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Macro Review & Fixed Income Market Outlook

Global Economy Update:

Macro Backdrop:

- As 2023 has come to an end and a new year begins, the long-awaited normality still eludes the global economy.
- The years 2020 to 2023 will perhaps go down in history as the period of 'Great Volatility', comprising a host of black swan events in quick succession.
- The global economy is showing signs of slowdown, though unevenly across geographies and sectors.
- The Emerging Market Economies (EMEs) as a group have remained resilient during the current bout of volatility, unlike previous episodes.
- While headline inflation has receded from the highs of last year, it remains above target in many countries.
- Core inflation continues to be sticky, impeding the last mile of disinflation.
- Major central banks have kept rates on hold while refraining from forward guidance in view of the prevailing uncertainties.
- Financial markets remain volatile in their quest for definitive signals about the future path of interest rates.

Indian Economic Growth:

Macro Backdrop:

- Against this unsettled global economic backdrop, the Indian economy presents a picture of resilience and momentum.
- The real gross domestic product (GDP) growth for Q2 of the current financial year has exceeded all forecasts.
- The fundamentals of the Indian economy remain strong with banks and corporates showing healthier balance sheets; fiscal consolidation on course; external balance remaining eminently manageable; and forex reserves providing cushion against external shocks.
- These factors, combined with consumer and business optimism, create congenial conditions for sustained growth of the Indian economy.
- India is currently experiencing robust macro-economic conditions, with growth surpassing expectations.
- Although headline inflation has shown volatility, it is primarily attributed to weather-induced fluctuations in food prices, while core measures of inflation remain very well behaved.
- Despite a slow initial phase, tax revenue growth has significantly rebounded, mitigating any potential risk of fiscal slippage amid increased spending pressures from subsidies and welfare programs.
- Notably, India's current account dynamics have strengthened, marked by an upward trend in the monthly services trade surplus over the recent quarters.
- India's goods and services tax (GST) collections was at Rs 1.65 lakh crore in December '23.

Inflation:

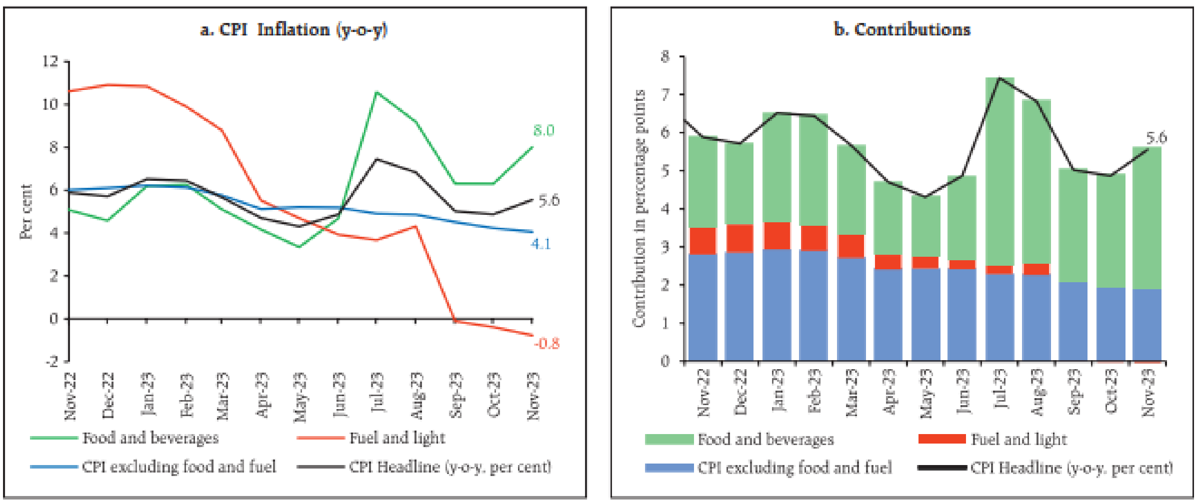
Global:

- Headline inflation has been on a downward trajectory, even though it is still above the target in most AEs.
- CPI inflation in the US also declined to 3.1 per cent in November from 3.2 per cent in October.
- As per the flash estimates, euro area inflation fell to 2.4 per cent in November from 2.9 per cent in October, reaching its lowest level since July 2021.
- Annual inflation rate in the UK slowed to 3.9% in November 2023, the lowest since September 2021, from 4.6% in October and well below forecasts of 4.4%.
- Among EMEs, inflation moderated in South Africa and Brazil in November.
- Inflation in Russia accelerated for the seventh month in a row, reaching 7.5 per cent in November.
- China recorded deflation of 0.5 per cent in November.
- Core inflation has also moderated in AEs, albeit at a much slower pace than the headline.

India:

- CPI inflation increased to 5.6 per cent in November 2023 from 4.9 per cent in October.
- Food inflation (y-o-y) registered an increase of 1.7 percentage points, rising to 8.0 per cent in November from 6.3 per cent during September-October.
- In terms of sub-groups, inflation in vegetables picked up sharply due to a steep rise in onion and tomato prices.
- Inflation in pulses, fruits, sugar, and non-alcoholic beverages also registered an increase while it moderated in respect of cereals, meat and fish, eggs, milk, spices, and prepared meals.
- Core inflation moderated to 4.1 per cent in November from 4.2 per cent in October, softening across sub-groups such as clothing and footwear, housing, household goods and services, recreation, and amusement, pan tobacco and intoxicants, and education.
- In terms of regional distribution, rural inflation stood at 5.85 per cent, higher than urban inflation at 5.26 per cent in November 2023.
- Majority of the states recorded inflation less than 6 per cent.

Trends and Drivers of CPI Inflation:



Sources: National Statistical Office (NSO); and RBI staff estimates.

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Bond Yields & Spreads:

- Indian Yield curve has remain well behaved since start of 2023.
- Apart from correction in short term rates, to be expected on rate hikes and tightening liquidity conditions through the year, longer term rates traded in a narrow range on back of strong local demand in government bonds and moderating inflation conditions.
- RBI MPC remaining in pause mode in FY24 further added to positive sentiment in bonds.
- 10Y yield had fallen to below 7% in May 2023 on back of soft global cues, but rebounded on changing global narratives and has been trading broadly in a range of 7.10%-7.40%.

Outlook:

- Market dynamics are likely to be influenced by short-term factors such as oil prices, U.S. yields, and a positive bond sentiment emanating from anticipated US FED rate cuts.
- In the short term, the impact on markets is expected to be more sentimental, given that the additional flows are anticipated only in FY25.
- FII flows have picked up in the last few months, as active positions get built up leading to the event.
- We expect more active flows from the start of 2024, which may continue to drive yields lower.
- The influx of foreign funds is anticipated to be liquidity-positive, further contributing to the positive sentiment surrounding bonds.
- Looking ahead to the medium and long term, the effect on bonds is expected to be positive due to inclusion in JP Morgan Bond Index, as the demand for Government Securities (G-Sec) is likely to drive yields downward.
- Inflation is likely to trend lower in 1QFY25.
- Coupled with anticipated rate moves from the US FED, RBI may change to neutral stance in 1QFY25.
- However, no sharp rate cuts are expected from RBI MPC, as inflation continues to remain above target of 4% and growth remains robust.
- We may expect about 50bps rate cut from RBI in FY2025.
- We anticipate that over the next few months, 10-year yields may gradually decrease to 7%.
- Any exuberance in Indian debt markets may be tempered by RBI's continuing hawkish stance and tight liquidity conditions.

Source: RBI, MOSPI, PIB, CMIE, FIMMDA, NSDL, Bloomberg, Internal Research.