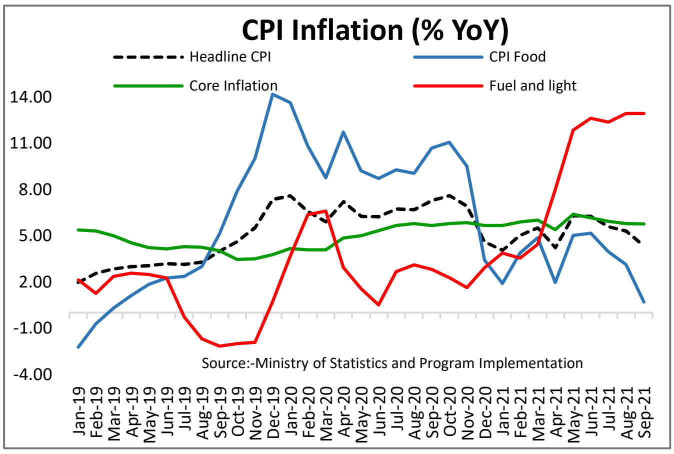
HDFC Bank Research **October 13, 2021**

CPI inflation- September 2021

Event Update

Domestic inflation based on Consumer Price Index (CPI) for September 2021 declined for the fourth consecutive month and stayed within the RBI's flexible inflation target of 2-6% for three months in a row. CPI inflation for September 2021 stood at 4.35% YoY as against 5.30% YoY in August 2021. The decline in the retail inflation was largely on account of a sharp decline in food inflation as well as a favorable base effect. CPI food inflation declined further to 0.68% YoY in September 2021, from 3.11% YoY in August 2021. Core CPI inflation (ex Food and Fuel but including 'Transport and communication') also moderated, albeit only marginally in September 2021 and stood at 5.75% YoY in September 2021, as against 5.77% YoY in August 2021.

Within the food segment of CPI, the prices of vegetables deflated further sharply by 22.47% YoY in September 2021 as against a deflation of 11.37% YoY in August 2021. Inflation in prices of fruits also moderate in September 2021 on a YoY basis and stood at 3.70% as against 6.69% in the previous month. Most of the items in the food segment witnessed a decline in YoY inflation in September 2021 barring 'Milk and products', 'Oils and fats', 'Sugar and Confectionery' and 'Prepared meals, snacks, sweets'. In case of Core CPI, movement in inflation was mixed in September 2021. Within Core CPI, items that witnessed a decline in inflation included Housing, Health, 'Transport and communication' and Education. Inflation in 'Fuel and light' continued to remain elevated and even increased to a level of 13.63% YoY in September 2021 from 12.95% YoY in August 2021.



Retail inflation remaining within the RBI's flexible inflation target range, over the past few months is likely to give room to the RBI to remain growth supportive for longer without having to worry about inflation immediately. This is also likely to allow RBI to be gradual in its monetary policy normalization process so as to not disrupt the stability in the financial markets. The RBI in its October monetary policy revised its inflation projection downwards to 5.3% for FY22; 5.1% in Q2, 4.5% in Q3; 5.8% in Q4 of FY22. However, there are certain upside risks to inflation that need to be closely watched going forward. Recently vegetable prices have seen an uptick and can rise further tracking the unseasonal rains as the withdrawal of monsoon is delayed this year. Crude oil prices have seen a sharp uptick tracking expectations of faster global economic recovery and supply issues. Even the domestic fuel prices have remained elevated and could rise further if the international crude oil prices continue to rise. Commodity prices have also remained high. The base effect which has helped the moderation of the CPI inflation recently, will turn unfavorable post November 2021. The inflation expectations globally also have risen recently, which can be another factor that could influence the trajectory of inflation. Thus, the factors mentioned above could be potential upsides risks to inflation.

Fixed income view:

Yield on the 10-year benchmark, the 6.10% G-sec 2031 was trading lower at 6.31% at the time of writing this note, as compared to its previous close of 6.33%. While the RBI has started the process of normalization of the large surplus liquidity, the current domestic macro-economic variables (recent moderation in inflation, fiscal deficit under control so far, high Forex Reserves amongst others) provide comfort, as these would help in doing away with the possibility of a sharp reversal in the monetary policy cycle. Better macro-economic variables would also help in cushioning the impact of the monetary policy tightening by the developed nations. While bond yields are likely to move up from here on, especially at the shorter end of the yield curve, market participants are likely to get sufficient time to adjust to uptick in yields as the current macro-economic situation would help in keeping the pace of the monetary policy normalization gradual and reasonable. Thus, while going forward bond markets are likely to witness volatility, it is likely to be relatively subtle than seen in the previous cycles.

Fixed Income Mutual Fund Strategy: - From fixed income investment strategy perspective, currently investors who have relatively longer investment horizon could look at Target Maturity Index Funds that invest in PSU Bonds plus SDLs. 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. Investors who are comfortable with volatility and who want to take advantage of opportunities available at the longer end of the yield curve can look at Dynamic Bond Funds with an investment horizon of 24 months and above. For a horizon of 3 months and above Arbitrage Funds can be considered. 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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