

TRADING INDIAN ELECTION RESULTS VIA THE INDIAN RUPEE

Bradley Krom — U.S. Head of Research

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By May 12, the world's largest democracy will have headed to the polls over the course of several weeks to elect a new government. Indian equity markets are rising to all-time highs on the news that the Bharatiya Janata Party's (BJP) Narendra Modi will be elected the next prime minister of India. Prices are rising on the hopes that he—seen as a pro-market, pro-reform agenda candidate—will be able to re-energize the Indian economy by reducing corruption and cutting red tape. With equity markets already rebounding on the news, we believe that increasing allocations to the rupee may be a prudent way to bet on renewed optimism in India. **Potential Flows into the Indian Economy Support the Rupee**

We believe that the Indian rupee can continue to rise for several reasons: • A stronger foundation provided by credible central bank policy • Optimism that a BJP-led government will enact changes that remove obstacles to achieving India's long-term potential • Attractive levels of [carry](#) offered by local money market rates • Likelihood that these factors will continue to support foreign capital inflows As we discussed in a [previous blog post](#), governor Raghuram Rajan's efforts to restore the [inflation](#)-fighting credibility of the Reserve Bank of India have created a more supportive backdrop for investment in India. Additionally, the finance ministry has taken steps to facilitate foreign investors' access to rupee-denominated assets. As a result of greater access and conviction, an expanding consensus behind the pro-growth candidate has quickly led to strong inflows into local assets from foreign investors. Over the last month, more than \$5.5 billion has moved into Indian equity and bond markets.¹ As emerging market investors are all too aware, investment flows can have a significant impact on the value of a currency. This is particularly true for the Indian rupee, which historically has a high level of sensitivity to portfolio flows. Money flowing out of markets—as it did last year—can weaken the currency, as foreign sellers seek to sell locally denominated assets and repatriate their U.S. dollars. But this is also true in reverse. Positive flows back into Indian equity and bond markets cause the currency to rise as global demand for rupees—and rupee-denominated assets—increases. As we have seen over the last several weeks, the rupee has appreciated in value against the U.S. dollar by 3.2% in the lead-up to the elections.² Many investors may want to express a bullish view of the Indian economy but may be stuck deciding how to allocate between stocks and bonds. In our view, increasing demand for both asset classes will naturally support the value of the Indian rupee against the U.S. dollar.

Income Potential via Carry in Short-Term Rupee Exposures While equity-only investors may be cheering the [SENSEX](#) to new all-time highs, the rapid gains over the last few weeks could make some investors think that a pullback might be just around the corner. With most Indian stocks trading at around 17 times earnings—compared to the broader emerging market average of 12 times earnings—Indian stocks may appear like less of a bargain.³ With efficient access to Indian bonds still limited for many investors, we believe that accessing the currency and local money market rates through exchange-traded funds (ETFs) provides an attractive means of participating in the optimistic outlook in India. Historically, many investors have been interested in the rupee because it is trading at a significant discount to its long-term [purchasing power parity](#). In fact, the rupee is currently undervalued by 62%.⁴ However, this discount will likely begin to fade in the long run. A more immediate reason why we are constructive on the rupee is that the short-term interest rates in India are currently at 8%.⁵ Since the [WisdomTree Indian Rupee Strategy Fund \(ICN\)](#) seeks to provide its exposure to the rupee through forward currency contracts, foreign investors are able to capture the higher interest rates available to Indian investors. In our view this 8% interest rate, the third-highest across all emerging markets,⁶ can serve as a buffer to investor returns, should the Indian rupee decline in value. As we mentioned in an [earlier blog post](#), the cost of hedging the rupee can largely be attributed to this interest rate factor. As a result, investors who take a long position in the rupee are being compensated a large portion of this 8% interest rate differential.⁷ **Indian Asset Class Risk vs. Return**

September 2013 – March 2014				
Asset Class	Index	Return (%)	Std Dev (%)	Sharpe Ratio
Indian Rupee Currency Forwards	J.P. Morgan EIMI+ India Index	17.53	7.35	2.382
Indian Rupee Spot	INR Currency	9.71	6.1	1.587
Indian Equities	MSCI India Index (Net)	30.31	15.59	1.943
Indian Bonds	J.P. Morgan GBI-EM India Index	16.99	8.1	2.095

Sources: Bloomberg, J.P. Morgan, MSCI, as of 3/31/14. Past performance is not indicative of future results. You cannot invest directly in an index.

For definition of terms in the chart, please

visit our [Glossary](#). As shown in the table above, Indian rupee [currency forwards](#) have provided the best Sharpe ratios across nearly all Indian assets—including stocks and bonds—since the local markets bottomed out in August 2013.⁸ In addition to its comparatively attractive risk-adjusted returns, this asset class allows investors to take a position on Indian markets with approximately half the [volatility](#) of Indian equities, the most traditional means of accessing India markets for U.S.-based investors. **Conclusion** The Indian election entails a fair degree of uncertainty. While markets remain hopeful that a change in India's political winds will ultimately lead to profit, we believe that the rupee represents the most attractive means of expressing a bullish view on the Indian economy. ¹Source: EPFR Global, as of 4/9/14. ²Source: Bloomberg, 12/31/13–3/31/14. ³Based on the price/earnings ratio of the MSCI India and the MSCI Emerging Markets indices. ⁴Source: IMF, as of 3/31/14. ⁵Source: Bloomberg, as of 3/31/14. ⁶Sources: Bloomberg, WisdomTree, as of 3/31/14. ⁷In order to provide investors with an idea of the income potential of investments in forward currency contracts, WisdomTree provides them with an [embedded income yield](#). The embedded income yield for ICN was 7.81% as of 3/31/14. ⁸The Indian rupee and MSCI India Index traded at their weakest levels in over 4 years on 8/28/13.

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You cannot invest directly in an index.

DEFINITIONS

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

Inflation : Characterized by rising price levels.

Sensex : An abbreviation of the Bombay Exchange Sensitive Index (Sensex) – the benchmark index of the Bombay Stock Exchange (BSE). It is composed of 30 of the largest and most actively-traded stocks on the BSE. Initially compiled in 1986, the Sensex is the oldest stock index in India.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.

Forward currency contracts : A forward contract in the forex market that locks in the price at which an entity can buy or sell a currency on a future date.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Embedded Income Yield : Represents the annualized rate of return generated by a fund's investments in both fixed income securities and derivatives exclusive of interest rate changes and movement in foreign exchange spot rates. The calculation is intended to capture the Fund's potential to earn income return over the following year given current holdings and market conditions. The embedded income yield will differ from the portfolio's yield to maturity, due to the incorporation of derivatives in the embedded income yield. Embedded income yield and portfolio yield to maturity may differ from a Funds actual distribution and SEC yield and do not reflect Fund expenses.