INSIGHTS

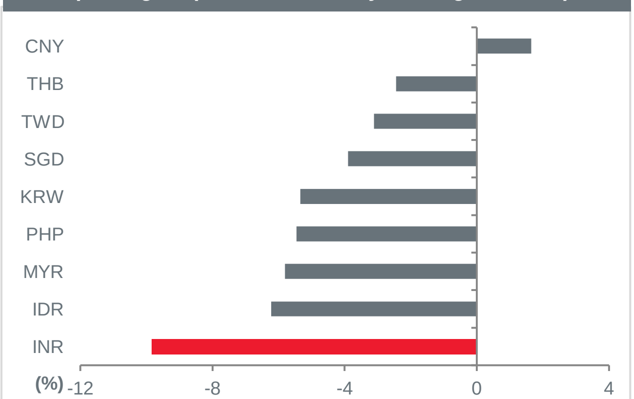
August 2013

Near Term Currency Stability Takes Precedence Over Growth in India

Against a backdrop of slowing growth, high inflation and a depreciating currency, Indian policymakers are facing a dilemma. An easing stance would help growth while the reverse would rein in inflation and support the Rupee (INR). Recent measures aim to support the latter but its outcome remains to be seen.

Concerns about the US Federal Reserve tapering its QE program sooner than expected triggered broad sell-offs across Asia Pacific in late May/June. Asian markets weakened as US rate rise expectations continued to drain fund flows from the region. India was no exception. Consequently the INR which has been under pressure for sometime now, mainly due to the country's elevated current account deficit, depreciated significantly against the US dollar.

Chart 1: Indian Rupee is the worst performer in the Asia ex Japan region (Year-To-Date July 2013 against US$)



The sharp depreciation of the Rupee led the Reserve Bank of India (RBI) to introduce tightening measures, including some unconventional ones, to attract portfolio flows into the debt market, facilitating a more attractive US dollar carry (refer to Table 1).

Furthermore, in a bid to attract more US dollars, the finance ministry liberalised a few sectors in a rush, increasing the Foreign Direct Investment limits in Telecom and Defense sectors to attract investments.

Table 1 : RBI announces measures to address exchange rate volatility

15th July 2013	23rd July 2013
To reduce the credit available	**in the system**
The RBI restricted the amount of inter-bank liquidity under liquidity adjustment facility (LAF) to INR 750 billion / US$12.5 billion (1% of net demand & time liabilities (NDTL)	The RBI introduced further restrictions by halving the LAF to 0.5% of NDTL)
Increased the marginal standing facility (MSF) rate to 10.25% (by 200bps) if banks want liquidity of more than INR 750 billion	
To drain INR liquidity from the system	
Announced open market sales of INR 120 billion / US$ 2 billion	Increased the minimum daily Cash Reserve Requirement (CRR)

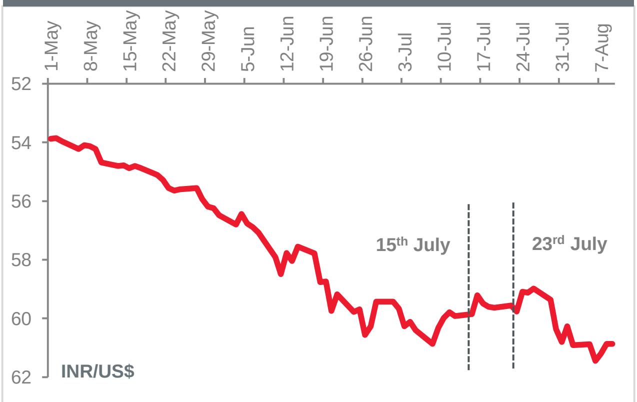
The measures announced on 23rd July have tightening implications equivalent to a 25 to 50 basis points (bps) hike in the policy Repo rate.

During the 30th July quarterly monetary policy, RBI maintained the policy rates; however they said "We are determined to bring down exchange rate volatility. We know there will be pain in doing this".

However, given that these measures have not been able to bring back any stability or positive price movement in the Rupee so far (see Chart 2 overleaf), more may be required from the RBI and the government. Expectation of a policy rate hike in the next RBI meeting is building.

Source : (Chart 1) Thomson Reuters DataStream 30 July 2013. Note: CNY =Chinese Yuan, THB =Thai Baht, TWD=Taiwan Dollar, SGD=Singapore Dollar, KRW =Korean Won, PHP=Philippines Peso, MYR=Malaysia Ringgit, IDR=Indonesia Rupiah, INR=India Rupee. (Table 1) Reserve Bank of India, July 2013.

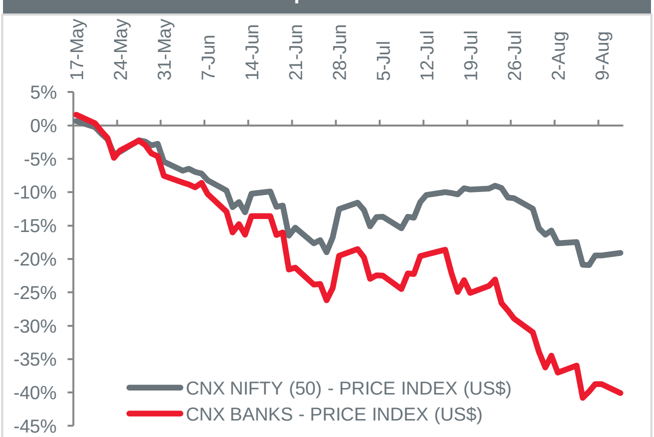
Chart 2: Rupee depreciation continues despite recent measures



Impact of Measures

Indian equities have reacted negatively to the recent tightening measures as expectations of continued easing trajectory were built in given that growth has been subdued. While a pause may have been acceptable, a reversal in the policy stance has surprised the market.

Chart 3 : Downward trend persists



Interest rate sensitive sectors such as Financials and Industrials have been hit the most. At the margin the new measures do not bring many near term positives for Banks with low deposit base and for Non Banking Finance Companies (NBFCs), which borrow from the wholesale market to lend to their customers.

Outlook and Strategy

In our India portfolios, we have been underweight Banks and overweight NBFCs and Real Estate. The NBFCs that we own are strong and established franchises with low dependence on wholesale funding.

In Real Estate, our exposure is to names that are net cash positive companies with no/or low gearing of 0.5 to 0.6.

We believe the medium to long term structural story and business model of these franchises and property companies remain intact. That said, these stocks have been punished and current price may be more than discounting a temporary blip, in our view. We are monitoring the developments closely and should the current environment tighten any further and there be a need to alter our long term valuations assumptions, we may take corresponding portfolio action at appropriate market timings.

Source : (Chart 2 and 3) Thomson Reuters Datastream, 12 August 2013.

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