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Economy

Financial conditions tighten marginally in July 2020

Chart 1: Financial Conditions Index

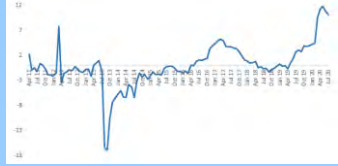


Chart 2: Aggregate Demand Conditions

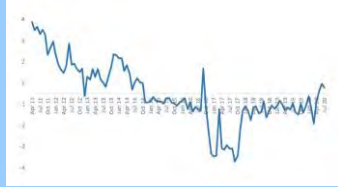


Chart 3: Money Market Conditions

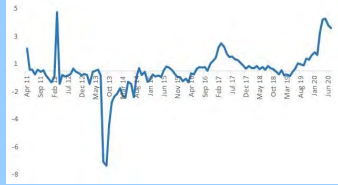


Chart 4: Money Market Conditions

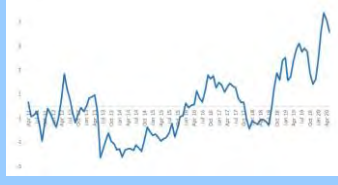
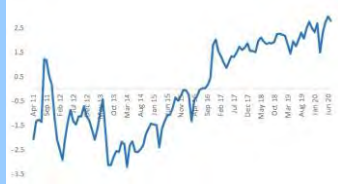


Chart 5: Equity Market Conditions



Chart 6: Forex Market Conditions



Financial conditions tightened for the second consecutive month in July 2020. Our proprietary Financial Conditions Index fell to 10.15 in July 2020 down from 10.86 in June and 11.8 in May. Out of the five subcomponents, four recorded worsening conditions, with equity market being the sole exception. The main factors contributing to worsening conditions were falling non-food bank credit, lower surplus liquidity in banking system, and rising rupee forward premia. Despite the recent modest tightening, financial conditions have improved substantially since March 2020 as the RBI and government took a number of measures to keep financial conditions easy during Covid-19 pandemic.

We expect the MPC to hold rates in the 4-6 August monetary policy meeting. However, should the MPC decide to cut rates, financial conditions could ease further.

- ▶ **Aggregate demand conditions deteriorate during July '20:** Aggregate demand conditions deteriorated during July 2020 mainly due to falling bank credit growth. Non-food bank credit growth fell to 5.9% during the month, hitting a 38-month low. July 2020 also marks the 11th consecutive month when non-food bank credit has clocked single-digit growth and first month of sub-6% growth since May 2017. Given the risk aversion in banking system, we expect bank credit growth to remain muted in the coming months. M3 growth remained broadly unchanged from previous month, growing 12.4% y/y during the month. However, lower bank credit growth dragged Aggregate Demand (AD) score to 0.29 in July 2020 from 0.47 in the preceding month.
- ▶ **Money market conditions worsen for second consecutive month:** Money market conditions worsened too, albeit moderately due to decline in surplus liquidity and modest hardening of overnight rates. Overnight call rate remained tightly anchored around reverse repo rate at 3.48% during the month. However, CBLO rate inched up to 3.12% in July 2020 from 2.92% in the previous month. Also, average surplus liquidity during the month reduced to Rs 5.9trn from Rs 6.1trn in June 2020. As a result, Money Market (MM) score fell to 3.1 in July 2020 from 3.3 in June 2020.
- ▶ **Equity market conditions improve substantially as market recoups losses:** Equity market conditions improved considerably during the month as Nifty index and PE ratio increased and volatility declined. Nifty index averaged 10,890 during the month, up from 10,137 in June 2020. PE ratio also increased to 26.4 from 22.2. India VIX declined to 25 in July 2020 from 30 in the preceding month while US VIX also fell to 26.8 from 31.5. Positive movement in all components led to equity market score increasing to 3.23 in July 2020 from 1.8 in the previous month.
- ▶ **Debt market conditions worsen despite fall in short-end yields:** Debt market conditions worsened during July 2020 despite softer short-end yields. Although 1yr and 5yr gilt yields eased by 11bps and 44bps respectively, gains in the 10yr yield were small at just 1bp. Also, while corporate risk spreads narrowed during the month, they are still trading above Covid-19 levels. Worryingly, the spread between India 10yr and US 10yr bond widened by 10bps during the month to 5.2%. As a result, Debt Market (DM) score fell to 6.2 from 7.1 in June 2020.
- ▶ **Forex market conditions tighten due to higher forward premia:** Forex market conditions tightened during July 2020. Although the rupee appreciated to average 74.97/dollar up from 75.77/dollar during the preceding month, rise in forward premia across tenors led to the worsening of conditions. 1-month, 3-month and 6-month forward premia inched up by 27bps, 15bps and 6bps respectively. As a result, forex market score decreased to 2.8 in July 2020 from 2.98 in the preceding month.

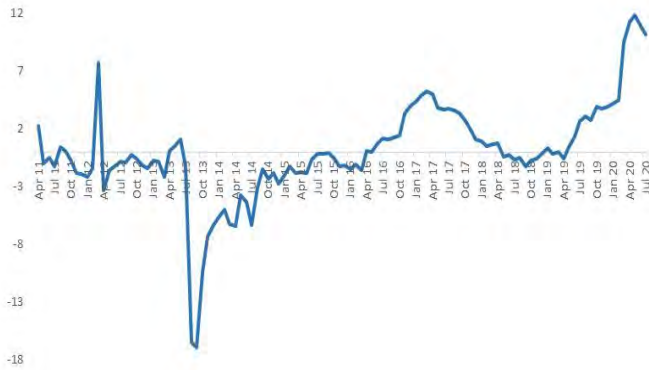
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Financial Conditions Index and its components

Chart 1: Financial Conditions Index



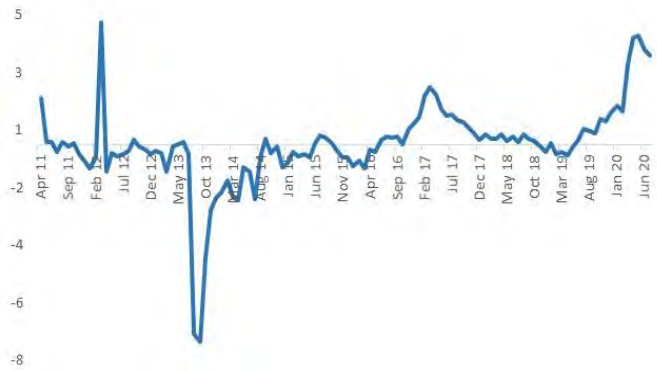
Source: Bloomberg, I-Sec Research

Chart 2: Aggregate demand conditions



Source: Bloomberg, I-Sec Research

Chart 3: Money market conditions



Source: Bloomberg, I-Sec Research

Chart 4: Debt market conditions



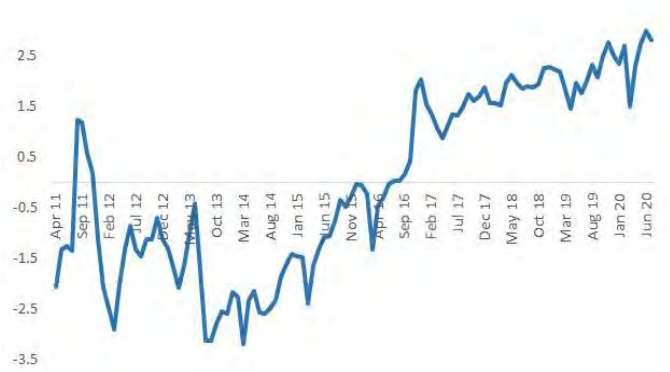
Source: Bloomberg, I-Sec Research

Chart 5: Equity market conditions



Source: Bloomberg, I-Sec Research

Chart 6: Forex market conditions



Source: Bloomberg, I-Sec Research

Constituents of sub-indices and their movement

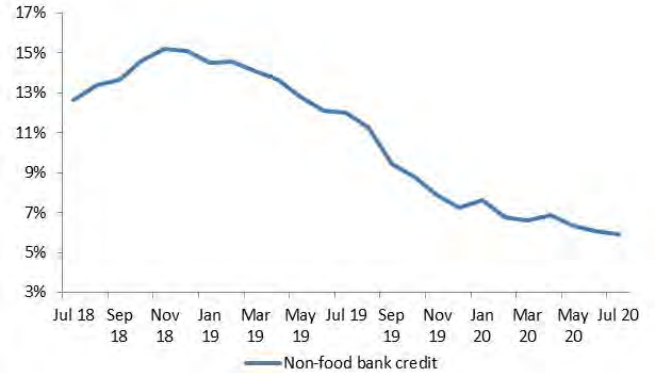
Aggregate demand conditions

Chart 7: Money supply growth (% y/y)



Source: Bloomberg, I-Sec Research

Chart 8: Non-food bank credit growth (% y/y)



Source: Bloomberg, I-Sec Research

Money market conditions

Chart 9: Spread between repo and call rate



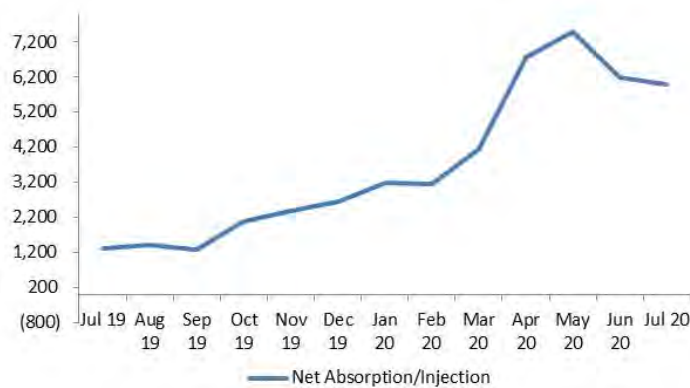
Source: Bloomberg, I-Sec Research

Chart 10: Spread between repo and CBLO rate



Source: Bloomberg, I-Sec Research

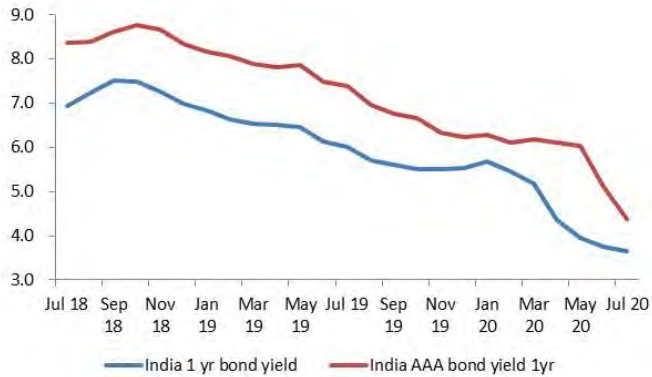
Chart 11: Interbank liquidity



Source: Bloomberg, I-Sec Research

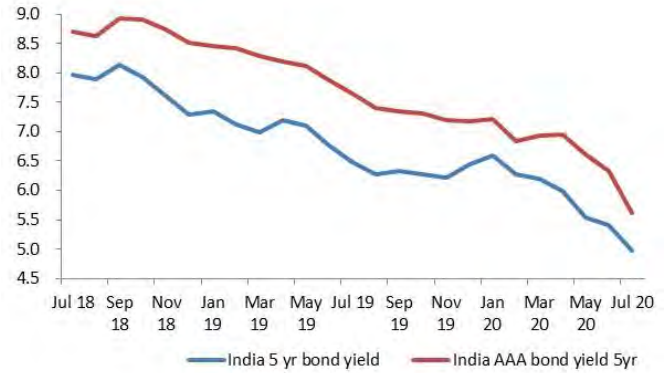
Debt market conditions

Chart 12: Spread between 1yr gilt & AAA bond



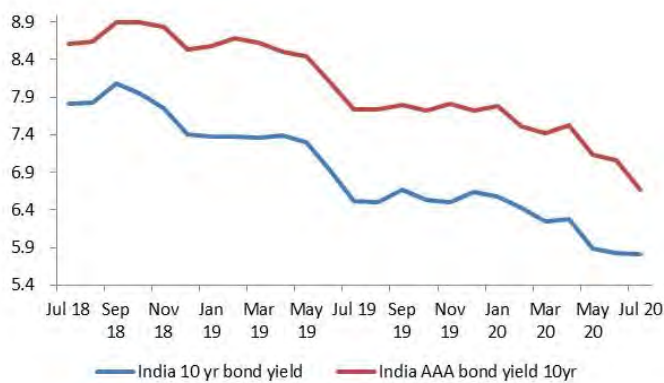
Source: Bloomberg, I-Sec Research

Chart 13: Spread between 5yr gilt & AAA bond



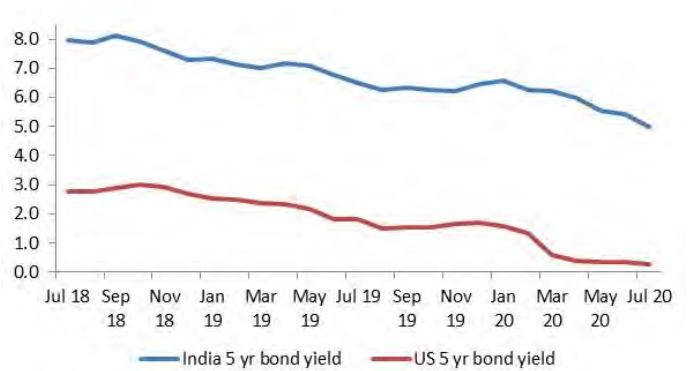
Source: Bloomberg, I-Sec Research

Chart 14: Spread between 10yr gilt & AAA bond



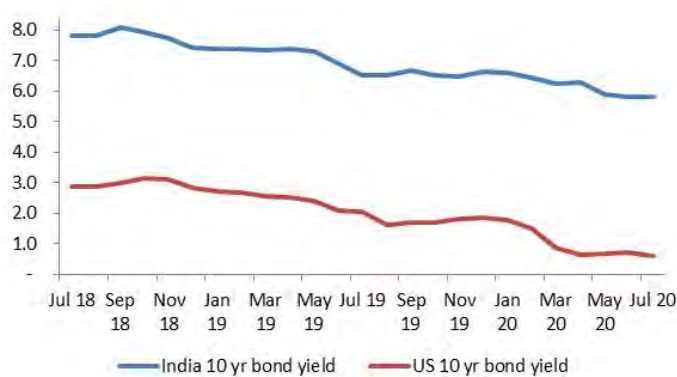
Source: Bloomberg, I-Sec Research

Chart 15: Spread between 5yr AAA & US bond



Source: Bloomberg, I-Sec Research

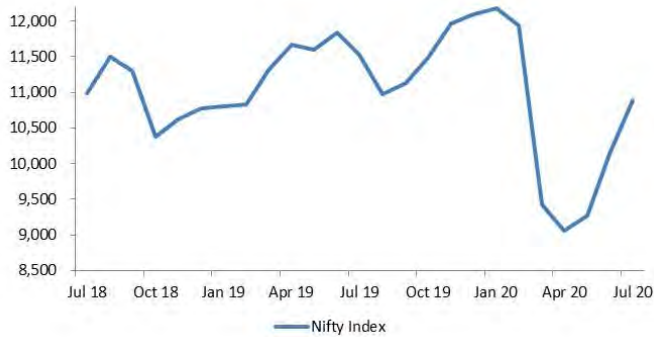
Chart 16: Spread between 10yr AAA & US bond



Source: Bloomberg, I-Sec Research

Equity market conditions

Chart 17: Nifty Index (monthly average)



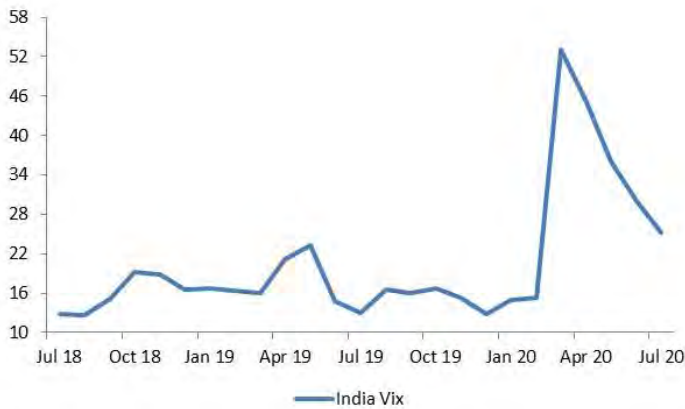
Source: Bloomberg, I-Sec Research

Chart 18: Nifty PE (monthly average)



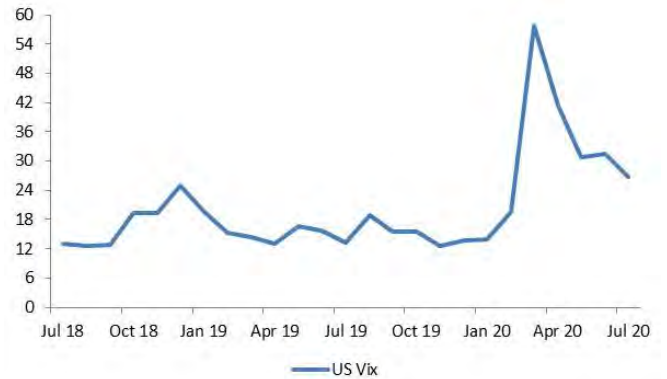
Source: Bloomberg, I-Sec Research

Chart 19: India VIX



Source: Bloomberg, I-Sec Research

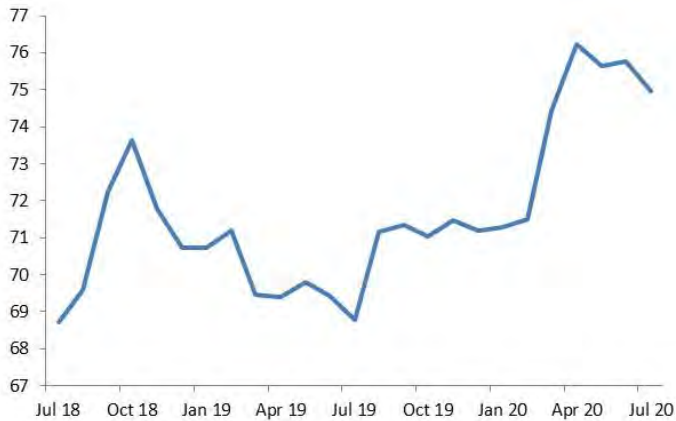
Chart 20: US VIX



Source: Bloomberg, I-Sec Research

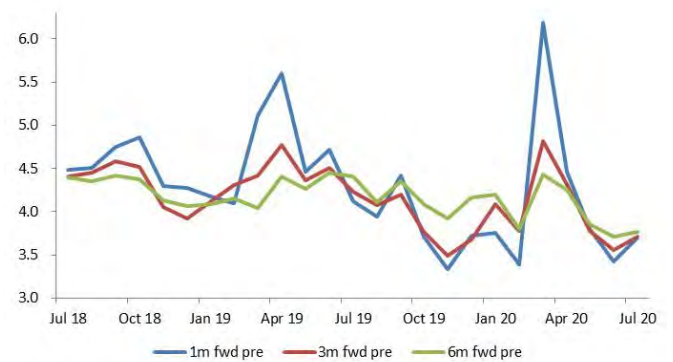
Forex market conditions

Chart 21: USDINR



Source: Bloomberg, I-Sec Research

Chart 22: Forward Premia



Source: Bloomberg, I-Sec Research

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