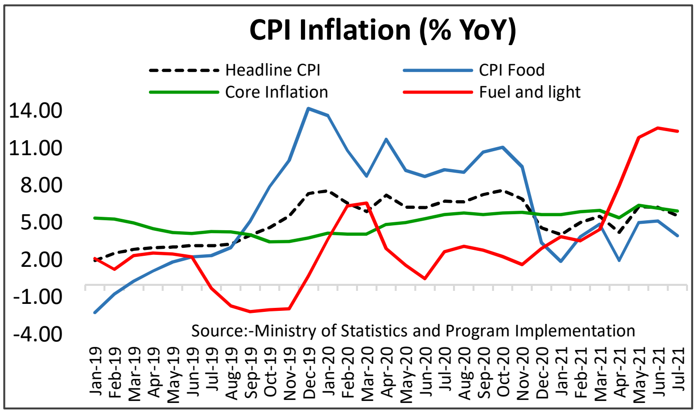
CPI inflation- July 2021

Event Update

Domestic retail inflation based on Consumer Price Index (CPI) for July 2021 declined for the second month in a row, and came within the RBI's target range of 2-6%. CPI inflation for July 2021 came in at 5.59% YoY, as against 6.26% YoY in June 2021. The decline in the headline inflation was mainly on account of moderation in CPI food inflation which declined to 3.96% YoY in July 2021, from 5.15% YoY in June 2021. Core CPI inflation (ex Food and Fuel, but including 'Transport and communication') also moderated and came in at 5.94% YoY in July 2021, as against 6.11% YoY in the previous month. A favorable base effect also contributed to the decline in the CPI inflation in July 2021.



Within the CPI food basket, most of the protein food items saw inflation rising on a YoY basis in July 2021. However, most of the other CPI food internals witnessed a decline in YoY inflation in July 2021. The deflation in vegetable prices rose to 7.7% YoY in July 2021, from 0.7% YoY in June 2021. Inflation in prices of fruits also declined to 8.91% YoY in July 2021, as against 11.82% YoY in the previous month. The deflation in prices of 'Cereals and products' continued in July 2021 as well, and stood at 1.75% YoY as against a deflation of 1.94% YoY a month ago. In case of Core CPI inflation, the sub-segments witnessed a mixed movement in prices on a YoY basis. Inflation in 'Clothing and footwear' continued to rise for the third month in a row and stood at 6.46% YoY in July 2021 as against 6.14% YoY in June 2021. Other segments within Core CPI that witnessed a rise in inflation included Clothing and footwear, Housing, Health and Recreation and amusement. Rest of the sub-segments of Core CPI witnessed a decline in inflation on a YoY basis in July 2021. Inflation in 'Fuel and light' also moderated in July 2021 and stood at 12.38% YoY as against 12.61% YoY a month ago.

While the decline in inflation in July 2021 is a welcome relief, inflation pressures are likely to continue to going forward. In August 2021 the base effect is unfavorable, however for the next couple of months after that, the base effect becomes favorable again, which may help in cooling off the headline inflation to some extent. This may help retail inflation remaining just below the upper band of the RBI's inflation target range in the very near term. Input cost pressures in the form of higher commodity prices are likely to continue, which will eventually get passed onto the end consumers. Opening up of the economies globally as well as domestically, is likely to revive the demand conditions, which has the potential to create a demand-supply mismatch in the absence of quick improvement in capacity utilization. Additionally, monsoon progress has been erratic, and has also affected the Kharif crop sowing, which can have an impact of food inflation. Another important factor that can have implications on inflation, is the third wave of the Covid-19 pandemic, if it happens, and the severity of the same. While another wave of the pandemic can disrupt supply, it can also delay the process of demand revival. Thus, further developments in pandemic and the vaccination drive will also have a role to play in the trajectory of inflation going forward.

Fixed income view:

Yield of the new 10-year benchmark, the 6.10% G-sec 2031 was trading at a level of 6.24% at the time of writing this note, as compared to its previous close of 6.23%. The RBI has reiterated, that it will look through the recent elevation in inflation, as RBI believes it to be transitory in nature and not demand driven at this point. Thus, the focus on economic growth and hence the accommodative stance is likely to continue in the near term. Some of the Monetary Policy Committee (MPC) members have been raising caution on the recent rise in inflation. So long as the CPI inflation remains below the 6% mark (RBI's target range being 2-6%), RBI will be comfortable in remaining accommodative. Should the inflation readings rise above the 6% mark, the normalization process can likely speed up, but with a caveat, that a possible third wave does not derail the nascent economic recovery. In terms of the bond yields, a very gradual flattening of the yield curve may take place given that the enhanced Variable Rate Reverse Repo (VRRR) auctions have kicked in and that the level of liquidity surplus is very high in the system. At the longer end of the yield curve while the supply pressure may lead to some rise in the yields, RBI's supply absorption measures are likely to prevent any meaningful spike in yields.

Fixed Income Mutual Fund Strategy: - Thus, from fixed income investment strategy perspective, currently investors should 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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