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Growth indicators

In India the process of reopening the economy is underway with Unlock 3.0, even as Covid-19 cases continue to rise. However, the severity of disease in India appears to be low with healthy recovery rate. India had seen one of the strongest lockdown and hence the growth collapse has been more severe. Even as we enter the Unlock 3, most super high frequency indicators suggest economic recovering plateauing at about 85-90% of the pre-Covid levels.

Even as overall mobility remains low. Purchasing Managers Index (PMI) data for July shows that while manufacturing has come closer to normal level, services remains a drag. Composite PMI for July remained in contractionary territory at 37.2, marginally lower than 37.8 in June. Mfg PMI declined to 46 from 47.2 while services PMI role marginally to 34.2. India's PMI has been relatively lower than the peer EMs which attest to the severity of lockdown. IIP growth of the last 2 released data has come deeply negative at -57% and -34% and non-food credit growth has fallen below 6%. Traffic both air and railway are at quite low level, and fuel consumption is also down with mid-teens contraction.

The silver lining is healthy recovery in rural economy, which is expected to do well with healthy government transfers, good harvest and low impact of pandemic. Kharif sowing is doing good at 13% y-y owing to healthy rainfall.

India growth has been weak in the run-up to the crisis, with 8 quarters of steadily declining growth to 3.1% in the last quarter of FY20 and annual growth at 4.2%, lowest since the Global Financial Crisis. The growth would have been much weaker if we remove the heavy lifting done by government with government expenditure growing by about 11% in the last three years. Ex-govt expenditure growth is closer to 2% in the run up to crisis. Gross fixed capital formation has contracted for three consecutive quarters and private consumption growth has plummeted to 2.7%. We expect Indian economy to grow by -4% in FY21. With first quarter growth at ~(-)15%

Inflation

Inflation for June came at 6.1%, with 6% plus growth in the last 4 data prints and 6 of the last 7 months. Food inflation remained high at 7.9%, declining for the second straight months, from 9.2% in May and 10.5% in April. RBI core increased to 5.4%, but there was issue with collection of data in core Consumer Price Index (CPI) series and Central Statistic Office (CSO) had used imputation techniques to fill the gap which makes the data less useful to assess trend. We believe that inflation is headed downwards from current levels and would move towards 4% or lower by year end.

External account

India current account turned to a marginal surplus in 4Q FY20 itself where expectation was of a surplus in 1QFY21. This is first surplus since March 2007 and is likely to increase in 1QFY21. Annual FY20 Current Account Deficit (CAD) also stood at a benign -0.9% of GDP and along with strong capital account surplus, resulted in healthy BoP surplus of US$59.5 bn. Trade data for June shows deep negative growth in trade with imports particularly bad at -47% and exports at -12%. Trade balance turned to a rare surplus. Strong BoP surplus and the resultant rising forex reserve underpins the stable INR and gives greater flexibility to policy makers to deal with growth challenge.

RBI policy

After aggressive monetary easing in the last few months, RBI decided to pause this time keeping all the policy rates unchanged in a unanimous 6-0 vote. Monetary policy stance remained accommodative also with a unanimous 6-0 vote. So now Repo stands at 4.0%, Reverse Repo at 3.35% and Marginal Standing Facility (MSF) at 4.25%.

The decision to hold rates was in line with our expectations given the already aggressive easing done in the last few months which is still flowing through the broader economy. Hence we believe rate easing cut cycle is near to its bottom for now and any meaningful space for policy easing may open up only when "growth normalization process" disappoints policy makers.

Highlight of the policy was restructuring scheme announced by RBI to ease credit stress caused on account of Covid Fallout. Given limited efficacy of rates cuts with slowdown in overall credit growth, incremental policy focus will be on such unconventional tools to ease financial conditions and push for faster transmission of past rate cuts.

Liquidity is likely to remain abundant over next few quarters which will keep shorter end of curve anchored to repo rates. Higher fiscal supply and past experiences at these levels remaining an important overhang for longer end of yield curve to come down. Resultantly, curve is likely to remain steep for remaining part of financial year. Essentially, we believe that RBI is looking to create a low volatility environment with excessive liquidity to nudge financial markets and banks to start credit cycle. But this is a slow process.

Thus, Low duration and Short-term funds may be best risk adjusted places for fixed income investors to have "accrual returns "over other fixed income assets.

(Source – Bloomberg and CEIC)