

Capital Markets At A Glance

- November 2011

Key take away:

- Recently the Finance Minister has identified supply-side constraints as the primary reason for higher level of inflation. He has also added that serious attention needs to be paid to the weakening rupee as it adds to the inflationary pressures.
- According to the Chairman of the Prime Minister's Advisory Council, India's economic growth will be at lower-than-expected 8% during this fiscal year. He has also suggested for adopting both fiscal and monetary measures to combat the rising rate of inflation.
- Additional borrowings also impacted the market sentiment. In the last week of Oct RBI is expected to issue Rs.23,000 crore of securities which includes Rs.15,000 crore of G-sec auction.
- RBI is likely to issue the guidelines for entry of new banks during the end of November this year.
- Moody's has downgraded Spain's ratings by two notches from Aa2 to A1 due to high levels of debt in the banking and corporate sectors. Moody's has also warned of further downgrade if the euro zone debt crisis escalates further.
- Strong earnings from top US companies like Intel, Yahoo and Bank of America supported the European market on the day Reports that Germany and France would help the euro zone to come out of the debt problem, helped to shrug off Moody's downgrade of Spain's government debt rating.
- China's GDP growth eased to 9.1% in the third quarter as against 9.5% recorded in the previous quarter. Following the tight monetary policy and fall in foreign demand lowered the GDP growth for this quarter.
- The government is soon likely to raise the purchase limit of government securities by the FIIs.
- Moody's has warned that it may decline France's rating in the near term if the country exceeds the budgetary limit too much for helping the debt-ridden euro zone countries and the banks.
- Concerns over Europe's debt crisis following comments from the German Finance Minister against a quick-fix to Europe's debt problems, lower third quarter Chinese GDP data and a warning on France's sovereign credit rating also weighed on the investors' mood.

CONTROLLING INFLATION & ACHIEVING TARGET GROWTH: A TOUGH TASK AHEAD FOR INDIA

During last 2 weeks in Oct, 11 Asian stocks climbed 8-10%, extending the best biweekly rally since 2009, the won strengthened and bond risk fell as Europe's agreement to stem the debt crisis and better-than-expected U.S. data renewed confidence in the global economy.

The U.S. economy grew in the third quarter at the fastest pace in a year as Americans reduced savings to boost purchases and companies stepped up investment in equipment and software. Treasuries rose on speculation the U.S. economy isn't expanding fast enough to justify the rout that sent yields up in October by the most in 2011.

Increasing downside risk and growth projections revised India GDP growth lower to 7.6% for FY12 by the RBI. The RBI in its second quarter review is acknowledging the increasing downside risk to domestic growth due to worsening of global growth prospects and slowdown in the domestic investment demand. The Growth in FY12 likely to moderate to below trend and hence the projections are revised lower to 7.6% from 8.0% levels with downside risk.

India's trade deficit with China (its biggest trading partner) has been risen significantly in last 5 years, jumped 160% to \$23.9 billion in the five years to 2010-11. Power Sector equipments and the low-end market for mobile phone handsets have been already taken over by China. While imports of Chinese goods rose to \$43.5 billion in 2010-11 from \$17.5 billion in 2006-07, exports fell back, up to just \$19.6 billion from \$8.3 billion over 5 years.

Power sector seems to be in crises zone, the sector that only a few years ago was a gold mine of opportunities for investors and lenders, is turning out to be an unwanted child for PE investors & lenders. ICICI bank leads the list of lending banks with the highest exposure to the power sector. Major lenders are ICICI Bank's Rs37233crs or 5.9% of its total book, SBI's Rs36915crs or 2.5% of its total book, Axis Bank's Rs17110.60crs or 5.7% of its total book. At least for the record in file, no power producer has been defaulted so far, but the state of affairs has begun to ring alarm bells with some estimates showing that losses on loans could squeeze the banking system and revive memories of what happened when the textile industry went through a similar crisis in the 1990s.

The steep depreciation (>10%) in rupee in the past couple of months is worsening the problem of high crude oil prices for the Indian economy. In meantime, the global crude oil prices have been eased but the actual cost to India has been going up. At a time when India is battling several woes such as high inflation, rising deficits and slowing growth, a combination of weak rupee and high crude prices could further complicate matters. Indian economy is already seen falling behind its revenue targets and overshooting expenditure targets and hence looking at a wider fiscal deficit. India imports around 80% of the crude oil it needs. Although, the country is a net exporter of finished petroleum products, the domestic consumption has been growing at a high pace. In June 2011 when rupee-dollar exchange rate was Rs 44.85, since the currency has weakened 10%. The industry lost Rs 64,900 crore in the first half of FY12 and Rs 272 crore daily in the first fortnight of October 2011. Further depreciation in rupees would be creating pressure, an upward revision to the overall under-recovery numbers in the near future. Looking at the fundamental picture, over the next 6-12 months, the oil prices could stagnate particularly with moderate global economic growth and rising oil production from the Gaddafi-less Libya and Iraq. Foreign investors' worries about widening budget deficit and slowing economic growth, contending higher inflation will be decide the rupees fate.



GLOBAL MARKETS:

The recent economic news flow from both the sides of the Atlantic has been disappointing. The Fed gave a stern warning in terms of significant downside risks to growth and cautioned on the financial market stress. Sovereign debt crisis concerns among Euro zone countries remain unresolved and measures adopted by policy makers seem to be focusing solely on the short-term postponement of the problem rather than on a long-term resolution once and for all. However, the expanded bailout fund (EFSF) is large enough, in our view, to avert a sudden financial shock. The IMF also cautioned, in no uncertain words, that the global economy is entering a 'new dangerous phase'.

Increased volatility and uncertainty across global markets, be it equities or commodities, have led to risk aversion amongst global investors, which has led to FIIs pulling out over US\$2bn from Indian equities and a 10.2% fall in the benchmark index over the past two months Aug-Sept, 2011.

There seem to be only three ways in which a nation can pay off its debts. **Repay, print or default.** The first two seems almost out of the equation for several countries like the fabled PIIGS (Portugal, Italy, Ireland, Greece, and Spain) in the Euro zone. Thus, default seems to be the only viable option before them. In view of the increasing possibility of such an event, **investors seem to be taking global financial institutions like BNP Paribas, Societe Generale and Unicredit completely to the cleaners.** This is because in case of a default, the capitalization of these banks will suffer enormously. What more, even institutions on the other side of the Atlantic have started facing the investor fury, take Morgan Stanley for example. The banking giant, one of the few remaining independent investment banks, has seen its share price drop as much as 50% in the last one year. The fall is mainly on account of a



large exposure to bonds of troubled Euro nations. Executives at Morgan Stanley however continue to insist that the fundamentals of the bank remain as sound as ever. It should be noted that similar optimism was shown by top executives at Lehman Brothers right until the time the bank went bankrupt. Thus, it is only correct that investors are **acting twice shy despite being bitten once**.

The global crisis is something everyone is talking about. The bleak picture painted for the developed countries is not much of a surprise to anyone. A direct result of this crisis has been the visible change in the employment patterns in the world. As per a report of the International Labour Organisation (ILO), **the companies in the developed world are rolling back their hiring intentions**. The big reason for this is the fear that things are just going to get worse than what they are currently. The governments of these countries are trying very hard to save themselves from another, deeper recession. But unfortunately most of the measures adopted by them to boost the economies have not helped as these were bailouts to help save the sinking ships. Very little was spent on activities that directly help in generating employment opportunities.

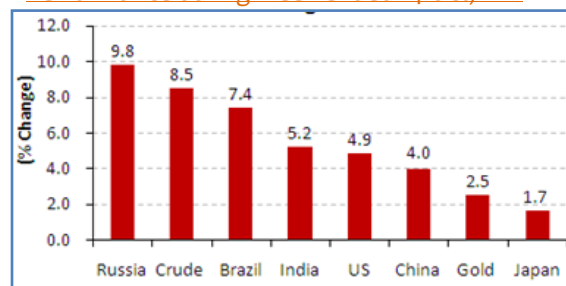
At the same time, the employment opportunities in the developing nations have continued to rise. This is even more prominent in the manufacturing sector. **So while the developed world is right in cribbing that the developing countries have 'stolen' their jobs, the truth is that they should actually blame their own governments for this**. Had the governments focused more on the healthy and performing sectors rather than saving the dead and sinking ones maybe things would have been different.



It was an enthralling week for the global stock markets. Sustained buying amidst positive global cues lifted the overall market sentiments. The US stock markets closed the second week in Oct,11 on a positive note (+4.9%) on better than expected retail sales data for the month of September and positive earnings surprise from Google Inc. Retail sales increased 1.1% in September, the largest gain recorded in the last seven months. Being a key barometer of consumer spending, strong sales figures excited the street. Better than expected earnings from Google Inc also buoyed the markets.

Indian stock markets were up 5.2% during the week. Absence of negative news flow and short covering led to healthy gains during the week. Expectations of strong corporate earnings for the September, 2011 quarter also instilled momentum in the markets with the Sensex posting the highest weekly gain in the last six weeks. Amongst the other world markets, Brazil was the biggest gainer (up by 7.4%) with Germany registering a gain of 5.1% during the week. However, UK and Japan posted modest gains of 3.1% and 1.7% respectively. See Chart1

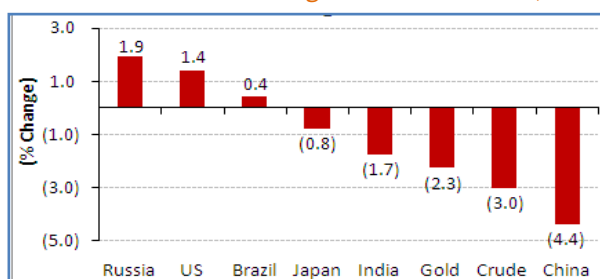
Performance during week ended 14 Oct,2011



Source: Yahoo finance, CNNfn, Kitco

Global Markets Performance:

Performance during week ended 21 Oct, 2011



Source: Yahoo Finance

It was a mixed week, 21 Oct for the global stock markets. While the US and the UK were up by 1.4% and 0.4% each, most of the Asian and European markets closed the 3rd week in the red. The US markets in particular saw their highest levels since early August in anticipation of the upcoming European Union summit. The US markets also got a boost from strong earnings declared by blue-chip companies. As per Thomson Reuters, most of the S&P 500 companies that have declared results so far have exceeded analyst expectations.

Indian stock markets however fell by almost 1.7%. The markets were plagued with a number of fears including the worsening of European debt crisis resulting in the outflow of FII (Foreign Institutional Investor) money. There were concerns about inflation remaining at intolerably high levels and the RBI hiking interest rates yet again. Amongst the other world markets, Brazil and Germany were up by 0.4% and 0.1% respectively. Asian stock markets were down led by China (down by 4.4%).

Difference in US and Euro zone Crises:

There has been a growing buzz about the impending collapse of the Euro. You must note here that until last year, the collapse of the Euro was unthinkable. Let's understand **the reasons why the Euro was destined to fail**. The Euro is a case of a monetary union through the use of a single currency. But to ensure that it works well, member nations have to adhere to strict discipline as far as fiscal deficit, inflation, government debt, current account deficit and such other factors are concerned. The concept seemed to work well for a while. It was only last year that it was found out that Greece had fudged accounts and understated numbers to be able to join the Eurozone. But by then Greece was on the brink of default.



Now, there is a striking difference that sets the Euro apart from the US dollar. While the US central bank can print unlimited amount of dollars to pay up its liabilities, Eurozone members cannot do the same. The Euro is controlled by the European Central Bank (ECB). The other important fact is that about 30-60% of ailing nations had their debts held by other Euro members. So allowing these economies to default meant a major loss to the lending countries. No wonder the entire Eurozone got affected by the debt contagion. In retrospect, it is clear that the idea of a common currency among nations with diverse economic and political pressures was not really a smart thing to do. When and how the Euro dies and what consequences it will have on the globe is sometime to watch out for.



China: Facing Debt Pressure?

China has been growing at a blistering pace since the last few years. Loose monetary policies adopted by the Chinese central banks enabled unprecedented lending thereby boosting investments in infrastructure and housing. **It would be worthwhile to note that since September 2008, new loans doled out by banks in China have totaled to US\$3.8 trillion. This is significantly higher than the entire GDP of India! Thus, the growth was fuelled by injecting liquidity into the system.**

However, **after three years of credit boom, concerns have started emanating that slowing economic growth may spur a bad debt problem in China.** In fact, if the legendary hedge fund manager, Jim Chanos, is to be believed the situation is about to get worse in the near future. He cites that the property market is an important gauge of where the economy is headed in China. And with China's home transactions falling with a correction in residential prices the situation looks gloomy. If prices correct further it could spell trouble for Chinese banks. While the government is making calibrated efforts like raising rates and imposing restrictions on bank lending to developers it would be interesting to see whether these steps can protect the deteriorating health of its banking system.

China Seem Extremely Capricious

China's role in the global economy has mounted significantly in the last few years, especially after the global financial crisis has made the developed economies bed-ridden. So, the most important question currently in the mind of the global economy is: **What's going to become of China?**



Asking the question was an easy task. But getting an answer is anything but easy. For China is a huge emerging economy with very diverse regional economies. Add to that the communist party's love for secrecy. All these factors make China seem extremely capricious, so much so that people change their views on China in a matter of few weeks. There are economists who believe China is gearing towards some short-term pain while in the long term China will lead the global economy. Then there are those who believe that China could save its face in the short term by pumping up its economy through monetary or fiscal stimuli. But 2 to 3 years from now, China is set for a hard landing. The years of high growth and low inflation would be passé. It seems that both bulls and bears could be right about China. But only time will tell whose timing was right.

China, where is the country headed now?

Given the influence of China on the global economy, it is pertinent to ask where the country is headed now. In the aftermath of the 2008 global financial crisis, the Chinese government came up with massive stimulus packages amounting about US\$ 2.1 trillion, which was about 33% of the GDP (Gross Domestic Product). The money was channelized into building cities, roads, malls, commercial and residential buildings and so on. It not only boosted the country's economic growth in the short run but also generated significant employment.

The problem becomes apparent when you visit some of the Chinese 'ghost' cities. These cities have excessive real estate such as residential towers, malls and roads that are totally unoccupied. Meaning, there are no buyers or users for these properties. Then why were such projects built in the first place? Well, because cheap money was available. But why did the banks lend to such risky lenders? Because the central authorities ordered to do so. All this hints towards impending turmoil in both the Chinese banking and real estate sector. With inflation high and growth slowing, it's difficult to guess whether China is heading towards a temporary correction or whether a big bubble is about to burst.



India Vs China:

The fact that of the two continental giants, China is far ahead of India in most matters of social and economic development is as old as the hills now. But how exactly ahead is far ahead? The Economist has made an attempt to answer the question. It has taken a few parameters and highlighted how many years back China had the exact same readings as India has currently on those parameters. For example China's GDP per person was similar to India's current levels almost nine years back. India consumes the same electricity per person today as China consumed around 18 years back. The gap is even more glaring in the field of

social progress. More than 33 years have passed since a child in China had the same odds of surviving beyond its fifth birthday as the one existing in India currently! Furthermore, **India's adult literacy rate is a mere 63%, the rate which China enjoyed around 25 years back.**

This is not all. There are quite a few other parameters where the dragon nation has opened up a huge lead over India. Thus, the question that remains answering is whether India would be able to notch up numbers similar to China and that too in the time period highlighted by the data. It is a tall order indeed. Some paradigm change in the way our economy functions would be needed if we are to stand shoulder to shoulder with our neighbor from the north.

Challenges for Emerging Economies e.g. India, China.

There are several challenges confronting emerging economies like India and China in recent times. Income inequalities, inflation, slowing growth are just few of these. Nevertheless a 9 to 10% growth rate in the long term can ensure that these economies put together account for nearly half of global GDP. Also the per capita income levels are expected to eventually touch that in the Europe currently. However, the same cannot be achieved without some significant policy actions. The **chief of Asian Development Bank (ADB) opines that India and China could well get into the 'middle income trap'.** Technically it means that where national productivity and income growth stall after per capita income hits US\$ 3,000 to US\$ 6,000. Growth

spurred by exports and investments cannot sustain unless domestic consumption demand remains strong. In India consumption has been one of the key drivers of growth so far. However, the ADB believes that volatility in food prices and inability to control inflation could wreck havoc to India's consumption potential. Thus all things said and done, India's long term economic prosperity hinges on the country's ability to keep necessities affordable to the middle and lower income population.

Slovakia: No Go For The Plan To Overhaul The Bailout Fund.

Out of the 17 member nations of Euro currency bloc, Slovakia, one of the smallest in the consortium, has given a no go for the plan to overhaul the bailout fund. The bailout is being adopted as a tool of last resort to address the stubborn debt crisis in Greece and other Eurozone nations. However, Slovakia's disapproval to the bailout comes as a pleasant surprise. It finally seems as though someone has the guts to stop foolishly supporting the misdeeds of the powerful.



Issuing fresh debt is no solution to solve a debt crisis. Going by the fate of the first bailout plan, Greece doesn't deserve a second chance, and it certainly is not worth putting the tax payers' money at stake. There is no reason why one nation should pay for the debts piled by another.

However, one also needs to look at possible domino effect if Greece's insolvency spills the crisis beyond its borders. To give money to Greece does not make sense, but there seem to be very limited options. Without the bailout, the situation can get even worse and may doom all members of the euro zone, Slovakia included. However, the success of the overhaul will hinge upon the ensuring fiscal discipline and combining it with a comprehensive strategy to fight the debt crisis.

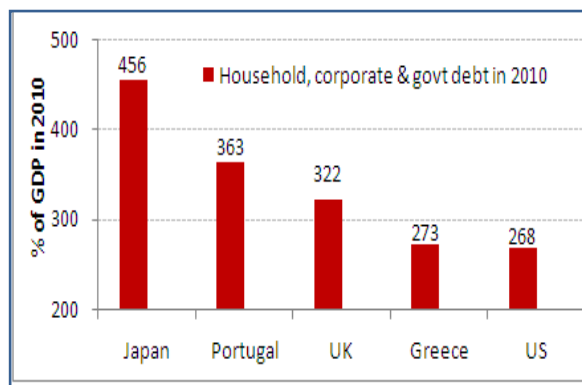
Debt Warning Signal:

An article published in the Telegraph, according to that 80 to 100% of GDP for governments, 90% of GDP for companies and 85% of GDP for households can be the debt warning signal claims the article. For companies and households, the GDP can be construed as the annual income levels.

Rich world is drowning in debt!

That the rich nations' debt levels have touched obscene numbers can be judged easily based on these benchmarks. The

combined debt of the developed nations rose from 165% of GDP 30 years ago to 310% in 2010. This is 3 times the acceptable level! The chart shows, Japan and Portugal have combined household, corporate and government debt levels of 456% and 363% of GDP respectively. In fact, the economies did not see such high levels of debt even during the wars. Add to that the facts that demographic atrophy and aging costs will make the scenario even nastier. However, it is not enough to know that such high debt levels are dangerous. The wrong notion that debtors can keep borrowing as long as creditors are willing to lend needs to be shed immediately. If not, we may end up with too many cases like the US and China where neither has benefitted from the economic excesses.



Source: The Telegraph

Europe Debt Crises: strengthen US Dollar

The global crisis has weakened the sentiment for each and every asset class. Stocks are too volatile. Commodity prices have corrected sharply. Debt has become a problem as well. So which asset class would benefit? **As per Dr Marc Faber, US dollar is the only asset that will benefit from this crisis.** He opines that the debt crisis in US and Europe would lead investors to invest in the US dollar denominated assets like treasuries. And this investment would boost the value of the greenback. He also opines that the European governments would need to pump money into



their own economies in order to boost growth. This move would further aid the movement in the US dollar as it is still considered to be safer as compared to the Euro. Unfortunately the US is also on shaky grounds thanks to the mountains of debt that it has piled on itself. So will the safety tag continue to be attached to the US dollar?

EFSF (European Financial Stability Fund)

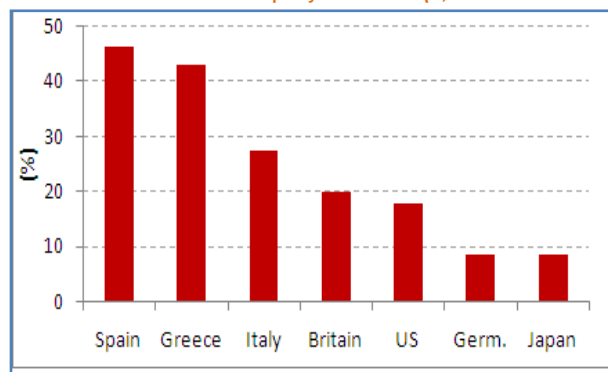
The latest suggestion by the Euro zone members is to allow the risky countries to issue bonds to bail themselves out of trouble. The guarantee for these bonds would be by them borrowing 20% of the bond value from the EFSF (European Financial Stability Fund). This way in case of a default on the bonds issued by the borrowing country, the lender will be compensated by the 'guarantee' that would be held by the EFSF.

As confusing as this process sounds, it is actually very simple at heart. What the Euro zone is suggesting is that they solve the problem of debt through more debt. This process would help the risky countries that are on the brink of a default appear risk free as they have the 'guarantee' of the EFSF borrowing. So the new debt now acts as a guarantee instead of a risk.

Rising Youth Unemployment:

It is a well documented fact that prolonged recession in the developed world has resulted in a surge in overall unemployment. And what these countries will have to worry about more is the unemployment prevalent among the youth. As the chart shows, youth unemployment has risen in the developed world with Spain leading the pack at 46%. Indeed, over time unemployment among the young population can be a dangerous thing as it means years lost due to no jobs, unattractive salaries and the diminishing prospect of getting a better job in the future. What is more, it creates great unrest and the prospect of revolution of the kind we have been witnessing in certain countries.

Youth unemployment in Q2, 2011



Source: The Economist

India Capital Markets:

During 2QFY2012, Indian markets fell in tandem with peers on heightened global macro concerns, registering their worst quarterly performance since the 3QFY2009 fall following the Lehman crisis. Uncertain global macro environment, moderating domestic growth with persistently higher inflation and concomitant policy rate hikes by the Reserve Bank of India (RBI) have overshadowed the reasonable valuations of domestic equities.

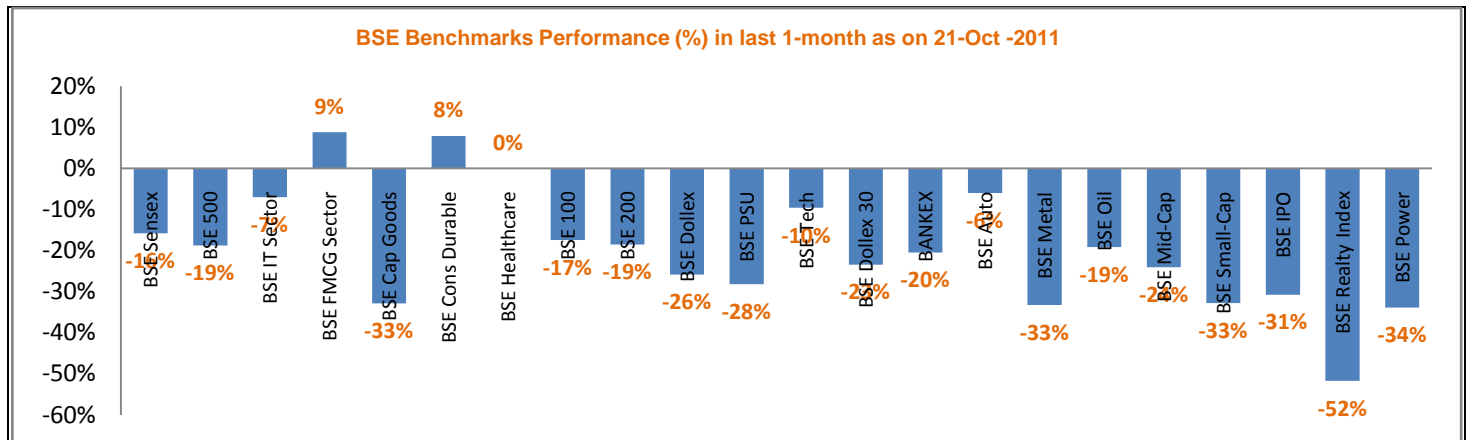
The key triggers for Indian equities are likely to be in the form of a) peaking of the domestic inflation and interest rate cycle and b) restoration of some degree of certainty in global markets on the back of structural reforms in the Euro zone. Hence, in the short term, Indian equities are likely to gyrate depending on global cues, despite reasonable valuations. However, over the longer term, we remain confident on the long-term prospects of the Indian growth story due to benefits of demographic dividend, a primarily internal consumption-driven economy, better positioning vis-à-vis peers, reasonable earnings growth trajectory and reasonable valuations in the context of India's structurally positive outlook.

In the near term as well, cooling global commodity and energy prices also bode well for the Indian economy and are likely to lead to peaking out of the WPI inflation cycle in September 2011. Inflation is likely to see meaningful deceleration from January 2012. As inflation peaks out, we expect the interest rate cycle to peak out with expected policy rate cuts from CY2012

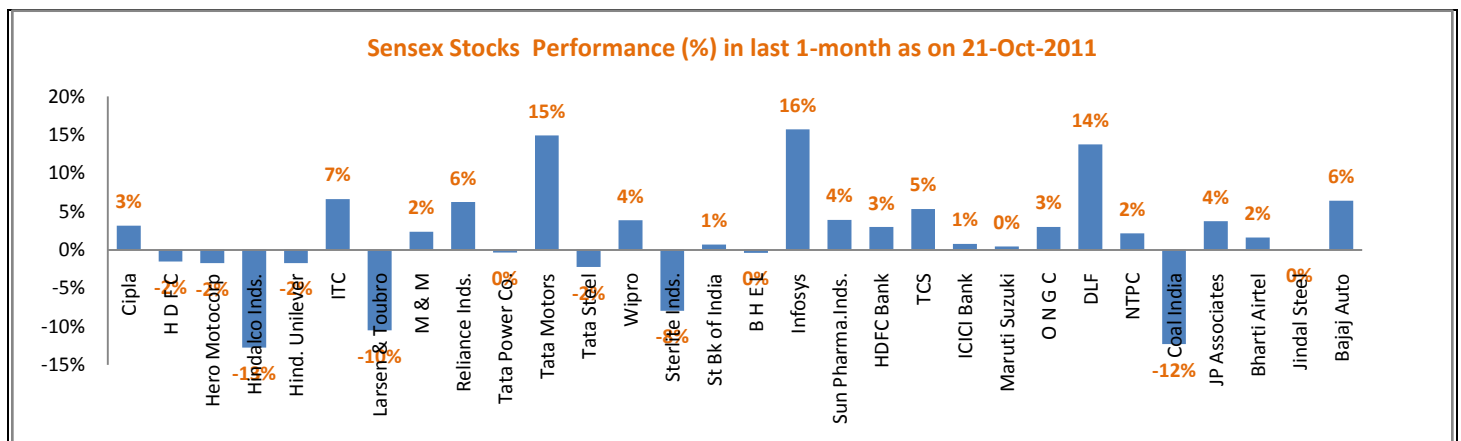
Sectorial Bench Marks & Stock Movements:

The BSE Benchmark performance chart⁵ depict negative picture. Only BSE FMCG and Consumer Durable Index surged by 9 percent and 8 percent respectively. All other indices show negative figures. The BSE Realty Index hit severely and decline by 52 percent. BSE Power declined by 34 percent.

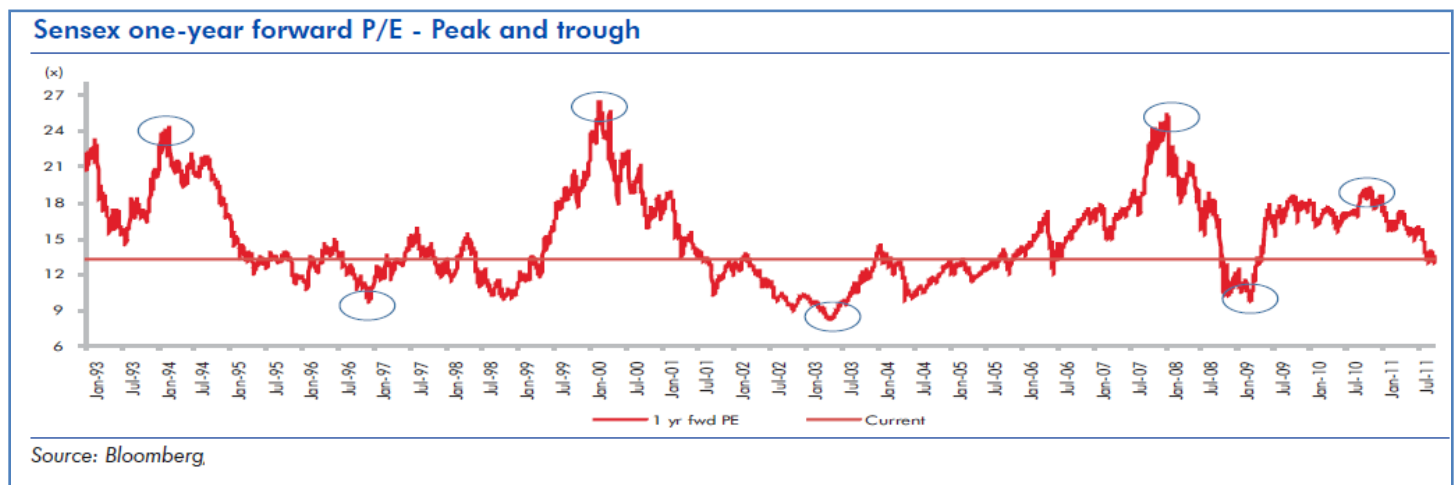
The Sensex Stock Performance Chart⁶ highlights mixed scenario. Infosys increased by 16 percent on account of its quarterly result. Tata Motor and DLF also increased by 15 and 14 percent respectively. Hindalco Industries decelerate by 13%.



BSE Benchmarks Performance (%) in last 1-month as on 21-Oct -2011, ISE-Research Cell



Sensex Stocks Performance (%) in last 1-month as on 21-Oct-2011, ISE Research Cell

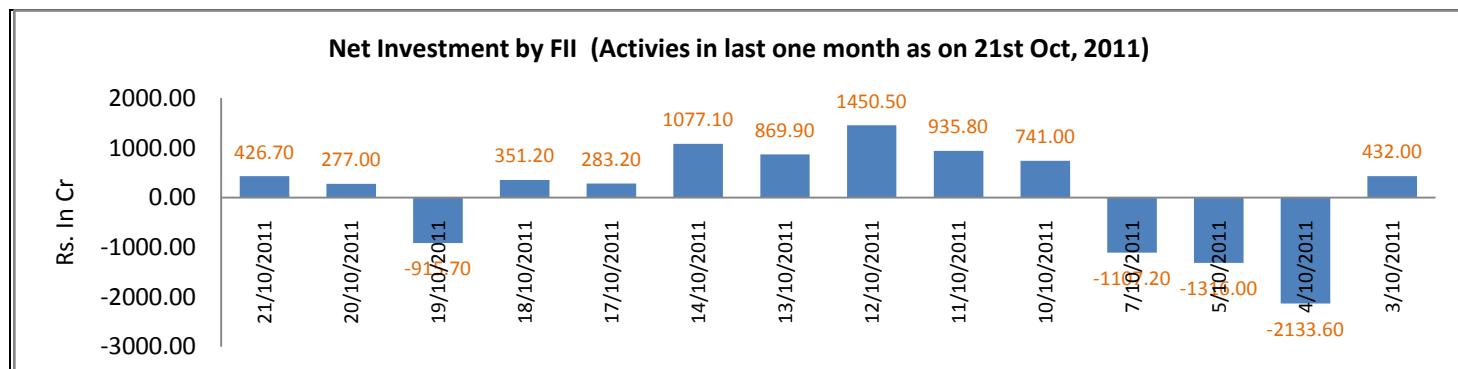


Sensex one-year Forward P/E – Peak and trough Sensex PE (Peak/Trough) Cycle:

Cycle	Days	Peak P/E	Trough P/E	Diff	% fall
Jan'94 - Dec'96	1,054	23.8	9.9	13.8	58.2
Feb'00 - May'03	1,187	26.4	8.2	18.2	69.0
Jan'08 - Jan'09	427	25.4	9.8	15.6	61.4
Nov'10 - till date	330	19.2	13.3*	6.1	31.7

Source: Bloomberg, * As on Sept. 30, one-year forward P/E

FII Movement in the last month:



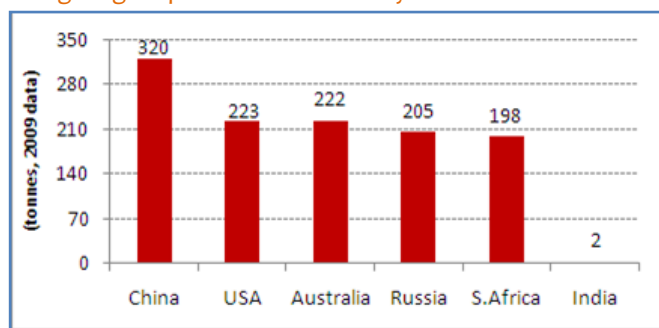
Tax Regime: Tax the Rich more!

Europe has decided to change its tax structure to tax the rich more. Should India follow suit? Indians are already being taxed as per their income levels. As a result, people in the higher income brackets are paying anywhere between 30% to 50% of their income in the form of taxes. Things are very different in Europe where tax shelters help the rich in paying minimal amounts of tax. Plus, the countries there need larger funds to be able to invest in the countries' growth. This is not the case in India. The problem in India is not the quantum of funds raised through taxes. It is the appropriation of these funds. Most of the funds are siphoned into populist policies. A large part is lost to poor governance. The government needs reforms to correct these issues. Not to torture the people by raising tax rates.



Gold Production Vs Consumption:

Largest gold producers : India way behind



Source: British Geological Survey, Rediff.com

Most of us know that India is one of the biggest consumers of gold in the world. But does the country have a similar standing when it comes to the production of the yellow metal? Certainly not. The chart shows as per data collected by the British Geological Survey, **India stands nowhere as compared to the largest producers of gold in the world.** At a little more than 2,000 tonnes of gold, its production absolutely pales in comparison to the largest producers like China and the US. Little wonder, it has to satisfy the needs of its gold consumers by resorting to large scale imports.

Is the power sector emerging as the biggest threat to the stability of India's banking system?



Policy inaction, lack of coal linkages and financial distress of select State Electricity Boards (SEBs) have brought the fortunes of the otherwise high potential sector to its knees. However, it is the 70:30 debts to equity financial structure of power projects that is most worrying. With several new capacities coming up, banks are worried that the power producers may not be able to service the loans if fuel scarcity affects utilization rates. Also, lack of recovery from SEBs may put the power producers' finances in distress.

Having said that we do not think that the power sector is in the same condition as the steel and cement companies were in the late 90s. Neither is the sector in a state of overcapacity, nor are its problems incorrigible. Re-pricing of tariffs and coal mining rights to power producers can solve most of the problem. Also, increased private sector participation in electricity distribution will go a long way in making the sector more economically resilient. We do not think that the sector will heap NPAs on banks unless the government keeps sleeping on policy reforms for a very long time.

Inflation:

Inflation in India has been high for quite some time now with the main culprit being rising food prices. And despite Reserve Bank of India's (RBI) attempts to tone it down through rate hikes, it has still not come within the comfort levels of the central bank. What is more, Mr. Richard Iley, Chief Economist, Asia, BNP Paribas opines that **inflation in India is different from that of its Asian peers and has been the most acute for several years now**. This is because of increasingly structural food price issues and rising demand for proteins and food grains as a result of higher disposable incomes. And food being a significant part of the wholesale price index (WPI), rise in food prices has fueled overall inflation as well. Further, according to Mr. Iley, food prices in India do not have a strong correlation with global food prices the way China does. Prices here are determined more by domestic factors. As far as rate hikes are concerned, Mr Iley believes that the RBI has reached the peak of the cycle. But even if it chooses not to raise rates further, it will be reluctant to loosen monetary policies too. This means that in a high interest rate environment, India's GDP growth could witness some slowdown in the medium term at least.

Real Estate:

The real estate sector in India is being recognised as an infrastructure service that is driving the economic growth engine of the country. FDI flows into housing and real estate in April-July 2010-11 stood at US\$ 301 million. Housing and real estate sector including cineplex, multiplex, integrated townships and commercial complexes etc, attracted a cumulative foreign direct investment (FDI) worth US\$ 10,682.69 million from April 2000 to July 2011.



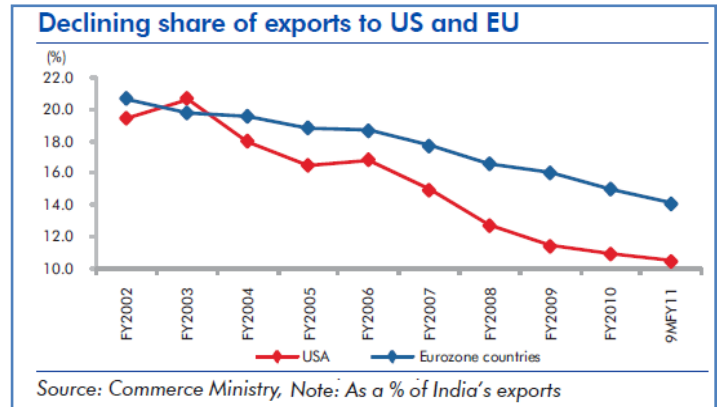
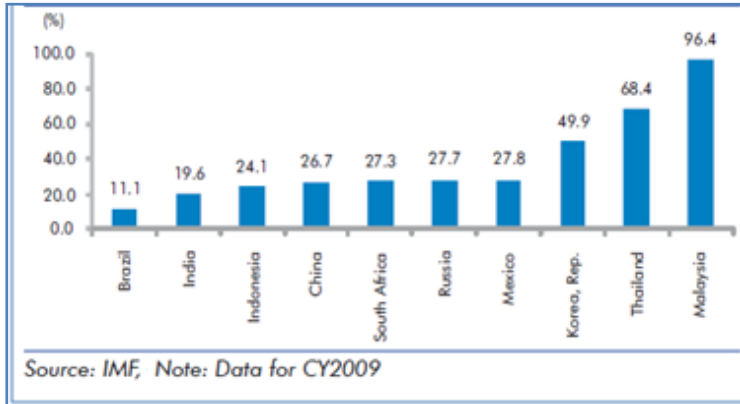
Real estate players seem to have iron nerves. **Despite weak macro-economic environment and gloom in the real estate sector, housing prices continue to remain firm across India**. According to a survey by the National Housing Bank, house prices have displayed a rising trend in 12 Indian cities in the April-June quarter of 2011. While metro cities of Delhi, Chennai and Hyderabad have witnessed double-digit price appreciation, Mumbai and Bangalore have shown an increase of low single-digit. However, is this demand-driven price appreciation? It does not appear so as buyers' sentiments remain weak. RBI has raised interest rates 11 times since March 2010 to tame inflation. The sharp increase in borrowing costs and high property prices have kept buyers on the sidelines. The double whammy of plunging sales and rising construction costs is taking its toll on the profitability of real estate majors who already are weighing under heavy debt and interest costs. Whether real estate companies reduce property prices ahead of the festive season is something that remains to be seen. But one thing is for sure, the current rise in housing prices is not sustainable, particularly because the demand-supply economics is not favorable to developers at the current levels.

India lower dependence on exports:

With the prospects of weaker growth in the US and Europe, concerns have arisen about the adverse impact on exports from India to these countries. However, we note that India has a relatively lower dependence as compared to other emerging market peers (exports to GDP of ~20% vs. ~40% for peers). Also, the share of these trading partners in India's exports basket has been on a declining trend; it has dipped from 40%+ in FY2003 to sub-25% during 9MFY2011.

India's exports to GDP lower vis-à-vis peers

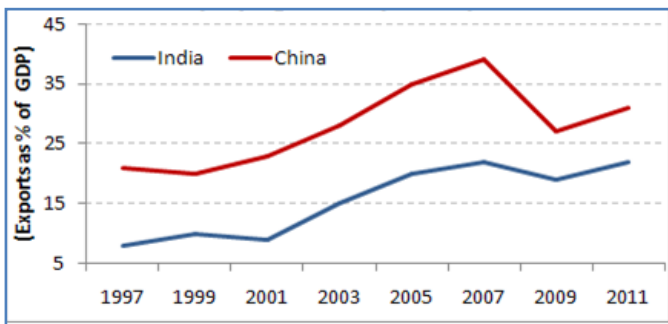
Declining share of exports to US and EU



India's export to GDP ratio :

No, this is not yet another account of how India's GDP growth is set to breach the 9% mark sooner or later. Nor is this another thumbs up to the economy's demographic virtues. High inflation, tight liquidity and fiscal deficits too remain finely etched on our minds when we speak on the Indian economy. However, there is one upside to the economy's resilience that is being ignored by most experts. The potential to export value added products to other growing economies.

India playing catch-up on export front



Yes, unlike China, India has always been perceived as an import dependent country. Well, that may remain true for several years to come. But the fact that needs to be noted is that India's export to GDP ratio is rapidly closing in on China's. There too there is a differentiation. Unlike earlier, India's exports are no longer restricted to gems and textiles. Engineering and petrochemicals that comprised barely 14% of exported goods a decade back, today account for a lion's share (42%).

As shows India's latest export to GDP ratio closes on the heels of China's. In fact, China's cheap and low quality goods may soon find fewer takers in its biggest export destinations in the US and Europe. On the contrary, India is not just exporting value added products but also has very little concentration to the barely growing developed nations. The share of goods exported to sluggish US and Europe has dropped from a half to a third in the past decade.

Coming to India's trade deficit (excess of imports over exports), economists opine that a reasonable deficit is a healthy sign. Certainly better than following China's footstep of building giant surpluses! More so since the funds are recycled as loans to weak Western governments. Thus whether or not the exchange rates support a flourishing export route from India, the future is certainly more crisis resilient here than in China. If that assures you of the Indian economy's encouraging long term prospects, it should certainly influence your investment decisions. For the doomsayers on the Indian economy, sooner or later they are set to be proven wrong.

Govt. Disinvestment Program:

It is October already and the Government is still a long way off from achieving its target disinvestment program. The Government had set up a disinvestment program that was expected to mop up nearly Rs 4 bn. However, due to the volatility in the stock markets, most of the public offers of the PSUs were postponed. Now, the government is contemplating a plan to list these companies outside of the country to meet the disinvestment target. It plans to issue **GDRs (Global Depository Receipts)** or **ADRs (American Depository Receipts)** on PSUs to mobilize the equity money.

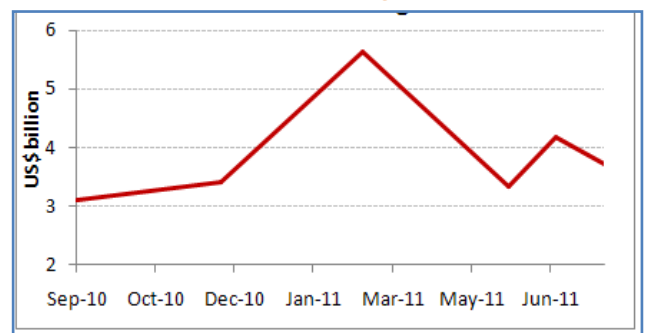
It would be an interesting option for sure as it would woo the global institutional investors to invest in the Indian companies. But consider the fact that stock markets in the developed world are currently even more volatile than that in India. As a result, we do wonder if the companies would be able to achieve the valuation multiples that they are hoping for. If they are willing to accept the lower valuation multiples, then why not just list the companies in India itself. It poses lesser regulatory hassles. And also gives the country's investors a way to participate in the offer.

Monetary Policies:

ECBs :

Higher interest rates in India had forced India Inc to look outwards to meet their borrowing needs. Little wonder that most companies turned to ECBs (External Commercial Borrowings) for their funding requirements. However, as shown in **chart, India Inc's ECBs have started to trend downwards**. One reason for this is that with the financial crisis gripping the world, most banks outside of India are cutting down their lending. At the same time, with increasing interest rates, most companies have postponed or cut down their capex plans. As a result, most of them have been able to meet their investment needs with their own cash balances.

India Inc. ECBs coming down

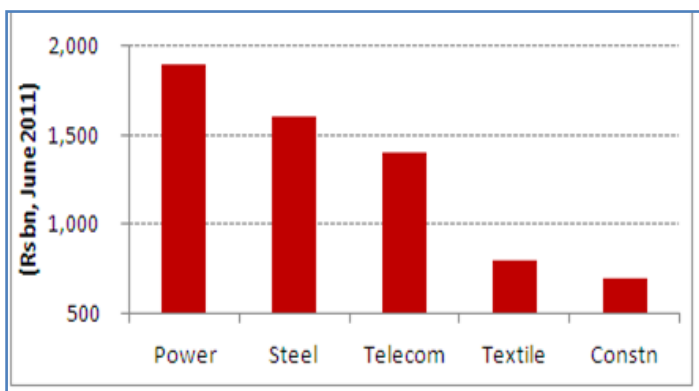


Source: Reserve Bank of India (RBI)

A new policy initiative by the Department of Industrial Policy and Promotion (DIPP) is set to hurt private equity (PE) deals in India where the investor is a foreign entity. As per the new policy, investment instruments with built-in options of any type would not qualify as eligible instruments of foreign direct investment (FDI). Any equity instrument issued by an Indian company to a foreign entity which allows the foreign firm to exit the arrangement through a buyback or through put and call option, will be treated as external commercial borrowing (ECB). Hence, this arrangement would curb all foreign companies from exiting ventures. Moreover, ECBs are subject to caps and limits. All this will act as a major deterrent to foreign investors.

What is the reason behind such a change in policy, you may ask? Well, it is important to note that the Reserve Bank of India (RBI) had raised concerns about foreign investors exiting through the put option route. The DIPP move has been initiated to curtail transactions in real estate that came under the guise of FDI-compliant investment, but were actually ECBs.

India's most indebted sectors - Financial Express



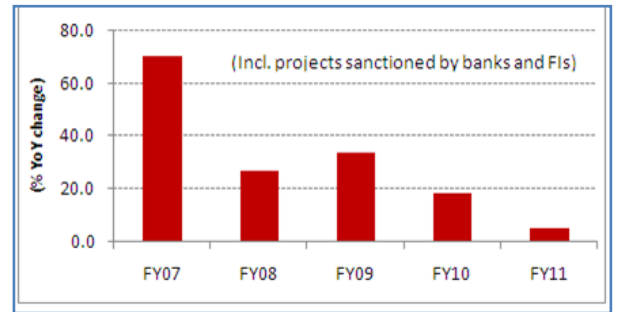
Sectors Trend:

There has been a lot of talk in recent times about how if the interest rates are not reduced; the banking sector in India could be left saddled with a lot of debt. Chart **has tried to highlight the most indebted sectors in the country as at the end of June 2011**. This data is based on outstanding loans of Indian banks and identifies the power sector as the biggest borrower of them all. While steel and telecom are not far behind, the gap between these three and the next two sectors on the list is indeed huge. It should be noted that execution is not the only issue that plagues the power sector, its long gestation period could also lead to asset liability mismatches for the Indian banking

system.

Falling Capital Expenditure:

The RBI may be pulling out all stops to tame inflation. But the strategy of high interest rates that it is using could also be leading to some unintended consequences. Take capex for instance. The chart15 shows, **future capacity building in India grew at a very low rate in FY11**. If this is not enough, the current year could actually see capex coming lower than the previous year. Of course, a lot of people could argue that it is much better to have low capital expenditures rather than have it grow at break neck speed only to see the underlying loans going bad in the future.



Capex: A victim of high interest rates? Source: Mint

Auto:

Labour unrest at Maruti's plant in Manesar:

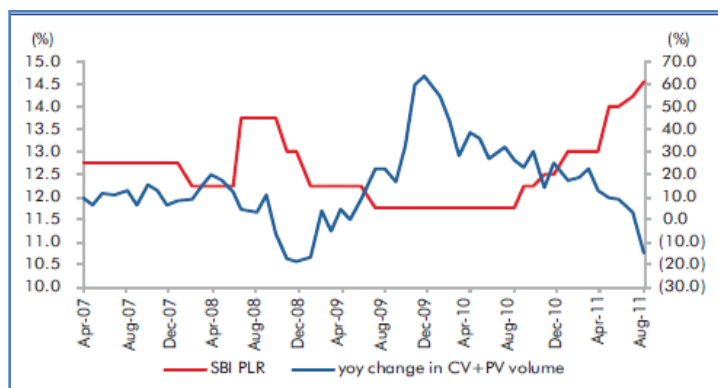
The Indian auto industry has not had a particularly good year so far. With interest rates and fuel prices rising, demand has dampened especially for passenger vehicles. And the ongoing labour unrest at Maruti's plant in Manesar has only made matters worse. That said, the labour problems that Maruti is facing is not something new. The auto industry especially has witnessed these kinds of strikes in the past. So the question to be asked is why such labour problems have repeatedly occurred in the auto space.

The answer lies in the lure of contract labour and the difference in pay and working conditions for these workers as compared to permanent ones. First of all, the ratio of permanent to temporary employees in the auto industry is as high as 60:40. Secondly, **though the wage difference between permanent and contract workers is Rs 10,000 or sometimes a little higher, the delivery expectations from the two are almost the same**. Thirdly, apart from the salary, a contract worker is not entitled to other benefits like a bus service, paid leave, medical benefits etc. There is also a difference in the uniform that the two wear. The auto sector is attracted to contractual labour because it wants to curtail production costs and also have the option of laying off workers during a slump. It has contended that all such strikes typically have political interests. Whatever be the case, the industry will have to give a long and hard thought to these problems and come out with a more meaningful and long term solution if such issues are to be avoided in the future.

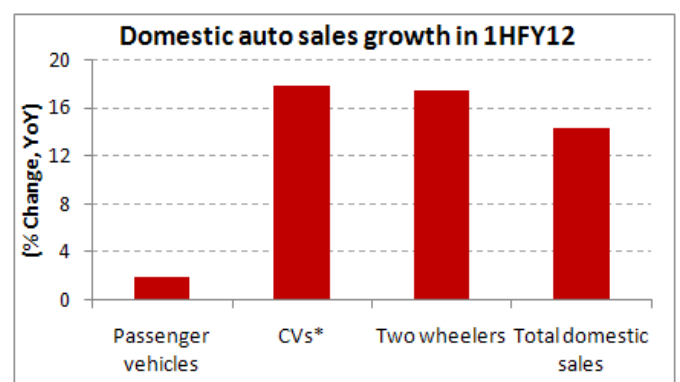
Domestic Auto Sales Growth:

After two stupendous years (read FY10 and FY11) for the auto industry, where sales numbers across all vehicles registered robust growth, the scenario in FY12 so far has been rather mixed. The chart16 shows, **growth in total domestic sales were largely led by commercial vehicles and two wheelers** as passenger vehicles failed to put up a strong show. Rising interest rates and fuel prices dampened demand for passenger vehicles and labour unrest at Maruti's plant at Manesar only compounded woes.

Interest Rate Vs. Auto Sales

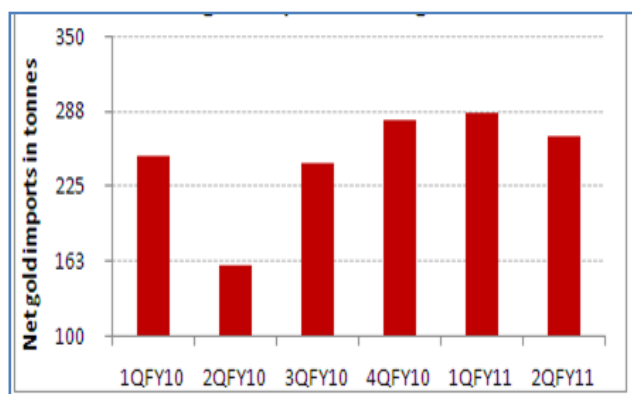


Domestic Auto Sales Growth in 1H FY12 (Commercial vehicles), SIAM



Food has remained costly:

Despite good rainfall over the past two years, the inflationary crisis in India has still shown no signs of abating. This is despite 12 rate hikes over a period of 18 months. The cumulative 5% increase in policy rates over this period is the fastest pace of tightening since the RBI was established. And still, inflation remains stubbornly above 9%. Well, we believe that not just focusing on boosting farm output, but also improving the food distribution system is the key to cooling prices. Thus, it may be time for the RBI to stop, and the government to take the reins.



India's gold imports see a "gold" run; Source: World Gold Council

Gold:

Gold has seen a dream run in recent times. The price of the yellow metal has been trending upwards due to its status as a safe haven. This has become more pronounced in recent times with the uncertainty clouding global markets. Though several investors have doubts that the metal might be in a state of a bubble, this has not deterred India from increasing its gold imports. As the chart¹⁸ shows, **India's import of gold has gone up on a year-on-year (YoY) basis.** Despite the September quarter being a slow one in terms of off take for the metal, gold imports during the quarter ended September 2011 is still up by almost 68% YoY.

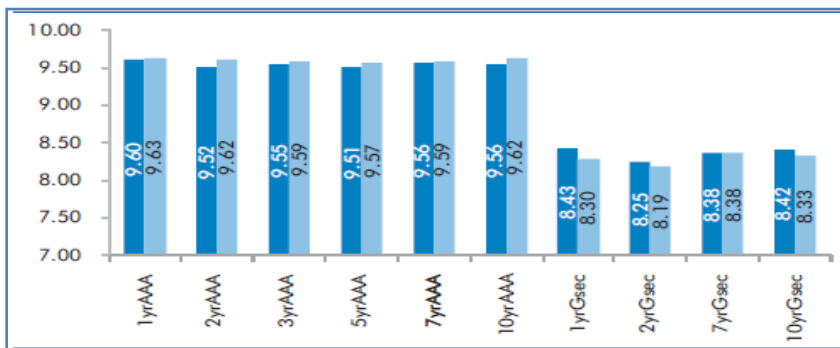
Bank: FY2012-Q2 Stock Performance

Banks going belly up is not uncommon in the US. Ever since the collapse of Lehman Brothers, scores of them have been declared bankrupt each month. Lack of regulation and indiscriminate lending by the smaller and regional players led to the collapse of banking sector in the US. Comparatively, the Indian banking scenario seems far more robust. The scheduled commercial banks here are far better regulated by the RBI. The private sector and foreign players too play by the book. Stricter provision norms and capital controls have ensured almost negligible cases of bankruptcy even during times of crisis. However, dig a little deeper and the scenario does not seem as rosy.

Currently, India has 27 public sector banks, 7 new private sector banks, 15 old private sector banks and 31 foreign entities. In addition, there are 90 regional rural banks, 1,721 urban cooperative banks, 31 state cooperative banks and 371 district central cooperative banks. The list seems pretty distorted in terms of regulatory control and supervision. While the PSU, private and foreign entities are well regulated, control over the large number of rural and cooperative entities leave a lot to be desired. What else can explain the fact that **26 cooperative banks closed operations in FY11 and another 8 are set to follow suit in FY12?** While consolidation is a must for better regulation in Indian banking, the government needs to ease up regulations for the same.

(%)	Returns (qoq)	Returns (yoy)
Indian Bank	0.2	(23.8)
J & K Bank	(4.8)	(0.7)
HDFC Bank	(6.6)	(5.8)
South Ind.Bank	(7.3)	(7.1)
Andhra Bank	(7.7)	(22.5)
HDFC	(9.2)	(12.4)
Oriental Bank	(10.9)	(36.3)
Syndicate Bank	(11.6)	(9.4)
Punjab Natl.Bank	(12.0)	(25.8)
Bank of Baroda	(12.4)	(12.5)
Yes Bank	(12.6)	(22.5)
Sensex	(12.7)	(18.0)
LIC Housing Finance	(12.8)	(26.6)
Dena Bank	(14.1)	(26.8)
Bankex	(15.4)	(22.6)
Union Bank	(16.0)	(36.6)
Canara Bank	(16.1)	(24.5)
Central Bank	(17.5)	(37.9)
Bank of Maharashtra	(18.2)	(34.5)
Federal Bank	(19.0)	(6.5)
Corporation Bank	(19.6)	(39.0)
Allahabad Bank	(19.8)	(31.7)
ICICI Bank	(19.9)	(21.2)
St Bk of India	(20.6)	(40.9)
Axis Bank	(20.8)	(33.3)
Vijaya Bank	(21.6)	(33.1)
United Bank	(23.2)	(36.7)
Bank of India	(23.7)	(38.8)
IDBI Bank	(24.5)	(32.6)
UCO Bank	(31.2)	(41.7)
Indian Overseas Bank	(36.9)	(29.9)

Corp. and G-Sec bond yields rise in 2QFY2012

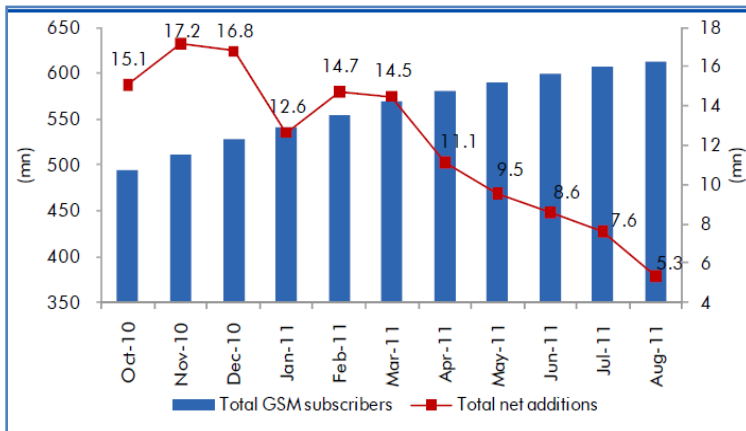


Source: Bloomberg, ISE Research

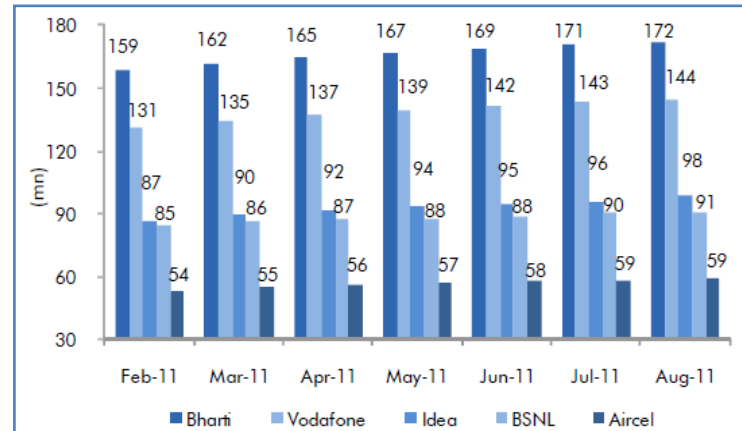
Telecom:

Cellular Operators Association of India (COAI) reported GSM subscriber data for August 2011. GSM subscriber net addition data continued its declining trend during this month as well and was reported to be weak on mom basis across all telecom operators (except Idea). Net subscriber addition number stood at merely 5.3mn (almost at all-time low), down by whopping 30% mom, taking the total GSM subscriber base to 611.8mn subscribers in August 2011.

Total GSM Subscriber base and net additions

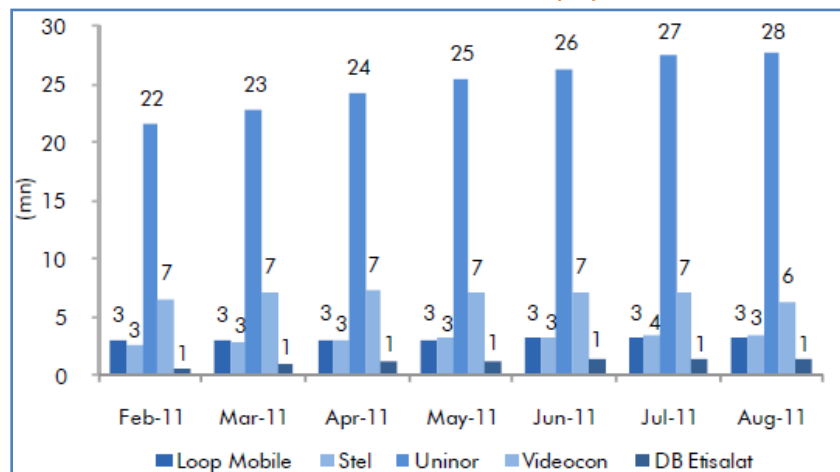


Pan India Total GSM subscribers – Incumbents



Source: Company, TRAI and ISE Research

Total GSM subscribers – New players



Source: Company, TRAI, ISE Research

Quick Facts:

- India's foreign exchange (Forex) reserves rose by US\$ 266 million to US\$ 316.763 billion in the week ended September 16, 2011, according to the Reserve Bank of India's (RBI) 'Weekly Statistical Supplement'.
- Net direct tax collection upto September 15, 2011, in 2011-12 grew by 6.7 per cent at Rs 1,27,858 crore (US\$ 26.75 billion) as against Rs 1,19,849 crore (US\$ 25.07 billion) collected from April 1 to September 15 in 2010.
- Private equity (PE) and venture capital (VC) investments grew by 29 per cent to US\$ 648 million (around Rs 2,916 crore) in the period January-September 2011 as compared to US\$ 500 million (around Rs 2,250 crore) in the same period last year.
- The index for eight core sector industries—crude oil, petroleum refinery products, coal, electricity, cement, steel, fertilizers and natural gas—rose 7.8 per cent in July 2011 compared to 5.7 per cent in July last year.
- Exports of spices during April-July 2011 increased 22 per cent in rupee terms and 26 per cent in dollar terms, with total receipts in the period at Rs 2,613.50 crore (US\$ 585.46 million), compared to Rs 2,135 crore (US\$ 464.92 million) during the same period last year.
- The wind energy sector has attracted foreign direct investment (FDI) worth Rs 1,510 crore (US\$ 328.87 million) over the past three years. In the renewable energy sector, wind energy has emerged as the fastest growing category, according to Dr Farooq Abdullah, Union Minister for New and Renewable Energy.
- The monthly net investment by mutual fund (MF) houses in August 2011 has hit a 38-month high, at Rs 2,524 crore (US\$ 547.18 million), according to the statistics from the Securities and Exchange Board of India (SEBI).
- Small Industries Development Bank of India (SIDBI) has announced its plans to disburse Rs 1,000 crore (US\$ 209.36 million) to microfinance companies in 2011.

Mutual Fund & Insurance Update

- Kotak Mutual Fund files offer document with SEBI to launch Kotak FMP Series 70-79.
- IIFL Mutual Fund files offer document with SEBI to launch IIFL Monthly Income Plan, an open ended income scheme and IIFL Fixed Maturity Plan-Series 1 & Series 2, a close ended income scheme.
- Berkshire Insurance has introduced customized travel insurance products in India.
- IRDA will issue the guidelines for listing of non-life insurance companies by March 2012.

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