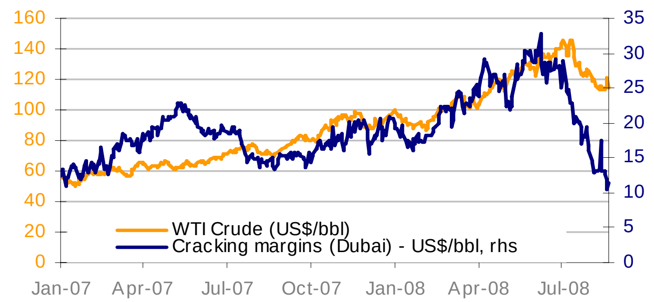
India Strategy: Charting India – August 2008

27 August 2008

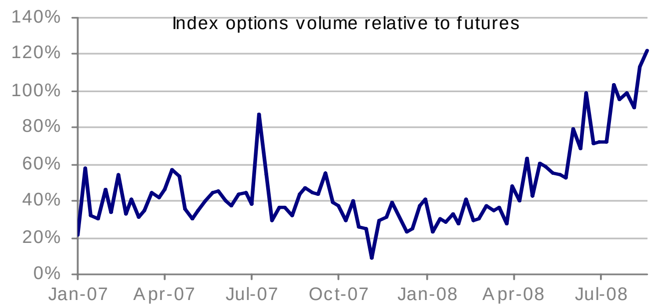
- Even as the economic slowdown is palpable all around, a near-term reprieve for India has come from: 1) a turnaround in monsoon rainfall; and 2) a sharp decline in commodity prices. The number of regions with deficient rainfall has fallen to four currently, from 14 in mid-July. Rice production during the current season is no longer at risk, mitigating worries of a further rise in food subsidy. The fall in commodity prices, especially subsidised products such as diesel, should provide some succour to a government battling a rapidly worsening fiscal balance. Still, FY09 fiscal deficit as percentage of GDP is likely to be 250bps YoY higher.
- The continued tightening in liquidity has resulted in a sharp uptick in lending rates in the past month. SBI raised its benchmark PLR by 100bps to 13.75% after the 29 July monetary policy, and effective borrowing rates have almost doubled since the FY05 lows. Data published by CMIE, albeit for a smaller universe of companies, suggest that the incremental downgrade to upgrades ratios has been rising. Emerging-market risk spreads are also back to 3-year highs, rendering overseas borrowing expensive too. The yield curve inversion, at the shorter end, has further steepened, with 1-yr treasury yield almost 40bps higher than 10-yr gilts.
- Consensus earnings, as one would intuitively expect, continue to see downgrades. In the past month alone, earning estimates for real-estate and financials have seen 4-8% cuts, while aggregate earnings for BSE-100 have seen a downgrade of 1-2%. The expected softening in commodity prices (especially cracking margins) and investment cycle bodes ill for earnings forecasts, and despite the recent cuts, earnings estimates remain too optimistic.
- India was a favourite market to short till very recently, justified by the valuation premium and worsening macro environment. The recent weakening in commodity prices, especially crude oil and its derivatives, has reduced conviction levels on the short side as well. With low conviction on either shorts or longs, market volumes have been negatively affected. For the first time since equity derivates was launched about six years ago, notional value of options traded exceeded value of futures traded, in the past couple of weeks, suggesting that derivates markets are being increasingly used to hedge or buy protection.

Cracking margins have more than halved



Source: Bloomberg

Index options volumes exceed futures



Source: Bloomberg

Key charts

Figure 6: While area sown for rice is up 7% YoY, that for coarse grains, pulses, sugarcane and jute has seen a drop

Figure 8: Cracking margins have crashed 50% from their highs, implying earnings risk for oil refiners

Figure 19: Yield curve has shifted upwards and inverted, with 10yr now below 1yr and 5yr yields

Figure 39: Gross invisible inflows account for over 90% of merchandise exports – making them as important from BoP perspective

Figure 44: Real Estate and Construction made up over 25% of FDI during Apr-May

Figure 47: India's FX reserves have declined almost US$20bn from recent peak

Figure 49: Banks' investment books have shown marked deceleration even as credit growth is still holding up

Figure 59: State fiscal deficit widened 40bps in FY08 but it is budgeted to improve in FY09 – VI Pay Commission presents a key risk to this

Figure 78: Delivery volumes on exchanges have seen steady decline, indicating low institutional activity

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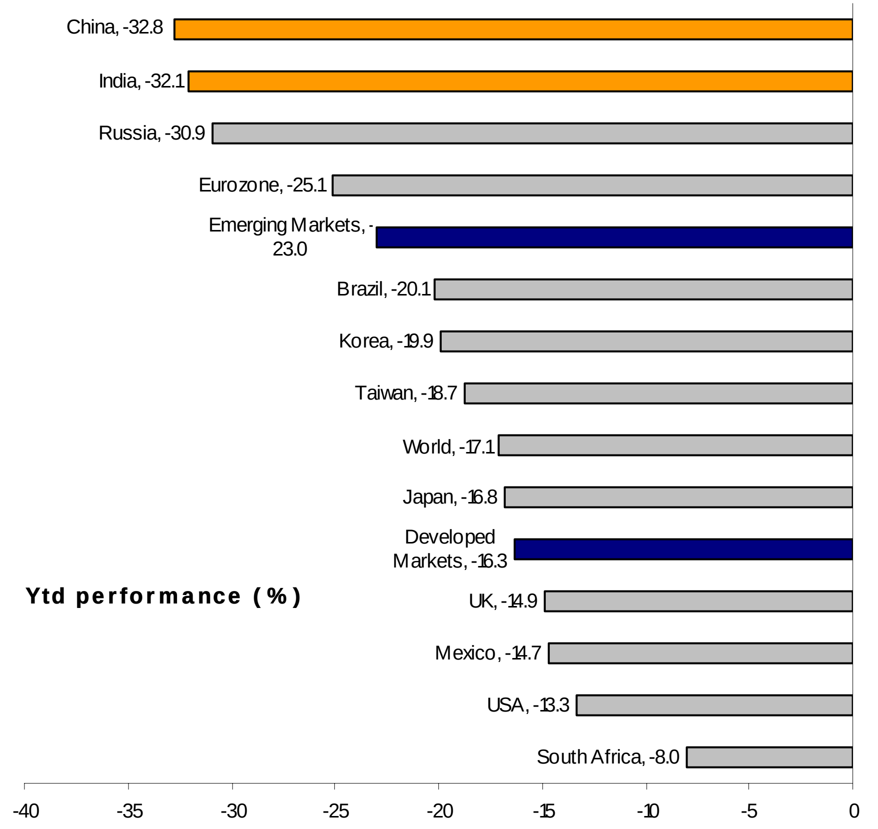
Global equities – the turn in tide

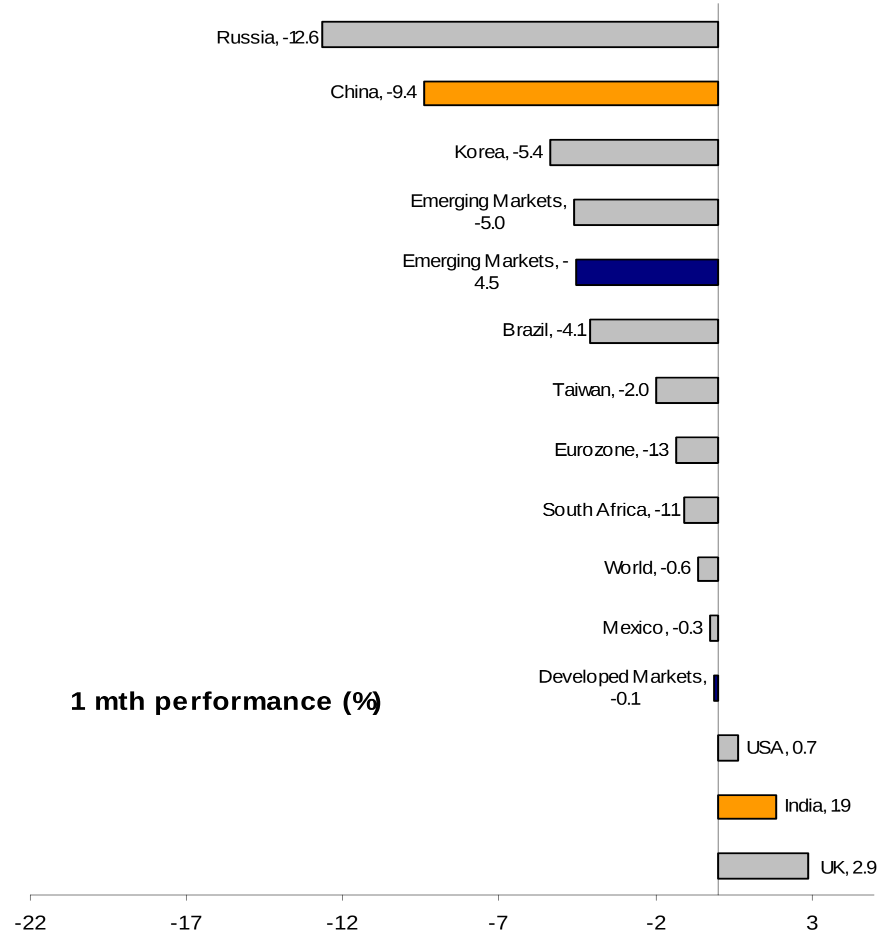
Figure 1: EMs have underperformed developed-market equities by over 600bps YTD



Source: Bloomberg, MSCI

- This will be the first year since 2000 that EM equities would underperform developed-market equities, should this trend persist till year-end.
- India and China continue to be the laggards, but Brazil and Russia have fallen back after their underperformance in the current commodity correction.

Figure 2: India outperformed EMs by a wide margin over the past month; China underperformed, while commodities corrected sharply

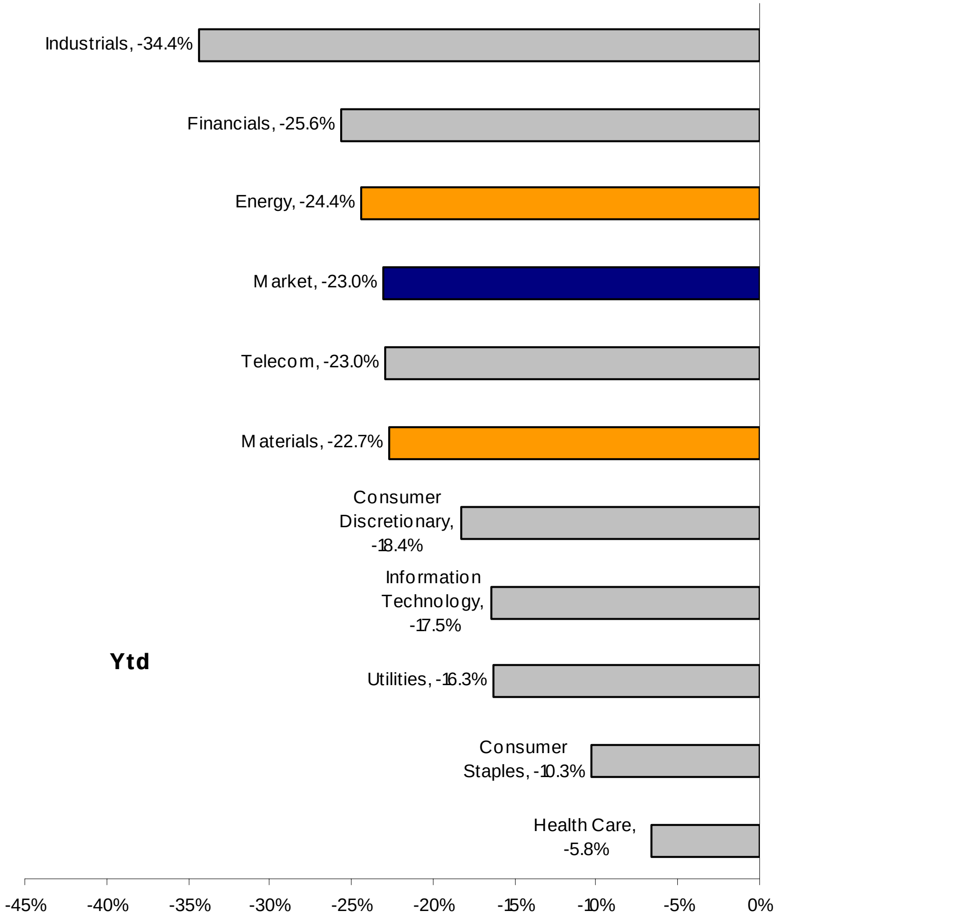


Source: Bloomberg, MSCI

- India and China have seen divergent performance over the past month, with India significantly outperforming China.
- Even on a 3-month basis, India has now outperformed EMs by 6 percentage points.

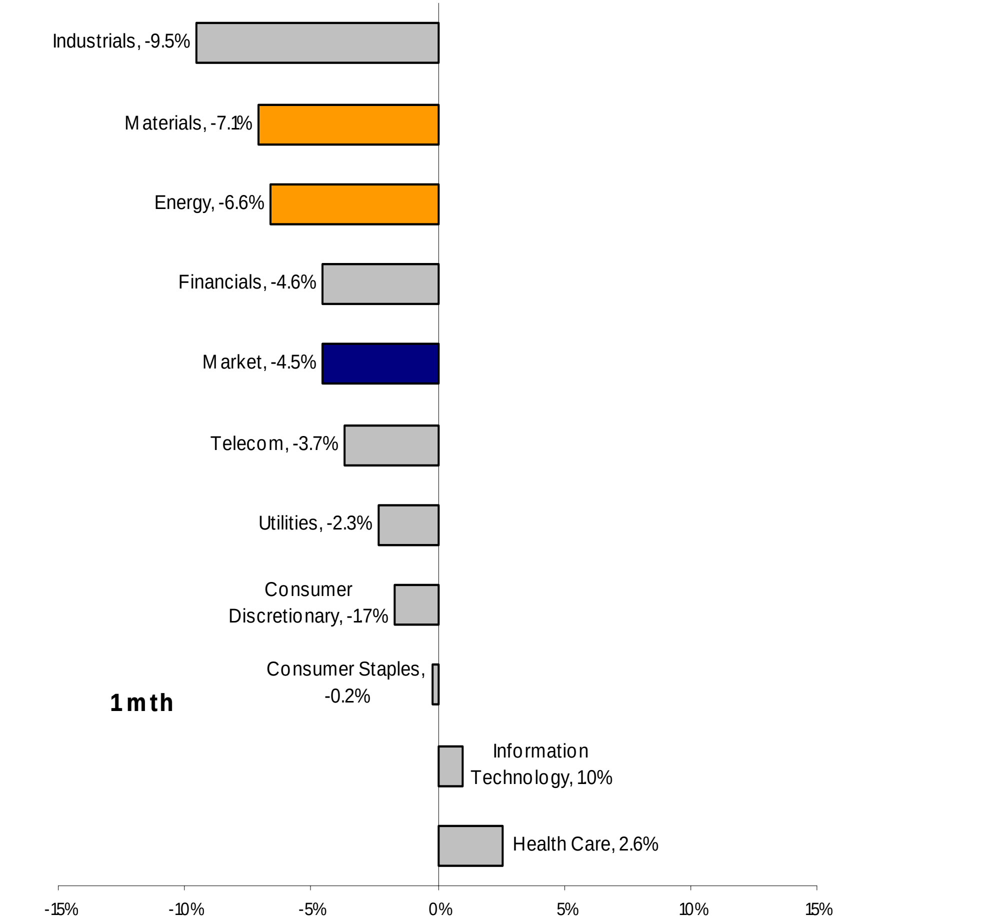
EM sector performance

Figure 3: Industrials and Financials the worst-performing sectors YTD



Source: Bloomberg, MSCI

Figure 4: Healthcare and IT – the best-performing sectors on 1mth basis

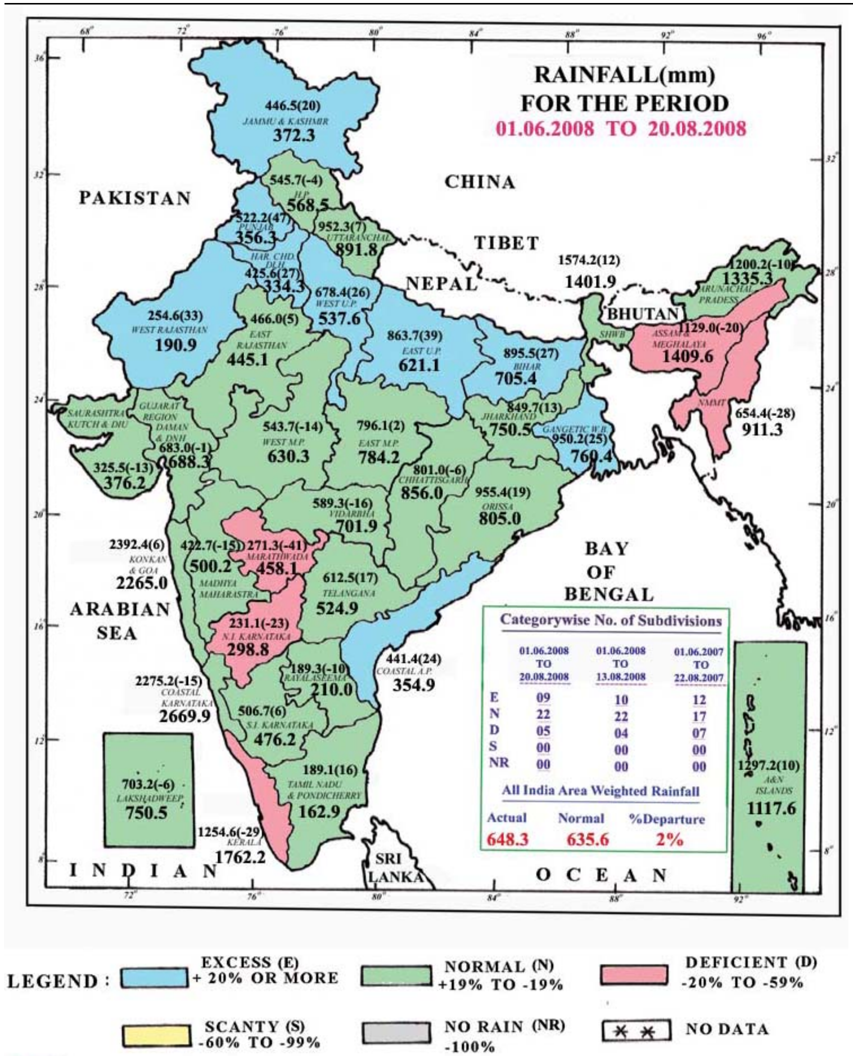


Source: Bloomberg, MSCI

- After being amongst the best-performing sectors YTD, energy and materials have corrected sharply over the past month and are now down broadly in line with the market YTD.

Monsoons – welcome relief

Figure 5: Monsoons give South and West a miss



Source: Indian Meteorological Department
Note: Figures in bold denote normal rainfall in mm, non-bold figures represents actual rainfall and figures in parentheses represent excess/deficit rainfall so far

Figure 6: Kharif sowing for rice has been good so far

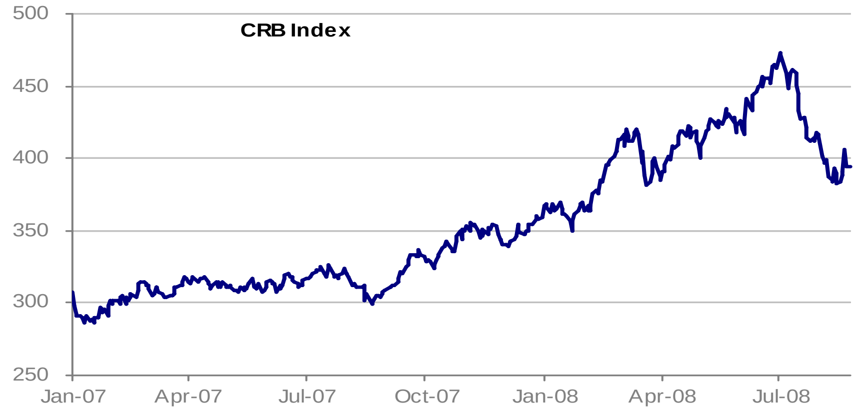
	Area sown till 20th August		
Kharif season sowing (m hectares)	2008 season	2007 season	Growth (%)
Rice	**32.5**	**30.4**	**6.9%**
Jowar	2.8	3.3	-17.4%
Bajra	7.2	8.1	-10.1%
Maize	6.7	7.2	-7.2%
Total of coarse cereals	**18.4**	**20.4**	-9.8%
Groundnut	5.0	5.1	-2.6%
Soyabean	9.4	8.7	8.4%
Total of oilseeds	**16.9**	**16.8**	0.7%
Arhar	3.2	3.7	-14.9%
Urad	2.0	2.5	-21.6%
Moong	2.3	3.0	-24.4%
Total of pulses	**9.6**	**11.3**	-15.3%
Cotton	8.6	9.1	-5.3%
Sugarcane	4.4	5.3	-16.8%
Jute	0.7	0.8	-10.8%

Source: Ministry of Agriculture

- After giving early jitters, monsoon has picked up and barring a couple of regions in Maharashtra, Karnataka, Kerala and North-East, rainfall is at least normal in other regions
- The number of regions with deficient rainfall has reduced from 14 in mid-July to just 4 now
- Sowing of rice has progressed well, with area sown 7% higher this year vs. last year. Coarse grains, pulses, sugarcane and jute, on the other hand, have seen a sharp decline in area sown
- The brighter outlook for rice in particular has reduced the risk of a further rise in food subsidy

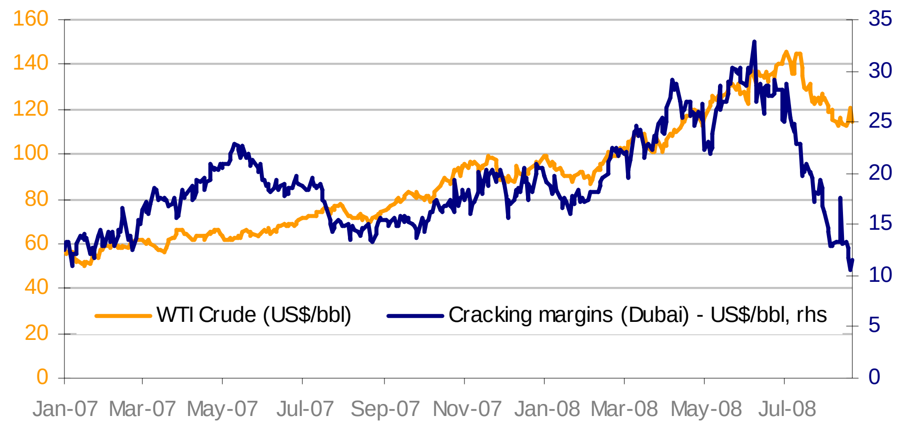
Commodities

Figure 7: CRB Index is down 15% from its peak



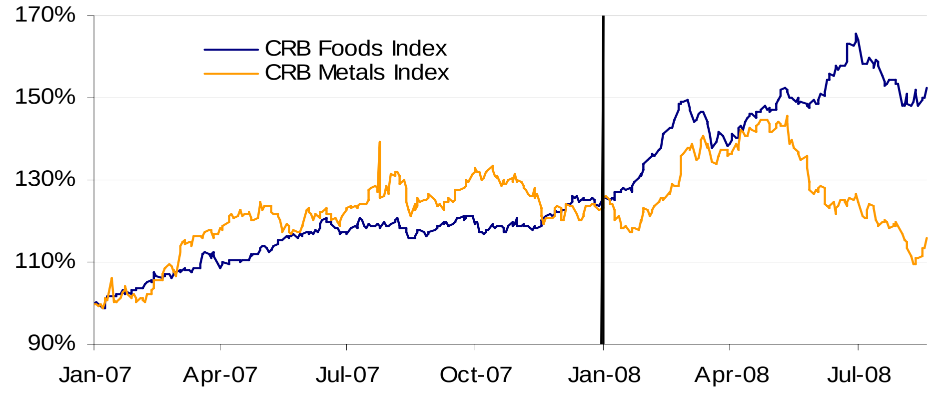
Source: Bloomberg

Figure 8: While crude has corrected 21%, cracking margins have more than halved



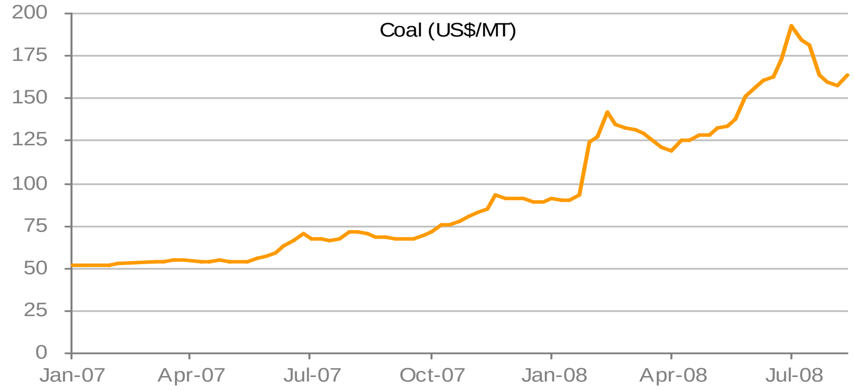
Source: Bloomberg

Figure 9: Metals have fallen more sharply than soft commodities in this correction



Source: Bloomberg

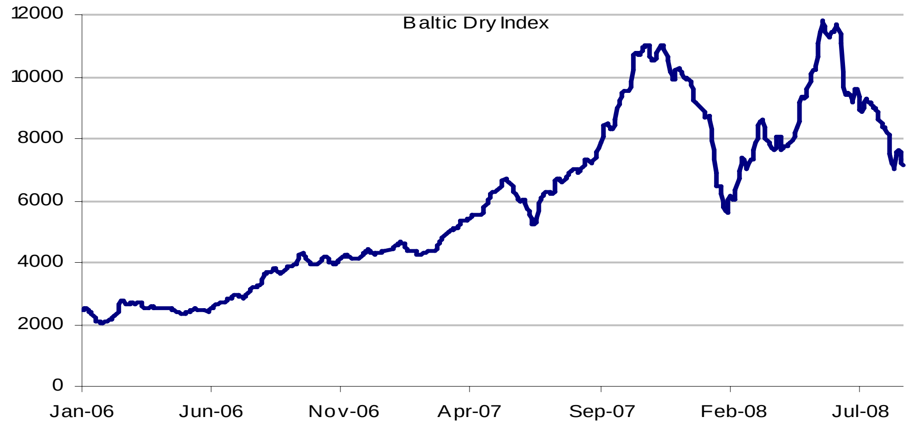
Figure 10: Non-exchange-traded commodities such as coal have also corrected, though relative to recent history they remain elevated



Source: Bloomberg

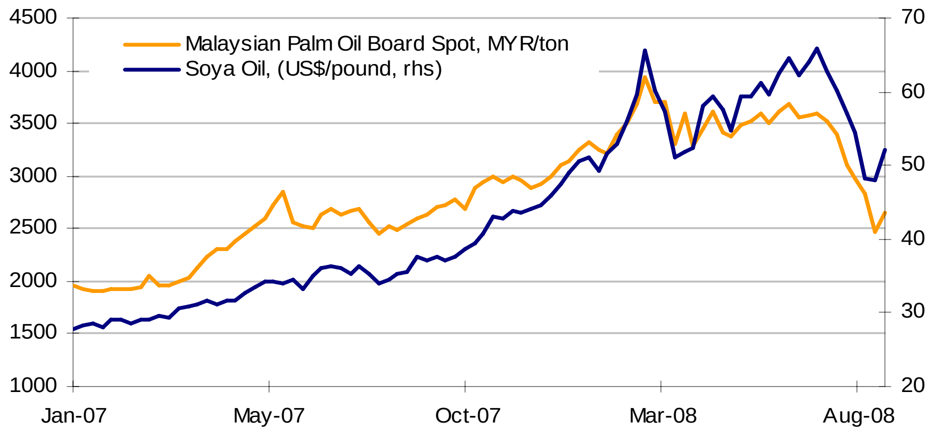
Commodities contd...

Figure 11: International freight costs have fallen over a third



Source: Bloomberg

Figure 12: Palm oil – a key import item for India has corrected almost 30%



Source: Bloomberg

Figure 13: Commodity price performance

	Current Price	1 mth chg	3 mth chg	6 mth chg	1 yr chg	Ytd chg
Aluminium (US$/tonne)	2,740.0	-8.2	-7.2	-5.0	11.7	16.2
Coal (US$/tonne)	163.5	-11.3	23.4	15.1	133.6	82.7
Coffee (US$/pound)	132.1	1.5	0.7	-8.9	23.8	11.7
Copper (US$/tonne)	7,765.0	-7.0	-5.7	-7.3	7.3	16.9
Corn (US$/bushel)	5.4	4.1	-1.6	9.6	66.8	27.4
Crude oil (USD/bbl)	114.2	-10.7	-12.3	15.4	64.8	19.0
Diesel (US$/bbl)	127.7	-17.3	-25.7	10.3	56.5	15.1
Gold (USD/t oz.)	821.6	-11.6	-11.2	-12.6	23.0	-1.5
Lead (US$/tonne)	1,878.0	-12.8	-5.7	-42.6	-38.3	-26.2
LPG (US$/tonne)	791.0	-17.0	-9.0	-1.7	43.8	-9.1
Natural gas (US$/MMBtu)	8.0	-21.5	-31.0	-7.6	36.4	11.5
Nickel (US$/tonne)	20,815.0	2.4	-10.9	-26.2	-25.5	-20.0
Platinum (US$/t oz.)	1,419.8	-19.1	-34.5	-34.0	13.7	-7.0
Wheat US$/bushel (60lb)	7.2	8.5	16.2	-28.1	10.7	-10.8
Zinc (US$/tonne)	1,811.5	-1.1	-13.2	-26.9	-41.5	-23.0

Source: Bloomberg

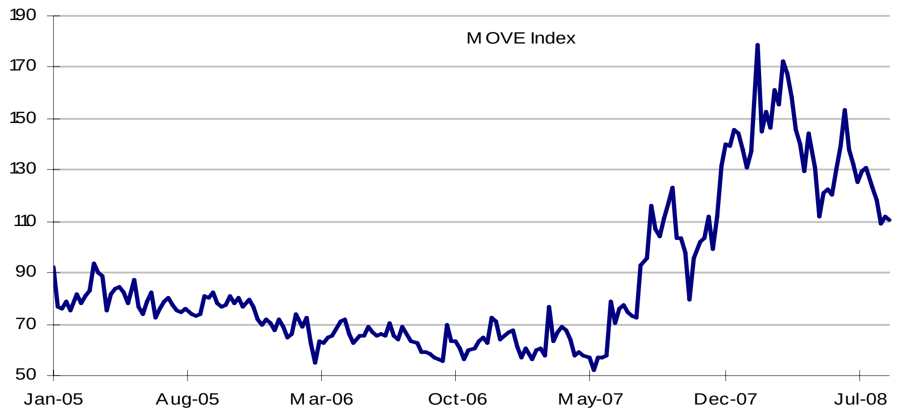
- Precious metals have seen sharp corrections over the past month. Platinum in particular, which has jewellery as well as industrial applications, is down by a third over the past three months
- Soft commodities such as wheat, corn and coffee, however, have rallied over the past month and after coal are among the best-performing commodities over a three-month horizon – and still with positive 3mth returns
- The sharp correction in refined petroleum products, particularly diesel (down 30% from recent peak), and the overall decline in refinery crack spreads should also help mitigate the oil subsidy bill. However, this is not good news for index earnings, given the large earnings weight of the sector
- The follow-through impact of lower commodity prices will take some time to reflect in WPI, as domestic prices of most commodities are still lower than the landed prices of imports

Volatility down, risk spreads up

Figure 14: Implied volatility in equities has also come off sharply

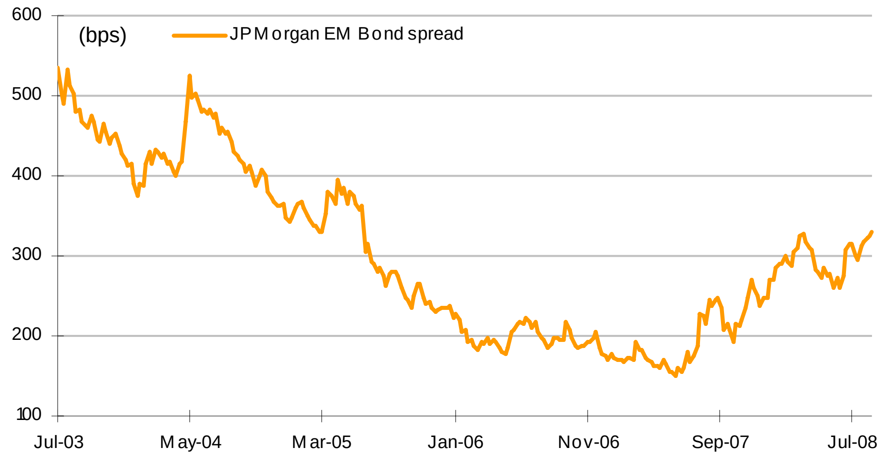
Source: Bloomberg

Figure 15: Implied volatility in US treasuries has come off to its lowest this year



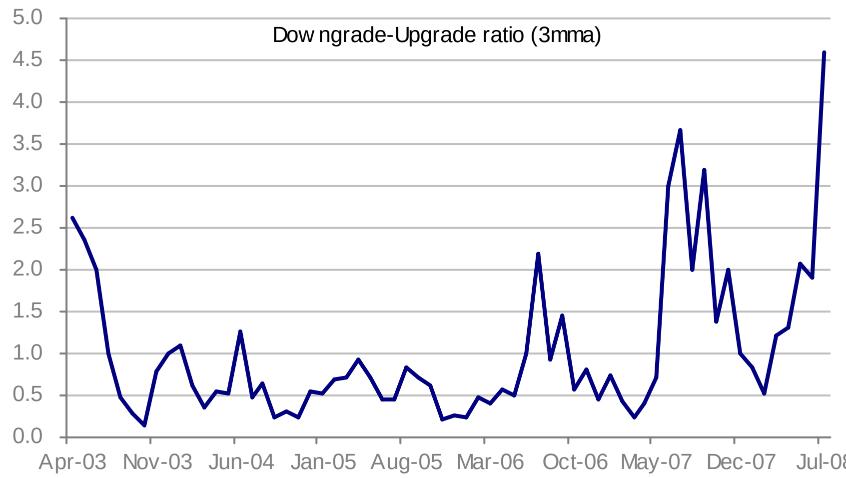
Source: Bloomberg
MOVE Index is the trademark of Merrill Lynch

Figure 16: EM bond spreads have widened to around their highest since late 2005



Source: Bloomberg

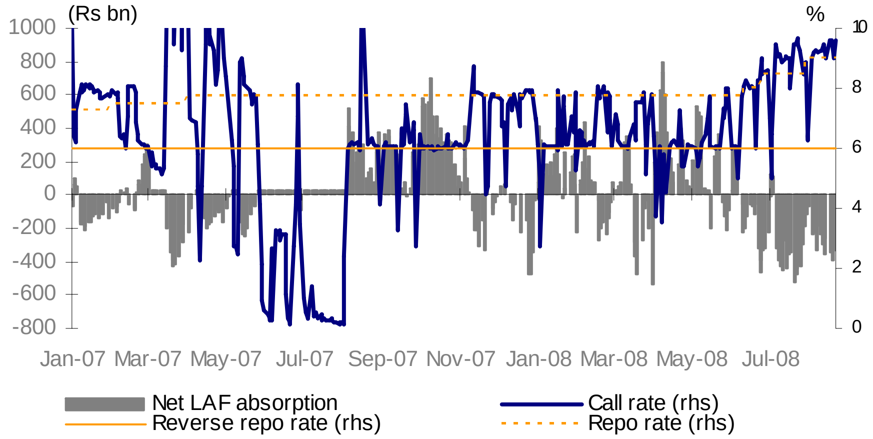
Figure 17: Domestically credit quality, however, deteriorated further



Source: CMIE. Note: Data is based on limited number of companies and tends to be volatile

Money markets – liquidity squeeze

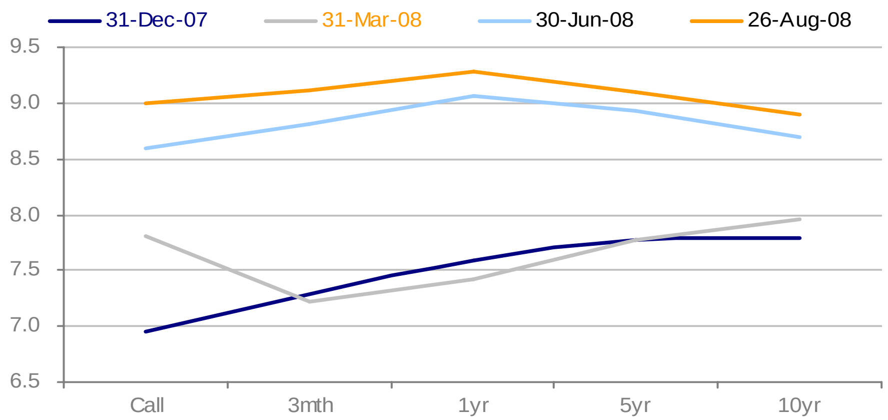
Figure 18: Liquidity remains tight in money markets



Source: Bloomberg

- RBI has been in liquidity injection mode for over two months now

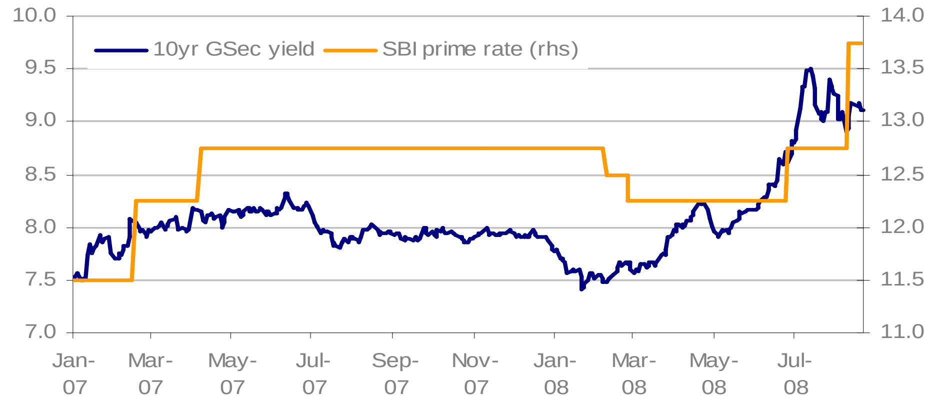
Figure 19: Yield curve has shifted up and inverted



Source: Bloomberg

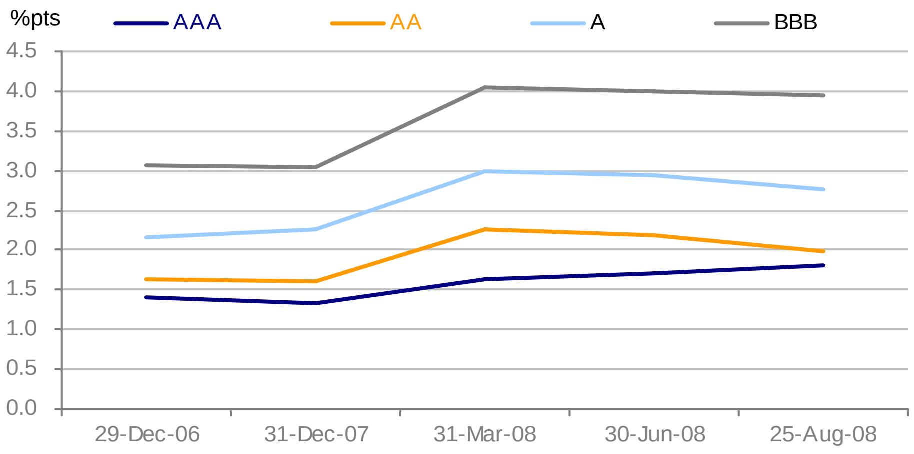
- 10yr bond yield is now below call rate, 1yr t-bill as well as 5yr bond yield

Figure 20: Lending rates have seen a sharp jump even as bond yields have come off



Source: Bloomberg

Figure 21: Domestic credit spreads have remained unchanged

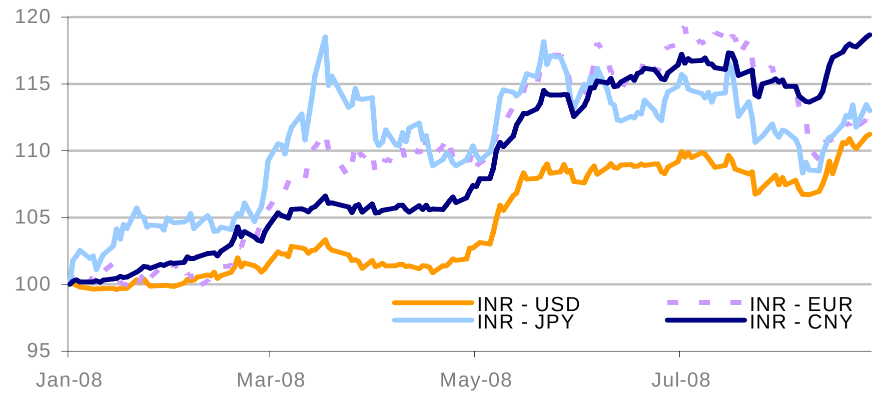


Source: Bloomberg

- After rising in 1QCY08, bond spreads have stabilised and modestly improved for a few categories

Currency Market

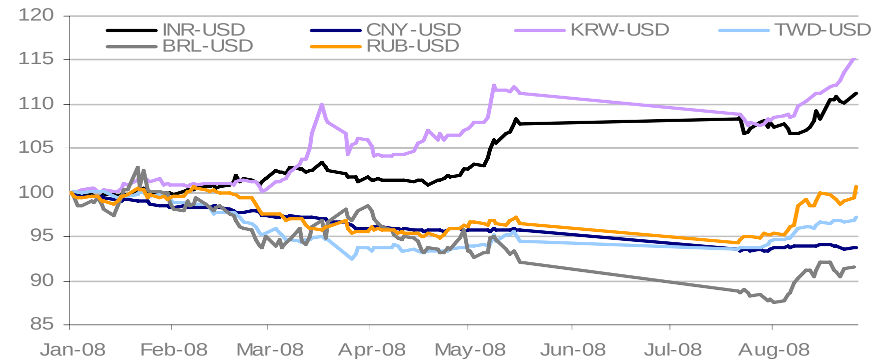
Figure 22: Rupee – down 11-19% YTD against USD, EUR, JPY and CNY



Source: Bloomberg
Note: Currencies rebased to 100 at start of 2008

- INR has now depreciated by 19% YTD vs. the Chinese yuan, increasing the competitiveness of Indian goods relative to those from China

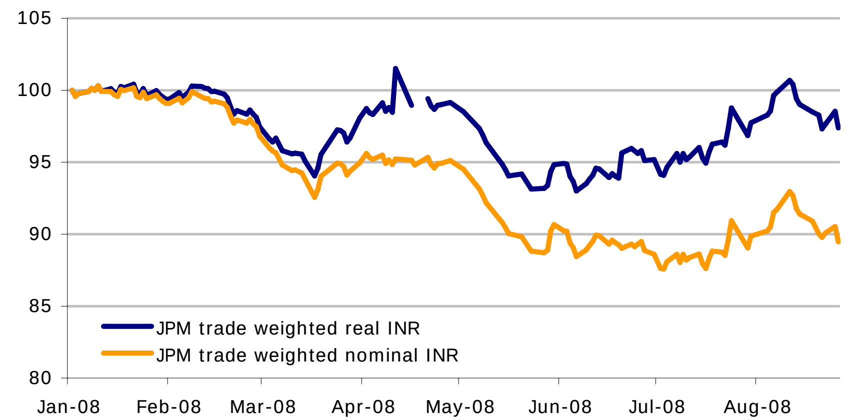
Figure 23: YTD, INR is one of the few currencies to have depreciated against USD



Source: Bloomberg
Note: Currencies rebased to 100 at start of 2008

- Along with the Korean won, INR continues to be the only major EM currency to have depreciated against USD this year

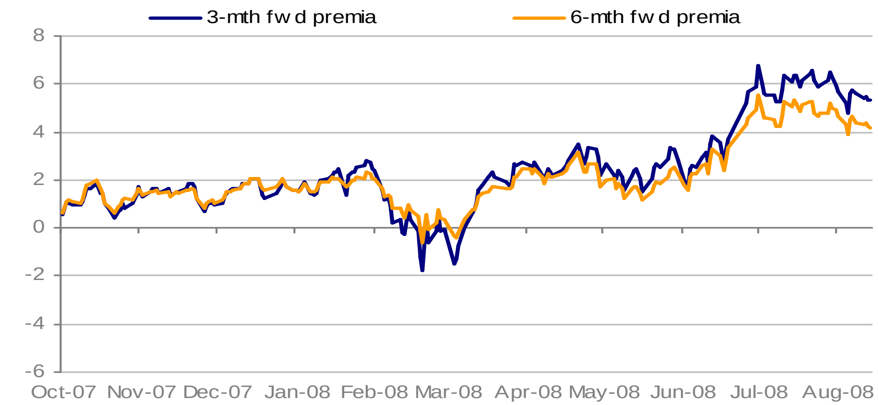
Figure 24: On a trade-weighted basis, Ytd INR has depreciated 10% in nominal terms



Source: Bloomberg
Note: Rebased to 100 at the start of 2008

- However, given the rise in inflation, depreciation has been modest in real terms

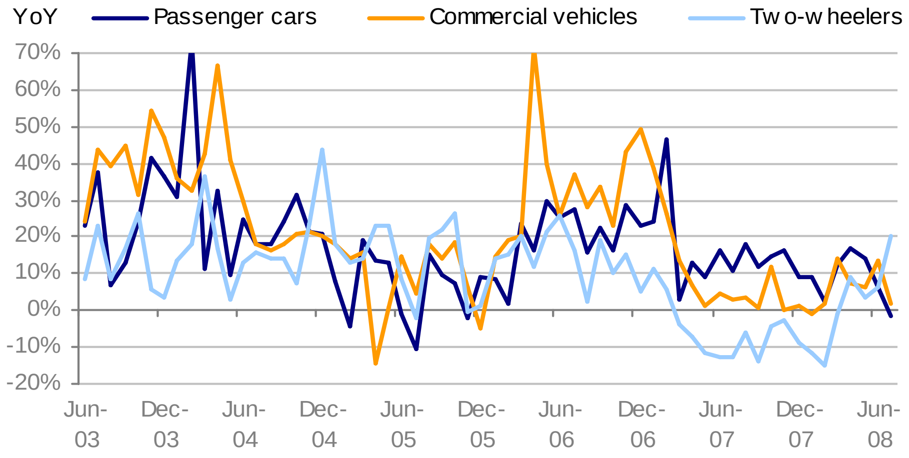
Figure 25: Sharp rise in forward premia to increase hedging costs for companies



Source: Bloomberg

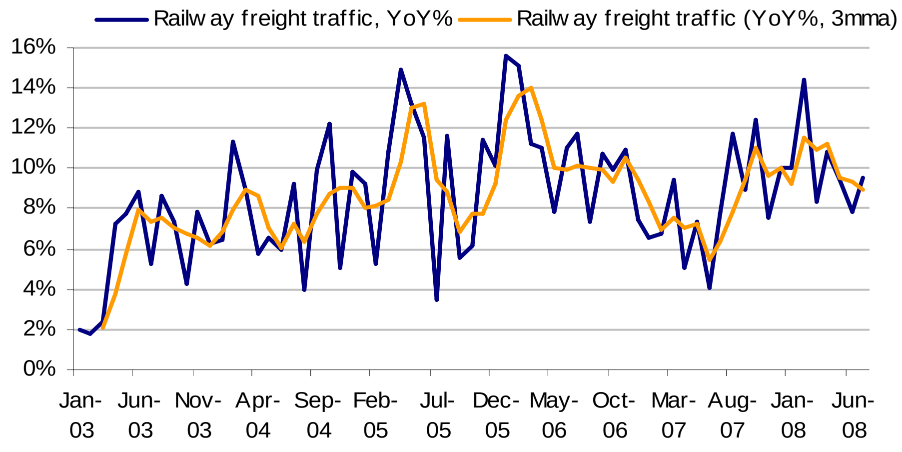
Leading indicators

Figure 26: Auto sales growth is decelerating, with passenger car sales declining in Jul



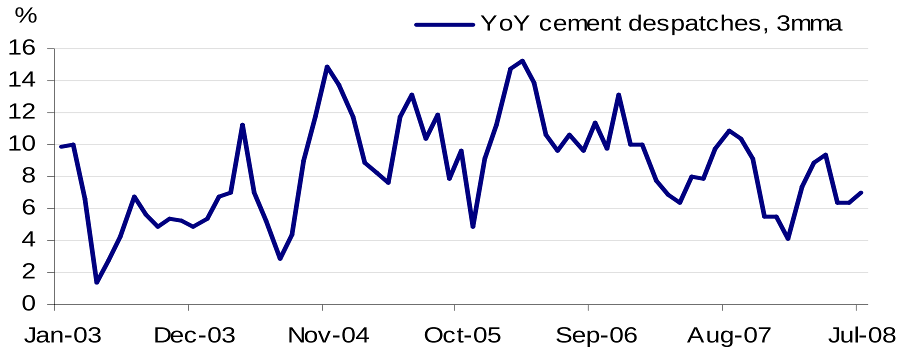
Source: Bloomberg

Figure 28: Freight traffic growth at Railways has similarly decelerated



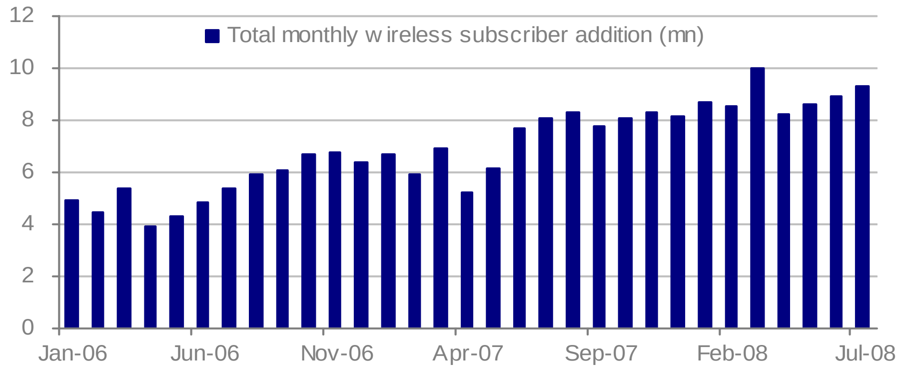
Source: CMIE

Figure 27: Cement despatches have ticked up over the past month



Source: CMA India

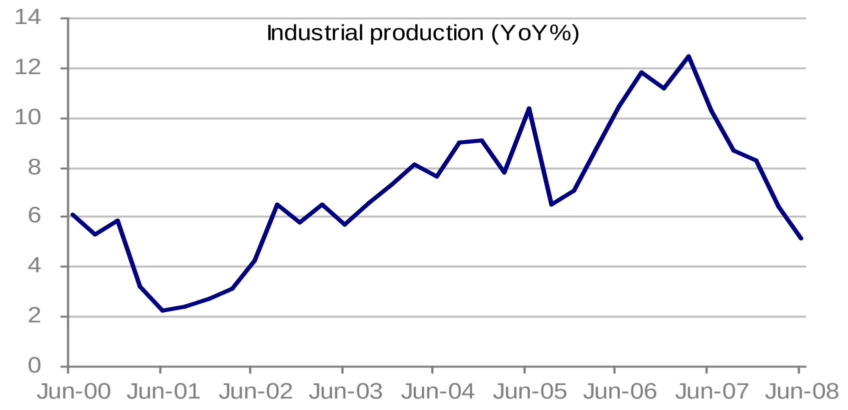
Figure 29: Monthly mobile subscriber additions – one bright spot



Source: TRAI

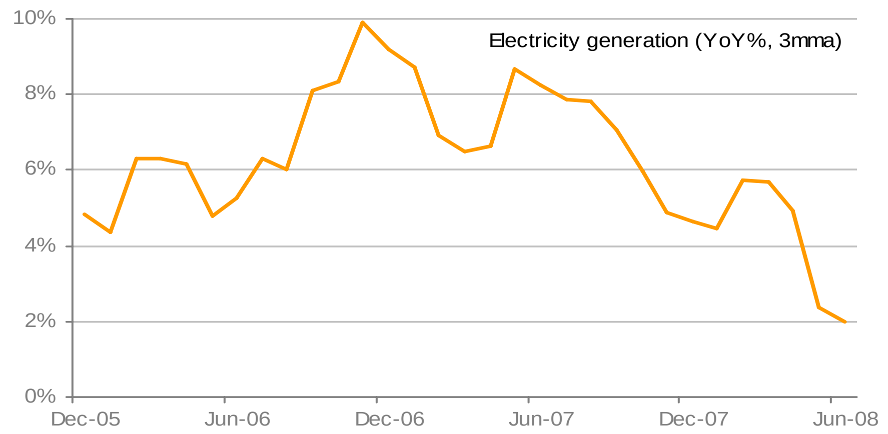
Industrial activity – sharp deceleration

Figure 30: Industrial production has decelerated to a six-year low (quarterly basis)



Source: CSO

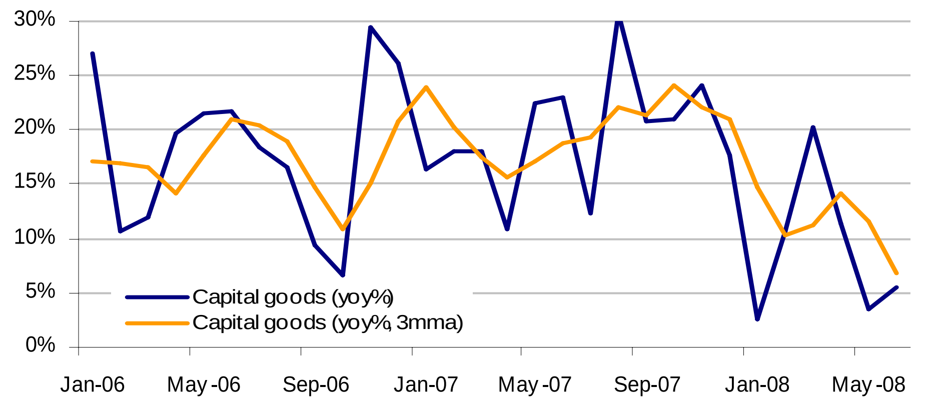
Figure 31: Electricity growth has decelerated sharply, increasing power shortages



Source: CSO

- In spite of all the buzz surrounding the sector, electricity output growth has decelerated sharply, growing just 2% in 1QFY09. Sharply lower hydro output, coal shortages, lack of capacity addition explain this deceleration

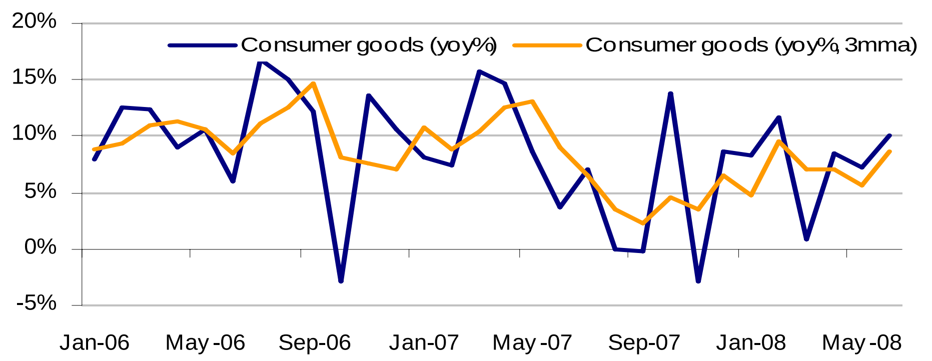
Figure 32: Capital goods sector – marked deceleration



Source: CSO

- Capital-goods growth has slipped to single digits in 1QFY09 from above 20% rate seen in many months of 2007

Figure 33: Consumer goods sector has however rebounded

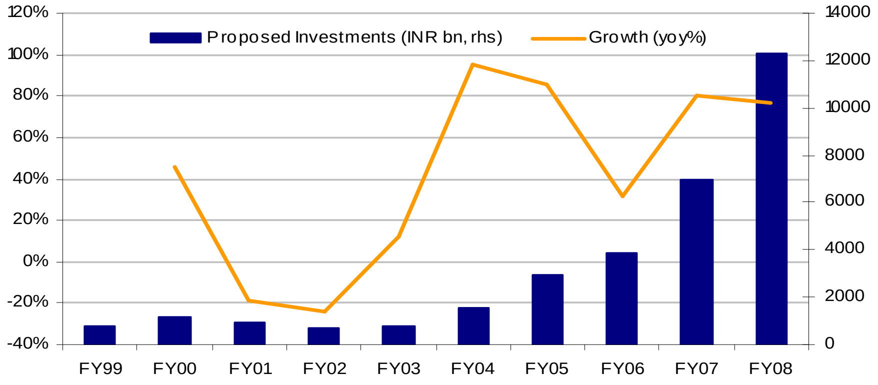


Source: Department of Industrial Policy and Promotion

- The sector is being helped by low base of last year as well as strong fiscal support – lower direct and indirect taxes

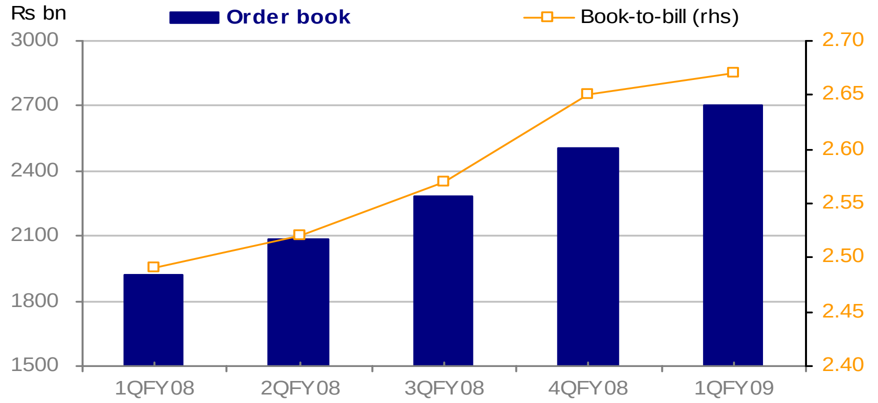
Capex cycle – signs of stress

Figure 34: New investment proposals reached a new high in FY08



Source: Department of Industrial Policy and Promotion

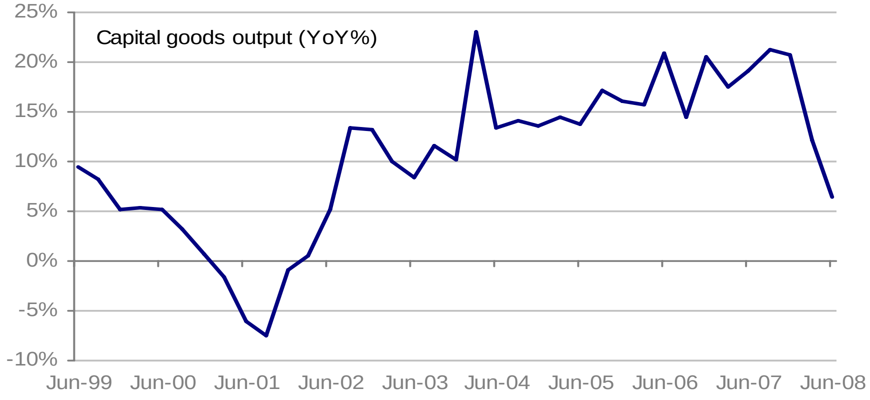
Figure 35: Similarly, order books for most capital goods companies remain healthy



Source: IIFL Research. Based on our coverage universe of construction and engineering companies excluding Alstom, BL Kashyap, CCCL, Kalpataru and Sadbhav

- Slowdown in capex cycle is a hotly debated topic—momentum behind new investment proposals and large order backlog at capital goods companies suggests still robust momentum

Figure 36: However, capital goods output has decelerated sharply



Source: CMIE. Note: Chart plots quarterly average

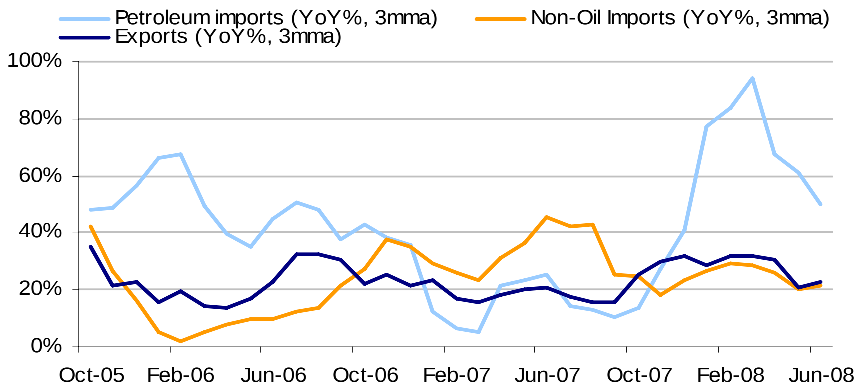
Figure 37: And growth in capital-goods imports has decelerated

Source: CMIE

- In our view, given the signs of deceleration and significantly tighter monetary conditions, and high base due to strong growth since FY03, pace of capex growth would decelerate further in FY09

Foreign trade

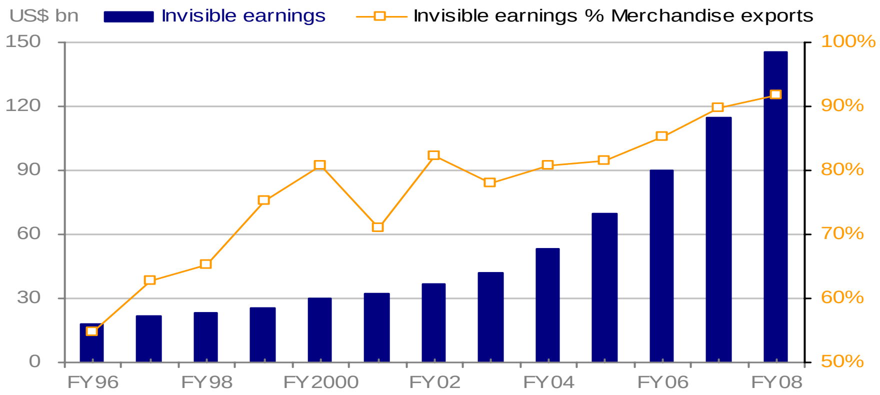
Figure 38: Merchandise exports growing faster than non-oil imports



Source: RBI, IIFL Research

- The weakening of trade deficit is largely attributable to the surge in oil imports

Figure 39: Invisibles are as important as merchandise exports in current account



Source: RBI, IIFL Research

- In FY08, invisible receipts (software, remittances, but excluding capital flows) totalled US$145bn and accounted for 92% of merchandise exports

Figure 40: Invisibles – much more than software

US$ bn	FY04	FY05	FY06	FY07	FY08
Services earnings	18.0	30.6	42.1	57.6	64.9
- Software services	12.8	17.7	23.6	31.3	40.3
- Other services	5.2	12.9	18.5	26.3	24.6
Private remittances	22.2	21.1	25.0	29.0	42.6
Travel	5.0	6.7	7.9	9.1	11.3
Transportation receipts	3.2	4.7	6.3	8.1	9.5
Investment Income	3.8	4.1	6.2	8.9	13.8
Others	1.3	2.4	2.2	2.5	3.1
Total Invisible receipts	**53.5**	**69.5**	**89.7**	**115.1**	**145.3**
Services payments	10.2	16.9	17.9	28.6	27.9
- Business services	0.8	7.3	7.7	17.1	16.7
- Other Services	9.4	9.6	10.1	11.5	11.2
Travel	3.6	5.2	6.6	6.7	9.2
Transportation receipts	2.3	4.5	8.3	8.1	11.6
Investment expense	7.5	8.2	11.5	14.9	19.0
Others	2.0	3.4	3.4	3.4	4.8
Total invisible payments	**25.7**	**38.3**	**47.7**	**61.7**	**72.6**
Total Invisible balance	**27.8**	**31.2**	**42.0**	**53.4**	**72.7**
Merchandise balance	**-13.7**	**-33.7**	**-51.9**	**-63.2**	**-90.1**

Source: RBI, CMIE

- While software services have grown 3x since FY04, other services (largely business services, financial services and communication services) have grown almost 5X
- Travel earnings (largely tourism) have doubled and investment income (thanks to the burgeoning FX reserves) has tripled since FY04
- On invisible payments side, business services have risen from under US$1bn in FY04 to US$17bn in FY08

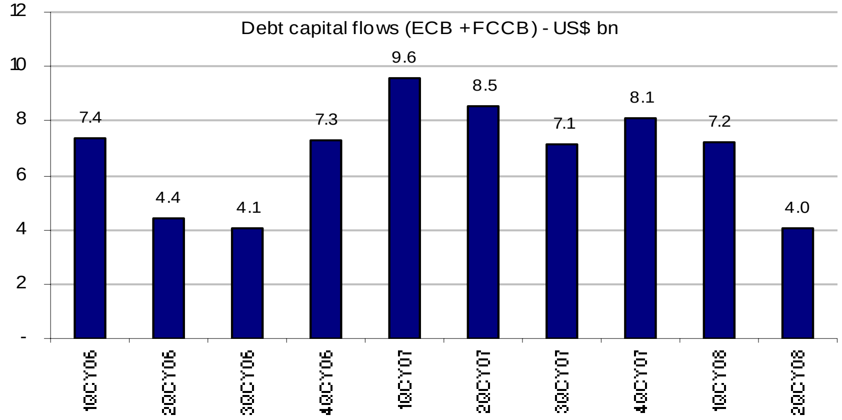
Capital flows

Figure 41: Large capital flows easily funded the widening of current-account deficit

US$ bn	FY04	FY05	FY06	FY07	FY08
Current Account Balance	14.1	-2.5	-9.9	-9.8	-17.4
Capital Flows	16.7	28.0	25.5	45.8	108.0
Foreign Investment	13.7	13.0	15.5	15.5	44.8
- Net FDI	2.4	3.7	3.0	8.5	15.5
- Portfolio flows	11.4	9.3	12.5	7.1	29.3
Loans	-4.4	10.9	7.9	24.5	42.0
Others	7.4	4.1	2.0	5.7	21.3

Source: RBI

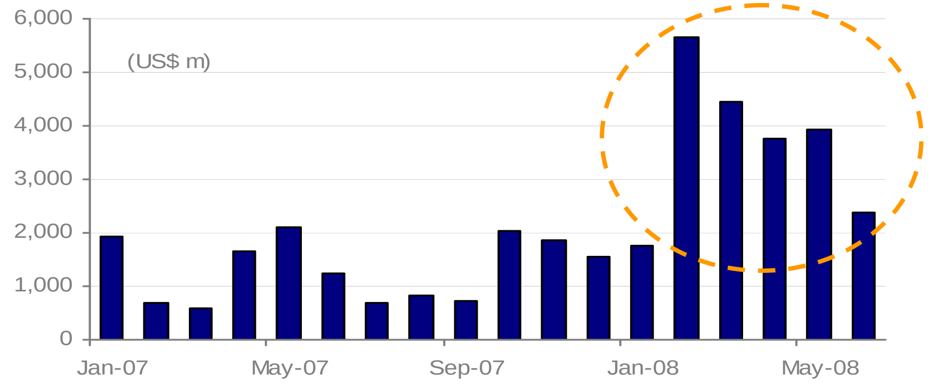
Figure 42: Debt capital flows have seen sharp deceleration



Source: RBI

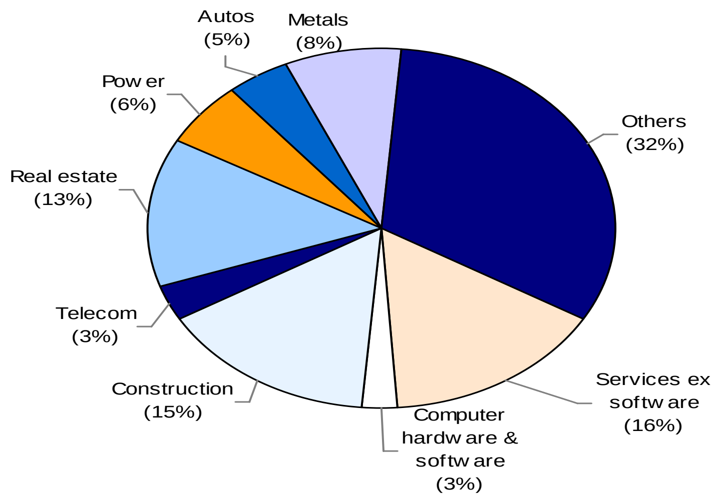
- Apr-June 2008 quarter saw debt capital flows drop over 50% YoY, partly reflecting tight credit markets globally as well as RBI restrictions on ECB flows

Figure 43: Gross FDI inflows – sharp pick up over past 5 months, more than 3x avg



Source: RBI

Figure 44: Sectoral breakdown of FDI during Apr-May 2008

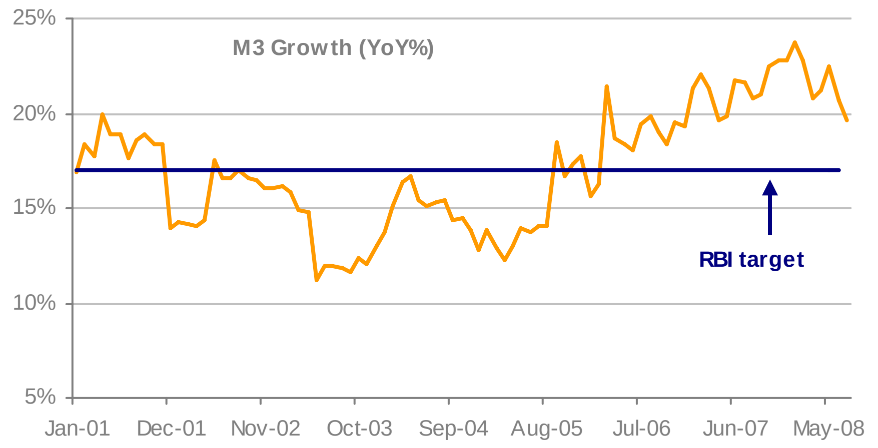


Source: Department of Industrial Policy and Promotion

- India received US$7.6bn of FDI during Apr-May 2008 – up 100% YoY
- Construction and Real Estate accounted for over a quarter of the FDI with services another sixth

Monetary indicators – above RBI comfort zone

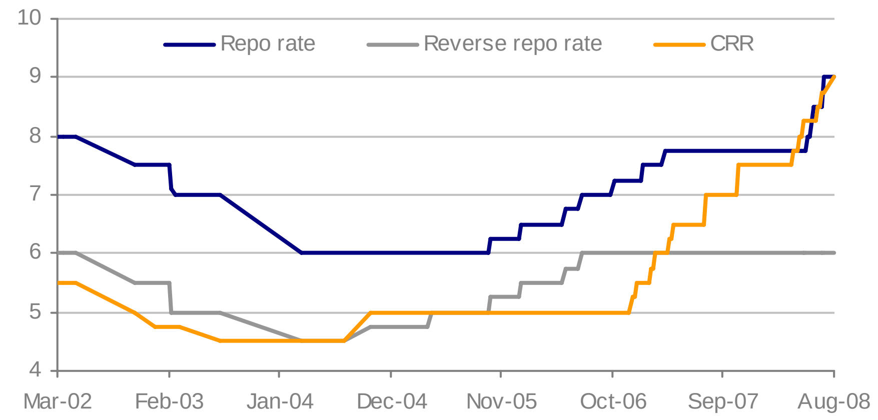
Figure 45: Money supply growth is decelerating – now below 20%



Source: Bloomberg

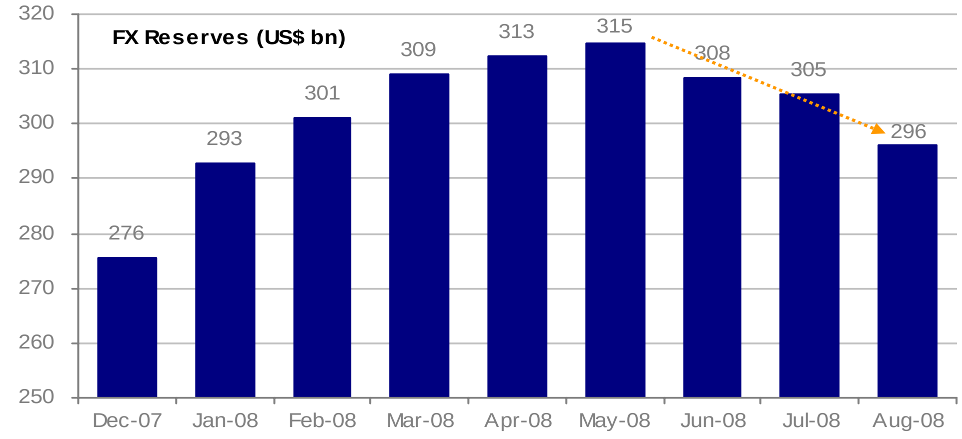
- M3 growth is decelerating, but still above RBI target.

Figure 46: Monetary policy has come full circle – rates are above the early 2000s level



Source: Bloomberg

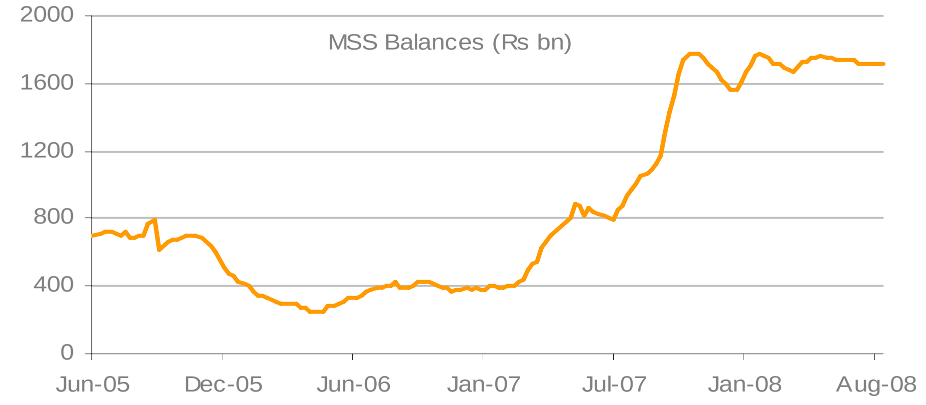
Figure 47: FX reserves have declined almost US$20bn from their highs in May



Source: RBI

- From its peak, India's FX reserves have declined by almost US$20bn

Figure 48: Almost US$7bn of FII outflows, however liquidity overhang continues

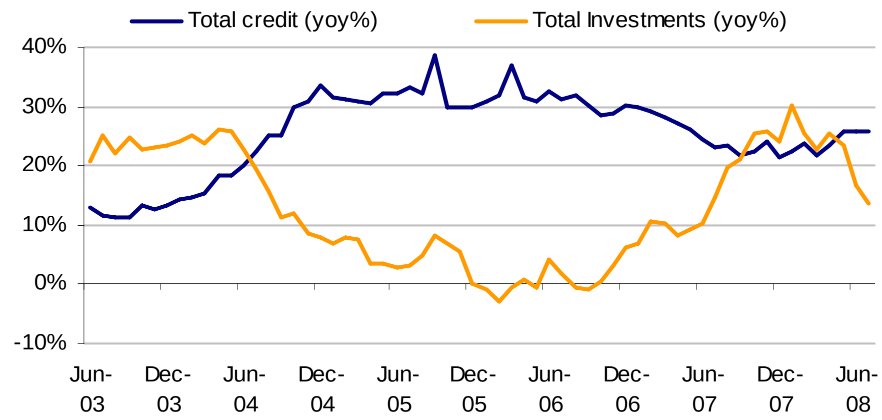


Source: Bloomberg

- MSS balances continue at their all time highs ~US$40bn or over 3% of GDP

Credit growth – still elevated

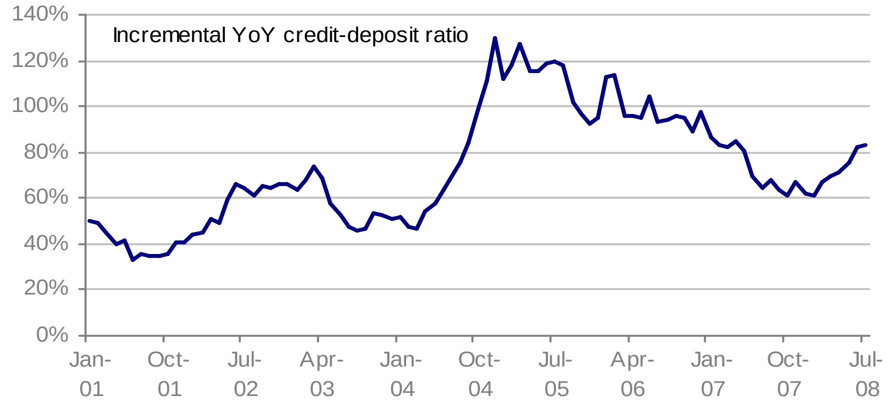
Figure 49: Credit growth has accelerated from a low of 22% in Dec to above 26%



Source: Bloomberg

- The rise in credit growth has caused a sharp deceleration in banking sector's investments as deposit growth has also decelerated from 25% in January to 20% currently

Figure 50: Incremental credit-deposit ratio has also risen this year



Source: Bloomberg

Figure 51: Sectoral Credit Growth YoY

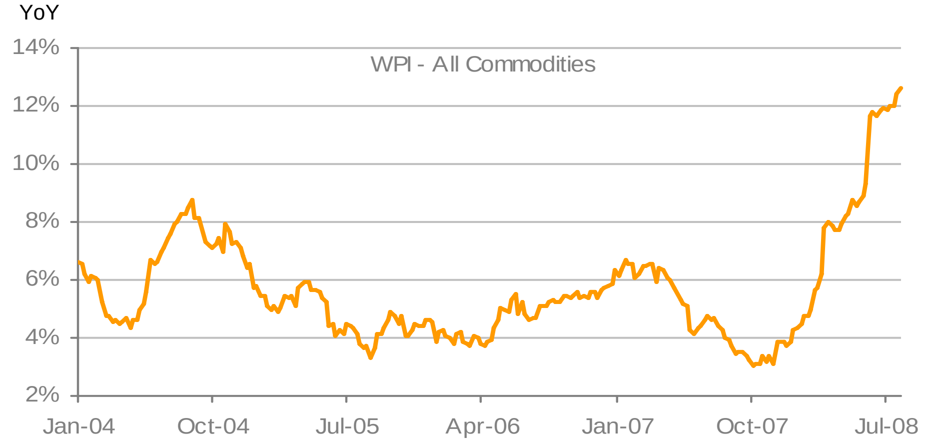
% YoY growth	Mar-06	Mar-07	Feb-08	May-08
Non-food Gross Bank Credit	**39.6**	**27.9**	**22.0**	**24.1**
Non-food bank credit ex Oil sector			**21.9**	**23.5**
Agriculture and Allied Activities	**39.9**	**32.4**	**16.4**	**19.3**
Industry (Small, Medium & Large)	**30.0**	**25.7**	**25.9**	**26.9**
Personal loans	**40.5**	**26.5**	**13.2**	**15.9**
--- Housing	38.3	24.6	12.0	13.8
--- Credit cards	41.3	46.6	50.6	87.0
Services	**58.8**	**31.0**	**28.4**	**31.3**
--- Real estate loans	97.1	69.8	26.7	31.9
--- NBFCs	50.3	41.5	48.6	62.0

Source: RBI

- The slowdown in credit growth over the past year is attributable largely to agriculture and personal (households) sectors where credit growth has halved; Credit growth at industry and services still continues to be robust
- The acceleration in credit growth from February this year to May was fairly widespread and not driven solely by increased lending to PSU Oil companies as was believed – leading RBI to sharply tighten monetary policy

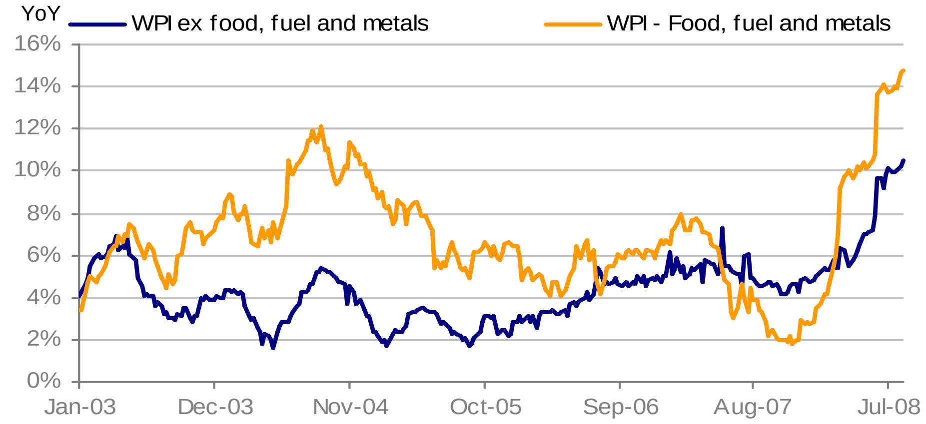
Inflation – uncomfortably high

Figure 52: WPI at 16-year high



Source: Bloomberg

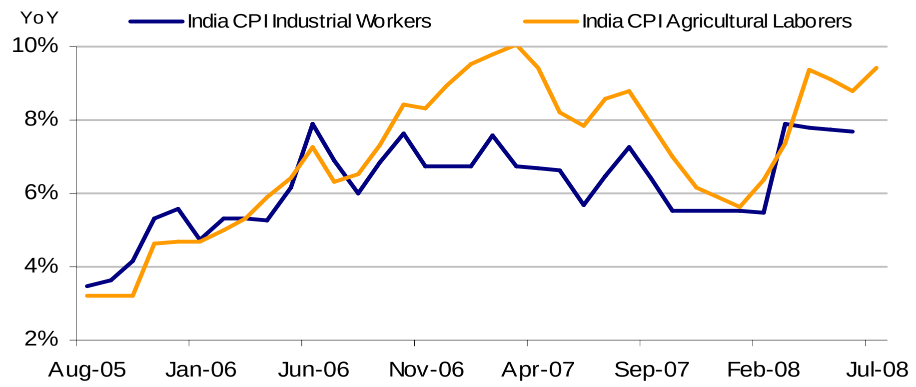
Figure 53: Commodity prices not entirely to blame for rising inflation



Source: Bloomberg

- Although commodity prices are the 'source' of the inflation (with inflation being cost push rather than demand drive), they are pulling prices up in other products as producers try and pass down the rising input costs

Figure 54: Rural CPI (Agri labourers and Rural labourers) ticked up sharply in July



Source: Bloomberg

- Rural CPI rose to 9.4% (~65bps rise) in July to highest in over a year. The more widely tracked CPI – Industrial Workers data for July would be available end of the month and would be keenly watched to see if similar trend is witnessed there

Figure 55: WPI Inflation breakdown

	Weight (%)	9-Aug (% YoY)	24-Nov (% YoY)
All commodities	100.0	12.6	3.1
Primary articles	22.0	11.8	5.0
Food	15.4	7.5	3.0
Non-food articles	6.1	17.1	11.4
Minerals	0.5	50.9	0.6
Fuel, Power, Light and Lubricants	14.2	18.0	0.3
Manufactured products	63.7	10.9	3.5
Food products	11.5	13.2	1.7
Basic metals, Alloys and Metal products	8.3	22.7	3.5
Machinery and machine tools	8.4	5.3	6.8
Food Inflation	26.9	9.9	2.5
Metals	8.8	24.3	3.3
Energy Inflation	14.2	18.0	0.3
WPI ex Food, Energy and Metals	50.1	10.5	4.2
Food, Energy and Metals inflation	49.9	14.7	2.0

Source: Bloomberg

Government finances

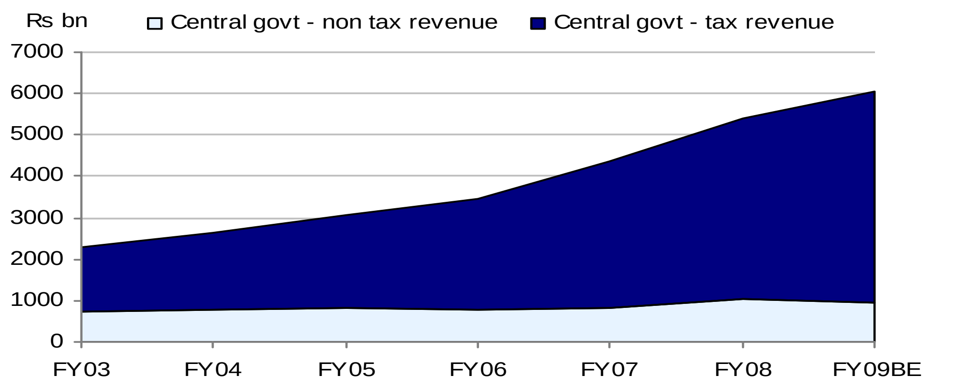
Figure 56: Fiscal deficit to worsen even under optimistic assumptions

FY09 Fiscal deficit (% GDP)	EAC[1] estimates	Optimistic estimates	Comments for optimistic estimates
Budget estimates	2.5%	2.5%	Does not factor in the reduction in customs and excise duties – but we assume buoyancy in direct taxes would compensate
Oil bonds	2.2%	1.0%	Due to over-estimation of under-recoveries, fall in oil price
Under provision of Food and fertiliser subsidy	2.0%	2.0%	
Others (VI-pay commission, NREGA, Agri-dent w/off)	0.8%	0.8%	
3G Auctions	Nil	-0.8%	3G auctions are expected to raise up to US$10bn
Disinvestment (via IPOs)	Nil	-1.2%	IPOs of BSNL, Coal India, OIL India could raise up to US$15bn
Total adjusted fiscal deficit	7.5%	4.3%	FY08 adjusted fiscal deficit was 3.6%

1. EAC refers to Prime Minister's Economic Advisory Council. Source: EAC, IIFL Research

- Even under optimistic assumptions, FY09 fiscal deficit likely to worsen and exceed 4% of GDP on adjusted basis

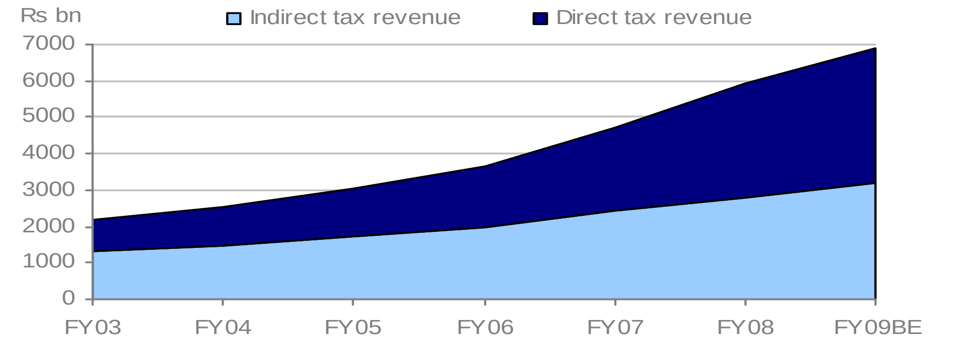
Figure 57: Almost entire increase in revenues has come from tax receipts



Source: Controller general of accounts

- Total revenues of the government increased by 19% Cagr from FY03-08 with tax revenues growing 23% and non-tax revenue growing 7%

Figure 58: Direct taxes have grown at 14%pts more annually than indirect taxes from FY03-FY08



Source: CMIE, Controller general of Accounts

- Both corporate and personal income taxes have doubled over past three years and government is relying on continued buoyancy in tax collections to help manage the fiscal situation
- Corporate and Personal tax collections have grown 43% and 50% respectively in 1QFY09 – however with the economy slowing, corporate tax collections would likely to slow significantly in the next three quarters

Figure 59: State govt finances have also slipped in FY08 – FY09 budgeted to be better

Aggregate State deficit indicators (% GDP)	Revenue deficit	Fiscal deficit
FY03	2.3	4.1
FY04	2.3	4.4
FY05	1.2	3.4
FY06	0.2	2.5
FY07	-0.6	1.9
FY08 RE	-0.5	2.3
FY09 BE	-0.6	2.1

Source: RBI, Data from FY07 is provisional and based on budgets pf 27 state governments

- State government's fiscal deficit rose 0.4%pt in FY08, but it is budgeted to improve in FY09 – a key risk factor would be the implementation of the VI pay commission which could add a few bps to aggregate fiscal deficit (though its impact would be far lower than the Fifth Pay Commission, which had almost crippled state finances)

Earnings growth

Figure 60: BSE 100 consensus sectoral earnings growth

	Profit growth	
	FY09	FY10
Consumer Discretionary	9.5%	16.6%
Consumer Staples	-5.1%	17.7%
Energy	48.0%	37.8%
Financials	3.8%	22.8%
Health Care	12.9%	20.2%
Industrials	17.6%	32.3%
Information Technology	24.5%	15.8%
Materials	-12.3%	10.0%
Telecommunication Services	21.3%	21.1%
Utilities	8.4%	16.1%
Aggregate	9.6%	22.0%

Source: Bloomberg

Figure 61: Consensus Index Earnings estimates

	SENSEX			NIFTY		
	FY08	FY09	FY10	FY08	FY09	FY10
Index EPS (Rs)	903	975	1165	271	307	373
Growth (%)		8%	19%		13%	21%
Index ex Oil and Gas EPS (Rs)	771	780	909	213	224	262
Growth (%)		1%	17%		5%	17%
Index ex Financials EPS (Rs)	725	798	952	236	274	333
Growth (%)		10%	19%		16%	22%
Index ex Oil & Financials EPS (Rs)	593	603	696	178	190	222
Growth (%)		2%	15%		7%	17%

Source: Bloomberg, IIFL Research

Figure 62: Consensus BSE100 FY09 and FY10 EPS upgrade/downgrades over past one month

Sector	FY09	FY10
Auto	-0.4%	0.1%
Capital Goods	-0.8%	-0.7%
Cement	-1.1%	-1.9%
Consumer Staples	-1.0%	-1.2%
Energy	-0.5%	-0.7%
Financials	-4.7%	-4.3%
Metals	1.4%	0.1%
Pharma	-0.5%	0.4%
Real Estate	-4.1%	-7.7%
IT Services	0.2%	0.1%
Telecom	-1.2%	-2.5%
Utilities	-1.6%	-0.7%
Others	0.1%	1.0%
Aggregate	-1.3%	-1.5%

Source: Bloomberg, IIFL Research
Updated as of 25th Aug, 2008

- Financials and Real Estate have seen the biggest consensus earnings downgrades over the past month
- IT Services and Metals have seen earnings upgrades over the past month
- Energy sector is expected to see the strongest earnings growth in FY09 and FY10 – largely led by RPL and RIL. The downward pressure on refinery margins bodes ill for the index earnings.

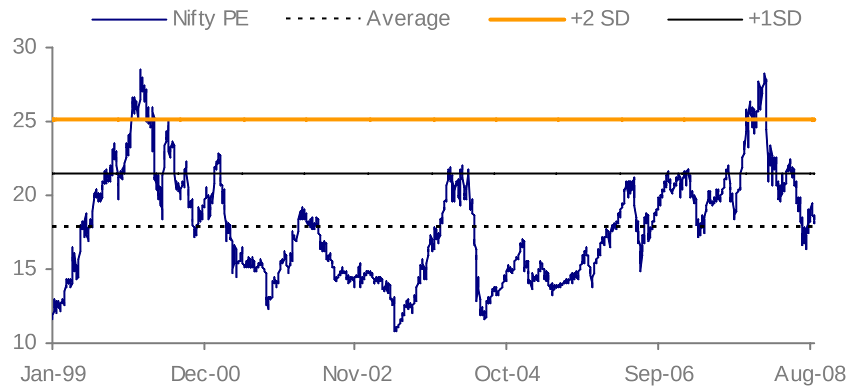
Valuations

Figure 63: BSE 100 Consensuses – Sector Valuations

Nifty sectors	P/E		
	FY08	FY09ii	FY10ii
Consumer Discretionary	12.3	11.2	9.6
Consumer Staples	20.5	21.6	18.4
Energy	22.1	15.0	10.9
Financials	14.8	14.2	11.6
Health Care	24.2	21.4	17.8
Industrials	26.5	22.5	17.0
Information Technology	18.4	14.8	12.7
Materials	6.9	7.8	7.1
Telecommunication Services	20.0	16.5	13.6
Utilities	21.5	19.9	17.1
Aggregate	16.0	14.6	12.0

Source: Bloomberg
Updated as of CoB 25th Aug 2008

Figure 64: Nifty trailing PE



Source: Bloomberg

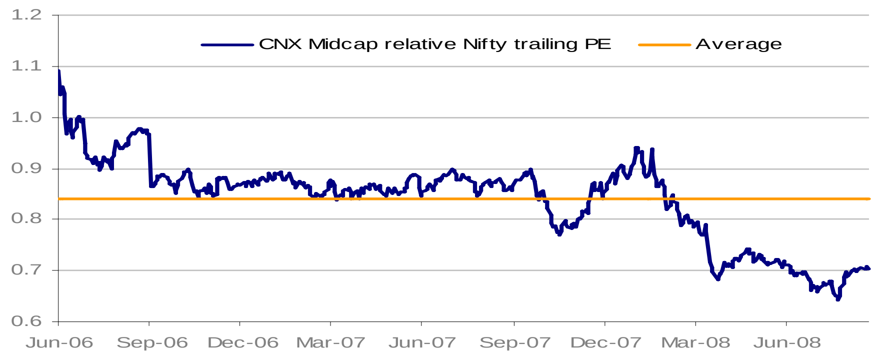
- After having traded at over 2SD above its average in early January, Nifty has de-rated and now trades at its average since 1999. PERs, though, are misleading, as earnings estimates are vulnerable for downgrades.

Figure 65: Bottom-up Consensus Index Valuations

Index	SENSEX			NIFTY		
	FY08	FY09ii	FY10ii	FY08ii	FY09ii	FY10ii
Index PE	15.9	14.8	12.4	15.9	14.1	11.6
Index ex Oil and Gas PE	14.9	14.7	12.6	14.8	14.1	12.0
Index ex Financials PE	15.7	14.3	12.0	16.3	14.1	11.6
Index ex Oil & Financials PE	14.3	14.1	12.2	15.1	14.1	12.1

Source: Bloomberg
Updated as of CoB 25th Aug 2008

Figure 66: Midcaps are trading at 30% discount to large caps – below the 2yr avg



Source: NSE

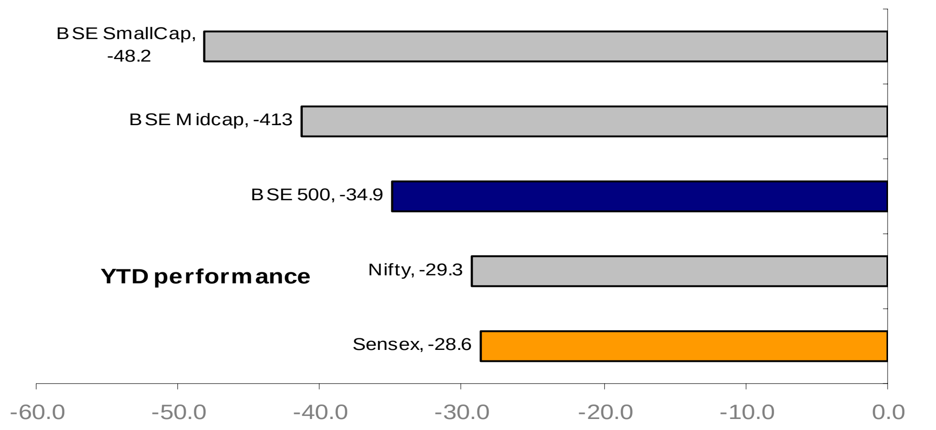
Figure 67: Regional valuations – India's valuation premium has expanded

	Fwd PE	Premium to MSCI EM (x)
India	13.9	1.5
China	11.3	1.2
Korea	9.0	0.9
Taiwan	11.4	1.2
Russia	6.4	0.7
Turkey	7.6	0.8
South Africa	8.5	0.9
Brazil	9.4	1.0
Mexico	11.3	1.2

Source: Bloomberg. Fwd EPS as on 31 July 2008 and 22 August 22 Index levels, On MSCI basis

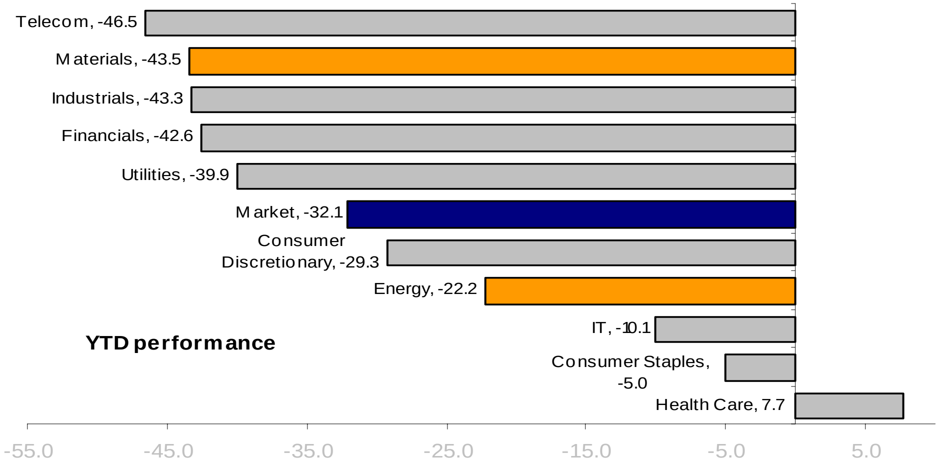
Market performance

Figure 68: Small-caps have almost halved YTD



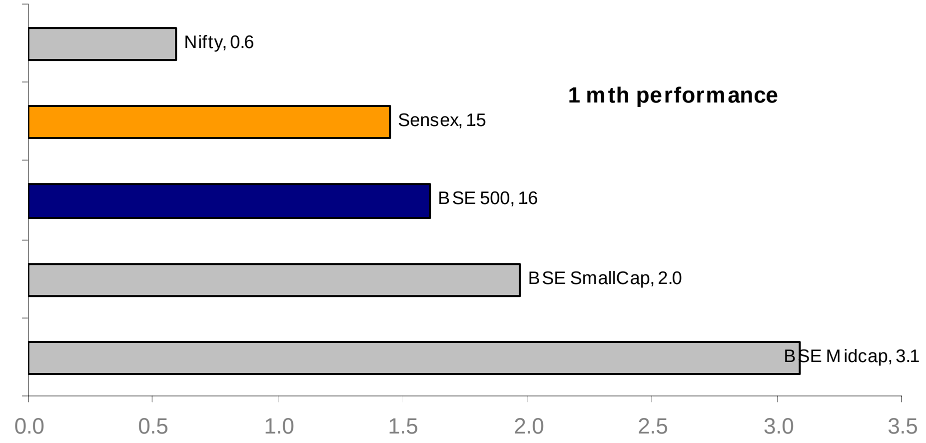
Source: Bloomberg

Figure 69: YTD, Healthcare is the only sector in positive territory



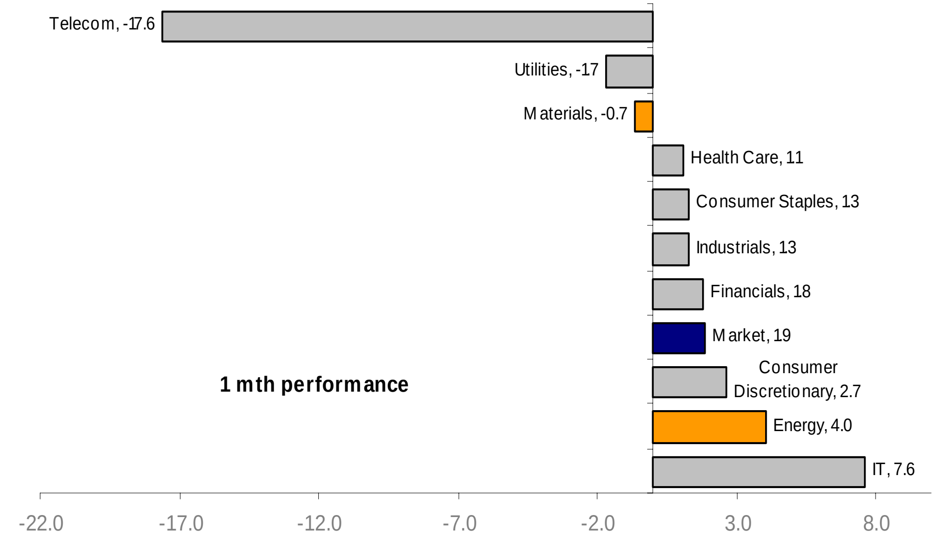
Source: Bloomberg, On MSCI basis

Figure 70: Small-caps have modestly outperformed large caps over the past month



Source: Bloomberg

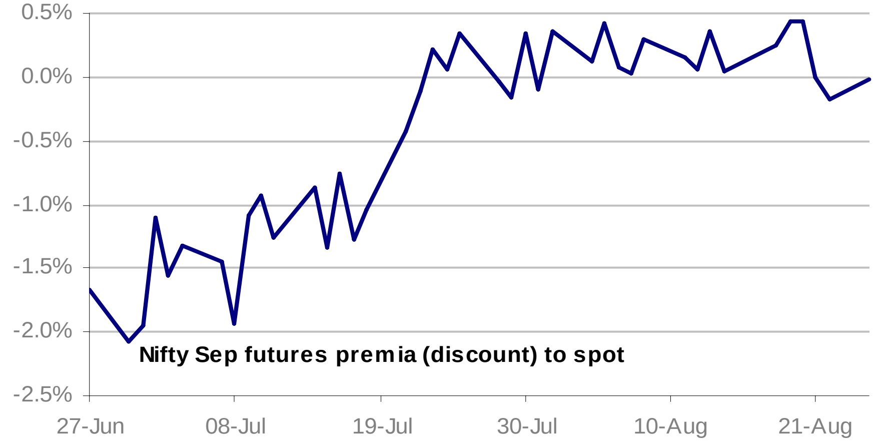
Figure 71: Telecoms have been a big underperformer, led by RCom



Source: Bloomberg, On MSCI basis. MSCI India Telecom does not include Bharti

Derivatives market activity

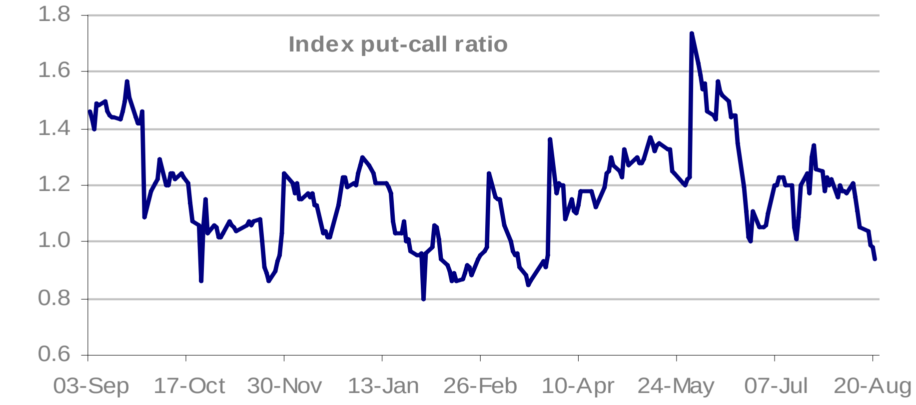
Figure 72: Nifty futures traded at premium for most of August



Source: Bloomberg

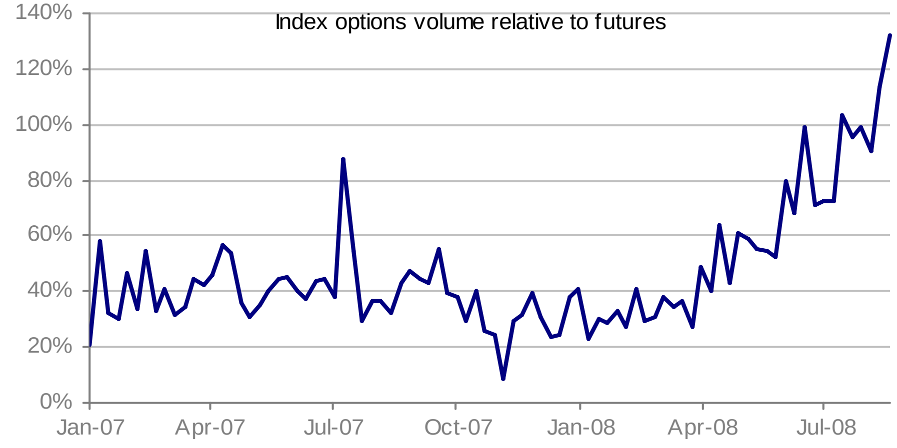
- Nifty futures have been trading at premium to spot for most of August

Figure 73: Put call ratio has slipped to ~0.9, a four-month low



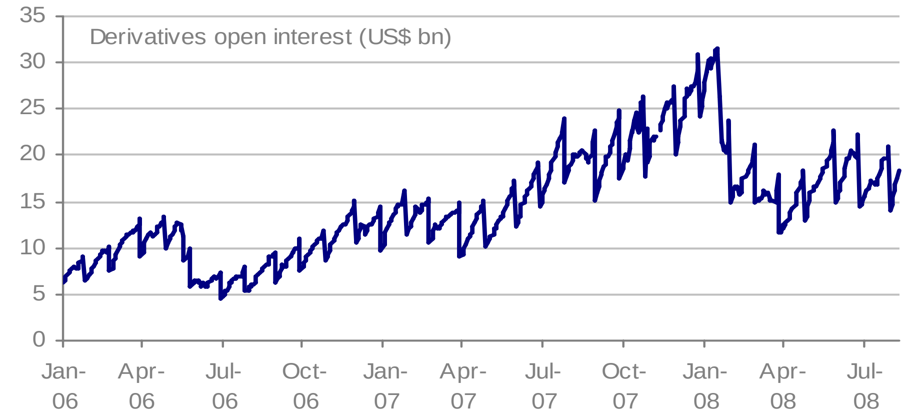
Source: Bloomberg

Figure 74: Derivatives action is increasingly concentrated in options vis-à-vis futures



Source: Bloomberg

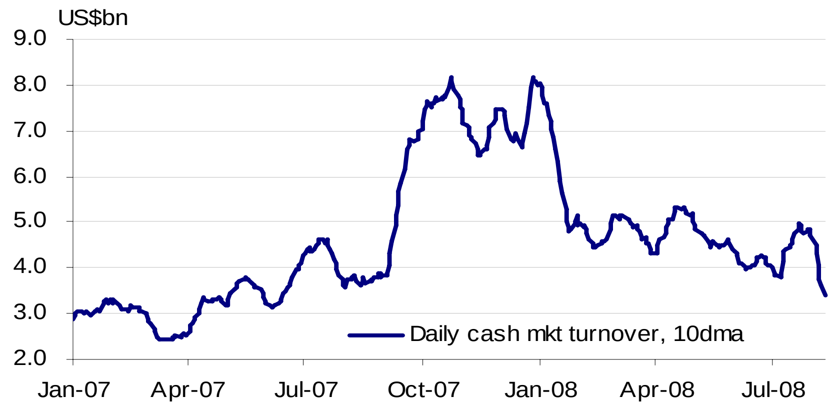
Figure 75: Derivatives open interest has stabilised between US$15bn and US$20bn



Source: Bloomberg

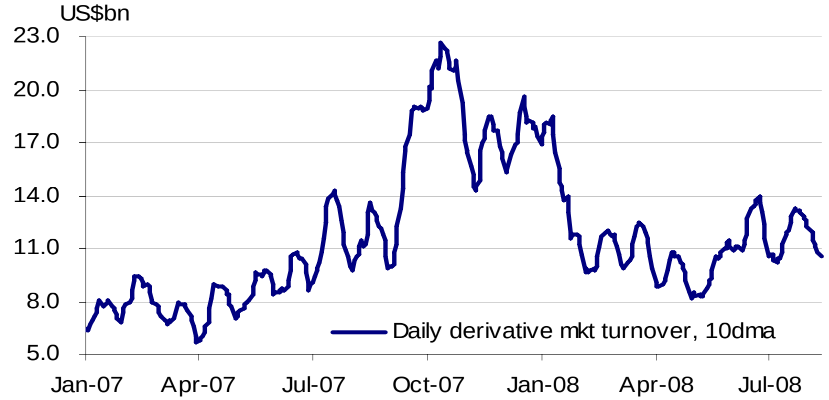
Market activity decelerated sharply

Figure 76: Cash volumes have fallen sharply over the past 2-3 weeks



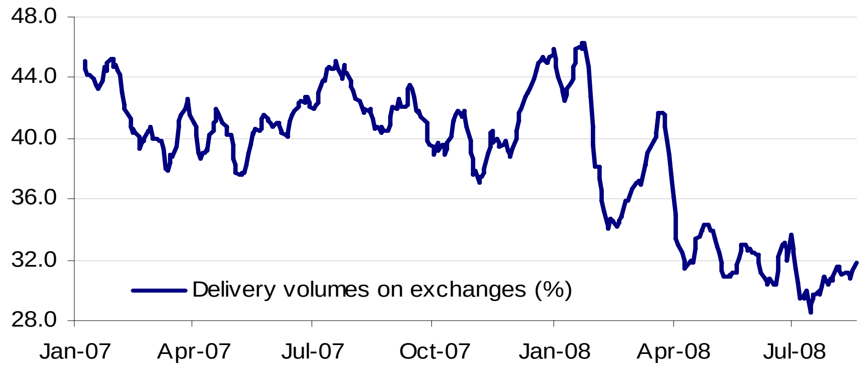
Source: Bloomberg

Figure 77: Similarly derivatives volumes have fallen sharply over the past 2-3 weeks



Source: Bloomberg

Figure 78: Delivery volumes have steadily come down, indicating low institutional activity



Source: Bloomberg

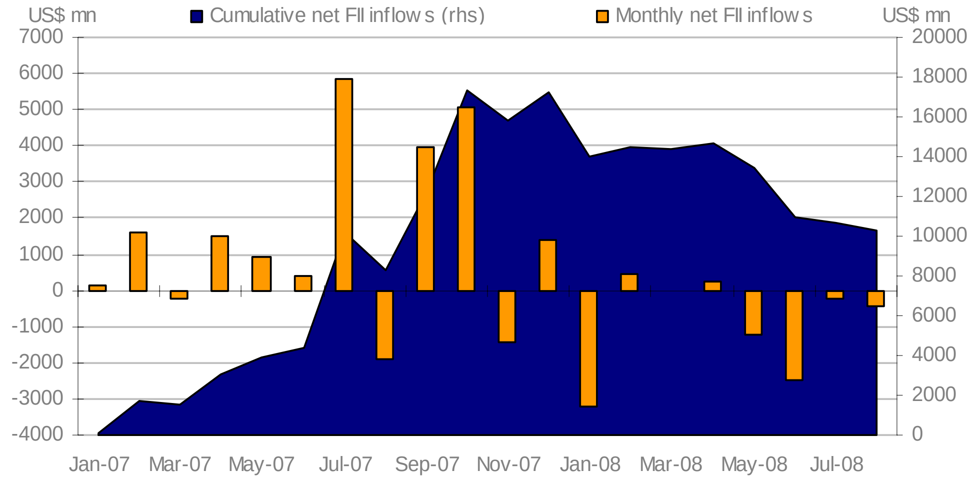
Figure 79: BSE200 - Top 10 and Bottom 10 stocks' performance over the past month

Company	%	Company	%
Rei Agro Ltd	44.9	Essar Shipping	-26.2
BF Utilities Ltd	27.5	Jai Corp	-22.9
Bajaj Holdings	26.5	NDTV	-20.6
Dish TV	24.7	Aban Offshore	-20.5
EIH Ltd	24.3	Reliance Comm	-19.1
Balrampur Chini	20.8	Bharat Electron	-19.1
Bajaj Finservices Ltd	18.4	HDIL	-18.7
Indian Bank	18.2	Lanco Infratech	-17.9
Thermax Ltd	17.6	Amtek Auto	-17.4
Mphasis Ltd	16.9	Bombay Dyeing	-17.2

Source: Bloomberg. As of Aug 25th 2008

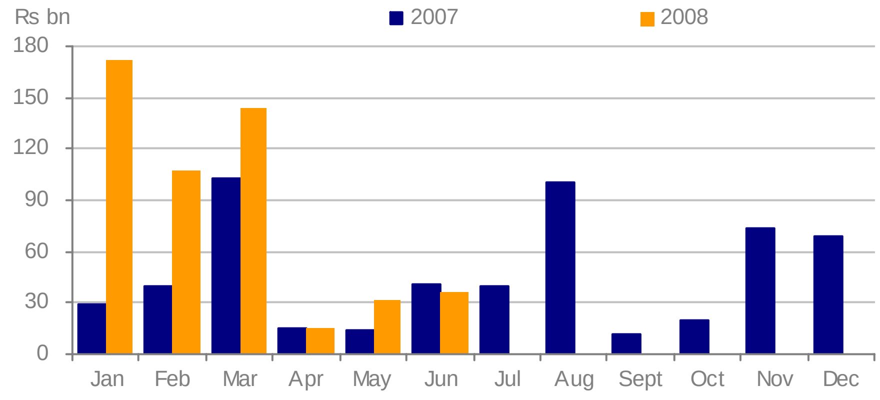
Liquidity/Fund flows

Figure 80: Ytd FIIs outflows of over US$6.5bn



Source: Bloomberg

Figure 81: Domestic retail inflows (equity related) continue to remain positive



Source: AMFI, IRDA
Note: Includes insurance premiums and inflows into 'growth' and 'ELSS' schemes of Mutual Funds. In case of insurance, assumes renewal premiums at 45% of first year premiums, share of ULIPs at 50% and 50% of ULIPs inflows being directed towards equity

Figure 82: Inflows into Domestic mutual funds have almost halved

	January - July	
Rs bn	2007	2008
Equity funds	113.8	312.8
Money market funds	351.2	-182.1
Fixed Income funds	952.4	640.4
Other funds	34.0	8.3
Total net inflows	1451.4	779.5

Source: AMFI
Note: Equity funds includes 'growth' and 'ELSS' schemes, Fixed income funds includes 'Income' and 'Gilt' schemes, Others funds includes 'Balanced', ETFs and Fund of funds

- After having sold US$2.5bn of stock in June, FII selling has reduced sharply – under US$1bn since end of June. Indeed, the sharp correction in commodity markets has brought India back into favour leading to some short covering
- Inflows into domestic equity mutual funds have been positive in each of the first seven months of 2008 inspite of the significant fall in equity markets and totalled over US$7bn
- First year insurance premiums grew 38% in Jan-June 2008 to US$12bn – however there has been a marked contrast in performance of LIC and private insurers with LIC growing just 22% (with premiums contracting in two of the preceding three months) while private insurers growing at a robust 69% YoY.

We have moved to a new recommendation structure from 14 July. The key objective of the change is to provide an unequivocal view on each stock, either positive or negative.

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, we introduce **Add** and **Reduce** recommendations based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
