

India Equity Strategy

Monsoon woes

- Monsoon – off to a weak start:** YTD seasonal rainfall is 45% below normal. The Met department has indicated that the weakness could continue over the next week. It is early days yet, as June typically accounts for only 20% of the total south west monsoon. But a recovery over the next month is critical, in our view.
- Economic significance has decreased, but is still meaningful:** Structurally the importance of agriculture as a percentage of GDP has decreased over the past few decades, from nearly 50% in the early 1970s to about 17% now. But the monsoon is still important for the farm sector, as nearly 60% of India's agriculture is rainfall-dependent.
- Adverse impact on sentiment:** Nearly 60% of India's population lives in rural areas. Although they do not derive their entire livelihood from agriculture, the sentiment impact of the monsoon on private sector consumption cannot be underestimated. Also, in the recent past, rural India has been driving consumption growth on the back of various government stimuli. This segment is vulnerable to a pull back.
- Consumption underperforms:** An analysis of weak monsoons over the past indicates that the earnings impact has been mixed due to various offsetting factors. But consumption-related sectors, i.e. staples, discretionary and telecom, typically underperform both over the July-Sept quarter and the fiscal year in which the monsoon has been weak. We have been cautious on the telecom sector since the beginning of the year and have had an underweight stance on the staples sector over the last two months. Our overweight stance on the discretionary sector would, however, be vulnerable if the monsoon weakness persists.

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Seasonal rainfall

(mm)	Category wise no. Of Subdivisions	
	1-Jun-09 to 17-Jun-09	1-Jun-08 To 17-Jun-08
Excess	4	21
Normal	4	11
Deficient	12	4
Scanty	15	0
No rain	1	0

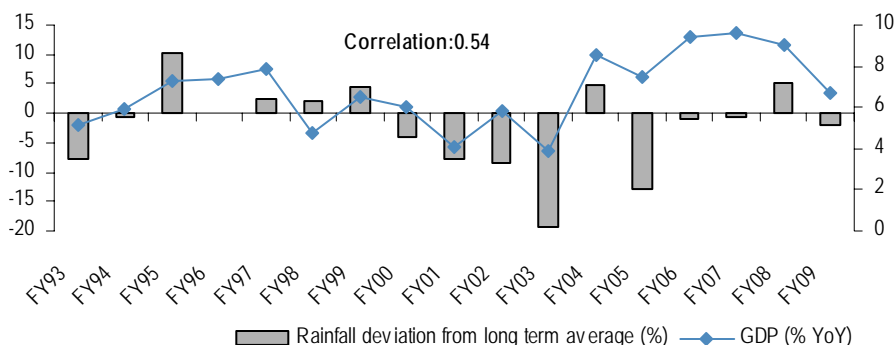
Source: IMD

Stocks vulnerable to a bad monsoon

Hero Honda
Hindustan Unilever
Mahindra & Mahindra
Bajaj Auto
Idea Cellular
Bharti Airtel

Source: J.P. Morgan

Monsoon performance vs. GDP growth

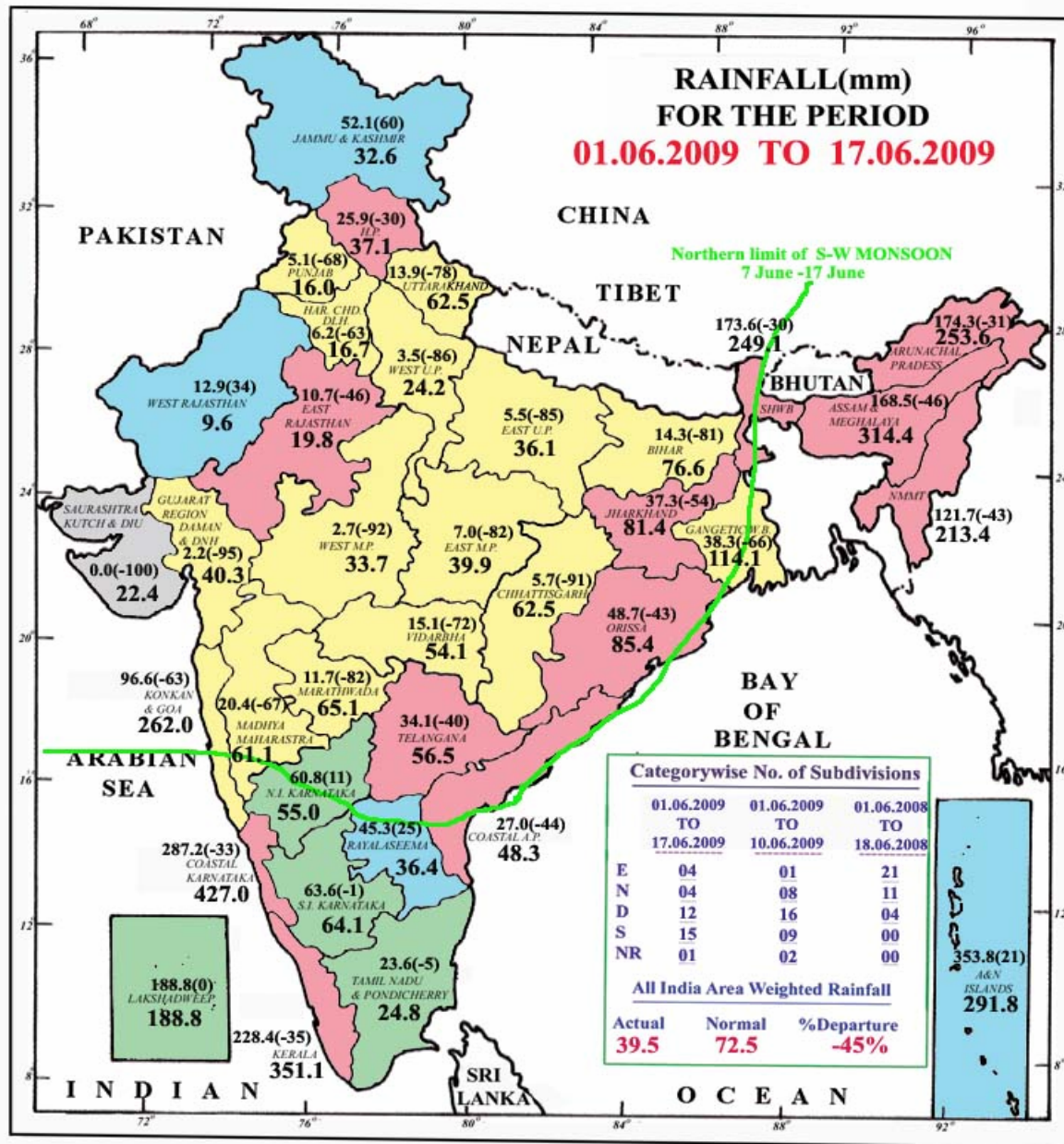


Source: Datastream, IMD

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India rainfall map



Source: IMD

Monsoons – weak start

India's south west monsoon has started on a weak note. As per data released by the India Meteorological Department (IMD), rainfall for the first three weeks of June at 39.5 MM was 45% below normal levels (72.5 MM).

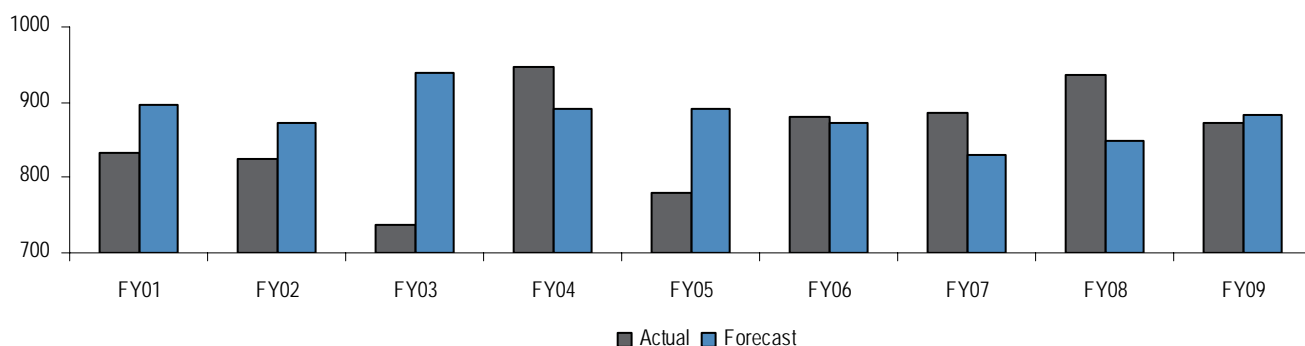
The performance of the south west rainfall is important for growth of the agriculture sectors as the seasonal "Kharif" crop accounts for half of the annual food grain production and over 60% of Indian agriculture continues to be rainfall dependent.

The IMD has indicated that the weak phase is likely to continue over the next week as well. While IMD had called for a normal monsoon this year; it is expected to review their earlier forecast around June 25.

We do note that the IMD has had its fair share of misses in forecasting the monsoon over the last few years. Actual rainfall has deviated meaningfully ($\pm 5\%$) from IMD's forecast for six years over the last decade. Moreover the historic trend suggests that the risk to the forecasts typically appears to be more on the downside. Five of the six significant deviations registered over the past decade have been on the scarce side.

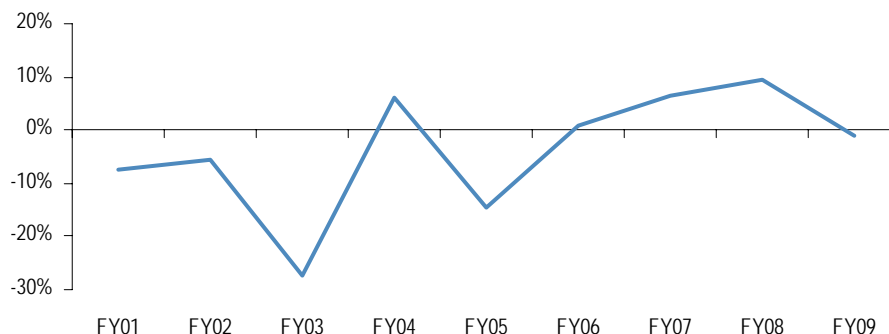
Figure 1: IMD monsoon forecast vs. actual monsoon

Millimeters



Source: MET

Figure 2: Deviation of actual monsoon from the IMD forecast

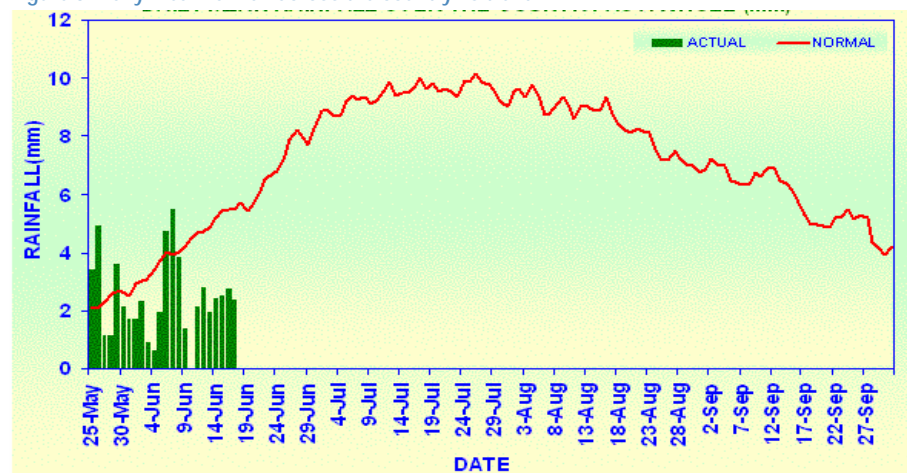


Source: MET

Too early to panic; July will be the key month

June typically accounts for only 18% of the total seasonal rainfall. Consequently it may be too early to call for an overall monsoon failure and we remain hopeful of a recovery over July-September.

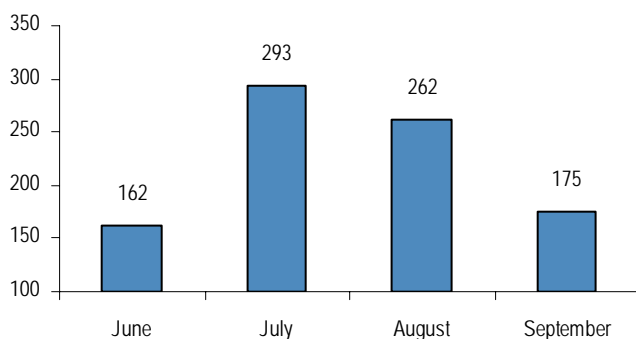
Figure 3: Daily mean rainfall across the country vs trend



Source: IMD

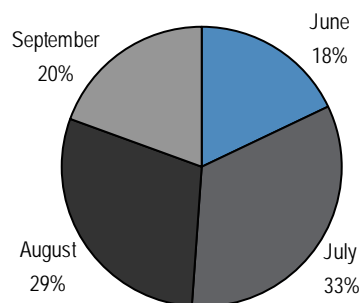
But given the importance of the monsoon we believe it is a data point worth monitoring consistently over the immediate term. Besides the overall intensity it is also important that the spatial and temporal distributions are optimal.

Figure 4: Average monthly rainfall distribution



Source: Ministry of Agriculture

Figure 5: Average rainfall breakdown by month

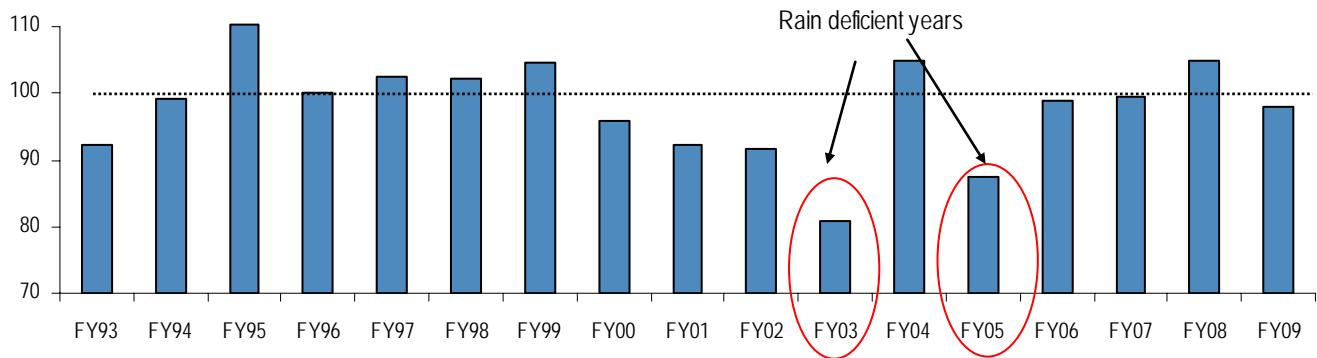


Source: Ministry of Agriculture

Monsoon and the Indian economy

Against the backdrop of negative news flow on the monsoon, we analyze the impact of bad monsoons on the economy.

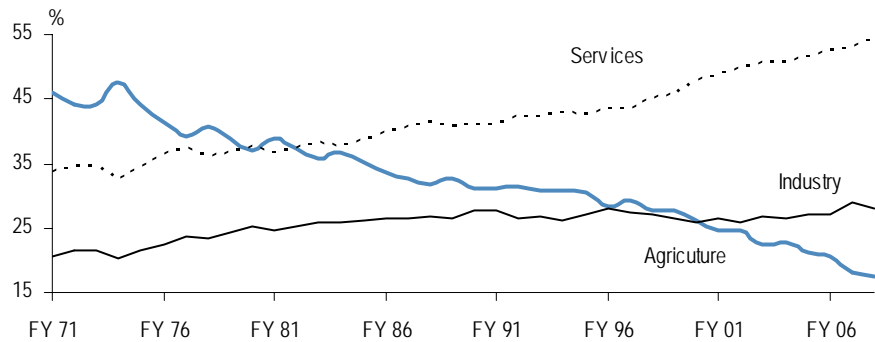
Figure 6: Actual rainfall as a percentage of the long-term average (892 MM)



Source: IMD

The contribution of agriculture to overall GDP has decreased from nearly 50% in the early 1970s to just 17.5% in FY09. Consequently the impact of weak monsoons on overall economic growth has decreased structurally.

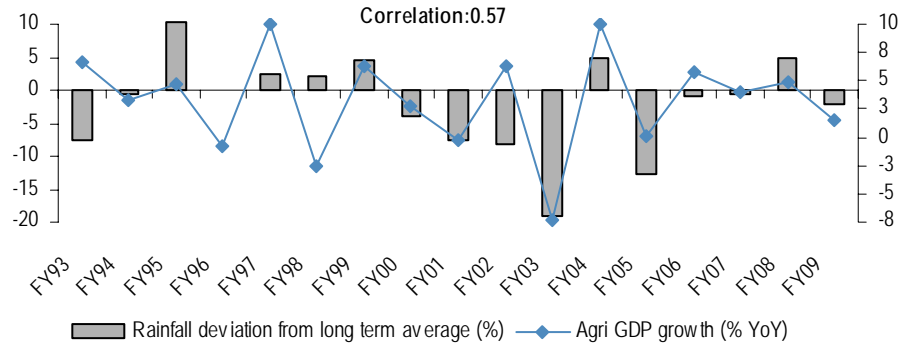
Figure 7: GDP composition



Source: J.P. Morgan

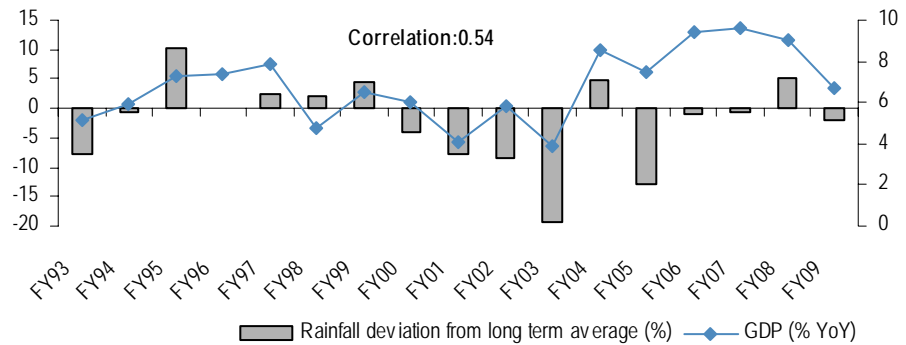
But it remains meaningful nevertheless, given the dependence of the agricultural sector on the monsoon and also because of inter-linkage with the other sectors, particularly private sector consumption.

Figure 8: Monsoon performance vs. agricultural GDP growth



Source: Datastream, IMD

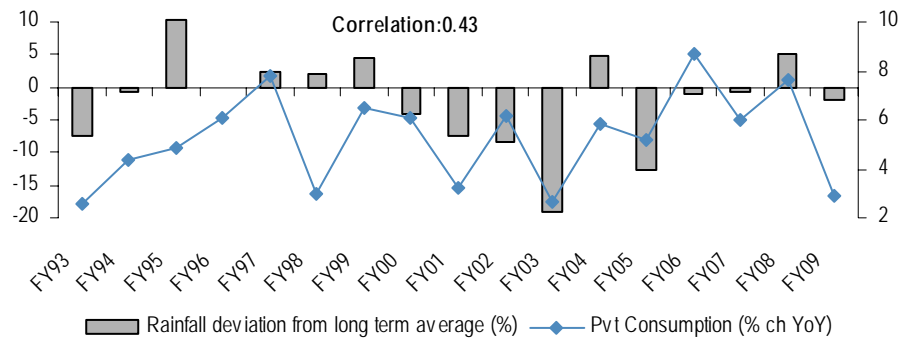
Figure 9: Monsoon performance vs. GDP growth



Source: Datastream, IMD

The historic trend also suggests that weak monsoons do affect private consumption growth. Nearly 60% of India lives in rural areas, and while not all of these people earn their living completely from agriculture, there is no denying the sentiment impact of a weak monsoon on consumption.

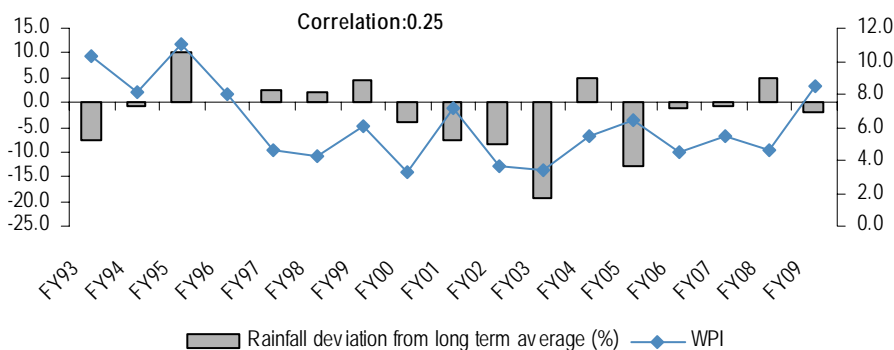
Figure 10: Monsoon performance vs. private consumption



Source: Datastream, IMD, Ministry of Agriculture

Over the past, a weak monsoon has not necessarily had an adverse impact on headline inflation numbers. Primary articles have a weight of 22% in the WPI basket, but there are a substantial number of other factors that need to be considered too.

Figure 11: Inflation vs. monsoons

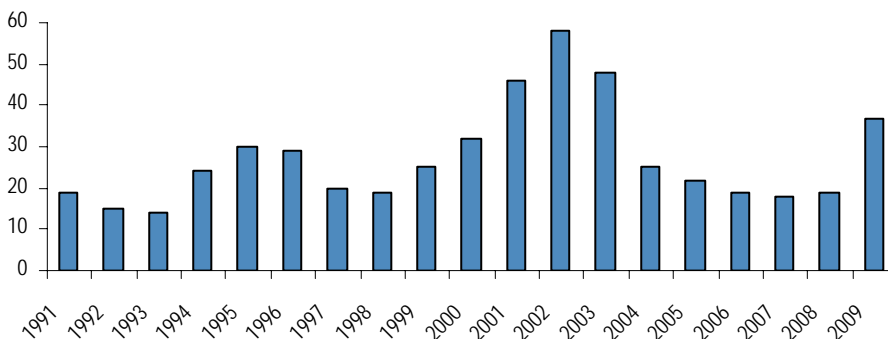


Source: Datastream, IMD

It is also worth highlighting that the stock of food grains with the Government is currently at a nearly six-year high, giving substantial flexibility to deal with inflation emanating from a weak monsoon. But a weak monsoon could have a more pronounced impact on the prices of cash crops and vegetables and fruits. Rice, sugarcane, cotton, soy and oilseeds are the key kharif crops.

Figure 12: Food stock

Million tons



Source: Food Corporation of India (as of beginning of the year)

Monsoon and earnings growth

The impact of weak monsoon on earnings growth, particularly for impacted sectors, has been mixed over the recent past, due to the offsetting impact of other economic factors.

But over the last 18 months, consumption demand has largely been driven by the robust performance of the agri sector, particularly against the backdrop of weak industrial production and constraints in funding availability. Loan waivers to the agri sector and substantial increases in minimum support prices of agri commodities have also helped rural prosperity. Consequently we believe that growth herein could face a setback if the weakness in the monsoon persists.

Table 1: Earnings growth during periods of weak monsoons

	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Consumer Discretionary	18.6	23.5	101.5	32.2	45.4	7.7	10.7
Consumer Staples	21.0	6.3	5.2	(3.6)	7.3	37.6	4.8
Energy	15.4	40.4	5.4	14.5	4.9	311.2	21.9
Financials	38.4	53.7	20.9	14.0	21.3	24.4	38.0
Health Care	112.6	(1.2)	(1.2)	(18.5)	57.3	125.1	(8.9)
Industrials	142.2	87.1	106.9	44.0	62.9	0.1	22.6
IT	33.4	10.0	25.7	71.8	33.0	47.9	15.1
Materials	(7.8)	(17.6)	207.9	64.0	(0.4)	43.0	20.5
Telecom	(3.3)	(22.9)	0.5	10.6	(65.4)	334.8	60.8
Utilities	252.9	(28.6)	42.0	32.5	38.1	14.0	32.6
MSCI India	41.9	11.2	39.5	30.4	20.7	52.4	23.9

Source: Datastream, J.P. Morgan

Market performance

The impact of weak monsoons on the broad market has been mixed. But sectors perceived to be adversely impacted, i.e. those linked to the consumption cycle including staples, discretionary and telecoms, typically tend to underperform both over the July-Sept quarter and in the fiscal year in which the monsoon has been weak.

Table 2: Quarterly market performance

	Jun - Sep 01	Jun - Sep 02	Jun - Sep 03	Jun - Sep 04	Jun - Sep 05	Jun - Sep 06	Jun - Sep 07	Jun - Sep 08
Consumer Discretionary	(4.6)	(21.0)	36.3	2.9	22.2	12.8	8.1	8.1
Consumer Staples	(5.8)	(6.6)	3.9	9.4	17.8	4.8	17.8	9.1
Energy	(11.0)	(19.1)	31.0	17.2	16.8	9.6	28.8	(3.3)
Financials	(23.3)	(2.3)	23.1	15.0	25.0	34.6	21.1	1.5
Health Care	7.9	(4.0)	15.2	16.2	6.1	17.6	0.9	(11.7)
Industrials	(25.1)	(6.6)	34.9	6.2	27.3	15.1	24.0	2.1
IT	(38.9)	(5.0)	35.2	20.8	7.1	17.7	(4.0)	(22.2)
Materials	(27.0)	(9.0)	28.8	30.2	27.6	13.5	27.4	(26.5)
T/Cm Svs	1.8	(23.1)	3.6	7.5	23.9	30.0	10.9	(21.0)
Utilities	(11.8)	(10.6)	28.6	17.0	10.2	6.8	47.8	7.3
MSCI India	(17.4)	(8.2)	23.8	15.1	16.9	17.3	17.3	(6.6)

Source: Datastream, J.P. Morgan

Table 3: Annual market performance

	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09
Consumer Discretionary	57.7	(27.3)	171.5	2.6	95.9	2.1	(11.5)	(22.9)
Consumer Staples	(2.5)	(25.4)	22.0	4.8	107.3	(26.1)	22.0	(12.2)
Energy	35.0	(11.9)	90.9	(2.3)	92.6	45.4	52.2	(31.4)
Financials	(1.6)	4.8	105.7	23.2	55.0	32.5	30.3	(52.4)
Health Care	29.7	(8.8)	43.2	2.5	48.2	(1.6)	6.9	(23.7)
Industrials	(4.5)	9.2	196.1	17.7	127.3	1.2	44.1	(51.2)
It	(8.6)	(12.2)	27.1	65.9	47.8	26.5	(26.5)	(29.9)
Materials	(14.0)	(15.4)	118.1	25.5	64.5	(6.1)	43.9	(54.1)
T/Cm Svs	13.8	(48.9)	66.0	(11.0)	70.8	24.1	16.6	(60.3)
Utilities	17.0	(2.0)	143.3	(1.6)	43.8	(16.9)	93.1	(30.0)
Msci India	2.2	(13.2)	74.2	16.0	71.5	15.6	19.7	(40.4)

Source: Datastream, J.P. Morgan

Portfolio implications

In terms of both growth and sentiment we observe that sectors likely to be impacted substantially by a weak monsoon would be those linked to the consumption cycle including staples, discretionary and telecoms.

We have been underweight on consumer staples over the last two months given substantial outperformance, rich valuations and concerns over rising input costs. A weak monsoon could imply further pressure on input costs and more importantly weaker demand. We reiterate our underweight stance herein.

We have also been cautious on telecoms since early 2009 due to increasing competition and regulatory uncertainty.

We have however been overweight in the consumer discretionary space, particularly automobiles as a play on the cyclical economic recovery. If the weakness in the monsoon persists, we would have to review this position.

In terms of potential beneficiaries, in the event of a weak monsoon, the government may chose to increase spending on public works to provide employment in rural areas. Such stimuli would benefit the infrastructure and capital goods /construction sectors.

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