

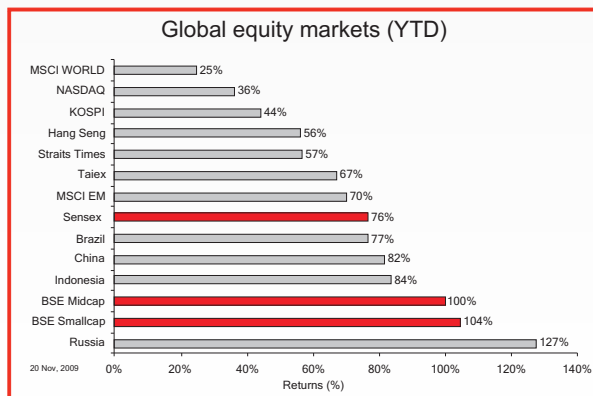
November rains bode well for the bulls



After a spectacular rally in September, global equity markets took a breather in October'09, as economic dataflows painted a mixed picture of the nature and extent of the recovery underway. Developed equity markets witnessed a minor sell-off - the MSCI World Index lost 1.8% during the month, while emerging market equities (MSCI Emerging Market Index) ended the month on a flat note.

Expectations of an imminent withdrawal in monetary policy accommodation have gained momentum across most emerging markets (EMs) with signs of a strong economic revival in these regions and a sharp surge in capital flows. On the other hand, policymakers in most developed economies - challenged with deteriorating labour markets and falling consumption - remain focused on maintaining a low interest rate environment over the next few quarters.

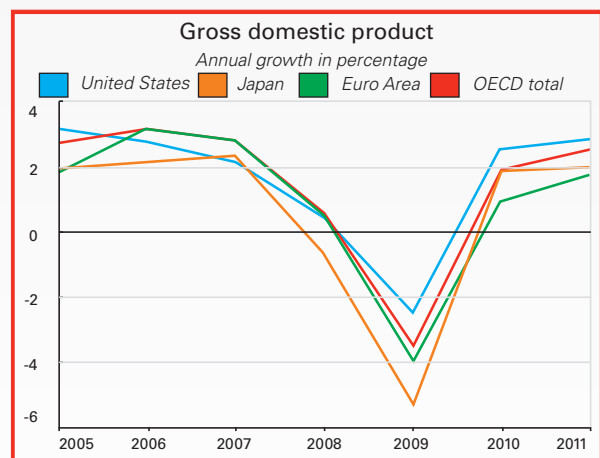
Indian equities underperformed most global equity markets in October'09, on concerns of the swift run-up in valuations and mixed corporate performance during Q2FY10. However, despite the recent fall, Indian equities remain among the best performers in calendar '09, outperforming most EMs by a wide margin - the Sensex is up 76% , while the mid and small cap indices are up by almost 100% and 104% respectively.



Source: Bloomberg

Fragile recovery seen in developed economies; Emerging markets pace ahead on strong domestic fundamentals

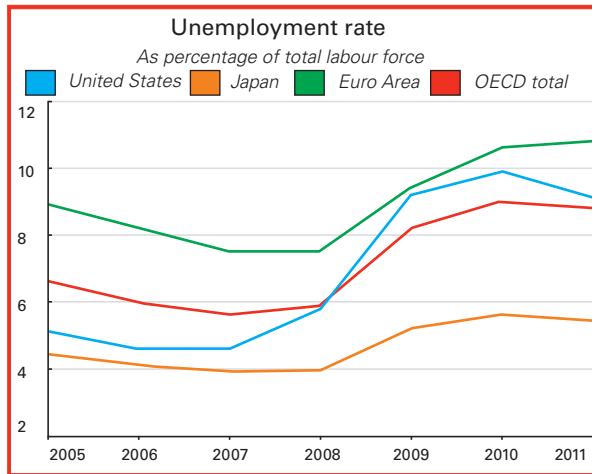
Economic data flows in developed nations have turned positive, portending an earlier-than-expected recovery in these regions. The US and Euro zone economies appear to have bottomed out and seem well positioned to gain strength over the coming months, with dataflows indicating a revival in manufacturing, exports as well as a pick-up in the beleaguered housing markets. The UK however remains an exception to this – the economy has continued to contract leading to policy makers ramping up their fiscal and monetary measures to stimulate economic growth. In a reflection of the recent improvements, the OECD upped its growth forecast for the US and OECD economies for this year and the next from 0.9% and 0.7% initially, to 2.5% and 1.9% respectively.



Source: OECD.org

Despite the strong headline data, observers have pointed out to the fact that the recent economic strength has been largely stimuli-driven – thereby offering little confidence regarding the sustainability of these trends. Fears of a 'jobless' economic recovery with mounting unemployment (unemployment in the US has reached a 26-year high of

10.2% in October '09) and high levels of household debt have strengthened expectations of an anemic recovery marked by a prolonged period of easy monetary stance in developed markets.



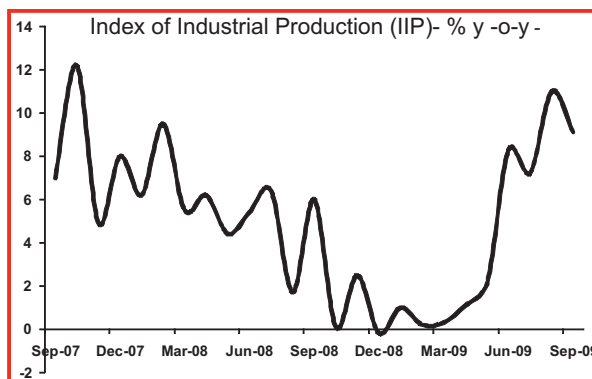
Source: OECD.org

On the other hand, a few developed (Australia) and most emerging economies (China, India and S.Korea) have posted a well-entrenched, structural rebound. Central banks in these regions have initiated exit strategies to withdraw the easy monetary stance and restore normalcy in policy and interest rates.

The resultant widening differential in interest rates that could accelerate capital inflows and appreciate currencies has led Governments to impose various disincentives on such investments. Recent moves by Brazil, South Korea and Taiwan sparked concerns of similar action from other countries, including India and equity markets turned nervous more so, on this count.

Domestic economy: Strong growth signals, fiscal stimuli to remain for now

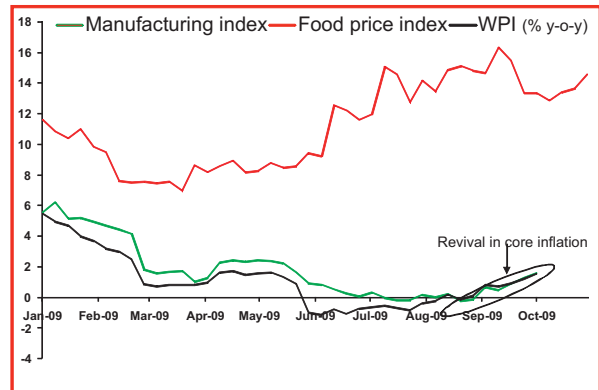
The Indian economy seems well on track to achieve the projected 6-6.5% GDP expected for this year, on the back of a strong revival in industrial output and a gradual improvement in services sectors that are likely to offset the sizable drop in agricultural output (kharif output estimated to fall by c18% y-o-y). Industrial production has grown by c6.5% during the Apr-Sep'09 period, higher than the 5% in the corresponding period of last year, thus continuing to encourage economists and analysts to revise up their forecasts furthermore.



Source: Bloomberg

Alongside the strong growth momentum, inflation (WPI) continues to rise rapidly mainly owing to higher food prices and to some extent, rising commodity prices and the lower

statistical base last year. Although policy makers remain optimistic about inflation (WPI) remaining within the projected estimates of 6.5% on the back of a seasonal fall in food prices and a slew of measures to prevent supply shortages, the expected pick up in core-inflation (ex food and fuel) with a revival in the economy is likely to be closely watched for monetary policy adjustments and its ramifications.



Source: Bloomberg

Despite the sure signs of a strong recovery, the Government has indicated its desire to retain the fiscal stimuli measures for now. However, the recent spate of news flows on massive disinvestments planned over the coming months and the decision on 3G auctions amply reflect the political will to redress the ballooned fiscal deficit of last year.

As far as monetary stimuli are concerned, markets widely expect a gradual normalization of the monetary environment, from January 2010 and policy rate hikes likely from April 2010, although stronger-than-expected economic dataflows or an unexpected spike in inflation could trigger earlier policy action.

Domestic equities: Led by global flows, even as valuation concerns emerge amid mixed corporate results

Equity markets corrected sharply in October on concerns over the swift rise in valuations over the past 2 months as well as on the macro-economic front arising from:

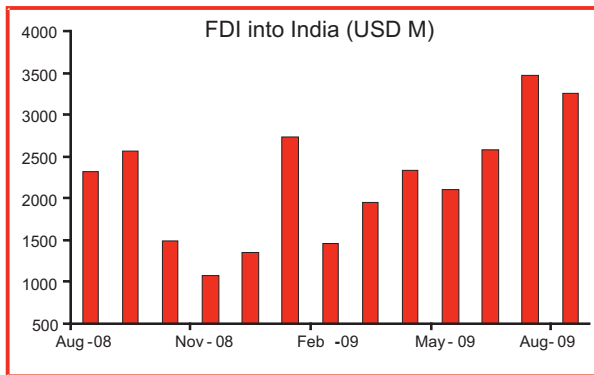
- the expected rise in interest rates going forward
- increasing competition
- rising raw material costs
- near-term hints of renewed global risk aversion and a "double-dip".

Corporate results for the quarter ended September '09 broadly beat analysts' expectations as the Sensex companies (on an aggregate basis) reported a marginal increase in profit (1%) although revenue growth remained flat. This increase in profit marks a turn-around in the performance of corporate India, as earnings have increased for the first time in a year, boosted mainly by lower input costs and austerity measures. Among sectors - autos, FMCG, banks, software and pharmaceuticals reported a better than expected performance, while oil & gas, telecom, property and metals delivered results lower than market expectations.

Significantly, some sections of the analyst community have trimmed their earnings expectations following the recent results season over concerns on growth potential of certain commodity stocks. Despite this downward revision in

the earnings estimates of select companies, **corporate earnings are expected to grow by c7-10% in FY10 and by c20-25% in FY11.**

Foreign Institutional Investors (FIIs) remained positive on Indian equities and invested cUSD 1.8B in October, thereby taking their cumulative investments for the year (January – October) to c USD 14.2B. Apart from sizeable FII investments, India continues to witness large overseas flows through the FDI (Foreign Direct Investment) route that stand at c USD 13.7B during the April – August period.



Source: Bloomberg

Outlook: Valuation concerns likely to cap sharp rallies in equities over the near term, Bond yields may drift higher with sporadic trading opportunities.

Equities: After having corrected sharply in October, domestic equity markets seem to have regained

momentum on the back of positive economic news flows globally as well as assurances from the Government on much awaited economic reform areas including disinvestments, FDI in select sectors, introduction of GST, taxation & pension sector reforms. While equity markets are likely to oscillate to global portfolio flows, the swift run-up in valuations (at c 17,000 the Sensex trades at over c 19 X FY10 – higher than long term averages), together with concerns over the massive pipeline of equity issuances over the coming months (estimated at cUSD 11 B), rising commodity prices and the impact of the reversal in interest rate cycle are likely keep markets within a broad range over the near term. Key factors which could likely negatively impact sentiments include 1) poor global economic data-flows 2) a sharp reversal in the largely weakening USD, suggesting changing risk perception and 3) policy actions to moderate capital flows (as has been seen in Taiwan, Brazil).

Bonds: There seems little scope for any incremental positives for the longer end of the yield curve in light of the emerging inflation and growth scenario. Long bond yields are therefore expected to drift higher with the build-up in market expectations of rate hikes, rising inflationary pressures together with deteriorating fiscal situation and persistent bond issuances. The short and medium segment of the curve appears to be relatively better positioned and hence, could be relatively resilient to emerging developments.

This publication has been issued by The Hongkong and Shanghai Banking Corporation Limited in India (HSBC), incorporated in Hong Kong SAR with limited liability for the information of its customers who are resident in India. This publication should not be distributed to any other persons and in particular should not be distributed to the United States of America, Canada or Australia. It cannot be reproduced or further disseminated.

This publication does not constitute investment advice or an offer to sell, or a solicitation of an offer to purchase or subscribe for any investment. The information herein is derived from publicly available sources that HSBC considers reliable but which has not been independently verified. Whilst every care has been taken in compiling the information, HSBC makes no guarantee, representation or warranty and accepts no responsibility or liability as to its accuracy or completeness. Some of the information in this document is derived from third party sources as specified at the relevant places where such information is set out. The Bank believes such information to be reliable but it has not independently verified the same. Expressions of opinion are those of HSBC only and are subject to change without notice. Opinions expressed herein do not have regard to specific investment objectives, financial situation and the particular needs of any specific person who may receive this publication. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies that may have been discussed in this publication and should understand that the views regarding future prospects may or may not be realized. This document is for circulation in India. The Bank makes no representations that the products or services mentioned in this document are available to persons of any other country or are necessarily suitable for any particular person or appropriate in accordance with their local law. Among other things, this means that the disclosures set forth in this document may not conform to rules of the regulatory bodies of any other country and investment in the products discussed will not afford the protection offered by the local regulatory regime in any other country. The information contained herein is confidential to the recipients thereof and may not be reproduced or otherwise disseminated. The Bank or its affiliates or their officers, directors and employees may have investments in any of the products mentioned in this publication (or in any related products) and may from time to time, add to or dispose of any such investment.