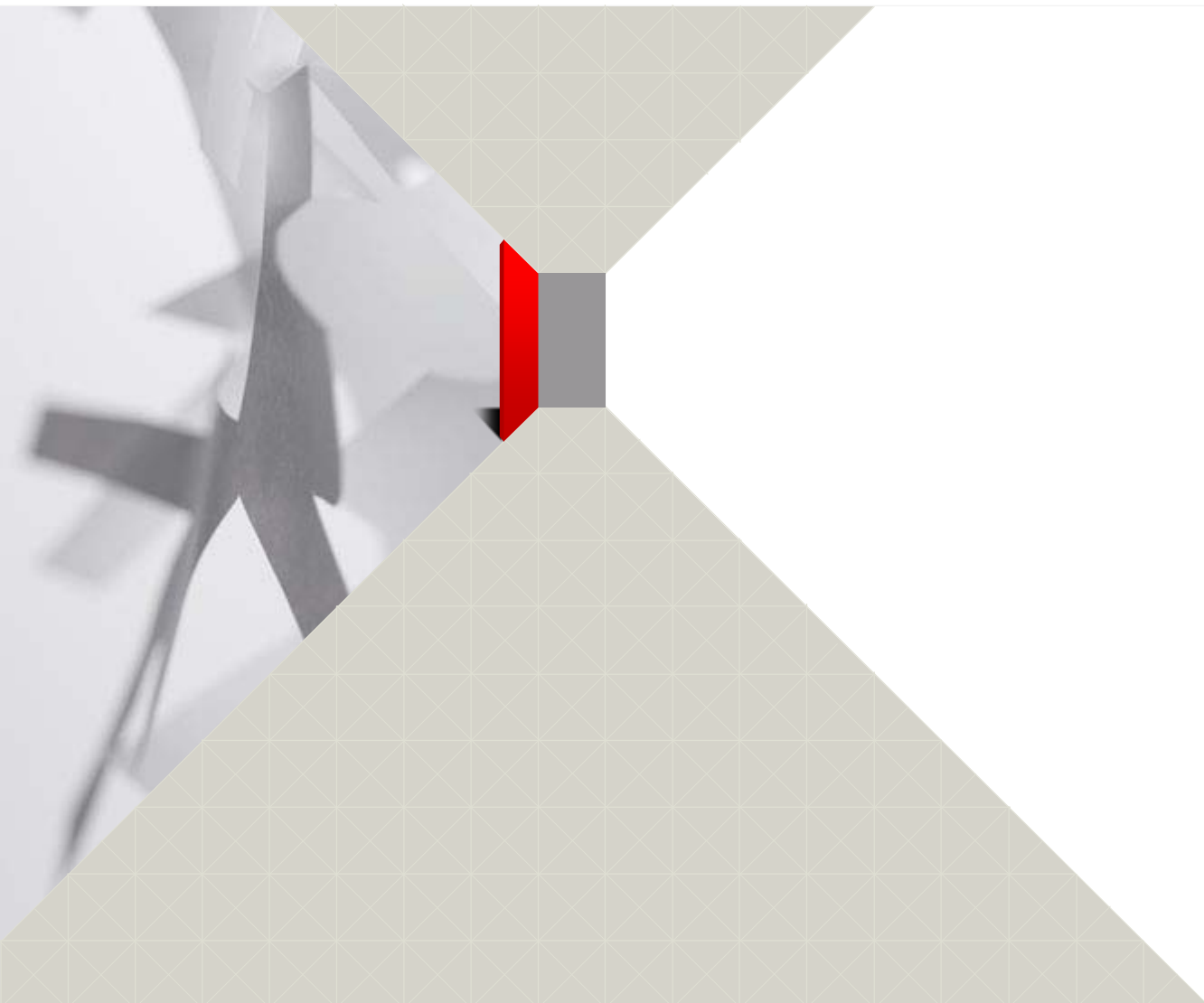


India Strategy

August 2009



Equities

August – Strategy

Market continues to climb in July – Auto, IT, FMCG and Metals outperform

- ▶ Indian equity markets continued to rally during the month of July. The BSE Sensex closed the month at 15670 (8.12% M-O-M) and the NSE Nifty closed the month at 4636 (8.05% M-O-M).
- ▶ Auto, IT, FMCG, and Metals outperformed the main indices where as Healthcare, PSUs, Consumer Durables, Banking, Oil & Gas and Capital Goods underperformed. Mid caps outperformed large caps marginally while small caps were in line.

| Index | Monthly Change | Index | Monthly Change |
|-------------------|----------------|------------------|----------------|
| BSE AUTO | 25.34% | BSE-SMALLCAP | 8.11% |
| CNX IT | 23.80% | NSE NIFTY | 8.05% |
| BSE FMCG | 21.01% | BSE HEALTHCA | 7.13% |
| BSE IT | 20.53% | BSE PSU | 5.59% |
| BSE METAL | 14.44% | BSE CONS DUR | 5.43% |
| BSE TECK | 12.52% | BSE BANKEX | 3.10% |
| BSE-MIDCAP I | 9.74% | NSE BANK NIF | 2.80% |
| NSE MIDCAP | 9.64% | BSE OIL&GAS | 0.96% |
| BSE SENSEX | 8.12% | BSE CAP GOOD | -1.57% |

Source - Reuters

August – Strategy

Global cues and foreign fund flow key to short term movement



Source - Reuters

August – Strategy

Monsoons a worry, but we maintain our GDP estimates

- ▶ India is now bracing itself for the first really poor monsoon in seven years and only the second in the last two decades. So far rainfall has been 19% below normal in the country as a whole, with large parts of the north suffering much greater shortfalls. If the agricultural sector were to experience a 2% drop in output, this would directly lower GDP growth by 1% point compared with a year of average agricultural expansion. We expect the various fiscal stimulus measures, many of which are targeted at the rural sector, to offset the effects of a weak monsoon and maintain our GDP estimates at 6.2% for FY'10 and 8% for FY'11.
- ▶ Monetary policy measures have been accommodative with the Reserve Bank slashing the repo rate by 425 bps, the reverse repo rate by 275 bps and the CRR by 400 bps since late last year. Given rising commodity prices, we do not expect any further repo or repo rate reductions from the RBI. These policy measures will boost growth but with a lag. These measures have also eased the previous liquidity squeeze in the banking sector.
- ▶ During July, WPI inflation remained in negative territory as expected. Inflation came in at -1.54% for the week ended July 20th (Source: Reuters). We expect headline WPI to continue to remain low in the near term given the high base effect, but the recent rally in oil and other commodity prices threatens to turn WPI inflation around sooner rather than later.

Institutional Activity:

- ▶ FIIs continued to be net buyers in July. They bought \$2.39 bln (Source: SEBI) of Indian equities during the month. Global risk appetite has been improving and India has got its share of global fund flows. Global cues to drive FII flows in the near term.
- ▶ Domestic mutual funds also continued to be buyers in July. Domestic MFs bought \$414 mln (Source: SEBI) of Indian equities during the month.

August – Strategy

Fiscal deficit projected at 6.8% of GDP – rating agencies likely to keep a close watch

- ▶ In his budget speech, the Finance Minister made it clear that the government's first challenge was to "lead growth back to 9%" and there was a need to give "further stimulus" despite "signs of revival in the domestic economy."
- ▶ The government has projected the fiscal deficit to hit 6.8% of GDP in 2009/10, up from the original forecast of 5.5%. Our own forecast, prior to the budget, was for a 7% deficit, but the risks are now on the upside. The budget estimates provide for an increase of 36% in total expenditure - 37% increase in Non-planned expenditure and 34% in Plan expenditure with the revenue side remaining almost neutral.
- ▶ We expect the fiscal deficit (central and state governments combined) to near the 11% mark, levels not seen since 1991. In our view India remains a long way from achieving and sustaining a 9-10% GDP growth and will need a lot more in the way of infrastructure spending and economic reform. Our fear is that the deficit will be controlled more by undershooting infrastructure spending targets rather than expanding the revenue base or cutting bureaucracy.
- ▶ Merchandise exports fell 29% y-o-y in May 2009, while imports fell more than 39%. This has resulted in a trade deficit of \$5.2 bln, less than half the figure for May last year. We believe the trade balance will deteriorate later this year, as rising oil prices increase import bills, while lacklustre demand from the Western world keeps export growth under pressure.
- ▶ The fiscal deficit will under further strain if the move to liberalise oil prices is blocked by populism.
- ▶ Rating agencies are likely to keep a close watch on the fiscal deficit and would be looking for measures to be taken to keep the deficit in check. Given India's sovereign rating, this could play a crucial role in future FDI and FII flows.

August – Strategy

Green shoots apparent - Recovery appears underway

- ▶ Indian real GDP growth averaged 8.6% during the last 5 years, and the new government is now faced with the challenge of turning the economy around again after growth has slowed to 5.8% (Q4 CY'08) (Source: Reuters). The route it appears to be taking is that of promoting inclusive growth targeted at stimulating the domestic economy. The Finance Minister did suggest that it was important for the country to return to the fiscal deficit targets “at the earliest possible opportunity” and that “reforms were required” to curb the fiscal shortfall.
- ▶ Early signs of recovery in India appear to be emerging. Backed by surprisingly strong Q4 GDP numbers of 5.8% and 2.7% y-o-y IIP growth in May, output in India's 6 “infrastructure industries”, which include cement, steel and oil, looks to have turned the corner. Year-on-year growth in June came in at 6.5%, which is up from 2.8% in the previous month and a low of 1% at the end of last year. The June figure is the highest since February 2008. This bodes well for June's IIP release where we expect production to register 5% growth.
- ▶ The industrial sector as a whole accounts for 25% of the economy and was the main factor in driving GDP growth lower in 2007 and 2008. We believe, the reverse to be true for the rest of 2009 and 2010.
- ▶ The following indicators appear to be pointing to an economic recovery which is already underway;
 - **Motor vehicle sales** have shown a strong improvement in February through July 09 but this could be a temporary impact of the public sector's pay hike.
 - **Cement production** has shown an improvement in its 3 month moving average growth rate.
 - **Manufacturing Purchasing Managers Index (PMI)** has also shown a significant improvement over the last few months. Since a December low of 44.4 it has bounced to 55.7 in May with the new order index at 59.1.

August – Strategy

India more resilient to global slowdown with a combination of positives

- ▶ Our optimism on India lies in the fact that we expect a combination of the following to maintain visibility on growth prospects later this year and believe that the long term growth story remains intact;
 - **Commodity price collapse** which has seen the Commodity Research Bureau (CRB) index register its largest y-o-y drop since it began 50 years ago. Being a big commodity importer, this should add about 1.5% points to GDP growth (Source: HSBC)
 - **Higher domestic oil and gas output** in the coming quarters which we estimate could add 0.3-0.5% to real GDP growth each year over the next couple of years
 - **The lagged effects of buoyant inward & outward FDI** – The benefits of the inward FDI which came in at \$33 bln in CY'08 (Source: HSBC) should be felt over the coming quarters and years. Outward FDI, which totaled around \$18 bln in CY'08, has been largely to acquire skills from companies operating in the developed world which can then be transferred back to the local economy in order to boost productivity.
 - **Fiscal policy** - The government's fiscal action mainly in the form of the farm loan waiver scheme, the public sector pay hikes, fuel and import duty cuts and additional infrastructure spending on roads, ports and utilities, is worth roughly 4% of GDP in 2009 (Source: HSBC estimates).
 - **Monetary policy** – Since September 2008, the RBI has aggressively lowered the repo rate, reverse repo rate and Cash Reserve Ratio (CRR) as well as the SLR by 1% to 24%. It has also eased ECB limits, raised interest rates on NRI deposits, improved access to funds for non-bank financial corporations, lowered the risk weightings for bank lending to commercial real estate companies and reduced provisioning requirements for housing, personal and credit card loans. Although commercial banks are still cautious in lending to the private sector and lending growth continues to soften, the central bank is stepping up its verbal pressure on the banks to do more and recent signs that commercial banks are becoming more responsive is more evident.

August – Strategy

India “neutral” from Asia Pacific perspective

- ▶ With early signs that at a global level things are beginning to look “less bad”, risk appetite appears to be reemerging. India has been one of the best performing markets since mid March with ~ \$9 bln of FII inflows moving into Indian equities during the period.
- ▶ Although we expect to see signs of stress on account of the slowdown, Indian companies’ earnings have been among the least volatile among emerging markets. Overall leverage of Indian companies is low (av. net debt/equity ratio of 0.45x).
- ▶ Our expectations for Sensex companies are 5-10% EPS growth in FY10 and a return to trend growth of 10-15% in FY11. We believe the current slowdown in India is cyclical and expect growth to pick up in the second half of CY09. The quarter ending July 2009 is likely to be the trough of the economic cycle and, along with a recovery, we expect corporate earnings to recover from the quarter ending September 2009.
- ▶ Given that global uncertainty still exists, the government failing to lay out a roadmap for reforms, a growing fiscal deficit and a delayed monsoon, we believe the stock market could take a breather.
- ▶ The deficient monsoon is also a cause for concern, but as highlighted earlier we believe the fiscal stimulus measures outlined by the government should offset the effects of a weak monsoon.
- ▶ Valuations are no longer cheap. Clear signs of an economic recovery could lead to a sustainable rally towards the end of CY’09. The risks and rewards appear fairly balanced and we remain “neutral” on India relative to the Asia Pacific region.

August – Strategy

Valuations “not cheap”, though current EPS forecasts pessimistic. Phased entry suggested

- ▶ We continue to remain positive about Indian equities over the longer term, but near term market movement is likely to depend on global news flows.
- ▶ Based on historical trends, equity valuations are no longer cheap but remain reasonable. At 15670 (Sensex at July end), India trades at a P/E of 17.1X FY10e and 15.1X FY11e (HSBC estimates). The Indian markets are currently at a PE premium of 20% to MSCI GEMs, compared to 16% premium historically, and a 6% premium to EM Asia, compared to 11% historically.
- ▶ Given ample liquidity amongst most institutional, HNI and retail investors, support for the market at lower levels appears likely.
- ▶ We continue to encourage rebalancing of portfolios towards strategic asset allocations. In our view, long term investors could use an SIP or quasi SIP approach over the next few months to achieve this. A phased entry is suggested given that markets could remain range bound and volatile in the near term. Sharp corrections could be viewed as good buying opportunities to rebalance portfolios more aggressively.
- ▶ Clients with high risk appetite could look at continuing to build exposure to mid cap funds and stocks as the valuation gap to large caps, although having narrowed, still exists. Higher volatility should be expected in mid caps and exposure would be advisable for clients with an “aggressive” risk profile.
- ▶ We continue to favour banks as a key overweight because of low valuations and strong earnings outlook. Our other key overweight sector is consumer staples to add defensiveness currently. Our key underweight sector is materials. Our sector views follow.

August – Strategy

Overweight – Banks, Consumer Staples & IT, Neutral – Industrials, Telecom, Energy

- ▶ **Financials** – Overweight – Current valuations and recent RBI measures, do make us overweight PSU banks that account for the bulk of banking activity in India. The widely expected reforms for the sector were missing from the budget, but measures in agriculture, infrastructure and exports could help revive demand for credit.
- ▶ **Consumer Staples** – Overweight – Cost pressures should ease with commodity prices having corrected sharply from their peaks. The sector has weathered the downturn much better than other sectors and we believe that the budgetary thrust on rural development should benefit the sector. We maintain our overweight rating as the sector's defensive nature should retain appeal. Relative to market, sector valuations now reasonable. We also like Sugar as a sub sector.
- ▶ **Information Technology** – Overweight – Cheap valuations should limit further downside and absolute returns may be limited but the sector may outperform on account of operational resilience, cash flow generation and the uncertain outlook on the monsoon. We upgrade our rating on the sector to overweight.
- ▶ **Industrials** – Neutral - Capital goods remains a strong growth story in India and we prefer long capex cycle companies. Economic stimulus measures announced by the new government should benefit the sector but valuations now reflect fair value and MAT rate increase from 10% to 15% will negatively impact some. We remain neutral on the sector.
- ▶ **Telecom** – Neutral - Increasing penetration and consumer spending remain strong growth drivers for the sector. However, recent changes in competitive scenario and increased possibility of change in regulations impacting the sector may impact profitability of the segment hence our neutral rating on the sector.
- ▶ **Energy** – Neutral – Environment challenging for upstream and refineries as margins are likely to remain moderate in 2009, but capacity additions over the next 12-18 months will help. We maintain our neutral rating on the sector as valuations are now fair.

August – Strategy

Neutral – Utilities, Consumer Disc, Underweight – Materials, Real Estate, Retail, Healthcare

- ▶ **Utilities** – Neutral – Overall risk reward is balanced for the sector. The budget had a mixed bag for the sector with increased allocations for the sector but increase in MAT would impact power companies with their own subsidiaries. We rate the sector as neutral given that valuations are now reasonable.
- ▶ **Consumer Discretionary** – Neutral Autos & Underweight Retail – The outlook for autos is improving as we near the trough of the economic cycle. We are neutral autos with a preference for two wheelers as sales of two wheelers may remain robust on account of healthy rural growth. With the credit crunch hampering expansion, we are underweight the retail sector. It remains one of the most expensive sectors in the market.
- ▶ **Materials** – Underweight – Outlook for cement is improving as we near the trough of the economic cycle but over capacity on the supply side will be an issue over the next 1 year. We remain cautious on metals and mining and given current valuations we downgrade the materials sector as a whole to underweight.
- ▶ **Healthcare** – Underweight – The competitive landscape in the healthcare sector is strong and recent news flow has been negative. Our rating on the sector is an underweight.
- ▶ **Real Estate** – Underweight – The improved balance sheet strength of most large players following the recent fund raising, along with recovering demand conditions, leads us to have a less cautious view on the sector. We remain underweight the sector.

August – Strategy

Derivatives indicate continuation of moderately positive bias

Equity Derivatives:

- ▶ Nifty near month future gained 8% during the month of July
- ▶ Open Interest for Nifty future was up by 7%
- ▶ Bank Nifty near month future gained marginally by 3%
- ▶ Open Interest for Bank Nifty future was up by 47%
- ▶ CNX IT near month future gained 24%
- ▶ CNX IT futures open interest gained by 40%, though on a lower base

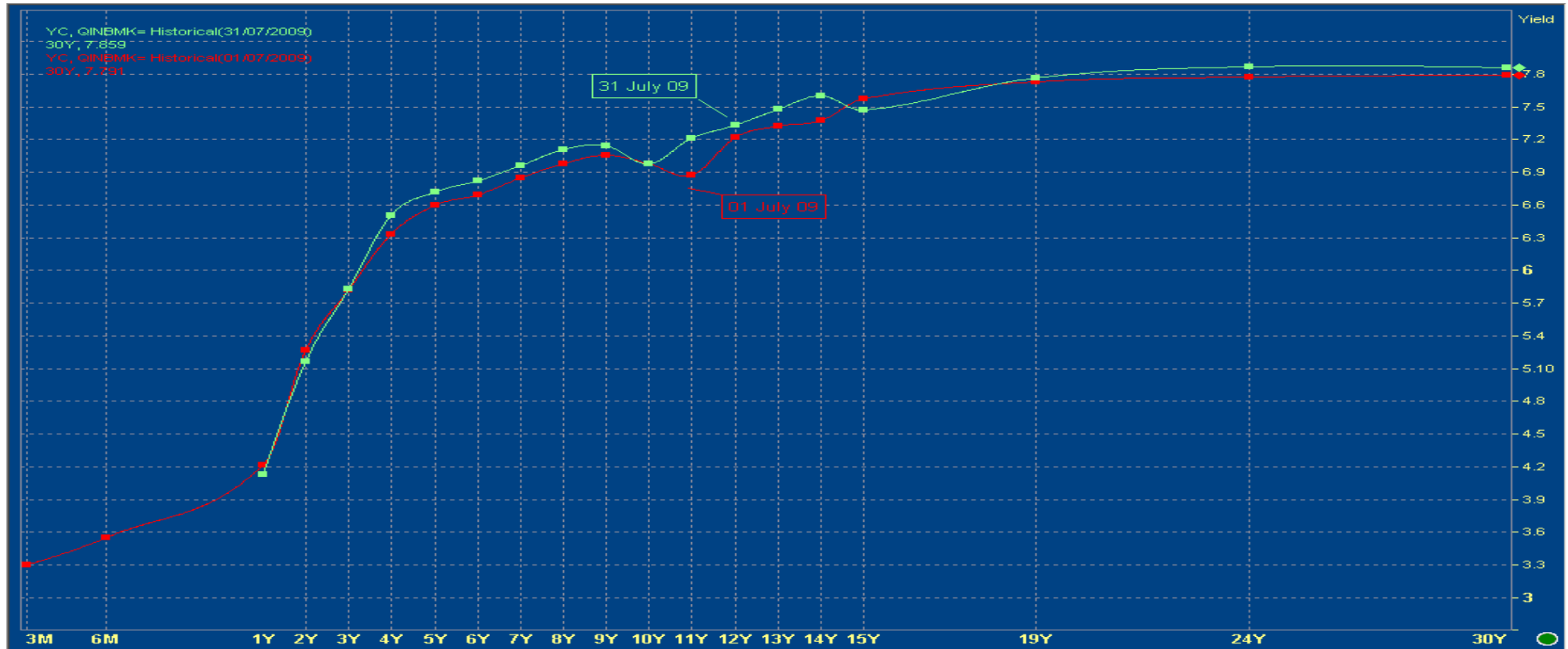
Source – Reuters



Fixed Income

August – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- The sovereign yield curve moved marginally upwards with the slope of the curve increasing. Liquidity in the system continued to be abundant with approximately Rs.1000 bn (similar numbers in June) placed with the central bank in the reverse repo window on any given day.
- We believe that short yields will continue to remain benign with a possibility of a marginal upward movement. The longer end is expected to move upwards to the higher end of its trading range. We continue to recommend low durations in portfolios and accumulate long duration funds for high risk investors in the event the benchmark 10 year gilt moves above 7.25% levels.

August – Strategy

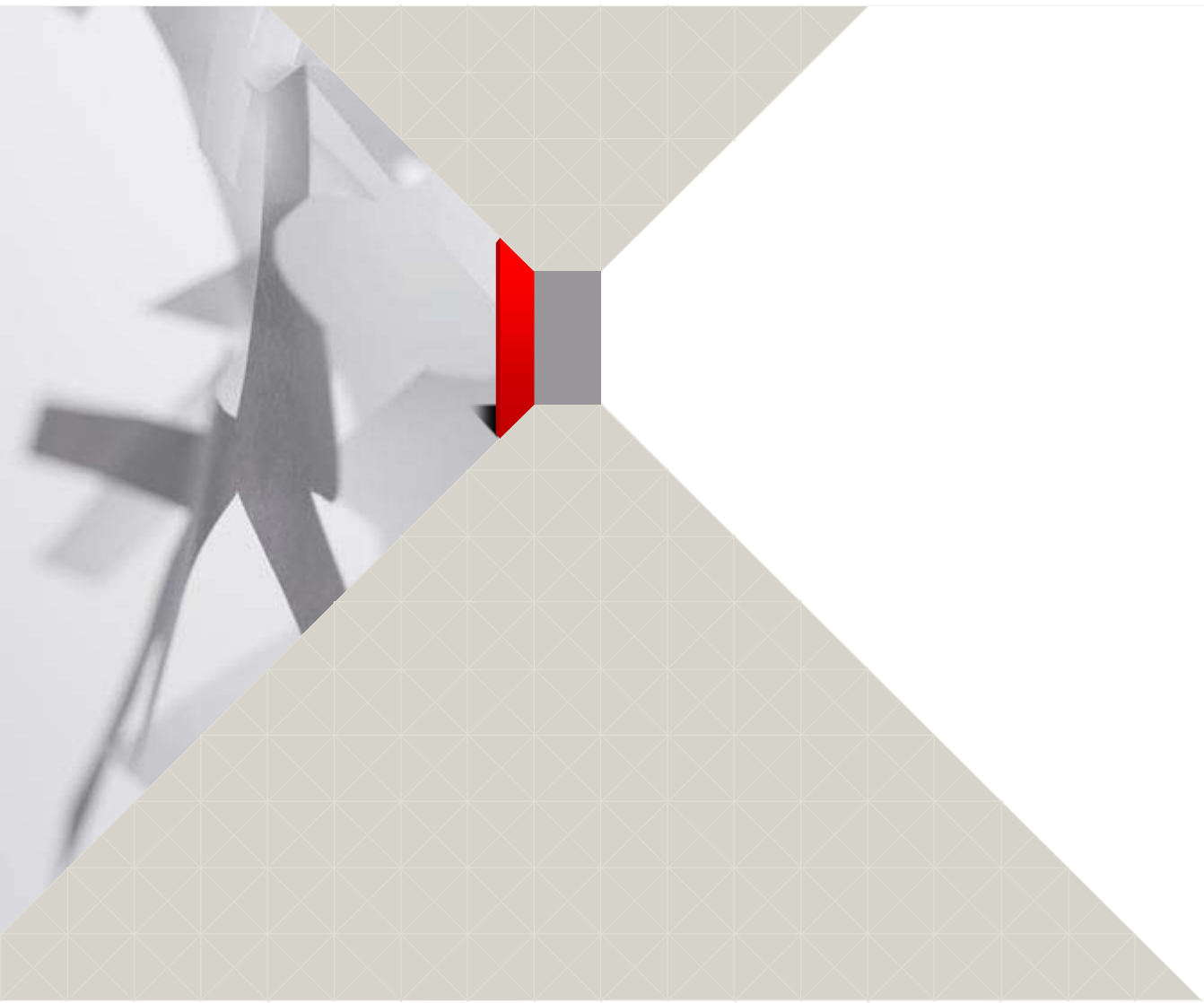
Easy liquidity to continue. Inflationary expectations and large government borrowing program will prevent any bond market rally

- ▶ Liquidity continued to be easy in the month of July. The average Mumbai Inter Bank Offer Rate for the month remained flat at 3.28% in comparison to the previous month. The outstanding amounts lent in reverse repo on 31st July 09 was at Rs.1404 bln as against Rs. 883 bln on 30th June 09 (Source: NSE/ RBI website).
- ▶ The inflation numbers reported for the week ended 20th July 09 declined to -1.54 % as compared to -1.3% for the similar period last month (Source: Reuters). The negative number is as per our expectations and arising from the high base effect in comparison to the previous year. This is the first time that the reported inflation has been in negative since 1977-78.
- ▶ The collapse in commodity (particularly oil) prices has already driven wholesale price inflation into negative territory and we expect it to remain low in the short term before moving sharply higher again in the final few months of the year. CPI is proving much more stubborn thanks to food prices.
- ▶ We stand by our stance that inflation numbers will inch upwards for the year 2009-10 and expect inflation numbers to reach 7-8% by end of the fiscal year. This is against our previous forecast of 1.8% and RBI target of 4%.
- ▶ On the monetary policy front the RBI has delivered 400 bps of cuts in cash reserve ratio since mid September, taking it down to 5%. In addition, the repo rate has been lowered by 425 bps to 4.75% and the reverse repo has been reduced by 275 bps to 3.25%. While it is too early in the recovery for the Central Bank to contemplate tightening policy, the prospect of higher inflation means further rate reductions are unlikely. We expect the next move in the policy rate to be up, albeit not until the April 2010 policy meeting.

August – Strategy

Expect the 10 year to sell off due to higher fiscal deficit - increase duration for high risk investors > 7.25% on the GOI 2019

- ▶ We expect volatility in the bond markets across the longer maturities. Hence, we recommend conservative and medium risk investors to invest into a mix of debt schemes with six to eight month maturities with minimum amounts locked into fixed rate instruments.
- ▶ We expect short end yields to remain benign over the next couple of months. Hence, ultra short term bond funds with low durations along with some allocations to hybrid funds may provide a good risk reward trade off in the near term.
- ▶ Our 10 year GOI yield regression model suggests that bank liquidity and the RBI's reverse repo and CRR ratios are the main determinants for the level of 10 year yield followed by the size of fiscal deficit. Therefore, unless we see evidence that the RBI will change its accommodative policy stance or for bank lending growth to pick up sharply, we believe that the budget announcement will primarily result in a one off jump in GOI yields rather than a steady rise in GOI yields.
- ▶ High risk investors can look to build duration in portfolios by investing in income funds and gilt funds. As per the regression model of our economist, the fair value range for the 10 year GOI yield is 4.6-6.84% (based on a 99% confidence interval). Hence, we recommend accumulating income funds at yields of 7.25% or higher for trading gains.
- ▶ We believe that investments into interest rate sensitive products such as gilt or income funds requires a minimum horizon of twelve months and allocations are made after due consideration to the risk profile, concentration risks and plans to book regular profits from the segment.



Currencies

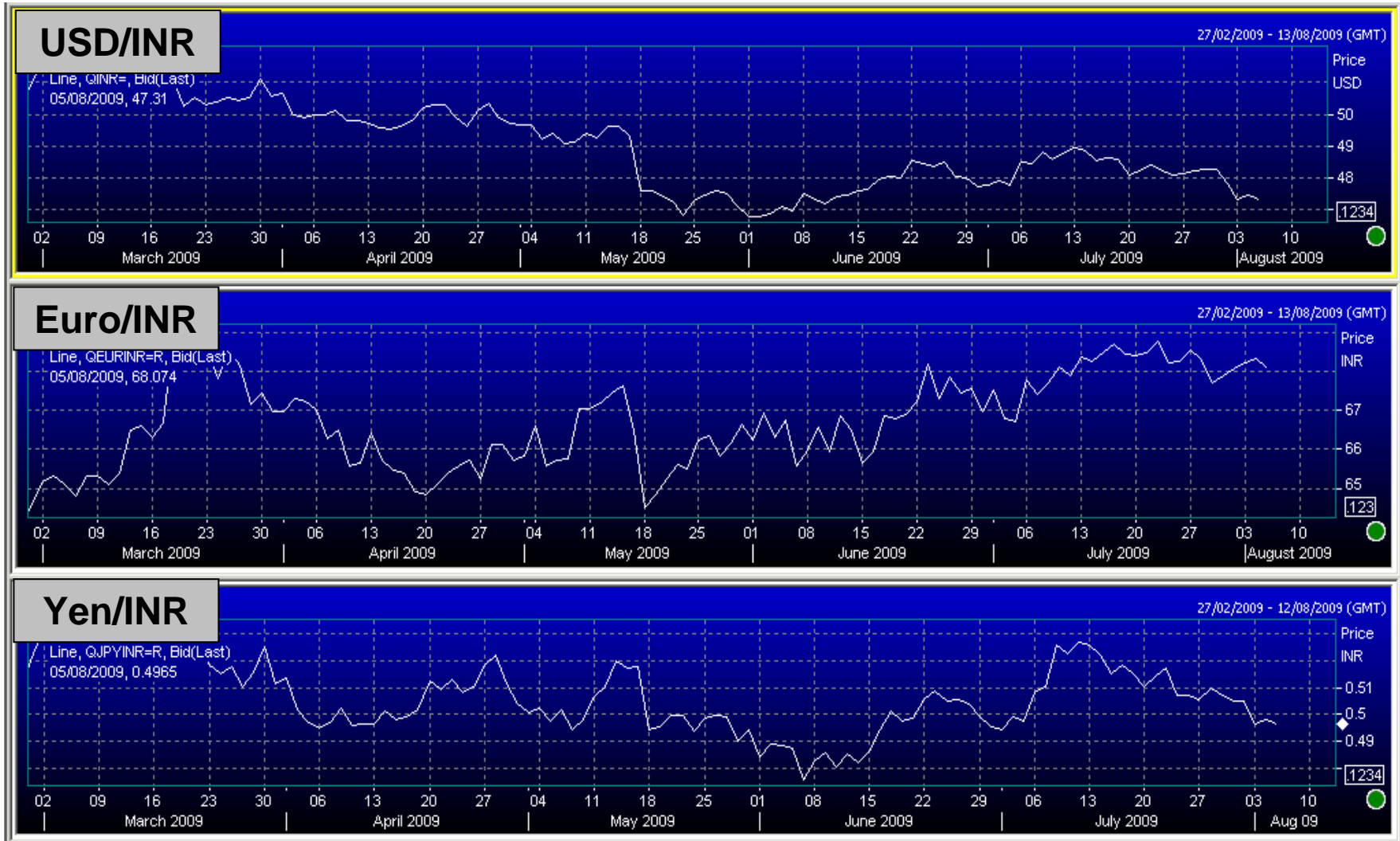
August – Strategy

We believe USD has settled at current levels for the time being

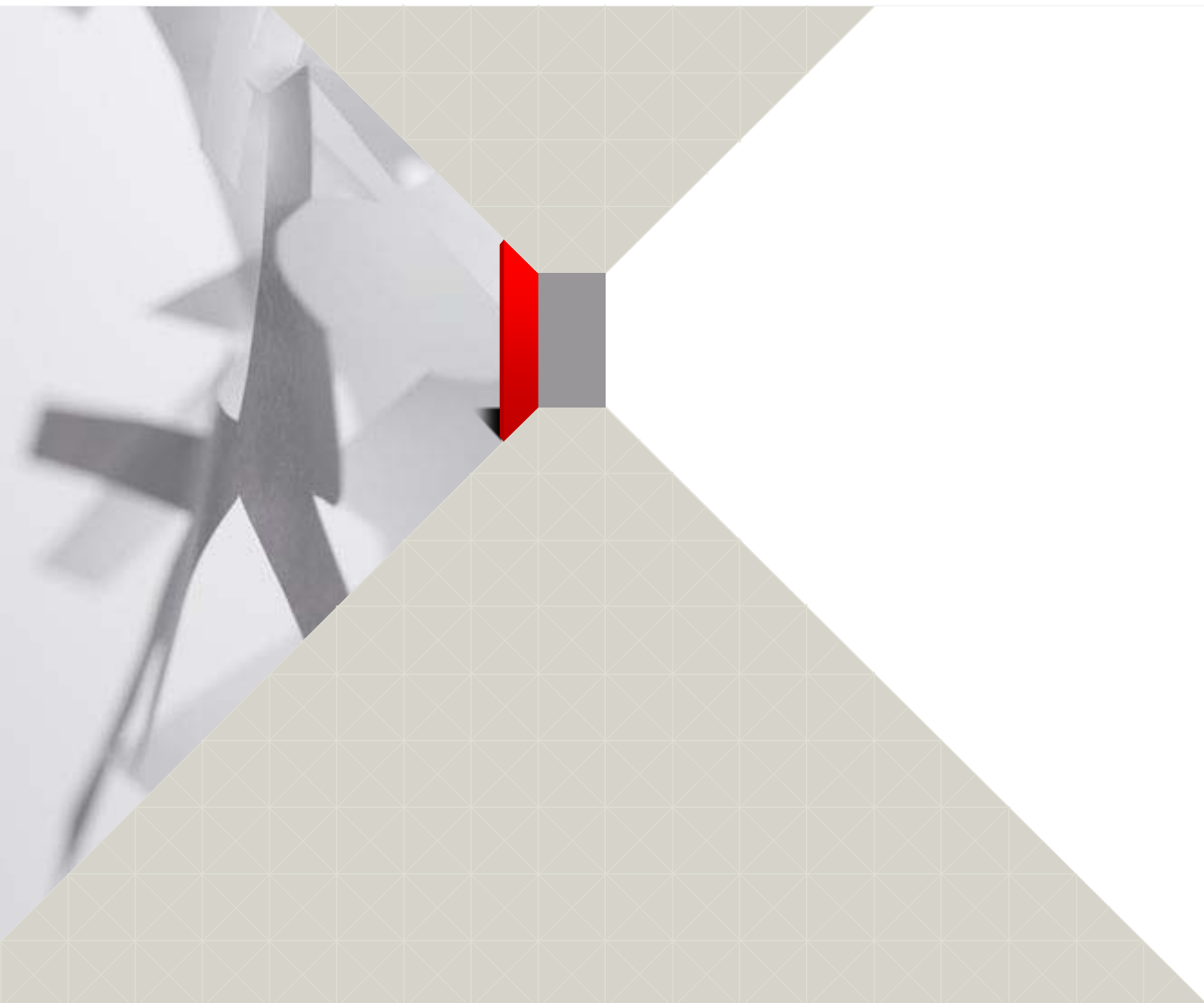
- ▶ **INR** –The INR weakened marginally during the last month and closed the month at 47.8 against the USD (Source: Reuters). The INR remains the only currency in Asia with a persistent outright current account funding requirement and remains one of the most expensive currencies vs the USD. We expect the USD-INR to reattempt to close the post-election gap down in the near term and reiterate our CY end target of 54.
- ▶ **USD** - As we had predicted, the US dollar weakened over the past months as a result of improving risk appetite and quantitative easing by the Federal Reserve. We believe it has settled at current levels for the time being. As markets normalize, a return to traditional market-movers should prove USD supportive in the long term. We have upgraded our long-term view on USD to neutral, and now hold a neutral view for both the short-and long-term.
- ▶ **GBP** – GBP has strengthened against USD and is now more fairly valued. We therefore expect a period of sideways trading.
- ▶ **EUR** – As concerns over the Eurozone growth increase, we expect a period of consolidation.
- ▶ **JPY** – Improving market sentiment and returning risk appetite will likely lead to weakening JPY as investors seek yield elsewhere.

August – Strategy

Currency movements....



Source - Reuters



Commodities

August – Strategy

As risk appetite returns, commodities should slowly improve

- ▶ We maintain our neutral with a positive bias view for commodities overall, as we believe improving investor sentiment, in particular their returning risk appetite, should complement resurgent demand from a global economic recovery that we expect to develop during 2010.
- ▶ **Gold:** Gold corrected during the last month and closed the month at US\$953 (Source: Reuters). We maintain a short-term neutral view on gold, as it appears to have settled in a trading range and we believe it will remain range-bound as supportive (inflation fears) and pressuring (risk appetite) factors appear to be balancing out. We maintain our neutral long term view as we believe that inflation fears are likely to increase going forward, supporting gold prices.
- ▶ **Oil:** Light crude oil remained in a broad range and closed the month of July flat at \$69.45/bbl (Source: Reuters). In the short term, we hold a neutral view on oil, as we believe it has found a range for the time being. Our long-term outlook remains positive, as we believe demand will pick up again (whilst supply remains inelastic), particularly from Emerging Markets, driving prices higher over the next 12 months.

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