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June 5, 2006

India Strategy

The Lessons Are Evident

Conclusion: There are three lessons to be learnt from the recent correction in Indian equities. Firstly, the market triggers continue to lie overseas rather than at home. Secondly, India is a high beta "bear" market. Thirdly, FII flows are critical to market performance despite the renewed faith in equities by domestic investors.

What's New: Our global macro team is arguing that we may be in a risk reduction trade globally. While this does not augur well for emerging markets, India is worse off. Firstly, Indian equities still trade at a significant premium to emerging markets and the world. Secondly, India's policy response has been very different from the rest of the emerging world. Consequently, India has run a consumption-driven growth cycle in contrast to a more-needed investment-driven cycle. The current account has slipped into deficit and capacity constraints are clearly visible especially in infrastructure. Lastly, India is distinguished from the rest of the emerging world by its dependence on portfolio flows to sustain economic performance and fund its current account deficit.

Implications: India's recent growth acceleration springs from the benefits of burgeoning risk love in the world. The virtuous cycle of low interest rates, leveraged consumption-led growth, buoyant corporate earnings, higher equity prices, bull markets in other asset classes and thus wealth creation for households and corporates is disproportionately dependent on portfolio flows. The worrying aspect of the recent sell off is not that this may be start of a more serious bear market but that it could test India's near term fundamental story.

Model Portfolio

Company	Reuters Ticker	MSCI Weight (%)	Portfolio Weight (%)	Over/Under - Weight (bps)	Price (Rs) 2/6/06	Mkt Cap US$mn	Avg 3M T/O US$mn	Analyst Rating	YTD Perf. (%)
Consumer Discretionary		**7.5**	**2.6**	**-493**					
Bajaj Auto Ltd.	BJAT.BO	1.6	2.6	100	2,718.1	5,934	20.0	Overweight	35.9
Consumer Staples		8.7	14.4	568					
ITC Ltd.	ITC.BO	3.5	5.5	200	164.4	13,206	38.5	Overweight	15.8
Hindustan Lever Ltd	HLL.BO	3.5	7.0	350	241.8	11,478	26.4	Overweight	22.6
Marico Industries	MRCO.BO		2.0	200	433.6	543	0.7	Overweight	18.0
Energy		**16.2**	**20.2**	**399**					
Oil & Natural Gas Corp.	ONGC.BO	3.6	6.6	300	1,126.2	34,647	59.0	Overweight	-4.1
Reliance Industries Ltd.	RELI.BO	11.6	13.6	200	957.4	28,774	151.9	++	39.9
Financials		**18.0**	**17.9**	**-1**					
HDFC Bank Ltd.	HDBK.BO	3.1	7.1	400	764.8	5,167	13.2	Overweight	8.1
ICICI Bank	ICBK.BO	6.6	6.0	-60	551.0	10,568	14.8	Equal-Weight	-5.8
IDFC	IDFC.BO	0.3	2.8	250	55.9	1,353	7.2	Overweight - V	-23.7
Union Bank	UNBK.BO	NA	2.0	200	106.0	1,052	3.5	Overweight	-13.2
Healthcare		**5.3**	**4.7**	**-59**					
Sun Pharma	SUN.BO	0.7	4.7	400	813.8	3,637	4.5	Overweight	19.3
Industrials		9.7	5.3	-442					
Tata Motors	TAMO.BO	2.8	5.3	250	789.0	6,824	57.8	Overweight	20.8
Materials		**7.3**	**7.2**	**-12**					
Hindalco Industries Ltd.	HALC.BO	3.5	2.5	-100	179.7	4,496	37.6	Overweight	25.3
Steel Authority of India	SAIL.BO	NA	1.5	150	80.1	7,137	37.7	Overweight	48.3
Associated Cement Cos.	ACC.BO	0.8	3.3	250	786.2	3,107	58.0	Overweight	47.2
Technology		**20.4**	**21.5**	**117**					
Infosys Technologies Ltd.	INFY.BO	12.4	15.4	300	2,886.3	16,999	88.4	Overweight	-3.7
Patni Computer Systems	PTNI.BO	NA	1.0	100	350.2	1,041	4.2	Overweight	-29.3
Tata Consultancy Services	TCS.BO	2.2	5.2	300	1,788.1	18,877	31.9	Overweight	5.0
Telecoms		**4.5**	**3.5**	**-99**					
Reliance Communication Ventures	RLCM.BO	3.5	3.5	0	259.5	6,848	NA	NA	NA
Utilities		**2.3**	**2.0**	**-35**					
National Thermal Power	NTPC.BO	NA	1.5	150	110.0	19,560	18.9	Equal-Weight	-1.9
Reliance Energy Ventures	RLEV.BO	NA	0.5	50	33.0	871	NA	NA	NA
Cash		**0.0**	**0.6**	**57**					

++Data for this company have been removed from consideration in this report because, under applicable law and/or Morgan Stanley policy, Morgan Stanley may be precluded from issuing such information with respect to this company at this time. NA = Not applicable/available.
Source: Bloomberg, Morgan Stanley Research

Market Focus

	Current	1-W	YTD
BSE Sensex	10,451.33	-3.31	11.21
MSCI India *	408.84	-6.57	6.78

Local Currency, * as of June 1, 2006. Source: Bloomberg, Morgan Stanley Research

Recent Reports

India Monthly Review: Retrospect May 2006	June 2, 2006
Model Portfolio Change	May 25, 2006
Ownership: Domestic Players in the Act	May 15, 2006
Domestic Flow Monitor: April 2006	May 10, 2006
Almost Everybody Is Bearish	May 8, 2006

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Lessons From the May Movements

The market has fallen about 14% in May and 18% from its all-time high on May 11, 2006. Expectedly the trigger has been global. While there has not been a specific event, investor concern about growth and inflation has caused a sell off in risky assets. There were two more lessons to be picked up from an Indian perspective. Firstly, India remains a high beta “bear” market, i.e. its beta tends to rise in bearish conditions (Exhibit 1). Thus while the going was good India performed mostly in line with emerging markets with concentrated bouts of outperformance. When the going got tough, Indian equities slipped more than most emerging markets. This high beta nature of Indian equities underscores India’s strong linkages to global financial markets despite the apparent low correlation of its economic growth to the world.

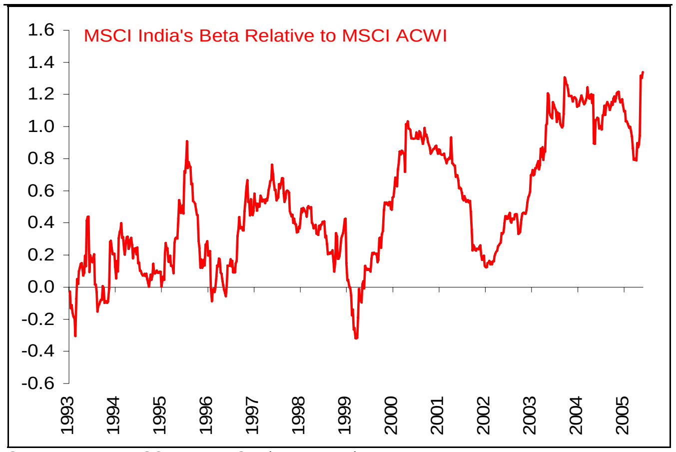
Foreign portfolio investors sold US$1.6 billion of stock in May, the highest ever in their 13 years of investing in India. Domestic institutions, on the other hand, bought more stock than ever in a month. In fact, their net buying of US$1.7 billion offsets the net FII selling during May. Even so, markets fell hard. Once again, this emphasizes the equity market’s dependence on overseas factors in contrast to domestic factors. The second lesson is that the flow data debunks the theory that growing domestic interest in the equity market will make the market less vulnerable to foreign portfolio outflows. The dependence on portfolio flows is deep and fundamental.

FIIs Are Critical

The source of India’s cyclical acceleration of the past three years has been the rise in global risk love. Global risk appetite has caused an upswing in foreign capital flows, mainly portfolio flows in debt and equity. The increase in capital flows (and hence foreign exchange reserves) has depressed the cost of capital, allowed consumers to leverage their balance sheets and consume ahead of income growth. This, in turn, has boosted overall economic activity, corporate earnings and ROE and thus share prices. The rise in share prices has led to wealth creation, which has in turn pushed other asset markets higher.

Exhibit 1

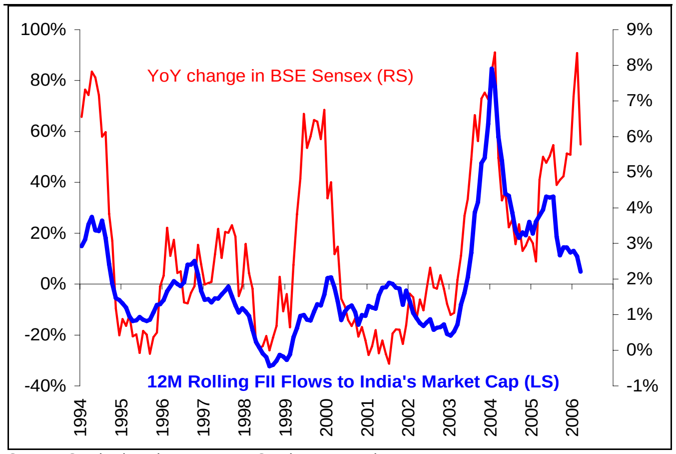
India: A High Beta Market



Source: Factset, MSCI, Morgan Stanley Research

Exhibit 2

Stock Prices Depend Directly on FII Flows



Source: SEBi, Bloomberg, Morgan Stanley Research

Widespread asset market bubbles have enriched Indian households by around US$250 billion over the past two years, on our estimates. This wealth accumulation allows households to leverage balance sheets and consume and absorb possible shocks to the cost of borrowing. However, most pertinently, it has fostered appetite for risky assets, creating a huge virtuous cycle of confidence, economic performance and asset returns. This virtuous cycle has seemed infallible. The critical link was portfolio flows. Equity portfolio flows, until April 2006, had alone accounted for more than 35% of India’s foreign exchange reserve growth since March 2003 when the bull market began. Thus any slow down in FII flows could adversely impact foreign exchange reserve accretion, which, in turn, would have negative implications for interest rates, economic growth and hence stock market fundamentals.

The change in forex reserves has a direct bearing on equities, too (Exhibit 2). With the exception of the tech bubble, when the rise in share prices exceeded the magnitude suggested by the change in foreign exchange reserves, the change in forex reserves has been a good leading indicator of stock price performance. It tends to lead share price performance by about three months and is better at explaining directional movement rather than the scale of the move in stock prices. The fundamental underpinning is the fact that the change in forex reserves determines the excess liquidity in the system, which, in turn, has express relevance to asset prices, including bonds, equities and real estate.

Quite obviously, FIIs directly influence share price performance (Exhibit 3). With exception of the 2001, when flows were possibly overstated due to the stock market scam in the early part of that year, FII flows have left an impression on share prices since they began investing in India in 1993. The bottom line is that, even if domestic investors fill up any void left behind in the event FIIs slow down their pace of buying, it may not be good enough for stocks unless foreign exchange reserves are helped by some other event, such as a surge in FDI. Quite aside from their direct impact on equities, FIIs play a central role in fueling economic growth, hence their lack of participation could have a cascading effect on asset prices, in our view.

Risk Re-pricing Will Put Fundamentals to Test

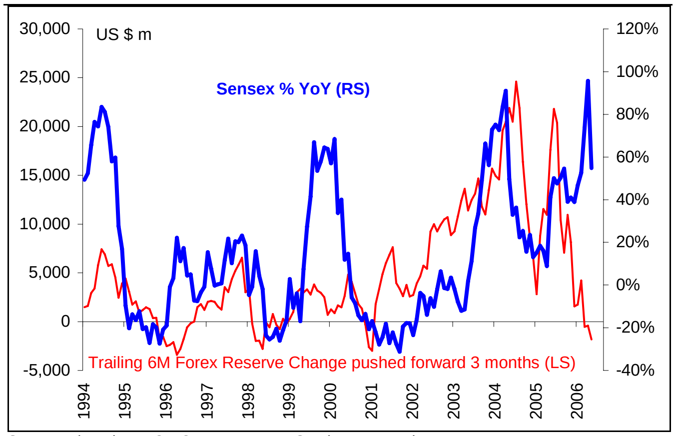
This assessment of the influence FIIs wield on India's macro and stock markets is relevant in the context of our macro's team of the world. Our global macro team is arguing that we may be in a risk reduction trade globally as the investors get worried about growth and/or inflation. Such a risk reduction trade obviously does not augur well for emerging markets. However, even in the EM context, India is worse off. To start with India trades at a significant premium to emerging markets and the world. Even after the recent underperformance, the Indian P/E multiple is 47% and 35% (Exhibit 4) higher than the emerging market and world market average respectively (based on the MSCI indices and current earnings). While the risk love was high, rich valuations did not bother investors. On the way down, matters could be different.

Secondly, India's policy response has been very different from the rest of the emerging world. Consequently, India has run a consumption driven growth cycle in contrast to a more needed investment driven cycle. The current account has slipped into deficit and capacity constraints are clearly visible especially in infrastructure. Thirdly, India is distinguished from the rest of the emerging world by its dependence on portfolio flows to sustain economic performance and fund its current account deficit.

The worrying aspect of the recent sell off is not that investors have suffered losses and that this may be start of a more serious bear market but that it could test India's fundamental story. The long story is still intact but the near term story could be tested given that India is heavily dependent on portfolio flows to sustain near term growth rate and a smooth transition to FDI flow may not be forthcoming in a short period.

Exhibit 3

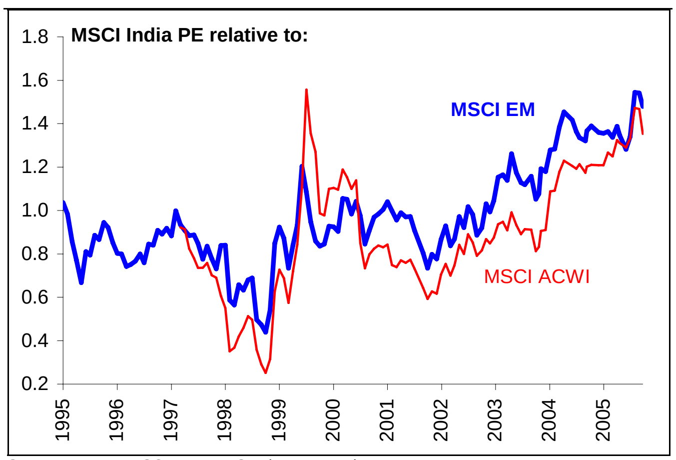
Market Depends on Positive Forex Reserve Changes for Performance



Source: Bloomberg, CEIC, RBI, Morgan Stanley Research

Exhibit 4

Valuations Remain Rich



Source: Factset, MSCI, Morgan Stanley Research

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(as of May 31, 2006)

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Underweight/Sell	349	17%	78	12%	22%
Total	1,997		662		

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