

23 January 2008

Monetary policy preview

Pressure building up on RBI for a rate cut, but...

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Softening becoming a Hobson's choice, "delay" notwithstanding

We believe that in the January policy review RBI may not effect a rate cut and postpone the "inevitable" to a later point, going by its innate conservativeness and insufficient comfort on inflationary expectations. We however continue to strongly advocate our rate reduction thesis for 2008, which should be beneficial to the banking sector in general. Our three top picks ICICI, HDFC and IDFC are incidentally heavily leveraged to rate softening. Minor moves to kick start credit growth in some sharply slowed-down segments are also likely.

Currency the first priority now, but inflation not forgotten

Unpalatable socio-economic fallout of the appreciating exchange rate – read job losses in the forex-sensitive sectors – has made it a top priority for the authorities. So RBI's intervention in the forex market will conceivably not reduce in the short term, and a subsequent cash reserve ratio (CRR) increase in the upcoming policy cannot be precluded. Of course, in the present relatively benign liquidity scenario this should not matter to banks, except those that have failed to bring down deposit rates sufficiently. We feel that RBI still does not perceive inflationary expectations are well-anchored, and will postpone a rate cut.

Increasingly tougher for RBI to hold on to high interest rates

RBI would have to address the rate differential issue seriously, with heavy leakages on the capital controls front, massive negative carry that they are running to carry out forex sterilization, and now a decidedly downward spiral in developed country rates. At the very least, RBI will have to unsettle short dollar positions that are currently very profitable. Other strong arguments for easing are: i) high interest rates have done their bit in cooling down loan growth and inflation ii) indefinite use of auctions and CRR increases can manifest in fiscal and banking sector problems.

Encouraging outlook for profitability

Rate softening – whether in the form of an explicit rate cut or otherwise – coupled with some capital controls and expected corporate loan demand should lead to healthy loan growth and improving margins for banks. Since we expect lending rates to stay stable (decline marginally in some segments), the probability of worsening of asset quality due to rising rates also reduces correspondingly. Though impact of bond portfolios on bank P&Ls have fallen with reduction in durations, declining bond yields are always viewed positively from the sentiment standpoint, at least at the margin.

We continue to remain positive, sector froth has reduced sharply

We value frontline large-cap private banks on P/E, public sector banks on single-stage Gordon Growth model and mid-sized private banks on two-stage Gordon Growth model. Banking stocks have suffered recently along with the rest of the market, and our outlook has not changed in any way. Other sector triggers in 2008 could be stabilization of asset quality, increase in leverage and value-unlocking. Key risks to the sector are: i) RBI's excessive emphasis on price stability ii) asset quality deterioration iii) politics, reflecting in loan writeoffs, for instance.

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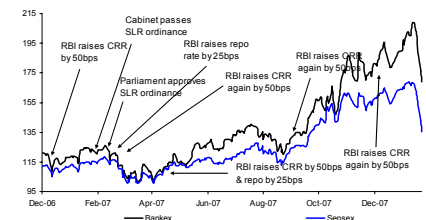
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Monetary Policy

Top picks		
ICICI Bank (ICBK.BO),INR1,150.80		Buy
HDFC (HDFC.BO),INR2,531.85		Buy
IDFC (IDFC.BO),INR190.85		Buy

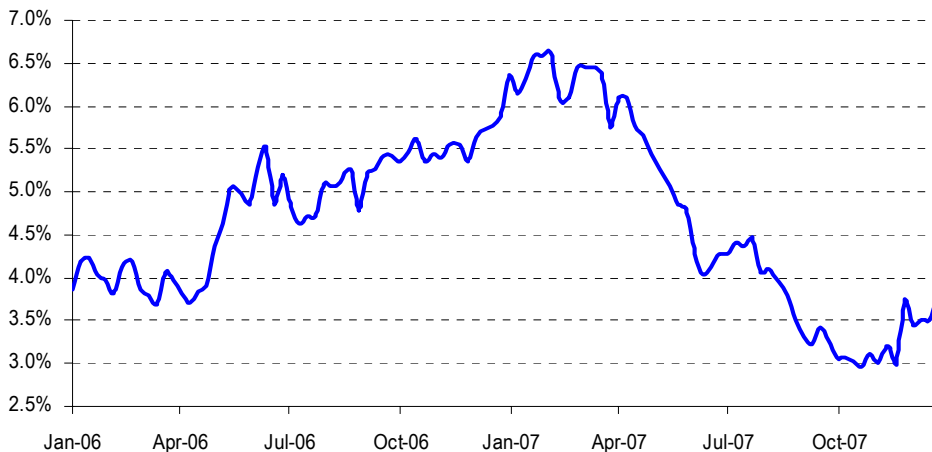
Companies featured			
ICICI Bank (ICBK.BO),INR1,150.80		Buy	
	2007A	2008E	2009E
P/E (x)	20.4	29.4	24.6
Div yield (%)	1.4	0.8	1.0
Price/book (x)	3.1	2.7	2.5
HDFC (HDFC.BO),INR2,531.85		Buy	
	2007A	2008E	2009E
P/E (x)	22.3	32.6	28.9
Div yield (%)	1.6	1.0	1.2
Price/book (x)	6.9	6.9	6.1
IDFC (IDFC.BO),INR190.85		Buy	
	2007A	2008E	2009E
P/E (x)	15.9	29.0	25.2
Div yield (%)	1.6	0.7	0.7
Price/book (x)	3.2	4.3	3.8
Axis Bank (AXBK.BO),INR1,022.60		Buy	
	2007A	2008E	2009E
P/E (x)	16.8	32.4	26.8
Div yield (%)	1.2	0.5	0.7
Price/book (x)	4.1	4.3	3.8
HDFC Bank (HDFC.BO),INR1,534.75		Buy	
	2007A	2008E	2009E
P/E (x)	25.1	32.5	25.9
Div yield (%)	0.8	0.5	0.6
Price/book (x)	4.7	4.7	4.1
PNB (PNBK.BO),INR602.00		Buy	
	2007A	2008E	2009E
P/E (x)	9.3	9.1	7.1
Div yield (%)	2.9	1.8	2.0
Price/book (x)	1.4	1.6	1.3
Bank of Baroda (BOB.BO),INR412.85		Buy	
	2007A	2008E	2009E
P/E (x)	8.4	10.2	8.3
Div yield (%)	2.5	1.6	1.7
Price/book (x)	0.9	1.5	1.3
Canara Bank (CNBK.BO),INR273.80		Sell	
	2007A	2008E	2009E
P/E (x)	7.0	8.4	7.7
Div yield (%)	2.9	2.6	2.6
Price/book (x)	1.0	1.2	1.1

Bankex vs. Sensex



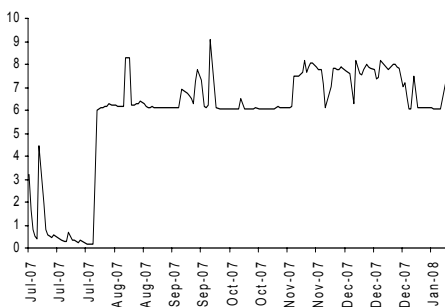
All that we need for a rate softening...

Figure 1: Inflation now well below RBI's medium target of 4-4.5%



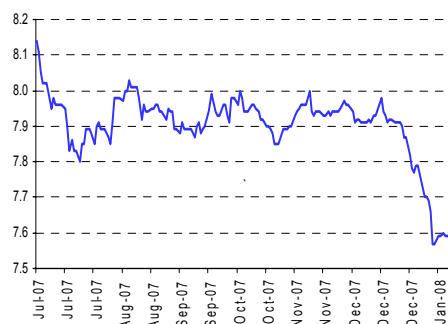
Source: Bloomberg, Deutsche Bank

Figure 2: Call rates stabilising



Source: Bloomberg, Deutsche Bank

Figure 3: 10yr bond yields have come off



Source: Bloomberg, Deutsche Bank

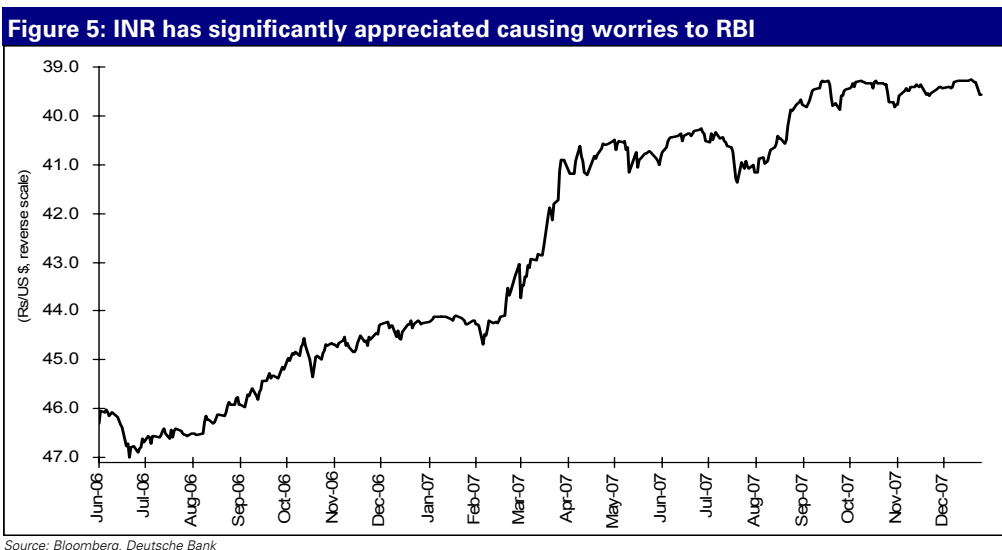
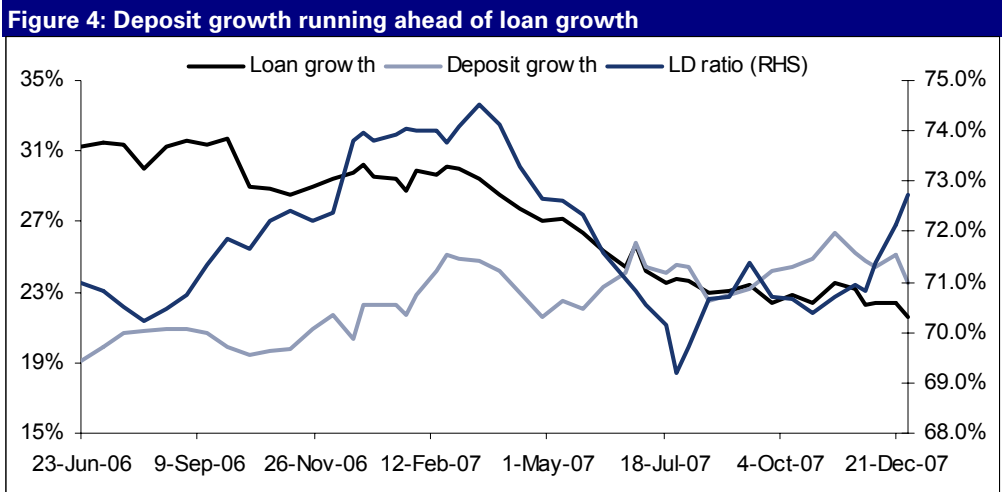
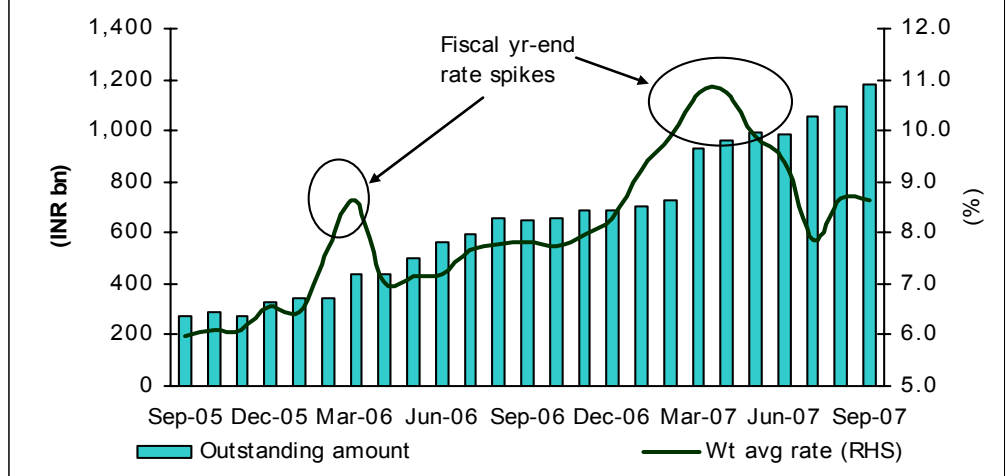
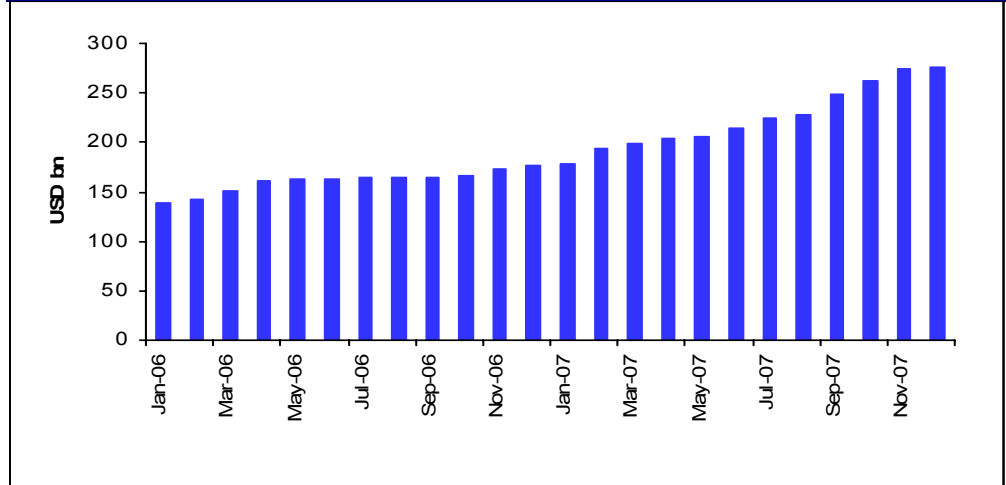


Figure 6: Certificates of deposits rates are coming down...

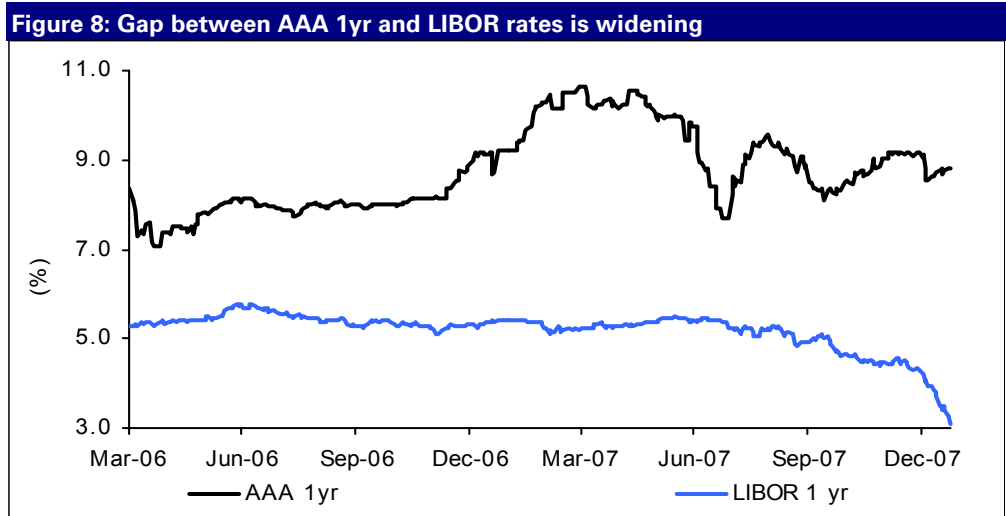


Source: RBI, Deutsche Bank

Figure 7: Burgeoning FX reserves



Source: RBI, Deutsche Bank



Source: Bloomberg, Deutsche Bank

Valuation comfort has increased after the fall

Figure 9: Financials – valuation snapshot

	EPS growth (%)		P/E		P/BV		ROE (%)	
	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E
Axis Bank	20.8	35.7	28.4	20.9	3.9	3.4	15.0	17.8
BOB	22.1	15.9	7.8	6.7	1.2	1.1	17.0	17.1
Canara	8.9	13.7	7.9	6.9	1.2	1.1	12.6	13.2
Centurion Bank	48.0	53.5	40.4	26.3	4.0	3.5	10.4	14.1
Dev Credit Bank	100.5	26.2	15.8	12.5	2.3	2.0	16.0	17.1
HDFC Bank	27.5	31.9	25.3	19.2	4.0	3.4	17.1	19.2
HDFC Ltd	12.9	21.6	30.8	25.3	6.5	5.6	23.3	24.5
ICICI Bank	16.0	30.9	25.4	19.4	2.5	2.3	10.4	12.5
IDFC Ltd	17.9	22.5	27.4	22.4	3.7	3.3	14.5	15.7
Karnataka Bank	11.4	20.6	11.8	9.8	1.8	1.6	16.3	17.3
Kotak Mahindra Bank	28.2	29.4	29.9	23.1	5.0	4.2	18.3	19.8
Oriental Bank	18.8	52.8	7.4	4.8	0.9	0.8	13.3	17.5
PNB	27.7	17.6	7.1	6.1	1.3	1.1	20.6	20.3
Union Bank	16.7	17.6	7.9	6.7	1.4	1.2	19.4	19.6
YES Bank	46.8	50.7	31.0	20.6	3.4	3.1	14.7	16.9

Source: Deutsche Bank Note: Kotak Mahindra Bank and IDFC valuations are based on consolidated nos

Figure 10: Sector price performance

Banks	22- Jan over 31-Dec-07	22- Jan over 7-Jan when Bankex was at its peak
Development Credit Bank	-35.4%	-39.7%
Canara Bank	-23.7%	-36.8%
IDFC Ltd	-22.3%	-21.0%
Kotak Mahindra Bank	-22.1%	-27.2%
Union Bank	-20.5%	-27.3%
Bank of Baroda	-19.6%	-21.0%
PNB	-17.7%	-20.6%
HDFC Bank	-16.7%	-13.1%
YES Bank	-15.7%	-20.5%
HDFC Ltd	-13.7%	-20.3%
Oriental Bank	-12.1%	-20.1%
Centurion Bank of Punjab	-11.1%	-27.2%
ICICI Bank	-8.7%	-17.5%
Karnataka Bank	-1.0%	-14.1%
Axis Bank	1.9%	-9.5%

Source: Bloomberg, Deutsche Bank

Appendix 1

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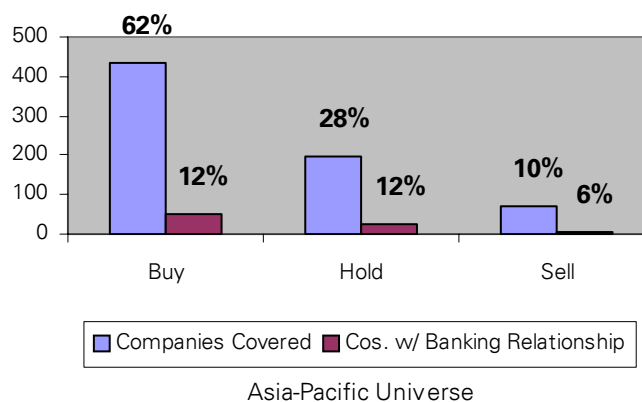
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