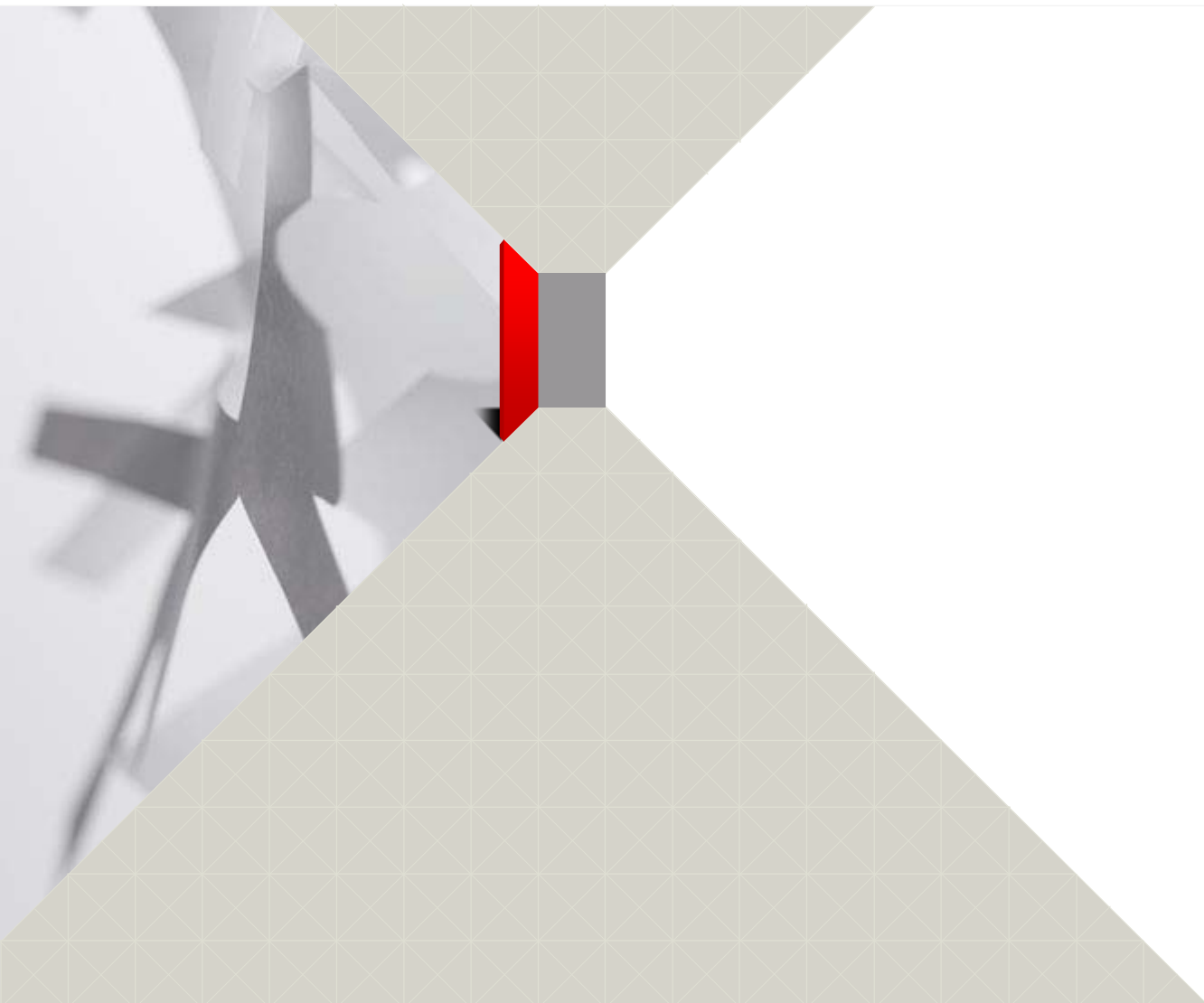


India Strategy

October 2009



Equities

October – Strategy

Markets rally on the back of strong FII flows; Banking, Metals, Auto & Healthcare outperform

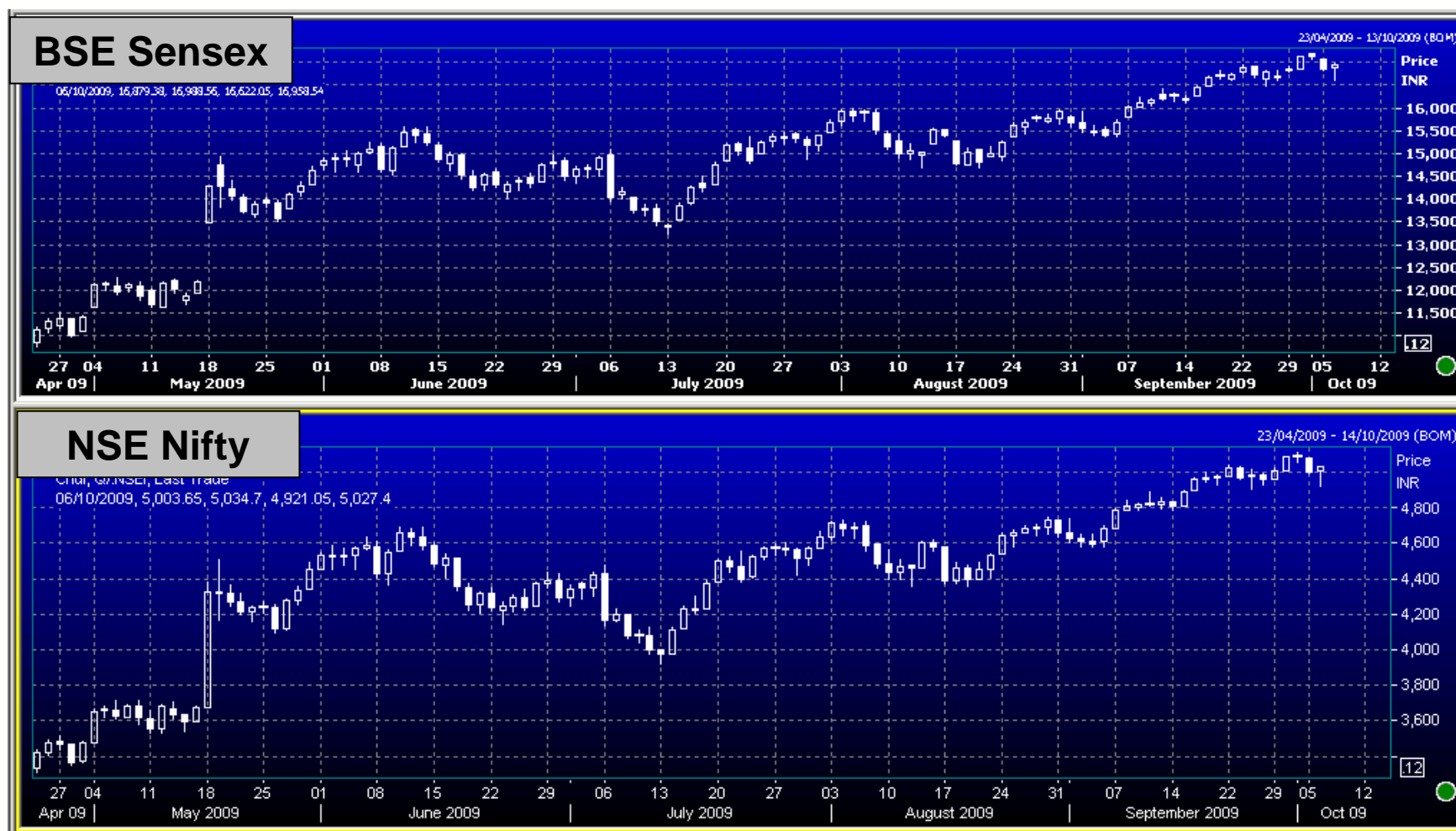
- ▶ Indian equity markets resumed their run up during the last month on the back of strong FII fund flows. The BSE Sensex closed the month at 17126 (9.32% M-O-M) and the NSE Nifty closed the month at 5083 (9.05% M-O-M).
- ▶ Banking, Metals, Auto, Healthcare outperformed the main indices where as Oil & Gas, Consumer Durables, Capital Goods and FMCG underperformed the main indices.

Index	Monthly Change	Index	Monthly Change
NSE BANK NIF	18.58%	NSE NIFTY	9.05%
BSE BANKEX	18.11%	BSE-SMALLCAP	8.48%
BSE METAL	14.49%	BSE-MIDCAP I	7.50%
BSE AUTO	13.37%	BSE OIL&GAS	7.17%
BSE HEALTHCA	12.90%	BSE TECK	7.02%
CNX IT	10.91%	BSE CONS DUR	6.43%
NSE MIDCAP	9.73%	BSE PSU	6.28%
BSE IT	9.55%	BSE CAP GOOD	4.61%
BSE SENSEX	9.32%	BSE FMCG	0.87%

Source - Reuters

October – Strategy

Equity markets continued to rally in September, liquidity remains key for further upside



Source - Reuters

October – 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 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 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 and 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 September, WPI inflation moved into the positive. Inflation came in at .83% for the week ended Sep 12th (Source: Reuters). We expect headline WPI 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 strong buyers of Indian equities in September. They bought \$4.14 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 turned net sellers in September possibly due to profit booking by domestic retail investors. Domestic MFs sold \$493 mln (Source: SEBI) of Indian equities during the month.

October – 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, possible further support to drought hit farmers and the second installment of the public sector pay hike recommended by the Pay Commission (60% still left to be paid). This pay hike is likely to come in this month and is worth roughly 0.5% of GDP.
- ▶ 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.

October – Strategy

Green shoots and recent data releases point to recovery

- ▶ 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.
- ▶ Signs of recovery in India appear to be emerging. Backed by surprisingly strong Q1 GDP numbers of 6.1% and 7% y-o-y IIP growth in July. We expect August IIP growth, which is expected to be released October 12th, to be 9.5% on a y-o-y basis. This could be thanks partly to a helpful base effect. Our GDP growth expectations are 6.2% for FY'10, 8% for FY'11 and 8.5% for FY'12.
- ▶ 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 which is already underway;
 - **Motor vehicle sales** have shown a strong improvement in February through September 09.
 - **Cement production** has shown an 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 55.0 in September with overall orders improving to 58.3. This points to strengthening domestic demand as export orders fell marginally to 50.9.
 - **Industrial Production** has recovered to 7% y-o-y in July and is expected to come in at close to 10% for August

October – 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 September 2008, the RBI has aggressively lowered the repo rate, reverse repo rate and Cash Reserve Ratio (CRR) as well as the SLR by 1% to 24%. It has also eased ECB limits, raised interest rates on NRI deposits, improved access to funds for non-bank financial corporations, lowered the risk weightings for bank lending to commercial real estate companies and reduced provisioning requirements for housing, personal and credit card loans. Given inflation expectations going forward, RBI has been sounding more hawkish of late.

October – Strategy

Jitters over policy means India could lag other markets; Q2 results to impact 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 with ~ \$14 bln of FII inflows moving into Indian equities during the period.
- ▶ 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 season starts in the next few days and should provide direction to the market.
- ▶ Our expectations for Sensex companies are 5-10% EPS growth in FY10 and a return to trend growth of 10-15% in FY11. We expect growth to pick up in the second half of CY09 and corporate earnings to recover from the recently ended September 2009 quarter.
- ▶ 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 rate move will be in the January - March 2010 quarter.
- ▶ 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.
- ▶ Valuation of the Indian market is stretched and with the risk of monetary tightening, India may lag peers in the Asia Pacific region. Given this we are "underweight" on India relative to the Asia Pacific region.

October – Strategy

Valuations “stretched”. “Book Profits” if over allocated to equity

- ▶ We continue to remain positive about Indian equities over the longer term, but near term market movement is likely to depend on Q2 results, global news flows and liquidity flows.
- ▶ Based on historical trends, equity valuations are now stretched. At 17126 (Sensex at September end), India trades at a P/E of 18.6X FY10e and 16.7X 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, this would be an opportune time to bring 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, although having narrowed, 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 and industrials 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 consumer discretionary, real estate and materials. Our sector views follow.

October– Strategy

Overweight – Banks, Industrials & IT; Neutral – Telecom, Consumer Staples, Energy

- ▶ **Financials** – Overweight – Current valuations and higher growth prospects in a scenario of economic recovery make us overweight Private sector banks. We move PSU banks to neutral given rising bond yields are a risk to our 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 the uncertain outlook on the monsoon. We maintain overweight stance on the sector and like the companies positioned to benefit from the recovery in the BFSI space.
- ▶ **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** – Neutral – Cost pressures should ease with commodity prices having corrected sharply from their peaks. Monsoon a risk to the outlook for the sector, but we believe that the budgetary thrust on rural spending should offset effects of a weak monsoon. We maintain a neutral rating on the sector and given it's defensive nature means it is unlikely to underperform.
- ▶ **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 now fair.

October – Strategy

Neutral – Utilities, Healthcare; Underweight – Materials, Real Estate, Consumer Discretionary

- ▶ **Utilities** – Neutral – Generation capacity being increased, but shortfall remains; We rate the sector as neutral given that valuations are now reasonable.
- ▶ **Healthcare** – Neutral – The competitive landscape in the healthcare sector is strong and recent news flow has been negative. Due to defensive in nature and valuations no longer a premium to the market, We upgrade our rating on the sector to neutral
- ▶ **Consumer Discretionary** – Underweight - Autos should benefit from the revival in urban demand, but the weak monsoon means rural demand a risk. We are neutral autos. We are underweight the retail sub sector as valuations are high and risk to discretionary spending may be squeezed.
- ▶ **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 and remain underweight the sector.
- ▶ **Real Estate** – Underweight – Balance sheet strength of most large players following the recent fund raising has improved. Demand conditions seem to be recovering, but we see limited upside to property prices and think valuations are high and we remain underweight the sector.

October – Strategy

Derivatives indicate possibility of profit booking at higher levels indicating a cap on upside

Equity Derivatives:

- ▶ Nifty near month future gained 8.5% during the month of September
- ▶ Open Interest for Nifty future was down by 4.6%
- ▶ Bank Nifty near month future gained by 17.6%
- ▶ Open Interest for Bank Nifty future was up by 83%
- ▶ CNX IT near month future gained 10.4%
- ▶ CNX IT futures open interest gained by 4.7%, though on a lower base

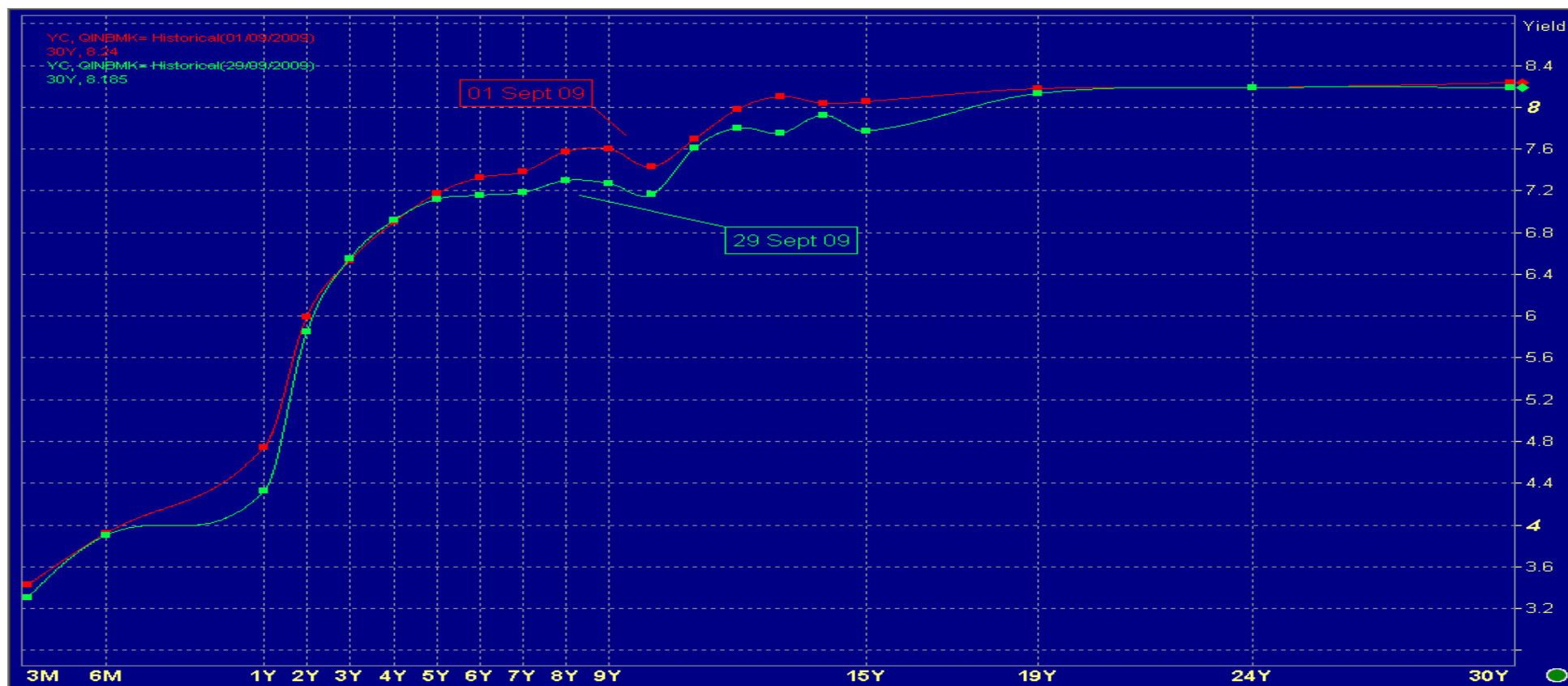
Source – Reuters



Fixed Income

October – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- The sovereign yield curve eased post the advance tax dates 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 with selling pressure on news of any withdrawal of liquidity, in case no changes are made to percentages of held to maturity securities for banks and lastly as the base effect of inflation wears out. We continue to recommend low durations in portfolios and look to use multiple value strategies for improving fixed income yields.

October – Strategy

Liquidity to keep yields range bound with the possibility of declines in 2-3 year bucket

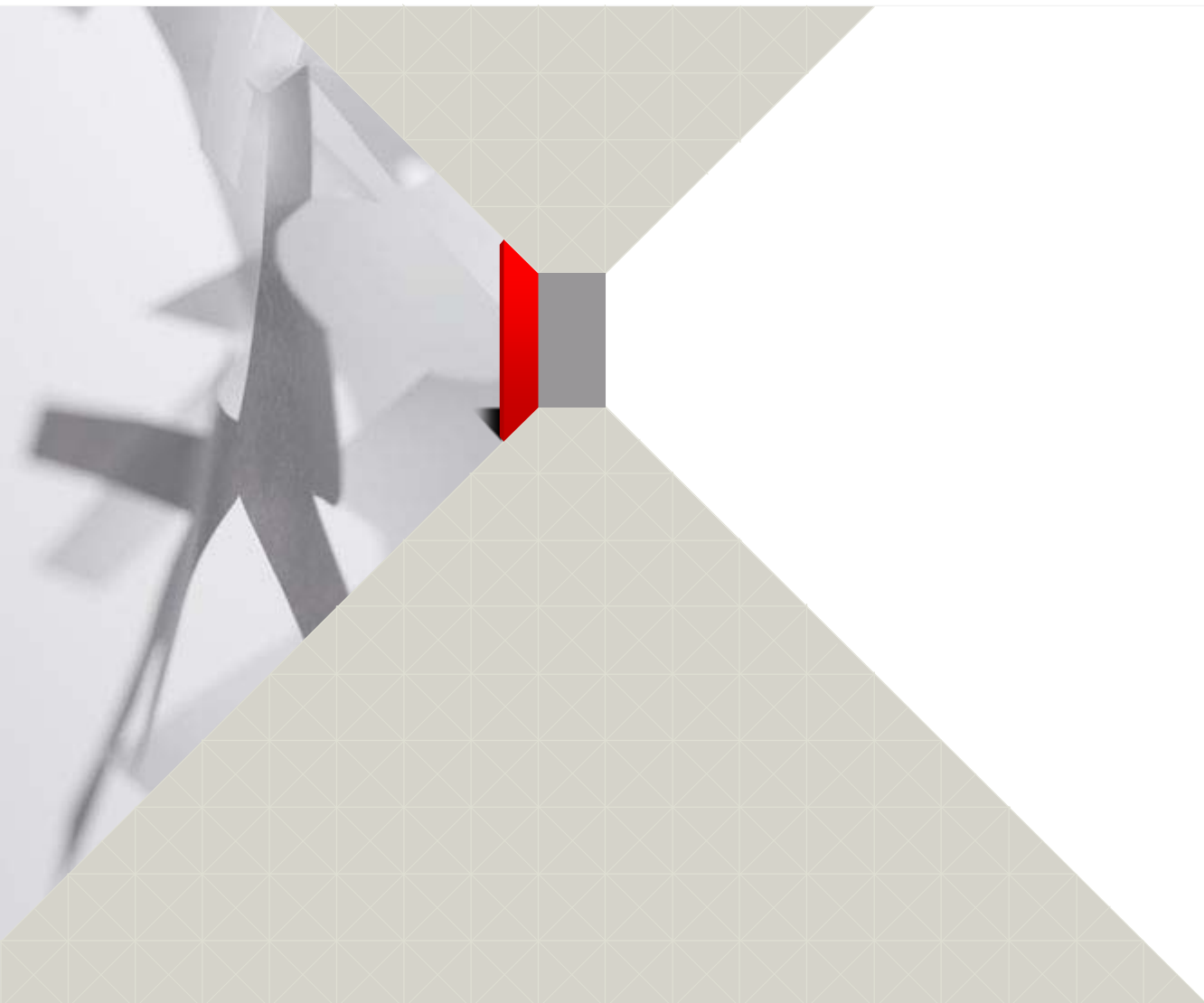
Fixed Income:

- ▶ Liquidity continued to be easy in the month of September. The average Mumbai Inter Bank Offer Rate for the month remained flat at 3.33% in comparison to 3.29% for the previous month. The outstanding amounts lent in reverse repo on 30th September '09 was Rs.1214 bln as against Rs.607 bln on 31st August '09 (Source: NSE/ RBI website).
- ▶ The inflation numbers reported for the week ended 12th September '09 accelerated to 0.83 % as compared to -0.95 % for the similar period last month (Source: Reuters). This is higher than consensus expectations of 0.68% for the week. 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.
- ▶ Wholesale Price Inflation has now bottomed and is starting to move higher. We expect the headline 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.
- ▶ RBI Governor Dr. Subbarao, has seemingly become more worried about inflation, raising the possibility that the Cash Reserve Ratio at least will be hiked before the end of calendar 2009.
- ▶ We are sticking to the view that the first move will come in 2010 although we have brought forward our expectation for the first CRR hike to be likely in the January - March quarter instead of the April – June quarter. The repo and reverse repo is unlikely to start rising until calendar Q2 2010.

October – Strategy

Volatility may remain as investors search for better yields while unfavourable macro conditions continue

- ▶ 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 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 and structural high government deficit.
- ▶ Although we do not recommend interest rate sensitive products at this time, we believe that investments into these products such as gilt or income funds requires a minimum horizon of twelve months and allocations are made after due consideration to the risk profile, concentration risks and plans to book regular profits from the segment.



Currencies

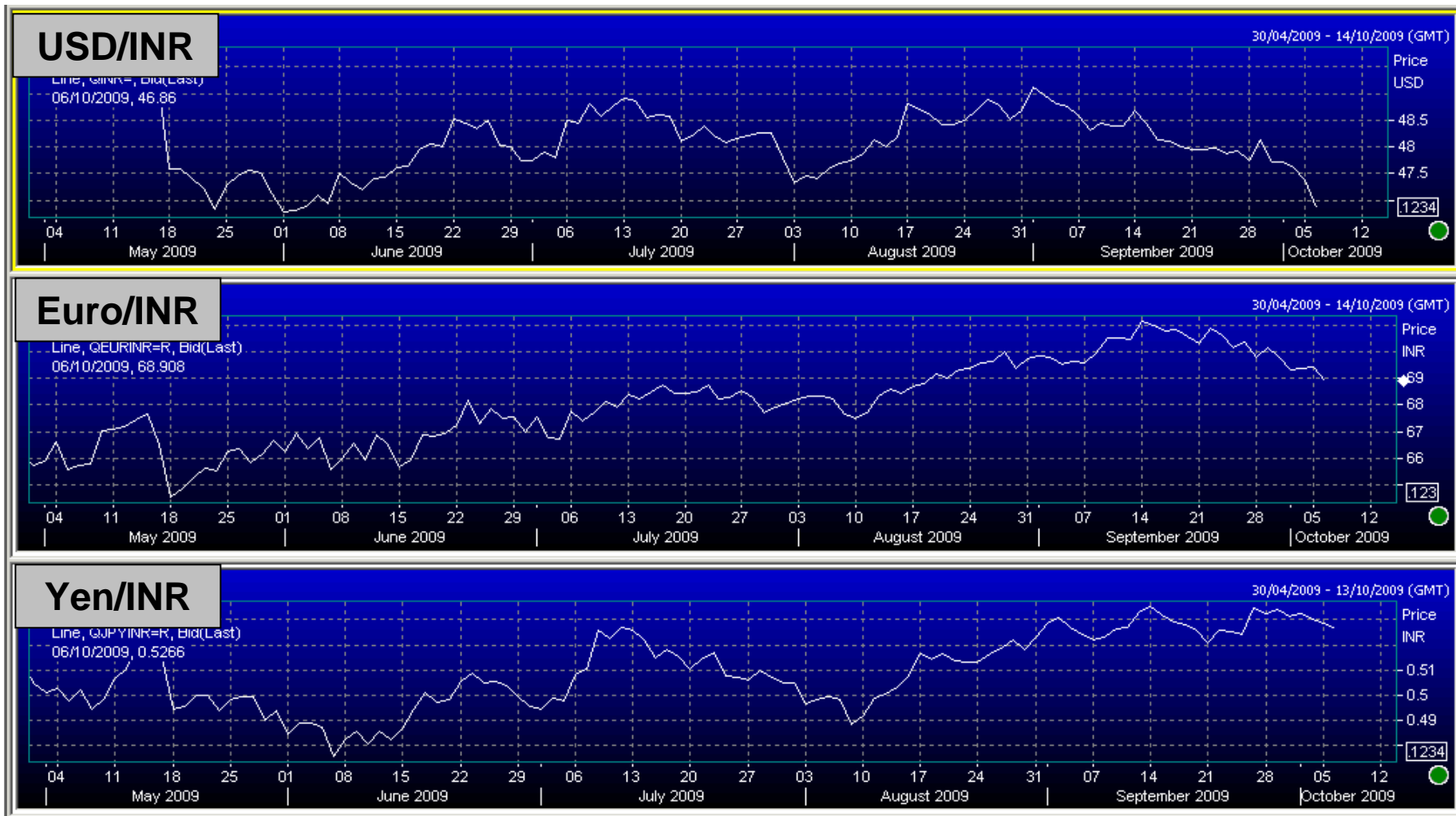
October – Strategy

As markets normalise, we believe the focus will shift back to fundamental market movers

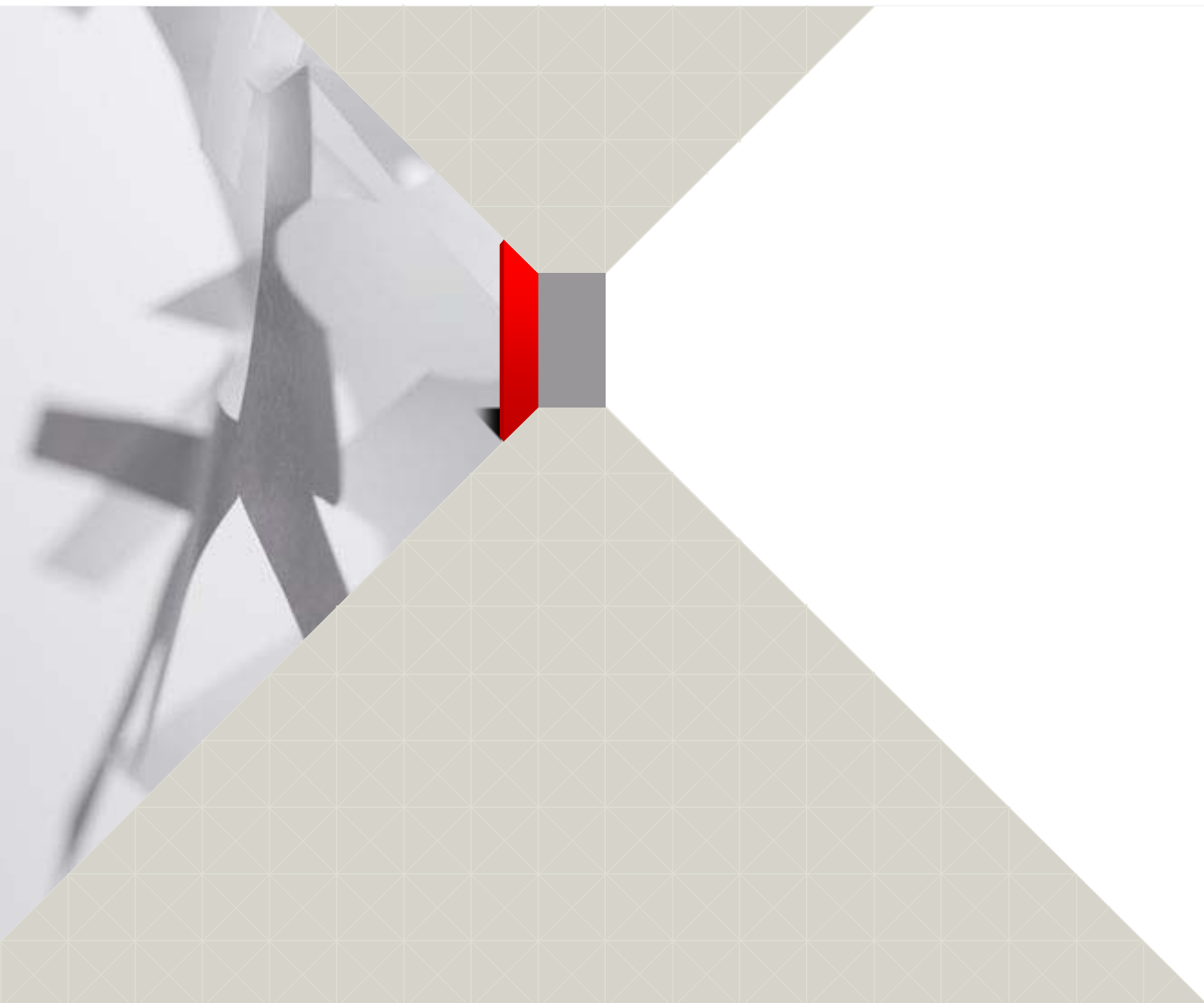
- ▶ **INR** – The INR strengthened marginally during the last month and closed the month at 47.72 against the USD (Source: Reuters). Going forward, we expect INR to strengthen marginally on account of a narrowing current account deficit and capital inflows. Our Dec 2010 target for INR stands at 46.5, while that for Dec 2011 stands at 44.5 against the USD.
- ▶ **USD** - As markets normalise, we believe the focus will shift back to fundamental market movers. In line with our positive outlook on the US economic recovery, we believe markets may be quick to price-in favourable USD interest rate differentials. As a consequence, we believe USD will find support and we expect the next move to be positive USD, though that may take some time to develop.
- ▶ **GBP** – We continue to expect a period of sideways trading for GBP as further gains appear unlikely.
- ▶ **EURO** – Although EUR has been trading at strong levels, the outlook for further gains appears limited given monetary policy expectations.
- ▶ **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** - With the improving economic backdrop, we believe select EM currencies are likely to appreciate. Nonetheless, we expect a divergence between currencies of countries with strong fundamentals and those of weaker countries.

October – Strategy

Currency movements....



Source - Reuters



Commodities

October – Strategy

As risk appetite returns, commodities should slowly improve

- ▶ 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\$1006 (Source: Reuters). The gold price appears to be based more on trends than on fundamentals. Fears of a consolidation in equity and credit markets as well as a weaker USD appear to have been providing support to gold prices since early September. However, as inflation fears remain muted for the time being, demand for gold as a hedge may be reduced. We maintain our neutral outlook both in the short and long term, as we do not expect much more upside to gold prices.
- ▶ **Oil:** Light crude oil remained in a broad range and closed the month of September flat at \$70.61/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. However, we believe the current oversupply remains an issue in the short-term.
- ▶ **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. In the meantime, we maintain our neutral view.

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