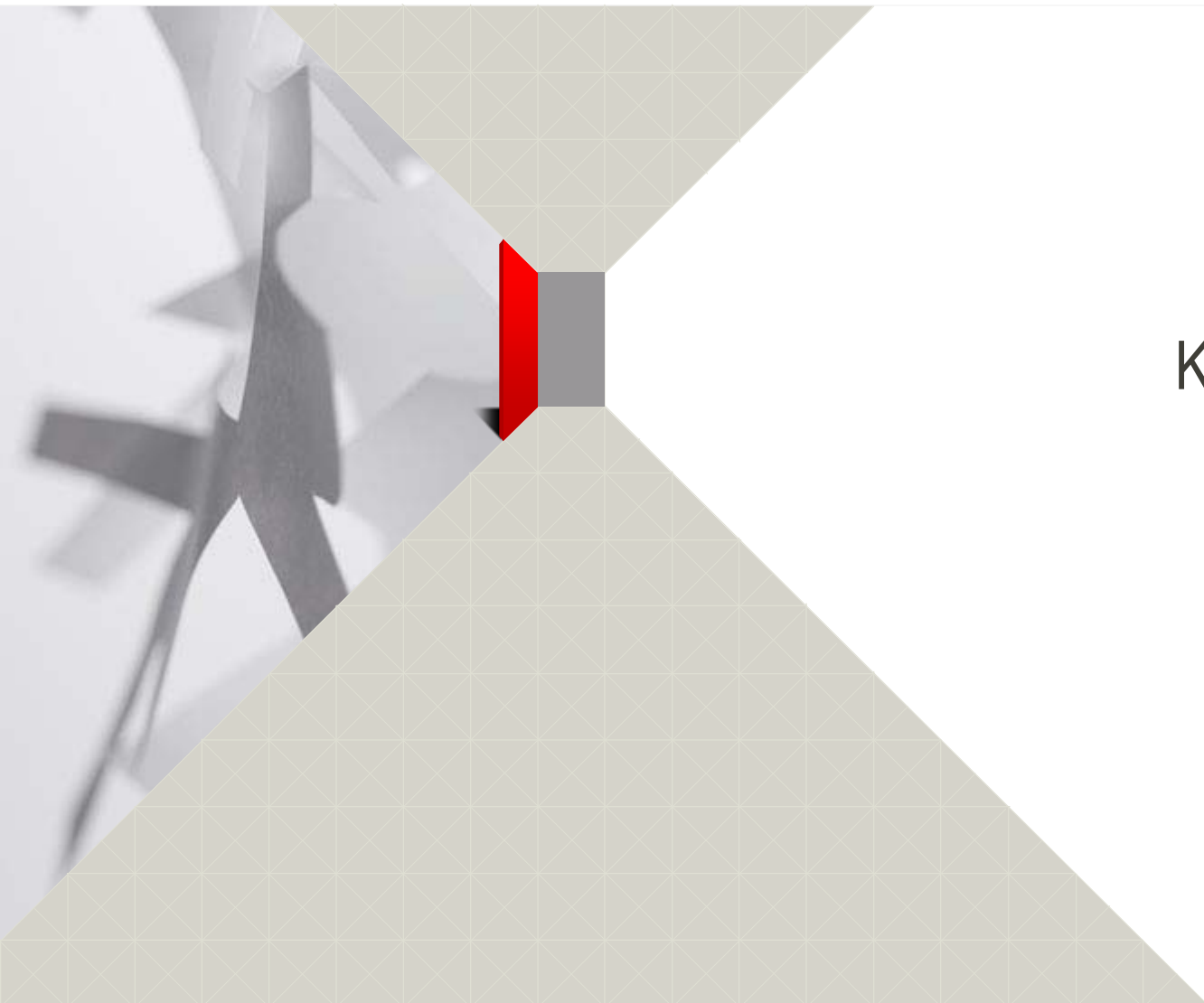


# India Strategy

August 2011



# Key Economic Forecasts

# August – Strategy

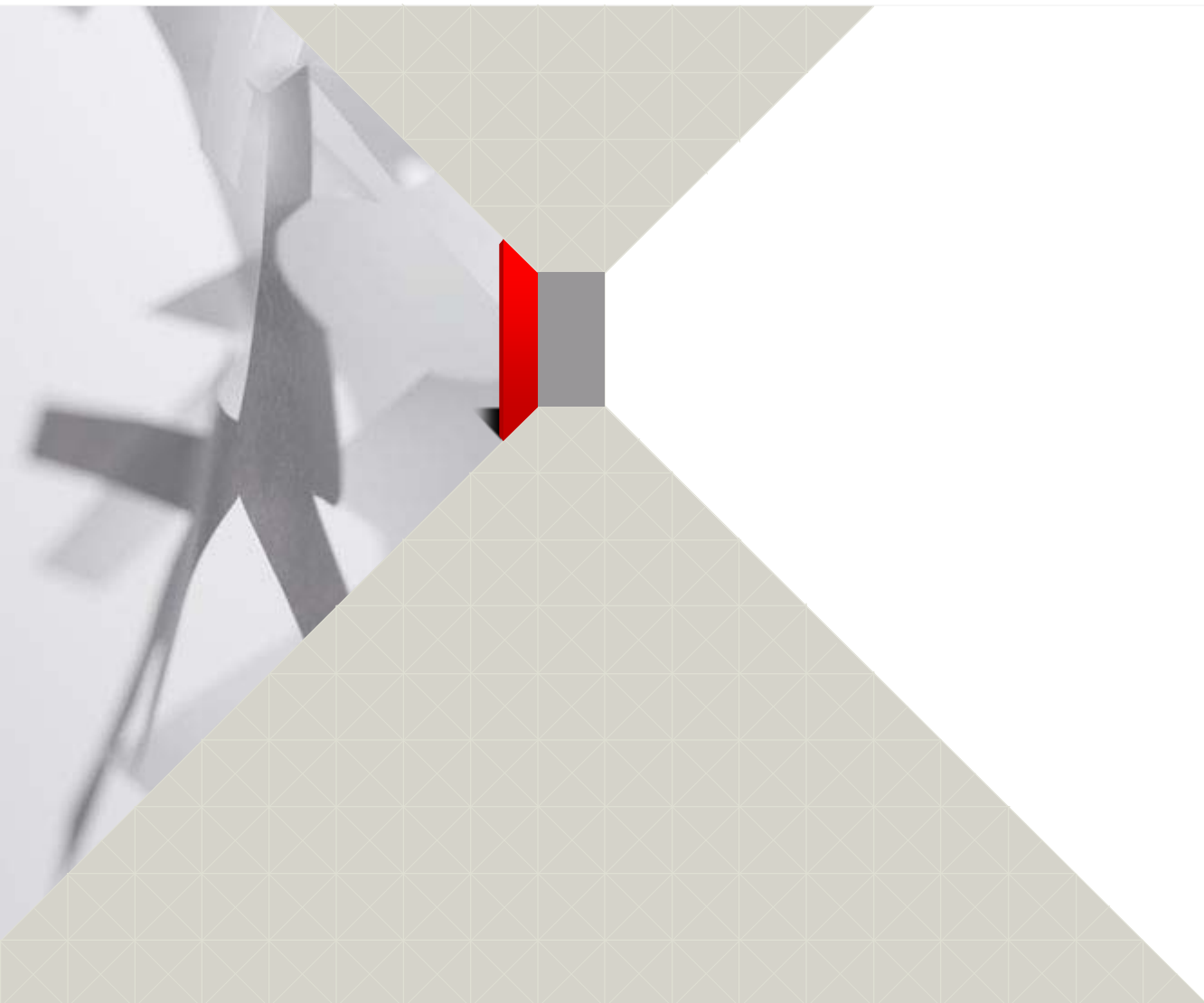
## India - Key Macro Economic Forecasts

### ▶ Snapshot of key Indian economic forecasts

	2006	2007	2008	2009	2010	2011f	2012f
<b>Production, demand and employment</b>							
GDP growth (% y-o-y)*	9.6	9.3	6.8	8.0	8.5	7.6	8.2
Nominal GDP (USDbn)*	949	1,220	1,252	1,354	1,722	2,071	2,499
GDP per capita (USD)*	779	985	1,027	1,083	1,347	1,591	1,911
Private consumption (% y-o-y)*	8.3	9.3	7.7	7.3	8.6	7.9	8.3
Government consumption (% y-o-y)*	3.7	9.5	10.7	16.4	4.8	3.7	3.8
Investment (% y-o-y)*	13.8	16.2	1.5	7.3	8.6	7.0	8.3
Net Exports (contribution to GDP growth, ppt)*	-1.0	-1.5	-3.1	-0.8	1.2	-3.2	-1.1
Industrial production (% y-o-y)	11.0	15.6	7.7	0.2	9.7	6.9	6.4
Gross domestic saving (% GDP)*	34.8	35.6	32.3	32.3	33.7	34.5	35.1
<b>Prices &amp; wages</b>							
CPI, average (% y-o-y)*	6.8	6.2	9.1	12.4	10.4	8.0	7.7
CPI, end-year (% y-o-y)*	6.7	5.5	9.7	15.0	9.5	6.9	7.7
Core WPI, average (% y-o-y)*	4.5	5.2	6.6	-0.3	4.9	7.7	6.5
Core WPI, end-year (% y-o-y)*	6.8	4.4	4.6	1.1	6.2	8.7	5.4
WPI, average (% y-o-y)*	6.6	4.7	8.1	3.8	9.6	8.6	6.7
WPI, end-year (% y-o-y)*	6.7	7.7	1.6	10.4	9.7	6.7	5.5
<b>Money, FX &amp; interest rates</b>							
Central bank money M1, average (% y-o-y)	17.3	15.0	18.9	16.1	19.2	18.0	15.0
Broad money supply M3, average (% y-o-y)	19.6	21.9	20.4	19.2	16.0	15.0	16.1
Real private sector credit growth (% y-o-y)	18.3	15.6	14.0	6.8	12.0	15.0	15.0
Policy rate, end-year (%)	7.75	7.75	6.50	4.75	6.25	8.00	8.25
5yr yield, end-year (%)	7.52	7.67	5.35	7.31	7.85	8.00	8.20
INR /USD, end-year	44.25	39.42	48.46	46.69	44.81	42.00	42.00
INR /USD, average	45.22	40.88	44.58	48.39	45.74	44.15	42.00
INR /EUR, end-year	58.40	57.55	67.35	66.76	60.04	60.48	60.48
INR /EUR, average	56.83	56.82	64.92	67.62	60.37	62.36	60.48

Source – HSBC Global Research

Asian Economics Third Quarter 2011



# Equities

# August – Strategy

Market retract in July on concerns over slowing domestic growth and uncertainty over US debt default

- ▶ Indian Equity markets shed previous month's gains in July. The BSE Sensex ended the month of July at 18197 (↓3.4% M-O-M) and the S&P Nifty closed the month at 5482 (↓ 2.9% M-O-M).
- ▶ Mid and Small cap indices out performed during the month as the BSE Midcap and the BSE Smallcap rose by 0.9% and 1.8% respectively. On the sectoral front, the Consumer durables, FMCG, Realty and Healthcare indices registered gains while Metals, Capital Goods, Power and Energy indices registered losses.

Index	% Change	Index	% Change
BSE Small-Cap	1.8%	BSE 100	-2.7%
BSE Consumer Durable	1.5%	BSE PSU	-2.8%
BSE FMCG	1.2%	BANKEX	-2.9%
BSE Realty Index	1.1%	<b>Nifty (S&amp;P CNX)</b>	<b>-2.9%</b>
BSE Mid-Cap	0.9%	<b>BSE Sensex</b>	<b>-3.4%</b>
BSE Healthcare	0.4%	BSE IT	-4.3%
BSE Auto	-0.5%	BSE Oil	-4.4%
BSE IPO	-1.0%	BSE Power	-6.0%
BSE 500	-2.1%	BSE Capital Goods	-6.5%
BSE 200	-2.5%	BSE Metal	-6.9%

Source – Capitaline/ Bloomberg

# August – Strategy

Markets continue to consolidate

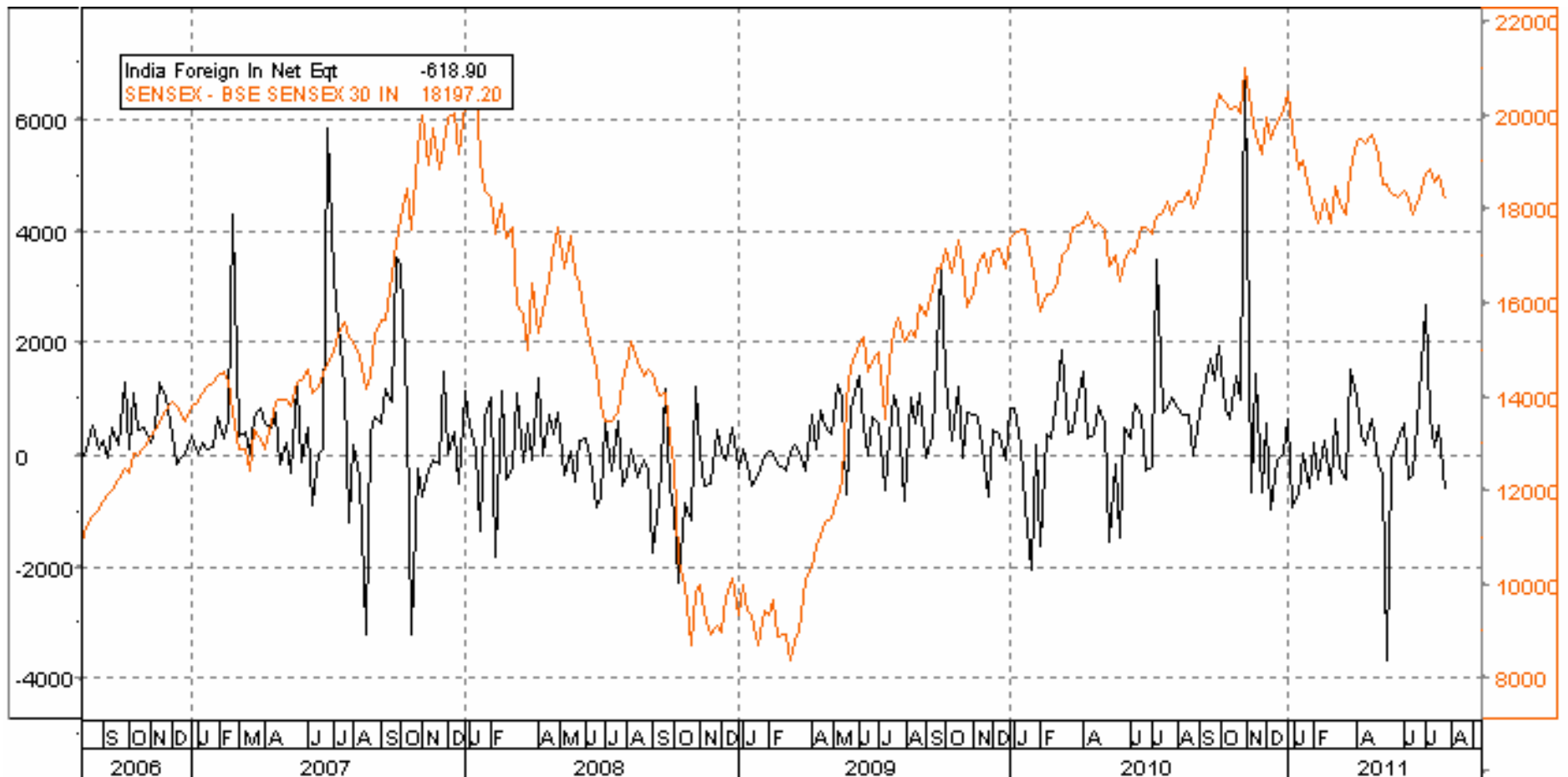


Source - Bloomberg

# August – Strategy

## Foreign institutional investors continue to be net buyers of Indian equities

- ▶ FIIs were net buyers of Indian equities in July. They net bought \$1.7bn of Indian equities during the month. YTD, FIIs remained net buyers of Indian equities worth \$3Bn.



# August– Strategy

## Moderation in high frequency indicators continues reflecting the lagged effect of monetary tightening.

- ▶ The index of industrial production's (IIP) in May'11 unexpectedly slowed to 5.6% vs a downwardly revised 5.8% y-o-y in April. Sequential growth also eased.
  - Manufacturing drove the slowdown (5.6% vs 6.3% in April) while electricity production picked up pace (10.3% vs 6.5% in April) and mining was flat.
  - The moderation is primarily the result of the slowdown in domestic demand associated with the tightening in monetary policy besides capacity constraints and high utilisation rates are imposing a natural speed limit on growth in the manufacturing sector.
- ▶ Momentum in India's manufacturing PMI eases further in July, but remained in expansionary territory.
  - PMI eased further to 53.6 vs 55.3 in June driven by a marked deceleration in sequential output growth (57.2 vs 58.4 in June) and a slower expansion in order books with total orders coming in at 54.5 vs 60.1 in June and export orders contracting to 49.2 vs. 53.2.
  - Bottom Line: Indian manufacturing growth is easing as expected and the degree of deceleration is not of concern. At the same time, inflation pressures are not abating. With monetary policy at best in neutral gear, the policy rates will have to rise further to diffuse inflation pressures and we expect an increase of 25bps in policy rates (repo & reverse repo).
- ▶ WPI inflation for June 2011 rose to 9.4% y-o-y (vs. 9.1% in May).
  - Core inflation (non-food manufacturing) was broadly steady at 7.1% vs 7.2% in May. Of concern, historical data was yet again revised significantly (April data revised up from 8.7% to 9.7%).
- ▶ The Prime Minister's Economic Advisory Council (PMEAC) has projected a GDP growth rate of 8.2% for the FY 12 as against its earlier forecast of 9%. WPI inflation rate is forecasted to be at 9% or higher in the months of July-October 2011 and at around 6.5% in March 2012.
- ▶ The Reserve Bank of India, in a decisive move, increased the repo rate by 50bps to 8% beating consensus expectations of 25bps hike, and accompanied by concerning statement emphasizing the upside risks to inflation from global commodity prices and demand led price pressures. The central bank also categorically indicated that it is not concerned about moderating growth and would continue to focus on containing inflation.
  - Revised up the end FY 12 WPI inflation forecast to 7% from earlier forecast of 6%
  - Given sustained inflationary concerns, we expect one more rate hike during this fiscal.

Source: Bloomberg/HSBC

## August – Strategy

High frequency indicators hinting towards further moderation in growth. FY 12 GDP growth estimated at 7.6%

- ▶ Exports during June 2011 rose by 46% in USD terms to USD 29.2Bn while imports rose by 42% in USD terms to USD 36.8Bn. Oil imports during June rose by 30% on a year on year basis. Non oil imports were higher by 48%. The trade deficit for April - June 2011 was estimated at \$31Bn (vs. \$27Bn in April - June 2010).
- ▶ Bank credit growth remains steady (19% y-o-y as on 15<sup>th</sup> July, 2011).
- ▶ Global economy update – As inflationary fears fade, growth concerns return
  - While there are plenty of near term reasons, including the Japanese earthquake, and, more convincingly, higher commodity prices, western economies, by not facing up to the fiscal challenge, are in danger of locking into structurally lower growth.
  - Key reasons for the commodity price rise globally – structural tilt in global economic growth led by emerging economies, unforeseen ‘carry trade’ efforts of Western monetary stimulus, and more recently, the political upheavals in the MENA region
  - On the back of this, we have trimmed some of our global growth forecasts – notably in the US (2.5% for 2011 from 2.9% earlier) & UK (1.2% for 2011 from 1.4% earlier) and have raised our inflation forecasts.

However we are not expecting another financial crisis on par with Lehman any time soon, though remain concerned over the sovereign debt situation in the Eurozone and on absence of the deficit reducing intent of the US

  - We have not made major changes to our global economic forecasts as a consequence of the tragic events that befell Japan early March. Too often, the economic and financial consequences of such human tragedies prove to be smaller than feared and contrary to the knee-jerk downgrades in economist forecasts.
  - The US economic recovery continues to be restrained by a stagnant housing market and by budgetary cutbacks from state and local governments. Those headwinds are likely to persist, limiting the pace of growth over the years ahead.
  - The Eurozone, more than an year into the sovereign crisis, a resolution has yet to be reached. Greece, clearly is the focal point. The ECB remains vehemently opposed to any selective default to avoid buying more peripheral bonds and instead focus on its mandate of price stability.
  - Back home in India, the high frequency indicators show early signs of cooling, but the sequential momentum is still robust.

Source: HSBC/RBI/Ministry of Commerce

## August– Strategy

High inflation & macro headwinds, uncertainty over further US QE, Euro zone concerns, Q1 FY 12 results and movement of crude oil prices to affect market sentiments.

- ▶ No major positive surprises from the ongoing Q1 FY 12 results announced so far. Markets are expected to trade sideways in the near term given the uncertainties on several fronts (inflation, political uncertainty, global macro risks) .
- ▶ However, India's long-term earnings outlook continues to remain bullish given its robust economic growth prospects, while India's minimal exposure to global structural risks may result in continuance of foreign investment funds into the country.
- ▶ At 18,197 the Sensex trades at a P/E of 13.7X CY12e (HSBC EPS estimate of Rs.1,325).
- ▶ Our year end 2011 Sensex target is 20,000. We forecast that EPS will grow at 15% over the next two years.
- ▶ We advise staggered entry into equities to take advantage of the ongoing volatility in the markets.
- ▶ We continue to favour select large caps given the valuations at which they are trading, while a stock specific approach is advised towards mid-cap stocks. Key events that may impact the markets in the near term are: Inflation, global economic data-flows (clarity on US Quantitative expansion, Euro zone debt issues) and progress of the domestic monsoons.
- ▶ At the sector level, we favor IT services, Telecom and Healthcare. We are neutral on industrials, consumer staples, utilities, energy, materials and consumer discretionary. We recommend under weight on Financials.

## August – Strategy

### Overweight – IT services, Healthcare & Telecom; Neutral – Industrials, consumer staples, utilities and materials

- ▶ **Information Technology** – Overweight – We maintain our Over-weight rating on the sector as concerns over global demand recede and revenue growth prospects look strong for the IT sector.
- ▶ **Healthcare** – Overweight – Key themes to play the sector are – strength in emerging markets, development of new growth areas such as bio similars & several block buster drugs losing patent exclusivity in the US and EU during 2011- 15. Further, rising incomes and ageing populations, coupled with pension and insurance reform, could lead to continued strong demand.
- ▶ **Telecom** – Overweight - We expect the outlook for the Indian telecom sector to improve going forward, driven by progress on the regulatory front, stabilization of tariffs and launch of 3G services. Increasing penetration and consumer spending remain strong growth drivers for the sector. Better volumes and price stability offers increased earnings visibility.
- ▶ **Industrials** – Neutral – Fat order books are expected to drive earnings growth while valuations of the sector look attractive even in worst case scenario. We expect order book to continue to pick up. Not a lot has changed in terms of the demand outlook, where in companies are positive on pricing but cautious on margins and market expectations.
- ▶ **Utilities** – Neutral – With rising energy costs and stable electricity prices, the utilities sector is facing a margin squeeze, which is the reason for our neutral stance on the sector though we expect acceleration of power capacity addition (18GW in FY12 versus 31GW commissioned over the last four years) and high sector capex during FY12 (the last year of the 11th five-year plan). The sector will continue to face an overhang regarding project execution, fuel availability and financial health of SEBs (State Electricity Board)
- ▶ **Consumer Staples** – Neutral –Key themes for playing this sector are product re-pricing and earnings recovery. Things have changed during the last three to four months as companies have developed strategies to deal with rising food prices.
- ▶ **Energy** – Neutral– Environment is challenging for upstream and refineries as margins are likely to remain moderate. Also the sector faces government policy risk.
- ▶ **Consumer Discretionary** – Neutral –Inflationary concerns and higher interest rates continue to be key near term concerns for the sector. Rising rates tend not to be conducive to discretionary spending. Indeed, the reaction to slower consumer spending often comes with some time lag particularly in the automobile sector.
- ▶ **Materials** – Neutral – While there are positive developments within the industry, ranging from steel mergers and government measures, we believe this is offset by risks to global demand for metals, which is the basis for our rating.
- ▶ **Real Estate/Property** - Neutral - Recent data suggests demand volume in India's top 7 cities has either been flat or declined over the past two quarters, with Mumbai and Pune reporting sharp drops. While developers could hold prices firm in the near term due to stable balance sheet liquidity, we think this will only hurt demand as interest rate rises and higher property prices will curtail affordability.
- ▶ **Financials** – Underweight – Expectations of higher inflation and further monetary tightening is likely to impact the margins of the banking sector. Added a slowdown in the macro growth prospects could add pressure on asset quality. We expect 2011 to be the second consecutive year of credit up cycle with loan growth expected in excess of 20%. Given the higher earnings visibility and fewer concerns for private sector banks coupled with valuations at their 5-year near average levels we continue to prefer private sector banks to PSU banks.

Source HSBC Global Research

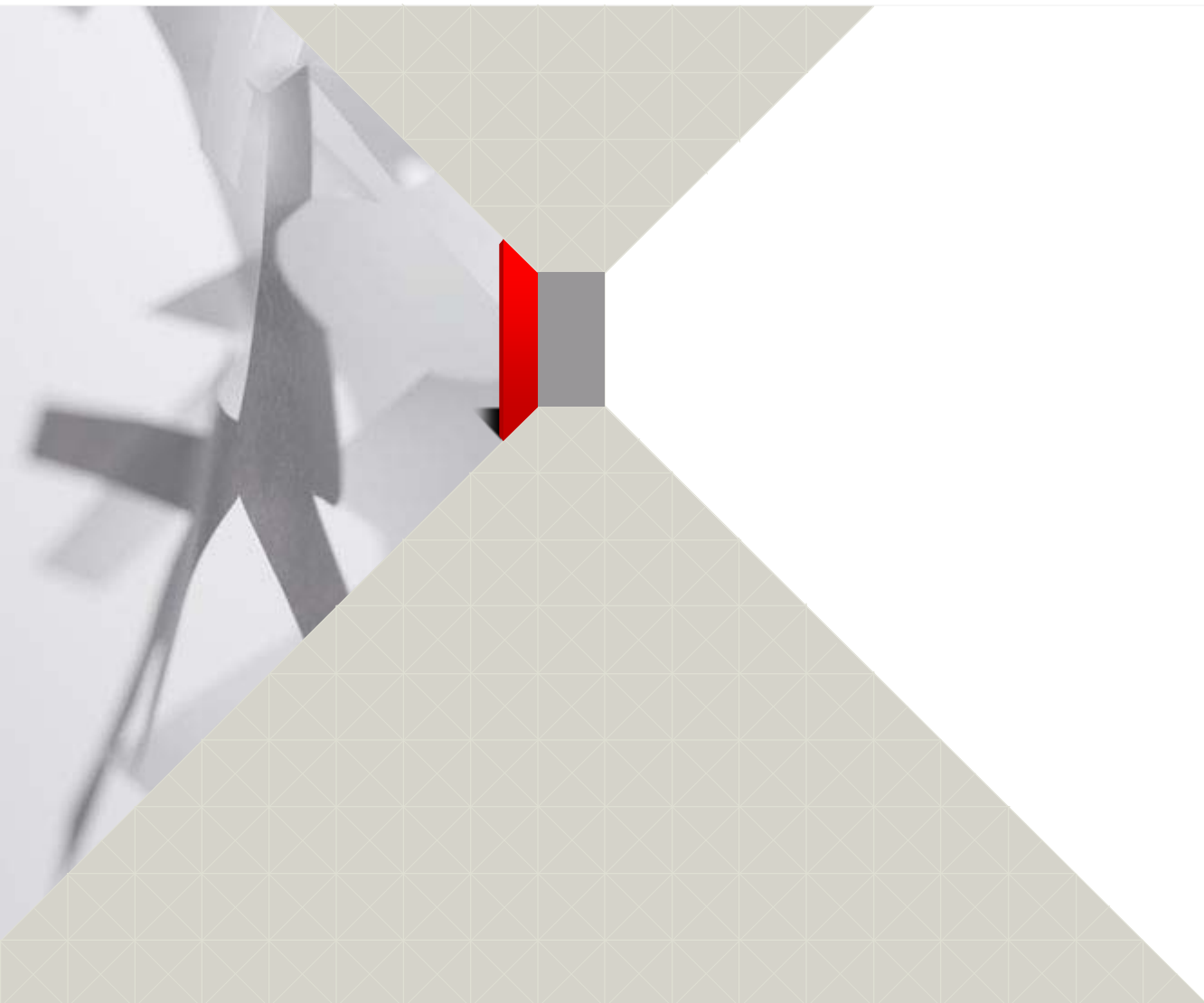
# August – Strategy

Derivatives parameters indicate reduction in long positions

## Equity Derivatives:

- ▶ Nifty near month future lost 2.96% during the month of July
- ▶ Open Interest for near month Nifty future was down by about 5.92%.
- ▶ Bank Nifty near month future lost 3.12% for the month.
- ▶ Open Interest for Bank Nifty future was down by about 1.31%
- ▶ CNX IT near month future lost 4.70% during the month.
- ▶ CNX IT futures open interest declined by about 54.75% though on a small base

Source – Reuters



# Fixed Income

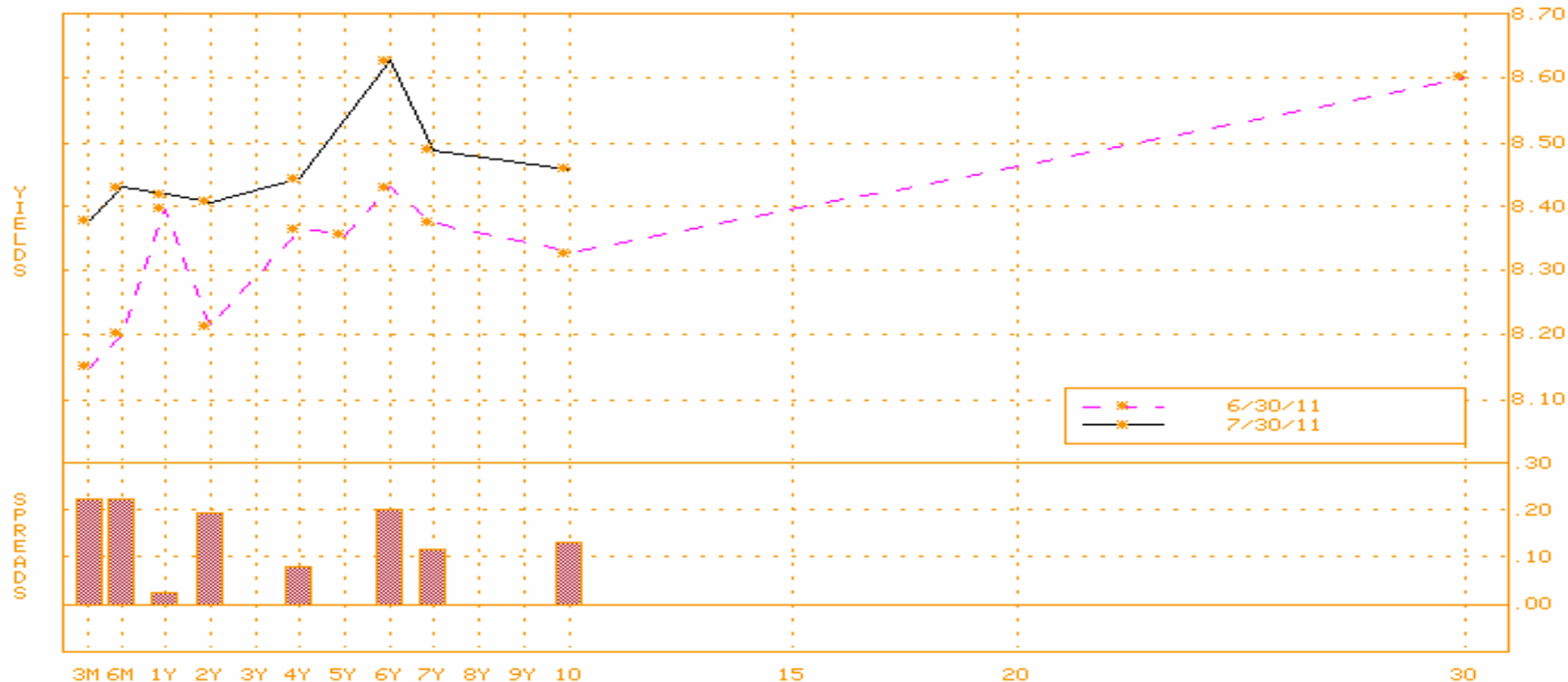
# August – Strategy

## Fixed Income

INR India Sovereign

7/30/11 vs 6/30/11

3M - 30



Indian Government Yield Curve

Source: Bloomberg

- The ten year bond yield in July '11 traded in a range of 8.26% to 8.46% and ended the month at levels of 8.45% (Source Bloomberg) predominantly due to the Reserve Bank of India increasing policy rates (repo & reverse repo) greater than market expectations and on inflation (WPI) being higher than consensus expectations.
- The RBI in July '11 on a daily basis infused liquidity amounting to INR 377B (month's average) as against INR 377B (month's average) in June '11 (Source: Bloomberg)

## August – Fixed Income Strategy

### Inflation continues to remain at elevated levels

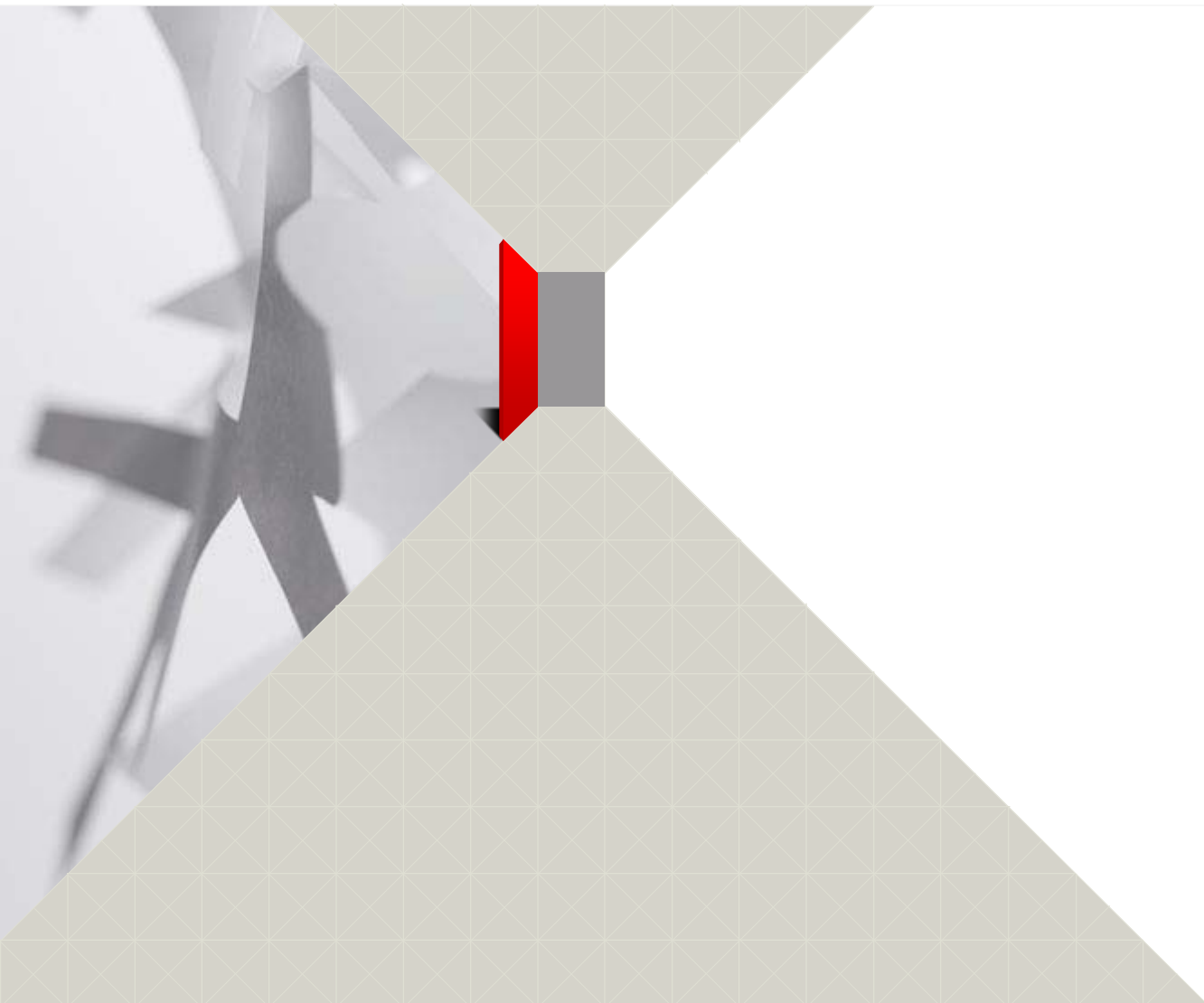
- ▶ The RBI in its First Quarter Review of Monetary Policy 2011-12 apart from increasing policy rates (repo & reverse repo) has revised upwards its WPI inflation target for March '12 from 6% to 7% predominantly due to the recent hike in petroleum product prices, hike in select agriculture minimum support prices, underlying non-food manufacturing inflation and on uncertainty over international commodity prices.
- ▶ The RBI in its monetary policy review has revised downwards its money supply and credit growth estimates for FY12 from 16.0% to 15.5% and from 19.0% to 18.0% respectively.
- ▶ WPI Inflation in June '11 was 9.44% (provisional numbers and on a year on year basis) as against 9.06% (year on year basis) witnessed in May '11. In June, primary articles, fuel & power and manufactured products rose by 12.22%, 12.85% and 7.43% respectively (on a year on year basis). WPI Inflation reading for April '11 was revised upwards from 9.74% to 8.66%. (Source: Government of India)
- ▶ Systemic liquidity in July '11 remained tight due to the ongoing government borrowing programme and the Reserve Bank of India during the month issued INR 80B worth of 42 days and INR 40B worth of 56 days cash management bills at a yield of 8.15% and 8.05% respectively.
- ▶ Various state governments issued 10 year papers amounting to INR 105B at yields of 8.56-8.69%.

Data Source: HSBC/ Reuters/ Bloomberg

## August – Fixed Income Strategy

### Central Bank action push short term rates higher

- ▶ Yields at the shorter end of the yield curve surged vis-à-vis the longer end due to the RBI increasing policy rates higher than consensus expectations. In view of the shorter end of the yield curve remaining elevated, we propose investors should seek to capitalize on such opportunities by investing into ultra short term and short term bond funds.
- ▶ Investors having a pre-defined investment horizon and are willing to lock-in their monies may selectively consider Fixed Maturity Plans.
- ▶ Investors having a medium term investment horizon may consider investing into products that maintain exposure to issuances maturing over the next two years as apart from earning accrual income, there exists the possibility of trading gains.
- ▶ Investors may selectively undertake exposure to high coupon bearing bonds with a medium to long term investment horizon.
- ▶ Long term investors may selectively consider investing into long term bonds/bond funds during periods of volatility.



# Currencies

# August – Strategy

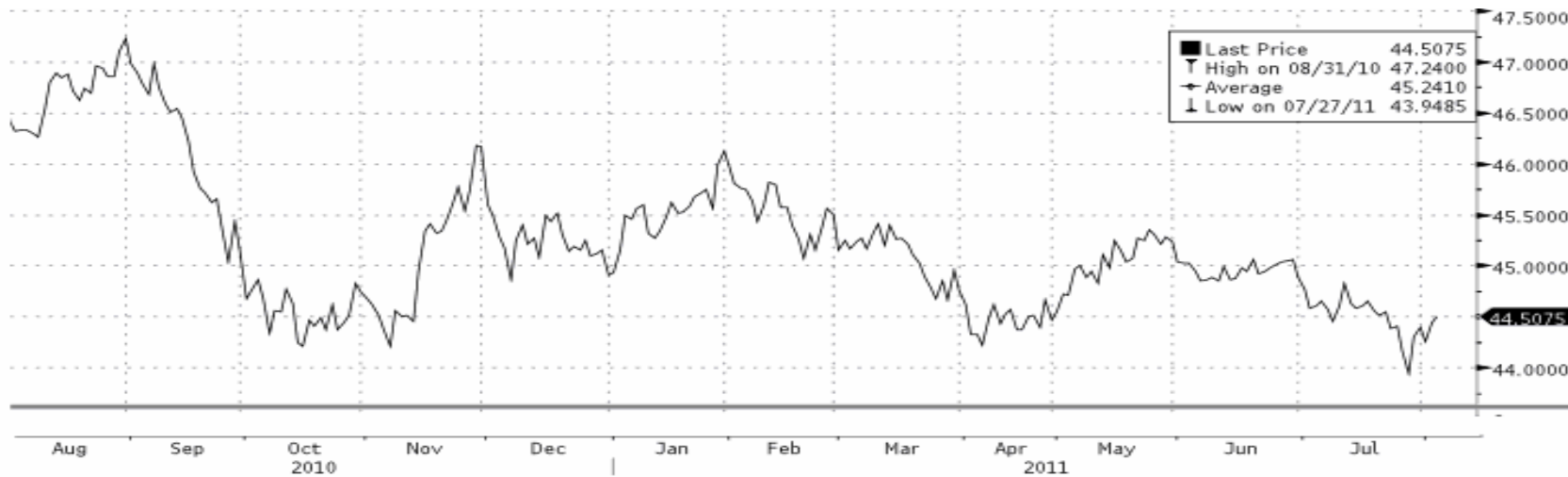
## The three main Western currencies face their own hurdles

- ▶ **INR** - The INR strengthened marginally during July and ended the month at 44.19 against the USD (Source: Bloomberg). Our December 2011 target for INR stands at 42.
- ▶ **USD** –We believe further downside for the USD maybe somewhat limited despite worries over the US deficit, as the USD is nearing historical lows. We hold a Neutral view on USD for the next 12 months.
- ▶ **Euro**– We believe that the positive sentiment towards the Euro, driven by the interest rate hikes by the European Central Bank, is running into resistance, as sovereign debt concerns accelerate further. This may limit EUR strength and we downgrade our short-term view to neutral. We hold a Neutral view on Euro for the next 12 months.
- ▶ **GBP**- The weak economic backdrop may keep the GBP under check as interest rate hike expectations continue to be pushed into 2012 now. We hold a Neutral view on GBP with a negative bias for the next 12 months.
- ▶ **JPY** – Safe haven currencies are near their peaks due to the ongoing volatility, thereby supporting the JPY. JPY may have limited upside potential given already record highs, but they are likely to remain in demand as long as instability and uncertainty rule. Additional intervention against the JPY cannot be excluded, as an excessively strong JPY could hurt the recovery of the Japanese economy. We hold a Neutral view on JPY for the next 12 months.
- ▶ **Emerging Markets (EM)** – We believe emerging market currencies will continue to appreciate particularly as we expect investors' search for yield to continue in the low yield environment. Further, EM countries may use currency appreciation as a tool to fight inflation. We favour currencies that are less likely to see government intervention in an attempt to curb appreciation. We hold positive view on Emerging market currencies for the next 12 months.

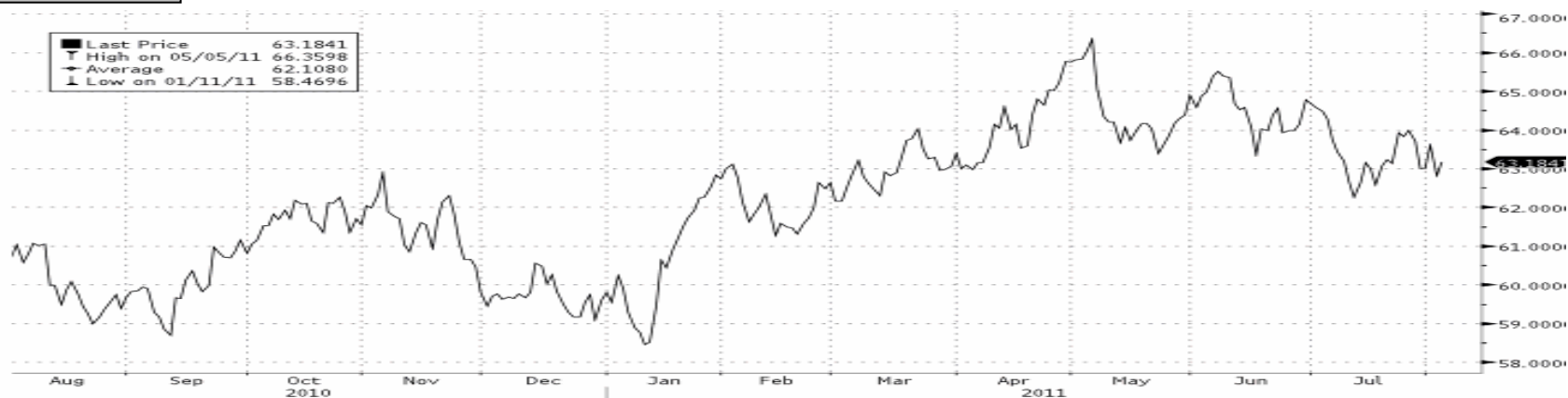
# August – Strategy

## Currency movements....

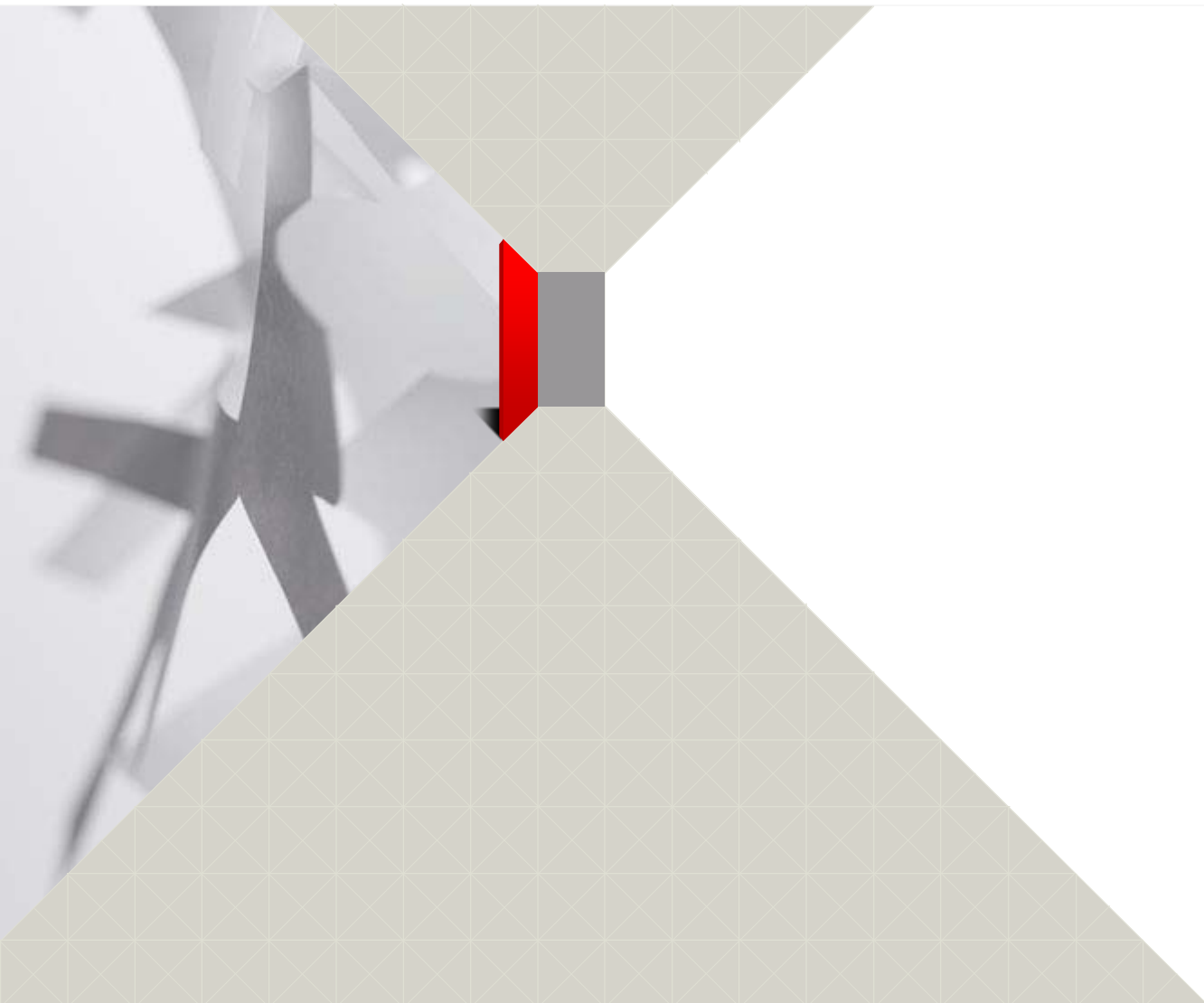
USD/INR



Euro/INR



Source - Bloomberg

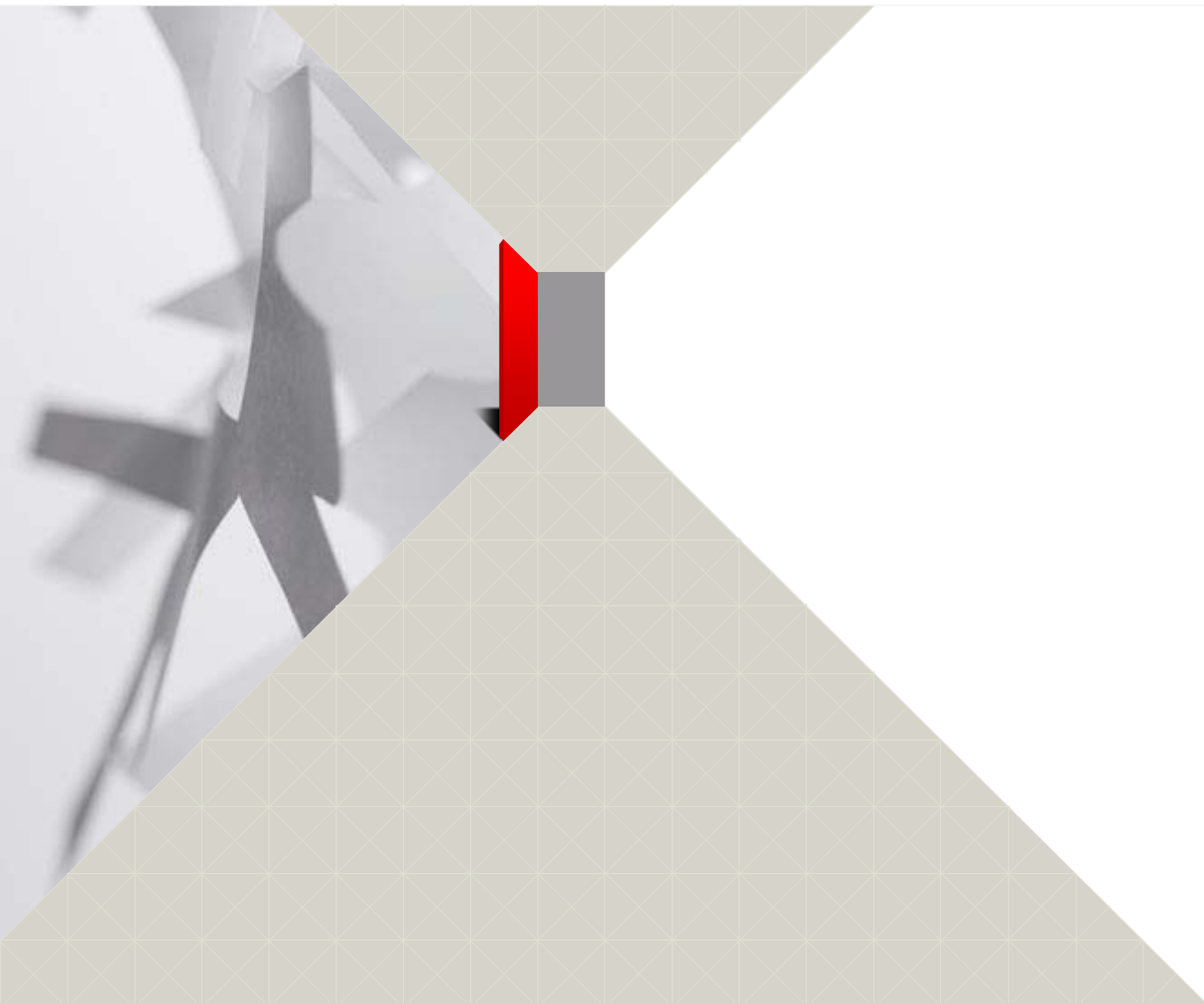


# Commodities

# August – Strategy

## The uncertain economic outlook may lead to volatility

- ▶ We believe that concerns about the current slowdown in economic growth and ongoing tightening measures in the emerging markets are likely to weigh on demand for commodities in the coming months, muting price appreciation. However, USD weakness should provide some underlying support to prices.
- ▶ **Gold:** Gold strengthened in July and ended the month at US\$1,617 (Source: Bloomberg). Gold should remain in demand thanks to its status as a safe haven asset, an inflation hedge, and a commodity that benefits from a weaker US dollar. Middle East tensions as well as continued worries about the Euro zone periphery should support gold as uncertainty persists. Rising inflation in EM and fears of future inflation in the developed world should provide further support to prices. Although interest rate hikes increase the 'opportunity cost' of holding gold (as it does not pay a coupon) and the US quantitative easing has come to an end, gold still seems a good alternative to Western currencies, which see their value deflated by high government debt piles. For the next 12 months, we hold a neutral view on Gold with a positive bias.
- ▶ **Oil:** Brent crude oil strengthened during the month and ended July at \$116.70/bbl (Source: Bloomberg). The slowdown in growth is likely to outweigh ongoing tensions in the Arab World and keep prices near current levels. In the longer term, we expect higher-trending oil prices to remain supported by EM demand, but this may take some time to materialise. For the next 12 months, we hold a neutral view on oil.
- ▶ **Industrial Metals:** In our view, industrial metal price appreciation may be subdued as growth slows, but underlying demand appears fairly resilient and should benefit from the strong Chinese economic outlook and growth in the emerging markets. For the next 12 months, we hold a neutral view on Industrial Metals.
- ▶ **Agricultural Commodities :** We expect agricultural commodities to remain volatile given uncertain weather patterns, although the longer-term trend of growing demand from the emerging markets should provide some support to prices. For the next 12 months, we hold neutral view on agricultural commodities.



# Summary of Views

# August – Strategy

Asset Class	Sub Class	Current Month	Previous Month
<b>Equity</b>		=/+	=/+
	Industrials	=	=
	Utilities	=	=
	Metals	=	=
	Cement	=	=
	Real Estate	=	=
	Financials	-	-
	Information Tech	+	+
	Consumer Staples	=	=
	Consumer Discretionary	=	=
	Healthcare	+	+
	Telecom	+	+
	Energy	=	=
<b>Debt</b>		=	=
	Liquid Assets	+	+
	Duration	=	=
	Credit	=	=
<b>Currency</b>			
	INR	=/+	=/+
	USD	=	=
	GBP/ USD	=-/	=-/
	Euro/USD	=	=
	USD/JPY	=	=/+
	Emerging Markets	+	+
<b>Commodities</b>		=	=/+
	Gold	=/+	=/+
	Oil	=	=
	Industrial Commodities	=	=
	Agri Commodities	=	=/+

## Guide to Symbols in this document

- Negative

=/- Neutral with a negative bias

= Neutral

=/+ Neutral with a positive bias

+ Positive

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