26 July, 2024

India's Growth Story continues; stubborn food inflation to keep RBI on hold in August

- The Fed is poised to join other major economies in cutting interest rates soon, as evidenced by the steady decline in core inflation, particularly in the service sector.
- Furthermore, the weakening of the labour market as reflected in multiple indicators including rising unemployment, lower quit rates and the concentration of headcount addition in public sector etc. bolsters the rationale for cutting rates.
- We had earlier assigned a higher probability of a rate cut post the election, however, Mr. Biden's exit from the presidential race provides greater flexibility to the Fed to cut rates sooner should it so desire. While a 50-bps cut by the end of 2024 is the current forecast, the possibility of a larger rate reduction cannot be ruled out.
- India's economic growth remained robust in Q1 FY25, with the industrial sector growth remaining robust despite moderation due to heatwaves and the general elections. Meanwhile, the services sector also exhibits buoyance despite slight moderation.
- Consumer durables are leading growth, but the growth in non-durables (proxied for rural demand) continues to lag. Nonetheless, we are optimistic about the revival in rural demand given the hopes of recovery in agricultural sector activity due to the expectation of an above normal rainfall for this year.
- Headline inflation in India quickened to a four-month high of 5.1% in June, driven by elevated food price pressures. Food inflation rose to a three-month high of 8.4% driven by continued volatility in vegetable prices.
- Encouragingly, core inflation remained stable at 3.2%, but is expected to edge up in the coming months due to a combination of factors including telecom tariff hikes and the fading of a favorable base effect. Overall, for the full year we expect headline inflation to print closer to 4.6%.
- With food inflation picking up in the latest inflation print and high frequency suggesting the sustained growth momentum, we retain our view that the RBI is likely to wait until the monsoon is over to gauge the full impact of the southwest monsoon on food prices before pivoting. We pencil the first rate cut in Q3 FY25.

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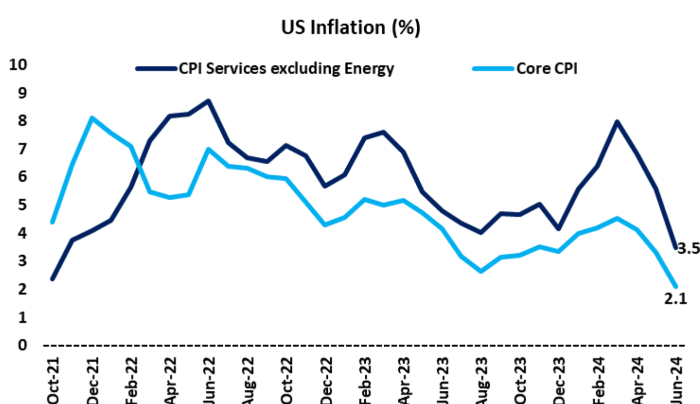
Fed expected to join the rate cut bandwagon in the period not too far ahead

Recent events suggest that the US Federal Reserve is likely to join many of its advanced economy central bank counterparts in reducing interest rates in the period not too far ahead. A half percentage point (50bp) reduction in the US policy interest rate spread across two quarter percentage point (25bp) reductions now seems the most likely outcome between now and the end of calendar year 2024. Risks around this projection are tilted to the Fed doing more easing, not less, with the policy rate more likely to fall by three quarters of a percentage point (75bp) than just a quarter of a percentage point (25bp).

This judgment is built on two key foundations. First, US core inflation readings in recent months have been favourable and, per multiple Fed policymakers' own words, have helped to increase officials' confidence that inflation is trending – however gradually and irregularly – back toward the Fed's medium-term target. Core CPI in the three months ended in June increased at a benign 2.1% annualized pace, the slowest three-month rate of advance in the post COVID recovery. Equally importantly, if not more so, are signs that service sector inflation is beginning to moderate. Prices for consumer services excluding energy moderated to an annualized rate of increase of 3.5% in the latest three months – and just 2.75% annualized in the latest two months – representing a marked stepdown from the more than 6% annualized pace such prices have averaged since the start of 2022.

Core inflation in the US is moderating gradually



Source: Bloomberg; Note: Data is calculated using 3 months annualised change

To be sure, a few months of favourable inflation data could be an anomaly. But unlike 2023H2 when favourable core inflation readings were due to a good sized deflation in a relatively narrow segment of the overall price index (durable goods prices), prices currently are moderating in a significantly broader manner. As a result, there is a meaningfully higher probability that current inflation readings are sustainable than was the case in 2023H2.

Continued softening of the US labour market opens door for policy easing

At the same time, the US labour market is moderating. A month ago, we noted that there were some early warning signs of labour market cooling and that should those signals continue they would (1) confirm a softer labour market and (2) open the door to monetary easing by the Fed even if spot inflation failed to improve given the Fed's dual mandate of stable prices and maximum employment.

In the intervening month, the five metrics we highlighted last month have largely softened further:

- The unemployment rate nudged up by another tenth of a percentage point and now is at 4.1%, up 70bp from its cycle low. As discussed last month, a 50bp increase in unemployment off its cyclical low typically presages a labour market where employment opportunities are less plentiful over the ensuing 12 months.
- Headcount additions continue to be narrowly concentrated. The preponderance of public sector jobs in recent payroll additions suggests a diminished appetite/growing caution among the US private sector to expand and/or add to expenses.
- The percentage of employed people working multiple jobs has risen. Such a development occurs when a worker's primary job is providing them insufficient income – often due to reduced working hours – leading workers to seek out additional sources of compensation.
- The quit rate continues to trend lower. A declining quit rate implies a mix of increasing risk aversion on the part of employees and greater focus on cost control by businesses as job switchers typically receive pay increases far above the prevailing norm.
- Jobless claims have not come back down from what we suspected was an inflection higher in May and June, strengthening our judgment that employment opportunities are becoming less plentiful. Moreover, continuing claims that measure the stock of formerly employed workers receiving unemployment benefits also are not improving; such a trend is a robust signal that laid-off workers are having a difficult time being rehired post-layoff.

Taken together, these recent labour market and core inflation developments have ratcheted up the likelihood of the Fed beginning its so-called mid-cycle adjustment sooner rather than later. Another month of data on either the labour or price front that is qualitatively similar to the latest months

would put in place a fundamental case for the Fed to start adjusting interest rates as soon as September.

Mr. Biden's exit from the presidential race provides greater flexibility to the Fed to cut rates sooner should it so desire

We, previously, articulated what we judge to be an extremely high hurdle to US rate cuts beginning in September given that broad macro fundamentals, even with signs of labour market moderation, do not entail any urgency with respect to the precise start date, the Fed's desire to be apolitical, and the proximity of the September policy meeting to the US presidential election. Our assessment with respect to those first two points remains wholly unchanged. However, President Biden's decision to no longer seek re-election has implications for the final point. Given Mr. Biden's status as the incumbent president, the Fed starting to lower rates so close to the election could have been interpreted as the central bank trying to bolster his re-election chances. Now, however, with him out of the presidential race and no incumbent seeking re-election, that potential awkwardness has diminished. It has not been eliminated entirely. But it does, in our judgment, provide the Fed greater room to manoeuvre ahead of the election should it so desire.

More broadly, Mr. Biden's exit from the presidential election likely will increase uncertainty about the prospective path of the US economic policy generally for the next six to nine months until the next Presidential Administration settles in. As of this writing, it appears nearly certain that Vice President Harris will replace Mr. Biden as democratic nominee. Ms. Harris has neither a defined economic policy philosophy nor any related policy advisors of note. Meanwhile, former President Trump's policy philosophy is more defined – low taxes, limited regulation, energy independence – and helped to produce favourable economic outcomes (solid growth, low inflation, low unemployment) for the US prior to COVID. But as evidenced in his first Administration, he often made policy by tweet, e.g. tariffs, and sometimes unbeknownst to key officials in his own Administration. And whereas Mr. Trump was the favourite to return to the White House as of Mr. Biden's dropping out, the prospect of Ms. Harris as his opponent will shake up the election in ways impossible to predict with any accuracy or confidence.

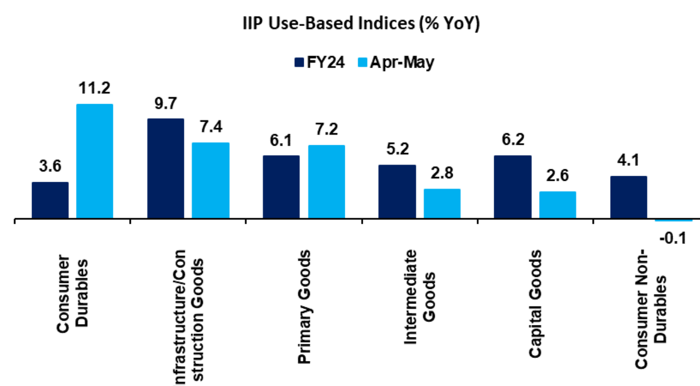
Economic growth remains robust in Q1 FY25, but some moderation is expected

India's strong economic performance continued in Q1 FY25 and the macro-outlook continues to be a favourable one. While growth is strong, it is not so strong as to ignite underlying inflationary pressures, as highlighted by the trend in core inflation. The combination of favourable economic growth and inflation that has moderated towards a more tenable pace means that India continues to be one of the world's economic standouts.

Industrial sector growth moderated amidst heat wave & general election

The industrial sector continues to grow at a solid clip. Manufacturing production in the most recent quarter grew at an average of 4.3%. That's a slightly slower rate of increase than in the prior quarter which is primarily attributed to disruptions caused by heatwaves and the general election. Manufacturing growth was led by consumer durables such as electronics, computers etc. suggesting a sustained urban demand. Meanwhile, the output of the infrastructure sector remained stable compared to the prior quarter. However, it has been lower than FY24 on account of the general elections. The growth was due to strong growth in steel production whereas cement has seen contraction in the first quarter of FY25. With the capital expenditure target left unaltered in the full Union budget of FY25, we remain optimistic of pick-up in this segment.

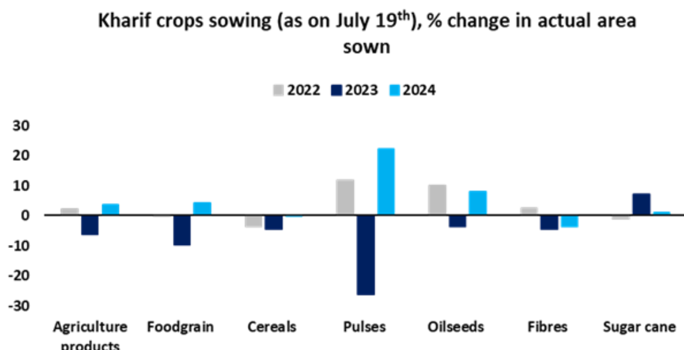
Consumer durables are leading the growth while growth in non-durables underwhelms



Source: CMIE

The only sub-sector within industrial activity where growth has remained somewhat subdued in Apr-May is non-durables indicating that rural demand is still suffering from the blows of a sub-par monsoon last year. The activity in the agricultural sector has thankfully improved in the ongoing sowing season. Most kharif crops have seen an increased area sown in YoY terms, except for fibres. However, this growth is largely due to a low base from last year's poor agricultural performance. To gauge the true picture of sowing progress, we compare the area sown as a % of normal area sown. This is tracking at 64% of the normal area sown (by 19th July) by this time compared to a usual of 67-70% of normal area. That being said, the pick-up in monsoon in the past few weeks and an expectation of above-normal rainfall this year should bode well for sowing in the upcoming weeks. This in turn should have a positive impact on rural consumption.

Kharif sowing tracking above last year and is likely to improve ahead



Source: CMIE

Services shows mixed performance; outlook leans towards positive

Services Indicators (% YoY)									
	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24
Air Cargo Handled	13.1	6.6	10.8	15.5	22.6	17.3	10.0	15.6	
Railway Freight	8.5	4.3	6.4	6.4	10.1	8.6	1.4	3.7	10.1
GST E-way Bills Generation	30.5	8.5	13.2	16.4	18.9	13.9	14.5	17.0	16.3
Air Passenger Traffic	10.7	8.7	8.1	5.0	5.8	4.7	3.8	5.9	6.6
NETC Volume	13.0	12.3	13.0	10.2	12.1	10.6	7.6	3.6	37.4
Hotel Occupancy (%)	62.5	63.0	70.0	66.6	72.5	64.4	62.3	60.3	
Foreign Tourist Arrival	25.2	13.7	16.0	-10.4	4.6	-14.3	-24.3	-7.7	
Services Exports	10.9	4.4	1.4	10.7	3.4	-1.4	17.7	10.3	8.9
First Year Life Insurance Premium	7.6	-25.3	43.8	27.0	48.4	15.6	61.2	15.1	14.8
PMI Services	58.4	56.9	59.0	61.8	60.6	61.2	60.8	60.2	60.5
Govt Revenue Expenditure	-13.8	-16.1	-5.5	-6.2	0.8	0.6	43.7	-33.1	

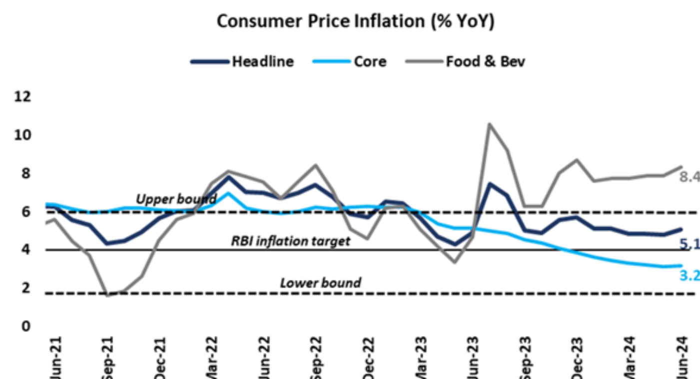
Source: CMIE; RBI; HVS Anarock; S&P Note: PMI and Hotel Occupancy are not YoY.

Service sector indicators continue to exhibit strength, albeit with a slight moderation in the rate of growth. For instance, the PMI Services Index remained above 60, a historically high level indicating a strong pace of service sector activity, in the quarter but moderated from 61.2 observed in Q4 FY24. On a sectoral basis, trade and the insurance sector both strengthened in Q1 FY25 compared to Q4 FY24. Travel, transport, and hotel indicators also grew but showed moderation in Q1 FY25 compared to the previous quarter. Of note, the pace of activity picked up in the latter part of the quarter, indicating the impact of elections on the economy. Furthermore, the momentum in real estate services is expected to have been sustained based on growth in leasing activity and sales from reports by market experts. The real estate sector is likely to get further impetus from the additional support provided to the affordable housing (Rs 10 lakh crore allocated to Pradhan Mantri Awas Yojna scheme) in the latest budget. Overall, the outlook for the services sector leans towards positive.

Headline inflation quickened to a four-month high of 5.1%

Headline consumer inflation inched up modestly in June, rising to 5.1% YoY from 4.8% in May. The pickup in June followed five consecutive months of slowing inflation print. With that, the average inflation for Q1 FY24 stood at 4.9% aligning with the RBI's projection.

Food price pressures caused headline inflation to edge up



Source: CMIE

The increase in inflation is mainly due to higher food inflation, while – notably – core inflation has remained relatively flat. Food & beverage inflation rose to a three-month high of 8.4% in June from 7.9% in May, driven by higher vegetable and fruit prices. Vegetable inflation jumped to 29.3% in June from 27.4% in May, and fruit inflation increased by 50 bps to 7.2% in June, reflecting the (likely temporary) impact of heatwaves. Most other segments in the food basket have also experienced a mild uptick in inflation, except for protein and pulses, which saw some moderation. Oils and fats though remained in the deflationary category but have continued to harden for the seventh consecutive month.

While the heatwave has boosted select food prices, the fading of that weather distortion should filter through to prices, especially for those items experiencing the most direct effect of the heatwave. Related, it is likely that food prices will 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.

Core inflation at 3.2% in June was little changed versus May, a strong indication that underlying price trends currently are well behaved. Both core services and core goods inflation were largely stable. Looking ahead, we expect the core inflation to edge up on account of the recent rise in telecom tariff hikes, fading of the favourable base effect and producers reporting passing-on the higher input cost to the consumer (based on PMI surveys). Overall, we expect the headline inflation to moderate in July-Aug supported by the favourable base effect and is expected to pick up afterwards led by an unfavourable base even as food prices could moderate gaining support from the favourable monsoon. We retain our view of headline inflation printing close to 4.6% for FY25 (in March report).

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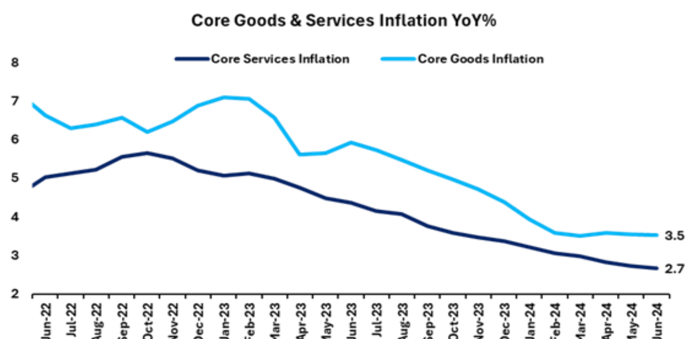
Core inflation remains flat but is expected to rise following the hike in telecom prices



Outlook: With food inflation picking up in the latest inflation print and high frequency suggesting the sustained growth momentum, we retain our view that the RBI is likely to wait until the monsoon is over to gauge the full impact of the southwest monsoon on food prices before pivoting. Further, with the Fed having more flexibility to cut rates in September amidst a softer labour market and inflation data, and Mr. Biden's exit from the presidential race, we retain our view of the RBI potentially implementing a rate cut in Q3 FY25 (most likely in October).

Market Update

Bond Market: Indian bond yields have experienced some volatility with the benchmark 10-yr bond yields falling for the first three weeks of June before bouncing back up to 7% at the beginning of July tracking the uptick in the US treasury yields amidst persistent geopolitical uncertainties. However, recent positive inflation data in the US has helped to temper Indian bond yields. The inclusion of Indian bonds in global bond indices also contributed to this softening, with FPI inflows reaching record values in July. With lower-than-expected market borrowings announced in the budget, bond yields remained relatively flat. For the outlook, the yields are likely to gather support from increased liquidity from the global index inclusion and favorable domestic macroeconomic conditions. However, geopolitical tensions continue to pose a risk and could exert upward pressure on Indian bond yields.

Equity Market: Indian equity markets continued their upward rally since the low seen post the election results, with the NIFTY index growing by 6.6% MoM in June. Foreign portfolio inflows (FPIs) also turned positive in June, with inflows of Rs 266 bn, whereas domestic capital inflows declined from Rs 557 bn in May to Rs 286 bn in June. Mid-cap and small-cap stocks performed particularly well in June, registering gains of ~9% and ~11%, respectively. The auto, IT, and real estate sectors also saw strong gains. This upward momentum continued into July with the NIFTY growing by over 2% from end June, until the Union Budget release. However, the government's move to raise capital gains tax and securities transaction tax impacted the investor sentiment negatively causing the equity market to close in red. Further, weaker global cues also exerted pressure on the market. Looking ahead, budget induced volatility is likely to fade away as the market takes fresh cues from corporate earnings and global triggers.

Currency Market: The Indian rupee traded at an average of 83.48 INR/USD during June. It weakened against the dollar in the first week of June due to uncertainty surrounding the Indian government formation. However, RBI intervention stabilized the rupee, but fluctuations continued due to rising crude prices and a stronger dollar. In early July, the rupee remained relatively stable, with a slight weakening following the US inflation data, and faced some volatility after the Indian budget, reaching 83.7INR/USD on July 24th. FPI outflows from the domestic equity market and a weak global risk appetite weighed on the domestic currency. However, RBI intervention and a decline in crude oil prices likely capped the losses. Looking ahead, the rupee could trade with a depreciation bias amidst election-related uncertainty in the US, but any sharp fluctuations are likely to be limited due to potential RBI intervention.

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