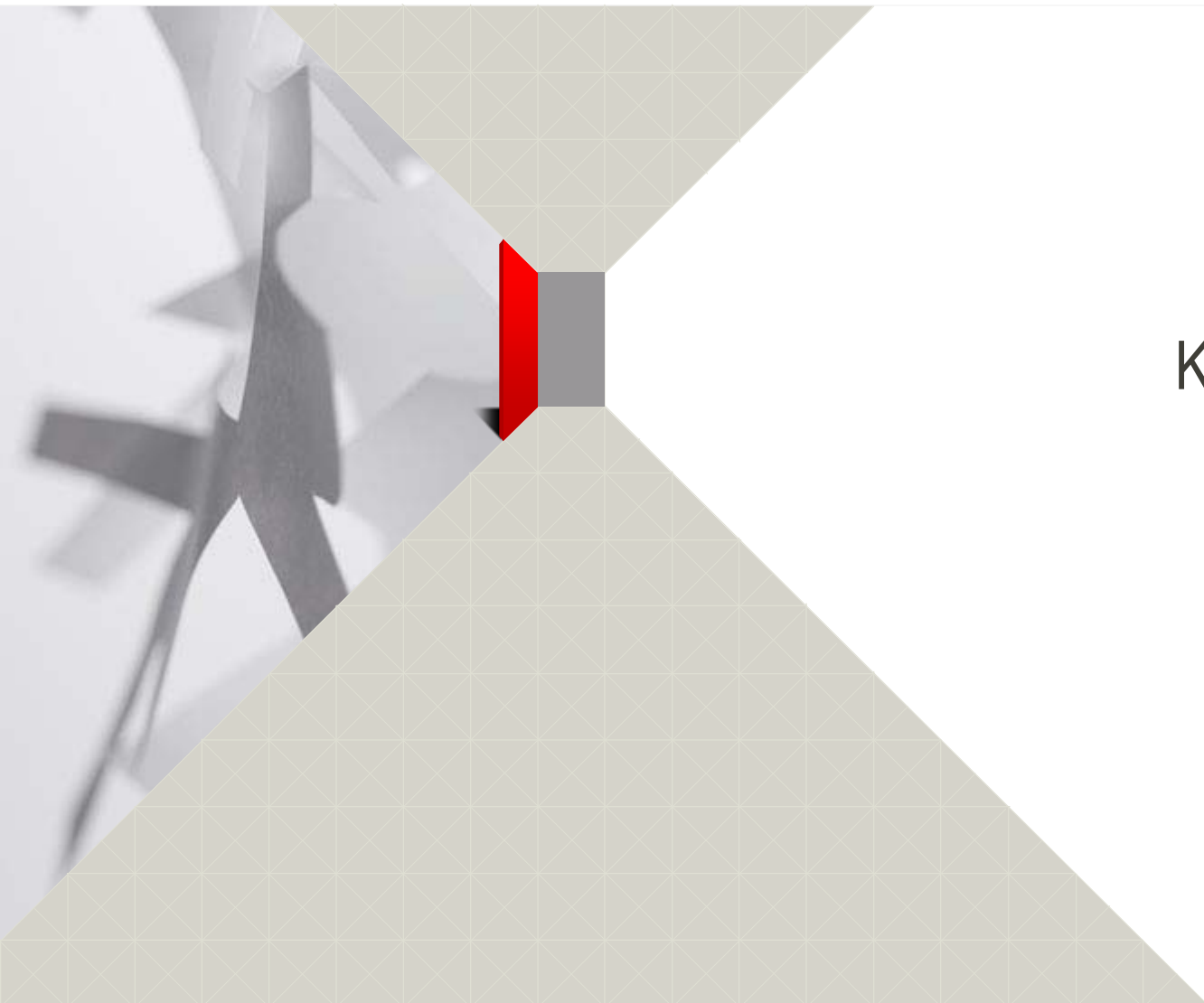


# India Strategy

October 2011



# Key Economic Forecasts

# October – Strategy

## India - Key Macro Economic Forecasts

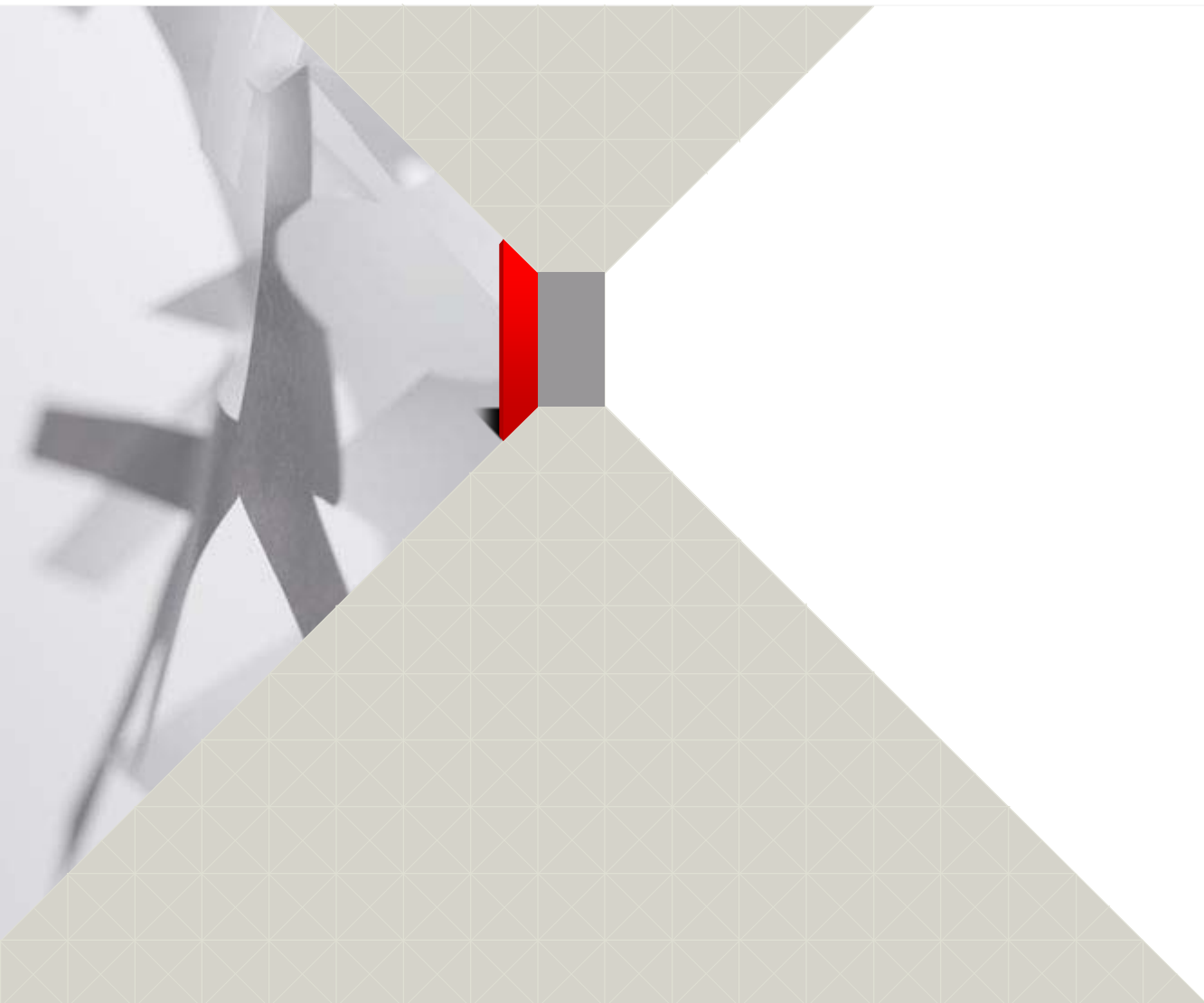
### ▶ Snapshot of key Indian economic forecasts

	2007	2008	2009	2010	2011f	2012f	2013f
<b>Production, demand and employment</b>							
GDP growth (% y-o-y)*	9.3	6.8	8.0	8.5	7.4	8.1	8.3
Nominal GDP (USDbn)	1,220	1,252	1,353	1,720	2,067	2,500	2,751
GDP per capita (USD)*	985	1,027	1,083	1,347	1,586	1,906	2,158
Private consumption (% y-o-y)*	9.3	7.7	7.3	8.6	7.9	8.1	8.3
Government consumption (% y-o-y)*	9.5	10.7	16.4	4.8	3.7	3.8	3.7
Investment (% y-o-y)*	16.2	1.5	7.3	8.6	7.1	8.5	8.8
Net Exports (contribution to GDP growth, ppt)*	-1.5	-3.1	-0.8	1.2	-3.5	-1.2	-1.5
Industrial production (% y-o-y)	8.7	3.2	10.5	7.8	4.2	6.4	8.1
Gross domestic saving (% GDP)*	35.6	32.3	32.3	33.7	34.5	35.1	35.2
<b>Prices &amp; wages</b>							
CPI, average (% y-o-y)*	6.2	9.1	12.4	10.4	8.0	7.7	6.5
CPI, end-year (% y-o-y)*	5.5	9.7	15.0	9.5	6.9	7.7	6.5
Core WPI, average (% y-o-y)*	5.2	6.6	-0.3	4.9	7.5	6.1	4.5
Core WPI, end-year (% y-o-y)*	4.4	4.6	1.1	6.2	7.4	4.5	4.5
WPI, average (% y-o-y)*	4.7	8.1	3.8	9.6	8.7	6.9	5.6
WPI, end-year (% y-o-y)*	7.7	1.6	10.4	9.7	7.0	5.2	6.4
<b>Money, FX &amp; interest rates</b>							
Central bank money M0, average (% y-o-y)	15.0	18.9	16.1	19.2	18.0	15.0	14.8
Broad money supply M3, average (% y-o-y)	21.9	20.4	19.2	16.1	15.0	16.1	16.6
Real private sector credit growth (% y-o-y)	15.6	14.0	6.8	12.0	11.5	16.0	17.5
Policy rate, end-year (%)	7.75	6.50	4.75	6.25	8.50	8.25	8.00
5yr yield, end-year (%)	7.67	5.35	7.31	7.85	8.20	7.70	7.50
INR /USD, end-year	39.42	48.46	46.69	44.81	49.00	45.50	44.00
INR /USD, average	40.88	44.58	48.39	45.74	46.46	47.36	44.44
INR /EUR, end-year	57.55	67.35	66.76	60.04	67.62	65.52	63.36
INR /EUR, average	56.82	64.92	67.62	60.37	64.34	67.14	63.99

▶ We have lowered our 2011/12 GDP forecast from 7.6% to 7.4% and for 2012/13 we have lowered GDP forecast from 8.2% to 8.1%

▶ We have revised our year end (CY 2011) INR/USD forecast from 42 to 49.

Source – HSBC Global Research , Asian Economics Q4 2011



# Equities

# October – Strategy

Markets extend the previous month's losses on continued concerns over Euro zone debt worries.

- ▶ Indian Equity markets extended previous month's losses, triggered by negative sentiments emanating out of continued concerns over the global growth prospects and Euro zone debt worries as investors perceive an imminent Greece default.
- ▶ Domestically, sustained higher inflation, RBI's aggressive monetary stance and expectations of muted Q2 FY 12 earnings impacted sentiments.
- ▶ The BSE Sensex ended the month of September at 16454 (↓1.3% M-O-M) and the S&P Nifty closed at 4943 (↓ 1.2% M-O-M).
- ▶ Mid and Small cap indices under performed during the month as the BSE Midcap and the BSE Smallcap indices were down by 2.3% and 3.5% respectively. Sector wise, IT, Energy and Consumer Durables witnessed some buying interest while Capital Goods, Metals, Power stocks witnessed selling pressure.

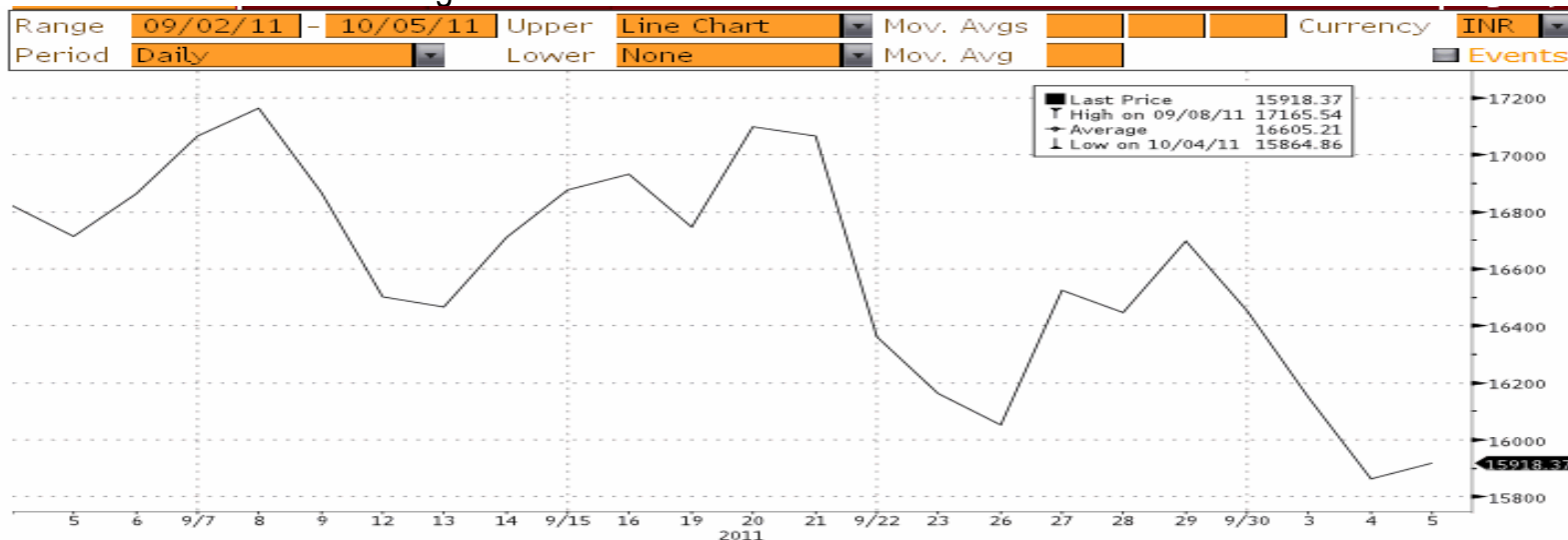
Index	% Change	Index	% Change
BSE IT Sector	4.2%	BSE Sensex	-1.3%
BSE Oil	1.7%	BSE 500	-1.6%
BSE Cons Durable	1.6%	BSE Healthcare	-1.6%
BSE Realty Index	1.3%	BSE 200	-1.6%
BSE Auto	1.2%	BSE Mid-Cap	-2.3%
BANKEX	-0.5%	BSE Small-Cap	-3.5%
BSE FMCG Sector	-1.0%	BSE Power	-4.8%
NSE Nifty	-1.2%	BSE Metal	-9.1%
BSE 100	-1.3%	BSE Cap Goods	-10.8%

Source – Capitaline/Bloomberg

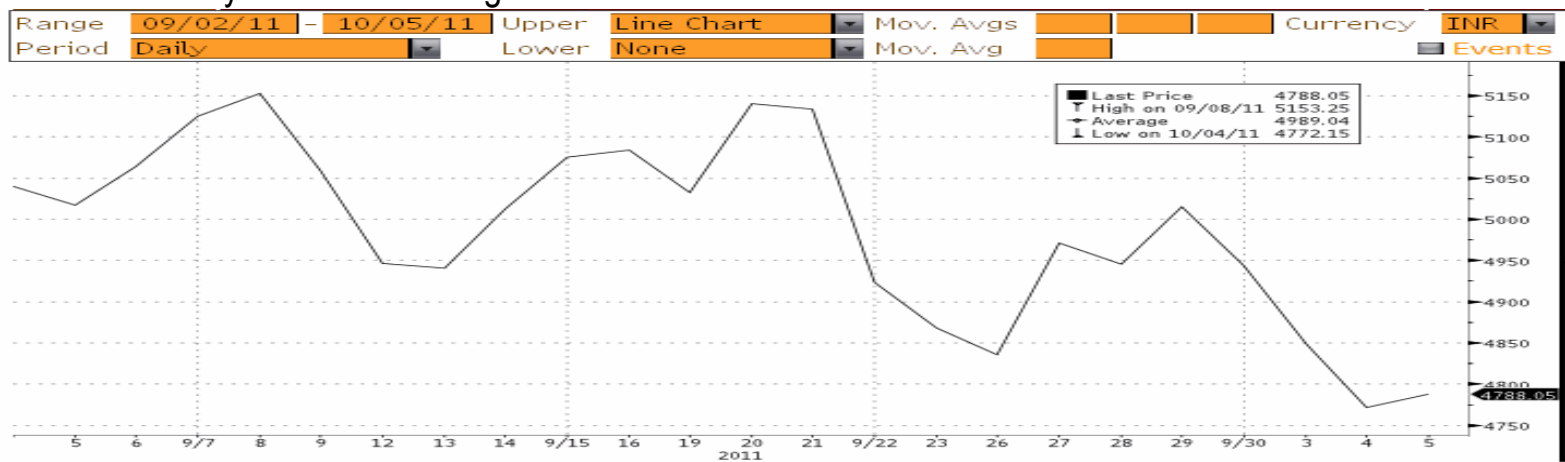
# October – Strategy

## Weakness Persist

BSE Sensex movement during the month



S&P CNX Nifty movement during the month

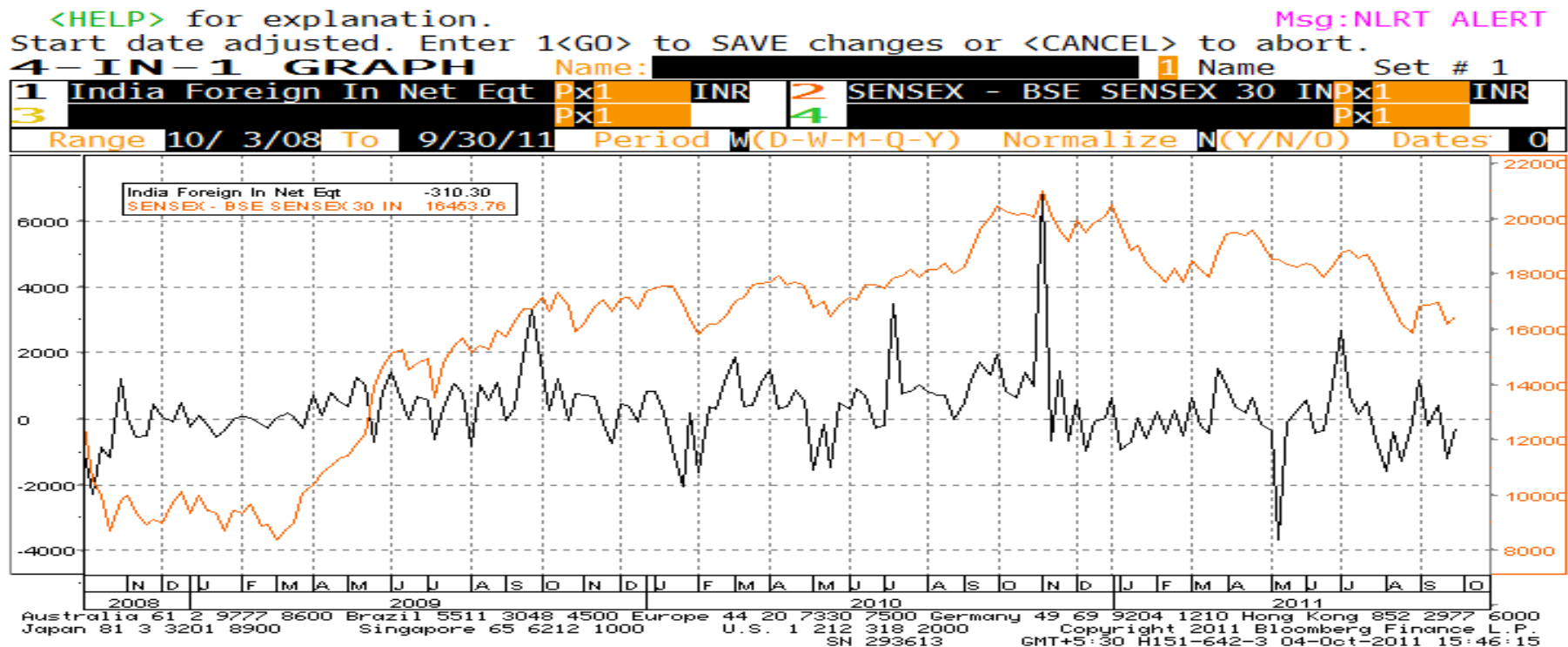


Source: Bloomberg

# October – Strategy

## Foreign institutional investors turn net sellers of Indian equities during September

- ▶ FIIs were net sellers of Indian equities in September. They net sold \$42.3Mln of Indian equities during the month. YTD, FIIs remained net buyers of Indian equities worth \$638.4Mln.
- ▶ Domestic mutual funds net sold \$162mn during the month.



Source: Bloomberg. FII Flows in USD M

# October– Strategy

## Moderating growth in high frequency economic indicators

- ▶ The index of industrial production's (IIP) in July11 grew slower than expected 3.3% y-o-y vs 8.8% y-o-y in June,
- ▶ Manufacturing saw growth to slow to 2.3% y-o-y (10.3%in June) while electricity production (13.1% y-o-y) and mining (2.8% y-o-y) grew faster.
  - By use, the main driver of the deceleration was capital goods (-15.2vs. 38.2% in June) while Consumer goods (6.3%y-o-y) grew faster led by both durables (8.6% y-o-y) and non-durables (4.1% y-o-y)
  - Bottom line: while the lower growth is not a reason to panic about growth in India, as stripping out volatility and looking at other sectors, this is just a moderation rather than a collapse.
- ▶ Momentum in India's manufacturing PMI eased further in September primarily due to a deceleration in output and order growth
  - PMI eased further to 50.4 vs 52.6 in August driven by a marked deceleration in sequential output growth (51.1 vs 56 in August) and a slower expansion in order books with total orders coming in at 51.3.
  - Bottom Line: Indian manufacturing is clearly slowing while inflation remains stubbornly high. On balance, monetary policy will have to stay its course to ease inflation pressures markedly over the policy horizon.
- ▶ WPI inflation approaching double – digits. August 2011 number rises further.
  - Core inflation (non-food manufacturing) continued to rise, coming in at 7.6% y-o-y (vs. 7.3% in July). Moreover, sequential core inflation accelerated slightly to 0.4%. Primary food inflation rose to 9.6% y-o-y
  - Core inflation continues to be the key driver, which, from an RBI's perspective, confirm the need for continued tightening.
- ▶ RBI hikes policy rates by 25bps and the statement remained hawkish
  - While voicing more concern about the global economic backdrop and seeing downside risks to domestic growth, the central bank still sees upside risks to inflation.
  - The RBI still rightly sees inflation as dominant concern for India's domestically oriented economy. However, further moves are now explicitly conditioned on global developments.

Source: Bloomberg/HSBC Global Research

# October– Strategy

## Moderating growth in high frequency economic indicators

- ▶ Exports during August 2011 rose by 44.25% in USD terms to USD 24.3Bn while imports rose by 41.82% in USD terms to USD 38.3Bn. Oil imports during August rose by 49% on a year on year basis. Non oil imports were higher by 39%. The trade deficit for April – August 2011 was estimated at \$55Bn (vs. \$48Bn in April - August 2010).
  
- ▶ Global economics –
  - As the Euro crisis builds and the US economy stalls, the developed world is succumbing to economic permafrost. The emerging world, however, looks better, but is not completely immune.
  - Unconventional monetary policies offered hope, but achieved little, undermined by the growing political uncertainty stifling economic growth.
  - We expect global growth of 2.5% in 2011 (compared to 3% in our last update). While the growth numbers remain positive (unlike the collapse post-Lehman in 2009), they are not sufficiently robust to suggest that we are approaching a decent recovery in economic activity. **Remain positive on the outlook for China and India.**
  - With already fragile investor sentiment, the risks of a negative spiral cannot be overlooked that could potentially feed into broader economy.
  - We expect cautious investor sentiment to remain the main driver of markets in the coming months.
  
- **India economics**
  - High frequency indicators show that the growth rate is declining particularly in the manufacturing sector
  - While the domestic orientation of the economy limits the spill over from adverse global economic conditions, it is not immune, and global weakness has spilled over through the trade and confidence channels.
  - For this reason, we lower our 2011/12 forecast to 7.4% from 7.6% and our 2012/13 forecast from 8.2% to 8.1%
  - The 2011/12 central government budget target of 4.6% of GDP may not be achieved due to slower growth and a larger than budgeted subsidy bill
  - Consequently, fiscal policy will at best be neutral leaving monetary policy with the main responsibility for tackling inflation.
  - We expect the policy rate to rise another 25bps over the rest of 2011/12, taking the repo rate to 8.5%.

Source: HSBC Global Research/RBI/Ministry of Commerce/HSBC Private Bank Market Primer/Q4 2011 Global economics quarterly

**HSBC Private Bank**



## October– Strategy

High inflation & macro headwinds (US growth, Euro zone concerns), Q2 FY 12 earnings and policy initiatives from the government to affect market sentiments.

- ▶ Markets are expected to trade lower in the near term given the uncertainties on several fronts (inflation, political uncertainty, global macro risks) .
- ▶ However, India's long-term earnings outlook continues to remain positive given its robust economic growth prospects, while India's minimal exposure to global structural risks may result in continuance of foreign investment flows into the country.
- ▶ At 16,232 the Sensex trades at a P/E of 13.7X FY12e (Bloomberg Consensus EPS estimate of Rs.1,187). Our year end 2011 Sensex target is now revised to 16,500 from earlier estimates of 20,000 and for CY 2012 end it is 17,800.
- ▶ We advise staggered entry into equities to take advantage of the ongoing volatility in the markets.
- ▶ We continue to favour select large caps given the valuations at which they are trading, while a stock specific approach is advised towards mid-cap stocks. Key events that may impact the markets in the near term are: Inflation, global economic data-flows (clarity on US growth prospects, Euro zone debt issues, particularly news flows on a perceived default by Greece) and corporate guidance on growth prospects along with the Q2 FY 12 earnings announcements.
- ▶ At the sector level, we favor Industrials, Materials, Utilities & Telecom. We are neutral on Financials, IT, Energy & Consumer Discretionary. We are Underweight on consumer staples & Healthcare

# October – Strategy

## Overweight – Industrials, Material, Utilities & Telecom; Underweight – Consumer Staples & Healthcare

- ▶ **Industrials – Overweight** – While near term order book inflows are expected to be muted valuations of the sector look attractive even in worst case scenario, after the recent correction. We expect order book to continue to pick up. Not a lot has changed in terms of the demand outlook, where in companies are positive on pricing but cautious on margins and market expectations.
- ▶ **Materials – Overweight** – While there are positive developments within the industry, ranging from steel mergers and government measures, we believe this is offset by risks to global demand for metals. While demand still remains weak given global growth uncertainties making it difficult for metal makers to pass on rising raw material costs, valuations start to look attractive with most of the stocks now trading their historical average P/BVs.
- ▶ **Utilities – Overweight** – With rising energy costs and stable electricity prices, the utilities sector is facing a margin squeeze, which has been the reason for our neutral stance on the sector in the past though we expect acceleration of power capacity addition (18GW in FY12 versus 31GW commissioned over the last four years) and high sector capex during FY12 (the last year of the 11th five-year plan). The sector will continue to face an overhang regarding project execution, fuel availability and financial health of SEBs (State Electricity Board). However, given the fact that the Indian players enjoy relatively better returns than most of their Asian counterparts and hence are in a position to safeguard their margins, raise the rating to Overweight.
- ▶ **Telecom – Overweight** - We expect the outlook for the Indian telecom sector to improve going forward, driven by progress on the regulatory front, stabilization of tariffs and launch of 3G services. Increasing penetration and consumer spending remain strong growth drivers for the sector. Better volumes and price stability offers increased earnings visibility.
- ▶ **Consumer Staples – Underweight** –Key themes for playing this sector are product re-pricing and earnings recovery. Things have changed during the last three to four months as companies have developed strategies to deal with rising food prices. Underweight largely due to stretched sector valuations and recent out performance
- ▶ **Healthcare – Underweight** – Key themes to play the sector are – strength in emerging markets, development of new growth areas such as bio similars & several block buster drugs losing patent exclusivity in the US and EU during 2011- 15. For Indian generic players, demand for cheaper generic drugs is set to remain healthy as western governments cut back on healthcare budgets. Underweight rating largely on the back of recent out performance and valuation richness and not on fundamental weakness.

Source HSBC Global Research

# October– Strategy

## Neutral – Energy, consumer discretionary, Financials & IT

- ▶ **Energy – Neutral–** Environment is challenging for upstream and refineries as margins are likely to remain moderate. Also the sector faces government policy risk. However strong economic growth would keep the demand strong.
- ▶ **Consumer Discretionary – Neutral –**Inflationary concerns and higher interest rates continue to be key near term concerns for the sector. Rising rates tend not to be conducive to discretionary spending. Indeed, the reaction to slower consumer spending often comes with some time lag particularly in the automobile sector. However increasing purchasing power would keep the demand strong.
- ▶ **Financials – Neutral –** Rising rates has been one reason for the weak performance of bank stocks. Another reason for bank's underperformance is concern about bank loans to the power sector, where projects have been delayed and the risk of NPLs is rising. However, we believe these concerns are overblown (NPLs remain low), highlighting that the combination of a peak in interest rate expectations, a recovery in working capital demand and low valuations could boost performance over the next few quarters. Hence rising the sector to Neutral from Underweight.
- ▶ **Information Technology – Neutral –** We believe demand momentum remains uncertain for 2012, as the macro data coming out of the US and Europe have been deteriorating. However, unless the macro situation deteriorates materially, we do not see significant downside risk to our average 10-15% USD top-line growth forecast for the sector. Moreover, we have not factored in any benefit from INR depreciation and margin levers such as lower variable pay. While stocks are likely to remain range-bound in the near term, unless macro data from the West improve, long-term investors may want to look for value buying opportunities on dips. Downgrade to Neutral given the lack of easily identifiable catalyst for this sector to perform in the near term.

Source HSBC Global Research

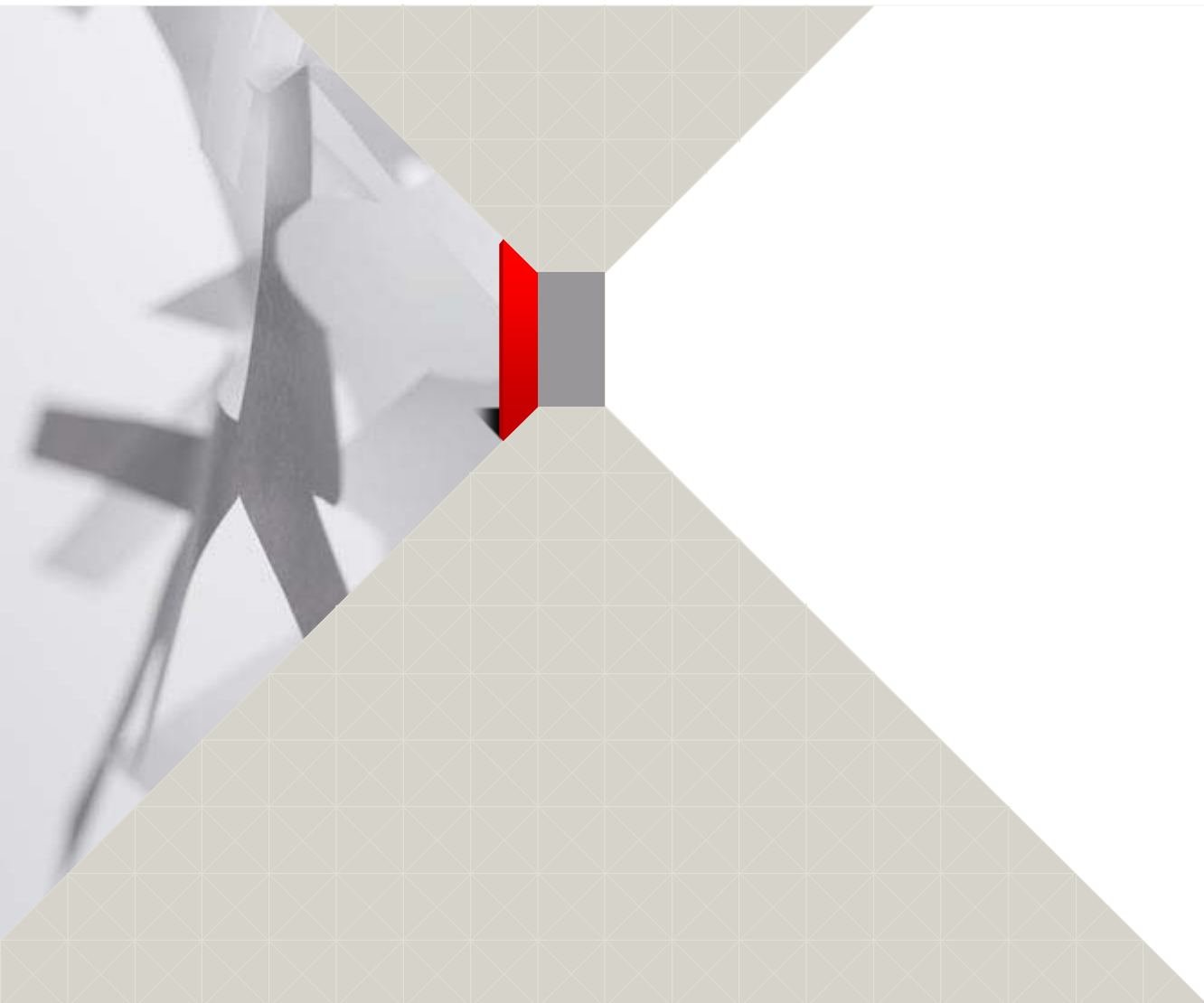
# October – Strategy

Derivatives parameters indicate possibility of continuation of volatility

## Equity Derivatives:

- ▶ Nifty near month future lost 1.37% during the past month
- ▶ Open Interest for near month Nifty future was down by about 14.09%.
- ▶ Bank Nifty near month future lost 1% for the month.
- ▶ Open Interest for Bank Nifty future was up by about 14.13%
- ▶ CNX IT near month future gained 3.57% during the month.
- ▶ CNX IT futures open interest was up by about 86.83% though on a small base
- ▶ VIX increased by 28% during the month and closed at 31.94%

Source – Reuters



# Fixed Income

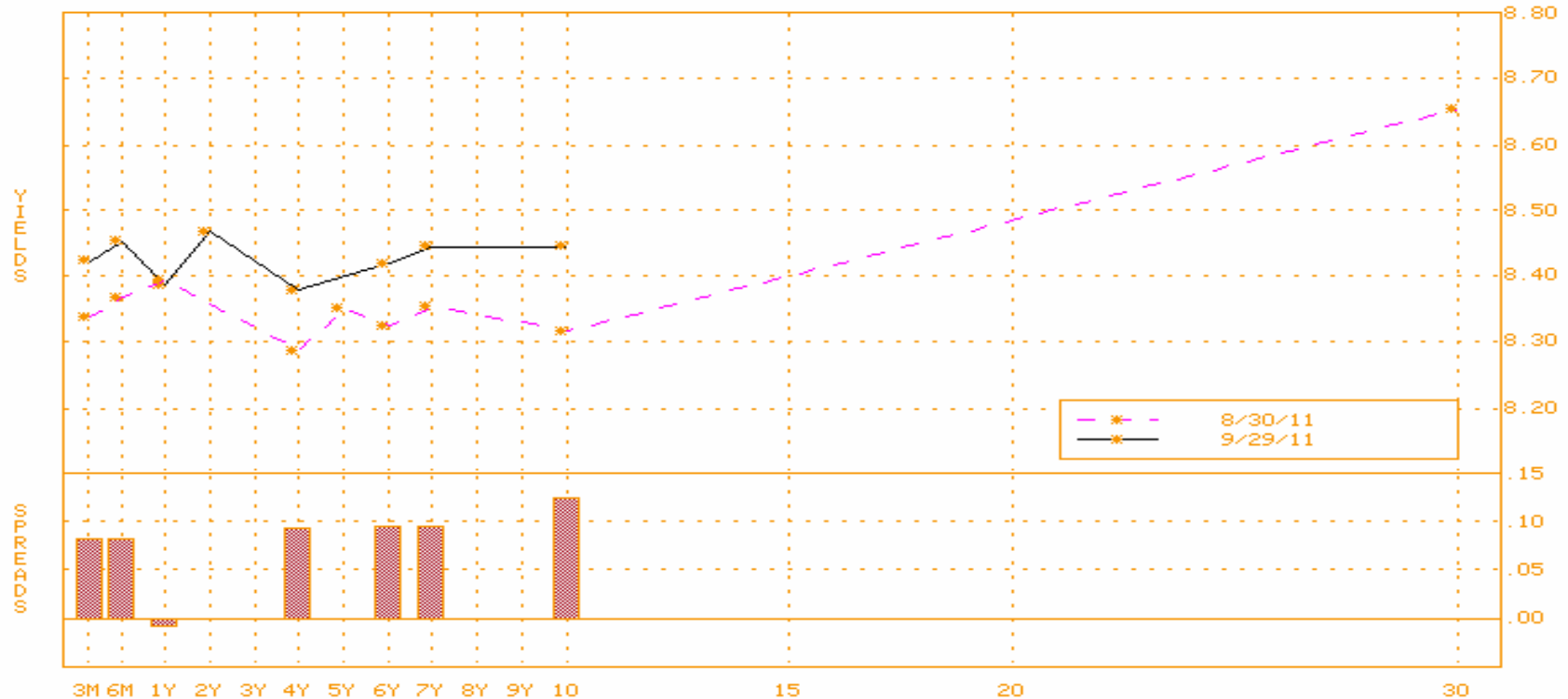
# October – Strategy

## Fixed Income

INR India Sovereign

9/29/11 vs 8/30/11

3M - 30



Indian Government Yield Curve

Source: Bloomberg

- The ten year bond yield in September '11 traded in a range of 8.29% to 8.43% and ended the month at levels of 8.43% (Source Bloomberg) predominantly due to the proposed government borrowing for H2FY12 being higher than consensus expectations.
- The RBI in September '11 on a daily basis infused liquidity amounting to INR 522B (month's average) as against INR 385B (month's average) in August '11 (Source: Bloomberg)

# October – Fixed Income Strategy

Higher than expected government borrowings, impacting sentiments

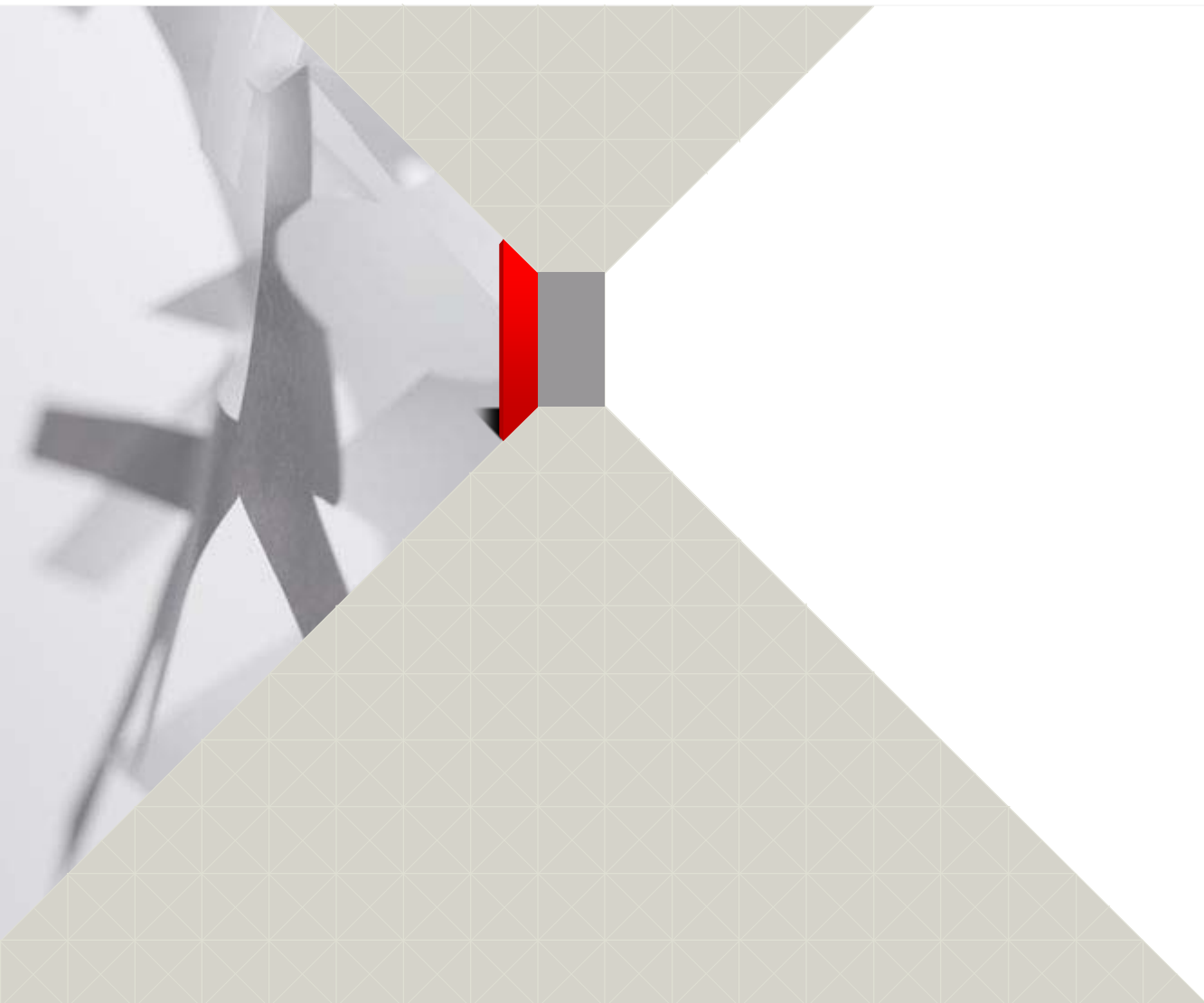
- ▶ The Government of India seeks to borrow INR 2.20T during the period October – February '12 as against the initial budgeted estimates of INR 1.67T (Source: RBI). According to the Secretary – Department of Economic Affairs, Finance Ministry the additional borrowing is due to lower cash balances and on decline in small savings. Approximately 75% of the government's borrowing is in issuances having a maturity of 5 – 9 years and 10-14 years. Only 11% of the borrowing is in issuances having a maturity of 20 years and greater.
- ▶ India's fiscal deficit during the period April – August stood as INR 2.74T or 66.3% of the budget estimates of INR 4.13T Revenues during the period on a year on year basis contracted by 35% due to non tax revenues contracting by 71.3%, while revenues on an aggregate basis rose by 5.5% during the same period. (Source: Government of India)
- ▶ The Reserve Bank of India in its mid-quarter monetary policy review apart from increasing policy rates by 25 bps (repo and reverse repo) stated that there are downside risks to its earlier growth projections of 8% while inflation remains generalized and higher than the central bank's comfort zone.
- ▶ WPI Inflation in August '11 was 9.78% (provisional numbers and on a year on year basis) as against 9.22% (year on year basis) witnessed in July '11. In August, primary articles, fuel & power and manufactured products rose by 12.58%, 12.84% and 7.99% respectively (on a year on year basis). WPI Inflation reading for June '11 was revised upwards from 9.44% to 9.51%. (Source: Government of India)

Data Source: HSBC Global Research/ Reuters/ Bloomberg

# October – Fixed Income Strategy

## Inflation remaining sticky

- ▶ We recommend investors to take exposure at the shorter end of the yield curve through ultra short and short term bond funds.
- ▶ Investors having a pre-defined investment horizon and are willing to lock-in their monies may selectively consider Fixed Maturity Plans.
- ▶ Investors having a medium term investment horizon may consider investing into products that maintain exposure to issuances maturing over the next two years as apart from earning accrual income, there exists the possibility of trading gains.
- ▶ Investors may selectively undertake exposure to longer dated bonds especially tax free issuances planned during the month as consensus expectations are emerging that the RBI policy tightening spree is nearing its end.



# Currencies

# October – Strategy

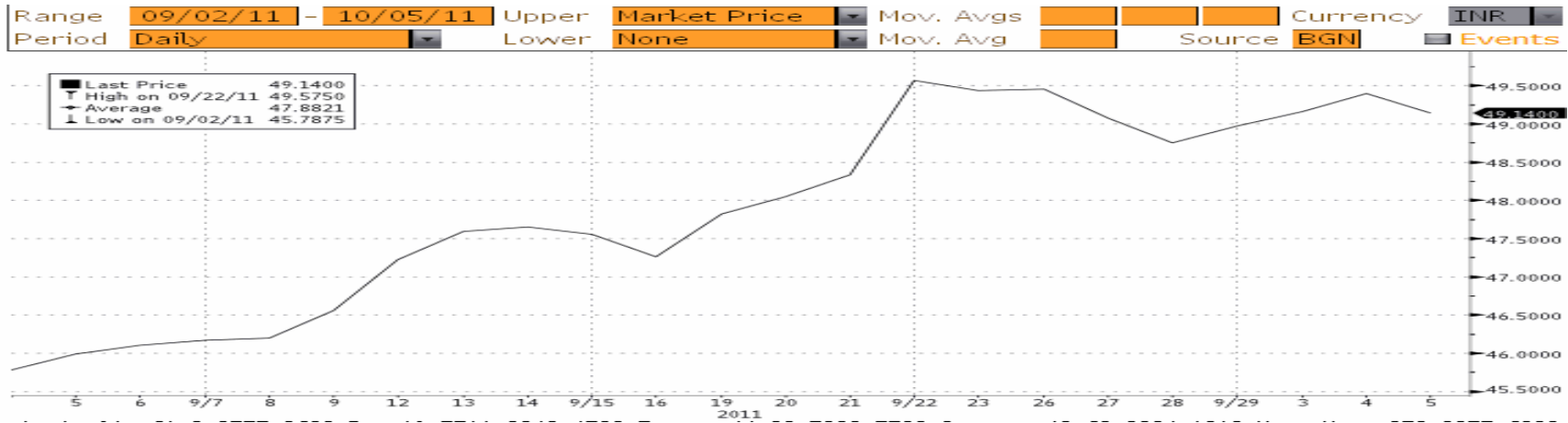
## Short term risk aversion should support USD

- ▶ **INR** - The INR weakened during September and ended the month at 48.97 against the USD (Source: Bloomberg). Our December 2011 target for INR has been revised from INR42 to INR 49
- ▶ **USD** – In the short term, we expect the rise in risk aversion to remain the main driver of currencies, and therefore expect USD to continue to benefit in the coming months. We hold a Neutral view on USD for the next 12 months.
- ▶ **Euro**– We believe that the positive sentiment towards the Euro, driven by the interest rate hikes by the European Central Bank, is running into resistance, as sovereign debt concerns accelerate further. This may limit EUR strength and we hold a Neutral view on the EUR over the next 12 months.
- ▶ **GBP**- The weak economic backdrop may keep the currency in check as interest rate hike expectations continue to be pushed further out. In addition, growing prospects for further QE by the Bank of England are likely to weigh on GBP. We hold a Neutral view on GBP with a negative bias for the next 12 months.
- ▶ **JPY** – Intervention remains a strong possibility given the strength of the yen and its impact on exporters. We hold a Neutral view on JPY for the next 12 months.
- ▶ **Emerging Markets (EM)** – While we maintain our positive outlook on emerging market (EM) currencies in the long run, we believe the current environment may impact these currencies in the short term and we downgrade our view to neutral. We focus on currencies with strong fundamentals for the time being. In the longer term, we continue to believe that strong fundamentals will support EM currencies. We hold positive view on Emerging Market currencies for the next 12 months.

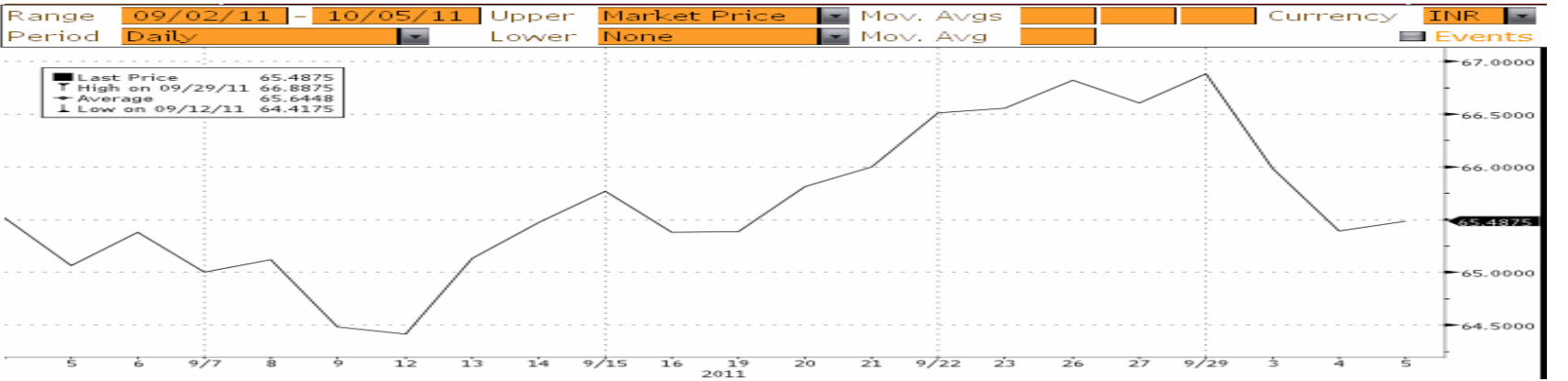
# October – Strategy

## Currency movements....

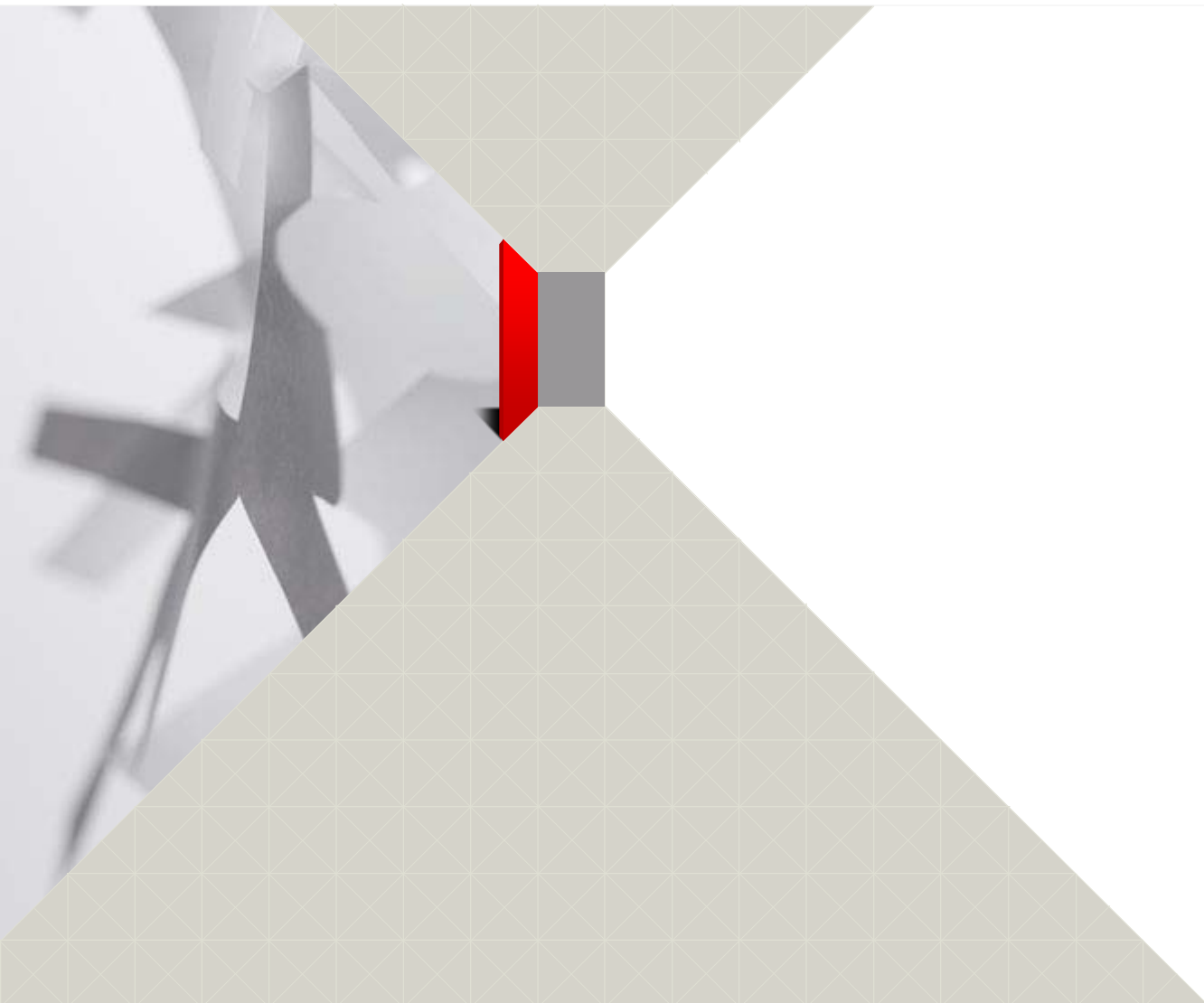
USD/INR



Euro/INR



Source - Bloomberg

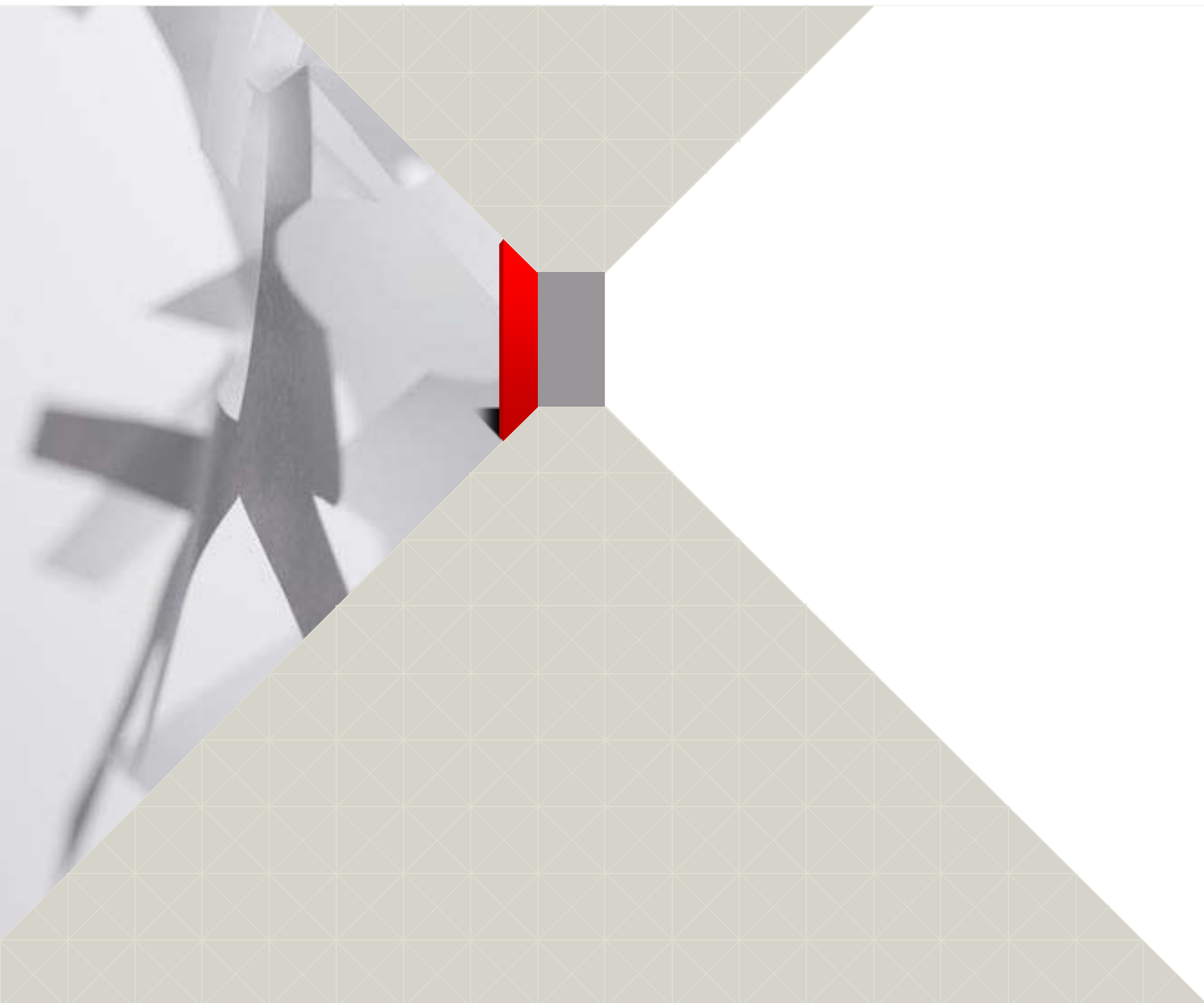


# Commodities

# October – Strategy

## The uncertain economic outlook is likely to continue to weigh on prices

- ▶ We believe that concerns about the current slowdown in economic growth and ongoing tightening measures in the emerging markets are likely to weigh on demand for commodities in the coming months, weighing on prices. In addition, USD strength is likely to be an additional headwind for commodities.
- ▶ **Gold:** Gold weakened in September and ended the month at US\$1,628 (Source: Bloomberg). We prefer gold over cyclical commodities because we want to limit our exposure to the global economic cycle. While we like gold, this is not because of inflationary fears, or the belief that gold would be a good hedge against inflation. Rather, we see it as a hedge against the many uncertainties in the world, and the desire of many investors to stay away from currencies that can be manipulated by authorities. However, we expect price volatility to remain high in the coming months as we could see more violent swings. This is in part due to extreme risk aversion, which is supporting USD. For the next 12 months, we hold a neutral view on Gold with a positive bias.
- ▶ **Oil:** Brent crude oil corrected during the September and ended at \$102.76/bbl (Source: Bloomberg). The slowdown in growth is likely to outweigh ongoing tensions in the Arab World and keep prices near current levels. In the longer term, we expect higher-trending oil prices to remain supported by EM demand, but this may take some time to materialise. For the next 12 months, we hold a neutral view on oil.
- ▶ **Industrial Metals:** In our view, industrial metal price appreciation may be subdued as growth slows, but underlying demand appears fairly resilient and should benefit from the strong Chinese economic outlook and growth in the emerging markets in the longer term. For the next 12 months, we hold a neutral view on Industrial Metals.
- ▶ **Agricultural Commodities :** We expect agricultural commodities to remain volatile given uncertain weather patterns, although the longer-term trend of growing demand from the emerging markets should provide some support to prices. For the next 12 months, we hold neutral view on agricultural commodities.



# Summary of Views

# October – Strategy

Asset Class	Sub Class	Current Month	Previous Month
<b>Equity</b>		=/-	=/+
	Industrials	+	=
	Utilities	+	=
	Metals	+	=
	Cement	+	=
	Real Estate	=	=
	Financials	=	-
	Information Tech	=	+
	Consumer Staples	-	=
	Consumer Discretionary	=	=
	Healthcare	-	+
	Telecom	+	+
	Energy	=	=
<b>Debt</b>		=	=
	Liquid Assets	=	+
	Duration	=	=
	Credit	=	=
<b>Currency</b>			
	INR	=/+	=/+
	USD	=	=
	GPB/ USD	=/-	=/-
	Euro/USD	=	=
	USD/JPY	=	=
	Emerging Markets	+	+
<b>Commodities</b>		=	=
	Gold	=/+	=/+
	Oil	=	=
	Industrial Commodities	=	=
	Agri Commodities	=	=

## Guide to Symbols in this document

- Negative

=/- Neutral with a negative bias

= Neutral

=/+ Neutral with a positive bias

+ Positive

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