Macro Review
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Inflation remains elevated, industrial activity recovers further; RBI to stay put for now

Headline CPI inflation remained steady on a sequential basis at 6.7% in August 2020—marginally lower than the Consensus Estimate of 6.85% (Source: Reuters), marking the fifth consecutive month (and eight out of last nine months) of a 6%+ print—**the upper bound of the RBI's target range.** A slight moderation in food inflation last month—primarily led by cereals, pulses, milk and spices even as vegetable inflation hardened further—was largely offset by higher fuel and core inflation, with the latter rising to a 22-month high of 5.8%. While higher fuel and commodity prices (bullion and other metal prices) continued to impart cost pressures despite a weak demand environment, incessant rains in August and persistence of supply-side disruptions led to higher vegetable prices.

Industrial production (IIP) recovered further and contracted by a lower-than-expected 10.4% YoY in July (Consensus estimate: -11.5%) vs. an upwardly revised drop of -15.8% YoY in June. The trend is on expected lines as continued easing of lockdown restrictions is paving way for a gradual return of normalcy in industrial activity. Excluding consumer non-durables (wt.: 15.3%)—the only sector by use-based classification to report growth for the second consecutive month, primarily led by pharmaceuticals—industrial production fell by 13.9% YoY in July. Consumer durables and capital goods, however, continue to witness a huge contraction, reflecting a prolonged weakness in consumption and investment demand. During Apr-July 2020, the IIP fell by 29.2% YoY.

An unrelenting surge in COVID-**19 cases over the last few weeks, upping India's rank to 2**nd in the world in terms of total cases, is expected to significantly weigh on the underlying economic recovery, questioning its credibility and durability. Inflationary pressures on the other hand are expected to remain high in the near-term on the back of persistence of supply-chain disruptions, notwithstanding expectations of a good *kharif* harvest and weak aggregate demand, but should ease in the latter part of the fiscal, supported by a favourable base. The minutes of the recent RBI policy also point to an increasingly more cautious stance on inflation. A rate-cut is therefore off the table at least until the end of this ye**ar, even as there's space available for another** 25-50bps cut in the current easing cycle, contingent on a durable reduction in inflation trajectory.

- Retail inflation remained at uncomfortably high levels in August: Retail inflation (CPI) remained steady on a sequential basis at 6.7% in August 2020 (July print revised lower by 20bps)—lower than the Consensus estimate of 6.85% (Source: Reuters). This marks the fifth consecutive month and eighth of the last nine months to see headline inflation hover above the upper bound of the RBI's target range (4% +/- 2%). Headline inflation in this fiscal thus far (Apr-Aug'20) has averaged at 6.6% vs. 3.1% in the same period last year.

Retail inflation remained steady in August at 6.7%, marking the fifth consecutive month of a 6%+ print.

- Incessant rains and sustained supply-chain diruptions kept food prices elevated: Food inflation declined marginally to 8.3% in August from 8.5% in the previous month, primarily led by moderation in prices of cereals, pulses, milk, spices and meat & fish. Prices of other food items, particularly vegetables, fruits, egg, and oils & fats, increased further, reflecting persistence of supply-side disruptions. Incessant rainfall in August caused damage to the vegetable crops and impacted supply to the wholesale markets, thereby resulting in a spike in the retail vegetable prices. While inflation in pan, tobacco & intoxicants remained high at 11.2%, fuel & light inflation inched up to 3.1% in August, reflecting the impact of higher crude prices (+135% from April-lows). Transportation and communication inflation rose to 11% in August—the highest in the series—owing to higher fuel prices. A sharp increase in gold/silver prices this year due to rising uncertainty led to personal care and effects inflation rising to more than eight-year high of 14.5%. Other hard commodities have also rebounded meaningfully, prices of most of which are now back to pre-COVID-19 levels, thereby further imparting cost pressures.

Incessant rainfall in August, coupled with sustained supply-chain disruptions, resulted in a further increase in vegetable prices.

- Core inflation inched up further: Core inflation (ex-food & beverages and fuel & light) inched up for the fifth month in a row to 5.8% in August 2020—the highest in 22 months. This was primarily led by a sharp rise in personal care & effects inflation (on higher bullion prices), continued surge in transportation and communication inflation due higher petrol and diesel prices, and a modest pickup in inflation in household goods & services and recreation & amusement. Core inflation in FY21 till date (Apr-Aug'20) has averaged at 5.3% vs. 4.3% in the same period last year.

- Industrial production recovered further...: Industrial production contracted by a lower-than-expected 10.4% YoY in July 2020 (Consensus est.: -11.5%)—a meaningful improvement from a 35.5% YoY drop in the first quarter of FY21. The improving trend is on expected lines as continued easing of lockdown restrictions is paving way for a gradual return of normalcy in industrial activity, as also reflected in other high frequency indicators viz. manufacturing PMI and e-way bills. On a cumulative basis, the IIP fell by 29.2% YoY during Apr-July 2020.

Industrial production declined by 10.4% YoY in July, translating into a cumulative decline in this fiscal thus far of 29.2%.

- ...led by reduced pace of contraction across the board: All industrial sectors witnessed an improvement in the pace of contraction in July, reflecting continued easing of lockdown restrictions. Manufacturing sector fell by 11.1% YoY in July vs. 16% YoY drop in the previous month, primarily led by a strong growth in pharmaceuticals production and a meaningful recovery in production of food products, chemicals, metal & metal products, rubber & plastic products and non-metallic minerals. Excluding pharmaceuticals—the only sub-sector to report a strong double-digit growth—manufacturing production fell by 15.0% YoY. 11 out of 23 sub-sectors within the manufacturing space recorded more than 20% YoY contraction in July, led by other manufacturing (-43.9%), paper & paper products (-37.6%), beverages (-33.5%) and motor vehicles, trailers and semi-trailers (-31.4% YoY). Mining activity also improved, with decline in production coming off from 19.6% YoY in June to 13.0% in July. Electricity production is almost back to pre-COVID-levels, recording a decline of mere 2.5% YoY in July vs. -10.0% in June, reflecting higher demand from industrial and commercial establishments amid continued unlocking of the economy.

- Huge contraction in consumer durables and capital goods persist: Based on use-based classification, the contraction in capital goods and consumer non-durables moderated but remained quite significant for yet another month, with production falling by 23.6% and 22.8% YoY respectively, reflecting a severe and prolonged weakness in discretionary consumption and investment demand. Consumer non-durables, however, reported growth for the second consecutive month, rising by 6.7% YoY, primarily led by a robust growth in pharmaceuticals. Production of primary, intermediate and infrastructure/constructions goods declined by 10.9%, 10.6% and 12.5% YoY respectively.

- RBI to keep rates on hold for now: An unrelenting surge in COVID-19 cases over the last few weeks, upping India's rank to 2nd in the world in terms of total cases, and consequent sporadic lockdowns implemented by some states is expected to significantly weigh on the underlying economic recovery, thereby questioning its credibility and durability. Inflationary pressures on the other hand are expected to remain high in the near-term on the back of persistence of supply-chain disruptions, notwithstanding expectations of a good kharif harvest and weak aggregate demand, but should ease in the latter part of the fiscal, supported by a favourable base. The minutes of the recent RBI policy also point to an increasingly more cautious stance on inflation. A rate-cut is therefore off the table at least until the end of this year, even as there's space available for another 25-50bps cut in the current easing cycle, contingent on a durable reduction in inflation trajectory.

Persistence of inflationary pressures is likely to keep the MPC on hold at least until the end of this year.

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

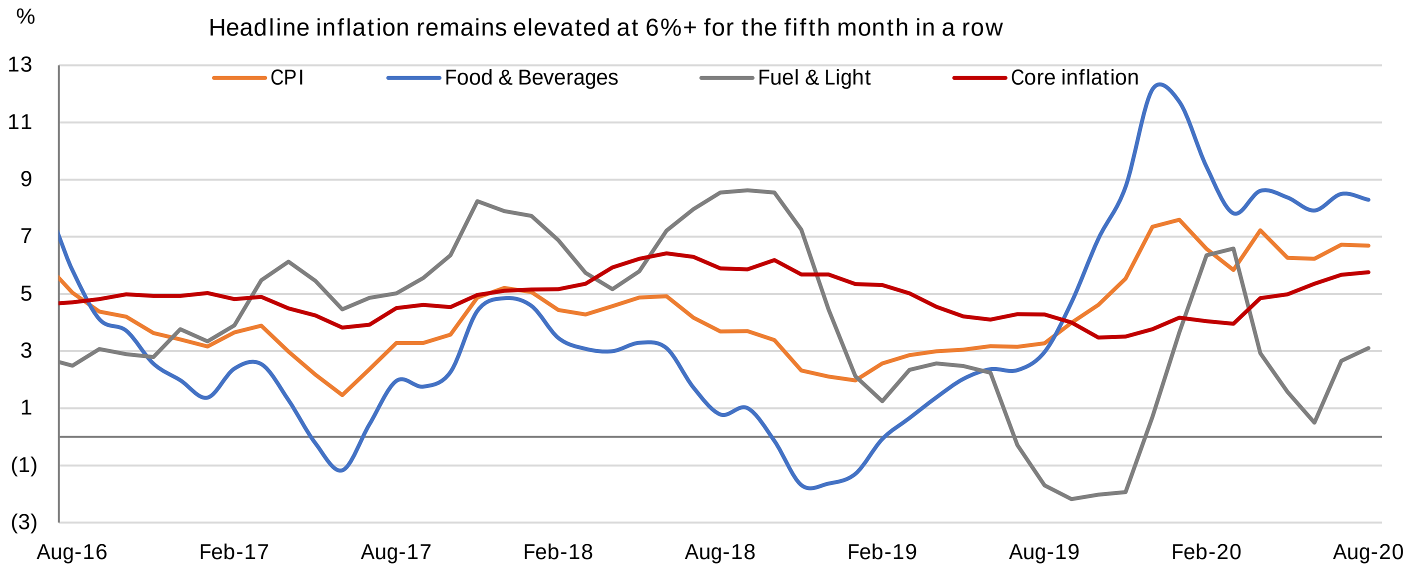
	Weight (%)	Aug-20	Jul-20	Aug-19	FY21TD	FY20TD
CPI		6.9	6.2	3.1	6.7	3.1
Food & Beverages	45.9	8.7	7.9	2.3	8.4	2.0
Pan, Tobacco & Intoxicants[2]	2.4	12.3	11.3	4.9	9.0	4.3
Clothing & Footwear[2]	6.5	2.9	2.7	1.4	3.1	1.7
Housing	10.1	3.3	3.5	4.9	3.6	4.8
Fuel & Light	6.8	2.8	0.5	(0.3)	1.9	1.7
Miscellaneous[2]	28.3	7.0	6.1	4.7	6.1	4.7
Core CPI inflation[1, 2]	47.3	5.8	5.4	4.3	5.3	4.3

Source: CSO, NSE. NA = Not Available.

Note: [1] Headline inflation excluding food & beverages and fuel & light.

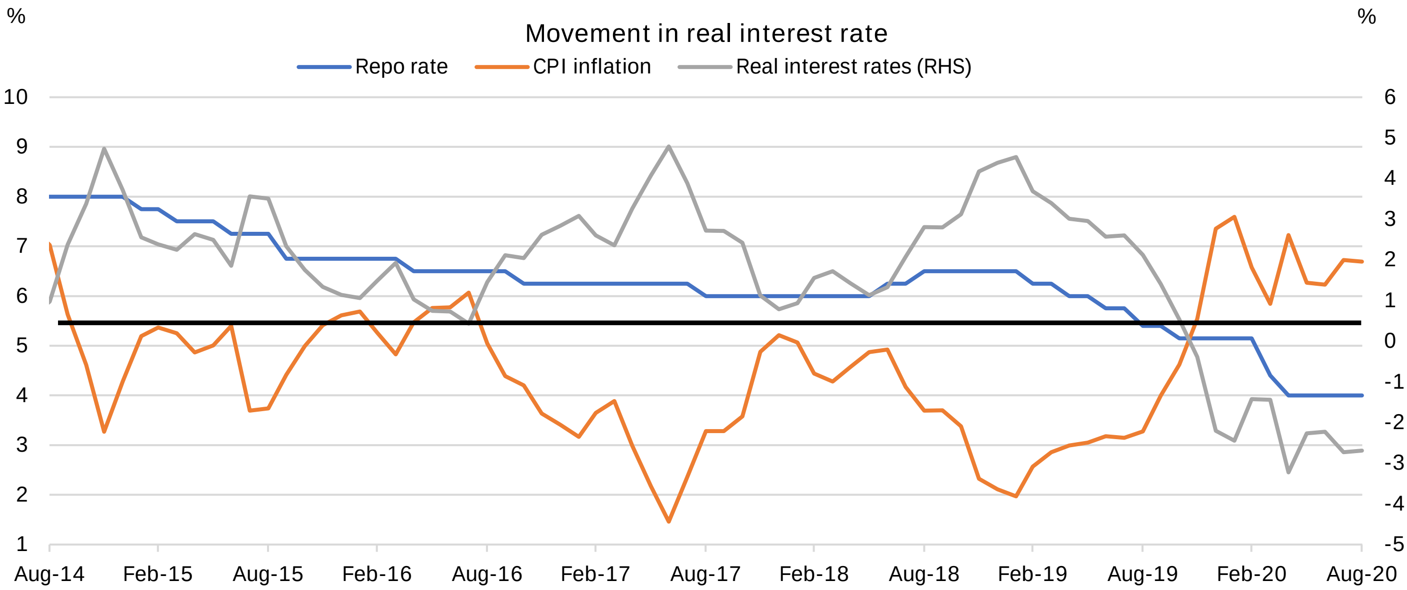
[2] Inflation data for these components for April and May 2020 are based on the imputed index calculated by MOSPI.

Figure 2: Headline CPI inflation trend



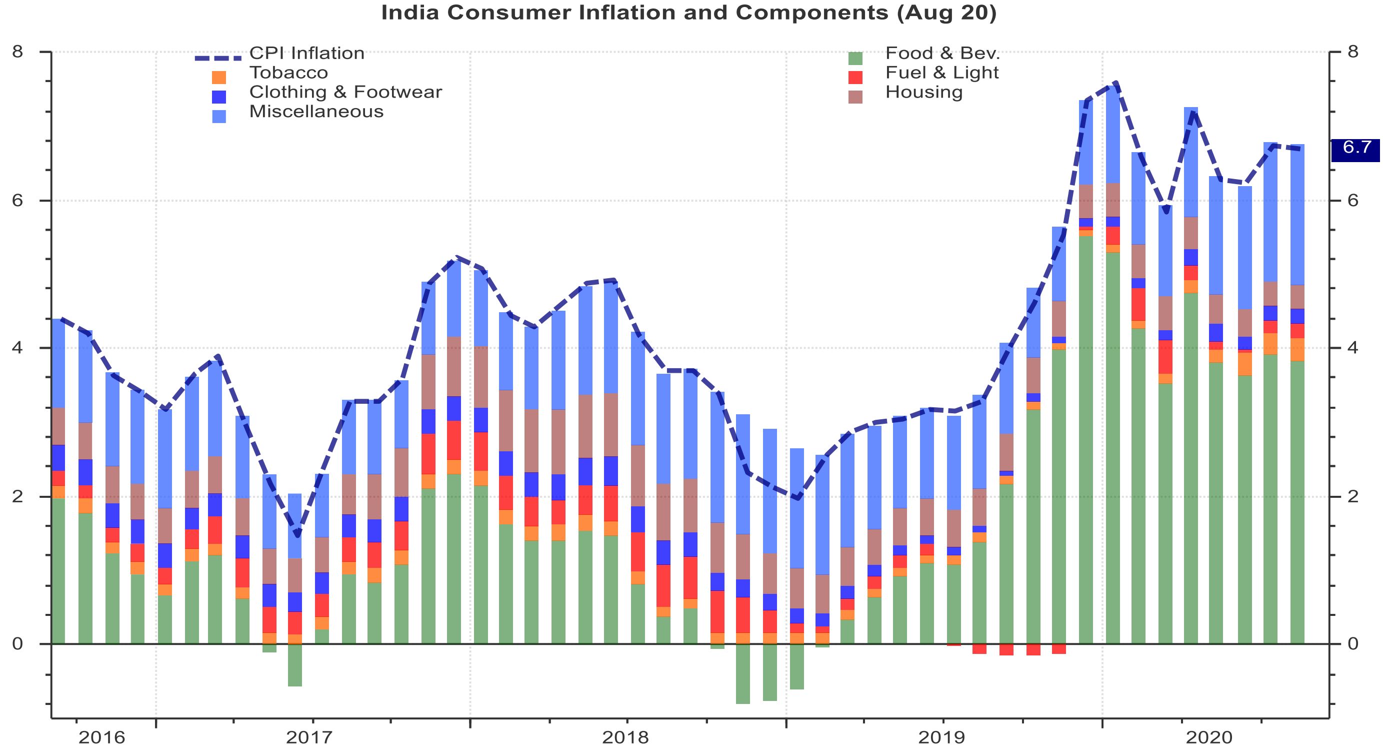
Source: CMIE Economic Outlook, NSE

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



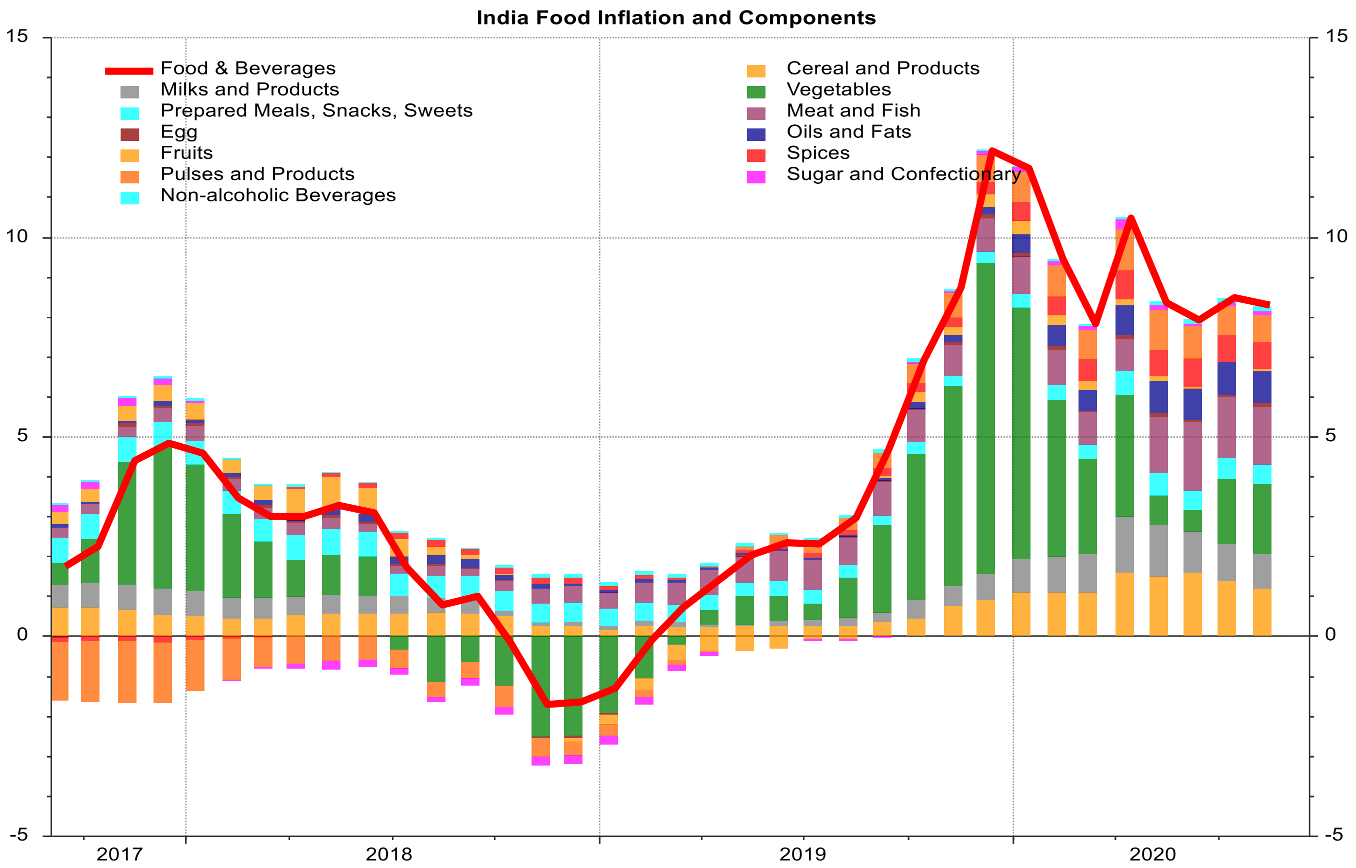
Source: CMIE Economic Outlook, NSE

Figure 4: Category-wise contribution to India consumer price inflation (CPI)



Source: Refinitiv Datastream, NSE.

Figure 5: Category-wise contribution to India Food and Beverages inflation (CPI)



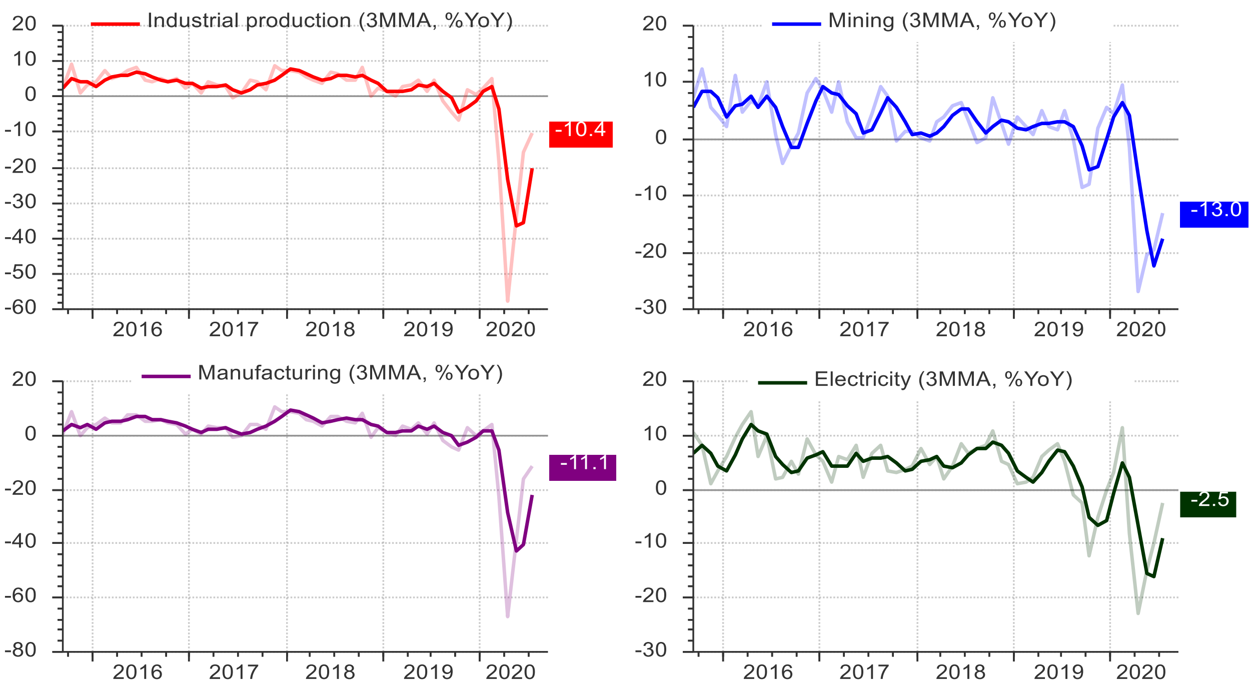
Source: Refinitiv Datastream, NSE.

Figure 6: India industrial production for July 2020 (%YoY)

		Weight (%)	Jul-20	Jun-20	Jul-19	FY21TD	FY20TD
	IIP		(10.4)	(15.8)	4.9	(29.2)	3.4
Sector-based indices	Mining	14.4	(13.0)	(19.6)	4.9	(20.1)	3.4
	Manufacturing	77.6	(11.1)	(16.0)	4.8	(32.7)	3.0
	Electricity	8.0	(2.5)	(10.0)	5.2	(12.5)	6.8
Use-based Goods	Primary Goods	34.0	(10.9)	(14.5)	3.6	(17.9)	2.8
	Capital Goods	8.2	(22.8)	(37.4)	(7.0)	(54.8)	(4.4)
	Intermediate Goods	17.2	(12.5)	(23.0)	15.7	(34.2)	10.8
	Infra/Construction Goods	12.3	(10.6)	(18.8)	2.9	(38.3)	1.0
	Consumer Goods	28.2	(6.3)	(6.1)	3.5	(29.3)	2.8
	Consumer Durables	12.8	(23.6)	(34.3)	(2.4)	(56.0)	(2.6)
	Consumer Non-durables	15.3	6.7	14.3	8.5	(9.5)	7.4

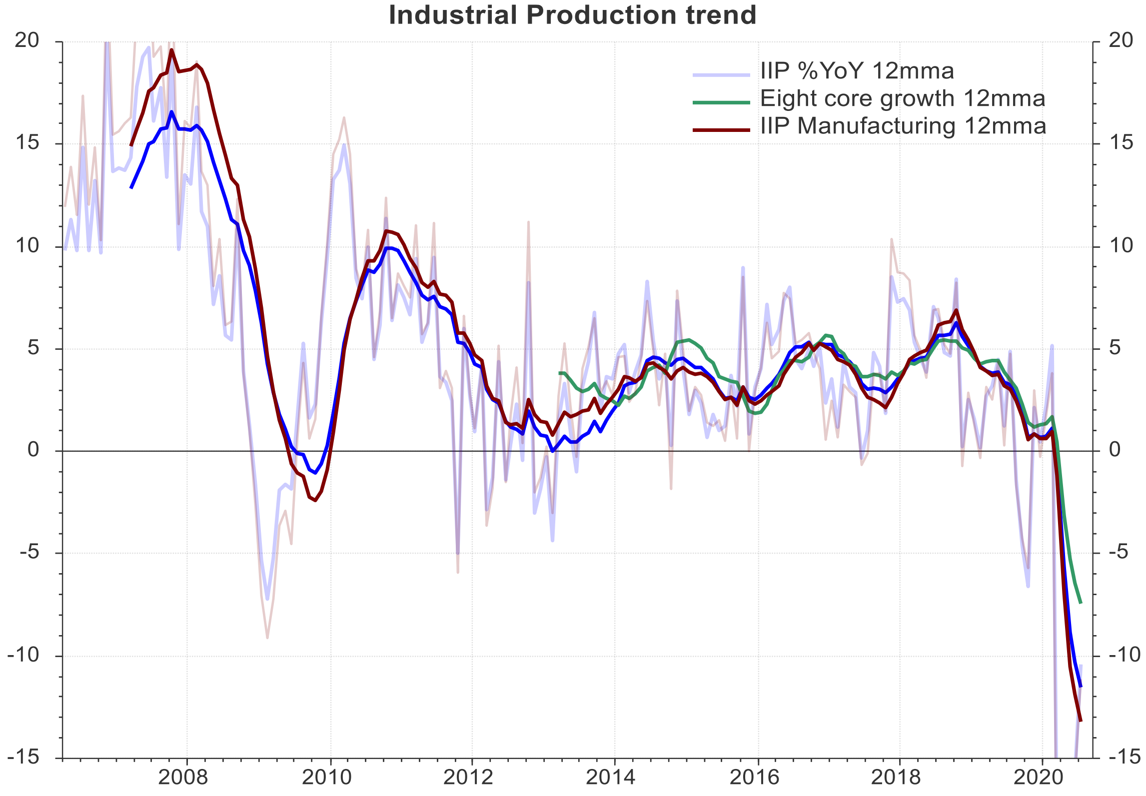
Source: CSO, NSE

Figure 7: India industrial production (3MMA)



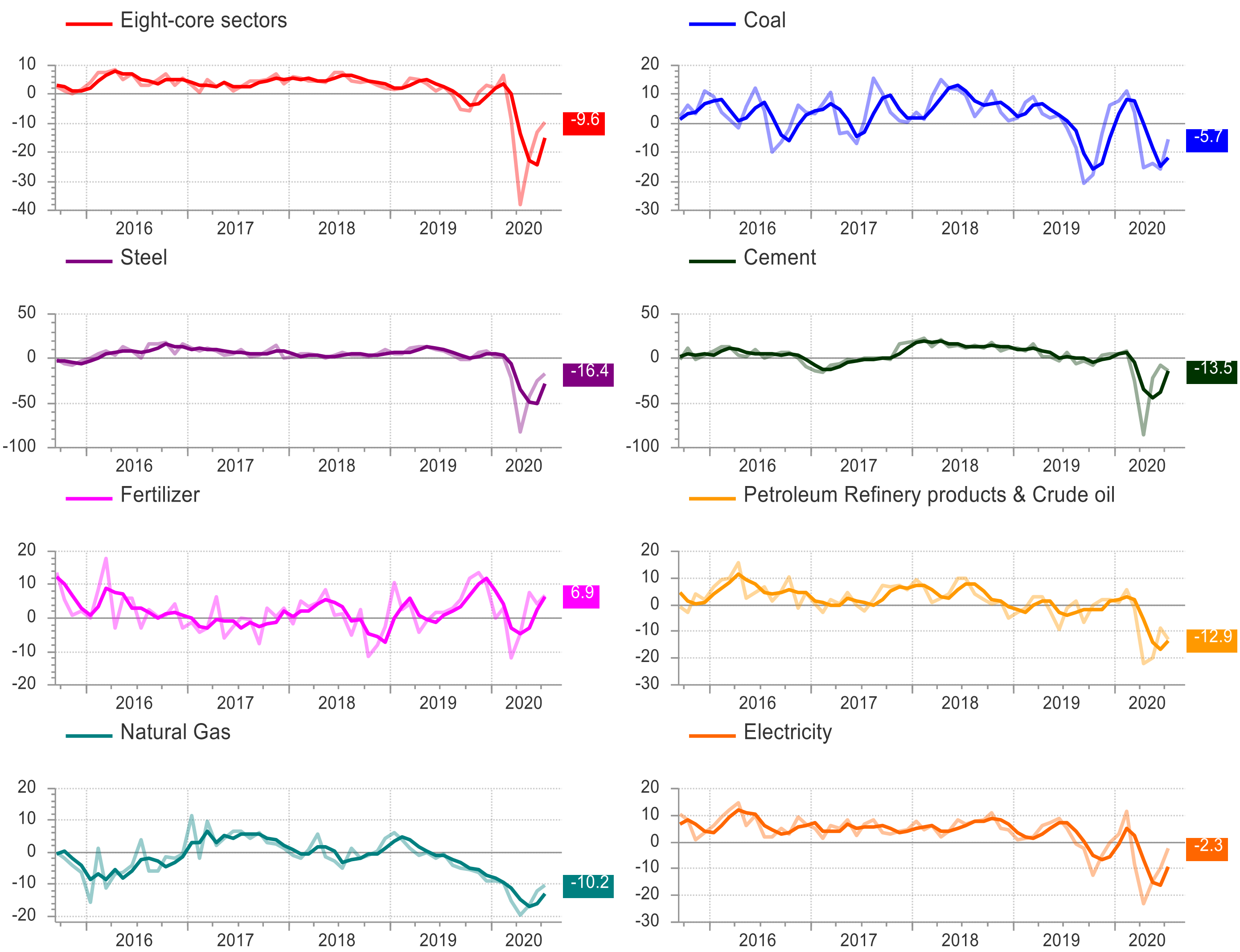
Source: Refinitiv Datastream, NSE

Figure 8: Long-term industrial production trend (12MMA)



Source: Refinitiv Datastream, NSE

Figure 9: India eight-core sector growth (3MMA)



Source: Refinitiv Datastream, NSE

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