

Macro Review & Fixed Income Market Outlook

Global Economy Update:

Macro Backdrop:

- ✦ The global economy continues to face daunting challenges of elevated inflation, elevated debt levels, tight and volatile financial conditions, continuing geopolitical tensions, fragmentations, and extreme weather conditions.
- ✦ Belying earlier apprehensions, developed economies have demonstrated remarkable resilience and the grim prospects of hard landing appear to have receded.
- ✦ Nevertheless, global growth is likely to remain low by historical standards in the current year and next few years, despite the upward revision in the global growth forecast for 2023 by the IMF.
- ✦ World merchandise trade volume growth is projected by the WTO to decelerate from 2.7 per cent in 2022 to 1.7 per cent in 2023.
- ✦ Global growth was restrained by lacklustre activity in manufacturing and trade in Q2:2023 although the performance of the services sector remained resilient.
- ✦ Headline inflation is easing unevenly across countries and remains above the target in major economies.
- ✦ The cumulative effects of monetary policy tightening are beginning to show up in credit and labour market conditions across advanced economies (AEs).
- ✦ While the pace of monetary tightening has been scaled down, policy rates could stay higher for longer.
- ✦ In its July 2023 update of the World Economic Outlook (WEO), the International Monetary Fund (IMF) revised its global growth forecast for 2023 marginally upwards to 3.0 per cent from its April projection of 2.8 per cent.
- ✦ Much of the revision was in the AE group (0.2 percentage points), following better than expected H1:2023 performance.
- ✦ Global growth for 2023 is, nonetheless, expected to trail below its 2022 level (3.5 per cent) as well as historical (2000-19) average of 3.8 per cent.
- ✦ Incoming data across geographies point towards a mixed picture.
- ✦ GDP growth in the US, the UK and the Euro area accelerated in Q2:2023, although in the case of the latter, Germany's economy stagnated, and Italy unexpectedly experienced a contraction.
- ✦ In China, GDP growth decelerated sharply in Q2 as pent-up demand waned after the rebound in late 2022.
- ✦ Forecasts for global GDP growth point towards a positive momentum in Q2:2023.
- ✦ Global supply chain pressures remained below historical averages despite a sequential pick-up in June and July.
- ✦ Financial markets, which had been buoyed by expectations of an early end to the cycle of monetary tightening, have turned volatile with sizeable two-way movements in response to recent rating event (US rating downgraded by Fitch to AA+) and incoming data.

Indian Economic Growth:

Macro Backdrop:

- ✦ Volatile global factors are likely to impinge on the growth prospects of most major advanced and emerging economies.
- ✦ India is, however, expected to withstand these external headwinds far better than many other countries.
- ✦ In this stressed global environment, the Indian economy is gathering momentum in the second quarter of 2023-24. India GDP grew by 7.8% in 1QFY2024.
- ✦ The momentum of overall economic activity in India continues to be positive.

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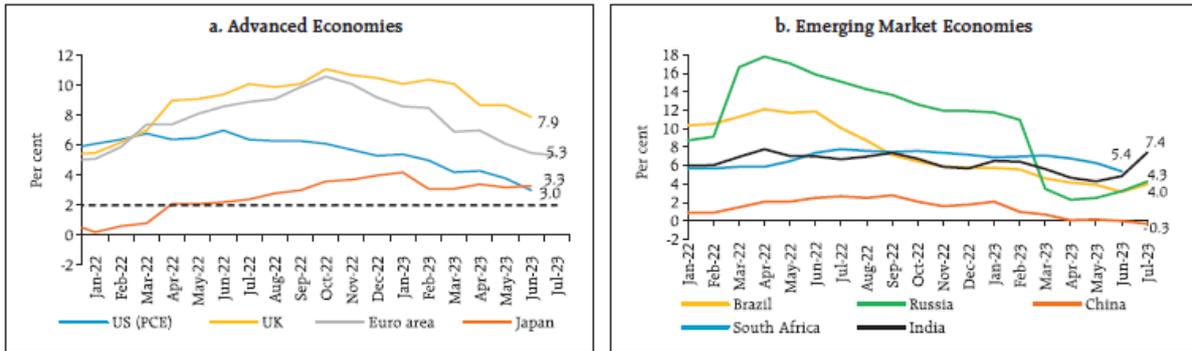
- ✚ Domestic drivers such as private consumption and fixed investment are offsetting the drag from the contraction in exports.
- ✚ The uptick in inflation in its June reading swung decisively in July to 7.4%, with the unprecedented shock to tomato prices spilling over to prices of other vegetables.
- ✚ While core inflation witnessed a moderation, headline inflation is expected to average well above 6 per cent in the second quarter.
- ✚ The Indian financial sector has been stable and resilient, as reflected in sustained growth in bank credit, low levels of non-performing assets and adequate capital and liquidity buffers.
- ✚ India's current account deficit (CAD) was contained at 2.0 per cent of GDP in 2022-23 as compared with 1.2 per cent in 2021-22.
- ✚ Merchandise trade deficit has narrowed in Q1 of 2023-24 with contraction in imports exceeding contraction in exports.
- ✚ Services exports and remittances are likely to continue to provide cushion to the current account deficit.
- ✚ The index of industrial production (IIP) expanded by 5.2 per cent in May while core infrastructure output rose by 8.2 per cent in June. The purchasing managers' index (PMI) for manufacturing was 57.7 in July.
- ✚ PMI services rose to 62.3 in July from 58.5 in June led by robust demand and new business gains, signalling the sharpest expansion in output since June 2010.
- ✚ Investment activity gained further steam on the back of government capital expenditure, rising business optimism and revival in private capex in certain key sectors.
- ✚ The capital expenditure by the Central government increased by 59.1 per cent (y-o-y) during Q1:2023-24.
- ✚ Information available for 20 states indicates that their capital expenditure jumped by 74.4 per cent (y-o-y) during Q1:2023-24 as compared with a contraction of 8.7 per cent a year ago.
- ✚ Continued increase in import and production of capital goods further reaffirms this trend.
- ✚ Construction activity also remained strong in Q1 as indicated by healthy growth in cement production and steel consumption.
- ✚ Capacity utilisation in the manufacturing sector at 76.3 per cent (and 74.1 per cent on seasonally adjusted basis) remained above the long-term average of 73.7 per cent.
- ✚ The goods and services tax (GST) collections in August rises 11% to about Rs 1.65 lakh crore.

Inflation:

Global:

- ✚ Headline inflation moderated across most economies.
- ✚ As per flash estimates, inflation in the Euro area further moderated to 5.3 per cent in July 2023, its lowest level since January 2022.
- ✚ In the US, CPI inflation edged up to 3.2 per cent in July from 3.0 per cent last month.
- ✚ Inflation based on the US personal consumption expenditure (PCE) index stood at 3.0 per cent in June 2023, the lowest reading since April 2021.
- ✚ In the UK, CPI inflation eased to 7.9 per cent in June while Japan's CPI (all items less fresh food) inflation edged up marginally to 3.3 per cent in June (3.2 per cent in May).
- ✚ Among the EMEs, inflation edged up sharply in Brazil and Russia in July, while China registered a deflation of 0.3 per cent.
- ✚ Inflation in South Africa moderated in June.
- ✚ Core and services inflation are exhibiting incipient signs of moderation but continue to remain above the headline in most regions.

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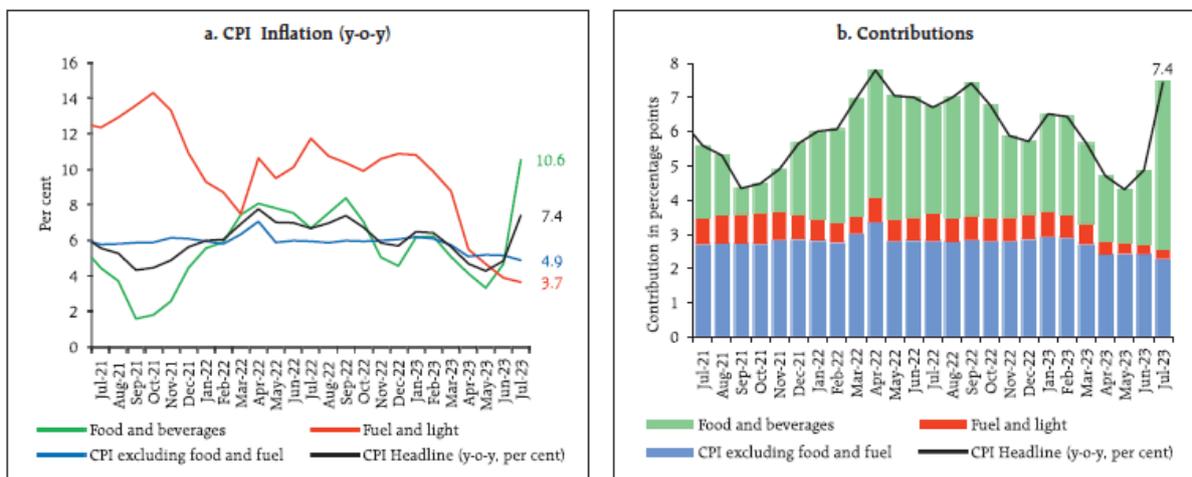


Source: Bloomberg and OECD

India:

- ✚ CPI inflation surged to 7.4 per cent in July 2023 from 4.9 per cent in June 2023.
- ✚ Inflation in the food and beverages group more than doubled to 10.6 per cent in July from 4.7 per cent in June, driven by a jump in momentum (5.7 per cent in July – the steepest increase in the CPI series so far vis-à-vis 2.2 per cent in June).
- ✚ This was driven primarily by the vegetables sub-group, which emerged out of deflationary territory over the last 8 months to register a y-o-y increase of 37.3 per cent in July.
- ✚ Inflation also edged up in cereals, meat and fish, fruits, pulses, sugar, and spices.
- ✚ On the other hand, inflation in eggs, milk and prepared meals softened while the rate of deflation in edible oils eased.
- ✚ CPI Core inflation (excluding food and fuel) was marginally lower at 4.9%.

Trends and Drivers of CPI Inflation:



Sources: National Statistical Office (NSO); and RBI staff estimates.

Bond Yields & Spreads:

- ✚ Global central banks continue to remain extremely data dependent as inflation remains higher than their respective goals.
- ✚ The Bank of Japan (BOJ) tinkered with its yield curve control (YCC), pushing the 10Y upper band to 1% from 0.5%. This roiled the world bond markets, as the only remaining source of cheap funding was seen going away sooner or later.
- ✚ US 10Y yields moved higher as growth continues to remain robust with soft-landing narrative taking hold, and rate easing expectation pushing further into 2024.

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- ✚ With global rates firming up on good growth data and hawkish central banks, 10Y G-Sec yield went to around 7.25%. However, sentiment remains cautiously positive and 10Y G-Sec closed the month around 7.18%.
- ✚ Overall yields rose across the curve in first half of the month, but retraced the move as the global rate moves were seen overdone. Overall the yield curve moved sideways in the month.
- ✚ Medium to long term corporate spreads remained on lower side in absence of any material increase in supply.

Outlook:

Global:

- ✚ The global economy continues to confound central bankers, as growth sustains despite sharp rise in rates in last 15 months. Recession fears have receded, and markets are forecasting a “soft landing” scenario as a high probability.
- ✚ Inflation seems to have peaked in major countries, though reasons to cheer may still be far away, as the momentum of drop in inflation has slowed down, belying market expectations of a quick “pivot” in policy rates.
- ✚ With core inflation rates remaining sticky, Central banks are failing to provide forward guidance and remain highly data dependent.
- ✚ US FOMC seems to be at the end of rate hike cycle but continues to indicate probability of rate moves on incoming data.
- ✚ With the banking crisis addressed and debt ceiling issue behind us, markets will likely be driven by incoming data as policy makers are becoming more data dependent.
- ✚ Rate markets have reversed most of the drop seen in early Apr-June quarter as global narrative changed from “rate pivot” to “higher rates for longer.”

India:

- ✚ In India, macro situation remains resilient.
- ✚ GDP growth for FY2023 surprised on the upside, printing 7.2% (against 7% estimates), with a blowout 4QFY23 growth at 6.1% (against projection of 5.1%).
- ✚ 1QFY2024 GDP number was 7.8%, tad below RBI’s projections. Overall growth trends are positive with FY2024 growth projected to be around 6.5%.
- ✚ August rains were 36% below normal, which may put pressure on rural growth. However, September rains are expected to be normal.
- ✚ The inflation downtrend had started in 1Q FY24 but reversed sharply on inclement weather affecting food prices.
- ✚ Core inflation remains under control, which will likely dissuading RBI MPC from any rate hike action.
- ✚ GOI has taken several steps to manage primary inflation. This should bring down inflation in the near term. Fresh arrival of kharif crop in September should have salutary impact on inflation.
- ✚ With RBI projecting inflation to be 5.4% for FY2024, it remains above their 4% medium term policy target. Coupled with strong growth numbers, there is no pressure on the RBI to ease any time soon.
- ✚ This may keep RBI on hold for much longer as it sees the impact of higher food prices on overall inflation trajectory.
- ✚ Markets rallied post April policy but have given up gains as expectations of quick pivot of rates has been belied and likely inflationary pressures in the near term.
- ✚ 10Y GSEC rates climbed back to around 7.25%, on rise in global yields, higher commodity prices as well as expectation of sharp rise in India CPI numbers in coming months on back of elevated food prices.

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- ✚ Markets are likely to remain volatile as the narrative of “rates higher for longer” takes hold. Market movements may depend on global cues, supply-demand of local bonds in the market, oil price movements and inflation trajectory. 10Y G-sec may trade in the 7.10%-7.25% range.

Source: RBI, MOSPI, CMIE, FIMMDA, NSDL, Bloomberg.

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