India Raises Rates. No Film At 11

In heaven there is no fear; that's why we have it here, especially when it comes to short-term interest rates. If we listen to Federal Reserve officials, government economists and assorted Wall Street fatsos gorging off of low short-term interest rates and the positive carry resulting therefrom – and that's the business I have chosen – the world will come to an end if we so much as contemplate raising the target federal funds rate to the draconian level of, say, 50 basis points. At a full 1%, the rate that did not prompt the previous financial bubble that did not exist and which they neither caused nor could have recognized while it was happening, the sun will rise in the west if it deigns to rise at all.

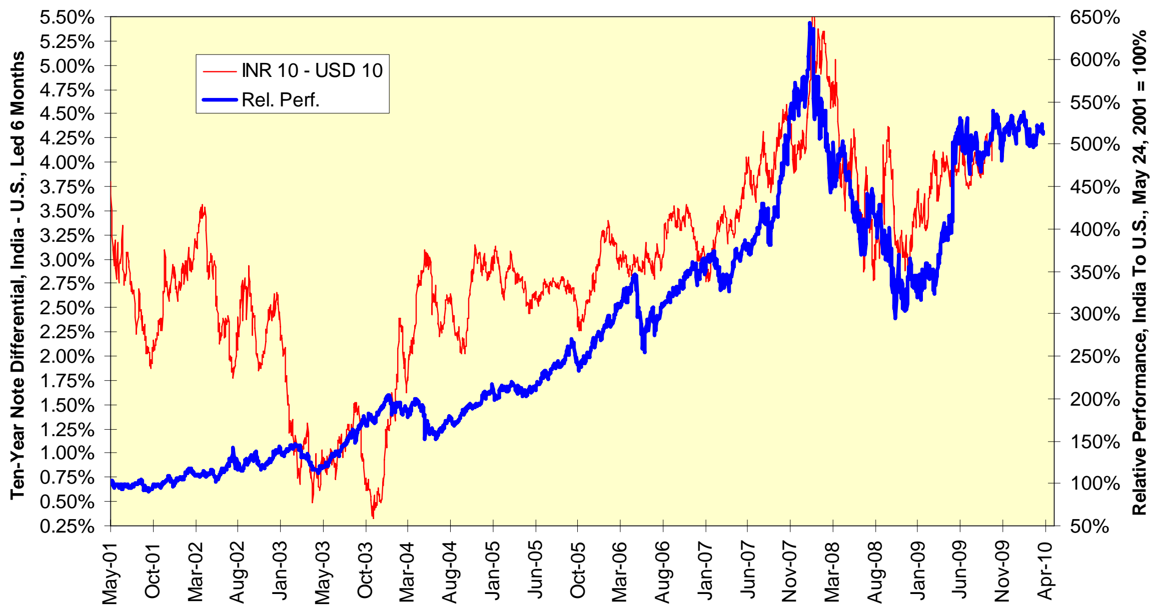
Nonsense, say I and the Reserve Bank of India agrees. They raised their key rate by 25 basis points two weeks ago, and nothing bad has happened yet. Four general trends, all of which had been in place in anticipation of such an event, should continue. These are a steepening of the Indian yield curve, a firming of the rupee (INR), a stall in the relative total return of the Indian stock market vis-à-vis the U.S. market and higher long-term Indian government bond yields vis-à-vis U.S. bond yields.

Let's try to compress this information into two views. First, we can compare relative short-term interest rate expectations between the two countries by taking the difference between the forward rate ratios over the six-nine month horizon ($FRR_{6,9}$). This is the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate. The more it exceeds 1.00, the more short-term interest rates are expected to rise.

This differential, marked with the roseate columns in the chart below with the last datum highlighted in black, leads the INR rate, but with a twist: Ever since the Federal Reserve began its money-spraying campaign in 2009, investors have been locked into a "perma-expectation" of higher short-term rates in the U.S. As a perverse result, the INR has been strengthening against the greenback even though expectations have been for a relative rise in U.S. short-term rates.

Rupee Strengthens As Interest Rate Expectations Favor Dollar

Now let's take a look at the capital markets. Here the relative total return in USD terms of the Indian stock market to the U.S. stock market leads the ten-year government bond differential by six months (score one for those who believe the stock market looks ahead or even looks to see in what is stepping). That stock market differential, surely to the disappointment of BRIC-heads everywhere, has been treading water since June 2009. Part of this is due to the rising spread between Indian and American ten-year yields; those who ignore the role of higher bond yields in determining stock valuations do so at their peril.



Overall, the most attractive exposure to the Indian market has been and likely will continue to be at the short-end of the yield curve. The excess return for swapping three-month USD for three-month INR since the U.S. embarked on quantitative easing in March 2009 has been a gaudy 14.96%. Whether congratulations are in order for India or opprobrium for the U.S. is in the eye of the beholder; let's just say I am partial to the concept risk-averse savers should not be punished by their hometown central bank.