Lunch At The New Delhi

It is an experience shared by baseball fans everywhere, regardless of technological prowess and preferences, and that is studying player performance rankings. That little joy in life used to be confined to the Sunday newspaper; now it can be done on-line in ever-greater levels of statistical detail.

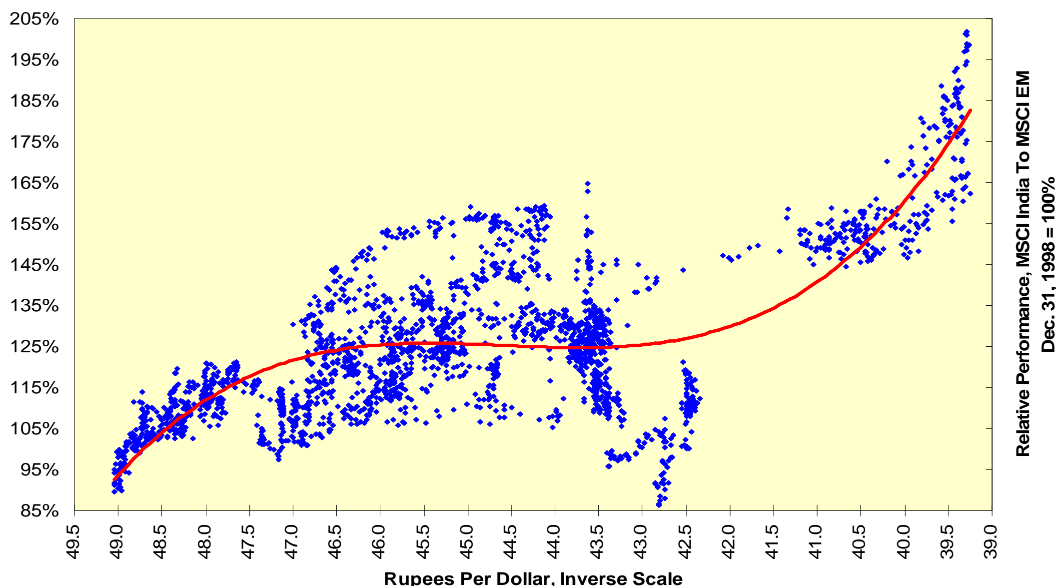
Small wonder indeed Americans leapt to the forefront of global finance. Soccer games end 1-0; 2-0 if they are a blowout. How are you going to learn statistical analysis painlessly from that?

This brings us to our current topic, the Indian stock market. I did a little double-take when I glanced down the equity performance screens on *Bloomberg* (more respectable for adults than the sports page) and saw the flagship stock index of India, the Sensex 30, was down 13.24% on the year, 15.93% in U.S. dollar terms. Wait a minute; not only is the poster-child of the multiple-year emerging market rally both down and underperforming major indices in Europe, North America and Japan, the rupee is down against the dollar? I did you-know-what with that BRIC.

Rupee Relationship

American protectionists believe in the face of overwhelming evidence to the contrary a weak dollar somehow rewards both American business and American stocks. This never stops others from proclaiming the opposite, a weak dollar is bearish for U.S. stocks; lately, the argument has been made that the weak dollar caused the commodity boom. I must have tired of bashing the former argument as the last piece I wrote on it was in December 2006; the commodity-dollar argument was made in March of this year.

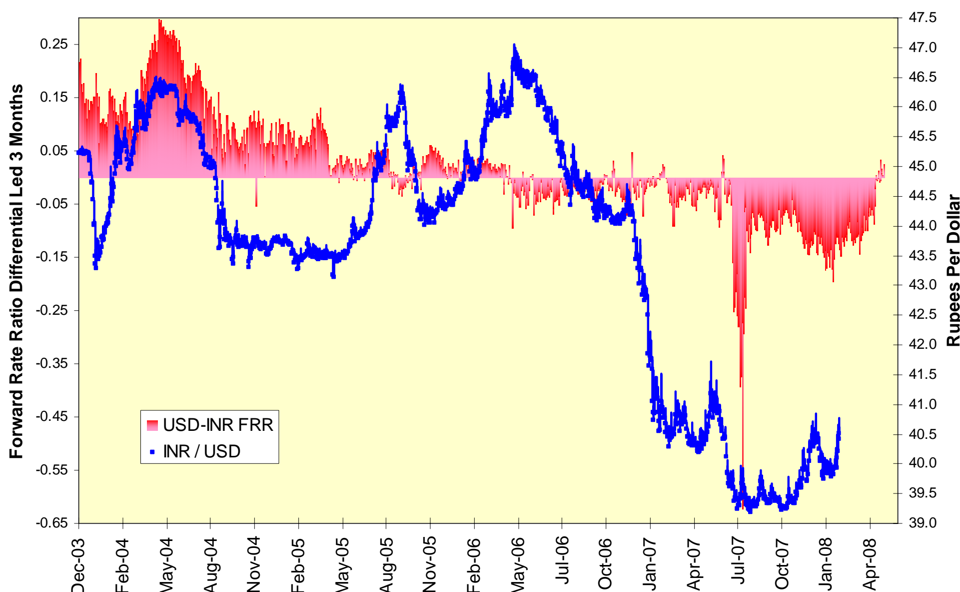
As a generalization, emerging markets tend to have a fairly direct relationship between their stock markets and their currencies. This is a function of capital flows adding to or subtracting from the strength of both simultaneously and of carry trades such as the yen carry trade discussed in January 2007. India is no exception to this generalization. If we compare the relative total return of the Morgan Stanley Capital International India index to that of MSCI's emerging markets index against the rupee, plotted inversely, we see this relationship quite clearly.



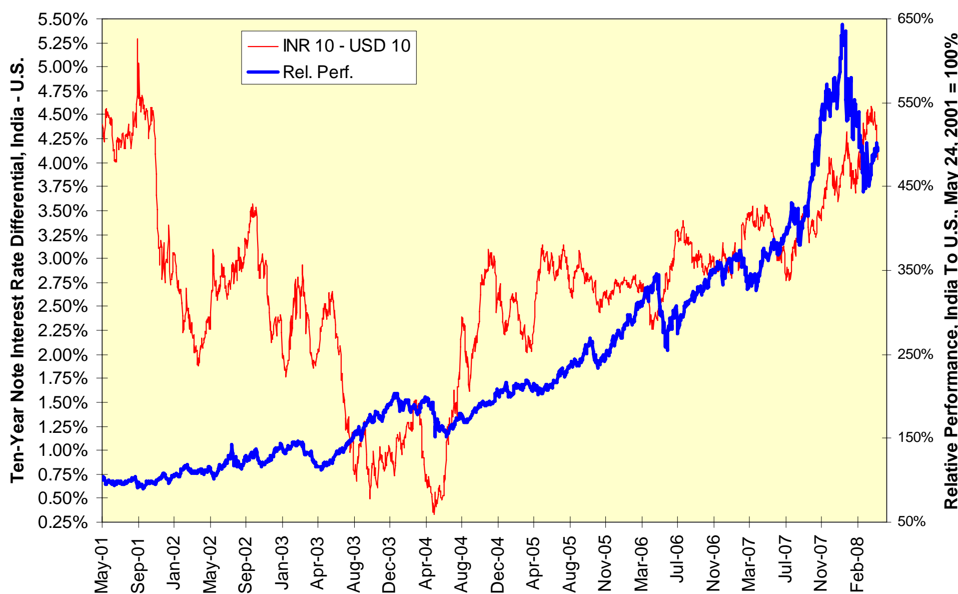
The logical question at this point becomes assessing the rupee's course. Unlike China, which has grudgingly acquiesced to a gradual revaluation of the yuan, another backfiring scheme of the protectionists as noted in January, or Japan, which has managed the yen forever, India has decided the let the rupee move both higher and lower in a "managed float." It weakened several time in 2004, late 2005 and mid-2006, and then embarked on a substantial rally between July 2006 and January 2008.

Its course matches that of expected future interest rate differentials. If we take the forward rate ratio between six- and nine-month LIBOR, the rate at which we can borrow money for three months starting six months from now,

divided by nine-month LIBOR itself, and subtract a similar measure for the rupee based on Indian Treasury bills, we get a forward-looking measure of whose short-term interest rates are going to rise the fastest. Right now, that measure, which leads the currency by three months on average, is moving substantially in favor of the dollar.



Another way of looking at the relative interest rate picture is to map the absolute differential of Indian and American ten-year note yields against their stock markets' relative total returns as calculated by MSCI. After a brief collapse in the differential in early 2004 when it became apparent the Federal Reserve would have to start raising short-term interest rates, long-term Indian yields began a prolonged climb against U.S. yields. As the Indian stock market was running rings around ours at that time, few saw the relative performances of stocks and the interest rate differential as related, but they in fact were two sides of the same coin: The Indian economy was overheating, Indian inflation was rising to its present 7.87% level, capital was being drawn into the country and it was pushing both stocks and the rupee higher.



There are two types of investors in this world, those who sell too soon and those who stay in the bubble to the bitter end and then yell and scream for the Federal Reserve to bail them out and begin a bubble cycle anew. India has had a great run over the past five years. Betting on such a run to continue would be foolish.

India and Pakistan, its beloved neighbor, both enjoy a good game of cricket. If you ever have time and a thirst for Pimm's Cup, have someone try to explain the rules of cricket to you with a straight face. It is very easy to see how our game of baseball evolved from those who did not have three free days for a cricket match. Combine their mastery of that silliness with their litigious nature – India is as lawyer-infested as we are – and you have the makings of what should be an economic powerhouse for a long time to come after they digest their recent gains.