SBI RESEARCH

ECOWRAP

CPI MAY HAVE ALREADY PEAKED: RBI IS THE FED OF YESTER-YEARS. FED CAN BORROW RBI TEMPLATE TO CONTROL RAMPAGING US INFLATION: PASSTHROUGH OF FUEL A GLOBAL PHENOMENON, BUT INDIAN GOVERNMENT INTERVENTION WAS TIMELY

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The CPI data released today came dot along our projections, belying many expectations built on the far upper side. After rising to a 95-month (almost 8 years) high to 7.79% in Apr'22, CPI inflation moderated to 7.04% in May'22 due to broad-based deceleration. Core CPI also moderated in May to 6.09% as compared to 6.97% in Apr'22.

The deceleration in Rural CPI is the major reason for this slowing of inflation in May. Rural CPI decelerated to 7.01% in May from 8.38% in Apr'22 mainly on account of health, education and personal care and effects whose combined weighted contribution declined by 35 bps and food and beverages whose weighted contribution declined by 40 bps. Urban inflation on the other hand remained sticky at 7.08%. One divergent trend is visible in case of food and beverages, whose weighted contribution has declined in rural areas but increased in urban areas.

In recent times there have been commentaries that have questioned whether RBI has been behind the curve in controlling inflation. We believe RBI is much ahead of the curve in controlling inflation and the Fed can borrow a template from RBI to control US inflation that is all pervasive and threatens to rip apart global financial stability. In fact, pass through of energy inflation has been sharply higher in US also and in fact is higher than India. The interesting part is that energy and transport have higher share in weighted contribution in overall inflation in the US when compared to India. In India, share of energy in weighted contribution of CPI inflation is 9.2% while in the US it is 29.2%. For transport it is 36.6% in the US compared to 10.3% in India. **We must appreciate the invisible Government hand of controlling inflation in India of limiting the pass through by employing an activist fiscal policy.**

Meanwhile global economy continues to grapple with multi-decadal high inflation and slowing growth, persisting geopolitical tensions and sanctions, elevated prices of crude oil and other commodities and lingering COVID-19 related supply chain bottlenecks. As per World Bank's latest assessment, global growth is expected to slump from 5.7% in 2021 to 2.9% in 2022. Russian invasion of Ukraine has magnified the slowdown in the global economy, which is entering what could become a protracted period of feeble growth and elevated inflation. Growth in advanced economies is projected to sharply decelerate from 5.1 percent in 2021 to 2.6 percent in 2022 - 1.2 percentage point below projections in January. Among emerging market and developing economies, growth is also projected to fall from 6.6 percent in 2021 to 3.4 percent in 2022. The slowdown in the US and EU will adversely impact the Indian exports as export demand may slow down.

An uptick in economic activity in Apr/May'22 is evident in high frequency leading indicators. The percentage of indicators showing acceleration (% yoy growth) have risen to 88% and 95% in Apr and May, respectively in comparison to 55-65% range in Jan to Mar. Apart from other sectors, responding to the removal of restrictions, services sector retained momentum which was echoed in high frequency leading indicators recording growth in most trade and transport sectors. Contact-intensive aviation and tourism sectors recorded sequential improvement, but the recovery remains lagged and will take time to recoup.

The provisional data of ASCB for the fortnight ended 20 May'2022 indicates that, aggregate deposits grew by 9.3% YoY, compared to last year growth of 9.7% and Bank credit grew at 12.1% YoY compared last year growth of 6.0%. The incremental growth in credit is Rs 1.35 lakh crore, compared to last year negative growth of Rs 1.18 lakh crore. Robust credit growth reported across sectors including, Industry, Services and Personal segment, which grew by 14.7% YoY, as per the sectoral deployment as of April'2022.

We are expecting that RBI could factor in rate hike in Aug'22 (as inflation in Jun'22 is likely to come above 7%) and even in October policy, and take it higher than pre-pandemic level by October to 5.5%. **Our peak rate at the end of the cycle now has now a higher probability of a lower bound of 5.5% and a lower probability of going up to 5.75% depending on inflation trajectory. This is purely data dependent and subject to revisions. Our average inflation forecast for FY23 is 6.7% but our quarterly inflation numbers are slightly different from RBI. The best thing is that the peak of inflation may have been reached at 7.8%, with a little bit of luck. 10 year yield is also likely to be capped at 7.5%, assuming 5.5% as peak repo rate.**

CPI MODERATED TO 7.04%

- After rising to a 95-month (almost 8 years) high to 7.79% in Apr'22, CPI inflation moderated to 7.04% in May'22 due to broad-based deceleration (SBI forecast at 7.04%) Core CPI also moderated in May to 6.09% as compared to 6.97% in Apr'22.
- The deceleration in Rural CPI is the major reason for this slowing of inflation in May. Rural CPI decelerated to 7.01% in May from 8.38% in Apr'22 mainly on account of health, education and personal care and effects whose combined weighted contribution declined by 35 bps and food and beverages (-40 bps).
- Urban inflation on the other hand remained sticky at 7.08%. One divergent trend is visible in the case of food and beverages, whose weighted contribution has declined in rural areas but increased in urban areas.

INFLATION PASSTHROUGH—A GLOBAL PHENOMENON

- India is not alone in witnessing higher CPI inflation owing to increased global commodity prices.
- Inflation in the US surged to 40-year high level of 8.6% in May'22, with price increase in case of food and beverage, housing, gas, medical care, recreation and other goods and services.
- Energy and transport have higher share in weighted contribution in overall inflation in the US when compared to India. In India, share of energy in weighted contribution of CPI inflation is 9.2% while in the US it is 29.2%. For transport it is 36.6% compared to 10.27 in India. Interestingly, the weighted contribution of energy and transport has been declining in the US since May-June 2021, there is no particular trend in case of India.

GLOBAL ECONOMY

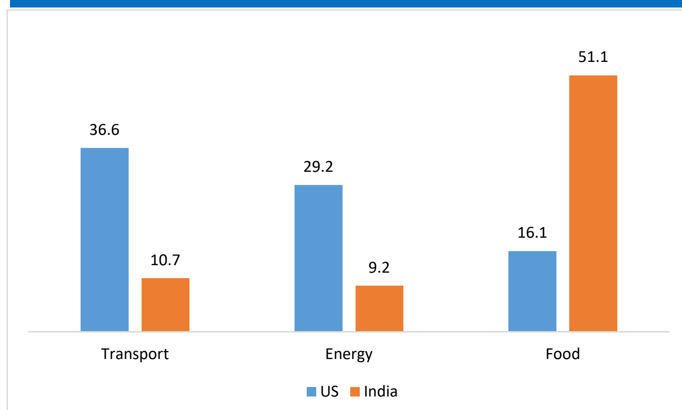
- Global economy continues to grapple with multi-decadal high inflation and slowing growth, persisting geopolitical tensions and sanctions, elevated prices of crude oil and other commodities and lingering COVID-19 related supply chain bottlenecks. As per World Bank's latest assessment, global growth is expected to slump from 5.7% in 2021 to 2.9% in 2022. Russian invasion of Ukraine has magnified the slowdown in the global economy, which is entering what could become a protracted period of feeble growth and elevated inflation.
- Growth in advanced economies is projected to sharply decelerate from 5.1 percent in 2021 to 2.6 percent in 2022 - 1.2 percentage point below projections in January. Among emerging market and developing economies, growth is also projected to fall from 6.6 percent in 2021 to 3.4 percent in 2022.

CPI: Weighted Contribution (%)

Item	Rural CPI			Urban CPI		
	Apr-22	May-22	Chg in BPS	Apr-22	May-22	Chg in BPS
Food and beverages	**4.5**	**4.1**	**-40**	**2.9**	**3.0**	**16**
of which, Cereals and products	0.7	0.6	-12	0.3	0.3	0
Meat and fish	0.4	0.4	5	0.2	0.3	6
Oils and fats	0.9	0.7	-19	0.4	0.4	-7
Fruits	0.2	0.1	-7	0.1	0.0	-9
Vegetables	0.9	1.0	14	0.8	1.0	20
Pulses and products	0.1	0.0	-8	0.0	0.0	-3
Prepared meals, snacks, sweets etc.	0.4	0.4	-6	0.4	0.5	6
Pan, tobacco and intoxicants	**0.1**	**0.1**	**-6**	**0.0**	**0.0**	**-3**
Clothing and footwear	**0.8**	**0.7**	**-14**	**0.5**	**0.5**	**2**
Housing	**0.0**	**0.0**	**-**	**0.8**	**0.8**	**5**
Fuel and light	**0.9**	**0.7**	**-20**	**0.6**	**0.6**	**8**
Miscellaneous	**2.1**	**1.7**	**-45**	**2.4**	**2.1**	**-23**
Health	0.5	0.4	-14	0.4	0.3	-5
Education	0.1	0.1	-6	0.2	0.3	7
Personal care and effects	0.4	0.2	-15	0.3	0.2	-3
All Groups (CPI)	**8.4**	**7.0**	**-136**	**7.1**	**7.1**	**0**

Source: SBI Research

Share in Weighted Contribution in CPI inflation (%)



Source: SBI Research

- The slowdown in the US and EU will adversely impact the Indian exports as export demand will slowdown.

US AND EU INFLATION

- US inflation has hit a new 40-year high as supply shock has become broad based. Consumer prices surged 8.6 per cent, faster than April's year-over-year increase of 8.3 per cent. Inflation figure, the highest since 1981 which will weigh in Federal Reserve's calculations. Fed is expected to hike rates by 50 bps and showcase a more aggressive tone.
- In EU as well, the inflation hit a record-high of 8.1%. The rate of inflation will persist after the decision to ban Russian gas. Accordingly, ECB ended its long-running monetary accommodation and signalled a series of rate hikes that may be scaled up from September if the inflation outlook fails to improve. A 25-bps hike is expected in July. Cumulatively ECB rate hits are expected in excess of 100 bps in current year.

LEADING INDICATORS

- An uptick in economic activity in Apr/May'22 is evident in high frequency leading indicators. The percentage of indicators showing acceleration (% yoy growth) have risen to 88% and 95% in Apr and May, respectively in comparison to 55-65% range in Jan to Mar. Apart from other sectors, responding to the removal of restrictions, services sector retained momentum which was echoed in high frequency leading indicators recording growth in most trade and transport sectors. Contact-intensive aviation and tourism sectors recorded sequential improvement, but the recovery remains lagged and will take time to recoup.

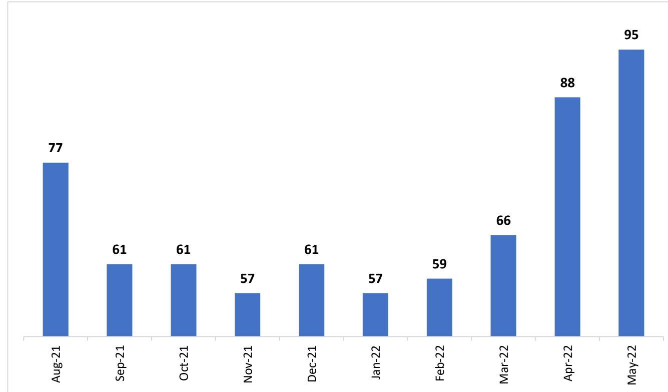
ROBUST CREDIT GROWTH ACROSS SECTORS, MOMENTUM TO CONTINUE IN FY23

- The provisional data of ASCB for the fortnight ended 20 May'2022 indicate that, Aggregate deposits grew by 9.3% YoY, compared to last year growth of 9.7% and Bank credit grew at 12.1% YoY compared last year growth of 6.0%. The incremental growth in credit is Rs 1.35 lakh crore, compared to last year negative growth od Rs 1.18 lakh crore.
- Robust credit growth reported across sectors including, Industry, Services and Personal segment, which grew by 14.7% YoY, as per the sectoral deployment as of April'2022.
- Service sector reported YoY growth of 11.1% driven by 17.4% growth in NBFC sector and 13.4% in Trade segment. Industry credit crew by 8.1% led by infrastructure sector including Power, Road, Telecom. Other sector reported double digit growth includes Food Processing, Chemical and Chemical Products, Electronics, etc.
- Further, with Capacity utilisation nearing 75% in Q4FY22 coupled with increased investment activities driven by Government's capex push and deleveraged corporate balance sheets, we expect the double-digit growth momentum to continue in FY23.

WAY FORWARD

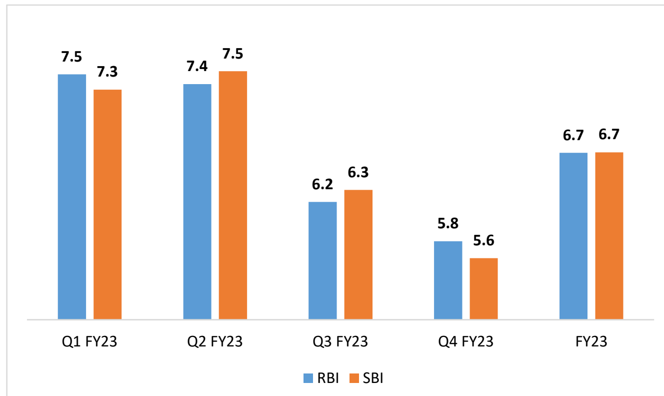
- We are now expecting that RBI could factor in rate hike in Aug'22 (as inflation in Jun'22 is likely to come above 7%) and even in October policy, and take it higher than pre-pandemic level by October to 5.5%. Our peak rate at the end of the cycle now has now a lower bound of 5.5% and could go up to 5.75% depending on inflation trajectory. This is purely data dependent and subject to revisions.
- Our average inflation forecast for FY23 is 6.7% but our quarterly inflation numbers are slightly different from RBI.

High Frequency Leading Indicators



Source: SBI Research

CPI Inflation (%): RBI vis-à-vis SBI Estimates



Source: SBI Research

- Though 10 year-G-sec yield has moved to 7.60% recently, we believe yields are likely to be capped at 7.5%, even assuming a 175 basis point spread over our peak repo rate at 5.75%. This is because, term premium is likely to be 50 basis points, factoring in a further market adjustment of 50 basis points over and above 5.5% as an insurance rate hike and an additional 75 basis points because of supply overhang. This makes the total spread of 175 basis points over 5.75%. Interestingly, the pre pandemic spread was around 135 basis points.
- The accelerated rates hike by Federal reserve and ECB will impact the overall level of USD/INR exchange rates. Strengthening dollar, FII outflows, and high commodity prices have contributed to USD/INR movement in recent months. There has been come some correction in forward premium since May and the current 12-month forward premium is 3.59% which implies a USDINR rate of 81 per dollar. **We are however hopeful of rupee mean reverting with inflation in India showings signs of slowing.**

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