HSBC Private Banking

India Strategy - June 2008

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June – Strategy

IT, Metals, Healthcare and FMCG outperform; noticeable shift to defensives

Equities:

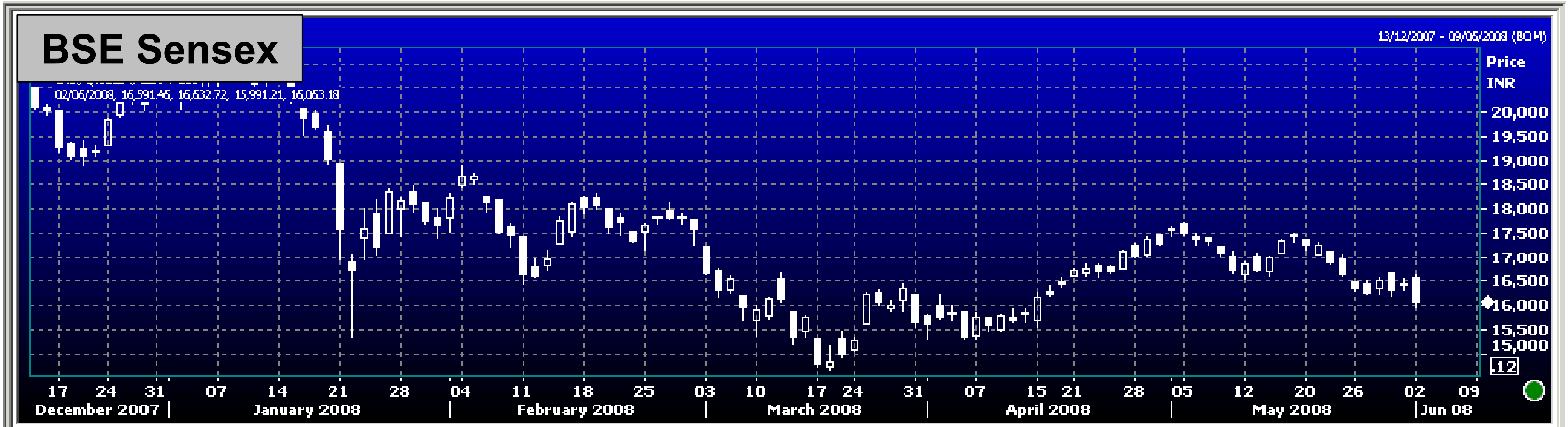
- Sensex closed the month of May at 16415 (5.04% loss M-O-M) and Nifty closed the month of May at 4870 (5.73% loss M-O-M)
- Sectoral movement was mixed. IT, Metals, Healthcare, FMCG outperformed where as Banking, Oil & Gas, Auto underperformed the main benchmark indices.

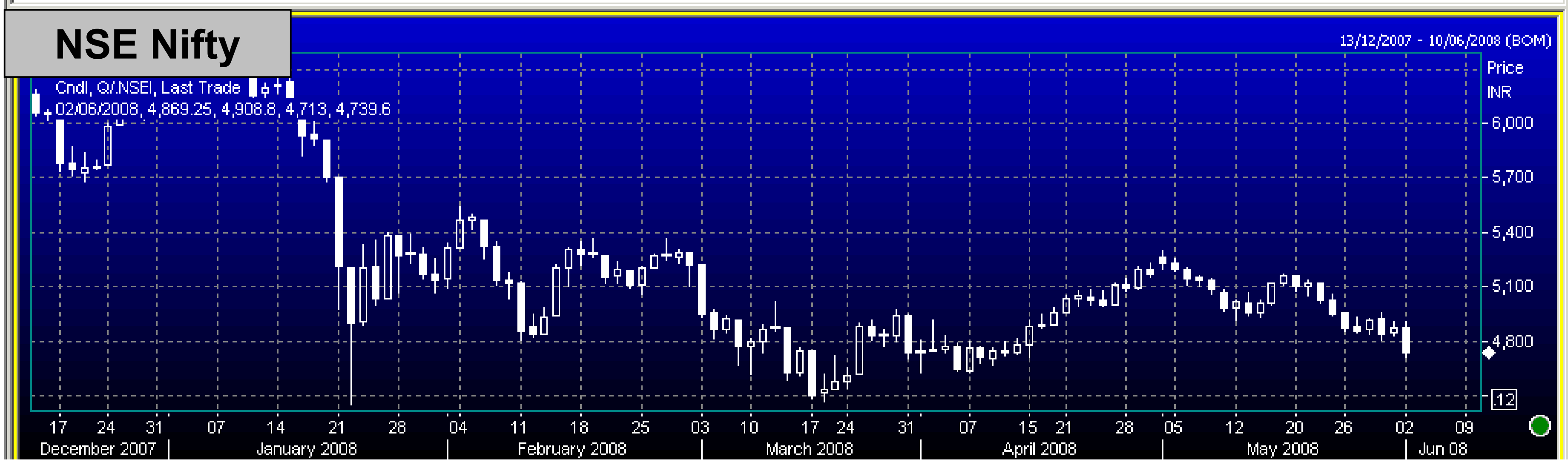
Index	Monthly Change	Index	Monthly Change
BSE IT	8.96%	BSE CAP GOOD	-5.60%
CNX IT	7.59%	**NSE NIFTY**	**-5.73%**
BSE METAL	4.97%	NSE MIDCAP	-6.31%
BSE TECK	4.11%	BSE-SMALLCAP	-7.30%
BSE HEALTHCA	2.83%	BSE AUTO	-7.83%
BSE FMCG	-1.37%	BSE OIL&GAS	-9.64%
BSE CONS DUR	-4.89%	BSE PSU	-12.40%
BSE SENSEX	**-5.04%**	BSE BANKEX	-12.53%
BSE-MIDCAP I	-5.30%	NSE BANK NIF	-13.69%

Source - Reuters

June – Strategy

Market corrects in May, consolidation expected to continue





Source - Reuters

June – Strategy

Positive GDP figures but inflation a serious concern, FIIs net sellers last month

- GDP growth numbers for Q4 and FY08 have been better than expected. Q4 GDP growth came in at 8.8% (Source: Reuters) against our expectation of 8.1% and GDP growth for FY08 came in at 9% (Source: Reuters). In our view GDP is expected to slow to 7.5% in FY 09 (revised upwards from 7%) due to the higher base effect, a stronger currency, and the lag effect of interest rate hikes over the last 2 years coupled with weaker global growth. There are signs of a softening economy but not dramatically so.
- Meanwhile, WPI inflation currently at 8.1% (Source:Reuters), for the week ended May 17th, continues to rise further away from the Reserve Bank's objective. A further increase in energy prices has just been announced and will add to inflation. We expect headline WPI to hit double digits in the not too distant future and remain at elevated levels for some time.
- In this inflationary environment and with the upcoming state and general elections, we expect the RBI to raise CRR by 75 bps and repo rates by 25 bps in the next few months.

Institutional Activity:

- May saw FIIs resume their selling of Indian equities. They sold ($1.24 bln) (Source: SEBI) during the month of May. YTD FIIs have sold ($3.77 bln) (Source: SEBI) of Indian equities. During this period of risk aversion and uncertainty, FII flows might continue to remain muted.
- Domestic mutual funds also saw muted flows in May also suggesting a cautious approach taken by domestic institutional investors as well. MFs sold ($13.5 mln) (Source: SEBI) of Indian equities during the last month.

June – Strategy

Risk aversion and P/E contraction expected to linger

- The high growth expectations for India seem to be moderating. We have upgraded our GDP growth expectation for FY09 to 7.5% from an earlier 7% . This remains strong given the global environment.

- In the current global environment of risk aversion, and P/E contraction, India has corrected from recent peaks and the Sensex is now down 19.1% YTD (Jan-May). Although IBES consensus earnings estimates for Sensex companies between FY08-10 remains 20% CAGR, there could be downside risks to these forecasts in the way of slower than expected global growth, higher inflation and interest rates, and the impact of higher oil prices.

- Given the current uncertainty, rising inflation, impending elections and the slowing environment that prevails, we maintain our year end Sensex target of 17500. We remain cautious over the shorter term given the high inflation levels which could result in the RBI raising repo rates by 25 bps and CRR by 75 bps over the next few months and ultimately depressing GDP growth expectations to some extent.

- The India growth story remains intact from a long term perspective but equity markets could remain volatile given the uncertain global scenario of a slowing US economy and the prevailing credit crisis. Global investors with a long term perspective are likely to remain attracted to structural growth stories like India and global liquidity flows could improve post clarity emerging in the global scenario.

- Volatility could remain elevated until signs of a recovery in the US economy are visible. Any negative news-flow on the sub prime crisis in the US could cause a further pullback.

June – Strategy

Buy on dips, volatility could provide good entry points

- We continue to remain positive about Indian equities over the longer term, but expect current volatility to continue in the near term. Market movement is likely to depend on FII flows and perception of risk among foreign institutional investors.

- Politics, along with inflation, is expected to dominate much of domestic news over the next 12 months and markets are likely to remain nervous ahead of state and general elections.

- Equity valuations appear to be more reasonable and compelling than at 21000 levels. At 16415 (Sensex at May end), India trades at 19.22X FY08e EPS and 16.22X FY09e EPS (Source: HSBC global research). Given the approximate 20% expected corporate earnings growth for the next 3 years, any dips could be viewed as good buying opportunities.

- Q4 FY 08 GDP data points to a slowdown in the industrial and agricultural sectors to 7.6% and 2.9% (from 8.2% and 3.1% in Q4 FY07 respectively) which was offset by higher services output growth which improved to 11.2% from 10.4% (Source: Reuters).

- As has been witnessed over the last one year, movement has been sector specific and stock specific. We expect this to continue and stock picking will continue to be key.

- Given the correction during Q1 and again in May and into early June, we continue to encourage rebalancing of portfolios towards strategic asset allocations. In our view, long term investors could look to use dips in the current volatile environment as entry points. A staggered entry strategy is suggested given that markets could remain volatile in the near term.

- Our views on various sectors follows;

June – Strategy

Overweight consumption themes, RE and industrials, Neutral energy & materials

- We expect domestic consumption to be the dominant theme in 2008. Our sector views are below;
  - **Consumer Discretionary** – Overweight – Earnings growth in the Media and Retail sectors are expected to be 59% and 84% CAGR over the next 2 years (IBES consensus estimates). Autos have underperformed the last 12 months due to monetary tightening and rise in metal prices. Reduced duties and implementation of pay commission are positives. We remain neutral on autos due to risk of further monetary tightening.
  - **Consumer Staples** – Overweight – With recent positive earnings upgrades and the defensive nature of the sector we believe that earnings in the sector face the least quantum of risk and have the least earnings volatility compared to earnings growth.
  - **Telecom** – Overweight - Increasing penetration and consumer spending remain strong growth drivers for the sector. Unlocking of value of tower assets could also have a positive impact over the coming quarters. The sector is expected to grow at a CAGR of 28% between FY08e-FY10e (IBES consensus estimates).
  - **Real Estate –** Overweight **–** Real estate stocks have corrected sharply in the recent fall and they now trade at a discount to NAV. Net income is expected to grow at 68% CAGR over the next 2 years (IBES consensus estimates) making the sector attractive.
  - **Industrials** – Overweight - Capital goods remains a strong story in India and the sector is expected to grow at 33.3% CAGR over the next 2 years (IBES consensus estimates). The sector is placed favourably to benefit from increased infrastructure spend. Also, in case of slowing growth, the government may increase infrastructure spend to boost growth.
  - **Materials** – Neutral – Global slowdown could be a negative for the metals sector and margins in the cement sector may have peaked. We are neutral on the sector.

June – Strategy

Underweight Financials, Utilities, Healthcare, & IT

- **Energy** – Neutral – Although fundamentals do look strong, the volatility in global crude oil prices, government policies with respect to subsidies and issuance of oil bonds, delays in the development of new oil and gas field remain risks for the sector.
- **Financials** – Underweight – Banks are expected to post 24.7% earnings growth over the next 2 years (IBES consensus estimates) but there are risks to earnings in the sector; stress on NIMs as business cycle slows, EPS dilution as banks raise capital and slowing loan growth.
- **Utilities** – Underweight – Although this sector is well placed to benefit from additional electric generation and grow at 13.1% CAGR over the next 2 years (IBES consensus estimates), the recent run up in prices have run ahead of fundamentals and ignores regulatory risks.
- **Healthcare** – Underweight – We believe that increasing competition will constrain upside. Valuations remain high given near term growth prospects although we expect positive EPS revisions to continue.
- **Information Technology** – Underweight – We retain our underweight rating primarily due to the concerns of a US slowdown which continue to weigh on investor sentiments for the sector. We remain convinced about the strong fundamentals of the sector and remain bullish from a long term perspective. Our view is that any slowdown in the US would increase the pressure to outsource; however this is likely to benefit IT companies with a lag. The sector is expected to grow at 14.9% CAGR over the next 2 years (IBES consensus estimates) and valuations remain reasonable.

June – Strategy

Parameters indicate presence of some shorts at this juncture..

Equity Derivatives:

- Nifty near month future lost close to 6.5% during the month of May.
- OI for Nifty Future was up by about 10.5%.
- Bank Nifty near month future lost close to 15%.
- OI for Bank Nifty future increased by about 35%
- CNX IT near month future gained by about 6.2%.
- CNX IT Futures OI showed a reduction in OI by about 37%.

(Source: Reuters)

June– Strategy

Just one IPO listing in May; weak primary market sentiment continues

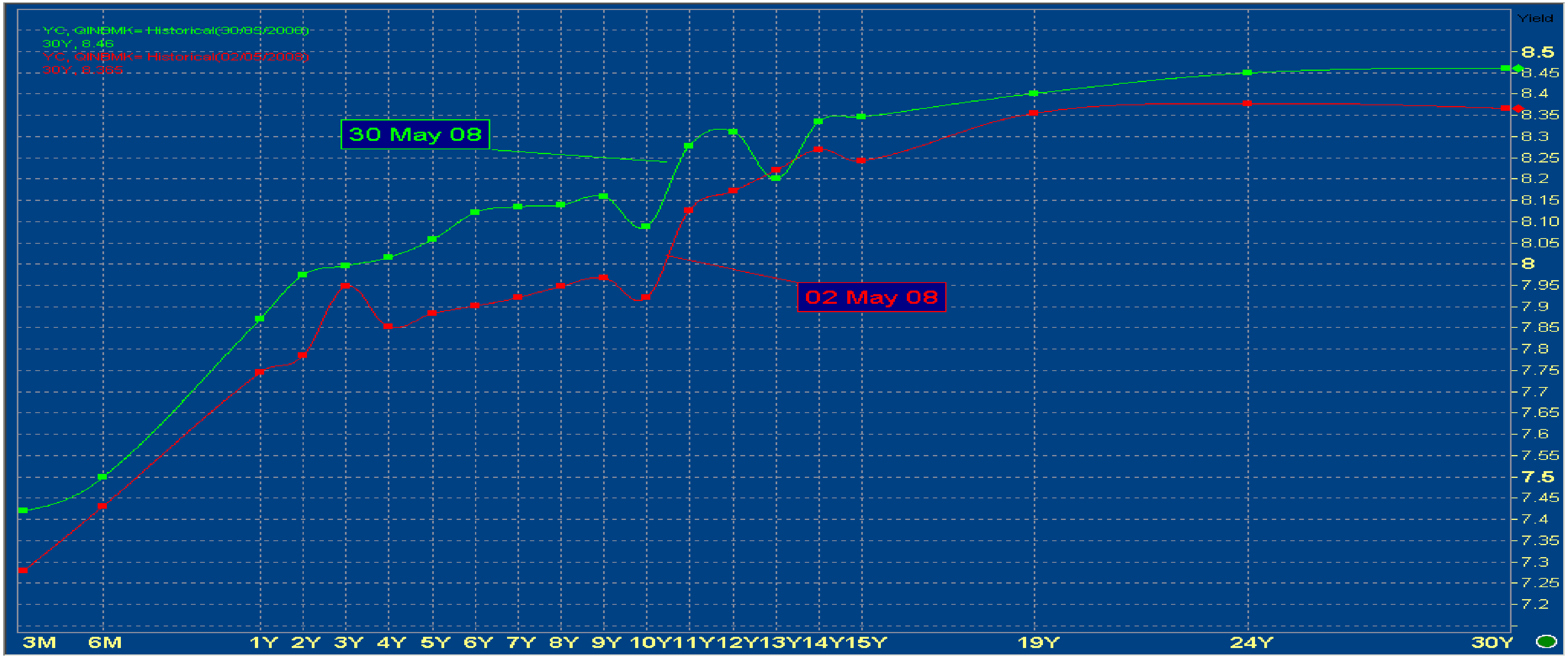
ISSUER	DEBUT DATE	DEAL VALUE (Rs. Mn)	MKT CAP (Rs. Mn)	Issue Price	30-May-08	% GAIN LOSS
Aishvarya Telecom	07-May-08	140	898,27	35	94	167

Source – Reuters

- The total deal value for the month of May was Rs.140 mn.

June – Strategy

Fixed Income



Indian Government Yield Curve

Source: Reuters

- Yields increased during the month of May due the full effect of CRR hikes coupled with a fall in liquidity at the beginning of the financial year. The increase in rates was across the yield curve though the rates for the shorter term maturities were less affected.
- We expect liquidity to tighten further by the middle of June as we approach the first installment of advance tax. Also there could be further pressure on rates if the Reserve Bank increases CRR/ repo rates in order to curb spiraling inflation.

June– Strategy

Possible increase in Repo / CRR given inflationary expectations

Fixed Income:

- Liquidity declined significantly during the month of May. The average MIBOR for the month was 6.78% as against 6.45% last month. The outstanding amounts borrowed in repo on 30 May was at Rs 96 bln as against the amount lent in reverse repo of Rs 42 bln on 30 April (Source: HSBC/Reuters).
- Inflation continues to raise its ugly head. The inflation numbers reported for the week ended 17 May was 8.1% as compared to 7.57% for the similar period last month. Inflation is the highest witnessed since 9 June 07.
- In our view, the rise in inflation has been on account of increase in prices of metals and primary articles. We continue with our expectations on further increase in WPI towards the double digit levels. The rise in inflation has been mainly due to high international commodity prices and hence, we expect the headline number to remain at elevated levels during the year.
- We expect policy action due to the more gentle slowdown in growth and sharp pick up in the numbers of wholesale price index. We expect the central bank to raise CRR by 75 bps and hike repo rates by 25 bps in the next few months.
- We reiterate our call that liquidity would dry up as we move towards the advance tax dates in June. We expect the benchmark ten year to head higher to 8.7% by the end of this calendar year as compared to 8.08% as on June 2nd 2008. We recommend investors take exposure to Liquid / Liquid Plus schemes of mutual funds or shorter duration fixed maturity plans. In our view, schemes that would be sensitive to changes in interest rates could be avoided.

June – Strategy

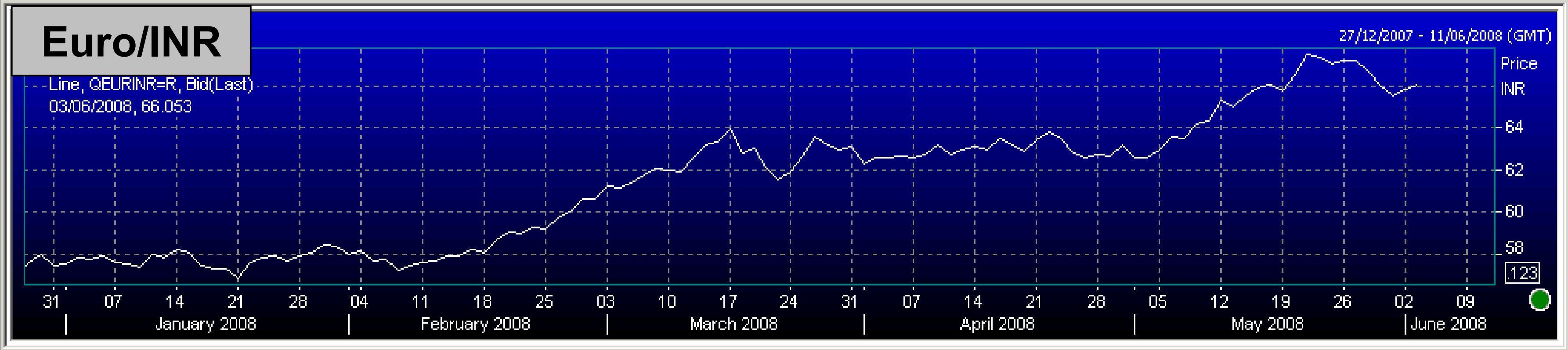
Factors support USD recovery in 2008…

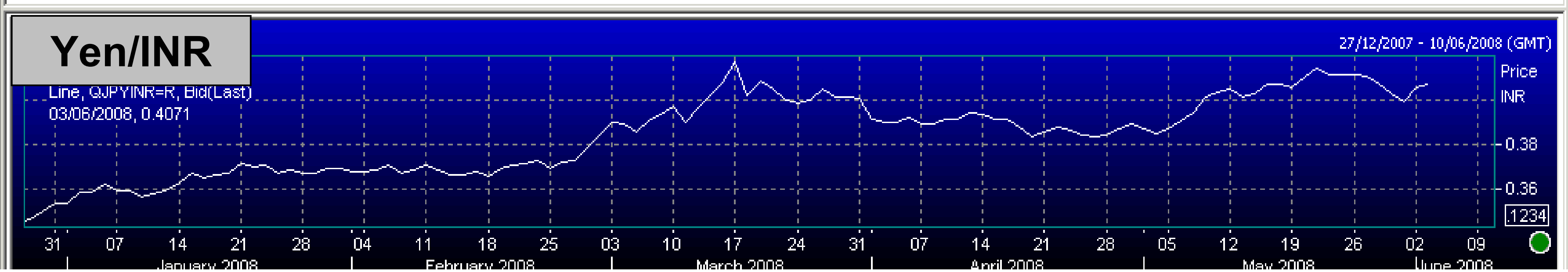
Currencies:

- INR - During the month of May, the INR weakened significantly against the USD and closed the month at 42.16 after hitting an intra-month high of 43. We expect the INR to flatten out around current levels, ending the year at 42.5 against the USD and 41.0 by the end of 2009.
- USD - We continue with our positive USD view versus most developed world currencies based on the view that negative US economic news is largely priced in.
- EUR – Growth concerns should surface more clearly while inflation threats will remain putting the ECB in a difficult predicament.
- GBP – Interest rate cuts are likely on growth concerns, however GBP has already experienced a large and broad based sell off. Therefore it is now likely to trade mixed in the short term.
- JPY – Japanese search for yield and improving risk apetite could move JPY to weak levels.

June – Strategy

Currency movements….





Source - Reuters

June – Strategy

We remain positive towards commodities on a long term basis

Commodities:

- Light crude oil continued its firm trend and closed the month of May at $127.35/barrel (Source: Reuters). As oil prices have crossed $120/barrel mark, we feel that the plentiful supply of crude oil and slower US and European economies could lead it back towards $100/barrel mark in the medium term.
- Agricultural commodity prices are expected to increase further in 2008.
- Demand for industrial metals is likely to abate more than previously thought and could lead to lower prices in this segment.
- We prefer Uranium in the energy field as we see renewed interest in nuclear power around the world and suggest investors consider exposure in this arena.
- Precious metals may continue to benefit from the increased fear towards financial markets. We feel that gold at $880 per ounce may be an opportunity to enter an ongoing bull market

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