

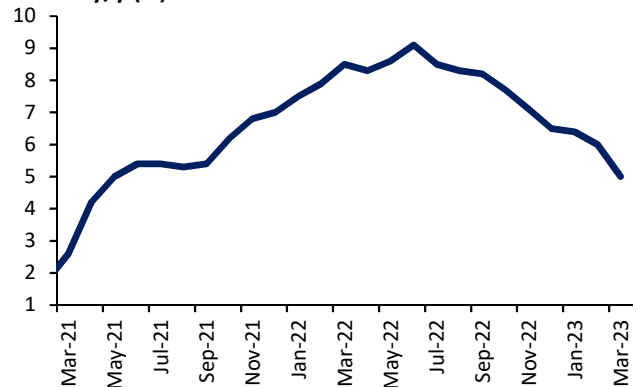


May 8th, 2023.

Balancing act for Fed

Federal Reserve has raised rates by a quarter of a percentage point, tenth consecutive time in just more than a year, bringing the federal funds rate to a new target range of 5% to 5.25%, the highest level since mid-2007. The Fed commentary continues to be “Data-Dependent” and suggest that the upcoming economic numbers will be important to guide the market. The governor added that inflation remains a concern, while tighter credit conditions stemming from the recent banking turmoil “are likely to weigh on economic activity”.

US CPI y/y (%)



Source: Reuters

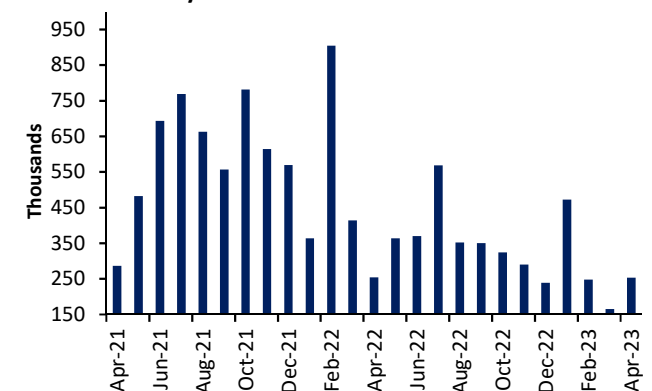
Fed surrounded by Banking stress, inflation and growth

While market participants initially cheered the possibility of a pause, their confidence waned as Fed Chairman clarified that inflation remains the primary concern and that it is too soon to say with certainty that the rate-hike cycle is over. Fed officials are still of the view that inflation and the impact of a credit tightening is still evolving in the wake of higher interest rates. The Fed governor pushed back on market expectations that the policy-setting FOMC would cut rates this year.

The governor mentioned that the conditions in the US banking sector have broadly improved and currently is sound and resilient. In wake of failures of three lenders namely Silicon Valley Bank, Signature Bank and First Republic Bank, Powell said, “committed to learning right lessons.” These banks failed due to illiquidity in their systems which was due to rate hike cycle that began in early 2022. He was very focused on what happens with credit availability and would broadly monitor what is going on in the banking sector.

The latest jobs report released from the US showed the economy added 253,000 jobs in April as compared to revised down number of 165,000 job addition in the previous month. The unemployment rate and wage growth figures also pointed to continuing tightness in the labor market, raising doubts over whether the Fed will begin to cutting rates. Data released earlier last week supported Fed governor’s assessment, showing a sharper than expected drop in job openings to their lowest level since April 2021. However, Friday’s figures are the latest reminder that inflationary pressures are still high.

US Non-farm Payrolls

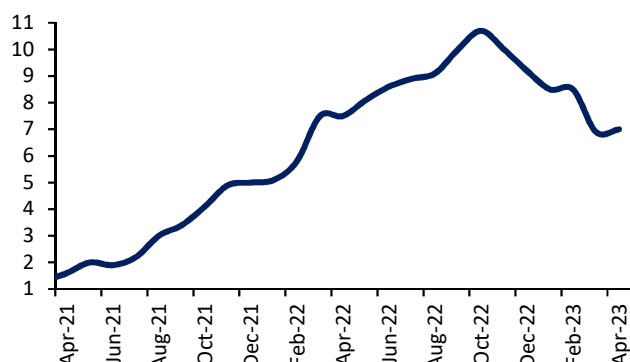


Source: Reuters

The Fed governor seems making a bit of blunder by hinting too strongly that a pause is forthcoming, leaving the Fed exposed to having to abruptly change course if economic data suggests the inflation problem persists.

ECB has more ground to cover

EU CPI (%)



Source: Reuters

Last week, the ECB raised rates by a quarter of a percentage point as the governor warned the fight against inflation was not yet won. The ECB President mentioned that the central bank has more ground to cover and is not looking to pause but also highlighted that rates were in a “restrictive territory” and signs of a credit crunch had been a big factor in its decision to slow the pace of rate rises. Inflation in the Euro zone is still at a level well above the ECB’s target of 2% and latest number showed price rise has been to the tune of 7% in April.

The central bank President noted that rate-setters had backed a bigger rise of half a percentage point and said the “inflation outlook continues to be too high for too long”. The ECB is likely to raise rates high enough to bring inflation down to its target and it would then keep them there “for as long as necessary”.

Outlook

Inflation that has been the focus for most of the major central banks and any uptick in the number change the course for the dollar that has fallen by over 5% in the last one month. Expectation is that inflation could remain unchanged and that could restrict downside for the dollar. Apart from inflation, market participants are now keeping an eye on the upcoming debt limit deadline that in the first week of June and the ongoing banking crisis in the US which is going to be the key highlight even for the Fed. We expect that volatility in the dollar against its major crosses could remain elevated as there are a lot of moving points in the next couple of weeks.

We expect the overall momentum for the dollar to remain negative, but a higher inflation data or better-than-expected economic data from the US could lead to a sudden up move in the dollar. As far as the USDINR(Spot) pair is concerned it could trade in a broad range of 81.50 and 82.50 and a break on either side of the range is likely to provide direction in the currency. Depreciation or appreciation of the rupee on either side of the range is likely to be to the tune of 40-50 paise.

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