25 September 2024

The US Fed delivers an outsized rate cut; is it RBI's turn to pivot?

- The US Federal Reserve cut its policy interest rate by 50 basis points, signalling a proactive approach to sustaining economic expansion and possibly further reductions in 2024 and 2025.
- India's economic growth slowed to 6.7% YoY in Q1 FY25, down from 7.8% YoY in Q4 FY24, influenced by heatwaves and subdued government spending; however, robust private consumption and investment were encouraging.
- The growth outlook turns cautious amid mixed high-frequency economic data, with concerns over urban consumption and external demand potentially dampening recovery, despite a revival in rural demand and government spending.
- CPI inflation in August rose slightly to 3.65%, remaining near a five-year low. This uptick was primarily due to a less favourable base effect, as inflation remained flat on a sequential basis.
- With the broadening of disinflation among CPI subgroups and a positive outlook for food inflation thanks to above-normal rainfall, risks to the inflation outlook are falling.
- This coupled with recent mixed high-frequency economic data and expectations of additional U.S. rate cuts, the RBI should begin preparing for a policy pivot.
- We believe the RBI will signal future policy changes by adopting a dovish tone at the next meeting, which may or may not coincide with a shift in the policy stance from "withdrawal of accommodation" to "neutral". We continue to anticipate the first rate cut at the December policy meeting.
- The US Fed's latest monetary policy and guidance for further rate cuts boosted risk sentiment leading to strong FPI inflows, supporting India's stock market and recent appreciation of the rupee.

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US Fed delivers an outsized rate cut, signals further easing ahead

The US Federal Reserve this month joined the monetary easing brigade, lowering its policy interest rate by one half of a percentage point (50bps) and – more importantly – signalled that it intends to adjust monetary policy as it deems necessary to try to sustain the US economic expansion. This posture – that the Fed is seeking to sustain the expansion or to put it colloquially is "buying insurance" – has important implications for both the United States and the global economy.

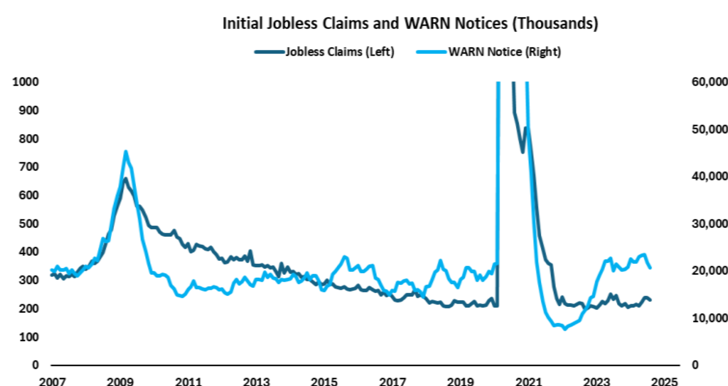
There was no doubt that the Fed would reduce interest rates at its September policy meeting and send a robust signal that additional rate reductions would take place over the balance of 2024 and into 2025. This dynamic reflected a combination of moderating core inflationary pressures since Q1 2024, a cooling in labour market conditions as we have written about in recent months, and Fed Chair Powell's explicit declaration at the Fed's annual Jackson Hole symposium in late August that the time had arrived to begin easing monetary policy.

What was uncertain heading into the Fed's meeting was the size of the initial rate cut and – more importantly – the forward-looking signal Chair Powell and his colleagues would send through the combination of officials' economic and policy projections and Mr. Powell's press conference. The resulting signal was unambiguous: The Fed judges that with inflationary pressures having cooled, it has considerable scope to support aggregate demand and, hopefully in turn, labour market conditions. While Mr. Powell was careful not to pre-commit to a specific amount of easing either at the next policy meeting (November) or cumulatively, the totality of his remarks conveyed clearly that he wants labour market conditions to strengthen going forward and officials as a group anticipated that the Fed's policy rate is likely to fall by another roughly 2 percentage points (200 bps) to achieve that desired outcome.

The Fed's actions and forward-looking signal come amidst a backdrop of a US economy that is still growing at a solid pace and appears bereft of imbalances in the household and business sectors outside of commercial real estate. Indeed, real private sector demand growth has increased at annual rates of 3.0%, 3.3%, 2.6% and 2.9% in the past four quarters and is tracking in the mid-3% range in the current quarter. These are not the types of growth rates for private sector demand that typically would be associated with the action and signalling the Fed just undertook. On the other hand, these types of growth rates are also not consistent with the degree of cooling the US has experienced in broad labour market conditions, particularly the magnitude of the rise in the unemployment rate.

On that score, however, it is important to note that the bulk of the cooling in US labour market conditions has been due to softer gross hiring combined with a good-sized increase in labour supply. This does not offset the nearly percentage point rise in the unemployment rate from its cyclical low nor that nominal wage growth has moderated nor that workers have become more risk averse, as highlighted in surveys and by a declining quit rate. But sustained labour market downturns – i.e. those that take place during a recession or recessionary-like conditions – almost always are associated with rising layoffs. While layoffs are not as low as they were during the post-COVID boom, the prevailing pace of layoffs remains at very low levels that historically have been associated with continued economic expansion. Moreover, so-called WRAN notices – regulatory filings of potential large layoffs – have started to edge down a bit of late (see chart), suggesting that layoff activity is likely to remain at quite low levels at least through the year-end.

Layoffs remain at a comfortable level



Source: Bloomberg; Note: WARN refers to Worker Adjustment and Retraining Notification.

Nonetheless, the Fed is seeking to take out insurance against any further labour market cooling, placing the balance of risks toward continued 50bps rate cuts at upcoming meetings. The bar to dropping the pace back to 25bps, at the next policy meeting on November 6 (the day after the US presidential election), appears to be quite high, likely requiring (at minimum) a notable acceleration in job growth to more than 200,000 net new jobs per month and a lower unemployment rate in both employment reports to be released prior to the Fed's next meeting.

We envision the need for a less than 200 bps additional rate cut but given the Fed's mindset there is a risk of the central bank overdoing the easing

More sizable rate cuts upfront likely will translate to less cumulative easing, as by front-loading rate reductions into a solid economy the response by broad financial conditions and economic actors is likely to be relatively speedy. To this point, US equity markets have quickly touched new highs, credit spreads are at their narrowest levels in the cycle, the

yield curve is steepening, and applications for credit, including mortgage credit, are rising. Consumer confidence about future economic prospects was already beginning to turn up and lower rates should help to accentuate that nascent trend. In our judgment, we do not see the necessity of rate cuts of the magnitude that Fed officials in aggregate projected (or markets currently are pricing) to sustain the business cycle and – sometime in 2025H1 – produce a pickup in the labour market. Our baseline envisions the US policy rate falling by another 100bps or thereabouts. That said, we recognize that given the prevailing Fed mindset, there is a risk of the US central bank potentially overdoing it on the easing of monetary policy.

The US Dollar in recent years has been generally firm but the prospective US policy environment should ameliorate that strength. In our judgment, the Dollar Smile framework is a useful one to assess the US Dollar's prospects at a high level. That framework denotes that in times of significant and unexpected US outperformance and in global crisis/recessions the USD tends to appreciate broadly. In other macro settings, the USD tends to be stable or depreciate. We anticipate that currencies underpinned by a combination of strong fundamentals and relatively high yields likely will perform the best relative to the US Dollar in the next 12 to 15 months.

Should former President Trump regain the US Presidency in the November election, the Fed-driven benign USD environment could be threatened, particularly vis-à-vis currencies with poor fundamentals and/or for those countries with outsized goods exports to the United States. Mr. Trump has been campaigning on tariffs that would have a scale and scope unseen since the 1930s. While it is unclear just how aggressive he might be on the tariff front should he be elected, there is no doubt that a second Trump Administration would pursue an aggressive trade protection agenda, which if implemented – in our assessment – would at a minimum result in foreign exchange volatility that surpasses that experienced in the past 30 to 35 years.

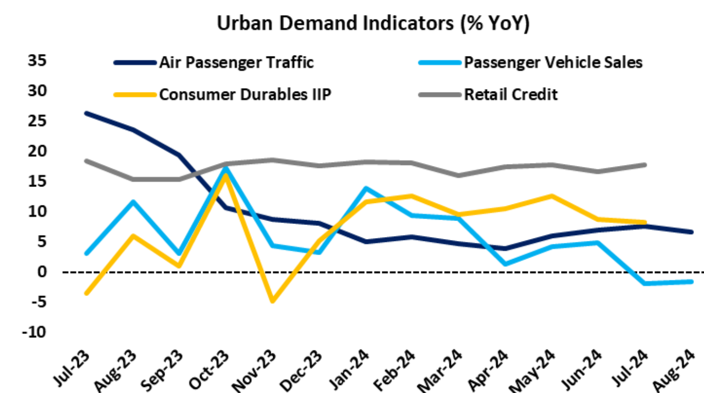
Q1 FY25 growth slips to a five-quarter low of 6.7%; mixed data in Q2 raises outlook concerns

Economic growth fell to a five-quarter low of 6.7% in Q1 FY25, down from 7.8% in Q4 FY24, primarily due to the impact of heatwaves and subdued government expenditure during the general elections. However, GDP internals reveal a more positive narrative, driven by a rebound in private consumption, an increase in non-government investment, and a significant contribution from net exports. Notably, GDP growth excluding government spending was robust at 7.4% YoY in Q1 FY25. This raised hopes for strong overall growth for the remainder of the year, contingent on sustained momentum in consumption, investment, and exports, coupled with a rebound in government spending post-elections. Nonetheless, high-frequency economic data has been mixed, with some indicators proving outright disappointing, which raises concerns about the economic outlook.

Consumption surprised on the upside in Q1 FY25

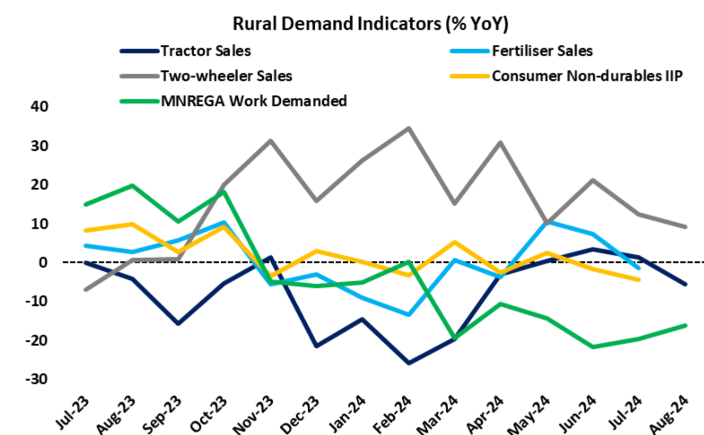
In Q1 FY25, private consumption growth rebounded to a seven-quarter high of 7.4% YoY, following a sluggish average of 4% in FY24. This increase is likely driven by a revival in rural demand, while urban consumption appears to have maintained its momentum. However, incoming high-frequency data from July and August indicates an uneven recovery. Proxy indicators for urban demand present mixed trends; for instance, consumer durables output growth fell to a seven-month low despite a favourable base, and passenger vehicle sales contracted for the second consecutive month in August. Although banks' retail credit saw double-digit expansion, the slowdown in unsecured credit may dampen overall consumption. That being said, consumers' spending on experience (like music shows, dining, foreign travel etc), and entertainment are rising, suggesting a K-shaped recovery among urban households.

Urban demand indicators suggest uneven recovery



Source: CMIE

Rural demand indicators suggest recovery likely concentrated in relatively affluent households



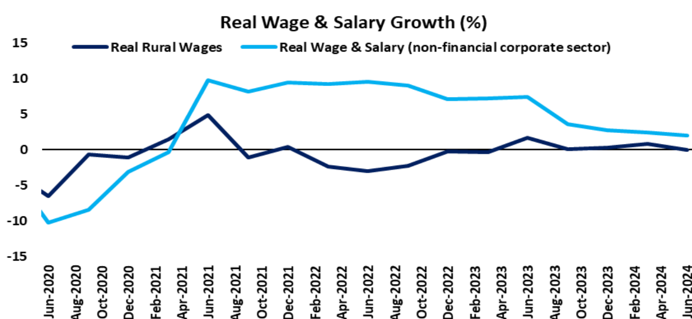
Source: CMIE

Conversely, proxy indicators for rural demand, such as robust two-wheeler sales and a continued decline in demand for jobs under NREGA, suggest that recovery in rural areas is underway. This is on expected lines given above normal rainfall boosting agriculture outlook. FMCG sales data also indicate that rural areas are outperforming urban ones. However, consumer non-durables remained in the red in July, suggesting that the recovery in rural demand may be concentrated among relatively affluent households.

Outlook for consumer spending in FY25 is mixed, with rural demand poised for growth, but the jobs market raises concerns

The outlook for consumer spending for the remainder of FY25 is mixed. While the recovery in rural demand could bolster consumption, the slowing pace of urban demand may weigh on overall figures. A positive agricultural outlook, supported by healthy Kharif sowing and above-average reservoir levels (boosting Rabi crops prospects), is anticipated to enhance farm income and rural consumption. Nonetheless, the uneven spatial distribution of rainfall could hinder broader rural demand recovery. Beyond the near-term boost from positive agricultural trends, concerns remain about the lack of productive jobs to absorb the rising labour supply. According to the CMIE survey, the share of self-employed individuals in total employment rose from 13% in FY17 to 20% by FY24, while the share of salaried employees remained flat at 22%. Simultaneously, the proportion of wage labourers plummeted from 42% to under 30%, and the share of farmers increased from 23% to 27% during the same period. These trends suggest rising under-employment in self-employed and farmers' occupations groups due to a shortage of better-paying jobs in the formal sector. Furthermore, real wages in rural areas and real salary growth in the corporate sector continue to slow, raising doubts about the sustainability of the consumption demand revival. On a positive note, Naukri Jobs and CMIE labour market data were generally positive with a pick-up in hiring activity in July-August, though its sustainability beyond a possible boost from the festive season needs to be watched closely.

Real Wage & Salary Growth continue to disappoint

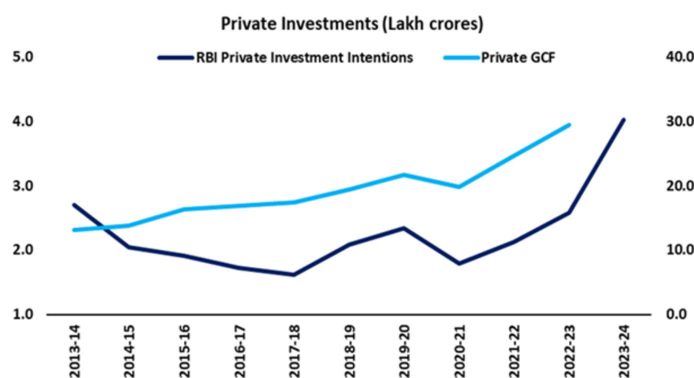


Source: CMIE

Signs of revival in investment but broader recovery faces headwinds

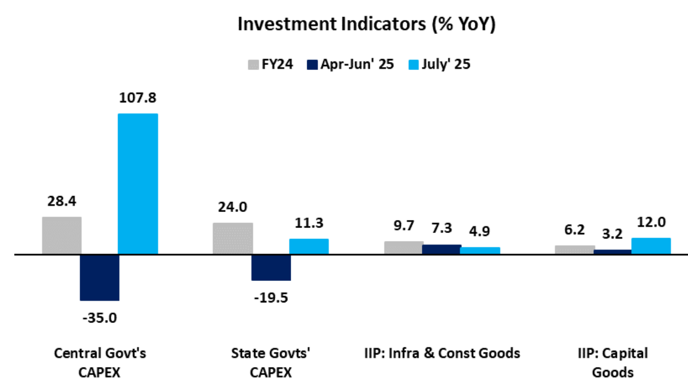
In Q1 FY25, investment growth accelerated to a healthy 7.5% YoY, up from 6.5% in Q4 FY24, despite a contraction in government capital expenditure (CAPEX). This suggests a robust increase in private and household investment, further supported by recent data on private investment intentions released by the RBI. According to the RBI, private investment intentions surged by 56.6%, reaching Rs 4.03 lakh crore in FY24, up from Rs 2.58 lakh crore in FY23. This rise in intentions indicates a positive outlook for private investment, as historical data show a strong correlation between intentions and actual private investments.

Tentative signs of improvement in private sector CAPEX



Source: RBI; Private Sector Intentions uses information on the amount sanctioned for the capex projects by Banks/FIs, External Commercial Borrowings and IPOs. It pertains to data where the cost of projects is estimated above Rs 10 crores.

Investment indicators paint a mixed picture



Source: CMIE

While high-frequency data on investment indicators present mixed results, there are encouraging signs. After a lacklustre Q1, central government capital expenditure picked up sharply in July, rising by over 100%. Within the Index of Industrial Production (IIP), the growth of infrastructure and construction-related goods moderated to an eight-month low, while capital goods output growth accelerated to a nine-month high. Additionally, manufacturing capacity utilization reached an 11-year high of 76.8% in Q4 FY24, corporate

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balance sheets remain healthy, credit to large industries rose to a 20-month high in July, and strong IPO activity further supports the investment outlook. However, risks such as uneven consumption recovery and weakening external demand could impact the investment landscape and delay a broader revival. In the near term, we expect government CAPEX to remain the main driver of investment activity.

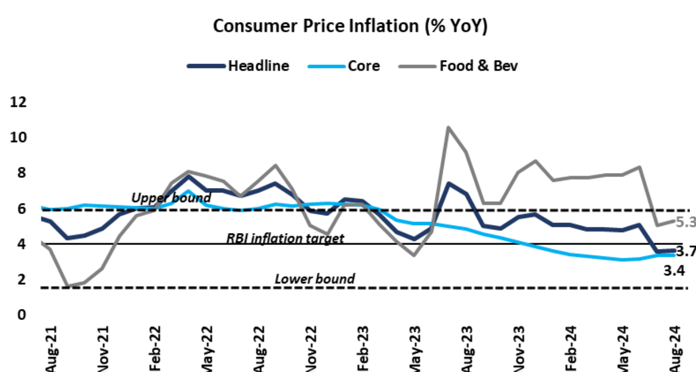
External demand conditions weaken

On the external front, net exports contributed positively to growth in Q1 FY25. However, incoming high-frequency data indicate a sharp weakening in external demand conditions. Merchandise exports fell by 9.3% YoY in August 2024, primarily due to a 37.6% contraction in petroleum exports, while non-oil exports remained flat. In contrast, imports grew by 3.3% YoY in August 2024, largely driven by record-high gold imports. As a result, the merchandise trade deficit widened significantly, reaching a 10-month high of $29.6 billion in August 2024. Looking ahead, the trade deficit is expected to widen further amidst slowing global growth. However, if the recent cooling in commodity prices, particularly crude oil, continues, it could help contain the import deficit. Furthermore, the upcoming US presidential elections and the associated trade policies, especially concerning China, could significantly impact India's trade outlook.

Inflation remains near a five-year low in August; the outlook looks favourable

In August, CPI headline inflation remained near a five-year low, rising slightly to 3.65% YoY from 3.60% in July (which was revised upwards from an earlier estimate of 3.54%). This uptick was primarily due to a less favourable base effect, as inflation remained flat on a sequential basis. The average inflation for July-August is markedly lower at 3.62%, compared to an average of 4.91% in Q1 FY25, continuing the downward trend from 6.4% in Q2 FY24. For September, inflation is tracking around 5%, suggesting that Q2 FY25 inflation will undershoot the RBI's projection of 4.4%.

Inflation rises marginally and remains near a five-year low

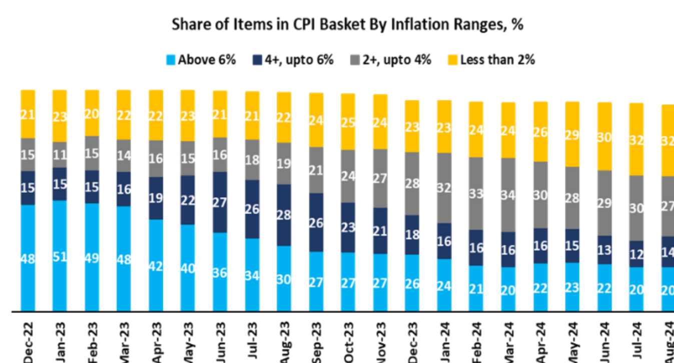


Source: CMIE

Further, the dispersion of CPI inflation indicates a disinflationary trend, with the share of items registering inflation above 6% falling to 20% in August 2024 from 30% in August 2023. This transition is reflected in an increasing share of items in the 4-6% and 2-4% categories. Additionally, the proportion of items with inflation below 2% rose to 32% in August 2024, up from 24% in August 2023.

Within the CPI subgroups, food and beverages inflation fell by 0.3% on a sequential basis but rose from 5.1% YoY in July to 5.3% YoY in August due to the unfavourable base effect. This food inflation was primarily driven by increases in cereals, pulses, and vegetables. Food and beverage inflation, which has a weight of 45.86% in the CPI, accounted for 67% of the overall inflation increase in August. Notably, just three categories—cereals, vegetables, and pulses (with a combined weight of 18% in the CPI basket)—contributed 69% of the total rise in food inflation and 46% of overall inflation.

Broad disinflationary trend in the CPI basket is intact



Source: CMIE

The outlook for food inflation is favourable, supported by cumulative monsoon rainfall that was approximately 7.4% above the long-term average as of September 18th. While the spatial distribution of rainfall improved, nine out of 36 sub-divisions still faced double-digit deficits. However, abundant rainfall across much of India led to a 1.5% YoY increase in Kharif sowing, with pulses (7.8% YoY) and cereals (2.6% YoY) showing solid growth, which bodes well for food inflation. The WPI food inflation (covering primary food articles and manufactured food items) eased to a 10-month low of 3.3% in August 2024. Moreover, recent data indicates sequential moderation in food prices during the first two weeks of September.

Meanwhile, core inflation remained relatively unchanged at 3.4% YoY in August. While core services inflation edged up due to higher telecom tariffs, this was offset by lower core goods inflation due to lower gold prices. Overall, core services inflation rose to 3.4% from 3.3%, while core goods inflation eased from 3.5% in July to 3.4%. As core inflation has likely bottomed out, we expect a gradual increase in the

coming months, although it should remain contained. PMI data for services and manufacturing indicate easing output prices, and there is potential for retail fuel price cuts given falling global crude oil prices amidst weak global demand. Additionally, the recent softening of global commodity prices should support contained core inflation.

It's time for RBI's "Pivot" after an extended pause

In its August meeting, the RBI maintained a hawkish tone, emphasizing the need to bring inflation down towards the 4% target on a durable basis. Recent comments from the RBI governor highlight his focus on "successfully navigating the last mile of disinflation", suggesting that the central bank may not rush to pivot. However, we believe the RBI should begin preparing for a policy shift, as monetary policy works with a lag and therefore it needs to be guided by a forward-looking outlook. Economic growth has come in below the RBI's projections for Q1 FY25, and there are emerging risks to the growth outlook from mixed consumption patterns and weak external demand. Furthermore, inflation in Q2 FY25 is expected to undershoot the RBI's projection.

The food inflation outlook is also promising due to above-normal rainfall and growth in Kharif sowing. A decline in global crude oil prices, along with softening commodity prices and reduced currency pressures, should also contribute positively to disinflation. Inflation expectations appear anchored, as do wage and salary pressures. Moreover, as noted earlier, there is broad-based disinflation across CPI sub-groups, with cereals, vegetables, and pulses contributing significantly to inflation. It is more prudent to address inflation in these three food categories through enhanced supply-side measures rather than maintaining a tight policy for longer than necessary, which could hinder economic growth.

Moreover, substantial rate cut by the US Fed and expectations for further cuts before year-end could influence policy discussions in India even though the RBI will continue to prioritize domestic factors. A change in policy stance at the October meeting would provide the RBI with the flexibility to respond to emerging risks. We believe the RBI will signal future policy changes by adopting a dovish tone at the next meeting, which may or may not coincide with a shift in the policy stance from "withdrawal of accommodation" to "neutral." We continue to anticipate the first rate cut at the December policy meeting. Additionally, it's important to note that the MPC will see three new external members (yet to be appointed) following the expiry of the current members' terms. Two existing external members have advocated for a change in stance and a rate cut. We may see some fresh perspectives in the upcoming policy from the new members.

Market Update

Debt Market: Indian 10-year benchmark yields continued to soften in August and September, primarily due to lower crude oil prices, softer US Treasury yields, and positive foreign investor sentiment following the inclusion of Indian bonds in global bond indices. This trend persisted after the Fed's 50-bps rate cut in September, with benchmark yields reaching 6.76% as of September 19. Meanwhile, overnight money market rates remained below the repo rate in August and the first half of September, reflecting surplus liquidity. However, liquidity turned into a deficit during the second half of September, averaging Rs 1.7 lakh crore due to outflows associated with advance tax payments and GST. Consequently, the weighted average call rate rose to 6.65% on September 19. Following the RBI's announcement of a variable repo auction, the call rate adjusted closer to 6.2%. Looking ahead, 10-year yields are likely to soften further, supported by weaker crude prices and positive investor sentiment, while RBI interventions may help align overnight rates with the repo rate.

Equity Market: After a sharp decline in early August due to weaker US employment data raising recession fears and a hawkish Japanese monetary policy, the equity markets rebounded in the latter weeks of the month. By the end of August, the Nifty and Sensex posted modest gains of 1.1% and 0.7%, respectively. However, this positive momentum continued into September amidst volatility. The US central bank's outsized rate cut and guidance of further cuts head fuelled bullish sentiment in the Emerging Market asset class. FPI inflows rose sharply in the past few days. Consequently, the NIFTY50 gained 2.2% by September 20 from the end of the previous month. The Price-to-Earnings (P/E) ratio of the NIFTY50 index increased further in August and September, reaching 24.0 as of September 20. We expect this upward momentum to continue; however, global triggers may lead to higher volatility in domestic equities.

Currency Market: The Indian rupee averaged 83.9 INR/USD in August, slightly weaker than the 83.6 INR/USD average in July, making it one of the worst-performing currencies of the month. This depreciation was primarily driven by FPI outflows and strong dollar demand from importers, exacerbated by a surge in gold imports. In the first two weeks of September, the rupee remained within a narrow range of 83.9-84 INR/USD. However, it appreciated leading up to the US Fed meeting and continued to strengthen after the Fed announced a 50-bps rate cut. Overall, the rupee has appreciated approximately 0.5% from August end level and is tracking at 83.5 as of September 20. While future capital inflows are expected to support the rupee, the RBI is likely to intervene to mitigate excessive volatility.

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