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Macro Review & Fixed Income Market Outlook - February 2025

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Global Economy Update:

Macro Backdrop:

- As of early February 2025, the global economy is navigating a complex landscape shaped by recent policy shifts, ongoing geopolitical tensions, and evolving trade dynamics. While the U.S. imposed new tariffs on China in early February 2025, planned tariffs on imports from Canada and Mexico were postponed, alleviating immediate trade tensions in North America. This decision reflects ongoing negotiations to address concerns in key sectors, particularly automotive and agriculture.
- **GDP Growth:**
  - In January 2025, global GDP growth projections remained modest.
  - The International Monetary Fund (IMF) maintained its forecast of 3.3% growth for both 2025 and 2026, with an upward revision for the United States offsetting downward adjustments in other major economies.
  - The Organization for Economic Co-operation and Development (OECD) projected global GDP growth of 3.3% in 2025, up from 3.2% in 2024, with inflation expected to ease further, supported by the still restrictive stance of monetary policy.
  - The U.S. Federal Reserve maintained a status quo policy during its January 2025 meeting, citing persistent, albeit moderating, inflationary pressures and steady labor market conditions. This cautious approach aims to balance economic growth with the need to ensure long-term price stability.
- **Purchasing Managers' Index (PMI):**
  - The global manufacturing sector faced challenges in January 2025, with PMIs indicating contraction in several regions due to weakened demand and supply chain disruptions stemming from recent tariff implementations.
  - The S&P Global US Manufacturing PMI edged up to 50.1 in January 2025 from 49.4 in December, beating market expectations of 49.7 and signaling a slight improvement in manufacturing conditions after six months of decline.
  - Services sector demonstrated resilience, particularly in advanced economies, buoyed by robust consumer spending in areas such as travel and hospitality.
- **Trade and Export-Import Dynamics:**
  - While the U.S. imposed new tariffs on China in early February 2025, planned tariffs on imports from Canada and Mexico were postponed, alleviating immediate trade tensions in North America. This decision reflects ongoing negotiations to address concerns in key sectors, particularly automotive and agriculture.
  - In response, Canada has threatened retaliatory tariffs, signaling potential escalation in trade tensions.
  - These developments have led to fears of a sweeping trade war, with potential far-reaching economic repercussions, including recession risks and inflation.

Inflation Trends:

Global:

- Headline inflation declined over much of 2024 to reach close to targets in most major economies.
- The pace of its decline has slowed down in recent months, along with uptick in the US to 2.9 per cent (y-o-y) in December from 2.7 per cent in November.
- In the Euro area, headline inflation edged up to 2.4 per cent in December from 2.2 per cent in November.
- In the UK, it moderated to 2.5 per cent in December from 2.6 per cent in November.
- Inflation in Japan increased to 2.7 per cent in November from 2.3 per cent in October.
- Among EMEs, CPI inflation in China weakened further to 0.1 per cent in December, its lowest level since March, and in Brazil, it moderated to 4.8 per cent.
- Inflation, however, increased in Russia in December and South Africa in November.
- Core inflation moderated in the US and UK in December but remained steady in the Euro area.
- While services inflation slowed down in the US and UK in December, it recorded a marginal acceleration in the Euro area.

Indian Economy Update:

Macro Backdrop:

- In January 2025, the Indian economy exhibited resilience amid global uncertainties, driven by robust domestic demand and strategic government initiatives.

- **GDP Growth:**
  - India's GDP is expected to grow by 6.6% in 2025, supported by strong private consumption, and rising investments.

- **Purchasing Managers' Index (PMI):**
  - Rising from December's one-year low of 56.4 to 57.7 in January, the seasonally adjusted HSBC India Manufacturing Purchasing Managers' Index signaled a robust improvement in the health of the sector.
  - Domestic and export demand were both strong, supporting new orders growth.
  - The HSBC India Services PMI fell to 56.8 in January 2025 from the highest reading in four months in December of 59.3, below market estimates of 59.5, preliminary data showed. This marked the 42nd consecutive month of growth in services activity and the softest pace since November 2022, as outstanding business rose the least in 14 months.

- **Trade and Export-Import Dynamics:**
  - The trade balance remained under pressure due to high imports of crude oil and electronics. However, exports of software services, textiles, and pharmaceuticals showed resilience.
  - The government's Production Linked Incentive (PLI) schemes began to show results, enhancing export competitiveness in electronics and renewable energy components.

- **Labor Markets and Employment:**
  - The labor market witnessed steady improvement.
  - Urban employment rates improved with the expansion of tech and service industries, while rural employment benefited from higher agricultural output and government rural employment schemes.
  - The January hiring season in sectors like retail and logistics contributed to temporary job creation, though concerns over underemployment in informal sectors persisted.

Inflation Trends:

Domestic:

- The Inflation in India eased to a four-month low of 5.2 per cent in December 2024 from 5.5 per cent in November 2024.
- Food inflation decelerated to 7.7 per cent in December from 8.2 per cent in November. Core inflation remained steady at 3.7 per cent in December 2024, the same as in November.
- In terms of regional distribution, rural inflation stood at 5.76 per cent higher than urban inflation (4.58 per cent) in December 2024.
- Majority of the states faced inflation less than 6 per cent.

Budgetary Impact on Fixed Income Markets:

➢ Indian yields trended in December, post policy, as rate cut expectations did not materialize.

The Union Budget 2025-26's focus on fiscal consolidation and manageable borrowing levels is expected to positively influence the fixed income market, with potential declines in bond yields and stable spread movements.

Fiscal Deficit and Government Borrowing:

- **Fiscal Deficit Target:** The government has set a fiscal deficit target of 4.4% of GDP for the fiscal year 2025-26, a reduction from the revised 4.8% for the current year.

- **Gross Market Borrowing:** To fund this deficit, gross market borrowing is projected to increase to ₹14.82 lakh crore. However, net market borrowing is expected to see a slight reduction to ₹11.54 lakh crore, considering repayments.

Impact on Bond Yields and Spreads:

- Yields on sovereign securities are expected to reduce marginally, supported by the lower fiscal deficit target (4.4% for FY 2026) and manageable net borrowing of ₹11.54 trillion for FY 2026.
- The government's focus on fiscal consolidation and reduced supply of government securities, along with increased corporate bond issuances due to infrastructure and power sector initiatives, is expected to support a narrowing of spreads between sovereign and corporate bonds.

State-Level Borrowing Dynamics:

- An interest-free loan of ₹1.5 lakh crore to states on a long-term basis will lower their immediate borrowing needs in the primary market, leading to reduced state spreads in the short term.

- Additional borrowing of 0.5% of GSDP (Gross State Domestic Product), similar to the previous year, will encourage higher issuances, particularly in states linked to the power sector's performance.

Infrastructure Bond Issuances:

- The National Bank for Financing Infrastructure and Development (NaBFID) aims to boost infrastructure bond issuance (~₹1.5 lakh crore in the last three years), focusing on bringing lower-rated bonds up to investment grade. This will reduce dependence on bank funding and promote diversification of financing sources. However, success hinges on regulatory responsiveness and further market development.

Fixed Income Market Outlook:

- The RBI's stance on monetary policy will play a pivotal role. A stable or easing interest rate environment could further support bond yields, enhancing the attractiveness of fixed-income instruments.

- The fiscal discipline demonstrated in the budget could improve India's sovereign rating outlook, increasing foreign investor appetite for Indian bonds.

Source: RBI, MOSPI, PIB, CMIE, NSDL, S&P Global, Ministry of Commerce and Industry, Reuters, Bloomberg, Internal Research.

Note: Data updated as available in the beginning of the month.

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