



# ***CURRENCY QUARTERLY- Q4, 2011***

***RUPEE - PLAYING A DIFFERENT GAME??***



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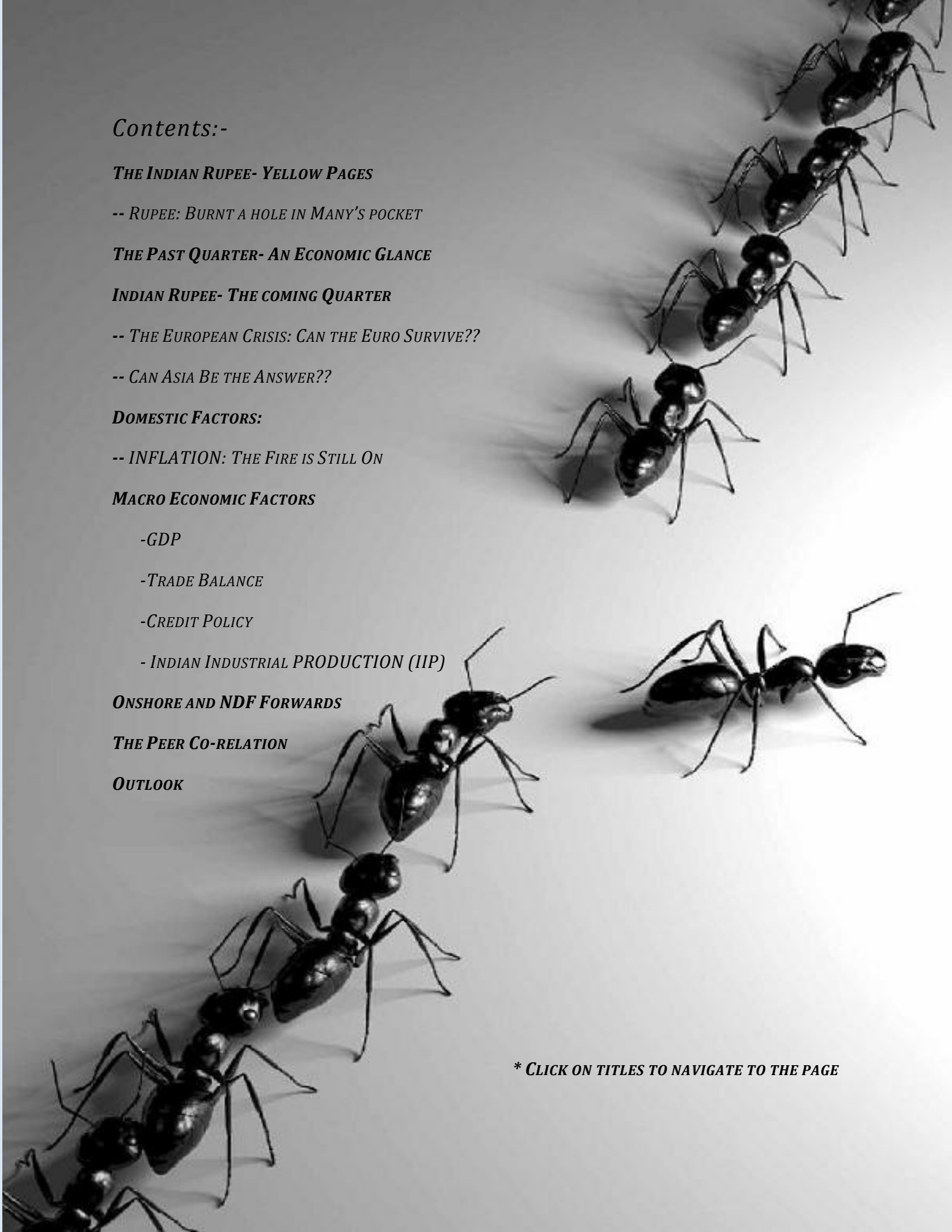
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## ***SUMMARY:***

The past quarter performance of rupee has surprised not only the market participants but also the general public as a whole. The quarter has been the worst performing one for the local unit over a decade. Such depreciation was last seen in the 1990's. The ever rising inflation has forced the RBI to keep raising rates; this has affected the investment and the corporate growth as seen in the decline in the IIP. The governments borrowings have also been drastically affected with the rise in Fiscal deficit, the rising cost of imports of Crude oil have raised the government's expenditure on the higher side. The rupee is likely to weaken further in 2011. Higher interest rates in India would always allure investors to invest in this country, thereby adding to capital flows. But the eroding corporate profits will act as a damper for such investments. We have seen even after such a depreciation in the rupee no major intervention was taken by the RBI to stop the rupee's losses, as its becoming difficult for the government to support the weaker rupee as due to higher expenditures its hand are also tied.

## ***RECOMMENDATIONS:***

**Action point:** Looking at the current scenario, we believe Indian rupee to trade in a consolidation phase however, buying at dip is suggested.

**Strategy (Spot):** Buy X-lots near 48.65-85, Y-lots at 47.80/48.20 and Z-lots at 47.20/47.00 targeting 50.50 then 52.00 with stop loss below 46.50

**Investment weights at X, Y and Z can be 50%, 40% and 10% respectively.**

**Option Strategy:** Buy X-lots of USDINR 50 CE December Contract at 0.35-.45 paisa and Y lots USDINR 49.25 CE December Contract at 0.45-50 paisa and then Z lots USDINR 48.75 CE December Contract at 0.50-60 paisa for targets of 50.50 then 52.00 in Spot and Stop Loss below 46.50 in Spot.

*CE- Call Option*

**Investment weights at X, Y and Z can be 50%, 40% and 10% respectively**

## THE PAST QUARTER – AN ECONOMIC GLANCE

The quarter gone by, world economic recovery remained fragile. Fears of “Double-dip” recession although did not materialize, anxiety is still knocking. The growth of advanced economies would fizzle largely after the fiscal stimulus turned in to fiscal consolidation. Fears have turned in to commodities prices reflecting anchored inflation expectation and thereby accommodating credit policy throughout the world left confined space to a speedy recovery. In most of the advanced economies and emerging economies unemployment remained high retracing back to the pre crisis excesses and crisis wounds. In the US especially, the housing sector remained pretty distressed leading to anemic housing investments.

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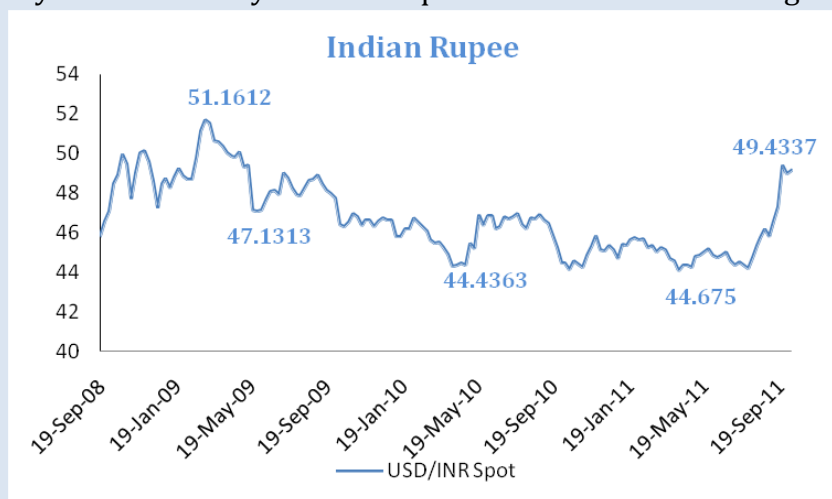
### INDIAN RUPEE: YELLOW LEAVES

After two very quite Quarters we saw the rupee depreciate drastically following the global meltdown. The move was so erratic that many participants were left in a tizzy. The quarter ended September 30 saw the rupee depreciates by 9.56% to end at 48.96 on a quarterly basis. This is the biggest quarterly fall since last seen in the 90’s. The fall was not only bad on a quarterly basis but on a weekly as well as daily basis this quarter saw new lows being created. For the week ended

September 24<sup>th</sup> the rupee went on to post its biggest weekly fall in more than 15 years as the fears of heightened risk aversion amid the possibility of a recession in the developed world. This fall was compiled with the single day’s loss in nearly 3 years when it lost more than 2.5 % on a single day. It went on to

lose 4.4 percent in that week, its biggest fall since the week ended July 12, 1996. The Rupee has already lost more than 11 percent so far this year from its high in late July and remains the biggest under performer among Asian peers.

Ever since the US was downgraded the Asian currencies were left looking for cover as their equities were beaten out of shape which led to huge FII’s outflows from their respective countries. India was not far behind as we saw very high outflows which were last seen in the crash of 2008. The rupee was hurt further on doubts and growing concern about the



impact of a possible Greek default on the banking sector will negate any move by India's central bank to support the unit. There were even reports that the RBI would not be coming forward anytime soon to support the rupee. The domestic market's hunger for dollars was another major reason for the rupee's underperformance despite the Dollar index not gaining so substantially as the rupee's loss. The rupee however did reverse its losses a tad bit which could be attributed to the dollar sales by the Reserve Bank of India. But this was also not enough for it to restrict its huge Worries over trajectory of global growth have already risen a notch, this shows that the local currency might not be heading for any respite as of now.

A lot of selling pressure has been seen from foreign funds that are very close to being net sellers for the year with their selling spree continuing in the third quarter as well. Foreign funds have bought USD 416 million rupees of local shares so far this year after having sold over USD 2.2 billion in the September month. The currency slumps and global investors retreat from India's higher-yielding bonds has hurt the rupee further than anticipated. The rupee's 9.3 percent drop this year, the worst performance among Asian currencies, has reduced the allure of the nation's debt. Global funds turned net sellers of India's bonds in September for the first time in five months, trimming holdings by \$200 million to \$21.7 billion. The currency's depreciation is deterring foreign investors from buying local debt.

### ***RUPEE: BURNT A HOLE IN MANY'S POCKET***

The unexpected and steep decline of the rupee in the last quarter has caught many traders in the currency market on the wrong foot. Many banks and corporate have lost in this steep and avid volatility. Many traders had placed bets that the rupee would not fall below 47 to 48 against the USD. But their forecasts went awry when the rupee slid to 50. The repercussions of such blundered bets in the forex futures and options segment have been severe. Resulting in very huge losses for all participants. The unanticipated dollar rush led by the flight of money from riskier assets, including emerging markets in September that drove down the rupee, tossed a spanner in the works for these traders most of these losses have come in the currency futures segment where once again the faults of leverage and over leverage have shown its effects. The low margins in the currency derivatives segment lets the person to leverage himself up to limits of 5-10 times of that in equities or commodities space. This combined with overnight risk has caused massive losses once the position has gone on the wrong side. Not only have the clients lost but many of the brokerage houses running proprietary accounts have also been forced to shut down sue to such a huge volatility and erratic move. According to sources the losses can be as high as 600 crores in just the month of September for many of these brokerage firms.

## *THE PAST QUARTER- AN ECONOMIC GLANCE*

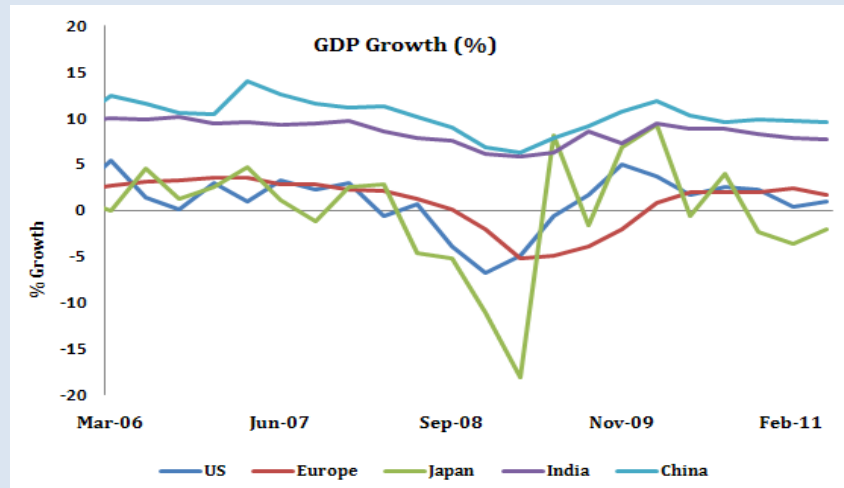
The quarter gone by, world economic recovery remained fragile. Fears of “Double-dip” recession although did not materialize, anxiety is still knocking. The growth of advanced economies would fizzle largely after the fiscal stimulus turned in to fiscal consolidation. Fears have turned in to commodities prices reflecting anchored inflation expectation and thereby accommodating credit policy through out the world left confined space to a speedy recovery. In most of the advanced economies and emerging economies unemployment remained high retracing back to the pre crisis excesses and crisis wounds. In the US especially, the housing sector remained pretty distressed leading to anemic housing investments.

The problem of the Euro periphery, stemming from the combined interactions of low growth, fiscal woes were particularly acute. While the month of June was marred by the Euro debt crisis and downgrades of the Euro nations by rating agencies, July brought the arrival of US debt ceiling issues. Fitch cut Greece’s credit grades to its lowest for any country in the world. The move from “B+” to “CCC” reflected the absence of a new fully funded and credible program by the IMF and the EU which intensified a real possibility of default. Despite Greece got a 110 billion Euros of aid after a promising austerity measures, contagion speeded to Italy and focus shifted on to the world’s largest economy (US) at the brink of default. The debt ceiling issue came in to limelight as the Republicans and Congress were trapped in to an impasse since they were bound to find solution on or before August 2. With debt negotiations at a clear, heavily entrenched standoff over how to deal with the \$14.3 trillion debt ceiling, financial markets remained jittery. Despite the increase in debt limit ceiling after many political controversies, growth momentum still remained subdued, rather, it grew at a slower pace. The expected US credit rating downgrade by the S&P was then announced on August 5, first time ever in the US history, undoubtedly added more volatility in to the global financial markets. ***S&P has downgraded US credit rating by one notch from “AAA” to “AA+” which slammed the nation’s political process in absence of a credible plan to lower deficits even if the nation’s \$14.3 trillion debt limit was lifted.*** Federal Reserve vowed to keep the interest rate near zero and also discussed a range of policy tools to bolster the economy, raised speculation of a third round quantitative easing through bond purchases. US treasuries yields lowered to its five decades rate which prompted investors to expect Feb chairman Bernanke to signal a third round of asset purchase to boost the economy. The US president on 19<sup>th</sup> Sep therefore announced for \$1.5 trillion increase in tax over the next decade from the wealthy and corporate preferences as a part of a plan to cut the deficit by \$3 trillion.

## GDP- THE COMING QUARTER

The global recovery has not picked up to encompass enough jobs and more components of aggregate demand. The recovery in the United States has not gained strength over the past six months and showed signs of a flagging economy. Significant lower levels of manufacturing and services activity, industrial productions have put a lid in U.S. labor market growth. Unemployment stand tall at 9.1% with the private sector openings slashed. Following a relatively weak than expected second quarter GDP results, and some flagging in the pace of the recovery in the second quarter, GDP growth is expected to remain subdued for the world's largest economy.

The recovery in Europe continued to face substantial headwinds from uncertainty surrounding sovereign debt in several Euro Area members, and a wide-reaching but



necessary process of fiscal consolidation. Growth is becoming constrained by fiscal consolidation programs, ongoing banking sectors stress tests and restructuring and by cynicism regarding the financial sector that is serving to raise the borrowing cost. As monetary policy has entered a renewed tightening phase, additional stresses in the financial sector may become more apparent, presenting further challenges for these economies. Overall, the debt laden Europe and the peripheral nations are expected to limp unless the bottleneck of PIIGS is broken.

While Japan's second quarter GDP declined at a 2.10 percent annualized rate, the pace of activity is expected to pick up. The export driven country is likely to prop up with the BOJ's decision to keep the borrowing rate unchanged at 0.10% and government's aid to the tsunami affected area to grow the business. For developing countries like India and China, the slowdown stems from a moderation in domestic demand due to elevated inflationary pressure which had bite in to people's disposable income and household spending. Beside, the restrictive monetary conditions have contributed to a dampening investment activity. To rein in domestic demand and curb the inflationary pressure, monetary authorities have initiated subsequent rate hikes with RBI started raising rates from March 2010.

***INFLATION, INTEREST RATE AND MONETARY POLICY:***

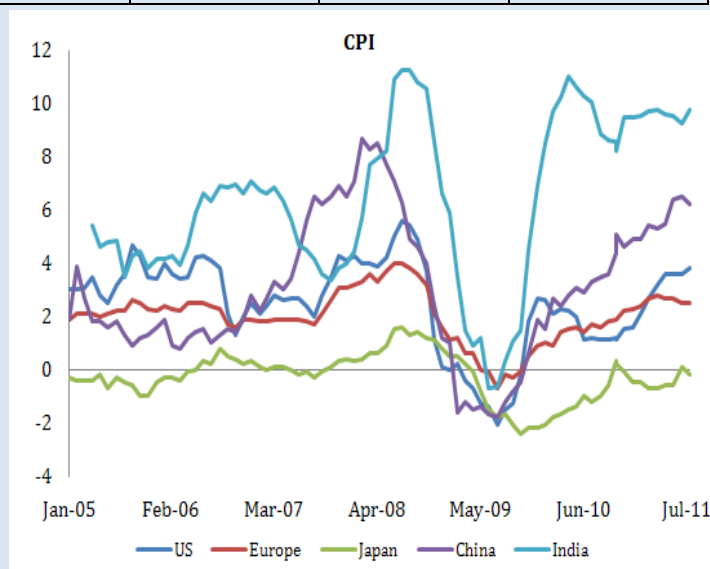
International food prices have risen to levels last seen during 2005-08 levels. Oil and energy prices also rose in recent months on concern of geo political turmoil and supply disruptions. The price of barrel crude reached \$110 in April 2011, compared with an average of \$34 a barrel over the past 30 years. The significant volatility in commodities prices and the prospect that the food prices remain elevated for a sustained period are a challenge for monetary policymakers. From Aug' 2009 the significant rise in prices played the major role to spike the prices of inflation hedged commodities like gold and silver.

| Country         | US      | Europe   | Japan  | China   | India    |
|-----------------|---------|----------|--------|---------|----------|
| % change in CPI | 353.33% | 1350.00% | 88.24% | 616.67% | 3054.84% |

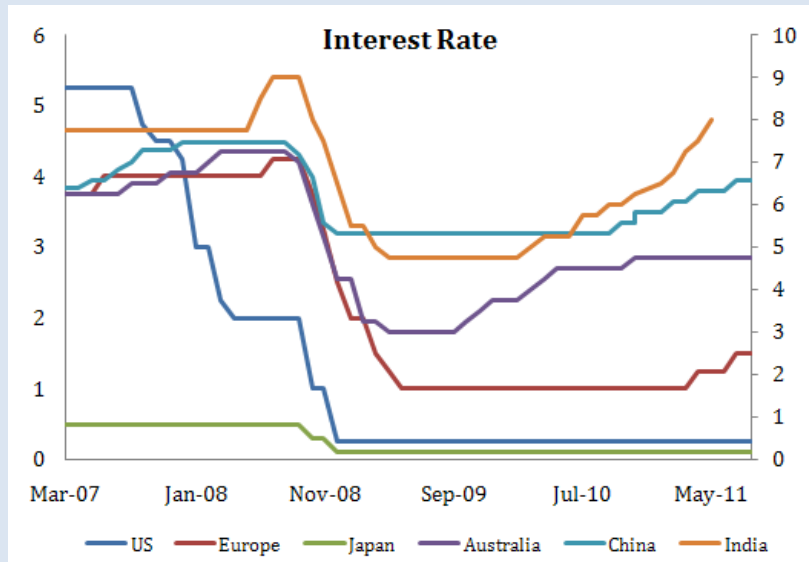
***Data incorporated from Aug'09-Aug'11***

One concern is that the recent rise in food and energy prices may persist, which could face the spill over effects in to higher wage demands and underlying inflation. Beside, attempts to stabilize this, could have significant economic cost.

Central Banks therefore often intervene in line with target to stabilize the price rise. With various tools Central banks may come up with raising interest rate or Fiscal policies (increase in tax or decrease in government expenditure). That is what now happening through out the globe. ***Increased interest rate makes the borrowing costly, reducing spending and thereby makes it more attractive to save money. As a fiscal policy measure, government sometimes can raise the tax or reduce spending to curtail the aggregate demand.***



So, interest rate was being increased by the respective central banks. Among the Asian countries, India has increased its rate by 12 times in the last 18 months while China made it 5 times for the same period. The European Central Bank which kept its benchmark rate constant for the last two years was bound to raise it two times within last five months to contain the price rise. However, US due to a slowing economy could not able to raise the rate. It can be seen that among the emerging economies, India remained at the fore front in raising rates followed by China, Australia and then Europe. So, the major Asian emerging nations were also got a punch from this global inflationary pressure.

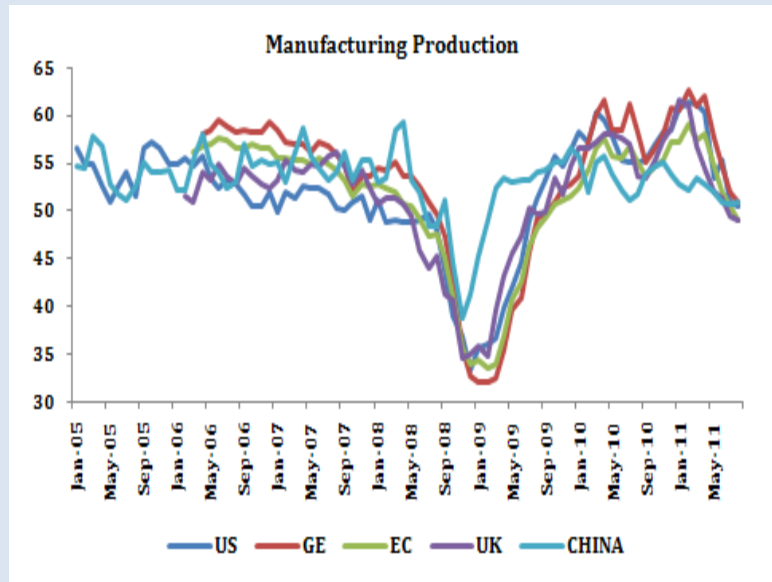


Despite these measures, real policy interest rates are negative or remain looser than they were prior to the crisis. Unfortunately, bringing inflation back down will be complicated by the trend rise in inflation over the past decade, which has contributed to an increase in inflationary expectations in recent years. Despite the steps taken earlier to reduce fuel subsidies, the pass-through of higher international energy prices is incomplete, increasing subsidization costs and contributing to fiscal deficits. The large general government budget deficits are also complicating efforts to restrict domestic demand and reduce inflation. So, global inflation is likely to remain on up trend, fuelled by higher future inflation expectation

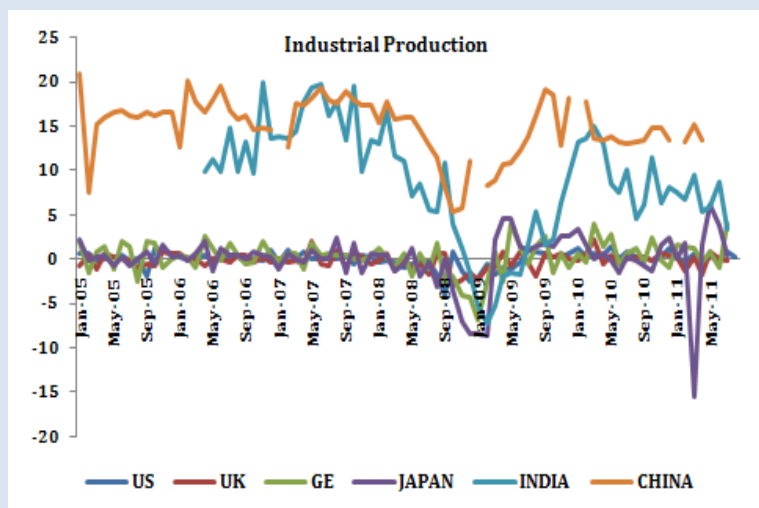
### **MANUFACTURING & INDUSTRIAL PRODUCTION**

Global manufacturing and industrial activities shattered owing to the developed nation's tumultuousness over debt burden and gloomy picture about the economic outlook. Much of the impetus came from lower aggregate demand and rising producer cost. Lower income due to high unemployment rate also might have eaten in to a larger part of the demand for luxurious cars, homes and other real assets. Inventories piled up, retail sales took a back step and hurt the productions. Lastly, global slowdown in GDP growth might have lessened the consumption pattern of consumers which drove the manufacturing and industrial production to fall.

Going forward, growth in GDP is less likely to be seen in the coming quarter as discussed above. Also the US president's plan to raise the tax from rich and corporate preferences to cover the budget deficit over the next decade might also hamper the industrial production. The root cause is the demand; which is expected to be lacking for some more time unless Obama's job creation programs materialize. There are ways to improve the situation if foreign country demands increases, in other word, import demand rise. Like Japan, being an export oriented country, recovered smartly when it faced Tsunami this year but then again industrial production fell due to government intervention in currency market. Overall, industry can not grow unless and until economy grows and demand increases. Foreseeing the faint outlook of global economy, we expect this sector to under perform in the coming quarter.



**In a nutshell**, the enduring Euro area uncertainty and rising borrowing cost globally could further reveal weakness in the global economy. IMF recently has therefore come out with a reduced target of global economic growth of 4% from 4.3%. The fiscal situation in advanced economies is expected to jitter despite recently announced spending cuts. Axing the rich and corporate, the Obama administration is although trying to reduce the country's deficit over the next decade, there arise the concern of mounting debt. At the same time in Europe, despite numerous steps to reduce deficits in several countries and multiple financial rescue packages brought to the front, concern remains that one or more Euro area has to restructure its debt. Such deterioration in financial and economic conditions in Europe could weaken demand for developing country exports. In addition, banks could be forced to



reduce credit growth, or even repatriate funds from foreign affiliates with more direct impacts on credit and economic growth in developing countries; notably in Europe and Asia. Indeed, the very low long-term interest rates engineered by central banks through measures such as quantitative easing, may have allowed some firms and banks to survive and equities, commodities to prosper, the underlying structural problems have not been resolved. As central banks stop intervening in Treasury, mortgage and corporate bond markets and stricter financial regulations kick-in, long-term interest rates are expected to rise, increasing financing costs. Such higher costs may expose vulnerabilities that until now have remained hidden.

Policymakers around the world commit “to take all necessary actions to preserve the stability of banking systems and financial markets as required,” according to a joint statement issued by the finance ministers and central bank governors of the G20 largest economies. The Euro zone needs the right firewall to prevent contagion, referring to the €440 billion European Financial Stability Facility, the ad hoc bailout mechanism set up last year. Fed’s “Operation Twist” with an objective to reduce the long term interest rate is likely to be felt in longer term. Their aim of buying long term securities by replacing shorter term bonds might give the stability to long term interest rate, but it might not reduce the inflation expectation.

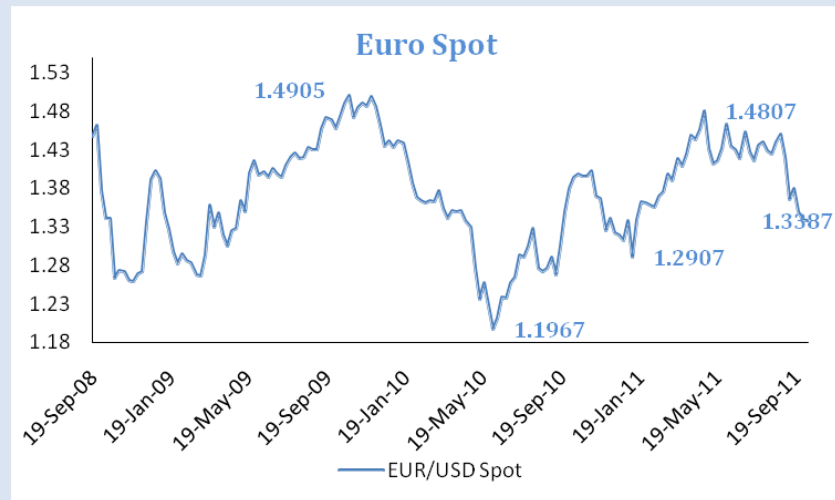
## INDIAN RUPEE- THE COMING QUARTER

The Indian Rupee has been very volatile for the past quarter and looking at the global scenario we expect the same to continue at least till the end of this year. We have underlined many factors which will guide the rupee going forward and their likely implications are mentioned below.

## THE EUROPEAN CRISIS: CAN THE EURO SURVIVE??

The European region as whole specially the Western Europe has become a very strange and somewhat disturbing place economically and financially. It is bound together by a single currency, but, unlike other continent-sized single currency zones, it is neither a fiscal nor a full political union. Ever since the inception of Euro in 1998, there have not been many problems until about two years ago. But the Euro Zone's internal contradictions have become much more worrisome. Given that the euro area economy is the world's second largest and that complex interbank linkages would automatically spread any European financial problems everywhere. One of the major reasons why the problems in Europe command all investors' attention.

It's become worrisome and very difficult to predict the future course of the currency union. The governance structure that might generate a solution or prevent chaos is diffuse and ambiguous. But, despite its complexity and ambiguity, the situation is still subject to careful analysis. Our analysis leads us to conclude that Europe will continue to "muddle through." This process is unlikely to end in a financial catastrophe or in a radically restructured relationship among the

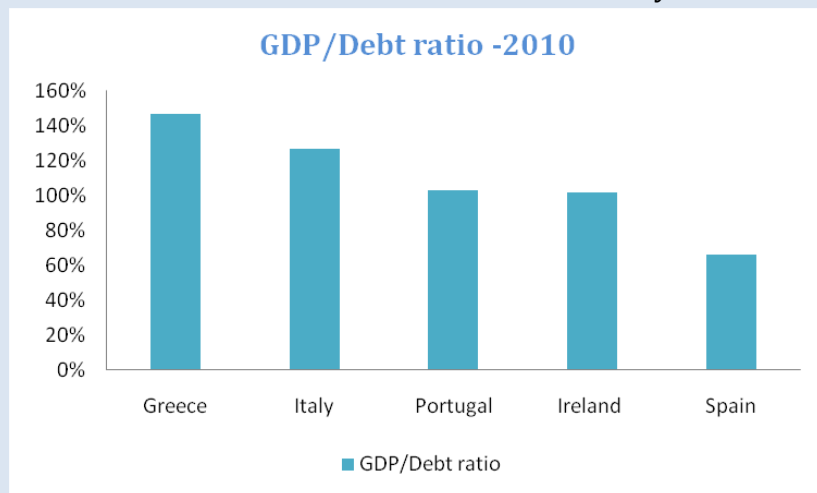


euro area member countries any time soon. Uncertainty about the ability of some European governments to meet their full debt service obligations will continue to be the source of periodic market volatility over several years to come. But whenever the situation threatens to drive any large number of banks into insolvency, policymakers will likely find some way to relieve the pressure temporarily, moving the euro area towards a more perfect fiscal union, one small step at a time. The threat of a Greek default concentrated policymakers' minds. This has also lead to diverse and indifferent predications from other countries as to how big a default could be. Its not that other larger economies have not defaulted or faced any headwind, but because of the interbank linkages in the European Union make it a soft

target for concentrated action. Government bonds serve as the principal lubricant of any modern financial system. To process payments quickly and thereby facilitate billions of financial transactions daily. Because government bond holdings are essential to banks' operations and because the bonds of governments denominated in their own currency are deemed credit "risk-free," accountants have generally allowed banks to carry their holdings in these securities at "book value," and regulators have not required banks to hold capital reserves against potential credit losses on home-currency government bonds.

Until August 2010, European banks and their regulators had operated on the presumption that all euro area sovereign bonds would always be treated equally. The possibility that bonds from Greece and other euro area countries were no longer credit "risk-free" and that banks might realize losses on these bonds raised the risk that interbank lending might freeze up. At that point, global financial markets began sending the clear signal that the world financial system was again at risk and something needed to be done to avoid sudden default by a European sovereign borrower. In response, Europe's governments, the European Central Bank (ECB) and the International Monetary Fund (IMF) or the so called "Troika" sought a way to prevent a Greek default and set it on a sustainable debt path. Leaders managed to find what looked like a solution – a combination of direct "bailout" loans to Greece from the European Union and the IMF

The impact of the euro area sovereign debt problem has been substantial but episodic, and each flare-up has affected different markets. When Greece was threatened by imminent default, currency and equity markets suffered most. The U.S. dollar/euro exchange rate fell below €1.20 per dollar on June 7, 2010, reflecting fears that the common currency's design flaws would precipitate the union's break-up. Subsequently, however, the exchange rate impact has been minimal; investors have apparently concluded that the euro will survive for the present.



Greece's fiscal situation remains worse than any other euro area member. Its financial liabilities totaled 147% of gross domestic product at the end of 2010. The total for Italy, Ireland, Portugal and Spain were 127%, 102%, 103% and 66%, respectively. Even so, when

it became clear that other countries also needed help and that the first rescue package for Greece was insufficient, contagion spread as investors sold Spanish and Italian government bonds, forcing yields higher. Aggressive intervention by the ECB stabilized these markets, at least temporarily. But the risk that Italy and/or Spain – with combined government debt that is 3.6 times larger than that of Greece, Ireland and Portugal in total – might require a bailout continues to disrupt markets.

The flaws in the euro area structure have become one of the two primary sources of uncertainty and risk in the global economy, the other being the fragility of the U.S. economic recovery. When the crises flares up, investors become more worried and the prices of stocks and other risk assets decline, so assessing how this saga may unfold is germane to any global investment outlook

### *WHERE IS THE EURO HEADED??*

Since the euro area sovereign debt crisis began, the problem has been extended over a long period of time. It had been anticipated that the debt crisis would be accompanied by periodic spikes of market volatility and would continue to be a source of uncertainty and risk for investors. We still maintain the same view, and to support the cause we have given detailed explanation.

Popular unrest in Greece could reach the point where a debt service suspension became the only option. Or, a coalition of northern European governments could balk at providing further help. Under such circumstances, banks could refuse to lend to each other on an unsecured basis and, lacking sufficient reliable collateral in the world for secured interbank lending, the international finance system might freeze up. The effect would very likely be a resumption of the global economic downturn which could invariably lead to a second great depression. In investment terms it would mean large losses on all investments except a very few governments' bonds. The euro might survive this disaster, but the nature of the currency union would be very different from what it is today. This outcome would be so disastrous that policymakers will likely do what is required to avoid it.

This is what has been happening and seems the most likely way for things to continue. Under this scenario, the Greeks, the Portuguese and the Irish reduce spending and increase tax collections less than originally agreed to but by enough to keep the bailout money flowing. The EFSF does get fully capitalized, but markets remain skeptical as to whether the facility is large enough. The ECB continues supporting Spanish, Italian and possibly other bond markets as needed until the EFSF can assume the role of euro area lender of last resort. In this scenario disaster is always averted, but at each point, it's a close call with temporary solutions adopted only *after* markets signal there is no alternative. Uncertainty

about the outcome continues to suppress consumer, business and investor confidence. The European and global economies and financial markets remain chronically ill, neither recovering nor dying.

This is the same as the muddle through badly scenario but things evolve more quickly. The Greeks and others continue receiving bailout tranches for good faith efforts despite their failure to achieve deficit reduction goals. Euro area parliaments approve the EFSF legislation relatively easily. European banks build up their capital cushions, enabling them to realize more losses on their government bond portfolios. Problems tend to be solved before market volatility spikes. Extreme fiscal austerity keeps growth so weak that government debt continues to increase slowly as a percentage of GDP. So the fundamental problem remains unresolved and the risk of eventual default by euro area sovereign borrowers continues to unsettle markets.

It is unlikely that such substantial changes could be adopted quickly. But if crisis-fatigue sets in, opinions might unify quickly around a resolution, removing the risk of euro area sovereign insolvency. If such an outcome looked more likely and nothing adverse were happening elsewhere in the world, a sharp rally in equity markets would occur (especially the European bourses). German government bond yields would increase sharply and peripheral bond spreads would collapse.

### *CONCLUSION*

Hence reaching a simple and easy solution would not be the right dish served to the world as of now. The Europeans have got into an economic muddle which might not be very easy to get out of, but given the fact that it's the second largest Economy after the US the "Troika" wouldn't let it down so easily. So going forward the Euro is very much dependent on the periodic injection of money flow into the system which might give the boost even though for a shorter time. These injections might breathe life into the single currency for a shorter term but for longer term the problems fail to find and answer until and unless the debt ridden countries try to cut down their cost.

### *CAN ASIA BE THE ANSWER??*

Ever since the two of the largest economies the US and Europe have hit a roadblock the world has been looking for other frontiers to find the solution to the financial crisis. And invariably the answer falls to Asia where the growth might have slowed but has not stopped and many of the Asian economies still growing at over 7-8% annually. But as it's also clear that most of the Asian economies find their growth from the western economies, and this dependence will show its weakness as and when the western economies hit the depression as seen in 2008. We have listed a few of the reasons that could form the "Third

World” as a possible answer for the ongoing economic problems. But there are many issues which have to put into order before Asia stands a change to be a leader in the economic world. These are also a point of discussion. The revival may not be as fast as the one seen in the time from 1990 to 2010 which was indoubtably named as the “Asian Miracle”. There are a lot of problems which might slow down the growth; these must be adequately addressed to get the best of the Asian countries.

### *DRIVERS FOR GROWTH*

**Exports:** An export-driven focus within an industrialization program that is based on a country’s comparative advantages. The Asian economies have been a major driving force for the World’s exports from the Asian region. They have definitely benefited from these as we have seen growth in exports for major of the Asian countries. The best example for such a policy is seen in the form of countries like, Hong Kong, Singapore, Korea, Taiwan, and China. Countries like Korea and China have become manufacturing hubs not only for the Western world but also the Asian region.

**Labor Force:** The Asian countries have one thing in abundance and it’s the labor force. For countries like China and India labor force has been the driving force behind the ever growing economic growth. India and China have been the major benifitor’s of the labor force. China has succeeded in becoming the manufacturing hub wheras, India has become the services hub for other countries. But for the continuation of such a growth the countries need to have an educated, well-trained labor force with a very strong work ethic. Or else the same competiveness and quality would not be maintained.

**A High Savings Rate** – The gross savings rates across Asia was 42.3% in 2009 up from 24.8% in 1982, which has typically translated into high levels of investment. Although expected to moderate in the coming years, this savings rate should remain relatively high. These key factors will continue to power Asia’s economic expansion in the coming decade. But in order to sustain future growth, Asian policymakers must successfully manage certain structural transitions that are critical for investment and business planning.

### **A Few Hindrances:**

**Appropriate socio-political** development must accompany economic development; this maintains the social stability necessary for strategic business planning and therefore growth. Take Indonesia: During Suharto’s regime, which fostered a socially unstable environment in which cronyism and corruption were perceived as rampant, foreign investors did not want to invest and there was little incentive for work or productivity. Growth rates fell below the long-term trend of 4% annual GDP growth. By contrast, since

Indonesia righted its political regime in 2004 and implemented sound economic policies, GDP growth has been above 5%. Countries like Indonesia, Thailand, Philippines and India still appear more volatile to such socio-political factors.

**Technological capability** must continue to increase to ensure competitiveness. The Philippines, Malaysia, Thailand and Indonesia, for example, must continue to expand their technological base. Countries like China and Singapore invite multinational companies into their countries which enable technological sharing between them. Countries like South Korea and Singapore have been major benefiteres and lately South Korea has become a major IT hub. Other Asian developing countries like Indonesia, Malaysia and Thailand should try to follow such models to improve their technological quality.

**Infrastructure** must be adequately developed or improved to eliminate economic bottlenecks. For example, countries like India, where GDP growth in excess of 7% is expected to continue, older infrastructure needs updating. Policymakers there are working on the land reform bills needed to facilitate transport network development and the increased economic openness necessary to attract foreign investment into infrastructure.

Greater transparency in corporate financial reporting and management must be actively fostered to further develop Asia's domestic capital markets and attract foreign investment.

### **CONCLUSION:**

Assuming the structural elements are successfully managed, we believe that Asia's growth in the next two decades will be similar to that of the past 30 years, regardless of any slowdown or prolonged period of very slow growth in the developed economies (i.e., Europe, Japan, U.K. and U.S.). Because the region will benefit from the growing impact of two trends that are not dependent on the developed economies' health: rising intra-Asian trade and increasing domestic demand and consumption.

If intra-Asian exports and imports grow in China, India, and Indonesia at similar rates, the value of intra-Asian trade will double by 2015. Such an ongoing and significant increase in intra-Asian commerce will likely benefit the more open economies of Singapore, Taiwan and South Korea which have substantial exposure to electronics, pharmaceutical, oil and IT sectors.

The second regional driver of Asia's future growth in the medium term, linked to the first, is rising domestic demand and consumption, especially in the countries with continent-sized potential consumption bases like China, India and Indonesia. These countries' large populations coupled with, by 2020, an emerging middle-class consumer, will drive the next phase of economic development. China has 1.3 billion people (20% of the world's

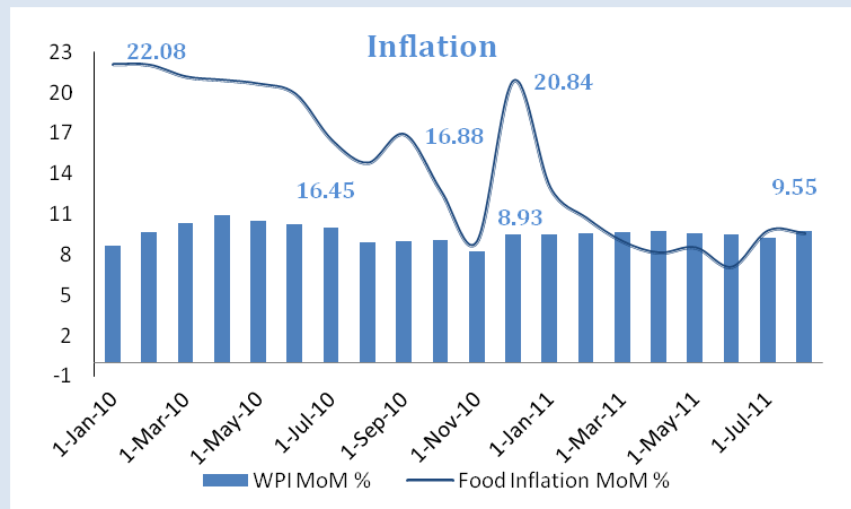
population), while India has 1.2 billion people (18% of global population) and Indonesia 245 million.

## DOMESTIC FACTORS:

### INFLATION: THE FIRE IS STILL ON

Well India has been hurt the most by inflation in the Asian region. The problem of inflation has been haunting the Indian people as well as the government. The long fight against inflation is not coming to an end. At some times light at the end of the tunnel seems to brighten up but then global commodity prices again dampen those hopes. If the food inflation cools then international factors like crude and manufacturing commodities have

been on elevated levels which have not let the inflation of the hook. As a result the Indian GDP estimates have been dropping from both analyst as well as the finance ministry. The slower growth is becoming a concern for both the investors as well as the government as despite many efforts not much has worked out for the Indian economy.



As anticipated the RBI had gone ahead and raised Repo Rate by 25bps to 8.25% from 8.00%, the 12th increase since March last year. The hike would however hurt the corporate sector the most which would have to borrow at higher costs; could hurt the country's growth further. The RBI has already lowered its growth forecast for the next year, along with lowering of the inflation forecast as well. The RBI has lowered its forecast of Inflation to 7% for the year end.

India's food and fuel inflation have ceased to ease and remained at elevated levels, maintaining the case for further monetary tightening to keep a lid on headline inflation. Headline inflation in August was at 9.78%, well above the RBI's perceived comfort zone of 6-7% and compared with its end-year target of 7%. These figures are thus far the highest we have seen for the year of 2011. The Food inflation though has shown a decline for the current year falling to 9.55% as compared to double digit figures the same time last year around. Major factors for a rise in headline inflation remain s to be a steep increase in

global commodity prices. The Central Banks across Asia are under pressure to act as fears that global commodity costs will fuel broader inflationary pressures in the Asian economy which would hamper the economic growth.

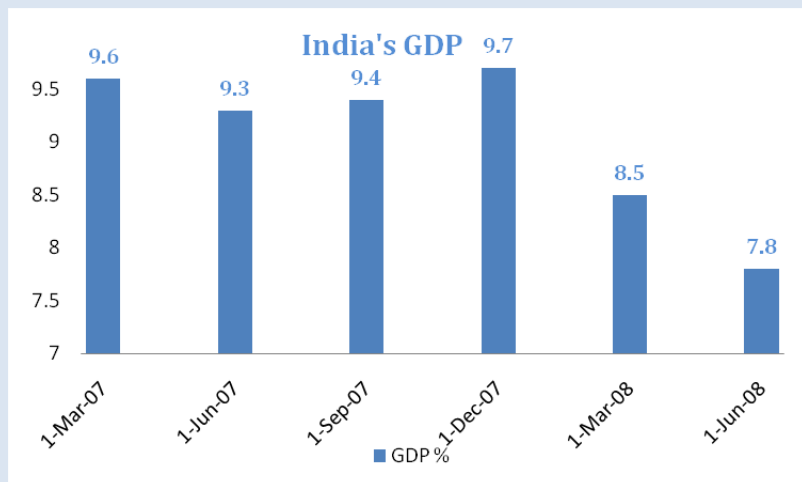
### **MACRO ECONOMIC FACTORS**

The most important factor shaping in today's global economy is the process of globalization. Indian companies are moving in search of low-cost markets, technology is driving growth in production and competition is becoming more intense. A second factor is the fastest growth in private capital flows, mainly short-term flows by banks and financial institutions, portfolio flows by mutual funds and pension funds and foreign direct investment into India. A third factor is the increasing share of India and other emerging market economies in world trade.

The outburst in communication technology has led to greater integration of Indian financial markets across the world. The impact of these changes could be felt from the extremely buoyant activity in Indian stock markets. Currently FII investment is at \$ 32.5 Billion compared to \$ 2 Billion in 2001. All these factors have helped India achieve a growth rate of more than 7% on a consistent basis. These macro factors are given a detailed view below

### **GDP**

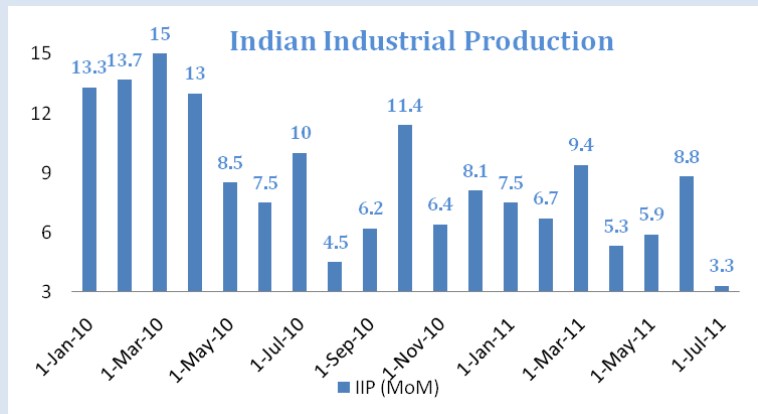
The RBI along with the Finance ministry has lowered its outlook on the growth for the coming year to 7% as compared to earlier estimates of 8%. Moreover, the growth rate is expected to remain slightly lower for 2011-12 as the increasing interest rate structure has hampered growth and corporate profits. The IMF has also lowered its estimates of the Indian economy and has to grow at 6.75% in 2011-12 and 6.5% in



2011-12, due to expected increase in corporate costs. The growth rate in India has been on a decline ever since the start of the Year, with the latest figures coming in at 7.7 percent. These figures are lower than previous year 8.6 percent in the same period last year. This has been a cause of concern for the finance ministry but they seem to be more concerned about the ever rising inflation and are ready to give up growth to tame inflation.

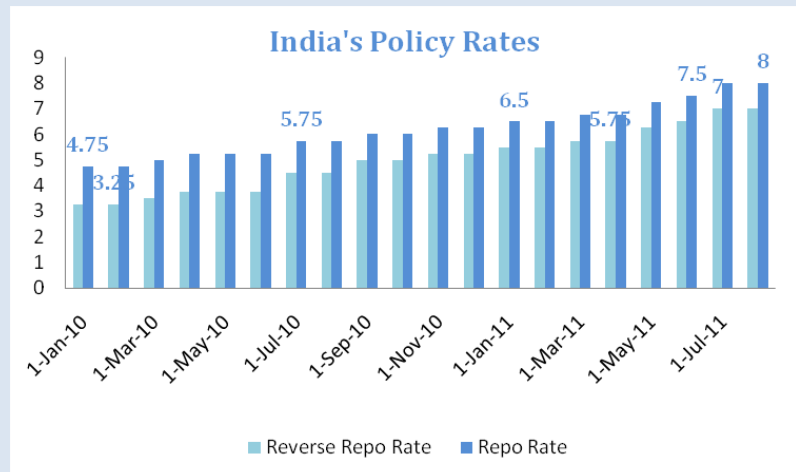
## INDIAN INDUSTRIAL PRODUCTION (IIP)

The economic recovery paused the momentum in the last quarter due to weaker commercial investments. India's industrial output is gradually declining after it hit a high of 9.4 percent in March 2011. The government's rising of benchmark interest rates have not helped the corporate as the borrowing costs have raised. According to the data released by the Central Statistical Organization, The industrial production dropped to 3.3% in August from a revised 8.6% in July 2011, because of continued growth in the borrowing costs of manufacturing sector along with higher labour costs. The rises in global commodity prices have not helped the manufacturing sector as their production costs have increased drastically.



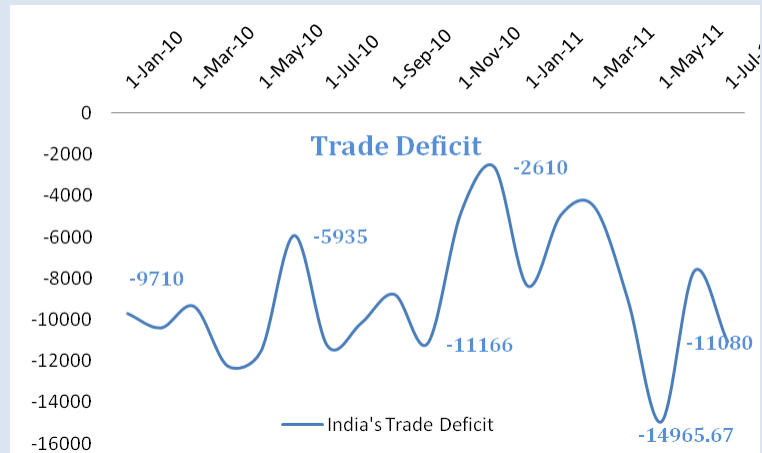
## CREDIT POLICY

The central bank has been hawkish for a long time now. The RBI has raised rates for twelfth time since March last year. Taking both the Repo and Reverse Repo rates up to 8.25% and 7.75% respectively. The RBI is very worried about the rising inflation which is still at high levels of 9.78%. The ever rising crude oil prices and the supply-bottleneck constraints have been the major contributors to inflation. The RBI is widely expected to further raise both the repo and reverse repo rates until the inflation cools to nominal levels of 6-7%, which is also the RBI's target for the year end. As the rates have reached near top levels the last two policy meets on 25<sup>th</sup> October and then in December would be closely watched. This would give an indication as to what extent the RBI is ready to sacrifice the growth to contain inflation.

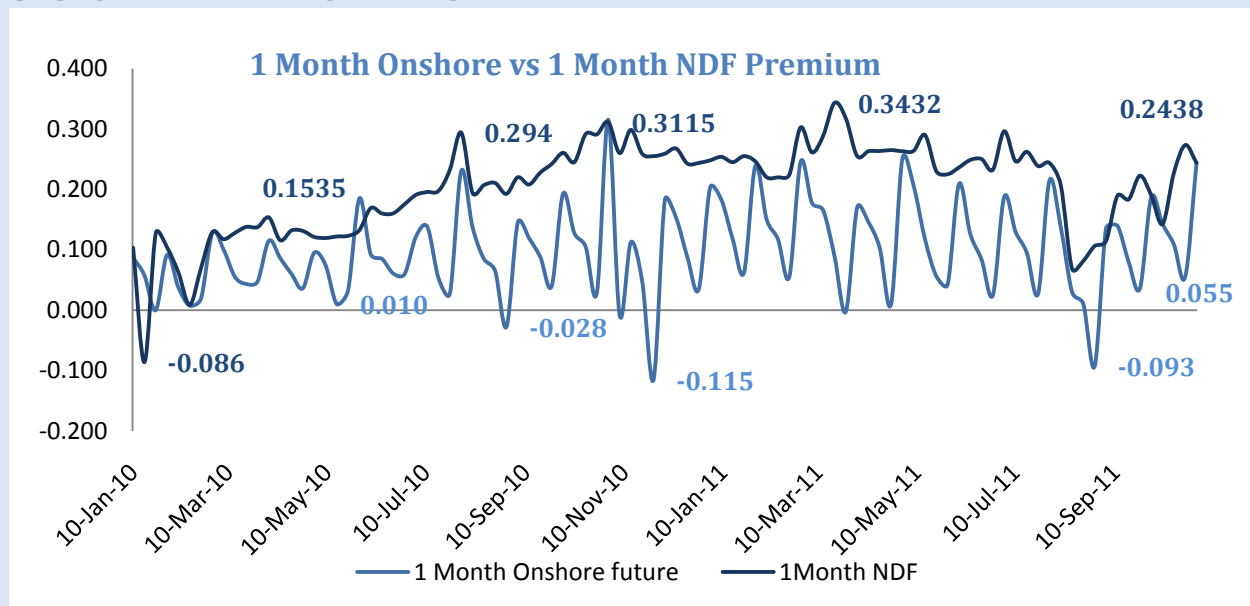


## TRADE BALANCE

As of August 2011, the trade deficit has risen to \$14.04 Billion up by 27% from the last month. From a year ago for the same period it has risen by 38%. The major contributors for widening of the deficit are the higher imports of both oil and non oil products. The rise in crude oil prices along with the depreciation of the Indian rupee has led to such a big deficit. India imports more than 70% of its oil demands and this is a big baggage on the trade balance. The oil imports have risen by about 6% for the last quarter whereas from the same period last year to this year the imports have risen by more than 45%. This has been one of the major factors for the huge trade deficit.



## ONSHORE AND NDF FORWARDS



The premiums on the forwards market have fallen from their highs due to decrease in participation, as investors, traders and speculators are shifting to futures market as a more reliable source of currency valuation. In this quarter we saw the premium's on the one month onshore contract go into discount. This was witnessed due to the mismatch between

Spot and future demand supply. The Demand for dollar in spot had reached a high with no one ready to supply dollars. This was a cause of concern for the market as whole as this leads to an unhealthy market. In this quarter we saw a low of -0.09 paisa. But this was covered quite quickly and the market has reached its normal premiums in the range of .20-0.25 paisa. On the other hand, the one-month NDF premiums remained in the range of 0.18-0.26 paisa. This decreased the arbitrage opportunities—wherein investors buy in NDF and sell at on-shore markets to earn riskless profits. Due to higher participation in both the markets the Futures and NDF's the difference in premiums spread have reduced drastically.

### *THE PEER CO-RELATION*

| Currency                 | Q4-2010 | Q1- 2011 | Q2- 2011 | Q3-2011 |
|--------------------------|---------|----------|----------|---------|
| <b>Indian Rupee</b>      | -0.34   | 0.72     | -0.37    | 10.26   |
| <b>Singapore Dollar</b>  | -1.77   | -1.78    | -2.5     | 6.02    |
| <b>Chinese Yuan</b>      | -0.89   | -1.26    | -1.21    | -1.61   |
| <b>Korean Won</b>        | -2.13   | 3.18     | -1.18    | 9.67    |
| <b>Malaysian Ringgit</b> | -1.32   | 0.45     | 0.75     | 4.97    |
| <b>Thailand Baht</b>     | 0.8     | 1.45     | -0.96    | 0.88    |

For the third quarter we have seen that the rupee has been one of the worst performers among the Asian currencies. It has been the worst performer with a fall of more than 10% in the third quarter followed by the Korean won which ended up losing more than 9%. Apart from the Chinese Yuan no other major Asian currency gained in the previous quarter. The Yuan gained by more than 1.61%. The Thailand Bhatt ended flat on a quarterly basis after a new prime minister was elected and hopes of a change in the economic structure let the currency gain. The Central banks of major Asian economies halted from raising rates in the last quarter whereas India's RBI continued with its hawkish view and raised rates for the twelfth time since March 2010. The European crisis had its full toll on the Asian currencies, as almost all of them ended the quarter with losses.

## *OUTLOOK:*

The past quarter performance of rupee has surprised not only the market participants but also the general public as a whole. The quarter has been the worst performing one for the local unit over a decade. Such depreciation was last seen in the 1990's. The ever rising inflation has forced the RBI to keep raising rates; this has affected the investment and the corporate growth as seen in the decline in the IIP. The governments borrowings have also been drastically affected with the rise in Fiscal deficit, the rising cost of imports of Crude oil have raised the government's expenditure on the higher side.

The government is aiming to manage foreign capital flows and to promote higher exports, which in turn would increase the currency flow in the economy. But the widening fiscal deficit and lowering GDP has kept away the foreign investors for the time being. The continuous corruption cases and scandals have done nothing good to the Indian economies image, which has also been a major factor in driving away the foreign investors from our country.

The rupee is likely to weaken further in 2011. Higher interest rates in India would always allure investors to invest in this country, thereby adding to capital flows. But the eroding corporate profits will act as a damper for such investments. We have seen even after such a depreciation in the rupee no major intervention was taken by the RBI to stop the rupee's losses, as its becoming difficult for the government to support the weaker rupee as due to higher expenditures its hand are also tied.

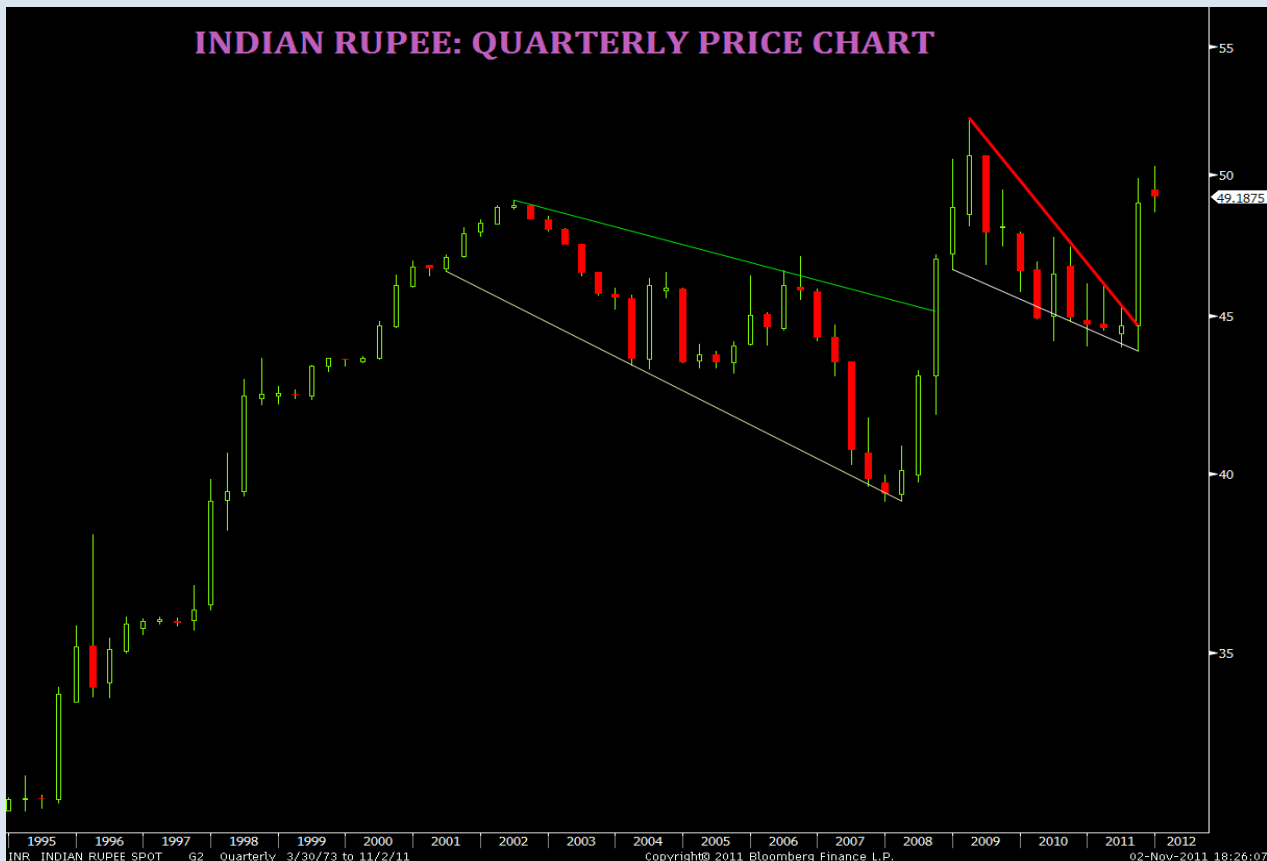
On the global front the US is still recovered from the downgrade it suffered by rating's company S&P. The US might of decided on many steps that it might initiate to reduce its debt burden, but it'll take long before we seen the face of that. The step to pump in cash (in form of two quantitative easing programs) might have helped the US economy to recover little bit but it has also caused a huge debt on the US government which can have drastic effects in the long run. The decision of the US Federal bank (FOMC) to keep the rates unchanged till mid 2013 has come of no surprise. This however had drastic effects as investors are dumping the US debt and looking for higher yielding assets else where. Because of the overall weakness in the global economy the greenback has found support as a safe haven and a reserve currency due to which we can see the dollar moving up in the coming months as well.

On the European front as mentioned earlier in the report in our view we thing the Euro is still not out of the dumps and they would have to take very stringent steps to put the Euro in the right place. The single currency will directly suffer because of the ongoing slowdown and the sovereign debt crisis.

Given the above mentioned facts, one would say that the outlook for India looks dim for the coming quarter. Because of its higher costs and corruption charges India would loose out on being a preferred destination for investments. This effect will be directly seen in the depreciation of the rupee for the coming quarter. Further more, recovery in the global economy, surging food prices and the resultant high food inflation will remain a cause for concern.

*Overall, we expect the rupee to depreciate further in the short term. However, it is expected to shed some losses in the long term, as the hopes that the European region will be able to find a solution to its debt crisis will bring back money into riskier assets. The rupee is also come back to some parity as such huge depreciation over a quarter might not be sustained. In the longer term we can see the rupee appreciate going into the next year as India tries to put behind the scams and higher inflation for a better growth.*

### TECHNICAL ANALYSIS:



May be fundamentals have made Indian rupee to move so much in a single quarter that INR has depreciated by around 9 per cent to settle the quarter at Rs. 48.9737/USD. However, such gigantic move has happened after ten consecutive quarters consolidation phase. Such

scenario has formed a technical pattern and many call it as a pennant break out, some name it as a consolidation break out etc. However, we are also convinced about the break out pattern and were much expected. Therefore, our last quarter's view on Indian rupee was to move higher. Now, it is important to portray an outlook about Indian rupee for the next two months. Already one month of CYQ4 2011 is over where market has not moved at all. The second month of Q4 has also now begun and market is still silent, probably waiting for a major move, technically we may call it a consolidation move is on from its recent up move. Certainly, a correction can be expected may be until 23.6% retracement of the previous move which can be seen at 48.61 (October month's low). On break of the same may see prices correcting until 47.6180, or may be till 48.00/48.50. In fact the ongoing scenario may not permit rupee to correct so much but a correction is inevitable. To get proper support levels it is also important to look at the monthly chart. As per the monthly chart support could be seen at 47.75. Looking at the above analysis we seen Indian rupee may have a strong support near 47.50 to 48 levels. Nevertheless, a convicting break below 46.90 should pull INR to test 46.19 levels. Likewise, the upside targets can be defined at 50.32 (recent high) and breach of the same may see Indian rupee moving towards life time high of 52.18 levels. Interestingly, quarterly and monthly RSI-14 is at 0.60 and 0.62 respectively suggesting market still has potential to move higher.

SO, the broad range for Indian rupee for the next two to three month is 47.00 on the lower side and 52.10 on the higher side.

Another important tool which is fitting on the chart is CYCLE FINDER and that suggests that rupee may stay higher until November 2012 (Although a long term approach).

**Action point:** Looking at the current scenario, we believe Indian rupee to trade in a consolidation phase however, buying at dip is suggested.

**Strategy (Spot):** Buy X-lots near 48.65-85, Y-lots at 47.80/48.20 and Z-lots at 47.20/47.00 targeting 50.50 then 52.00 with stop loss below 46.50

**Investment weights at X, Y and Z can be 50%, 40% and 10% respectively.**



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