Market View

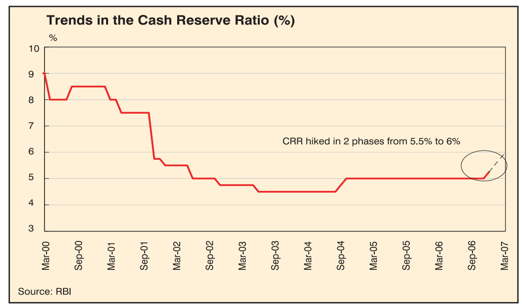
FRANKLIN TEMPLETON INVESTMENTS

RBI'S CRR RATE HIKE - A PERSPECTIVE

FEBRUARY 13, 2007

RBI announced a 50 bps hike in the Cash Reserve Ratio (CRR) to 6%, which will come into effect in a phased manner in – the first 25 bps during the fortnight beginning February 17 and the second 25 bps during the fortnight beginning March 3, 2007.

This comes against the background of a sharp rise in headline inflation numbers and credit growth/money supply at above projected levels for the current fiscal years. Economic data has continued to be buoyant in terms of GDP growth, industrial production and core sector growth. In recent months, we have witnessed a plethora of fiscal and monetary measures from the government and the central bank to tame inflation and to address overheating concerns in certain sectors. Another factor that needs to be considered is the appreciating rupee and RBI's efforts to protect export competitiveness, which increases domestic liquidity.



Debt Markets

While a tightening bias was expected and yields moved up yesterday on comments from the Deputy Governor, the timing of the move has caught the market by surprise. At the time of writing this report, benchmark 10 year yields have moved to around 8.07%. The hike has impacted the short end of the yield curve, wherein 1 year gilt yields rose by 10 bps from yesterdays close by 10 bps to 7.55%. Long dated bonds have been affected to a lesser extent and yields on the 30 year paper are at 8.29% .

This hike is expected to take out around Rs.14,000 crores from the system and liquidity is expected to tighten further. This along with the fiscal year-end factors, are expected to result in firming up of short term yields in the coming months. While long term yields might also move up, the yield curve is expected to flatten further until March. At this stage, investors can consider locking in at the higher short term yields by investing in floating rate, liquid and money market funds.

Equity Markets

Major indices have also reacted negatively as the rising rates and tightening liquidity have impacted sentiment, which has been bearish in recent times due to profit booking, concerns over the overseas acquisitions of corporate India & FII flows. Banking stocks in particular have been weak as the second CRR hike in past 3 month is expected to result in margin pressure and impact loan growth. Rising borrowing costs for corporate India could be mitigated to a large extent due to cheaper overseas borrowings, but retail loans and the housing starts are likely to witness a slowdown. However, a slowdown in credit growth is desirable as current growth levels are unsustainable.

Volatility was expected at higher levels given the tepid nature of FII flows in 2007. We believe it is futile to focus on market levels over the short term and one needs to keep in mind that economic/earnings fundamentals are robust. India as an asset class continues to attract interest amongst long term global investors and belief in India's economic potential is growing. Domestic flows could be impacted by the potentially higher returns from fixed income instruments, but on a risk-adjusted basis we expect equities to outperform over the medium to long term.

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