

India's economic growth has likely moderated in Q1 FY25, outlook leans towards positive; expect a rate cut in Q3



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- Despite geopolitical tensions and China's economic slowdown the global economy has grown at a decent pace buoyed by resilient US domestic demand and India's continued rapid growth.
- The pace of global economic growth in 2025 is likely to exceed the consensus forecast (~3%) boosted by favourable fundamentals including strong balance sheets of both consumers and businesses, steady consumer confidence despite rising unemployment and expected moderation in inflation. However, downside risks from geopolitical tension, stretched asset valuation and the outcome of US elections remain.
- India's economic growth in Q1 FY25 has likely moderated amidst heat waves, the general elections and budget speculations. This is reflected in the softening observed in multiple high-frequency indicators from both the demand and supply sides of the economy. That being said, the incoming data for July shows tentative signs of a pick-up in growth momentum.
- On balance, the outlook remains positive with a revival in rural demand expected to support consumption, while the government's continued focus on capital expenditure and favourable conditions for a pick-up in private sector investment are expected to support investment.
- We expect economic activity to grow at a healthy pace of ~6.9%-7.0% in FY25 vs 8.2% in FY24.
- Headline inflation printed at a near five-year low of 3.5% in July supported by moderation in food inflation due to favourable base effect.
- Meanwhile, core inflation inched up to 3.3% in July (vs 3.2% in June) reflecting the impact of higher telecom tariffs. Looking ahead, core inflation probably will edge up a bit due to the fading of the favourable base effect and the passing on of the higher input costs to consumers.
- In the August policy meeting, the MPC maintained the status quo on rates with a 4:2 majority amidst elevated food price pressures. Two external members advocated for a rate cut with minutes highlighting their concerns about the monetary policy becoming too restrictive.
- From a policy perspective, we retain our view of a rate cut likely in December. However, we do not rule out a change in stance in October, given that the RBI will have a complete picture of the monsoon by then along with the Fed's decision in September.

Christopher Wiegand

Group Head - Economics & Data
christopher.wiegand@dmifinance.in

Bhawna Sachdeva

Economist
bhawna.sachdeva@dmifinance.in

Yuva Simha

Economist
yuva.simha@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 economy remains resilient; likely to exceed growth forecast in 2025

Led by the United States and aided by India, the global economy is poised to continue growing at a solid pace. Geopolitical tensions in the Middle East and Eastern Europe, China's ongoing economic slump, decades' high consumer inflation rates in the West, and rapid tightening in monetary policy to combat that inflation all have failed to short circuit the post-COVID economic expansion. To be sure, these forces have created pockets of economic weakness and decent-sized drops in living standards in recent years – see, for instance, the United Kingdom and Germany for two high-profile examples among the G10. But buoyed by resilient US domestic demand and aided by India's continued rapid growth, the global economy continues to weather the storm and is now on the verge of receiving support from (somewhat) easier monetary policies in many of the world's largest economies.

Consensus expectations are for the global economy to expand by about 3% in inflation-adjusted terms in 2025 and for headline consumer inflation to rise by about 3.5% (sourced from Bloomberg Consensus Economic Forecasts). Such an outcome – if realized – would represent a solid, albeit slightly below average, rate of increase in real GDP and close to an average global consumer inflation rate. Embedded in the consensus economic growth forecast is that China will continue to plod along in a lackluster manner, growth in the United States will moderate somewhat but the pace of economic activity in many advanced economies will strengthen.

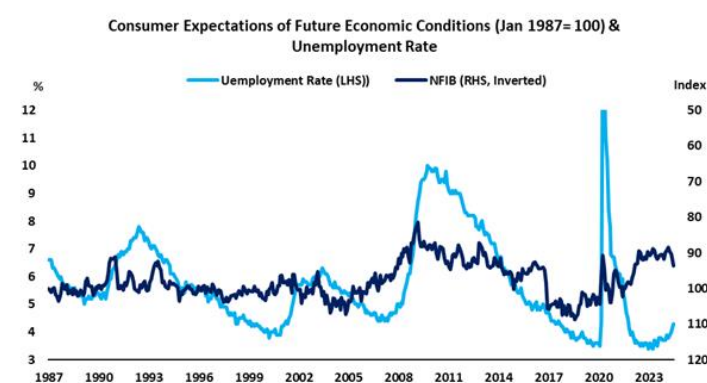
Based on underlying macro fundamentals in the bulk of the world's biggest economies – particularly the United States – the pace of economic growth in the year ahead is likely to exceed the consensus. Balance sheets for both consumers and businesses in the world's major Western economies remain in very good condition. The asset side of balance sheets has been bolstered by rising prices of financial and non-commercial real estate assets. The liability side is more country-specific: In the US, the prevalence of fixed rate term financing has helped to shield consumers and businesses from the full effects of higher interest rates; in other G10 countries where higher interest rates have been passed through – and been key catalysts to cooling the rate of growth and inflation – these countries' central banks have begun to reduce rates and likely will do so in a range of one to two percentage points (100bps to 200bps) in the next 12 months. Cooling inflationary pressures also are in the process of helping to reverse recent years' downward pressure on real purchasing power.

Despite Labor Market Cooling, Consumer Confidence Holds Steady

Labour markets have cooled from their breakneck pace in the period immediately after the COVID reopening. This is positive, as the rapid job turnover, rising wages, and labour supply/demand imbalances were not conducive to low inflation or medium-term economic performance. To date, labour market cooling has been quite useful in helping to mitigate inflationary pressures and currently we see no major economy where the labour market still is a major source of upside inflation risk.

Nonetheless, and as detailed in the past couple of Economic Monthly reports, when labour market conditions start to weaken, that weakening tends to persist for multiple quarters. Partly, this is because the economy becomes more sensitive to shocks – real or perceived – on both the business and household fronts. It is also partly due to greater caution on the part of consumers: As labour market conditions cool, workers (consumers) tend to become less confident about their future economic prospects. This dynamic historically has shown up in forward-looking confidence measures declining as labour market conditions soften, leading to a self-reinforcing cycle of more muted consumer spending, disappointing corporate sales and profits and retrenchment by businesses that result in further upward pressure on the unemployment rate.

Consumer sentiment remains steady despite a pick-up in the unemployment rate



Source: Bloomberg; Note: NFIB refers to the National Federation of Independent Business Small Business Optimism Index

Importantly, such a self-reinforcing dynamic is not currently in train. Somewhat the opposite is taking place. Consumer sentiment measures had previously fallen due to high inflation but have not eroded further as the labour market has eased. And recent reports on consumer demand point to a continued solid rate of advance. Using the US as a proxy for other advanced economies due to the richness of US data on these measures, the above chart highlights this point. (Small business optimism is a proxy for upper-income households' economic expectations).

Global economy to gain support from easing monetary policy; downside risks from geopolitical tension, stretched asset valuation and outcome of US elections remain

Our baseline expectation is that with many major central banks now having begun to reduce interest rates – and with the Federal Reserve set to begin doing so next month – chances are good that counter-cyclical monetary policy will be able to help buffer downside economic risks. While no two business cycles are alike, we see current conditions as similar to those of the mid-1990s – a period with similar underlying fundamentals to today – where macro policy tilted slightly more accommodative, helping to prolong the expansion.

In our judgment, the key risks to the outlook - mostly are away from pure macro fundamentals. Ongoing geopolitical tensions could escalate and spiral in a way that damages confidence and/or catapults energy costs. Select asset valuations are high vis-à-vis mainstream valuation metrics in many economies – e.g. equities via Shiller’s CAPE and the dividend-discount model; housing via affordability measures that incorporate the cost of credit and median incomes – and a steep correction could affect confidence and willingness/ability to spend. The outcome of the US presidential election also is a risk: Both candidates appear to be running on somewhat heterodox economic programs, the effects of which – if implemented – are uncertain.

Indian Economy: GDP growth in Q1 has likely moderated; data out on Aug 30

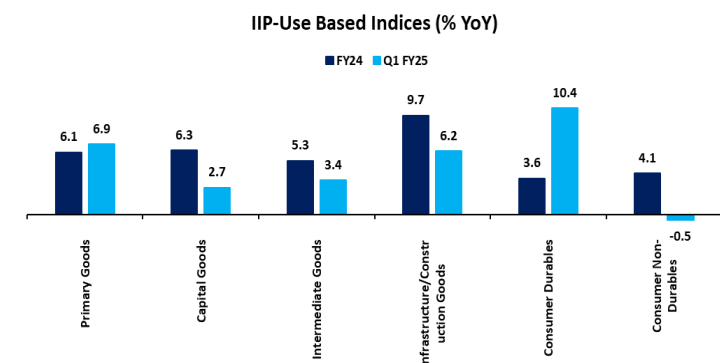
The economic activity in the first quarter of the current financial year has likely slowed amidst the elections, heat waves, and budget speculations. Nonetheless, the incoming high-frequency indicators suggest the activity gained momentum in July and overall macro fundamentals remain encouraging. On balance, the outlook remains positive with a revival in rural demand expected to support consumption while the government’s continued focus on capital expenditure and favourable conditions for pick-up in private sector investment are expected to support investment. We expect economic activity to grow at a healthy pace of ~6.9%-7.0% in FY25 vs 8.2% in FY24.

Industrial sector growth moderated amidst heat waves & the general election

Activity in the industrial sector likely moderated in the final month of Q1 FY25 amidst the disruptions caused by a heat waves and the general election. The index of industrial production grew by a five-month low of 4.2% in June primarily attributed to a weaker activity in the manufacturing sector (contributing ~78% to IIP) where growth almost halved to 2.6% from 5.0% in May. With that, the growth in

the manufacturing sector stood at 3.8% in Q1 down from 4.9% in the previous quarter and 5.5% in FY24. Sectors that are dragging down the manufacturing sector growth in the first quarter of the current fiscal year mainly include consumer non-durables such as food products and pharmaceuticals. Softer growth in manufacturing is also indicated in a softening in the companies’ profit (based on a sample of listed companies sourced from CMIE) due to rising input costs.

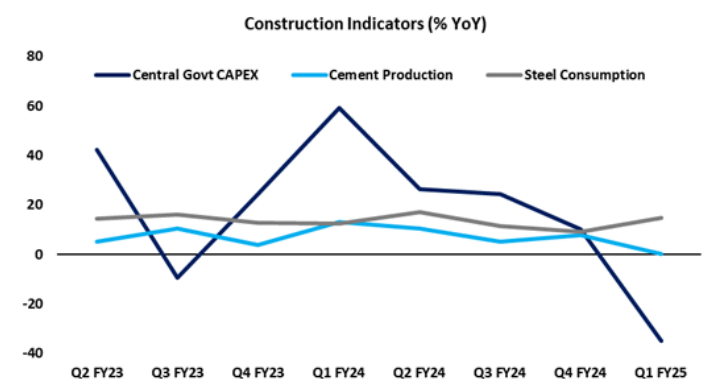
Consumer non-durables weighed on manufacturing growth



Source: CMIE

The growth of infrastructure and construction goods continued to slow down in June placing the growth in Q1 FY25 at 6.2% (down from 9.7% in FY24). This is likely reflecting the impact of general elections. Indeed, the growth of central government CAPEX in Q1 was down by 35% from the previous year. A similar story is observed in states expenditure, with states CAPEX spending tracking at ~20% lower in Q1 compared to the corresponding period of FY24. The view is also supported by the slower growth in cement production. That said, the growth in steel consumption has remained robust. Notably, we expect this to be a temporary disruption which is likely to be corrected in the latter half of the year given the government has left its capital expenditure target unchanged (Union Budget presented in July) for the current fiscal year.

Indicators for construction activity suggest some moderation



Source: CMIE

Private sector investment activity also was adversely affected by the elections, a fairly typical outcome as businesses often become cautious regarding big-ticket spending in the run-up to a major election. New projects completed by the private sector in Q1 FY25 fell sharply by ~60%; announcements of new projects also moderated. However, we believe this likely was a temporary disruption and anticipate improvement during the remainder of FY25.

Services sector indicator suggests tempering of growth in Q1 FY25; nonetheless, sentiment remains optimistic

Services Indicators (% YoY)					
	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
Domestic Air Passengers	19.1	23.0	9.1	5.2	5.6
Air Cargo Handled	-1.9	1.7	10.2	18.4	13.9
Railway Freight	1.1	4.8	6.4	8.4	5.1
Port Cargo Traffic	1.9	2.9	10.0	2.7	3.9
CV Sales	-5.3	4.2	3.1	-4.4	3.8
GST E-way Bills	15.8	15.0	17.1	16.3	16.0
Services Exports	5.9	4.2	5.2	4.1	10.4
Life Insurance First year Premium	-0.9	-21.2	5.4	26.0	22.9
Bank Spread (%)	3.4	3.2	3.0	3.0	2.9
Services PMI*	60.6	61.1	58.1	61.2	60.5
Govt Revenue Expenditure^	-7.3	34.6	-7.5	-5.2	-1.5

Source: CMIE; RBI; S&P Note: PMI is shown in level terms.

Meanwhile, services sector-related indicators suggest a tempering of growth in Q1 FY25. The slowdown in the transportation sub-sector is visible in indicators like, air cargo handled and railway freight while commercial vehicle sales and GST E-way bills suggest the sector has likely sustained momentum. The hotel occupancy rate was also slightly lower than in Q1 FY24. In the financial sector, bank profitability is likely to have narrowed owing to the narrowing of the bank spread with the increase in deposit rates as banks compete for deposits to meet incremental credit demand. Nevertheless, sentiment in the services sector remained highly positive as the PMI averaged higher than 60 for the quarter, although slightly lower than the previous quarter.

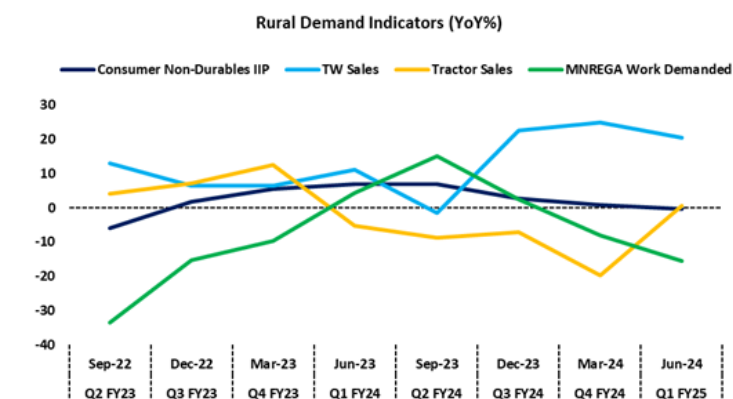
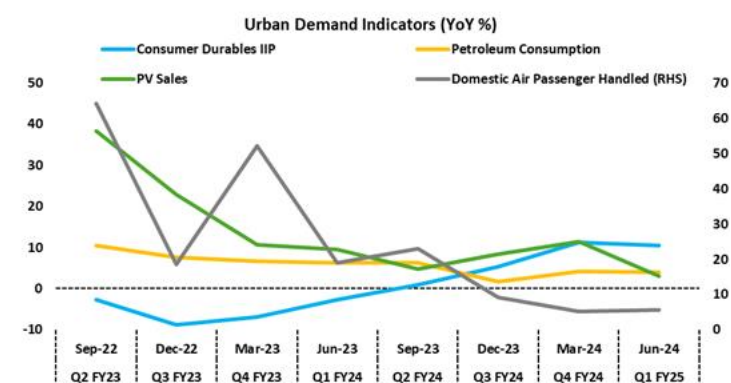
We expect growth in the agriculture sector to have remained muted in Q1 FY25 owing to a lesser sowing of Rabi crops in FY24 compared to the previous year. According to the third advance estimate of agricultural production for 2023-24, for the Rabi season, foodgrain production is expected to be lower by 1.0% YoY, with cereals lower by 0.6% and pulses by 4.4%.

Mixed Signals for Consumer Demand in Q1 FY25: Rural Upswing, Urban Caution

From the expenditure side, indicators of consumption in Q1 FY25 were mixed compared to the prior quarter. Signs of improving rural demand are reflected in recovery in tractor sales, robust two-wheeler sales and continued decline in employment demanded under MNREGA - likely underpinned by the healthy progressing monsoon season. From the urban side, the passenger vehicle sales dropped

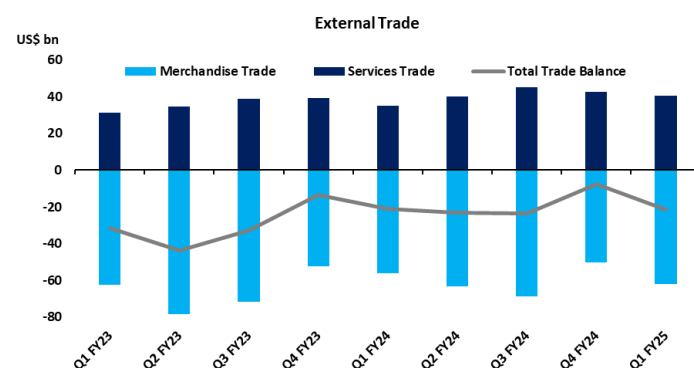
in Q1 – but this is due to the very high base of FY24 and not necessarily a sign of weakening urban consumption. Meanwhile, other indicators such as growth in consumer durables, domestic air traffic etc. remained stable compared to the previous quarter. On the other hand, some caution in consumer sentiment was reflected in the RBI's consumer confidence survey with consumers' perception of the current situation index worsening in the latest round of survey.

Urban demand indicators remained stable while rural demand indicators showed tentative signs of improvement



Source: CMIE

Part of the drag from merchandise trade is likely to be offset by services surplus



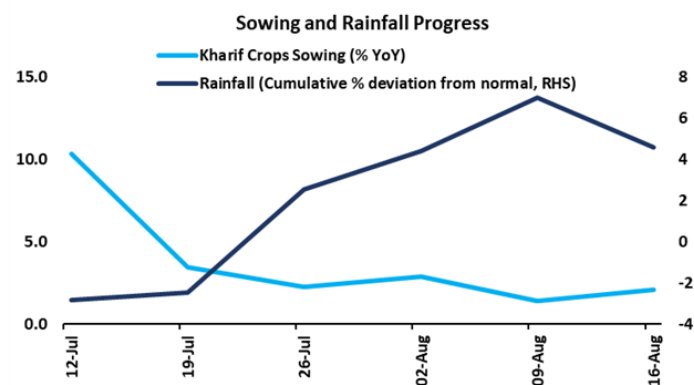
Source: CMIE

Lastly, on the external sector front, the net export is likely to exert a drag on growth with the merchandise trade deficit

widening from US \$56.2 in Q1 FY24 bn to US \$62.0 bn in Q1 FY25 owing to higher imports, particularly oil imports (up by ~23% YoY). This is due to higher prices as well as lower discounts on Russian oil (calculated price of Russian oil is tracking at US ~\$83 in Q1 FY25 compared to US ~\$76 in FY24). Meanwhile, some of the drag is expected to be contained thanks to the robust services surplus. Overall, the trade balance (merchandise+services) has remained almost flat at US \$21.5 bn in Q1 FY25 (compared to Q1 FY24).

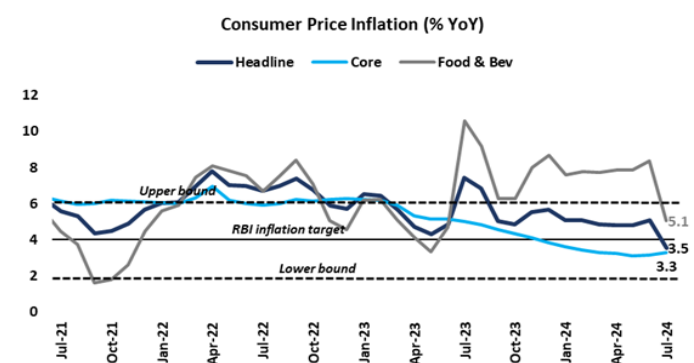
While the pace of economic activity has likely moderated in Q1 FY25 – this disruption is expected to be temporary. With Q2 FY25 halfway through, the incoming high-frequency indicators suggest the pace of economic growth has regained momentum in July. Proxy for urban consumption such as passenger vehicle registrations and petrol sales picked up in annual terms. Regarding rural consumption, there has been an improvement in Kharif crop sowing due to the increase in rainfall during July/August. The forecast of above-normal monsoon bodes well for the rural demand outlook. Investment activity is also expected to gather pace in the rest of FY25 amidst a continued public sector push to CAPEX, positive sentiment in the real estate sector, increasing capacity utilisation of manufacturing companies, and robust twin balance sheets of banks and corporates.

Improving Kharif sowing augurs well for the rural demand outlook



Source: CMIE

Headline inflation printed at a five-year low supported by favourable base effect

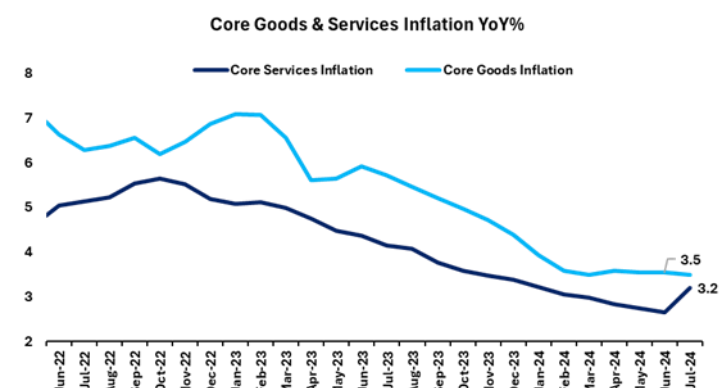


Source: CMIE

Headline inflation, after a slight increase in June, reached nearly a five-year low of 3.5% YoY in July. This moderation was primarily driven by a decline in food inflation, supported by a favourable base effect, despite positive sequential momentum. In contrast, core inflation inched up ~15 basis points to 3.3% in July, mainly due to the impact of higher telecom tariffs.

Within the food basket, vegetable inflation, which had been the main driver of food and overall headline inflation, eased to 6.8% in July, down from an average of around ~27% over the past eight months. This is primarily due to a supportive base effect, as sequentially the prices were up by ~14% MoM. Almost all categories, except for proteins, have shown moderation in food inflation. Although pulses inflation has decreased, it remains in double digits. However, with improved sowing in the Kharif crop, particularly in pulses, prices are expected to decline. Except for fibers, all Kharif crops have seen an increase in cropping area compared to the previous year, due to improved rainfall, which is tracking ~4% above normal, with the improved spatial distribution. This is also reflected in the improved reservoir level, which is tracking about above the normal level (as of 21st August), indicating positive prospects for Rabi cropping as well. With the improved monsoon, daily data on food prices for the first two weeks of August also shows signs of moderation.

Core inflation remains well-behaved; inches up to 3.3% in July



Source: CMIE

Core inflation edged up slightly to 3.3% in July but that slight increase is not concerning given the broader trend in underlying inflation and the prospects of a more moderate, albeit still solid, economic growth. Details reveal core goods inflation remained steady at 3.5%, while core services inflation rose by 50 bps to 3.2%, contributing to the overall rise in core inflation. The increase in core services inflation was driven by higher telecom tariffs, which pushed it up from its historical low of 2.7% and these higher tariffs will not be a sustained source of upward inflation pressures. Looking ahead, core inflation probably will edge up a bit, as

producers are reporting passing on the higher costs to consumers, as indicated by PMI surveys. The unfavourable base effect will also weigh on core components. Overall, we anticipate headline inflation to remain at low levels in August, supported by a favourable base effect, before rising due to an unfavourable base effect, even as food prices may moderate with support from a favourable monsoon.

Monetary Policy Committee maintained the status quo in the August meeting

In line with expectations, the RBI kept the repo rate and stance unchanged with a 4:2 majority in the last MPC meeting in August against the backdrop of strong growth and elevated food inflation. The minutes of the meeting show a clear divergence between the views of internal and external MPC members (whose tenure ends after the August meeting). The two external members (Dr. Ashima Goyal and Prof. Jayanth Varma) who advocated for a 25 bps rate cut and a neutral stance cited concerns that the monetary policy might be becoming too restrictive. Based on the RBI's projection of 4.4% headline inflation for Q1 FY26, the real repo rate stands at 2.1% (Repo Rate minus Inflation forecast for Q1 FY26) – which is higher than the neutral rate of interest estimated by the RBI (1.4%-1.9%). Higher real interest rate negatively impacts the economic growth. Dr Ashima Goyal also noted early signals suggesting growth might be slowing down including softer sales and profit of listed manufacturing companies in Q1 FY25 and moderating consumer confidence. On the other hand, the members who voted for a status quo stated the need for monetary policy to be disinflationary to prevent any spillover of food price pressures to core components.

Policy Outlook: As indicated in our RBI policy report the tone of the recent policy meeting was more hawkish with emphasis laid on the need to bring down inflation towards the 4% target on a durable basis. The latest inflation reading does not change our view of a shallow rate cut in Q3 as the RBI is likely to look past the base effect-induced fall in inflation. Amidst a decently strong growth and no signs of softening in tone in the August policy statement, we assign a higher probability of a rate cut in December as opposed to October. However, we do not rule out a change in stance in October given the RBI will have a complete picture of the monsoon by then. Furthermore, the much anticipated Fed rate cut in September could also influence the RBI's decision in October.

Market Update

Bond Market: Indian benchmark yields softened in July (averaging 6.97% vs 7.0% in June) supported by higher foreign capital inflows into the Indian debt market owing to India's bond inclusion in the global index, decline in the US treasury yields and downward revision in the fiscal deficit

target from 5.2% to 4.9% in the Union Budget announcement. The cooling off yields continued in August with the average 10-year benchmark yields tracking at 6.87% aided by moderating crude oil prices and falling treasury yields. Looking ahead, strong macro fundamentals and higher foreign capital inflows should support yields, though escalating tensions in the Middle East could exert upward pressure on yields.

Equity Market: After scaling their fresh high in the first half of July, the risk-off sentiment due to the higher-than-anticipated jobless claims weighed on the domestic equity market. However, the market recovered in the last week of July closing at 3.9% higher than the previous month. This was quickly reversed in the first week of August with NIFTY falling sharply by 3% following the weaker employment data in the US raising recession fears and a hawkish Japanese monetary policy. However, the markets have gained since then with the NIFTY50 index growing by 3.5% by August 23rd due to positive global cues. We expect to experience volatility in the near term arising on account of global triggers.

Currency Market: The Indian rupee weakened modestly against the dollar in July, trading at an average of 83.6 INR/USD compared to 83.48 INR/USD in June. Despite the weakening dollar, the net FPI outflows following the Indian budget announcement of increased taxation on equity products, along with increased month-end demand for dollars weighed on the currency. Depreciatory pressure continued in August with negative factors including a widening current account deficit, the unwinding of JPN carry trade position and ongoing foreign outflows from the equity market offsetting the impact of moderating crude oil prices and a weakening dollar. On average, the rupee has depreciated by 0.3% by August 23rd. Looking ahead, while capital flows on account of India's inclusion in the global bond index and the Fed rate cut (expected to begin in September) are expected to support the rupee, the rising tensions in the Middle East could exert upward pressure on the INR.

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