

Economy & Gilt Watch

Q2 GDP: Flip Or A Blip?

The second quarter GDP growth data released last Friday, showed real GDP contracting at a pace of 7.5% as against -23.9% in the first quarter of the year. In terms of GVA, y-o-y contraction in Q2 GVA (at basic prices) stood at 7% (-22.8% in Q1). The narrowing of contraction has been rather sharp as against expectations as consumption and investment activity quickened amidst relaxed restrictions and release of pent up demand. The economy was expected to rebound, but the pace of the rebound has been a surprise, kindling hopes of the momentum continuing in the coming quarters and a much better than annual GDP growth number for FY21. Whether the numbers are reflective of the ground economic realities or need to be taken with a pinch of salt can only be known with forthcoming data as the festive season passes us by while COVID cases witness a spike in different parts of the country.

A Closer Look

The numbers are a welcome relief from the Q1 scare and as many as three sectors posted positive growth in Q2, with agriculture leading from the front, followed by electricity and manufacturing. Sector wise break up of numbers shows continued resilience of the agricultural sector. During the second quarter, GVA growth in the agri sector remained flat at 3.4%. Overall, the sentiment in the rural sector continues to remain positive as successive bumper crops, a promising rabi season, hike in MSPs and higher spending on rural schemes shall keep the momentum going. On the other hand, the industrial sector rebounded sharply, contracting by only 2.1% in Q2 (-38.1% in Q1). The improved performance of the industrial sector was largely on account of manufacturing sector which posted a marginal growth of 0.6% and construction sector which witnessed a sharp reversal in contraction in Q2 (-8.6% in Q2 vis-à-vis -50.3% in Q1). Manufacturing sector fared better than expectations, benefitting from increased activity post lifting of lockdown and a favorable base effect. The manufacturing GVA is also likely to have benefitted from sharp reduction in input costs for firms. On the other hand, construction activity witnessed a sharp rebound, which portends well from employment perspective. Recovery in services sector remained fragile, with only trade, hotels, transport, communication segment showing an improvement in activity in Q2, with contraction narrowing to -15.6% in Q2 as against -47% in Q1. On the other hand, the performance of other two segments, financial, real estate & professional services and Public administration, defence and other services (PADOS) worsened during the second quarter. Recovery in the services sector will likely be lagged and will be strongly contingent on the fall in infections. The contraction in PADOS (-12.2% in Q2 & -10.3% in Q1), which is considered as a proxy for government expenditure, for two consecutive quarters is a worrying trend, though the dire fiscal position gives very limited scope for a generous spend by the state.

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Sector Wise GVA Growth

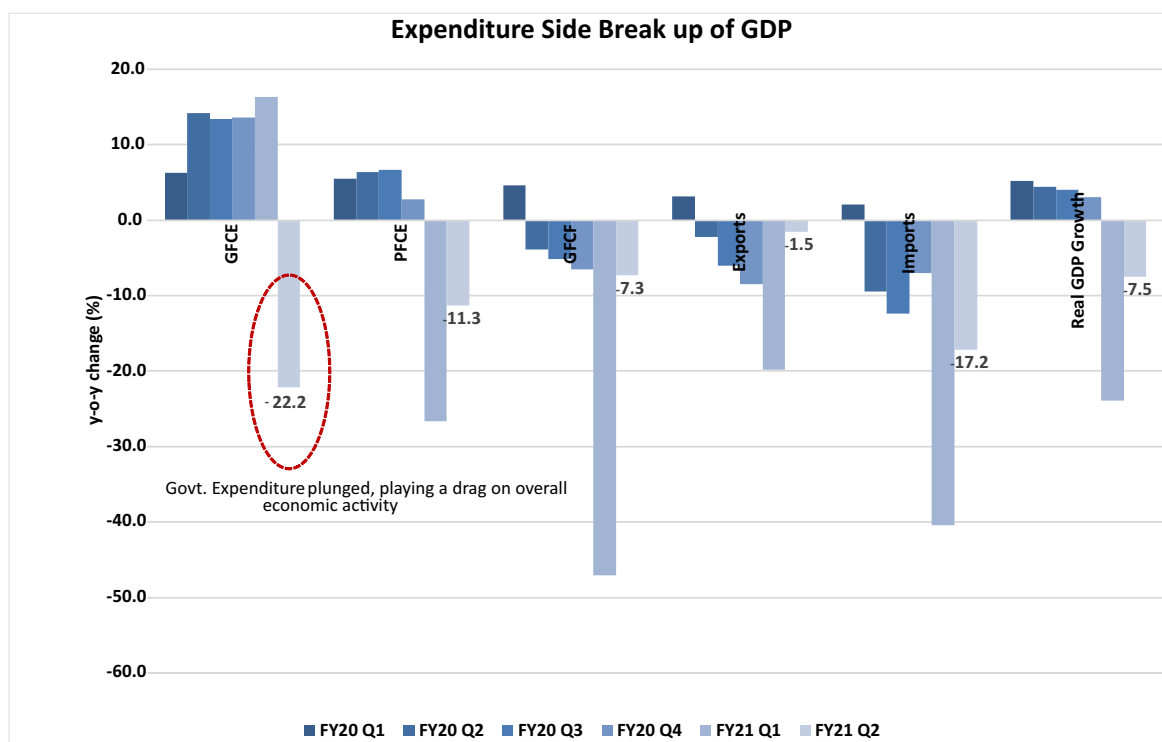
| GVA at basic prices from (y-o-y %) | 2019-20 | | | | 2020-21 | |
|--|------------|------------|------------|------------|--------------|-------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 |
| Agriculture | 3.0 | 3.5 | 3.6 | 5.9 | 3.4 | 3.4 |
| Industry | 4.2 | 0.5 | -0.3 | -0.6 | -38.1 | -2.1 |
| Mining & quarrying | 4.7 | -1.1 | 2.2 | 5.2 | -23.3 | -9.1 |
| Manufacturing | 3.0 | -0.6 | -0.8 | -1.4 | -39.3 | 0.6 |
| Electricity, gas ,water supply& other utility services | 8.8 | 3.9 | -0.7 | 4.5 | -7.0 | 4.4 |
| Construction | 5.2 | 2.6 | 0.0 | -2.2 | -50.3 | -8.6 |
| Services | 5.5 | 6.5 | 5.7 | 4.4 | -20.6 | -11.4 |
| Trade, hotels, transport, communication & broadcasting | 3.5 | 4.1 | 4.3 | 2.6 | -47.0 | -15.6 |
| Financial, real estate & professional services | 6.0 | 6.0 | 3.3 | 2.4 | -5.3 | -8.1 |
| Public administration, defence & Other Services | 7.7 | 10.9 | 10.9 | 10.1 | -10.3 | -12.2 |
| GVA | 4.8 | 4.3 | 3.5 | 3.0 | -22.8 | -7.0 |

The expenditure side break - up of the GDP numbers reveal a similar pattern, with a sharp contraction seen in government expenditure (-22.2% in Q2 vis-à-vis 16.4% in Q1). The cut back in government expenditure is seen extending in the third quarter as well, as seen in the monthly expenditure trends, which can be drag on the economic recovery. On the other hand, the contraction in private consumption and gross fixed capital formation narrowed in Q2, in consonance with the uptick in consumer demand and investment activity. However, continued weakness in imports (contraction of 17.2% in Q2) indicates the inherent weakness in the domestic demand and the patchy nature of recovery.

Will the recovery sustain?

The Q2 GDP number has turned out to be far better than expectations, even beating RBI's "nowcast" estimate of -8.6%. This is despite a contraction in government expenditure, leading to optimism that the economy is well on track towards recovery. The recent set of high frequency indicators data released for the month of October (GST collections of over a lakh crore, PMI index at a decade high, robust vehicle sales, surge in e way bills, fuel consumption) may give enough reasons to believe that the optimism is not misplaced. However, it should be noted that the surge in these indicators can be largely attributed to the festive demand and the risk of this demand being transient is a significant one as the season comes to an end. While the worse is certainly behind us, there are a few factors that may pose challenges in the path to recovery.

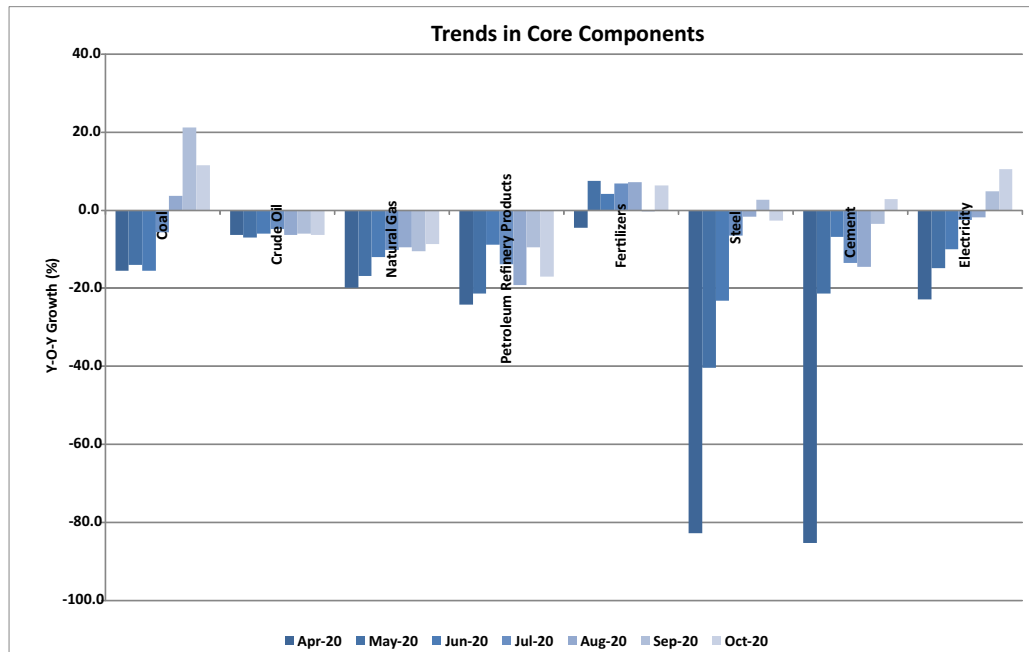
The main driver of Indian GDP is private consumption, which faces significant headwinds as COVID infections continue to remain resurgent and we are still far from vaccines being available at large scales. The investment demand is contingent on domestic consumption and external demand. The external environment is muted with rising infections in US and Europe. And with India keeping out from the RCEP, it will be difficult to find markets in the South East Asian and other countries which are a part of the pact. Another key factor which can give significant leg up to economic growth is government spending. But in our context, government finances are under severe constraint at both Center and the state level. Finally, persistent price pressures in the economy pose a significant risk and can nip the recovery which is still in very nascent stages. All in all, sustainability of recovery needs to be gauged with some caution and all eyes would be on the RBI policy meet to see their interpretation of the recent data release.



Macro Monitor

Core sector bucks the momentum, contracts by 2.5% in October

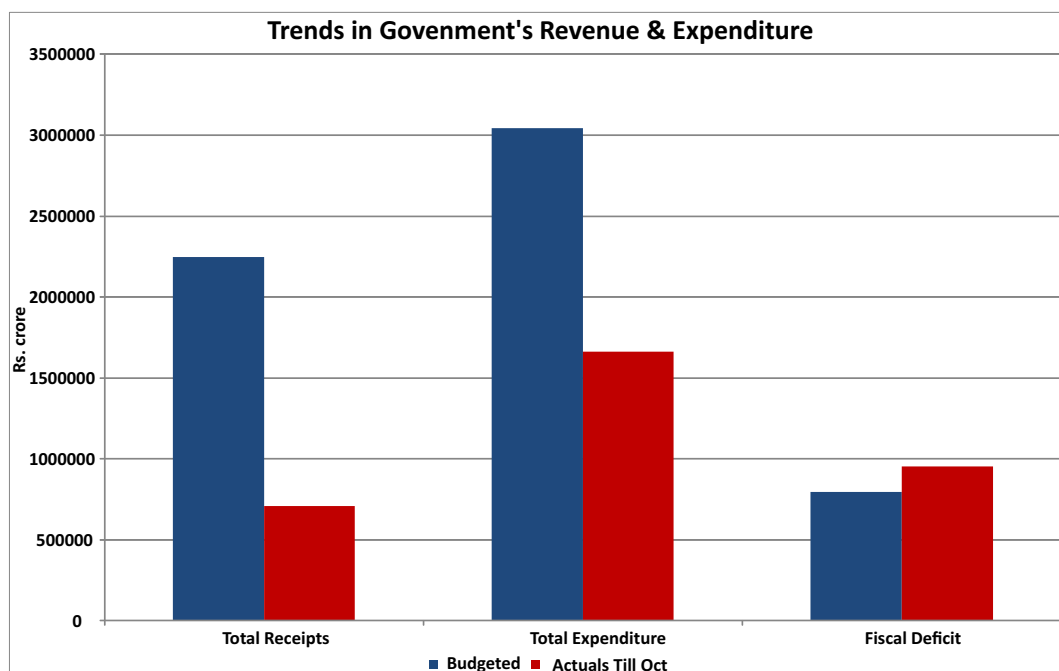
After gaining traction in the last few months, the core sector posted a contraction of 2.5% in the month of October, highlighting the vulnerability in recovery of economic activity. Of the eight sectors which comprise the core sector, coal, fertilizer, cement and electricity recorded positive growth, while crude oil, natural gas, refinery products and steel posted negative growth in the month under review. In last two-three months, Coal and Electricity sectors have witnessed a sustained turnaround as business activity resumed post lifting of lockdowns. However a part of it is also attributable to a low base of the previous year. Fertilizer sector has managed to post positive growth largely on back of a robust agricultural performance. On the other hand, key sectors such as steel, cement, refinery products continue to grapple with weakness, indicating lack of investment demand.



Fiscal Deficit: Revenues continue to trail

The fiscal position of the government continues to remain characterized by flailing revenue realizations with deficit for the period April to October 2020 widening to Rs. 9.53 lakh crore. On the revenue side, net tax inflows stood at Rs. 5.76 lakh crore, which is 35% of the annual target. Non tax revenues also remain muted, with only 30% of the annual target being achieved till Oct'20. And as against the lofty disinvestment target of Rs. 2.1 lakh crore set for the year, only 3% has been achieved.

On the expenditure front, the revenue expenditures remain on track, seeing y-o-y rise of 0.72%, as outgo on account of rural development schemes remain significantly high. While, capital expenditure contracted on y-o-y basis by 1.95%, as government attempts to scale back some part of the expenditure as its fiscal position remains extremely dire.



Fixed Income Outlook

Fundamental View

As expected, G-sec market has been trading in a narrow range of around 10 bps, which continues to remain solidly intact. However, the release of GDP data and a slew of high frequency indicators for October which are largely positive, may induce some caution in the bond markets. The MPC meet which is due later this week on 4th December will be watched out for RBI's interpretation of the latest GDP numbers and the revision of its own growth forecast. Though, growth is still fragile and it's too early to turn overtly optimistic about the recovery, any caution expressed by RBI on inflation and the current levels of liquidity being a risk factor, would be detrimental for the bond markets which are already reeling under a deteriorating fiscal position. Under such a scenario, a break out from the hitherto maintained range of 5.82% to 5.90% looks likely and we expect the old 10-yr paper to trade in the range of 5.92% to 5.98% in the coming fortnight.

Technical View

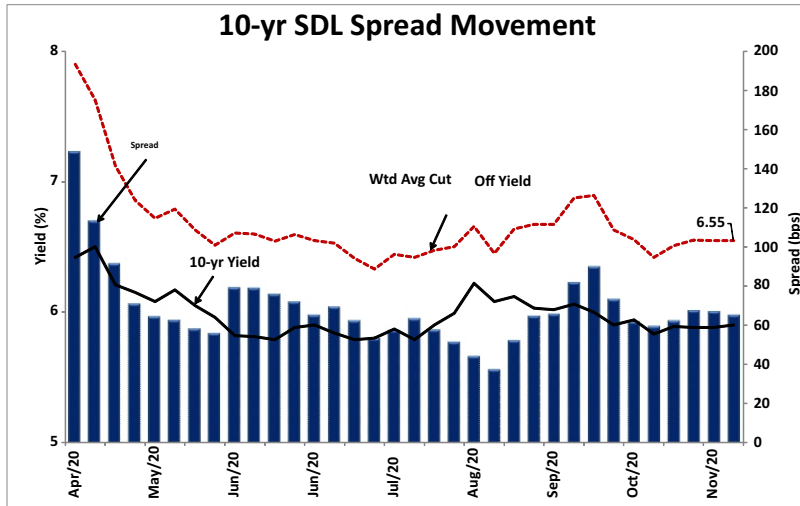
Analyst 1: 5.77% G-Sec 2030 yield settled at 5.91% on Friday's session. Last fortnight, benchmark Yield traded range bound broadly in range of 5.85% to 5.91%.

Momentum oscillator RSI is placed at 54 zone. Benchmark yield is trading near major resistance zone of 5.91%/5.92% which also coincide with upper Bollinger band range, indicating stiff resistance level. However, any closing above 5.92% can take 10yr yield towards 6.00% level. On lower side 5.85% will act as a crucial support zone on any dip in yields.

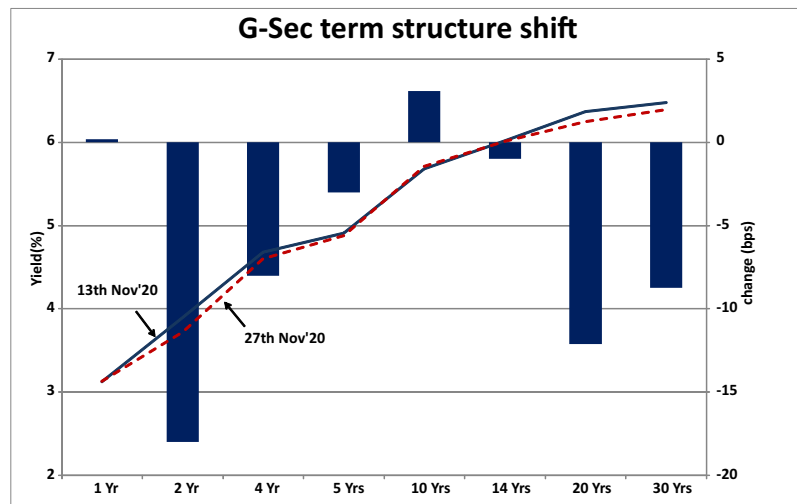


Analyst 2: The price action seems weak as 5.77% GOI 2030 fails to break 5.85% on the lower side. Hence, this time 5.91% resistance might be broken and in that case, we expect this paper to move towards 5.97%. The stop loss for this view would be a closing below 5.85%.

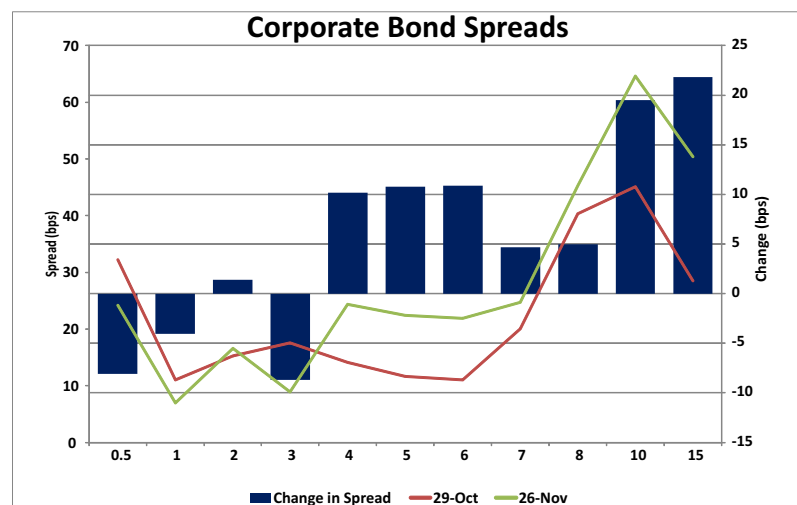
SPREAD MONITOR



SDL spreads are expected to widen going forward on account of heavy supplies expected in the last quarter



Yield curve steepens during the fortnight as excess liquidity in the system pulls down short end rates



Corporate Bond Spreads eased at the shorter end of the curve, benefitting from excess liquidity in the system

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