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EMERGING MARKETS STRATEGY

November 6, 2008

Investment strategy and recommendations in equities, bonds and currencies for developing economies

Special Report

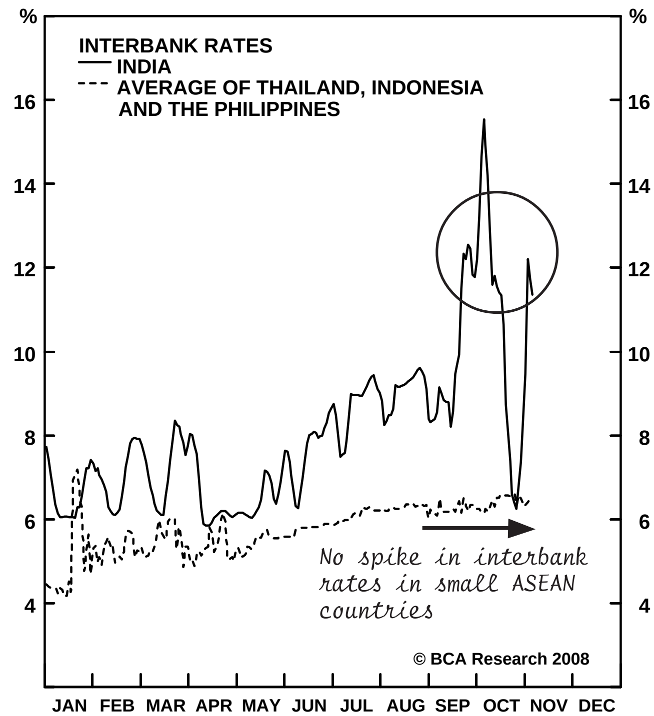
INDIA: WILL THE LIQUIDITY SQUASH EVOLVE INTO SOLVENCY CRISIS?

We will be publishing a series of *Special Reports* on various emerging market countries examining whether the current liquidity squeeze in their domestic financial systems will evolve into a solvency crisis. Today, we look at India. Reports on Korea, Brazil, Mexico, Russia and Turkey will follow in the near future.

HIGHLIGHTS

- The liquidity crisis in India should not turn into a major solvency crisis.
- The main reason is that credit has been utilized efficiently in India and there are not many segments within the economy that have major imbalances/excesses.
- Indian banks can maintain 30%-plus credit growth over the next year. However, if foreign credit continues to withdraw *en masse*, a mild form of credit crunch will likely persist going forward.
- The starting point of Indian companies' financial health is relatively benign, meaning they can withstand a mild credit crunch.
- Upgrade Indian stocks from underweight to neutral.
- Consider buying Indian corporate (bank) spreads.
- The currency has been cheapened and the recent lows should hold.

CHART 1
Liquidity Crunch In India Is Worse Than in ASEAN



*BOTH SERIES SHOWN AS 5-DAY MOVING AVERAGES

Among emerging Asian economies, only India (and most recently Korea) has been running current account deficits, implying it has been reliant on foreign capital. The main difference between India and the rest of Asia has not been financial market outflows (equities and fixed income) but rather foreign bank and commercial financing.

Not surprisingly, with global banks withdrawing credit over the past few months, interbank rates in India have shot up dramatically. Meanwhile the increases in interbank funding rates throughout the rest of Asia (except in global financial centers where global banks play an important role) have been rather tame (**Chart 1**). The key issue facing investors is whether these liquidity shortages in India will evolve into solvency problems.

The framework for our analysis is as follows: **If the credit binge of the past several years has been misallocated, the solvency problem will emerge sooner than later. The opposite also holds true: If credit in these countries has been allocated to decent projects and investments, liquidity constraints should not degenerate into solvency issues.** This general framework will also be applied for other emerging economies in the coming *Special Reports*.

Both emerging Asia a decade ago, and U.S. housing today fall into the category of capital misallocation, which has led to solvency problems and eventual busts. However, it is important to realize that in the case of emerging Asia, the return on capital was declining for a while (since 1994-95) while massive capital spending continued until 1997, creating massive overcapacity and debt deflation.

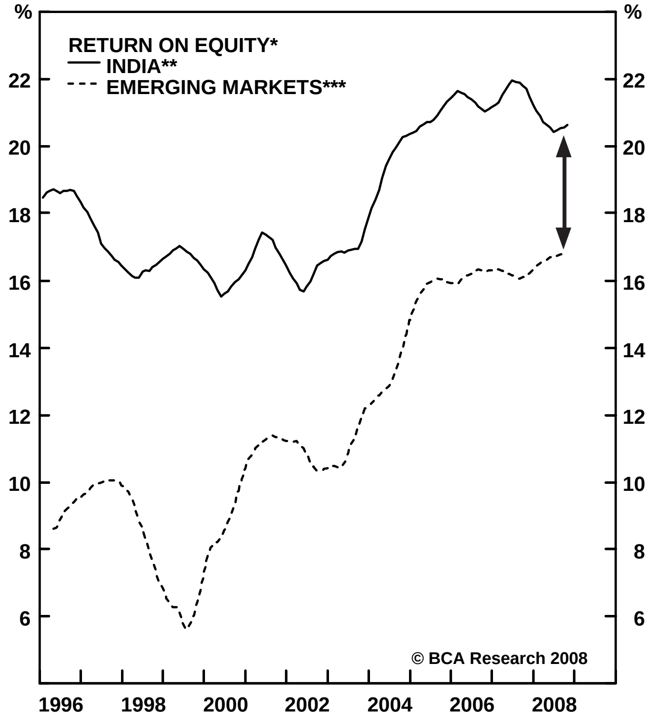
In the case of India, we remain relatively constructive as credit flows into the country appear to have largely been utilized in a productive way. As a result, the ongoing liquidity squash should not evolve into a solvency crisis on a massive scale.

India In Need of Global Savings

From a big picture perspective, India is an underinvested country, and it has been ramping up its capital spending in the past several years. While India's savings rate has risen markedly (from 24% in 2003 to 34% of GDP), it still falls short of desired savings. Capital spending early this year was 36% of GDP, and if anything, there is potential to boost capital spending further.

Given the underinvested nature of India's economy, the return on capital is very high, not only relative to the G7 but also in comparison to other emerging markets (**Chart 2**). This, along with a lack of major imbalances in the economy should keep India a magnet for global capital.

CHART 2
Return On Capital Is Higher In India Because It Is Underinvested



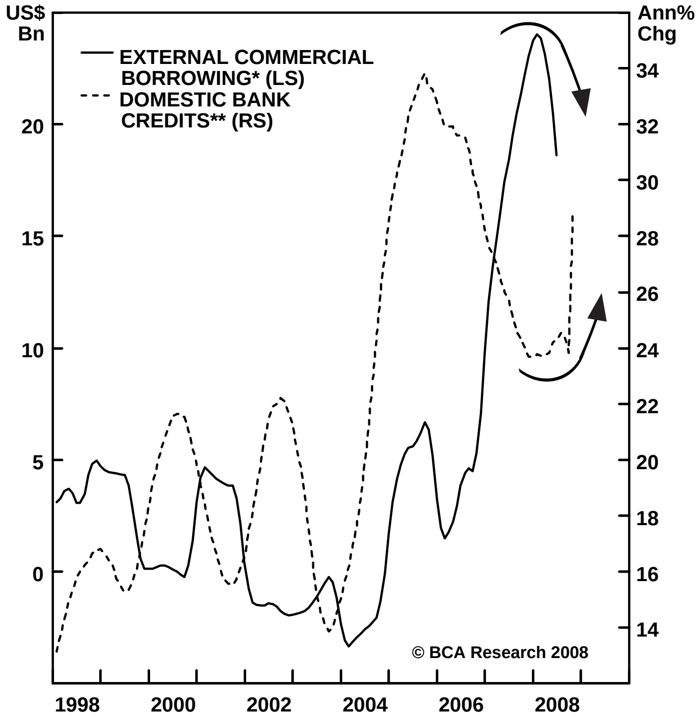
*SOURCE: MSCI Inc. (SEE LAST PAGE)
**SHOWN AS A 12-MONTH MOVING AVERAGE
***SHOWN AS A 6-MONTH MOVING AVERAGE

We had expected that the G7 recession would free up more global savings, and that falling returns (interest rates) in the developed world would increase the attractiveness of India as a destination of credit. This might still happen in the years to come but the crisis in the G7 has become so deep that banks have curtailed funding, even to attractive high-return projects such as those in India.[1]

Going forward, the foremost factors that will shape India's economic and financial dynamics are the financial health of Indian banks and corporations, and whether they can ultimately withstand such an intense global shock.

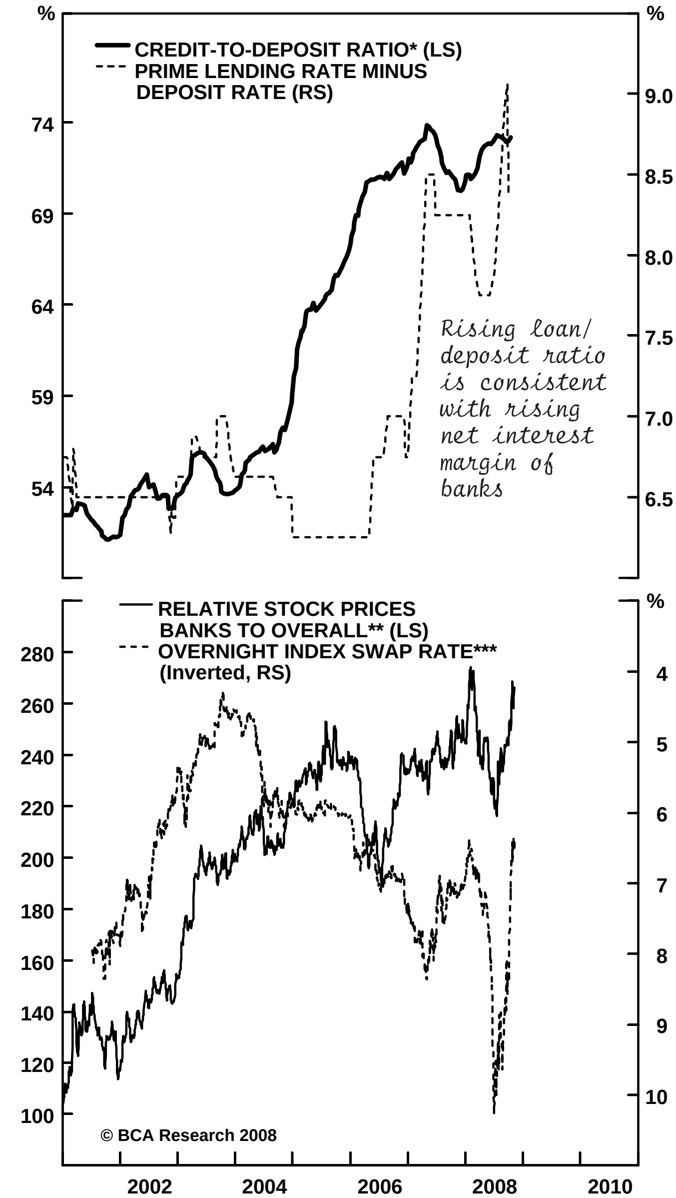
1 This was discussed in our October 30, 2008 *Weekly Bulletin* titled "Capital Flows Redux" available at www.BCAresearch.com.

CHART 3
India: Shift From Foreign To Domestic Credit



*SHOWN AS A 12-MONTH MOVING TOTAL
**SMOOTHED EXCEPT FOR THE FINAL DATA POINT

CHART 4
Indian Banks Have Pricing Power



*SHOWN AS A 13-WEEK MOVING AVERAGE
**REBASED TO JANUARY 2001=100; SOURCE: MSCI Inc. (SEE LAST PAGE)
***FOR 3 YEARS

Corporates: Shift From External To Domestic Funding

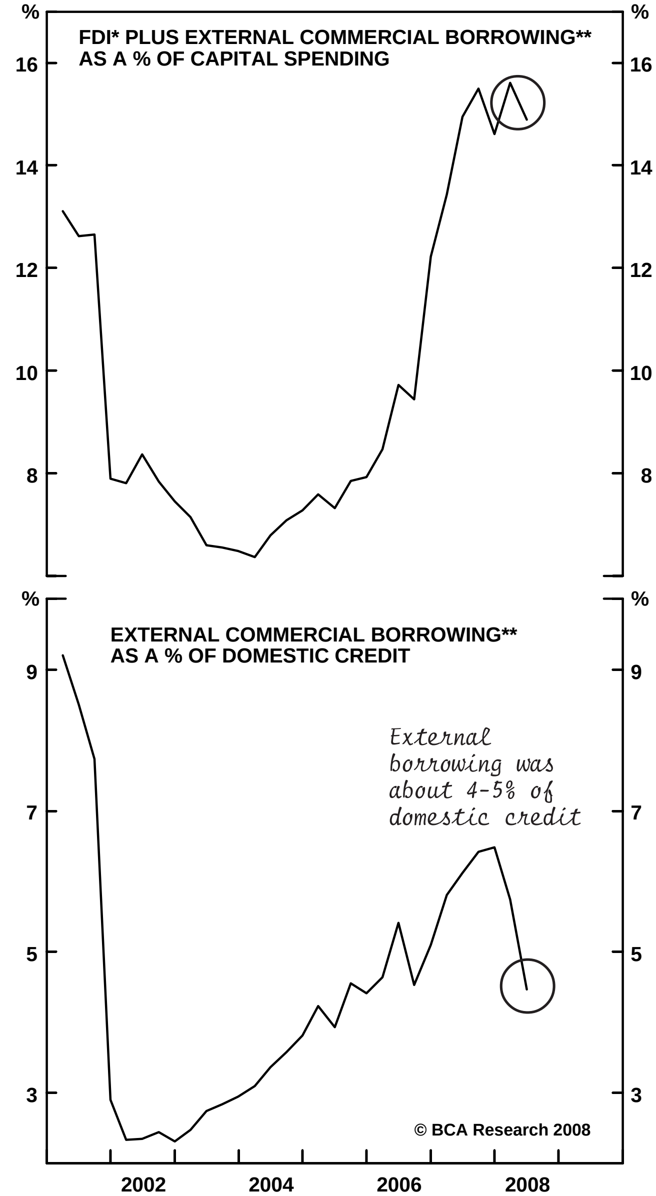
While global credit growth is decelerating rapidly, credit growth in India has accelerated. The main reason is that companies cannot obtain or roll over loans from foreign banks, and have increasingly been forced to resort to domestic bank credit (**Chart 3**).

Overall, loan demand is stronger than deposit growth, which is putting upward pressure on lending rates and will prevent lending rates from matching reductions in policy rates (**Chart 4**). Banks, therefore, will have stronger bargaining power than corporations. This, along with the drop in interest rates, has manifested itself in banks' relative share price outperformance of late (**Chart 4**, bottom panel).

There is no question that like every economy in the world, India is witnessing considerable growth deceleration. The key point is that India is an underinvested economy, implying there are no widespread overcapacity problems that would create non-performing loans on a large scale. Meanwhile, demand trends in India are rather sustainable and there is no froth in most segments of the economy.

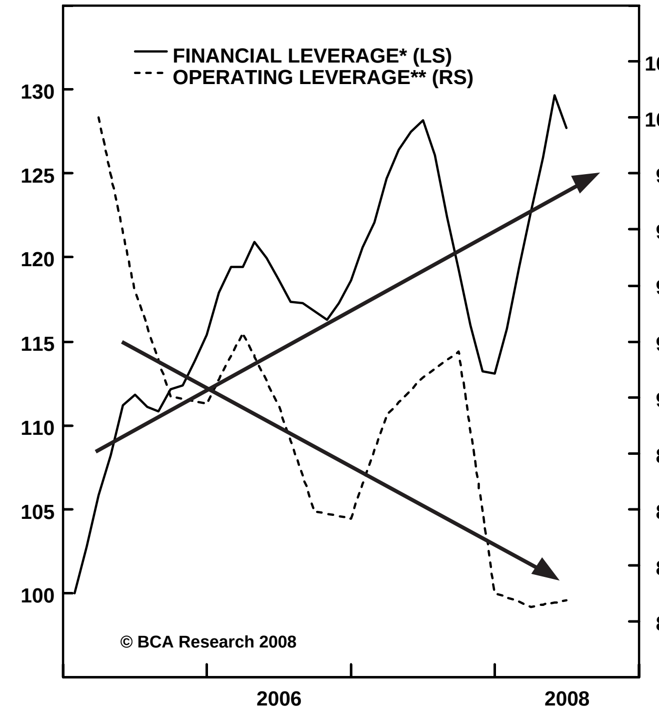
With respect to India's corporate sector, we have the following observations:

CHART 5
Share Of Foreign Financing In India's Capex



*INBOUND FOREIGN DIRECT INVESTMENT
**INBOUND MID TERM AND LONG TERM
ALL SERIES SHOWN AS 4-QUARTER MOVING TOTALS

CHART 6
India: Structurally Lower Operating Leverage Moderates The Downside Risk



*CALCULATED AS DOMESTIC CREDIT PLUS EXTERNAL BORROWING DIVIDED BY BOOK VALUE
**CALCULATED AS FIXED COST DIVIDED BY SALES
NOTE: BOTH SERIES REBASED TO THE BEGINNINGS AS 100

- Foreign financing has largely been used for infrastructure and manufacturing capital investments, which in India is clearly deficient. Therefore, there is no overcapacity in these areas that would make return on capital plunge and generate difficulties in repaying loans.

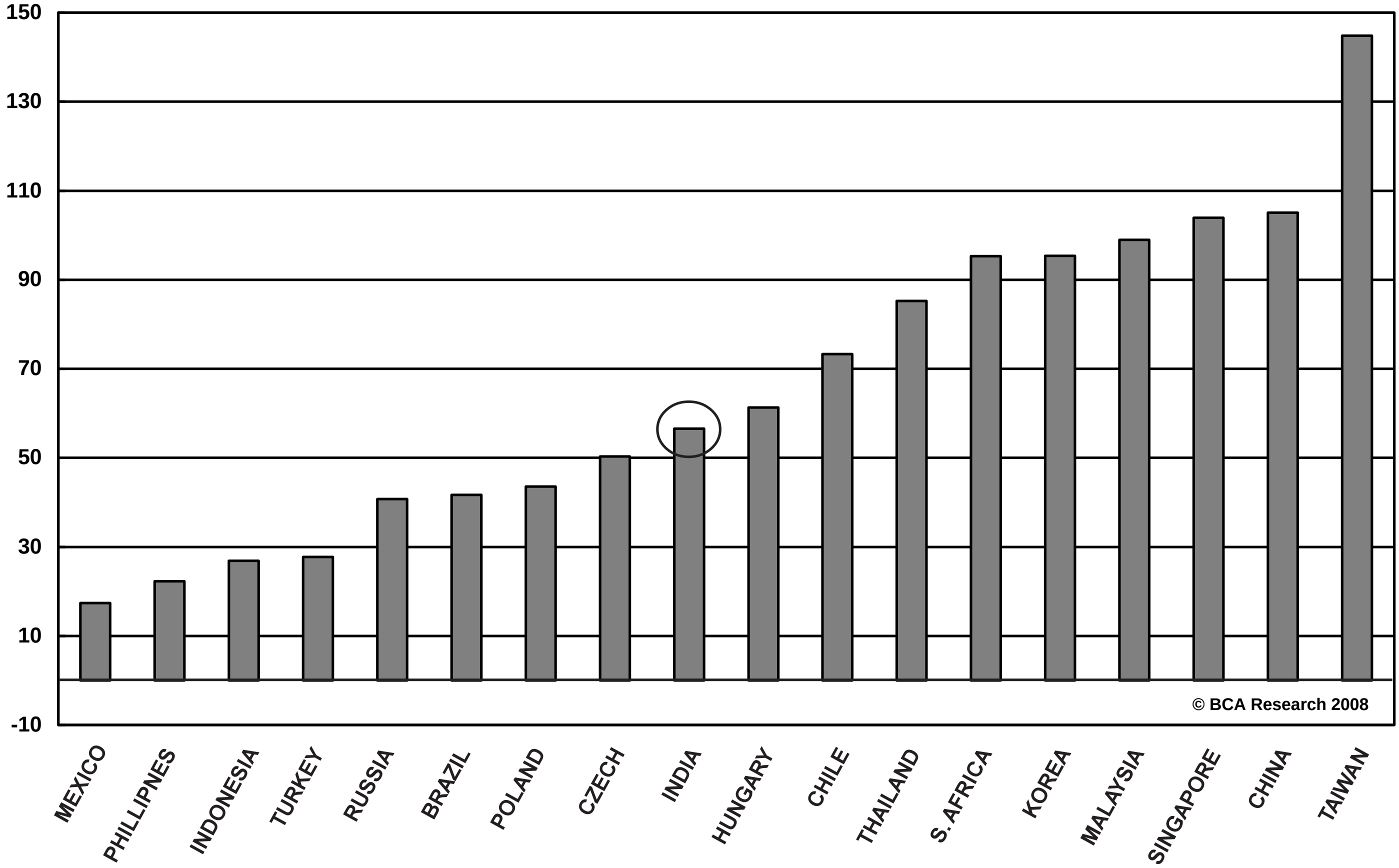
  Taking infrastructure projects for example, India is looking to invest $500 billion by 2012 compared with about $50 billion of foreign capital (FDI plus external commercial borrowing) inflows in the past year.

- Although the share of foreign financing in capital spending has been rising, total FDI inflows and external commercial borrowing have accounted for only 15% of capital spending (**Chart 5**, top panel). Meanwhile, external borrowing has amounted to 5% of domestic corporate credit (**Chart 5**, bottom panel).

- India's financial leverage has increased but the operating leverage has fallen in the past several years (**Chart 6**). These leverage ratios determine profit sensitivity to top line growth. As the rise in one of these ratios is offset by a fall in the other, the overall impact should be muted.

  Operating leverage refers to the level of fixed costs relative to the total cost structure, while financial leverage is the extent of debt financing relative to the total capital structure.

CHART 7
Emerging Market Private Sector: Domestic Credit As A % Of GDP



Relative to China and other emerging Asian economies, India's economy is more service- and less manufacturing-oriented and therefore has a lower capital stock, indicating the share of fixed costs (operating leverage) should be lower than in China or other Asian manufacturing-based economies. As to financial leverage, the private sector credit-to-GDP ratio is only 57% in India, which is lower than its peer economies in Asia (**Chart 7**).

All of this implies that earnings volatility in India will remain lower than in other manufacturing-heavy and credit-reliant economies of emerging Asia. This is probably one of the main reasons why the Indian bourse has commanded higher multiples than in other emerging economies, a trend likely to continue.

- Furthermore, interest expenses as a share of sales are rising, and the interest coverage ratio has

CHART 8
Corporate Debt Servicing Costs: Elevated But Not Outrageous

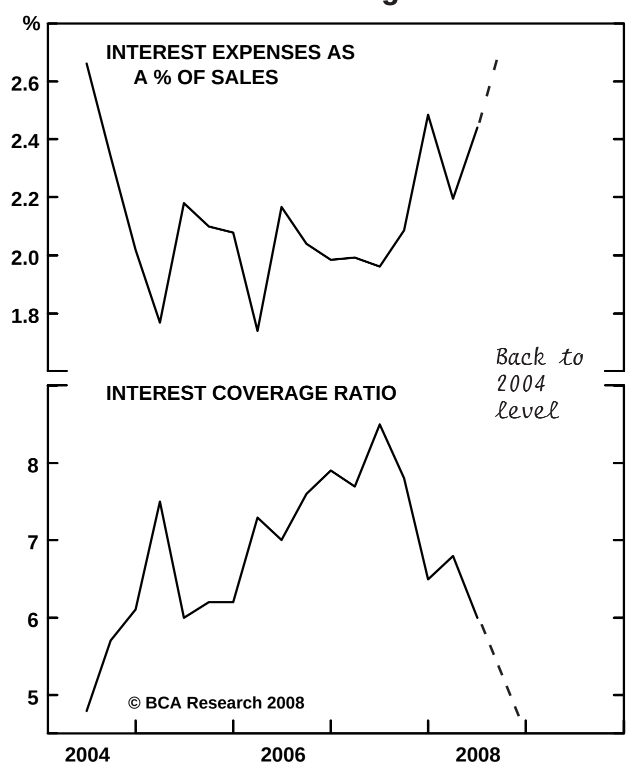


CHART 9
India: Profit Margins

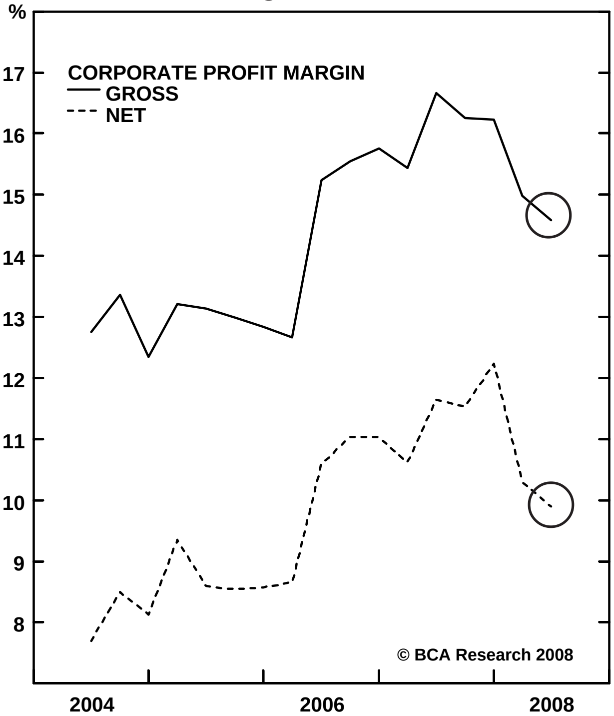
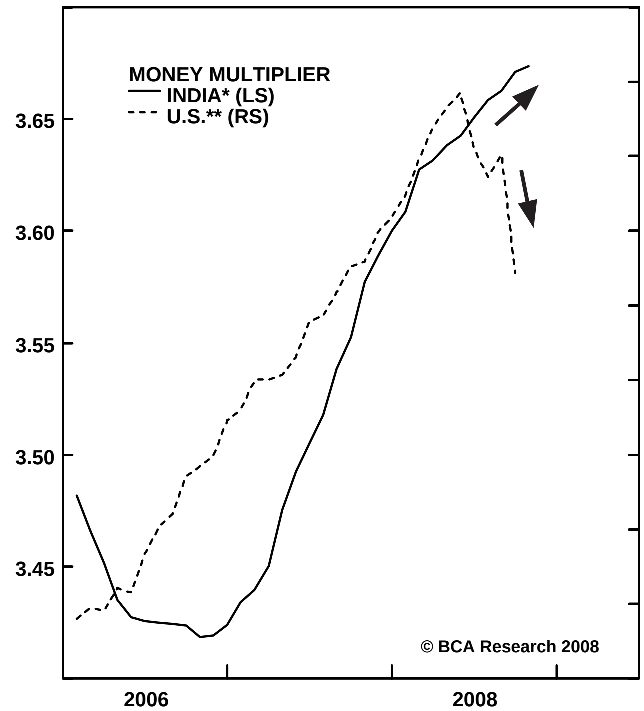


CHART 10
How India Is Different From U.S.



*M3 DIVIDED BY M1, SHOWN AS A 12-MONTH MOVING AVERAGE
**M2 DIVIDED BY M1

fallen to late 2004 levels (**Chart 8**). While this is a deterioration from levels of the past few years, it is still better than earlier this decade, or in the 1990s.

- Finally, the corporate sector's gross and net profitability were14% and 10%, respectively (**Chart 9**), and will stay higher than in many other emerging markets or G7.

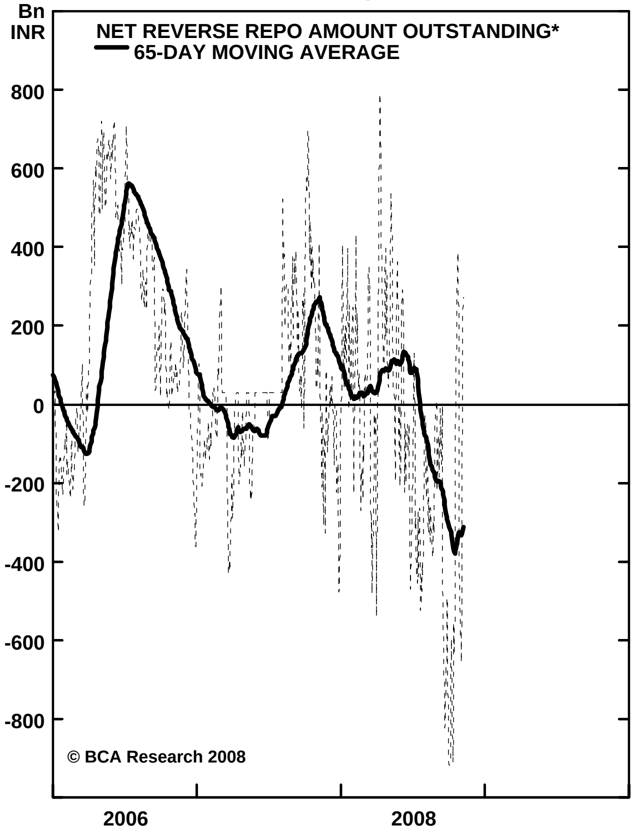
Bottom Line: Indian companies' financial health is relatively benign, which will help them withstand the recent plunge in growth and curtailed foreign financing — as long as it does not last longer than several months. On the whole, the performance of India's corporate sector will be contingent on Indian banks' ability to offset/mitigate the withdrawal of foreign credit.

Banks: Willing To Lend, But Short Of Funds

The major difference between India and the developed world is that the money multiplier is rising in India, while it has collapsed in the G7 (**Chart 10**). Unlike U.S. or European banks who are unwilling to lend because of both their impaired capital and lingering credit risk, Indian banks are eager to extend credit. However, the ability of Indian banks to accelerate credit growth even further (from the current annual rate of 30%) is restrained by a lack of domestic savings (deposits) and to some extent an insufficiency of capital. To make things worse, outflows of foreign capital have put additional strains on domestic liquidity (**Chart 11**).

In a nutshell, the recent rise in interbank rates in India has been for different reasons than what has been behind the rise in LIBOR in the U.S. and Europe. In the Indian banking system, there are major liquidity shortages but little counterparty risk, whereas in the U.S. and Europe counterparty risk is the predominant concern.

CHART 11
India: Liquidity Shortages



*NEGATIVE FIGURE IMPLIES LACK OF LIQUIDITY IN THE SYSTEM; AND BANKS HAVE BORROWED FUNDS FROM CENTRAL BANK

We look at several fronts to assess the health of the Indian banking sector:

- **Currency risk**. Net foreign liabilities are just 2% of banking assets (**Chart 12**), although it is higher for some private sector banks, such as ICICI bank. On the whole, however, net currency exposure is not significant.

- **Refinancing risk**. The primary risk comes from the refinancing of foreign borrowings. Although soared in recent years, the banking sector borrowings from foreign banks still constitute only about 7% of its liabilities (**Chart 13**). On the other hand, there is no sign of problems with domestic financing. The share of time deposits has been rising, which is constructive (**Chart 14**). Notably, despite strains in interbank market liquidity, there have so far been no bank runs.

CHART 12
Indian Banks' Net Currency Exposure Is Low

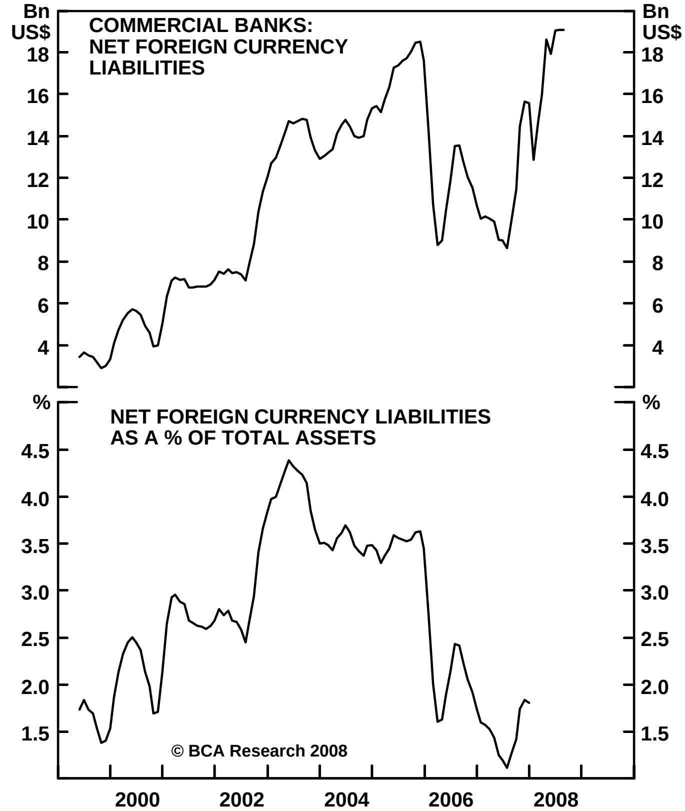
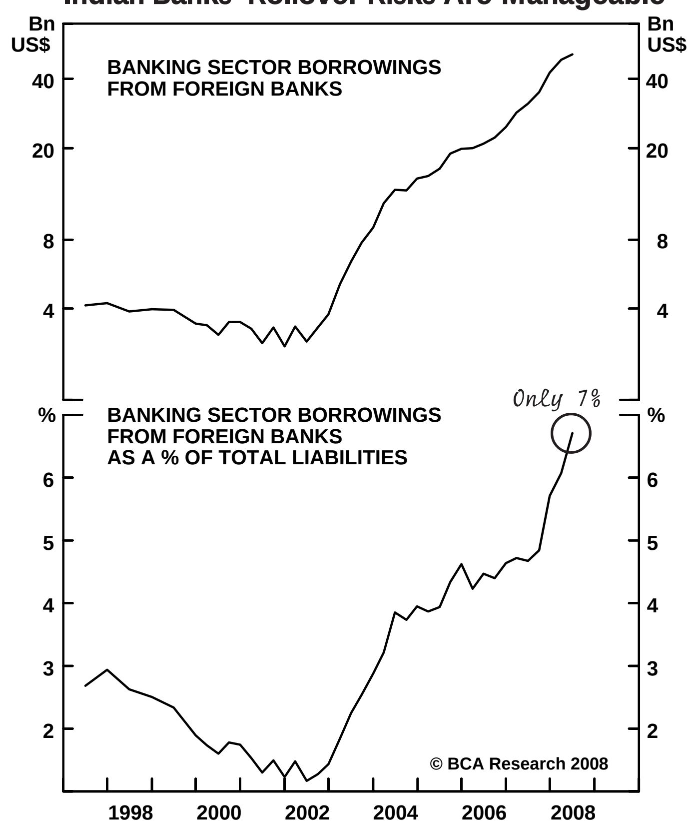
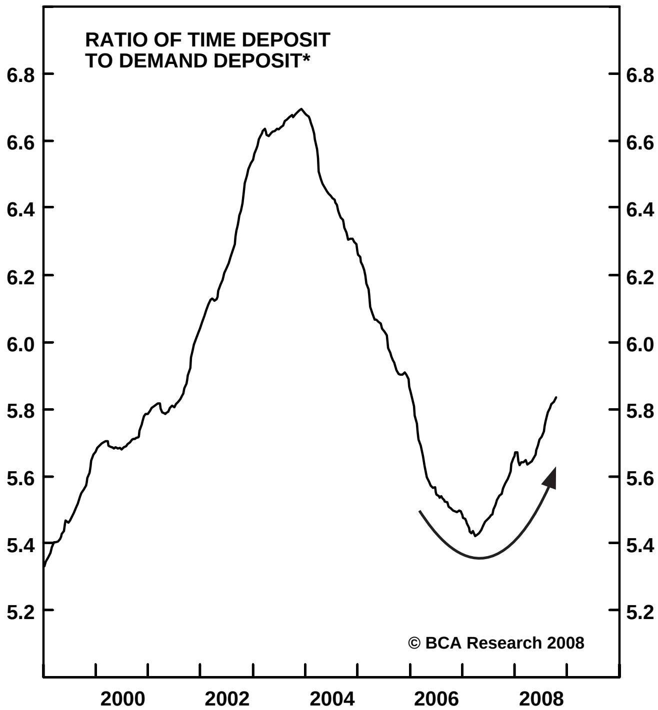


CHART 13
Indian Banks' Rollover Risks Are Manageable



SOURCE: BIS

CHART 14
Indian Banks: Banking On Stable Domestic Deposits



*SHOWN AS A 12-MONTH MOVING AVERAGE

- **Credit risk**. In compliance with the central bank's conservative credit policy, banks are well-capitalized, with the majority having a capital adequacy ratio of 12% or more (against central bank stipulation of 9%).

  The only area of concern is the real estate sector, where tightening credit norms by banks along with price overshoots in some areas have reduced demand. However, loosening fiscal policy (government's significant pay hikes), coupled with the ongoing monetary easing, will likely prevent a major bust in property prices.

  Chart 15 presents the structure of Indian banks' loan portfolios. It shows that the housing/real estate sector, considered the most vulnerable, accounts for just 14% of total loans, or 8% of GDP. Besides, most of these loans are well collateralized. This indicates that banks' risk exposure to the property market is not substantial.

  For the last decade or so, Indian banks have been cleaning up their balance sheets, and net bad loans (net of provisions) are only 1% of their total loan book.

Going forward, the recent dramatic policy easing by the Indian central bank should help alleviate liquidity shortages in the banking system and to some extent ease credit shortages in the economy:

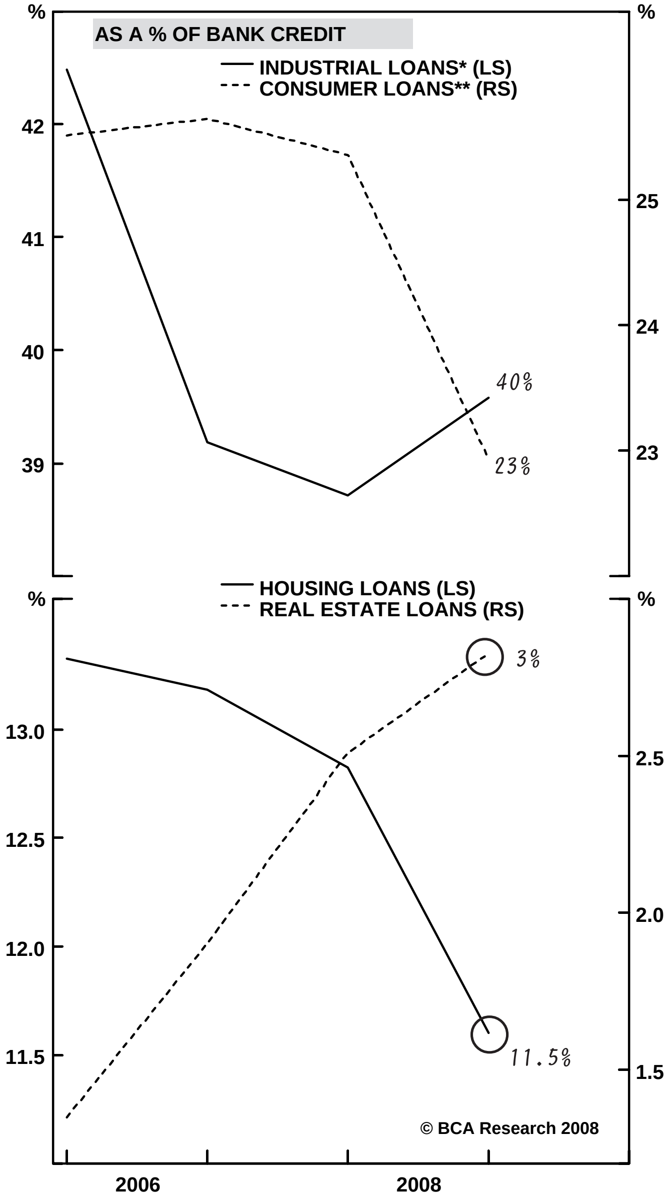
- The loan-to-deposit ratio is only 75%. This is because of banks' high reserve requirements. As much as 24% of net demand and time liabilities have to be mandatorily invested in government securities (known as the SLR, or statutory liquidity ratio), and another 6% must be put aside as cash reserves with the central bank.

  Thus, for decades banks have been helping the government run deficit financing and private sector credit has been crowded out. But, in times such as these, it gives both the government and the central bank significant headroom to replenish vanishing foreign credit with domestic liquidity.

- Short-term foreign loans due in the next 12 months amount to US$80 billion, or 14% of domestic banks' outstanding local currency credit. This implies that domestic credit should rise by an additional 14% a year to offset non-renewal of short-term foreign funding over the next year.

- Our calculations suggest that recent monetary easing measures (reductions in the repo rate, cash reserve ratio and SLR as well as liquidity support for mutual funds and non-bank finance companies) should allow Indian banks to generate $35 billion for making loans. If stabilization bonds (government bonds issued to sterilize huge foreign exchange inflows last year) are allowed to be used for SLR purposes, this will translate into another $35 billion of liquidity injection into the banking system. This would be enough to retire the $80 billion short-term foreign debt.

CHART 15
Indian Banks: Not Plagued By Soaring Consumer Finance



NOTE: FIGURES FOR MARCH 2008 ARE SHOWN AS 2008, AND SO ON
*INCLUDES SMALL, MEDIUM AND LARGE INDUSTRY'S LOANS
**INCLUDES HOUSING LOANS, CONSUMER DURABLE LOANS, EDUCATION LOANS, CREDIT CARD OUTSTANDINGS, LOANS AGAINST GOVT SECURITIES/ BANK DEPOSITS

- Nevertheless, banks' ability to generate credit is also conditioned on their capital base. Although Indian banks appear well capitalized now, a 30% per year credit growth means they likely will soon need additional capital to maintain their Basel II ratios.

  As per our estimates, at the current growth rate, banks would need an additional $60 billion of capital within the next three years, of which $20 billion can come from retained profits, assuming a 80% retention ratio. Of the remaining $40 billion, at least $27 billion (two-thirds) has to be Tier I equity capital.

  In tough times such as these, this amount of equity will be difficult to raise, and it could lead to a dilution of equity. To put things into perspective, total new equity raised from the market in the past three years has been $36 billion.

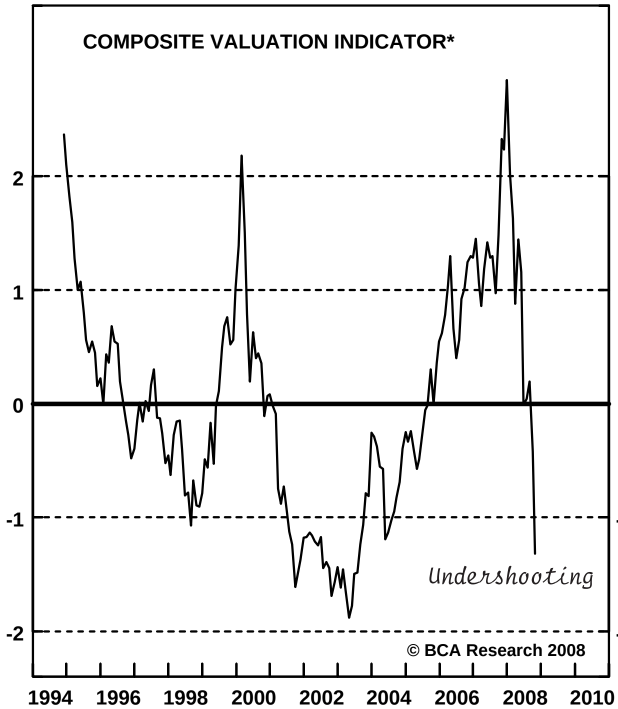
  Clearly, capital constraints will limit Indian banks' ability to boost domestic credit. This is another bearish factor for banks' share prices in the years to come.

- If credit withdrawal by foreign banks persists on a large scale, the final option for the central bank will be to extend U.S. dollar credit directly to corporations to replace foreign capital. This could be done from international reserves, which now stand at $270 billion, compared with $80 billion of foreign credit maturing in the next 12 months.

  Alternatively, the central bank could extend short-term (say, up to one year) guarantees on all foreign loan rollovers to creditworthy companies to see them through this turbulent phase (like Korea did with banks' external debt).

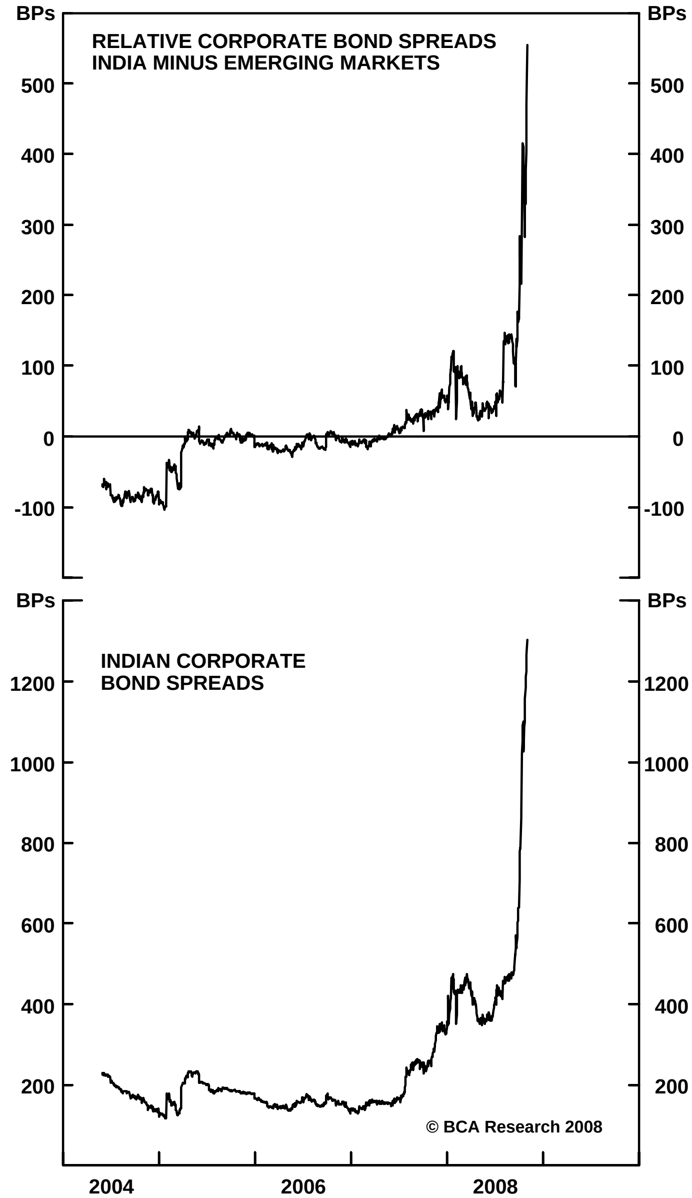
Bottom Line: Changes in the country's monetary regime will allow Indian banks to maintain 30%-plus credit growth over the next year, but this growth rate will still be insufficient to completely offset a curtailment in external borrowing. As a result, a mild form of credit crunch will likely persist going forward, but it should not degenerate into a full-blown crisis.

CHART 16
Equity Valuations Are Cheap



*AVERAGE OF TRAILING AND FORWARD P/E RATIO, P/B RATIO AND DIFFERENCE BETWEEN INDIAN 10-YEAR GOVERNMENT BOND YIELD AND DIVIDEND YIELD; STANDARDIZED

CHART 17
India: Corporate Bond Spreads Are Attractive



SOURCE: J. P. MORGAN CORPORATE EMERGING MARKETS BOND INDEX

Investment Implications

- The ability of India's central bank to cut interest rates and falling government bond yields amid a major global financial crisis is a sign of increased internal stability of India's economic system. This is also positive for the government's fiscal position.

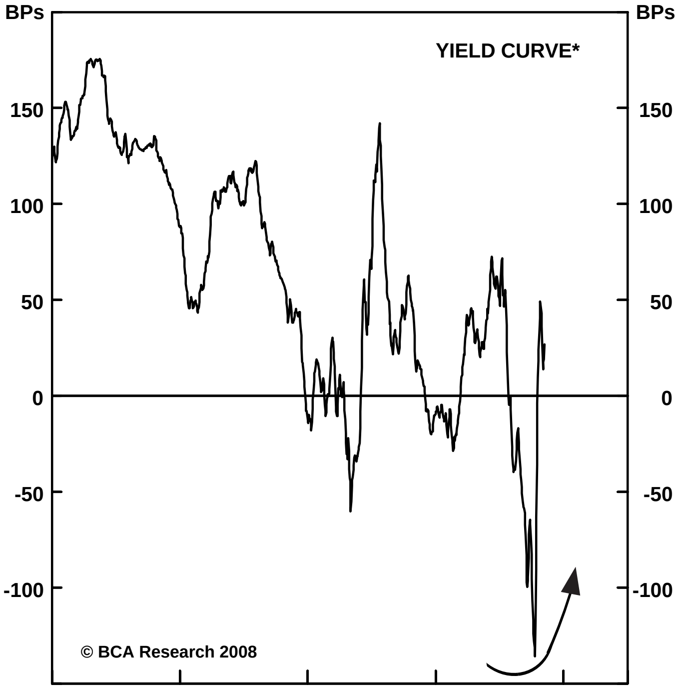
- Like many emerging markets, Indian stocks are cheap (**Chart 16**).

  Overall, the lows in Indian stocks have probably been reached, but share price dynamics will likely be choppy and stay in a trading range for now, due to the global environment and the continuation of a mild domestic credit crunch. **We recommend upgrading this bourse from underweight to market weight within the emerging markets benchmark.**

- Buy corporate (primarily bank) spreads. The central bank's recent policy actions confirm that the authorities will not hesitate to take measures to keep the banking system functioning smoothly. At more than 1200 basis points, spreads are too high for a relatively non-problematic banking system, and we expect them to come down in the months ahead (**Chart 17**).

- Bond yields will likely trend lower as the central bank cuts interest rates further and the currency stabilizes. However, the authorities are trying to "crowd in" private credit/investment by allowing banks to unload their government bond hold-

CHART 18
India: More Yield Curve Steepening

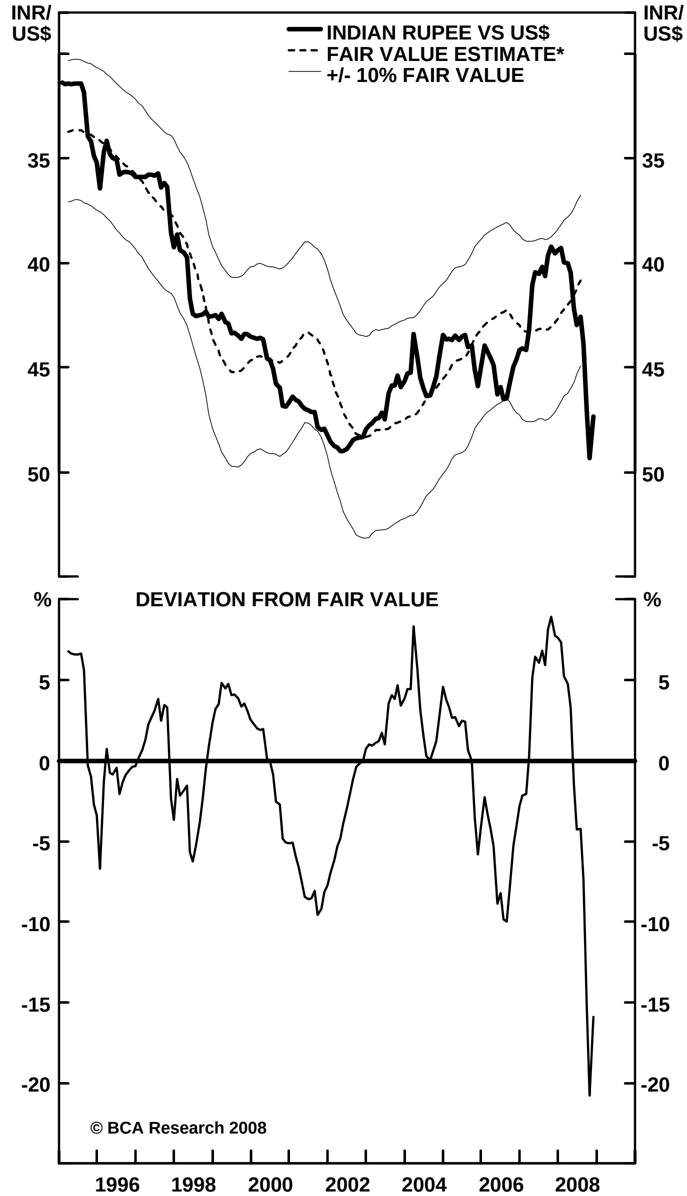


*10-YEAR OIS SWAP RATE MINUS 6-MONTH OIS SWAP RATE

ings. This, along with other measures to bail out the financial system, will produce a curve steepening. Bet on yield curve steepening (**Chart 18**).

- The rupee is attractively valued (**Chart 19**) and is likely to be in a trading range of 45 to 50 per US$, given its oversold conditions on the one hand and further balance-of-payments tensions on the other.

CHART 19
The Currency Is Cheap



*BASED ON RELATIVE CONSUMER PRICE, TRIMMED-MEAN CONSUMER PRICE AND WHOLESALE PRICE INDICES

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EQUITY STRATEGY

EMERGING MARKET EQUITY INDEX

	Absolute Performance	Relative Performance vs Global Stocks	Comments And Links To Reports
Recommendation	Accumulate select markets SEP 19/08, SR SEP 18/08	Overweight since APR 11/07	Volatility will persist, but the recent lows should hold. A breakdown of recent lows will imply global debt deflation.
Return	-23.5%*	-1.8% (in common currency)	

	COUNTRY ALLOCATION	Date of Initiation	Relative Return**	Links To Reports		
OVERWEIGHTS	Taiwan (Focus: Semis)	Aug 9/07	-3.5%	JULY 17/08,	JUNE 6/08,	
	Hong Kong Domestic Stocks	Sep 7/07	7.0%	APR 11/08,	SR SEP 7/07	
	Korea	Jan 25/08	-1.0%	SR JAN 3/08,	MAR 11/08	
	Peru	Mar 31/08	-12.9%	SEP 5/08,	JUNE 6/08,	SR APR 25/08
	Mexico	Jul 8/08	0.2%	MAY 29/08,	MAR 31/08	
	Turkey	Sep 9/08	-8.1%	JULY 17/08,	JUNE 20/08,	MAY 2/08
	China	Sep 9/08	7.1%	SR SEP 29/08,	SEP 19/08,	SR FEB 29/08
LARGEST UNDERWEIGHTS	South Africa	Apr-May/06	11.9%	AUG 4/08,	SR APR 18/08,	MAR 20/08,
	Hungary	Oct 30/07	7.3%	AUG 15/08,	JULY 8/08,	OCT 30/07
	Indonesia	Jan 3/08	12.2%	AUG 22/08	MAR 20/08,	SR JAN 3/08
SLIGHT UNDERWEIGHTS	Argentina	Oct 26/05		JUNE 6/08,	DEC 14/07	
	Chile	Nov 9/05		MAR 31/08,	JAN 11/08	
	The Czech Republic	Nov 30/05		AUG 15/08,	MAY 17/07,	SR NOV 30/05
	The Philippines	Aug 9/07		JUNE 20/08,	MAY 2/08,	SEP 28/07
	India	Feb 22/08	Move to neutral	AUG 4/08,	JULY 8/08,	SR MAR 27/08
	Russia (Focus: Non-energy)	Jul 25/08		SR JUL 25/08,	FEB 15/08,	SR JUL 6/07
	Thailand	Aug 4/08		AUG 4/08,	JUNE 6/08,	SR JAN 4/07
	Arabian Markets***	Aug 29/08		SR AUG 29/08		
NEUTRAL	Poland	Jan 11/08		AUG 15/08,	JAN 31/08,	JAN 11/08
	Colombia	Mar 31/08		MAR 31/08,	SR JUN 14/07	
	Singapore	Apr 15/08	Favor property stocks	SR APR 15/08		
	Brazil	May 29/08	Was overweight until May 29/08	JULY 17/08,	MAY 29/08,	SR FEB 8/08
	Malaysia	Sep 9/08		SEP 5/08,	AUG 4/08,	SR JULY 8/08

OTHER EQUITY POSITIONS

	Date of Initiation		Links To Reports	
Long Latam Banks	Aug 9/05	Accumulate these stocks since Sept. 19 /08	SR FEB 8/08,	SR AUG 9/05
Long Emerging Market Small Cap	Apr 19/07		JAN 25/08,	SR APR 19/07
Indian Software Stocks	Jan 3/08		SR JAN 3/08,	SR MAR 27/08
Long Singapore Property Stocks	Apr 15/08		SR APR 15/08	
Short South African /Long Polish Bank Stocks	Jan 31/08	-12.1%	SR APR 18/08,	JAN 31/08

Note: all equity market calculations are based on MSCI indexes unless specified otherwise.
*** Based on average prices of following two weeks **To Emerging Market MSCI Benchmark**
*****Performance calculation is based on MSCI Arabian markets index.**

BOND STRATEGY

TACTICAL TRADES*	Date Of Initiation	Return In USD or Basis Points	Links To Reports
Short South African 10-year (Hedged by Long Turkish 5-Year Domestic Bonds since Mar 20/08)	Dec 21/07	4.4%	AUG 4/08 MAR 20/08, JAN 31/08
Long Russian/Short S. African Sovereigns	Jan 25/08	37 bps	JUNE 6/08, JAN 25/08
Long Colombian/Short Venezuela Sovereigns	Jan 25/08	634 bps	JUNE 6/08, MAR 14/08
Long Korean 5-year Domestic Bonds	June 13/08	-10.9%	SEP 5/08 JUNE 20/08, JUNE 13/08
Short Philippine/ Long Turkish Sovereigns	June 20/08	16 bps	JUNE 20/08
Long Vietnam/Short Philippine Sovereigns	Aug 8/08	-468 bps	SR AUG 8/08

STRATEGIC POSITIONS**	Date Of Initiation	Return In USD	Links To Reports
Long Mexican 10-year Domestic Bonds	Jun 29/04	25.1%	JUNE 20/08, MAY 2/08, FEB 22/08
Long Brazilian 3-year Domestic Bonds	Feb 01/05	196.8 %	JULY 8/08, MAY 2/08, SR FEB 8/08
Long Turkish Domestic Bonds	Apr 4/08	-26.5 %	SEP 5/08 AUG 4/08, SR APR 4/08

CURRENCY STRATEGY

TACTICAL TRADES*	Date Of Initiation	Return	Links To Reports
Short PKR/Long KRW	Sep 5/08	-7.2%	SEP 5/08
Long RUB/Short KZT	Nov 2/07	-11.3%	SR OCT 10/07, NOV 2/07

STRATEGIC POSITIONS**	Date Of Initiation	Return	Links To Reports
Long Chinese RMB 12-month non-deliverable forwards (hedged by Short euro/ Long US$ on Jul 8/08)	Oct 26/05	18.8%	AUG 15/08, JUNE 6/08, SR FEB 29/08
Short ZAR (Hedged by Long TRY since Mar 20/08)	Nov 29/07	21.3%	AUG 4/08, SR APR 18/08
Long Russian RUB/ Short euro	Jul 8/08	4.5%	AUG 15/08, SR JUL 25/08, FEB 15/08
Long Brazilian *Real*/ Short euro	Jul 8/08	-6.7%	MAY 2/08, SR FEB 8/08, JUN 21/07
Long basket of SAR and AED 2-year forward	Aug 22/08	-0.4%	AUG 22/08
Long the basket of RMB, MYR, THB and SGD/ Short euro	Jul 8/08	13.7%	AUG 15/08, AUG 4/08, JULY 8/08
Long BRL/ Short HUF & RON	Oct 17/08	1.9%	SR OCT 17/08,
Long the basket of BRL, MXN, CLP & KRW / Short USD	Oct 30/08	1.4%	OCT 30/08

* Tactical trades' expected holding period between 6 weeks to 6 months.
** Strategic positions' expected holding period over 6 months.

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