29 June 2007

Macro
India Economics & Strategy

HSBC Global Research

India Watch (Issue 13)

Pause mode

- **RBI has finished raising rates for the time being…**
- **…and we have removed the one final hike we had in the profile for '07. We still expect tightening to resume in 2008**
- **Equity and bond strategy contributions are included**

A false sense of security

We have decided to remove the one final rate rise we had in the profile for the rest of this year, now expecting the Cash Reserve Ratio to remain at 6.5% and the repo and reverse rates at 6% and 7.75% respectively through the second half of 2007. In other words, it looks as though the anticipated pause in monetary tightening has come a little earlier than we previously thought. Two factors are important here in our view.

The fact that the RBI's preferred wholesale price measure of inflation has dropped is obviously no surprise, but the pace of decline has been even sharper than expected (it was down to 4% in mid-June). This is not because of the manufacturing component, where inflation has stabilised recently, but reflects a halving in food inflation to less than 5% over the last couple of months as well as the first year-on-year decline in energy prices since January 1999. We expect the manufacturing series to resume its decline shortly.

Lower food price inflation has also started to impact the various CPIs, with the Rural Workers headline rate, for example, falling to 7.9% in May from 9.1%, entirely because of food. Food accounts for a much higher proportion of the CPIs than the WPI (70% of the rural workers CPI and 15% of wholesale prices), and if the more timely WPI developments are any guide, we could see CPI inflation down to 5% in the next few months.

The second factor relates to the reaction of the policy authorities to recent events. While we knew their primary focus would be the WPI, we thought there might have been some response by now to the news that January-March GDP growth (at 9.1%) remained above even the most optimistic estimates of the sustainable growth rate; April industrial production was a huge 13.6% and monetary growth has moved back above 20%. Admittedly, there are some signs of credit growth slowing, but it is still above "target" at roughly 25%. Instead Finance Minster Chidambaram recently argued that "if inflation was contained at its current level (between 4-4.5%) and had a declining tendency there was no reason for interest rates to go up". RBI officials have been very quiet.

Our view remains that the drop in inflation doesn't mean that the cyclical excesses have been removed and the less rates go up this year, the more they will need to rise in 2008.

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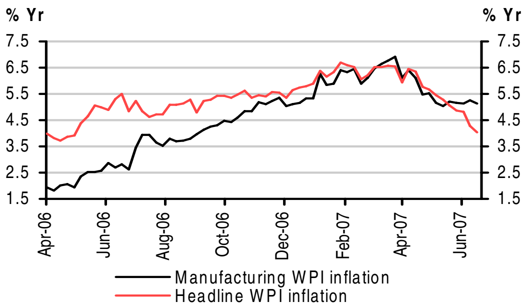
Indicators & Forecasts

Indicator watch

Headline WPI inflation continuing to drop

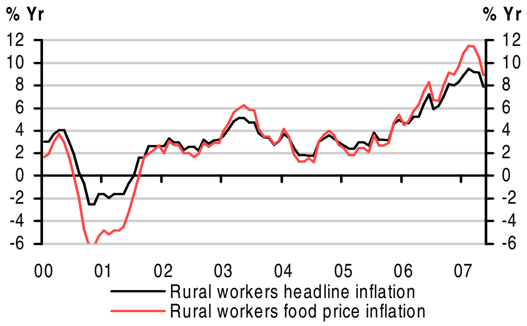


Source: CEIC

WPI inflation

- India's headline rate of Wholesale Price inflation continues to slump, hitting 4.0% in mid-June, down 2.5ppts in the last three months and the lowest since April last year.
- The fall initially reflected falls in fuel related products (which have a weight of 14% in the index) and, more importantly, manufactured goods (with a 64% weight). By contrast, the last month or so has seen inflation of manufactured products stabilise at 5-5.5%, while food price inflation has halved and the fuel rate turn negative for the first time since January 1999.
- It is hard to imagine that the headline rate will continue to drop without the manufacturing component resuming its fall. Our WPI model, however, suggests that this should be the case as the impact of the stronger rupee and lower non-oil commodity price inflation feed through.

CPI inflation also peaking

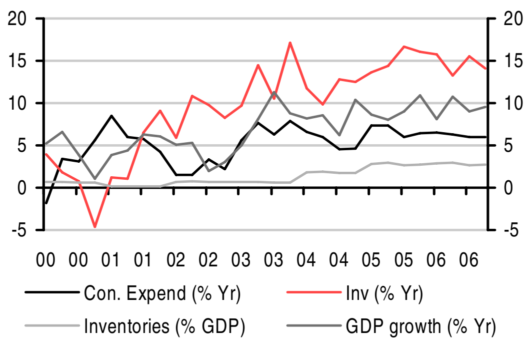


Source: CEIC

CPI inflation

- CPI inflation is also beginning to look as though it has peaked for the time being. The chart shows the rural workers headline rate, which has fallen from 9.5% in February to 7.9% in May – its lowest level since September last year.
- This sudden drop is entirely explained by food price inflation which has slowed to 8.9% in May from 11.5% in February. Food has a weight of 70.5% in the rural workers CPI.
- If recent developments in the wholesale price of food are any guide (there has been a reasonable relationship in the past), then CPI food inflation is likely to fall further, inevitably dragging the headline rate down with it. A drop in the food CPI rate to, say, 5% would see the headline rate of inflation decline to little more than 5%, everything else unchanged. Inflation looks set to keep falling.

Investment driven growth, but some inventory concerns



Source: Source: CEIC

GDP growth

- The expenditure breakdown of GDP growth shows that investment is the key driver behind the expansion in the overall economy, rising 14% year-on-year in the January-March quarter. There has only been one quarter in the last fifteen years that the growth in gross fixed capital formation hasn't been in double-digits. By contrast, consumer spending has generally risen at less than half this rate over the last few years.
- This is good news and would suggest that companies are adding to their productive capacity, although it is slightly strange why it has yet to show up in a meaningful drop in capacity utilisation.
- The potentially worrying aspect of the numbers is the strength of inventories. If we take the stock figures at face value they have been running at 2-3% of GDP every quarter. The question is, is this an involuntary action on the part of firms?

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Forthcoming economic releases

For the FOUR weeks commencing 2nd July

Date	Indicator	Previous	HSBC forecast	Comment
29th	Exports (May)	23.1%	15%	The first indication that export growth may be recovering again was provided by the April data and we expect another reasonably firm number in May.
29th	Imports (May	40.7%	30%	Import growth surged 41% in April with the trade deficit hitting an all-time high in USD terms. The strength of the economy means that imports of goods will continue to outpace exports.
12th	Industrial Production (May)	13.6%	12.0%	India has seen six consecutive double digit y-o-y increases in industrial production, with ten of the last 12 months showing at least 10% growth. May is likely to prove no exception.
20th	Agricultural Workers CPI (June)	8.2%	7.3%	Inflation fell sharply to 8.2% in May and with food prices coming off the boil a further drop to 7.3% seems likely in June.
20th	Rural Workers CPI (June)	7.9%	7.0%	Similar reasoning applies to the rural workers rate which rarely strays that much from the agricultural workers equivalent. A 7% outturn would be the lowest since September 2006.
25th	Urban non-manual Workers CPI (June)	6.8%	6.3%	The Urban non-manual workers CPI gives a smaller weight to food (albeit still nearly 50%) and hence is unlikely to fall quite as sharply.

Source: HSBC

Key economic forecasts

- Revisions to the first and second quarters of the fiscal year meant that average GDP growth for 2006/07 was 9.4%. This was despite a lower than consensus number for the January-March quarter.
- We expect GDP growth to slow to 8% in 2007/08 as the impact of the monetary tightening feeds through. It is important to bear in mind that the most aggressive rate rises were only delivered over the last 6 months, while it usually takes at least a year for the effects to be felt in full.
- Wholesale price inflation is now at 4% and we expect it to soften further over the next few months, perhaps falling as low as 3%. This reflects the impact of softer food, oil and non-oil commodity price inflation as well as the strong rupee. Lower food price inflation has also led us to cut the Industrial Workers CPI inflation forecast significantly (see table).
- We have made a small change to the interest rate view, removing the one further hike we had in the profile for the rest of this year. We still, however, expect the rate hiking to resume again in 2008.

Key Indian macroeconomic forecasts (numbers in red show change from previous report)

% Fiscal Year	2006/07	2007/08	2008/09	Jan-Mar 07	Apr-Jun 07	Jul-Sep 07	Oct-Dec 07	Jan-Mar 08	Apr-Jun 08
GDP	9.4	8.0	6.5	9.1	8.7	8.2	8.1	7.1	6.8
Agriculture	2.7	3.7	2.5	3.8	5.4	4.5	3.0	2.0	2.1
Industry	11.0	9.0	7.0	11.2	10.8	10.1	8.3	7.0	6.5
Services	11.0	9.0	7.5	9.9	9.5	9.1	8.8	8.6	8.2
Budget bal (% GDP)	-3.5	-3.4	-3.7	-	-	-	-	-	-
% Calendar year	**2006**	**2007**	**2008**	**Jan-Mar 07**	**Apr-Jun 07**	**Jul-Sep 07**	**Oct-Dec 07**	**Jan-Mar 08**	**Apr-Jun 08**
GDP	9.6	8.5	6.7	9.1	8.7	8.2	8.1	7.1	6.8
Wholesale prices	4.8	4.7	5.0	6.4	5.2	3.5	3.5	4.0	5.0
Consumer prices*	6.2	5.5	6.0	7.0	5.8	4.5	4.5	5.0	5.5
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	6.0	6.5	6.5	6.5	7.0	7.5
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	7.5	7.75	7.75	7.75	8.00	8.5
10 year yield (%)**	7.6	8.0	8.7	8.0	8.0	8.0	8.0	8.0	8.3
INR/USD**	44.3	39.0	38.5	43.6	40.0	39.5	39.0	38.5	38.5

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

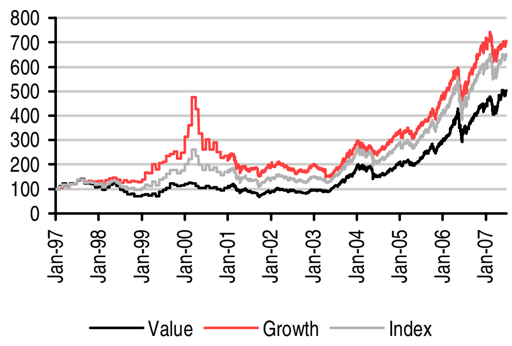
Strategy thoughts

Equities - Value and growth styles in India

Performance

In India, the growth style of investing has significantly outperformed the value style since January 1997, when MSCI started providing the style indices.

1. Performance of value and growth index: India



Source: HSBC, Thomson financial, MSCI

The difference in performance can be illustrated by the fact that INR100 invested in the Growth index is worth INR702 today vs. INR498 by investing the same amount in the Value index.

The Growth index has been more volatile then the Value index. However, on a risk adjusted basis, growth has still outperformed value.

2. Sharpe ratio and performance: value and growth

	Value	Growth	MSCI India index
Returns CAGR	17.0%	21.0%	20.0%
Annual volatility	36.8%	39.3%	35.3%
Sharpe ratio	0.34	0.44	0.42

Source: HSBC, Thomson financial, MSCI

The evidence from other regions is mixed, in MSCI all country world (all world index), Value has outperformed Growth, whereas in emerging markets, during the same period, the performance of both styles has been similar.

Out of the last 10 years, Growth has outperformed in 5 years and Value has outperformed in 5 years as can be shown by the graph at the bottom of the next page (chart 7).

In 2007, Value has outperformed Growth year to date.

Earnings

During the last ten years, earnings of companies classified as Growth stocks have significantly outperformed those of Value stocks, though earnings growth has been more volatile.

3. EPS growth: value and growth index

	Value	Growth	MSCI India index
EPS growth	8.3%	15.8%	12.7%
EPS growth volatility	15.7%	28.0%	11.9%
EPS growth/ volatility	0.53	0.57	1.06
Average ROE	19.1%	24.5%	20.6%

Source: HSBC, Thomson financial, MSCI

However, as shown in the table below, higher EPS growth of companies in the Growth index has compensated for their higher volatility.

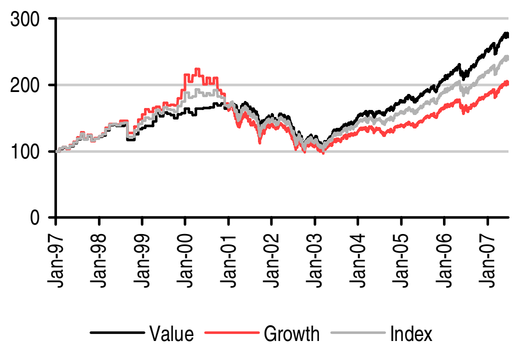
As we can see, EPS growth volatility for the index is less than that of the Value and Growth index due to better diversification.

4. Performance contribution of EPS growth and PE expansion

	Value	Growth	MSCI India index
EPS growth	48.8%	75.5%	63.5%
PE expansion	51.2%	24.5%	36.5%

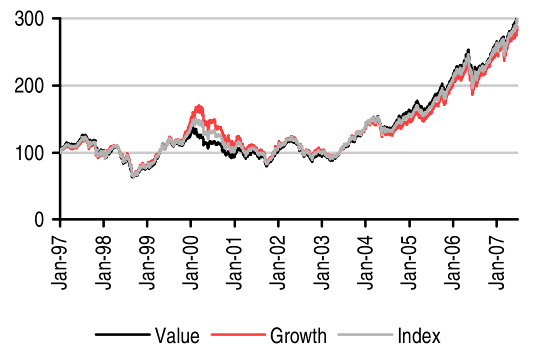
Source: HSBC, Thomson financial, MSCI

5. Performance of value and growth index: MSCI all country



Source: HSBC, Thomson financial, MSCI

6. Performance of value and growth index: Emerging markets



Source: HSBC, Thomson financial, MSCI

In the case of the Growth index, about 75.5% of performance can be explained by EPS growth, while it is 48.8% for the Value index. For the MSCI India index, 63.5% of performance is explained by EPS growth and 36.5% by PE expansion.

Industry with predominant styles

The five main Growth industry groups in India are

1 Media

2 Real estate

3 Software & services

4 Telecom

5 Diversified financials

The five most value oriented industry groups are

1 Consumer durables

2 Energy

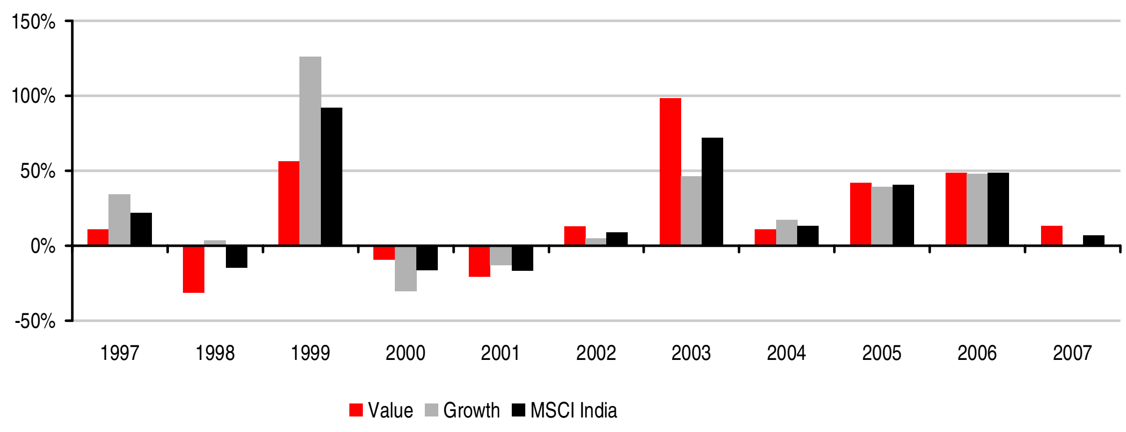
3 Food, beverage & tobacco

4 Household & personal products

5 Utilities

Table 8 shows the concentration of Growth in various industry groups by free float market capitalization.

7. Yearly performance of value and growth styles



Source: HSBC, Thomson financial, MSCI

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8. Concentration of value & growth

Industry group	Value	Growth
Automobiles & Components	56%	44%
Banks	68%	34%
Capital Goods	20%	79%
Consumer Durables & Apparel	100%	
Consumer Services	50%	50%
Diversified Financials	17%	84%
Energy	100%	
Food Beverage & Tobacco	100%	
Household & Personal Products	100%	
Materials	83%	17%
Media		100%
Pharmaceuticals & Biotechnology	37%	63%
Real Estate		100%
Software & Services		100%
Telecommunication Services	15%	85%
Utilities	100%	

Source: HSBC, Thomson financial, MSCI

Note: concentration calculated on the basis of free float market capitalization of each style in the industry group

Fixed income

The INR call money rate rose further to 6.7%, this year, which resulted in a rise in the 1yr INR OIS and a bearish flattening of the INR OIS curve as well. This reflects tighter money market liquidity as a result of INR110bn of T-bill issuance this week, which was INR50bn more than expected. Nevertheless, the rise in the call money rate reflects only a normalisation of money market liquidity, rather than a renewed, aggressive tightening of RBI’s liquidity stance, in our opinion.

Several considerations play a role in this respect:

- Liquidity was due to tighten in the fortnight starting 23 June as a result of INR160bn in additional T-bill issuance/GOI bond issuance brought forward during the second week of June, as well as the additional INR50bn in T-bill issuance this week;
- This liquidity tightening is largely related to the government’s INR400bn payment to the RBI to pay for the RBI's stake in State Bank of India. As the RBI is scheduled to make a related INR400bn special dividend payment to the government in July, these funds will likely flow back into the money market in July or August at the latest;
- Despite significant IPO-related inflows during June, further INR appreciation pressures have been contained in June with USD/INR firming modestly towards 41. This is important for the RBI, as a further decline in USD/INR below 40.60 would have resulted in a significant hit to the RBI’s Currency and Gold Revaluation Account, its capital base and the P&L statement as of RBI’s financial book-year close at the end of June. In turn, RBI could only afford to allow a renewed decline in USD/INR after the end of June (our FX strategists are looking for a renewed drop in USD/INR to 38.5 by year-end), which is why it chose to normalise the call money rate only towards the end of the month.

However, we do not see scope for a significant further rise in the call money rate in July given that;

- INR400bn in RBI’s special dividend payment will eventually flow back into the system;
- Despite significant GOI issuance in July (INR190bn gross, INR70bn net of coupon payments and redemptions) and August (INR170bn in gross issuance, INR102bn net of coupon payments), RBI will look to accommodate these government borrowings by maintaining reasonable liquidity;
- Our FX strategists estimate that RBI may have intervened approximately USD7bn during June, which has offset liquidity tightening as a result of increased T-bill/GOI/MSS issuance.
- WPI inflation has fallen below the RBI’s target ceiling of 5%. In this respect, India’s Finance Minister has stated that inflation has moderated as a result of tight liquidity and INR strength, and that ‘if inflation is

contained at current levels and shows a decline, there is no reason why interest rates should go up' (Reuters: 27 June). The Finance Minister also hoped that GDP growth 'would be close to 9% in the current fiscal year', and 10% by 2010. The official priority is on promoting strong growth right now.

Against this backdrop, we believe that INR OIS rates will be range-bound near current levels during July, albeit with a possible modest further underperformance of GOI bonds, and possible renewed underperformance of MIFOR rates.

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