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ECONOMY & GILT WATCH

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August CPI Preview
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August Inflation Preview: Another shocker awaiting?

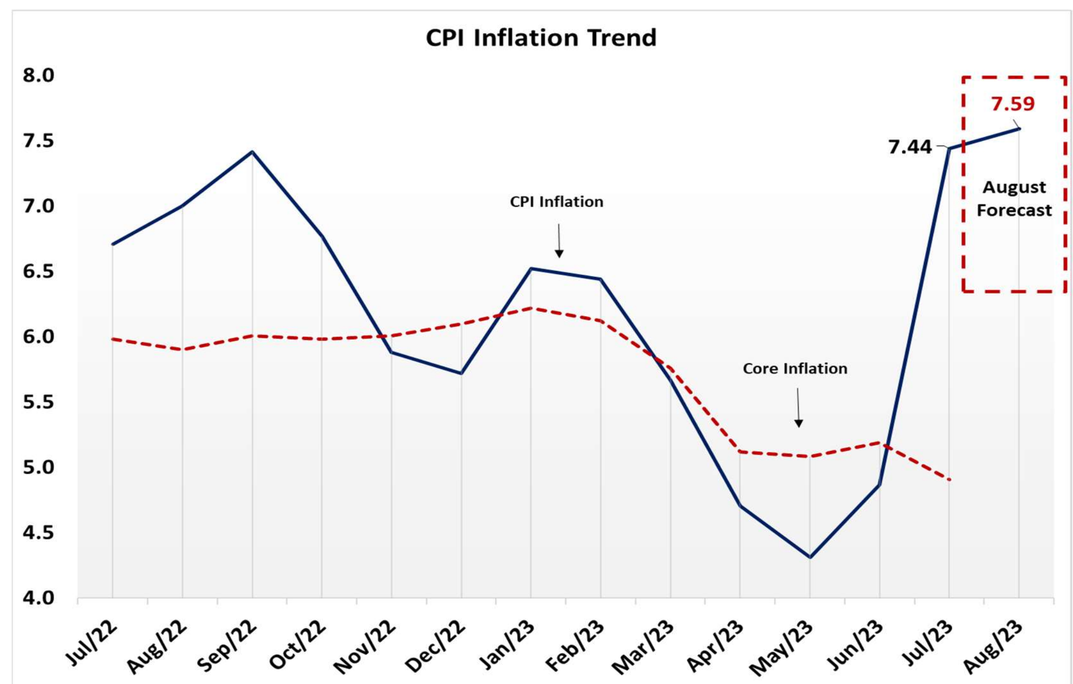
After a receiving a rude shock in form of sharply higher than anticipated inflation print for the month of July, the market is gearing up for the August inflation number due to be released on 12th September, i.e. today evening. RBI's Q2 inflation projection has been upended thanks to the July print of 7.44 per cent y-o-y as well as the forthcoming August print, which again is expected to be elevated. The recent production cuts announced by OPEC+ members, Saudi Arabia and Russia, have also come at a timing when the world economy is already grappling with food inflation. In the Indian context, higher crude oil prices will begin to shift the WPI trajectory upwards and the impact on the retail prices will depend on hike in retail petrol and diesel prices announced if any. A weaker rupee at this juncture with trading range shifting higher towards INR 83 a USD mark, only makes the situation a bit more painful for the Indian economy, perpetuating a self-reinforced cycle of higher trade deficit, which triggers further weakening of the currency. Of course, the forex reserves act as a buffer for alleviating such a situation. While there may not be direct first round effects on retail price inflation, imported inflation is known to impact domestic inflation accounting for 1 to 2 per cent increase in domestic prices according to an RBI study. Given the above developments and expectations, rate cut bets have been pushed to oblivion amidst the uptick in inflation and emerging sources of inflationary pressures. Rather the risk of another hike in policy rate has come to the fore and is pressurizing bond yields and OIS rates.

August Inflation Expectations

While the July inflation number baffled the economist and the markets, August inflation will be eyed closely for any unexpected uptick in the monthly inflation print. Though there is respite from the peak vegetable prices witnessed during the previous month, the food price pressures continue to persist even as the food price trajectory stands vulnerable to sharp variations in rainfall. Even though the kharif crop coverage for week ended 8th September shows significant catch up overall, with paddy exceeding previous year's level in terms of area sown, pulses continue to remain a laggard. In terms of sequential movement, we expect all items in the food basket to show an uptick from the previous month, barring vegetables, the prices of which softened from the peaks witnessed in July, which is likely to keep August inflation print elevated. We expect, cereals, pulses, fruits and spices to be

the chief sources of price pressures in August. M-o-M rise in prices of cereals, pulses, fruits and spices are expected to be 1.6 per cent, 1.8 per cent, 2.4 per cent and 5 per cent respectively. Spices have been under tremendous upward pressure, specifically, turmeric and black pepper, with lack of rainfall having affecting production, resulting in an unprecedented rise in price in last few weeks. Overall, we expect the August CPI index to witness a y-o-y of 7.59 per cent as against 7.44 per cent in July. Month of September is expected to witness moderation in the inflation number owing to a higher base effect. Nonetheless, the realised average inflation for the quarter is set to exceed the RBI's projection of 6.2 per cent, which will prompt RBI to maintain tightened liquidity conditions going forward.

September is expected to witness moderation in inflation owing to a higher base effect



Macro Monitor

I-CRR reversal in a calibrated phrasing manner

I-CRR was announced by RBI in the August policy meet, which aimed to be a stealth-tightening move aiming to keep inflation expectations anchored following a surge in inflation in the recent months. I-CRR of 10 per cent on deposits collected by banks was imposed by the RBI from August 12 to absorb the surplus liquidity due to multiple factors including the return of ₹2,000 notes.

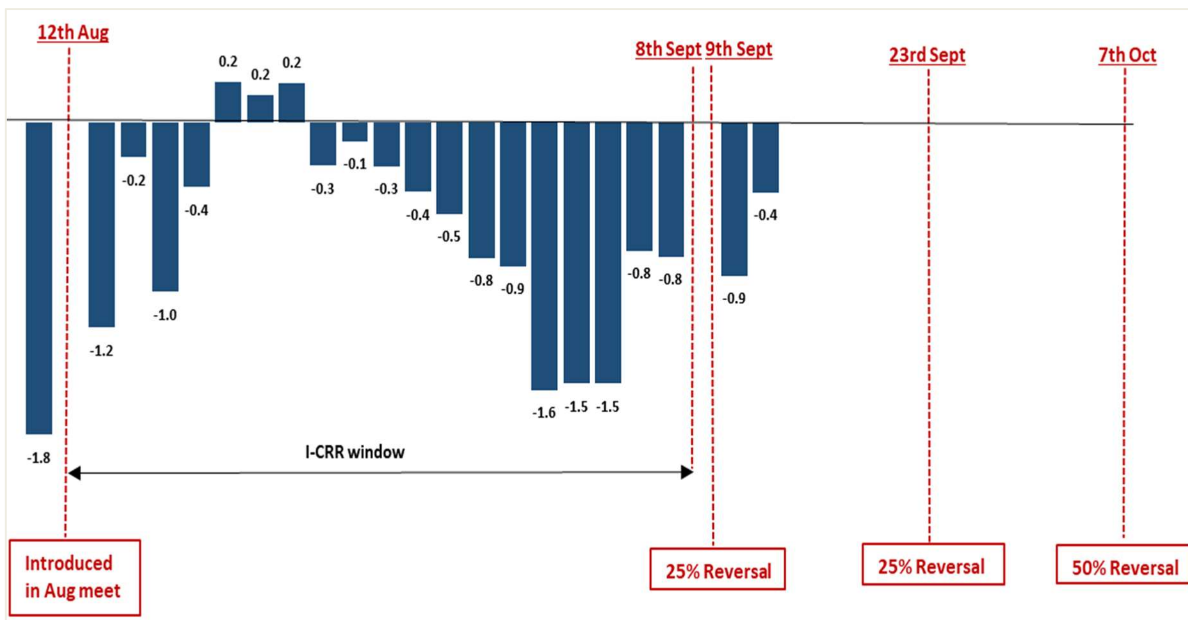
The net durable liquidity tightened as the Incremental CRR kicked in from 12th August onwards, lowering the net durable liquidity by ~ Rs. 1.1 lakh crore in week ended 18th August from 11th August's level of Rs. 3.6 lakh crore.

RBI has decided to unwind the I-CRR or release the funds parked with it in a phased manner – 25 per cent on September 9th, 25 per cent on September 23rd and remaining 50 per cent on October 7th. This calibrated phrasing of fund release will address the tight liquidity during the month of September on the back of advance tax payouts as well as an increase in currency in circulation with the onset of festive season in October. Further, the move will also safeguard the system liquidity from any sudden shocks while ensuring an orderly functioning of money markets.

This move will address the tight liquidity during the month of September on the back of advance tax payouts as well as an increase in currency in circulation

Since there is an asymmetry in borrowing and deposit rates w.r.t. liquidity, where the deficit pushes up the borrowing rates sharply but an excess would hardly impact the rates of deposit, the phased reversal will protect the borrowing rates from going up further. On the other hand, it comes as a good news for commercial banks as well, helping them to achieve higher credit growth due to an increased lending capacity, safeguarding their margins, keeping the call rates under check, which were nearing towards the upper end of the monetary policy corridor, and enable them to meet the requirements of higher credit and currency withdrawals during the festive season.

I-CRR Timeline & Banking Liquidity (in Rs. lakh crores)



Fixed Income Outlook

Fundamental View

During the last fortnight, as expected, the term structure witnessed further rise and flattening over the previous fortnight. The 10-yr yield traded within the long-standing range of 7.15%-7.25%. Yet on a point-to-point basis, the Indian bond markets outperformed the global bond markets, which underwent much more volatility and more bearishness too. Our markets also remained clouded by global sentiments mainly. The G-sec market also stood up to take notice of the sustained rise in crude oil prices, which crossed USD 90 per barrel. Amidst a general weak week, there were two days of sudden price rise in bonds on the back of renewed expectations of inclusion in bond index. The euphoria however was short lived and it seemed more of a September ritual that market starts talking about the bond index inclusion for Indian government bonds. The OIS rates also remained northward bound, with the 5-year rate breaching the six-month highs. The coming week will witness key inflation data, Indian CPI and US CPI. An adverse CPI data is likely to push yields higher and move the trading range of the 10-yr bond upwards towards, 7.25% to 7.32%.

An adverse CPI data may push the bond yields higher in the coming fortnight

SDL Overview

During the last fortnight, 10 Yr State Loans traded in the broad range of 7.39%-7.47%, whereas the 10 Yr CG benchmark, remained in the range of 7.06%-7.18%. In aggregate, State government have raised Rs 1,78,450 cr in this fiscal so far which is 18% lower vis-a'-vis an indicated figure of 2,10,750 Cr. The spread between the 10-year State Government Securities (SGS) and Government Security (G-Sec) of corresponding maturity rose mildly to 33 bps in this fortnight as compared to 30 bps in the previous fortnight.

The spread between long end SGS vs CG have compressed to 10 bps from 40+ bps at the starting of financial year FY24 illustrating strong demand for longer tenure state government securities (SGS) from specific investors, such as Insurance Companies & Pension Funds. This week, the scheduled auction amount of state government securities (SGSs) is Rs. 12,430 cr against the notified amount of Rs. 16,830 cr. Historically, states borrow less in the starting months of the quarter. Sighting low supply, we expect the spread between 10 yr SGS and CG to trade in the range of 30-33 bps in the next fortnight as well.

Technical View

Benchmark may continue its Higher High Higher Low formation and may surge towards immediate Resistance level of 7.32%

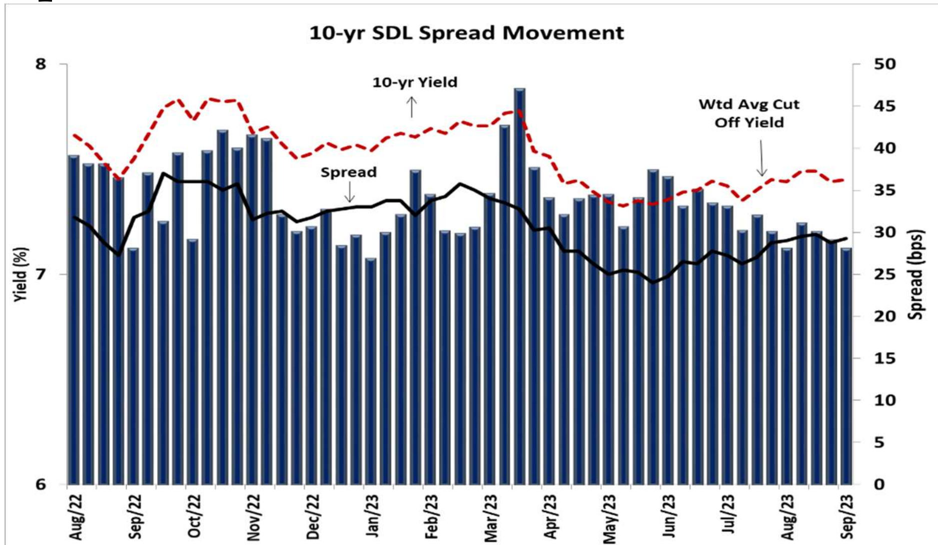
<u>Technical Synopsis 7.26% GS 2033 Yield:</u>

7.26% G Sec 2033 Yield settled at 7.245% on Monday's session. Passing week Benchmark bounced back from crucial support level of 7.14%-7.15% and settled at Fortnight high's.

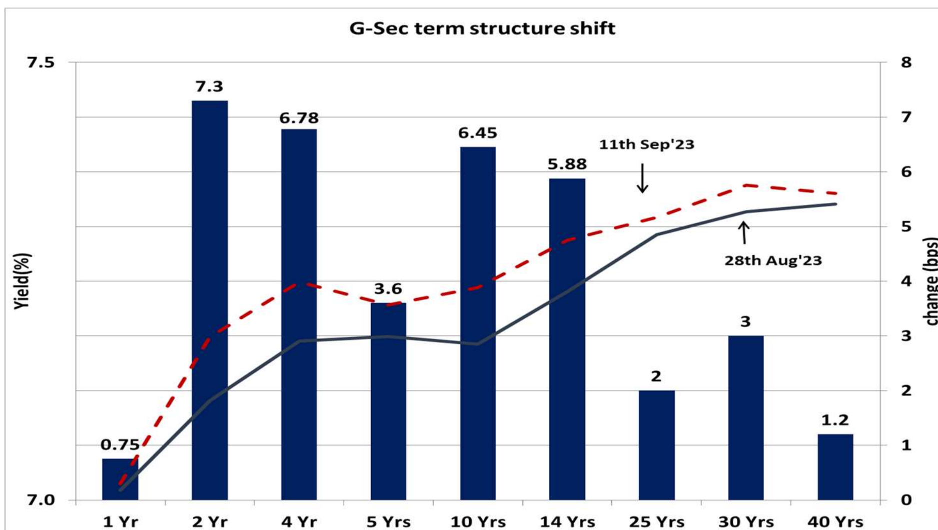
Momentum Oscillator RSI is placed at 62 level. As discussed earlier, Benchmark is trading in Ascending Channel pattern indicating further hardening possible in coming days. Going forward, Benchmark may continue its Higher High Higher Low formation and may surge towards immediate Resistance level of 7.32%, on lower side immediate support base now raised to 7.17% from 7.14% level.

Running Chart GOI 10yr Daily. Source: Tickerplant

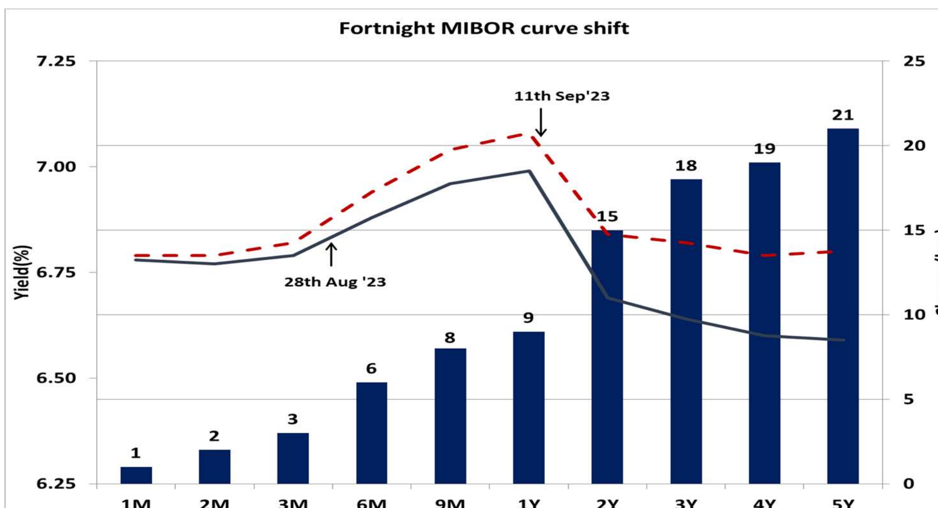
Spread Monitor



10 yr SGS and CG is expected to trade in the range of 30-33 bps in the next fortnight



Yield curve shifted upwards tracking sharp surge in US treasury yields



5-yr OIS rates surged to break six month highs tracking higher US treasury yields

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