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Research
India

India Strategy

What Tightening Could Mean for Equities?

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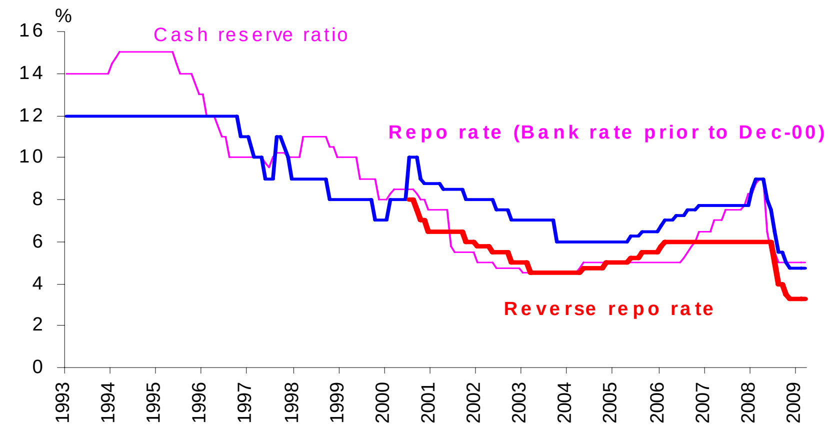
What Tightening Could Mean for Equities?

- Liquidity is still favorable: As we pointed out recently (see *Market Uptrend Intact*, August 13), liquidity remains accommodative of the Indian equities. The 91-day yield is a good indicator of liquidity in the system and in our view its current low level augurs well for the market's near-term outlook. Perversely enough, the prospects of a drought favor liquidity as both the government and the central bank may hesitate to initiate tightening steps in the face of an impending drought.
- How Has the Market Historically Responded to RBI Moves? Over the past 13 years, there have been two tightening cycles. The first one followed the tech bubble starting in July 2000 and ended into January 2001. The second one began during the bull market of 2003-08 in October 2004, and culminated in July 2006, after which the RBI held rates steady until September 2008, when the global financial crisis hit India's shores. The direct impact of policy rates on the market is always hard to isolate, as is the case with say the monsoons or any other market driver, but here are some key observations:
- Over the past few years, the RBI has seemingly lagged the US Fed in terms of rate action. Based on our economist forecasts for 2010, it appears that the RBI may lead the Fed in the coming tightening cycle. Our India economist Chetan Ahya expects a rate hike from the RBI in late 1Q10, whereas our US economist Dick Berner expects the Fed to move in June 2010.
- The short-end treasury yields (91-day) have moved in sync with effective policy rates, especially over the past decade. Not surprisingly, they correlate inversely with equity returns, although there is no discernable lead or lag.
- Purely from a policy rate environment, the previous two policy rate hike cycles were preceded by flat returns (relative to emerging markets) from Indian equities. In the 2000 cycle, Indian equities underperformed emerging markets by 3% whereas Indian equities outperformed EM by 5% in the six months preceding the next tightening cycle in 2004.
- Given that RBI is expected to lead the US Fed in this cycle, the market's response is harder to forecast. Our view is that India will likely outperform, but unrelated to the prospective monetary policy and largely due to superior growth and our expectation of persistent reforms/infrastructure spending.
- To the extent that excess money will decline in the coming months as growth accelerates, the pace of equity gains could also slow. This may coincide with higher credit growth and, hence, lower commercial bank liquidity leading to a similar conclusion. However, for the time being, liquidity remains supportive of equity markets.
- There is little historical evidence of distinctive sector performance patterns related to policy rate moves. During the previous two rate hike cycles, energy and industrials did better than other sectors. However, sector performances ahead of a rate hike appear random.

Monetary Policy Responses: Five Big Cycles Over the Past 15 Years

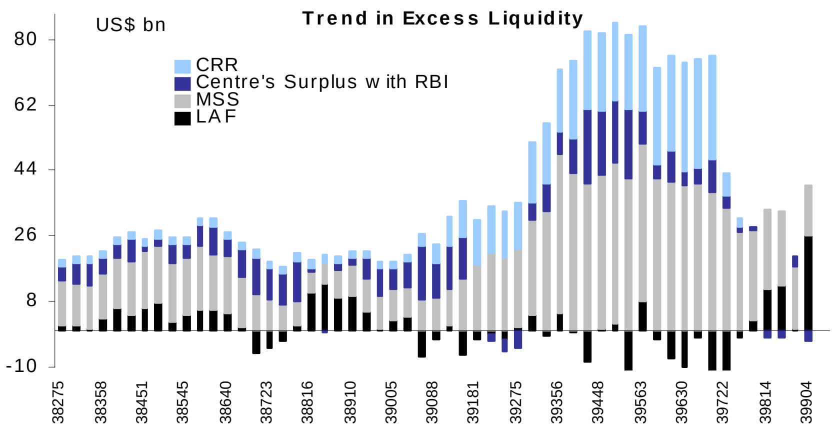
Monetary Policy Response: Next Move Coming in 1Q10*



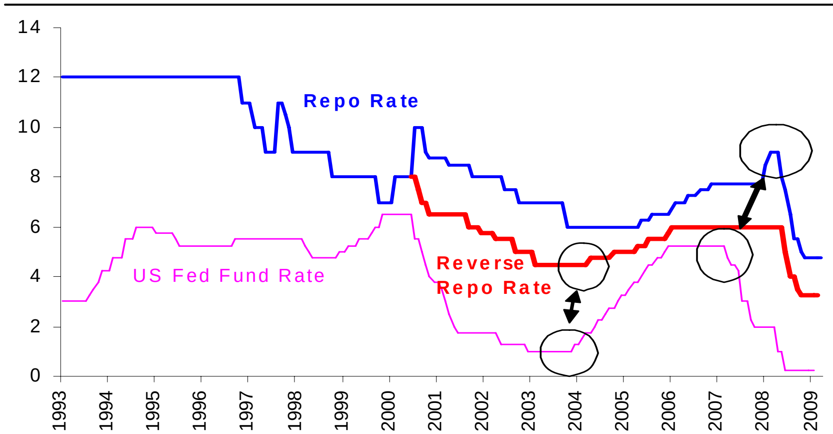
- Since 1996, the RBI has undertaken two major tightening cycles. The first one followed the tech bubble starting in July 2000, and ended in January 2001. The second one began during the bull market of 2003-08 in October 2004 and culminated in July 2006, after which the RBI held rates steady until September 2008, when the global financial crisis hit India's shores. Structurally, policy rates have been declining, in line with India's increased globalization and lower inflation rates.

- The RBI's effective policy tool shifts from repo to reverse repo and vice versa depending on liquidity conditions (reverse repo rate is the rate at which the RBI sucks liquidity out of the system, and this was the effective policy rate when capital flows were strong between 2003 and 2008). India's effective policy rate has seemingly lagged the US Fed Funds rate rate over the past few years. Based on our economist forecasts for 2010, it appears that the RBI may lead the Fed in the coming tightening cycle. Our India economist Chetan Ahya expects a rate hike from the RBI in late 1Q10, whereas our US economist Dick Berner expects the Fed to move in June 2010.

Liquidity Conditions Remain Supportive for Now



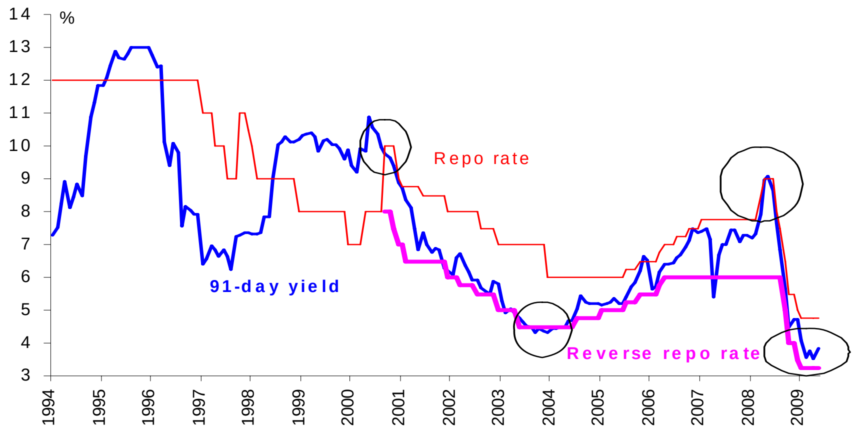
The RBI and the Fed: Not Necessarily Always in Sync*



Source: RBI CEIC, Morgan Stanley Research, ******Note: The RBI introduced repo and reverse repo rates in December 2000. Prior to that the policy rate was the bank rate and for simplicity sake we have merged it with the repo rate.***

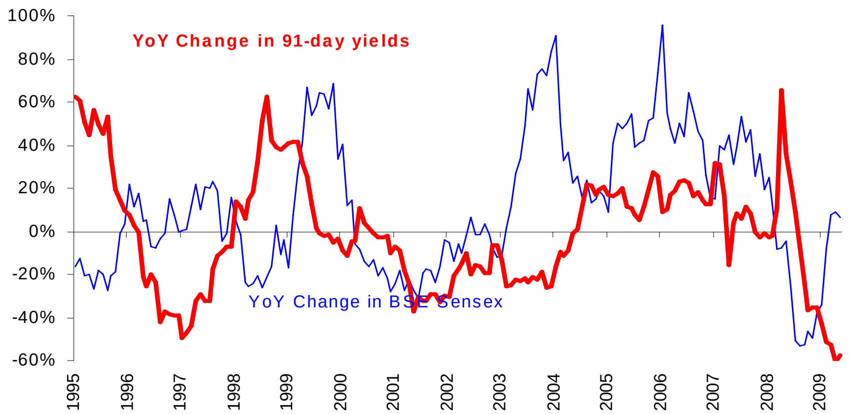
Market Response to Monetary Moves: Bonds in Sync, Equities Less Predictable

91-day Yield: Indicator of Liquidity/Monetary Position…

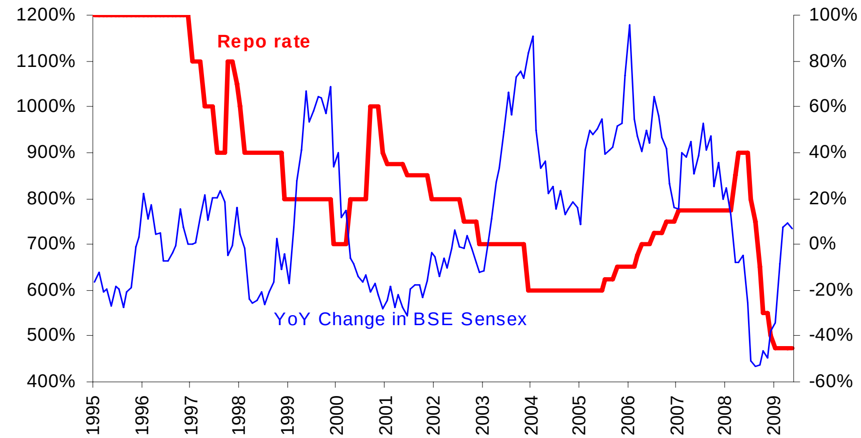


- The short-end treasury yields have moved in sync with the effective policy rates, especially over the past decade. Not surprisingly, they correlates inversely with equity returns, although there is no discernable lead or lag.
- Purely from a policy rate environment, the previous two policy rate hike cycles were preceded by flat returns (relative to emerging markets) from Indian equities. In the 2000 cycle, Indian equities underperformed emerging markets by 3% whereas Indian equities outperformed EM by 5% in the six months preceding the next tightening cycle in 2004. Given that RBI is expected to lead the US Fed in this cycle, the market's response is harder to forecast. Our view is that India will likely outperform, but unrelated to the prospective monetary policy and largely due to superior growth and our expectation of persistent reforms/infrastructure spending.

…And on Stock Market Returns



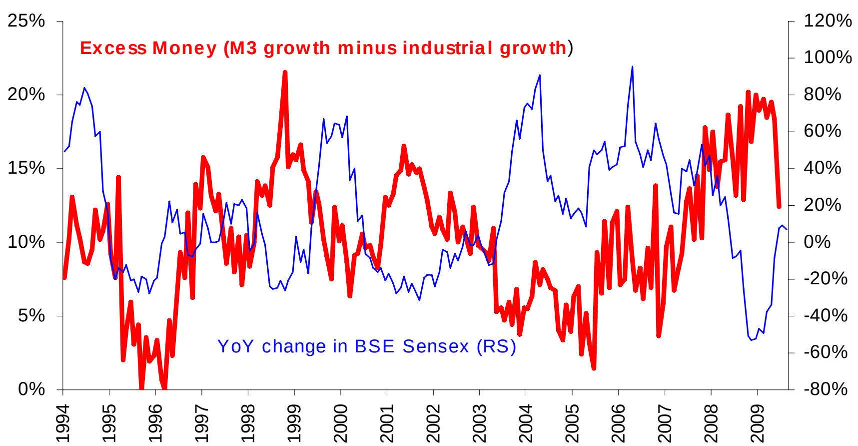
2003 vs. 2009: Similarities in Sector Performance



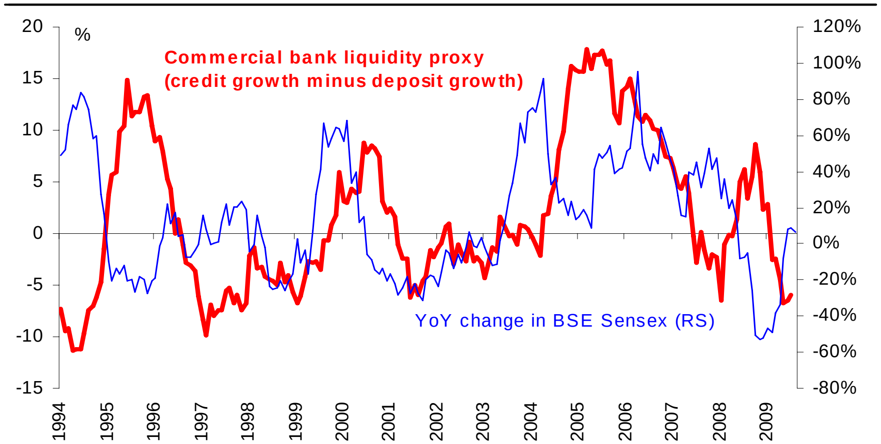
Source: RBI CEIC, Morgan Stanley Research

Liquidity Matters to Equities and Is in Good Fettle for Now

Excess Money is Important for Equities



Commercial Banks Appear to be More Liquid in 2009



- Apart from the obvious linkages between policy rates and market moves, the market does respond to liquidity. To the extent that excess money will decline in the coming months as growth accelerates, the pace of equity gains could also slow. This may coincide with higher credit growth and, hence, lower commercial bank liquidity leading to a similar conclusion. However, for the time being, liquidity remains supportive of equity markets.
- There is little historical evidence of distinctive sector performance patterns related to policy rate moves. During the previous two rate hike cycles, energy and industrials did better than other sectors. However, sector performances ahead of a rate hike appear random.

Sector Performance Around Rate Hikes: No Discernable Trends

	Jul 00- Jan 01		Oct 04-Jul 06	
Sector Performance Rank	During tightening	6mth prior to tightening	During tightening	6mth prior to tightening
Consumer disc	9	7	4	8
Consumer staples	8	3	3	7
Energy	1	9	2	9
Financials	6	1	6	6
Healthcare	3	10	8	3
Industrials	2	8	1	5
Technology	10	6	5	1
Materials	4	5	7	2
Telecom	7	4	9	4
Utilities	5	2	10	10

Source: RBI CEIC, FactSet, MSCI, Morgan Stanley Research

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Total	**2,299**		**641**		

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