

India Strategy
December 2009

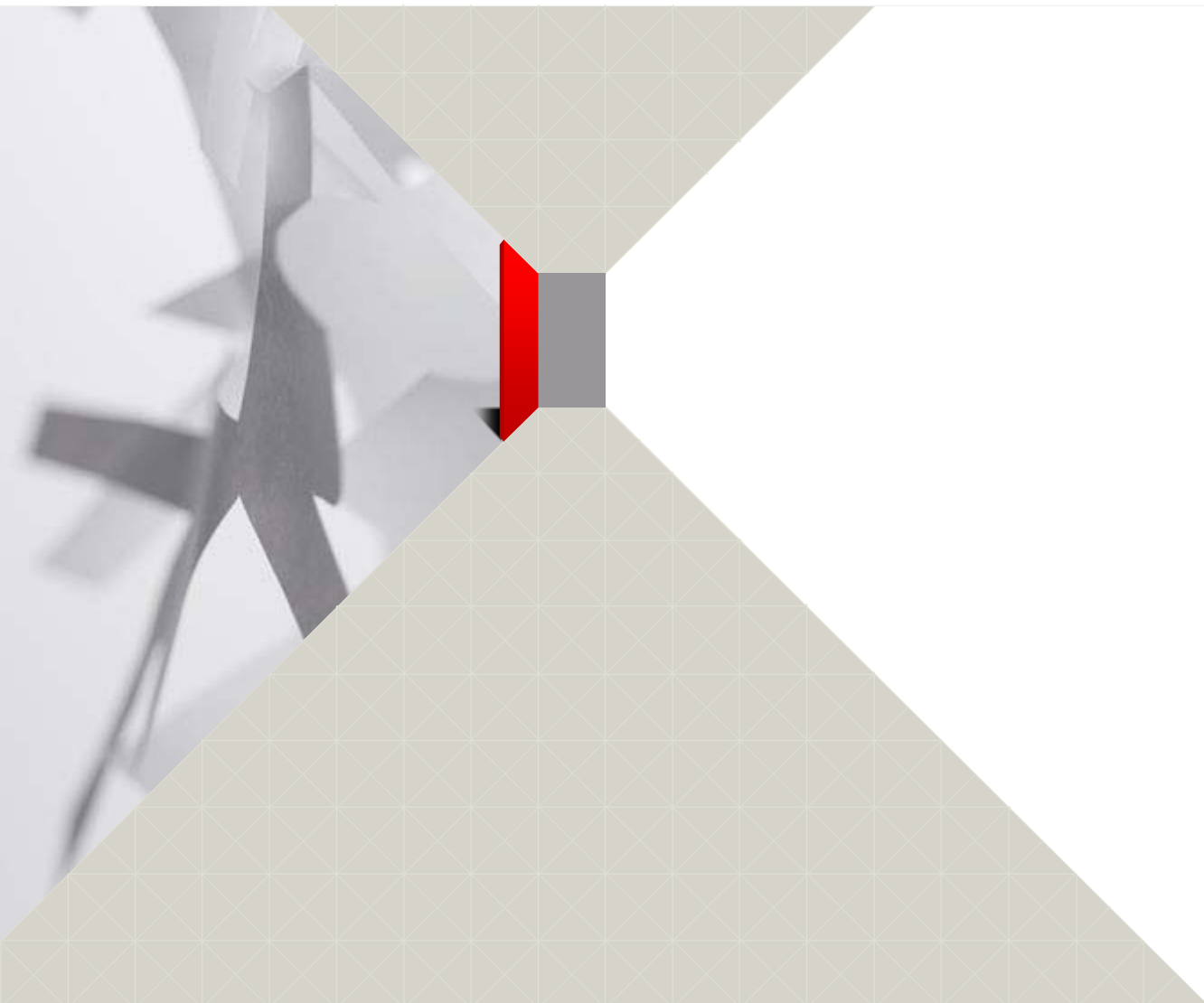
December – Strategy

India - Key Macro Economic Forecasts

- ▶ Snapshot of HSBC key Indian economic forecasts

HSBC Key Indian Economic Forecasts									
% Fiscal Year	2009/10	2010/11	2011/12	Apr-Jun 09	Jul-Sep 09	Oct-Dec 09	Jan-Mar 10	Apr-Jun 10	Jul-Sep 10
GDP	6.2	8.5	8.3	6.1	6.3	6.0	6.5	7.3	8.3
Agriculture	-4.0	7.3	2.3	2.4	-3.0	-9.0	-6.0	3.0	8.0
Industry	8.3	6.6	6.2	4.2	9.0	11.0	9.0	6.8	6.6
Services	8.2	9.4	10.3	7.8	7.4	8.6	9.0	8.5	8.8
Wholesale prices	3.4	6.6	5.1	0.6	1.0	4.0	7.5	7.3	7.0
Consumer prices*	11.2	8.1	6.0	8.9	11.5	12.0	12.0	11.5	8.0
Trade bal (% GDP)	-8.4	-9.3	-8.9	-	-	-	-	-	-
Current acc (% GDP)	-1.6	-2.0	-1.8	-	-	-	-	-	-
Budget bal (% GDP)	-6.9	-5.8	-4.9	-	-	-	-	-	-
Cash Reserve Ratio**	5.50	7.25	7.5	5.0	5.0	5.0	5.50	6.00	6.50
Reverse repo (%) **	3.50	5.0	5.5	3.25	3.25	3.25	3.50	3.75	4.25
Repo rate (%) **	5.0	6.5	7.0	4.75	4.75	4.75	5.0	5.25	5.75
10 year yield (%) **	7.6	8.0	7.5	7.1	7.0	7.3	7.6	8.3	8.3
INR/USD**	47.5	46.0	44.5	48.3	48.6	48.0	47.5	47.0	46.5

Source: HSBC. *Industrial Workers CPI. ** End-period rates



Equities

December – Strategy

Markets recover during November. Metals and Autos show strong outperformance

- ▶ Indian equity markets recovered during November and regained most of the lost ground from October. The BSE Sensex closed the month of November at 16926 (6.48% M-O-M) and the NSE Nifty closed the month at 5032 (6.81% M-O-M).
- ▶ Metals, Auto, Oil & Gas, Healthcare and Banking outperformed the main indices where as IT, Consumer Durables, Capital Goods and FMCG underperformed the main indices.

Index	Monthly Change	Index	Monthly Change
BSE METAL	16.87%	NSE NIFTY	6.81%
BSE AUTO	11.25%	BSE-MIDCAP I	6.67%
BSE OIL&GAS	8.99%	BSE-SMALLCAP	6.58%
BSE HEALTHCA	8.91%	BSE SENSEX	6.48%
BSE PSU	8.80%	CNX IT	6.25%
NSE MIDCAP	8.65%	BSE TECK	6.01%
BSE BANKEX	7.57%	BSE CONS DUR	4.22%
BSE IT	7.50%	BSE CAP GOOD	3.48%
NSE BANK NIF	7.21%	BSE FMCG	2.25%

Source - Reuters

December – Strategy

Global news flow and liquidity remain key for near term direction



Source - Reuters

December – Strategy

Stimulus measures to offset drought concerns. FIIs continue to buy Indian equities

- ▶ Recent months have witnessed a marked improvement in a number of Indian economic indicators and it is clear that the recovery has begun. However, the recovery faces the challenges of the country's 13th drought in the last sixty years. With agriculture now a smaller part of the economy (20% of total output), the GDP effect should be smaller than in the past. We also believe that the full impact of the various fiscal and monetary stimulus measures, many of which target the rural and urban poor, are slowly being felt and should offset the negative impact of the poor monsoons.
- ▶ With inflation now in the positive and food inflation at 15.6% (for the week ended Nov 14th), the RBI has been sounding more hawkish recently. Although there is a possibility of the RBI making it's first rate move this year, we expect the first CRR hike in January next year followed by repo and reverse repo rate hikes possibly in March. The lag impact of the earlier monetary policy measures will boost growth over the next few quarters.
- ▶ WPI data will now be released once a month. Food inflation came in at 15.6% for the week ended November 14th (Source: Reuters). We expect headline WPI inflation to rise sharply towards the end of this CY and early 2010 with an expectation of 8% by the end of this FY.

Institutional Activity:

- ▶ FIIs continued to be buyers of Indian equities in November. They bought \$1.17 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 are expected to drive FII flows in the near term.
- ▶ Domestic mutual funds continued to be net sellers in November but only marginally. Domestic MFs sold (\$102 mln) (Source: SEBI) of Indian equities during the month.

December – Strategy

Recent data releases point to recovery – Q2 GDP, IIP, PMI etc. surprise positively

- ▶ 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 6.7% (FY09) (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.
- ▶ India appears to be on the path to recovery evidenced by surprisingly strong Q2 GDP numbers of 7.9% (consensus market expectation was 6.3%) and 9.1% y-o-y IIP growth in September (consensus market expectation of 7.1%). We expect IIP growth to stabilise between 8-10% over the coming months.
- ▶ 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.
- ▶ Other than Q2 GDP figures, the following indicators appear to be pointing to an economic recovery already underway;
 - **Motor vehicle sales** have shown a strong improvement since February through November '09.
 - **Cement production** continues to show 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 54.5 in October with overall orders improving to 56.7. These numbers are marginally less than September. Export orders showed decent improvement and came in at 53.4 which is the highest level since August last year.
 - **Industrial Production** has recovered to 9.1% in September.

December – Strategy

India more resilient during global slowdown but pick up will not be as spectacular as others

- ▶ As expected, growth in India was more resilient during the downturn. But in the recovery, while growth is expected to be strong it will not be as spectacular as in other more cyclical markets. We believe the long term growth story remains intact with the following factors contributing to growth over the next few quarters;
 - **Commodity price collapse** resulted in 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 0.5% 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. FDI has picked up again after a couple of muted quarters.
 - **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 November 2008, the RBI has aggressively lowered the repo rate, reverse repo rate and Cash Reserve Ratio (CRR) as well as the SLR. Given inflation expectations going forward, RBI has been sounding more hawkish of late and in the last policy meet started by raising SLR by 1% to 25%. The lagged impact of the interest rate cuts should continue to be felt in the quarters ahead.

December – Strategy

GDP forecast for FY 10-11 revised upwards, we expect a pick up in the capex cycle soon

- ▶ We have an above-consensus GDP growth forecast of 8.5% for FY'10-11 led largely by an above-consensus investment growth forecast of 14% as we expect a pickup in the capex cycle at the turn of the calendar year.
- ▶ The financing for growth appears to be falling in place and capital issuance has a strong relationship with capex in the following year, and success in capital issuance bodes well for investment spend in FY'11.
 - Indian companies have raised INR528bn in equity and INR315bn in debt in the current fiscal, both excluding financial companies and is the second-highest level ever (Source: Bloomberg, HSBC).
- ▶ Interest rates are also a useful indicator of investment spending, and lending rates have softened by 150bps from their 2008 highs. Loan growth remains weak, but we believe it will pick up in the next two quarters.
- ▶ Private sector capex is likely to pick up, led by power, infrastructure and metals;
 - The power sector is likely to see a strong pick up and recent capital issuance by companies in this sector bodes well. The demand-supply mismatch is likely to persist despite added capacity.
 - The infrastructure space is also likely to see a pick up in investment spend and the government's attempts to clear some of the bureaucratic hurdles should enable meaningful order flow.
 - Given the high capacity utilisation and strong demand growth, the steel sector should also witness capex growth.
 - Cement is likely to be a laggard as capacity additions have outstripped demand growth although we expect demand growth to recover with the economy.

December – Strategy

We upgrade earnings expectations for FY'11 as we expect corporate earnings to improve

- ▶ With early signs that a global recovery appears underway, risk appetite has reemerged. India has been one of the best performing markets since mid March this year and has received its fair share of foreign fund flows.
- ▶ Historically, Indian companies' earnings have been among the least volatile among emerging markets. Overall leverage of Indian companies is low (average net debt/equity ratio of 0.45x). Q2 earnings reported were in line with market expectations and certain sectors like FMCG, Auto, and Banking reported results that were better than expected.
- ▶ Our expectations for Sensex companies are 8.2% EPS growth in FY'10 and 21.7% in FY'11. We expect growth to pick up going forward and corporate earnings to continue to show improvement.
- ▶ Strength in international commodity prices, increase in food prices (some related to the weak monsoon) and the pick up in growth means that the risk of monetary tightening is increasing; the RBI has indicated that India may be among the earliest to tighten policy. Our forecast is that the first policy move will be in the January - March 2010 quarter. For CY2010, we expect to see a 200 bps increase in CRR and a 125 bps rise in policy rates.
- ▶ 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.
- ▶ At 16926, current valuations of the Indian market are slightly stretched and with the risk of monetary tightening, India may lag peers in the Asia Pacific region.

December – Strategy

Equity markets “slightly stretched”; continue rebalancing towards target equity allocation

- ▶ 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 and liquidity flows.
- ▶ Based on historical trends, equity valuations are slightly stretched on a trailing basis but reasonable on a forward basis. At 16926 (Sensex at November end), India trades at a P/E of 18.4X FY10e and 15.1X FY11e (HSBC estimates).
- ▶ 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. For clients with under allocation to equity, we still recommend an SIP or quasi SIP approach over the next few months as we expect markets to consolidate. Sharp corrections could be viewed as good buying opportunities to rebalance under allocated portfolios more aggressively.
- ▶ For clients that are over exposed to Indian equity, we suggest bringing equity allocation back to strategic allocation. We still believe equity markets will be higher 12 months from now and recommend only reducing over exposure at this time.
- ▶ 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 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, industrials and consumer staples as our key overweights that play the pick up in the domestic economy. We also favour IT as a play on the pick up in the US economy. Our key underweight sectors are healthcare and materials. Our sector views follow.

December– Strategy

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

- ▶ **Financials** – Overweight – Current valuations and higher growth prospects in a scenario of economic recovery make us overweight Private sector banks. We are neutral PSU banks as rising bond yields are a risk to outlook. Banks stand to benefit from rising rates as economic activity picks up and expect loan demand to rise while RBI tightens rates, leading to increased pricing power for banks.
- ▶ **Industrials** – Overweight – We expect capex in this sector to be primarily investment related and should be a key beneficiary of the pick up in private or government investment spending. We expect outlook to improve in FY2011. Capital goods remains a strong growth story in India and we prefer long capex cycle companies.
- ▶ **Information Technology** – Overweight – Absolute returns may be limited but the sector may outperform on account of operational resilience, cash flow generation and upside growth surprises in the US. We maintain overweight stance on the sector and like the companies positioned to benefit from the recovery in the BFSI space. Currency appreciation a risk.
- ▶ **Consumer Staples** – Overweight – Defensive in nature, adds stability to portfolio and is a longer term play on growth in consumption. Valuations relative to the market, no longer at a significant premium compared to history.
- ▶ **Telecom** – Neutral - Increasing penetration and consumer spending remain strong growth drivers for the sector. However, as recent changes in competitive scenario and increased possibility of changes in regulations may impact profitability, we maintain our neutral rating on the sector.
- ▶ **Energy** – Neutral – Environment is 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 fair.

December – Strategy

Neutral – Utilities, Consumer Discretionary, Real Estate; Underweight – Materials, Healthcare

- ▶ **Utilities** – Neutral – Generation capacity being increased, but shortfall remains. We rate the sector as neutral given that valuations are at a premium but risks and rewards are balanced.
- ▶ **Consumer Discretionary** – Neutral - Autos should benefit from the revival in urban demand. Improving outlook and significant earning revisions mean growth prospects priced in after recent strong performance. We are neutral autos. Although valuations are high, we are neutral the retail sub sector with signs of improvement in the macro outlook.
- ▶ **Real Estate** - Neutral - Balance sheet strength of most large players following the recent fund raising has improved. Demand conditions seem to be recovering in the residential sector though commercial demand may take longer to recover. With the improving outlook for property prices, we remain neutral the sector.
- ▶ **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 expect Indian steel demand to pick up and with it utilisation rates and pricing should improve. Current valuations though largely reflect the positive outlook. The immediate risk of cheaper imports does exist which we expect to subside by Q1 2010 during which time the stocks could underperform. Suggest awaiting better entry valuations.
- ▶ **Healthcare** – Underweight – The competitive landscape in the healthcare sector is strong and recent news flow has been negative. Defensive in nature but valuations are at a premium to the market. We maintain our underweight rating on the sector.

December – Strategy

Derivatives parameters show lack of conviction for further upside

Equity Derivatives:

- ▶ Nifty near month future gained 6.8% during the month of November
- ▶ Open Interest for Nifty future was down by 6.5%
- ▶ Bank Nifty near month future gained by 7%
- ▶ Open Interest for Bank Nifty future was up by 8.5 %
- ▶ CNX IT near month future gained 6.82%
- ▶ CNX IT futures open interest was up by 43% though on small base

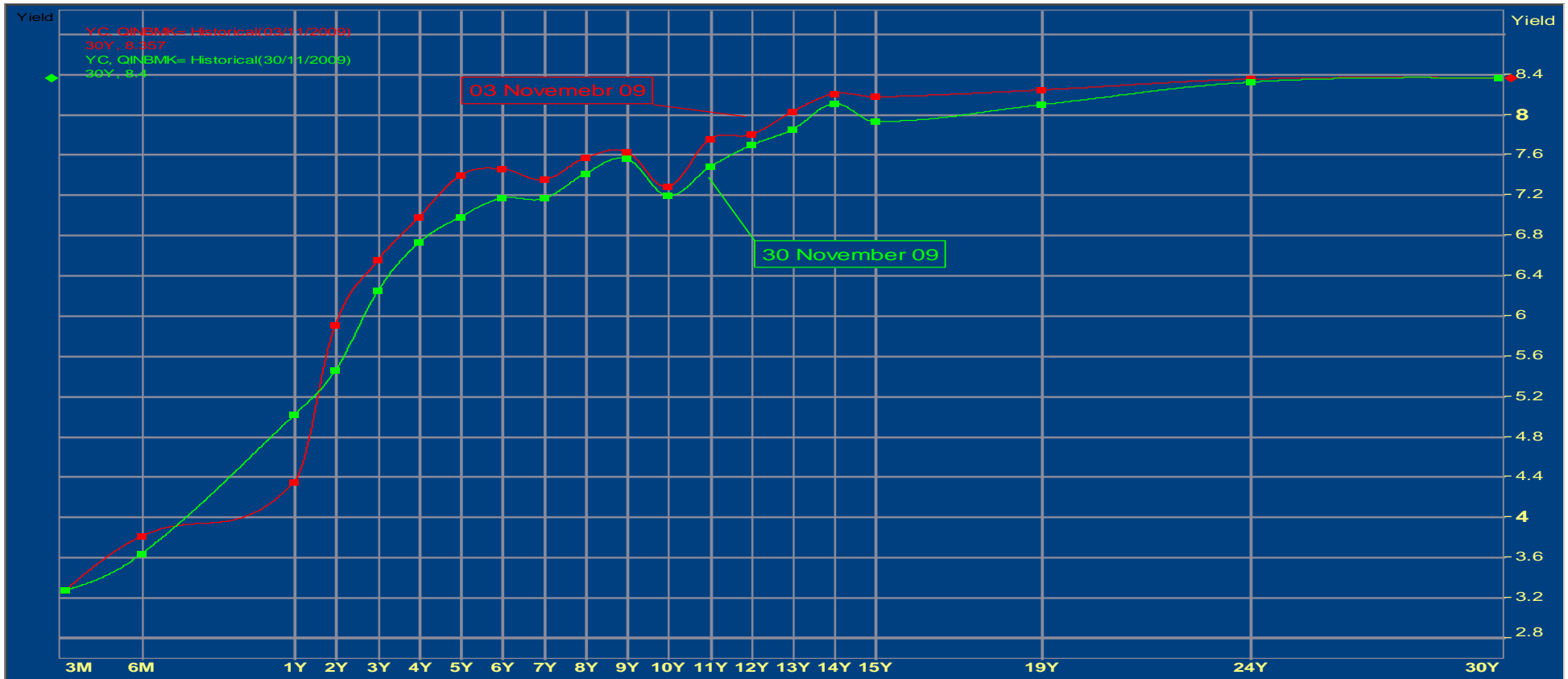
Source – Reuters



Fixed Income

December – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- The sovereign yield curve eased on maturities over one year while the shorter end showed signs of firming up. This mainly reduced the steepness of the curve partially. The amounts placed by banks with the central bank continued to be close to Rs.1000 bn which has been the phenomenon for some time. We expect liquidity to gradually reduce as we move towards the end of the financial year.
- We expect that volatility on both gilts and corporate bonds will be elevated as investors search for value across the curve with selling pressure on news of any withdrawal of liquidity, or higher inflationary expectations.

December – Strategy

Liquidity to keep yields range bound; 2Q GDP numbers / high food Inflation may trigger reduction in liquidity / rate increases

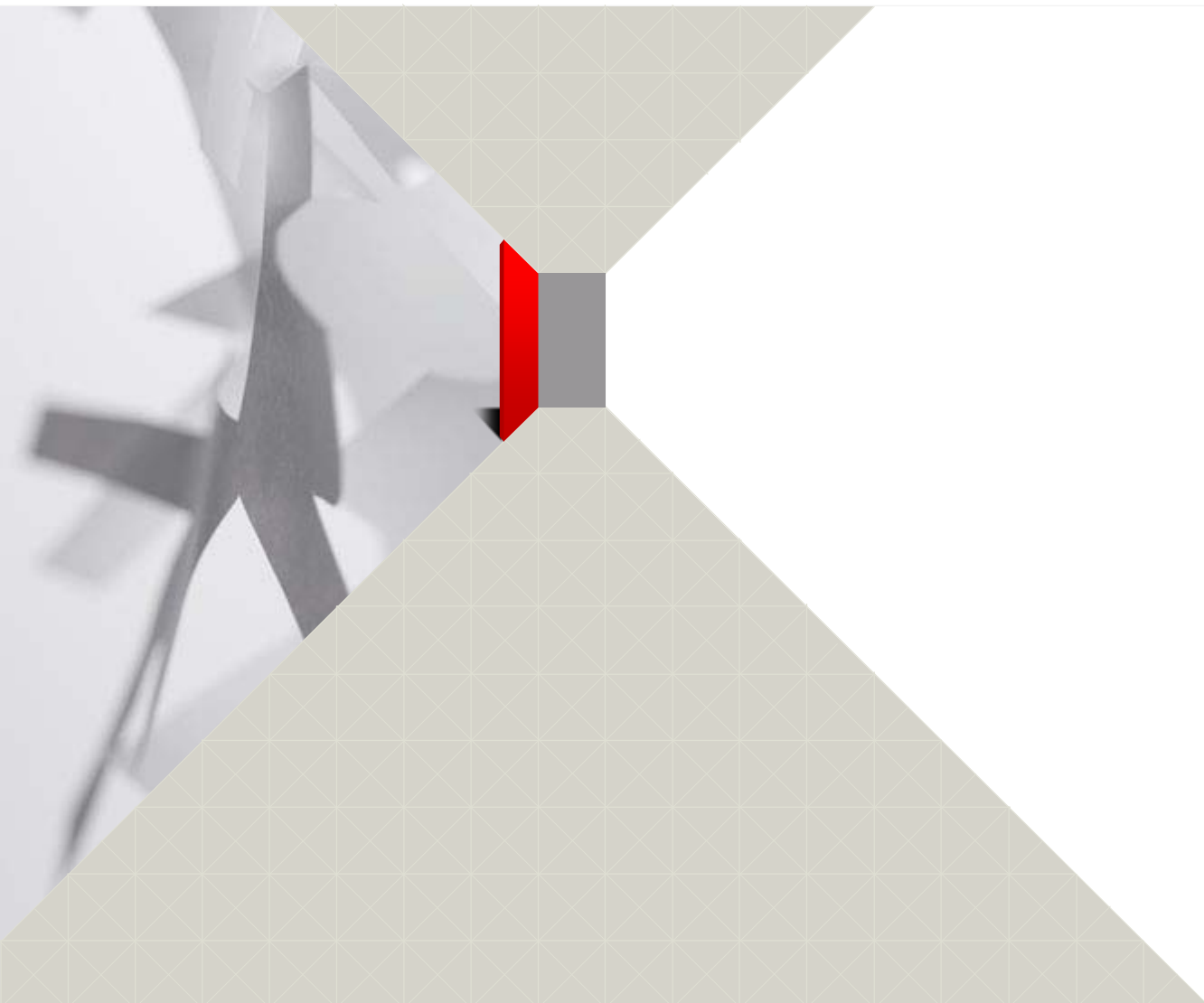
Fixed Income:

- ▶ Liquidity continued to be easy in the month of November. The average Mumbai Inter Bank Offer Rate for the month remained flat at 3.29% in comparison to 3.33% for the previous month. The outstanding amounts lent in reverse repo on 30th November '09 was Rs.886 bln as against Rs.846 bln on 30th October '09 (Source: NSE/ RBI website).
- ▶ The latest inflation number has seen a further increase in food inflation which has risen to 15.6% as on November 14th as compared to 14.6% in the previous week. The expectations within policy makers are that this would moderate by the end of the year.
- ▶ We expect the headline WPI inflation rate to reach 8% by March next year as the full impact of the commodity price rises feed through. Consumer price inflation has proved remarkably stubborn but we wouldn't be surprised if it is close to peaking.
- ▶ The huge upside surprise in the quarterly (July- September) GDP numbers will no doubt make RBI sit up and take notice and raises the possibility of the RBI raising CRR at least before the end of the CY. We are sticking to the view that the first move will come in Q1 2010 with a CRR hike in January 2010 followed by the first repo and reverse repo rate hike possibly in March 2010. We now expect 200 bps of CRR increases and 125 bps of policy rate rises in CY 2010.

December – Strategy

Volatility may remain as investors search for better yields. Suggest sticking to the short end of the curve

- ▶ We expect volatility in the bond markets across the curve and have a negative view on rates over the longer term. Hence, we continue to recommend conservative and medium risk investors to invest into a mix of debt schemes with six to eight month maturities. One can selectively start investing into fixed maturity plans with tenures in the one to two year bucket with double indexations to improve yields on portfolios besides the alternative strategies through hybrid schemes.
- ▶ We expect short end yields to remain benign over the next couple of months. Hence, ultra short term bond funds with low durations, double indexation fixed maturity plans along with some allocations to hybrid schemes or funds that have higher yield to maturity portfolios may provide a good risk reward trade off in the near term.
- ▶ We believe that longer end yields may move in a trading range with possibilities of rallies. The rallies would be led by increased inward fund flows and liquidity in the system searching for yields. However, volatility may be seen in case of any central bank policy action to stem rising inflationary expectations.



Currencies

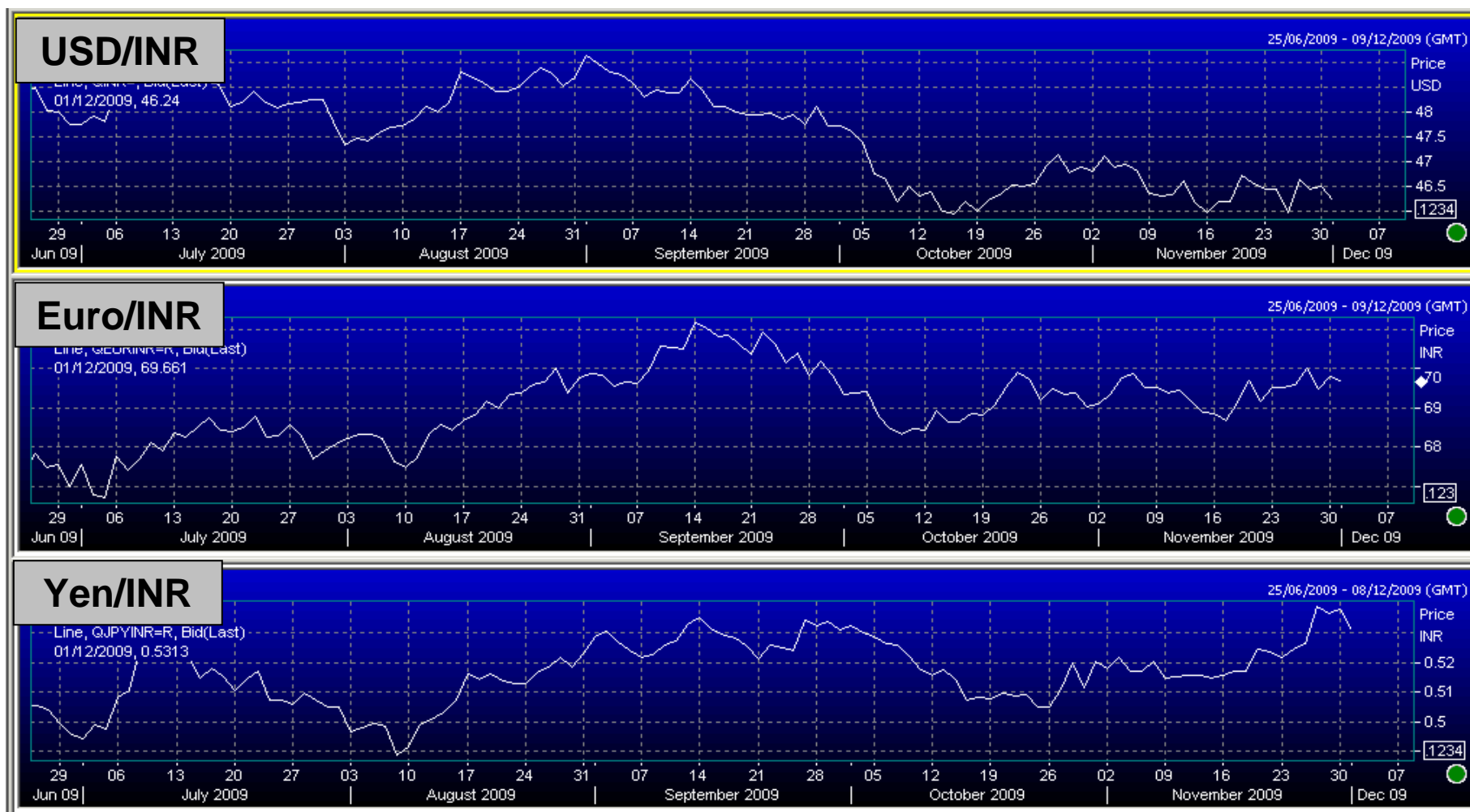
December – Strategy

USD long term outlook neutral. Positive EM currencies with strong fundamentals

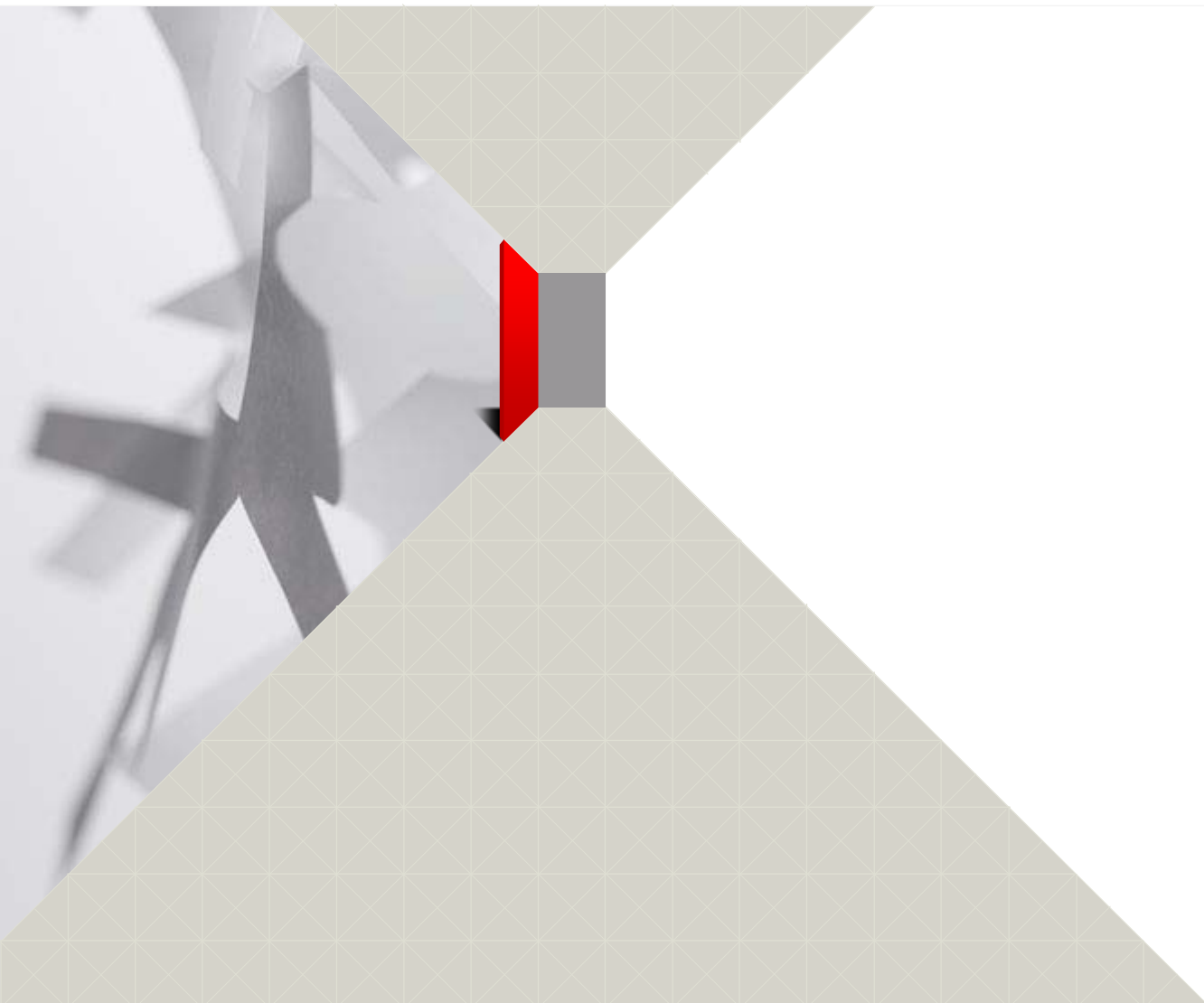
- ▶ **INR** - The INR remained in a narrow range during November and closed the month at 46.51 against the USD (Source: Reuters). Going forward, we expect INR to strengthen marginally on account of a narrowing current account deficit and capital inflows. Our Dec 2010 target for INR stands at 46.5, while that for Dec 2011 stands at 44.5 against the USD.
- ▶ **USD** - While we expect the US dollar to remain under pressure in the short term, our long-term outlook remains neutral. We continue to believe that, going forward, improvements in the economy will have a less negative impact on the dollar due to monetary policy expectations. As a consequence, we believe USD will find support, although it may take some time for this to materialise. We also remain of the view that in the event of a negative turn in economic releases, equity markets or increased risk aversion, the dollar's role as a safe haven may resurface.
- ▶ **GBP** - We continue to expect a period of sideways trading for the GBP as further gains appear unlikely.
- ▶ **EURO** – The Euro is one of the primary beneficiaries of the USD weakness in the short term, however in the long term, we expect USD to find support as policy decisions favour USD.
- ▶ **JPY** - Improving market sentiment and returning risk appetite will likely lead to weakening JPY in the long term, as investors seek yield elsewhere.
- ▶ **Emerging Markets** - We highlight our positive view on EM currencies with strong economic fundamentals, which we believe will continue to appreciate against the US dollar as they attract yield hungry investors

December – Strategy

Currency movements....



Source - Reuters



Commodities

December – Strategy

The improving global economy should provide support to commodities

We maintain our neutral with a positive bias view for commodities overall, as we believe the developing global economic recovery should be supportive of rising prices in line with growing demand and renewed investor risk appetite.

- ▶ **Gold:** Gold gained during November and closed the month at US\$1178 (Source: Reuters). With momentum firmly against the US dollar, we believe gold prices will continue to find support in the short term and have therefore upgraded our short-term view to neutral with a positive bias. Nonetheless, we believe the upside to gold prices is limited, and maintain our neutral outlook for the long term. We also remain of the view that in the event of a negative turn in economic releases, equity markets or increased risk aversion, the dollar's role as a safe haven may resurface.
- ▶ **Oil:** Light crude oil remained range bound and closed the month of November flat at \$77/bbl (Source: Reuters). Over the next 12 months, we expect oil prices to rise as demand from Emerging Markets is likely to compensate for the decline in demand from developed countries, while rather inelastic supply and limited alternatives should provide further support to oil prices. In addition, it appears that current USD weakness is outweighing the oversupply issue as oil prices have broken out of their long-lasting trading range. We have consequently upgraded our short-term view to neutral with a positive bias.
- ▶ **Industrial Metals:** With the global recovery taking hold, we believe that industrial metals will find support going forward. Industrial metals are also likely to be supported by the stimulus packages' focus on infrastructure, particularly in China and the US.

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