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The Indian economy continues to recover amid a stuttering global economy; spillovers from external developments pose risks to the outlook

- Global economic activity continues to slow down amidst high inflation, tighter financial conditions, geopolitical tensions, and a strict COVID containment policy in China.
- The IMF retained the global growth forecast for 2022 at 3.2% in its October outlook, but it revised the 2023 forecast downwards from 2.9% earlier in July to 2.7%.
- Most of the central banks have doubled down on their efforts to rein in the multi-decadal high inflation prints, as reflected in the increased pace of policy normalization.
- The IMF revised its global inflation forecast to 8.8% and 6.5% in 2022 and 2023, respectively, from 8.3% and 5.7% earlier, and projected the inflation to ease to 4.1% in 2024.
- India's economic recovery remains resilient, with high-frequency data indicating a continuation of catch-up in the services sector and mixed recovery in the industrial sector, while agricultural activity was moderately impacted by uneven rainfall.
- On the demand side, private consumption recovery seems to be gathering steam, supported by festive demand, while the investment outlook remains mixed. Net exports continue to exert a drag.
- Considering these factors, we retain our real GDP projection of 7.0% YoY for FY23, with downside risks primarily emanating from global developments.
- India's consumer price inflation jumped to 7.4% in September due to the waning of a favourable base effect and higher food price pressures. Meanwhile, the wholesale price inflation eased to 10.7% from 12.4% previously.
- In its last policy meeting, the RBI continued the front-loading of rate hikes and raised the policy repo rate by 50 bps to 5.90% to contain inflationary pressures.
- The RBI kept the policy stance unchanged as "focused on withdrawal of accommodation to ensure that inflation remains within the target going forward". In our view, this would imply the need for additional policy tightening.
- Given elevated inflation, the RBI's unchanged policy stance, and pressures on the currency, we see the terminal repo rate at 6.5% in the current policy tightening cycle.

Pramod Chowdhary
Chief Economist
pramod.chowdhary@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Sarthak Gupta
Economist
sarthak.gupta@dmifinance.in

www.dmifinance.in

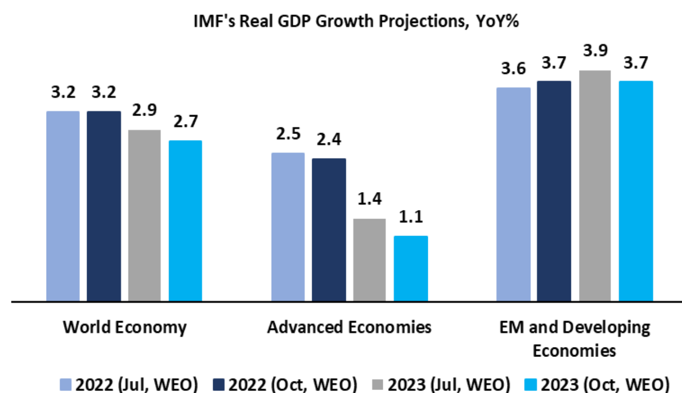
+91 11 4120 4444

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

Global economic activity continues to slow down amidst multiple shocks

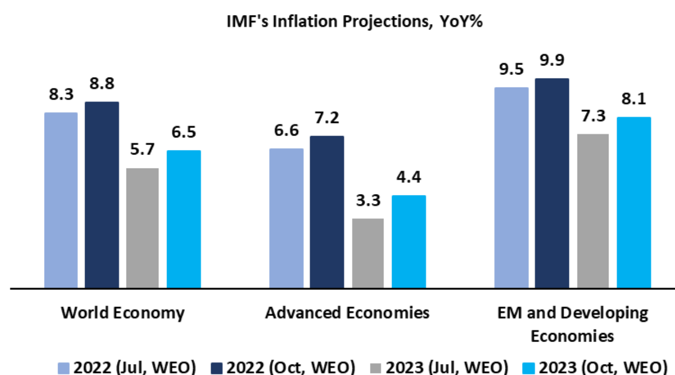
The global economy continues to reel under the impact of multiple shocks, including the protraction in the Russia-Ukraine war, aggressive and synchronized policy tightening by central banks to combat the high inflation, financial markets volatility, China's strict COVID containment strategy and the soaring energy prices in Europe. High-frequency data indicated that the slowdown intensified over the past month. The global manufacturing PMI slid into the contractionary zone in September for the first time since June '20 as the index deteriorated further to 49.8 from 50.3 in August, led by the decline in the output of the intermediate and investment goods sector, while the consumer goods sector noted a marginal uptick. Out of the total 30 economies used for the above index, output rose in only 10 economies, including the US, Brazil, India, Russia, and Australia. Meanwhile, the economic activity also remained subdued in the services sector as the PMI stood at 50 compared to 49.3 in August. Consequently, global economic activity contracted for the second consecutive month as the composite PMI remained below 50 (49.7 in September). The Composite Lead Indicator for OECD countries observed a further sequential decline in September. Factoring in risks to the outlook, the IMF retained the global growth forecast for 2022 at 3.2% in the latest report, but it revised the 2023 global growth forecast downwards from 2.9% earlier in July to 2.7%, citing that the worst is yet to come. With the slowdown becoming broad-based, the growth forecast for advanced economies has been revised downwards by 0.1 pp and 0.3 pp for 2022 and 2023, respectively, while for the emerging market economies, the growth has been revised slightly upwards for 2022 due to smaller than expected contraction while it is revised downwards for 2023.

IMF revised its global growth forecast for 2023 downwards to 2.7%



Source: IMF, Projections as per World Economic Outlook (WEO) reports of July and October '22

IMF revised its inflation forecast upwards for both 2022 and 2023



Source: IMF, Projections as per World Economic Outlook reports of July and October '22

Most of the central banks have doubled down on their efforts to rein in the multi-decadal high inflation prints, as reflected in the increased pace of policy normalization. In the last policy meeting, the US Fed announced a third consecutive rate hike of 75 bps bringing the benchmark interest rate to a range of 3.0%-3.25%. While a 75-bps hike was largely anticipated, what came as a rather surprise to the market was the upward revision to the median and terminal Fed fund rate signalling more rate hikes ahead. The US CPI inflation remained elevated at 8.2% in September, only marginally lower from 8.3% in August and rose by 0.4% sequentially. Moreover, US CPI, excluding food and energy, which the Fed focuses on closely, continued to accelerate, suggesting another larger rate hike is on the cards. Meanwhile, the BoE's governor signalled that the next interest rate hike could be larger than anticipated due to the government's energy subsidies and tax cut plans. The Bank of Canada also raised its interest rate by 75 bps in September following a 100-bps hike in July. Other central banks joining the bandwagon include the central bank of Sweden, Hungary, Thailand, Indonesia, Australia, etc. Meanwhile, Turkey remains an outlier which announced another rate cut despite the soaring inflation. Despite the central banks' resolution to bring inflation down, no respite has been seen in the inflation figures just yet. As per the latest outlook, the IMF also revised its global inflation forecast upwards to 8.8% and 6.5% in 2022 and 2023, respectively, from 8.3% and 5.7% earlier, and projected the inflation to come down to 4.1% in 2024. Global commodity prices have remained volatile as two opposite forces of weakening global demand and supply-side constraints continue to influence markets. While food prices increased by 0.1% sequentially in September, metal prices declined by 5.3%. Crude oil prices have started to rise again from an average of $91/bbl in September to $93/bbl in October (data till October 18) owing to the production cuts announced by OPEC+. Aggressive policy tightening by the US Fed amid the elevated inflationary prints and global

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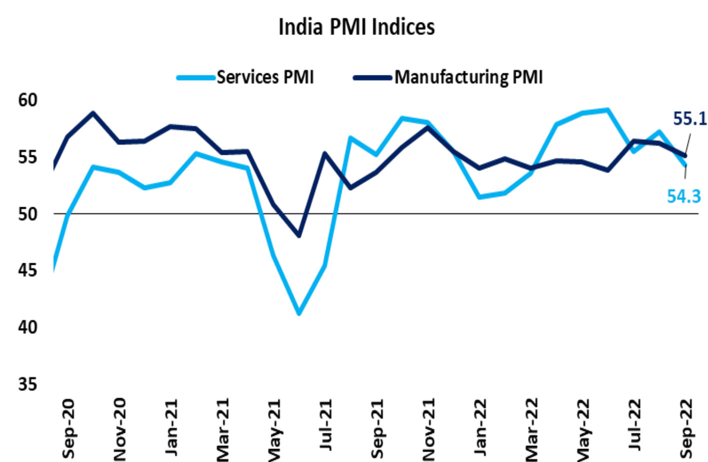
recessionary fears, the global equity markets have remained volatile of late. The dollar continued to gain strength as demand for safe-haven remained strong amid the global risk-off sentiment. Additionally, the solid labour market data for the US has provided a positive impulse for the dollar. As such, the dollar index surged to an average of 112.3 in October from 110.7 in September and 107.1 in August, and it will continue to gain strength in the near term as the investors are likely to remain risk-averse.

Indian economic recovery stays resilient: Services sector recovery continues; industrial activity mixed

High-frequency indicators for August-September continue to point to a resilient economic activity supported by a recovery in the services sector and the associated traction in private consumption demand. However, mixed industrial activity and a slowdown in external trade and investment suggest risks to economic recovery. The government continues to support economic recovery by pushing CAPEX. Demand conditions are expected to strengthen due to the festive season. However, risks to growth persist, as tightening financial conditions, high inflation, and slowing global growth pose risks to the economic outlook.

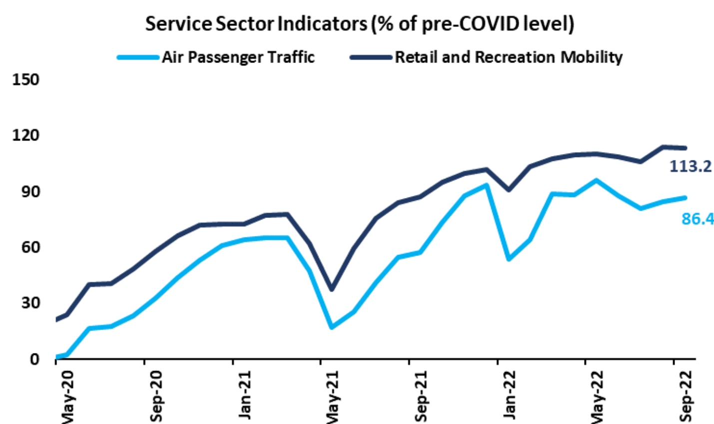
India's PMIs remained in the expansionary territory despite slowing



Source: IHS Markit

Industrial sector activity in recent months has been mixed. In August, the IIP contracted by 0.8% YoY, marking its first yearly contraction in 18 months. The mining and manufacturing sector led the slowdown, slipping below their pre-COVID levels while electricity production remained resilient. Despite soft IIP data, the lead indicator for September for manufacturing points to continued resilience in the sector with a reading of 55.1, much higher than the long-term pre-COVID average of 52.1. Encouragingly, input costs rose at the slowest pace since October '20 amidst a moderation in global commodity prices, while selling prices rose at the slowest pace in seven months. Hiring activity picked up in September '22 at the quickest pace in three months. CMIE data shows that employment in the industrial sector saw a sharp improvement in September. With receding inflation concerns and a rise in orders, the business sentiment index jumped to its highest level in over seven and half years. Other indicators like GST collections, E-way bills, and steel and electricity consumption continued to record robust growth in August-September. Credit to the industrial sector accelerated to over an eight-year high in August, pointing to improving prospects for the sector. Looking ahead, the activity in the sector is expected to be supported by softer global commodity prices and festive demand. On the other hand, a weaker global environment could put a dampener on overall demand conditions for the sector.

Festive season likely to support ongoing services recovery

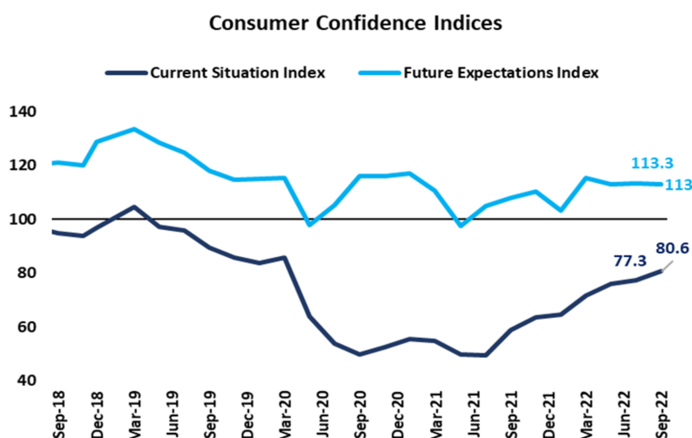


Source: CMIE

Activity in the services sector remained robust, with festival demand providing a further boost. The Services PMI index slowed to 54.3 in September from 57.2 in August while remaining comfortably above the pre-COVID long-run average of 51.3. New orders continued to increase in September, marking the fourteenth consecutive month of expansion. Weak external demand exerted a drag on overall sales. While the rate of increase of input cost inflation was almost the same as in August, the rate of increase in selling prices slowed to a six-month low. Meanwhile, services sector credit growth accelerated to the highest level seen in three and a half years in August, pointing to positive prospects and optimism about the outlook among services providers. Indeed, business confidence rose to the highest level in over seven and a half years in September. Other high-frequency indicators like air passenger traffic and port and freight traffic broadly point to continued recovery in the services sector in August-September. Activity in the sector is likely to be supported by the release of pent-up demand owing to the festival season.

The agriculture sector was moderately affected due to the uneven distribution of monsoon rainfall (deficit in the northern belt states and excess in the peninsular states). This mainly affected sowing in two crop categories, namely, rice and pulses. However, a surplus in coarse cereals and fibrous crops has more or less offset the shortfall in rice and pulses. As on September 30, the overall sowing of agriculture products was lower by only 0.8% YoY. Given the adequate level of rice stocks with the FCI (almost double the normative requirement), we do not expect a major sustained rise in rice prices. Additionally, the government recently banned the export of broken rice and imposed a 20% export duty on some rice varieties to ensure enough domestic availability. That said, we expect seasonal spikes in the prices of fruits and vegetables, which could temporarily increase inflation. Looking ahead, a comfortable level of reservoirs will likely bode well for the Rabi sowing, which commences around mid-November.

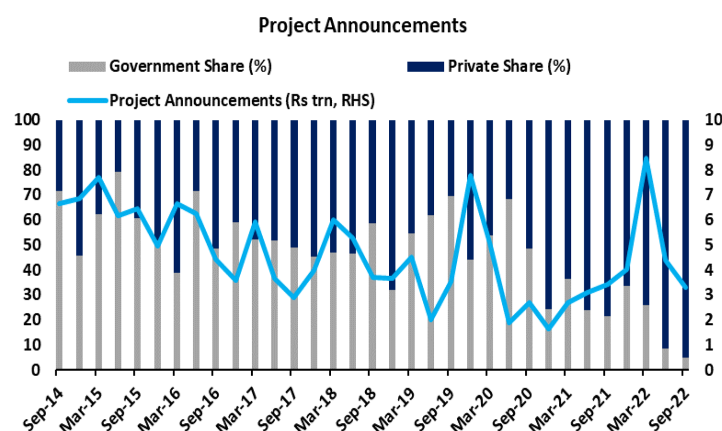
Consumer confidence improved for the 7th consecutive round



Source: CMIE

Private consumption indicators point to the consumer demand recovery gathering steam. An exception to this view was the weaker IIP data for consumer durables and non-durables, which we believe is a result of seasonal monsoon weakness and spillover from slower export growth. Given positive indications from other consumption metrics, we remain optimistic about recovery in this component in the near term. Retail credit demand continued to increase at an impressive pace in August, posting a yearly growth of 19.5% YoY, the highest since the onset of the pandemic, pointing to continued recovery in consumer demand. A general improvement in consumer demand conditions was also reflected in the latest consumer confidence survey data, which saw the current situation index in September improve to 80.6 from 77.3 in July. While this was still in the pessimistic territory (below 100), the future expectations index remained high at 113, indicating an expectation of improving consumer demand conditions over the next year. Improvement in sentiments was complemented by a recovery in labour market conditions in September, with unemployment falling to its lowest level since January ’22 despite a rise in the labour force participation rate. The recovery in greater UER (Unemployment Rate) was led by the rural areas, where the greater UER fell to 9.1%, the lowest level since January '22, despite an increase in the labour force. Meanwhile, the urban areas' greater UER fell to 11% in September from 13.2% in August, given a rise in employment and a decline in LFP. Positive developments were seen in the formal jobs space, with the Naukri JobSpeak index clocking its second-highest reading ever (July ’22 recorded the highest reading). While the festival season is likely to provide further impetus to the ongoing private consumption recovery, tightening financial conditions and high inflationary pressures will likely exert a drag going forward.

Investment activity losing steam



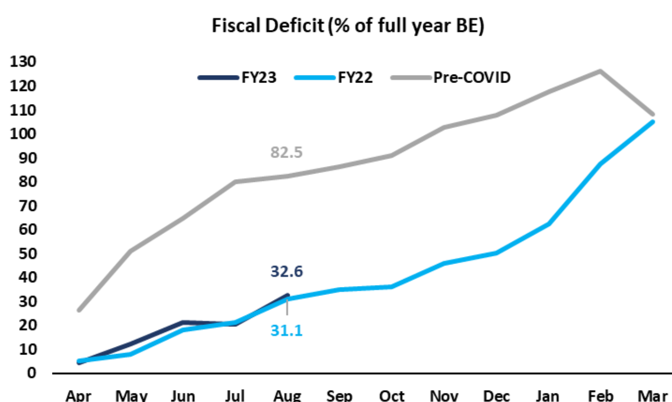
Source: CMIE

The investment outlook remains mixed owing to the high cost of inputs, tightening financial conditions, faltering external demand and thinning profit margins. On the one hand, the capital goods and intermediate goods sub-indexes of the IIP continued to register a decline in reading in August. On the other hand, the infrastructure and construction goods sub-index registered growth, making the reading of the investment climate unusually hard. According to the RBI's Industrial Outlook Survey, Business Assessment Index fell to 106.7 in Q2 FY23 from 110.1 in Q1 FY23. Although sentiment remained in the optimistic territory (above 100), the latest reading marked the fourth consecutive decline in the index. The Business Expectations Index remained much higher at 134.4 but also witnessed a decline from 137.7 previously. The value of new project announcements fell by 3.5% YoY in Q2 FY23, while projects completed fell by 10.3% (as of October 19). The government sector led the decline in project announcements while the private sector dragged its hands-on project completion (likely reflecting the impact of

high input costs). However, corporates' improved credit profile, rising capacity utilization (CU), and pick up in industrial credit bode well for the private investment revival. The seasonally adjusted CU increased to 74.3% in Q1 FY23 from 73.0% in Q4 FY22. Thanks to deleveraging and robust earnings, the corporate credit profile has posted a strong performance in FY22. According to CareEdge Ratings, the credit ratio (share of upgrades to downgrades) clocked a decadal high at 3.74 times in H1 FY23, up from 2.64 times in H2 FY22, pointing towards a "positive" outlook for investment activity. However, heightened uncertainty, high input costs, and global slowdown may delay the broader investment pickup. The government will continue to lead the investment spending.

Net exports continue to exert a drag on headline growth as import growth remains higher than exports. Continued domestic demand recovery drove higher imports while slowing global growth has caused export growth to fall. In Q2 FY23, the merchandise trade deficit widened to $80.2 billion from $68.3 billion in the previous quarter as exports were affected due to the imposition of windfall taxes on fuel products and slowing demand from key export destinations due to weaker economic prospects. In the first half of FY23, the merchandise trade deficit almost doubled to $148.5 billion from $76.2 billion a year ago during the same period.

Govt on track to achieve its deficit target; CAPEX remains supportive of recovery



Source: CMIE; Budget Documents

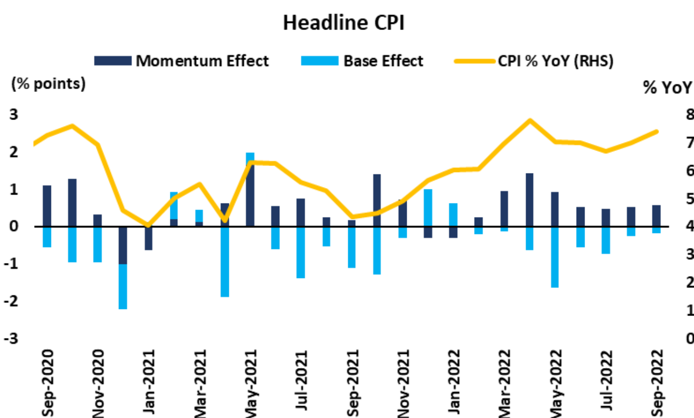
The government spending for FY23 is on track with the full-year targets, supporting overall economic growth. Central government expenditure reached 35.2% of the full-year budgeted estimate in the first five months of FY23, lower than the pre-COVID five-year average of 42.4%. Expenditure so far is being driven by capital expenditure which has grown by 46.8% YoY in April-August owing to the government's strong push towards infrastructure spending to support economic recovery. On the other hand, revenue expenditure has grown by a much sombre rate of 3% YoY during the same period. That said, the extension of the food security scheme for another three months until December and the payment of the recently announced dearness allowance are likely to prop up growth in revenue expenditure over the next few months. Meanwhile, the central government receipts grew by 4.9% YoY, driven by a healthy growth in gross tax revenue of 18.7% YoY in the first five months of FY23. Fiscal slippage risks for FY23 have eased, with higher-than-expected revenue growth and broadly on-target expenditure growth.

The RBI continues to front-load rate hikes amid the elevated inflationary landscape

With the domestic growth largely holding up in the face of prolonged global headwinds, the policy focus remained on a calibrated monetary policy withdrawal to keep the inflationary expectations anchored and contain the second-round impact. Accordingly, the RBI, in its recent Monetary Policy meeting, continued the front-loading of the rate hikes as it announced a rate hike of 50 bps taking the policy rate to 5.90% amid the heightened financial volatility and aggressive monetary policy action globally, intensification of global recessionary fears, and persistently elevated domestic inflationary pressures. The market was divided on the quantum of the hike, but the aggressive rate hike by the US Fed and the simultaneous forward guidance for the higher terminal rate may have had some leaning in the RBI's decision to go for the 50-bps rate hike given the implications for the yield differentials and pressures on the domestic currency. Further, the RBI left its stance unchanged to "focus on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth". Justifying no change in the stance, the RBI governor noted that the inflation-adjusted policy rate continues to remain negative, and the systemic liquidity remains in surplus mode. This contrasts with 2019 (when the stance was last neutral), where liquidity was in deficit, and the real policy rate was on a positive trajectory. While the outcome of the meeting was largely on expected lines, what was more interesting was that the decision for both the quantum of the rate hike and the stance came with one member dissenting. On the one hand, Dr. Ashima Goyal voted for a 35-bps hike citing the lagged effects of the monetary policy, and for India, an overreaction can be harmful, while Prof. Jayanth Varma voted for a neutral stance as he is of the view that MPC should pause rather than focus on tightening. Both the dissenting members seemed aligned on their view about the current policy rate being closer to the terminal rate. Although not much can be gauged regarding the future guidance from the minutes of the meeting, diverging views of the external members on the pace of policy normalization could see two members voting for a pause in the December policy. Keeping

the current global developments in mind, we now revise our expectation of the terminal rate to 6.5% from 6.0% earlier.

Headline inflation surged to 7.4% in September, led by the waning of the base effect and an uptick in food inflation



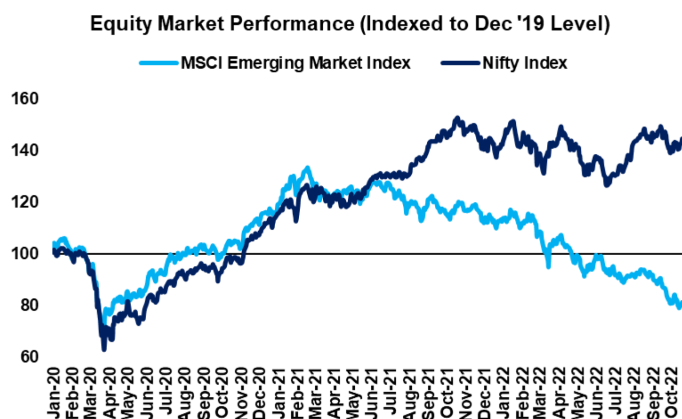
Source: CMIE

Strengthening the case for the RBI's tightening stance is the headline inflation print of 7.4% in September compared to 7.0% in the prior month. The headline inflation has remained above the RBI's upper threshold for the ninth consecutive month, placing the Q2 FY23 average at 7.0%, marginally lower than the RBI's forecast of 7.1%. The surge in inflation is primarily led by the tapering off of the favourable base effect and the acceleration in food inflation. Food & beverage inflation quickened to 8.4%, up from 7.6% in August, on the back of the rising price of vegetables and cereals due to erratic rainfall distribution and delayed monsoon withdrawal. Meanwhile, in tandem with the moderating oil prices, the fuel & light inflation noted a slight moderation but continued to be in double-digit levels (10.4% in September v/s 10.8% in August). As we highlighted in our previous monthly monitor of July, the upside risks to the services inflation have started materializing with the strengthening of the demand reflected in the uptick of the core inflation from 6.0% in August to 6.2% in September. Furthermore, an analysis of 299 items of the CPI basket revealed that the share of items with inflation above 6% increased from 46% in June '22 to 55% in September '22, reflecting the broadening of the inflationary pressures. While the upside risks to the food pressures are likely to remain in October due to seasonal factors, more firm moderation is expected from November/December onwards. Additionally, the favourable base effect and the easing of the input price pressures reflected in the further decline of WPI from 12.4% in August to 10.7% in September will aid in the softening of inflation. However, the upside risks from the strengthening of services inflation and imported inflation are likely to persist. Overall, we expect inflation to be in the vicinity of 6.8% for FY23.

Market Update

Indian bond market recorded volatility in September though the average 10-year G-Sec yield changed marginally on a sequential basis. The 10-year benchmark yield averaged 7.23% in September, only marginally lower than the 7.26% in August. The moderation in global oil prices, easing of inflation, an expectation of no change in the government borrowing calendar and the anticipation of India's inclusion in international bond indices kept the yields in check. However, the benchmark yields hardened across the yield curve following the Fed meeting, which indicated aggressive forward guidance. Further, the RBI's continued front-loading of the rate hikes in the latest monetary policy meeting, postponement in the inclusion of Indian government bonds in the emerging market bond index by JP Morgan, high inflation print, and the renewed rise in oil prices have kept the yields elevated. As such, the 10-year benchmark yield has increased by 20 bps to an average of 7.43% (data till October 18) from 7.23% in September. Meanwhile, the 1-year benchmark yields have increased by 35 bps (from 6.44% to 6.79%) during the same period leading to the narrowing of the 10-yr and 1-yr spread from 79 bps to 64 bps. On the liquidity front, systemic liquidity has been declining but has managed to stay in surplus as it stood at Rs 14.7K crores (data as of 18th October). Both the moderating liquidity and the tightening of the interest rates have put upward pressure on the money market rates. As such, the weighted average call rate has firmed up to 6.06% compared to 5.02% at the beginning of September. Going ahead, yields will likely remain range-bound in the near term, and global cues and incoming inflation data will influence further direction.

Indian equity markets ahead of other emerging markets

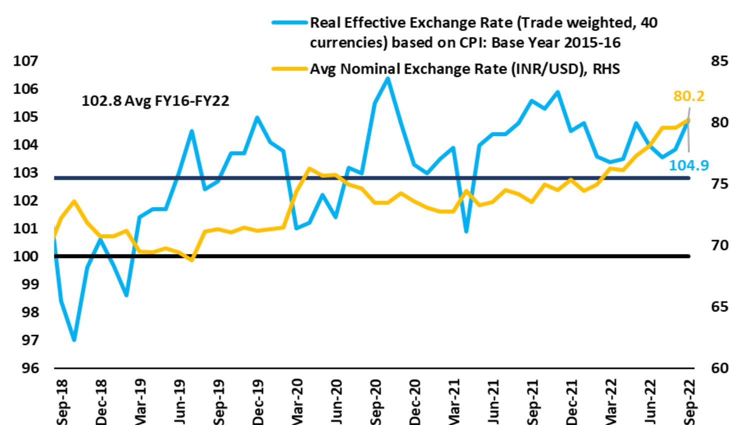


Source: CMIE

The equity markets have come under pressure again since the US Fed hiked its policy rate by 75 basis points on September 21 for a third consecutive time, which turned the sentiment on emerging markets sour once again. By September end, the NIFTY had fallen by 3.7% MoM while the

Sensex fell by 3.5%, partially wiping out the gains seen over July-August. While foreign portfolio investors had continued to invest in Indian equity markets in the first half of September, the Fed meeting triggered a selling spree resulting in flows being reversed. As such, US$ 1.6 billion worth of FPI outflows were recorded in September. Foreign investors have pulled ~US$ 0.8 billion of additional capital from the Indian equity markets in the first half of October. However, domestic institutional investors have continued to pump-in funds into the equity market. As such, the NIFTY gained 2.3% in October (until the 18th). Overall, the Indian equity market (reflected by the NIFTY index) was higher by ~44% (till October 18) compared to pre-COVID levels (December '19 average), outperforming other emerging markets (MSCI EM index at ~20% below pre-COVID levels). However, the valuations in the Indian equities market have remained higher than its peers, making the domestic market more susceptible to corrections. The outlook for the market remains volatile in the face of a rapidly shifting global environment and continued uncertainty over inflation and the pace of monetary policy tightening.

The rupee still overvalued in terms of REER; the depreciatory trend to continue



Source: CMIE

The Indian currency, like other emerging market currencies, had come under depreciatory pressure over the past few weeks owing to the shift of market expectations about US monetary policy since the US Fed meeting on September 21. The markets now expect ~125 bps of further hikes in 2022 and do not expect any cuts next year, meaning the US monetary policy stance is expected to be tighter for longer. This will add to dollar strength which has already appreciated by 18.1% in 2022 (year to date – data till October 19), and place further depreciatory pressure on EM currencies. The Indian rupee has depreciated by 11.7% YTD (4.1% since the September 21 FOMC meeting), more or less in line with other peer currencies breaching the 83 mark and has stayed around that level. In real effective exchange rate terms (September '22), the Indian currency was overvalued by 4.6% (and by 2.1% from its long-term average), meaning the nominal exchange rate would continue to face depreciatory pressure. The RBI is likely to let the rupee depreciate in a gradual and orderly fashion but will continue to intervene in the forex markets to smoothen any excessive volatility as it has done over the past year. The central bank's foreign exchange reserves stand at US$ 532.8 billion (as on October 7), down from US$ 633 billion at the start of the year. Over the next few months, we expect the rupee to trade in the range of 83-85.

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