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Issue No. 13, FY20
Date: 04 June 2019

WHY GROWTH NUMBERS MAY DICTATE LARGER RATE CUT

The discourse on growth is becoming more shrill, be it domestic or global. India's Q4GDP numbers came in at 5.8%, and it is likely that growth rate will stay below 6% at least in H1FY20, only to recover in H2FY20.

Global growth is fast turning out to be an Achilles' Heel. The trade war is becoming more severe with US getting more impacted simultaneously. For example, more than 800 U.S. food and agricultural products have been subject to retaliatory tariffs from China, the EU, Turkey, Canada and Mexico. This could be a reason for the slowing exports growth of agricultural products from US and US exports contracting more than US imports. With nearly 20% of farm income derived from exports, trade war will thus impact the US farmers to a considerable extent. Based on anecdotal evidence, we now expect that US may plunge into a slowdown mode possibly towards the end of 2019. Markets now expect that the US Fed will cut rates in quick succession. A June cut probability was 6% last week, now it is 32.4%. July cut probability is 65% and September cut probability is 95%.

Domestic growth impulses remain very weak. Firstly, the percentage of leading indicators showing an acceleration is below 50% since January. Out of 1623 entities that saw rating action in terms of rating upgrades and downgrades for all rating agencies for the period 1April 2019 to 31st May 2019, the number of entities downgraded surpassed the upgrades. With the Government bound by model code of conduct during elections, it is possible that industries like Construction may have higher receivables now, but it is likely to improve with better Government spending in the coming months. Corporate results have also been lackluster in Q4FY19.

Against this, we expect a rate cut of at least 25 bps in the forthcoming policy, if not more. We expect RBI to spell clearly its stand on how a large cut if impacted will lead to better transmission: will the banks be now mandated for benchmarking their asset and liability moving together? Otherwise, banks will not rate cut deposit rates given the huge currency leakage. The other argument of bringing down the deposit rates if the Government cuts deposit rates on small savings is difficult, as small savings now finance 20% of fiscal deficit, as against 2.5% in FY14. Clearly, the reliance on such schemes has increased manifold with the Government reducing its reliance on market borrowings. We thus believe a larger rate cut coupled with specific instructions on liquidity (middle ground of a CRR adjustment, the impact of which is instantaneous) coupled with a budget laying down a manageable fiscal consolidation roadmap will help rev up the economy.

RATING UPDATE

- Out of 1623 entities that saw rating action in terms of rating upgrades and downgrades for all rating agencies for the period 1 April 2019 to 31st May 2019, the number of entities downgraded surpassed the upgrades with wide disparity across rating agencies in term of ratio of upgrades to downgrades [U/D ratio]. Rating action of two rating agencies had higher downgrades as compared to upgrades with U/D ratio below 0.5x affecting the overall ratio.
- Industries such as Real Estate, Gems & Jewellery, Construction and Diversified reported U/D ratio below 0.5x. Industrial Machinery and Consumables, Iron & Steel and Auto Component & Ancillary were close to 1x.

GLOBAL GROWTH SLOWDOWN

- A recent IMF document has stated that at the global level, the additional impact of the recently announced and envisaged new US-China tariffs, will subtract about 0.3% of global GDP in the short term, with half stemming from business and market confidence effects.
- USA has also recently announced that 5% tariff will be imposed on all imported goods from Mexico beginning June 10.
- India is also facing the ire of President Trump, with more than 10% of India's exports to USA getting impacted due to termination of GSP privilege.
- Global headwinds are unfavourable, except for the positive impact that could happen on India's CAD due to declining crude, which has within a span of 6 days crude declined from $70/bbl to $61/bbl (likely to go below $60).

Rating Actions (all rating agency) in last two months (April'19 & May'19)

Industry	No of Entities		U/D Ratio
	Upgrades	Downgrades	
Construction	49	119	0.41
Textile	43	76	0.57
Traders	22	44	0.50
Diversified	17	42	0.40
Independent Power Producers & Energy Traders	32	42	0.76
Education Services	19	38	0.50
Agriculture - Others	23	31	0.74
Iron & Steel	28	31	0.90
Residential Real Estate Development	9	29	0.31
Electrical Components & Equipment	19	27	0.70
Health Care	10	24	0.42
Industrial Machinery and consumables	24	24	1.00
Trading	15	24	0.63
Gems & Jewellery - Diamond Jewellery & Retailing	8	23	0.35
Auto Components and ancillary	19	21	0.90
Others	275	416	0.66
Total	**612**	**1011**	**0.61**

Source: CRISIL Ratings; SBI Research; U/D ratio - upgrade to downgrade ratio

US MAY PLUNGE INTO RECESSION: BUT HOW QUICKLY IS THE QUESTION

- A consensus is yet to emerge when US could turn into a slowdown mode following the yield curve inversion last week. There is an interesting relationship between US inverted yield curve (i.e. 10 year G-sec yield minus 1 year yield) and US recession. If we analyse the data since 1950s, it is clearly evident that recession in US follows inverted yield curve (every instance, except one occasion). The average duration of lead months of inverted yield curve and US economy slipping into recession is 14 months and average duration of recession is 12 months. By this logic, US might plunge into recession by the end of 2019 or early 2020. In India and other emerging economies, the spread is positive and quite large, however the spread could narrow down if the fears of global slowdown increase. This would mean a decline in 10 year yield rates from the current levels.
- We now expect US economy may get into a slowdown mode sooner than later.

BANKING SECTOR LIQUIDITY

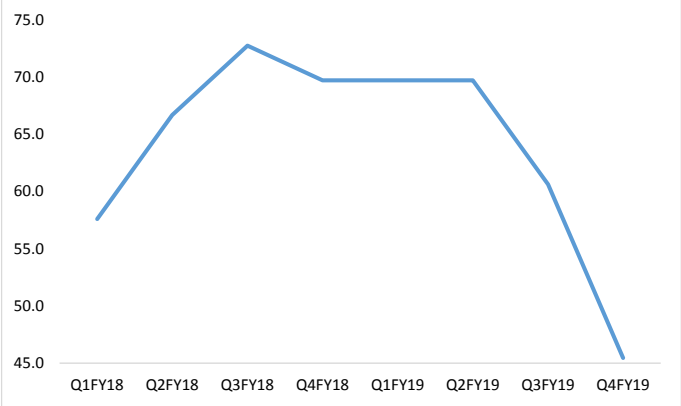
- A closer look at the drivers of liquidity management by RBI indicates that excess CRR reserves have acted as a drag in March. Interestingly, with RBI turning a net purchaser of $ in March, liquidity was positively impacted. Overall, the liquidity management framework of RBI has however seen at times frictional liquidity / Government cash balances substituting durable liquidity. It may be noted that liquidity was largely impacted in April and May with Government not spending because of model code of conduct.

Inverted Yield Curve (10y minus 1y) and US Recession

First Yield Curve Inversion	Lead (in months)	Recession Start Date	Duration of Recession (in months)
Dec-56	8	Aug-57	8
Sep-59	7	Apr-60	10
Dec-67	24	Dec-69	11
Mar-73	8	Nov-73	17
Sep-78	16	Jan-80	6
Sep-80	10	Jul-81	17
Feb-89	17	Jul-90	8
Apr-00	11	Mar-01	8
Jan-06	23	Dec-07	19
Average	**14**	**-**	**12**

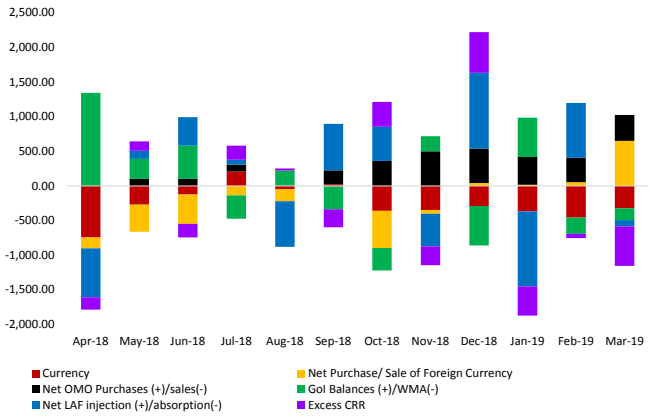
Source: NBER, FRED, SBI Research

% of Leading Indicators Showing Acceleration



Source: SBI Research

Liquidity Management by RBI (Rs billion)



Source: SBI Research

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