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Macro Review & Fixed Income Market Outlook

Global Economy Update:

Macro Backdrop:

- Global growth momentum looks to be slowing, particularly in manufacturing and investment, notwithstanding moderate headline inflation and a stubborn core.
- Interest rate market forecasts have risen.
- Equities prices rise in response to the aggressive policy stance have flattened, while bond yields have risen.
- International trade is showing the knock-on effects of re-engineering of supply chains through muscular industrial and trade policies.
- Once again, the world's constituents are set on diverging paths and the fear that a global growth deficit may be festering beneath the headline developments.
- The US economy is displaying surprising vigour, with fresh signs of labour market strength reflected in an ebbing of the unemployment rate in June and a higher than expected rise in hourly earnings.
- Interestingly, the surge in the US job quits rate has abated from its pandemic peak and top-line hiring is firming up.
- On the other side of the Atlantic, output has contracted in several manufacturing-heavy economies of Europe although labour markets remain tight and unemployment rates close to historical lows.
- China's re-opening has not triggered the tailwinds for global growth that were widely expected.
- By contrast, emerging market economies (EMEs) in Latin America and Asia are growing at a solid pace.
- Globally, inflation has been moderating on the back of easing commodity prices.
- Yet core inflation remains stubborn due to still strong momentum in prices of services that are usually sticky, with output being relatively labour-intensive and susceptible to wage pressures.
- Although many central banks have reduced the pace of interest rate increases, they have signalled their readiness to increase interest rates further and keep them high as long as they see the labour market as the key inflation risk.
- In response, market expectations of future interest rates have gone up, equity prices have flattened, and bond yields have hardened.
- Corporate bond issuances have stabilised, with those in high-yield segments virtually drying up.
- Among high frequency indicators, the global composite purchasing managers' index (PMI) moderated to 52.7 in June 2023 from 54.4 in the previous month.
- While the global services PMI remained in the expansionary zone despite a sequential moderation, the global manufacturing PMI contracted to a 6-month low of 48.8 in June 2023 following a decrease in new orders.

Indian Economic Growth:

Macro Backdrop:

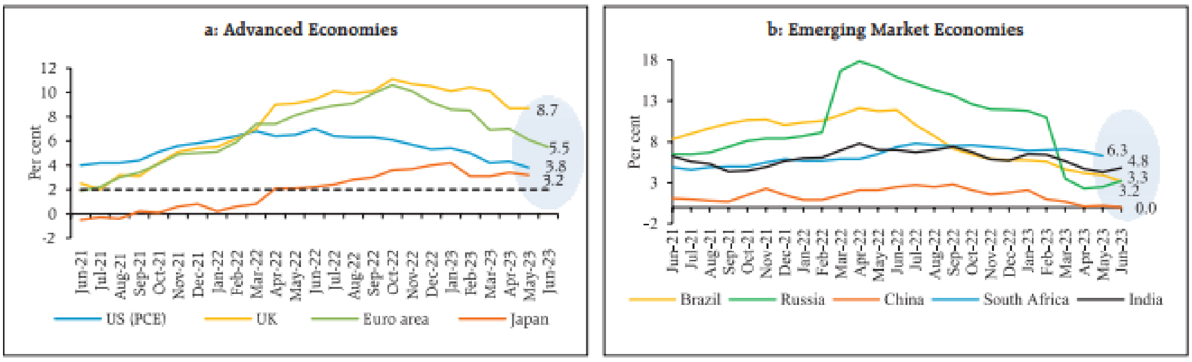
- The Indian economy is poised to be the fastest growing major economy in the world despite some sequential moderation in economic activity in June.
- Among lead indicators of demand conditions, E-way bill volumes marked double-digit y-o-y growth, pointing towards strong trade and transportation activity.
- Despite a sequential moderation, toll collections in June 2023 recorded the highest ever value of transactions for the month of June.
- The employment outlook in the organised sector, as polled by the purchasing managers' index (PMI) for manufacturing and services, remained in expansionary zone.

- India's merchandise exports registered contraction for the fifth consecutive month in June 2023, declining by 22.0 per cent (y-o-y) as a sharp negative momentum of (-) 5.8 per cent interacted with an adverse base.
- The contraction in exports was broad-based, with 77.5 per cent of the export basket (21 out of 30 major commodities) registering a decline on a y-o-y basis.
- The largest drag on growth was from petroleum products, followed by gems and jewellery.
- Amidst the overall decline, electronic goods, which account for 7.4 per cent of total merchandise exports, remained positive contributors to export growth.
- The headline PMI for the manufacturing sector moderated to 57.8 in June 2023 from 58.7 in May due to a deceleration in new orders, output, and stocks of purchases.
- Index of future output expanded to a six-month high of 65.8 in June 2023.
- The PMI services in expansionary zone, despite a sequential moderation, with a strong momentum in business expectations.
- High-frequency services sector indicators for June 2023 attest to the resilience of overall economic activity.
- Notably, both domestic and international aviation passenger traffic recorded growth in excess of 20 per cent.
- The goods and services tax (GST) collections (Centre plus States) in June 2023 stood at INR 1.65 lakh crore and recorded a growth rate of 11 per cent y-o-y.
- Gross GST collection crosses ₹1.6 lakh crore mark for 5th time since inception of GST.

Inflation:

Global:

- Headline inflation moderated across most economies although core inflation remained stubbornly high.
- As per the flash estimates, inflation in the Euro area moderated to 5.5 per cent in June 2023, its lowest level since January 2022.
- Annual CPI inflation in the US moderated sharply to 3.0 per cent in June 2023 from 4.0 per cent in May marking its lowest reading since March 2021.
- Inflation based on the US personal consumption expenditure (PCE) index slowed to 3.8 per cent in May 2023, the lowest reading since April 2021.
- In the UK, CPI inflation dropped to 7.9% per cent in June 2023 while Japan's CPI (all items minus fresh food) inflation declined to 3.2 per cent in May from 3.4 per cent in April.
- Among the EMEs, inflation has moderated across the board. Except South Africa, all the BRICS countries recorded inflation below 5 per cent.
- Early signs of cooling core and services inflation are emerging in most countries except in the UK and the European Union (EU).



Source: Bloomberg and OECD

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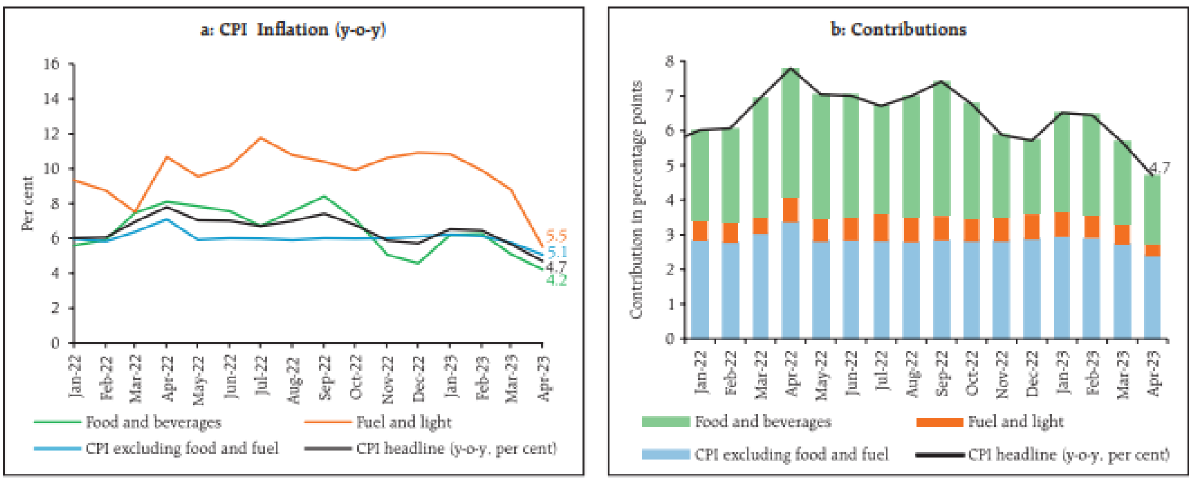
India:

- CPI inflation increased to 4.8 per cent in June 2023 from 4.3 per cent in May.
- The rise in headline inflation was primarily on account of an increase in food inflation.
- **Food inflation** increased to 4.6 per cent in June from 3.3 per cent in May as inflation in sub-groups such as spices and pulses witnessed a spike.
- Despite a m-o-m increase in prices by 12.2 per cent, y-o-y inflation in vegetables remained in negative territory. Deflation in edible oils also deepened.
- Inflation in cereals remained elevated.
- Inflation in the **fuel and light group** softened to 3.9 per cent in June from 4.6 per cent in May, mainly driven by steep deflation in kerosene (PDS) prices.
- Inflation in LPG moderated further.
- Electricity prices, however, increased sharply (206 bps m-o-m). Core inflation declined marginally to 5.1 per cent in June from 5.2 per cent in May.
- While inflation in most of the constituents of the **core group** softened, it remained steady for health and increased in the case of transport and communication, and education.
- In terms of **regional distribution**, rural inflation at 4.7 per cent was marginally lower than urban inflation (5.0 per cent) in June 2023.
- Majority of the states registered inflation in the range of 4 to 6 per cent.

Spatial Distribution of Inflation: June 2023 (CPI – Combined, y-o-y)

Source: NSO, RBI Staff Estimates

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:

- US FED hiked rates by 25 bps in July, as per expectation, and continued to remain data driven in future policies.
- ECB hiked by 25bps in July, with the Bank of England (BoE) hiking by a 25bps in August as inflation moderated. Both central bankers remained non-committal on future moves.
- With global rates firming up on hawkish central banks, 10Y GSec inched up and closed at 7.18%.
- Overall yields rose across the curve as expectations of easing in global rates were pushed further into 2024, on receding recession fears and resilient growth.
- Medium to long term corporate spreads remained on lower side in absence of any material increase in supply.

Outlook:

Global:

- 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 is indicating more rate hikes to ensure sustainable drop in inflation to target.
- 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 some of the drop seen in early Apr-June quarter as global narrative changed from "rate pivot" to higher rates or pause.

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%). Growth trend may continue into FY2024, though it is likely to slow down to 6%-6.5% in FY2024.
- Inflation downtrend has started, with 1Q FY2024 inflation likely printing well below 5%.
- With RBI projecting inflation to be 5.2% 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.
- The recent sharp rise in food prices, especially tomatoes, may lead to sharp rise in inflation.
- This may keep RBI on hold for much longer as it sees the impact of higher food prices on overall inflation trajectory.
- Markets had 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 7.20%, 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.
- Markets are likely to remain volatile as narrative has become data driven. 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 7.05%-7.25% range.

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

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