

HSBC Fund Update

- HSBC Global Investment Funds - Indian Equity ("the Fund")



Summary

- ▶ The Indian equity market experienced a strong rebound in January, as investor sentiment and economic data improved
- ▶ Going forward, we expect inflation to fall by about 50% from its peak level in 2011, which will be beneficial to the positioning of the HGIF Indian Equity Fund
- ▶ The Fund is overweight domestic cyclical sectors including rate sensitive companies, and healthcare and materials amongst the global sectors
- ▶ We expect strong demand for Indian equities this year, given valuations are still at very attractive levels, and foreign inflows will continue as funds rebalance their underweight or short India positions

Market review – 2011, the year that was

Most investors were happy to see the end of 2011. It was a very difficult year, which promised quite a bit early on and then disappointed badly, especially for the Indian market. A weak currency (INR down 18.7% against USD) exacerbated the fall in the market for foreign investors into India. In USD terms, the S&P IFCI India Investable index fell 37.3% as at 30 December 2011. The weakness in the market was primarily driven from policy inaction in India, sticky and high oil prices, and poor global risk appetite due to the European debt crisis.

The HGIF Indian Equity Fund underperformed the benchmark in 2011. We held an overweight position in cyclicals, because of their attractive price and future profitability, given the secular growth in India going forward. We were positioned underweight defensive sectors such as Consumer Staples which were already very expensive. However, the Fund's underweight in such names cost us relative performance. The Fund had taken a positioning by Q3/Q4 of 2011 that interest rates were going to peak, and moved the portfolio into a position to benefit from monetary easing.

We believe that inflation will fall dramatically in 2012 - by as much as half from 2011 peak levels - given easing food price inflation in recent months. We have already seen the benefit of this call to our Fund in January 2012.

January performance – the twist and turn

The S&P IFCI India Investable index turned around its poor performance last year by spiraling up 20.6% (USD terms) in January 2012. The INR also did its twist as it rose by a strong 6.8% against the USD. The key reasons for the improvement in the market is that we saw extremely negative sentiment normalising, a sharp fall in inflation, unexpected cut in cash reserve ratio by the Central Bank, expectations of the Congress Party doing better in UP State elections (results due early March) and an unexpected jump in industrial production.

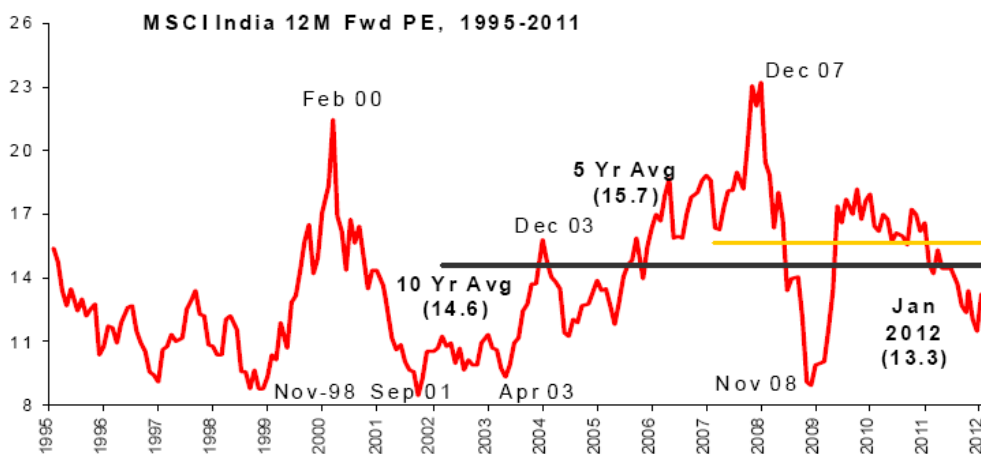
Outlook

Market:

We maintain our view that inflation should fall by 50% from the peak levels of around 10% witnessed in 2011. The latest numbers for November and December have supported this view with December inflation falling to 7.47% year-on-year. Given the slowdown in GDP, the Government's and Central Bank's focus has turned to growth relative to inflation. We have already seen a 50 basis points (bps) cut in the Cash Reserve Ratio (CRR) in January and ongoing open market operations by the Reserve Bank of India (RBI) to inject liquidity into the market. We expect further monetary easing over the course of 2012. Therefore, we continue to favour domestic cyclical sectors at the expense of domestic defensive sectors and global sectors, notwithstanding the sharp rally witnessed by these stocks in January.

Some key regional elections are scheduled in the first quarter of 2012 and the results of the Uttar Pradesh (UP) elections will be closely watched. If the Congress party does significantly better it could lead to changes in leadership with Rahul Gandhi taking a role in government, and a potential change in Prime Minister, which would be taken as a positive. If the Socialist Party (SP) party does better it could enable them to form the Government in UP with the support of the Congress Party. This will allow the Congress to disregard one or two of their less reform minded coalition partners as it could then count on the support of the SP in Parliament. Post these elections we could see a pick up in Government decision making. Some decisions have already been taken like the notification of Foreign Direct Investments (FDI) in single brand retail and allowing foreign nationals to buy shares on the Indian equity markets.

Valuations have rebounded following the 10% rally in January but still remain in attractive territory. Sentiment towards India has normalised from being extremely negative. Foreign flows have turned sharply as funds have rushed to cover their underweight or short India positions.



Source: Factset, Morgan Stanley (As at January 31, 2012)
Past performance is not indicative of future returns. Data shown is for illustrative purposes only.

Sector:

We retain overweight domestic cyclicals whilst maintaining our underweight stance on domestic defensives such as consumer staples, telecoms and utilities. We remain overweight healthcare and materials amongst the global sectors whilst being underweight information technology and energy.

Currency:

As a secular trend, the INR will appreciate over the decade to 2020, in our view, similar to the development of currencies of large, growing economies, over the last several decades. Given the large depreciation in INR in 2011, our view was that the INR would appreciate from end-2011 levels. INR did appreciate 6.8% in January, and still has some way to go to reach early 2011 levels of INR/USD. In the very short term, forex is always hard to predict and the INR does have risks, and it can be volatile due to the impact of oil prices (India is a large net importer), gold prices (India is one of the biggest markets for gold globally) and from debt repayments by Indian corporates.

Source: HSBC Global Asset Management, as of 31 January 2012

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