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Economic Round-up: February 2023

Recent economic data points from US and other major economies are showing that global growth remains steady so far. While in China economic activity (PMIs, home sales, travel) has rebounded sharply post the reopening of the economy, in the US, labour market strength is supporting domestic demand. Retail sales, services activity and even production activity remains on solid ground. In Europe however, economic momentum seems to have weakened again in Feb'23 (PMIs) after showing improvement in Jan'23. Globally, lower commodity prices are translating into lower input costs which in turn is helping in cooling inflation down. However, the pace of moderation is weaker in US than earlier anticipated. Core inflation also remains sticky in both US and Europe. This is likely to put pressure on central banks to keep rates elevated for long.

Global growth: While economic activity is improving in the US (barring real estate) and China, weakness is re-emerging in Europe. Domestic demand in China (services activity and home sales) got a boost from festive demand and reopening of the economy, which in turn will also provide a boost to other Asian manufacturing hubs (Taiwan, Korea, Thailand). In the US, labour market remains tight, retail sales are higher and services activity is solid footing. Manufacturing is gradually improving, while real estate sector continues to reel under the pressure of high interest rates. Manufacturing activity in Europe on the other hand is under stress owing to weak demand leading to drop in new orders. However, overall the outlook for global is still brighter than earlier anticipated. Although, effects of elevated interest rates on profit margins of firms will have to be keenly watched.

Global Central Banks: While in the last Fed meeting (Jan-Feb'23) it was believed that the central bank will pause soon, it is now almost certain that Fed will hike rates at least twice (March and May) before taking a decision to pause. Resilience in private consumption demand, tight labour market, and uptick in PCE index, are driving this expectation. Even BoE was expected to pause, but now looking at the strength of domestic economy (GDP, manufacturing, tax receipts) it will too raise rate by 25bps in its next 2 meetings. ECB has maintained its hawkish tone and considering stickiness in core CPI, it is also expected to raise key policy rates by 50bps in its next meeting. Central Bank of China is expected to maintain loose monetary policy for now, however if reopening builds up inflationary pressure then it may too consider tightening. BoJ has reiterated its stance to maintain ultra-loose policy for now, although it is expected to raise the yield cap targets in Mar'23.

Key macro data releases: Data on the fiscal state of the government till Jan'23 shows, fiscal deficit has reached 67.8 % (58.9% in FYTD22). Capex remains the bright spot. On the income side, net revenue rose as indirect tax collections picked up pace, supported by GST and custom duties. Direct tax collections continue to moderate.

On the industrial production side, core sector growth in Jan'23 accelerated by 7.8% (4-month high) against an increase of 7% in Dec'22. There has been broad based improvement across the sectors with fertilizers and electricity output clocking double digit growth.

CPI inflation data again posed concern as it edged up to 6.5% in Jan'23, after dropping to a 13-month low of 5.7% in Dec'22. CPI food index rose to 5.9% in Jan'23 from 4.2% in Dec'22. . Amongst major food items, sharpest pace of increase was led by vegetable prices. Core CPI remained sticky at 6.1% in Jan'23 as well. Amongst major items of core, housing inflation rose the most, followed by health and personal care and effect inflation.

Global developments

Global growth-not as bad as expected

OCED Secretary-General Mathias Cormann noted that outlook for global economy in CY23 has improved considerably at the start of the year, compared with what was being expected toward the end of CY22.. He cited multiple reasons, which included substantial decline in energy and food prices, diversification of sources of energy by Europe, strength in US and Asian economies, and reopening of China. Although he also cautioned that the fight against inflation is not yet over and global central banks will have to maintain tight monetary policies in order to bring down inflation to the targeted levels. Global manufacturing PMI also rose for the first time in 5 months in Feb'23 to 50 (49.1 in Jan'23).

US economy is giving mixed signals, as real estate sector remains under stress with existing home sales plummeting to a new low, while retail sales and ISM services PMI roared back and manufacturing output in Jan'23 also picked up. While new home sales took advantage of falling prices and mortgage rates and rose for the 1st time in 10 months in Jan'23 (+7.2% MoM), existing home sales, which contribute to bulk of homes sales in the US, continue to decline. Sales in Jan'23 have fallen to more than 12-year low of 4mn units (-0.7% MoM). In Jan'23, the 30-year fixed rate mortgage average had declined to 6.13% (as of 26 Jan 2023) from 6.42% in Dec'22 (as of 29 Dec). In Feb'23 rates have picked up again mortgage rate stands at 6.5% currently (as of 23 Feb 2023). On the other hand, private consumption demand is proving to be steady. Retail sales in Jan'23 rose by 3% on MoM basis (highest since Mar'21) compared with (-) 1.1% decline in Dec'23. Even on YoY basis it was up by 6.4%. Furniture store, restaurants, electronic appliances and clothing store posted hefty gains. ISM services index also rebounded from 49.2 in Dec'22 to 55.2 in Jan'23. Domestic demand so far has also been supported by tight labour market, with 4-week moving average of initial jobless claims continuing to decline (down by 3k to 1.67mn for the week ending 18 Feb 2023). Overall industrial production also showed improvement in Jan'23, supported by MoM growth in manufacturing (1% versus -1.8% in Dec'22) and mining (2% versus -1.2%) sector output. In Feb'23, the ISM index shows that contraction in manufacturing activity softened as the index moved from 47.4 to 47.7 in Jan'23. This was led by jump in new orders index (47 from 42.5). However, key concerns seen arising includes drop in employment index (49.1 from 50.6) and increase in price paid index (51.3 from 44.5). Fed will closely watch movement in prices to determine its trajectory of future rate hikes.

In Eurozone (EZ), while economic activity had improved in Jan'23, it was again seen faltering in Feb'23. Final manufacturing PMI Eurozone came in at 48.5 (2-month low) versus 48.8 in Jan'23. Activity in both Germany and France witnessed worsening conditions. Germany's index fell to 46.3 in Feb'23 from 47.3 in Jan'23, while in case of France it fell more steeply to 47.4 from 50.5 in Jan'23. Decline in new orders was the key reason in both economies. On the upside, input prices fell across the board, signalling that inflation might have peaked and ECB can continue to slowdown the pace of rate hikes in the coming months. In Feb'23, headline CPI is estimated to have cooled down further to 8.2% from 8.6% in Jan'23. However, stickiness in core CPI (5.3% estimated for Feb'23, unchanged from Jan'23) will continue to be a cause of concern. Germany's ZEW economic sentiment index (28.1 from 16.9 in Jan'23) and Ifo business climate index (91.1 from 90.2), both inched up in Feb'23. Fiscal stimulus and dip in inflation supported the increase. However the current situation index in both surveys remains unfavourable, signalling that recession risks still persist. Further, ECB has vowed to continue hiking rates, till inflation is substantially brought down, thus also fuelling recession fears.

In case of China, reopening of the economy is beginning to show impact with official manufacturing PMI inching up to 52.6 in Feb'23 (highest reading since Apr'12) from 50.1 in Jan'23. Official data showed that new orders picked up for the first time since in Apr'21. Production and new orders index improved the most (was above 60.0) for furniture manufacturing, metal products, and electrical machinery equipment. Even non-manufacturing index bounced back in Feb'23 to 56.3 from 54.4 in Jan'23, led by rebound in both services and construction activity. Construction PMI stood at 60.2 from 56.4 in the previous month, supported by pick up infrastructure spending and revival in financing to real estate developers. Other indicators such as home sales (reported first increase in Feb'23, since Jun'21), air passenger traffic (+35% in Jan'23), subway ridership and passenger vehicle sales, are also showing significant improvement, indicating that domestic demand is picking up. As a result, Moody's has also upgraded its GDP forecast for CY23 to 5% from 4% earlier.

Global central bank decisions

Following rate hikes by major central banks in Feb'23 (US Fed: +25bps; ECB: +50bps; BoE: +50bps), it was earlier expected that Fed and BoE may pause soon. However, it is now projected that the decision to pause by Fed will have to be delayed. So what has changed? Jan'23 US CPI data moderated to 6.4% from 6.5% in Dec'22, but it was still higher than markets' expectation of 6.2%. Further PCE index rose by 0.6% (MoM) in Jan'23 following 0.2% in Dec'22. Even in YoY terms, it was up at 5.4% from 5.3% in Dec'22. Also, core PCE (tracked by Fed) was up by 0.6% versus 0.4% in Dec'22. This has heightened the expectations that Fed will continue to opt for more rate hikes in the coming months. While earlier one more rate hike was expected by the Fed, now at least two more rate hikes are expected (March and May), taking the terminal rate to 5.4-5.5%. The likelihood of rate cuts in CY23 has also diminished.

In Case of BoE, while inflation is cooling down (10.1% in Jan'23 versus 10.5% in Dec'22), there are other emerging factors in the economy (sudden revival in manufacturing activity, increase in tax receipts and pickup in consumer confidence), which have raised the probability of more rate hikes by the central bank. It is now expected that the bank will raise its policy rate by 25bps in March and May this year. Market participants are expecting terminal rate for BoE at 4.75% by Sep'23. Recently, a member of MPC also reiterated that pausing the rate hike cycle is not advisable owing to continued pressure on wages and prices, which could result into stickiness of the inflation.

ECB has continued to maintain its hawkish tone, indicating another 50bps hike in its next policy meeting in Mar'23, however now analysts are expecting rate hike to extended until Jun'23 (earlier May'23) in view of sticky core inflation and expectation of elevated rates in the US. The terminal rate for ECB is thus expected at 3.75% (3.25% earlier).

Japan government recently announced new governor and deputy governor for BoJ. Both incoming governor and deputy governor have stressed that the ultra-loose monetary policy should be maintained and new ideas should be implemented to deal with consequent cost of the stimulus. Negative interest rates hurts profits of companies and also put pressure on Yen. Investors are expecting BoJ to announce further increase in yield cap in the Mar'23 policy meeting.

Special studies

Is credit growth tapering off?

Credit growth in India has seen a sharp revival in FY23. On a YoY basis, from just 9.9% at the start of Apr'22, credit growth picked up pace and peaked at 17.8% in Oct'22. This coincided with the festive season where the pent up demand for both goods and services showed. Thereafter, there were some signs of moderation with growth in credit eventually decelerating to 14.9% in the last fortnight of Dec'22. While there has been some revival in credit growth since then, it does beget the question of whether trend is sustainable. The RBI has been increasing the repo rate which has been transmitted to a large extent in lending rates. The main goal of increasing the repo rate is to slow down the pace of activity to control inflation. In this study, we analysed the trends in credit growth this year and its main drivers.

Credit growth in FY23 has been driven by increased credit demand in personal loans and services segment. Demand for agricultural credit has also shown traction. On the other hand, credit to industry though improving, has remained muted as credit demand has moderated sharply from 13% in Nov'22 to 8.7% in Dec'22. Retail credit which has been driving majority of credit growth this year, has continued to accelerate and registered a solid growth of 20% YoY in Dec'22 as well. Credit growth from the services sector despite moderating a bit in Dec'22, continues to grow at a robust pace.

Within industry, credit demand from the MSME segment has seen a marked slowdown since the start of the year. In fact, while credit growth to micro and small segment has moderated from 29% in Apr'22 to only 13.7% in Dec'22, for medium industries the decline has been much alarming from 53.5% to just 15.4% in Dec'22. On the other hand, credit to large corporates had shown an increasing trend for much of the year. From just about 1.6% in Apr'22, credit to large industry peaked at 10.9% in Dec'22. However, here too credit demand has slowed down in recent months from 10.9% in October to 10.5% in November and further to 7.5% in December. The growth in credit here has been driven by the sectors roads, airports, steel and automobiles.

In the personal loans segment, housing which accounts for more than 50% of the credit under this segment, has shown a stable and smart growth over the last few months. It is possible to conclude that higher repo rates and hence borrowing costs for home loans has not dented demand significantly. The same is true for vehicle loans which have also been increasing from 11.5% in Apr'22 to 24.7% in Dec'22.

Within services, much of the growth has come from NBFCs which have been growing at a rate of more than 30% even in Dec'22. Credit to wholesale and retail trade, which showed momentum initially, has shown deceleration in recent months. Credit to commercial real estate has also shown a similar trend, though the growth in this segment has been much more muted. In general growth remains stable though has shown a decline in the last two months.

However after being in the region of 17-18% in 5 successive fortnights ending December 16th 2022, growth is now in the range of 16-17% in the last 3 fortnights. Another interesting observation so far is that loans linked to external benchmark have behaved differently: for MSMEs growth in credit has slowed down while in case of personal loans, growth has been maintained.

Exchange rate view for FY24

INR to trade in the range of 82-84/\$ in FY24

The trajectory of USD/INR in the next year will be determined by both global as well as domestic macro fundamentals. Just like 2022, perhaps the most important driver of USD/INR rate this year will be the trajectory of the dollar. Amongst domestic factors, India's current account deficit will be the key factor impacting USD/INR. Apart from this, FPI flows and oil prices will also be important for the exchange rate going forward.

What will happen to the dollar?

The trajectory of the dollar (DXY) will be quite significantly be contingent on the Fed action, which in turn will be determined by the inflation and growth dynamics. Recent data points from the US suggest that while inflation has shown signs of moderation, it still remains uncomfortably high. Furthermore, several sub-components, such as services, continue to show significant inflationary pressures. In Jan'23, both CPI and PPI inflation in the US inched up on a MoM basis. This reinforces comments from several Fed officials who have continued to maintain that the war against inflation is far from over.

Notably, in Dec'22, Fed projected a terminal fund rate of 5.1%. However, developments since then suggest that the terminal rate could be much higher. Quite significantly several Fed officials including the Fed Chair have been openly advocating more rate hikes with some Fed members even estimating the terminal rate of closer to 5.5% or even higher. Markets have also adjusted their expectations, with the probability of at least two 25bps rate hikes in the next 2 meetings now above 80% (as per CME Fed Watch tool). This will push DXY higher.

However, we do not foresee DXY rising to the peak it attained in 2022. The upward momentum in DXY will be more gradual this time around as rates elsewhere have also gone up, and the peak will also be lower. This will put mild depreciating bias on INR. Growth differentials will also be undermining the dollar strength seen in 2022, as Eurozone growth has been much more resilient than what was estimated at the start of the year. Furthermore, with China opening up, global economic prospects have brightened to an extent which will also dampen the dollar's safe-haven appeal.

Domestic macros to offer some support

CAD to moderate: India's current account deficit (CAD) surged to 4.4% of GDP in Q2FY23 led by higher trade deficit, as imports rose much faster than exports. With global commodity prices having eased from their peaks, we expect CAD to moderate going forward. We expect CAD in the range of 3-3.5% in FY23. This will likely narrow to 2.5-3% of GDP in FY24.

FPI flows to be volatile: Our analysis has shown that FPI flows and USD/INR have a positive and statistically significant relation in the short-term. This was true for most part of 2022, with negative FPI flows exacerbating the depreciation in INR. So far in FYTD23, FPI outflows have totalled US\$ 5.9bn and may not see a significant revival. Even in FY24, with the Fed rates likely to stay elevated and with China opening up, FPI flows may remain muted. This will have a negative impact on INR. On the positive side, India will be an exciting market with the highest growth rate being expected. Further, India Inc. can expect a revival in FY24 in terms of earnings as the shadow of high inflation would have passed by. This will justify higher valuations in the market. RBI would also probably not be lowering rates any time soon thus making debt investments comparable. The talk on inclusion of India in the bond indices may also take shape next year. Therefore on balance there is reason to be sanguine here and the net inflows will turn positive this year and gently rise to the US\$ 10-20bn range.

Where do we see USD/INR in FY24?

Fed policy will be the most important driver of USD/INR in FY24. With the Fed widely accepted to hike rates by another 50bps in the next two meetings, the gap between US and India policy rate is likely to narrow to a record low of 125bps. This is based on the assumption that the RBI continues to remain on a long pause. Narrowing yield differential will put pressure on INR and also FPI flows. Hence we cannot rule out additional pressure on the currency, however the movement will be much more gradual. On a quarterly basis, we see USD/INR inching towards 82.5/\$ in Q1, 83/\$ in Q2 as the Fed rate hikes are materialized. We may also see the rupee inching closer to the 84/\$ mark, toward the end of FY24. However, a smaller CAD and favorable growth differential will lend some support to INR.

Putting together all these factors, we believe that the rupee will trade in the range of Rs 82-84/\$ in FY24.

Liquidity: Can it be a devil in disguise?

Liquidity has been quite a pertinent issue of late when financial conditions remained stringent on account of tightening policy response to higher inflation. In this context, we looked at how banking system liquidity is going to evolve in the coming year. In India's context, relatively well placed macro fundamentals and pent up demand contributed to faster pace of credit growth, which outpaced deposit growth where transmission to rates have been relatively slower as the new rates apply to fresh or renewed deposits while the existing ones remain unaffected. This has widened deficit significantly in context of liquidity in the current fiscal.

Even in the coming year, with anticipation of moderation in pace of nominal growth, we expect a considerable gap between demand and supply of funds to the banking system. Further, significant quantum of LTROs/TLTROs are to mature in FY23 and FY24, which will put additional strain on liquidity. This can be corrected through conduct of RBI's long term variable rate repo operations, with the frequency being increased. Or there could be OMOs to induce liquidity in the system on a permanent basis if required. Also, since Banks' net profit have improved significantly they are well placed in terms of capital. Thus, to continue with the higher pace of lending, they could consider digging into their own capital or reserves and surplus going forward.

How do we define liquidity?

Often when we talk about liquidity, we look at RBI's daily money market operations which consist of RBI's LAF operation, government cash balances and adjusting for all the figures, we arrive at the net system level liquidity. This is one way of looking at it as flows are examined. The other way is to look at stocks which are basically components of the balance sheets of banks. This encompasses the gap between the flow of funds to the banking system which comes broadly from the deposits and demand for funds in terms of credit and investments. Our exercise is based on the same. Further we have juxtaposed our assumptions on credit, deposit and investment growth in FY23 and FY24 and tried to arrive at the gap between demand and supply of funds, which gives us an idea about the quantum of deficit or surplus of liquidity in the system.

Demand and Supply of funds in FY23

The total incremental demand for funds taking into account credit and investment in FY23, translates to around Rs 23.8 lakh crore. Based on the asset and liabilities side of SCBs' balance sheet there is expected to be a gap of Rs 4 lakh crore in the banking system in FY23.

What will be the situation in FY24?

FY24 will be a crucial year, as some slowdown on growth front is expected, due to spill over effect of muted global growth. Based on the assumption of 11.5% growth in nominal GDP and incorporating our credit-GDP multiplier, the incremental change in credit comes to around Rs 15.3 lakh crore in FY24. For investments, we have assumed the same percentage of holding of securities by Banks (38%-Centre, 34%-State). We expect accretion of around Rs 6.5 lakh crore, which is higher than what is expected to observe in FY23. On the supply side, accounting for the deposit-GDP multiplier, there is expected to be accretion of around Rs 19.4 lakh crore in FY24. This is also based on the assumption that higher deposit rates is likely to continue in the competitive space for some since the rate cycle of deposits took at a laggard pace compared to the lending rate cycle. Thus in FY24, the deficit or the gap between demand and supply of funds is expected to come around Rs 2.3 lakh crore. The moderation is on account of slight slowdown in pace of credit growth in line with GDP growth.

Factors which are going to put stress on liquidity are:

- **Maturity of TLTROs:** The stimulus given in the form of LTROs and TLROs during Covid times is due for maturity in the coming months. For FY23, the amount is Rs 13,018 crore compared to Rs 66,131 crore in FY24. However, Bank had prepayment options. So the quantum of strain in liquidity is opaque. But definitely some pressure cannot be ruled out, which might be balanced by RBI through conduct of more variable rate repos.
- **Seasonal trend of pickup in credit growth:** As historical data shows, credit growth generally picks in the second half of financial year. This is on account of demand post sowing, festival demand etc. which is more seasonal in nature. In FY24 as well, owing to the election year, this number is likely to be elevated. Even credit growth outpacing nominal GDP growth in FY24, cannot also be ruled out. In that case, strain on liquidity would be much severe.

What is the way out?

- Banks are currently posting healthy jump in net profit (for the 9-month period net profit of major SCBs rose by 46% to Rs 1.7 lakh crore against Rs 1.1 lakh crore in the same period of previous year). Also, in terms of capital, Banks are comfortably placed. Thus going forward, to maintain a healthy pace of credit growth and to bridge the liquidity gap, some digging into the capital and reserves and surplus component may be a feasible option.
- Other than that, borrowing from RBI if the frequency of variable rate repo increases might also be another resort. In that case, long tenor variable rate repos will be helpful for maintaining durability.
- Though based on the underlying growth inflation dynamics, we are not foreseeing any rate cut from RBI. However, some stimulus from RBI in the form of OMO calendar if liquidity dips well below the neutral level, may prove to be helpful.

How is inflation in India related to global price movements?

Last year was fairly disruptive on the prices front due to the war in Ukraine. Commodity prices tended to be volatile during this period, rising in the first few months, post the war and then declining at different rates post July. It did look like that the world had adjusted to the war situation which involved supply disruptions and price hikes for

several commodities ranging from crude oil to wheat. While the war persists, countries have found ways of meeting their requirements from the global markets. And today few are talking of global inflation.

The situation in India has been different in a way. Prices of commodities that were linked to global supply chains did rise and there were several policies brought in to control price increases. At times physical intervention in the form of export policies for commodities like wheat were brought in to ensure that supplies remained stable within the country. But even today there is cause of concern on inflation which came in at 6.5% for the CPI in January though WPI inflation continues to move in the downward direction.

The foreign factor is still used to explain price movements in the country. The analysis here tried to demystify this relationship. The period chosen is January 2023 over January 2022. Data has been taken from the World Bank for global prices while the WPI changes have been reckoned for India. At the onset it should be noted that while World Bank gives average prices, they vary significantly across countries and do not take into account other logistics costs. Hence from the point of view of importing commodities where prices have gone up sharply in India, the options may get limited if the country is in say, Latin America.

For the 11 products where prices had gone up globally, prices in India had increased for 9 of them and declined for two – both related to soybean. Here the variation can be explained by the domestic nature of soybean and soy meal. Other products have also witnessed an increase in prices. For products like gold and silver, higher increase may be explained by the fact that India is a price taker and hence the international prices becomes the domestic price which is then converted by the currency. As the rupee had fallen by around 9%, there was a higher increase in the WPI.

In case of rice and wheat, prices were driven primarily by domestic supplies rather than the global factor. There were shortages in wheat as a part of the output was exported even while domestic output was lower which made the government clamp down on the same. But the shortfall resulted in higher prices. However, rice inflation was lower as output was good for the year. As global prices increased sharply it can be argued that there was a case of furthering exports of rice.

Groundnuts inflation had been on par, and this would be more coincidental as the product is fully domestic and there are no significant imports of groundnut oil. Higher inflation can be attributed to slower growth in supplies this year. Coal inflation in India has been modest even while global prices have increased sharply as only part of the consumption is dependent on imports.

Of the 20 commodities where global prices had fallen, WPI followed suit in 6 products of which 3 were edible oil related, two metals and one agro-based. Divergent movements were witnessed in case of fertilizers in general and energy products. Besides the exchange rate depreciation, domestic tax policies also came in the way of movements being similar.

On the whole for all products put together, the coefficient of correlation for changes in prices was nil. When the sample is split into two – where global prices have increased and fallen, the coefficient of correlation between the two series is low and negative indicating that to the extent there is a relation, there is divergence in direction of rate of change of prices. Therefore it is hard to really link the extent of price movements in global markets to those within.

The main reason for such divergence is that there are several factors which go into the price determination when the product is being imported. These are the exchange rate, government policies on trade, sources of imports, response of domestic producers, domestic tax structure etc. Theory says that higher price differential should lead

to equalization as exports move up taking advantage of global shortages as supplies get diverted. But this does not happen due to policy constraints as well as logistics issues. Hence while global price movements normally do get reflected in domestic prices when the product is imported to begin with, a series of economic responses and policy action tend to mitigate the impact.

Corporate performance in Q3-FY23

The third quarter of the year was expected to be more buoyant as this coincided with the festival cum harvest season. The kharif harvest was reported to be good and the rural demand conditions were expected to improve. With the shadow of the lockdown induced by Covid-19 behind us, the performance of companies was expected to be positive in terms of growth in turnover. The only negative factor happened to be inflation which was high during this period which could have come in the way of consumption. However, GST collections were robust with collections of around Rs 4.5 lakh crore in the period Oct-Dec which was the highest recorded in any quarter. It is against this background that the results of 2119 companies in this study were analyzed.

There was a slowdown in growth in sales from 24.3% to 16.1% for the sample companies. However, the number was still impressive as it came on a high base effect where pent up demand in FY22 tended to be blown up due to negative performance in FY21. While total expenditure also slowed down, growth was higher than that in sales resulting in pressure on profit growth (PBT) which slowed down to 5.6% from 30.5%. The same was reflected in just 5.3% growth in PAT. Interest payments for the sample showed an increase of 25% against a slight fall in FY22 as this was the time when the RBI had also increased the interest rates with the repo rate going up by 225 bps since April to December. This performance was propped up by the BFSI and IT sectors as a rising interest rate scenario is good for the former. The IT sector remained resilient notwithstanding the expected recession in the west.

When these 453 firms (BFSI & IT) were excluded, the performance changed considerably. Growth in sales was still quite firm at 14.3% in Q3FY23. Growth in expenditure was higher at 17.3% and 300 bps higher than that in sales against just 190 basis when the aggregate sample is considered. Interest costs were up by 29.6% against a fall of 2.5% last year. PBT and PAT had both fallen by 14.3% and 14.5% respectively, which was significant as profit margins too had come down from 7.8% in Q3FY22 to 5.8% in Q3FY23. The effective tax rate remained virtually unchanged. Interest cover had however gone down from 6.19 to 4.43 in Q3FY22. It had increased mainly due to the easy interest rate regime maintained by the RBI as the repo rate was unchanged at 4%.

Size wise data shows that the SME sector was affected on both counts. Sales had fallen for all three categories, while net profit growth declined for medium size units. In case of micro and small companies, they were still in losses. Therefore, their overall financial performance is still a concern.

How have FPI performed this year?

FPI flows have always been unpredictable and this year too was not an exception. While there was considerable volatility in the movement in FPI flows, overall the year saw total FPI outflows of US\$ 5.7bn. This is on top of outflows of US\$ 16bn in FY22. The trend in FPI flows this year has largely been negative, with the first three months of FY23 witnessing outflows of US\$ 14.3bn. Some of these losses were recovered in Q2FY23 with inflows of US\$ 6.9bn and US\$ 4.9bn in Q3FY23. However, the situation has quickly reversed since then with Jan'23 witnessing outflows of US\$ 3.2bn. It must be noted that the equity flows have dominated the overall trend in FPI flows as these account for the bulk of FPI inflows. FPI movement in debt and debt related instruments has remained largely muted this year.

In the last 5 years (FY18 to FY22), total FPI flows have remained negative for 3 years with the exception of FY18 and FY21. Both these years saw sizeable FPI inflows of more than US\$ 20bn, which more than offset the outflows seen in the other years. Interestingly, debt inflows of US\$ 18.5bn accounted for the bulk of FPI inflows in FY18 (inflows of US\$ 22.5bn). However, in FY21, which saw inflows of US\$ 36.2bn, equity segment saw huge FPI influx of US\$ 37bn.

What explains the FPI movement in FYTD23?

A number of factors impacted the movement in FPI flows this year, such as:

- **Geopolitical tensions** in Eastern Europe: Russia-Ukraine crisis and the resulting volatility in the global markets, led to huge outflows from Emerging Markets (EMs) to safer assets.
- **Interest rates:** With global central banks embarking on a rate hike cycle, the relative interest rate differential between countries was an important determinant of FPI flows.
- **Movement in dollar:** Much of 2022 was characterized by dollar strength which also impacted investment decisions of FPIs.
- **Global recession:** Another recurring theme of 2022 was the risk of an impending recession as a result of global monetary policy tightening. This resulted in a risk-off sentiment and also FPI flows.
- **China:** China is an important destination for FPI flows. Growth prospects in China were severely impacted last year amidst rising Covid-19 infections and the government's strict Covid-19 zero policy. This led to FPI flows to alternative sources, such as India. With China announcing removal of all Covid-19 related restrictions in Jan'23, FPI flows to India and other EMs have been impacted. This can to some extent, explain FPI outflows of US\$ 3.2bn in Jan'23.

FPI flows have a strong relation with the exchange rate as it is an important component of the balance of payments. Tracking the movement in USD/INR and FPI flows in FYTD23 gives some interesting observations.

- In the last 10 months, FPIs have remained negative in 6 months. Barring Jan'23, INR has depreciated in each of these months.
- Out of the 4 months in which FPI flows were positive, INR still depreciated in 3 of these months. In response to FPI outflows of US\$ 14.3bn in Q1FY23, INR depreciated by 4%. Between Jul to Aug'22, while FPI flows were positive (US\$ 7.3 bn), INR still depreciated, albeit at a slower pace.
- In the next 2-months, FPI outflows were relatively subdued at US\$ 0.8bn. However, INR depreciated sharply by 4% in response to a strengthening dollar.
- Nov'22 saw FPI inflows of US\$ 4.1bn. INR appreciated by 1.7%. In Dec'22, FPI inflows moderated to US\$ 1.1bn. INR depreciated by 1.6% in response.
- The appreciation in USD/INR during Jan'23 can be explained by a weaker dollar and lower oil prices.

It must also be mentioned here that FPI flows alone do not determine the movement in USD/INR. Other factors such as movement in dollar, inflation, oil prices, trade and current account deficits etc also have an important role to play in influencing the movement in exchange rate.

Update on Bank Deposits or Mutual Funds

The present financial year has been quite unusual in the sense that consumption kept ticking even with inflation being high as the pent up demand phenomenon played out. Savings were affected for sure and this was manifested in slower growth in deposits to begin with. How about mutual funds, which tend to compete with banks when it comes to savings allocation? In this report we looked at the movement in bank deposits and AUM of mutual funds for the period April 2022 and December 2022.

It is important to note that as RBI kept hiking the repo rate there was a tendency for bank deposits to also increase to match the increasing demand for credit. Notably, higher deposit rates have garnered an increase in deposits in the last few months. MFs on the other hand have been impacted by downside risks to global growth and tighter financial conditions, which impacted market fundamentals. Increase in Sensex (point to point) had also been considerably lower at 3.3% in FYTD'23 (last close: 06 Feb 2023) compared to 18.3% increase seen in FY22.

Thus, overall AUM of MFs rose by only Rs 2.3 lakh crore and if the same momentum is maintained it will not be able to reach Rs 6.1 lakh crore accretion as seen in FY22. Equity still holds up in FYTD23 compared to debt segment. The rising interest rate cycle has acted as a deterrent due to the discounting factor involved in pricing. The degree of substitutability between MF and bank deposits which in FY22 was slightly tilting towards MF, is showing reversal with Bank deposits being the preferred choice of allocation.

What was the situation in FYTD23?

- In the first 9 months of FY23 (Apr-Dec), AUMs of MFs increased to Rs 39.9 lakh crore in Dec'22 from Rs 37.6 lakh crore seen in Mar'22. This was an accretion of Rs 2.3 lakh crore. During this same period, Bank deposits increased by Rs 12.7 lakh crore.
- Within MFs, equity funds showed maximum increase from Rs 13.7 lakh crore to Rs 15.3 lakh crore, an accretion of Rs 1.6 lakh crore. This was in line with 3.3% increase in Sensex during the same period. Allocation in small cap and multi cap funds rose the most.
- Hybrid funds which invest 65 to 100% in equity also showed slight increase in the first 9 months of FY23. From Rs 4.8 lakh crore, it rose to Rs 4.9 lakh crore. This was led by Dynamic Asset Allocation/Balanced Advantage Fund, where investment in equity/debt that is managed dynamically and Multi Asset Allocation Fund.
- Debt funds on the other hand, were a disappointment. The inflow in this segment moderated to Rs 12.7 lakh crore in Dec'22 from Rs 13.5 lakh crore in Mar'22, thus showing decline of Rs 0.9 lakh crore. This was led by fall in allocation towards Banking and PSU Fund and other short duration funds. Also during the same period, 10Y G-Sec yield went up by 48bps in response to 225bps hike in repo rate. A higher yield reflect value of existing debt instruments may fall, due to the discounting factor.

What had been the situation in FY22?

- In FY22, AUM of MFs, rose to Rs 37.6 lakh crore from Rs 31.4 lakh crore in FY21, showing an accretion of Rs 6.1 lakh crore. Bank deposits during the same period rose by Rs 13.5 lakh crore.
- In FY22 as well, majority of the inflow was towards equity funds which rose by Rs 3.7 lakh crore from Rs 10 lakh crore in FY21 to Rs 13.7 lakh crore. There was also a sharp increase in Sensex by 18.3% in FY22.

- Hybrid segment also rose by Rs 1.4 lakh crore to Rs 4.8 lakh crore in FY22. However, debt segment continued to remain muted. Compared to an inflow of Rs 14.5 lakh crore in FY21, it moderated to Rs 13.5 lakh crore in FY22 (a fall of Rs 1 lakh crore). This is followed by 67bps increase in 10Y G-Sec yield in FY22. Policy rate on the other hand remained unchanged during this period.

In absolute terms, deposit inflow is much higher compared to MFs (around 4.5 times higher). Share of deposits in sum of increase in deposits and AUM of mutual funds increased from 68.8% in FY22 to 84.5% in YTD FY23. Notably, during the same period, Weighted Average Term Deposit rate went up by 75bps. The share of equity funds in total resources garnered by banks and MFs came down from 18.9% in FY22 to 10.7% in YTD FY23.

Data Releases

Currency outlook: INR is likely to remain range-bound

Strong macro data from the US coupled with a strong labour market, has raised the likelihood of more rate hikes. Specifically, markets are now expecting at least two more rate hikes of 25bps each in the next two meetings. Another 25bps rate hike in Jun'23 is also on the table. This implies that the Fed terminal fund rate will be much higher than earlier expectations, which has once again fuelled a rally in the dollar. DXY has strengthened, putting pressure on all currencies. INR has performed relatively better, supported by improvement in external outlook as well as RBI intervention. Oil prices are once again showing upward momentum buoyed by hopes of an economic recovery in China and FPI flows have been volatile. This suggests that INR is likely to remain under pressure. However, we do not expect INR to breach the 83/\$ mark as RBI is seemingly looking to defend it. Hence, we expect INR to trade in the range of 82-83/\$ in the next fortnight. Focus will be on US inflation and jobs report.

Bond Market Round-up

Global bond yields rose sharply following expectation of a higher terminal Fed Fund rate. Market is now pricing it at 5.5% against earlier expectation of 5%, as visible in the money market rates. India's 10Y yield has also reflected global yield movements to an extent. However, underlying domestic macros such as elevated inflation pressure and tighter liquidity conditions have also contributed towards the same. Interestingly, the correction in short term papers which was seen in the past month, was reversed. Feb'23 witnessed an increase in yield of short term papers with cut off rising sharply. This was visible in considerable flattening of the yield curve. The gap between 15Year and 6months paper fell sharply to 27bps in Feb'23 against 60bps in Jan'23. The 2-month OIS curve of India is now at 6.75%, going by that logic another 25bps rate hike by RBI might be translated. Adding to this, has been the liquidity situation which went into deficit on an average basis in Feb'23. Durable liquidity fell sharply, so did government cash balances, due to month end spending to meet the budgeted level. Going forward pressure on liquidity would aggravate with maturity of LTROs and TLTROs and possible increase in spending by States. All these would put pressure on India's 10Y yield in the near term which is expected to trade in the range of 7.4-7.5% in the next 30-days.

Core industries

Core sector growth in January accelerated by 7.8% (4-month high) against an increase of 7% in Dec'22. There has been broad based improvement across the sectors with fertilizers (17.9% versus 7.3%) and electricity output (12% versus 10.4%) clocking double digit growth. Given a weight of around 40% in IIP we could expect growth in industrial production to also be high at around 5%.

Central government finances

Central government's fiscal data shows that on FYTD basis (Apr'22-Jan'23) fiscal deficit reached 67.8% of the targeted level versus 59.8% as of Dec'22 and 58.9% as of FYTD22. In terms of spending, capex spending by the government continues to be the bright spot, with 78.3% of the budgeted target utilized as of Jan'23 (FYTD basis) compared with 65.4% spent as of Dec'22. Revenue spending remains at par (75.1% as of Jan'23) with last year (74.7% as of Jan'22). On the income side, government has seen 3.5% increase in gross tax revenues upto Jan'23, down from 12.5% growth recorded till Dec'22. Indirect tax collections improved (8.5% as of Jan'23 versus 7.1% as of Dec'22) while direct tax collections are showing sharp moderation (9.6% versus 18%). Within direct taxes, both income tax (18.9% versus 19.2%) and corporate tax collections have eased (14.8% versus 16.9%). Within indirect taxes, the pickup was mainly on account of slower contraction in union excise collections (-19.3% versus -19.9%) and improvement in custom duty collections (13.6% versus 12.4%). Overall, centre's net revenue gathered momentum, as it was up by 4.4% compared with 2.1% as of Dec'22.

Foreign trade in first 10 months

Merchandise exports in January 2023 were \$ 32.91bn as against \$ 35.23bn in 2022. Imports were \$ 50.66bn, compared with \$ 52.57bn in January 2022. Merchandise exports for the period April-January 2022-23 were \$ 369.25bn (\$ 340.28bn) while imports were \$ 602.20bn as against \$ 494.06bn in the previous year. Growth in exports was 8.5% for this period while imports increased by 21.9%. The merchandise trade deficit for April-January 2022-23 was estimated at \$ 232.95bn as against \$ 153.79bn in April-January 2021-22.

Non-petroleum and non-gems & jewellery exports during April-January 2022-23 was \$ 259.06bn, compared with \$ 257.36bn in April-January 2021-22 while non-petroleum, non-gems & jewellery (gold, silver & precious metals) imports were \$ 364.29bn in April-January 2022-23 compared with \$ 301.76bn in April-January 2021-22. The latter can be linked to demand from industry and hence related to the level of economic activity in the country. The top 5 commodities accounted for almost 67% of total exports. Of these, engineering and gems and jewellery witnessed negative growth primarily due to lower demand with the global economy witnessing low growth. Negative growth was also witnessed in the categories of readymade garments and cotton yarn which together have a share of 6% in total.

Imports have grown at a higher rate owing to mainly higher demand from industry which had recovered in some industries post the Covid-19 induced lockdown. They were also affected in the upward direction when the war caused prices to spiral. However, in the last 4-5 months prices have come down lowering thus the value of imports. This holds for both oil and non-oil imports. Crude continues to have the highest share in imports at around 30% followed by electronics with 10.7%. Coal is the third most important import followed by machinery and gold.

Prospects for trade would be driven by two sets of factors. With the world economy slowing down the demand for imports in general will slow down thus impacting our exports growth. The China factor however can turn things the other way, though presently the pace of recovery is uncertain. On the other hand growth of 6-6.5% in India

will necessitate higher growth in imports which will push up the bill. On the positive side benign commodity prices will work to our advantage. On the whole however, the trade deficit will remain elevated.

CPI ticks up

CPI inflation data again posed concern as it edged up to 6.5% in Jan'23, after dropping to a 13-month low of 5.7% in Dec'22. This is despite a favourable base of 6% seen in Jan'22. CPI food index rose to 5.9% in Jan'23 from 4.2% in Dec'22, on YoY basis. Amongst major food items, sharpest pace of increase was led by vegetable prices where pace of disinflation went down from -15.1% in Dec'22 to -11.7% in Jan'23. Other than this, cereals and product also rose to 16.1% from 13.8% in Dec'22. Eggs, meat and fish inflation also rose. Notably, 6 out of 12 broad group of food and beverage noticed inflation above 6%.

On MoM basis, vegetables (-3.8% from -12.7% in Dec'22), fruits (0.1% from -1.7% in Dec'22), cereal (2.6% in Jan'23 from 1.1% in Dec'22) and meat and fish (0.8% from -0.2% in Dec'22) items pose considerable risk. The pickup in momentum of vegetable prices has resulted from items such as ginger, garlic, chilly, brinjal and cabbage.

Core CPI (excl. food and fuel) remained sticky at 6.1% in Jan'23 as well. Excl. Pan and tobacco, the print of core inflation further goes up to 6.3% in Jan'23 from 6.2% in Feb'22. Amongst major items of core, housing inflation rose to 4.6% in Jan'23 from 4.5% in Jan'22. Health inflation rose to 6.4% from 6.2% in Dec'22. Rising gold prices have contributed to personal care and effect inflation to go upto 9.6% from 8.1% in Dec'22. However, transport and communication, clothing and footwear have given slight comfort with regard to moderation in inflation. Amongst the 8 major broad group of core inflation, 4 of the items have remained above 6%.

On a sequential basis, housing inflation went up to 0.8% from -0.6% in Dec'22. Other than that recreation and amusement (0.4% from 0.2% in Dec'22) and personal care and effects (1.6% from 1.3% in Dec'22, following a 5.8% MoM increase in international gold prices) pose considerable risks.

Going forward, we expect the pressure on inflation would continue. We expect CPI to average around 6.5% in FY23 (in line with RBI's projection), for FY24, we expect it to be at 5.7% higher than RBI's forecast of 5.3%. This month and print of the current quarter hold relevance since RBI would be watchful of the persistence in core and volatility in food inflation to take a call on rates. For now we remain with our earlier forecast of pause in the near to medium term.

WPI moderating

Headline WPI moderated to 2 year low of 4.7% in Jan'23 from 5% in Dec'22. Food inflation last month accelerated to 3-month high of 2.9% from 0.7% in Dec'22. This was led by increase in prices of food grains (13% in Jan'23 versus 11.6% in Dec'22), fruits (4.1% versus 1.3%), milk (9% versus 7%) and spices (16.1% versus 15.4%). Prices of vegetables (-26.5% versus -36%) fell less sharply. Within vegetables, pressure can be seen emerging in items like: onions, tomato, ginger, and cucumber. Within food grains, price build up was visible in both cereals and pulses. Amongst the cereals both paddy and wheat saw prices going up. At the international level, World Bank's pink sheet data shows that while global paddy prices continue to inch up (18.5% in Jan'23 versus 14.3% in Dec'22), wheat prices are slowing (1.6% versus 2.5%).

Fuel and power inflation in Jan'23 eased to 22-month low of 15.2% from 18.1% in Dec'22, owing to moderation in the mineral oil index (17.9% versus 22.7%). Coal and electricity price growth remained unchanged from the previous month in Jan'23 at 2.6% and 16.6% respectively. Within this index, prices of ATF, Kerosene, and petrol slowed, while that of Naphtha fell. The dip in mineral oil index in line with (-) 1.9% decline in average Brent price

in Jan'23 compared with 8.7% jump witnessed in Dec'22. However, as international oil prices remain on the lower side for now we can continue to expect easing in fuel and power inflation.

Core inflation moderated for the ninth consecutive month in Jan'23 to 2.8% from 3.2% in Dec'22. Manufactured products inflation was also down at 3% in Jan'23 from 3.4% in Dec'22. Of the 22 commodity sub-indices, 15 indices rose at a slower pace in Jan'23 than Dec'22 led by textiles, computer and electronic products, motor vehicles, electrical equipment, leather products and paper products. On the other hand, basic metals saw prices increasing (1.3% versus 0.8%). Within this, prices of copper, zinc, aluminum and lead declined at a slower pace in Jan'23 versus Dec'22. Even on international level, prices of some commodities have declined at a slower pace, as reflected in World Bank's pink sheet. Prices of copper is reflecting build of pressure. Zinc prices remained broadly unchanged. On the other hand, prices of aluminum and lead continue to see a decline.

IIP growth moderates

IIP growth slowed down to 4.3% in Dec'22 from 7.3% in Nov'22. This was below our estimate of a 5% increase. A sharp decline in exports in the same period (exports fell 12.2% in Dec'22) may explain the lower print. Manufacturing output moderated to 2.6% in Dec'22 from 6.4% in Nov'22. Slowdown in manufacturing output was broad-based with 20 out of the 23 sub-industries under this group showing a deceleration. Within this, production of computers and other electrical fell sharply, followed by wearing apparel, and tobacco products. On the other hand, 3 industries, i.e., pharma and chemicals, paper and paper products and coke and refined products showed an improvement. Moderation was seen in electricity production (10.4% versus 12.7% in Nov'22). Mining production was virtually stagnant at 9.8% (9.7% in Nov'22).

Within use-based, while primary goods output accelerated to 8.3% in Dec'22 from 4.8% in Nov'22, all output in all other segments lost momentum. Output of consumer durables fell sharply by 10.4% in Dec'22 from 5.3% in Nov'22 due to weakness in global demand. Intermediate goods output also contracted. Capital goods production also moderated to 7.6% in Dec'22, after increasing by 21.6% in Nov'22. Output of non-consumer durable segment also slowed down to 7.2% compared with 9.1% in Nov'22. High inflation and weakness in rural demand may explain this. Similar moderation was also seen in infrastructure and construction goods sector.

With global growth expected to slowdown, exports are likely to remain weak which will also impact industrial production. Interestingly, India's manufacturing PMI eased from 57.8 in Dec'22 to 55.4 in Jan'23 as growth in new export orders eased to a 10-month low. This suggests some pressure on IIP growth going forward. Further, re-opening in China has raised the likelihood of a possible resurgence in commodity prices suggesting a further squeeze on profit margins.

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