

India's Economic Growth Likely Held Up in Q2 FY26; Historic Low Inflation Keeps the Door Open for a Rate Cut



- Despite mixed public commentary from Fed officials, the US Fed is expected to deliver a 25-bps rate cut in December, bringing the total cuts since September to 75-bps. However, with growth near potential and core inflation remaining above target, the still significant number of rate cuts priced in are unlikely to be realised.
- The US economy remains resilient, supported by steady consumer spending, substantial AI-driven investment, and forthcoming fiscal tailwinds in 2026. With activity likely to firm modestly, labour-market risks should ease, leaving little justification for additional Fed easing (beyond December).
- India's economic growth likely remained robust in Q2-FY26, albeit moderating from the strong outturn in the previous quarter. We project real GDP growth at ~7.2% YoY in Q2-FY26, down from 7.8% in Q1, partly aided by the favourable base effect and a lower GDP deflator.
- While sequential momentum has softened, underlying real economic activity likely stayed healthy, supported by continued strength in government CAPEX (though slower than Q1) and front-loading of exports ahead of the US 50% tariff implementation in late August. Private investments also showed tentative signs of recovery.
- In Q2, industrial activity picked up, while services-sector indicators were mixed. Meanwhile, the agricultural sector is expected to show some moderation with unseasonal rains likely impacting the Kharif crop yields.
- Looking ahead, the private consumption outlook is improving on the back of policy measures and recovery in labour market conditions. If consumption recovery sustains, it should aid the revival in private investment, particularly in domestically oriented industries.
- The external sector, however, continues to face global headwinds, including US tariffs, with India's merchandise exports contracting and trade deficit reaching an all-time high in October.
- While downside risks from US tariffs persist, there are encouraging signs of progress in trade negotiations, according to media reports. Meanwhile, the RBI and the Government announced a slew of measures to provide interim relief to exporters.
- The inflation outlook remains favourable. Headline CPI inflation fell sharply to 0.25% YoY in October due to deflation in foods & beverages, a favourable base effect, and the pass-through of GST reductions. We revise our inflation projection for FY26 downward from 2.5% YoY to 2.1% YoY.
- Besides a dovish leaning in the October policy meeting, very low inflation and expectations of slower economic momentum in H2-FY26 strengthen the case for a 25-bps policy repo rate cut by the RBI in December.
- However, a stronger-than-expected Q2 GDP print and/or early progress on a US-India interim trade agreement could prompt the RBI to opt for a "dovish hold" instead.

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Fed Poised for December Rate Cut; Prospects for Additional Rate Cuts are Limited.

Despite the recent sharply divergent public comments from Federal Reserve policymakers, the US central bank remains highly likely to reduce interest rate again in December. At its upcoming monetary policy meeting, we remain confident that the Fed will lower its policy interest rate by another 25-bps, extending its rate reductions since September to 75-bps (and 150-bps from the peak in summer 2024). However, beyond the December rate reduction, prospects for additional rate cuts are limited.

The Fed's interest rate reductions in recent months have been about risk management, specifically truncating downside labour market risks, not about heading off or cushioning a dramatic fall in economic activity. Accordingly, we have been puzzled by the extent to which markets have priced in significant policy easing on a year-ahead time horizon. Despite economic growth running at a pace somewhat close to its potential and core inflation above its medium-term target, markets continue to anticipate that the rate reductions that resumed in September 2025 will ultimately total more than 150-bps. Even with the recent pushback against a December cut by some Fed officials, year-ahead rate expectations still anticipate an additional 100 bps of policy easing – the timing of rate cuts is now more backloaded vis-à-vis prior expectations.

To be sure, US interest rate futures markets often grossly overestimate the scope of monetary policy adjustments. But with economic growth proceeding at a pace not far from its potential rate of growth and core inflation still above its medium-term target, a cumulative 150-bps plus easing cycle (i.e. another 100-bps following the 50-bps already delivered) has been and continues to be disconnected from the macro fundamentals.

On this score, economic growth continues apace, and underlying macro fundamentals remain consistent with continued expansion. Although consumer sentiment is depressed, actual consumer spending has been resilient. Business capital investment remains strong, underpinned by robust AI-related investment and other productivity-enhancing capital investment. Meanwhile, as discussed in detail in last month's report, this past summer's fiscal package will buoy both consumer and business income in 2026 and that development is likely to result in a firmer pace of domestic demand in the new calendar year.

Nonetheless, the labour market continues to pose some downside risks to the US economic outlook. The labour market has been stuck in a low-hire/low-fire unstable equilibrium for roughly 18 months now. Some of the Trump Administration's policies have contributed to and extended this low-hire/low-fire employment environment. The chaotic

nature of tariffs has heightened uncertainty and paralysed certain types of business decision-making; immigration policy has reduced the supply of workers and complicated labour pricing, especially in select industries.

The prevailing low-hire/low-fire labour market backdrop would be particularly worrisome if corporate profits were being squeezed, if consumers in aggregate were resource-constrained, and/or if financial conditions were tightening markedly. At present, no such conditions are present.

As a result, chances are good that the US expansion will continue, albeit at a quicker yet still moderate pace, as the calendar turns to 2026. With that anticipated modest firming in economic activity, downside risks to the labour market should recede somewhat. With ongoing advancements and adaptation of AI and public companies being rewarded in the markets for productivity-enhancing measures, the US job market seems unlikely to strengthen notably in the next six months. But so long as it does not worsen, growth will remain on a solid, if unspectacular path, and the need/desire for further monetary policy support in the form of lower interest rates possibly will dissipate.

India's Economic Momentum Likely Remained Strong in Q2; Pullback in Government Spending and External Risks to Weigh on H2 Growth Momentum

India's economic growth likely remained robust in Q2-FY26, albeit moderating from the strong outturn in the previous quarter. We project real GDP growth of ~7.2% YoY in Q2, down from 7.8% in Q1. While sequential momentum has softened, underlying real economic activity likely stayed healthy, supported by a favourable GDP deflator, continued strength in government CAPEX (though slower than Q1), and front-loading of exports ahead of the US 50% tariff implementation in late August. A favourable base from last year will also support the GDP print in Q2.

Private consumption showed mixed trends in Q2, with households possibly postponing purchases from August to late September in anticipation of GST benefits. Even so, real consumption likely benefited from a lower deflator, improving labour-market conditions, including a recovery in both rural and urban wages/salaries and a sharp rise in demand in late September following the implementation of the GST cut. The private investment outlook showed tentative signs of improvement, given the increase in new project announcements in Q2. It will be important for these announced projects to come in line in the quarters ahead. Meanwhile, government CAPEX remained robust, albeit slower than Q1. However, a sharper moderation in government revenue expenditure is expected to have weighed on overall economic growth in Q2. From the supply side, a recovery in industry, led by manufacturing and alongside resilient services (with some moderation from Q1),

likely helped sustain economic momentum in Q2-FY26. On the other hand, the agricultural sector has somewhat slowed amid unseasonal rainfall possibly affecting Kharif crop yields.

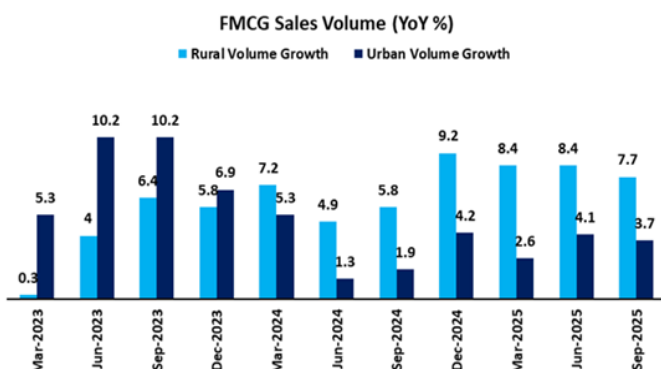
Looking ahead, the private consumption outlook is improving on the back of policy measures and better labour-market conditions. If this consumption recovery sustains, it should gradually revive private investment in domestically oriented industries, even as export-oriented sectors remain in a wait-and-watch mode amid external headwinds. Despite the expected pickup in consumption, overall economic momentum is likely to soften in H2 after a strong H1, as government spending normalises following front-loading during April–September and slower tax collections constrain fiscal space. Export momentum will also taper ahead with the ongoing delay in the US-India trade deal.

Given these risks to the economic growth outlook alongside very low inflation, we expect the RBI to cut the policy repo rate by 25-bps in the December policy. However, we do not rule out a dovish hold if Q2 GDP surprises on the upside and/or there is meaningful positive news on a potential US-India trade agreement.

Private Consumption Demand Remains Uneven in Q2 with Rural Demand Leading the Recovery

Despite moderating from the previous quarter, private consumption demand likely remained on solid ground in Q2. However, there were some mixed signals due to consumers possibly delaying purchases before the GST cut implementation towards the end of September. Nonetheless, the real consumption demand is expected to be supported by a lower deflator, favourable base effect, improvement in the labour market conditions, and revival of demand in late September.

Rural Sales Volume Growth for FMCG Sector Outpaced Urban Counterparts for Seventh Consecutive Quarter



Source: NielsenIQ, Media Articles

Rural demand continues to lead the domestic consumption recovery as reflected in improvements in rural demand proxies in Q2, such as tractor and two-wheeler sales, which were supported by rising rural wage growth. According to NielsenIQ data, FMCG sales volume growth in Q2 was also led by rural sales, which grew by 7.7% YoY (vs 8.4% in Q1), while urban sales continued to lag with 3.7% growth (vs 4.1% in Q1). Other indicators of urban demand suggested an uneven recovery in Q2, with a slowdown in some indicators (domestic air passenger traffic and retail credit), while credit card spending and PV registrations improved.

Demand Shows Early Rebound in Q3 due to Festive Led Demand and GST cuts, Outlook is Cautiously Optimistic

Encouragingly, private consumption showed early signs of a rebound in Q3, even as labour market indicators were mixed in October. Total automobile registrations observed double-digit growth in October, driven by festive demand and the anticipated release of pent-up demand following the GST cuts. Meanwhile, labour market data was volatile. The CMIE unemployment rate rose to a six-month high of 7.5% in October, driven by an increase in rural unemployment, though partly offset by an improvement in urban areas. Additionally, the pace of formal hiring activity (as per Naukri JobSpeak Index) slowed in October due to extended festival-related holidays.

Looking ahead, the optimism in domestic demand could sustain beyond the festive season, owing to a host of favourable factors, including earlier income tax cuts, lower inflation, continued monetary policy transmission, the expectation of healthy Kharif output, buoyant Rabi prospects, and incipient signs of improvement in urban wage growth. Based on the corporate employee expenses deflated by urban CPI inflation as a proxy for the change in urban real wages/salary, estimated real wages/salary growth for the non-financial sector¹ has picked up to 5.1% YoY- almost double the level seen in FY25. Having said that, the sustainability of consumption recovery hinges on steady recovery in the labour market.

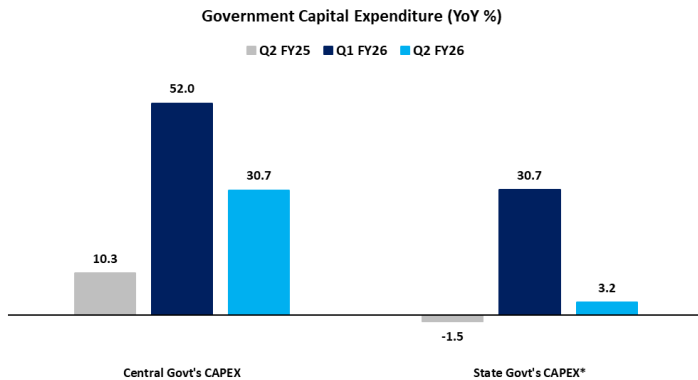
Government Support to Investment Activity is Showing Signs of Moderation; Support Expected to Taper Further

Investment activity was a mixed bag in Q2. This was primarily due to the slowing pace of capital expenditure by both the central and state governments, while there were tentative signs of a revival in private investment spending. Nonetheless, the support from the government CAPEX was still positive, with the Central government capital spending growing by 30.7% YoY in Q2 (vs 52% YoY in Q1) in nominal terms, while states' capital expenditure rose at a more

¹ Based on a sample of 3.4K listed companies with 1.8K companies in the manufacturing sector and 1.3K companies in the non-financial services.

modest pace of 3.2% YoY (vs 30.7% YoY in Q1). With government tax collections slowing and some anticipated revenue loss ahead from the GST cuts as well, we expect a decline in government investment support in the remainder of FY26.

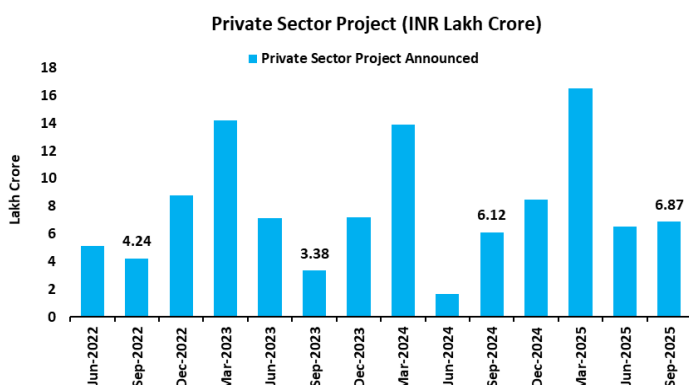
Government CAPEX Spending Moderated in Q2



Source: CMIE; Note: State Govts' CAPEX is based on data of 19 states.

Meanwhile, private-sector investment activity is showing positive signs. Based on CMIE data, the value of new private investment project announcements picked up pace and rose by ~12% YoY in Q2-FY26. This was despite the unfavourable base effect, as several new project announcements were deferred to Q2 and beyond amid the general elections in Q1-FY25. With that, for H1-FY26, the value of new project announcements rose by ~72% YoY, compared to a ~26% contraction during the same period last year, reflecting a sharp yet tentative recovery. A similar sentiment is also observed across other high-frequency indicators, such as large industrial credit and infrastructure & construction output (also supported by government CAPEX). We anticipate a gradual revival in private investment, particularly in domestically oriented industries, contingent on sustained momentum in consumption, while export-oriented sectors are expected to delay investments until there is further clarity on trade deal with the US.

New Project Announcements by the Private Sector are Tracking Well in Positive



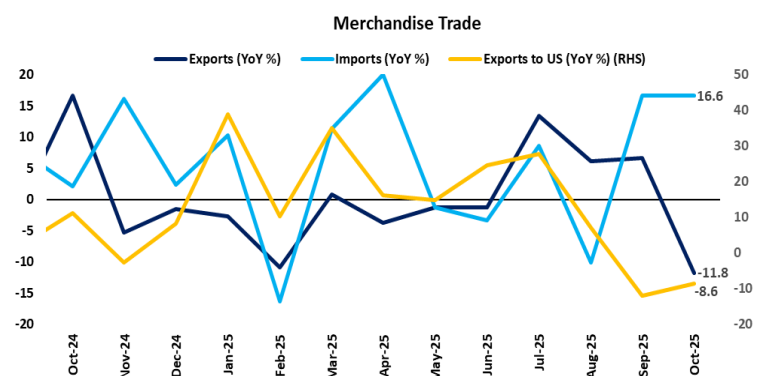
Source: CMIE; Note: Data as of 24 November

Merchandise Trade Deficit at an All-Time High in October, Partly Cushioned by Robust Services Surplus

Amidst the continued external headwinds, including US tariffs, India's merchandise exports slowed, contracting by 11.8% YoY in October, following an 8.7% YoY expansion in Q2 (partly aided by the front-loading of shipments to the US in July-August). The impact of 50% US tariffs became more evident with shipments to the US contracting further by 8.6% YoY in October (vs -11.9% in September). Several export product categories, including Gems & Jewellery, Organic & Inorganic Chemicals, Textiles and Related products, Plastic & Linoleum, Leather & leather products, and Ceramic products & Glassware, showed double-digit (YoY%) contraction in October. Meanwhile, imports grew by 16.6% YoY in October, driven by an extraordinary surge in gold and silver imports, led by pre-stocking ahead of the wedding season and high prices. Overall, the merchandise trade deficit widened to a historic high of US\$41.7 bn in October.

On the other hand, the services account surplus remains robust (~US\$19.9 bn), partly cushioning the impact of the high merchandise trade deficit. This is led by the sustained growth momentum in services export at about 12% YoY in October (9.8% averaged in FYTD). With that, the total trade deficit stood at a historical high of US\$21.8 bn in October.

Merchandise Exports Contracted due to External Headwinds, with Exports to the US Registering Second Consecutive Month of Contraction



Source: CMIE

Trade Outlook Marred with Uncertainty till an Interim Trade Agreement Between the US and India is Reached

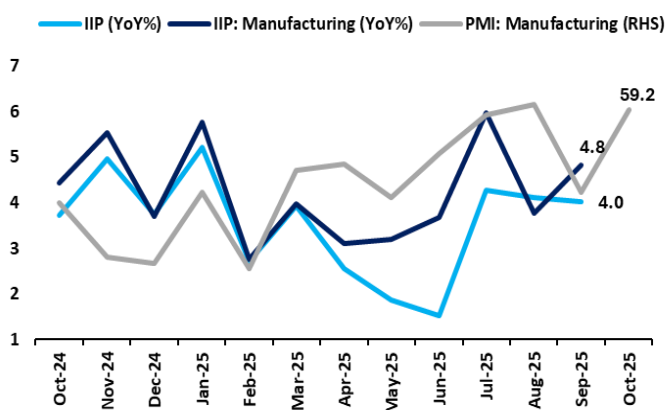
The trade sector outlook remains clouded by external headwinds, including US tariffs. While there is some positive media chatter about the US-India interim trade deal nearing closure, the official announcement is yet to come. The continued delay in this will exert pressure on merchandise exports in the upcoming months and weigh on economic growth. In the interim, to provide some relief to exporters, the RBI and the government have announced a slew of measures. The government has announced a credit

guarantee scheme for eligible exporters, including MSMEs, and has also approved the outlay for the export promotion mission. The RBI also announced targeted relief measures for exporters in select industries, including temporary moratoriums/deferments, working capital relief, and extended export credit tenors. These measures will offer temporary support to the exporters; however, the downside risks persist until an interim trade agreement with the US is concluded (For more details, refer to our report titled [RBI and Government Introduce Measures to Strengthen Support for Exporters and MSMEs](#)).

Industrial Activity Picked up in Q2, Services Indicators Showed a Mixed Picture, while Unseasonal Rains Likely Impacted the Agricultural Sector

From the supply side of the economy, an improvement in industrial sector activity would support a robust GVA print in Q2-FY26. The Index of Industrial Production (IIP) expanded by 4.1% in Q2 vs 2.0% in the previous quarter. This improvement was broad-based across sectors, led primarily by manufacturing growth. Within manufacturing, the infrastructure & construction output and consumer durable segment led the growth. The former benefited from continued government capital spending and tentative signs of a revival in private-sector investment, while the latter benefited from pre-stocking ahead of the festive season. Meanwhile, consumer non-durables output contracted, led by the food and pharma sectors. The listed corporate results¹ for manufacturing companies, as per the CMIE data, also showed recovery, with nominal sales growing by a 10-quarter high of 7.7% YoY (vs 3.3% in Q1-FY26) and profit margins improving.

Industrial Activity Gained Momentum in Q2 Led by Manufacturing



Source: CMIE

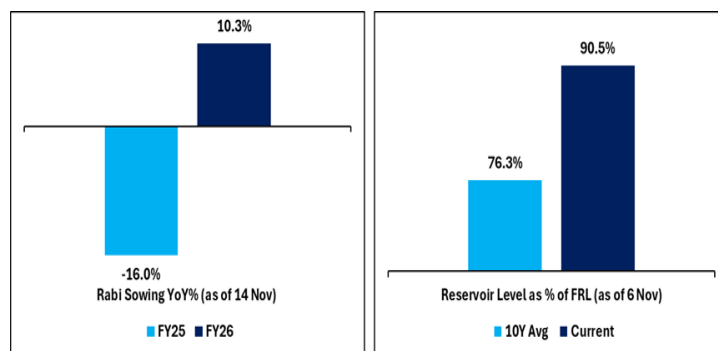
The lead indicator suggests that the strength in the manufacturing sector has continued with the PMI Manufacturing Index reported at 59.2 in October (vs 58.7 average in Q2), driven by a strong festive-season demand and new GST reforms that took place in late September. The

outlook for the industrial sector hinges on sustained recovery in domestic consumption demand, even as the export-oriented sectors continue to face pressures until the 50% US tariffs persist.

The service sector activity, while remaining robust, appears to have moderated slightly in Q2 compared to Q1. Some slowdown was witnessed in select high-frequency indicators, including domestic air passenger traffic and domestic & international air cargo traffic. Services exports also experienced a mild slowdown during the quarter. However, underlying strength was maintained, reflected in the robust PMI Services readings and strong e-way bill collections. Listed corporate results¹ also indicated this, with net sales of the services sector showing a pick-up; however, select industries such as hotel & tourism and communication services showed moderation. The financial sector is also likely to show some pick-up, with a modest uptick in the pace of nominal credit growth, along with banks reporting improvement in net profit growth. Meanwhile, public administration activity appeared to have slowed, due to a contraction in government revenue expenditure (excluding interest payments and subsidies) in nominal terms. Looking ahead, the PMI Services index was robust at 58.9 in October (although slightly lower than Q2, partly due to the unseasonal rainfall), but well above the long-term average, attesting to the sector's underlying strength.

Lastly, the agriculture sector is anticipated to show moderation in growth in Q2 (vs Q1) due to the unfavourable base effect and unseasonal rainfall, which is expected to adversely impact Kharif crop yields, with farmers reporting crop damage. However, the outlook for the sector remains optimistic, with Rabi sowing tracking 10.3% above the previous year's level and reservoir levels well above the 10-year average.

Outlook for the Agriculture Sector Is Positive with a Strong Start of Rabi Sowing and Adequate Reservoir Level

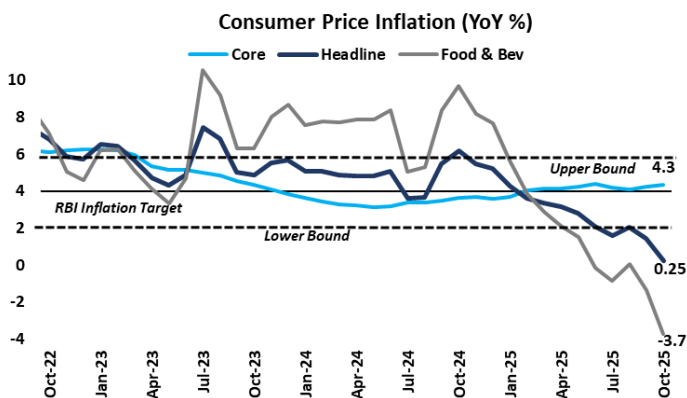


Source: CMIE; Note: FRL stands for Full Reservoir Level

CPI Inflation Falls to Historic Low in October, CPI Ex-Gold in Deflation

Headline CPI inflation fell sharply to 0.25% YoY in October, the lowest print in the current series (base 2012), down from a revised 1.44% in September and marking the third episode of inflation slipping below the RBI's 2-4% tolerance band. Excluding gold, CPI moved into deflation at -0.6%, reflecting sharper declines in food & beverages (-3.7% vs -1.4% in September), a favourable base effect, and the pass-through of GST reductions, especially in durables and, to some extent, non-durables. Core inflation stayed at 4.3%, but elevated gold prices masked broad-based moderation across most categories; core inflation excluding gold eased to 2.6% (from 3.0% in the previous month), with declines across clothing & footwear, health, transport & communication, and recreation. Disinflation remains widespread, with only 12% of CPI items recording inflation above 6% and nearly half the basket printing below 2%. Regionally, rural inflation slipped into deflation while urban inflation fell below 1% in October. The near-term inflation outlook remains favourable, supported by deflation in WPI (-1.2% in October), a positive Rabi crops outlook, contained crude oil prices, and remaining room for GST pass-through.

Headline CPI Printed at 0.25% in October



Source: CMIE

After averaging 1.7% in Q2 (slightly below both our and the RBI's 1.8% projection), headline CPI inflation is expected to undershoot the RBI's Q3 forecast of 1.8% as well. We expect inflation to average around 0.8% in Q3 before rising to roughly 3% in Q4 as the base effect turns unfavourable. Consequently, we revise our FY26 CPI inflation forecast down from 2.5% to 2.1% and expect the RBI also to trim its projection from 2.6% toward ~2%. For FY27, inflation is likely to normalise to around 4.0–4.5%, driven primarily by base effects.

Cut or Hold? Growth–Inflation Mix, and Uncertainty Around US–India Deal, Pose a Dilemma for RBI

Although the inflation trajectory provides meaningful policy space, the economic growth backdrop is more nuanced.

While real GDP growth in Q2 is expected to soften from 7.8% in Q1, it should still exceed the RBI's 7% projection. However, economic momentum is likely to slow in H2-FY26. Government spending is expected to moderate after heavy front-loading in H1-FY26, particularly as revenue collections lag budget assumptions. External risks have also increased, with US tariffs weighing on merchandise exports and adding pressure on labour-intensive sectors. These challenges are partly offset by an improving consumption outlook and tentative signs of private sector investment revival. The RBI, therefore, faces a delicate balance between exceptionally soft inflation, stronger growth in H1-FY26, and emerging growth risks in H2.

RBI Expected to Deliver a 25-bps Rate Cut in December; A Dovish Hold Cannot Be Ruled Out

The sharp disinflation, the dovish tilt in the October policy, and the likelihood of downward revisions to inflation forecasts collectively strengthen the case for a 25-bps rate cut in December. Additional monetary easing could help consolidate the transition in growth drivers from a public-sector-led recovery to one increasingly anchored by private consumption and private investment. The decision, however, is likely to be a close call, albeit with a tilt toward easing, given the MPC's guidance at the previous policy meeting. A stronger-than-expected Q2 GDP print and/or early progress on a US–India interim trade agreement could prompt the RBI to opt for a "dovish hold" instead.

Market Update

Bond Market: In November, the G-Sec yields eased from the October levels, with the 10-year benchmark G-sec yield softening to around 6.46% by November 25th from 6.53% at the end of October. This moderation was supported by an exceptionally low inflation print, rising expectations of a rate cut by the RBI, and a slight decline in US Treasury yields. The RBI's upcoming policy decision, clarity on potential OMOs, the US Fed's forward guidance, prospects of G-Sec inclusion in the Bloomberg Global Aggregate Index, and developments on the US-India trade deal will be key determinants of market sentiment.

Equity Market: Indian equities rebounded strongly in October. The NIFTY50 benchmark posted 4.5% sequential gains, supported by momentum from GST 2.0 reforms, festive-driven consumer spending, and positive signals around the US-India trade deal. In November so far, the domestic equities have managed to stay in green (0.6% till 25th November) with the positive factors including recovery in corporate earnings, and broader macro-optimism offsetting the negative factors including volatile foreign capital flows, weak global cues, and the delay in the potential US-India trade deal. Looking ahead, the progress of the US-India trade deal negotiations, the upcoming Q2 GDP print,

and the RBI's policy decision will shape the outlook for domestic equity markets.

Currency Market: In October, the rupee was range-bound with RBI intervention helping offset pressures from a stronger dollar, volatile foreign capital market flows and month-end dollar demand from importers. Depreciation pressures rose in November, with the domestic currency hitting a historical low of Rs. 89.4/USD (November 21st). due to widening trade deficit, global risk-off sentiment, and uncertainty over the US-India trade deal. The progress on the US-India trade deal will likely be a key driver of the rupee's movement, with further delays expected to lead to additional depreciation pressure. However, we expect the RBI to intervene in the FX market to prevent sharper volatility.

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