NIRMAL BANG
a relationship beyond broking

Institutional Equities

# What Aids The Indian Rupee?

19 June 2017

Thematic Report

**Teresa John, CFA**
Research Analyst (Economist)
teresa.john@nirmalbang.com
+91 22 3926 8114

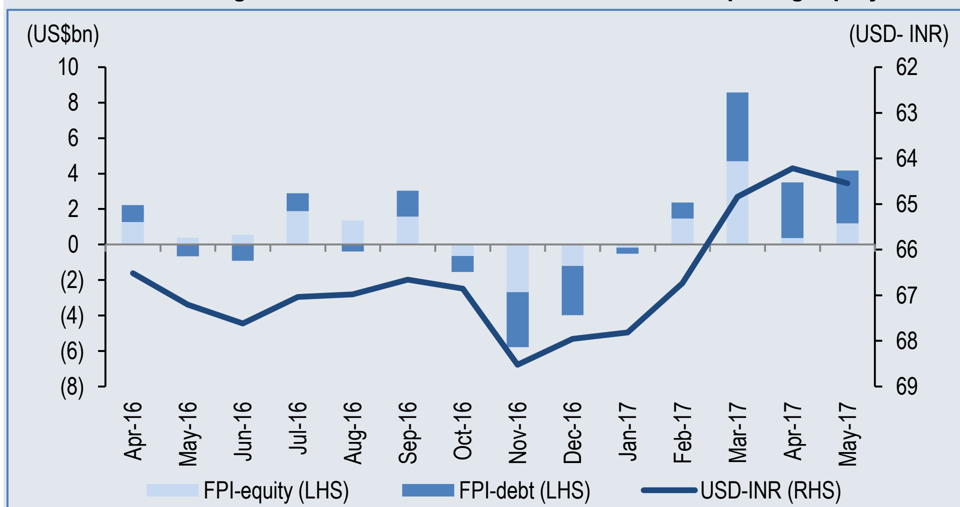
## Raising Our INR Forecast On Strong Capital Inflows

**We believe the recent strength in the Indian Rupee or INR is largely attributable to robust portfolio inflows, primarily into the debt market. The Reserve Bank of India or RBI has also preferred to remain on the sidelines, barring limited intervention, as a result of which the INR has been largely market-determined. As foreign direct investment or FDI flows are largely stable, we believe the swing factor for the INR is portfolio inflows. In our earlier note: Why The Indian Rupee Will Be More Volatile? we had pointed out that the sensitivity of the INR to capital inflows has increased, despite improved macroeconomic fundamentals . We continue to believe that the INR has a deprecation bias on account of a higher current deficit or CAD going forward, and to a lesser extent from medium-term inflation differentials as this impact is now largely negated by positive real yields. However, on the back of the INR's strength in 1QFY17, supported by foreign portfolio inflows, we have increased our USD-INR estimates to 65.6 for FY18 and 67 for FY19 from 68.5 and 70.0, respectively. Given the fact that portfolio flows into debt have outpaced equity, and prevalent regulatory limits on debt inflows, we do not believe the current pace of flows can sustain. Equity market valuations also look a bit stretched to justify significant flows into equity in the near term. Therefore, at the moment we see limited upside from the current level. Obviously the question remains: If the INR rally has been led by strong portfolio inflows, is there no risk of reversal? We believe the INR is volatility prone on reversal of portfolio flows. Nevertheless extreme reversals are likely to be relatively short-lived, given India's favourable macroeconomic fundamentals and positive real yields in the medium term.**

### 1. What aids the INR?

**Robust portfolio inflows have supported the INR:** We believe the recent strength in the INR is largely attributable to foreign portfolio inflows (FPI) into the Indian market since February 2016 (Exhibit 1). Between February and May 2017, the Indian market witnessed FPI inflows to the tune of US$18.6bn. Similarly, the sharp depreciation in the INR in late 2016 was on account of FPI outflows. Indian equity and debt market registered outflows of about US$11.3bn between October and December 2016, which can be attributed to a number of factors including demonetisation and global rebalancing as developed markets witnessed a pick-up. We are not negating the importance of FDI which is a robust and stable source of foreign capital, but we believe the swing factor for the INR is portfolio inflows.

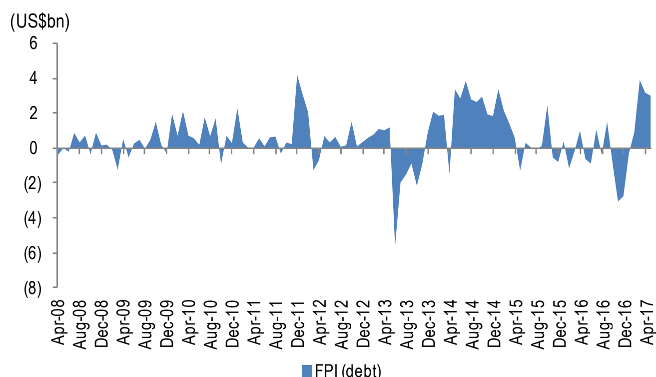
**Exhibit 1: INR strength attributable to FPI inflows with debt outpacing equity**




*Source: National Securities Depository or NSDL. RBI, CEIC, Nirmal Bang Institutional Equities Research*

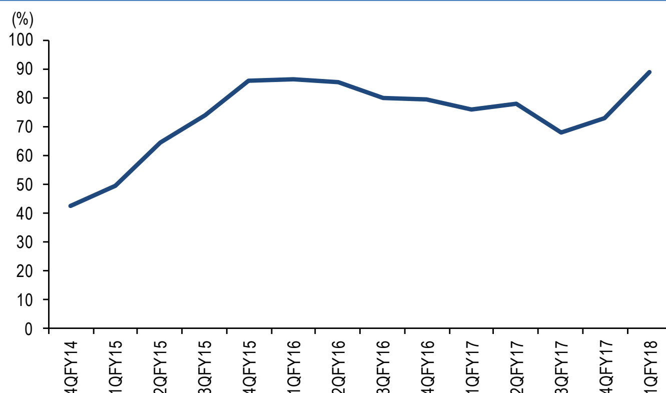
**Debt inflows outpace equity inflows:** A key point to note is that portfolio inflows into the debt market have outpaced inflows into the equity market. Between February and June 2017 while the equity market saw inflows of about US$8.2bn, debt market inflows stood at US$13.7bn. As Exhibit 2 illustrates, debt market inflows in the past couple of months have been robust and near all-time highs.

**Exhibit 2: Debt market inflows have been robust**




*Source: NSDL, CEIC, Nirmal Bang Institutional Equities Research*

**Exhibit 3: Foreign holding of debt near all- time highs**

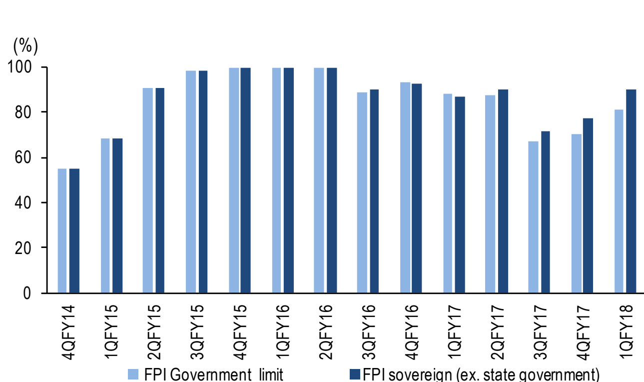



*Source: NSDL, Nirmal Bang Institutional Equities Research*

**Foreign holdings of Indian debt close to all-time high:** Foreign holding of Indian debt is also near all-time high, and currently stands at 89.13% (including unutilised auctioned limits) of the total available limit, up from 72.90% at the end of March 2017 (Exhibit 3). This increase in FPI debt utilisation limit of over 16% in a short span of less than three months comes on top of the fact that investment limit for central government securities was increased by about US$1.7bn, and for state government securities by about US$0.9bn at the beginning of April 2017. Foreign holding of central government securities stands at about 90% of total limit, up from around 77% in March 2017. However, interest in state government securities has been limited, with utilisation of only about 6% of the total available limit of Rs270bn. As a result, utilisation of total government limit stands at around 87% (including unutilised auctioned limits), up from 70% in March 2017 (Exhibit 4). The quota for state government securities is about 10% of the total limit for government securities.

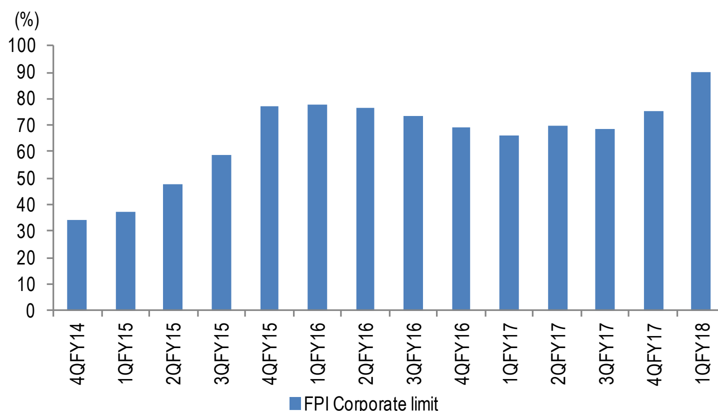
**Investment in corporate bonds has risen sharply:** In the case of corporate bonds, foreign holding is at all-time high and stands at over 91% of available limit (Exhibit 5). Please note that the upper limit for foreign investment in corporate bonds of Rs2,443bn also includes overseas issuances of INR-denominated bonds or masala bonds.

**Exhibit 4: FPI holding of government debt rises**




*Source: NSDL, CEIC, Nirmal Bang Institutional Equities Research*

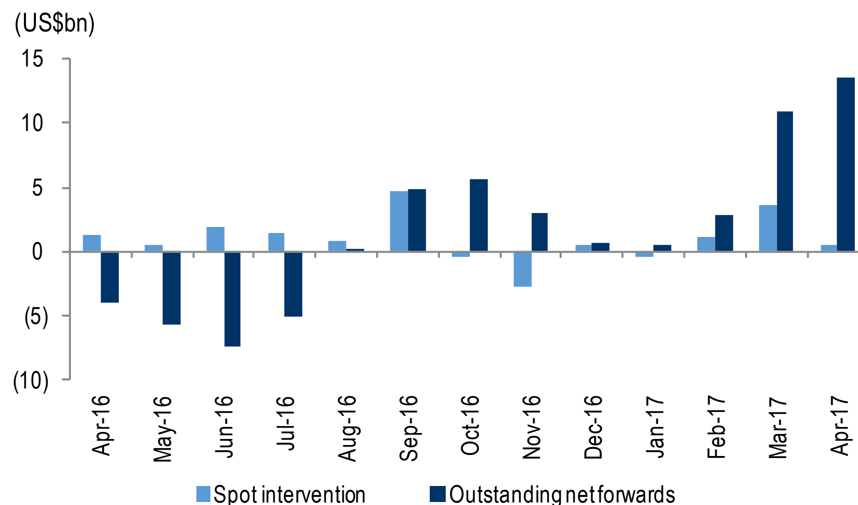
**Exhibit 5: Corporate bond investment increases sharply**




*Source: NSDL, Nirmal Bang Institutional Equities Research*

**RBI intervention has also been limited:** The RBI has also chosen to remain on the sidelines, apart from some intervention in the forward market in March 2017 and in a more limited way in April 2017. Spot intervention, we believe, has been largely limited to times of extreme volatility (Exhibit 6). Therefore, the INR is largely driven by the market.

**Exhibit 6: Positive real interest rates likely to stay till inflation expectations are anchored**




*Note: Real interest rates measured by policy repo rate and one year ahead of CPI outturn*

*Source: RBI, CEIC, Nirmal Bang Institutional Equities Research*

As pointed out in our earlier report that effectiveness of the RBI's intervention is likely to have fallen with the rise in FX market turnover. FX reserves are currently 6.9x FY02 levels, and spot FX market turnover has risen to 13.3x FY02 levels. Therefore, in our view, the cost of intervention is likely to be higher as the RBI will have to buy more US dollars to effectively stem INR appreciation, which increases liquidity in the system. At a time when the system is already flush with liquidity, the RBI probably thought it best to limit intervention.

## 2. Will the INR rally continue?

**Regulatory limits on debt investments for FPIs limit upside:** Given the regulatory limits on debt investment in India, we estimate that inflows into debt could be US$15bn at best (Exhibit 7) in the rest of FY18. This compares with over US$8.9bn of inflows from April 2017 to date. Therefore, we are of the view that the current pace of flows into debt is not likely to sustain for the whole of FY18. We also believe that inflows will be front-ended, given the favourable inflation dynamics in 1HFY18 and the prospects of a rate cut at the August 2017 monetary policy meeting. Of course, this situation can change if regulatory limits are significantly relaxed, but we do not believe this is likely.

**Exhibit 7: Maximum additional flows in 9MFY18 can be ~US$15bn at best, compared with over US$8.9bn till date**

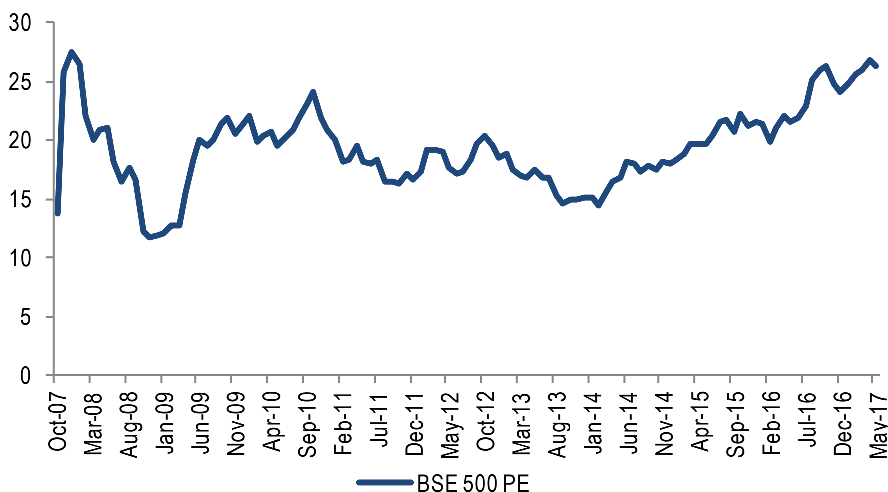
| Category | Current limit (Rsbn) | Estimated increase in limit in FY18 (Rsbn) | Estimated total limit by FY18-end (Rsbn) | Current investment (Rsbn) | Estimated additional investment (Rsbn) | Estimated additional investment (US$bn) |
|---|---|---|---|---|---|---|
| Government securities | 2310 | 425 | 2735 | 2,074 | 661 | 10.08 |
| State development loans | 270 | 230 | 500 | 155 | 0 | 0.00 |
| Corporate debt | 2443.23 | 0 | 2443.23 | 2,139.05 | 304.18 | 4.64 |
| Reinvestment of coupons of central government securities | 41.63 | 3.37 | 45 | 41.63 | 3.37 | 0.05 |
| **Total** | **5064.86** | **658.37** | **5723.23** | **4409.47** | **968.76** | **14.77** |

*Source NSDL, RBI, Nirmal Bang Institutional Equities Research*

Our US$15bn estimate assumes an increase in FPI debt limits for central government securities and state development loans (SDLs) according to the RBI's medium term framework, which envisages increasing foreign holding in central government securities to 5% of outstanding, and for SDL to 2% of outstanding by March 2018. We also assume 100% utilisation of debt limits, except in the case of SDLs, where we believe the status quo will be maintained despite increase in the limit available for investment. FPI interest in SDLs has been tepid, and we do not believe this is likely to change in the near future, particularly with the recent deterioration in state finances.

**Peak valuations may be a concern for equity investors in the near term:** Unlike the debt market, the equity market has no regulatory restrictions on the absolute quantum of investments apart from sectoral limits. But equity market valuations are also looking a bit stretched to justify significant inflows (Exhibit 8).

**Exhibit 8: Peak valuations could limit FPI equity inflows in the near term**

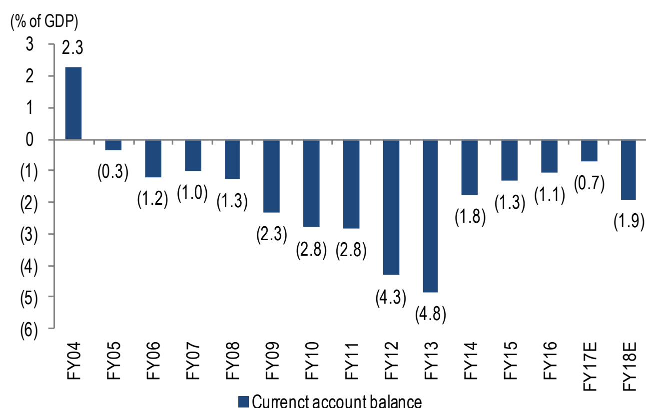



*Source: CEIC, Nirmal Bang Institutional Equities Research*

Therefore, in our view, the near-term upside for the INR is likely to be limited.

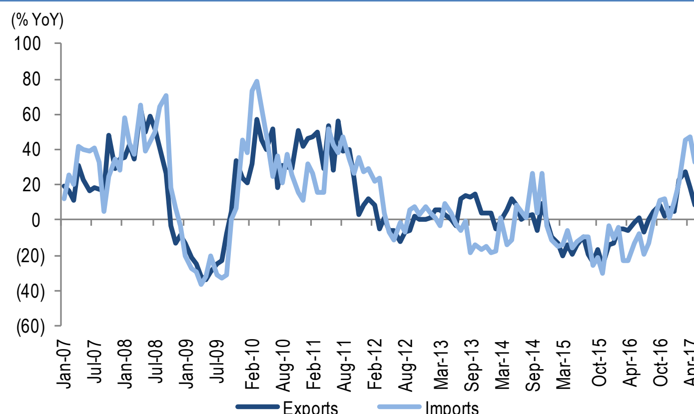
**CAD set to increase, rendering a depreciation bias to the INR:** A widening CAD, in our view, renders a depreciation bias for the INR. The current account deficit or CAD has been declining since FY13 and stood at 0.7% in FY17. However, we expect the CAD to rise to 1.9% in FY18 as growth recovers (Exhibit 9). It is also likely to sustain at around 1.5%-2.0% level in the coming years. Exports are recovering after over two years of decline, but imports are growing faster (Exhibit 10). The invisibles surplus comprising services exports and remittances from abroad, which has traditionally offset the trade balance, is also facing structural headwinds adding to the pressure on CAD.

**Exhibit 9: CAD likely to rise …**




*Source: RBI, CEIC, Nirmal Bang Institutional Equities Research*

**Exhibit 10: …as imports are rising faster than exports**




*Source: RBI, CEIC, Nirmal Bang Institutional Equities Research*

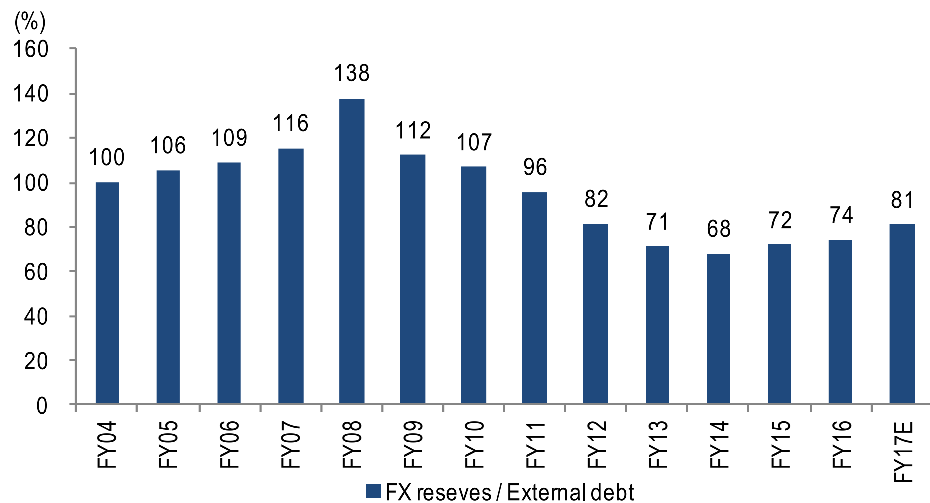
**Inflation differentials suggest depreciation, but the impact is negated by high real interest rates:** Economic theory tells us that a country with a higher inflation should witness depreciation of its currency against its trading partners. Considering the fact that the US inflation target is 2% and India's medium-term inflation target is 4%, it implies depreciation of about 2% of the INR against the USD to maintain competitiveness. But this relationship has, to a large extent, been negated in the short term by the sharp fall in inflation to around 2%, and the resultant high real interest rate environment combined with better growth prospects and relatively strong macro-economic fundamentals. We also expect real interest rates to be maintained at a relatively high level till inflation expectations are anchored. Therefore, while medium-term inflation differentials render a depreciation bias, the impact is probably much more muted than we earlier anticipated.

## 3. What if portfolio inflows reverse?

**Some downward pressure is inevitable….:** The rise of the INR supported by portfolio inflows also implies that the INR is prone to volatility on reversal of flows. In fact, the depreciation of the INR in late 2016 was on account of outflows of about US$11.3bn between October and December. Debt flows are particularly prone to contagion in the event of global market turmoil.

**…but extreme moves likely to be short-lived on better macroeconomic fundamentals….:** At the same time, we believe a sustained improvement in India's macro fundamentals suggest that reversals will be relatively short-lived. Firstly, despite all concerns, India is likely to remain among the fastest-growing economies in the world, which will continue to attract capital. Secondly, external vulnerability indicators are relatively sound. As a case in point, FX reserves stand at a comfortable 80% of total external debt, and have witnessed an improvement recently after falling to around 70% (Exhibit 11). According to estimates compiled by the Ministry of Finance, as of 2015, India ranked fifth based on FX reserves as a share of external debt, with China, Thailand, Philippines and Peru faring better. Based on 2017 data, India's ranking is likely higher. Finally, we believe, India is on track for a rating upgrade in the next couple of years which supports debt inflows into India. We had highlighted in our report: Does A Rating Upgrade Matter for India? based on experience from other markets, that investors tend to price in a upgrade before it actually happens.

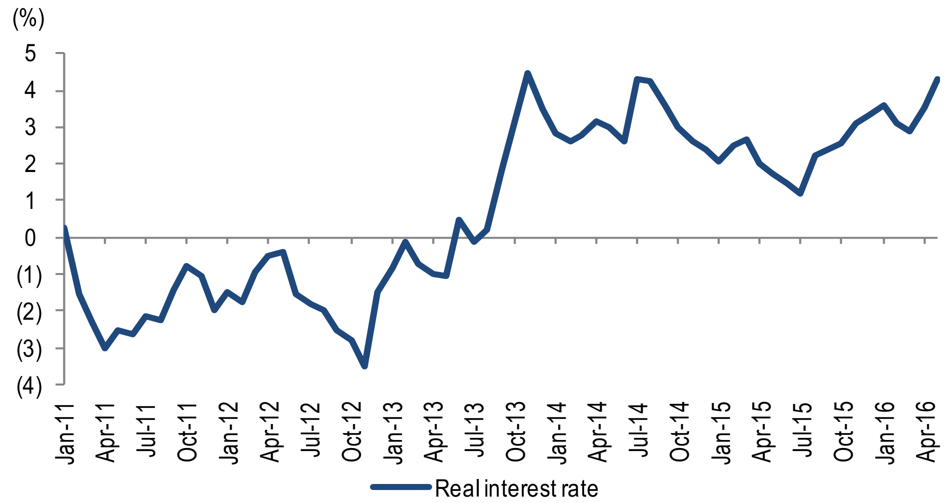
**Exhibit 11: FX reserves stand at a comfortable 80% of total external debt**




*Source: Ministry of finance, RBI, CEIC, Nirmal Bang Institutional Equities Research*

**…. supported by positive real yields:** The RBI's shift in stance to an inflation-targeting regime is also supportive of capital inflows as real yields have turned positive since 2014 (Exhibit 12). More recently, the fall in inflation to sub 3% level has been responsible for pushing real yields higher. As noted in our report: Inflation Targeting Aka 'Ghostbusting', our analysis of other inflation-targeting countries suggests that real interest rates are likely to remain relatively high in the short to medium term till inflation expectations are anchored. This, in our opinion, should continue to bode well for capital inflows.

**Exhibit 12: Positive real interest rates likely to stay till inflation expectations are anchored**




*Note: Real interest rates measured by policy repo rate and one year ahead of CPI outturn*
*Source: RBI, CEIC, Nirmal Bang Institutional Equities Research*

## Disclaimer

This report is published by Nirmal Bang's Institutional Equities Research desk. Nirmal Bang group has other business units with independent research teams separated by Chinese walls, and therefore may, at times, have different or contrary views on stocks and markets. Reports based on technical and derivative analysis may not match with reports based on a company's fundamental analysis. This report is for the personal information of the authorised recipient and is not for public distribution. This should not be reproduced or redistributed to any other person or in any form. This report is for the general information for the clients of Nirmal Bang Equities Pvt. Ltd., a division of Nirmal Bang, and should not be construed as an offer or solicitation of an offer to buy/sell any securities.

We have exercised due diligence in checking the correctness and authenticity of the information contained herein, so far as it relates to current and historical information, but do not guarantee its accuracy or completeness. The opinions expressed are our current opinions as of the date appearing in the material and may be subject to change from time to time without notice.

Nirmal Bang or any persons connected with it do not accept any liability arising from the use of this document or the information contained therein. The recipients of this material should rely on their own judgment and take their own professional advice before acting on this information. Nirmal Bang or any of its connected persons including its directors or subsidiaries or associates or employees or agents shall not be in any way responsible for any loss or damage that may arise to any person/s from any inadvertent error in the information contained, views and opinions expressed in this publication.

*Nirmal Bang Equities Private Limited (hereinafter referred to as "NBEPL") is a registered Member of National Stock Exchange of India Limited, Bombay Stock Exchange Limited. NBEPL has registered with SEBI as a Research Entity in terms of SEBI (Research Analyst) Regulations, 2014.* ***(Registration No: INH000001436 -19.08.2015 to 18.08.2020).***

*NBEPL or its associates including its relatives/analyst do not hold any financial interest/beneficial ownership of more than 1% in the company covered by Analyst.*

*NBEPL or its associates/analyst has not received any compensation from the company covered by Analyst during the past twelve months. NBEPL /analyst has not served as an officer, director or employee of company covered by Analyst and has not been engaged in market-making activity of the company covered by Analyst.*

*The views expressed are based solely on information available publicly and believed to be true. Investors are advised to independently evaluate the market conditions/risks involved before making any investment decision.*

**Access all our reports on Bloomberg, Thomson Reuters and Factset.**

**Team Details:**

| Name | | Email Id | Direct Line |
|---|---|---|---|
| Rahul Arora | CEO | rahul.arora@nirmalbang.com | - |
| Girish Pai | Head of Research | girish.pai@nirmalbang.com | +91 22 3926 8017 / 18 |
| **Dealing** | | | |
| Ravi Jagtiani | Dealing Desk | ravi.jagtiani@nirmalbang.com | +91 22 3926 8230, +91 22 6636 8833 |
| Pradeep Kasat | Dealing Desk | pradeep.kasat@nirmalbang.com | +91 22 3926 8100/8101, +91 22 6636 8831 |
| Michael Pillai | Dealing Desk | michael.pillai@nirmalbang.com | +91 22 3926 8102/8103, +91 22 6636 8830 |
| Atul Vitha | Dealing Desk | atul.vitha@nirmalbang.com | +91 22 3926 8071 / +91 22 3926 8226 |

## Nirmal Bang Equities Pvt. Ltd.

**Correspondence Address**
B-2, 301/302, Marathon Innova,
Nr. Peninsula Corporate Park,
Lower Parel (W), Mumbai-400013.
Board No. : 91 22 3926 8000/1; Fax. : 022 3926 8010