Explained: How a more aggressive US Federal Reserve impacts India and emerging markets

Investors used to stellar market returns may have to taper expectations

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The US Federal Reserve building in Washington DC | Reuters

The year was 2013. With the 2008-09 global financial crisis now firmly in the rearview mirror, the US Federal Reserve announced it would soon end its easy money policy. Just the talk of the taper tantrum, as it was called, led to an exodus of money from emerging markets, and stocks crashed.

2022 feels like 2013 as the US central bank move to quicken its pace of reducing its bond purchases and return to a more normalised monetary policy has sent shockwaves in EMs and foreign institutional investors are pulling out their funds in huge numbers.

In the last two years, the Fed as well as other major global central banks slashed interest rates to a record low and pumped in abundant liquidity in the system to lift the economy ravaged by the Covid-19 pandemic.

However, as the global economy has begun to rebound, inflation has shot up to levels that central banks can no longer ignore. In the US, consumer inflation has hit 7 per cent, levels not seen since the 1980s.

That has prompted the Fed to turn ever more aggressive in a bid to tame inflation. At present, the Fed’s benchmark overnight interest rate is at near-zero levels and Fed chairperson Jerome Powell said on Wednesday, that the interest rate may be raised in March.

There is a growing [illegible] investors and analysts that the Fed will increase rates as many as four times this year. This is way quicker than at best one rate hike that was earlier expected and is therefore bound to have some impact on EMs, including India.

The BSE Sensex and the NSE Nifty 50 indexes cracked 1 per cent on Thursday amid sustained selling pressure. In the past two weeks alone, the benchmark equity indexes are down over 6 per cent. Given that the markets had only largely seen a one-way rally since March 2020 (22 per cent returns in 2021 alone), analysts say a correction was overdue and there could be more volatility ahead.

The course correction by the US Fed is one reason. There are other worries too. The pandemic continues to cast its shadow on global growth; the International Monetary Fund recently cut its global growth forecasts for the year, in the wake of the Omicron variant of the coronavirus that has spread rapidly in the last few weeks. There is also growing border tension between Russia and Ukraine that has raised concerns about whether there will be an all-out conflict. That, coupled with drone attacks on oil facilities in UAE last week, have driven crude oil prices back to around $90 a barrel.

“The markets had already moved significantly higher. There will be jitters whenever you see such confluence of events happening, liquidity being withdrawn, rate hikes being conducted, hikes by few other countries in Europe and Latin America as well,” said Mayuresh Joshi, head of equity research at William O’ Neil.

Inflation is largely expected to remain sticky this year across markets, with demand picking up at a good pace and supply-side issues likely to remain, he feels. This has led to worries that global liquidity will dry up and the cost of borrowings will increase.

“Till a month back the quantum of interest rate hikes (by Fed) was disputed. People still believed that inflation would be transitory. However, with inflation being sticky, there is no confirmation whether it stops with a 50 bps or 75 bps rate hike. But, if d ... led Joshi.

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“Higher outflows from the domestic markets can be expected as the higher interest rates in the US makes EMs such as India less attractive,” said Kavita Chacko, senior economist at CARE Ratings.

So far in India, foreign portfolio investors have pulled out Rs 22,722 crore from India’s equity market. This is on top of the Rs 38,500 crore they pulled out in the October-December 2021 period. With such an exodus, further market volatility in the near term can't be ruled out.

“The market going down is broadly being driven by FIIs pulling out money and with less support from domestic institutions. Right now it is uncertain to what extent the Fed is going to increase the rates. There is uncertainty around the political situation in Ukraine too. Such uncertainty creates volatility and confusion and that is the problem right now,” said the CEO of discount broker 5Paisa.com.

Sustained FII outflows could in turn put pressure on the Rupee. On Thursday, the Rupee registered a fall for the third consecutive session and ended 31 paise lower at 75.09. In the last three sessions, the Rupee has fallen by 63 paise.

The rupee depreciation, as well as a more aggressive stance by the Fed, will weigh on the Reserve Bank of India’s monetary policy committee, which meets later this month.

Prasenjit Basu, the chief economist at ICICI Securities expects the Fed Funds rate to rise to 1.25 per cent by the end of calendar 2022.

So far the Reserve Bank of India has given preference to reviving economic growth, given that inflation has so far remained within its targeted 2-6 per cent range, albeit at the higher end.

However, aggressive monetary tightening by the Fed will invariably put pressure on EM central banks, said Basu.

While the current situation may seem very similar to the taper tantrum of 2013, India’s external balance sheet is in a far better position than it was back then. In the current financial year ending March 2022, India’s current account deficit is likely to be around 1 per cent of GDP, while back in 2013, it was approaching close to 5 per cent level. In the last two years, India’s foreign exchange reserves too have gone up considerably and stood at $635 billion in mid-January. These factors will augur well for India.

Against this backdrop, in the upcoming MPC meet, the RBI may well continue to maintain an accommodative policy stance and keep a status quo while focusing on its liquidity management programme to normalise the monetary policy, said Care’s Chacko.

Joshi of William O’ Neil too believes the RBI’s move will be driven more by domestic factors. The RBI may at most raise interest rates by 50 basis points in the current calendar year, he felt.

“With the Indian economy sustaining a strong recovery, the RBI will be more amenable to raising interest rates in response to the persistence of high inflation, and we expect the policy rate to rise by 50 bps through 2022,” he said.

As such say analysts, investors used to stellar market returns since March 2020, may have to temper their expectations this year, and even as the central bank may choose to keep rates on hold in the upcoming MPC meet, interest rates are largely going to move up in 2022.

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