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India Strategy and Economics

Road to Recovery, Low Visibility Ahead

Framework for India's growth cycles: We believe that cyclical global factors have a very important role in driving India's growth cycle. The two most important global factors include global risk appetite, which in turn reflects in the trend for capital inflows into India, and external demand. In this context, we believe that direct and indirect linkages with G7 growth outlook are high.

Tepid recovery likely from 4Q09: A weak recovery in the G7 economies from 4Q09 should start supporting a recovery in growth in India from 4Q09. We expect a drag from exports and capex to reduce from 4Q09 with recovery in G7 economies. We expect industrial production to improve to 4% in 4Q09 from -0.2% in 4Q08. As global growth recovers to 3% in 2010, we expect India's GDP growth to improve to 6.1% in 2010.

What are the risks to base case outlook? In our base case, we expect 2009 and 2010 GDP growth of 4.3% and 6.1%, respectively. The risks to our estimates will depend on the influence of the global growth outlook on capital inflows and external demand. Based on bull-bear case outlook for G7, we see bull scenario growth for India at 5% in 2009 and 7.4% in 2010 and bear case at 3% in 2009 and 4.5% in 2010.

Equity market outlook: The market could still face extreme outcomes depending on the length and depth of the NPL cycle, global developments, election results and pace and extent of corporate sector operational deleveraging. In our base case, we project a range-bound market but extreme outcomes have a one in two chance, in our view. Until the elections are out of the way, we think investors should continue to be overweight defensive sectors and underweight cyclical and rate sensitive ones. A pertinent point to note is that it is not necessary for the market to lead an earnings recovery (which is possible in 4Q09 due to a favorable base effect). Consumer discretionary and industrials are the sectors likely to lead a market recovery though we think it is still early to make a switch into these sectors.

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Road to Recovery, Low Visibility Ahead

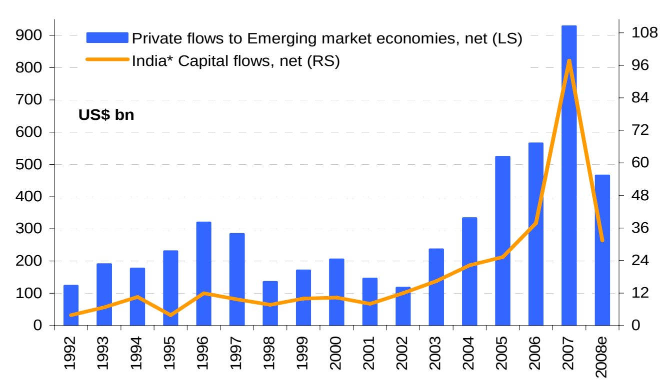
Summary
Most investors we speak with appear to be cognizant of the potential near-term weakness in the economy. Industrial production is now contracting 2% YoY from a peak of 15.8%. The key debate now is how long the poor growth environment will last and what will be the shape of the recovery ahead. In this note, we elaborate on the framework for assessing India's growth cycle and the outlook for the strength of the potential recovery. Later we share our views on the implications of the potential recovery in economic growth on the corporate sector's earnings trajectory.

Our Framework to India's Growth Cycle Drivers
India achieved average GDP growth of close to 9% during the four years ending March 2008 compared with an average of just 5.6% during the preceding four years ending March 2004. This sharp acceleration in growth was due to structural as well as cyclical forces. Indeed, we believe that cyclical global forces have had a much larger role to play in pushing India's growth above potential. The pace of structural reforms was relatively slow during this period. During the four years ended December 2007, global growth accelerated to close to 5% compared with 3.3% in the preceding four years ended December 2003. On traditional framework of trade linkages, India appears to be less exposed to global economy compared with its East Asian peers (Exhibit 3). India's foreign trade to GDP is just 22.6% (as of 2008). However, India got a major boost to its domestic demand growth due to large capital inflows, which systematically pushed down cost of risk capital.

Net capital inflows increased almost tenfold to US$108 billion in F2008 (YE March) from US$10.8 billion in F2003. A relatively loose monetary policy in the key developed world economies and increased risk appetite amongst global financial institutions supported this trend. Unfortunately, these inflows into India and other emerging markets have little to do with recipient country's fundamentals. A sharp rise in non-performing loans in some of the large global economies, including the US, is now causing risk aversion amongst global financial institutions, which in turn has resulted in a vicious feedback loop of tightening credit environment and slowing growth. Capital outflows and sharp contraction in exports is now slowing India's growth below underlying potential.

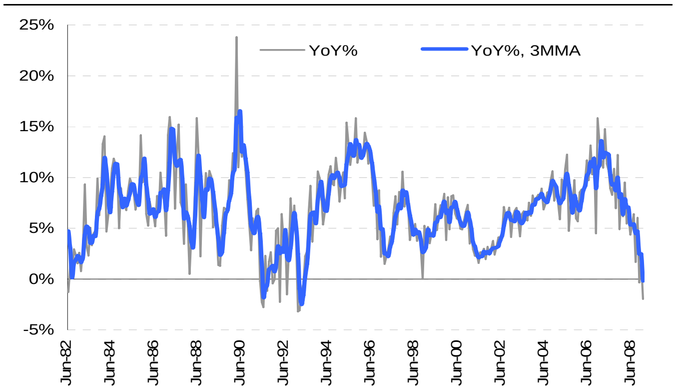
G7 Growth To Start Improving in 2H09
Our global economics team expects growth in G7 economies to improve to -2.5% YoY in 2H09 from -3.3% in 1H09 and further to +1.9% in 2H10. Aggressive monetary and fiscal policy

Exhibit 1
Capital Flows to Emerging Markets and India – Little To Do With EM Fundamentals



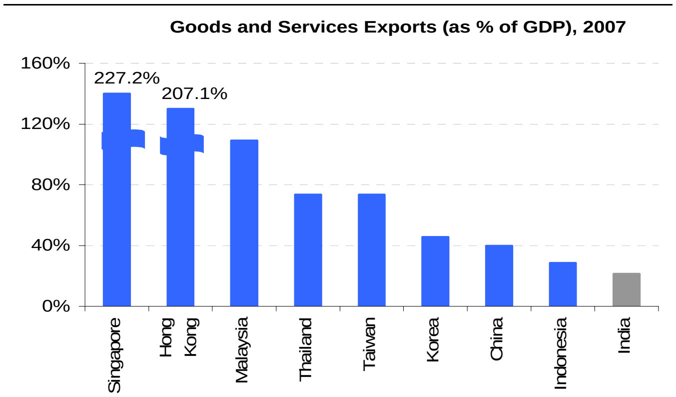
e = IIF estimates, Note: *India data is from CEIC and 2008e = Morgan Stanley Research Estimate; Source: IIF, CEIC, Morgan Stanley Research

Exhibit 2
Industrial Production Close to 16-Year Lows



Source: CSO, CEIC, Morgan Stanley Research

Exhibit 3
Exports of Goods and Services



Source: WTO, Morgan Stanley Research

response in the developed world is expected to support this gradual recovery. However, there is some uncertainty on the government's ability to fix the financial systems, which have been hit by the sharp rise in non-performing loans. Our US economist, Richard Berner, highlights that the key to whether or not such policies get traction lies in breaking the vicious circle between the credit crunch and the economy, with needed sequencing flowing from funding to credit markets'. (See, *Policy Traction: The Key to Recovery*, February 17, 2009.)

Tepid Recovery in India from 3Q09

A weak recovery in the G7 economies from 4Q09 should start supporting a recovery in growth in India from 4Q09. We expect GDP growth to accelerate to about 4.4% in 4Q09 from 3.5% in 3Q09. We expect a drag from poor exports and capex to reduce from 4Q09 with recovery in G7 economies. We expect India's industrial production to improve to 4% during the last quarter of 2009 from -0.2% in quarter ended December 2008. As global growth recovers to 3% in 2010, we expect India's GDP growth to improve to 6.1% in 2010. We believe that payback from India's own credit cycle excesses will hold back the pace the recovery in 2010.

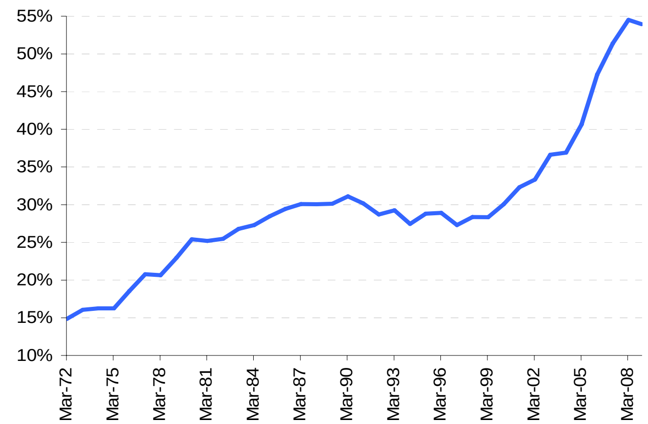
Payback From India's Own Credit Cycle Excesses

Over the last four years, the banking system has witnessed average credit growth of 28% compared with nominal GDP growth of 14.8%. To the extent to which banks were aggressive in disbursing credit at unusually low rates to marginal borrowers at cycle peak GDP growth, they are now facing a sharp rise in non-performing loans. We believe that in the second half of 2005 and in 2006, the banking and non-banking financial sector were extremely liberal in pricing credit. Banks were also aggressive in disbursing credit at the peak of the growth cycle. However, the first round of growth shock due to capital outflows and contractions in exports is now causing an increase in non-performing loans in non-banking as well as banking system. Non-performing loans are already rising in the real estate sector, in unsecured personal loans and amongst SMEs and in the export segment. With industrial production having reached a 16-year low of -2% as of December 2008 and cost of capital still high, non-performing loans will rise further. This turn is making banks risk averse to lend to the corporate sector, resulting in a vicious slowdown.

Recent High Savings Rate Is Not A Given

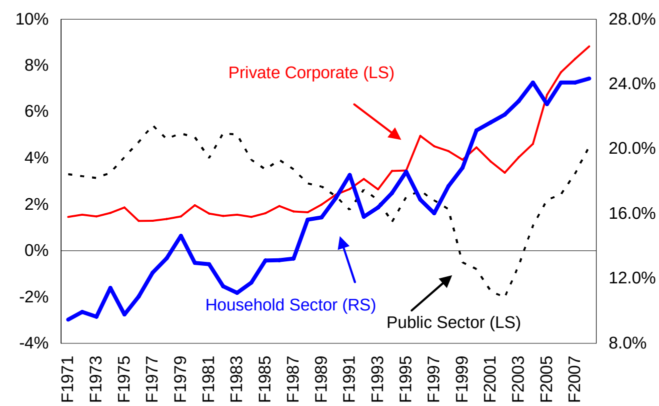
Many investors argue that the pick-up in domestic savings rate should ensure that India's GDP growth sustain the 8-9% GDP growth seen recently even if capital inflows collapse. We do not agree. Indeed, a part of rise in saving rate is endogenous to corporate profit cycle. A favourable global growth, sustained

Exhibit 4
How Big Was Credit Boom?



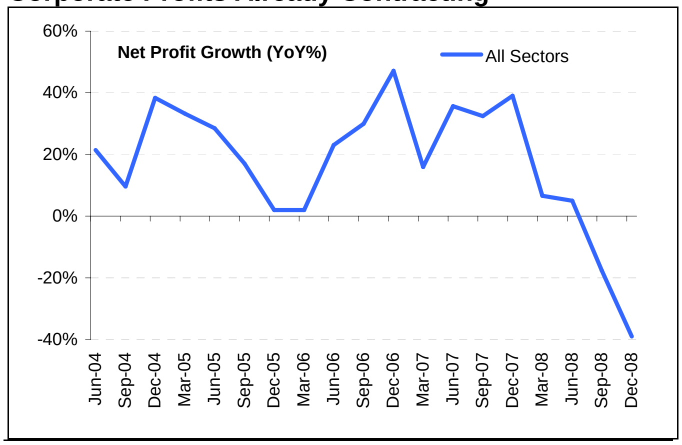
Source: CEIC, RBI, Morgan Stanley Research

Exhibit 5
Savings to GDP – Element of Cyclicality



Source: CSO, Morgan Stanley Research

Exhibit 6
Corporate Profits Already Contracting



Source: Capitaline database, Morgan Stanley Research *Based on a universe of 1814 companies increased capital inflows and strong domestic credit growth cycle supported a spike in corporate savings to GDP to 8.8% in F2008 from 3.4% in F2002. Similarly, strong corporate profits also contributed to higher tax to GDP and rise in public sector savings. Strong growth in public sector entities' profits also supported the improvement in public sector savings. Household savings to GDP have been largely stable in this period. A reversal in global growth trend and its adverse impact on capital and exports are now already reflected in sharp contraction in corporate profits. We expect the savings to GDP to reduce significantly over the next two years.

A Framework to Assess Upside and Downside Risks to Our Growth Estimates

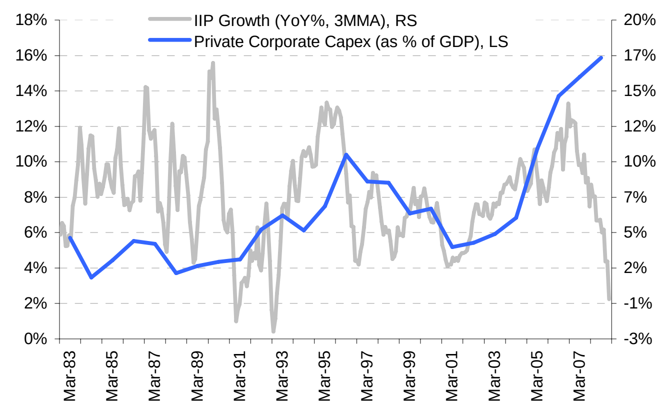
As highlighted earlier, the two most important factors for India's growth outlook will include global risk appetite, which will be reflected in the form of capital inflows in the country, and external demand. In our base case, we expect 2009–10 GDP growth of 4.3% and 6.1%, respectively. The upside & downside risks to our India GDP growth estimates will depend on the influence of the global growth outlook on these two factors. Based on this framework, we see bull scenario growth for India at 5% in 2009 and 7.4% in 2010 and bear case at 3% in 2009 and 4.5% in 2010. (See Exhibit 9 for our global economics team's bull-bear estimates for G7 growth.) In the bear case, we assume continued risk aversion in global financial markets and therefore a sustained adverse trend in capital inflows and sharper fall in exports. In the bull case, we assume a recovery in capital inflows and exports growth. We have assumed the political environment to be neutral. However, the outcome of general elections scheduled in May 2009 could also bring upside or downside risks to our base case outlook. A stronger coalition government outcome could improve the growth outlook with acceleration in the pace of structural reforms such as privatization and infrastructure investments. A weaker coalition government could add to the downside risks, slowing the pace of implementation of structural reforms.

Mind the Operating Leverage

We remain concerned on the outlook of aggregate corporate sector earnings due to the large operating leverage. The gap between corporate capacity for growth and realized growth is expected to be much larger in the current cycle than in the mid-1990s post Asian crisis; the capex binge was much larger in the current cycle. With growth trend remaining higher for longer and continued easy access of risk capital from the international market, the corporate sector was far more aggressive in building capacity. Private corporate capex to GDP increased to 15.9% as of F2008 from the trough of 6.4% in F2004. In the 1990s cycle, it increased to 10.4% of GDP in

Exhibit 7

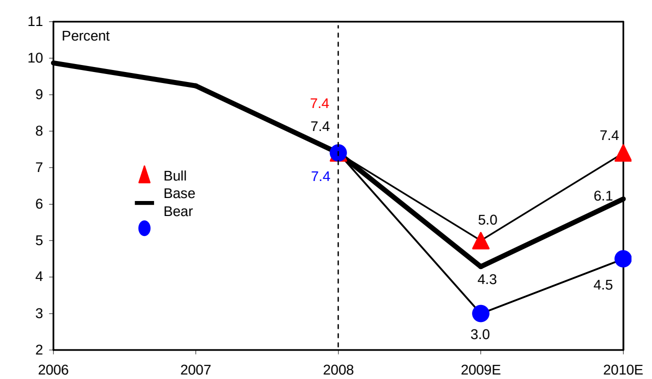
Mind the Operating Leverage



Source: CEIC, CSO, Morgan Stanley Research

Exhibit 8

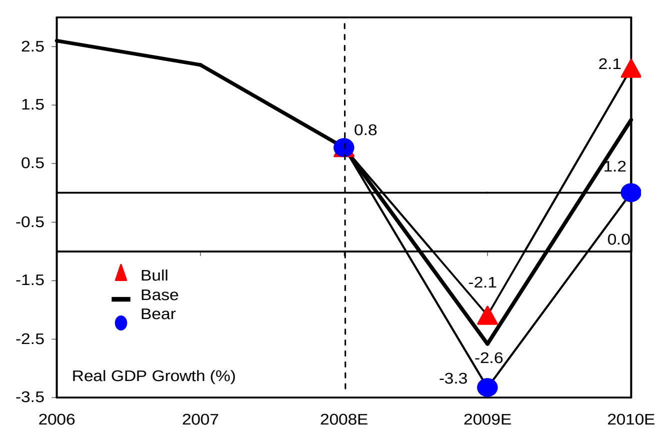
India's Real GDP Growth – Bull, Base, & Bear Case Scenario



E = Morgan Stanley Research Estimates Source: Morgan Stanley Research

Exhibit 9

G7 Real GDP Growth – Bull, Base, & Bear Case Scenario



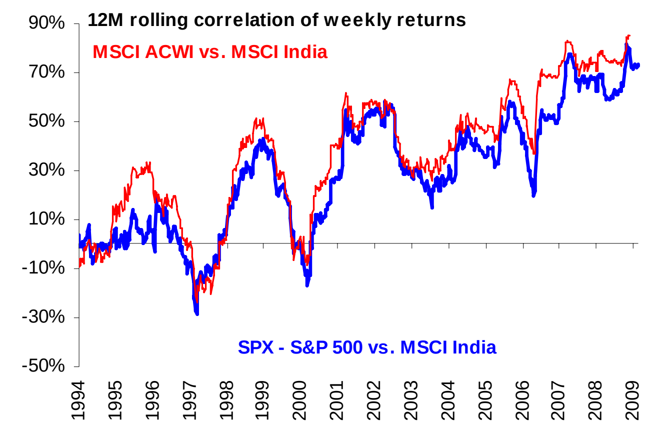
Source: Company data, Morgan Stanley Research

F1996 from 6.1% in F1994. However, industrial production, which is some proxy for utilization of that capacity created, contracted 2% YoY in December 2008 from the peak of 15.8% in November 2006. In the 1990s, the industrial production had decelerated to 1.5% by January 1997 from the peak of the 15.8% in September 1995. Hence, we see a much larger earnings shock in the current cycle compared with that of 1990s. Even with the recovery in industrial production to 5.4% in 2010 capacity utilizations for the corporate remain relatively low.

Equity Market Outlook: Extreme Outcomes Still Possible
The market outcome in 2009 will depend on two key factors; i.e., election results and global developments. If the global economy turns around, India will likely start faring better. However, elections in May will still hold the key to a sustainable recovery. A sustained turnaround in growth will need a fiscal response, which in turn depends on a strong government. A weak government could make a recovery tepid and long drawn. It could also lead to a paralysis in the reforms process and damage medium growth. Assuming a favorable election result and a global recovery, the strength of the subsequent equity market performance will depend on two factors. Firstly, the pace and extent of corporate operational deleveraging and, secondly, the pace at which the NPL cycle unwinds. Even if the global economy recovers, it is not necessary that profit growth recovers. This is because Corporate India has built its financial statements for 8-9% real GDP growth and hence unless growth reverts to those levels, margins could remain under pressure, undermining the profit recovery.

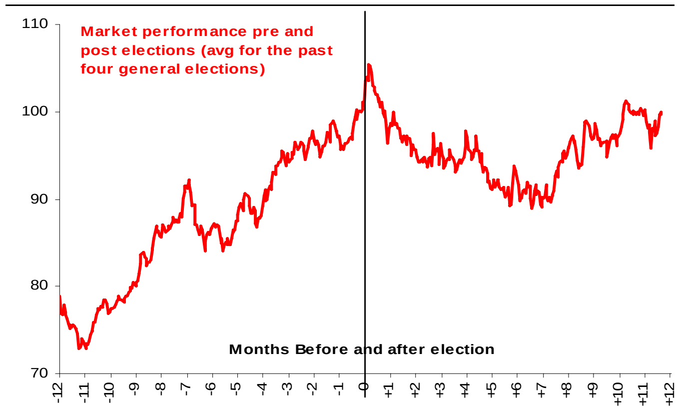
Our Base Case calls for some fiscal measures, a relatively weak nonperforming loan (NPL) cycle, some corporate restructuring that arrests the fall in earnings by 4Q09, steady improvement in the global situation, and a measured slowdown in credit growth. The Bear Case assumes that the election result does not bring a government with enough power to undertake fiscal measures, the NPL cycle is bad, corporate India is slow to restructure, and thus earnings fall quite sharply, and the global situation remains fragile, causing the balance of payments (BoP) to remain negative. The Bull Case assumes global calm and recovery in global growth, a market-friendly election result (i.e., a narrow coalition government that focuses on pump priming and privatizing government assets), benign deceleration in earnings as the corporate sector delevers its operations at a hectic pace, and a less severe NPL cycle in the banking industry than we currently anticipate, which allows liquidity to improve steadily in 2009. We assign a 50%

Exhibit 10
India's Correlation with SPX and ACWI



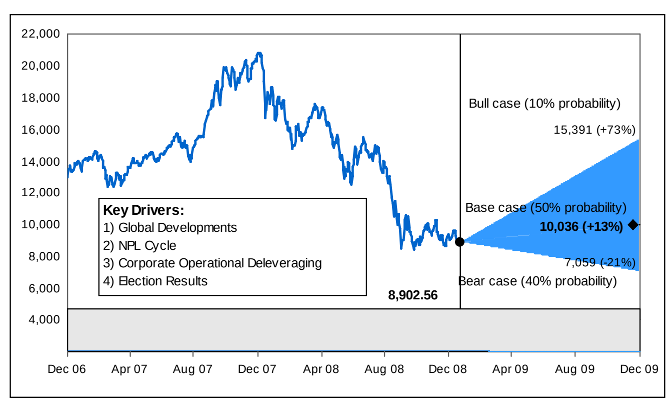
Source: FactSet, MSCI, Morgan Stanley Research

Exhibit 11
Performance Around Elections – Will it be Different This Time?



Source: Bloomberg, Morgan Stanley Research

Exhibit 12
BSE Sensex: Outcomes for 2009



Source: FactSet, MSCI, Morgan Stanley Research probability to our Base Case, a 40% probability to our Bear Case, and a 10% probability to our Bull Case. The probability-weighted outcome for the BSE Sensex is 9381 for December 2009.

What Are Investors Expecting?

Our recent survey with investors indicates that the buy side puts global markets as the most important factor driving the Indian markets. This is followed by general elections and corporate fundamentals in a distant second and third position respectively. Most investors (77% of the participants in the survey) believe that the BSE Sensex is heading higher in 2009. Investors think that the low point of the market will be reached sometime in the first half of 2009 though a new bull market will commence only in the first half 2010. However, investors expect the market to decline significantly before the bear market is over a new bull market begins.

What Is Priced Into The Market?

What earnings growth is priced into the index is a function of expected return. If an investor expects a 15% return, then using our residual income model, at current levels, the market is pricing in about a 5% growth F2010 earnings. This compares with our expectation of a 10% decline in earnings on a top-down basis. From our investor survey, earnings growth expectation is around flat to slightly positive, whereas the sell side consensus is currently forecasting a 1% growth for the BSE Sensex constituents in F2010.

Markets Need Not Recover Ahead of Earnings/Economy

There is one more important point to note. No doubt, earnings will have a more favorable base in 4Q2009 (broad market earnings fell 39% in the quarter ended December 2008). However, that does not mean the market will necessarily lead such a recovery in earnings. In 2002, the economy and earnings started to recover by the middle of that year, but the markets only bottomed out in April 2003. Given the degree of skepticism among investors and losses that they have suffered in this bear market, a repeat of that scenario is quite possible. Earnings is not the sole driver of stock prices and other factors such as macro (interest rates, etc), valuations and market dynamics (sentiment, liquidity, ownership, etc) also play a role in determining equity market outcomes.

Exhibit 13

Investor Survey (Jan09): What will be the Single Most Important Driver for Indian Equities in 2009?

	% of Participants
General election results	21%
Fiscal policy	4%
Monetary Policy	1%
Global markets	51%
Corporate fundamentals	20%
None of the above	1%
Other	2%

Investor Survey (Jan09): When will the Sensex hit its Low in this Bear Market?

	% of Participants
Already hit in Oct 2008	20%
1Q2009	27%
2Q2009	38%
2H2009	14%
2010	2%
2011	0%

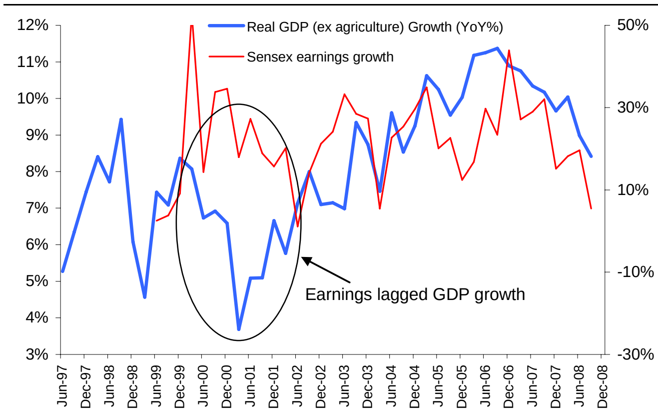
Investor Survey (Jan09): When will the Next Bull Market Start?

	% of Participants
Already started	3%
2Q2009	6%
2H2009	24%
1H2010	36%
2H2010	19%
2011	12%

Source: Company data, Morgan Stanley Research

Exhibit 14

Earnings Can Lag GDP



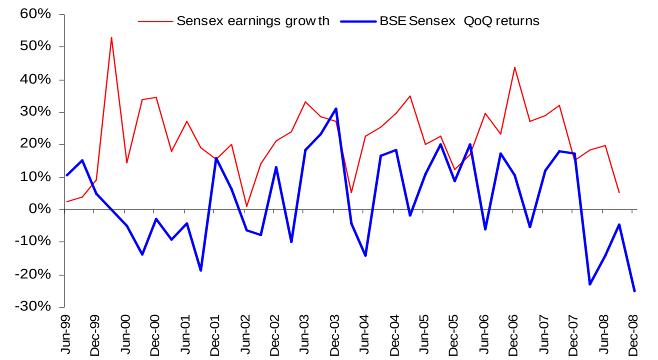
Source: CSO, Company data, Morgan Stanley Research

Stock/Sector Pick

Until the elections are out of the way, we think investors should continue to be overweight defensive sectors and underweight cyclicals and rate sensitives. Hindustan Unilever (HLL.BO, Rs253, OW) remains our favorite stock in India given its valuations and relatively reliable earnings growth. Incidentally, in the 2003 cycle, post the market bottom in April 2003, the best performing sectors in the subsequent six months were consumer discretionary and industrials with staples, telecoms and healthcare being the worst. However, we think it is still too early to make that switch given the uncertainties surrounding the elections as well as the world.

Exhibit 15

Stocks Can Lag Earnings



Source: CSO, Company data, Morgan Stanley Research

Exhibit 16

What Happened in 2003 – Sector Performance April 2003 to October 2003

	30-Apr-03	31-Oct-03	6M perf.	Perf. Rank
MSCI India	**126**	**206**	**63%**	
Consumer Discretionary	54	111	106%	2
Consumer Staples	86	104	21%	10
Energy	168	279	66%	7
Financials	603	1,020	69%	5
Health Care	226	342	51%	8
Industrials	120	251	109%	1
Information Technology	101	174	72%	4
Materials	138	256	85%	3
Telecom	41	53	30%	9
Utilities	141	236	67%	6

Source: FactSet, MSCI, Morgan Stanley Research

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(as of February 28, 2009)

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Equal-weight/Hold	**1003**	**44%**	**246**	**43%**	**25%**
Not-Rated/Hold	**33**	**1.5%**	**9**	**1.6%**	**27.3%**
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Total	**2,257**		**571**		

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