Equity Research

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India

Economy

Foreign exchange reserves being rebuilt, as INR holds steady against a depreciating USD

- Over the past 5 weeks, INR has held steady against the depreciating USD, thereby enabling INR to give up all its gains on EUR and virtually all its YTD gains against KRW, CNY and GBP – while foreign exchange reserves rebounded by US$27.1bn. We expect these trends to persist through Mar'23, as the seasonal improvement lowers the quarterly current account deficit (CAD) to below 1% of GDP in Q1CY23. The CAD will be fully funded by net FDI inflows, while fairer equity valuations should allow modest FII (foreign institutional investor) net inflows into Indian equities in Feb-Mar'23. We expect INR to end FY23 at 82.5/USD, and foreign exchange reserves to rebound to US$600bn in Mar'23.

- The BSE Sensex-30 trailing P/E ratio at end-Nov'22 was 23.94x, just 4.3% above its 10-year mean of 22.95x (but 15.6% above its 20-year mean of 20.71x). This compares favourably with end-CY21, when the trailing P/E ratio was 27.9x – nearly 25% above its 10-year mean (and 37.2% above its 20-year mean). Valuations were a key factor behind the large net FII outflows of US$37bn in Oct'21-Jun'22, and the subsequent net FII inflows of US$10.7bn in Jul-Nov'22. We expect modest net FII outflows this month and next, but net inflows to resume in Feb-Mar'23.

- Export growth will improve in Dec'22-Mar23 with the removal of most export duties on iron and steel (22nd Nov'22), and aided by the steadily more competitive INR. The YoY decline in crude oil prices will also contribute toward the seasonal improvement in the current account. Nonetheless, fund managers' rebalancing around year-end will initially cause portfolio allocation weights for India to decline in Dec'22-Jan'23 before rebounding once it becomes clear that India's nominal GDP growth is boosting EPS growth and keeping valuations reasonable despite India's relative equity out-performance in CY22.

Rise in foreign exchange reserves reflects a policy choice to allow INR to depreciate, clawing back competitiveness relative to EUR, JPY, KRW, CNY. India's foreign exchange reserves increased by US$11.02bn in the week ending 2nd Dec'22. At US$561.16bn, they are up by US$28.5bn from their recent trough in Sep'22, now providing a comfortable 9.3 months' import cover. While part (40-50%) of the rise in forex reserves likely reflects valuation gains (as non-USD currency reserves increased in value relative to the USD), the rest of the rise reflects a policy choice to allow INR to depreciate against the USD even as the latter itself depreciates (i.e., gives up some of the large gains of Jan-Oct'22) against other major currencies (EUR, JPY, GBP, CNY). This is as we expected (see our 24th Nov'22 report '*Period of surging USD over, but India likely to persist with mildly weaker NEER*').

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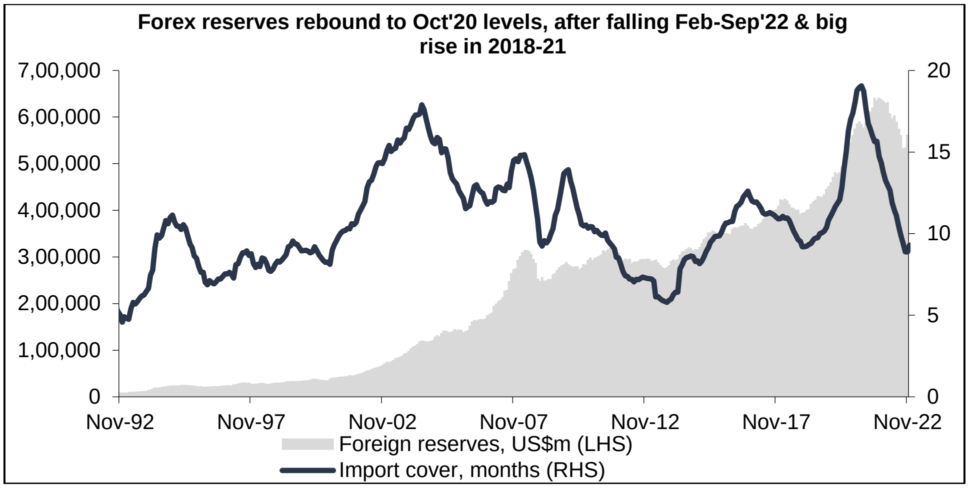
Chart 1: India's FX reserves rebounded in Nov'22



Source: I-Sec, based on data from CEIC

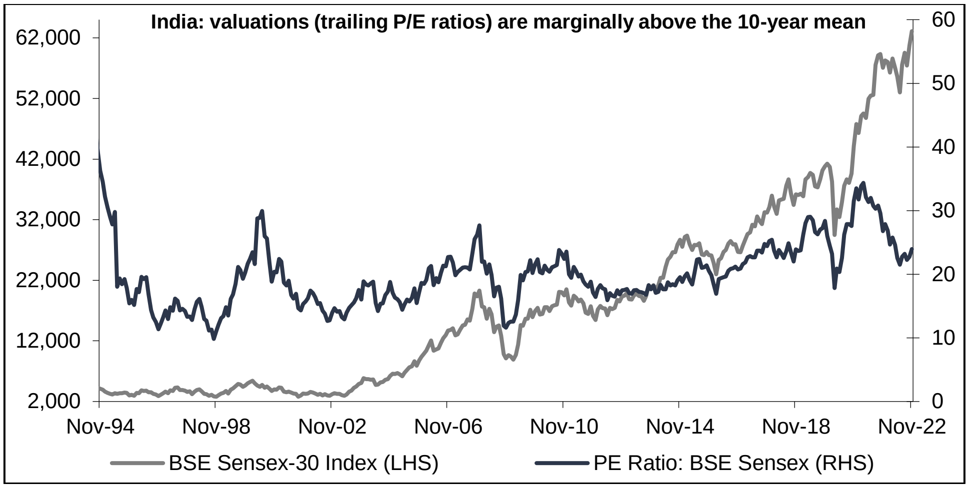
DXY up 9.1% YTD, and USD also up 9.1% YTD vs INR; so INR has given up all its gains on EUR from earlier in the year, and is up only marginally YTD vs GBP, KRW and CNY. The nominal effective exchange rate (NEER) of the USD (commonly labelled DXY) peaked on 26th-27th Sep'22, plateauing in Oct'22 and then depreciating by about 7% since 3rd Nov'22. At its 27th Sep'22 peak, DXY was 18.61% stronger than at the start of CY22. At end-Oct'22, DXY had appreciated by 19.1% YoY, but by end-Nov'22, DXY was up a more modest 13.8% YoY. Despite its recent weakening, DXY was still 9.15% stronger on 12th Dec'22 (noon) than on the first trading day of the year – and USD has appreciated approximately 9.1% vs INR too. Consequently, INR has now given up all of its appreciation against EUR and GBP from earlier in the year – and has appreciated less than 1% YoY vs CNY and KRW. Only against JPY is the INR still up (+10.7% YoY; +7% YTD).

Chart 2: DXY (NEER of the USD) has weakened over the past 5 weeks

Source: I-Sec, based on data from MarketWatch

India's trailing P/E ratio at end-Nov'22 was just 4% above its 10-year mean, much less expensive than end-CY22 (when it was 24.7% above the 10-year mean). Unlike at the end of CY21, India's equity valuations (as measured by the trailing P/E ratio of the BSE Sensex-30) weren't far from their 10-year mean at the end of Nov'22. The 10-year mean trailing P/E ratio is 22.95x, while the end-Nov'22 P/E ratio was 23.94x (just 4.3% above its 10-year mean, and 15.6% above its 20-year mean of 20.71x) -- despite the rise in the BSE Sensex-30 in recent months. Earnings have held up well, ensuring that valuations aren't too rich. By contrast, the trailing P/E ratio was 27.87x at the end of CY21 – 24.7% above its 10-year mean at the time (and 37.2% above its 20-year mean). And the global backdrop is different too: while there was trepidation last year at the prospect of a taper of QE and then tightening by the US FOMC, this year markets have factored in policy tightening by global central banks (with the Fed expected to tighten only a couple of more times after its widely expected 50bp hike later this week). With the USD no longer set to appreciate rapidly, emerging markets are facing a less adverse prospect than they were at this time last year.

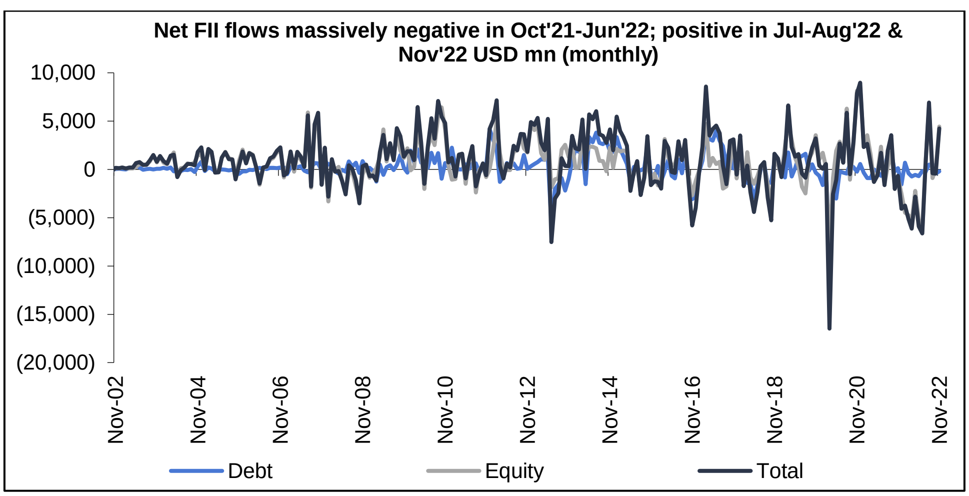
Chart 3: Equity valuations (trailing P/E) are only slightly above 10-year mean



Source: I-Sec, based on data from CEIC

In a year of volatile portfolio-capital flows (and massive net outflows from emerging markets), India suffered large net FII outflows in H1CY22, continuing the net outflows that began in Oct'21. After net outflows totalling US$37.13bn in Oct'21-Jun'22, there have been net inflows in Jul-Aug'22 and in Nov'22, totalling US$10.69bn in Jul-Nov'22. India's debt markets have seen modest net outflows every month in CY22 except January and Aug-Sep'22, so the bulk of the FII flows continue to be accounted for by flows into the equity market (US$6.44bn in Aug'22 and US$4.43bn in Nov'22, for instance, while monthly inflows into debt rarely exceed US$1bn).

Chart 4: Net FII inflows of US$10.7bn in Jul-Nov'22, after 9 months of big outflow



Source: I-Sec, based on data from CEIC

Valuations should ensure modest net inflows into India equities in Feb-Mar’23, slightly offset by small net outflows from India’s debt markets. Fund managers typically re-assess and rebalance their portfolios at the beginning of each calendar year. While the relative outperformance of India’s equity market in CY22 makes it a candidate for its model-portfolio weight to be reduced at the start of next year, India should still receive modest net inflows into equities (after likely net outflows in Jan’23) for Q1CY23, given that valuations have not become excessively rich, and strong nominal GDP growth should continue to buoy EPS growth. Small net outflows from India’s debt markets are likely to continue, as the yield differential between India and the US narrows as the US continues to hike rates while the RBI pauses.

Consequently, **we continue to expect INR to hold broadly stable *vs* USD near current levels, ending FY23 at 82.5/USD, thereby depreciating *vs* EUR, GBP, JPY, CNY**. With the removal of most export duties on iron-ore, steel and steel products, India’s export growth will improve in Dec’22-Mar’23. January-March is seasonally the strongest quarter for the trade and current account balance, and we estimate the quarterly current account deficit to be less than 1% of GDP in Jan-Mar’23 – fully funded by net FDI inflows alone, with FII inflows providing icing on the cake. We expect INR to fluctuate in a range around current levels, ending Mar’23 at 82.5/USD, with the YoY decline in Brent crude prices (and the availability of cheaper Russian oil for a fifth or more of India’s oil import needs) helping to further narrow India’s trade and current account deficits.

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