02	6.33	6.98	6.21	6.00
Food and beverages	45.9	3.69	5.58	5.93	7.47	8.10	7.84	7.56
Pan, tobacco and intoxicants	2.4	6.68	2.45	2.39	2.98	2.70	1.15	1.83
Clothing & footwear	6.5	4.25	8.78	8.86	9.40	9.85	8.85	9.52
Housing	10.1	5.57	3.52	3.57	3.38	3.47	3.65	3.93
Fuel & light	6.8	4.37	9.32	8.73	7.52	10.80	9.54	10.39
Household goods and services	3.8	4.49	7.11	7.22	7.67	7.97	6.79	7.49
Health	5.9	5.54	6.86	6.82	6.99	7.21	5.43	5.47
Transport and communication	8.6	2.75	9.29	8.13	8.00	10.91	9.47	6.90
Recreation and amusement	1.7	4.56	7.04	6.93	7.01	7.31	5.97	6.97
Education, stationery etc.	4.5	5.62	3.32	3.63	3.62	4.12	4.16	4.51
Personal care and effects	3.9	4.83	3.49	5.45	8.71	8.62	6.18	6.68

Source: CMIE, Pre-COVID average is for FY16-FY20 period

Going ahead, we continue to hold our view that inflation will remain elevated for the next few months due to multiple reasons. Firstly, we expect services inflation to firm up in the coming months as demand strengthens. Segregating the 299 items in the CPI basket into goods, food, and services groups, we find that growth in goods CPI since the pre-pandemic period (December 2019) has been around 21%, which is somewhat equal to the growth in manufactured goods WPI at 21.8%, whereas growth in services CPI has been only ~14% in the corresponding period. As such, the catch-up in the services inflation is likely to continue. Secondly, the input cost pressures remain high, as reflected in the double-digit levels of WPI (15.2% in June v/s 15.9% in May). Thirdly, the recently announced GST hikes on pre-packed unbranded items could put incremental pressure on prices. Fourth, the favourable base effect will wane in the coming months. And lastly, the weakening of the domestic currency would lead to further pass-through to the domestic prices. These will be partly countered by global growth slowdown and moderation in global commodity prices. Incorporating these factors, we expect inflation to average ~6.8% in FY23 compared to the previous estimate of 6.3%. The risk of oil price shock persists given geopolitical developments and limited spare capacity with major oil producers. Materialization of this risk will push inflation much higher than presently projected.

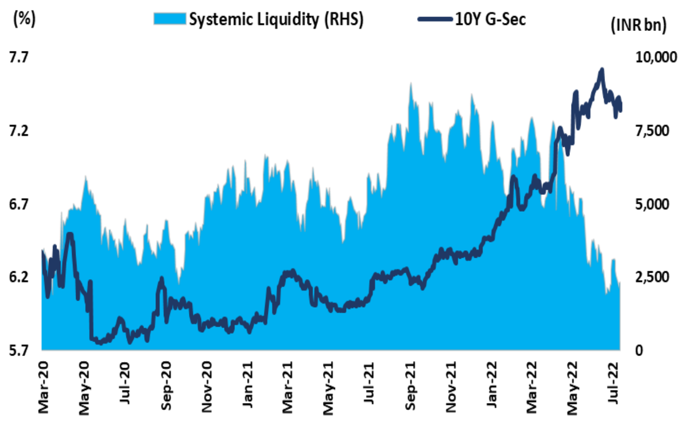
RBI to continue with policy tightening amidst elevated inflation and currency pressures

With the elevated inflation print, depreciating domestic currency, and the synchronized monetary policy tightening by the major central banks, the RBI is expected to continue the front-loading of the rate hikes as growth remains somewhat resilient, as reflected in other high-frequency indicators. The minutes of the meeting for the June meeting when the RBI hiked the policy rate by 50 bps suggest that members continue to be concerned about the broadening of the inflationary pressures in this volatile global environment. Even though the members recognize the uncertainties surrounding the inflation outlook, the MPC members do not seem to be leaning towards an aggressive tightening cycle. What can be gauged from the comments of the MPC members is that the RBI may potentially be aiming for a mildly positive real interest rate or even a negative real interest rate which is no more than -1%, to not act as a dampener to the growth. However, we continue to retain our view that the terminal rate is to be ~6% in the current policy tightening cycle, given inflation risks. On the liquidity management front, the RBI has taken several measures to curtail liquidity overhang, including VRRR auctions, suspension of GSAP operation, and an increase in CRR. These, coupled with a rise in credit growth and foreign capital outflows, have resulted in excess liquidity in the system falling to 1.3% of net demand and time liabilities (as of 13th July; NDTL data from 1st July) down from ~2% on 7th June, which is not considered to have an inflationary impact. With the current extent of liquidity, the pressure to hike CRR has reduced. However, if the pressures on the currency continue, the RBI is likely to tighten domestic liquidity to support the rupee. Over the last month, the central bank announced measures to boost foreign capital inflows and promote rupee use for international trade settlement (as discussed in the next section).

Market Section

Global geopolitical uncertainties, synchronized and aggressive monetary policy tightening by major central banks, high oil prices, and deteriorating global economic outlook have weighed on emerging markets, and India is no exception. In the month of June, both the benchmark indices – NIFTY and SENSEX noted a decline of 4.8% MoM and 4.6% MoM, respectively. However, markets recovered in July (data till 19th July), with NIFTY and SENSEX rising by 3.6% MoM and 3.3% MoM, respectively. Domestic market recovery was led by positive cues from global equity markets and a drop in commodity prices, especially brent oil. Indeed, the Bloomberg commodity index has declined by around 13.5% since mid-June. Notwithstanding this, the FPIs continued to exit Indian markets in June-July. In June, FII outflows increased to Rs 502 billion from Rs 400 billion in May. Meanwhile, market support from domestic investors seems to be waning as DIIs investment fell to Rs 466 billion in June from Rs 508 billion in May. NIFTY's PE ratio fell to 20.6 in June from 21.1 in May and stayed at ~20.6 by mid-July. Looking ahead, volatility in the market is expected to remain high as pressure on EMs continues amid protracted geopolitical uncertainties and monetary policy tightening by major central banks.

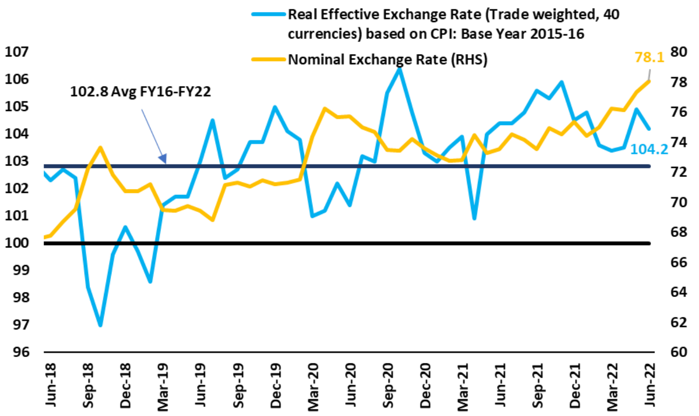
10-year yield moderated with easing in global commodity prices; liquidity falls further



Source: CMIE, Bloomberg

Bond markets saw some easing of pressure over the past month. The 10-year G-Sec yield softened to 7.43% on 19th July from its recent peak of 7.62% on 16th June as US treasury yields declined and oil prices fell to their lowest in ~3 months. The stabilization of domestic inflation (though it remains above RBI's tolerance range) in June has also aided in the drop in the 10-yr G-Sec yield. Additionally, the introduction of the special additional excise duty on fuel will help lower the risk of fiscal slippage, providing some respite to bond markets. Year to date (CY22), the 10-year and 2-year G-Sec yields have widened by 98bps and 191bps, respectively. Pressure on the bond market is expected to remain higher than previously anticipated policy hikes in the developed world, and elevated price pressures will continue to influence domestic yields.

Real effective exchange rate remains overvalued



Source: CMIE, RBI

The rupee has continued to depreciate as US dollar strength, high oil prices, and a widening current account deficit weighed on the exchange rate. The USD/INR pair depreciated further by 1% to average 78.1 in June compared to 77.3 in the preceding month. Further, by 19th July, the USD/INR exchange rate was 79.9 (crossing 80 levels before recovering). Year-to-date (CY22), the exchange rate has depreciated by 7.4%, which is in line with other emerging market peers. Depreciation in the rupee has been managed by the RBI to prevent excess volatility in the currency market, and the same is evident in the decline in its foreign exchange reserves from $633 billion at the end-2021 to ~$580 billion now. In July, the RBI announced several measures to boost foreign capital inflows via non-resident deposits, FPI investment in debts, and ECBs. The announcement indicates that RBI's focus is on slowing the pace of INR depreciation and preserving foreign exchange reserves. It also notified an additional arrangement for invoicing, payment, and settlement of exports and imports in INR, at market-determined rates. The arrangement is expected to reduce the demand for hard currencies for trade purposes over the long term. Should the depreciation pressures intensify further, we could see stronger measures from the RBI and government (such as restrictions on imports of some items). In terms of the real effective exchange rate (REER), the INR is slightly (~1.3%) overvalued compared to the FY16-FY22 average and overvalued by 4.2% in June '22 when compared to the base 100 level. This coupled with the widening current account deficit, foreign capital outflows, and dollar strength, would keep pressure on the rupee. The USD/INR is expected to depreciate towards 81-83 levels by the end of FY23.

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