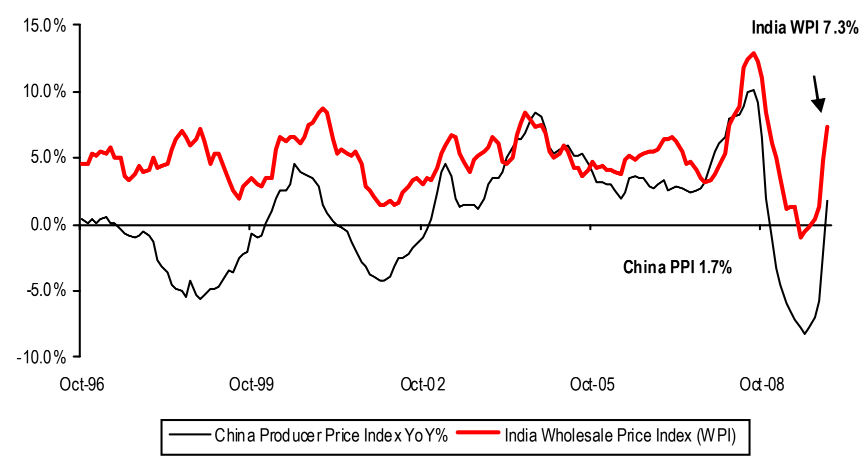
Asia Equity Strategy

Research Analysts
Sakthi Siva
65 6212 3027
sakthi.siva@credit-suisse.com
Kin Nang Chik
852 2101 7482
kinnang.chik@credit-suisse.com

STRATEGY

Downgrade India – not pricing in tightening risk the way China is

Figure 1: **India's WPI versus China's PPI**

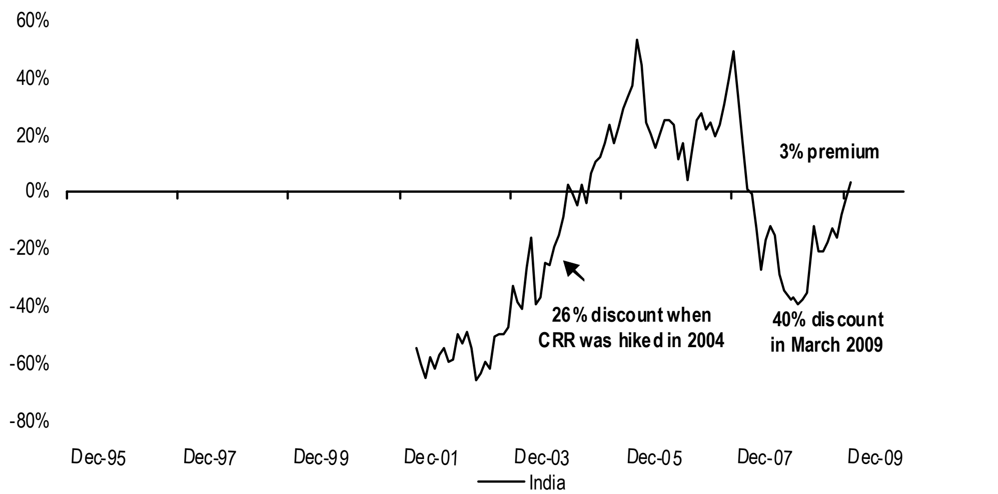


Source: CEIC, Datastream, Credit Suisse estimates

- **Downgrade India from Overweight to UNDERWEIGHT.** We expect India to be the next to tighten, after China. Credit Suisse economists believe India may raise Cash Reserve Ratio (CRR) on 29 January, hike taxes at the upcoming Budget (fiscal tightening as well) on 26 February and raise the more important reverse repo rate in March or April. While this is early-cycle tightening, our concern is that though India's Wholesale Price Index (WPI) is up 7.3% (likely to stay up in 1H10) versus China's Producer Price Index (PPI) up 1.7% (CPI up 1.9%), there appears to be less tightening risk priced into India.
- **Less tightening risk priced into India.** On our P/BV versus ROE valuation model, China H currently trades at a 25% discount to the region, higher than the 17% discount seen after the second RRR hike in April 2004. In contrast, India currently trades at a 3% premium to the region, compared with a 26% discount during the first CRR hike in September 2004 (Figures 2 and 3). India's historical P/E and price-to-cash flow are currently 2x the September 2004 level and dividend yield (DY) is half that level.
- **Sell cyclicals and rate sensitives trading at a premium to the region.** Historically, cyclicals and rate sensitives tend to underperform in a rising interest rate environment. We highlight that India consumer cyclicals are trading at a 67% premium to the region, real estate at 24% and materials at 7%. India banks, however, are trading at a 31% discount.

Focus charts

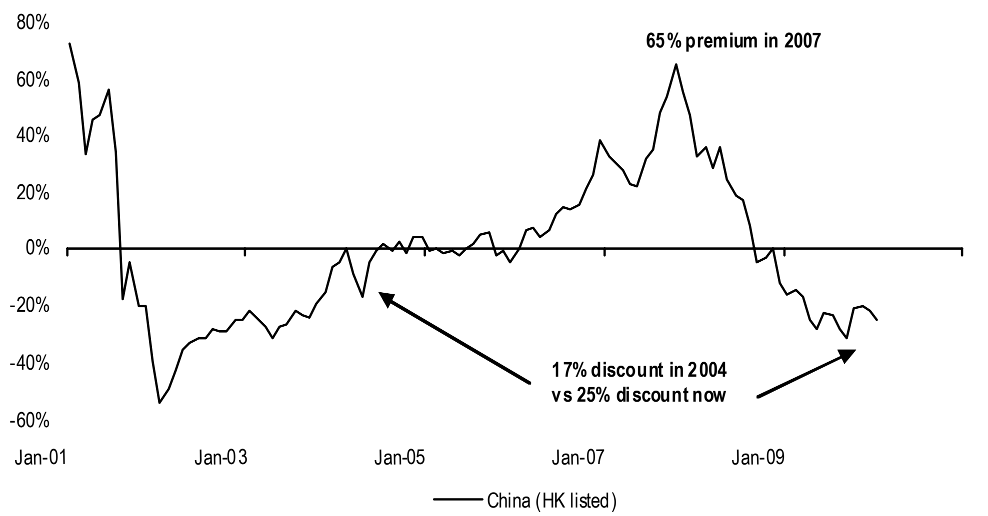
Figure 2: India – P/B versus ROE relative to the region



Source: Company data, Credit Suisse estimates

India is trading at a 3% premium to the region, compared with a 26% discount at the time of the first CRR hike in 2004

Figure 3: China H – P/B versus ROE relative to the region



Source: Company data, Credit Suisse estimates

China H currently trades at a 25% discount to the region, compared with a 17% discount in April 2004 after the second RRR hike

Downgrade India – not pricing in tightening risk the way China is

Having been bullish on India, and particularly India IT, over the past year, we have been suggesting in our recent notes that India looks less exciting from a valuation perspective (see our notes, *India Overweight – but becoming less interesting from a valuation perspective,* 8 January 2010, and *Early cycle Tightening – will the focus shift from China to India,* 26 January 2010). As Figure 2 highlights, India has moved from a 40% discount on our P/BV versus ROE valuation model in March 2009 to a 3% premium currently.

India has moved from a 40% discount to the region to a 3% premium now

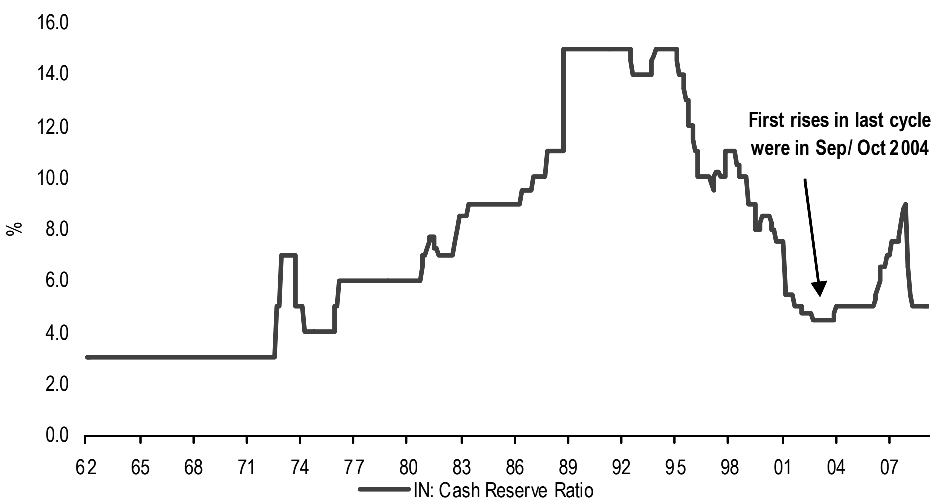
Our concern now is the sharp fall in China H shares with the first Reserve Ratio Requirement (RRR) hike on 12 January 2010. China H shares were trading at an 18% discount to the region on our P/BV versus ROE valuation model, but have fallen 13% since then. Credit Suisse economists think the Reserve Bank of India (RBI) may hike CRR at its 29 January meeting. They also expect taxes to be hiked in the upcoming Budget on 26 February and the more important reverse repo rate to be hiked in March or April.

CS economists believe India may raise CRR on 29 January

Raise taxes in the upcoming Budget in February

Raise reverse repo rate in March or April

Figure 4: India – Cash Reserve Ratio (CRR)

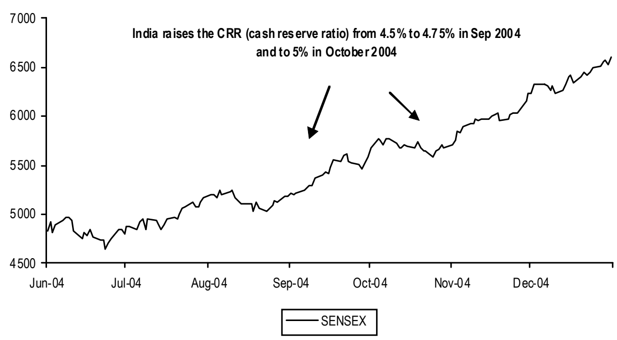


Source: Datastream, Bloomberg

While the first CRR hike in September 2004 was followed by mild corrections, valuations today are quite different from those in 2004. Figure 6 highlights that the current historical P/E of 21x is almost twice the September 2004 P/E of 12x.

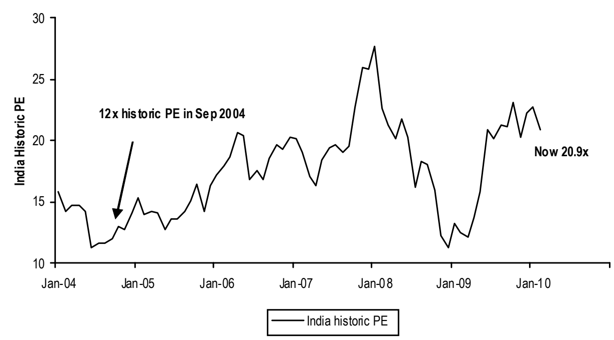
Previous CRR hikes saw mild corrections, but historical P/E today is twice those levels

Figure 5: Sensex daily during hike in CRR in 2004



Source: Datastream

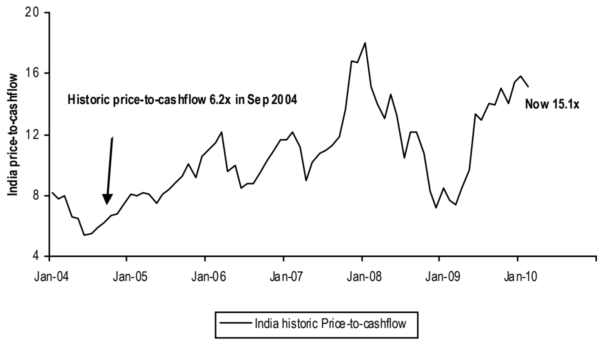
Figure 6: India – historical P/E



Source: Datastream

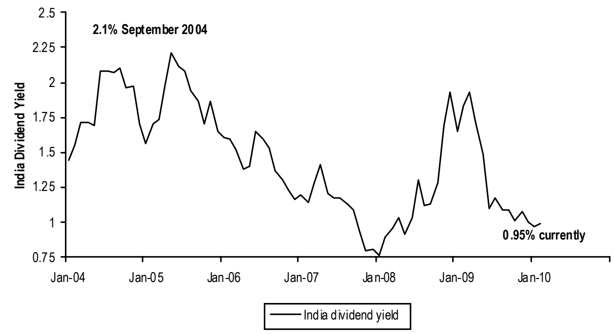
Furthermore, India's price-to-cash flow is at 15.1x, more than twice the September 2004 level of 6.2x. Figure 8 highlights that India's dividend yield (DY) of 0.95% is also half the September 2004 level of 2.1%.

Figure 7: India – price-to-cash flow



Source: Datastream, Credit Suisse estimates

Figure 8: India – dividend yield (DY)

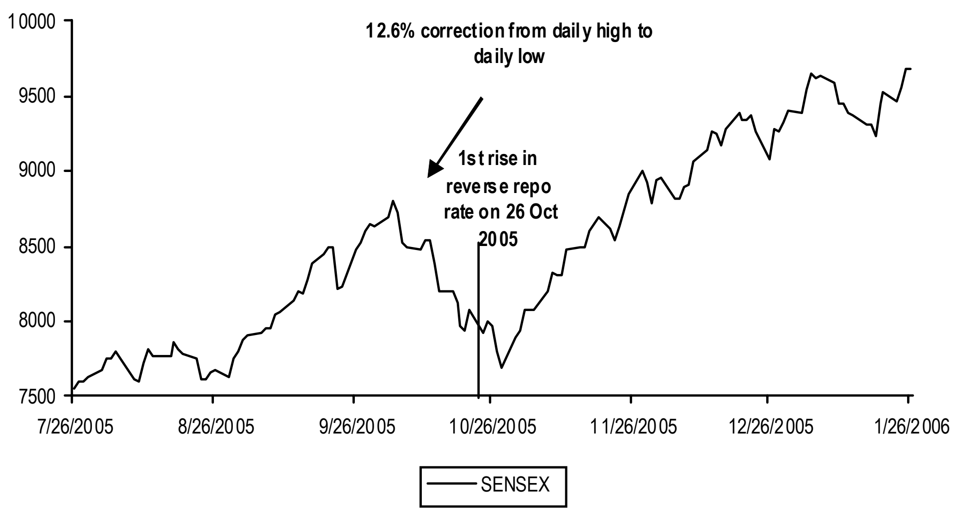


Source: Datastream, Credit Suisse estimates

Although Credit Suisse economists do not expect a hike in reverse repo rate until March or April, Figure 9 highlights that the Sensex's 12% fall mostly occurred in the month prior to the first reverse repo rate hike in the 2005 tightening cycle.

Figure 9: Sensex – daily movement during the first hike in reverse repo rate in 2005

Sensex's 12% fall mostly occurred prior to the first reverse repo rate hike in October 2005



Source: Datastream

Although this is early-cycle tightening in India, India equities do not appear to be pricing in this risk, despite a large movement in India bond yields.

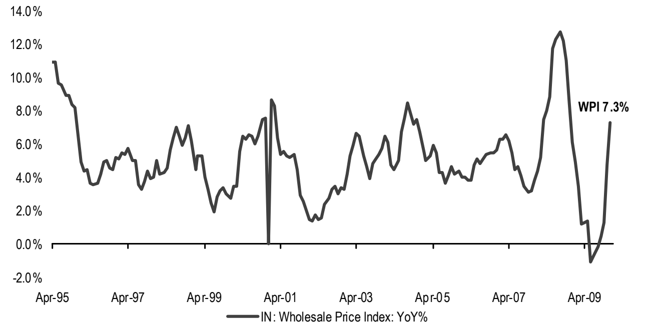
India bond yields have risen by almost 200 bp from their December 2008 lows

Figure 11 highlights that India bond yields have risen by almost 200 bp, from a low of 5.6% in December 2008 to 7.5% in January 2010. While a part of the rise may be attributed to depressed levels, bond yields have risen between 100 bp to 150 bp in the past nine months. Yet, the Sensex is down only 6% from its recent high.

India's consensus EPS upgrades lag the region

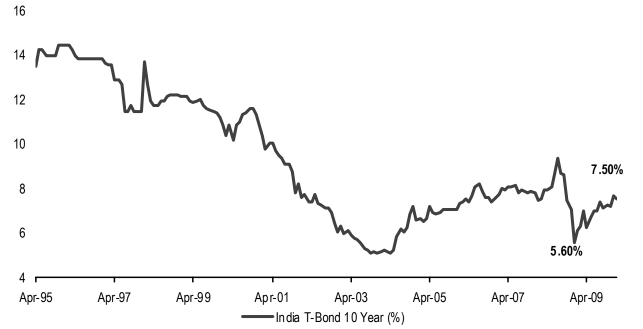
And while it could be argued that a 3% premium for India is not that high, we note that India traded at high premiums when its consensus EPS revisions were much stronger than that of the region. Over the past six months, however, consensus EPS revisions in India have lagged the region. For 2010E consensus EPS, India was +0.6% versus +1.1% for the region in January. In the prior month, India was +0.1% versus +0.9% for the region.

Figure 10: India – WPI (YoY %)



Source: Datastream

Figure 11: India – bond yields

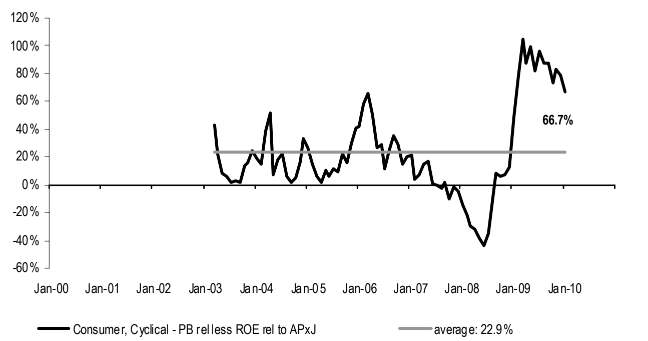


Source: Datastream

Historically, interest rate sensitive sectors and cyclicals tend to underperform in a rising interest rate environment. Figure 12 highlights that India consumer cyclicals are trading at a 67% premium to the region. While the premium for the materials sector is only 7%, it is close to the highest premium that the sector has ever commanded (Figure 13).

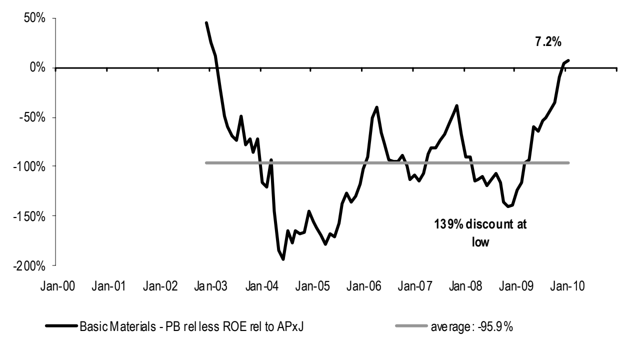
India consumer cyclicals are trading at a 67% premium to the region

Figure 12: India consumer cyclicals – P/B versus ROE versus region



Source: Company data, Credit Suisse estimates

Figure 13: India materials – P/B versus ROE versus region

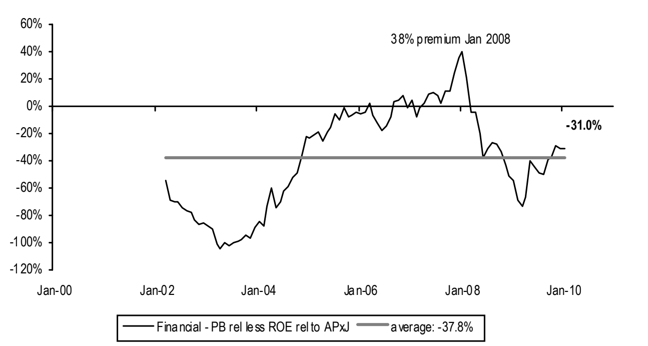


Source: Company data, Credit Suisse estimates

While interest-rate sensitives also tend to underperform in a rising rate environment, we highlight that India banks are trading at a 31% discount to the region (Figure 14). Figure 15 highlights that India real estate sector is trading at a 24% premium.

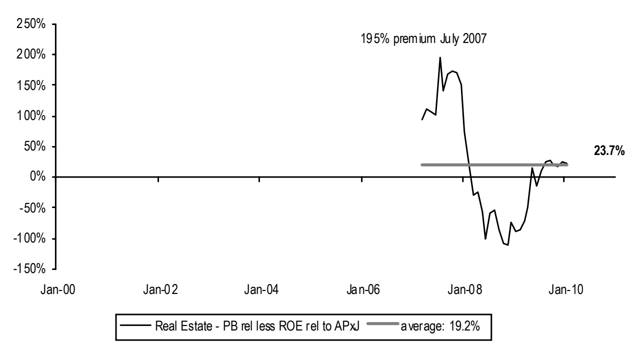
India real estate trades at a 24% premium

Figure 14: India financials – P/B versus ROE versus region



Source: Company data, Credit Suisse estimates

Figure 15: India real estate – P/B versus ROE versus region



Source: Company data, Credit Suisse estimates

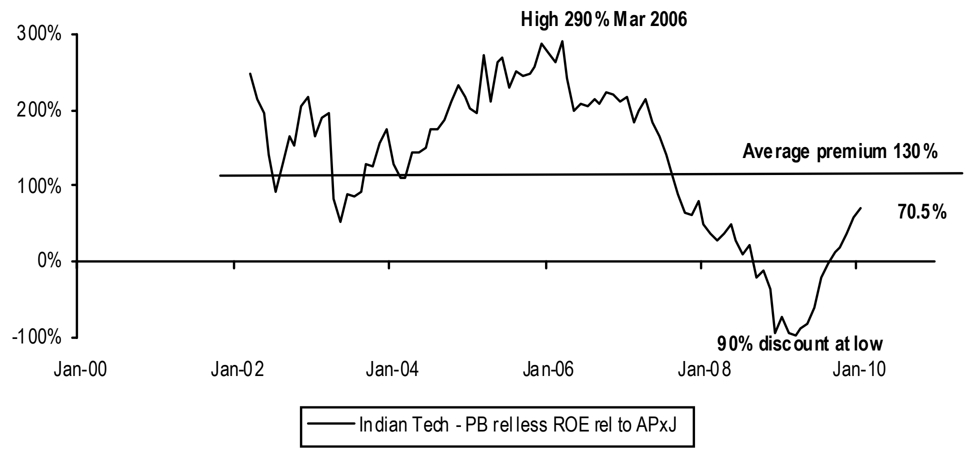
Model portfolio changes

We reduce India from 2% Overweight to 2% UNDERWEIGHT, largely by dropping Tata Steel (2.5% weighting) and reducing our weighting in Infosys (from 4% to 3%). Although we continue to like India IT as a play on global capex recovery, the sector is currently trading at a 71% premium to the region (Figure 16).

Moving from 2% Overweight to 2% Underweight in India

Figure 16: India IT – P/B versus ROE versus region

Drop Tata Steel and reduce our weighting in Infosys in our model portfolio

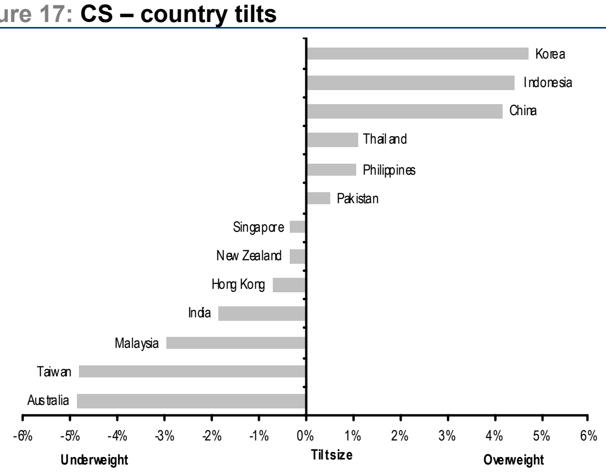


Source: Company data, Credit Suisse estimates

We increase our weighting in China H shares, given its 25% discount to the region, by including Bank of China (BOC) and Yanzhou Coal into our model portfolio. We had highlighted in our note, *What stocks to buy after this correction?*, 28 January 2010, that eight of the top ten stocks using a Quant screen (percentage decline from 11 January highs, low 2010E P/E, low 2010E P/B, high 2010E dividend yield and an OUTPERFORM rating by CS analysts) were China stocks and three of them were banks, with Bank of China ranking third on that screen. Yanzhou Coal ranked tenth.

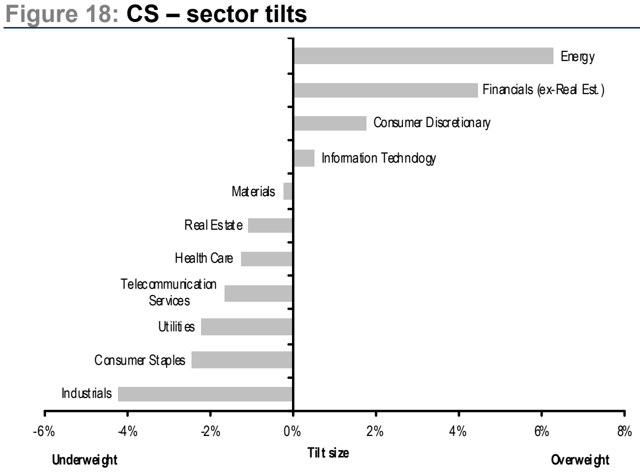
We increase our weighting China by including Bank of China and Yanzhou Coal

Figure 17: CS – country tilts



Source: MSCI, Credit Suisse estimates

Figure 18: CS – sector tilts



Source: MSCI, Credit Suisse estimates

Figure 19 illustrates our revised model portfolio.

Figure 19: CS – model portfolio

	Australia		Hong Kong/China		Korea		Taiwan		Singapore/Malaysia		TIPs		India/ Pakistan		Total
Consumer Discretionary			Skyworth	1.0%	Hyundai Mobis	4.0%					Astra	2.5%			7.5%
Consumer Staples	Woolworths	3.5%													3.5%
Energy			CNOOC	3.5%							ITMG	2.0%	Pak Petroleum	0.5%	14.0%
			Shenhua	3.5%							United Tractors	2.0%			
			Yanzhou Coal	1.0%							Banpu	1.5%			
Financials	Westpac	5.0%	CCB	5.0%	KB Financial	3.0%			UOB	3.0%	BAY	1.0%	Punjab National Bank	1.0%	32.0%
(ex-Real Est.)	CBA	7.0%	ICBC	3.5%	Daegu Bank	1.0%					Metrobank	0.5%			
			BOC	2.0%											
Health Care															0.0%
Industrials			Cathay	1.0%	Hyundai Heavy	2.0%			SIA	1.5%					4.5%
Information Technology					SEC	3.5%	Hon Hai	3.0%					Infosys	3.0%	14.5%
							AU Optronics	3.0%					TCS	2.0%	
Materials	BHP	4.5%			POSCO	5.0%									13.0%
	Rio Tinto	3.5%													
Real estate			SHK Properties	2.0%											6.0%
			Wharf	3.0%											
			Great Eagle	1.0%											
Telcos			China Mobile	2.0%			Chunghwa Telecom	1.0%			PLDT	1.0%			4.0%
Utilities			Guangdong Investment	1.0%											1.0%
Total		23.5%		29.5%		18.5%		7.0%		4.5%		10.5%		6.5%	100.0%
Rel. to MSCI AC APxJ		-5.2%		3.4%		4.7%		-4.8%		-3.3%		6.6%		-1.9%	0.0%

Source: MSCI, Credit Suisse estimates

Companies Mentioned *(Price as of 27 Jan 10)*
Astra International (ASII.JK, Rp34350.00, OUTPERFORM [V], TP Rp39500.00)
AU Optronics (2409.TW, NT$36.65, OUTPERFORM [V], TP NT$48.00)
Bank of Ayudhya (BAY.BK, Bt19.00, OUTPERFORM, TP Bt25.50)
Bank of China Ltd (3988.HK, HK$3.67, OUTPERFORM, TP HK$5.44)
Banpu Public Co Ltd (BANP.BK, Bt532.00, OUTPERFORM [V], TP Bt637.00)
BHP Billiton Limited (BHP.AX, A$40.70, NEUTRAL, TP A$45.00)
Cathay Pacific (0293.HK, HK$12.90, OUTPERFORM, TP HK$16.90)
China Construction Bank (0939.HK, HK$5.94, OUTPERFORM, TP HK$8.54)
China Mobile Limited (0941.HK, HK$73.90, OUTPERFORM, TP HK$105.00)
China Shenhua Energy Company Limited (1088.HK, HK$33.50, OUTPERFORM [V], TP HK$45.00)
ChungHwa Telecom (2412.TW, NT$58.10, OUTPERFORM, TP NT$66.36)
CNOOC Ltd (0883.HK, HK$11.02, UNDERPERFORM [V], TP HK$9.98)
Commonwealth Bank of Australia (CBA.AX, A$55.10, UNDERPERFORM, TP A$54.00)
Daegu Bank (005270.KS, W14,900, OUTPERFORM [V], TP W20,100)
Great Eagle Hdg. (0041.HK, HK$19.58, OUTPERFORM [V], TP HK$27.75)
Guangdong Investment (0270.HK, HK$3.90, OUTPERFORM, TP HK$4.47)
Hon Hai Precision (2317.TW, NT$133.00, OUTPERFORM, TP NT$171.00)
Hyundai Heavy Industries (009540.KS, W193,500, UNDERPERFORM [V], TP W135,000)
Hyundai Mobis (012330.KS, W144,000, NEUTRAL [V], TP W166,000)
Industrial & Commercial Bank of China (1398.HK, HK$5.62, OUTPERFORM, TP HK$7.37)
Infosys Technologies Ltd. (INFY.BO, Rs2502.40, OUTPERFORM, TP Rs2900.00, MARKET WEIGHT)
KB Financial Group (105560.KS, W49,650, OUTPERFORM [V], TP W70,000)
Metropolitan Bank & Trust (MBT.PS, P41.00, OUTPERFORM [V], TP P59.00)
Pakistan Petroleum Ltd (PPL.KA, PRs191.55, OUTPERFORM, TP PRs228.00)
Philippine Long Distance Telephone (TEL.PS, P2660.00, OUTPERFORM, TP P3120.00)
POSCO (005490.KS, W555,000, OUTPERFORM, TP W675,000)
PT Indo Tambangraya Megah (ITMG.JK, Rp31950.00, NEUTRAL [V], TP Rp32000.00)
Punjab National Bank Ltd (PNBK.BO, Rs862.00, OUTPERFORM [V], TP Rs1039.00)
Rio Tinto Limited (RIO.AX, A$71.44, UNDERPERFORM [V], TP A$75.00)
Samsung Electronics (005930.KS, W800,000, OUTPERFORM, TP W940,000)
Singapore Airlines (SIAL.SI, S$13.50, OUTPERFORM, TP S$16.70)
Skyworth Digital (0751.HK, HK$6.80, OUTPERFORM [V], TP HK$11.35)
Sun Hung Kai Properties (0016.HK, HK$101.40, OUTPERFORM [V], TP HK$133.96)
Tata Consultancy Services (TCS.BO, Rs742.25, OUTPERFORM, TP Rs900.00, MARKET WEIGHT)

United Overseas Bank (UOBH.SI, S$17.92, OUTPERFORM, TP S$23.00)
United Tractors (UNTR.JK, Rp16750.00, OUTPERFORM [V], TP Rp21500.00)
Westpac Banking Corporation (WBC.AX, A$24.58, UNDERPERFORM, TP A$26.00)
Wharf Holdings (0004.HK, HK$38.30, OUTPERFORM [V], TP HK$50.22)
Woolworths (WOW.AX, A$26.19, OUTPERFORM, TP A$32.00)
Yanzhou Coal Mining Co. (1171.HK, HK$16.28, OUTPERFORM [V], TP HK$20.50)

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CREDIT SUISSE (Hong Kong) Limited
Asia/Pacific: +852 2101-6000