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JPMorgan

Special Focus
2007 poised to be make-or-break year

- **Policymakers face a challenging year as they navigate the economy through the excesses of strong growth**
- **Fullyear GDP growth is forecast to moderate to 7.5%oya next year from 9.1% in the 1H of the current fiscal year**
- **Policymakers are likely to resort to monetary and fiscal measures to check inflation**
- **Government likely to meet this year's fiscal deficit of 3.8% of GDP and forecast deficit of 3.5% for next year**
- **Bonds are expected to rally in 2007; expect a significantly flatter yield curve**
- **INR may strengthen near-term, but is likely to gradually depreciate next year**
- **Equities are headed for a fifth consecutive year of positive returns, though returns in 2007 may be more modest**

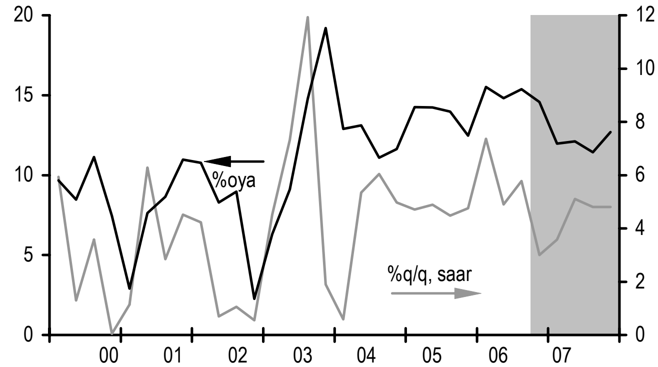
The Indian economy is likely to grow at a slower—but still impressive—pace next year. On JPMorgan's revised forecast, fullyear GDP will likely increase 7.5%oya (revised up from 7.0%) in 2007-08 (year beginning April 1), from an estimated 8.5% in the current fiscal year. GDP growth has averaged 9.1%oya in the first-half of the current fiscal year, and 8.1% annually in the last three years. Growth next year will be again powered by service and industry sectors. The impact of favorable structural changes in the economy has been amplified by easy global liquidity conditions, a domestic bank lending frenzy, and an unprecedented surge in asset prices that have all contributed to the upbeat consumer, business and investor confidence.

In 2007, however, the economy will face less favorable external demand conditions, and the growth momentum will also be impacted by the expected slowdown in the pace of credit expansion. Additionally, the lagged impact of monetary tightening, and the central bank's measures to check the pace of lending to the property sector will also impact consumer spending. However, investment spending will likely maintain its strong momentum owing to higher capex and increased expenditure on physical infrastructure.

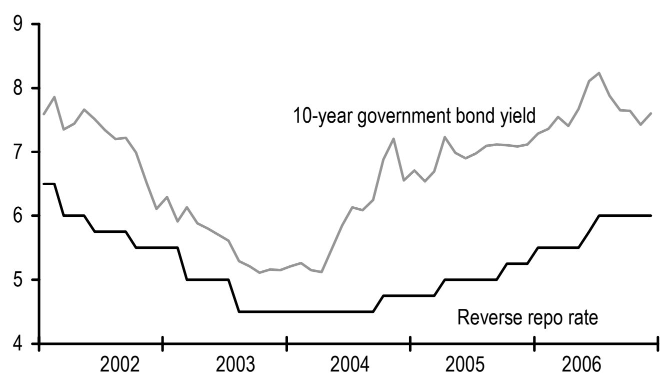
More measures likely to check inflation

Inflation remains a key concern for the government of Prime Minister Manmohan Singh and the Reserve Bank of India (RBI). To be sure, reported WPI over-year-ago inflation is

Real GDP
percent, both scales



Policy rate and 10-year government bond yield
% p.a.



poised to break above the central bank's forecast of 5.0-5.5%oya later this month. The still-strong pace of loan growth and higher inflation were the key reasons behind the RBI's recent two-step hike in the cash reserve ratio (CRR).

Both monetary and fiscal measures will be announced to further check inflationary pressures. JPMorgan maintains that the RBI will hike rates 25bp at the January 30 quarterly policy meeting. The government is also likely to announce cuts in import duties, most likely before the federal budget is announced toward the end of February. Indeed, the peak (or the most often cited) duty will probably be cut to 10% from 12.5%, and duties on intermediate goods will also be lowered. Note that still-high import tariffs remain a key reason for the structural rigidity in India's inflation.

A rate hike in January along with other monetary tightening so far, the expected fiscal measures, and the likely moderation in loan growth should probably stay the central

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bank's hand for the remainder of the year (the key risk is that continued strong capital inflows create challenges for monetary policy and force the central bank to hike CRR again. See more below). Note that recent monetary tightening will be more effective in checking credit expansion as the banks don't have the latitude they enjoyed previously in funding loan growth via running down their holding of government bonds. Most likely, at the April policy meeting, the RBI will announce a WPI inflation forecast range of 5.0-5.5%oya for 2007-08.

Between a rock and a hard place

Indian policymakers have a tightrope to walk over the next 3-6 months at least, as they navigate the economy trough some of the excesses of exceptionally strong growth in recent years. The pace of increase in property prices and the strength of bank lending, especially to the property sector, remain legitimate concerns (see "India's lending frenzy warrants sterner policy response," *Global Data Watch*, Dec 1.) The exceptionally easy global liquidity conditions appear to have amplified capital inflows, which in any case were attracted by the unprecedented growth momentum.

The RBI is correctly worried about the impact of capital inflows on the domestic monetary policy, but appears to be bound by the politicians' gung-ho approach for higher growth. Consequently, the central bank is forced to juggle its policy mix within the constraints imposed by the "impossible trinity". Indeed, if capital inflows remain strong into 2007 and challenges the efficacy of monetary policy, the central bank may not have much of a choice but to hike CRR again.

Specter of the mid-1990s tightening rears its head

Investors are likely to compare the current economic conditions with the situation in the mid-1990s and the heavy-handed response by the RBI to check rising inflation (see box). However, there are critical differences between the two periods that should not be ignored. In particular, the corporate sector's over-investment drive back then despite being unprepared to compete in a more liberalized environment following the 1991 economic reforms, a still-tentative industrial recovery, and stratospheric equity market valuation were key reasons for the subsequent bust.

The economic situation now is vastly different, despite some signs of excesses in property-related lending. To be sure, industrial activity is on a more solid footing, and corporates, partly owing to the nasty memories of the mid-1990s, have been more cautious in their expansion plans. Additionally, the emergence of favorable structural factors, and the significant change in the balance of payments suggest that the economy will be able to withstand gradual monetary tightening. Finally, unlike the mid-1990s experience, the changes in and the performance of corporate India and the increased spending on the long neglected physical infrastructure are key confidence-inspiring shifts. Most likely, it was perhaps the unpleasant experience of the mid-1990s that prompted the RBI to kickoff the monetary tightening cycle as early as September 2004, and move in small steps at a gradual pace. Admittedly, there is some froth following the brisk pace of growth and easy liquidity conditions, and the high expectations, but all monetary tightening cycles do not result in a bust.

Revisiting the monetary tightening overkill of the mid-1990s

Current Prime Minister Manmohan Singh was finance minister (1991-96) in Narasimha Rao's government, during which period he is correctly credited for undertaking key economic reforms following the balance of payments crisis in 1991. However, toward mid-decade, the reforms initiated in the early 1990s were beginning to pay dividends, leading to a jump in investment spending owing to expectations that, in hindsight, turned out to be unrealistic. Starting in earnest in 1993, growth in bank lending and industrial production soared to multiyear highs. Soon, inflation started to head north, fueling worries that the central bank was behind the curve in keeping inflation under control. To be sure, WPI inflation surged from around 6.5%oya in mid-1993 to cross 12% in May 1994.

Worried about inflation getting out of hand, the central bank, likely with a signoff by the ministry of finance, tightened monetary policy aggressively. This, along with the investment bubble bursting, caused the growth in bank lending and IP to collapse, pushing Indian industry into a prolonged slump. Admittedly, the central bank was ultimately able to control inflation, but it did so at a very heavy price.

Fiscal consolidation to proceed at slow pace

Following concerns in the first half of the fiscal year that the federal government could overshoot its fiscal deficit target, it now appears that it is on track to achieve target of 3.8% of GDP for 2006-07. This is largely owing to the strength of the economy that has pushed up tax revenues to a record high. The pace of fiscal consolidation could have been faster

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especially to take advantage of the pro-cyclical economic conditions. The government will probably announce a fiscal deficit target of 3.5% of GDP for 2007-08, and emphasize fiscal consolidation. If such an outcome materializes, rating agencies will likely react favorably to the budget announcement of sticking to the fiscal deficit targets of the Fiscal Responsibility and Budget Management Act. Indeed, S&P, which has a positive outlook on its India's BB+ rating, could announce a one-notch upgrade.

Gradual widening of current account deficit

India's current account (CA) deficit is likely to widen gradually to US$20.9 billion (2.1% of GDP) in 2007-08 from an estimated US$16.3 billion (1.8% of GDP) in the current fiscal year. However, capital inflows remain strong, though any increase in global risk aversion that hits sentiment and portfolio flows will negatively impact the rupee. Global crude oil prices remain a legitimate risk to the CA deficit, as India imports nearly 70% of the crude oil for its refineries, and crude oil imports account for nearly 33% of total imports.

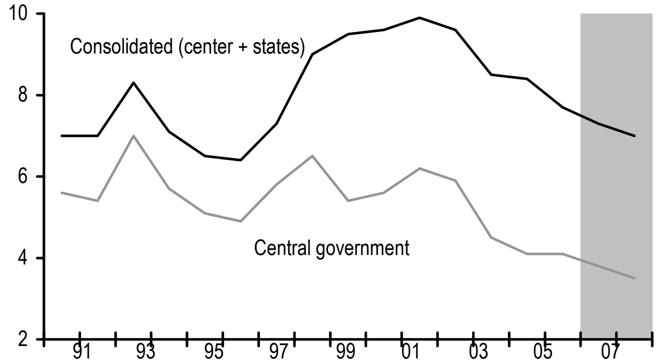
CRR hike or SLR cut next year?

There appears to be more uncertainty regarding RBI's monetary policy in 2007, owing mainly to uncertainty about the strength of capital inflows into India. As mentioned above, strong capital inflows are posing a challenge to the central bank in conducting monetary policy. Indeed, even if the central bank is successful in managing inflationary expectations, excessive capital inflows could still prompt another increase in CRR to tighten liquidity. However, this will be the last resort and would follow an increase in the issuance of bills and bonds under the market stabilization scheme (MSS) to mop up excess domestic liquidity.

Separately, a significant portion of the increase in money supply now owes to banks' requirement to meet the statutory liquidity ratio (SLR), currently at 25% of net demand and time liabilities. For example, as of November 24, the increase in banking system's lending to commercial sector accounted for nearly 30% of the 9.6% fiscal year-to-date increase of INR88,9.4 billion in M3, substantially less than the 41.3% share of funds that have gone to the government.

The deceleration in loan growth should be clearer by midyear, and with a lower budget borrowing announcement by the government in February, the central bank should then start thinking about measures to prevent an exaggerated slowing in lending. The liquidity and inflation outlook permitting, the RBI should consider cutting the SLR ratio in 2H07, if it appears that productive lending is being severely impacted by the SLR constraint, and there is risk of substantial slowdown in loan growth. Cutting the SLR at that time should be interpreted as the central bank wanting to stabilize loan growth around 20-23%oya rather than fueling rapid credit expansion. Needless to say, it will be a difficult balancing act.

Budget deficits
% of GDP, fiscal years beginning Apr 1



Balance of payments
US$ billion, except as noted, fiscal years beginning Apr 1

	03/04	04/05	05/06	06/07f	07/08f
Exports	66.3	85.2	104.8	125.7	147.1
Imports	80.0	118.9	156.3	189.0	222.0
Trade balance	-13.7	33.7	-51.6	-63.3	-74.9
Invisibles balance	27.8	31.2	40.9	47.0	54.0
Remittances	21.6	20.5	24.1	25.5	27.0
Software exports	12.3	16.9	22.3	27.0	32.0
Current account bal	**14.1**	**-2.5**	**-10.6**	**-16.3**	**-20.9**
% of GDP	2.3	-0.8	-1.3	-1.8	-2.1
Foreign investment	13.7	12.1	18.2	16.0	17.0
Direct	2.4	3.7	5.7	6.5	7.0
Portfolio	11.4	9.3	12.5	9.5	10.0
Loans[1]	-4.4	10.9	4.7	12.0	10.0
Banking capital	6.0	3.9	1.4	9.0	9.0
Nonresident deposits	3.6	-1.0	2.8	3.5	3.5
Other capital[2]	0.7	0.9	0.9	0.9	0.9
Capital account bal	**16.7**	**28.0**	**24.7**	**38.0**	**37.0**
Overall balance	**31.4**	**26.2**	**15.1**	**21.7**	**16.1**

1. 2005-06 impacted by redemption of US$5 billion for maturing 5-year India Millenium Deposit

2. Includes delayed export receipts and advance payments against imports

Bonds are likely to rally further in 2007

The Indian bond market has rallied smartly out of the gloomy bearishness of June-July 2006. Just a few days ago, the 10-year yield had rallied to 7.4%, almost a full percentage point lower from its mid-July high. Although last week's surprise CRR hike has trimmed part of the gains, we believe that the bond market is set for a rally in 2007.

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The bond rally over the past few months has been driven by softer US rate expectations, lower oil prices, demand for bonds principally from insurance firms and, to a lesser extent, from banks. In 2007, we believe three important themes will dominate interest rate markets: (1) expectations of the conclusion of the RBI's rate tightening cycle; (2) the secular return of demand for bonds from banks (partly countered by a likely reduction in SLR requirements); and (3) relatively tight liquidity conditions.

End of RBI tightening will swing sentiment

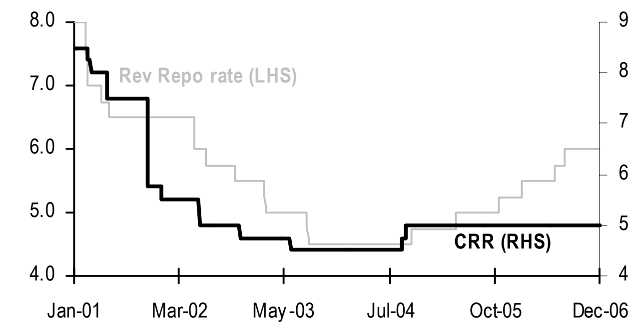
Using a variety of measures, the central bank has been removing policy accommodation since September 2004. We feel policy rates are no longer accommodative and, as discussed in detail above, expect that a 25bp rate hike at the end-January RBI policy review will probably be the final rate move in this cycle. However, the RBI will likely retain a hawkish bias and will prefer keeping a tight rein on liquidity conditions. Investors currently anticipate another rate hike as well as an uncertain liquidity environment; indeed, the swap curve suggests that a January hike is already fully priced in.

But investors are not as yet focused on the probability of a near-term end to the RBI tightening cycle. Such an eventuality will likely shift bond market sentiment decisively, particularly if, as we expect, this is complemented by a secular rise in demand from banks. Note that a majority of bond market participants are long-only players who have for the past several quarters either stayed on the sidelines or have actively reduced their portfolios. Demand for bonds from these segments is likely to sustainably return as expectations firm that policy rates are likely to remain on hold. Having said that, Indian policymakers face a difficult balancing act, and the precise timing of the end of RBI tightening remains uncertain.

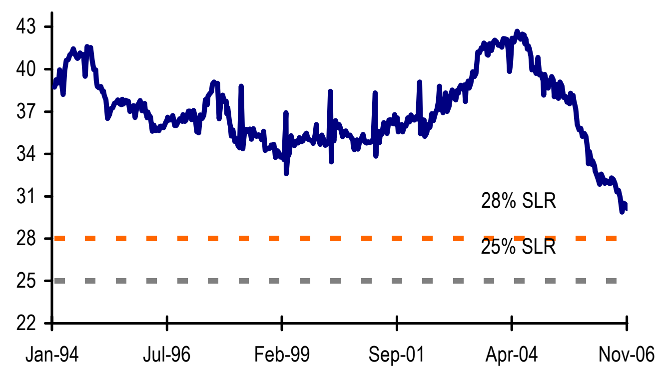
Banks are likely to turn secular bond investors

Non-discretionary bond investments by banks will likely be the single most important issue for the bond market next year. Banks are required to maintain 25% of their net liabilities in central and state government bonds as SLR, and have over the past few years trimmed their bond portfolios considerably — from over 40% of liabilities to around 29%, just 4 percentage points above the mandated floor — to generate funds for lending.

RBI's rate tightening cycle is likely to end in 2007
percent *percent*



Banks have reduced bond portfolios significantly over past few years
bond holdings as a ratio of net liabilities, percent



Even if deposit growth were to slow from the current 20%oya pace to around 15% in 2007, banks would need to purchase around INR950 billion of bonds (net of maturities) to maintain their current portfolio composition. Note that banks currently maintain a 4 percentage point "buffer" above the minimum requirement of 25% and could trim this further. But we believe they will choose to always have at least a 2.5-3.0% buffer, i.e. to keep bond portfolios at least at 27.5-28.0% of liabilities, in order to retain some portfolio flexibility and insure against a tight liquidity situation (banks need surplus bonds to avail emergency liquidity at the RBI's Liquidity Adjustment Facility). Such demand for bonds will likely be price insensitive and, in the absence of other negatives, could create significant upside for bond prices.

In addition to the demand from banks, insurance firms will likely need about INR500 billion in long-duration securities over the course of next year. Other investor categories may likely also opportunistically add to their bond portfolios.

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Demand will likely easily meet bond supply

The above leads us to believe that demand for bonds will probably overwhelm the likely supply next year. INR290 billion of net issuance is scheduled for the January to March quarter, while we expect the government to stick closely to its fiscal responsibility mandate and announce a near-unchanged net issuance plan at around INR1.1 trillion for 2007-08. With cash-rich state governments unlikely to issue significantly more next year than they did this year, we estimate the cumulative supply of duration will fall short of the potential demand.

A key risk to this view is a possible cut in SLR from the current 25%. Indeed, we believe a reduction in SLR is quite likely in 2007, particularly in the second half of the year as credit growth slows and inflation moderates. That having been said, note that policymakers cannot cut SLR below 25% until an amendment to the Banking Regulations Act is passed by Parliament.

Liquidity may remain tight in 2007

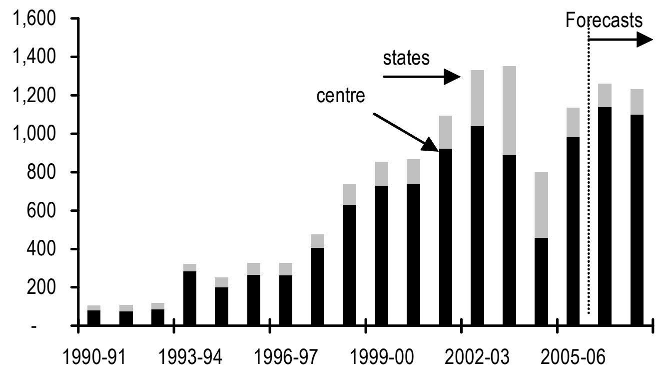
Despite the end to RBI's rate tightening cycle, we believe the RBI will prefer to keep surplus liquidity on a tight leash, with the overnight call money rate more likely to hover closer to the upper end of the RBI's repo-reverse repo rate band than the lower.

Indeed, the RBI decision last week to raise the CRR underscores the central bank's intent. To be sure, we believe that if capital inflows remain strong and add materially to the stock of surplus domestic liquidity, the RBI may actively issue more securities under the MSS, or may even choose to raise the CRR again.

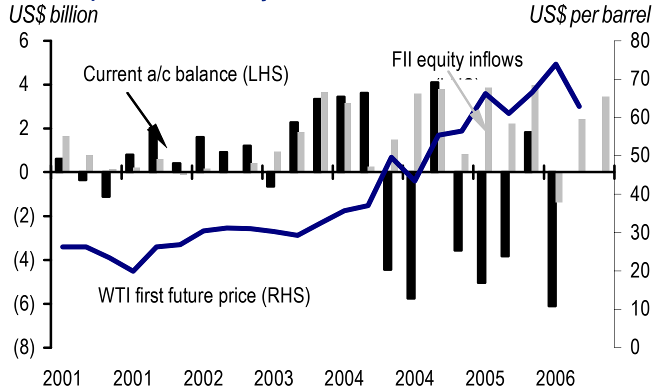
Expect a much flatter curve next year

On balance, we believe the worst is over for the bond market and that this cycle's peak in yields is behind us. Despite a forecast RBI rate hike in end-January, we are confident about a bond market rally in 2007, with a possible cut in banks' SLR possibly slowing the move later in the year. We expect the yield curve to flatten as tight liquidity keeps the front end of the curve elevated. In addition, tight liquidity conditions could keep MIBOR fixing rates high and extend the trend of OIS underperformance vs. bonds. We forecast the 10-year yield at 7.0% by end-2007, 60bp lower than its present level.

Net government bond issuance is expected to remain stable
INR billion



India's current account deficit has been partly offset by equity flows, while oil prices remain a key risk
US$ billion *US$ per barrel*



INR may strengthen near-term ...

We expect INR will retain a strengthening bias in the near term, assisted by a favourable trend of strong portfolio flows. In addition, a strong pipeline of overseas equity and debt capital receipts has been established, which further supports INR.

... but we remain concerned over the medium-term

Despite this, we are less sanguine about INR's prospects over next year. Recent INR strength owes primarily to the steep decline in oil prices and a revival of global investor risk appetite. INR also drew comfort from the resurgence in Asian currencies. However, note that the recent dip in USD/INR was likely exaggerated by the sharp technical pullback in USD demand from overhedged domestic oil firms. We expect USD demand from oil firms will recover significantly even without higher crude oil prices. Further, the continued reliance on equity flows to offset a still widening current account deficit remains a concern.

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RBI will likely remain a key fx market participant

The recent bout of RBI intervention has intensified the focus on INR valuations. The RBI's intent in not allowing the real trade-weighted INR to break above last year's high has drawn a line in the sand that the market will watch closely. This is especially important as the US dollar has recently started to weaken again, and several Asian currencies have strengthened. Also note that the CRR hike announced this last Friday will partly sterilise domestic liquidity injected by the RBI's aggressive fx intervention over the past several weeks and thus, in some ways, will allow the RBI greater flexibility to conduct additional intervention. If INR continues to richen on the REER and the fx market remains volatile, continued central bank operations may cap near-term INR gains. The still expensive current REER valuation will also serve to dissuade unbridled INR optimism.

USD/INR forecast at 46.0 by end-2007

For 2007, we maintain a view of gradual INR depreciation. As discussed above, the current account deficit will likely worsen further, and, after three years of exceptionally strong inflows, stretched equity valuations and tightening global liquidity, continued strength in portfolio flows may not be a reliable offset. The key risks to our view are: a sustained drop in oil prices; and resilience in capital inflows. We forecast USD/INR at 46.0 by December 2007, about 2½% above its current level.

Equities: Riding the crest

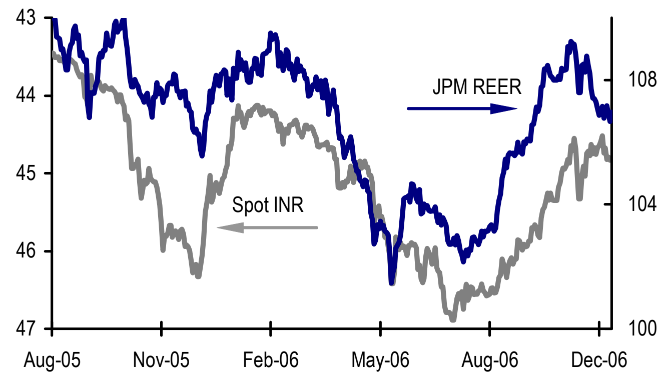
The Sensex has gained 40% ytd in 2006, driven by strong earnings growth and continued faith in the sustainable growth prospects for the Indian economy. The outlook for corporate earnings growth in 2007 remains healthy as key growth drivers including the investment cycle, increased outsourcing and a stable consumption cycle remain. However, growth rates could moderate, given a more challenging base effect and tightening in local liquidity.

Valuations had reached new highs during the course of the year, but are now beginning to look relatively more reasonable after the recent sell off. We estimate fair value for the BSE Sensex at 13,600.

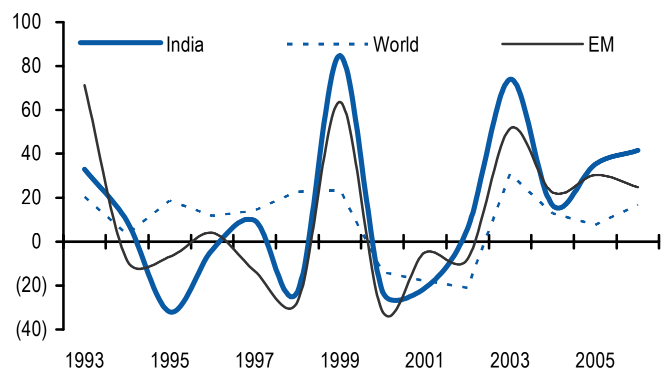
Current market expectations of 34% earnings growth for FY07 appear stretched in the backdrop of a 31% growth reported for 1H, particularly as the base effect will be more

RBI has thwarted large real appreciation as INR traded a wide band

USD/INR *6-currency INR REER, base: 100 = 2003-04*



Equities performance -- global linkage



challenging into 2H. This raises the possibility of earnings downgrades. After negligible fund raising for nearly 6 months, equity issuances aggregating more than US$ 6bn are expected to hit the market over the next 3 months.

Given current valuations, we prefer sectors with stable and visible earnings growth. We prefer technology, industrials, healthcare and telecom sectors. Strong order book and acceleration of the investment cycle should be positive for the industrials sector. Business flows continue to be strong for large cap IT and telecom companies. Momentum in the domestic formulations business and huge generic opportunities are good for healthcare earnings. We remain cautious on interest rate cyclicals, mainly state owned banks and consumer discretionary as the local liquidity environment remains tight over next quarter.

Top five stocks to own in 2007. Bharti Airtel, BHEL, Dr. Reddy's Lab, ICICI Bank, Infosys Tech.

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	Overweight (buy)	Neutral (hold)	Underweight (sell)
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IB clients*	44%	47%	37%
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IB clients*	62%	57%	47%

* Percentage of investment banking clients in each rating category.

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