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Impact of Recent MPC Announcements on Equity and Forex Markets

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ABSTRACT

The “unscheduled” Monetary Policy Committee (MPC) announcement by Reserve Bank of India on May 2nd, 2022 marked a hike in repo rate by 40 basis points and a ‘withdrawal of accommodative stance’. This was followed by a sharp fall in Indian equity indices. The depreciation of rupee that has continued from April 2022 continued unabated. In this context, I discuss, using an event study analysis, the impact of MPC announcements on the equity and forex market for the period April 2020 to May 2022.

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Impact of Recent MPC Announcements on Equity and Forex Markets

I. IMPACT OF RECENT MPC

The "unscheduled" Monetary Policy Committee (MPC) announcement by Reserve Bank of India on May 2nd, 2022 marked a hike in repo rate by 40 basis points and a 'withdrawal of accommodative stance'. In fact, the 'withdrawal of accommodative' stance was started from April 2022 MPC, though in both cases the central bank has mentioned it would 'remain accommodative'. While it may sound like 'Parseltongue' to the non-initiated, it signifies that while the rate hikes for fighting inflation may continue as well as the mopping up of liquidity, the central bank would not hesitate to step in if 'growth' needed a support.

The May 2nd decision being unscheduled, the markets have, as expected, turned jittery, with Nifty 50 plummeting more than 7% from 17092 on May 2nd, 2022 to 15739 on May 16, 2022. It is important to note here even before the MPC announcement, from April 2020 onwards Nifty was largely heading down from the 18000 levels, and MPC announcement on May 2nd exacerbated the fall. Rupee has been trending down majorly on account of the geopolitical situation and increased FII outflows since early April depreciating from 75.44 to 76.52 just before the MPC announcement. Post the announcement, after an initial strengthening, it slid again to 77.88 on 16th May, 2022. Fears of rupee reaching 80 are not unfounded.

To understand the market behaviour, let us go back a bit to the start of the pandemic. As can be seen in Chart 1, from January 2020 to March 2020, Nifty lost almost 5000 points, sliding from 12400 levels to 7500. However, the bull market move after that has been tremendous. Markets not only retraced back to 12000 levels, zoomed to around 18600 levels by October 2021. Like Nifty, major equity markets around the world saw a massive bull run. Chart 2 plots this bull run from March 2020 onwards in major indices: Nifty 50 (India), Dow Jones (US), BOVESPA (Brazil), SSE composite Index (China). There was 'irrational exuberance' at many points and besides retail participation, a major reason for the strong bull was the massive liquidity drive that central bank have doled around the world.

Right now, central banks all over the withdrawing the easy money conditions. Other than US and UK, who have each raised rates by 50 basis points, Australia, Brazil, Iceland (in addition to India) have raised rates in the last week. In response markets, world over, are crashing like a pack of cards. Chart 3 shows the movement in the major stock markets post 2021. While markets in China have been heading down for sot time now, the steep fall in markets post the April, 2022, with withdrawal of accommodation is significant. Globally, liquidity in markets all though the pandemic was driven by the ultra-accommodative monetary policies of the central banks. Equity markets have come to depend on the liquidity airdropped like 'manna from heaven'. The withdrawal of liquidity is therefore a cause for panic, resulting in the crash for major markets globally.

II. MOVEMENT IN EQUITY AND STOCK MARKET POST MPC: AN EVENT STUDY ANALYSIS

In the chart 4 below, I use an event study methodology for comparing the post MPC market movements. For all MPC announcements from 2020 onwards, the stance has been accommodative and support for growth remained a priority. The April 2022 MPC kept the rates unchanged but changed the stance to 'withdrawal of accommodation", with finally rates being raised in the May 2nd MPC by 40 basis points. As can be seen markets had remained lukewarm to 'pro-growth' rates unchanged stance all though 2021. Compared to this, they have been brutal to every hint of the rate hike, including the change in stance.

Chart 5 shows volatility in the same windows post the MPC and we in context the markets have from late 2021 reacted sharply to MPC. The present episode is also amongst the few episodes like in Feb, 2022, where the volatility has persisted at similar levels from two day to the five-day window.

Rupee had started its downhill journey much before the MPC announcement as discussed earlier. Post the announcement, after a slight appreciation of rupee from 76.31 May 2nd, 2022 to 75.98 on 5th May, rupee started the free fall again, touching 77.88 on 16th May 2022. The present MPC saw an initial appreciation and then a sharp deprecation in rupee, as also seen in Chart 6. Looking at previous MPC announcements, there is a clear trend of sharp depreciation in the last four MPCs, which gets subdued over the five-day period. Nifty and INR demonstrate a strong correlation and Nifty downslide is matched by a depreciating trend in INR. The strong co-movement in Nifty and INR is shown in Chart 7 (a & b). While Chart 7 (a) looks at the period from 2020, Chart 7 b focusses on the period from May 2022, post the MPC, where we see a stronger co-movement. This is brought about by the sharp FII outflows from the Indian market (Chart 8), which had played havoc on both stock and currency market. The strong co-movement is a cause of worry, as it highlights dependence of our market on short term and volatile FII flows.

III. MPC DILEMMAS: EQUITY, CURRENCY AND INFLATION

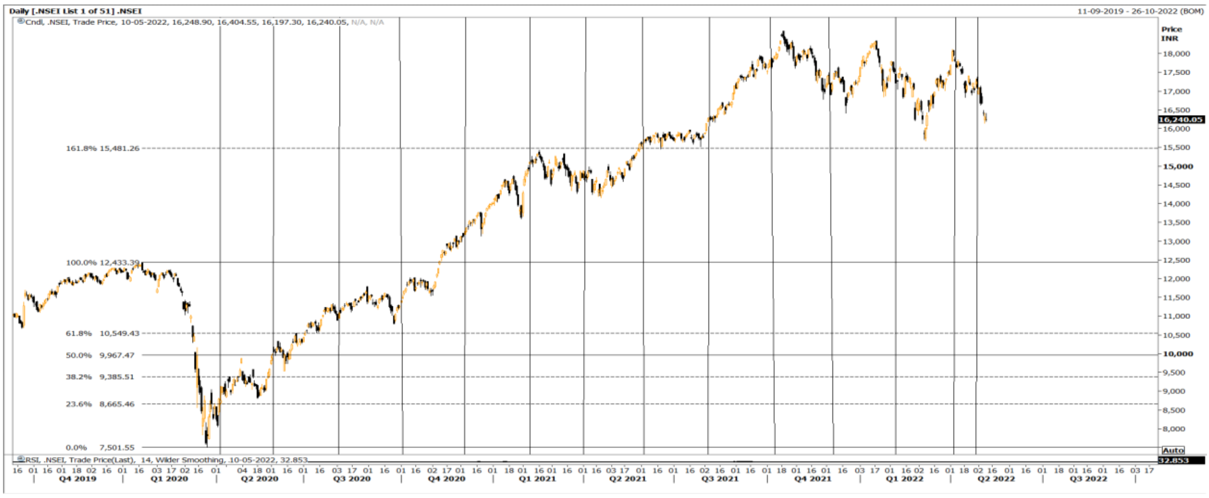
The stock market correction, happening globally, is of course painful for retail and institutional investors alike as a huge chunk of their valuation gets washed away. However, for the point of view of the long-term sustenance of the equity markets, as well as retail investors who have 'new found' the stock market as an investment avenue this correction in equity markets is very much required. There are three reasons for this. First, the extent of overvaluation in the markets during this period has remained high, and correction cuts some flab. Markets still remain to a large extent delinked from fundamentals, as inflation and its consequences for demand driven growth are still not factored in by the equity markets. Second, it is important for retail traders especially those who came in post the pandemic to realize the equity market is not one long bull haul. The volatility and bearish conditions are part of the market as much as windfall gains is. This hopefully will lead to some much-needed diversification across asset categories for retail investors. Third, as has been happening since early 2022 in the global markets, also pointed out by the BIS Quarterly Report of March 2022, a stock market rotation in favour of 'value stocks' and against 'growth stocks' is expected. Rates hikes will help the long established 'value' stocks with stable cash flows, while growth stocks, like technology stocks remain sensitive to the interest rate hikes.

What about the currency? Can the central bank afford to have the currency depreciating to 80? Reserve bank of India as always attempted to moderate extreme volatility in rupee. The speculation following the MOC in May was whether the MPC rate hike is an attempt to keep rupee at a particular rate. RBI has over the years consistently stated that it looks to address rupee volatility and not a particular rupee rate. So, is the RBI's decision to step ahead of the Fed in raising rates driven by the objective of appreciating the currency? This is very unlikely, as while rupee support remains the central bank's major concern, the central bank knows that targeting a particular rate is neither possible (amidst the heightened speculation) or wise (given the foreign exchange reserve position). Fighting inflation should be a priority now given the impact of inflation on purchasing power of the masses, which ultimately will impact the demand and hence growth.

References

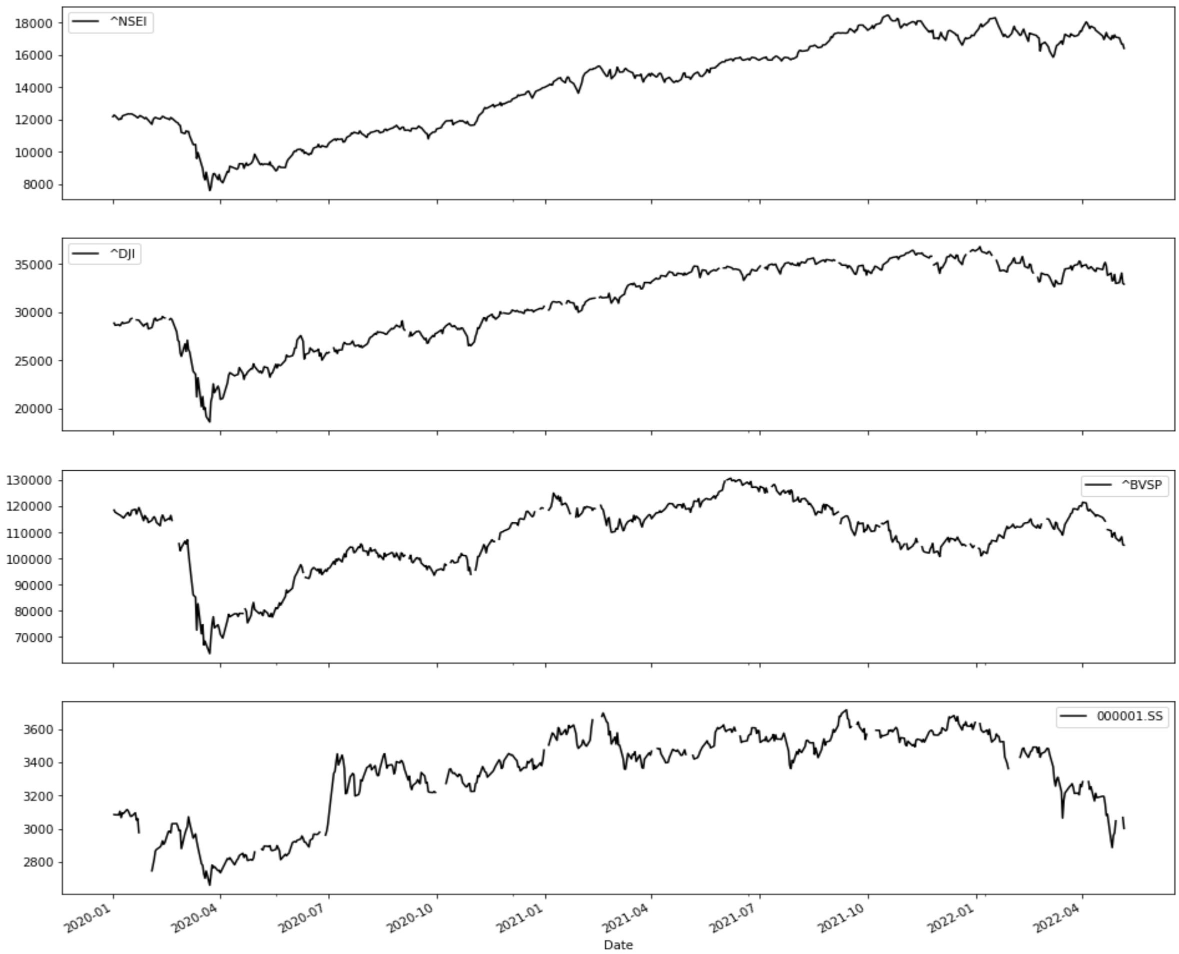
1. BIS (2022), Markets jolted, BIS Quarterly Review, March 2022. https://www.bis.org/publ/qtrpdf/r_qt2203.htm
2. Reserve Bank of India (April 2020 to May 2022), Monetary Policy Statement. https://www.rbi.org.in/scripts/Annualpolicy.aspx
3. Raw Date: Refinitiv Eikon, RBI Database, Money Control

Chart 1: Movement in NIFTY post pandemic:



Source: Author, Chart: Refinitiv Eikon

CHART 2: MAJOR STOCK MARKETS SINCE 2020

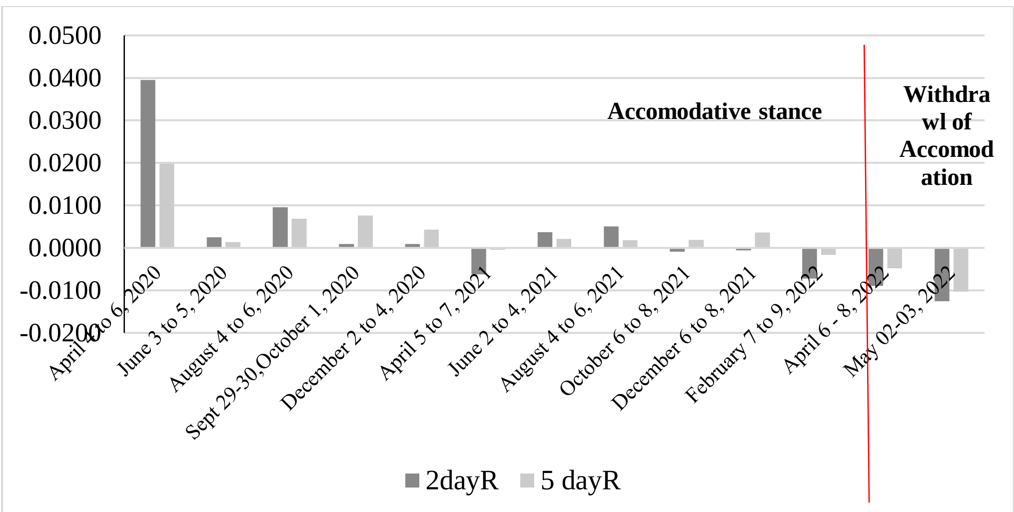


Source: Author, Raw data: Yahoo

CHART 3: THE RECENT DOLDRUMS: WITH END OF ACCOMMODATIVE POLICIES

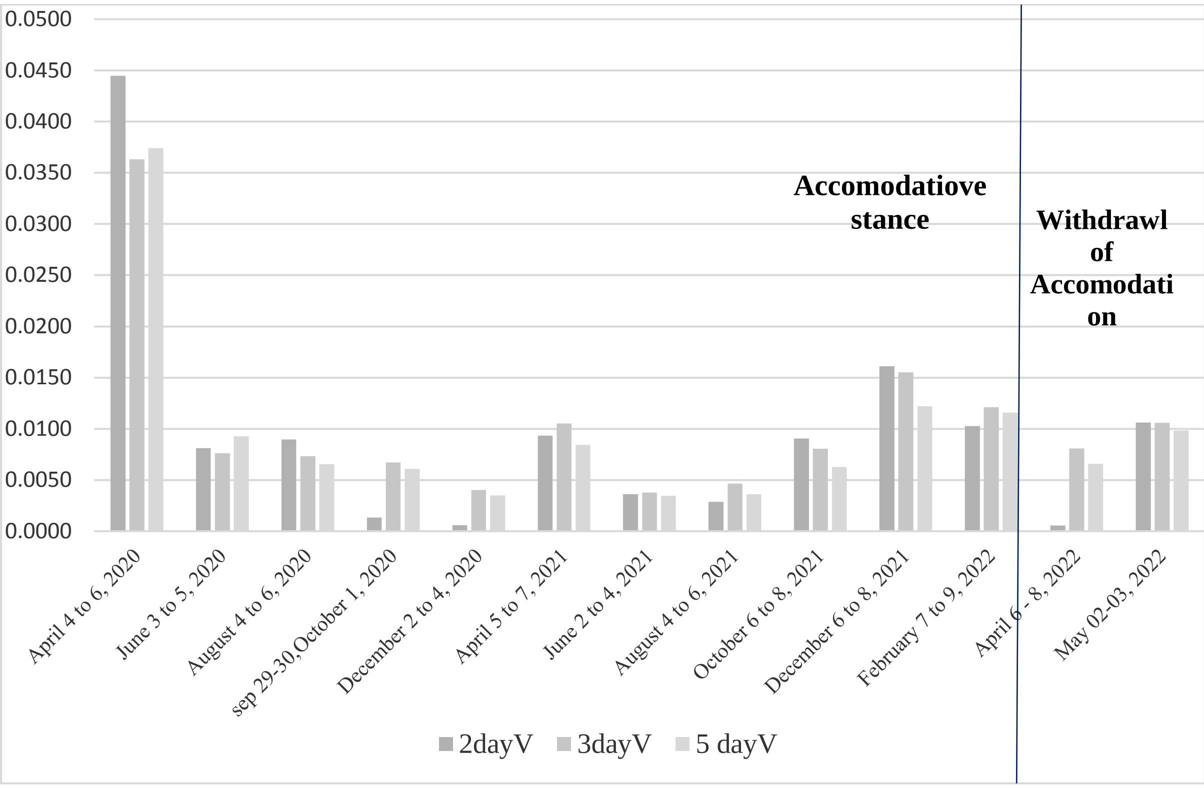
Source: Author, Raw data: Yahoo Finance

CHART 4: NIFTY MOVE IN RESPONSE TO MPC



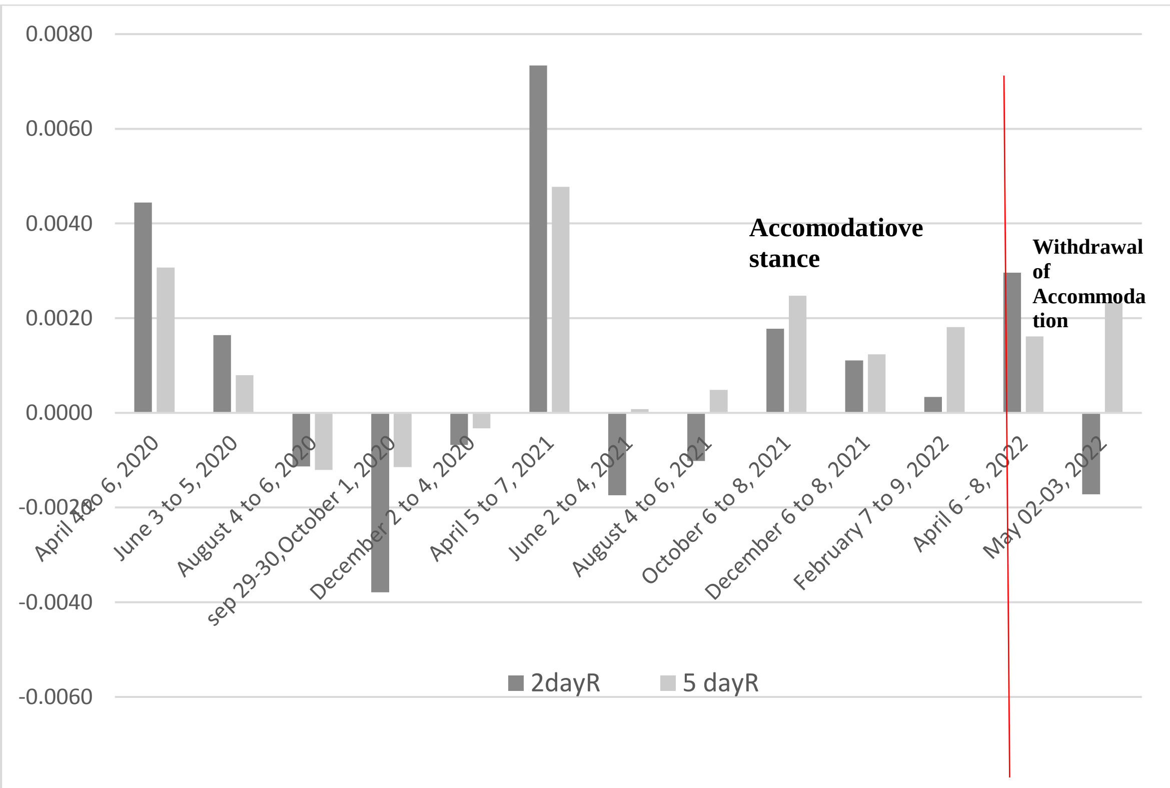
Source: Author, Raw data: Refinitiv Eikon, RBI MPC statements

CHART 5: NIFTY VOLATILITY IN RESPONSE TO MPC



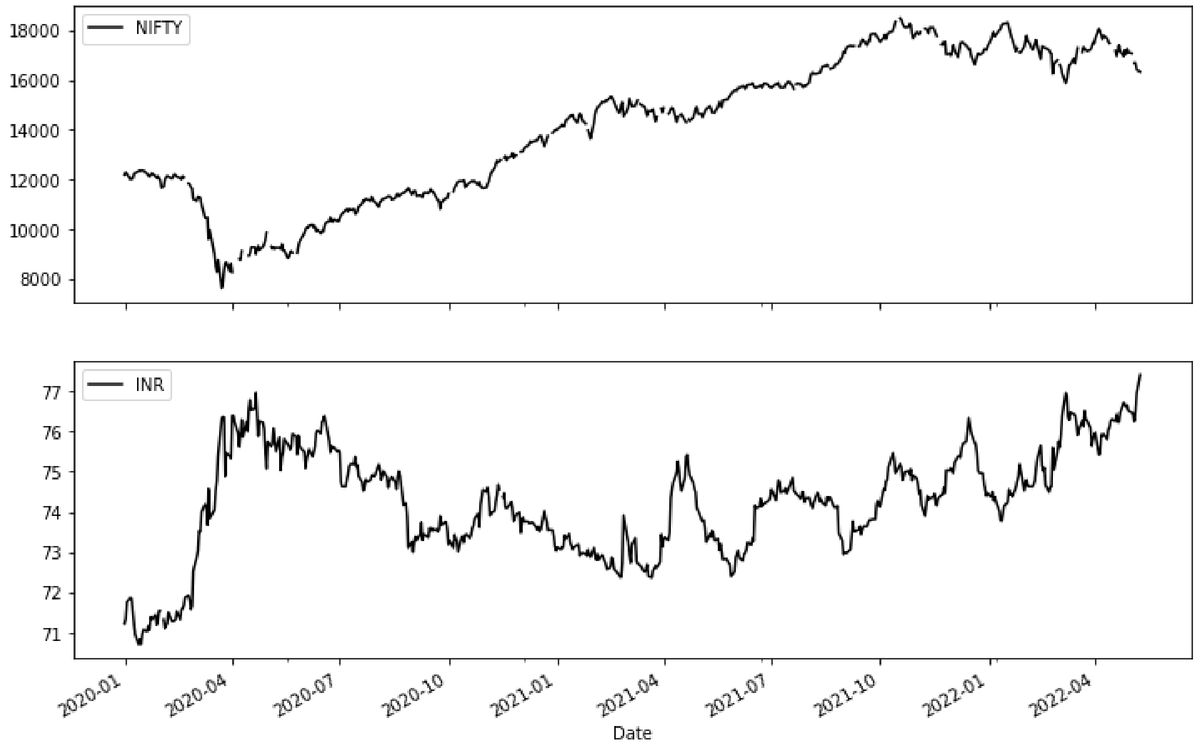
Source: Author, Raw data: Refinitiv Eikon, RBI MPC statements

CHART 6: INR MOVEMENT POST MPC (TWO AND FIVE DAY)



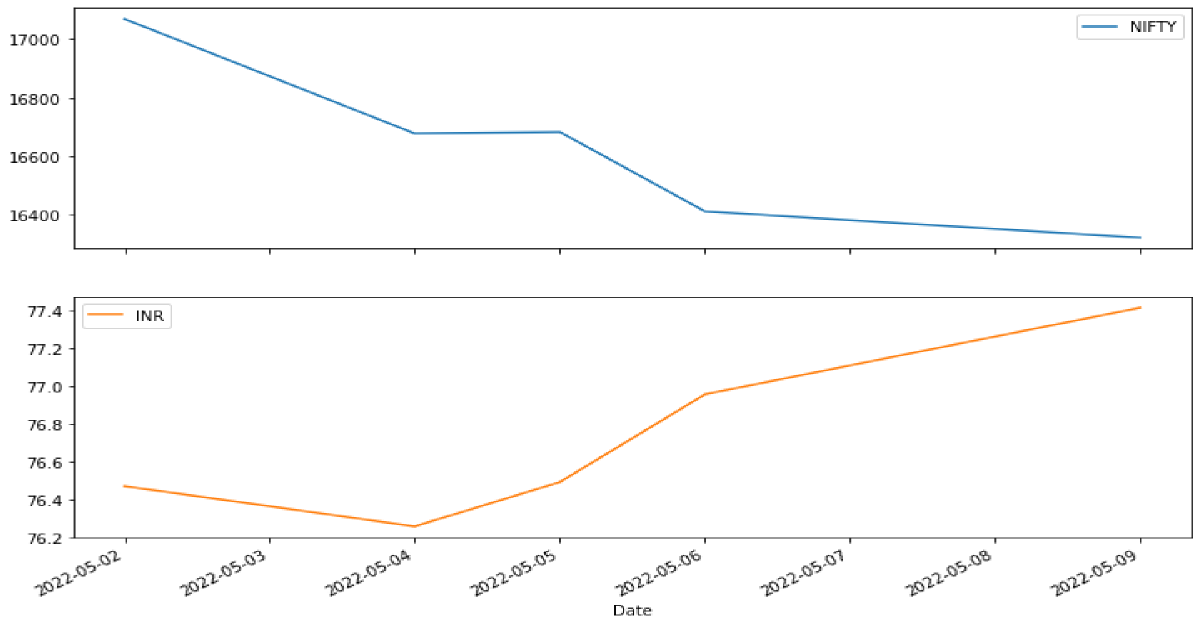
Source: Author, Raw data: Refinitiv Eikon, RBI MPC statements

CHART 7a: INR AND NIFTY CO-MOVEMENT FROM 2020



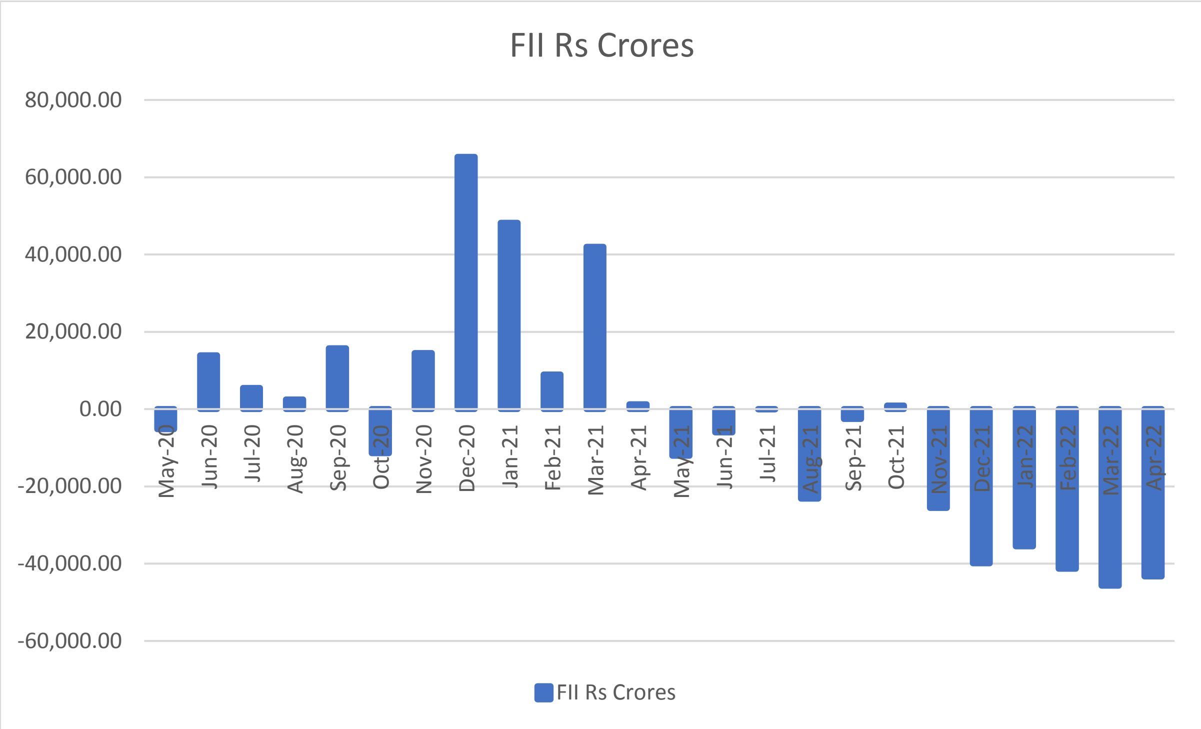
Source: Author, Raw data: Refinitiv Eikon, RBI MPC statements

CHART 7B: INR AND NIFTY CO-MOVEMENT POST MAY MPC



Source: Author, Raw data: Refinitiv Eikon, RBI MPC statements

Chart 8: FII flows in the Indian market



Source: Author, Raw data: Moneycontrol[1]

[1] https://www.moneycontrol.com/stocks/marketstats/fii_dii_activity/index.php