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How US Fed rate hike will impact Indian markets; BofA says it's a positive

By *Kshitij Anand*, ECONOMICTIMES.COM | 17 Sep, 2014, 02.10PM IST

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NEW DELHI: As the world awaits the outcome of the two-day policy meeting of the US Federal Reserve later on Wednesday, most analysts hold the view that even if the Fed decides to raise interest rates sooner than expected, it will be less disastrous for India than the other emerging markets.

Along with the policy statement, the Fed will lay out new economic and interest rate projections that will extend out to 2017 for the first time, Reuters reported.

The FOMC should taper by another $10-15 billion from its bond purchase programme, but more importantly the central bank is expected to provide guidance on the timing for its first rate rise, say analysts.

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The rate projections - or 'dots chart' - show where individual Fed officials think rates should be at the end of each year.

"We hold the contrarian view that Fed tightening is a long-run positive, although EMs could well see one round of sell off in the coming months," said Indranil Sengupta, India chief economist, Bank of America Merrill Lynch.

"We expect softer oil prices and sufficient forex reserves to keep Fragile Five fears at bay for India in the event of a sell-off, although India's BoP indicators still trail other BRICs. Fed tapering is also pulling down oil prices below US$100/bbl from US$118/bbl when INR crossed Rs68/USD last year," he added.

Fed Chair Janet Yellen's press conference will set the tone for the market reaction, say analysts. Additionally, the US central bank is expected to modify the July statement to say that rate hikes are to be expected after 'considerable economic improvement' from 'considerable time'. They have recently advanced the first rate hike to June from September.

FII flows are driven by interest rates movement in the US and other developed economies. Also, asset price movements in those economies also impact global flows.

No doubt, to that extent India is vulnerable and if there is a selloff in global equities or emerging markets, then we will not be spared. "However, the decline may be less than other markets. Nonetheless, there will be a negative effect. India cannot escape a 'risk off' trade," said Dipan Mehta, Member, BSE and NSE.

"Since the new government formation, international events are having a less of an impact as investors focus on government steps to revive the economy and the RBI moves based on macro data such as inflation, GDP growth rates, IIP etc.," he added.

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How would India benefit?

It would be any time before the second half of 2015 when the Fed will start to increase interest rate. A higher US interest rate or expectation of that will definitely have some impact on emerging markets in the form of capital outflows. So, yes, we may see some correction in emerging markets.

"Now for India, the economic situation is much better than it was 2-3 quarters ago. India has taken some of the major steps compared to its EM peers to control currency movement and increase foreign exchange reserves," said Sutapa Roy, Research Analyst-Economy at Microsec Capital Ltd.

"Only in recent past the Indian market hit an all-time high. So corrections will definitely be there, but not as much as we saw in 2013 as fundamentals are better now," he added.

Roy is of the view that India has already outperformed the other markets in the recent past and after corrections, it will definitely attract some fresh capital.

Although it will take the US Fed some time to shift from its zero interest rate policy, but if they do that, there may be a kneejerk reaction wherein some hot money may try to get out.

"On a totality basis, India is possibly the only market in the emerging market basket, where a 15 per cent to 20 per cent earnings growth is reasonable to expect and the economy recovery looks robust with GDP move from 5 per cent to 7.5 per cent in three to five years' time being almost a surety," said Vikram Kotak, CEO & MD, Asset & Wealth Management, Fortune Financial Services

"There are a lot of positives for India right now than the negatives. However, you might see some healthy corrections coming in when the markets start consolidating again," he added.

The overall trend of the market looks quite positive and given the fact that the markets have run up in the last three to four months, a correction is indeed healthy as it will give opportunity for fresh investments.

"The US FOMC meet could provide the much-needed correction and about 5 per cent to 10 per cent correction at the index level in any market is part of the bull market story," said Hemang Jani, Senior Vice President, Sharekhan.

"I am not really perturbed by this. In fact, this would be a great opportunity for a large number of retail investors who have not been able to participate to the extent they would have wished. So it is a great welcome sign for the investors," he added.

Why would the US Fed rate hike impact emerging markets?

A large part of the rally that we have seen in emerging markets, including India, was largely contributed by an increase in global liquidity, popularly known as 'hot money'.

The S&P BSE Sensex has rallied over 25 per cent so far in the year 2014, helped by a strong support by foreign institutional investors which have already made a net investment of Rs 1.98 lakh crore ($33 billion) into the country's securities market.

Emerging markets are considered vulnerable to monetary policy tightening in the US because a stronger dollar is likely to deter FIIs from making fresh investments.

However, BofA-ML do not see impacting much because they expect the RBI to hold Rs58-62/USD for now even though the US dollar has strengthened below 1.30/Euro.

"The impact of a stronger US dollar is largely offset by softening of oil prices and the continuation of gold import curbs. Our FY15 current account deficit forecast of 1.7 per cent of GDP is based on our oil strategists' US$108/bbl forecast," added the report. (US$10/bbl swings about US$8bn on the current account deficit.)

A signal of rate increase by the US Fed will be negative for the markets as it will signal that the era of easy money is largely over, at least in the near term, say analysts. Emerging markets will correct because the global monetary liquidity is being reduced through an interest rate increase.

"When this happens investors will recalibrate their relative risk assessment of various assets and go for ones which are viable investments given the higher discount rates," said Vikas V Gupta - Executive Vice President at ArthVeda Fund Management Pvt. Ltd.

"Since at lower discount rates riskier assets start looking less risky, people make larger allocations to risky assets. However, when the discount rates are higher and liquidity is less, the riskier assets start seeing less allocations and even de-allocations," he added.

Gupta is of the view that this is the main reason for money moving out of the emerging markets on the announcement or reasonably credible expectation of an interest rate hike.

Further, once the hike starts, the investors will start taking into account the future hikes too and hence there is an acceleration in the outflows, assuming much higher interest rates than have been announced.