

India: Market View

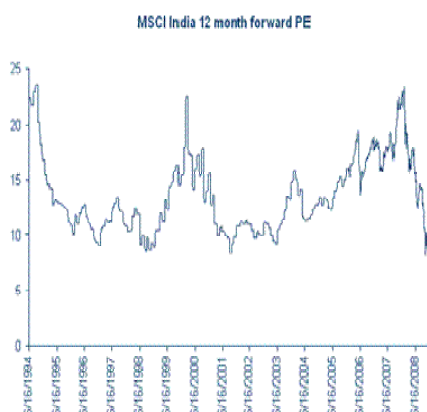
23 January 2009

Economic & Market Trends

VALUATIONS BACK TO CYCLICAL LOWS - SENSEX



VALUATIONS BACK TO CYCLICAL LOWS – MSCI INDIA



Recovery for Indian equities likely to be a protracted process. The Sensex fell over 60% from its record high of 21,206 in January 2008, with high volatility and broad-based declines. Trailing earnings have fallen to their lowest level at least since 2000, while forward earnings are at the lowest level at least since 1994, reflecting uncertainty over corporate earnings growth. While valuations have come down sharply, a number of negatives continue to overhang the outlook for equities. 1) Political uncertainty, with elections scheduled in a few months time, 2) a weak growth outlook and 3) ongoing global de-leveraging.

All these concerns will keep the market volatile in Q1. From a technical perspective, markets seldom stage a V-shaped recovery after sharp slides or episodes of “burst bubbles”. More often, it is W-shaped or U-shaped, characterizing the base-building or confidence building process. For instance, after the 2000-2001 bear market, which saw a decline of 54%, Sensex underwent a bottoming process until mid-2003 before embarking on a new bull market. Equity exposure should be restricted to companies with strong corporate governance and reputation, strong balance sheets, low immediate financing needs, strong cash flows, relatively low valuations and strong dividend payment track records.

Data coming out of India continues to paint a gloomy outlook. Exports contracted for two consecutive months, in October and November, for the first time since February 2002. Manufacturing sector outlook remains bleak – October industrial output unexpectedly contracted 0.3%, for the first time since the series began in 1993-94. Even though the November industrial output rebounded slightly to 2.4% on-year, manufacturing activity continues to weaken sharply and the trend is clearly downward. Furthermore, the balance of payments printed its first quarterly deficit in several years.

Rapidly falling inflation gives room to the Reserve Bank of India to cut rates more aggressively. The RBI cut the repo rate and the reverse repo rate by 100 basis points to 5.5% and 4% respectively, and cut the cash reserve ratio (CRR) by 50-basis points to 5% at the start of the new year. Interest rates have fallen sharply, with the repo rate down from a peak of 9%, reverse repo rate down from 6%, while the CRR has come off from 9%, reflecting pro-active monetary policy pursued by the RBI to cushion the economic growth

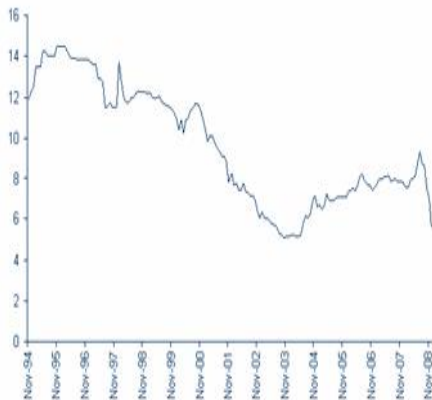
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LONG BASE BUILDING PROCESS FOR SENSEX IN 2002-2003



Source: Thomson Reuters

INDIA TREASURY BOND YIELD: 10 YEAR



Source: Datastream

slowdown. We continue to expect more rate cuts, with the repo rate seen falling to 4% by mid-2009, reverse repo rate to 3% and the CRR to 3.5%.

The latest cut in the reverse repo rate is probably aimed at encouraging banks to lend instead of parking it with the RBI. Even though interest rates have come down, bank credit to the commercial sector continues to be rationed due to increasing credit risk. In a bid to increase the flow of credit to the private sector, the government has raised the bank loan target for public-sector banks, provided new credit lines and set up committees to monitor the disbursement of credit to the relevant sectors. Other measures by the government include easier access to overseas loans for companies and non-banking finance companies that lend to the infrastructure segment, and an increase in the foreign investment limit in corporate debt to US\$15 billion from US\$5 billion. In addition, the government has already announced a fiscal package of INR320 billion (US\$6.5 billion or 0.54% of GDP), and its intention to ensure that the US\$60 billion budget expenditure for the remainder of the year is fully spent. Despite the monetary and fiscal stimulus, we continue to expect economic growth to slow to 6.3% in FY09 and 5% in FY10 (year ending Mar. 31).

Expectations of more rate cuts by the RBI, declining inflation and slowing economic growth should continue to support bonds. We expect inflation to fall to 2% on-year in Q2 from 5.91% currently, with a possibility of deflation in Q3. Indian government bond yields have fallen significantly, thanks to the RBI's aggressive monetary policy and weakening oil prices, with the 10-year benchmark yield falling to under 6% from 9.2% in mid-2008. But the fiscal stimulus and prospects for increased supply of government securities should limit the upside in bond prices. Nevertheless, government bonds remain a valid hedge as the first quarter is likely to remain volatile for equity markets.

The Indian rupee was the worst performing currency after the Korean won in the Asia ex-Japan region, depreciating by 25% in 2008, which worsened the returns for foreign investors. During the July-September quarter, the balance of payments worsened to -2.9% of GDP from -1.7% of GDP in the previous quarter on a widening trade deficit due to high oil prices and foreign institutional investor outflows. But lower oil prices should help improve external balances, supporting a rebound in INR in 2009, though the first quarter of the year could see USD/INR at elevated levels as global markets could remain highly volatile and global deleveraging could support the U.S. dollar. But we expect USD/INR to eventually fall to 46 in Q4 as the U.S. dollar weakness gains momentum.

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