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MARKETS

Will El Nino Further Heat Up Indian Macro?

Depleting water levels, erratic monsoon and high temperatures may aggravate the economic situation, which is already grappling with inflation and slowdown concerns



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WITH INDIA ALREADY BATTLING a severely hot summer and receding water levels, the task to mitigate climate risks has become acute as the United Nations has warned of an increasing likelihood of El Nino developing later this year. This may further cripple the economy, which is combating challenges like steep inflation, growth slowdown concerns, and weather fluctuations between heatwaves and unseasonal rains.

As agriculture contributes 18 percent of India's GVA (gross value

added), growth in agricultural GVA may be thwarted during El Nino years. A bad or scanty monsoon and severely hot temperatures—even if not drought—damage crops, hitting agricultural income, which has an impact on inflation, sales of two-wheelers and tractors, overall rural demand and credit off-take for banks.

“Our assessment of the demand environment revealed that El Nino has, in the past, adversely impacted the topline as well as volume of FMCG companies. The sharp deceleration in sales of tractors

as well as two-wheelers paints a grim picture of the rural demand environment. We believe that the nascent rural recovery could get delayed in an event of an El Nino,” Hitesh Suvarna, analyst, JM Financial Institutional Securities says. Agriculture also employs around half of the country's workforce.

According to a statement on May 3 by World Meteorological Organization (WMO), specialised agency of the United Nations, the development of an El Nino will most likely lead to a new spike in global

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60%
Chances for a
transition to El Nino
during May-July



heating and increase the chances of breaking temperature records.

As per WMO estimates, El Nino can also cause severe droughts over Australia, Indonesia, and parts of southern Asia. There is a 60 percent chance for a transition to El Nino during May-July, and this will increase to about 70 percent in June-August and to 80 percent between July and September. Subsequently, there could be increased rainfall in parts of southern South America, the southern United States, the Horn of Africa and central Asia.

El Nino is a naturally occurring climate pattern associated with warming of the ocean surface temperatures in the central and eastern tropical Pacific Ocean. It occurs on average every two to seven years, and episodes usually last nine to 12 months.

The Indian Meteorological Department (IMD) projected rainfall for the upcoming June-September monsoon season at 96 percent of the Long Period Average (LPA), within the 'normal' range (96-104 percent of LPA). This contrasts slightly from the forecast of private forecaster Skymet, which sees 'below normal' monsoons at 94 percent of LPA, due to El Nino conditions. The IMD downplayed the El Nino impact, expecting such conditions to develop in the second half of the season and stating that there was normal or above-normal rainfall in 40 percent of El Nino years.

WATER EVAPORATING?

A look at the water reservoir levels in India is not comforting either. As on May 4, the live storage status of 146 reservoirs in the country, according to Central Water Commission (CWC), shows depleting water levels. CWC data shows live storage available in the reservoirs is 61.807 BCM (billion cubic meters), which is 35 percent of total water available. This is far less than 63.244 BCM in the corresponding period last year.

However, current water volume is still 120 percent of storage of the average of the last ten years.

States having less storage than last year for the corresponding period are Jharkhand, West Bengal, Nagaland, Bihar, Gujarat, Maharashtra, Uttar Pradesh, Uttarakhand, Andhra Pradesh, Telangana, Karnataka, Kerala and Tamil Nadu, as per CWC.

Depleting water levels, combined with an erratic monsoon and high heat, may aggravate the economic situation. Monsoon serves as a crucial water source for agricultural activities as approximately 50 percent of the country's net sown area relies on the monsoon rains, which also replenish water reservoirs.

The summer monsoon season, spanning from June to September, accounts for 80 percent of the total annual rainfall, coinciding with

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Hitesh Suvarna, analyst, JM Financial institutional securities

the main crop-growing season, Kharif. The season is responsible for producing major crops such as rice, pulses, oilseeds, cotton, and sugarcane. States with limited access to irrigation rely even more heavily on a normal monsoon.

"Prices of major Kharif crops such as rice and pulses are already at elevated levels. A bad monsoon could affect the production of these commodities putting upward pressure on food inflation. Poor rainfall could also deplete reservoir levels, which could have a bearing on Rabi crops (such as wheat) as well. What is even more important is the temporal and spatial distribution of rainfall. While states such as Punjab and Haryana have good irrigation facilities, other major crop-

producing states such as Rajasthan, Maharashtra, and Karnataka are more dependent on rains. Even in case of below normal monsoon, if these states receive abundant rainfall, the harm can be contained," says Rajani Sinha, chief economist, Care Ratings. Central parts of the country, including Maharashtra, Madhya Pradesh, Telangana, Chhattisgarh, and Jharkhand, being the main rainfed states, are most vulnerable to lower rainfall, which may impact production of rice, groundnut, cotton and sugarcane. In contrast, northern states such as Punjab and Haryana have their resources and irrigation network in place.

EL NINO, MONSOON AND THE ECONOMY

According to Sinha, El Nino may impact inflation as it may worsen if there is an uptick in global commodity prices. El Nino has varied economic impacts across different regions and can significantly affect global commodity prices including crude oil. "Damage in domestic agricultural production could also mean lower income for rural households as about 60 percent of the rural population is still employed in the agriculture sector. This could be detrimental to the rural demand, which has been struggling to witness any durable pick up. A number of other sectors including FMCG, auto and agrochemicals could also feel the heat of muted rural demand. This in turn could weigh on overall GDP growth," Sinha says.

However, in the past 50 years, there has been an increasing contribution of non-farm sectors to rural income, Sinha adds. About two-thirds of rural income is contributed by non-agricultural sectors such as manufacturing, construction and services. The government-led infrastructure push and focus on the tourism sector are expected to boost non-farm employment further, which could contribute positively to rural income and limit the downside risk of

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21
Number of El Nino
years in India
since 1950



El Nino on rural demand and India's GDP, Sinha believes.

She feels the government should ensure enough buffer stock of essential food items such as wheat, rice and pulses. As on April 1, wheat stocks stood at a six-year low of 8.35 million tonnes and only marginally above the minimum required 7.46 million tonnes for this date. "The procurement of wheat must be watched closely and in case of any shortfall, the option of import should be kept open to fill the demand-supply gap. Rice, which is a main Kharif crop, is quite sensitive to the amount and spatial distribution of rainfall. Last year, the government-imposed curbs on rice exports amid concerns over production due to below-average monsoon rainfall in key growing states. If there is a shortfall in rice production this year too due to below-normal monsoon, these export bans should be extended to ensure adequate domestic supplies," Sinha says.

As rainfed agriculture is dependent on rainfall, a deficit monsoon or scanty rainfall results in lower levels of productivity, resulting in wide variation and instability in crop yields. "Our assessment of credit demand in the past indicates that a lower monsoon (El Nino) coincided with an uptick in credit demand for agricultural activities," says Suvarna.

Considering Hindustan Unilever (HUL) as a proxy for the FMCG sector, Suvarna's estimates indicate that both topline and volume moderated during El Nino years; the exception was 2009, when there was an uptick. "We looked at tractor and two-wheeler sales to assess the impact on the rural economy. Two-wheeler sales showed mixed signals, while tractor sales fell sharply during El Nino years. However, incremental sales growth of both tractors as well as two-wheelers decelerated sharply during past instances of El Nino," Suvarna explains.

Since 1950, there have been 21 El

Nino years and 15 drought events in India. Interestingly, 10 of these 15 droughts were led by El Nino events. In the last four years, India has observed normal monsoons due to prevailing La Nina conditions, which favour good monsoons.

According to Nomura, even the spectre of a below-normal monsoon could lead to lower agricultural output growth, but the implications for food inflation are not as clear-cut. Despite reports of ongoing heatwave and sporadic rainfall causing some damage to the winter (Rabi) crops, including a fall in wheat yields, cereal prices remained subdued in March and April.

"While it is too early to assess the impact of below-normal monsoons, they typically lead to weaker food production and lower agricultural

"Damage in domestic agricultural production could mean lower income for about 60 percent of the rural population."

Rajani Sinha,
chief economist, care ratings

output growth. The link to food inflation, however, is not immediate. In the past, food inflation has increased despite good rainfall and vice versa, which suggests there are many other factors that determine the food inflation outlook," say Aurodeep Nandi and Sonal Varma, economists, Nomura. They expect headline inflation to average 4.9 percent year-on-year in FY24, down from 6.7 percent in FY23 and below the RBI's projection of 5.2 percent.

WHAT ABOUT EQUITY MARKETS?

El Nino's impact on inflation due to bad weather conditions has subsided over a period of time, analysts at Credit Suisse Wealth Management feel. "Moreover, the government has been proactively taking steps to curb food inflation with higher imports

and export restrictions as and when needed," say Jitendra Gohil and Premal Kamdar, analysts, Credit Suisse Wealth Management.

Gohil and Kamdar are expecting a good recovery in the second half of the year 2023 as major central banks may likely end their rate hiking cycle amid a deteriorating global growth outlook. "The valuation froth in the India equity market has settled after the recent derating, in our view. However, with global uncertainties still elevated, Indian equities may remain range-bound in the near term. We reiterate our view that any sharp correction could offer a good buying opportunity as India's medium-term growth outlook remains sanguine," they add.

Globally, equity markets recovered in April driven by improved sentiment after regulators stepped in to avert the banking crisis. The MSCI World, MSCI EM and MSCI Asia ex-Japan indices gained by 5.4 percent, 5 percent, and 4.4 percent, respectively, in the month. In India, the gains were marginally lower versus peers with the Nifty rising by 3.7 percent.

Benchmark Nifty has been underperforming the emerging markets and the world indices in the year 2023 so far amid varied global macro headwinds such as inflation, interest rates, and currency.

"After a flat FY23, Nifty now trades at 18 times one-year forward price to earnings (PE), which is a decent drop from the level of 21 times seen at the beginning of FY23. While absolute valuations are reasonable and well within the range of long period average (LPA) multiples, the relative valuations for MSCI India are still at an 88 percent premium versus MSCI EM. We believe the relative equity versus bond valuations are now far more palatable than at the beginning of FY23," says Deven Mistry, analyst, Motilal Oswal Financial Services.

• NASRIN SULTANA