Publication: Money Control

Date: June 15, 2022

Link

The inflation-growth mix is getting even more complicated for India with the WPI inflation rising to a 30-year high of 16 percent in May 2022, higher than the previous six-month average of 15 percent. This blunts the transient respite from moderation in retail inflation to 7.04 percent from the eight-year high print of 7.8 percent for April 2022.

Given that the momentum in retail inflation this year (February-May at 0.89 percent MoM) is the highest in four years, the continued rise in pipeline inflation could imply sustenance of high retail inflation of around 7 percent for the rest of FY23.

Separately, US inflation has also been trending higher (8.6 percent in May 2022 versus 8.3 percent in April 2022) and is challenging the common notion that inflation may have peaked. Despite the moderation in core inflation of 6 percent (versus 6.4 percent in March 2022), the pervasive rise in prices is indicative of inflation getting entrenched. And, along with the unemployment rate (3.6 percent), which is only fractionally higher than the all-time low (3.5 percent in February 2020), there is a strong case for a wage-price spiral.

These risks will reflect in the ongoing Federal Open Market Committee (FOMC) discussion ahead of the Fed's decision late on June 15. Views are generally divided between expectations of a 50bps or 75bps hike but there is a significant chance that the Fed will deliver a 75bps hike.

The US real rate, net of core inflation, stands at -5.2 percent (May 2022) despite the cumulative 75bps Fed rate hike thus far. This is significantly lower than the neutral level of the real Fed rate at 0.5 percent, and it needs to go above neutral. Thus, it is quite possible that the Fed may get even more hawkish in its guidance on both rates and quantitative tightening.

That the market has factored in a steep rate hike is reflected in the following variables: the dollar index (DXY) rebounding to 105.23, crude oil at $122 a barrel, US 10-year government bond yields at 3.4 percent, CBOE VIX rebounding to 32.7 and major equity indices declining by 5-10 percent over the past week. Hence, there is a half chance of the market recovering after the FOMC announcement. If, however, the Fed gets even more hawkish than expected a relief rally may not occur at all.

From the India standpoint, we consider the neutral real policy rate at 1 percent; currently, we are deeply in the negative at –2 percent and, hence, there is scope for further tightening. India 10-year is being managed at 7.6 percent and the RBI is ensuring INR/USD stability, allowing only a gradual depreciation (78.1). We expect these trends to pick up pace, going forward; India 10-year can go beyond the 8 percent mark and INR/USD can weaken beyond 80.

Over the medium term, we expect the ongoing market correction to continue as more liquidity tightening is expected. Our capitulation monitor suggests that a market capitulation is still far away. Cyclical sectors are getting increasingly vulnerable, thereby justifying a defensive positioning.