UNION BUDGET FY22: Growth over Fiscal consolidation…

In the backdrop of a year, where the economy faced unprecedented challenges and stress due to the pandemic, this was one of the most anticipated Budgets in the last few years. The Government faced a dilemma of either propelling growth through incremental spending (and in turn a higher borrowing) or continues on the path of fiscal consolidation. With the intention of bringing the economy back on track, the Government picked Growth over Fiscal consolidation.

The most noteworthy point is the growth in capital expenditure. Capital expenditure is budgeted at INR 5.54 trillion, accounting for a robust growth of 26.2% led by an increase in spending on infrastructure. In addition to steps taken last year to increase transparency where extra-budgetary borrowings were provided separately, the Government has decided to discontinue the NSSF loan to FCI for food subsidy and making relevant budget provisions. The nominal GDP growth for FY2022 is expected to be 14.4%. Another notable announcement was the creation of a Development Financial Institution (DFI) by providing an initial capital of INR 200 billion, with aim of creating an INR 5 trillion loan book. Additionally, debt financing of InVITs and REITs by FPIs is now allowed, providing another avenue of funding. The Government also aims to monetize some of the infrastructure assets which would further allow spending on capex.

On the Revenue front, Direct Tax collection is expected to grow by 22.4%, while Indirect tax revenue is expected to grow at a modest 11%. Non-tax revenue is expected to grow by 15.4% led by higher dividends from PSUs. Divestments have been budgeted at INR 1.75 trillion, with some of the pipelines of FY21 having being shifted to the next fiscal. Divestment of BPCL, Air India, Shipping Corporation, IPO of LIC and stake sale in two PSU Banks and one insurance company are expected to be completed in FY22. All in all, the Revenue expectations look credible and targets under each head seem achievable.

Given, the focus on growth, the Government borrowing numbers have increased significantly. The revised fiscal deficit for FY21 is 9.5% against an initial estimate of 3.5%. Additional borrowing of INR 800 billion for the remaining part for FY21 has clearly caught the markets by surprise. Similarly, against market expectations, the fiscal deficit number for FY2022 is pegged at 6.8% of GDP, with a gross borrowing number of INR 12 trillion. To further push growth in the coming years, the glide path for fiscal consolidation has also been relaxed (with an amendment to the FRBM Act), and the fiscal deficit is expected to reach 4.5% by FY26.

As can be expected with such a growth-focused budget, bond markets immediately sold off with yields flying higher by 15-35 bps across the curve with the 2-5 year part of the curve selling off the most. A similar impact was seen in Corporate bonds as well. Markets then turned their hopes on the RBI, and its intent and ability to reassure the markets. However, as it turned out, the RBI's MPC meeting on 5-February ended up disappointing the markets.

MONETARY POLICY REVIEW – February 2021

The Monetary Policy Committee (MPC) came out with their bi-monthly policy statement on 5-Feb. Some of the key announcements are as follows:

- The MPC members unanimously voted for keeping the policy rates unchanged
- The MPC also unanimously decided to continue with an accommodative stance as long as necessary (at least during FY2021 and into FY2022) to revive growth on a durable basis and mitigate the impact of the pandemic on the economy, while ensuring that inflation remains within the mandated target band going forward
- With a growth-driven Budget announced by the Government, the RBI expects real GDP to grow at 10.5% in FY2022, with a range of 26.2% to 8.3% in H1 FY2022 and 6% in Q3 FY2022
- The projection for CPI inflation has been revised to 5.2% for Q4 FY2021 (from 5.8% earlier), 5.2% to 5% in H1 FY2022 (from 5.2% to 4.6% earlier) and 4.3% in Q3 FY2022

Some of the other non-policy related announcements are as follows:

- The CRR cut of 100 bps which was effective till March 26, 2021, will now be gradually restored in a phased manner. Banks will have to maintain 3.5% CRR from Mar 27, 2021, to May 21, 2021 and 4% thereafter
- In Sep 2020, RBI increased the HTM category for Banks from 19.5% to 22% of NDTL in respect to SLR securities. This dispensation was earlier till Mar 2022, but has now been pushed to Mar 2023, providing greater flexibility to Banks to plan their investments
- Retail investors will now be allowed to participate in the G-Sec market, both in primary and in the secondary market
- FPIs will now be allowed to invest in defaulted bonds which will be exempted from short term limits

The Governor emphasized that the RBI stands committed to ensuring ample liquidity in the system in consonance with the monetary policy stance. Additionally, the Governor also reiterated that the RBI will ensure that the market borrowing goes through in a non-disruptive manner.

Although, the RBI Governor tried to comfort the market on liquidity and yield movements, market participants were expecting more clarity on the calendar, quantum and schedule of open market operations which the RBI would conduct to absorb the increased supply of dated securities both in this financial year and the next one. However, in absence of any such announcements, yields shot up across the G-Sec and Corporate Bonds.

MARKET PERFORMANCE

The 10-year benchmark G-Sec yield closed at 5.91%, up by 05 bps from its previous close of 5.86% while that on the short-term 1-year bond ended 20 bps higher at 3.65%.

In the corporate bond segment, yields rose across the yield curve over the month. The 10-year AAA bond yield ended 05 bps higher at 6.62%, while the short-term 1-year AAA bond yield ended 10 bps up at 4.05%.

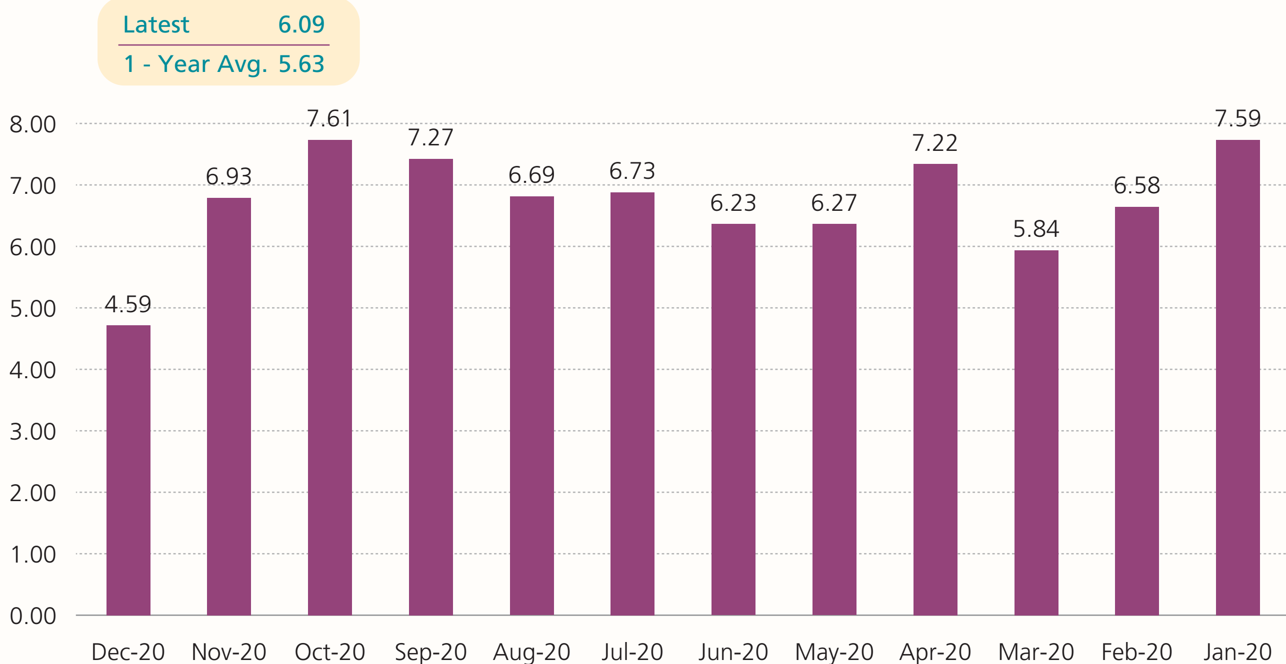
The spread between 1-year and 10-year AAA bonds narrowed. Within the short term segment, the yield on 3-month commercial paper (CP) was at 3.70% while 1-year CP yield was up 10 bps at 4.05%.

MACRO-ECONOMIC DEVELOPMENTS

PMI: India's manufacturing industry started the year 2021 on a strong note with Manufacturing Purchasing Managers Index (PMI) for the month of January at 57.7, reflecting the strongest improvement in three months, according to the latest survey by IHS Markit.

Inflation & IIP: Retail inflation was 6.93% in Nov 2020; food inflation declined to 3.41% in Dec in 2020, compared to 9.5% in the previous month. Separately, the factory output, which is measured in terms of Index of Industrial Production (IIP), contracted by 1.9% in November.

Export: Cumulative exports during April-January 2020-21 exhibited a negative growth of 13.66 per cent at $228.04 billion, as compared to $264.13 billion during the same period last year.



MARKET OUTLOOK

We believe the RBI will have to offer much clearer guidance and support to the bond markets, given the huge government bond supply, that's pending in rest of FY21 and the whole of FY22. If the market's confidence in RBI's intent get shaken, these worries can manifest themselves in a sudden sharp spike in yields across the curve, making it that much harder for the central bank to control later. We expect the RBI to comfort the markets over the coming weeks through appropriate signaling, which we expect will lead to stabilization of interest rates post the sell-off over the past few weeks.

Following the upward move in interest rates, the carry in the 2-5 year part of the G-Sec and AAA curve is a lot more attractive and offers good value and buffer to absorb the gradual normalization of rates that is likely over the coming few years. The 10-year G-Sec benchmark, which had been trading in a 5.75-6% range for the past many months, has now convincingly broken past the 6% barrier. ***With the economy now picking up, core inflation likely to remain above 5% and the huge borrowing program announced in the budget, we believe yields are likely to now trade in a higher range of 6-6.5% range, with RBI being forced to take aggressive supportive measures to ensure that rates remain in the lower end of that range.***

Source: MOSPI, Internal, Bloomberg

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