Strategy

The India story: Opportune times

December 31, 2009

Edelweiss
Ideas create, values protect

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INDIA STRATEGY

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Interest rates to stay "lower for longer" in advanced economies

The global economy is up from the trough. However, we believe growth is still nascent and stimulus-dependent, especially in the developed world. Globally, particularly in developed nations, stimulus unwinding is likely to be slow as policymakers would rather prefer to err on the side of caution than putting growth recovery at risk. While most of the extraordinary stimulus measures are to be gradually rolled back during the first half of CY10, we believe, the Fed will keep interest rates at current levels for most of the year. Appreciation in the EUR is anyway acting as a "pseudo tightening" for the Euro zone and will delay rate hike by the European Central Bank (ECB). On the other hand, Japan is still in the process of injecting fresh stimulus, acknowledging likelihood of poor economic performance for a prolonged period.

USD to remain weak; flows to remain strong into emerging markets

We expect the USD to remain weak during CY10, primarily driven by: (1) surging federal deficit and large treasury issuances; (2) sharp expansion of the Fed balance sheet; (3) improved risk appetite globally, reducing significance of the USD as 'safe haven'; and (4) several emerging markets (EMs) shifting their reserves from USD to gold. Low interest rates in the US, without the fear of any quick appreciation of the domestic currency, will lead to continued flow of USD to EMs.

Even in case of a slowdown in USD flows, EMs will still enjoy inflows of other low-yielding developed country currencies. JPY remains a prime candidate for being used in such "carry trade" as a result of the near-certainty of its continued weakness and extremely low interest rates in Japan.

India stands to benefit more than peers

India has been relatively less battered in the global crisis and most indicators suggest a strong growth recovery ahead. The country remains largely immune to the risk of any rollback in stimulus as the same was miniscule at less than 1% of GDP (against ~15% of China), targeted at the lower strata of the economy—in line with GoI's long-term strategy of "inclusive growth". In our view, the current phase of high inflation will be a concern for just around six months and, thus, will not put undue pressure on the interest rate scenario. With the economy poised to re-enter a healthy growth zone, the pro-cyclicality of India's fiscal dynamics will reduce deficits considerably over FY11-12. With stability and strength in income generation, efficient use of capital, favourable demographics, India is in the early phase of a virtuous cycle of high savings, capital formation, and high growth.

Focus on consumption and infrastructure creation in India

India's current valuation premium over EMs has been in line with the recent past. Given the strong visibility of growth and political stability, there should not be any de-rating in the premium over the near term. We expect earnings estimates for FY11 to grow further. Even if there is no further uptick in valuation multiples, Indian markets will keep moving up along with earnings upgrade. While we are bullish on Indian equities in general, we believe key to outperformance will be with bottom-up sector and stock selection. We prefer to play the India growth story via infrastructure creation and end-consumption. We are overweight on BFSI, industrials, real estate, and consumer discretionary.

Growth recovery nascent and stimulus-dependent in advanced countries

Globally, growth outlook and confidence levels are up from the trough; but still at a nascent stage. In the US, economic activities are stabilizing, nevertheless, remain stimulus-dependent. Several macro-indicators across G-7 also suggest the need for stimulus to continue. Japan remains an area of heightened concern.

- ### Global growth: Far from the old glory

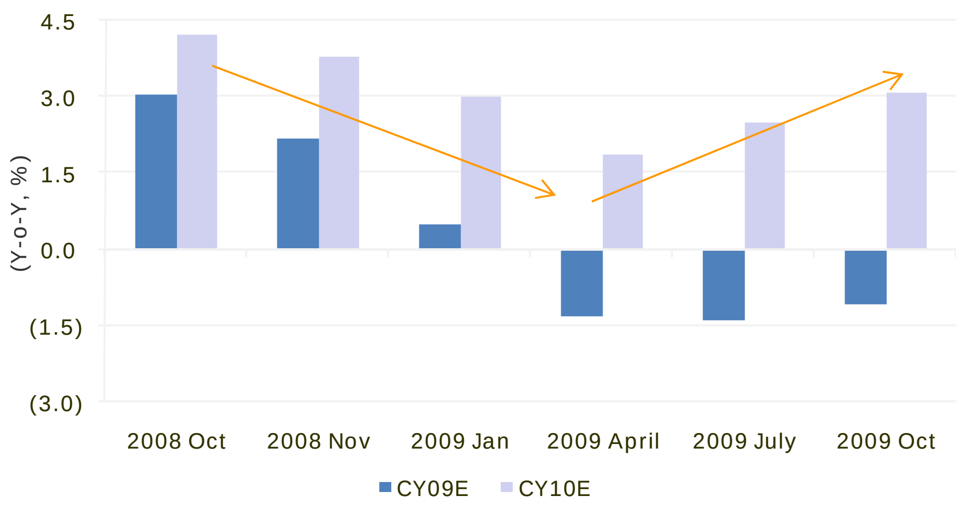
The recent financial turmoil has been without precedence and the global economy has suffered an annual contraction in GDP in CY09, the first time since World War II. The slew of stimulus measures and rapid and synchronized rate cuts across economies helped significantly in controlling the downfall, but the damage was far-reaching.

Downfall in the global economy and dwindling confidence, which had set in during CY08, continued till the early part of CY09. Outlook for the global economy reached its worst level in Q1CY09; several multilateral organizations continued to downgrade their forecasts for the global economy till that period. For example, for CY09, the International Monetary Fund (IMF), whose October 2008 projections forecast the global economy to grow ~3%, predicted ~1.5% decline in April 2009. There were continuous downgrades for global GDP for CY10 as well during this period.

Growth recovery at nascent stage; still stimulus dependent

However, numerous stimulus measures adopted across the globe since CY08, particularly after the collapse of Lehman Brothers in September 2008, started showing some results with a lag. While the continued downslide in advanced economies started coming to an end, emerging market (EM) economies started returning to their growth path. Growth projections for CY09 did not undergo any major upward revision. However, the improvement in the outlook for CY10 was relatively more discernible.

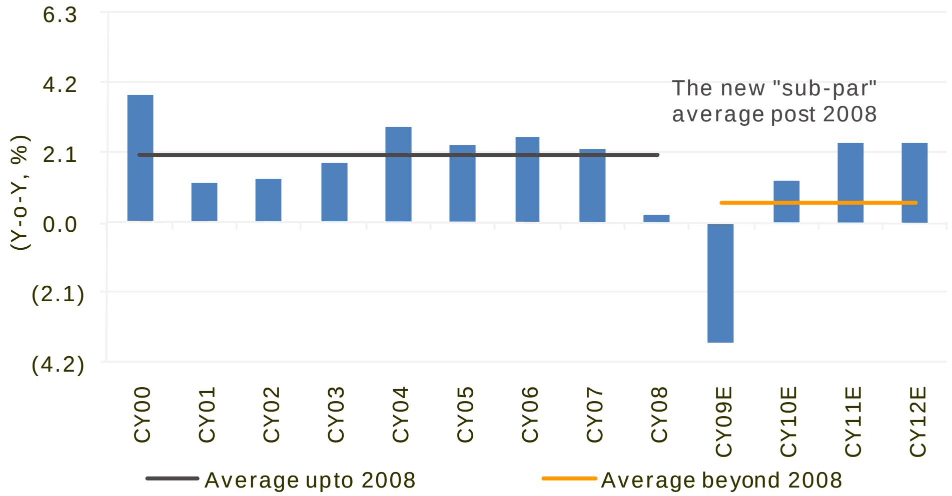
Chart 1: World GDP growth outlook – Improvement since Q2CY09



Source: World Economic Outlook (various issues), IMF

Although CY10 is expected to be a year of further recovery, there is a great degree of uncertainty about the magnitude and future direction of most macro-economic variables. Growth recovery is still at its nascent stage and we may witness a period of sub-par growth, particularly for G-7 economies, for the next couple of years. The contraction in GDP for G-7 economies during CY09 was deep and the recovery is expected to be slow. IMF estimates GDP of the G-7 countries to contract ~4% in CY09. Even after the improvement in outlook since Q2CY09, GDP growth estimates for advanced economies for CY10 is just ~1.3%, way off the 2.2-3.0% range clocked between CY04 and CY07. Most importantly, as per the current IMF projections, growth in these economies is not decisively crossing the 2%-mark till CY12. Since the G-7 countries constitute ~55% of the world's total GDP, weakness of these economies will cause global growth to remain subdued. Recovery in global economic outlook, at the moment, is likely to be largely EM-centric. Prolonged muted performance of the advanced economies could start inflicting the negative externalities for the EMs as well.

Chart 2: G-7 GDP growth to stay sub-par for long



Source: IMF, Edelweiss research

Moreover, the current improvement in global economic outlook, though moderate, has been supported immensely by the flurry of stimulus measures across the globe. Bulk of such measures was unconventional, emergency and one-time stimulus in nature. They could have adverse implications for government finances and central bank balance sheets unless rolled back within a definite time-frame. It is thus important to assess how dependent is the current growth outlook across countries on such stimulus. This will give us insights on the trajectory of growth and the course of stimulus withdrawal in different economies in the near-to-medium term.

Accordingly, we attempt a closer scrutiny of the pace and trajectory of improvement seen in case of some of the important macro-variables in the recent months for certain major economies.

- **Recovery in US in nascent state; still looks largely stimulus-dependent**

Several macro indicators in the US have improved over the past 3-4 quarters and the economy has attained significantly better stability over CY09. However, most indicators remain in a phase of consolidation, with their growth nascent and uncertainty persisting regarding the pace of further recovery.

US housing demand propped up by stimulus support

As the US housing market was the genesis of a large part of the crisis, significant attention goes into assessing the inherent strength of the recovery in this sector. It is felt that a large part of the recovery process in the housing industry has so far been driven by government stimulus. For example, the Obama administration had put in place a tax credit of USD 8,000 for the first-time home buyers, which actually strengthened the sale of residential accommodation during Q2-Q3CY09. Once the scheme was withdrawn in October, housing starts recorded a sharp dip. Policymakers, therefore, re-introduced the scheme in November, which made the statistics look healthier once again.

Chart 3: Housing starts – Marginal improvement

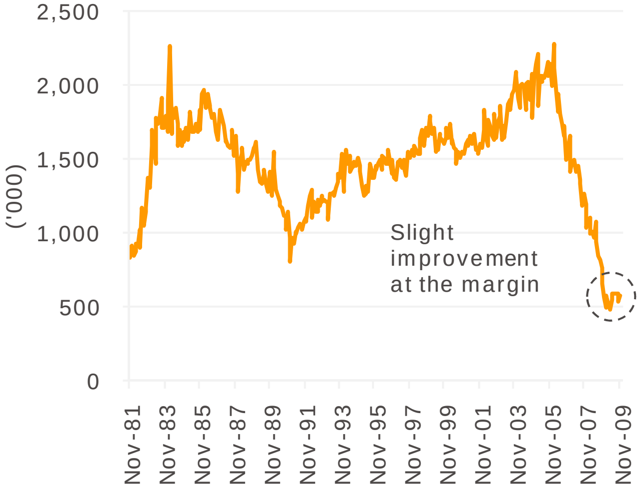
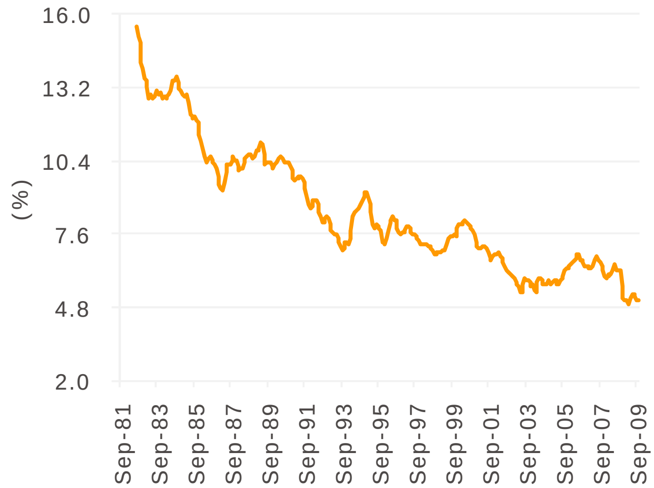


Chart 4: Mortgage rates remain low



Source: Bloomberg

Note: 1. Housing starts data are in '000 units.

2. Mortgage rates pertain to US conventional mortgages effective rate.

Delinquencies and foreclosures high; may rise further

Delinquency and foreclosures are still extremely high – the highest in the last three decades. Although the pace of decline is slower, the mortgage problem is still some distance away from turning around. Mortgage Bankers Association expects delinquency rates and foreclosures to worsen further before they improve. The problem is also spreading to the parts of housing traditionally considered to be safe – prime loans. Data released by Mortgage Bankers Association (MBA) show that 33% of foreclosures started in the third quarter were on prime fixed-rate loans and those loans were 44% of the quarterly increase in foreclosures. Home prices remain subdued. The data released by Federal Housing Finance Agency (FHFA) still signifies that Purchase Only Home Prices, though off their lows, continue to remain weak. FHFA expects twin headwinds of unemployment rates and rising delinquency to continue as dampeners. Although the Purchase Only Index has shown an improvement, the All-Transactions Index, which includes both home purchases and refinancing, fell over the last quarter.

Chart 5: Delinquencies still rising

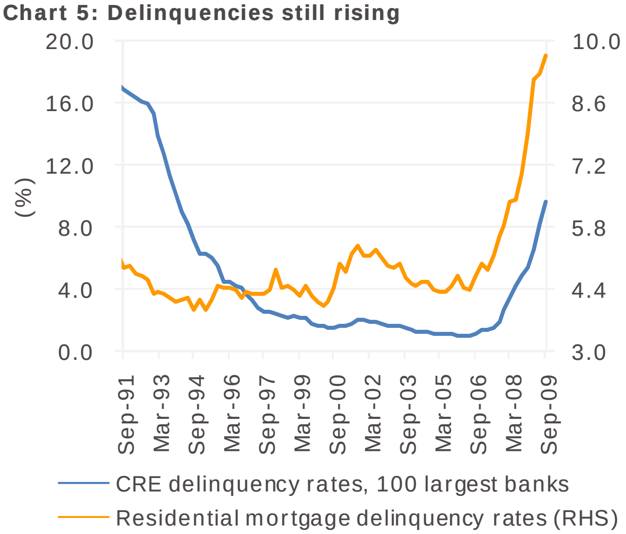
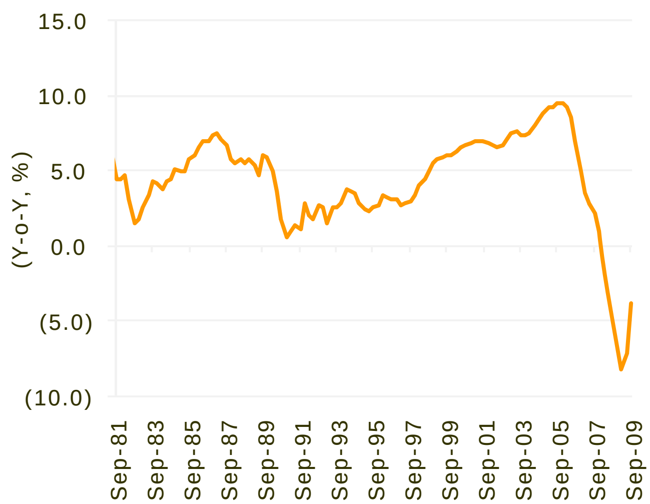


Chart 6: FHFA home price index still depressed



Source: FHFA, Bloomberg

Note: 1. Home price index for purchase only (not refinancing)

2. CRE stands for commercial real estate

Another area of concern is commercial mortgages in the US. Currently it is closer to 9% and although we do not foresee a situation such as the CY90-91 'Savings and Loan Crisis', when commercial delinquency rates peaked to ~17%, any additional increase in commercial delinquency will put pressure on banks.

Several other statistics around housing, labour market and investments in the US remain on uncertain ground. Although off its extremely depressed level, unemployment rate still remains high at ~10% and jobless claims, although declining, is close to two-decade high.

Chart 7: Weekly jobless claims – Early stage of recovery

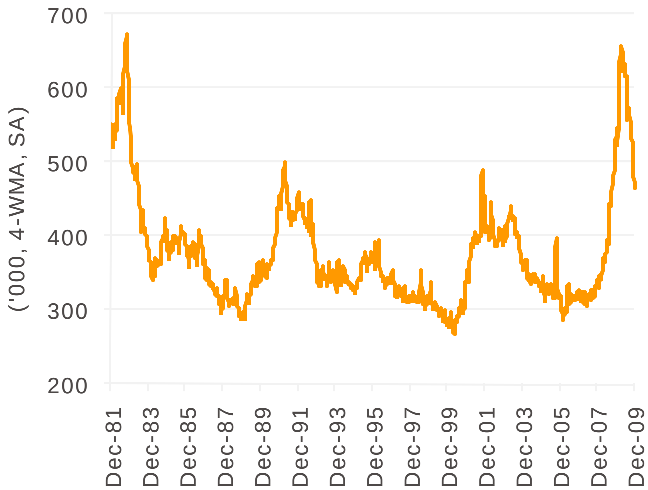
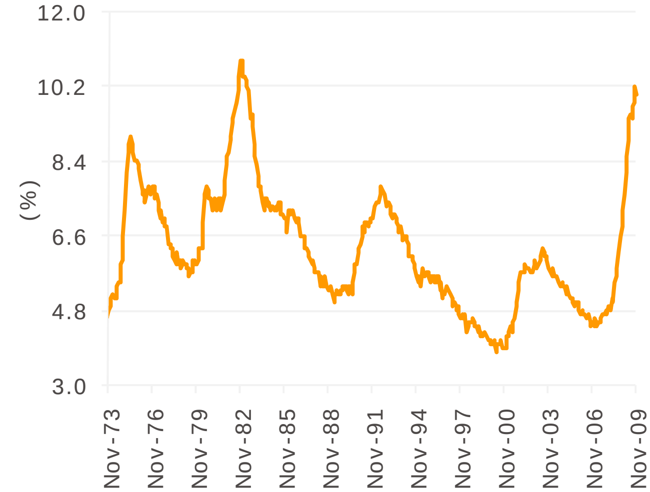


Chart 8: Unemployment Rate still high



Source: Bloomberg

Note: 4-WMA stands for 4 week moving average; SA stands for seasonally adjusted

Uptick in consumption also largely stimulus driven

In the recent months, two important consumption indicators – ICSC retail sales and auto sales - have shown some improvement. However, stimulus programmes have had a big role to play in lifting them from an abyss. For instance, stimulus plan announced by the Bush administration in February 2008 and by the Obama administration a year later had revived retail sales and auto sales (Cash for Clunkers), respectively.

Chart 9: US auto sales – Benefitting from stimulus

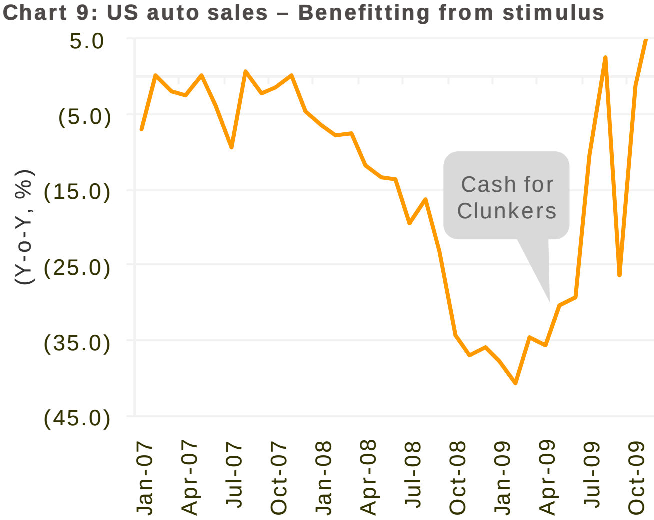
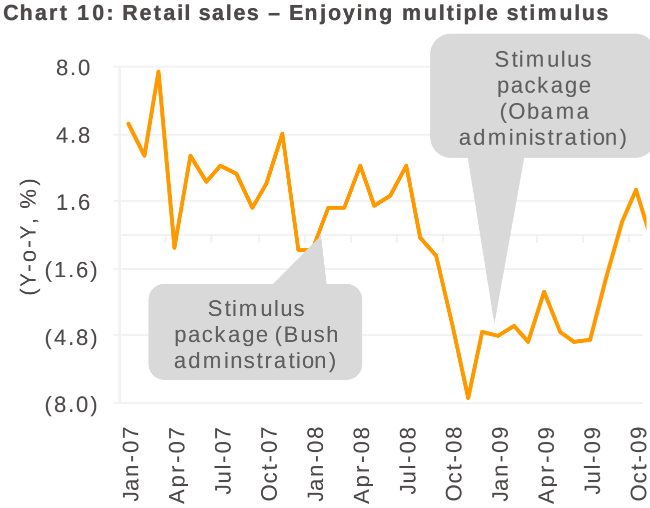


Chart 10: Retail sales – Enjoying multiple stimulus



Source: Bloomberg

Note: Retail sales data pertain to ICSC (International Council for Shopping Centre) retail sales.

Some of the other important indicators, including consumer confidence, are still at depressed levels. The New York-based Conference Board's Consumer Confidence Index, focused on the labor market and purchase plans, is currently at 52 after ending CY08 at 39 and CY07 at 90. Real private fixed investment is also trailing behind. Only the ISM has shown a significant uptick from its lows.

Chart 11: ISM manufacturing – Up from the though

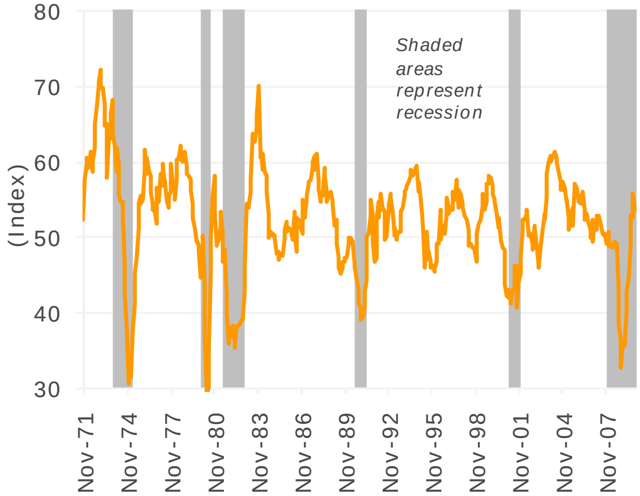
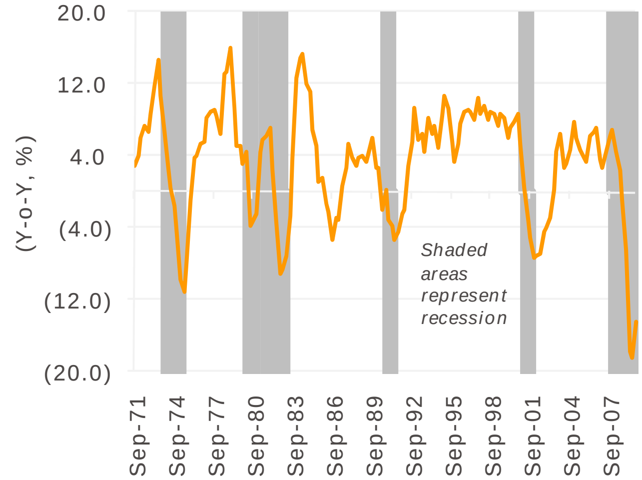


Chart 12: Nosedive in Business Investment



Source: Bloomberg

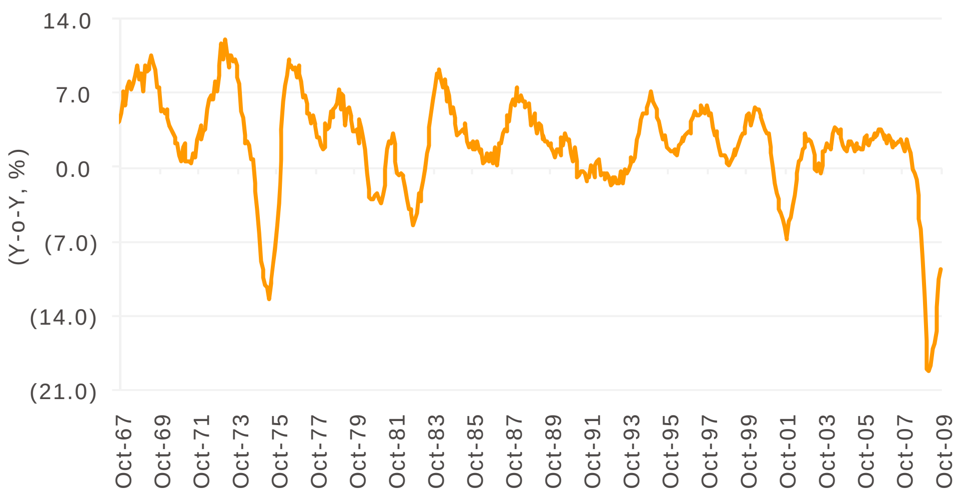
We, thus, believe that Fed, like most other developed country central banks, cannot afford a rapid "exit" from its accommodative policy stance. Although some of the extraordinary measures may be withdrawn by the first half of CY10, Fed will not try to stay ahead of the curve in withdrawing the stimulus and risk the growth recovery process in any fashion as the economy is just coming out of a deep recession.

- **Several macro indicators in other major economies still in disarray**

Macro indicators in Euro zone not out of the woods

Several important indicators across major economies (G-7) suggest that we are still in a period of high macro uncertainty. G-7 industrial production (IP), although off its record lows, is still in the depressed zone. Euro zone's unemployment is still at a 10-year high and Japan's capital investment is at multi-decade low.

Chart 13: OECD G7 IP (ex-construction) – Not far from the record low



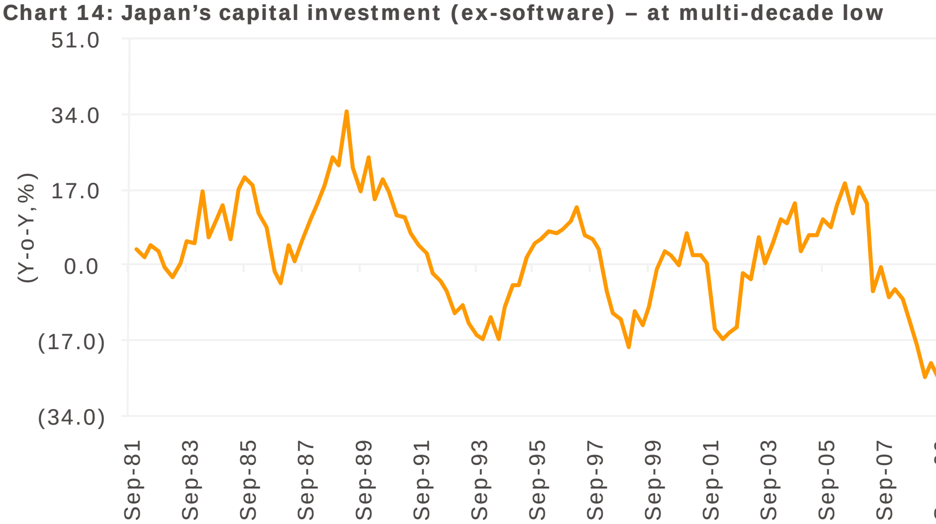
Source: Bloomberg

Several key economic indicators for Euro zone remain at depressed levels. Factory orders for major economies like Germany are still declining and unemployment rate remains at multi-decade high. Although ECB has indicated that it may roll back some quantitative easing (like conducting refinancing operations less frequently than in the recent past), we believe a rate hike in Europe will not be undertaken for the larger part of CY10. A strengthening Euro, which is causing exports to slow down, is already acting as a "pseudo tightening" measure for the Euro zone. A rate hike, apart from putting pressure on interest rates, will cause the Euro to appreciate further (after ~20% rise since March lows) and put further pressure on export-driven economies such as Germany.

Japan remains a case for heightened concern

Japan particularly remains an area of concern. It accounts for ~8% of world's total GDP and the current recession is one of the worst in the post-war period. Its capital investment (ex-software) is at record low levels, surpassing even the CY93 and CY98 lows. Further, its high dependence on exports makes the economy vulnerable to shocks from a continued slwodown in external trade. Although the government has unveiled stimulus plans of ~USD 326 bn since September 2008, there is a growing apprehension that Japan may again slip into depression. Japan is, in fact, still injecting fresh funds into the economy. There are possibilities that it may continue with further stimulus injection for a prolonged period to support the economy.

Chart 14: Japan's capital investment (ex-software) – at multi-decade low



Source: Bloomberg

Interest rates to stay “lower for longer” in advanced economies

Globally, particularly in developed nations, stimulus unwinding is likely to be slow as policymakers would rather prefer to err on the side of caution than putting growth recovery at risk. We expect the US Fed and ECB to roll back bulk of the unconventional liquidity measures by the first half of CY10; however, a formal rate hike will come later. The Fed will keep interest rates at 0-0.25% for bulk of the year. ECB will also keep rates low for major part of the year. Euro appreciation, in our view, is already acting as a "pseudo tightening" measure and will delay a rate hike by ECB. Japan will be the last among major economies to hike rates, and by no means in CY10. In fact, Japan is still in the process of injecting fresh stimulus, acknowledging the likelihood of poor economic performance for a prolonged period.

- ### Fed to keep rates "lower for longer"

Fed likely to keep rates near zero for bulk of the year

Continued volatility and mixed signals from different macro-indicators have resulted in uncertainty around the shape, magnitude, and speed of further economic recovery in CY10. We are of the view that while EMs will lead the recovery process, macroeconomic conditions in the developed economies, especially in the US and Japan, will improve only gradually. As discussed in the previous section, stability is now coming back for several macro-variables in the US over the past 3-4 quarters. However, growth is still in a nascent state with uncertainty persisting around further recovery in the near term. Several segments of the economy still remain dependent on stimulus. Despite the early signs of recovery, unemployment rate still remains high at ~10% and jobless claims, though have started improving, are close to two-decade high.

Fed had been proactive in adopting a markedly accommodative monetary policy stance and a flurry of unconventional stimulus measures when the US economy started slipping into the recession. We, however, do not expect Fed now to be proactive in making an "exit" from the accommodative policy stance, unless recovery becomes decisively strong-footed. Policymakers, at the moment, would prefer erring on the side of caution rather than adopting a course of aggressive unwinding and put growth recovery at risk.

Most indicators are far from the "median" value at which Fed made its first rate hike in previous cycles in last 25 years

Fed would have to look at recovery across a wide range of indicators comprising employment, housing, consumer confidence, CPI, ISM, business investment, industrial production (IP) to name a few. The table below provides a snapshot of the levels observed for few such important variables at the time of first hike in Fed funds rate after a spell of recession. Five such cycles are available over the past 25 years for the US economy. The data below provides the levels of several macro economic variables at the time Fed went for its first rate hike post-recession. The data clearly establishes that the US economy today is in a distinctly disadvantageous position compared with median value of all such macro indicators at the beginning of previous tightening cycles. ISM is the only indicator close to the median value, but, in sum, all indicators point to the fact that Fed is still far from a rate hike.

Table 1: Macro economic data during previous rate hikes post recession

Preceeding event	First rate hike post recession	IP (YoY, %)	Housing starts (000 units)	Unemp. rate	Consumer confidence	ISM	CPI (YoY, %)	Business Investment (YoY, %)	10 year Yield (%)
Collapse of Bretton Woods System	Jun-75	(11.8)	1,087	8.8		45.1	9.3	(11.1)	8.0
Energy crisis	Aug-80	(4.5)	1,436	7.7	70.8	45.5	12.8	(3.3)	11.6
Stagflation and energy crisis	May-83	0.2	1,776	10.1	87.7	56.1	3.5	(2.7)	10.8
Savings and loan crisis	Feb-94	3.0	1,337	6.6	79.9	56.5	2.5	6.4	6.1
Tech bubble	Jun-04	2.5	1,828	5.6	102.8	60.5	3.3	3.2	4.6
	Median	**0.2**	1,436	**7.7**	**83.8**	**56.1**	**3.5**	**(2.7)**	**8.0**
	Currently	(5.1)	584	10.0	52.9	53.6	1.8	(14.4)	3.8

Source: CEIC, Bloomberg, Edelweiss research

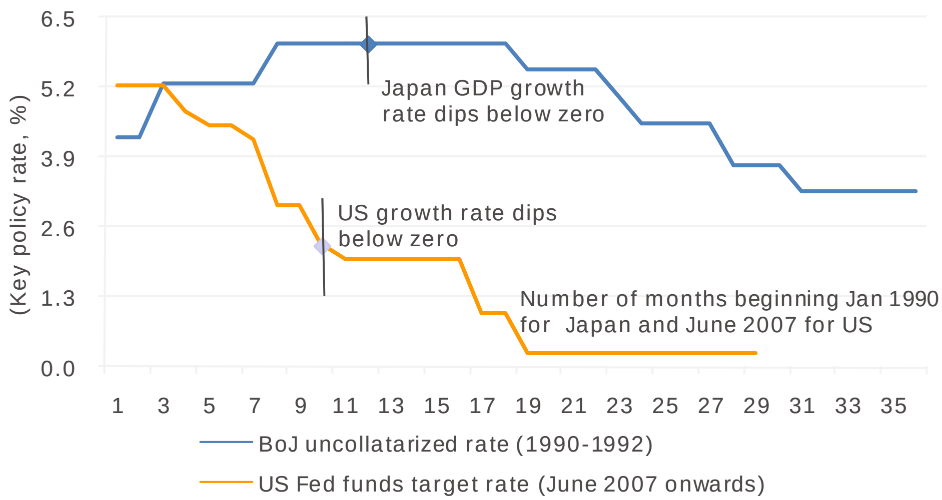
- **US not to repeat Japan's mistakes**

The current US recession is in many ways being compared with the lost decade (of the 1990s) in Japan. Japan too faced a massive crisis exacerbated by an asset price bubble. Since then, for major part of the past two decades, deflationary pressures have bogged down the Japanese economy and the Fed would do well not to repeat some of the mistakes that Bank of Japan (BoJ) had committed.

Fed was more proactive than BoJ in reducing interest rates

Fed's policy reaction to tackle the economic downturn seems to be more appropriate till date. Fed had been more pro-active in triggering off the monetary easing cycle compared with BoJ during the 1990s. Fed started reducing policy interest rates around 7 months prior to the economy actually slipping into recession. Japan, during the 1990s, on the other hand, started reducing the policy interest rates after around 6 months when GDP growth actually entered into the sub-zero zone.

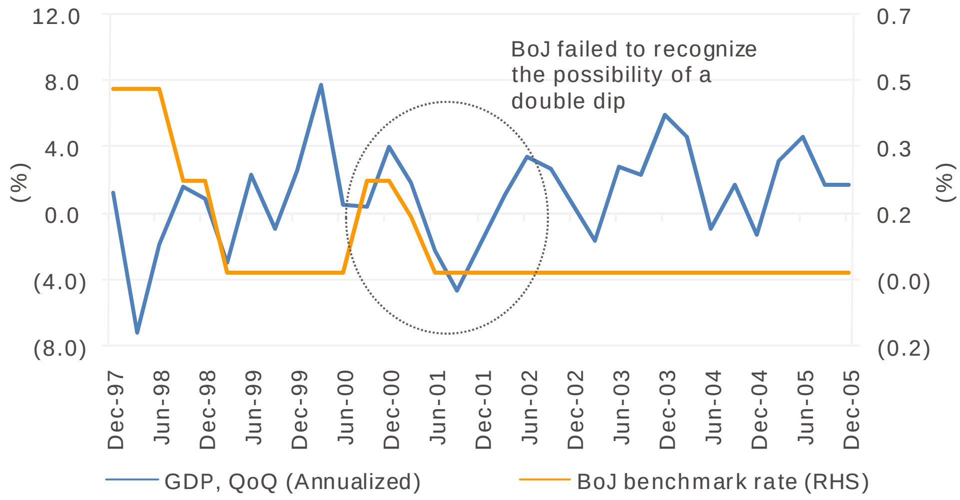
Chart 15: Fed adopted the rate cut cycle faster



Source: Bloomberg, Edelweiss research

The Fed will also avoid repeating the mistake BoJ made in CY00. After years of keeping policy interest rates at zero, BoJ hiked the rates by 25bps in CY00. It failed to anticipate the negative effect of the hike that caused the economy to spiral downwards over the next 4-5 quarters. GDP growth was anemic and did not recover to pre-CY00 levels for the next five years. We believe, the US Fed will draw its lessons from this and will be careful not to hike rates prematurely, lest it hazard another dip in the economy.

Chart 16: BoJ benchmark rate versus GDP

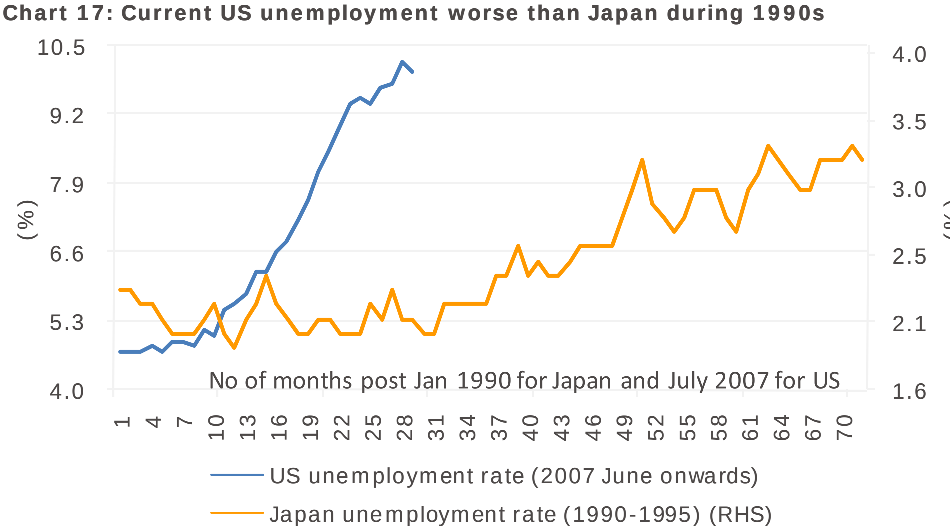


Source: Bloomberg, Edelweiss research

And, will do its best to avoid an untimely hike like BoJ

Moreover, in spite of an early action, Fed could not manage to rein in the spiraling unemployment rate. The impact of the crisis and recession on the employment scenario turned out to be far worse in case of US today than that in Japan during the 1990s. This factor will be a further deterent for Fed to make a rapid rollback of the stimulus measures.

Chart 17: Current US unemployment worse than Japan during 1990s



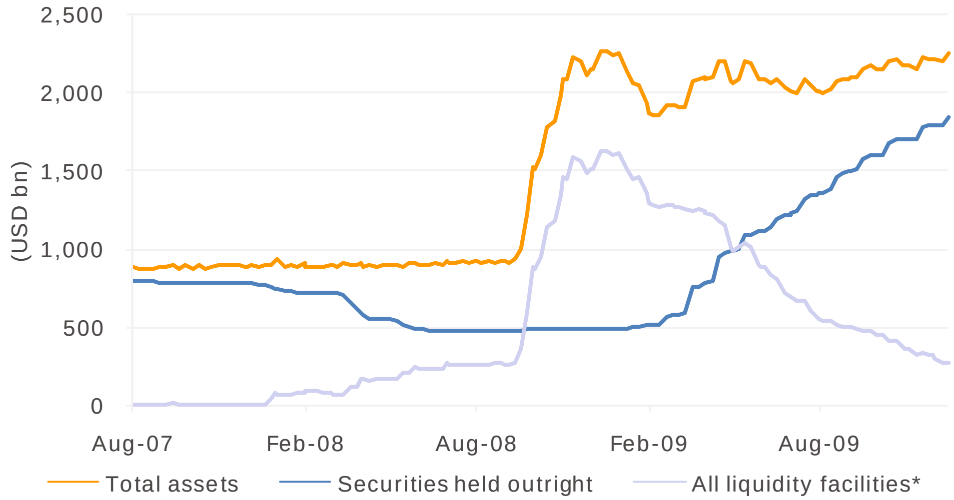
Source: Bloomberg, Edelweiss research

- ### Unconventional liquidity to be withdrawn gradually

Most unconventional liquidity measures already being unwound by Fed; liquidity impact of further unwinding not a major risk

Fed has already stated that it will withdraw most of the unconventional stimulus by end of June 2010. However, we believe that such a rollback will not have any major impact on the liquidity situation or domestic interest rate scenario in the US. A large part of such liquidity (that was injected in the post-Lehman bankruptcy phase through Term Auction credit; primary credit; secondary credit; seasonal credit; Primary Dealer Credit Facility; Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility; Term Asset-Backed Securities Loan Facility; Commercial Paper Funding Facility) has been unwound since Q2CY09. Compared to the peak level of ~USD 1.6 tn outstanding under these heads in Q1CY09, the current outstanding amount is ~USD 265 bn. As such, this is not a significant chunk compared with the total amount of liquidity injected by the Fed. A large part of the drawdown of liquidity under this head over the last three quarters is actually being compensated by large infusion of liquidity by the Fed through outright purchase of securities during this period. As the outstanding quantum of liquidity as part of the unconventional liquidity injection is relatively less, impact of its rollback is not likely to be significant on the overall liqiuidity condition and the interest rate scenario.

Chart 18: Fed has already started to roll back some extraordinary measures



Source: Federal Reserve

**: *All Liquidity Facilities includes: Term Auction credit; primary credit; secondary credit; seasonal credit; Primary Dealer Credit Facility; Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility; Term Asset-Backed Securities Loan Facility; Commercial Paper Funding Facility; outstanding principal*

■ “Pseudo tightening” for Euro zone already via currency appreciation

Recovery signals remain mixed in case of the Euro zone as well. Euro zone’s GDP growth, though a tad above its lows, is in a depressed zone. High unemployment continues to be an area of concern for policymakers in several contries.

EUR appreciation acting as “pseudo tightening”; ECB not to hike rates soon

Additionally, the sharp appreciation of Euro vis-à-vis USD in CY09 has turned out to be another challenge for the export competitiveness of the economy. In fact, the appreciation of EUR (~3% during CY09 and ~13% since March 2009 lows) turned out to be a “pseudo tightening” for Euro zone. ECB would have to keep this factor under consideration while making an “exit” from the easy money policy. We believe, the sharp appreciation of EUR willl lead to a delay in a formal rate hike by ECB.

As such, ECB would have to select course of its monetary policy keeping in mind interests of a diverse group of countries. At the moment, while Germany is concerned about the appreciation of the EUR and a potential impact on its exports, France and Italy are saddled with the unemployment scenario, and others like Spain and Greece are fighting possibilities of a sovereign default. Given these complexities, a formal rate hike becomes a delicate balancing act on the part of ECB and appears quite distant currently.

Chart 19: EUR appreciation causing concern for exports

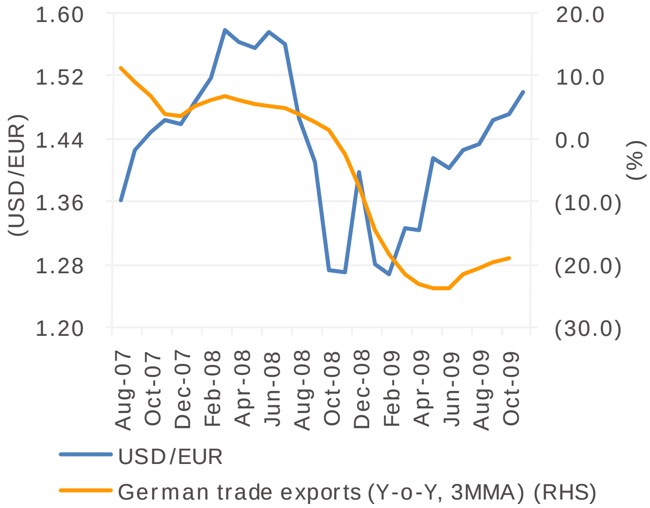
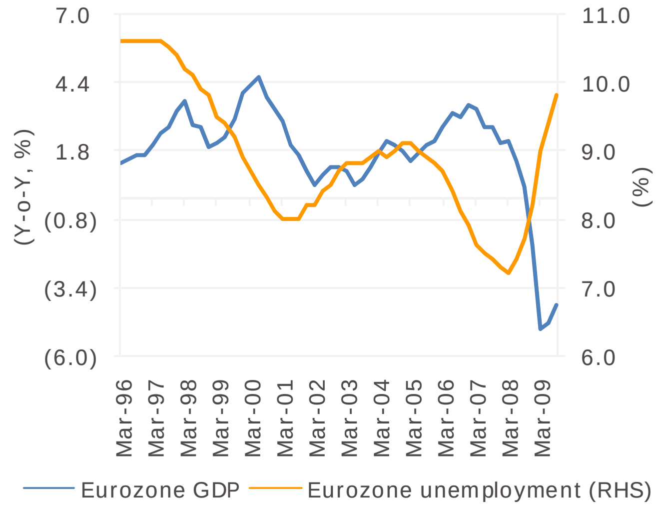


Chart 20: Eurozone macro-fundamentals remain weak



Source: Bloomberg

- **Fears of another dip for Japan**

Japan's recovery has been tepid and there is a risk of another dip. Imortant indicators such as Economy Watchers Outlook and business investments are charting out a tepid recovery and the appreciating JPY since March has been a source of worry for the export dependent economy. Japan is, in fact, in the process of injecting more stimulus and we don't forsee any possibility of a rate hike in CY10.

Japan is still injecting fresh stimulus; no possibility of tightening in CY10

Japan has responded to the crisis with four stimulus packages since August 2008, totaling USD 326 bn. Most of the programmes were concentrated on guaranteeing employment and kick-starting domestic consumption. The slowdown has meant lower tax collections than originally budgeted and a higher–than-expected bond issuance to fund new programmes means that it would be the first time in 60 years that new bond issuance will exceed tax revenues. The latest round of stimulus plan, unveiled in December, focuses on grants to local governments to make up for failing tax revenues, subsidies for purchase of environment friendly consumer goods and cheaper loans for home purchases and healthcare.

Chart 21: Fears of a new dip in Japan

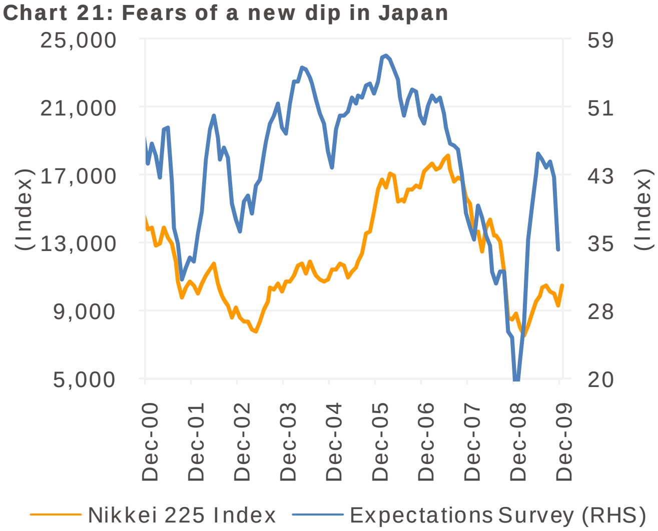
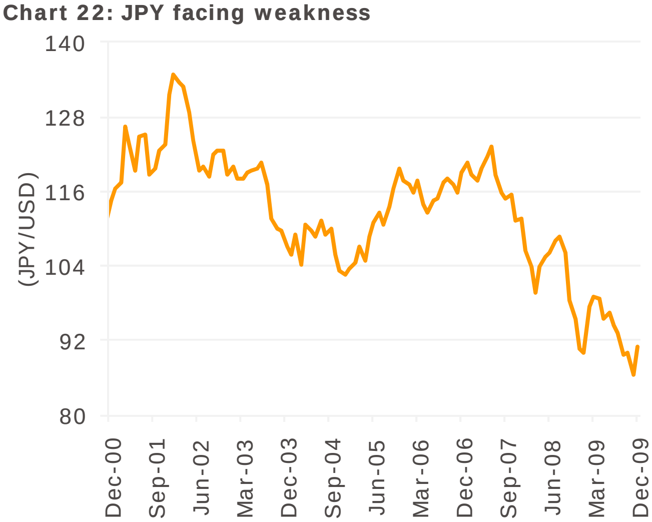


Chart 22: JPY facing weakness



Source: Bloomberg

Clearly in FY09, according to data released by Japan's Ministry of Finance, owing to the large number of stimulus plans, the issuance target was overshot by about JPY 20 tn. The new government in place is looking to avoid a depression at any cost and there is every possibility it could opt for a fresh stimulus package in FY10 should the latest round fail to lift up consumption. Issunace target for FY10 which is already running at close to JPY 10 tn could even get bigger.

Table 2: JGB issuance plan could widen the deficit further in FY10 (Yen bn)

	FY09 (Initial)	FY09 (2nd suppl budget)	FY10 (Initial)
New financial resource bonds	33,294	53,455	44,303
Construction bonds	7,579	15,011	6,353
Special deficit financing bonds	25,715	38,444	37,950
Refunding bonds	90,991	90,490	102,611
FILP bonds	8,000	14,100	15,500
Total	**132,285**	**158,405**	**162,414**

Source: Ministry of Finance, Government of Japan

Flows to EMs to remain strong

We believe USD is set to remain weak throughout CY10. Low interest rates in the US, without the fear of any quick appreciation of the currency, will lead to continued flow of USD to EMs. In case of a slowdown in USD flows, EMs can still enjoy inflows of other low-yielding developed country currencies. JPY remains a prime candidate for being used in such "carry trade" as a result of the near-certainty of its continued weakness and extremely low interest rates in Japan. CY10 is, thus, set to witness strong fund flow to EMs.

■ No quick buck for USD; JPY to remain weak

USD to remain weak because of structural factors

The "lower for longer" interest rate regime is expected to keep USD and JPY weak. The Trade Weighted Dollar (TWD) has already depreciated ~14% over its YTD highs and we expect the USD to remain weak over CY10. This, in our view, will lead to continued flow of USD to high yielding currencies (AUD, NZD) and flows into EM equities, resulting in EM outperformance over developed markets.

With likelihood of rollback of at least a part of the unconventional liquidity and an outside possibility of interest rate hike by Fed as early as in Q3CY10, there are widespread concerns about an upside risk to the exchange rate of USD. Although we have taken cognizance of the view, we still believe that the USD will remain weak throughout CY10 because of a host of reasons discussed below:

(a) **Rising federal deficit and sharp balance sheet expansion by Fed**: A rising federal deficit for the US will continue to put pressure on the USD. On a comparative basis, the current state of federal deficit is in a far worse shape than it was in the previous lows in the recent past. A rising deficit means that the US treasury will continue to print papers, which will put a downward pressure on the USD. The treasury is expected to announce new issuances over CY10, which will act as a constant stumbling block to the USD appreciation.

Rising federal deficit and monetisation to put pressure on the USD

Moreover, to ensure stability of the financial system since H2CY09, particularly after the collapse of Lehman Brothers, Fed injected huge amount of liquidity into the financial system and expanded the size of its balance sheet by ~100%. In a period of about three months, Fed's total assets increased dramatically from ~USD 900 bn in August 2008 to ~USD 2.2 tn by November 2008. Increase in size of Fed's balance sheet was accompanied by a shift in composition of assets held over time. Over CY09, the central bank's holdings of securities increased significantly, primarily reflecting purchases of treasury and guaranteed mortgage-backed securities under its immensely large asset purchase programme. Around this time, various other unconventional liquidity facilities[1] were wound down gradually. However, the overall size of Fed's balance sheet is still at ~USD 2.2 tn. Such sharp balance sheet expansion means injection of additional USD, leading to a constant weakening bias for the currency until such additional liquidity is absorbed back from the system.

[1] Largely term auction credit, primary dealer credit facility, money market mutual fund liquidity facility, term asset-backed securities loan facility, commercial paper funding facility, outstanding principal amount of loans to American International Group (AIG), TALF LLC, and FX swaps.

Chart 23: US is running far larger budget deficit today (as % of GDP)

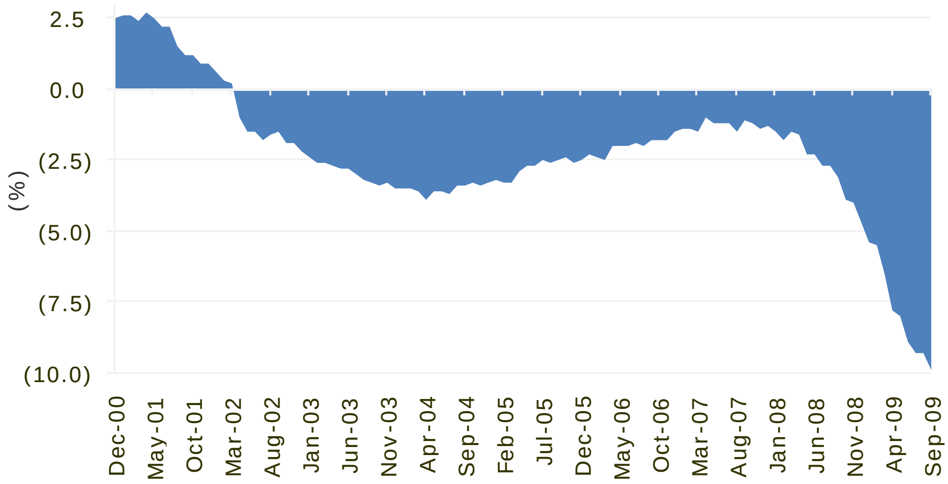
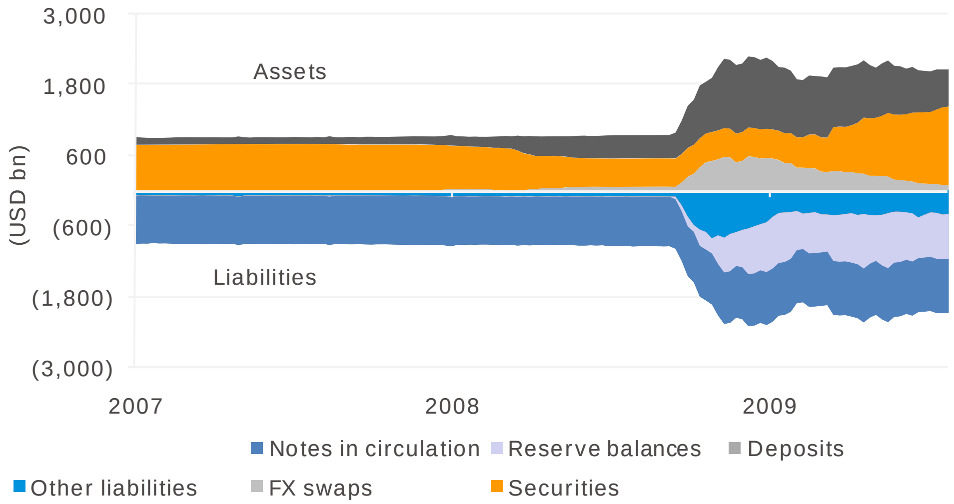


Chart 24: Fed's balance sheet expansion - Monetization & excess USD supply



Source: Federal Reserve, Bloomberg

Diversification of forex reserves across EMs to reduce USD dependence

(b) **Diminishing preference for USD as a reserve currency:** The recent past has been a time for heightened cross-currency volatility and deep-rooted uncertainties around the prospects of the US economy even over the long term. To stay insulated from such uncertainties, certain EM central banks are currently reducing their dependence on USD as a reserve currency. Most of these central banks are shifting a part of their foreign exchange reserves to gold. Since the end of September, India, Mauritius, and Sri Lanka bought more than half of ~400 tonnes of gold sold by IMF. Bank Rossii, Russia's central bank, also increased its gold holdings by 2.6% in October/November 2009. This shift of preference of central banks towards gold, often at the cost of their USD holding, will to some extent be a contributor to USD weakness in CY10.

Chart 25: Gold as % of total Forex reserves

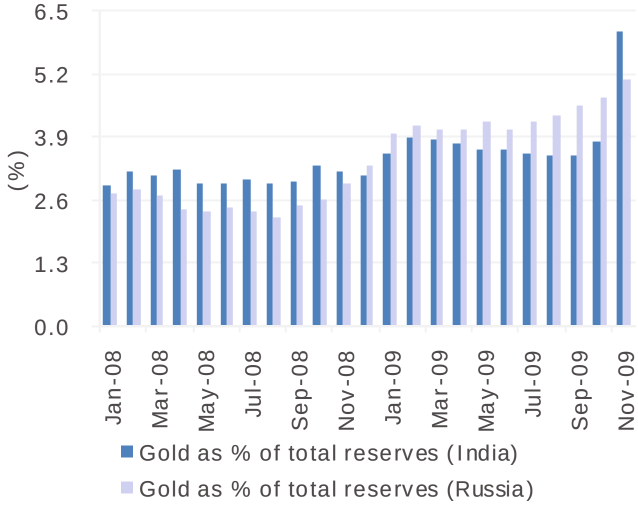
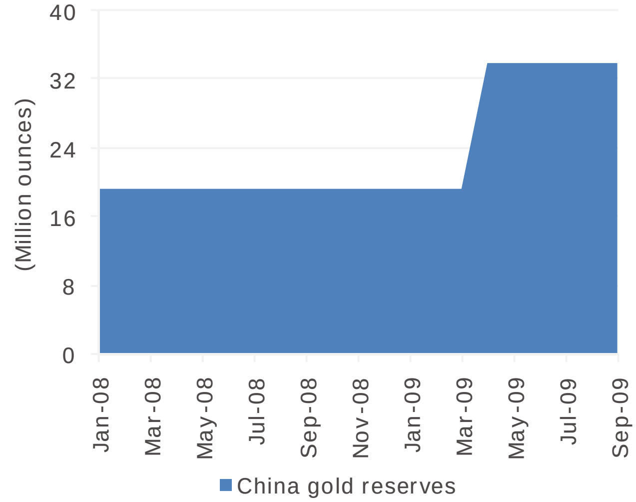


Chart 26: China Gold reserves

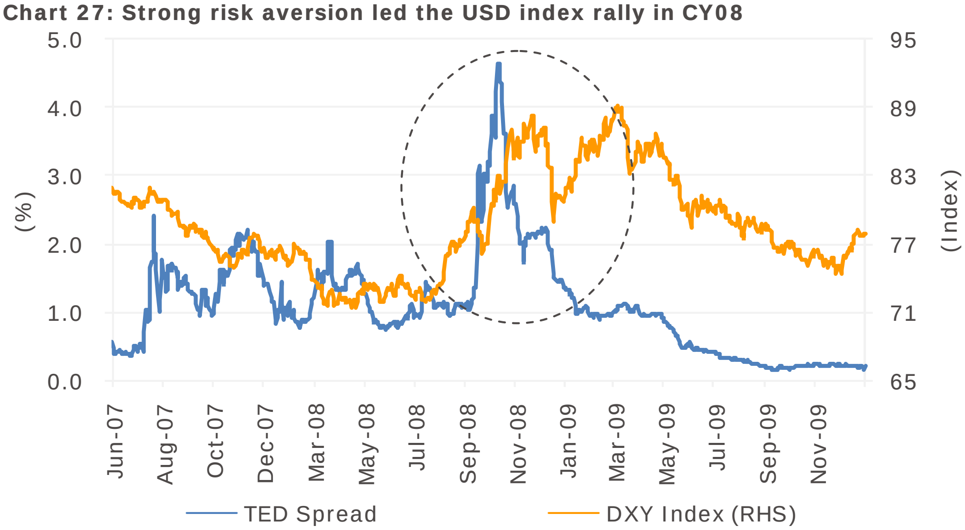


Source: Bloomberg, CEIC

Risk aversion to be kept in check; fresh "flight to safety" unlikely

(c) **Proactive policy vigil to pre-empt any further systemic risk:** The fast appreciation in USD in CY08 happened after risk appetite collapsed post Lehman bankruptcy. Heightened systemic risk across markets around that time led to strong deleveraging and flight of funds under the safe umbrella of USD. Intervention from policy authorities today is expected to be strong and all the more proactive in case there are signs of systemic risks in the financial markets (as no economy can really withstand the risk of another system level crisis). The cross-border concerns and policy intervention at the time of the recent Dubai-fiasco corroborates this hypothesis. With focused policy attention to avoid any further systemic crisis, the fear of loss of risk-appetite to the extent witnessed during Q4CY08-Q1CY09 remains absent. As a result, any sharp rally driven by a further round of flight to the safety of USD looks unlikely at the moment. This largely negates possibility of any sharp rally for USD (as was seen during the post-Lehman crisis).

Chart 27: Strong risk aversion led the USD index rally in CY08

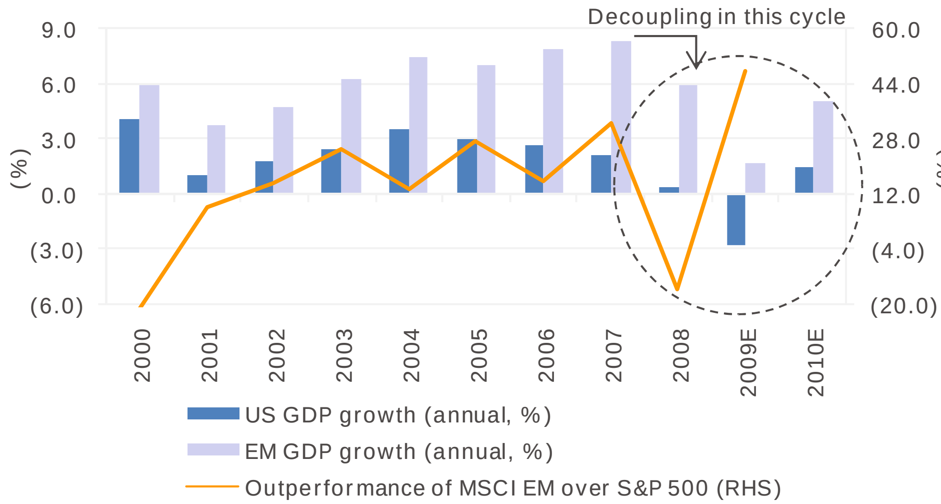


Source: Bloomberg

(d) **Decoupling of US and EM economies**: Compared with the recent past, divergence in the performance of developed and developing countries is likely to stay strong over the near term. During the early phase of the recovery in economic activities, Decoupling of US and EM economies to make assets denominated in EM currencies more attractive

EMs are actually leading the show. We expect this growth differential to sustain, which will eventually result in an increasing demand for assets denominated in EM currencies against developed country currencies (say USD). This could inflict a continued weakness-bias for certain developed country currency including USD.

Chart 28: Decoupling of US and EM economies

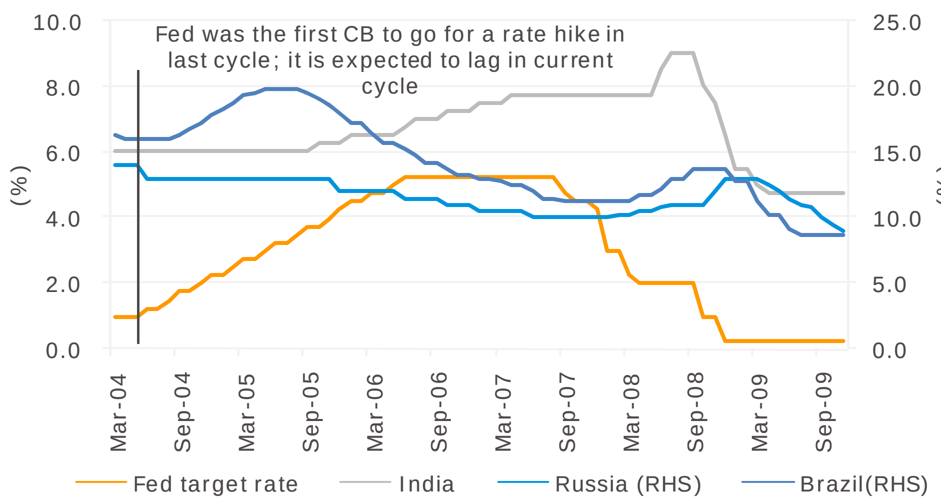


Source: Bloomberg

Continued differential in interest rates also acting as headwind for USD

(e) **Fed will be laggard in this rate hike cycle:** In the previous cycle, US' was the first central bank to raise interest rates and other banks, especially in EMs, followed. In the current cycle, however, the situation is different. With the US economy only in a nascent phase of recovery, the Fed, in our view, will be wary of a rate hike. Once some of the other economies start hiking their policy interest rates, such delayed rate hike by Fed will serve as another source of weakness for USD.

Chart 29: Fed will be a laggard in the upcoming tightening cycle



Source: Bloomberg

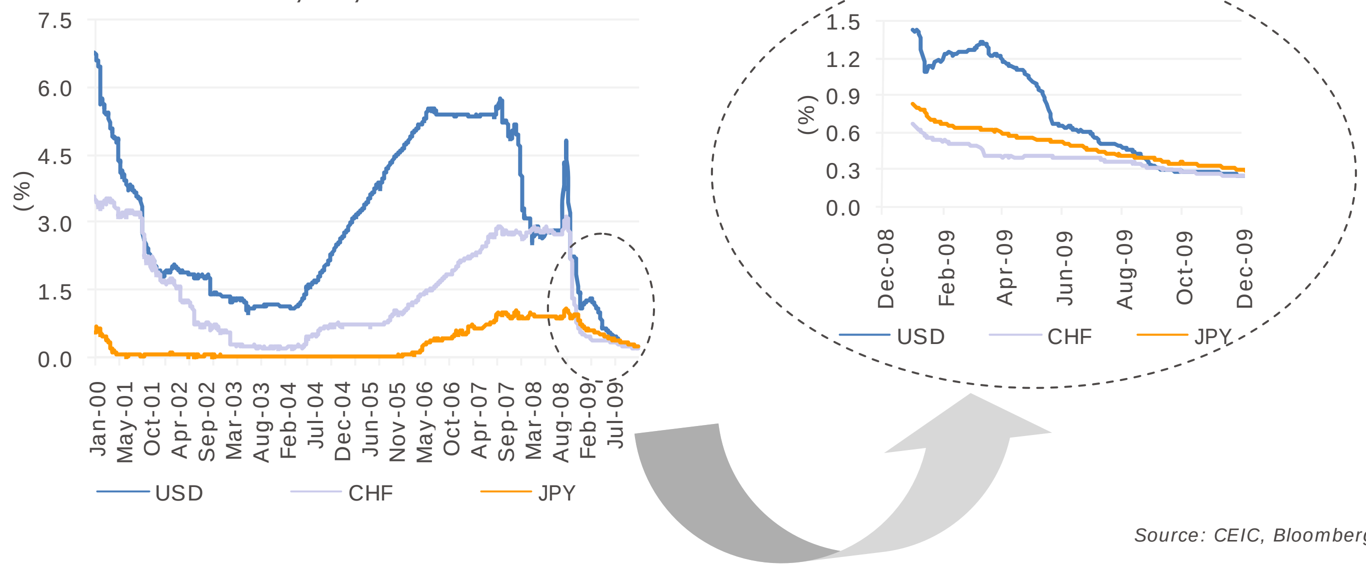
- ## Flows to favour EMs

Given the low interest rate regime in the developed world and weakness in currencies like USD, JPY or CHF (the Swiss Franc), flows to EMs remained strong for most of CY09. With continued low interest rates in Japan for most of the current decade, we have seen JPY being used for “carry trade”, particularly against currencies like AUD and NZD, which

Carry trade to continue; in JPY or CHF if not in USD

had been high-yielding and freely convertible. At the moment, with abundant liquidity in the global markets, several countires including the US, Japan, Switzerland are having exceptionally low interest rates. For example, LIBOR of developed economies' currencies (USD/JPY/CHF) are currently at record lows, making it easy to borrow at lower costs. USD LIBOR (3-month), which was at 1.13% at the beginning of the year, now stands at ~0.25%. This has generated a USD carry trade much like the Yen during the earlier part of the decade when JPY LIBOR was close to 0%. Moreover, fundamental factors for most of these economies are not favourable enough so as to expect any quick turnaround in their respective domestic currencies. Consequently, these currencies are likely to continue flowing towards EMs, where they can enjoy a better rate of return without any significant risk of cross-currency rates.

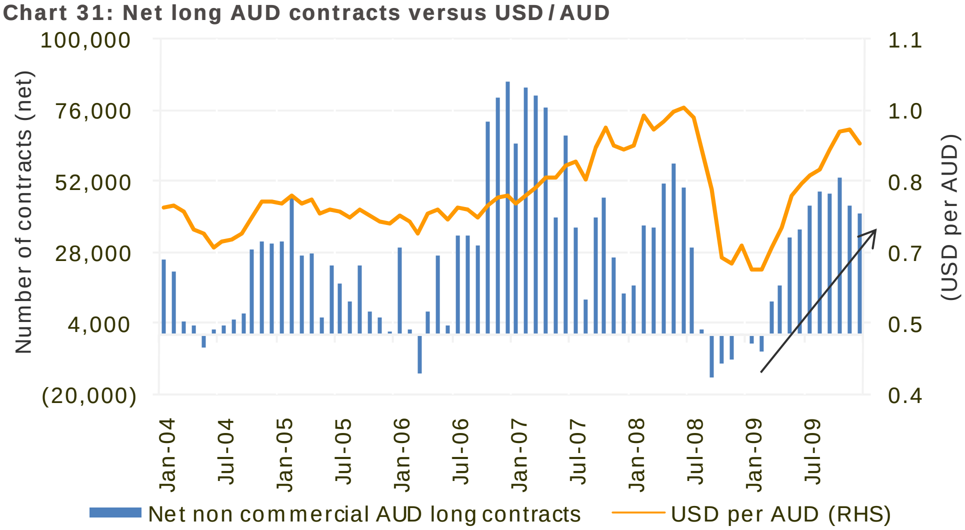
Chart 30: LIBOR for USD, JPY, and CHF at their lows



Source: CEIC, Bloomberg

Some of the beneficiaries are high yielding currencies such as AUD and NZD which have appreciated ~27% and ~24%, respectively, in CY09. Although the net longs in AUD/USD trade are below CY07 levels, they are well above their September-October 2008 lows. We believe this trend will continue and barring short-term corrections, the carry trade of high yielding currencies (AUD, NZD) will continue.

Chart 31: Net long AUD contracts versus USD / AUD



Source: Bloomberg

At the moment, after a spell of short but sharp “USD carry trade” and depreciation of the greenback, USD has staged a pullback towards the end of CY09. Such an uptick in USD has been a result of emerging possibilities of Fed adopting a rate hike by mid-CY10 on the back of better–than-expected growth recovery. We, however, believe that Fed is still far from a rate hike and the weakness in USD will continue for most of CY10 due to a host of factors discussed above. Rollback of the unconventional liquidity measures is not so significant at the moment to change the easy liquidity scenario. Thus, we do not expect any strong and sharp upside for the USD from its current level. As a result, flow of USD to EMs is likely to continue.

In case, the market verdict favours an appreciation of USD, it may weaken the “USD carry trade”, but will not put an end to flow of funds to EMs. In such a scenario, certain other developed market currency can actually be used as “carry trade” currency. JPY remains a prime contender for the same with extremely low home country interest rates, continued weakness of the currency and poor economic recovery delaying possibilities of a rate hike.

EMs to outperform developed world; India to benefit more than peers

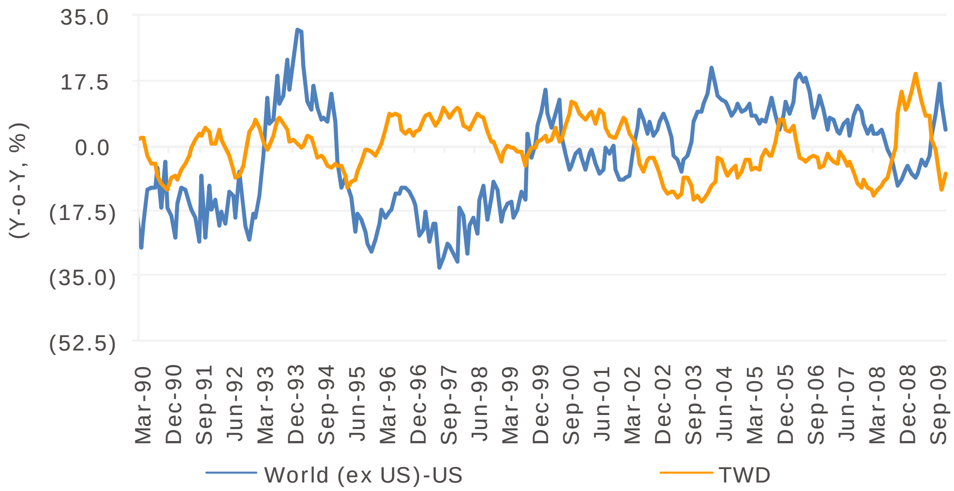
EMs are set to outperform the developed world on the back of strong capital flows. India, with strong visibility of high and stable growth, is likely to benefit more than most of its peers. India's low export dependence makes it less vulnerable to an appreciation of the domestic currency.

EMs to continue outperforming developed world

EMs to continue benefiting from increased flows

In CY09, there has been a deluge of flows into EMs. A cheaper USD and decoupling of economies have fuelled fund flows into EMs. Analysis shows that in an environment of depreciating USD, developed world (ex US) outperforms the US.

Chart 32: Relative performance of World ex-US over US

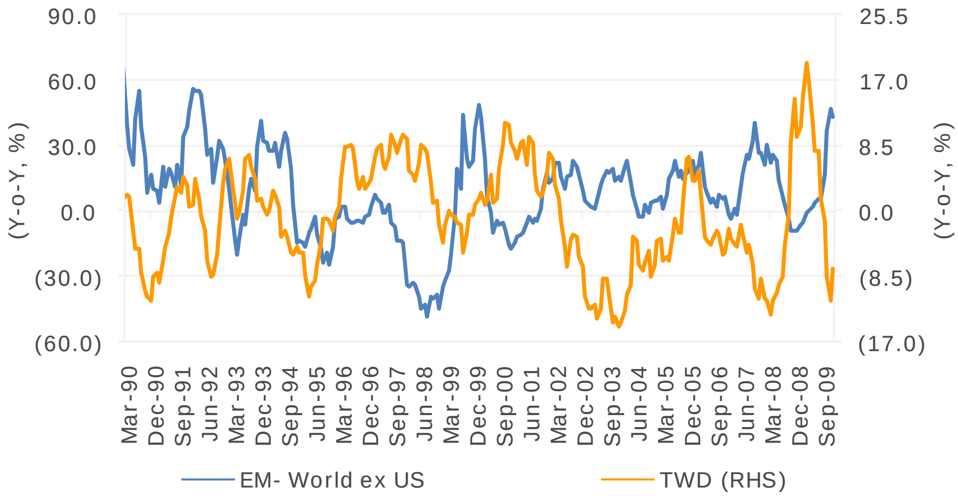


Source: Bloomberg

Note: Data pertain to MSCI index on a monthly basis

Further, among the rest of the world, EMs as an asset class have outperformed the developed world (ex-US) whenever USD has depreciated. This was true throughout the CY01-04 cycle when USD depreciated and EMs markets outperformed developed nations. There was a brief period between CY04 and CY05 when the currency appreciated and although the EM outperformance story was intact, the relative outperformance was much lower. In late-CY08 and early-CY09 when the USD appreciated, EMs underperformed the developed world (ex-US). This, we believe, happens because of the status of USD as a "safe" asset class. Every time there has been a crisis in global markets, the greenback has staged a rally as there is a flight to safety away from EM equities, which are perceived to be relatively riskier. A weakening of the USD is perhaps associated with an improved risk appetite in the global market, which is generally correlated well with better flows to EMs and an outperformance of the latter.

Chart 33: Relative performance of EM over World Ex-US



Source: Bloomberg

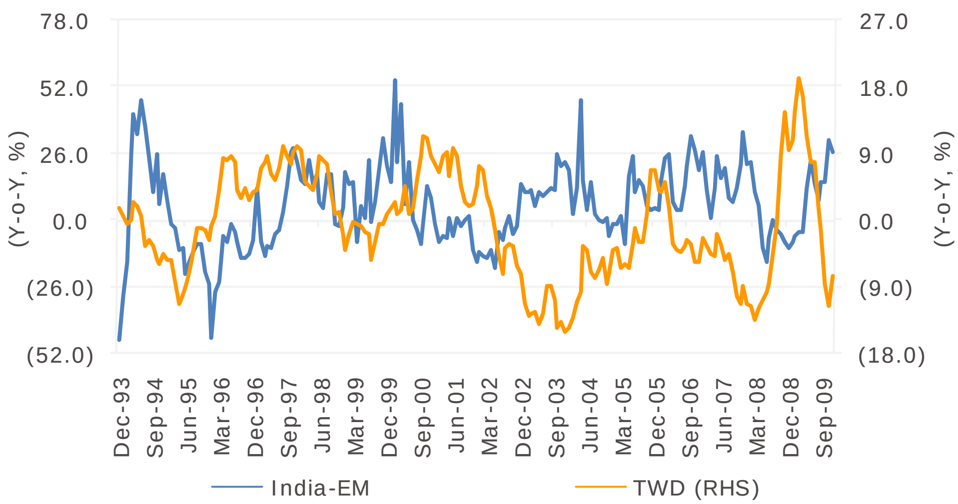
Note: Data pertain to MSCI index on a monthly basis

- India's outperformance set to be stronger

Among EMs, MSCI India has outperformed MSCI-EMs almost every time the USD has depreciated. That was the predominant theme in CY06 and CY08, and for large part of CY09. In CY09 also, MSCI-India outperformed MSCI-EM by ~23%.

USD appreciation benefits Indian equities more than other EMs

Chart 34: Relative performance of India over EM

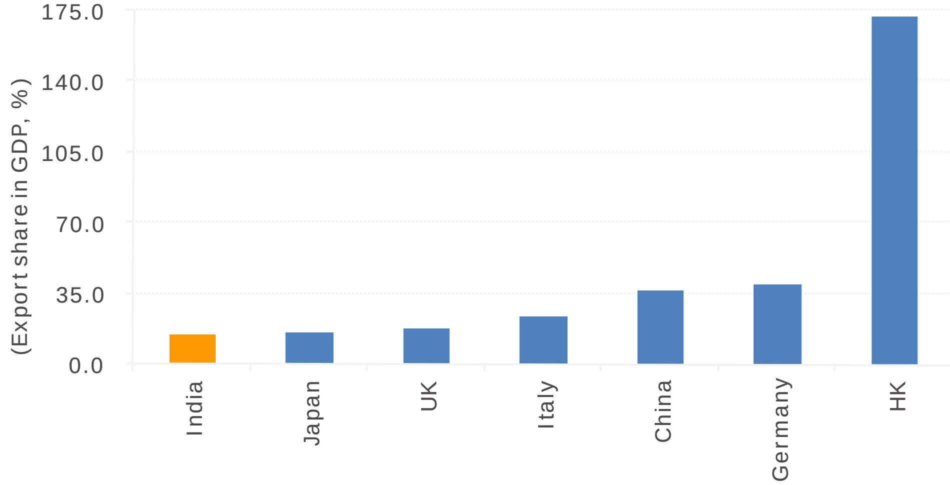


Source: Bloomberg

Data for MSCI index on a monthly basis

One of the reasons attributed to this phenomenon is the lower dependence on exports of the Indian economy compared with other Asian or EMs such as Taiwan, Korea and Singapore. Such countries, with their relatively higher share of exports, typically take a hit on the front of export-competitiveness with the appreciation of the local currency. For India, whose exports as a percentage of GDP are merely ~17%, this is not a major blow. So, when the USD weakens, export-driven economies of South-East Asia take a bigger hit than India where exports as percentage of GDP is relatively low.

Chart 35: Exports as % of GDP

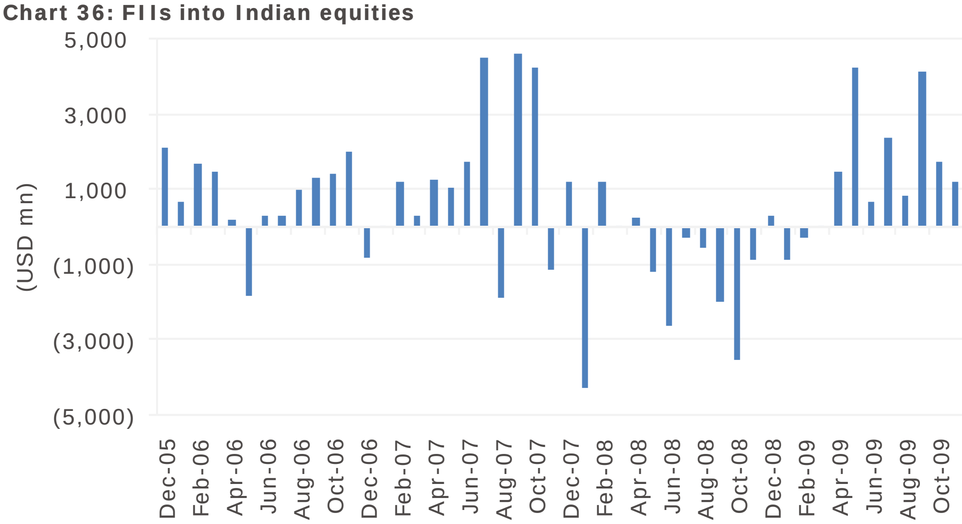


Source: Bloomberg

India's low export dependence insulates it against appreciation of local currency

As discussed in the preceding section, we believe that USD will stay weak for bulk of CY10. This will imply continued strong performance of EM equities, particularly India that is enjoying thriving domestic-focused growth and low dependence on exports. FII inflows to India, recognizing possibilities of such outperformance by Indian equities, have staged a sharp recovery (already ~USD 16 bn since March 2009). In fact, in May and September 2009, net FII flows to India were as good as they were about two years ago during the peak of the bull cycle. This is in sharp contrast to net outflows from May 2008-February 2009 (~USD 12 bn, net). With continued improvement in sentiments, we expect FII flows to remain strong throughout CY10.

Chart 36: FIIs into Indian equities



Source: Bloomberg

In India, growth is back with a bang

India has been relatively less battered in the global crisis and most indicators suggest a strong growth recovery ahead for India. The country remains largely immune to the risk of any rollback in stimulus as the same was miniscule at less than 1% of GDP (against ~15% of China), targeted largely at the lower strata of the economy - in line with the government's long-term focus of "inclusive growth". With the economy poised to re-enter a healthy growth zone, the pro-cyclicality of India's fiscal dynamics will reduce deficits considerably over FY11-12. With stability and strength in income generation, efficient use of capital, favourable demographics, India is in the early phase of a virtuous cycle of high savings, capital formation and high growth.

- India suffered markedly less during the downswing …

India's pain-share was much less compared to other EMs

We believe, India's growth recovery is clearly sustainable over both the medium and long term. India has further strengthened its standing as a key investment destination. As the global economy took a beating post the Lehman crisis, India, like the rest of the world, witnessed a knee-jerk decline in several key macro-economic indicators. However, the downslide was relatively modest in India. At the trough, while H2CY08 and H1CY09 saw several economies contracting, India continued to grow at a decent pace — the lowest level of GDP growth being ~6%. Although the manufacturing cycle witnessed a temporary setback, mostly led by an anticipation of lower demand and some setback to discretionary consumption, the rebound was quick and has sustained over several months now.

Chart 37: India's IIP stayed mostly in the positive zone

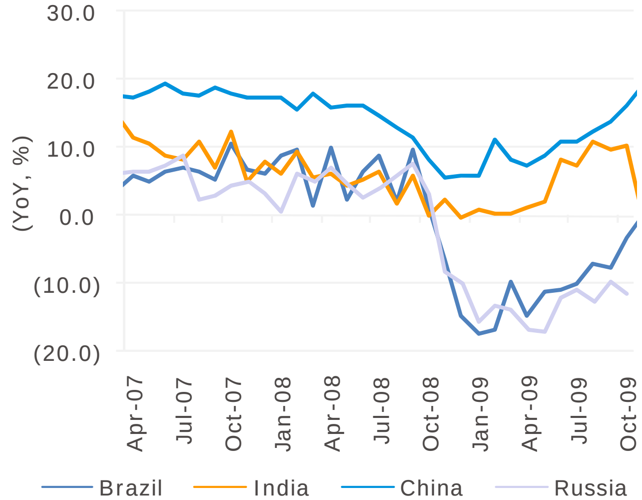
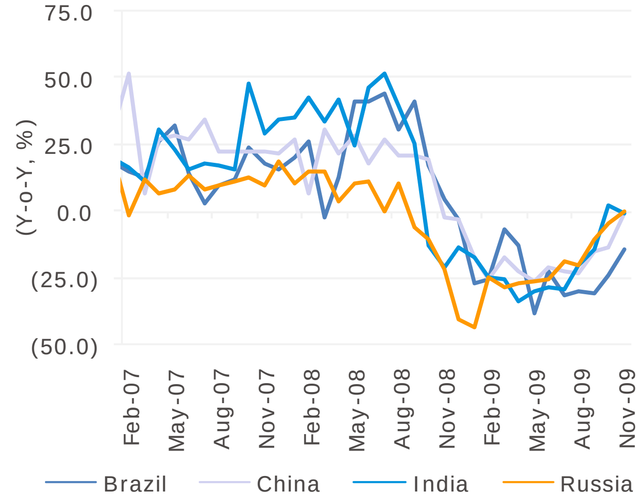


Chart 38: Exports took a hit; but recovering now



Source: Bloomberg

India and China, the only two EMs to post over 5% growth consistently

Very few countries, even EMs, could avoid at least one quarter of negative GDP growth; India, China, Indonesia, Philippines and Vietnam qualified in that category. In fact, India and China were among the only two large EMs to consistently record above 5% growth rate even at the peak of the crisis. Brazil, Russia, Taiwan and Mexico recorded negative growth rate either in the fourth quarter of CY08 or in the first quarter of CY09.

Table 3: GDP growth of various EMs

	Real gross domestic product (GDP)										
	Q107	Q207	Q307	Q407	Q108	Q208	Q308	Q408	Q109	Q209	Q309
Argentina	8.0	8.6	8.8	9.1	8.5	7.8	6.9	4.1	2.0	(0.8)	-
Brazil	5.1	6.4	6.0	6.7	6.3	6.5	7.1	0.8	(2.1)	(1.6)	(1.2)
Chile	4.7	5.5	3.6	3.6	3.4	4.6	4.6	0.2	(2.4)	(4.7)	(1.6)
China	13.0	12.6	11.5	11.2	10.6	10.1	9.0	6.8	6.1	7.9	8.9
Hong Kong*	1.1	1.7	2.0	2.1	1.0	(1.0)	(0.8)	(1.9)	(4.3)	3.5	0.4
Hungary	2.6	1.0	0.8	0.7	1.8	2.1	1.3	(2.5)	(6.7)	(7.5)	(7.2)
India	9.8	9.2	9.0	9.3	8.6	7.8	7.7	5.8	5.8	6.1	7.9
Indonesia	6.0	6.6	6.6	5.9	6.3	6.4	6.4	5.2	4.5	4.0	4.2
Mexico	3.0	3.0	3.5	3.7	2.6	2.9	1.7	(1.6)	(7.9)	(10.1)	(6.2)
Philippines	7.0	8.3	6.8	6.3	3.9	4.2	4.6	2.9	0.6	0.8	0.8
Russia	7.5	8.0	7.7	9.0	8.7	7.5	6.0	1.2	(9.8)	(10.9)	(8.9)
South Africa	6.1	3.4	5.1	5.7	2.5	5.5	1.3	(0.7)	(7.4)	(2.8)	0.9
Taiwan	4.5	5.7	7.1	6.5	6.9	5.4	(0.8)	(7.1)	(9.1)	(6.9)	(1.3)
Thailand	4.4	4.4	5.1	5.7	6.0	5.3	3.9	(4.2)	(7.1)	(4.9)	(2.8)
Vietnam	7.7	7.8	8.2	8.5	7.4	6.5	6.5	6.2	3.1	3.9	4.6

Source: Bloomberg

Growth below 0%
Between 0% and 5%
Above 5%

**Q-o-Q (annualized)*

Note:1.All date on calendar year basis,for example,Q208 indicates April-June 2008 for all countries

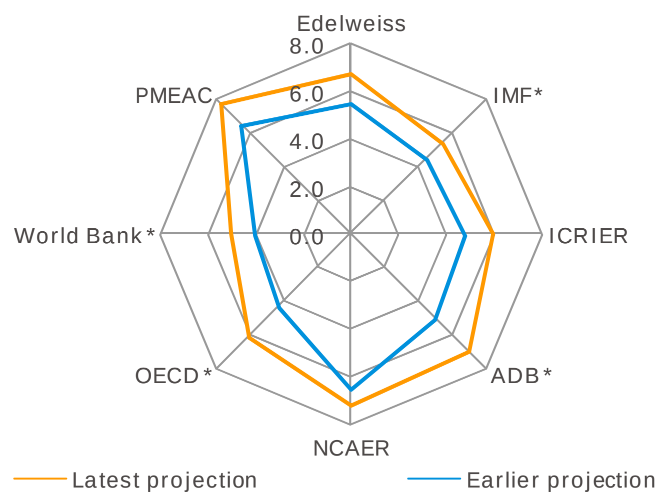
2.Data indicates Y-o-Y growth rate in % unless mentioned otherwise

- **...... and, currently at the forefront of recovery**

Growth projections for India being revised upwards aggressively

The current phase of growth recovery is being led by EMs, with India being one of the front-runners. Recovery in the Indian stock market has also been strong—MSCI India has outperformed most global indices; among major markets, only Russia and Brazil have done better on the back of rising commodity prices in H2CY09. Most multilateral agencies are currently in the process of aggressively enhancing their CY10 growth estimates for India. Most agencies feel that the large and relatively steady domestic demand from India makes it largely immune to global uncertainties. The current growth recovery in the country has largely been on the back of domestic consumption demand. No major contribution has been seen so far from investment demand or exports, which are incrementally expected to recover from the trough.

Chart 39: GDP projections for FY10 being revised upwards



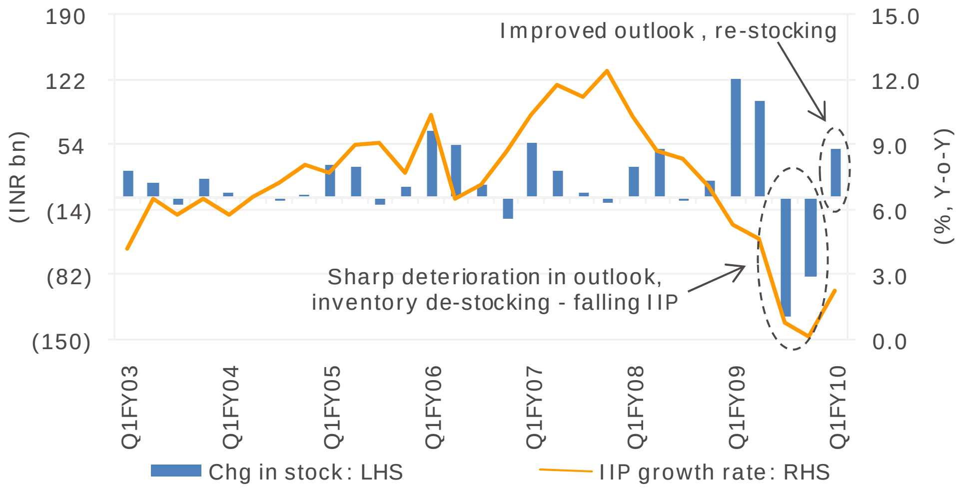
*Source: IMF, OECD, RBI, Edelweiss research   *: Pertain to CY09Note: PMEAC stands for Prime Minister's Economic Advisory Council, ADB is Asian Development Bank, NCAER is National Council for Applied Economic Research, OECD is Organisation for Economic Co-operation and Development while ICRIER is Indian Council for Research on International Economic Relations*

Sustained recovery in several lead indicators enhances confidence

Lead indicators pointing to near term uptick

Turnaround in Indian manufacturing is reflected in an improved outlook and signs of recovery. Indian manufacturing had accumulated huge inventories during H2FY09, which had led to a sharp drop in production. By March 2009, however, there was significant inventory de-stocking, which finally made room for improved production since Q1FY10.

Chart 40: Inventory re-stocking boosting production in FY10



Source: CMIE, Edelweiss research

Several other lead indicators for growth which had started improving since early FY10 have become stronger in recent months. Intermediate goods production, which was on the decline since August 2008, has turned positive since Q2CY09. Other domestic factors such as improving automobile production and growth in the infrastructure index are also pointing towards steady revival in industrial growth. November witnessed a huge turnaround in commercial vehicles production, indicating a strong pick-up in activity. Besides, the India PMI Index has stayed in the 'expansion zone' of above 50 for the eighth month in a row. With the US-ISM Index posting a steady rise since January 2009, declining Indian exports are likely to get a fillip on the back of rise in global demand.

Chart 41: India PMI–On expansion mode since April

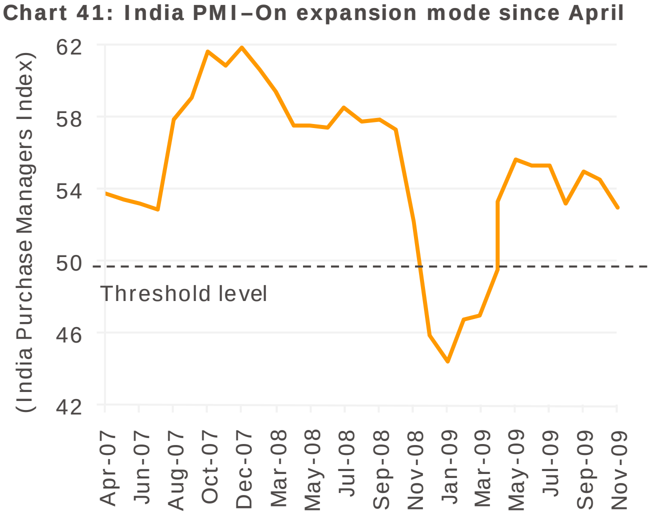
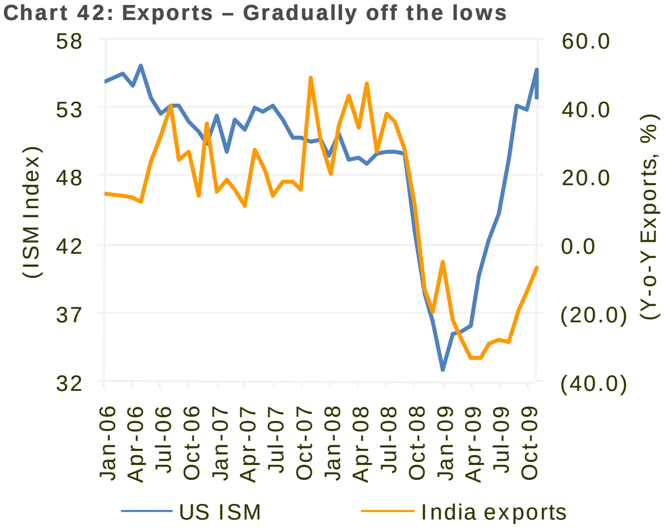
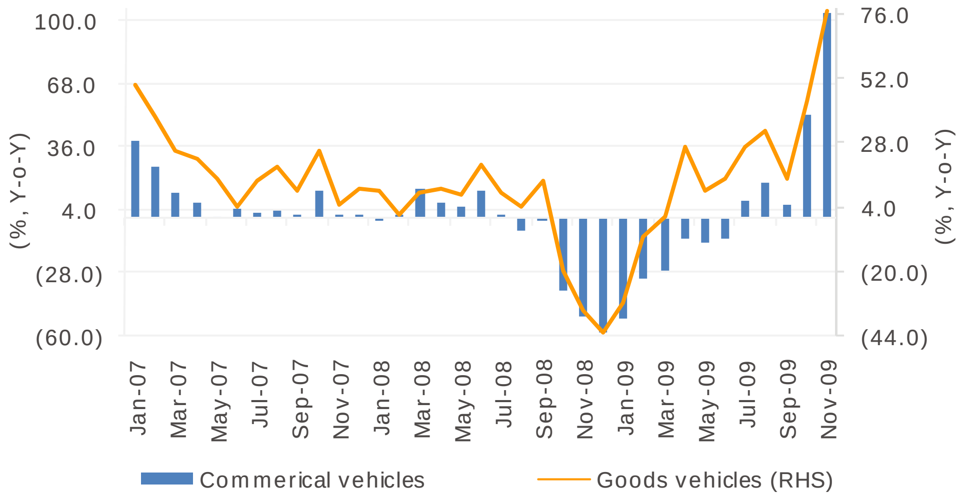


Chart 42: Exports – Gradually off the lows



Source: Bloomberg

Chart 43: Commercial vehicles production witnessing turnaround

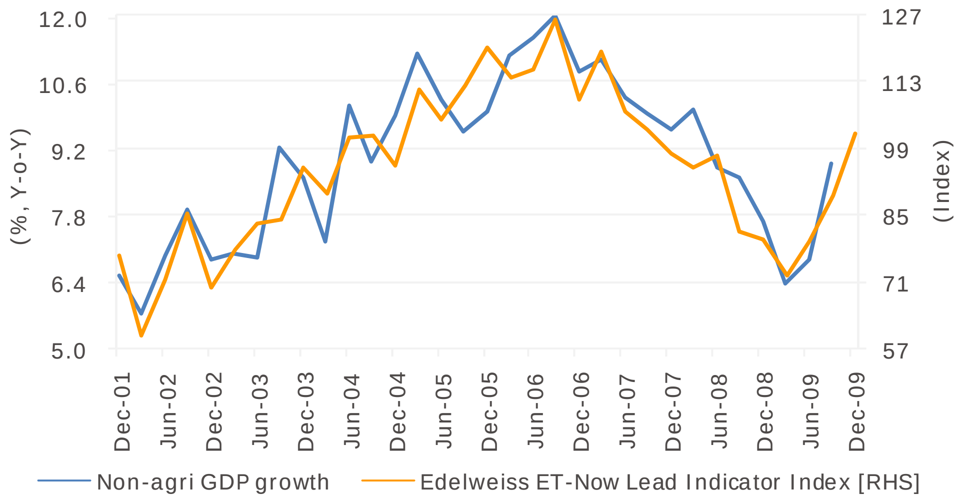


Source: CMIE

Edelweiss ET-Now Lead Indicator Index pointing to a sustained growth uptick

The Edelweiss ET-Now Lead Indicator Index (EELII), which is a composite weighted average index of a number of lead macro-variables, exhibiting strong predictive ability of core trends in the Indian economy, continues to strengthen. From a trough of ~73 in Q4FY09, EELII touched ~103 in Q3FY10, crossing the 100-mark for the first time since September 2007. A value of ~100 for EELII suggests non-agriculture GDP growth of ~9% Y-o-Y.

Chart 44: Edelweiss ET Now Lead Indicator Index crosses 100



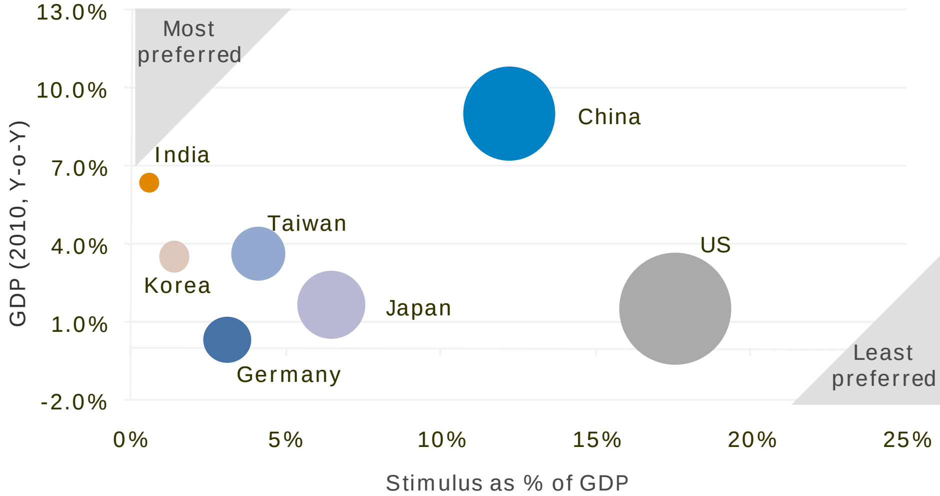
Source: CMIE, Edelweiss research

- India immune to fears of any rollback in stimulus ....

India's stimulus programme has been managed well. It focused on real areas of the economy and not on bailing out institutions, financial or non-financial. Support to the financial sector was provided through sharp monetary accommodation from the RBI. Thus, the quantum of direct fiscal stimulus had been miniscule in India compared with most developed countries. While India's stimulus package accounted for less than 1% of the GDP, countries such as Japan, China and the US announced packages worth 10% or more of their respective GDPs. Nevertheless, the whole of the fiscal boost was designed to reach the real economy, for example, excise duty reduction on productive sectors such as steel, infrastructure and exports, or encouraging demand for housing and generating rural employment.

A stimulus rollback will not have any significant impact on India

Chart 45: India's growth revival less dependent on stimulus



Source: Federal Reserve, Bloomberg, Edelweiss research

Note: 1. US data includes TARP, TALF

2 Size of bubble indicates stimulus as % of GDP

Moreover, India is least exposed to a stimulus rollback. A large chunk of stimulus packages is in fact at the grass-root level of the economy—MSPs, NREGA, etc. to generate rural employment—and gels well with the government's priority of "inclusive growth". They were implemented long before the financial crisis broke out and will continue to remain in place even when some of the more non-traditional measures such as excise cuts are done away with.

- ......, and on the threshold of large import substitution

Import substitution to play an important role in reducing the strain on fiscal balances

India is also on the threshold of better utilization of some of its natural resources and large import substitution. One such product where an increasing supply from within India could result in significant reduction on external dependency in the near term is natural gas. According to Edelweiss' Oil & Gas analysts, domestic natural gas consumption in India will be more than double by FY12E from ~98 mmscmd in FY09. Further, the increase in natural gas supply, among other benefits, will result in improving trade balance through lower imports and savings of ~USD 10 bn (~0.8% of India's GDP) from lower fuel/feedstock cost. Most of the savings will come from replacement of costly liquid fuel with natural gas. The fertilizer sector accounts for ~40% of estimated savings, most of which accrue to GoI and help reduce subsidy burden on the sector.

Table 4: Impact of increased natural gas supply on trade balance

Sector	Liquid fuels replacament MMT	Average price (USD/MT)	Value (USD bn)
Fertilizer-current import reduce to zero			4.6
Fertilizer- replacament for naptha/fuel oil	3.4	650	2.2
Power- replacament of liquid fuels	3.0	450	1.4
Refining - replacement of mostly naptha	9.4	650	6.1
Others - replacement of liquid fuels	5.7	450	2.5
Total positive trade balance (USD bn)			**16.8**
India's trade balance for Dec'09 (USD bn)			**(107.7)**
Positive impact (%)			**16.0**

Source: Edelweiss research

Table 5: Direct savings from increased natural gas supply

Sector	Value (USD bn)
Fertilizer	4.0
Power	2.1
City gas distribution	1.8
Refining	1.1
Savings to other sectors	0.6
Total savings to economy	9.7
India's CY09 GDP	1,242
% of GDP	**0.8**

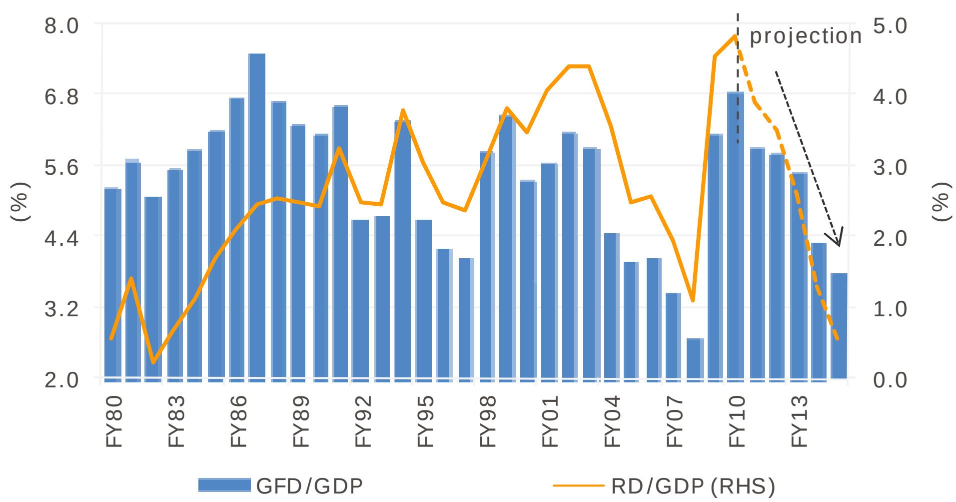
Source: Edelweiss research

■ Likely improvement in fiscal situation to free up resources for infrastructure

Improving fiscal situation to free up resources for infrastructure

India's fiscal health has been at the centre of concern in the recent past with high deficit emanating from sharp cyclical downturn in government's revenue collection and simultaneous jump in government's expenditure. Fiscal consolidation was pushed off-track with the onset of the financial crisis and need to infuse stimulus in the domestic economy. However, with likelihood of continued growth, GoI's revenue collection can improve significantly FY11 onwards. Several one-time expenses like arrears for the Pay Commission disbursements, agriculture loan waivers, election related expenses, sacrifice of tax revenue for reduction in excise tax and customs will be absent or significantly less from the next fiscal. The forthcoming union budget, in fact, is expected to chart out the path back to fiscal consolidation. In addition, the ensuing PSU divestment plans and 3G auction sales will add one-time revenues to government coffers, aiding it to reduce the deficit burden. Introduction of GST is expected to expand the tax base. Going forward, we expect the fiscal deficit to almost halve in the next five years. The resulting cut down in debt levels will reduce India's debt service commitment levels.

Chart 46: Fiscal situation set to improve over medium term



Source: Ministry of Finance, Edelweiss research

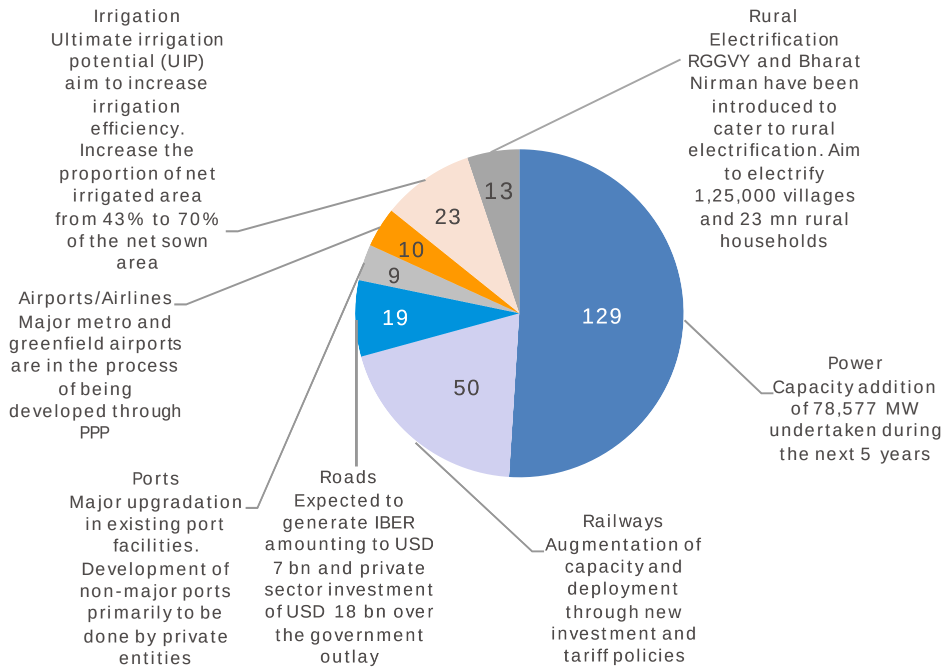
Note: Projections are indicative, RD stands for revenue deficit and GFD stands for Gross fiscal deficit

We expect reforms, particularly those focused on reducing deficit and encouraging investments, to add delta to growth. Continued focus on reform orientation will boost the economy and capital markets, going a long way towards strengthening investor belief in India's fundamentals.

Spending on infrastructure to add large delta to growth

Positive implications of a lower deficit burden for the government are manifold. Lower government borrowing will mean less crowding out of resources for industry, making credit available at reasonable rates. In fact, it gels well with the government's long-term plan to escalate expenditure towards infrastructure projects, typically with strong forward and backward linkages and often offering significant scope of generating employment. GoI aims to increase gross capital formation (GCF) in infrastructure to more than 9% of GDP by 2014 (~USD 350 bn during 2008-13). It has already had some success in attracting private investment in telecommunication, power generation, airports, ports, roads and even railways through public-private partnerships (PPP). Other initiatives such as encouraging 'takeout financing' and refinancing part of capital expenditure on large infrastructure projects are sure to make sufficient funds available to the infrastructure sector.

Chart 47: Government to spend sizeable sum on infrastructure



Source: Planning Commission of India, Edelweiss research

Note: Numbers on the pie indicate government expenditure over the 11th Plan (USD bn)

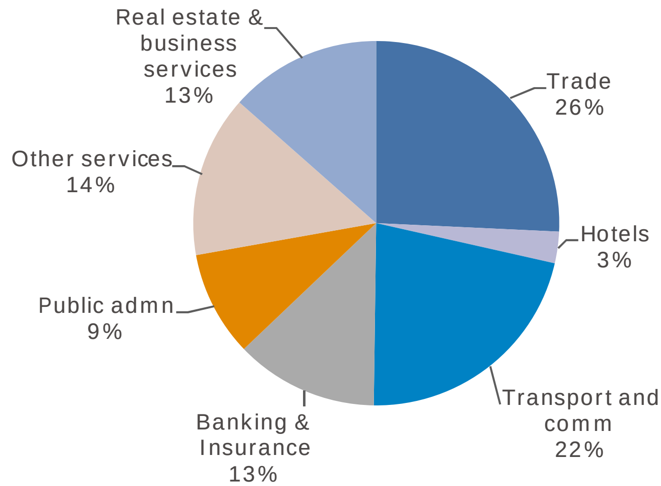
India in early phase of the virtuous cycle of high savings, capital formation, and high growth

- **Stability and efficiency adding delta to savings, capital formation and growth**

The long-term structural transformation of the economy also establishes the point of sustainability and stability of India's growth potential beyond doubt. It is widely recognized that the largest growth driver for India today is the services sector, which has a significantly higher level of productivity compared with sectors like agriculture and industry. However, a relatively less recognized corollary is the fact that this structural transformation has made India's growth much more stable and even immune to external shocks. Contrary to the perception of a large number of people, especially abroad, bulk of India's services focus on the domestic economy and enjoys a large, stable, and increasing demand base.

Services GDP, unlike the popular belief, is oriented towards domestic consumption

Chart 48: Break up of services GDP



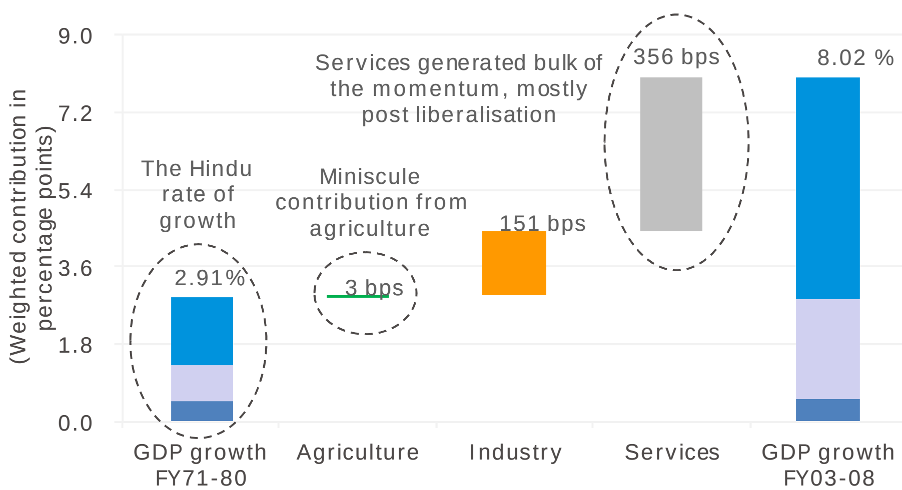
Source: RBI, Edelweiss research

Note: Data pertain to FY08; trends are similar for recent years.

In reality, ~48% of India's overall services GDP is contributed by trade, transportation and communication, which is driven largely by domestic demand. Public administration and other services, which are ~24% of the services GDP, represent spending by the government. This part is not only domestic-focused but in times of a downturn (as in FY09), can play a strong contra-cyclical role—the government actually increases spending in the economy. Only a relatively smaller percentage, ~13.5%, comes from 'real estate, ownership of dwellings and business services'. Software services, which are influenced largely by global demand, are only a sub-component of this category. Eventually, software services constitute only ~5% of services GDP or ~3% of the overall GDP, contrary to the perception that large part of India's services GDP is actually export oriented. The dominance of large domestic-driven sectors, a significant part of is actually contra-cyclical, adds to the strength and resilience of Indian services.

Majority of GDP contribution is from services, which is far less volatile

Chart 49: Contribution of various sectors to GDP



Source: RBI, Edelweiss research

Chart 50: Falling share of agriculture reducing volatility

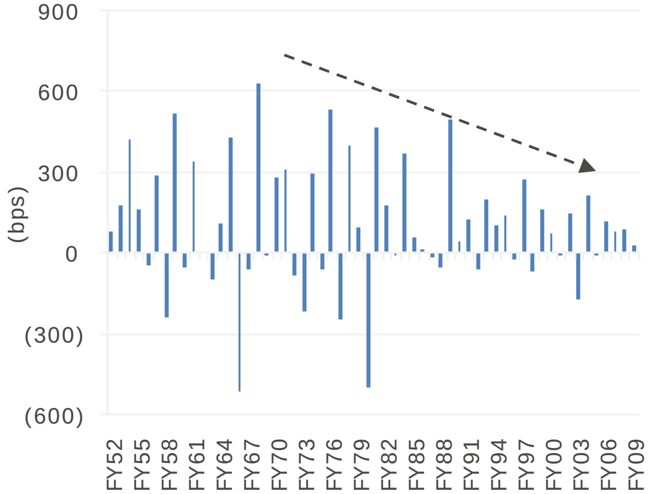
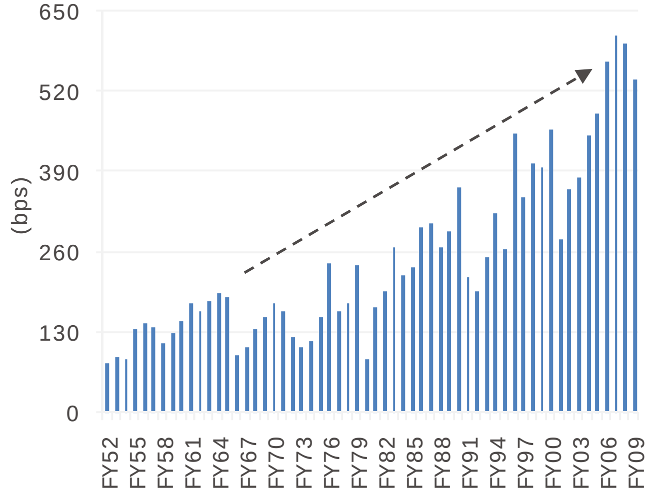


Chart 51: Services adding to stability of GDP growth



Source: RBI, Edelweiss research

Note: Data in the above two charts pertain to weighted contribution of the respective sectors to real GDP

India is far better user of incremental capital than peers

The continued shift towards better organized sectors, ongoing technological upgradation, and benefits from increasing economies of scale have turned India into an efficient user of capital; India's incremental capital output ratio (ICOR) of ~4% stands out to be better than most peers.

Table 6: ICOR of India better than those of peers

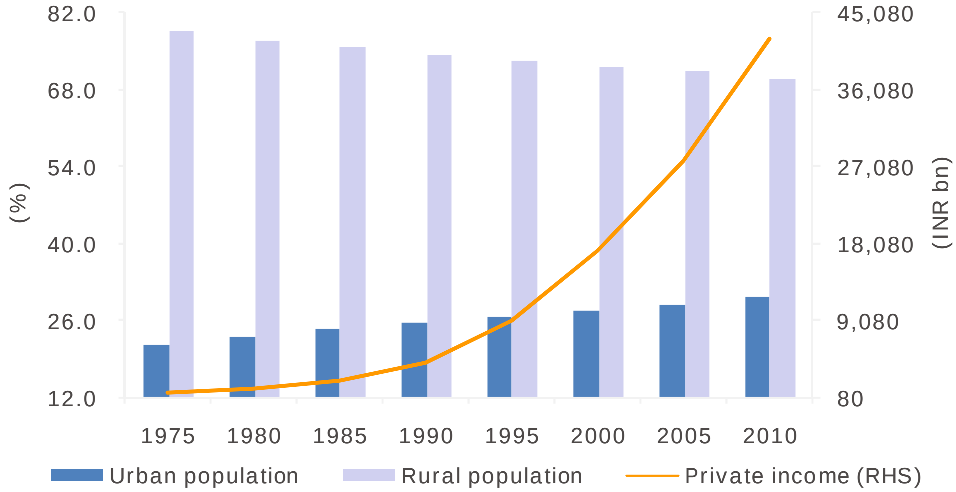
ICOR	1960s	1970s	1980s	1990s	2000-2006
Brazil	2.6	2.1	5.5	9.9	5.1
China	7.9	4.8	3.8	4.0	4.3
India	**4.3**	**6.6**	**3.6**	**4.1**	**4.0**
Indonesia	2.4	2.3	4.6	6.9	4.7
Korea	1.5	2.5	3.6	5.7	5.7
Mexico	3.8	4.1	8.8	6.0	7.6
Phillipines	3.9	4.0	10.7	8.2	4.3
South Africa	2.6	6.2	8.0	10.7	4.2
Thailand	3.4	4.2	4.1	6.9	4.5

Source: IMF, World Development Indicator (WDI), RBI

The dominance of sectors with markedly better productivity and utilization of capital as discussed above had been a big boost for India's overall income level. With widening gap in remuneration in traditional and new-generation activities and increasing opportunities in the organised sector, trends in education, skill development and urbanization are going through a phase of structural upswing, weaving a virtuous spiral for growth and income generation.

Lower dependence ratio and rapidly growing urban population long term positives for India

Chart 52: Income versus population distribution



Source: United Nations, CMIE, Edelweiss research

Such boost to income, apart from further strengthening the domestic consumption demand, is turning out to be a significant fillip for domestic savings and capital formation, adding further momentum to the growth cycle. Cross-country comparisons highlight India's strength in the arena of savings, particularly household savings. An improving dependency ratio is on India's side towards pushing household savings further up.

Chart 53: Dependency ratio

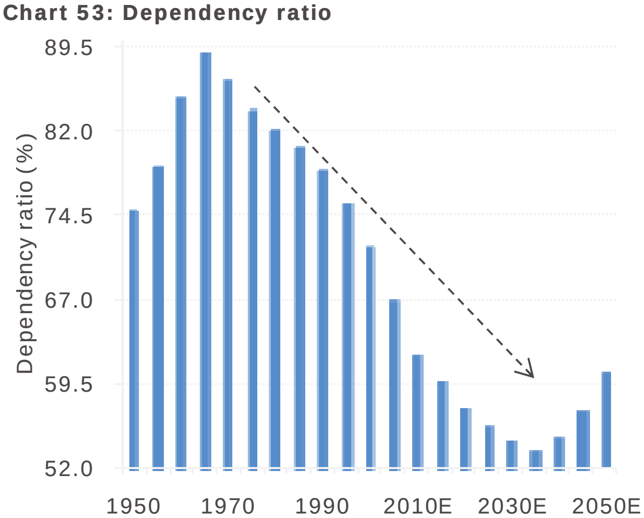
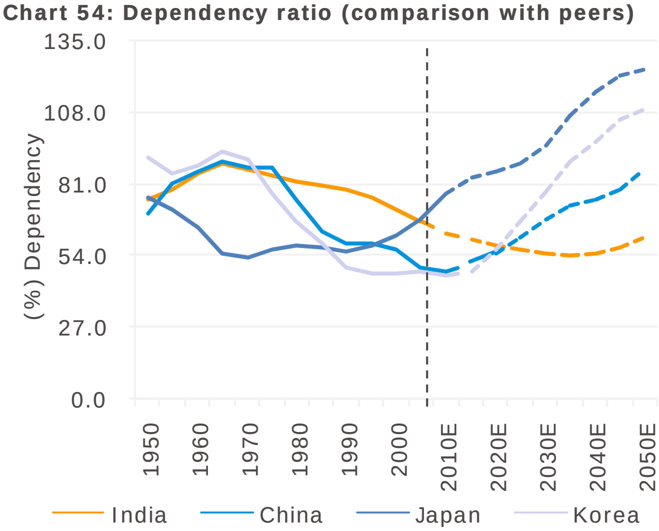


Chart 54: Dependency ratio (comparison with peers)



Source: United Nations

High inflation to be short lived; interest rate fears overdone

India's headline inflation is set to reach 8-9% by March 2010. However, the spell of high inflation is likely to be short-lived; headline inflation should return to 5-6% by mid-CY10. Monetary policy reaction is likely to be gentle and, thus, will not put any undue pressure on interest rates so as to jeopardize growth recovery.

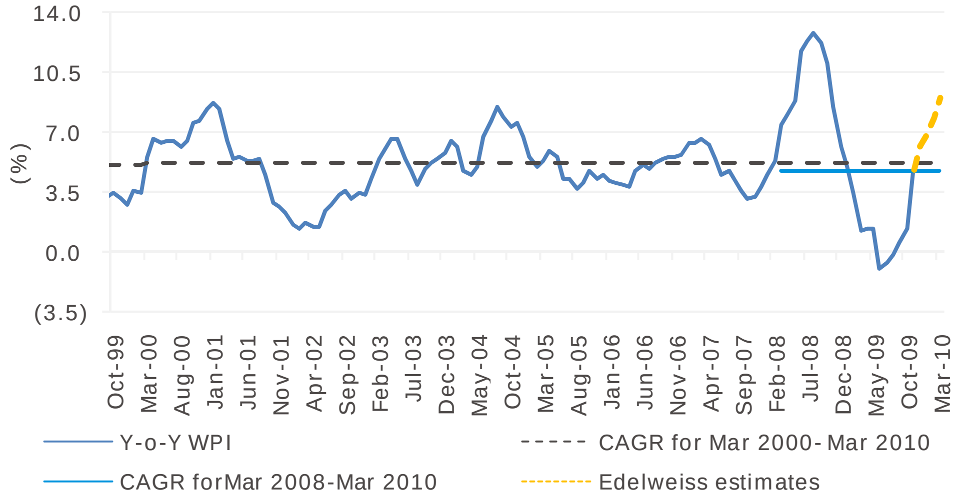
Hump in headline inflation likely to be short-lived

A large part of rise in inflation would be statistical, driven by a lower base effect

Inflation has already touched 4.8% and is expected to be in the range of 8-9% by March 2010. The market is already expecting a CRR hike, followed by a more formal interest rate hike in the early part of CY10 that is being perceived as a risk for recovery in credit offtake and economic growth.

However, we believe a large part of this inflation is just statistical as we had seen a spell of "statistical deflation" for a significant part of CY09. If we try to adjust the current (March 2010) set of inflation numbers for that dip, CAGR of WPI inflation from March 2008 to March 2010 is ~4.5%, even below long-term average of ~5.1%.

Chart 55: Large part of expected increase in inflation is statistical



Source: CMIE, Edelweiss research

A large part of this high inflation has been contributed by supply-side shocks in both domestic and global markets. Domestically, food prices are up ~18% Y-o-Y. In the global market, the recent upsurge has been driven majorly by prices of commodities like metals and fuel for which India is a complete "price-taker" in the global market. Upsurge in prices of these commodities in CY09 has often been driven by demand from developing economies like China, speculative forces and a weak dollar.

We believe that though real demand from developed economies will kick in some time next year, the speculative element of the jump in metals prices is set to be less in CY10. At least, markets will factor in a reversal of liquidity gradually after mid-CY10. Apart from speculative elements, prices of several metals had shot up in CY09 on the back of China entering into multi-year contracts. Such events are unlikely in CY10.

Chart 56: Y-o-Y spot copper prices

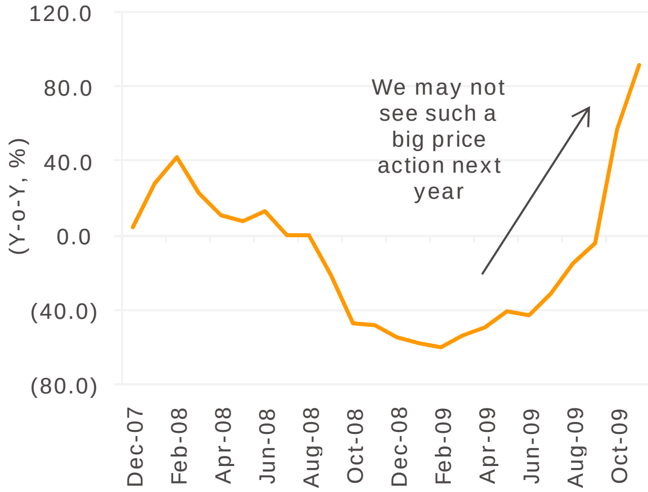
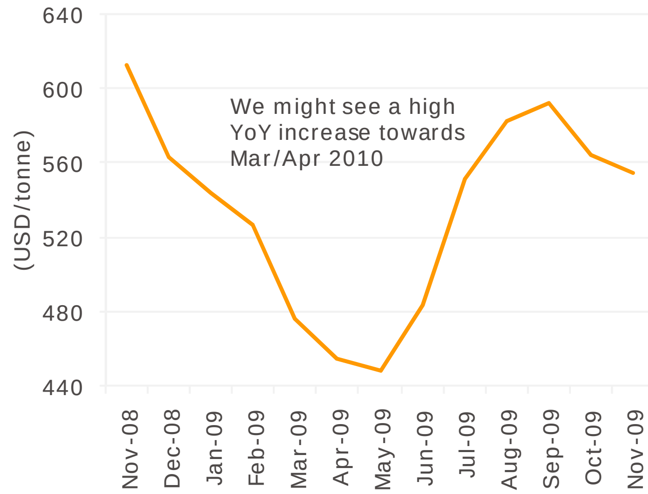


Chart 57: Steel prices (USD/MT)



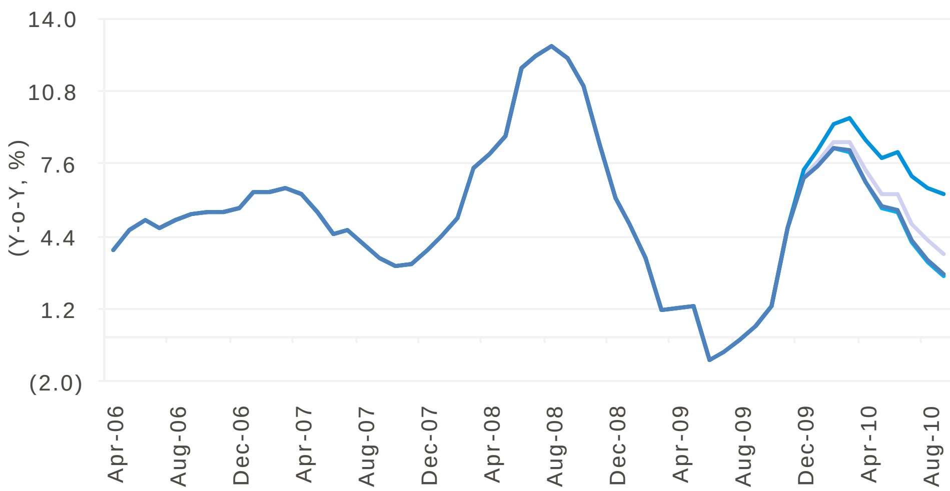
Source: Bloomberg

Note: Prices are for i) LME Spot for copper ii) Hot rolled coil price tracker for Steel

We are expecting a bell-shaped trajectory for inflation

Because of these factors, we expect only a moderate rise in prices of metals and fuel in the global market in CY10. In the current phase, surge in food prices in India has been a big driver of inflation. However, given India's high buffer stock of food grains, fundamental factors do not suggest further upsurge in food prices. Thus, the trajectory of inflation in 2010 can actually be a bell-shaped one.

Chart 58: Likely trajectory for WPI inflation



Source: Bloomberg, Edelweiss research

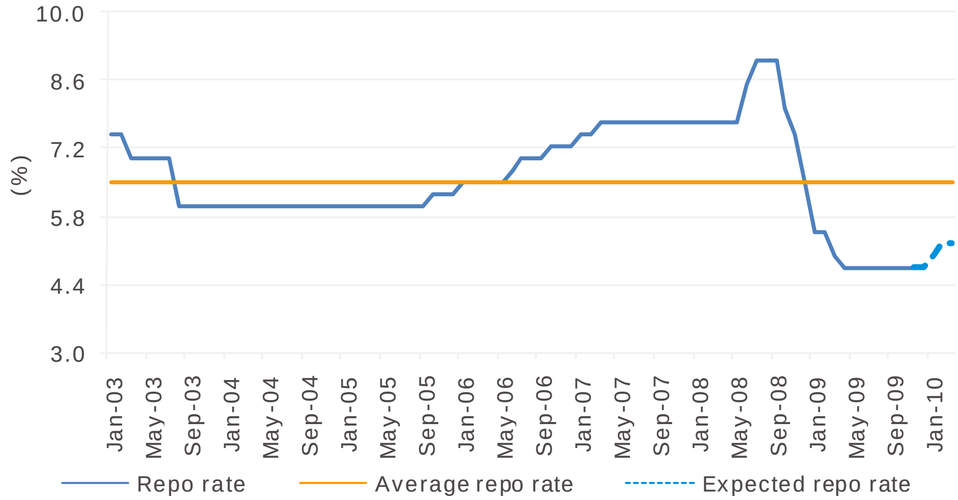
- ## Monetary policy reaction to be gentler ......

Given the continued positive surprise on the GDP and IIP fronts and rising inflation, RBI is poised to make a 'calibrated exit' from the current overtly accommodative monetary policy and will hike policy rates (repo/reverse repo rate) and/or reserve requirements (CRR) during the first quarter of CY10. However, the current inflationary pressures are largely driven by the supply side, and the resultant central bank tightening will largely act as a signaling mechanism for curbing inflation expectations. In that case, we feel that RBI will be very cautious and will hike policy rates at very small increments at a slow pace. Thus, even with the first few rounds of hike, policy rates will stay much lower than their "steady-state" levels (e.g., long-term average level of repo rate in India is ~6.0-

6.5%). A tightening by RBI at the moment will not be a shocker for the market as the same has been largely factored into expectations. Instead, a hike in policy rates will indicate RBI's confidence in robustness of the economic recovery.

Even with an expected hike, policy rates to stay below the "restrictive" zone

Chart 59: Policy interest rates far below the "steady-state" level



Source: CMIE

- ......, and not to jeopardize growth recovery

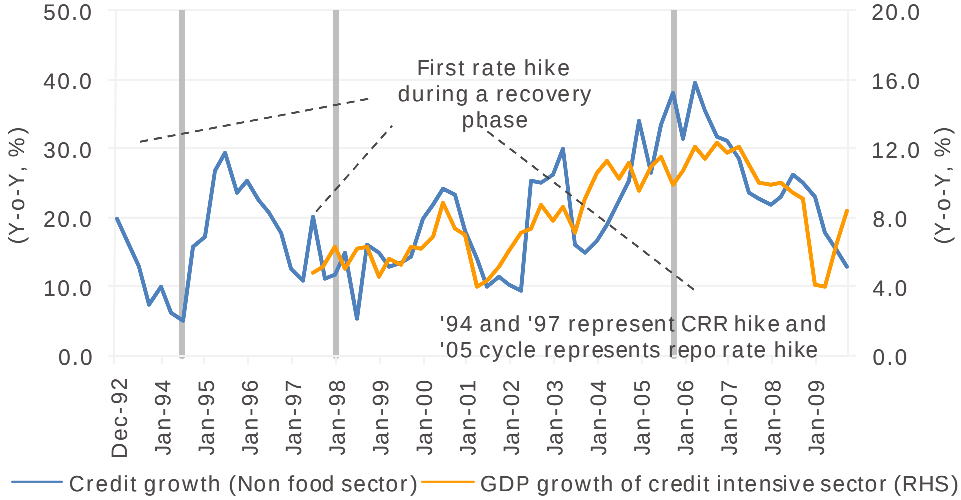
We can draw similarities from the three successive rate hikes in Australia. In December 2009, for the third month in a row, the Reserve Bank of Australia (RBA) hiked the benchmark cash rate by 25bps. Australia, like India, escaped a full fledged recession, and the third straight month of rate increase is seen as re-iteration of RBA's stance that the economic growth is on an upswing. One must note that even after the third straight month of increase, the rates are at 3.75%, which is far lower than the long-term average (~5.5%). We feel these rates are still low enough to stimulate demand.

In case of India, we have looked at June 1994, December 1997 and October 2005 when RBI had hiked benchmark rates for the first time in a recovery phase. We observed that in each of these three cycles, credit growth (defined by non-food credit) and GDP growth of credit-intensive sectors[2] (on a quarterly basis 1996 onwards) continued to increase post the first rate hike[3]. It is clear that the first rate hike during a recovery phase indicates RBI's confidence in robustness of growth recovery, and, hence, is viewed as a positive move by markets. From there on, however, it is the level of interest rates, which will decide if the growth is sustainable or not.

The first instance was in June 1994, when RBI hiked the CRR for the first time post the CY91-92 slowdown, following the balance of payments crisis. The second instance was in December 1997, post the downturn caused by the Asian crisis. The third instance was the repo rate hike in October 2005, after the tech downturn. In each of the above cycles, post the first rate hike, credit growth and GDP of credit-intensive sectors continued to remain on an upward trajectory for at least 4-5 quarters before slowing down.

[2] Manufacturing, mining, construction, electrcity & trade, hotels, and transport & communication.
[3] CRR hike in case of June 1994 and December 1997 and repo rate in case of October 2005.

Chart 60: Credit growth versus GDP growth of credit sensitive sectors



Source: CMIE, Edelweiss research

Credit growth remains decent till rates reach a "restrictive" zone, which we believe is ~6-6.5%

The trajectory of credit growth and GDP growth was different in each of the above cycles. Credit growth was seen for a lower duration post CY94 hike because CRR was already at elevated levels (14%) and a further increase caused growth rates to taper off. Similar was the case for CY05 when growth rates tapered off once repo rates were hiked to a restrictive range of ~7%. To conclude, in course of a recovery, credit growth will continue to increase until subsequent hikes make interest rates restrictive for growth. We believe that rate is ~6.0-6.5% (repo rate) for India against the current rate of 4.75%.

Valuations steeper; but, India typically enjoys premium over EMs

India is currently enjoying a valuation premium over most other EMs. Such premium for India over other EMs has, however, been the trend in the recent past. Given the strong visibility of growth, and political stability in India, we do not think there will be any de-rating in the valuation premium India is enjoying at the moment. We expect earnings estimates for FY11 will continue to grow further. Even if there is no further uptick in the multiples, Indian equities will keep moving up along with such earnings upgrade.

Indian equities costlier than peers at the moment

India's current valuations costlier than EM peers

Valuations have been a key concern among the investor community, given that India has run up ~100% since the March lows. India is currently trading at a premium to most of its peers. As shown in the table below, apart from Taiwan, India is more expensive than most EMs. MSCI India trailing PE is currently at ~21x, which is higher than the long-term average of ~17x. On a forward PE basis, India is trading at ~18x, which is higher than most peers.

Table 7: Valuation parameters of India versus EMs

Index	PE CY09E	PE CY10E	PB CY09E	ROE (%) CY09E	DY CY09E (%)
MSCI The World Index	18.4	14.3	1.9	10.1	2.5
MSCI USA	17.8	14.4	2.2	12.5	1.9
MSCI Australia	18.4	15.6	2.1	11.5	3.8
MSCI Singapore	17.6	15.3	1.8	10.4	3.1
MSCI EM (Emerging markets)	16.6	12.9	2.1	12.5	2.1
MSCI China	16.9	13.9	2.4	14.4	2.2
MSCI India	21.8	18.1	3.2	14.9	1.0
MSCI Russia	11.0	8.1	1.2	11.2	1.3
MSCI Brazil	18.2	13.8	2.3	12.7	2.4
MSCI Taiwan	27.1	16.7	2.1	7.6	2.7
MSCI India					1.0
Consumer discretionary	20.2	16.4	5.1	25.2	1.0
Consumer staples	27.3	22.8	7.8	28.6	1.9
Energy	18.1	13.9	2.6	14.2	1.0
Financials	24.2	20.8	2.7	11.0	1.0
Health care	31.2	22.4	4.4	14.3	0.7
Industrials	32.2	24.4	4.4	13.5	0.7
Information technology	23.9	21.8	6.5	27.3	1.0
Materials	16.6	13.4	2.6	15.5	0.8
Telecommunications services	10.1	13.3	1.0	9.6	0.4
Utilities	21.2	18.9	2.8	13.3	1.3

Source: Factset

Most of the run-up in prices during CY09 (up ~100% since March lows) has been led by a PE multiple expansion, while the EPS has seen only a moderate uptick. However, we don't feel that this is unique to India. MSCI-EM is also trading above its long-term average. Although India is more expensive than MSCI-EM on each of the above parameters, we feel that Indian equities are still not far from their fair value zone.

During FY10, although forward earnings estimates have moved up only ~19%, the run-up in valuations has been ~48%. The market upsurge has been more on expectations of a strong economic performance in FY11 – expansion in forward P/E has been the biggest market driver rather than any significant uptick seen already in the current EPS. The expansion in the forward PE, thus, implicitly reflects expectations of strong future earnings growth. Incrementally, market valuations are likely to hinge critically on the actual expansion in earnings over the next 2-3 quarters.

Table 8: Valuations primary driver of rally

	% change during FY10		
Sector	Price	1 Yr forward P-E	1 -Yr forward rolling EPS
Real estate	133	148.2	(6.0)
Materials	200	113.5	40.7
Industrials	118	98.7	9.5
Financials	117	65.0	31.8
Discretionary	139	78.2	34.0
IT	109	84.1	13.6
Utilities	53	43.6	6.4
Telecom	(8)	24.3	(26.4)
Healthcare	79	82.9	(2.0)
Energy	44	23.9	15.9
Staples	39	24.3	12.0
India	**76**	**48.0**	**18.7**

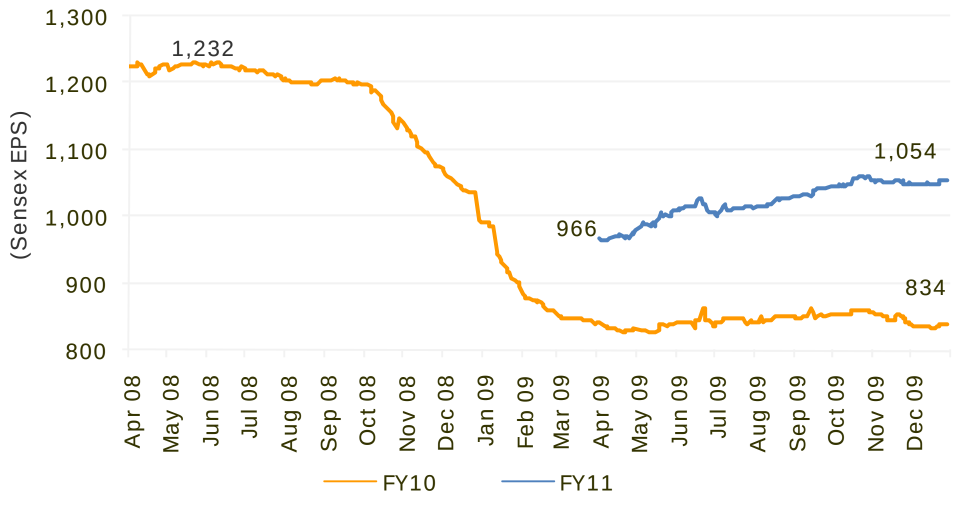
Source: Bloomberg, Edelweiss research

No de-rating of the valuation multiples expected

However, we do not feel that there could be a de-rating of India's valuation multiples in the near term. In CY04 to CY07, the recent phase of infra-led growth, forward PE got re-rated from ~12x to ~23x. We believe we are at the cusp of another virtuous growth cycle and, hence, a de-rating is not on the cards.

Meanwhile, consensus estimates for FY11 earnings for the Sensex are continuously being revised upwards. In April, estimates were at INR 966 and since then they have moved upwards by ~10%.

Chart 61: Sensex earnings revisions



Source: Bloomberg

- India has historically traded at premium to peers

There are heightened concerns over India's relative valuation, given that the country has outperformed MSCI-EM ~29% since April 2009. However, India has always traded at a premium to MSCI-EM and at current levels we are only close to the average premium for both PB and PE ratio typically enjoyed by Indian equities. We believe India's valuation premium can be attributed to certain inherent fundamental factors and going forward, India will be able to maintain this premium. India traded at a premium to other EMs in the previous cycle as well. We believe that the similar secular growth factors that were in place in CY05 will play out in CY10 also, i.e., an infra led growth story, driven by increased private and government expenditure. India could very well maintain its premium over other EMs over the next few years as well.

Chart 62: Relative NTM P/B ratio of India versus EM

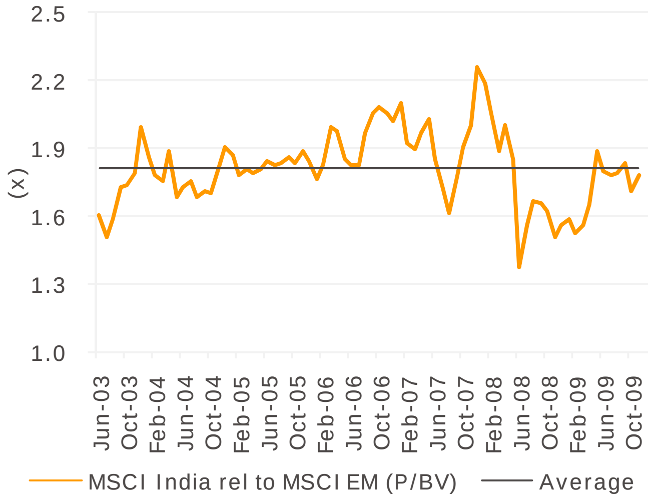
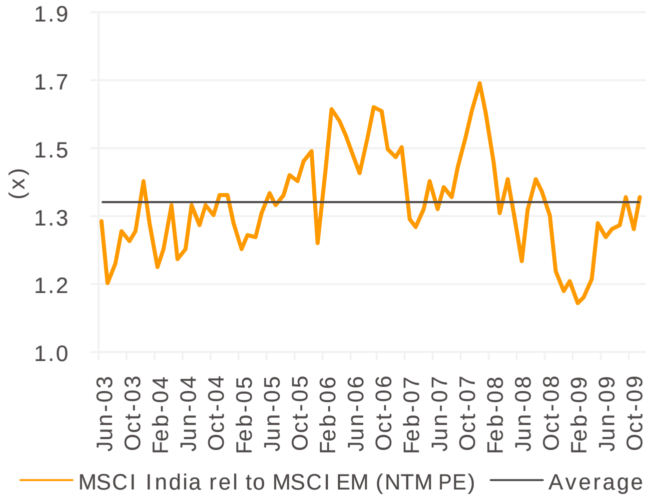


Chart 63: Relative P/E ratio of India versus EM

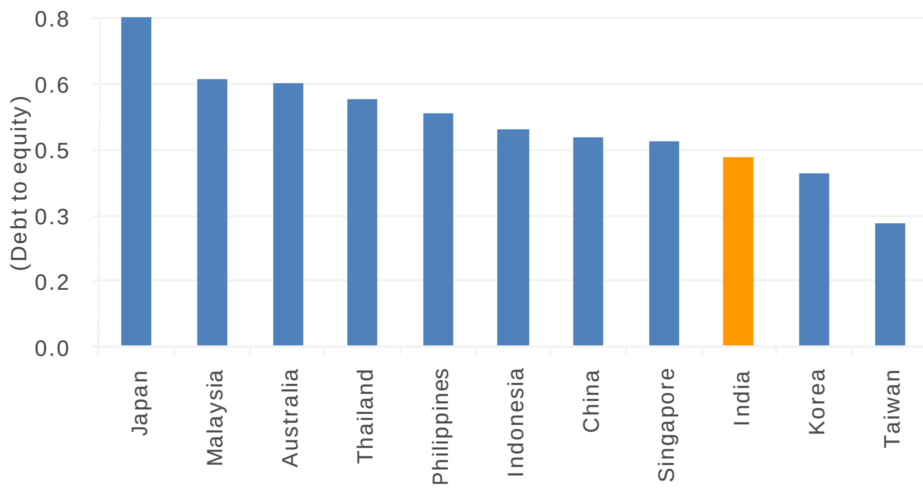


Source: Bloomberg, Edelweiss research

Note: NTM stands for "Next Twelve Months"

At the micro level, we believe, the two factors that support India's premium over other EMs are: (i) India's ROE has always been higher than that of MSCI-EM average; and (ii) Indian corporates are less leveraged than MSCI-EM average.

Chart 64: Lower leverage of India Inc



Source: CMIE, Bloomberg, Edelweiss research

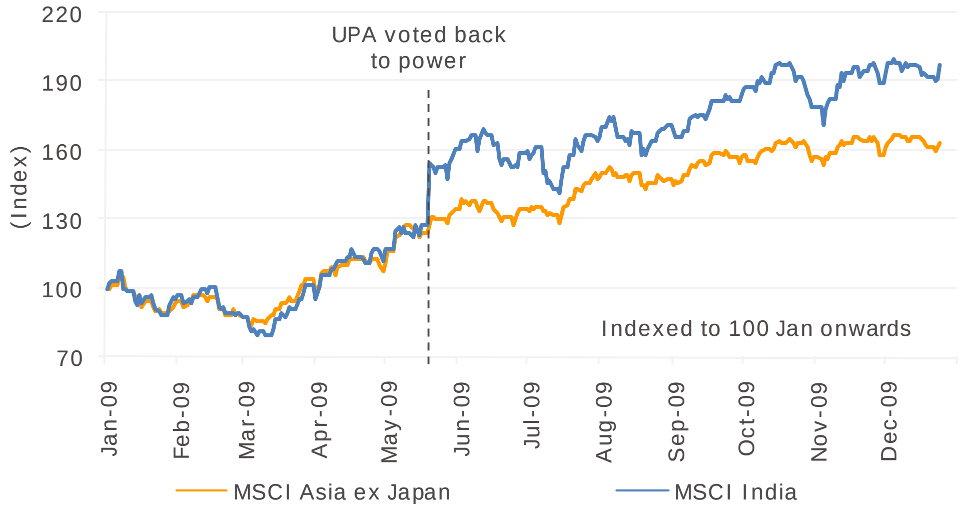
Strong visibility of growth, political stability leading to such premium

- **Visibility of growth, political stability supporting growth premium further**

  At the macro-level, India enjoys strong visibility of stable and high growth. CY09 has decisively established that a GDP growth of ~6% can be generated almost completely by India's domestic-driven sectors even if there is no tailwind from the external world.

In CY09, although sentiments for Indian equities started improving gradually March onwards, the big difference came from the May 2009 election results. Since then, India has consistently outperformed regional peers. This is because with the incumbent government back in power, there was a feeling among market participants that reforms process would be hastened. Prior to elections, there was lack of clarity as to which government would be formed and what would be the nature of the government (majority, coalition, etc). The strong UPA-led majority, which beat expectations in terms of stability, raised hopes that reforms would be continued in key sectors.

Chart 65: MSCI Asia Ex-Japan and MSCI India - Pre and post India elections



Source: Bloomberg

Key concerns: Continued supply of papers, GoI's failure to deliver, and faster-than-expected stimulus withdrawal

Continued issuance of papers by the primary market will keep diverting a part of the equity market liquidity during CY10. However, flows (FII, insurance, MFs) will be strong enough to boost the markets. Global recovery being still in the nascent stage, any further systemic uncertainty is a risk for equities, particularly for EMs.

- ## Large supply of papers, supported by strong flows into equities

Expect continued large issuance of papers

Issuances of QIPs and IPOs had been strong throughout CY09, and are likely to remain so in CY10. While the comeback of IPOs has been seen as a sign of risk appetite returning to the markets, the fact that we may see more paper issuances in CY10 could be a risk to liquidity being diverted from secondary markets. We have already seen over INR 150 bn in new issuances in CY09, and divestments and new paper issuance could act as overhang as we move into CY10.

QIPs have been very active in CY09. Significant amount of money was mobilized under QIPs in real estate (DLF, Unitech, IB Real, Sobha Developers and Unitech) and infra/industrials (GVK, HCC). The turn in market sentiments allowed some of the companies to tap liquidity. The market for QIPs is expected to remain strong through to CY10 as more companies look to cleaning up their balance sheets and/or expanding into new businesses.

On the other hand, the fiscal mismatch is increasing pressure on the government to resort to alternate sources of revenue generation, like divestments. The government has stated an indicative figure of ~USD 5 bn to be raised in each of the next five years through divestments. Some of such divestments can actually be front-loaded taking the tally for FY10 ~USD 7-8 bn.

Strong inflows to counterbalance such large issuances

Supply of papers will, thus, be strong in CY10. However, inflows to the Indian equities are also set to remain strong. We are factoring in flows of USD 30-35 bn from FIIs, insurance companies and MFs. Outflows on account of disinvestments, IPOs and QIPs are likely to be at ~USD 15 bn. This leaves ~USD 15-17 bn to be absorbed by secondary markets, which is 3-4% of the free-float market-cap of Indian markets. Overall, the inflow-outflow matrix is favourable for secondary markets even after the large primary market issuances.

Table 9: Inflow/outflow of funds into secondary markets during CY10E

Inflows (USD bn)		Outflows (USD bn)	
FIIs	15	Government disinvestments	8
Insurance companies	15	IPOs	2
Mutual funds	2	QIPs/FCCBs	5
Total	32		15

Source: Edelweiss research

In sum, large issuance of papers is currently being perceived as a risk to the markets. We, however, believe that the strong inflows into Indian equities will be enough to counterbalance such diversion of funds from the secondary markets.

- ## Government inaction

Government's failure to meet investor expectations a key risk

Another potential worry for markets during CY10 is the ability of the government to meet expectations of the investors. We have already discussed how the re-election of the UPA government acted as a catalyst for India's outperformance during CY09. Stock markets since May have rallied up in anticipation of reform programs not only being introduced, but also being implemented. Indian government's track record in implementing capital projects is often far from satisfactory. This factor will, thus, continue to be watched closely by investors, especially in case there is any negative news flow (e.g., delay in project implementation or reforms being postponed). Inaction from the government's side will dampen sentiments. As per the Eleventh Five Year Plan, the government has increased outlay for power, roads, ports and railways. This creates added pressure on execution.

Table 10: Government execution unsatisfactory in case of infra projects

(INR bn)	Outlay	Tenth Plan expenditure	Eleventh Plan outlay
Infrastructure	5,707	4,552	11,448
Power	2,702	1,793	5,548
Railways	1,290	1,150	2,150
Roads	595	426	820
Ports	30	25	360
Civil aviation	129	78	436
Oil and gas	960	1,080	2,135
Shipping	78	30	

Source: CMIE, Ministry of Power, Edelweiss research

■ The double-edged sword of global growth recovery

Trajectory of global recovery, faster-than-expected stimulus withdrawal are risks from the global arena

In the global arena, growth revival is still at a nascent state. Risk of a double-dip in developed world or the contagion effect of any fresh systemic instability (e.g. Dubai financial crisis) has not been eliminated altogether. Although India is better insulated from the direct impact of any global turmoil, largely due to its stronger local demand base, it cannot escape the knock-on effects of global downturn. In such a scenario, if the risk appetite goes down significantly once more for the EMs, India can actually underperform for a while. In recent times, MSCI India has underperformed MSCI EM as an immediate reaction whenever there is any systemic uncertainty in the global markets (e.g., CY01 and CY08). Governments, central banks and multi-lateral institutions (e.g., IMF) around the world today would focus policy attention in escaping any further systemic crisis. However, with the scars of CY08 still fresh in memory, risk appetite and preference for EMs will be tested even with the smallest sign of any systemic instability.

While a double-dip in the developed world is a risk, better–than-expected recovery in the US and some of the other economies also pose a threat. IMF currently projects US GDP to grow by ~1.5% in CY10 and EMs by ~5%. It is clear that so far India has attracted fund flows because of prospects of higher growth vis-à-vis other countries. If there is better–than-expected growth in either developed countries (e.g. the US) or EMs, we could see fund flows being diverted from India. Moreover, if performance of the global majors surprises on the upside, stimulus withdrawal could be faster than expected. In the unlikely event of such an accelerated exit, fresh uncertainty will surround EMs, including India. Thus, a rapid exit from the current accommodative stance by the Fed may also lead to curbing any extraordinary flow to EMs and a pullback for USD.

However, under normal circumstances we do not foresee a strong likelihood of such a possibility. Even if growth turns out to be somewhat better than expected, policy authorities will hold their guns and will not be aggressive in tightening. At the moment, when growth recovery is only in a nascent state, policy makers are not likely to commit a mistake on the side of aggressive tightening.

Liquidity to continue supporting Indian equities in the near-term; volatility to remain high

Traditionally, developed market equities have often swiveled between years of low and high returns. However, EMs like India – which are passing through a phase of structural upsurge in growth – have often enjoyed clusters of great equity market returns. During the five-year spell of CY03-07, except in CY04, every single year posted a return of over 40% for the Sensex.

A good year of growth in developed economies typically gets followed by a not so good year

Traditionally, developed market equities have often swiveled between years of low and high returns. In most cases, years of strong market returns have been followed by a year of relatively low return. For example, in the recent past, there is only one example of a spell of back-to-back high growth years for S&P 500 – during CY96-99, the period of the tech-boom, cluster of four years when growth was 20% or more every year. Such clusters are in fact extremely rare in the history of the US stock market. Apart from the said cluster, there had not been a single occasion when S&P 500 generated over 20% returns in two successive years since over the last 25 years. On the back of high returns in CY09 (~24%), in order to post high returns in CY10, market would have to break the trends followed in the recent past.

Chart 66: S&P 500 yearly returns

-50 to -40	-40 to -30	-30 to -20	-20 to -10	-10 to 0	0 to 10	10 to 20	20 to 30	30 to 40	40 to 50	50 to 60
							2009			
						2006	2003			
					2007	2004	1999			
					2005	1988	1998			
					1994	1986	1996			
				2000	1993	1979	1983			
				1990	1992	1972	1982			
				1981	1987	1971	1976	1997		
				1977	1984	1968	1967	1995		
				1969	1978	1965	1963	1991		
				1962	1970	1964	1961	1989		
				1953	1960	1959	1951	1985		
				1946	1956	1952	1943	1980		
			2001	1940	1948	1949	1942	1975		
			1973	1939	1947	1944	1925	1955		
			1966	1934	1923	1926	1924	1950		
			1957	1932	1916	1921	1922	1945		
		2002	1941	1929	1912	1919	1915	1938		
		1974	1920	1914	1911	1918	1909	1936	1958	
	2008	1930	1917	1913	1906	1905	1901	1927	1935	1954
1931	1937	1907	1910	1903	1902	1904	1900	1908	1928	1933

Source: The Economist, S&P, Edelweiss research

However, for India, years of high return can come in clusters

While such back-to-back high growth years are rare in matured markets, EMs like India – which is passing through a phase of structural upsurge in growth – enjoys a markedly different situation. Years of high equity market returns are not necessarily followed by periods of slow or sluggish growth. For example, even as late as during CY05-07, BSE Sensex generated returns in the range of 40-50% in every single year for three successive years. During the five-year spell of CY03-07, except in CY04, every single year posted a profit of over 40% for the Sensex. More of such growth clusters of 3-4 years are also available in the recent history of the Sensex (CY90-93 – over 28% return each single year).

Chart 67: Yearly Sensex returns

									2009
									2003
									1999
				2002	2004				1988
		2001		1984	1997			2007	1991
	2000	1998	1996	1983	1994		1992	2006	1985
2008	1995	1987	1986	1982	1989	1993	1990	2005	1981
-30 to -60	-30 to -20	-20 to -10	-10 to 0	0 to 10	10 to 20	20 to 30	30 to 40	40 to 50	>50

Source: Bloomberg, Edelweiss research

Volatility to remain high; sector leadership could keep changing

In the context of such an analysis, if CY09 looks comparable with CY03, it makes sense to revisit the experience of CY04 or CY05. During that period, while markets at large were enjoying the benefits of the early days of the one of the strongest bull cycles of Indian equities, volatility across sectors was very high during this phase with sector leadership changing hands frequently. For example, during CY04 sector leadership in the Indian markets kept changing in every single month. Similarly, even during CY09, we have seen very high degree of volatility with frequent change in sector leadership.

Table 11: Sector performance in CY'04 (MSCI India)

2004	Discretio-nary	Staples	Energy	Financials	Health-care	Industrials	Tech	Materials	Telecom	Utilities
Jan	1	6	5	3	7	2	9	10	4	8
Feb	4	6	5	8	9	1	7	3	2	10
Mar	6	10	4	2	9	3	7	8	5	1
Apr	7	10	8	6	1	4	2	9	3	5
May	4	3	8	6	2	7	1	5	9	10
Jun	6	8	7	9	10	4	2	5	1	3
Jul	8	10	3	5	6	7	4	2	9	1
Aug	5	6	8	7	4	3	2	1	10	9
Sep	10	4	8	6	1	9	5	3	2	7
Oct	7	8	3	2	6	4	1	10	9	5
Nov	6	3	10	2	9	8	4	7	1	5
Dec	4	8	7	6	3	1	9	2	10	5

Source: Factset, Edelweiss research

We are bullish; want to play the India growth story via asset creation and domestic consumption

India looks attractive as an investment destination. However, given the current valuations, which are enjoying a premium over EMs, investors will keep spotting value. A proactive bottom-up stock selection will hold the key in CY10. We are bullish on the asset creation and domestic consumption cycle in India.

Given India's strong growth outlook, long-term investment in Indian equities is likely to remain attractive. However, overall market valuations are not cheap. In such a scenario, investors will keep spotting value in some of the relatively less-known pockets. This may inflict continuous change in sector leadership and volatility in markets. In that case, a proactive bottom-up stock selection will hold the key in CY10.

We are bullish on asset creators, asset enablers, financials and sectors leveraged to consumption

We are bullish on the asset creation and domestic consumption cycle in India. Just as in CY04-05, we believe we are at the beginning of a cycle which will be led by asset creation and strong consumption. We prefer sectors leveraged to the virtuous cycle of asset creation and end-consumption.

The government has already allocated INR 11.5 tn for infrastructure development in the Eleventh Five Year Plan. We expect continued investments in building infrastructure facilities such as roads, power, railways, and ports once the central government's fiscal situation starts improving from FY11. These investments, we believe, will lead to wealth creation for three different sectors:

- Those leveraged to asset creation, asset ownership and asset enablers (e.g., infra and industrial companies).
- Those leveraged to end-consumption (e.g., retail and auto).
- Those that are intermediaries and benefit from the above (e.g., financials).

Asset owners, asset creators and asset enablers: Asset owners are companies owning ports, airports and power plants. As infrastructure building is undertaken across the country, asset creators stand to benefit. The opportunity lies not only in building new assets (e.g., national highways), but also in ramping up and replacing existing assets (e.g., airports). Especially, with the thrust on public private partnership (PPP) in building resources (e.g., airports, ports), there will be strong investment among private players as well.

Asset enablers are companies which will assist creators in ramping up facilities and maintaining them. Asset enablers have a higher yield than asset owners. As the asset cycle matures and capacity building ramps up across sectors, we will see an increased yield accruing from these assets.

End consumers: Consumerism is another theme that we are bullish on. The economy is in a virtuous cycle of growth and income generation. With consumption following an up-cycle, we remain bullish on consumer discretionary (auto, media and retail) stocks. We like stocks with strong linkage to consumption, strong distribution network, pricing power and scalability across the country.

Financials: The main catalyst behind the growth in asset creation and increasing consumption is banking and financial services. We prefer institutions present across the entire range of corporate and consumer banking services.

Top picks

In the selection of specific stocks within each of the above themes, we have focused on those which have scalability, execution skills and strong management. We believe we are entering a phase of rapid growth and, hence, it is imperative that companies which can scale up significantly without building in overcapacities (as seen in the previous cycle) lead this growth. Accordingly, our selection is based on the bottom-up approach and strong focus on quality.

Table 12: Top picks

	Price (INR)	Market cap (USD mn)		EPS (INR)	P/E	PB	ROE (%)	Div yield (%)
ICICI Bank	880	21,012	FY10	34.5	25.5	1.9	7.5	1.4
			FY11	42.3	20.8	1.8	8.7	1.5
Tata Steel	622	11,826	FY10	20.2	30.8	1.6	5.2	1.7
			FY11	69.9	8.9	1.5	16.9	2.4
Reliance Infra	1,132	5,463	FY10	65.8	17.2	1.9	11.0	0.9
			FY11	67.0	16.9	1.8	10.7	1.0
ABB India	763	3,462	FY10	19.2	39.7	6.5	16.4	0.3
			FY11	26.9	28.4	5.4	19.0	0.3
Thermax	610	1,558	FY10	23.0	26.5	6.1	23.0	0.8
			FY11	31.6	19.3	4.8	24.9	0.8
Aban Offshore	1,242	1,156	FY10	172.5	7.2	2.3	31.9	0.3
			FY11	258.8	4.8	1.6	33.3	0.3
Aurobindo	910	1,053	FY10	90.1	10.1	2.8	27.7	0.6
			FY11	118.2	7.7	2.2	28.6	0.7
Havell's India	530	684	FY10	11.0	48.1	6.3	13.0	0.2
			FY11	31.0	17.1	4.3	25.0	0.3
Orbit Corporation	308	350	FY10	22.6	13.6	2.0	14.7	0.7
			FY11	31.8	9.7	1.7	17.5	0.9
Escorts India	130	260	FY10	14.0	9.3	0.8	9.4	0.0
			FY11	16.1	8.1	0.8	9.8	0.0

Source: Bloomberg, Edelweiss research

Note: Data updated as on December 29, 2009

Sector view

At the sector level, we are overweight on BFSI, industrials, real estate, and consumer discretionary (auto, media and retail), and underweight on IT, telecom, utilities, consumer staples, and cement.

Table 13: Sector view

Sector	View	Key positive	Risks
BFSI	↑	Higher credit, lower NPAs with economic	Higher government borrowing may push yields up
		Improved capital market activities	A likely rate hike in early part of 2010
		Expectation of reforms in insurance and	
Industrials	↑	Push to infra spending in 2010	Execution challenges
		Strong demand for infrastructure	Rising input costs
Real estate	↑	Improvement in job and income outlook	High-ticket demand may take some time to revive
		Improved equity capital availability	
		Government encouraging low-cost housing	Some players still facing liquidity issues
			Relatively hawkish stance of RBI towards the sector
Discretionary (Auto, Media, Retail)	↑	Faster than expected recovery driving	Possibility of rollback of excise duty exemption
		Improvement in financing	Possibility of a rate hike in early 2010
		Favourable demographics, rapid urbanisation	Uncertainty regarding FDI in retail sector
Metals	↔	Turnaround in non-ferrous prices	Increase in input costs
		Selective volume expansion plays	Policy uncertainty around import and excise duty
		Most Indian players are integrated	Delay in capacities coming on stream
		India among lowest cost producers	
Energy	↔	Increase in natural gas output	Risk of higher under-recoveries
		Increase in E&P activity	
Healthcare	↔	Defensive play during US slowdown	Risks from molecule failures and litigations
		Resilient demand	Valuations at premium to markets
		Contracts with big pharma companies	
Telecom	↓	Resilient consumption demand	Increasing competition putting pressure on margins
		Likely increase in non voice tariffs for integrated operators	New growth mostly from rural areas leading to declining ARPUs
			Upcoming 3G auction and MNP introduction
Cement	↓	Push to infra spending with stronger govt. in	Overcapacity
			Slowdown in key markets in North, West and South
Utilities	↓	Push to infra spending with stronger govt. in	Execution challenges
		Under capacity - explained by power deficit	Reosurce availaibility (fuel, water, land)
		PPP to speed up the pace of expansion	High valuations
		Fixed return on equity, so resilient cash flows	
IT	↓	High cash in books and near zero leverage	Possible US protectionism
		Direct play on global recovery	INR appreciation; leading to long term margin risk
Staples	↓	Cost containment themes become centrestage during and post recession	Risk of down-trading
		Relatively resilient consumption demand	Inflation in key raw materials like palm oil
		Strong management in key players	High valuations
		High dividend yield	

Source: Edelweiss research

Model portfolio

Presented below is our model portfolio. The model portfolio is designed specifically for a time frame of around three months (Q1CY10) and, thus, may be in variance of the stocks selected as our top picks.

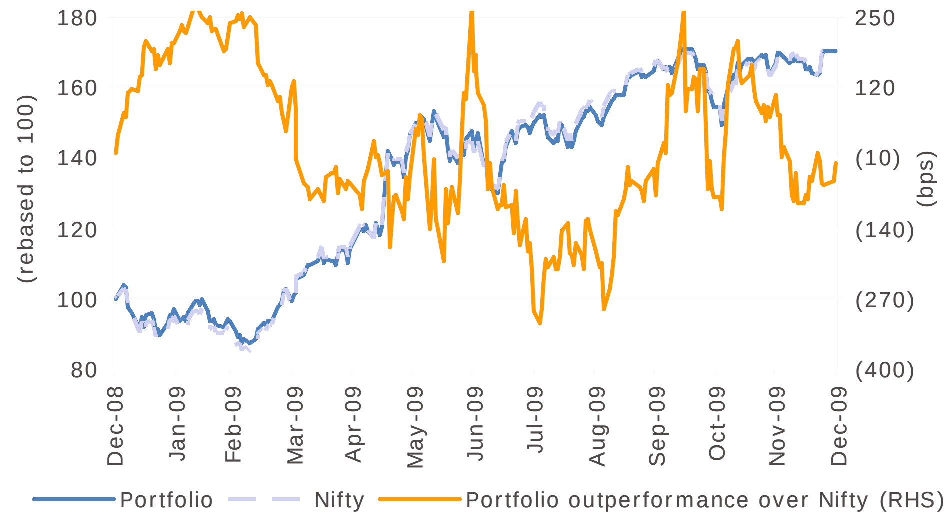
Performance of the Edelweiss model portfolio vis-à-vis the Nifty since January 2009 is also given below. The Edelweiss model portfolio return, on a point-to-point basis, has largely been in line with Nifty returns in CY09 (till December 30, 2009).

Table 14: Model portfolio

Stocks	Mkt Cap (USD bn)	Price (INR)	Portfolio wt %	Nifty wt %	Rel wt bps	P/E FY10E	P/E FY11E	P/B FY10E	RoE FY10E	Div Yld FY10E	Beta 2yr
Industrials			**13.9**	**11.1**	**283**						
Larsen & Toubro Ltd	22	1,684	6.1	7.0	(88)	28.2	23.2	4.8	17.0	0.7	1.2
Bharat Heavy Electricals Ltd	25	2,375	2.6	2.6	0	27.0	21.0	7.2	26.7	0.8	1.0
ABB Ltd/India	3	763	1.0	0.5	46	39.7	28.4	6.5	16.4	0.3	1.0
IVRCL Infrastructures & Projects Ltd	1	361	1.0	0.0	105	19.7	15.4	2.5	12.7	0.4	1.6
KEC International Ltd/India	1	585	1.0	0.0	105	14.6	12.6	4.0	27.4	0.9	1.0
Thermax Ltd	2	610	1.0	0.0	105	26.5	19.3	6.1	23.0	0.8	1.1
IRB Infra. Developers Ltd	2	245	1.0	0.0	103	23.3	18.9	4.0	17.2	0.6	0.9
BFSI			**25.2**	**22.7**	**254**						
ICICI Bank Ltd	21	880	8.6	6.8	177	25.5	20.8	1.9	7.5	1.4	1.5
State Bank of India Ltd	30	2,220	4.0	4.0	0	12.6	11.0	2.1	16.7	1.6	1.0
Axis Bank Ltd	9	985	2.7	1.6	109	18.8	13.8	2.5	13.3	1.1	1.2
Punjab National Bank Ltd	6	914	2.5	0.8	164	7.7	6.9	1.8	23.4	2.4	1.0
Kotak Mahindra Bank Ltd	6	809	2.5	0.0	246	33.2	27.6	3.7	11.1	0.1	1.4
Union Bank of India	3	267	2.5	0.0	252	7.3	5.7	1.6	21.9	1.9	0.9
Bank of Baroda	4	507	2.5	0.0	247	7.0	6.2	1.4	20.1	1.8	1.0
Consumer Discretionary			**6.9**	**5.5**	**146**						
Maruti Suzuki India Ltd	10	1,567	1.4	1.4	0	21.9	18.4	4.0	18.3	0.4	0.8
Ashok Leyland Ltd	1	49	1.0	0.0	102	29.7	20.3	1.9	6.4	3.0	1.1
Escorts Ltd	0	130	1.0	0.0	102	9.3	8.1	0.8	9.4	0.0	1.2
Mahindra & Mahindra Ltd	6	1,060	2.1	1.5	61	14.8	13.5	3.4	23.0	1.2	1.1
Zee Entertainment Ltd	2	266	1.0	0.0	104	27.6	24.5	3.1	11.2	0.8	1.0
Pantaloon Retail India Ltd	2	381	1.0	0.0	104	34.6	22.3	2.5	7.2	0.1	1.1
Real Estate			**2.3**	**1.6**	**71**						
DLF Ltd	13	364	1.3	0.9	39	23.0	19.2	2.4	10.4	0.5	1.5
Anant Raj Industries Ltd	1	131	0.5	0.0	48	15.4	8.9	1.1	7.1	0.0	1.3
Sobha Developers Ltd	1	247	0.5	0.0	47	20.7	14.8	1.6	7.8	0.4	1.3
Metals & Materials			**9.0**	**9.0**	**0**						
Tata Steel Ltd	12	622	3.6	2.5	104	30.8	8.9	1.6	5.2	1.6	1.4
Sterlite Industries India Ltd	15	860	1.9	1.9	(0)	15.5	8.7	1.9	12.3	0.3	1.3
Steel Authority of India Ltd	21	238	1.6	1.0	66	20.5	16.3	3.1	15.1	0.8	1.2
Hindalco Industries Ltd	7	162	1.8	1.4	47	9.6	10.9	1.5	15.6	0.6	1.3
Energy			**16.6**	**16.6**	**0**						
Reliance Industries Ltd	76	1,080	11.1	11.1	0	9.6	7.3	1.0	10.4	1.4	1.2
Oil & Natural Gas Corp Ltd	54	1,182	3.1	2.8	33	11.1	9.6	2.5	22.5	3.0	0.9
GAIL India Ltd	11	418	1.3	1.3	0	17.9	15.8	3.1	17.3	1.7	0.8
Aban Offshore Ltd	1	1,242	1.1	0.0	107	7.2	4.8	2.3	31.9	0.3	1.6
Health Care			**2.5**	**2.5**	**0**						
Jubilant Organosys Ltd	1	343	1.2	0.0	124	14.8	11.6	3.9	26.4	2.4	0.9
Aurobindo Pharma Ltd	1	909	1.2	0.0	124	10.1	7.7	2.8	27.7	0.6	0.9
Consumer Staples			**5.8**	**6.5**	**(67)**						
ITC Ltd	21	256	4.6	4.6	0	25.0	21.8	6.1	24.4	1.7	0.6
Hindustan Unilever Ltd	12	265	0.2	1.9	(171)	24.3	21.4	23.6	97.1	2.9	0.5
United Spirits Ltd	3	1,288	1.0	0.0	104	35.3	25.0	3.1	8.8	0.3	1.1
Information Technology			**11.7**	**13.0**	**(127)**						
Infosys Technologies Ltd	32	2,577	7.4	8.6	(118)	24.8	21.6	6.6	26.6	1.1	0.7
Tata Consultancy Services Ltd	31	741	2.6	2.4	24	23.1	19.8	7.2	31.2	1.0	1.6
Wipro Ltd	21	681	1.7	1.4	21	22.8	20.1	5.4	23.7	1.0	0.9
Telecommunication Services			**2.9**	**4.4**	**(157)**						
Bharti Airtel Ltd	27	326	2.9	2.8	5	13.3	14.0	3.2	24.1	0.6	0.9
Utilities			**3.1**	**4.8**	**(171)**						
Tata Power Co Ltd	7	1,353	1.4	1.5	(7)	40.1	36.8	3.7	9.2	0.6	1.0
Reliance Infrastructure Ltd	5	1,132	1.1	1.1	(5)	17.2	16.9	1.9	11.0	0.8	1.5
Lanco Infratech Ltd	3	557	0.6	0.0	63	20.1	13.2	3.8	18.9	0.0	1.6
Cement			**0.0**	**2.3**	**(233)**						
Model Portfolio	**526**		**100.0**	**100.0**	**0**	**15.7**	**12.7**	**2.4**	**15.2**	**1.3**	**1.1**

Source: Edelweiss research

Chart 68: Performance of Edelweiss' model portfolio in CY09

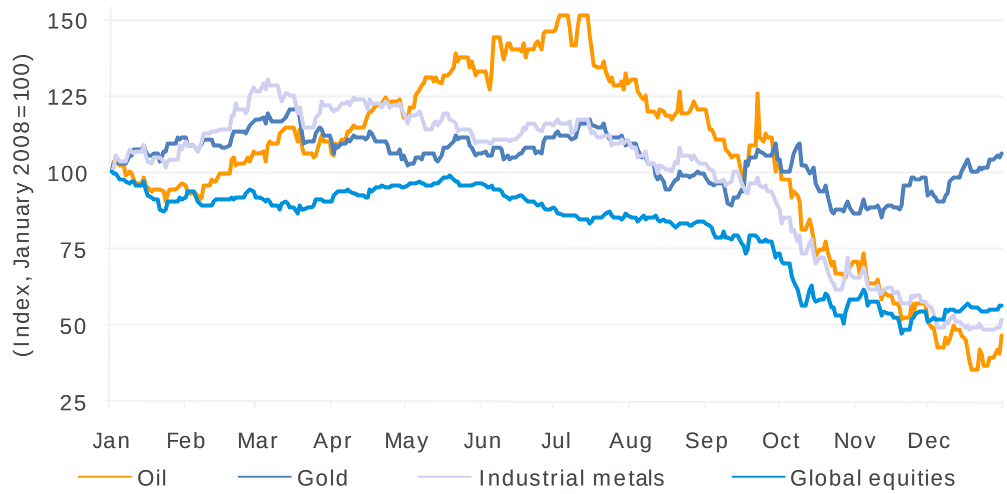


Source: Bloomberg, Edelweiss research

Annexure

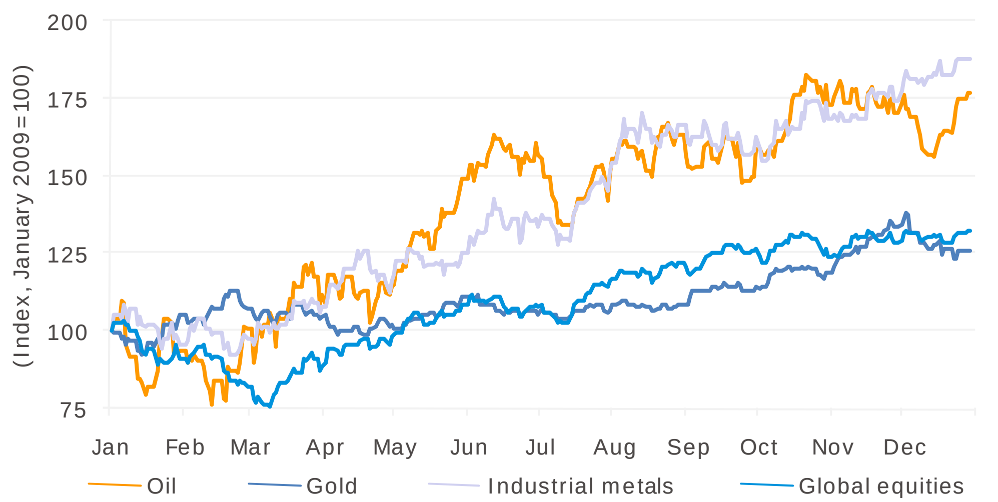
Annexure-I - Performance Of Asset Classes

Chart 1: Performance of various asset classes in CY08



Source: Bloomberg, Edelweiss research

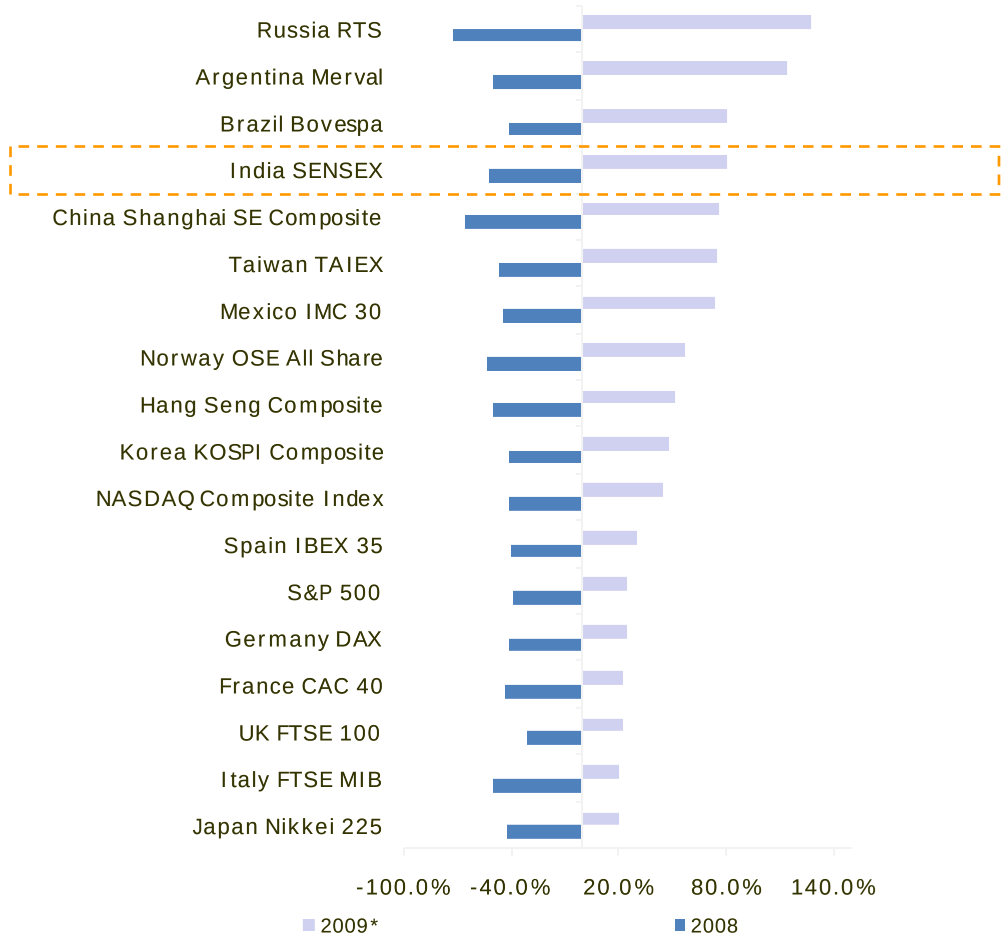
Chart 2: Performance of various asset classes in CY09



Source: Bloomberg, Edelweiss research

Annexure-II – YTD Returns Across Major Stock Markets

Chart 3: CY08 and CY09 returns for stock markets around the world

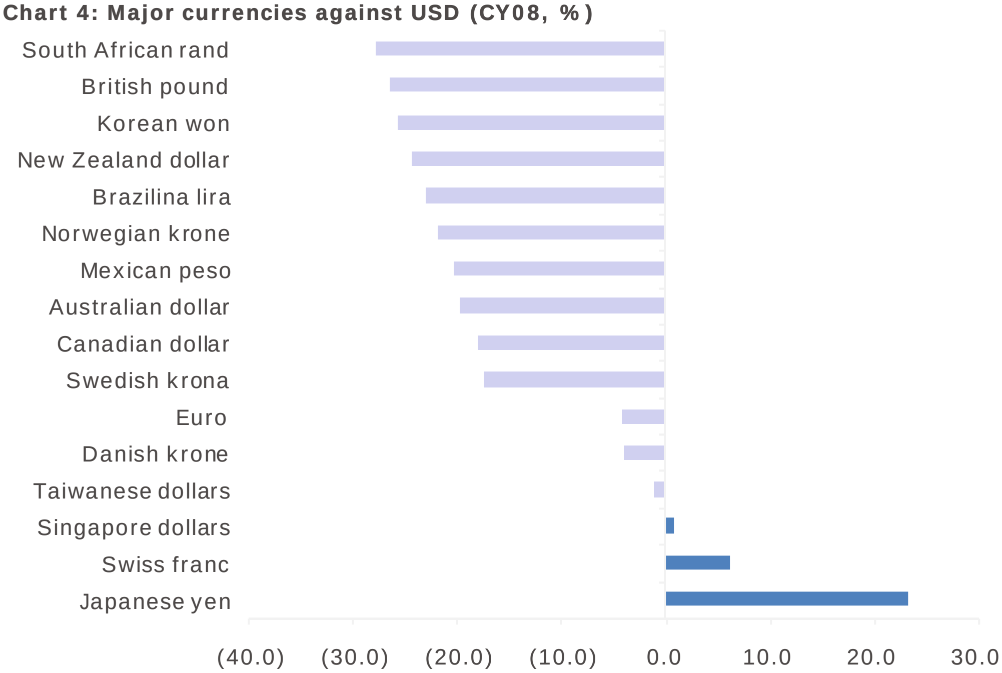


Source: Factset, Edelweiss research

**: Up to December 28, 2009*

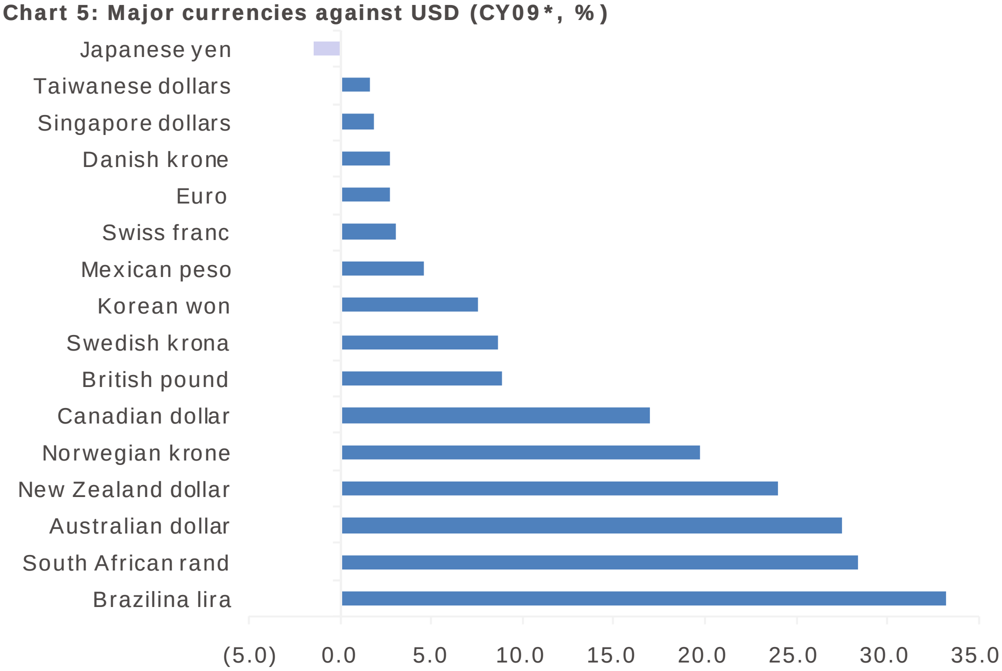
Annexure-III – Performance Of Various Currencies Versus USD

Chart 4: Major currencies against USD (CY08, %)



Source: Bloomberg, Edelweiss research

Chart 5: Major currencies against USD (CY09*, %)

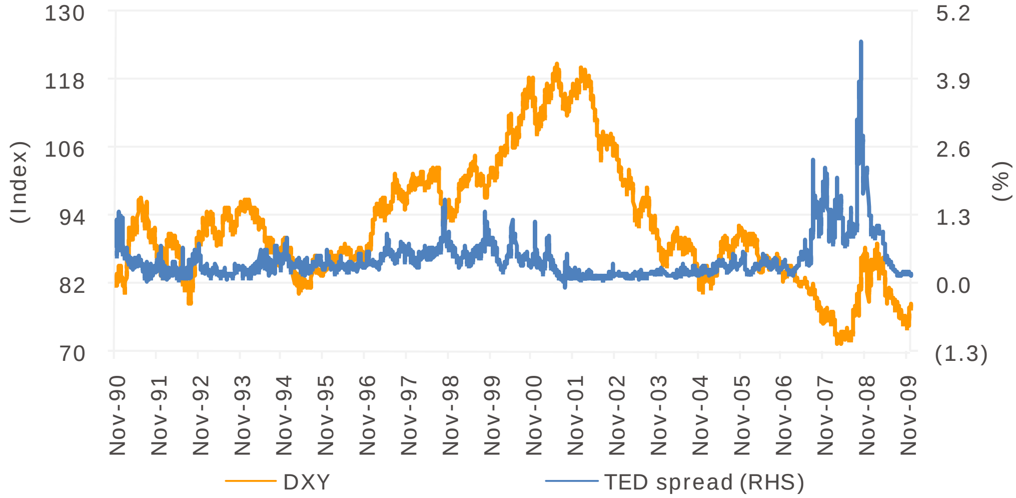


Source: Bloomberg, Edelweiss research

**: Up to December 29, 2009*

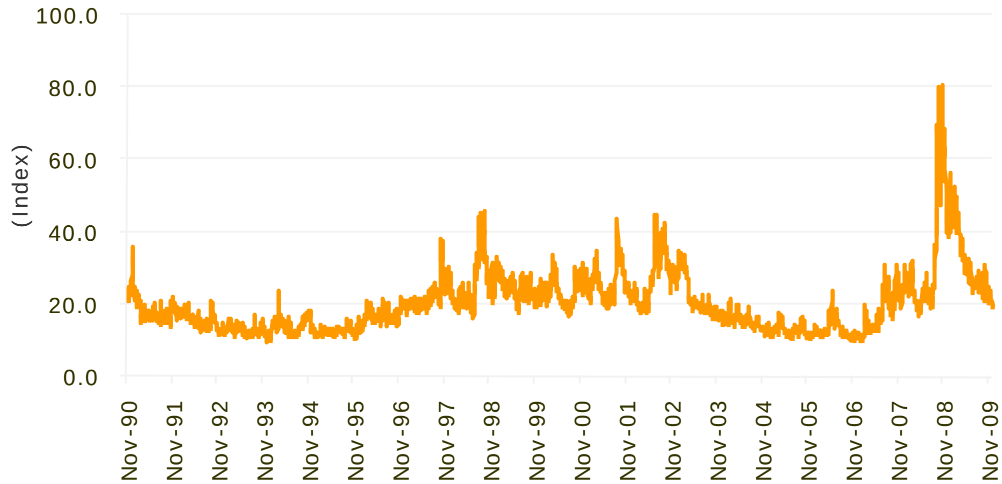
Annexure IV – Volatility In Equity Markets

Chart 6: TED spread versus DXY



Source: Bloomberg

Chart 7: VIX



Source: Bloomberg

Note: TED stands for spread between 3month Tbill rate and 3 month LIBOR, DXY is the Dollar index, and VIX is the acronym for volatility index on the Chicago Board Options Exchange (CBOE).

Annexure V – The Crisis Chronology

Table 1: Timeline of the crisis

2007	
9-Aug	Problems in mortgage and credit markets spill over into interbank money markets when issuers of asset-backed commercial paper encounter problems rolling over outstanding volumes, and large investment funds freeze redemptions
12-Dec	Central banks from five major currency areas announce coordinated measures designed to address pressures in short-term funding markets, including the establishment of USD swap lines
2008	
16-Mar	JPMorgan Chase agrees to purchase Bear Sterns in a transaction facilitated by the US authorities
4-Jun	Moody's and Standard & Poor's take negative rating actions on monoline insurers MBIA and Ambac, reigniting fears about valuation losses on securities insured by these companies
13-Jul	The US authorities announce plans for backstop measures supporting two US mortgage finance agencies (Fannie Mae and Freddie Mac), including purchases of agency stock
15-Jul	The US Securities and Exchange Commission (SEC) issues an order restricting 'naked short selling'
7-Sep	Fannie Mae and Freddie Mac are taken into government conservatorship
15-Sep	Lehman Brothers Holdings Inc files for Chapter 11 bankruptcy protection
16-Sep	Reserve Primary, a large US money market fund, 'breaks the buck', triggering large volumes of fund redemptions; the US government steps in to support insurance company AIG (and is forced to repeatedly increase and restructure the rescue package over the following months)
18-Sep	Coordinated central bank measures address the squeeze in USD funding with USD160 bn in new or expanded swap lines; the UK authorities prohibit short selling of financial shares.
19-Sep	The US Treasury announces a temporary guarantee of money market funds; the SEC announces a ban on short sales in financial shares; early details emerge of a USD700 bn US Treasury proposal to remove troubled assets from bank balance sheets (the TARP)
25-Sep	The authorities take control of Washington Mutual, the largest US thrift institution, with USD300 bn in assets
29-Sep	UK mortgage lender Bradford & Bingley is nationalized; banking and insurance company Fortis receives capital injection from three European governments; German commercial property lender Hypo real estate secures a government-facilitated credit line; troubled US bank Wachovia is taken over; the proposed TARP is rejected by the US House of Representatives
30-Sep	Financial group Dexia receives a government capital injection; the Irish government announces a guarantee safeguarding all deposits, covered bonds and senior and subordinated debt of six Irish banks; other governments take similar initiatives over the following weeks
3-Oct	The US Congress approves the revised TARP plan
8-Oct	Major central banks take a coordinated round of policy rate cuts; the UK authorities announce a comprehensive support package, including capital injections for UK-incorporated banks
13-Oct	Major central banks jointly announce the provision of USD funds to ease tensions in money markets; Euro Area governments pledge system-wide bank capitalizations, reports say the US Treasury plans to invest USD125 bn to buy stakes in nine major banks
28-Oct	Hungary secures a USD25 bn support package from IMF and other multilateral institutions aimed at stemming growing capital outflows and easing related currency pressures
15-Nov	The G20 countries pledge joint efforts to enhance cooperation, restore global growth and reform the world's financial system
25-Nov	The US Federal Reserve creates a USD200 bn facility to extend loans against securitizations backed by consumer and small business loans; in addition, it allots up to USD500 bn for purchases of bonds and mortgage-backed securities issued by US housing agencies.

2009	
16-Jan	The Irish authorities seize control of Anglo Irish bank; replicating an approach taken in the case of Citigroup in November, the US authorities agree to support Bank of America through a preferred equity stake and guarantees for a pool of troubled assets
19-Jan	As part of a broad-based financial rescue package, the UK authorities increase their existing stake in Royal Bank of Scotland. Similar measures by other national authorities follow over the next few days
10-Feb	The US authorities present plans for new comprehensive measures in support of the financial sector, including a private-public investment program of upto USD1 tn to purchase troubled assets
10-Feb	G7 Finance Ministers and central bank governors reaffirm their commitment to use the full range of policy tools to support growth and employment and strengthen the financial sector
5-Mar	The Bank of England (BoE) launches a programme, worth about USD100 bn, aimed at outright purchases of private sector assets and government bonds over a three-month period
18-Mar	The US Federal Reserve announces plans for purchases of upto USD300 bn of longer-term Treasury securities over a period of six months and increases the maximum amounts for planned purchases of US agency-related securities
2-Apr	The communiqué issued at the G20 summit pledges joint efforts by governments to restore confidence and growth, including measures to strengthen the financial system
6-Apr	The US Federal Open Market Committee (FOMC) authorizes new temporary reciprocal foreign currency liquidity swap lines with the BoE, ECB, BoJ, and Swiss National Bank
24-Apr	The US Federal Reserve releases details on the stress tests conducted to assess the financial soundness of the 19 largest US financial institutions, declaring that most banks currently have capital levels well in excess of the amount required for them to remain well capitalized
7-May	The ECB's governing council decided in-principle that the Euro system will purchase Euro-denominated covered bonds; the US authorities publish the results of their stress tests and identify ten banks with an overall capital shortfall of USD75 bn, to be covered chiefly through additions to common equity.
17-Jun	In the US, President Obama announces a comprehensive plan for regulatory reform. The plan would give the Federal Reserve new responsibilities for consolidated supervision of systemically important banks among other changes

Source: Bank of England, Federal Reserve Board, RBI, Edelweiss research

Table 2: Stages of the crisis

		Industrial economies		Emerging economies	
Stages of crisis	Markets and institutions	Macroeconomic conditions	Policy responses	Macroeconomic conditions	Policy responses
1. Pre-March 2008: prelude to the crisis	Subprime mortgage defaults create widespread financial stress. Uncertainty about size and distribution of losses. Crisis starts when interbank markets are disrupted in August 2007; waves of increasing intensity until March 2008.	Growth weakens.	Central bank (CB) rate cuts. Liquidity operations targeted at money markets.	Robust growth with inflation rising. Many inflation targeters above their targets.	Rate increases in response to high inflation.
2. Mid-March to mid-September 2008: towards the Lehman bankruptcy	Takeover of Bear Stearns in March slows decline, but bank losses and writedowns accumulate as downturn weighs on asset prices. More countries affected. Liquidity crisis reveals underlying solvency crisis, increasing pressure on financial institutions.	G3 economies contract even as oil prices fall steeply after August.	Initially further rate cuts. Liquidity facilities grow. Govt supported entreprises put into conservatorship	GDP growth slows after June but remains positive. Exports weaken in central Europe.	Further rate increases due to high inflation.
3. 15 September 2008 to late October 2008: global loss of confidence	Demise of Lehman Brothers on 15 September 2008 triggers a bigger run on key funding markets. More financial institutions fail or are rescued. Loss of confidence affects markets and countries globally. Reprieve only after unprecedented and broad-based policy intervention.	As confidence falls and financing conditions tighten, forecasts are revised down sharply.	Sharp rate cuts, CB swap lines expanded, rapid CB balance sheet growth. Large-scale bank rescues, deposit and debt guarantees.	Confidence slumps. Financing conditions tighten. Steep currency depreciations.	Rate cuts, more flexible provisions of central bank liquidity. Deposit and debt guarantees. Capital injections.
4. Late October 2008 to mid-March 2009:global downturn	Markets remain volatile, with increasingly dire economic data releases, weak earnings reports and uncertainties over ongoing government intervention. Downturn means that credit losses keep mounting.	Spending drops, leading to declines in goods trade and GDP. Inflation falls, with the price level declining in some countries.	Rates cut to near zero, liquidity provision to nonbanks. Outright purchases of public debt. Big fiscal stimulus packages.	GDP growth declines sharply in Q4 CY08 as exports inflows reverse.	Further rate cuts, lower reserve requirements. FX intervention, CB swap lines. Large fiscal stimulus packages in some EMEs.
5. Since mid-March 2009: downturn deepens but loses speed	Asset prices recover somewhat after more policy action. But signs of market dysfunction remain, as official efforts have failed to fully restore confidence in the global financial system. Continued credit losses.	Consumption and production continue to decline, with possible signs of bottoming-out.	Further rate cuts in some countries. Accounting rules for banks eased.	Equity markets recover, and exchange rates stabilise.	Increased external official financing to support EMEs.

Source: Bank for International Settlement (BIS) Annual Report, June 2009

Note: This table has been adapted from the above source and, does not capture developments in views/perception since June 2009

Annexure VI – Key Policy Response From Major Economies To Tackle The Global Turmoil

- United States

Monetary Policy Easing

- The target range for Federal funds rate was brought down continuously from 4.25% in January 2008 and was set between 0.00% and 0.25% on December 16, 2008. It has been kept unchanged since then.

Liquidity Provision

- Term funds continued to be auctioned through new channels such as the Term Auction Facility (TAF).
- The set of eligible collateral for loans extended by the Term Asset-Backed Securities Loan Facility (TALF) was expanded to include four additional categories of asset-backed securities.
- Five liquidity facilities—the Primary Dealer Credit Facility (PDCF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), the Commercial Paper Funding Facility (CPFF), the Money Market Investor Funding Facility (MMIFF), and the Term Securities Lending Facility (TSLF)—were extended up to October 30, 2009.
- The Temporary Money Market Funds Guarantee Program extended up to September 18, 2009.
- The set of institutions eligible to participate in the MMIFF was expanded. Several economic parameters of the MMIFF were adjusted so that it remained a viable source of back-up liquidity for money market investors even at very low levels of money market interest rates.
- The Fed to purchase USD 1.25 tn of agency mortgage-backed securities and USD 200 bn of agency debt in CY09.
- The Fed to purchase USD 300 bn of longer-term Treasury securities by September 2009.
- A Public-Private Investment Programme to generate purchasing power of up to USD 1 tn to buy legacy assets.

Recapitalisation of the Financial System

- Restructuring of government's financial support to the American International Group (AIG) was announced in March 2009.
- The US government entered into an agreement with the Bank of America to provide a package of guarantees, liquidity access, and capital.
- The US Treasury to participate in Citigroup's exchange offering by converting a portion of its preferred security to common equity alongside other preferred holders.
- Community Development Financial Institutions (CDFI) fund announced to award nearly USD 100 mn in grants and USD 3 bn in additional tax credit authority to support community-based financial institutions such as loan funds, credit unions, banks, venture capital firms, and other financing entities.
- Total Capital Purchase Programme (CPP) investment of USD 195.3 bn in 359 institutions since October 2008.

- Capital Assistance Programme announced for major US banking institutions.

Other Measures

- A policy announced to help avoid preventable foreclosures on certain residential mortgage assets held, owned, or controlled by a Federal Reserve Bank.
- Application of the Intercontinental Exchange (ICE) trust to provide central counterparty services for certain Credit Default Swaps (CDS) contracts was approved.

United Kingdom

Monetary Policy Easing

- Official bank rate was cut thrice by 50bps each during January-March 2009 to 0.5%.

Liquidity Provision

- Asset Purchase Facility to buy gilts, commercial paper, and corporate bonds from the secondary market using central bank reserves amounting to GBP 75 bn.
- Extension of the drawdown window of the Credit Guarantee Scheme (CGS) up to December 31, 2009.
- Extension of the term of the BoE's permanent discount window facility to 364 days for an additional fee of 25bps.

Financial Restructuring

- The UK Treasury's preference share investment in Royal Bank of Scotland (RBS) was converted to ordinary shares.

Recapitalisation of the Financial System

- Asset Protection Scheme, which aims to remove uncertainty about the value of banks' past investments, clean up banks' balance sheets, and enable them to rebuild and restructure their operations and increase lending in the economy. The scheme is available for a fee on eligible assets of select participating institutions. Agreement signed with Lloyds Banking Group and RBS.

Other Measures

- The Banking Act 2009, which strengthens UK's statutory framework for financial stability and depositor protection, was enacted.

Other Countries

Monetary Policy Easing

- ECB cut its interest rates on the main refinancing operations by 50bps each in January and March 2009 and by 25bps in April 2009 to 1.25%, on the marginal lending facility by 50bps in March 2009, and by 25bps in April 2009 to 2.25% and on deposit facility by 100bps in January 2009, 50bps in March 2009, and 25bps in April 2009 to 0.25%.
- Central Bank of the Republic of Turkey cut its overnight borrowing rate by 450bps during January-March 2009.
- South Korea reduced its monetary policy base rate by 50bps each in January and February 2009 to 2.0%.

Liquidity Provision

- Japan issued fresh guidelines on eligible collateral for credit extended by banks.
- Bank of Japan announced terms and conditions for outright purchase of corporate financing instruments such as CP and corporate bonds.
- The frequency and duration of special funds supplying operations were increased. Most other provisions taken for achieving financial stability, that were set to expire in April 2009, were extended up to at least September 2009.

Recapitalisation of the Financial System

- Germany extended a bailout package to Commerzbank to backstop losses at newly acquired Dresdner Bank and took a 25% holding in the combined entity.
- Ireland took control of the Anglo Irish Bank.
- The Dutch authorities granted ING Group a backup facility guaranteeing part of the bank's securitised mortgage portfolio worth USD 35 bn.

Other Measures

- To address continued pressures in global USD funding markets, the temporary reciprocal currency arrangements (swap lines) between the Fed and other central banks were extended till October 30, 2009.

Source: Websites of respective central banks, finance ministries, RBI

Annexure-VII – Key Unconventional Stimulus/ Guarantee Measures Adopted By US

Table 3: Key details of unconventional stimulus expenditure by the US

Program	Purpose	Amount (USD bn)	Withdrawal status
Purchase of agency MBS and agency debt	Kick start the mortgage lending market		Gradual phase out by March 2010
Asset-Backed Commercial Paper (ABCP) Money Market Mutual Fund Liquidity Facility	Kickstart the ABCP market- Provides funding to banks to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds	146*	Phasing out by March 2010
Commercial Paper Funding Facility (CPFF)	The CPFF was created to provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle (SPV) that will purchase eligible three-month unsecured and asset-backed commercial paper from eligible issuers using financing provided by the Federal Reserve Bank of New York (New York Fed)	Earmarked USD 1.8 tn for the program.	Phasing out by March 2010
Primary Dealer Credit Facility (PDCF)	The PDCF is an overnight loan facility that provides funding to primary dealers in exchange for any tri-party-eligible collateral and is intended to foster the functioning of financial markets more generally. Primary credit rate at 0.5%	147*	Phasing out by March 2010
Term Securities Lending Facility (TSLF)	The TSLF is a weekly facility that offers Treasury securities for loan over a one-month term to primary dealers against program-eligible general collateral. The program promotes liquidity in the Treasury security and other collateral markets and thus fosters the functioning of financial markets more generally.	-	Phasing out by March 2010
Term Asset-Backed Securities Loan Facility (TALF)	TALF is a funding acility that issues loans with a term of up to three years to holders of eligible asset-backed securities (ABS). The program is intended to assist the financial markets in accommodating the credit needs of consumers and businesses of all sizes by facilitating the issuance of ABS backed by consumer and small business loans and to improve the market conditions for ABS more generally.	Earmarked USD 1tn for the program.	Phasing out by June 2010

Source: Federal Reserve, Edelweiss research

**: Amount disbursed*

Chart 8: ABCP, MMF* liquidity facility

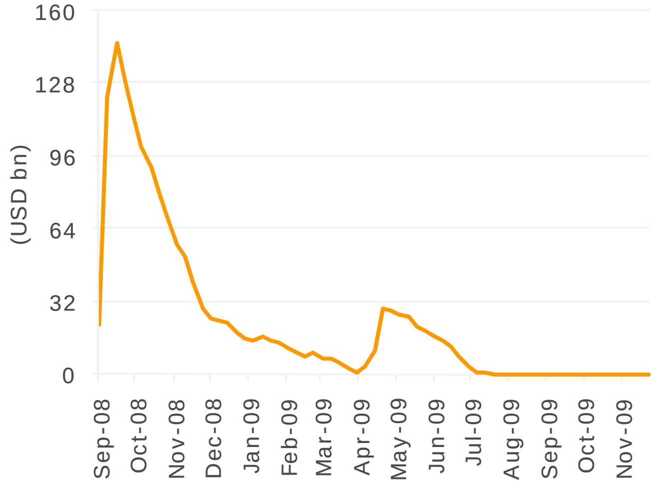


Chart 9: PDCF

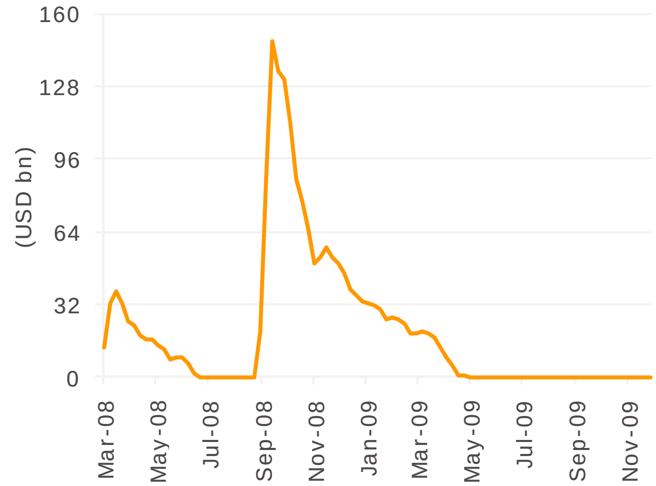


Chart 10: TSLF

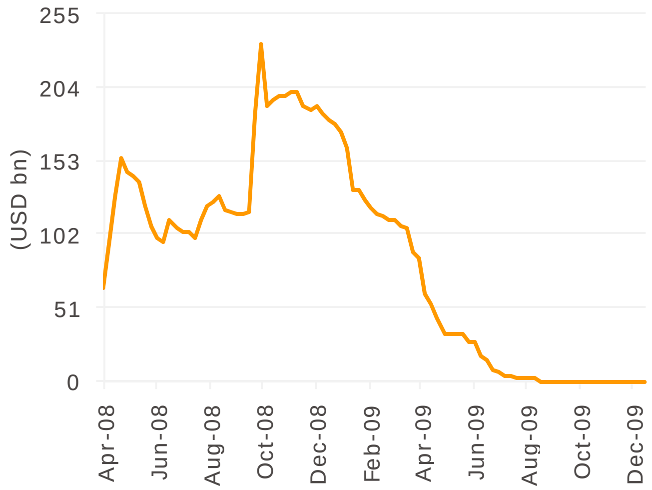
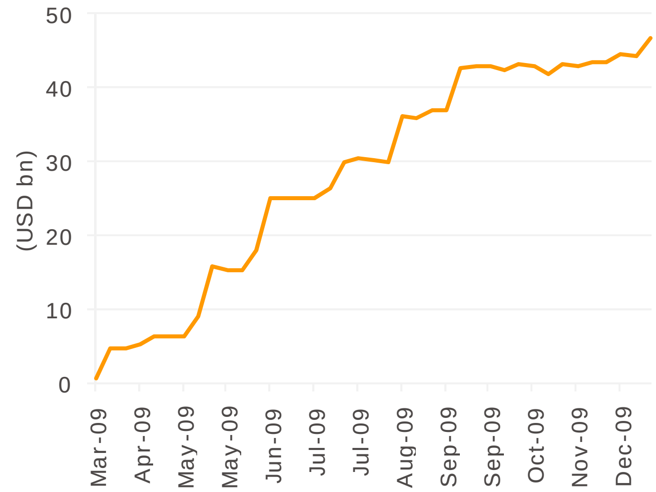


Chart 11: TALF



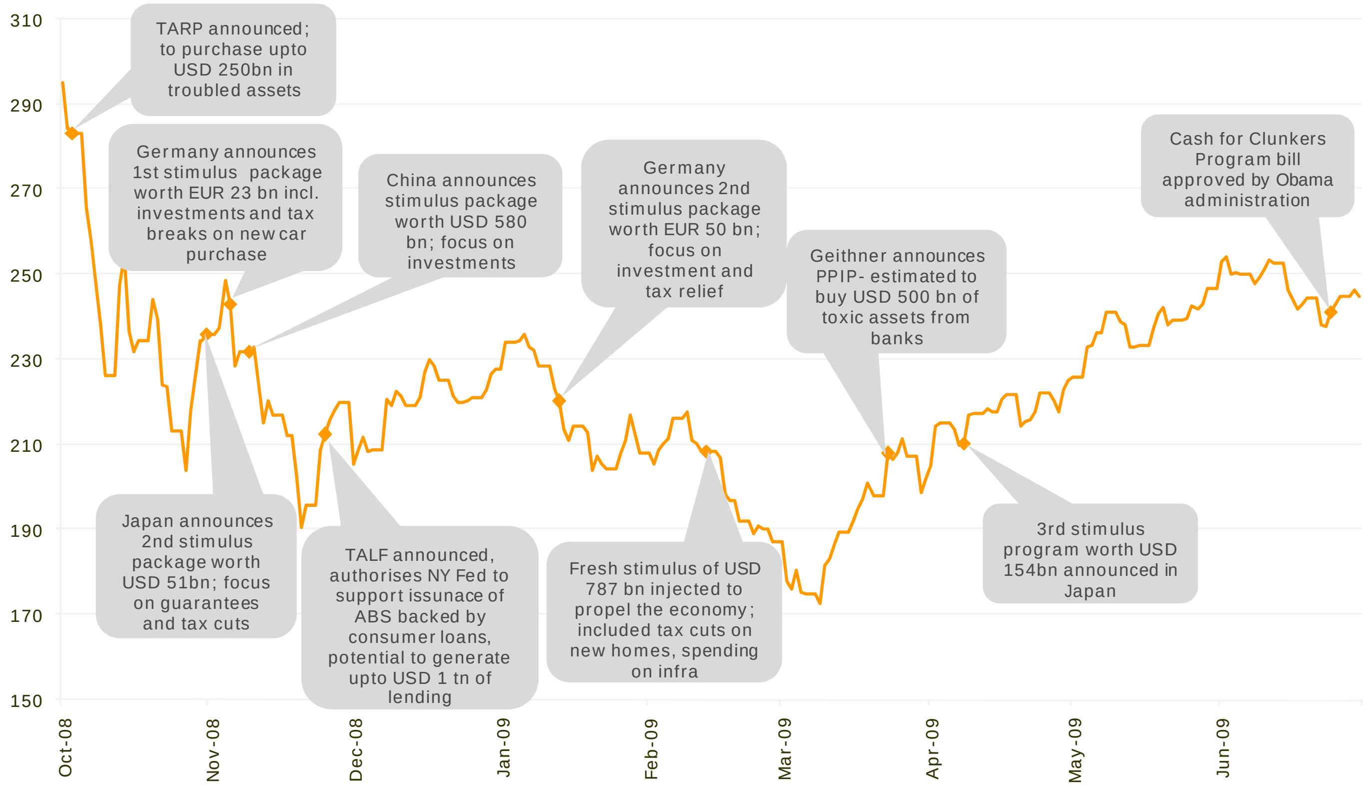
Source: Federal Reserve

**: Money Market Mutual Fund*

Note: Data pertain to outstanding amounts as on date

Annexure-VIII – Impact Of Stimulus Measures On Equities

Chart 12: Impact of stimulus measures on equities



Source: Federal Reserve, Edelweiss research

Note: The line in the chart indicates the MSCI AC-World Index

Annexure-IX – Chronology Of RBI Actions To Battle The Crisis

September 2008

- A second LAF was reintroduced on a daily basis.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were increased by 50bps each to LIBOR/swap rates minus 25bps and LIBOR/swap rates plus 50bps, respectively.
- As a temporary measure, scheduled banks were allowed to avail additional liquidity support under the LAF to the extent of up to 1% of their net demand and time liabilities (NDTL) from their SLR portfolios and seek waiver of penal interest.

October 2008

- The CRR was reduced by 250bps from 9.0% to 6.5% effective from the fortnight beginning October 11, 2008.
- A 14-day special repo facility for a notified amount of INR 200 bn was instituted to alleviate liquidity stress faced by mutual funds, and banks were allowed to temporarily use SLR securities for collateral purposes by an additional 0.5% of NDTL exclusively for this purpose.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were increased further by 50bps each to LIBOR/swap rates plus 25bps and LIBOR/swap rates plus 100bps, respectively.
- Banks were permitted to borrow funds from their overseas branches and correspondent banks to the extent of 50% of their unimpaired tier-I capital or USD 10 mn, whichever is higher.
- On October 20, 2008, the repo rate under the LAF was reduced by 100bps to 8.0%.
- External commercial borrowings (ECBs) up to USD 500 mn per borrower per financial year were permitted for INR expenditure and/or foreign currency expenditure for permissible end uses under the automatic route. Further, the all-in-cost ceiling for ECBs of average maturity period of three years and up to five years was raised to 300bps, and over five years, to 500bps above six-month LIBOR.

November 2008

- The repo rate under the LAF was reduced by 50bps to 7.5% with effect from November 3, 2008.
- The CRR was reduced by 100bps, from 6.5% to 5.5% of NDTL.
- The statutory liquidity ratio (SLR), which was relaxed on a temporary basis earlier, was made permanent and reduced to 24% of NDTL effective November 8, 2008.
- In order to provide further liquidity comfort, a special refinance facility for scheduled commercial banks (excluding RRBs) up to 1.0% of each bank's NDTL as on October 24, 2008, was introduced under Section 17(3B) of the RBI Act, 1934, up to a maximum period of 90 days.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were further raised by 75bps each to LIBOR/swap rates plus 100bps and LIBOR/swap rates plus 175bps, respectively.
- The RBI permitted Indian corporates to prematurely buy back their FCCBs at prevailing discounted rates.

December 2008

- The repo rate under the LAF was reduced by 100bps from 7.5% to 6.5% and the reverse repo rate by 100bps from 6.0% to 5.0%, effective December 8, 2008.
- A refinance facility was introduced for SIDBI, NHB, and EXIM Bank for INR 70 bn, INR 40 bn, and INR 50 bn, respectively. This facility will be available up to March 31, 2010.
- Loans granted by banks to HFCs for on lending for housing up to INR 2 mn per dwelling unit were classified under priority sector.

January 2009

- The repo rate under the LAF was reduced by 100bps from 6.5% to 5.5% with effect from January 5, 2009. The reverse repo rate under the LAF was reduced by 100bps, from 5.0% to 4.0% with effect from January 5, 2009.
- The CRR was reduced from 5.5% to 5.0% of NDTL effective from the fortnight beginning January 17, 2009.
- The special term repo facility under LAF for the purpose of meeting the funding requirements of MFs, NBFCs, and HFCs was extended up to September 30, 2009.

February 2009

- The ceiling rate on export credit in foreign currency was raised from LIBOR + 100bps to LIBOR + 350bps on February 5, 2009, subject to the condition that banks will not levy any other charges.
- Correspondingly, the ceiling interest rate on the lines of credit with overseas banks was also increased from six months LIBOR/ EURO LIBOR/ EURIBOR + 75bps to six months LIBOR/ EURO LIBOR/ EURIBOR + 150bps.

March 2009

- The repo rate under the LAF was reduced by 50bps, from 5.5% to 5.0%, with effect from March 5, 2009. The reverse repo rate under the LAF was reduced by 50bps, from 4.0% to 3.5%, with effect from March 5, 2009.
- The MoU signed by the RBI with the government on March 25, 2004, on MSS was amended on February 26, 2009, to enable the transfer of a part of the amount in the MSS cash account to the normal cash account as part of the government's market borrowing programme for meeting government's approved expenditure. An amount of INR 120 bn was transferred from the MSS account to the normal cash account of the GoI on March 4, 2009, and an equivalent amount of government securities issued under the MSS formed a part of the normal market borrowing of the GoI. Based on the emerging fund requirements of the government, INR 330 bn of MSS would be de-sequestered against the approved market borrowing programme or bought back during FY10.
- The RBI announced OMO purchase of government securities of the order of INR 800 bn in the first half of FY10, of which, INR 575 bn was unwound in the first quarter of FY10.

April 2009

- In the policy statement for FY10, repo rate and reverse repo rate under the LAF were further slashed by 50bps to **4.75%** and **3.25%,** respectively, with effect from April 21, 2009.
- The special refinance facility and term repo facility export credit refinance for banks was extended up to March 31, 2010.

July 2009

- RBI set out a (gross) borrowing calendar of ~INR 4.1 tn for FY10, of which, ~INR 2.9 tn was raised in H1FY10, while ~INR 1.2 tn has been proposed to be raised by early February 2010.

August 2009

- GoI in consultation with RBI decided to issue cash management bills, essentially short-term instruments with maturities of less than 91 days, to meet the temporary cash flow mismatches of the government. These have an SLR status and are in addition to the ways & means advances resorted to by state and central governments.

October 2009

- SLR for SCBs raised from 24% to 25% of NTDL w.e.f. fortnight beginning November 7, 2009.
- Limit of export credit refinance facility reduced from 50% to 15% of eligible outstanding rupee export credit extended under Section 17(3A) of the RBI Act.
- Special refinance facility for SCBs instituted under Section 17(3B) of the RBI Act, discontinued.
- Special term repo facility of SCBs for funding to mutual funds, non-banking financial companies, and housing finance companies discontinued.
- Forex swap facility of banks discontinued.

Source: RBI, Edelweiss research

Annexure-X – Basic Concepts And Construction Of EELII

The Edelweiss ET-Now Lead Indicator Index (EELII), which is released on a monthly basis effective October 2009, is available with a lead period of around three months before the availability of actual data on GDP for any particular period.

This is a composite weighted average index of a number of macro-variables that typically exhibit a strong predictive ability of the core trends in the Indian economy. Instead of tracking different macro-variables, which typically influence the economy with different intensity and varying lead times and often move in opposite directions (especially at times of turns in the economy), this single indicator summarises movements in all such different variables into one value. Hence, this can be an easy, yet effective, tool to track and predict inherent trends in the economy. The construction of the index was based on a multiple regression framework using quarterly data for the past 10 years.

As a starting point, around 60 different macro-variables—spanning over capital availability, credit demand, cost of funds, purchase managers' index (PMI), freight rates, property prices/rentals, consumption demand, intermediate goods production, electricity production, tourist arrivals, and commodity prices—were considered.

This initial set of indicators was trimmed down on the basis of three criteria—degree of influence on non-agricultural GDP (high correlation), availability of high frequency and reliable data (longer/sufficient history), and lead property (lead period of at least one quarter). Redundancies were also removed for sets of indicators demonstrating auto-correlation (for example, supply of broad money (M3) and non-food credit offtake).

On the basis of such criteria, the final set of variables that was chosen for inclusion in the index are as follows: (1) credit offtake; (2) policy interest rates; (3) slope of the yield curve; (4) non-oil imports; (5) commercial vehicle production; (6) cement dispatches; (7) domestic steel prices; (8) government expenditure; and (9) resource mobilisation in the primary capital market. The range of variables included in the index augurs well with several lead indicator indices followed globally.

Weights of different variables were assigned after removing the time trends and seasonality, and after normalising all the variables to one common scale. Weights were determined on the basis of the regression model, hence, assigning more weight to indicators that have historically shown to have a greater influence on the overall activity level and have captured turns in the economy better with a lead.

Lack of availability of data for certain potential lead variables like housing starts, property prices/rentals, PMI, business confidence indices, job losses etc., however, imposes constraints in their inclusion in the index. While the basic approach for constructing the indicator has by and large been in line with several other lead indicators followed internationally, certain customisations have also been made to suit Indian conditions.

Table 4: Comparison of variables used in EELII with other studies

Sl No.	Variables used as lead indicators by other studies	Whether used in EELII/ other comments
1	Broad money (M2)	Credit used as proxy - broad money and credit highly correlated
2	CPI	In India, CPI is largely determined by food prices and exposed to supply shocks in agriculture. Domestic steel price has been used instead as a proxy of inflation of industrial commodities
3	S&P500	Resources raised from domestic market used as proxy
4	Government borrowings	Government expenditure used as a proxy
5	Consumer sentiment / Advance monthly sales for retail and food services/ Real final sales of domestic product	No long dated series exists for India. Non-oil imports and commercial vehicles production used as indirect indicators of retail sales
6	No. of manufacturing orders for consumer goods and materials	No specific data series exists for India. Commercial vehicle production reflects demand for consumer goods. PMI could have been used; but the available data series too short for any statistically meaningful regression
7	Amount of new orders for non-defense capital goods	No specific data series exists for India. Domestic steel prices reflect input demand for capital goods to some extent
8	Initial applications on unemployment	Not used in EELII due to data unavailability
9	Housing permits	No data series exists for India. Cement despatch figures / Domestic steel prices reflect construction activity to some extent
10	Slope of the yield curve	Used in EELII also

Source: Edelweiss research

Annexure-XI – IPOs In Pipeline

Table 5: List of IPOs in pipeline (approved by SEBI)

Company name	IPO/FPO	Date of approval	Est amt (INR mm)
Astec Lifesciences	IPO	04/11/2008	550
C.Mahendra Exports	IPO	05/11/2008	3,000
Chiripal Industries	IPO	25/02/2009	800
Gini & Jony	IPO	15/01/2009	500
Infinite Computer Solutions (India)	IPO	20/03/2009	750
MBL Infrastructures	IPO	30/07/2009	1,250
Midvalley Entertainment	IPO	05/05/2009	500
Radiant Info Systems	IPO	11/06/2009	1,250
Usher Eco Power	IPO	24/04/2009	525
Total			**9,125**

Source: PRIME Database

Note: Issues where SEBI approval received till 18.09.2009 and still valid

Table 6: List of IPOs in pipeline (filed with SEBI; approval awaited)

Company Name	IPO/FPO	Date of filing	Est amt (INR mm)
AMR Constructions	IPO	30/09/2008	1,750
Aravali Infrapower	IPO	29/09/2008	1,000
Arss Infrastructure Projects	IPO	21/08/2009	1,030
Birla Shloka Edutech	FPO	02/09/2009	348
BS Transcomm	IPO	29/09/2008	2,250
DB Corp	IPO	13/08/2009	10,000
Great Eastern Energy Corp.	IPO	26/12/2008	4,000
Kabirdass Motor Co.	IPO	27/04/2009	600
Mayajaal Entertainment	IPO	27/01/2009	1,250
Neoteric Informatique	IPO	30/04/2008	500
Pradip Overseas	IPO	31/12/2008	1,500
Sai Silks (Kalamandir)	IPO	09/07/2009	250
Sea TV Network	IPO	31/12/2008	502
Syncom Healthcare	IPO	15/09/2008	600
Texmo Pipes & Products	IPO	23/12/2008	600
Thangamayil Jewellery	IPO	07/08/2009	350
Trinity India	IPO	07/08/2008	600
Total			**27,129**

Source: PRIME Database

Note: 1. Issues where Offer Document filed with SEBI, awaiting approval

2. Figures are indicative

Annexure-XII – QIPs In Pipeline

Table 7: List of QIPs in pipeline

Company	Estimated issue amount (INR mn)
Nagarjuna Construction Co	5,500
Bank Of Rajasthan	2,500
BLKashyap & Sons	4,500
Omaxe	18,000
GMR Infrastructure	50,000
Housing Development & Infrastructure	28,800
Anant Raj Industries	20,000
Essar Oil	100,000
PSL	NA
Adani Enterprises	15,000
Asian Electronics	NA
Pantaloon Retail (India)	10,000
Orbit Corp	4,000
Puravankara Projects	NA
Hindustan Construction Co,	15,000
Gammon Infrastructure Projects	5,000
Anu'S Laboratories	NA
Nitin Fire Protection Industries	NA
Vishal Retail	1,500
Karnataka Bank	5,000
Hindustan Dorr-Oliver	NA
Dhanalakshmi Bank	4,000
DLF	NA
Austral Coke & Projects	NA
Sarang Chemicals	350
JSL	5,000
Gujarat Nre Coke	10,000
IOL Netcom	NA
Total	**304,150**

Source: Edelweiss research

Note: Figures are indicative

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