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Indian Economics & Strategy

HSBC Global Research

India Watch (Issue 6)

Cash crunch…the bigger message

- **The last few days have seen overnight rates soar as high as 70%. We view this as an aberration…**
- **…but it highlights the underlying problem of lending growth continuing to run far above deposit expansion**
- **In this issue we have credit and equity strategy contributions**

Feeling the strain

It's not only physical capacity that is feeling the strain of a rapidly growing economy but the financial system has run into problems of its own over the last few days – overnight interbank interest rates jumped as high as 70% at one point. There seems to be a number of temporary factors behind this, including a larger than expected withdrawal of deposits as people rushed to beat the deadline for paying their tax bills.

But it also illustrates more long-standing issues. In particular, lending growth has persistently been running above the growth in deposits (see chart on the next page), leading banks to reduce their holdings of government debt close to the 25% (of deposits) minimum level in order to free up some funds. The trouble is, however, those "excess" government securities are needed as collateral when banks borrow from the RBI, potentially creating a liquidity crunch when they are no longer available. As such, recent events are likely to put pressure on the Central Bank to implement a reduction in the 25% Statutory Liquidity Requirement sooner rather than later.

To our minds, however, this would simply hide the key problem, which is that lending growth is too strong, or at least is being directed to many of the wrong areas. Lending to the commercial sector was up more than 27% in the year to February and has doubled in the space of three years. It is also showing no convincing signs of slowing down, despite the various tightening measures that have been delivered by the RBI.

If even more reminders of India's supply constraints and inflationary problems were needed, then the last few days have provided them. CPI inflation for rural workers rose to within a whisker of 10% in February, with agricultural workers at 9.5%, while there looks to be a growing threat of rolling blackouts returning to Mumbai as power shortages intensify. Against this background, the chances of the RBI tightening again at the 24th April policy meeting are high, and rising almost by the day.

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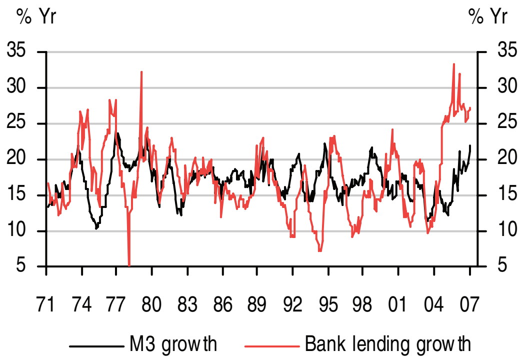
Indicator Watch

Lending growth continues to exceed 25%

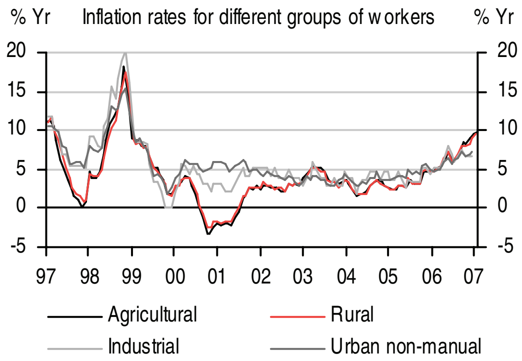


Source: CEIC

Money and lending growth

- Bank lending growth to the commercial sector shot higher from early 2004 and has yet to return to earth. In fact, it has exceeded 25% for 26 consecutive months now – easily a record.
- At the same time, the growth in deposits has also improved, albeit much less sharply. Indeed over the last three years, while lending has more than doubled, M3 has risen 60% - a gap which again we haven't seen before.
- In response, banks have been raising funds by selling their "excess" holdings of government securities above the 25% Statutory Liquidity Requirement. The government has now provided the RBI the opportunity to cut the SLR below 25% and will probably be putting pressure on the Bank to act sooner rather than later given the recent cash crunch.

The rise and rise of CPI inflation

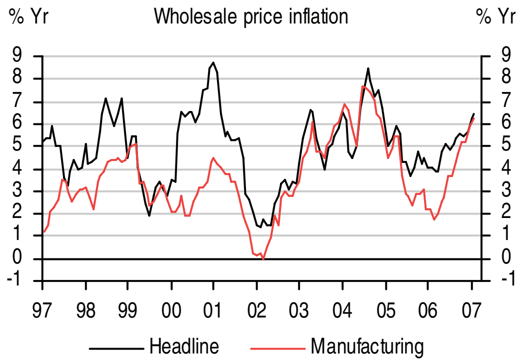


Source: CEIC

Consumer price inflation

- The rise of consumer price inflation continues unabated, with the February numbers for agricultural and rural workers jumping to 9.8% and 9.5%, respectively, in February. Both series are at their highest level since December 1998.
- Higher food price inflation explains the bulk of the increase, although, as we saw in the previous edition of this report, service sector inflation has also started to pick up again.
- The coming week will see the release of the February CPI figures for industrial and urban non-manual workers and we are expecting both to strengthen further. Our own weighted national aggregate (which combines the four series for the different groups of workers) rose above 8% in January and looks set to move higher still in February.

Manufacturing price inflation is now running above 6%



Source: CEIC

Wholesale price inflation

- Some have argued that there is little to worry about in the rise in wholesale inflation above the RBI's 5-5.5% target range as it largely reflects the temporary impact of higher food prices. Indeed food price inflation amounted to 10% in February.
- This is, however, the same rate as it was in September last year, during which time the headline WPI has moved up a full percentage point. A sharp drop in energy price inflation over recent months has also failed to prevent the headline rate from rising.
- As the chart shows, the increase in the overall WPI largely reflects a strong pick up in the prices of manufactured goods, which account for more than 60% of the index and are the best indicator of what is going on in underlying terms. As such, the country's inflationary problems are clearly not all about food.

Forthcoming Economic Indicators (26th March – 6th April)

Date	Indicator	Previous	HSBC Forecast	Comment
23rd – 27th	Exports (Feb)	5.5%	***12%***	The 5.5% year-on-year growth rate in January, was the weakest since November 2005 and we wouldn't surprised to see something of a bounce back in February
23rd – 27th	Imports (Feb)	23.2%	***30%***	Over the last 3 months, year-on-year import growth has averaged around 30% and we expect February to see a similar sort of outturn
26th	Urban non-manual workers CPI (Feb)	7.4%	***7.8%***	The 7.4% inflation rate for urban non-manual workers in January was the strongest since May 1999 and likely to rise further in February. This is the message coming from the numbers for both rural and agricultural workers where inflation was 9.5% and 9.8%, respectively, in February
30th	Industrial workers CPI (Feb)	6.7%	***7.6%***	CPI inflation for industrial workers in India has remained stable at 6.7% for three months now, but is likely to return to its recent high of 7.6% seen in October last year

Source: HSBC, Bloomberg

Key Economic Forecasts

- Year-on-year GDP growth of 8.6% in the final quarter of calendar 2006 was surprisingly soft in view of the preliminary estimate of 9.2% GDP growth given by the government for the 2006/07 fiscal year as a whole. Assuming no back revisions, year-on-year growth would have to be more than 10% in the January-March quarter to achieve this. This seems unlikely on the basis of our own seasonally adjusted series, as it would imply an implausible 4% quarter-on-quarter increase.
- As such, we have reverted to our 8.8% forecast for the 2006/07 fiscal year, expecting a 7.8% outturn in 2007/08 and just 6.3% in 2008/09. The last of these reflects the assumption that the cumulative effects of the monetary tightening will eventually come to bear on the economy. Also, after a prolonged period of above-trend growth, one should presumably expect a period of sub-trend growth.
- Our interest rate views remain unchanged, envisaging further RBI tightening to come. We are looking for the CRR to rise another 100bps this year, with the repo rates up 50bps. All the projections are detailed in our recently published Asian Economics Quarterly entitled "*Signs of decoupling*".

Key Indian Macroeconomic Forecasts (numbers in red show changes from previous report)

% Year	2006	2007	2008	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07
GDP (calendar year)	9.1	8.1	6.8	9.2	8.6	8.4	8.1	7.8	8.0
GDP (fiscal year)	8.8	7.8	6.3	-	-	-	-	-	-
Agriculture*	2.1	2.8	2.4	1.7	1.5	0.5	2.6	3.2	3.0
Industry*	9.7	6.6	5.9	10.3	9.9	9.5	8.2	7.0	6.3
Services*	10.8	9.7	7.5	10.8	11.3	10.8	10.6	10.0	9.5
Wholesale prices	4.8	5.9	6.6	5.1	5.5	6.3	5.8	5.5	6.0
Consumer prices**	6.2	7.5	8.5	6.6	7.0	7.1	7.5	7.7	7.9
Budget bal* (% GDP)	-3.2	-3.4	-3.7	-	-	-	-	-	-
Trade bal (% GDP)	-8.0	-8.8	-8.1	-	-	-	-	-	-
Current acc (% GDP)	-2.8	-4.0	-3.6	-	-	-	-	-	-
Cash Reserve Ratio***	5.25	7.0	8.0	5.0	5.25	6.0	6.50	7.0	7.0
Reverse repo (%)***	6.0	6.5	7.5	6.0	6.0	6.0	6.25	6.5	6.5
Repo rate (%) ***	7.25	8.0	9.0	7.0	7.25	7.50	7.75	8.0	8.0
10 year yield (%)***	7.6	8.0	8.9	7.7	7.6	8.0	8.0	8.0	8.0
INR/USD***	44.3	43.0	43.0	45.9	44.3	44.0	43.5	43.0	43.0

Source: HSBC. * Fiscal year numbers. ** Industrial workers CPI. *** End period

Strategy Thoughts

Credit – USD Bonds

USD Indian bank debts continued to drift wider both in the cash and CDS market in the early part of March. Overall, Indian bank senior 5-year CDS has widened by 10-15bps since the beginning of February. The biggest underperformer was the Industrial Development Bank of India (IDBI) Senior 5-year CDS, which widened 15bps to 63bps followed by ICICI and State Bank of India (SBI), whose Senior 5-year CDS both gapped out 13bps each to 62bps and 53bps, respectively. Meanwhile, in the cash bond market, ICICI senior bank debts were surprisingly the worst performers in terms of spreads. ICICI 2011 and 2012 gave up 19bps and 20bps, respectively, to 5T+118bps and +119bps, since the beginning of March. Contrast this with 13bps and 14bps spreads underperformance by ICICI and SBI tier-1 bank debts, respectively, to 10T+206bps and +190bps (bid) during the same period.

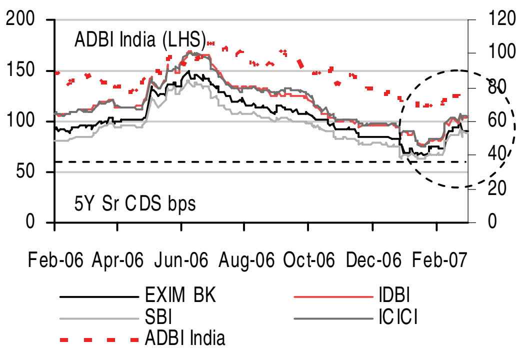
Inflationary pressure, rising interest rate trend to place downward pressure on the Indian banks

The Indian banking sector outlook remains challenging, to say the least. We have flagged our concern about the risk of slowing loan growth and rising NPLs on the back of imminent further interest rate hikes by the RBI in the short term (see ACID *Mar 1*). Hence, we retain our Underweight recommendation on the sector but, at the same time, we would remain opportunistic following the next down leg.

Trade ideas

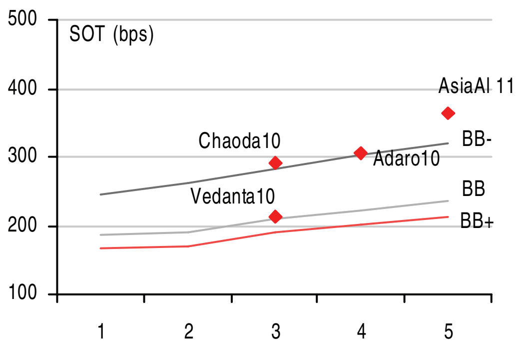
- **Outright.** Overweight ICICI 2011 and 2012. These bonds were the biggest underperformers in the month so far.
- **Outright.** Underweight ICICI Bank 2049-16c tier-1
- **Switch trade.** Sell ICICI 2008 at 2T+78bps (ASW+28bps), Buy SBI 2009 at 2T+70bps (ASW+32bps). Investors will take out 0.5bps and pick up 4bps on asset swap basis. On absolute yield basis, the swap trade gives up 10bps in yield.
- **CDS trade.** Long 5-year ICICI protection with short-term target of 75bps (60/65bps as of 3 Mar 07).

Indian bank senior 5-year CDS show some stability



Source: HSBC, Bloomberg

Vedanta 2010 looks fair value at this point



Source: Markit, HSBC

India's top ten corporates moving up and moving out…

S&P recently commented on the rising risk tolerance amongst the Indian corporates, which is evident in aggressive expansion strategies by the likes of Mittal and Vedanta. In fact, Indian corporates have recently been diversifying into non-core businesses as well. However, S&P believes that Indian corporates are operationally more efficient and financially stronger, and hence should be able to withstand moderate stress.

Vedanta Resources (Vedanta, Ba1/BB): On Mar 20, Financial Express reported that Vedanta may spend USD2bn to purchase mines to augment its metals and mining operations. While this was not confirmed by the company, we think it pays to err on the side of caution given their expansion track record the last three years. Our HSBC analyst currently has a Neutral weight recommendation on Vedanta 2010 bonds based on the fair valuation of the bonds.

Trade idea

- **Basis trade.** Buy Vedanta 2010 at 100.5 (ask), Z-spread plus 149bps, long Vedanta CDS matched maturity (2/22/10) at 135bps. Negative basis of 14bps.

Equity – Earnings revisions

Earnings of the BSE 500 index have been revised up slightly in the past three months, but in the last one month, there have been slight negative revisions. However, breaking the revisions down by sector reveals that certain sectors have seen strong upward or downward revisions. The table below summarizes the one-month and three-month revisions by sector.

EPS forecast revisions, BSE 500 Index

	FY08e EPS		FY09e EPS	
	1 Month	3 Month	1 Month	3 Month
Automobiles & Auto Parts	-0.9%	-3.1%	-1.8%	-4.6%
Building Materials	-1.1%	2.5%	-0.1%	9.2%
Chemicals	1.3%	7.5%	2.1%	10.1%
Construction	-4.0%	-6.0%	-7.0%	-15.2%
Consumer Goods	-1.3%	-3.9%	-2.2%	1.0%
Electric Utilities	0.1%	0.1%	0.3%	-2.5%
Engineering	-0.3%	3.9%	-1.1%	5.1%
Financial Institutions	-0.2%	1.8%	0.4%	1.3%
Gas Distribution	0.5%	7.5%	2.2%	5.7%
Healthcare	-0.2%	1.7%	-0.7%	1.7%
IT Services	0.5%	2.9%	1.2%	6.8%
Media	-0.3%	-5.2%	-0.8%	-2.2%
Metals & Mining	0.4%	7.1%	-3.4%	-1.2%
Oil – E & P	-0.4%	4.7%	-4.7%	10.7%
Oil Integrated	1.0%	2.1%	6.5%	0.1%
Real Estate	0.0%	-2.8%	0.0%	-38.4%
Retail	-1.8%	-10.6%	4.6%	9.7%
Telecommunications	0.7%	9.0%	0.9%	9.4%
Travel & Leisure	-5.7%	51.5%	0.0%	10.6%
Others	0.5%	5.6%	1.5%	-0.8%
BSE 500 Index	-0.1%	3.1%	-0.1%	3.6%

Source: HSBC, Thomson Financial, IBES

Sectors with strong upward revisions are Chemicals, Gas Distribution, IT Services and Telecom and Travel & Leisure. Sectors with strong negative revisions are Automobile and Auto Parts, Construction and Real Estate (FY 09 EPS has been revised down by 38%).

Budget proposals would have a negative impact on earnings of Building Materials and Construction. This is reflected in EPS revisions of the Construction sector, but not visible in Building Materials yet. In Retail, EPS has been revised strongly downwards for FY08 and strongly upwards for FY09.

However, the breadth of revisions remains thin: the table below shows the percent of analysts who have revised their estimates. Overall, 17% of analysts have revised FY08 earnings and 14% have done so for FY09. We have looked at the difference in the percent of analysts who have revised upwards and downwards. This refers to analysts who were covering the same stock before and have revised down or up. EPS revisions can also occur when additional analysts initiate coverage on the stock.

Revision breadth and variation in EPS forecasts, BSE 500 Index

	FY 08			FY 09		
	% of Analysts revising	Coefficient of variation of EPS forecasts	Revisions breadth	% of Analysts revising	Coefficient of variation of EPS forecasts	Revisions breadth
Automobiles & Auto Parts	15.0%	10%	34.8%	11.8%	9.9%	15.4%
Building Materials	17.4%	10%	70.6%	20.8%	13.9%	69.2%
Chemicals	23.6%	11%	67.2%	21.0%	16.7%	81.8%
Construction	17.0%	11%	34.2%	12.9%	21.2%	11.1%
Consumer Goods	14.7%	11%	46.5%	12.6%	12.2%	37.0%
Electric Utilities	15.2%	11%	50.0%	7.2%	10.5%	50.0%
Engineering	17.1%	10%	73.1%	12.0%	21.1%	83.3%
Financial Institutions	17.5%	9%	50.5%	10.5%	14.7%	52.2%
Gas Distribution	13.3%	14%	73.3%	16.1%	12.7%	80.0%
Healthcare	16.9%	19%	57.5%	9.6%	12.6%	56.1%
IT Services	20.0%	10%	70.2%	18.1%	8.4%	89.1%
Media	12.1%	11%	47.8%	18.4%	12.8%	66.7%
Metals & Mining	17.6%	13%	62.9%	20.4%	18.4%	57.1%
Oil – E & P	24.7%	10%	73.9%	27.3%	13.9%	66.7%
Oil Integrated	14.4%	21%	46.2%	16.1%	23.5%	57.1%
Real Estate	7.4%	44%	100.0%	5.0%	40.2%	100.0%
Retail	19.6%	10%	27.3%	10.3%	12.0%	33.3%
Telecommunications	24.9%	15%	71.2%	22.9%	10.8%	80.6%
Travel & Leisure	11.1%	2718%	68.8%	16.7%	147.8%	85.7%
Others	14.9%	16%	30.8%	11.1%	7.2%	55.6%
BSE 500 Index	17.4%	91%	59.7%	14.7%	15.7%	67.6%

Source: HSBC, Thomson Financial, IBES

Sectors showing strong positive breadth of revisions for both FY08 and FY09 are Building Materials, Chemicals, Engineering, Gas Distribution, IT Services, Oil E&P, Real Estate, Telecom, Travel & Leisure.

The following sectors combine strong positive EPS revisions, positive revision breadth and low coefficient of variation in EPS – Chemicals, Gas Distribution, IT Services and Telecoms. The following sectors combine strong negative EPS revisions, negative revision breadth and low coefficient of variation in EPS – Automobiles & Auto Parts, Construction.

Sectors with strong negative breadth of revisions for both FY08 and FY09 are Automobiles & Auto Parts, Construction and Retail.

The following sectors combine strong positive EPS revisions, positive revision breadth and low coefficient of variation in EPS – Chemicals, Gas Distribution, IT Services and Telecoms. The following sectors combine strong negative EPS revisions, negative revision breadth and low coefficient of variation in EPS – Automobiles & Auto Parts, Construction.

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