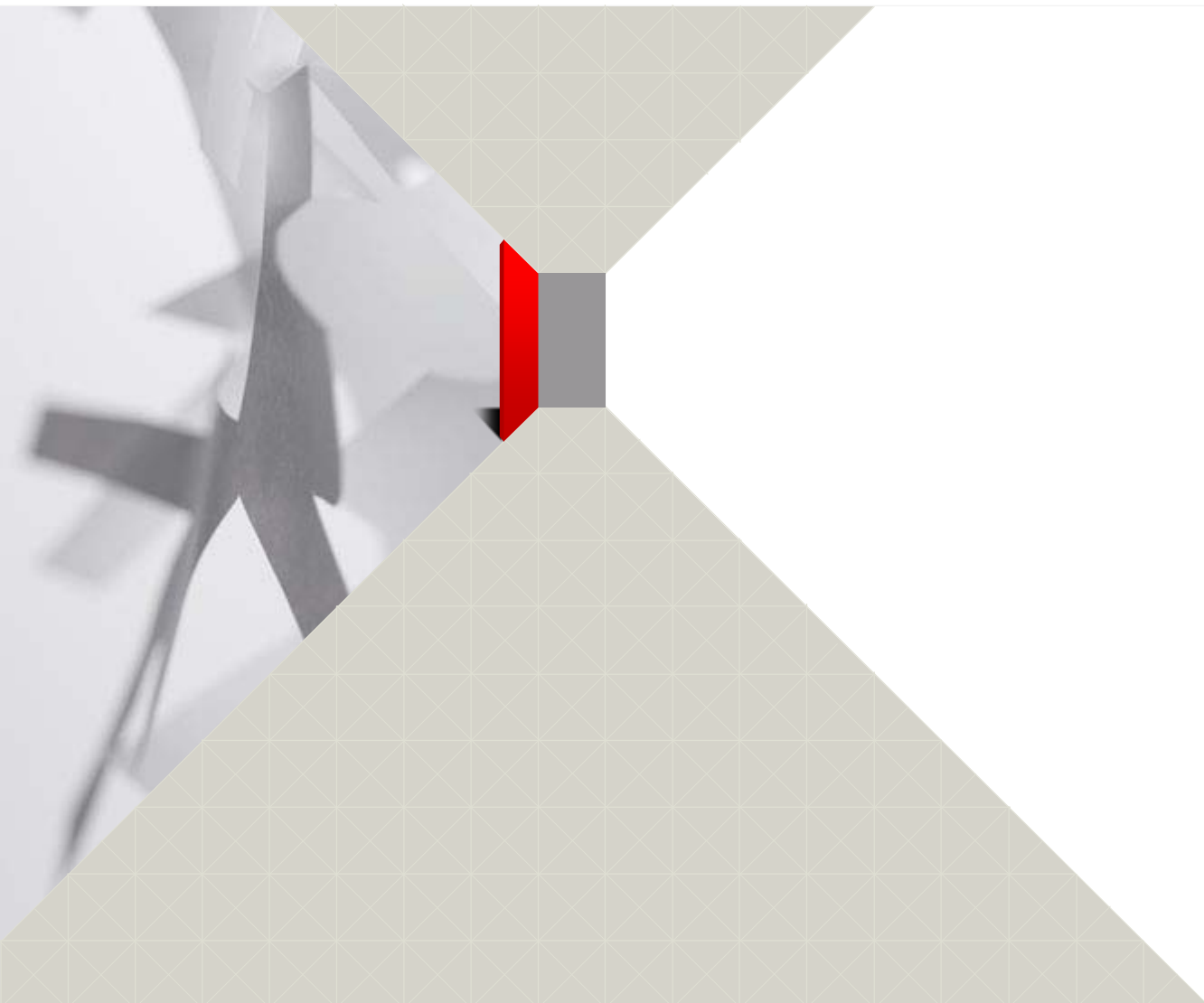


India Strategy  
November 2009



Equities

## November – Strategy

Profit booking witnessed across most sectors in Oct. FMCG the only sector firmly in the green

- ▶ Indian equity markets showed signs of profit booking during the last month. The BSE Sensex closed the month of October at 15896 (-7.18% M-O-M) and the NSE Nifty closed the month at 4711 (-7.32% M-O-M).
- ▶ FMCG, Metals, Banking, Auto and Capital Goods outperformed the main indices where as Oil & Gas underperformed the main indices.

Index	Monthly Change	Index	Monthly Change
BSE FMCG	9.05%	BSE BANKEX	-5.27%
BSE HEALTHCA	-0.61%	BSE AUTO	-5.36%
CNX IT	-1.43%	BSE PSU	-5.71%
BSE METAL	-1.67%	BSE CAP GOOD	-6.42%
NSE MIDCAP	-1.99%	BSE-SMALLCAP	-7.00%
BSE IT	-3.18%	<b>BSE SENSEX</b>	<b>-7.18%</b>
NSE BANK NIF	-4.24%	<b>NSE NIFTY</b>	<b>-7.32%</b>
BSE CONS DUR	-4.54%	BSE OIL&GAS	-9.94%
BSE-MIDCAP I	-4.90%	BSE TECK	-12.43%

Source - Reuters

# November – Strategy

Global news flow and liquidity remain key for near term direction



Source - Reuters

## November – Strategy

### Stimulus measures to offset drought concerns; we maintain our GDP estimates

- ▶ Recent months have witnessed a marked improvement in a number of Indian economic indicators and it is clear that the recovery has begun. However, the recovery faces the challenges of the country's 13<sup>th</sup> 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 yet to be felt and should offset the negative impact of the poor monsoons.
- ▶ With inflation now in the positive and given rising commodity prices, the RBI has been sounding more hawkish recently. We doubt that the RBI will make a rate move this year and expect the first CRR hike in Q1 of next CY followed by repo and reverse repo rate hikes possibly in Q2 of next CY. The lag impact of the earlier monetary policy measures will boost growth over the next few quarters.
- ▶ During October, WPI inflation moved into the positive. Inflation came in at 1.51% for the week ended October 17th (Source: Reuters). We expect headline WPI inflation to rise sharply towards the end of this CY and early 2010 with an expectation of 8% by the end of this FY.

#### Institutional Activity:

- ▶ FIIs continued to be buyers of Indian equities in October. They bought \$1.74 bln (Source: SEBI) of Indian equities during the month. Global risk appetite has been improving and India has got its share of global fund flows. Global cues to drive FII flows in the near term.
- ▶ Domestic mutual funds continued to be net sellers in October possibly due to profit booking by domestic retail investors. Domestic MFs sold (\$1.1 bln) (Source: SEBI) of Indian equities during the month.

## November – Strategy

### Fiscal deficit looks to have peaked, we revise down our 09/10 & 10/11 deficit projections

- ▶ In his budget speech, the Finance Minister made it clear that the government's first challenge was to "lead growth back to 9%" and there was a need to give "further stimulus" despite "signs of revival in the domestic economy."
- ▶ The government has projected the fiscal deficit to hit 6.8% of GDP in 2009/10, up from the original forecast of 5.5%. We have cut our central government budget deficit forecast to 6.9% of GDP from 7.5% previously for 2009/10 and expect it to fall below 6% of GDP in 2010/11.
- ▶ We believe that the pick up in industrial production growth bodes well for a sharp turn in government revenues. The bad news is that there are plenty of upward pressures on spending in the form of a rising subsidy bill and possible further support to drought hit farmers.
- ▶ India remains a long way from achieving and sustaining a 9-10% GDP growth and will need a lot more in the way of infrastructure spending and economic reform. Our fear is that the deficit will be controlled more by undershooting infrastructure spending targets rather than expanding the revenue base or cutting bureaucracy. The government's various income support measures for the rural and urban poor will continue to put pressure on the deficit.
- ▶ We also project India's current account deficit to be maintained in the -1.6% - 2% of GDP between F2009/10 and 2011/12. This will be possible as domestic oil and gas output starts to come through from this FY onwards.

## November – Strategy

### Recent data releases point to recovery. FY'11 GDP estimates revised upwards

- ▶ 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 Q1 GDP numbers of 6.1% and 10.4% y-o-y IIP growth in August. In spite of the drought which we believe will negatively impact GDP by 1.5%, we are maintaining our GDP growth expectations at 6.2% for FY'10. Agricultural production generally bounces back strongly in the year after a drought and we are therefore revising upwards our GDP estimate for FY'11 from 8% to 8.5%.
- ▶ 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 the rest of 2009 and 2010.
- ▶ The following indicators appear to be pointing to an economic recovery already underway;
  - **Motor vehicle sales** have shown a strong improvement since February through October '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 December low of 44.4 it has bounced to 54.5 in October with overall orders improving to 56.7. These numbers are marginally less than September. Export orders showed decent improvement and came in at 53.4 which is the highest level since August last year.
  - **Industrial Production** has recovered to 10.4% in August.

## November – Strategy

### India more resilient during global slowdown but pick up will not be as spectacular as others

- ▶ As expected, growth in India was more resilient during the downturn. But in the recovery, while growth is expected to be strong it will not be as spectacular as in other more cyclical markets. We believe the long term growth story remains intact with the following factors contributing to growth over the next few quarters;
  - **Commodity price collapse** which has seen the Commodity Research Bureau (CRB) index register its largest y-o-y drop since it began 50 years ago. Being a big commodity importer, this should add about 1.5% points to GDP growth (Source: HSBC)
  - **Higher domestic oil and gas output** in the coming quarters which we estimate could add 0.3-0.5% to real GDP growth each year over the next couple of years
  - **The lagged effects of buoyant inward & outward FDI** – The benefits of the inward FDI which came in at \$33 bln in CY'08 (Source: HSBC) should be felt over the coming quarters and years. Outward FDI, which totaled around \$18 bln in CY'08, has been largely to acquire skills from companies operating in the developed world which can then be transferred back to the local economy in order to boost productivity. FDI has picked up again after a couple of muted quarters.
  - **Fiscal policy** - The government's fiscal action mainly in the form of the farm loan waiver scheme, the public sector pay hikes, fuel and import duty cuts and additional infrastructure spending on roads, ports and utilities, is worth roughly 4% of GDP in 2009 (Source: HSBC estimates).
  - **Monetary policy** – Since October 2008, the RBI has aggressively lowered the repo rate, reverse repo rate and Cash Reserve Ratio (CRR) as well as the SLR. Given inflation expectations going forward, RBI has been sounding more hawkish of late and in the last policy meet started by raising SLR by 1% to 25%. The lagged impact of the interest rate cuts should continue to be felt in the quarters ahead.

## November – Strategy

### Jitters over policy means India could lag; global liquidity to provide near term direction

- ▶ 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 this year 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 so far have been in line with market expectations and certain sectors like FMCG, Auto, and Banking have 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 in the second half of CY09 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 mean 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 January - March 2010 quarter. 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 15896, current valuations of the Indian market are now reasonable but with the risk of monetary tightening, India may lag peers in the Asia Pacific region.

## November – Strategy

### 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 15896 (Sensex at October end), India trades at a P/E of 17.3X FY10e and 14.2X 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 sectors are healthcare and materials. Our sector views follow.

## November– 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. Policy measures in agriculture, infrastructure and exports could help revive demand for credit.
- ▶ **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 overweight stance on the sector and like the companies positioned to benefit from the recovery in the BFSI space. Currency appreciation a risk.
- ▶ **Industrials** – Overweight - Sentiment for the sector to improve considerably on account of government boost to infrastructure. Though valuations are at a premium, investment theme may find favour at expense of consumption theme. We expect outlook to improve in FY2011. Capital goods remains a strong growth story in India and we prefer long capex cycle companies. We remain overweight the sector.
- ▶ **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. We upgrade sector rating to overweight.
- ▶ **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 2009, but capacity additions over the next 12-18 months will help. We maintain our neutral rating on the sector as valuations are fair.

## November – 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 upgrading the retail sub sector to neutral 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 and with improving outlook for property prices we upgrade the sector to neutral.
- ▶ **Materials** – Underweight – Outlook for cement is improving as we near the trough of the economic cycle but over capacity on the supply side will be an issue over the next 1 year. We remain cautious on metals and mining and given current valuations we remain underweight the sector.
- ▶ **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 downgrade sector rating to underweight.

## November – Strategy

Derivatives show presence of selling pressure indicating a cap on upside

### Equity Derivatives:

- ▶ Nifty near month future lost 7.2% during the month of October
- ▶ Open Interest for Nifty future was up by 11.4%
- ▶ Bank Nifty near month future lost by 3.92%
- ▶ Open Interest for Bank Nifty future was marginally up by 2 %
- ▶ CNX IT near month future lost 1.73%
- ▶ CNX IT futures open interest remained absolutely flat

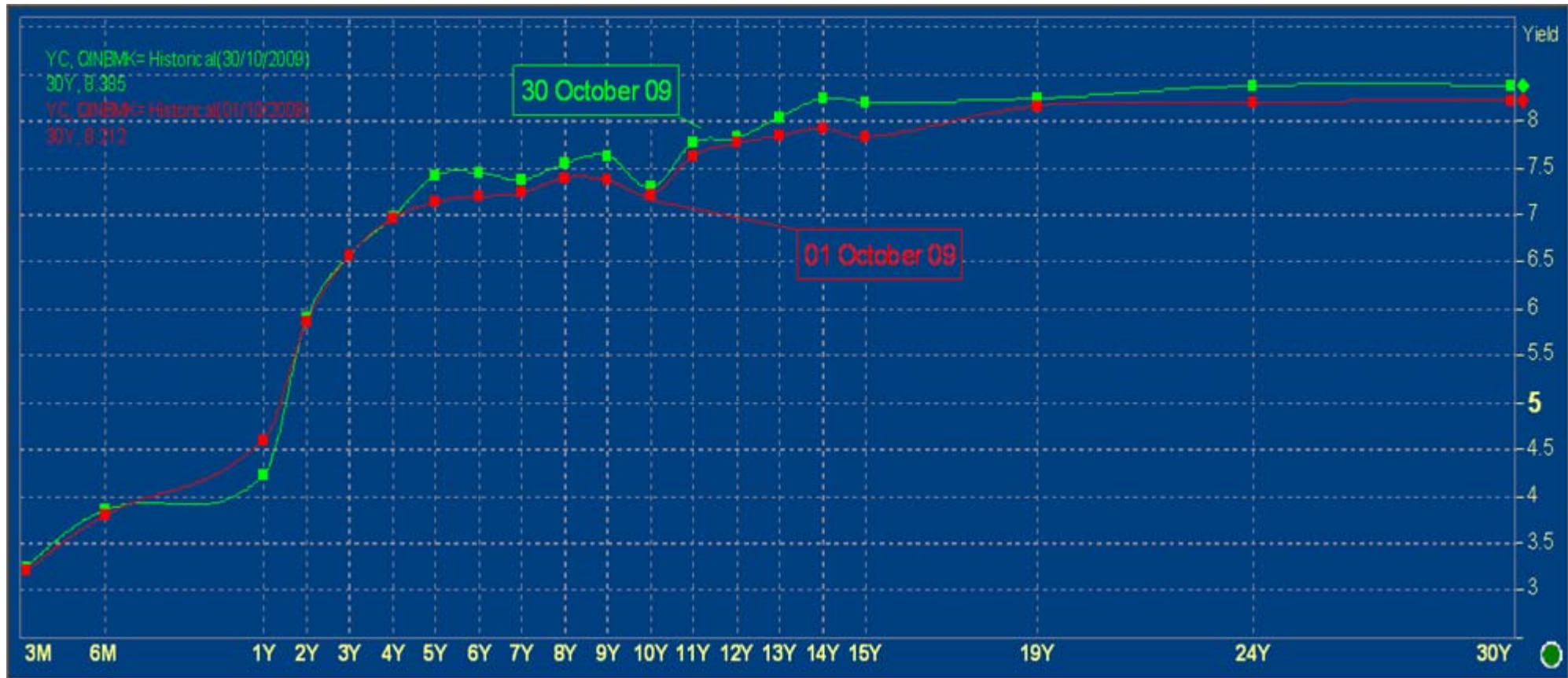
Source – Reuters



# Fixed Income

# November – Strategy

## Fixed Income



Indian Government Yield Curve

Source: Reuters

- The sovereign yield curve eased marginally at the shorter end with sufficiently high liquidity in the system. The amounts placed by banks with the central bank continued to be close to Rs.1000 bn which has been the phenomenon for some time. We expect liquidity to gradually reduce as we move into the busy season.
- We expect that volatility on both gilts and corporate bonds will be elevated as investors search for value across the curve given the uncertainties. We continue to recommend low durations in portfolios and look to use multiple value strategies for improving fixed income yields.

## November – Strategy

Liquidity to keep yields range bound; RBI sounding hawkish given inflationary expectations

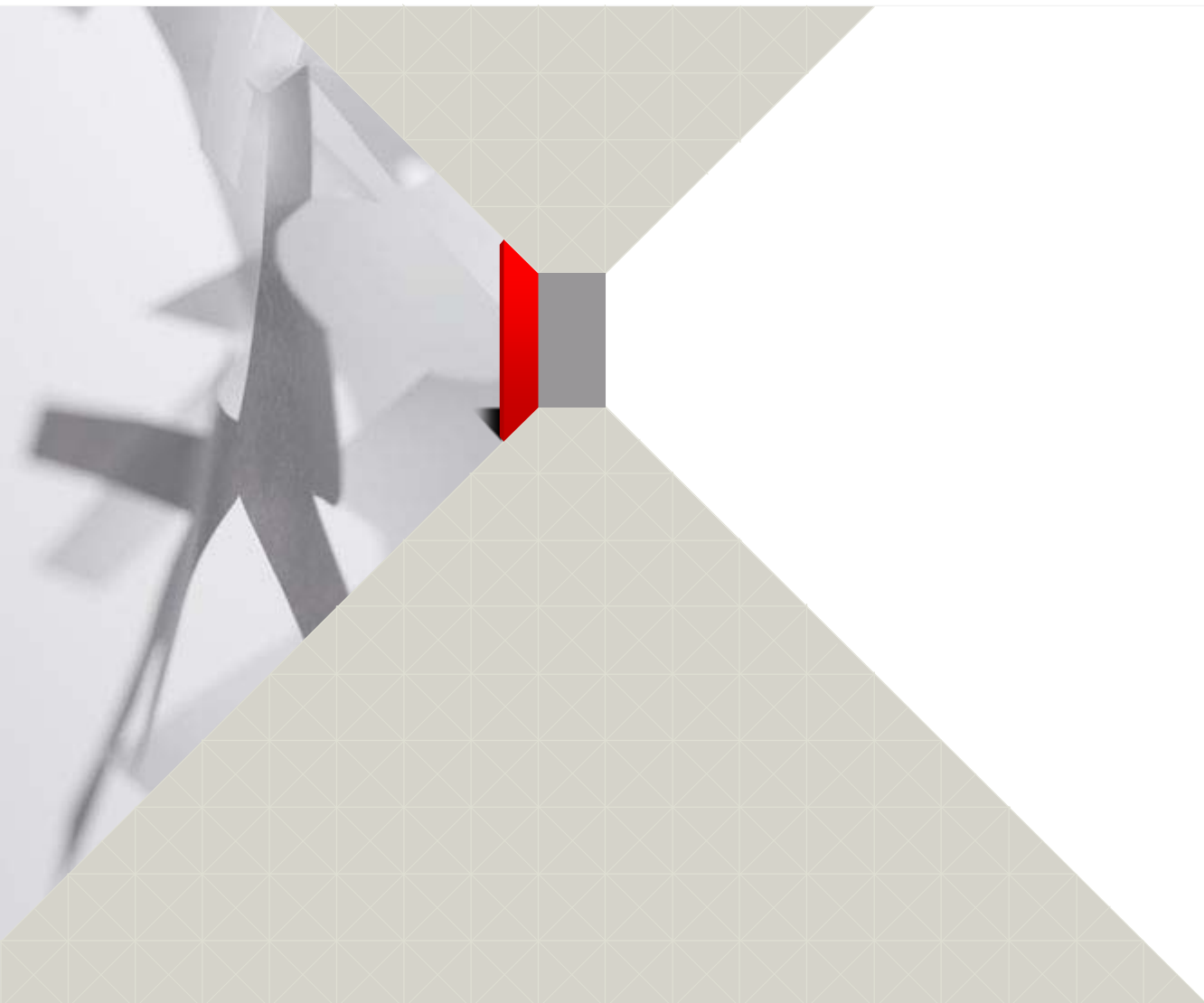
### Fixed Income:

- ▶ Liquidity continued to be easy in the month of October. The average Mumbai Inter Bank Offer Rate for the month remained flat at 3.29% in comparison to 3.33% for the previous month. The outstanding amounts lent in reverse repo on 30th October '09 was Rs.846 bln as against Rs.1214 bln on 30th September '09 (Source: NSE/ RBI website).
- ▶ The WPI inflation numbers reported for the week ended 17th October '09 accelerated to 1.51% as compared to 0.83 % for the similar period last month (Source: Reuters). The low numbers can be deceptive due to the high base of last year and incrementally rising inflation may prove to be a challenge for the central bank given that it is more related to supply side issues rather than demand. The alarming part on the latest inflation number has been the sharp increase in food inflation at over 13%. The expectations within policy makers is that this would moderate by the end of the year.
- ▶ We expect the headline WPI inflation rate to reach 8% by March next year as the full impact of the commodity price rises feed through. Consumer price inflation has proved remarkably stubborn and there is risk of further rises ahead.
- ▶ The RBI in its policy meet for the quarter left the key repo and reverse repo rates unchanged (at 4.75% and 3.25% respectively) and the cash reserve ratio also untouched at 5%. The unnoticed factor of the policy was SLR raised to 25% from 24%, provisioning requirement for lending to commercial real estate from 0.4% to 1% and provisioning ratio for non performing assets to 70% from 10%.
- ▶ The tone of the policy was slightly more hawkish than expected. Price stability was mentioned in all the three bullet points that the RBI used to describe its overall policy stance which was different from past policies.
- ▶ We are sticking to the view that the first move will come in Q1 2010. We now expect 200 bps of CRR increases (previously 150 bps) and 125 bps of policy rate rises (previously 75 bps) in CY 2010.

## November – Strategy

Volatility may remain as investors search for better yields. Suggest sticking to the short end of the curve

- ▶ 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 with minimum amounts locked into fixed rate instruments. Fixed maturity plans with tenures in the one to two year bucket can be selectively considered to improve yields on portfolios.
- ▶ We expect short end yields to remain benign over the next couple of months. Hence, ultra short term bond funds with low durations along with some allocations to hybrid schemes or funds that have higher yield to maturity portfolios may provide a good risk reward trade off in the near term.
- ▶ We believe that longer end yields may move in a trading range with possibilities of rallies. These rallies could be led by increased inward fund flows and liquidity in the system searching for yields.
- ▶ Volatility may be seen in case of any central bank policy action to stem rising inflationary expectations and structural high government deficit.



# Currencies

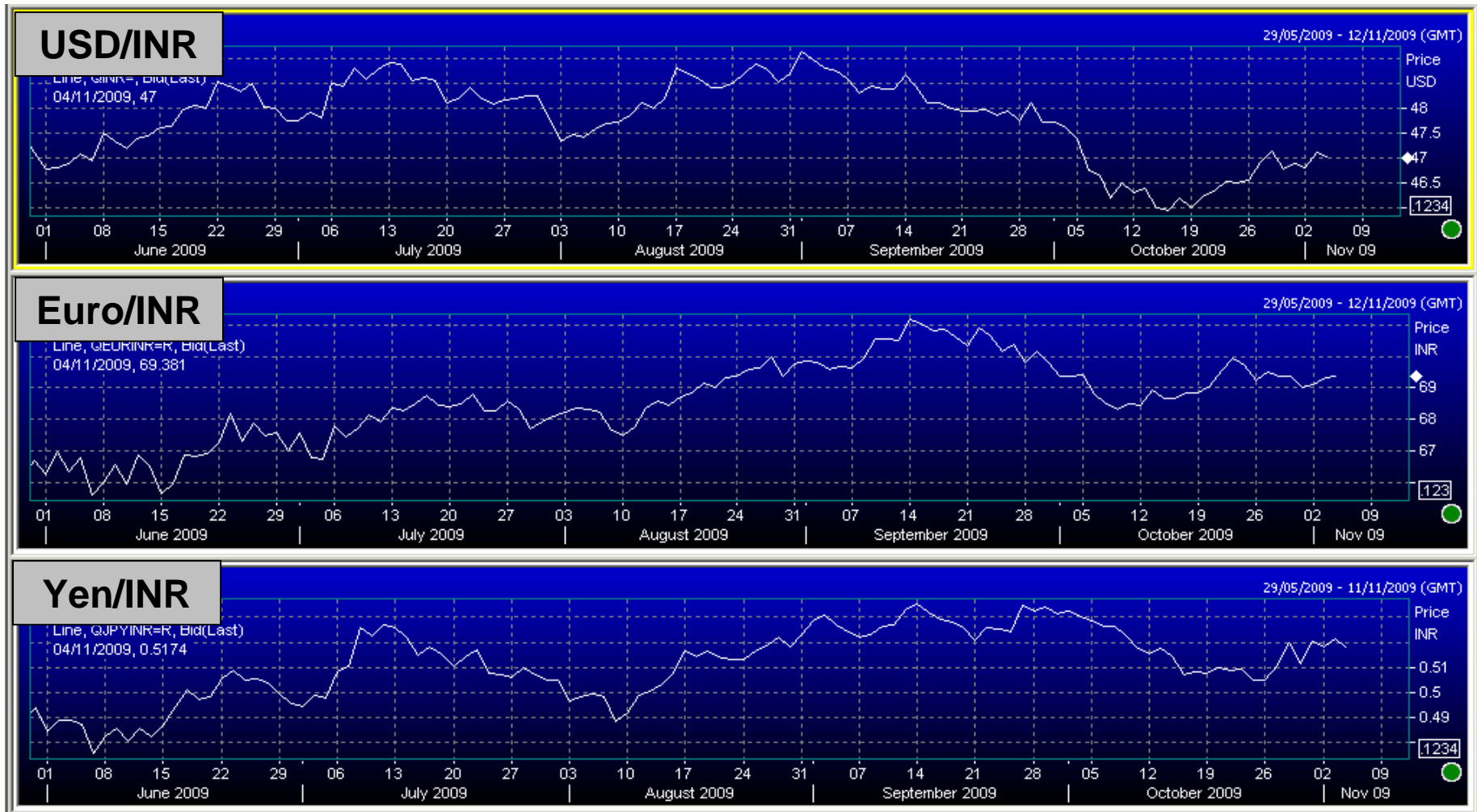
## November – Strategy

### Return to traditional market-movers should provide support to USD in the long term

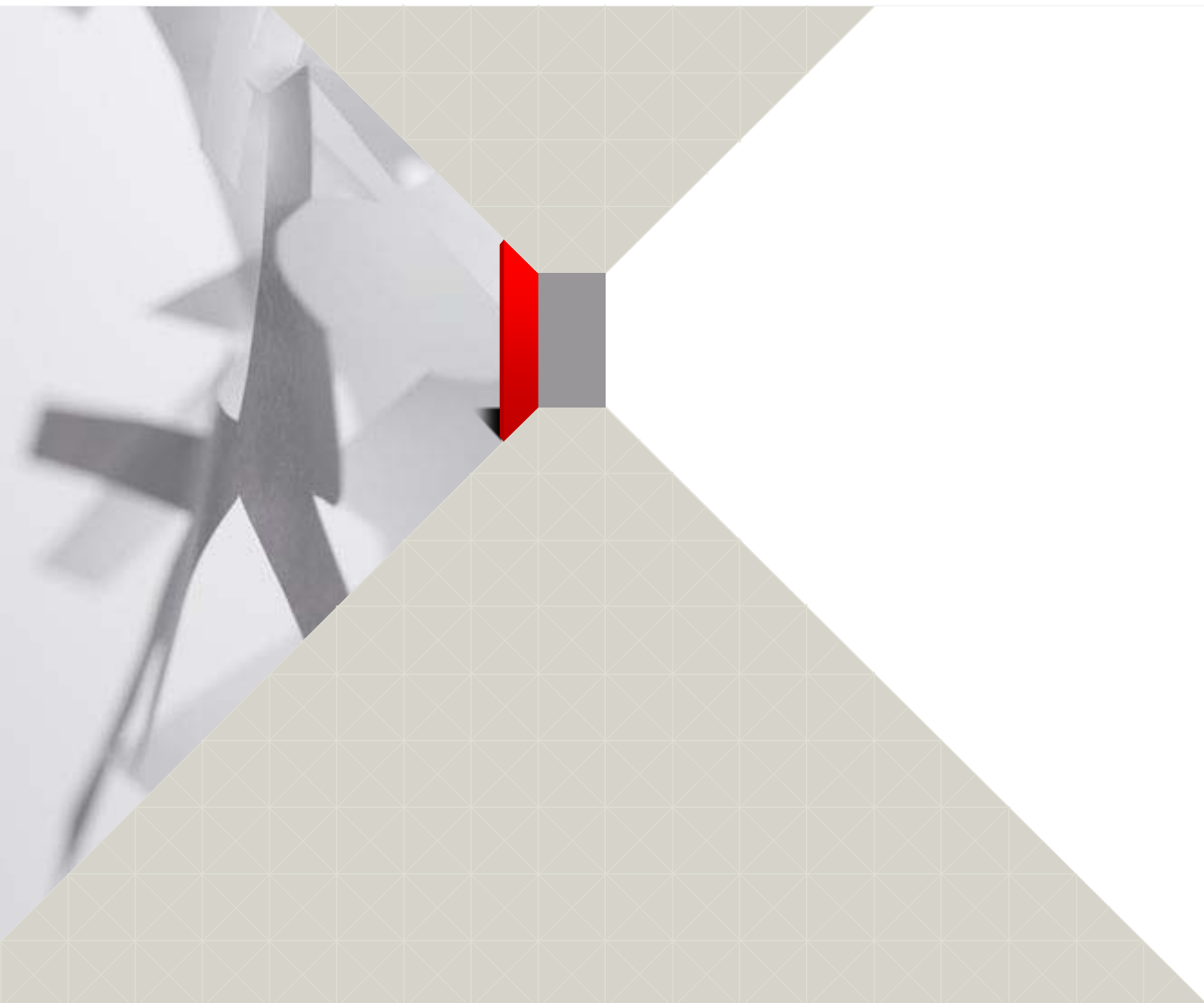
- ▶ **INR** - The INR strengthened during the last month and closed the month at 46.90 against the USD (Source: Reuters). Going forward, we expect INR to strengthen marginally on account of a narrowing current account deficit and capital inflows. Our Dec 2010 target for INR stands at 46.5, while that for Dec 2011 stands at 44.5 against the USD.
- ▶ **USD** - With talk of exit strategies unlikely to surface in the short term, the momentum against USD is strong. However, as markets normalise, a return to traditional market-movers should provide support to USD in the long term. In the past few weeks, the momentum against the US dollar has been very strong as well as broad-based against all currencies, and we have therefore downgraded our USD view to negative for the short term as we expect this trend to persist.
- ▶ **GBP** - We continue to expect a period of sideways trading for GBP as further gains appear unlikely.
- ▶ **EURO** – The Euro is one of the primary beneficiaries of the USD weakness in the short term, however in the long term, we expect USD to find support as policy decisions favour USD.
- ▶ **JPY** - Improving market sentiment and returning risk appetite will likely lead to weakening JPY in the long term, as investors seek yield elsewhere.
- ▶ **Emerging Markets** - We continue to believe that EM currencies offer attractive opportunities, as investors look to diversify from the weakening USD and look for higher yielding currencies.

# November – Strategy

Currency movements....



Source - Reuters



# Commodities

## November – 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 burgeoning global economic recovery should be supportive of rising prices in line with resurgent demand and renewed investor risk appetite.

- ▶ **Gold:** Gold gained during the month and closed the month at US\$1044 (Source: Reuters). With momentum firmly against the US dollar, we believe gold prices will continue to find support in the short term and have therefore upgraded our short-term view to neutral with a positive bias. Nonetheless, we believe the upside to gold prices is limited, and maintain our neutral outlook for the long term.
- ▶ **Oil:** Light crude oil gained ground and closed the month of October at \$77/bbl (Source: Reuters). Over the next 12 months, we expect oil prices to rise as demand from Emerging Markets is likely to compensate for the decline in demand from developed countries, while rather inelastic supply and limited alternatives should provide further support to oil prices. In addition, it appears that current USD weakness is outweighing the oversupply issue as oil prices have broken out of their long-lasting trading range. We have consequently upgraded our short-term view to neutral with a positive bias.
- ▶ **Industrial Metals:** With stimulus packages placing the emphasis on infrastructure, particularly in the US and in China, we believe industrial metals should find support in the longer term, when the full effects of the stimuli are deployed.

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