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HSBC Global Research

India Watch (Issue 10)

The rise and fall of WPI inflation and its implications

- **WPI inflation is falling and should continue to do so. But this doesn't mean the cyclical excesses have been removed**
- **We believe INR has further to run while the bond strategists are looking for a drop in 1yr OIS and 10y GOI yield**
- **Equity strategists review the winners & losers from the January-March Indian earnings season**

The end of the excesses?

Wholesale price inflation has fallen sharply over the last couple of months, dropping from a recent high of 6.5% in the week ending 17 March to 5.4% on the latest figure for the first week of May. As such, WPI inflation is back within the RBI's old target range of 5-5.5% and not too far away from the new objective of "close to 5% inflation during 2007-08" as established in last month's Annual Policy Statement.

We have argued that this fall reflects a combination of lower oil and non-oil commodity price inflation as well as the strength of the rupee. It is also likely to continue for some time, with our model still pointing to WPI (manufacturing) inflation of 4-4.5% by the end of this year. We have also suggested such a decline is likely to be deemed highly significant by the Central Bank and would probably be enough, along with a bit of weakness in bank lending growth, to prompt the Bank to pause in its rate hiking cycle.

In practice, however, a fall in WPI inflation, which is an internationally determined price index, doesn't mean that India's overheating problems have been solved. It also doesn't necessarily mean that CPI inflation will fall either. The correlation between WPI inflation and our national CPI measure (generated by weighting together the individual series for the four different groups of workers) is just 0.1 over the last 10 years and has frequently been negative over shorter time periods.

Although there are tentative signs that the Indian economy is slowing (as detailed in the previous edition of this report and further discussed in the charts on the next page) it is too early to argue that the GDP growth is slipping below its sustainable/trend rate. In our minds, however, a period of sub-trend growth is exactly what is required if the wide-ranging cyclical excesses are to be reduced and eventually removed. With this in mind, the GDP numbers clearly need to be watched very closely, with the January-March figure released on 31 May. We are expecting a year-on-year rise of 8.4%, down from 8.6% in October-December, but still consistent with a strong seasonally adjusted (by us) rise on the quarter – see page 3.

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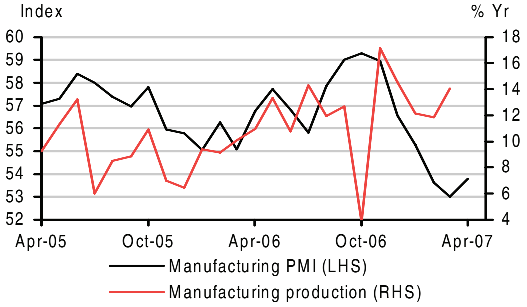
Indicators & Forecasts

Indicator watch

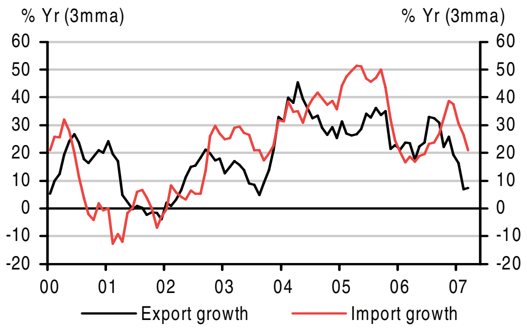


Source: CEIC, Ecowin

Manufacturing

- India's manufacturing PMI survey started life in April 2005 and we have tracked it against year-on-year manufacturing growth in this chart. The correlation between these two series has actually been –0.1 over the period and even smoothing the production variable doesn't improve the fit.
- Although it's still early days, this would suggest either that the PMI should be ignored (as an early indicator of production) or alternatively that manufacturing output is being mismeasured in some way.
- Manufacturing was certainly surprisingly strong in March, rising by 14.1% year-on-year in March – the third strongest rise in 10 years. Meanwhile, overall industrial production rose 12.9%, which was the second biggest increase in the last decade. Our seasonally adjusted estimates suggest the output rose a huge 3.5% in month-on-month terms in March.

Export and import growth have both softened

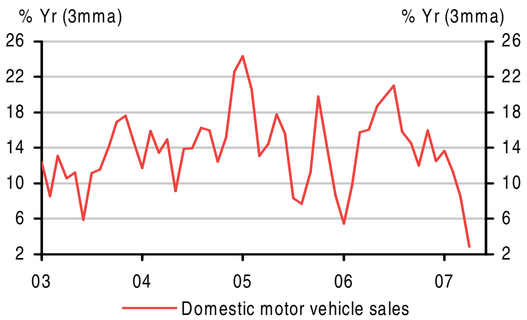


Source: CEIC

Trade

- The sharp downturn in the PMI certainly fits better with the recent weakness in exports and it may be that the survey gives too much weight to exporters over domestically orientated firms (the correlation between the two series since April 2005 has been 0.37).
- One problem with this argument, however, is that import growth has also been softening recently. In other words the strength of domestic demand has failed to offset any export-related hit to imports (remembering that India will need to import some products in order to export).
- All this raises some question marks as to the reliability of the industrial data recently (particularly the March outturn) and we would be surprised if production growth didn't slow over the next few months.

Motor vehicle sales the weakest for years



Source: Source: CEIC

Consumer spending

- Timely consumer related data in India are few and far between, but motor vehicle (including motor cycle) sales are available and don't make for pleasant viewing at present – see chart. In the 3 months to April, the series showed its weakest year-on-year growth rate since the series began in mid-2002.
- The reason for the softness may be entirely innocent (after all we had similar sorts of dips in the recent past without it meaning that much), but it could also be symptomatic of the various interest rate hikes beginning to have some effect.
- Bearing in mind the lags with which monetary policy typically operates, then one would expect this interest rate sensitive sector to remain under pressure for some considerable time yet. We will continue to watch developments closely.

Forthcoming economic releases

For the two weeks commencing 20th May

Date	Indicator	Previous	HSBC forecast	Comment
25th	Urban non-manual workers CPI (Apr)	7.6%	7.7%	CPI inflation for urban non-manual employees has climbed from 4.8% in February last year to 7.6% in March this year. We expect to edge up to 7.7% in April.
31st	Industrial workers CPI (Apr)	6.7%	7.5%	The industrial workers CPI surprisingly dropped to 6.7% in March from a high of 7.6% in February. We expect it to bounce back again to 7.5% in April.
31st	GDP (Jan-Mar, 2007)	8.6%	8.4%	After a disappointing Oct-Dec quarter, GDP should bounce strongly in Jan-Mar and we are looking for a 2.5% seasonally adjusted quarter-on-quarter increase. If we are right, however, this would still not prevent the year-on-year rate slipping slightly to 8.4%.
31st-1st	Exports (Apr)	8.8%	15%	Export growth may now have bottomed and we are looking for a modest recovery from here.
31st–1st	Imports (Apr)	14.5%	25%	Import growth was surprising weak in March and we expect April to show a bounce.
1st	Manufacturing PMI (May)	53.8	54.3	The manufacturing PMI may also have bottomed and we expect a further improvement in May

Source: HSBC

Key economic forecasts

- Year-on-year GDP growth of 8.6% in 2006 Q4 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, y-o-y 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 implausibly large 4% quarter-on-quarter increase.

- We are expecting 8.8% GDP growth for the 2006/07 fiscal year, slowing to 7.8% in 2007/08 (which compares with the RBI's new 8.5% forecast) and just 6.3% in 2008/09. The slowdown largely reflects the cumulative impact of the monetary tightening to date as well as negative net trade effects as capacity constraints continue to boost import growth. Clearly, after a prolonged period of above trend growth, one should expect a period of sub-trend growth.

- On interest rates, we are looking for the CRR to rise another 50bps this year to 7% (in the second quarter, perhaps in June), with the repo rate up 25bp to 8% (also in the second quarter. We have now removed the hikes in the reverse repo rate for this year that were previously in the profile.

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

% Fiscal Year	2006/07	2007/08	2008/09	Jul-Sep 06	Oct-Dec 06	Jan-Mar 07	Apr-Jun 07	Jul-Sep 07	Oct-Dec 07
GDP	8.8	7.8	6.3	9.2	8.6	8.4	8.1	7.8	8.0
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
Budget bal (% GDP)	-3.2	-3.4	-3.7	-	-	-	-	-	-
% Calendar year	**2006**	**2007**	**2008**	**Jul-Sep 06**	**Oct-Dec 06**	**Jan-Mar 07**	**Apr-Jun 07**	**Jul-Sep 07**	**Oct-Dec 07**
GDP	9.0	8.1	6.8	9.2	8.6	8.4	8.1	7.8	8.0
Wholesale prices	4.8	5.7	5.5	5.1	5.5	6.4	5.8	5.5	5.0
Consumer prices*	6.2	7.5	8.5	6.6	7.0	7.3	7.6	7.7	7.9
Trade bal (% GDP)	-7.8	-8.6	-7.9	-	-	-	-	-	-
Current acc (% GDP)	-1.2	-2.5	-2.0	-	-	-	-	-	-
Cash Reserve Ratio**	5.25	7.0	8.0	5.0	5.25	6.0	7.0	7.0	7.0
Reverse repo (%)**	6.0	6.0	6.5	6.0	6.0	6.0	6.0	6.0	6.0
Repo rate (%) **	7.25	8.0	9.0	7.0	7.25	7.75	8.0	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	42.0	41.5	45.9	44.3	43.2	43.0	42.5	42.0

Source: HSBC. * Industrial workers CPI. ** End period

Strategy thoughts

FX strategy

The Indian rupee broke out of its three year trading range over March and April, and hit a nine-year high of 40.55 on 7 May. The market has been speculating about how voluntary the recent aggressive move in USD/INR has been. Have the authorities let spot decline just because of domestic policy considerations, as the consensus argues, or have other forces been at work? We think domestic policy has been important, but not the entire story. There are several points to make:

- On a cumulative basis, reserves are up USD24.5bn since the beginning of February, with USD20.2bn of this likely to be intervention (some of this increase is earnings on reserves and the valuation effect of a weaker USD). This is one of the largest such increases on record, and takes the level of reserves to USD196.6bn from USD150.7bn this time last year. On a monthly basis, our estimates of intervention come in at USD4.2bn and USD3.5bn for March and April respectively, which is well down on the USD12.8bn for February. These numbers suggest to us that the authorities stepped away from the spot market, at least partly, because the sheer amount of intervention needed had grown to levels that were proving difficult to sustain.
- Furthermore, the sheer size of this reserve increase highlights to us that what is really underlying the move in USD/INR is a substantial imbalance in fundamental private sector supply and demand for INR. As a reminder, in 2006, the current account deficit was only one-quarter the size of the capital account surplus. The adjustment in the currency needed to rebalance these accounts is likely to be much larger than that seen to date.
- One other factor posited for the apparent slowdown in intervention is the fact that RBI was likely to be pressing up against their sterilisation limit, as determined by the mandated ceiling to outstanding Market Stabilisation Securities (under MSS Scheme) allowed to be circulating at any one time. On 27 April (two days after the RBI announced its annual monetary policy statement), the government, in consultation with the RBI, further raised the annual ceiling for outstanding securities under Market Stabilsation Scheme (MSS) in 2007-08 to INR 1.11trn, from the earlier limit of INR800bn. The threshold for future review of these ceilings was also raised to INR950bn from INR700bn. The MSS outstandings at the time of review stood at INR780bn against the limit of INR800bn. In other words, if the policy imperative had been to continue to stem the rate of INR appreciation, we don't see too many real hurdles to the RBI gaining further increases in their sterilisation limits, earlier than that which occurred. The key constraints here may be genuine concerns about the rapid rate of reserve accumulation, and the sterilisation and balance sheet costs that could subsequently be borne by the central bank.

In summary, our view remains that the decline in USD/INR has significantly further to run. While policy is likely to return as a market feature, if it has not already, the medium term trend in the INR is towards appreciation. The carry, even in the NDFs in our view, continues to over-compensate for the risks of being short the dollar.

Equity strategy

MSCI earnings (Jan-Mar)

This is the earnings season in India and 47 companies in the MSCI India universe have reported their earnings for the January-March quarter.

The performance continues to be strong with 34.8% y-o-y growth and 82.6% of companies reporting positive growth. On a q-o-q basis, earnings grew 7.4% with 60.9% of companies reporting positive growth over the quarter. Earnings growth for the fiscal year 2006/07 averaged 27.9%.

Sectors with high earnings growth on a y-o-y basis are:

Telecoms - where earnings are up by 473%, led by Reliance Communication, whose March 2007 earnings were up 44 times from the March 2006 quarter. Expected growth in CY2007 for the sector is 43%.

Materials - Earnings are up by 47.6% y-o-y, 58.2% for the period April 2006 to March 2007, compared to the same period a year earlier. For the CY2007, a sharp deceleration is expected, with earnings expected to decline by 2.7%.

IT- Earnings are up by 44.4% y-o-y, 15% q-o-q and 43.4% for the period April 2006 to March 2007, compared to the same period a year earlier. For the next three years, earnings are expected to grow at 21.5% (2007), 27.5% (2008) and 24.9% (2009).

Financials- Earnings are up by 34.2% q-o-q, 22.4% q-o-q and 16.8% for the period April 2006 to March 2007, compared to the same period a year earlier. For the next three years, earnings are expected to grow at CAGR of 33.4%.

Sectors with disappointing earnings growth on a YoY basis are:

Consumer staples- Earnings have declined by 12.2% y-o-y, and 13.4% q-o-q basis, for the period April 2006 to March 2007 earnings are up by 8.8%.

Consumer discretionary- Earnings are up by a modest 3.4% y-o-y, but have declined by 8.8% on a q-o-q basis. For the period April 2006 to March 2007, earnings are up by 13.3%.

Healthcare- Earnings are up by 11.9% y-o-y. On a q-o-q basis, however, the number is a bit alarming with a 35% decline. However, for the period April 2006 to March 2007, earnings growth is up an impressive 35.9%, leading the wider market.

Earning growth: MSCI India

Quarterly net income	YoY growth	% Companies with positive YoY growth	QoQ growth	% Companies with positive QoQ growth	Last 12 months' net income growth
Consumer Discretionary	3.4%	40.0%	-8.8%	20.0%	13.3%
Consumer Staples	-12.2%	50.0%	-13.4%	50.0%	8.8%
Energy	14.0%	100.0%	1.9%	100.0%	20.3%
Financials	34.2%	100.0%	22.4%	60.0%	16.8%
Health Care	11.9%	66.7%	-33.0%	16.7%	35.9%
Industrials	24.0%	75.0%	48.7%	75.0%	32.0%
Information Technology	44.4%	100.0%	15.0%	100.0%	43.4%
Materials	47.6%	100.0%	7.6%	100.0%	58.2%
Telecommunication Services	473.9%	100.0%	-10.4%	0.0%	10.5%
Utilities	58.6%	100.0%	6.0%	100.0%	7.7%
MSCI India	**34.8%**	**82.6%**	**7.4%**	**60.9%**	**27.9%**

Source: HSBC, Thomson Financial Datastream, MSCI

Energy- Earnings are up by 14% y-o-y, and by 1.9% q-o-q basis, while for the period April 2006 to March 2007, earnings growth is significantly better at 20.3%.

Fixed income strategy

A favourable GOI auction on 16 May (INR60bn of 2010 GOI issuance was auctioned at 8.07% versus expectations for a 8.10% cut-off yield), optimism that Indian rates have peaked given signs of a peak in WPI inflation, and slowing bank credit growth have led to a sharp decline in INR OIS rates and GOI bond yields over the past few days. INR195bn of redemption flows on 28 May (contributing to a net INR136bn of coupon + redemption flows in May) should also ease money market liquidity over the coming week.

Given a 7.75% RBI repo rate, we believe that there is further downside in the 1yr INR OIS rate towards 8%, but that further downside in 5yr INR OIS is limited at current levels (7.92%). Next week's bond redemption flows also bode well for a further decline in long-dated GOI bonds, which have underperformed 5yr INR OIS, although this depends on how much the RBI will mop up through MSS issuance.

However, we note that liquidity will likely tighten again in June by a net INR255bn, consisting of INR150bn in advance tax payments and INR116bn in net GOI issuance.

As such, we believe that 1yr INR OIS will bottom around 8% and the 5yr INR OIS around 7.85%, while the 10yr GOI yield may decline to or slightly below 8%

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