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Expect domestic recovery to remain uneven

A shift in preferences in consumption of services will likely constrain growth in goods for most of the year

WITH A 50BPS repo rate hike in the August 2022 policy review, the Monetary Policy Committee (MPC) took the policy rate to levels last seen in August-September 2019. It maintained its stance, and left the CPI inflation and GDP growth projections for FY23 unchanged from the June 2022 policy review. The focus on anchoring inflationary expectations, emphasis on getting inflation closer to the target of 4%, and the acceptance that it will exceed 6% for three consecutive quarters, appear to have driven MPC to front-load another rate hike of 50 bps, exceeding our projection of 35 bps. Separately, the Governor described an increase of 50 bps as the new normal. The MPC acknowledged that inflation has flattened and the supply outlook is improving, aided by easing of global supply constraints. Regardless, it underscored that inflation is projected to remain above the upper tolerance level of 6% through the first three quarters FY23, with the attendant risks of inflation expectations becoming unanchored, which could trigger second round effects. While it maintained its inflation projections for full-year FY23 at 6.7%, the MPC cut the Q2 estimates, while surprisingly raising the Q3 projection. We forecast inflation to undershoot the MPC's Q2 and Q3 FY23 projections modestly, with expectations of the first monthly sub-6% inflation print in Q3 itself, resulting in our full year CPI inflation projection of 6.5%. Given the elevated inflation levels in the recent months and resilient domestic economic activity, the MPC averred that further calibrated action is warranted to contain inflationary pressures, dampen headline inflation within the tolerance band and, importantly, closer to the 4% target, and keep inflation expectations anchored to ensure the growth momentum is sustained.

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On the outlook for growth, the MPC highlighted risks emanating from global factors, including geopolitical tensions, alongside expectations of an improvement in domestic factors such as the recovery in contact intensive services. It maintained its FY23 growth forecast at 7.2%, in line with our expectations. While we broadly concur with the assessment, we expect the domestic economic recovery to remain uneven. A shift in preferences towards the consumption of services will likely constrain the growth in goods, particularly durables, for the majority of the year. A moderation in external demand is likely to weigh on the output of goods, limiting the improvement in capacity utilisation levels hereafter, after the surge seen in H2 FY22. Nevertheless, commodity prices have moderated since mid-June 2022 and a sustenance of this trend could augur well for corporate margins and GVA growth during Q2-Q4 FY23. We're less optimistic on agricultural growth, given the uneven monsoon and lagging paddy sowing. Given the MPC's focus on anchoring inflation expectations and the RBI Governor's statement, we expect another rate hike of ~10-35 bps in the September meeting, albeit lower than the newly coined 'new normal' of 50 bps. After that, the MPC is likely to turn extremely data-dependent. Our analysis suggests that a sustenance of the correction in global commodity prices could lead to inflation readings being lower than what the MPC has projected for the rest of 2022. As of now, we suspect this would avert the need for rate hikes beyond the September 2022 meeting.

After the policy announcement, the 10-year G-sec yield rose from its temporary low of 7.15% to as much as 7.3% intraday. Interestingly, when the repo rate was last at 5.4% in August-September 2019, the 10-year G-sec yield was considerably lower at 6.4-6.8%, benefiting from benign crude oil prices in the range of $60-65/barrel. We aren't convinced that the prevailing price of $95/barrel will sustain given geopolitical uncertainties. Presuming our forecast range of $100-120/barrel, we expect the 10-year G-sec yield to move between 7.2-7.7% in 2022, in spite of our assessment of limited fiscal stress at the central government level.