Economic Developments and Debt Market Outlook

Global Economy

The world is experiencing very high inflation leading to a *"The Cost-of-Living Crisis"*. Geo-political tensions surrounding the Russia-Ukraine War have impacted energy supplies and prices thereby elevating commodity inflation. Russia's invasion of Ukraine has led to a severe energy crisis in Europe that is sharply increasing the costs of living and hampering economic activity. Gas prices in Europe have increased more than four-fold since 2021, with Russia cutting deliveries to less than 20 percent of their 2021 levels, raising the prospect of energy shortages over the next winter in Europe and beyond.

More broadly, the war has also pushed up food prices on world markets, causing serious hardship for low-income households worldwide, and especially so in low-income countries. Persistent and broadening inflation pressures have triggered global central banks to sharply hike interest rates. The US Federal Reserve has increased its interest rates by 375 bps or 3.75%, since March 2022. This has led to a powerful appreciation of the US dollar against most other currencies.

Other major central banks including India have also hiked their interest rate sharply to fight Inflation and moderate growth going forward

Why Central Bank hikes interest rates?

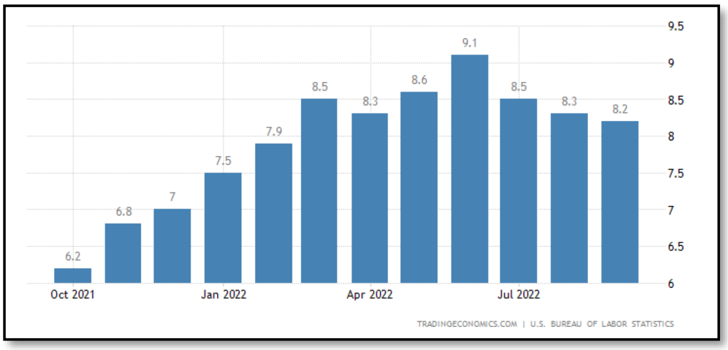
Higher interest rates would reduce demand for goods as the consumer and corporates would borrow less as loan/interest rates would be higher. Consumers would tend to spend less on his/her house, vehicle, durables purchase, or other consumption. This would slowly reduce overall demand in the economy and demand for general goods and services which in-turn would reduce the prices of such goods. Contractionary monetary policy would reduce the money supply within an economy via increase in interest rates. Due to this phenomenon, general prices tend to reduce and thereby reduce inflation in the economy.

As major central banks including India are hiking interest rates, IMF expects global inflation to peak in late 2022 but to remain elevated for longer than previously expected, decreasing to 4.1 percent by 2024.

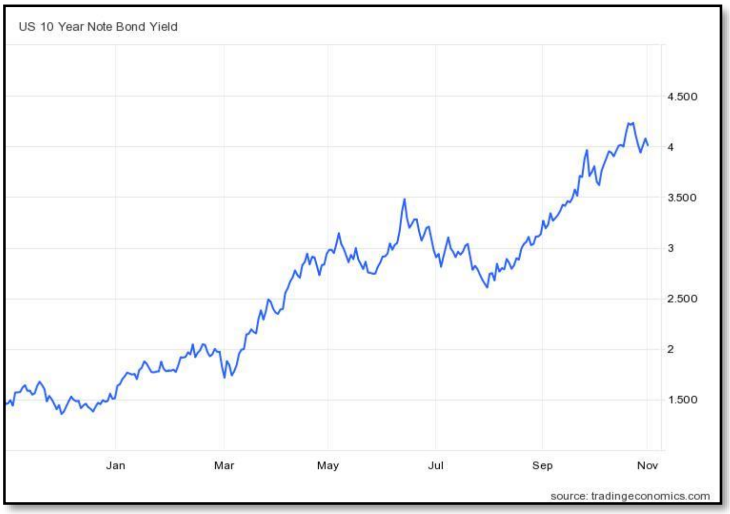
Three largest economies - the United States, the European Union, and China - will continue to stall in the near future. In short, the worst is yet to come, and for many people in the world, 2023 will feel like a recession.

The external environment is already very challenging for many emerging markets and developing economies including India. The sharp appreciation of the US dollar adds significantly to domestic price pressures and to the cost-of-living crisis for these countries. The 2022 shocks will re-open economic wounds that were only partially healed following the pandemic.

US Inflation (CPI in %)



Recent US inflation print was at 8.2% which used to hover below 2% before covid.



As inflation tends higher, bond yields also shoot up expecting the central Bank to hike rates.

US 10 year Government treasury note has crossed 4% market in October from around 1.5% seen in January this year. (refer chart in LHS)

Global growth is forecast to slow from 6.0 percent in 2021 to 3.2 percent in 2022 and 2.7 percent in 2023. This is the weakest growth profile since 2001 except for the global financial crisis and the acute phase of the COVID-19 pandemic and reflects significant a slowdown for the largest economies: a US GDP contraction in the first half of 2022, a euro area contraction in the second half of 2022, and prolonged COVID-19 outbreaks and lockdowns in China with a growing property sector crisis.

Global inflation is forecast to rise from 4.7 percent in 2021 to 8.8 percent in 2022 but to decline to 6.5 percent in 2023 and to 4.1 percent by 2024.

IMF - World Economic Outlook Projections							
GDP Growth	**2021**	**2022**	**2023**	**Inflation**	**2021**	**2022**	**2023**
World Output	6.0%	3.2%	2.7%	World	4.7%	8.8%	6.5%
United States (US)	5.7%	1.6%	1.0%	United States (US)	4.7%	7.9%	3.8%
Euro Area	5.2%	3.1%	0.5%	Euro Area	2.6%	8.3%	5.7%
China	8.1%	3.2%	4.4%	China	0.9%	2.2%	2.2%
India (Financial year)	8.7%	6.8%	6.1%	India (Financial year)	5.5%	6.9%	5.1%

For many emerging markets, the strength of the dollar is causing acute challenges, tightening financial conditions, and increasing the cost of imported goods. The dollar is now at its highest level since the early 2000s. So far, this appreciation appears mostly driven by fundamental forces, such as the tightening of monetary policy in the United States and the energy crisis. The appropriate response in most countries is to calibrate monetary policy to maintain price stability, while letting exchange rates adjust, conserving valuable foreign exchange reserves.

As the global economy is headed for stormy waters, financial turmoil may well erupt, prompting investors to seek the protection of safe-haven investments, such as US Treasuries, and pushing the dollar even higher. Now is the time for emerging market policymakers to prepare for a crisis.

Indian Economy

Indian growth data suggest softening of growth momentum. Q1 FY23 GDP data disappointed and the print came in at 13.5% YoY, below consensus. Growth estimates are being steadily downgraded. The worsening global environment has added another downside risk to growth through trade, confidence, commodity prices and capital inflows. Exports, which had been a bright spot for much of the last few quarters had turned negative. Hawkish RBI will also negatively impact growth.

Inflation

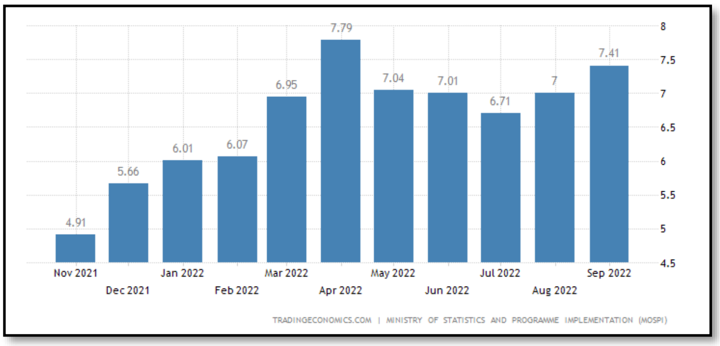
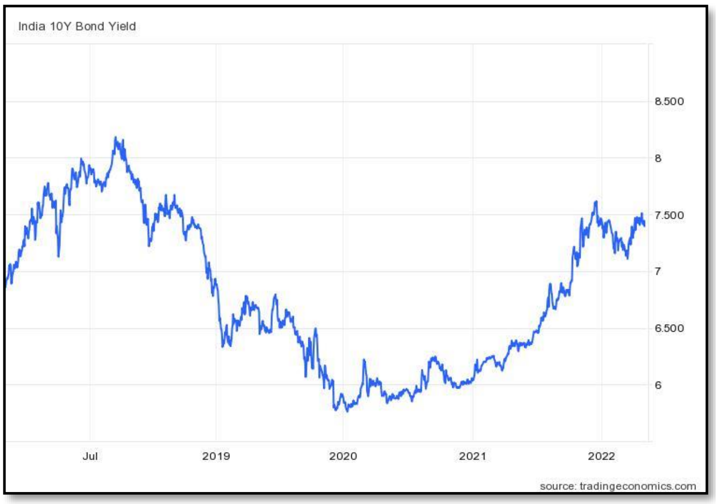
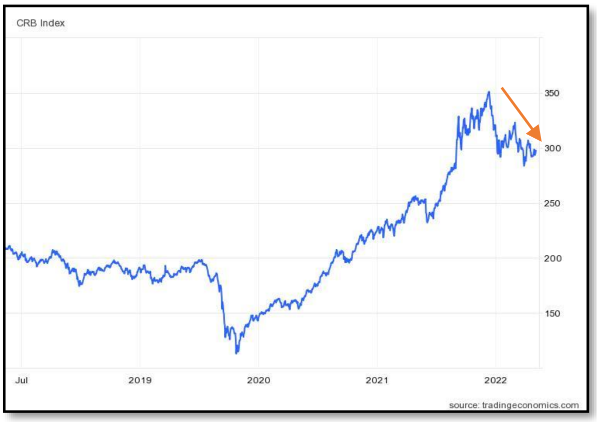


Figure in LHS (CPI in %)

CPI remained at inflated levels and posted 7.41% for the month of September (up from 7.0% in August). Food and core CPI were the major cause of the uptick.



10-year Government securities yield has been trading in the 7.10%-7.60% range since June 2022. The yields rose from around 6% levels in May 2021 to 7.61% in June 2022. 10-year G-sec was trading at 7.40% as on 02-Nov-2022.



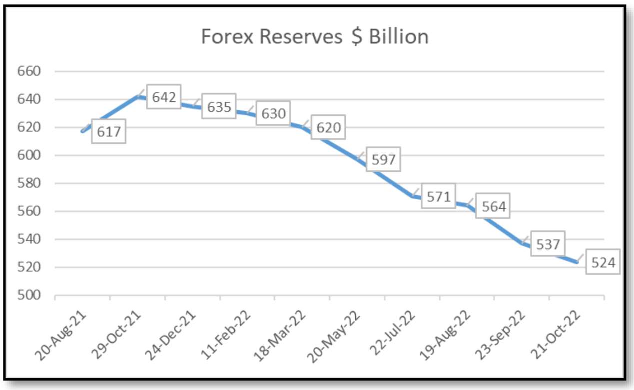
CRB Index (fig. in LHS) is an index consisting of all commodities suggests that commodity prices, have softened recently and recession risks in advanced economies (AEs) are rising. On the domestic front, the late recovery in sowing augurs well for kharif output. The prospects for the rabi crop are buffered by comfortable reservoir levels. The risk of crop damage from excessive/unseasonal rains, however, remains. These factors have implications for the food price outlook. Elevated imported inflation pressures remain an upside risk for the future trajectory of inflation, amplified by the continuing appreciation of the US dollar. The outlook for crude oil prices is highly uncertain and depends on geopolitical developments.

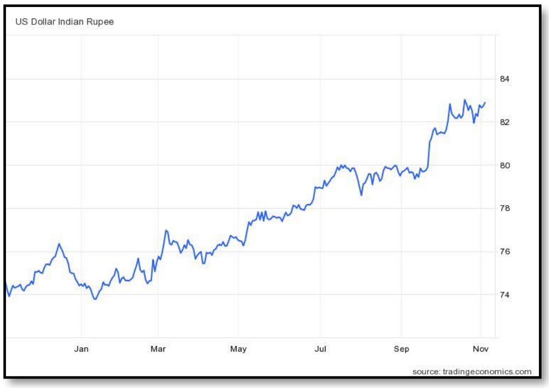
RBI in its latest policy has assumed an average crude oil price (Indian basket) of US$ 100 per barrel, inflation is projected at 6.7 percent in 2022-23, with risks are evenly balanced. CPI inflation for Q1:2023-24 is projected at 5.0 percent which gives some comfort for bond investors.

GDP Growth

According to the RBI's surveys, the consumer outlook remains stable and firms in manufacturing, services and infrastructure sectors are optimistic about demand conditions and sales prospects. On the other hand, headwinds from geopolitical tensions, tightening global financial conditions and the slowing external demand pose downside risks to net exports and hence to India's GDP outlook. Taking all these factors into consideration, real GDP growth for 2022-23 is projected at 7.0 percent with risks broadly balanced.

Outlook





India's forex reserves down $118 billion from $642 billion peak in November 2021, while the absolute amount of reserves still remain comfortable. INR is under pressure since the beginning of this year, bulk of the depreciation can be attributed to the strength in US dollar. INR which traded at ₹74 at the beginning of the year was trading above ₹82 in October.

As per IMF projections, the current account deficit (CAD) which was at 1.2% of GDP in FY2022 would deteriorate to 3.5% in FY2023 and would continue to be at an uncomfortable level of 2.9% even in FY24. Elevated commodity prices especially Crude Oil prices have been to be blamed for this deterioration. This continued stress on our current account balance would definitely pressurise INR and India's Balance of Payments. India being a huge net importer is dependent on FDI/FPI flows. If capital flows dry up to some extent, India's currency reserves may continue its south-ward march going forward.

The outlook is fraught with considerable uncertainty, given the volatile geopolitical situation, global financial market volatility and supply disruptions. Meanwhile, domestic economic activity is holding up well and is expected to be buoyant in H2 FY23, supported by festive season demand amidst consumer and business optimism. RBI is of the view that further calibrated rate hikes are warranted to keep inflation expectations anchored. Keeping all these in mind, RBI raised the Repo rate by 50 basis points to 5.90% in its September Policy. RBI would remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.

Fiscal deficit (FD) was set at 6.4% of GDP for FY23 and given the tax buoyancy seen in GST and Direct tax collections markets do not anticipate any uncertainty at-least in this front.

Given this backdrop, I believe that the 10-year benchmark Government security (G-Sec) yield is nearing its peak in the next 2-4 months. Indian bond markets would take cues from rising US yields and its spread differential, INR volatility, fiscal deficit and prevailing geo-political tensions. Investors are advised to gradually add duration assets or long term G-sec / State Government Securities (SGS/SDL) in the next 2-4 months. As the global economy is entering into a slow or anaemic growth going forward, India GDP would also slow down as we are integrated with the global markets. Very soon, major central banks including India would shift focus towards growth once inflation comes under control. However, rising US bond yields, the Russia-Ukraine war and its impact on commodity prices, and India's trade imbalances could pose as significant risk factors to bond investors going forward.

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