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Why will any US Investor invest in any EM currently?

The theory of Interest rate parity states:

If the interest rate in:
Country 1 = 2%
Country 2 = 6%
You can borrow money from country 1 at 2% and invest it in country 2 at 6% and make a 4% risk-free return (arbitrage) on borrowed money. If such a situation exists, every last capital in the world would exploit this situation, this will increase the demand for currency 1 and increase the supply of currency 2, thus, currency 1 must appreciate and currency 2 must depreciate until this 4% gap is fully exploited. In other words, currency 2 must depreciate by 4% with respect to currency 1 sounds logical, right? But it doesn't always work linearly.

E.g.:
In 2021
USA interest Rate: 1%
India Interest Rate: 5%
USD/INR: 75

In 2022
USA interest Rate: 4%
India Interest Rate: 6%
USD/INR: 82

The interest rate differential has gone from 4% to just 2% but INR has depreciated by 9%. Shouldn't INR depreciate less with respect to USD, since the interest rate parity has narrowed now?

Not really,

One major reason why INR is depreciating so rapidly is a rapid flow of USD out of India. Think about this- if Indian equity markets grow by 12%, US investors don't make 12% returns they make: 12% (minus) currency loss so if INR depreciates by 4%. They only make 8% return.

Compare this to an interest rate of 4% in the US today and PE ratio of 20+ in India (highest among its peers) wouldn't you be much better off just parking the money in your USD bank account, then invest in a foreign country trading at high valuations (vs emerging market peers) with its own set of economic risks and currency risks? Is it worth the trouble for an extra 4% return in the best-case scenario? I don't think so.

Now put yourself in the shoes of a US investor. If you invested money in Indian Equities in 2021
Equity returns : 0%
currency depreciation: 9%
total return: -9%

Interest Rates have risen by 3-4% in the western world since 2021
US govt bonds today are yielding 4%
UK govt bonds are yielding 5%

Why would anyone sitting in US & UK take the additional risk of investing in a foreign economy (trading at 20-year high valuations) for just a 3-4% extra return? It just doesn’t make sense. So, what is the solution?

RBI can increase Indian interest rates to increase the interest differential again, but guess what? This will increase Indian bank FD rates, Govt bond yields, even liquid MFs yields will increase to 7% or more. Given the high valuations of our Equity markets, domestic investors will start shifting money from Equity to Debt (which is now giving 2% more returns than just a year ago) Another negative for Indian equity markets. An increasing cost of capital is never good for Equities. India has a good long-term story, but in the short to mid-term if money keeps flowing out of Equities, they are bound to correct, it's only a matter of time. There is a time to be opportunistic and a time to be cautious. One has to choose wisely.

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