

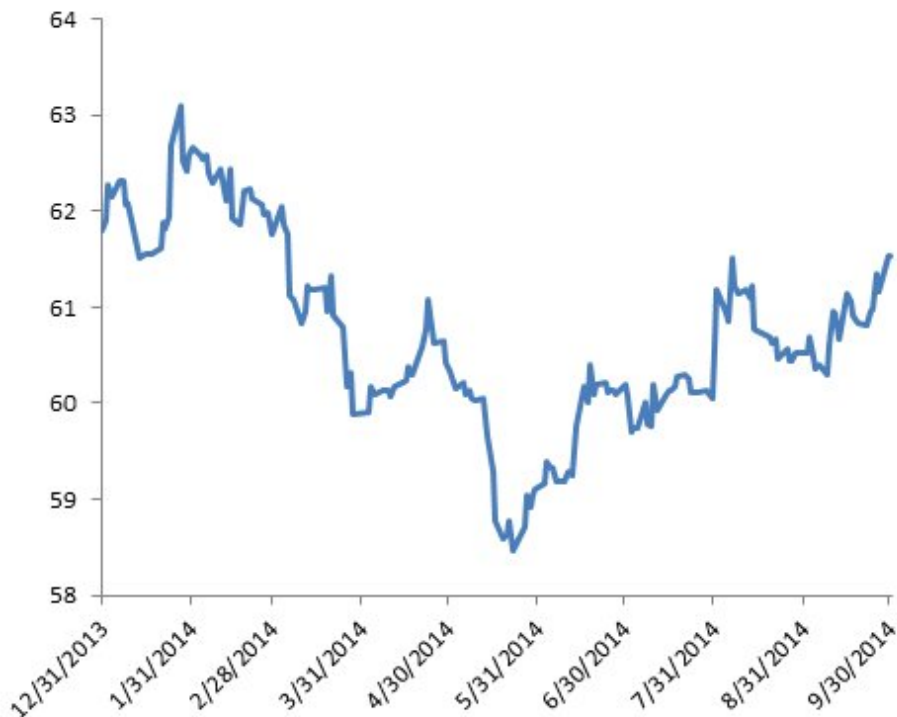
What's Next for the Indian Rupee?

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On September 30, 2014, Indian prime minister Narendra Modi met with President Obama during his first official visit to the U.S. since he was sworn in as prime minister four months ago. For Modi, this meeting marks the end of an ambitious foreign policy schedule that included meetings with leaders from nearly every major economy around the world. While the details of these discussions were not made public, the message from Modi's public speeches has been clear: India is open for business. In advance of any formal changes in policy, we highlight a way to position for a resurgence in Indian growth through investments in the Indian rupee. Even before the election results were fully counted in May, Indian currency and equity markets were reacting. After touching all-time lows last year, the rupee surged on the optimism that the reform-minded Modi would push through an agenda to improve Indian economic competitiveness. Today, Indian equity markets remain near their recent highs, up nearly 30% year-to-date. However, recent concerns about changes in Federal Reserve (Fed) policy and a general increase in risk aversion have seen the rupee fall back to pre-election levels. In our view, the rupee represents an attractive way to play Modi's turnaround story in India. It also offers high short-term interest rates (8% implied yield for one month forward), specifically in relation to perceived risk in the currency. The rupee's carry per unit of volatility is one of the highest among EM currencies (only China and Peru are higher). As we detail below, we believe the recent positive developments could support continued rupee appreciation through year-end. **Indian Rupee, 12/31/13-9/30/14**



Source: Bloomberg, as of 9/30/14. Lower values imply Indian Rupee appreciation against the U.S. dollar. Past performance is not indicative of future results.

For definitions of terms and Indexes in the chart, visit our [glossary](#). **#1: All Emerging Markets Are Not Created Equal** As our equity team noted in a [recent blog post](#), India has been a bright spot for emerging market investors so far this year. As the market began pricing in the prospect of a Modi victory, equity markets rallied in anticipation. Although equity markets are up nearly 30% year-to-date, we believe that positive economic momentum could continue to push markets higher. As we noted in previous pieces, foreign investor flows into the Indian equity market can have a significant impact on the value of the rupee. Should these flows persist, we believe that they could support rupee appreciation. **#2: Credit Rating Agencies Are Taking Notice** On September 26, 2014, the credit rating agency [Standard & Poor's](#) revised its outlook from negative to neutral. In their report, analysts noted that the political environment had shown a marked improvement. This could potentially support the government's ability to implement reforms, spur growth and improve its fiscal performance.¹ From the currency's perspective, we believe that improved investor sentiment could support foreign investment. Longer term, S&P noted that, should per capita GDP increase to 5.5%, this increase could support a credit rating upgrade from BBB-. **#3: Knock on Effects of Sound Central Banking** Just over a year ago, Raghuram Rajan, the governor of the Reserve Bank of India, set out to strengthen the Indian economy from the ground up. After a series of interest rate hikes, his hawkish stance has finally started to bring inflation under control. Now that prices are beginning to stabilize, growth is starting to accelerate. As growth rebounds, it attracts foreign investor flows, helping to strengthen the currency and control inflation further. Also, after lessons learned during the "taper tantrum" last summer, Rajan has made significant strides in strengthening India's primary balances. Since November 2013, Standard Chartered estimates that foreign exchange reserves have increased

from \$258 billion to \$330 billion.² Should the currency unexpectedly come under pressure, we believe that India is in a much-improved position to utilize these reserves in managing currency volatility. Ultimately, the performance of Indian assets will largely be dictated by the effectiveness of government reforms in unlocking India's economic potential. While excitement over these prospects has led to a rapid rise in Indian equities, a recent decline in the rupee could signal an attractive entry point for positions in the rupee. With short-term interest rates at 8.0%³, we believe that attractive levels of carry augment the positive reform story and could continue to support flows into the rupee for the remainder of 2014. ¹Source: S&P, as of 9/26/14. ²Source: Standard Chartered, as of 9/29/14. ³Source: Bloomberg, as of 9/30/14.

Important Risks Related to this Article

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Investments focused in India are increasing the impact of events and developments associated with the region, which can adversely affect performance. 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.