Macro Review & Fixed Income Market Outlook

Global Economy Update:

Macro Backdrop:

- Global economic activity has sustained its growth momentum in the second quarter of 2023, albeit with two diverging roads.
- The world composite purchasing managers’ indices (PMIs) rose to an 18-month high in May, powered by the vibrancy of the services sector.
- Global food prices have fallen to their lowest levels in two years, with declines in prices of grains, vegetable oil and dairy offsetting higher sugar and meat prices.
- This is reviving hopes that sticky inflation will start to ease, although the pass-through to consumers is taking time with transportation, labour and energy costs remaining relatively high.
- Agricultural prices could fall even further in the rest of 2023 – by 7.2 per cent projected by the World Bank for 2023 and further by 2 per cent in 2024.
- While inflation remains generally elevated relative to targets, it has started to relent, emboldening some central banks to sight the light at the end of the tunnel and breathe easier on monetary policy stances.
- Major economies have borne well the headwinds assailing the global economy, and some like India have rebounded strongly.
- The optimism generated by these developments has started to influence the forecasts.
- In June, both the OECD and the World Bank have modestly upgraded their outlooks for 2023, indicative of a directional shift in their view of the world.
- The global composite PMI increased to 54.4 in May 2023.
- The global services PMI inched up to 55.5 in May from 55.4 in April, with expansion in output and new orders gathering pace.
- The global manufacturing PMI, however, remained unchanged at 49.6 in May, even though input costs decreased for the first time in three years.

Indian Economic Growth:

Macro Backdrop:

- India’s real gross domestic product (GDP) recorded a growth of 7.2 per cent in 2022-23, stronger than the earlier estimate of 7.0 per cent.
- It has surpassed its pre-pandemic level by 10.1 per cent. Real GDP growth in Q4:2022-23 accelerated to 6.1 per cent (y-o-y) from 4.5 per cent in Q3, aided by fixed investment and higher net exports.
- On the supply side, real gross value added (GVA) accelerated from 4.7 per cent in Q3 to 6.5 per cent in Q4, driven by rebound in manufacturing activity which moved into expansion territory after two quarters of contraction.
- Turning to 2023-24, domestic demand conditions remain supportive of growth on the back of improving household consumption and investment activity.
- Urban demand remains resilient, with indicators such as passenger vehicle sales, domestic air passenger traffic, and credit cards outstanding posting double digit expansion on a year-on-year basis in April.
- Rural demand is also on a revival path – motorcycle and three-wheeler sales increased at a robust pace (y-o-y) in April, while tractor sales remained subdued.
- Growth in steel consumption, cement output, and production and imports of capital goods suggest continued buoyancy in investment activity.
Fixed investment by manufacturing companies expanded in 2022-23, reversing the contraction seen in 2021-22.

The purchasing managers’ index (PMI) for manufacturing exhibited sustained expansion, rising to 58.7 in May, a 31-month high.

PMI services maintained strong expansion at 61.2 in May on top of 62.0 in April.

The goods and services tax (GST) collections (Centre plus States) in June 2023 stood at INR 1.61 lakh crore and recorded a growth rate of 12 per cent y-o-y.

**Inflation:**

**Global:**

Inflation eased further across most economies.

In May, consumer inflation cooled off in the US for the 11th consecutive month to 4 per cent (y-o-y).

Inflation based on the US personal consumption expenditure (PCE) index, however, edged up to 4.4 per cent in April from 4.2 per cent in March.

In the UK, inflation remained unchanged at 8.7 per cent in May while Japan’s CPI (all items less fresh food) inflation edged up to 3.5 per cent in April after remaining steady at 3.3 per cent since February 2023.

Inflation in the Euro area moderated to 6.1 per cent in May 2023 (from 7.0 per cent in April), its lowest level since February 2022.

Among the EMEs, while inflation firmed up in May in Russia (2.5 per cent) and China (0.2 per cent), it fell in Brazil to 3.9 per cent.

**Source:** Bloomberg and OECD

**India:**

CPI inflation moderated to 4.3 per cent in May 2023 from 4.7 per cent in April.

The fall in headline inflation was driven by food and fuel sub-components while core (excluding food and fuel) inflation remained steady.

**CPI food inflation** (y-o-y) moderated sharply to 3.3 per cent in May from 4.2 per cent in April on account of a large favourable base effect of around 145 bps, which more than offset a positive price momentum of around 55 bps.

In terms of sub-groups, inflation moderated in cereals, fruits, non-alcoholic beverages, and prepared meals.

Edible oils, meat and fish and vegetables remained in deflation while inflation in milk, eggs, sugar, spices, and pulses edged up in May.
Inflation in the fuel and light group declined to 4.6 per cent in May from 5.5 per cent in April as a large favourable base effect of 140 bps more than offset the positive momentum (55 bps).

Within the group, inflation in LPG, firewood and chips prices continued to witness further moderation. Electricity price inflation, on the other hand, edged up in May.

Core inflation remained unchanged at 5.1 per cent in May as the momentum of 40 bps was completely offset by the base effect.

Within this category, subgroups such as housing, clothing and footwear, household goods and services, health, transport and communication and education witnessed further deceleration in inflation.

Inflation in tobacco and intoxicants, and personal care and effects, however, registered in uptick in May.

Trends and Drivers of CPI Inflation:

![Graph showing CPI Inflation and Contributions](image)

Bond Yields & Spreads:

- US FED held rates in June FOMC meet but indicated further rate hike may be required as core inflation remains high and labour market conditions are tight. Bond yields surged with 10Y UST closing at 3.84% in June end, rising from a low of 3.60% in early June.
- ECB hiked by 25bps in June, with the Bank of England (BoE) hiking by a surprise 50 bps in June as inflation beat estimates.
- Whilst RBI MPC maintained status quo on rates, the commentary was hawkish leading to rise in rates with 10Y yield rising to 7.12% at end of month (from 6.98% on 1st June 23).
- 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.
- While growth is slowing, labor market in the US remains strong, keeping US FED on its toes.
Receding risks from US bank failures and the speed at which these were addressed has brought confidence back into markets.

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.

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%.

RBI MPC continued to maintain status quo on rates but did not change stance, confounding markets, as inflation has dropped near its target of 4%.

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.

Markets had rallied post April policy, but has given some gains as expectations of quick pivot of rates has been belied.

10Y GSEC rates climbed back over 7%, and the downside may remain limited in absence of any rate easing expectations in the near term.

Markets are likely to consolidate from here. 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 7.0-7.20% range.

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

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