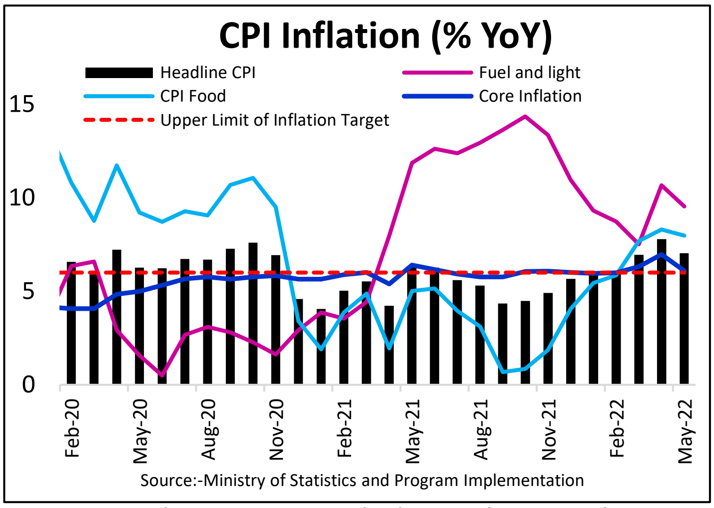
HDFC Bank Research June 14, 2022

CPI inflation- May 2022

Event Update

Domestic inflation based on Consumer Price Index (CPI) for May 2022 moved in line with the general market expectations and came in at 7.04% YoY, lower than that for April 2022 at 7.79% YoY. That said, retail inflation remained above the upper end of the RBI's flexible inflation target of 4% (+-2%) for five consecutive months. The decline in CPI inflation was largely on account of the base effect of last year, wherein inflation in the month of May 2021 had jumped to 6.30% YoY. In May 2022, there was a broad-based rise in the CPI across various sub-segments. On a month on month (MoM) basis, CPI inflation rose to 0.94% in May 2022 from 1.43% in April 2022. Inflation in Consumer Food Prices came in at 7.97% YoY in May 2022 as against 8.31% YoY in April 2022. Core CPI inflation (ex Food and Fuel but including 'Transport and communication') also came in lower at 6.09% YoY in May 2022 as compared to 6.97% YoY in the previous month.



Within the CPI food basket, most of the items witnessed a decline in inflation on a YoY basis in May 2022 barring 'Meat and fish', 'Milk and products' and Vegetables. Prices of vegetables rose by 18.26% YoY in May 2022 as compared to15.34% YoY in April 2022. Inflation in prices of 'Meat and fish' stood at 8.23% YoY in May 2022 as against 6.97% YoY in April 2022. However, on a MoM basis CPI food inflation stood at 1.59% in May 2022 as compared to 1.50% in the previous month. Within Core CPI, the only sub-segment that saw rise in inflation on a YoY was Housing; whereas, all the other segments saw a decline in YoY inflation. On a sequential basis, Core CPI inflation stood at 0.48% YoY in May 2022 as against 1.15% YoY in April 2022. Inflation in the 'Fuel and light' segment, which came in at 9.54% YoY in May 2022 as against 10.67% YoY April 2022, stood at 1.39% MoM in May 2022 as against 2.99% MoM in the previous month.

Going forward the trajectory of inflation is likely to remain under pressure as the factors that have been pushing inflation higher, continue to persist. In its latest monetary policy, the RBI has also revised its inflation target upwards and now expects CPI inflation to be at 6.7% YoY in FY23, with Q1FY23 at 7.5%; Q2FY23 7.4%; Q3FY23 at 6.2%; and Q4FY at 5.8%. In the April monetary policy, the RBI had forecasted inflation to be at 5.7% for FY23. Crude oil prices continue to rise and have stayed elevated, which can lead to a structural rise in overall inflation. Persisting supply chain disruptions due to the geopolitical tensions between Russia and Ukraine are also likely to continue putting upward pressure on domestic inflation. In terms of food prices, monsoon would be a key monitorable in the near term. While the forecast of a normal monsoon is positive from food prices perspective, any negative developments thereof could add to the domestic inflation woes, as globally also food prices have been on the rise. The recent measures of the government to help contain inflation could have a positive impact on rising inflation to some extent, in the very near term. More such measures by the government cannot be ruled out as the monetary policy alone cannot address the issue of current high inflation given that large part of the inflationary pressures are due to supply side issues. CPI inflation is likely to remain closer to the 6% mark in the near to medium term given that the inflationary pressures are not likely to abate any time soon. Thus, it is likely that the RBI hikes the policy rate to the Pre-Covid level rather quickly and then act depending upon the incoming date on inflation.

Fixed income view:

The bond markets were trading on a marginally positive note as inflation came in line with market expectations. Yield on the 10 year benchmark, the 6.54% G-sec 2032 bond, was trading at a level of 7.58% at the time of writing this note as against its previous close of 7.60%. The current yield curve seems to be factoring in aggressive monetary policy tightening by the RBI, in light of the elevated inflation. At the longer end of the yield curve the yields are also pricing in the higher supply of government bonds. Currently, the inflation trajectory that the RBI has forecasted, and also what the markets are expecting seems to have been priced into the bond yields. However, if inflation surprises beyond the expected trajectory, the yield curve could shift upwards from the current levels. At the shorter end of the yield curve, the movement in the system liquidity is also likely to influence the bond yields. Additionally, certain other macro-economic variables also require close monitoring such as Current Account Balance, Fiscal Deficit, and movement in Rupee amongst others, as any further deterioration, is likely to push bond yields higher from here on. Expectations of faster monetary policy tightening by the major global central banks is also leading to volatility in domestic bond markets which is also another variable that will require close monitoring.

Fixed Income Mutual Fund Strategy: - Thus, considering the expected volatility, investors who have relatively longer investment horizon could look at Target Maturity Index Funds that invest in a mix of high credit quality securities. Investors with an investment horizon of 12 months and above can look at Short Duration Funds, Money Market Funds, Ultra Short Duration and Low Duration Funds. Investors with a horizon of 15 months and above can start looking at Corporate Bond Funds and Banking & PSU Debt Funds. With the rise in yields at longer end of the yield curve, investors who are comfortable with volatility and have a longer investment horizon could gradually start looking at Dynamic Bonds for a 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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