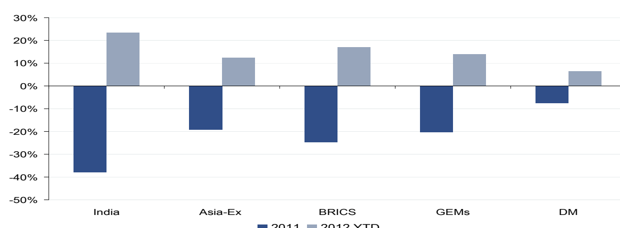
India Equity Strategy

India's Swings: China and the Euro-zone, or Back Home

- **India has bounced back quite spectacularly in 2012**— The bounce across equity (+15%), FX (+9%) and rates (- 38 bps) markets has caught the investing community by surprise. But where is this coming from? A low base (2011 was terrible), a more decisive turn on lower interest rate expectations or, critically (and a key driver of EM buoyancy (+9.3%)), easing of concerns on a euro zone/China slowdown. It's probably a combination, but should India really be swinging so wildly to the euro-zone/China's tune?
- **The euro-zone/China matter, but less for India than for EMs** — Relative to EMs, India's a) trade exposure to euro/China is low (it's a net importer), b) India accounts for only about 4% of EU bank exposure to EMs (euro banks' deleveraging an overstated risk), c) FX reserves cover relative to off-shore debt is reasonable, and d) doesn't really participate in China's growth (vulnerability to a China slowdown is low). This does not make India immune to euro-zone/China troubles, but it is more so than EMs as a group, and distinctly more than the markets seem to suggest (underperforming (-18%) / outperforming (12%) EMs with rising/falling euro-zone/China concerns).
- **Look at Home, rather than at China or the euro-zone?** — India's challenges, and potential upsides, lie at home; fiscal profligacy, high inflation, lack of policy/reform and execution challenges. The past years' global economic challenges were an opportunity for India to break out of its near-EM straight jacketing, but it blew them away on global/euro-zone/China excuses. It needs foreign capital/markets, but we see India's economic/market trajectory lying in fixing domestic issues rather than global gazing.
- **Remain positive: though increasingly the market will likely wait for the economy to catch up** — We remain positive on the market: we maintain our 18,400 Dec 12 Sensex target and a Financials-heavy model portfolio. But we do believe it will be a tough grind from here, as the market waits for the economy to signal the recovery that equities have now partly factored in. Our preferred picks: Axis Bank, Adani Ports & SEZ, Maruti, SBI, Dr. Reddy, United Spirits, Havells and M&M Financial Services.

Figure 1. Equity Markets Performance (in USD terms) in 2011 and 2012 YTD



Source: MSCI, Datastream

- Equities

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India's Swings

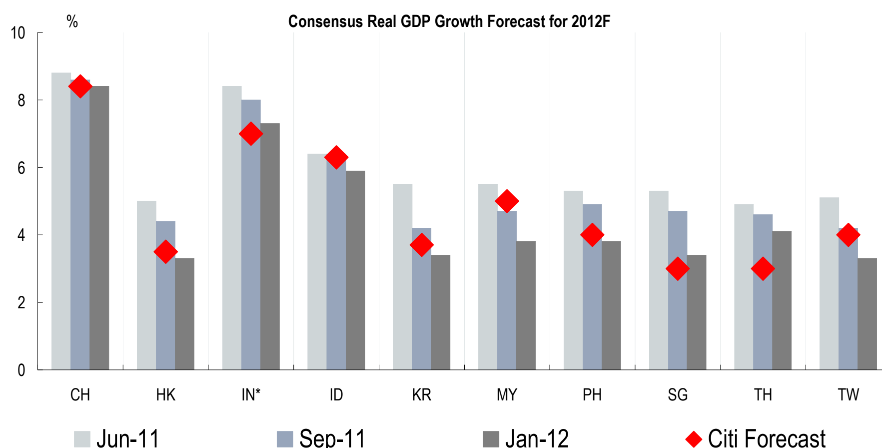
Down and now Up

2011 - A tough year

One of the worst global markets – across Equity, FX and Rates

India has had a rough 2011 – growth expectations down 1.5%, the equity market lower by 25%, and INR lower by almost 20%. The step down for India from its relatively exalted economic opportunity position has been quite significant. India is not alone in seeing a dip in GDP growth expectations; global growth has come down across DM and EM. But India's fall has been sharper: its GDP growth expectations have been pared about 150bps over the last year. And each of its markets - equity, currency and Interest rates, proved to be amongst the worst-performing globally.

Figure 2. Revisions to Consensus 2012 GDP Forecasts



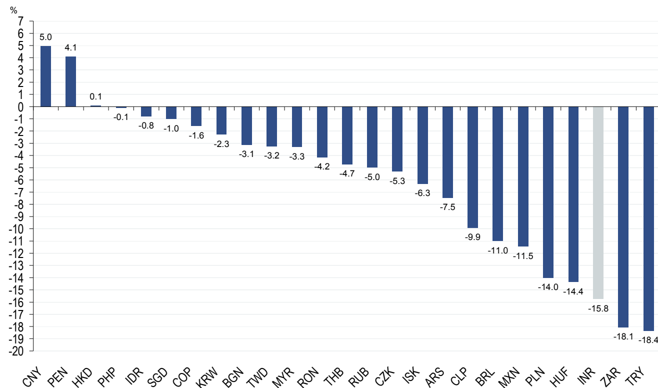
Source: CIRA Consensus Economics, *FY12 for India

2012 – A very bright start

The best currency adjusted equity market

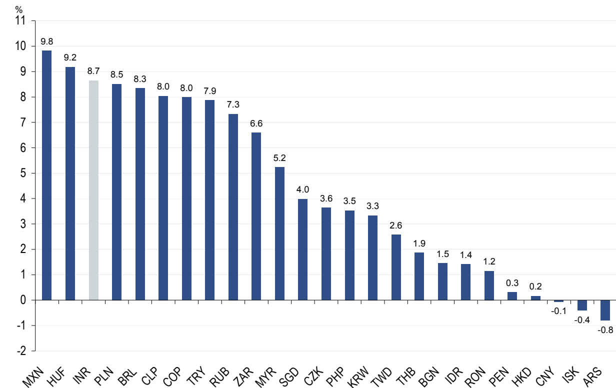
2012 has started very differently, and pretty dramatically contrary to consensus expectations. Markets have bounced back sharply: equities up 15%, the currency up 9%, meaningfully leading global peers in performance, and reversing a fair share of the erosion of 2011. The mood too seems to have changed fairly dramatically (for global risk appetite of course, but probably a little more so for India). It has not yet translated into any GDP upgrades – and we believe upgrades are still some way away, but India does present a fairly different mood in the beginning of February 2012 than in the beginning of January 2012.

Figure 3. Returns of EM currencies against USD – 2011



Source: Citi Investment Research and Analysis

Figure 4. Returns of EM currencies against USD – 2012 YTD



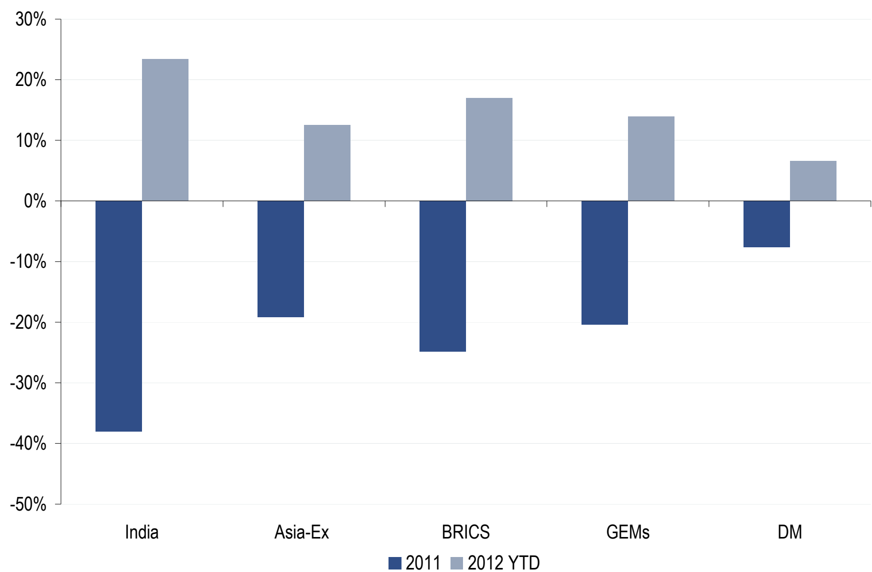
Source: Citi Investment Research and Analysis

And a big global mood swing – but is it only global?

A more global economy and market than peers?

So what has driven this sharp pain – and then its quick reversal into gain? It is never black or white, but we do believe India's challenges, and prospects (and growth and market outlook), need more precise anchoring, whether to its global linkages, or to its domestic story (the original source of its glowing reputation – and some performance). We believe this is particularly important as the public posture of government and some commentators has tended to suggest that India's economic and market weakness has tended to be globally driven, rather than by closer to home. Its not either or, but what is the predominant driver?

Figure 5. Equity Markets Performance (in USD terms) in 2011 and 2012 YTD



Source: MSCI, Datastream

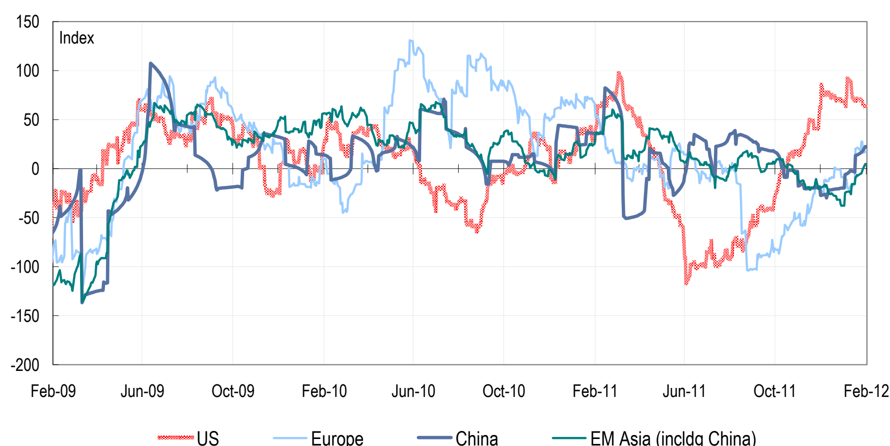
Or emerging market, or local?

India's economic and market pendulum has swung sharper than the Emerging market group, in the last year

The increased linkages between economic growth, market performance, funds flows and global themes are now all too apparent. Emerging markets are no different – they do tend to perform as a group (in real economic terms to some extent, and in market terms in a more pronounced manner). But is the brush getting too broad? We believe that as India has got more integrated with global trade and capital flows – its market and economic swings appear sharper than EM peers, with global overriding the domestic. Should this really be the case? We dig a little deeper.

2011 was about the euro-zone and China – and it hurt India

Figure 6. Economic Surprise Indices



Source: Bureau of Economic Analysis, CIRA

The US has been looking up…euro-zone and China have looked down, and then up

As the economic surprise index above reflects, the US has been seen to be on a recovery path through most of 2011. What changed during the year was the precipitous drop in the euro-zone's prospects, and continuously dipping expectations of China. That has been the global swing theme through the latter half of 2011, and the most recent upward trend in these markets reflects an easing of caution, or an upward bias in the outlook for Europe.

India has swung more wildly than EMs, on euro/China Swings

India seems to have been impacted more than EM, on the back of the direction of these trends, with a very weak performance in 2011 (across equities, currency and rates), and a bounce back well ahead of peer performance in 2012. There has been a swing in India's domestic fortunes over the period (predominantly a downswing), but clearly not as dramatic as that of the euro-zone / China outlook.

Citi expects a troubled euro-zone and a weaker China, but is more optimistic than consensus

So, is India more impacted than EM as a group by euro-zone and China swings? We take a look against the backdrop of Citi's expectations for China and the euro-zone in 2012. We look at the risks and transmission effects of a slowdown in China, as is widely expected, even though it is not a view shared by Citi (Citi economists expect a soft landing, weak but holding property markets, and more RRR cuts). We also look at risks emanating from the euro-area: Citi expects a recession in 2012 (-1.5% growth), a weaker euro (1.15-1.20) and continued question marks over the structure and stability of the EA mechanism, albeit we do not expect the structure to break.

What are the Economic/Market Linkages? How Exposed Is India?

What drives these linkages: a) Trade, b) Funding – particularly in the context of ongoing euro-bank de-leveraging c) FX debt / Reserve Coverage levels, and d) How much does India participate in China's growth?

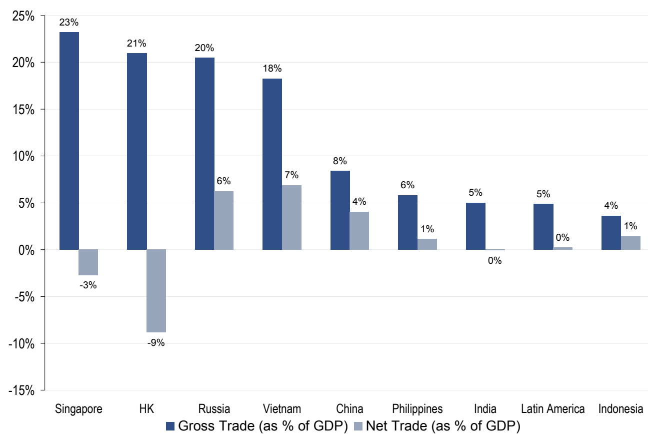
How exposed is India to the euro-zone, and China, in absolute terms, and relative to other EMs?. We believe there are four drivers that should have a meaningful impact on growth and markets. These are the areas of a) Trade, b) Funding – particularly in the context of ongoing euro-banks deleveraging, c) FX debt / Reserve Coverage levels, and d) How much does India participate in China's growth?. These need to be appreciated in absolute terms as well as relative to other EMs.

1. Trade – Rising, but how material is it?

Trade, at the gross and net levels, is a lot less material for India than most EMs

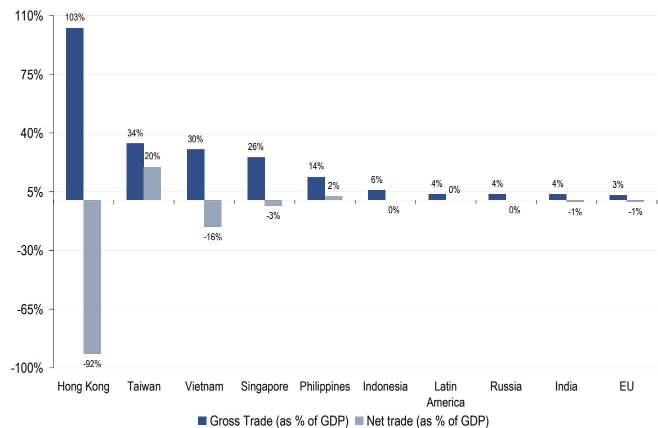
India's trade levels have been going up, with total trade now at 42% of GDP – increasing India's exposure to global demand and pricing cycles. But is it material relative to EMs? The charts below suggest when it comes to trade with the EU and China, India is a bit player, with only limited absolute and relative dependence compared with EM peers.

Figure 7. Trade with EU (as % of GDP)



Source: Citi Investment Research and Analysis

Figure 8. Trade with China (as % of GDP)

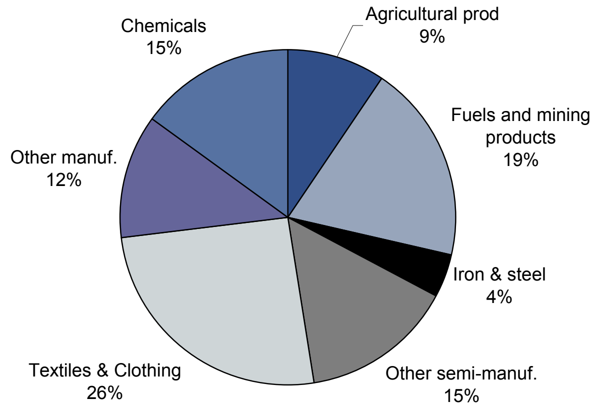


Source: Citi Investment Research and Analysis

The EU is India's biggest trading partner…but this trade is balanced between exports and imports

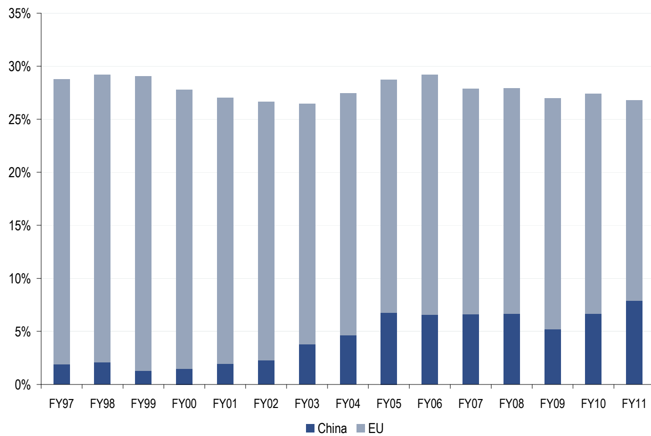
The EU is actually India's second-largest trading partner, accounting for 15% of India's gross trade (MENA region is the largest with 26% share, though this trade is dominated by oil). However, the EU trade basket is quite balanced, with India being a net exporter only to the tune of about $2bn (0.14% of GDP, 1.9% of India's trade deficit). Secondly, the EU's share in India's trade pie is on a declining trend. The fairly broad-based composition of this trade also suggests that concentration or swing risks are modest - and a weak euro-zone should have only limited overall implications for India; and distinctly less than some large EMs.

Figure 9. EU27 – Composition of Imports from India (2010)



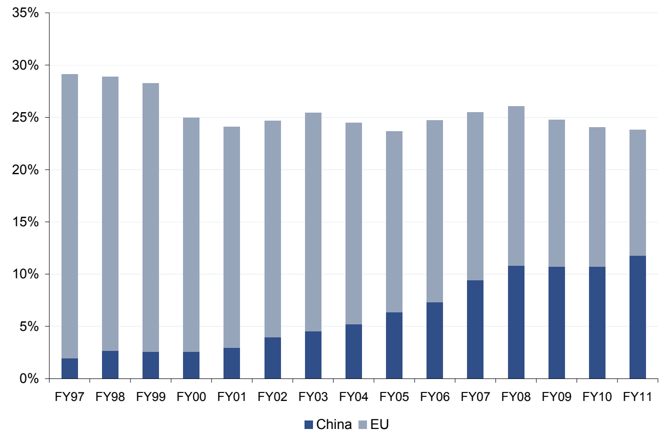
Source: Eurostat

Figure 10. India's exports (% of total) to China and EU



Source: Citi Investment Research and Analysis

Figure 11. India's imports (% of total) from China and EU



Source: Citi Investment Research and Analysis

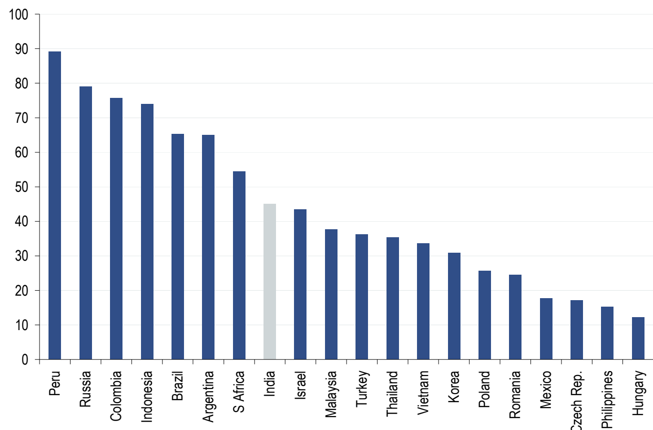
India's trade with China has been growing rapidly…and hugely driven by imports

It's a little different with China. The level of trade has been rising, but India is increasingly a net importer, with the deficit at 1.42% of GDP, or 19.6% of the trade deficit. While China slowing could hurt exports (which are 7.9% of India's total exports, and primarily commodities, so there could be a price-risk factor), the fact that India's exports to China are consumption-based rather than investment should limit potential pressures. A slower China could widen this trade gap; but India's low export levels should limit any meaningful impact.

And India is a net importer…a weaker global growth environment should play to India's advantage…

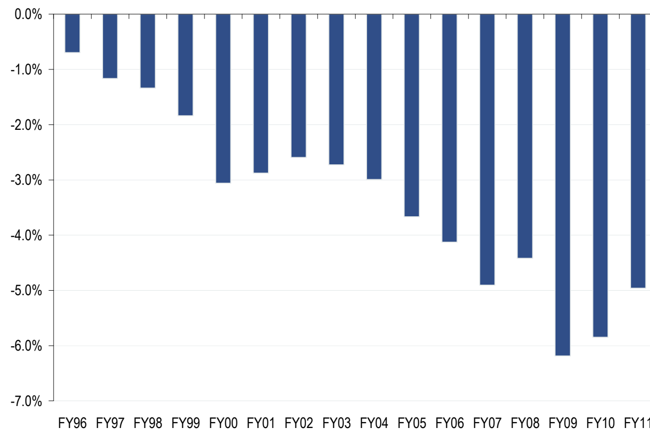
India is one of the few EMs that is a net importer, and this fundamentally limits its risk to global growth. In addition, it is a significant net importer of commodities – which typically should weaken in a modest global growth environment (though that has not been the case in recent years, particularly regarding oil, India's predominant import). While there are clearly other ramifications from a weakening of euro-zone/China growth (on capital, investment flows, leverage), India's trade mix itself is a meaningful hedge in absolute terms, and more so relative to other EMs.

Figure 12. Commodities exports as % of total exports in 2010



Source: Citi Investment Research and Analysis

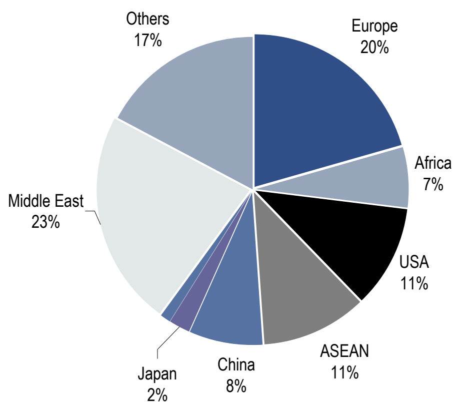
Figure 13. Net Commodity exports for India as % of GDP



Source: Citi Investment Research and Analysis

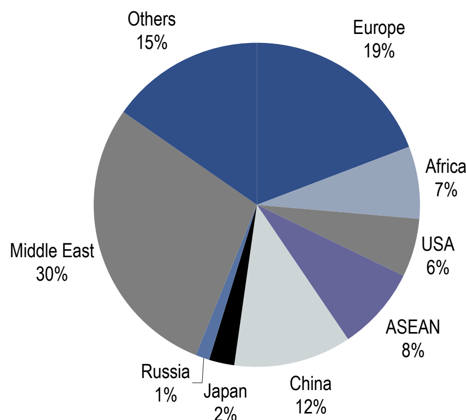
India's overall exports are fairly diversified across geographies and products: in the Middle East there is some concentration, although imports are largely crude

Figure 14. Composition of India's exports



Source: Citi Investment Research and Analysis

Figure 15. Composition of India's imports



Source: Citi Investment Research and Analysis

2. European bank Deleveraging

Deleveraging fears for India were seen to be high on account of increased borrowings – and the INR's reaction seemed to suggest as much

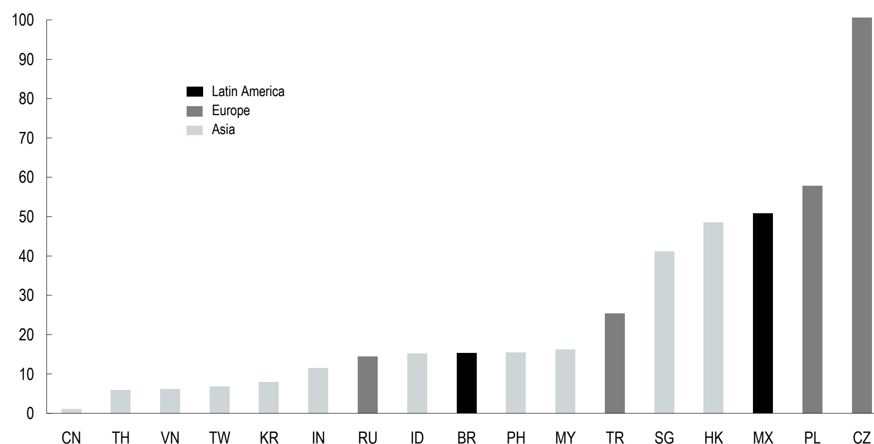
The INR was one of the worst-performing EM currencies in 2HY11, as concerns on European bank deleveraging took hold of the Indian market, along with some lumpy oil payments. This was in the backdrop of the structural current account deficit that India runs, and the increased offshore credit it had raised in its stronger growth years (big pricing arbitrage - given India's high interest rate regime and, until recently, a relatively stable currency).

It is a risk factor – India does consume offshore credit – and it will be vulnerable to bunchy withdrawals. But the market's reaction on the currency (and companies with impending off-shore repayments) would suggest India is amongst the most exposed countries on this count.

Only 4% of European bank credit to EMs is in India – relatively small, especially compared with India's size

This does not appear to be the case. India falls in the top half of the pack of least exposed EMs, in terms of credit originated from European banks, as a % of domestic borrowings. It also represents only about 4.1% of European bank credit to EMs, and given the relatively large size of the Indian economy, this suggests it is unlikely to be amongst the exposures that call for reduction, at least in the initial stages of a deleveraging. India is more exposed than Asian EMs – but this gets extrapolated to the broader EM group, which we believe is not the case.

Figure 16. European Banking Claims on Non-Bank Private Sector (% of Total Domestic Credit to Non-Bank Private Sector), June 2011

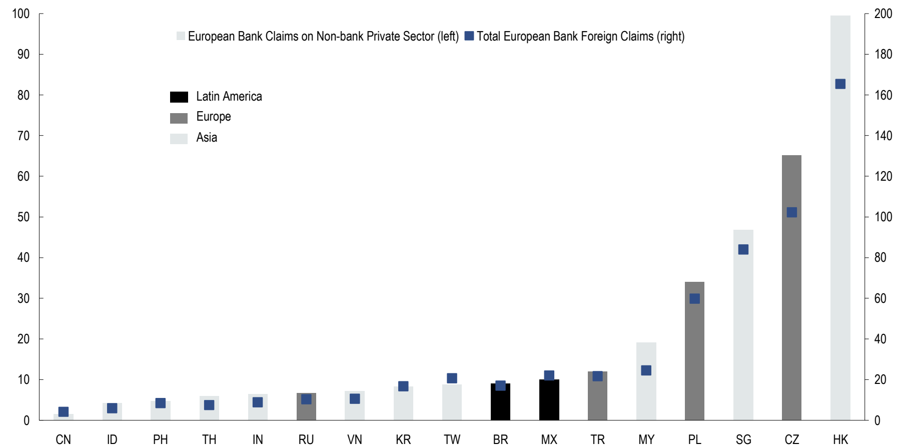


Source: BIS Consolidated Banking Statistics (The European claims on non-bank private sector are calculated using the ultimate risk basis), IMF IFS data

CEEMEA is where the risks are most pronounced…India is a little more exposed than some Asian peers

This is true for a broader definition of the credit too and, while exposure to CEEMEA markets is understandably high, India is amongst the EMs with exposure to this risk. That India is not leveraged to trade (to the same extent as most EMs) should also moderate the risk perception of this credit, and the deleveraging risk.

Figure 17. Comparing Consolidated European Banking Claims, Total and Claims on Non-Bank Private Sector (% of GDP), June 2011

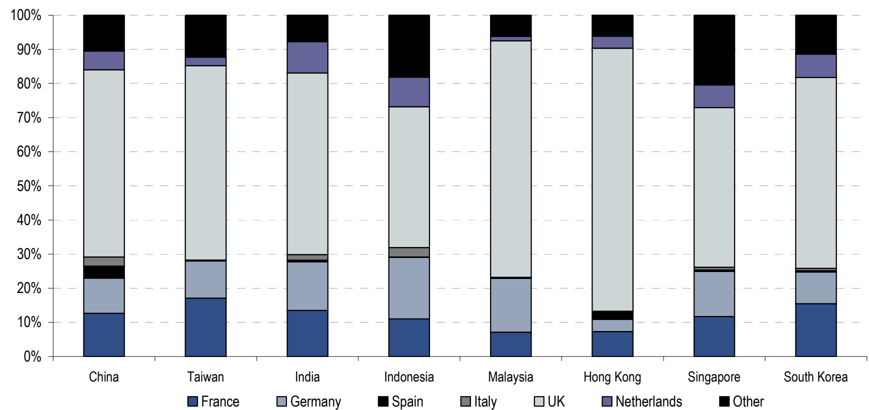


Source: BIS Consolidated Banking Statistics and CIRA

European banks, with limited direct exposure to India because of regulatory restrictions, will likely be cautious of cutting credit too quickly

The origins of this credit too – primarily from the UK, German and French banks – should also limit deleveraging risks. This is because these banking systems are under relatively less stress to raise capital, and compulsion to deleverage. This is particularly so in the context of the CEEMEA exposures of these banks. The fact that quite a few of these banks have been trying to gain direct access into Indian banking, and have been unable to do so because of regulatory restrictions, will likely make them reluctant to reduce their Indian exposures, relative to other emerging markets.

Figure 18. Nationality of European Banks Exposure with Asia (%)

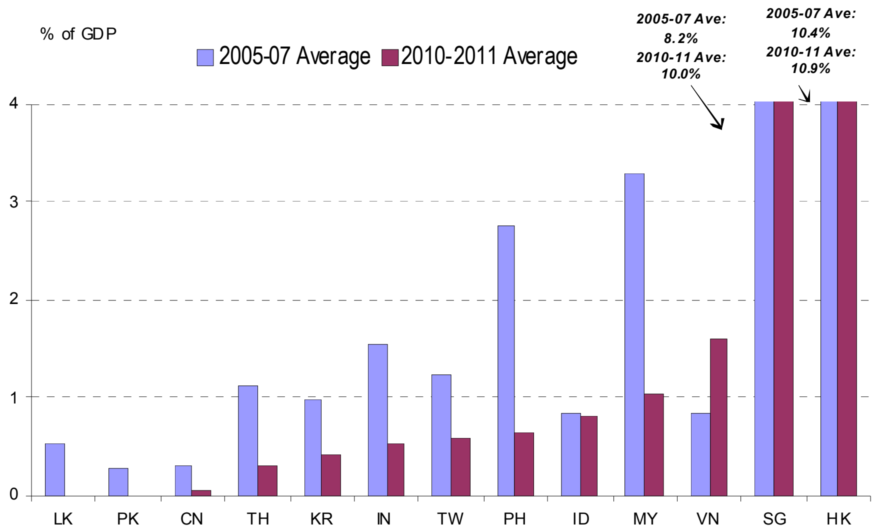


Source: BIS and CIRA

The syndicated-loan market tells a similar tale

The syndicated-loan market tells a relatively similar story. India is exposed, but a lot less than its historical averages, and also a lot less than most of its Asian EM peers.

Figure 19. Importance of Syndicated Loans in Asia with at least one European bank as a Lead Arranger, % of GDP



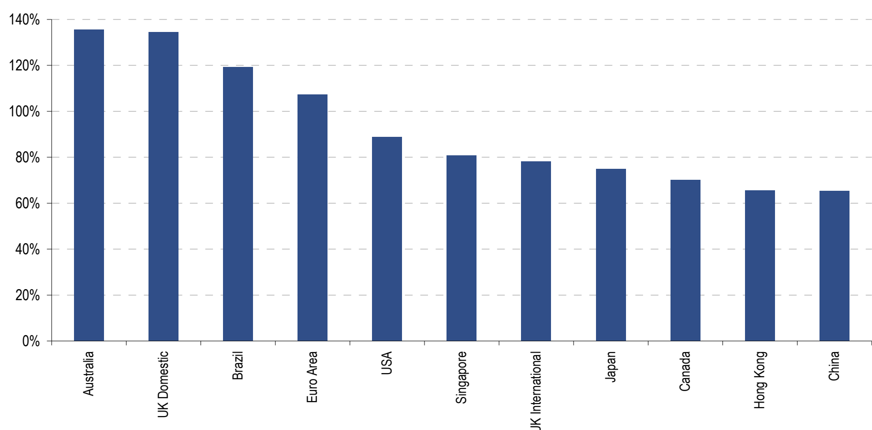
Source: Thompson Reuters (Loan Connector), CIRA

Note: We exclude loans where the only indentified European bank is Standard Chartered and/ or HSBC

India should increasingly have access to Chinese, Japanese and other developed markets – and that should limit capital reliance on European banks

And Europe is not the only place to go for off-shore funding. We believe Indian credit is probably only moderately held by some of the Chinese, US, Korean and Japanese banks: all of these economies have been making strategic and large investments into the Indian markets, and we do believe they will have the appetite to take up some of the fallout of continued European Bank deleveraging. There have been a few large recent Chinese bank re-financings, and we do believe, with the scale of the economy, the restrictions of offshore debt investment into the Indian market (caps have been raised recently, but the market remains restricted), the negative implications from deleveraging of European banks are meaningfully lower for India than for most EM peers.

Figure 20. Global Banks – Loan to Deposit Ratio, 2010 (%)



Source: Citi Investment Research and Analysis

3. FX Funding gap

India's large current account deficit (3% in FY12) – and almost structural in nature – should leave India vulnerable to swings in capital flows …

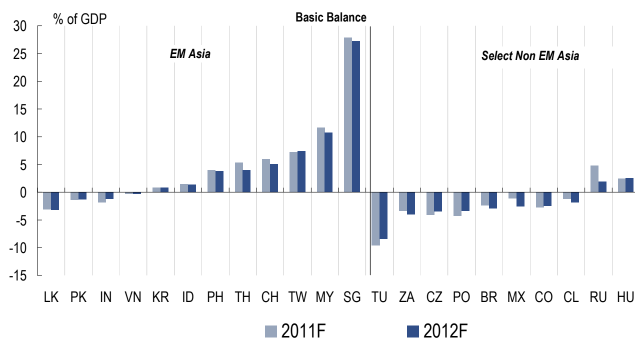
A high current account deficit is a structural concern, and that fact that India also runs a relatively high fiscal deficit does increase risks, and limit policy elbow room. This is in part a reflection of the sharp 16% depreciation of the rupee in 2HY11, when deleveraging concerns were heightened, India's fiscal weakened and concerns on portfolio outflows increased. The currency was also a major underperformer vs EMs – and was the second-worst performer of the group in 2011.

While it was a structural weakness, was the relative performance of the currency a fair reflection of the risks compared with EM peers? We believe not, and the INR's recent pull back (9% YTD – meaningfully outperforming EM currencies) probably reflects a fairer picture.

Figure 21. Trends in the INRUSD

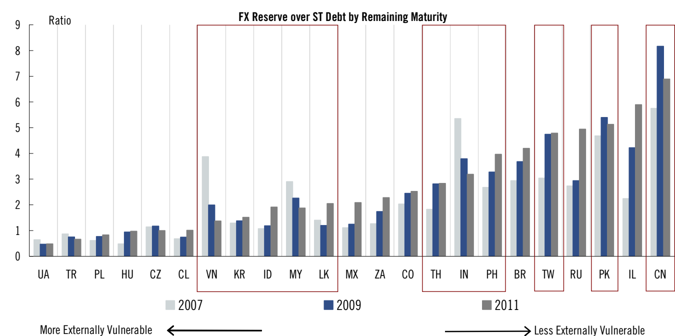
Source: RBI

Figure 22. Basic Balance (Current Account + FDI), as a % of GDP



Source: BIS and CIRA

Figure 23. FX Reserve Coverage over ST Debt by remaining maturity



Source: CEIC Data Company Ltd and CIRA

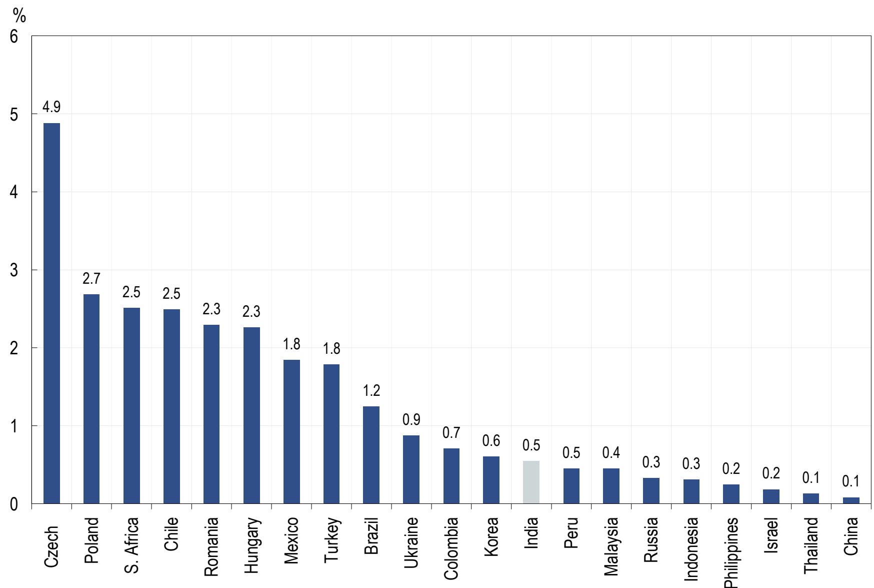
… which is clearly not the case…..it has a problem, lags Asian peers, but lies about the middle of the pack amongst EMs at large

We believe a wider measure of foreign funding risks (CA + FDI) also suggests that India is placed in the middle of the EM market group in terms of possible risk, and not at the highest end, as the weakness in the currency would suggest. While it does lag its Asian peers, it is distinctly better placed than peers in Latam and CEEMEA. That India has been an increasing beneficiary of FDI (and this should only increase as the economy gets bigger), should fundamentally continue to build a cushion for FX funding reversals.

And its FX reserve coverage for ST debt is also middle of the pack

This is further extended to its exposure to short-term FX funding risks, which are well covered with by the FX reserves that it does carry. This is in part a reflection of policy – India has consistently sought to encourage longer-term borrowings which, while moderating inflows, limit outflow risks in more challenging market environments.

Figure 24. European banks' exposure to EM countries as multiple of each country's fx reserves (Jun 2011)

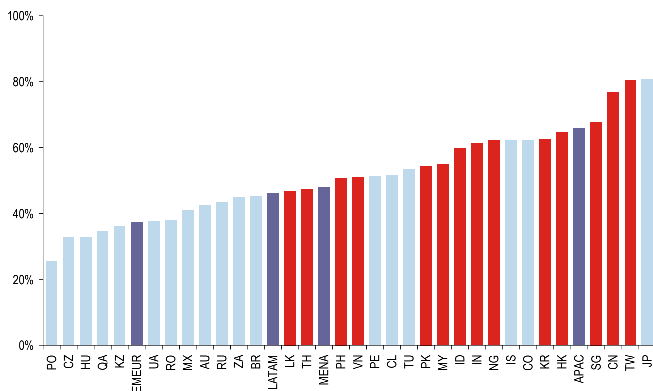


Source: Citi Investment Research and Analysis

Euro-bank leverage is only one of the risks – but India's coverage here is fairly comfortable

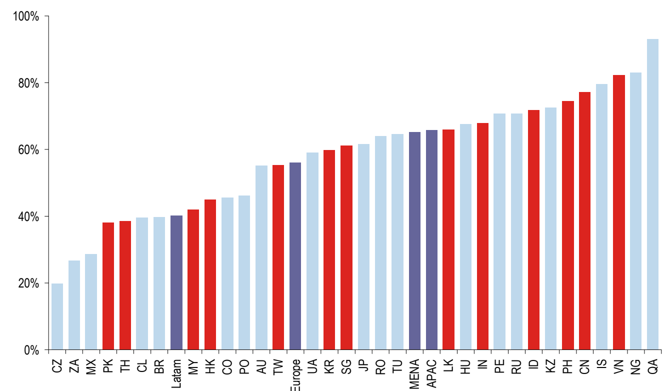
This is also reflected by FX reserves as a function of European bank exposure in these markets. We consider this measure as this was the precipitator of current concerns. India makes the middle of the pack: it lags most of its Asian peers, but is meaningfully less exposed than EMs as a group.

Figure 25. Share of Short-term (<1yr remaining maturity) International Claims, as a % of total international lending by BIS reporting banks



Source: BIS Consolidated Bank Statistics, as of June 2011

Figure 26. Share of Cross-border claims, as a % of total foreign lending of BIS reporting banks



Source: BIS Consolidated Bank Statistics, as of June 2011

Still vulnerable, but not as much as the currency suggested, or relative to some EMs

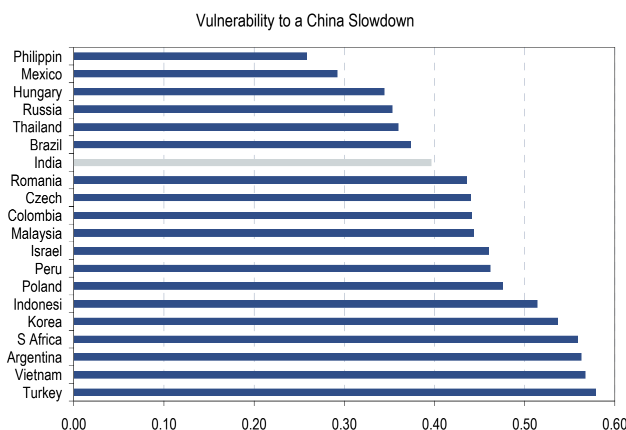
So is India vulnerable on funding flows, given its current account deficit? Yes. But in the context of EMs, is it as vulnerable to such flows as its 2011 currency underperformance suggests? We think not.

4. China Slowdown

China is the big global growth driver – and its slowing will impact…

The increased economic and financial interdependence means India, like other EMs and DMs, will be exposed to crises and opportunities globally. This was evident in 2003-2008 in the high-growth years when India grew at over 9%pa, (in part) on the back of global liquidity. It will potentially also come into play if China slows meaningfully, which equity markets are increasingly aware of. But by how much would India be impacted if China were to slow appreciably?

Figure 27. Vulnerability to a China Slowdown



Source: Citi Investment Research and Analysis; score of 1 implied highest vulnerability

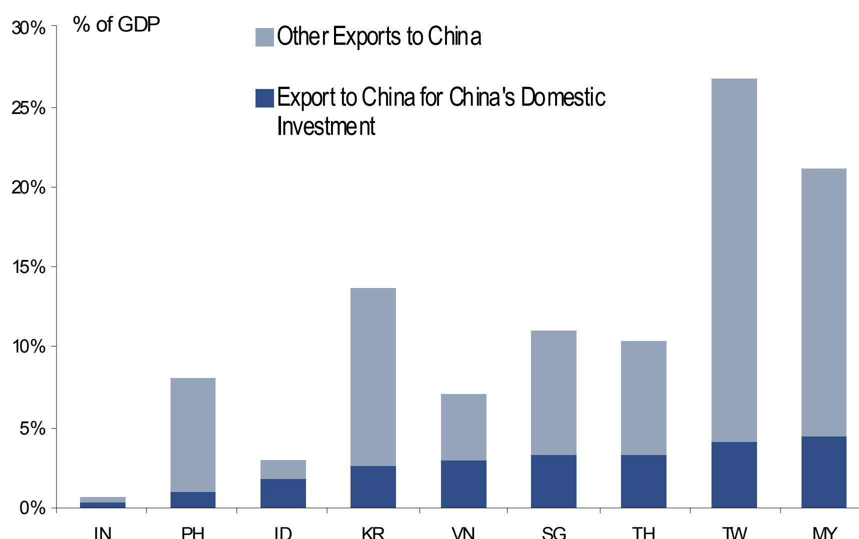
Our 'vulnerability to a China index' suggests India should be among the least impacted, if China were to slow appreciably.

Where would India stand? Our 'Vulnerability to a China slowdown' index suggests India is amongst the best placed off the emerging markets. This measure is a mix of (a) exports to China as a share of GDP, (b) commodity exports as a share of total exports, (c) FX reserves as a share of short-term external debt and (d) the current account deficit as a share of GDP. We also believe India is relatively well placed from a capital flow perspective – China bank lending / equity investments have so far been limited, and a protracted China slowdown could if anything open up capital inflow opportunities. That China is a meaningful net exporter to India would suggest a China slowdown will only increase physical and capital investments into the markets.

And India is only a modest commodity exporter (in fact, accounting for oil, it's a big net importer)…and a slower China could potentially help India on account of lower import and inflation pressures.

India is also a relatively modest commodity exporter compared with EM peers. In fact India is a meaningful net commodity importer, particularly of oil. A meaningful China or indeed a global slowdown that translates into lower commodity prices should actually benefit India (on inflation, and FX). So a China slowdown would hurt – but India should be amongst the least impacted, and there could well be some benefits of such a development.

Figure 28. Asia's Total Exports to China, and Estimated Exports to China for Domestic Investment (% of GDP)



Source: Citi Investment Research and Analysis

Could this be 'Complacency' – Given that India was seen as a cushioned economy leading into the GFC?

How did India fare in the 2008 Global Financial Crisis? It did hurt – and more than generally expected going into the crises. However, it was only one of three countries in the Asian region that did not see negative GDP growth, it operated off an interest rate structure that enabled meaningful monetary easing (and still has that ability), and was in a position to fiscally stimulate the economy.

India would hurt, but likely a lot less than most EMs

So would slowing, and any ripple effects on the global growth and financial system, leave India relatively less impacted? While India is vulnerable on the currency and funding fronts (and now restrained on the fiscal one), its domestic growth cushion, rate structure, and position as a net importer of commodities (particularly oil), should fundamentally position it more securely than most EM peers, both within Asia, but more so in the broader EM space. India would hurt, but likely a lot less so than most EMs, and distinctly less so compared with the EMs as a group.

Figure 29. A look back at history – impact of the 2008 Global Financial Crisis

	CN	HK	SG	IN	ID	KR	MY	PH	TW	TH
No of Qtrs of negative QoQ growth	0	4	4	0	0	1	3	1	4	3
Peak to trough decline in real output	n.a.	-7.6%	-8.6%	n.a.	n.a.	-4.6%	-6.5%	-2.2%	-9.4%	-7.6%
No of Qtrs to return to pre-crisis peak	n.a.	8	8	n.a.	n.a.	4	6	3	7	6
Rate Cuts (in bps)	189	n.a.	n.a.	425 / 275	300	325	150	200	238	250
Change in Fiscal Balance (% of GDP)	1.8*	0.5	7.4	2.2	1.5	2.9	2.2	1.6	3.0	1.9
FX Returns (Sep 08 to Mar 2009	-0.1%	0.0%	-8.2%	-12.4%	-22.4%	-24.5%	-7.5%	-4.3%	-7.4%	-5.8%
5y CDS Sprd Peak to Trough (June 08 ave vs. Sep 08 peak)	222	n.a.	n.a.	606 (SBI)	1002	600	411	602	n.a.	400

Source: Bloomberg and CIRA

Note: The change in central Govt. fiscal balance in China significantly underestimates the degree of fiscal stimulus funded via bank lending to local govt. led infrastructure projects.

There is no escaping the euro-zone or China for India – but these economies should matter less to India than to EMs in general.

In our view, the euro zone and China do matter for India – a fall back to the sluggishness of 2011 would impact the real economy and the market negatively. A continuation of the most recent trends of concerns easing should be a positive for the Indian economy, fund flows and the market. We do however believe the relatively higher impact that these trends have had on India, relative to EMs, should actually moderate going forward; and India should be among the market less impacted – regardless of which way the euro-zone/ China go.

So what does drive India?

If it's not so much the euro-zone or China then what explains India's performance tracking that of Frontier EMs over the last 12 months?

If, as we have argued, the euro-zone and China are important but not the primary drivers, then why has the Indian economy, and its markets, had such a tough run? GDP growth expectations have fallen by150bps (to 7.1% from 8.6% for FY12), the INR fell 18% from peak to trough, and the equity markets fell over 25% in 2011. And sentiment, both top down and bottom up, amongst Indian businesses has been even worse. The Indian economy and markets now appear more cyclical relative to the structural story than it was perceived to be at the start of 2011, and more vulnerable to external dislocations, than most EM peers.

The 'official blame' for India's economic and market distress lies at the feet of euro-zone and China

The reason for this step down, if official government communication is to be considered, is the global slowdown and the European debt crisis. We do believe it is a contributory factor – and India remains vulnerable to weakness and uncertainty in the euro-zone and China.

But this can only really be part of the problem (and likely a small part) ...

But it is not the driving factor. It is in fact less relevant for India than most EMs, given the economy's greater domestic orientation, its lower share/dependence on trade, its moderate dependence on global debt capital and, while Europe is its largest provider, its funding concentration and dependence is far lower than most other EMs.

What is the problem? And is there an opportunity?

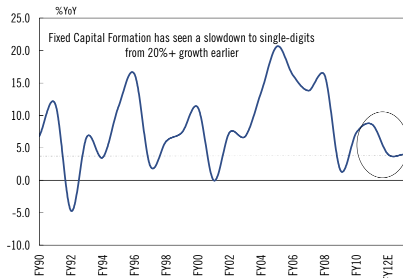
The problems lie at home…..as do (we believe) the solutions …

India's problems lie at home, we believe, and the solutions are also largely domestically controllable and fixable. We also believe these solutions are a mix of short-term and longer-term measures, governmental and from the RBI, some to be executed by executive fiat and others that require a broader political consensus. We also believe a lot of issues that have become overhangs on domestic growth face execution and process challenges, rather than policy, market or economic constraints.

A positive global environment will help – but there's a big 'To Do' list for India, that can be ticked off without global support

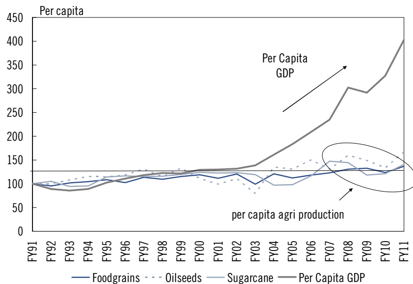
Most of these measures can be taken independent of the global context, although a supportive global environment will help (particularly on capital). We do however believe progress on these issues will revitalize the economy, reduce its vulnerability to global developments, and could be a magnet for global capital. This should effectively also differentiate it further from the broader EM group, as its growth drivers shift back to the domestic market, rather than veering towards global ones. We have prepared a To Do list that could get India back on growth track, and moderate its exposure to global economic and capital cycles.

Figure 30. Trends in Fixed Capital Formation



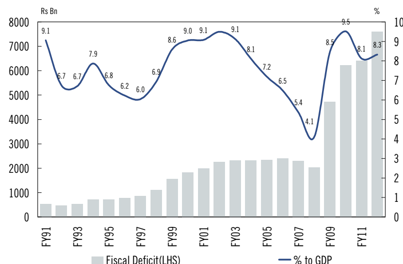
Source: CSO, CIRA

Figure 31. Trends in Per Capita GDP & Agri Production



Source: Ministry of Agriculture, CSO

Figure 32. Trends in the Combined Deficit



Source: Ministry of Finance, CIRA

1. Incentivizing Investments – Resolving Power, Mining, Land Issues

The sharp deceleration in investment growth has been the key factor behind headline GDP growth expectations coming off to ~7% levels. Growing policy uncertainty/inaction, coupled with rising rates, has stifled fixed capital formation. To this end, key to reviving investments would be reforms in (a) power (b) mining (c) land acquisition

2. Foreign Capital – Measures to Attract Flows

Given the rise in India's external financing needs, a key issue in 2012 would be measures to augment capital flows. In addition to higher FII limits on bonds, relaxing norms on non-resident deposits infrastructure financing, and liberalization in FDI norms would provide the right signals and be sentiment-positive. The government has already taken some measures, and a more consistent and predictable path of capital inflow relaxations should provide longer-term visibility to the potential of inflows.

3. Inflation – Addressing Structural Issues

The fact inflation has been sticky, averaging 9.7%+ for nearly two years, despite effective monetary tightening to the tune of 525bps, is a clear indication that addressing supply-side issues is key. Steps could include (a) improving the logistics chain, (b) raising productivity, and (c) unifying markets. We believe the structural problems with inflation are a primary cause for the tight money policy that the RBI has been running over recent years. And we do not see that going away, unless inflation moves down to more comfortable and sustainable levels (target at 4%). If this does not happen and the rate structure remains high, it will become a structural headwind to growth. We do see some near-term cyclical easing in inflation pressures but, unless the structural issues are addressed, the interest rate policy will be inimical to higher levels of growth.

4. Fiscal – Some Efforts towards Consolidation

Following consolidation efforts through FY02-08 that resulted in the combined deficit coming off from 9.5% of GDP to 4%, trends have seen a continued reversal. Clearly, the deficit bugbear needs to be addressed – and fast. With the current year's fiscal deficit likely to be in the 5.5%-5.8% range, we believe the interest rate structure, and the ability of the government to invest, will be fundamentally constrained. We do believe fiscal consolidation - and it has been achieved in the past – is critical, if growth is to sustain 7% for now, and accelerate beyond.

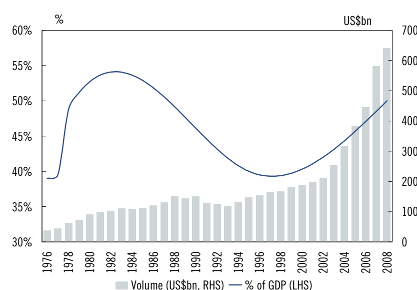
Key structural steps could be (a) Implementation of GST and the Direct Tax Code, and (b) Proper auditing and monitoring of social welfare programs,

5. Politics – Current Model of Governance Needs a Revamp

The current policy gridlock is to a large extent attributed to poor governance. Recent corruption allegations have resulted in a steady slide in popularity of the incumbent UPA. There is growing awareness that the combination of Congress President Sonia Gandhi, and PM Singh, who worked well in the past, has not proven successful this time around. Mrs. Gandhi's long absence due to a medical condition, coupled with dissent within the Congress and blemishes on PM Singh's authority, have all weakened the party's position. With major state elections approaching, there is an urgent need to either (a) appoint a popularly-elected leader, which would entail a new look at the current model of governance or (b) improve momentum on reforms under the current leadership and prevent risks of a mid-term election.

6. Battling Corruption and Electoral Reform

Figure 33. India's Underground Economy (US$bn, % GDP)



Source: Global Financial Integrity

Allegations of corruption and a growing number of scams, both corporate and political, have tainted the government and have stalled parliamentary functioning. Following the campaign for a strong '**Lokpal Bill (anti-corruption)**[1]**'**, passing this bill is now likely to be topmost on the government's agenda during the ongoing winter session of parliament. Another important aspect to rooting out corruption would involve electoral reform. Low limits on election spending have resulted in lack of transparency, widespread corruption, and the pervasiveness of 'black money'.

[1] The Lokpal bill aims to create an ombudsman's office (or a Lokpal) to investigate and prosecute suspected government corruption and has been the subject of much debate and controversy given demands that it not grant immunity to even the Prime Minister

7. Improving Data Quality and Dissemination

Poor decision-making has also been complicated by unreliable statistical data. As the RBI as well as other officials have pointed out, '*policy has been handicapped by the reliability of some of the basic data…used in policy calculations*". In particular, data on (a) poverty ratios, (b) wage statistics, (c) trade, and (d) industrial production are most difficult to reconcile. The last in particular has been widely censured as being '*analytically bewildering*', depicting extreme volatility and counter-intuitive trends. These key issues need to be addressed in order for policy makers and observers to make well-informed decisions.

Figure 34. India's Demographic Dividend

	2005	2010	2025	2035
Total Population	1,131	1,214	1,431	1,528
% Growth*	1.6	1.4	0.9	0.6
Popn between 15-59	677	749	919	994
% Growth*	11.5	10.6	5.8	3.3
% share of total popn	59.9	61.6	64.2	65.0

* 5-Yr growth rate. Source: UN Population Prospects

8. Labor Reforms – Key to Avoid a Demographic Nightmare

Several instances of worker unrest seen in 2011, particularly in the autos and mining sectors, have been due to higher wage demands, consequently impacting production and taking a toll on growth. Moreover, due to rigid labor laws (i.e. high severance costs, difficulties in hiring and firing workers), many firms are now opting for contract laborers who fall outside the purview of regulation. However, this in turn is resulting in industrial unrest, Given that only 6% of India's total workforce of 506m is within the organized sector, this points to a need to increase the number of formal jobs and a restructuring of the current labor policy.

Figure 35. Sectoral Share of Employment

	Sectoral Share FY07		Additional Expected (FY07-12)
	(%)	(Mns)	(Mns)
Agriculture	50.2	201.9	-4.0
Industry	20.4	81.9	50.9
Services	29.4	118.4	69.0
Total	**100**	**402.2**	**116.0**

Source: Planning Commission

9. Employment - The National Manufacturing Policy Could Help

The share of the manufacturing sector in GDP (ex-mining/construction; currently at 16%) has seen little growth over the years. To this end, the government's recently announced National Manufacturing Policy aims to create National Investment and Manufacturing Zones (NIMZ) that would function as large autonomous industrial townships. This is estimated to create 100m new jobs and boost the share of manufacturing from 16% of GDP to 25% by 2022.

10. NREGA – More Productive Work; Putting Funding to Better Use

Although the National Employment Guarantee Act (NREGA) has been touted as one of the UPA's flagship reform programs, such a large scale social safety program does present governance challenges. While NREGA does have special monitoring and auditing mechanisms in place, key issues include (a) managing funds effectively. Reports indicate that there has been an underutilization of funds, with many states using less than 50% of the allocated amount. Efforts should be made such that unspent NREGA funding is put to effective use; (b) enhancing the scope of work could result in more long-term benefits for the economy.

Figure 36. NREGA Snapshot

	FY10	FY11	FY12*
Total Expenditure (Bns)	379	394	162
Works Completed (000s)	2259	259	352
Households Employed(Mns)	53	55	33
Participation of Scheduled Castes/Tribes (%)	51.7	39.8	39.9
Participation of Women (%)	49.2	51.1	50.1

*April – October. Source: NREGA

11. Urban Infrastructure – Key for Balanced Growth

The uptrend in urbanization has resulted in growing strain on urban infrastructure. Given the fragmented nature of Urban Local bodies, the onus of development has been on the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) which was initialized in Dec 2005 for a period of seven years, with an outlay of Rs1trillion. Key to sustaining balanced growth would be higher funding, further encouraging public private partnership and upgrading ministry capacities.

12. Vigil on NPLs – to prevent negative feedback loop

Lastly, as cautioned by the RBI, banks need to remain vigilant to the headwinds from the prevailing inflation and interest rate situation. This could affect their asset quality, as changes in the interest rate are found to have the most significant (negative) impact on the slippage ratio of the banks. This in turn could result in tighter lending standards and further dampen growth.

Remain Optimistic on the Market

We remain positive on market with a 18,400 Sensex target for Dec12 – but believe the big gains for the year are done – now the markets need to wait for the economy to catch up

We continue to hold our view that India will rally in 2012 – and more upfront than back-ended. While a lot of that has already played out in a record January 2012 performance, we also retain our Sen-sex target of 18,400 by Dec 2012, and believe gains from here should be modest. This is because we believe while the market has moved, as it became attractive on valuations, the rate cycle has moved and there has been global equity capital momentum, the market will now look for economic and corporate earnings indicators to start looking up. That could take some time, as the economy is still on a downswing, rates have yet to fall, and the market is unlikely to get these indicators, as the recent mood would suggest.

Maintain a relatively aggressive model portfolio – with OWs on Financials, Auto's and Telecos, and UWs on IT services and Consumer staples

We would continue to position our model portfolio relatively aggressively – OWs on Financials, Autos, Telecom and Pharma, with EWs on Capital goods, Energy and Real estate, and UWs on IT services, Consumer staples and Utilities. Our top stock picks for 2012 are Axis Bank, Adani Ports & SEZ, Dr. Reddy, Maruti, SBI, United Spirits, Havells and M&M Financial Services.

Top Picks

Figure 37. Our top picks for 2012

Stock	RIC	Rating	Current Price	Comment1	Comment2
AXIS Bank	AXBK.BO	1	1109.9	Axis has strong deposit franchise, healthy loan growth (20%+) and robust profitability (18%+ sustainable ROEs). Its relatively larger SME exposure makes it more interest rate sensitive, which helps in a falling rate environment	Stock is still reasonably valued (at 1.6x FY13 P/BV), despite recent jump, remains our preferred pick in the banking sector.
Adani Port And Special Economic Zone	APSE.BO	1	145.35	APSEZ offers the best exposure to the India port theme, in our view, with a balanced captive/merchant cargo mix, scale benefits and expansion potential	Our Rs185 target price for APSEZ is based on SOTP methodology. We value Mundra Port at Rs143/share on a discounted cash flow to equity basis, using a cost of equity of 13%. The SEZ is valued at Rs13/share, using a cost of equity of 14% and assigning a 30% discount to the calculated NAV (consistent with how we value the smaller Indian real estate companies).
Havells India	HVEL.BO	1	482.35	Havells has strong lead over its competitors in distribution of electrical equipments/appliances to consumer. Business is semi-consumer and demand in India remains healthy. Sylvania has stabilized and profitability has recovered.	Our target price of Rs554 is based on a sum-of-the-parts approach. We value the India business at Rs520 and Sylvania at Rs34. The parent business is valued at 18x March13 P/E, at a premium to its historical average of 14x to reflect buoyant demand and strong business traction in India. The 18x P/E is supported by a ~21% EPS CAGR over FY11-14E and ~21% average RoE. P/E is generally used to value branded consumer and capital goods companies, segments in which Havells operates. We value Sylvania on 5x March 13E EV/EBITDA. Despite recovery in operations and profitability, PAT is expected to remain depressed due to high depreciation and interest costs and thus we prefer to use EV/EBITDA. We conservatively use 5x, derived from a comps analysis and taking the European risks into consideration. At our TP of Rs554, Havells will trade at consolidated P/E of ~16x on FY13 EPS with FY11-14 EPS CAGR of 19%.
Maruti	MRTI.BO	1	1255	We rate Maruti Suzuki as Buy as we believe that the earnings downgrade cycle is bottoming out. Also we expect industry volume growth to recover over FY13/14 as customers adjust to the new petrol prices (and some abatement in interest rates) and pent up demand buoys dispatches. Maruti, as a dominant player in the industry (esp after recent capacity addition) should benefit from this overall industry growth	The competitive landscape in the compact car space isn't expected to meaningfully change, given that there are no major incremental new model launches by key competitors like Toyota, Honda, Nissan and Hyundai over the next 12-18 months. Maruti should thus have some pricing power. In addition, New Dzire, A Star and Ertiga should help boost volumes for the company
SBI	SBI.BO	1	2171	SBI has the strongest deposit franchise amongst PSU banks with low exposure to power sector and relatively higher SME exposure. This is likely to improve with lower interest rates and will lead to an improvement in asset quality outlook for the bank.	Valuations are not expensive (1.3x FY13 P/B) and remains our preferred PSU bank play
Dr Reddy	REDY.BO	1	1642.8	One of the best positioned firms to capitalize on the multiple growth drivers for pharma over the next 3-4 years : 1) Strong US pipeline with several P-IV & niche oppys; 2) well established biz in Russia/CIS & India; 3) Emerging biosimilars opportunity . Key Catalysts: a) Ramp up in key products in US – Fondaparinux, OTC franchise; b) 180-d exclusivity launch of Geodon; c) Niche launches including Seroquel IR, Lipitor over the next 6 months	Valuations attractive at 16xFY13E (adj for its US P-IV pipeline value of Rs50/sh)
United Spirits	UNSP.BO	1	723.7	UNSP should benefit from double digit growth in India's organized liquor market, driven by rising disposable incomes, favorable demographics, and a shift in consumption patterns. Mgmt's cost control initiatives and a healthy pricing environment bodes well for profitability. We expect commodity cost pressures to abate going forward, as UNSP achieves greater self sufficiency in ENA production. W&M's shift to branded products is also a long-term positive, in our view.	Given the steep share price correction, we believe near-term risks are largely discounted and current price offers a good opportunity to buy
M&M Financial Services	MMFS.BO	1	700.55	MMFSL has a large rural distribution network and also has the early mover advantage in rural segments. Its loan growth is strong and we expect the company to continue growing at close to 30% levels medium term with a healthy 20% ROE and lower asset quality concerns	Valuations are not cheap (2.0x FY13 P/BV), but reasonable given the strong long term prospects of the company.

Source: Citi Investment Research and Analysis

Appendix A-1

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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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	12 Month Rating			***Relative Rating***		
Data current as of 31 Dec 2011	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	57%	34%	9%	10%	79%	10%
% of companies in each rating category that are investment banking clients	45%	41%	40%	49%	43%	41%

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