Strategy In-Depth

COUNTRY RESEARCH

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India Equity Strategy

Playing Contrarian Again; Revisit Rate, Credit Sensitives

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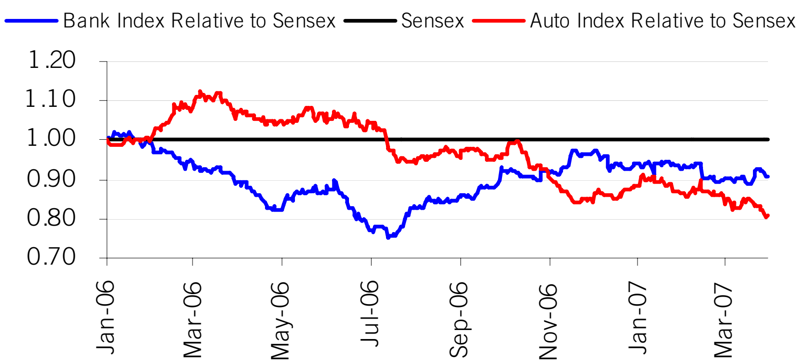
- Crescendo approaching on inflation, liquidity, rate concerns — After another round of liquidity tightening and rate hike by the central bank, equities have taken a further beating. We think this may well mark the peak of concerns on inflation, liquidity and rates. Inflation should get lower in a couple of months, while slower credit growth should ease the liquidity crunch. Emergence of those trends in coming months should also make the central bank also less hawkish.

- Time to revisit rate, credit sensitivities — Pointing to threats from rising inflation, higher rates and impending credit growth moderation, we have been Underweight on rate- and credit-sensitive sectors since mid-2006. The story has mostly played out. Likely further correction and volatility in coming days should present value opportunities.

- Raising Banks to Overweight, Autos to Neutral — There are three key rate and credit sensitive plays in the Indian market: autos, banks and real estate. We raise Banks to Overweight and Autos to Neutral (both were Underweight earlier). The impact on volumes and pricing in the real estate sector is likely to be felt longer.

- Has tightening gone too far? — The key question now is whether tightening measures and rate hikes have been too much, too fast. Credit growth slowing below 20% will be a risk to growth forecasts and needs close monitoring.

Figure 1. India Banks, Autos Performance Relative to Sensex (Multiple)



Source: Citigroup Investment Research

See Appendix A-1 for Analyst Certification and important disclosures.

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Playing Contrarian Again; Revisit Rate, Credit Sensitivities

Pointing to concerns regarding inflation, interest rates and the impending credit growth moderation, we have been Underweight on key rate- and credit-sensitive sectors since 3Q2006. With the latest round of aggressive liquidity tightening and rate hikes by the RBI, we think a peak might be approaching in concerns on these factors. We think inflation and credit growth will both head lower in the coming 2-3 months, making the RBI less conservative. We raise Banks to Overweight and Autos to Neutral in our Model Portfolio.

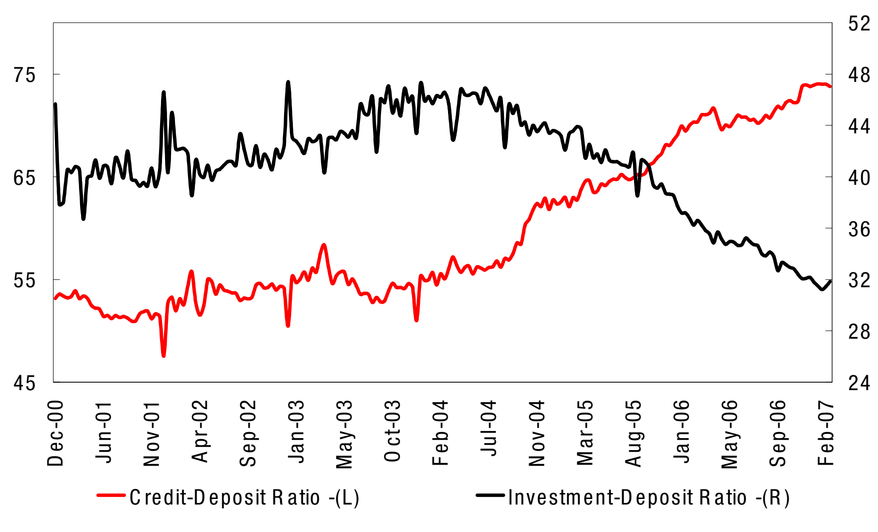
While attempts to rein in excessive credit growth and inflation are all welcome, the risk is whether the tightening and rate hikes have been too much, too fast. Credit growth slowing to below 20% will be a risk to growth forecasts and needs close monitoring.

Peak approaching on inflation, liquidity, rates

Excessive credit growth and the banking system's ability to sustain that without creating a liquidity crunch, as well as higher rates and inflation, have been of concern to us for since 3Q2006. Due to these factors, we have been Underweight key rate and credit sensitive sectors since 3Q2006 (refer to India Equity Strategy notes *'Back From The Bubble Zone: Looking For Consolidation'* 5 July 2006 and *'The Coming Bite From Sticky Lending Rates'* 11 September 2006).

With credit deposit ratios below 50% around three years ago (maximum allowed around 74%), the banking system had the luxury of lending out almost every incremental rupee of deposit. That helped sustain a credit growth of 30-35% despite deposit growth being around 20%. Although deposit growth has been increasing, it is still not sufficient to fund such a high credit expansion. As credit deposit ratios breached 70% few months ago, something had to give, i.e. either credit had to slow down or a liquidity crunch causes an interest rate spike. The former would have been a more palatable option, as an interest rate spike has the danger of hurting some long-term growth drivers for India.

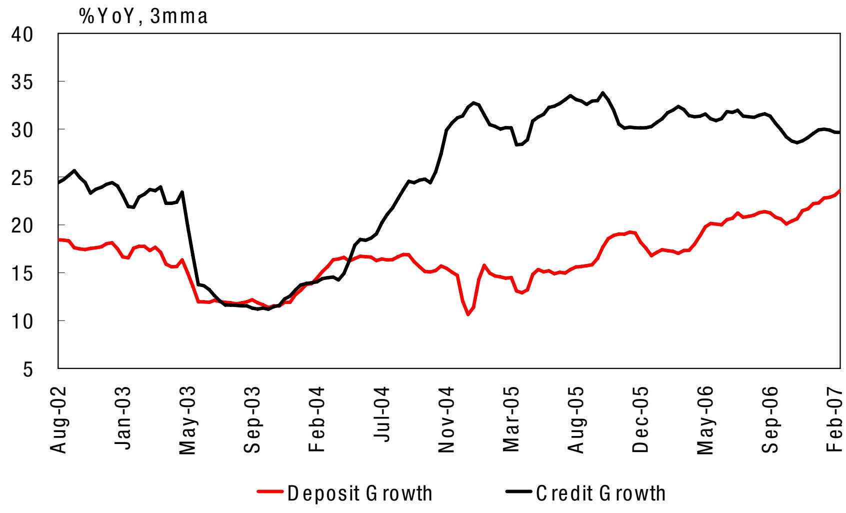
Figure 2. Trends in Indian Credit and Investment Deposit Ratios (Percent)



Source: RBI

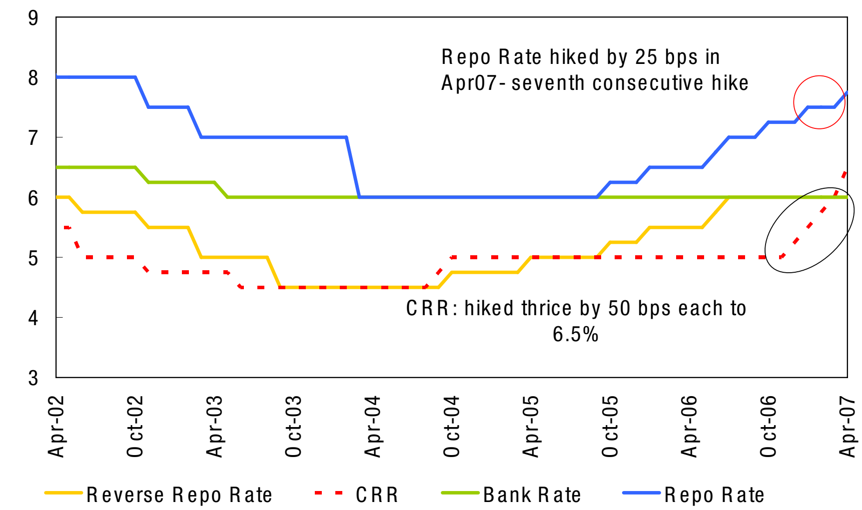
Unfortunately, the preferred scenario of slower credit growth sorting out liquidity crunch, rates and inflation issues didn't materialize. Through a combination of tough talk and tighter norms, the RBI did try to slow credit in the last few months, but did not succeed. As a consequence, the central bank resorted to aggressive pull-out of excess liquidity from the banking system through a series of CRR increases and rate hikes (see Figure 3), catching the system off balance and resulting in call money rates shooting up to as high as 50-60% on some recent days. The less preferred scenario of an interest rate blow-out is now here.

Figure 3. India Credit and Deposit Growth (Percent YoY, 3mma)



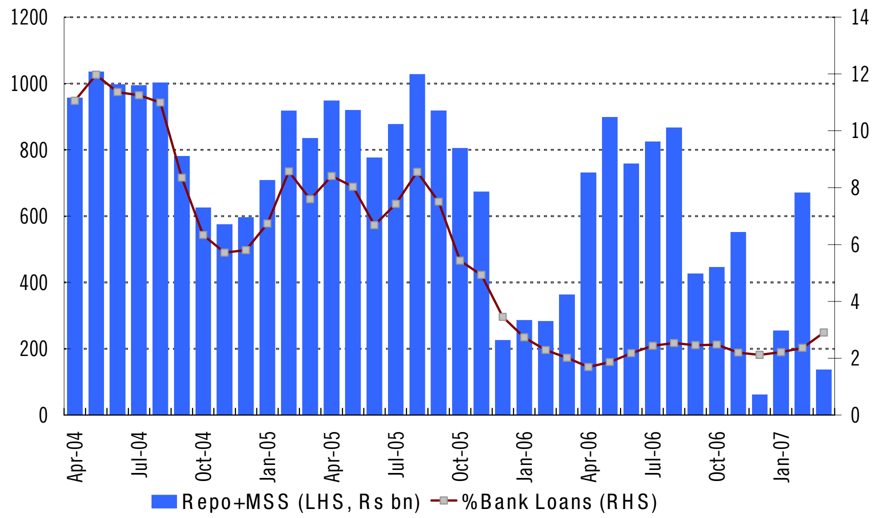
Source: RBI

Figure 4. India: Key Monetary Policy Moves



Source: Citigroup Investment Research

Figure 5. Shrinking Liquidity in the Indian Banking System

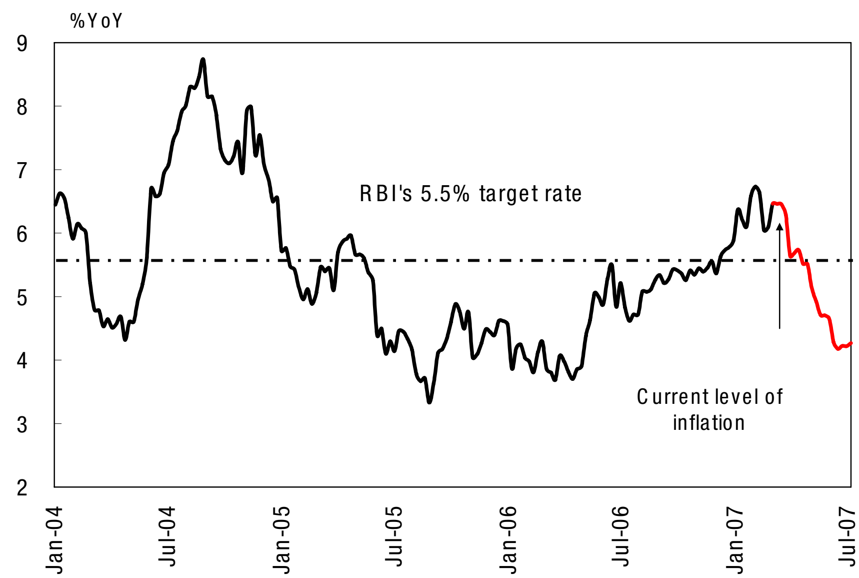


Source: Citigroup Investment Research

Inflation and credit growth expected to moderate going forward

Gloomy as it seems right now, we now see the concerns on inflation, liquidity crunch and excess credit growth close to peaking. Liquidity tightening, interest rate hikes, recent policy measures (fuel price cut, import tariff cuts on commodities) and the base effect should together get inflation indicators trending down . Our economist Rohini Malkani expects WPI to be at around 5% by May-June. By then, we also expect credit growth moderation to around 20-25% (vs. near-30% currently and 30-35% over last two years). If both these trends do materialize as we expect, the RBI may be less hawkish.

Figure 6. India Inflation - WPI

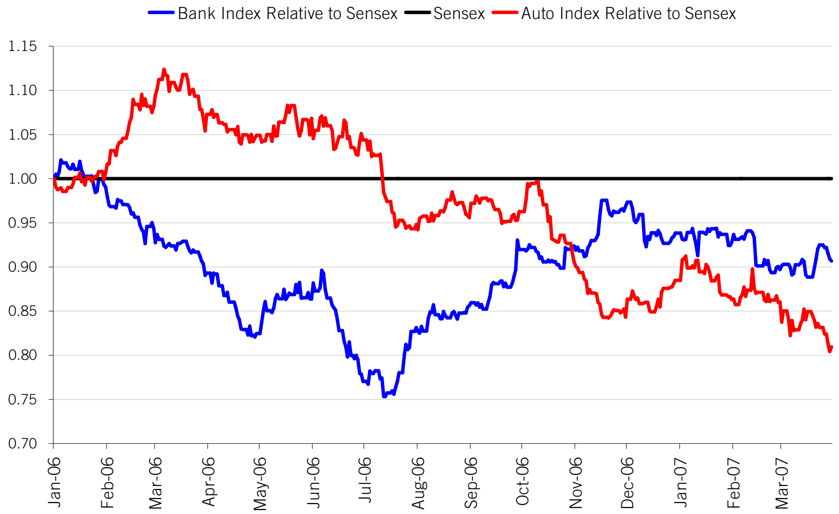


Source: Citigroup, *India Economics, 2 Apr 2007, Rohini Malkani and Anushka Shah*

Playing contrarian again. Time to revisit rate, credit sensitivities

As the scenario of high credit growth, rising inflation, liquidity tightening and interest rates have played out, key sectors and stocks sensitive to rates and credit (autos, banks, real estate) have underperformed the market significantly.

Figure 7. India Banks, Autos Performance Relative to Sensex (Multiple)



Source: Citigroup Investment Research

A cool-off in inflation and credit growth may only unfold gradually in coming weeks. But just as the time to position against the rate and credit sensitivities was well before the adverse trends set in, investors need to be early in looking for value opportunities in the space.

We are raising Banks to Overweight and Autos to Neutral in our Citigroup India Model Portfolio (both Underweight earlier).

Our India bank analyst Aditya Narain in a recent note (refer *India Banks CRR Hike: As the RBI Cuts Out Risk, Is It Time To Take Some?* 1 Apr 2007, https://www.citigroupgeo.com/pdf/SAP04060.pdf) has highlighted the fact that banks are likely to move with higher rates to protect profitability, with growth as the likely compromise (more specifically in the consumer segment). Asset quality concerns will no doubt rise as higher rates impact demand growth in the economy and raise interest costs – but the overall health of the banking system is still not in question. Overall, the banking sector should remain healthy and profitable, albeit with slower growth. With growth more a question mark, government banks at cheaper valuations appear better positioned than private banks. We are consequently adding three public sector banks (Canara Bank, State Bank of India and Punjab National Bank) to our portfolio at the expense of the private banks previously held in the portfolio, HDFC (HDFC.BO - Rs1,497.25), HDFC Bank (HDBK.BO - Rs916.20), and Federal Bank (FED.BO - Rs205.35).

In Autos, we have already modeled in slower growth expectations and conservative pricing for FY08E (CVs 5%, cars 12%, motorcycles 10%). Any further adverse impact from tighter liquidity and higher rates will have moderate downside. Our Auto sector weighting is raised to Neutral only from Underweight, as we are still concerned about the competitive pressures and profitability of the two-wheeler segment. Adding Maruti Udyog to the model portfolio.

Real estate is another key sector which is very sensitive to rates and liquidity. Given the sharp real estate price inflation in recent years and the tendency of developers to try to hold prices, the impact of higher rates on pricing and volumes may be a little more prolonged. Unlike Autos, there is also some price deflation risk here and we still advise caution on the sector.

Utilities and high dividend yield stocks have done well in 2007 year-to-date in the face of a sharp market correction. With their job done as relatively better places to hide in the event of a market correction, we are now removing GAIL (GAIL.BO - Rs285.30; 1L), NTPC (NTPC.BO - Rs160.95; 1L) and ONGC (ONGC.BO - Rs847.20; 1M) from the model portfolio.

We are also adding Reliance Communications and Zee Telefilm to the model portfolio, to take advantage of the recent correction and increasing weighting in defensive, visible growth sectors.

Has tightening gone too far, too fast?

A key concern at this stage has to be whether the central bank has gone too far and too fast in tightening liquidity and raising rates. Some key components of India's core growth story (capex, urban consumption) need a reasonably liquid banking system and affordable cost of funds. Choking liquidity too much may damage some of those growth drivers still in their infancy stage, hurting overall economic growth prospects and investor sentiment. While credit moderation is expected, we would view any sustained slowdown in credit growth below 20% (vs. 30-35% last couple of years) as a risk to growth forecasts for the economy as well as corporate earnings. Hence, credit growth trends in coming months need close monitoring.

India Model Portfolio

								FY08E			
	3-Apr-2007 (Rs)	YTD Perf (%)	RIC Code	Analyst's Rating	MSCI Weight (%)	Portfolio Weight (%)	OW/UW Rel. to MSCI (bps)	PE (x)	EPS Growth (%)	PB (x)	ROE (%)
Automobiles and Components					5.0	5.0	0				
Maruti Udyog	756.0	(18.5)	MRTI.BO	1L		2.0	O/W	13.6	8%	2.6	21%
Tata Motors	681.1	(24.3)	TAMO.BO	1L		3.0	O/W	12.3	22%	3.2	30%
Banks & Diversified Financials	-	-			21.6	24.0	237				
Canara Bank	183.7	(33.5)	CNBK.BO	2M		5.0	O/W	5.2	18%	0.8	17%
ICICI Bank	804.0	(9.7)	ICBK.BO	1L		7.0	U/W	17.6	17%	2.6	15%
Punjab National Bank	427.0	(15.8)	PNBK.BO	1M		4.0	O/W	7.1	33%	1.1	17%
State Bank of India	926.8	(25.6)	SBI.BO	1L		8.0	O/W	9.7	17%	1.4	15%
Capital Goods		-			9.1	12.0	285				
Bharat Heavy	2,254.0	(1.9)	BHEL.BO	1L		5.0	O/W	18.8	25%	4.6	28%
Jaiprakash	526.7	(27.5)	JAIA.BO	2L		2.0	O/W	25.3	28%	3.5	17%
Larsen & Toubro	1,527.4	5.9	LART.BO	2L		5.0	O/W	27.1	32%	6.5	27%
Energy	-	-			17.0	12.0	-496				
Reliance Industries	1,341.2	5.6	RELI.BO	2L		12.0	M/W	18.5	-3%	4.1	24%
Food Beverage and Tobacco, Household & Personal Products					5.7	9.0	330				
Asian Paints	746.6	1.8	ASPN.BO	1L		2.0	O/W	21.3	20%	8.1	41%
Hindustan Lever	198.8	(8.2)	HLL.BO	1L		5.0	O/W	19.6	19%	16.7	87%
United Spirits	811.0	(6.1)	UNSP.BO	1L		2.0	O/W	22.9	46%	5.3	25%
Materials	-	-			6.0	2.0	-396				
Grasim Industries	2,104.4	(24.5)	GRAS.BO	1L		2.0	O/W	11.2	12%	2.6	25%
Pharmaceuticals, Biotechnology, Agrochem				-	5.0	2.0	-295				
United Phosphorus	315.1	4.9	UNPO.BO	1L		2.0	O/W	13.2	58%	3.2	27%
Software & Services		-			21.5	25.0	351				
Infosys Technologies	1,963.8	(12.3)	INFY.BO	1L		13.0	M/W	23.2	29%	7.6	39%
Tata Consultancy Services	1,200.9	(1.5)	TCS.BO	1L		7.0	O/W	22.2	28%	8.9	47%
Wipro	534.2	(11.6)	WIPR.BO	1L		5.0	O/W	21.3	28%	6.7	35%
Telecom Services/Media					5.7	9.0	333				
Bharti Airtel	734.6	16.8	BRTI.BO	1L		4.0	O/W	23.1	46%	7.8	39%
Reliance Communications	401.6	(14.8)	RLCM.BO	1M		3.0	U/W	19.4	51%	4.7	27%
Zee Telefilms	241.0	14.7	ZEE.BO	1L		2.0	O/W	26.1	52%	7.1	28%
Utilities					2.3	-	-234				
Others*					1.1	-	-112				
Cash						-	0				
Total					100.0	100.0		18.1	21%	4.2	26%

Source: Citigroup Investment Research estimates. *Others – Hotels, tech hardware, transportation. Note: This table provides a guideline for the types of stocks that would fit our investment strategy.

Appendix A-1

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