20th January 2020

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ECONOMY & GILT WATCH

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Budget 2020: Biting or dodging the bullet

The Union Budget for FY 21 is set to be presented on 1st February, 2020, which is incidentally a Saturday. In the backdrop of continuing slump in the economy, the government holds the unenviable task of fixing the economy amid deteriorating government finances and fiscal constraints. Though the government has taken a slew of measures to tackle the slowdown in the current fiscal, it would be interesting to see if the government comes out with an expansionary and reformist budget or exercises restraint to keep the fiscal deficit under check.

Propelling Demand

That the economy is desperately in need of a fiscal push and reforms is a fact that has only gained ground with successive data releases. The latest being the advance nominal GDP estimate for FY 2019-20 being pegged at a four decade low of 7.5% as against budget estimate of 11%. The measures taken by the government hitherto have focused largely on supply side issues while the collapse in demand remains a problem which is yet to be addressed by the policy makers. Government in last few months has taken several measures to facilitate private sector investment by slashing taxes (corporate & GST), initiating bank consolidation, cutting interest rates etc. The main issue that needs to be given much consideration in the budget is reviving consumption demand which is the mainstay of economic growth and in absence of which investment is unlikely to pick up. Consumption can be stimulated with a two pronged strategy of directly increasing incomes in hand of consumer (by income tax rate cuts in case of salaried class, enhancement of allocation to schemes focusing on farmer income such as PM-Kisan) and also laying emphasis on employment generation especially in the rural sector through increased allocation to schemes such MGNREGA (which generates not only employment but also creates durable assets). The 100 lakh crore of infrastructure push intended over a period of five years will also result in employment creation and improve purchasing power in the economy, besides increasing demand for industrial products such as steel, cement etc.

Economic stability over fiscal prudence

Several renowned economists have advocated forgoing of fiscal austerity to trigger the investment-demand cycle in the economy. In the current scenario of high unemployment and depressed private investment demand despite low interest rates, deficit spending is unlikely to stoke inflation or crowd out private investment. This makes a strong case for the government to relax the fiscal path and provide a spending boost to the economy. However, funding of the deficit is a key concern given that markets have been absorbing record borrowings and government revenue is unlikely to see immediate improvement in the coming fiscal. Whether the government will resort to higher borrowings, tap overseas borrowings, or simply monetize the deficit will be a matter of decision which will have different implications in the current scenario. For now, biting the bullet seems to be the solution to the many problems being faced by the Indian economy.

Fiscal Math

Lately, the government has made efforts to reduce next year's redemption pressure by conducting switch operation to the tune of Rs. 42,000 crore with RBI. Another switch of Rs. 25,000 crore is planned on 20th Jan'19 for Rs. 25,000 crore with market participants. Broadly, the government is expected to target a fiscal deficit of 3.5% of GDP in FY 2020-21, which may translate in gross borrowings in the range of Rs. 7.10 to 7.50 lakh crore (assuming nominal GDP in the range of 9.0% -9.5%). In the current year, we expect a slippage of 35 to 45 bps.

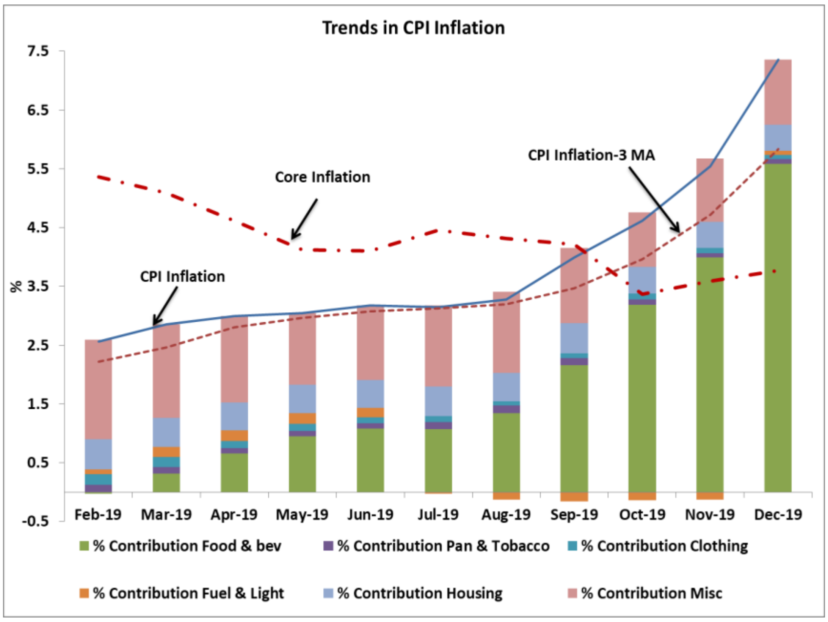
Heading towards "Stagflation"?

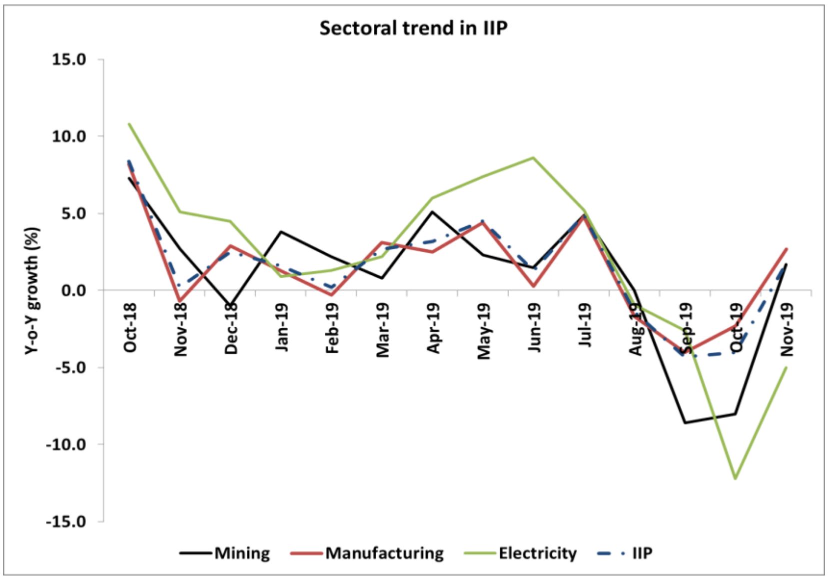
In one of the interviews, former PM Manmohan Singh had warned about the imminent risk of economy facing stagflation. The fears seem to be getting corroborated with the economy facing highest retail inflation in more than five years. CPI December 2019 stood at 7.35% with maximum contribution from food prices. This is third time in a row that inflation has breached RBI's medium term target i.e. 4% (+/- 2%). The food price inflation reached at 12.16% in December 2019 from -1.69% in November 2018, while a low base further exacerbated the headline inflation number. On the other hand core CPI, which is calculated by removing volatile component like food and oil, continues to give some respite by still staying below 4%.

Stagflation is a term coined for condition of slow economic growth (or high unemployment rate) accompanied with relatively high inflation. At the current juncture, stagflation will complicate policy making as the economy is badly in need of a fiscal push and it will also tie RBI's hands in maintaining an accommodative stance or delivering further rate cuts. Nonetheless, some comfort can be drawn from the fact that core inflation, which is stickier than headline inflation, continues to remain subdued. Also, since, announcement of CPI December 2019 the food prices, especially onions, have decreased 15% from the highest price seen in past few months. Going forward, headline inflation is expected to correct as the fall in food prices gets reflected in forthcoming data. Rabi prospects are also bright as data from agriculture ministry shows good y-o-y growth in most rabi crops. Neverthless, from monetary policy perspective, RBI is largely expected to keep rates on hold given the fact that the inflation is much above its comfort zone.

IIP rebounds to positive territory in November

Industrial output rebounded in November to record y-o-y growth of 1.80%. This is a modest expansion rate after three consecutive contractions, but many sectors remained in red. The expansion rate in the month is more than what it was in the same month for last year i.e 0.2%. Mining and manufacturing output rose 1.7% and 2.7%, respectively, in the month. However, electricity generation contracted 5% in November. April-November industrial growth at 0.6% is well below 5% for the same period in the last fiscal. The growth in the manufacturing sector was 2.7% as against a contraction of 0.7% in the same month last year. Mining sector output decelerated to 1.7% from 2.7% in the year ago month. Electricity generation turned negative (-) 5% as against a growth of 5.1% in November 2018.





Inflation data becomes increasingly discomfiting stoking fears of economy entering into stagflation. IIP has made a modest recovery, though it's too early to interpret it as green shoots emerging in the economy.

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Fixed Income Outlook

Fundamental View

In the previous fortnight, bond markets were rattled by sharp surge in headline inflation. Markets also witnessed announcement of switch operation during the fortnight to the tune of Rs. 42,000 crore (between RBI and GOI), with GOI buying back securities due for redemption in the upcoming fiscal. While, another switch to the tune of Rs. 25,000 crore (GOI with market) is planned for the coming fortnight apart from special OMO for Rs. 10,000 crore. While these announcements have been positive for the bond markets, the 10-year paper has come under pressure as the switches and auctions have resulted in increase in supply in this paper. In the coming fortnight, bond markets would remain largely cautious ahead of the budget announcement. The recent maneuvers by the government and RBI have helped anchor yields to a large extent. We expect the 5 year and 15 year segment to see further improvement, while the 10-year paper is expected to largely underperform and trade in the range of 6.58% to 6.72%.

Technical View

6.45% GS 2029 yield settled at 6.62% on Friday's session. Last fortnight yields traded with positive bias, as it sustained above crucial resistance zone of 6.56% level. In last trading session it has made an inside candle after three weak closing in a row, indicating close fight between bulls and bears at current level. Momentum indicator RSI is placed around 54 and 20 SMA is placed at 6.56% zone. Going forward, any sustainability below 6.59% can trigger swift move on the downside with immediate targets of 6.56%/6.51% and on higher side 6.66%/6.68% will act as an immediate resistance zone for coming days.

Source: Investing.com

Measuring Economic Activity

Gross Domestic Product refers to the market value of all the goods and services produced in a country within the national boundary, irrespective of whether these products and services are produced by domestic or foreign nationals. It is a crucial economic indicator which helps in determining the growth of the economy.

Gross National Product on the other hand, also provides us the market value of all the goods and services produced but unlike GDP, it only includes the services and products produced by domestic nationals (within or outside the country). That is, it does not include products and services produced by foreign nationals within the national border.

Gross Value Added: It is a measure of total output and income in the economy. It provides the rupee value for the amount of goods and services produced in an economy after deducting the cost of inputs and raw materials.

Calculating GDP

GDP = Private Consumption + Gross Investment + Government Expenditure + Net Exports

i.e. GDP = C + I + G + (Exports-Imports)

- **Private Consumption C**, is the sum of expenses made by households or individuals on durable goods, non-durable goods, and services. Examples include clothing, food, and health care.

- **Investment, I**, is the sum of expenditures made by investors on capital equipment, inventories, and structures. Examples include machinery, unsold products, and housing.

- **Government spending, G**, is the summation of expenses made by all the government bodies on goods and services. Examples include naval ships, salaries to government employees, hospitality, education, etc.

- **Net exports, NX**, equals the difference between value of exports and imports made by a country. Exports refer to the products and services produced in a nation and sold abroad whereas, Imports refer to buying of goods and services from a foreign nation.

What is the Difference between Real GDP and Nominal GDP?

There are two kinds of GDP i.e., Real GDP and Nominal GDP.

Real GDP refers to the value of all goods and services measured on base prices or predetermined prices whereas, **Nominal GDP** provides value of all goods and services measured on current market prices.

Basically, the general difference between these two terminologies is that Nominal GDP considers inflation whereas Real GDP does not i.e. if Real GDP id 5% and Inflation is 1% then Nominal GDP is 6%.

Key Equation:

Real GDP = Nominal GDP / GDP Deflator

Where, GDP Deflator refers to the average prices of all goods and services produced in an economy over a period of time.

COMMON MISPERCEPTIONS:

- An increase in GDP does not necessarily mean a nation has produced more output; it must be specified whether the GDP in question is nominal or real. An increase in nominal GDP may just mean prices have increased, whereas an increase in real GDP definitely means output has increased.
- Rising GDP does not necessarily imply all round welfare and development of an economy. Indicators of inclusive and sustainable growth such as Human Development Index, per capita growth, Ginni Index etc also need to be monitored for gauging equitable growth in the economy.

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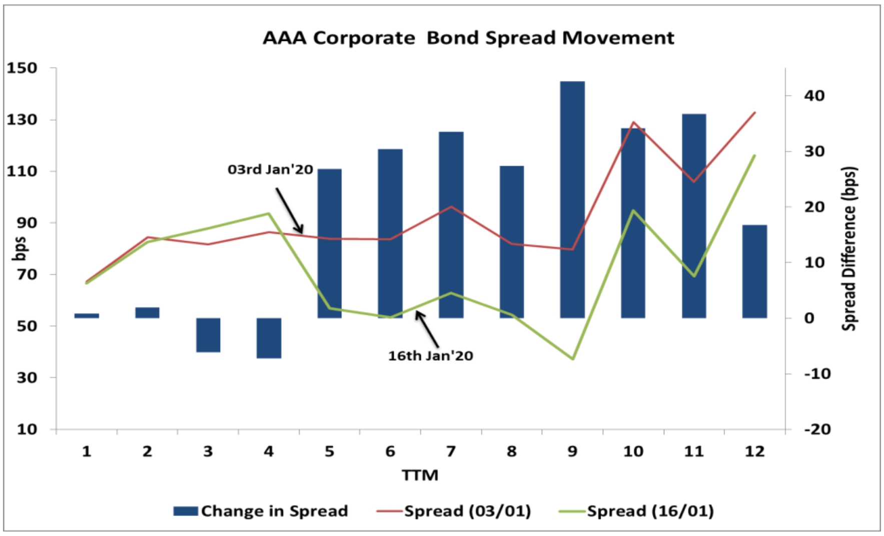
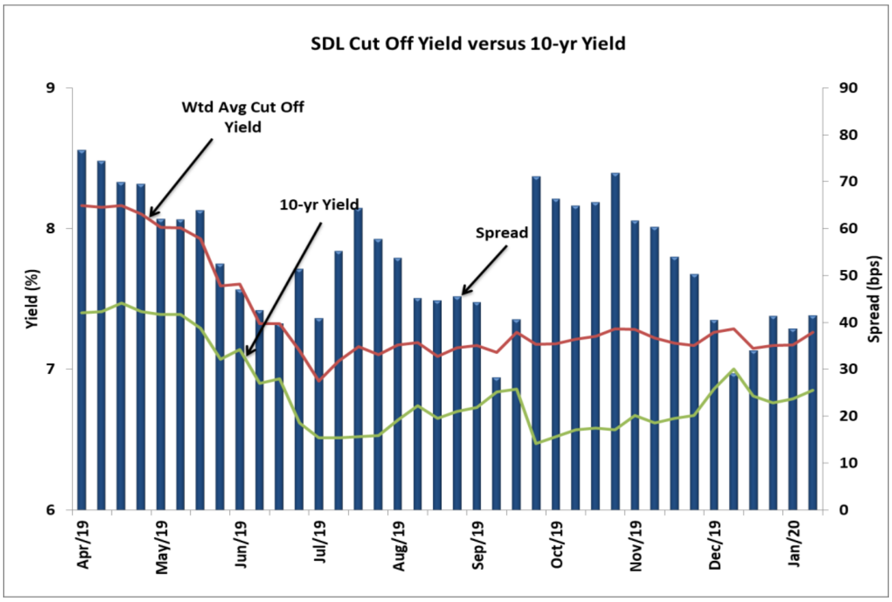
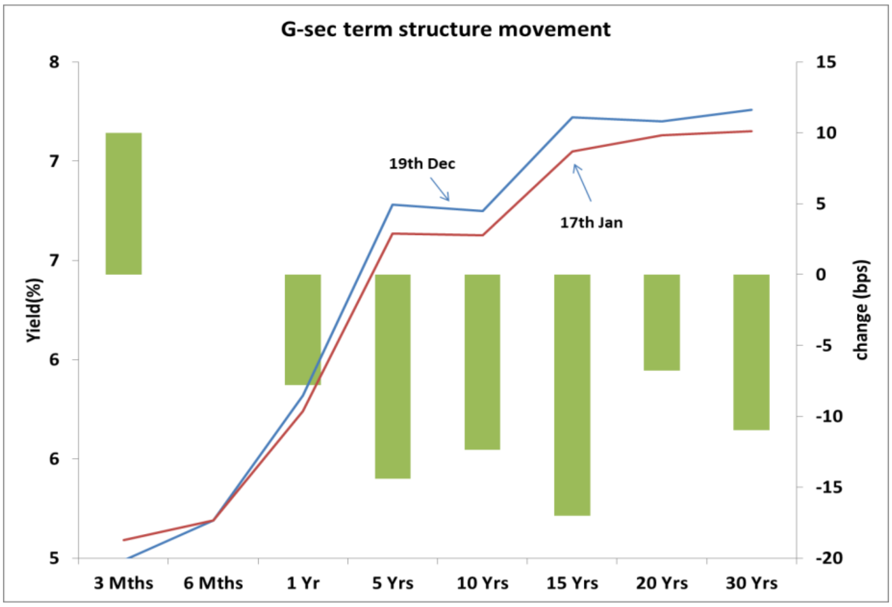
SPREAD MONITOR



SDL spreads are expected to firm up due to supply concerns. Corporate bond spreads have narrowed vis-à-vis previous fortnight.





RBI's OMO intervention has started to yield the desired impact on the term structure as short term yields have moved up while the mid and long term yields have softened.

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