

India Strategy

June 2010

June – Strategy

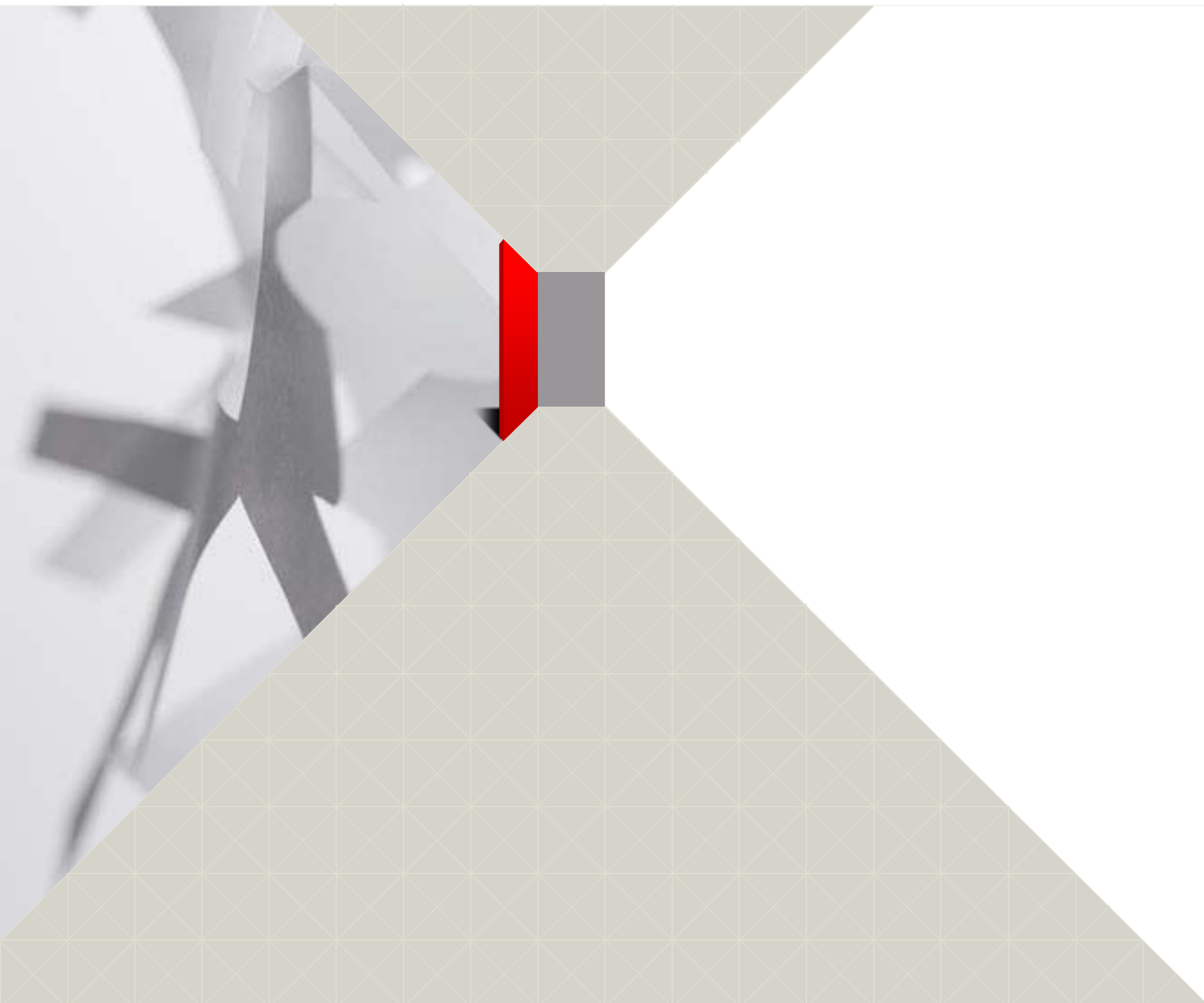
India - Key Macro Economic Forecasts

- ▶ 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

June – Strategy

Euro zone debt worries pulls back the momentum in May

- ▶ Amidst high volatility, Indian equity markets declined in May responding to the news flows from global markets, largely arising out of Euro zone sovereign debt worries and its impact on the global economic recovery.
- ▶ The BSE Sensex closed the month of May at 16,944.63 (↓3.5% M-O-M) and the NSE Nifty closed the month at 5,086.3 (↓3.6% M-O-M).
- ▶ FMCG, Healthcare and Oil & Gas were major sector out performers. Metals, Realty, Banking and Power sector stocks underperformed the broader indices. Mid and Small cap indices underperformed the large cap peer group.

Index	Change	Index	Change
BSE FMCG Sector	3.6%	BSE 100	-3.6%
BSE Healthcare	2.7%	Nifty (S&P CNX)	-3.6%
BSE Oil	2.6%	BSE 500	-3.7%
BSE PSU	0.2%	CNX Midcap	-3.8%
BSE Auto	-1.3%	BSE Power	-4.4%
BSE Cap Goods	-2.6%	BANKEX	-4.5%
BSE Cons Durable	-3.1%	BSE Mid-Cap	-4.9%
BSE IT Sector	-3.4%	BSE Smallcap Index	-4.9%
BSE 200	-3.5%	BSE Realty Index	-11.3%
BSE Sensex	-3.5%	BSE Metal	-14.3%

June – Strategy

Markets in a trading range and expected to consolidate



Source - Reuters

June – Strategy

Sustained growth in manufacturing shores up Q4 GDP. FIIs turn net sellers

- ▶ Macro indicators remain strong and it is clear 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%. Investment, partly due to infrastructure spending and partly by private firms, rose 17.7% y-o-y. Agriculture rose 0.7% y-o-y up from -1.8% in the previous quarter. However, consumption disappointed, rising a mere 2.6% y-o-y, reflecting in part the impact of higher food prices.
- ▶ For FY 2010, GDP growth came in a 7.4%.
- ▶ The Wholesale Price Inflation has shown further deceleration after failing to cross the double digits. The index rose an annual 9.59% in April driven by food and fuel prices.
- ▶ India reported another set of strong numbers on the trade front – exports for the month of April were up 36% y-o-y and imports were up 43% y-o-y. Exports growth has covered a lot of ground after the steep fall in the second half of 2008. However, the latest manufacturing PMI suggests a less promising outlook for manufacturing exports in the near future.
- ▶ Doldrums from uncertainty in macroeconomic conditions in peripheral Europe could impact trade with Asia in general. On the other hand, as domestic demand picks up, led by stronger consumption and soaring private investment, we believe that demand is likely to outstrip supply drawing in ever growing quantities of goods from abroad.

Institutional Activity:

- ▶ FIIs turned net sellers of Indian equities in May. They net sold \$2.3 bln (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 emerged marginal net buyers as market volatility paved way for some value buying opportunities. They net bought \$0.02 bln (Source: SEBI) of Indian equities during the month.

June – Strategy

Data releases continue to point recovery

- ▶ The index of industrial production (IIP) growth eased slightly, but still registered a very strong 13.5% y-o-y growth in March. Capital goods production slowed down by 27% y-o-y as against 44% in February. It is, however still very strong by past standards and we would be surprised if fixed capital investment wasn't expanding rapidly. Consumer durables production continued to boom, rising 32% y-o-y.
- ▶ In our view, some of the softening in production reflects supply-side rather than demand side constraints, as the manufacturing PMI continues to register very strong monthly gains.
- ▶ The services purchasing managers index (PMI) measured 58.2 in May down from 62.1 in April. Though a decline,, it still shows rock – solid growth. So far this quarter, the service PMI readings are consistent with sector growth of 10%.
- ▶ The new business component is at 60.1 and the employment index is at a cycle high of 53.2. From a growth perspective, therefore we see little convincing evidence of a slowdown in the Indian economy.
- ▶ The following indicators continue to be point to an economic recovery already underway:
 - Motor vehicle sales continue to exhibit strong sales growth across different segments.
 - Cement production continues to show improvement in its 3 month moving average growth rate.
 - Manufacturing Purchasing Managers Index (PMI) hit another cycle high of 59 in May, up from 57.2 the month before and the highest reading since February 2008. New orders rose after two months of declines to 63.7, while the bounce in the output component to 62.3 from 60.4 suggests that we are in for another robust industrial production reading.
 - We believe, this will help sustain domestic demand growth, especially at a time when exports look set to slow:

June – Strategy

GDP forecast for FY'10-11 at 8.5% as we expect a pick up in the capex cycle soon

- ▶ We maintain our GDP growth forecast of 8.5% for FY'10-11 led largely by an above-consensus investment growth forecast of 14%.
- ▶ The financing for growth appears to be falling in place
 - Indian companies have raised INR 1460bn in equity and INR 578bn in debt in FY 10 (as at March end), both excluding financial companies (Source: Bloomberg, HSBC).
 - Loan growth has been showing signs of a pick up, with bank credit growth at 17.2% (week ended May 7th) up from 10% levels in Oct – Nov 2009 (Source: RBI, Bloomberg).
- ▶ We believe 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.
- ▶ 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 with recent capital issuance by companies in this sector. 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.

June – Strategy

We expect corporate earnings to improve over the next few Quarters. Valuations are reasonable

- ▶ 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 March 2009 and has also 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). Q4 earnings reported so far 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. After the recent correction, at 16944 current valuations of the Indian market are reasonable. However, due to higher valuations Indian markets may lag Asian peers.
- ▶ International commodity prices, increase in food prices (some related to the weak monsoon) and possible hikes in interest rates may be key risks to the local markets.

June – 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 be in a trading range.
- ▶ Based on historical trends, equity valuations are slightly stretched on a trailing basis but reasonable on a forward basis. At 16944 (Sensex at May end), India trades at a P/E of 15.1X FY11e (HSBC estimates).
- ▶ Given ample liquidity amongst most institutional, HNI and retail investors, support for the market exists at lower levels. Fresh issuances and interest rate hikes may act as a dampener.
- ▶ 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. Sharp corrections could be viewed as good buying opportunities to rebalance under allocated portfolios more aggressively.
- ▶ Clients with high risk appetite could look at continuing to build exposure to mid cap funds and stocks from a valuation standpoint though they may be subject to higher volatility..
- ▶ We continue to favour banks and industrials as our key overweights to play the pick up in the domestic economy and we favor IT as a play on the pick up in the US economy. Our key underweight sector is healthcare.

June – 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 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 key risk.
- ▶ **Consumer Staples – Neutral** – Defensive in nature, can add stability to a portfolio and is a longer term play on growth in consumption. Valuations is no longer at a significant premium compared to historical premiums relative to the market. However, one needs to be selective in this segment.
- ▶ **Utilities – Neutral** – Generation capacity being increased, but shortfall remains. We rate the sector as neutral given that valuations are at a premium and risks 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 the recent strong performance and hence are neutral for this segment. Although valuations are high, we are neutral the retail sub sector with signs of improvement in the macro outlook.

June – 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 year. We expect Indian steel demand to pick up along with 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 quarte. The intermediate time the stocks could underperform. Hence, 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, we turn underweight on the sector.
- ▶ Energy – Underweight – Environment is challenging for upstream and refineries as margins are likely to remain moderate in 2010. Also the sector runs the government policy risk.

June – Strategy

Markets likely to face resistance at higher levels

Equity Derivatives:

- ▶ Nifty near month future closed about 4% down for the month of May
- ▶ Open Interest for near month Nifty future was up by 3.9%.
- ▶ Bank Nifty near month future corrected by about 6% during the month.
- ▶ Open Interest for Bank Nifty future was down by about 5.9%
- ▶ CNX IT near month future corrected by 4% during the month.
- ▶ CNX IT futures open interest was down by 24% though on a small base

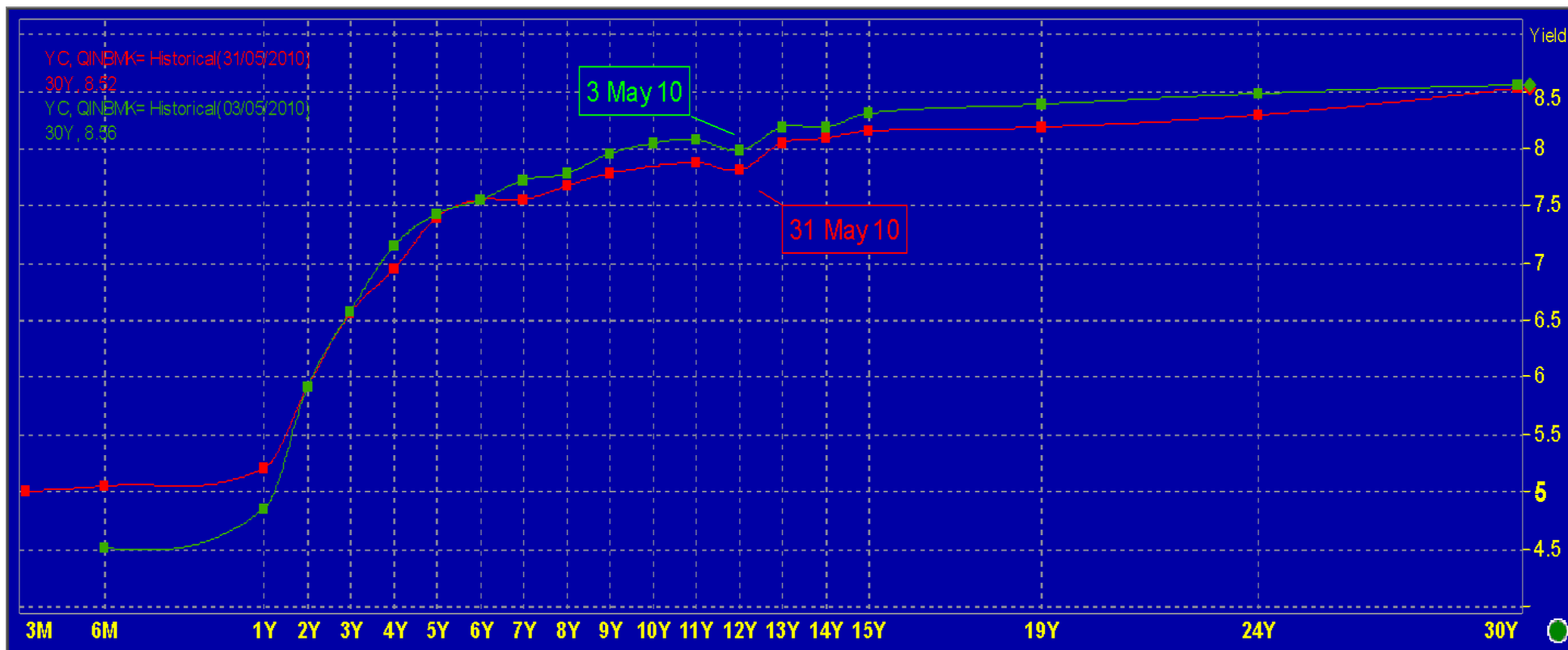
Source – Reuters



Fixed Income

June – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- The steepness of the continued in the month of May with some rally in the longer end. The ten year benchmark yield gilt moved from 7.65% to 7.5% levels.
- Liquidity declined at the end of the month due to outflows on account of the 3G auctions and RBI announced adhoc measure of allowing additional borrowing under the LAF to meet SLR requirements. We maintain our view of volatility in the shorter end of the curve due to gradual drying down of liquidity from the pick up in credit growth.

June – Fixed Income Strategy

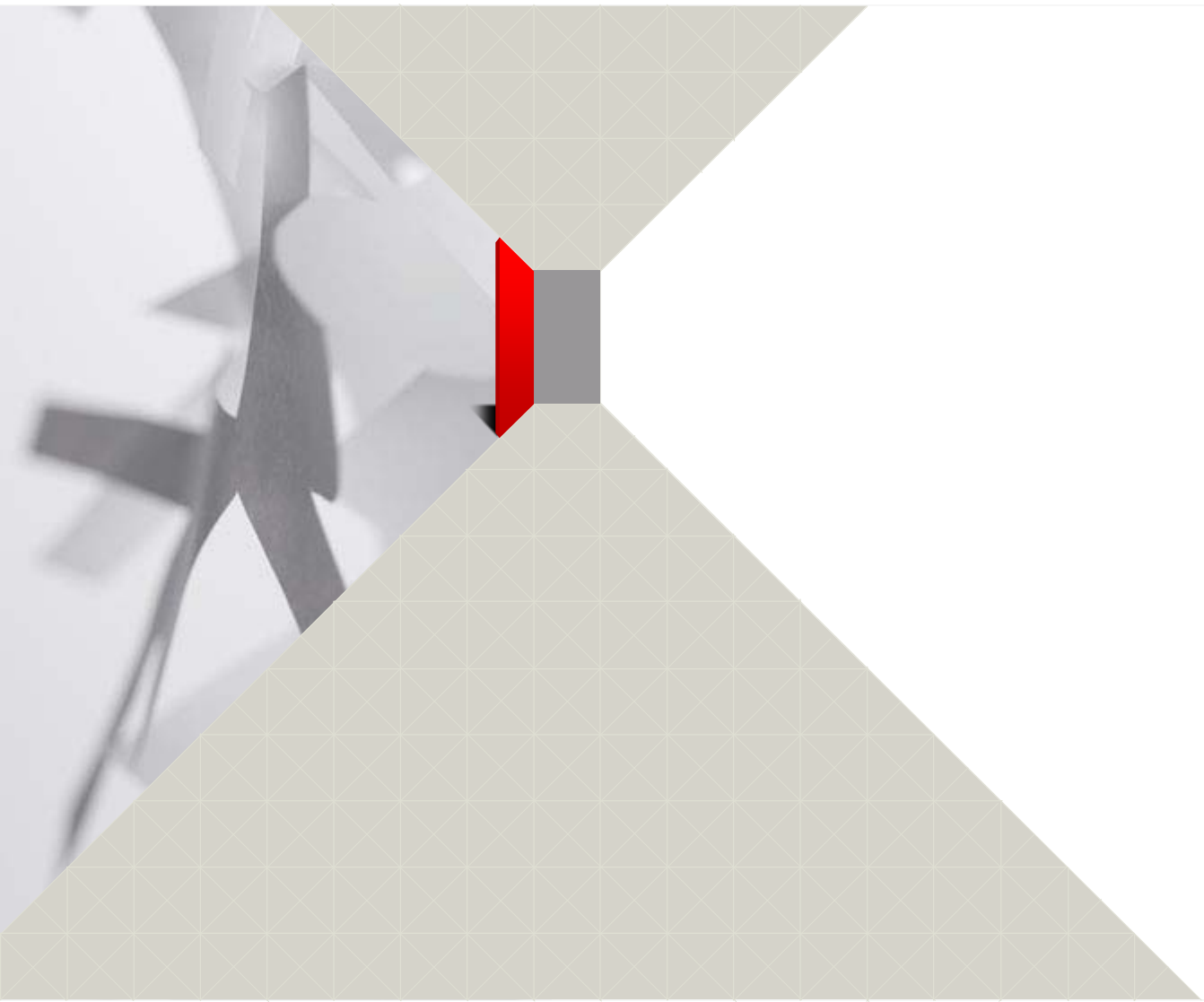
Inflation and Yields may reflect an intermediate high. Liquidity to return post advance tax outflows

- ▶ Liquidity in the system reduced significantly with large outflows for 3G auctions in the end of the month. The average Mumbai Inter Bank Offer Rate for the month moved up to 4.04% as compared to 3.69% as for the previous month. The outstanding amounts borrowed in repo on 31st May 10 was INR 40 bln as against INR 357 bln lent in reverse repo on 30th April 10 (Source: NSE/ RBI website).
- ▶ The latest inflation number continued to be at elevated levels with softening bias. The food inflation numbers was reported at 16.23% for week ended May 22 as compared to 16.61% in the previous month. The WPI declined to 9.59% in April 10 as compared to 9.9% in March 10.
- ▶ We believe that the Wholesale Price Inflation is likely to peak in the next few months and has the prospect of fairly sharp falls thereafter due to the base effect.
- ▶ The Reserve Bank of India introduced a special facility for banks to borrow under the LAF to the tune of 0.5% of Net demand and time liabilities for any shortfall in maintenance of SLR. This move is adhoc in nature and targeted to ease the pressure on liquidity due to outflows on account of 3G auctions and advance tax. The validity of the same has been kept till July 2.
- ▶ We continue to expect a total of 200 bps of repo and reverse repo rate hikes by mid 2011 of which we have had 50 bps so far.
- ▶ 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.

June – Fixed Income Strategy

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

- ▶ We recommend longer term investors to gradually start locking into higher maturities as the ten year moves to higher levels (over 8%). For investors with shorter horizons we would look to invest into liquid to ultra short term bond 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

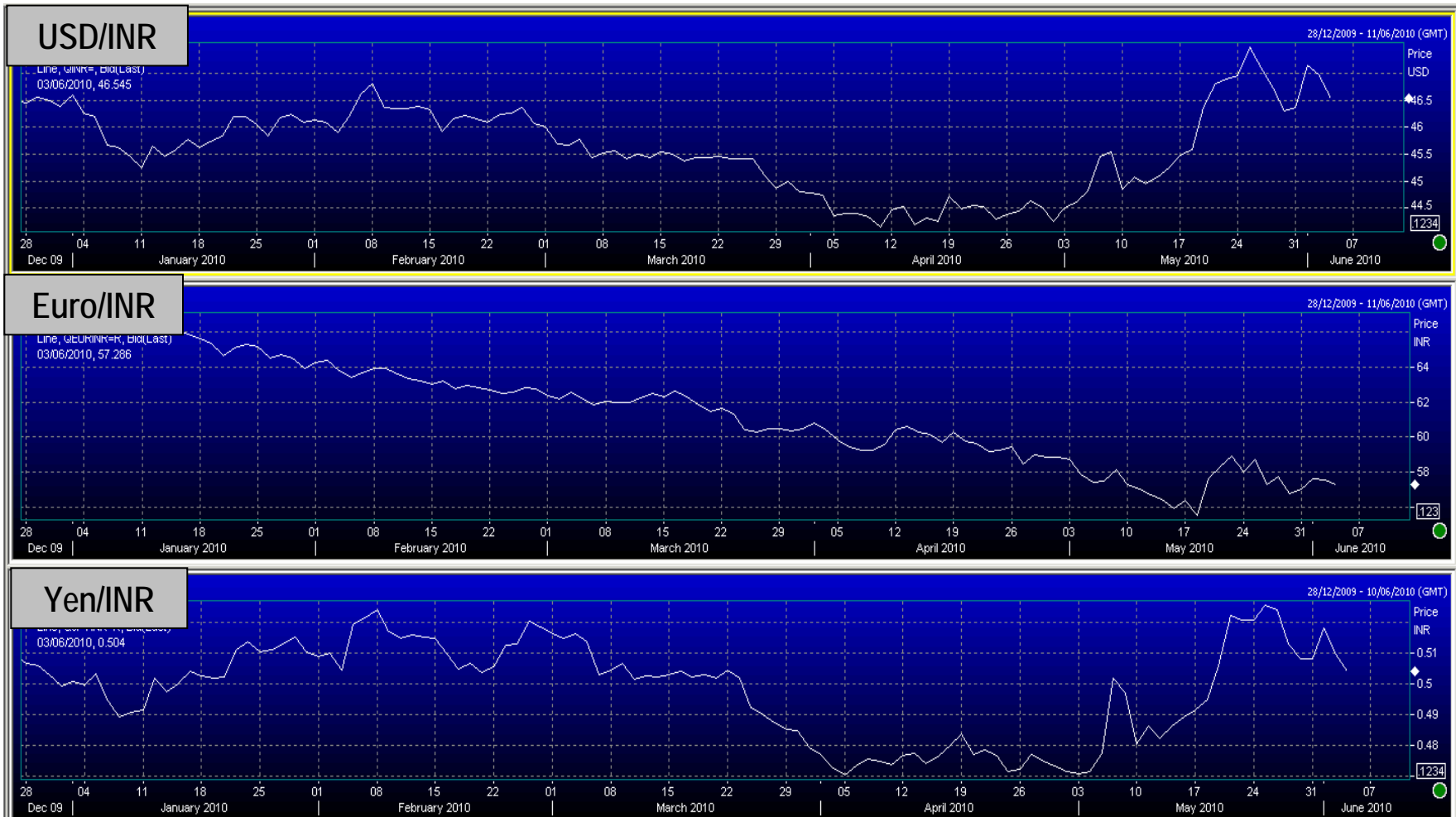
June – Strategy

Increased risk aversion should be supportive of USD & JPY in the near term.

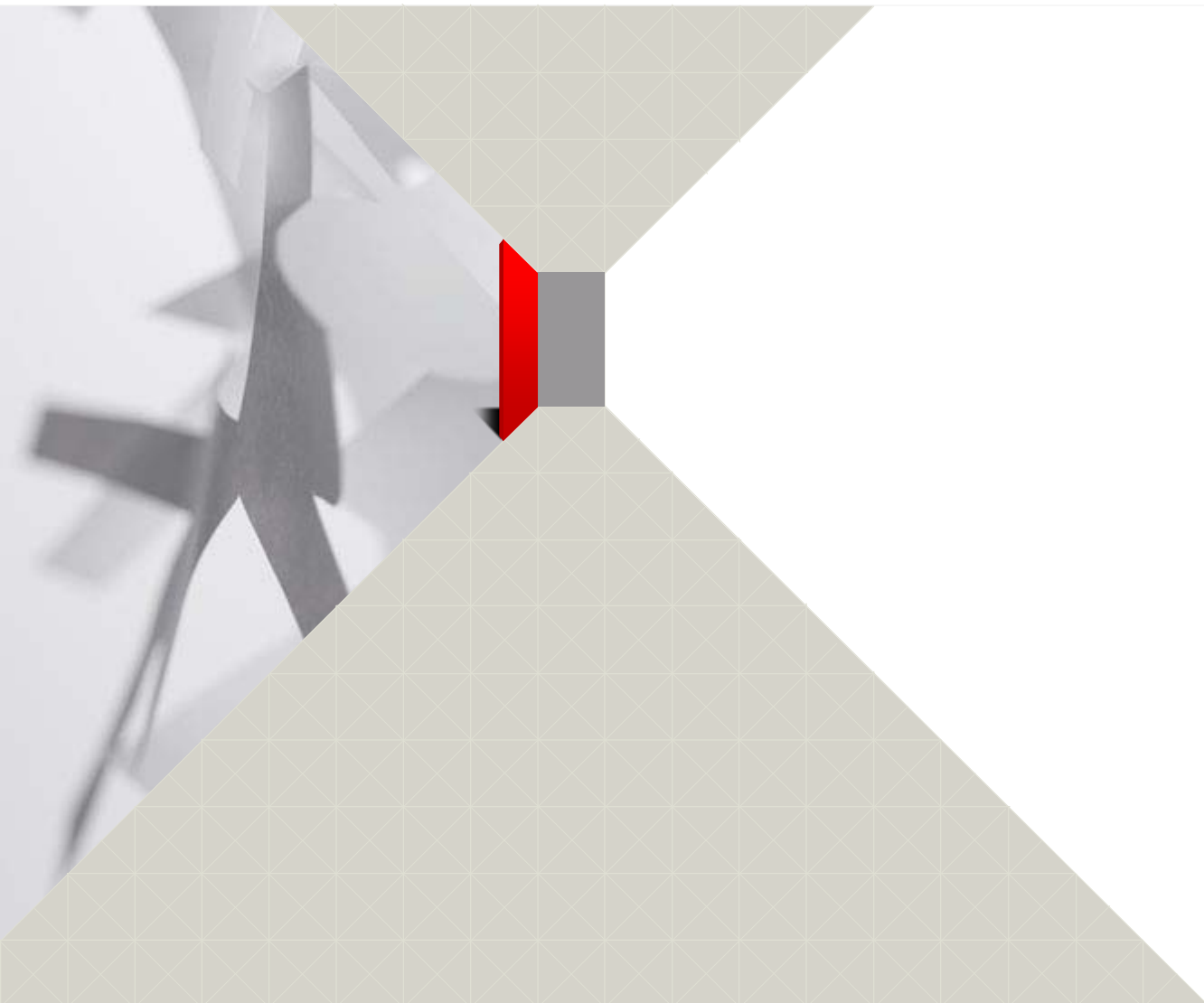
- ▶ **INR** - The INR weakened sharply during May and closed the month at 46.36 against the USD (Source: Reuters). Going forward, we expect INR to gradually appreciate from current levels on account of a narrowing current account deficit and capital inflows. Our Dec 2010 target for INR stands at 44.
- ▶ **USD** - The US dollar continues to perform well benefiting from the increase of risk aversion and the hit to Euro's credibility. We expect this trend to continue for some time. As such, we hold neutral to positive view for the next 12 months.
- ▶ **GBP** – We believe GBP may also come under pressure in the near term, although to a lesser extent, due to political and fiscal issues. Ability of the coalition's ability to tackle the deficit, will be key factor going ahead. We hold neutral view on GBP for the next 12 months.
- ▶ **EURO** – The sovereign debt issues have highlighted the structural weakness of the Euro zone. We believe this credibility concern will continue to weigh on the Euro for the time being.
- ▶ **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

June – Strategy

Currency movements....



Source - Reuters



Commodities

June – Strategy

Risk aversion may impact prices of commodities excluding gold in the short term.

We are Neutral on commodities. We believe the sovereign debt concern and unknown impact of tightening measures on global economy, may impact demand.

- ▶ **Gold:** Gold gained ground amidst uncertainty over Greece and some other European countries during May and closed the month at US\$1215 (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. In the long term, we believe the price appreciation may be more muted, as demand may suffer from historically high prices.
- ▶ **Oil:** Light crude oil corrected sharply during the month of May and closed the month at \$73.97/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 the 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 muted in the short term. However industrial metals do have some underlying demand. We hold neutral to positive view on both these segments for the next 12 months.

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