

India Strategy
February 2010

February – Strategy

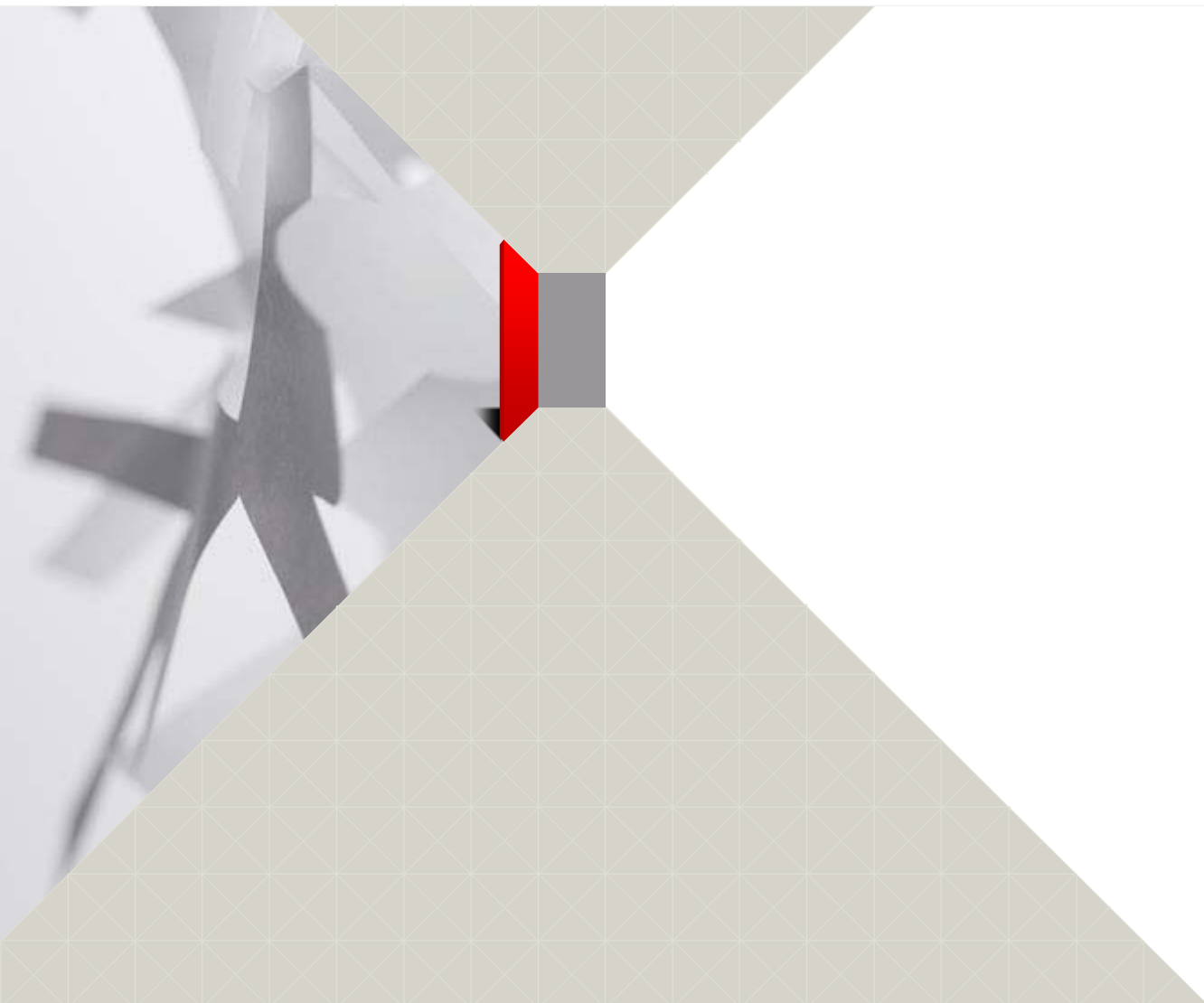
India - Key Macro Economic Forecasts

- ▶ Snapshot of HSBC key Indian economic forecasts

HSBC Key Indian Economic Forecasts

% Fiscal Year	2009/10	2010/11	2011/12	Jul-Sep 09	Oct-Dec 09	Jan-Mar 10	Apr-Jun 10	Jul-Sep 10	Oct-Dec 10
GDP	7.2	8.5	8.3	7.9	7.7	7.2	7.9	7.1	9.1
Agriculture	-3.0	7.1	2.7	0.9	-7.0	-5.8	2.8	5.0	11.0
Industry	8.3	6.9	6.3	9.0	11.0	9.0	7.0	6.8	7.3
Services	9.4	9.5	10.2	9.0	10.7	10.0	9.5	7.5	10.0
Wholesale prices	3.6	7.7	5.1	-0.1	4.5	9.3	9.5	8.5	7.0
Consumer prices*	11.2	8.1	6.0	11.8	11.8	12.5	11.5	8.0	7.0
Trade bal (% GDP)	-8.2	-9.0	-8.3	-	-	-	-	-	-
Current acc (% GDP)	-1.0	-2.0	-1.7	-	-	-	-	-	-
Budget bal (% GDP)	-6.9	-5.8	-4.9	-	-	-	-	-	-
Cash Reserve Ratio**	5.50	7.25	7.5	5.0	5.0	5.50	6.00	6.50	7.0
Reverse repo (%) **	3.50	5.0	5.5	3.25	3.25	3.50	3.75	4.25	4.75
Repo rate (%) **	5.0	6.5	7.0	4.75	4.75	5.0	5.25	5.75	6.25
10 year yield (%) **	7.8	8.4	7.8	7.0	7.6	7.8	8.0	8.2	8.3
INR/USD**	48.0	46.0	44.5	48.1	46.5	48.0	47.5	47.0	46.5

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



Equities

February – Strategy

Markets correct during January led by Metals, Cap Goods and Autos as underperformers

- ▶ Indian equity markets corrected during January. The BSE Sensex closed the month of January at 16357(-6.34% M-O-M) and the NSE Nifty closed the month at 4882 (-6.13% M-O-M).
- ▶ Consumer Durables, PSU, FMCG, IT and Banking outperformed the main indices where as Metals, Capital Goods and Auto underperformed the main indices.

Index	Monthly Change	Index	Monthly Change
BSE CONS DUR	0.37%	BSE IT	-4.02%
BSE PSU	-0.61%	NSE BANK NIF	-4.19%
BSE-SMALLCAP	-1.49%	BSE HEALTHCA	-5.05%
BSE FMCG	-2.37%	BSE OIL&GAS	-5.08%
BSE-MIDCAP I	-3.10%	NSE NIFTY	-6.13%
NSE MIDCAP	-3.11%	BSE SENSEX	-6.34%
BSE BANKEX	-3.76%	BSE AUTO	-6.49%
BSE TECK	-3.82%	BSE CAP GOOD	-7.02%
CNX IT	-3.85%	BSE METAL	-8.26%

Source - Reuters

February – Strategy

FII fund flows to determine market direction. Consolidation could continue



Source - Reuters

February – Strategy

Stimulus measures to offset drought concerns. FIIs turn net sellers of Indian equities

- ▶ Recent months have witnessed a marked improvement in a number of Indian economic indicators and it is clear that the recovery is underway. 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 being felt and should offset the negative impact of the poor monsoons.
- ▶ With inflation now firmly in the positive with December WPI coming in at 7.31% and food inflation at 17.56% (for the week ended Jan 23rd), the RBI has been sounding hawkish. As expected, the first CRR hike came in the January policy meet and we expect this to be 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.
- ▶ We expect headline WPI inflation to continue to rise with an expectation of 10% by March and then taper off.

Institutional Activity:

- ▶ FIIs continued to be buyers of Indian equities in the first part of January but turned net sellers in the second half of the month. They net sold (\$94 mln) (Source: SEBI) of Indian equities during the month. Global allocation to risk assets will be key to providing market direction in the near term. Global cues are expected to drive FII flows in the near term.
- ▶ Domestic mutual funds continued to be net sellers in January. Domestic MFs net sold (\$276 mln) (Source: SEBI) of Indian equities during the month.

February – 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% and 11.7% y-o-y IIP growth in November (well above consensus market expectation of 10%). We expect IIP growth to stabilise 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 2010.
- ▶ Other than Q2 GDP figures, the following indicators continue to be point to an economic recovery already underway;
 - **Motor vehicle sales** have shown a strong improvement since February through January '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 January 2009 low of 44.4 it has bounced to cycle high of 57.6 in January. New export orders showed significant improvement and came in at 59.8 suggesting that external demand is playing a part in output gains.
 - **Industrial Production** has recovered to 11.7% in November.

February – Strategy

GDP forecast for FY'09-10 revised upwards, we expect a pick up in the capex cycle soon

- ▶ We have revised upwards our GDP forecast for FY' 09-10 to 7.2% and 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 going forward.
- ▶ 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 (as at Dec end), 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 and are already seeing signs with bank credit growth at 13.9% (week ended Jan 15th) up from 10% levels in Oct – Nov 2009 (Source: Bloomberg).
- ▶ 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 a laggard as capacity additions have outstripped demand growth although we expect demand growth to recover with the economy.

February – Strategy

We expect corporate earnings to improve over the next few Qs

- ▶ With signs that a global recovery appears underway, risk appetite reemerged through CY 2009 and India has been one of the best performing markets since mid March 2009 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). Q3 earnings reported so far have been in line with market expectations and certain sectors like FMCG, Metals, 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 monetary tightening will continue after the RBI raised CRR by 75 bps at the January 29th policy meet. Our forecast is that this liquidity tightening measure will be followed by repo and reverse repo hikes probably in March. For CY2010, we expect to see another 125 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.
- ▶ After the recent correction, at 16357, current valuations of the Indian market are more reasonable but with the risk of policy rates being hiked in the near term, India may lag peers in the Asia Pacific region.

February – Strategy

Equity markets expected to consolidate; buy on dips

- ▶ We continue to remain positive about Indian equities over the longer term, but near term market movement is likely to depend not only on global news flows and liquidity flows but also on budget expectations.
- ▶ Based on historical trends, equity valuations are slightly stretched on a trailing basis but reasonable on a forward basis. At 16357 (Sensex at January end), India trades at a P/E of 17.8X FY10e and 14.6X FY11e (HSBC estimates).
- ▶ Given ample liquidity amongst most institutional, HNI and retail investors, support for the market at lower levels appears likely although IPOs and FPOs lined up could absorb some of this liquidity as well.
- ▶ 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. Investors with “growth” and “balanced” risk profiles can look to add exposure to flexicaps in this environment.
- ▶ 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 sector is healthcare.. Our sector views follow.

February– 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 our 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 but one needs to be selective.
- ▶ **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 2010, but capacity additions over the next 12-18 months will help. We maintain our neutral rating on the sector as valuations are fair.

February – 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 with the recovery in 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 to improve. Current valuations though largely reflect the positive outlook. The immediate risk of cheaper imports does exist which we expect to subside during this quarter at 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.

February – Strategy

Market likely to face resistance on rallies

Equity Derivatives:

- ▶ Nifty near month future lost 6.51% during the month of January
- ▶ Open Interest for Nifty future was up by 36%.
- ▶ Bank Nifty near month future fell by 4.32%
- ▶ Open Interest for Bank Nifty future was up by 21 %
- ▶ CNX IT near month future fell by 3.99%
- ▶ CNX IT futures open interest was up by 7% though on a small base

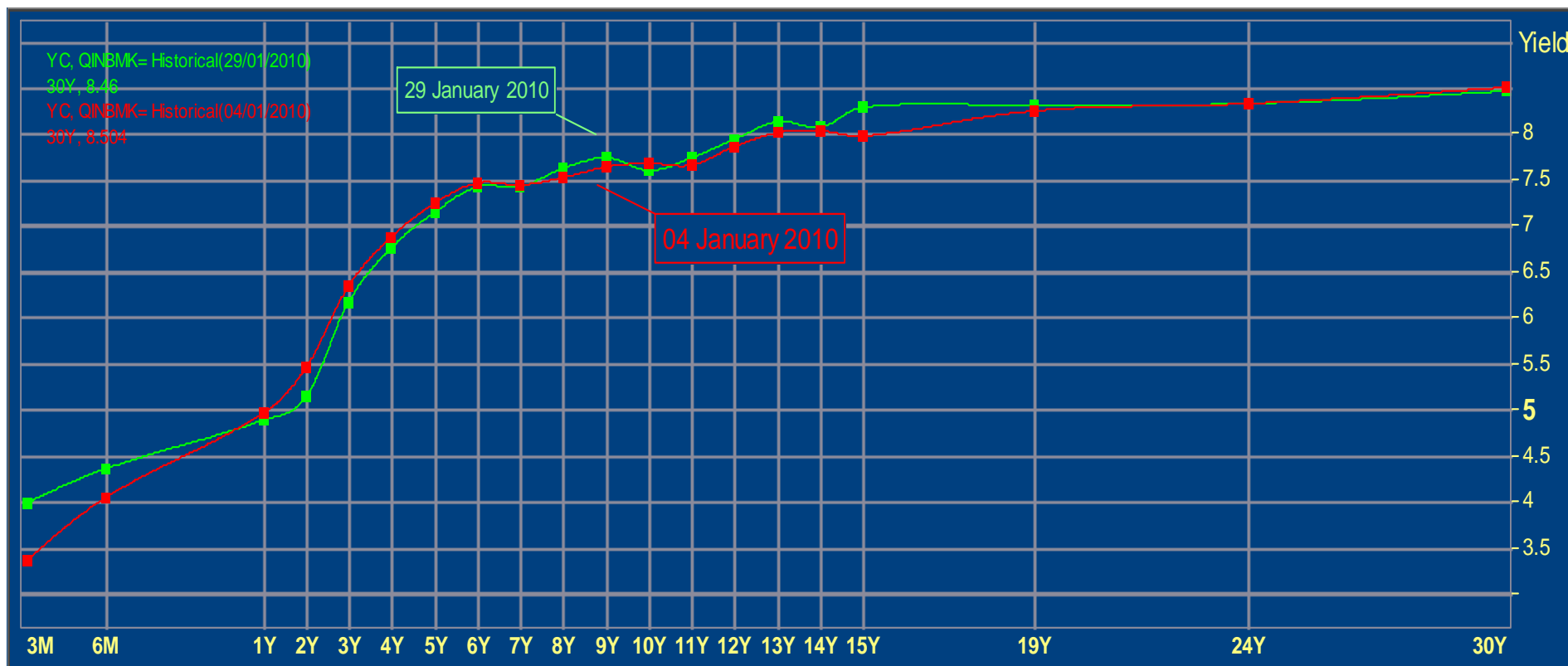
Source – Reuters



Fixed Income

February – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- The sovereign yield curve has marginally moved up at the shorter end post the credit policy. The amounts placed by banks with the central bank has continued to be over INR 500 bn. We expect the liquidity to gradually reduce as we move towards the end of the financial year.
- The Central Bank in its policy raised CRR by 75 bps which was above consensus expectations of 50 bps. There were no changes made to the repo and reverse repo rates. We continue to recommend low durations in portfolios and look to use multiple value strategies for improving fixed income yields.

February – Strategy

Shorter term yields likely to harden with lower liquidity post increase in CRR

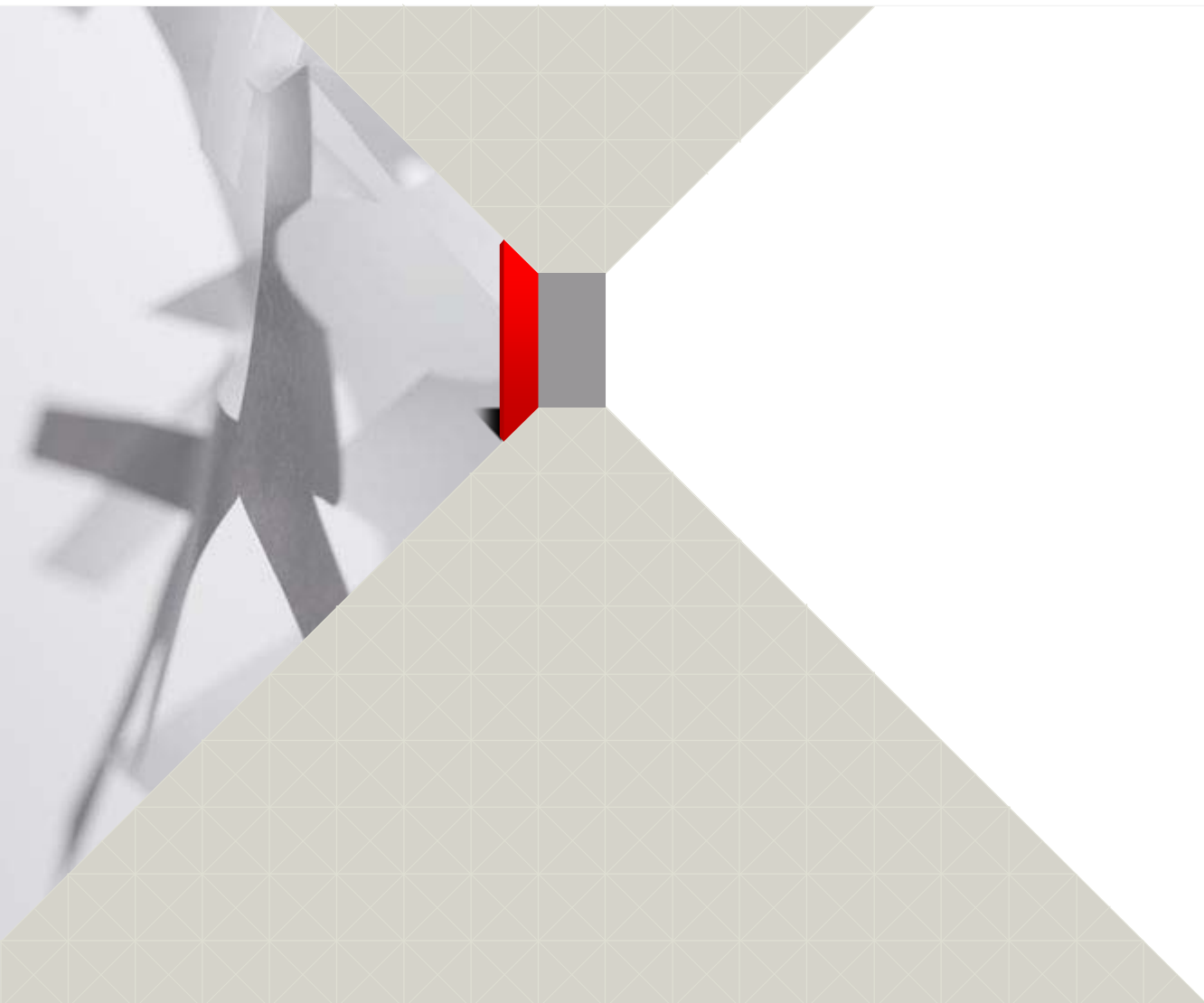
Fixed Income:

- ▶ Liquidity continued to be easy in the month of January. The average Mumbai Inter Bank Offer Rate for the month remained flat at 3.32% in comparison to the previous month. The outstanding amounts lent in reverse repo on 31st January '10 was Rs.886 bln as against Rs.436 bln on 31st December '09 (Source: NSE/ RBI website).
- ▶ The latest inflation number remains at elevated levels with food inflation at 17.4% as on January 16th as compared to 16.81% in the previous week. The WPI rose by 7.31% in December as compared to 4.78% in November.
- ▶ We expect the headline WPI inflation rate to reach 10% by March this year as the full impact of the commodity price rises feed through but expect it to taper off from there. Consumer price inflation has proved remarkably stubborn but we wouldn't be surprised if it is close to peaking.
- ▶ The RBI in it's 3rd Q review of monetary policy raised CRR by 75 bps as against a consensus expectation of 50 bps. The policy rates were left unchanged. They revised upwards the WPI forecast for March '10 to 8.5% and credit growth projections were revised downwards to 16% from an earlier projection of 18%. The policy highlighted the fact that the policy orientation has now shifted from managing the crisis to managing the recovery with increasing focus of withdrawing the excess liquidity in the system.
- ▶ We are sticking to the view that the first repo and reverse repo rate hikes will come in March 2010. We expect another 125 bps of CRR increases and 125 bps of policy rate rises in CY 2010.

February – Strategy

Unfavourable macro conditions to push yields up with the longer end getting impacted less

- ▶ We expect volatility in the bond markets across the curve as shorter term yields get re-priced with the exit of liquidity. We have a negative view on short term rates. The longer end will bear some impact though a large part of the same is already reflected in the yields. We continue to recommend conservative and medium risk investors to invest into a mix of debt schemes with six to eight month maturities that will be quick to reflect the increasing rates or longer dated instruments with favourable risk reward ratios.
- ▶ 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 or schemes that would take advantage of the steepness in the yield curve.



Currencies

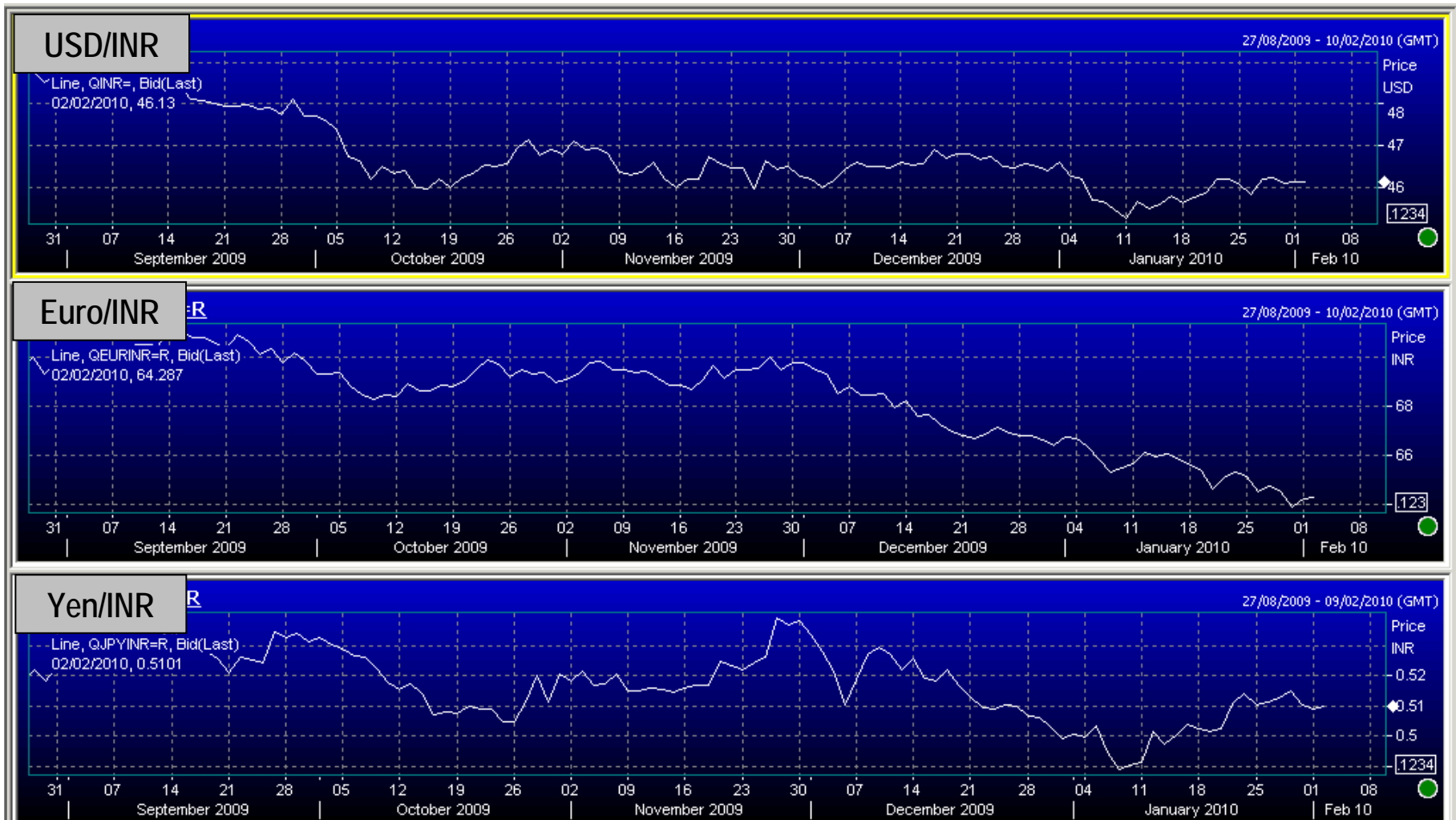
February – Strategy

The USD appears to have reversed its downward trend

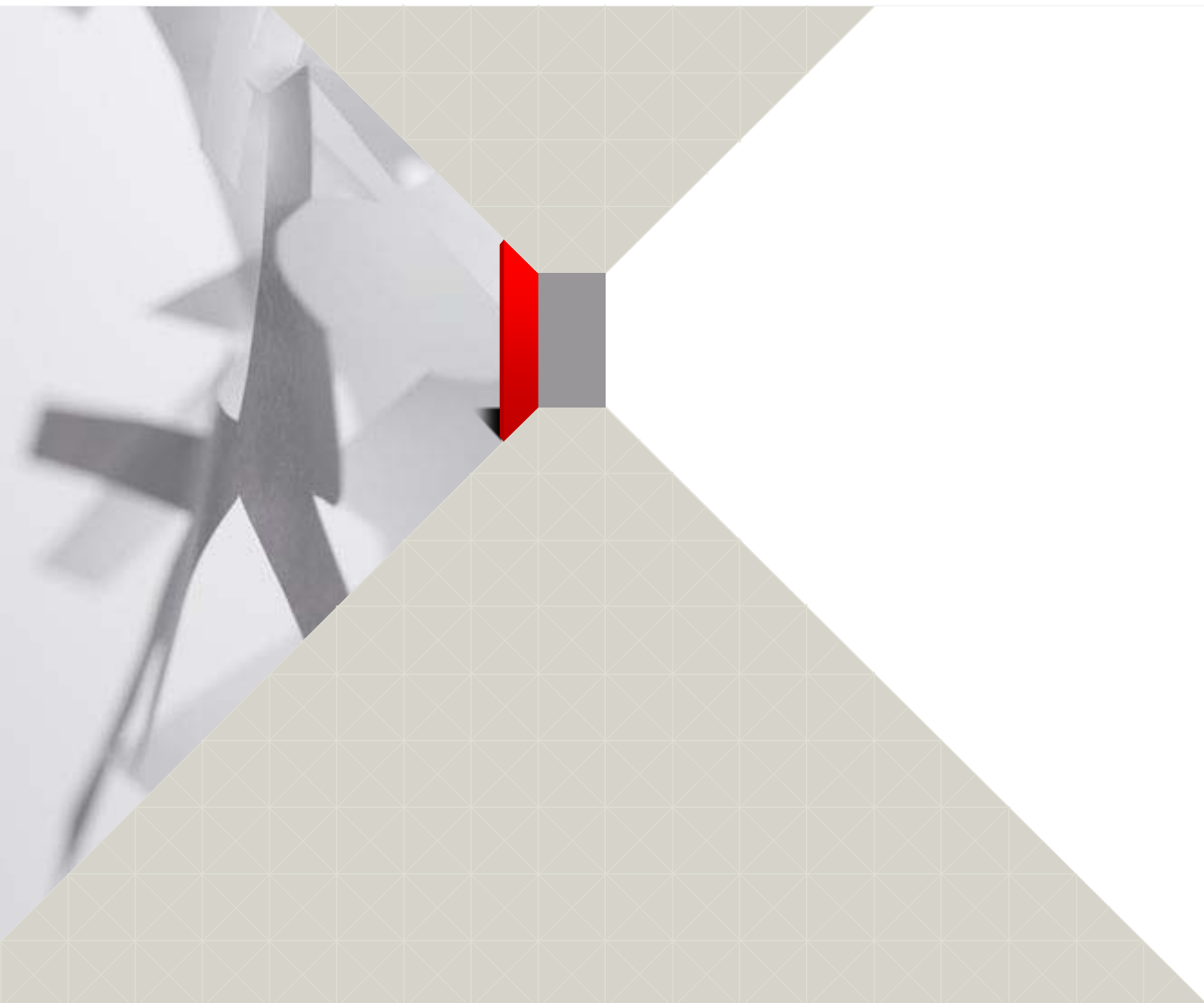
- ▶ **INR** - The INR remained in a choppy range during January and closed the month at 46.17 against the USD (Source: Reuters). Going forward, we expect INR to remain range-bound on account of a narrowing current account deficit and capital inflows. Our December '10 target for INR stands at 46.5, while that for December '11 is 44.5 against the USD.
- ▶ **USD** - The US dollar appears to have reversed its course, and started recovering from its long weakening trend against major currencies. The “high risk appetite = weak dollar” theme that drove market movements in past months seems to have faded. Rather, the focus is now on the positive economic data flow from the US which may accelerate the Federal Reserve's exit strategies and is thus providing support for the dollar. We have therefore upgraded our short-term view on the dollar.
- ▶ **GBP** - We continue to expect a period of sideways trading for GBP as further gains appear unlikely.
- ▶ **EURO** – We have downgraded our view on the Euro, which remains under pressure due to sovereign debt concerns in Greece, Portugal and Ireland, weighing on the Euro's credibility. USD showing signs of strength, we have downgraded our outlook for the Euro, which appears plagued by bad news
- ▶ **JPY** – Continued economic weakness, coupled with low yields on JPY investments and high government deficits are likely to lead to weakening JPY.
- ▶ **Emerging Markets** - We maintain our positive view on EM currencies, which we believe will continue to appreciate against the US dollar and particularly the Euro, although we are more selective in our choices.

February – Strategy

Currency movements....



Source - Reuters



Commodities

February – Strategy

The improving global economy should provide support to commodities

We believe the developing global economic recovery should continue to provide support to rising prices in line with growing demand and investor interest. Emerging markets are responsible for a large share of marginal demand growth for many commodities, and healthy EM growth should therefore provide longer-term support.

- ▶ **Gold:** Gold corrected during January and closed the month at US\$1079 (Source: Reuters). Many commodities had attracted investors in light of the weakening USD, but with the dollar appreciating since December, this support appears to have weakened, particularly for gold. Consequently, we have downgraded our short-term view on gold, which we believe is likely to remain under pressure for the time being. In the long term, we believe gold prices will remain muted.
- ▶ **Oil:** Light crude oil gained some ground during the month of January and closed the month at \$72.89/bbl (Source: Reuters). While we expect oil demand from emerging markets to continue to rise, the potential for increased supply, coupled to high inventories of oil should limit upward price momentum in the short term.
- ▶ **Agricultural Commodities and Industrial Metals:** With the global recovery taking hold, we believe that both agricultural commodities – which have thus far not benefitted much from the upward momentum – and 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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