CLSA ASIA-PACIFIC MARKETS GREED & FEAR

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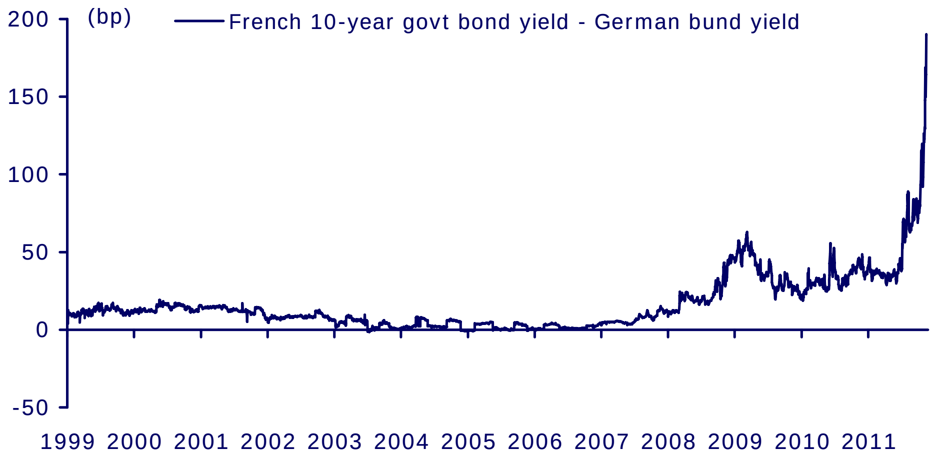
Trickling down

Gurgaon

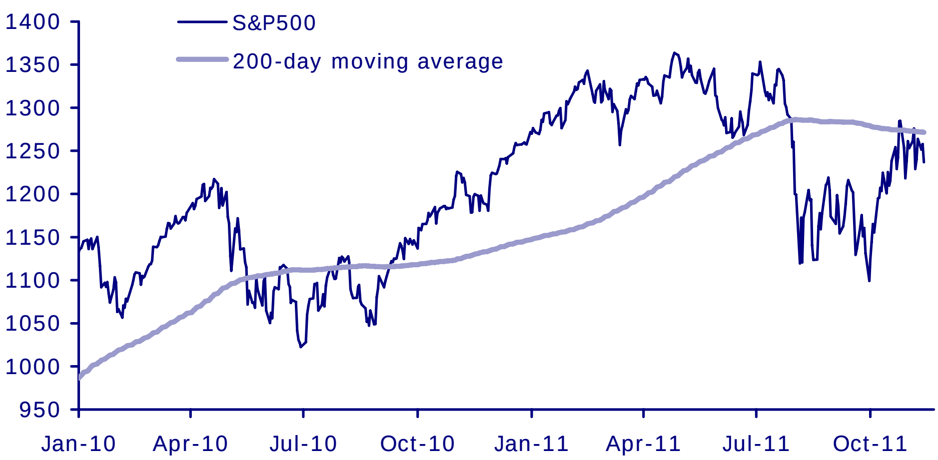
World stock markets clearly continue to *want* to go up since they continue to ignore the deteriorating action in the Eurozone credit markets. Thus, the S&P500 and the MSCI AC Asia Pacific ex-Japan Index have only fallen by 4% and 6% from their recent high reached in late October, and are still 13% and 15% above their recent low reached in early October. While the all important spread between the 10-year French government bond yield and the 10-year German bund yield has again widened to a new euro-era high of 190bp on Wednesday, up from 150bp last Friday (see Figure 1).

Figure 1
French 10-year government bond yield spread over 10-year German bund yield



Source: Bloomberg

Figure 2
S&P500



Source: Bloomberg

The stubborn desire to buy stocks is driven in *GREED & fear*'s view primarily by the time of the year. Those who have done well in 2011 betting against risk naturally want to lock in their gains. While those who have not are desperate to chase a year-end rally. Still *GREED & fear* remains firmly of the view that it will pay to bet against risk if the S&P500 makes it temporarily above the 200-day moving average (see Figure 2). Any such rally is likely to be driven by the new technocratic government in Italy coming up with seemingly meaningful austerity measures.

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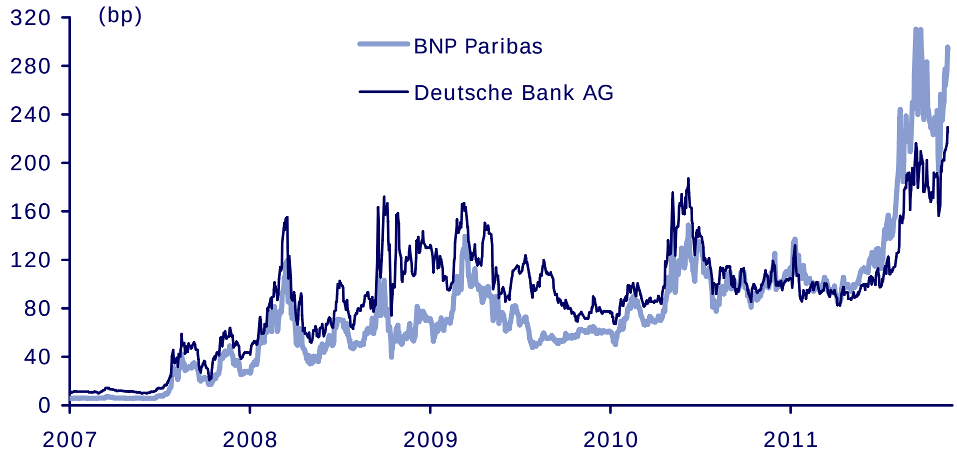
Meanwhile, a hint that the base case, or end game to the Eurozone crisis, remains fiscal union was provided this week by Frau Merkel at a party congress of her Christian Democratic Union held in Leipzig. The congress passed a resolution confirming the commitment to European integration including the ultimate goal of political union. *GREED & fear* continues to believe that the German *quid pro quo* for an increasingly likely move to full scale monetisation by the ECB will be a German dictated fiscal union complete with a European Treasury or fiscal authority with the power to raise taxes and issue joint and several eurobonds. True, the supplicants in the periphery may not like this. But in *GREED & fear*'s view the terms will not be negotiable.

Figure 3

European banks' five-year CDS spreads

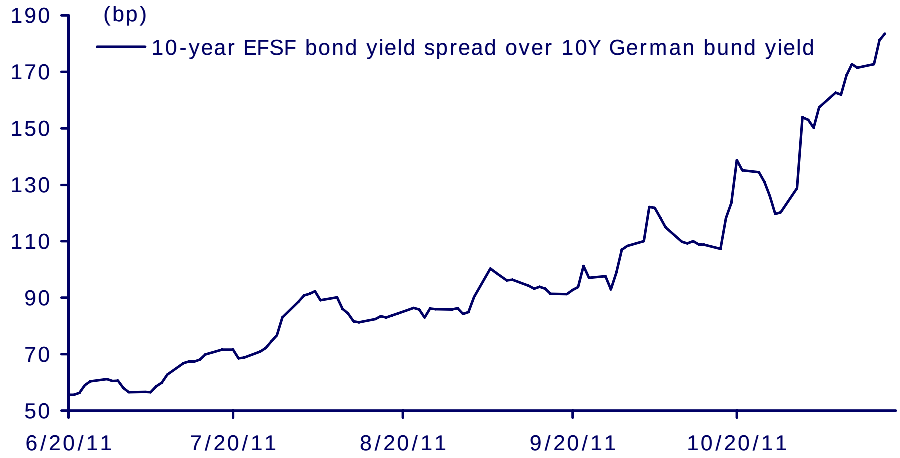


Source: Bloomberg

If this is the base case, investors for now should assume a further weakening in the euro and continue to keep a close eye on the French-German bond spread. Meanwhile, the vulnerability of European banks can be seen in the renewed surge in recent weeks in European banks' CDS spreads, with Deutsche Bank's CDS spread rising to a new high of 229bp on Tuesday (see Figure 3). While the challenges facing the EFSF can be seen from the chart below showing the yield spread of the EFSF 10-year bond yield and the 10-year German bund yield. This rose to 184bp on Wednesday, the highest level since the EFSF bond was issued in June (see Figure 4).

Figure 4

10-year EFSF bond yield spread over 10-year German bund yield



Source: Bloomberg

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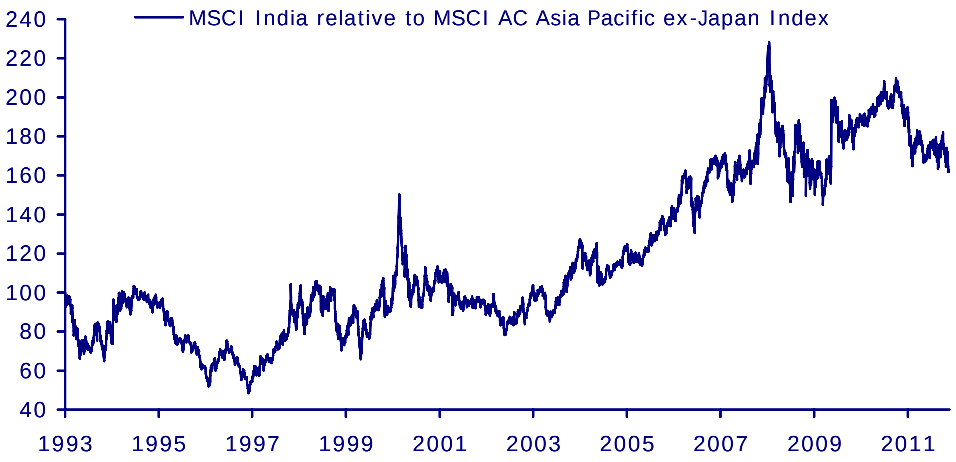
The mood at CLSA 14th India Forum this week has been much more subdued than in recent years. This is no surprise. The Indian stock market has underperformed this year as it has discounted Asia's most aggressive monetary tightening cycle. Thus, the MSCI India Index has fallen by 29% in US dollar terms so far in 2011, compared with a 15% decline in the MSCI AC Asia Pacific ex-Japan Index (see Figure 5). This is the worst relative performance since 2008. Meanwhile, there remains no concrete evidence that inflation has peaked, most particularly in the non-food area. Still the RBI has, for now at least, gone on hold while the hope is that the base effect should bring down the overall level of inflation from the December month. Headline WPI inflation stood at 9.73%YoY in October, almost unchanged from 9.72% in September. While non-food manufactured goods WPI, a proxy for core inflation, also remained unchanged at 7.6%YoY (see Figure 6).

Figure 5

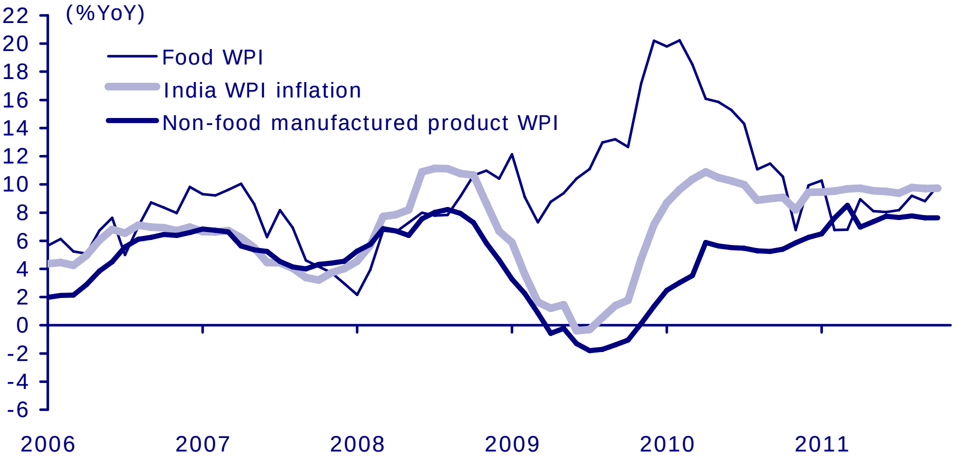
MSCI India relative to MSIC AC Asia Pacific ex-Japan Index



Source: Datastream

Figure 6

India WPI inflation



Note: Food WPI includes primary food articles and manufactured food products. Source: Ministry of Commerce & Industry, CLSA Asia-Pacific Markets

Still reassurance on the inflation front will only come with confirmation from the data. This is because inflationary pressures have proved much more intense in this cycle than either the central bank or private-sector economists were predicting. The main reason why is because non-food core inflation did not come down with food prices over the past seven quarters, as had been expected. This was taken as confirmation by the central bank that inflation expectations were becoming entrenched. Hence the renewed tightening in recent months.

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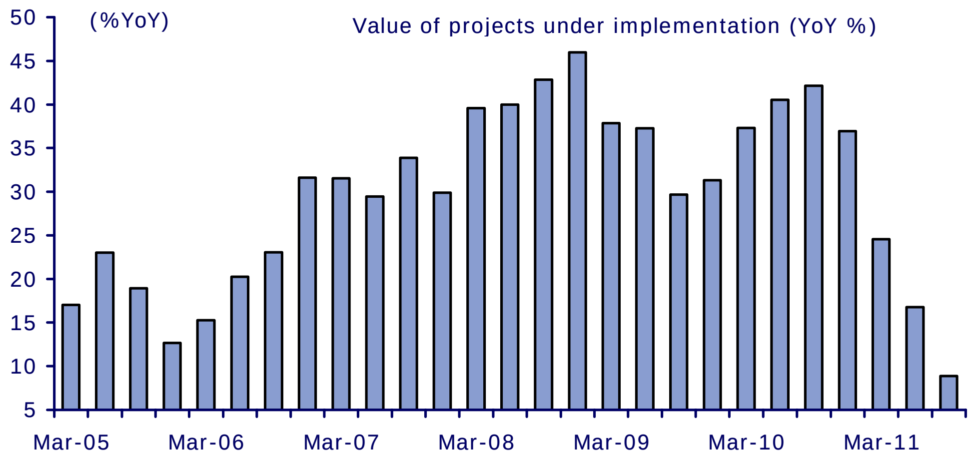
Why has inflation proved so stubborn? The best explanation heard this week was described to *GREED & fear* as "force-fed trickle down". The trickle down refers to the fact that labour has found itself with much greater bargaining power in a country where unskilled workers have generally been viewed as having no pricing power whatsoever. The "force-fed" nature of the trickle down refers to the Congress-led government's policies consciously seeking to redistribute income, be it the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) or the Minimum Support Price (MSP) scheme.

If this is the best explanation for the stubbornly entrenched pressures, the macroeconomic issue is whether Congress' populist initiatives have led to a positive one-off redistribution of income or whether they have set off a self-feeding inflationary spiral. The Reserve Bank of India has stepped in, clearly, in the aim of avoiding such a spiral. But the central bank's problem is that the level of development in the Indian economy means that consumption patterns are not particularly influenced by monetary tightening, save for relatively affluent areas of consumption such as car sales and mortgage finance which impact that part of the population, say 300m at most, which might be described as the aspiring bourgeoisie.

This is why monetary tightening in India is a rather blunt tool in the current Indian macroeconomic context. For it is more likely to hit investment than consumption, as is now happening. Yet investment is what is needed to deal with the supply constraints which remain the major impediment to Indian growth and which, incidentally, are also a contributor to inflationary pressures. Yet if this is the case, it is also a reality that the RBI has felt obliged to continue its tightening in recent months precisely because of the failure of the government to play its part and take more contractionary action on the fiscal front. Indeed the central bank has stated as much in its policy statements.

Figure 7
Growth in value of investment projects under implementation

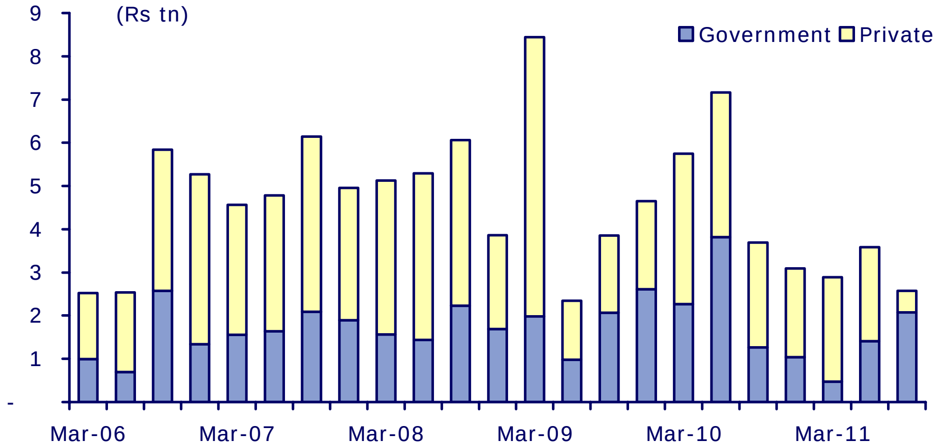


Source: Centre for Monitoring Indian Economy (CMIE)

If this is the state of play, the reality for now is that the central bank has gone on hold and is hoping, like everyone else, that inflationary pressures will now subside as predicted. This is because it is increasingly mindful of growth issues, most particularly given the deteriorating external context. It is also as aware as everyone else that monetary tightening is a blunt tool in India.

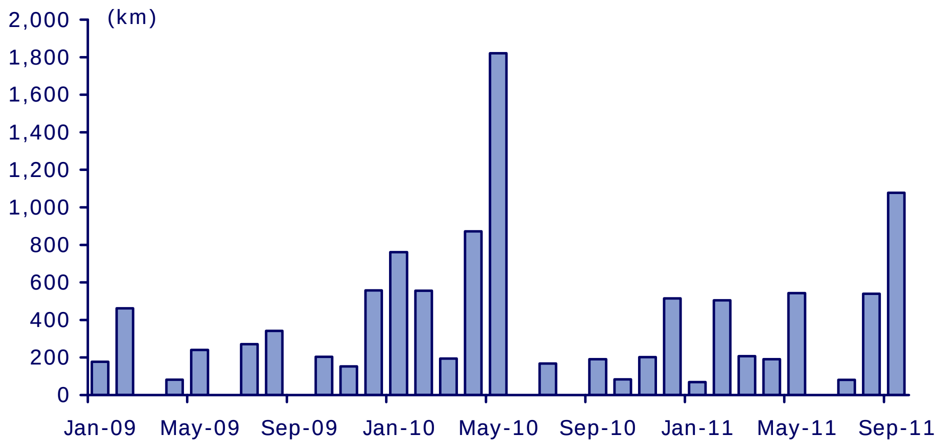
This leads *GREED & fear* to the other factor in the Indian story which is complicating what otherwise remains one of the world's best long-term growth stories. That is the sharp slowdown in investment projects, most particularly in the infrastructure sector. This is much more severe than what was experienced after the 2008-2009 crisis, as can be seen in the attached charts (see Figures 7 & 8). Thus, according to the Centre for Monitoring Indian Economy (CMIE), growth in investment projects under implementation slowed from 40%YoY in September 2010 to 9% in September 2011. While new investment project announcements during the July-September quarter fell by 30%YoY to Rs2.6tn, the lowest level since April-June 2009.

Figure 8
India new investment project announcements



Source: Centre for Monitoring Indian Economy (CMIE)

Figure 9
India monthly highway projects awarded



Source: National Highway Authority of India (NHAI)

The good news on the infrastructure issue in India is that the noise level regarding the slowdown in Delhi is rising. The other good news is that the highway programme has picked up significantly since *GREED & fear* was last in India six months ago (see Figure 9 and *GREED & fear – Noise inflection*, 26 May 2011). The bad news is a lack of action so far in what is probably the biggest infrastructure issue in India right now. That is the lack of progress on energy. Thus, as one speaker told Forum attendees this week, energy consumption is growing at a rate of 6-7% annualised whereas domestic sources of energy are growing at a rate of only 2.5-3%, resulting in a continued reliance on imported energy.

The main explanation for this deficiency is the lack of the necessary incentives for private capital given that the cost of coal and natural gas within India is still about half world prices. The power issue is, therefore, a growing constraint on growth. *GREED & fear* assumes, as is traditionally the case in India, that the more media noise generated on this issue the more likely action will be forthcoming. Still for now it is not really possible to point to dramatic concrete action taken. Indeed the most effective *GREED & fear* has been made aware of this week has again been an initiative by the RBI, which in September told the banking sector to

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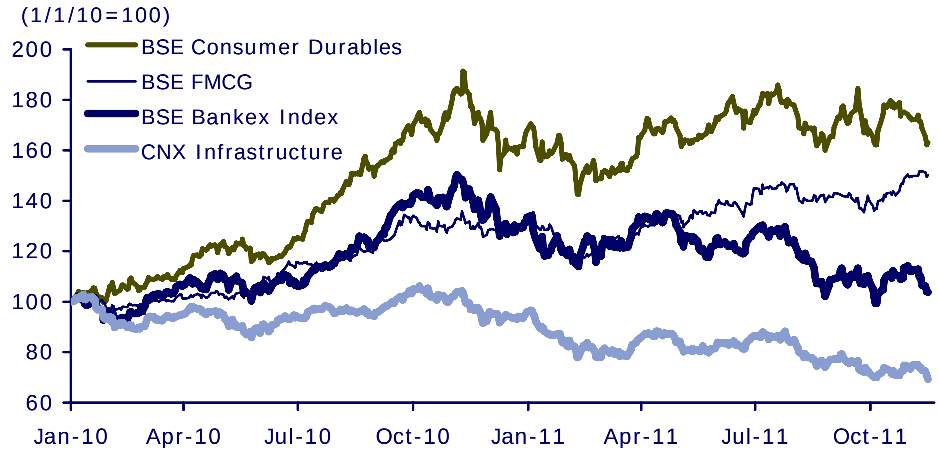
stop lending to loss-making state electricity boards (SEBs) unless they raised tariffs. The purpose of this move is to put pressure on the state governments either to provide more funding for the SEBs out of their own budget – remember India is a federal system – or to raise prices.

If the above are the issues, they are also largely reflected in the stock market. Consumption stocks have performed dramatically better than the likes of bank stocks or infrastructure plays during the course of the 20-month-long monetary tightening cycle. Thus, the BSE Consumer Durables Index and the BSE FMCG Index have risen by 46% and 48% respectively since the end of March 2010 following the first interest rate hike, while the BSE Bankex Index and the CNX Infrastructure Index are down 2% and 27% over the same period (see Figure 10). This reflects both the buoyant rural economy, courtesy of rising income growth, as well as the weakness in investment and related concerns about NPL risk in the infrastructure lending area, most particularly again in the energy sector.

Figure 10
India consumer stocks relative to banks and infrastructure plays



Note: FMCG = Fast Moving Consumer Goods. Source: Datastream

For the reason that much of this is by now discounted, *GREED & fear* would advise against becoming too bearish. Indeed the more the investment data weakens from here the more will the political pressures grow to do something about it. Still *GREED & fear* would recommend a barbell strategy where positions are maintained in the highly rated consumption sector while building investments in the relatively depressed banking and infrastructure area. The reason to build positions rather than jump in aggressively is two fold. First, there is the likelihood of rising asset quality problems in the banking sector. Second, there is the probability, sooner or later, of renewed Euroland risk aversion.

That same external risk issue also raises the issue of the rupee which so far in 2011 has been Asia's weakest currency. Thus, the rupee has depreciated by 12% against the US dollar so far this year to Rs50.7/US$ (see Figure 11). *GREED & fear* was interested to hear from CLSA's India economist Rajeev Malik that the RBI has been running a predominately hands-off policy towards the currency since 2010. Still this raises the risk of a sudden drop significantly beyond the 50 level should a renewed wave of Eurozone-triggered risk aversion lead to a deleveraging-driven US dollar surge. The point to be aware of here is that Indian corporates have increased their borrowing of dollars during the recent monetary tightening cycle because it has meant cheaper funding, as well as because some of them have had foreign acquisitions to finance. Thus, total external commercial borrowings have risen by 48% over the past two years from US$63bn at the end of 2Q09 to US$93bn at the end of 2Q11 (see Figure 12). Still a reassuring point is that accounting rules now require companies to take currency-related losses through their profit and loss accounts on a quarterly basis.

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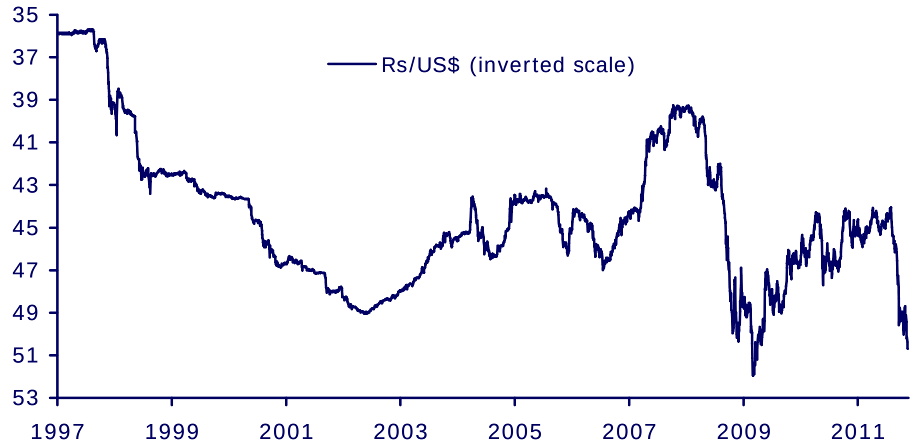
Figure 11

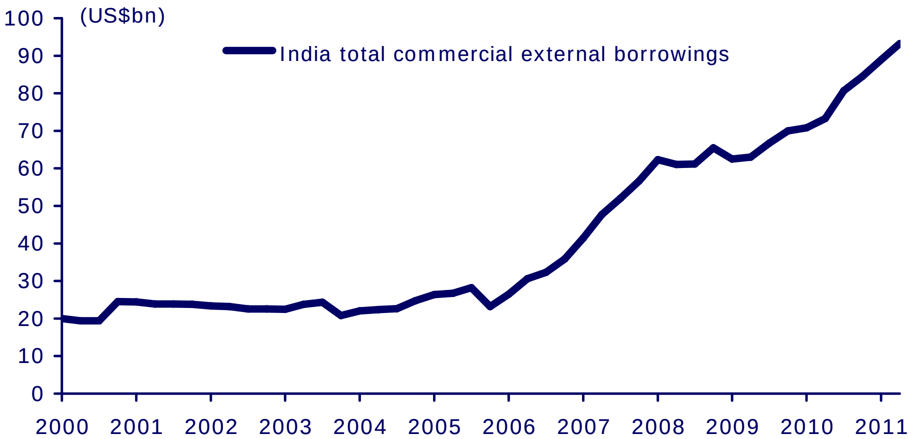
India rupee against the US dollar



Source: Bloomberg

Figure 12

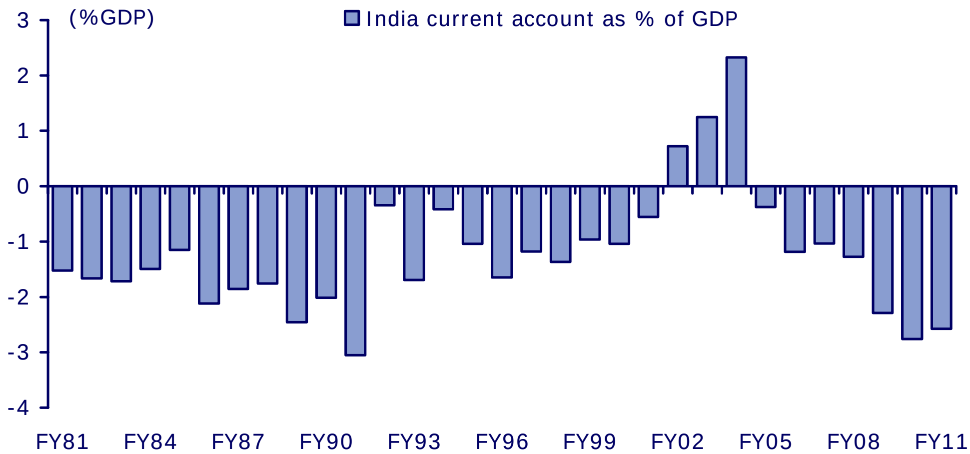
India total external commercial borrowings



Source: CEIC Data, RBI

Figure 13

India current account deficit as % of GDP



Note: Fiscal years ending 31 March. Source: CEIC Data, RBI, CLSA Asia-Pacific Markets

The potential for rupee weakness is also clearly driven by India's perennial current account deficit. Thus, India's current account deficit rose from 0.4% of GDP in FY05 to 2.6% in FY11 and is expected by Malik to rise to 3% this fiscal year (see Figure 13). This is not an issue

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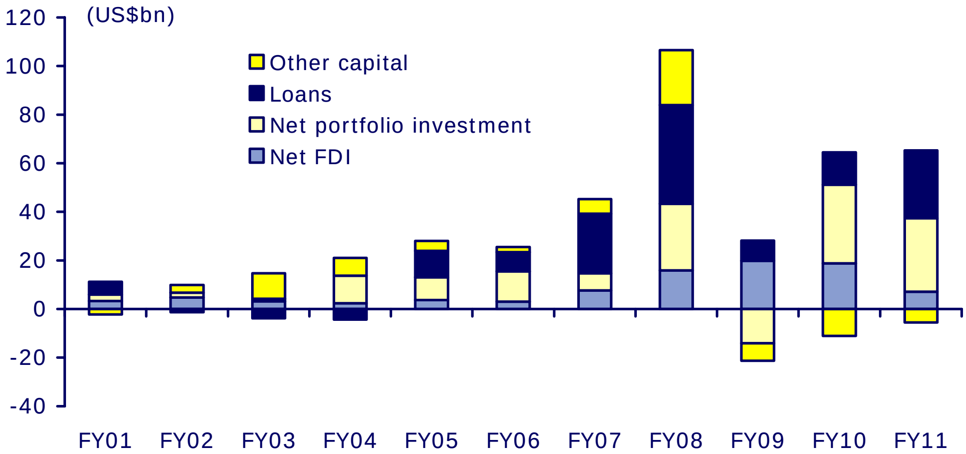
when growth is robust and risk tolerance is high. But with renewed external risk aversion likely sooner or later, at a time when there is a question mark on Indian growth for domestic reasons, there is clearly every reason for renewed currency weakness. This raises the issue of India's dependence on foreign capital, and the related large proportion of that foreign capital comprising potentially fickle foreign portfolio equity investment rather than FDI. Thus, the capital account surplus was US$60bn in FY11, with US$30bn in net portfolio investment and US$7bn in net FDI (see Figure 14). On this point, foreign institutional investors bought a net US$24.3bn worth of India equities and US$7.9bn of Indian debt securities in FY11.

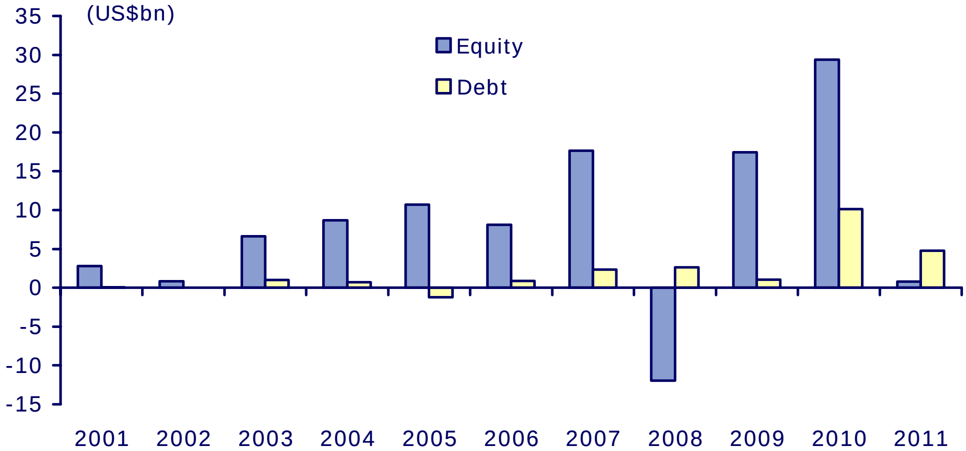
Figure 14
India capital account balance



Note: Fiscal years ending 31 March. Source: CEIC Data, RBI, CLSA Asia-Pacific Markets

This is why one of the amazing features so far this calendar year has been the lack of net selling by foreign equity investors given the deteriorating external environment and the relative underperformance of India within the Asian ex-Japan context. Indeed foreigners have, remarkably, been net buyers of US$800m worth of Indian equities year to date, after having bought a net US$29bn in 2010 (see Figure 15).

Figure 15
Foreign institutional investors' net investment in Indian securities



Note: Data up to 16 November 2011. Source: CEIC Data, SEBI, CLSA Asia-Pacific Markets

It would be tempting to conclude that, if foreigners have not sold now, then they are never going to sell. But with *GREED & fear*'s base case still being a "euroquake", that is too complacent a conclusion. Meanwhile, it may be the case that a currency-triggered market panic is what the Congress-led government needs to wake up and address the challenge to India's growth in a more proactive fashion.

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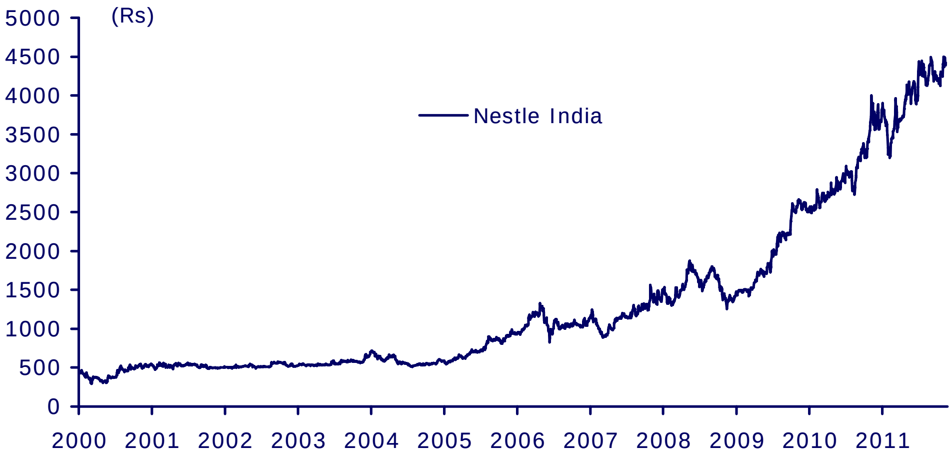
None of the above means *GREED & fear* has given up on the Indian growth story. The investment-driven infrastructure story will kick in again, with the only question when. For this remains one of the world's best growth stories on a 20-30 year view. It is so good precisely because India spent so little on infrastructure in the 50 years following independence with infrastructure spending running at only 3% of GDP in 1990 compared with the average of 7% of GDP since 2007.

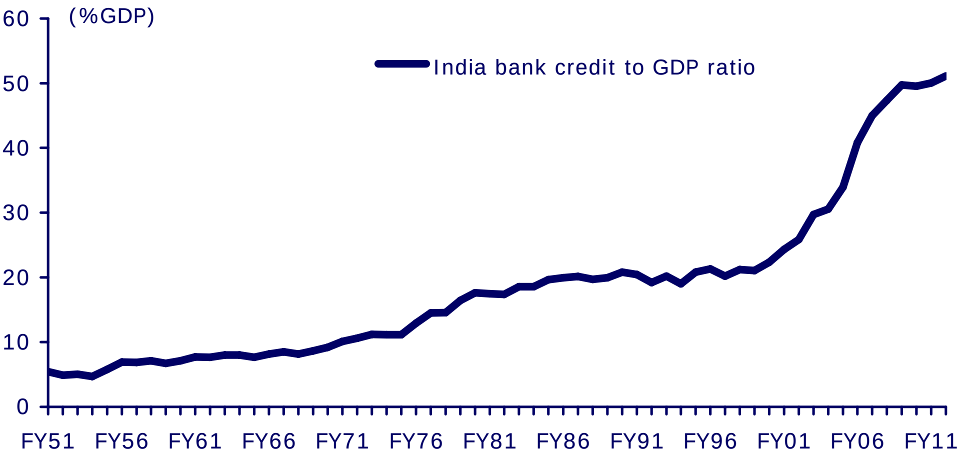
The other point about India is that the stubborn inflationary pressures entrenched in the past two years are fundamentally a function of growth, and especially income growth. That sellers of consumer goods at the mass market level have the power to raise prices reflects the ability to pay for these goods. Thus, *GREED & fear* heard this week that the cost of infant food is rising by around 30% a year, which helps explain the share price chart of Nestle of India (see Figure 16). This is the opposite of the trend seen in the Western world when pricing power is only really enjoyed by people selling goods to the rich, or increasingly the very rich.

Figure 16
Nestle India share price



Source: Datastream

Figure 17
India bank credit to GDP ratio



Source: RBI

To be sure, there is always the risk of an inflationary spiral; though *GREED & fear* finds this extremely unlikely in the Indian context given the relatively hawkish stance of the RBI. Meanwhile, investors should also remember that the Indian economy is still emerging from a low base. Thus, the bank credit to GDP ratio is still only 51% of GDP even though credit growth has risen by an annualised 23% over the past ten years (see Figure 17). It is a credit to the

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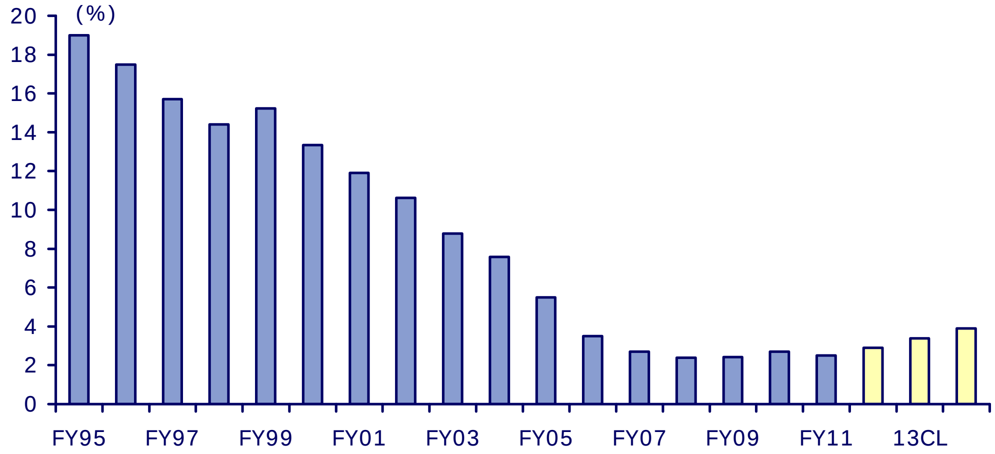
central bank, as well as the banking sector itself, that the country has so far avoided a credit bust during this period of rapid loan growth. NPLs are on the rise now. But the base case is for a moderate pick up, not a train wreck. CLSA's Mumbai office forecasts that gross NPLs of the Indian banking sector will rise from 2.5% of total loans at the end of FY11 to 3.9% at the end of FY14 (see Figure 18).

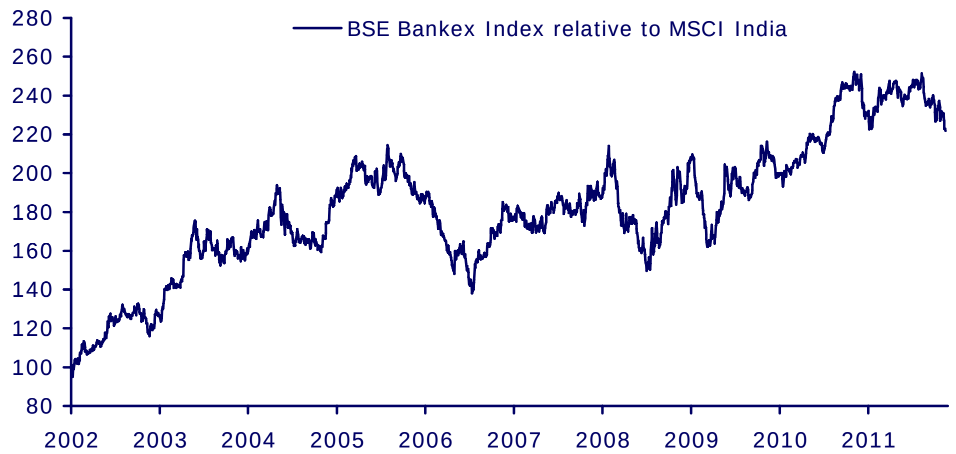
Figure 18
Indian banking sector gross NPLs as % of total loans



Source: CLSA Asia-Pacific Markets

This is the reason why a weighting in Indian bank is maintained in the long-only Asia ex-Japan portfolio as it has been since the inception of the portfolio at the end of 3Q02. On this point, Indian banks have outperformed both the MSCI India Index and the MSCI AC Asia-Pacific ex-Japan regional benchmark index by a significant amount during this period (see Figures 19 & 20). Thus, the BSE Bankex Index has risen by 721% in US dollar terms since the end of 3Q02, while the MSCI India Index and the MSCI AC Asia Pacific ex-Japan Index are up 381% and 175% respectively over the same period.

Figure 19
BSE Bankex Index relative to MSCI India Index



Source: Datastream, CLSA Asia-Pacific Markets

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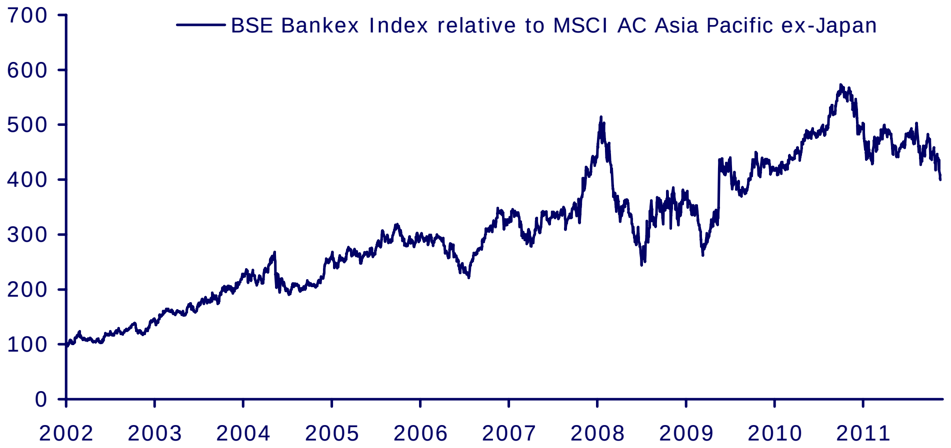
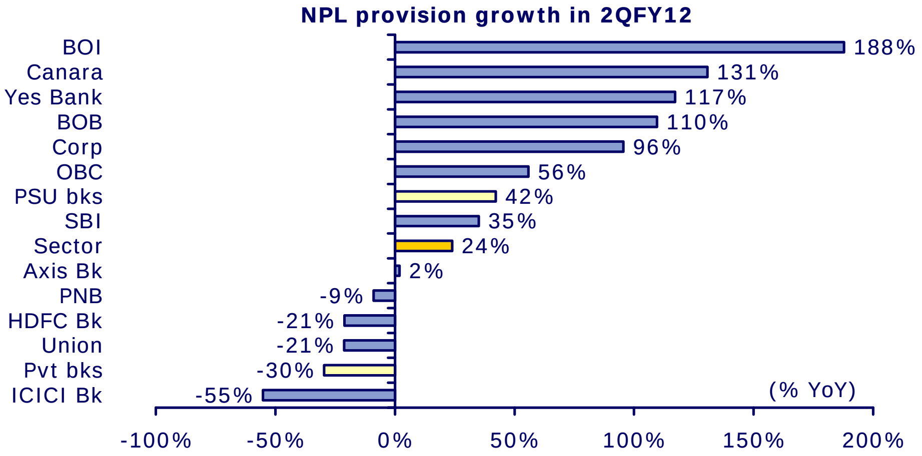
Figure 20
BSE Bankex Index relative to MSCI AC Asia Pacific ex-Japan Index



Source: Datastream, CLSA Asia-Pacific Markets

Figure 21
Indian banks' NPL provision growth in 2QFY12



Source: CLSA Asia-Pacific Markets

However, in the recent cycle there is a significant divergence in the growth of NPL provisions between state-owned banks and private banks, as can be seen in the chart above from the presentation this week by CLSA's Indian banking analyst Aashish Agarwal (see Figure 21). On the same related theme, it is interesting to note that for the first time ever HDFC Bank overtook State Bank of India on Tuesday as the largest bank in India in terms of market capitalisation. Thus, the market capitalisation of HDFC Bank was Rs1.105tn on Tuesday, compared with SBI's Rs1.098tn (see Figure 22). Meanwhile, the market share of public sector banks has fallen significantly over the past two decades, declining from 92% in FY89 to a still large 74% in FY11 (see Figure 23). This is why the growth story for private sector banks remains compelling.

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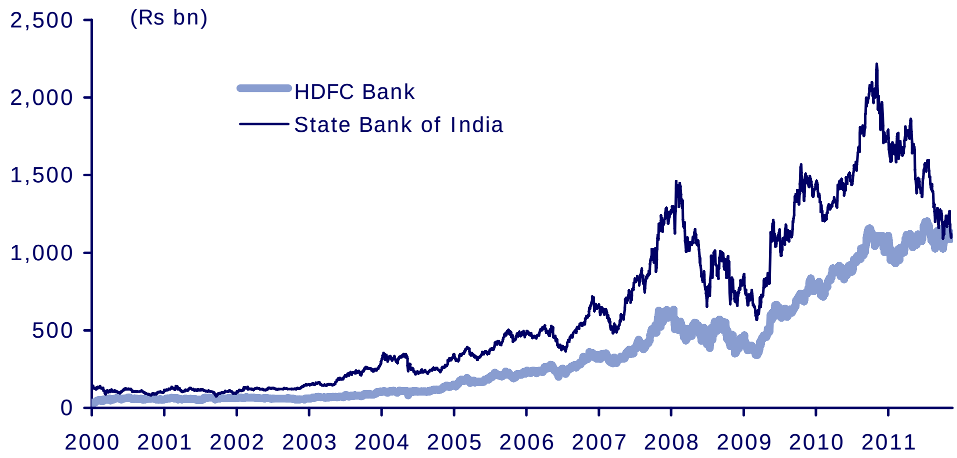
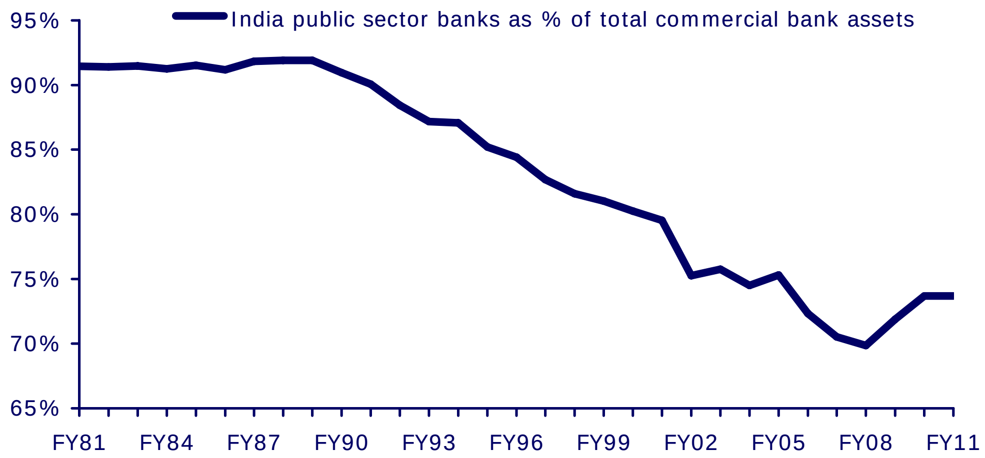
Figure 22
HDFC Bank and State Bank of India market capitalisation



Source: Datastream

Figure 23
India public sector banks' market share (% of all commercial banks' assets)



Source: RBI, CEIC Data

With the continuing focus on inflation in India, it is interesting to note the contrasting extremely doveish stance by the central bank in Indonesia. Thus, Bank Indonesia has cut rates by 50bp this month and 25bp last month to 6% (see Figure 24). That it can do so reflects the lack of inflationary pressures this year, which is primarily the result of the strong rupiah.

Still in *GREED & fear*'s view the long term investment case for Indonesia would be helped if the Indonesian central bank had displayed more caution. After all credit growth is already running at 25%YoY, well above nominal GDP growth of 15.3%YoY (see Figure 25). Still this does not mean Indonesia is about to blow up, while the accommodating monetary stance justifies a continuing overweight in the relative-return portfolio. Still the latest 50bp cut means the rupiah will be weaker than would otherwise be the case when the anticipated euroquake triggers the next global financial panic. For more on the case for and against the Indonesian easing read the recent CLSA economic research report ("*The Infofax: Indonesia rate cut – The case for and against*, 11 November 2011).

Finally, the risk of further rupee weakness in the context of a euroquake causes *GREED & fear* to reduce the overweight in India in the Asia Pacific ex-Japan relative-return portfolio by two percentage points by increasing the weighting in China to an overweight (see Figure 26).

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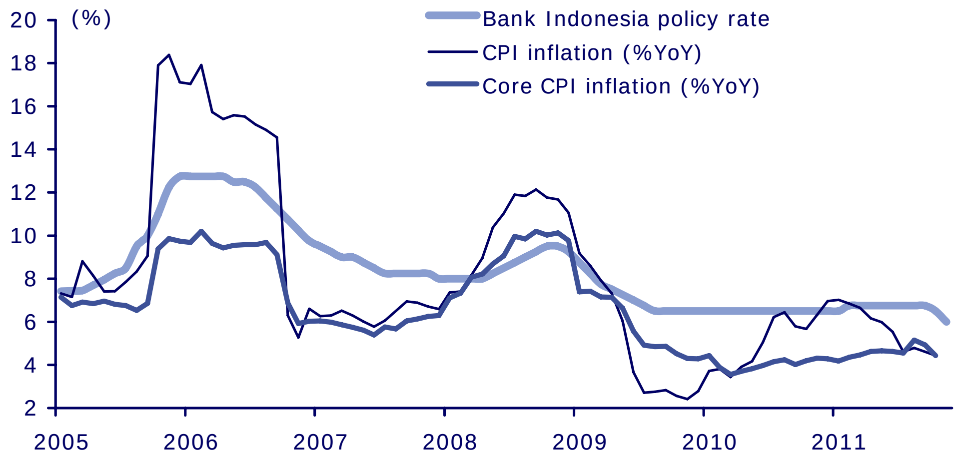
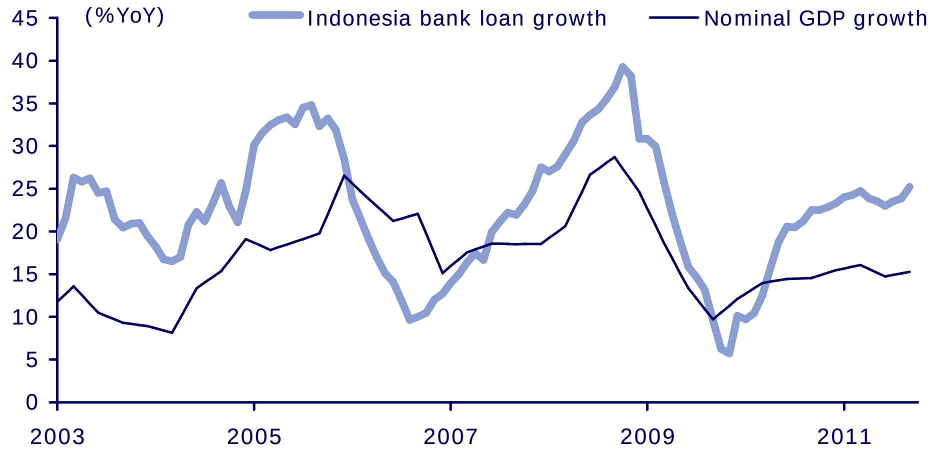
Figure 24
Indonesia CPI inflation and Bank Indonesia policy rate



Source: CEIC Data, Bank Indonesia

Figure 25
Indonesia bank loan growth and nominal GDP growth



Source: CEIC Data

Figure 26
CLSA Asia Pacific ex-Japan asset allocation

	MSCI AC Asia Pacific ex-Japan weightings 16-Nov-11	CLSA recommended weightings 17-Nov-11	Mismatch from current benchmark
Australia	26.1%	6.0%	-20.1%
China	17.8%	20.0%	2.2%
Hong Kong	8.2%	7.0%	-1.2%
India	7.0%	13.0%	6.0%
Indonesia	3.0%	7.0%	4.0%
Korea	15.1%	13.0%	-2.1%
Malaysia	3.5%	8.0%	4.5%
New Zealand	0.4%	0.0%	-0.4%
Philippines	0.7%	5.0%	4.3%
Singapore	5.1%	4.0%	-1.1%
Taiwan	11.2%	13.0%	1.8%
Thailand	1.9%	4.0%	2.1%
Total	100.0%	100.0%	--

Source: CLSA Asia-Pacific Markets

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Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local marketby 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).