Equities

27 May 2012 | 17 pages

India Equity Strategy

Currency – Cause or Casualty?

- Equities

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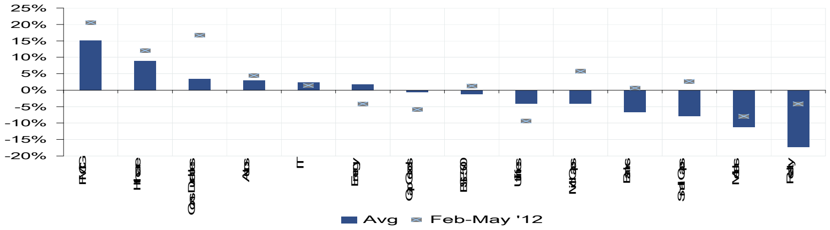
- **It's a big and different depreciation** — India's rupee has fallen 12% from its 2012 peak, is off 20% from its 12-month high, and is among the worst-performing currencies YTD. So is it a cause of the market's/economy's recent weakness, or a consequence of it? More important, how does one play it?
- **Weak rupee is bad for the market, but impact moderating?** — The INR and the equity markets are a) positively correlated; b) this correlation has been weakening in the recent past; and c) the market rises more when the INR rises sharply (than the fall when currency depreciates). Does the currency matter less to the market than before?
- **Portfolio: indirect impact more than the direct one** — The best-performing sector in a depreciating rupee environment is the completely domestic Consumer staples (IT– almost 100% of FX revenues, is only 4th). In contrast, the weakest sectors are Realty, Metals and Financials – all impacted only indirectly. So portfolio positioning could be more critical than underlying FX exposures, when playing a falling/rising INR.
- **Stocks: Balance-sheet pain/gain over that of the P&L** — There is more P&L gain on INR weakness for India's top stocks (IT, Pharma and metals) than loss (Utilities) – mixed for Auto's and Energy. But, the BS offsets - increased (and less transparent) FX debt hurts P&Ls, and BS swings might be a more dominant theme than the P&L one.
- **What is driving the currency this time?** — INR swings in the last 5 years have been driven/accompanied by strong equity flows. This is not the case this time (CAD/Economy/Global uncertainty) – and could impact the market differently. The INR's woes are a little different this time – more a casualty (rather than a cause) of India's economy/market performance
- **Our view, and portfolio position** — We expect the INR to be at 54.8 in Mar '13, continue to OW rate sensitives (Financials, Cap goods, Autos) but keep a traditional currency hedge in the portfolio – OW Pharmaceuticals, Neutral IT services. Maintain our December 2012 Sensex Target of 18,400 (+13%).

Figure 1. Sectors rel. to Sensex when INR weakens*



Source: Bloomberg, CIRA * Avg performance over 5 periods of sharp INR depreciation

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

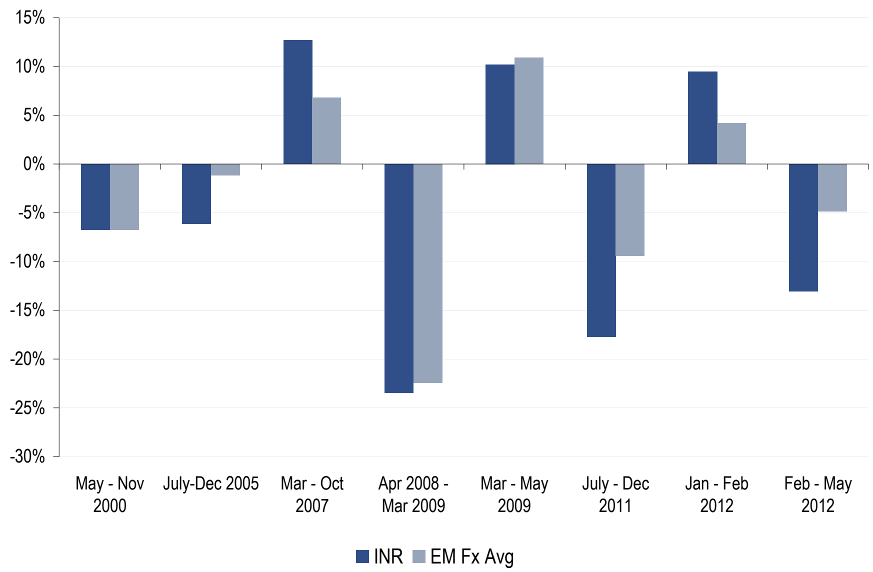
Currency – Cause or Casualty?

A big depreciation

A big dip…more damaged than peer currencies

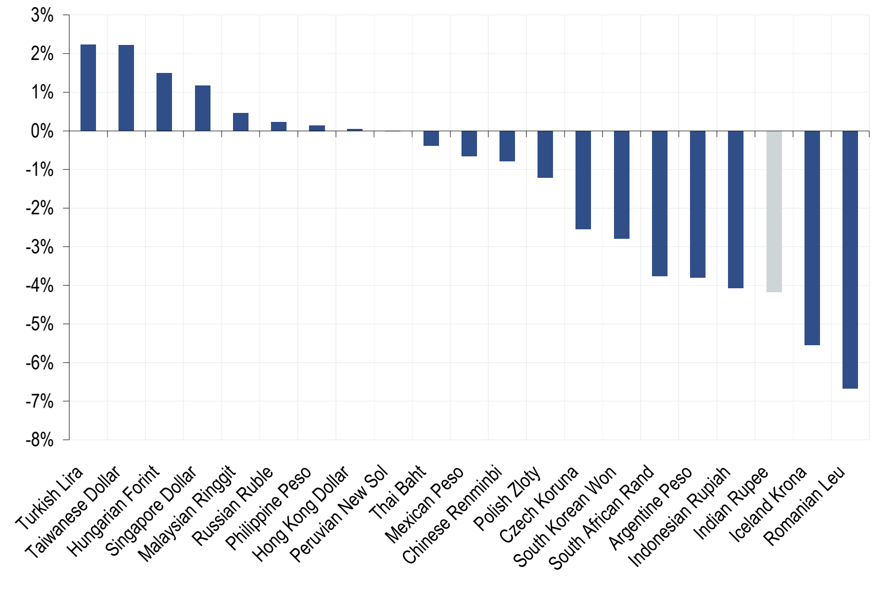
The INR has taken a beating. It has hit an all-time low, is down 12% from its 2012 peaks, and is down over 20% from its peak over the last 12 months. It is not the only one – EM currencies have been under pressure over 2012, but it clearly has been more damaged than most peer currencies. The sheer scale of the fall too has been disconcerting, and has tended to shift the market's focus to India's burgeoning CAD deficit, which at 4% of GDP is large and structurally challenged.

Figure 2. Currency moves: INR vs. EM currencies (against USD)



Source: Bloomberg

Figure 3. Performance of EM fx 2012 YTD

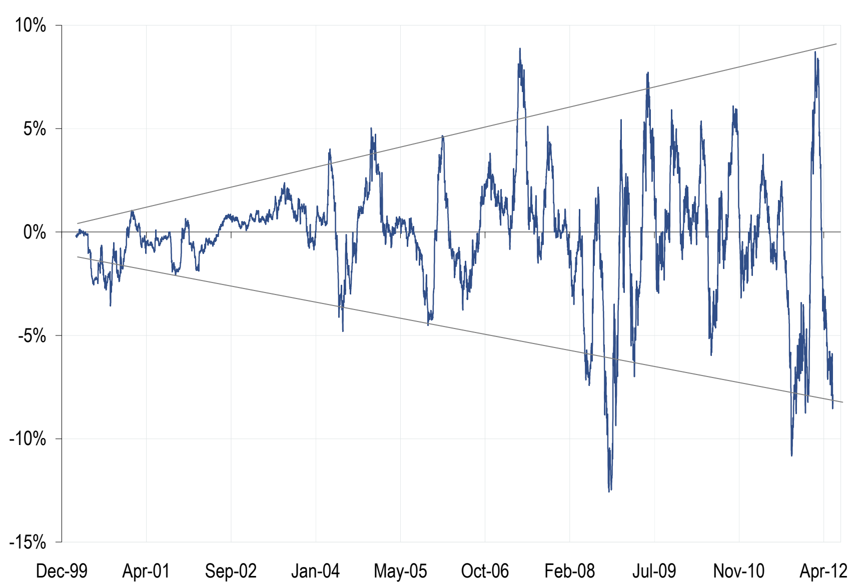


Source: Bloomberg

Sharper currency swings...which have only been rising

What has also changed is the fact that the INR's swing has been relatively sharper this time than on previous occasions when the currency has moved sharply (up or down) – suggesting that some of the drivers are probably a little more local / India-specific than in the past. This is also accompanied by a longer-term trend of increasing volatility in the INR. It has not been as volatile as at the time of the financial crises, but the current swing is distinctly more extreme than at any time in the past.

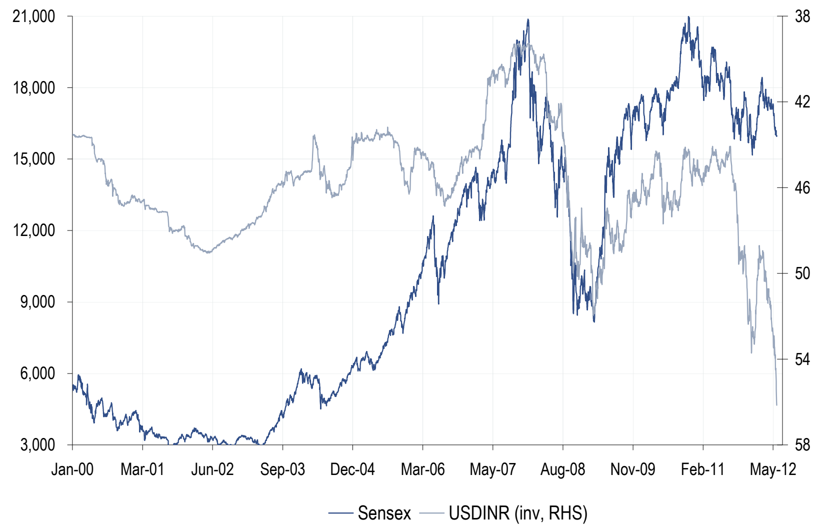
Figure 4. 2-mth rolling % moves in USD/INR



Source: Bloomberg

So how has it been impacting the market?

Figure 5. Sensex and the INR



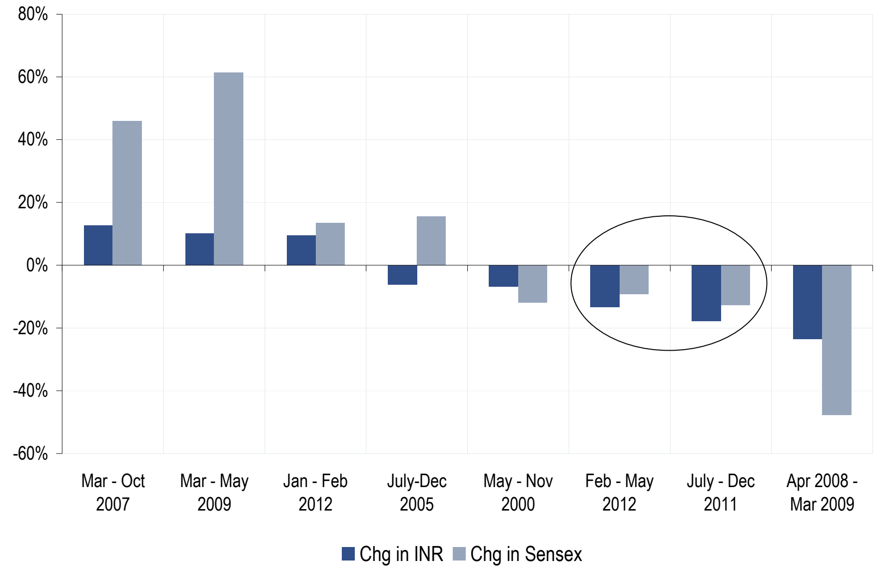
Source: Bloomberg

In the recent INR fall, the market has not fallen as much as in previous times

It's the old 'chicken and egg' phenomenon – is the currency bringing the market down (or up), or is it the state of the market/economy? What came first? We believe it's a bit of both – they do influence the outlook, confidence and underlying dynamics. But more important, we believe there might be a moderation in the impact under way – a falling INR might not hurt the underlying equity market as much as previously, and likewise, an appreciation might have less of an impact on equities.

In the last two INR depreciations, the market has fallen less than the currency….in all INR rises, the market has gained more than the INR

Figure 6. INR vs. Sensex changes in periods of sharp INR moves



Source: Bloomberg, CIRA

Very visually, the data also suggests that over the last five years, market upswings as the INR has appreciated have tended to be more pronounced than equity market downswings when the currency has fallen sharply. In fact in two-thirds of cases when the currency has appreciated, the market has gained over 2X of what the currency gains, whereas in the last two periods of INR depreciation, the equity market has actually fallen less than the Rupee. While these are historical trends (we have taken periods of sharp currency appreciation / depreciation), they seem to get support from correlation analysis.

INR and market correlations remain positive but have been falling

The correlation between the INR and the equity market remain distinctly positive but has moderated in the recent past. This also seems to stand out when we analyze periods of sharp up/down swings in the INR. Quite clearly, the equity market moves on currency depreciation in Aug 2011 and Mar 2012 have been more modest than upswings in the past.

Figure 7. Correlations of INR with…

	10_Yr Yield	Sensex	Brent Crude
1-month	0.51	0.47	0.26
3-months	0.25	0.47	0.39
1 year	0.15	0.52	0.29
3 years	0.13	0.55	0.33

Source: Bloomberg, CIRA

* these correlations are computed using INR/ USD rate, i.e. the exchange rate goes up with INR appreciates and vice versa

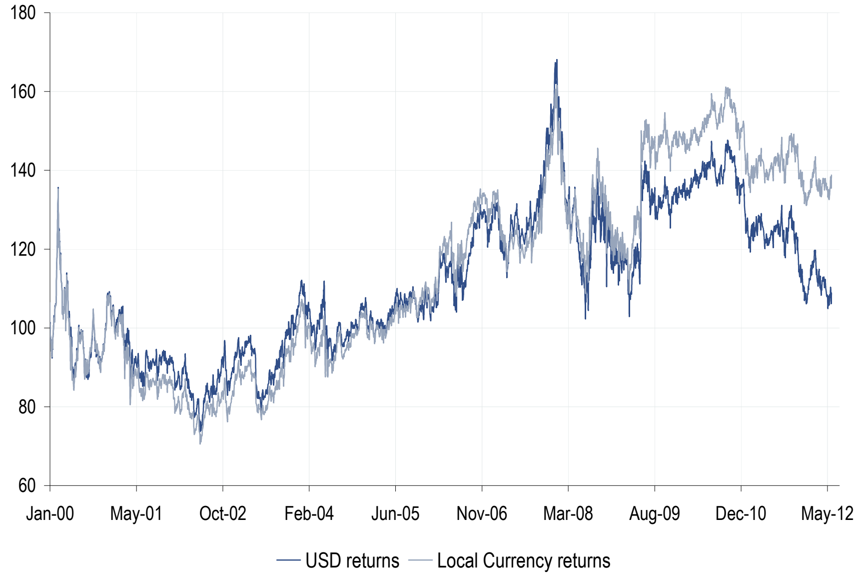
Interest rates – INR correlations are up, the INR-Sensex ones are down

Importantly, even as correlations between the INR and equities have moderated, those between the INR and interest rates have actually risen quite meaningfully. While in many senses this is traditional economics coming to the fore – the fact that India still is a fairly regulated market from a fixed income side suggests we need a longer time frame to track these correlations for stronger inferences. But it does suggest the interest rate-currency correlations could be trending higher, and equity market and INR ones lower.

India's returns vs. GEMs on local currency and on $ basis are now wide…and have widened recently…the INR seems to have de-rated more than the other EM currencies

It's also interesting to note that over an extended period, India's returns relative to GEMs were relatively similar in local currencies and USD. This trend however broke with the financial crises, and the gap has only widened – in fact the most recent move has significantly widened this gap. This would suggest that India's currency has somewhat structurally depreciated vs. EMs – and its sharp recent deterioration has only added to this.

Figure 8. Returns of MSCI India relative to MSCI GEMs



Source: MSCI, Datastream

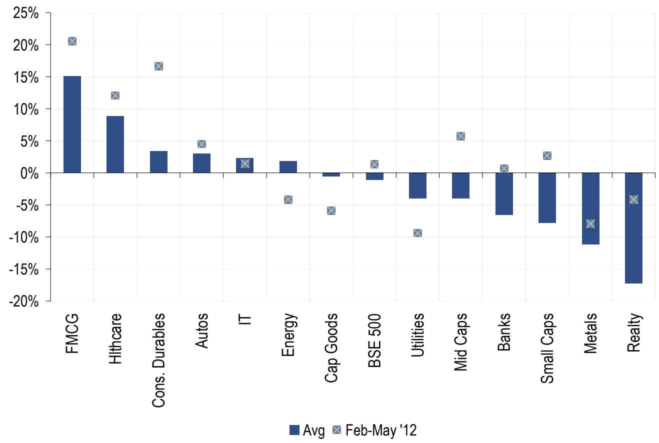
A lot of this data could suggest that if there is to be some form of mean reversal, then either the INR needs to strengthen quickly, or the equity market could be facing meaningful downside adjustments.

How do you manage the portfolio in such a scenario?

The best-performing sector in an INR dip has nothing to do with the currency: consumer staples…and the best sectors in an appreciating INR are rate cyclicals, again with little to do directly with the currency

Conventional wisdom suggests that to hedge your portfolio against a falling INR you should load up on businesses that are export oriented, and have their revenues in USD. However, if you look at periods of sharp rupee depreciation, these would not have been the best sectors to have been positioned in. In fact IT services, where almost 100% of revenues are FX denominated, was only the 4th best performing sector. And Pharmaceuticals, with FX revenues in the 60-90% range (with off-shore debt in a few cases), was the second best.

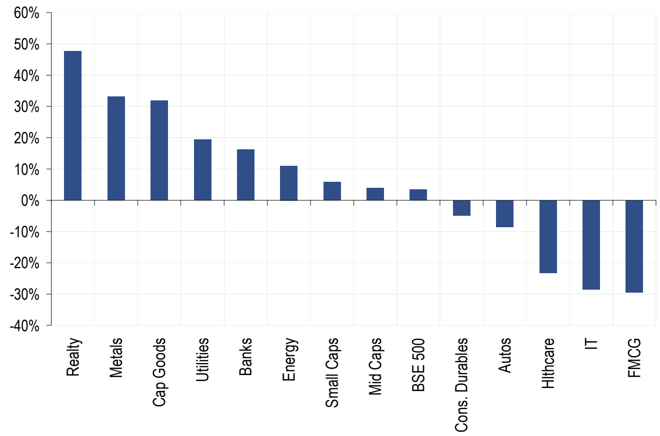
Figure 9. Sectors rel. to Sensex when INR weakens*



Source: Bloomberg, CIRA

* Avg performance over 5 periods of sharp INR depreciation

Figure 10. Sectors rel. to Sensex when INR strengthens*



Source: : Bloomberg, CIRA

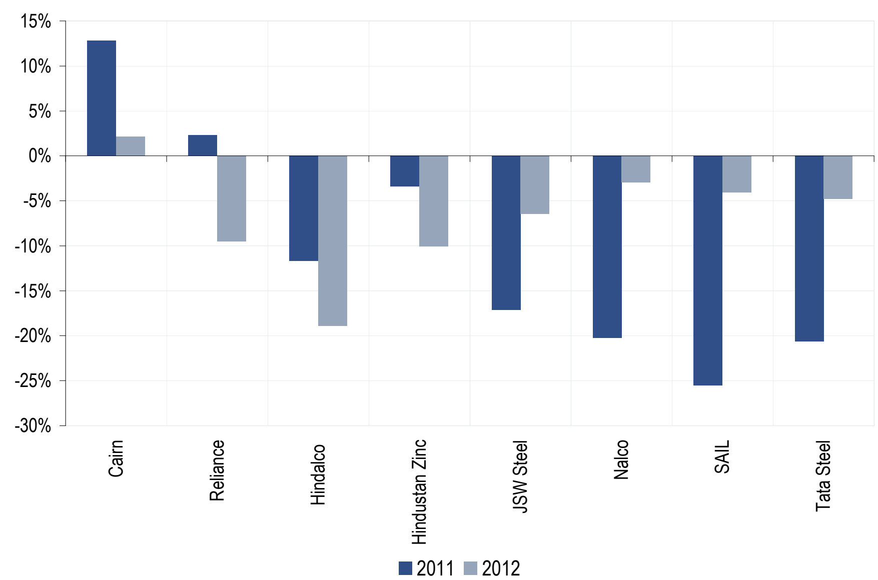
* Avg performance over 3 periods of sharp INR appreciation

IT services....with almost 100% of revenues in FX is only the 4th best performer

But what has worked best and consistently over depreciation episodes has actually been the Consumer staples sector, which has no FX gains, but is seen as a portfolio defensive. It also has the tailwind of strong consumption growth – which is perceived to be relatively intact. On the flip side, the worst-performing sectors have been real estate, Metals and Banking. Real Estate and Banking have no direct FX linkages. And Metals (oddly enough), should actually be a beneficiary, as these businesses get more pricing headroom as the selling prices are benchmarked to global prices (which rise as the currency depreciates).

The commodity space is an aberration…in-spite of earnings upsides on INR depreciation; they do poorly when the INR falls…Commodity prices possibly over-ride the INR

Figure 11. Metals and Energy performance in INR depreciation episodes in 2011 & 2012



Source: Bloomberg, CIRA

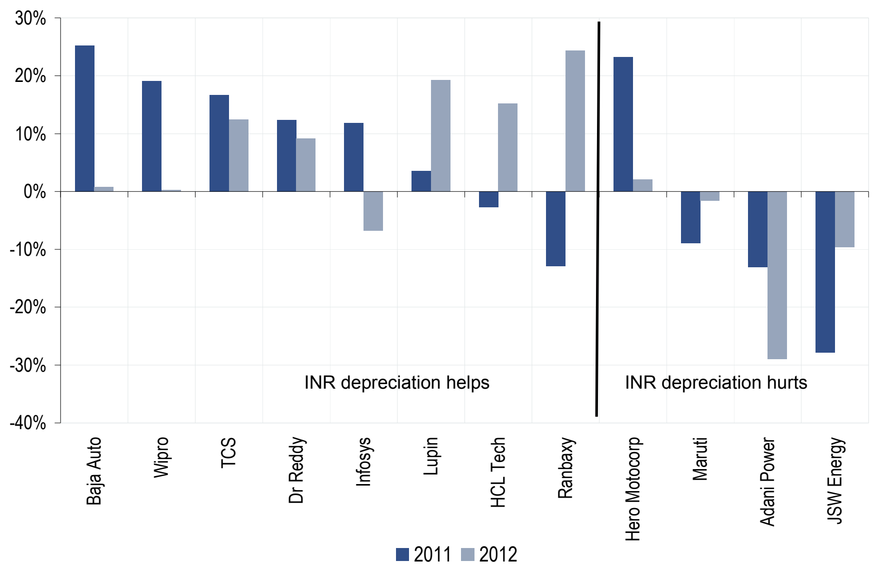
Sector positioning could well be more critical for managing a portfolio during INR swings, than focusing on P&L and BS exposures

So while stocks do matter, we would argue that portfolio positioning on swings on the currency might be a more dominant theme, than purely stock picking. While we do recognize some of these skews could be influenced by the underlying demand / business environment (weak IT outlook, strong Indian consumption perspective), there clearly is a strong underlying theme driving these performances.

Balance Sheet pain or P&L gain – What stocks would you pick?

With a weaker INR, is there an earnings gain at the aggregate? We do believe there will be an aggregate gain on the P&L. More sectors than not are leveraged to a weakening INR. Those that gain and typically see earnings upsides are IT Services, Pharmaceuticals and Metals; Utilities usually see earnings downsides, while Energy and Autos are more mixed. At aggregate though, there are earnings upsides.

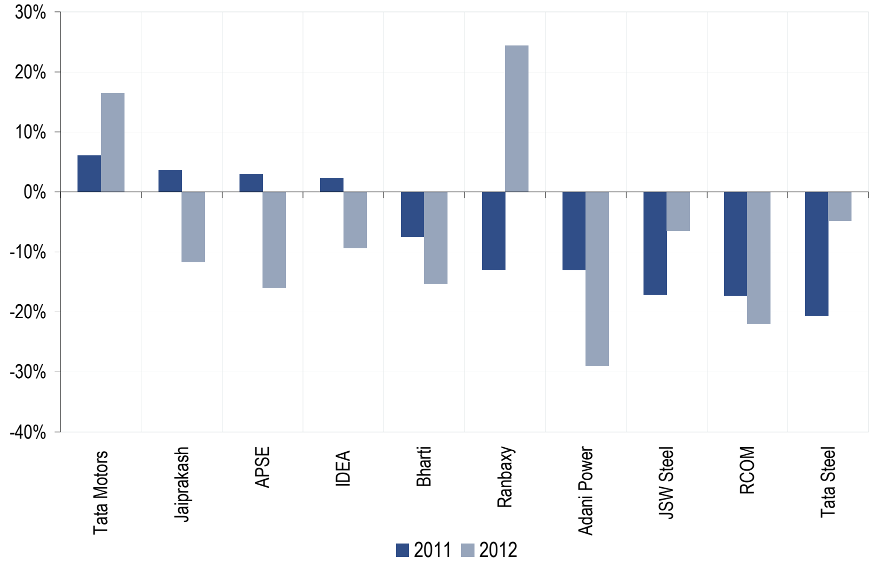
Figure 12. Performance of key stocks with P&L exposures in episodes of INR depreciation



Source: Bloomberg, CIRA

There is however an offset – on the Balance-sheet. This is because an increasing number of businesses have aggressively borrowed from off-shore markets as funding has been cheaper, easily available (including aggressively priced convertible bonds), and during a lot of times this has had the tailwind of an appreciating currency. In addition, a few corporates have made relatively aggressive offshore acquisitions. All this has meant that there is a reasonable level of off-shore funding on Indian balance-sheets; some of it hedged naturally (with exports), some of it hedged through market mechanisms, but a fair share of it possibly un-hedged (with moderate transparency, at best). A lot of this will need to be marked to market – and will eventually come through the P&L.

Figure 13. Performance of key stocks with BS exposures in episodes of INR depreciation

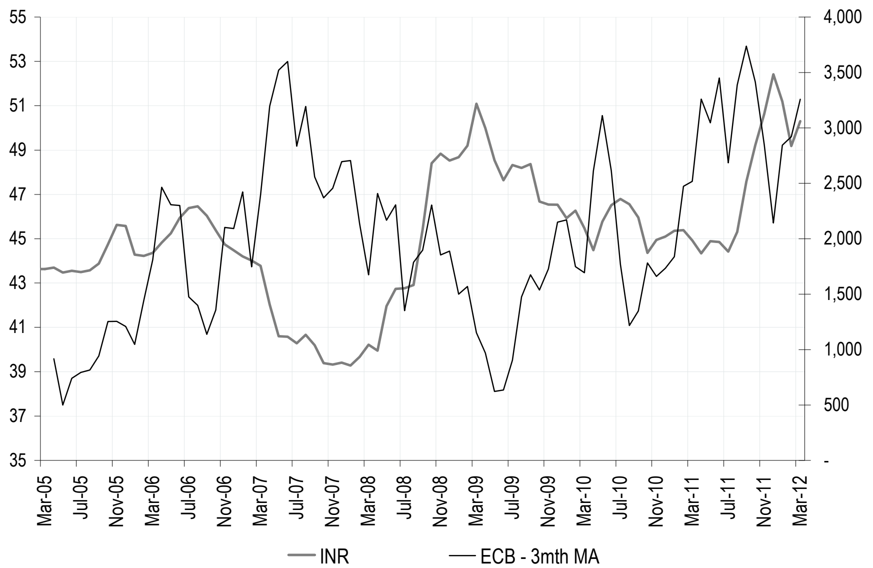


Source: Bloomberg, CIRA

So if the INR continues to depreciate, at aggregate, is there more BS induced pain than P&L driven gain? We do not have data to back a strong claim, but we would argue the potential risks and surprises on the BS will outweigh the gains on the P&L. We believe this will also play through more aggressively on individual stock performances – where stocks with unhedged or large FX exposures will likely see more of a valuation charge than necessarily a financial one. That some of this will necessarily come through the P&L will also be an offset for aggregate earnings gains on account of a weaker INR (or vice-versa).

Corporates have borrowed aggressively as and when the currency has appreciated…and will have to pay as it depreciates

Figure 14. Trend in USD/ INR vs. External Commercial Borrowing



Source: Citi Investment Research and Analysis

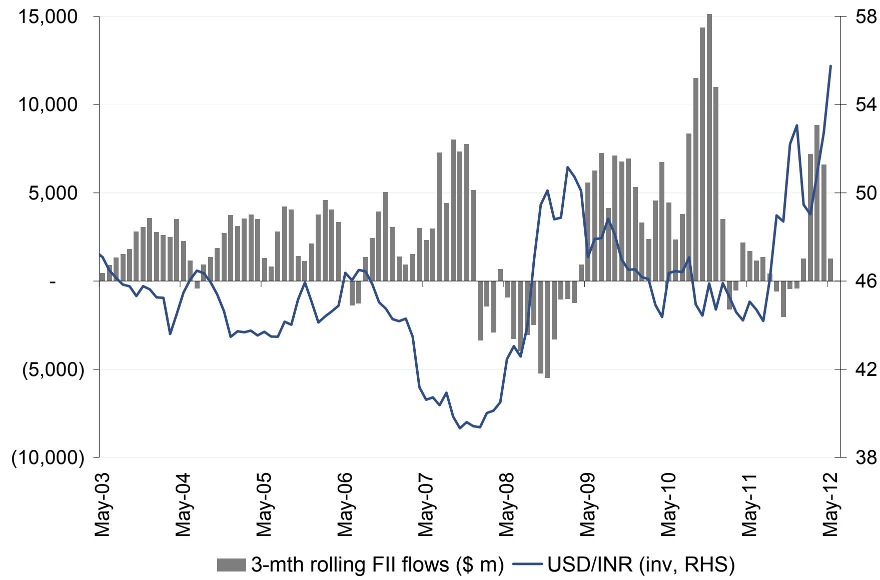
Effectively, we would argue that the BS pain and uncertainty of FX exposures would cause greater stock pain if the currency were to weaken than purely P&L driven ones. But it is these stocks that would potentially see more gain if the currency were to show signs of appreciating.

Anything different about the INR's move this time?

Yes. The INR has historically either been driven by, or at least accompanied by, strong equity inflows/outflows. This has not been the case in the INR's recent depreciation in 2012 (although the Jan/Feb 2012 appreciation was driven by flows) or the one in Aug 2011. We would believe it's a combination of CAD pressures (and Oil and Gold prices), increasing concerns on India's economic growth outlook and its ability to attract capital, and global uncertainty (which has seen most EM currencies weak) that has driven the rupee recently.

A first ….INR depreciating without meaningful equity outflows

Figure 15. FII Flows vs. the INR



Source: SEBI, Bloomberg, CIRA

This could suggest that the INR's moves could well be different from previous patterns. It could also more suggest that the way the market, portfolios and stocks behave on INR moves could well be relatively different. We do believe that it is critical to keep this in mind – given equity flows driving the currency, and the currency determining portfolio and stock positioning.

Figure 16. Citi India Model Portfolio

	Price 26-May-12 (Rs)	YTD Perf. (%)	YTD Rel. Perf.	RIC	Rating	MSCI Weight (%)	Portfolio Weight	OW/ UW/Rel. MSCI (bps)	FY13 PE (x)	FY13 EPS Growth (%)	FY13 PB (x)	FY13 ROE (%)
Automobiles and Components						**7.8**	**8.9**	**109**				
M&M	638.2	-6.6%	-12.7%	MAHM.BO	2		2.2	O/W	14	4.3%	2.6	20.8%
Maruti	1117.1	21.4%	15.3%	MRTI.BO	1		2.5	O/W	16	26.6%	1.9	12.8%
Tata Motors	269.4	51.0%	44.8%	TAMO.BO	1		4.2	O/W	7	22.8%	2.0	37.9%
Banks & Diversified Financials						**25.3**	**30.6**	**527**				
AXIS Bank	1000.6	24.0%	17.9%	AXBK.BO	1		4.0	O/W	9	14.4%	1.6	19.2%
IDFC	124.9	36.1%	30.0%	IDFC.BO	1		1.0	M/W	10	11.8%	1.3	13.7%
HDFC Bank	500.4	17.2%	11.0%	HDBK.BO	2		5.5	U/W	18	26.8%	3.2	19.7%
ICICI Bank	815.9	19.2%	13.0%	ICBK.BO	1		6.0	O/W	12	21.0%	1.5	12.4%
State Bank of India	2005.0	23.8%	17.7%	SBI.BO	1		3.5	O/W	9	20.0%	1.4	16.2%
Yes Bank	330.6	38.6%	32.4%	YESB.BO	1		1.0	O/W	10	23.5%	2.0	23.3%
Kotak Mahindra	544.1	25.9%	19.7%	KTKM.BO	2		1.0	U/W	18	23.8%	2.7	16.2%
MMFSL	615.1	1.5%	-4.6%	MMFS.BO	1		1.0	O/W	9	15.2%	1.8	22.4%
Bank of Baroda	671.9	1.7%	-4.5%	BOB.BO	1		1.0	O/W	5	18.2%	0.9	20.9%
MCX	896.8			MCEI.BO	1		0.5	O/W	12	25.6%	3.5	30.6%
Industrials & Capital Goods						**6.7**	**7.5**	**76**				
Larsen & Toubro	1186.4	19.2%	13.1%	LART.BO	1		4.0	O/W	15	10.0%	2.5	18.0%
Adani Port & SEZ	114.0	-5.4%	-11.6%	APSE.BO	1		1.5	O/W	15	31.4%	3.5	26.2%
Havells	569.8	48.5%	42.3%	HVEL.BO	1		1.0	O/W	19	20.4%	3.7	21.2%
IRB Infra	113.6	-12.6%	-18.7%	IRBI.BO	1		1.0	O/W	7	7.2%	1.1	16.8%
Energy						**11.4**	**9.2**	**-229**				
Reliance Industries	692.0	-0.1%	-6.3%	RELI.BO	1		7.0	U/W	11	1.8%	1.2	11.5%
Cairn	324.3	3.4%	-2.7%	CAIL.BO	1		2.2	O/W	5	49.5%	1.1	22.5%
Consumer						**9.5**	**6.2**	**-332**				
ITC	231.8	15.1%	9.0%	ITC.BO	1		3.7	U/W	25	18.8%	10.2	42.3%
United Spirits	640.1	30.3%	24.2%	UNSP.BO	2		1.5	O/W	20	16.3%	1.7	8.5%
Hindustan Unilever	421.0	3.2%	-2.9%	HLL.BO	3		1.0	U/W	30	18.5%	21.8	80.0%
Materials						**10.3**	**8.7**	**-163**				
Coal India	313.3	4.1%	-2.0%	COAL.BO	1		1.0	U/W	13	11.0%	3.9	33.3%
Hindalco	111.8	-3.4%	-9.5%	HALC.BO	1		1.0	U/W	8	0.6%	0.6	8.3%
Jindal Steel & Power	456.5	0.7%	-5.4%	JNSP.BO	1		1.7	O/W	10	11.0%	1.9	22.4%
Grasim	2374.1	-5.4%	-11.5%	GRAS.BO	1		1.0	O/W	7	12.1%	1.1	15.9%
Ambuja Cement	143.6	-7.6%	-13.7%	ABUJ.BO	1		3.0	O/W	12	36.8%	2.4	21.5%
JSW Steel	607.1	19.7%	13.6%	JSTL.BO	1		1.0	O/W	7	111.9%	0.7	11.1%
Pharmaceuticals, Biotechnology, Agrochem						**5.1**	**7.0**	**187**				
Ranbaxy	530.3	30.9%	24.7%	RANB.BO	1H		1.5	O/W	20	43.1%	3.8	30.6%
Dr Reddy	1692.6	7.3%	1.1%	REDY.BO	1		2.5	O/W	16	36.6%	3.7	26.8%
Lupin	532.9	19.2%	13.0%	LUPN.BO	1		1.5	O/W	19	31.5%	4.7	27.8%
IPCA Lab	333.9	21.5%	15.4%	IPCA.BO	1		0.5	O/W	11	26.3%	2.6	26.2%
United Phosphorous	114.7	-9.6%	-15.8%	UNPO.BO	1		1.0	O/W	6	36.7%	1.1	19.6%
Software & Services						**17.1**	**17.2**	**6**				
Infosys Technologies	2372.0	-14.2%	-20.3%	INFY.BO	1		12.0	O/W	15	12.1%	3.4	25.4%
Tata Consultancy Services	1221.6	5.2%	-0.9%	TCS.BO	2		2.0	U/W	18	23.5%	5.9	35.9%
Wipro	393.6	-1.3%	-7.5%	WIPR.BO	1		1.8	O/W	14	20.5%	2.9	21.7%
HCL Technologies	487.0	25.4%	19.3%	HCLT.BO	1		1.4	O/W	13	25.6%	2.9	24.8%
Telecom Services						**2.5**	**2.0**	**-47**				
Bharti Airtel	298.7	-12.9%	-19.0%	BRTI.BO	1		2.0	O/W	14	67.1%	1.9	14.4%
Utilities						**3.1**	**2.0**	**-110**				
Tata Power	89.2	2.2%	-4.0%	TTPW.BO	2		1.0	O/W	22	-10.5%	1.8	8.1%
Power Grid Corp	104.2	4.3%	-1.8%	PGRD.BO	1		1.0	M/W	14	16.8%	1.9	14.4%
Real Estate						**1.0**	**0.8**	**-23**				
DLF	188.5	3.0%	-3.2%	DLF.BO	1		0.5	U/W	18	38.3%	1.2	7.1%
Phoenix	184.3	11.5%	5.3%	PHOE.BO	1		0.3	O/W	21	34.7%	1.4	7.2%
Total						**100.0**	**100.0**					

Source: Citi Investment Research and Analysis

*Weights may not add up 100 due to regulatory restrictions; ** Green: stocks that benefit from INR depreciation, Yellow: stocks that hurt from INR depreciation

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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