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India: Last Market Standing

Short-Term Hedging Strategies on a So-far Resilient Market

Derivatives commentary ☑
Equity ☑

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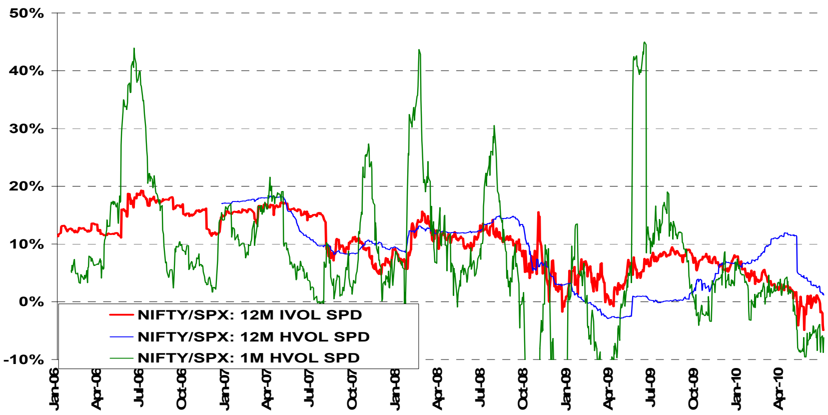
- **NIFTY Resilient** — The Indian market has so far defied the global macro wobbles: 1) NIFTY +1.6% YTD, while other key indices -7% to -25%, 2) With all the talk about falling government bond yields, which signify delays in rate hikes or even deflation, Indian long-dated yields have been holding up, while short-dated has even risen due to high inflation expectations, 3) Volatility keeps drifting lower, e.g. 1Yr ATM IVOL at cheapest level vs. SPX's.

- **Rates: Receive Longer-End** — Given the downward pressure on yields globally, we would close our recommended long 2Yr/5Yr IRS spread, now that the spread has narrowed from -119bps to -76bps. If global markets continue to correct, we expect yields to fall in the longer-end. We do not recommend receiving on the short-end, given the possibility of further rate hikes.

- **Derivatives: 1) Buy NIFTY Puts, 2) Accumulate Longer-Dated Volatility** — NIFTY has the lowest 3M ATM IVOL among key global indices, and is trading in single-digit percentile. While CIRA remains positive on India over the medium term, there is only +4% upside to our 2010 year-end target for NIFTY (5,237 vs. 5,450). Investors can get an attractive risk-reward in the short-term by buying 3M NIFTY puts. They can also consider accumulating longer-dated volatility. NIFTY has become the second cheapest long-dated volatility to carry (after KOSPI 200). It is at single-digit %-tile vs. its own history, and trading at historic low vs. SPX's.

Figure 1. NIFTY 12M ATM IVOL: At cheapest level relative to SPX



Source: Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

India: Last Market Standing

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Rates: Receive Longer-End of the Curve

Figure 2 and Figure 3 compare 2Yr and 5Yr Interest Rate Swaps (IRS) in India vs. other key markets in the world (there is limited liquidity for INR IRS beyond 5Yrs). We notice significant falls across other countries in both 2Yr and 5Yr buckets since Apr-10, signaling delays in rate hikes in the short-term and deflation concerns in the medium-/long-term respectively. On the other hand, IRS level for INR 5Yr has only fallen slightly – it even rose in the 2Yr bucket. High inflation in India has led to expected rate hikes. Indeed, the RBI hiked rates by 25bps as recently as 02-Jul-10. This is supporting the IRS level in the shorter-end, e.g. 2Yr. Since we recommended buying India 2Yr/5Yr bear flattener in "The Rates Connection" (23-Mar-10), INR 2Yr/5Yr IRS spread has narrowed from -119bps to -76bps.

Figure 2. 2Yr IRS level rose in India while it has fallen in other countries

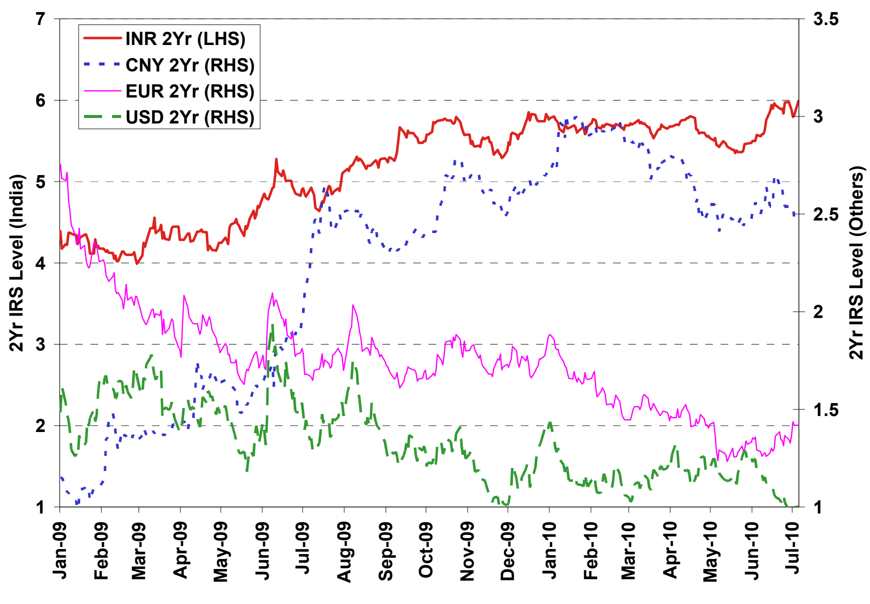

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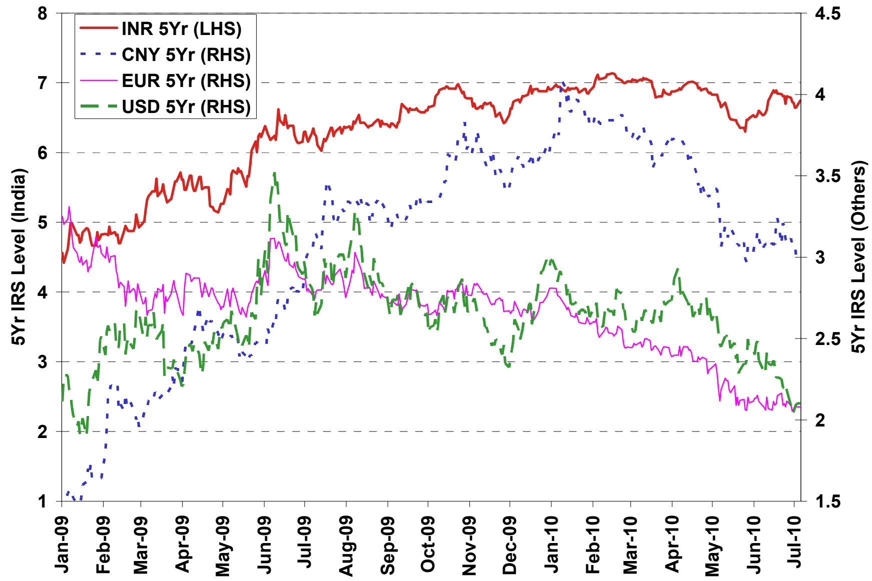
Figure 3. 5Yr IRS level fell slightly in India while it has corrected significantly in other countries



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Inflation may remain high in India, with a) continued increase in food articles price index, b) acceleration in non-food manufactured goods prices, and c) uptick in fuel index which is likely to trend higher following the recent fuel price hike ("India Macro Flash", 02-Jul-10). However, given the current fear of deflation for most markets, we believe it is **prudent to close out the long2Yr/5Yr IRS spread and take the view that growth expectations are likely to slow by receiving the longer-end of the curve, e.g. 5Yr**. We refrain from receiving the shorter-end, in case there were to be surprise rate hikes in the near future.

Derivatives: 1) Buy NIFTY Puts, 2) Accumulate Longer-Dated Volatility

Echoing the still pro-risk sentiment in India, NIFTY has been one of the best performing indices YTD (Figure 4).

Figure 4. 2010 YTD Index Total Returns

Index	2010 YTD Return (in USD)*
NIFTY	1.6%
Hang Seng	-7.3%
NKY	-8.3%
SPX	-8.4%
KOSPI2	-9.0%
HSCEI	-10.3%
AS51	-17.2%
SX5E	-25.1%

Source: Citi Investment Research and Analysis
* Up to 02-Jul-10

While CIRA still remains positive on India, there is only +4% upside to our 2010 year-end target for NIFTY (5,237 vs. 5,450). In "India Strategy" (27-Jun-10, link: https://www.citigroupgeo.com/pdf/SAP37653.pdf), CIRA India Strategist, Aditya Narain, wrote "… India's dependence on foreign flows is rising… this could keep market volatility high – and more so from a return perspective as INR increasingly mirrors the market – on the upside, but potentially more on the downside, given the markets' relative outperformance over the recent past."

Indeed, if one does not believe India can stand aloof from the globe, being positioned for the downside could offer good risk-reward in the short-term:

- NIFTY has the lowest 3M ATM IVOL among key global indices (Figure 5). It is trading at single-digit percentile. Investors should consider buying 3M puts (from 90% strike to ATM) on NIFTY, to get tactical downside exposure.

Figure 5. NIFTY has the lowest 3M ATM IVOL amongst key global indices

Index	3M ATM IVOL	3M HVOL	1M HVOL	2Yr Low	2Yr High	Percentile
NIFTY	***22.0%***	***19.7%***	***17.1%***	***18.5%***	***78.6%***	***8.6%***
KOSPI2	22.8%	18.3%	15.2%	16.6%	77.1%	30.4%
Hang Seng	24.0%	21.0%	19.3%	20.7%	83.2%	12.6%
TWSE	24.4%	21.1%	19.3%	18.1%	58.8%	26.0%
AS51	26.2%	20.8%	19.2%	15.1%	55.4%	59.6%
NKY	27.8%	24.7%	26.0%	18.2%	74.0%	57.0%
SPX	29.4%	25.4%	24.6%	15.7%	63.9%	66.9%
HSCEI	30.2%	28.4%	25.5%	25.3%	96.1%	15.5%
SX5E	32.0%	35.8%	26.2%	18.2%	60.7%	67.6%

Source: Citi Investment Research and Analysis

- In "2H10 Derivatives/Multi-Strategy Outlook" (24-Jun-10), we recommended clients to accumulate longer-dated KOSPI 200 volatility, as a hedge against medium to long-term uncertainties. It appears over the past couple of weeks, value is starting to emerge in NIFTY longer-dated volatility as well.
  - Figure 6 shows that NIFTY longer-dated volatility is the second-cheapest volatility to carry amongst key global indices (after KOSPI 200)

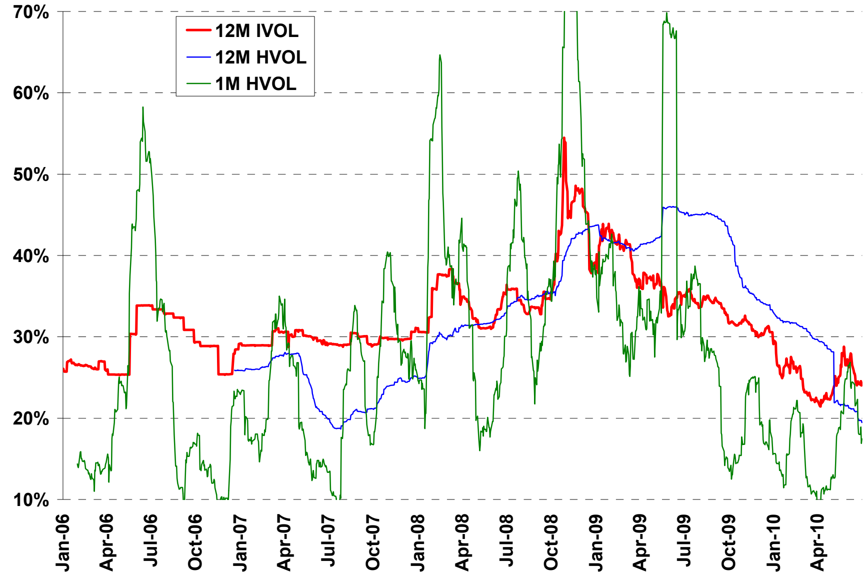
Figure 6. NIFTY 1Yr ATM IVOL: Second cheapest to carry. At 9th percentile

Index	1Yr ATM IVOL	2Yr Low	2Yr High	Percentile
KOSPI2	23.4%	18.9%	54.8%	26.2%
NIFTY	***24.3%***	***21.5%***	***54.6%***	***9.0%***
TWSE	24.8%	19.8%	45.6%	24.8%
Hang Seng	25.1%	22.5%	55.8%	14.2%
AS51	25.3%	17.5%	43.3%	56.3%
NKY	26.4%	19.9%	50.0%	57.1%
SX5E	29.1%	20.6%	45.7%	67.6%
SPX	29.2%	18.7%	48.5%	68.2%
HSCEI	30.6%	27.3%	67.0%	15.1%

Source: Citi Investment Research and Analysis

  - Compared to its own history, NIFTY long-dated volatility is trading at single-digit percentile (Figure 7). KOSPI 200 is at its 26th percentile

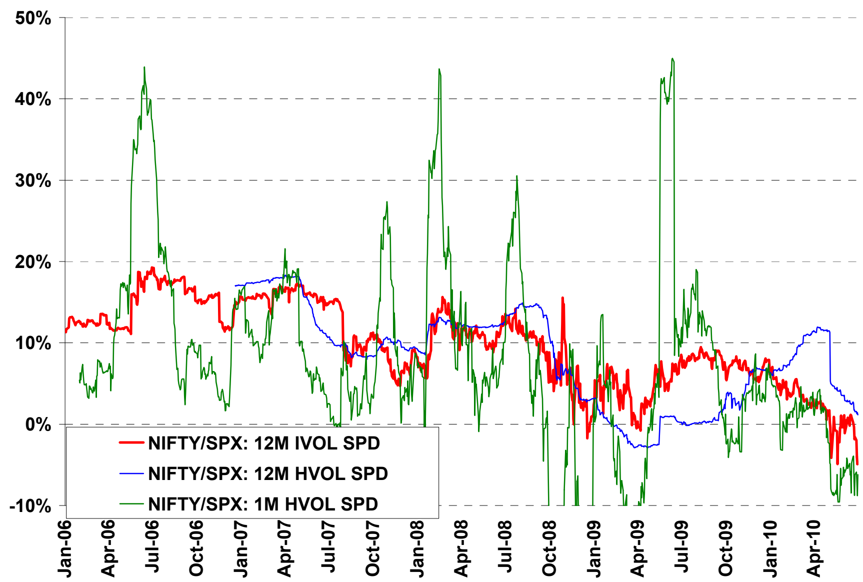
Figure 7. NIFTY 12M ATM IVOL: Near historic bottom



Source: Citi Investment Research and Analysis

– NIFTY long-dated volatility is trading at its cheapest level vs. SPX (Figure 8)

Figure 8. NIFTY 12M ATM IVOL: At cheapest level relative to SPX



Source: Citi Investment Research and Analysis

Risks: Buying puts means an investor is at risk of losing the entire premium paid. In terms of accumulating volatility, the investor will lose money if the market realizes less volatility than the investor has paid for.

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Document (Characteristics and Risks of Standardized Options) at
http://www.optionsclearing.com/components/docs/riskstoc.pdf
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Appendix A-1

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