Rupee Outlook for H2FY24

September 22, 2023 | Economics

Overview

The Indian Rupee has recently breached the 83-level against the US Dollar, but its decline has been curtailed by interventions by the Reserve Bank of India (RBI) across various markets, including the spot, Non-Deliverable Forward (NDF), and futures markets.

In the coming second half of the fiscal year 2023-24, we anticipate the USD/INR exchange rate to fluctuate within the range of 82 to 84, gradually gravitating toward the lower boundary of this range. This projection marks a shift from our prior forecast of 81 to 83. The Federal Reserve's hawkish stance, communicated during the September meeting, is expected to sustain elevated yields in the US Treasury market and maintain strength in the US Dollar Index (DXY) in the short term. However, we anticipate US Treasury yields to moderate subsequently, as the Federal Reserve signals that interest rates have peaked, and as market participants re-evaluate their interest rate expectations when signs of weakness in the US economy become more pronounced in broader economic indicators.

The weakness in Chinese Yuan is expected to persist until China unveils substantial stimulus measures, and this is likely to exert downward pressure on the currencies of other emerging Asian markets. Tight supply conditions are projected to keep oil prices elevated in the near term; nonetheless, we anticipate a moderation in oil prices in the absence of substantial stimulus from China and as pace of economic growth in the United States begins to slow.

India's current account deficit is forecasted to remain manageable in FY24. Foreign Portfolio Investment (FPI) inflows are poised for recovery, driven by robust economic fundamentals and the eventual moderation of UST yields and the DXY. Furthermore, we anticipate that RBI interventions will persist, serving to mitigate rupee volatility and imported inflation.

Elevated UST Yields, Weak Yuan & Rising Crude Oil Prices Weighing on Rupee. However, RBI Interventions have kept USD/INR Range Bound.

Source: Refinitiv

Recent Selloff in US Treasury Yields Unlikely to Sustain

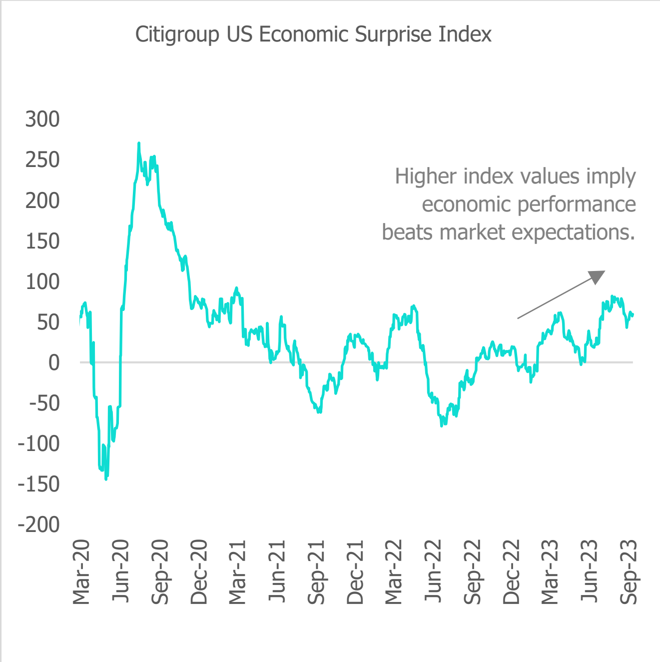
10Y UST yields have risen ~70bps over the past three months. DXY has strengthened ~6% over the same period. Markets have turned hawkish with respect to the timing and quantum of Fed rate cuts as recent data releases point to a more resilient US economy than previously thought. As per the CME FedWatch tool, markets largely expect the Fed to be done with rate hikes, however, the probability of a 25 bps rate hike in November 2023 has increased. Markets have pushed forward their expectations of a first rate cut to H2 CY24 from March 2024. They now expect the Fed to cut rates by less than 100 bps in 2024 as opposed to 125 bps rate cuts expected earlier. A higher supply of Treasuries is also weighing on yields. US Treasury has announced higher net market borrowings to fund its increasing budget deficit. The Treasury deficit in the first eleven months of the current fiscal year stood at USD 1.5 trillion i.e. 61% higher than the corresponding period a year ago. The Treasury now expects to borrow USD 1 trillion in June-September 2023, which is 36% higher than USD 733 billion expected earlier. Market borrowings in October-December 2023 are expected to amount to USD 852 billion or 128% higher than a year ago. Few market participants are also attributing the recent rise in UST yields to the Bank of Japan's tweak in its yield curve control policy and thin trading volumes.

During its September meeting, the Fed opted to keep its policy rate unchanged but provided a hawkish guidance. The median rate projection suggests an additional 25 bps rate hike in 2023, followed by a more conservative 50 bps rate cut in 2024, as opposed to the previously indicated 100 bps cut in 2024. The growth forecast was revised upward to 2.1% in 2023 from previous estimate of 1%. Unemployment forecast was revised downward to 3.8% in 2023 from 4.1%. Personal Consumption Expenditure (PCE) inflation forecast was kept unchanged at 3.3% in 2023. Core PCE inflation, which excludes food and fuel, was revised downward to 3.7% in 2023 from 3.9%. It anticipates that in 2024, growth will slow to 1.5%, inflation will moderate to 2.5% and unemployment will experience a slight uptick to 4.1%.

In our opinion, the recent surge in UST yields is unlikely to be a persistent trend. Given the robust economic data, US will probably avoid a recession. However, growth in US is still expected to moderate as Fed's 500 bps of rate hikes since March 2022 work their way through the economy. Elevated UST yields are already weighing on economic growth. Refinance costs and unrealised losses on banks' balance sheets have increased. Consequently, bankruptcy filings have risen, and banks are tightening credit conditions. Concerns surrounding these developments have led to downgrades of several US lenders. Additional vulnerabilities are evident within the US economy. For instance, the commercial real estate sector is struggling with low occupancy rates. Manufacturing activity has been contracting for ten consecutive months. Excess savings, which have been a key driver of consumption, are depleting. Households' expectations regarding their current and future financial situations have deteriorated. Going ahead, we anticipate these signs of weakness to reflect in broader economic indicators, prompting a re-evaluation of interest rate expectations within financial markets. We do not anticipate further rate hikes by the Fed and expect the UST yields to moderate once the Fed communicates that interest rates have peaked.

UST yields are likely to trade between 3.80-3.90% in the near term, which will support the rupee. DXY is likely to trade between 104-107 before softening to 100-104 as UST yields moderate.

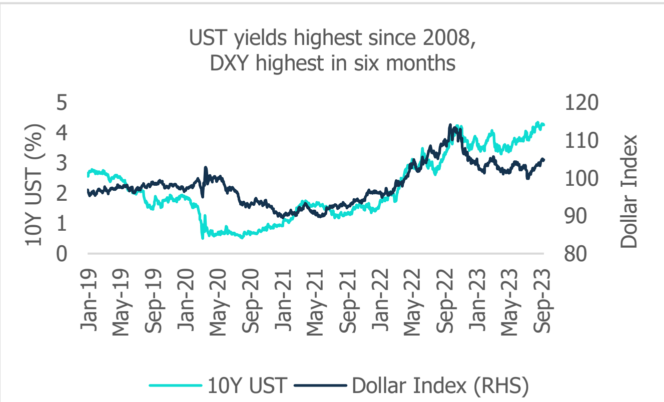
Investors Turn Hawkish as Recent Economic Data Surprises



Source: Refinitiv

- The Fed staff no longer expects the US economy would enter a mild recession towards the end of the year.
- Labor market showed signs of rebalancing in August. 187,000 jobs were added after downward revisions to previous two months. Unemployment rate unexpectedly rose to 3.8%. Average hourly wages rose 4.3% YoY, a smaller increase than in July.
- ISM Services PMI unexpectedly jumped to 54.5 in August 2023, pointing to the strongest growth in the services sector in six months.
- Earlier, market was expecting first Fed cut in March 2024 and total cuts of 125bps in 2024. Market is now expecting first Fed cut in H2 2024 and less than 100bps rate cuts in 2024. Further, probability of a 25bps rate hike in November 2023 has increased.

UST Yields and DXY Strengthen, Weigh on Rupee



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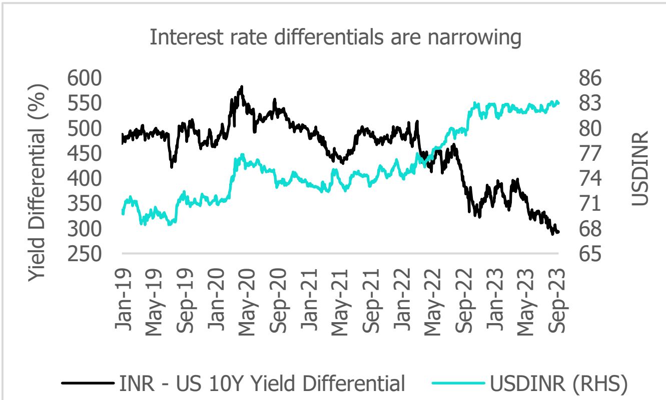
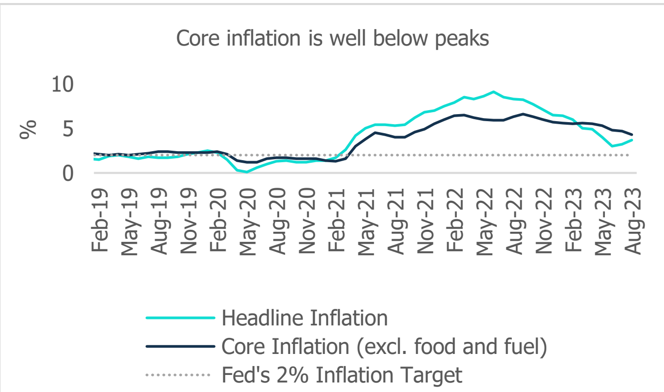


Source: Refinitiv

Rise in UST Yields Unlikely to Sustain as Inflation Cools & Impact of Past Rate Hikes Shows



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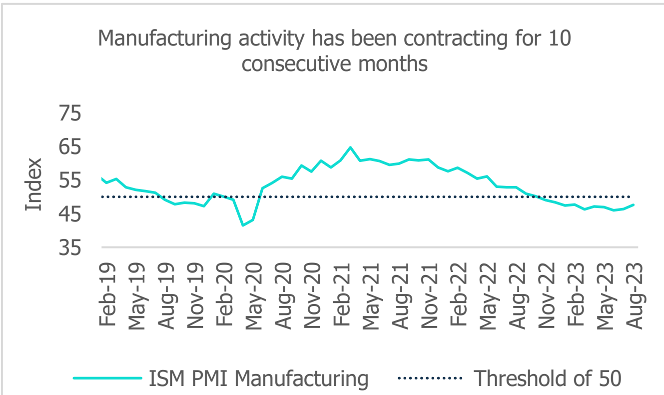

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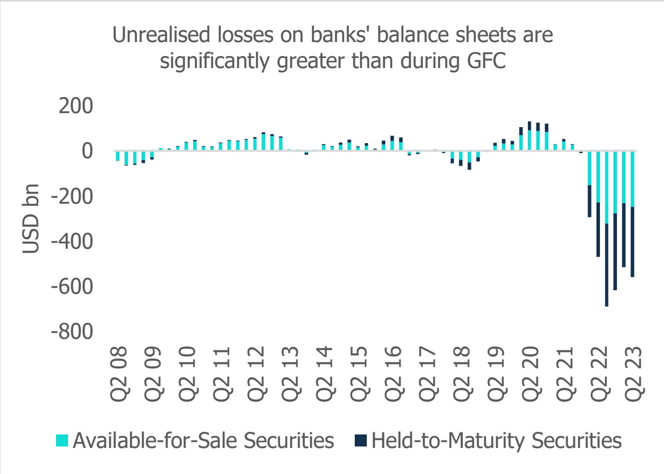
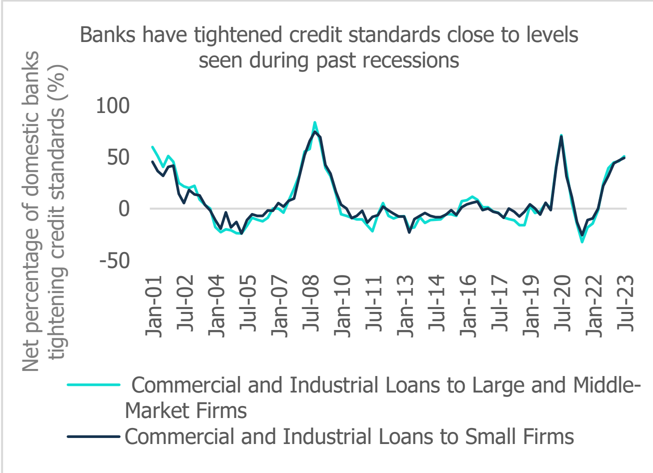


Source: Federal Deposit Insurance Corporation (FDIC)



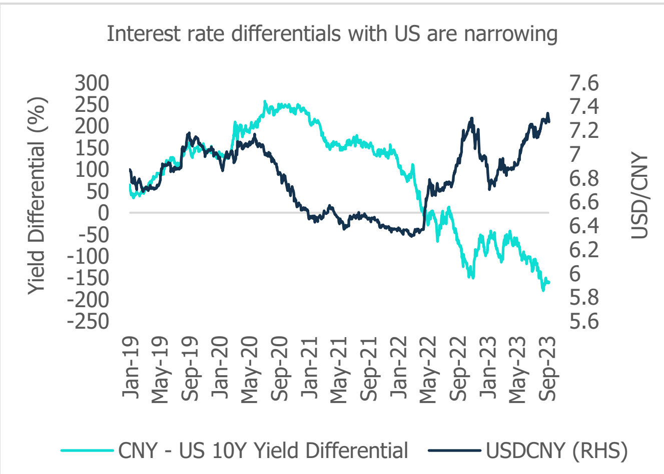
Source: Board of Governors of the Federal Reserve System

Yuan's Weakness Likely to Persist

CNY is one of the worst performing Asian currencies this year, falling around 5%. Despite a recent bout of stimulus measures, China's recovery following end of its zero-Covid policy remains disappointing and is weighing on yuan.

In our opinion, weakness in CNY is likely to persist until any meaningful fiscal stimulus is announced to revive consumption. Meanwhile, the PBoC is expected to offer monetary support by cutting interest rates further. This is expected to widen interest rate differentials with the US and weigh on CNY. However, any major depreciation in CNY is likely to be contained by the PBoC. PBoC has recently cut the foreign exchange reserve requirement ratio (RRR) by 200 bps to 4%. This is expected to release up to USD 16.4 billion worth of foreign exchange. Further, PBoC has issued statements that it will not withstand any excessive overshoot in the currency and has been aggressive with its daily CNY fixings. We expect USD/CNY to trade between 7.10-7.30 in the near term and pose depreciation risks to Asian EM FX, including the rupee.

Yuan Trades Near 16-year Lows, Weighs on Asian EM FX



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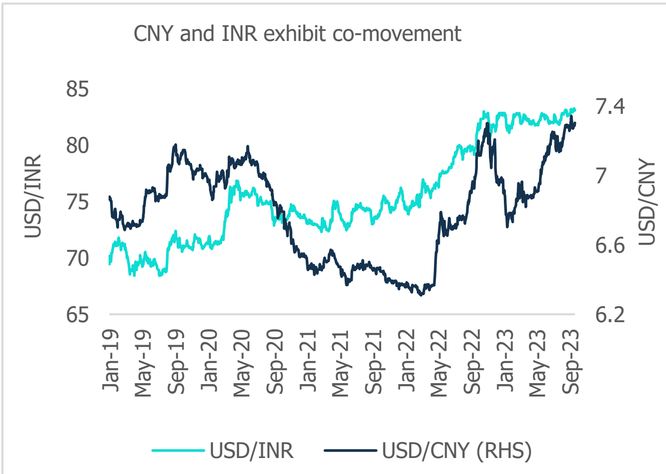
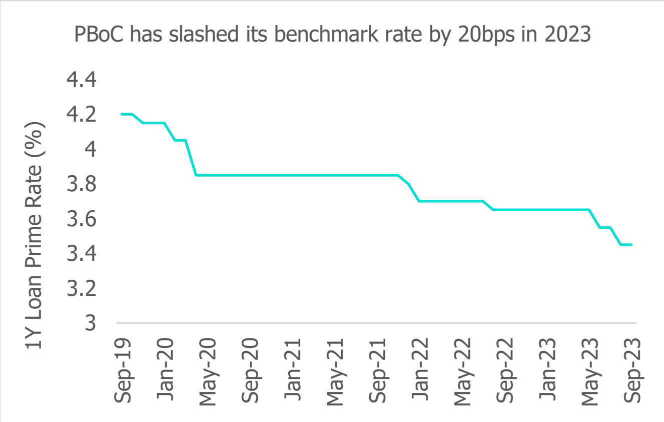


Source: Refinitiv

PBoC Expected to Cut Rates Further to Stimulate Economy



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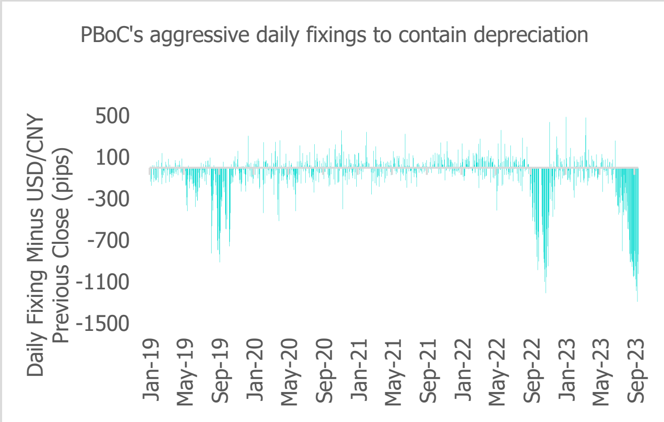


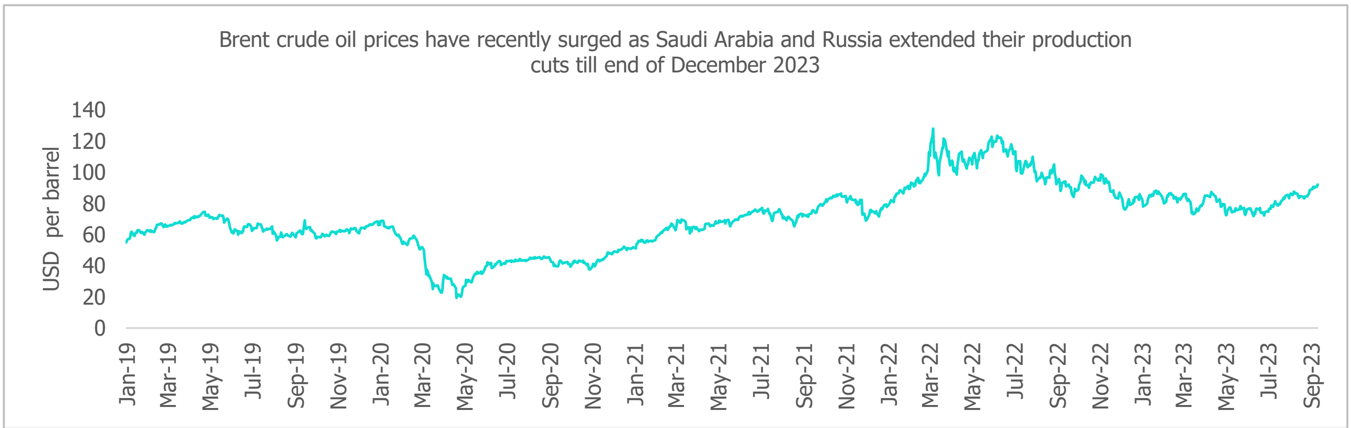
Source: Refinitiv

Crude Oil Prices to Remain Elevated in Near Term but Moderate Thereafter

Brent crude oil prices have risen by 15% over the last three months as tight supply worries have outweighed demand concerns. As per EIA, total world production of crude oil and liquid fuel is projected to slow by 3.2 percentage points to 1.2% in 2023 from 4.4% YoY in 2022, led by production cuts by Saudi Arabia and Russia. Whereas total world consumption of crude oil and liquid fuel is projected to slow by 0.3 percentage points to 1.8% YoY in 2023 from 2.1% YoY in 2022, mainly on account of China's sluggish recovery.

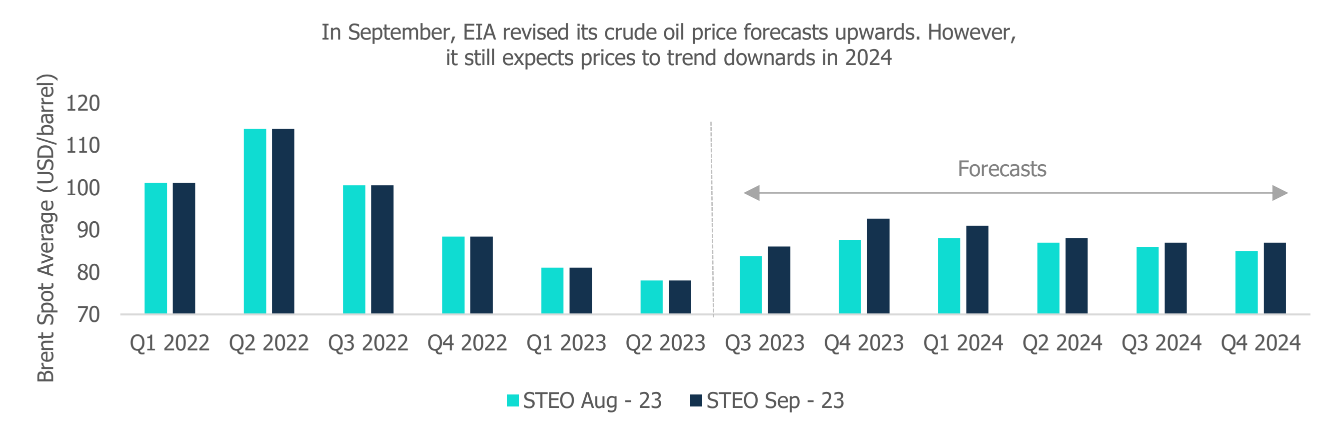
In our opinion, crude oil prices are expected to stay elevated in the near term on account of tight supply but are expected to moderate thereafter. More production cuts seem unlikely as they could come at the expense of growth in oil producing countries. Oil demand is expected to slow until China announces any meaningful stimulus and as growth moderates in the US, the world's largest oil consumer. Consequently, any pressure on the rupee from elevated crude oil prices is likely to be limited to the near term.

Crude Oil Prices Cross USD 90 per barrel for the First Time in 2023

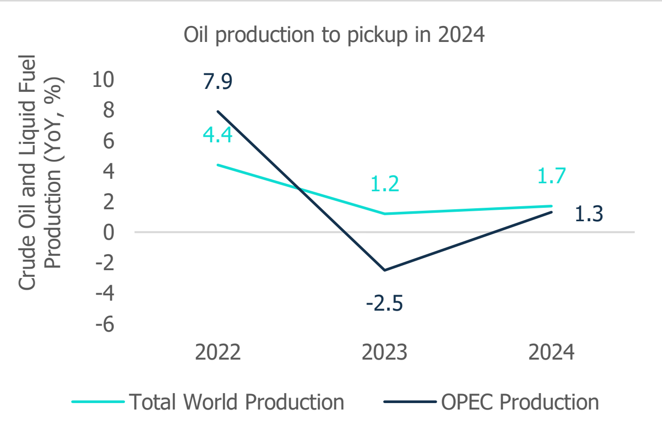


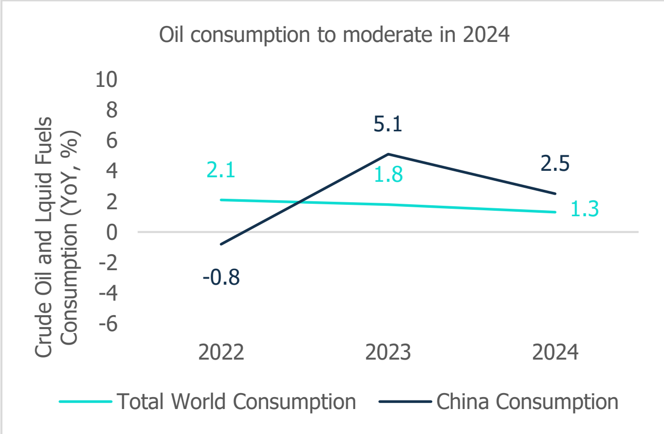
Source: Refinitiv

Moderation in Demand to Weigh on Oil Prices in 2024 as More Supply Cuts seem Unlikely



Source: EIA Short-Term Economic Outlook (STEO). Note data is for calendar quarters.





Source: EIA Short-Term Energy Outlook (STEO). Data is for calendar quarters/years.

RBI to Keep Rupee Range Bound against the Dollar

As crude oil prices are expected to stay elevated in the near term, we have revised our projections for India's current account deficit (CAD) by 20bps to 1.8% of GDP in FY24 from 1.6% projected earlier. This is still lower than CAD of 2% in FY23. Our projection assumes the Indian crude oil basket would average USD 87 per barrel in FY24 versus USD 85 per barrel assumed earlier.

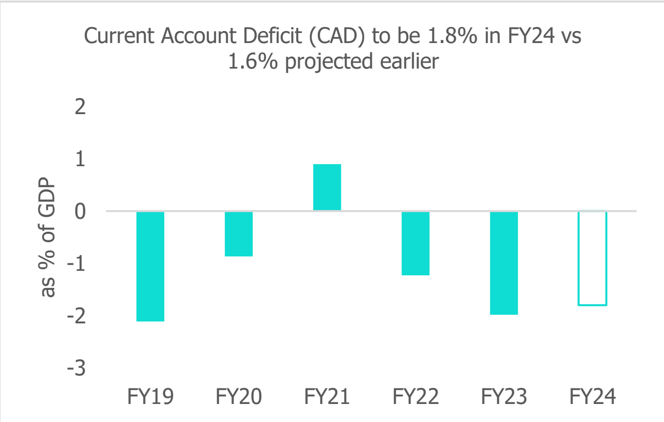
India's net foreign direct investment (FDI) inflows have fallen to ~USD 5 billion in Q1FY24 from ~USD 13.4 billion in Q1FY23. We expect FDI flows to moderate in FY24, as businesses delay investments amidst a global slowdown.

Elevated UST yields and strong DXY are weighing on foreign portfolio investments (FPI). India's net FPI inflows fell to USD 2.2 billion in August from USD 5.8 billion in July and a peak of USD 6.9 billion in June. September has seen net FPI outflows of USD 0.5 billion so far. We expect FPI flows to gain momentum once the Fed signals that interest rates have peaked. We maintain our view that India will witness net FPI inflows in FY24 as UST yields moderate eventually and as India benefits from favourable growth differentials arising from being the fastest-growing major economy.

In the last two MPC meetings, RBI has emphasized its commitment to bring inflation to its 4% target. Hence, we expect RBI to intervene to contain rupee volatility and imported inflation. India has adequate forex reserves, equivalent to an import cover of ~11 months, to support RBI intervention. Further, RBI's forward book position looks comfortable at net purchases of USD 19.5 billion as of July 2023.

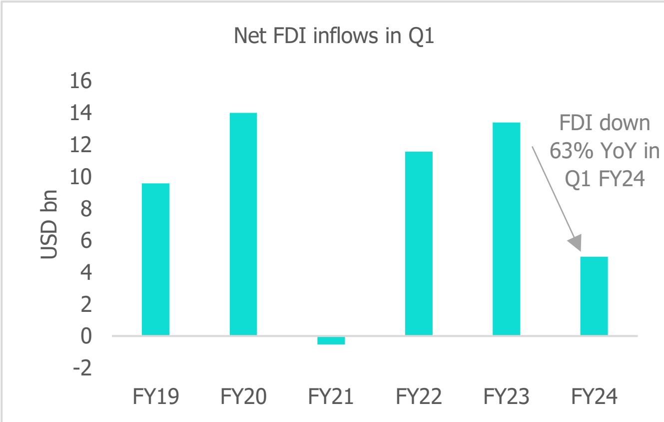
We expect USD/INR to trade between 82-84 in H2FY24. Elevated UST yields, weak yuan and crude oil prices are expected to weigh on rupee in the near term. Thereafter, some moderation in UST yields and crude oil prices should offer support.

Higher Crude Oil Prices to Weigh



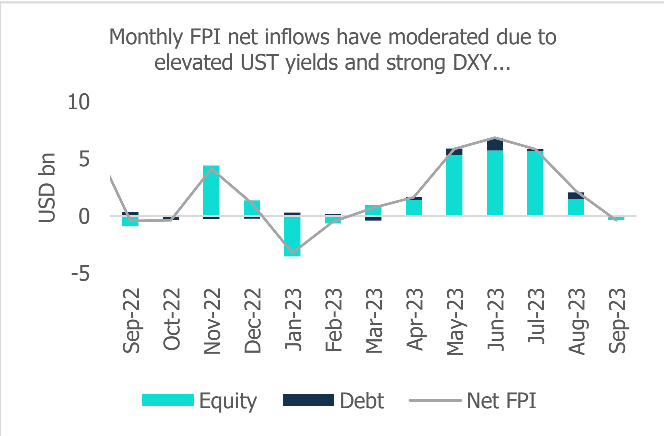
Source: CMIE, CareEdge

FDI Flows Likely to Moderate in FY24

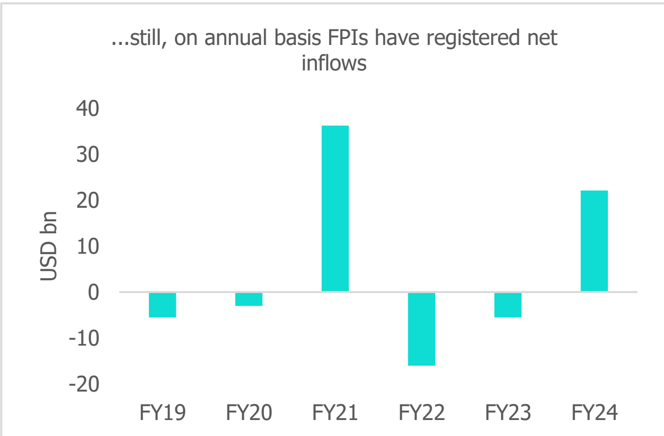


Source: CMIE

India's Strong Fundamentals and Expected Moderation in UST Yields to Support FPI Inflows in H2

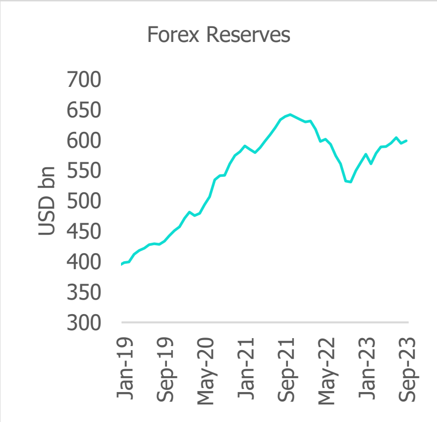


Source: NSDL. Note Data as on 20th September 2023.

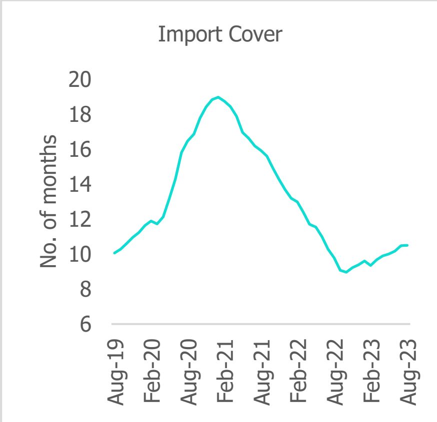


Source: NSDL. Note: FY24 data as on 20th September.

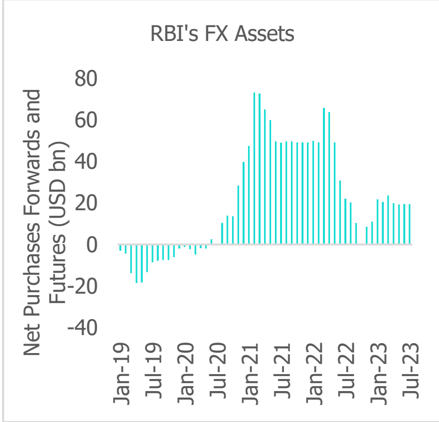
RBI has Adequate Ammunition to Intervene in the FX Market to Limit Rupee Volatility



Source: CMIE

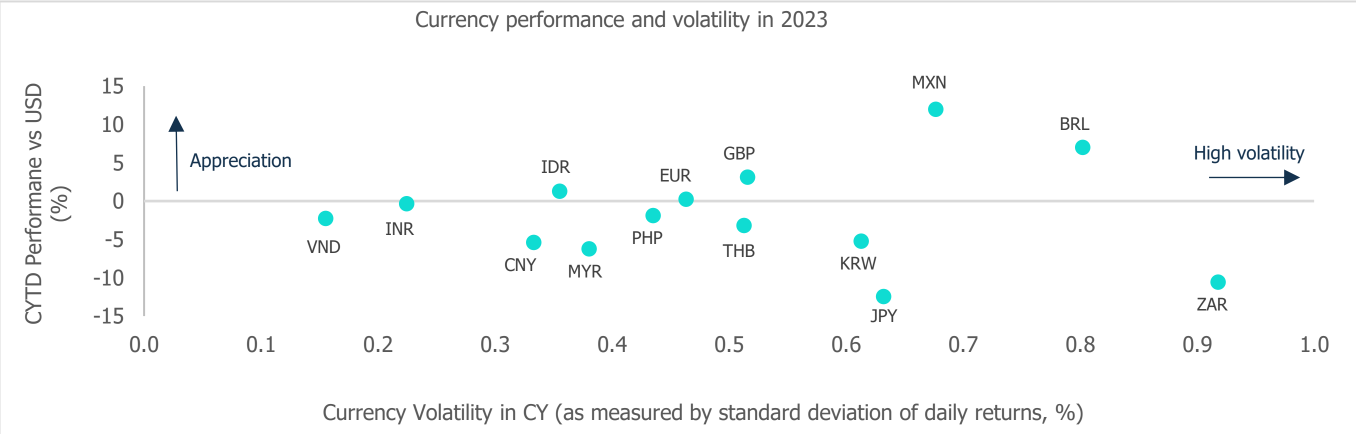


Source: CareEdge



Source: CEIC

INR has been One of the Stable Currencies in CY23 and this is Expected to Sustain



Source: CareEdge

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