

COVID-19: The globalization of a virus

Rupee alert

Indian financial markets and the INR are caught in the middle of a global rout driven by the global spread of Corona Virus (COVID-19). While parallels are now being drawn between the current sell-off and the Great Financial Crisis of 2008, we reserve our judgment. However, given the current momentum in the currency a breach of 73 to the USD and a move towards 74 seems possible. We suggest the following:

- *While the USD-INR pair is likely to see higher levels (depreciation), a couple of days of good news could see a temporary reversal. As we write, hopes of a coordinated global economic stimulus has led to some pullback in Asian markets. These dips would be buying opportunities – that is, we remain long USD unless the threat of contagion abates or markets are convinced that coordinated global stimulus measures will offset the economic impact of the virus.*
- *Second, we recommend hedging for a period of sustained depreciation in the INR going forward.*

If markets do melt down, we see further pressure on the INR but see it as an outperformer in the EM pack. Unlike say the taper tantrum where India was seen as a member of the “fragile five”, the current perception that it is to some extent a COVID hedge could make it an outperformer in the EM pack. The hammering that the INR has seen over the last few days notwithstanding, the INR has remained an EM outperformer if we take the period when the COVID news has hit the markets.

COVID-19 goes global

Financial markets across the world have been hit by the recognition of the fact the Corona virus (COVID-19) has “globalized”. Thus the key issue is no longer limited to how quickly China contains the virus or the economic buffers China’s government and central bank puts in place to counter the inevitable economic slowdown that it has brought in its wake. It now seems to be more about how rapidly the virus could spread across the globe and its ability to cripple or at least damage production systems around the world.

The latest sell-off has come on the back of two things.

- First the identification of individual carriers of the virus who have neither visited China nor come into direct contact with individuals from virus-affected regions.
- Second the rapid expansion of the list of economies affected by the virus makes the crisis global by definition

If this contagion were to become truly global, any attempt to “forecast” the impact becomes challenging in more ways than one. The initial strategy that analysts followed of treating China as the mother lode and looking at its economic and financial links to different economies has to be reworked to some or perhaps considerable extent.

Coronavirus going global

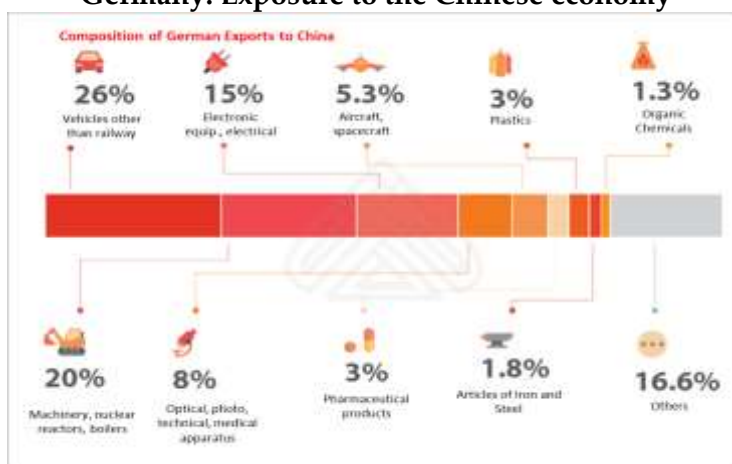
Countries	Confirmed Cases>10
China	78961
Republic of Korea	2337
HK	745
Italy	650
Iran	245
Japan	210
Singapore	96
USA	59
Kuwait	43
Thailand	40
France	38
Bahrain	33
Germany	26
Spain	25
Malaysia	24
Australia	23
UAE	19
Vietnam	16
UK	16
Canada	11

Source: WHO, HDFC Bank

To put it in simpler terms, recent analysis of COVID-19's impact on, say, Germany focused on the intensity of Chinese demand for German products and China's links to the supply chain. **If the risk of global contagion is real, we now need to assess the threat of a large-scale industrial shutdown in Germany itself and indeed in other European economies.**

The China centric view: will it still work?

Germany: Exposure to the Chinese economy



Source: WSJ, HDFC Bank

This is not just an EM crisis but using the EM prism might offer some insight!

Quite clearly, this is not a plain vanilla EM crisis where there is a large capital outflow from just this asset class. However, a number of Asian economies that also happen to be EMs have strong China links. A number of other EMs also have strong ties with China. South Africa for instance exports gold, diamonds and metal ores to China (total exports to China to \$27.4 bn). Brazil exports soyabean, iron ore and petroleum to China. Besides historically, the prevailing sentiment towards China has historically affected capital flows to EMs. Thus the COVID-19 impact could be seen through the EM prism and the relative performance of different EM currencies during a contagion might tell us a story. For instance, looking at the INR performance vis-à-vis other EMs can help us gauge how much weight markets are putting on India-specific factors—for instance the perception that its production structure is relatively insulated from China - in trading the currency.

INR performed relatively well compared to other EM currencies

	GFC	Taper Tantrum	Oil & Trump	COVID
(%)	May-Nov 2008	Apr-Sep 2013	Feb-Oct 2018	16 Jan - Present
INR	-22.5	-15.5	-10.5	-1.4
CNY	2.3	1.4	-10.7	-1.9
Thai Baht	-12.1	-6.5	-5.8	-4.2
Malaysian Ringgit	-14.7	-5.3	-7.3	-3.9
Indonesian Rupiah	-29.5	-18.8	-13.2	-3.7
Brazil Real	-38.6	-9.7	-17.5	-7.2
Russian Rouble	-17.4	-4.2	-17.7	-7.9
South African Rand	-33.4	-9.6	-24.9	-8.1

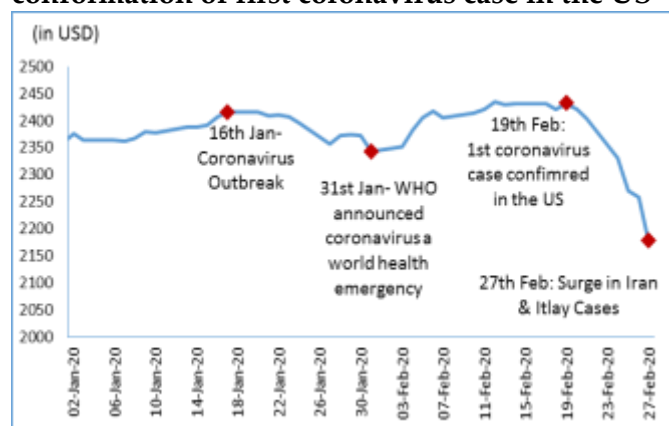
Source: Reuters, HDFC Bank, GFC: Great Financial Crisis

Uncharted territory?

Currencies have depreciated across the board since news of the virus first broke and other financial markets have come under pressure. Conventional “safe” assets such as the USD, US treasuries and gold have firmed up significantly. The JPY has lost this status because of Japan’s exposure to the epidemic. This leads to the question: how much of the pandemic is “already in the price”? Our sense is that while the first round effects, so to speak, that works largely with China as the centrepiece is baked into asset markets.

However, the risk of a global pandemic is, in our opinion, still not fully captured in asset prices or exchange rates. The sharp fall in the US equity indices, the record low in US treasury yields and the weakness in multiple asset classes and geographies is part of what could be a bigger move in asset markets. *This is uncharted territory as there is no recent instance of a global pandemic. The SARS (2002) and H1N1 epidemics were relatively tame. The Global Financial Crisis (GFC) of 2008 now seems to be emerging as a benchmark to gauge how this crisis will pan out.*

MSCI index has declined sharply since the conformation of first coronavirus case in the US



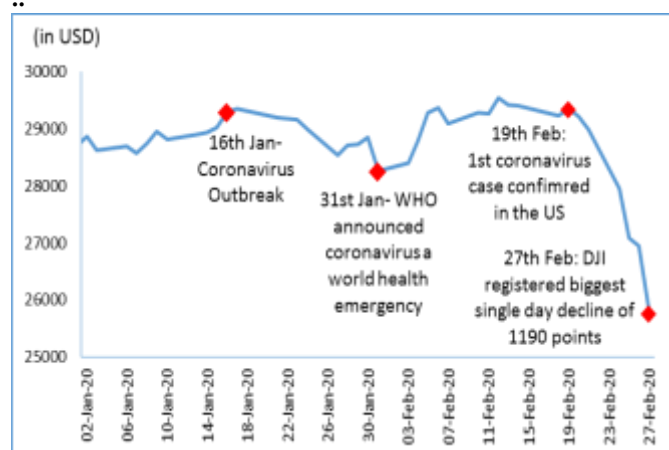
Source: Reuters, HDFC Bank

However, gold prices are rising in response to a safe investment alternative



Source: Reuters, HDFC Bank

DJIA registered largest single day decline on 27th Feb..



Source: Reuters, HDFC Bank

.. ..US Yields also dropped to record low levels



Source: Reuters, HDFC Bank

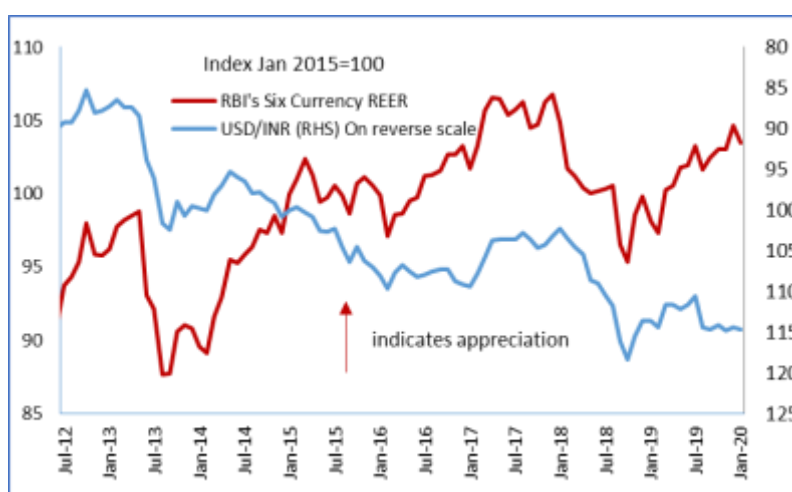
We see the possibility of a further depreciation in the INR against the USD going forward. Two things follow from a trading or risk-management perspective:

- While the USD-INR pair is likely to see higher levels (depreciation), a couple of days of positive news or RBI's attempt to curb volatility could see a temporary reversal. These dips would be buying opportunities – that is, we would remain long USD unless the threat of contagion abates.
- Second, we recommend hedging for a period of sustained depreciation in the INR going forward.

How much can the INR depreciate? A brief history

In the absence of a comparable episode, we answer this question by analysing the behaviour of the INR in previous crisis or selloffs. We find that the typical behaviour of the INR has been to depreciate rapidly, find a bottom and then pull back to a more stable level over the next three months. This pull back has been mild in a couple of instances but has been sharp after the 2018 “correction”. This post-bottom reversal is aided in part by RBI action both in terms of the USD supply from reserves or policy measures (such as the subsidization of forwards to attract more hedged inflows following the taper tantrum). The last two “crises” have come amidst a considerably overvalued INR going by the 6 country REER and this is the case now. However, the fall in the currency has not corrected for the entire overvaluation in the past and to view the REER as a guide to the extent of correction:

REER suggests overvaluation in USD/INR pair



Source: RBI, CEIC, HDFC Bank

We have specifically analysed three recent episodes of global disruptions and how it impacted the domestic currency:

- 1. The GFC (Global Financial Crisis, 2008):** The USD/INR pair depreciated by a whopping 17.6% between May-Nov 2008. However, the pair reversed some losses later as the INR settled around 48.9 level against the USD vs. the peak of 49.6 during the mentioned period.
- 2. The Taper Tantrum (2013):** The INR slid to 62.6 level from 53.7 between Apr-Sep 2013 in response to the sharp rise in the US yields. To recall, the US yields rose after the Fed announced its intention to end the purchase of bonds under its QE program.
- 3. The Trump Trade and Oil prices (2018):** The domestic currency registered a decline of 13.4% between Feb and Oct-18, on account of positive dollar sentiments, rising crude oil prices and Fed rate cuts. That said, the pair reversed some of its earlier loss later.

Movement in the USD/INR during global crisis

	USD/INR				
				Post 3M Position	
Events	Beginning	Peak	Depreciation	Average	Gain/Loss Compared to peak
GFC	40.4	50.2	-24.0%	48.9	2.5%
Taper Tantrum	54.2	67.6	-24.9%	62.1	8.2%
TheTrump Factor	64.0	74.3	-16.2%	71.1	4.3%

Source: Reuters, HDFC Bank

Factors supporting the INR

The INR's relative outperformance throughout the COVID phase suggests, in our opinion, that India is being viewed as a "COVID hedge". For one thing, the number of virus infected cases has been relatively low.

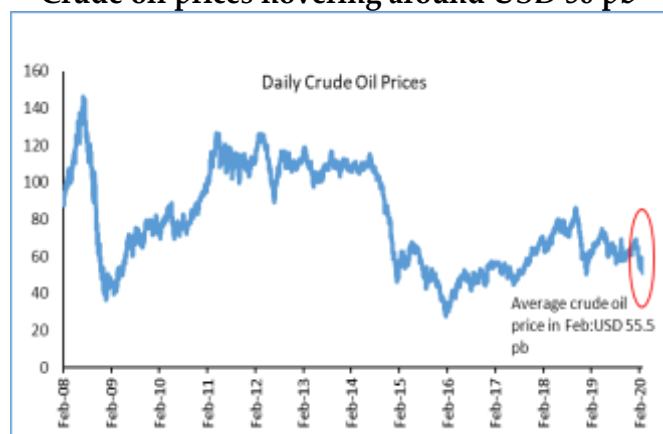
Second and perhaps most importantly, India is being seen as a potential alternative sourcing base for products that are either produced in China or in economies that are heavily dependent on inputs from China. This is not to suggest that India is not dependent on China for its input or final product imports –in electronic devices its dependence is large. However, for other categories like textiles it is more insulated than its Asian peers. This in our opinion will continue to give the INR an edge.

Other support for the INR could emanate from lower crude oil prices. To recall, crude oil prices have corrected by 21% since the outbreak of the COVID-19 and are hovering around USD 50 pb as on 28th Feb-20 as concerns about the economic impact of COVID-19 weighed on the oil demand outlook. Going forward, we expect crude oil prices to remain contained in the near term (in the range of USD 52-56 pb) amidst the coronavirus related demand slowdown. In addition, a comfortable current account deficit (1.8% of GDP) in FY20 as India stands to benefit from the lower crude prices (being a net oil importer) and on account of lower non-oil imports, is also likely to keep pressure on the INR in check.

Furthermore, the RBI has sufficient FX reserves in its kitty to fund import bill for another 11-12 months, implying that RBI can intervene in the spot market as and when required. We reckon the aforementioned factors should provide support to the INR.

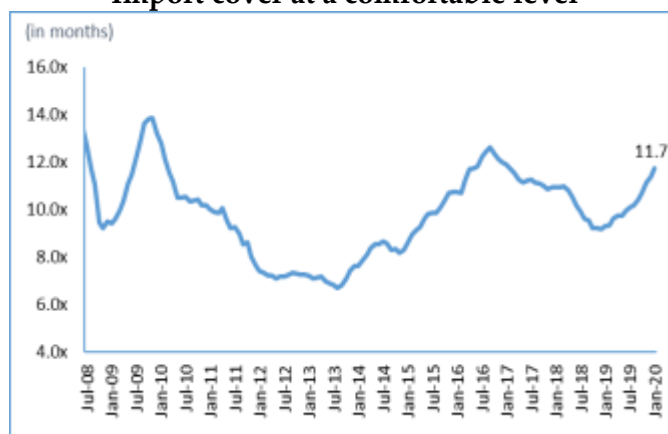
Finally, the hopes of a synchronized global fiscal and monetary stimulus could rein in depreciation pressures on all non-USD currencies including the INR. This "stimulus includes" a rate cut by the US Fed as early as Q2 CY2020.

Crude oil prices hovering around USD 50 pb



Source: Reuters and HDFC Bank

Import cover at a comfortable level



Source: Reuters and HDFC Bank

Imported Manufacturing Inputs from China as a % of total imported Manufacturing inputs

	Food & Drinks	Textiles	Chemicals	Rubber & Plastic	Electronic devices	Electrical machinery	Autos & Parts
Vietnam	12	47	22	29	41	39	40
Malaysia	14	42	14	19	29	28	25
Thailand	17	38	16	23	39	31	27
S. Korea	16	44	15	24	45	33	29
Taiwan	9	29	12	19	36	30	21
Phillipines	14	38	19	22	18	29	18
Singapore	8	21	6	7	6	9	9
Indonesia	12	36	15	21	43	34	14
India	8	35	25	26	48	15	21

Source:IMF, HDFC Bank

How will the RBI behave?

The RBI's intervention in FX markets is typically asymmetric. It tends to prevent excessive appreciation by buying the USD either in spot or forward markets with an eye on competitiveness. Its interference when the INR depreciates is less for the same reason of competitiveness. Thus for a while if other EM currencies continue to shed weight the central bank is unlikely to intervene in the market except to iron out excess volatility. This, in lay terms, means that our central bank could sell dollars in periods of very rapid fall in the INR.

However, a run on the INR amidst large scale capital flight is likely to see the RBI step in a bigger way both through spot and forward market intervention and perhaps change in policies related to the FX market:

- For one thing, the coronavirus is to an extent a stagflation-inducing supply shock. Thus while it will compress global demand for things like oil, it will create quick but acute supply shortages in a number of items that are either produced in or depend on inputs from virus –affected regions. A sharply depreciating INR will exaggerate the “imported inflation” pressures. Thus from an inflation management perspective, there is a reason for the RBI to halt the fall in the INR.
- Rapid depreciation in the midst of a rush to safe havens often exaggerates capital flight. Thus the central bank might want to break a vicious cycle of depreciation, capital flight and further depreciation.

The level at which a healthy correction in line with peers’ morphs into a crisis of confidence and a run is difficult to gauge. We see a high probability of the RBI step in and try and at least break the momentum if the INR were to head towards 74 and breach that level.

Finally, is there a risk to our forecast?

We understand that there we are broadly with the consensus in calling for further pressures on the INR. As with all consensus forecasts there is a non-negligible probability of a contrarian move in asset markets. How would this pan out?

We recognize two things. US equity markets have seen a massive dip over the past week while the safe-haven bid has pushed US treasury bond prices to record levels. The treasury rally prices in aggressive rate cuts by the Fed and if this expectation gets entrenched it could stanch the bleeding in non-safe-haven asset classes.

The DJIA has led the pan-market fall in asset prices and exchange rate depreciation. This has introduced a high beta in the relationship between US equities and all other asset classes that have seen a sell-off. If the DJIA were to find a bottom and recover (partly on pure value buying and partly baking expected rate cuts) and these betas were to remain significant, asset markets including the USD-INR market could follow. In such a situation a range of 72-73 could be toppish for the pair followed by a tilt to the down-side.

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