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Currency Outlook

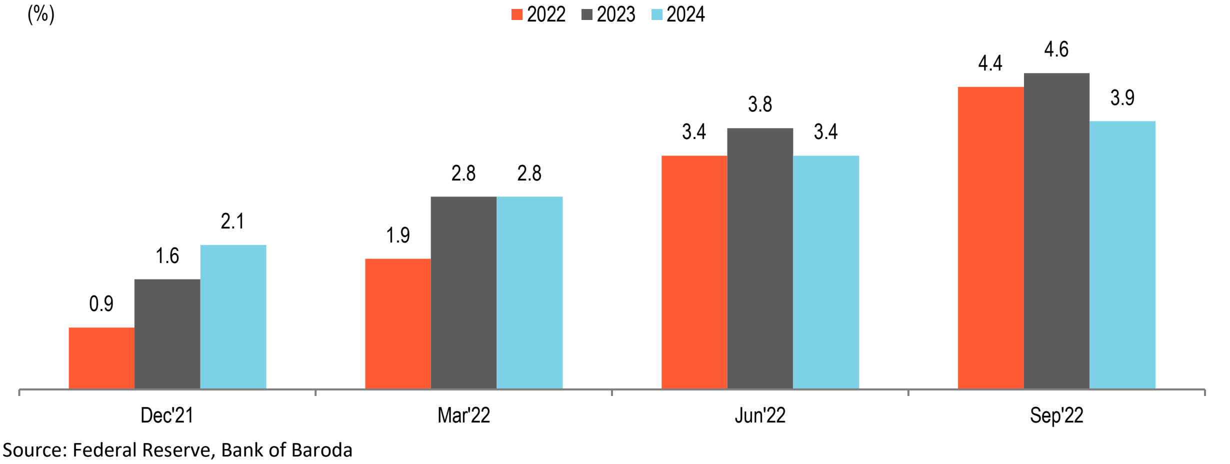
Is 82 the new 80?

The last fortnight was marked by sharp volatility in the global markets, with the foreign exchange market being particularly badly hit. The Federal Reserve raised rates further by 75 bps, much in line with expectations. However, the forward guidance was much more hawkish than expected which led to a sharp knee-jerk reaction in the markets. In the currency market, dollar surged to a 20-year high while most global currencies depreciated to multi-year lows. Fallout from UK's expansive fiscal measures provided further negative stimulus to the markets. Even though BoE's announcement to buy gilts helped to calm investors' sentiments. PBOC and BoJ stepped in the market to provide support to their respective currencies. INR too was not immune to the hostile global sentiment and depreciated to a new record low of 81.94/$ on 28 Sep 2022. A combination of adverse global environment along with rising domestic headwinds is likely to keep INR under pressure. It is likely to trade in the range of 81-81.95/$ in the near-term (below the psychological mark of 82).

Currency movement in the last fortnight

Volatility returned to the currency market after the Fed policy meet. All major currencies came under pressure as expectations of more aggressive rate hikes by the Fed spurred demand for the dollar. In the immediate aftermath of the Fed policy, DXY index rose to a 20-year high, registering its largest single day gain in close to 6 years. In the fortnight, DXY index is up by 2.2%.

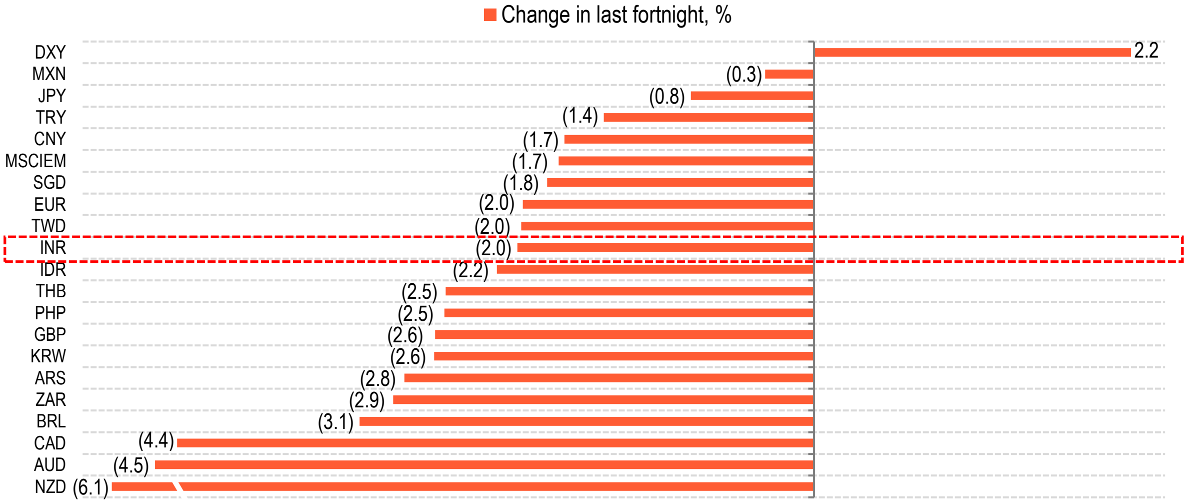
Figure 1: Fed's economic projections suggest further rate hikes



Source: Federal Reserve, Bank of Baroda

Global currencies fell across the board, with several of them falling to lows last seen during the Asian Financial Crisis in 2008-09. Amongst the worst affected were currencies of New Zealand (NZD), Australia (AUD) and Canada (CAD). In fact, Developed Market (DM) currencies performed worse than Emerging Market (EM) currencies. Notably, GBP fell sharply to a record-low in the last fortnight after the UK government unveiled a new fiscal plan involving sweeping tax cuts, leading to concerns over elevated borrowings and inflation. However, it did consolidate some of the losses as intervention by BoE through gilt buying helped revive sentiments. As a result, GBP ended the fortnight 2.6% lower, after having lost over 6% of its value in just 6 days.

Figure 2: Global currencies depreciated in Sep'22



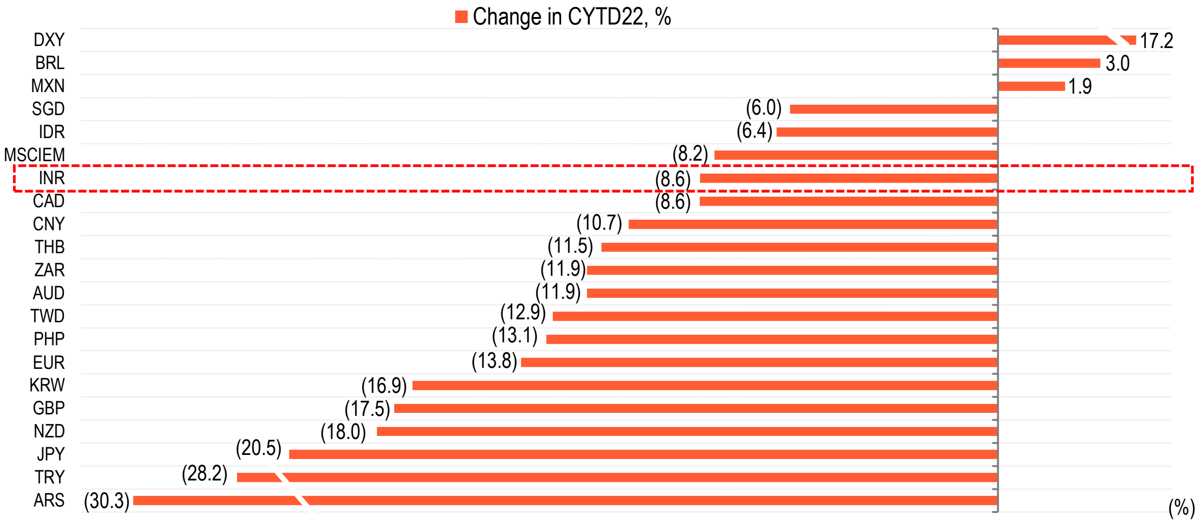
Source: Bloomberg, Bank of Baroda | Data as of 30 Sep 2022 | Note: Figures in bracket denote depreciation against USD

Amongst other major currencies, EUR depreciated by 2% and once again fell below the dollar-parity mark. Energy crisis and weak macro outlook continued to weigh on EUR. CNY depreciated by 1.7% to 14-year lows amidst muted macro data and rising yield differential with US. Apart from verbal intervention, PBOC also raised forex risk reserve ratio to support the yuan and as per reports, more intervention may be forthcoming. JPY performed relatively better, depreciating by only 0.3% in the last fortnight with intervention by the BoJ cushioning some of the decline.

<u>What about INR?</u>

Despite depreciating to a record low, the decline in INR (2%) in the last fortnight was a tad lower when compared to the median depreciation of 2.3% in a sample of 20 currencies. However, in comparison to other EM currencies (decline of 1.7% in MSCI EM currency index), INR has depreciated more. Dollar strength and muted FPI flows weighed on the rupee, despite support from lower oil prices. In CYTD22 (upto Sep'22), INR has depreciated by 8.6%, compared with a 10.7% fall in CNY and 13.8% decline in EUR. Further, when compared with a 17.2% increase in DXY in the same period, INR's performance can be termed relatively better.

Figure 3: Global currencies in CYTD22

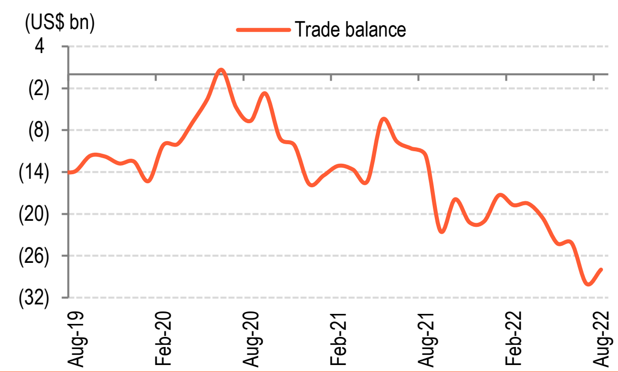


Source: Bloomberg, Bank of Baroda | Data as of 30 Sep 2022 | Note: Figures in bracket denote depreciation against USD

Outlook for INR remains fuzzy. On one side, global factors such as Fed rate hikes and rising risks to the global growth outlook are likely to push the greenback even higher. Even on the domestic side, risks to the outlook have increased. Trade deficit remains elevated and is tracking at ~US$ 25bn per month this year. While oil imports may some easing on the back of lower prices, festive demand is likely to push non-oil-non-gold imports even higher (~US$ 40bn per month in FYTD23). On the other hand, hit by a slowdown in global demand, India's export momentum has weakened. This will be detrimental for India's external position, particularly since foreign exchange reserves have seen a sharp decline in recent months. India's foreign exchange reserves have declined by US$ 80bn since Mar'22 as the RBI stepped up its defense of the rupee. In fact, in the last eight weeks alone, forex reserves have seen a decline of US$ 36.4bn. As a result, India's import cover too has declined from about 12 months at the start of FY23, to less than 10 months presently.

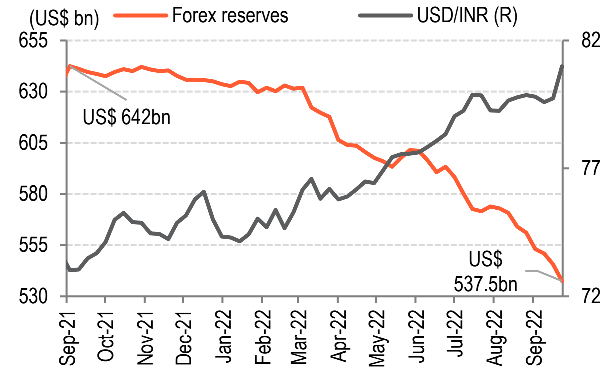
Further, FPIs which returned to the domestic market after a long gap of 9-months have once again started exiting. From inflows of US$ 7.1bn in Aug'22, India saw outflows of US$ 437mn in Sep'22. Further, domestic inflation has remained stubbornly high which will also weigh on the INR going forward. But, lower oil prices and RBI's rate hikes will offer some support to the INR. However, we believe that given the growing global headwinds, RBI will likely have to do the heavy lifting to support the currency like it has in the past. We think RBI is likely to defend the psychological level of 82/$. Hence, we expect INR to trade in the range of 81-81.95/$ in the next fortnight. Amongst the key watchable this fortnight will be the US jobs and inflation data. Any negative surprise is likely to further exacerbate the precarious balance in the global financial market and may lead to further pressure on global currencies, including INR.

Figure 3: Trade deficit remains elevated



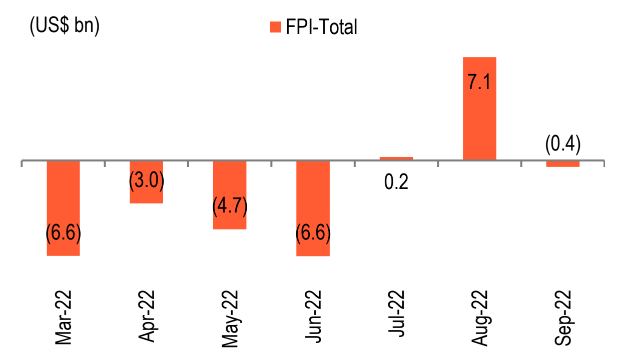
Source: Bloomberg, Bank of Baroda Research

Figure 4: Forex reserves declining



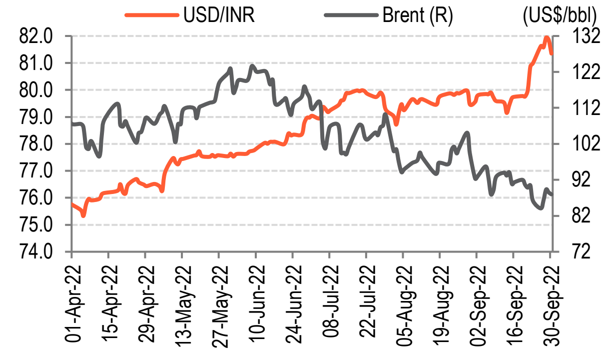
Source: Bloomberg, Bank of Baroda Research

Figure 5: Muted FPI flows



Source: Bloomberg, Bank of Baroda Research

Figure 6: Lower oil prices to support INR



Source: Bloomberg, Bank of Baroda Research

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