

India Economic Outlook: Geopolitical Risks Ease, but Persistent Uncertainty and El Niño Conditions Continue to Pose Headwinds



- Global economic activity remains broadly resilient despite the supply shock from the conflict in the Middle East. However, the cumulative erosion in household purchasing power due to higher trend inflation continues to weigh on consumer confidence and could fuel political and policy uncertainty across several countries, especially in advanced economies.
- Geopolitical risks have moderated, but uncertainty remains elevated. The US-Iran interim peace deal has eased immediate risks to energy markets and the Strait of Hormuz, with the Brent crude oil price retreating to around pre-conflict levels. The durability of the agreement, ongoing regional tensions, and the pace of transit normalisation through the Strait of Hormuz remain key uncertainties.
- We retain our FY27 real GDP growth forecast for India at 6.7%, with downside risks, while revising our CPI inflation forecast upward from 4.7% to 5.1%, with risks tilted to the upside. Lower crude prices have eased external headwinds, but lingering geopolitical uncertainties, elevated input costs, and a potentially deficient monsoon continue to weigh on the outlook.
- After recording strong real GDP growth of 7.7% in FY26, high-frequency economic indicators point to resilience in early FY27, despite pockets of pressure. Industrial activity has picked up, while the services sector continues to exhibit resilience and energy supplies are gradually normalising.
- The agricultural outlook has emerged as a key domestic risk. The IMD has revised its southwest monsoon rainfall forecast down to 90% from 92% of the long-period average amid El Niño conditions, with cumulative rainfall already ~43% below normal through June 28. The quantum and spatial distribution of rainfall will be critical for farm output, rural demand, and food inflation.
- Private consumption is facing emerging signs of pressures. Labour market conditions, urban real wage growth, and consumer confidence have softened. These, coupled with the drag from expected higher inflation on purchasing power and monsoon-related risks to rural incomes, are likely to moderate consumption momentum ahead.
- The external sector has demonstrated resilience in early FY27. Merchandise exports reached a record high in May, while robust services exports continue to partly offset the trade deficit. We maintain our FY27 current account deficit forecast at around 1.7% of GDP, up from 0.6% in FY26.
- Inflationary pressures are gradually broadening. CPI inflation rose to a 16-month high of 3.9% in May, while elevated WPI inflation signals pipeline cost pressures are yet to reach retail prices. Input costs pass-through, rising food inflation, and monsoon risks are expected to further push up the inflation in the coming months.
- The RBI held the policy repo rate at 5.25% with a neutral stance in June, continuing its wait-and-watch approach, while announcing measures alongside the government to attract foreign capital inflows and strengthen external account resilience.
- We expect the RBI to remain on hold in August. However, rising inflation expectations, weather-related risks, and pass-through of built-up input costs pressures keep 50 to 75 bps of cumulative rate hikes during H2 FY27 on the table. That being said, a faster normalisation of energy supply routes and better-than-expected monsoon could reduce or even eliminate the need for monetary tightening altogether.

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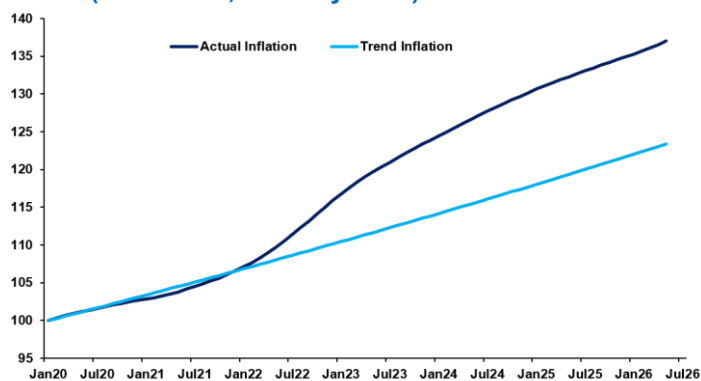
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Global Economy: Resilient Activity but Elevated Price Levels Weigh on Sentiment

Aspects of the prevailing macroeconomic setting continue to weigh on sentiment and foster dissatisfaction toward incumbent (elected) policymakers in many countries – especially those in advanced economies. Dissatisfaction with economic conditions in the United Kingdom contributed to British Prime Minister Starmer’s announcement that he would be stepping down. Similarly, in the United States, Congressional incumbents are losing primary elections at an elevated clip: With multiple states still to hold primary elections this summer, incumbent losses on an outright basis already are the highest this century and well above the post-WWII average.

A key driver of this trend is the elevated price level in many economies worldwide. To be sure, current inflation rates tend to be higher than desirable, as underscored by official inflation statistics around the world, and recent Middle East geopolitical tensions have lifted further rates of inflation, even if due to an exogenous supply shock, troubling many monetary policymakers around the globe. But the degree to which today’s inflation rates are above target is relatively modest and pale in comparison to the overshoot that occurred in preceding years.

Index of Global Inflation: Actual and Implied by Pre-2020 Trend (Index=100, January 2020)



Source: Bloomberg and DMI calculations. Note: Global inflation is weighted by country on a purchasing-power-parity basis.

It is the multi-year accumulation of above-target inflation that is a major source of angst among households and small businesses. Inflation globally averaged 3.35% from 2015 through 2020. However, such inflation has averaged 5½% since the start of 2021. That nearly 2 percentage points higher rate of inflation per year has translated to a global price level that is 14 percentage points higher than would have been the case had inflation continued to average 3.35% per annum (see the chart above). These 14 percentage points are the cumulative inflation-adjusted loss to purchasing power / standard of living that households globally (on average) have experienced in the past 5½ years.

By the standards of recent decades, this is an outsized “inflation tax”, and the accompanying hit to real wage-based purchasing power has been a major contributor to depressed economic sentiment in many economies worldwide. Rock-bottom sentiment in many economies has been and continues to be at odds with lower unemployment rates, actual consumer outlays, and other economic statistics. But perception can be a potent force, and exert itself at any point in time. The United States has the most comprehensive data in this regard:

- Nearly 50% of consumers in the University of Michigan sentiment survey proactively mention that elevated prices have eroded their living standards.
- Roughly 90% households, according to a Federal Reserve survey, are concerned about elevated prices.
- Housing affordability is severely challenged given current home prices and mortgage rates.
- While prices for food consumed at home have steadied, they are up about 25% in the past five years. As a good that is consumed multiple times per week, its highly visible nature leads consumers to feel that economy-wide prices are elevated.

Like food prices, energy prices are highly visible and frequently consumed and thereby often have a disproportionate influence on macro perception. Some relief on this front is in train with cooling Middle East hostilities and the corresponding decline in prices of key energy commodities. Indeed, Brent crude oil price has dropped by ~39% (~\$46 per barrel) as on June 26, from its post-conflict high in late April 2026. And if shipping traffic through the Strait of Hormuz picks up in the period ahead, additional energy price relief would likely be forthcoming.

Despite downbeat sentiment, discontent with policymakers, and price-level headwinds to economic growth, the actual pace of economic activity remains resilient. The pace of global economic growth eased only modestly in response to headwinds from the US-Iran conflict; meanwhile, economic growth in the world’s largest economy, the US, appears to be strengthening.

This dynamic is a good reminder that reality and perceptions can be disconnected – including for prolonged time periods. Chances are good that sentiment toward the economy will remain downbeat until the economy (nominal income) is able to grow into the elevated price level. Or, alternatively, there are outsized declines in highly visible food and energy prices that shift broad household attitudes toward inflation. A by-product of this likely backdrop is that there will be continued cycling through of elected leaders and the risk that non-monetary macro policies could shift rapidly with changes in governments.

India Economic Outlook: De-escalation of Geopolitical Tensions Eases External Headwinds but Pressures on the FY27 Outlook Persist

The US and Iran reached an interim peace agreement in the third week of June, paving the way for further negotiations toward a final settlement, de-escalation of regional tensions, and the gradual restoration of maritime transit through the Strait of Hormuz. Brent crude oil prices have fallen to near pre-conflict levels of around US\$72 per barrel (as of the close of June 26, 2026), although volatility remains elevated.

Deep mutual distrust persists on both sides, posing risks to the implementation of the interim peace agreement and the prospects of securing a final settlement. The interim agreement provides a narrow 60-day window to negotiate a comprehensive deal covering sanctions relief, maritime governance, and Iran's nuclear programme- an issue that has remained unresolved throughout successive US administrations and continues to represent the principal obstacle to a lasting resolution. While the interim agreement also provides for toll-free transit during the negotiation period, the future management of Hormuz transit remains uncertain. Media reports indicate that Iran has proposed joint administration of the Strait of Hormuz with Oman and the introduction of transit service fees, both of which have been rejected by the US administration. The Israel-Lebanon conflict and the associated threat from Hezbollah continue to pose risks to the durability of the US-Iran agreement.

The interim peace agreement is directionally positive for India, reducing the external headwinds that have weighed on the economic outlook. Risks of renewed geopolitical tensions and fresh disruptions to maritime transit remain, however, as highlighted by sporadic exchanges between US and Iranian forces over the weekend (week ending June 28). The key variables to monitor are the credibility and durability of a final agreement and the pace at which transit through the Strait of Hormuz normalises; the latter will be particularly important for the near-term prices of key energy commodities.

External headwinds to the FY27 economic outlook have eased since our last update following progress in US-Iran negotiations, though uncertainties remain elevated. The de-escalation of geopolitical tensions and the correction in global energy prices have eased near-term pressures on the macroeconomic outlook. We have revised our FY27 assumption for the Indian crude oil basket price down to an average of around US\$ 85 per barrel from US\$ 90 per barrel previously, reflecting the moderation in crude oil prices following the announcement of the US-Iran peace framework. The adjustment in physical energy markets is, however, likely to be gradual. Even if vessel movements through the Strait of Hormuz continue improving from June,

broader normalisation across energy supply chains is likely only by mid-FY27. On the other hand, domestic risks have risen due to evolving weather conditions. The IMD has projected below-normal rainfall at 90% of the long-period average during the southwest monsoon rainfall season amid El Niño conditions, posing downside risks to agricultural output and rural demand while increasing upside risks to food inflation.

Against this backdrop, we retain our FY27 real GDP growth forecast at 6.7%, with downside risks, and revise our CPI inflation projection upward from 4.7% to 5.1%, with risks tilted to the upside. A credible and sustained reopening of the Strait of Hormuz would reduce downside risks to economic growth, contain upside risks to inflation, and potentially eliminate the need for monetary tightening. We will also closely monitor both the magnitude and spatial distribution of the monsoon rainfall, which will be critical in shaping the trajectory of food inflation, rural demand, and the broader macroeconomic outlook through the remainder of FY27.

Strong FY26 Economic Growth Outturn Aided by Policy Measures

India's economic growth showed resilience in FY26 despite external shocks, including US trade policy uncertainty and the global energy supply shock arising from the Middle East conflict. Real GDP growth came in at 7.7% in FY26, up from 7.1% in FY25. Growth was led by an acceleration in private consumption and investment, while government consumption and net exports played a relatively smaller role. Policy measures, including income tax reductions, GST rationalisation, and monetary policy easing, boosted private consumption during the year, while investment was supported by government capex in the early part of the year and a tentative revival in private sector capital formation.

India's GDP Estimates at a Constant Price

(GDP Constant Prices)	% YoY										
	Q1-FY25	Q2-FY25	Q3-FY25	Q4-FY25	FY25	Q1-FY26	Q2-FY26	Q3-FY26	Q4-FY26	FY26	
Private Consumption	6.1	5.6	6.0	5.6	5.8	8.7	7.2	8.2	7.1	7.7	
Government Consumption	7.5	7.0	7.6	3.6	6.5	5.8	6.6	4.6	4.9	5.5	
Gross Fixed Capital Formation	6.5	6.6	6.3	6.2	6.4	4.9	8.4	8.2	10.8	8.2	
Exports	7.3	3.1	10.5	5.4	6.6	6.6	9.7	5.8	3.7	6.3	
Less Imports	8.3	4.6	2.9	5.5	5.3	7.0	6.0	7.2	1.9	5.6	
Real GDP	7.5	6.6	7.4	7.0	7.1	6.8	8.3	8.0	7.8	7.7	

Source: CMIE

The quarterly growth profile remained robust towards the end of the fiscal year. Real GDP growth came in at 7.8% in Q4-FY26, moderating slightly from 8.0% in Q3. Private consumption remained the primary driver of headline economic growth, though it slowed from its Q3 pace. A pick-up in investment activity, higher government consumption, and a positive contribution from net exports also provided support. On the supply side, real GVA growth came in at

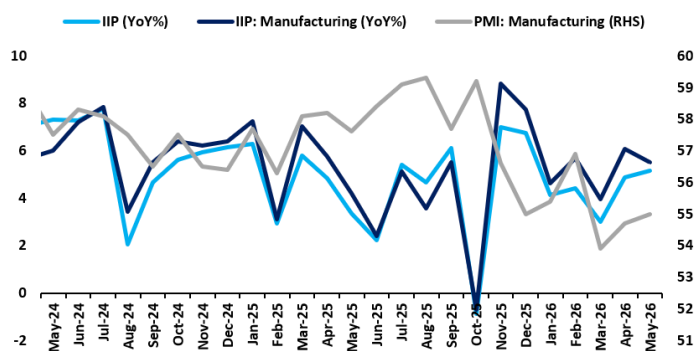
7.9% in Q4, broadly sustaining the previous quarter's pace, supported by a resilient services sector and a pickup in agriculture and allied activities, which partly offset a sharp deceleration in manufacturing growth.

Economic Activity in Early FY27: Manufacturing Picks Up, Services Remain Resilient, Agriculture Faces Headwinds

Economic activity in early FY27 showed resilience, despite pockets of pressure from spillover effects of the global supply shock stemming from the Middle East conflict.

Industrial activity picked up in April-May. Under the new IIP series (with the base year revised from 2011-12 to 2022-23), industrial output grew by an average of 5% YoY in April-May 2026, a notable improvement from 3.0% in March. This acceleration was driven by a robust average 5.8% expansion in manufacturing, which largely offset the sharp average 2.7% contraction in mining and quarrying during April-May. Growth was also supported by the newly added Water Supply and Waste Management sector, which recorded an average growth of 6.1% during April-May, while electricity and gas output increased by an average of 7.3%, reflecting strong demand driven by elevated temperatures.

Industrial Activity Picks Up in Early FY27 Led by Manufacturing



Source: CMIE

However, core sector output growth moderated to 0.5% YoY in May, weighed heavily by energy products, particularly refined petroleum products. This slowdown was partially offset by stronger electricity generation, robust cement production, and a narrowing contraction in fertiliser output. The Manufacturing PMI, however, rose to 55.0 in May from 54.7 in April, marking the strongest improvement in overall manufacturing conditions in three months. Input cost inflation remained elevated, reflecting higher energy, fuel, transportation, and material costs amid ongoing tensions in the Middle East. The June flash Manufacturing PMI softened slightly to 54.5 as inventory-building lost momentum, and new export orders slowed, though input cost pressures eased.

Fuel consumption presented a mixed picture in May. Petrol consumption growth moderated in May compared to the previous month, while diesel demand showed a modest recovery. Meanwhile, domestic LPG consumption contracted in the double digits for the third consecutive month, reflecting a combination of supply constraints and administrative demand-management measures. LPG consumption could improve in the coming months following the government's decision to remove all sectoral restrictions on the supply of non-domestic packed LPG and restore supplies to pre-Middle East conflict levels. The relaxation of bulk LPG supply to 50% of pre-conflict consumption levels should also provide some relief to commercial and industrial consumers. India's crude oil imports showed a sequential recovery in May (reaching ~93% of the FY26 monthly average), with increased shipments from Russia and other alternative suppliers cushioning the supply shortfall from Middle Eastern suppliers caused by transit disruptions in the Strait of Hormuz. While LPG supply continued to face constraints (reaching ~61% of FY26 monthly average), LNG imports recovered to near their pre-conflict monthly average in May, driven by increased volumes from the US.

Services Sector Activity Remained Resilient

Indicators (YoY%)	Sep-25	Oct-25	Nov-25	Dec-25	Jan-26	Feb-26	Mar-26	Apr-26	May-26
PMI Services	60.9	58.9	59.8	58.0	58.5	58.1	57.5	58.8	59.8
International Passenger Traffic	7.3	9.7	7.5	6.0	7.1	3.0	-18.5	-16.7	-9.7
Port Cargo Traffic	11.5	11.9	14.5	12.7	7.6	5.1	0.6	2.4	6.6
GST E-way Bills	21.0	8.2	27.6	23.5	15.8	18.8	12.9	11.8	10.9
Services Exports	12.5	2.2	6.7	13.0	9.8	9.7	7.2	12.7	13.2
Banking Non-Food Credit	10.2	11.1	11.4	14.4	14.4	14.3	15.9	15.8	17.4

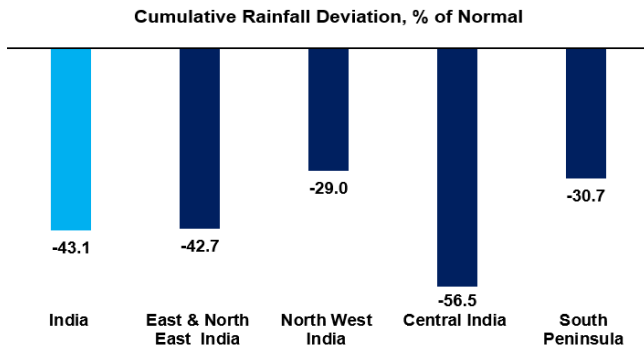
Source: CMIE and RBI. Banking Non-Food Credit for May 2026 is provisional as per the RBI Bulletin.

The services sector continued to demonstrate resilience. The Services PMI Business Activity Index climbed from 58.8 in April to 59.8 in May, indicating the sharpest rate of expansion since November 2025, supported by sustained domestic demand and robust new business inflows. The flash Services PMI eased to a 17-month low of 57.3 in June as cost pressures and softening demand conditions began to curb the recent upturn; however, the final print is expected to improve following the announcement of the US-Iran peace agreement. Banking non-food credit growth edged up to a two-year high in May, while services exports and e-way bill generation maintained robust double-digit growth. Port cargo traffic continued its steady recovery. International air passenger traffic remained in contraction due to ongoing disruptions from the Middle East conflict, though the pace of decline eased compared with the previous month.

The agricultural outlook remains challenging. The IMD, in its revised forecast, has projected below-normal rainfall at 90% of the long-period average (vs. 92% of LPA earlier) during the southwest monsoon season amid El Niño conditions. Monsoon rainfall has been below normal so far, with

cumulative rainfall ~43% below the long-period average through June 28. Kharif sowing, though still in its initial stages at around 16.5% of the total area sown, was 22.7% lower compared to last year as of June 26. Rainfall in July and August will be critical, as these two months account for the bulk of Kharif activity.

Weak Start to the Monsoon Season with Acute Shortfall in Rainfall



Source: CMIE. Data as on June 28, 2026.

Meanwhile, the government has noted that fertiliser stocks remain adequate for the ongoing Kharif sowing season. The recent correction in international fertiliser prices should help improve supply availability and contain the impact on the government's fertiliser subsidy bill. Looking ahead, the quantum, timing, and spatial distribution of rainfall during the southwest monsoon season will remain key variables to monitor, given their implications for agricultural output, rural demand, and the trajectory of food inflation.

Private Consumption Facing Emerging Pressures; Investment Activity Improved; External Sector Exhibits Resilience; Fiscal Pressures Persist

Private consumption is showing emerging signs of pressure amid pockets of resilience. Retail passenger vehicle sales grew at a robust pace, up 23.2% YoY in May, driven by a revival in demand for small cars and rising demand for fuel-efficient vehicles. Two-wheeler sales growth, in contrast, eased sharply to 7.5% YoY following four months of double-digit gains, as heatwaves and retail fuel price hikes weighed on the segment. However, underlying vehicle demand remained supported by affordability gains from the GST 2.0 implementation.

Private Consumption Related Indicators Uneven

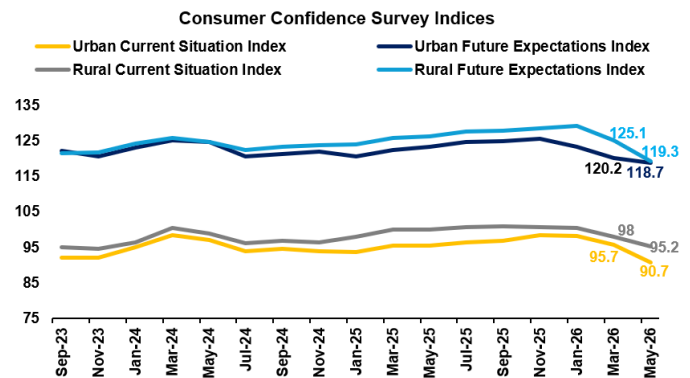
Indicators (YoY%)	Sep-25	Oct-25	Nov-25	Dec-25	Jan-26	Feb-26	Mar-26	Apr-26	May-26
Passenger Vehicle Sales	5.8	10.7	20.4	26.6	7.2	26.1	21.5	18.1	23.2
Two-wheeler Sales	6.5	51.8	-3.1	9.5	20.8	25.0	28.7	17.2	7.5
IIP-Consumer Durables	4.6	-6.0	13.0	7.4	-0.2	4.2	2.4	5.6	7.2
IIP-Consumer Non-durables	-0.5	-9.4	3.9	5.9	-1.2	1.6	-0.6	0.2	3.6
Retail Credit Growth	11.7	14.0	12.8	14.4	14.9	15.2	16.2	16.0	
Domestic Air Passenger Traffic	-2.5	3.5	7.0	-4.9	3.1	-0.1	-1.3	-2.8	8.5
Unemployment Rate (%)	6.3	7.5	6.5	6.9	6.7	6.7	6.6	6.7	6.9
Rural	5.0	7.6	6.1	7.0	5.8	6.4	6.5	6.7	6.2
Urban	8.5	7.3	7.2	6.8	8.3	7.3	6.9	6.7	8.0
Naukri JobSpeak Index	10.1	-9.3	23.5	13.2	3.4	11.9	9.2	5.8	1.0

Source: CMIE and RBI. Numbers shown are YoY% except for unemployment rates, which are in percentage.

Banking sector retail credit growth maintained a robust pace in April, while UPI and credit card transactions showed resilience in May despite some moderation in growth momentum. Domestic air passenger traffic recovered sharply in May, growing by 8.5% YoY after contracting over the previous three months.

However, pressures are emerging. The labour market softened in May, with the unemployment rate rising to 6.9% from 6.7% in April, according to CMIE data. While both the labour force and employment declined, the sharper fall in employment drove the increase in the unemployment rate. Formal sector hiring intent, proxied by the Naukri JobSpeak Index, moderated further in May, indicating rising caution in hiring plans. Estimated urban real wage growth, proxied by listed non-financial companies' quarterly employee costs deflated by urban CPI inflation, moderated to ~5.1% in Q4-FY26 from ~6.7% in the previous quarter. Meanwhile, consumer confidence weakened further across both urban and rural households, according to the RBI's latest survey. These, combined with the likely drag from expected higher inflation on purchasing power and risks to rural incomes from a potentially deficient monsoon, suggest an increasing possibility of softer private consumption momentum ahead.

Consumer Confidence Softened Across Urban and Rural Areas



Source: RBI. Values greater than 100 indicate optimism, and values less than 100 indicate pessimism.

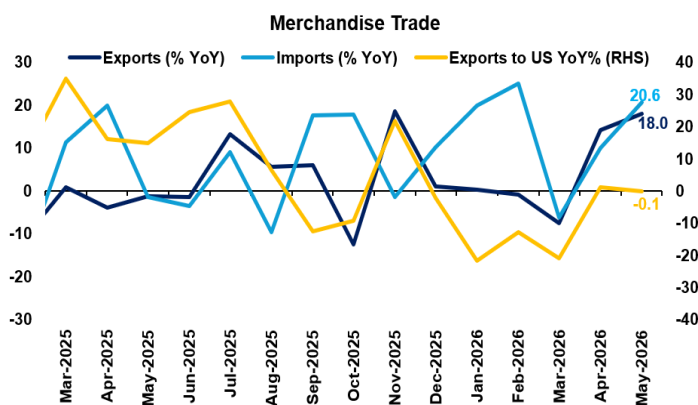
Investment indicators improved in early FY27. IIP capital goods production growth accelerated to an average of 12.5% during April-May from 8.5% in March, and infrastructure and construction goods output edged up to an average of 6% in April-May, rebounding from a five-month low in March. According to early results of the RBI's quarterly OBICUS survey, capacity utilisation in the manufacturing sector stood at 75.2% in Q4 FY26, marginally down from 75.6% in Q3 FY26, remaining above the long-term average and signalling a supportive environment for investment. While near-term caution is likely to persist, the signing of the US-Iran memorandum of understanding has mitigated downside geopolitical risks. A sustained reopening of the Strait of Hormuz and easing energy prices could support a

recovery in corporate confidence and pave the way for a broader revival in private-sector investment.

On the fiscal front, the central government's fiscal deficit for FY26 came in at ~4.4% of GDP, in line with the government's target and down from 4.9% of GDP in FY25 (estimated based on revised GDP series). Expenditure rationalisation relative to the Revised Budget Estimate more than offset revenue shortfalls, keeping the deficit on target despite a downward revision in nominal GDP. However, fiscal developments in the first month of FY27 point to emerging pressures. The central government's fiscal deficit widened to around 21% of the Budget Estimate in April, compared with around 12% in the same period last year, driven by front-loaded expenditure, up 23.5% YoY, alongside a sharp ~24% YoY decline in total receipts. The increase in expenditure was primarily driven by higher subsidy payouts and front-loading of capital expenditure. The decline in revenue mainly reflected weaker non-tax revenue and a contraction in indirect tax collections due to IGST outflows, despite resilient direct tax collections.

Looking ahead, absent a concerted effort to boost revenues or rationalise expenditure, the central government's fiscal deficit could rise to ~4.8% of GDP in FY27, against the budgeted 4.3% and the estimated ~4.4% under an assumption of ~12% nominal GDP growth. The key drags are revenue losses from the excise duty cut on petrol and diesel, likely lower OMCs dividend transfers, and higher fertiliser subsidies, partly offset by the export duty hike on petroleum products and ATF, the higher import duty on gold and silver, and drawdowns from the Economic Stabilisation Fund. The recent correction in crude oil prices, if sustained, following the US-Iran peace agreement, could reduce the fiscal slippage risks. Further, the recent correction in international fertiliser prices, if sustained, could also partially limit slippage in the fertiliser subsidy bill.

Goods Exports Recovery Strengthened in May



Source: CMIE

The external sector has exhibited resilience in early FY27 despite ongoing headwinds. Goods exports reached a record monthly high of US\$45.2 billion in May, growing

18.0% YoY, up from 14.2% in April and recovering sharply from a 7.4% contraction in March. This growth was driven by higher petroleum exports amid elevated energy prices during the month, alongside a pick-up in non-oil shipments. By destination, exports to the US registered modest sequential gains but were broadly flat on a YoY basis, while exports to GCC (excluding Bahrain) nations recovered sharply, up ~29% MoM, even as they remained broadly unchanged on a YoY basis. Goods imports grew 20.6% YoY, supported by resilient domestic demand and elevated global commodity prices, keeping the merchandise trade deficit broadly stable at US\$28.2 billion.

Preliminary services trade data estimated exports at US\$36.8 billion and imports at US\$19.1 billion, resulting in a services surplus of US\$17.7 billion that continued to substantially offset the merchandise trade deficit.

India's current account registered a surplus of US\$4.7 billion in April, reversing a US\$4.8 billion deficit in the same period last year, according to RBI monthly data. This turnaround was driven by robust services receipts and remittances, with the latter rising to US\$16.0 billion from US\$9.4 billion a year earlier. The April surplus is encouraging but is unlikely to be sustained through FY27 as import volumes recover with normalisation of supply routes, even as energy prices normalise. We maintain our FY27 current account deficit forecast at around 1.7% of GDP, up from 0.6% in FY26, as higher import volumes are expected to largely offset the benefits of lower crude oil prices.

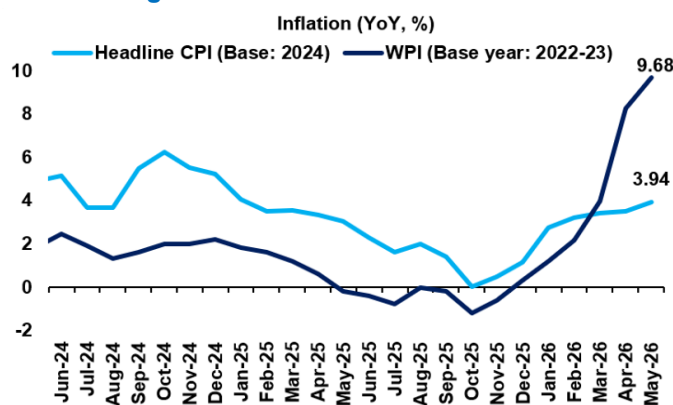
CPI Inflation Firms Further; Deficient Monsoon Keeps Risks Tilted to the Upside Despite Lower Energy Prices

CPI inflation continues to edge up, though it remains below the 4% target. Nevertheless, upside risks to the inflation outlook remain elevated. Inflation is expected to firm up further in the coming months as earlier fuel price increases and elevated input costs continue to pass through to retail prices. A broadening pick-up in food inflation and the risks associated with deficient monsoon rainfall are also likely to exert upward pressure on consumer prices. Supply chain disruptions arising from the Middle East conflict may also take longer to normalise, keeping input cost pressures elevated. Offsetting these pressures to some extent, the recent correction in global energy prices could provide some relief to the inflation outlook if the US-Iran interim agreement holds and transit through the Strait of Hormuz normalises more quickly. However, any re-escalation of geopolitical tensions or renewed disruptions to Hormuz transit would pose fresh upside risks.

CPI headline inflation edged higher, rising to a 16-month high of 3.9% YoY in May from 3.5% in April, as favourable base effects continued to fade. The increase was driven primarily by food and beverages, transport, restaurants and

accommodation, and personal care and miscellaneous. Food and beverages inflation accelerated to 4.5% from 4.0% in April, reflecting a broader pick-up in food price pressures. Food inflation is likely to remain firm amid rising input costs and heatwave conditions, while the IMD's projection of a deficient monsoon presents an additional upside risk.

CPI Inflation Continues to Edge Up; Pipeline Pressures Accelerating



Source: CMIE

The impact of higher fuel prices became more visible in May. Transport inflation rose sharply to 1.8% from a flattish print in April, reflecting the cumulative Rs 7.5 per litre increase in retail petrol and diesel prices. Inflation in restaurants and accommodation also accelerated to 5.7% from 4.2% in the prior month, driven by supply shortages and higher transportation and commercial LPG costs. Inflation in electricity, gas and other fuels remained relatively contained at 0.8%, suggesting partial pass-through of elevated energy costs thus far.

Core inflation (CPI excluding food and beverages, electricity, gas and other fuels, and fuels and lubricants for personal transport equipment) edged up to 3.9% in May from 3.7% in April, indicating partial transmission of higher energy costs into broader consumption categories. Core inflation excluding gold and silver also increased modestly to 2.4%, suggesting that underlying demand-side pressures remain relatively contained.

Under the revised WPI series with the new base year 2022-23, WPI inflation rose to 9.7% in May from 8.3% in April, led by fuel and power, manufactured products, and primary articles. The wide divergence between WPI and CPI inflation points to substantial pipeline cost pressures yet to be transmitted to consumers, increasing the likelihood of broader retail price pass-through in the coming quarters. Reflecting these dynamics, along with expectations of firmer food prices, we revise our FY27 CPI inflation forecast upward to 5.1% from 4.7% previously. A larger-than-expected monsoon rainfall shortfall, together with persistent supply-side pressures arising from geopolitical tensions, could push inflation above our revised baseline.

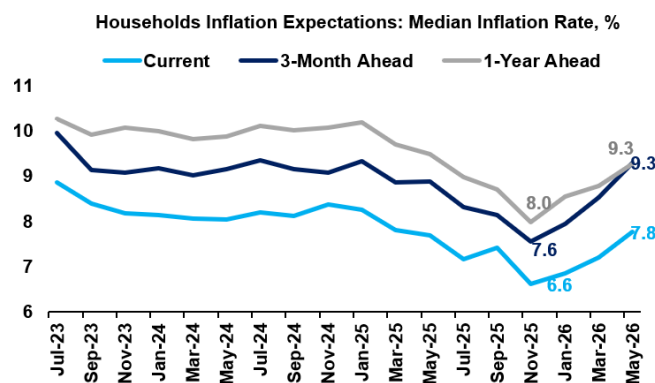
RBI Maintains Wait-and-Watch Approach in the June Policy Meeting; Status Quo on the Policy Rate Likely in August Policy Meeting as Geopolitical Risks Ease

As expected, the RBI kept the policy repo rate unchanged at 5.25% and retained its neutral policy stance at the June meeting. In line with our expectations, the RBI and the government simultaneously announced a package of measures to encourage foreign capital inflows. These measures collectively aim to augment foreign capital inflows, support exchange rate stability, and strengthen external sector resilience. Please refer to the report [RBI Policy Review](#) for more details.

The RBI's MPC revised its FY27 real GDP growth forecast downward to 6.6% from 6.9% and raised its CPI inflation projection to 5.1% from 4.6%, reflecting higher energy prices, supply chain disruptions arising from the Middle East conflict, and weather-related risks. While noting that cost pressures were becoming increasingly visible, the MPC judged it prudent to await greater clarity on the duration of supply disruptions and the extent of their pass-through to inflation.

Subsequent remarks by the RBI Governor suggest that the central bank remains focused on assessing the broadening of inflationary pressures rather than reacting to temporary commodity price volatility. While the US-Iran ceasefire and the correction in crude oil prices have reduced immediate risks, the Governor noted that the truce remains fragile and that energy supply chains may take time to normalise fully. Consistent with the RBI's recent communication, the policy focus appears centred on monitoring second-round effects through fuel, freight, logistics, and broader input costs, as well as developments in inflation expectations and exchange rate stability.

Households' Inflation Expectations Continue to Harden



Source: RBI

The RBI's willingness to look through first-order supply shock effects appears to be intact, although the balance of risks has shifted increasingly toward more persistent and generalised inflationary pressures. The RBI's latest household inflation expectations survey for May 2026

showed that inflation expectations have further hardened, raising the risk that price pressures could become more broad-based and entrenched. From the recent low in November 2025, the current median inflation perception of households continues to rise, increasing sequentially by 60 bps to 7.8%, while inflation expectations for the next three months and one year rose by 80 bps and 50 bps, respectively, to 9.3% for both horizons, relative to the previous survey round.

Our base case assumes that the US-Iran peace framework holds, allowing energy supplies to normalise gradually and reducing imported inflation pressures, with broader normalisation occurring by mid-FY27. Under this scenario, we expect the RBI to keep the policy repo rate unchanged at its August meeting while assessing the transmission of elevated input costs, the progress of the monsoon, and the effectiveness of recent measures to attract foreign capital inflows. The easing of geopolitical tensions and the correction in crude oil prices have reduced the immediate case for a rate hike. However, upside risks to food inflation from a possible deficient monsoon amid El Niño conditions, the continued pass-through of elevated input costs, hardening inflationary expectations and the persistent risks of renewed geopolitical tensions mean that the option of monetary tightening is likely to remain on the table.

In our view, persistent energy supply disruptions, a sustained rise in inflation expectations, or a weaker-than-expected monsoon leading to higher food inflation could shift the RBI's policy focus more decisively on inflation management, necessitating cumulative policy rate hikes of 50 to 75 basis points during H2 FY27. Conversely, a faster and more durable normalisation in global energy markets, coupled with easing external pressures, contained second-round inflation effects, and better-than-expected monsoon rainfall, would reduce the need for monetary tightening and could potentially eliminate it altogether.

Market Update

Bond Market: Banking system liquidity tightened through May and June. The average liquidity surplus moderated to around Rs 1.7 lakh crore in May from ~Rs 3.9 lakh crore in April, reflecting FX intervention, higher government cash balances, and a rise in currency in circulation. In response, the RBI provided liquidity support through variable rate repo operations and a USD/INR buy-sell swap auction. Liquidity conditions tightened further in June, with the average surplus falling to around Rs 1.0 lakh crore through June 25, with a deficit in the last few days, driven by advance tax outflows, prompting the RBI to conduct VRR operations to inject liquidity. The WACR averaged 5.18% in May, up from 5.04% in April, and rose further to around 5.23% in June (through June 25), amid tighter liquidity conditions. Looking

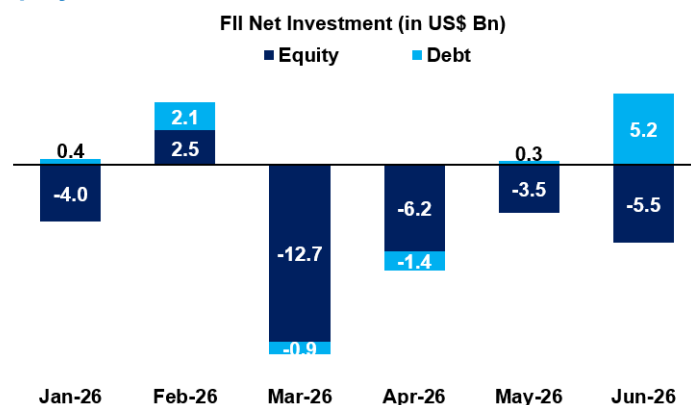
ahead, liquidity conditions are expected to improve, supported by a pick-up in government spending, lower FX intervention requirements, and potential deposit inflows under the FCNR(B) scheme.

India's 10-year G-Sec yield rose to a high of ~7.13% in mid-May amid concerns over fiscal slippage, inflation risks, and rupee weakness, before easing to ~7.0% by month-end as optimism surrounding a potential US-Iran agreement improved sentiment. The decline extended through June, with the 10-year G-Sec yield softening to around 6.77% by June 25. The rally was supported by the government's decision to exempt eligible FPIs from interest and capital gains taxes on government securities, the RBI's expansion of the Fully Accessible Route to longer-tenor bonds, strong FPI debt inflows following the June policy meeting, and lower crude oil prices after the announcement of the US-Iran interim peace agreement. Sentiment received an additional boost from the RBI Governor's comments that discussions of a policy rate hike are premature, helping to anchor rate expectations and ease concerns about a near-term monetary policy tightening cycle.

Going ahead, bond yields will be driven by geopolitical developments and the associated trajectory of crude oil prices, the sustainability of FPI debt inflows, domestic inflation dynamics, and the broader global risk environment.

Equity Market: Indian equity markets remained volatile in May, largely tracking global crude oil price movements amid geopolitical tensions in the Middle East. The Nifty 50 Index declined 1.9% MoM in May, partially reversing April's gains as elevated crude oil prices and continued FPI outflows weighed on sentiment. Sustained DII buying, however, helped cushion downside pressures.

Policy Measures Aid FPI Debt Inflows, Even as FPI Equity Outflows Continue



Source: CMIE. June data is till June 25, 2026.

Market sentiment improved in June as geopolitical risks eased. The Nifty 50 Index gained around 2.2% through June 25 compared to the end-of-May level, supported by optimism surrounding the US-Iran interim peace agreement and

progress on the US-India trade deal. The pullback in Brent crude prices around pre-conflict levels provided additional support to equities.

FPIs remained net sellers in the equity market for a fourth consecutive month, with net outflows rising to around US\$5.5 billion in June (through June 25) from US\$3.5 billion in May, although selling pressures moderated in recent days and reversed into modest net inflows over the last few trading sessions. Debt markets, in contrast, witnessed strong FPI capital inflows of around US\$5.2 billion in June (till June 25), reflecting a positive investor response to the RBI and government measures to attract foreign capital. Looking ahead, equity market performance is likely to remain sensitive to geopolitical developments, crude oil price trends, the trajectory of foreign capital flows, and broader global risk appetite.

Foreign Exchange Market: Pressure on the rupee intensified through the first half of May amid elevated crude oil prices and heightened geopolitical tensions in the Middle East. The currency depreciated to a record low of Rs 96.83 per US dollar on May 20. The rupee subsequently recovered towards Rs 95.0 per US dollar by the end of May, supported by RBI intervention in the foreign exchange market and a US\$ 5 billion USD/INR buy-sell swap auction.

Sentiment improved in June following the RBI's policy measures to attract capital inflows and the announcement of the US-Iran interim agreement. The rupee appreciated to around Rs 94.40 per US dollar by June 25, aided by lower crude oil prices and stronger foreign debt inflows following measures by the RBI and the government.

RBI's foreign exchange reserves have declined by ~US\$56 billion since the onset of the Middle East conflict, to around US\$673 billion as of June 19, reflecting active spot-market intervention. Nevertheless, external buffers remain comfortable, with headline foreign exchange reserves providing merchandise import cover of around 10 months and covering ~88% of outstanding external debt. Looking ahead, the rupee's trajectory will depend on the sustainability of lower crude oil prices, the pace and durability of foreign capital inflows, and broader global risk sentiment. A sustained moderation in energy prices would help ease pressure on the current account and support the currency.

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