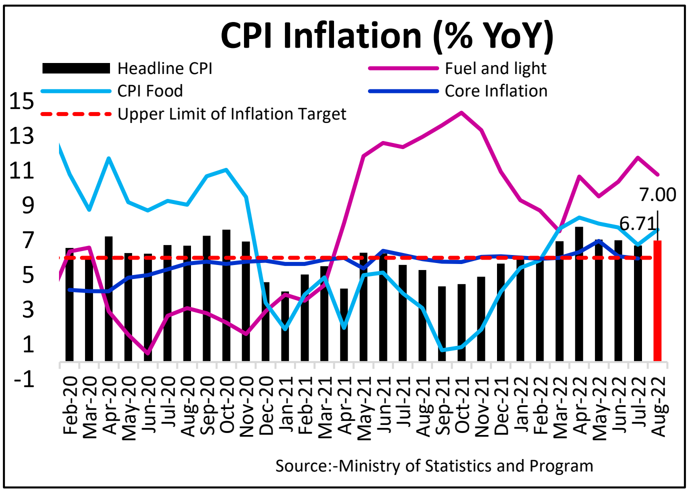
HDFC Bank Research **September 13, 2022**

CPI inflation- August 2022

Event Update

Domestic retail inflation rose in the month of August 2022 and came in higher than expectations, after decelerating for three consecutive months till July 2022. Inflation based on Consumer Price Index (CPI) for the month of August 2022 came in at 7% YoY as compared to 6.71% YoY in July 2022. On a month on month (MoM) basis, CPI inflation declined to 0.51% in August 2022 from 0.46% in July 2022. The rise in the headline inflation was led by higher food inflation, wherein Consumer Food Price inflation stood at 7.62% YoY in August 2022 as against 6.69% YoY in the previous month. Core CPI inflation (ex Food and Fuel but including 'Transport and communication') remained sticky in August 2022 and came in higher at 5.84% YoY as compared to 5.78% YoY in July 2022.



Within the food basket, some of the more staple items such Cereals, 'Milk and products', Vegetables, Pulses and 'Prepared meals, snacks and sweets' amongst others and also those that have relatively higher weights in the overall CPI, witnessed a rise in inflation in August 2022. Inflation in Cereals rose to 9.57% YoY in August 2022 from 6.90% YoY in July 2022. 'Milk and products' inflation also rose to 6.39% YoY in August 2022 from 5.78% YoY in July 2022. Vegetable prices rose by 13.23% YoY in August 2022 from 10.90% YoY in July 2022. Inflation in prices of 'Prepared meals, snacks, sweets etc.' saw an uptick of 7.75% YoY from 7.55% YoY. Inflation in prices of 'Oils and fats' declined to 4.62% YoY in August 2022 from 7.52% YoY in July 2022 tracking the decline in international prices of edible oils and also the efforts taken by the government. In case of Core CPI inflation, the movement was mixed. Some of the segments in Core inflation that saw a rise in inflation in August 2022 as compared to August 2022 included Clothing, Housing, 'Household goods and services' Education and 'Personal care and effects'. Items that witnessed a decline in inflation rate on a YoY basis in August 2022 included Health, 'Transport and communication' and 'Recreation and amusement' amongst others. In case of 'Fuel and light', inflation declined to a level of 10.78% YoY in August 2022 as against 11.76% YoY in July 2022, helped by the decline in international crude oil prices in August 2022.

The rise in food inflation has been a result of a host of factors such has heat waves globally as well as domestically impacting crop production; the Russia-Ukraine war resulting in supply crunch; abnormal rains in some parts of the country and below normal rains in others leading to crop destruction, amongst others. This is reflecting in prices of staple items both globally as well as domestically. As we continue with the festival season, the prices of essential items such as vegetables and fruits are likely to rise, which could add to the inflation woes in the near term. As per latest updates, crop acreage have seen a decline as compared to last year due to erratic behaviors of monsoon across various states, which also requires close monitoring. That said, currently, as per statements from government there is sufficient food grain stock. After declining in July 2022, commodity prices have seen an uptick in August 2022. While further slowdown is expected in the major economies of the world, which could cap the rise in the commodity prices, this will also be an important variable to track very closely. Volatile crude oil prices are another source of uncertainty for domestic inflation. On another front, India's Current Account (CAD) deficit is likely to widen, leading to implications on Rupee exchange rate and thereby pries of imported items. Here the Balance of Payments' situation and RBI's Forex management will be critical. Thus, currently a host of variables both global and domestic are imparting uncertainty to the inflation trajectory.

Fixed income view:

G-secs closed on a positive note today notwithstanding the rise in retail inflation. Yield on the old 10 year benchmark, 6.54% G-sec 2032 bond, declined sharply and closed at a level of 7.10% today as against its previous close of 7.18%. The recent rally in bonds has largely been on account of rising expectations of inclusion of Indian G-secs in global bond indices. If the announcement of the inclusion does come about, we may see some further rally in the domestic bond markets; and if it does not then that could erase some of the recent gains. Looking at the stickiness of the inflation currently, the RBI is likely to continue with the monetary policy tightening through rate hikes and withdrawal of liquidity. Uncertain global macro-economic environment may also warrant RBI to remain hawkish in the near to medium term. Thus, while there is downward bias to bond yields at the longer end of the yield curve, volatility cannot be ruled out given the various moving parts impacting the fixed income markets.

Fixed Income Mutual Fund Strategy:- For investors looking for accrual strategies, they can consider Target Maturity Index Funds that invest in a mix of better quality bonds with investment horizons matching the maturity of the funds. Investors could also look at funds oriented towards the shorter end of the yield curve for stabler returns in the near term and to benefit from the reset in interest rates on the higher side. For this one can look at Short Duration Funds, Money Market Funds, Ultra Short Duration and Low Duration Funds for a horizon of 12 months and above. Investors who are comfortable with volatility and have a longer investment horizon could look at Dynamic Bonds for a horizon of 24 months and above. For a horizon of 3 months and above Arbitrage and Money Market Funds can be considered. Whereas, for a horizon of up to 3 months investors can consider Overnight Funds and Liquid Funds. Investors should invest in line with their risk profile and product suitability.

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