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Economy Review & Fixed Income Market Outlook

Global Economy Update:

The outlook for the global economy remains clouded with downside risks. Global financial conditions have been tightening and deteriorating market liquidity is amplifying financial price movements. Markets are now pricing in moderate increases in policy rates and risk-on appetite has returned.

Geopolitical hostilities without any end in sight, combined with aggressive and synchronised monetary tightening across economies to bring inflation down to tolerable levels, are clearly weighing on global growth. However, as few countries have started exhibiting signs of softening inflation, some central banks have either begun to pause tightening cycle or have hinted at lowering the pace of rate hikes going forward. Global stock markets remain edgy with an upward bias and sovereign bond yields moderated from highs on expectations of slower rate increases. The US dollar moderated from highs, but increasingly, two-way expectations on the magnitude and timing of rate hikes are impacting global economic prospects with attendant spill overs that cascade onto the shores of emerging and developing economies.

Indian Economic Growth:

In India, supply responses in the economy are gaining strength. With headline inflation beginning to show signs of easing, the domestic macroeconomic outlook can best be characterised as resilient but sensitive to formidable global headwinds. Urban demand appears robust, rural demand is muted but more recently picking up traction.

According to S&P Global, India's Manufacturing Purchasing Managers' Index rose to 55.7 in Nov 2022 from 55.3 in Oct 2022. India's manufacturing sector expanded at its highest rate in three months in Nov as input cost inflation dropped to a two-year low despite the worsening state of the global economy.

Reflecting the growing preference for bank credit for working capital requirements, issuances of CPs and corporate bonds have declined. The banking system is well-capitalised, with capital ratios for the system well above 16 per cent of total risk-weighted assets. The provision coverage ratio is above 70 per cent, even unadjusted for write-offs. Gross non-performing assets (GNPAs) have consistently declined, with net NPAs were sliding down towards 1 per cent of total assets. Liquidity cover is robust, and profitability is shored up. The levels of inflation are, however, impacting corporate performance. Corporate earnings results covering more than 90 per cent of all listed non-financial companies point to loss of momentum in earnings in the second quarter of 2022-23. Expenditure growth, driven by input cost pressures, outpaced revenue growth, exerting pressure on operating profits and sending them into contraction. With other income declining in this quarter, net profits contracted on a y-o-y basis.

According to the Centre for Monitoring Indian Economy (CMIE), India's unemployment rate rose to 8.0% in Nov 2022 from 7.77% in Oct 2022. The urban unemployment rate rose 8.96% in Nov from 7.21% in Oct, while the rural unemployment rate fell 7.55% in Nov from 8.04% in Oct.

According to the finance ministry, Goods and Services tax (GST) collection rose 11% YoY to Rs. 1,45,867 crores in Nov 2022. The rise came due to higher revenues from imports. The CGST accounted for Rs. 25,681 crore and SGST for Rs. 32,651 crores. The IGST accounted for Rs. 77,103 crore and Cess for Rs. 10,433 crores.

GDP:

India's economy grew by 6.3% in the second quarter of FY23 following a double-digit growth of 13.5% in the first quarter of this fiscal. The slowdown in growth compared with the first quarter was on account of the normalisation of the base and a contraction in the manufacturing sector's output. However, both sequential improvement and good growth over the pre-pandemic level (Q2 FY20) signal the economy's resilience despite global growth and financial uncertainties. The GDP growth in Q2 was only marginally higher than our expectation (6.2%) mainly because of higher-than-expected growth in trade, hotels, transport, and communication-related sectors.

On a sequential basis, domestic economic output expanded by 3.6% reversing the contraction seen in the previous quarter with services gaining momentum. When compared with the pre-pandemic period, GDP has recorded a growth of 7.6% with a broad-based recovery across sectors. Increasing discretionary spending and higher mobility have boded well for the services sector. The industrial sector's performance was led down by the manufacturing sector which contracted by 4.3% (y-o-y).

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.

Inflation:

Global:

Consumer price inflation reigns high across economies due to sustained cost push pressures from elevated food and energy prices and lingering pandemic-induced supply chain bottlenecks, although there are signs of inflation easing in a few economies, especially amongst Emerging Market Economies (EMEs).

US CPI inflation softened to 7.7 per cent (y-o-y) in October 2022 from 8.2 per cent in September, while personal consumption expenditure (PCE) based inflation held steady at 6.2 per cent (y-o-y) in September 2022.

In the Euro Area, on the other hand, inflation soared to a new peak of 10.6 per cent in October 2022, up from 9.9 per cent in September on high energy, food, alcohol, and tobacco prices. In the UK, CPI inflation shot up to 11.1 per cent in October, rising from 10.1 per cent in September.

Among the BRICS economies, inflation in Brazil eased to 6.5 per cent in October from 7.2 per cent in September, in Russia it eased to 12.6 per cent in October from 13.7 per cent in September, while in China inflation fell to 2.1 per cent in October 2022 vis-à-vis 2.8 per cent in September 2022.

India:

India's CPI eased to 6.77% in Oct 2022 as against 7.41% in Sep 2022. Consumer Food Price Index (CFPI) also eased to 7.01% in Oct 2022 as compared to 8.60% rise in Sep 2022.

India's Wholesale price index-based inflation (WPI) eased to 8.39% YoY in Oct 2022 from 10.70% rise in Sep 2022 and 13.83% increase in Oct 2021. The growth of WPI Food index eased to 6.48% in Oct 2022 from 8.08% in Sep 2022 and 10.06% in Aug 2022.

Export & Fiscal Deficit:

India's merchandise exports fell to $29.78 billion in Oct 2022 from $35.73 billion in Oct 2021. Merchandise imports rose to $56.69 billion in Oct 2022 from $53.64 billion in Oct 2021. During Apr to Oct 2022, exports rose to $263.35 billion, and imports rose to $436.81 billion.

Government data showed that India's fiscal deficit stood at 45.60% of the Budget Estimates (BE) from Apr to Oct of FY23. The revenue deficit stood at 38.80% of Budget estimate. Total receipts stood at Rs. 13.86 lakh crore or 60.7% of the budget target as compared to 64.7% in the corresponding period of the previous year.

Bond Yields & Spreads:

Bond yields hardened in early part of November but reversed course on lower US inflation numbers, as this likely would slow down pace of rate hikes from US FED. Globally market sentiment turned positive on softening inflation across large economies and sovereign yields dropped. US 10Y yield dropped to 3.60% at end of Nov, from highs of 4.24% seen in early part of November. India 10Y Yield dropped from 7.45% at end of Oct to close at 7.28% at Nov end on back of positive global sentiment as well drop in India CPI.

The yield curve continued to remain flat. Tightening liquidity had impact on short term rates, pushing them faster as compared to long end of yield curve.

Corporate bond yields fell/rose in tandem with the G-sec yields across tenors and the rating spectrum. Credit risk premium as reflected in the spread of corporate bond yields over G-sec yields of equivalent maturities also declined marginally during the same period, except for up to 1 year segment, where corporate spreads have gone up. Corporate issuance remained modest though it gathered a little pace, with primary market issuances during 2022-23 so far (up to Oct 2022) at Rs.3.08 lakh crore.

Fixed Income Market View:

The sharp concurrent tightening of financial conditions in advanced economies (AEs) is leading to recession fears in large economies with risks of spill overs to emerging markets through global trade and financial linkages. The recent softening of inflation in few economies, especially USA, has led to the belief that FED tightening is likely to slow down, which led to sharp drop in bond yields. US FED is now expected to raise rates by 50bps in Dec FOMC (Federal Open market committee) meet. Market data indicates that terminal rate for FED funds rate is likely to be 4.75%-5%. Data of US economy continues to show strength, especially the labor markets, though the housing markets have seen correction. The strong labor market is likely to continue to push the FED to keep raising rates till moderation of inflation is seen on more consistent basis and labour markets show signs of easing.

In line with global positive sentiments, bond yields dropped in Nov. Liquidity further improved post the festive season, further helping bond markets. Strong FII inflows in equity in August 22 had reversed September 22 on global risk off sentiment but were moderately positive in October 22. However, FII inflows picked up strongly in Nov, with net inflows of almost Rs.40000cr. The rupee recovered sharply hitting a low of Rs.80.51/$ before ending the month slightly higher at Rs.81.42/$. Large FII equity flows coupled with global US dollar weakness aided rupee.

Evolving global cues relating to geo-politics, US rates, and crude oil, would likely continue to drive Indian markets. Market participants closely track AE inflation prints for signs of moderation in momentum, as global financial tightening is largely driven by systemically important central banks. With US inflation now showing some signs of easing, there is still long way to go to achieve the long-term target of 2%. US FED is projected to take the Fed funds rate to 4.75-5.00% by early next year. FED officials continue to push back markets on rate cut expectations for next year, indicating that rates may have to stay higher for longer in face of unprecedented inflationary environment, and even if there is pause in rate hike cycle, rate cuts are not on cards. Market movement is likely to remain data dependent, though with FED nearing the end of rate hike cycle, rate markets would be looking at forward guidance, if any, from the FED.

RBI MPC is likely to moderate its pace of hike, as inflation is expected to drop to 5% by 1QFY2024. RBI MPC may hike by 35bps in December 2022 and further by 25bps in February taking the repo rate to 6.5%. With liquidity easing in November, overnight rates are trading around standing deposit facility (SDF) rates. Overnight rates are likely to remain volatile as liquidity fluctuates between deficit and surplus. As per our opinion markets may get new direction post RBI MPC on 7th December.

Source: RBI, MOSPI, CMIE, FIMMDA, NSDL, Bloomberg, CareEdge Analytics, ICRA Analytics Ltd.

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