India Strategy

May 2010

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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

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After gathering momentum in March, markets consolidate in April

- Indian equity markets remained range bound during April, responding to the news flows from the global markets, largely the Greece imbroglio and the rating downgrade of Spain and Portugal by S&P.
- The BSE Sensex closed the month of April at 17,558.7 (↑0.2% M-O-M) and the NSE Nifty closed the month at 5,278 (↑ 0.6% M-O-M).
- Consumer Durables and Realty were major sector out performers. Metals, Energy and Capital Goods underperformed the broader indices. Mid and Small cap indices outperformed the large cap peer group.

Monthly Change Index			
Index	Change	Index	Change
BSE Cons Durable	10.1%	BSE Tech	1.0%
BSE Small-Cap	8.4%	BSE 100	0.8%
BSE Realty Index	6.6%	BSE PSU	0.8%
BSE Mid-Cap	5.6%	NSE Nifty	0.6%
BSE IPO	3.9%	BSE Healthcare	0.3%
BSE Power	2.8%	BSE Sensex	0.2%
BSE IT Sector	2.3%	BSE Cap Goods	-0.4%
BSE 500	1.8%	BSE Metal	-1.7%
BSE Auto	1.7%	BSE Oil	-2.3%

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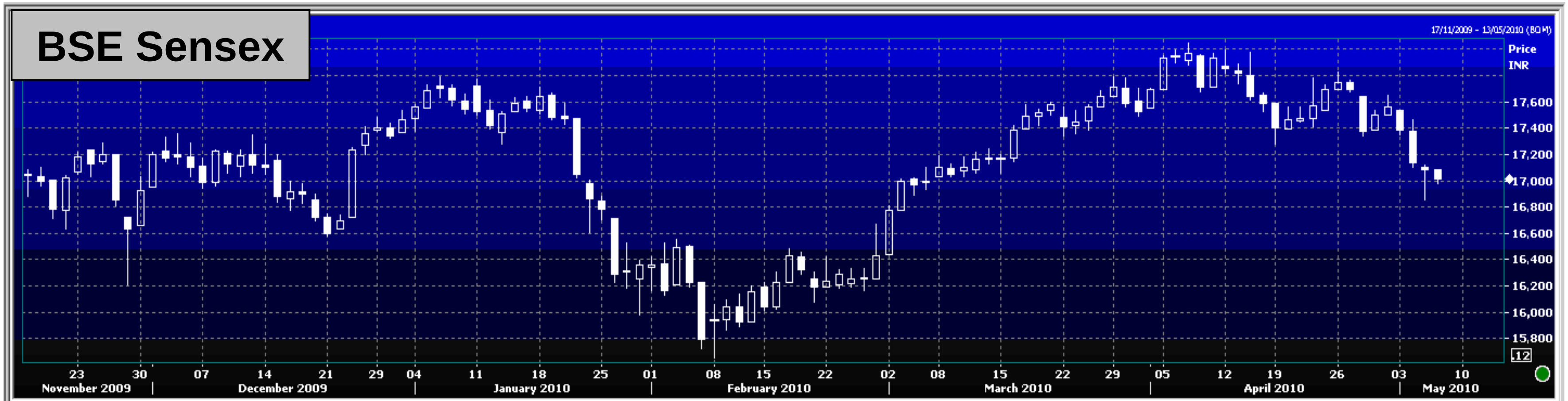
FII fund flows remain critical for further upward movement



Source - Reuters

May – Strategy

Strong growth in manufacturing shores up Q3 GDP. FIIs continue to be net buyers

- Recent months have been witnessing marked improvement in a number of Indian economic indicators and it is clear that the recovery is underway. However, the October to December quarter GDP figure of 6% was below market expectations but consistent with a 1.2% q-o-q drop in output on a seasonally adjusted basis. This was primarily due to the effects of the drought which led to a contraction of 2.8% in agricultural output and a severe clampdown in government spending on community and social services (CSS) during the quarter. Stripping out agriculture and CSS, we estimate that GDP expanded by 10.1% driven by strong growth of 14.3% in manufacturing and 10% in trade, hotels, transportation & communication.

- The Wholesale Price Inflation surprised on the downside in March, failing to cross the double digits. The 9.9% figure reported was the same as February. However, the statistics office is progressively revising up the historical numbers and a similar revision can be expected to the February and March figures.

- The Reserve Bank of India raised the cash reserve ratio, repo and reverse repo rates by 25bps (to 6%, 5.25% and 3.75% respectively), a little less aggressive than the market was building in. The relief is likely to be temporary, however, as an intra-meeting hike (possibly by 50bps) is likely which in turn will be followed by several more steps, in our view. We continue to expect a total of 200bps of repo and reverse repo rate hikes by mid 2011 of which we have had 50bps so far.

Institutional Activity:

- FIIs continue to be net buyers of Indian equities in April. They net bought $1.5 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 continued to be net sellers in April. They net sold ($0.4 bln) (Source: SEBI) of Indian equities during the month.

May – Strategy

Recent data releases point to recovery – Q3 GDP drops but IIP, PMI etc. surprise positively

- India appears to be on the path to recovery evidenced by surprisingly strong Q2 GDP numbers of 7.9% and 16.8% y-o-y IIP growth in February. Q3 GDP dropped to 6% given the impact of the drought but we expect Q4 GDP to rebound strongly.
- The index of industrial production (IIP) growth eased slightly, but still registered a very strong 15.1% y-o-y growth in February. Capital goods production, in particular, rose by 44.4% y-o-y, which is the second highest number on record and supports our bullish capex/bank lending argument.
- The indices of industrial production for mining, manufacturing and electricity sectors grew 12.2%, 16% and 6.7% y-o-y respectively.
- The services purchasing managers index (PMI) continues to show improvement and paints a very encouraging picture of economic activity. The series has reached a new cycle high of 62.1. PMI figure for April and is the main reason for our expectation of a rebound in Q4 GDP.
- The following indicators continue to be point to an economic recovery already underway:
  - Motor vehicle sales have shown a strong improvement.
  - Cement production continues to show improvement in its three month moving average growth rate.
  - Manufacturing Purchasing Managers Index (PMI) has also shown a significant improvement over the last few months. Since January 2009 low of 44.4 it has bounced to cycle high of 57.8 in March following the February's number of 58.5 and 57.7 figure for January. New export orders showed significant improvement suggesting that external demand is playing a part in output gains.

May – 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 forecast for FY'09-10 at 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 FY 10 (as at Dec end) - 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 17% (week ended April 12th) 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 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.

May – Strategy

We expect corporate earnings to improve over the next few Quarters. Valuations "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 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). 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 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 recent correction and at current valuations of the Indian market are reasonable but with the risk of policy rates being hiked in the near term, India may lag peers in the Asia Pacific region.

May – 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 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 17500 levels, India trades at a P/E of 19.X FY10e and 15.7X 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. Interest rate hikes could also put dampeners in the short-term.
- 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 overexposure 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 a mix of large cap and mid cap funds in this environment.
- We continue to favour banks, industrials and IT to play the pick up in the domestic economy and offshore theme. Our underweight sectors are materials, energy, telecom and healthcare. Our sector views follow.

May – 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 BFSI space. Currency appreciation 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 be selective.

- **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.

May – 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, 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.

May – Strategy

Derivatives indicate continuation of consolidation

Equity Derivatives:

- Nifty near month future closed flat for the month of April
- Open Interest for near month Nifty future was up by 8.9%.
- Bank Nifty near month future gained by about 3.7%
- Open Interest for Bank Nifty future was up by 16%
- CNX IT near month future gained by 1.43%
- CNX IT futures open interest was down by 51% though on a small base

Source – Reuters

Fixed Income

May – Strategy

Fixed Income

Indian Government Yield Curve

Source: Reuters

- The steepness of the curve increased in the month of April with the one to five year segment rallying significantly. Liquidity improved significantly as compared to March . Going forward we expect volatility in the shorter end of the curve due to gradual drying down of liquidity as credit growth picks up and possible intra meeting hikes by RBI.
- The RBI raised the repo and reverse repo by 25 bps in the Annual Monetary Policy Meeting for 2010-11. This was lower than market expectation with the bond and equity markets reacting favorably given the less hawkish stance in the policy.

May – Fixed Income Strategy

Post policy meet rally in bonds to continue. Credit growth and intra meeting rate hike may be the catalyst for up tick in rates.

- Liquidity in the system returned in April. The average Mumbai Inter Bank Offer Rate for the month moved up marginally to 3.69% as compared to 3.67% for the previous month. The outstanding amounts lent in reverse repo on 30th April 10 was INR 357 bln as against INR 10 bln on 31st March 10 (Source: NSE/ RBI website).
- The latest inflation number continued to be at elevated levels with food inflation numbers reported at 16.61% for week ended April 17 as compared to 16.35% in the previous month. The WPI was flat at 9.9% in March 10 as compared to February 10.
- We continue on our stance that Wholesale Price Inflation is likely to rise further, hitting 10.5% in the next few months (above the RBI's revised 8.5% projection). This should prove to be the peak, however with the prospect of fairly sharp falls thereafter.
- In the Annual Monetary Policy for 2010-11 the Reserve Bank of India raised the cash reserve ratio, repo and reverse repo rates by 25 bps to 6%, 5.25% and 3.75% respectively. This was in line with our economists forecast, but a little less aggressive than what the market was building in, indicated by the rally in bond and equity markets thereafter.
- 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 also believe that there is a possibility of a 50 bps intra meeting hike prior to the next policy meet in July.
- 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.

May – 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 (8.25%-8.5%). For investors with shorter horizons we would look to invest into liquid to ultra short term bond or dynamic bond funds. Allocations could be considered to higher accruals from longer term tax free bonds to hedge against a more gradual upward move in interest rates.

Currencies

May – Strategy

USD continues to perform well globally, but we moderate our short term positive view as it has already appreciated

- INR - The INR strengthened marginally during April and closed the month at 44.25 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 Dec 2010 target for INR stands at 44.

- USD - The US dollar continues to perform well on the back of improving growth prospects and increasing talk of exit strategies from current monetary policy. As such, we hold neutral to positive view for the next 12 months. We believe a return to traditional market- movers such as interest rate differentials should provide support to USD going forward.

- GBP - While GBPUSD has suffered from political uncertainty, sterling is cheap on a historical basis, and the upcoming election may lead to some short covering.

- 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 – Continued economic weakness, coupled with low yields on JPY investments and high government deficits are likely to lead to weakening JPY against USD.

- Emerging Markets (EM) - We continue to believe that EM currencies offer attractive opportunities, as many EM countries offer a yield pickup and solid economic fundamentals.

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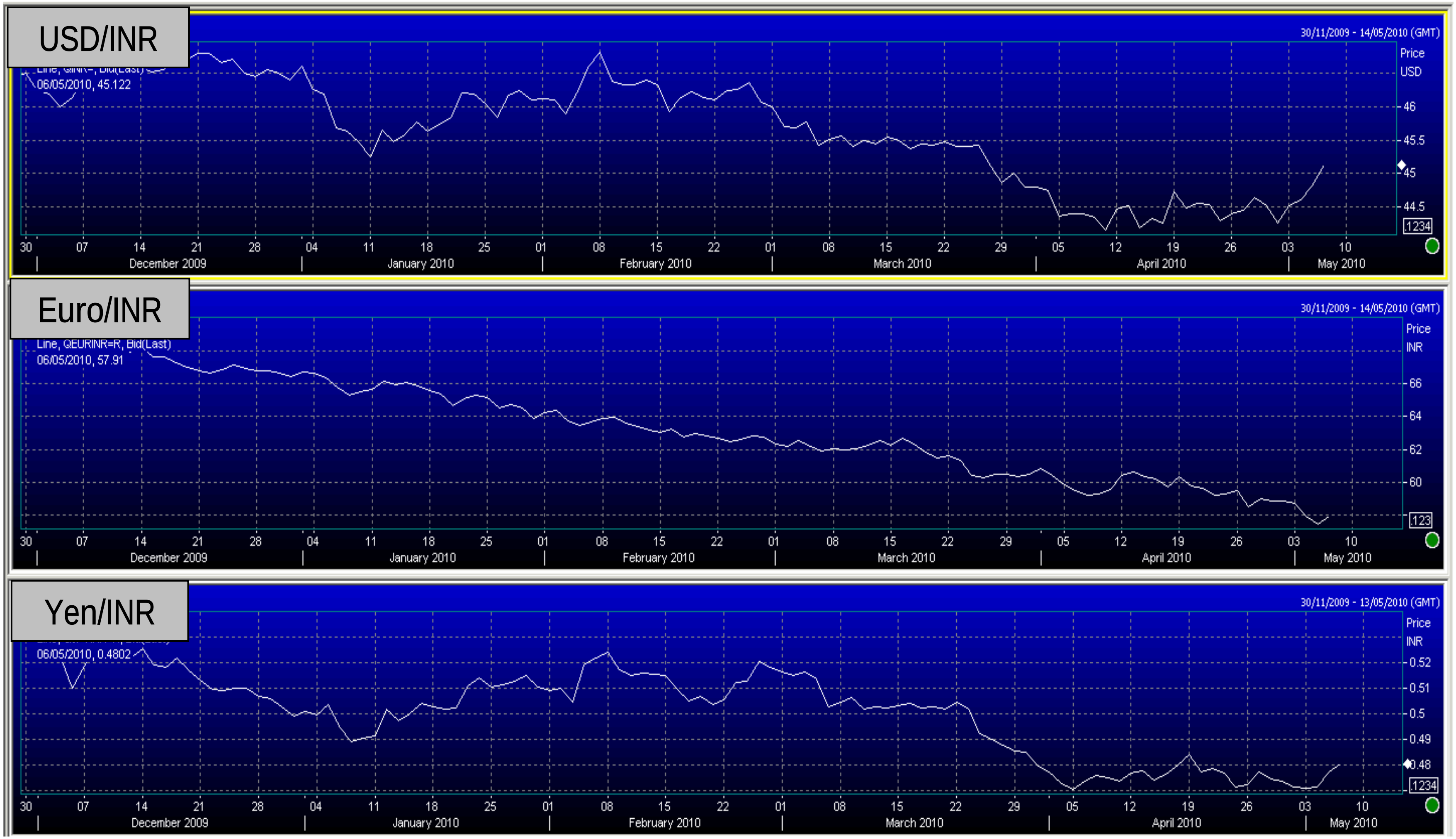
Currency movements….



Source - Reuters

Commodities

May – Strategy

Improving global economy should provide support to commodities

We believe the developing global recovery should continue to provide support to rising prices of commodities 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 gained ground amidst uncertainty over Greece and some other European countries during April and closed the month at US$1178 (Source: Reuters). We believe gold is likely to remain range-bound as US dollar strength is counteracted by sovereign risk concerns and emerging market demand.

- Oil: Light crude oil gained some ground during the month of April and closed the month at $86.75/bbl (Source: Reuters). While we expect oil demand from emerging markets to continue to rise, a stronger USD and higher inventory build ups appear to be keeping price appreciation muted.

- Agricultural Commodities and Industrial Metals: With USD strengthening, we believe price appreciation of agricultural commodities will remain muted in the short term. However, industrial metal prices have held up well, even in light of possibly faster interest rate hikes in emerging markets, demonstrating strong underlying demand

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