Rates Strategy – Focus | 08:45 GMT 06 January 2012

India – GoISecs to have a robust 2012

- **Monetary policy easing will drive GoISec performance in 2012**
- **Sustained INR gains are likely to resume once economic expectations bottom out**
- **Duration and FX contribute equally to USD total returns**
- **The key risk to our view is fiscal deficit slippage beyond 5.5% of GDP in FY13**

Nagaraj Kulkarni, +91 22 6115 8842
Nagaraj.Kulkarni@sc.com

Priyanka Kishore, +91 22 6115 8841
Priyanka.Kishore@sc.com

Monetary easing is the key theme for rates market in 2012

With inflation likely to have peaked in Q4-2011 and the Reserve Bank of India (RBI) having switched its focus to growth in its latest policy statement, 2012 is likely to be a year of monetary policy easing. We forecast that the easing cycle will begin with a reduction in the cash reserve ratio (CRR) in January and continue until Q1-2013, bringing cumulative repo rate cuts of 150bps. We expect such easing to be the key driver of the INR rates market in 2012.

Monetary easing expectations are partly reflected in softening GoISec yields – the benchmark 10Y GoISec yield has dropped c.70bps from its three-year high of about 9%, despite supply pressure. We expect the drop in GoISec yields to accelerate once monetary easing begins. During the upcoming monetary easing cycle, we anticipate that the yield on the benchmark 10Y GoISec will fall by c.100bps in response to the expected 150bps of repo rate cuts. Yields and policy rates showed similarly strong co-movement during the two previous monetary policy easing cycles. During both cycles, the magnitude of the peak-to-trough declines in the benchmark 10Y GoISec yield tracked that of policy rates very closely (see Table 2). The key hypothesis behind our rates forecast in 2012 is that monetary policy easing will outweigh any negative impact from fiscal slippage.

Table 1: Our forecasts
End-period, %

	Current	Q1-12	Q2-12	Q3-12	Q4-12	Q1-13	Q2-13
Repo rate	8.50	8.50	8.25	7.75	7.25	7.00	7.00
91-day T-bill rate	8.06	8.25	7.75	7.25	7.00	6.75	7.00
10Y GoISec yield	8.38	8.50	8.25	7.75	7.50	7.50	7.75
USD-INR	52.98	53.00	51.80	50.50	48.50	48.00	48.50

Source: Standard Chartered Research

Demand and supply seem balanced

Under our base-case scenario, in which the government contains the fiscal deficit for FY13 (begins 1 April 2012) to 5.5% of GDP and continues to finance c.85-90% of the deficit via market borrowing, we estimate the supply of dated securities for FY13 in the range of INR 4.8-5.0trn. After taking into account state governments' borrowings (estimated at about INR 1.0-1.2trn), we estimate aggregate supply at INR 5.8-6.2trn. However, statutory demand from the banking system (assuming banks maintain a statutory liquidity ratio of 27%) should absorb more than half of this supply if deposit growth remains robust. Insurance and provident funds, the second-largest investor segment, are likely to absorb about 25-30% of the supply. We expect the benign policy rate environment to create enough demand for the remaining supply from traders, foreign institutional investors (FIIs) and mutual funds to just balance demand and supply.

However, if the recent trends of slowing government revenues (on the back of slower growth) and a growing subsidy burden continue throughout FY13, the government may not be able to consolidate its fiscal position. If such fiscal slippage leads to significantly higher market borrowing than we estimate, this could offset the impact of monetary easing, dampening GoISec performance.

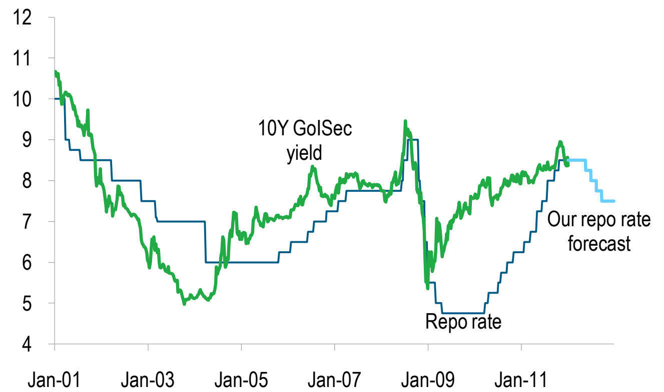
Key considerations

Entry timing

GoISecs have gained recently on the back of monetary policy easing expectations. For these gains to be sustained over the medium term, the market will require indications that policy easing will continue throughout 2012. Inflation will have to stay soft throughout 2012 in order to prevent a sudden change in the RBI's policy stance. The market will also be waiting for the government to confirm the extent of fiscal slippage in FY12 and announce its fiscal consolidation plans for FY13; these are likely to be announced in the budget session of parliament scheduled for March 2012. Considering these factors, March 2012 (the end of the current fiscal year) seems to be an appropriate time to build a long-duration portfolio in GoISecs.

Chart 1: 2012 – A year of monetary policy easing

%



Sources: Bloomberg, Standard Chartered Research

Table 2: Peak-to-trough changes in policy rates and 10Y GoISec yields

Monetary policy easing period	Peak-to-trough change in repo rate	Peak-to-trough change in 10Y GoISec yield
Mar-01 to Mar-04	10% to 6% (400bps)	10.28% to 4.95% (533bps)
Oct-08 to Apr-09	9% to 4.75% (425bps)	9.47% to 5.24% (422bps)

Sources: Bloomberg, Standard Chartered Research

Security selection

Secondary-market liquidity and issuance patterns are important considerations in selecting investment securities. The majority of issuance (c.60-80% in FY12) has typically been in the 5Y-14Y segment, which has seen considerable secondary-market liquidity. We therefore suggest that investors choose benchmark securities in this segment, specifically the 10Y GoISec (currently the 8.79% 2021).

Regulations for FIIs

- Aggregate limits for FII investments in debt securities were recently raised to USD 15bn for GoISecs and USD 45bn for corporate bonds (of which USD 25bn is for long-term infrastructure-sector bonds). We believe that while the majority of the GoISec quota is utilised, almost USD 25bn of investment in long-term infrastructure-sector bonds is still available (on a first-come, first served basis).
- The Securities and Exchange Board of India (SEBI) recently amended regulations on FII debt investment. For all fresh allocations of FII debt investment quota, no reinvestment will be allowed; this means that quota acquired through bidding will expire upon either the sale or the redemption at maturity of the debt investment.
- Quota that is already allocated will expire if total sales made from the existing debt portfolio are twice the size of the FII's debt portfolio (as of 3 January 2012). This provision will be removed from 2 January 2014.
- Although most of the GoISec quota is utilised, we believe the investments are mostly in short-dated securities. We therefore expect considerable portfolio churn once these securities mature. Under the recently amended regulations, such churn should increase the availability of quota to new participants.

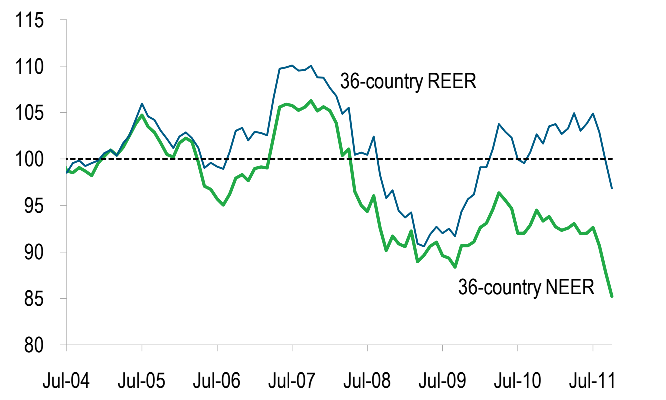
INR appreciation to boost USD total return

FX is an important risk for foreign investors. We expect FX risks to recede as 2012 progresses, with sluggish Indian rupee (INR) performance in early 2012 giving way to strong gains in H2. We forecast USD-INR at 48.50 by the year-end. Our bullish outlook is based on the following factors:

- Anticipated rate cuts are likely to revive investment and improve India's growth momentum. We expect growth to pick up to 7.8% y/y by Q4-2012, after bottoming at 6.2% in Q2-2012.

Chart 2: INR edging closer to undervalued

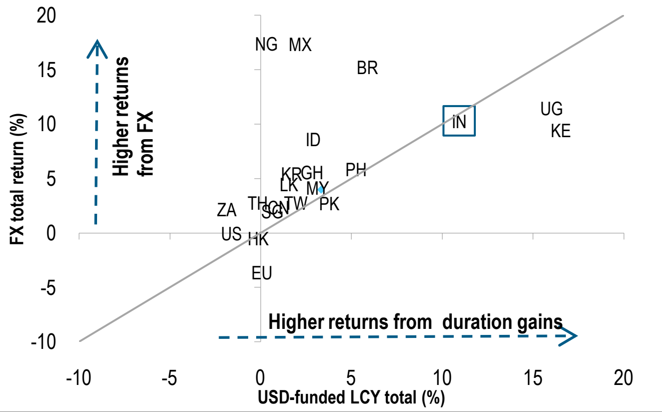
INR valuations



Sources: CEIC, Standard Chartered Research

Chart 3: Duration and FX gains contribute equally

Total return forecasts, %



Source: Standard Chartered Research

- Once economic expectations find a floor, investors are likely to focus more on relative growth than absolute levels. India would benefit under such a scenario, as it has over the last two years – especially if the Fed announces QE3 in Q1-2012, as anticipated.

- Recent policy measures to encourage capital inflows – including deregulation of interest rates for non-resident Indian (NRI) deposits, allowing foreign investors to invest directly in equities, and easing norms for FII investment in infrastructure bonds – are likely to gain traction as cyclical negatives fadnegatives fade.

- Lower non-oil imports due to below-trend growth for most of 2012 are expected to provide a floor to trade deficit, although the correction is likely to be limited by lower exports and elevated oil imports. Overall, we expect India's balance of payments (BoP) to register a USD 7bn surplus in FY13, after turning negative in FY12. While India last registered a single-digit BoP surplus in FY01, the low surplus in FY13 is likely to be a function of H1 uncertainties, rebounding in H2 on improved fundamentals.

- Carry and valuations are also likely to support medium-term FX gains. Following its depreciation in 2011, the INR is edging close to undervalued territory on a 36-country real effective exchange rate (REER) basis.

- Disappointing growth and a possible surge in crude prices are the key risks to this view.

Overall, we expect foreign investors to derive gains from both duration and FX exposures in 2012.

Table 3: Total return analysis, incorporating Standard Chartered Research's FX and rates forecasts for 2012

Country	Forecast return	Total return	Risk-adj. Return	Yield	Forecast yield	USD-funded local returns	FX	Forecast FX	FX return
Uganda		26.0%	1.00	19.20	15.00	16.5%	89.45	97	9.5%
India		21.3%	3.23	8.67	7.50	10.9%	51.34	48.5	10.3%
Brazil		21.2%	1.29	10.56	9.40	5.9%	1.78	1.65	15.3%
Mexico		19.6%	1.31	6.39	6.60	2.2%	13.48	11.8	17.4%
Nigeria		17.7%	1.22	12.90	12.00	0.3%	161.55	158	17.4%
Indonesia		11.5%	0.55	6.23	6.00	2.9%	9035	8700	8.6%
Philippines		11.1%	1.04	5.88	5.70	5.3%	43.22	41.5	5.9%
Vietnam*		9.1%	-	12.80	11.25	-	21011	22600	-
Ghana		8.4%	-	13.00	13.50	2.8%	1.64	1.7	5.6%
Malaysia		7.3%	0.74	3.26	3.10	3.1%	3.13	3.03	4.2%
Korea		7.3%	0.39	3.49	3.30	3.3%	1128.1	1095	4.0%
Pakistan		6.5%	-	12.50	13.25	3.8%	89.42	94	2.7%
Sri Lanka		6.1%	1.51	8.81	10.00	1.6%	113.91	114.8	4.5%
Taiwan		4.7%	1.07	1.32	1.40	1.9%	30.17	29	2.8%
China		3.4%	0.75	3.49	3.90	1.0%	6.35	6.21	2.4%
Singapore		2.7%	0.26	0.61	0.70	0.7%	1.28	1.25	2.0%
Thailand		2.6%	0.30	3.12	3.40	-0.1%	30.78	30.5	2.8%
South Africa		0.3%	-0.06	7.94	8.85	-1.8%	7.99	8.2	2.2%
Hong Kong		-0.6%	-0.71	0.82	1.10	-0.1%	7.77	7.79	-0.5%
US		-1.6%	-1.01	0.93	1.45	-1.6%	1	1	0.0%
EU		-3.5%	-0.56	2.14	2.50	0.1%	1.34	1.3	-3.6%

** NDF market is not liquid; Note: Thicker, lighter bars denote Q1-12 total return, while thinner, darker bars show Q4-12*

Disclosures Appendix

Analyst Certification Disclosure: The research analyst or analysts responsible for the content of this research report certify that: (1) the views expressed and attributed to the research analyst or analysts in the research report accurately reflect their personal opinion(s) about the subject securities and issuers and/or other subject matter as appropriate; and, (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in this research report. On a general basis, the efficacy of recommendations is a factor in the performance appraisals of analysts.

Global Disclaimer: Standard Chartered Bank and or its affiliates ("SCB") makes no representation or warranty of any kind, express, implied or statutory regarding this document or any information contained or referred to on the document. The information in this document is provided for information purposes only. It does not constitute any offer, recommendation or solicitation to any person to enter into any transaction or adopt any hedging, trading or investment strategy, nor does it constitute any prediction of likely future movements in rates or prices, or represent that any such future movements will not exceed those shown in any illustration. The stated price of the securities mentioned herein, if any, is as of the date indicated and is not any representation that any transaction can be effected at this price. While all reasonable care has been taken in preparing this document, no responsibility or liability is accepted for errors of fact or for any opinion expressed herein. The contents of this document may not be suitable for all investors as it has not been prepared with regard to the specific investment objectives or financial situation of any particular person. Any investments discussed may not be suitable for all investors. Users of this document should seek professional advice regarding the appropriateness of investing in any securities, financial instruments or investment strategies referred to on this document and should understand that statements regarding future prospects may not be realised. Opinions, forecasts, assumptions, estimates, derived valuations, projections and price target(s), if any, contained in this document are as of the date indicated and are subject to change at any time without prior notice. Our recommendations are under constant review. The value and income of any of the securities or financial instruments mentioned in this document can fall as well as rise and an investor may get back less than invested. Future returns are not guaranteed, and a loss of original capital may be incurred. Foreign-currency denominated securities and financial instruments are subject to fluctuation in exchange rates that could have a positive or adverse effect on the value, price or income of such securities and financial instruments. Past performance is not indicative of comparable future results and no representation or warranty is made regarding future performance. While we endeavour to update on a reasonable basis the information and opinions contained herein, there may be regulatory, compliance or other reasons that prevent us from doing so. Accordingly, information may be available to us which is not reflected in this material, and we may have acted upon or used the information prior to or immediately following its publication. SCB is not a legal or tax adviser, and is not purporting to provide legal or tax advice. Independent legal and/or tax advice should be sought for any queries relating to the legal or tax implications of any investment. SCB, and/or a connected company, may have a position in any of the securities, instruments or currencies mentioned in this document. SCB and/or any member of the SCB group of companies or its respective officers, directors, employee benefit programmes or employees, including persons involved in the preparation or issuance of this document may at any time, to the extent permitted by applicable law and/or regulation, be long or short any securities or financial instruments referred to in this document and on the website or have a material interest in any such securities or related investment, or may be the only market maker in relation to such investments, or provide, or have provided advice, investment banking or other services, to issuers of such investments. SCB has in place policies and procedures and physical information walls between its Research Department and differing public and private business functions to help ensure confidential information, including 'inside' information is not disclosed unless in line with its policies and procedures and the rules of its regulators. Data, opinions and other information appearing herein may have been obtained from public sources. SCB makes no representation or warranty as to the accuracy or completeness of such information obtained from public sources. You are advised to make your own independent judgment (with the advice of your professional advisers as necessary) with respect to any matter contained herein and not rely on this document as the basis for making any trading, hedging or investment decision. SCB accepts no liability and will not be liable for any loss or damage arising directly or indirectly (including special, incidental, consequential, punitive or exemplary damages) from use of this document, howsoever arising, and including any loss, damage or expense arising from, but not limited to, any defect, error, imperfection, fault, mistake or inaccuracy with this document, its contents or associated services, or due to any unavailability of the document or any part thereof or any contents or associated services. This material is for the use of intended recipients only and, in any jurisdiction in which distribution to private/retail customers would require registration or licensing of the distributor which the distributor does not currently have, this document is intended solely for distribution to professional and institutional investors.

Country-Specific Disclosures - If you are receiving this document in any of the countries listed below, please note the following:
United Kingdom and European Economic Area: SCB is authorised and regulated in the United Kingdom by the Financial Services Authority (FSA). This communication is not directed at Retail Clients in the European Economic Area as defined by Directive 2004/39/EC. Nothing in this document constitutes a personal recommendation or investment advice as defined by Directive 2004/39/EC. **Australia:** The Australian Financial Services License for SCB is License No: 246833 with the following Australian Registered Business Number (ARBN: 097571778). Australian investors should note that this document was prepared for wholesale investors only within the meaning of section 761G of the Australian Corporations Act 2011 and the Corporations Regulations. This document is not directed at persons who are "retail clients" as defined in the Australian Corporations Act 2011. **Brazil:** SCB disclosures pursuant to the Securities Exchange Commission of Brazil ("CVM") Instruction 483/10: This research has not been produced in Brazil. The report has been prepared by the research analyst(s) in an autonomous and independent way, including in relation to SCB. THE SECURITIES MENTIONED IN THIS REPORT HAVE NOT BEEN AND WILL NOT BE REGISTERED PURSUANT TO THE REQUIREMENTS OF THE SECURITIES AND EXCHANGE COMMISSION OF BRAZIL AND MAY NOT BE OFFERED OR SOLD IN BRAZIL EXCEPT PURSUANT TO AN APPLICABLE EXEMPTION FROM THE REGISTRATION REQUIREMENTS AND IN COMPLIANCE WITH THE SECURITIES LAWS OF BRAZIL. **China:** This document is being distributed in China by, and is attributable to, Standard Chartered Bank (China) Limited which is mainly regulated by China Banking Regulatory Commission (CBRC), State Administration of Foreign Exchange (SAFE), and People's Bank of China (PBoC). **Hong Kong:** This document is being distributed in Hong Kong by, and is attributable to, Standard Chartered Bank (Hong Kong) Limited which is regulated by the Hong Kong Monetary Authority. **Japan:** This document is being distributed to Specified Investors, as defined by the Financial Instruments and Exchange Law of Japan (FIEL), for information only and not for the purpose of soliciting any Financial Instruments Transactions as defined by the FIEL or any Specified Deposits, etc. as defined by the Banking Law of Japan. **Singapore:** This document is being distributed in Singapore by SCB Singapore branch, only to accredited investors, expert investors or institutional investors, as defined in the Securities and Futures Act, Chapter 289 of Singapore. Recipients in Singapore should contact SCB Singapore branch in relation to any matters arising from, or in connection with, this document. **South Africa:** SCB is licensed as a Financial Services Provider in terms of Section 8 of the Financial Advisory and Intermediary Services Act 37 of 2002. SCB is a Registered Credit Provider in terms of the National Credit Act 34 of 2005 under registration number NCRCP4. **UAE (DIFC):** SCB is regulated in the Dubai International Financial Centre by the Dubai Financial Services Authority. This document is intended for use only by Professional Clients and should not be relied upon by or be distributed to Retail Clients. **United States:** Except for any documents relating to foreign exchange, FX or global FX, Rates or Commodities, distribution of this document in the United States or to US persons is intended to be solely to major institutional investors as defined in Rule 15a-6(a)(2) under the US Securities Act of 1934. All US persons that receive this document by their acceptance thereof represent and agree that they are a major institutional investor and understand the risks involved in executing transactions in securities. Any US recipient of this document wanting additional information or to effect any transaction in any security or financial instrument mentioned herein, must do so by contacting a registered representative of Standard Chartered Securities (North America) Inc., 1095 Avenue of the Americas, New York, N.Y. 10036, US, tel + 1 212 667 0700. WE DO NOT OFFER OR SELL SECURITIES TO U.S. PERSONS UNLESS EITHER (A) THOSE SECURITIES ARE REGISTERED FOR SALE WITH THE U.S. SECURITIES AND EXCHANGE COMMISSION AND WITH ALL APPROPRIATE U.S. STATE AUTHORITIES; OR (B) THE SECURITIES OR THE SPECIFIC TRANSACTION QUALIFY FOR AN EXEMPTION UNDER THE U.S. FEDERAL AND STATE SECURITIES LAWS NOR DO WE OFFER OR SELL SECURITIES TO U.S. PERSONS UNLESS (i) WE, OUR AFFILIATED COMPANY AND THE APPROPRIATE PERSONNEL ARE PROPERLY REGISTERED OR LICENSED TO CONDUCT BUSINESS; OR (ii) WE, OUR AFFILIATED COMPANY AND THE APPROPRIATE PERSONNEL QUALIFY FOR EXEMPTIONS UNDER APPLICABLE U.S. FEDERAL AND STATE LAWS.

Document approved by	Data available as of	Document is released at
Samiran Chakraborty	08:45 GMT 06 January 2012	08:45 GMT 06 January 2012
Regional Head of Research, India		