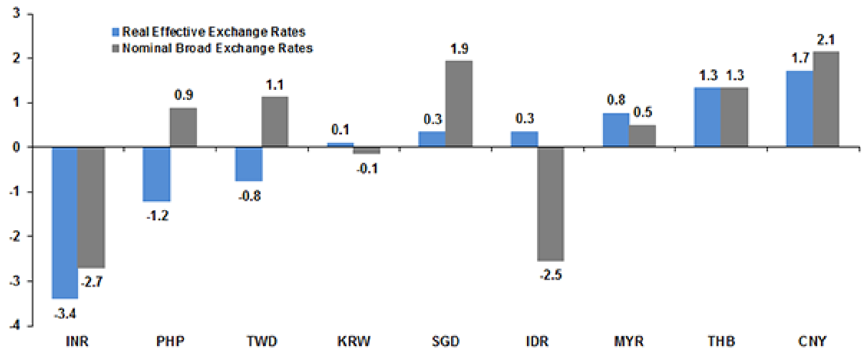
THE INDIAN RUPEE MAY OFFER RELATIVE VALUE

Rick Harper — Head of Fixed Income & Currency
10/16/2013

India has been in the eye of the emerging market (EM) storm in the middle of 2013. Among EM economies, India has one of the largest current account deficits—at -5% of gross domestic product (GDP)—which is driven primarily by its trade deficit. As we mentioned in a previous blog post, in today's market environment, countries with large external vulnerabilities have come under pressure. Given that India's principal imports are oil and gold, the trade balance is particularly sensitive to rises in commodity prices. However, the Indian rupee's recent performance has not been driven solely by domestic factors. Speculation that the U.S. Federal Reserve (Fed) would begin tapering its bond-buying programs caused interest rates to rise for a four-to-five-month period from early May to September 18—the day the Fed decided to delay its tapering decision. Coinciding with a global rise in interest rates, the Indian rupee declined by over 15% from the beginning of May up until September 18[1]. With the Fed surprising markets, we believe the India rupee may be undervalued at current levels. **Fed's Inaction Delivers a Reprieve to India** The Fed's decision not to taper, announced in its September 17/18 Federal Open Market Committee (FOMC) meeting, has supported prices in both equities and currency in India. In September, the MSCI India Index appreciated approximately 6.5%, while the Indian rupee appreciated over 4%. In addition to the Fed's action, the Reserve Bank of India (RBI), under the stewardship of its new governor, Dr. Raghuram Rajan, raised its main policy rate (i.e., the reverse repo rate) in its September 20 policy meeting to combat inflationary pressures in India[2]. As a result, higher rates could further support the currency in the months ahead as investors seek higher carry abroad. **Relative Value in the Rupee Still?** The rupee has depreciated 40% against the U.S. dollar since early 2008, the most of any Asian currency[3]. To contrast this with one of its prime competitors, the Chinese yuan, the rupee reached all-time lows in 2013 whereas the yuan has continued to reach new all-time highs. In our view, the nearly 50% divergence between these two currencies could have a significant impact on trade, especially compared to China. Even though China's currency does not freely-float in value against the U.S. dollar, the fact remains that the significant depreciation of the rupee makes India's goods and service exports cheaper compared to China's. Should inflation remain contained, a weaker currency could help the economy get back on track. Focusing now on one broad gauge of the currency's value, the real effective exchange rate is used by market participants as a way to gauge a currency's value on a relative basis. The real effective exchange rate takes into account the measure of a currency's performance versus its major trading partners after adjusting for inflation. **Figure 1: Exchange Rate Historically Cheap Compared to its Trading Partners [09/30/2003 – 09/30/2013]**



Sources: Bloomberg, WisdomTree. JP Morgan Broad Effective Exchange Rate Indices. Past performance is not indicative of future results. Indian rupee (INR), Taiwanese dollar (TWD), Philippine peso (PHP), Korean won (KRW), Singapore dollar (SGD), Malaysian ringgit (MYR), Thailand baht (THB), Chinese yuan (CNY).

For definitions of terms in the chart, please visit our Glossary. • We evaluated the current exchange rates in the context of their history over last 10 years and show, using a measure of standard deviation from its average rate over this period, how low or high the exchange rate values are compared to their own history. • The real effective rupee exchange rate is approximately 3 standard deviations below its 10-year average. In other words, the rupee has traded at such inexpensive valuations relative to the U.S. dollar less than 0.1% of the time in the past 10 years! • The broad nominal rupee, a measure of the currency versus its trading partners' (without taking into account inflation), is also at historically cheap levels. • The rupee has the most attractive valuations relative to its peers, as indicated by the largest negative bars in the chart above. **Conclusion** In our view, the rupee weakness should translate into improved exports over time, especially if some of the key trading partners such as Europe return to more positive growth. The European Union and North America together comprise almost 30% of India's exports; improved growth in these regions combined with the rupee's depreciation has the potential to be helpful to its exports. This could release pressure from the current account deficit situation and provide additional support for the currency. For foreign investors, the Indian rupee has faced a substantial headwind in recent years. At current levels, we believe the rupee and rupee-denominated assets offer a comparatively attractive way to play a rebound in the Indian economy. With the recent appointment of Dr. Rajan as the head of the Reserve Bank of India, we believe that market sentiment has begun to turn. Although we acknowledge that a turnaround is far from certain, a combination of a historically cheap currency with attractively priced equities and bonds may pave the way for a rebound in the coming months. [1]Source: Bloomberg [2]Source: Reserve Bank of India (RBI), As of 9/20/2013 [3]Source: Bloomberg

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments focused in China and/or India are increasing the impact of events and developments associated with the region, which can adversely affect performance.

For more investing insights, check out our Economic & Market Outlook

Current account : The difference between a nation's total exports of goods, services and transfers, and its total imports of them.

Trade deficit : The amount by which the cost of a country's imports exceeds the value of its exports.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

MSCI India Index : A market capitalization-weighted index designed to measure the performance of the Indian equity market.

Reverse Repo Rate : Reverse repo rate is the rate of interest that banks get when they keep their surplus money with the RBI.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

free-floating : an exchange rate regime whereby the value of the currency is determined by supply and demand against other currencies.

Real effective exchange rate : The weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for the effects of inflation.

Standard deviation : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.