23 May 2024

India's economic outlook for FY25 remains bright; RBI unlikely to cut before Q3 FY25

- The ongoing resilience in the US economy has helped to keep US inflation at rates that are higher than desired, which has led many global central banks, especially those in less advanced economies, to proceed cautiously given the dominant role US interest rates can have on setting global interest rates and foreign exchange rates.
- Despite the stickiness of US inflation, the Fed continues to see policy as restrictive. As such, should there be a few months of favourable inflation news this summer we would not be surprised to see the Fed adjust rates lower. However, even in such a scenario, the magnitude of easier policy is likely to be limited.
- India's favourable economic performance continues with the latest update. Indicators of both industrial and services sectors continued to exhibit signs of strength over the past quarter and into the current quarter. The one exception to these trends is the agricultural sector, which seems to have remained weak in Q4.
- For FY25 as a whole, economic prospects appear to be bright. Hopes of improved activity in the agricultural sector, lower food price inflation, continued government push on CAPEX, expectations of an upswing in private sector investment and lower political uncertainty post the general elections should bode well for economic growth.
- On the negative side, given slow global growth (except in the US) and a precarious geopolitical environment, there is a risk that exports and FDI flows could be affected, which is likely to have some dampening effect on growth.
- Headline inflation continues to ease despite elevated food inflation, caused mainly by a seasonal rise in vegetable inflation. While we remain confident that inflation will ease in the upcoming months owing to a favourable base effect (till July), continued deflation in manufacturing input prices and moderation in gold prices, the risks from sudden spikes in food inflation will continue to persist in the summer months.
- Given still high food price inflation and with the timeline for rate cuts in the US being pushed back to September, the possibility of the RBI opting for a rate cut earlier than that seems highly unlikely. Therefore, while we retain our view that the rate cuts are likely to happen in the second half of CY24, we now assign a higher probability to a rate cut happening in the final three months of the calendar year v/s in August.

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Caution prevails among global central banks amid a resilient US economy

The US economy's performance in the coming quarters will continue to hold outsized sway on prospects for global economic growth and the potential path of interest rates both in the US and in many countries globally. Among the world's largest economies, the US (along with India) remains one of the persistent standouts, as measured by both absolute performance and relative to its potential (i.e. its trend rate of growth). The ongoing resilience in US economic activity has been a key support for the global economy, especially amidst the geopolitical tensions of the past two years and the effects of monetary tightening throughout much of the world. However, resilient economic activity also has helped to keep US inflation at rates that are higher than desired.

Accordingly, US interest rates thus far in calendar year 2024 have remained elevated, at least by the standards of the post global financial crisis period. The 2Y benchmark bond yields have oscillated in the 4.25% to near 5% range and the Fed's monetary policy rate has held steady at more than 5%. This, in turn, has led many global central banks, especially those in less advanced economies, to proceed cautiously given the dominant role US interest rates can have on setting global interest rates and foreign exchange rates.

Despite sticky inflation, Fed continues to see policy as restrictive

The latest US inflation reading (April) was "less bad" than those reported for the January to March period but still far from something that could be characterized as "good." For April, US core CPI increased by 0.3% MoM but still is rising by roughly 4% on a six-month annual percent change basis. As we have written in prior Monthly Reports, core CPI inflation on a six-month annual percent change basis likely needs to be trending definitively toward 3% to 3.25% for there to be confidence that realized inflation is tracking back toward the US's medium term inflation target.

Despite the stickiness of US inflation, Federal Reserve Chairman, Jerome Powell, remains biased toward lower interest rates and in a manner that is hard to square with either economic reality and/or much of the Chairman's own assessment of the US economy. For instance, Mr. Powell continues to characterize the economy, both contemporaneously and prospectively, as strong with favourable trends in wage growth, corporate profits, and other sensitive leading economic indicators. Yet, he continues to emphasize that monetary policy is restrictive.

We suspect that Chair Powell and the Fed leadership are fixated on the notion that because US interest rates are their highest in 23 years and increased rapidly they must be restrictive. But the level of interest rates, in and of itself – especially nominal interest rates – is irrelevant for judging monetary policy's restrictiveness (or lack thereof). Rather, what matters is the intersection of broad financial and credit conditions and macroeconomic performance. On this score, the general sweep of financial conditions (equities, credit cost and availability, rates, liquidity, lending terms, and standards) are more stimulative today than they were at any point in 2023 or 2022. Moreover, the most interest rate-sensitive sectors such as housing are not in distress; while these sectors are not supporting economic growth at present, neither are they dragging the pace of activity, which typically is the case when monetary policy is clearly restrictive.

As has been the case for the past 2.5 years, we continue to judge that US inflation will prove stickier than anticipated by the Fed, the market, and prognosticators. We do not see convincing signs that monetary policy is restrictive; financial conditions are not an impediment to economic activity; service sector inflation is unlikely to cool materially absent a softer labour market, which leading indicators do not suggest is imminent in the period ahead.

A summer Fed rate cut not ruled out

Nonetheless, this is a Fed whose Chairman is biased heavily toward lower interest rates vis-à-vis prevailing rate levels. This also is a Fed that has misjudged inflation prospects repeatedly since mid-2021, including the 'inflation pressures will be transitory' debacle. As a result, should there be a few months of favourable inflation news this summer – e.g. a couple 0.2% MoM core inflation readings even if those are 0.2% readings that round down – we would not be surprised to see the Fed adjust rates lower. However, even in such a scenario, the magnitude of easier policy is likely to be limited absent a markedly higher unemployment rate and/or pronounced slowing in the pace of economic activity, neither of which underlying macro fundamentals point toward.

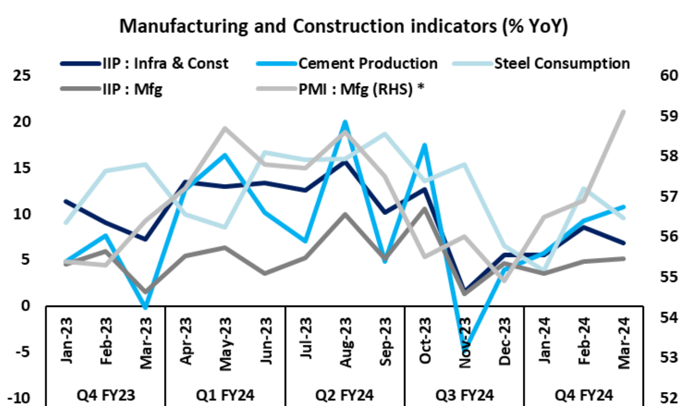
Economic growth remained strong in Q4 FY24; slight moderation in pace expected

India's favourable economic performance continues with the latest update (Q4 FY24; Jan-Mar 2024) likely to show a continued rapid pace of GDP growth when the data are released on 31st May. Indicators of both industrial and services sectors continued to exhibit signs of strength over the past quarter and into the current quarter. The one exception to these trends is the agricultural sector, which seems to have remained weak in Q4.

Production in the manufacturing sector grew by 4.5% YoY in the quarter ended in Mar-24, slightly slower compared to the 5.3% growth in Q3. Among major manufacturing sub-sectors, metals, motor vehicles, and transportation remained strong and led manufacturing growth. Manufacturing of

electrical equipment also improved in Q4 (from a mild contraction in Q3). Meanwhile sectors like food manufacturing, chemicals and textiles continued to lag. Growth in manufacturing of coke and refined petroleum fell flat in Q4 compared with 7% growth in Q3. Based on the corporate results preliminary data, net sales growth of the manufacturing sector improved to 4.1% YoY in Q4, up from 1.7% in Q3 and a contraction in H1 FY24. Activity in the construction sector likely remained strong as evidenced by quicker growth in IIP infrastructure and construction goods as well as cement production and steel consumption. Early indicators from April like the manufacturing PMI and steel consumption suggest that momentum in these sectors is likely to continue into FY25.

Major industrial sector indicators remained robust in Q4



Source: CMIE; Note: * PMI data is an index. Value above 50 indicates expansion.

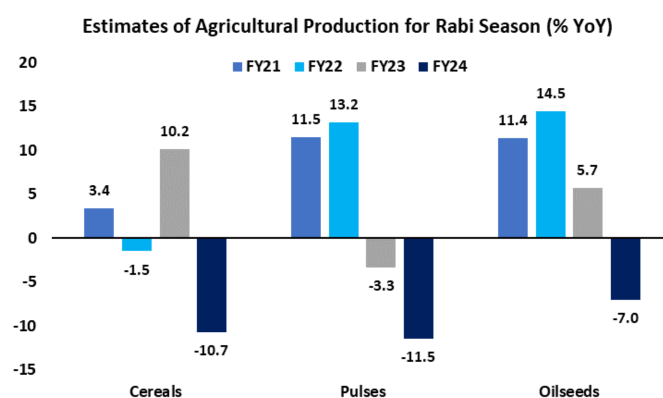
Services performance mixed; some trade and transportation indicators suggest moderation

Services Indicators (% YoY)							
	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24
Air Cargo Handled	13.1	6.6	10.8	15.5	22.6	17.3	
Railway Freight	8.5	4.3	6.4	6.4	10.1		
GST E-way Bills Generation	30.5	8.5	13.2	16.4	18.9	13.9	14.5
Air Passenger Traffic	10.7	8.7	8.1	5.0	5.8	4.7	
NETC Volume	13.0	12.3	13.0	10.2	12.1	10.6	7.6
Hotel Occupancy (%)	63%	63%	70%	67%	73%	64%	
Services Exports	10.9	4.4	1.4	10.8	3.5	-1.4	14.7
First Year Life Insurance Premium	7.6	-25.3	43.8	27.0	48.4	15.6	61.2
Govt Revenue Expenditure	-13.8	-16.1	-5.5	-6.2	0.8		

Source: CMIE; HVS Anarock

Services sector indicators continue to exhibit strength albeit with some bit of moderation in the rate of growth. Trade, transport, travel and hotel indicators seem to be leaning towards improvement between Q3 and Q4 although growth of air passenger traffic and toll collections moderated. Banking and insurance sector activity remains robust with strong credit, insurance premium growth, and healthy profitability based on Q4 financial results. Furthermore, momentum in real estate services and professional services is expected to have been sustained based on growth in leasing activity and sales from reports by market experts[1]. Services sector outlook for Q1 FY25 appears bright given that momentum in major sub-sectors seems to be sustaining according to early indicators for April and continued favourable fundamental underpinnings.

Agriculture sector growth likely held back by crop cultivation



Source: CMIE

Conversely, activity in the agriculture sector likely remained weak in Q4 given tepid sowing activity and low reservoir levels. According to the second advance estimates of agricultural production, the overall foodgrains production in the Rabi season is likely to have been ~11% lower than last year, while oilseeds production could be ~7% lower. According to CMIE, the employment in crop cultivation which accounts for 80% jobs in the agriculture and allied sectors fell by 5% YoY in Q4. That said, employment in the overall agriculture sector was 1% higher YoY due to shift of labour from crop cultivation to plantation, fruits and vegetables farming, poultry farming, animal husbandry and vermiculture and other agriculture allied activities. As such, we expect some bit of slowdown in activity due to crop cultivation to be offset by improvement in other agricultural activities. The sector's outlook for Q1 FY25 seems positive with higher summer crops acreage, development of La Nina conditions and the expectation of normal monsoon rainfall which should bode well for the Kharif crops season.

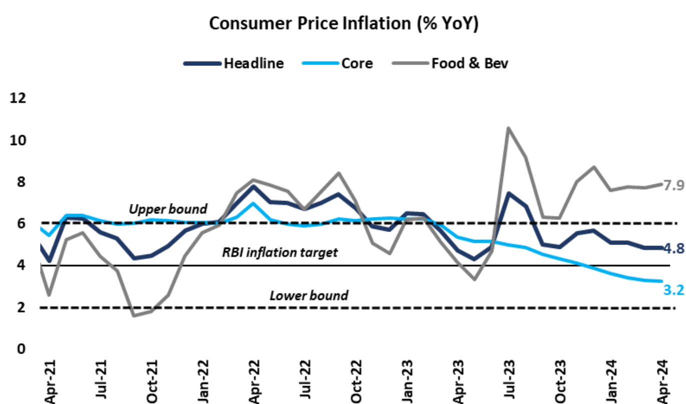
For FY25 as a whole, economic prospects appear to be bright.

- Hopes for improved activity in the agriculture sector coupled with the expectation of a moderation in food price inflation bodes well for consumption growth particularly for the rural consumers where consumption has lagged urban.

[1] Based on Q4 FY24 market assessment reports by Savills and Knight Frank.

- Government CAPEX will remain the main driver of investment growth, given that share of the private sector in investment project completions remained at a three-year low of 36% in FY24.
- That said, conditions are prime for a revival of private sector CAPEX. The share of the private sector in investment announcements remains very high at 84%. This coupled with rising capacity utilisation, favourable corporate profit trends, strong corporates' and banks' balance sheets, expectation of rate cuts, and lower market borrowings by the government point to an impending private sector investment upswing.
- Easing of political uncertainty after general elections in June should help to boost investor and business confidence due to continuity of public policy.
- On the negative side, given slow global growth (except in the US) and a precarious geopolitical environment, there is a risk that exports and FDI flows could be affected which is likely to have some dampening effect on growth.

Headline inflation inched down further in April



Source: CMIE

Consumer price inflation softened further to an 11-month low of 4.83% in April from 4.85% in March. The marginal decline in the headline print was led, very importantly, by continued cooling in core inflation and deflation in fuel component. These developments offset the uptick in food inflation. Food & Beverages inflation remained elevated at 7.9% in April, slightly inching up from 7.7% in the prior month. In contribution terms, food inflation continues to be led by the vegetables category (which is contributing ~50%). Excluding vegetables, the food inflation stood at 5.2% YoY, lower than the average of 5.9% in FY24. Daily data for the vegetable prices (data till 19th May) indicate a further sequential pick-up owing to the summer months and is expected to weigh on inflation in May. Apart from vegetables, inflation in cereals and pulses also remained elevated in April at 8.6% and 16.8% respectively and the daily data suggest the trend will likely continue in the current month. Helping to limit these specific price pressures, the government's stock of wheat and rice is tracking above the stocking norms. Looking past the summer months, food price inflation should ease given the expectation of a normal monsoon, which should bode positively for the upcoming Kharif season. However, the spatial and temporal distribution of the rainfall will play a crucial role in determining food inflation.

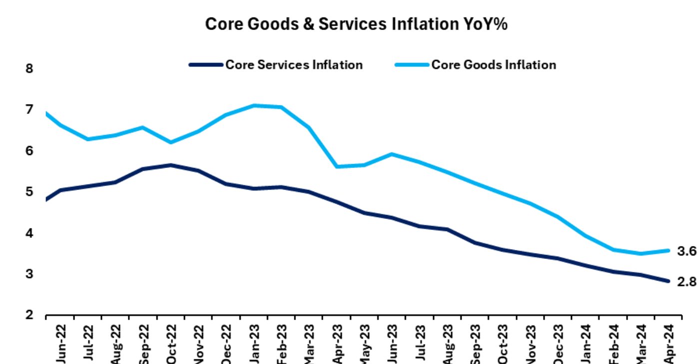
Daily vegetable prices remain elevated; Cereal and pulses price show no sign of easing

Daily Prices of Food Articles (% change, YoY)								
	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24
Cereals	3.4	4.1	3.7	2.4	2.2	7.4	8.5	8.3
Pulses	14.4	15.7	16.5	15.9	15.8	15.6	14.6	14.1
Oil	-13.9	-14.9	-14.1	-13.6	-12.3	-10.7	-8.3	-7.0
Potatoes	-13.7	-13.2	-7.7	-1.7	5.3	22.0	38.9	39.4
Onions	36.6	90.6	82.6	41.3	28.9	40.1	41.4	42.2
Tomatoes	-35.4	3.6	28.4	31.8	38.2	36.2	40.4	37.9
Vegetables	-9.9	26.1	35.1	24.8	24.9	33.4	40.3	39.8

Source: CMIE; Note: May data is based on average of daily prices until the 19th.

Deflation in the fuel and light component deepened further to 4.2% from 3.4% in the previous month supported by lower LPG prices. The moderation in LPG prices is likely to keep the segment in deflationary territory in the upcoming months, helping to offset the effect of food prices on consumers' general purchasing power.

Pick-up in goods core inflation was offset by the decline in services inflation owing to moderation in transportation inflation



Source: CMIE; Note: DMI Calculations

Encouragingly, core inflation remained on a downward trend as it printed at 3.2% vs 3.3% in March. This marked the lowest rate of core inflation since the pandemic. The moderation was led by core services inflation which eased from 3.0% in March to 2.8% primarily due to the decline in transportation prices due to a reduction in retail petrol and diesel prices (announced in mid-March). On the other hand, core goods inflation while remaining subdued accelerated

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slightly to 3.6% (vs 3.5% in March), reflecting the impact of higher gold prices.

For the outlook ahead, while we remain confident that inflation will ease in the upcoming months owing to a favourable base effect (till July), continued deflation in manufacturing input prices and moderation in gold prices, the risks from sudden spikes in food inflation will continue to persist in the summer months. However, post that, the anticipation of normal monsoon should bode well for the food inflation. Moreover, with core inflation pressures dissipating, the risk of a pass through of higher food prices to the generalized price level is very low. Overall, for FY25, headline inflation should print close to the RBI's projection of 4.5% assuming normal monsoon and moderate commodity prices.

Implications for Monetary policy

From the policy perspective, the still elevated food inflation implies that the RBI will likely continue to sound cautious in their communication in the upcoming monetary policy meeting in June. Strong domestic growth along with cooling of the crude oil prices will provide the policy space to remain on pause in June. Based on the minutes of the previous meeting the MPC members will likely wait and watch the progress of the southwest monsoon to judge its impact on the food prices. Further, with market expectations of the Fed rate cut being pushed out to September and our own judgmental assessment seeing September or November as the earliest possible timing for lower US policy rates, the RBI opting for a rate cut earlier than that seems highly unlikely.

As such, we are of the view that the RBI is likely to remain on a pause even in its August monetary policy meeting, contingent on the expectation that the US Fed maintains status quo as well. Therefore, while we retain our view that the rate cuts are likely to happen in the second half of CY24, we now assign a higher probability to a rate cut happening in the final three months of the calendar year v/s in August. Further, we continue to believe that the room for substantial cuts will be limited in FY25 given that headline inflation is expected to accelerate again towards the end of the year.

Market Update

- **Bond Market:** Indian bond yields fluctuated in April with benchmark 10-year yields rising from 7.06% at the start of April to 7.23% by April 19th. The rise in yields was fueled by heightened geopolitical tensions in the Middle East and rising US treasury yields owing to stronger inflation. Following a couple of face-saving tit-for-tat exchanges between Israel and Iran, tensions fizzled out bringing some calm to the markets in late April. Yields fell further following the Fed's decision to maintain interest rates at its May 1st meeting and weaker-than-expected economic data in the US. Lower global oil prices and domestic factors like continued disinflation also likely contributed to downward the pressure on yields. Further, the cooling of inflation in the US in April aided the softening of domestic yields. By May 21st, the Indian 10-year G-sec yield had declined by 11 bps from the start of the month, while the US 10-year Treasury yield decreased by 27 basis points during the same period.

- **Equity markets:** Indian equity markets ended in green in April despite heightened uncertainty on account of rising tensions in Middle East. This was largely due to the strong corporate earnings of the banking and the auto sector. However, volatility returned in the market in May owing to heightened political instability due to the ongoing general elections. The market was supported by the domestic investors as Foreign institutional investors (FIIs) were cautious amidst persisting global uncertainties and ongoing elections in India. FII outflows increased from Rs.86.7 billion in April to Rs. 282.4 billion in the first half of May. Overall the index was down 0.3% by May 21st compared to the start of the month. Looking ahead, the conclusion of general elections is likely to improve political stability and reduce volatility in the markets. However, concerns regarding stretched valuations of Indian equities, further delays to the start of monetary easing cycle and episodes of heightened geopolitical instability could inhibit gains in the domestic equities.

- **Currency market:** The Indian rupee remained relatively stable compared to other EM currencies during April and the first half of May, averaging Rs 83.4/US$1 over this period. This stability can be attributed to the RBI's intervention aimed at smoothening excessive volatility. The US dollar index (DXY), which measures the US$ value against a basket of six major currencies – the Euro, Swiss Franc, Japanese Yen, Canadian Dollar, British Pound, and Swedish Krona – experienced a fair bit of volatility. It peaked at 106.3 in mid-April, driven by wider geopolitical tensions and stronger than anticipated inflation data for March (released in mid-April), before easing to 104.7 by May 21st. Weaker economic data, such as lower sales and higher unemployment figures in the US, coupled with softening of US inflation bolstered expectation of a rate cut later in the year and led to the dollar's weakening trend. Despite heightened volatility from

geopolitical strains and FII outflows, the rupee remained relatively stable. Looking ahead, the pressure on the exchange rate could ease following the conclusion of the general elections. However, sustained FII outflows and fluctuations in global oil prices, which have recently moderated, pose potential risks and remain a cause for concern. Strong forex reserves of RBI mean that the exchange rate will continue to be tightly managed to smoothen any excess volatility.

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