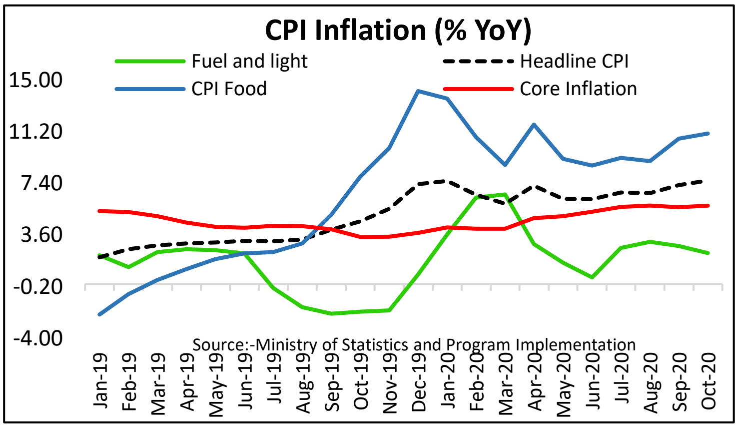
CPI inflation- October 2020

Event Update

Domestic inflation based on Consumer Price Index (CPI) for the month of October 2020 rose and came in higher, in line with market expectations. CPI inflation for October 2020 stood at 7.61% YoY as against 7.27% YoY in September 2020 (revised downwards from 7.34% YoY). The rise in CPI inflation was mainly on account of higher inflation in retail food prices. Inflation in Consumer Food Price index stood at 11.07% YoY in October 2020 as against 10.68% YoY in the previous month. Higher Core CPI inflation (ex Food and Fuel, but including 'Transport and communication') also contributed to the rise in the headline inflation. Core CPI inflation for the month of October 2020, stood at 5.77% YoY as against 5.66% YoY in September 2020.



Vegetable prices continued to put an upward pressure on inflation in the food basket. Inflation in vegetable prices rose to 22.51% YoY in October 2020, as against 20.79% YoY in the previous month. Prices of most of the protein food items also witnessed higher annual inflation in October 2020, as compared to September 2020. However some of the food items like 'Cereals and products' and 'Milk and products', that have relatively higher weightage in the overall inflation, witnessed a decline in annual inflation. While the overall Core CPI inflation increased in the month of October 2020, the internal components of Core CPI witnessed a mixed trend in annual inflation. Some of the Core CPI components that witnessed a rise in annual inflation included, 'Clothing and footwear', Health and 'Recreation and amusement'. Inflation in Housing segment also increased and stood at 3.27% YoY in October 2020 as against 2.83% YoY in the previous month. Annual inflation in 'Fuel and light' segment declined in the month of October 2020 and stood at 2.28% YoY as against 2.80% YoY in September 2020.

As has been the case over the past few months, going forward also, the trajectory of retail inflation is likely to be dependent upon the movement in food prices. Despite the easing of lockdown restrictions, food prices have remained on the higher side. While unseasonal rains may be blamed for the currently elevated prices of vegetables, prices of other essential food items have also remained high. Thus, government's supply side efforts are likely to play an important role in food prices going forward. Additionally, improvement in demand conditions due to factors such fulfillment of pent up demand and festival season, may also be leading to the stickiness and rise in Core CPI inflation. While international crude oil prices have declined, higher government taxes on fuel, in order to shore up government revenues which have been hit amidst the current pandemic, has also contributed to the stickiness in the overall retail inflation. Going forward, as the impact of unseasonal rains on vegetable prices wears off and the likely seasonal decline in food prices due to winters may happen, some easing of inflation may be seen in the coming few months. That being said, demand conditions in the economy is also going to be an important variable to track. To that effect, it will also be important to track further developments in the spread of Covid-19 infections, given that some of the advanced economies are currently going through the second wave of infections.

Fixed income view:

Yield on the 10 year benchmark G-sec 5.77% 2030 bond was trading marginally lower 5.88% at the time of writing this note as compared its previous close of 5.90%. Despite the rise in the retail inflation, markets have not reacted negatively, as the RBI has assured the continuation of the accommodative monetary policy stance, for as long as it is required for economic growth revival to happen. Additionally, the RBI has become more active in its Open Market Operations (OMOs), in order for the increased government borrowing program to go through. This is likely to prevent any meaningful rise in the bond yields. In terms of interest rate cut, the RBI may leave the key policy rates unchanged in the next monetary policy in December 2020, given the higher level of retail inflation. However, a rate cut can be expected, if a sustained decline in inflation is witnessed over the next few months. Thus, the trajectory of bond yields is likely to be guided by the near term movement in inflation, RBI's OMOs and other support measures, and the supply of government bonds.

Fixed Income Mutual Fund Strategy:- Investors who want to invest at the relatively shorter end of the yield curve and are looking to benefit from relatively better accruals, can look at Corporate Bond Funds and Banking and PSU Funds that have allocation to higher credit quality bonds, with an investment horizon of 15 months and above. Investors with an investment horizon of 12 months and above can look at short duration funds. Investors who want to take advantage of relatively higher term spreads, and can take volatility, may look at Dynamic Bond Funds with an investment horizon of 24 months and above. Investors who want to invest for a shorter horizon can continue to look at Ultra Short Duration Funds/Low Duration/Money Market/Arbitrage Funds for a horizon of 3 months and above. 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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