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Antipodal Challenges

Two Federal Governors in two countries, antipodal in location and also in many an economic sense, are grappling with diametrically opposite conundrums. One is under immense pressure to cut interest rates and spur growth, the other to hike interest rates in response to growth supposedly returning soon.

No marks for guessing that the debates raging are in India and the U.S respectively. The Reserve Bank of India (RBI) Governor has been managing expectations rather well, arguing why cutting rates too early would be counter-productive to the economic recovery. He has in his recent policy statement been more forthcoming on where he stands. He pointed out that "…turning to the medium-term (6% January 2016 CPI inflation) objective, the balance of risks is still to the upside, though somewhat lower than in the last policy statement…". Effectively he has sent a strong message that his battle with intransigent inflation is far from over and, until that battle is won, any move on interest rates is risky and would be a misadventure that the country could ill-afford.

The US Fed: Raised expectation of rate increases and is now managing it down

The US Fed has been hemming and hawing for some time now on where they truly stand and what their reading of the economy is. To be fair, inclement weather in the early part of the year distorted the data series and much of the data since has not shown a clear enough signal that the economy was indeed breaking out of its low growth range. The markets have perhaps themselves to blame in this debate for assuming that an end to quantitative easing necessarily meant an early and imminent reversal of the interest cycle. Janet Yellen's off-the-cuff 'about six months' comment still rings loud in the markets' ears and hence the markets' anxiety about rising Fed rates. It is now becoming more apparent that going forward the Fed will have to choose its words more wisely and manage Wall Street's rate hawks better.

The US Fed is finally worried that a strengthening greenback poses all sorts of problems in the months ahead, something it can hardly wish away. After all, even though some of the data from the U.S. suggests that the economy is stable, there is little evidence that it is shifting into higher gear or that it will anytime soon. The recent minutes of the US Fed meet make it evident that they are more likely to err on the side of caution and take their time before they decide to pull the trigger.

The RBI: Raised expectation of rate drops and now needs to manage it up

The RBI Governor is wary of global events impacting India's external account that could leave him little room to respond if he were to wield the knife too early. The RBI Governor would not just like the inflation rate to hit its target before he pulls the trigger. He would also like to ensure that the supply side of things in India have been sufficiently addressed to make that 6% or lower targeted CPI stick for much longer. For this, the Government will have to put in place policies to address supply side issues on food, rural wages and fuel prices. Declining crude prices (always India's bugbear) have given India a massive short term economic relief in terms of taking some pressure off the fiscal deficit, putting a lid on the current account and leading to lower inflation. **This creates a window to address structural issues driving inflation. The RBI does not have full belief in these issues being sorted out and hence it does not want to cut rates too soon.**

The Market Expectations need to Normalise

The markets' reaction to both the Governors' utterances and actions have been quite striking. The chorus on Wall Street for a hike in rates in mid-2015 has reached a crescendo now even as the US 10-year bond yield has persisted southward. In India too, the chorus for the first interest rate cut in the March-June 2015 period risks drowning out voices of reason from the RBI.

Before long, expectations will re-adjust at both these antipodes. Investors in the U.S. could realise that interest rates to the lower bound are going to be with them for much longer and therefore call for a tweak to their short to medium term investment strategy. Also, the ill-effects of the strong dollar will likely lead to a recalibration of growth expectations in the months ahead. The stock market's future course will therefore be more challenging than at any point in its rally of the past two years.

In India, the RBI Governor is unlikely to oblige and offer an early cut to interest rates as a salve for weak economic growth. Investors will therefore need to fervently pray that the Central Government can come up with a magic mantra that will aid an economic recovery and fix the supply side issues without impacting inflation, for interest rates to decline later in 2015. Consensus views now assume that interest rates are not likely to stay at the upper bound for much longer and that GDP growth will rise. This dichotomy of expectation versus reality will be ironed out by the markets in the months ahead. How equity markets respond to this dichotomy, post their massive surge in 2014, remains to be seen.

Clearly, as we enter the last quarter of the year, two Federal Governors on either side of the planet have given their markets plenty to think about.

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