Indian Markets Outlook and Strategy

- **Special Focus:** Recent trends in the balance of payments suggest only a gradual deterioration in the current account deficit but record-high capital inflows. Indeed, the RBI appears overwhelmed by the surge in capital inflows, which have been substantially boosted by the government's own policy of hiking the ceiling on the overseas borrowing by Indian companies. The government needs to step forward by cutting the ceiling on overseas borrowing, and limit its use domestically in order to ease the self-inflicted complications in monetary management.

- **Macroeconomic outlook:** Recent data on merchandise exports indicate a worrying deceleration in growth, partly owing to the significant appreciation of the INR's real effective exchange rate. JPMorgan has revised the forecast for the balance of payments, and now expects a small current account deficit than previously thought. Separately, substantial easing in money market liquidity increases the risk of aggressive MSS issuance and possibly even a CRR hike.

- **Equities:** The macro environment for equities continues to be challenging. An appreciating currency, higher interest rate, equity issuances and limited positive surprises in the reported quarterly earnings have prompted the recent profit booking, following the sharp rally over March-April. Easing inflation concerns and increased possibility of a normal monsoon could provide support to equities.

- **Currency:** INR traded in a wide 40.6-41.5 range during the past two weeks. Peak valuations and concerns on export competitiveness due to rapid real appreciation strengthen the case for weaker INR, though still strong inflows, soaring risk appetite and limited intervention by the central bank, can perhaps lead to renewed INR strength. We position neutral USD/INR though stay with forward curve steepeners.

- **Fixed income:** Swaps rallied sharply even as overnight rates displayed heightened volatility while bonds remained lackluster, trading in a relatively narrow range. Easy money market liquidity raises the risk of policy action to tighten liquidity. We recommend remaining paid at the front end of the OIS curve to position for tighter liquidity conditions. We also recommend investors stay long bonds, though hedge via duration neutral paid position in 5y OIS.

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Contents

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Special Focus: Tracking the shifts in India's balance of payments

- **Current account deficit showing only gradual deterioration but capital account surplus surging**
- **Policy measures have exacerbated the increase in capital inflows, complicating monetary management**
- **Overseas borrowing limit should be cut and reforms stepped up to increase the ability to digest capital inflows**

India's balance of payments (BoP) shows a record increase in capital inflows that has substantially offset a gradual widening of the current account (CA) deficit. The magnitude of the inflows has overwhelmed the central bank, and complicated monetary policy. Moreover, policymakers made their task more difficult last year by increasing the ceiling on overseas borrowing by Indian corporates. Cutting this ceiling would ease the self-inflicted pain, though it is unlikely to fully reverse the appreciation pressure on INR.

Gradual worsening of CA deficit

A striking feature of the deterioration in the CA deficit is how slow it has been, despite the boom in domestic demand and a sharply higher merchandise trade deficit. The explanation lies in record-high surpluses on invisible trade, which include receipts for software exports and remittances from Indians working overseas. JPMorgan estimates that India posted a merchandise trade deficit of US$64 billion (7% of GDP) in 2006-07 (fiscal year ended March 31), up from US$51.8 billion in the previous year. Yet, the CA deficit worsened only marginally in dollar terms and as a share of GDP (table).

The rise in the merchandise trade deficit was driven mainly by a higher bill for crude oil-related imports. India's total oil-related imports (including products) jumped 27.7%oya to US$57 billion in 2006-07. Crude oil imports, which made up 84.5% of total oil-related imports, rose 24%oya to US$48.1bn, mainly on account of higher international prices. Still, in volume terms, crude oil imports rose 11.5%oya in the last fiscal year; this above-trend increase reflected additional demand from new refineries. India's oil exports have also become more important in recent years: total exports of petroleum products surged 79%oya to US$12.8 billion in April-November 2006, pushing up their share in total exports to 15.8% from 4.9% in 2002-03.

Even apart from oil-related exports and imports, the merchandise trade balance has been worsening. It is estimated to have posted a deficit of US$19.5 billion in the last fiscal year, up nearly three times from the year before. Still, the absolute level of the deficit is low compared to the 9.1% average annual growth of GDP in the last couple of years, and the US$1 trillion size of the economy. Policymakers, however, need to step up the kind of economic reforms, such as cutting import duties and improving physical infrastructure, that would substantially increase the economy's ability to digest net capital inflows without the unwelcome consequences for inflation and asset prices.

Balance of payments

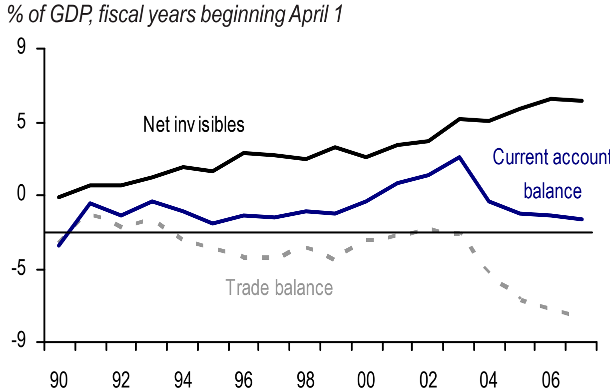
US$ billion, except as noted, fiscal years beginning Apr 1

	02/03	03/04	04/05	05/06	06/07f	07/08f
Exports	53.8	66.3	85.2	105.2	127.0	146.0
Imports	64.5	80.0	118.9	157.0	191.0	227.0
Trade balance	-10.7	-13.7	33.7	-51.8	-64.0	-81.0
Invisibles balance	17.0	27.8	31.2	42.7	53.5	64.0
Remittances	16.4	21.6	20.5	24.1	26.0	29.0
Software exports	8.9	12.3	16.9	22.6	28.0	34.0
Current account balan	**6.3**	**14.1**	**-2.5**	**-9.2**	**-10.5**	**-17.0**
% of GDP	1.2	2.3	-0.4	-1.1	-1.2	-1.5
Foreign investment	4.2	13.7	13.0	17.2	18.0	14.5
Direct	3.2	2.4	3.7	4.7	10.0	8.0
Portfolio	0.9	11.4	9.3	12.5	8.0	6.5
Loans[1]	-3.9	-4.4	10.9	6.1	20.0	15.0
Overseas borrowing	-1.7	-2.9	5.0	2.7	16.0	12.0
Banking capital	10.4	6.0	3.9	1.4	2.5	2.5
Nonresident deposits	3.0	3.6	-1.0	2.8	4.5	2.0
Rupee debt service	-0.5	-0.4	-0.4	-0.6	-0.4	-0.4
Other capital[2]	0.6	1.7	0.7	-0.7	6.4	6.4
Capital account balan	**10.8**	**16.7**	**28.0**	**23.4**	**46.5**	**40.0**
Overall balance	**17.0**	**31.4**	**26.2**	**15.1**	**36.0**	**23.0**

1. 2005-06 impacted by redemption of US$5 billion for 5-year IMD.
2. Includes delayed export receipts and advance payments against imports

Current account balance

% of GDP, fiscal years beginning April 1



Capital inflows overwhelming the RBI

Capital inflows have been increasing rapidly in recent years (first chart, next page), raising the capital account surplus to an estimated US$46.5 billion (5.1% of GDP) in 2006-07. Initially, portfolio inflows were the main contributor, comple-

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menting an anemic US$2-4 billion annually in FDI receipts. However, portfolio inflows have declined in the last couple of years, and have been replaced by net external commercial borrowings (ECBs) by Indian companies. Also, last year, net nonresident Indian (NRI) deposits probably jumped to an all-time high of US$4.5 billion. Together, ECBs and NRI deposits totaled 44% of the capital account surplus compared to a mere 12% in 2002-03, and were the single biggest contributor to the capital account surplus.

Implications for monetary policy

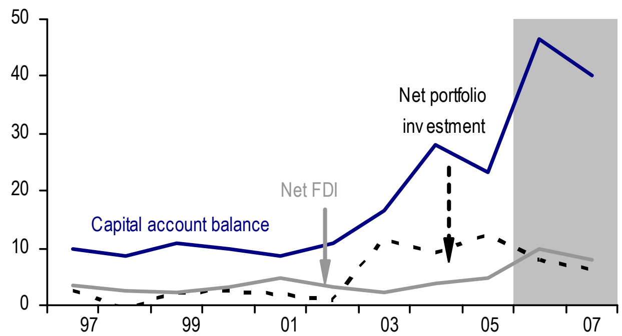
A key challenge for policymakers is that the economy is not running wider current account deficits that would substantially ease the pressure on the exchange rate to appreciate. Worse, policymakers have announced measures that have boosted capital inflows, thereby complicating their own task of monetary management at time when a tight monetary policy has to be in place. The capital account surplus was probably 4.4 times the size of the current account deficit in the last fiscal year—the key reason for the authorities' difficulty in monetary management. Differences between the RBI and the ministry of finance (MoF) on capital inflows have probably contributed to the inconsistent policies.

Last year, the government raised the ceiling on ECBs to US$22 billion in two steps. They increased the limit and eased norms at a time when local interest rates were rising and there were widespread expectations of rupee appreciation over the medium term, boosting unhedged borrowing by Indian companies from flush international capital markets. This jeopardized monetary management at a time when the economy could not absorb enough inflows to avoid aggravating inflationary pressures. To sterilize increased intervention in the foreign exchange market, the RBI had little choice but to raise the banks' required cash reserve ratio. Essentially, the RBI was battling capital inflows that were substantially policy induced.

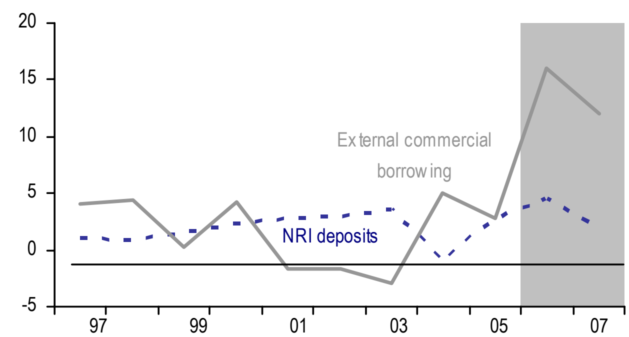
In its recent policy statement, the RBI moved to make NRI deposits less attractive by cutting the ceiling for interest rates on these deposits. In reality, India needs to overhaul the NRI deposit scheme—or even dismantle it—as it has outlived its usefulness. These deposits were an important source of hard currency when India was struggling for dollars. However, today's situation of dollar glut is vastly different, and there is little reason to continue offering preferential returns to NRIs.

In addition, the government should step forward and cut the ceiling on ECBs, raise the bar on these borrowings in order to lower total inflows, and limit their usage domestically to check monetary expansion. Encouraging outflows, as policymakers have been doing, may not be sufficient to

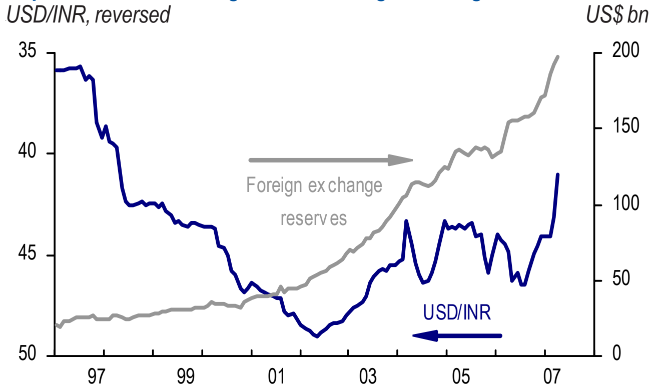
Capital account balance
US$ billion, fiscal years beginning April 1



External commercial borrowings and NRI deposits
US$ billion, fiscal years beginning April 1



Rupee-US dollar exchange rate and foreign exchange reserves
USD/INR, reversed *US$ bn*



check net inflows. For example, although there will be portfolio diversification by some, the majority of Indian households are unlikely to take substantial funds out of the country despite the increased annual individual limit of US$100,00. Given the expectations of higher returns on local assets and further currency appreciation, the bias will be to park funds at home.

The bottom line is that the built-in policy inconsistency that is encouraging capital inflows despite conflicting domestic monetary goals remains in place. No matter how well intentioned last year's hike in the ECB ceiling, the government now needs to reassess that policy action and cut the ceiling to ensure monetary stability.

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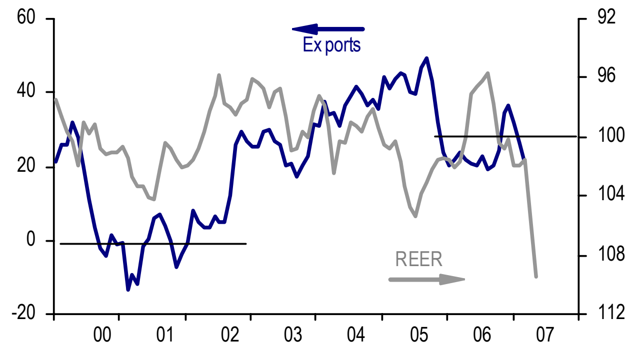
Macroeconomic Outlook

- **Merchandise trade deficit narrows but deceleration in export growth worrying**
- **Revised forecast for balance of payments assumes a smaller current account deficit than previously expected**
- **Easier liquidity conditions increase risk of aggressive MSS issuance and a hike in cash reserve ratio**

Merchandise exports and JPMorgan's "broad" REER
%oyay 3mma *2000=100, reversed*



Merchandise exports on the backfoot

The merchandise trade deficit came in US$3.8 billion in March, lower than the shortfall of US$4.7 billion for the prior month. For fullyear 2006-07 (year that ended March 31), the trade deficit jumped 43.2% to US$5.67billion, pointing to further widening of the current account (CA) deficit. Goods exports increased a mere 8.8%oya in March, owing mainly to last year's high base and a likely hit from recent INR appreciation (note that exports had risen a hefty 27.9% in March 2006.) Total exports grew 23.9%oya in the last fiscal year, despite the deceleration in recent months.

The detailed breakdown of March exports is not yet available, but it is quite likely that the recent trend of nonoil export growth running below the headline export growth was maintained in the latest month. Further, the nearly 14% appreciation of the rupee's real effective exchange rate (REER) since the middle of last year is most likely hurting export competitiveness (note that both the Reserve Bank of India's 6-country REER and JPMorgan's broad REER have posted similar gains over that period.)

Import growth also decelerated in March, to 14.5%oya, with significant slowdown in nonoil (+16.6%) shipments. However, oil imports bounced back from the prior month's unexpected decline. Total import growth will probably pickup slightly from the current level but still moderate from last year's growth of 29.3%. Moderation in nonoil imports owing to rolling over in domestic activity will likely offset the higher crude oil-related imports. Within nonoil products, capital goods should have continued their robust outcome owing to higher spending on infrastructure and capex.

CA deficit likely to be better than expectations

JPMorgan has revised its forecast for the current account deficit owing to better-than-expected outcomes for software exports and remittances from Indians working overseas. We now estimate that the CA deficit widened only slightly to US$10.5 billion (-1.2% of GDP) in 2006-07 from a deficit US$9.2 billion (-1.1% of GDP) in the prior year. The invisible surplus includes software export receipts and remittances from overseas Indians and probably jumped 25.3%oya to US$53.5 billion in 2006-07, substantially offsetting the wider trade deficit (BoP basis) of US$64 billion.

India's goods and services exports are likely to worsen owing to the recent significant INR appreciation. This, along with the adverse impact of higher international crude oil prices, is expected to widen the CA deficit to US$17 billion (1.5% of GDP) in 2007-08. Still, the size of the deficit is manageable, and financing it is unlikely to be a problem as capital inflows will likely remain strong, despite the forecast of moderation in capital inflows (see "Tracking the shifts in India's balance of payments," page 2.)

Risk of increased MSS issuance and CRR hike

Domestic money market liquidity conditions have improved significantly, with the overnight call rate declining to 3.0%, well below the repo rate (the rate at which the central bank injects liquidity) of 7.75%. WPI inflation is beginning to roll over and we expect better inflation data, but still assess that it is too early for the Reserve Bank of India (RBI) to allow money market rates to fall below the operational benchmark repo rate. Liquidity will also be boosted by about INR70 billion of coupon payments due in the next fortnight, and by INR200 billion of bond redemption at the end of the month.

The scheduled INR100 billion bond auctions next week will not be sufficient to offset the expected easing in liquidity. This is because a substantial portion of the funds siphoned off by the auction will return to the money market via government spending. Given that the RBI's tight liquidity stance remains unchanged, there is a heightened risk of the central bank announcing increased issuance under the market stabilization scheme (MSS) and then, if needed, hike the cash reserve ratio (CRR).

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Equity Market Outlook

- **Limited positive surprises in the quarterly earnings, equity issuance announcements and strong currency prompted recent profit booking**
- **Strong INR , lower crude oil prices and low inflation likely to support refineries' performance**
- **We expect lower inflation and increased possibility of a normal monsoon to boost equity market sentiment**
- **We expect mid cap outperformance to continue**

The MSCI India index lost a marginal 2.2% over the fortnight and underperformed the broader emerging market index. As expected, consumer discretionary, materials and utilities companies were relative outperformers, while financials and healthcare underperformed. The unexpected announcement of a large size equity issuance by a leading private sector bank caused financials' underperformance. Separately, continued INR strength dampened sentiment for export oriented sectors, mainly IT which is 21% of the MSCI India weight.

Both the FIIs and domestic mutual funds turned buyers over April. Year-to-date, FIIs have invested US$3,020 million while domestic mutual funds have sold US$ 380 million.

Quarterly earnings - reflecting moderation

The quarterly earnings reported so far, have had limited positive surprises. IT majors have guided towards a reasonably strong revenue growth for FY08 in US$ terms. However, INR strength remains a key risk for the IT sector's performance. Among the non-tech companies reporting so far, telecom has done better than expectations, while consumer staples and discretionary earnings have disappointed. Building materials companies have delivered in line with our expectations.

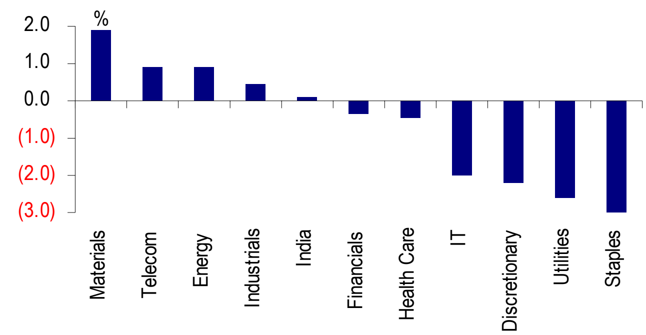
Quarterly earnings delivered vs. expectations - Sensex companies

Exceed	Met	Disappoint
Satyam Computer	Associated Cement	Cipla
Wipro	Grasim Industries	Hindustan Lever
Bharti Airtel	Ambuja Cements	ICICI Bank*
	HDFC Bank	Infosys Technologies
	Ranbaxy Labs.	Maruti Udyog
	Reliance Industries	Tata Consultancy
	Reliance Energy	
	Reliance Com	

Source: : Bloomberg

* Performance inline prior to one time provisioning

1M change in IBES consensus earnings estimates - 12 M forward EPS



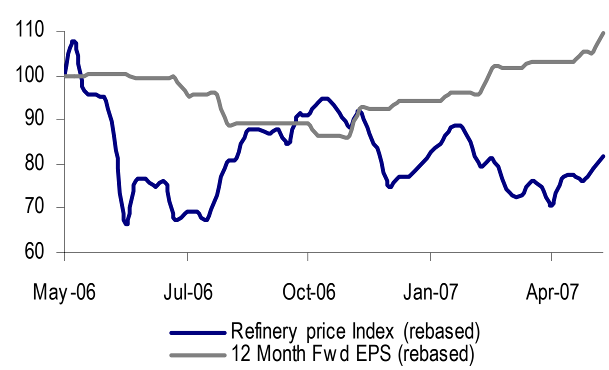
Source: IBES, MSCI, Datastream

Consensus earnings' estimates for materials, telecom and energy have been revised higher, while staples, utilities and discretionary have been reduced over the reporting season.

Macro support for PSU refineries performance

We believe macro factors are supportive of oil refinery outperformance. JPMorgan economics and rates team expect INR to possibly strengthen over the short term, given large capital inflows on account of outsized equity issuance and the central bank's bias toward relatively tight domestic liquidity. Also, crude oil prices have corrected by more than 7% over the past two weeks. Separately, domestic inflation (headline WPI) is likely to fall to within the central bank's 5.0% forecast by end June. We believe lower headline inflation is likely to reduce the possibility of a reduction in retail petrol prices over the short-term. These factors should

PSU refineries - earnings expectations and index performance



Source: JPMorgan calculations, IBES

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support strong earnings growth.

Divergence in EPS expectations and price performance

The MSCI India index is trading at 17.4 times 12 month forward EPS and we do not expect a significant market re-rating in the current macro environment. We believe the earnings support is going to be the key factor determining returns. Also, there has been a relatively high degree of accuracy in the prediction of stock EPS compared with PE multiple expectations. In our analysis, we highlight stocks with divergence in the earnings growth expectations and stock price performance over the past six months.

Stocks likely to benefit from improvement in sentiment - Changes over last six months

Company	Sector	Change in12 M Fwd EPS (%)	Price perf (%)
Bharat Petroleum	Energy	28.4	-9.2
Grasim Industries	Materials	26.1	-10
Hindustan Petroleum	Energy	25.2	-8.6
Ultratech Cement	Materials	19.3	-8.2
ACC	Materials	15.5	-11.3
Indian Hotels	Consumer Discretionary	16.9	-7.3
Dr.Reddy's Lab	Health Care	12.3	-11.2
Bank Of Baroda	Financials	16.1	-7
Colgate-Palmolive	Consumer Staples	14.2	-7.2
Maruti Udyog	Consumer Discretionary	6.3	-14.6
ITC	Consumer Staples	6.7	-13.7
Infosys Technologies	Information Technology	14.1	-5.8
Tata Motors	Industrials	6.8	-9.6
Ambuja Cements	Materials	5.8	-8.5

Source: IBES, Datastream

Midcap outperformance to continue

As expected, the midcap index outperformed the large cap over the last fortnight. There has been a noticeable pick up in the secondary market activities of domestic mutual funds. Also, fund raising pipeline of NFOs indicate the demand for mid caps is likely to continue in the short term.

Stocks without any earnings expectations support - Changes over last six months

Company	Sector	Change in12 M Fwd EPS (%)	Price perf (%)
Mahanagar	Telecom	-20.2	6.8
Tata Tea	Consumer Staples	-6.7	3.7
Nestle India	Consumer Staples	-2	8.3
Siemens	Industrials	-3	1.4

Source: IBES, Datastream

Sectoral performances and RSI

Index	Return -1M (%)	Return -3M (%)	RSI 10 D
MSCI India	4.8	-5.2	52.5
Consumer	3.1	-11.9	52.5
Consumer Staples	0.4	-3.9	49.9
Energy	13	11.7	62.9
Financials	3.6	-9.4	46.4
Health Care	0.1	-4.3	43
Industrials	5.5	-5.8	56.3
Information	-1.2	-11.9	41.4
Materials	11.9	-6	68.9
Telecom	9.6	-3.5	55
Utilities	3.3	-3.4	52.4

Source: Datastream

Market Strategy

The recent rally was led by FII investors, and mutual funds joined in relatively later. We believe the cash levels of mutual funds are still high, and lower headline inflation along with increased possibility of a normal monsoon could be supportive of equity performance. Reduced uncertainty over domestic interest rates and higher investor confidence are likely to support cyclicals and relative underperformer sectors in the short term.

We expect refineries, consumer discretionary and healthcare to outperform over the next month, and prefer telecom, industrials, IT, and healthcare for the medium- to long-term portfolio.

Strategic over weight sectors

	Key drivers
Telecom	Strong subscriber growth momentum Huge potential for higher value added services revenue Consolidation
Industrials	Structural infrastructure investment cycle. Process industries operating at peak capacity utilization. Companies up on the value chain focusing on exports. Key companies have good earnings visibility.
Technology	Strong business flows
Health care	Significant opportunity for generic players - drugs with aggregate sales of US$45 bn coming off patent over next 3 years. Indian companies are fully integrated and growth is coming off a low base.

Source: JPMorgan

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Rates Markets Outlook

- **INR see-sawed in the recent past; USD/INR traded sharply higher today on strong all round buying**
- **RBI's fx operations, global environment and exporter action will be crucial for near-term market direction**
- **Position neutral in USD/INR given heightened uncertainty; stay with forward curve steepener**
- **Bonds traded lackluster while swaps rallied amid easy liquidity conditions**
- **Risk of policy action to tighten liquidity; stay long bonds though hedge via duration neutral paid position in 5y OIS**

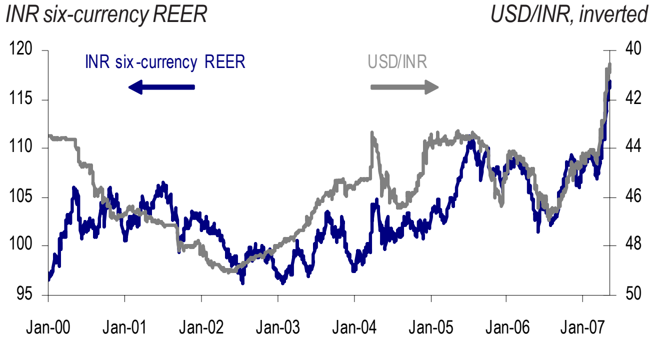
The ceiling for issuance of sterilization securities was enhanced to INR1.1 trillion from INR950 billion earlier which increased speculation on whether central bank's fx operations would indeed pick up. The initial market response, unsurprisingly, was for USD/INR to trade higher. However, the currency pair retraced the entire move, as net inflows remained strong while there were limited signs of a revival in RBI's intervention. INR though could not break below 40.60 and the currency pair reversed direction again. Strong buying by nationalized banks, reduced carry on short USD/INR position, little exporter interest to sell and change in sentiment toward dollar globally contributed to the sharp move higher in USD/INR today.

Carry on short USD/INR to remain attractive

Liquidity continued to be in focus, and comfortable money market liquidity led to easy overnight rates this week, pulling forward points down. However, liquidity will likely stay tight, over the medium-term, and overnight fixings average in excess of the 7.75% repo rate, as there is little dilution in the tight liquidity stance of the central bank. This would possibly keep intact upward pressure on forwards, which can perhaps get re-enforced by customer positioning. During the current move in USD/INR, importers with the exception of oil companies have largely been absent, and possible hedging by them, can create paying pressure on forwards. Thus, carry in staying short USD/INR will likely become attractive again, and potentially act as a deterrent for investors looking to initiate long positions.

INR close to peak valuations

INR six-currency REER *USD/INR, inverted*

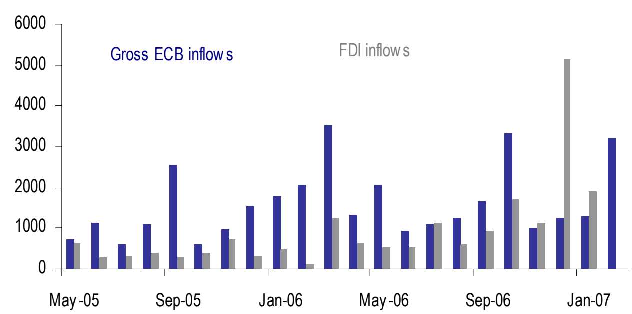


Capital inflows display unfaltering strength

The flow support to INR is only likely to strengthen, in the absence of measures to discourage capital inflows. FDI inflows are likely to be strong in 2007-08 as well – the macro-economic environment is attractive for long-term investment to India. External commercial borrowings (ECB) gathered substantial momentum during the previous fiscal year, and will possibly remain a preferred financing route for Indian corporates. Indeed, the pipeline of companies looking to raise resources is sizable and the possible inflow over the next few months can exceed US$7 billion, in our opinion.

ECB and FDI inflows stay strong

US$ million



JPMorgan's foreign exchange forecasts

exchange rates vs. USD

	Actual	Forecast (end of period)			
	10-May-07	Jun-07	Sep-07	Dec-07	Mar-08
€	1.35	1.34	1.35	1.36	1.33
£	1.98	1.99	2.01	2.03	2.02
¥	120.1	123	123	125	126
CHF	1.22	1.22	1.21	1.21	1.23
CNY	7.69	7.40	7.20	7.00	6.80
KRW	925	945	970	990	1000
INR	**41.3**	**41.0**	**42.0**	**43.0**	**42.5**

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However, regulatory measures to restrict outsized ECB inflows are possible, and lowering of the US$22 billion ceiling is one of the restrictions possibly being contemplated.

Also, two big ticket initial public offerings (IPOs) are likely to open during the coming weeks. The combined issue size is estimated at US$7.5 billion, and 40% of the offer amount can be easily subscribed by foreign institutional investors (FIIs). An inflow of this magnitude would further strengthen the flow support for INR.

However, valuations might spoil the party

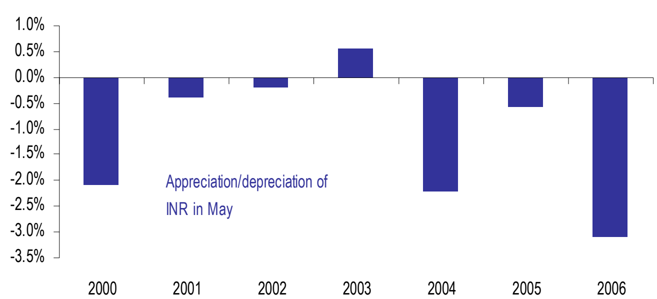
The next six to twelve months do not appear conducive for further INR strength as valuations are of immense concern. INR valuations are currently in uncharted territory – more than three-standard deviations higher than the 5-year mean and close to 16% richer than fair value. Moreover, export growth slowed in the final quarter of 2006-07, even before the effect of the recent sharp real appreciation influenced price realization. This rather strong and rapid real INR strength can adversely impact export growth, and possibly necessitate corrective policy action. Moreover, on the JPMorgan forecast, headline WPI inflation is likely to decline below 5% by June; with inflation below the central bank's forecast, the political will to accept INR appreciation might perhaps be limited.

Risk from higher oil prices intact

Crude oil prices are a source of risk to the current account deficit, especially if there is a re-test of earlier highs. With the summer driving season in swing, inventories still low compared with historic norms, limited spare capacity in the

INR tends to weaken in the month of May

% change vs US$ (positive reading indicates appreciation of INR)



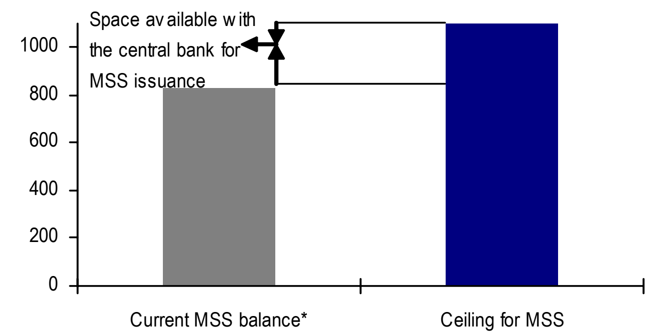
JPMorgan's official interest rate forecast

Percent

		Forecast (end of period)			
Country	Current	07Q2	07Q3	07Q4	08Q1
United States	5.25	5.25	5.25	5.50	6.00
Euro area	3.75	4.00	4.25	4.50	4.50
United Kingdom	5.50	5.50	5.50	5.50	5.50
Japan	0.50	0.50	0.75	0.75	1.00
Hong Kong	6.75	6.75	6.75	7.00	7.50
Korea	4.50	4.50	4.50	4.50	4.50
India	**7.75**	**7.75**	**7.75**	**7.75**	**7.75**

RBI can potentially issue another INR270 billion of sterilization securities

INR billion



**The ceiling and outstanding balances are based on face value of securities*

major oil-producing countries and the US hurricane season approaching, there are upside risks to oil prices. Note that every US$10 rise in oil prices increases India's oil import bill by close to US$6-7 billion – which amidst a slowing export growth backdrop – can worsen the current account deficit from its expected trajectory and perhaps weaken INR bullish sentiment.

Seasonality not supportive of INR strength

Although there is little evidence of a rise in risk aversion currently, equity market sell-offs during May in the past three years warrants caution. Importantly, INR tends to depreciate during the month of May – seasonality analysis reveals that INR weakened in six of the past seven years. This fairly strong seasonal pattern is possibly another reason to be wary of a move higher in USD/INR and it is thus imperative to keenly watch evolving global developments for the perceived impact on INR. However, the FOMC statement yesterday did little to suggest an early Fed move, and financial markets liked the message, leading to a

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rally in risky assets across the globe.

On balance, risks are skewed toward INR weakness over a 2-3month horizon, though near-term strength is possible, especially if RBI's fx operations stay muted and risk appetite does not falter, in an environment where capital inflows remain sizable. Moreover, exporters have shown limited interest to increase their hedge ratios in the recent move higher in USD/INR, though if spot reverses direction, possible panic selling by exporters can potentially amplify the move lower in USD/INR.

Market strategy

- **Position neutral in USD/INR**
  Peak valuations and slowing export growth strengthen the case for weaker INR, though still strong capital inflows, soaring risk appetite and limited intervention by the central bank, can perhaps lead to renewed INR strength. Given the heightened uncertainty, we position neutral in USD/INR.

- **Stay with forward curve steepener**
  The central bank's focus on keeping liquidity conditions tight is unlikely to waver anytime soon, and thus the forward curve is likely to bear steepen. We opened this position with 6s12s spread at 70p, current 76p, and target a widening to 100p, while tightening the stop to 60p.

Sharp rally in swaps

Momentum gripped the swap market and the rally in shorter tenor swaps, similar to the sell-off, was quite sharp. The 1y OIS which dealt in excess of 8.8% at its peak, declined to a low of 8.3%. However, bonds were lackluster and traded in a narrow range on relatively thin volumes.

Improved money market liquidity can persist

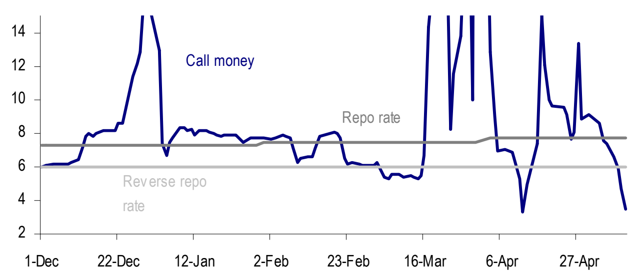
Liquidity conditions improved significantly over the past week and the overnight rate declined to a low of 3% today from 15% two weeks ago. This will likely reverse once the INR100 billion auction payout occurs early next week; though, possibly flip again as large coupon inflows, seasonal decline in currency in circulation and discretionary government spending pushes money market liquidity back to surplus territory. Note that the INR200 billion bond redemption later this month, though likely to be part neutralized by an INR80 billion auction outflow around the same time, can potentially further increase the surplus liquidity available to the banking system. The total money market liquidity surplus can perhaps become quite sizable by end of the month, if RBI adheres to the planned issuance schedule.

JPMorgan's long term interest rates forecast
10-year government bond (unless specified), % local convention

	Actual	Forecast (end of period)			
	9-May-07	Jun-07	Sep-07	Dec-07	Mar-08
United States	4.63	4.65	4.70	4.95	5.15
Euro area	4.20	4.13	4.05	3.95	3.90
United Kingdom	5.07	4.90	4.90	4.85	4.85
Japan	1.67	1.90	2.00	2.10	2.30
Hong Kong	4.22	4.24	4.20	4.40	4.55
Korea***	5.12	5.10	5.15	5.25	5.50
India	**8.08**	**7.60**	**7.30**	**7.00**	**7.00**

****5-year bond*

Overnight rates eased significantly this week
percent



Risk of policy action to tighten liquidity...

The previous occasion when liquidity conditions threatened to improve so significantly, i.e. before the deluge of government spending swiftly turned the end-March liquidity deficit to a sizable surplus early April, the central bank delivered a hike in the cash reserve ratio and supplemented it with regular issuance of sterilization bills and bonds to prevent liquidity conditions from becoming too comfortable. It is reasonable to believe there has been no material change in the central bank's stance, and the commitment to keep liquidity conditions tight is still intact. Thus, the risk of aggressive issuance of sterilization securities is reasonably high. A hike in the cash reserve ratio cannot be ruled out, especially if RBI's fx operations pick up. Efficiently managing money market liquidity when the central bank is intervening in the fx market, will likely be an insurmountable task if the RBI relies only on issuance of sterilization securities to mop up surplus liquidity.

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...though further hikes in interest rate are unlikely

Non-food credit growth eased from close to 30%oya growth to around 27%oya as per the latest data release, though is still in excess of the central bank's 24-25%oya target. Anecdotal evidence is supportive of further easing in credit growth, as most banks are witnessing slowdown in loan sanctions, particularly to retail borrowers. Moreover, the fall in growth is likely to be greatest in sectors which were of concern to the central bank, and over time, can possibly lead to a less hawkish RBI. Additionally, with headline inflation likely to roll over during the coming months, and possibly print below the RBI's 5% forecast by June, the central bank is likely to refrain from further interest rate hikes.

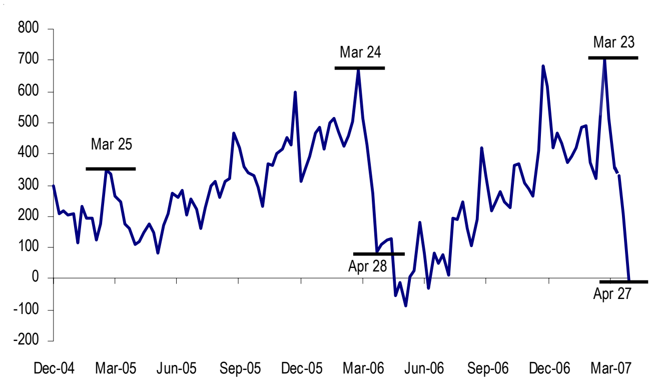
Bonds can benefit from RBI on hold and rising demand from banks

A central bank that is likely done with hiking interest rates, large liability expansion of the banking system and status quo on the statutory liquidity ratio (SLR), will ensure demand for bonds stays strong. To be sure, there is a need to reduce SLR, but it is likely to be a 2H2007-08 event, and only after there is evidence that credit growth has indeed slowed to within the central bank's forecast. Even then, the reduction in SLR is unlikely to be more than 50bp a quarter; and thus, excess demand for bonds is likely to persist, as long as net liabilities of banks increase by close to 20%oya pace.

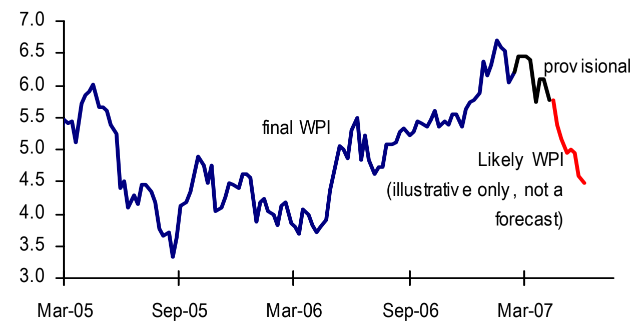
Large issuance can keep bonds subdued in the near-term

There is a lot of impending supply of bonds this month – two twin auctions of INR100 billion and INR80 respectively, as part of the regular borrowing program, while potentially INR100 billion as part of the market stabilization scheme. Although a large redemption - INR200 billion 11.90% 2007 - will likely lead to strong demand to replenish the maturing stock, sentiment might be cautious as auctions are likely to be conducted every week, or perhaps even twice a week. Additionally, likely weak response in the longer tenor auctions due to limited demand from insurance companies, can further dampen sentiment. However, the downside for bond prices will likely be limited, as investors would possibly accumulate long bond positions on sell-offs, as has been observed in the recent past.

Government's cash balances already in negative territory
INR billion



Headline WPI inflation likely to roll over
Percent



Market strategy

- **Stay long bonds though hedge via paid position in 5y OIS**
  We remain invested in the 9.39% 2011 bond and the 7.94% 2021 bond as demand for bonds is likely to remain strong, though purchase protection through a duration-neutral paid position in the 5y OIS. This is to safeguard from a potential policy response by the central bank, in view of the comfortable liquidity situation. Any measure to tighten liquidity will likely have a greater impact on swaps, and even though bonds might weaken in absolute terms, they will likely outperform swaps.

- **Stay paid at the front end of the OIS curve**
  We initiated a paid position on OIS as a way to position for imminent tightness in liquidity, which will most likely occur through larger than usual sterilization bond issuance during the coming weeks. We entered 1y OIS at 8.5%, targeting a move to 8.8% while risking 8.25%. At 8.37% currently, we stay with the position.

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