

EDELWEISS ET-Now Lead Indicator Index (EELII)

Be future ready

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**WHEN YOU KNOW WHERE THE ECONOMY IS HEADING,
YOU KNOW WHAT TO DO.**



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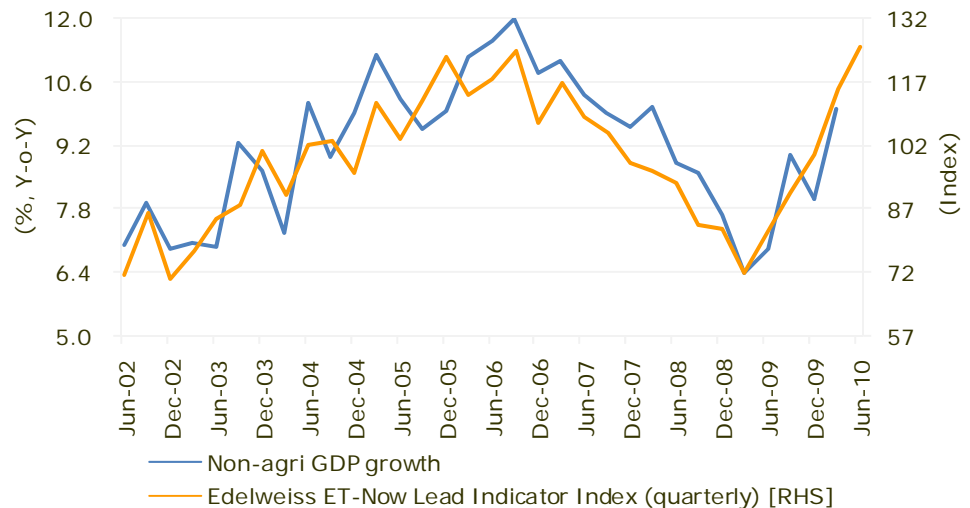
Edelweiss Securities Limited

■ **EELII moderates to 122 for August**

The Edelweiss ET-Now Lead Indicator Index (EELII) has moderated to ~122 for August 2010. This is a tad lower than ~125 in Q1FY11 (a value of ~100 for EELII suggests non-agriculture GDP growth of ~9% Y-o-Y).

EELII, a composite weighted average index of a number of macro-variables exhibiting strong predictive ability of the core trends in the Indian economy, is moderating for the first time since March 2009. However, a clear picture will emerge once the quarterly EELII projections for Q2FY11 are available next month. Earlier, EELII had been effective in capturing the upturn in the economic cycle during the past few quarters. From a trough of ~73 in Q4FY09, the indicator touched ~125 by Q1FY11 – the fastest in the current decade.

Chart 1: EELII remains elevated



Source: CSO, Edelweiss research

Each of the lead variables constituting the index affects the real economy with different lead periods. For example, as per our model, the effect of change in policy interest rates (repo rate) is most pronounced on the economy with a lead of ~9-12 months, while the impact of change in commercial vehicle production is the highest with a lead of around three months. EELII has historically predicted non-agriculture GDP growth closely; the adjusted coefficient of determination (adjusted R-squared) for the multiple regression is over 0.80.

The uptick in EELII over the past five quarters was contributed by a host of factors—strong production of commercial vehicles, surge in non-oil imports, buoyant resource mobilisation in the domestic primary market, and a reasonable interest rate scenario. However, of late, certain variables like government expenditure, among others, are turning softer. The pressure on interest rates is also set to be reflected on EELII gradually.

■ **Q1FY11 expected to record strong growth ...**

The EELII had correctly predicted the 10% Y-o-Y growth in non-agri GDP during Q4FY10. Non-agri GDP growth rates have accelerated for almost all successive quarters since Q4FY09 and the same has been corroborated through the trajectory of EELII during this period.

EELII suggests over 10% growth in non-agri GDP in Q1FY11 as well. Several other indicators coincident with GDP, viz., IIP growth, core sector growth, Purchase

Manufacturer's Index (PMI) have continued to indicate robustness in recovery. In fact, recent GDP and IIP data is showing early signs that capex may have started picking up, indicating that peaking capacity utilisation may be prompting corporates to make fresh investments. All of the above lend credence to the inference from EELII that we will have a strong set of numbers in Q1FY11 as well.

- **... but, likely to soften during Q2-Q3FY11**

A strong growth of over 10% Y-o-Y in non-agri GDP is expected even in Q1FY11. However, during Q2-Q3FY11, the growth trajectory is likely to settle a tad lower. For example, the IIP growth rate is already showing signs of moderation and given that the base effect is wearing out, we expect it to consolidate at high single digits June onwards.

In fact, although several variables that determine the movement of EELII are still robust, some items have already started signaling a moderation. For example, cement dispatches and central government expenditure have begun to decelerate Y-o-Y from early CY10. Subsequently, the impact of an uptick in interest rates will also be reflected on EELII.

Going by these trends, we expect non-agri GDP to start accounting for some of this moderation Q2-Q3FY11 onwards, with the balance months of H2FY11 experiencing somewhat slower (yet strong) growth. However, this should not be mistaken for a slowdown. Rather, over the next six months growth will consolidate around a more steady-state and sustainable path.

- **Overheating concerns largely overdone**

Does the elevated level of EELII in the past few quarters indicate a case of demand overheating in India? We do not think so. Broad money (M3) growth and credit growth have been modest through Q1FY11. From the foreign capital inflows side as well, we are likely to witness greater uncertainties for portfolio flows and ECB flows to India. The current high rate of inflation prevailing in the current calendar year also does not necessarily reflect an overheating in domestic demand (read our note dated July 7, *India Inflation Outlook: The delusion of Demand Overheating*). Our re-aligned WPI basket suggests that out of the current 10.6% Y-o-Y inflation, only ~260bps is contributed by non food domestic demand inflation while the balance ~800bps is contributed by agro and imported inflation. Thus, we do not see any meaningful evidence of demand overheating in India. With large part of cyclical upswing being already over, we believe economic momentum will consolidate at a more sustainable level.

- **RBI to continue with slow-but-steady tightening**

With demand recovery and early signs of resurgence of inflationary pressures, anchoring inflation expectations has been the central bank's foremost objective since late 2009. Accordingly, CY10 has witnessed a policy rate hike of ~75bps, in addition to CRR increases of ~100bps till date, targeted at containing inflation and inflationary expectations.

Despite the tightening, of late, there was a debate on whether RBI was falling behind the curve. We, however, believe that given the uncertainties globally, a one step-at-a-time kind of approach was the natural choice for the central bank over the past few months. Further, some cooling off in global commodity prices has given the RBI some headroom to opt for milder incremental rate hikes.

- **Current hike in policy rates to be restricted to 25bps**

Still, with domestic economy inching towards normalcy, policy rates also need to move towards their long-term steady state levels. Accordingly, our base case expectation is that RBI will hike repo and reverse repo rates by another 25bps each in its July 27 monetary policy meet. We further expect the central bank to continue tightening gradually through rest of FY11, taking the repo rate to 6.0-6.25% by March 2011. However, CRR has already reached its long-term steady state level and we do not expect further use of this instrument in tightening the monetary policy.

- **An outside chance of RBI hiking only reverse repo rate**

We do assign ~25% probability to the policy action in which reverse repo rate is hiked by 25bps while repo rate is left unchanged. The rationale behind such a move could be that since LAF is running into deficit, repo rate has become the operational rate and if RBI believes that liquidity conditions will remain tight for some more time, it may choose to postpone repo rate hike to a more suitable time. This may also look reasonable from the point of view that just three weeks ago RBI has hiked both the policy rates and with global growth environment turning more uncertain and US economic indicators deteriorating considerably, the cautious approach could be helpful at this juncture.

Annexure

■ Basic concepts and construction of EELII

The EELII, which is released on a monthly basis effective October 2009, is available with a lead period of around three months before the availability of actual data on GDP for any particular period.

This is a composite weighted average index of a number of macro-variables that typically exhibit a strong predictive ability of the core trends in the Indian economy. Instead of tracking different macro-variables, which typically influence the economy with different intensity and varying lead times and often—especially at times of turns in the economy—move in opposite directions, this single indicator is typically capable of summarising movements in all such different variables into one value. Hence, this can be an easy, yet effective, tool to track and predict inherent trends in the economy. The construction of the index was based on a multiple regression framework using quarterly data for the past 10 years.

As a starting point, around 60 different macro-variables—spanning over capital availability, credit demand, cost of funds, PMI, freight rates, property prices/rentals, consumption demand, intermediate goods production, electricity production, tourist arrivals and commodity prices—were considered.

This initial set of indicators was trimmed down on the basis of three criteria—degree of influence on non-agricultural GDP (high correlation), availability of high frequency and reliable data (longer/sufficient history), and lead property (lead period of at least one quarter). Redundancies were also removed for sets of indicators demonstrating auto-correlation (for example, supply of broad money (M3) and non-food credit offtake).

On the basis of such criteria, the final set of variables that was chosen for inclusion in the index are as follows: (1) credit offtake; (2) policy interest rates; (3) slope of the yield curve; (4) non-oil imports; (5) commercial vehicle production; (6) cement dispatches; (7) domestic steel prices; (8) government expenditure; and (9) resource mobilisation in the primary capital market. The range of variables included in the index augurs well with several lead indicator indices followed globally.

SI No.	Variables used as lead indicators by other studies	Whether used in EELII/ other comments
1	Broad money (M2)	Credit used as proxy - broad money and credit highly correlated
2	CPI	In India, CPI is largely determined by food prices and exposed to supply shocks in agriculture. Domestic steel price has been used instead as a proxy of inflation of industrial commodities
3	S&P500	Resources raised from domestic market used as proxy
4	Government borrowings	Government expenditure used as a proxy
5	Consumer sentiment / Advance monthly sales for retail and food services/ Real final sales of domestic product	No long dated series exists for India. Non-oil imports and commercial vehicles production used as indirect indicators of retail sales
6	No. of manufacturing orders for consumer goods and materials	No specific data series exists for India. Commercial vehicle production reflects demand for consumer goods. PMI could have been used; but the available data series too short for any statistically meaningful regression
7	Amount of new orders for non-defense capital goods	No specific data series exists for India. Domestic steel prices reflect input demand for capital goods to some extent
8	Initial applications on unemployment insurance	Not used in EELII due to data unavailability
9	Housing permits	No data series exists for India. Cement despatch figures / Domestic steel prices reflect construction activity to some extent
10	Slope of the yield curve	Used in EELII also

Lack of availability of data for certain potential lead variables like housing starts, property prices/rentals, PMI, business confidence indices, job losses etc., however, imposes constraints in their inclusion in the index. While the basic approach for constructing the indicator has by and large been in line with several other lead indicators followed internationally, certain customisations have also been made to suit Indian conditions.

Weights of different variables were assigned after eliminating time trends and seasonality, and after normalising all the variables to one common scale. Weights were determined on the basis of the regression model, hence, assigning more weight to indicators that have been historically shown to have a greater influence on the overall activity level and have captured turns in the economy better with a lead.

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