INR falls behind in the EM Currency Race

Just a pit stop? Or has the engine failed?

HDFC Bank, February 2019

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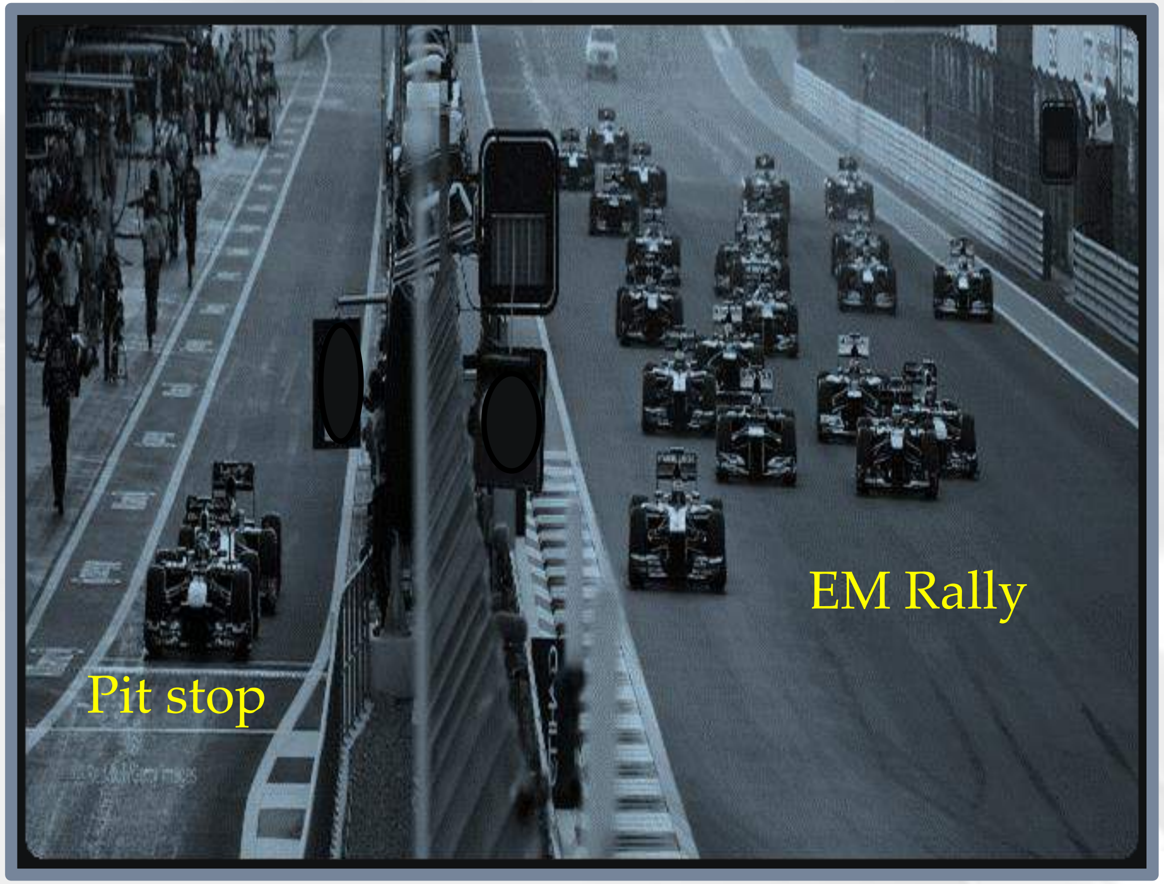
Summary: Pit stop for the INR

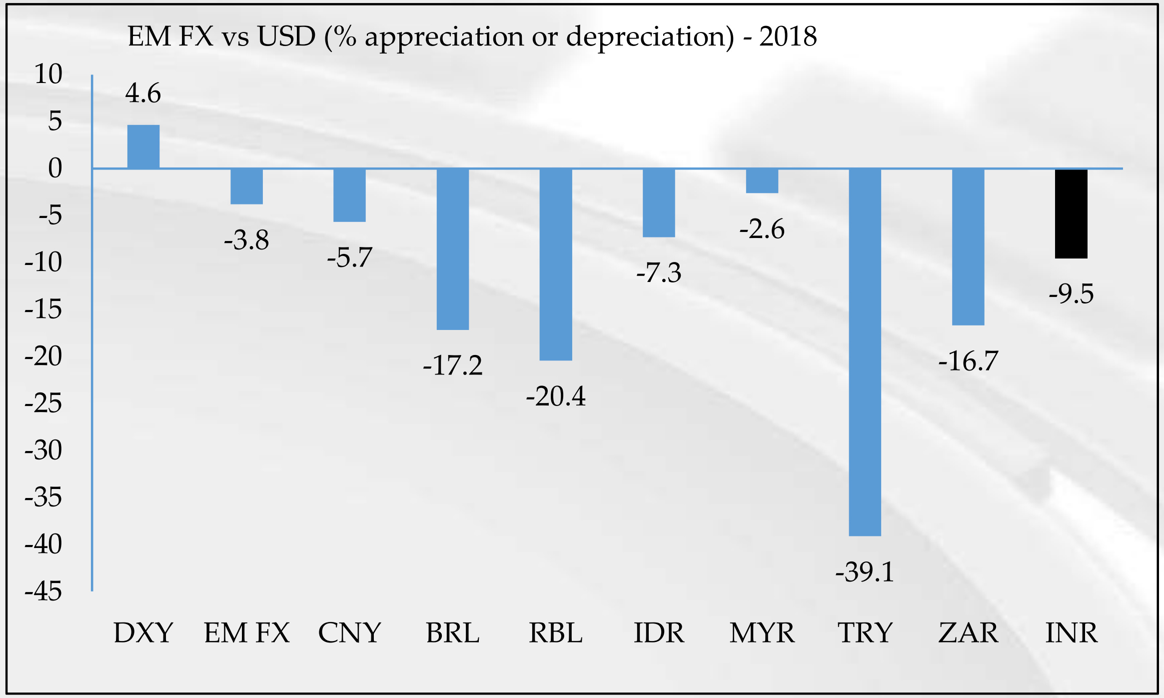


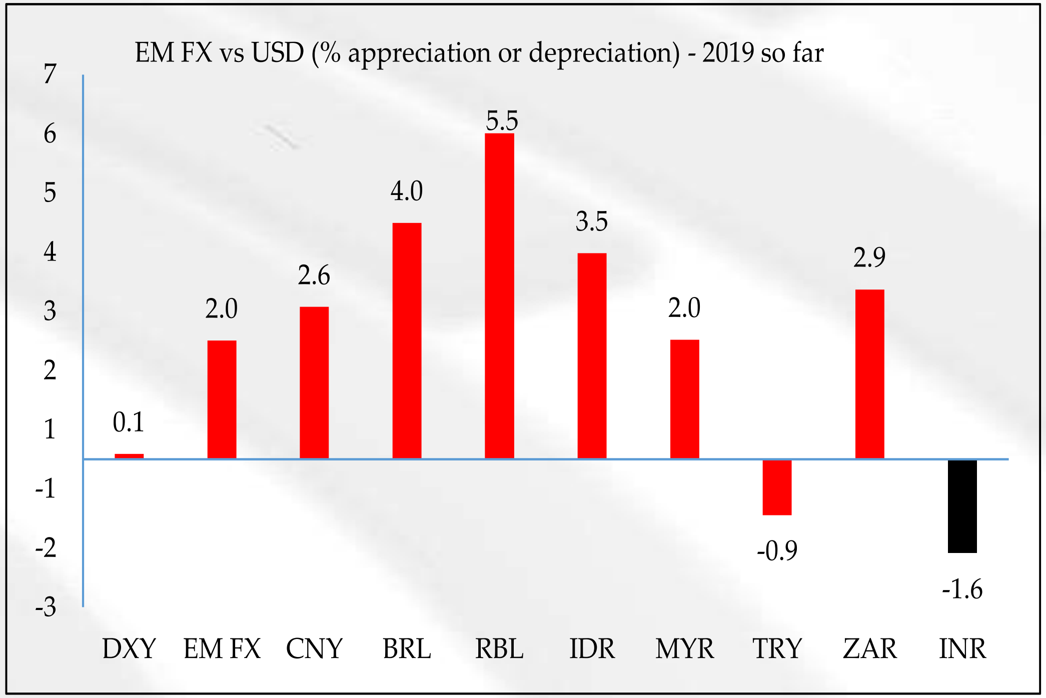
- With the US Fed turning dovish, the EM FX seems to be making a comeback this year. The news flow on the US-China trade negotiations has also been somewhat positive, thus offering some support to the overall EM rally.
- Meanwhile, the INR seems to be stuck in the pit lane for now. Uncertainty around general elections, rural slowdown worries, high valuations, and fiscal concerns are keeping the investors on the sidelines.
- Will the INR join the rally once the elections related uncertainty goes away or the EM trade will falter? Read our report for details.

This year seems to be different, at least for the other EM currencies

In 2018, the USD was the winner. In 2019, EM currencies seem to be making a comeback.

However, the INR continues to struggle, despite the weakness in the USD.





Source: Reuters, CEIC and HDFC Bank

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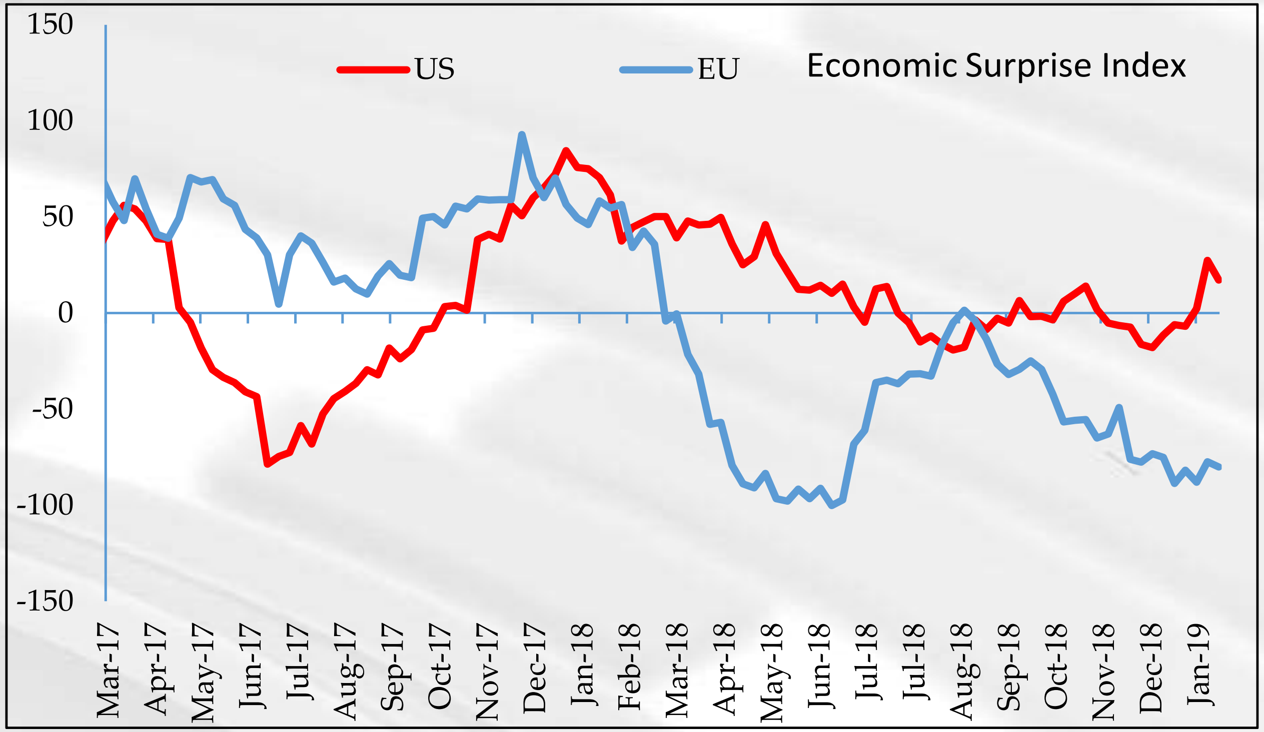
US data soft but not falling off the cliff

What's impacting the USD



- While the high frequency data in the US has been softer (retail sales and industrial production), overall growth is still above the trend.
- Moreover, data coming out of the euro zone and the UK is relatively more negative. Therefore, the outperformance of the US compared to rest of the G3 world still stays intact.

Source: Reuters and HDFC Bank

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The key change has been in the tone of the Fed

- 2019 has seen a pivot in Fed thinking. Earlier the Fed was expected to hike the policy rate 2-3 times in 2019.
- However, now it is believed that the Fed is near the end of interest rate increases and the program to reduce the bonds it holds on its balance sheet.
- Markets now expect the Fed to remain on hold in 2019 with a slight chance of a rate cut in 2020. This is what has mainly weighed on the dollar.

US Fed Expectations

"3 rate hikes in 2019" to "Rates on hold"

Meeting Date	Implied Rate	Basis Points
20-Mar-19	2.398	-0.1
1-May-19	2.398	-0.1
19-Jun-19	2.403	0.4
31-Jul-19	2.408	0.9
18-Sep-19	2.408	0.9
30-Oct-19	2.41	1.1
11-Dec-19	2.387	-1.2
29-Jan-20	2.282	-11.7

Some expecting a rate cut in 2020

Source: Reuters, US Fed and HDFC Bank

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While the other EM currencies have benefitted, the INR seems to be struggling

External factors should have favored the rupee but the domestic factors have been adverse

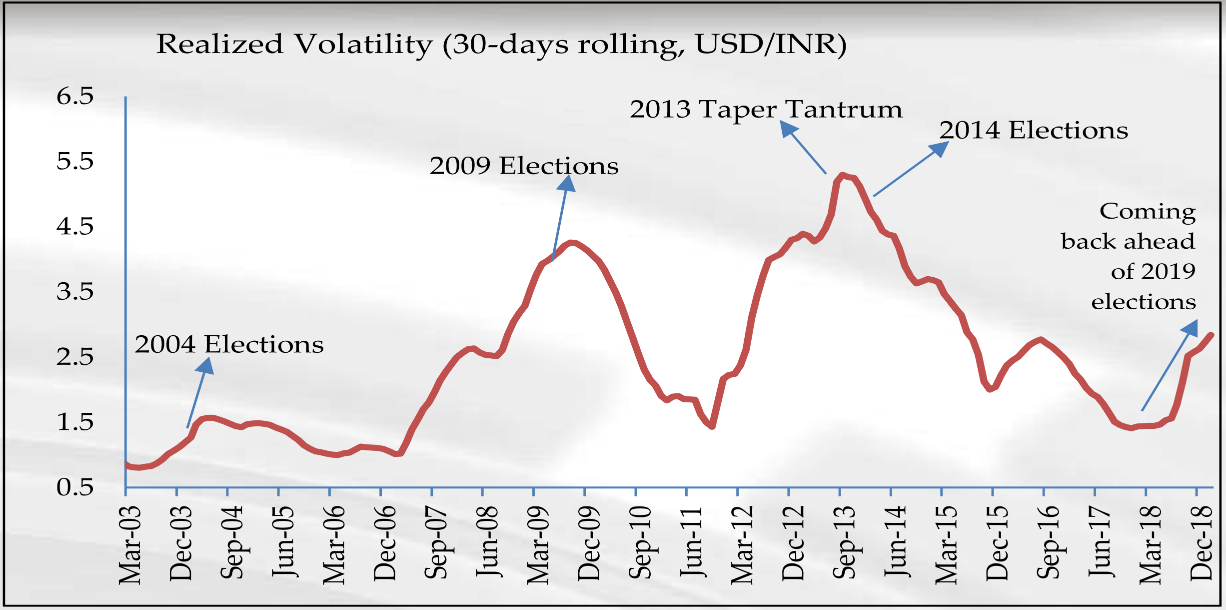
External factors (EMs)

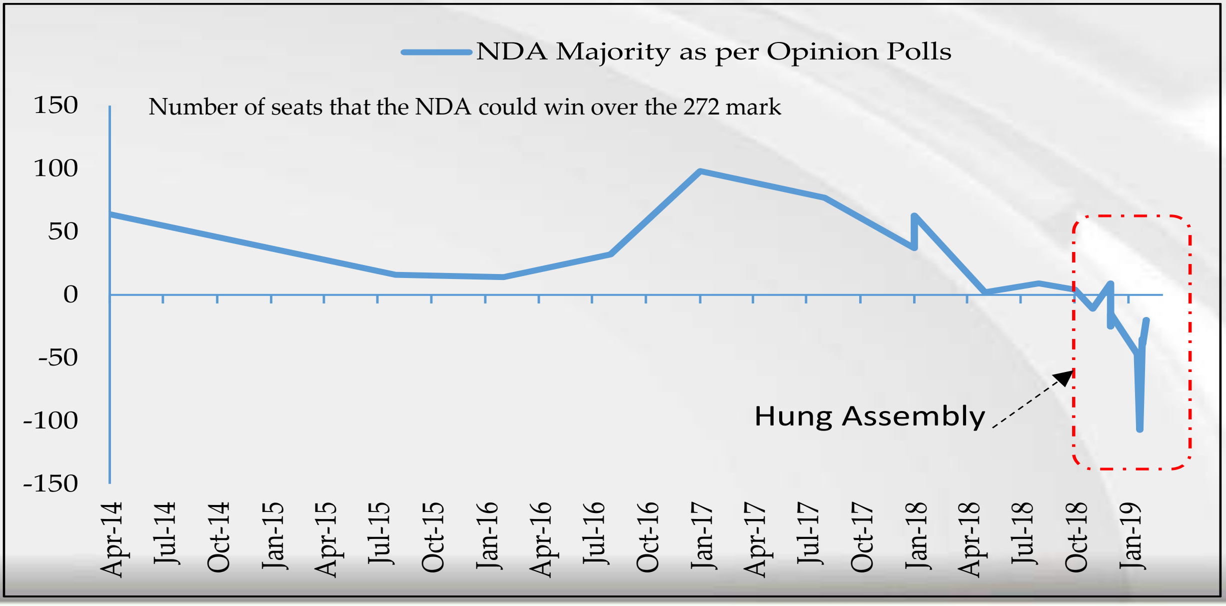
- Change in the stance of the major Central Banks (Increasing dovishness)
- Plus lower oil (commodity) prices and progress on US-China talks
- Working in favor of the EM assets

Domestic factors (India)

- Elections uncertainty has been a cause of worry
- Risk of discontinuity in reforms & possible delay in NPA resolution
- Domestic investments yo-yo
- Domestic growth engine could falter

Two big risks for India in 2019





1. The Election Effect: Difficult to draw a definite causality but it certainly leads to volatility

- **While elections related uncertainty do affect Indian markets, it's tough to draw a definite causality**. In two out of the last three elections, the rupee has in fact appreciated in the run up to poll results.

- **A fractured mandate** is a bigger risk which is not yet fully priced in by the markets. Fractured Mandate is when neither of the parties are able to secure 50% of the seats.

% Appreciation/Depreciation in the INR			
	2004	2009	2014
90 Days to Election Results	0.4	-1.1	4.0
90 Days after Election Results	-1.4	-0.5	-3.7

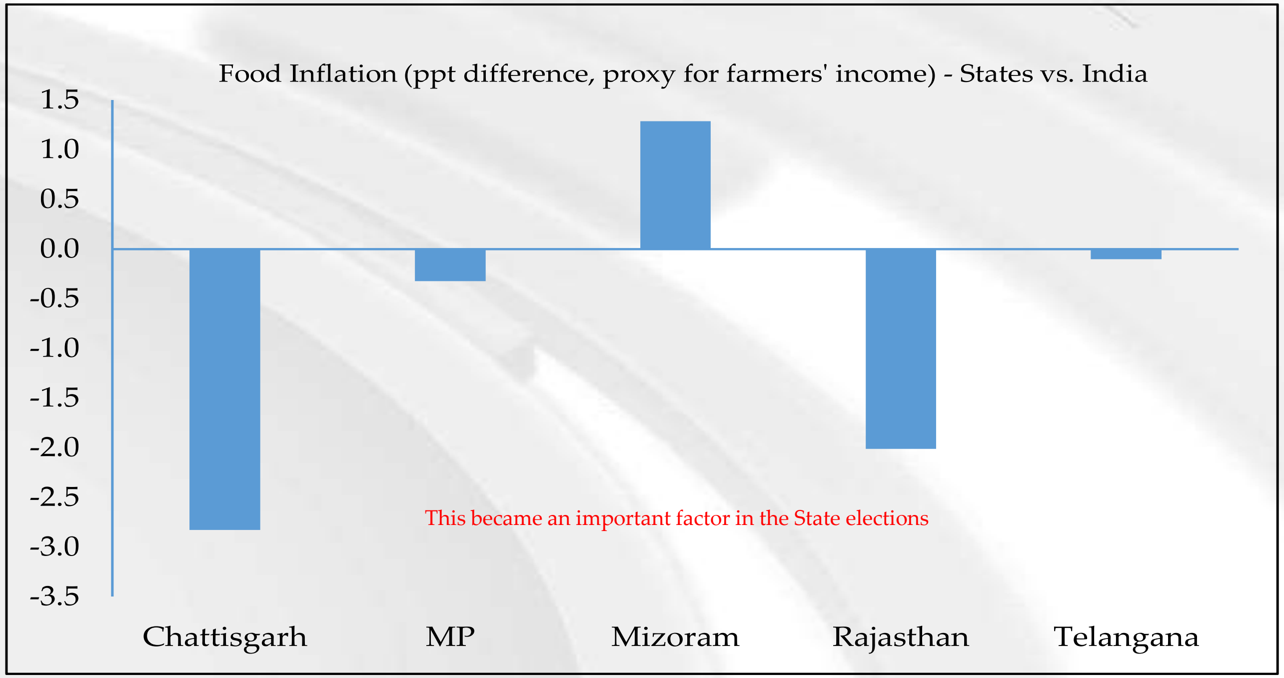
Source: Reuters, Opinion Polls done by India Today, Republic-Cvoter, Republic-Cvoter, India Today- Karvy, ABP News-CSDS, ABP News - C Voter, India TV – CNX, VDP Associates, Deccan Herald, Times Now-VMR

…and declining rural demand

2. The Rural effect: If the slowdown in the rural economy intensifies, the growth advantage of India could shrink

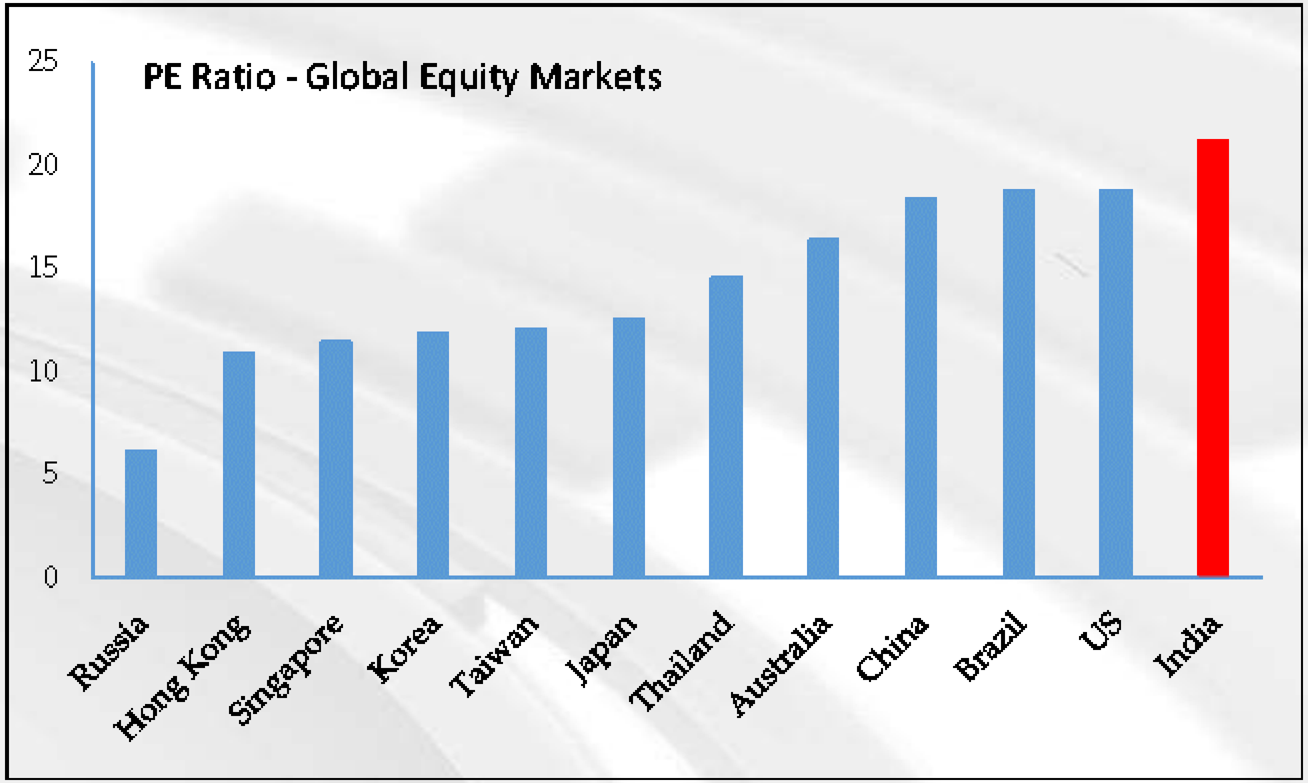
- **The rural wage growth** rate in India (average of agricultural and non agricultural workers - men) has declined from an average of 5% in 2015 to 3% recently.

- **The average number of employment days per household under MGNREGA have also declined.**



Source: Reuters, CEIC and HDFC Bank. **State inflation data comparison is till October that is before the state polls**

While Brazil, Russia and China (the rest of the BRIC) have an average price-earnings ratio of 14.4 (for their respective local equity indices), Indian equity market (NIFTY) is currently trading with a multiple of more than 20.



NB: P-E multiples are based on earnings from the most recent fiscal year (i.e. trailing) and are for local indices such as BOVESPA for Brazil, NIFTY for India, S&P Index for the US etc.

Source: Reuters, CEIC, and HDFC Bank

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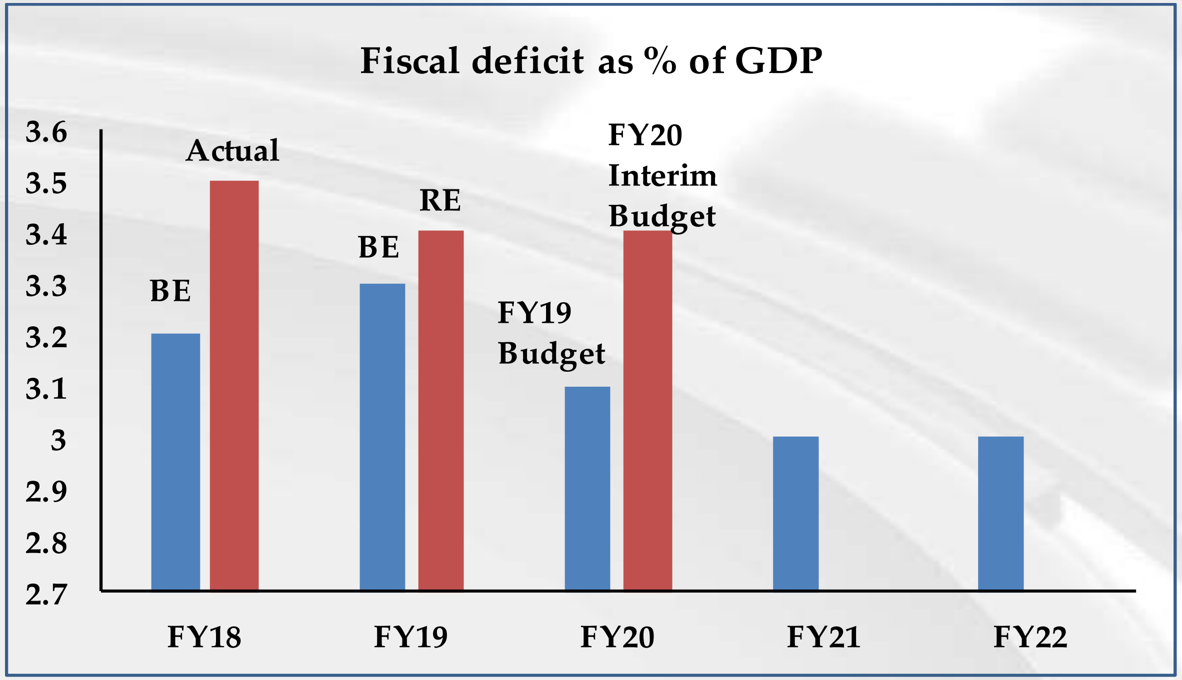
The fiscal deficit has been higher than expected for FY19. Moreover, there has been some digression from the roadmap of fiscal consolidation for the years ahead, which is making it difficult to justify the high valuations for Indians markets.

In September, the government had cut the borrowings on account of good traction in the small saving funds and reduction in buybacks



Market Borrowings	FY18	FY19 BE	FY19 Mid Year Guidance	FY19 RE	FY20 BE
G-Secs (Rs. Trn)					
Gross G-Secs Borrowings	5.9	6.1	5.4	5.7	7.1
Redemptions	1.4	1.4	1.4	1.5	2.4
Buybacks	0.4	0.7	0.5		0.5
Net G-Secs Borrowings	4.1	3.9	3.4	4.2	4.2

Source: Reuters, CEIC, and HDFC Bank

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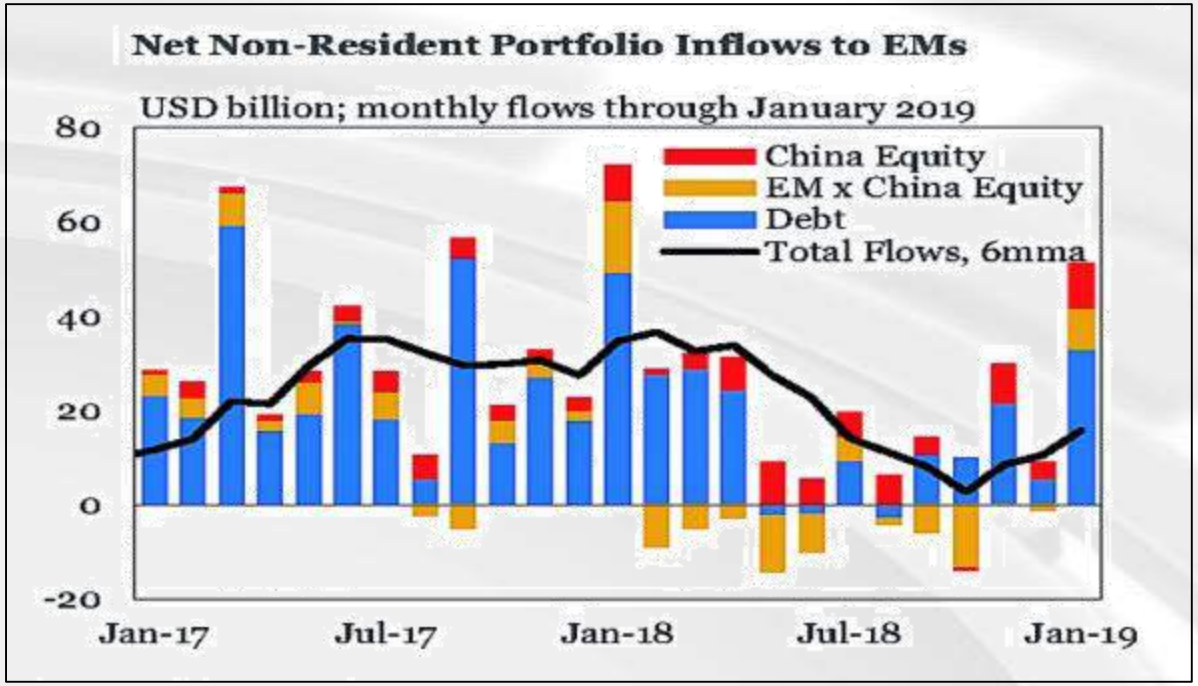
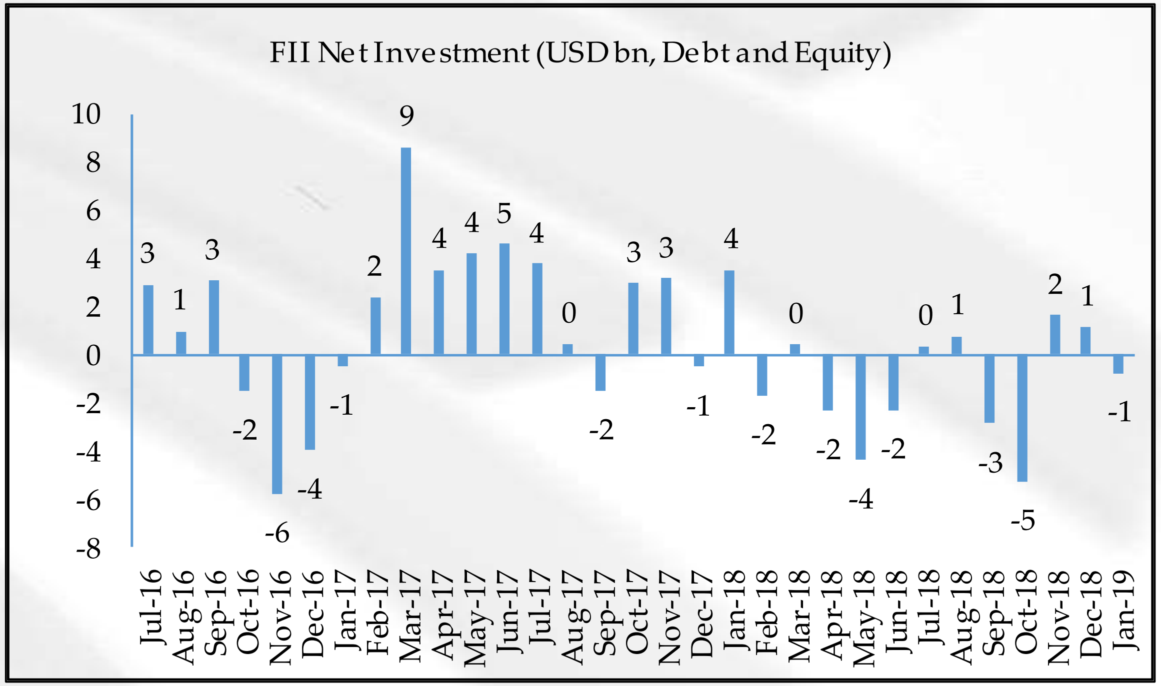
Capital flow data captures some of these worries

- The month of January saw a rebound in net non-resident portfolio flows to Emerging Markets (EMs). The EM securities attracted an estimated USD 51.1bn of foreign capital in January, the highest level in 12 month.
- However, there was an outflow of $0.8bn from Indian debt and equity markets. So far on CYTD basis, while the EM FX has appreciated by 2%, the INR has depreciated by 1.6% against the dollar





Source: IIF, Reuters, CEIC, and HDFC Bank

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Going forward…

Election Results
???

The EM Rally
???

The USD Index
???

Oil Prices
???

How we expect things to unfold…

USD/INR consolidates ~69 levels by the end of 2019.

- Coalition government led by the NDA, with reduced majority for the ruling party
- Broad policy direction of the government remains unchanged
- Full year budget in June unlikely to entail a large fiscal slippage
- DXY remains flat as US relatively outperforms in the G3 World
- Long-EM Trade weakens but does not lead to a sharp sell off
- Assuming no sharp slowdown in China. GDP growth unlikely to fall below 6.2%
- Oil remains around $65 pb

Base-case (75% Probability)
Marginal appreciation but limited gains as the long EM currency trade weakens…

USD/INR touches 74 levels by June-19 and consolidates ~72 levels by the end of 2019

- Fractured mandate and unstable coalition with Regional parties leading
- Long-EM Trade weakens but does not lead to a sharp sell off
- Assuming no sharp slowdown in China. GDP growth unlikely to fall below 6.2%
- Oil prices rise to $75/barrel
- There's modest rise in the DXY

Worse-case (25% Probability)
USD/INR stays above 70 levels for an extended period…

Read ahead for detailed assumptions…

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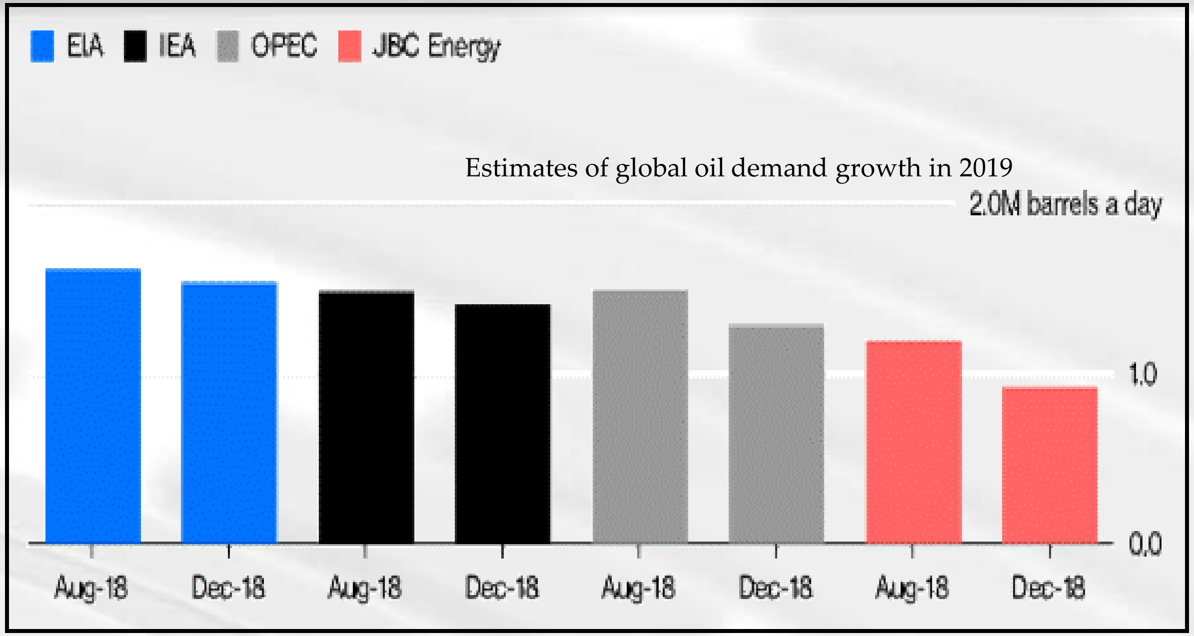
We don't expect a sharp rally in oil prices



The Output Cut: OPEC+ has decided to cut 1.2 mb/d beginning in January. However, the downside risks to global growth could cap the rise in the oil prices.

Important factors to watch out for, going forward…

- **Consumption trend-** The OPEC recently cut its oil demand forecast for 2019, for the fourth consecutive month.
- **Supply scenario–** While supply cuts will help in lowering the surplus to an extent, offsets could come in from Libya, Nigeria (exempted from the pact) and the US.
- **Developments on the US-China trade war could impact the global energy demand**
- **Review of the supply cut and Iran sanctions -** the OPEC+ agreement is due for a review in April. Iran waivers will also expire in May.

USD 65/barrel average for FY20. H1: $60, H2: $70

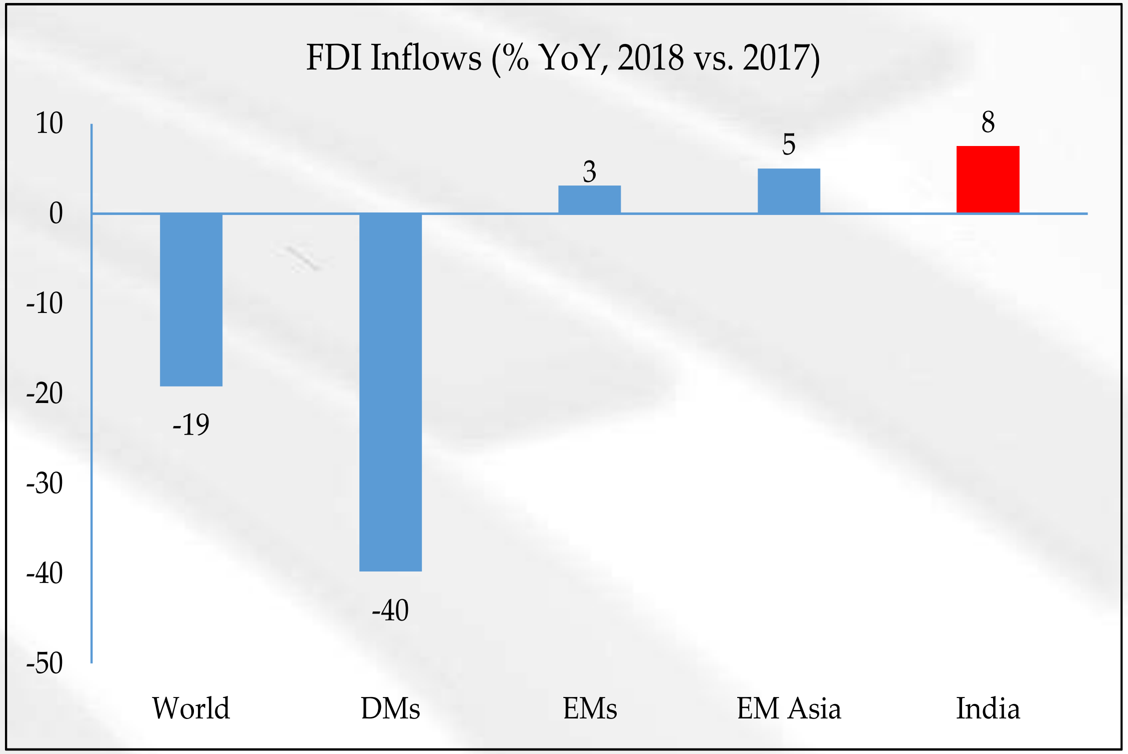
Source: Reuters, Bloomberg, and HDFC Bank

Despite downside risks to growth, we expect India to outperform

Outperformance in terms of growth likely to be a positive factor for the rupee

India is expected to buck the trend: GDP growth is likely to remain robust at around 7.3-7.5% despite a slowdown in global growth

GDP Growth (%)	IMF Projections 2018	IMF Projections 2019	2019 Outlook - Difference from Oct-2018 Projections
World	**3.7**	**3.5**	**-0.2**
DMs	**2.3**	**2.0**	**-0.1**
US	2.9	2.5	0.0
Euro zone	1.8	1.6	-0.3
UK	1.4	1.5	0.0
EMs	**4.6**	**4.5**	**-0.2**
Russia	1.7	1.6	-0.2
China	6.6	6.2	0.0
India	7.3	7.5	0.1
Mexico	2.1	2.1	-0.4
EM Europe	3.8	0.7	-1.3

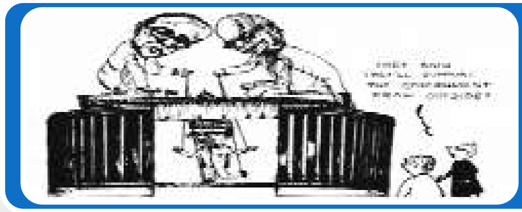


Source: IMF, UNCTAD, CEIC and HDFC Bank

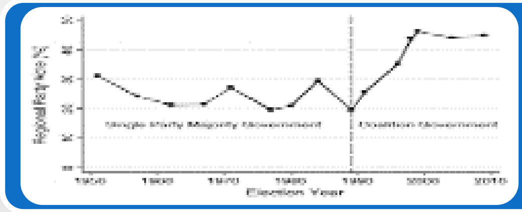
Coalition dynamics would be a critical factor

As such a coalition government is not risky for the markets. The quality of coalition is more important.

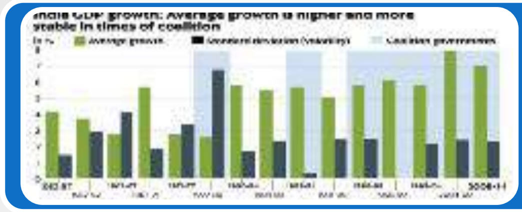
What will be the balance of power of the next coalition? This question will shape its direction and consequently the play in the markets.



In India, the seeds of coalition governance were sown for the first time in 1989. Until then a single party rule of Congress dominated the political landscape at the Centre, except during the Janata experiment between 1977 and 1979.



So far we have had around 10 coalition governments in India. Out of these, three coalitions were able to serve the full terms as the GOI – NDA (1999-04), UPA I (2004-09), and UPA II (2009-14)



Interestingly, the highest growth in India has really been during the periods of coalition governments. So a general perception that a coalition probably produces adverse economic results is not necessarily true.

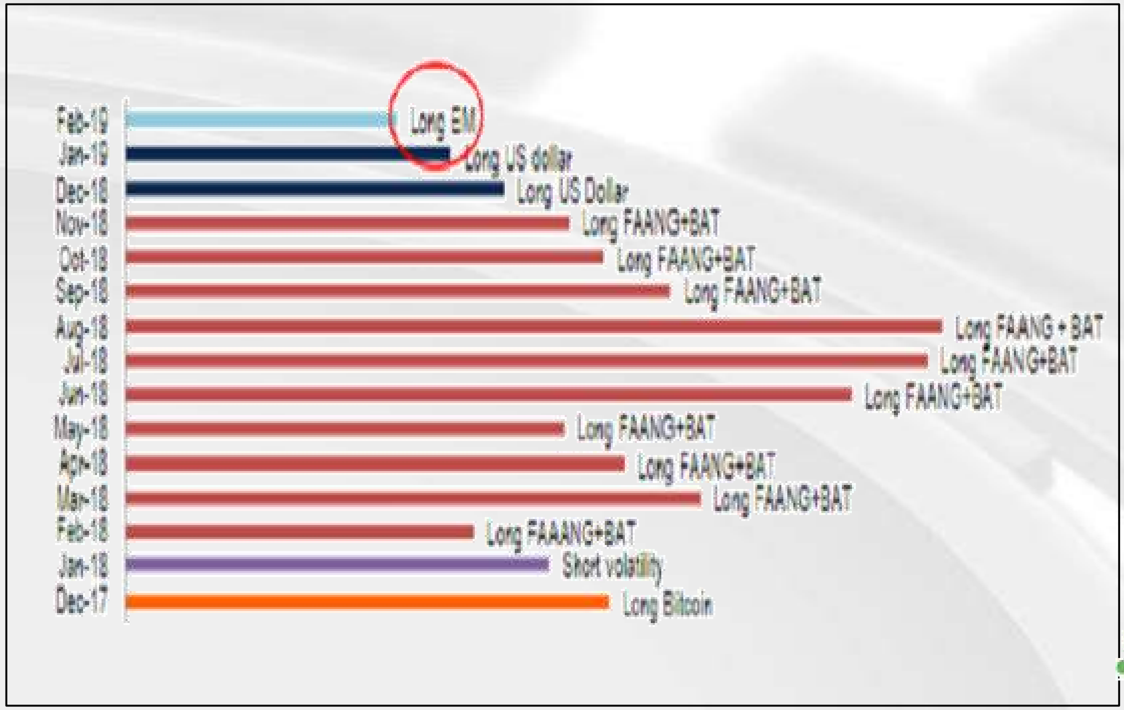
Balance of power is an important factor: Coalition governments in which a national party exercise the major control with outside support of the regional parties tend to be more stable than the ones where national parties play a secondary role.

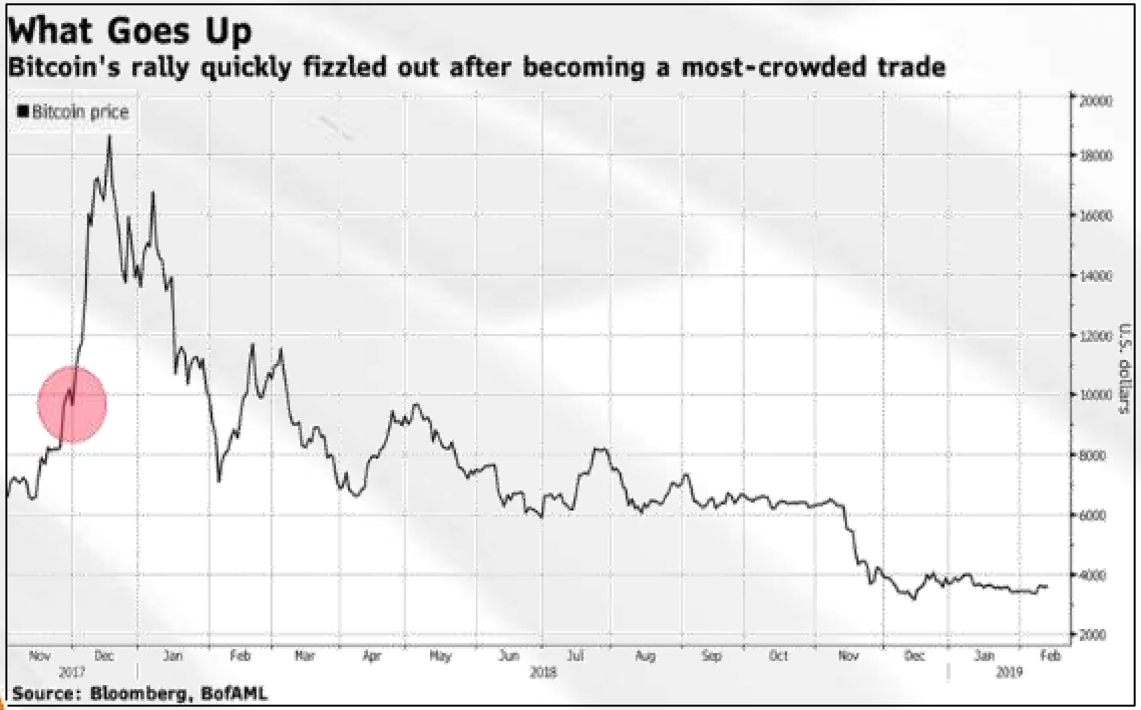
Source: Reuters, CEIC, Media Reports and HDFC Bank

Besides there is a risk that the EM rally could peak soon

- As per the survey of global fund managers done by Bank of America Merrill Lynch, 'Long EM' is the most crowded trade currently. Comparisons are drawn to the last crowded trade which panned out in case of Bitcoins and peaked out in 2017.

- The Bitcoin trade peaked in December 2017, before beginning its precipitous decline, and is now down about 80% from its high. If something similar pans out for the EM trade, the gains in the INR (post elections) might be limited.





Source: Bloomberg, BOAM-FA, and HDFC Bank

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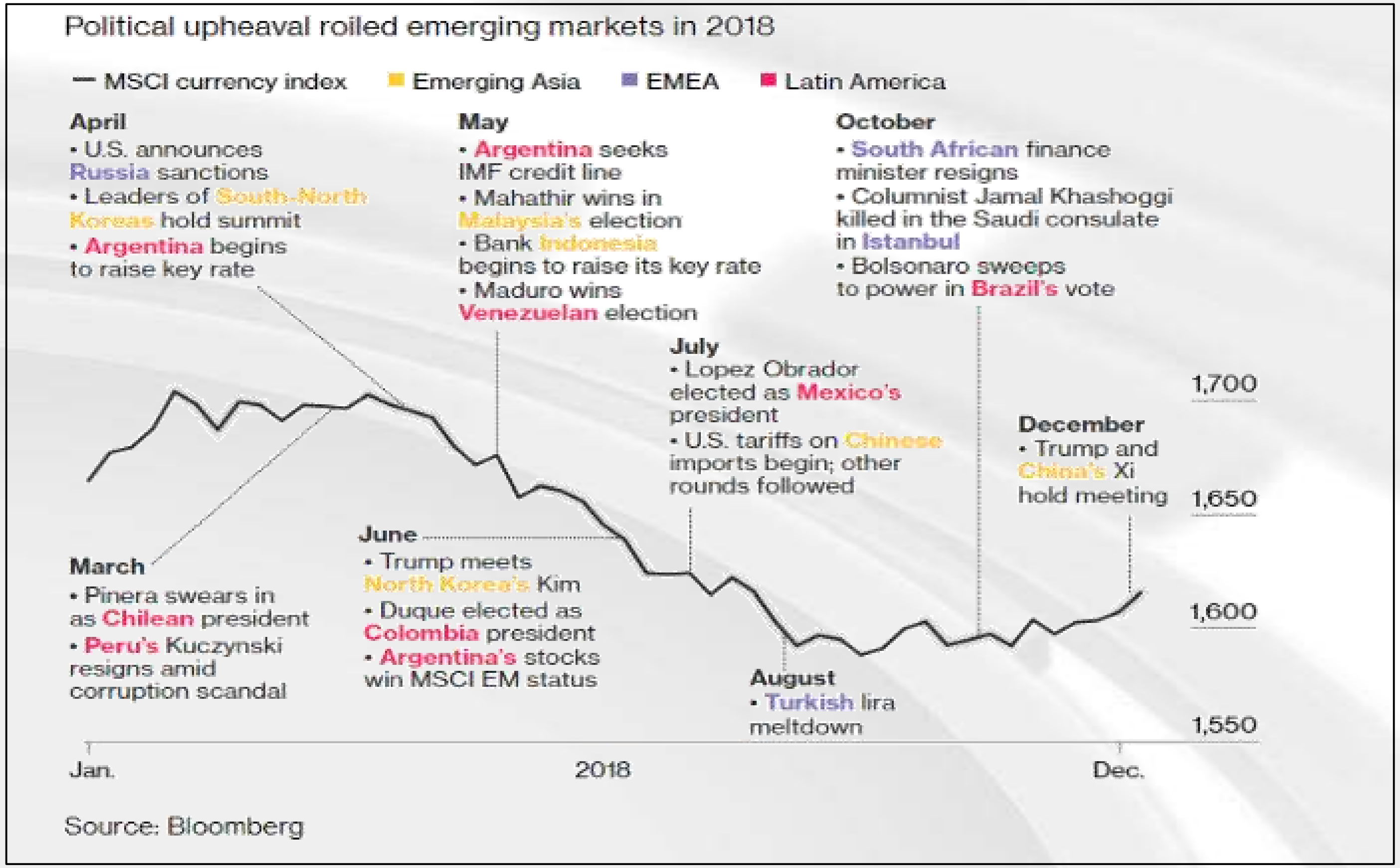
Just to recall, 2018 too started on a positive note for the EMs but then…

EM performance in 2018 was somewhat disappointing - for a variety of geopolitical reasons



We could see clarity emerging on a lot of issues troubling the markets at this stage. However, it would still be a volatile situation for the EMs

Risks for the EMs in 2019

Trade Wars & China's slowdown

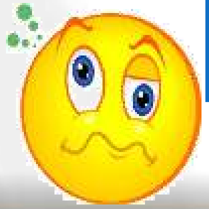
New Populists *(Fiscal worries in Brazil, Mexico and India)*

Sanctions on Russia

Elections *(India, Thailand, Indonesia, Argentina, South Africa)*

Middle East woes *(low oil prices)*

Fed and the dollar



Source: Bloomberg, and HDFC Bank

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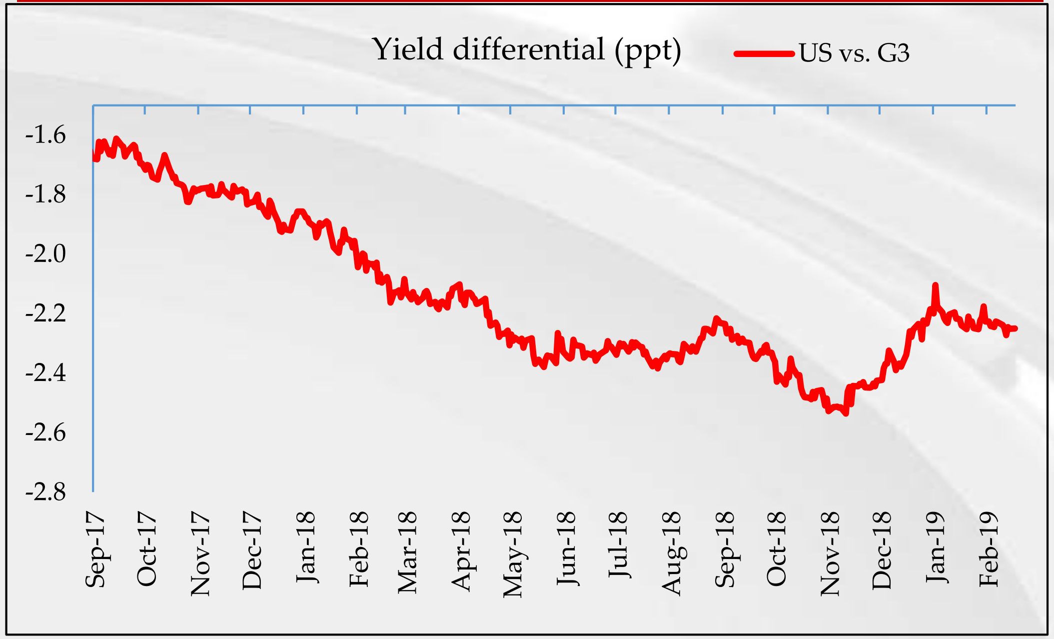
We assume only a marginal decline in the DXY (USD)

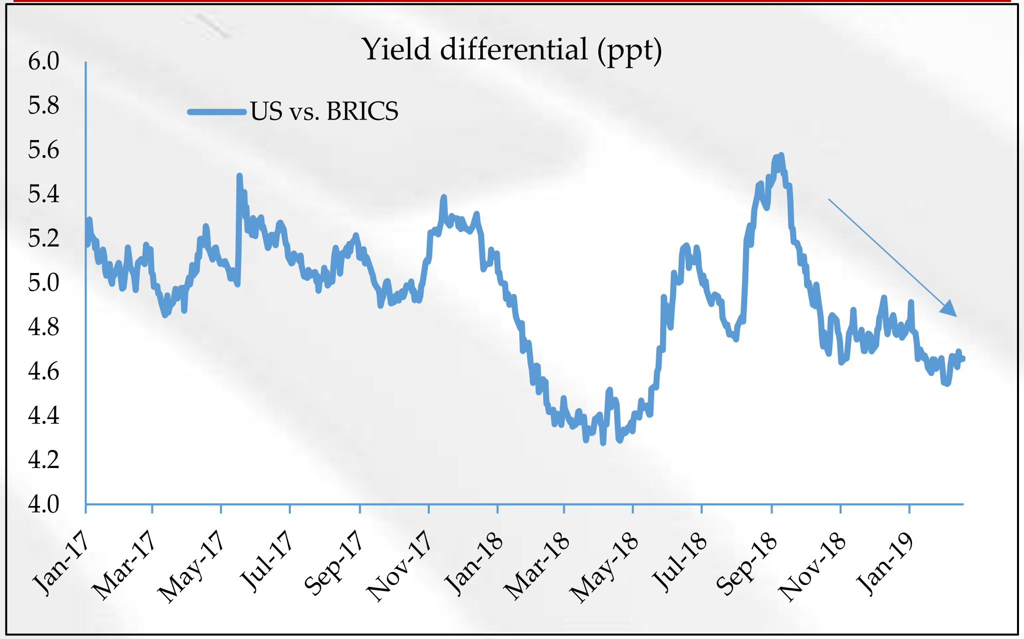
- While the bearish USD sentiment could remain in place as US growth momentum is softening and the Fed is increasingly become dovish, growth momentum in the non-US world is turning out to be much more weaker.

- Economic performance in both the Euro zone and China could be relatively more disappointing than the US. Consequently, the pace of downside in the USD is likely to be moderate. Perhaps, the most likely outcome is that the DXY stay broadly unchanged for the most part of the year.

G3 (Japan, EU, UK) still do not enjoy a yield advantage compared to the US



Despite the decline in US yields, the spread that EMs enjoy has narrowed



Source: Reuters, CEIC, and HDFC Bank

FX Forecasts: Two scenarios

HDFC Bank Quarterly Forecasts (period end)									
	FY19				FY20				
	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	
EUR-USD	1.17	1.16	1.15	1.13-1.16	1.17-1.19	1.19-1.21	1.21-1.23	1.22-1.24	
GBP-USD	1.32	1.3	1.28	1.29-1.31	1.30-1.32	1.32-1.34	1.34-1.36	1.34-1.36	
USD-JPY	111	114	110	110	109	111	112	110	
AUD-USD	0.74	0.72	0.71	0.72	0.73	0.73	0.75	0.77	
USD-CNY	6.62	6.87	6.88	6.80	6.95	6.90	6.85	6.90	
USD-INR	**68.45**	**72.5**	**69.6**	**71.0-72.5**	**70.0-72.0**	**69.0-70.0**	**68.5-69.5**	**68.0-69.0**	← **Base-case**
	Worse-Case→				**73.0-74.0**	**72.0-73.0**	**71.5-72.5**	**70.5-71.5**	

During last three elections (2204, 2009 and 2014), the rupee has depreciated on average by 2% in the three months post election results. However, this time we expect volatility and overshoot before the elections and hence the general post-election deprecation is unlikely to play out, assuming there is a coalition government led by the NDA

BOP Forecasts

USD billion	FY16	FY17	FY18	FY19F	FY20 F
Current Account Balance	-22	-14	-49	-64	-70
Merchandise	-130	-112	-160	-185	-198
Exports	266	280	309	326	342
Imports	396	393	469	511	539
Oil imports	83	87	109	140	141
Gold imports	32	28	34	30	34
Non Oil non gold	282	278	326	341	364
Invisibles	108	98	111	121	127
Services	70	68	78	78	81
Capital Account Balance	41	36	91	58	85
FDI (Net)	36	36	30	40	45
Portfolio Investment	-4	8	22	-13	11
Loans	-5	2	17	6	8
External Assistance	2	2	3	1	2
ECBs	-5	-6	0	2	3
Short Term Credit	-2	6	14	3	4
Banking Capital	10.6	-16.6	16.2	18.2	15.0
NRI Deposits	16.1	-12.4	9.7	13.7	10.0
Overall Balance of Payment	17.9	21.6	43.6	-7.2	14.5
Current Account Balance (% GDP)	-1.1	-0.7	-1.9	-2.4	-2.3

Oil: $65/barrel
Current account deficit lower than 2.5% of GDP is somewhat sustainable and does not pose a big risk for India.

Source:, CEIC and HDFC Bank

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