

India Strategy

July 2010

July – Strategy

India - Key Macro Economic Forecasts

- ▶ Snapshot of HSBC key Indian economic forecasts

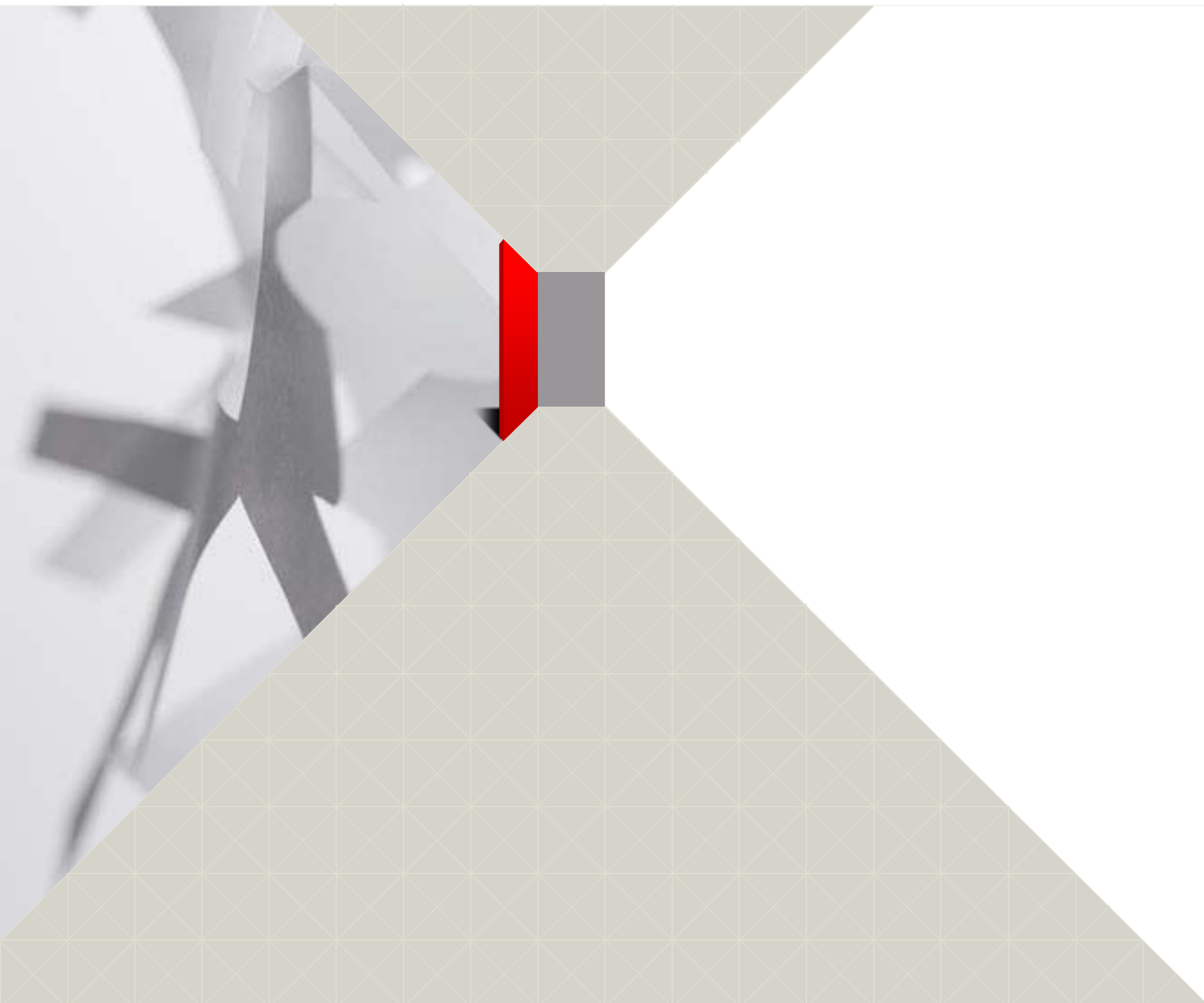
HSBC Key India Economic Forecasts

% Fiscal Year	2009/10	2010/11	2011/12	Apr-Jun 10	Jul-Sep 10	Oct-Dec 10	Jan-Mar 11
GDP	7.4	8.8	8.3	8.7	8.2	9.7	8.9
Agriculture	0.2	5.4	2.2	2.5	5	8	6
Industry	9.3	9.3	6.3	13.8	9.0	7.5	6.8
Services	8.3	9.5	10	8.5	8.5	10.8	10
Wholesale prices	3.8	6.7	4.9	9.9	7.8	5	4
Consumer prices*	12.3	7.1	6.5	13.7	7.6	5.2	2.0
Trade bal (%GDP)	-9.3	-9.9	-9.2	-9.9	-11.7	-10.0	-7.9
Current acc (%GDP)	-2.8	-3.9	-3.5	-3.3	-6.0	-4.7	-1.5
Budget bal (%GDP)	-7.1	-5.5	-4.8	-6.7	-6.4	-6.1	-5.5
Cash Reserve Ratio**	5.75	6.25	6.5	6	6	6	6.25
Reverse repo (%)**	3.5	4.75	5.25	3.75	4.25	4.5	4.75
Repo rate (%)**	5	6.25	6.75	5.25	5.75	6	6.25
10 year yield (%)**	7.8	8.4	7.8	8.3	8.5	8.5	8.4
INR/USD**	46.5	45	43.5	47	46	45.5	45

*Industrial Workers CPI.

** End-period rates

Source: HSBC.



Equities

July – Strategy

Markets re-bound in June. Volatility persists on global uncertainties.

- ▶ Amidst volatility, Indian equity markets gained back the momentum on the back of improving domestic macro prospects and positive news flows from global markets.
- ▶ The BSE Sensex closed the month of June at 17,700.9 (↑4.5% M-O-M) and the NSE Nifty closed the month at 5,312.5 (↑4.4% M-O-M).
- ▶ FMCG, Auto, Capital Goods and Oil & Gas sectors' were major out performers. Metals stocks underperformed the broader indices. Mid and Small cap indices outperformed the large cap peer group.

Index	% Change	Index	% Change
BSE FMCG Sector	8.4%	BSE Sensex	4.5%
BSE Auto	8.1%	Nifty (S&P CNX)	4.4%
BSE Cap Goods	7.7%	BSE PSU	4.1%
BSE Oil	6.8%	BSE Power	3.9%
BSE Small-Cap	6.1%	BSE Realty Index	3.2%
BSE Cons Durable	5.2%	BSE IT Sector	2.8%
BSE Healthcare	4.7%	BANKEX	1.0%
BSE Mid-Cap	4.6%	BSE Metal	-2.9%

July – Strategy

Domestic Business Undertone positive, global macro news flow critical



Source - Reuters

July – Strategy

Growth momentum remains strong. FIIs turn net buyers

- ▶ Macro indicators remain strong and it seems that the recovery is underway. The economy expanded by a strong 8.6% during the January to March quarter (Q4 FY 10) up from a revised 6.5%. For FY 2010, GDP growth came in a 7.4% (Source: HSBC Global Research).
- ▶ The Wholesale Price Inflation rose during the month of May beating market estimates and ended up above the double digit mark. The index rose an annual 10.2% (Source: Reuters/ Bloomberg) driven by primary articles and minerals. Also, the March number was revised upward to 11% y-o-y (Source: Reuters/ Bloomberg). Recent policy moves, including the deregulation of energy prices, may keep headline inflation firm, but the trajectory is clearly downwards as base effect wears off and agricultural output improves. We lower our WPI forecast for 2010 to 8% and expect the WPI index to reach 4% by end of December.
- ▶ On the trade front, activity seems to be cooling sequentially – exports and imports for the month of May, were up 35.7% y-o-y and 38.5% y-o-y respectively but down m.o.m. (Source: Reuters/ Bloomberg).
- ▶ Overall, we expect domestic demand to hold up better than shipments abroad, which raises the risk of a further widening of trade balance. This is reflected in India's trade deficit in May (USD 11.3Bn up from USD 7.9Bn from the previous year) and would act as one more reason for RBI to press rate hikes .

Institutional Activity:

- ▶ FIIs turned net buyers of Indian equities in June. Their net purchases was USD 2.0 bln (Source: SEBI) during the month. Global cues are expected to drive FII flows in the near term.
- ▶ Domestic mutual funds emerged net sellers. Their net sales was (USD0.12 bln) (Source: SEBI) during the month.

July – Strategy

Manufacturing data releases reflect slowing down, but India is still going (a little too) strong

- ▶ The index of industrial production (IIP) rose by a strong 17.6% y-o-y in April. Capital goods production, at 73% , was the highest since the series began in April 1995. Consumer durables (37%) has been growing at over 30% since November last year. Demand is broadening with private and public sector investment in infrastructure driving growth higher.
- ▶ Manufacturing Purchasing Managers Index (PMI), After hitting a 27 month peak of 59 in May, India PMI has pulled back to 57.2 in June. Output and new orders softened over the previous month, but new export orders saw a slight rebound. The most important indication came with regards to prices: input prices crashed 10 points from the previous month's high, highlighting easing cost pressures in manufacturing.
- ▶ Unlike manufacturing, which reported a slight slowdown in business in June, India's service sector, the economy's largest, is still ramping up. The headline PMI index rose to 63.97 in June from 58.2 in May.
- ▶ 'New Business' rose to 63.2, a cyclical high for this index. Yet again, outstanding business rose due to demand outpacing existing capacity. Firms continue to increase prices, albeit at a modest pace.
- ▶ The other big message from recent HSBC PMI readings is the increase in supply side constraints as firms struggle to keep pace with new orders. This only means that more firms will resort to imports to meet domestic demand thereby deteriorating trade balance further.

Source: Bloomberg/ Reuters

July – Strategy

GDP forecast for FY'10-11 at 8.8% as we expect a pick up in the capex cycle soon

- ▶ We revise our GDP growth forecast upwards to 8.8% for FY'10-11 from 8.5% earlier due to improvements in the outlook for investment and consumption this 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 INR 528bn in equity and INR 315bn in debt in FY 10, both excluding financial companies – and is the second highest level ever (Source: Bloomberg, HSBC).
- ▶ Loan growth has been showing signs of a pick up, with bank credit growth at 19.6% (week ended June 18th) up from 10% levels in Oct – Nov 2009 (Source: RBI, 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 sector 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 and lack of pricing power have added up in the interim, but we expect demand growth to recover with the economy.

July – Strategy

Corporate earnings to improve over the next few quarters. Valuations not stretched

- ▶ With signs of a global recovery underway, risk appetite has reemerged and India has been one of the best performing markets since mid March 2009 and has received 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).
- ▶ FY 10 earnings reported were largely in line with market expectations and certain sectors like IT, FMCG, Auto, and Banking reported results that were better than expected.
- ▶ Our expectations for Sensex companies is 21.7% EPS growth in FY'11. We expect growth to pick up going forward and corporate earnings to continue to show improvement.
- ▶ At index levels of 17700, India trades at a P/E of 15.8X FY11e (HSBC estimates). At these levels, valuation of the Indian market are on the higher side and hence India may lag peers in the Asia Pacific region on relative basis.

July – Strategy

Equity markets expected to consolidate; buy on dips

- ▶ 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 risks of missing out on larger rallies is high. Sharp corrections could be viewed as good buying opportunities.
- ▶ For clients that are over exposed to Indian equity, we suggest gradually trimming allocations back to strategic levels. We still believe equity markets will be higher 12 months from now.
- ▶ 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 yet exist. Higher volatility should be expected in mid caps.
- ▶ We continue to favor banks, industrials as our key over weights to play the high growth rates in the domestic economy. We also favor IT to play on the pick up in the US economy. Our key underweight sector is healthcare.

July – Strategy

Overweight – Banks, Industrials & IT; Neutral – Cons Staples, Utilities, Cons Disc.,

- ▶ **Financials – Overweight** – Current valuations and higher growth prospects in a scenario of economic recovery make us overweight banks. 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 financials space. Currency appreciation is a key risk.
- ▶ **Consumer Staples – Neutral** – 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 take selective in stock picking.
- ▶ **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 also neutral to the 'Retail' sub sector with signs of improvement in the macro outlook.

July – Strategy

Neutral –Real Estate; Underweight – Materials, Healthcare, Telecom, Energy

- ▶ 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.
- ▶ Telecom – Underweight - 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.
- ▶ Energy – Underweight – Environment is still challenging for upstream and refineries as margins are likely to remain moderate in 2010. Also the sector runs the government policy risk.

July – Strategy

Derivatives indicate positive undertone, but global news flow may play spoilsport.

Equity Derivatives:

- ▶ Nifty near month future closed about 5% up for the month of June
- ▶ Open Interest for near month Nifty future was up by 22%.
- ▶ Bank Nifty near month future gained by about 2.54% during the month.
- ▶ Open Interest for Bank Nifty future was up by about 23%
- ▶ CNX IT near month future gained by 3.4% during the month.
- ▶ CNX IT futures open interest was down by 10% though on a small base

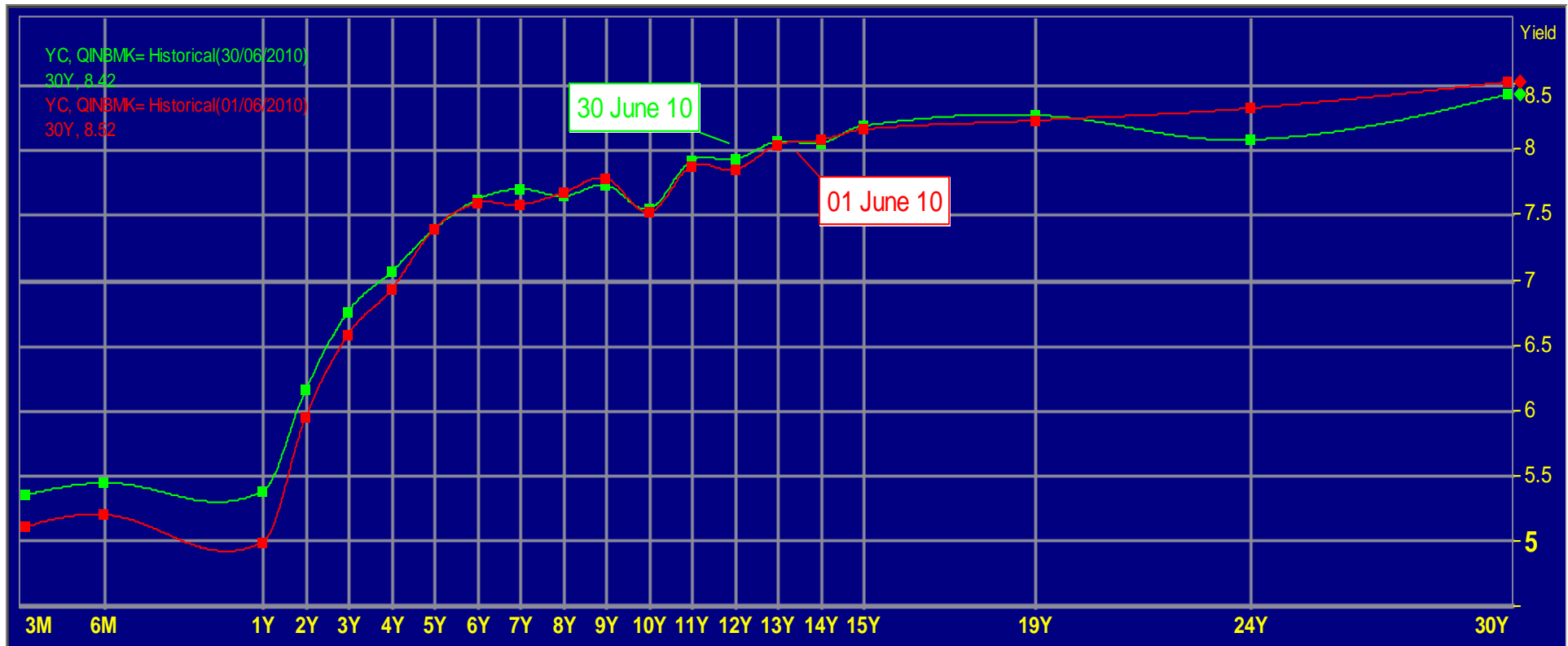
Source – Reuters



Fixed Income

July – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- The yields moved up in the shorter end with the tight liquidity during the month. The ten year benchmark yield gilt stayed in the range of 7.5% to 7.7% levels.
- Liquidity has been tight post the outflows on account of the 3G and BWA auctions. We expect liquidity to improve by end of the coming month with the resumption of Government spending and gilt maturities, We expect shorter term rates to remain high in the near term due tight liquidity and expectations of further rate hikes.

July – Fixed Income Strategy

Upward movement in the shorter term rates may continue with the intra meeting hike

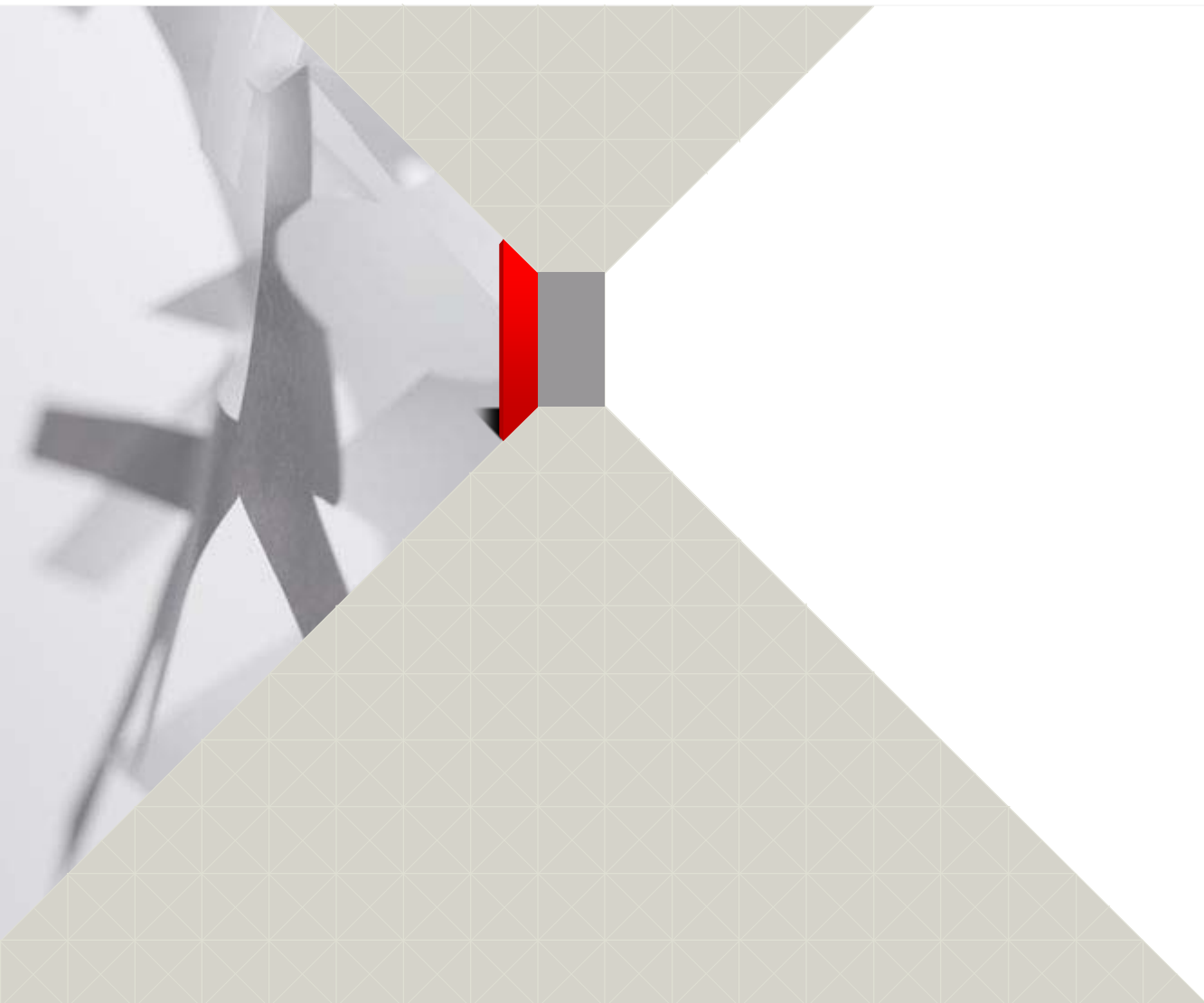
- ▶ Liquidity continued to be tight post the dry down from the last few weeks of May. The average Mumbai Inter Bank Offer Rate for the month moved up to 5.39% as compared to 4.04% as for the previous month. The outstanding amounts borrowed in repo on 30th June 10 was INR 786 bln as against INR 40 bln on 31st May 10 (Source: NSE/ RBI website).
- ▶ The latest inflation number continued to be at elevated levels. The food inflation numbers dropped to an eight month low at 12.92% for week ended June 19 as compared to 16.23% in the previous month. The WPI increased to 10.16% in May10 as compared to 9.59% in April 10.
- ▶ We are lowering our WPI forecast for 2010 from 8.8% annual average to 8%. We also expect the inflation numbers to hit 4% levels by December. The expectations stems from the softening outlook for commodity prices and early indications of a good monsoon this year. However, overflowing order books with tight capacity may be a key risk to the forecasts.
- ▶ RBI in an intra meeting move increased the policy repo and reverse repo rates by 0.25% to 5.5% and 4% respectively with effect from 02 July 10. RBI also extended the liquidity support given to banks at 0.5% of the Net Demand and Time Liabilities for the purpose of meeting their statutory liquidity ratio from 02 July to 16 July. The policy move was ahead of our expectations of 0.5% in the policy meeting on July 25th.
- ▶ We expect RBI to raise rates by 0.25% in the July policy meeting and in total we expect another 125 bps in repo rate hikes and 50 bps in CRR hikes over the next 12 -18 months.
- ▶ We continue to expect credit growth to at least touch 30% later this calendar year largely because of a strong pick-up in capital expenditure.

Data Source:HSBC/ Reuters/ Bloomberg

July – Fixed Income Strategy

Dynamic bond funds continue to provide good risk reward in the near term

- ▶ We continue to recommend longer term investors to gradually start locking into higher maturities on upward movements of the ten year (~8% levels). For investors with shorter horizons we would look to invest into liquid / ultra short term bond funds or dynamic bond funds that can take active interest rate calls or play on the steepness of the curve.
- ▶ Allocations could be considered to higher accruals from longer term tax free/deep discount bonds to hedge against a more gradual upward move in interest rates.



Currencies

July – Strategy

Increased risk aversion should be supportive of safe haven currencies

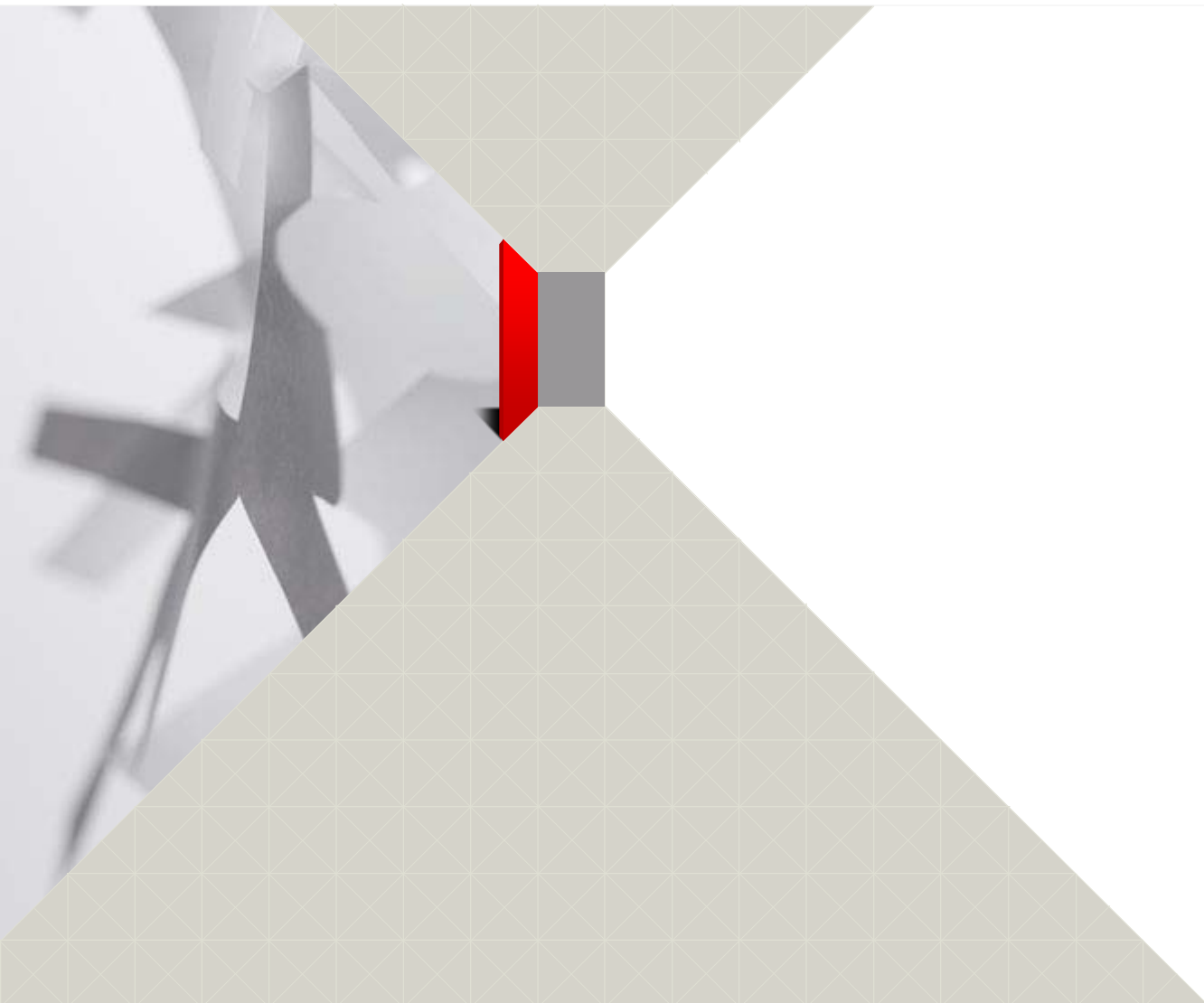
- ▶ **INR** - The INR remained in choppy waters during June and closed the month flat at 46.44 against the USD (Source: Reuters). Going forward, we expect INR to remain range-bound on account of increasing capital inflows. Our Dec 2010 target for INR stands at 45.5.
- ▶ **USD** - With concerns about sovereign debt levels and the impact of fiscal tightening on global growth prospects, the US dollar may continue to find some support, although we believe appreciation to be muted going forward.
- ▶ **GBP** – We believe GBP will gradually find support, as much of the bad news appears priced in, and the coalition government appears to be serious about cutting the deficit, which is appealing to markets.
- ▶ **EURO** – EUR is likely to remain under pressure as the Euro zone crisis is not resolved, but, following such a significant drop, we believe the scope for further weakness to be limited
- ▶ **JPY** – The return of risk aversion is supporting JPY in the near term due to flight to safety. However, in the longer term, we expect JPY to weaken again.
- ▶ **Emerging Markets (EM)** - We continue to believe that EM currencies offer attractive opportunities. However we remain selective as risk aversion may impact currencies with weaker economic fundamentals

July – Strategy

Currency movements....



Source - Reuters



Commodities

July – Strategy

Risk aversion may impact commodities prices in the short term.

We maintain our overall commodities view to Neutral, as we believe the sovereign debt concern and unknown impact of tightening measures on global economy, may impact demand.

- ▶ **Gold:** Gold gained further ground during June and closed the month at US\$1241 (Source: Reuters). With heightened risk aversion and concern over Euro's integrity, we believe gold prices will continue to benefit from a safe haven status in the short term.
- ▶ **Oil:** Light crude oil remained in choppy waters during the month of June and moved laterally to close the month at US \$75.6/bbl (Source: Reuters). We believe oil will remain under pressure in the current environment, as historically increased risk aversion affects all commodities except gold, particularly when supply levels are high. Going forward, we believe the oversupply may keep up with growing EM demand, muting price appreciation.
- ▶ **Agricultural Commodities and Industrial Metals:** With USD strengthening, we believe price appreciation of agricultural commodities and industrial metals will remain somewhat muted in the short term. However industrial metals have shown solid underlying demand and agricultural commodities offer attractive valuations, which may generate investor interest. We hold neutral to positive view on both these segments for the next 12 months.

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