

India Strategy

January 2010

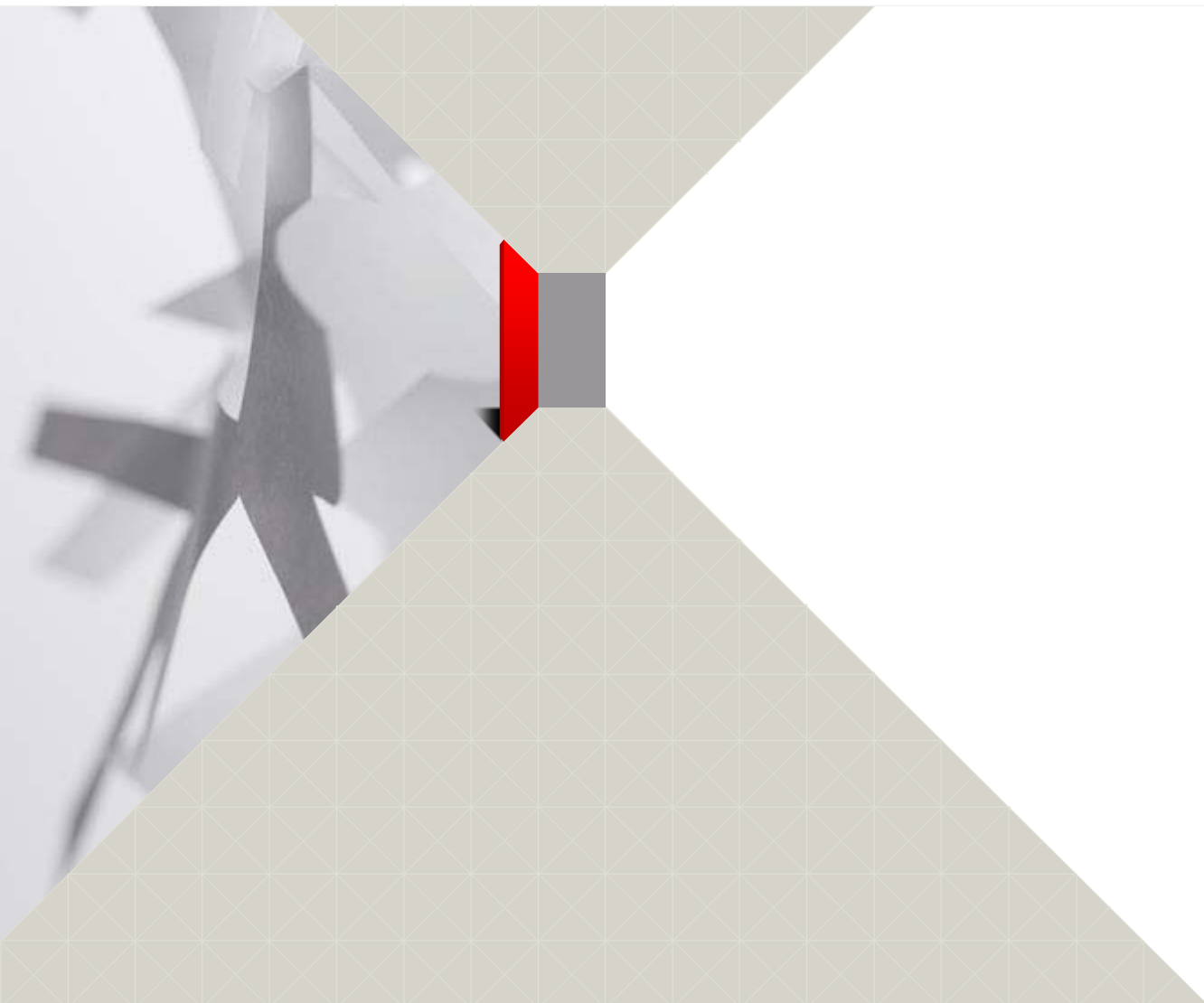
January – Strategy

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

January – Strategy

FII inflows support market rally in December. Small Caps, IT and Consumer Durables shine

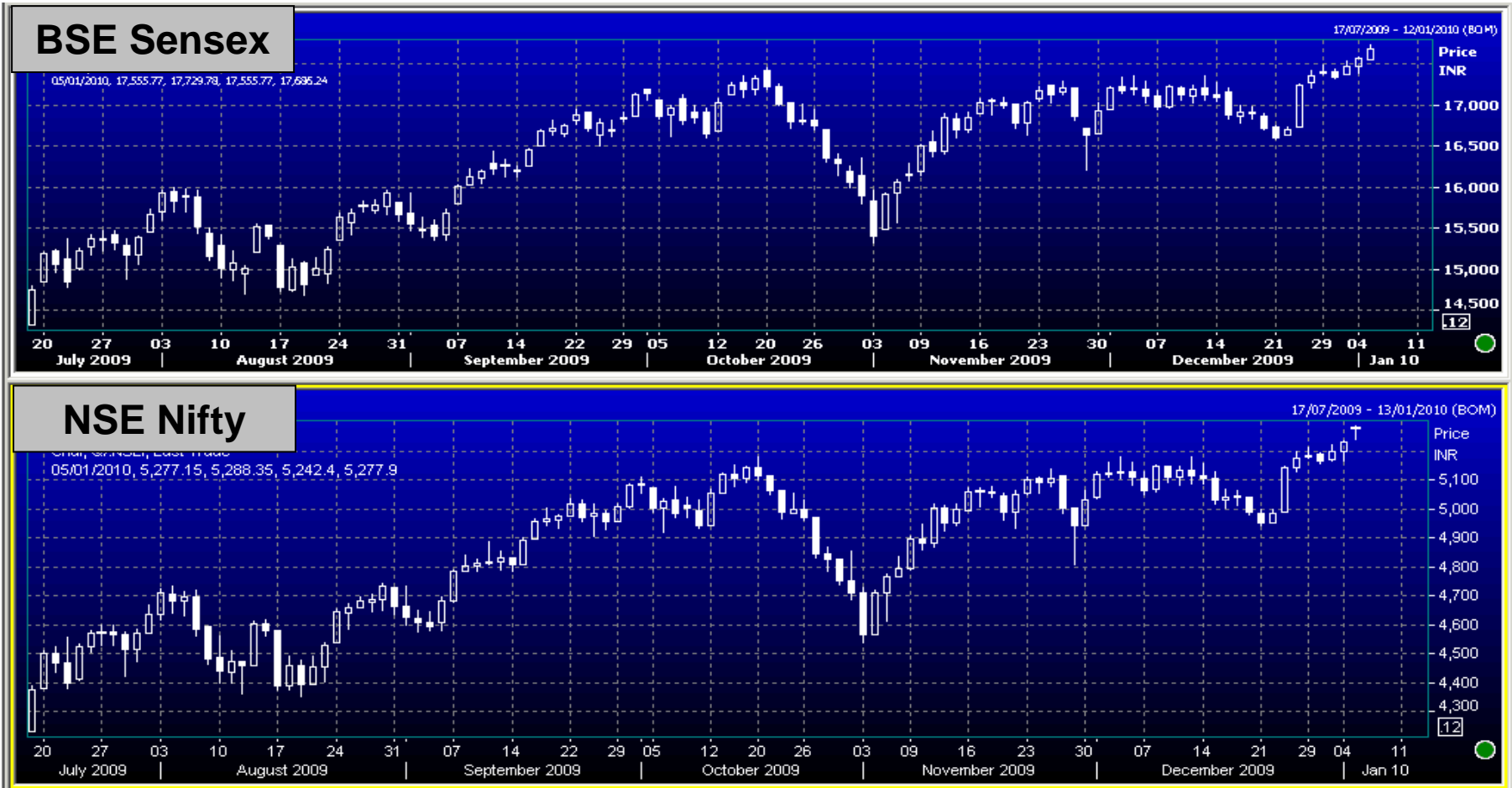
- ▶ Indian equity markets rally during December. The BSE Sensex closed the month of December at 17464 (3.18% M-O-M) and the NSE Nifty closed the month at 5201 (3.35% M-O-M).
- ▶ Small Caps, IT, Consumer Durables, Metals, Auto, Capital goods and Healthcare outperformed the main indices where as FMCG, Banking and Oil & Gas underperformed the main indices.

Index	Monthly Change	Index	Monthly Change
BSE-SMALLCAP	11.09%	BSE-MIDCAP I	4.71%
BSE IT	9.02%	BSE PSU	4.29%
BSE CONS DUR	8.48%	NSE MIDCAP	3.97%
CNX IT	8.47%	NSE NIFTY	3.35%
BSE TECK	8.26%	BSE SENSEX	3.18%
BSE METAL	6.80%	BSE OIL&GAS	1.83%
BSE AUTO	5.97%	BSE BANKEX	-0.12%
BSE CAP GOOD	5.97%	NSE BANK NIF	-0.19%
BSE HEALTHCA	5.26%	BSE FMCG	-2.80%

Source - Reuters

January – Strategy

FII fund inflows key for further upside



Source - Reuters

January – 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 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 November WPI coming in at 4.8% and food inflation at 19.83% (for the week ended Dec 19th), the RBI has been sounding more hawkish recently. We expect the first CRR hike in January 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 8% by the end of this FY.

Institutional Activity:

- ▶ FIIs continued to be buyers of Indian equities in December. They bought \$1.98 bln (Source: SEBI) of Indian equities during the month. Global allocation to risk assets continues and India continues to get 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 December. Domestic MFs sold (\$319 mln) (Source: SEBI) of Indian equities during the month.

January – 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 10.3% y-o-y IIP growth in October (consensus market expectation of 12%). The September number was revised up to 9.6% from 9.1%. 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 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 December '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 low of 44.4 it has bounced to 55.6 in December with overall orders improving to 60.1. New export orders showed good improvement and came in at 54.6 suggesting that external demand is playing a part in output gains.
 - **Industrial Production** has recovered to 10.3% in October.

January – Strategy

GDP forecast for FY 9-10 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, 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 from this quarter onwards.
- ▶ 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.

January – 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 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). Q2 earnings reported were in line with market expectations and certain sectors like FMCG, Auto, and Banking reported results that were better than expected. Given advance tax numbers in December, Q3 results should not disappoint.
- ▶ 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 current quarter with a CRR hike in January followed by repo and reverse repo hikes probably in March. 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 17464, current valuations of the Indian market are slightly stretched and with the risk of monetary tightening in the near term, India may lag peers in the Asia Pacific region.

January – 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 17464 (Sensex at December end), India trades at a P/E of 19.0X FY10e and 15.6X 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 sector is healthcare.. Our sector views follow.

January– 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.
- ▶ **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.

January – 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.

January – Strategy

Derivatives parameters indicate possibility of profit booking on rallies

Equity Derivatives:

- ▶ Nifty near month future gained 3.68% during the month of December
- ▶ Open Interest for Nifty future was down by 13%
- ▶ Bank Nifty near month future remained flat
- ▶ Open Interest for Bank Nifty future was down by 28 %
- ▶ CNX IT near month future gained 8.46%
- ▶ CNX IT futures open interest was up by 166% though on a small base

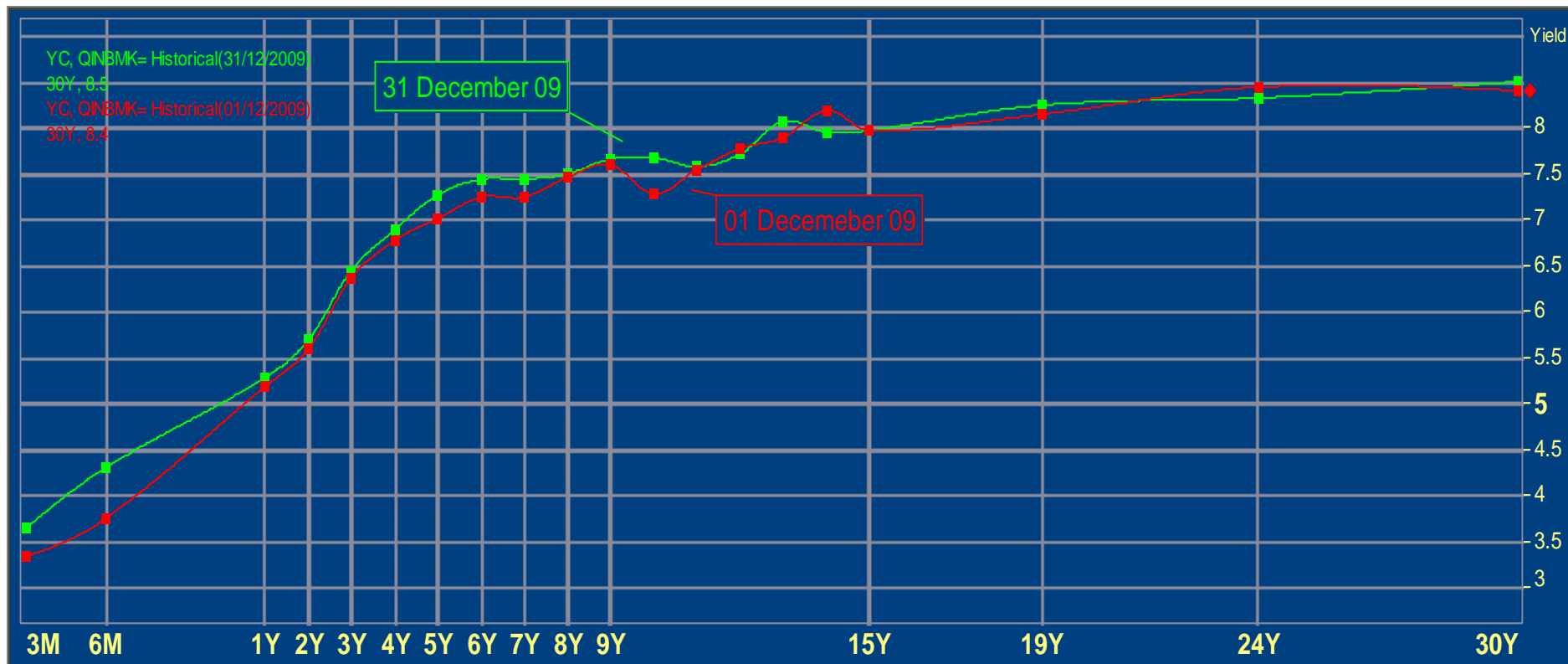
Source – Reuters



Fixed Income

January – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- The sovereign yield curve has shown signs of firming up across maturities with the longer end pricing in expected rate hikes. The amounts placed by banks with the central bank has been large though lower than the average of INR 1000 bn for the last six months. We expect the liquidity to gradually reduce as we move towards the end of the financial year.
- The increasing debate on withdrawal of stimulus as well as the high inflationary expectations is likely to push the Central Bank for some policy action though we expect it to be muted. We continue to recommend low durations in portfolios and look to use multiple value strategies for improving fixed income yields.

January – Strategy

Liquidity to keep yields range bound. The focus of participants may change based on policy action in the regular quarterly review scheduled at the end of January

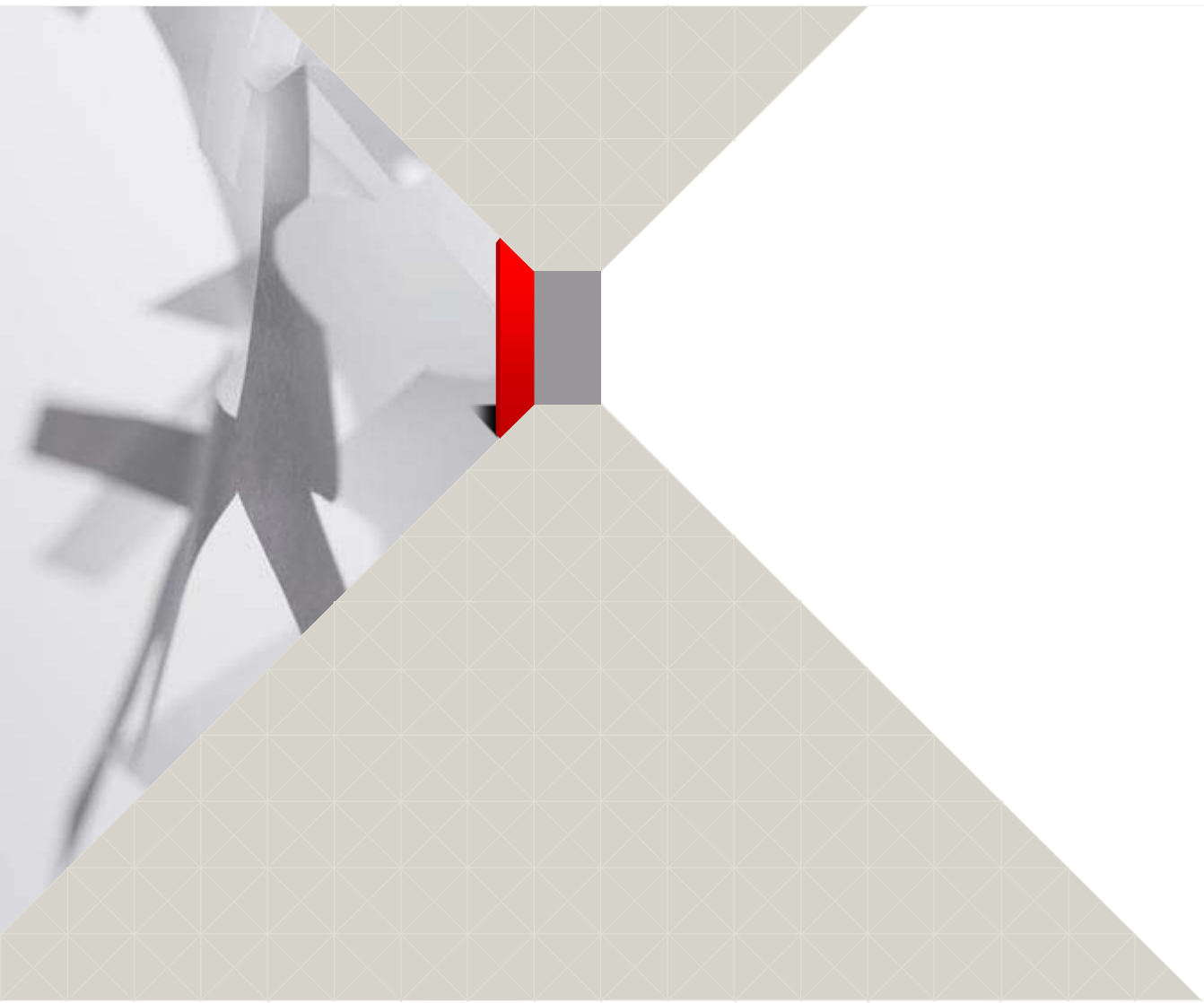
Fixed Income:

- ▶ Liquidity continued to be easy in the month of December. The average Mumbai Inter Bank Offer Rate for the month remained flat at 3.32% in comparison to 3.29% for the previous month. The outstanding amounts lent in reverse repo on 31st December '09 was Rs.436 bln as against Rs.886 bln on 30th November '09 (Source: NSE/ RBI website).
- ▶ The latest inflation number has seen a further increase in food inflation which has risen to 19.83% as on December 19th as compared to 18.65% in the previous week. The expectations within policy makers are that this should moderate going forward. The WPI rose by 4.78% in November as compared to 1.34% in October.
- ▶ We expect the headline WPI inflation rate to reach 8% by March this 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. We are sticking to the view that the first move will be a CRR hike in January 2010 followed by the first repo and reverse repo rate hike possibly in March 2010. We expect 200 bps of CRR increases and 125 bps of policy rate rises in CY 2010.

January – Strategy

Volatility may remain as investors search for better yields. Selectively position bond portfolios

- ▶ 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 or schemes that would take advantage of the steepness in the yield curve.
- ▶ 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

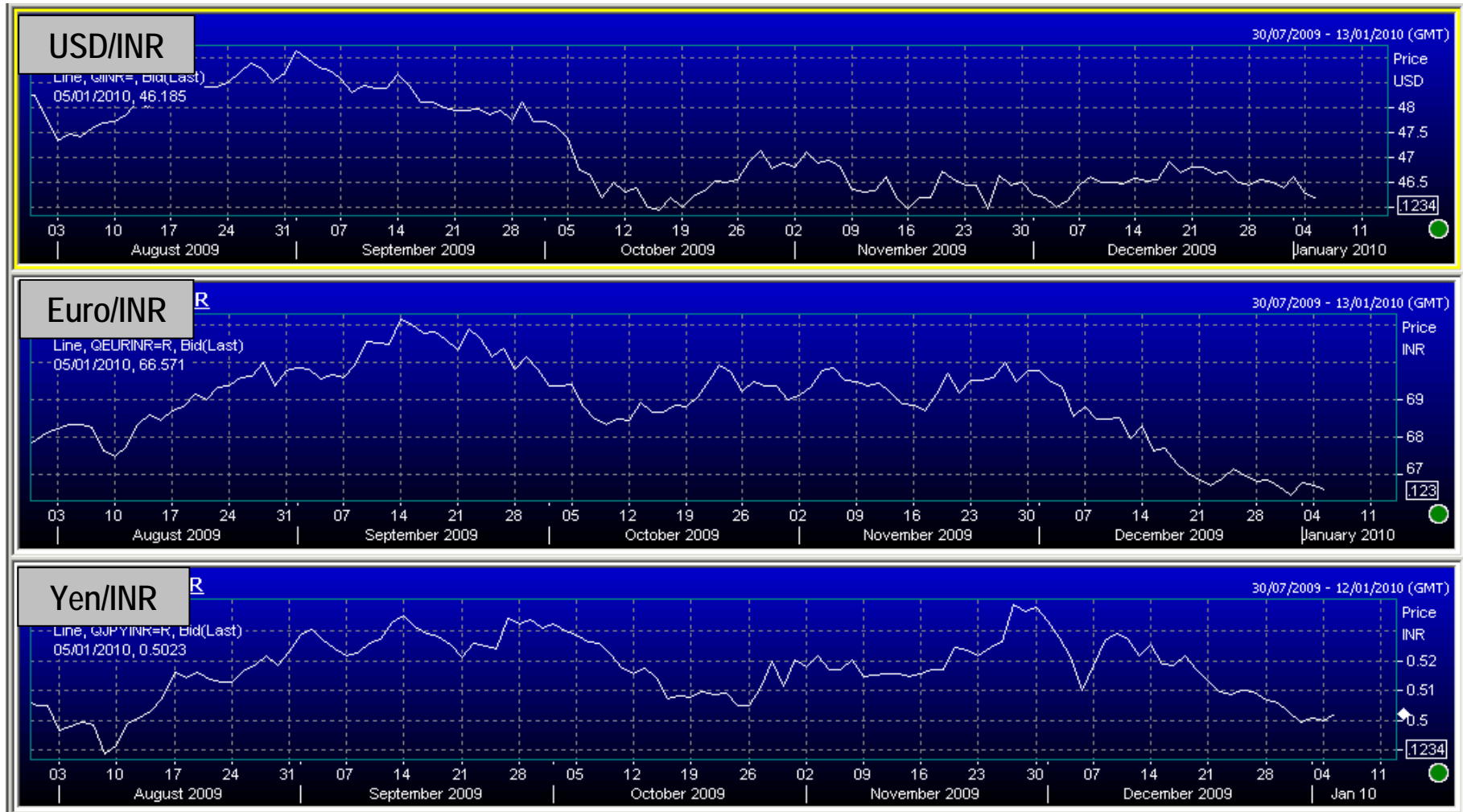
January – Strategy

USD outlook neutral with + bias. Positive on EM currencies with strong fundamentals.

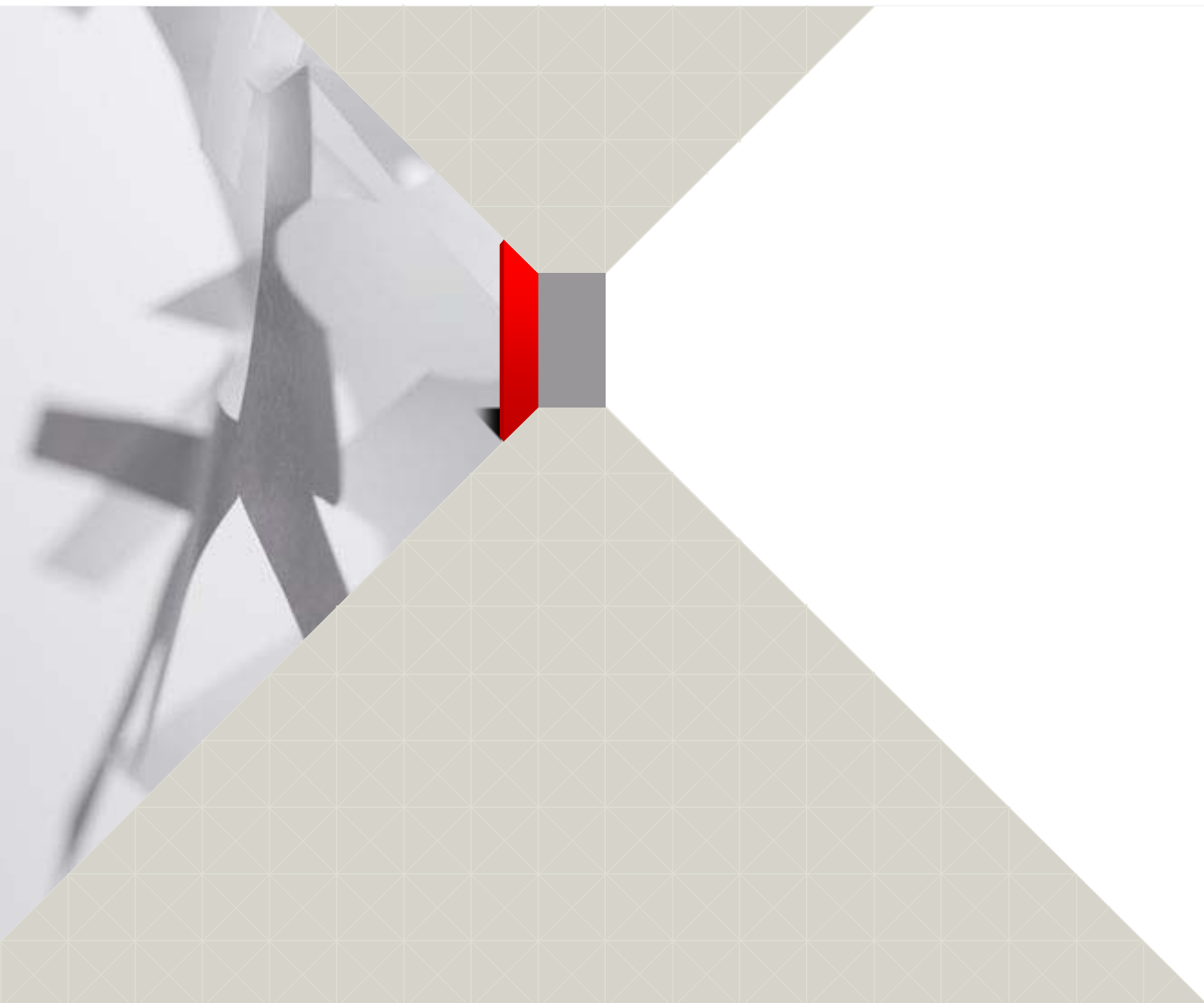
- ▶ **INR** - The INR remained in a narrow range during December and closed the month at 46.40 against the USD (Source: Reuters). Going forward, we expect INR to strengthen marginally on account of a narrowing current account deficit and capital inflows. Our Dec 2010 target for INR stands at 46.5, while that for Dec 2011 stands at 44.5 against the USD.
- ▶ **USD** - The US dollar appears to have broken from its downward trend of recent months, supported by talk of exit strategies from current monetary policy and improving macroeconomic data. As such, we have upgraded our 3 month view to neutral, and our 6-12 month view to neutral with a positive bias.
- ▶ **GBP** - We continue to expect a period of sideways trading for the GBP as further gains appear unlikely.
- ▶ **EURO** – With USD showing signs of strength, we have downgraded our outlook for the Euro, which appears plagued by bad news
- ▶ **JPY** – We believe the yen is likely to depreciate against USD, as the new government steps up its talk against a strong currency.
- ▶ **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.

January – Strategy

Currency movements....



Source - Reuters



Commodities

January – 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 corrected during December and closed the month at US\$1095 (Source: Reuters). In light of its recent rally, we now hold a more neutral view on gold, as it may enter a period of range-trading. We believe the upside to gold prices is limited, and maintain our neutral outlook for the long term.
- ▶ **Oil:** Light crude oil gained some ground during the month of December and closed the month at \$79.36/bbl (Source: Reuters). The outlook for the supply side of oil is improving, and is likely to keep up with emerging market demand, moderating our positive outlook. With moderate demand, high inventories in the US and renewed upside potential for oil supply, as highlighted by the Iraq oil bids, we believe oil is likely be range-bound with positive bias in coming months.
- ▶ **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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