Treasury Report

HDFC Bank Ltd.
HDFC Bank House,
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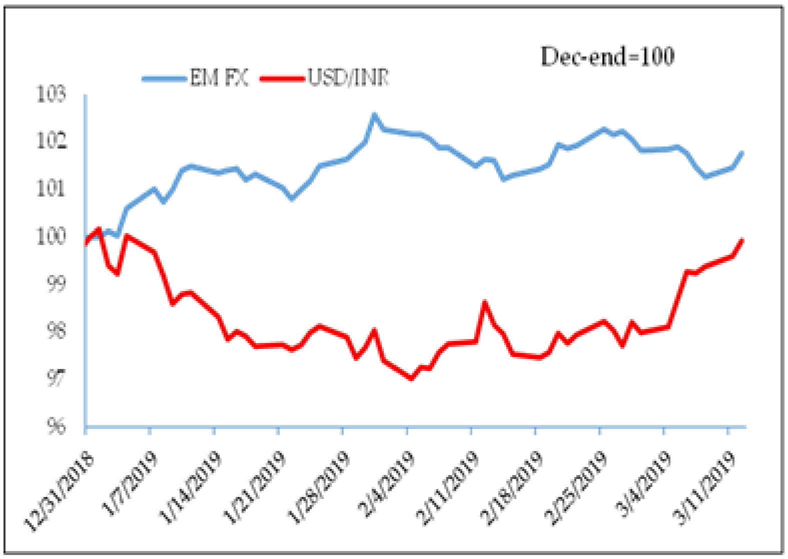
Mumbai - 400 013.
CIN:
L65920MH1994PLC080618

THE INR: BACK IN PLAY!

Mar 13, 2018

THE INR: BACK IN PLAY!

While the rupee missed the rally in the beginning, there seems to be some catching up now



After a brief lull in February the momentum has turned in favour of emerging markets (EMs) yet again. While it is arguable whether there have been substantive changes over last few weeks in terms of either risks or supports—the US was showing clear signs of a somewhat marked slowdown over the past couple of months, China was trying to counter its deceleration with an aggressive stimulus and so forth – it is clear that the narrative moving markets has changed and in the near term could drive the bull trade on EMs forward.

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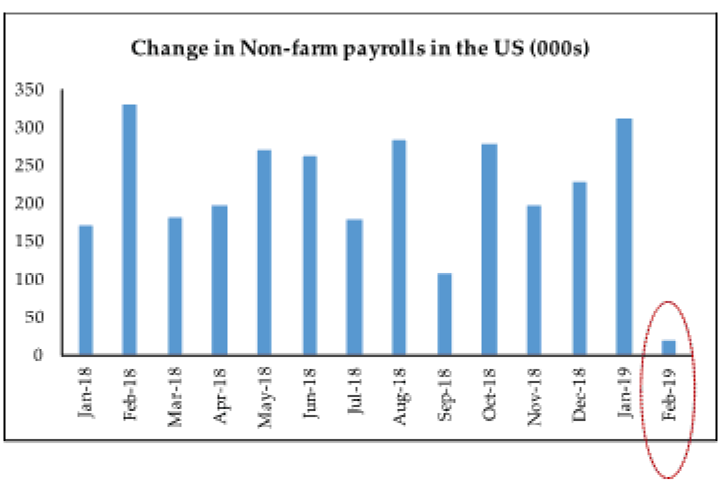
EMs got a lift on further China's stimulus

The Chinese Premier Li Keqiang announced new stimulus measures at the annual National People's Congress on 5th March 2019 to prop up the economy

- *Cuts in taxes and fees worth nearly 2 trillion yuan ($289.28 billion). Last year, China made 1.3 trillion yuan in tax cuts.*
- *Plans to increase infrastructure financing - around 2.15 trillion-yuan worth of local government special bonds to meet spending needs for key projects.*
- *A clear mandate to large state-owned banks to increase loans to smaller businesses by more than 30% in 2019.*

The increasing likelihood of a trade deal between the U.S. and China has also brightened the outlook – *media reports over the weekend suggested that the two sides might be close to reaching a currency deal as part of their continuing trade negotiations.*

This recast in the narrative could have been triggered by somewhat shocking non-farm payroll data in the US for February (20K against the consensus forecast of 180K) released on 8th march 2019 that made the case for a soft monetary stance in the US stronger. This was abetted by the European Central Bank's indication in its monetary policy meeting on 7th March 2019 that it would not only hold rates but fall back on reviving its liquidity infusion programme. The allocation of additional liquidity needs narratives to justify its movement and the current rally in EMs is a product of that narrative.



A reverse course on policy by the ECB?

Forecast Changes: Eurozone's 2019 GDP growth downgraded to 1.1% from earlier estimate of 1.7%. 2020 growth forecast also cut to 1.6% from 1.7%. 2019 inflation forecast also slashed to 1.2% from 1.6% estimated earlier and for 2020 to 1.5% from 1.7%.

Stimulus: A new series of quarterly targeted longer-term refinancing operations (TLTRO-III) to be launched in September 2019 to go on until March 2021, with each of two years' maturity.

Forward guidance: Rates on marginal lending facility and deposit facility now to remain unchanged "at least through the end of 2019" in comparison to ECB's earlier stance of "end of the 2019 summer".

We had pointed out that India had decoupled from the broader EM rally predominantly due to pre-poll uncertainty and the fog surrounding the course of monetary action under

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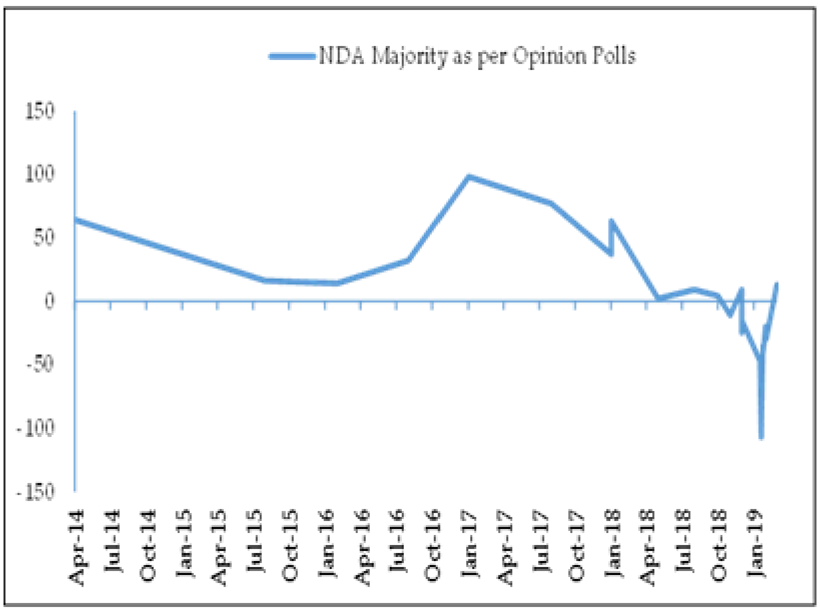
the new RBI governor. While the RBI's pro-growth stance was made clear in the February policy itself, the current rally in the INR and all other domestic asset markets seems to be a reaction to a set of widely publicized opinion polls that predict a return of the NDA to power in the upcoming general elections. Thus Indian markets are at the heart of the EM rally and one could legitimately argue that India has some catching up to do after falling behind in the last leg of the rally.

Moreover, opinion polls seems to be changing now



Opinion Polls done by India Today

There might be a seasonal factor working for the rupee as well. It has been observed in the past that the rupee typically rises in March as exporters bring back their dollars to India towards the end of the fiscal year to settle their annual accounts and repayment of debts.

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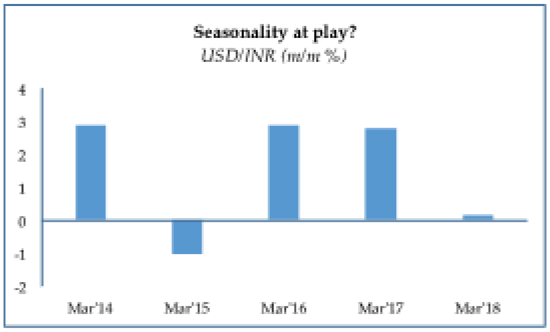

Clearly there are risks going forward. EM trades have looked a little too crowded for comfort ever since they picked up from December onwards. However, given the alignment of global factors, these rallies are likely to be followed by some moderation rather than a sharp pullback.

Recently released US data has come in weaker than expected

- CPI inflation rose 1.5% (y/y) in Feb compared to expectations of a 1.6% increase
- New York Fed's survey of consumer inflation expectations for 1Y and 3Y fell to 2.8% each in Feb'19 from 3.0% in Jan'19
- Non-farm payrolls increased by just 20k in Feb'19against expectations of a 180k increase
- Dec'10 retail sales data was revised lower to show a drop of 1.6% against 1.2% drop as was previously reported

The Federal Reserve Chair Jerome Powell said on 10th March 2019 that the U.S. central bank does "not feel any hurry" to change the level of interest rates again as it watches how a slowing global economy affects local conditions in the U.S. Rates are currently "appropriate" and "roughly neutral" said Powell.

Global political uncertainty, especially with the Brexit issue nowhere to be resolved, could see episodes of "risk off" trade in the market, keeping flows (and in turn the USD/INR) volatile. As far as India specific factors are concerned it might be worthwhile to remember that a week or perhaps even a day is too long in politics. Thus going forward there could be volatility as both good and bad news trickle in. That said, periodic niggles notwithstanding, if the political news flow, particularly the opinion polls point towards a return of the NDA, history suggest that the INR would have an appreciation bias in the run-up to the elections and then sell off post elections. Besides the impending elections, possible sharp spikes in oil prices remain a probable risk for the EMs particularly India. Oil prices are likely to stay supported with media reports suggesting that Saudi Arabia will further extend its crude oil exports cuts in April to below 7 mbpd (30% below the production ceiling of 10.311 mbpd that OPEC+ agreed on) and the OPEC agreement on production cuts will likely see an extension.

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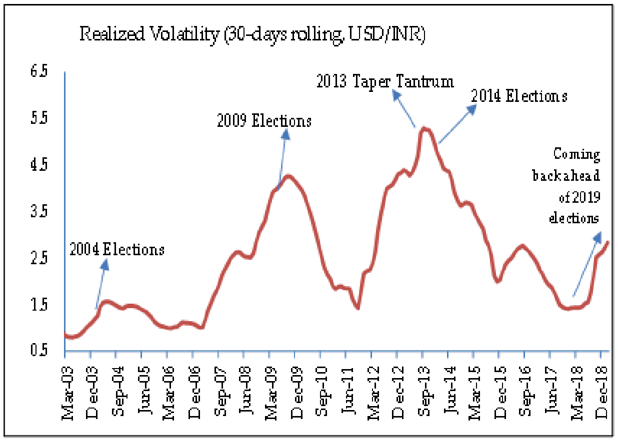

% Appreciation/Depreciation in the INR			
	2004	2009	2014
90 Days to Election Results	0.4	-1.1	4.0
90 Days after Election Results	-1.4	-0.5	-3.7

Where is the INR headed then? The extent of appreciation in the USD/INR pair was capped by possible intervention by the RBI yesterday. The pair touched 69.56 levels, and then bounced back, ending the day at 69.61. The next resistance levels for the pair are seen at 69.50 and 69.30. From a purely technical perspective, the buck would stop at 68.40-50 levels, which is a strong resistance level for the pair.

That said, we expect the pair to stabilise between 69.0-69.50 levels, as the sheer momentum that drives these reversals in the rupee is limited by some intervention by the RBI.

A number of factors could continue to nudge the RBI to intervene:

- With clear signs of a growth slowdown the RBI is likely to be concerned about the contractionary effects that INR appreciation entails.
- Besides with inflation at the lower end of the tolerance band, the fear of excess liquidity (through an unsterilized buy USD, sell INR trade by the RBI) driving inflation up to uncomfortable levels may not hold at this juncture.
- Besides, there is enough government bond supply in the pipeline to de facto sterilize the excess liquidity and act as an alternative to open market operations *(Central government's FY20 gross borrowings are budgeted at Rs 7.1 trillion compared to Rs 5.7 trillion in FY19 – net borrowings are expected to remain unchanged from FY19 at Rs 4.2 trillion).*

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Revised forecast					
	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
USD-INR	69.0-70.5	70.5 - 71.5	69.0-70.0	68.5-69.5	68.0-69.0