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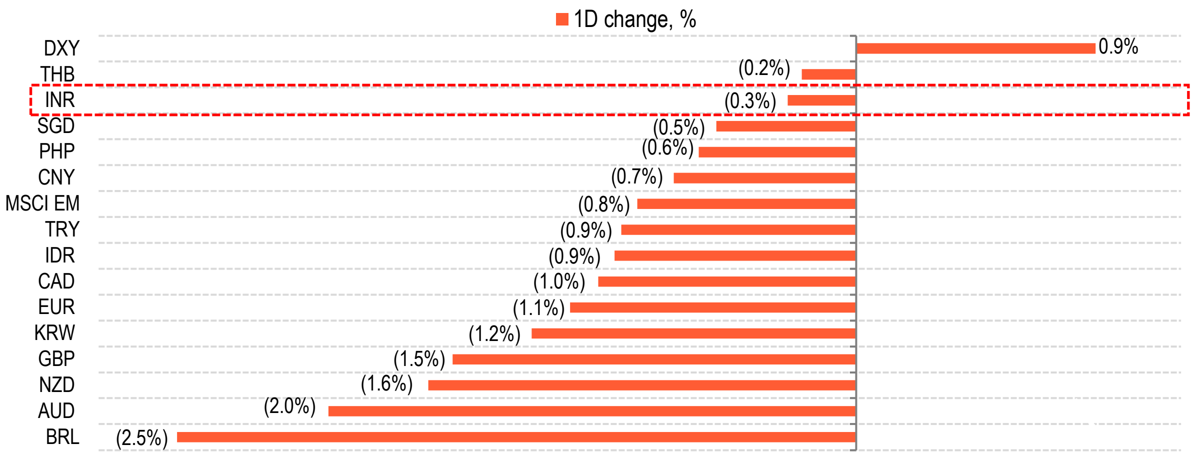
Currency Outlook

Rupee slips to a record-low: What to make of it?

Indian rupee slipped to a fresh record low of 78.04/$ yesterday amidst a resurgence in dollar strength. Other global currencies also ended sharply lower as DXY index surged to a 20-year high ahead of the US Fed meet. EM currencies depreciated sharply by 0.8%. Brazilian Real (BRL) fell the most by 2.5%. Australian and New Zealand dollar were also lower by 2% and 1.6% respectively, in the day. It must be noted that while INR did slip to a record-low against the dollar, it performed relatively well compared to other EM peers. In fact, while the median depreciation in the basket of 15 currencies was 0.9%, INR depreciated by only 0.3%.

Figure 1: Currency movement



Source: Bloomberg, Bank of Baroda | Data as of 13 Jun 2022 | Note: Figures in bracket denote depreciation against USD

There are several reasons underpinning the dollar strength.

First, expectations of aggressive policy tightening by US Fed this week. US inflation surged to a 41-year high of 8.6% in May'22 from 8.3% in Apr'22 on a YoY basis. This was against the widely held market view that inflation in US has peaked. In fact, analysts had expected CPI inflation in May'22 at 8.3% (Bloomberg estimate). As a result, expectations that the Fed may aggressively hike rates have resurfaced. Markets are now even expecting a 75bps rate hike by Fed on Wednesday (biggest rate hike since 1994), even as Fed Chair had explicitly ruled out such a move in the last policy. Some investment banks expect the Fed rate to end at 3.25-3.5% by this yearend. Hence it would be well ahead of Bank of England which is expected to increase rates by 25 bps this Thursday.

Second, US 10Y yield rose by 20bps in the last trading session. This is also contributing to the dollar strength as funds move towards dollar assets thus making it stronger.

Third, increasing risks to global growth have increased the safe-haven demand for dollar. Reports that China has once again imposed lockdown restrictions in Beijing have severely dented investor sentiments. Several global agencies such as World Bank and OECD have downgraded global growth forecasts and also warned of severe risks to the growth outlook. Covid-19 restrictions in China, Russia-Ukraine war and monetary tightening by global central banks will weigh on the global growth outlook.

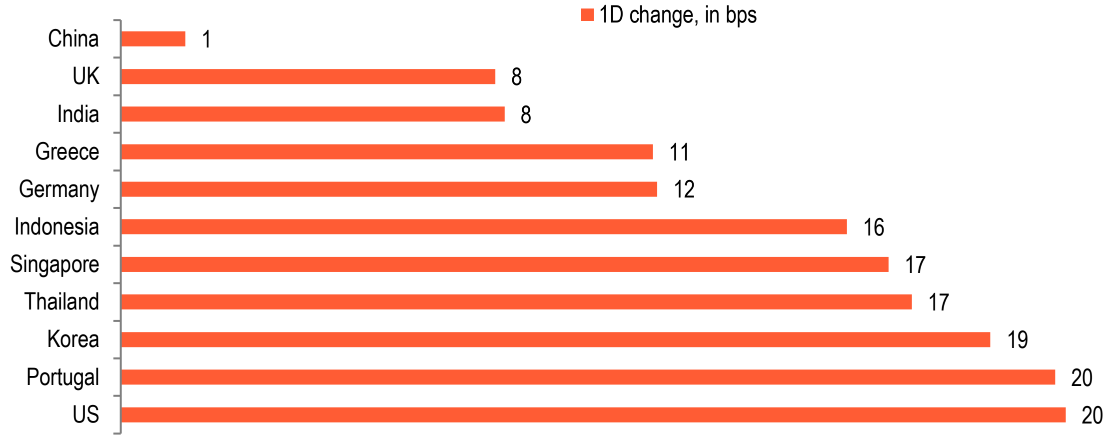
Apart from this, domestic factors too have contributed to the pressure on INR.

First, oil prices continued to remain elevated at above US$ 120/bbl. This is putting pressure on India's external position. Trade deficit in May'22 rose to a record-high of US$ 23.3bn and is expected to remain elevated amidst a pickup in demand as well as higher commodity prices.

Second, persistent FPI outflows. FPIs have remained net sellers in the domestic market for 9-straight months now. Even in Jun'22, FPIs have pulled out US$ 2.4bn from the Indian market so far. With interest rates in US likely to go up much faster than elsewhere, FPI inflows into EM markets such as India are likely to remain muted.

Even in the bond market, India's 10Y yield slipped to 7.6% yesterday to a more than 3-year low ahead of the May'22 inflation print. CPI inflation eased to 7% in May'22 from 7.8% in Apr'22 led by base effect. It is believed that inflation will range at higher levels in the next few months. This was also lower than market expectations and hence will provide some comfort to yields. Today, the 10Y bond yield is trading lower at 7.58%.

Figure 2: Movement in 10Y yields



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Outlook for INR:

INR is trading marginally lower at 78.05/$ even today. We expect INR to continue to remain under pressure in the near-term amidst a combination of negative global cues as well as domestic factors at play. However, RBI is likely to intervene in the forex market to support the rupee and prevent any sharp depreciation in the exchange rate.

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