

Economics

RBI: Rate cut outlook obscured

Key takeaways: Repricing of US inflation risks to the upside and growing uncertainties over Fed's policy course have firmed up the USD and UST, adding challenges to the entire EM space, including India. Incrementally, recent geopolitical developments and positive macro-economic data from China have led to firming up of commodity prices. On the domestic front, healthy growth outlook and risks of sticky food inflation due to inclement weather conditions remain key risks. In this backdrop, we expect the MPC to hold policy repo rate through CY25 – expect first rate cut only by Q4FY25 versus prior expectation of Q3FY25.

Fed policy course, the key unknown in CY24/FY25

The recent upturn in US inflation risks led by seasonal and lagged components led to the markets repricing rate cut expectation to 1-2 cuts versus 6-7 in the start of CY24. We feel the Fed's reaction function warrants a 'wait and watch' approach. While the potential of inflation going down to 2% does not exist, a near about 2.6% inflation (core PCE), 4% unemployment rate and <2% growth can lead Fed to cut by at least 50bps this CY24E, starting in Q3CY24. Falling labor demand (job openings-to-unemployed ratio at 1.35x versus 2x at peak) and wage growth (4.7% in Mar-24 versus 6.7% peak) supplement this view. For now, we assign more probability to rate cuts than hold by the Fed in CY24 – stronger-than-expected labor market and re-emergence of supply shocks are the key risks that can move the probability higher for a hold in CY24 than cuts.

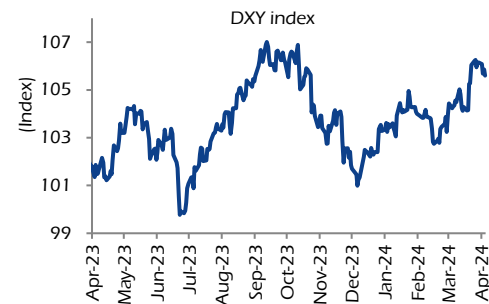
The uncertain policy course of the Fed with ECB's guidance to start rate cuts in Jun-24 is firming up the US Dollar. Geopolitical developments and safe haven demand are further aiding USD's upside. In this scenario of firmer USD and rising US rates, if the Fed starts to cut in Q3CY24, the RBI is likely to get the policy space to start its cutting cycle too. If Fed holds for CY24, USD and US rates may see more upside, which can prompt the MPC to hold too. The RBI is likely to lean towards a real policy rate at 1.5-2% with growth staying robust.

Commodity price rise transitory but needs monitoring

The recent, 'above consensus' growth from China and potential of greater stimulus have injected greater optimism as regards the Chinese economy. However, the question remains as to how broad-based the growth is, as consumer sentiment remains weak with the real estate sector on the ebb. Chinese growth coincided with geopolitical events in the Middle East, leading to a further upside in commodity prices, with CRB Index rising 3.4% MoM and Brent crude up 3.7% MoM.

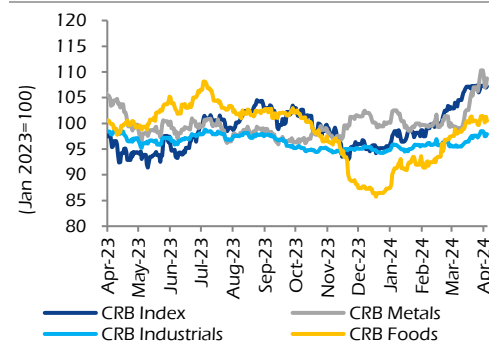
We see geopolitical events as transitory unless Israel and Iran (OPEC member) embark on retaliatory actions. Also, the upside impact on industrial metals (2.2% MoM) should be carefully monitored although the possibility of this price rise getting passed on to India's CPI is muted given the composition of CPI basket and limited possibility of a hike in pump prices in the election season. We are more concerned with continued stickiness in shipping costs, which trebled in end Jan-24 compared with end Sep-23 (start of Israel-Hamas conflict spilling over to Red Sea tensions) and has declined only ~30% since the peak in Jan-24.

US dollar on an uptrend



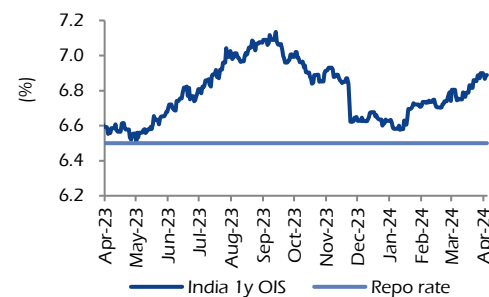
Note: Data till 25 April 2024; Source: CEIC, Elara Securities Research

Metals prices on the rise



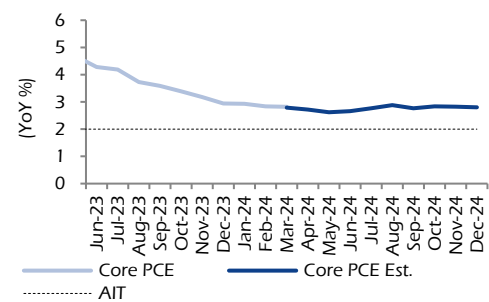
Note: Data till 25 April 2024; Source: Bloomberg, Elara Securities Research

Swap markets pricing in a 25bps rate hike from RBI in next 12 months



Note: Data till 25 April 2024; Source: Bloomberg, Elara Securities Research

US inflation: Projected path through CY24E



Source: CEIC, Elara Securities Estimate

Domestic factors – growth robust, sticky food inflation to keep RBI's hands tied

With India's GDP growth projected at a robust 7% for FY25E, the RBI has enough policy room to hold rates at 6.5%. India's credit growth grew at a robust 16% YoY in FY24, even when weighted average lending rate remained elevated at 9.6-9.81% (Apr-Feb FY24) suggesting that the elevated repo rates are yet to hamper risk sentiments in the system. High frequency indicators such as PMIs, GST collections, rail freight and domestic passenger growth remain encouraging compared with the historical standards. As such, risks associated with growth remain at bay.

On the food inflation front, we expect rising temperatures across the Indian peninsula to keep food inflation sticky. While forecast of normal monsoons is likely to keep the RBI in comfort zone, the spatial inter-temporal distribution of monsoon has been a risk. CYTD, we already have seen 68.5% of the days with above normal rainfall in Jan-24 to Apr till date.

As such, in H1FY25, RBI MPC may stay focused on global developments than domestic factors unless any adverse growth shocks emerge (the possibility of which is low at present).

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