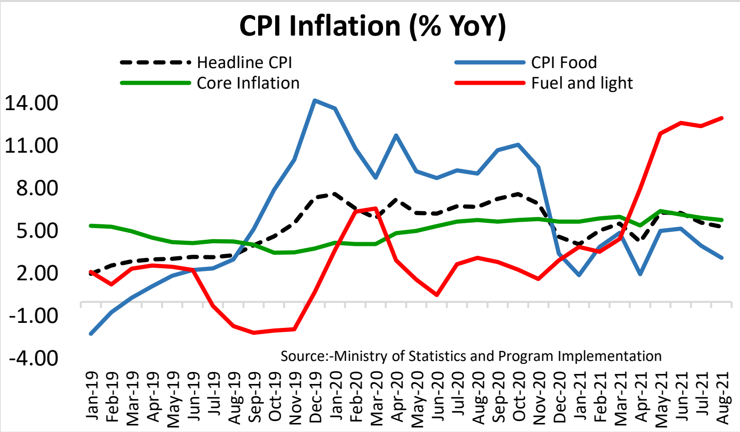
CPI inflation- August 2021

Event Update

India's retail inflation based on Consumer Price Index (CPI) for August 2021 came in lower than market expectations and the previous month, tracking a decline in inflation in the retail food prices on a year on year basis (YoY). CPI inflation for August 2021 stood at 5.30% YoY as against 5.59% YoY in July 2021. The markets were expecting inflation to be at ~5.6% in August 2021. CPI food inflation declined further to 3.11% YoY in August 2021, from 3.96% YoY in July 2021. Core CPI inflation (ex Food and Fuel, but including 'Transport and communication') also moderated further in August 2021 and came in at 5.77% YoY in August 2021, as against 5.94% YoY in the previous month.



On a YoY basis, vegetable prices continued to deflate in August 2021, wherein the deflation increased to 11.68% in August 2021 as against 7.8% in July 2021. Deflation in prices of Cereals also continued, which stood at 1.42% YoY in August 2021 as against 1.68% YoY in the previous month. Inflation in prices of eggs, which have been rising over the past four consecutive months till July 2021, witnessed a decline in inflation in August 2021 and came in at 16.33% YoY as against 20.82% YoY in July 2021. However, some other proteinaceous food items such as 'Meat and fish' and 'Milk and products' saw a rise in YoY inflation in August 2021. Within Core CPI, inflation in 'Personal care and effects' witnessed a shaper decline in August 2021, wherein inflation stood at 1.01% YoY, as against 3.76% YoY in July 2021. Other items that saw a decline in inflation within Core CPI included 'Pan, tobacco and intoxicants' and 'Transport and communication'. The movement of inflation in the internal segments of the Core CPI, was mixed. Inflation in 'Fuel and light' increased in August 2021 and stood at 12.95% YoY as against 12.38% YoY a month ago.

Retail inflation has stayed within the RBI's flexible inflation target range of 2-6% for the past two consecutive months. Inflation has also undershot the RBI's forecast of 5.9% for the Q2FY22, so far in the quarter. Looking at the base effect for the next few months, which is on the favorable side, CPI inflation is likely to remain within the RBI's inflation target range. This may give some comfort to the RBI to remain accommodative for relatively longer in order to support the economic growth recovery. As the favorable base effect weans off mostly post November 2021, which may also coincide with demand picking up due to progress in Covid-19 inoculation, inflation may witness upward pressure again. Another important factor that is likely to shape the headline inflation could be the domestic crop production in light of the deficient monsoons and relatively lower sowing of Kharif Crops this year, with implications on food inflation. While commodity prices have seen some consolidation recently, the uptrend could continue given the expected improvement in demand conditions globally going forward. Elevated fuel prices are also another pressure point for the overall inflation. Governments' efforts in addressing the supply side issues could help in easing the pressure on inflation to some extent. Overall CPI inflation may remain closer to the upper band of the RBI's inflation target in the near to medium term.

Fixed income view:

Yield on the new 10-year benchmark, the 6.10% G-sec 2031 was trading at a level of 6.20% at the time of writing this note, almost flat as compared to its previous close of 6.19%. While the RBI has been re-iterating that it will look through the current elevated inflation in order to support growth, the current decline in inflation is likely to provide some support. Central Banks of the major developed countries, are at the cusp of embarking on normalization of their respective ultra-loose monetary policies, given that the economic prospects have improved with the strong vaccination progress, which is also accompanied with spike in inflation. In case of India, the normalization of the monetary policy could be some time away, as the recent data on Index of Industrial Production (IIP) for July 2021, shows muted progress in economic activity. The vaccination progress in the country has also been discouraging. The liquidity normalization process by the RBI is already underway in the most subtle manner, as the RBI would not want to disrupt the financial conditions which could hamper the nascent economic recovery phase. The domestic bond markets are likely to draw comfort from the possible gradual normalization process of the RBI's monetary policy which may not happen any time soon. However, the start of the normalization process by the central banks of the developed nations could impart volatility to domestic bond markets.

Fixed Income Mutual Fund Strategy: - Thus, from fixed income investment strategy perspective, currently investors could look at Arbitrage Funds for a horizon of 3 months and above. Investors who would like to lock in current available yields and are not comfortable with volatility, can look at relatively longer tenor Fixed Maturity Plan (FMPs). Investors with an investment horizon of 12 months and above can look at Short Duration Funds, Corporate Bond Funds and Banking and PSU Funds. Whereas, for a horizon of upto 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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