SBI RESEARCH
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FIRST RATE HIKE LIKELY IN JUNE POLICY MEET:CUMULATIVE 75 BASIS POINTS EXPECTED THROUGH THE CYCLE

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CPI inflation surged to 6.95% on yearly basis in Mar'22 as compared to 6.07% in Feb'22 mainly on account of food price inflation. Inflation prints are now likely to stay higher than 7% till September. Beyond September, inflation prints could hover in between 6.5%-7%. Our FY23 inflation forecast is now closer to 6.5%, taking into account the possibility of an extended food price shock.

The Russia-Ukraine conflict has significantly impacted the trajectory of inflation. The latest March'22 inflation print shows wheat, protein items (chicken in particular), milk, refined oil, potato, chillies, kerosene, firewood, Gold and LPG contributing to overall inflation in a substantive manner. The conflict has pushed up prices of chicken abruptly as chicken feed imports from Ukraine are getting disrupted. The pressure on sunflower oil supplies from Ukraine has led to change in export policy from Indonesia, thereby leading to lower palm oil imports. Further the war has exacerbated crop loss concerns in South America which in turn has impacted soybean oil supplies.

Milk, Refined Oil prices have also jumped significantly. Surprisingly, the contribution of petrol and diesel in overall inflation has been declining steadily since Oct'21, while there is a steady increase in weighted contribution of kerosene and firewood in headline inflation. There is also a decline in weighted contribution of LPG in headline inflation. It seems that fuel consumption has been declining even before the omicron had set in and the trend to alternate sources of fuel like kerosene and even firewood may have gathered momentum and will possibly gather further traction in coming days. This does not augur well for rural demand.

We have already taken the impact of this pass through of WPI food inflation to CPI food inflation while estimating our average CPI of 5.5%-6% (oil price of $95-$100 per bbl). However, there is an additional factor that could lead to further upside risk to inflation in the next fiscal year. There has been an increase in prices of various inputs used in agriculture. The cost of production is likely to increase by around 8-10%. Thus, CACP will have to take this higher cost of production into account while estimating minimum Support Price (MSP) for FY23. Generally the recommended MSP is calculated as 150% of the cost of production (A2+FL). MSP increase has been in the range of 3-5% in the past. In FY23, MSP should at least be higher by around 12-15%. As per our estimates, inflation is likely to remain above 7% in H1 and 6.5% in H2. US inflation is expected to hit 6.6% over the next year, according to the New York Fed's survey in March. Fed officials reached consensus at their March meeting that they would begin reducing the central bank balance sheet by $95 billion a month. The Federal Reserve is therefore expected to deliver two back-to-back half-point interest rate hikes in May and June to tackle runaway inflation.

Historically, at the lowest end of spectrum, the spread between the Repo and G-sec hovers around 250 basis points. In an interest rate hardening cycle, the spread vaults up to 350 points. 10-year Benchmark yields should thus move towards 7.50%, even with the current repo rate at 4%. We now expect a 25 basis point rate hike each in June and August, with a cumulative rate hike of 75 basis points in the cycle. Given that the spread between G-sec yields and repo rate jumps in an increasing interest rate cycle, G-sec yields could touch 7.75% by September. We believe, RBI will keep the G-sec yields capped at 7.5% through unconventional policy measures.

The current jump in yields also has to do with the RBI circular on Friday. In principle, in order to make SDF attractive and to bring it on par with Reverse Repo facility as far as maintenance of SLR is concerned, RBI has made deposits parked under SDF an eligible asset for the maintenance of SLR. Thus, from Bank's point of view, SDF facility offers higher return without compromising on maintenance of statutory ratio and risk exposure being minimal (counterparty being the central bank). As the funds parked under SDF are eligible to be reckoned for SLR, we do not envisage introduction of this facility to lead to any incremental demand for SLR securities. This could mean yields in uncharted territory if the RBI does not cap it. As expected, technically speaking a move to 7.5% and beyond for G-sec yields could be swift and rapid as being witnessed right now.

The recent spike in benchmark yields lays bare the growing disconnect, and divergence between benchmark yields and bank lending rates, with banks entering a new territory where lending rates are now effectively lower than yields, thereby taking the sheen off risky lending for banks. Also, as and when benchmark rates start rising, the effective yield may spike further, a disincentive ensuring demand degrowth from corporates for proposed capex. As banks would be forced to enhance the lending rates, aligning it with market determined course (with NBFCs following suit with a mark-up), the effects on economy can be destabilising.

The good thing is that we have also seen substantial increase in new investment announcements which were around Rs 10 trillion in last two years, increasing to a record high of around Rs 19 trillion in FY22.

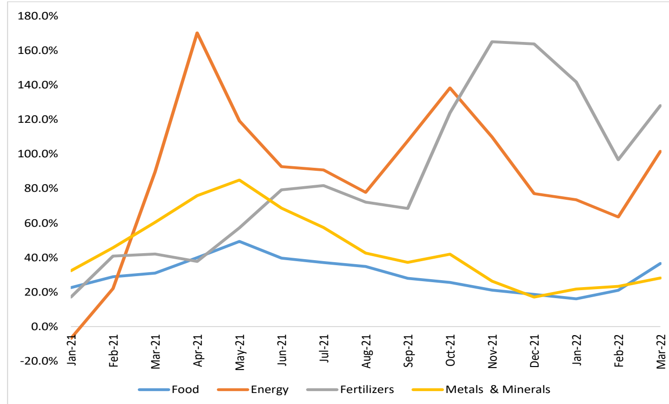
CPI INFLATION

- CPI inflation surged to 6.95% on yearly basis in Mar'22 as compared to 6.07% in Feb'22 mainly on account of food price inflation. Apart from food prices, other components which registered high inflation include personal care and effects, and clothing and footwear.
- On monthly basis, the inflation rose to 0.96% as against 0.24% in Feb'22. The core CPI has increased to 10 month high at 6.32%.
- Weighted contribution of food prices has increased to 3.42%. Within food, oils and fats, vegetables, meat and fish and cereals have all witnessed increase in prices. The Russia-Ukraine war has dealt a serious blow to edible oil supplies, leading to increase in its prices. The pressure on sunflower oil supplies from Ukraine has led to change in export policy from Indonesia, thereby leading to lower palm oil imports. Further the war has exacerbated crop loss concerns in South America which in turn has impacted soybean oil supplies.
- Global increase in commodity prices has also pushed up domestic prices. The imported inflation for Mar'22 has risen to 1.07% from 0.98% in the previous month. Item wise analysis reveal that weighted contribution of refined oil and gold in imported inflation has increased when compared to Feb'22 but that of petroleum has declined in Mar'22 compared to Feb'22.
- Interestingly, services inflation which increased more than goods inflation till Dec'21 has now started to rise less than goods inflation. The gap between the two has now increased to 2% (services inflation at 5.53%, goods inflation at 7.58%) in Mar'22 from 0.7% in Feb'22 and 0.2% in Jan'22.
- Under the services inflation, prices of 'health', 'recreation and amusements' has increased in line with the rise in economic activities.
- The 'personal care & effects' inflation has increased to 8.71% in March, mostly contributed by Gold prices (10 bps contribution).

RURAL-URBAN COMPARISONS

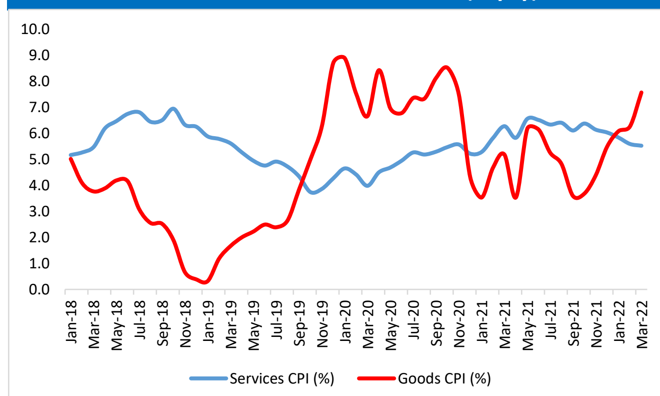
- In terms of pure number, the rural inflation is tad higher the urban figure but in terms of statistical differences, the trend is identical. Higher food inflation in rural areas at 8.04% indicate supply shock in major food producing areas. The pass thorough of high energy prices is clearly cascading across all items of CPI basket.
- Clothing and footwear, fuel and light and personal care and effects are others items where rural CPI is higher than urban CPI.

Global Commodity Prices (% yoy)



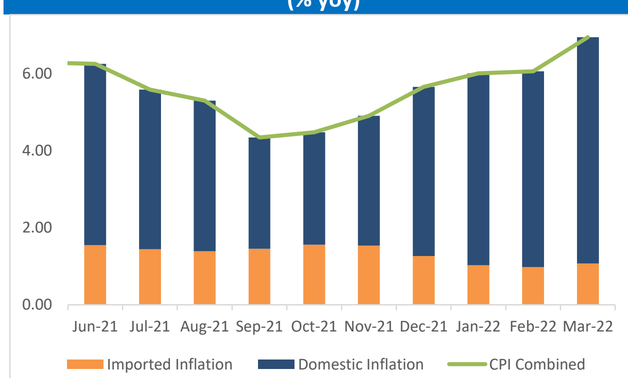
Source: SBI Research, MOSPI

Services and Goods CPI inflation (% yoy)



Source: SBI Research, MOSPI

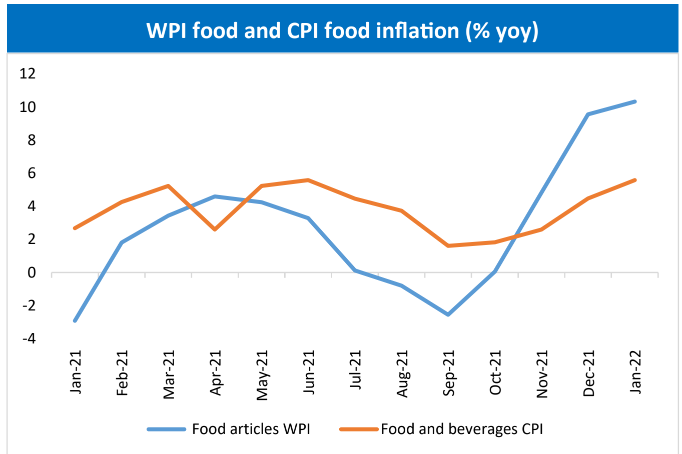
Weighted contribution of Imported Inflation in Headline CPI (% yoy)



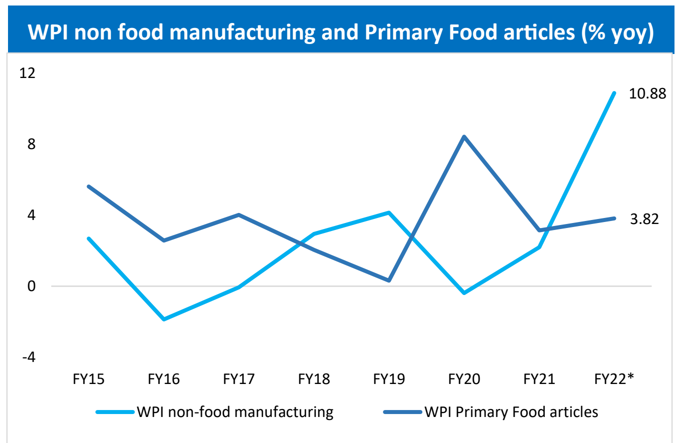
Source: SBI Research, MOSPI

UPSIDE RISKS TO FOOD PRICE INFLATION

- There was huge gap between WPI and CPI food inflation with WPI food prices being higher than CPI food prices, which indicated incomplete pass-through of prices. The gap was 4.7% in Jan'22 and it has now reduced to 2.3%.
- We estimated the impact of this pass through of WPI food inflation to CPI food inflation while estimating our average CPI of 5.5%-6% (oil price of $95-$100 per bbl).
- However, there is an additional factor that could lead to upside risk to inflation in the next fiscal year. There has been an increase in prices of various inputs used in agriculture. Diesel prices have increased by Rs 10 in the last 2 weeks. Meanwhile, FMB fertiliser prices have surged in the range of 70%-240% between Feb'22 and Feb'21. Notably, labour charges have increased on an average by 4% compared to 6% in the previous fiscal.
- Furthermore, one must also take into account the terms of trade. The average yoy growth in WPI manufacturing of non-food products has been higher than the average yoy growth in WPI primary food articles in FY22 so far (10.8% and 3.8% respectively), with the huge gap between the two. This is particularly worrisome as terms of trade are moving significantly against the agri sector indicating the stress on rural economy.
- Taking these factors into account, the cost of production is likely to increase by around 8-10%. Thus, CACP will have to take this higher cost of production into account while estimating minimum Support Price (MSP) for FY23. Generally the recommended MSP is calculated as 150% of the cost of production (A2+FL). MSP increase has been in the range of 3-5% in the past. In FY23, MSP should atleast be higher by around 12-15%.
- Our estimates show that 1% increase in MSP leads to higher CPI inflation of 4bps. Thus overall higher MSP should lead to upside risk to CPI inflation of 48-60 bps over our earlier inflation forecast of 5.8%.
- Thus taking the impact of MSP on inflation, CPI inflation could be pushed above 6% in FY23. This is higher than RBI inflation at 5.7%.
- Inflation prints are now likely to stay higher than 7% till September. Beyond September, inflation prints could hover in between 6.5%-7%. Our FY23 inflation forecast is now closer to 6.5%, taking into account the possibility of an extended food price shock.



Source: SBI Research, MOSPI



Source: SBI Research, MOSPI

SDF AS SLR: KEEPING SECURITIES AT HAND

- Though RBI decided to maintain accommodative policy stance, however the forward guidance was changed from "*as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward*" to "*focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth*". RBI also decided to narrow LAF corridor to 50 bps from 90 bps earlier.
- In narrowing the LAF corridor, RBI introduced Standing Deposit Facility (SDF) as an additional tool for absorbing liquidity without any collateral. Adoption of Standing Deposit facility in the operating framework for Monetary Policy was proposed in Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework under the chairmanship of Urjit Patel in Jan. 2014. Consequently, amendment to RBI Act in 2018 empowered RBI to introduce such facility.

- As stated in MPC resolution, the SDF, at the rate of 3.75%, will now be the floor of LAF corridor in place of fixed rate reverse repo. As a tool, SDF enables RBI to absorb liquidity without collateral constraint. The facility has been operationalized with immediate effect on 08.04.2022 and participants parked an amount of Rs. 2,34,996 crore on first day.
- Funds parked under SDF are not eligible to be reckoned for the maintenance of CRR under section 42 of the RBI Act. It may be noted that Securities acquired under reverse repo are eligible to be reckoned for SLR maintenance. In order to make SDF attractive and to bring it on par with Reverse Repo facility as far as maintenance of SLR is concerned, RBI has made deposits parked under SDF an eligible asset for the maintenance of SLR. Thus, from Bank's point of view, SDF facility offers higher return without compromising on maintenance of statutory ratio and risk exposure being minimal (counterparty being the central bank).
- As the funds parked under SDF are eligible to be reckoned for SLR, we do not envisage introduction of this facility to lead to demand for SLR securities.

RATE HIKE

- With RBI prioritizing inflation over growth, as stated by RBI Governor in post policy press conference, we now expect RBI to hike repo rate by at least 50 bps, beginning June. Yields are expected to move up tracing yields in advance economies and Asian peers. Any extension of GST compensation beyond June 2022 and any additional borrowing to meet it will be another factor to watch for. Taxation issues have ruled out inclusion of IGBs in global bond indices in near future which could have brought additional flows.
- Historically, at the lowest end of spectrum, the spread between the Repo and G-sec hovers around 250 basis points. In an interest rate hardening cycle, the spread vaults up to 350 points. 10-year Benchmark yields should thus move towards 7.50%, even with the current repo rate at 4%. We now expect a 25 basis point rate hike each in June and August, with a cumulative rate hike of 75 basis points in the cycle. Given that the spread between G-sec yields and repo rate jumps in an increasing interest rate cycle, G-sec yields could touch 7.75% by September. We believe, RBI will keep the G-sec yields capped at 7.5% through unconventional policy measures.

US RATE HIKE

- US inflation is expected to hit 6.6% over the next year, according to the New York Fed's survey in March. Fed officials reached consensus at their March meeting that they would begin reducing the central bank balance sheet by $95 billion a month. The Federal Reserve is therefore expected to deliver two back-to-back half-point interest rate hikes in May and June to tackle runaway inflation.

CROUCHING YIELDS, NOT-SO-HIDDEN LENDING RATES TRAJECTORY AND A SLUGGISH CORPORATE DEMAND: THE TROIKA OF UPHEAVALS IN THE OFFING

- The recent spike in benchmark yields, and the expectations of further run off in days to come as the Central bank should trudge the rate hike path from August meet probably, lays bare the growing disconnect, and divergence between benchmark yields and bank lending rates, with banks entering a new territory where lending rates are now lower than yields, thereby taking the sheen off risky lending for banks. Also, as and when benchmark rates start rising, the effective yield may spike further, a disincentive ensuring demand collapse from corporates for proposed capex. As banks would be forced to enhance the lending rates, aligning it with market determined course (with NBFCs following suit with a mark-up), the effects on economy can be destabilising.

Interest Rates vis-à-vis Benchmark Yields

Month	WALR	10 Year Gsec Yield	1 Year MCLR	(EBLR SBI)
Jan-20	9.32	6.601	8.25	7.80+ Credit Risk Premium
Jan-22	7.82	6.681	7.25	6.65+ Credit Risk
Feb-22	7.82	6.765	7.2	
Mar-22	-	6.836	7.25	
Latest	-	7.19	-	

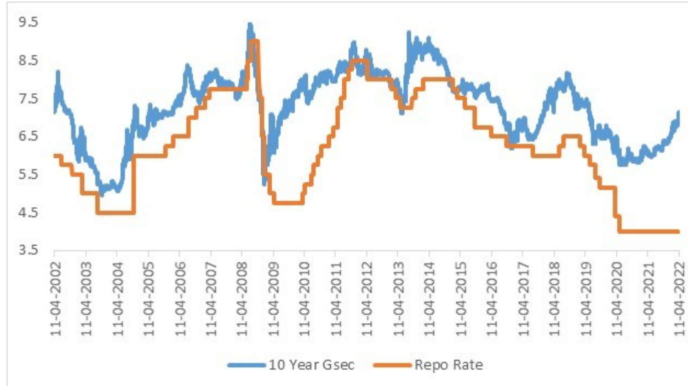
Source:RBI,SBI Research, WALR for Fresh Rupees loan

- With US CPI inflation breaching 8% mark today, Fed would pitch for a double-score with full might; selling bonds every month to the tune of USD 95 billion and fast paced increase in interest rates of 50 bps in coming meets. A pertinent question that market sections are asking is who will buy the bonds the Fed no longer wants, and its impact on yields of different maturities with inflation further heating up and growth impetus faltering in a high credit cost environment.

CREDIT GROWTH IMPROVED IN FY22

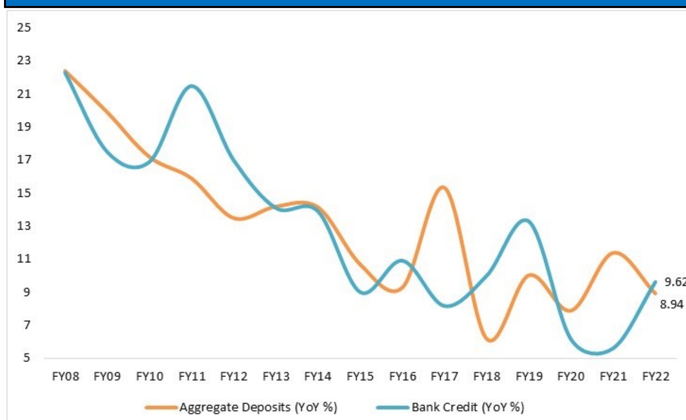
- Credit offtake picked up during 2021-22, with the gradual return of normalcy after the pandemic. ASCB's credit grew by 9.6% as on March 25, 2022 (5.6% a year ago). The recovery in bank credit was led by private sector banks that provided the bulk (50.4%) of the incremental y-o-y credit (up to March 25, 2022), followed by PSBs (44.7%). Credit growth was driven by all the major economic sectors.
- Interestingly Retail loans have emerged as the main driver of bank credit in recent years and now have the largest share (30.5%) in the outstanding credit of ASCBs, displacing industrial loans (28.9%).
- Within retail, housing loans have the largest share (47.7%). The importance of retail loans has increased for both PVBs and PSBs. In view of subdued profitability and deleveraging by corporates, banks shifted their focus away from large infrastructure and industrial loans towards retail loans.
- ASCBs deposits growth slowed to 8.9% in FY22, compared to 11.40% in FY21.
- Generally, during the last fortnight/month (March) of every financial year, both deposits and credit surged up and most part of the same flows out in the next month (April). However, it is interesting to know that in the last 2 years, the trend is different.
- During April of FY20 and FY21, there has been increase in deposits and credit, consequent to the rise in March also.
- We expect the same trend will continue in the current year 2022-23 too. So, banks have to increase the deposits rate to garner more deposits to fund credit.

10 Year Gsec and Repo Rate



Source: SBI Research

ASCB's Deposits & Credit Growth



Source: RBI; SBI Research

ASCB's Change in Deposits & Credit during March & April (Rs crore)

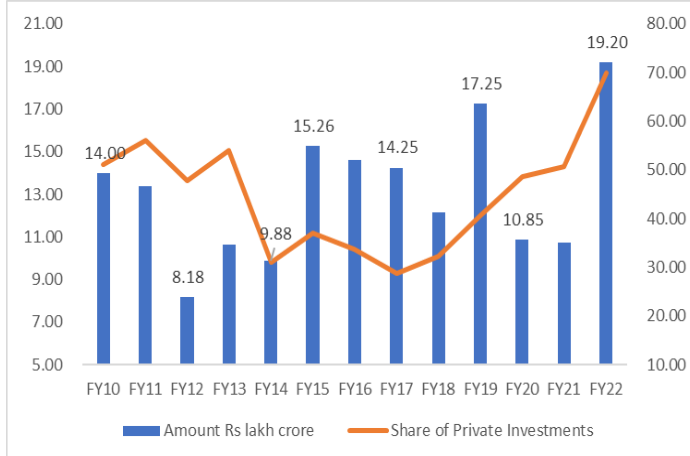
	Deposit		Credit	
	March	April	March	April
FY15	353342	81655	302574	-151387
FY16	313107	-142861	280030	-268202
FY17	263414	-193246	352473	-259075
FY18	289004	-44628	306392	-107800
FY19	343120	-89902	251270	-150777
FY20	241224	155690	163773	4777
FY21	179932	20794	72545	13198
FY22	247787	-	246921	-

Source: RBI, SBI Research

CAPACITY UTILISATION CROSSES 72%, PRIVATE CAPEX ON CARD

- Capacity utilisation (CU) in the manufacturing sector recovered to 72.4 per cent in Q3FY22 from 68.3 per cent in the previous quarter. It reached the pre-pandemic levels of 69.9 per cent in Q4FY20. More than 70 per cent CU was last reported in Q1FY20 i.e. 73.6 per cent which was reduced to 47.3 per cent in Q1FY21.
- We have also seen substantial increase in new investment announcements which were around Rs 10 trillion in last two years, increased to a record high of around Rs 19 trillion in FY22.
- It is pertinent to mention that share of private investment increases to around 70% in FY22 from around 30% during FY17-FY18.
- Further, sectors where Production Linked Incentive (PLI) schemes are available will also see increase in capex.
- All these variables favourably suggest rise in capex activities. We feel sectors such as Chemicals, Iron & Steel, Cement, Electronics, Automobiles, Power including renewable energy etc. will drive the capex cycle.

New Investment Announcements and Share of Private Investments



Source: Projects Today; SBI Research

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