

US Fed & Indian Equities

The US Federal Reserve — commonly called the **Fed** — has a profound influence on global markets. Although it is America's central bank, its decisions echo across borders, especially in **emerging markets like India**. Whenever the Fed raises interest rates, investors across the world pay close attention. But why does a decision taken in Washington D.C. affect Dalal Street in Mumbai?

This article explores the structure of the Fed, how it works, and how its interest rate hikes influence the **Indian equity markets** — both in the short and long term.

The **core job of the US Federal Reserve (the Fed)** is to manage the nation's monetary policy in a way that promotes a stable and healthy economy. Its primary mandate, set by the US Congress, includes two key objectives: **maintaining price stability** and **ensuring maximum employment**. To achieve price stability, the Fed aims to keep inflation at a moderate and predictable level, typically around 2%. Simultaneously, it works to create conditions that support strong job growth without causing the economy to overheat.

Beyond these two central goals, the Fed also plays several critical roles: it **regulates and supervises banks**, ensures the **stability of the financial system**, and oversees the **nation's payment and settlement infrastructure**. Additionally, the Fed is responsible for **issuing the US currency** in coordination with the US Treasury.

To fulfill its mission, the Fed uses a variety of tools — the most important being the **Federal Funds Rate**, which influences borrowing costs across the economy. Other tools include **open market operations** (buying and selling government securities), setting the **discount rate** at which banks borrow from the Fed, and determining **reserve requirements** for commercial banks. Through these measures, the Fed seeks to guide economic growth, control inflation, and respond to financial crises as needed.

Understanding the US Federal Reserve

The **Federal Reserve System** was established in **1913** through the Federal Reserve Act, primarily to stabilize the American banking system and manage monetary policy. It is the **central bank of the United States** and plays a critical role in regulating the flow of money and maintaining financial stability.

The Fed has three main components:

1. **Board of Governors** – Located in Washington, D.C., and appointed by the US President.

2. **12 Regional Federal Reserve Banks** – Spread across major cities in the US.
3. **Federal Open Market Committee (FOMC)** – A policymaking body that sets interest rates and guides monetary policy.

The FOMC meets regularly to assess the health of the economy and decide whether to increase, decrease, or hold interest rates.

How Does the Fed Control Interest Rates?

The Fed's main tool is the **Federal Funds Rate** – the interest rate at which US banks lend money to each other overnight. This is the **benchmark for all other interest rates** in the US economy.

If the Fed feels that inflation is getting out of control, it may **increase this rate** to reduce consumer and corporate borrowing. Conversely, if the economy is slowing down, the Fed may cut the rate to stimulate demand.

The Fed also uses:

- **Open Market Operations** (buying/selling government securities)
- **Reserve Requirements** (how much cash banks must hold)
- **Forward Guidance** (signals about future rate plans)

These tools help the Fed influence liquidity, inflation, and economic growth.

Why Do Fed Rate Hikes Impact Indian Equities?

While the Fed's mandate is domestic, the impact of its decisions is global. Here's how rate hikes affect Indian stock markets:

1. FII Outflows

When US interest rates go up, US bonds become more attractive. As a result, **Foreign Institutional Investors (FIIs)** may **pull money out of Indian equities** and invest in safer, higher-yielding US assets. This can lead to a fall in stock prices in India.

2. Stronger Dollar, Weaker Rupee

A Fed hike often strengthens the **US Dollar**, which causes the **Indian Rupee to weaken**. A weaker rupee makes imports (like crude oil) more expensive, leading to **higher inflation** in India. This can hurt sectors like aviation, oil & gas, and auto components.

3. Costlier Global Borrowing

Indian companies that borrow from international markets may face **higher interest costs**, reducing their profitability. Sectors like infrastructure, telecom, and capital goods are particularly vulnerable.

4. Market Volatility

Fed announcements usually lead to **short-term volatility** in Indian markets. Traders tend to react quickly to global cues, causing sharp moves in indices like the Nifty and Sensex.

Is the Impact Always Negative?

Not necessarily. A Fed rate hike can also have **neutral or even positive** implications for India:

- If the US economy is doing well (which is why the Fed is hiking), it can lead to **stronger global trade** and benefit Indian exporters.
- India's own **macro fundamentals** — like GDP growth, low fiscal deficit, and corporate earnings — often attract long-term investors, even if FII exit temporarily.
- The **Reserve Bank of India (RBI)** can take countermeasures like raising domestic interest rates or managing liquidity to stabilize markets.

Case Study: Past Fed Hike Cycles

- **2013 (Taper Tantrum):**
When the Fed hinted at reducing its bond purchases, Indian markets saw heavy FII outflows and the rupee depreciated sharply.
- **2015-2018:**
A gradual Fed rate hike cycle, during which Indian markets remained largely resilient due to strong domestic fundamentals.
- **2022-2023:**
Aggressive rate hikes to tackle US inflation created volatility, but Indian equities performed better than most global peers thanks to SIP flows and robust earnings.

The US Fed's interest rate decisions are watched by investors across the globe, and with good reason. They impact capital flows, currencies, commodity prices, and investor sentiment. But while Indian equities may see **short-term pressure**, strong economic fundamentals and proactive policy responses make India a promising destination for long-term investors.

In today's interconnected world, global cues are unavoidable — but so is India's **unstoppable growth story**.

"It's not about timing the market. It's about time in the market."

CA Mukta Gogate

Crescent Research Team