

May 2011

Inflection Point

ECONOMICS & STRATEGY

India: Taming the Inflation Tiger...

- **We have maintained a tactical underweight stance on Indian equities since mid Q4 as rising macro risks were not remotely discounted in equity valuations** which peaked in November at over 20% above the market's long-term average multiple. The spike in energy prices since February has exacerbated the inflation pressures deriving from ongoing supply side bottlenecks, and we have seen a dramatic slowdown in capital goods output and the progress of key infrastructure projects over the last 6 months. **The Indian economy has basically exceeded its inflationary speed-limit on GDP growth of about 7% given structural constraints in infrastructure, productive capacity and human capital.** In the absence of radical supply side reforms and the fixed investment necessary to execute them, **curbing aggregate demand in the economy is the only way to control inflation this year.**

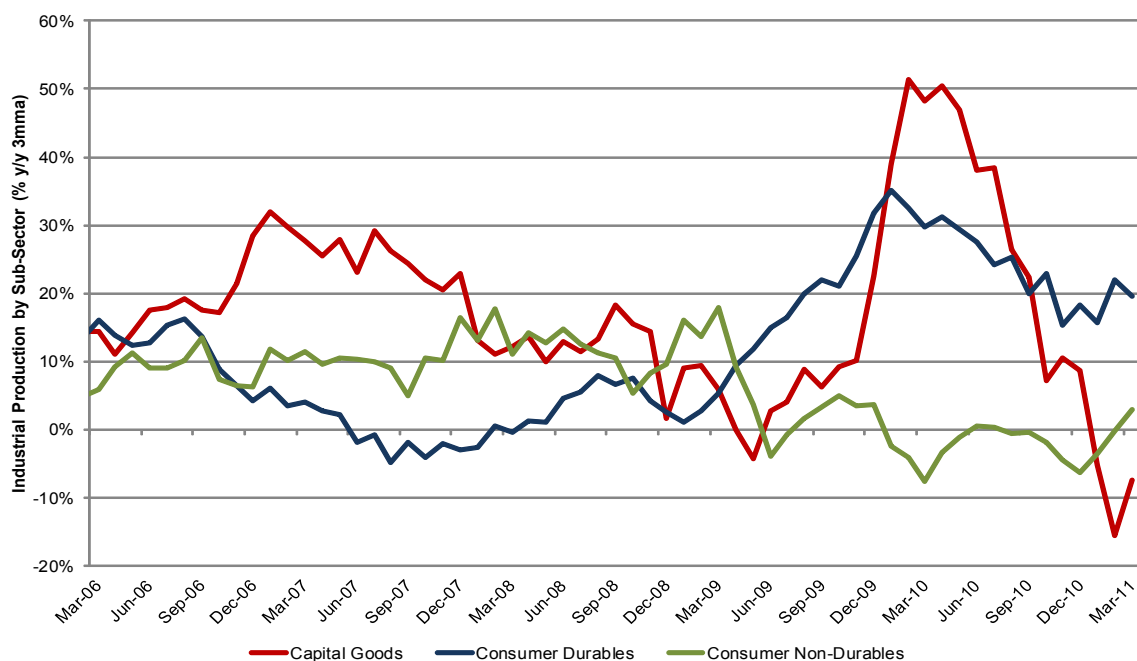
Key Points

- **Growth should average 7.5% both this fiscal year and next, with modest upside if we see a sustained fall in oil prices.** That implies that y/y growth falls to 7% or lower for at least one quarter by early 2012. **Annualised credit growth looks set to fall below the RBI target of 19% from recent levels of 22%.**
- **A further 75bps on the repo rate is likely within the next quarter.** The cumulative lagged impact of the rate hikes to date is going to undermine the consumer durables and capital intensive sectors in H2; **the forthcoming monsoon and global commodity prices will help determine the pace of further tightening.**
- The biggest surprise to the consensus has come from the RBI's explicit acknowledgement that lower growth was a necessary trade-off to restrain inflation expectations. **An interim budget to tighten fiscal policy would help moderate the rate cycle and is justified now that tax revenues are set to undershoot and the deficit looks set to be closer to 6% than the forecast 4.6%, posing downside risks for domestic bonds and the rupee.**
- **The April WPI at 8.7% showed a marginal moderation from March, but it has been clear since late 2010 that inflation has become structural in nature; the February number was revised sharply higher, from 8.3% to 9.5%. Ten year yields have reached 8.3%, while the rupee has been surprisingly stable so far in a 44-45 range versus the dollar with the oil import bill being partly offset by surging exports, but export momentum may be set to flag.**
- As capital account flows are largely portfolio investment related, a slowing domestic economy/higher funding costs will **likely create another period of outflows this summer**, as we saw from January to mid March. We've seen a subdued set of quarterly earnings and **consensus EPS growth expectations are likely to drop 2-3 percentage points to 14-15%.**
- Decelerating global growth later this year and into 2012 to sub 4% would reduce overheating risks via imported commodity inflation, boost the relative valuation premium attached to India's earnings visibility and generate potentially more stable portfolio flows.
- Look for opportunities to **opportunisticly re-weight in H2 to neutral versus the Asia ex Japan benchmark at 16-17k on the Sensex with a focus on the structural investment story via capital goods and a 3G telecom revenue uplift for mobile operators - financials remain acutely vulnerable on net interest margin compression/slowing credit growth.**

Industrial Production Slowdown Led by Capital Goods

- **Chronic underinvestment in infrastructure, machinery and productive capacity relative to Asian peers has led to extensive supply bottlenecks across the Indian economy.** These pressures are most notable in agriculture with its primitive logistics and storage systems that create huge crop wastage (and for all the talk of boosting the manufacturing share in GDP to 25%, **boosting appalling agricultural productivity is the real economic opportunity** (doubling the sector's trend growth rate to 4% would add 1.5-2% to overall GDP growth). Regulatory obstacles such as difficulties in acquiring land, slow environmental clearances, and notoriously slow government decision-making are **also hindering investment in transport infrastructure, energy generation and manufacturing capacity.** Additional monetary tightening threatens to further weaken the investment climate, potentially exaggerating the supply-demand imbalance and prolonging supply-side inflation pressures.
- Indicators such as the PMI and credit expansion signal consumer demand is still holding up. Commercial credit offered by banks is up 22% y/y, exceeding the 19% RBI target. India plans to unveil a new industrial output index in June that will use a different base year and have about 400 items, up from the 283 in the current index, to give a more "realistic picture" of industrial output. The end of state elections last week gives the government room to ease fuel price controls on state refiners; **a meeting of a panel of Indian ministers is scheduled to consider raising fuel prices, which would add further impetus to inflationary momentum, but help limit the overshoot of the fiscal deficit target to maybe 5% of GDP.**

Rising Rates Hit Capital Goods and Consumer Durables Momentum

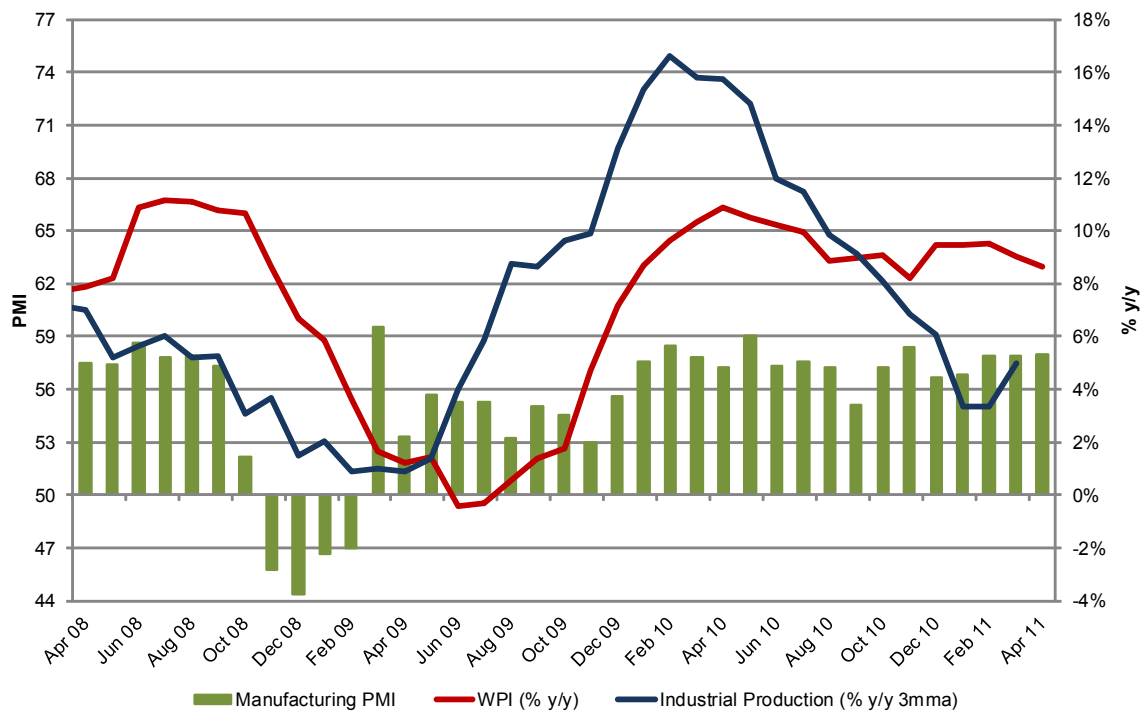


Source: Office of the Economic Adviser, own estimates

- **Already in the wake of higher commercial interest rates and rising project costs, many local companies have pulled back on expansion plans.** SEZ developers, including the Maharashtra Industrial Development Corporation, have either shelved projects or slowed down execution. In addition, there are several high profile 'mega projects' that are running behind schedule due to land, logistics or fuel linkage issues. As 2011-12 is the final year of the ongoing Eleventh Plan period, the prospects of significant shortfalls in incremental infrastructure capacity loom large. **Capital formation and the investment multiplier are likely to see a growing adverse impact over the rest of this year.**
- Factory output in March as measured by the Index of Industrial Production (IIP) grew by 7.3%, compared to a 15.5% expansion in the same month a year ago and just 3.6% growth in February. **The manufacturing sector, which accounts for almost 80% of the index, grew by 7.9%, compared to a 16.4% rate of expansion in the same month**

last year. The mining sector grew marginally compared to 12.3% in the same month of 2009-10. Growth in the capital goods sector slowed to 12.9% from 36% in the same month of 2010. **Overall, 13 out of 17 industry groups achieved positive growth in March this year.** It's hard to see industrial production breaking out of a mid single digit growth range for the rest of this year given the lagged impact of monetary tightening on order flows.

Manufacturing Growth Stabilising But WPI Still Near 9%



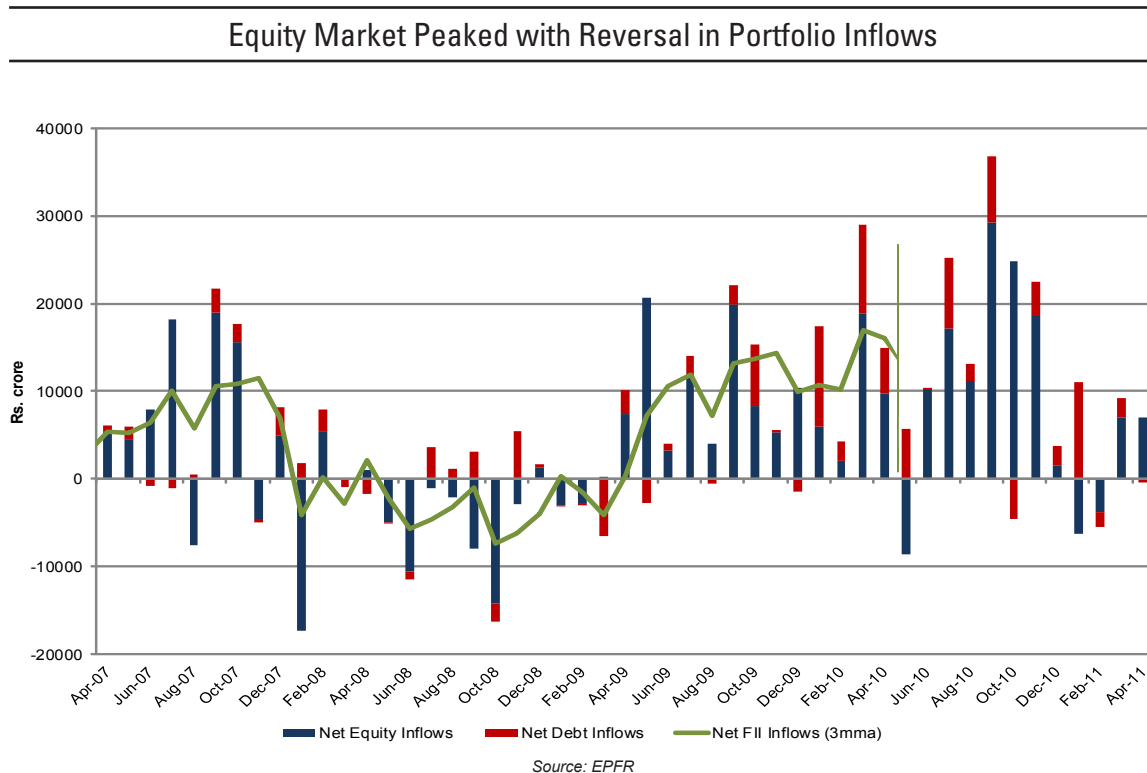
Source: Office of the Economic Adviser, HSBC

- **The y/y rise in the wholesale price index (WPI) moderated slightly to 8.66% in April** as against 9.04% in March. However, **the trend of upward revisions to prior data has continued**, with the WPI revised up to 9.04% for March from the original projection of 8.98% and more significantly **the inflation figure for February has also been revised upward to 9.54% from the provisional 8.31%**. State-run oil refiners **have just raised petrol prices by about 8.6%, or 5 rupees a litre**, a record hike that will fuel inflation in Asia's third-largest economy ahead of likely imminent subsidy reductions.

Sustained Foreign Portfolio Inflows Crucial to Fund Current Account Deficit

- Total inflows soared through last summer, peaking in early autumn before a dramatic decline in the wake of QE2 being announced by the Fed; **equity flows turned negative in January and aggregate inflows in February for the first time since early 2009**. India's dependence on foreign portfolio flows has risen as domestic savings directed to equities have declined because of new marketing procedures in mutual funds and insurance policies last year. Foreign investments in Indian government and corporate bonds are close to the maximum allowed, but the government isn't looking at raising the thresholds for now as it wants investments to flow to the debt being raised by infrastructure companies.
- Official policy is to encourage foreign funds to invest in bonds of infrastructure companies. India is targeting investments of \$1 trillion for infrastructure development in the five-year period starting April 2012, a large chunk of which is expected to come from private companies and overseas investors. In the federal budget for the current financial year announced late February, **the government increased five-fold the limit for foreign investments permitted in bonds issued by infrastructure companies to \$25 billion from \$5 billion**. In corporate bonds other than those issued by infrastructure companies, foreign investors still have headroom up to \$15 billion, with only about \$500m of this unutilised currently. Current regulations also cap foreign investments in government bonds at \$10 billion, half of which must be in bonds

maturing in more than five years. **The remaining \$5 billion limit for investments in government bonds maturing in less than five years has been completely exhausted.**



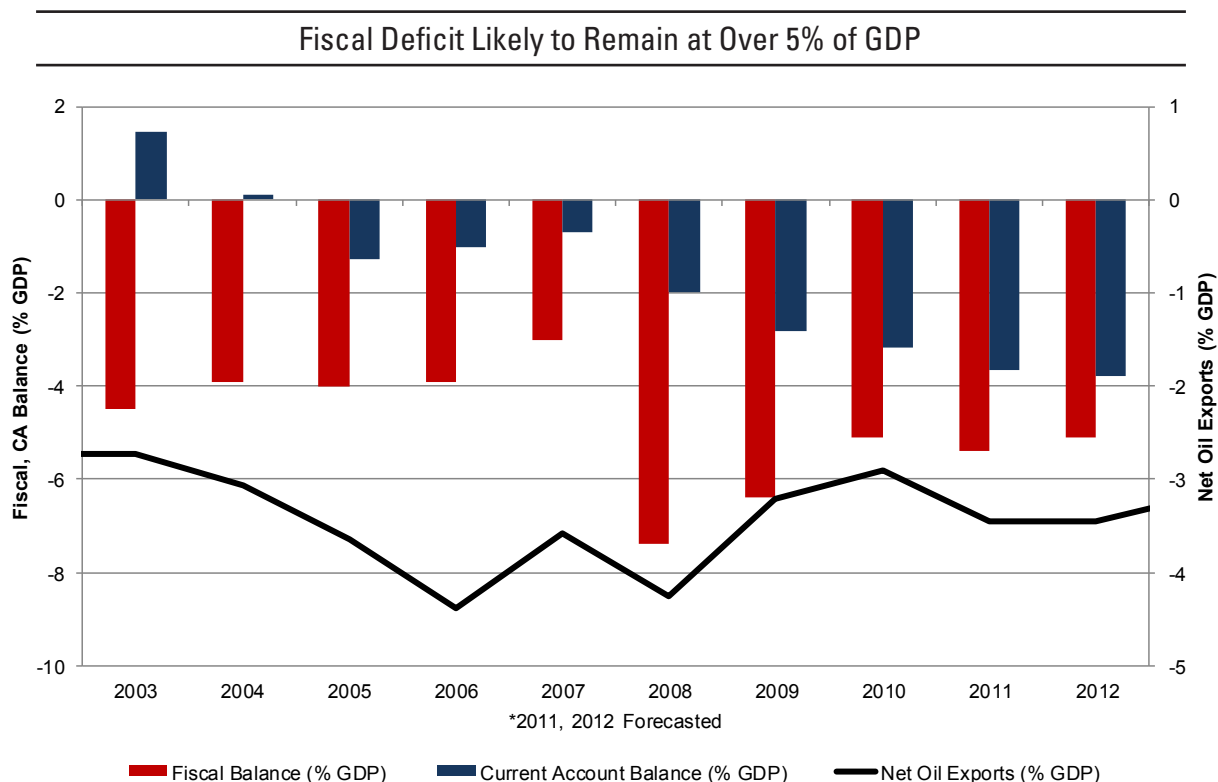
- Since 1991, when major economic liberalization started, **FDI as a share of Indian GDP has grown from an average sub 1% through the 1990s to 3.5% in 2008**, before falling back to 2.5% in 2009/10 as a result of the global financial crisis. **Manufacturing represents only 16% of GDP**, and official policy is to raise this to 25% of GDP over the next decade, an ambition which will depend critically on boosting India's global share of direct investment flows. **FDI inflows have been running at only a third to half of Chinese levels in dollar terms in recent years**, and have been concentrated in a handful of sectors, notably mobile communications, the automotive industry (which already accounts for about 4% of GDP) and real estate. **The IT and outsourcing market has been attracting less investment as relative wage costs have steadily risen** and increased competition from rival countries has reduced demand for Indian call centres, a trend underlined by the fact that some Indian companies like Wipro are themselves moving into countries such as Brazil as a base to serve global clients.

Fiscal Tightening Needed to Avoid Crowding Impact on Corporate Investment

- **The Indian FY 2011/12 budget looked hopelessly optimistic when originally tabled, particularly on assumed subsidy and interest costs.** The changes in the macro-economic numbers underpinning that budget over the past month have been drastic. Of these, **the most significant has been the acknowledgement by the finance minister that the real rate of growth of the Indian economy for fiscal 2011-12 will be at a lower pace of 8% instead of the expected 9%.** The Medium Term Fiscal Policy Statement had estimated the real GDP to grow by 9% and inflation by 5% versus 8 and 6% now; while nominal GDP growth remains at 14%, the implications for the fiscal deficit are clearly very different and a substantial overshoot of the 4.6% official target seems inevitable.
- **Consolidated Indian government debt is 80%, which is very high in Asian terms and falling growth estimates combined with a rising deficit pushes that to uncomfortable levels** and at the very least delays any foreign currency bond rating upgrade. However, the high rate of local inflation and earnings growth reduces the real debt burden, which is largely domestically funded. Aside from the immediate cyclical issue post the growth downgrade, a reduction in the ongoing structural fiscal deficit would boost potential growth by reducing the 'crowding out' effect on the cost of capital

for local industry and help sustain investment momentum.

- At the very least, the finance ministry should budget for a lower growth in corporate and even direct taxes. **The correction to budget assumptions is the largest that has occurred since the 2008/9 global crisis**, which India sailed through relatively unscathed with GDP growth dipping to a still robust 6.8%. **The finance ministry should present a mini-budget next quarter reflecting the redrawn numbers and reversing planned expenditure rises** to avoid any increase in market borrowing rates from higher bond issuance; that would be a supportive signal for investors. The Fiscal Responsibility and Budget Management Act of 2003 says any variations in the government accounts that affect the numbers projected for the year must be reported and corrections made every six months.
- Structurally, **speeding up decision-making at the political and administrative levels will translate into huge savings on time, project costs and ultimately inflation pressures**. In some sectors of the economy such as consumer goods, Indian producers compete with multinationals effectively, but in many from civil aviation to the marketing of agricultural produce, they can operate as a cartel with impunity and **tougher competition policy would be a very low-cost way to improve inflation/growth trade-off terms**. Free movement of goods across state borders alongside the new GST would remove cascading taxes and wasted time, fuel and manpower, again paving the way for cheaper goods and services.



Source: IMF WEO April 2011, calendar years

- Since 2009, higher interest rates have tended to intensify capital inflows into EM economies, putting upward pressure on exchange rates and causing major policy problems, as in Brazil. In India's case, capital flows are needed to finance the current account deficit. Yield seeking portfolio flows have helped boost Indonesia's rupiah by 5% and the Singapore dollar 4% YTD but the rupee is about flat. **The rupee partly owes its resilience to India's \$300bn in foreign exchange reserves as well as the fact that the country's imports are mostly inputs for its manufacturing sector and not consumer products as in a country like Vietnam**, all of which reduces somewhat its vulnerability to the global oil price spike.
- India's current account deficit narrowed to \$9.7 billion in the three months ended Dec. 31, from a \$16.8 billion shortfall in the previous quarter. Clearly, the composition of foreign capital inflows remains a potentially destabilising issue; **upwards of 75% of the current account deficit has been financed by volatile portfolio capital inflows**. If oil

persists at recent levels, the government will struggle to continue subsidising consumers with a cap on the diesel price, while the fertiliser subsidy also looks unaffordable under the new growth and tax revenue outlook.

- The Indian government last year deregulated gasoline prices to help the state-run oil marketing companies (OMCs) curb huge revenue losses (or so called “under-recoveries” they have had to incur for selling auto and cooking fuels at state-set prices to help the government control inflation. These under-recoveries have been borne partly by the government, partly by state-run upstream firms such as ONGC, and the rest by the OMCs themselves, based on a subsidy-sharing formula. While the government compensated OMCs by giving them cash or special oil bonds, and upstream firms offered discounts on crude oil and products. **As with China’s gasoline pricing reform since 2008, it’s a welcome move toward rational energy pricing, which will gradually encourage energy efficiency and reduce the energy trade deficit.**

Rupee Stable on Strong Exports Despite Surge in Oil Import Costs

- Back in 2008, crude oil prices soared by nearly \$30 a barrel between April and July. In India, as oil importers scurried to source dollars to continue importing the precious commodity, **the rupee weakened, depreciating to 42.49 to the dollar by the end of July from 39.90 at the start of April 2008.** A similar upsurge in international oil prices has accompanied the political upheaval in North Africa since the beginning of this year. The unrest in Libya and Bahrain has pushed up the price of Brent crude by nearly \$30 a barrel since November 2010 to \$125/barrel before the recent selloff, similar to the levels in May 2008. However, over the past six months, the rupee has moved in a narrow band of 44 to 45.9 to a dollar. **The relative stability of the rupee is the only good news in an otherwise difficult macro-economic scenario.** Inflation accelerated in March at a rate of just under 9%, more than the RBI had projected, as the costs of fuel and manufactured goods rose. The government’s failure to adequately address supply side constraints in recent years has kept inflation persistently high.
- **A run on the rupee in such a situation, given the economy’s high oil intensity, could take a couple of percentage points off the growth rate** but that risk will diminish if we have seen the highs for the year in global oil prices although that would coincide with cyclical recovery for the broad dollar index. **However, that stronger dollar scenario is negative for EM portfolio flows;** foreign institutional investors have invested \$3.6 billion into Indian security markets (predominantly bonds) YTD, which though far less than the \$10.3 billion invested during the corresponding period last year **is still sufficient to provide a steady supply of dollars to meet demand but those flows bear close watching through H2.**
- In 2008, the oil crisis was accompanied by a flight of foreign institutional investors from Indian markets as \$9.3bn was pulled from Indian equity and debt markets. The drop in the current account deficit, prompted by a surge in exports has certainly helped maintain rupee stability. **The RBI is forecasting India’s C/A deficit to be around 2.5% of GDP in 2010/11,** having moderated in Q3 (Oct-Dec) with a significant acceleration in exports; **however, India’s exports may decline sharply in the current financial year as export duty refunds under the Duty Entitlement Pass Book (DEPB) scheme are withdrawn,** according to the Federation of Indian Export Organizations. The finance ministry announced the discontinuation of the scheme, which allows duty neutralization, after June 30, 2011, due to its non-compliance with WTO rules. Currently, the government has to pay exporters about Rs 81 billion per year under the scheme.
- **The government is aiming at \$312 billion worth of exports in 2011/12, representing y/y growth of almost 27%.** With the duty entitlement passbook facility, the exporters get credit for import duty paid on inputs used in making export goods, while under the duty drawback scheme, exporters receive duty-free scrips, or entitlements, which they can use to pay import duties. The scheme, meant to originally end in 2007, was extended over the years to encourage exports. Revenue officials have maintained that the scheme allows double benefit to exporters instead of just neutralising all levies on inputs. The scrips are provided on the assumptions that all inputs are imported, but exporters are allowed to use up to 50% domestic inputs under the scheme. Exporters claim credit for the excise duty they pay on the domestic inputs while receiving duty-free scrips. **Any decline in export momentum in coming months as this scheme expires would shake currency market complacency and undermine the rupee.**

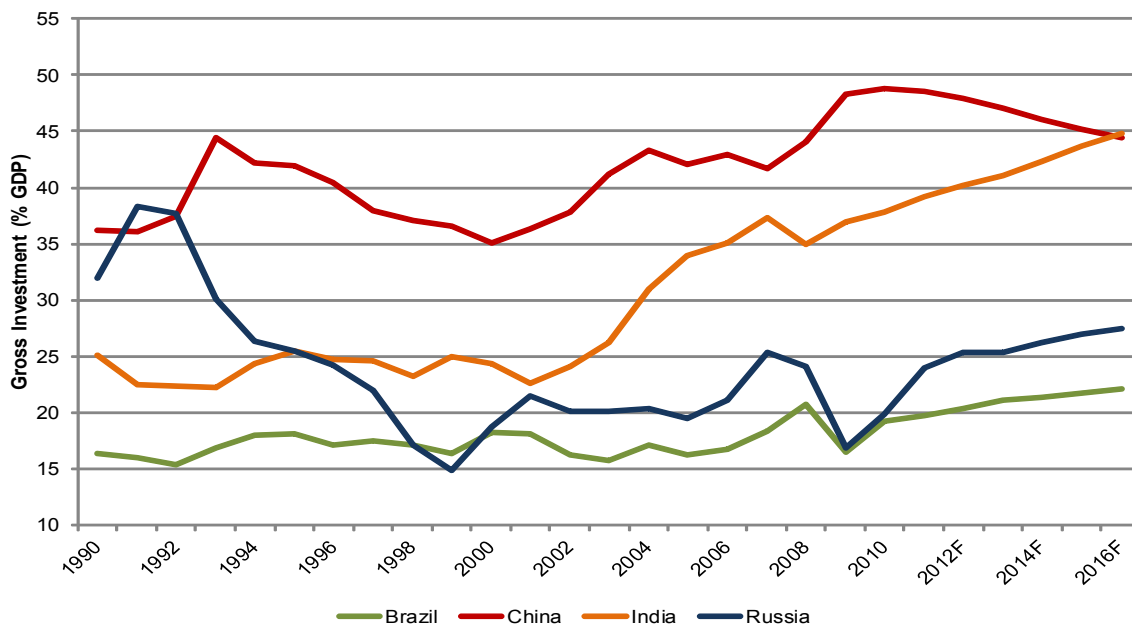
India Needs to Boost Investment to 45% of GDP by Mid Decade

- **India has been hamstrung by inadequate infrastructure, a key reason its merchandise exports total less than 1% of global trade, compared with 7% for China,** although spending has steadily risen from 4.8% of GDP in FY2004

to 7.5% in FY2010 and there is now a clear political consensus that the country can't achieve sustained double digit growth without addressing this issue. **The country is looking to invest \$1 trillion in infrastructure over the next seven years**; however, the government is expected to miss its \$500 billion planned investment in the Eleventh Five-Year Plan (2007-12), with the actual spend likely to be around \$300 billion due to bureaucratic delays in awarding projects. **It takes more than two weeks and about \$840 to dispatch a container the 870 miles separating New Delhi and Mumbai, while it will only take four or five days to for the container to cover the 2,400 miles between India and Singapore by sea at a third of the cost.** Indian trains can only haul 5,000 tons of cargo, compared to 20,000 for US and Chinese trains, while Indian airports and the highway network are largely decrepit compared to China's.

- **Improving the efficiency of its 40,000 mile, 150-year-old rail network, which moves seven billion passengers and 830 million tons of cargo a year, will be critical to boosting trend GDP growth over the next decade**, but political priorities still dominate commercial. Traffic between large cities like Mumbai and Delhi runs at more than 120% of planned capacity, which means slower average speeds and faster depreciation of track and rolling stock. **Freight traffic on Indian railways is priced to subsidize passenger travel, so that the cost of dispatching a container by rail in India can be four times that in the US and twice as much as in China.** Plans for dedicated freight corridors that would greatly increase capacity along the country's most congested stretches of rail but the 1,700-mile network is expected to cost more than \$9bn and unlikely to be completed before 2018.

IMF Expects Indian Investment to Overtake Chinese



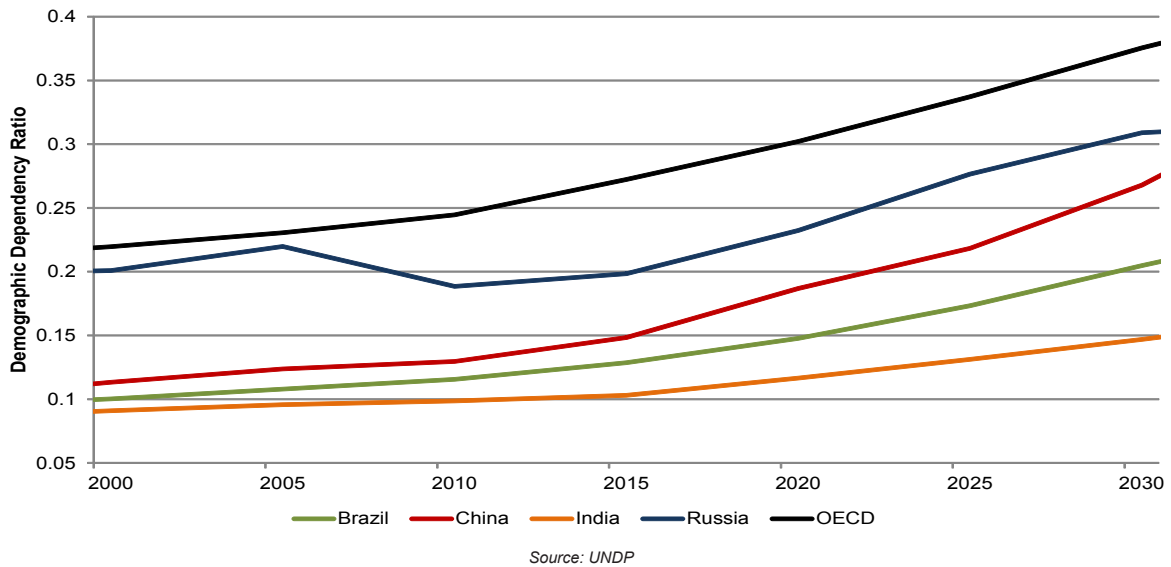
- **India has set up an \$11bn fund to invest in infrastructure, with the government aiming to attract about 40% of that total from long-term international sources including sovereign wealth funds.** Many high profile projects have stalled because of a shortage of long-term funding. India faces obstacles to efficient project implementation, including battles over acquiring land and local bureaucracy. **Conflicting policies and rules across the country and powerful entrenched interests at state level make banks reluctant to finance 'green field' projects with a 10 year plus payback.** The most successful projects to date have been 'brown field' redevelopments of existing infrastructure, such as the new \$1.3bn international airport terminal in Delhi, which avoid the land acquisition and planning problems that have delayed so many schemes. The government's goal is to build 20km of new highway every day, with the aid of \$41 billion in private-sector investment over the next three to four years to help fund the construction. **Of India's 70,000km of highways, 16,000 are closer to African than Asian standards and are not only constraining growth but fuelling food inflation;** 40% of India's fruit and vegetable output rots before reaching market because of delays from poor transport links.

- **India needs domestic savings as well as FDI to fund rising investment; it reported a 33.7% gross domestic savings rate as a percentage of GDP in FY 2010, still well below pre global financial crisis levels of almost 37%.** The economic slowdown in 2009 saw gross domestic savings fall to 32.2% of the GDP, down from 36.9% in 2008. Gross domestic savings from private corporations increased to INR5,314 billion in FY 2010, up 21%. In the same period, the public sector saw a tremendous increase in gross domestic savings, contributing 2.14% of the GDP in 2009-2010 versus 0.52% the previous year. **These positive trends risk reversal however because rising inflation in India threatens to erode real savings.** The high saving rate has been one of the key sources of investment capital, providing funds for capital formation. **Rising saving rates correspond to substantial improvements in gross capital formation, which rose to INR23,892 billion in FY 2010** from INR19,271 billion the previous fiscal year. While the household share of gross domestic savings declined from 74% to under 70% of total gross domestic savings, household savings showed sustained growth and remain the largest source of savings, followed by private corporate savings with 24.1% and public savings with 6.3% of gross domestic savings in 2009-2010. **The corporate investment share of Indian GDP trebled in the seven years before the financial crisis**, rising from around 5% in early FY2001 to 16% in FY2008 before falling back to near 13% in FY2009 and **restoring that uptrend is vital to unlock the economy's potential.**

Is India's Demographic Dividend a Myth?

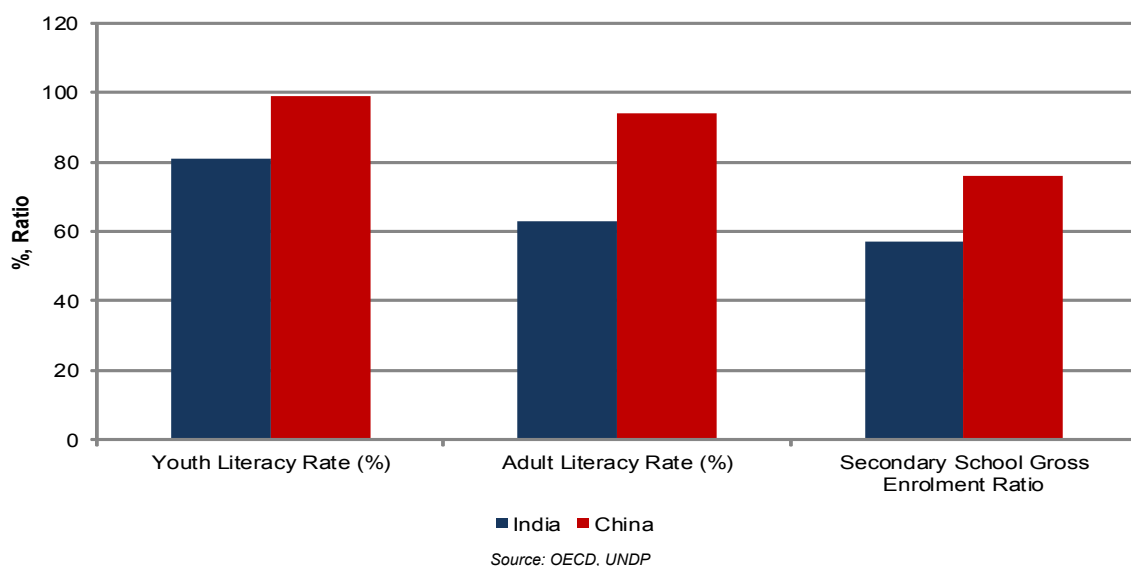
- The UN estimates that India's age dependency ratio (the number of working age people supporting children and the elderly) will improve substantially, from 55.6% in 2010 to 47.2% in 2025. China, by contrast, will soon begin to age and decline: its dependency ratio will rise from 39.1% in 2010 to 45.8% in 2025. In theory, an expanding working age population and the savings it generates can in turn be invested in their economy to boost trend growth. However, the issue is the quality of that potential workforce and **India is currently seeing the highest wage inflation of any Asian economy as skills shortages emerge across most sectors.** When compared to China, **India lags in every measure of human capital development, from basic literacy to the employability third level graduates.**
- The adult literacy rate is 63% in India, compared to 94% in China, and this does not look set to reverse given that **India's youth literacy rate is still only 81%, compared to China's 99%.** The underdevelopment of the country's human capital will undermine India's ability to ever compete with China as a manufacturing hub, particularly when adjusted for productivity. At present, only 12% of Indians enter higher education, although the government hopes to increase this to 21% by 2017. **The Indian Institutes of Technology, universities focused on engineering and technology, are world-renowned, but offer only 7,000 places to students each year. Current vocational and technical training schools unfortunately can only absorb 1.1 million students a year.** While India isn't facing a shrinking working age population like China over the next couple of decades, that presents an opportunity that can only be realised in terms of potential growth if structural deficiencies in the education system are addressed.

India has Best BRIC Demographics...



- The Federation of Indian Chambers of Commerce and Industry estimates **average salaries rose 15% last year** as employers tried to retain skilled labour. Indian salaries will rise almost 13% this year, according to research from Aon Consulting. **Double-digit rises are forecast in the range of 12 to 15% through mid decade.** General Electric remarkably declared earlier this year that **the cost difference between running a call centre in the US and India had narrowed to as little as 10%.** The fastest salary growth is in entry level skilled jobs in a country that produces 3.3m graduates each year, or less than half of China's output. **There is a growing talent shortage affecting some of India's most promising sectors.** India's higher education system produces about 100,000 chemistry graduates every year but local drugs companies claim that while these fresh graduates may be able to do entry-level jobs, even after intensive training they are not prepared for more innovative, cutting-edge research, leading to salaries for research scientists approaching US levels.

But Lags China in Human Capital Measures



Radical Structural Reforms on Hold, but GST Efficiency Boost Significant

- Despite the boost from a strong showing in the state assembly elections, the United Progressive Alliance coalition government, led by the Indian National Congress party, may struggle to serve its full term to May 2014. **A recent spate of corruption scandals has been destabilising, although at this stage the opposition is weak and the defeat of the Communists in state elections in West Bengal shows an ongoing popular appetite for economic modernisation.** The government's lack of a reliable parliamentary majority means that the most likely scenario is **the continuation of modest incremental reform, with the government focusing on areas where change is possible without legislative action.** Near-term, the government is likely to maintain its focus on populist measures, with ongoing part-privatisation of state-owned firms and moves forward with modest reforms that increase competition.
- India will adopt the International Financial Reporting Standards (IFRS) from 2011 to 2014, and will also see the introduction of significant fiscal reforms through the Direct Taxes Code (DTC) and the goods and services tax (GST) as well as initiatives to introduce new, progressive legislation such as the Competition Act and the Limited Liability Partnerships Act. **The DTC and the GST are two significant tax system reforms which would improve India's business competitiveness.** While China reduced the cost of starting up a business from 17.8% to 4.9% of per capita national income between 2003 and 2009, this ratio **increased from 53.4% to 66.1% for India in the same period.** Taxes on commercial profits are about 24% in India, but only 6% in China. Any evolution toward a tax regime with a wider base and moderate rates backed by an effective tax administration clearly will boost FDI flows and domestic private sector investment. **The unified national General Sales Tax is the single most important tax initiative in India since independence, finally creating a 'common market' across the subcontinent which will significantly enhance economic efficiency and growth.**
- FDI limits look set to be relaxed in some sectors as the government seeks to simplify investment procedures and remove bottlenecks. Petroleum prices in India need to be raised to bolster public finances, but could stoke inflation. **A small rise would help limit the government's fuel subsidy burden to a budgeted \$5.2 billion for 2011/12** and help it meet its fiscal deficit target. Labour laws are likely to remain restrictive, as union resistance slows the pace of labour market liberalisation while poor infrastructure will continue to constrain growth unless land zoning and planning regulations are relaxed. Much needed investment in roads, airports and railways will be limited by the government's budget deficit and a weakening financing environment.

RBI Needs Tighter Fiscal Policy/Lower Oil Prices to Moderate Tightening Cycle

- Another 75bps in RBI tightening is likely by early Q3; **beyond that policy depends on global commodity prices (oil constitutes about a third of total imports) and the forthcoming monsoon;** the India Meteorological Department has predicted the southwest monsoon in 2011 to be 98% of the long period average with a model error of plus/minus 5%. Good rains, if they arrive on time and if they are well spread, would help ease food inflation and boost rural income. **Rainfall that comes within 96% to 104% of the long-term average is considered a normal monsoon season, but this alone doesn't guarantee a good crop.** The quantity and geographical spread of rainfall during the monsoon season is **crucial for India's agriculture sector, which lacks irrigation facilities on more than half its farm land.** Monsoon rains usually enter India's mainland through the southern state of Kerala in the first week of June, gradually progressing to cover most of central and northern India by July, before retreating in September.
- While GDP growth had been accelerating since 2009, credit has grown at an even faster rate. **The commercial bank credit-to-GDP ratio rose from 25.3% to 52.1% over the last decade.** Housing loans, that constitute the largest chunk of personal loans, registered robust growth in 2009-10, at 20%. Banks in India are increasingly securitising retail debt with the securities thus created being sold to financial institutions, insurance companies and mutual funds. **Aggregate personal loans provided by the commercial banking sector rose by 17% in 2010-11, compared with 4.1% in 2009-10.** Within this category, the growth during 2010/11 in housing loans stood at 15% and in loans against consumer durables at 22.4%, as compared with 7.7 and 1.3% respectively in 2009/10.

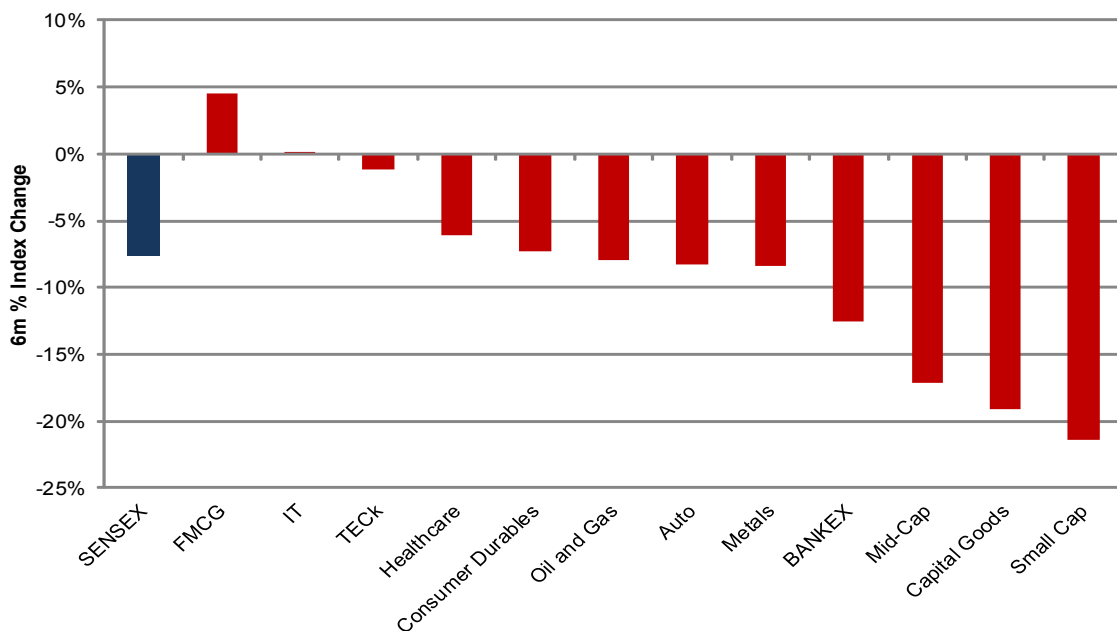
Margin Compression to pressure Earnings but Structural Investment Case Intact

- Concerns that sustained inflation would drive tighter policy have led Indian equities to underperform regional and global indices, with the Sensex tumbling by 8% over the last 6 months and over 10% from its November peak. **Predictably, sectors that were more domestically focused, more illiquid and more sensitive to a rising cost of capital have borne the brunt of the ongoing correction.** The capital goods sector has been particularly hard hit by slowing investment momentum (and looks reasonable long-term value) while export-oriented sectors such as IT and defensive domestic sectors such as FMCG and media/telecoms (represented in the TECK index) have outperformed, and ebbing

liquidity as well as fears of margin compression and surging funding costs have hit small/mid cap stocks significantly harder.

- **The latest Indian quarterly earnings numbers were mixed, with revenue growth remaining healthy, as might be expected in an environment of rising inflation, but margins coming under pressure owing to rising input costs.** While consumer-oriented industries continue to hold up quite well, the capital goods segment has witnessed limited improvement in order books reflecting a slowdown in underlying investment activity. Private investment has been disappointing in recent quarters and the rate hikes will exacerbate that trend. **Consensus earnings growth expectations look set to decline 2-3% from current levels with interest rate sensitive sectors such as banks, auto, capital goods and infrastructure most vulnerable.** The real estate sector looks cheap after a spectacular collapse but lacks transparency and has limited earnings visibility.

Large Cap Defensives have Outperformed since November



Source: FactSet as at 16th May

- **Structurally, India remains under-served in terms of financial services** and increasing income levels will support longer term growth but **near term, banks face pressure on net interest margins and contraction in credit growth.** Recent regulatory uncertainty and corruption probes have led to attractive value in regional terms in top-tier telecoms stocks; **the industry will consolidate over the next couple of years with recent entrants exiting as losses mount and rising average revenues per subscriber as 3G services roll out,** reflecting the global sector trend. Broadly, the domestic demand story and sectors that offer exposure to the domestic consumption and rising trend investment themes from logistics to construction are good opportunities from a medium- to long-term perspective. The structural transition underway in India, with growing income levels, increased urbanisation and a volatile but ongoing rise in infrastructure/capex spending by both the government and private sectors.
- Despite the cyclical volatility, India remains an attractive growth story over the medium term with a well-balanced growth model, high savings rate and supportive demographics. **The government will eventually push through further structural reforms that address infrastructure and skill gaps** - the reform process does have support across the political spectrum, which would have been unthinkable a decade ago. India **needs to continue politically painful subsidy reforms, particularly in energy, which will exacerbate near-term inflation trends** but improve the profitability of capacity investment in power generation and oil refining.
- Growth in India is driven by domestic consumption and has **the potential to surprise beyond the current cyclical**

setback if key structural impediments are removed by ongoing reform and faster infrastructure investment. India's medium-term sustainable potential growth rate can rise from 6.5-7% toward 8% by mid decade at a time when China's is clearly slowing as demographic factors weigh. Decelerating global growth later this year and into 2012 to sub 4% would reduce overheating risks, raise the relative valuation of India's domestic oriented earnings and generate potentially more stable portfolio flows as large scale privatisations and infrastructure projects attract foreign capital. Longer term, the combination of democratic legitimacy, demographic dynamism and a broadly reformist political agenda seeking to accelerate potential growth rates **makes India a more appealing secular investment exposure than a fast aging China**, which faces a difficult structural transition in its export and investment oriented growth model.

Author:
SEAN MAHER
Consultant Strategist
Quam Securities
s.maher@globalalliancepartners.com
Tel: +852.2847.2270

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