January 1, 2023

CANARA ROBECO

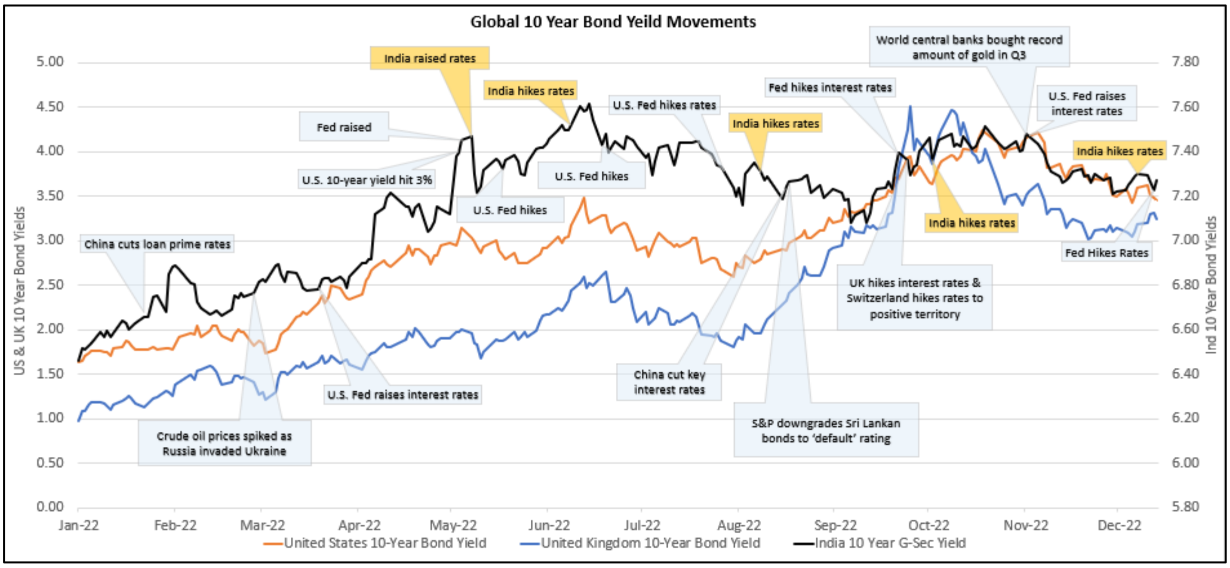
Macro Review & Fixed Income Market Outlook

Global Economy Update:

Macro Backdrop:

- 2022 has come to an end. It was a tumultuous year with an ever-changing macro landscape.
- 2022 began with global economies slowly recovering from pandemic-induced disruptions and looking forward to economic relief before being hit by Russia's invasion of Ukraine.
- The conflict led to host of sanctions on Russia leading to an energy crisis (Russia being one of largest supplier of crude oil and main source of natural gas for European nations). Apart from oil & gas, Russia is also a large exporter of key minerals.
- Commodity prices in general skyrocketed, though they would come down later.
- The pandemic disruptions engendered high inflation in advanced economies (AE), which had surged probably on back of supply chain disruptions, as well as demand side impulses led by Central bank stimulus and government handouts given during the pandemic.
- Expectations of reversal of the inflation trend, as pandemic disruptions eased and supply chains recovered to normal levels, had prevented Central banks from reversing ultra-accommodative monetary policies.
- Hit by Ukraine conflict, inflation continued to surge, blindsiding global central banks. Faced with 40-decade high inflation across AEs, global central had to act swiftly and decisively.
- The US Federal Reserve (FED) has raised the key FED Funds rate by 425 bps since March 22 to 4.25%-4.50% range. This includes raising 75bps each in four consecutive FOMC (Federal Open market committee) meetings.
- Other AEs followed suit, raising rates from zero/negative to positive territory to levels not seen since the Global financial crisis (GFC) of 2008.
- The Bank of England (BoE) has raised rates by 275 bps to 3%, while the European Central Bank (ECB) raised its key refinancing rate to 2.5% from 0%.
- The Bank of Japan surprised markets by raising its benchmark interest rate to 0.5% from 0.25%, sending the yen higher and ending a long period in which, it was the only major developed-nation central bank that did not raise rates.
- Further, global central banks, concurrently, reversed the quantitative easing (QE) policies, which they have been adopting since the GFC for managing dis-inflation to quantitative tightening (QT) i.e., withdrawal of excess liquidity added to the system since pandemic.

Events that happened in CY22 and the corresponding Yield movements:



Source: Bloomberg, Internal Product Research; Data as on Dec 15, 2022

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Indian Economic Growth:

Macro Backdrop:

- In this hostile international environment, the **Indian economy** remained **resilient**, drawing **strength from its macroeconomic fundamentals**. India's **financial system** remains **robust** and **stable.**
- **Banks and corporates** are **healthier** than before the war crisis. **Bank credit** is **growing** in **double digits** for 8 months now.
- **India** is widely seen as a **bright spot** in an otherwise gloomy world.
- **India's inflation remained elevated for most part of the year**, as in most parts of the world. Global spill overs continue to impart high volatility and uncertainty.
- According to the latest data released by National Statistical Office (NSO), **real gross domestic product (GDP)** posted a **growth of 6.3 per cent** year-on-year (y-o-y) in Q2:2022-23, driven primarily by private consumption and investment.
- Going into Q3:2022-23, **economic activity** continued to **gain strength**.
  - ✓ Urban consumption firmed up further, driven by sustained recovery in discretionary spending, especially on services such as travel, tourism, and hospitality.
  - ✓ Passenger vehicle sales and domestic air passenger traffic posted robust y-o-y growth. Rural demand is recovering as reflected in the pace of tractor and retail two-wheeler sales, with rising farm activity. Investment activity is also gaining traction.
  - ✓ Non-food bank credit rose by ₹10.6 lakh crore during April-November 2022 as compared with an increase of ₹1.9 lakh crore last year.
  - ✓ The total flow of resources to the commercial sector expanded by ₹14.7 lakh crore during 2022-23 (up to November 2022) as compared with ₹6.8 lakh crore in the same period of 2021-22.
  - ✓ On the other hand, the drag from net external demand further accentuated in October as merchandise exports contracted by 12.1 per cent (y-o-y) after expanding during the previous 19 months. Merchandise imports expanded by 10.0 per cent in October.

RBI's response to Global and Domestic Events:

- With India being no different from rest of world, the RBI had to react when CPI inflation started consistently breaching the RBI's comfort zone of 6%.
- In a surprise off policy move, RBI Monetary Policy Committee (MPC) raised rates by 40bps in May 22 and followed it with 3 consecutive 50bps rate hikes before slowing down to 35bps in Dec 22 MPC meet.
- Repo rate was raised by 225 bps from 4% to 6.25% in just over 7 months.
- RBI was also working on reducing the extremely easy liquidity conditions created during pandemic and started by raising CRR by 50bps.
- Other tools were used to bring down liquidity to manageable levels over a period, including the introduction of the standing liquidity facility (SDF) to replace reverse repo rate. The SDF is placed 25bps below repo rate.
- The combined impact of rate hike and liquidity withdrawal has pulled up the overnight rate from 3.00-3.40% at start of 2022 to 6-6.50%, effectively raising daily borrowing costs by almost 300bps.
- Both private consumption and investment rate edged up in Q2 FY23 compared with the corresponding quarter of previous year supported by higher economic activity.
- However, the global growth slowdown has weighed on the net exports.

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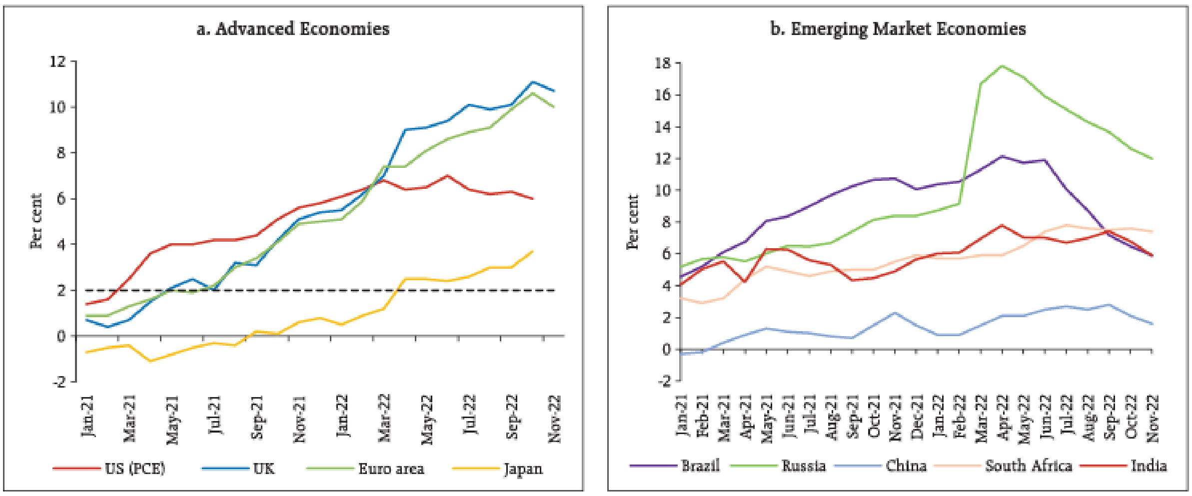
Inflation:

Global:

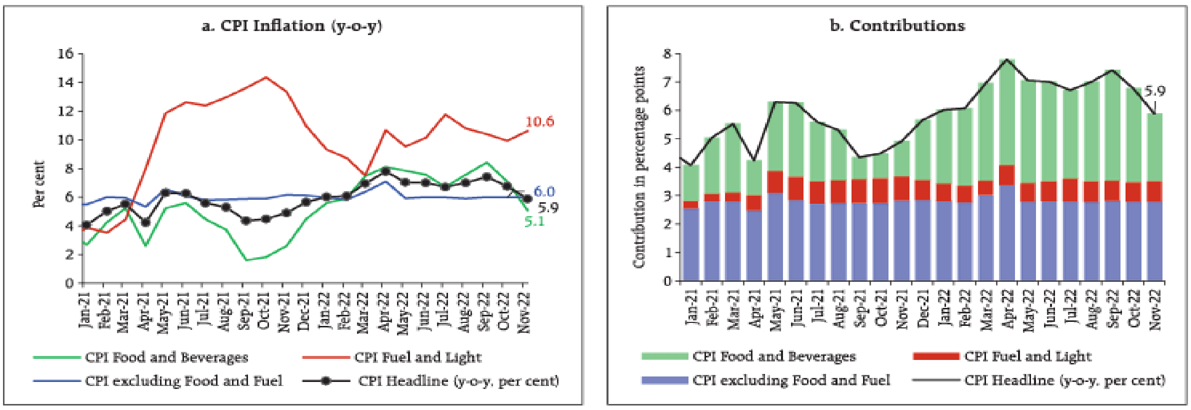
- There are **signs of inflation easing**, especially amongst **emerging market economies** (EMEs).
- The **US CPI inflation** eased markedly to 7.1 per cent in November 2022 from 7.7 per cent in October. Inflation based on the **US personal consumption expenditure** (PCE) index **eased** to 6.0 per cent (y-o-y) in October 2022 from 6.3 per cent in September.
- In the **Euro area**, annual inflation **slowed** to 10.0 per cent in November 2022 from 10.6 per cent in October **due to negative momentum in the cost of energy and services**.



Source: Bloomberg, RBI Bulletin

India: The provisional data released by the National Statistical Office (NSO) on December 12, 2022, showed that inflation, as measured by y-o-y changes in the all-India **consumer price index** (CPI), **moderated to 5.9 per cent in November** from 6.8 per cent in October. The **easing** was **primarily driven by the sharp moderation in food inflation**. The index declined by 11 bps month-on-month (m-o-m), which along with a favorable base effect (month-on-month change in prices a year ago) of 73 bps, resulted in a **fall in headline inflation by around 90 bps** between October and November.

Trends and Drivers of CPI Inflation:



Note: CPI inflation for April-May 2021 was computed based on imputed CPI indices for April-May 2020.
Sources: National Statistical Office (NSO); and RBI staff estimates.

Bond Yields & Spreads:

- **Rate markets**, expectedly, have been **extremely volatile** during the year.
- While the **direction** of rate markets has been **upward**, these were punctuated by relief rallies on any rate positive data.
- **US 10Y yield rose** from ~1.6% to a high of 4.25-30% before retreating to ~3.65% as of now.

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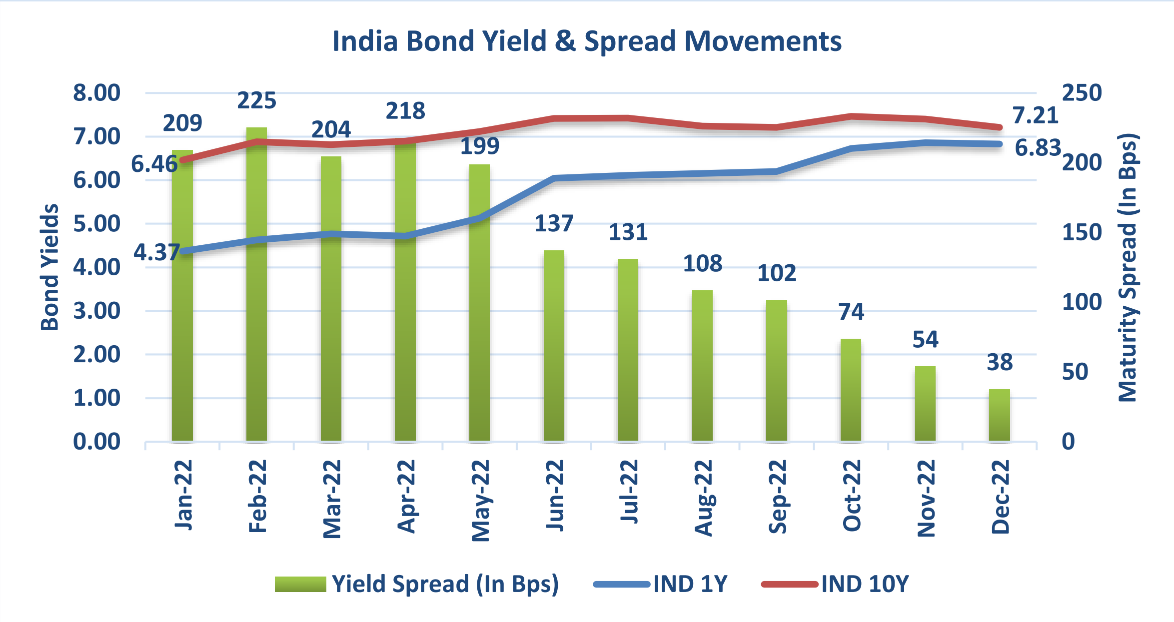
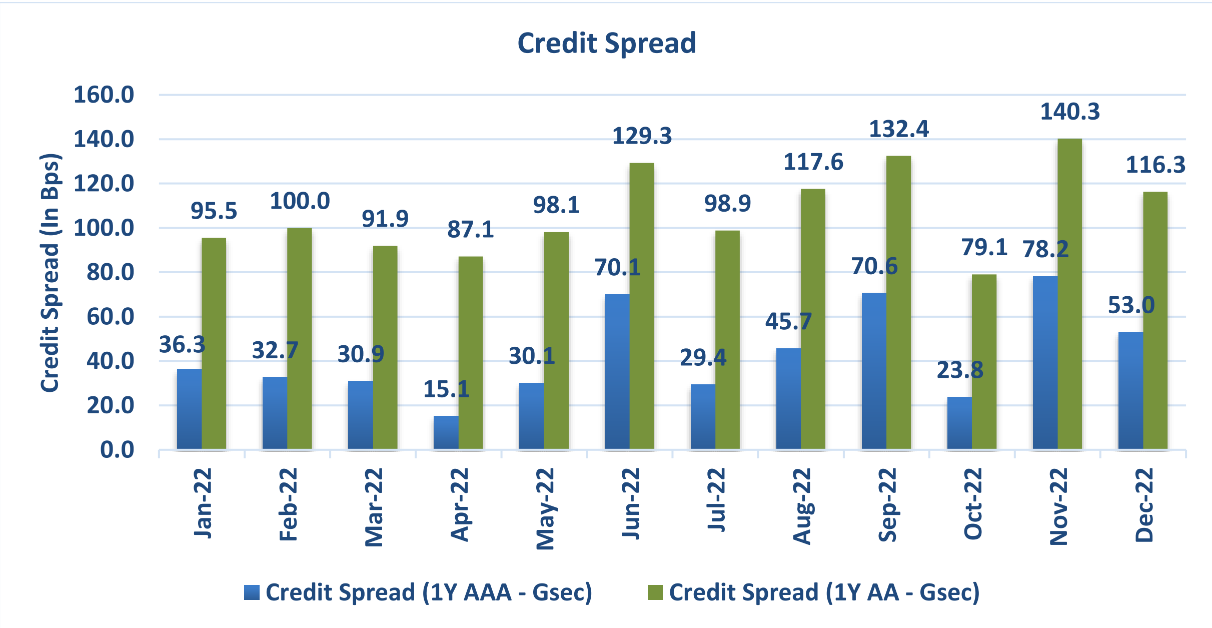
- **Indian markets** got a taste of **volatility** when **RBI MPC hiked 40 bps** in a surprise move in **May 22**.
- **G-Sec 10Y yield** started 2022 at 6.46%, climbed to 7.62% (in June 22) and **now has moderated to ~7.30%.**
- **Markets discounted multiple rate hikes after the first move**, as the long end of the curve did not move appreciably higher after the initial jump in May-June 22.
- **Short-term rates** moved **slowly higher** on the back of consecutive rate hikes by RBI MPC in all scheduled meetings in the year.

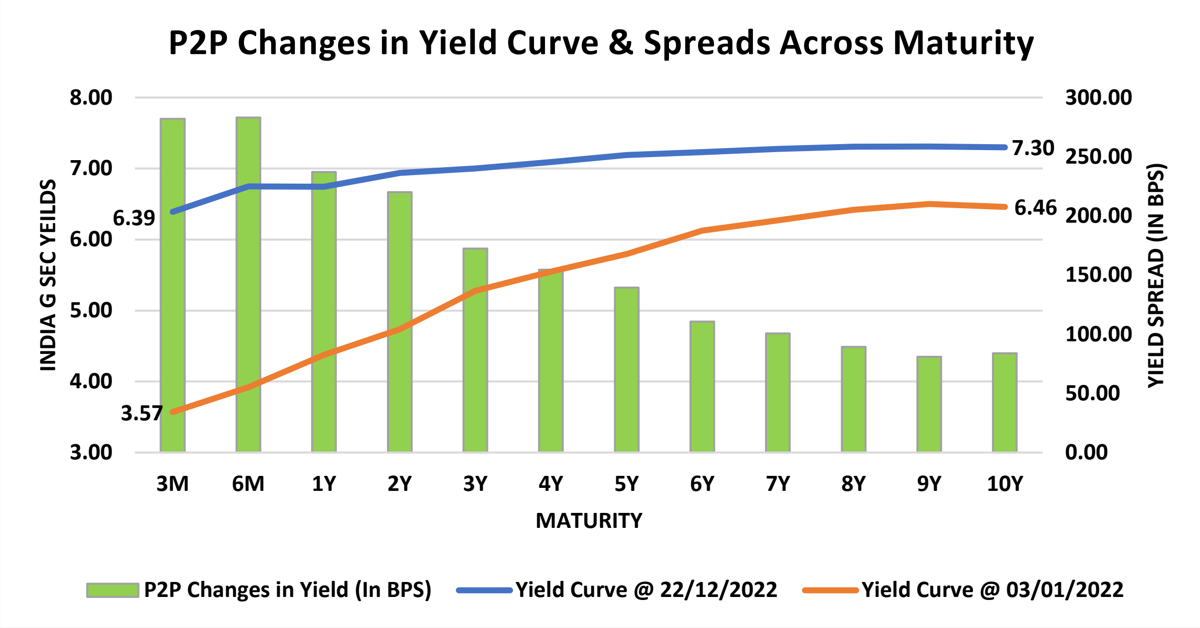


Source: Bloomberg; Data as on Dec 15, 2022. Past performance may or may not sustain in future



Source: Bloomberg; Data as on Dec 15, 2022. Past performance may or may not sustain in future

GSEC Yield Curve (Jan 22 vs Current):



Source: Bloomberg; Data as on Dec 15, 2022. Past performance may or may not sustain in future.

- The above chart shows the **yield curve movement** wherein the **yield curve** is **now flat**.
- **Short term rates** have **moved** the **highest,** with **less 1-year rates** moving **up by 225-275 bps** in the calendar 2022, whilst **10Y** moved **up** by about **80bps**.
- **Flat yield curve** provides **opportunity** to investors **to invest in short to medium term funds**, without foregoing on yield pickups associated with a steep curve, **while reducing interest rate risk** from shorter duration in such type of funds.

Outlook:

Global:

- **Global economy** is **likely** to be marked by **slow growth**, **moderating but elevated inflation**, **peaking policy rates**, and **continuing geo-political risks**.
- Inflation seems to have peaked in major countries, though reasons to cheer may still be far away.
- The **sharp rise in rates by the US FED and other central banks** points to the seriousness of this inflation problem.
- **AE inflation** is in the **high single digits** and in **some cases is in double digits**. The mandate in these countries is to have inflation around the 2% mark. While the sharp rate hikes are coming to an end, with the US FED slowing down to 50bps in Dec 22 FOMC (Federal Open Market Committee) meet, most of the central banks are of the view that rates may have to stay higher for longer for the inflation genie to be put back into the bottle. This view seems to conflict with general market consensus that FED may start easing in end 2023 (and other central banks following suit) whilst the FED projections point to easing starting 2024. AE Central banks may be reluctant supporters of growth in backdrop of unprecedented high inflation and may err on the side of caution, waiting for inflation to trend down meaningfully.

India:

- **In India, macro situation is better**. Growth while **remaining resilient** is likely to slow down to below 6% in FY2024.

- **CPI inflation** has **fallen to below 6%.** RBI MPC has already delivered 225 bps rate hike taking repo rate to 6.25%. Inflation has receded from highs of 7.8% in April 22 to 5.90% in Nov 22. While this is a positive development, core inflation remains sticky above 6%, a concern flagged by RBI MPC as well. Expectations of 25 bps hike to take repo to 6.5% are priced in by the market. India macro conditions are likely to be punctuated by global demand slowdown in the shadow of volatile geo-politics with risks of persisting negative surprises.
- The **rupee (INR)** has **depreciated 10.39%** against the US$ (3/Jan/22 to 16/12/22). This is **broadly in line with other major currencies** as a sharp rise in US rates has led to unprecedented appreciation of the USD against major currencies.
- A **persistent rise in trade deficit** on the back of **slowdown in exports**, has **impacted INR value**, though **positive FII equity flows in Oct/Nov 22, helped the INR to recover**. Going to end of fiscal 2023, INR could trade in range of 81-84/US$.

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