ACUMEN

US Rate Hikes - Impact on local markets

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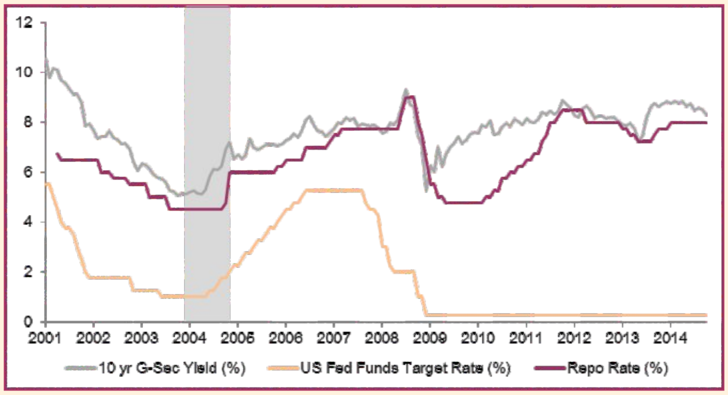
Stance of monetary policy

Back in 2004-06, there was a coordinated series of rate increases by many global central banks as the global economy was on a boom. Specifically RBI and the Fed were hiking at the same time as inflation rose in both countries.

Currently we are facing very different monetary policy regimes. While the Fed ended QE and is probably planning to increase rates next year, RBI is at its peak of rates and has indicated that with lower inflation there would be room for monetary accommodation (i.e. lower interest rates). In the last cycle, bond yields rose in response to expected and actual RBI rate hikes. This time around, we have seen a sell-off on QE tapering fears, but RBI may actually be cutting rates even as the Fed hikes.

The end of the quantitative easing programme of the US Federal Reserve and potential rate hikes next year could have a significant impact on our bond markets. We look at what happened the last time the Fed embarked on a series of rate hikes and try and draw some conclusions.

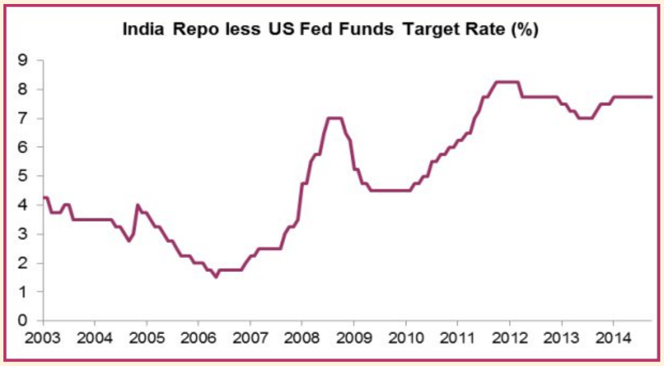
Timelines: then and now



Between 2004 and 2006, the Fed hiked rates from 1% (then a historic low) to 5.25%. From a bottom of 5% in 2003, Indian 10-year benchmark yields rose to 7.5% by the time these rate hikes ended. The sell-off should be seen in two phases. Between Oct 2003 and Nov 2004, yields rose by about 200 basis points (bps) from 5.1% to 7.2%. This was the period when the markets adjusted to the change in local and global monetary policy. In comparison to the 2001-03 period when rates came down in India and the US, rates were expected to rise. Consequently we saw a sharp market re-pricing as the bond market adjusted itself to revised expectations. It is instructive to note that this adjustment occurred largely before the rate hikes started (the first Fed hike was in Jun 2004 and the first RBI hike was in Oct 2004). During the actual period of the Fed hikes, the market was relatively sideways.

In comparison, we have already seen a 200+ bps sell-off in bonds last year. From a low of 7.2%, 10-year benchmark G Sec yield rose to 9.4% last year – in response to expected Fed tapering of QE. Once again this has happened in advance of any actual tapering or rate hike by the Fed. This leads us to believe that a substantial part of the risk of future US rate increases has probably been priced into our markets.

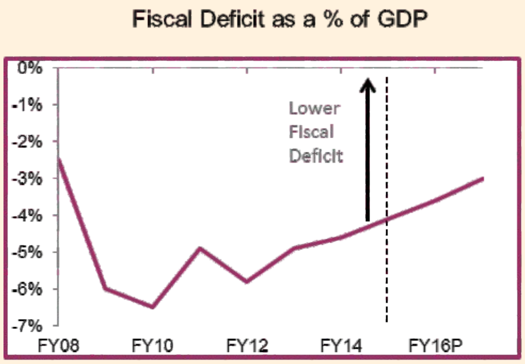
What about interest rate differentials? Will not higher US rates lead to outflows from India?

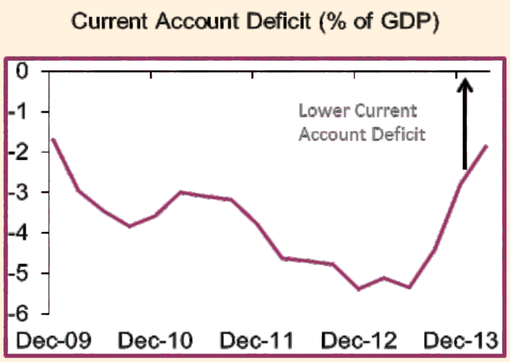


There is the fear that higher US rates will draw FII money away from India. This is not borne out by history. During 2004-06 even with rate hikes money continued to flow into India from FIIs. Secondly, back in 2004 at the start of the cycle, US rates were at 1% and Indian rates were at 4.5% implying a 350 bps differential. By the end of the Fed rate hikes, the rates were respectively 5.25% and 6.50% implying a differential of just 125 bps. In contrast currently the US is close to zero (officially the overnight target is 0 to 0.25%), while RBI is at 8%, a differential of nearly 800 bps. If the previous differential of 125-350 bps did not lead to outflows why should the market expect outflows when the differential is much larger now?

Another way of looking at this is that we can sustain a number of rate cuts by RBI and/or a number of rate hikes by the Fed before the interest rate differential narrows to previous cycle levels.

A changed macro-economic scenario

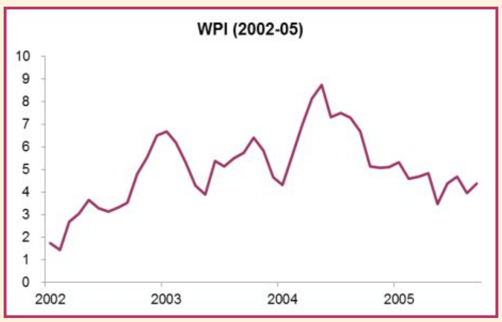


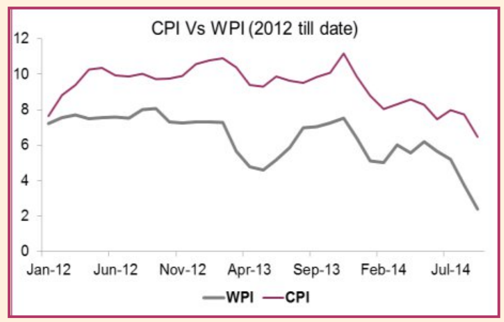


The 2013 sell-off in the Indian Rupee and bonds should be seen in the context of the time. With the current account deficit at record high and high fiscal deficits till 2012, the "twin deficits" were hurting India. Between 2010 and 2013 the Rupee depreciated by a cumulative 17.2%. In contrast the last year and a half has seen substantial improvements in the two deficits: the current account deficit has fallen to under 2%, while the fiscal deficit has fallen to 4.1%. The government has committed to bringing the fiscal down to 3% in two years. Thus the twin deficit problem has been largely resolved reducing the system's reliance on external funding. Inflation which has been the most significant concern for RBI has begun to recede – and will further be aided by falling global commodity prices and a relatively stable currency.

The US macro environment too is important in this context. The US Fed will hike rates only if the US economy is doing well. And as RBI Governor Dr. Rajan pointed out in a recent article, this is good for India. Better US macro will lead to higher exports and a better current account situation. We saw this in the last cycle when the current account turned to a surplus and the Rupee rose during the years of rate hikes by the Fed.

The RBI rate hikes starting in 2004 happened as inflation rose sharply. Over the course of 2004, WPI inflation rose from 4.3% to 8.7 %. In contrast both WPI and CPI inflation have fallen during the past year and the RBI has indicated that they do not foresee any rate increases and would look to cut rates if inflation stabilizes at lower levels.





In summary

While at first glance it would seem that the possible US rate hikes next year could lead to upward pressure on Indian yields we see that the situation this time around is very different from where we were ten years ago. The starting interest rate differentials are much higher and the direction of monetary policy of the Fed and RBI are likely to be different. The macro environment - in terms of current account and the currency – are likely to be supported by US economic performance if the evidence of the last cycle holds. And indeed to the extent that the last cycle saw a 200+ bps sell-off in bonds here, we have seen a similar magnitude move already.

All of this leads us to believe that while yields shot up last year on tapering concerns, the market has not taken into account the very different macro environment this time around as compared to the last rate cycle. We believe that the bond market will react over time to RBI rather than the Fed. Thus expectations of RBI rate cuts in response to lower inflation will dominate the movement in Indian gilts.

Data updated as on 31st Oct 2014. Source : Bloomberg, IIFL Research.