

The Great Disconnect for Commodities in India How the sharp move in the INR has affected Futures markets

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Over the last month, traders of commodities futures in India have been facing a market, which has been broadly disconnected from the movements in overseas markets. This is thanks to the fluctuation in the exchange rate of the INR. In this report, we delve into some statistics and fundamental factors that have been at play.

What's driving the INR to strength

Over the last two months, the Indian Rupee has shown one of its sharpest waves of appreciation in history. The move has been literally a linear one with a surprising absence of central bank intervention. This never-before-seen move in the currency has startled and struck many traders and hedgers in Indian commodities markets. In this report, we present some statistics and comparisons, which should help us in planning a better strategy in the coming months. To begin with, let us look at the factors that have been responsible for the Rupee's break-neck move.

1. Interest Rate Differentials

While the Indian monetary authority has been hiking rates, the developed economies have not been doing so. Over and above this, the monetary tightening through CRR hikes took up banks' lending rates further up, adding significantly to the cost of borrowings in INR. Thus, the rate differential between domestic markets and overseas markets such those of US and Japan widened considerably. The active swap markets offered by Indian banks makes it possible for corporates to borrow overseas (ECBs) and thus swap it to rupees at an effective interest cost significantly lower than local costs. This practice has been growing rapidly and created huge inflows of USD into the Indian markets. This has not been a new phenomenon. What's different this time is that RBI has completely stayed out of the market to absorb (buy) these dollars. As a result of this, we have only sellers of dollars in the market.

2. FDI and FII Flows

Owing to the vibrant state of the domestic economy and the stock markets, we have also witnessed a spate of inflows from these two sources. NRI remittances have been sizeable as well.

3. Monetary Policy tightening

It is ironic but true. The Monetary Policy of recent months strived to tighten money supply by hiking reserves requirements along with raising interest rates. However, this has instead induced overseas funds to flush our markets and counter all tightening measures of the RBI. We must appreciate the fact that India's financial markets are now highly integrated to global markets and the doors for entry and exit of funds is much larger in size.

4. Purely Domestic Story

It is important to note that this move in INR has not been part of any broader global or Asian theme. The INR appreciation has been strictly an isolated case. In the past, whenever the INR



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has made big moves on it's own, they have been for it's weakening. This time it has been on the strengthening side and one with a historic magnitude.

Indian Rupee



Commodities – The Disconnect

Let us now take a peek at the performance of some of the most active global commodities vis-à-vis on the local exchanges.

Commodity	Price on 31.1.07	Price on 26.4.07	% Move
INR	44.07	40.89	-7.22%
Gold – Comex	658	678	3.04%
Gold – MCX	9,423	9,098	-3.45%
Silver – Comex	13.66	13.31	-2.56%
Silver – MCX	20,299	18,252	-10.08%
Crude Oil- Nymex	59.30	65.30	10.12%
Crude Oil – MCX	2,563	2,703	5.46%
Copper - LME	5,730	7,714	34.62%
Copper – MCX	261.20	315.45	20.77%
Zinc – LME	3,470	3,720	7.20%
Zinc - MCX	160.95	151.45	-5.90%



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Now, we compare the actual % moves to the %moves actually implied by the movement in INR and international commodities

Commodity	Actual % Move	Implied % Move*
Gold – MCX	-3.45%	-4.18%
Silver – MCX	-10.08%	-9.78%
Crude Oil – MCX	5.46%	2.90%
Copper – MCX	20.77%	27.41%
Zinc - MCX	-5.90%	-0.01%

* *Implied % Move is the move that should have been 'expected' to have occurred in line with actual movement in the international commodity and INR market*

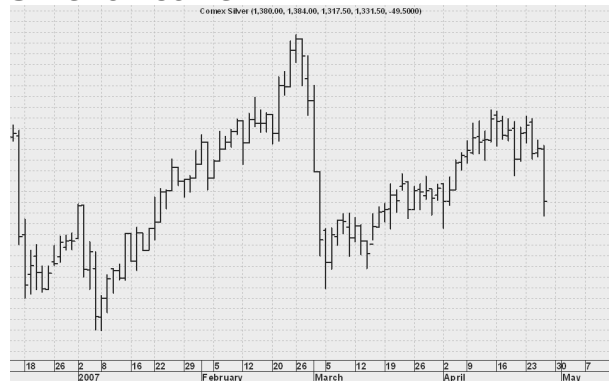
Gold on Comex



Gold on MCX



Silver on Comex



Silver on MCX





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Crude on Nymex



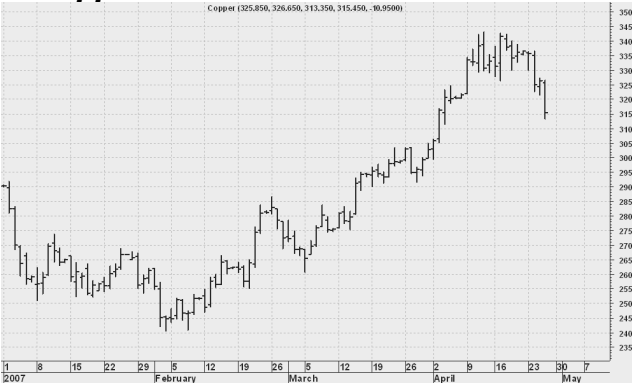
Crude on MCX



Copper on LME



Copper on MCX



Zinc on LME



Zinc on MCX



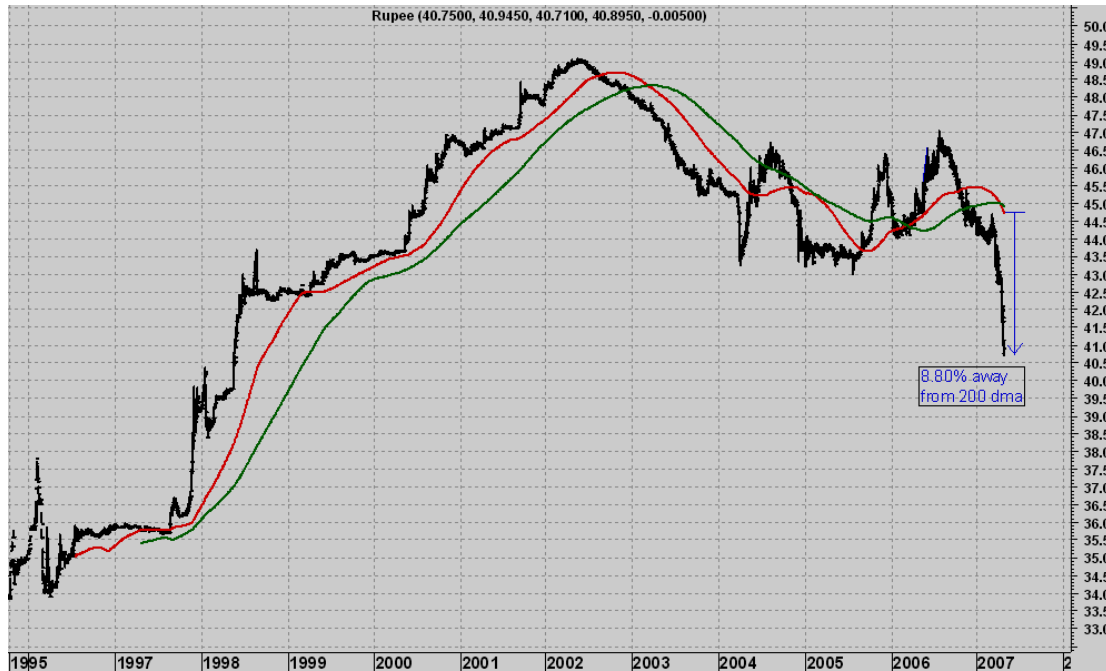
Looking ahead for the Rupee

The recent appreciation has been unprecedented and is considered extreme if seen in historical perspective. The sharp move has taken it to a level which is now 8.80% away from its 200dma. The 200 dma generally acts as a strong anchor to most prices and any perpendicular move away from it will generally catch up gravity pulling it back towards the 200dma. Whether, the INR pulls back to the 200dma or not is not really what we're looking forward to but the fact that the current level of the INR is most likely to be surpassed on the upper side within the next few days and possibly even a couple of weeks. The 200dma itself has veered downwards very



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sharply, indicating that the medium term trend for the INR should be on the downside and 2007 will most likely be a year of Rupee strength. However, in the near term, we opine the INR to pullback just like a rubber band and test 42.00-42.50 before the end of May.



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