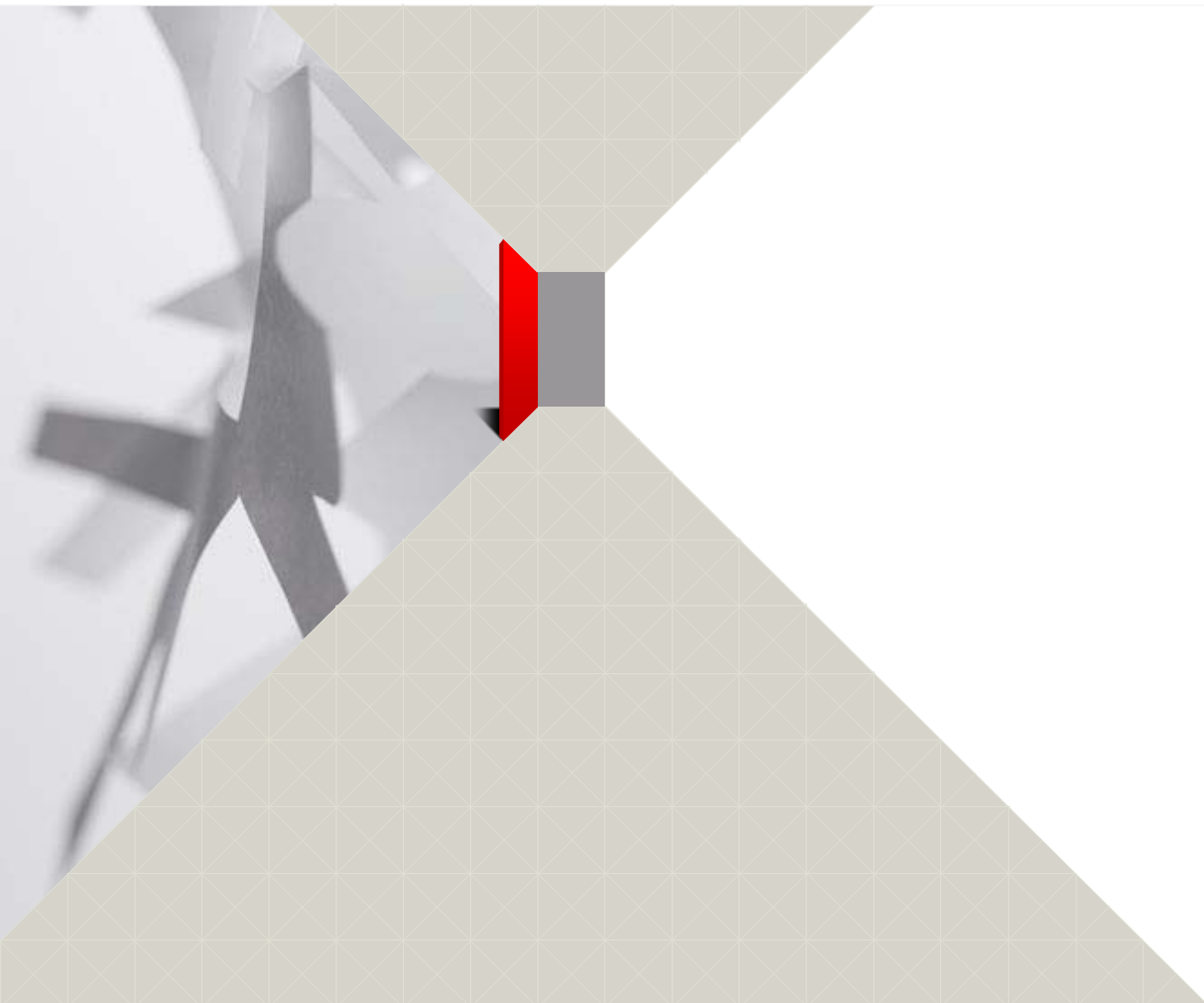


# India Strategy September 2009



Equities

## September – Strategy

Market consolidates – IT, Consumer Durables, Cap. goods & Oil n Gas outperform

- ▶ Indian equity markets consolidated during the last month and moved sideways. The BSE Sensex closed the month at 15666 (-0.02% M-O-M) and the NSE Nifty closed the month at 4662 (0.55% M-O-M).
- ▶ IT, Consumer Durables, Capital goods, Oil n Gas, Healthcare outperformed the main indices where as Metal, banking and FMCG underperformed. Small caps segment was the star performer during the month.

Index	Monthly Change	Index	Monthly Change
BSE-SMALLCAP	12.75%	NSE MIDCAP	2.82%
CNX IT	6.66%	BSE HEALTHCA	2.52%
BSE CONS DUR	5.65%	<b>NSE NIFTY</b>	<b>0.55%</b>
BSE-MIDCAP I	5.60%	BSE PSU	0.20%
BSE IT	5.31%	<b>BSE SENSEX</b>	<b>-0.02%</b>
BSE CAP GOOD	4.41%	BSE METAL	-0.10%
BSE TECK	4.01%	BSE BANKEX	-1.43%
BSE OIL&GAS	3.11%	NSE BANK NIF	-1.50%
BSE AUTO	2.88%	BSE FMCG	-6.74%

Source - Reuters

# September – Strategy

Global cues and foreign fund flow key to near term movement



Source - Reuters

## September – Strategy

### Monsoons a worry, but we maintain our GDP estimates

- ▶ India is now bracing itself for the first really poor monsoon in seven years and only the second in the last two decades. So far rainfall has been “below normal” in the country as a whole, with large parts of the north suffering much greater shortfalls. If the agricultural sector were to experience a 2% drop in output, this would directly lower GDP growth by 1% point compared with a year of average agricultural expansion. We expect the various fiscal stimulus measures, many of which are targeted at the rural sector, to offset the effects of a weak monsoon and maintain our GDP estimates at 6.2% for FY'10 and 8% for FY'11.
- ▶ Monetary policy measures have been accommodative with the Reserve Bank slashing the repo rate by 425 bps, the reverse repo rate by 275 bps and the CRR by 400 bps since late last year. Given rising commodity prices, we do not expect any further repo or repo rate reductions from the RBI. These policy measures will boost growth but with a lag. These measures have also eased the previous liquidity squeeze in the banking sector.
- ▶ During July, WPI inflation remained in negative territory as expected. Inflation came in at -0.95% for the week ended Aug15th (Source: Reuters). We expect headline WPI to continue to remain low in the near term given the high base effect, but the recent rally in oil and other commodity prices threatens to turn WPI inflation around sooner rather than later.

#### Institutional Activity:

- ▶ FIIs continued to be net buyers in August. They bought \$1.08 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 also continued to be buyers in August. Domestic MFs bought \$117 mln (Source: SEBI) of Indian equities during the month.

## September – Strategy

### Fiscal deficit projected at 6.8% of GDP – rating agencies likely to keep a close watch

- ▶ 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%. Our own forecast, prior to the budget, was for a 7% deficit, but the risks are now on the upside. The budget estimates provide for an increase of 36% in total expenditure - 37% increase in Non-planned expenditure and 34% in Plan expenditure with the revenue side remaining almost neutral.
- ▶ We expect the fiscal deficit (central and state governments combined) to near the 11% mark, levels not seen since 1991. In our view 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.
- ▶ Merchandise exports fell 28% y-o-y in July 2009, while imports fell more than 37%. This has resulted in a trade deficit of \$6 bn. We believe the trade balance will deteriorate later this year, as rising oil prices increase import bills, while lacklustre demand from the Western world keeps export growth under pressure.
- ▶ The fiscal deficit will under further strain if the move to liberalise oil prices is blocked by populism.
- ▶ Rating agencies are likely to keep a close watch on the fiscal deficit and would be looking for measures to be taken to keep the deficit in check. Given India's sovereign rating, this could play a crucial role in future FDI and FII flows.

## September – Strategy

### Green shoots apparent - Recovery appears underway

- ▶ 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.
- ▶ Early 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.
- ▶ 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 August 09 but this could be a temporary impact of the public sector’s pay hike.
  - **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 53.2 in August with the new order index at 56.2.

## September – Strategy

### India more resilient to global slowdown with a combination of positives

- ▶ Our optimism on India lies in the fact that we expect a combination of the following to maintain visibility on growth prospects later this year and believe that the long term growth story remains intact;
  - **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.
  - **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. Although commercial banks are still cautious in lending to the private sector and lending growth continues to soften, the central bank is stepping up its verbal pressure on the banks to do more and recent signs that commercial banks are becoming more responsive is more evident.

## September – Strategy

### India “neutral” from Asia Pacific perspective

- ▶ With early signs that at a global level things are beginning to look “less bad”, risk appetite appears to be reemerging. India has been one of the best performing markets since mid March with ~ \$9 bln of FII inflows moving into Indian equities during the period.
- ▶ Although we expect to see signs of stress on account of the slowdown, Indian companies’ earnings have been among the least volatile among emerging markets. Overall leverage of Indian companies is low (av. net debt/equity ratio of 0.45x).
- ▶ Our expectations for Sensex companies are 5-10% EPS growth in FY10 and a return to trend growth of 10-15% in FY11. We believe the current slowdown in India is cyclical and expect growth to pick up in the second half of CY09. The quarter ending Jun 2009 is likely to be the trough of the economic cycle and, along with a recovery, we expect corporate earnings to recover from the quarter ending September 2009.
- ▶ Given that global uncertainty still exists, the government failing to lay out a roadmap for reforms, a growing fiscal deficit and a delayed monsoon, we believe the stock market could take a breather.
- ▶ 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.
- ▶ Valuations are no longer cheap. Clear signs of an economic recovery could lead to a sustainable rally towards the end of CY’09. The risks and rewards appear fairly balanced and we remain “neutral” on India relative to the Asia Pacific region.

## September – Strategy

Valuations “not cheap”, though current EPS forecasts pessimistic. Phased entry suggested

- ▶ 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.
- ▶ Based on historical trends, equity valuations are no longer cheap but remain reasonable. At 15922 (Sensex at August end), India trades at a P/E of 17.4X FY10e and 15.3X FY11e (HSBC estimates). The Indian markets are currently at a PE premium of 20% to MSCI GEMs, compared to 16% premium historically, and a 6% premium to EM Asia, compared to 11% historically.
- ▶ 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. In our view, long term investors could use an SIP or quasi SIP approach over the next few months to achieve this. A phased entry is suggested given that markets could remain range bound and volatile in the near term. Sharp corrections could be viewed as good buying opportunities to rebalance portfolios more aggressively.
- ▶ 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 as a key overweight because of low valuations and strong earnings outlook. Our other key overweight sector is Industrials and IT. Our key underweight sector is materials. Our sector views follow.

## September– Strategy

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

- ▶ **Financials** – Overweight – Current valuations and recent RBI measures, do make us overweight PSU banks that account for the bulk of banking activity in India. The widely expected reforms for the sector were missing from the budget, but 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.
- ▶ **Industrials** – Overweight - Sentiment for the sector to improve considerably on account of government boost to infrastructure, though valuations 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 upgrade our rating on the sector to overweight
- ▶ **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, we believe that the budgetary thrust on rural spending should offset effects of a weak monsoon. We also like Sugar as a sub sector. We maintain neutral rating on the sector.
- ▶ **Telecom** – Neutral - Increasing penetration and consumer spending remain strong growth drivers for the sector. However, recent changes in competitive scenario and increased possibility of change in regulations impacting the sector may impact profitability of the segment hence our neutral rating on the sector.
- ▶ **Energy** – Neutral – Environment 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.

## September – 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** – Underweight – 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 – The outlook for autos may deteriorate on account of poor monsoon, with that note we have downgraded the autos to underweight. With the credit crunch hampering expansion of franchise, we are underweight the retail sector. It remains one of the most expensive sectors in the market.
- ▶ **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 downgrade the materials sector as a whole to underweight.
- ▶ **Real Estate** – Underweight – The improved balance sheet strength of most large players following the recent fund raising, along with recovering demand conditions. However, we see limited upside to property prices and think valuations are high and we remain underweight the sector.

## September – Strategy

Derivatives indicate continuation of moderately positive bias with some choppiness

### Equity Derivatives:

- ▶ Nifty near month future gained 0.8% during the month of August
- ▶ Open Interest for Nifty future was up by 8%
- ▶ Bank Nifty near month future lost marginally by 1.3%
- ▶ Open Interest for Bank Nifty future was up by 3%
- ▶ CNX IT near month future gained 7%
- ▶ CNX IT futures open interest gained by 23%, though on a lower base

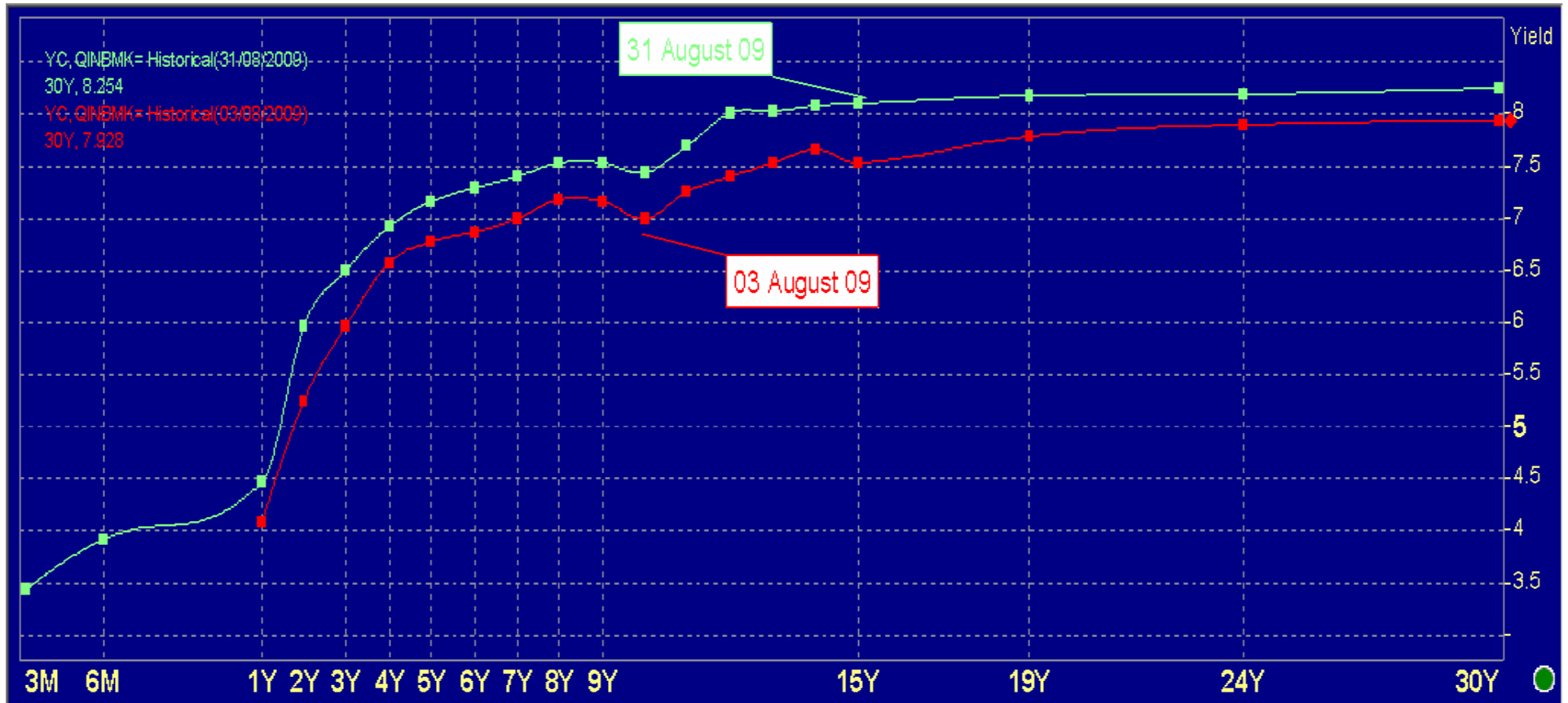
Source – Reuters



# Fixed Income

# September – Strategy

## Fixed Income



Indian Government Yield Curve

Source: Reuters

- The sovereign yield curve sharply moved upwards with increasing fears of the high government borrowing for the year would push up overall interest rates. Liquidity in the system continued to be abundant with approximately Rs.1000 bn (similar numbers in July) placed daily with the central bank in reverse repo.
- We believe that short yields will harden as we move into the advance tax month. The longer end is expected to continue to move upward with volatility. We continue to recommend low durations in portfolios and accumulate long duration funds for high risk investors at higher levels.

## September – Strategy

Advance tax to impact short term yields in the current month. Inflationary expectations and large government borrowing program will prevent any bond market rally

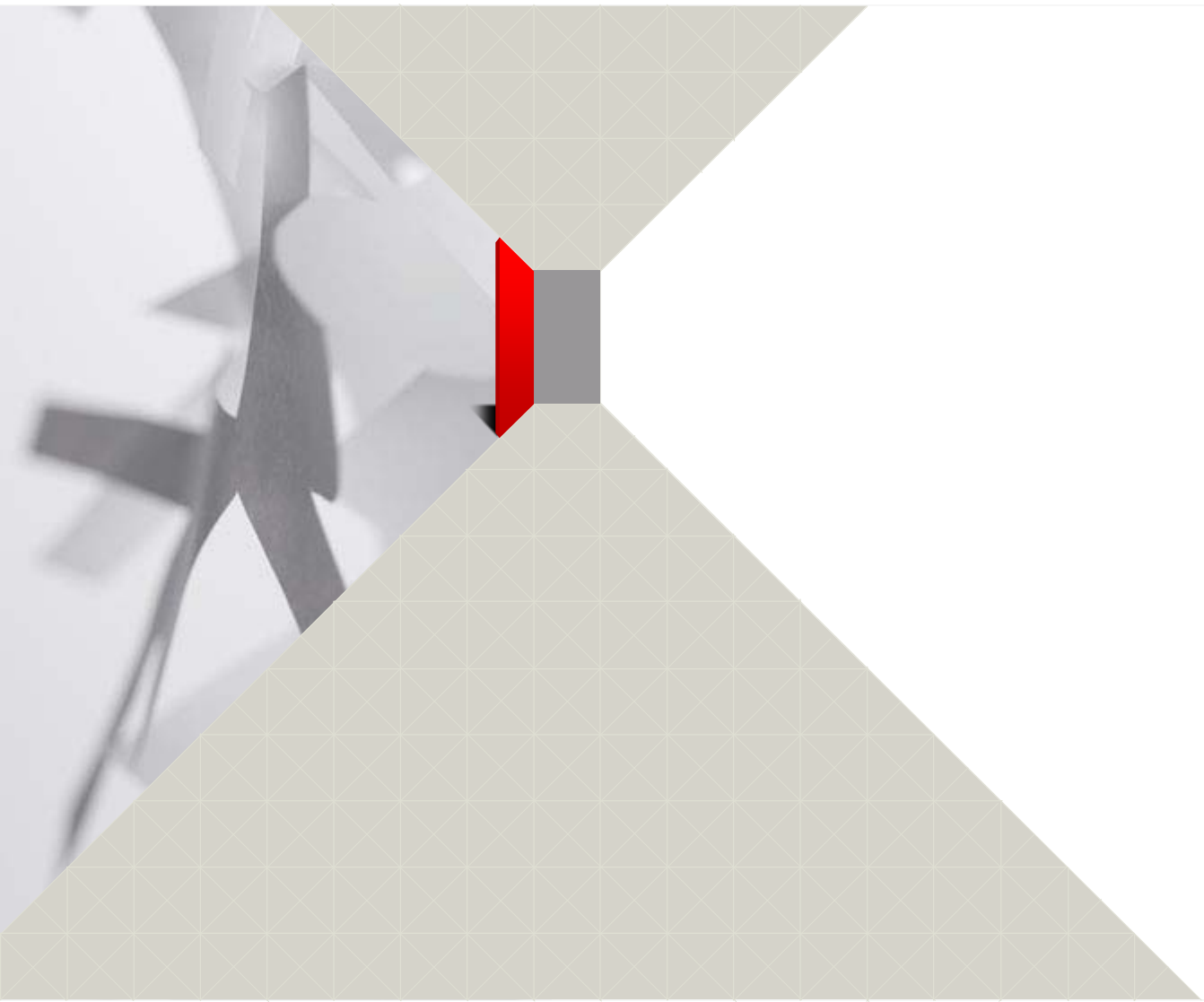
### Fixed Income:

- ▶ Liquidity continued to be easy in the month of August. The average Mumbai Inter Bank Offer Rate for the month remained flat at 3.29% in comparison to the previous month. The outstanding amounts lent in reverse repo on 31st Aug 09 was at Rs.1214 bn as against Rs. 1404 bn on 31st July 09 (Source: NSE/ RBI website).
- ▶ The inflation numbers reported for the week ended 15th August 09 declined to -0.95 % as compared to -1.54% for the similar period last month (Source: Reuters). The negative number is as per our expectations and arising from the high base effect in comparison to the previous year. This is the first time that the reported inflation has been in negative since 1977-78.
- ▶ The collapse in commodity (particularly oil) prices has already driven wholesale price inflation into negative territory and we expect it to remain low in the short term before moving sharply higher again in the final few months of the year. CPI is proving much more stubborn thanks to food prices and supply side pressures.
- ▶ We stand by our stance that inflation numbers will move upwards for the year 2009-10 and expect inflation numbers to reach 7-8% by end of the fiscal year. This is against our previous forecast of 1.8% and RBI target of 4%.

## September – Strategy

### Government Borrowing overhang to shadow the entire yield curve

- ▶ On the monetary policy front the RBI has delivered 400 bps of cuts in cash reserve ratio since mid September, taking it down to 5%. In addition, the repo rate has been lowered by 425 bps to 4.75% and the reverse repo has been reduced by 275 bps to 3.25%. While it is too early in the recovery for the Central Bank to contemplate tightening policy, the prospect of higher inflation means further rate reductions are unlikely. We expect the next move in the policy rate to be up, albeit not until the April 2010 policy meeting.
- ▶ We expect volatility in the bond markets across the longer maturities. 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. However, fixed maturity plans with higher yields and duration is an opportunity as we move closer to the advance tax dates.
- ▶ We expect short end yields to remain benign over the next couple of months, with temporary spikes. Hence, ultra short term bond funds with low durations along with some allocations to hybrid funds may provide a good risk reward trade off in the near term.
- ▶ High risk investors can look to build duration in portfolios by investing in income funds and gilt funds. As per the regression model of our economist, the fair value range for the 10 year GOI yield is 4.6-6.84% (based on a 99% confidence interval). Hence, we recommend accumulating income funds at yields of over 7.25-7.5% or higher.
- ▶ We believe that investments into interest rate sensitive products such as gilt or income funds requires a minimum horizon of twelve months and allocations can be made only after due consideration to the risk profile, concentration risks and plans to book regular profits from the segment.



# Currencies

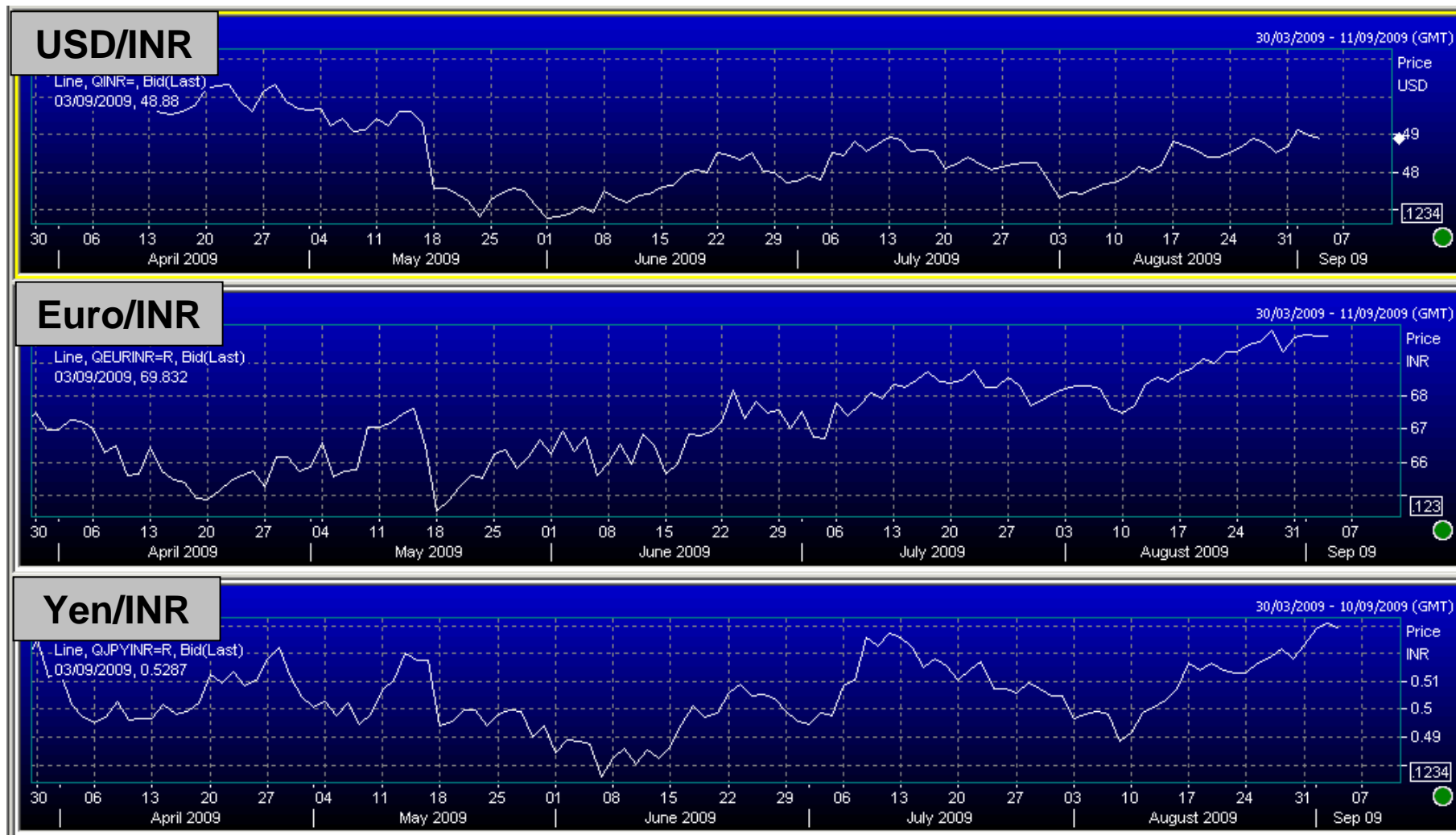
## September – Strategy

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

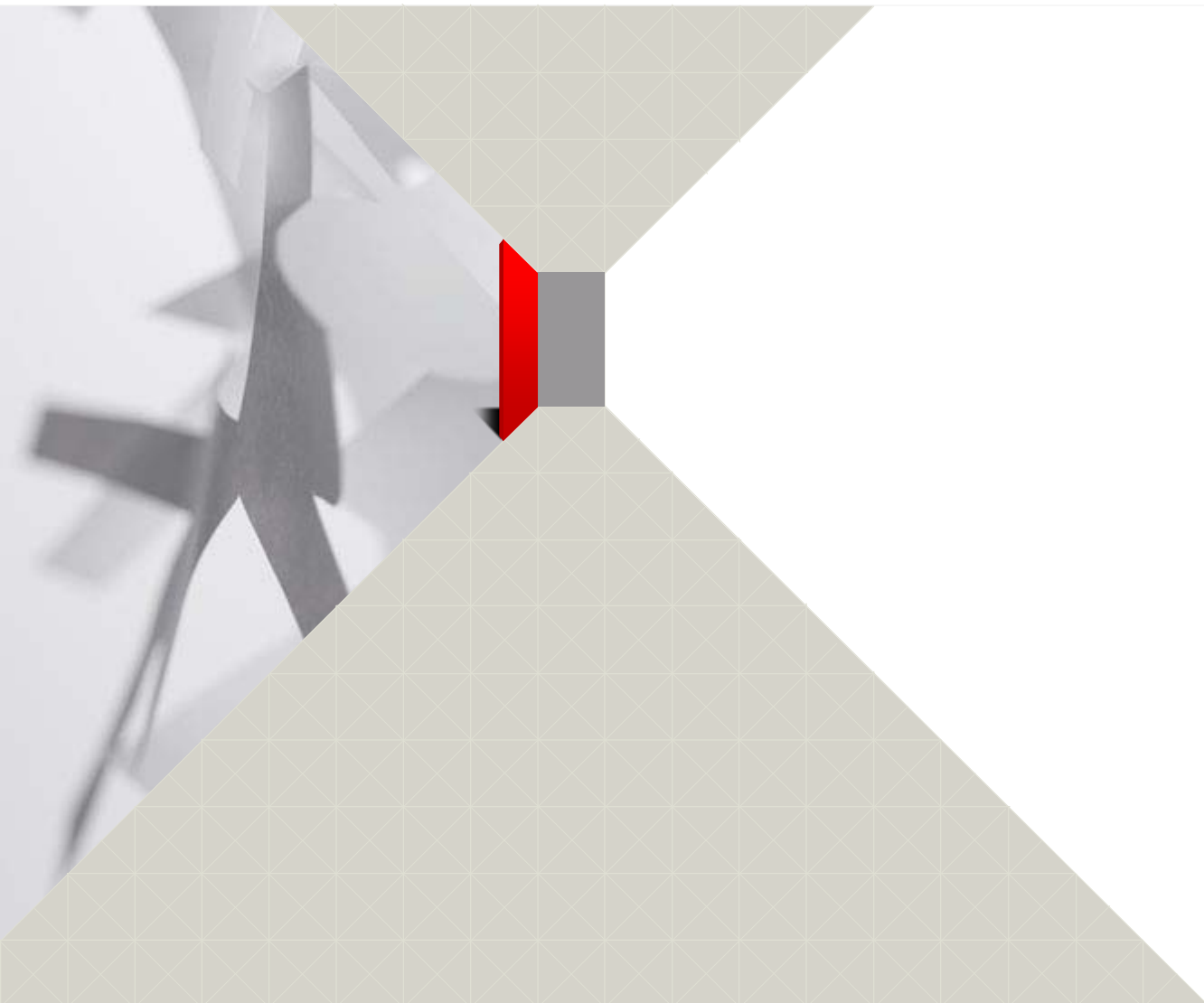
- ▶ **INR** –The INR weakened marginally during the last month and closed the month at 48.68 against the USD (Source: Reuters). The INR remains the only currency in Asia with a persistent outright current account funding requirement and remains one of the most expensive currencies vs the USD. We expect the USD-INR to weaken and reiterate our CY end target of 54.
- ▶ **USD** - As we had predicted, the US dollar weakened over the past few months due to improving risk appetite and quantitative easing by the Federal Reserve. We believe USD has settled at current levels for the time being, particularly against Euro and GBP, although we expect these currency pairs to trade toward the higher levels of the range in the short-term, as returning risk appetite keeps USD under pressure. As markets normalize, a return to traditional market-movers should prove USD supportive in the long term.
- ▶ **GBP** – GBP has strengthened against USD and is now more fairly valued. We therefore expect a period of sideways trading.
- ▶ **EURO** – As concerns over the Eurozone growth increase, we expect a period of consolidation.
- ▶ **JPY** – Improving market sentiment and returning risk appetite will likely lead to weakening JPY as investors seek yield elsewhere.

# September – Strategy

Currency movements....



Source - Reuters



Commodities

## September – Strategy

### As risk appetite returns, commodities should slowly improve

- ▶ We maintain our neutral stance with a positive bias for commodities overall, as we believe that investor sentiment is improving. In particular, their returning risk appetite should complement the resurgent demand from a global economic recovery that we expect to develop during 2010.
- ▶ **Gold:** Gold remained in a range and closed the month at US\$949 (Source: Reuters). We maintain a short-term neutral view on gold, as it appears to have settled in a trading range. Supportive (inflation fears) and pressuring (risk appetite) factors appear to be balancing out leading us to believe that price will remain range-bound. We maintain our neutral long-term view as we believe that inflation fears are likely to increase going forward, supporting gold prices.
- ▶ **Oil:** Light crude oil remained in a broad range and closed the month of August flat at \$69.96/bbl (Source: Reuters). In the short term, we hold a neutral view on oil, as we believe it has found a range for the time being. Our long-term outlook remains positive, as we believe demand will pick up again (whilst supply remains inelastic), particularly from Emerging Markets, driving prices higher over the next 12 months. However current over supply remains an issue in the short term.
- ▶ **Industrial Metals:** Infrastructure spending as part of stimulus packages may provide support to the price of industrial metals in the longer term. However, we believe a more widespread return to global growth is a prerequisite for outright positivism at this point. With the global economy only beginning to show signs of a recovery, we remain neutral toward industrial metals.

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