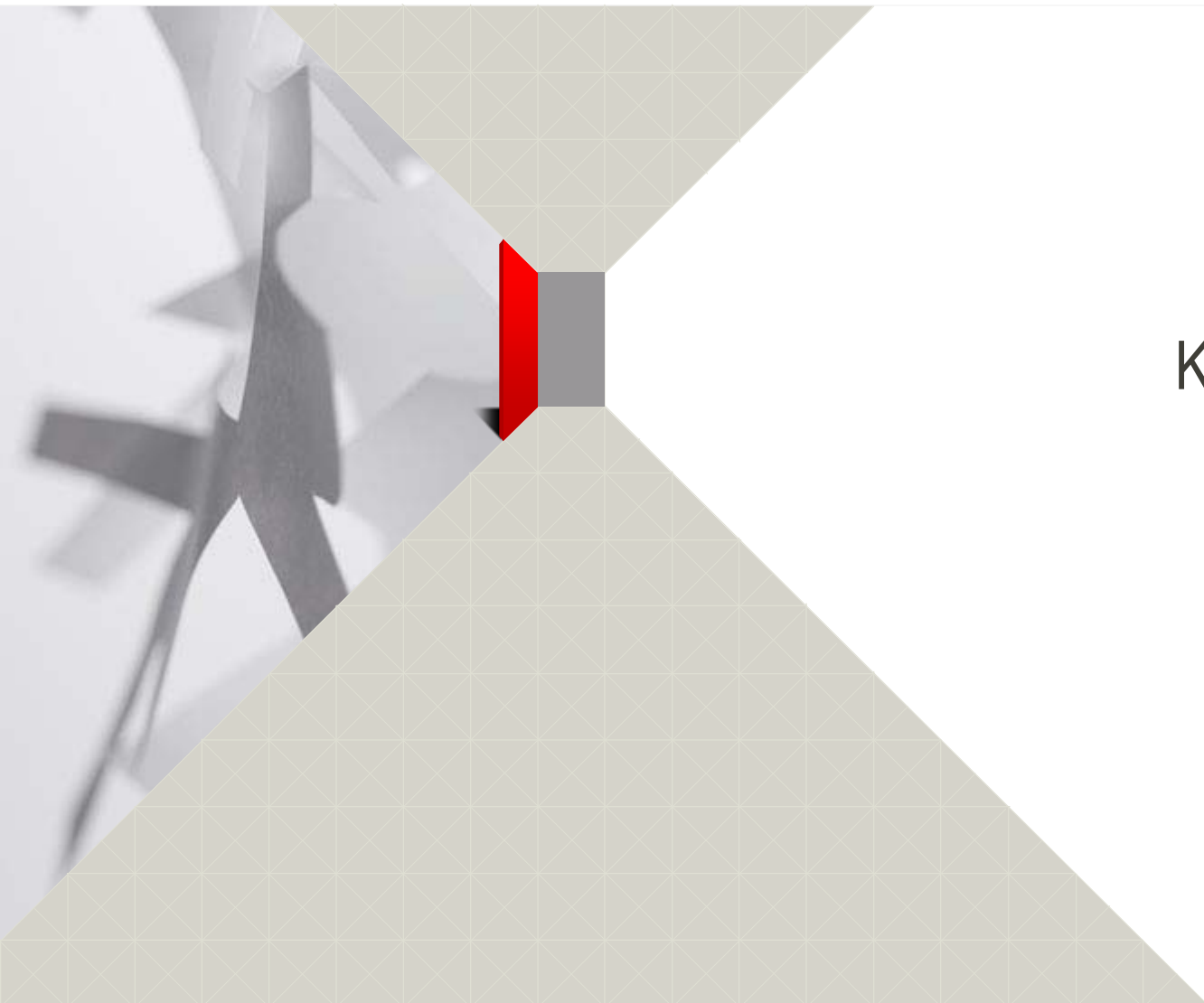


India Strategy

September 2011



Key Economic Forecasts

September – Strategy

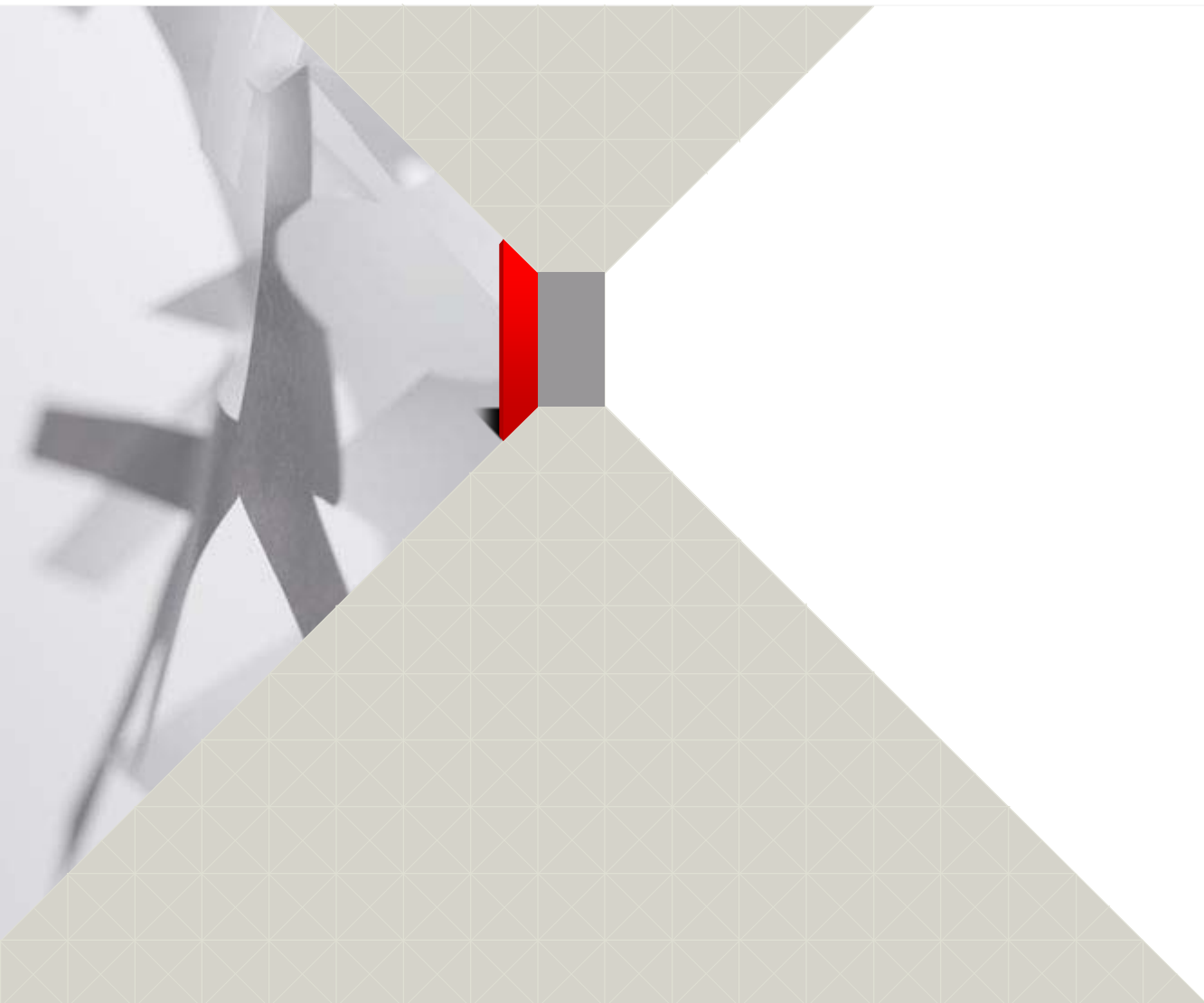
India - Key Macro Economic Forecasts

► Snapshot of key Indian economic forecasts

	2006	2007	2008	2009	2010	2011f	2012f
Production, demand and employment							
GDP growth (% y-o-y)*	9.6	9.3	6.8	8.0	8.5	7.6	8.2
Nominal GDP (USDbn)*	949	1,220	1,252	1,354	1,722	2,071	2,499
GDP per capita (USD)*	779	985	1,027	1,083	1,347	1,591	1,911
Private consumption (% y-o-y)*	8.3	9.3	7.7	7.3	8.6	7.9	8.3
Government consumption (% y-o-y)*	3.7	9.5	10.7	16.4	4.8	3.7	3.8
Investment (% y-o-y)*	13.8	16.2	1.5	7.3	8.6	7.0	8.3
Net Exports (contribution to GDP growth, ppt)*	-1.0	-1.5	-3.1	-0.8	1.2	-3.2	-1.1
Industrial production (% y-o-y)	11.0	15.6	7.7	0.2	9.7	6.9	6.4
Gross domestic saving (% GDP)*	34.8	35.6	32.3	32.3	33.7	34.5	35.1
Prices & wages							
CPI, average (% y-o-y)*	6.8	6.2	9.1	12.4	10.4	8.0	7.7
CPI, end-year (% y-o-y)*	6.7	5.5	9.7	15.0	9.5	6.9	7.7
Core WPI, average (% y-o-y)*	4.5	5.2	6.6	-0.3	4.9	7.7	6.5
Core WPI, end-year (% y-o-y)*	6.8	4.4	4.6	1.1	6.2	8.7	5.4
WPI, average (% y-o-y)*	6.6	4.7	8.1	3.8	9.6	8.6	6.7
WPI, end-year (% y-o-y)*	6.7	7.7	1.6	10.4	9.7	6.7	5.5
Money, FX & interest rates							
Central bank money M1, average (% y-o-y)	17.3	15.0	18.9	16.1	19.2	18.0	15.0
Broad money supply M3, average (% y-o-y)	19.6	21.9	20.4	19.2	16.0	15.0	16.1
Real private sector credit growth (% y-o-y)	18.3	15.6	14.0	6.8	12.0	15.0	15.0
Policy rate, end-year (%)	7.75	7.75	6.50	4.75	6.25	8.00	8.25
5yr yield, end-year (%)	7.52	7.67	5.35	7.31	7.85	8.00	8.20
INR /USD, end-year	44.25	39.42	48.46	46.69	44.81	42.00	42.00
INR /USD, average	45.22	40.88	44.58	48.39	45.74	44.15	42.00
INR /EUR, end-year	58.40	57.55	67.35	66.76	60.04	60.48	60.48
INR /EUR, average	56.83	56.82	64.92	67.62	60.37	62.36	60.48

Source – HSBC Global Research

Asian Economics Third Quarter 2011



Equities

September – Strategy

Market continued the downtrend in August on concerns over the US rating down grade by S&P & weaker global cues.

- ▶ Indian Equity markets continued the downtrend triggered by the US rating downgrade by S&P and concerns on global economic growth prospects. Domestically, sustained higher inflation, lower than expected Q1 FY 12 earnings and lack of policy direction from the government continued to hurt market sentiments.
- ▶ The BSE Sensex ended the month of August at 16677 (↓8.4% M-O-M) and the S&P Nifty closed the month at 5001 (↓ 8.8% 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 9.3% and 14.1% respectively. On the sectoral front, there was no sector gainer. FMCG and Auto indices closed with minimum losses while Realty, Metals, IT and Banking sectors were the major losers.

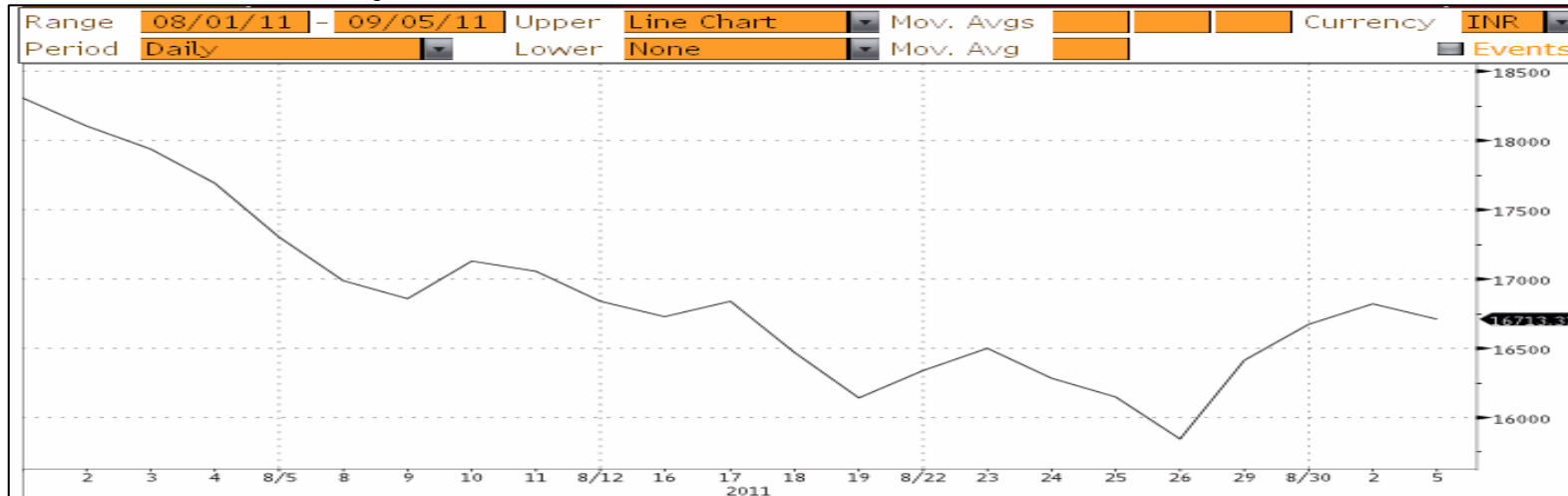
Index	% Change	Index	% Change
BSE FMCG Sector	-3.5%	BSE 200	-8.7%
BSE Auto	-4.1%	Nifty (S&P CNX)	-8.8%
BSE Oil	-5.1%	BSE 500	-8.8%
BSE Healthcare	-7.1%	BSE Power	-9.1%
BSE Cons Durable	-7.3%	BSE Mid-Cap	-9.3%
BSE Cap Goods	-7.3%	BANKEX	-12.4%
BSE IPO	-8.0%	BSE IT Sector	-13.3%
BSE PSU	-8.3%	BSE Metal	-13.7%
BSE Sensex	-8.4%	BSE Small-Cap	-14.1%
BSE 100	-8.5%	BSE Realty Index	-14.8%

Source – Capitaline/ Bloomberg

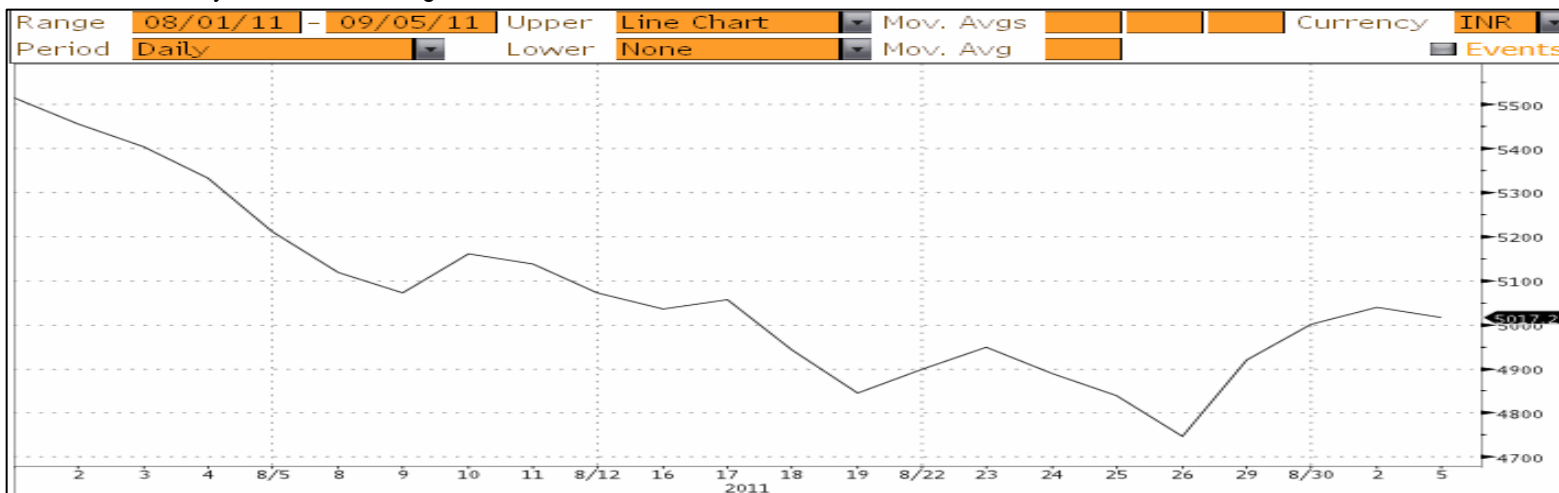
September – Strategy

Markets witness weakness

BSE Sensex movement during the month



S&P CNX Nifty movement during the month

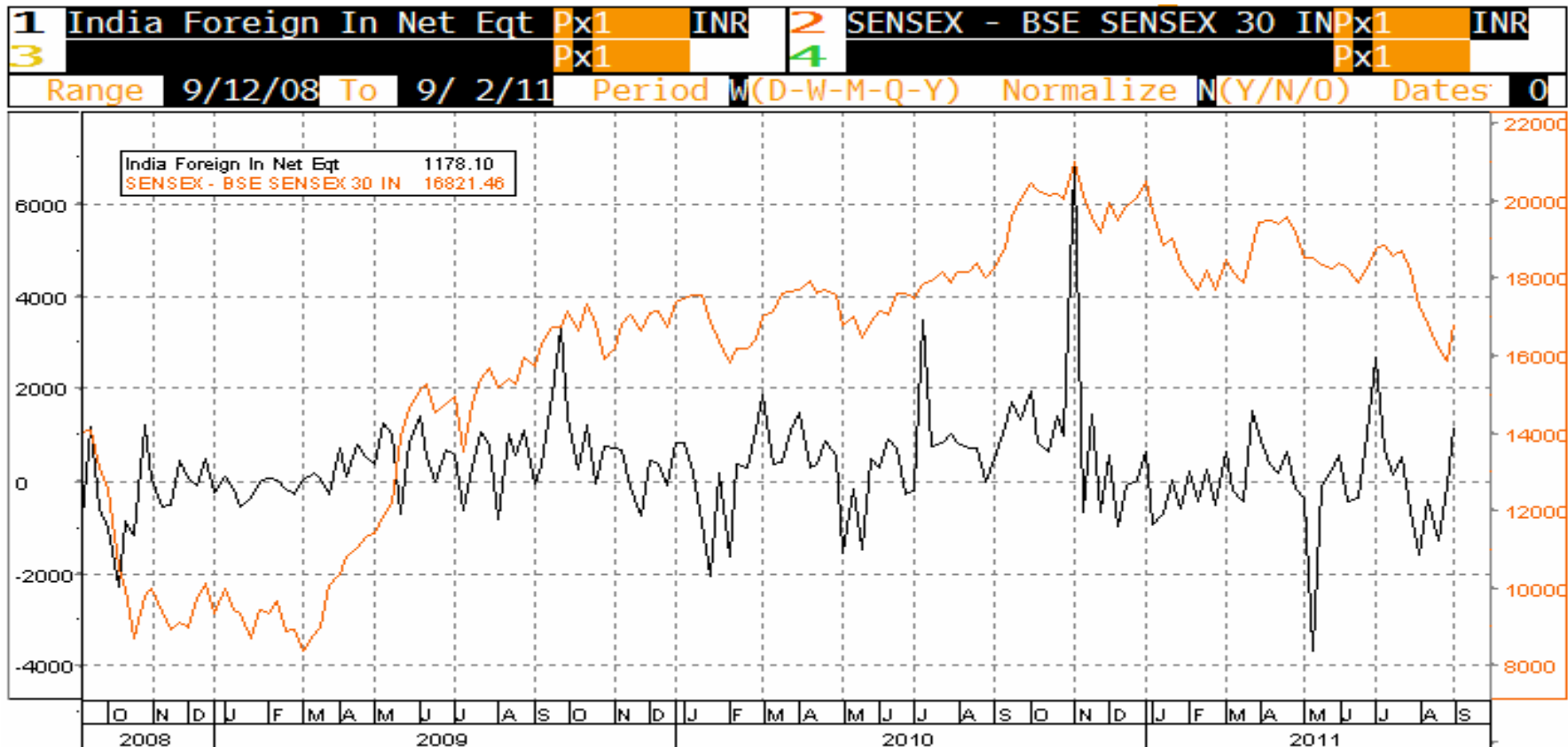


Source: Bloomberg

September – Strategy

Foreign institutional investors continue to be net buyers of Indian equities

- ▶ FIIs were net sellers of Indian equities in August. They net sold \$2.4bln of Indian equities during the month. YTD, FIIs remained net buyers of Indian equities worth \$0.6Bn.
- ▶ Domestic mutual funds net bought INR.2524cr during the month.



Source: Bloomberg. FII Flows in USD M

September– Strategy

Moderation in high frequency indicators continues reflecting the lagged effect of monetary tightening.

- ▶ The index of industrial production's (IIP) in June11 surprised on the upside (8.8% y-o-y vs 5.9% y-o-y in May, well above consensus and our estimates
 - Manufacturing drove the acceleration (10% vs 6.1% in May) while electricity production (7.9% vs 10.3% in May) while mining slowed down (0.6% vs. 1.35 in May)
 - By use, the main driver of the acceleration was capital goods (37.8% vs. 5.9% in May) while Consumer goods (1.6% vs. 6.6% in May) continued to decelerate, with weakness in both durables (1.0% vs. 5.2% in May) and non-durables (2.1% vs. 7.9% in May)
 - Bottom line: June IP growth bolstered by strong expansion in the capital goods sector, while other sectors saw more moderate growth.
- ▶ Momentum in India's manufacturing PMI eased further in August primarily due to a contraction in export orders, while input and output costs continued to head north
 - PMI slowed further to 52.6 vs 53.6 in July driven by a marked deceleration in sequential output growth (56 vs 57.2 in July) and a slower expansion in order books with total orders coming in at 53.1 vs 54.5 in July and export orders contracting to 45 vs. 49.2.
 - Bottom Line: The moderation in growth is clearly not just a blip and is set to continue over the next several months in response to policy tightening and weaker external demand. Also, inflation pressures are not abating either. Chances are that the RBI will hike in September, barring a further worsening of global economic conditions.
- ▶ WPI inflation for July 2011 eased to 9.2% y-o-y (vs. 9.4% in June), in line with consensus, but core inflation rose.
 - Core inflation (non-food manufacturing) was broadly steady at 7.3% vs 7.1% in June.
- ▶ India Q1 FY 12 GDP eased marginally to 7.7% y-o-y from 7.8% y-o-y in the previous quarter.
 - On the supply side, growth slowed for agriculture, but held up for manufacturing output and service sector activity. On the demand side, private and public consumption growth eased while investment growth rebounded. Export growth held steady.
 - Looking ahead, however, growth is expected to moderate in response to the lagged effect of the monetary tightening and the additional tightening still expected.

Source: Bloomberg/HSBC

September– Strategy

High frequency indicators hinting towards further moderation in growth. FY 12 GDP growth estimated at 7.6%

- ▶ Exports during July 2011 rose by 81.79% in USD terms to USD 29.3Bn while imports rose by 51% in USD terms to USD 40.4Bn. Oil imports during July rose by 37% on a year on year basis. Non oil imports were higher by 58%. The trade deficit for April - July 2011 was estimated at \$42.6Bn (vs. \$37.5Bn in April - June 2010).
- ▶ Bank credit growth remains steady (20.2% y-o-y as on 12th August, 2011).
- ▶ Global equity update –
 - Equities are going through a typical mid-cycle correction. But, we believe there is no reason this will turn into a bear market.
 - While there are plenty of near term reasons, including the Japanese earthquake, and, more convincingly, higher commodity prices, western economies, by not facing up to the fiscal challenge, are in danger of locking into structurally lower growth.
 - Key reasons for the commodity price rise globally – structural tilt in global economic growth led by emerging economies, unforeseen ‘carry trade’ efforts of Western monetary stimulus, and more recently, the political upheavals in the MENA region
 - Despite the massive policy stimulus, healthy economic recovery is a distance dream, on the back of this, we have trimmed some of our global growth forecasts – notably in the US (1.6% for 2011 from 2.5% earlier) & Eurozone (1.6% for 2011 from 2.0% earlier) and have raised our inflation forecasts for the World for 2011 from an earlier 3.4% to 3.5%.

However we are not expecting another financial crisis on par with Lehman any time soon, though remain concerned over the sovereign debt situation in the Eurozone and on absence of the deficit reducing intent of the US
 - The US economic recovery continues to be restrained by a stagnant housing market and by budgetary cutbacks from state and local governments. Those headwinds are likely to persist, limiting the pace of growth over the years ahead.
 - The Eurozone, more than an year into the sovereign crisis, a resolution has yet to be reached. Greece, clearly is the focal point. The ECB remains vehemently opposed to any selective default to avoid buying more peripheral bonds and instead focus on its mandate of price stability.
 - Back home in India, the high frequency indicators show early signs of cooling, but the momentum is still decent.

Source: HSBC/RBI/Ministry of Commerce

September– Strategy

High inflation & macro headwinds (US QE, Euro zone concerns), downward earnings revisions subsequent to the Q1 FY 12 results and policy initiatives from the government to affect market sentiments.

- ▶ No major positive surprises from the Q1 FY 12 results announced so far. Markets are expected to trade sideways 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 bullish 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 16,677 the Sensex trades at a P/E of 13.9X FY12e (Bloomberg Consensus EPS estimate of Rs.1,194).
- ▶ Our year end 2011 Sensex target is 20,000. We forecast that EPS will grow at 15% over the next two years.
- ▶ 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 Quantitative expansion, Euro zone debt issues) and progress of the domestic monsoons.
- ▶ At the sector level, we favor IT services, Telecom and Healthcare. We are neutral on industrials, consumer staples, utilities, energy, materials and consumer discretionary. We recommend under weight on Financials.

September– Strategy

Overweight – IT services, Healthcare & Telecom; Neutral – Industrials, consumer staples, utilities and materials

- ▶ **Information Technology** – Overweight – We maintain our Over-weight rating on the sector as concerns over global demand recede and revenue growth prospects look strong for the IT sector.
- ▶ **Healthcare** – Overweight – 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. Further, rising incomes and ageing populations, coupled with pension and insurance reform, could lead to continued strong demand.
- ▶ **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.
- ▶ **Industrials** – Neutral – Fat order books are expected to drive earnings growth while valuations of the sector look attractive even in worst case scenario. 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.
- ▶ **Utilities** – Neutral – With rising energy costs and stable electricity prices, the utilities sector is facing a margin squeeze, which is the reason for our neutral stance on the sector 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)
- ▶ **Consumer Staples** – Neutral –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.
- ▶ **Energy** – Neutral– Environment is challenging for upstream and refineries as margins are likely to remain moderate. Also the sector faces government policy risk.
- ▶ **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.
- ▶ **Materials** – Neutral – 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, which is the basis for our rating.
- ▶ **Real Estate/Property** - Neutral - Recent data suggests demand volume in India's top 7 cities has either been flat or declined over the past two quarters, with Mumbai and Pune reporting sharp drops. While developers could hold prices firm in the near term due to stable balance sheet liquidity, we think this will only hurt demand as interest rate rises and higher property prices will curtail affordability.
- ▶ **Financials** – Underweight – Expectations of higher inflation and further monetary tightening is likely to impact the margins of the banking sector. Added a slowdown in the macro growth prospects could add pressure on asset quality. We expect 2011 to be the second consecutive year of credit up cycle with loan growth expected in excess of 20%. Given the higher earnings visibility and fewer concerns for private sector banks coupled with valuations at their 5-year near average levels we continue to prefer private sector banks to PSU banks.

Source HSBC Global Research

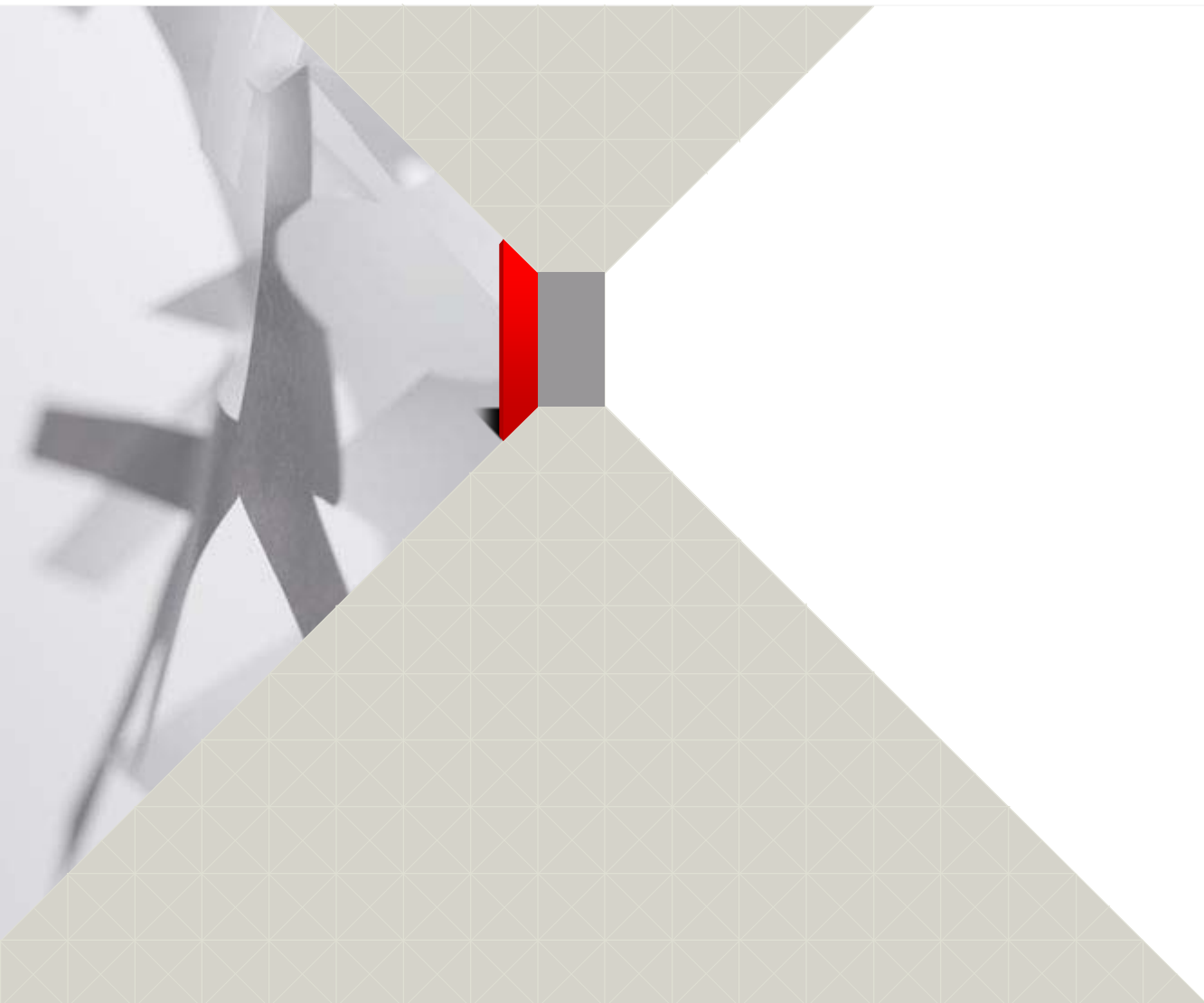
September – Strategy

Derivatives parameters indicate presence of shorts positions

Equity Derivatives:

- ▶ Nifty near month future lost 9% during the month of August
- ▶ Open Interest for near month Nifty future was up by about 17%.
- ▶ Bank Nifty near month future lost 13% for the month.
- ▶ Open Interest for Bank Nifty future was up by about 81%
- ▶ CNX IT near month future lost 14% during the month.
- ▶ CNX IT futures open interest gained by about 21% though on a small base

Source – Reuters



Fixed Income

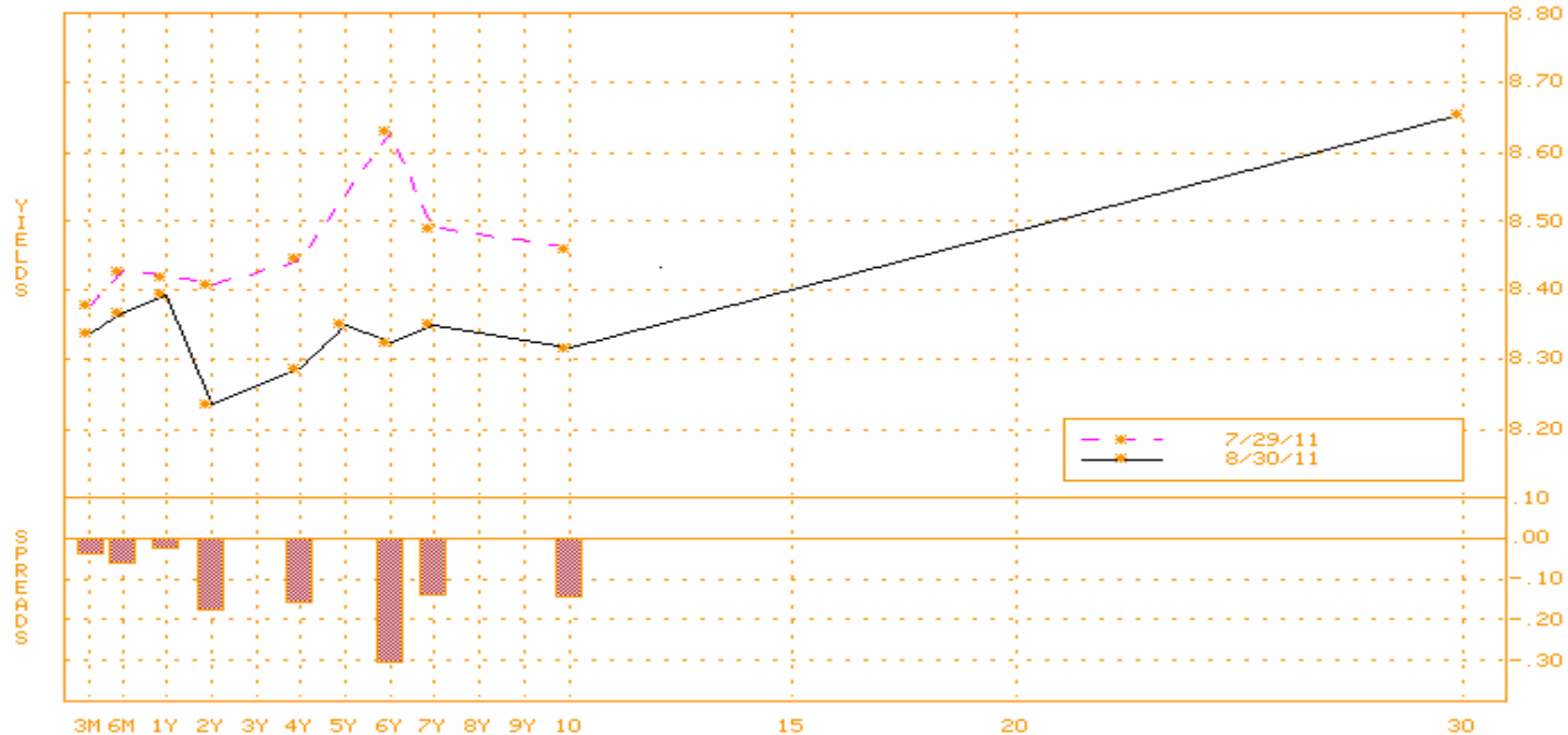
September – Strategy

Fixed Income

INR India Sovereign

8/30/11 vs 7/29/11

3M - 30



Indian Government Yield Curve

Source: Bloomberg

- The ten year bond yield in August '11 traded in a range of 8.20% to 8.46% and ended the month at levels of 8.32% (Source Bloomberg) predominantly due to inflation (WPI) exhibiting mixed trends and on varying expectations on the upcoming RBI's policy review meet.
- The RBI in August '11 on a daily basis infused liquidity amounting to INR 385B (month's average) as against INR 377B (month's average) in July '11 (Source: Bloomberg)

September – Fixed Income Strategy

Growth easing, inflation remains elevated

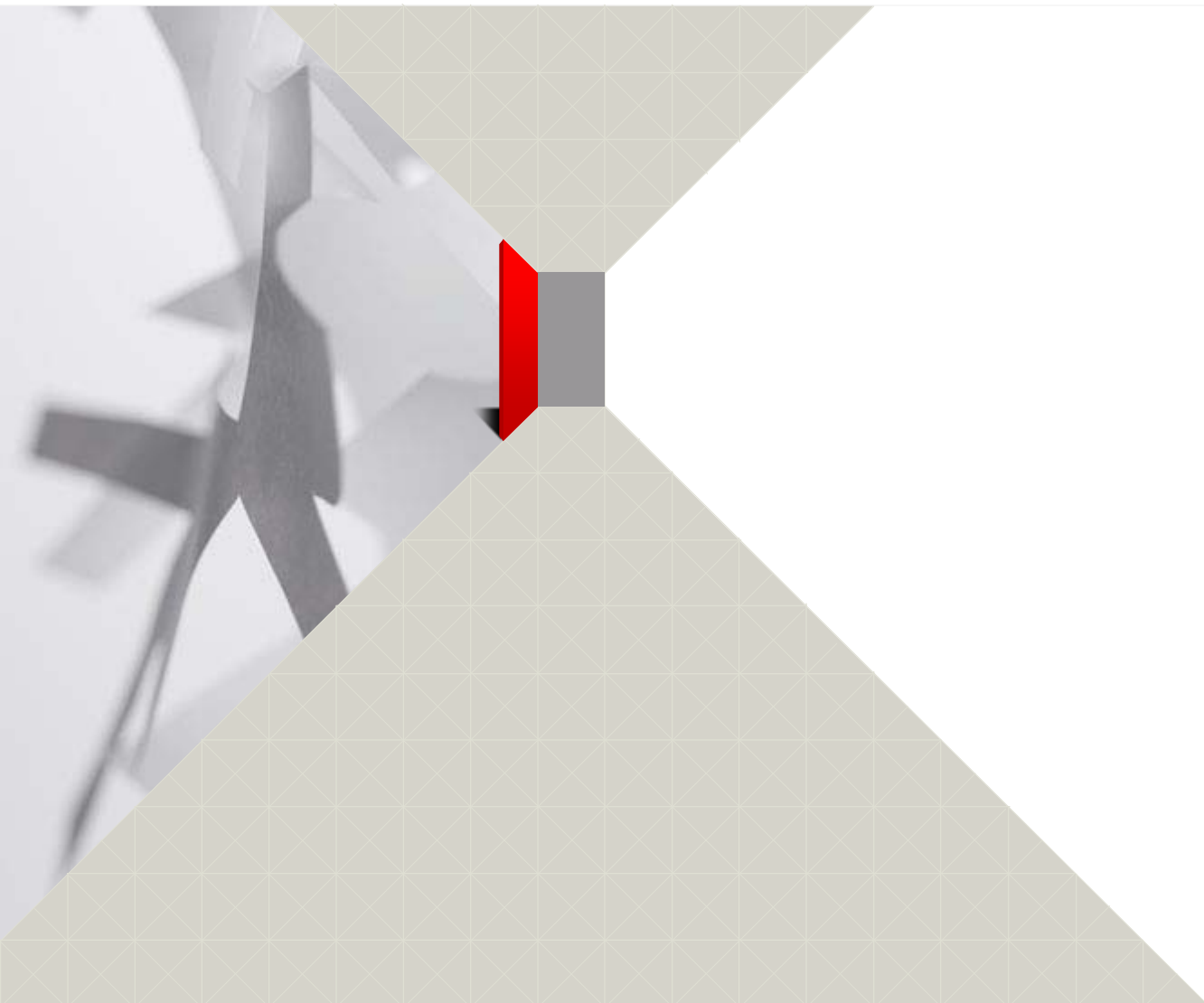
- ▶ The Indian economy in Q1FY12 registered economic growth of 7.7% (on a year on year basis) as against 7.8% registered in Q4FY11. Private and government consumption registered growth of 6.3% and 2.1% respectively during the quarter as against 8.0% and 4.9% registered during January – March '11. (Source: Bloomberg)
- ▶ The RBI conducted a survey of professional forecasters and its key findings are (Source: RBI):
 - FY12 median growth estimate of 7.9% as against 8.2% in its earlier survey
 - Forecasters have assigned a probability of 32.8% that inflation will range between 7.0-7.9% in end March 2012
 - Central government's fiscal deficit is estimated at 5.3% of GDP in FY12, combined fiscal deficit is estimated at 8% of GDP.
- ▶ The Government of India issued securities amounting to INR 560B during the month, under its annual borrowing programme. Various state governments issued 10 year papers amounting to INR 127.5B at yields of 8.52-8.64% in August '11.
- ▶ WPI Inflation in July '11 was 9.22% (provisional numbers and on a year on year basis) as against 9.44% (year on year basis) witnessed in June '11. In July, primary articles, fuel & power and manufactured products rose by 11.30%, 12.04% and 7.49% respectively (on a year on year basis). WPI Inflation reading for May '11 was revised upwards from 9.06% to 9.56%. (Source: Government of India)
- ▶ Systemic liquidity in August'11 remained tight due to the ongoing government borrowing programme and the Reserve Bank of India during the month issued INR 140B worth of 49 days cash management bills.

Data Source: HSBC/ Reuters/ Bloomberg

September – Fixed Income Strategy

Easing growth leading to expectations of an end in RBI's policy action

- ▶ Consensus expectations are emerging that the RBI's is nearing the end to its policy tightening spree due to declining domestic economic growth and on global macro concerns.
- ▶ 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 high coupon bearing bonds with a medium to long term investment horizon.
- ▶ On a tactical basis investors may selectively gradually lock into long term bonds/bond funds during periods of volatility.



Currencies

September – Strategy

The three main Western currencies face their own hurdles

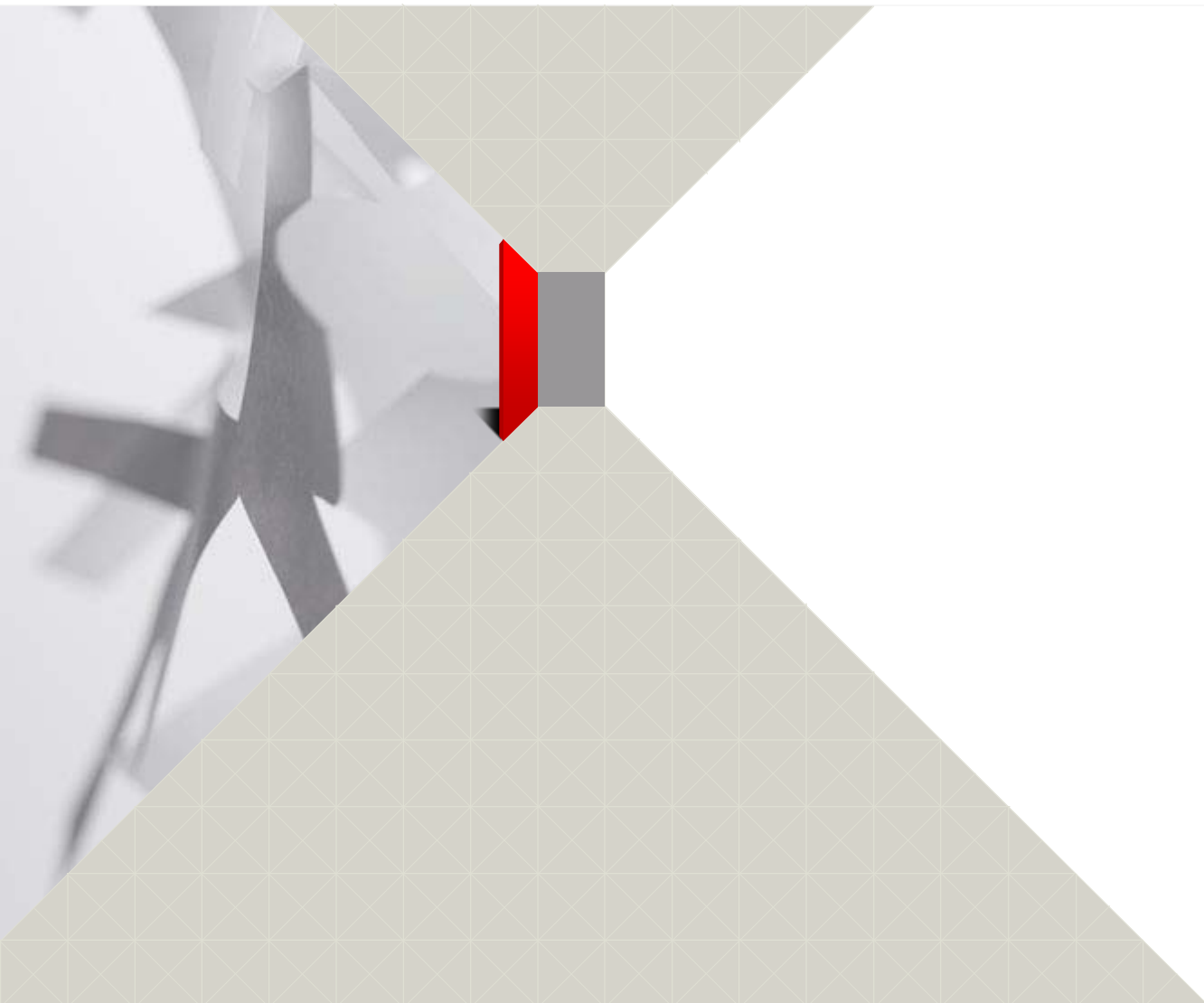
- ▶ **INR** - The INR weakened during August and ended the month at 46.09 against the USD (Source: Bloomberg). Our December 2011 target for INR stands at 42.
- ▶ **USD** –We believe further downside for the USD maybe somewhat limited despite worries over the US deficit, as the USD is nearing historical lows. 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. We hold a Neutral view on Euro for the next 12 months.
- ▶ **GBP**- The weak economic backdrop may keep the GBP under check as interest rate hike expectations continue to be pushed into 2012 now. We hold a Neutral view on GBP with a negative bias for the next 12 months.
- ▶ **JPY** – Safe haven currencies are near their peaks due to the ongoing volatility, thereby supporting the JPY. JPY may have limited upside potential given already record highs, but they are likely to remain in demand as long as instability and uncertainty rule. Additional intervention against the JPY cannot be excluded, as an excessively strong JPY could hurt the recovery of the Japanese economy. We hold a Neutral view on JPY for the next 12 months.
- ▶ **Emerging Markets (EM)** – We believe emerging market currencies will continue to appreciate particularly as we expect investors' search for yield to continue in the low yield environment. Further, EM countries may use currency appreciation as a tool to fight inflation. We favour currencies that are less likely to see government intervention in an attempt to curb appreciation. We hold positive view on Emerging market currencies for the next 12 months.

September – Strategy

Currency movements....



Source - Bloomberg

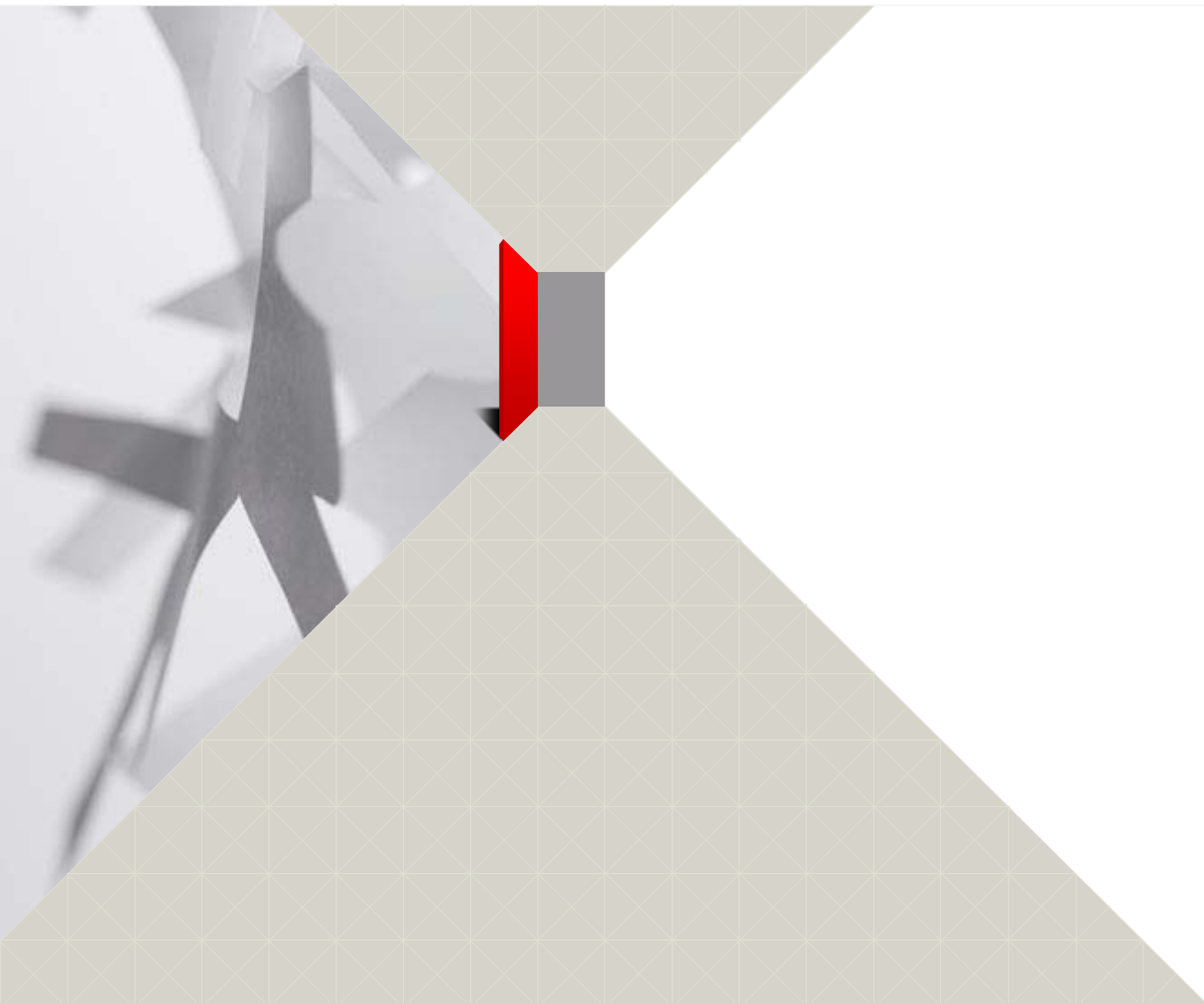


Commodities

September – Strategy

The uncertain economic outlook may limit upside potential

- ▶ 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, muting price appreciation. However, USD weakness should provide some underlying support to prices.
- ▶ **Gold:** Gold strengthened in August and ended the month at US\$1,825 (Source: Bloomberg). Gold should remain in demand thanks to its status as a safe haven, an inflation hedge, and a commodity that benefits from a weaker US dollar. Ongoing debt concerns, particularly in the Euro zone and in the US should support gold as uncertainty persists. High inflation in EM should provide further support to prices. With commitment by western central bankers to keep monetary policy accommodative for a long time, the 'opportunity cost' of holding gold (as it does not pay a coupon) remains negligible. Further, currency diversification should continue to support demand for gold, which still seems a good alternative to Western currencies, which see their value deflated by high government debt piles. For the next 12 months, we hold a neutral view on Gold with a positive bias.
- ▶ **Oil:** Brent crude oil corrected marginally during the August and ended at \$114.85/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. 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

September – Strategy

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