

India: Rates pricing in cuts; FX vulnerable to global cues

Economics/Growth/Rates/FX/India

DBS Group Research

August 6, 2019

Radhika Rao
Economist



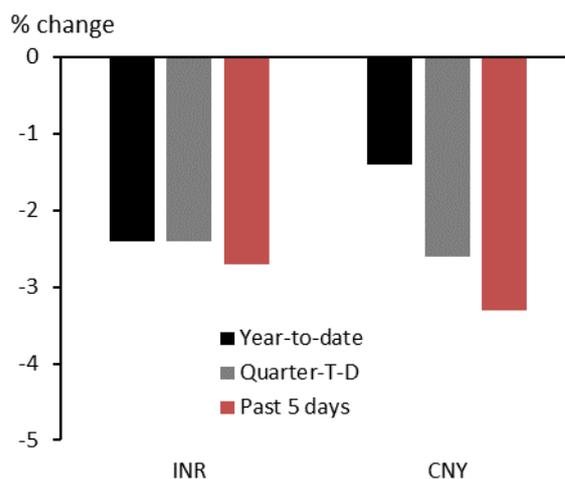
Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@db.com

- *Risk-appetite took a knock overnight, as trade and currency conflicts escalate*
- *A weakening CNY bodes poorly for the Indian rupee*
- *In contrast, INR bond yields are relatively stable, caught between a weak INR and decline in US yields*
- *The RBI monetary policy committee decides on rates on Wednesday*
- *Indian benchmark rates have fallen the most compared to regional peers this year*
- **Implications for forecast:** *Of the 50bp cuts we expect in rest of FY20, 25bp reduction is likely this week*
- *The RBI will look beyond policy decisions, as we noted in an OpEd*
- **Implications for investors:** *Indian rates have priced in this cut, INR is vulnerable to yuan depreciation*
- *News on the sovereign bond is under watch, with a delay to be negative for rates*

Risk-appetite took a knock in overnight trade, as trade and currency conflicts continue to escalate. The latest salvo was the US Treasury department labelling China a currency manipulator after the CNY depreciated past 7 against the US dollar on Monday (see Macro Strategy dated Aug 6, 2019 for details).

The turmoil in global markets is spilling over to the Indian asset markets, adding to domestic concerns. For the INR, the US dollar trend, CNY direction and flows matter more. As the chart shows, the rupee and yuan have moved closely this year, particularly during bouts of weakness.

2019 performance - INR vs CNY

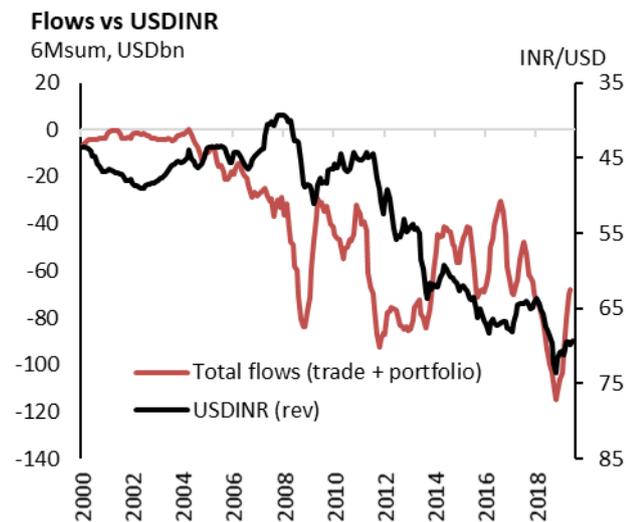


Source: Bloomberg, DBS

This puts the rupee at risk of further depreciation. On the broader USD, we retain our long-held view that the positive rate and growth differentials will continue to support the USD this year, as growth risks are starker in the EU/ Japan.

In addition to USD and CNY, domestic flows will also be key for the INR. Portfolio (~USD13bn

YTD) and trade flows (narrower deficit since year ago) have been positive, providing some cushion to the rupee at the margin. Oil prices sliding on global growth concerns is favourable for the trade balance. Our FX Strategist maintains his call for the INR to gradually weaken this year.



Source: CEIC, DBS

In contrast, INR bond yields are relatively stable, caught between a weak currency and a sharp decline in US yields. Our suggested range of 6.30-6.45% for the 10Y bond yields held in the past week. An under-pressure rupee could hurt the appetite of debt portfolio investors, as reflected in outflows in August yet far.

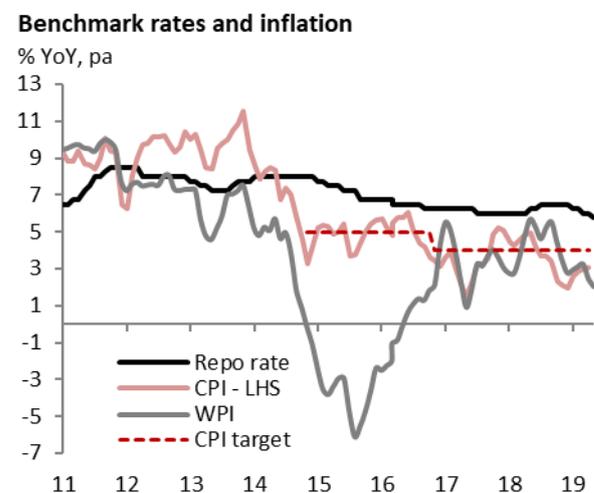
But this is being offset by US yields that have declined sharply, as an escalation in the trade conflicts trigger growth worries, spurring expectations of further policy easing from the US Fed. The next chart highlights that past episodes of a decline in global/ US yields have also held down INR yields. In this environment and with the Indian central bank likely to cut rates further, we don't expect INR 10Y yields to return to 6.8-7% levels for the time being, despite risk aversion.

We continue to watch progress on the offshore sovereign bond. There is still lack of clarity on the issuance, but an outright delay beyond FY20 might hurt INR bonds as it would be perceived as negative for demand conditions. Yields are likely to be 5-10bp higher in the near-term.



Source: Bloomberg, DBS

RBI expected to cut rates on Wednesday



Source: CEIC, DBS

Of the 50bp more cuts we expect in FY20, the RBI-led monetary policy committee is likely to cut by 25bp on Wednesday. Markets have

already priced this in, with further gains in 10Y bond yields hinging on RBI's dovish guidance along with a liquidity framework (if announced) that signals a surplus balance stance.

Besides monetary policy, there are other things weighing on the central bank's mind (see our Opinion piece on [moneycontrol.com](https://www.moneycontrol.com) [here](#)). Foremost is to ensure that policy easing matters to borrowing costs. Banks' six-month to one-year lending rates are lower by an average of 5-15 bps since the start of 2019, a fraction of repo rate cuts. The country's largest bank recently announced cuts in time deposit rates, which is expected to help lower loan rates down the line. Sharper cuts are, however, a challenge as cutting deposit rates further will require returns on national small saving to also fall meaningfully.

Few means by which transmission can be accelerated:

- Dovish guidance to suggest further easing is likely to defend against growth risks from a

weak monsoon, soft consumption and tight financial conditions. 1QFY20 growth is likely to be sub-6% for the second consecutive quarter

- Liquidity stance will be key. Prevailing conditions are already in surplus (of INR1-2trn) and have been maintained such, suggesting an unofficial shift in stance. Intuitively, surplus liquidity during a rate cutting cycle and vice versa during rate hikes helps with transmission
- Plans to link lending rates to external benchmarks, in a bid to expedite the transmission process, was deferred at the April rate review

In the interim, extent of transmission will rely on the respective banks' balance sheet strength, deposits size, and anticipated duration of the rate-cutting cycle. Transmission has been better in the bond markets though that arguably is less beneficial to stakeholders' vs banks' lending rates.

Group Research

Economics & Strategy

Taimur Baig, Ph.D.

Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@db.com

Nathan Chow

Strategist - China & Hong Kong
+852 3668-5693 nathanchow@db.com

Masyita Crystallin, Ph.D.

Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@db.com

Joanne Goh

Regional equity strategist
+65 6878-5233 joannegohsc@db.com

Eugene Leow

Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@db.com

Chris Leung

Economist - China & Hong Kong
+852 3668-5694 chrisleung@db.com

Ma Tieying

Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@db.com

Radhika Rao

Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@db.com

Irvin Seah

Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@db.com

Duncan Tan

FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@db.com

Samuel Tse

Economist - China & Hong Kong
+852 3668-5694 samueltse@db.com

Philip Wee

FX Strategist - G3 & Asia
+65 687-4033 philipwee@db.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

Disclaimer:

The information herein is published by DBS Bank Ltd and PT Bank DBS Indonesia (collectively, the "DBS Group"). It is based on information obtained from sources believed to be reliable, but the Group does not make any representation or warranty, express or implied, as to its accuracy, completeness, timeliness or correctness for any particular purpose. Opinions expressed are subject to change without notice. Any recommendation contained herein does not have regard to the specific investment objectives, financial situation & the particular needs of any specific addressee. The information herein is published for the information of addressees only & is not to be taken in substitution for the exercise of judgement by addressees, who should obtain separate legal or financial advice. The Group, or any of its related companies or any individuals connected with the group accepts no liability for any direct, special, indirect, consequential, incidental damages or any other loss or damages of any kind arising from any use of the information herein (including any error, omission or misstatement herein, negligent or otherwise) or further communication thereof, even if the Group or any other person has been advised of the possibility thereof. The information herein is not to be construed as an offer or a solicitation of an offer to buy or sell any securities, futures, options or other financial instruments or to provide any investment advice or services. The Group & its associates, their directors, officers and/or employees may have positions or other interests in, & may effect transactions in securities mentioned herein & may also perform or seek to perform broking, investment banking & other banking or financial services for these companies. The information herein is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation. Sources for all charts & tables are CEIC & Bloomberg unless otherwise specified.

DBS Bank Ltd., 12 Marina Blvd, Marina Bay Financial Center Tower 3, Singapore 018982. Tel: 65-6878-8888. Company Registration No. 196800306E. PT Bank DBS Indonesia, DBS Bank Tower, 33rd floor, Ciputra World 1, Jalan Prof. Dr. Satrio Kav 3-5, Jakarta, 12940, Indonesia. Tel: 62-21-2988-4000. Company Registration No. 09.03.1.64.96422.