Economics

DBS Flash

India: Market volatility to hurt June rate cut odds

DBS Group Research May 14, 2019

Radhika Rao
Economist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

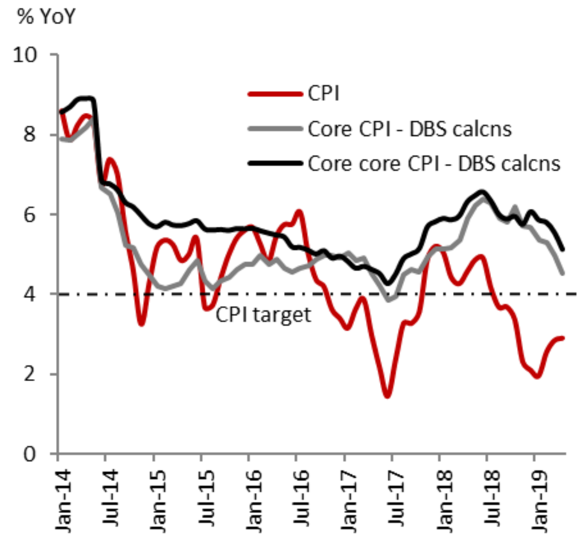
- *April inflation remained benign at 2.9% YoY, steady from month before and below FY19 average 3.4%.*
- *Higher food and fuel components were offset by slower services*
- *Core inflation has eased to below 5%, a first in sixteen months.*
- *Industrial production ended FY19 on a weak note, owing to broader slowdown amongst sub-components*
- *Benign inflation and softening growth will keep the RBI on an accommodative bias.*
- *We are expecting RBI to cut the policy rate in June, but ongoing market and geopolitical volatility could cause the INR to weaken and oil prices to spike, getting in the way of a dovish central bank*
- ***Implications for forecast**: Odds of a rate cut in June are falling due to recent market volatility and consequent rupee weakness.*
- *Probability of a delay to Q319 is likely to rise, subject to global risk sentiments. By August, the authorities may also have better visibility on the monsoon and full-year Budget.*

Inflation remains benign. April inflation was subdued at 2.9% YoY, steady from month before and below FY19 average 3.4%. This marks the ninth successive month of sub-target inflation.

Food inflation continues to recover from last year's trough, up 1.1% YoY in April from 0.2% in FY19. This reflects a combination of easing disinflation in pulses, and higher vegetables, fruits and protein items (egg, milk etc.). Fuel rose to 2.6% YoY from 2.3% month before, but higher retail fuel prices are still to feed into the transport and communications category. Fuel prices might be raised after this month's elections conclude.

Core inflation, which has been relatively sticky in recent months, eased to sub-5% in March. Much of the correction was on account of a pullback in health and personal care and effects segment, the latter mainly reflecting softer gold prices. Notably, the factors that had lifted core inflation in December 2018 (one-off spike in rural healthcare and education costs) have subsided.

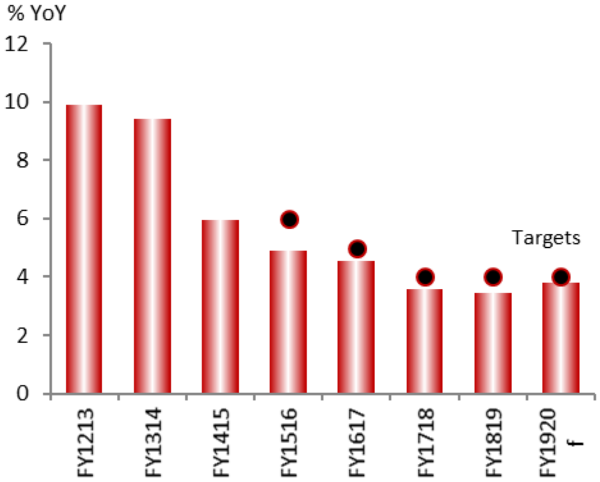
Core inflation readings moderate



Source: CEIC, Data transformations are by DBS Group Research

Headline CPI readings are likely to grind higher in rest of FY20, nearing 4% in the final quarter i.e. March 2020, as base effects fade and seasonal factors kick in. Despite the lift, full-year inflation is expected to stay benign at 3.8% - marking the third year of sub-target inflation, underscoring the central bank's confidence on a subdued price trajectory.

CPI inflation and targets



Source: CEIC, Data transformations are by DBS Group Research

Industrial production disappointed again, reinforcing cyclical growth concerns. March IP moderated to -0.1% YoY from 4Q18's 3.7%. Drivers of this weak outcome were broad-based, including consumer durables, capital and intermediate goods. These trends largely mirror other sectoral lead indicators (auto sales, rural wages, non-oil non-gold imports etc.) which point to softer consumption and moderate investment spending/ demand. While PMIs are still holding above the 50-mark, IP trends have softened, likely due to the lagged impact of a slowdown in government spending, weaker global growth and election related uncertainty. Despite the central bank's easing cycle, markets-based borrowing costs have risen due to tight liquidity conditions.

All eyes are on the Reserve Bank of India (RBI) monetary policy in early-June. Back in April, the central bank lowered its growth and inflation projections. The central bank expects inflation to stay below 4% in FY20, with 1H seen at 2.9-3% and 3.5-3.8% in second half of FY20. The benign inflation trend and weak growth outlook provide enough justification for the RBI to stay on an accommodative path.

The timing, however, is a matter of debate. June's policy meeting will be a close call, as oil prices ease from recent highs and growth indicators falter. Global risk sentiments have also soured as the US-China trade dispute escalated last week, weighing on the rupee (back to January lows). The probability of a delay to Q319 might rise as the authorities look to factor in the nuances of the next government's Budget, which is likely to be tabled by June/ July. Southwest monsoon will also be underway, with not only the rainfall strength, but also its spatial and temporal spread of utmost importance.

Banking system liquidity has been in net deficit in recent months, hindering an efficient transmission process. Despite the ongoing rate cutting cycle, corporates and non-banks borrowing costs remain elevated. Liquidity has been tight, aggravated by ongoing elections where a delay in government spending has led to a build-up in the government's cash balances, alongside a sharp increase in the currency in circulation. An eye is on efforts to ease this crunch. More bond buybacks (~INR500bn) is likely in June-July, alongside a third FX swap tranche. While conditions are likely to improve post elections, in June to August, there is a sizeable wall of supply on the central and states bonds this year, which will require the dominant players i.e. banks to stay bid and the global environment to remain conducive for portfolio investors to tap the onshore markets.

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Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit Strategist
+65 6878-2072 neelg@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan
FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 687-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).