23 June 2022

India’s economic recovery gains traction: inflation, COVID, and external headwinds to weigh on the outlook

- Synchronized monetary policy normalization gathers pace as inflation pressures intensify even as the global growth outlook deteriorates.
- The World Bank projects global growth to decelerate from 5.7% in 2021 to 2.9% in 2022— a sharp 120 basis points (bps) downgrade compared to the projections made in January 2022. It forecasts growth to be at 3% next year.
- India’s real GDP grew by 8.7% YoY in FY22, precisely in line with our projection, following a contraction of 6.6% YoY in FY21.
- All major sub-components of aggregate demand crossed their respective pre-COVID levels. However, private consumption continues to lag other demand indicators.
- Despite headwinds from external developments, India's economic activity showed signs of gaining traction in Q1 FY23. We expect economic growth to be around 7% YoY in FY23, with downside risks.
- Global growth slowdown, elevated commodity prices, global supply chain disruptions, rise in COVID cases, high domestic inflation, and a tightening monetary policy pose downside risks to economic recovery.
- High vaccination levels should help limit the economic impact of the ongoing rise in COVID cases, provided hospitalization/fatality rates don’t increase significantly.
- Without expenditure rationalization, the risk of fiscal slippage for the central government has risen due to additional subsidies and a cut in fuel excise duty announced post unveiling of the FY23 budget.
- Consumer price inflation moderated to 7% YoY in May, compared with an eight-year high of 7.8% YoY in April. Elevated WPI inflation of 15.9% YoY in May suggests continued upside risks to inflation.
- The RBI raised the policy repo rate by 50 bps in June to 4.9% and changed the forward guidance to focus on the “withdrawal of accommodation” to tame inflationary pressures.
- In line with our expectation of front loading of rate hikes, we expect the RBI to continue with rate hikes in the upcoming meetings. Given upside risks to inflation, the risk of the terminal rate being above 6% has gone up.

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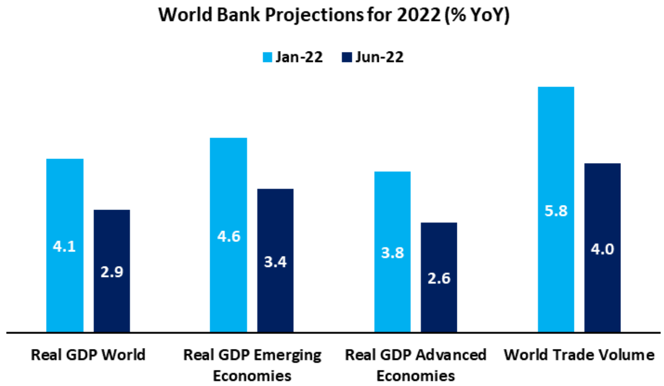
Global Economy: Monetary policy normalization gathers pace as inflationary pressures intensify even as the global growth outlook deteriorates

The global economy continues to face a stagflationary mix of slowing economic growth and rising inflation driven by the spillover effects of the Russia-Ukraine war and supply chain strains. The Global Composite Purchasing Managers' Index (PMI) registered a reading of 51.5 in May (marginally up from 51.2 in April), indicating the third-weakest expansion (above 50 level) since July 2020. Meanwhile, the survey's gauge of input cost inflation hit the second-highest since the commodity price surge of 2008-09, with service sector inflation exceeding that of manufacturing for the first time in almost two years. The World Bank's latest report also shows this mix of weaker economic growth and a higher inflation outlook. As per the World Bank, global economic growth is projected to decelerate from 5.7% in 2021 to 2.9% in 2022—a sharp 120 basis points (bps) downgrade compared to the previous projections made in Jan 2022. The surge in energy and food prices, along with the supply and trade disruptions triggered by the Russia-Ukraine war and the ongoing interest rate normalization, accounted for most of the downgrade. For 2023, it forecasts global growth to flatten to 3%, largely reflecting the unwinding of the fiscal and monetary policy support provided during the pandemic. The outlook remains subject to several downside risks, including any intensification of geopolitical tensions, rise in stagflationary headwinds, increase in financial/socio-economic instability, and persistence of supply strains.

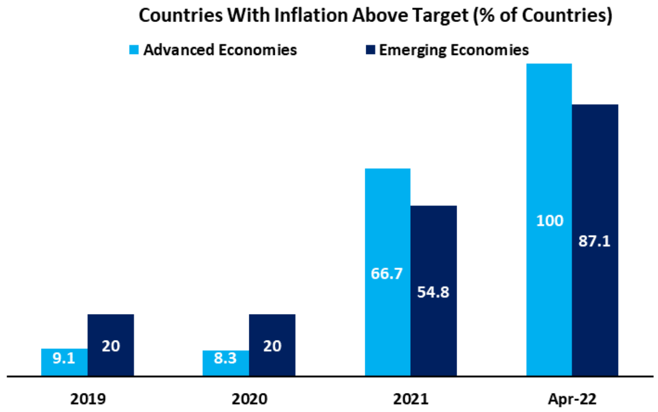
The World Bank cuts 2022 global growth projection sharply



Source: World Bank

Inflationary pressures intensified and broadened globally, forcing several central banks to accelerate policy tightening. As of April '22, inflation was above target in all advanced economies and ~90% of emerging and developing economies that have adopted inflation targeting. Concerns about persistently above-target inflation have prompted central banks in several advanced and emerging economies to tighten monetary policy. In May, US CPI inflation accelerated to a fresh four-decade high of 8.6%, with a strong sequential pick-up of 1%, dashing hopes of peak inflation in April. Consequently, US FOMC raised the policy rate by 75 bps in June, a larger than previously indicated magnitude of 50 bps. The "dot plot" of individual committee members' expectations indicated that the Fed's benchmark rate would reach 3.4% by the end of 2022, an upward revision of 150 bps from the March estimate. The committee also sees the rate rising to 3.8% in 2023, 100 bps higher than the projection made in March. Meanwhile, the Euro area annual inflation also soared to a new record high of 8.1% in May. Accordingly, the European Central Bank (ECB), in its June meeting, announced an end to its QE programme (on July 1) and indicated a rise in the policy rate (by 25bps) in the July meeting and again in September. Inflation in the UK also escalated to a fresh four-decade high of 9.1% in May. The Bank of England raised its main Bank Rate by 25 bps to 1.25% in the June meeting, a fifth consecutive rate hike and pushing borrowing costs to the highest in 13 years. Central banks of Australia, Canada, Switzerland, Peru, Poland, Brazil, and Chile raised their respective policy rates in June to tame inflationary pressures. China's central bank, on the other hand, reduced the 5-year loan prime rate (LPR), the mortgage reference rate, by 15 bps to 4.45% and retained the policy rate, i.e., the 1-year LPR at 3.7%, to support economic recovery amidst downside risks posed by strict zero-COVID strategy while inflation was steady at 2.1% in May (below the target of ~3% for 2022). Faster and synchronized monetary policy tightening in advanced and emerging-market economies is leading to tightening global financial conditions and a rise in volatility with a sharp correction in equity markets, hardening of government bond yields, and a weakening of most EM currencies against the US dollar. The economic cost of taming inflation through monetary policy tightening will critically depend on easing supply-side constraints and geopolitical developments.

Broad-based rise in inflation as the majority of inflation-targeting countries reported inflation above the target

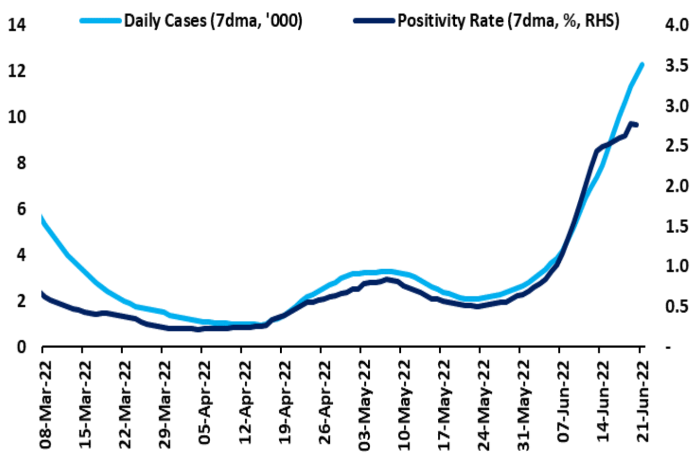


Source: World Bank

Indian Economy: Economic recovery gains traction; headwinds from external factors persist

Despite headwinds from external developments, India's economic activity showed signs of gaining traction as per the high-frequency data. However, global growth slowdown, high commodity prices, global supply chain disruptions, rising domestic inflation, and monetary policy tightening by the RBI will weigh on economic recovery. The renewed surge in COVID cases in the country may also put a dampener on economic recovery.

COVID cases in India jumped in June, raising concerns of a new wave

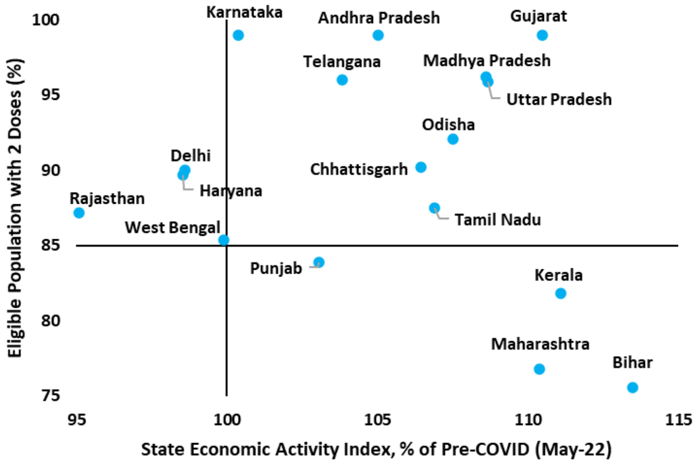


Source: CMIE

India's daily COVID cases (7dma) increased in June, from 2.6K on May 31 to ~12.3K on June 21. The increase in cases is led by Maharashtra, Kerela, and Delhi, which together accounted for 68% of total daily (7dma) cases in the country. Cases have also started to rise in other states from a low level. The daily positivity rate (7dma) increased from around 0.65% at the end of May to 3% during the same period. On a positive note, daily fatalities (7dma) have remained below 20 over the past two weeks but could rise in the coming weeks. Higher vaccination levels (89% of the eligible population received both doses) should help limit the potential impact of any new COVID wave. We expect the economic impact of a new COVID wave to be limited as long as hospitalization/fatality rates don't rise significantly, which otherwise will force states to impose tighter virus-containment measures.

Supported by economic activity normalization and higher vaccination rates, most states' economic activity surpassed the respective pre-COVID (% of CY19 level) levels by May '22. Among major states, Rajasthan, Haryana, Delhi, and West Bengal's economic activity was still below pre-COVID levels, while their vaccination (both doses for eligible population) rates are above 85% level, indicating a potential for economic activity to catch up. Among major states, Maharashtra, Kerala, Punjab, and Bihar lagged in their vaccination coverage (below 85% vaccination rates), even as their respective economic activity levels surpassed pre-COVID levels, indicating a risk to economic recovery from a new COVID wave.

The majority of states reported above 85% vaccination levels and economic activity above pre-COVID levels.



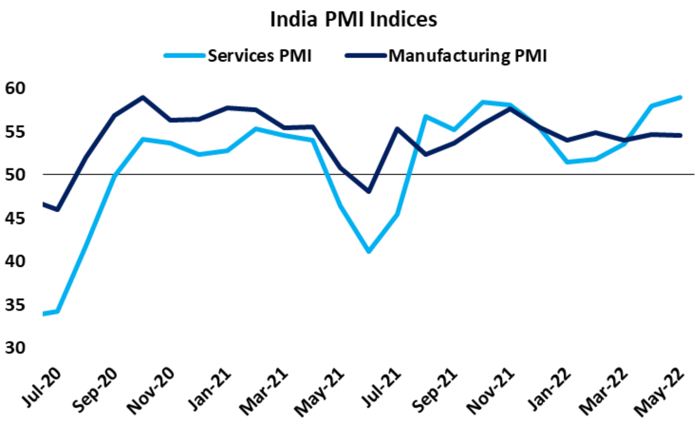
Source: CMIE. Google Mobility Report; Note: State Economic Activity Index has been constructed based on high-frequency data

In Q4 FY22, India's economic growth slowed compared to the previous quarter in line with continued normalization of the base effect and the possible impact of several factors, including disruptions related to the third COVID wave, supply chain issues, and a sharp rise in global commodity prices. Real GVA growth noted an expansion of 3.9% YoY in Q4 FY22, slowing from 4.7% YoY in Q3 FY22, led by the services sector, followed by agriculture, while the industrial sector noted sluggish growth. In fiscal year terms, real GVA grew by 8.1% YoY in FY22, following a 4.8% contraction in FY21. Real GVA reached almost 103% of its pre-COVID level (v/s FY20) in FY22. While industry and agriculture reached above their pre-COVID levels, services sector recovery lagged with the trade, hotels, transport, and communication segment, remaining ~11% below its pre-COVID level, indicating incomplete recovery for contact-intensive services. High-frequency data for Q1 FY23 show that economic activity is gaining traction, led by a catch-up in the services sector thanks to pent-up demand for contact-intensive services such as travel, entertainment, etc.

Industrial recovery showed resilience in April, with the Industrial Index of Production (IIP) rising by an eight-month high of 7.1% YoY in April compared to 2.2% YoY in March on a favourable base. On a sequential basis, IIP contracted by 9.2% MoM but fared better than the pre-COVID five-year average of 11.8% contraction for April. Within IIP, the recovery was led by electricity production, which reached 123.3% of its pre-COVID (CY19 average) levels, followed by mining at 107% and manufacturing lagging at 100.6%.

However, the outlook for the electricity industry remains clouded due to a shortage of coal stock with power plants, which could affect electricity production going forward. Despite lagging manufacturing performance, PMI readings suggest an optimistic picture for the sector. Manufacturing PMI for May came in at 54.6, marginally lower than April's print of 54.7. This was the eleventh consecutive month manufacturing PMI remained in the expansionary zone. While factory orders and production rose at a similar pace as in April, export orders rose at the fastest pace in 11 years. Other indicators like E-way bills and GST collection growth remained strong on a YoY basis but moderated sequentially. Meanwhile, cement production growth slowed in April despite last year's low base, while steel production picked up in May, pointing to the mixed performance of the construction sector. That said, the government's planned capital spending supports the outlook for this sector. Despite the pick-up in industrial activity as per high-frequency data, we continue to see the risks that a high commodity price environment and tighter monetary conditions, coupled with global supply chain disruptions, could tamper with the industrial outlook.

Services PMI surges to the highest level in over eleven years; Manufacturing PMI stays in the expansion zone



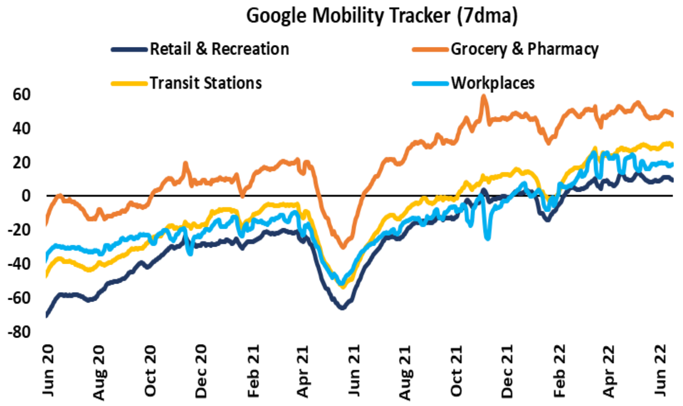
Source: IHS Markit

Services sector performance continued to benefit from the release of pent-up demand for contact-intensive services. The sector's strong performance was reflected in the services PMI reaching its highest reading in over 11 years, at 58.9, on top of the already strong reading of 57.9 for April. Domestic air passenger traffic grew by almost 90% YoY in April (air traffic had dropped in April-May last year during the delta outbreak), indicating a continued recovery in travel and tourism. There is also an increase in the growth of credit to tourism, hotels, and restaurants to 8.5% YoY in April, up from 8.1% YoY in March, indicating traction in activity in these industries. As per Naukri JobSpeak sub-indices in May, the jobs opening for contact-intensive sectors like Hotels/Restaurants/Airlines/Travel and Retail continued their triple-digit recovery in May on an annualized basis (358% YoY and 175% YoY), with retail surpassing its pre-pandemic level (111% of CY19)), while travel and hospitality continued to fare below the pre-pandemic level (73% of CY19). Rail freight traffic grew at double digits by 21% YoY in May, lending further credibility to services revival. While services recovery has gained momentum over the past few months, a recent rise in COVID cases may cast a shadow on the outlook for the sector in the near term. While higher vaccination rates and low lethality of the pervasive COVID variants in the country might have made the economic activity more impervious to minor outbreaks, the economic impact of any new COVID wave will critically depend on the evolution of fatality/hospitalization rates.

Regarding the agriculture sector, the forecast of a normal monsoon, adequate reservoir levels, a hike in fertilizer subsidy, and prospects for better realization given the rise in food prices and MSP (by an average of 6.1% for 14 major Kharif crops for FY23) bode well for the outlook. The possibility of higher Agri exports despite restrictions on wheat and sugar exports should support prospects of higher income. However, the rainfall has been in deficit despite an early onset of the monsoon. Cumulative rainfall from June 1 - June 20 was 5% lower than the long period average. This weighed on sowing progress, with the area sown under Kharif crops at nearly 10 million hectares as of June 17, 2022. This is 8% lower than the area covered in the corresponding period last year. The potential impact on the outlook will critically depend on the progress and spatial distribution of rainfall in the coming weeks. Healthy reservoir levels should help limit the impact on irrigated areas, with total live storage in 143 major reservoirs reported at ~29% of the full reservoir level (FRL) as compared to the decadal average of ~22% (data as of June 16).

Real GDP growth for Q4 FY22 came at 4.1% YoY compared to our estimate of ~4.0%, driven by investment, exports, and private consumption. In fiscal year terms, real GDP grew by 8.7% YoY in FY22, precisely in line with our projection, following a contraction of 6.6% YoY in FY21. The level of real GDP in FY22 reached 101.5% of the pre-COVID level (i.e., FY20). All major components of aggregate demand crossed their respective pre-COVID levels. However, private consumption (at 101.4% of its pre-COVID level) continues to lag other demand indicators. High-frequency data for Q1-FY23 indicate a mixed picture with uneven recovery in private consumption, slower export growth, robust spending by the central government, and signs of traction in investment. The outlook for demand conditions faces several headwinds, including rising inflation, tightening monetary policy, increasing uncertainty, and reducing fiscal flexibility.

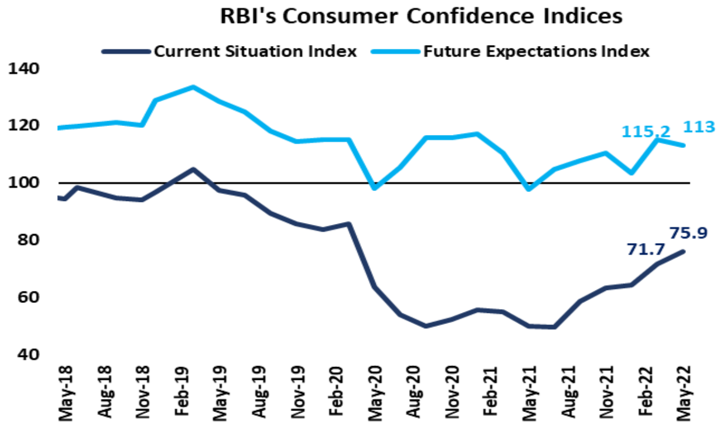
Despite the heatwave, mobility levels held steady at high levels, supporting the normalization of economic activity



Source: Google Mobility Reports; Data for June is till June 17

Private consumption-related indicators continue to show an uneven recovery. The consumption index (weighted average of consumer durables and non-durables) moved into the growth territory after two consecutive months of deterioration as it grew by 3.4% YoY in April, supported by a favourable base. However, compared to the pre-COVID level, the index dropped to 93% of the pre-COVID level (CY19 average) in April compared with 102.5% in March. Recovery in consumer durables is still lagging compared to non-durables as the former remains at around 90% of its pre-COVID level while the latter is at around 95%. Looking at retail auto sales data, passenger vehicle sales largely remained flat at ~117% of thei pre-COVID level in May. Meanwhile, two-wheeler sales continued to improve but remained well below the pre-COVID levels at 89%. Rising vehicle and fuel prices are likely the reasons for the drag in demand for automobiles. Other indicators, however, showed a recovery in demand conditions. Despite the heatwave, Google mobility data indicated that mobility levels in the retail and grocery categories remained high, with the average of the two categories holding steady around 30% above the baseline in May-June. Moreover, retail credit growth accelerated for the third consecutive month and reached 14.7% YoY in April. RBI's survey indicated continued improvement in consumer sentiment. As per the consumer confidence survey, the current situation index (CSI) continued to recover as the index rose to 75.9 in May 2022, the highest level since May 2020, on the back of improved sentiments on the general economic situation, employment, household income, and spending. The future expectation index declined slightly to 113.0 in May 2022, compared with 115.2 in March 2022, owing to a decline in sentiment around price levels. Future expectations on the economic situation, employment, and income declined but remained in the positive territory. From the labour market perspective, the greater unemployment rate fell from 11.8% in April to 10.3% in May. Although the total number of jobs increased by around 1mn, part of the improvement in the unemployment rate is attributed to a decrease in the labour force (the participation rate fell from a four-month high of 42% in April to 41.3% in May). Meanwhile, the Naukri JobSpeak index (an indicator of organized sector jobs) improved by 39.9% YoY in May, remaining steady at 125% of pre-COVID levels. Looking ahead, we believe that a globally and domestically high inflation environment and tighter monetary conditions will impinge on consumer demand growth.

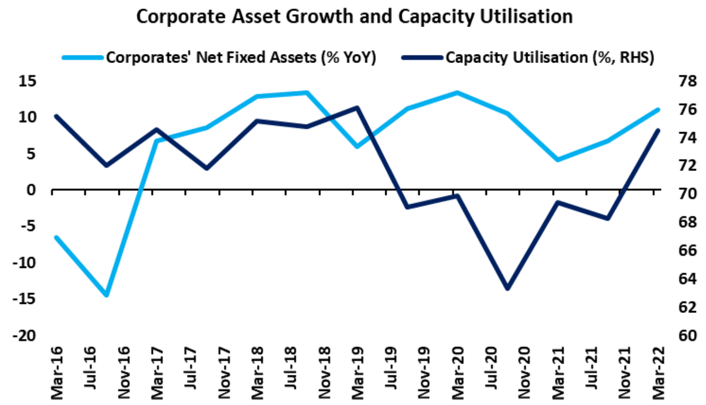
Consumers' assessment of the current situation continues to recover, and that of the future situation drops marginally



Source: RBI, CMIE

There are signs of traction in investment activity, but heightened uncertainty may weigh on momentum. Gross capital formation (GCF) noted a robust growth of 5.2% YoY in Q4-FY22, though slowing from 8.4% in the prior quarter in line with the waning of the base effect. With the acceleration in the pace of the capital expenditure by the central government, the investment demand noted a solid sequential growth of 15.6% QoQ in Q4-FY22 (v/s 8.1% QoQ contraction in Q3). This momentum seems to have continued in FY23. In April, the IIP capital goods index grew by 14.7% YoY (up from 2% in March), while the infrastructure and construction goods grew by 3.8% YoY (down from 6.7% in March). Government CAPEX grew by a staggering 67.5% YoY in April. Looking at credit growth, the growth of loans to the infrastructure sector remained strong at 10.2% YoY in April (up from 9.1% in March). As per the quarterly financial reports, the non-financial corporate sector reported a continued rise in net fixed assets growth. Meanwhile, going by the early results of the RBI's survey, manufacturing capacity utilization improved to 74.5% in Q4 FY22 from 72.4% in Q3 FY22, which, coupled with healthier corporate balance sheets and the government's commitment to focus on infrastructure growth, bodes well for investment revival. However, high economic uncertainty and elevated input costs may lead to companies adopting a wait-and-watch strategy, delaying the broader pick-up in investment.

A continued rise in capacity utilization bodes well for investment revival



Source: RBI, CMIE

After a robust growth last year, export growth is starting to moderate, given slowing global growth. Meanwhile, imports growth remained strong, owing to higher commodity prices and domestic demand recovery, resulting in a widening of the trade deficit. In May, the trade deficit widened to $24.3 bn compared to $20.4 bn in the previous month on account of weaker exports (2.1% MoM contraction) due to slowing external demand. Imports remained high, increasing by 5% MoM as high oil prices and strong non-oil non-gold imports continued to add to the import bill. The trade deficit is expected to stay at elevated levels in FY23 amid high oil prices and ongoing economic recovery. With dark clouds over the global economic outlook, India's exports are likely to face a challenging operating environment compared to last year. Overall, higher vaccination coverage and continued broadening of the economic recovery are expected to support economic activity in FY23. However, global growth slowdown, high commodity prices, rising domestic inflation, risk of a new COVID wave, and expected monetary policy tightening by the RBI could weigh on India's economic recovery. We expect economic growth to be around 7% YoY in FY23, with downside risks.

Fiscal slippage risks increased in FY23 after a better performance last year

As expected, the government contained the FY22 budget deficit at 6.7% of GDP compared to the target of 6.9%. Despite higher revenues expenditure and disappointment on the divestment front, better than budgeted revenues growth, lower CAPEX, and higher nominal GDP helped the budget deficit fall below the target. Government spending in FY23 started on a strong note, with total expenditure growing by 21.2% YoY in April, driven by capital expenditure growth of a whopping 67.5% YoY, while revenue expenditure grew by a moderate rate of 9.1% YoY. On the other hand, total receipts grew by a healthy 35.1% YoY in April, driven by revenue receipts. Gross tax revenue receipts grew by 36.5% YoY in April and reached 8.4% of the budgeted estimate for FY23.

In FY23, expected better revenues growth, LIC IPO proceeds, and likely higher than budgeted nominal GDP growth provided the government fiscal flexibility. However, additional food, fertilizer, and LPG subsidies and a cut in petrol & diesel excise duty announced post-budget would push the deficit to ~6.8% of GDP without expenditure rationalization. The finance ministry report indicated the need to rationalize revenue expenditure to prevent fiscal slippage. Given the limited scope for cuts in revenue expenditure, the risk of a cut in CAPEX has risen. Fiscal flexibility at state levels also looks to be constrained. As per RBI's data, the consolidated gross fiscal deficit of states/UTs for FY22 came at ~2.9% of GDP compared to 4.3% in FY21 and even lower than the budgeted target of 3.7% for FY22. Similar to the central government, higher revenue receipts, led by tax and non-tax revenue, coupled with a reduction in revenue expenditure, helped better than the budgeted fiscal deficit target at the state levels. However, several states continue to have a high fiscal deficit, worsening the debt vulnerability. States like Bihar, Kerala, Madhya Pradesh, Punjab, Rajasthan, Uttar Pradesh, and West Bengal have limited fiscal flexibility in the face of future shocks or to carry on with the CAPEX push, which the central and many state governments have focused on.

Several states have limited fiscal flexibility

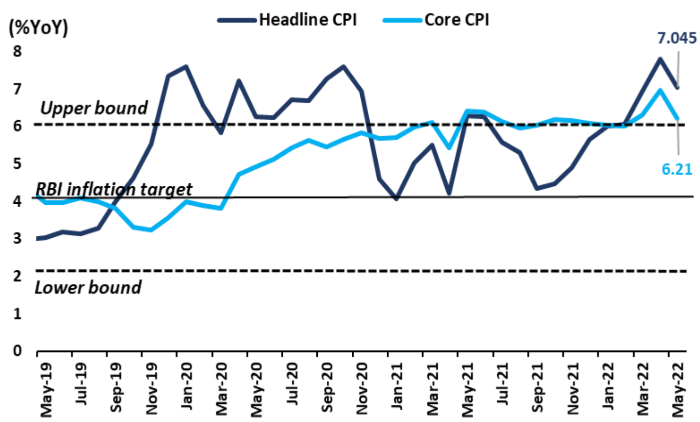
2021-22 Revised Estimate			
State	Fiscal Deficit (% of GSDP)	Outstanding Debt (% of GSDP)	Fiscal Flexibility
Andhra Pradesh	3.2	32.5	Medium
Bihar	11.3	38.6	Low
Chhattisgarh	3.8	26.2	Medium
Delhi	1.6	5.2	High
Gujarat	1.5	19.0	High
Haryana	3.0	29.4	High
Karnataka	2.8	26.6	High
Kerala	4.2	37.0	Low
Madhya Pradesh	4.2	31.3	Low
Maharashtra	2.8	17.9	High
Odisha	3.5	18.8	Medium
Punjab	4.6	53.3	Low
Rajasthan	5.2	39.5	Low
Tamil Nadu	3.8	27.4	Medium
Telangana	3.9	24.7	Medium
Uttar Pradesh	4.3	34.9	Low
West Bengal	3.5	34.4	Low

Source: RBI, PRS. Note: States breaching indicative (as per 15th Finance commission) fiscal deficit and debt levels of 3.3% and 30.7% of GSDP for FY22 are classified as under Low flexibility; states breaching one of the above two caps are classified under Medium flexibility, and states not breaching any caps are classified under High flexibility. Delhi's debt number is for FY21 RE.

The RBI continues with front-loaded rate hikes; will focus on the withdrawal of accommodation

With domestic inflationary pressures intensifying and becoming broad-based, the RBI decided to prioritize taming inflation over economic growth in FY23. The RBI's Monetary Policy Committee (MPC) voted unanimously to increase the policy repo rate by 50bps to 4.90% in the June meeting. Consequently, the standing deposit facility rate stands adjusted to 4.65% and the marginal standing facility rate and the bank rate to 5.15%. This came on the back of a 40bps rate hike announced in the off-cycle meeting in early May. The RBI governor also noted that the MPC decided unanimously to "focus on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth". This is a shift from the last meeting when it had decided "to remain accommodative while focusing on withdrawal of accommodation". Given the intensification of inflationary pressures, the RBI stated a need for calibrated monetary policy action to keep inflation expectations anchored and restrain the broadening of price pressures. Inflationary pressures remain largely driven by adverse supply shocks emanating from the Russia-Ukraine and related developments.

Headline inflation eases in May but remains above 7%



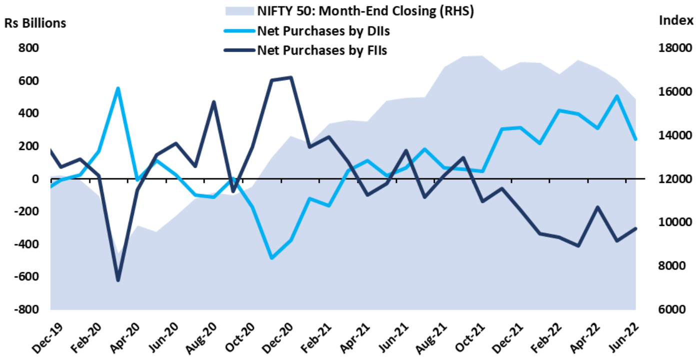
Source: CMIE

Consumer price inflation moderated to 7% YoY in May, compared with an eight-year high of 7.8% YoY in April, mainly due to a high base of comparison. Headline inflation has remained above the RBI's tolerance level (6%) for the fifth consecutive month. Despite moderation in the annualized rate of inflation, inflationary pressures remain broad-based. Food and beverages price inflation eased to 7.8% YoY in May from 8.1% in April, but sequential momentum quickened to 1.5% MoM from 1.4% in April (pre-COVID five-year average for May is 0.7%). Fuel inflation eased slightly due to the partial impact of the excise duty cut (which should fully reflect in June). Core inflation eased in May, driven mainly by transport and communication, health, clothing and footwear, and household goods and services. The share of items in the CPI basket with inflation above 6% has increased from 32% in February 2021 to 45% in May 2022, though down from 59% in April. The headline rate of inflation is likely to firm up again from July onward as the high base impact fades. On a positive front, the RBI's survey conducted post the diesel and petrol excise duty cut on May 21 noted a significant downward revision in households' expectation of future inflation, with the three-month ahead expectation declining by 190 bps to 8.9% and the one-year ahead inflation expectation declining by 90 bps to 10.1% (compared with the survey conducted before fuel excise cut). However, wholesale price inflation quickened to 15.9% YoY, the highest in the series' history (since 2012), in May, up from 15.1% in April. Thus, input price pressures remain elevated, posing upside risks to the inflationary trajectory as pass-through to final consumer continue with demand recovery. With the global oil supply outlook also deteriorating, the risk of elevated oil prices persists. These factors pose upside risks to our projection of CPI inflation of 6.3% YoY for FY23. In the June meeting, the RBI raised its FY23 inflation projection sharply from 5.7% YoY to 6.7% YoY, with quarterly projections showing inflation remaining above the 6% threshold in the first three-quarters of FY23 before easing to 5.8% YoY by Q4-FY23. The RBI assessed that economic activity was gaining traction, retaining its FY23 economic growth projection at 7.2% YoY, with risks broadly balanced. In line with our expectation of front loading of rate hikes, we expect the RBI to continue with rate hikes in the upcoming meetings. With the significant upward revision in inflation projection by the RBI, the risk of the terminal rate being above 6% has gone up.

Market update: Global risk aversion weighs on Indian markets

Indian equity markets have remained under pressure ever since the Russia-Ukraine war, moving in tandem with the global markets. The decline in Indian stocks has been accompanied by increased volatility. Both the benchmark equity indices – NIFTY50 and SENSEX noted a correction of 3.0% and 2.6%, respectively, in May, despite some recovery noted in the second half of the month. The correction was much more pronounced in the case of the BSE MidCap and BSE SmallCap, which noted a decline of 5.2% and 7.8%, respectively, in May. The tightening of the monetary policy by the global central banks, surging inflationary pressures, high oil prices, and the rate hikes by the RBI weighed on the domestic market. The domestic investors remained resilient while the capital outflow continued on the part of the foreign investors for the eighth consecutive month. As such, FIIs sold Indian equities worth Rs 377 bn in May, while the domestic investors doubled down on their investments as they ploughed in Rs 508 bn in equity markets (Rs 308 bn in April). The markets continued their downward trend in June, and NIFTY50 declined further by 5.7% (data till June 21) amidst weaker global cues, supply-chain disruptions, and rising interest rates by major central banks and the RBI amidst high inflation. Going ahead, we expect volatility to remain elevated in the current environment; however, optimism around the economic recovery reflected in the high-frequency indicator could support the markets.

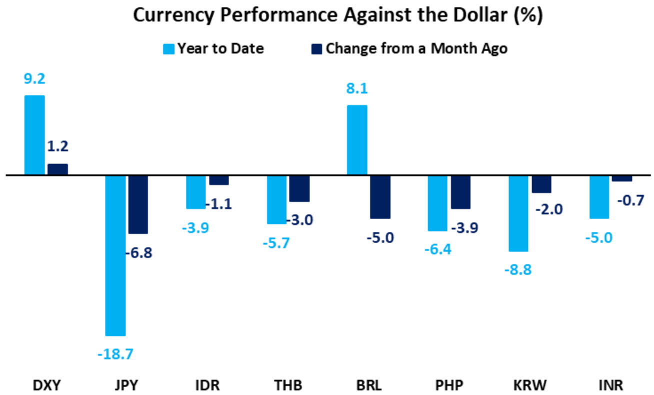
Indian equity markets continued to correct; domestic investors prevented a sharper decline



Source: CMIE, Bloomberg; Note: Data for June is till June 21

The bond market remained under pressure. The 10-year G-Sec yield rose from 7.52% on June 7, a day before the RBI announced the second-rate hike of this hiking cycle, and rose to 7.60% by June 13. The rise in yields also coincided with the increase in the global oil price to ~$120/bbl levels by mid-June. A drop in inflation in May and an easing in global oil prices in the recent week provided some respite to the bond market as yield eased to 7.48% by June 21. On a year-date basis, the 10-year and 2-year G-Sec yield widened by 103bps and 204bps to 7.48% and 6.56%, respectively, out of which 37bps and 104bps happened after the RBI's May 4 meeting. The surplus systemic liquidity declined from around Rs 5.6 lakh crores at the end of April to Rs 4.6 lakh crores on May 20 before the CRR hike came into effect, to around Rs 3.5 lakh crores at the start of June, which also weighed on the short-term rates more. This has led to the flattening of the yield curve. Rising domestic inflationary pressures, elevated oil prices, risk of fiscal slippage, record-high government borrowing, and expected continued tightening of monetary policy suggest that pressures on the bond market are expected to continue in FY23.

RBI's intervention prevented sharper rupee depreciation



Source: CMIE, Bloomberg; Note: Latest date is as of June 21

The rupee crossed the 78 level in June, falling to an all-time low of 78.12 versus the dollar on June 21. On an average monthly basis, the rupee depreciated by 1.48% in May and further by 0.74% in June (till June 21). US dollar strength amidst US Fed rate hikes and global risk aversion coupled with continued foreign capital outflows and widening trade deficit weighed on the currency. RBI's intervention continues to prevent sharper correction in the rupee. On a year-to-date basis, the rupee depreciated by ~5%, which shows relatively lesser depreciation when compared to peer EM currencies. RBI's forex reserves remain strong at around $596 bn on June 10, although this is down from over $630 bn at the start of the year. This will allow the central bank to smoothen any sharp fluctuations in the currency market, although we expect that the bank will allow gradual depreciation of the currency to retain export competitiveness.

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