

Currency Outlook

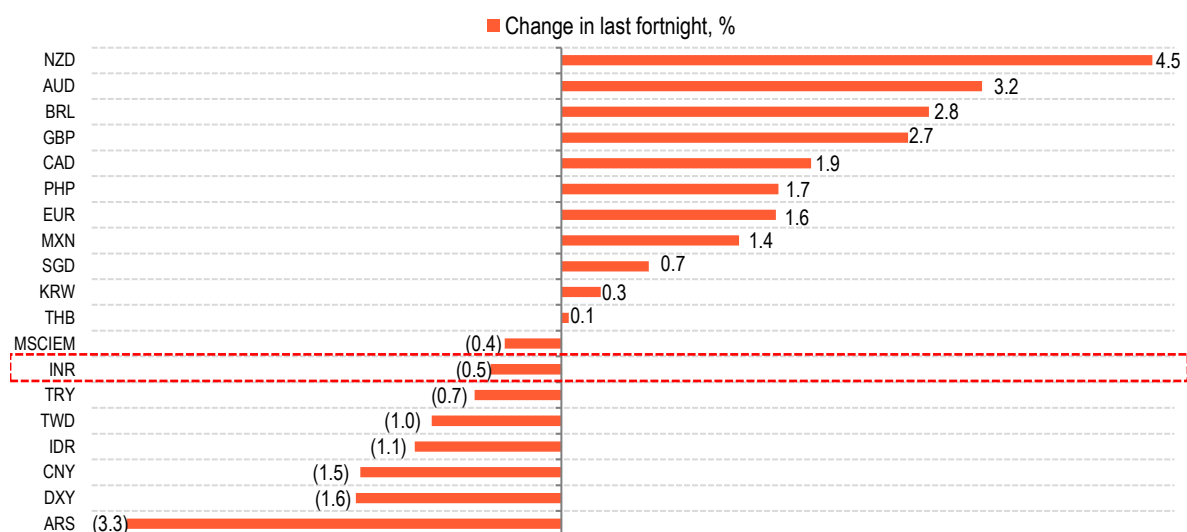
Focus on Fed

INR depreciated by 0.5% in the last fortnight even as DXY retreated from a 20-year high. While expectations of a likely slowdown in pace of Fed rate hikes drove DXY lower, slowdown in pace of FPI flows and dwindling macro fundamentals drove INR lower. Fed decision and commentary will determine the trajectory of the dollar, which in turn will determine the movement in INR. In the absence of any shocks, we expect INR to trade in the range of 82.5-82.95/\$ in the near-term.

Currency movement in the last fortnight

DXY index retreated in the last fortnight as concerns over growth buoyed expectations that the Fed may pivot from its rate hike path. Stress in the housing segment as well as weakness in consumer spending do not bode well for the economic outlook. As a result, while a 75 bps rate hike is imminent this week, investors have now pared back expectations of future rate hikes, with many analysts now expecting only a 50bps rate hike in Dec'22.

Figure 2: Global currencies depreciated in Sep'22



Source: Bloomberg, Bank of Baroda | Data as of 31 Oct 2022 | Note: Figures in bracket denote depreciation against USD

Despite the weakness in DXY, global currencies were mixed in the fortnight. NZD and AUD rose sharply as CPI inflation inched up further, raising hopes of further rate hikes. Notably, while Reserve Bank of New Zealand has continued with aggressive rate hikes, Reserve Bank of Australia has slowed down the pace of rate hikes in its recent policy meet. Political developments in UK and Brazil drove their respective currencies higher. Further, expectations that the Bank of England may accelerate the pace of its rate hike to 75bps (highest in almost 30 years) this week, as inflation continues to surge, also pushed GBP higher. EUR too gained 1.6% in the fortnight as European Central Bank raised policy rates by another 75 bps. However, concerns over growth capped gains.

On the other hand, EM currencies fell by 0.4% in the fortnight led primarily by a fall in CNY. CNY declined by 1.5% due to a worsening economic outlook amidst China's strict Covid zero policies. China's official manufacturing and services PMI for Oct'22 slipped into the contraction zone.

What about INR?

Despite a weaker dollar and lower oil prices, INR depreciated by 0.5% in the last fortnight. For the month, INR is 1.7% lower. Weakening domestic fundamentals as well as a slowdown in FPI flows may explain the fall in rupee. The outlook for INR remains heavily dependent on the dollar trajectory. Trade deficit has remained elevated. Inflation too continues to remain uncomfortably high. On the other hand, foreign exchange reserves have fallen to a more than 2-year low. Overall, we expect a range of 82.5-82.95/\$ for INR in the near-term.

Fed meeting this week will be key, as investors will look for any dovish undertones in its commentary, failing which we may see a resumption in the dollar rally. This will be detrimental for the rupee and may lead to a knee-jerk reaction in the currency market. RBI too has announced an unscheduled MPC meet this week, however no rate action is expected.

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