India Strategy

September 2010

September – Strategy

India - Key Macro Economic Forecasts

- Snapshot of HSBC key Indian economic forecasts

HSBC Key India Economic Forecasts

% Fiscal Year	2009/10	2010/11	2011/12	Apr-Jun 10	Jul-Sep 10	Oct-Dec 10	Jan-Mar 11
GDP	7.4	8.8	8.3	8.7	8.2	9.7	8.9
Agriculture	0.2	5.4	2.2	2.5	5	8	6
Industry	9.3	9.3	6.3	13.8	9.0	7.5	6.8
Services	8.3	9.5	10	8.5	8.5	10.8	10
Wholesale prices	3.8	6.7	4.9	10.6	7.8	5	4
Consumer prices*	12.3	7.1	6.5	13.7	7.6	5.2	2.0
Trade bal (%GDP)	-9.3	-9.9	-9.2	-9.9	-11.7	-10.0	-7.9
Current acc (%GDP)	-2.8	-3.9	-3.5	-3.3	-6.0	-4.7	-1.5
Budget bal (%GDP)	-7.1	-5.5	-4.8	-6.7	-6.4	-6.1	-5.5
Cash Reserve Ratio**	5.75	6.25	6.5	6	6	6	6.25
Reverse repo (%)**	3.5	4.75	5.25	3.75	4.25	4.5	4.75
Repo rate (%)**	5	6.25	6.75	5.25	5.75	6	6.25
10 year yield (%)**	7.8	8.4	7.8	8.3	8.5	8.5	8.4
INR/USD**	46.5	45	43.5	46.4	46	45.5	45

Source: HSBC. *Industrial Workers CPI. ** End-period rates

Equities

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Volatility persists. Markets to continue upward momentum in the near term

- Indian equity markets continued its upward movement in August. The BSE Sensex closed month of August at 17971 (0.58% M-O-M) and the NSE Nifty closed the month at 5439 (0.68% M-O-M).
- Consumer Durables, Banking, FMCG, Auto, Mid caps and small cap index outperformed the main indices where as Metals, Oil n Gas, IT, Healthcare, Capital Goods underperformed.

Index	Monthly Change	Index	Monthly Change
BSE CONS DUR	7.08%	BSE PSU	0.68%
NSE BANK NIF	5.76%	**BSE SENSEX**	**0.58%**
BSE BANKEX	5.64%	BSE CAP GOOD	-0.46%
BSE FMCG	4.81%	BSE TECK	-0.76%
BSE AUTO	4.62%	BSE HEALTHCA	-0.95%
NSE MIDCAP	3.14%	BSE IT	-1.81%
BSE-MIDCAP I	2.55%	CNX IT	-1.84%
BSE-SMALLCAP	2.05%	BSE OIL&GAS	-2.41%
NSE NIFTY	**0.68%**	BSE METAL	-2.74%

Source - Reuters

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Consolidation to continue, undertone still positive

Source - Reuters

September – Strategy

FII net buyers in August. Higher demand leading to capacity constraints

- FIIs continue to be net buyers of Indian equities in August. They net bought $2.1 bln (Source: SEBI) of Indian equities during the month. Domestic mutual funds continue to be net sellers. They net sold ($0.7 bln) (Source: SEBI) of Indian equities during the month of August.
- India's GDP growth hit a two and half year high. Industry grew (↑ 12% y-o-y), and manufacturing (↑12.4% y-o-y). Agriculture growth was seen at 2.8% y-o-y, while services clocked 9.7% y-o-y. The numbers reflect that growth in Indian economy is broad based and strengthening despite some pull backs in policy stimulus recently.
- The index of industrial production (IIP) rose by 7.1% y-o-y in June vs. 11.3% in May. against consensus expectations of 8.1%. Basic (-2%) and intermediate goods (-1%) declined over the previous month, but capital goods expanded by 6%. Consumer goods output remained flat.
- Manufacturing Purchasing Managers Index (PMI), dipped to 57.2 in August (from 57.6 in July). Output, new orders and export orders continue to expand at a healthy pace. Input prices rose substantially over the month but firms were not able to pass on the increase to prices charged by equal measure. Material shortages were witnessed.
- Exports and imports for the month of July were up 13.2% y-o-y and 34.3% y-o-y respectively. We expect domestic demand to hold up better than shipments abroad, which raises the risk of a further widening of trade balance. The trade deficit for April-July 2010 was estimated at $43.6Bn.
- Industry continues to report healthy order book growth, signaling improving demand conditions. The inability of firms to service this demand is of evident concern and will continue to stoke price pressures. Growing capacity constraints in the domestic economy with little sign of a slowdown in final domestic demand makes a strong case for the RBI to continue in its measures to cool demand.
- Improved sentiment for farm produce due to good monsoons, higher need for public spending on infrastructure and capacity expansion by firms are likely to drive manufacturing growth in coming quarters.

Source: Bloomberg/HSBC

September – Strategy

GDP forecast for FY'10-11 at 8.8% as we expect a pick up in the capex cycle

- We maintain our GDP growth forecast of 8.8% for FY'10-11 led largely by an above-consensus investment growth forecast of 14%.

- Loan growth has been showing signs of a pick up, with bank credit growth at 2.1% (week ended Aug 13th) up from 10% levels in Oct – Nov 2009.

- Capex is likely to pick up, led by power, infrastructure and metals;
  - As per data collected by the CMIE, Indian companies plan to spend INR 8.7tn (13% of GDP) on expanding capacities in the current fiscal year.
  - Firms in the steel, aluminum, electricity, cement and tire sectors are expected to make the investments.
  - The public sector will continue to be an important source of demand for industry as the government raises spending on urgent infrastructure needs in a bid to catch up with spending targets ($500Bn) laid out in the 11th plan (2007-12). Only half of this amount has been spent in the first three years of the plan.

Source: Bloomberg

September – Strategy

Indian equity valuations not stretched and in line with historical averages. Earnings growth to bridge the relative higher valuations

- Historically, Indian companies' earnings have been among the least volatile among emerging markets. Overall leverage of Indian companies is low (average net debt/equity ratio of 0.45x). Q1 FY 11 earnings reported were largely in line with market expectations and certain sectors like IT, Healthcare, Auto, Metals and Banking reported results that were better than expected.

- We look for a 20% EPS CAGR over the next two years. At 17,971 (Sensex at Aug end), India trades at a P/E of 16.0X FY11e (HSBC estimates). Thus, while valuations versus peers are at a significant premium (40% on P/E and 58% on P/B), we expect them to look less demanding rolling forward to FY 12.

- We continue to encourage rebalancing of portfolios towards strategic asset allocations. For clients with under allocation to equity, we still recommend an SIP or quasi SIP approach. Sharp corrections could be viewed as good buying opportunities to rebalance under allocated portfolios.

- Exposure to mid cap funds and stocks can be considered based on individual risk profiles. We believe the segment will continue to outperform in the near term. Our view stems from the valuation gap relative to large caps being higher than historical standards.

- We continue to favor banks and industrials as our key over weights to play the pick up in the domestic economy. Our under weights are Telecom and Materials (Cement and Aluminum). Our individual sector views follow;

September – Strategy

Overweight – Banks, Industrials; Neutral – IT Services, Cons Staples, Utilities, Cons Disc.,

- **Financials** – Overweight – we expect FY 11 to be the beginning of the next credit up cycle. Expanding output gap, industries running at close to full capacities and credit growth lagging capital formation gives us ample confidence that credit growth is likely to beat street expectations and even potentially exceed our estimate of 25% in FY 11.

- **Industrials** – Overweight – Robust medium-term sector growth outlook. The government expects infrastructure investment to reach $135bn pa in FY 11 and FY 12, which represents 145% growth over the last three years' annual spend. We believe these could create huge growth opportunity over the next two years. We expect power, roads and water to contribute the most.

- **Information Technology** – Neutral – we remain positive on the long-term fundamentals of the sector and believe top line growth will remain robust for the next 2-3 years, led by increase in off-shoring and pick up in discretionary spending.

- **Consumer Staples** – Neutral – our outlook is neutral on the back of strong fundamentals. We expect growth to be strong on a good monsoon and likely reduction in food inflation and its consequent beneficial impact on purchasing power. However, valuations have moved definitively above historical averages and look rich.

- **Utilities** – Neutral – Generation capacity being increased, but shortfall remains. We rate the sector as neutral given that valuations are at a premium with risks and rewards are balanced.

- **Consumer Discretionary** – Neutral – Demand is strong and the sector continues to benefit from improving job outlook and bank financing, strong farm income and economic recovery. On the flip side, margins can be under pressure due to change in emission norms and rising input costs.

September – Strategy

Neutral –Real Estate, Energy, Healthcare; Underweight – Materials, Telecom

- **Real Estate** - Neutral - Balance sheet strength of most large players following the recent fund raising has improved. Demand conditions seem to be recovering in the residential sector though commercial demand may take longer to recover. Tier II cities should outperform on volume and pricing over FY 10-12. New launches will likely spur demand for transfer of development rights (TDRs) over FY 11 and FY 12,making TDR generators early beneficiaries of any demand revival.

- **Energy** – Neutral – Environment is challenging for upstream and refineries as margins are likely to remain moderate in 2010. Also the sector runs the government policy risk.

- **Healthcare** – Neutral – The potential for growth in the healthcare sector is strong. Defensive in nature but valuations are at a premium to the market.

- **Materials** – Underweight (Cement and Aluminium) – Outlook for cement is improving with the recovery in the economic cycle but over capacity on the supply side will be an issue over the near term. We expect Indian steel demand to pick up and with it utilisation rates and pricing to improve. Current valuations though largely reflect the positive outlook. The immediate risk of cheaper imports does exist which we expect it to subside until such time the stocks could underperform. Suggest awaiting better entry valuations.

- **Telecom** – Underweight - Increasing penetration and consumer spending remain strong growth drivers for the sector. However, as recent changes in competitive scenario and increased possibility of changes in regulations may impact profitability, we turn underweight on the sector.

September – Strategy

Derivatives parameters point to continuation of consolidation.

Equity Derivatives:

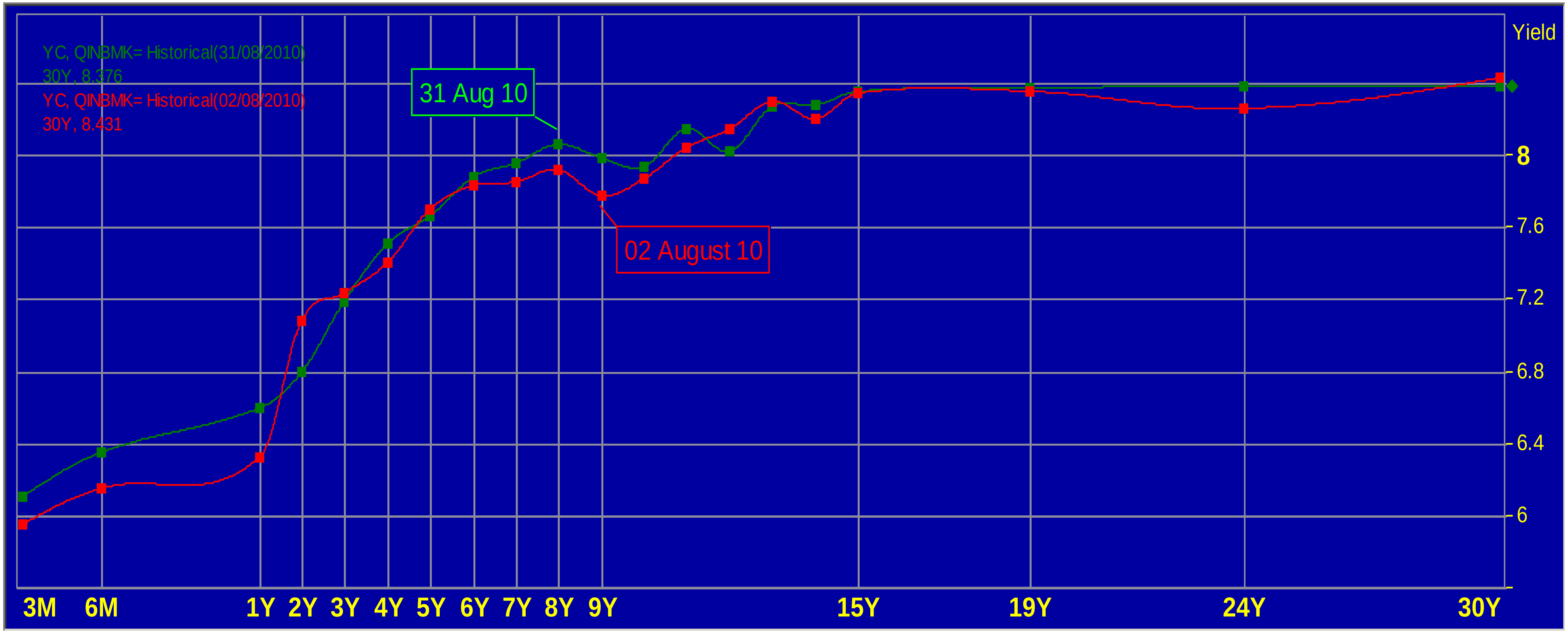
- Nifty near month future closed about 0.5% up for the month of August
- Open Interest for near month Nifty future was however up by about 16%.
- Bank Nifty near month future gained by about 6.07% during the month.
- Open Interest for Bank Nifty future was down by about 13.75%
- CNX IT near month future corrected by 2.1% during the month.
- CNX IT futures open interest was up by 18.77% though on a small base

Source – Reuters

Fixed Income

September – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- Liquidity improved in August. However, as per our expectations the shorter end of the curve showed a higher movement than the long end. The ten year benchmark yield moved up to touch the 8% levels. We expect the longer term curve to be range bound with more volatility on short term rates.
- We believe liquidity will be easy up to the advance tax dates. Subsequently, we may see some squeeze in the liquidity to the end of the month. We continue on our expectations of shorter term rates to remain high in the near term due tight liquidity and expectations of further rate hikes.

September – Fixed Income Strategy
Short term rates to ease post the advance tax dates

- Liquidity improved in August as compared to the previous month. The average Mumbai Inter Bank Offer Rate for the month was 5.67% as compared to 5.67% in the previous month. The outstanding amounts lent in reverse repo on 31st Aug 10 was INR 1.2 bn as against INR 18 bn on 30th July 10 (Source: NSE/ RBI website).
- The inflation numbers released, though at elevated levels, showed first signs of easing. The food inflation numbers dropped to 10.86% for week ended 21 Aug 10 as compared to 12.47% in the previous month. Wholesale Price Index (WPI) eased below double digits to 9.97% in July 10 as compared to 10.55% in June 10.
- We continue with our WPI forecast for 2010 from 8.8% annual average to 8%. We also expect the inflation numbers to decline to 4% levels by December. The expectations stems from the softening outlook for commodity prices and indications of a good monsoon this year. However, overflowing order books with tight capacity may be a key risk to the forecasts.
- We are seeing strong readings on the growth momentum. In the second quarter the economy expanded by 8.8% yoy. This comes along with strong consumer spending and evidently possible price pressures due to demand side. Hence, there is a strong argument to tighten monetary policy. We expect another 100 bps in repo rate hikes and 50 bps in CRR hikes over the next 12 -18 months. The RBI has started a new practice of undertaking mid- quarter reviews in June, September ,December and March. The expectations are building around for a possible 25 bps hikes in policy rates in the upcoming mid- quarter review of monetary policy in the current month.
- The increase in rates by the central bank has pushed some of the public sector banks to revise their deposit rates upwards. We expect the busy season to see higher competition for raising deposits with pressure on liquidity due to strong credit growth numbers. However, we may see the longer end to rise lower as a part of the rate hike has already been factored in this segment.

Data Source:HSBC/ Reuters/ Bloomberg

September – Fixed Income Strategy
Short term fixed maturity plans will continue to provide opportunities

- We continue to recommend longer term investors to gradually start locking into higher maturities on upward movements of the ten year (~8-8.25% levels). For investors with shorter horizons we would look to invest into liquid / ultra short term bond funds or dynamic bond funds that take advantage of volatility in interest rate or steepness of the curve. With the firming of the one year rates fixed maturity plans of this duration also provide good opportunities.
- We believe that a strategy to invest into six month fixed maturity plans may provide an opportunity to capture the high short term rates and also the cyclical tightness in March when the proceeds comes up for reinvestment.

Currencies

September – Strategy

Increased risk aversion should be supportive of JPY in the near term.

- INR - The INR weakened during August and closed the month flat at 47.06 against the USD (Source: Reuters). The INR's weakness this year highlights that the current account deficit has now become a more important currency driver. Our Dec 2010 target for INR stands at 45.5.

- USD – The dollar has come under pressure with concerns having shifted from the Euro zone to the sustainability of the US economic recovery. We continue with our neutral stance with a negative bias.

- GBP – With much of the bad news priced in and a better-than-expected Q2 GDP figure, we believe GBP may gradually find support. We are Netural GPB /USD pair.

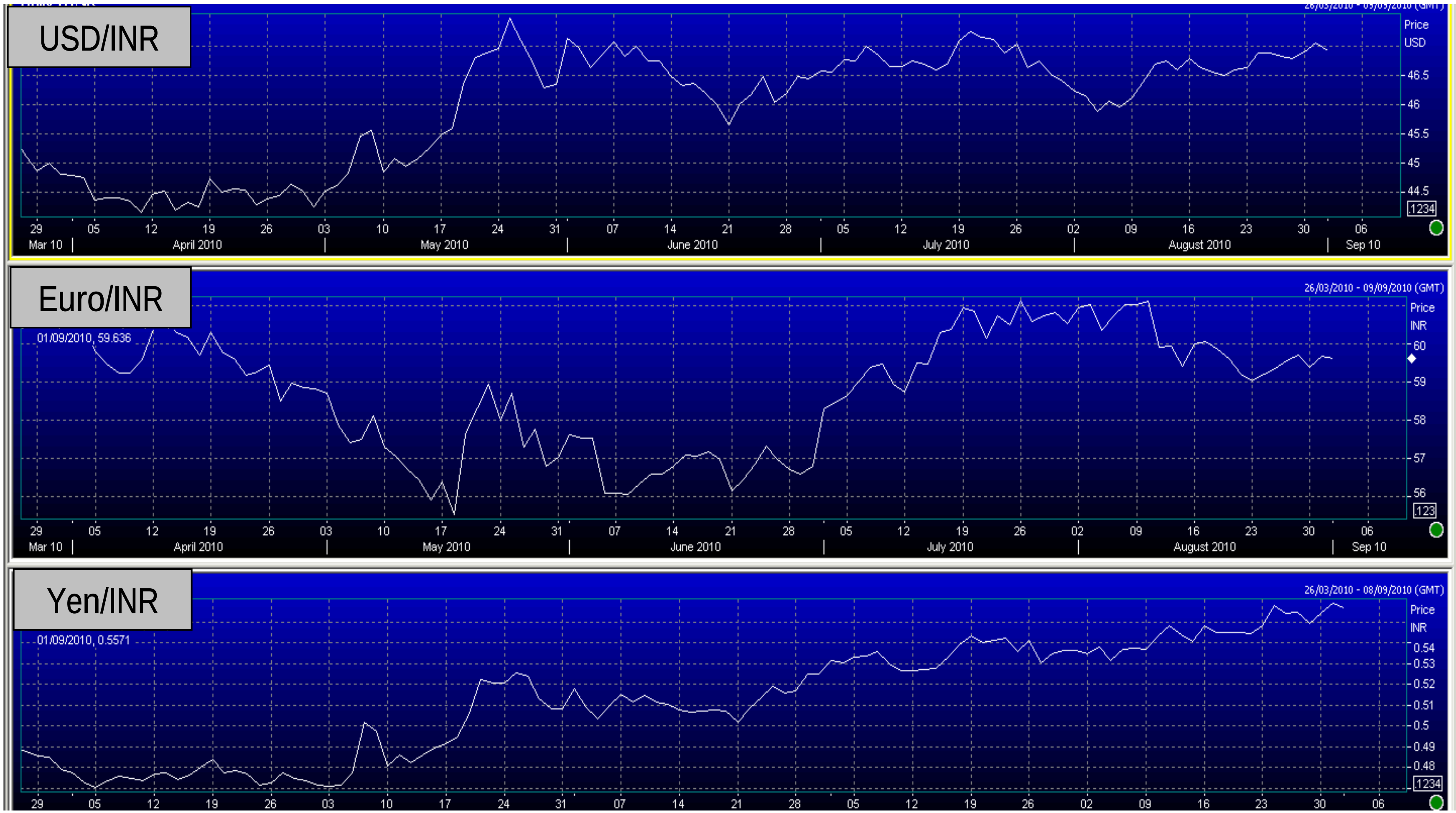
- EURO – The Euro found some support from a stabilisation in sovereign debt concerns (at least temporarily) and better-than-expected economic data, but risk aversion should keep EUR range-bound. We are neutral EUR/ USD pair as counteracting factors will keep both the above currencies range bound.

- JPY – The return of risk aversion is supporting the yen, which benefits from a flight to safety. In the longer term, we expect JPY to weaken again.

- Emerging Markets (EM) - While we continue to believe that emerging market currencies offer attractive opportunities, we are very selective in our choices, as risk aversion may impact currencies with weaker economic fundamentals. However, we believe that a search for a yield will resurface as Western Central Banks maintain the low interest rate regime.

September – Strategy

Currency movements….



Source - Reuters

Commodities

September – Strategy

Risk aversion may impact commodities prices in the short term.

- The uncertain economic environment and the slowing global recovery are likely to keep commodity prices subdued for the time being. We consequently maintain our neutral overall view on commodities.

- **Gold:** Gold gained ground during August and closed the month at US$1245.65 (Source: Reuters). With heightened uncertainty due to concerns about sovereign debt levels and the slowing global recovery, we believe gold prices will continue to benefit from a safe haven status. Even with improving risk appetite, we expect investors to look to hedge their riskier bets, providing underlying support to gold prices. In addition, the weakening of USD may help support prices.We hold neutral to positive view on Gold for the next 12 months.

- **Oil:** Light crude oil corrected during the month of August and closed the month at $72 /bbl (Source: Reuters). We believe oil will remain range-bound in the current environment, in a period of consolidation as investors wait for more clarity on economic growth. Going forward, we believe the oversupply may keep up with growing EM demand, muting price appreciation. We hold neutral view on oil for the next 12 months.

- **Agricultural Commodities and Industrial Metals:** Industrials metal have shown solid underlying demand, but price appreciation may remain muted until investors are more optimistic about the economic recovery. Agricultural commodities have benefited from the unfavourable weather in recent weeks, and prices on grains have jumped. While we may see some short-term consolidation, we believe further appreciation in light of uncertain harvest conditions is likely.We hold neutral to positive view on both these segments for the next 12 months.

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