NSE

Macro Review

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Inflation firms up further; industrial recovery strengthens

Headline CPI inflation shot up to near six-and-a-half year high of 7.6% in October from 7.3% in the previous month, ahead of the market expectations of 7.3% (Source: Reuters). This marked the seventh consecutive month (and 10/11 months) of a 6%+ print—**the upper bound of the RBI's target range.** The increase was primarily led by a broad-based rise in food inflation, particularly vegetables (+22.5%). Excluding vegetables, headline inflation inched up by a much lower 14bps MoM. Barring food and fuels, the core inflation print also hardened by 13bps MoM to 5.5% led by a jump in housing, recreation & amusement and health inflation.

Industrial production (IIP) continued to recover and reported a growth of 0.2% YoY in September following a contraction in the previous six months, albeit off a low base. Further easing of lockdown restrictions has helped get industrial activity back to pre-COVID levels, supported by improving domestic demand. The recovery was broad-based, with Electricity/Mining sectors registering a growth of 4.9%/1.4% and Manufacturing sector contracting by a mere 0.6%. In the use-based classification, Consumer Durables posted a 2.8% YoY growth—the first YoY expansion in last 16 months, signalling a potential pick in consumption demand ahead of the festive season. Recovery in investment activity, however, was relatively muted, as reflected in sustained contraction in Capital Goods production, notwithstanding a favourable base. For the Apr-Sep period, IIP is down 21% YoY.

Headline inflation is expected to soften in the coming months supported by a) recent measures taken by the Government to arrest rising food prices, including easing import duties and curbing exports, b) a good *Kharif* harvest, c) reduced supply-side disruptions, and d) favourable base effect. That said, it is likely to remain at the **higher end of the RBI's 2**-6% target range. The revival in economic activity, however, has been better-than-anticipated, aided by a good festive demand and a sharp drop in COVID-19 cases, notwithstanding a weakening global recovery, thereby posing upside risks to our GDP estimate of -10.5% for FY21. Amidst an elevated inflation trajectory and improving growth, further rate cuts seem unlikely at least in this fiscal year. That said, the R**BI's** focus is likely to remain on liquidity infusion and ensuring effective monetary transmission to support growth.

- Retail inflation surges to 77-month high in **October…**: CPI inflation continued to remain uncomfortably high, printing at six-and-a-half year high of 7.6% in October, marking the second consecutive month of a 7%+ reading. In fact, barring Mar'20's 5.8%, consumer inflation has remained above the MPC's 4+/-2% band for 10 months now. Headline inflation has averaged 6.9% this fiscal vs. 3.5% over the same period last year. In this context, any base effect should only kick in by December (Dec'19 at 7.35%).

Retail inflation rose further to 7.3%, marking the 7th consecutive month of 6+% prints.

- **…led by a broad-based rise in food inflation…**: Persistence of supply chain disruptions led to food inflation rising further in October, with vegetables (22.5%) and protein-based food items (Meat and fish +18.7%, Eggs +21.8%, oils & fats +15.2%) contributing to a large part of the increase. Pulses inflation also rose meaningfully in October to a five-month high of 18.3%, despite a high base. Consequently, food inflation inched up to a six-month high of 11.1% in October. Across the rest of the categories in the inflation basket, easing fuel and bullion prices translated into a modest drop in Transportation inflation (-33bps MoM to 11.2%) and Personal Care & Effects inflation (-31bps MoM to 12.1%) respectively.

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- **…and a pick**-up in core inflation: Even as food inflation made up the bulk of the price rise in October, the rest of the basket also inched up, reflecting a consequence of continued opening of the economy amid declining COVID-19 infections. Core inflation rose by 13bps MoM to a 22-month high of 5.5% led by a jump in housing (+3.3%), recreation & amusement (+4.7%) and health (+5.2%) inflation, partly offset by lower Transportation and Personal Care inflation. The latter was particularly supported by a fall in bullion prices last month. That said, core inflation has remained quite sticky over the last few months (5.3-5.5% during Jul-Oct'20) unlike food where the impact of the lockdown has been clearly disproportionate.

- Industrial Production continues to improve…: At +0.2% YoY, the September IIP turned into positive territory for the first time time in seen months, albeit off a low base (-4.6% in September 2019), reflecting continued easing of lockdown restrictions and improving domestic demand. This was a meaningful improvement from an uwardly revised -7.4% YoY in August (revise dup by ~60bps). Amidst an encouraging festive-led demand, the recovery in industrial activity is likely to continue in October, further supported by a favourable base. This is reflected in a sharp rebound seen in other high-frequency indicators such as E-way bills, Manufacturing PMIs, GST collections, power consumption and railway freight.

Industrial production improved further in September (+0.2% YoY), albeit off a low base, in-line with continued easing of lockdown restrictions.

- …led by an improvement across the board: All three broad sectors of the IIP basket witnessed a meaningful improvement. Contraction in Manufacturing production came off meaningfully in September (-0.6%), with 10 out of 23 sub-sectors recording a YoY expansion led by electrical equipment, rubber & plastic products, pharmaceuticals, metal products, chemical & chemical products and transport equipment. On the negative side, discretionary items including textiles, wearing apparel, and furniture continued to report a huge contraction. Following a significant contraction in the previous month owing to incessant rainfall and labour shortages, the mining activity improved meaningfully in September, registering a growth of 1.4% YoY, albeit off a low base (-8.6% in September 2019). Electricity production, however, grew at the highest pace of 4.9% YoY as demand from industrial and commercial establishments is back to pre-COVID levels thanks to continued easing of restrictions.

All three broad sectors of the IIP basket witnessed an improvement.

- Investment activity recovering at a slower pace: Use-based classification showed a meaningful improvement in consumption even as recovery in investment activity has been relatively muted. Capital goods production fell by a much lower 3.3% YoY in September vs. an upwardly revised 14. 8% YoY drop in the previous month but has come on top of a 20.5% contraction in Sep'19, reflecting a much slower recovery in investment activity. Contraction in Primary Goods also eased to -1.5% YoY from 10.8% in the previous month owing to a sharp pick-up in mining activity. While production of intermediate registered a modest 1.4% YoY drop, infra/construction goods moved into positive territory after six months, rising by 0.7% YoY. fell by 6.8% and 2.3% YoY respectively. Consumer Durables posted a 2.8% YoY growth—the first YoY expansion in last 16 months, signalling a potential pick in consumption demand ahead of the festive season, while Consumer non-durables production picked up after a weak August.

Contraction in capital goods production remained despite a very favourable base, reflecting a much slower recovery in investment activity.

- Rate cuts off the table for now: Headline inflation is expected to soften in the coming months supported by a) recent measures taken by the Government to arrest rising food prices, including easing import duties and curbing exports, b) a good Kharif harvest, c) reduced supply-side disruptions, and d) favourable base effect. That said, it is likely to remain at the higher end of the RBI's 2-6% target range. The revival in economic activity, however, has been better-than-anticipated, aided by a good festive demand and a sharp drop in COVID-19 cases, notwithstanding a weakening global recovery, thereby posing upside risks to our GDP estimate of -10.5% for FY21. Amidst an elevated inflation trajectory and improving growth, further rate cuts seem unlikely at least in this fiscal year. That said, the RBI's focus is likely to remain on liquidity infusion and ensuring effective monetary transmission to support growth.

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Figure 1: Consumer price inflation in October 2020 (%YoY)

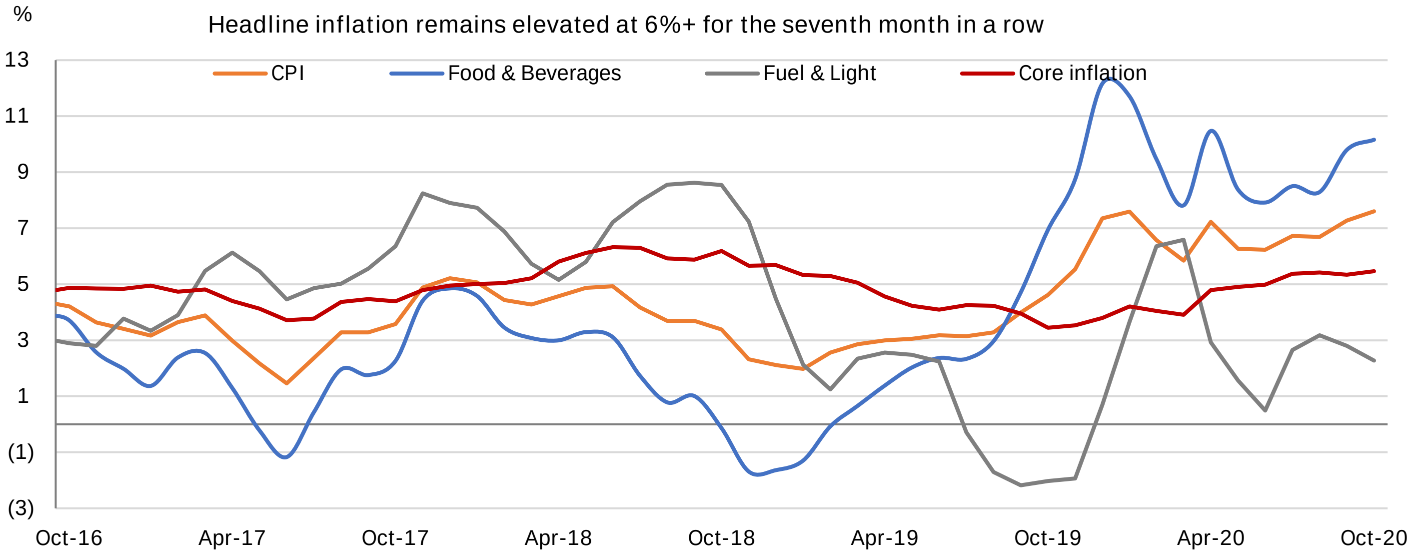
	Weight (%)	Oct-20	Sep-20	Oct-19	FY21TD	FY20TD
CPI		7.6	7.3	4.6	6.9	3.5
Food & Beverages	45.9	10.2	9.8	6.9	9.1	3.3
Pan, Tobacco & Intoxicants[2]	2.4	10.7	10.7	3.9	9.5	4.4
Clothing & Footwear[2]	6.5	3.2	3.0	1.6	3.0	1.5
Housing	10.1	3.3	2.8	4.6	3.4	4.8
Fuel & Light	6.8	2.3	2.8	(2.0)	2.3	0.1
Miscellaneous[2]	28.3	6.9	6.9	3.4	6.4	4.5
Core CPI inflation[1, 2]	44.9	5.5	5.3	3.4	5.2	4.1

Source: CSO, NSE. NA = Not Available.

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

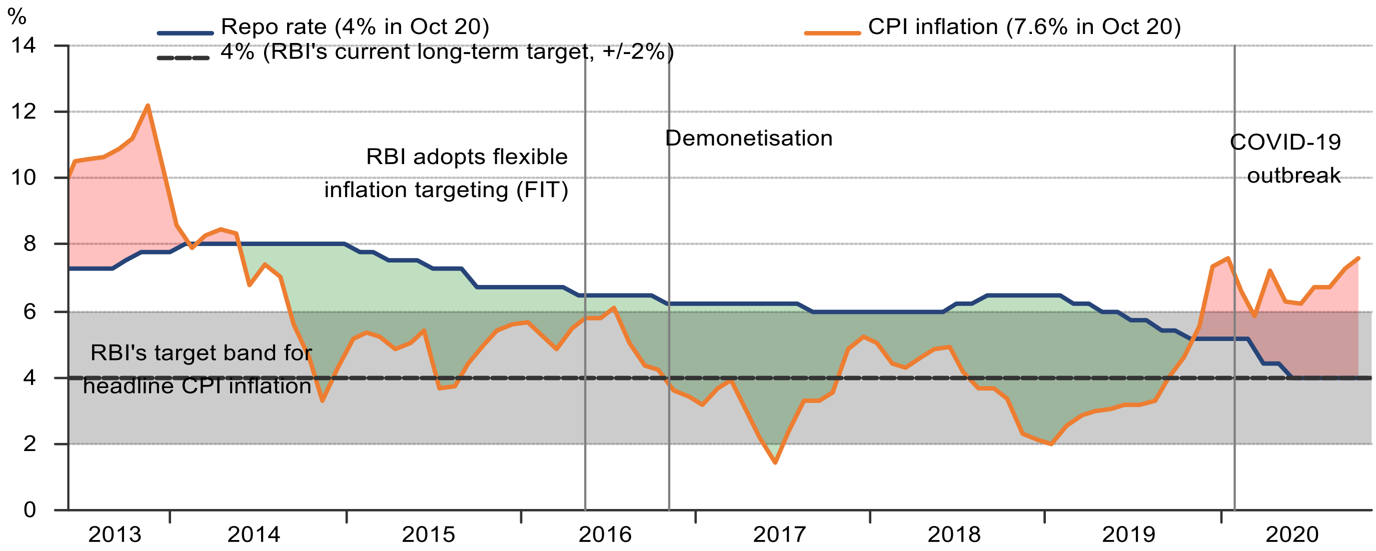
[2] Inflation data for these components for April and May 2020 are based on the imputed index calculated by MOSPI.

Figure 2: Headline CPI inflation trend



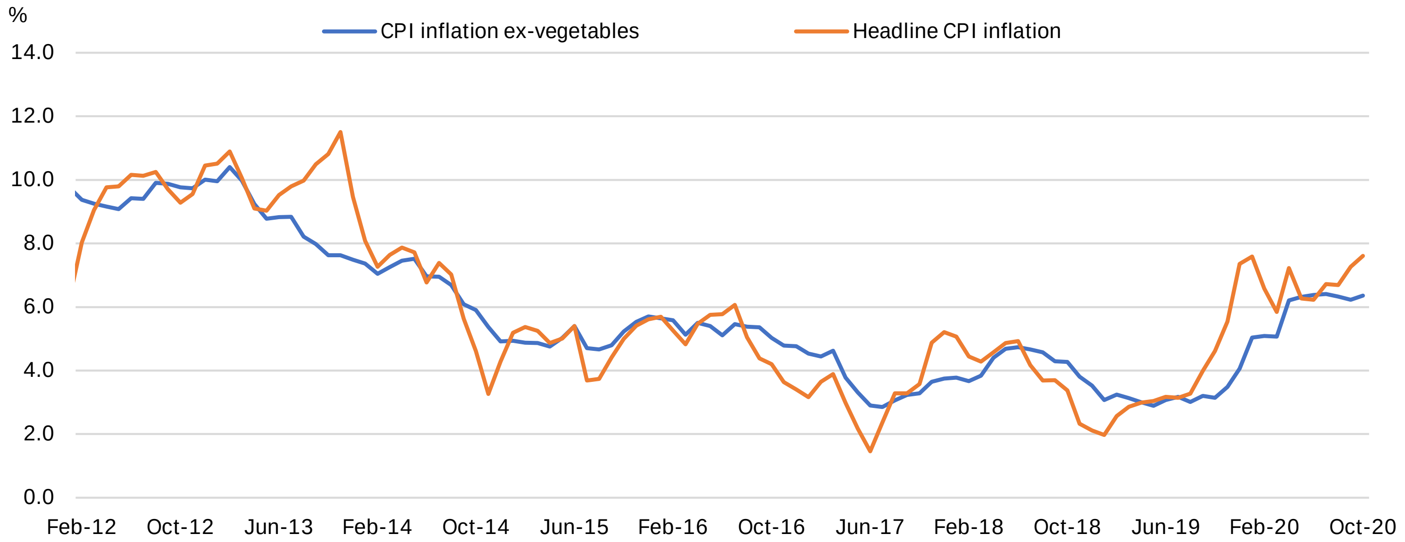
Source: CMIE Economic Outlook, NSE

Figure 3: Real interest rates have remained negative for quite some time now



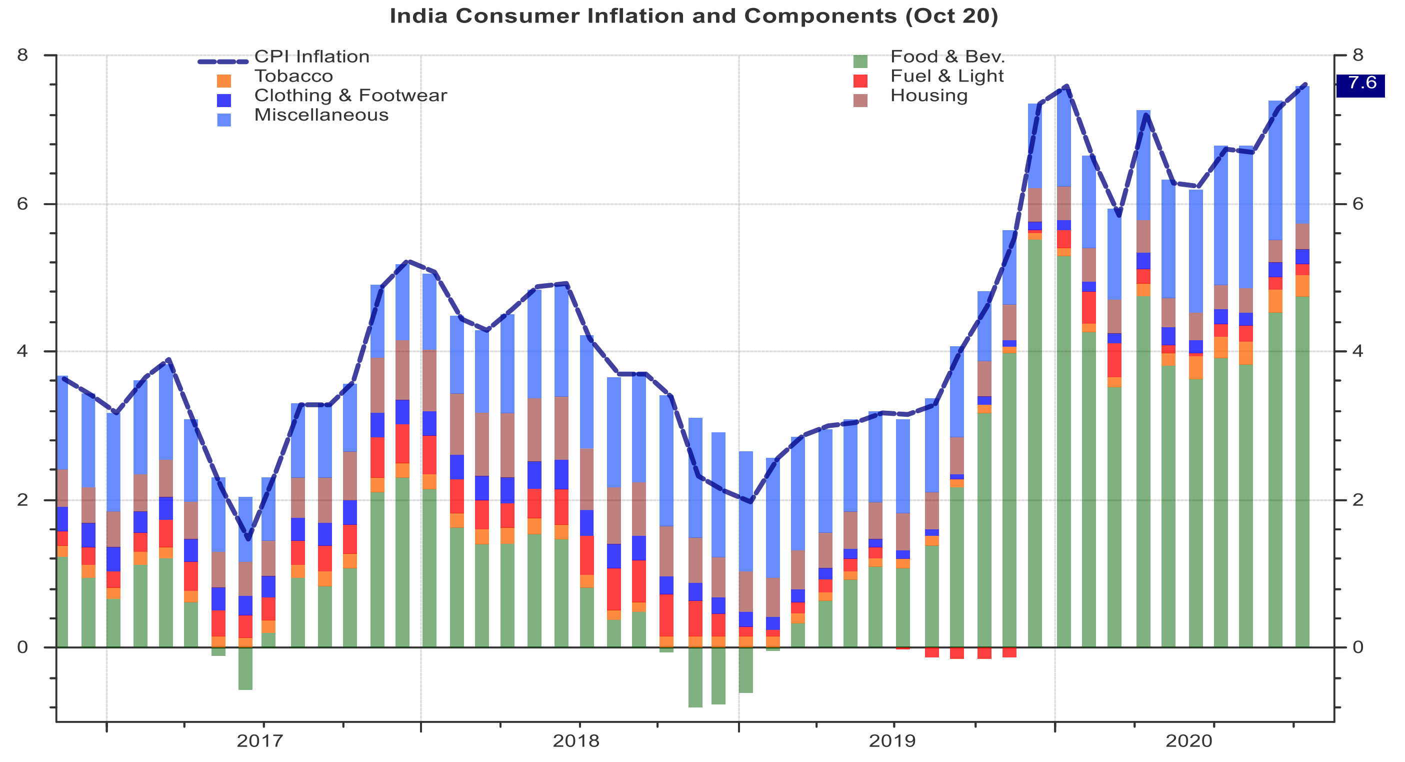
Source: CMIE Economic Outlook, NSE

Figure 4: Recent spike in headline inflation largely led by perishables



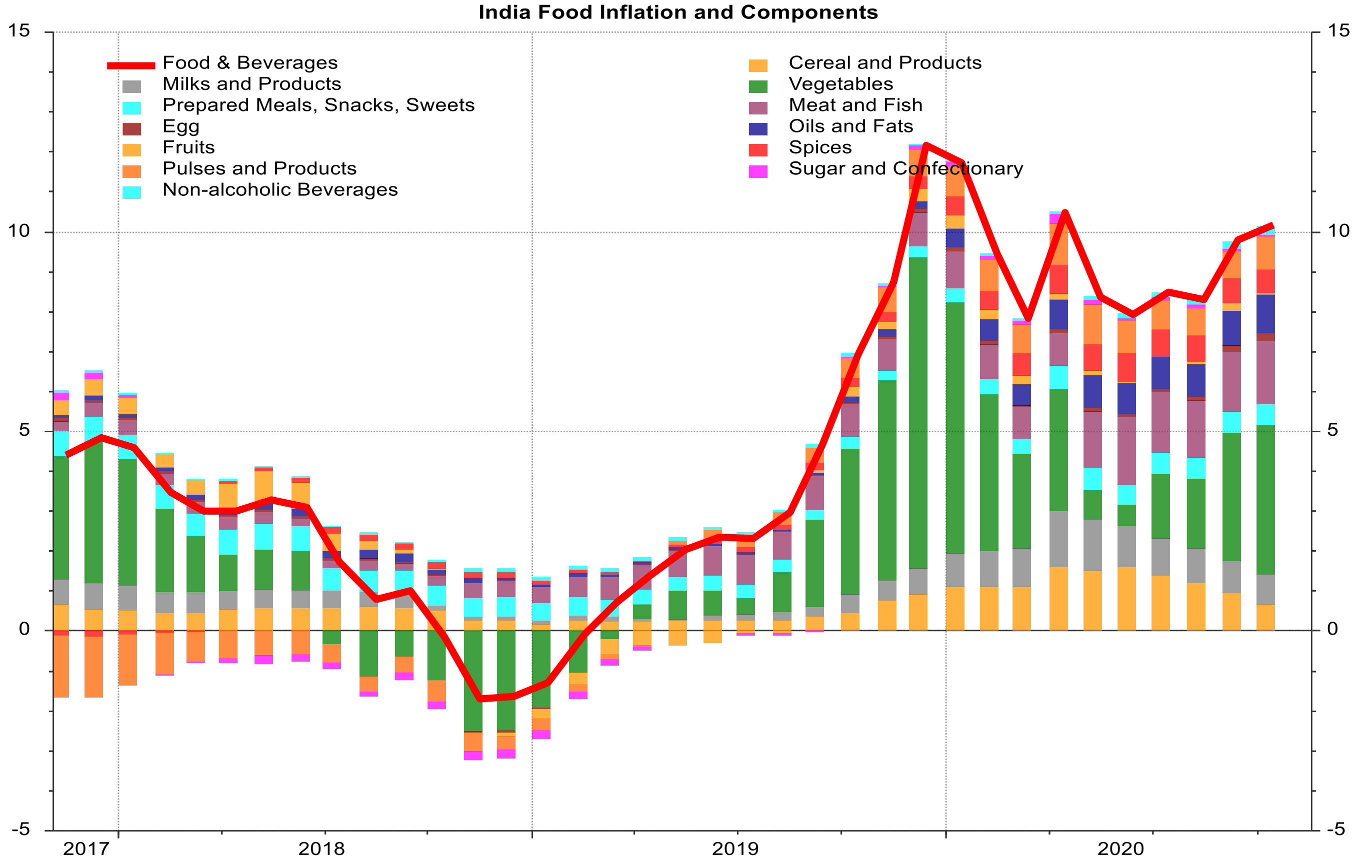
Source: CMIE Economic Outlook, NSE

Figure 5: Category-wise contribution to India consumer price inflation (CPI)



Source: Refinitiv Datastream, NSE.

Figure 6: Category-wise contribution to India Food and Beverages inflation (CPI)



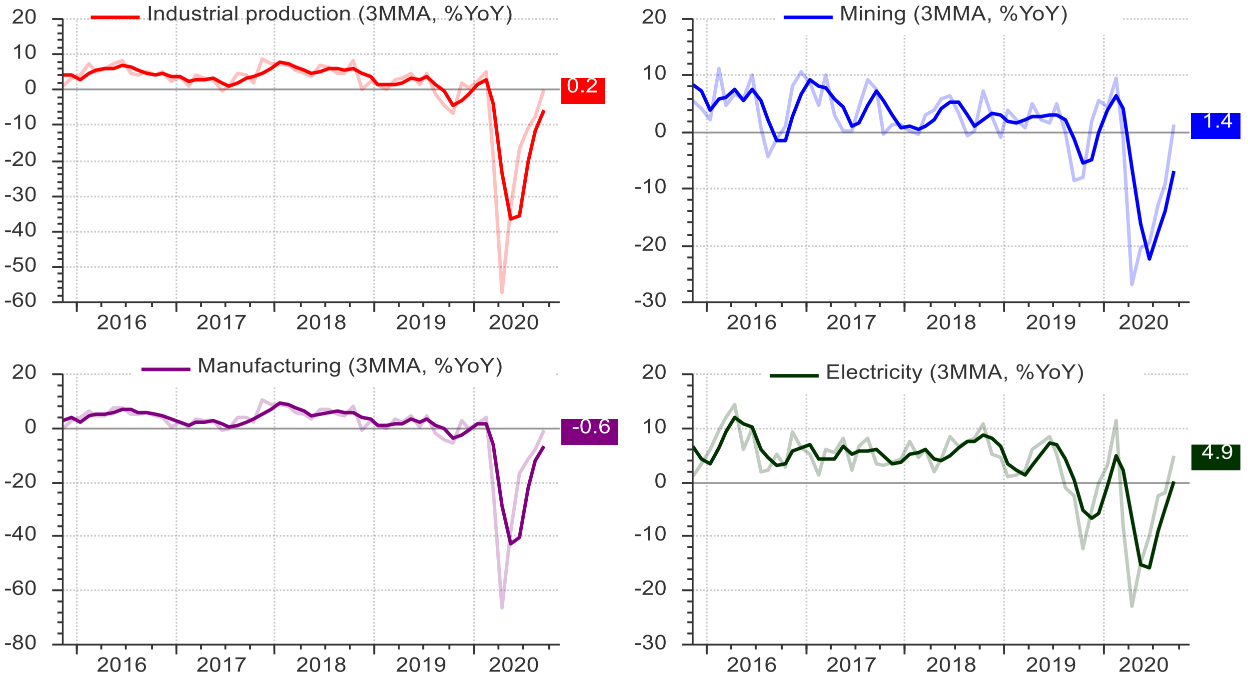
Source: Refinitiv Datastream, NSE.

Figure 7: India industrial production for September 2020 (%YoY)

		Weight (%)	Sep-20	Aug-20	Oct-19	FY21TD	FY20TD
	IIP		0.2	(7.4)	(6.6)	(21.0)	1.3
Sector-based indices	Mining	14.4	1.4	(9.0)	(8.0)	(15.3)	1.0
	Manufacturing	77.6	(0.6)	(7.9)	(5.7)	(23.6)	1.0
	Electricity	8.0	4.9	(1.8)	(12.2)	(8.0)	3.9
Use-based Goods	Primary Goods	34.0	(1.5)	(10.8)	(6.0)	(14.2)	1.2
	Capital Goods	8.2	(3.3)	(14.8)	(22.4)	(40.6)	(10.2)
	Intermediate Goods	17.2	(1.4)	(6.0)	8.7	(23.4)	9.5
	Infra/Construction Goods	12.3	0.7	(1.6)	(9.7)	(25.7)	(1.4)
	Consumer Goods	28.2	3.5	(5.3)	(10.3)	(21.0)	0.5
	Consumer Durables	12.8	2.8	(9.6)	(18.9)	(39.1)	(5.2)
	Consumer Non-durables	15.3	4.1	(2.3)	(3.3)	(7.8)	5.1

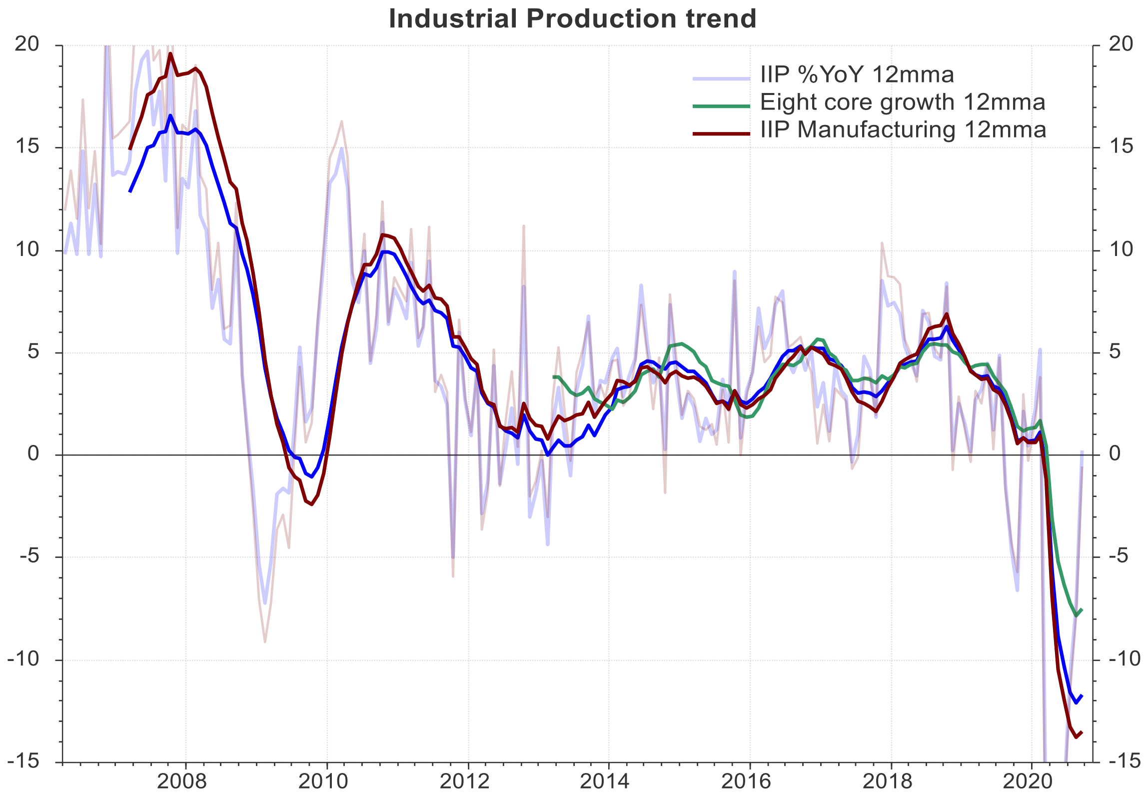
Source: CSO, NSE

Figure 8: India industrial production (3MMA)



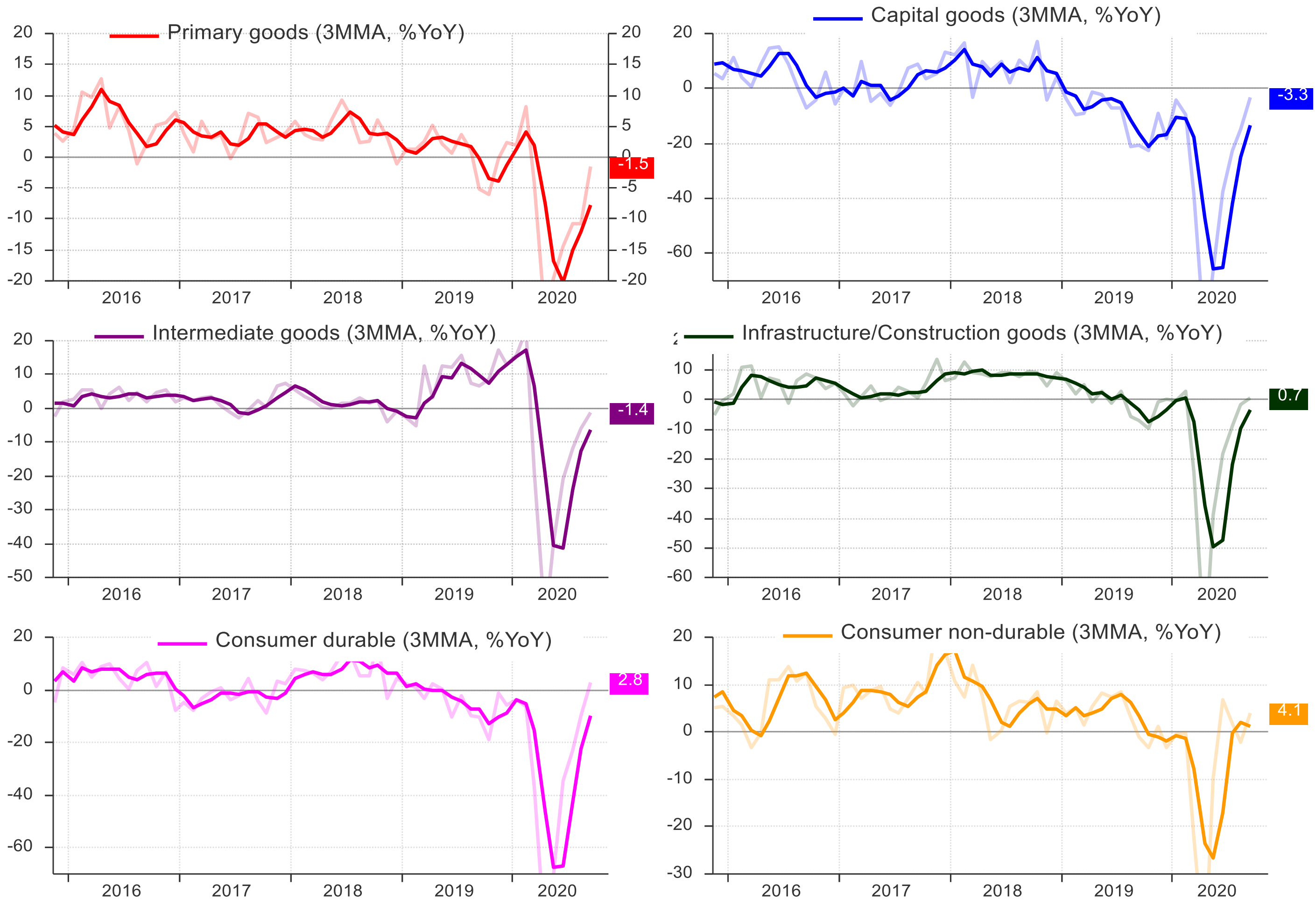
Source: Refinitiv Datastream, NSE

Figure 9: Long-term industrial production trend (12MMA)



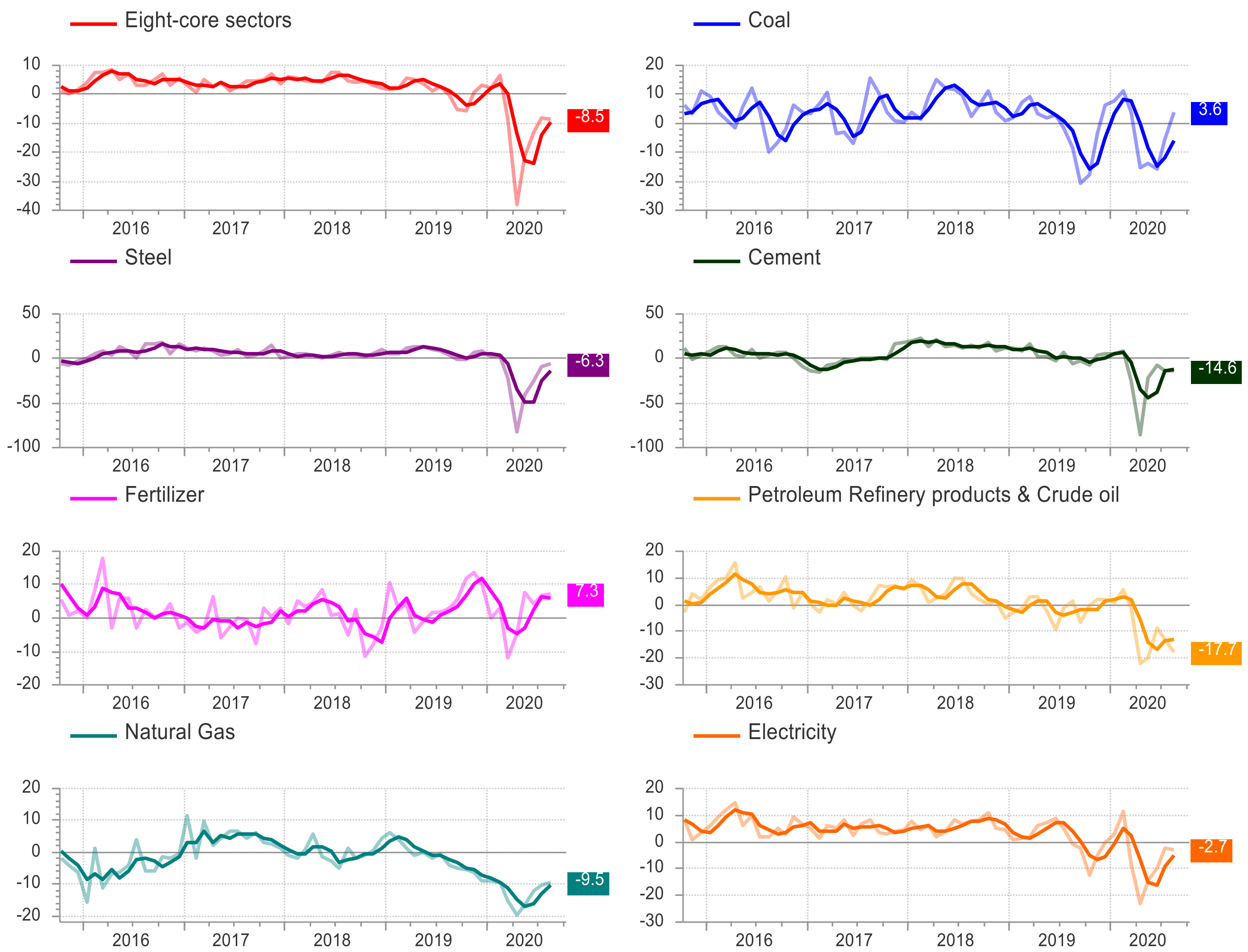
Source: Refinitiv Datastream, NSE

Figure 10: India industrial production use-based goods (3MMA)



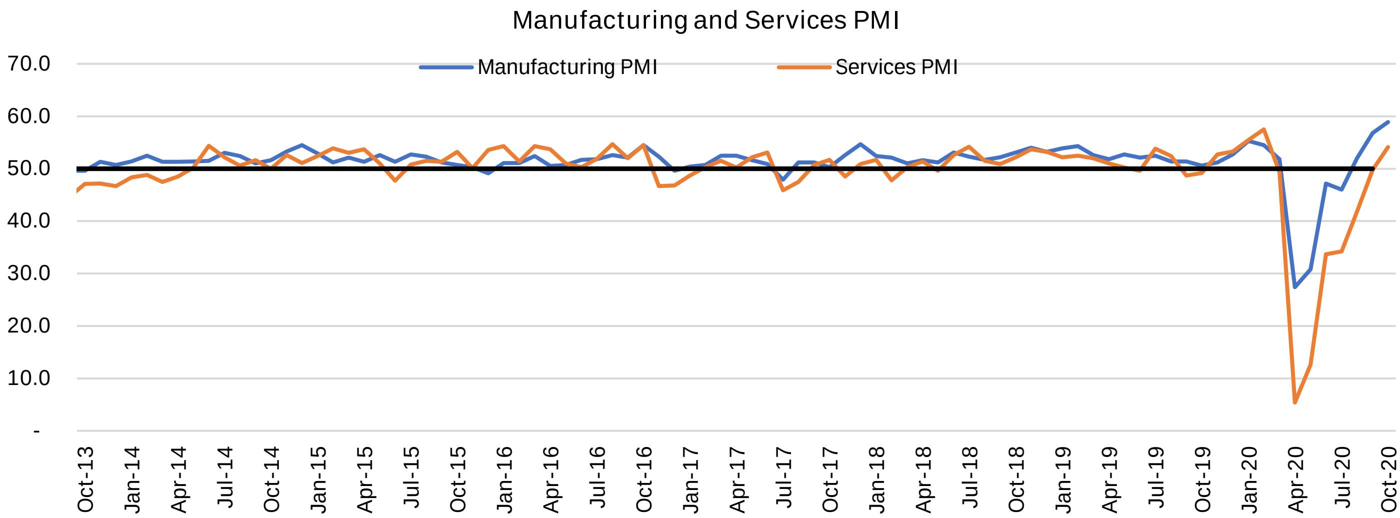
Source: Refinitiv Datastream, NSE

Figure 11: India eight-core sector growth (3MMA)



Source: Refinitiv Datastream, NSE

Figure 12: Manufacturing and Services PMI rebounds sharply in September



Source: CMIE Economic Outlook, NSE.

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