ICRA

FINANCIAL MARKETS & BANKING UPDATE
Vol. 2: FY2022-23

Corporate bond spreads to widen further with reducing liquidity surpluses

AUGUST 2022

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Table of Contents

Table of Exhibits

HIGHLIGHTS

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ICRA expects fresh bond issuances to remain at Rs. 6.5-7.0 trillion in FY2023 and bonds outstanding to rise by ±4% in FY2023 to Rs. 41-42 trillion by March 31, 2023

Policy tightening and large borrowing programme to drive hardening in yields, although recent easing of commodity prices could rein in yields

Protracted geopolitical tensions, elevated commodity prices, heightened volatility in global financial markets, and fresh waves of Covid-19 could lead to broader risk aversion towards emerging market (EM) assets and result in FII outflows in H1 FY2023

FDI inflows in FY2023 to trend closely to levels seen in the last two years

Rupee-denominated bond issuances dropped to the lowest levels in Q1 FY2023 since June 2018 and recorded the second lowest quarterly volumes in four years at Rs. 1.0 trillion in Q1 FY2023 (Rs. 1.7 trillion in Q4 FY2022 and Rs. 1.3 trillion in Q1 FY2022). Overall bond issuances are pegged at Rs. 6.5-7.0 trillion for FY2023, translating to a year-on-year (YoY) change of ±4%. Accordingly, we expect the volume of bonds outstanding to rise to Rs. 41-42 trillion by March 31, 2023. Further, ICRA expects incremental policy rate hikes of 35 basis points (bps) and 25 bps, respectively, in the August and September 2022 Policy meetings. This, coupled with the large Government borrowing programme, is likely to lead to a further hardening in the yields in the coming months.

- **Net FII outflows remained sizeable at $14.3 billion in Q1 FY2023, driven by equity segment:** The net outflows of the foreign institutional investors (FII) segment (equity, debt and hybrid) eased slightly to $14.3 billion in Q1 FY2023 (+$0.3 billion in Q1 FY2022) from the all-time high of $15.5 billion in Q4 FY2022 (+$7.6 billion in Q4 FY2021), while remaining substantial, owing to the risk-off sentiment prevailing across the globe. Subsequently, this segment witnessed mild net outflows of $0.4 billion during July 1-27, 2022, driven by the trends in the equity segment (-$0.2 billion). Going forward, FII flows would take a cue from developments around the Russia-Ukraine conflict, movements in commodity prices and their anticipated impact on the earnings of Indian corporates, monetary policy normalisation and forward guidance by major central banks, fears of a prolonged global recession, and the strength of the domestic economic recovery relative to other major economies. If monetary tightening by the US Fed ends earlier than expected, we anticipate that global sentiment will ease, leading to inflows in H2 FY2023.

- **FDI inflows mildly lower in FY2022:** Foreign direct investment (FDI) inflows moderated by 2% to $60.2 billion in FY2022 from $61.4 billion in FY2021 and were driven by private equity (PE)/venture capital (VC) deals. During April-May 2022, FDI inflows were lower by ~16% at $12.7 billion against inflows of $15.1 billion during the corresponding period last year, although they were healthy compared to the pre-Covid level. Furthermore, for the trailing 12 months (TTM) ending May 2022, FDI flows stood at $57.8 billion, 18.8% lower than $71.3 billion for the TTM ending May 2021.

- **FDI outflows slow down while remittances under LRS surge in Q1 FY2023:** The gross outward FDI flows touched a record $15.8 billion in FY2022 ($11.5 billion in FY2021), while outflows (net of repatriations) were higher by 74% at $12.4 billion against $7.1 billion in FY2021; to an extent, the latter was also driven by the surge in initial public offerings (IPOs) during the year, that had provided exits to PE/VCs. However, during April-May 2022, FDI outflows slowed to $1.3 billion (against $3.0 billion during the corresponding period last year), while outflows (net of repatriations) stood at $1.0 billion (against $2.7 billion last year). Similarly, remittances under the Liberalised Remittance Scheme (LRS) surged by 55% to an all-time record high of $19.6 billion in FY2022 ($12.7 billion in FY2021 and $18.8 billion in FY2020), driven by normalising travel and the maintenance of Indians abroad. The same remained strong at $4.1 billion during April-May 2022 compared to $2.4 billion during April-May 2021.

FDI outflows slow in Q1 FY2023 after witnessing record outflows in FY2022, while remittances under LRS continued to remain strong

ECB approvals remain seasonally low in Q1 FY2023 (April-May). Approvals expected to remain at $35-38 billion in FY2023

ICRA pegs YoY growth in GDP at 12.5-13.0% for Q1 FY2023, with services growth likely to outpace that of the industry

ICRA expects CPI inflation to print at 6.6-7.0% in Q2 FY2023; sequential momentum in services inflation remains a key monitorable amid seemingly robust demand

We expect WPI inflation to ease to ~13% in July 2022, reflecting the ongoing correction in global commodity prices and domestic food prices

We continue to foresee front-loaded rate hikes of 60 bps spread over the Aug 2022 and Sep 2022 policy reviews, followed by an extended pause to ascertain the growth momentum

Incremental deposits of banks pegged at Rs. 13.0-14.0 trillion for FY2023,

- **ECB approvals higher in FY2022, but remained seasonally weak in Q1 FY2023:** The aggregate gross external commercial borrowing (ECB) approvals rose by 10% to $38.6 billion in FY2022 from $35.1 billion in FY2021, although they sharply lagged $53.9 billion witnessed in FY2020. Net of refinancing, approvals were higher by 4% at $31.5 billion in FY2022 compared to $30.3 billion in FY2021, while trailing $47.3 billion recorded in FY2020. However, the same remained subdued at $1.9 billion during April-May 2022, a considerable decline from $3.1 billion reported during the corresponding period last year. Nevertheless, full year approvals are expected to remain between $35 billion and $38 billion in FY2023.

- **India's YoY GDP growth estimated at 12.5-13.0% for Q1 FY2023:** While most high frequency indicators displayed an elevated YoY growth in Q1 FY2023, aided by the low base due to Covid-19, amidst the robust recovery in the demand for services, the spike in global commodity prices following the escalation of the Russia-Ukraine conflict for a larger part of the quarter is expected to have compressed demand for goods as well as the margins of some listed corporates, impacting the value-added growth. With services growth likely to outpace that of the industry, ICRA pegs the YoY growth in real gross domestic product (GDP) at 12.5-13.0% for Q1 FY2023, lower than the Monetary Policy Committee's (MPC) projection of 16.2% for that quarter. The recent correction in commodity prices, following fears of a global recession, is likely to ease the pressure on input costs and hence, the margins of India Inc., in the immediate term. If this downtrend sustains, we see a tangible upside to our estimate of the YoY GDP growth of 6.5-7.0% for Q2 FY2023.

- **CPI inflation to print above MPC's upper limit of 6.0% in the near term:** The YoY combined consumer price index (CPI) inflation rose to 7.3% in Q1 FY2023 from 6.3% in Q4 FY2022, breaching the upper threshold of the MPC's medium-term target band of 4%±2% for the second consecutive quarter. However, the print was mildly lower than the MPC's projection of 7.5% for the quarter. Going forward, with the decline in commodity prices as well as vegetable and edible oil prices, the CPI print is expected to soften to 6.6-7.0% in Q2 FY2023, well below the MPC's projection of 7.4% for the quarter. However, the sequential momentum in services inflation remains a key monitorable, as high domestic demand is likely to create upward pressure on the prices for this sector.

- **WPI inflation likely to soften, following correction in global commodity prices, but to remain in double digits:** Similar to CPI inflation, the YoY wholesale price index (WPI) inflation rose to 15.5% in Q1 FY2023 from 13.9% in Q4 FY2022, driven by primary food articles (to +11.7% from 9.0%), crude petroleum and natural gas (to +75.4% from +57.1%), and fuel and power (to +40.0% from +32.3%). The recent correction in commodity prices augurs well for inflation prints and should translate into lower WPI inflation much faster vis-à-vis the transmission to lower CPI inflation. We expect the WPI inflation to ease to ~13% in July 2022.

- **60 bps of rate hikes likely by MPC in Q2 FY2023, followed by extended pause:** With the inflation print for Q2 FY2023 likely to fall short the MPC's projection for that quarter, and given the unevenness in domestic economic activity and the fears of a global recession, we continue to foresee front-loaded rate hikes of 60 bps spread over the August 2022 and September 2022 Policy reviews, followed by an extended pause to ascertain the momentum of economic growth.

translating to YoY growth of 7.9-8.5% in total deposits

ICRA expects credit growth to sustain and close at 10.1-11.0% in FY2023, with incremental NFBC pegged at Rs. 12.0-13.0 trillion

- **Liquidity surplus declined sharply in Q1 FY2023; WACR crossed the repo rate in July 2022:** The average daily liquidity surplus under the liquidity adjustment facility (LAF) eased to Rs. 4.54 trillion in Q1 FY2023 from Rs. 6.54 trillion in Q4 FY2022, with a particularly sharp fall towards the end of the quarter (to Rs. 2.9 trillion in June 2022), and further to sub-Rs. 1.0 trillion during July 25-27, 2022. The dip is likely to have been led by the drain in rupee liquidity potentially on account of forex sales by the Reserve Bank of India (RBI), given the decline of $25.2 billion in foreign currency assets between June 3, 2022 and July 15, 2022. Consequently, the spread between the repo and the weighted average call rate (WACR) narrowed throughout Q1 FY2023, and the WACR exceeded the repo rate during July 25-27, 2022, after a gap of 27 months.

- **Deposit growth lags credit growth:** The deposits in the banking system expanded by Rs. 5.0 trillion in Q1 FY2023 to Rs. 169.6 trillion as on July 1, 2022, from Rs. 164.7 trillion as on March 25, 2022 (Rs. 2.2 trillion in Q4 FY2022 and Rs. 3.4 trillion in Q1 FY2022). As a result, the YoY deposit growth stood at 9.8% as on July 1, 2022, which was similar to the YoY growth as on July 2, 2021 and higher than 8.9% as on March 25, 2022. Weak foreign capital inflows and the RBI's intervention in the forex market to support the INR weighed down the pace of deposit accretion. The incremental deposits of banks are estimated at Rs. 13.0-14.0 trillion in FY2023 (Rs. 13.5 trillion in FY2022). This will translate to a YoY deposit growth of 7.9-8.5% for FY2023 (8.9% in FY2022).

- **Credit growth remains strong; momentum expected to sustain in coming quarters:** Non-food bank credit (NFBC) stood at Rs. 123.4 trillion as July 1, 2022, up from Rs. 118.4 trillion as on March 25, 2022, translating to a strong increase in incremental credit of Rs. 5.1 trillion in Q1 FY2023 (against incremental credit of Rs. 2.4 trillion in Q4 FY2022 and contraction of Rs. 0.4 trillion in Q1 FY2022). As a result, the YoY credit growth improved sharply to 15.0% as on July 1, 2022 from 9.7% as on March 25, 2022 and was markedly higher than 6% as on July 2, 2021. ICRA estimates the YoY credit growth at 10.1-11.0% for FY2023, with incremental NFBC in the range of Rs. 12.0-13.0 trillion (incremental credit of Rs. 10.5 trillion in FY2022).

Abbreviations

AUM: Assets Under Management
BSNL: Bharat Sanchar Nigam Limited
CASA: Current and Savings Account Ratio
CAD: Current Account Deficit
CD: Certificates of Deposit
CDSL: Central Depository Services (India) Limited
CEA: Central Electricity Authority
CIC: Currency in Circulation
CP: Commercial Paper
CPI: Consumer Price Index
CMB: Cash Management Bills
CRR: Cash Reserve Ratio
CSO: Central Statistics Office
CWP: Cash with Public
CY: Calendar Year
DII: Domestic Institutional Investors
DIPP: Department of Industrial Policy and Promotion
ECBs: External Commercial Borrowings
EM: Emerging Markets
FAR: Fully Accessible Route
FCCBs: Foreign Currency Convertible Bonds
FCI: Food Corporation of India
FDI: Foreign Direct Investment
FII: Foreign institutional Investment
FPI: Foreign Portfolio Investment
FPO: Follow on Public Offer
FSB: Fully Serviced Bonds
FY: Financial Year
G-Sec: Government Securities
GDP: Gross Domestic Product
GFCE: Government Final Consumption Expenditure
GFCF: Gross Fixed Capital Consumption
GoI: Government of India
GST: Goods and Services Tax
GVA: Gross Value Added
HFC: Housing Finance Company
IDBI: The Industrial Development Bank of India
IIP: Index of Industrial Production
IPO: Initial Public Offer
IMD: Indian Meteorological Department
INR: Indian National Rupee
JV: Joint Venture
LAF: Liquidity Adjustment Facility
LIBOR: London Interbank Offered Rate
LPA: Long Period Average
LRS: Liberalised Remittance Scheme
MGNREGA: Mahatma Gandhi National Rural Employment Guarantee Act
MPC: Monetary Policy Committee
MSCI: Morgan Stanley Capital International
MSF: Marginal Standing Facility
NABARD: National Bank for Agriculture & Rural Development
NDTL: Net Demand & Time Liabilities
NBFC: Non-Banking Financial Company
NSDL: National Securities Depository Limited
OMO: Open Market Operations
PFCE: Private Final Consumption Expenditure
PSB: Public Sector Bank
PVB: Private Sector Bank
QoQ: Quarter on Quarter
RBI: Reserve Bank of India
RDB: Rupee Denominated borrowings
SIAM: Society of Indian Automobile Manufacturers
SIDBI: Small Industries Development Bank of India
SCB: Schedule Commercial Bank
SDL: State Development Loans
SLR: Statutory Liquidity Ratio
TLTRO: Targeted long-term repo operations
T-Bill: Treasury Bill
TTM: Trailing Twelve Months
UAE: United Arab Emirates
$: United States Dollar
VRR: Voluntary Retention Route
WPI: Wholesale Price Index
WACR: Weighted Average Call Rates
YTD: Year to Date
LTRO: Long-term repo operations
WoS: Wholly Owned Subsidiary

ICRA

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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