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SBI Research

Prelude to MPC Meeting on Dec 5-Dec 7
Are globally markets now macro agnostic to the dilemmas in US labour market and Fed hikes?

05-December-2022

See the last page for disclaimer

Global economic outlook

- Recent forecast of global economy show deteriorating global economic outlook
- IMF expects one-third of global GDP to enter contraction
- The global manufacturing PMI remained in contraction zone for the second successive month, as output in the intermediate goods sector fell
- World merchandise trade volume rose by 5.3% year-on-year in August 2022
- However, the Baltic Dry Index, a measure of shipping charges for dry bulk commodities, was down by 16.9% by end October
- **Outlook: Geopolitical uncertainty, synchronized monetary tightening, high energy prices clearly weighing on global growth in Q1 of 2023**

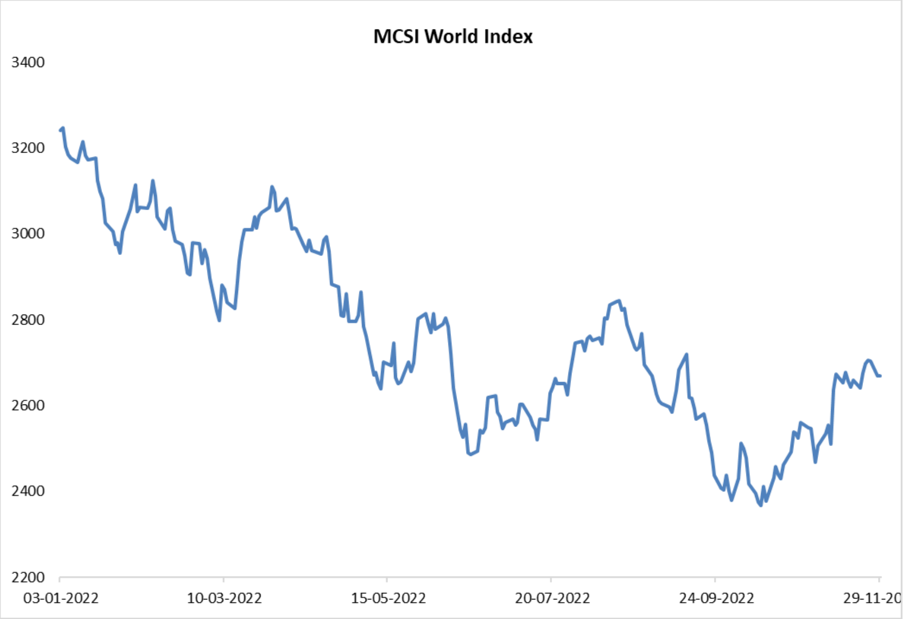
Outlook on Global Asset Prices

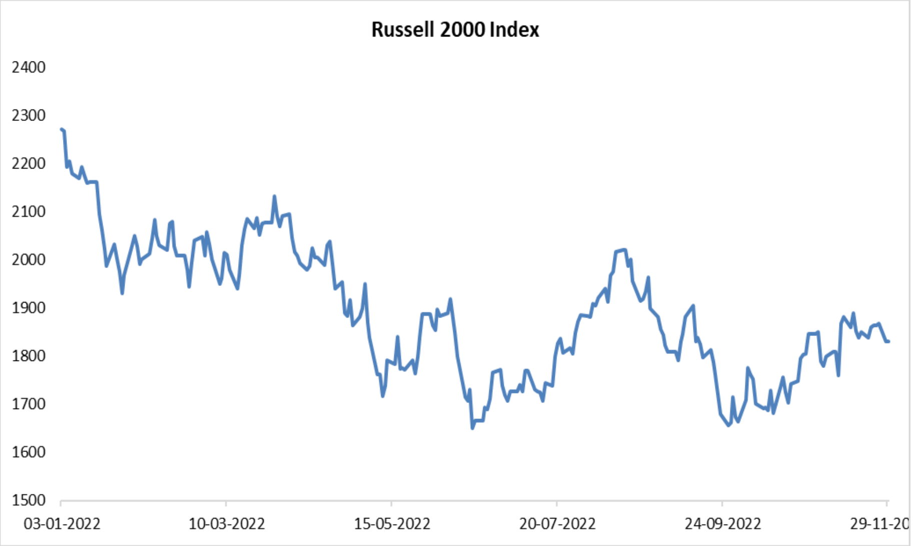
- Global Markets rebounded in November on expectations of more moderate US Fed actions going forward

- The MSCI world equity index ended the month 6% higher than in September, led by the AE sub-index

- In the bond market, 10-year G-sec yields hardened across major AEs reflecting central banks' persisting hawkish monetary policy stance

- **Outlook: Asset prices to display volatility with bouts of bearish and bullish phases**





Key Risks to Track

- IMF has highlighted two major risks to global financial stability:
  - Disorderly tightening of financial conditions; and
  - Debt distress among emerging and frontier economies

- The rapidly spreading Omicron COVID-19 variant in China may dislodge the global demand and supply: China has no coherent strategy to deal with the spread, with health crisis proliferating into eco-political crisis with a rare show of people's angst

- Downsizing of workforce in the IT and software sectors in the US poses risk for EMEs

- How far the global rate cycle will last in 2023

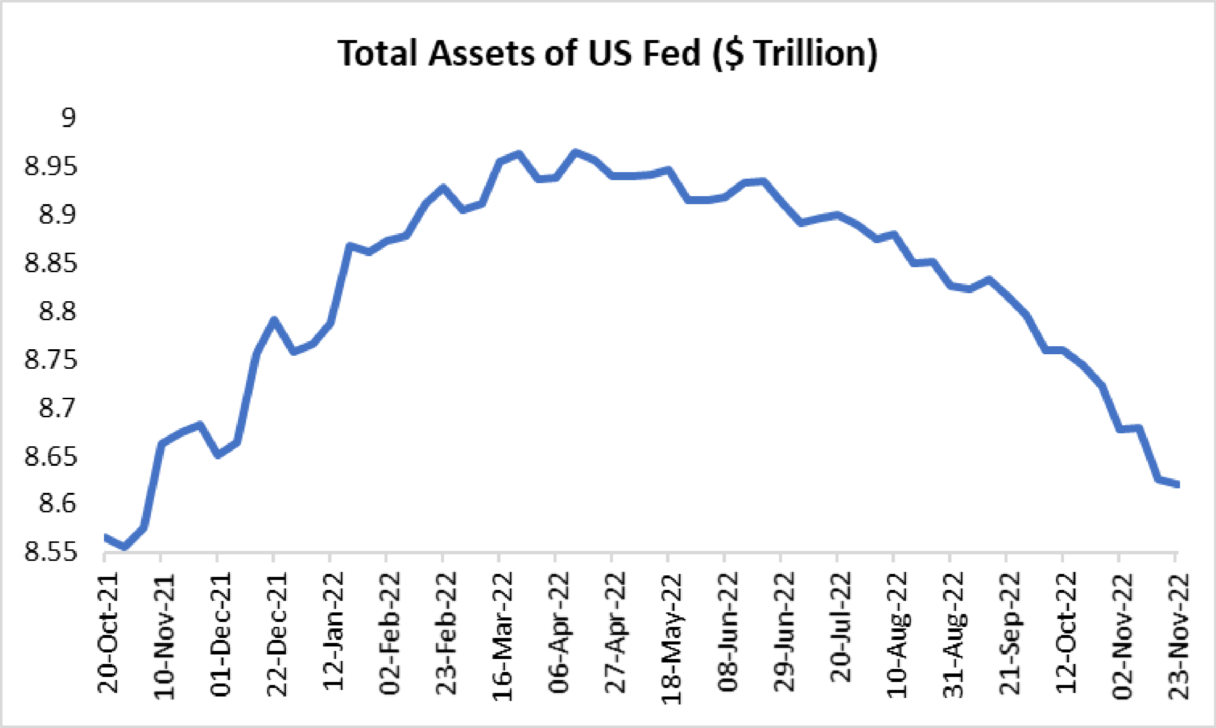
- High consumer price inflation across economies due to sustained cost push pressures from elevated food and energy prices and lingering pandemic-induced supply chain bottlenecks to further impact demand and growth

Global economy: Inflation and Rate Actions

- Consumer price inflation reigns high across economies due to sustained cost push pressures from elevated food and energy prices and lingering pandemic-induced supply chain bottlenecks, although there are signs of inflation easing in a few economies, especially amongst Emerging Market Economies (EMEs)
- Central Banks of most AEs and EMEs continued with their aggressive monetary tightening to bring down inflation, although magnitude of rate hikes seems to have slowed:
  - On November 2, 2022 the US FOMC did a fourth consecutive 75 bps rate hike and communicated that ongoing increases will be appropriate to return inflation to 2% over time
  - ECB and Bank of Canada also frontloaded their monetary policy with a 75 bps and 50 bps rate hike in October
  - UK and Australia raised their policy rates by 75 bps and 25 bps, respectively in November
  - Norway increased its policy rate by 25 bps in November
  - Japan, however, continued to diverge by maintaining an accommodative stance
- In contrast, most EME central banks have continued with policy tightening, although the pace of tightening has decisively slowed for a few countries while few others have even announced a pause in their tightening cycles:
  - Colombia and Indonesia increased their policy rates by 100 bps and 50 bps, respectively, in October
  - Malaysia increased its policy rate by 25 bps in November
  - Brazil went for a pause in its October meeting and maintained its rate at 13.75%
  - In contrast to other EMEs, Turkey had cut its rate by 150 bps in October and China remained accommodative
- Global commodity prices remained volatile in October and early November as slowing global growth dampened demand in spite of the war in Ukraine providing unrelenting upsides

Global Liquidity: How Far US Fed Balance Sheet may Contract?

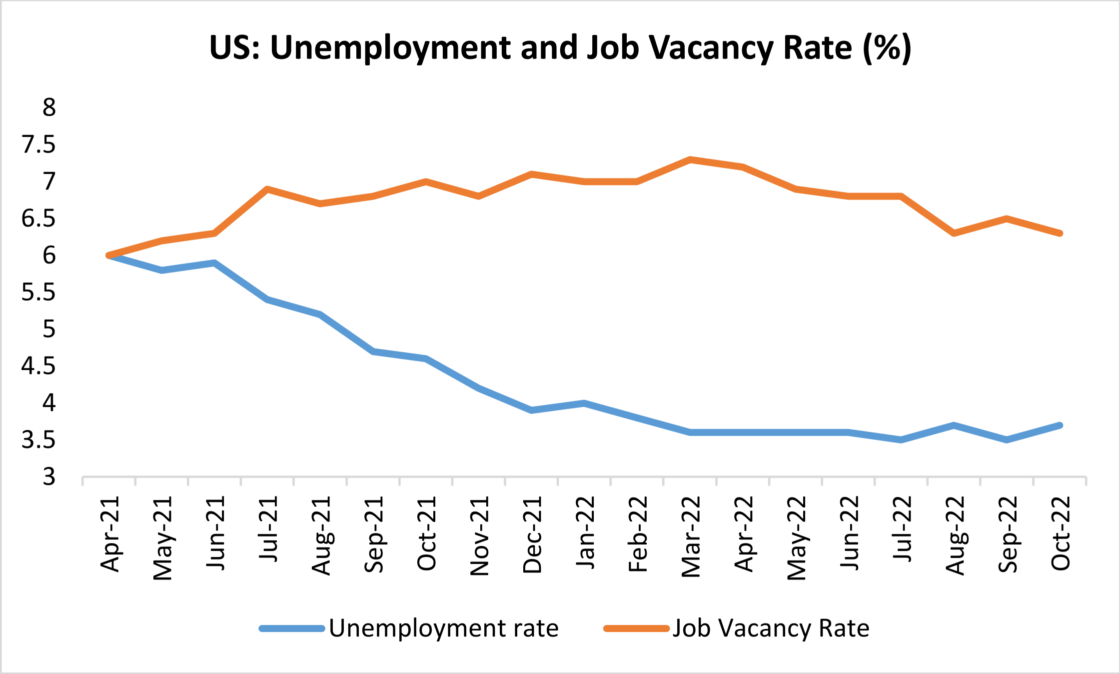
- The US Fed balance sheet that expanded with a faster pace till Apr'22, now is in the contraction mode
- From a peak of $8.96 trillion on 13 Apr'22, it has declined by ~$344 billion to $8.62 trillion recently
- Absent other changes in conditions, as securities holdings/balance sheet decrease/contract, reserve balances decrease. The Fed will need to make sure its level of securities holdings keeps reserve balances "ample," or large enough so that small shocks to the level of reserves in the banking system do not put stress on money market interest rates



Current Regime for US Unemployment Rate/Vacancy rate will last longer for longer: NFP & Wage growth data reveal a continued traction in November too….

Continued strong labour market in the US portends a situation of slow growth and high inflation / Job full recession? ….

- The wide gap between the job vacancy rate (currently at 6.3%) and unemployment rate (currently at 3.7%) in the US currently indicates a strong labour market (also vindicated by significantly high quit rates)
- Fighting inflation will require an increase in unemployment rate and a decline in vacancies. This looks difficult as higher vacancies in the US labour market are a by-product of inadequate skill matching on which Fed has little control
- *"In those circumstances historically, businesses have brought down hiring and reduced openings rather than necessarily laying off workers*" (Fed Vice-Chair: Lael Brainard)
- This is, thus, likely to translate into continued higher nominal wages. This in turn might create a **wage-price spiral**. Hence a moderation in commodity prices may not be enough to halt rising inflation and we might end up in a situation of slow growth and high inflation



Markov regime-switching dynamic regression model: US Labour Market has transitioned to an extended low unemployment and a high vacancy rate regime with a low volatility

- Markov-switching models are used for series that are believed to transition over a finite set of unobserved regimes, allowing the process to evolve differently in each regime. The transitions occur according to a Markov process. The time of transition from one regime to another and the duration between changes in regime is random
- We used the Markov regime-switching dynamic regression model to understand the structural shifts in the US Labour market (as we did in our Aug'22 special report). We have run the Markov regime-switching model for US unemployment and Job Vacancy rate (Jan'18 to Sep'22)
- As per our analysis,
  - Regime 1 (i.e., low unemployment regime) is the current regime in US unemployment rate and
  - Regime 2 (i.e., high job vacancy regime) is the current regime in US job vacancy rate
  - Since it would be unreasonable to assume same variance for both high/low volatile regimes, we have calculated the regime-wise variance also. Accordingly, the volatility of the current unemployment regime 1 is low compared to regime 2

US	Regime	Average	Variance
Unemployment Rate	1	3.7%*	0.18
	2	7.2%	2.79
Job Vacancy Rate	1	4.5%	0.29
	2	6.7%*	0.44
***Current Regime**			

US Labour Market will remain in the current regimes……

- A key characteristic of a Markov-chain is the estimation of **transition probabilities**. **The transition probabilities describe the likelihood that the current regime stays the same or changes**
- Values closer to 100% indicate a more persistent process, or in other words, that it is expected to stay in a given regime for a long time
- Our results indicate that:
  - In the case of unemployment rate: Regime 1 / Low Unemployment Rate is the persistent regime with a 97.8% probability!!!
  - In the case of job vacancy rate: Regime 2 / High Job Vacancy Rate is the persistent regime with 97.8% probability!!!
- **Low unemployment and high job vacancy rate may continue to define the US Labour market and the Fed will thus continue to hike rates**

US Unemployment Rate: Transition Probabilities		
From/To	Regime 1	Regime 2
Regime 1	97.8%	2.2%
Regime 2	6.1%	93.9%

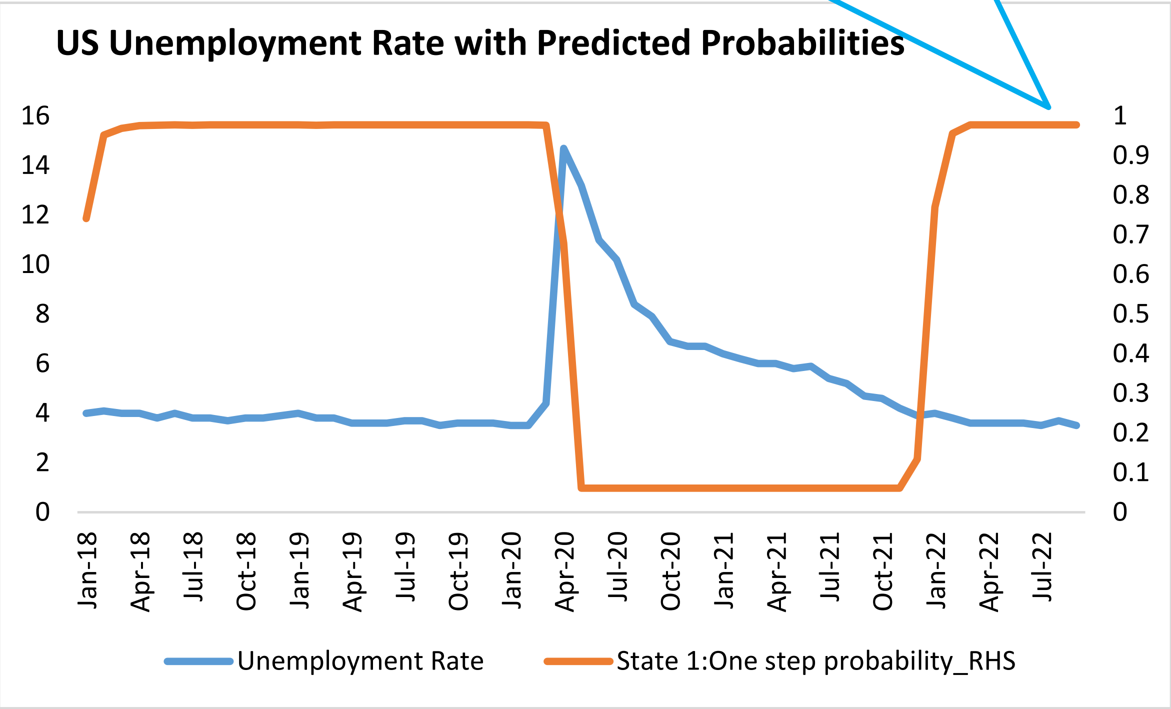
US Job Vacancy Rate: Transition Probabilities		
From/To	Regime 1	Regime 2
Regime 1	98.4%	1.6%
Regime 2	2.2%	97.8%

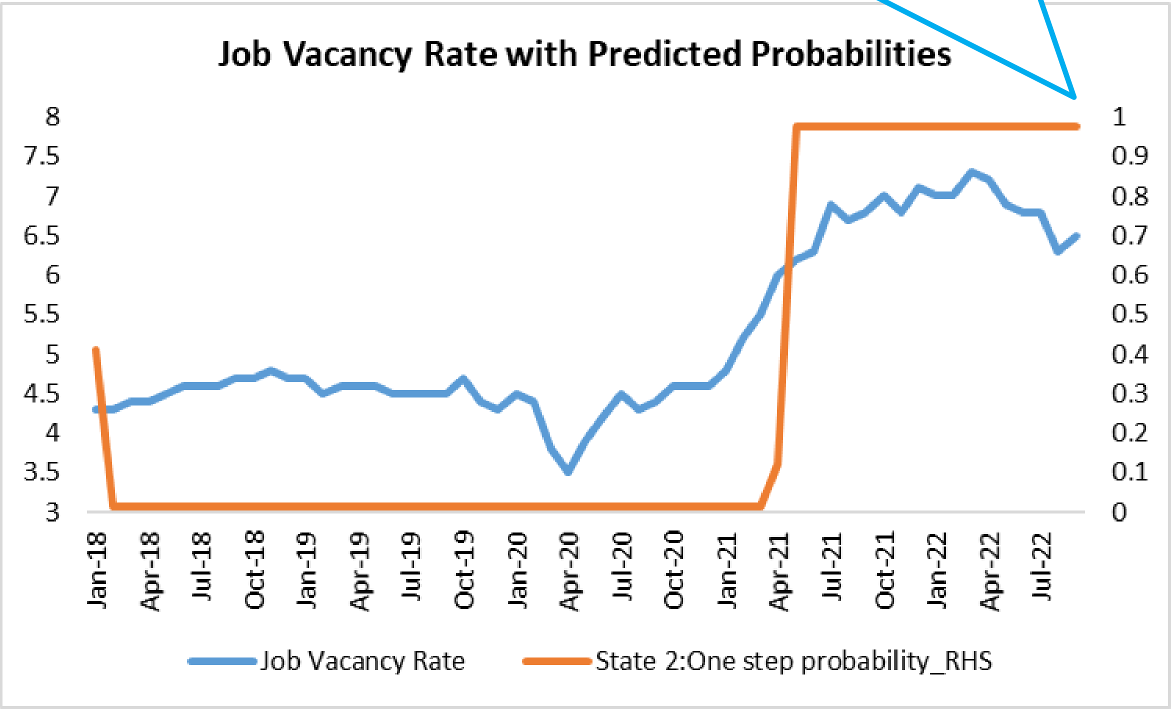
Technically, Current Regime for Unemployment Rate/Vacancy rate could last much longer

- We also predict the probability of being in the various regimes. We have only two regimes, and thus the probability of being in (say) regime 1 / regime 2 tells us the probability for both regimes
- Apart form this, we have predicted **the expected duration of the current regime (i.e., average time it spends in a given regime)** for both US unemployment rate and job vacancy

As per the estimate, the current regime of low unemployment **will last for another 21 months from Sep-22**

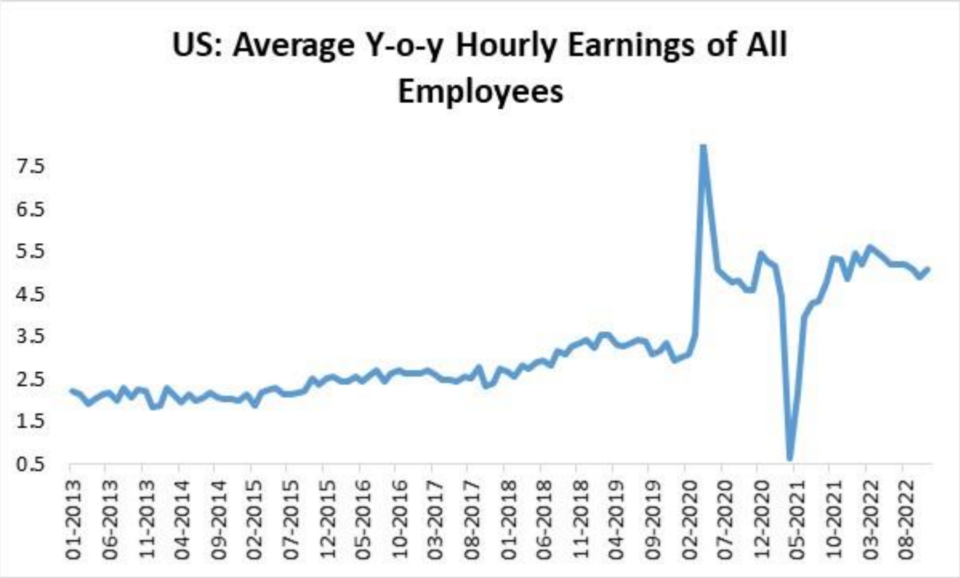
In case of job vacancy rate, the current regime **will last for another 26 months from Sep-22**

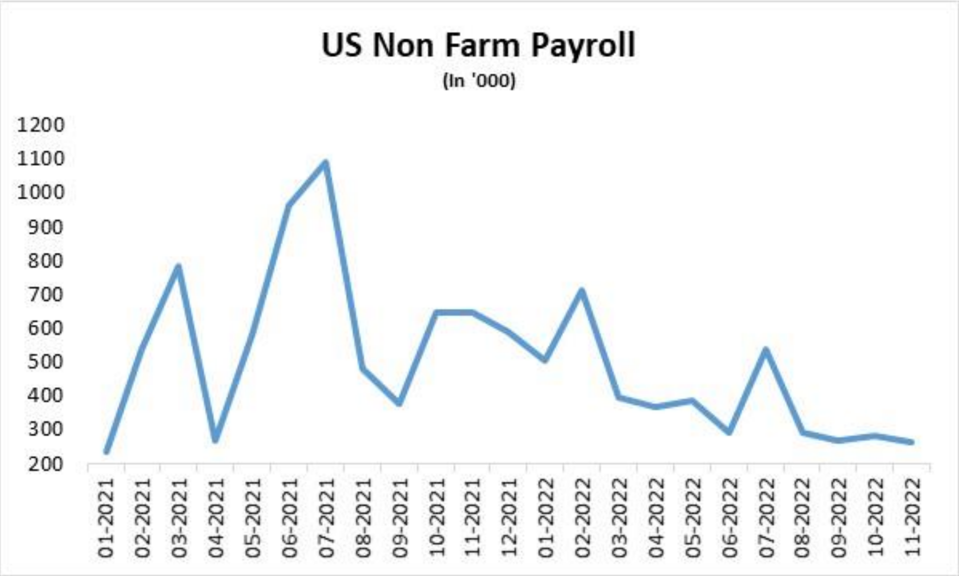




Wage Price spiral suggesting further rate hikes by US Fed beyond the terminal rate of 5%?

- Higher than expected drop of US October 22 CPI showed headline inflation dropping to 7.7% instead of market expectation of 8%. Core inflation accelerated just 0.4% instead of market expectation of 0.6%
- There was a good reason to believe that US inflation has showed signs of peaking and it is coming under control till the US NFP data released on Dec 2nd showed US Non-Farm payrolls was 263K in November against the expectation of 200K, and 284K in October
- Recent wage growth data shows in November wages expanded by 5.1% on a y-o-y basis with a sequential increase of 0.6%, fastest since Jan'2022. Are rising prices increasing demand for higher wages and leading to higher production costs and further upward pressure on prices creating a spiral?.......
- …. Fed may have to pursue rate hike cycles though of smaller magnitudes….. as reflected in increasing wages, stagnant unemployment rate, and increasing job openings…rate cycle getting longer and might stretch beyond February 2023….





The story of Missing Men in US labour force… and hence the current extreme tightness…

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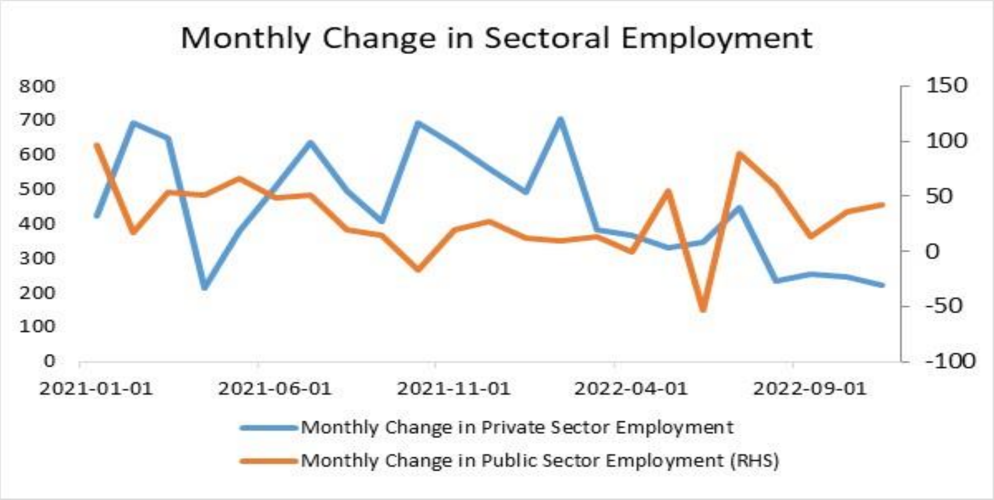
- Declining Non-Farm Payroll might be linked with mysterious case of Missing Men from US labour force
- A recent report by the US Council of Economic Advisers stated that out of 83% of people in the prime working age of 25-54 (at Feb 2020 level), who are currently not in labour force this year were also not in labor force a year before, implying around 10 million people are missing from the workforce
- The primary reason for missing men is weak labour demand for non college educated and less skilled workers post pandemic
- Curiously, lesser people are entering into private sector jobs due to lack of safety nets and are in search of public sector jobs
  - However, private sector jobs still account for around 84% of payroll in a month… down from 95% in September…
- With no increase in public sector job vacancies, missing men & women are not able to join public sector jobs out of compulsion, and private sector jobs out of choice



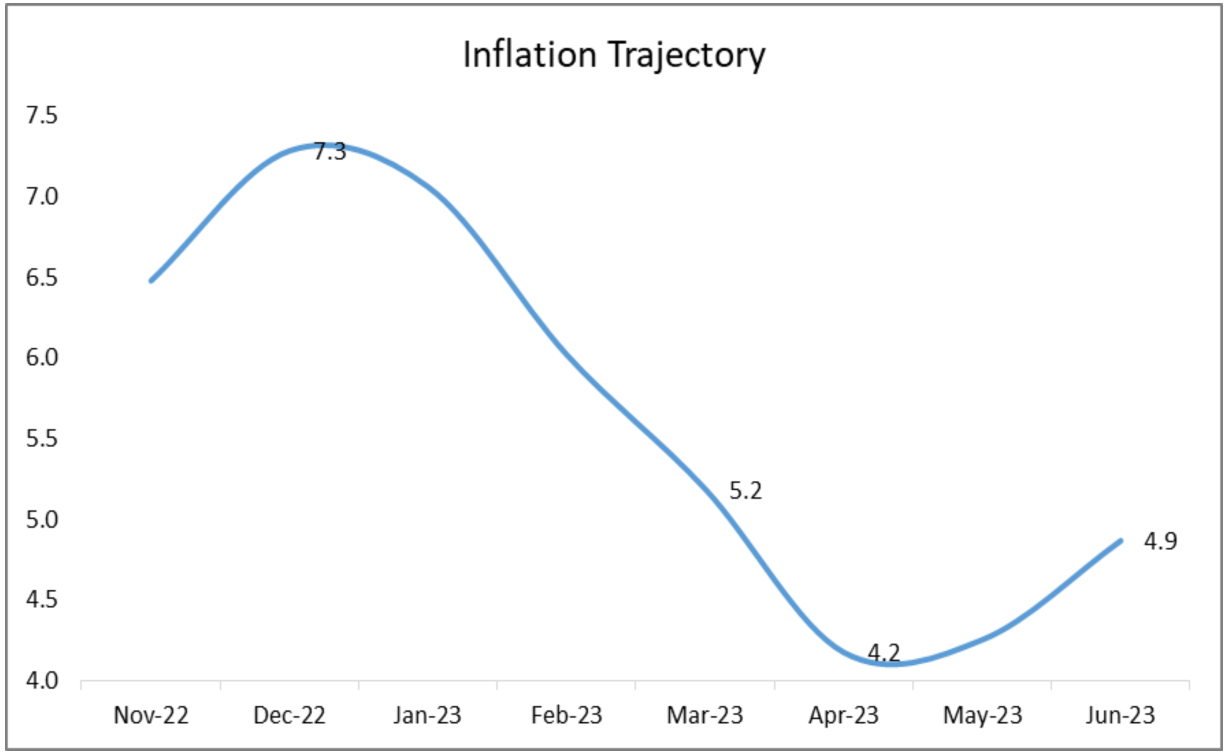
Domestic Conditions

Inflation: No fears from unseasonal rains

- The fear of impact of unseasonal rains on CPI inflation (particularly on food CPI) is likely to be unfounded. While India had received a staggering 54% above normal rains in Oct'22, during Oct-Nov'22 India's excess rainfall was only 23% above normal… Farmers have become smarter and more tuned to ground realities…For example, crop of larger duration are being planted to take care of unseasonal rains….
- However, the vegetables' arrival since Oct till date indicates that the country received 9.8 lakh tonnes vegetables so far as compared to 6.8 lakh tonnes in 2021 (same period)- 44% increase….
- As per our estimate, inflation will be on downward trajectory post Dec'22. Mar'22 CPI should be around 5.2%

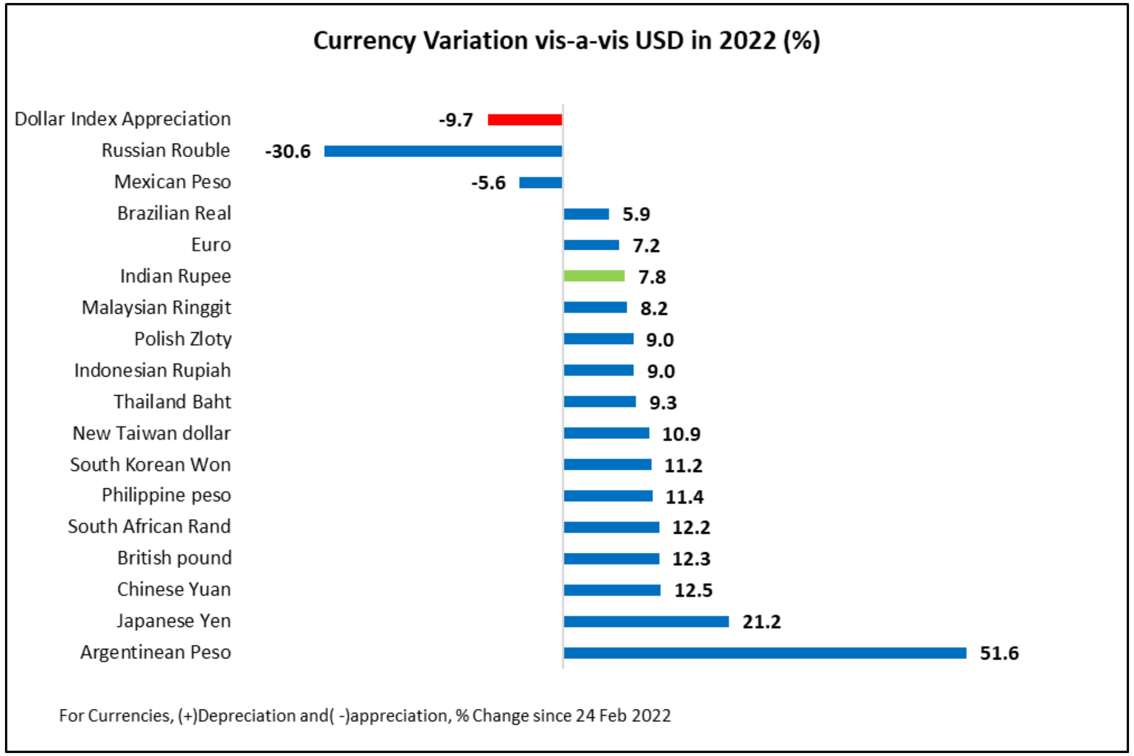
Unseasonal Rainfall: % Deviation from Normal				
	Oct-30 Nov			
	2019	**2020**	**2021**	**2022**
Haryana	34	-51	83	174
Madhya Pradesh	20	-52	38	119
Rajasthan	156	-61	119	105
Uttar Pradesh	-34	-81	156	361
Uttarakhand	33	-77	381	220
India	**32**	**1**	**48**	**23**
Memo: Food inflation during Nov-Jan (%)				
Average Food Inflation	10.9^	5.1	4.2	7.7*
Average Vegetable Inflation	48.9	-3.6	-3.8	12.97*
Vegetable arrival (sum of weekly arrival in tonns)	681471	460440	680091	981507

Source: CEIC; SBI Research; ^ increased from 4.9% in preceding three months; *Sep-Oct



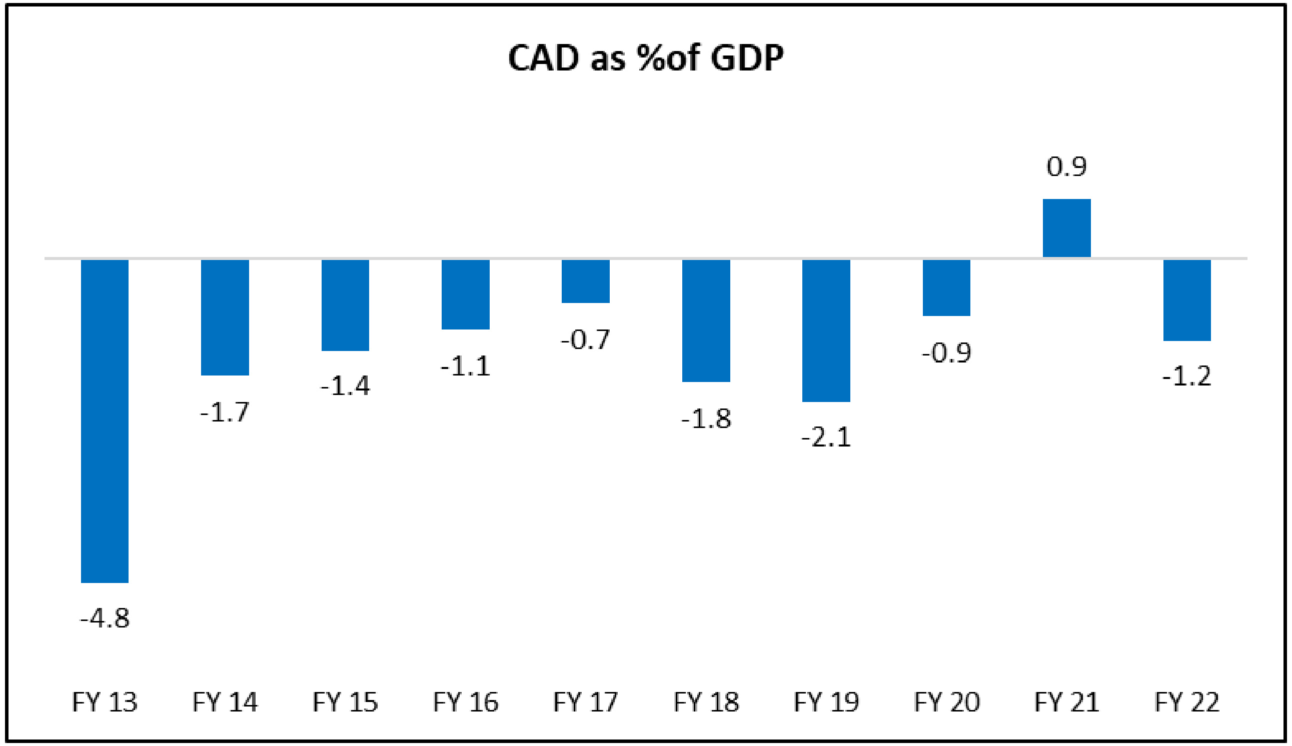
Rupee to remain anchored at close to current levels as RBI recoups dollars at every possible opportunity

- Indian rupee has entered a **phase of unmatched maturity**, if one has to go by its recent resilience in the face of Dollar rout that decapacitated currencies from DM pack mercilessly
- The 'less fall' of the rupee post the Ukraine war that upped the ante on energy and commodity fronts and clogged the supply lines has been a testimony to the renewed prowess of Indian economy and our policy makers who have taken pains to chalk out strategies and plans to keep the country largely immune from the external material shocks
- The depreciation of rupee, around 7.2% only since war has given credence to theories that IT'S NOT A WEAK CURRENCY any more



CAD for FY23 could still be closer to 3% of GDP

- In Q1, India’s CAD was expected to breach $30 bn / 3.8% of GDP, but the actual numbers came in at 2.8% of GDP. The positive surprise was because of strong remittances and software exports, the CAD got a lift of 60 basis points
- We expect that if such trends of strong remittances and software exports have continued (RBI data suggests software exports in Q2 was strong) in Q2, and India’s CAD comes in below the threshold level of 3.5% of GDP in Q2, **the CAD for FY23 could still be closer to 3% benchmark or lower and not in excess of 3.5% of GDP**



Domestic Liquidity: Liquidity has again turned into moderate surplus

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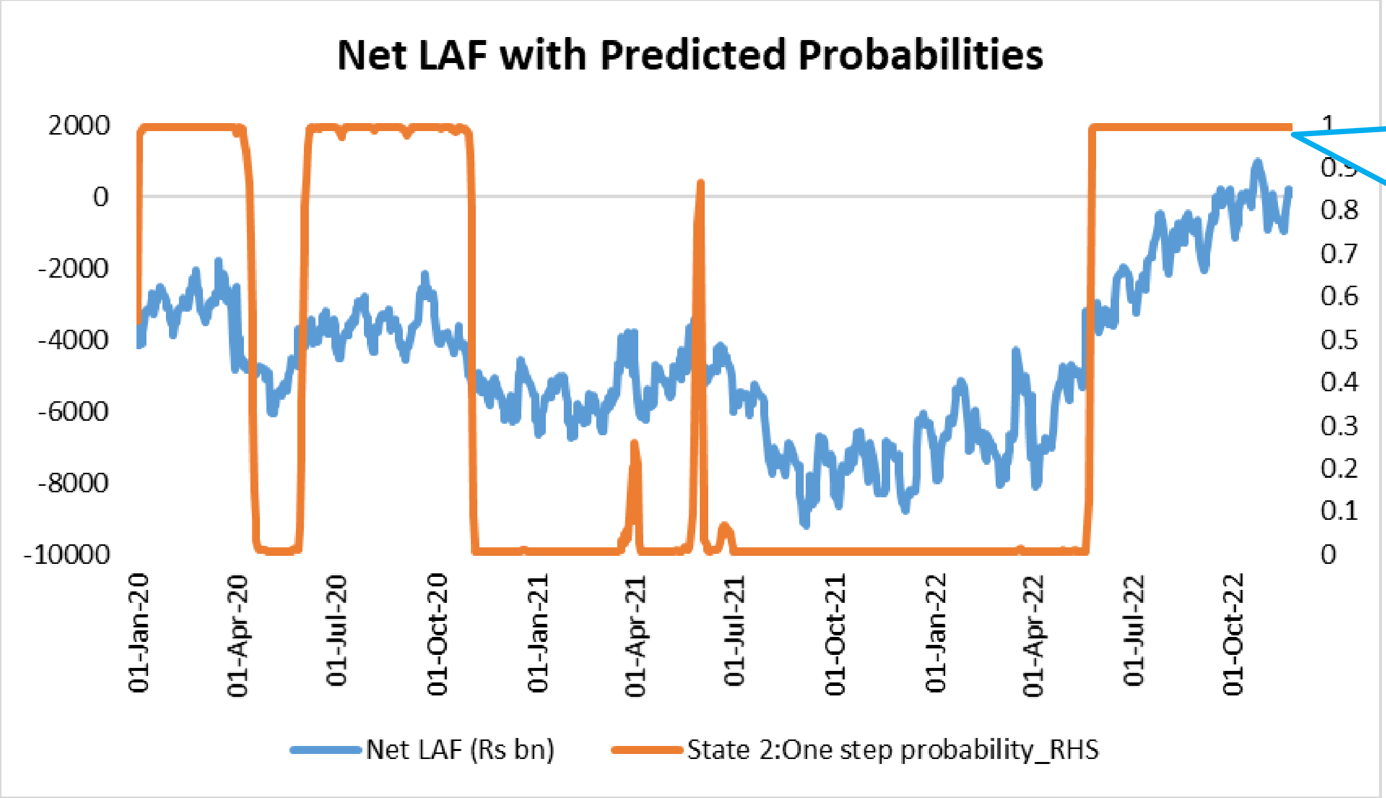
- Liquidity inflows to the financial system could be either policy induced by the central bank (for example changes in reserves, open market operations etc) or non-policy induced (foreign exchange reserves, government cash balances, and currency in circulation)
- Liquidity in the banking system that remained in deficit mode of an average of Rs 0.54 lakh crore (during 20-31 October), surprisingly turned positive in November with an average surplus Rs 0.41 lakh crore. The immediate reason for such was a decline in recourse to MSF window by bank
- By March-end, we expect that the system might be in liquidity deficit within tolerable limits if there are no liquidity injection / withdrawals

RBI Liquidity Position (Rs lakh crore)				
	01-Apr-22	**30-Sep-22**	**Average from last MPC till date**	**Latest**
Repo Outstanding	0.84	0.84	0.84	0.84
Reverse Repo Total	6.78	0.48	0.35	0.52
SDF statrted on 08.04.2022	2.35	1.11	1.05	2.20
MSF	0.01	0.18	0.84	0.00
Net LAF (+absorption)	6.35	0.33	0.29	1.68
Government Cash Balance	1.08	2.61	2.55	1.06
Core Liquidity (+Surplus)	8.32	3.62	2.90	2.72
Rates				
Call Rate	3.25	5.98	6.00	6.03
Treps	3.13	6.02	5.91	6.09
91-T bills Yield	3.84	6.18	6.33	6.32
182- T Bills Yield	4.27	6.64	6.68	6.69
364- T bills Yield	4.58	6.80	6.87	6.80
1 Year Gsec	4.67	6.70	6.83	6.93
5 Yrs Gsec	6.33	7.32	7.23	7.07
10 Yrs Gsec	6.84	7.40	7.38	7.22
Source: RBI, Bloomberg, SBI Research				

Markov Switching indicates that the liquidity is currently in a LOW deficit mode and will remain so at least for next 3 months… RBI could recoup further reserves



The current state of LOW Deficit in Net LAF will last for ~90 days (expected duration) from today based on Markov regime switching dynamic regression model. **However, the LOW deficit regime is more volatile than the HIGH deficit regime**

Rs Billion	Regime	Average	Variance
Net LAF	1	-6069	1183
	2	-2700*	1344
***Current Regime**			

Final Thought: 35 bps is the new normal….

- So, what will be the RBI's policy look like:

Indicator	Our View
Repo rate	• We expect the RBI to hike rates in smaller magnitude in December policy attuned to emerging market central banks and the overall rate setting tone • A 35-bps repo rate hike looks imminent • We believe at 6.25%, it could be the terminal rate for now…
Stance	• If the current Government cash balances is any indication.. At Rs 1 trillion… might force RBI to change stance to neutral purely on technical grounds.. However…given that Government cash balances is unlikely to decline any further as budget nears & Government cognizant of fiscal deficit in FY23 & capital inflows continuing.…& US labour market continued tightness forcing Fed's hand to raise rates beyond Feb 23, it may not be just yet to change the stance for RBI as it might confuse the markets…The good thing is that with capital inflows picking up rapid pace in November, liquidity could get an unlikely buffer of rupee injection in lieu of $ purchases / building up reserves by RBI
Risks for growth/inflation	• US Labour Markets are showing uncanny knack of not correcting soon from low unemployment rate, high vacancy rates and high wage growth. This could mean Fed extend its rate hikes beyond February 2023 and take the terminal fed fund rate beyond 5% • Is 5% or beyond, the new Fed Fund Target rate?.... • This will keep the boil on emerging market central banks to follow Fed though markets seems to have largely become agnostic to macros globally.…35 bps may be the new normal and markets will be happy to accept that.…this will keep capital flowing into emerging markets…
Forward Guidance	• In an environment of rising rates, it is clearly not advisable to give a forward guidance

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