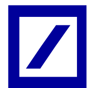
Deutsche Bank 

9 January 2012

India Equity Strategy: 2012 Outlook

At the crossroads of confidence

2012 year end Sensex target – 18,000
We are setting our year end (Dec-12) Sensex target at 18,000, implying a 14% return from current levels. At our target, the Sensex would trade at a fwd PE multiple of 13.8x, is a slight discount of 3% to the average multiple at which the market has traded over past 15 years. Restoring confidence in capital markets is likely to be the strongest starting point for the Government in rebuilding the faith of Corporate India, which we would argue is an overwhelmingly important determinant for return of the investment cycle.

Indian equity market at the crossroads of confidence
As we head into 2012 we see equity investors at two ends of the expectations spectrum, with a dominant majority still nervous and negative on the Indian equity markets despite the precipitous fall in markets and low equity valuations. Imminent confidence building remains critical to ensuring that the weakening sentiment does not spill over to becoming a self fulfilling prophecy.

Earlier-than-anticipated easing of monetary policy and confidence in navigating BoP turbulence will be imminent confidence boosters
Any move to loosen monetary policy – ahead of March or mid-year, as consensus expects - will be seen as a positive signal to Indian industry, while the government's cognizance of the seriousness of the worsening global macro environment and a sharp preemptive move against any undue worsening of the health of the Indian banking system should also help sentiments.

We remain constructive for 2012 but March to be pivotal month
Record pessimism is – perversely – the most positive variable for India, with the burden of expectations now shifting in India's favor, after a long gap. The Indian state election calendar is front ended, the elections precede the union budget, the crucial UP state election will be over by the end of February and a near 15-month election-free window may give the government long-needed maneuverability to address economic exigencies meaningfully. We would also expect that the much needed clarity on Eurozone crisis will emerge by March.

Banks, real estate and infrastructure to emerge as key sectoral themes in 2012 but timing will be critical
With a near 19-month monetary tightening cycle expected to reverse in 2012, we believe the classical rate sensitives—banks (though the sector may have to cross the hump of NPL's in the near term) and real estate, together with infrastructure will be the key sectors driving Indian markets in 2012. We believe investors looking at sectors to hide in, until March, could take the comfort of the IT sector which may provide investors with a strong hedge against continuing uncertainty in the domestic economy. Our top picks—Axis Bank, ICICI Bank, Coal India, Larsen and Toubro (now the biggest overweight in model portfolio), TCS, Bharti and DLF. Continuation of policy paralysis, persistent inflation, and a severe crisis in Europe are key risks.

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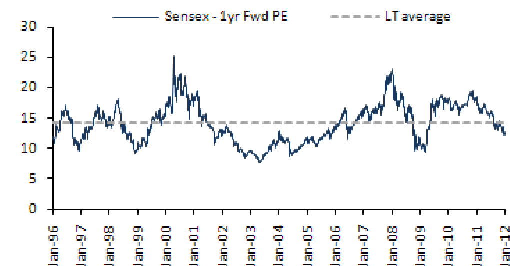
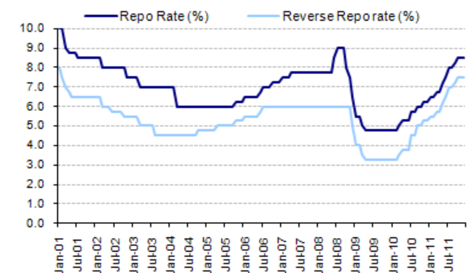
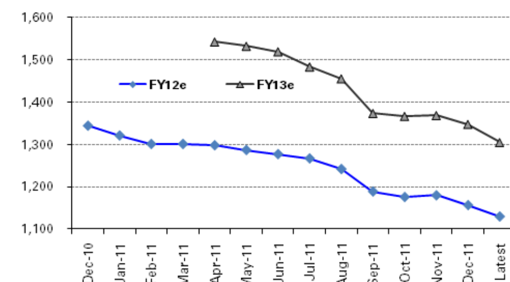
Sensex 1 year forward PE



Trend in repo and reverse repo rate



Sensex earnings trend (DB est)



Deutsche Bank AG/Hong Kong

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It's all about confidence

Indian equity market at the crossroads of confidence

2011 has proven to be nothing short of Annus Horribilis for the Indian equity markets which have seen the worst annual performance in dollar terms (barring the credit crunch in 2008-09). The Indian equity market has seen its valuations compressed to a near 6-year low (barring the subprime crisis, Sensex last witnessed similar valuations in Jun 2006). India's valuation premium has shrunk to just 13% over MSCI Asia ex Japan. As we head into 2012 we see equity investors at two ends of the expectations spectrum, with a dominant majority still nervous and negative on the Indian equity markets despite the precipitous fall in markets and low equity valuations. The minority group of investors who are relatively more sanguine are drawing comfort from expectations of policy easing being a critical catalyst. Expectations of further weakening growth and even weaker business and investor confidence lie at the epicenter of investor angst. Imminent confidence building remains critical to ensuring that the weakening sentiment does not spill over to becoming a self-fulfilling prophecy.

Any further deterioration in domestic confidence in 2012 when global systemic risks are rising disproportionately can have a manifold impact on the economy and investor confidence. India cannot afford a simultaneous combination of hostile domestic and global headwinds.

Rebuilding confidence with India Inc and building protective moat around BoP will be imminent confidence builders

While our conversations with investors lead us to believe that a large majority believe that coalition politics and the compulsions of a popular democracy will prevent the government from moving ahead briskly on policy-related issues, we would like to give the government of India the benefit of doubt.

In 2012, we expect the government to begin rebuilding the confidence of corporate India. In our view, a sooner-than-anticipated turn in monetary policy and building a protective moat – through facilitation of accelerated forex inflows - around the Balance of Payments can be imminent confidence boosters and prevent a continuing erosion in confidence and sentiment. We expect any move to loosen monetary policy – ahead of March or mid year, as consensus expects - will be seen as a positive signal to Indian industry, while the government's cognizance of the seriousness of the worsening global macro environment and a sharp preemptive move against any undue worsening of the health of the Indian banking system should also help snetiments. Consequently, with a declining inflation trend and slowing global growth, an easing monetary policy assumes far greater significance than being just a monetary policy tool.

We remain constructive on India for 2012, but believe that visibility of turnaround will become clearer only by March

Record pessimism is – perversely – the most positive variable for India, with the burden of expectations now shifting in India's favor, after a long gap. Since 2003 we have not seen investors being as negative on India's investment story, as they are today. In what has been the most protracted period of earnings cuts (barring 2009) our analysts have cut their earnings estimates throughout CY2011 by 13-15%. Our analysts now expect yoy earnings growth for FY12-13 at a far muted 12% and 15% respectively (at the beginning of 2011 our analysts were estimating FY12 earnings growth at 23%).

We remain constructive on 2012 and believe that confidence in Indian markets should begin to return by the end of the first quarter of the current calendar year – three to six months prior to our expectation of an economic and earnings turnaround - unless there is a systemic crisis emanating from Europe or the geopolitical issues in the Persian Gulf escalate.

Restoring confidence in capital markets will in our view be the strongest starting point for the Government in rebuilding the faith of Corporate India, which we would argue is the single most important determinant for the return of the capex and investment cycle.

We believe the Indian economy has a self-restorative capability in case the balm is applied in time

To restore the confidence of investors we believe the following are needed—demonstration of the government's commitment to reforms, albeit within the constraints of coalition politics—addressing fiscal consolidation through stepping off the accelerator on excessive populism, expansion of the service tax base, enactment of the direct tax code, accelerated resolve on the Goods and Service Tax, and quicker approvals on issues ranging from environment and mining approvals to business clearances. Non-political but bold policy decisions on state electricity board reform, revision of long overdue power tariffs, addressing supply-side bottlenecks in coal mining will be the strong threads weaving the government's confidence building tapestry for corporate India.

March promises to be a pivotal month for Indian equities

We are enthused by the fact that unlike last year, the Indian state election calendar is front ended (February-early March), the elections precede the union budget, the crucial UP state election will be over by the end of February and a near 20-month election free window (barring Gujarat and Karnataka) will give the government long-needed maneuverability to address many of the issues we have underlined above. We would also expect that the much-needed clarity on how the situation in Europe is likely to evolve will also be clearer by March

2012 year-end Sensex target of 18,000, implying a return of 14% from current levels

We are setting our year-end (December 2012) Sensex target at 18,000, implying a 14% return from current levels. At our target, the Sensex would trade at 13.8x FY13 earnings—a small discount (3%) to India's 15-year average one-year forward multiple.

However we would like to highlight the fact that our confidence in a sustainable rally is more back ended with a more convincing recovery likely after March. Until then the Indian markets may see intermittent rallies alternating between risk appetite and aversion in response to both domestic as well as global factors. The markets may bottom earlier than our expectation (Feb/Mar) in case the RBI reverses its monetary policy stance in the January credit policy (January 24).

Banks, real estate and infrastructure to emerge as key sectoral themes in 2012 but timing will be critical

With a near-19-month monetary tightening cycle expected to reverse in 2012, we believe the classical rate sensitives—banks (though the sector may have to cross the hump of NP's in the near term) and real estate, together with infrastructure will be the key sectors driving Indian markets in 2012. We believe investors looking at sectors to hide in, until March, could take the comfort of the IT sector which may provide investors with a strong hedge against continuing weakness in the domestic economy. Our top picks—Axis Bank, ICICI Bank, Coal India, Larsen and Toubro (now the biggest overweight in model portfolio), TCS, Bharti and DLF.

Sector summary

Figure 1: Brief Sector views

Sector	Summary
Consumer Discretionary	
Autos	The three-year outperformance streak of the Indian auto sector is unlikely to continue. We expect a decline in volume growth and margins for most segments and companies under our coverage. Our FY12/13 forecasts are: 2W, 15%/13%; Heavy CVs, 5%/0%; Light CVs, 27%/20%; Tractors, 18%/10%. We expect 4W growth to normalise in FY13 to around 15.5% after a 1% growth in FY12E. For 2W, channel checks suggest a weakening demand environment. CVs would go through a cyclical downturn, reflecting the soft manufacturing environment and ban on mining in several areas. We expect competition to increase across most segments with 2W & commercial vehicles witnessing maximum change compared to FY12E. Overall, we expect margins to fall 30-60bps for most companies in FY13E. For stock selection we would be tactical through the year rather than take a stance based on structural factors. Our ladder of preference is M&M, Bajaj, TVS, Ashok Leyland, Hero, Maruti and Tata Motors.
Media	Ad environment will remain challenging for the broadcasters as FMCG companies have cut back quite dramatically on ad spends to protect their margins. Digitalization would help the incumbent broadcasters grow their subscription revenues. DTH is likely to be a key driver for growth in subscription revenues. With relatively stable revenues, DTH companies will be better placed than the broadcasters.
Consumer Staples	
Food, Beverage & Tobacco	While there is a strong possibility of a cigarette excise duty hike in the Union budget, we believe cigarette companies will be able to comfortably pass it on. ITC has already taken 10% price hike on select brands over the last 5 months in the run-up to the budget. Discretionary items like paints, jewellery, watches etc will witness growth moderating in CY12. Ability to grab market share under a slow growth scenario will determine the relative winners. Valuations continue to remain rich.
House & Personal Products	Soaps and detergent will continue to face headwinds related to higher raw material prices. We expect companies to take small price increases multiple times through the year as they try to maintain the delicate balance between volume growth and margins. 2% excise duty cut reversal during the union budget could make the environment challenging. Rural demand could see a slowdown as a fall in prices of agri-commodities hurts rural income. Personal products like skin care will continue to benefit from relatively lower penetration.
Energy	DB's oil team forecasts Brent crude to average US$115/bbl in 2012 driven by global GDP growth of 3%+ and geopolitical risks. Coupled with a weak INR we expect upstream oil companies, particularly Cairn India, to benefit from high oil prices. However, the Indian oil marketing companies will continue to see challenging times as losses on sales of subsidized fuels keep mounting. We expect domestic gas transmission volumes to continue to stagnate in 2012 in the absence of any significant domestic gas production growth. We believe Petronet LNG, which benefits from the widening natural gas demand - supply deficit, will continue to outperform the sector as its volume growth momentum continues. We see Coal India as a strong proxy on India's widening fuel shortages.
Financials	
Banks	Concerns related to macroeconomic factors and banks' asset-quality are likely to dominate in the near term. A slower economy and likely lower inflation will push RBI to cut rates, release liquidity in the market, which should be positive for banks. We do believe that the situation could improve starting from 2QCY12 onwards with policy reforms being implemented by the government, lower interest rates, lower commodity prices, etc. For banking system we expect loan growth to be 16-17% for FY12E and FY13E. NIM is likely to remain high for most banks as the competition is lot more rational and there does not seem to be any undercutting on pricing.
Real Estate	We are positive on the medium to L-T prospects of the sector driven by demographics & demand potential. However, we are worried on the immediate prospects (tightening liquidity & fall in affordability) and expect developers to cut prices & increase focus on execution to drive demand & cash flows. Fortunately these near-term concerns seem well factored in the ~100%+ underperformance of sector since 1 Jan'09. Expecting interest rates to decline in next 2-12 weeks, we are more positive on DLF (due to its high gearing & ongoing asset monetisation plans) & Sobha (a company with good corporate governance, but suffering from high gearing).
Health Care	
Pharmaceuticals	Significant outperformance (~10%) since 1 Jan'11 despite limited positive news flow. Thus companies will now have to deliver on promises (launches and market-share) in CY12. Risks include delivering on high market expectations given (a) intensifying competition driven in one-offs in US as also across markets & niche segments (b) increasing regulatory risks, (c) high inflation, (d) deteriorating exclusivity pipeline post CY12 and (e) possibility of INR appreciation post ~20% depreciation in INR since Aug'11.
Industrials	
Capital Goods	Capex turnaround expected by end H1CY12 largely driven by the construction sector particularly from the railroad segments. Clarity could also emerge for mining capex-which would start the process for power capex by end CY13e. Reduced competition especially in roads and T&D sector could also help us in differentiated themes for CY12
Information Technology	
Software	We maintain our robust view on the Indian IT services sector, with TCS and Wipro our top picks. The following key themes will influence the overall IT services market in 2012: 1) demand strength in the largest vertical, financial services, is likely to continue, with regulation and compliance the big drivers, 2) recession in Europe will hasten share gains for Indian vendors, particularly in Germany and France, and 3) stable margins, aided by stable pricing and a weak rupee.
Materials	
Building Materials	Industry maturity and the start of the busy season could help pricing environment. Incremental capacity would lag the incremental demand and we would move one more year closer to upturn likely in H2CY13e onwards.
Metals & Mining	Commodities complex will remain challenged by concerns on global growth and expectations of China FAI slowdown esp. in 1H'CY12. We do expect a gradual recovery in metal demand and pricing in 2H'CY12 driven by monetary and fiscal easing in China and growth stabilisation in the western world. We anticipate Aluminum to outperform as cost inflation provides downside protection and tight energy markets in China likely increase reliance on imports. In steel, prefer integrated producers with captive access to raw materials.
Telecoms	Indian telcos will face significant policy risks in 2012 even as the competitive environment continues to improve. We expect mobile revenues to grow at 15-16% YoY, aided by 3-4% growth in revenue/minute and 12-13% YoY growth in minutes. Higher tariffs should drive 200-400bps margin expansion by FY14E. The three key policy issues which could have a negative impact are: a) cost of excess spectrum, b) cost of license extension, and c) decision on 3G roaming. Based on strength of balance sheet, cash flows and relative impact of likely regulatory costs, our ladder of preference is Bharti, Idea and RCOM.
Utilities	Sustained power demand growth and scarce availability of cheap energy may result in a higher floor rates for merchant power. High operating leverage with a preference on domestic coal use could benefit Indian central utilities.

Source: Deutsche Bank,

Portfolio recommendations

Portfolio positioning

Figure 2: DB India model portfolio positioning

Overweight	Neutral	Underweight
Banks	Cement	Automotives
Energy	Consumer Staples	Healthcare
IT Services	Industrials	Metals
Real Estate		Utilities
Telecom		

Source: Deutsche Bank

Figure 3: DB India Top Picks

Stock	Code	Investment Case	Share Price	Target Price	Upside
Top Buys			**(INR)**	**(INR)**	**(%)**
Axis Bank	AXBK.BO	Axis Bank is likely to grow its loan book at rates higher than the banking system, driven by good traction in retail and SME loans. The bank has significantly expanded its branch network and this should help in sustaining its low-cost deposit ratio, which in turn should help in buffering the NIM contraction. The bank continues to have a very strong fee income franchise. Despite factoring in moderation in loan growth, NIM contraction and higher credit costs, we forecast earnings CAGR of 18-20% over the next three years. The bank is among the more profitable banks in the sector in terms of RoA and RoE	852	1,380	62%
Bharti	BRTI.BO	Bharti's business momentum continues to improve driven by tariff increases and 3G rollout in India, and the solid progress in its African operations. Its strong FCF generation (Rs368bn over FY12-14E) and relative resilience to global factors should enable it to temper policy risks relating to a) excess spectrum costs, and b) licence renewal costs. While the impact of regulatory costs could be material for Bharti, it is better placed than its incumbent peers to absorb them. Stock currently trades at 13xFY13E P/E	331	420	27%
Coal India	COAL.BO	Recent correction in stock price has pushed valuations closer to regional peers; Earnings yield at ~ 8% provides strong support Initiatives for price hike likely to go through as delivered price of coal in India on an average is still at 45% discount to international prices Re-start of clearances from MoEF is likely to drive up long term volume growth-which is a significant positive Strong Cash on b/s raises possibility of one-time special dividend or buy-back which is also a big positive	320	430	35%
DLF	DLF.BO	Best play on expected fall in interest rates as DLF has the highest net gearing (88%) and is also in midst of asset monetisation (which are also valued on DCF basis). By the end of asset monetisation program (ie Mar'14e), we expect net gearing to fall to 67% Unlike most peers, it has a clear focus on execution. Good quality land bank and flexible strategy should enable it to capitalise on potential demand recovery across verticals/ geographies Has a significant leasing income (~USD 300m annually) that can support almost all fixed costs (overheads & interest) once debt burden is reduced	177	255	44%
ICICI Bank	ICBK.BO	We believe that ICICI Bank is one of the very few banks likely to witness NIM expansion over the next few quarters and in FY13 on the back of higher yields and a higher proportion of yielding assets. ICICI Bank did not see huge growth prior to the current slowdown and hence the asset quality concerns are limited. While it has its share of corporate exposures which may be under stress, overall we believe the stress portfolio for ICICI Bank is limited. Over the past six months ICICI Bank has underperformed the BSE Sensex sharply by ~15% and now trades at 1.3x FY2013E P/B.	745	1,050	41%
Larsen & Toubro	LART.BO	Recent correction implies residual E&C valuations at less than 10x- one of the lowest in the last decade We expect order inflow cycle to slowly turn-around by Q1FY13e largely driven by the revival of orders from road/rail sectors. With competition having weak b/s, Larsen could well be an early beneficiary of uptick in the capex cycle	1,083	1,850	71%
Tata Consultancy	TCS.BO	While near-term demand for the top-tier vendors is intact, uncertain global macroeconomic outlook could weigh on the CY12E IT budgets of clients. This, in our view, will only accelerate the need to cut costs and hence Indian IT services companies should benefit from the increase in offshoring by clients. We expect TCS, India's largest offshore services provider, to be the key beneficiary of clients' increased focus on using offshore delivery. For FY13, we forecast earnings to grow 18% in rupee EPS. The company has an estimated long-term earnings growth potential of at least 15%-20% given a likely increase in focus on cost control and outsourcing in developed economies.	1,173	1,350	15%

Source: Deutsche Bank, Bloomberg Finance L.P. Prices as at 8th Jan 2012;

Model Portfolio

Figure 4: Model Portfolio

		Last Price	% Up				P/E (x)		EPS Growth (%)		P/BV (x)		ROE (%)	
Company	**Reco**	**INR**	**side**	**MSCI wt.**	**DB wts**	**O/U wt.**	**FY12e**	**FY13e**	**FY12e**	**FY13e**	**FY12e**	**FY13e**	**FY12e**	**FY13e**
CONSUMER DISCRETIONARY				**7.85**	**7.34**	**-51 bps**								
Automobiles & Components				***7.04***	***5.70***	***-134 bps***								
Bajaj Auto	Hold	1,448	14%	1.15	1.95	80 bps	14.2	12.6	12.5	12.9	6.6	5.2	52.3	46.2
Mahindra & Mahindra	Buy	654	22%	1.84	2.74	90 bps	14.6	11.9	6.8	23.4	3.3	2.8	24.5	25.3
Maruti	Hold	955	-8%	0.61	1.01	40 bps	11.6	10.4	6.4	11.3	1.7	1.5	16.0	15.5
Consumer Durables & Apparel				***0.34***	***0.97***	***63 bps***								
Titan	Buy	174	52%	0.34	0.97	63 bps	25.1	19.8	41.9	26.5	11.2	8.1	51.1	47.3
Media				***0.46***	***0.67***	***21 bps***								
Zee Entertainment	Buy	116	38%	0.46	0.67	21 bps	17.3	14.8	12.4	16.5	2.4	2.1	14.3	15.1
CONSUMER STAPLES				**8.16**	**7.97**	**-19 bps**								
Food Beverage & Tobacco				***4.57***	***5.76***	***119 bps***								
ITC	Buy	202	9%	4.16	5.16	100 bps	23.9	21.8	30.6	9.8	7.9	6.6	36.5	32.8
Nestle	Hold	4,126	8%		0.60	60 bps	36.8	29.3	32.1	25.5	31.4	22.3	101.8	88.8
Household & Personal Products				***3.59***	***2.21***	***-138 bps***								
Hindustan Unilever (HUL)	Hold	396	-21%	3.21	2.21	-100 bps	32.4	27.6	14.5	17.2	27.2	22.9	91.4	90.1
ENERGY				**12.25**	**13.94**	**169 bps**								
Consumable Fuels				***1.48***	***2.53***	***105 bps***								
Coal India	Buy	320	35%	1.48	2.53	105 bps	14.1	12.9	31.9	8.9	4.7	3.7	37.4	31.9
Oil & Gas				***10.77***	***11.41***	***64 bps***								
Oil & Natural Gas Corp (ONGC)	Buy	256	42%	1.81	2.33	52 bps	8.0	7.4	21.6	8.0	1.7	1.5	22.0	20.8
Petronet LNG	Buy	160	24%		0.40	40 bps	12.8	11.9	50.9	7.6	3.5	2.9	30.8	26.6
Reliance Industries	Buy	715	36%	8.58	8.68	10 bps	10.5	9.2	15.8	14.2	1.4	1.2	14.2	14.3
FINANCIALS				**25.40**	**27.66**	**226 bps**								
Banks				***13.68***	***15.84***	***216 bps***								
Axis Bank	Buy	852	62%	1.77	2.61	84 bps	8.8	7.2	17.5	22.2	1.6	1.3	19.5	20.3
HDFC Bank	Buy	451	22%	6.28	6.95	67 bps	22.1	17.1	29.4	29.6	3.6	3.0	18.7	20.8
ICICI Bank	Buy	745	41%	2.91	3.74	83 bps	13.8	11.6	18.9	19.3	1.4	1.3	10.8	11.9
Sate Bank of India (SBI)	Buy	1,669	47%	1.94	2.34	40 bps	7.3	5.5	31.8	32.7	1.2	1.0	16.4	19.0
Yes Bank	Buy	251	43%		0.20	20 bps	9.6	8.0	23.4	21.0	1.9	1.6	21.8	21.9
Diversified Financials				***3.56***	***2.49***	***-107 bps***								
Industrial Development Finance Corp (IDFC)	Hold	98	40%	0.85	0.85	0 bps	9.9	8.5	7.1	16.9	1.2	1.1	11.9	12.6
Rural Electrification Corp (REC)	Buy	161	56%	0.44	1.04	60 bps	5.8	4.9	-6.6	19.4	1.1	0.9	19.9	20.6
Shriram Transport Finance	Buy	482	74%	0.55	0.60	5 bps	7.0	6.1	19.7	14.4	1.7	1.4	26.9	24.9
Thrifts and Mortgage Finance				***7.26***	***7.07***	***-19 bps***								
Housing Development Finance Corp (HDFC)	Buy	669	14%	6.67	7.07	40 bps	24.1	20.4	18.5	18.0	5.1	4.1	23.0	23.1
Real Estate				0.90	2.26	136 bps								
DLF	Buy	177	44%	0.66	1.66	100 bps	20.2	13.7	-3.7	47.4	1.1	1.0	5.5	7.7
Sobha Developers	Buy	207	55%		0.60	60 bps	12.0	8.6	-7.8	39.3	1.0	0.9	8.8	11.2

Source: Deutsche Bank, Bloomberg Finance L.P

Figure 5: Model Portfolio (contd..)

		Last Price	% Up				P/E (x)		EPS Growth (%)		P/BV (x)		ROE (%)	
Company	**Reco**	**INR**	**side**	**MSCI wt.**	**DB wts**	**O/U wt.**	**FY12e**	**FY13e**	**FY12e**	**FY13e**	**FY12e**	**FY13e**	**FY12e**	**FY13e**
HEALTH CARE				**5.27**	**3.31**	**-196 bps**								
Aurobindo Pharma	Buy	91	66%		0.65	65 bps	7.0	4.4	-29.8	59.0	1.2	0.9	15.9	23.6
Cipla	Hold	336	-11%	1.01	0.81	-20 bps	24.8	21.4	12.4	15.8	3.6	3.3	15.4	16.0
Lupin	Hold	445	1%	0.60	0.60	0 bps	22.1	19.9	4.1	11.0	5.0	4.1	24.7	22.7
Sun Pharma	Hold	500	0%	1.42	1.25	-17 bps	24.3	21.0	48.5	15.5	5.0	4.3	23.7	22.5
INDUSTRIALS				**5.70**	**5.36**	**-34 bps**								
Construction & Engineering				***2.06***	***3.96***	***190 bps***								
IRB Infra	Buy	125	53%		0.60	60 bps	8.0	8.9	15.2	-10.7	1.4	1.3	19.6	15.0
Larsen & Toubro	Buy	1,083	71%	2.06	3.36	130 bps	14.5	13.0	6.4	12.0	2.2	1.9	16.3	15.6
Electrical Equipment				***1.47***	***1.40***	***-7 bps***								
Bharat Heavy Electricals (BHEL)	Buy	251	58%	1.35	1.40	5 bps	9.3	10.1	9.6	-7.4	2.3	1.9	28.3	20.9
Industrial Conglomerates				***1.70***	***0.00***	***-170 bps***								
Transporation Infrastructure				***0.47***	***0.00***	***-47 bps***								
INFORMATION TECHNOLOGY				**18.75**	**20.10**	**135 bps**								
Infosys	Buy	2,835	9%	11.19	11.72	53 bps	20.1	17.3	18.0	16.2	5.3	4.7	28.0	28.8
Tata Consultancy	Buy	1,173	15%	5.05	6.05	100 bps	21.3	18.1	23.7	17.5	8.0	7.0	39.8	41.2
Wipro	Buy	407	25%	1.83	2.33	50 bps	17.2	15.0	7.9	14.7	3.7	3.2	22.6	22.9
MATERIALS				**9.08**	**8.74**	**-34 bps**								
Chemicals				***0.98***	***1.23***	***25 bps***								
Asian Paints	Hold	2,663	22%	0.70	1.23	53 bps	24.1	20.3	25.7	18.9	9.1	7.2	42.5	39.8
Construction Materials				***2.12***	***2.15***	***3 bps***								
ACC	Buy	1,102	13%	0.53	1.00	47 bps	17.9	14.3	3.5	25.0	2.9	2.6	17.1	19.3
Grasim	Buy	2,428	24%		0.80	80 bps	9.4	8.5	3.2	10.9	1.4	1.2	15.4	14.9
Shree Cement	Buy	2,086	8%		0.35	35 bps	29.9	12.0	16.7	148.5	3.4	2.7	11.8	24.8
Metals & Mining				***5.98***	***5.36***	***-62 bps***								
JSW Steel	Buy	570	40%	0.47	0.77	30 bps	7.9	5.4	-8.5	46.7	0.7	0.7	9.6	12.8
Jindal Steel & Power	Buy	467	62%	1.60	2.20	60 bps	10.5	7.8	11.1	34.2	2.4	1.9	26.0	27.4
Sterlite	Buy	94	72%	1.16	1.17	1 bps	5.6	4.8	13.0	17.6	0.7	0.6	12.9	13.5
Tata Steel	Buy	363	38%	1.02	1.22	20 bps	5.8	4.2	-8.6	37.9	1.3	1.0	25.7	18.3
TELECOMMUNICATION				**2.59**	**3.23**	**64 bps**								
Bharti	Buy	331	27%	1.73	2.73	100 bps	22.3	13.2	-9.4	68.9	2.4	2.0	10.0	16.4
Idea Cellular	Hold	82	29%	0.49	0.50	1 bps	54.7	21.1	-41.2	160.0	2.1	1.9	3.9	9.6
UTILITIES				**4.95**	**2.35**	**-260 bps**								
Gas Utilities				***1.34***	***0.00***	***-134 bps***								
IPP				2.80	2.35	-45 bps								
NTPC	Hold	157	21%	0.83	1.33	50 bps	13.1	11.8	5.5	11.1	1.7	1.6	13.7	14.0
Power Grid	Buy	100	15%	1.02	1.02	0 bps	15.1	13.0	13.6	16.2	2.0	1.8	13.7	14.5

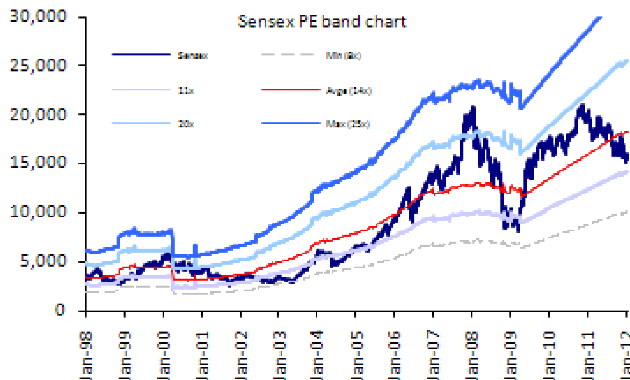
Source: Deutsche Bank, Bloomberg Finance L.P

Valuations appear cheap on absolute and relative basis

Sensex valuations are lowest in the current cycle

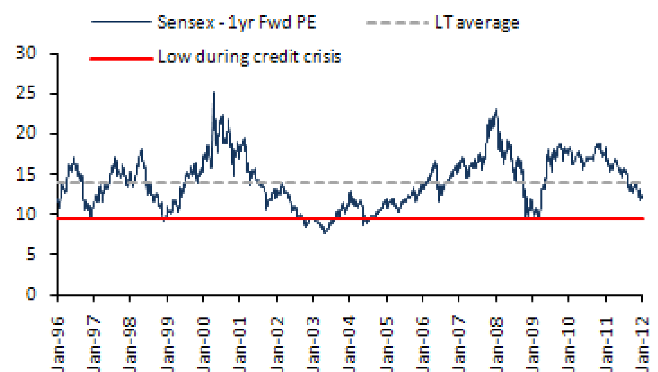
2011 proved to be nothing short of *Annus Horribilis* for India, as political paralysis, civil activism, economic deterioration, decline in corporate profit growth impacted Indian equity markets, with the Sensex declining by 25% yoy (36% in dollar adjusted terms)—the worst performance ever, barring 2008, when markets were hit by the global financial crisis. This has led to severe compression in valuations with India's 1yr forward PE now at ~12.5x (vs. 17x at the beginning of 2011).

Figure 6: Sensex 1 yr fwd PE band



Source: Deutsche Bank, Bloomberg Finance L.P

Figure 7: Sensex 1 yr fwd PE



Source: Deutsche Bank, Bloomberg Finance L.P

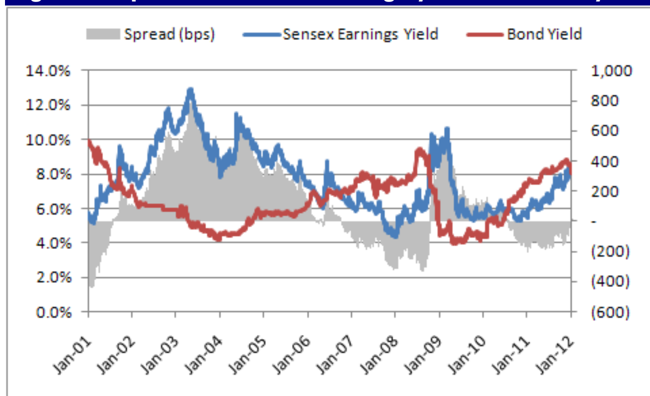
The sharp compression in valuations would seem to discount the extreme pessimism and reduces the burden of expectations on the Indian market. In addition, we believe the market valuations have also not yet begun to factor in the impact of monetary easing which we believe is imminent (expected in 1QCY2012).

We believe the pall of extreme gloom should begin to lift as RBI starts cutting rates and markets are likely to derive comfort from amply supportive and cheap valuations, unless events in Europe turn worse.

The spread between earnings yield and bond yields is now close to parity

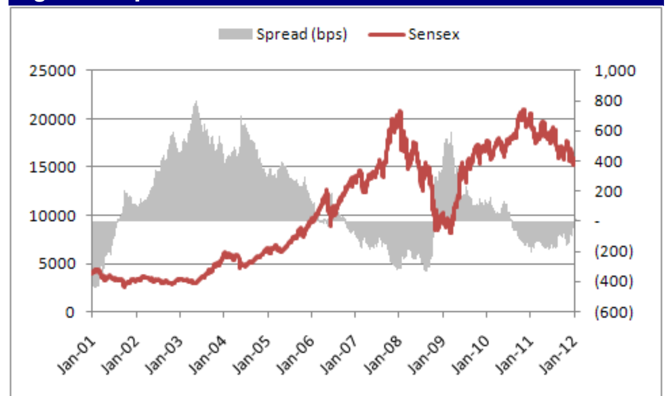
The Sensex's sharp dip in 2011 has resulted in valuations becoming cheap not just to its own history but also relative to other asset classes. The spread between the Sensex earnings yield and Govt. of India 1yr bond yield is now close to parity after being in negative territory for 17 months since August 2010. This is closely comparable to the period between Oct-06 to Sep 08 (24 months) when the spread remained in negative territory, initially as equity started to become expensive in 2006-2007 vis-à-vis bonds, and later in the cycle primarily as RBI raised rates sharply to contain sudden spurt in inflation, leading to higher bond yields. In the current bout too, bond yields have shot up sharply, from 6% to 8.5% in response to RBI's tightening measures, strained liquidity and higher govt. borrowings driving spread in favor of bonds even though equity valuations shrunk.

Figure 8: Spread between earnings yield and bond yield



Source: Deutsche Bank, Bloomberg Finance L.P

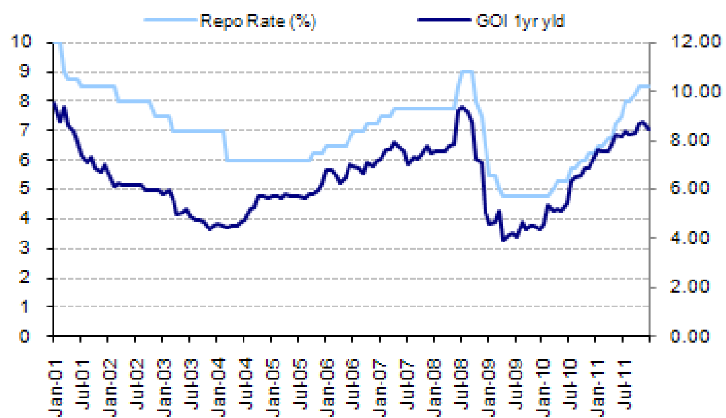
Figure 9: Spread and Sensex



Source: Deutsche Bank, Bloomberg Finance L.P

With expectations of imminent cuts in policy rates, we believe Govt. bond yields will also follow suit (despite the continuing overhang of high fiscal deficit and govt. borrowings). As we illustrate in the chart below, government bond yields respond very readily and strongly to RBI's rate actions (76% correlation over last decade) even though the overhang of high government borrowings may sustain. RBI has also attempted to address tight liquidity and higher government borrowings by embarking on OMOs (total OMOs of ~US$8bn in past few months) and also raising the FII cap on investing in Indian govt. bonds to US$15bn from the existing US$10bn – which could allay some concerns over bond yields moving sharply above current levels.

Figure 10: Trend in repo rate and 1 yr government bond yield



Source: Deutsche Bank, Bloomberg Finance L.P

We believe as the RBI begins to cut rates and bond yields and other interest rates in the economy move lower, this could lead to the spread getting more favorable for equities which should in our view make equities relatively attractive, unless there is a big risk event (not our base case)—in the form of either European crisis getting worse or India's policy environment remaining unable to benefit from the election free window— in which case equities can get even cheaper.

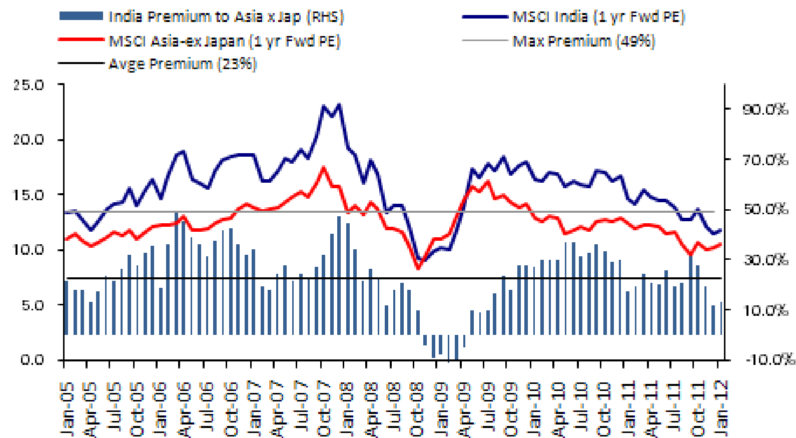
India's valuation premium to Asian peers is at cyclical lows

Following the Annus Horribilis in 2011, India's valuation premium to its Asian peers saw a sharp compression of 17 percentage points. MSCI India's valuation premium to MSCI Asia-ex Japan currently stands at barely 13% (vs. 30% at the start of 2011), reflecting the high levels of investor pessimism on India. The average premium over the past eight years has been ~23%. Even more importantly, this is close to the lowest premium witnessed at the

beginning of the current cycle since April '09, and is clearly reflective of the fact that India has lost favor with investors more than most of its Asian peers.

In our view most of the concerns now appear to be well discounted and there is little scope for MSCI India's valuation premium to shrink further, unless there is a big negative risk event (most likely in form of further deterioration of EU crisis), in which case India (being a high beta market) may again be a top casualty of risk aversion. However, any positive development especially on the domestic policy front and monetary actions may lead to higher gains than other markets driven by extremely low valuations.

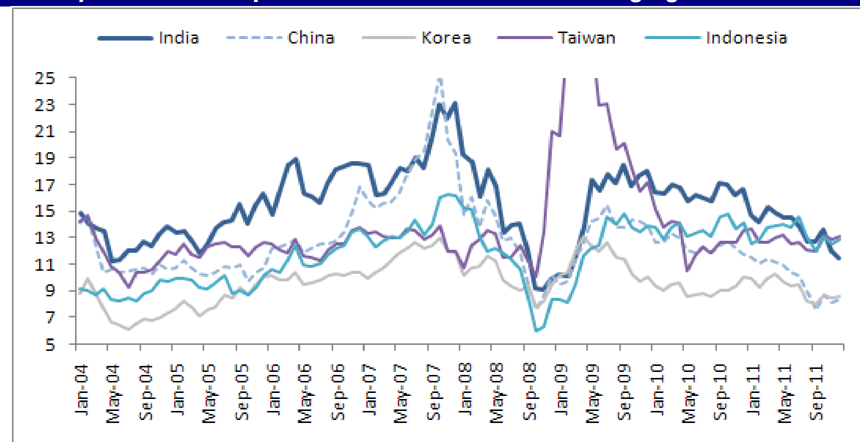
Figure 11: MSCI India and MSCI Asia ex Japan 1yr fwd PE and premium



Source: Deutsche Bank, Bloomberg Finance L.P.

As can be observed from the following chart, among Asian peers Taiwan and Indonesia have barely seen any valuation contraction while India, alongside China has witnessed sharpest contraction of valuation multiple at >20%.

Figure 12: 1yr fwd PE multiple for MSCI indices across emerging Asia



Source: Deutsche Bank, Bloomberg Finance L.P.

Figure 13: Sector-wise trend in annual PE ratios of DB India universe

	FY10	FY11	FY12e	FY13e
DB India	**16.6**	**14.0**	**12.2**	**10.4**
Automotives	21.0	11.8	11.3	10.3
Capital Goods	16.2	14.7	13.3	12.3
Cement/Construction	11.1	16.4	14.2	11.7
Consumer	39.8	32.8	25.9	23.2
Fertilizers & Agro Chem	13.9	12.0	9.5	8.4
Financials	13.2	11.4	9.9	8.1
IT Services	26.5	22.6	18.4	16.1
Media	26.9	21.8	16.1	13.5
Metals	9.6	6.6	6.3	5.3
Oil & Gas	12.3	10.4	8.9	7.9
Pharmaceuticals	36.3	26.9	22.6	19.1
Real Estate	12.8	12.7	13.2	8.8
Telecom	18.4	21.7	26.8	15.4
Utilities	17.7	16.4	13.5	11.1

Source: Deutsche Bank, Bloomberg Finance L.P

Figure 14: Sector-wise trend in annual PBV ratios of DB India universe

	FY10	FY11	FY12e	FY13e
DB India	2.5	2.2	1.9	1.7
Automotives	5.3	3.8	3.1	2.6
Capital Goods	2.9	2.8	2.3	2.0
Cement/Construction	2.3	2.1	1.9	1.6
Consumer	12.1	10.6	8.7	8.3
Fertilizers & Agro Chem	2.3	2.0	1.7	1.5
Financials	2.0	1.7	1.6	1.3
IT Services	6.8	5.6	4.9	4.4
Media	4.4	3.9	3.3	3.0
Metals	1.3	1.0	0.9	0.8
Oil & Gas	1.8	1.6	1.4	1.2
Pharmaceuticals	5.3	4.4	3.9	3.3
Real Estate	0.7	0.7	0.7	0.6
Telecom	1.7	1.6	1.5	1.4
Utilities	2.4	2.1	1.9	1.8

Source: Deutsche Bank, Bloomberg Finance L.P

Figure 15: Valuations and earnings metrics across Emerging Markets (DB est)

	PE		EPS Growth		EV/EBITDA		PB	ROC
	CY11 (X)	CY12E (X)	CY11 (%)	CY12E (%)	CY11 (%)	CY12E (%)	CY11 (X)	CY11 (%)
China	8.7	9.0	16.1	5.2	5.7	5.0	1.4	14.3
India	13.9	12.1	12.0	15.3	8.4	7.3	2.2	15.7
Indonesia	15.5	13.1	23.9	18.9	8.3	7.0	3.4	19.9
Korea	9.0	8.3	13.2	14.2	5.8	5.0	1.2	11.8
Taiwan	13.9	12.3	-2.8	14.8	7.7	6.7	2.1	12.5
Russia	5.1	5.7	38.5	-1.5	3.4	3.6	0.9	17.0
South Africa	11.0	9.2	33.9	18.9	6.4	5.5	2.5	21.1
Brazil	9.6	9.1	8.6	8.5	6.2	5.9	1.4	14.4
Mexico	15.7	14.1	13.0	17.8	7.7	6.8	2.7	14.5
ASIA	**10.3**	**9.9**	**14.4**	**10.7**	**6.8**	**5.7**	**1.6**	**14.9**
EMEA	**7.5**	**7.5**	**29.1**	**8.9**	**4.7**	**4.6**	**1.3**	**16.9**
LATAM	**11.1**	**10.3**	**10.4**	**11.6**	**6.7**	**6.2**	**1.7**	**15.0**
GEM	**9.6**	**9.2**	**17.3**	**10.4**	**6.0**	**5.4**	**1.6**	**15.5**
US	13.1	11.9	15.5	10.0				
EUROPE	10.8	9.9	1.9	8.2				

Source: Deutsche Bank; In case of India, CY11 implies FY12 and CY12 implies FY13

Figure 16: Growth and inflation expectations across key economies

	GDP growth (%)			Inflation (%)		
	CY11	CY12F	CY13F	CY11	CY12F	CY13F
US	1.8	2.5	3.0	3.3	3.2	2.4
Japan	-0.4	0.5	1.2	-0.3	-0.3	-0.1
Euroland	1.6	-0.5	1.0	2.7	1.9	1.5
G7	1.5	1.3	2.1	2.6	2.3	1.8
Asia (ex Japan)	7.3	6.9	7.4	6.0	3.9	4.3
India	7.3	7.3	8.0	9.4	6.3	6.9
China	9.1	8.3	8.6	5.3	2.8	3.5
Lat Am	4.1	3.6	4.3	8.9	8.4	8.1
Brazil	3.0	3.3	5.0	6.4	5.3	5.6
EMEA	4.5	3.7	4.5	7.7	6.8	6.6
World	3.6	3.2	4.0	4.4	3.4	3.3

Source: Deutsche Bank

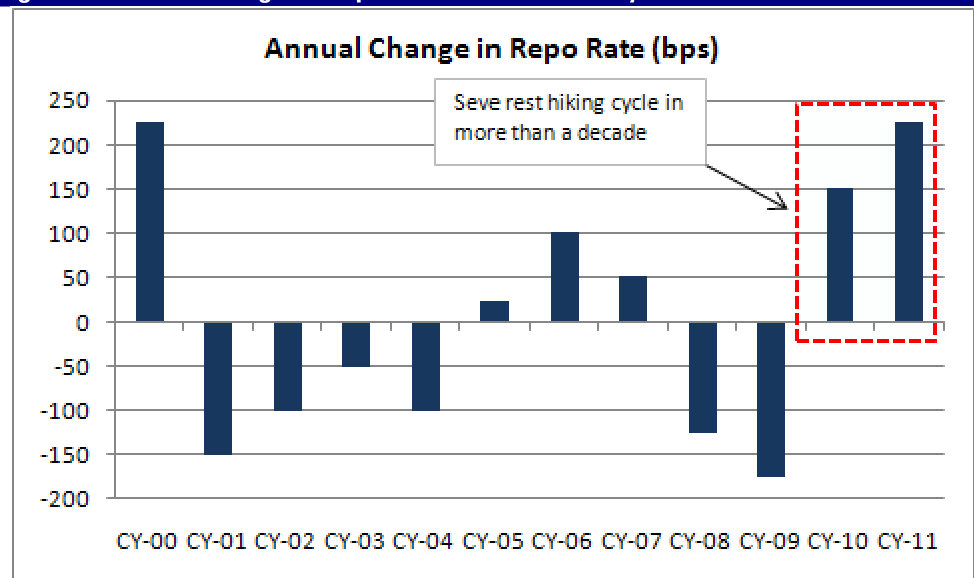
Role reversal: tightening fiscal policy, easing monetary policy

More accommodative RBI should provide support to market and rate-sensitives

Since early 2010, the Indian Reserve Bank of India (RBI) has been in a tightening mode, having raised interest rates 13 times and by 375bps, to address persistently high inflation. On the other hand, the government has largely carried on with its stimulative, countercyclical fiscal policies - which it had embarked upon after the 2008 sub-prime crisis and an inclusive growth focused bias on welfarist, populist schemes. Slowing economic growth and large increases in food, oil and fertilizer subsidies now threaten India's fiscal deficit, leaving the finance minister with virtually zero fiscal maneuverability. This situation will warrant a reversal in roles of both the RBI and the government in 2012.

Slowing growth momentum, easing food inflation and tight liquidity have together encouraged RBI to formally acknowledge that its next policy action will be one of accommodation *(while timing is still not clear, we are intent to believe dovish monetary policy—albeit not an aggressive one—should commence in the Jan-Mar qtr itself)*. The current bout of rate tightening has cumulatively been the severest and most hawkish hiking cycle in more than a decade as the RBI raised policy rates by 375bps (effectively 525bps if the switch from rev repo to repo is considered) over 19 months with the nearest comparison being 225 bps hike in 2000.

Figure 17: Annual changes in repo rate shows current cycle is the severest in a decade



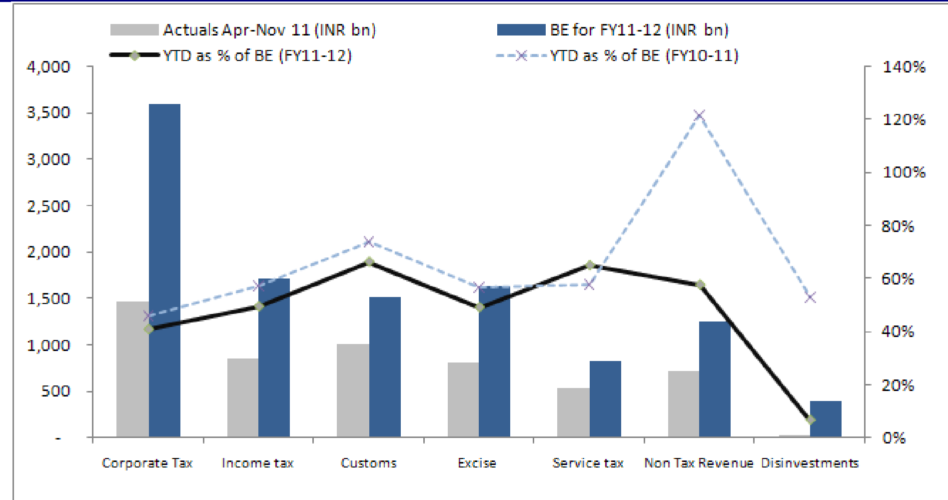
Source: Deutsche Bank, Bloomberg Finance L.P

Fifteen-month election-free window increases hope of government addressing overdue fiscal consolidation

On the other hand, with no forthcoming signs of relief in a sharply deteriorating fiscal situation (Apr-Nov fiscal deficit is running at 86% of the full year budgeted target), we firmly believe fiscal consolidation will assume top priority in the making of the FY-12/13 union

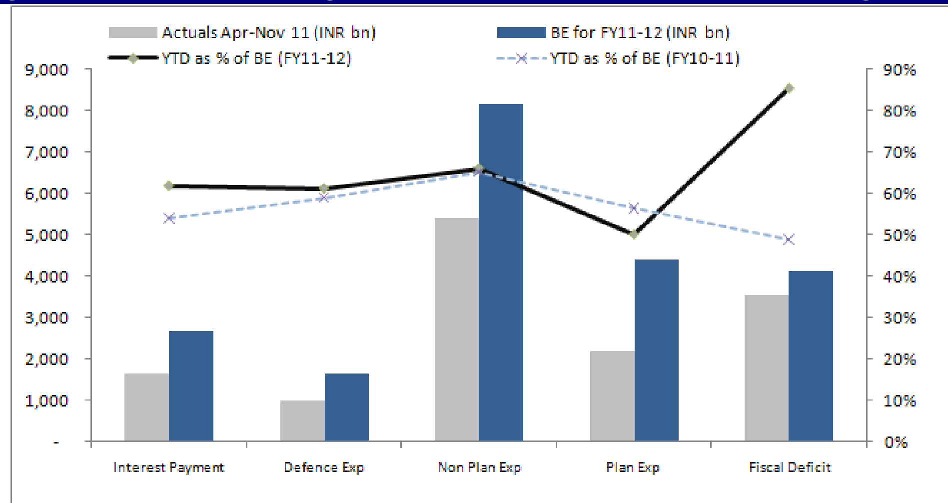
budget. We also expect the state election calendar in 2012 (February) preceding the announcement of the union budget (mid March) and an unusually long, 15-month election-free window (barring Gujarat), will allow the government to take up the economic agenda, more forcefully. Government is currently having to contend with multiple fiscal stress points (sticky transfer payments, ballooning subsidy bill, slim possibility of achieving disinvestment target, dwindling tax collections and rising interest payments), hence we expect the Finance Minister to raise excise/service tax rates in the union budget, while simultaneously desisting from populist temptation of providing fiscal dole-outs (either in form of direct tax relief or large social transfer schemes).

Figure 18: Run rate of central government revenue Apr-Nov 2011 vs. budgeted est



Source: Deutsche Bank, Government of India

Figure 19: Run rate of central government expenditure Apr-Nov 2011 vs. budgeted est



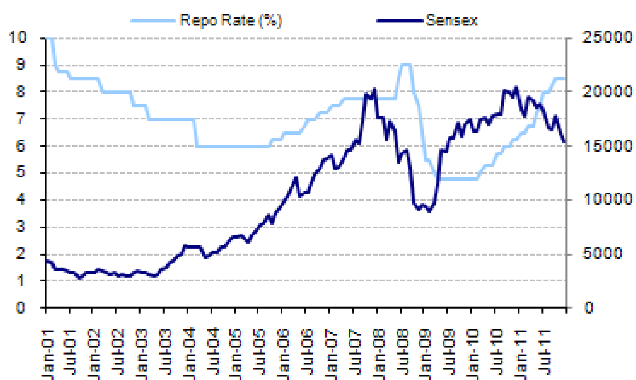
Source: Deutsche Bank, Government of India

Equity market implications of role reversal:

While monetary and fiscal policies are expected to pull in opposite directions in 2012, we believe the net impact of this role reversal is likely to be marginally positive for equity markets.

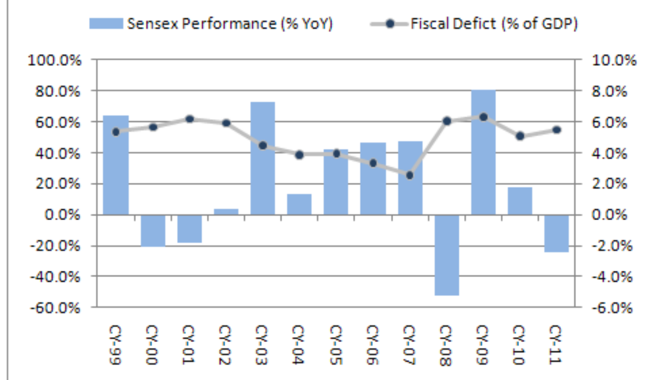
The stock market should react more briskly to the reversing rate trajectory while response to fiscal measures could be more protracted and indirect. In our view, this thesis is particularly relevant at the inflection point of reversal in the direction of monetary policy, which in our view will largely neutralize negative impact of the imminent fiscal drag. However, a key positive emanating from fiscal consolidation will be a lower pressure on government. Bond yields (aided further by easier monetary policies) as government's demand for borrowings eases, which should also lead to greater availability of banking capital for the private sector.

Figure 20: Sensex and repo rate



Source: Deutsche Bank, Bloomberg Finance L.P

Figure 21: Sensex performance and fiscal deficit



Source: Deutsche Bank, Bloomberg Finance L.P

We expect government to address policy concerns

Light election calendar from Mar'12 to Nov'13 indeed provides enough election free window

As the government has been tied down by revelations of numerous scams, belligerent opposition, rising civil activism against corruption and lack of co-ordination amongst ruling party members and allies, policymaking has been put in a virtual freeze and tough reforms measures (such as deregulation of diesel prices, allowing FDI in multi-brand retail, ushering in tax reforms in form of GST or DTC etc.) have been key casualties. While a positive turnaround in policymaking (especially in those items requiring parliamentary approval) is highly unlikely, we still see a glimmer of hope in the relatively election-free calendar (from Mar12 to Nov 13) once the current state elections (in UP, Punjab etc.) have wound down.

Figure 22: Likely State Election Calendar based on last election date

	Likely date for Next election	Date of Last Election	Lok Sabha Seats	% of total
2012				
Manipur	Jan-Mar 2012	Mar-07	2	0%
Uttarakhand	Jan-Mar 2012	Mar-07	5	1%
Punjab	Jan-Mar 2012	Mar-07	13	2%
Uttar Pradesh	Jan-Mar 2012	May-07	80	15%
Goa	Jan-Mar 2012	Jun-07	2	0%
Gujarat	**Dec-12**	**Dec-07**	**26**	**5%**
Himachal Pradesh	Dec-12	Dec-07	4	1%
2013				
Tripura	Mar-13	Mar-08	2	0%
Meghalaya	Mar-13	Mar-08	2	0%
Nagaland	Mar-13	Mar-08	1	0%
Karnataka	**May-13**	**May-08**	**28**	**5%**
Madhya Pradesh	Nov-Dec-13	Nov-Dec-08	29	5%
Rajasthan	Nov-Dec-13	Nov-Dec-08	25	5%
Chhattisgarh	Nov-Dec-13	Nov-Dec-08	11	2%
Delhi	Nov-Dec-13	Nov-Dec-08	7	1%
J&K	Nov-Dec-13	Nov-Dec-08	6	1%
Mizoram	Nov-Dec-13	Nov-Dec-08	1	0%
2014				
Andhra Pradesh	Apr-May '14	Apr-May '09	42	8%
Orissa	Apr-May '14	Apr-May '09	21	4%
Sikkim	Apr-May '14	Apr-May '09	1	0%
Lok Sabha Elections	**Apr-May '14**	**Apr-May '09**	**543**	**100%**
Arunachal Pradesh	Oct-14	Oct-09	2	0%
Haryana	Oct-14	Oct-09	10	2%
Maharashtra	Oct-14	Oct-09	48	9%

Source: Deutsche Bank; Election Commission of India; In case of Uttar Pradeh, Uttarakhand, Punjab, Goa & Manipur, the dates have already been announced

We are sanguine that this election-free window should allow the government an opportunity to shift focus from populist measures (within constraints) to getting through some of the key

policy initiatives which can be implemented through executive actions and do not require being tested on the floor of the parliament. With the government in a desperately tight situation and very keen to re-establish its reforms credentials, we believe this election-free window of ~15-20 months offers good opportunity for the government

What are the key policy measures which can likely be implemented without recourse to parliament?

While measures such as Goods and Services Tax, Direct Tax Code, Lokpall Bill, Judicial Accountability Bill, MMDRA bill etc. require parliamentary approval, the government can still implement several measures which by themselves will help unclog the severely stalled process of capital formation (which posted a negative growth in Jun-Sep qtr) and raise hopes of a return of the investment cycle, helping boost stalling economic momentum. The key measures which require urgent attention of policymakers and can be passed if the government demonstrates the requisite political include:

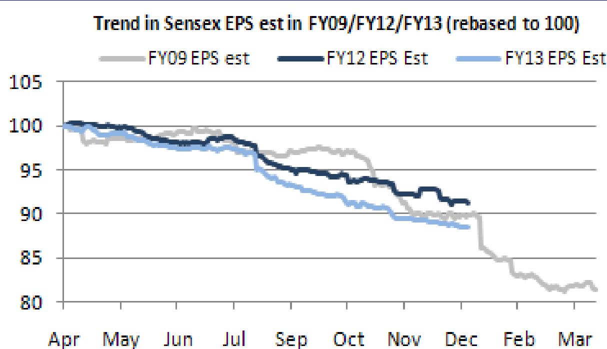
- With "Go, No-Go" policy now abandoned, the government can expedite allocations of coal blocks which should help address the excruciating fuel shortage for power sector and also other industries like cement and aluminum which are heavily dependent on coal for their fuel feed requirements
- The government can move further ahead on reforming power sector by facilitating higher power tariffs, in line with the sharp escalation in power costs. In 2011 we have already seen several SEBs being allowed to raise tariffs while few other have filed for revisions
- The government can also by itself (i.e. without going through the parliamentary legislative process) accord faster environmental and forest approvals which can help create a more conducive landscape for industrial investments

2012 may not see an encore of 2011 earnings cuts spree

Despite subdued demand environment, falling cost pressures should prevent an encore of 2011

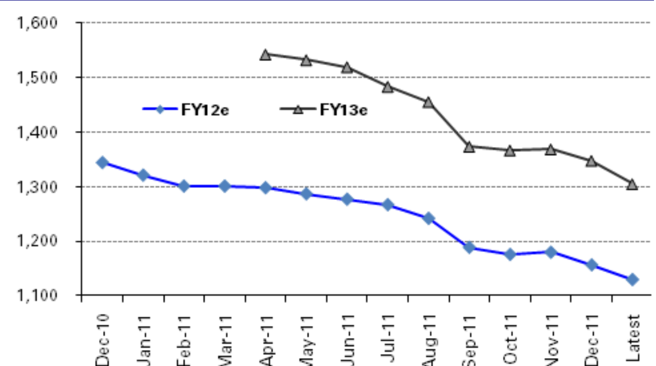
Rising interest rates, policy paralysis, deteriorating business confidence, slowing aggregate demand and a weakened rupee resulted in a sharp cut in analyst earnings estimates for India. Consensus estimates for Sensex' FY12/13 earnings were trimmed by 10% and 12%, with our analysts cutting estimates by 13% and 15% respectively over the course of last year.

Figure 23: Sensex EPS trend FY12/13 vs. FY09 (cons est.)



Source: Deutsche Bank, Bloomberg Finance L.P.

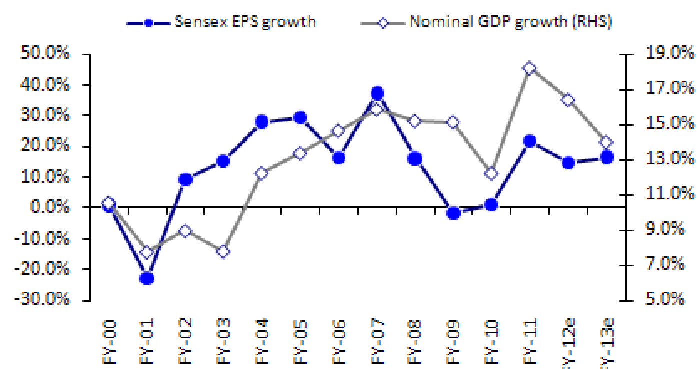
Figure 24: Trend in Sensex EPS (DB est.)



Source: Deutsche Bank

When compared with 18% cut in FY09 Sensex earnings estimates, the cut in FY12/13 earnings estimates could be construed as rather sharp, particularly given that FY09 earnings were cut in a recessionary environment driven by an unprecedented credit crunch across key global markets. Hence, unless we witness another Lehman-moment kind of shock, we believe a large part of earnings cuts are behind us. Currently, DB analysts are expecting FY13 Sensex earnings to come in at 15% (vs. 14% of consensus), which is not too high an expectation in our view, given specially that Sensex earnings growth exhibits reasonably strong multiple to nominal GDP growth (~1-2x) with a relatively strong correlation of 52%.

Figure 25: Nominal GDP growth and Sensex EPS growth



Source: Deutsche Bank, CMIE

In addition to an already sharp earnings cut which should provide a support, several cost pressures are likely to either peak out or moderate from here on. While prices of several key commodities are already down in late 2011 (which should start to favorably reflect in

quarterly earnings going forward), an imminent turn in RBI's rate cycle should also lower interest rates, while a 16% decline in INR should help to stem INR's weakness henceforth. However, crude prices remain key imponderable, as it has defied the generic pressure on other commodities' prices and hence may play spoilsport, putting pressure on both the current account and fiscal deficits. The current imbroglio in strait of Hormuz and further souring of US-Iran relationship is an immediate upside risk for crude prices, while a high likelihood of continuation of the tectonic upheaval in the polity of other Middle Eastern countries poses a structural upside risk to crude prices – this will continue to be an overhang on earnings of Indian corporate.

Figure 26: Sector-wise trend in annual Earnings Growth of DB India universe

	FY10	FY11	FY12e	FY13e
DB India	**12%**	**18%**	**15%**	**20%**
Automotives	235%	77%	4%	9%
Capital Goods	11%	8%	12%	8%
Cement/Construction	24%	-25%	15%	21%
Consumer	16%	21%	27%	11%
Fertilizers & Agro Chem	-4%	16%	27%	13%
Financials	18%	15%	13%	23%
IT Services	71%	17%	23%	17%
Media	53%	24%	35%	19%
Metals	-25%	47%	6%	19%
Oil & Gas	26%	18%	17%	12%
Pharmaceuticals	-8%	35%	19%	18%
Real Estate	-62%	-2%	-4%	51%
Telecom	-43%	-15%	-19%	75%
Utilities	33%	6%	22%	24%

Source: Deutsche Bank

Figure 27: Sector-wise trend in annual ROE of DB India universe

	FY10	FY11	FY12e	FY13e
DB India	18%	17%	17%	18%
Automotives	23%	40%	30%	27%
Capital Goods	25%	20%	19%	17%
Cement/Construction	22%	14%	14%	15%
Consumer	33%	35%	37%	36%
Fertilizers & Agro Chem	17%	18%	19%	19%
Financials	16%	16%	17%	18%
IT Services	30%	27%	28%	29%
Media	18%	19%	22%	22%
Metals	13%	19%	17%	16%
Oil & Gas	18%	16%	17%	17%
Pharmaceuticals	17%	19%	20%	20%
Real Estate	6%	5%	5%	8%
Telecom	11%	7%	5%	9%
Utilities	16%	14%	15%	16%

Source: Deutsche Bank

BoP issues may pressure companies with forex loans

BoP situation has deteriorated due to convergence of several issues

India's BoP has been hit by multiple headwinds in form of (a) persistently high crude oil prices—despite a generic weakness in commodities complex due to US$ strength, (b) deteriorating FII flows due to contraction in global risk appetite and domestic issues, and (c) slowing export growth and downward restatement of earlier exports number. The only silver lining in the BoP has been the sharp turnaround in FDI inflows which are up a massive ~64% yoy (Apr-Oct), but have not been enough to mitigate the pressures emanating from other segments of the BoP which have together driven INR lower by ~16% in 2011.

Prospects of deleveraging of European banks create overhang for refinancing of India's short-term external debts

As per the Bank of International Settlements (BIS), the ongoing stress in Europe coupled with a big tranche of sovereign debts in Euro Area coming due for redemption implies that several European banks will be compelled to deleverage, particularly by reducing their lending to emerging market economies. In our view, if these worries accelerate they may create an overhang for India's external debt servicing, a good portion of which comes due for redemption in 2012 itself. As per the RBI, based on residual maturity as on June-11, India's short-term external debt accounted for 43% of India's total external debt which amounts to ~US$137.3bn. As per the BIS, European banks account for ~56% of India's short-term claims (see table below).

Figure 28: Country-wise breakup of share of European Banks in respective county's external debts

	Euro area banks' share of total credit [1]	Euro area banks' cross border claims share [3]	Euro area banks' short-term claims share [4]	Euro area banks' debt securities share [5]
Emerging Europe	**47.3 (5.2)**	**33.5**	**33.1**	**10.3**
Poland	63.2 (5.3)	23.1	21.6	17.5
Russia	18.9 (3.4)	48.8	35.2	2.6
Turkey	20.6 (3.5)	37	46.3	5.7
Hungary	82.4 (9.0)	45	29.5	19.3
Romania	99.4 (8.2)	35.7	36.8	7.2
Latin America & Caribbean	**17.1 (1.5)**	**21.8**	**39.2**	**14.3**
Brazil	10.9 (1.1)	24.1	30.7	28.5
Mexico	35.9 (3.3)	17.4	30.9	7
Chile	43.5 (3.1)	18.7	50.4	1.8
Peru	44.4 (1.9)	16.3	64.3	5
Argentina	18.0 (0.7)	27.2	55.4	8.6
Emerging Asia-Pacific	**2.3 (0.9)**	**67.6**	**51.8**	**7.8**
China	0.9 (0.5)	67.1	61.7	1.2
Korea	5.7 (2.6)	71.6	53.1	24.7
India	**4.1 (1.2)**	**60.7**	**55.8**	**4.7**
Chinese Taipei	4.1 (0.9)	55	74.5	9
Indonesia	4.6 (0.9)	77.6	49	2.6
Africa & Middle East	**13.7 (2.8)**	**73.7**	**40.5**	**2.7**
United Arab Emirates	8.5 (1.9)	91.9	47.5	2.9
Saudi Arabia	15.9 (5.6)	93.8	68.2	–
Qatar	12.3 (1.8)	98.3	16.4	3.5
Liberia	55.7 (–)	99.9	14.3	2.2
South Africa	4.2 (1.9)	75.3	35.5	15.1

Source: Deutsche Bank, Bank of International Settlements; 1 Euro area banks' foreign claims on all sectors as a share of total credit to non-banks, in per cent. The numbers in parenthesesindicate euro area banks' foreign claims on banks as a percentage of total credit to non-banks. 3 Euro area banks' cross-border claims as a share of their foreign claims, in percent. 4 Euro area banks' international claims with a remaining maturity of up to one year as a share of their international claims, in per cent. 5 Euro area-located banks' debt securities as a share of their cross-border claims, in per cent

Navigating likely BOP turbulence will assume critical importance

While RBI/Govt of India have already endeavored to address the BoP situation we expect few more key measures in 2012

Given the emergence of multiple pressures on India's BoP and as a corollary on the INR, both RBI/GoI have announced several liberalization measures cumulatively aimed at accelerating inflows into the country and stem the sharp decline in INR. Some of the key measures over the past month include:

Figure 29: Key measures adopted by RBI/GoI to address BoP issues

The cap on foreign holding in Indian corporate bonds was raised to US$20bn vs. US$15bn earlier. This was in addition to the hike in FII cap in infrastructure corporate bonds was raised to US$20bn vs. US$5bn in the Union Budget
The cap on FII holding in Government of India bonds was raised to US$15bn vs. US$10bn earlier
RBI allowed corporates to pay higher interest rates on ECBs with maturity upto 5 years, raising the limit by 50bps to LIBOR+350bps
Interest rate on NRI rupee deposit of 1-3 year maturity raised by 100bps to LIBOR/Swap plus 275bps
Interest rate on NRI foreign currency deposits by 25 bps to LIBOR/Swap plus 125bps
Later Interest rate on NRI rupee deposits fully deregulated

Source: Deutsche Bank, RBI, Government of India

The government/RBI have shown alacrity in announcing the above measures and we believe they will continue to remain proactive on this front. We expect government to announce some more measures with one of the key measures being issuance of US$ denominated international sovereign bonds similar to the Resurgent India Bonds scheme of 1997 and India Millennium Deposit Scheme of 2000. We believe the likelihood of such a measure is very high given that India was able to mobilize a significant sum of money from these schemes earlier.

2012 will be a year of reckoning for FCCBs issued by India Inc.

Quite a few Indian companies have their FCCBs due for redemption in 2012 as corporate India had issued significant amount of FCCBs at the height of EM exuberance in 2007, assuming a significant appreciation in the underlying equities. However, the optionality of most of the FCCBs is out-of-the-money due to weakness in equity markets. This implies that most of these FCCBs will have to be redeemed, rather than converted to equities, leading to an overhang of refinancing pressure for such companies. The following table lays out a list of companies which have FCCBs maturing in 2012.

Figure 30: FFCBs due for redemption in 2012/13

Full Name	Maturity	Redemption Premium	YTM %	Redemption Amount (US$ mn)	Prem %
Adani Enterp 6% 2012 6% 2012 USD	27 Jan 2012	0.0%	178.39	$0	-1.7
Orchid 0% 2012 0% 2012 USD	28 Feb 2012	42.8%	57.51	$168	245.5
Reli Comm 0% 2012 0% 2012 USD	01 Mar 2012	27.7%	24.3	$1,182	1216.4
Uflex Ltd 4% 2012 USD 4% 2012 USD	09 Mar 2012	0.0%	-18.02	$22	35.1
MERCATOR LINES PTE 2.5% 2012 USD	26 Mar 2012	36.2%	0	$22	18.2
Hotel Leela 0% 12 0% 2012 USD	25 Apr 2012	46.6%	15.65	$61	287.1
Sterling Bio 0% 2012 0% 2012 USD	16 May 2012	36.7%	0	$184	207.6
Suzlon 7.5% 2012 USD	12 Jun 2012	50.2%	36.18	$53	391.6
Suzlon 0% JUN 2012 0% 2012 USD	12 Jun 2012	45.2%	37.32	$307	540.8
Moser Baer 0% 12 (A) 0% 2012 USD	21 Jun 2012	35.1%	317.91	$61	1221.7
Moser Baer 0% 12 (B) 0% 2012 USD	21 Jun 2012	39.4%	333.76	$60	1380.3
Strides Arcolab 0% 12 0% 2012 USD	27 Jun 2012	45.1%	14.53	$116	94
JSW Steel 0% 2012 0% 2012 USD	28 Jun 2012	42.8%	12.09	$392	206.5
Tata Motors 0% 2012 0% 2012 USD	12 Jul 2012	31.8%	4.61	$624	72.1
3I Infotech 0% 2012 0% 2012 USD	27 Jul 2012	41.4%	15.34	$94	1482.3
Gayatri Project 2012 0% 2012 JPY	03 Aug 2012	20.4%	105.76	$42	249.9
Tulip IT SER 0% 2012 0% 2012 USD	26 Aug 2012	44.5%	12.4	$140	206
Tata Steel 1% 2012 USD	05 Sep 2012	23.3%	2.9	$471	204.3
Jaiprakash 0% 2012 0% 2012 USD	12 Sep 2012	47.7%	21.26	$524	358.2
GreatOffshore 7.25 12 7.25% 2012 USD	07 Oct 2012	0.0%	37.21	$40	450.6
Everest Kanto 0% 2012 0% 2012 USD	10 Oct 2012	42.8%	18.61	$50	1180.7
Suzlon 0% OCT 2012 0% 2012 USD	11 Oct 2012	44.9%	36.2	$176	485.1
Suzlon_7.5%_OCT 12 7.5% 2012 USD	11 Oct 2012	57.7%	39.32	$33	359.4
Karuturi 0 Oct 12 0% 2012 USD	19 Oct 2012	41.2%	47.21	$55	456.5
Plethico Pharma 0% 12 0% 2012 USD	23 Oct 2012	45.9%	71.88	$109	50
GTL Infra 0% 2012 0% 2012 USD	29 Nov 2012	40.4%	142.23	$321	305.2
Firstsource 0% 2012 0% 2012 USD	04 Dec 2012	39.4%	14.13	$267	1867.9

Source: Deutsche Bank, Bloomnberg Finance L.P.

Will global macro stabilize or remain an overhang?

Europe:

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While we continue to believe that the eurozone's authorities will do whatever it takes to hold the euro together, the urgency of the need to act has risen sharply. The eurozone economy now appears to be sliding into recession which we hope will only last for a couple of quarters, although we admit something worse could happen, especially if politicians and central bankers fail to respond rapidly to the deteriorating situation. Europe remains deeply mired in its sovereign debt crisis, something that is likely to dominate markets in the year ahead, and not just in Europe. The whole world has an interest in the resolution of a crisis that deepened dramatically through the fourth quarter, and enveloped more and more major economies putting European leaders on the back foot as events threatened to overwhelm them.

US:

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2012 is likely to mark the fourth year of a painfully sluggish recovery of the US economy from the recession of 2008. However, the range of uncertainty around the central expectation of slow to moderate growth is unusually wide thanks to the crucial role that politics will be playing in determining the course of economic events. The broad consensus expectation, and our own, is that real GDP growth will struggle to rise much above its trend rate of about 2.5%. This means that unemployment is likely to remain uncomfortably high near 9%. The high unemployment, in turn, should help to quell inflation pressures and hold the underlying rate of inflation a bit below the Fed's informal target of just under 2%. One of the striking features of current economic milieu is that the corporate profits are at all-time highs relative to output, and corporate net worth is robust; this financial strength is underpinning the recovery of business spending on equipment and new structures. Consumer spending will be supported by the significant progress US households have made in deleveraging, reducing their debt service burdens to below normal levels.

On the negative side are several drags on growth, including fiscal drag and ongoing uncertainties about economic policies in the US and Europe, continued weakness in the US housing sector, and the negative effects of depressed home and stock prices on household wealth and consumer spending. Absent the drags, the economy would be expanding at a robust pace; absent the drivers, it would be headed into recession. Either extreme is possible depending on how political forces shape the resolution of US fiscal challenges over the year ahead and the resolution of fiscal and financial challenges facing the eurozone. Given the relatively subdued central projection and the wide range of risks, we expect the Fed to continue with its extraordinarily stimulating monetary stance over the year ahead and not to adopt further quantitative easing unless the economy edges toward recession.

China:

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The Chinese economy is likely to visibly decelerate in early 2012, amid a significant drop in export growth and weakening real estate activities. We expect annualized quarter-on-quarter GDP growth to fall to 7% (or slightly below) in Q1 2012, before recovering in the remainder of the year towards 9%. For the year as a whole, we expect China's GDP growth to be 8.3% in 2012, down from 9.1% in 2011. CPI inflation is also likely to decline sharply to 3% in the first half of 2012, from 5% in Q4 2011, as a result of falling agriculture and commodity prices. The three main factors driving the deceleration of Chinese economic growth will be the eurozone sovereign debt crisis, falling volumes in the local real estate market and ongoing credit tightening. We expect the government to ease macro policy in the final months of

2011 and early 2012 in reaction to inflation and GDP data. Thanks to this policy easing, we expect China's GDP growth to recover on a quarter-on-quarter basis from Q2 2012, begin to rise on a year-on-year basis from Q3, and reach 9% on an annualised qoq basis in H2 2012.

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Despite our concerns about the economic outlook, we think there are just as many upside risks in the oil markets in 2012 as there are risks to the downside. Physical fundamentals in the oil market are tightening and we would continue to view geopolitical risk in the oil market as a supporting factor, especially in Libya, Iraq, and Iran. Longer term, with non-OPEC supply expected to flatten while oil demand continues to rise, OPEC spare capacity will remain tight. We maintain our US$115/bbl Brent forecast for oil prices in 2012, but lifting our WTI estimates to account for the surprise decision to reverse the Seaway pipeline. We now expect WTI prices to average circa US$105/bbl in 2012. Our forecast for Brent to reach US$125/bbl in 2015 is unchanged. The global economic outlook remains the key to the near-term oil market outlook. If world GDP growth remains above 3%, we believe pricing in the energy markets will be firm.

Appendix 1

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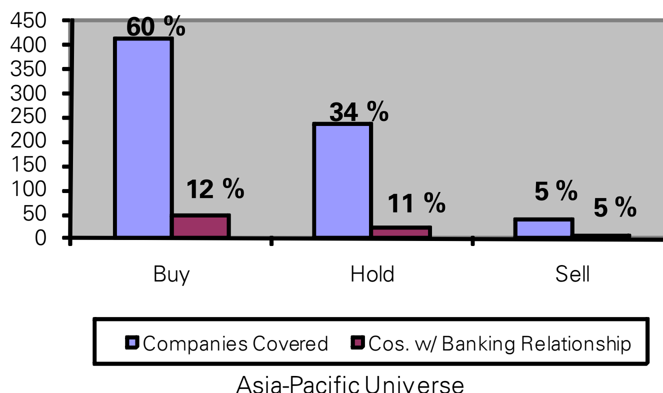

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