Macro Outlook 2024

EXPLORING THE BIG PICTURE

CONTENTS

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2024: A Year Brimming with Possibilities and Promise

2023 unfolded as an extraordinary year. At the outset, most experts anticipated a global recession as central banks synchronously tightened monetary policy. However, it concluded as a remarkable year, with growth surpassing expectations and global equities reaching all-time highs.

2024 has commenced on a highly positive note with the prospect of a 'soft landing' and the anticipation of interest rate cuts. The advance estimate for India's GDP growth in FY24 is 7.3% YoY, significantly surpassing the consensus estimates of 6.5% YoY from just a few months ago. This adds an extra layer of positivity.

2024 is a year of significant developments for the Indian economy and markets. Fueled by strong economic momentum, the inclusion of Indian government securities in global bond indices, and the expectations of monetary policy easing by the RBI, the year holds considerable promise.

In 2024, we foresee the private sector taking the lead in capital expenditure while government spending decelerates to adhere to the fiscal deficit glide path. Additionally, we expect a recovery in the rural sector, assuming a healthy rabi output and a normal monsoon season. The decline in inflation and the steady improvement in consumer confidence are expected to result in a rebound in consumer spending in 2024.

Furthermore, export-oriented sectors may experience a turnaround as the risk of a global recession diminishes and business confidence improves. FII inflows are anticipated to remain robust in 2024, with equity flows driven by robust economic growth and debt flows influenced by India's index inclusion.

However, the volatility observed in 2023 might extend into 2024. Anticipated changes in the timing and scale of rate cuts by Central Banks can potentially increase financial market volatility. Additionally, there is the looming risk of an escalation in geo-political conflicts. There are also presidential or legislative elections scheduled across the world in which nearly half the global population is expected to participate.

India is also scheduled to conduct general elections this year. The broader expectation is for policy continuity and further progress in various reform initiatives.

Regardless of the developments in 2024, India continues to represent a long-term structural growth opportunity. It is poised to maintain its position as the world's fastest-growing major economy in the foreseeable future.

Structural factors, including an aspirational middle class, favourable demographics, rapid digitalisation, and various economic reforms, contribute to this outlook. All of these factors make India a highly attractive long-term proposition.

We look forward to 2024 as a year full of opportunities and promises, marking a significant chapter in India's ongoing growth narrative.

Warm regards,

Anup Maheshwari
Co-Founder & CIO, 360 ONE Asset

Preface

Gazing into the future is a precarious endeavour. The abundance of 'unknown unknowns' implies that any outlook about the economy, rates, inflation, and such at the start of the year might turn out quite different from reality by the end. So, is there a point in putting together an outlook?

Well, yes, because...

"....policy frameworks have to be forward-looking, given the lags in the transmission of policy impulses to the rest of the economy. Forecasts play a central role in these frameworks. They provide a glimpse of the future, based on everything we know today and our best judgement, and perform the role of intermediate variables – they capture a reflection of the goal variables. More often than not these reflections can be hazy, obscured by uncertainties and unknowns and when that happens, it becomes standard operating procedure to denigrate the forecasts. Illustratively, the economist Ezra Solomon once remarked that "The only function of economic forecasting is to make astrology look respectable." Economic forecasting is an inexact science, but its criticism has to be tempered by an understanding of what forecasts actually represent. They are conditioned on the best smell test of all available information at a particular point in time. As new information arrives, judgment has to be recalibrated. As John Maynard Keynes is credited to have remarked: "When the facts change, I change my mind. What do you do, Sir?"

-State of the Economy, RBI Monthly Bulletin, May 2023

This outlook aims to provide readers with our perspective on India macros, relying on our best judgment and considering all available information. We hope that laying out our thought process will assist in educating readers, enabling them to make more informed financial decisions.

The Macro Outlook 2024 explores five crucial questions about the Indian economy that are currently preoccupying investors. However, we adhere to the 'Strong Opinions, Weakly Held' adage. Given the complexity of our world, we remain open to changing our stance based on new data and developments.

We hope this report makes for an enriching read.

Vikram Chhabra,
Senior Economist, 360 ONE Asset

Chapter 1:

Will India's growth momentum sustain in 2024?

Will India's growth momentum sustain in 2024?

The year 2023 commenced with a pessimistic global outlook. Inflation was surging, and central banks were synchronously tightening monetary policy. Cracks in the banking sector were beginning to appear on both sides of the Atlantic. The consensus view anticipated a recession in developed markets. However, reality turned out to be quite different.

Economic activity across most developed markets surpassed expectations. Consequently, the narrative transitioned from a 'hard landing' to a 'soft landing' as inflation prints continued to trend lower with no signs of impending recession. By the end of 2023, the rate hike cycle of most developed market central banks concluded, with attention shifting to the extent and pace of rate cuts in 2024.

India's economic momentum has also proven to be much better than expected. The GDP growth in H1FY24 for India stood at 7.7% YoY (Table 1), significantly surpassing the consensus estimate of 7.2-7.3% YoY. This remarkable growth can be credited to the robust service sector activity and a turnaround in the manufacturing sector.

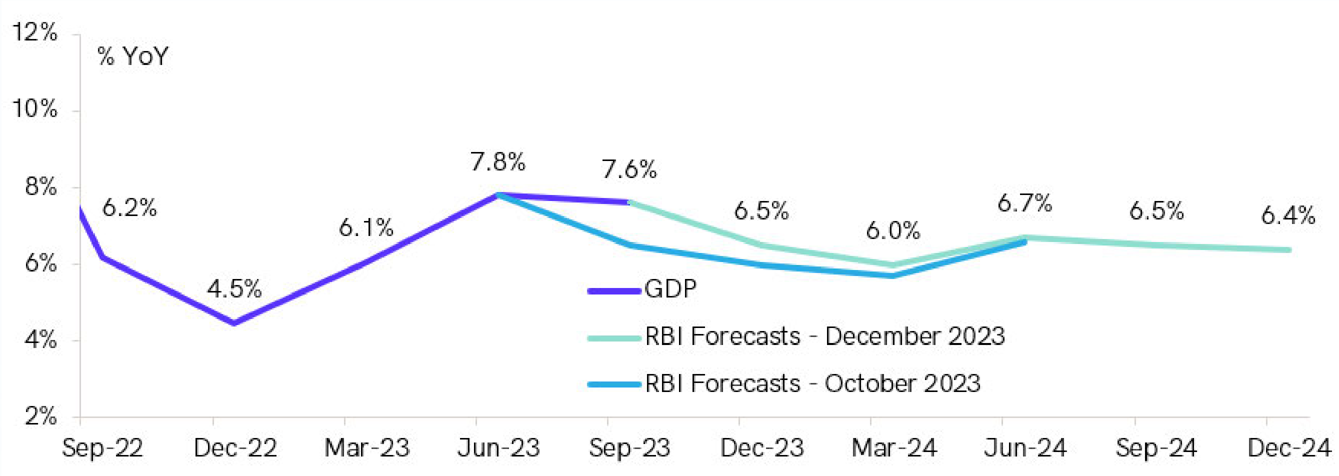
Table 1: India's GDP Growth by Sectors

YoY%	Share	FY23		FY23	FY24
Sector		H1	H2		H1
Agriculture	**15%**	2.4%	5.1%	4.0%	2.4%
Industry	**22%**	2.3%	2.5%	2.4%	8.8%
Mining	2%	5.1%	4.2%	4.6%	7.6%
Manufacturing	18%	0.9%	1.7%	1.3%	9.3%
Electricity	2%	10.3%	7.5%	9.0%	6.4%
Services	**63%**	12.3%	6.9%	9.5%	8.3%
Construction	8%	10.7%	9.5%	10.0%	10.5%
Trade, Hotels, Transport, Communication	19%	20.1%	9.3%	14.0%	6.6%
Financial services, Real estate, Professional Services	22%	7.8%	6.4%	7.1%	9.0%
Public Admin, Defence & Other Services	13%	12.6%	2.6%	7.2%	7.7%
Real GVA	**100%**	**8.6%**	**5.6%**	**7.0%**	**7.6%**
Real GDP		**9.5%**	**5.3%**	**7.2%**	**7.7%**

Source: MOSPI, 360 ONE Asset Research

In the December 2023 policy, the RBI revised the quarterly GDP forecasts upward due to the strong growth momentum (Chart 1). The growth forecast for FY24 was revised upward to 7% YoY from the initial estimate of 6.5% YoY. However, the first advance estimates released in January 2024 peg India's FY24 GDP growth at a robust 7.3% YoY.

Chart 1: RBI's Quarterly GDP Projections in October and December 2023 Policy



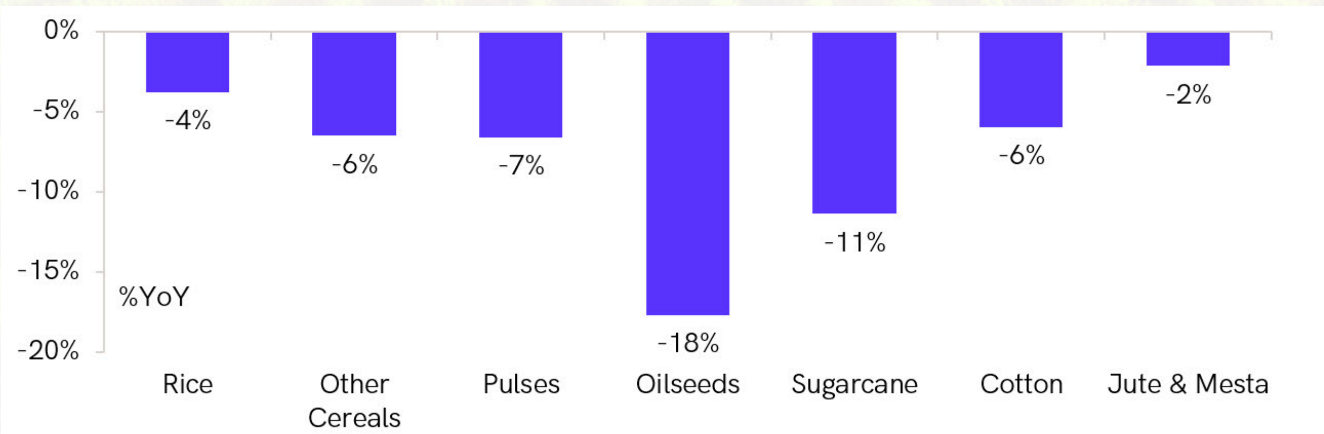
Source: MOSPI, RBI, 360 ONE Asset Research

The services sector demonstrated robust growth of 8.3% YoY in H1FY24, driven by the construction and financial services sectors. Various leading indicators continue to show healthy momentum in H2 as well. Both steel consumption and cement production maintain double-digit growth. Freight/cargo indicators for air, rail, and ports have seen a significant uptick in growth in the December quarter. Credit and deposit growth stay robust at 16% YoY and 13% YoY, respectively, in December 2023.

The manufacturing sector recorded a phenomenal 9.3% YoY growth in H1, owing to a steep improvement in operating profit growth. The decline in raw material costs led to improved operating margins for manufacturing firms.

However, the growth of the agriculture sector disappointed in H1 due to the uneven spatial and temporal distribution of monsoon, impacting kharif production (Chart 2). Consequently, the anticipated recovery in the rural sector remained elusive, and rural consumption was subdued.

Chart 2: Agriculture Production 2023-24: First Advance Estimates (Kharif Season)



Source: CMIE, 360 ONE Asset Research

From the expenditure perspective, investment recorded a strong growth of 9.5% YoY in H1FY24 (in real terms), while consumption growth remained muted (Table 2). The post-pandemic recovery in India has been primarily driven by investment. The government drove the initial surge in capital expenditure, but of late, we are also witnessing a recovery in private capital expenditure.

Table 2: India's GDP Growth by Expenditure

Real Growth YoY%	Share	FY23		FY23	FY24
		H1	H2		H1
Consumption Expenditure	**68%**	**11.3%**	**2.3%**	**6.4%**	**4.6%**
Private Consumption	58%	13.6%	2.5%	7.5%	4.5%
Government Consumption	10%	-0.9%	1.0%	0.1%	5.1%
Gross Capital Formation	**36%**	**12.9%**	**5.7%**	**9.1%**	**8.6%**
Fixed Investments	34%	14.7%	8.5%	11.4%	9.5%
Changes in Stocks	1%	2.2%	3.1%	2.7%	7.7%
Valuables	1%	-8.5%	-32.2%	-18.9%	-8.1%
Exports	**23%**	**15.8%**	**11.5%**	**13.6%**	**-1.7%**
Less Imports	**26%**	**28.0%**	**7.7%**	**17.1%**	**13.5%**
Real GDP	**100%**	**9.5%**	**5.3%**	**7.2%**	**7.7%**

Source: MOSPI, 360 ONE Asset Research

We expect India's growth to be robust in 2024 as well. However, there are three broad trends that we need to watch out for in 2024.

1. Rural sector recovery will hinge on the Rabi output and a normal monsoon

The Rabi crops are sown around mid-November after the monsoon, and harvesting begins in April/May. In the last two years, heatwaves in parts of northern India during February-March have impacted Rabi production, especially wheat. If adverse climatic conditions persist in 2024, Rabi crop yields could again be impacted, affecting agricultural growth and, in turn, the rural recovery.

The ongoing El Niño may also adversely affect the next monsoon season. Our analysis suggests a 69% probability of below-normal or deficit rainfall during an El Niño (Table 3). According to the latest update from the World Meteorological Department, El Niño conditions are expected to last at least until April 2024.

Table 3: Monsoon Probabilities based on El Niño-Southern Oscillation (ENSO) conditions

	El Niño	La Niña	Neutral	Total
Deficient [<90%]	10	0	5	15
Below Normal [90-95%]	1	2	6	9
Normal [96-104%]	3	4	19	26
Above Normal [105-110%]	2	7	5	14
Excess [>110%]	0	5	4	9
Total	16	11	39	73
Prob. of Below Normal or Deficient Monsoon	69%	11%	28%	33%

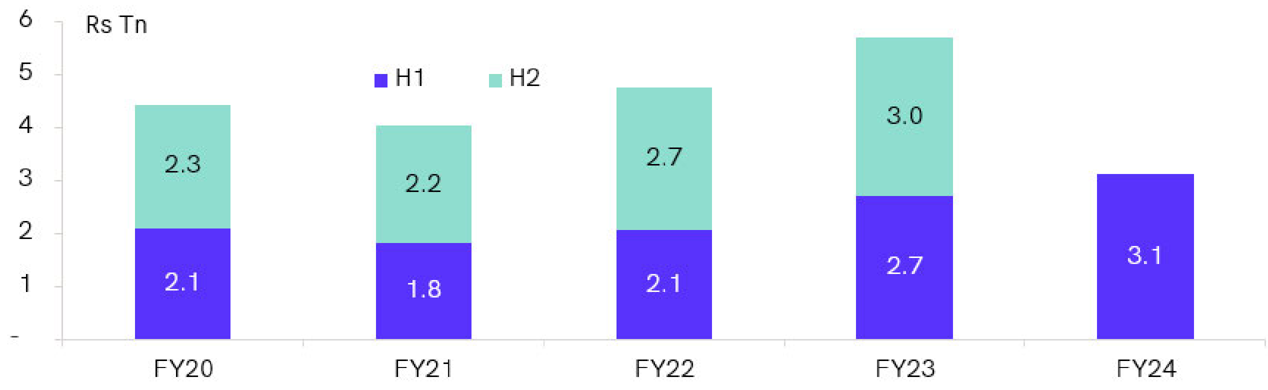
Source: CMIE, IMD, NOAA - US Department of Commerce, 360 ONE Asset Research

2. A strong investment pipeline indicates that capex momentum will sustain

We anticipate the private sector to take the lead in capital expenditure (capex). Government capex is expected to slow down as the government cuts back on expenditure to gradually align the fiscal deficit to 4.5% of GDP by FY26 from 5.9% in FY24.

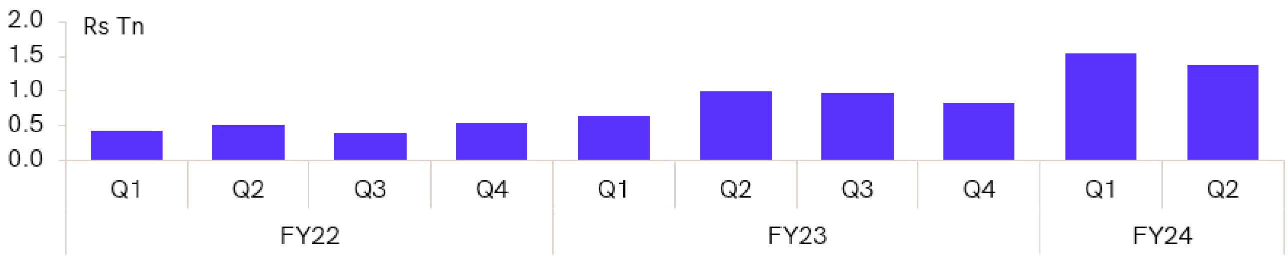
We are already witnessing signs of a revival in private capex. Listed companies have consistently increased capex over the last three years (Chart 3). Private sector investment intentions, as measured by funds raised through multiple channels (banks, ECBs, IPOs), also exhibit a steep improvement in H1FY24 (Chart 4).

Chart 3: Capital Expenditure by Listed Corporates



Source: ACE Equity, 360 ONE Asset Research, data based on a sample of 870+ companies

Chart 4: Private Corporate Investment Intentions



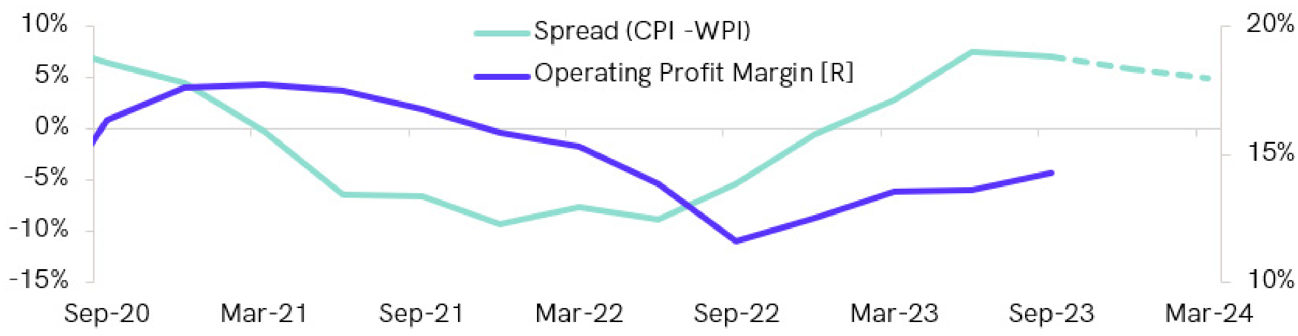
Source: RBI, 360 ONE Asset Research

3. Operating profit margins have probably peaked, and volumes would need to improve for earnings growth

In 2023, the manufacturing sector experienced earnings growth driven by margin improvement alongside subdued volume growth. Our analysis indicates that the spread between the Consumer Price Index (CPI), representing output price inflation, and the Wholesale Prices Index (WPI), representing input price inflation, will likely moderate in the upcoming quarters (Chart 5). Thus, the potential for further margin expansion in 2024 is limited.

The earnings growth in 2024 would have to arise from volume recovery. We have dealt with the issue of volume/consumption recovery in much more detail in Chapter 3.

Chart 5: Correlation Between CPI – WPI Spread and Manufacturing Operating Profit Margin



Source: ACE Equity, MOSPI, CMIE, 360 ONE Asset Research

Overall, we anticipate FY25 GDP growth to be around 6.5% YoY, with risks evenly balanced. The potential interest rate cuts by RBI and developed market central banks in 2024 are expected to support growth. However, we remain concerned about the recovery of the rural sector, which depends on favourable climatic conditions. Furthermore, the consumption recovery is crucial for maintaining growth momentum.

As we enter 2024, with everything considered, there is a positive outlook, and we keep our fingers crossed for another year of pleasantly surprising growth.

Chapter 2:

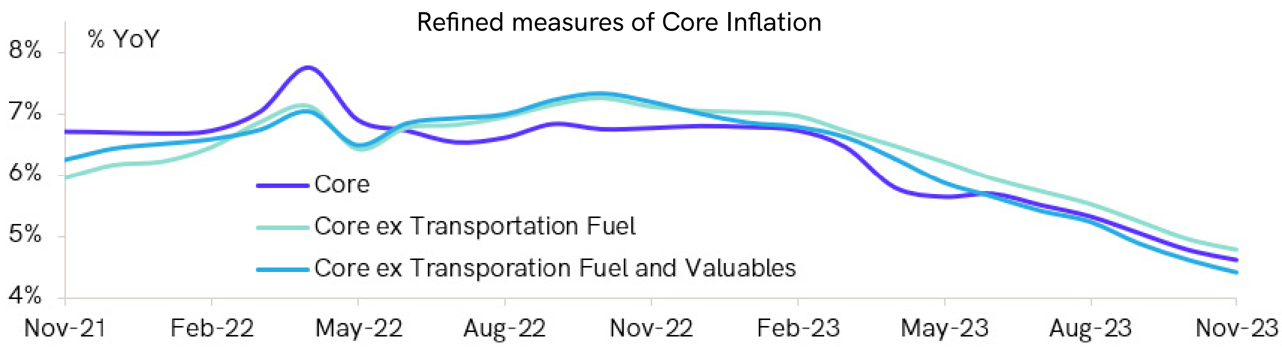
When will the RBI ease monetary policy?

When will the RBI ease monetary policy?

This question doesn't have a straightforward answer. We believe multiple scenarios are possible. However, let's establish some context first.

India's economy appears to be in a Goldilocks scenario - well, almost. The economic growth momentum is upbeat, and core inflation, excluding fuel and food components, continues to decline. Even the more refined measures of core inflation, excluding transportation fuels and valuables, are on a downward trend (Chart 1). However, the 'almost' qualifier arises from volatile and broad-based food inflation.

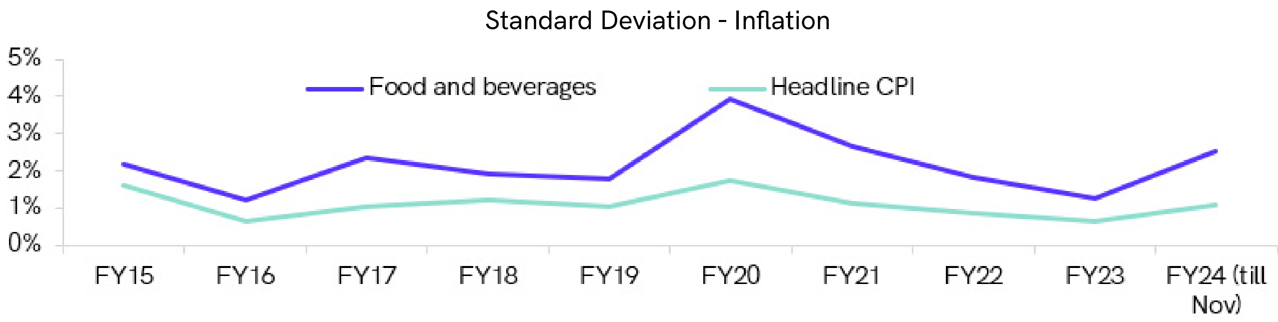
Chart 1: Core CPI inflation and refined measures



Source: MOSPI, 360 ONE Asset Research

The Reserve Bank of India (RBI) has repeatedly expressed concern that *"the recurring incidence of large and overlapping food price shocks can impart generalization and persistence to headline inflation."*[1] Food inflation has contributed to higher volatility in the headline CPI in FY24 (Chart 2). The increased volatility can be attributed to significant fluctuations in certain essential vegetables throughout the year. Poor kharif production has also imparted upward pressure on rice, pulses, and sugar prices. Overall, food inflation remains quite broad, with 41% of the items within the food basket witnessing >6% (upper band of RBI target range) inflation (as of November 2023).

Chart 2: Volatility in Food and Headline CPI

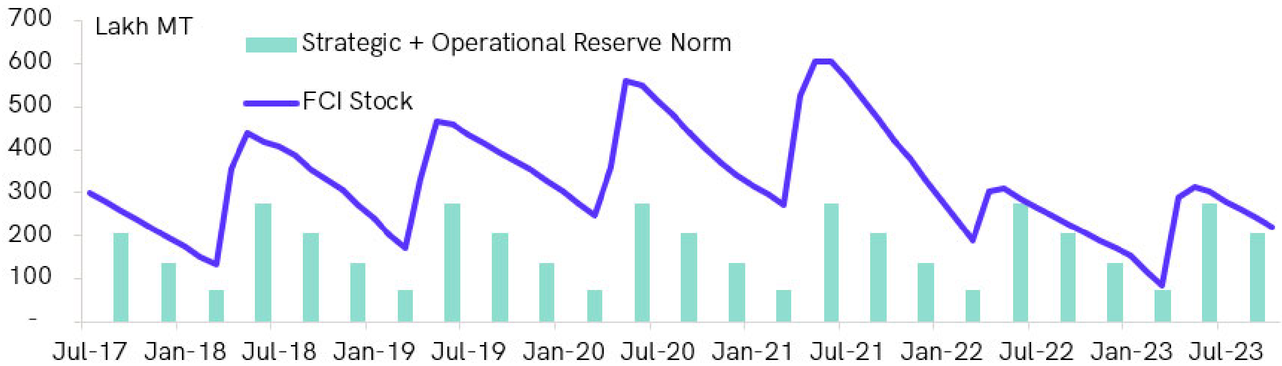


Source: MOSPI, 360 ONE Asset Research

In the last two years, heatwaves have affected wheat production, resulting in a notable depletion of wheat stocks held by the Food Corporation of India (Chart 3). Wheat stocks are approaching the buffer norms, constraining the government's capacity to intervene aggressively in the market to curb price increases if the crop is impacted again this season.

[1] *Governor's Statement: RBI Monetary Policy October 6, 2023*

Chart 3: Food Corporation of India Wheat Stocks and Buffer Norms

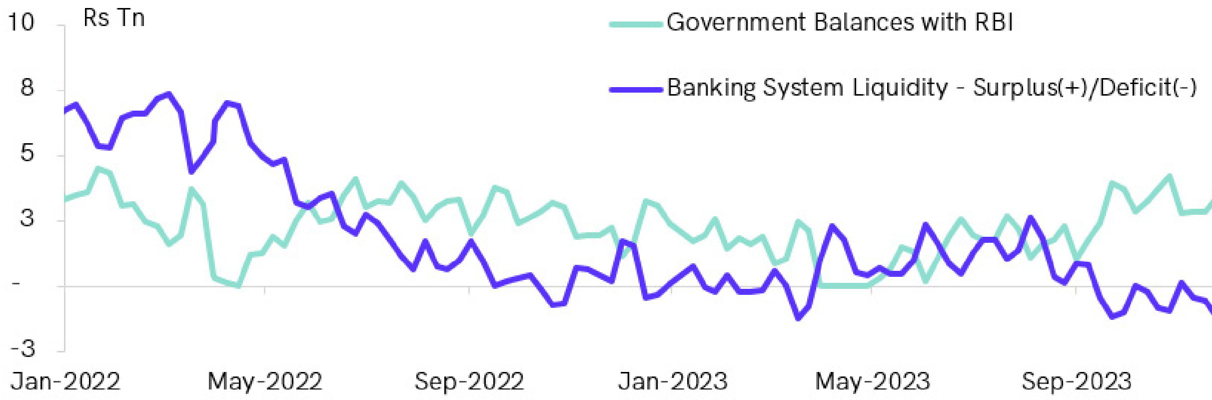


Source: CMIE, 360 ONE Asset Research

The RBI is concerned that similar supply shocks could unsettle households' inflation expectations and sustain elevated headline inflation. The RBI is cautious not to jeopardise the progress made so far by easing policy prematurely.

The RBI's other concern revolves around liquidity in the banking system. The RBI has repeatedly stressed that *"excessive liquidity can pose risks to both price and financial stability"*[2]. However, the banking system's liquidity has mostly been in deficit since September 2023. This is partly because of the large government cash balance maintained with the RBI (Chart 4). As and when government spending picks up, liquidity in the banking system could turn into a surplus.

Chart 4: Banking System Liquidity and Government Balances with RBI



Source: CMIE, 360 ONE Asset Research

Additionally, heavy Foreign Portfolio Investment (FPI) inflows are expected in the debt segment in FY25 due to the inclusion of Indian government securities in JP Morgan GBI-EM indices. These inflows could also be liquidity accretive.

[2]*Governor's Statement: RBI Monetary Policy October 6, 2023*

As stated earlier, RBI is concerned that surplus liquidity in the system could lead to excessive risk-taking by the banks and other financial institutions, thereby posing a risk to financial stability[3]. Hence, the RBI indicated in the October 2023 policy to utilise Open Market Operation (OMO) sales to absorb excess system liquidity when required.

The timing of the RBI's monetary policy easing hinges on when the central bank gains clear visibility of inflation durably aligning with the 4% target. When will the RBI achieve that visibility? We believe it largely depends on two factors: the Ministry of Agriculture's advance estimates for Rabi foodgrain production, expected to be released in mid-February 2024, and the Indian Meteorological Department (IMD) forecasts for Monsoon 2024, scheduled for release by mid-April 2024.

In the event of a robust Rabi production, the RBI may contemplate a rate cut in the April 2024 policy. RBI could also decide to await the monsoon forecasts. In the case of normal monsoon projection by IMD, we foresee a high likelihood of a rate cut in the June 2024 policy (Scenario 1). In the event of a below-normal monsoon projection, we anticipate that the RBI will defer any rate decisions until at least the September policy (Scenario 2).

If Rabi production is below par and the IMD projects a normal monsoon, the RBI could still choose to implement a rate cut in the June policy or wait for a couple of more meetings (Scenario 3). However, in the event of subpar Rabi production and a below-normal monsoon, we expect a prolonged pause in policy (Scenario 4).

Here's a quick reference guide for the discussed scenarios:

	Normal Monsoon	Below Normal Monsoon
Robust Rabi Production	Scenario 1 First rate cut in April or June 2024	Scenario 2 First rate cut in September 2024 or later
Poor Rabi Production	Scenario 3 First rate cut in June 2024 or later	Scenario 4 Prolonged pause

Irrespective of the abovementioned scenarios, we expect the RBI to maintain liquidity conditions close to neutral levels. Given the anticipated strength of the Indian economy, we do not foresee any need for the RBI to maintain surplus liquidity in the banking system. Also, maintaining deficit conditions would be counterproductive, as it would unnecessarily impact the productive credit requirements of the economy.

As noted at the beginning of this chapter, there is no clear-cut answer to when the RBI will ease the monetary policy. The statement from the RBI Governor in the December 2023 policy address precisely outlines the underlying reasons for this ambiguity - "Policy makers have to be mindful of the risk of being carried away by a few months of good data ….They have to be also mindful of the risk of overtightening, especially when large structural changes, geopolitical and geoeconomic shifts are taking place. On top of this, they have to be watchful of the risks from new shocks that could hit the economy from anywhere anytime."

[3]In November 2023, RBI announced a series of regulatory measures to restrict unsecured retail credit, pre-empting any potential stress. For further details, you can refer to our note on the implications.

Chapter 3:

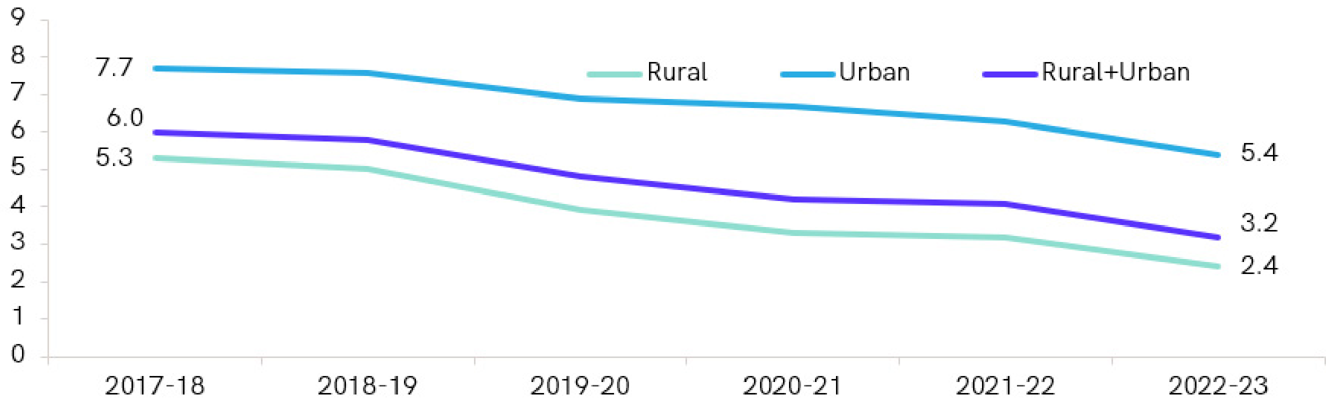
What hinders India's consumption, and when can we expect a recovery?

What hinders India's consumption, and when can we expect a recovery?

The absence of productive employment has been impeding consumption in India.

According to the annual Periodic Labour Force Survey (PLFS), India's unemployment rate[4] decreased from 6% in 2017-18[5] to 3.2% in 2022-23, with the decline observed in rural and urban areas (Chart 1). However, the quality of job gains has been below par, concentrated in low-productivity and low-income sectors.

Chart 1: India Unemployment Rate (%)

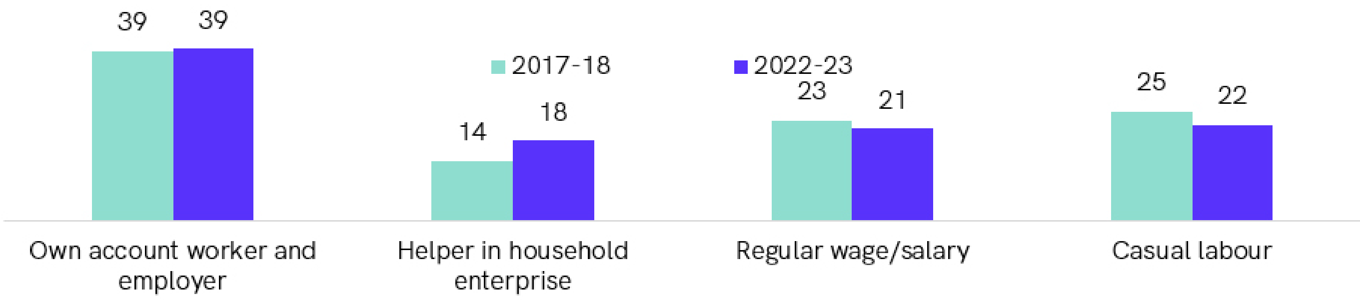


Source: PLFS, 360 ONE Asset Research

Employment can broadly be divided into three categories – self-employment, regular wage/salary, and casual labour. Self-employment can further be classified into 'own account worker and employer' and 'helpers in household enterprise'.

Over the last five years, the percentage of individuals employed as 'helpers in household enterprises' has risen from 14% in 2017-18 to 18% in 2022-23. These roles are typically low-paying jobs within the informal sector. Notably, the proportion of higher-paying and more productive regular wage/salary employment has declined from 23% to 21% over the same period (Chart 2).

Chart 2: Percentage Distribution of Workers by Employment Status



Source: PLFS, 360 ONE Asset Research

The indication of low-quality job creation is also evident in the sectoral composition of employment. The percentage of agriculture in employment has risen from 44.1% in 2017-18 to 45.8% in 2022-23 (Table 1). The agriculture sector is primarily characterised by self-employment, either as an own-account worker or as a helper. The sector also experiences high levels of disguised unemployment.

The share of employment in the construction sector has also risen from 11.7% to 13.0% over the past five years. This sector is characterised by a higher proportion of daily wage casual labour, which tends to be the lowest paid among all employment categories.

Table 1: Share in Employment by Sectors

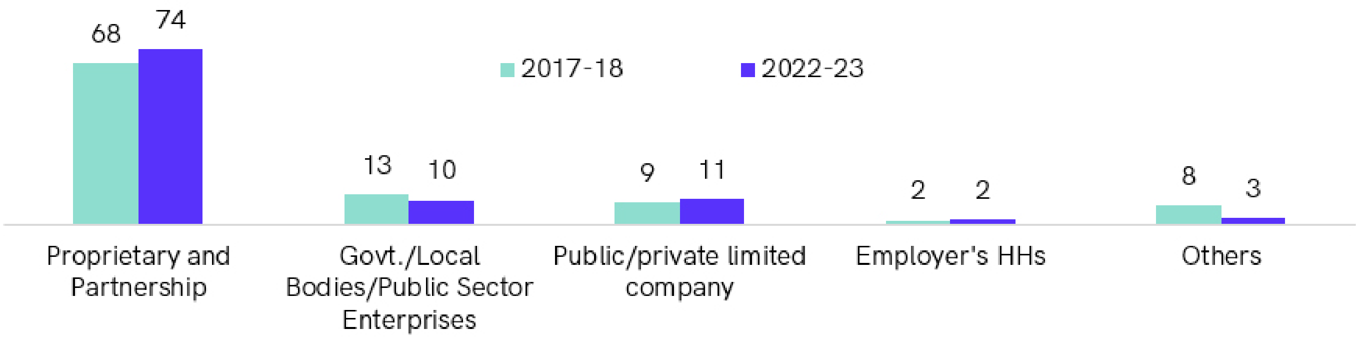
Employment Share (%)	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Agriculture	44.1	42.5	45.6	46.5	45.5	45.8
Mining & quarrying	0.4	0.4	0.3	0.3	0.3	0.3
Manufacturing	12.1	12.1	11.2	10.9	11.6	11.4
Electricity, water, etc.	0.6	0.6	0.6	0.6	0.6	0.5
Construction	11.7	12.1	11.6	12.1	12.4	13
Trade, hotel & restaurant	12	12.6	13.2	12.2	12.1	12.1
Transport, storage & communications	5.9	5.9	5.6	5.4	5.6	5.4
Other services	13.2	13.8	11.9	12	11.9	11.4
Total	**100**	**100**	**100**	**100**	**100**	**100**

Source: PLFS, 360 ONE Asset Research

As per the PLFS, proprietary and partnership enterprises are considered informal sector enterprises[6]. According to this criterion, the share of the informal sector in employment has risen from 68% in 2017-18 to 74% in 2022-23, contrary to the general expectations of a decline in the informal sector (Chart 3).

[4]usual status (ps+ss) for persons of age 15 years and above
[5]2017-18 refers to the period July 2017 - June 2018 and likewise for 2018-19, 2019-20, 2020-21, 2021-22 and 2022-23
[6]According to the 15th International Conference of Labour Statisticians (ICLS) conceptual framework

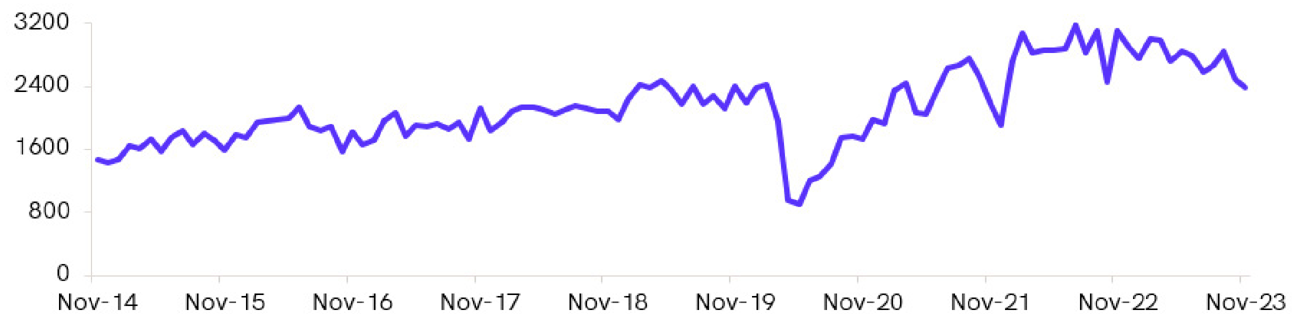
Chart 3: Percentage Distribution of Workers (Non-agriculture) by Enterprise Type



Source: PLFS, 360 ONE Asset Research

The slowdown in white-collar hiring in India also indicates the lack of regular wage or salaried employment. According to the Naukri Jobspeak index, white-collar hiring has gradually decreased over the last eighteen months (Chart 4). This decline is primarily driven by the IT sector, which constitutes a substantial portion of India's white-collar workforce. Concerns regarding the impending recession in the American and European markets have affected the IT industry.

Chart 4: Naukri JobSpeak Index



Source: CMIE, 360 ONE Asset Research

Therefore, although the overall employment situation with lower unemployment rates seems better, it conceals the absence of high-quality, productive, and well-compensated jobs. This, in turn, is reflected in subdued consumption trends.

In addition to the structural issues discussed above, cyclical factors, such as high inflation and weak rural growth, have also contributed to subdued consumption.

However, consumption, in our view, has bottomed out and is anticipated to improve in 2024, spurred by the following factors:

1.Strong economic momentum: We maintain an optimistic outlook that robust economic growth will result in improved job opportunities, higher income, and a resurgence in consumption. The workforce demand in IT and other export-oriented industries will improve as global recessionary concerns fade, and business confidence picks up. Additionally, India has positioned itself as a hub for Global Capability Centres (GCCs), and we foresee continued strong hiring in this sector, with the export of business services remaining robust.

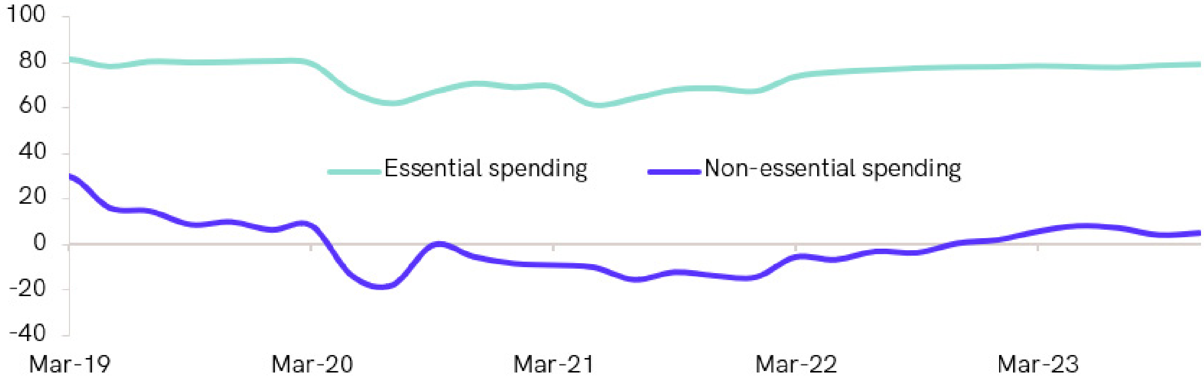
However, the above outlook is based on the premise of a 'soft landing.' If global economic growth stalls due to the impact of past rate hikes and central banks delay the rate cut cycle, external demand may worsen. In that case, hiring in the export-oriented sector could remain weak. Consequently, there could be a delay in consumption recovery.

2.Improvement in consumer confidence: Consumer preference for essential and non-essential spending has consistently risen from pandemic lows (Chart 5). The increased preference for spending on consumer durables is evident across all income groups (Chart 6). However, higher consumer confidence has not yet translated into tangible spending, partly due to higher prices. Higher inflation, particularly food inflation, has constrained consumer spending.

Consumer companies have also refrained from passing on the lower cost of raw materials to end consumers, instead opting to maintain higher profit margins. Consequently, consumers shifted to affordable alternatives from regional players to economise.

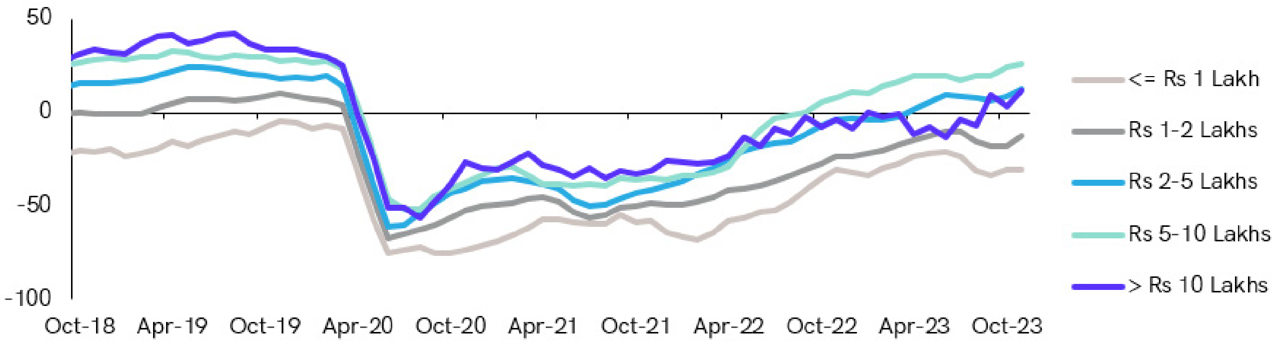
We anticipate that a decline in inflation and a steady improvement in consumer confidence will translate into actual spending in 2024. Consumer companies may also consider reducing prices to stimulate volumes. A decline in interest costs due to RBI repo cuts could further enhance consumer purchasing power.

Chart 5: Consumer Confidence – One Year Ahead Expectations



Note: "Net Response" - difference between the percentage of respondents reporting optimism and those reporting pessimism.
Source: RBI, 360 ONE Asset Research

Chart 6: Is This a Good Time to Buy Consumer Durables? Net Better – Across Income Groups



Note: "Net Better" - difference between percentage of respondents reporting "better" and "worse"
Source: CMIE, 360 ONE Asset Research

3.Recovery in the rural sector: One of the reasons for weak consumption in 2024 was that the expected recovery in the rural sector did not materialise. Erratic monsoon adversely impacted both agriculture production and rural incomes. As discussed in Chapter 1, rural sector recovery hinges on the rabi output and monsoon. Under the assumption of a healthy Rabi output and a normal monsoon season in 2024, we anticipate the recovery of the rural sector and, consequently, a rebound in consumption.

While we expect a recovery in consumption in 2024, it is essential to highlight that addressing the lack of high-quality job opportunities is a long-term structural challenge that won't be swiftly resolved within a year. It's imperative to prioritise the creation of meaningful and productive employment to maintain long-term growth and foster enduring economic well-being.

Chapter 4:

What are the implications of India's inclusion in the global bond index?

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India's inclusion in JP Morgan GBI-EM indices has wide-ranging implications. In the near term, inclusion will probably enhance India's balance of payments surplus, potentially result in an appreciation of the INR, and drive down yields on Indian government bonds (IGBs). Over the medium term, it will reduce the cost of capital and boost long-term growth.

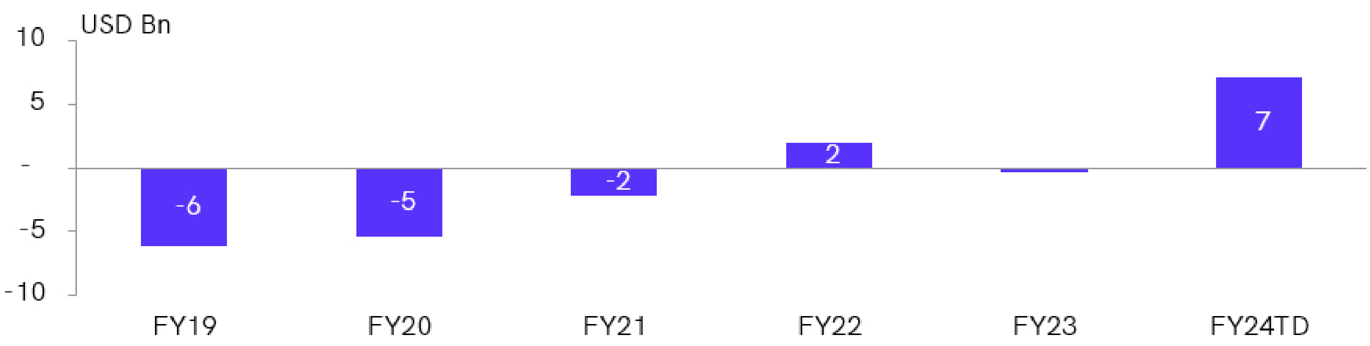
Let's delve deeper into the macro-implications of India's bond index inclusion:

Inclusion is expected to drive significant inflows into Indian government bonds: India will be included in the GBI-EM Global Diversified Index (GBI-EM GD) and other related indices with effect from 28th June 2024. India is expected to carry a 10% weight in the GBI-EM GD. The inclusion of the Indian bonds will be phased in over ten months, with the weight increasing by 1% each month until March 31, 2025. The benchmarked AUM of the GBI-EM family of indices is US$ 236 billion, of which GBI-EM GD accounts for US$ 213 billion. The market consensus anticipates around US$ 30 billion in inflows by March 2025.

Enhanced funding for the current account deficit to support INR: Index inclusion offers an additional means of financing the current account deficit. A substantial portion of these inflows (passive) will likely be concentrated during the inclusion period (June 2024 - March 2025) and will introduce an appreciating bias to the INR. However, RBI is anticipated to intervene in the foreign exchange markets (by purchasing dollars in the spot or carrying out FX swaps) to prevent any significant volatility in the INR.

Active inflows are anticipated to start well ahead of the inclusion. We have observed robust debt inflows in FY24 to date (Chart 1).

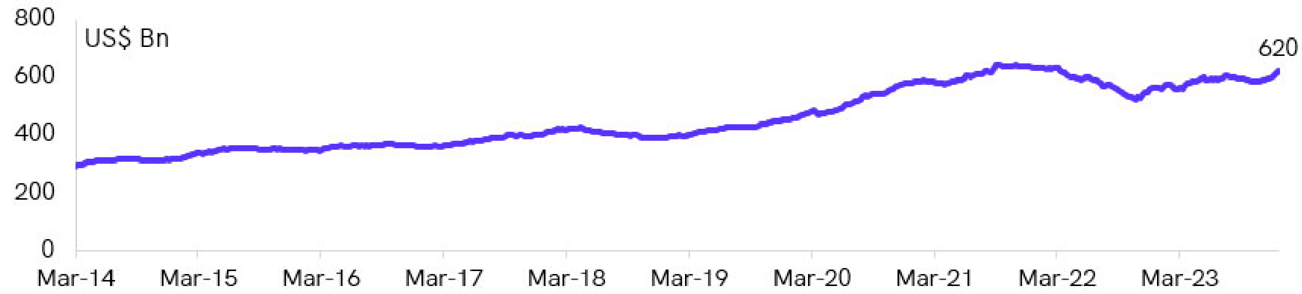
Chart 1: FPI Debt Flows till December 2023



Source: NSDL, 360 ONE Asset Research

Opportunity to build Fx Reserves: RBI can engage in foreign exchange spot interventions to augment its reserves. As of December 15, 2023, the RBI's foreign exchange reserves stand at approximately US$ 616 billion, lower than the peak of US$ 642 billion in September 2021 (Chart 2). Thus, RBI is well-positioned to absorb significant incoming debt inflows to replenish and bolster its foreign exchange reserves.

Chart 2: RBI Foreign Exchange Reserves

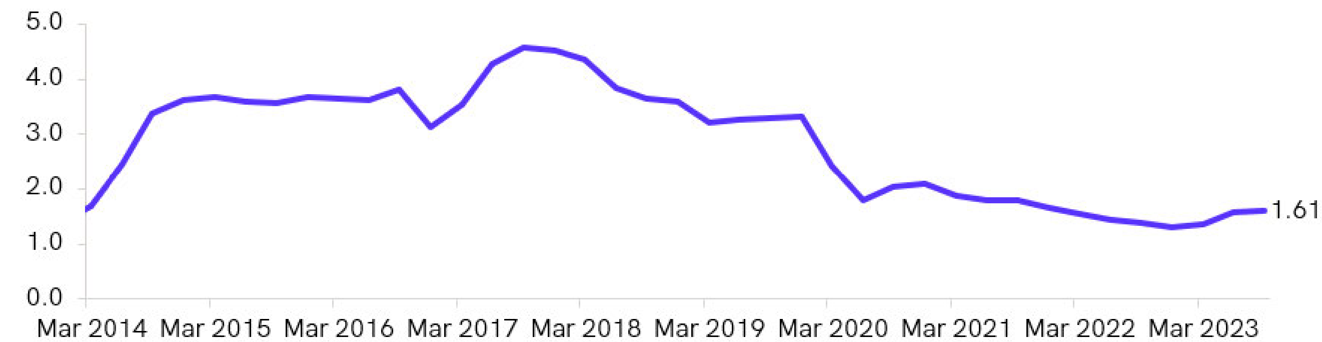


Source: CMIE, 360 ONE Asset Research

Inflows could improve domestic banking liquidity and may need to be neutralised: RBI's foreign exchange spot buy intervention adds to banking system liquidity. However, considering the inflation concerns and the financial stability risks associated with excess system liquidity (discussed in Chapter 2), the RBI would take measures to neutralise the surplus liquidity. RBI has already announced its intent to utilise Open Market Operation (OMO) sales to absorb excess liquidity when required.

Expected to reduce the cost of borrowings for the government: The most significant impact of bond index inclusion will be a substantial increase in the demand for Indian government securities, potentially resulting in lower yields. The ownership share of FPIs in IGBs has been steadily decreasing since September 2017, and this trend is expected to reverse with the inclusion (Chart 3).

Chart 3: FPI's Ownership Share in Indian Government Bonds (%)



Source: CMIE, 360 ONE Asset Research

Expected to reduce the cost of capital for the private sector: This decline in G-sec yields is also likely to influence other markets since market interest rates are often anchored to the benchmark risk-free G-sec yields. Index inclusion provides an additional funding source for the fiscal deficit. This frees up space for the domestic financial sector to meet the growing capital needs of the private sector. This leads to a reduction in financing costs for private borrowers as well.

In summary, India's inclusion in the global bond index holds significant structural benefits. It fosters long-term growth and macroeconomic stability by augmenting funding for the twin deficits – fiscal and current account. It lowers the cost of capital for both the government and the private sector. It also provides stability to the INR, lowering the hurdle rate for foreign investors.

However, the inclusion could heighten susceptibility to external shocks. It is also expected to result in greater scrutiny of India's fiscal deficit, underscoring the importance of adhering to the committed path of fiscal deficit reduction.

Chapter 5:

What factors can influence the markets in 2024?

What factors can influence the markets in 2024?

In 2024, various factors are poised to exert influence on the markets. Elections across the globe and the easing of monetary policies by systemic central banks are among the pivotal factors that demand attention. Additionally, geo-political conflicts and resulting volatility in crude oil prices could affect the markets. The Indian government will also present the budget, outlining key fiscal policies and economic priorities for the upcoming financial year.

Understanding these factors will be crucial for investors navigating the dynamic economic landscape ahead. Let's discuss each of these factors in detail.

1. India and US Elections:
Nearly half the global population is expected to participate in presidential or legislative elections in 2024[7]. However, the polls in the world's oldest democracy – the United States of America and the world's largest democracy – India, are by far the most important.

First, India is set to go to the polls during April-May 2024. In the elections held in Rajasthan, Madhya Pradesh, and Chhattisgarh in 2023, the Bharatiya Janata Party (BJP) secured victories. These outcomes significantly heightened the likelihood of the incumbent government's re-election in the 2024 Lok Sabha elections. Responding to the results, the equity markets reached a record high on expectations of policy continuity at the centre. We expect higher economic uncertainty and market volatility around elections if there are any indications of electoral surprises.

The US Presidential elections are scheduled for November 2024. Currently, it appears to be a toss-up between the Republicans and Democrats. The US has pursued an active industrial policy over the last few years, and we think that is likely to continue irrespective of which government comes to power. However, the elections are important from a geopolitical perspective. Rising geopolitical conflicts stemming from the Russia-Ukraine war, the Israel-Hamas war, and ongoing tensions between China and the West make US leadership elections crucial for shaping responses to these global challenges.

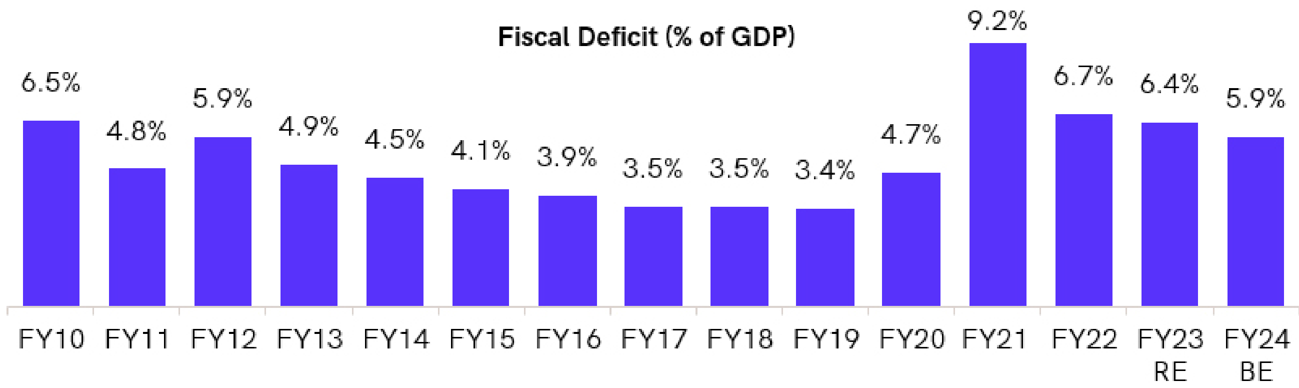
2. India Union Budget FY25:
The Central Government is scheduled to present an interim budget in February 2024 before the general election. However, it is anticipated that there will be no significant policy announcements. Nevertheless, it can offer guidance on expected revenues, expenditures, and, most importantly, the fiscal glide path for the next financial year.

The full budget will likely be presented in June-July 2023 after the election. Major policy declarations related to commitments made during the election may find inclusion in the budget. The government could also announce welfare schemes to boost lagging consumption. The central government's borrowing plans would also be crucial for the debt markets.

While we expect the government to focus on the quality of expenditure, the pace of capital expenditure could slow down as the government trims spending to gradually align the fiscal deficit (Chart 1) with the target of 4.5% of GDP.

[7] https://www.economist.com/interactive/the-world-ahead/2023/11/13/2024-is-the-biggest-election-year-in-history

Chart 1: Central Government Fiscal Deficit as a % of GDP



Note: RE- Revised Estimates, BE - Budget Estimates
Source: Budget Documents, 360 ONE Asset Research

3. Monetary Policy Easing by Systemic Central Banks:
The rate hike cycle by global systemic central banks, such as the Federal Reserve, the European Central Bank, and the Bank of England, seems to have concluded. Attention now turns to the timing and extent of the upcoming policy easing, which will be a driving factor for currency, equity, and debt markets.

The markets appear overly optimistic in predicting aggressive rate cuts for 2024. In many advanced economies, inflation still persists above the target, and central banks are likely to prioritise addressing inflation over concerns about potential growth slowdown or recession. Hence, we believe that rate cuts in advanced economies will be more moderate than expected by the markets.

Anticipated shifts in the timing and magnitude of Central Banks' rate cuts can introduce market volatility. We witnessed multiple similar market re-pricing scenarios during the rate hike cycle in 2023, which heightened market volatility.

We have detailed our expectations for the monetary policy easing by the RBI in Chapter 2.

4. Geo-political Conflicts:
The markets are potentially facing the highest level of risk from geopolitical conflicts. In a major escalation, extreme risk aversion among investors could upend markets across asset classes—interest rates, currency, and equities.

There are valid concerns about the Israel-Hamas conflict spreading across the broader Middle Eastern region. Additionally, the ongoing Russia-Ukraine war continues to pose challenges. While supply chains have adjusted to changing geopolitical dynamics so far, the escalation of existing conflicts or the emergence of new ones could disrupt supply chains again. This might lead to shortages. A subsequent increase in inflation could impact expectations of early easing by central banks and potentially result in increased economic uncertainty and financial volatility.

5. Crude Prices
Crude oil prices can significantly impact various aspects of the Indian economy, including growth, inflation, the current account, and the currency. As outlined in the RBI Monetary Policy Report from October 2023, an increase of 10% in crude oil prices beyond the baseline of $85 per barrel could potentially result in a 30 basis points uptick in domestic inflation and a 15 basis points reduction in growth. Therefore, crude prices consistently stand out as a crucial factor to monitor. The potential escalation of geopolitical tensions and additional production cuts by OPEC+ could contribute to a price rise, subsequently affecting the country's macro fundamentals.

Although this list isn't exhaustive, the above factors are crucial in shaping markets across various asset classes. Therefore, we hope that staying mindful of these factors can assist you in making more informed decisions.