₹, bonds gain despite US rate hike

Markets perceive Fed as being less hawkish

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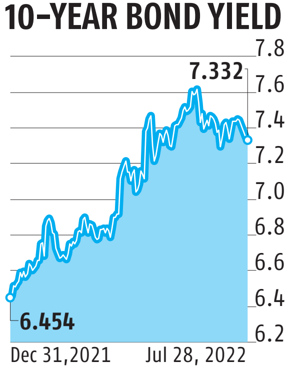
Rupee and Indian government bonds strengthened on Thursday despite a 75-basis-point (bp) rate hike by the US Federal Reserve as key aspects of the central bank's commentary were perceived as indicating that future policy tightening may occur at a slower pace in the world's largest economy.

The rupee settled at 79.76 per US dollar as against 79.90 in the previous close. Strength in domestic equities also bolstered the currency, with the BSE Sensex and the NSE Nifty gaining 1.9 per cent and 1.7 per cent, respectively.

Yield on the 10-year benchmark 6.54 per cent, 2032 government bond settled at 7.33 per cent, one basis point lower than Wednesday's close. Bond prices and yields move inversely. Late Wednesday, the US Federal Reserve announced a 75-bp rate hike, taking its benchmark policy rates to 2.25-2.50 per cent. The latest move takes the total tally of rate hikes announced by the US central bank so far in 2022 to 225 bps.

The Fed's move comes ahead of the Reserve Bank of India's (RBI's) monetary policy statement on August 5, in which the central bank is seen raising the repo rate by 35-50 bps from the present 4.9 per cent.



Compiled by BS research bureau

While the US central bank reiterated its commitment to reining in 40-year high inflation in the US, markets took comfort from US Fed Chair Jerome Powell's assessment that as the stance of monetary policy tightens further, "it may become appropriate to slow the pace of (rate) increases".

"We continue to expect the Fed to hike by 50bp in September, and then by 25bp in November and December. After that we expect the Fed to pause, with rates clearly in restrictive territory and clear signs that the economy is in recession," economists from Bank of America Global Research wrote.

The aggressive pace at which the US Fed has raised interest rates thus far in 2022 has been a key reason behind the large-scale exodus of foreign funds from Indian equities as investors have preferred improved returns in the US. FPIs have net sold $28.6 billion worth of Indian stocks so far in 2022, the largest outflow so far on record, NSDL data showed.

As a result, the rupee has faced considerable pressure versus the dollar this month, weakening to a lifetime low of 80.06 per dollar on July 19. The domestic currency has lost 6.8 per cent versus the dollar so far in 2022. US bond yields fell sharply after the Fed's statement, with the 10-year yield declining 5 bps to a three-and-a-half-month low of 2.73 per cent, while the five-year yield dropped 7 bps to 2.97 per cent.

The US dollar index, which earlier this month had climbed to a 20-year high of 108.54, declined as well. The index was at 106.31 at the time of going to press as against 107 around 5 pm on Wednesday.

"The markets consequently cheered the indication that the biggest rate hikes of this cycle were over," economists from ICICI Securities wrote. Lower US bond yields make Indian debt more attractive for foreign investors.

"Domestic government bonds have rallied in line with the OIS (overnight indexed swap) market. The swap curve has steepened as short-term swaps have fallen sharply on view that the Federal Reserve will now be data dependent instead of providing clear forward guidance of rate hikes," ICICI Securities Primary Dealership's Head of Trading Naveen Singh said. With the RBI said to have been strongly defending the rupee whenever it approaches 80 per dollar, currency traders said the domestic currency is likely to stabilise after the recent bout of volatility.

"The RBI's aggressive intervention in the spot has limited an anticipated fall in rupee and helped it gain post yesterday's currency future expiry, unlike the previous month when the currency had fallen sharply," wrote Amit Pabari, managing director of CR Forex Advisors.