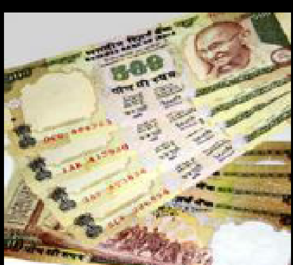


25 August 2009

KARVY STOCKBROKING LIMITED

INR APPRECIATION:

A BLESSING IN DISGUISE

Introduction to rupee trends and the macro-economy

The last five months of 2009 have been quite eventful for the Indian rupee, with the currency gaining steadily against the US dollar, ***after a catastrophic 2008*** that saw the Indian rupee fall more than 20% from 39 levels to 50 levels. At a time when the Indian economy was visibly slowing down, the recent gain in the rupee has proved to be a blessing in disguise.

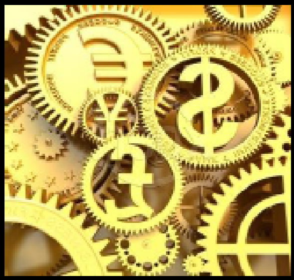
Improving industrial production numbers, better-than-expected corporate results, political stability, rising commodity prices, revival of exports, and considerable inflows into the equity markets have changed the economic landscape since early March 2009 when financial markets had retested their October lows.

With the ***Indian economy and financial markets*** the cynosure of all eyes, we expect the rupee to strengthen further in the near term. The rupee has been largely volatile since January 2009, trading in a wide range between 46.75 and 52.18. It has appreciated close to 1.30% YTD (year-to-date) after making a low of Rs52.18 per dollar in early March 2009.

Meanwhile, ***India's $1.2-trillion economy, Asia's third-biggest***, expanded 6.7% in the year-ended March 31, the slowest pace since 2003, although it is still among the fastest-rising countries in the world. The RBI has forecast a 6% growth for the current year.

The Congress-led UPA alliance won a second consecutive five-year term in May, and as an extension of programs implemented in the last five years, it plans to focus more on poverty-alleviation, social welfare, healthcare and education, besides infrastructure building. If implemented effectively, we believe that these measures will benefit the Indian economy in the long-term.

However, according to Finance Minister Pranab Mukherjee, the ***fiscal deficit will widen to 6.8% in FY10***, the most since 1994, as the government implements increased public spending to combat the economic slowdown.



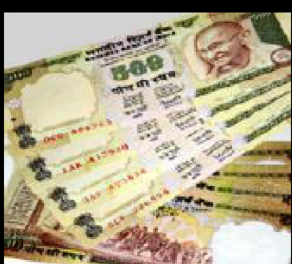
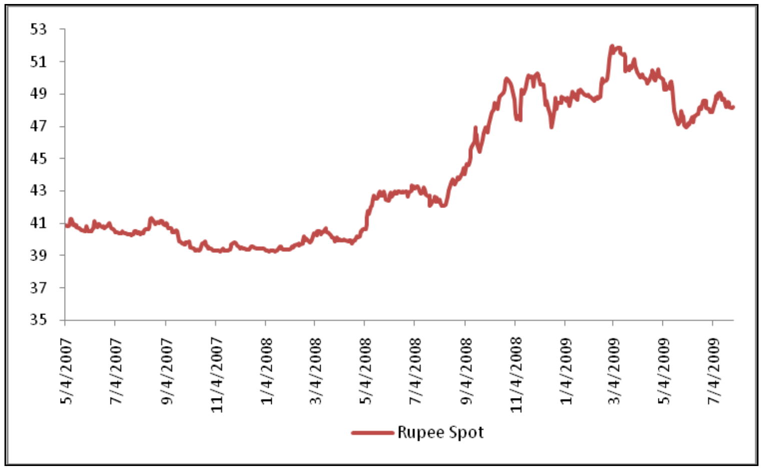


Figure 1: Spot rupee movement



Determinants of currency fluctuations

While the rupee movement in a certain direction may benefit some, it may prove to be detrimental for others. For instance, if the rupee appreciates against the dollar (or any other currency, for that matter), the importers stand to gain as they have to shell out less units of the local currency (rupee payments) for each unit of dollar imports. On the other hand, the exporters stand to lose as they notch up less units of the local currency in exchange for their exports dollar earnings.

In other words, due to a strong rupee, Indian goods and services become costlier in the international market even as it weakens the competitiveness of the exporter. Meanwhile, the impact of a depreciating rupee (against the dollar) is exactly the opposite, with the exporters standing to gain while importers have to do business at a higher cost.

Currency fluctuations depend on ***numerous macroeconomic factors*** with varying degrees of importance. Some of the factors that played a key role in the recent rupee volatility include rising crude prices, widening trade deficit, major international currency trends, surprising election results and the expectations of increased political stability, the Union Budget for 2009, and strong domestic and global cues that saw money flowing into the equity markets as the bellwether BSE Sensex jumped more than 80% since March 2009.

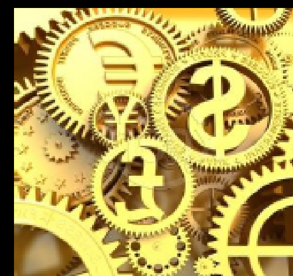
For instance, ***global financial markets*** retested their October lows in early March 2009. However, a steady stream of positive economic data emanated from the US, besides better-than-expected quarterly results announcements, raising investor hopes that the US economy may be turning the corner. The result was that emerging markets like India came back strongly, notching up spectacular gains as the investment climate visibly improved.

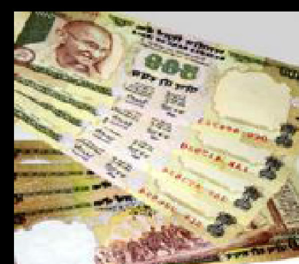
The return of ***FII's (foreign institutional investors)*** in the Indian markets was marked by strong dollar inflows into the country, thus strengthening the rupee.

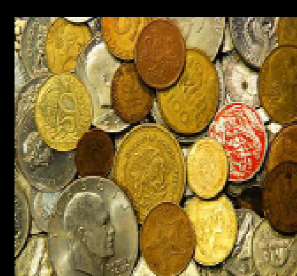
In other words, while 2008 was marked by strong dollar outflows as the rupee plummeted from 39 levels, the strong rupee in 2009 marked the return of the FII's back into the Indian markets. Of course, the RBI, in the larger interest of the economy, tries to minimize fluctuations in the rupee-dollar exchange rates by buying and selling in the international currency market. As it is a big player in that market, it is able to influence the exchange rate by suitably affecting the market forces of demand and supply.

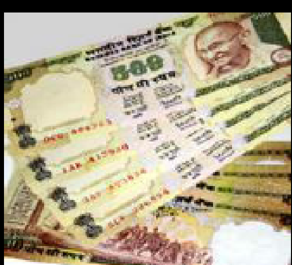
The ***extreme volatility*** of the rupee over the last six months have attracted market participants of all hues—speculators, investors, and hedgers (exporters, importers, corporate treasuries). Accordingly, both the NSE and MCX-SX have witnessed a spectacular rise in currency futures trading.

The turnover has grown manifold since both these operations were set up—currency futures trading at the NSE was introduced in August 2008, and in October 2008 at the MCX-SX. The ***trade volumes on the MCX-SX*** have surged close to 380% since the beginning of 2009, from 1, 04,490 lakhs to 500,355 lakhs (as on August 18, 2009). The pace on the NSE, too, has been quite spectacular, gaining close to 385% from 102,218 lakhs to 497.685.94 lakhs (as on August 18, 2009).





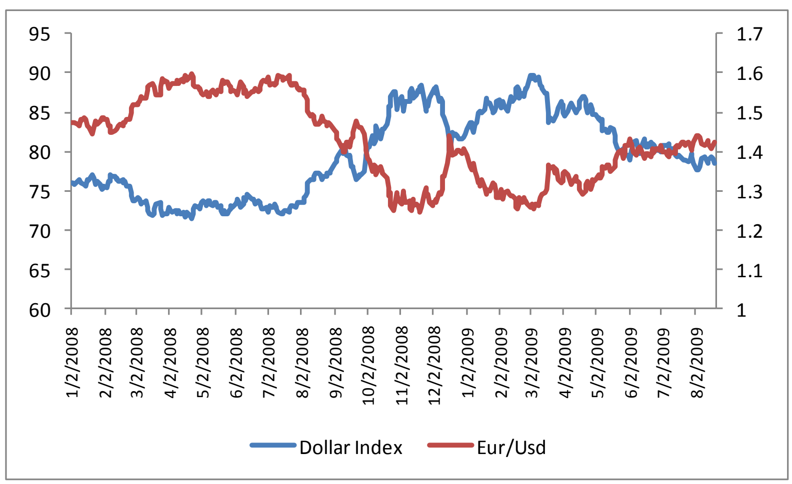




Global currency trends

The ***appreciation or depreciation of the rupee***, as the case may be, is more influenced by the weakness or strength of the US dollar. This means that factors affecting the dollar against a host of other international currencies need to be closely monitored. A string of economic reports released by the US and Euro regions, statements made by central banks in these regions, ***inflationary concerns***, and the GDP growth of these economies play a direct role in determining the value of a particular currency. For instance, the appreciation of the rupee to 47 levels (from 53 levels) in the second quarter of 2009 was also attributed to the weakness of the Dollar Index against major currencies, such as the euro and the pound, and positive sentiment on the back of the euro—a composite currency of 15 nations—gaining strength.

Figure 2: Dollar Index v/s euro movement



Moreover, China sold dollars to diversify its forex portfolio, thus pushing the dollar down. Furthermore, in the ***G8 summit***, Russia expressed concerns about the need for an alternate currency considering that revival of the US economy might take awhile and the dollar may be unable to sustain the pressure of world trade. **Figure 2** shows a smart crossover of the euro over the Dollar Index, whereby the euro continued to gain against the ICE Dollar Index, a cumulative performance measure of six major currencies.

Capital flows and the Indian stock market

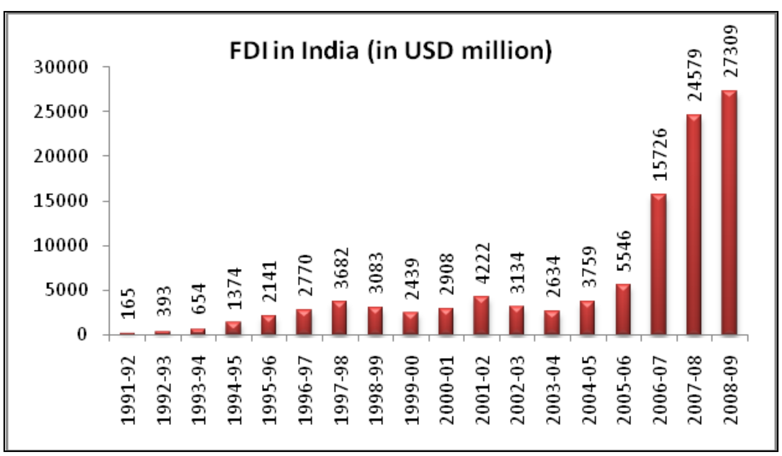
The inflow into the Indian economy in the form of debt and equity capital also played an important role in determining the exchange rate. For instance, despite the trade deficit, until early January 2008, the rupee had appreciated smartly to 39 levels, primarily due to the huge FII inflows into Indian equities. In fact, it was these very inflows that fuelled a spectacular four-year bull run in the stock markets that culminated in 2007.

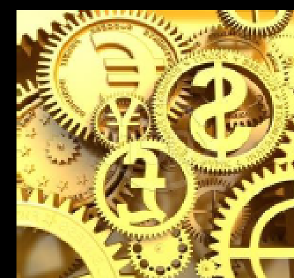
According to data released by the ***Securities and Exchange Board of India (SEBI),*** during the first quarter of the current fiscal, FII's bought shares worth US$37.66 billion, while they sold equities valued at US$31.36 billion, resulting in a net inflow of US$6.32 billion. In the May month alone, the market saw an inflow of US$4.17 billion, accounting for 66% of the total investment in the June quarter.

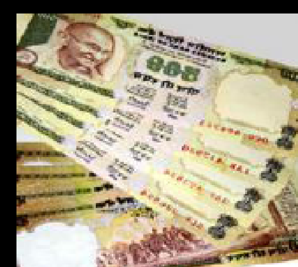
With ***strong net FII inflows*** into the Indian equity market, aggregating US$6 billion, or 83% higher than the same period last year, the BSE Sensex skyrocketed from its March lows of 8160 to the 15000+ levels in the current quarter. Meanwhile, despite the global recession, FDI inflows rose 11% from US$24.6 billion to US$27.3 billion in financial year 2008-09.

Figure 3: FDI in India

US$ in millions







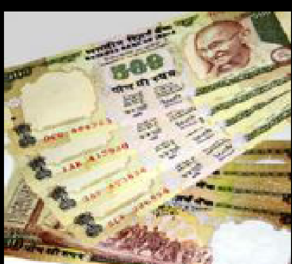
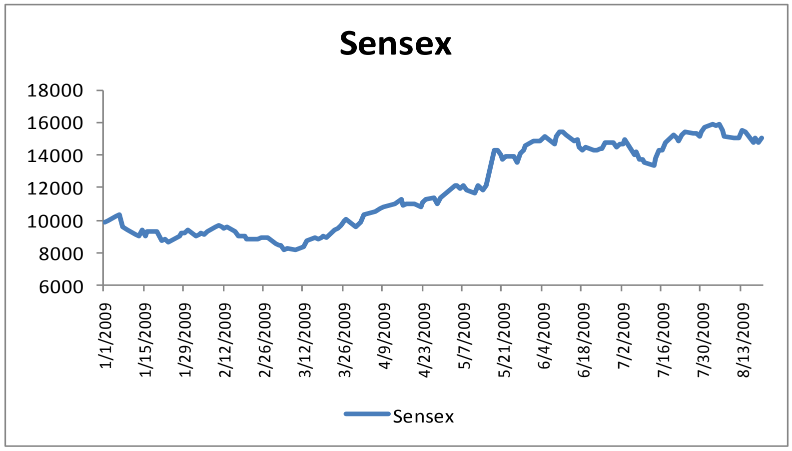


Figure 4: 2009 BSE Sensex movements



Bond market

The yield on the 10-year benchmark government notes maturing in 2019 rose as the government increased its borrowing target for the first half of the fiscal year by 24%, to Rs2.99 trillion (US$61.7 billion). ***India scheduled 10 auctions***, starting July 24, to raise the remaining Rs1.1 trillion, according to the central bank, to help the government fund its mega budget deficit. In other words, higher the government borrowing programme, greater will be the volatility in currency flows. This has particularly come into sharp focus in recent times due to the government's huge impending borrowing programme.

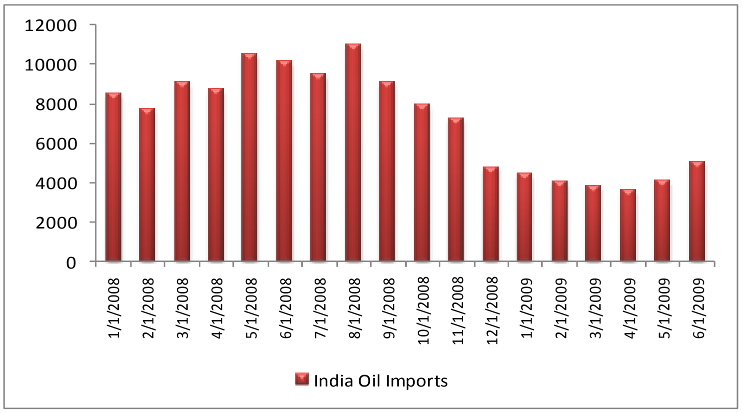
Forward market

The ***one-month onshore currency forwards*** take the cues from the INR Spot and RBI Reference Rate, and, therefore, the premium has narrowed. The average premium earlier of 20-22 paisa has now come down to 10-12 paisa. It indicates a shift in market investments, and also greater product knowledge among investors to decide on the premiums quoted. The ***Offshore Non-Deliverable Forwards (NDF's)*** actively traded in Singapore and Hong Kong has also showcased a similar trend. Earlier, investors actively traded in the NDF market when they found less participation or liquidity on the domestic front, but with volumes surging in the latter, it has taken on an increasingly important role. The contraction in the gap between onshore and offshore market premium indicates potential rupee appreciation.

Oil imports

Asia's third-largest economy depends on ***imports to meet about 70% of its annual energy needs***, and, therefore, the impact of the same on the Indian currency assumes significance. After skyrocketing to US$147 per barrel in July 2008, prices crashed in the second half of 2008, hitting a low of US$33 per barrel by end-2008. Thereafter, since the first quarter of 2009, crude oil prices have recovered smartly to touch US$70 per barrel, a rise of 43% in 2009, thus raising India's oil import bill again. Typically, the rupee is under considerable pressure at the end of every month as oil importers take steps to meet their payment obligations. In other words, with oil firms stepping up the demand for dollars, there is a downward pressure on the rupee.

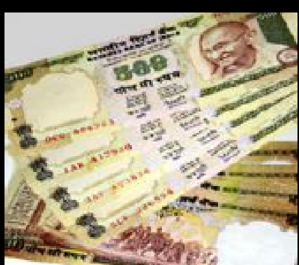
Figure 5: India—Oil imports



Interest rates

Developed economies have typically enjoyed low inflation and low interest rates, whereas developing countries face ***higher inflation and higher interest rates***. The low interest rates prompted Indian companies to tap foreign debt during the bull phase a couple of year's back, particularly in a rising rupee scenario, driving the rupee even higher.

Conventionally, from a stock market perspective, a high-interest rate scenario is associated with capital outflows as companies find it difficult to finance their capex plans, impacting profitability, besides affecting retail consumption.



RBI intervention

In comparison to currencies like the dollar and the euro, which are determined by pure demand and supply forces, ***the Indian rupee is "partially managed" by the RBI***. The RBI has occasionally intervened in the Indian currency markets, particularly when the rupee exhibits signs of extreme volatility. For example, towards the end of 2008, when the euro and the Asian currencies, such as the Japanese yen, appreciated sharply against the US dollar, it was RBI intervention that kept the Rupee from appreciating at a steep pace.

Meanwhile, in the face of ***global recessionary fears***, market meltdowns, and falling inflation in the last quarter of 2008, the central bank adopted a highly accommodative monetary policy, slashing interest rates aggressively from October 2008 onwards to boost economic growth. Currently, the repo rate and reverse repo rate are fixed at 4.75% and 3.25%, respectively, from the highs of 9% and 6% in October 2008. The cash reserve ratio has also been reduced to 5% from 9% during the same period.

Surprising election results

With coalition governments the order of the day, ***political instability*** was high on global investors' radar when it came to putting money in the Indian markets. Markets had expected a highly fragmented coalition to come to the centre, and right up to the election results, markets had already factored in the huge uncertainty that such a government would bring about. However, the ***Congress-led UPA alliance's*** resounding victory on May 16 changed everything. Political instability was no more a major deterrent, and political risk had been largely mitigated in one single stroke. Global investors cheered at the election outcome with many international brokerages raising India's rating to Overweight. Needless to say, Monday, 18 May saw the Indian indices hitting its upper circuit filter twice within a few minutes of trade as the ***Sensex skyrocketed*** 17.5% in a single day. The huge global inflows into India equities also saw the rupee appreciating sharply to Rs47.92 per dollar levels from Rs49.39, a rise of nearly 3%.

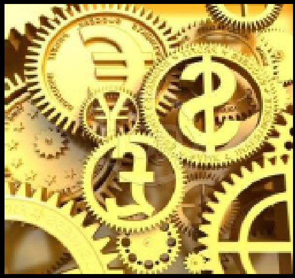
Disappointing budget

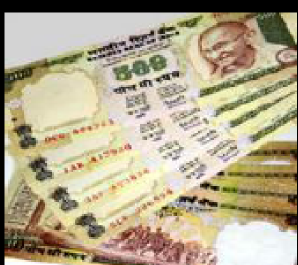
Many investors felt left out in the phenomenal market rally that began in March 2009. They were further dejected when the market shot up post the elections. However, with a stable government coming to the centre, investors, market experts, and the media alike built up huge, or should we say unrealistic, expectations from the budget. It was hoped that an aggressive approach would ensure huge capital inflows into the country and raise investors' confidence further. However, ***given the sky-high expectations***, the budget ended up sorely disappointing the markets. Consequently, the Indian stock markets plummeted by more than 800 points. While the stock markets tumbled nearly 6%, bond yields spiked and the rupee fell 1.4%—in the face of a daunting ***fiscal deficit target of 6.8% of the GDP*** even as the Finance Minister said very little about disinvestment and easing of FDI in certain sectors.

What lies ahead?

While it is an unwieldy task to predict the movement of the rupee, its impact on the Indian economy and industry cannot be undermined. For example, the depreciation of the rupee would increase the value of oil imports, as oil firms will now have to buy dollars at a higher rate. It is important to recognize here that imports account for almost three-quarters of our oil consumption, which, in turn, would then negatively impact the already widening trade deficit. On the other hand, sectors focusing largely on exports, including software, pharmaceuticals and textiles, would benefit immensely from a depreciating rupee.

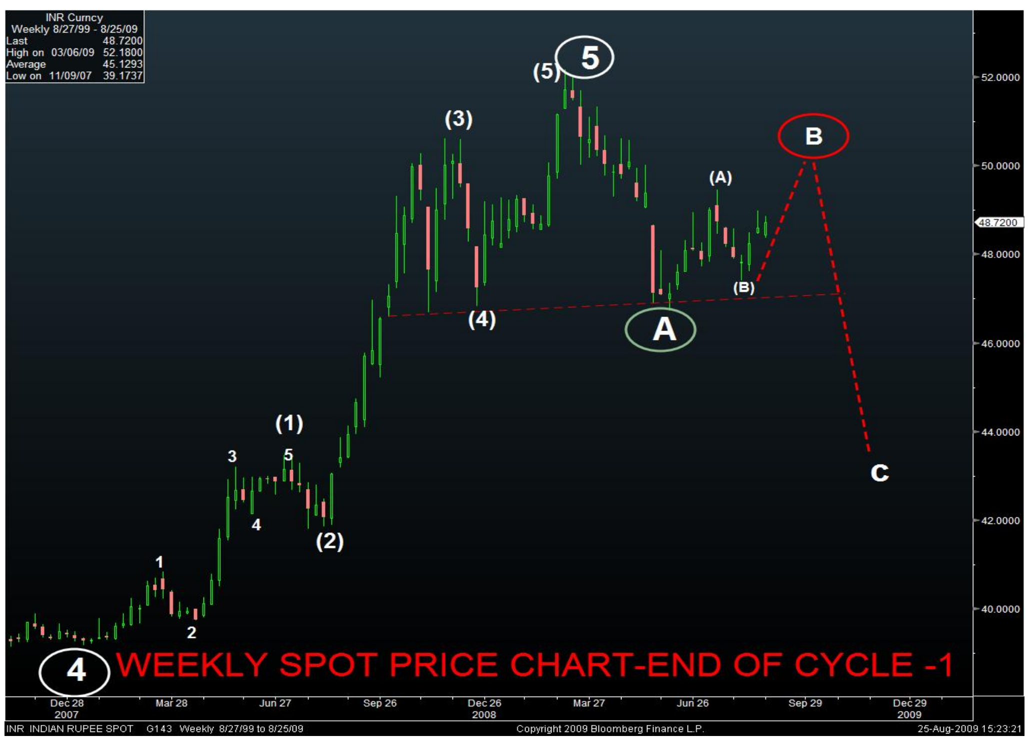
Regardless of your expectations, appreciation or depreciation needs to be quantified and timed. At the end of the day, while it is not easy to completely eliminate forex risks, it boils down to the risk management measures that companies have adapted to hedge against the same. Given that the worst is over for the developed economies, we expect the rupee to gain against the Dollar Index in the backdrop of rising markets, increasing commodity prices, greater earnings upgrades, and better global cues. Of course, the impact of the monsoons will play a key role in this regard.





Technical analysis of rupee trends

Figure 6 & 7: Technical analysis



Going by the ***Elliott wave principles***, presently we are running a corrective CYCLE-2 and within which A-B-C corrections are in progress. In this chart, we have plotted a plausible move of Indian rupee in the short to medium term against the greenback. Taking a close look at the count, we are seeing intermediate (a)-(b)-(c) waves and wave(C) is in progress which may end somewhere around 51 marks. If the count moves inline with our expectations then a major corrective C can not be ruled out which may pull the rupee to 44/43 levels.

Medium term: Supports: 46, 43, Resistances: 51, 53

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