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What India-US rates tell us?

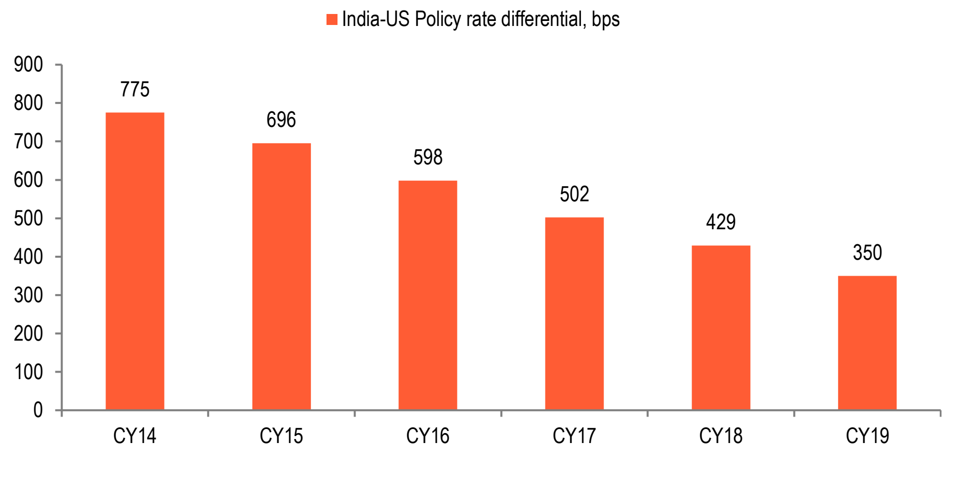
A lot of discussion is going on regarding the terminal Fed fund rate. Money market is pricing another peak of above 5% - maybe around 5.5%, which translates to another 75bps rate hike in the current cycle. Previously, anticipation was anchored at a 5% peak. The current high frequency data in the US ranging from services activity, home sales, core capital goods orders, personal spending and inflation all point to buoyant demand conditions. Also labour market conditions have remained tighter with payroll and wage numbers remaining strong.

In this context, we see what the difference between India and USA policy rates have been since Apr'22. Also we look at sovereign yield differential to gauge how policy rate differential is translated in the market. Next we try to bring into picture the inflation differential which is a primary guiding factor. This is done for the current year as well as past 5 years (before Dec-2019), to get an idea about what has been the differential rates historically and how much is the current divergence. We exclude the Covid-19 period to even out the volatility.

Policy rate differential

- After a prolonged period of ultra-low rates to support the economy, US Fed has already frontloaded 450bps rate hike in the current cycle. On the other hand, RBI's current cycle translates to 250bps rate hike. There prevails much debate on ahead or behind the curve. *But the tinkering of policy rate is contingent on underlying macros indeed.* In this backdrop, we try to see whether the current policy rate differential is in line with the historical trend.

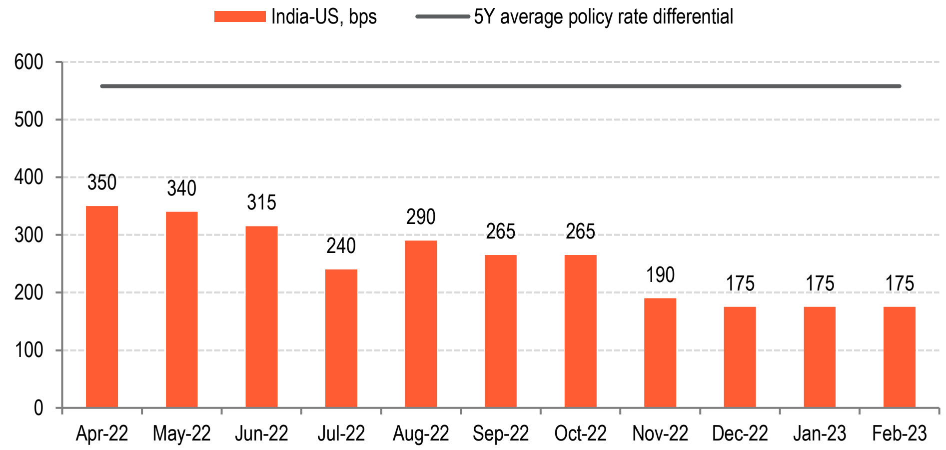
Fig 1. Historically Policy rate differential have fallen



Source: Bloomberg, Bank of Baroda Research, Note: Policy rate differential=India-US

- *An interesting thing which gets reflected in the past 5 years data in Fig 1 is that policy rate differential between India and US has come down consistently in these years. This is on account* *of an easing policy space in India in most of these years (except for some months in CY18). On the other hand, for US, moderate degree of tightening was prevalent.*

Fig 2. The current policy rate differential is far below the long run average



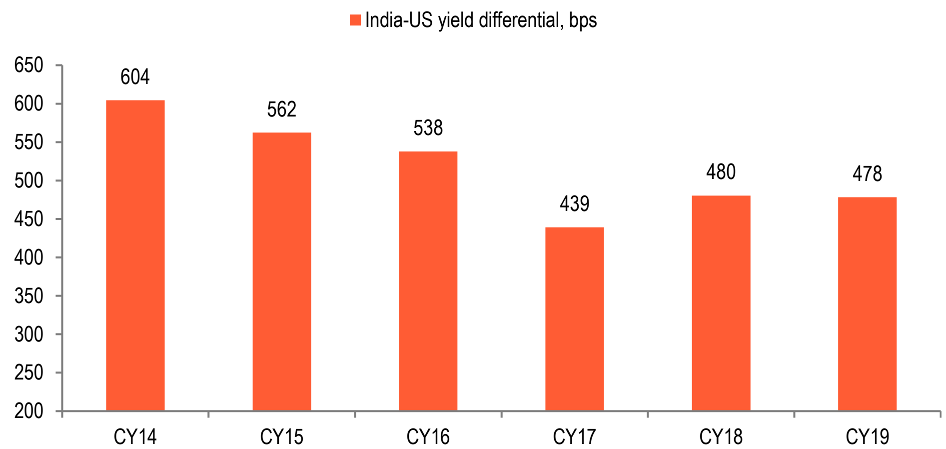
Source: Bloomberg, Bank of Baroda Research, Note: Policy rate differential=India-US

- The current policy rate differential is far below long run average which is around 558bps. *This is attributable to faster pace of catch up in terms of policy rate of the central banks. Again it is contingent on the evolution of underlying inflation and growth conditions of the economy*.

Yield differential

- 10Y yield in both the economies exhibited quite a bit of volatility. Till CY16, faster pace of decline in India's 10Y yield compared to US 10Y yield has resulted in narrowing yield differential. Between CY16, CY17 and CY18, US 10Y yield exhibited considerable volatility. While for India's 10Y yield, between CY17 and CY18, the yield trajectory moved upward in response to the slightly tighter policy rate cycle. Thus, in these years, yield differential is bit inconclusive. For CY19, the same pace of decline in sovereign yields in both the economies helped in maintaining the yield gap.

Fig 3. Till CY17, yield differential have fallen, while post that it inched up

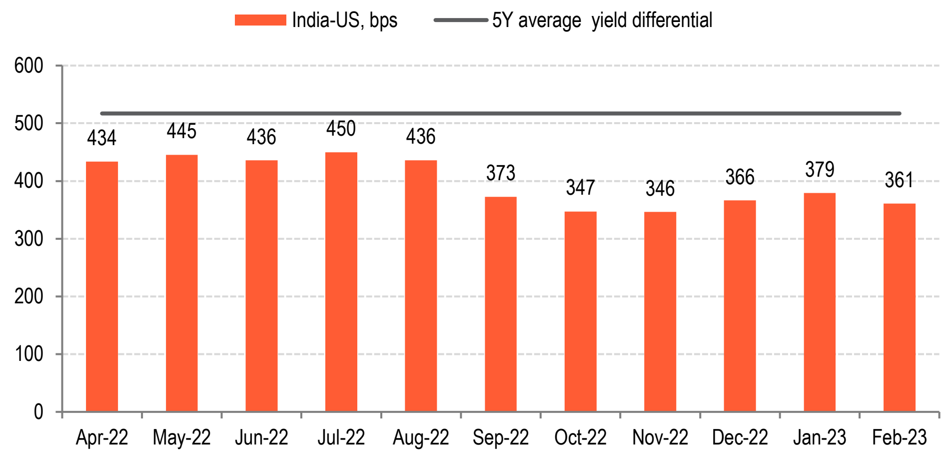


Source: Bloomberg, Bank of Baroda Research, Note: Yield differential=India-US' 10Y yield, 10Y yield has been averaged out

- *Another interesting fact is that long run average of yield differential of around 517bps is more or less the same as the policy rate differential which was also around 558bps.* For the current scenario, between Apr-22 to Aug-22, yield differential was broadly higher nearing the long term average. Post that, faster pace of increase in US 10Y yield till Nov'22 has led to slight moderation in yield differential. Thereafter, it remained broadly stable.

- *Interestingly, whereas in the US, the translation of policy rate hike to sovereign security (10Y paper), has been higher at 23% (Apr'22-Feb'23) compared to India's response where translation has been just 11%. This can be on account of a host of other factors ranging from evolving liquidity situation, fiscal situation and the underlying growth-inflation dynamics.*

Fig 4. The current yield differential has stabilized

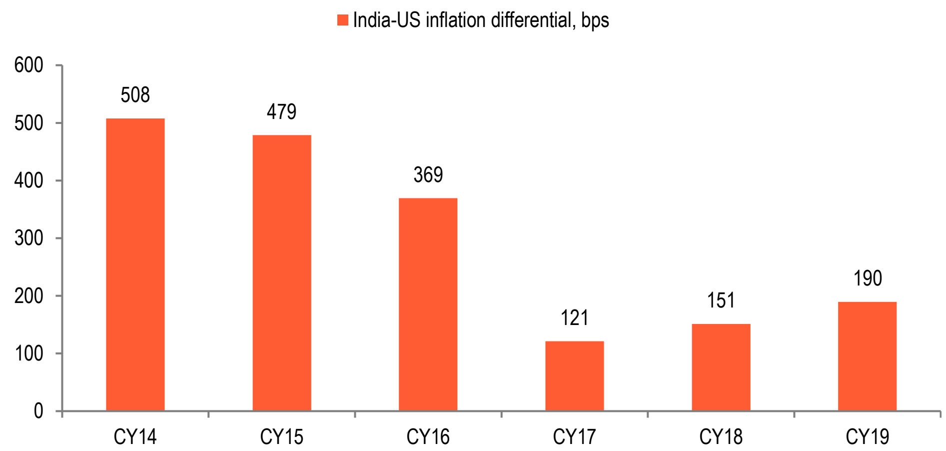


Source: Bloomberg, Bank of Baroda Research, Note: Yield differential=India-US' 10Y yield, 10Y yield has been averaged out

Inflation differential-a puzzle in the story:

- Between CY14-15, falling India's inflation and episodes of stable or disinflation in the US kept inflation differential low between India and US. *The sharp fall in inflation differential in CY17 is attributable to both fall in inflation in India and inching up of inflation in the US. Notably, during CY14 to CY17, policy rate, yield and inflation differential mirrored the same trend.*

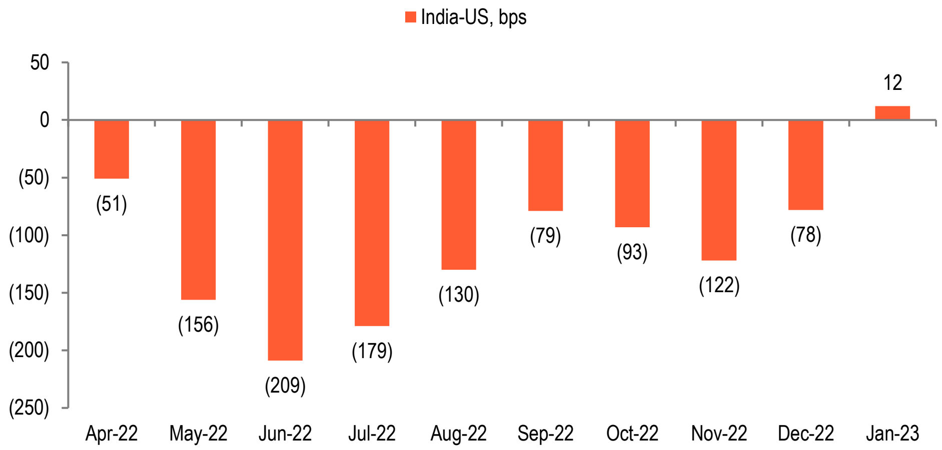
Fig 5. India-US inflation differential has fallen till CY17, post that it slightly inched up



Source: Bloomberg, Bank of Baroda Research, Note: Inflation differential=India-US' CPI

- The current situation with regard to inflation differential is puzzling. *It noticed a complete reversal, a trend which was not noticed in the past. Only since Sep'21, this phenomenon of* *reversal is noticed due to a sharp uptick of inflation rate in the US.* In Jun'23, inflation differential between India and US was the most. Post that, with slight moderation in US CPI and considerable uptick in inflation in India, the differential started to narrow.

Fig 6. Complete reversal in terms of direction of inflation differential has been noticed of late



Source: Bloomberg, Bank of Baroda Research, Note: Inflation differential=India-US' CPI

What to conclude?

Putting all the pieces together, some facts which become clear are:

- *Policy rate differential between India and US has been narrowing*. Even in the coming months with money market in the US predicting terminal rate of 5.5% and India OIS 2-month curve at 6.75%, the policy rate differential, can go down depending on how the RBI takes action. *But everything is contingent on the underlying macro dynamics*.

- *Yield and inflation differential in an ideal situation should mirror policy rate differential, as observed during CY14-CY17*. However, when it comes to the translation of policy rate to yields, a host of other factors ranging from underlying fiscal, liquidity and growth dynamics come into play. For India, we do not expect much of upside risk for 10Y paper and is expected to be in the range of 7.4-7.5% in the near term, for US 10Y paper, however, the volatility may be higher if another 75bps rate hike materializes. Thus we expect the yield differential to moderate to some extent. For the coming months we might observe some inversion between 3M and 10Y paper as well in the US. For India, as well, the spike in short term is likely to continue.

- The toughest piece in the puzzle is inflation. It is something which is inconclusive. *However, what we can see from the trend is that the negative differential between India and US inflation rate is likely to enter into positive territory, as some degree of softening will be visible in US inflation. So also will be the case with India's inflation*.

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