Indian Rupee under EU Contagion Risk, FII outflow in May

FX Research Desk Publication

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The relief rally of emerging stock and currencies halted on fresh waves of economic pessimism due to the contagion risk of Eurozone. The Eurozone is still struggling with fragile growth despite rebound in economic activities in major economies such as the US, China and Japan. The major economies had just started evolving from the financial crisis, when fresh concerns of Greece's $413.6 billion sovereign default, about 120% of the country's economy, hit the world market.

Greece's crisis contagion exposed other EU nations Portugal, Republic of Ireland, Italy and Spain (PIIGS) into the red. If Greece's public debt to GDP to be over 125% is rated risky, Italy at 115% is equally bad. If Greece's external debt to GDP is bad at 187% then Portugal at 220% and Spain ay 229% are worse. If unemployment in Greece 9.8% then unemployment rate of Spain at 20.5% and Portugal at 10.5% is dangerous and equally bad in Italy at 8.6%. If the fiscal deficit of Greece is 12.7%, is high then it is no different in Spain at 11.4% and Portugal at 9.3%. Rather in per capita income Greece at $ 32,000 scores over Portugal at $ 21,700 and Spain $ 22,486.

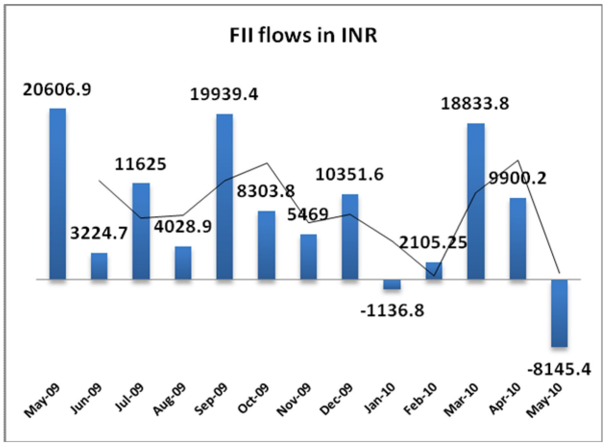
In inflation, the entire PIGS nations are in the band of 0.5-1 %. The woes of the PIGS nation have now expanded to add Ireland and Great Britain. The S&P downgraded the credit rating of Greece which sent the global indices to their record lows. This raised the borrowing costs for these countries and reflected badly on the credibility of the Euro. The PIIGS nations have a share of around 40% into the GDP of EU; its share in total debt is around 50% of debt of EU.

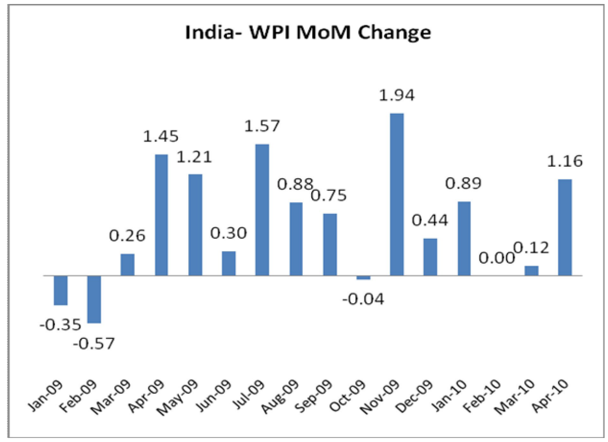
	Recent	Yield Spread	Week	Month	Year
Germany 2.595 %- Yield on 10 Year Govt Bond					
Australia	5.327 %	273.2	264.6	272.9	179.8
Austria	2.931 %	33.6	33.7	40.2	62.2
Belgium	3.103 %	50.8	40.6	49.7	57.2
Canada	3.255 %	66	62.6	62.6	-19
Denmark	2.693 %	9.8	11.5	25.6	17.5
France	2.861 %	26.6	23.2	31.5	33.9
Greece	8.274 %	567.9	541.7	562.6	172.2
Ireland	4.874 %	227.9	183	172	172.6
Italy	4.044 %	144.9	126.2	88.5	92.5
Japan	1.22 %	-137.5	-148.4	-174.5	-216.8
Netherlands	2.836 %	24.1	20.5	25.8	39.2
Portugal	4.807 %	221.2	190.2	196.5	79.3
Spain	4.25 %	165.5	150.6	92.6	68.9
Sweden	2.545 %	-5	-15.9	4.2	3.9
U.K.	3.483 %	88.8	89.2	97.3	6.2
U.S.	3.185 %	59	59.4	74.6	-6.1

Source- JRG Analytics

The crisis of the Eurozone simultaneously pressurized the global stocks and currencies directly and indirectly. *The EU crisis was further worsened by the political dialogues that questioned the very existence of Euro. The partial intervention of IMF and the laggard attitude of ECB in aiding Greece, the rift between France and Germany in giving a common aid to Greece exposed the internal problems of the members.* US Dollar and Japanese Yen treasuries became the safe haven for risk averse investors.

In the meanwhile Indian rupee is weakening on EU debt crisis. Though the Indian economy remained decoupled from the EU debt crisis and all its fundamentals were positioned right, the data for IIP and GDP were all bullish, yet rupee suffered because USD strengthened. The Foreign Institutional Investors have removed around $2 billion so far in May reducing the FII flow in 2010 to $4.6 billion. FII outflow is the key reason for Rupee to depreciate. The global risk aversion has lead to continuous FII outflows from the Indian economy.





Source- JRG Analytics

From interest rates perspective, we expect the RBI to be a less hawkish in coming meetings with lower food inflation expectations due to good monsoon. The concern of European economies will keep the RBI on back stand. The recent consolidation in the IIP suggests manufacturing inflation to moderate. India's industrial production eased to 13.5% in March from 15.1% in February.

We do not expect any rate hike by the RBI for next 3 months.

From the US economy perspective, recent consumer inflation readings have been benign. In April, the overall CPI rose 2.2% y/y a pace broadly consistent with the FOMC's long-run PCE inflation objective of 1.7-2.0%. However, many FOMC members focus more on core inflation, and the core CPI rose only 0.9% y/y in April. The low readings on the core are suggesting no rate hikes in the near future.

On overall economic activity side, US economy has emerged out of recession with two quarter solid economic growth. However, the issues created by highly leveraged EU economies are casting doubt on further sharp reading in the US. Country's Gross domestic product expanded at a 3.0 percent annual rate in the 1Q 2010. Consumer spending, which is key to the economy's recovery is growing at 3.5 percent rate, more than double the 1.6 percent pace in the fourth quarter and the largest advance since the first quarter of 2007. Consumer spending accounts for 70 percent of U.S. economic activity.

Recovery from the longest and deepest recession since the Great Depression had so far been largely driven by the manufacturing sector as businesses replenished their warehouses to meet strengthening demand. In the first quarter, businesses stepped up the accumulation of goods. Business inventories rose $33.9 billion rather than the $31.1 billion reported last month. It was the first increase since the first quarter of 2008.That contributed 1.65 percentage points to overall economic output during the quarter.

Business spending on software and equipment increased at a 12.7 percent rate. After tax corporate profits rose 2.1 percent in the first quarter after increasing 6.5 percent in the final three months of 2009.

We see some consolidation in business activity in the second quarter with issues of rising borrowing cost due to risk premium. Overall on the economic activity side, we maintain positive stand on the US for rest of 2010.

USDINR Outlook: The sharp depreciation of the Indian rupee during the month of May has been attributed to the heavy funds outflow. May 2010 is the month of largest FII outflow from domestic equity since last 12 months. There may be further outflows but may not be very sharp on strong bottom lines of domestic companies. The rupee has a potential for further depreciation, but decline seems limited.

Technical Analysis- USDINR reversed from bearish trend breaking 46.00 marks.

Despite all betting on further decline in the USDINR pair, the market reversed taking support from the 61.8% retracement of 39-52.13 moves, pegged at 44 levels. Rates rose sharply after breaking the trend line resistance of 46 and posted a high of 47.75. The recent move seems unsustainable to market viewer, but break of the 46-45.50 range is now casting some serious doubt on the prevailing intermediate downtrend.

The high posted at 47.75 is a trend line resistance and if the level broken then some further rally can be expected towards 49.10 levels- the 61.8% fibonacci level of 52.13-44.15 intermediate downtrend.

We are not very bullish on the market as of now and maintaining a neutral stand. As per our expectation the recent pullback rally from 44.15 to 47.75 should sustain as long as the market holds the 46 support level. Apart from that, a major rally can be expected only above 47.75 which may push the market towards 49.10 levels.

Risky traders (short term) traders can look for sell at 47.30-47.40 range for a maximum target of 46.00-45.80 with a strict stop loss above 47.75. (Bases on Fusion Analysis)

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