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Rupee Monthly Forecast 70% Reliable

KSHITIJ MONTHLY USDINR FORECAST – 06 Nov 17

USD-INR Spot 64.72 / Nifty 10433 / 10Yr GOI 6.8806 / Dow 23539 / Euro 1.1615 / Gold 1269 / USDCNY 6.63

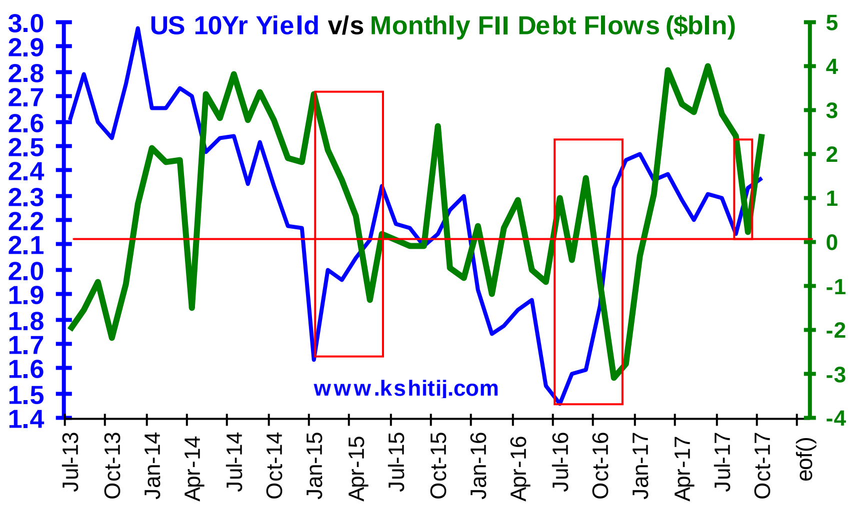
RECAP

In our October 2017 forecast we had said that Dollar-Rupee could average near 65 in October. The market has moved exactly like that for most of October, except that Dollar-Rupee came down sharply in the last few days of the month. The one major surprise for us has been the continued rise in the Sensex without a correction.

64-65 BEFORE 66.25+

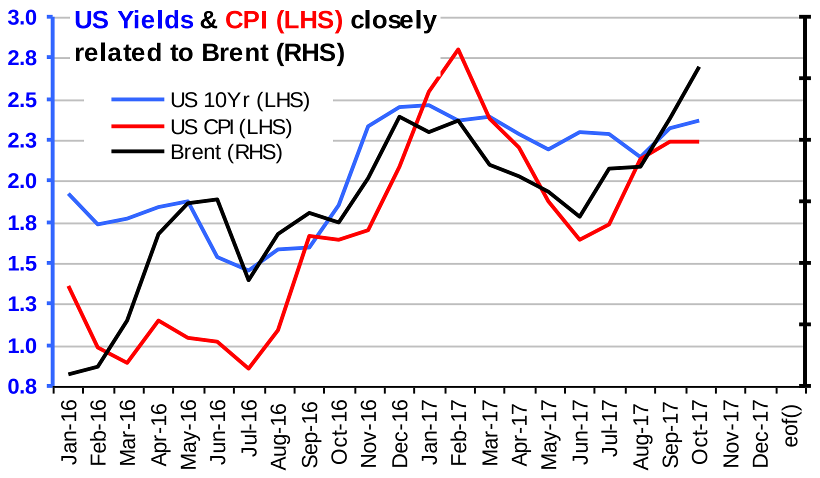
Going forward, ***November may be ranged between 64-65.*** Beyond that, we stick to the forecast of a ***rise to and past 66.25 in Dec-Jan and then further up to 67.50 by March.***

The coming months may see an increase in volatility if US Yields rise more than is currently anticipated by the market. This is examined in detail in this report.



US YIELDS ➔ DEBT MARKET FLOWS

The Rupee gained in October due to FII inflow of $2.4 bln into the debt market. Debt inflows (right axis) have been continuously positive since Feb ‘17, the longest positive streak of Debt inflows since April ’15, a period in which US Yields (left axis) have dipped a little. Earlier there had been outflows from Oct ‘16 to Jan ‘17 when there was a sharp rise in US Yields. Similarly, the Jan ‘15 to Jul ‘15 period had see Debt outflows accompanied by a sizable increase in US Yields (see red boxes in the chart). In short, ***Debt Inflows are vulnerable to sharp increases in US Yields.***

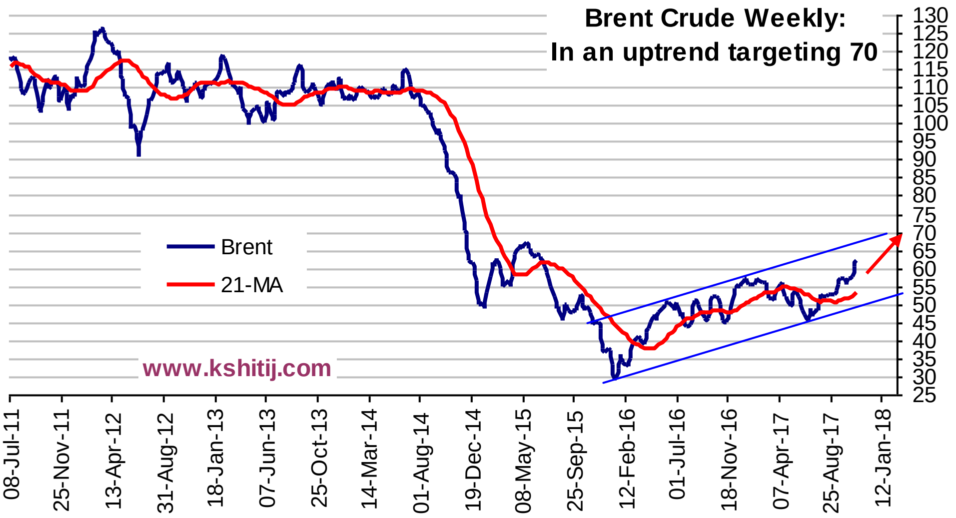


BRENT DRIVES US CPI AND YIELDS

US Yields and the US CPI inflation (left axis) and **Brent Crude (right axis)** are positively correlated. When Brent rises, US inflation rises and vice versa. US Yields, in turn, rise/ fall along with the US CPI and Brent. The relation between US CPI and Brent has been particularly close since May 2016.

We saw a slow decline in US Yields so far in 2017, caused by the fall in Brent from $57 in Dec ’16 to $49 in Jun ’17. As seen in the last chart, ***this led to good FII inflows into Indian Debt.***

Since Jun '17 however, we have seen Brent rise from $49 to $60+ now. This is reflected in US CPI rising from 1.65% to 2.23% and in the small increase in US Yields from 2.14% to 2.37%, which in turn resulted in a very small Debt inflow in September. ***Going forward, a rise past $62-65 in Brent → increase in US CPI → increase in US yields → FIIs outflows from the Indian Debt market → weakness in the Rupee.***

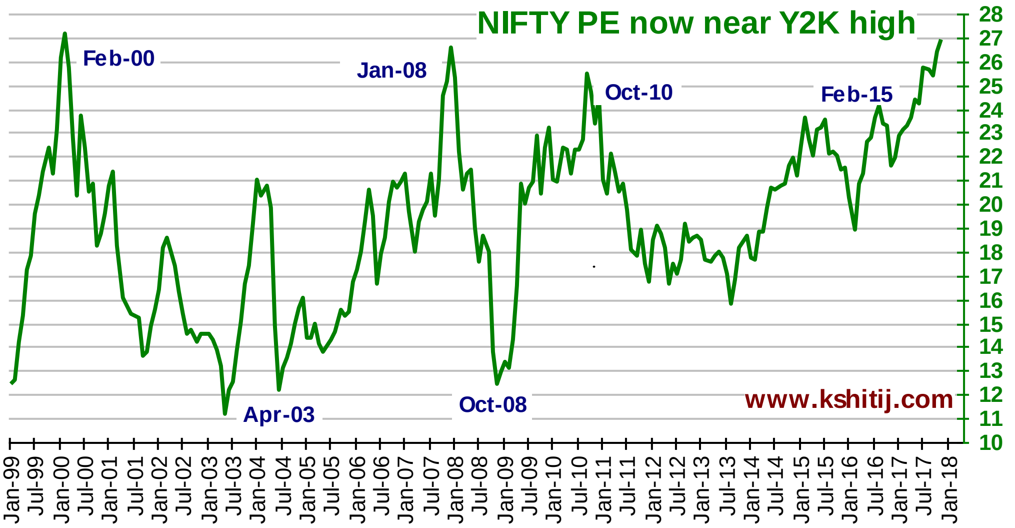


CAN BRENT RISE TO 70+ ?

Brent can well target $70 by December '17, despite some chances of a near term dip to $58 in early November. Such a rise would break the long term downtrend since $115.71 (June 2014) and ***increase the chances of a rise past $70 in 2018***.

Given the current talk of plummeting solar energy prices and future of electric vehicles, we feel that ***the market has not priced in levels above $70.***

As such, it is also likely that the ***market is underestimating the possibility of an increase in US CPI which can then translate into an increase in US Yields.*** A rise in Brent to $70 could take the US 10Yr up to 3% and a rise past $70 could pull the US 10Yr past 3% also. ***Since this possibility is simply not priced into the market at the moment, it can bring in a lot of volatility into the markets, leading to weakness not only in global equities, but also in Dollar-Rupee.***



BUBBLE PEAK IN NIFTY

Although we have been surprised by the continued rise in global equities and Nifty, ***we are still unable to become bullish.*** The reasons have been detailed in our Nov-17 Global Equity report dated 26-Oct-17.

Also, as we see in this chart, the *Nifty PE is now higher than the peak of Jan-08 and just a whisker away from the 2000 high*. A lot of the positive long term prospects are already built into the price. As such, ***the chances of a negative surprise or even normal profit-taking are very high, which would be negative for the Rupee.***

CONCLUSION

Downside in Dollar-Rupee may be limited to 64 (Nov). Thereafter, see a break above 66.25 (Dec-Jan) leading to 67.50+ by March.

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