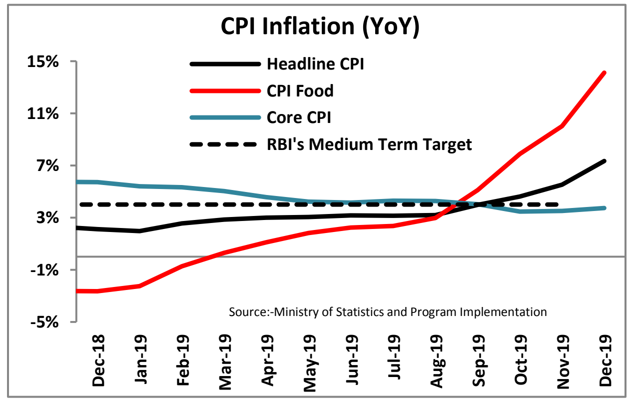
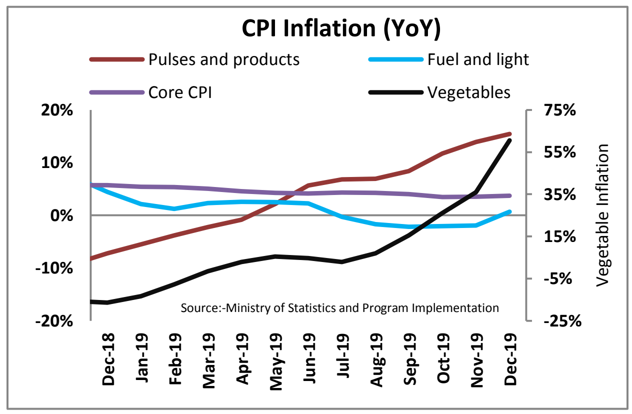
CPI inflation - December 2019

Event Update

Domestic retail inflation continued with the rising trend and rose above the RBI's flexible inflation target range of 4% (+-2%) in the month of December 2019, tracking sustained rise in food inflation. Inflation based on Consumer Price Index (CPI) for December 2019 came in at 7.35% YoY compared to 5.54% YoY for the month of November 2019. Apart from food inflation, rise in Core CPI inflation also contributed to the higher CPI inflation in December 2019. Core CPI inflation (ex food and fuel but including 'Transport and communication'), rose in December 2019 and came in at 3.74% YoY as against 3.50% YoY in November 2019.

Prices of the internal items of the food segment witnessed a broad based increase on a year on year basis. Within food, vegetable prices witnessed, the highest increase in annual inflation which came in at 60.50% YoY in December 2019 versus 35.99% YoY in November 2019. Inflation in Prices of 'Pulses and Products', also increased and came in at 15.44% YoY in December 2019 as against 13.94% YoY in November 2019. Inflation in proteinaceous food items also increased in December 2019 as compared to the previous month. Inflation in the 'Fuel and light' segment reflected the rise in international crude oil prices, which jumped over 8% Month on Month (MoM) in December 2019. Thus, 'Fuel and light' segment which has witnessed deflation annually over the past five months saw an inflation of 0.70% YoY in December 2019. Within the Core CPI basket, items that witnessed rise inflation in December 2019 included 'Clothing and footwear', 'Transport and communication' and 'Pan, tobacco and intoxicants'. Rest of the items in Core CPI saw decline in inflation on a YoY basis.





Retail inflation has now been above the RBI's medium term inflation target of 4% for the past two consecutive months. It will now be important to see if vegetable prices witness the seasonal decline in prices. Also, the sowing of Rabi crops has been good, which could also influence the prices of pulses, wherein annual inflation has been on the higher side recently. Another important aspect would be the Core inflation. If the government does announce measures to boost demand conditions in the economy, then that could show up in Core inflation. Thus, the CPI inflation trajectory hinges upon movement in vegetable prices, Rabi crop harvest and the demand support measures by the government. To that effect the upward pressure on CPI inflation may continue for the time being.

Fixed income view:

The bond markets reacted negatively to the CPI inflation data, wherein the 10 year benchmark bond, the 6.45% 2029 G-sec yield rose from its yesterday's close and is trading at 6.66% at the time of writing this note, after rising to a level of 6.68%. In the December 2019 monetary policy the RBI had paused on interest rates to see the incoming data on inflation and government's measures on growth in the Union Budget for FY21. Additionally, there has been a modest pickup in the recently released data on Index of Industrial Production (IIP) for the month of November 2019. The IIP for November 2019 grew by 1.8% YoY as against a contraction of ~4% YoY in Oct 2019. On the Union Budget for FY21, the RBI is expected to watch the measures the government announces to push the economic growth and their impact on the government's fiscal deficit. Thus, looking at recent data on inflation as well as IIP, the RBI may choose to pause on interest rates yet again in February 2020 to get more clarity on the evolving trend macro data before deciding to act. We expect bond yields to remain volatile in the near term, in the run up to the Union Budget for FY21.

Fixed Income Mutual Fund Strategy:- Investors who are looking to benefit from relatively better accruals can look at Corporate Bond Funds and Banking and PSU Funds for a horizon of 15 months and above. Investments in Medium Duration Funds can be considered with a horizon of 15 months and above. Investments into Short Duration Funds can be considered with an investment horizon of 12 months and above. Investors, who are comfortable with intermittent volatility, can also look at strategies that have allocation to the longer end of the yield curve, through Dynamic Bond Funds with an investment horizon of 24 months and above. Investors looking to invest with a horizon of up to 3 months can consider Liquid Funds, while Ultra Short Duration Funds and Arbitrage Funds can be considered for a horizon of 3 months and above.

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