SBI RESEARCH

ECOWRAP

INDIA CPI INFLATION REMAINS SKETCHY (6% IN AUGUST ONLY A TAIL EVENT) BUT WITH POSITIVE CORE CUES: US DATA SHOWS UNEVEN BALANCING OF RISK WITH SQUEEZING OF LIQUIDITY AN ALIAS FOR ~25 BPS RATE HIKE

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CPI inflation edged higher to 4.81% from May's 4.31%, front led by food and beverages with usual suspects of vegetables, pulses and meat/fish prices exhibiting largest increase while cereals, spices and milk CPI remained at elevated levels. On positive cues, Core CPI though declined marginally to 5.12% in June from 5.21% in May, and remains below the one-year average of 5.8%. Though, retail inflation remains within the tolerance range of the RBI for the fourth consecutive month (and should remain so for the rest of the fiscal), continued vigil on the evolving inflation outlook is warranted given the erratic progress of monsoon and its impact on Kharif sowing and subsequently on pulse inflation.

Analysing volatility in vegetable prices, Tomato, Onion and Potato (TOP) form the staples in Indian kitchen and their price variation is the chief cause of volatility in the vegetable/ food inflation. **We believe if tomato prices increase without any substantial change in potato & onion then average inflation in Q2 FY24 will come near 5.8% yoy but if the TOP inflation increases, then CPI might come around 6.0% yoy in Q2 FY24. Accordingly, average CPI for FY24 will vary between 5.2%-5.4%.** While at all India level rainfall is 2% above normal till 12 July, the spatial distribution is uneven. The north-west India has rains of 59% above normal, the south peninsula has deficit of 23%. However, these uneven rains will have minimum impact on food grains production. **Further, to see the price cycles of cereals and pulses, we analysed the monthly inflation data of cereals and pulses from Jan 2012 to till now (June 2023).** The results indicate that in an increasing price cycle, cereals continue to rise on an average for 20-months and pulses 19-months. While in a declining price cycle, cereals prices decline continuously for 15-months and pulses by 21-months. **Currently, cereals prices are on a declining trend, while pulse prices are on an increasing trend. It is thus crucial to mitigate the increase in pulse prices through Government intervention.**

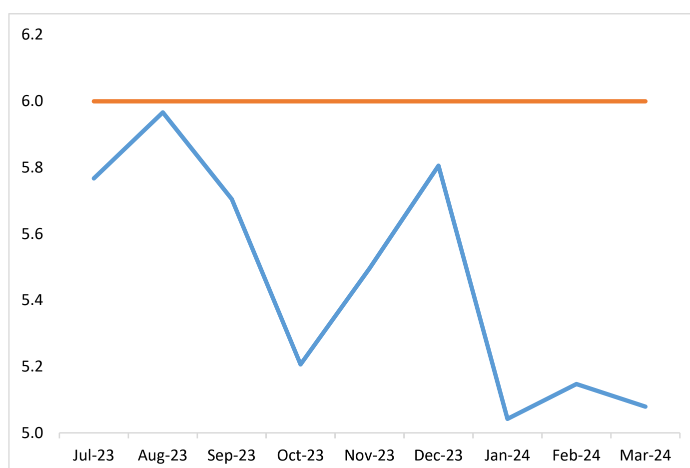
The industrial production based on IIP registered a growth of 5.2% in May from 4.5% in April. For the first two months IIP registered a growth of 4.8%. The mining sector recorded a growth rate of 6.4% in May, manufacturing sector also witnessed growth, with a rate of 5.7%.

Uneven balancing of risks in the US financial system is getting elongated as replenishing the TGA (Treasury General Account) post debt ceiling negotiations which has been the imminent priority for the Fed, coupled with Fed's targeted balance sheet reduction and Quantitative Tightening (QT) would squeeze liquidity significantly out of the system. **Interestingly, the squeeze in liquidity itself may work for a ~25 bps-plus increase in prevailing interest rates across tenors, fulfilling Fed's desire if it wishes to temporarily pivot for a longer period for now.**

CPI INFLATION AT 4.81%

- CPI inflation slightly increased sequentially to 4.81% (SBI estimate: 4.52%) in June'23 as compared to 4.31% in May'23. The increase in CPI is mainly in food and beverages. Vegetables, pulses and meat & fish prices exhibited largest increase. Cereals, spices and milk CPI are still at elevated levels.
- Core CPI though decreased marginally to 5.12% in June as compared to 5.21% in May, yet it is still below the one-year average of 5.8%.
- Though, the retail inflation remained within the tolerance range of the RBI for the fourth consecutive month (and will remain for the rest of the fiscal), continued vigil on the evolving inflation outlook is warranted given the progress of monsoon and its impact on Kharif sowing and subsequently on cereals inflation.

CPI Trajectory Outlook (%)



Source: SBI Research

TOMATO-ONION-POTATO INFLATION

- Tomato, Onion and Potato (TOP) form the staples in Indian kitchen and their price variation is the chief cause of volatility in the vegetable/ food inflation.
- Price change of tomatoes has seasonality in production and induces irregular shocks. As about 70% of the tomato production takes place during the rabi season (Oct/Nov till Mar/Apr) and Kharif production during July-November usually contributes less than 30% of the total tomato production in a year, this variation in supply puts upward pressure on tomato prices every year during July-November, with pressure maximum in July.
- **The past 10 years data shows that tomato price increase alone did not influence the overall CPI inflation much. It was only when the tomato price increase was accompanied by substantial increase in price of potato and onion. We believe if tomato price increase without any substantial change in potato and onion then average inflation in Q2 FY24 will come near 5.8% yoy but if the TOP inflation increases, then CPI might come around 6.0% yoy in Q2 FY24. Accordingly, average CPI for FY24 will vary between 5.2%-5.4%.**

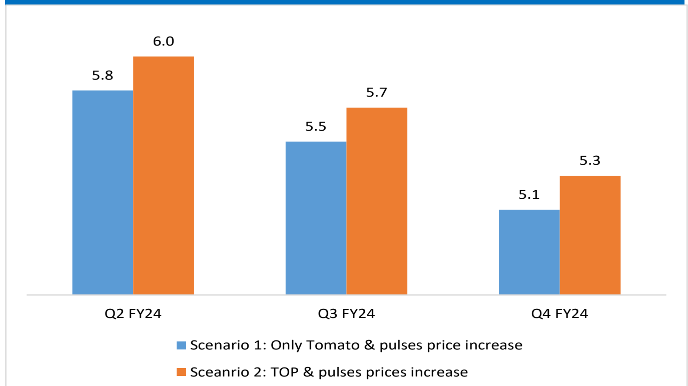
IMPACT OF MONSOON RAINS

- While at all India level rainfall is 2% above normal till 12 July, the spatial distribution is uneven. The north-west India has rains of 59% above normal, the south peninsula has deficit of 23%. However, these uneven rains have minimum impact on foodgrains production.
- Top five states accounted for almost 50% of total foodgrains production and of these five states three received normal rainfall. Punjab where rainfall is in excess, the area under irrigation is almost 100% and hence no impact of excess rains. While in Rajasthan where area under irrigation is very low, the excess rains will compensate that. **Hence, we believe that so far, the excess rains in northern India will not impact foodgrains production. The problem will arise only in those states where area under irrigation is low and rainfall is in deficit mode (like Maharashtra, Odisha, etc.).**

PULSES & CEREALS PRICE CYCLES

- To see the price cycles of Cereals and Pulses, we analysed the monthly inflation data of cereals and pulses from Jan 2012 to till now (June 2023). The results indicate that in an increasing price cycle, cereals continue to rise on an average 20-months and pulses 19-months. While in a declining price cycle, cereals prices decline continuously for 15-months and pulses by 21-months.

CPI inflation forecast based on 2 scenarios (% yoy)



Source: SBI Research

Retail TOP Prices Vs Inflation

Period	Change in Price (Rs/Kg)			Change in inflation (%)	
	Tomato	Potato	Onion	Vegetable Inflation	Headline Inflation
Apr13 to Jul 13	25	4	9	15.9	1.3
Jul13 to Sep 13	-11	0	26	24.3	0.7
Sep 13 to Nov13	14	8	2	22.6	1.0
Nov13 to Feb 14	-15	-6	-40	-29.7	-1.6
Feb14 to Aug 14	34	15	10	-0.1	-0.9
Aug 14 to Nov 14	-26	3	-3	-29.4	-4.1
Nov 14 toSep 15	1	-14	29	16.8	1.1
Sep 15 to Dec 15	5	1	-26	4.4	1.2
Dec15 to Jul 16	22	9	-2	13.3	0.8
Jun16 to Jan 17	-27	-10	-3	-16.6	-1.9
Jan 17 to Aug 17	45	1	11	21.6	0.1
Aug 17 to Jan18	-37	-1	17	21.0	1.8
Jan 18 to Nov 18	1	7	-21	-42.6	-2.7
Nov 18 to Dec19	5	3	73	76.1	5.0
Dec 19 to Sep 20	23	11	-63	-39.7	-0.1
Sep 20 to Apr 21	-33	-19	-8	-35.3	-3.0
Apr 21 to Nov 21	40	8	16	1.0	0.7
Nov 21 to Mar22	-35	-6	-8	25.2	2.0
Mar 22 to Jun 22	29	4	-8	5.7	0.1
Jun 22 to Apr 23	-29	-6	-2	-23.8	-2.3
Apr 23 to Jul 23	86	5	5	28.0	1.1

Sorce: SBI Research, Jul 23 prices are average till date and inflation is SBI Estimate, Change in Price is the movement of lowest level to highest level of prices and vice versa in a particular time period, Change in inflation is the inflation movemet in that time period

Impact of Monsoon on Foodgrain Production

State	Foodgrains Production (Mn Tonnes)*	Major Kharif Crops	Area under Irrigation	Rainfall (Deviation from Normal)@
Uttar Pradesh	58.1	Rice, Sugarcane, Pulses, Oilseeds	84.9%	12%
Madhya Pradesh	32.8	Maize, Pulses, Oilseeds	67.1%	15%
Punjab	30.4	Rice, Fruits, Vegetables	98.8%	96%
Rajasthan	24.3	Pulses, Oilseeds	34.4%	145%
West Bengal	20.0	Rice, Fruits	53.7%	-14%
Haryana	18.3	Rice, Sugarcane, Sunflower	95.0%	91%
Maharashtra	15.8	Pulses, Oilseeds	19.1%	-23%
Bihar	15.4	Jute, Tobacco	75.2%	-33%
Karnataka	14.6	Rice, Maize, Pulses, Sugarcane, Cotton	27.4%	-27%
Telangana	12.8	Rice, Cotton, Maize, Pulses	81.8%	-31%
Andhra Pradesh	11.3	Rrice, Jowar, Bajra, Maize, Sugarcane	63.4%	-17%
Tamil Nadu	10.8	Rice, Jowar, Maize, Millet	56.2%	23%
Odisha	9.5	Rice, Maize, Small Millets, Pulses, Oilseeds	28.9%	-26%
Gujarat	9.0	Rice, Cotton, Pulses, Oilseeds, Sugarcane	67.6%	110%
Chhattisgarh	8.2	Rice, Fruit, Vegetable, Spices.	35.4%	-17%
All India	291.3	-		2%

Source: SBI Research; * Latest Available; @ till 12 July 2023

- **As cereals prices is declining from last 4-months and hence expected to decline by another 11/12 months, while the pulses price is increasing and expected to reach the peak in the next 6/7 months.**
- To check the pulses prices, Government has imposed stock limits on tur and urad by invoking the Essential Commodities Act, 1955 in order to prevent hoarding and unscrupulous speculation and also to improve affordability to the consumers. Further, Government may release pulses Tur from the national buffer stock to check the prices in the domestic market.

ENSO, IOD AND MONSOON OUTLOOK

- El Niño (ENSO) is expected to strengthen further in the coming months although its current position will not alter the boundary conditions for long range forecast of the monsoon.
- The latest forecasts from global models indicate high probabilities for the El Niño conditions to develop during the middle of the monsoon season and continue till the first quarter of 2024. It is observed that if ENSO matures during the middle of the monsoon season results in stronger impact on the rainfall during the second half of the season.
- The Indian Ocean Dipole (IOD) has remained in the neutral territory and is expected to move to positive territory in coming month as per Bureau of Metrology Australia. A positive IOD despite the strengthening of ENSO is favorable for the monsoon in coming months. Concomitantly, Madden Julian Oscillation (MJO) is also favourable for second half of July.
- **The overall outlook of the rains based on current information is that deficit of -7% as on July 5 for country as a whole can narrow further by July-end.**

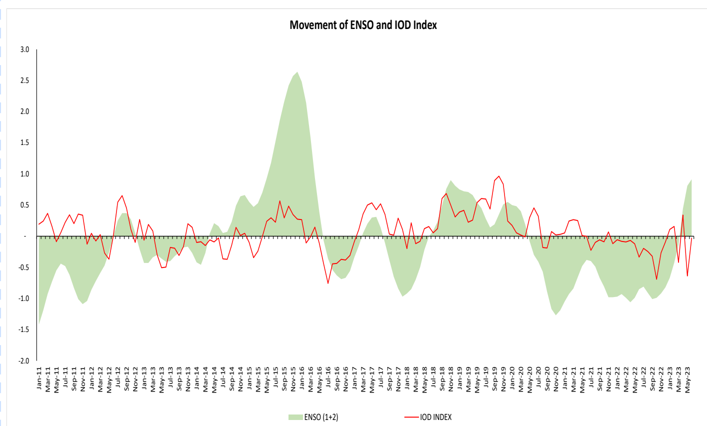
INDEX OF INDUSTRIAL PRODUCTION

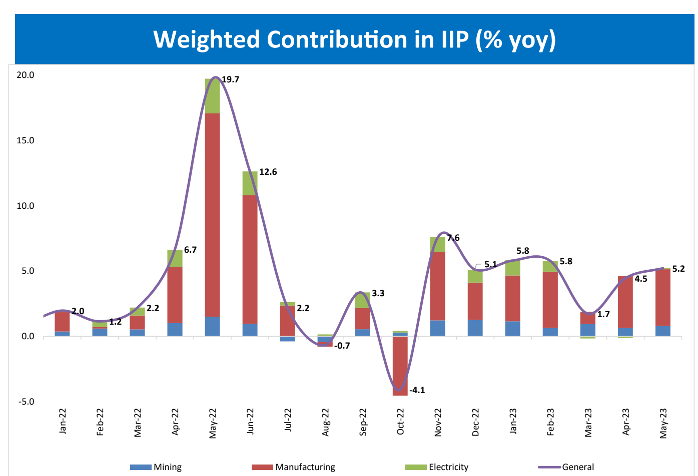
- The industrial production based on IIP registered a growth of 5.2% in May from 4.2% in April. For the first two months IIP registered a growth of 4.8%. The mining sector recorded a growth rate of 6.4% in May, manufacturing sector also witnessed growth, with a rate of 5.7%. The electricity sector showed a slight improvement, with a growth rate of 0.9% in May, in comparison to -1.1% growth seen in the previous month.
- As per the used based classification, all sub-indices except consumer durables were in positive territory.
- **The two-month run of IIP shows capital good sector has healthy run while the consumer good is still lagging. Thus, overall demand conditions still do not indicate broad based traction.**

Pulses & Cereals Price In/De-crease Cycles

Cycle	Cereals			Pulses		
	From	To	Number of Months	From	To	Number of Months
Increasing	2.6	16.5	18	3.5	14.7	9
	Jan-12	Jun-13		Jan-12	Sep-12	
Declining	16.5	1.1	25	14.7	0.8	13
	Jun-13	Jul-15		Sep-12	Oct-13	
Increasing	1.1	5.1	21	0.8	46.1	25
	Jul-15	Apr-17		Oct-13	Nov-15	
Declining	5.1	0.8	21	46.1	-23.6	24
	Apr-17	Jan-19		Nov-15	Nov-17	
Increasing	0.8	7.9	17	-23.6	22.8	29
	Jan-19	Jun-20		Nov-17	Apr-20	
Declining	7.9	-3.0	10	22.8	-1.0	26
	Jun-20	Apr-21		Apr-20	Jun-22	
Increasing	-3.0	16.7	22	-1.0	10.5	12
	Apr-21	Feb-23		Jun-22	Jun-23	
Declining	16.7	12.7	4	-		
	Feb-23	Jun-23				
Increasing Cycle (Avergae Months)			**20**			**19**
Declining Cycle (Avergae Months)			**15**			**21**

Source: SBI Research





Source: SBI Research

THE SHIFTING PRISM OF GLOBAL ECONOMY & MARKETS

- Today's "pivotal" CPI numbers for June countered views expressed by Mary C Daly, President of the SF Fed this week indicating Fed to go for at least two more hikes (softer ones) through 2023 to return inflation to **a stable zone for a longer period**. Given Fed's predicament, juxtaposing extremely high data dependent mindset with ever unfolding surprises and shocks, the road ahead offers little visibility. Banks in general are widely believed to lend less in an attempt to conserve capital, also further deepening a credit crunch that truly exaggerates the domino effects of preceding actions of Fed on economy and curtailing its flexibility. The risks, it seems, are becoming more **unevenly balanced** with probability of a mild recession resurfacing in talks and market polls as the financial ecosystem heads for a limbo.
- Replenishing the TGA (Treasury General Account) post debt ceiling negotiations has been the imminent priority for the Fed, which would however squeeze liquidity significantly out of the system. Fed is expected to keep funds to the tune of $600-700 billion plus now to foot the nation's bills from TGA. TGA balances had dipped to lows of around $49 billion this May from highs of $782 billion in May 22, as the treasury resorted to provide extraordinary measures in an attempt to avoid breaching the debt ceiling. System was also awash with additional liquidity provided by the Fed as it struggled to control the turmoil extending in banking through March onwards.
- Additionally, Fed has shed much of the assets it acquired on the balance sheet at the height of the unfolding banking contagion. While total assets at the Fed had ballooned by around $400 billion in the two weeks period of utter chaos (March 8 to March 22), these holdings had subsequently dropped by ~$300 billion through May 24. Coupled with targeted reduction of balance sheet by Quantitative Tightening (QT) of $95 billion each months and not providing fresh liquidity stimulus, elevated TGA refunding should ensure incipient stress rebuilding on the market liquidity in near course. **Interestingly, the squeeze in liquidity itself may work for a ~25 bps-plus increase in prevailing interest rates across tenors, fulfilling Fed's desire if it wishes to temporarily pivot for a longer period for now.**
- **We believe Fed to rather pause for a longer period going ahead, but stepping on the pedal early 2024/ late 2023 even though Headline numbers may come lower but the sequential momentum does not decline and that could take inflation to a new territory of persistently higher (than targeted 2%) hovering around 3%. That could unleash more pain for markets globally.**
- Also, US money market is bracing for US SEC's vote today on rules reshaping the $5.5 trillion industry, third such amendment since 2008. The amendments were announced by SEC in December'2021 itself, in a bid to limit stress in the short-term funding markets as prime and tax-exempt money market funds, particularly institutional funds had experienced large outflows due to sudden reallocation of assets by investors during March'20, a fallout of the virus induced fears.
- In UK, BoE found some hope in its fight to rein inflationary concerns as unemployment numbers rose 0.8% from the previous month to reach 4.3%, the biggest increase in any single month rate since records keeping started three decades back. However, the double whammy of living cost squeeze for many and heightened interest rates offer little reason for cheers to Bailey & Co. as a strong labour market pushed average weekly earnings (ex-bonuses) to 7.3% for a three month period ending May. Investors confidence in German economy slid further, a gauge of expectations coming at -14.7 against preceding month's -8.5, as global economic situation and lacklustre Chinese demand take a toll on exports.
- Mainland China seems to be taking every effort to get the limping economy back on track, cutting key cash ratio last June which boosted aggregate financing, a broad measure of credit demand, to 4.2 trillion yuan (~$582 billion), much better than median estimates of 3.1 trillion yuan ($418 billion) as banks and financial institutions were prodded to adopt more property market supportive initiatives, including restructuring outstanding property related loans. Xi also called for accelerating reforms and enhancing foreign cooperation in investment, trade and financial innovation.

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