

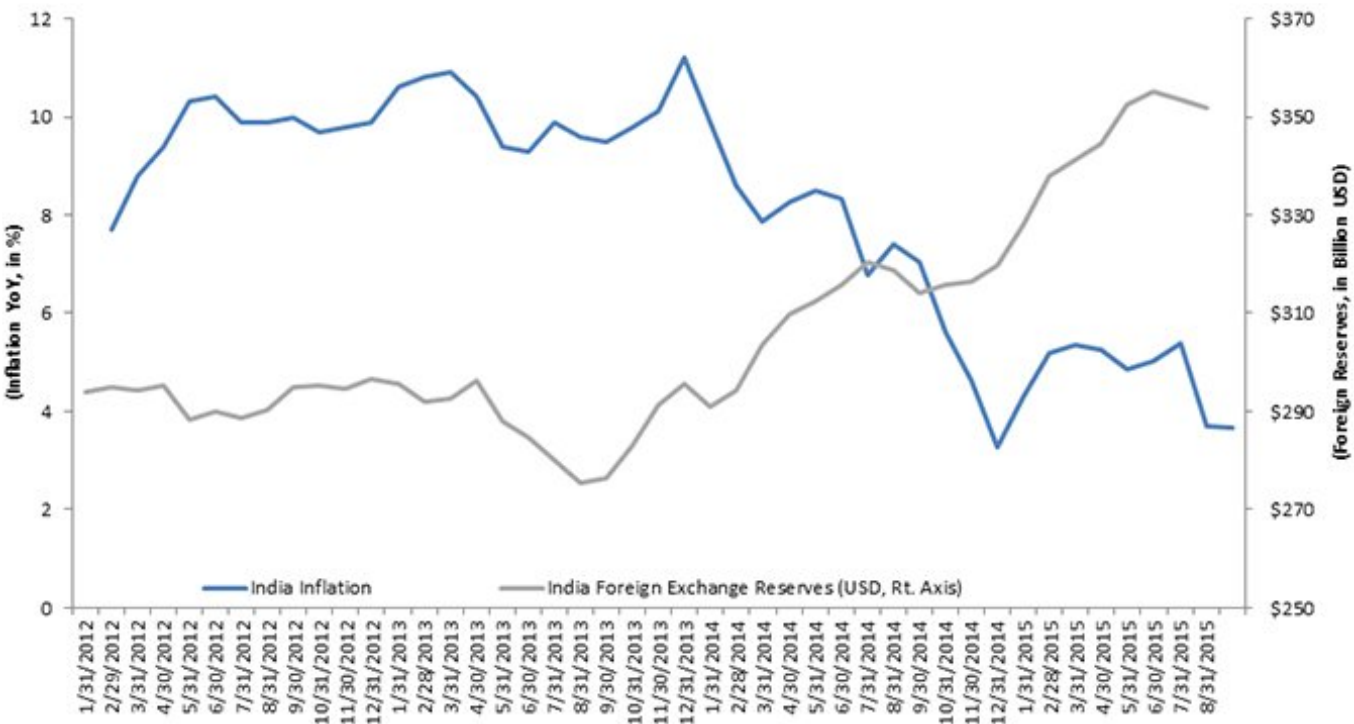
India's Fourth Consecutive Rate Cut and Its Implications

Published October 9, 2015

Gaurav Sinha

Associate Director, Asset Allocation and Modern Alpha

On September 29, Dr. Raghuram Rajan, governor of the Reserve Bank of India (RBI), surprised everyone by again reincarnating as “Rate-Cut Raghu.” Not only did RBI cut interest rates for the fourth consecutive time in a year so far, the magnitude this time was 50 basis points (bps). [We had been anticipating a rate cut in September](#), but the magnitude surprised us. In light of a looming rate hike in the U.S., which has put downward pressure on emerging market (EM) currencies especially, we believe this step is reflective of RBI's confidence in the forward-looking health of the Indian economy. Before we take a deeper dive into short- and medium-term implications of rate cuts for investors, let's also look at other key announcements by RBI in its follow-up meeting, and reasons that led to this decision. **Other Key Notes by RBI** • The tone of RBI remained dovish, and it will be accommodative to the extent possible. • January 2016 inflation will most likely stay below its target of 6% and is expected to average around 5.5% in the current fiscal year 1. • RBI has front-loaded policy action.¹ • **Accessibility of Government Debt to Foreign Investors:** The limit for government bonds available to foreign investors was increased by 5% of total outstanding bonds (or entailing an increase of \$18 billion). A new category for investments in state bonds was created (again limited at 5% of outstanding or ~\$8 billion). • Easing of capital requirements for banks for housing loans will be a boost to the housing sector. • Expect rate transmission by banks to retail/institutional customers soon. **Forward Outlook for Rupee—A Key Concern for U.S. Investors** Local currency performance is always a factor for U.S. investors when investing offshore; therefore, we take a look at the outlook for the rupee in light of the current rate cut. Persistent foreign institutional investor (FII) inflows and a 48% jump in foreign direct investment (FDI) have pushed India's foreign exchange (FX) reserves to an all-time high at \$380 billion (including forward sales).² This has given RBI ammunition and market confidence in the health of the rupee. RBI has already been intervening in FX markets to stabilize the rupee within a broad band and has repeatedly communicated its intent to continue doing so. As a result of these factors continuing its outperforming streak of 2014, the rupee continues to beat the broad MSCI EMerging Markets Currency Index so far this year (the rupee is -3.5% on a year-to-date basis while the EM Currency Index is -6.1%).³ Overall, we feel fairly confident in the rupee's strength and more so in RBI's ability and intention to step in and support the rupee if it were to go through a temporary phase of volatility. **India Inflation and Foreign Exchange Reserves (as of 8/31/15) Rising Foreign Exchange, Declining Inflation**



Past performance is not indicative of future results. As of most recent Inflation numbers published by RBI i.e. 08/31/2015 at the time of writing.

What Does Rate Cut Mean for the Economy and Investors? Let's look at the **immediate impact** of the rate cut first. Financials are a key sector in India, accounting for about 6% of its \$2.5 trillion economy, with commercial banking underpinning growth in this sector.⁴ Within hours of RBI cutting rates, India's largest bank, the State Bank of India (SBI), was first to trim down its lending rates, bringing them down by 40 bps. ICICI bank, India's largest private sector bank, followed suit by cutting its lending rates by 35 bps. It's important to note that SBI and ICICI are regional behemoths, and combined they have assets close to \$500 billion, or about 26% of market share in deposits and loans.⁵ All other regional giants, such as Axis Bank, Punjab National Bank and Bank of Baroda⁶, have also slashed their lending rates by ~40 bps. Reduction in borrowing rates is a major boost for lending activity and thus translates to all other sectors. Real estate, construction, manufacturing, automobiles, etc., are the primary beneficiaries of less expensive credit, as are Financials, which could experience significant expansion of the earnings base. In short, RBI's rate reduction could be analogous to the electric current that jump-starts a car in the cold of winter. As a result, we would expect a pickup in the velocity of money and continued acceleration of the Indian economy, which has already been gaining momentum, owing to macro factors that we have previously discussed. Now, let's look at a **medium-term impact** of the rate cut. As economic activity continues to gain momentum, we expect to see an increase in private sector earnings with some lag. It's important to highlight here that the [WisdomTree India Earnings Index](#) weights companies traded in India based on their trailing earnings. Thus, over a medium term, as equities go up, supported by improving corporate earnings, we believe the WisdomTree India Earnings Index could represent a smart exposure to the Indian market. The table below shows periods in which RBI engaged in consecutive rate-cut cycles and reaction of the WisdomTree India Earnings Index in the following year.

Consecutive Repo Rate Cut Cycles			WT India Earnings Index Total Returns 1 Year Following Rate Cuts	
Phases	Period Engaged	Rate: Starting Level -Ending Level	Time Length (One Year Following Rate Cut Cycle)	Total Returns
Phase 1	Oct. 2008 - May 2009	9% - 4.75%	May 2009-May 2010	24.45%
Phase 2	April 2012 - May 2013	8.5% - 7.25%	May 2013-May 2014	23.27%
Phase 3	Jan. 2015 - Present*	8% - 6.75%*	-	-

* As of 09/30/2015

Past performance is not indicative of future results. You cannot invest directly in an index.

In both of the previous phases (1 & 2), the Index reacted with double-digit returns one year after the end of the rate-cut cycle. We believe this is the medium-term impact that investors should be mindful of. Overall, rate cuts typically support equities over the medium term; however, there is also a plethora of other macro parameters that we have been covering in previous blog posts that could make India attractive. We do expect Indian equities to go through phases of temporarily heightened volatility driven by global or local factors. However, Indian equities with an element of an earnings-weighted approach look attractive at current levels. RBI's description implies that the bulk of the reduction is being done proactively based on

forward-looking inflation estimates. 2Source: Reserve Bank of India, as of 8/31/15. 3Source: Bloomberg, as of 8/31/15. 4Source: Government of India, Indian Brand Equity Foundation, as of 8/31/15. 5Source: Government of India, Indian Brand Equity Foundation, as of 8/31/15. 6Axis Bank and Bank of Baroda are a part of the WisdomTree India Earnings Index.

Important Risks Related to this Article

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 India increase the impact of events and developments associated with the region, which can adversely affect performance.

Please keep in mind that high double-digit returns were achieved primarily during favorable market conditions. Investors should not expect that such favorable returns can be consistently achieved.