January 2015

CRISIL Economy First Cut

Mild, yet positive surprise from inflation and IIP

Overview: *Retail inflation rose to 5% in December, albeit lower than expected. As the base effect wore off, food inflation edged up a notch while core inflation continued to decline. With the inflation readings coming in the comfortable zone, we expect the RBI to cut rates by April 2015. For 2015-16, we expect inflation to average at 5.8% supported by lower oil prices, normal monsoons, proactive steps by the government and better monetary and fiscal coordination.*

Industrial growth climbed up to 3.8% in November, as manufacturing activity saw a mild pick-up. However, despite a sharp jump in the November reading (compared to 4.2% decline in October), weakness in industrial activity appears to have continued in Q3 as well. In 2014-15, we expect industry (including construction) to growth by 3.6% compared to 0.4% last fiscal. In 2015-16 however, industry is estimated to grow 5.5% led by; (i) an improvement in private consumption demand as it benefits from an increase in discretionary spending, as food and fuel inflation decline, (ii) faster implementation of infrastructure projects as the investment climate improves, and (iii) a pick-up in mining activity.

Inflation momentum remains contained…

CPI inflation rose to 5% in December from 4.4% last month, albeit coming in lower than expected. The strong base effect which had pulled down vegetable inflation in the last two months, wore off. As a result, food inflation rose to 4.8% in December from 3.1% in November. However, excluding vegetables, food inflation stepped down with a sharp drop witnessed in cereals and products (fell by 1.2ppt). It was a relief to see inflation starting to come down even in items that have remained sticky for the past few months – pulses and products (7.2% from 7.5% previously), egg, fish and meat (5.2% from 6.4% in November). Elsewhere, inflation in milk and milk products (9.6%) and condiments and spices (7.9%), fruits (14.8%) - (weight of 26% in food inflation) - remained in an uncomfortable zone (Table 1).

Core inflation fell to 5.5% from 5.8% in November. This is the lowest core inflation recorded since the beginning of the new CPI series. Inflation fell in recreation and amusement to 4.1%, in personal care to 6.1% and in transport and communication to 0.9% (from 1.9% in November). That said core inflation excluding transport and communication remained unchanged (at 6.4% versus 6.5% in November). This was as inflation in medical care, education and stationary, and others category remained sticky (accounting for 21% weight in the core).

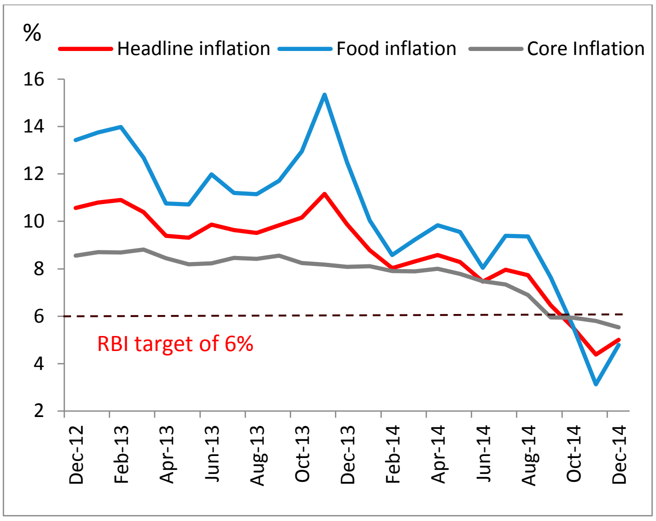
…providing further room for the RBI to ease

In its recent monetary policy meeting (December 2), RBI adopted a more dovish tone indicating that while a change in monetary policy stance was premature at the moment – a sustained fall in inflation in the coming months will open the door for a rate cut early next year. The RBI had revised down its forecast for inflation to 6% by March-end FY15. The current inflation momentum suggests that inflation might come down even below this target.

Given this, we expect RBI to cut rates by April 2015. By that time there would be more clarity on the inflation trajectory as well as the fiscal health of the economy.

Looking ahead, we expect inflation to average at 5.8% in 2015-16 as compared to an estimated 6.7% for 2014-15. The one of dampeners to inflation next fiscal will be 1) lower crude oil prices - We expect crude oil prices to decline to $70-75/barrel (Brent) in FY16 from $85-90/barrel in FY15. This is the first round effect. Additionally, second round effects through lower production and transportations costs will also play out. 2) Normal monsoons in 2015-16. Factors that will keep inflation low in 2015-16 and beyond include 1) proactive steps by the government such as lower MSP increases and better utilization of food grain stocks 2) improved monetary and fiscal coordination.Trajectory of inflation beyond 2015-16, will strengthen further once the government adopts an inflation target as recommended by the Urjit Patel Committee report (expected in January 2016).

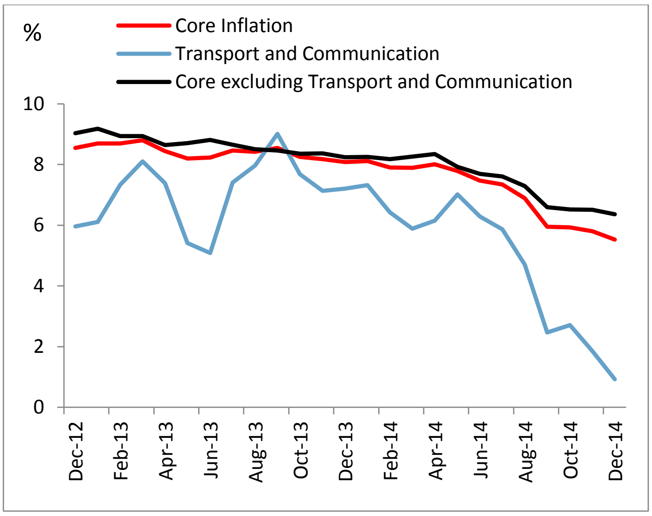
Figure 1: Inflation moderates as food inflation edges down



Note: RBI's target of 6% by Jan 2016

Source: Central Statistical Office, CRISIL Research

Figure 2: Oil continues to pull down the core



Source: Central Statistical Office, CRISIL Research

Table 1: Persistence of CPI inflation, year-on-year

CPI (%y-o-y)	Weight	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14	Dec-14
Headline CPI	100.0	8.3	8.6	8.3	7.5	8.0	7.7	6.5	5.5	4.4	5.0
Food CPI	42.7	9.2	9.8	9.6	8.0	9.4	9.4	7.6	5.6	3.1	4.8
Cereals & Products	14.6	9.5	9.5	8.8	7.6	7.5	7.3	6.4	6.0	5.2	4.0
Vegetable	7.3	17.1	17.7	15.2	9.1	16.9	15.0	8.6	-1.4	-11.0	0.6
Milk & Milk products	7.7	11.0	11.3	11.3	11.1	11.3	11.7	11.0	10.7	10.2	9.6
Fuel & Light	9.5	6.3	5.9	5.0	4.7	4.5	4.2	3.5	3.4	3.4	3.4
Core CPI	47.8	7.9	8.0	7.8	7.5	7.3	6.9	6.0	5.9	5.8	5.5
Housing	9.8	9.9	9.7	9.2	9.1	8.9	8.5	8.1	8.1	7.9	7.8
Clothing, bedding & footwear	4.7	9.0	8.7	8.8	8.6	8.7	8.4	7.6	7.4	6.9	6.5
Transport and communicatio	7.6	5.9	6.2	7.0	6.3	5.9	4.7	2.5	2.7	1.9	0.9

Below 4%	4-6%	6-8%	8-10%	>10%

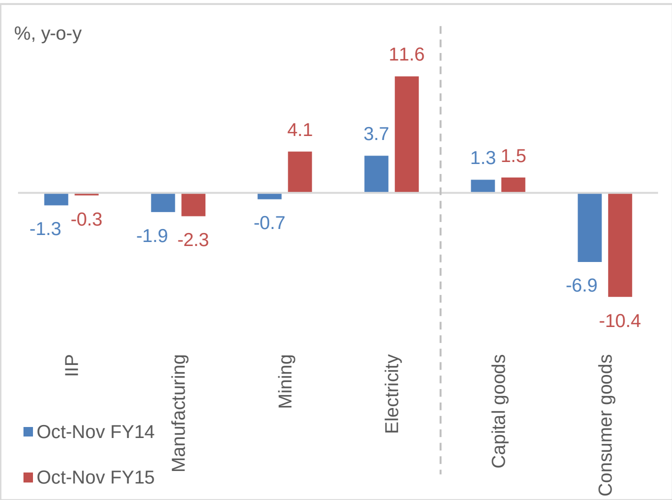
Source: CSO, CRISIL Research

IIP: Industrial production rises 3.8%; sluggishness in non-core IIP – a drag on growth

Industrial production grew by 3.8% in November, led by a mild uptick in manufacturing, a steady momentum in mining output that is benefiting from a weak base and continued strong growth in electricity production. The November IIP reading is a sharp jump from last month's fall of 4.2% in growth. But the continued weak momentum in industrial activity even into Q3, is a cause of concern. According to CRISIL Research estimates, in Q3, corporate India is expected to to see the lowest revenue growth in six quarters.

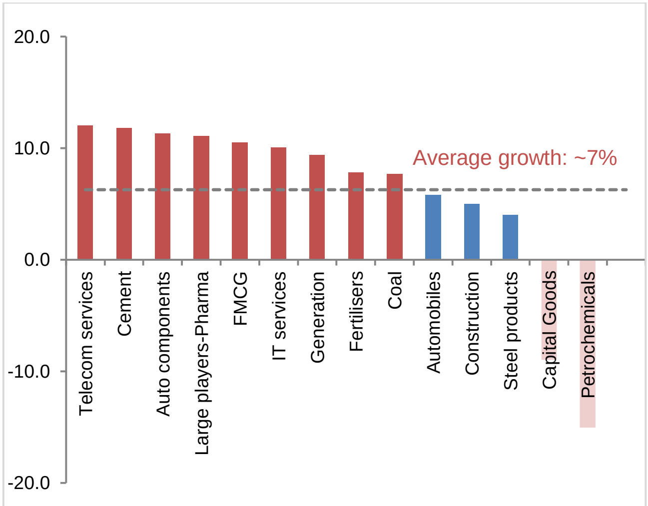
This month too, the core infrastructure sectors continued to outperform, posting 6.7% growth in output, however, despite some improvement during the month, non-core sector growth was a weak 2.1% (Figure 5). And, for the year so far it grew 0.8% versus core sector growth of 4.6%. Most of this weakness in non-core sector comes from consumer-oriented sectors where despite a low base, sluggishness in demand continues to drag down growth.

Figure 3: Manufacturing sector, a drag on growth



Source: CSO, CRISIL Research

Figure 4: Revenue growth outlook bleak in Q3

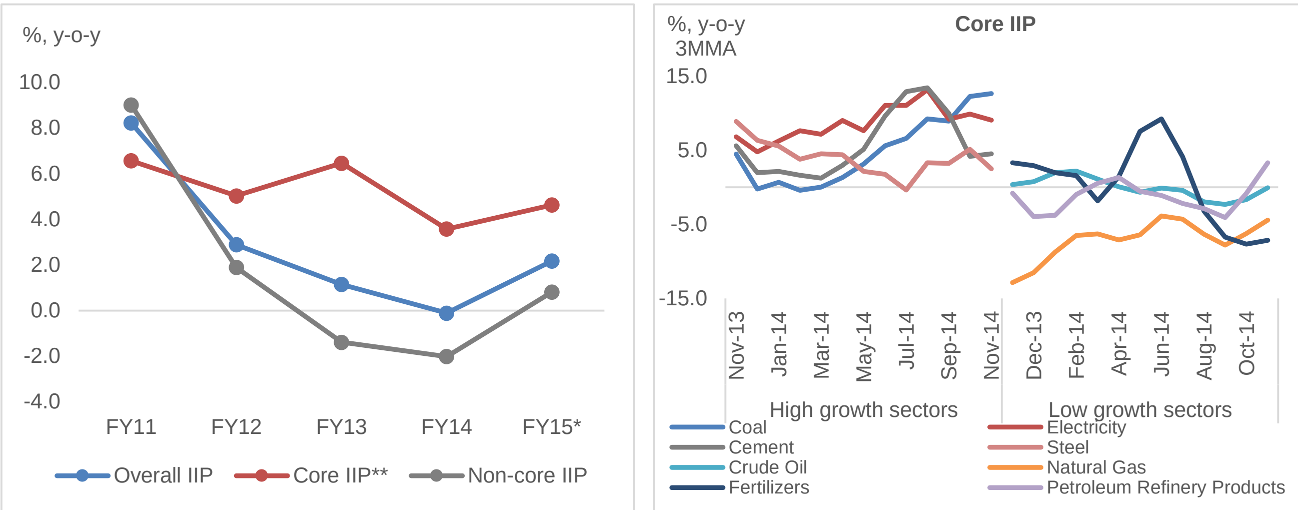


Source: CRISIL Research

- Manufacturing output rose 3% in November, a sharp turn from the 7.4% contraction in October. Excluding three sectors – 'Radio, TV and communication equipment & apparatus', 'Office, accounting & computing machinery' and 'Tobacco products', where output declined by an average 50% - manufacturing sector growth is up 7% in November. Nevertheless, it is too early to conclude a turnaround in manufacturing activity.
- This is because, despite a weak base effect and rapidly declining food and fuel inflation which would have increased consumers' purchasing power, consumer-oriented sectors are yet to see a recovery (Figure 3). Continued slowdown in consumer goods sectors, especially consumer durables (-14.5% growth in November and -15.9% in the year so far) also suggests a possible increase in reliance on imports to meet demand. The sharp decline in ''Radio, TV and communication equipment & apparatus' and 'Office, accounting & computing machinery' particularly supports this premise.

- During the month, the fall in consumer goods' output was lower, at 2.2%, as consumer non-durables sector grew 6%. Growth in capital goods output too turned positive during the month, at 6.5%.
- This fiscal so far, the continued sluggishness faced by consumption-oriented sectors has wiped out gains from higher production in the eight core infrastructure sectors. Large part of this drag on non-core sector growth comes from the consumer goods sector, where output has fallen by nearly 5.7% till date - more than twice that of last year.
- Meanwhile, within the core sector, growth this year has come from electricity (at 10.4%) and coal sectors (at 9.4%). In the coal sector, in recent months, part of the higher production is also attributed to an easing of norms for providing of environmental clearances. In the electricity sector, higher capacity additions led to an increase in production. The sharpest fall in growth came from natural gas production (at -5.3%) (Figure 5).
- Compared to Q2 (1.4% growth in IIP), the current Q3 quarter is seeing only a mild uptick in industrial activity (at 2.2% growth in October-November 2014). Meanwhile, CRISIL Research estimates suggest that revenue growth in Q3, at about 6.7% y-o-y, could be the lowest in six quarters (Figure 4). Revenue growth was 8.6% in Q2 and 12% in Q3 FY14. The decline in revenue growth is mainly due to;
  - Weak performance of investment-linked sectors led by sluggishness in capex cycles,
  - Some slowdown in export revenues due to weak demand in importing countries and lack of support from currency is expected to impact topline of export-oriented sectors and,
  - The rapid slide in global commodity prices is expected to hurt revenue growth for steel, petrochemicals and commodity chemical producers as it brings domestic prices under pressure.

Figure 5: Sluggish pick-up in non-core sectors have offset the surge in core IIP



Note: *April to November 2014, **8 core infrastructure industries include coal, crude oil, natural gas, petroleum refinery products, fertilizers, steel, cement and electricity

Source: CSO, CRISIL Research

Table 2: Sectoral Growth (%, y-o-y)

	Weight	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14
General	1,000.00	1.1	-2.0	-0.5	3.8	5.6	4.4	0.9	0.5	2.8	-4.2	3.8
Mining	141.6	2.7	2.3	0.5	1.7	2.5	4.8	0.1	1.2	0.3	4.9	3.4
Manufacturing	755.3	0.3	-3.9	-1.3	3.0	5.9	2.9	-0.3	-1.1	2.9	-7.4	3.0
Electricity	103.2	6.5	11.5	5.4	11.9	6.7	15.7	11.7	12.9	3.9	13.3	10.0
Use-based classification												
Basic	355.7	2.8	4.5	4.6	8.6	7.5	10.2	7.0	9.0	5.1	5.9	7.0
Capital	92.6	-3.9	-17.6	-11.5	13.4	4.2	23.3	-3.0	-10.0	12.5	-3.2	6.5
Intermediates	265.1	4.3	4.0	1.3	3.0	3.5	2.6	2.9	-0.1	2.2	-3.5	4.3
Consumer Goods	286.6	-0.5	-5.2	-2.2	-4.8	4.6	-8.8	-5.9	-6.2	-3.6	-18.0	-2.2
-Durables	53.7	-8.3	-9.8	-11.8	-7.7	3.6	-23.3	-20.4	-15.0	-11.2	-35.2	-14.5
-Non durables	233	4.6	-2.0	5.0	-2.7	5.2	1.9	5.2	0.4	2.1	-3.3	6.0

Source: CSO, CRISIL Research

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