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India's economic momentum slows: time for a policy rate cut ahead?

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- The global economy has been remarkably resilient in the face of myriad headwinds in recent years, and with some of those headwinds diminishing in intensity, prospects for the period ahead remain favourable.
- However, India's economic growth outlook is becoming increasingly cautious, reflecting softening high-frequency economic data.
- India's industrial activity slowed sharply in recent months, dragged by softer domestic demand, weaker exports, and muted government spending. Excess rainfall also disrupted economic activity.
- There are signs of softening in urban consumption demand, while rural demand conditions are mixed. Still, the outlook for rural demand remains favourable, supported by better prospects for the agriculture sector.
- Positively, investment activity is showing signs of recovery, but it remains concentrated in a few sectors. Government CAPEX is running behind target, leaving space for a step-up in the rest of FY25.
- The RBI kept the repo rate unchanged at 6.5% for the tenth consecutive meeting in October; it revised the monetary policy stance from "withdrawal of accommodation" to "neutral."
- Despite anticipated near-term inflationary pressures, the RBI expressed greater confidence in navigating disinflation, supported by improved prospects for kharif and rabi crops and ample buffer stocks of food grains.
- In September, headline CPI inflation surged to a nine-month high of 5.49% YoY, up from 3.65% YoY in August due to the base effect and a jump in food inflation, particularly vegetable prices.
- As inflation is expected to ease going ahead, slowing economic growth should keep alive the possibility of a rate cut in December.
- However, if inflation surprises and remains elevated in October, we do not rule out the likelihood of a rate cut shifting to Q4-FY25.

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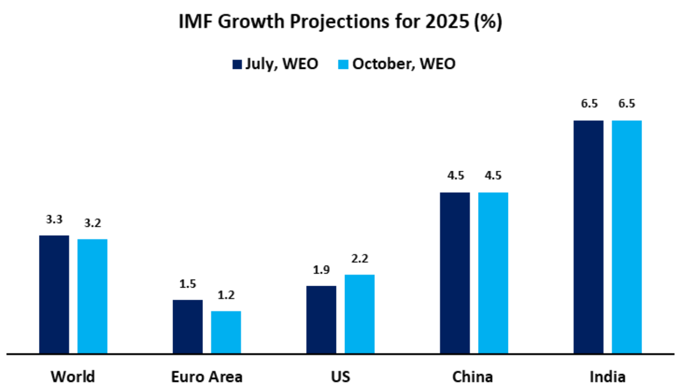
Global economy shows resiliency, the outlook is favourable

The global economy has been remarkably resilient in the face of myriad headwinds in recent years and with some of those headwinds diminishing in intensity, prospects for the period ahead remain favourable. Despite generational highs in consumer inflation in advanced economies and the resulting rapid tightening in monetary policy, pronounced economic weakness in China, geopolitical tensions and the changeover (and prospect of changeover) in governing coalitions in some of the world's largest economies, the pace of economic growth has held up well.

Global economy expected to grow by 3.2% in 2025



Source: IMF, World Economic Outlook (WEO), July and October 2024

The consensus expects the global economy to expand by 3% to 3¼% in 2025 and for headline consumer inflation to rise by about 3½% to 4%.[1] Economic growth in that range would be similar to that of the prior couple of years and not far off from the global economy's likely trend rate of growth. Underpinning these growth expectations are slower rates of economic growth in both the United States and China. Such a rate of consumer inflation – if realized – would be a notable improvement from the 2022-24 period but still somewhat higher than desired.

We are more optimistic about economic growth in the year ahead than the consensus. It is our judgment that growth in the US likely will continue to expand at rates that surpass expectations. At the same time, while considerable uncertainties persist regarding China, Chinese policymakers are finally moving to deploy measures to try to deal with some of the country's major macro headwinds. The combination of continued solid growth in the US plus even a modest pickup in growth in China could push global economic growth close to 4% - or even higher under certain policy and electoral outcomes. Elsewhere, growth in advanced economies likely will pick up – especially those where private debt tends to be floating rate and where debt service costs will be declining as central banks lower interest rates.

Labour markets around the world currently are the most balanced they have been in the post-COVID period. The specifics varied by economy, but generally, from mid-2021 to mid-2023, supply and demand imbalances in labour markets were severely disjointed. The upshot was unsustainable employment and wage packages with feedthrough into higher inflation rates. Normalization of supply and less stimulative macroeconomic policy combined to smooth out those prior imbalances. As a result, the labour market is not currently a major source of upside inflation risk.

The type of economic support Chinese policymakers have been previewing is also unlikely to be a major source of upside inflation risk – at least for 2025. Unlike large, pro-growth measures in the past 25 years that have focused primarily on the industrial side and sometimes catapulted global commodity prices, current and prospective measures are more focused on pulling consumer confidence and activity out of the doldrums and stabilizing the ailing property sector and the impairments it is causing to the financial sector.

Nonetheless, inflation risks have not been squashed entirely, especially in countries where the pace of economic growth has proved persistently resilient. The US is the most noteworthy of these countries. To be sure, a softer labour market, as highlighted by the rise in the unemployment rate, more moderate wage trends and more caution on the part of both employers and employees has been a key factor in helping to bring down the US inflation rate. But private-sector demand in the past year rose by roughly 3%, a rate that in our judgment is not consistent with material additional disinflation.

Whether US inflation accelerates in a problematic way in 2025 hinges on the outcome of the election and decisions the Federal Reserve makes in the coming months. As discussed last month, the Fed's 50bps rate cut in September and its signal of additional action ahead is a by-product of the central bank's desire to try to take out insurance against any further cooling in the US labour market by shifting policy from what the Fed views currently as "restrictive" to "neutral." The Fed's view of "neutral" entails its policy rate being at a minimum 75bps lower than at present although economic performance and events could alter that perception. With the US presidential election now less than two weeks away, the prospective policy plans of the two candidates and the resulting macro implications have become clearer: A Trump

[1] Source: World Economic Outlook: Policy Pivot and Rising Risks, International Monetary Fund, October 22, 2024, and Bloomberg Consensus Economic Forecasts.

victory will be considerably more pro-growth – even accounting for the possibility of broad-based tariffs – than a Harris victory. With US inflation not totally vanquished and the Fed cutting rates, the likelihood of a demand-driven pickup in inflation at some point in 2025 would not be trivial in a second Trump Administration.

India's economic growth likely slowed in Q2 FY25; outlook turns cautious

India's growth outlook is becoming increasingly cautious, reflecting softening high-frequency economic data. This cautious outlook follows slower economic growth in Q1 FY25, where temporary disruptions—such as a heatwave and the general elections—significantly impacted economic activity. Expectations for the remainder of the fiscal year were for a pickup in economic activity, driven by anticipated recovery in consumption, exports, and investment activities, along with an increase in government spending post-elections. However, these anticipated recoveries have yet to materialize.

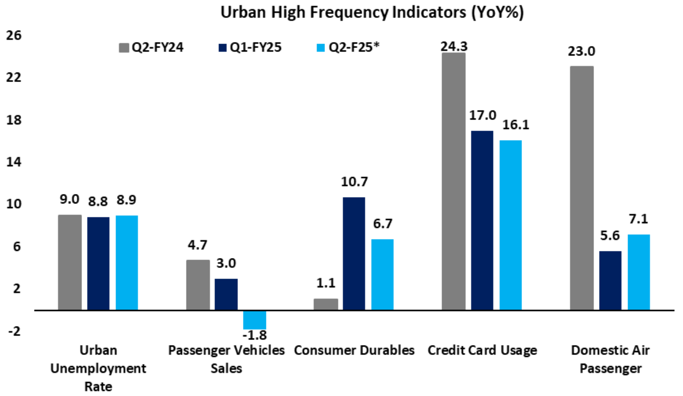
Signs of softening in urban consumption, weakening external demand, and sluggish government spending are evident, while rural demand presents a mixed picture. Private investment shows some improvement, albeit concentrated in select industries. Excess rainfall and an extended monsoon season have also dampened economic activity while contributing to inflation, particularly in food prices. Given these developments, we perceive downside risks to our current GDP growth projection of 6.9% to 7% for FY25.

Rural demand is mixed; urban demand shows signs of softening

In Q2 FY25, domestic demand conditions seem to be softening. Gross Goods and Services Tax collections growth fell to 6.5% YoY in September, marking the slowest pace in 40 months. There are signs of softening in urban consumption demand, while rural demand conditions remain mixed. Some FMCG companies that have reported Q2 earnings noted slower sales growth in urban areas compared to rural areas. Furthermore, proxy indicators related to urban demand are showing slower growth, including passenger vehicle sales and consumer durables output. The Federation of Automobile Dealers Associations reported historically high inventory levels, averaging 80 to 85 days—equivalent to 7.9 lakh vehicles. Consequently, auto companies have begun recalibrating dispatches, with some scaling back production.

Early indicators for festival season sales are also underwhelming, with a reported fall in credit card usage. Banking retail credit growth has also slowed, averaging 14.1% YoY during July-August 2024, down from 16.6% in Q1. On a relatively positive note, demand for services appears to be holding up, as reflected in the continued growth in air passenger traffic. There are also reports of a pickup in auto sales around Dusshera.

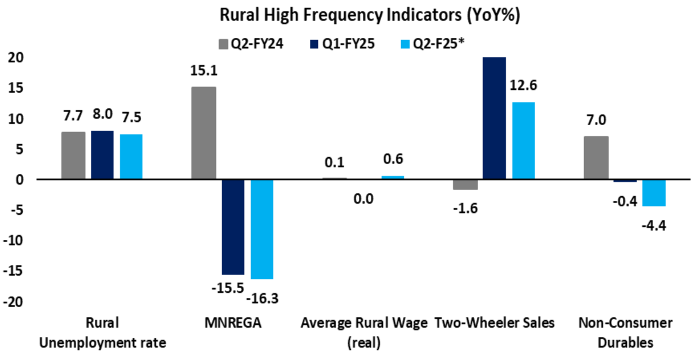
Urban demand indicators show signs of softening



Source: CMIE, *Based on July-August if September data is unavailable. The unemployment rate is in percentage.

In what appears to be a K-shaped recovery among the rural population, two-wheeler sales have seen robust growth. Conversely, the contraction in non-consumer durables has deepened. Despite this, there are continued expectations of recovery in rural demand in the coming months, supported by above-normal rainfall, growth in Kharif sowing, and higher reservoir levels boosting prospects for rabi crops.

Rural demand indicators suggest a mixed picture



Source: CMIE, *Based on July-August if September data is unavailable. The unemployment rate is in percentage.

Labour market conditions reflect mixed signals, posing uncertainty about a strong consumption recovery in the rest of FY25. According to CMIE data, the urban unemployment rate rose to a nine-month high of 9.2% in September, despite an increase in salaried employment. Meanwhile, the Naukri Job Index rose by 6% YoY in September, following a contraction the previous month, with 23 out of 37 industries reporting increases, partly due to festival-related hiring. However, it remains uncertain whether this recent uptick in the formal sector hiring will continue beyond the festival season, given the overall signs of slowing demand.

In rural areas, there has been a notable decline in work under the MNREGA scheme, reflecting improving job conditions. According to CMIE data, rural unemployment fell to 7%, the lowest level since January 2024, despite a decrease in agricultural employment. Job opportunities in allied activities and construction have contributed to this improvement. However, concerns about job quality and earnings growth persist, given subdued rural real wage growth.

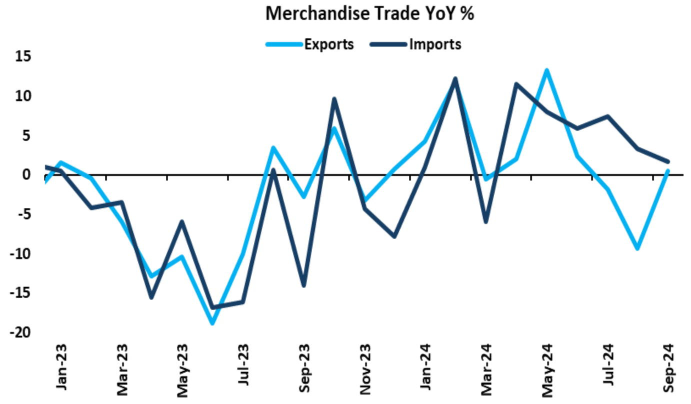
Industrial activity slowed down amidst excess rainfall, weaker external demand, and muted government expenditure

Industrial activity appears to be slowing sharply due to subdued domestic consumption, a weaker external demand environment, and a decline in government capital expenditure. Excessive rainfall and an extended monsoon season have further exacerbated the slowdown. In August, the Index of Industrial Production (IIP) contracted for the first time in 22 months, declining by 0.1% YoY compared to a growth of 4.7% YoY in July.

The downturn in the Index of Industrial Production (IIP) was primarily driven by the mining and electricity sectors, which contracted by 4.3% YoY and 3.7% YoY, respectively, largely due to excessive rainfall. The high base effect from the previous year further intensified this decline. Although manufacturing remained in a growth phase, it slowed significantly to just 1% YoY growth, down from 4.4% YoY in July. This growth is not broad-based, with production in 11 out of 23 sub-sectors contracting in August, the highest number in nine months. The slowdown in manufacturing activity coincides with tepid government expenditure. Total expenditure contracted by 1.2% YoY during April-August 2024, primarily due to a notable 19.5% YoY decline in capital expenditure. Revenue expenditure also remained muted, growing only by 4.1% YoY compared to the budgeted target of 6.2% for FY25. There is significant headroom for the central government to increase spending in the remainder of FY25, as the fiscal deficit has narrowed to 27% of the Budgeted Estimate in the first five months, down from 36% during the same period last year. However, there is a risk that the government may miss its capital expenditure target this year, as it needs to significantly boost spending by nearly 41% YoY in the remaining months to meet the budget target.

Merchandise exports also remained sluggish, contributing to weaker manufacturing activity. Exports grew by only 0.5% YoY in September and just 1% YoY in H1 FY25, despite a favourable base effect. The external environment remains challenging, particularly due to geopolitical developments in the Middle East, which pose risks to global commodity prices and supply chains. The World Trade Organization has slightly revised its world merchandise trade volume growth projection up by 10 bps to 2.7% YoY for 2024. However, it has cut the projection for 2025 by 30 bps to 3.0%, citing intensified downside risks, especially stemming from the escalation of conflicts in the Middle East that could further disrupt trade flows. Additionally, the upcoming U.S. presidential election may significantly influence trade policies and the global trade outlook next year.

Exports growth remains lacklustre

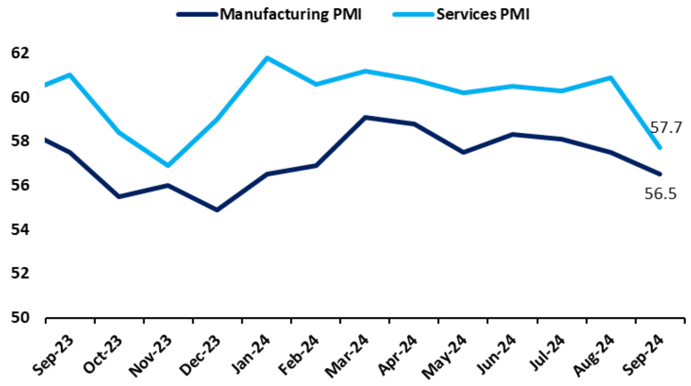


Source: CMIE

Leading indicators suggest a loss of momentum in economic activity

In terms of leading indicators, the PMI manufacturing index eased in September to its weakest level since January 2024. There is also easing in the services sector, with the Services PMI falling to a 10-month low in September. Furthermore, early indications from the quarterly earnings reports of 341 companies show a slowdown in growth for net sales, revenues, and net profits in Q2 FY25. While the ongoing festival season, expected pickup in government spending, and a recovery in rural demand may support some recovery in H2 FY25, challenges persist, including softening urban demand and weakening external demand.

PMI Indices recorded the lowest levels in 2024 but continued to remain in the expansionary zone



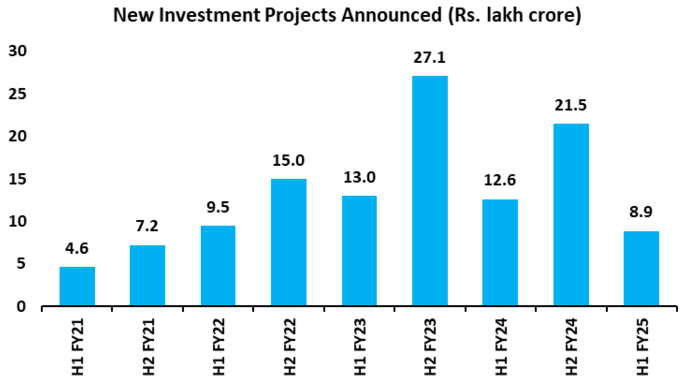
Source: CMIE

Signs of private investment picking up, but it remains concentrated in select industries

On a more positive note, private investment activity is showing signs of a pickup in Q2 FY25, although it remains concentrated in a few sectors. Bank credit to large companies has increased, and fundraising through IPOs continues at a robust pace, indicating a healthier financing environment for corporations. Corporate balance sheets are also in better shape, with the interest coverage ratio reaching a nine-quarter high in Q1, driven by sustained operating profit growth and reduced interest expenses. Seasonally adjusted capacity utilization in the manufacturing sector has risen, increasing by 120 bps to 75.8% in Q1.

The CMIE reports that new capacity creation projects amounted to Rs 6.7 trillion in the September 2024 quarter, nearly doubling from Rs 2.2 trillion in the previous quarter. Positively, 77% of the total projects are accounted for by the private sector. However, it is noteworthy that new projects announced in H1 FY25 are approximately 30% lower compared to the same period last year. Furthermore, only five sectors—Chemicals and Chemical Products, Transport Equipment, Transport Services, Electricity, and Real Estate and Construction—accounted for around 82% of the new projects announced by value in Q2. Given the softening in domestic and external demand conditions, a broader, sustained revival in investment seems unlikely in the near term. We anticipate that government CAPEX will need to drive investment activity in the near term.

New projects picked up in Q2 but are still lower than last year



Source: CMIE

RBI kept the policy rate unchanged, but revised the policy stance to "neutral"

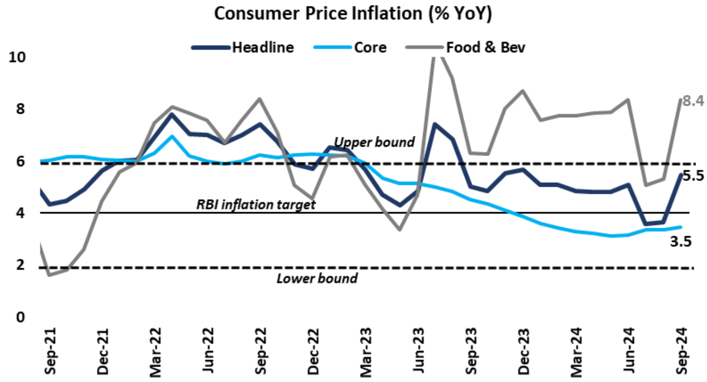
In its October meeting, the RBI's Monetary Policy Committee (MPC) decided to keep the repo rate unchanged at 6.5% for the tenth consecutive meeting. Importantly, the MPC changed the monetary policy stance from "withdrawal of accommodation" to "neutral." This change in the stance gives the RBI greater flexibility and optionality to act in line with evolving conditions and the outlook.

The RBI remains upbeat about the economic outlook, leaving its FY25 projections for economic growth and inflation unchanged at 7.2% YoY and 4.5% YoY, respectively. Further, despite anticipated near-term inflationary pressures, the RBI expressed greater confidence in navigating disinflation, supported by improved prospects for kharif and rabi crops and ample buffer stocks of food grains. It maintains a cautious approach given continuing risks to the inflation outlook, which stem from ongoing geopolitical tensions, financial market volatility, adverse weather events, and a recent uptick in global commodity prices. Recent remarks from the RBI Governor- "rate cut at this stage will be very premature and can be extremely risky"- align with this cautious approach.

Inflation rises to a nine-month high in September

In September, headline CPI inflation surged to a nine-month high of 5.49% YoY, up from 3.65% YoY in August. This increase was significantly influenced by a base effect, contributing approximately 113 bps to the rise, compared to just 5 bps in the previous month.

Headline CPI surges in September led by food inflation



Source: CMIE

A primary contributor to the unexpected rise (consensus forecast: 5.1% YoY) was a significant rise in food inflation, which reached 8.4% YoY in September, up from 5.3% YoY in August. Prices for vegetables skyrocketed by 36% YoY, notably affecting overall inflation figures. Excluding vegetables, headline and food inflation were approximately 4.1% and 3.4%, respectively. The sharp rise in vegetable prices can be attributed to heightened sensitivity to weather conditions, particularly excessive rainfall in August and September. While these pressures may persist through October, they are expected to ease thereafter.

On a positive note, previously high inflation rates for cereals and pulses showed signs of relief, with inflation dropping to a 27-month low of 6.8% YoY for cereals and a 16-month low of 9.8% YoY for pulses. This trend is likely to continue with increased kharif arrivals. Meanwhile, core inflation remains stable, recording a muted 3.47% YoY in September, slightly up from 3.36% YoY in August. We anticipate a slight uptick in core inflation in the coming months.

With the September inflation print, CPI inflation averaged 4.24% YoY in Q2, only slightly above the RBI's projection of 4.1% (revised down from a previous forecast of 4.4%). We expect inflation to ease from September levels, but it may hover around 5% in October. Furthermore, slowing economic growth should also influence the RBI's policy actions going forward. As inflation is expected to ease going ahead, slowing economic growth should keep alive the possibility of a rate cut in December. However, if inflation surprises and remains elevated in October, we do not rule out the likelihood of a rate cut shifting to Q4-FY25.

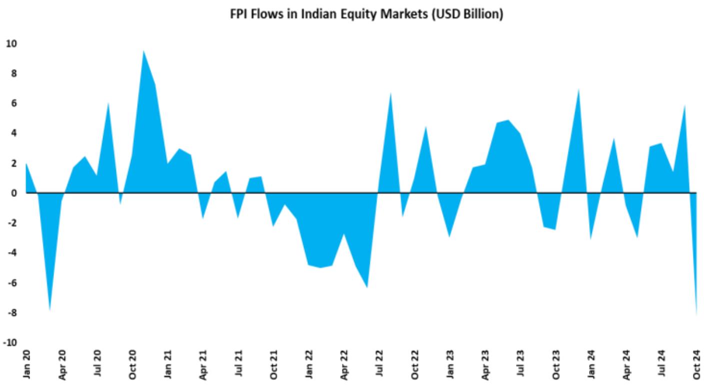
Market Update

Debt Market: The Indian government securities (G-Secs) market continues to benefit from fiscal consolidation and increased foreign portfolio investment (FPI) demand following the inclusion of Indian Government Bonds (IGBs) in the JPMorgan EM bond index. Lower crude oil prices and a dovish U.S. Federal Reserve also supported the IGBs market in September. Compared to the end of August, the 10-year benchmark yield decreased by 11 bps to 6.75%, while the 2-year benchmark yield fell by approximately 10 bps to 6.66% in September. However, the market experienced increased volatility in October due to conflicting factors. A change in the RBI's policy stance in October and improved investor sentiment following the announcement of IGBs' inclusion in the FTSE EM Bond Index supported the bond market. Conversely, rising U.S. yields and volatility in crude oil prices weighed on bond prices. Additionally, higher-than-expected inflation and cautionary comments from the RBI's governor, describing a rate cut at this stage as "premature and risky," also pressured yields. Overall, this push-and-pull dynamic resulted in the 10-year benchmark yield rising to 6.82% by October 23. While the current demand-supply dynamics are favourable for the Indian G-Sec market, uncertainty regarding the RBI's policy outlook, volatility in U.S. bond yields, and geopolitical developments may continue to contribute to market volatility.

Equity Market: Bolstered by risk-on sentiment following the U.S. Fed rate cut, large FPI inflows, and continued Domestic Institutional Investors (DIIs) buying, the Indian stock market reached record highs in September, with the benchmark index NIFTY50 rising by 2.3% MoM. However, the market experienced a sharp fall in October (up to the 23rd), with benchmark indices, namely NIFTY50 and BSE SENSEX 50, declining by 5.3% and 5.0%, respectively, from the end of September levels. Amid the broader market correction, small-cap and mid-cap stocks registered sharper declines due to their stretched valuations.

The market correction is largely attributed to the reallocation of funds toward Chinese markets, early signs of weaker corporate earnings in Q2, and geopolitical developments dampening investor sentiment. Furthermore, foreign investors are becoming increasingly cautious about emerging markets due to the repricing of the U.S. Fed rate outlook and uncertainty surrounding the U.S. presidential elections. FPIs are net sellers, withdrawing $8.3 billion in October so far, the highest monthly outflow ever, compared to inflows of $6 billion in the prior month. However, DIIs remain upbeat about the outlook, having invested approximately $9.9 billion during the same period (following a $4 billion investment in September), providing crucial support and preventing a sharper correction. Looking ahead, the near-term outlook is clouded with uncertainty due to the widening conflict in the Middle East and the upcoming U.S. presidential elections.

FPI outflows hit a record high in October after robust inflows in previous months



Source: CMIE

Currency Market: In the currency market, the USD/INR cross was range-bound in the early part of September but experienced increased volatility in the second half of the month, ending flattish compared to the end of August. Despite the U.S. dollar's weakness due to the Fed's rate cut and lower crude oil prices, gains in the rupee were limited. This may be attributed to the RBI's intervention in the forex market, as reflected in the buildup of Forex reserves to a historical high of $705 billion by the end of September.

Heading into October, the rupee faced pressure as the dollar strengthened amid repricing in the U.S. Fed rate outlook and rising geopolitical tensions. Additionally, significant foreign capital outflows from Indian markets weighed on the currency. By October 23rd, the rupee had depreciated by 0.3% from the end of the previous month. The rupee is expected to trade with a depreciation bias amidst heightened global uncertainty, but the RBI is anticipated to intervene to prevent any sharp movements in the currency.

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