Global Economic Outlook

- **Euro zone factory activity declined again in Sept as inflation zooms:** Euro zone inflation zoomed past forecasts to hit 10.0% in September, a new record high that will reinforce expectations for another jumbo interest rate hike next month from the European Central Bank.
- Price growth in the 19 countries sharing the euro accelerated from August’s 9.1%, data from Eurostat showed on 30 Sep 2022, beating expectations for a reading of 9.7%, with some euro zone members experiencing the fastest price growth since the time of the Korean War 70 years ago.
- Manufacturing activity across the Euro zone declined further last month as a growing cost of living crisis kept consumers wary while soaring energy bills limited production.
- S&P Global’s final Manufacturing Purchasing Managers’ Index (PMI) fell to a 27-month low of 48.4 in September from August’s 49.6, just below a preliminary reading of 48.5 and further below the 50 mark separating growth from contraction.
- **Italy's economy to shrink for 3 straight quarters:** Italy’s economy probably shrank in the third quarter and will continue to contract for the following two quarters, according to the latest Treasury forecasts.
- The forecasts indicate the euro zone's third largest economy, hit by soaring energy costs and record high inflation, is heading for a technical recession, defined by economists as two consecutive quarters of declining gross domestic product.
- **UK manufacturing PMI shows falling output, weak foreign demand:** British manufacturing output fell for a third month in a row in September and orders declined for a fourth consecutive month, hurt by falling foreign demand.
- The S&P Global Manufacturing Purchasing Managers’ Index (PMI) rose to 48.4 from August’s 27-month low of 47.3 but remained below the 50-level that separates growth from contraction and was a fraction weaker than the initial ‘flash’ estimate of 48.5.
- **US Bond market witnesses’ massive outflows:** U.S. bond funds witnessed massive outflows in the week to Sept. 28 as investors girded for further rates hikes from the Federal Reserve to control stubborn inflation. Investors withdrew a net $9.08 billion out of U.S. bond funds, marking their biggest weekly net selling since June 22, Refinitiv Lipper data showed.
- **Asia’s factory activity weakens on global slowdown, cost pressures:** Asia’s factory output mostly weakened in September as slowing demand in China and advanced economies added to the pain from persistent cost pressures, clouding the region’s economic recovery prospects.
- Manufacturing activity shrank in Taiwan and Malaysia, and grew at a slower pace in September compared with August in Japan and Vietnam, as rising raw material costs and the darkening global outlook weighed on corporate sentiment.

Domestic Outlook

- **RBI hikes policy repo rate:** The Reserve Bank of India (RBI) hiked policy repo rate by 50 basis points (bps) to 5.9 per cent, today. The standing deposit facility (SDF) now stands at 5.65 per cent and the marginal standing facility (MSF) is at 6.15 per cent. This is the fourth instance of a hike in repo rate by the RBI. In all, the RBI has hiked rates by 190 basis points since the beginning of the current fiscal year. Policy repo rate went up from 4 per cent at end-March to 5.9 per cent after today’s hike. It is now at a more than 3-year high. RBI has also decided to continue with withdrawal of accommodation.
- **Manufacturing growth slows down:** India’s factory growth dipped to a three-month low in September due to a moderation in demand and output, despite easing inflationary pressures and strong business confidence, a private survey showed.
- The output of eight core infrastructure sectors grew just 3.3 per cent in August, the slowest pace in nine months and compared with 4.5 per cent in the previous month, partly because the base effect turned unfavourable. They had grown 12.2 per cent in August last year. The slowdown will weigh on the index of industrial production given that these core sectors account for 40.3 per cent of the index of industrial production.
- The Manufacturing Purchasing Managers’ Index, compiled by S&P Global, fell to 55.1 in September from 56.2 in August, below the 55.8 predicted by economists in a Reuters poll. The pace of growth was still solid, however, and was above the 50-mark separating growth from contraction for a 15th straight month.
- **Growth Projections revised downwards:** The Reserve Bank of India (RBI) has lowered its projection for India’s real GDP growth in 2022-23 to 7 per cent from 7.2 per cent projected earlier in the beginning of August 2022. The downward revision has come as the first quarter GDP growth, at 13.5 per cent, turned out to be lower than the RBI’s projection of 16.2 per cent. The RBI has actually revised its GDP growth forecast for the remaining three quarters of the year upwards. It now pegs the second quarter GDP growth at 6.3 per cent as compared to 6.2 per cent earlier. The growth projection for the third and the fourth quarter has been scaled up to 4.6 per cent from 4.1 per cent and 4 per cent, respectively.
RBI’s CPI projections remain unchanged: RBI has kept its projection for consumer price inflation in 2022-23 unchanged at 6.7 per cent. The apex bank expects the second quarter inflation to come in at 7.1 per cent. It expects inflation to ease to 6.5 per cent in the third quarter, which is still way above the upper limit of its tolerance band of 2-6 per cent. The RBI has projected inflation to fall to 5.8 per cent in the fourth quarter and further down to five per cent in the first quarter of 2023-24.

Inflation expected to remain elevated: Households’ median inflation perception increased to 10.2 per cent in September 2022 from 9.3 per cent in July 2022, as per the RBI Inflation Expectations Survey of Households (IESH). Inflation expectations for three months ahead rose by 50 basis points to 10.8 per cent and that for one year ahead also increased by the same magnitude to 11 per cent in September 2022 as compared to July 2022. Households believed that future inflation would be higher than the prevailing inflation levels.

Interest Rate Outlook

US Federal Reserve Retains hawkish stance: The US Federal Reserve hiked benchmark short-term rate by 75 bps on September 21. The Fed chairman also signalled more rate hikes to contain inflation. Currently, the US short term benchmark rate is at 3-3.25 per cent. The Fed forecast that it would hike benchmark rate to around 4.4 per cent by end-2022. This was 100 bps higher than the forecast made in June. The Fed expects to hike rate further to 4.6 per cent in 2023. However, analysts expect that the US benchmark rate would have to go up to around 5-5.25 per cent to bring down soaring inflation.

Bond Yield Inversion being witnessed in the US: Yields on short-term bonds in the US are now higher than those on long-term bonds, which is most often the case in normal economic conditions. The yield on the two-year US government bond is now 4.21 per cent while the 10-year US government bond yields 3.80 per cent. (For further reading refer to our DTalks)

Euro zone yields continue to rise on inflation angst: The European Central Bank hiked policy rate by 75 bps. It expects the hikes to continue in order to bring down inflation. However, Euro zone government bond yields edged higher, with gilts out of the spotlight, as inflation concerns kept providing some upward pressure on forecasts for monetary tightening.

Hikes in Advanced Economies put pressure on domestic currency and interest rates: The hikes in interest rates in the developed world puts pressure on the RBI to raise rates correspondingly to avoid the possibility of an increase in capital out-flows.

The impact of the hike in US benchmark rate on FII flows in India was immediately evident. After the US Fed rate hike, there were net FII outflows of USD 1.9 billion. This has exerted pressure on the rupee. By September 29, it plunged further to Rs.81.86 per US dollar. The rapid depreciation of the Indian rupee against the USD is expected to lead to imported inflation. It also has repercussions for trade deficit and current account balance.

Narrowing bond yields signal liquidity squeeze in the markets: Financial markets are signalling the liquidity tightening and a slowdown in the economy, as shown by a sharp rise in yields on short-term bonds, resulting in the spread between those and the rates on long-term bonds narrowing.

Banks look towards refinance avenues: Banks are reportedly looking to tap the National Housing Bank (NHB), Small Industries Development Bank of India (SIDBI) and National Bank for Agriculture and Rural Development (NABARD) for refinancing. As RBI looks to drain away liquidity in the banking system in its bid to control inflation leading banks tend to raise funds via certificates of deposit (CD) to tide over funds crunch. In the case of CDs, banks have to set aside 4 per cent as cash reserve ratio and invest 18.4 per cent in government securities. However, if banks raise funds from the aforementioned finance institutions, there is no requirement to do so.

Spreads can converge further: Bond yields in India are following developments in the United States, where the yield curve is inverted three-month in a row.

We expect short term yields to remain elevated as RBI is expected to continue with its stance of withdrawal of accommodation and bond markets are expected to follow global cues.

Yields on bonds maturing in under five years are likely to flatten closer to the 10-year yield as the panel moves closer to pausing rate hikes, according to analysts.

While in the current scenario, we do not expect spreads to come flat versus the 10-year as liquidity will remain in neutral to marginal deficit zone, spreads could converge further.

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<th>Weekly Benchmark Bond Yield Movement (%)</th>
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<tbody>
<tr>
<td>Date</td>
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<tr>
<td>USA 10 years</td>
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<td>India 10 years</td>
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<td>India 3 months</td>
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Source: CMIE, worldgovernmentbonds.com

The yield on the government benchmark 10-year bond for the period (03-07 October 2022) is expected to be in the range 7.40% to 7.50%.