Where is the Rupee Headed - 60 or 70?

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Lets just rewind a little to the beginning of 2017 when the Rupee was on the brink of breaking 69 against the US Dollar. The consensus market expectations then were that the Rupee would soon break the 70 mark, the US Dollar index would attempt 110 and that the US 10 year yields would head higher to 3.5%. There was a lot of anticipation around the new US president's populist policies stoking inflation and ultimately pushing the US yields and the US Dollar higher (popularly known as the Trump trade). These expectations were justified then as market participants felt that it would be a cakewalk for a Republican president with a Republican majority in the Senate and a Republican majority in the House of Representatives to push through legislative reforms. Of course it did not pan out that way and Trump trade fizzled out. The thing here is that expectations and views can definitely go wrong but it is important how quickly one reassesses the big picture and positions accordingly? How quickly one gets rid of what behavioral economists refer to as the anchoring bias? How quickly one realizes that a move is not a retracement but a reversal? How quickly one gives up hope of Rupee going to 70 (in this case)…when it is at 68 or 67 or 66 on the down move? As the Indian economy gets more integrated into the global fabric, it is important to closely track global economic and political de-velopments (sometimes more important than tracking domestic headlines and data) to capture the market pulse and sense key macroeconomic shifts earlier than others do. What the US Federal Reserve does or what happens in Capitol Hill directly impacts the Rupee.

In fact, the move from 69 to 63.55 can be attributed largely to yield seeking hot money inflows. It has got little to do with domestic macroeconomic strength in my opinion. As the Trump trade/reflation trade collapsed, so did the US yields. Pursuit of higher yields drove money into emerging market stocks and bonds, causing the currencies of these economies to appreciate (also referred to as carry trade). Rupee has appreciated in line with other Asian currencies such as the Korean Won, Taiwanese Dollar, Thai Baht.

India, on account of its sound fundamentals and stable governance has been one of the biggest beneficiaries of hot money inflows but not the only one. Certainly when the global liquidity tide turns (unwinding of carry trade) India would not remain insulated and Rupee would depreciate in line with other currencies then. What substantiates the opinion that the Rupee rally has got little to do with domestic factors is the fact that most of the high frequency data such as PMIs, IIP, core sector data have pointed to deceleration in domestic industrial activity post demonetization. The output gap continues to remain negative, which indicates that there is excess capacity. The economy is operating below its potential output and therefore private capex cycle is not picking up. Growth in credit off take is at a multi year low and continues to remain sluggish. Corporate earnings growth has also not picked up to warrant current exorbitantly high stock valuations. What makes India's fundamentals appear robust are a combination of three factors; low global crude prices, strong Rupee and normal monsoons. These three factors combined have kept a lid on inflation, resulting in high real rates and this is what is continuing to draw inflows, especially into the debt markets (The debt market utilization limits are running close to 100% for FPIs for both government as well as corporate bonds). There are other concerns on the domestic front as well such as the NPA situation of banks and fiscal deficit of states. Though the center may achieve its fiscal deficit target for the financial year, finances of state governments are in tatters and may deteriorate further due to farm loan waivers, increase in MSPs and implementation of pay commission. The combined fiscal deficit of state and center is therefore alarming.

Though Rupee appreciation helps keep inflation under check, it poses another set of challenges. Our exports priced in foreign currency terms become expensive if Rupee appreciates more in comparison to those of other countries which compete for the same share of export pie. In case of sectors where the cost of switching for the overseas buyer is low, it can severely hurt exports. Earlier government used to extend sops to such sectors by way of export promotion schemes, interest subventions, tax breaks etc. but as India is a signatory to the WTO (World Trade Organization), it will eventually have to phase out such sops. Also, one-sided intervention by the central bank to protect the Rupee can be considered by trading partners as manipulative. Therefore the only ways for exporters to stay competitive is by improving productivity (reduce operating cost by embracing automation and improving skills of labor force), by differentiating product offerings and by hedging exposures efficiently*.

What will continue to drive the Rupee going forward would be the yield differential between the US and India which in turn will be driven by Federal Reserve monetary policy to a large extent. Currently despite the US economy being close to full employment, wage and price pressures are moderate. This coupled with the inability of Trump administration to pass legislative reforms is allowing the Federal Reserve to hike rates gradually. Any spike in inflation or wage growth can drive up US yields and push the US Dollar higher. The Federal Reserve is likely to announce balance sheet reduction in September and may keep the December rate hike data dependent. Balance sheet reduction is likely to be calibrated and is not likely to be disruptive for the emerging markets. However, announcement of corporate tax reforms could result in a reversal for the US Dollar. National Economic Advisor, Gary Cohn has been categorical in stating that the US cannot have a higher tax rate than OECD average and that tax reforms is his number one priority this year. The RBI monetary policy will depend to a great degree on the pace of Fed rate hikes. If Fed indicates that pace of hike rates would be faster than what is currently factored in by the markets, it will be difficult for the RBI to cut rates from here on.

Euro has thrashed expectations of those who felt parity with the US Dollar was inevitable. Though the ECB has indicated that asset purchases would continue well into 2018 and that rate hike would happen only after asset purchases have stopped, the Euro has rallied. This is because the business confidence and economic sentiment indicators of most of the Eurozone economies have improved and markets believe the ECB is behind the curve as far as monetary policy action is concerned. This macroeconomic shift has completely altered the view on the Euro and real money institutions are buyers of Euro on dips. 1.20 is a key psychological level on the up side whereas 1.1490 would be a key support from a medium term perspective.

The Bank of England has signaled that the pace of rate hikes would be more gradual as compared to previous hiking cycles due to Brexit related uncertainties. High inflation on account of weaker Sterling (postBrexit) has reduced real wage growth and this could hurt consumption in the UK. Sterling continues to remain a sell on rallies due to uncertainties around Brexit negotiations. 1.25 is the likely target on the down side. A break above 1.3250 would require a reassessment of this view.

As far as Rupee levels are concerned; as we saw in the beginning of this article; in February market expectations were skewed to the up side (towards 70 and above). At this point too the expectations are skewed albeit in the opposite direction (towards 61-62). A break above 64.90 would imply a reversal and may require us to shed our anchoring bias again. In order to benefit from a sudden spike in Rupee, exporters can consider hedging their exposures through a combination of forwards and options. For example, hedging a part of the exposure through forwards ensures that for-ward premium or carry is not missed out on and hedging the other part through zero cost risk reversals ensures that down side is protected and up side participation is retained (in case Rupee breaks out on the up side).

**Another challenge that Rupee appreciation relative to other currencies poses is that there is a chance of domestically manufactured goods being replaced by cheap imported substitutes. For example, our trade deficit with China was USD 50Bn in 2016. It may widen further if Rupee continues to appreciate against the Chinese Yuan. This could affect domestic manufacturers adversely.*