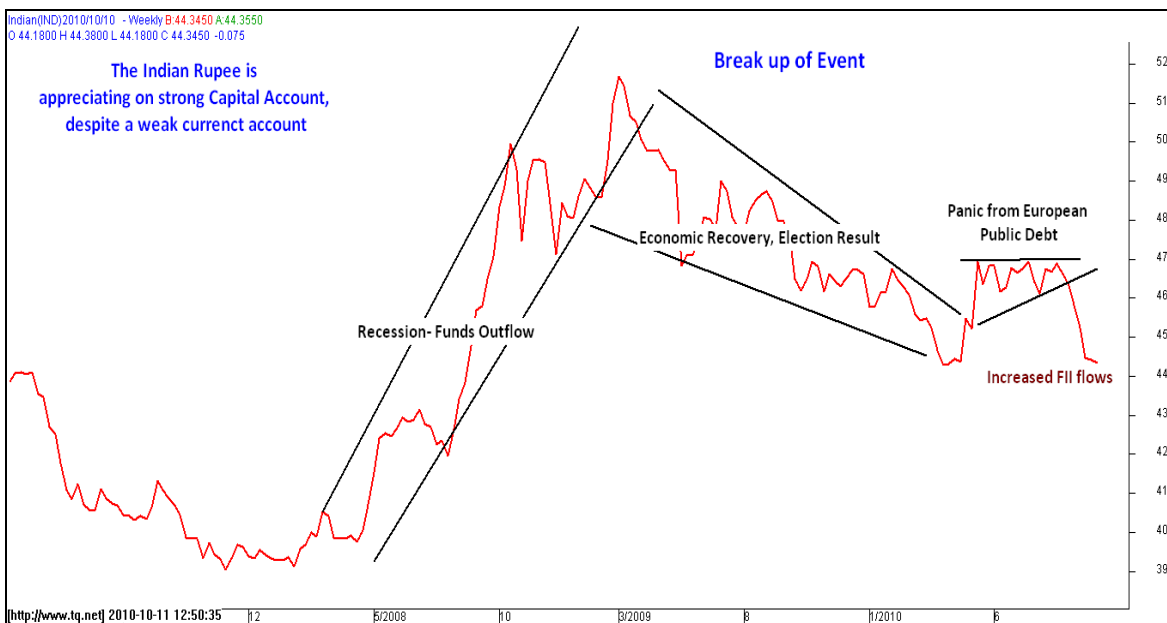


## Indian Rupee – Historical Perspective

The second phase of liberalisation of the Indian economy represented by opening up of the external sector and positive stand on the foreign portfolio investment exposed the Indian Rupee to global macro economic events.

The partially convertible rupee has depreciated from 30 in 1995 to 49.90 in 2001 against the US dollar on greenback's strength globally. The US dollar index posted a high of 121 during 2001 from low of 80.00 posted during 1995. And from then onwards the rupee has been appreciating or the USDINR has been falling to post a low of 39.00, as the US dollar slid against the major currencies. However, the Indian rupee has started losing against the US dollar from 2008 onwards on global economic recession and as US Dollar attracted some buying interest as a safe heaven investment.



**Figure 1**

**Period 2008-2009 March-** The period marked with massive FII outflow from India following redemption pressure of funds in their home countries. As a broad measure, overall foreign Investment in India as a percentage of GDP declined from 5% in FY2008 to 1.7% in FY 2009. The current account deficit widened from 1.3% of GDP to 2.4% during the period.

The USDINR rose to a high of 52.13 following short supply in the market. Among all asset classes, the US dollar performed during the period as safe heaven instrument despite its own structural problems.

**2009 March till Date –** Recovery of the domestic industrial sector (Strong IIP numbers), convincing victory of congress during the parliamentary election and improving outlook of emerging economies lead to steady improvement of fund flows into India. FIIs had pumped in a record \$17.45 billion into the equities market in 2009.

The current account deficit remained higher and reached 2.9% during the FY 2010. The depreciation of the US dollar globally due to emergence of risk appetite investors helped the Indian rupee to strengthen against the greenback. The USDINR spot rates fell from 52.13 posted in March 2009 to 44.15 in April 2010 - in line with macro economic development.

However, risk aversion due to European debt crisis pushed down most of the riskier assets and USDINR rose to 47.75 (May, 2010) from 44.15 (April, 2010).

The EURUSD dropped to multi-year lows and broke below 1.20 mark after Portugal, Ireland, Italy, Greece and Spain's public finance issues casted doubt on global economic recovery. However, encouraging steps from the IMF and the European Central Bank helped to stabilize the situation. Later, encouraging debt sales from Portugal and Greece helped Euro and other high yielding currencies to recover against the US dollar.

## Present Scenario

The present market is underlined by fear of a double dip recession in the US and sharp rise in capital account inflows in India. Following are the dominant factors playing a crucial role in Indian forex market as of now and developments of these variables will determine the further outlook of the USDINR pair.

- ❖ Capital account inflows and outlook of the Current account ( Indian Economy)
- ❖ Policy Rate Change (Repo and Reverse repo rate) and inflation ( Indian Economy)
- ❖ QE expectations by the Federal Reserve Bank, US
- ❖ Central Bank's Intervention (RBI)

**Indian External Sector:** The current account deficit is a closely tracked measure of the excess of imports of goods and services over exports. In absolute terms, it represents the shortfall of domestic savings in relation to investment, which has to be offset by capital inflows. The Indian currency account position remains weak and expected to reach 3% of GDP this fiscal compared to 2.9 last fiscal. Last time when trade deficit touched 3% of GDP the country was under the grip of economic crisis.

The current account deficit was USD 13.7 billion in the June quarter, compared with USD 4.5 billion deficit in the same period year earlier and USD 13 billion in the quarter through March 2010. Net invisible receipts, which mostly include earnings from services exports, were USD 20.5 billion in the June quarter compared with USD 21.2 billion in the year-earlier period.

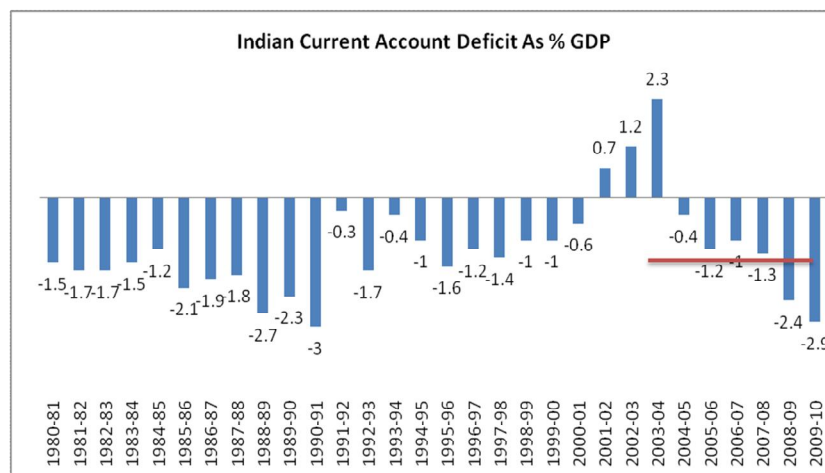


Figure 2

India's capital account surplus jumped to USD 17.5 billion in April-June from USD 4.6 billion same quarter in 2009/10 and USD 16.1 billion in the January-March period. The capital account surplus increased significantly, over the corresponding quarter of last year, mainly due to short-term credit, external commercial borrowings, external assistance and banking capital. The improvement in the capital account flow in the form of portfolio investment is providing relief, but is causing concern from any external shocks.

According to data available with the Securities and Exchange Board of India (SEBI) FII inflows in 2010, have crossed \$21.4 billion.

FIIs had pumped in a record \$17.45 billion into the equities market in 2009, but started exiting in early 2010. In January, they were net sellers to the tune of \$94.48 million. But from February, the scenario changed with foreign funds buying scrips worth \$269 million in the month. In March, it was over \$4.3 billion and in April the net buys were over \$2 billion. May, however saw a huge sell-out, with FIIs dumping stocks worth \$2.1 billion.

The buying has been fairly consistent since, with FIIs lapping up stocks worth \$2.27 billion in June, \$3.5 billion in July and \$2.4 billion in August.

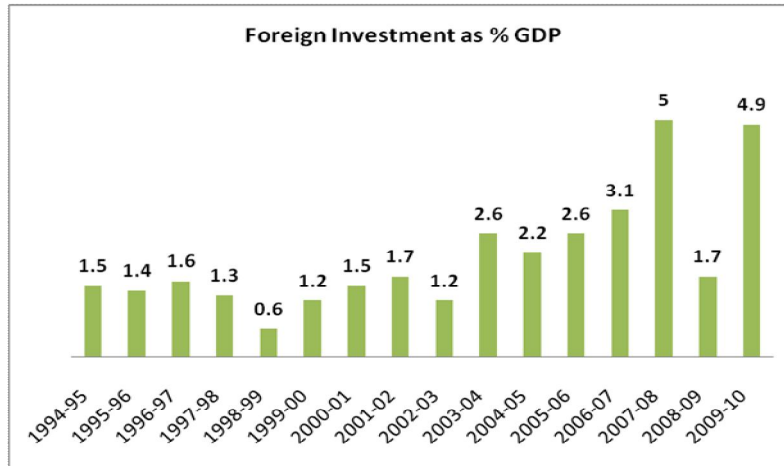


Figure 3

Funds flow continued mostly in emerging markets with exception of better return. The rise in policy rates also attributed to increase in investment by foreign funds.

**Interest rate and Inflation :** The rise of headline inflation numbers above double digit compelled the Reserve Bank of India to raise policy rates. Higher food prices along with concern of manufacturing inflation due to sharp rise in industrial output pushed the headline inflation numbers above 10% mark. The Reserve Bank of India (RBI) in its mid quarter monetary policy review recently, hiked the repo rate further by 25 basis points (bps) and also the reverse repo by 50 basis points (bps). The repo now stands at 6% while reverse repo stands at 5%.



Figure 4

However, inflation moderated with few ticks below 10% mark in August and as per new numbers it is at 8.5%. The momentum of inflation has slowed significantly, irrespective of old or new index we use. The trend of slowing inflation is expected to continue in the near term. As per market expectations inflation may moderate till 6.5% by december 2010 along with the fall in non-food manufacturing inflation.

The recent RBI rate hike in the mid review policy during September has been very aggressive and Indian rupee has appreciated from 46.50 to almost 44 mark apart from support from other factors ( figure 4)

**Weak US dollar amidst 2<sup>nd</sup> QE expection by Fed:**

The US dollar has been sold off against high yielding currencies due to expectations of 2<sup>nd</sup> QE by Federal Reserve bank following a string of weak to moderate economic data. The term quantitative easing (QE) describes a monetary policy used by central banks to increase the supply of money by increasing the excess reserves of the banking system. This policy is usually invoked when the normal methods to control the money supply fails, i.e the bank interest rate, discount rate and/or interbank interest rate are either at, or close to, zero.

New York Fed President William Dudley provided the clearest call for further Fed action, saying the current levels of unemployment and inflation were “unacceptable” and that “further action is likely to be warranted unless the economic outlook evolves in a way that makes me more confident that we will see better outcomes for both employment and inflation before too long.”



Figure 5

Renewed asset purchases should support economic activity by easing financial conditions further and improving sentiment towards risk assets, which should bolster consumption. But it will put pressure on US dollar with decline in the market rate of interest. The 2<sup>nd</sup> QE also suggest Fed’s programme of near zero rate policy till 1<sup>st</sup> Qauarter of 2011.

**RBI Intervention:** Reserve Bank of India Governor Duvvuri Subbarao said recently that, the bank will intervene in the foreign exchange market if capital inflows become volatile or lumpy. Despite a recent surge in capital inflows, India’s central bank, unlike many of its counterparts in Asia, has stayed away from intervening in its foreign exchange markets.

"The reason why we did not feel the need to intervene is because our absorption, driven by a widening current account deficit as imports have surged on the back of a positive outlook on growth and investment, has also increased," Subbarao said. The recent appreciaation of Indian rupee is suggesting possible intervencion by the RBI in the coming days.

## Outlook of variables

**External Account :** Capital account inflows to continue in the short term, QE 2<sup>nd</sup> by US, BoJ rate cut, Stable rate of interest by ECB and BoE may bring in capital to emerging nations such as India. The current account deficit to stay in the range and expected to reach 3% mark this fiscal. However, recovery of the global economy which is presently consolidating may also lead to rise in exports. Imports are likely to be buoyant and appreciation of Indian rupee is expected to boost import.

**Policy rate hike to get halt in November as per market expectations:** Moderation in inflation numbers which is expected to reach 6.00-6.5% by market participants may cause a halt in monetary tightening cycle.

**QE 2<sup>nd</sup> by FRB:** The second phase of quantitative easing is most likely in November. The market has already priced in the asset purchases programme.

**RBI Intervention:** RBI will not take any strong measures to moderate the inflow of capital from foreign investors even as it cautions that such inflows are a potential threat. RBI's interventions to curb rupee's rise will involve infusion in the market of rupees to absorb the big supply of dollars. Such a step would add to banking system's liquidity, which will contribute to inflationary pressures. However, with inflation pressure slightly moderating, the RBI may intervene mild if they see further sharp appreciating of Indian rupee.

## TECHNICAL ANALYSIS PERSPECTIVE

The USDINR spot pair tested the April month's low recently and currently trading slightly above 44.50 marks. The market posted a low of 44.08 last week and closed as Doji. Trend remains bearish for the market and rates are trading far below the short term moving averages.

Momentum indicators are trading at the oversold territory with the daily RSI (14) is trading at 0.38 levels. The weekly RSI (14) is trading at 0.31 levels.

The 44 mark is very crucial support in the short term and market has taken support here once in April 2010 and recovered towards 47.75 levels. The 44 mark is also 61.8% Fibonacci retracement level of 39-52.00 moves (2007, Nov to March 2009). Below 44, we can expect selling pressure till 42.50.

We expect mild pullback in the short term after a sharp decline in rates from past few weeks. The immediate resistance is at 45.60-45.70 levels and a pullback towards the level is possible this October.

***We see a range of 45.60-45.70 on the higher side in October and lower level as 44 and below that we may see selling pressure till 42.50.***

***Trading Recommendation: Buy Nov contract at 44.40-44.45 targeting 45.30 with strict stop loss below 44.05 or Sell at 45.50-45.70 targeting 44.20 with stop loss above 46.00***

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