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Macro Review & Fixed Income Market Outlook

Global Economy Update:

Macro Backdrop:

- The year 2024 represents a leap in time, accounting for all the seconds that the earth's revolution around the sun accrued over the three years prior.
- Despite overwhelming odds, 2023 ended on a positive note, and there are many reasons to be optimistic for 2024.
- First, new data regularly validates the pessimistic projections. It's possible that optimistic predictions of global growth, which are already dropping well below 3 percent for 2024, will be proven false once more.
- Second, the world economy has shown remarkably resilient in the face of devastating climate change, financial hardship, and conflict. Global economies are adjusting more successfully than anticipated, which offers a solid foundation for the upcoming year.
- Third, the genie of inflation is being bottled, with food and energy costs on the decline and crude prices falling despite output cuts, despite their trepidation over tensions in the Red Sea, which accounts for 12% of seaborne oil commerce and 8% of liquified natural gas trade.
- The relentless cycle of tightening by central banks is taking a break.
- Global trade growth, which had flatlined in 2023, is expected to recover in 2024, although it will likely remain below its pre-pandemic trend.
- According to the World Bank, the expected upturn in trade volume will reflect a recovery in the demand for goods.
- International tourism has been showing signs of a robust recovery, particularly in Asia, and is expected to reach pre-pandemic levels by 2024.
- There is an emerging trend of realignment in international trade relations, with countries seeking to secure supply chains closer to home or from more resilient sources.
- In the financial markets, the prospects of lower borrowing costs and slower central bank selling of treasuries, to avoid liquidity stresses, is acting like a tail wind for bond markets, bringing yields off their 2023 highs.
- The US dollar is trading below critical resistance levels, and this has lifted the downward pressures weighing down other currencies through 2023.

Indian Economic Growth:

Macro Backdrop:

- The Indian economy recorded stronger than expected growth in 2023-24, underpinned by a shift from consumption to investment.
- The government's thrust on capex is starting to crowd-in private investment.
- Headline inflation recorded a marginal uptick in December, driven by higher food inflation due to unfavourable base effects.
- The first advance estimates (FAE) of national income released by the NSO on January 5, 2024, placed the real gross domestic product (GDP) growth for 2023-24 at 7.3 per cent, up from 7.2 per cent in the preceding year.
- Among the components of real GDP, growth in private final consumption expenditure (PFCE) moderated to 4.4 per cent from 7.5 per cent a year ago, primarily due to the drag from rural demand owing to lower kharif production.
- Urban demand, on the other hand, remained robust on the back of higher disposable income, led by robust growth in salaries and wages.

- Government final consumption expenditure (GFCE) growth at 4.1 per cent recorded an uptick over the previous year.
- Gross fixed capital formation (GFCF) remained strong, with growth of 10.3 per cent in 2023- 24.
- The government's sustained thrust on capital expenditure along with ebullience in residential housing underpinned the strength of investment.
- India's export growth, tapered to 1.4 per cent in 2023-24 (April-November), primarily on account of sluggish merchandise exports, while services exports registered steady growth.
- Evidence from high frequency indicators point towards the sustained strength in demand conditions in Q3: 2023-24 and the first half of January 2024.
- E-way bills posted a growth of 13.2 per cent in December 2023.
- Toll collection reached a series high, expanding by 18.6 per cent (y-o-y) in December.
- Automobile sales albeit moderating sequentially, registered an expansion of 14.1 per cent (y-o-y) in December, while two and three-wheeler sales recorded double digit y-o-y growth.
- Tractor sales recorded a two-year low in December and contracted by 19.8 per cent (y-o-y).
- Vehicle registrations recorded strong y-o-y growth in December following hefty discounts on high inventory models, although the momentum eased post the festival season.
- The consumption of petroleum products grew by 2.6 per cent y-o-y in December.
- As per the data available from the Centre for Monitoring of Indian Economy (CMIE), the all-India unemployment rate (UR) declined to 8.7 per cent in December, driven by lower UR in rural areas even as urban UR recorded an increase.
- The labour force participation rate (LFPR) and employment rate (ER) increased in both urban and rural areas.
- The employment outlook in the organised sector, as polled by the PMIs for manufacturing and services, remained in the expansionary zone.
- For services, it recorded a sequential pick-up in December whereas it recorded a m-o-m moderation for manufacturing.
- India's goods and services tax (GST) collections stood at Rs 1.72 lakh crore during January 2024, records 10.4% Year-on-Year growth.

Interim Budget Impact on the Debt Markets:

- The budget was positive for bond markets, as it was surprised by sharp drop in the fiscal numbers at 5.1% for FY2025, well below market expectations. This a consolidation of 70bps over revised fiscal deficit for FY2024 at 5.8%.
- Further, the FM reiterated that government's intention was to bring fiscal deficit to 4.5% by FY2026, adhering to the fiscal guide path, which further enthused the markets.
- The gross borrowing numbers for FY2025 projected to drop to below consensus ₹14.13 Lakh Crore vs Rs.15.43 Lac crores for FY2024.
- Net borrowing numbers were projected at ₹11.7 Lakh Crore (vs ₹11.8 Lakh Crore FY2024RE).

Inflation:

Global:

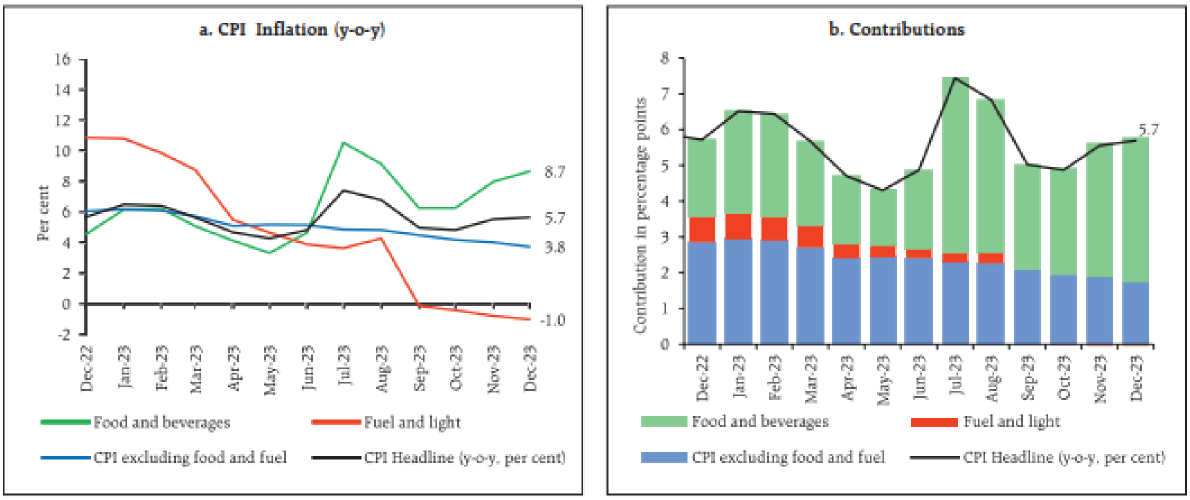
- Globally, headline CPI declined substantially through 2023 but it continues to remain above target in most inflation-targeting AEs and about half of inflation-targeting EMEs.
- CPI inflation in the US rose to 3.4 per cent in December from 3.1 per cent in November.
- Euro area inflation also rose to 2.9 per cent in December from 2.4 per cent in November.
- In the UK, CPI inflation rose to 4.0 per cent in December, up from 3.9 per cent in November 2023.

- Japan's Core inflation moderated to 2.3 per cent in December 2023 from 2.5 per cent in November 2023.
- Among the emerging market economies (EMEs), inflation moderated in Russia and Brazil in November while China recorded a deflation of 0.3 per cent in December.
- Despite the recent moderation in core inflation in AEs, it continues to remain above headline inflation.

India:

- CPI inflation edged up to 5.7 per cent in December 2023 from 5.6 per cent in November.
- The 14-bps increase in inflation came primarily from an unfavourable base effect of around 50 basis points which more than offset a negative price momentum of around 30 bps.
- Food inflation (y-o-y) increased to 8.7 per cent in December from 8.0 per cent in November, as negative momentum was more than offset by an unfavourable base effect.
- The fuel and light group recorded a larger deflation of (-) 1.0 per cent in December as compared with (-) 0.8 per cent in November.
- Core inflation moderated to 3.8 per cent in December, its lowest print in more than 4 years, from 4.1 per cent in November.
- The moderation was broad based, with sub-groups such as clothing and footwear, household goods and services, health, education, personal care and effects, and pan tobacco and intoxicants recording a decline.
- Inflation in housing, transport, and communication, and in recreation and amusement remained steady.
- In terms of regional distribution, rural inflation stood at 5.9 per cent, marginally higher than urban inflation (5.5 per cent) in December 2023.

Trends and Drivers of CPI Inflation:



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

Bond Yields & Spreads:

- Indian Yield curve remained rangebound in first month of 2024, moving both ways on absence of any new data and largely following global cues.
- Yields trended lower ahead of US FOMC on 31st Jan 2024.
- US FOMC and officials indicated that rate cuts are likely leading to market yields dropping.
- US Chair Powell has pushed against a rate cut in March, noting that it is too early to ease in face of continuing resilient economy.
- The Union Budget 2024-25 provided further impetus to bond market rally as the FM indicated a target fiscal of 5.1% and sticking to FRBM target of 4.5% for FY2026.

- Lower than expected borrowing numbers supported bond market sentiments.
- RBI MPC is likely to remain in pause mode with high probability of stance shifting to “neutral”.
- Liquidity improved in the second half of Jan 24, after remaining tight for the last couple of months.
- 10Y yield dropped to around 7.03% post budget announcement.
- Bond yield curve bull flattened with longer term yields falling more than short term yields.
- Corporate bond spreads remain elevated in absence of clarity from RBI on liquidity stance, which may be known only post MPC on 8th Feb 24.

Outlook:

- Market dynamics are likely to be influenced by incoming RBI MPC as well as global factors.
- With the US rate easing cycle likely in 2024, the question remains only on timing of rate cuts.
- RBI may follow US rate moves but may be predominantly influenced by near term inflation dynamics.
- However, no sharp rate cuts are expected from RBI MPC, as inflation continues to remain above target of 4% and growth remains robust.
- FII flows have been strong ahead of Index inclusion with USD 3.51 bio CYTD (USD 1.06 bio MTD).
- Liquidity has improved in the recent past probably on account of Government spending. RBI had further injected short term liquidity via VRR (variable rate repo auctions).
- The influx of foreign funds is anticipated to be liquidity-positive, further contributing to the positive sentiment surrounding bonds.
- Looking ahead to the medium and long term, the effect on bonds is expected to be positive due to inclusion in JP Morgan Bond Index, as the demand for Government Securities (G-Sec) is likely to drive yields downward.
- Fiscal consolidation in the interim Budget is likely to provide further positive impetus to bond markets.
- Coupled with anticipated rate moves from the US FED, RBI may change to neutral stance in next few policies.
- We may expect about 50bps rate cut from RBI in FY2025.
- We anticipate that over the next few months, 10-year yields may gradually fall below 7%.

Source: RBI, MOSPI, PIB, CMIE, FIMMDA, NSDL, Bloomberg, Internal Research.