28 June, 2024

Growth in Q4 beats expectations, but consumption revival is key for FY25; RBI holds rates amidst elevated food inflation

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- Various advanced economy central banks have started cutting rates in recent weeks. However, these actions have been accompanied by uncertainty and a lack of clear rationale, suggesting a tentative rather than strategic approach to monetary easing.
- The Fed, on the other hand, was more hawkish, reiterating that the economy remains strong and emphasizing the need for more favourable inflation data to boost officials' confidence that inflation would return to target levels. Consequently, the dot plot now indicates the possibility of only one rate cut in 2024, down from three projected in March.
- However, there are emerging signs of a softer labour market, including rising unemployment and mixed employment measures. If these trends continue, they could pave the way for easier monetary policy in the US, even if inflation remains stubborn.
- Domestically, real GDP grew by 7.8% in Q4, driven by robust investments, as growth in private consumption was muted. Improved rural demand resulting from a good monsoon and lower inflation could support consumption in FY25, pending a sustained labour market recovery.
- Government-led investments were pivotal in driving economic growth in FY24, particularly in sectors like infrastructure and logistics. Ongoing government support and fiscal measures are expected to sustain growth in FY25, while the recovery of the private sector hinges on steady consumption trends.
- For the external sector, the total trade deficit was lower in FY24; however, we expect it to increase in FY25 due to strong domestic demand, reduced support from the discounted Russian oil, and mixed exports amidst ongoing geopolitical uncertainties.
- Headline inflation softened to 4.75% in May, driven by lower core inflation and deflation in fuel components. However, persistently high food inflation, especially in vegetables, pulses, and cereals, remains a concern. Looking ahead, the trajectory of food prices will depend on monsoon patterns and global commodity trends amidst geopolitical uncertainties.
- Amidst the robust growth, softening headline inflation, and persistently high food inflation the MPC maintained the status quo in the June meeting with a 4-2 vote split. Looking ahead, we maintain our view that MPC members are likely to monitor the southwest monsoon's impact on food prices before pivoting. We expect the rate cut to begin in Q3 FY25, but with inflation expected to pick up again in H2 FY25, significant cuts may be limited.

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Half-hearted easing? Central Banks send mixed messages

Various advanced economy central banks in recent weeks have begun to tiptoe towards an interest rate cut and/or lowered their respective policy rates, marking the start - albeit tentative - of the long-awaited monetary easing cycle. We write 'tentative' because the largest central banks to have reduced interest rates have done so almost reluctantly and in some cases without a clearly articulated rationale.

To be sure, many central banks' judgment in recent years has been woefully off the mark, having missed the surge in inflation – especially in the West – and then having failed to appreciate that the root causes of the inflation surge did not lend themselves to being transitory, to borrow a phrase. Hence, cautiousness is understandable. But policy cycle inflection points – be the initial rate increase or decrease – tend not to have a half-heartedness to them but rather tend to be part of a strategic, forward-looking plan (even if that plan ultimately proves incorrect).

The European Central Bank's (ECB) 25bps reduction in its main policy rate earlier this month underscores this apparent lack of a strategic, forward-looking plan. At the press conference discussing the policy action, ECB President Lagarde noted, "We will keep policy rates sufficiently restrictive for as long as necessary…are we today moving into a dialing-back phase? I wouldn't volunteer that," stoking the question of why the ECB loosened monetary policy at all.

In addition to the ECB, the Bank of Canada (BOC) began to ease policy in June by lowering its policy rate by 25bps. The Swiss National Bank (SNB) also cut its policy rate by 25bps in June, marking its second-rate reduction of the cycle. The Bank of England (BOE) held rates steady in June, but its accompanying policy statement suggested that the BOE gradually was becoming more comfortable with beginning to ease policy in the months ahead, possibly as early as August.

Fed trims rate cut expectations for 2024

Despite these developments, the 2024 outlook for interest rates from the world's most important central bank, the US Federal Reserve, remains unchanged from our previous assessment. The Fed's latest policy meeting and Chair Powell's accompanying press conference on June 12th largely reiterated the Fed's previous assessments of the economy and the developments policymakers deem necessary to begin lowering interest rates. Namely, that the economy remains in a strong position, that the latest (May) consumer price inflation data were positive, but that considerable additional favourable inflation data still were needed to provide officials with their desired confidence that inflation was headed back toward the target. In short, lower interest rates remained possible in calendar 2024 but officials themselves have little, if any, confidence in the prospective timetable.

On this score, Fed policymakers in aggregate trimmed their expectations for lower rates in 2024. In March, the median expectation among officials was that rates likely would decline by 75bps this calendar year. In June, officials' median projection was for just a 25bps reduction in rates. Some of the previously anticipated 2024 rate cuts were postponed to 2025, reflecting a prevailing sentiment of "higher for longer."

Fraying at the Edges: Signs of Softening US Labor Market?

However, for the first time in this business cycle, we observe some tentative developments that – should they progress further – would enhance the case for a somewhat easier monetary policy in the United States. This would likely be the case even if inflation remains somewhat sticky (i.e. improves only slightly from prevailing rates / does not worsen from current rates) given that inflation is a lagging indicator.

Specifically, there are some signs of fraying on the edges of the labour market that – again, should they progress – historically have been leading indicators of a softer labour market and, eventually, more modest nominal wage and price trends. These developments include:

- The 60bps rise in the unemployment rate to a new cycle high of 4% is notable. While still low, historical experience is such that a 50bps increase in the unemployment rate from its cyclical low typically signals a labour market where the pace of hiring, wage growth and general employment opportunities becomes less plentiful over the ensuing 12 months.

- The breadth of job gains is narrowing and there is a growing divergence between the two main US based employment measures (payroll and household survey). Such developments typically presage more muted employment trends.

- The percentage of employed people working multiple jobs continues to creep higher. This measure has risen by 50bps from its low, and a steady increase often suggests that a worker's primary job isn't providing sufficient income, leading them to seek additional sources of compensation.

- The quit rate – the percentage of workers voluntarily leaving their job for a position at a different firm – continues to trend lower and is now below the quit rates that prevailed at the peaks of the prior two business cycles. A falling quit rate indicates (1) greater risk aversion by employees, typically because workers believe that in a challenging economic environment remaining in their current job is more secure than jumping to a new opportunity; (2) reduced hiring by businesses; (3) greater cost control by businesses, since moving voluntarily from one employer to another is the greatest source of employee compensation increase.

- Weekly jobless claims appear to have inflected somewhat higher. The absolute number of new filers for unemployment benefits remains low, but the shift higher since early May appears to represent a modest, durable pickup in the pace of layoff activity. Moreover, continuing claims, that the stock of individuals receiving unemployment benefits, is not declining, implying that laid-off workers are having a challenging time being rehired post-layoff.

Nonetheless, it remains our judgment that the ultimate scope for interest rate reductions by the Fed (and the aforementioned central banks, with the exception of the SNB given the low rate of inflation in Switzerland) will be relatively limited. We continue to see similarities to the mid-1990s interest rate cycle, which is often characterized as a mid-cycle policy adjustment. This refers to an adjustment in monetary policy against a backdrop of solid cyclical fundamentals and favourable productivity developments that helped to smooth out some rough edges of the economy following the Fed's three percentage point (300bps) rate hiking campaign from February 1994 to February 1995.

Indian economic activity remained resilient in Q4 FY24; growth expected to moderate in FY25

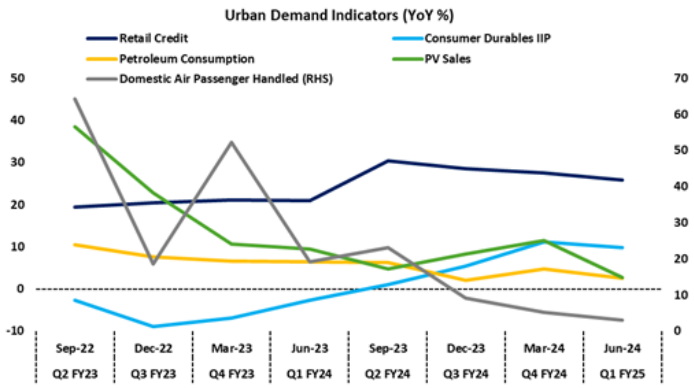
Economic growth in India remained robust amidst continued geopolitical turbulence. In Q4 FY24, the economic growth outpaced the market expectations as real GDP grew by 7.8% - slightly moderating from 8.6% in the previous quarter driven by the continued strong performance of the investment and turnaround in the net exports (contribution to growth turned positive in Q4). The impact of the higher net indirect taxes (due to falling subsidies) kept the real GDP growth buoyant. Meanwhile, the real GVA growth – which gives a more accurate description of the momentum of economic activity grew by 6.3% in Q4. Overall, FY24 real growth printed at 8.2% YoY reflecting the solid macroeconomic fundamentals of the country.

Based on high-frequency data, economic momentum slowed slightly in April-May amidst the elections and heatwaves - which is largely temporary. Looking ahead, while we expect the pace of growth to moderate in FY25, India is likely to remain the fastest-growing major economy in the world, owing to its continued favourable macro fundamentals.

Private consumption muted in FY24; FY25 outlook optimistic, however, an improved labour market crucial for a pick-up in demand

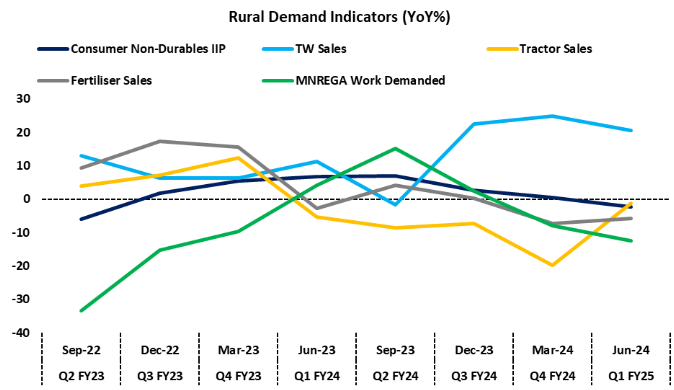
Private consumption growth was muted in FY24 as it grew by 4.0% slowing from 6.8% in the previous year due to a normalising base, high food inflation, uneven labour market recovery and subdued rural demand due to the agricultural slowdown from an uneven monsoon. Early signals from indicators of urban consumer demand suggest tempering in the pace of growth in Q1 FY25 with growth moderating in passenger vehicle sales, air passenger traffic, and petroleum consumption – which could very well be a result of rising temperatures leading to reduced mobility. Meanwhile, the rural demand indicators paint a mixed picture with improvement observed in tractor sales, strong two-wheeler sales and continued contraction in employment demanded under MNREGA. On the other hand, the consumer non-durable output contracted in April.

High-frequency indicators for urban demand suggest a moderating pace of growth



Source: CMIE; Note: Data for Q1 is based on April-May

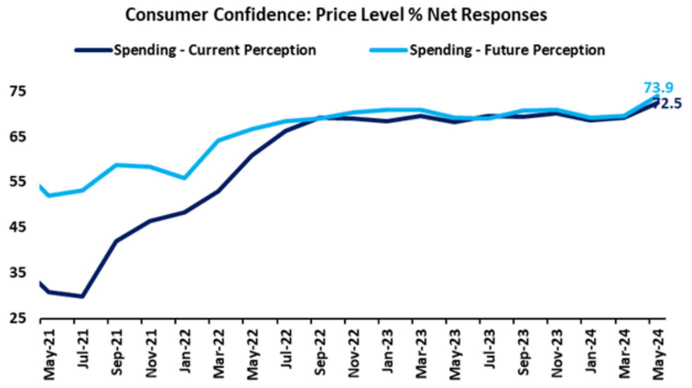
Early signs of rural demand revival?



Source: CMIE; Note: Data for Q1 is based on April-May

While the evolving high-frequency data for April-May suggest a more muted pace of growth immediate term, we expect demand to improve in FY25 due to the following factors. Firstly, the expectation of above normal monsoon should bode well for the agricultural sector which in turn will aid the rural demand. And secondly, the softening of inflation, particularly the food inflation again due to above-normal monsoon augurs well for the overall consumption spending via improved real purchasing power. The optimism around consumption is also reflected in the latest round of RBI consumer confidence surveys showing a larger number of respondents expect the spending to increase vis-à-vis the previous round of the survey. Having said that, a sustained recovery in the labour market will be crucial for a pick-up in demand growth. The incomplete recovery of the labour market is reflected in the trailing levels of labour force participation and employment rate (sourced from CMIE) from their pre-COVID averages. The government could potentially take some steps in the upcoming budget session to increase job opportunities in both rural and urban areas.

Urban consumer confidence improves in the latest round of RBI's consumer confidence survey

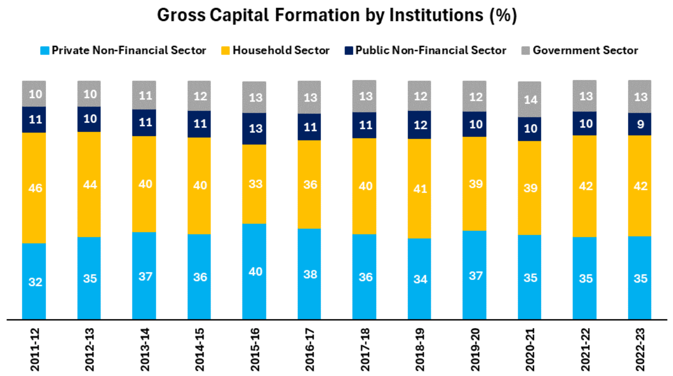


Source: CMIE

Investment drove economic growth in FY24 owing to the government's capex spending; government support expected to continue in FY25

Investment was the main driver of economic growth in FY24 as it grew by ~9.4% and contributed over 40% to the real GDP growth. Investment activity in the post-pandemic period has been led by the government sector given the government's focus on infrastructure development and logistics improvement. Indeed, the government's capital expenditure to GDP reached almost a nineteen-year high of 3.2% in FY24. Further, the upbeat momentum in the real estate sector also supported the investment activity. Based on the data for FY23, the share of household investment in the gross fixed capital formation has increased from 39% in FY20 to 42% in FY23. The trend has likely continued in FY24 indicated by robust housing credit demand. Meanwhile, the share of private investments has declined from ~37% to 35% during the same time. The broad-based signs of revival in private investments were missing in FY24 as the elevated cost of borrowings, uncertain geopolitical landscape and uneven consumption demand held back the private investment growth.

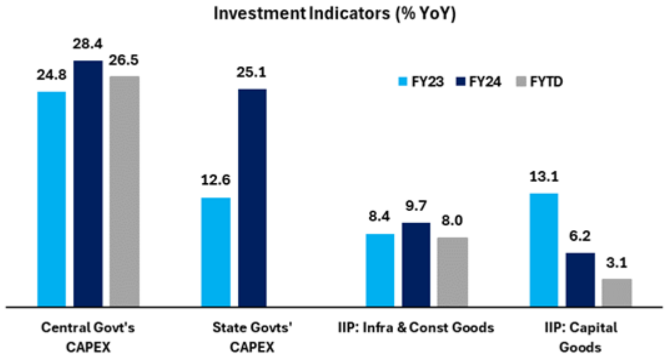
Share of household investments increasing gradually



Source: CMIE

Evolving high-frequency data for April suggests investment spending has likely moderated slightly. For the outlook ahead, the support from the government towards investment growth is expected to continue. Further, the exorbitant dividend transfer from the RBI provides the fiscal space of 0.3% of GDP which can create room for additional capital spending. For the private sector, while the increasing capacity utilization and robust twin balance sheet of the bank and corporate sector bode well for the outlook, a sustained recovery in consumption is essential for a broader pick-up in private investments.

Investment-related indicators suggest slight moderation at the start of FY25

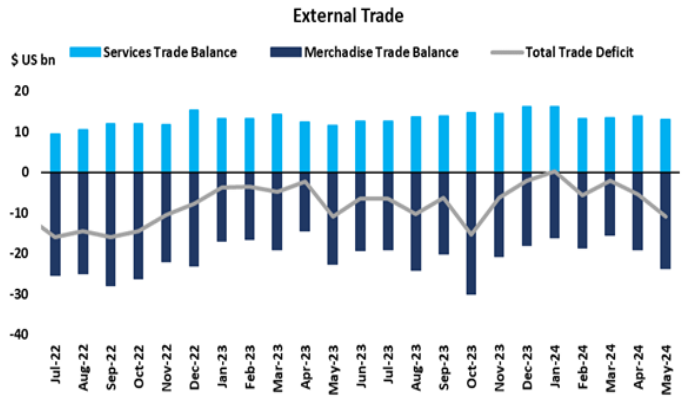


Source: CMIE; Note: FYTD data is based on April. States data is based on 26 States & UT and data for them is not available for April'24.

Drag from the external sector turned positive in Q4 FY24; trade deficit expected to increase in FY25

The drag from the external sector turned positive in the final quarter of FY24 after ten consecutive quarters. Overall, for FY24, the combined trade deficit stood at US$ 79.3 bn, lower than US$ 122 bn in the previous year led by moderation in the trade deficit as the services surplus grew due to expansion in services exports (~5%) while services imports contracted (~2%). For the first two months of FY25, the trade deficit widened from ~US$ 37 bn in the previous year to ~US$ 43 bn as import growth of 9% surpassed export growth of 5%. The higher imports are being led primarily by crude oil imports tracking both higher prices and volumes. Meanwhile, the services surplus remained robust growing from US$ 22.9 in Apr-May FY24 to US$ 26.6 bn in FY25. While the services surplus grew on a yearly basis, it has been showing some moderation in the past few months, reflecting an improvement in services imports. For the remainder of the year, the trade deficit is expected to increase with a stronger domestic demand while export demand will likely remain mixed amidst continued geopolitical uncertainties and modest growth trends in many large economies besides the United States. Further, the support from the discount oil price from Russia is expected to be missing in FY25, which will weigh on the import bill of the country. Based on the imputed data, for FY24 India imported 33% of crude oil from Russia for US$ 76/pbl and it increased to US$ 83/pbl in Apr'24. The services surplus is also expected to fall with a pick-up in services imports. Overall, the trade deficit is expected to widen in FY25.

Trade deficit widened in Apr-May due to higher merchandise trade deficit

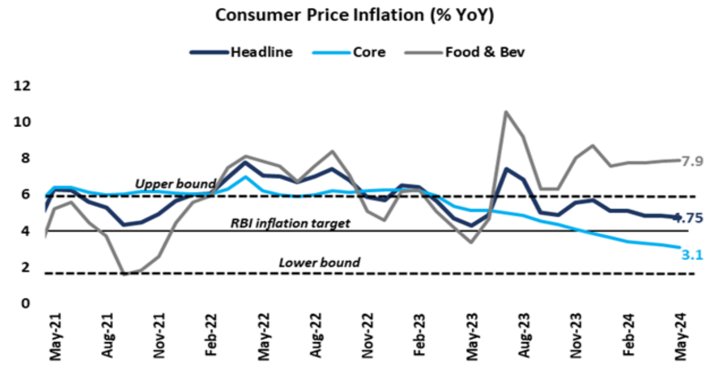


Source: CMIE

Headline Inflation eases slightly supported by continued softening of core inflation while food inflation remains elevated

Consumer price inflation continued to soften, reaching a 12-month low of 4.75% in May, down from 4.83% in April, supported by a consistent moderation in core inflation and deflation in the fuel component. However, food inflation remained high, with food and beverages inflation remaining unchanged at 7.9%. Food inflation is primarily driven by the vegetable category, contributing ~50% to the inflation. Further, inflation in pulses and cereals also remained stubborn at 17.1% and 8.7%, respectively, compared to 16.8% and 8.6% in April. Fruit inflation increased in May, potentially reflecting heatwave impacts, while spice inflation saw significant moderation.

Headline inflation continued to soften supported by easing core inflation



Source: CMIE

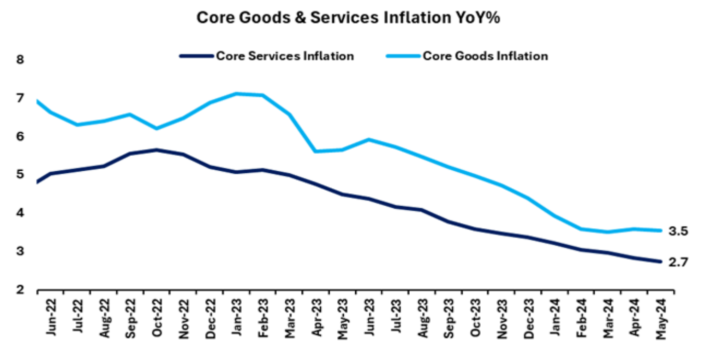
Daily data for vegetable prices (up to June 24th) indicate easing on an annualised basis supported by the base effect. In addition to vegetables, inflation in cereals and pulses, though still high, eased slightly to 8.2% and 14.4% in June from 8.4% and 14.6% in May. This improvement however masks the sequential uptick reflecting the impact of the heatwave. For the next few months, food prices are likely to ease with the progression of the southwest monsoon. However, the spatial and temporal distribution of rainfall will be critical in determining the food inflation trajectory in FY25.

Daily food prices suggest a slight easing in June aided by a supportive base effect

Daily Prices of Food Articles (% change, YoY)								
	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24
Cereals	4.1	3.7	2.4	2.2	7.4	8.5	8.4	8.2
Pulses	15.7	16.5	15.9	15.8	15.6	14.6	14.6	14.4
Oil	-14.9	-14.1	-13.6	-12.3	-10.7	-8.3	-7.1	-4.7
Potatoes	-13.2	-7.7	-1.7	5.3	22.0	38.9	41.7	43.8
Onions	90.6	82.6	41.3	28.9	40.1	41.4	43.4	53.7
Tomatoes	3.6	28.4	31.8	38.2	36.2	40.4	38.7	21.8
Vegetables	26.1	35.1	24.8	24.9	33.4	40.3	41.2	37.4

Source: CMIE; Data till 24th June

Core inflation marked multi-year lows in May



Source: CMIE

Core inflation continued its downward trend, registering at 3.1% in May compared to 3.2% in April, marking the lowest reading since FY2013. This moderation was driven by services inflation, which recorded one of its lowest readings at 2.7% in May, down from 2.8% in April, primarily due to disinflation in the transportation sector. Despite upward pressures from gold prices, core goods inflation softened slightly to 3.5% in May from 3.6% in April led by moderation in clothing & footwear.

Outlook: Looking ahead, inflation is expected to ease in the coming months primarily supported by a favourable base effect (lasting until July). The expectation of a normal monsoon also bodes well for the food inflation outlook. However, the spatial distribution of the same will be critical in determining the food inflation trajectory. Additionally, the risks from the higher commodity prices amidst geopolitical tensions need to be monitored. The commodity price index sourced from the World Bank grew by 5.6% YoY in May suggesting a buildup of price pressures in the global commodities market. Overall, FY25 inflation is expected to be closer to the RBI's projection of 4.5%.

RBI remains on pause in June; rate cut not expected before Q3 FY25

Amidst the robust domestic growth and softening in the headline inflation and still elevated food inflation, the Monetary Policy Committee (MPC) maintained the status quo in both stance and policy rate in the June meeting. The key change in the latest meeting, was the vote split where two MPC members voted to reduce the policy rate by 25 bps and change the stance to neutral, contrasting with only one member previously voting against the consensus. Based on the minutes of the meeting most of the members believed favourable growth-inflation dynamics, i.e. resilient growth and moderating inflation provide the policy space to remain on pause. However, food inflation continues to remain elevated and monetary policy should remain disinflationary to prevent any spillovers from food price pressures to core inflation and inflation expectations. The committee believes that although conditions are improving, risks still exist due to geopolitical factors and recurring incidences of food price shocks.

The two external members who voted for the rate cut viewed the current level of the repo rate as making monetary policy restrictive. At present, the real policy rate is closer to unity (repo rate minus inflation of 5.4% in FY24) which is the neutral policy rate in India. With inflation expected to decline to 4.5% in FY25, the real policy rate will be closer to 2% (repo rate 6.5% minus the inflation estimate for FY25). This will reduce the real growth rate with a lag. Prof. Varma stated that the growth-sacrifice ratio is becoming unacceptably high given the headline inflation is estimated to be only marginally higher than the target (using the FY25 projection of 4.5%).

Outlook: With growth remaining strong and food inflation still sticky at elevated levels we retain our view that the RBI is likely to wait and watch the progress of the southwest monsoon to judge its impact on food prices before pivoting. Although the governor emphasized that the RBI's monetary policy decisions do not "follow the Fed", we believe that monetary policy in the US will continue to influence the timing of a rate cut in India – which is generally the case for most emerging market economies. With market expectations of a Fed rate cut being pushed to September, and our assessment suggesting that September or even November could be the earliest possible timing for lower US policy rates, it seems highly unlikely that the RBI will opt for a rate cut before then. Against this backdrop, we expect the first rate cut to happen in Q3 FY25 (likely in October). Additionally, the room for substantial cuts will be limited in FY25 given that headline inflation is expected to firm up again towards H2 FY25 and that any adjustments by the Fed to US interest rates are likely to prove modest.

Market Update

Bond Market: Indian bond yields continued to decline in May, with the benchmark 10-year yields dropping by 21 bps, ending the month at 6.98%, down from 7.19% at the end of April. The yields firmed up on June 4th due to an unexpected election outcome and remained elevated until the release of US CPI data. Following the formation of a stable government and softer US inflation data, Indian bond yields resumed softening reaching 6.97% on June 24th. This softening was primarily driven by FPI flows into Indian bonds, bolstered by the inclusion of Indian bonds in global bond indices, and an exorbitant dividend transfer by the RBI to the central government. However, yields firmed up again tracking US treasury yields and higher crude oil prices. While the stable government and policy continuity, coupled with the inclusion of Indian bonds in global indices, were expected to moderate yields, geopolitical tensions could potentially influence yields in the opposite direction.

Equity markets: Indian equity markets remained relatively flat in May, with the NIFTY50 declining by 0.3% MoM. Despite this flat performance, daily fluctuations occurred due to the general elections. FPIs turned negative, with outflows of ₹256 bn in May, while domestic investors supported the market. The volatility continued into early June, with the NIFTY50 rising by 3.3% MoM on June 3rd and then dropping by ~6% the following day due to uncertainties over government formation. FPIs were negative for three days following the election results. However, the equity markets rebounded after a stable government was formed, with the NIFTY50 gaining by 5.9% from the end of May to June 26th. With the formation of a stable government and policy continuity, the Indian equity market is expected to continue its growth trajectory. The upcoming full budget may further boost market growth and stimulate specific subsectors.

Currency Market: The Indian rupee traded within a narrow range in May and June, fluctuating between 83.1/USD and 83.57/USD. In May, the rupee showed strength, reaching Rs. 83.1/USD on May 24th, despite the general elections. However, following the conclusion of the elections, the rupee experienced brief volatility due to electoral uncertainty, leading to net foreign outflows. The RBI's intervention helped prevent further depreciation during this period. Even after a stable government was formed, the rupee continued to depreciate due to a strong dollar ahead of US CPI data and Federal Reserve commentary. Following hawkish commentary from the Fed, the US dollar gained strength, yet the rupee remained stable, likely reflecting the RBI's market intervention, making it one of the least volatile currencies among its peers. The rupee is expected to maintain strong performance, as the RBI, with its substantial forex reserves of US$ 653 billion (~11 months of import cover), is anticipated to manage the rupee tightly to mitigate excessive volatility. However, rising tensions in the Middle East and the risk of rising oil prices pose potential downward risks to the domestic currency.