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India Strategy

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EVENT UPDATE

The Liquidity Tightening Begins

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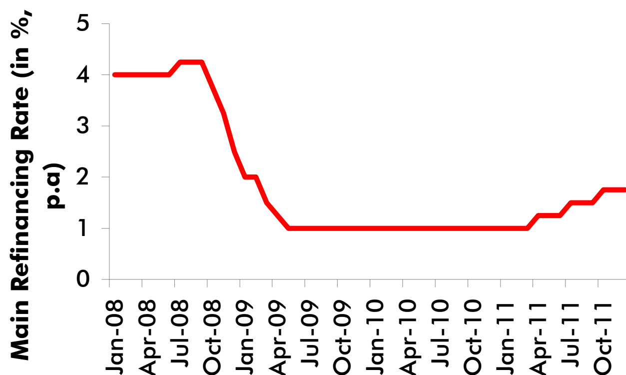
The Event

The European Central Bank (ECB) is widely expected to hike policy rates by 25bps this week after holding its key policy rate (i.e. the main refinancing rate) constant for 23 months (see exhibit 1 below). Whilst emerging market economies' monetary policy has held a tightening bias for more than a year now, the ECB will be the first major developed country central bank to join the tightening bandwagon.

Exhibit 1: The Street now expects a 75 bps increase in ECB's policy rate



Source: Bloomberg, Ambit Capital research

Note : Rate after March 2011 represents Bloomberg Consensus estimates

Exhibit 2: The tightening will aggravate sovereign debt problems in the slow growing, debt-laden economies of the EU

Source: IMF,CEIC, Ambit Capital research

Investment Implications

ECB tightening could drive volatility in the short term: The policy rate hike by the ECB is likely to aggravate sovereign debt problems in the peripheral European nations whose economic growth rate continues to be weak (see exhibit 2 above) and whose sovereign borrowing rate is already high. History suggests that concerns regarding the Southern European nations' (Portugal, Ireland, Greece and Spain) debt woes drive global risk aversion in the interim and thus the same cannot be ruled out again. Further, sovereign credit rating downgrades for the peripheral nations will follow (Moody's downgraded Portugal earlier this week) and this may translate into gyrations on Indian equities.FII inflows into India are inversely correlated to the CBOE's VIX (see exhibit 3 below) and this phenomenon could weaken FII equity inflows in the interim.

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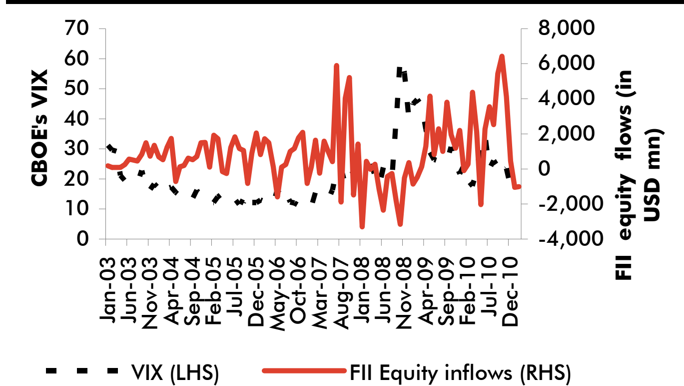
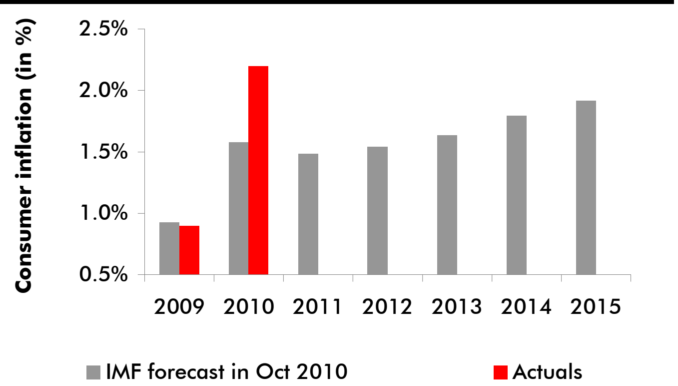
Exhibit 3: FII inflows into India are inversely correlated to VIX



Source: CEIC, Ambit Capital research

Exhibit 4: Inflation in EU was ahead of expectations



Source: IMF, CEIC, Ambit Capital research

ECB tightening ahead of expectations: Another source for a downward bias in Indian equities could be the underestimation of the extent of tightening that the ECB could undertake to clamp down on inflation in CY11. Given that inflation in the EU rose faster than expected (see exhibit 4 above), the possibility that the ECB tightens more than the currently expected 75bps over CY11 (as per Bloomberg consensus estimates – see exhibit 1 above) should inflation once again surprise on the upside, cannot be ruled out.

The Fed's decision on QE: Despite the global economy continuing to be fragile, MSCI World has risen by 28% since June 2010 mainly on account of the record liquidity pumped in by the US Federal Reserve Bank (its balance sheet has grown by 2.8x since August 2008). The ECB's decision to begin tightening its monetary policy in this context marks an interesting turning point.

The Fed's governor indicated earlier this week that inflation has now emerged as a variable in the Fed's decision matrix. Given the role played by the Fed's ultra loose monetary policy in buoying equities, the Fed's decision this summer to opt for QE3 or discontinue quantitative easing altogether, will be watched closely by the equity markets.

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