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Title: Newer Risks for Indian Markets in 2010

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The US Dollar (USD) vis a vis the Euro (EUR) has appreciated in last few weeks to around 1.43 levels now. The recent low on the USD was around 1.51 in last week of November this year. That makes the USD rally at 5% from its recent low. Though a 5% move has happened in the past, but in the current context it might prove a watershed event. *For risky asset classes like EM stocks including Indian stocks, the rapid USD rise or an expectation of the same remains a big risk.*

Chart I: EUR-USD in 2009: Is Risk Aversion & Safety Back?

Source: New York Times

Why did the USD appreciate? Let's quickly run through the reasons in brief:

1. The relatively higher, expected growth rebound (without inflation) and interest rates path for US as compared to Europe has helped the USD in recent times. ECB is expected to lag Fed in raising interest rates and the EU to US in the economic growth. The Q4 growth forecast for US was revised at 4.5% by JP Morgan in last week.
2. The return of Sovereign risk in form of Dubai and more in Europe (Greece, Spain, Ireland etc) has buoyed the USD. The recent country ratings downgrades are expected to rise in Europe, which is plagued by unsustainable deficits and mounting public debts as well as a shaky banking sector. A Global risk aversion is always USD positive, since it creates the "safety" demand for it. *A deteriorating sovereign quality globally will remain a source of risk to EM like India* especially when Greece was downgraded due to its deteriorating state of public finances.
3. In last few years, there did exist a tight & negative co relation between USD & risky assets such as US stock markets (S & P 500) , which has been diluted a bit in past few weeks, with the S & P 500 already up by more than 65% from its recent lows in March 2009. (Chart II). This has helped USD to appreciate even with a continuing S & P 500 appreciation. The relationship will further breakdown if US growth disappoints resulting in a fall in S & P 500.
4. The Short USD positions had peaked in November last week as USD had become the funding currency for Global Carry Trades. Viz Short USD & Long all risky asset classes such as EM stocks, commodities etc. The ratio

of long to short positions on USD had peaked at around -4.00 (November 09 last week), a recent high. The unwinding of the same has been boosting the USD rebound in recent times.

Chart II : US Dollar , S & P 500 : The Negative co relation Breakdown

Source: NewYork Times. Orange Line- S & P 500

What implications does a sustained USD appreciation has for Indian markets ?

1. The reversal of Carry Trade and improving perception on US growth will spell disaster for the risky assets such as EM stocks and commodities. These asset classes have been the largest beneficiaries of the easy global liquidity and US loose monetary policy, creating a bubble like scenario. EM funds in 2009 have got flows of around USD 75 bn and the assets under management of these funds now stand at almost USD 500 bn. Indian markets had foreign inflows of more than USD 16.5 bn which has been the prime driver of India's stellar performance in 2009. Global risk aversion and capital flight of all the hot money would destabilize the risky asset classes including Indian markets, more so when the market valuations are looking marginally higher than long term averages. And 2008 is a classic example of what capital outflows can do to Indian markets.
2. Business & Investment confidence in India in last few years has been more or less a function of global stability and capital inflows. The disruption of capital inflows will dent the same. The cost of raising money abroad would be expensive for Indian corporate's as risk premiums rise. A negative global sentiment and drying up of external liquidity has lowered India's growth rates in past. This would probably solve the current headache of rising capital inflows management faced by many countries. While countries like Brazil & Taiwan have already acted to stem the flow, others are contemplating.
3. Indian Rupee (INR) in 2009 has appreciated on back of strong capital inflows and better growth perceptions on India, though it has underperformed the EUR-USD parity. (Chart III). An USD appreciation

combined with capital outflows would weaken the INR. This will have impact across the economy including on trade defecits, inflation (already rising), Balance of payments, Interest Rates, Liquidity etc. On the flip side a falling INR will help export oriented businesses to boost their profitability.

Chart III: USD fell more vis a vis EUR than INR.

Source : Yahoo Finance. Chart Normalized. Data up to 15th December 2009

The appreciation of USD may not be a long term secular trend, but has the potential to disrupt the rally in risky assets globally in the short run, especially Gold. And for the time being the worry on how to set right the global imbalances might fade as the central banks world over may not be required to buy USD and increase there reserves. And the whole process of EM currency appreciation, reserve accumulation, investment in safer US treasuries and reserve diversification will reverse.

But the USD appreciation would also create one problem; the USD denominated assets such as US treasuries would not be attractive for non USD investors, unless the US interest rates move higher. Who will then fund the US deficits & the US consumers? If the USD continues to appreciate in 2010, there are good chances that the carry trades globally would continue, but with JPY as the base currency, which has appreciated recently. The funding currency in a global carry trade got to possess two important characteristics One, a depreciating trend and two, very low & stable interest rates.

So for Indian markets inter alia, do watch the US Dollar closely and track the trends in Sovereign risk in 2010.

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