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IIP contracts for the third month in a row; CPI inflation moderates but remains 6%+

Industrial production contracted by 34.7% YoY in May 2020—marking the third month of contraction, albeit lower than the 57.7% decline seen in the previous month, and Reuters poll of 37.8% drop. All sectors of the industrial economy witnessed a huge decline, led by manufacturing as a significant part of discretionary manufacturing was largely shut for the second month in a row in May. Electricity and mining sectors fared relatively better. Within the manufacturing sector, the contraction was far more severe in capital goods and consumer durables while essential categories such as primary goods and consumer non-durables performed somewhat better. During Mar-May 2020, industrial production fell by 36% YoY.

Headline CPI inflation moderated from imputed prints of 7.2%/6.3% in April/May to 6.1% in June, higher than consensus estimate of 5.3% (source: Refinitiv Datastream). This was primarily on the back of a decline in food inflation, particularly for vegetables and fruits, partly offset by a sharp rise in pan, tobacco & intoxicants, higher fuel inflation and a modest pick-**up in core inflation. That said, headline inflation has remained above the RBI's** 4% mid-point target and the upper end of its target range of 6% for the ninth and third month in a row.

With incremental lifting of restrictions on non-essential activities, industrial activity is expected to improve over the coming months, even as contraction is likely to persist for now. Initial signs of this are visible in manufacturing PMI, electricity generation and e-way bills for the month of June. However, downside risks remain significant in the wake of continued rise in COVID-19 cases and consequent potential tightening of restrictions. On the positive side, inflation should gradually taper off amid expectations of a normal monsoon, continued easing of supply chain bottlenecks and weak demand environment. This should facilitate frontloading of rate cuts by the RBI to support an ailing economy. We expect another 25-50bps cut in policy rates, *ceteris paribus*.

Industrial production declined by 34.7% in May after a 57.7% drop in the previous month, marking the third consecutive month of contraction.

- Industrial production contracts for the third month in a row: Following a sharp 57.7% YoY contraction in the previous month, industrial production fell by 34.7% YoY in May 2020, marginally higher than the consensus estimate of -37.8% (source: Reuters poll). This translates into a decline of 36% YoY in March-May 2020. This was primarily led by a huge 39.3% YoY decline in manufacturing output as a significant part of discretionary manufacturing was largely shut during the month in the wake of an extended lockdown. The YoY decline in electricity and mining sectors, however, was much lower at 15.4% and 21% respectively. While mining activity was hit by limited labour availability despite being categorised as an essential activity, electricity production got impacted due to reduced demand from industrial and commercial establishments. 13 out of 23 sub-sectors within the manufacturing space recorded more than 50% YoY contraction, led by transport equipment (-84% YoY), motor vehicles, trailers and semi-trailers (-80% YoY), textiles (-73% YoY) and electrical equipment (-71% YoY). Pharmaceuticals was the only sub-sector within the manufacturing space to register a growth in May.

  On the use-based side, consumer durables and capital goods got impacted the most, contracting by 68.5% and 64.3% respectively, followed by intermediate and infrastructure/construction goods at -44.1% and -42% respectively. Primary goods and consumer non-durables, largely falling under essential categories, saw a relatively much lower YoY contraction of 20% and 11.7% respectively.

Retail inflation moderated in June 2020 but remained above the RBI's 2-6% target range.

- **Retail inflation moderates but remains north of RBI's** target range: Retail inflation (CPI) inflation moderated from the imputed prints of 7.2%/6.3% in April/May to 6.1% in June, higher than consensus estimate of 5.3% (source: Refinitiv Datastream). The moderation was largely on account of a further decline in food inflation to an eight-month low of 7.3% led by price normalisation of vegetables/fruits as supplies improved following a temporary lockdown-induced disruption. This was partly offset by a sharp surge in inflation in pan, tobacco and intoxicants to a 59-month high of 9.7%, higher fuel inflation reflecting a pick-up in crude oil prices, and a spike in personal care & effects inflation to 95-month high 12.4%. Headline inflation has remained above the RBI's 4% mid-point target and the upper end of its target range of 6% for the ninth and third month in a row.

- Core inflation inches up: Imputed core inflation (ex-food and fuel) inched up for the third month in a row to 5% in June 2020. This was primarily on account of a sharp rise in personal care & effects inflation and higher transportation inflation due to hike in petrol and diesel prices. This was partly offset by a significant drop in inflation in household goods & services and recreation & amusement, reflecting a collapsed demand owing to lockdown restrictions. That said, weak aggregate demand should gradually bring down core inflation over the coming months.

Core inflation inched up for the third month in a row in June 2020.

- RBI to ease further: With incremental lifting of restrictions on non-essential activities, industrial activity is expected to improve over the next few months, even as contraction is likely to persist for now. Initial signs of this are visible in manufacturing PMI, electricity generation and e-way bills for the month of June. However, downside risks remain significant in the wake of continued rise in COVID-19 cases and consequent potential tightening of restrictions. On the positive side, inflation should gradually taper off amid expectations of a normal monsoon, continued easing of supply chain bottlenecks and weak demand environment. This should facilitate frontloading of rate cuts by the RBI to support an ailing economy. We expect another 25-50bps cut in policy rates, ceteris paribus.

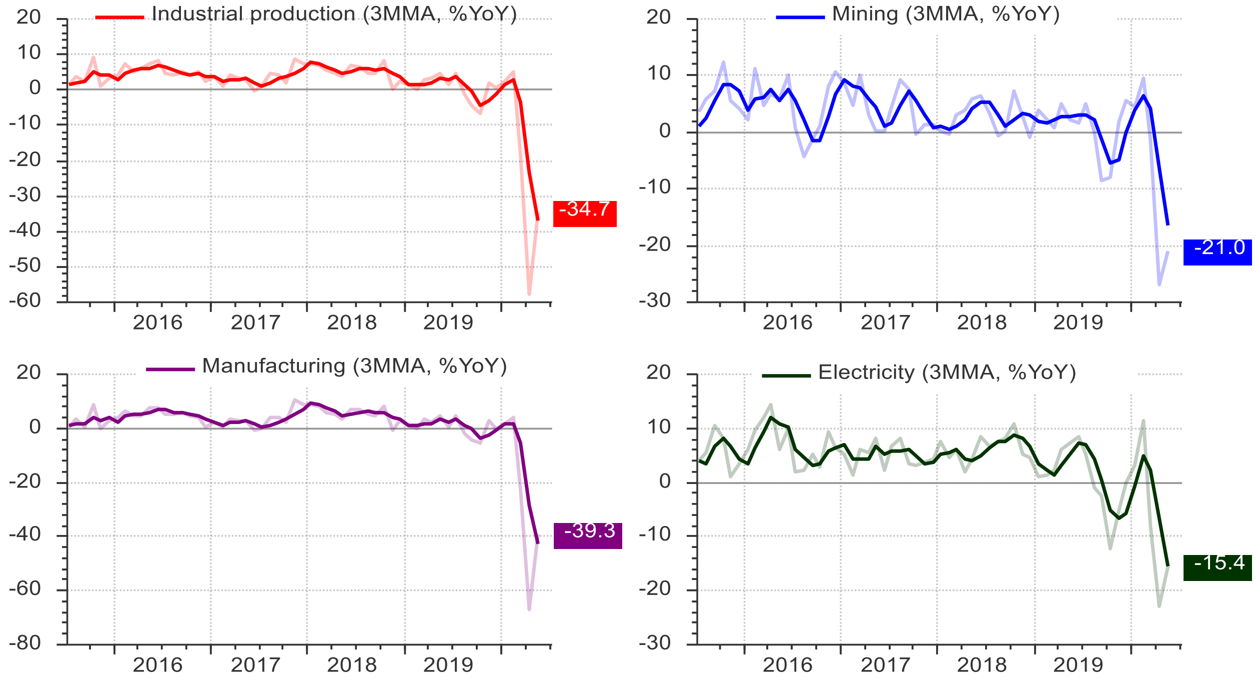
Expect RBI to cut policy rates by another 25-50bps, ceteris paribus.

Figure 1: India industrial production for May 2020 (%YoY)

		Weight (%)	May-20	Apr-20	May-19	FY21TD	FY20TD
	IIP		(34.7)	(57.7)	4.5	(45.8)	3.8
Sector-based indices	Mining	14.4	(21.0)	(27.0)	2.3	(24.0)	3.7
	Manufacturing	77.6	(39.3)	(67.1)	4.4	(52.7)	3.5
	Electricity	8.0	(15.4)	(23.0)	7.4	(19.0)	6.7
Use-based Goods	Primary Goods	34.0	(20.0)	(26.6)	2.2	(23.2)	3.6
	Capital Goods	8.2	(64.3)	(92.6)	(2.1)	(77.9)	(1.8)
	Intermediate Goods	17.2	(44.1)	(65.4)	12.5	(54.1)	7.8
	Infra/Construction Goods	12.3	(42.0)	(84.7)	3.0	(62.6)	1.2
	Consumer Goods	28.2	(36.0)	(69.1)	4.5	(52.1)	4.3
	Consumer Durables	12.8	(68.5)	(96.0)	0.2	(81.9)	1.2
	Consumer Non-durables	15.3	(11.7)	(48.7)	8.1	(29.6)	6.8

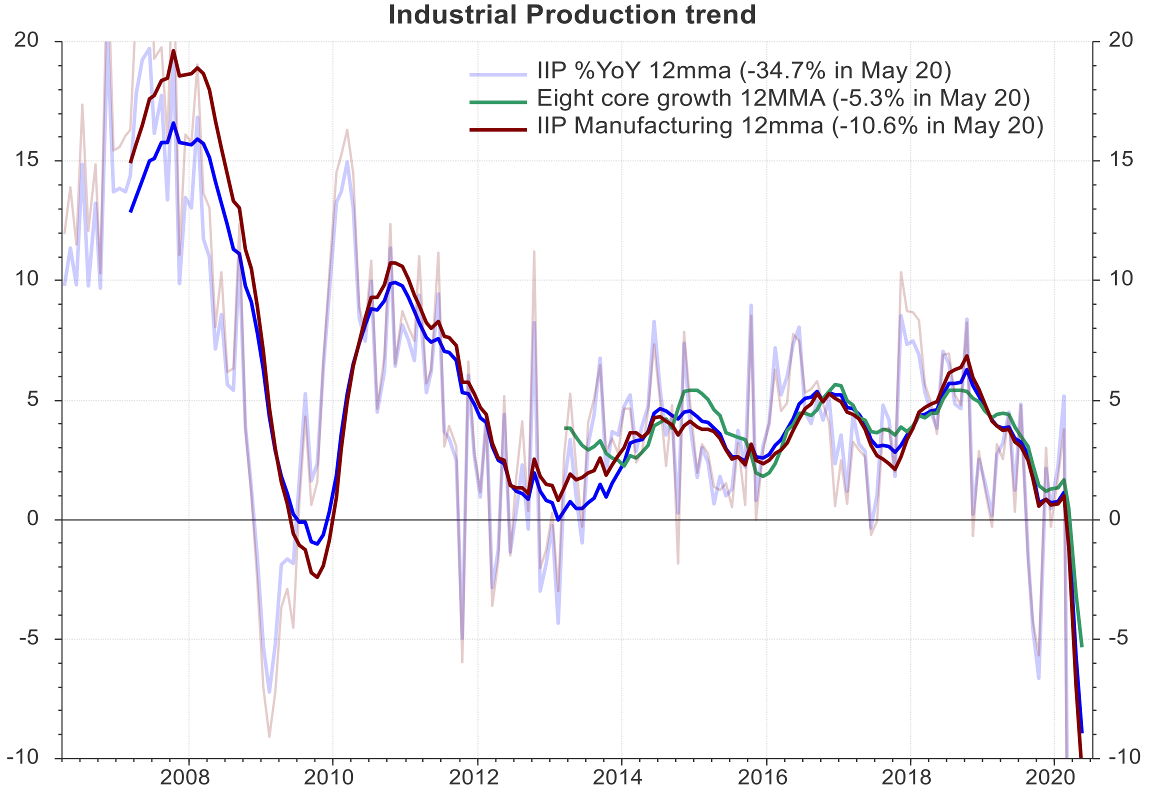
Source: CSO, NSE

Figure 2: India industrial production (3MMA)



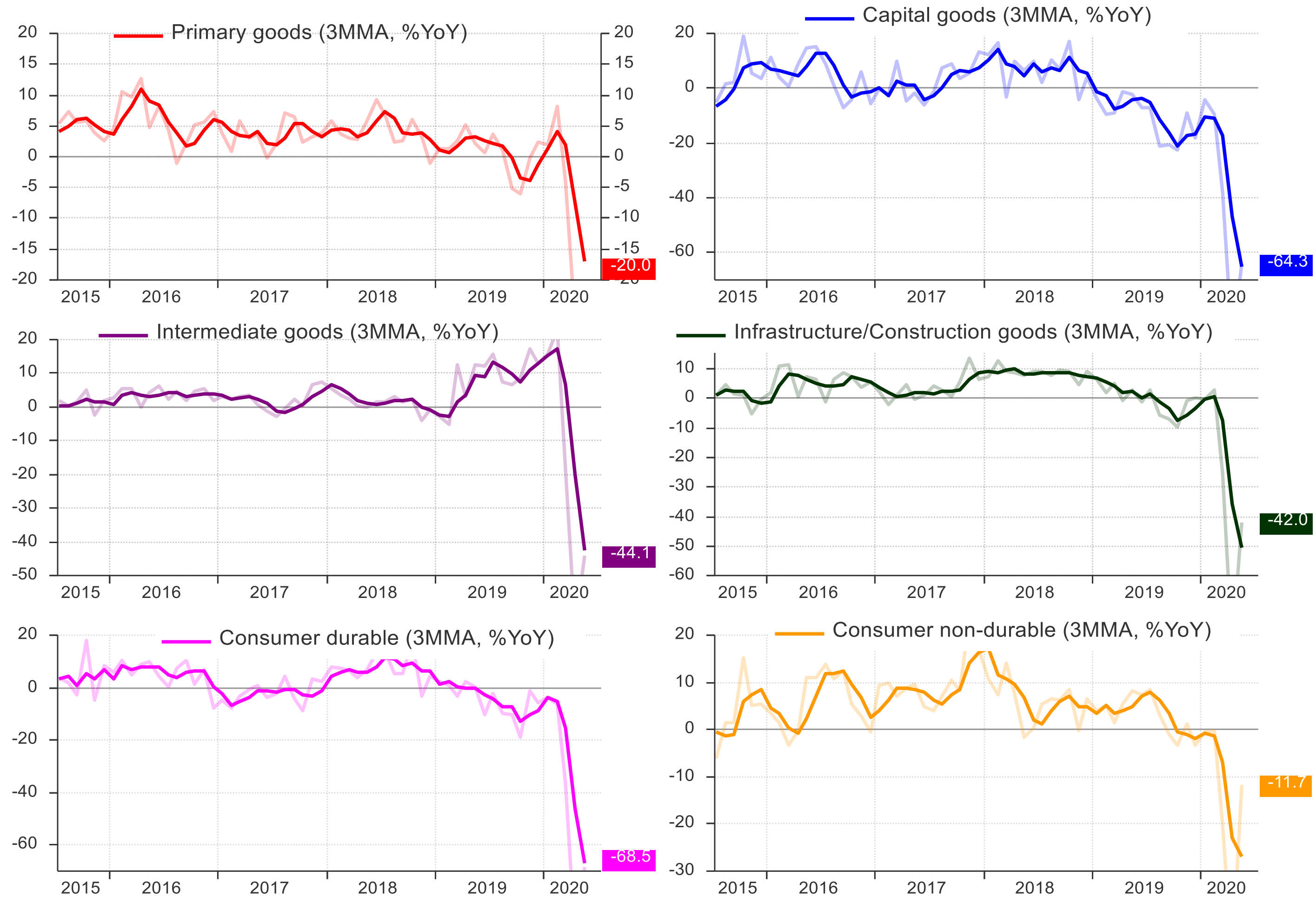
Source: Refinitiv Datastream, NSE

Figure 3: Long-term industrial production trend (12MMA)



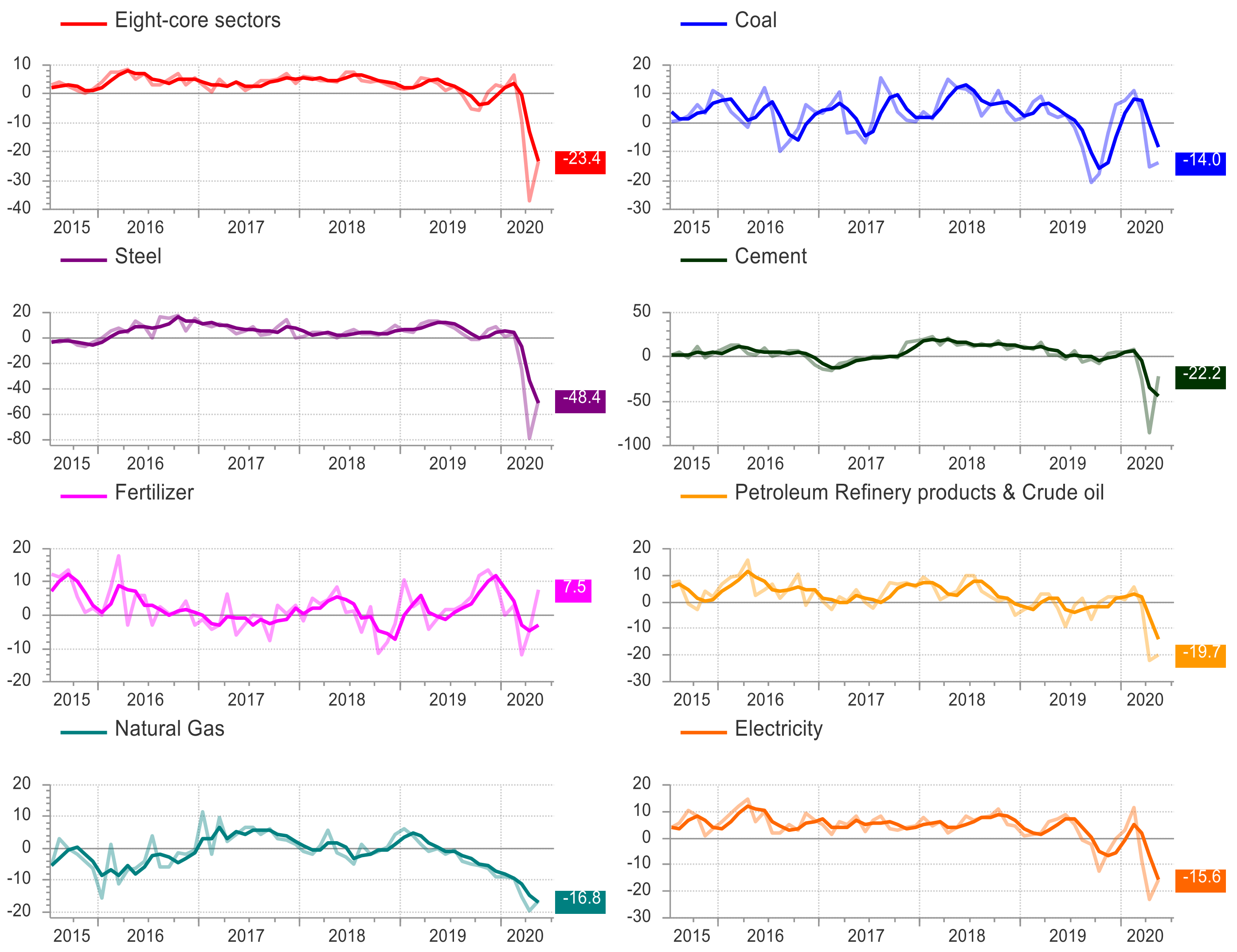
Source: Refinitiv Datastream, NSE

Figure 4: India industrial production use-based goods (3MMA)



Source: Refinitiv Datastream, NSE

Figure 5: India eight-core sector growth (3MMA)



Source: Refinitiv Datastream, NSE

Figure 6: Consumer price inflation in June 2020 (%YoY)

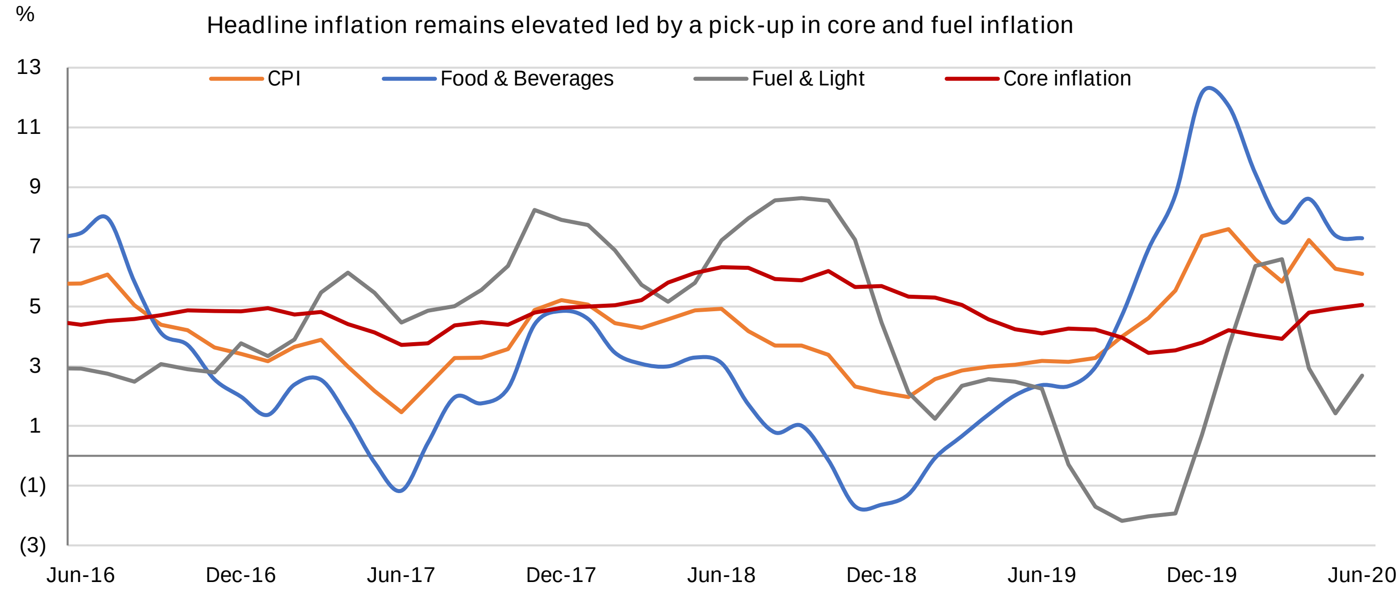
	Weight (%)	Jun-20	May-20	Jun-19	FY21TD	FY20TD
CPI		6.1	6.3	3.2	6.5	4.8
Food & Beverages	45.9	7.3	7.4	2.4	7.8	3.1
Pan, Tobacco & Intoxicants[2]	2.4	9.7	6.3	4.2	7.3	8.0
Clothing & Footwear[2]	6.5	3.5	3.4	1.5	3.5	5.4
Housing	10.1	3.5	3.7	4.8	3.7	8.5
Fuel & Light	6.8	2.7	1.4	2.2	2.3	6.1
Miscellaneous[2]	28.3	5.7	5.8	4.5	5.6	5.3
Core CPI inflation[1, 2]	44.9	5.0	4.9	4.1	4.9	6.1

Source: CSO, NSE. NA = Not Available.

Note: [1] Headline inflation excluding food & beverages, pan, tobacco & intoxicants and fuel & light.

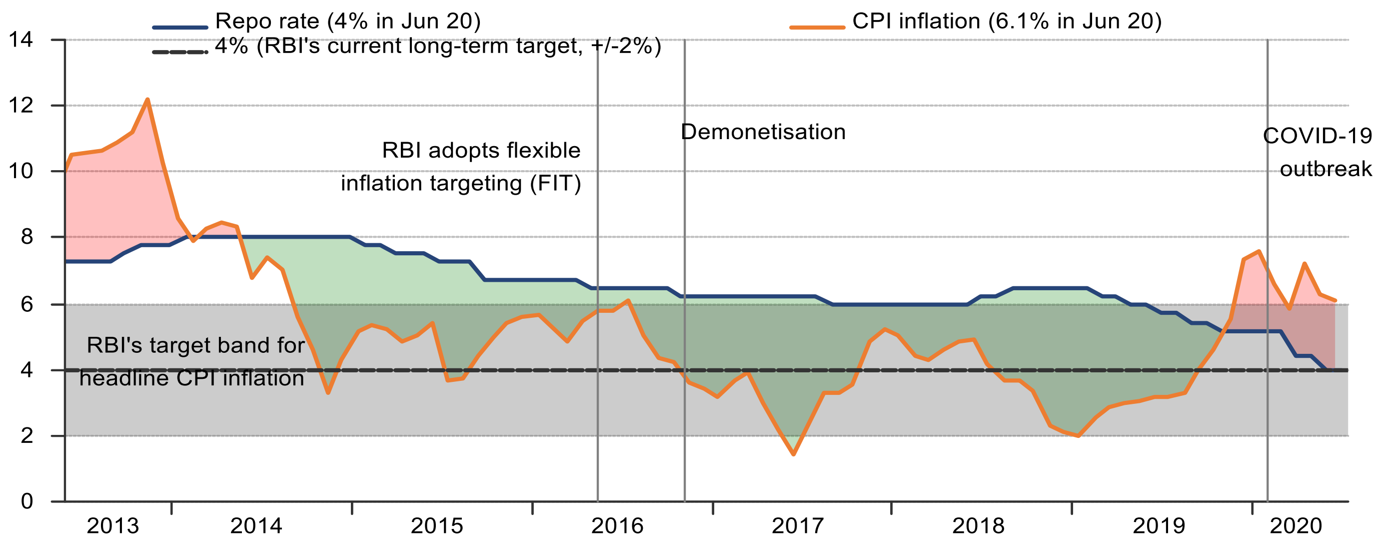
[2] Inflation data for these components for April and May 2020 are based on the imputed index calculated by MOSPI.

Figure 7: Headline CPI inflation trend



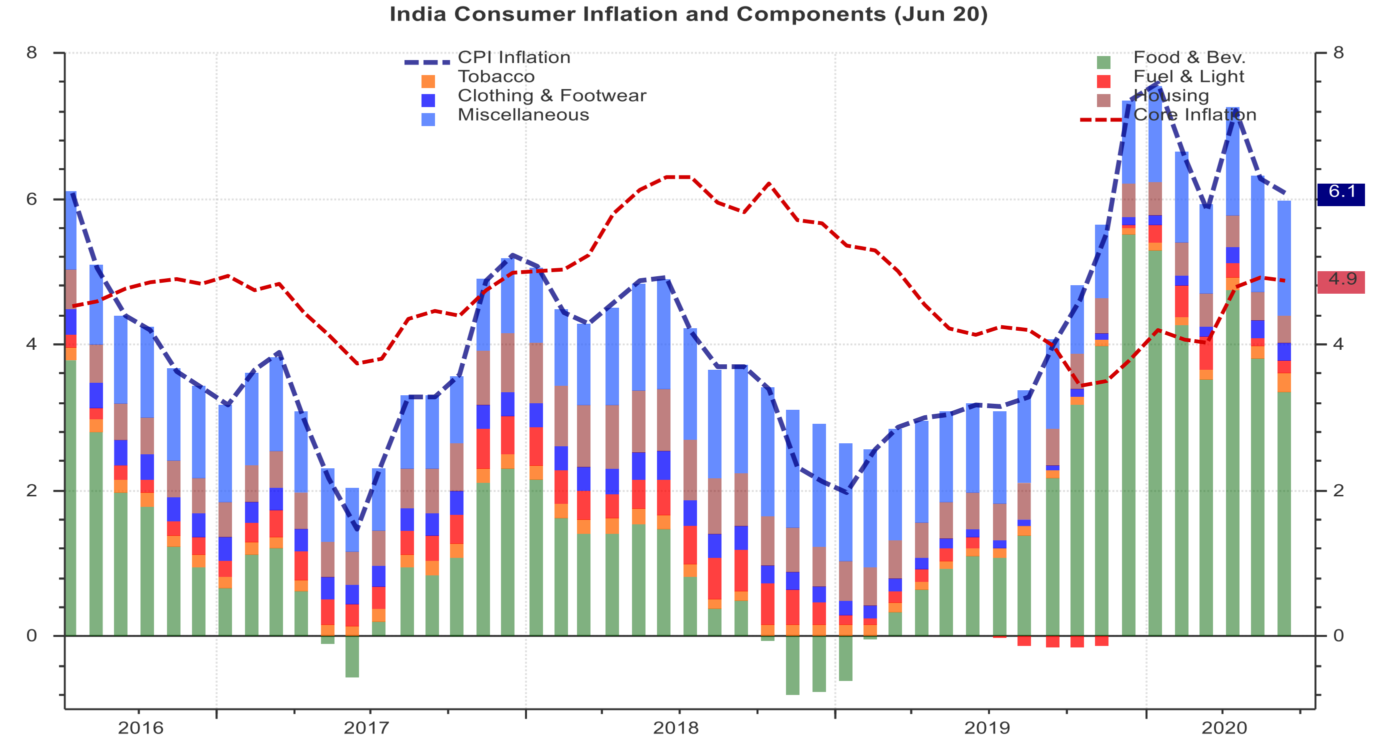
Source: CMIE Economic Outlook, NSE

Figure 8: Real interest rates have remained negative for quite some time now



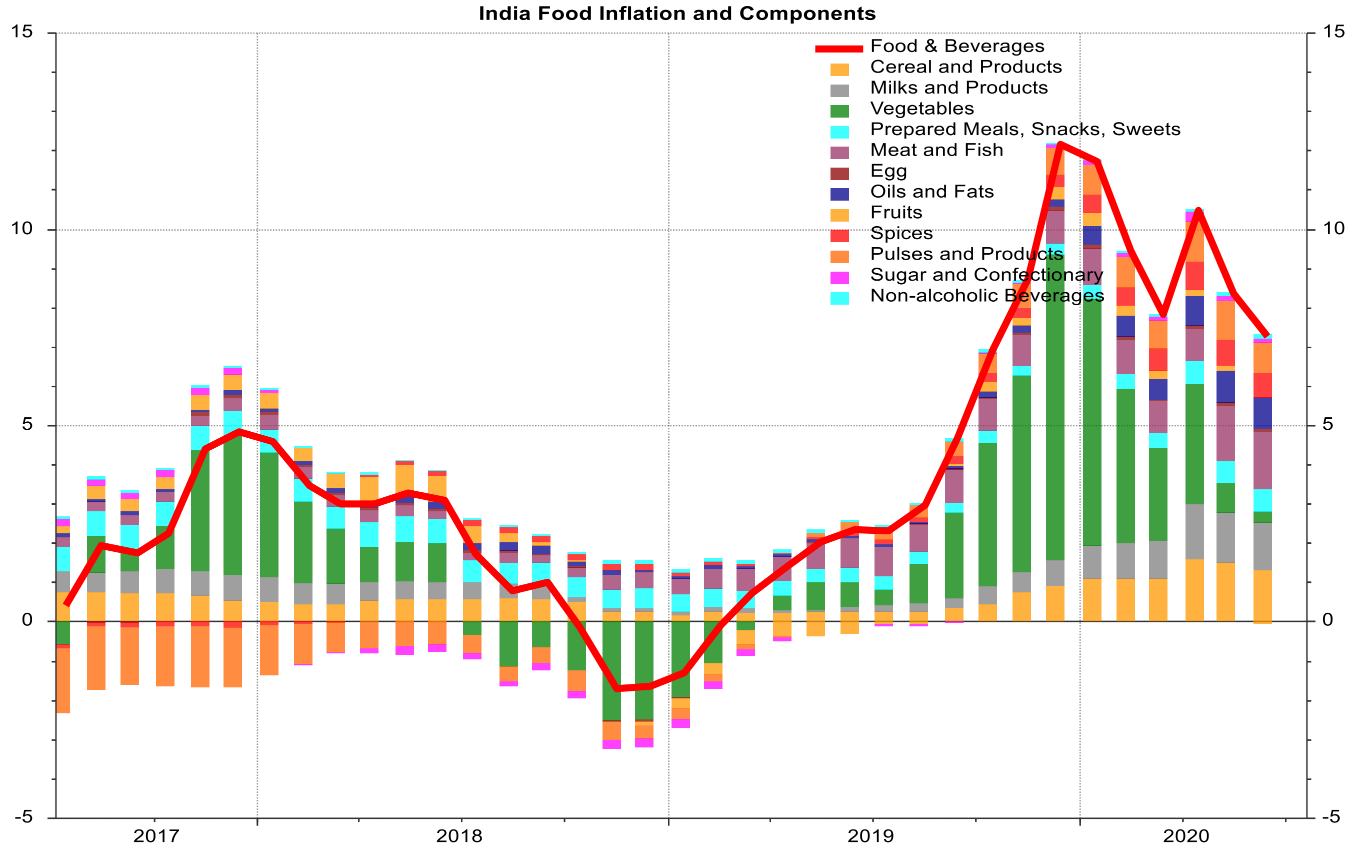
Source: Refinitiv Datastream, NSE

Figure 9: Category-wise contribution to India consumer price inflation (CPI)



Source: Refinitiv Datastream, NSE.

Figure 10: Category-wise contribution to India Food and Beverages inflation (CPI)



Source: Refinitiv Datastream, NSE.

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