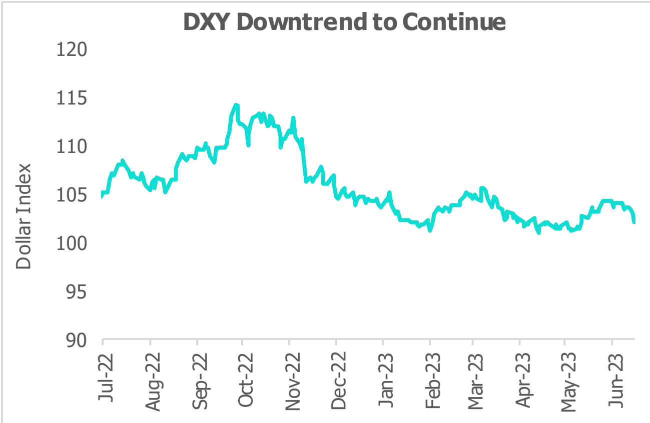
Monthly Forex Market Update

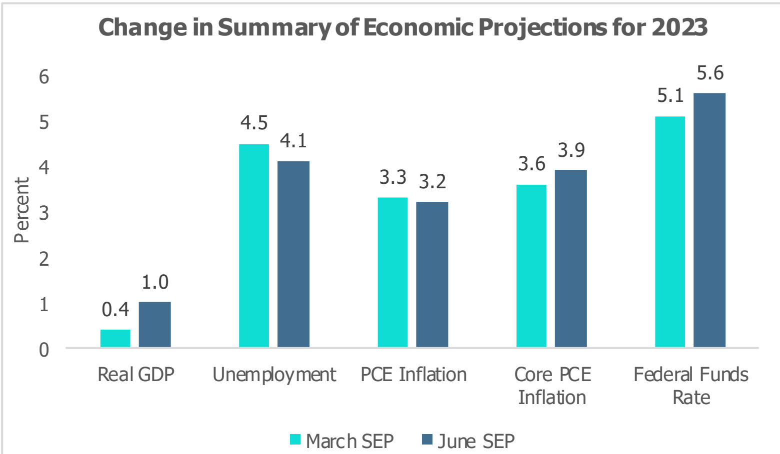
June 21, 2023 I Economics

Global Overview

Dollar Index

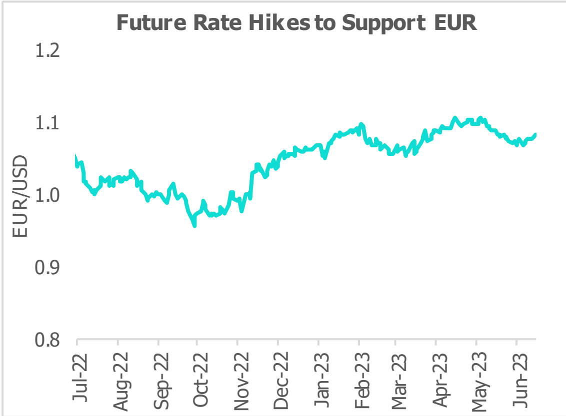


- Following the outcome of the Federal Open Market Committee (FOMC) meeting, the dollar index has experienced a marginal decline over the past month, erasing the gains it had made in May. As anticipated, the US Federal Reserve decided to keep interest rates unchanged. However, the market received conflicting signals from the meeting. On one hand, there was an upward revision of the median Fed funds target rate, indicating a potentially more hawkish stance. On the other hand, there were downward revisions in the unemployment and Personal Consumption Expenditures (PCE) inflation forecasts for the year, although core PCE forecasts were revised upward. Additionally, GDP estimates for 2023 were revised higher, reflecting increased economic optimism. The revision of the median estimates for the mid-point of the target range from 5.1% to 5.6% led to the market pricing in a total of 50 basis points (bps) of additional rate hikes for this year. Furthermore, Federal Reserve Chair Jerome Powell hinted at the possibility of action during the upcoming July meeting, referring to it as a "live meeting". Despite these developments, the dollar index has trended lower in response to the outlook for inflation and the labour market, indicating that rates could remain unchanged for the rest of the year if incoming data points to further softening.
- On the data front, while CPI moderated below market expectations (4% y-o-y in May vs 4.1% expected), sticky sequential momentum in core CPI (0.4% m-o-m, unchanged from previous month) pointed to underlying price pressures. The labour market showed mixed signals. Nonfarm payrolls beat forecasts rising 339K in May (vs 190K expected), wage growth slowed (4.3% y-o-y in May vs 4.4% prior), and unemployment rate rose above estimates (3.7% in May vs 3.5% forecast) in May. Other high-frequency indicators such as PMI and retail sales also pointed to slowing momentum.
- Fed Chair Powell discussed that rate decisions typically take into consideration three aspects, i) how high to go, ii) how fast to go, and iii) how long should the central bank stay at the peak, all of which require separate assessments. We believe that as long as incoming data points to softening, the possibility of rate increases could get priced out. In such a scenario, dollar could resume its downtrend. Moreover, the narrowing rate advantage over currencies like EUR and GBP could continue to weigh on the dollar.



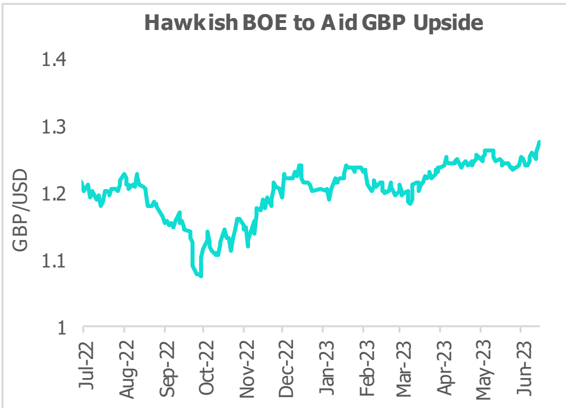
Source: US Federal Reserve (Note: Projections of real GDP and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the current year. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the current year)

Euro



- The EUR/USD pair rose over 1% in the past month, after ECB not only hiked interest rates by 25 bps as expected but also made upward revisions to its inflation forecasts signalling more rate increases in coming months.
- ECB hiked the policy rate by 25 bps to 3.5%, expressing concern over elevated inflation, even as recent prints have pointed to some moderation. It estimated headline inflation to average 5.4% in 2023, up from its March projection of 5.1%, while core inflation projection was revised significantly higher to 5.1% in 2023 from an earlier estimate of 4.6% citing effects of a robust labour market dampening the speed of disinflation. The ECB's survey on Access to Finance of Enterprises released earlier this month also showed that lower profitability of firms was driven by an increase in labour costs. The net percentage of firms reporting an increase in labour costs rose to 77%, a new historical peak in the survey. Meanwhile, GDP growth was revised slightly lower to 0.9% in 2023, from March projection of 1%.
- In the near term, we maintain an upside bias on the Euro on prospects of rates rising higher and as the dollar loses its rate advantage over euro. However, stronger-than-expected data coming from the US could dampen the upside. Markets have factored in two more rate hikes of 25 bps each in July and September.

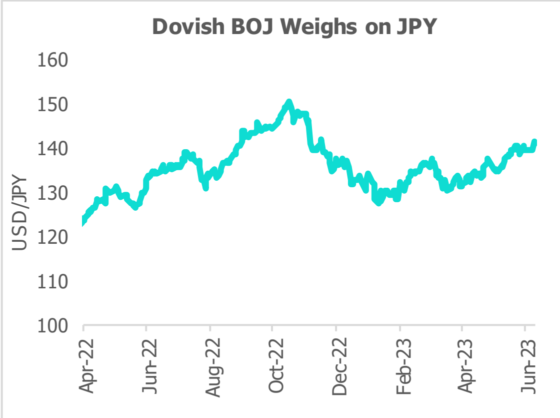
British Pound



- The British Pound gained 3% over the last month after stronger-than-expected macro data took terminal rate expectations to 5.75% from the current bank rate of 4.5%. Latest macro data also supported the case for further tightening in June. Although easing, CPI inflation at 8.7% y-o-y remained higher than BOE's estimate of 8.4% for April, while core CPI beat forecasts, rising 6.8% y-o-y in April. Moreover, GDP growth rose 0.5% y-o-y in April from 0.3% a month prior, pointing to a slow growth, rather than a recession. At the May MPC meeting, BOE revised its GDP forecast for Q2 2023 to 0% from a 0.3% contraction estimated in February. The labour market continued to show signs of resilience with a higher-than-expected rise in the number of employed persons (250K in 3 months ending April vs 150K estimated) and improving wage growth (7.2% in April vs 6.8% prior). The unemployment rate too edged lower to 3.7% in April, missing estimates of 4%.
- With an improvement in the economic outlook and concerns over inflation still intact, the pound could continue benefitting from BOE's need to hike interest rates further. We see another 25 bps rate hike at the June MPC meeting, with the possibility of more rate hikes arising if inflation remains above BOEs liking. However, BoE could pause earlier than the current market pricing if the growth outlook worsens. Markets are currently pricing in a total of 125 bps (including the June hike) of hikes by December 2023.

Japanese Yen

- The Japanese yen declined 3% in the past month despite a pullback in the dollar, in absence of any indication from Bank of Japan over policy adjustments. BoJ decided to leave its policy rate unchanged to support economic recovery amidst expectations of moderation in inflation. The central bank however highlighted uncertainty over firms' wage-setting behaviour as an upside risk to inflation.



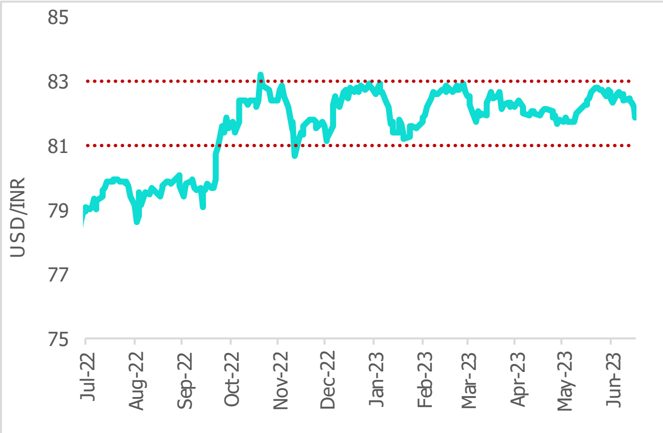
- On the data front, both headline and core inflation pointed to unabating price pressures. CPI rose 3.5% y-o-y (vs 3.2% prior), while core CPI came in at 3.4% y-o-y (vs 3.1% prior). Wage growth rose 1% in April, beating forecasts of a 0.5% rise. Meanwhile, Q1 GDP growth was revised higher at 2.7% from initial estimate of 1.6%. Other high-frequency indicators such as PMI, retail sales and industrial production however painted a mixed picture.
- We believe BOJ will look for sustained evidence of higher-than-expected wage growth and household spending before deciding to adjust its yield curve control (YCC) policy. With the review of past policies still underway, update on which is expected next month, it is unlikely that BoJ would consider moving away from its current stance until a complete assessment of the benefits and side effects of YCC is carried out. That said, we expect the yen to remain under pressure due to i) its rising preference as a funding currency amidst a prolonged dovish BoJ stance and, ii) a widening trade deficit.

Indian Rupee

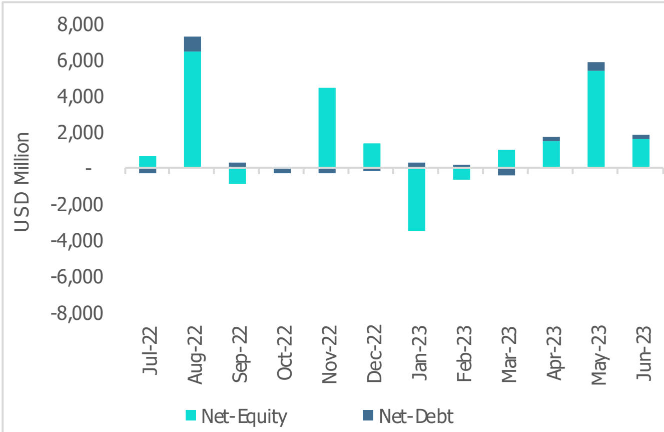
- The rupee remained constricted within the 81-83 band on aggressive RBI intervention, irrespective of the dollar's performance through the past month. RBI's continued two-way intervention is also evident from the sharp decline in FX volatility. A positive bias for the rupee can also be attributed to improved growth prospects, healthy capital inflows, and lower oil prices.
- On the domestic front, RBI left the repo rate unchanged at the June MPC meeting, while reiterating its commitment to bringing inflation down to the 4% medium-term target on a sustainable basis. RBI also lowered its inflation projection for FY24 marginally from 5.2% to 5.1%. Inflation data for May has further confirmed our view of a prolonged pause in the current tightening cycle by the RBI. CPI eased to over a 2-year low of 4.3% in May, supported by a favourable base and moderation in food inflation. WPI too remained in deflationary zone (-3.5% y-o-y) for the second consecutive month in May, signalling prospects of further softening of retail inflation going ahead. We retain our FY24 CPI inflation forecast at 5.1%, while revising FY24 growth estimates higher to 6.5% from 6.1% prior. That said, weather-related disruptions could be the main threat to food inflation and overall CPI inflation in FY24. We retain our view of RBI maintaining an extended pause in 2023. An extended pause on rates would ensure real rates are sustained above 1%.
- Lower crude oil prices, despite OPEC's efforts to tighten production, bode well for the domestic inflation and rupee outlook. Saudi Arabia decided to cut production by 1 million barrels per day from July, lowering its oil output to 9 million bpd in July from around 10 million bps in May. This voluntary cut is on top of a broader deal by OPEC+ countries to cut supply into 2024, as against the initial expiry of production cuts by end-2023. Despite this, Brent and WTI crude oil prices have declined 3% and 4%, respectively over the last month on lingering global demand concerns. With global oil inventories expected to decline, EIA revised its 2023 Brent crude oil forecast higher by $1/bbl to $79.54/bbl.
- Overall, we expect the rupee to remain in the 81-83 range by end-FY24, with an improving CAD, capital inflows, lower oil prices and positive real rates contributing to a positive bias.

Indian Forex Market Chartbook

Rupee Trades Rangebound on RBI Intervention



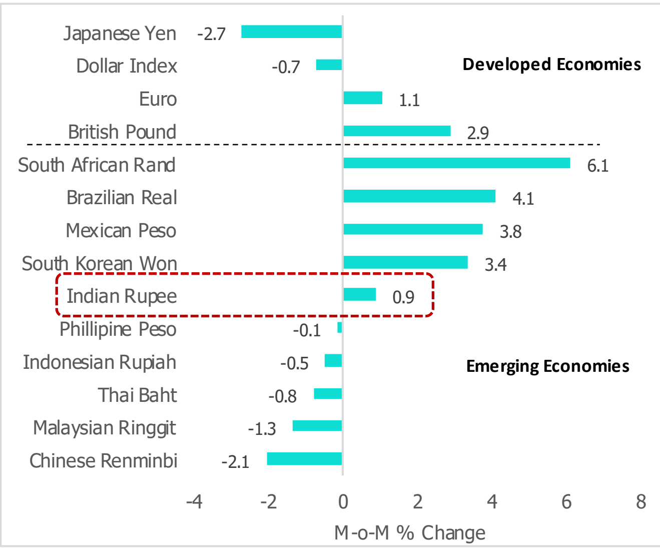
FPI Flows Turn Positive for the Fourth Month



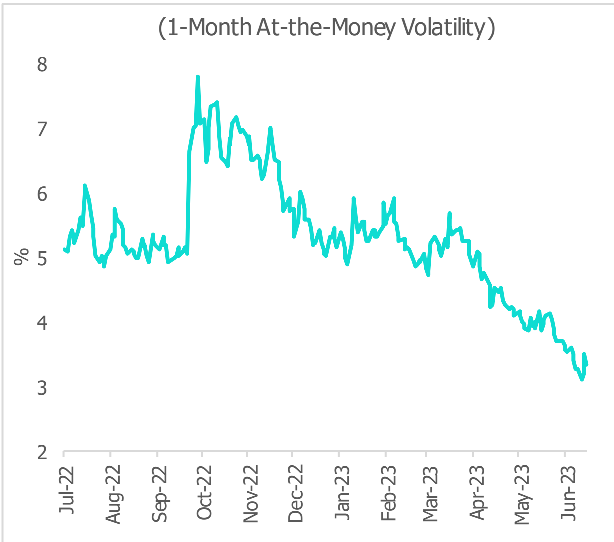
(Net FPI flows debt includes VRR; *Jun 2023 data up to Jun 15)

The Indian rupee has traded within a tight range of 81-83 since late 2022 on active RBI intervention. The Indian currency was largely supported by overseas inflows, lower oil prices and positive real rates. FPI flows rose to USD 5.8 billion in May, its highest level in 9 months, with the positive trend continuing in June.

INR Comparative Performance Vs Major Currencies

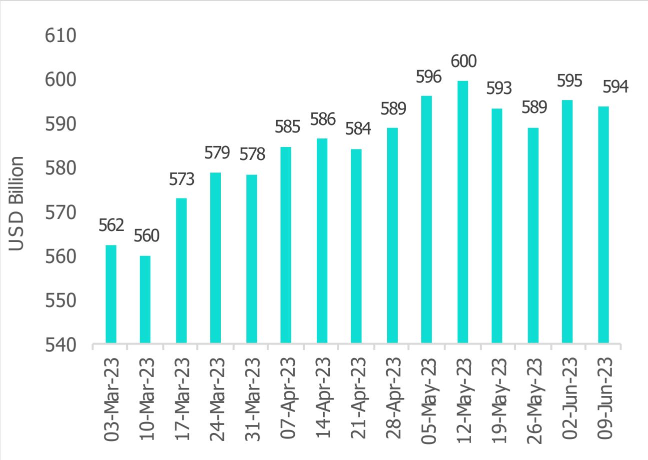


INR Volatility Dips to Multi-Decade Lows



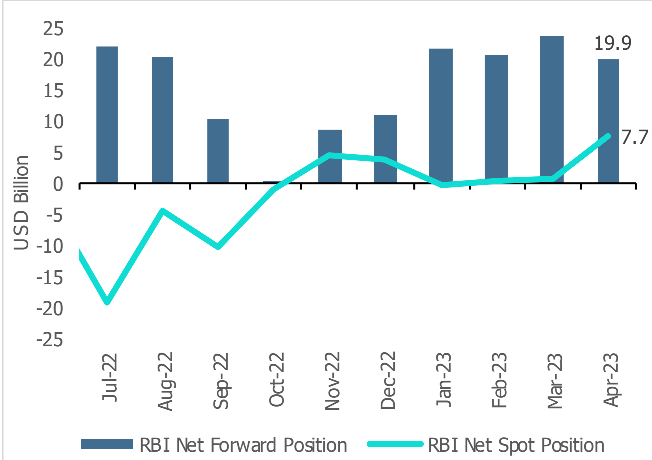
Rupee stood as one of the better-performing currencies amongst emerging market peers. Rupee's expected volatility also fell to multi-decade lows, reflective of RBI's active presence. That said, Chinese Renminbi's depreciation following rate cuts by the People's Bank of China (PBoC) is likely to put pressure on INR, to remain competitive on the export pricing front. Moreover, a declining CNY/INR could make imports from China attractive, further straining India's trade deficit with the Asian giant.

FX Reserves Decline from a Month Ago



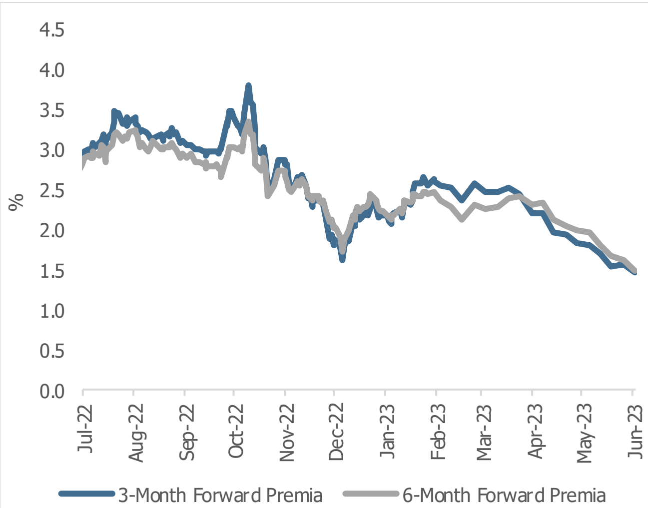
(*Data for June 2023 is as of week ended June 9)

RBI Builds its Forward Dollar Book

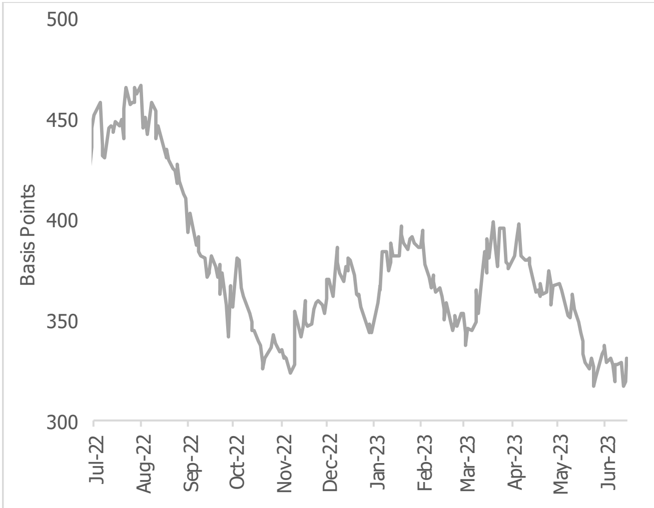


FX Reserves stood at USD 594 billion in the week ended June 9, lower than USD 600 billion recorded a month ago. Although still elevated, the weekly decline in reserves through most of May points to RBI's possible move to defend rupee after it weakened to near-83 levels. While RBI acquired a whopping net USD 7.7 billion of dollars in the spot market in April, its net forward dollar book declined marginally, indicating that it is taking delivery of its maturing forward position, alongside shoring up its spot dollar reserves to offset any liquidity consequences.

Forward Premia Rates Ease Further



India-US Interest Rate Differential Narrows



Forward premia rates have continued to trend, in sync with the narrowing yield differential between India and the US. The differential between India-US 10-year benchmark bonds narrowed to 327 bps as on June 16 from 350 bps a month ago, on account of a sharp rise in US yields.

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