



Equity Market Comment

24 March 2010

Summary

Impact of India rate hike likely limited

Tightening by Asian central banks is normalisation from crisis months

Last Friday, the Reserve Bank of India (RBI) hiked the repo and reverse repo rate by 25 basis points to 5% and 3.5% respectively.

Our view is that the impact of the tightening on the Indian equity market is limited. While the cost of borrowing for the corporate sector does increase, the stellar growth in industrial production and better pricing power should make up for it. Furthermore, S&P has upgraded its outlook on India from Negative to Stable and this should lower the cost of borrowing for the Indian corporate sector.

The Sensex has risen by about 10% since the middle of February and we believe that the anticipation of a good monsoon will help sustain the inflow of foreign funds. Strong inflows by domestic funds would further reinforce the momentum in the market.

A wider consideration for the equity market is the overall move towards tightening by Asian central banks. While we expect more Asian central banks to tighten monetary policy, we believe that these are steps to normalise policy from the crisis months rather than the usual tightening that puts growth at risk. Asian economies have rebounded strongly in Asia and the abundant amount of liquidity is no longer appropriate. Raising interest rates now will reduce the risk of inflation picking up pace further down the road.

Although concerns about tightening will persist, we believe the market has more or less priced these in and will focus again on fundamentals. In our view, the ongoing improvement in the global economy and the recovery in corporate earnings are likely to drive equity markets higher in the coming months.



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Rate hike limited impact on Indian equity market

Last Friday, after the market closed, the Reserve Bank of India (RBI) hiked the repo and reverse repo rate by 25 basis points to 5% and 3.5% respectively. While monetary tightening in India has been widely expected, the timing came as a surprise as this hike was an intra-meeting move. Changes in the repo rates typically take place when a monetary policy meeting is held.

Interest rate hikes have been expected because the strong growth in industrial production and the rise in food prices have led to accelerating inflation. The headline Wholesale Price Index (WPI) reached 9.9% in February this year, exceeding the RBI's 8.5% target for end March 2010. In its press statement accompanying the rate hike, the RBI said that it saw a risk of the WPI crossing into double digits in March 2010.

We believe that the RBI is not likely to over-tighten as raising interest rates does not fully solve the problem of supply-side bottlenecks. We also believe inflation could moderate if India has a good monsoon this year (what is currently expected) and also if global commodity prices, including oil, remain steady at current levels. The base effects of higher year-on-year global commodity prices should start falling off by the middle of the year. Moderating inflation will mean less urgency for the RBI to tighten.

In terms of the Indian equity market, our view is that the direct impact of the tightening is limited. While the cost of borrowing for the corporate sector does increase, the stellar growth in industrial production and better pricing power should make up for it. Furthermore, S&P has upgraded its outlook on India from Negative to Stable and this should lower the cost of borrowing for the Indian corporate sector.

The strength of Indian corporate earnings is reflected in the premium investors are willing to pay for Indian equities. At 17x 2010 Price/Earnings (P/E) ratio and 14x 2011 P/E, MSCI India appears relatively more expensive than the other markets in the region. MSCI Asia ex Japan is trading at 13.3x 2010 P/E and 11.6x 2011 P/E. However, with an expected earnings growth of 30% for 2010 and 21% in 2011, the higher P/E appears justified against India's own history.

Upward momentum likely to be sustained in anticipation of good monsoon

The Indian equity market corrected in the first weeks of this year but the Sensex has risen by about 10% since the middle of February and all the lost ground has been recovered. Investors turned more positive towards the Indian equity market following the lowering of the fiscal deficit and the growth-oriented budget delivered by the Union Government in February this year.

Although market sentiment is difficult to predict, we nevertheless believe that the anticipation of a good monsoon (between June and September) will help sustain the inflow of foreign funds and maintain the upward trend of the market. Inflows by domestic funds would further reinforce the momentum in the market.



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Tightening in Asia is normalisation from crisis months

A wider consideration for the equity market is the overall move towards tightening by Asian central banks. The early move by China in January to raise the reserve ratio and to rein in loan growth triggered the broader correction we saw in the first weeks of this year. India and Malaysia have also since tightened monetary policy.

While we expect more Asian central banks to tighten monetary policy, we believe that these are steps to normalise policy from the crisis months rather than the usual tightening that puts growth at risk. Asian economies have rebounded strongly in Asia and the abundant amount of liquidity is no longer appropriate. Raising interest rates now will reduce the risk of inflation picking up pace further down the road.

Recovery in earnings likely to drive equity market

Although concerns about tightening will persist, we believe the market has more or less priced these in and will focus again on fundamentals. In our view, the ongoing improvement in the global economy and the recovery in corporate earnings are likely to drive equity markets higher in the coming months.



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