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Macro
India Economics & Strategy

HSBC Global Research

# India Watch (Issue 12)

## A tale of two deficits

- **A sharply improving budgetary position may eventually tempt a looser fiscal stance…**
- **…while the soaring trade deficit is no barrier to a strong rupee which we expect to appreciate further**
- **The equities team remain wary of the Sensex, while the fixed income strategists suggest fair value for 1yr OIS is 8%**

## Growth holds the key

India is running two big deficits, albeit one that is improving and one that isn't. While the central government budget deficit shrank to 3.5% of GDP in 2006/07 from 4.1% in the previous year and a high of 6.2% in 2001/02, the trade deficit reached 6% of GDP in the last fiscal year compared with 1.5% five years ago. The first figures for 2007/08 have also indicated a continuation of these trends with the April government deficit 13% lower in year-on-year terms and the trade deficit 70% higher (hitting a record in USD terms). Both developments largely reflect one factor – the strength of economic growth. This has not only served to boost tax revenues but also sucked in huge quantities of imports. Imports of goods rose just less than 30% in 2006/07 and slightly more than 30% in April.

So what are the implications of all this? On the fiscal side, the objective is to bring down the central government deficit to 3% in 2008/09 and the overall shortfall (including local governments) to 6% of GDP. Given the extent of the improvement last year and the fact that the deficit was well below the government's 3.8% forecast made at the time of the February budget (which always looked rather conservative to us) then the temptation may be to "go easy" on fiscal policy. We wouldn't be surprised if signs of economic weakness were met promptly with a loosening of the budgetary stance, while an approaching general election (in 2009) may also serve to focus minds somewhat.

As far as the trade position is concerned, we believe the recent pace of deterioration is symptomatic of an economy which is growing beyond its means. We certainly do **not** believe that India is on the brink of an external financing crisis. Apart from anything else, a buoyant services surplus means the current account position is considerably healthier, while dependence on external debt has been cut and foreign exchange reserves amount to roughly USD200bn, equivalent to 20 months of goods imports.

As long as economic growth remains strong and interest rates high the country should continue to more than fund its external shortfall, supporting the rupee. Indeed the FX team are now looking for the INR to strengthen to 39 against the US dollar by end-2007.

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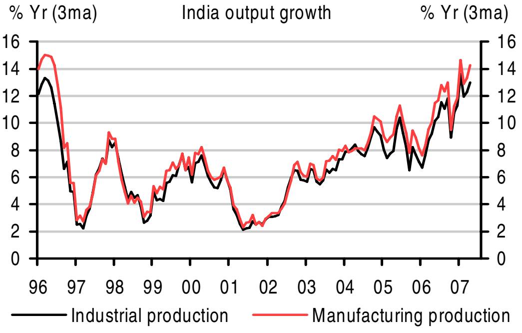
# Indicators & Forecasts

## Indicator watch

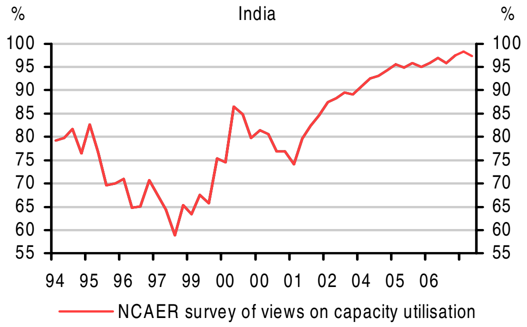



Source: CEIC

### Industrial production

- April saw another extremely strong industrial release, with production rising 13.6% on the year. Admittedly, this was down from the 14.5% rise in March but still more than 2ppts above the market median and one of the highest on record.
- Hence, despite the slowdown in export growth, the weakness in the manufacturing PMI and contracting motor vehicle sales (-6.5% year-on-year in May) there is no hint of an industrial downturn whatsoever. In fact, the chart shows that the trend remains firmly upwards.
- The worry is, however, that final demand, as indicated by the motor vehicle numbers, for example, is slowing but producers are proving slow to respond – the result being that inventories of unsold goods are beginning to build. Unfortunately, the data do not allow us to know whether this is occurring at a macro level but it's certainly a risk.

### Capacity utilisation is still extremely tight




Source: NCAER

### Capacity utilisation

- Given the strength of industrial production and the buoyancy of output in the economy as a whole it is perhaps not surprising that capacity remains extremely tight.
- An Indian research institute, the NCAER, publishes a quarterly survey asking, amongst other things, whether companies are operating "at or above an optimal level of capacity utilisation". The latest numbers for April did drop, but fractionally. According to the survey 97.3% of companies still answered "yes" to this question.
- While fixed asset investment is growing strongly the implication is that capacity is not coming on stream fast enough. The over-capacity problems of the mid-1990s may help explain why some firms have proved cautious in boosting their supply potential this time around.

### Skilled labour shortages


Source: Source: Thomson Financial Datastream

### Labour supply

- The latest World Economic Survey, conducted by the International Chamber of Commerce and Germany's Ifo Institute, showed the balance of companies reporting a lack of skilled labour back at a record high. Clearly the constraints faced by companies are not specific just to physical capital but human capital as well.
- For a country to continue growing strongly, while it is a necessary condition that there is a rapidly expanding workforce (which India certainly enjoys) it is not sufficient. People need to be qualified in the appropriate skills.
- Clearly this suggests that wage and price risks remain high in the country, notwithstanding the recent drop in Wholesale price inflation. We have argued that the latter says more about the drop in international oil and non-oil commodity prices than anything more domestic.

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# Forthcoming economic releases

**For the two weeks commencing 18th June**

| Date | Indicator | Previous | HSBC forecast | Comment |
|---|---|---|---|---|
| 20th | Agricultural workers CPI (May) | 9.4% | 9.0% | CPI inflation facing agricultural workers has remained between 9-10% every month this year and will probably do so again (just) in May. |
| 20th | Rural workers CPI (May) | 9.1% | 8.7% | With the base effects becoming more challenging now, a drop in the year-on-year rate seems likely this month. We are expecting an 8.7% outturn. |
| 25th | Urban non-manual workers CPI (May) | 7.7% | 7.6% | It's very unusual for agricultural/rural workers CPI inflation to have remained above that for urban non-manual employees for as long as it has. We look for a narrowing of the gap. |
| 29th | Industrial workers CPI (May) | 6.7% | 6.6% | Industrial workers are facing the smallest increases in inflation and looks set to remain the case for a few months yet. |
| 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. |

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 below 5% and we expect it to continue softening over coming months, perhaps hitting 4% before the year is out. This largely reflects the impact of softer oil and non-oil commodity price inflation and the strong rupee.
- On interest rates, we continue to look for the CRR to rise another 50bps this year to 7% (probably before the next formal policy meeting in July), with the repo rate up 25bp to 8%. After pausing for the rest of the year, we wouldn't be surprised to see the RBI resume its monetary tightening 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 | 5.2 | 5.0 | 6.4 | 5.5 | 4.5 | 4.3 | 4.0 | 5.0 |
| Consumer prices* | 6.2 | 7.4 | 8.5 | 7.0 | 7.6 | 7.5 | 7.5 | 7.7 | 8.0 |
| 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 | 7.0 | 7.0 | 7.0 | 7.5 | 8.0 |
| 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 | 7.5 | 8.0 | 8.0 | 8.0 | 8.25 | 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

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# Strategy thoughts

## Fixed Income

### INR OIS rates to stabilise around 8-8.25%

OIS rates declined sharply during the last week of May/early June close to zero on indications that RBI had eased its grip on money market liquidity. In response to INR195bn of GOI redemptions on 28 May, RBI belatedly announced only INR50bn of MSS issuance and INR25bn of increased Tbill issuance for the week of 4-8 June.

However, on 8 June after market close, RBI announced further measures to normalise money market conditions by announcing an additional INR120bn of Tbill and GOI issuance to mop up liquidity as well as finance additional GOI funding needs. With these latest funding measures, RBI will fully mop up the expansion of money market liquidity caused by the aforementioned GOI bond redemption and an expected USD4-6bn in IPO inflows from mid-June onwards as money market liquidity will also tighten as a result of an expected INR150bn of advance tax payments during June and INR116bn of net GOI issuance.

**Monthly coupon, redemption and issuance flows (INRbn)**

| | Redemptions | Coupons | Issuances |
|---|---|---|---|
| Apr-07 | 77 | 80 | 220* |
| May-07 | 195 | 121 | 180 |
| Jun-07 | - | 34 | 150 |
| Jul-07 | 30 | 90 | 190 |
| Aug-07 | - | 68 | 170 |
| Sep-07 | - | 52 | 70 |
| Oct-07 | 44 | 92 | - |
| Nov-07 | 6 | 124 | - |
| Dec-07 | - | 46 | - |
| Jan-08 | - | 104 | - |
| Feb-08 | 7 | 81 | - |
| Mar-08 | 5 | 57 | - |

Source: HSBC, RBI; *Includes INR60bn MSS bonds

Hence, the INR OIS curve is expected to bear flatten during the remainder of June on the back of a higher call money rate, though primarily led by higher front-end rates given the following:

- Recurring GOI + MSS issuance has already spurred paying activity in 5yr INR OIS for hedging and positive carry purposes as local banks now reportedly have sufficient GOI inventories to meet their SLR requirements. In turn, the spread between the 5yr INR OIS rate and the 10yr GOI yield has tightened already sharply to only around 6bp;

- Signs of slowing credit growth and headline inflation could potentially lead to some narrowing of corporate credit spreads and bank lending rates over the medium-term. If so, then this implies a flatter INR OIS curve as well as a lower premium in the MIFOR curve.

Nevertheless, RBI is unlikely to be as aggressive as in (late) March given:

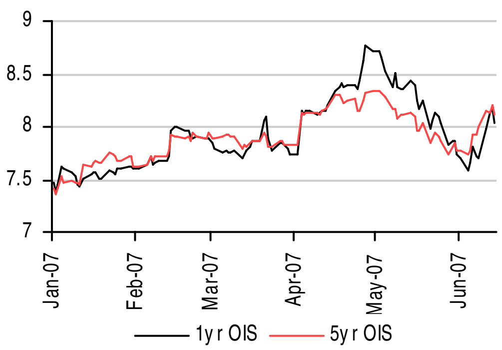
- Signs that inflation and credit growth have peaked (WPI inflation for the week ended 26 May declined to 4.85% and below RBI's 5% target);

- Less political pressure from the government to clamp down on inflation post the Uttar Pradesh state elections;

- Active attempts by RBI to curb INR strength (with external commercial borrowings being a major source of INR inflows in recent months) by easing money market liquidity ahead of its financial year-end at end-June – in part as further INR appreciation below 40 versus the USD could fully deplete RBI's Gold and Currency Revaluation Reserves account (a balance sheet item, which absorbs all unrealised gains & losses on its gold and FX reserves).

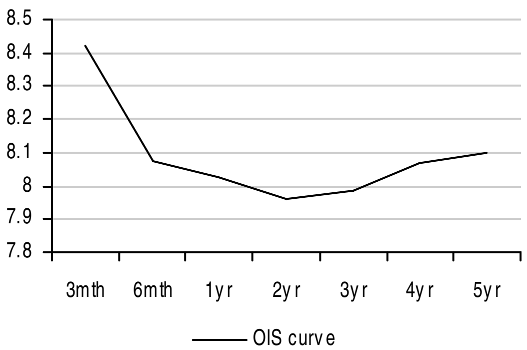
Hence, fair value is seen around 8% for the 1yr INR OIS and 8.10-8.15% for the 5yr INR OIS. Indeed, OIS levels have risen in the past week – closing at 8.04% and 8.12% for the 1yr- and 5yr-OIS, respectively on 14 June. This has been helped by the INR160bn in bond and Tbill issuance this past week.

**1yr and 5yr INR OIS**




Source: Bloomberg

**OIS curve**




Source: Bloomberg

However, this drain in liquidity will likely flow back in to the money market in Jul-07 when the RBI pays a dividend to help finance the government's INR400bn purchase of RBI's stake in the State Bank of India. When liquidity returns, the OIS curve will likely bull-steepen from current levels.

# Equities

## Market view

We continue to hold the view that market is currently trading at rich valuations. BSE Sensex is at 16.3x 12-month forward earnings, and MSCI India is 17.2x 12-month forward earnings. Consensus forecasts earnings to grow at a CAGR of 17.2% during FY08-09e.

Our Sensex target for end-2007 is 13,500, based on a target multiple of 15x 12-month forward earnings.

In the near term, the market faces significant risks including:

1. Earnings deceleration. Earnings growth for stocks in BSE 200 Index in FY03/2007 was 36.5%; this is expected to slow to 17.2% in FY3/2008, half the rate of growth in FY03/2007.

2. Strong equity issuance pipeline for this year is likely to divert funds from secondary to primary markets as well as increasing the risk of rupee appreciation.

3. Strengthening rupee may increase pressure on earnings of export sectors.

4. Likely pressure on margins due to capacity expansion.

5. Slowdown in consumer demand due to monetary tightening. Our economics team expects a further hike of 25bps in the repo rate and 50bps in the Cash Reserve Ratio in 2007. Higher than anticipated tightening presents a major risk.

6. Earnings revisions are thus likely to be downgrades rather than upgrades. Earnings momentum is slipping: FY3/2008 numbers

have been revised down by 2% in the past three months.

7. High valuation levels leave little room for downside surprises in share price performance.

### The attraction of mid caps

According to consensus forecasts, earnings growth in the mid-cap universe is expected at 27.1% in FY08-09 (CAGR) vs. 17.3% for large-cap stocks. Despite their significantly higher growth, mid-caps trade at an 11% discount to large-caps (based on 12-month forward PE).

The combination of cheaper valuation and higher earnings growth is appealing. We think it likely that mid-caps will outperform large-caps in the next year.

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