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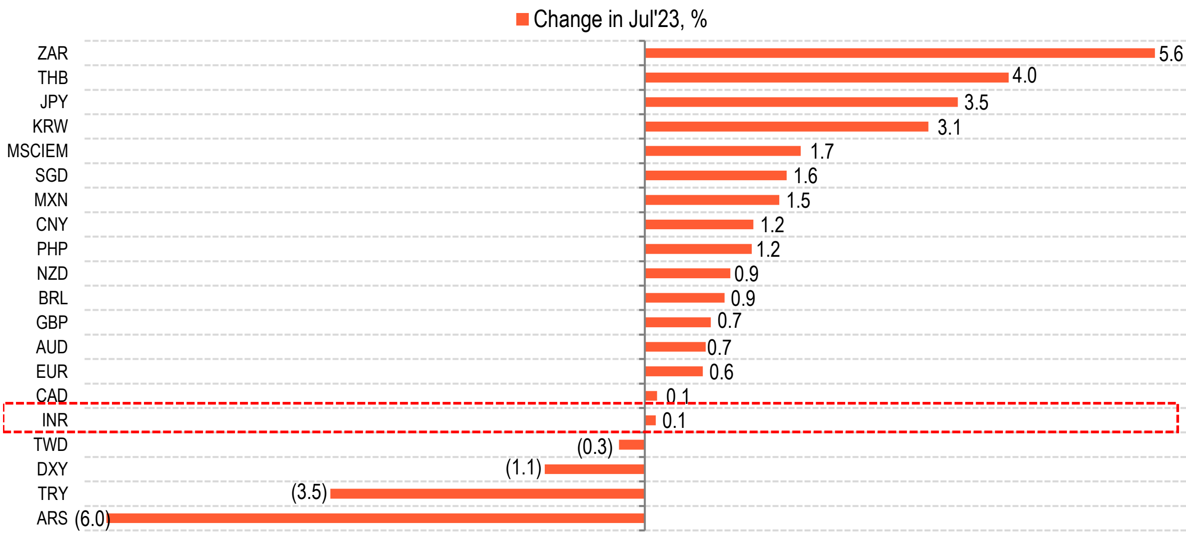
Currency Outlook

Global growth and inflation continue to show diverging trends. While growth in major advanced economies has been under pressure, US economy continues to remain on a strong footing. This has made guessing the future course of policy action highly uncertain. While the dollar remained under pressure for most part of the month, robust macro data i.e. Q2CY23 GDP and jobless claims has once again raised the possibility of more rate hikes. In response, DXY has rallied which is weighing on INR. We expect INR to trade in the range of 82/$-83/$ in the next fortnight. Support is likely to come from FPI inflows and RBI intervention, while rising oil prices pose a significant risk to the trajectory.

Movement in global currencies in Jul'23

Barring a few exceptions, most global currencies ended higher against the dollar in Jul'23. DXY came under pressure amidst expectations that the Fed is near the end of its rate hike cycle. This was reinforced by US CPI data which showed a significant moderation in price pressures. Commentary by Fed Chair suggested that the central bank is likely to weigh incoming data before moving on rates. However, data released yesterday showed that US GDP growth was much higher than expectations and labour market remains stubbornly tight, which has swayed market expectations in favor of an additional rate hike this year, which helped the dollar recoup some of its losses in the last trading session. Even so, DXY is 1.1% lower this month, which has benefitted other currencies. EM currencies such as ZAR and THB have in particular posted solid gains.

Figure 1: Pressure on global currencies



Source: Bloomberg, Bank of Baroda Research | Note: Data as of 27 Jul 2023| Figures in bracket denote depreciation against the dollar

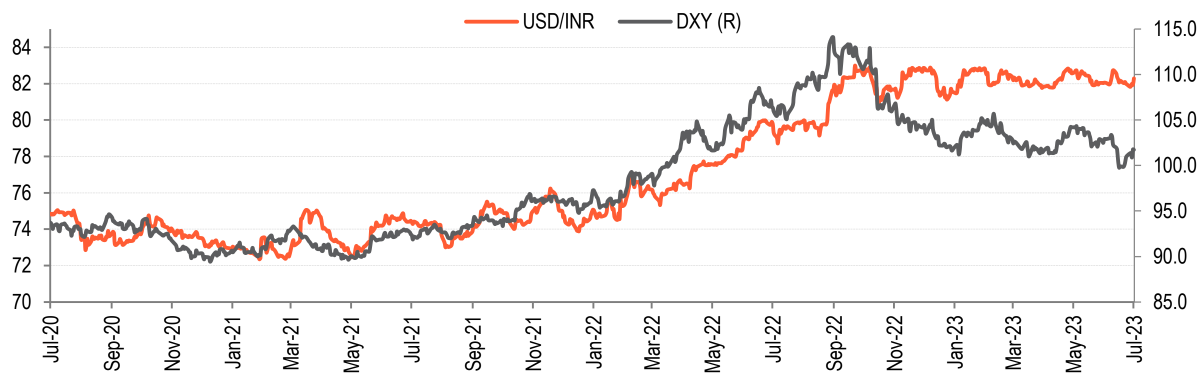
JPY which remained the worst performing currency for the major part of year, reversed its course and rose by 3.5%. This was on expectations of a possible action by BoJ amidst persistently above inflation prints. With the BoJ announcing a tweak in its yield control curve (YCC), JPY has jumped even more today. CNY has risen 1.2% in Jul'23, as government stepped up support for the ailing economy. EUR has also appreciated, but took a backseat amidst dovish comments from ECB Chief and worsening economic outlook of the region.

Performance of INR and outlook

In Jul'23, INR appreciated by 0.1%. However, it has given up its gains in today's session amidst rejig in market expectations of future path of Fed rates. It is trading 0.4% lower today at ~82.36/$. Daily annualized volatility in INR has also jumped to 3.1% in Jul'23 versus 2.8% in Jun'23. A number of factor will determine the trajectory of INR going forward.

Where is the dollar headed?: DXY has depreciated by 1.1% this month. Key triggers for the dollar came from the Fed meeting as well as macro data points. While the Fed has maintained that future course of rate action will be data dependent, a more than expected moderation in CPI, supports the view that the Fed may be done with rate hikes. Rate cuts are also off the table. On the other hand, US GDP rose more than expected in Q2CY23 and jobless claims suggest that labour market remains uncomfortably tight. This data has stirred up expectations that the Fed rates may still be far from the peak. However, the Fed is likely to weigh a slew of data scheduled to be released before it meets in Sep'23 to arrive at its rate decision. In particular, the inflation reports will hold the key. With both the CPI inflation and core PCE index indicating a moderation in underlying price pressures, the Fed is likely to remain on a wait and watch mode, keeping rates at the current levels. This suggests that DXY is likely to remain subdued and trade at current levels. This is positive for INR.

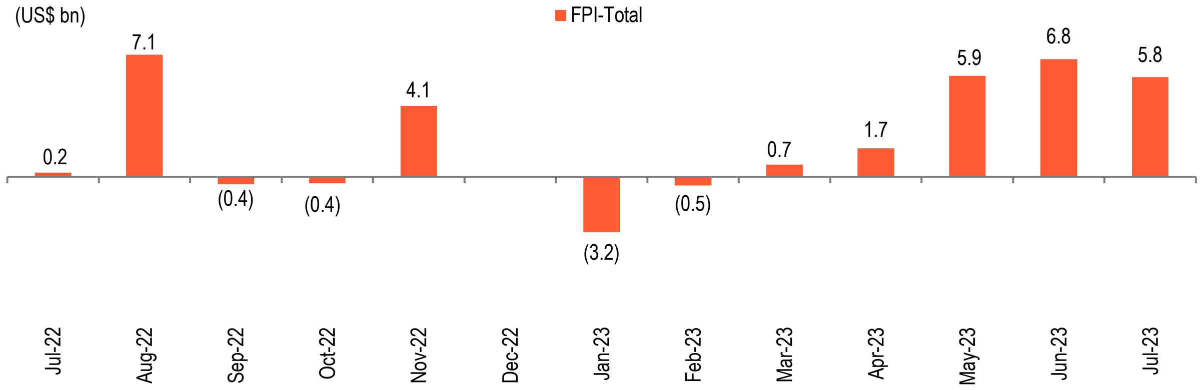
Figure 2: DXY has come under pressure



Source: Bloomberg, Bank of Baroda Research | Data as of 28 Jul 2023

Momentum in FPI inflows: Foreign investors have flocked to the Indian market with a renewed vigour in the last few months. In FYTD24, FPI inflows into India have risen to ~US$ 20bn, out of which, ~90% is concentrated in the equity segment. India's strong macro fundamentals has made it a preferred destination for FPIs. Unsurprisingly, India has attracted the highest amount of FPI inflows amongst other EM peers. Patchy growth recovery in China, in particular, has benefitted India. Apart from this, robust corporate profitability and balance sheet, has also helped to spur interest of foreign investors. This trend is likely to continue as India remains the fastest growing major economy. In fact, IMF recently upgraded India's growth forecast for FY24 which also attests to the strength of the domestic economy. Steady flows of dollars into India bode well for the stability of INR.

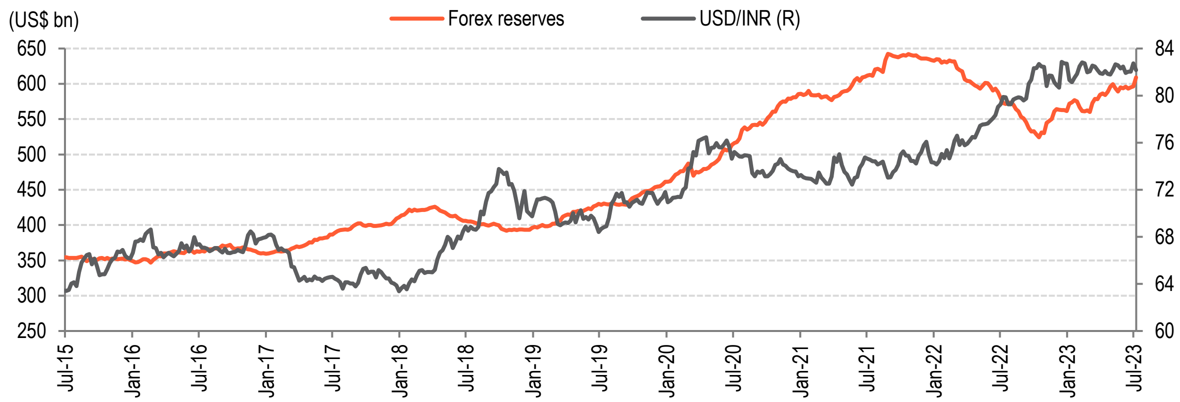
Figure 3: FPI flows have been robust



Source: NSDL, Bank of Baroda Research | Data as of 28 Jul 2023

<u>Forex reserves comfortable</u>: RBI has been steadily building up its foreign exchange reserves this year. Forex reserves crossed the US$ 600bn mark last week, rising to US$ 609bn (as of 14 Jul 2023) to the highest level since Apr'22. In FYTD24, forex reserves are up by US$ 30.6bn compared with a decline of US$ 44.9bn in the same period last year. Robust foreign inflows and revaluation gains due to a fall in value of dollar vis-à-vis other major currencies has aided the steady accretion in foreign reserves. A dip in trade deficit as well as increasing volume of trade settlements using rupees can also explain the rise in RBI's forex kitty. Apart from funding imports, forex reserves have also been used by RBI to prevent volatility in the exchange rate and hence a steady increase in forex reserves bodes well for the stability of INR.

Figure 4: INR movement in H1CY23

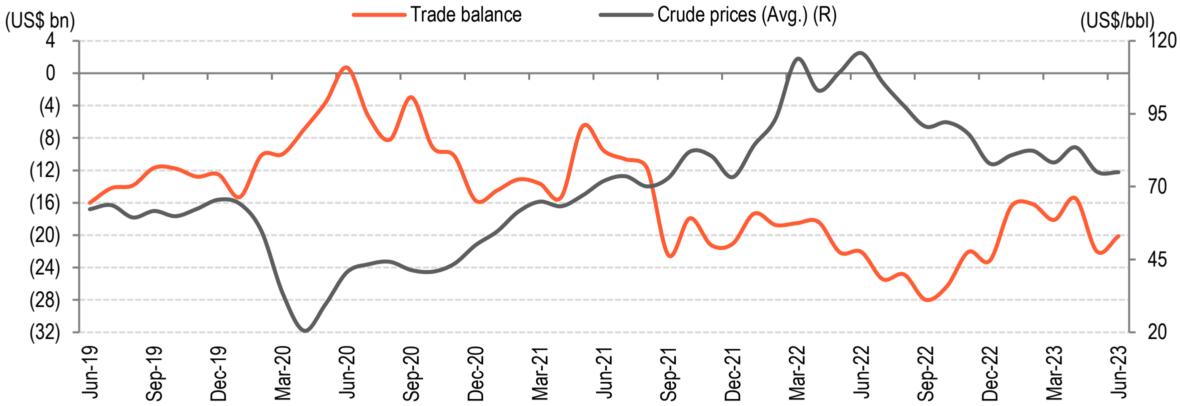


Source: CEIC, Bloomberg, Bank of Baroda Research | Data as of 14 Jul 2023

<u>Trade deficit moderating but risk remains:</u> India's trade deficit has moderated from US$ 62.6bn in Q1FY23 to US$ 57.6bn in Q1FY24. The moderation can be attributed to lower commodity prices. Global commodity prices have corrected this year which should keep import bill contained. This should offset the dip in exports due to weak global demand. Hence, trade deficit is likely to be lower than last year, which is positive for INR. However, risks remain from an uptick in oil prices seen recently. Oil prices have increased by ~12% in Jul'23, as OPEC+ producers extended output cuts. Our analysis suggests that for every 10% increase in oil prices on a permanent basis, CAD increases by ~0.4% of GDP which will put a downward pressure on INR. However, some of this will be offset by higher oil

exports as India also exports some refinery products. On the whole, while we expect trade deficit to moderate in FY24, rising oil prices have lent some degree of uncertainty to the outlook and hence it will be necessary to monitor the trajectory of oil prices, as it remains a key risk to the INR outlook.

Figure 4: Trade deficit and oil prices



Source: CEIC, Bloomberg, Bank of Baroda Research | Data as of 14 Jul 2023

Taking all of this into consideration, and also accounting for the knee-jerk reaction in the forex market to the US GDP data and BoJ's policy tweak, we expect INR to trade in the range of 82-83/$ in the next fortnight. Beyond that, we continue to believe that there is scope for INR to appreciate and maintain a range of 80-82/$ for FY24. At the other extreme Rs 83/$ can be the mark tested occasionally under tight conditions.

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