

January 8, 2011

India Strategy

If Inflation Comes Back...

Research
India

MORGAN STANLEY RESEARCH

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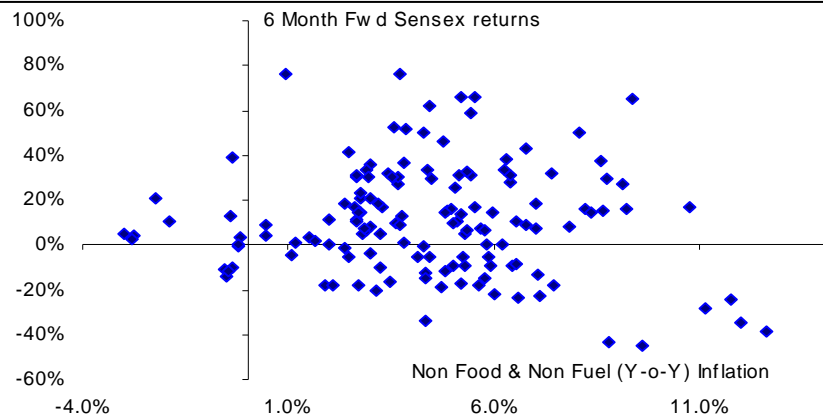
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If Inflation Comes Back...

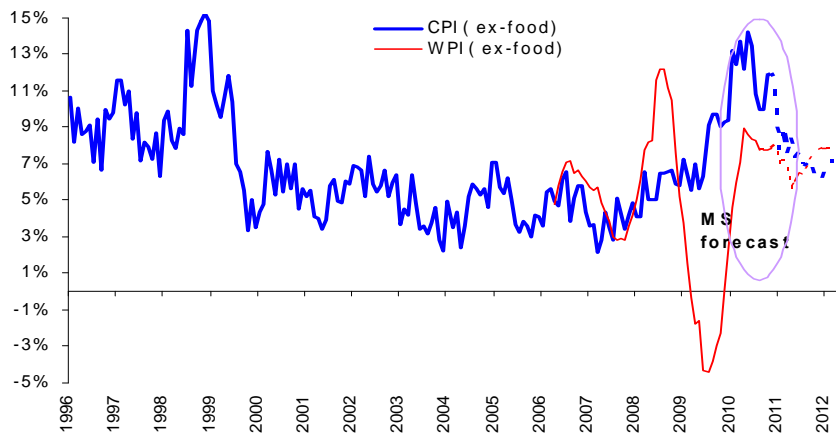
- **Key Debate:** The recent food inflation print has brought the inflation debate back into the market. How is the market likely to respond and which sectors will benefit or lose from the specter of rising inflation?
 - **Our View:** We still think that inflation may have peaked in April 2010 and is likely decelerating into 2011. That said, a rise in oil and agricultural commodities prices will keep inflation risks alive. Recent optimism in developed world growth outlook has increased the risk of a potential rise in crude oil prices to US\$110-120/bbl. It appears that inflation expectations have risen and thus the seasonal variation in food supply is causing a pronounced effect on overall inflation. Even if inflation rises persistently over the coming months, the situation is a bit different than 2009-10 because interest rates are also much higher. Using our current estimate of core inflation and short-term deposit rates, real rates are positive versus deeply negative levels at the start of 2010. However, investors need to be vigilant against persistent food inflation since it has a tendency to reflect into core inflation over time through higher wages.
 - **How does the Market Fare?:** We identify five periods of rising inflation over the past decade. Indian equities have outperformed emerging markets in the first three out of five occasions while performing almost in line with emerging markets in the two most recent episodes of rising inflation. The absolute performance was positive in four out of five of these cycles – the only exception being 2008 when rising inflation coincided with a sharp rise in rates as well as turmoil in global financial markets.
 - **Global Sectors Outperform Led by Energy; Consumer Staples and Telecoms Underperform:** The more solid evidence is with respect to sector performance. Very clearly, global sectors which include materials, energy and technology are outperformers with Energy leading the charge. Conversely, telecoms and consumer staples are consistent underperformers. We are underweight consumer staples and technology and overweight energy, materials and telecoms in our sector portfolio.
 - The historical trends for other sectors are less reliable. Banks, industrials, autos and utilities are mixed bags losing money more often than not.
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Rising Domestic Inflation: Buy Energy, Underweight Telecoms & Consumer Staples

Core Inflation (Currently 7.1%) Needs to Be in Double Digits to Decisively Hurt Equities over the Coming Six Months



Inflation Peak May be Behind Us

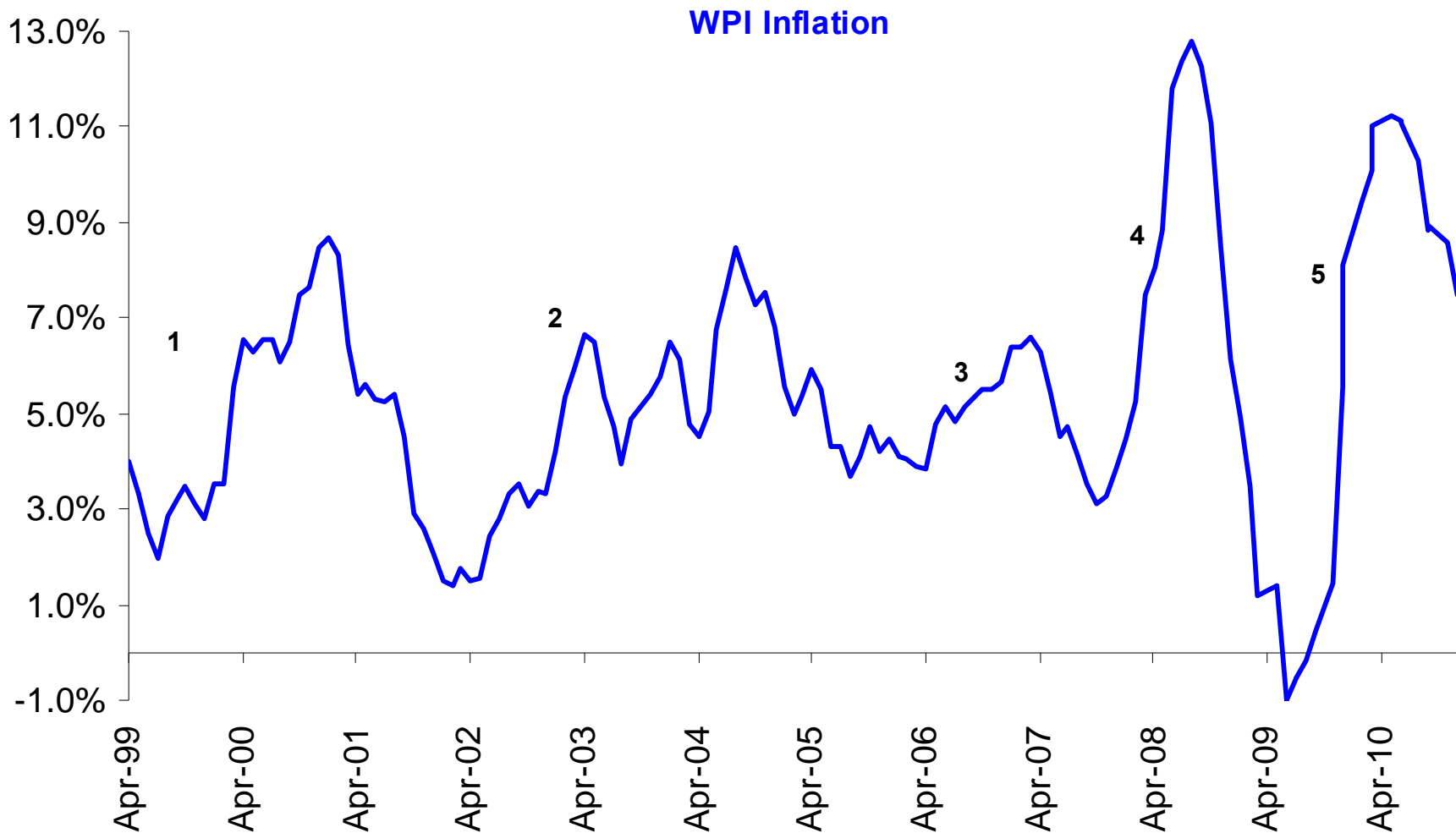


Sector/Market Returns During Inflation Cycles

Start	Jul-99	Feb-02	Aug-05	Oct-07	Jun-09	Average Returns
End	Jan-01	Aug-04	Mar-07	Aug-08	Apr-10	
Auto	-51%	112%	53%	-25%	43%	26%
Bank	-22%	104%	53%	-25%	26%	27%
Div. Fin	344%	NA	NA	-38%	4%	103%
Energy	7%	49%	115%	-14%	0%	31%
Healthcare	8%	36%	19%	23%	45%	26%
Industrial	-25%	170%	74%	-32%	18%	41%
Materials	16%	74%	35%	-34%	51%	28%
Media	NA	-10%	150%	-39%	64%	41%
Property	NA	NA	NA	-49%	-10%	-29%
Staples	-21%	-27%	10%	0%	14%	-5%
Tech	26%	26%	78%	-13%	70%	37%
Telecom	-23%	-33%	33%	-43%	-41%	-21%
Utilities	17%	85%	3%	-28%	1%	16%
MSCI India	2%	36%	62%	-23%	23%	20%
Sensex	-14%	42%	61%	-23%	26%	19%
MSCI EM	-9%	16%	40%	-24%	26%	10%

Sources: Factset, CEIC, Morgan Stanley Research, Morgan Stanley Estimates

Five Inflation Cycles Of the Past Decade



Sources: CEIC, Morgan Stanley Research



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(as of December 31, 2010)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Total	2,838		993		

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