CURRENCY OUTLOOK

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INR to range between 75-76/$

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INR has depreciated sharply today in the aftermath of Fed policy. This is mainly because of a strengthening dollar, as Fed signalled beginning of its rate-hike cycle from Mar'22. This along with rising US yields and inflation-growth dynamics is likely to push the dollar up. This implies further pain for INR, at least in the short-term. We expect INR to trade with a depreciating bias over the next two-weeks. However, over the medium-term, strong macro fundamentals will ensure INR in the range of 75-75.5/$.

Currency movements in Jan'22: Most global currencies have depreciated against the dollar in CY22. After increasing by 6.4% in CY21, DXY has gained another 0.8% this year. However, EM currencies have fared better, led by Brazilian real (up by 2.4%) and Chinese yuan (up by 0.6%). On the other hand, developed market currencies have been the biggest loser this year led by EUR (down by 1.1%) and GBP (down by 0.5%).

DXY strength likely to continue: Fed's hawkish tilt, US growth and inflation dynamics as well as rising US yields have buoyed the demand for dollar. We expect the trend to continue in CY22. As such, we believe DXY to rise further this year.

Drivers of INR performance: GDP growth is expected to be strong in FY22. This should spur foreign inflows in the form of FPI, FDI and ECB inflows. However, high inflation is likely to weigh on INR. Further, with oil prices touching US$ 90/bbl, INR is likely to come under renewed pressure. Higher oil prices imply a larger import bill which is negative for INR. We estimate that a 10% hike in oil prices leads to US$ 15bn increase in CAD. On the positive side, India's foreign exchange reserves have remained at a comfortable level and hence lend stability to the rupee.

Outlook for INR: Overall, we expect INR to depreciate in the near-term pressure due to Fed tightening and higher oil prices. INR has depreciated sharply by 0.8% today (biggest single day fall since Jun'21) in the aftermath of the Fed policy. We expect INR to trade in the range of 75-76.0/$ for the next two weeks.

However, over the medium-term, India's external position remains comfortable which should support foreign inflows. However, trade deficit is likely to expand further. We expect INR in the range of 75-75.5/$ in Q4FY22. Higher oil prices remain a key risk in our view.

Important disclosures are provided at the end of this report.

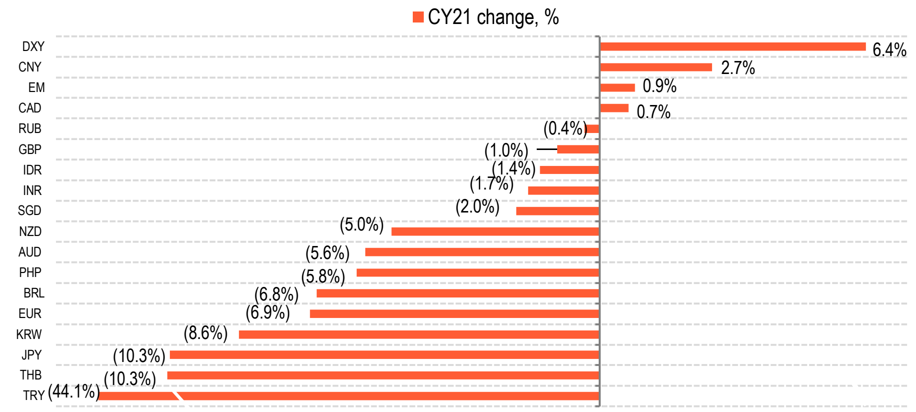
Currency movement

Currency movement in CY21

DXY appreciated sharply by 6.4% in CY21 as prospects of US growth recovery gained strength and continued to outperform other major advanced economies. US GDP increased by 5.6% in CY21, compared with Euro Area at 5.2% and Japan at 1.6%. GDP growth in UK rose by 7.2% but this was mainly attributed to base effect (GDP contracted by 9.8% in CY20). (World Economic Outlook, Jan'22).

JPY and EUR declined sharply by 10.3% and 6.9%. GBP depreciated by only 1% supported in part by BoE's surprise rate hike in Dec'21. Amongst EMs, while CNY strengthened by 2.7%, other currencies were mostly lower against the stronger dollar. Turkish lira fell by the highest magnitude of 44.1% driven by sub-optimal monetary and fiscal policies pursued.

Fig 1 – Currency movements in CY21



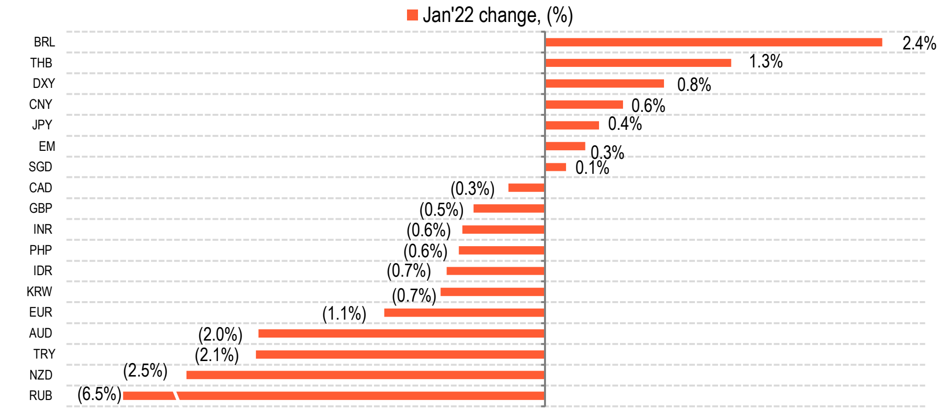
Source: Bloomberg, Bank of Baroda Research | Data as of 26 Jan 2022

Currency movement in Jan'22

DXY has strengthened by 0.8% in Jan'22 after remaining range-bound in the run-up to the FOMC meeting. However, DXY has appreciated by another 0.7% since then as the Fed signalled the beginning of its rate-hike cycle from Mar'22. RUB has depreciated the most by 2.7% in Jan'2021 despite having the benefit of higher oil prices. Tensions with Ukraine weighed on the rouble.

INR has depreciated by 0.6% in Jan'22 weighed down by higher oil prices. However, other EM currencies such as Brazilian real (2.4%) and CNY (0.6%) have fared better. EUR however, continues to depreciate and has lost another 1.1% this month.

Fig 2 – Currency movement in Jan'22

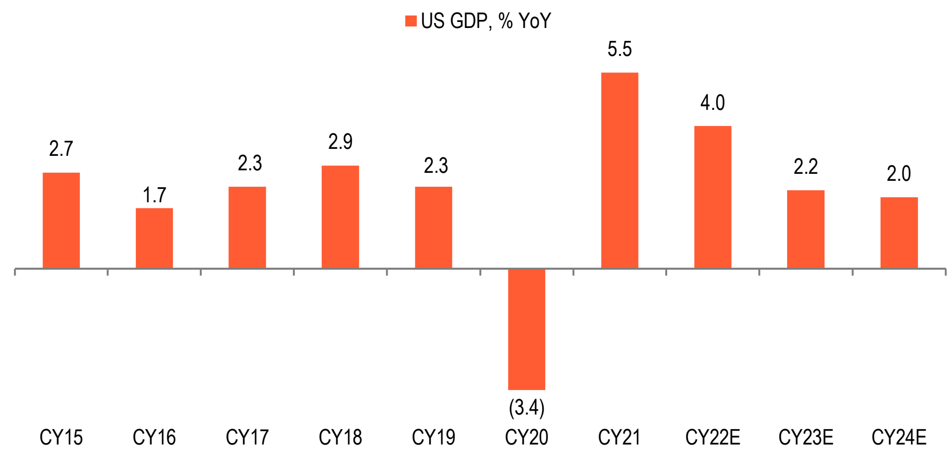


Source: Bloomberg, Bank of Baroda Research | Data as of 26 Jan 2022

Why has the dollar been gaining strength?

One of the major reasons for the strengthening of the dollar which is reflected in the DXY is that the US economy is expected to rebound strongly by 5.6% in 2021 which will be sustained albeit at a lower rate of 4% in 2022. IMF estimates growth at 4% for CY22 and 2.6% for CY23.

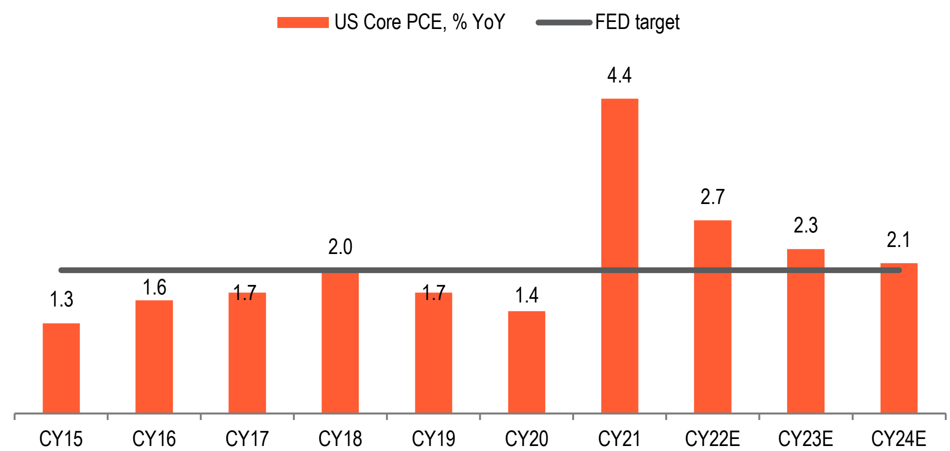
Fig 3 – US GDP growth expected to be strong



Source: Bloomberg, Bank of Baroda Research | E-FOMC median projections Dec'21

Along with higher GDP growth the Fed expects inflation to move up to 2.6% in CY22 and 2.3% in CY23. Inflation (core PCE) presently is at 4.7% (Nov'21) which has led to expectations of an earlier than expected rate hike by the Fed to quell inflation. This has again worked in strengthening the dollar.

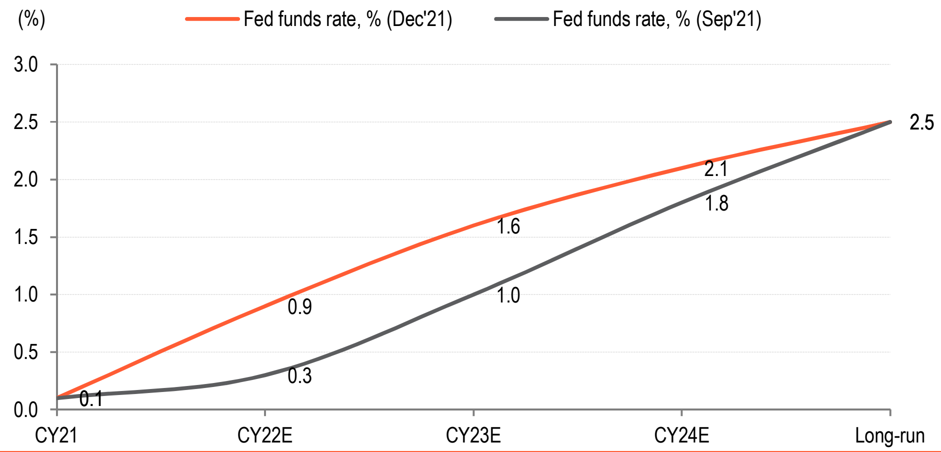
Fig 4 – US inflation expected to remain above Fed's target



Source: Bloomberg, Bank of Baroda Research | E-FOMC median projections Dec'21

The Fed stance points towards at least 2-3 rate hikes in CY22. In its latest policy meeting, the Fed signalled ending its ultra-loose pandemic-era monetary policy. It notes that "With inflation well above 2 percent and a strong labour market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate." It signalled the first rate-hike in Mar'22.

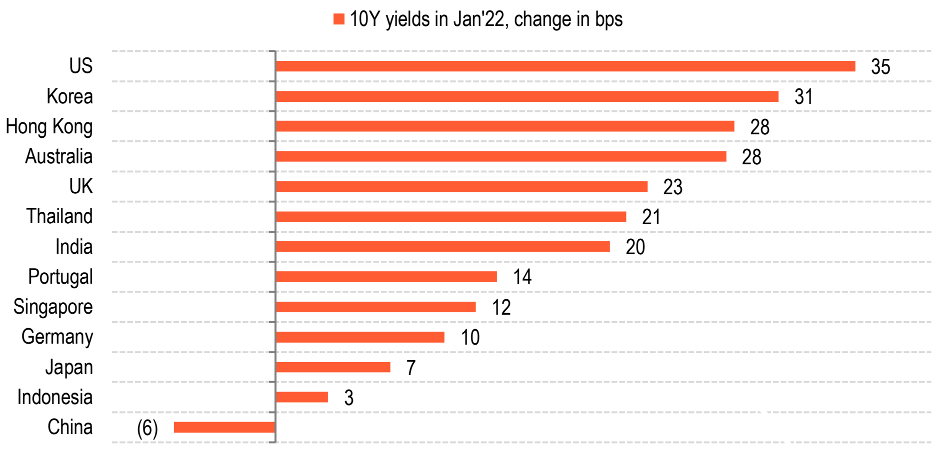
Fig 5 – Fed turning increasingly hawkish



Source: Bloomberg, Bank of Baroda Research | E-FOMC median projections Dec'21

Not surprisingly US yields have been rising recently led by a sustained recovery in US as well as Fed's hawkish tilt. While yields have increased elsewhere as well, US yields have risen by much more pushing the yield differential in favour of the dollar.

Fig 6 – US 10Y yield has risen by 35bps in Jan'22



Source: Bloomberg, Bank of Baroda Research | Data as of 26 Jan 2022

The combination of high potential growth and inflation in US along with rising Fed rate has meant that there would be a change in the direction of flow of funds to other markets. This has led bond yields across markets to increase as the contagion effect has led most players to expect their central banks to increase rates. The setting has been just about right with inflation rising across due to higher commodity prices. The chart above shows how these yields have moved since the beginning of the year. In case of India it has been 20bps while it is as high as 20-30bps in several EMs. Interestingly, it has come down in case of China.

How has the rupee performed?

The performance of the rupee can be judged on two metrics. The first is the extraneous factor where the dollar rises which pushes down others. This is something few currencies are immune to. The other is fundamentals.

Growth and inflation

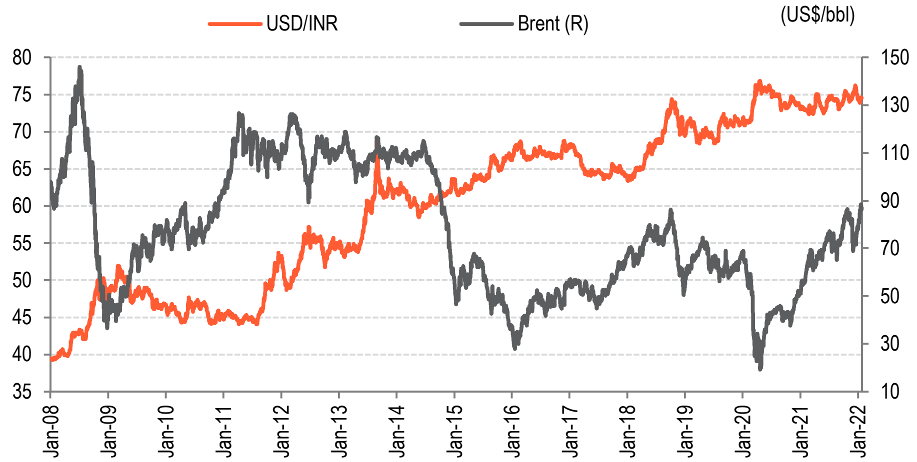
Underlying growth drivers strong, India will be one of the fastest growing economies in the world. As per CSO estimates, India's GDP is expected to grow by 9.2% in FY22. While there has been an increase in Covid-19 cases, states have refrained from imposing stringent lockdown like restrictions. This bodes well for growth. Further, with improved vaccination rates, the severity of further waves of infections is likely to be milder. Hence, we expect growth momentum to continue. This will attract foreign inflows into India which should support INR in the medium term.

High inflation remains a cause of concern. Inflation has been running higher than RBI's target for some time now. High inflation will drive INR lower.

Trade deficit and oil prices

Trade deficit/oil prices-Higher oil prices will push trade deficit higher. Trade deficit is tracking higher at US$ 139.2bn in FYTD22 (Apr'21-Dec'21) compared with US$ 100.4bn in FY21, and US$ 161.4bn in FY20. This is due to higher commodity prices (including oil) as well as a recovery in demand. With oil prices hovering above US$ 80/bbl, we expect trade deficit to expand further. We estimate that a 10% hike in oil prices pushes CAD upwards by ~15bn or 0.4% of GDP. This will weigh on INR. It must be noted that the correlation between oil prices and rupee is fairly high at -0.6.

Fig 7 – Higher oil prices to put pressure on INR

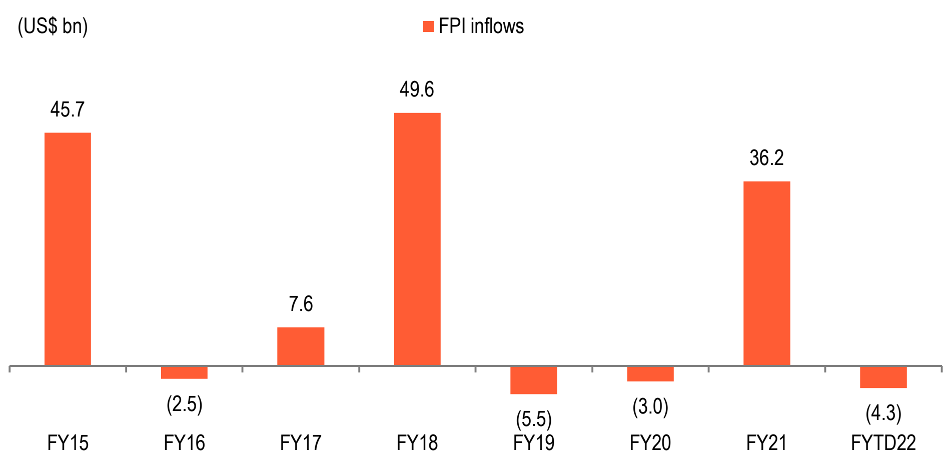


Source: Bloomberg, Bank of Baroda Research | Data as of 26 Jan 2022

Foreign inflows

FPI inflows are likely to recede as Fed is likely to be more hawkish than RBI and other major central banks. In 2013-14, Fed announced plans to taper its asset purchase programme, which resulted in sharp FPI outflows from India. This led to a sharp depreciation in INR. Rate hikes by Fed will likely cause FPI outflows from emerging economies such as India. However, it might not be to the extent that was seen during the "taper tantrum". Strong IPO pipeline as well as possibility of India's inclusion in global bond indices can buffer against sudden sharp FPI outflows.

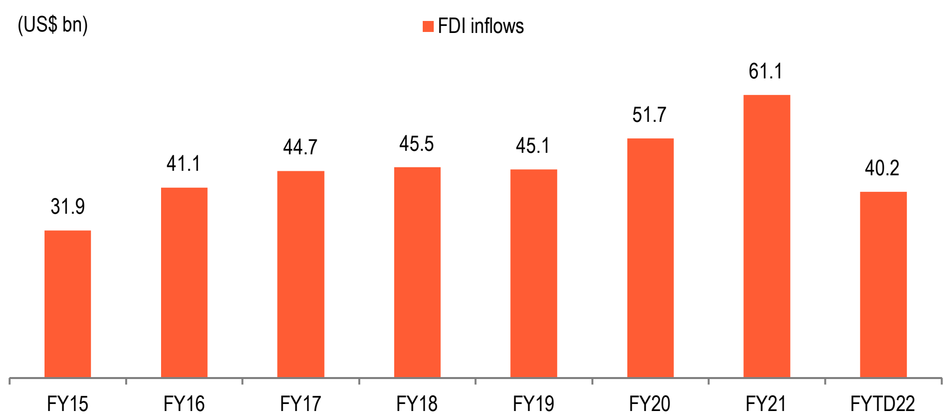
Fig 8 – FPI outflows of US$ 4.3bn in FYTD22



Source: Bloomberg, Bank of Baroda Research | FYTD22-Apr'21 to 21 Jan 2022

FDI inflows into India have been rising consistently over the last few years. In fact, India received record FDI inflows of US$ 61.1bn in FY21 despite disruptions due to Covid-19. In FYTDD22 as well, FDI inflows have remained robust at US$ 40.2bn between Apr'21 to Nov'21. With the growth momentum expected to remain strong, we expect FDI inflows to remain buoyant.

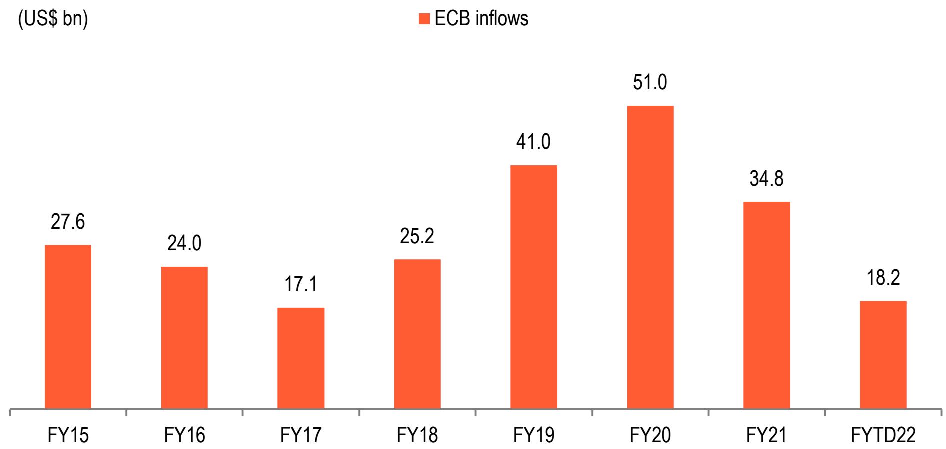
Fig 9 – FDI equity inflows continue to increase



Source: Bloomberg, Bank of Baroda Research | FYTD22-Apr'21 to Nov'21

After rising to a high of US$ 51bn in FY20, ECB inflows dipped to US$ 34.8bn in FY21. However, with economic activity picking up, Indian companies are now increasingly looking at external financing at cheaper rates. This is likely to continue in the rest of FY22 as well.

Fig 10 – ECB inflows buoyant



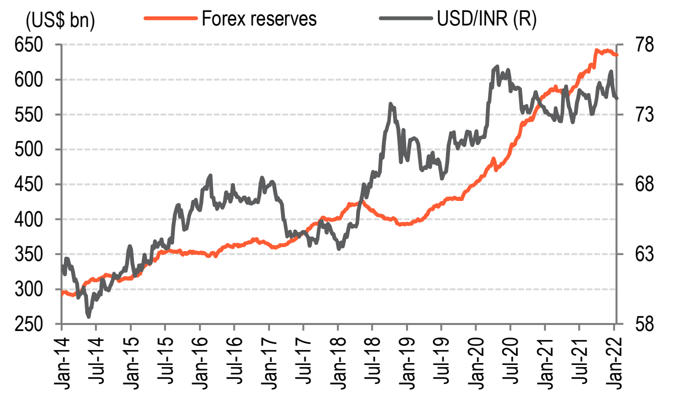
Source: Bloomberg, Bank of Baroda Research | FYTD22-Apr'21 to Nov'21

Foreign exchange reserves

The ultimate impact of fundamentals get reflected in the forex reserves position. As can be seen there has been an increase of US$ 55.7bn so far this year (Apr'21 to Jan'22). India's foreign exchange reserves remain at a comfortable level, which is positive for INR.

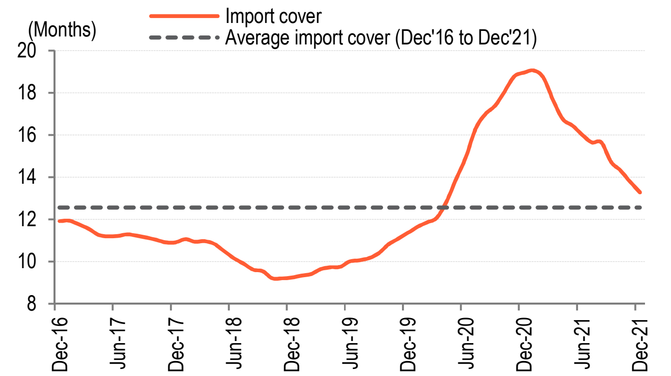
There has been a steady dip in India's imports cover after reaching a peak of 19.1 months in Jan'21. This is because imports have risen sharply this year on the back of pent-up demand. Even so, import cover remain above its long-term average of 12.7 months. As of end-Dec'21, India's import cover is at a healthy level of 13.3months implying that it can comfortable cover about 13 months of imports.

Fig 11 – Foreign exchange reserves at comfortable levels



Source: Bloomberg, Bank of Baroda Research | Weekly data as of 14 Jan 2022

Fig 12 – Import cover also above long-term average



Source: Bloomberg, Bank of Baroda Research

Outlook for the rupee

We expect some near-term pressure on INR due to Fed tightening and higher oil prices. In fact, INR has depreciated sharply by 0.8% today (biggest single day fall since Jun'21) in the aftermath of the Fed policy. We expect INR to trade in the range of 75-76.0/$ for the next two weeks.

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