Time to glide after the stride

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Markets on Your Fingertips

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House View

MSCI emerging Index CY09 returns at 72.6% has outpaced the MSCI world index return of 28% by 45%

Equity markets are well anchored for a decent performance in 2010 after a huge rally in 2009 as a fine balance between economic recovery at varying velocities across the globe and gradual phasing out of unconventional monetary and stimulus measures evolves. We expect pullbacks to be shallow though caution will also be pertinent as the pace of the rally would taper down due to divergence emerging between risky assets and also the high base effect. We expect emerging equity markets like India and China to be in a sweet spot and still outperform developed markets by a wide margin as they did in 2009 wherein they delivered more than 72% return as compared to 28% by the developed world. Hence, in a global canvas, emerging equity markets would still offer scope for further outperformance due to better and sustainable macro ecosystem, lack of opportunities in developed economies and flush of liquidity. This would make 2010 different wherein we will have few winners as compared to basket winners in 2009 as some rationing of liquidity cannot be ruled out.

The Indian equity market is likely to end 2009 with gains of about 79%. They are now well priced considering factors such as the easing global recession and the improving domestic scenario. Hence, we are headed for slower pace of gains with markets likely to offer 10-15% appreciation in line with earnings growth, going forward, and even considering the increased risk appetite. We estimate Sensex fair value at 19760 (16x FY12 EPS of Rs 1235, 14% upside) in our base case scenario of 15% growth in earnings. In case of negative surprises wherein valuation multiples contract and future earnings are ignored, we expect the Sensex to trade at 14952 (14x FY11 EPS of Rs 1068).

Sector rotation with likely preferred bets being defensives and domestic consumption stories

We expect sector rotation to happen as some of best performing sectors like commodities and IT may find it difficult to deliver similar out performance after a stellar run this year. We prefer plays like pharma, FMCG, PSUs, banks and power (domestic and defensives), sugar, tea (soft commodities, supply side correction to take time), hotels, media (outlook improving, valuations to catch up). We have negative preference for base metals (rich valuation, output polarised towards China), shipping (fortunes tied to China, oversupply), real estate (high beta, capital intensive). We are neutral on IT (play on global recovery, rich valuations), telecom (outlook hazy, attractive valuation), oil & gas (possible comfort from regulatory development, volatility in earnings).

On preferred stock picks, we believe investors need to be selective in 2010 as we will have few winners as compared to basket winners in 2009 wherein huge under-ownership and high risk aversion drove all assets and ignored divergence among risky assets. Hence, 2010 would be a year of bottom up strategy as compared to the top down approach.

Ipca Labs, Jayshree Tea, Renuka Sugar, Indian Hotels, Union Bank, Deccan Chronicle, Dish TV, Bharti Airtel, IDFC, Patni Computers, GVK Power, UTV Software, NHPC, Bajaj Auto, Lupin and Visa Steel are our preferred bets for 2010.

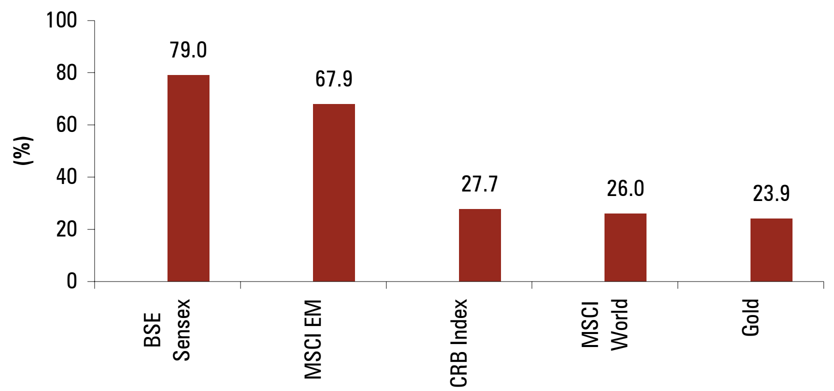
Equities — The asset class to be in

Equity as an asset class has outperformed other asset classes including gold in CY09. The outperformance also sustained over a longer period of time as can be seen from the exhibits below. Emerging equity markets have outpaced their developed counterparts in the last 10 years since 2001, indicating growing importance of developing economies as a preferred investment destination.

Commodities, as represented by Reuters/Jefferies CRB Index, have performed well in phases but huge volatility makes them less attractive vis-à-vis equities over a long period of time.

Emerging markets have outperformed their developed counterparts and are expected to continue to do so

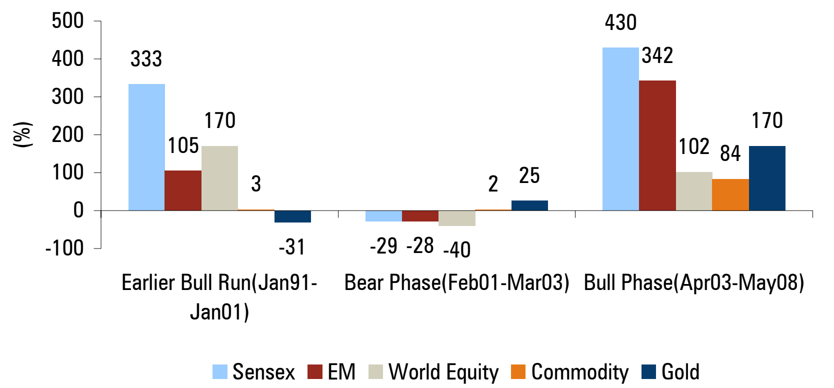
Exhibit 1: Performance of different asset classes in 2009



Source: Bloomberg,, ICICIdirect.com Research

The inherent strength of the Indian economy has been attracting global investors as can be seen from the outperformance of the Indian equity market

Exhibit 2: Performance over various market cycles



Source: Bloomberg, ICICIdirect.com Research

Investor's dilemma in 2010

The year 2010 would be a litmus test for the markets after we witnessed one of the best calendar year returns of all times, surprising us all. Investing was easy in 2009 with markets rewarding a basket of asset classes. Year 2010 would be different in this regard, where an investor would need to choose the right asset class and of equally sound quality. At the same time, the return expectation needs to be moderated as a repeat of 2009 is unlikely. Choosing an asset class in 2010 will become even more difficult when the global economy still throwing conflicting signals about the intensity of recovery. An investor would be facing major dilemmas and this noise is going to get even louder when we have lower liquidity, going forward. Some of the major predicament an investor could face would be whether the market would rally further and how emerging markets are likely to perform on that scale? Would there be tightening of money supply and could we face a double dip? or is Chinese growth for real? Even domestic factors like higher inflation, economic growth and efficacy of the government's role would create impediments in the minds of an investor. We try to asses these factors and hope to bring clarity on the same.

Emerging markets to lead the global recovery…

Global economies, despite some concerns have been on the recovery path for sometime now backed mainly by sustaining manufacturing activities, improvement in inventory cycle, rising home sales, etc. The International Monetary Fund (IMF) has revised upward the global growth prospect with ~3% growth in 2010 following a contraction of ~1% in 2009. During 2010-14 the growth is forecast to be ~4%, below the average of ~5% just before the financial crisis.

However, the pace of recovery is faster in emerging economies. Still, the stronger domestic demand helped these countries to replace the export dependence to a large extent. This, in turn, helped them to come out of the recession at a faster rate compared to the developed countries. The IMF has upgraded China's GDP growth prospect again with the current forecast of 9% growth for 2010. On the other hand, however, India's growth forecast has been downgraded marginally to 6.4% for the same period. We believe this is because of the adverse effects of the poor monsoon in the country.

Whether out performance by emerging markets will continue?

Real GDP growth for India and China remained robust even during turbulent times as compared to developed economies, which slipped into recession

Exhibit 3: Real GDP growth developed vs. emerging economies

	Q307	Q407	Q108	Q208	Q308	Q408	Q109	Q209	Q309
Advanced economies*									
United States	3.6	2.1	-0.7	1.5	-2.7	-5.4	-6.4	-0.7	2.2
United Kingdom	0.5	0.5	0.8	-0.1	-0.7	-1.8	-2.5	-0.6	-0.2
Eurozone	2.4	1.6	2.8	-1.2	-1.6	-7.2	-10.0	-0.8	1.6
Japan	-0.4	3.2	4.0	-4.4	-6.8	-12.0	-12.8	2.8	4.8
Emerging Economies									
Brazil	5.4	6.1	6.1	6.2	6.8	1.3	-1.8	-1.2	-1.2
Russia	7.7	9.0	8.7	7.5	6.0	1.2	-9.8	-10.9	-6.2
India	9.0	9.3	8.6	7.8	7.7	5.8	5.8	6.1	7.9
China	11.5	11.2	10.6	10.1	9.0	6.8	6.1	7.9	8.9

Source: IMF, ICICIdirect.com Research;

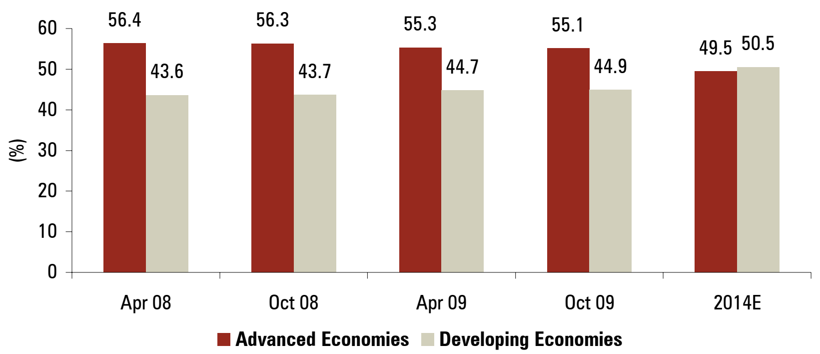
** QoQ data annualised; All data on calendar year basis*

Share of developing economies in total GDP to improve…

It is clear that the importance of emerging economies would improve, going ahead, in the global economic arena. The balance of power is also likely to shift towards emerging countries, as the share of emerging economies to the total world GDP is rising steadily.

Developing economies are increasing their share in global GDP on the back of strong domestic demand

Exhibit 4: Emerging economies to contribute more to world GDP

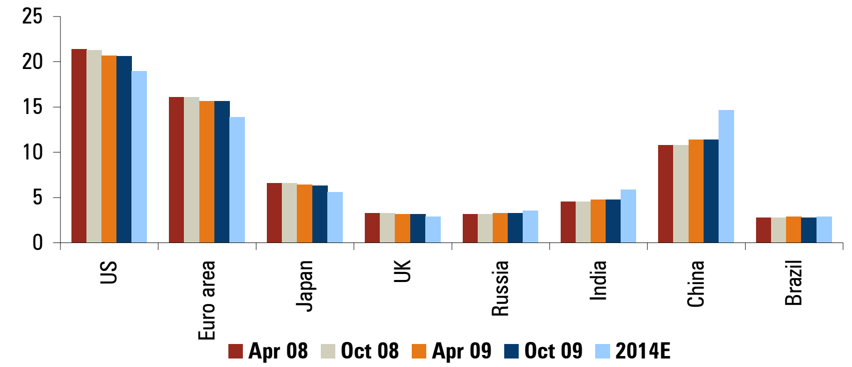


Source: IMF, ICICIdirect.com Research

Strong domestic demand to drive India and China

Among emerging economies, India is likely to remain more resilient to the global economic problems, as domestic consumption contributes ~60% of the GDP. Also, mass under penetration in India in terms of all economic variables provides a further fillip to the output to expand in a low interest rate scenario. On the other hand, China is trying to push up the domestic demand, which was clearly visible from the $584-billion stimulus package unveiled during the crisis. The same is evident from the fact that passenger car sales are making new highs, there is robust growth in bank credit, rising demand for commodities despite weak exports and a rebound in the Chinese real estate market.

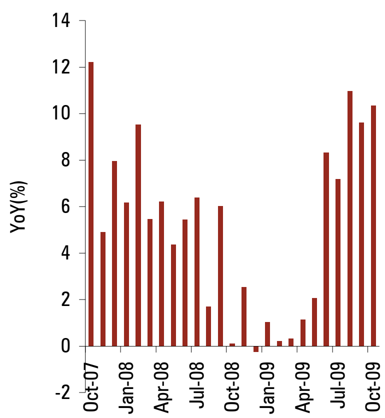
Exhibit 5: Share of India and China in global GDP improving



Source: IMF, ICICIdirect.com Research

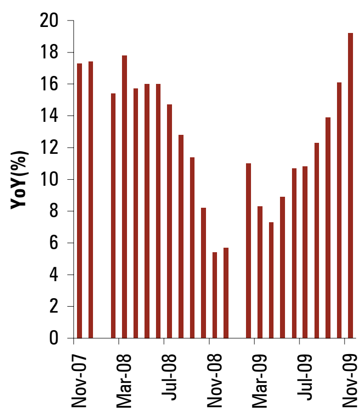
IIP growth for India has rebounded, auto sales is going strong and even cement sales are picking up for India. The same is the case with China with its retail sales also picking up

Exhibit 6: IIP in India growing sharply…



Source: Reuters, ICICIdirect.com Research

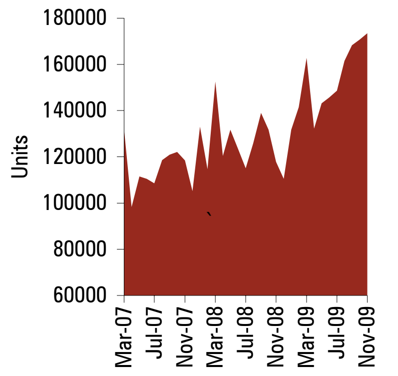
Exhibit 7: …China going stronger(IIP)



Source: Reuters, ICICIdirect.com Research

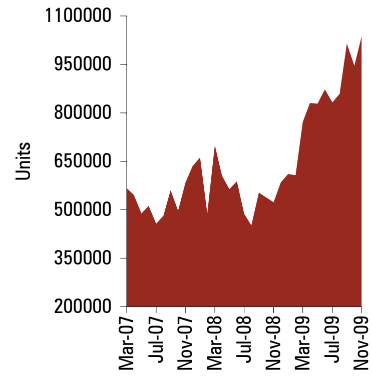
Rise in fixed asset investment a clear indicator of the thrust of the government to fuel domestic demand

Exhibit 8: Auto sales in India rising rapidly…



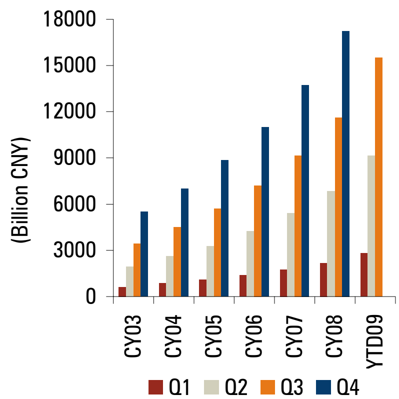
Source: Bloomberg, ICICIdirect.com Research

Exhibit 9: …Trend even more robust in China



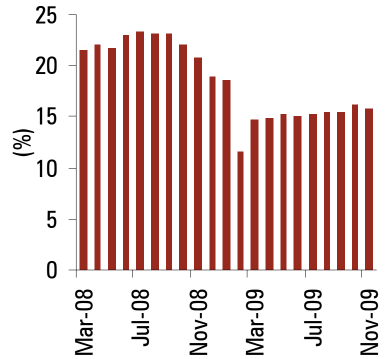
Source: Reuters, ICICIdirect.com Research

Exhibit 10: Fixed asset investment in China



Source: Reuters, ICICIdirect.com Research

Exhibit 11: China retail sales picking up



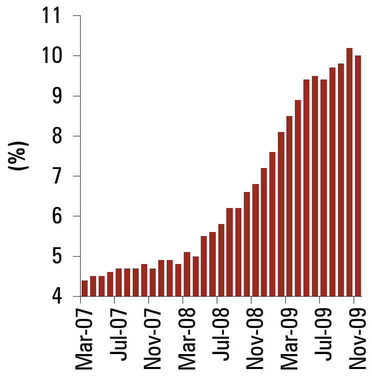
Source: Reuters, ICICIdirect.com Research

Developed countries to continue to suffer

Though in the previous quarters, developed economies have continued to exhibit encouraging economic data, which was mainly driven by the stimulus announced, the continuation of the same faces a big question mark. This is reflected by the fact that corporate earnings have grown on the back of cost efficiency measures and not topline growth. This suggests that the labour and consumer markets are still fragile and any premature exit from stimulus may impact the recovery process.

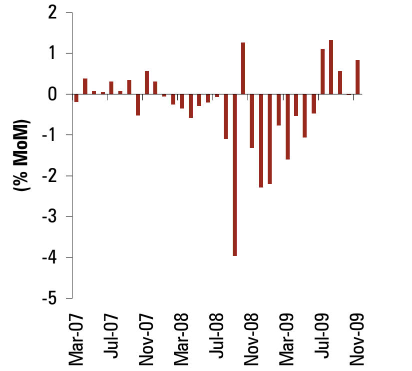
The US unemployment rate has hit an all-time high of 10%. However, going ahead, the markets expect the labour market to pick up in CY10. Retail sales and industrial output have rebounded on the back of stimulus induced by government. What needs to be seen is the pick up in consumer credit and progress in the labour market. These variables will dictate the trends for the global asset classes, going ahead, in 2010

Exhibit 12: Unemployment rate rising in US



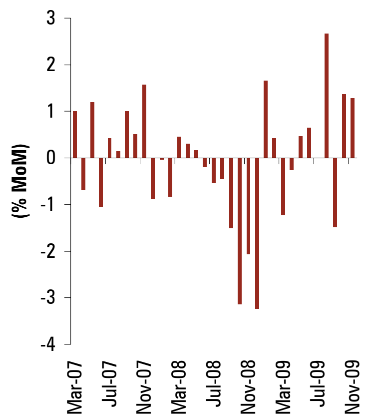
Source: Reuters, ICICIdirect.com Research

Exhibit 13: Industrial output for US



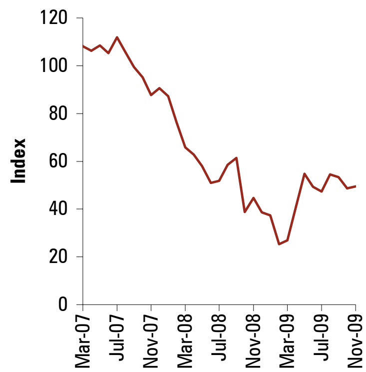
Source: Reuters, ICICIdirect.com Research

Exhibit 14: Retail sales (ex auto) for US



Source: Reuters, ICICIdirect.com Research

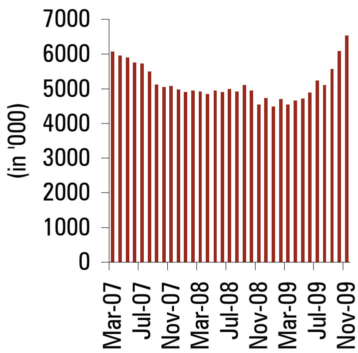
Exhibit 15: US consumer confidence index



Source: Reuters, ICICIdirect.com Research

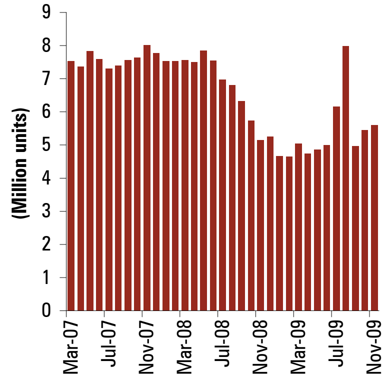
New and existing home sales have shown improvement on the back of tax rebate scheme introduced by the US government

Exhibit 16: US existing home sales improving



Source: Reuters, ICICIdirect.com Research

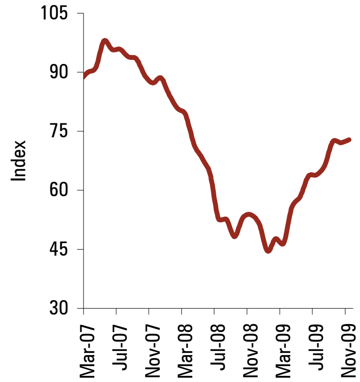
Exhibit 17: Car sales in US



Source: Reuters, ICICIdirect.com Research

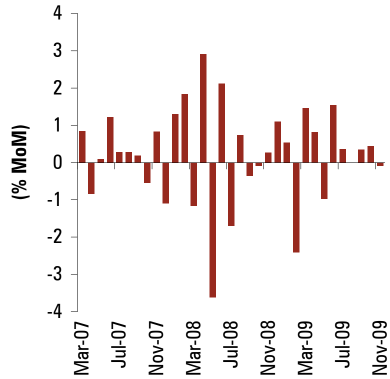
UK consumer confidence index is showing sluggish improvement but retail sales are down again

Exhibit 18: Consumer confidence index for UK



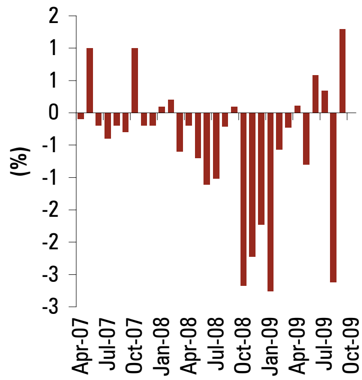
Source: Reuters, ICICIdirect.com Research

Exhibit 19: Retail sales in UK



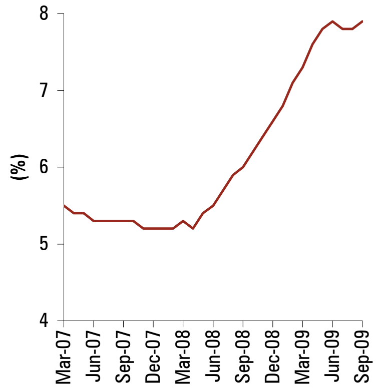
Source: Reuters, ICICIdirect.com Research

Exhibit 20: UK Industrial output: major concern



Source: Reuters, ICICIdirect.com Research

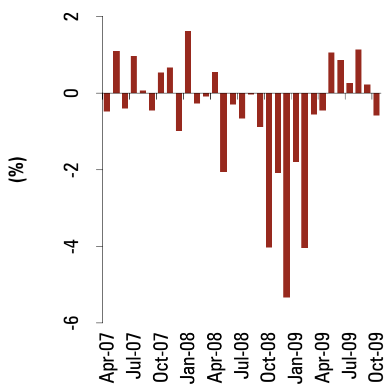
Exhibit 21: Unemployment rate for UK



Source: Reuters, ICICIdirect.com Research

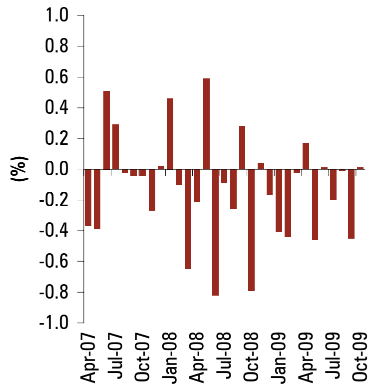
The European zone and particularly UK has been the laggard during this recovery process. Also, most of the growth has been on the back of the huge stimulus packages that these countries offered. Private investment has still been very low due to lack of conviction. We expect it to take longer for these developed economies to fully come out of the woods compared to their emerging economy counterparts.

Exhibit 22: Industrial output for Euro zone



Source: Reuters, ICICIdirect.com Research

Exhibit 23: Retail sales for Euro zone

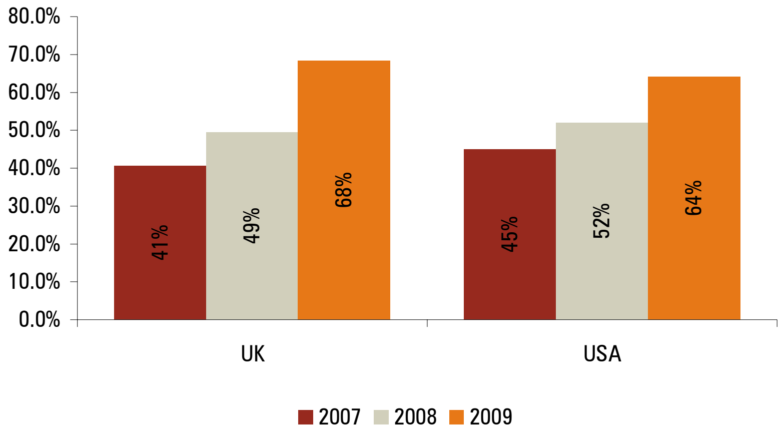


Source: Reuters, ICICIdirect.com Research

The growth in developed countries will be sluggish because even the debt/GDP is very high i.e. 62% and 58% for the UK and US. In the absence of a real economic recovery this will cap the capability of incremental government spending

High Debt/GDP: Another worry for developed countries…

Exhibit 24: Public Debt/GDP comparison



Source: Company, ICICIdirect.com Research

Other than concerns over the sustainability of economic recovery, high debt/GDP has been another cause for concern for the developed world.

High base effect may temper growth rate, going forward…

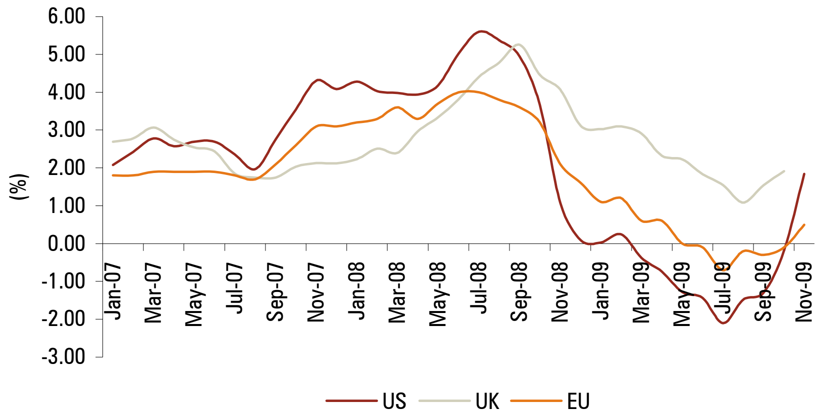
Though we have seen dramatic growth in most economic parameters in most of the emerging economies, the question of sustainability remains. The lower base for many parameters during the turbulent period has been partly responsible for their high YoY growth. The same factor, however, may turn negative in the coming year, as the high base effect may show lower YoY growth in many of the economic parameters. The absolute growth, we believe, should be watched closely in this regard.

Monetary tightening: Unlikely in near term

We believe rate tightening in developed economies is unlikely to happen in the near term. This is primarily because of the ongoing deleveraging process both at the corporate and household level. Also, as mentioned earlier, the economic recovery process has been fragile in most developed countries with unemployment still relatively high, lower retail sales and consumer confidence. Unless there is some stability in these parameters we do not think it would be prudent to tighten monetary policies in these countries, as that could derail the whole recovery process. Also inflation is still benign to warrant a rate hike.

On the back of stimulus given by the government the housing market, retail and auto sales have turned positive. The UK has been the worst affected by the outbreak of the financial crisis with real GDP still negative, high unemployment, retail sales de-growth, sluggish industrial output and laggard improvement in consumer confidence. Even the Euro zone is still not out of woods with heavy de-growth in industrial output, retail sales and de-growth in employment

Exhibit 25: Inflation - not a concern for developed countries



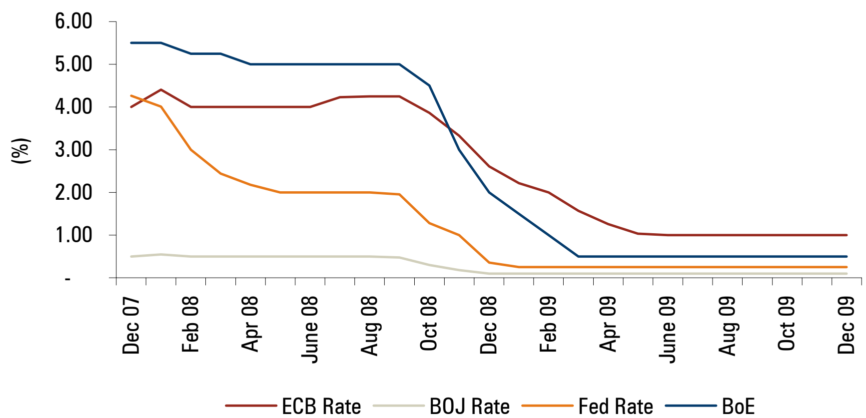
Source: Reuters, ICICIdirect.com Research

No early exit from stimulus packages

We believe emerging economies will be first to pull the plug and start tightening the grip on interest rates coupled with a gradual exit from stimulus measures. Classic examples are the Australian and Indian central banks, which have clarified their intent on tightening. However, on the other hand, the Fed and ECB are in no hurry and intend to keep rates low for an extended period. This will lead to more capital flows into developing economies and will act as a catalyst for currency carry trade to rise.

We believe emerging economies will be first to pull the plug and start tightening the grip on interest rates coupled with a gradual exit from stimulus measures.

Exhibit 26: Interest rate comparison



Source: Reuters, ICICIdirect.com Research

Therefore, as highlighted above, it is highly unlikely that developed economies would go in for early exit from stimulus package or pre-pone the timeline to pay back government debt. Some minor steps, however, have been indicated. Some are by governments including the US and UK to stabilise the process by restricting the creation of asset bubble.

US dollar carry trade not to get unwound soon

Like the Yen carry trade, which got famous after the debacle of the Japanese economy in 1990s as a result of low interest rates to combat deflation, the current scenario has also seen creation of carry trade in the US currency. The reason behind this is the Fed's decision to keep interest rates low for an 'extended period of time'. We believe, this has created huge amount of portfolio flows getting into asset class like equities and commodities as investors globally have borrowed in dollar and deployed the proceeds in risky assets. As the Asian central banks will be the first ones to tighten their monetary grip, carry trades will increase as the interest rate differential will favour the trade and liquidity will keep pouring into emerging economies as they are supported by relatively better fundamentals. However, in the interim there may be some technical pullback in the greenback, which may lead to some volatility in the markets. We believe this volatility will represent a buying opportunity in emerging market equities like India. In the long run Asian currencies are expected to continue appreciate against the greenback as the US is highly debt ridden on the one hand while emerging economies will fare better due to their better fiscal management and improved economic dynamics.

So in a scenario where interest rates will be low in the US amid rising deficit there lies only two options for the US to bridge the deficit gap: a) by hiking tax rates (the prudent way) and b) continue issuing treasury bonds (the necessity). The question that arises here is whether the prudent way is a viable option given the economic scenario in US.

Tax rates hike: prudent but not a viable option…

Other than spending, focus on savings would also restrict the US from hiking taxes. According to an IMF report, the gross national savings as a percentage of GDP in the US is likely to rise to ~13% in 2010 from ~11% in 2009

The US economy has basically been consumer driven, as consumer spending accounts for almost two-third of the total US GDP. Therefore, after the financial crises and poor state of the job market (US unemployment rate soared to 10% in November), the ideal strategy of the government would be to focus more on improving spending and also savings. The scenario is also true in case of the UK and European zone. Hence, we do not expect the US to hike tax rates anytime soon unless there is some self-sustainability in consumer sentiment.

Deficit financing via borrowing: a necessity rather than option

The US government is, thus, left with only one option to fund its huge deficit through borrowing, by issuing treasury bonds or FDs. This will fund the government expenditure but at the same time lead to an escalation in interest expenditure even if yields are managed tightly. Thus, it has become a kind of trap for the US government to finance its expenditure making fiscal deficit financing through borrowing a necessity rather than an option. Hence, unwinding of dollar carry trade is unlikely to happen any time soon.

US dollar index to continue to remain under pressure…

Though recently the US dollar has got some strength against major basket of currencies, we feel that the run-up is short lived and eventually the greenback is likely to weaken again, going forward.

Exhibit 27: Dollar Index

Source: Reuters, ICICIdirect.com Research

Possible diversification of assets by central banks

After the breakout of the financial crises, there has been concern over possible diversification of reserve assets held by various central banks across the globe. Gold, due to its safe haven investment status saw a significant boost in demand during recent times. Many central banks across the globe replaced part of their dollar reserves with gold. Also, other currencies are being preferred over the US dollar, which is evident from the fact that the dollar's ~37% share of new reserves fell from ~63% average since 1999. China, in this regard, could play a spoilsport given the massive size of its reserve (~2.2 trillion), which mainly comprises US dollars.

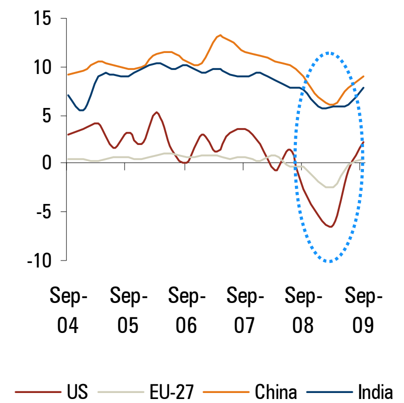
Is a global double dip in the offing?

Economy has started to expand again…

A slight recovery in GDP and industrial production across world economies aided by fiscal and monetary intervention indicates an end to the global recession

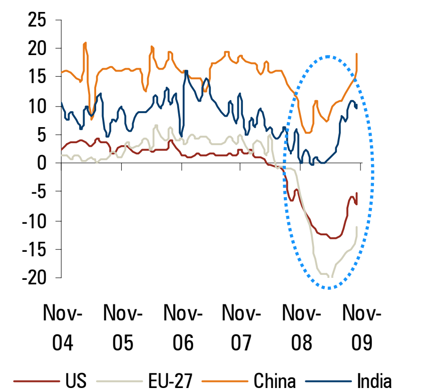
The global economy has started to expand again pulled by the strong performance of Asian economies and modest recovery in developed markets. Equity markets, the world over, are expected to continue their rally, albeit at a lower pace. The stimulus packages are not expected to be withdrawn hastily. However, the varying degree and slow pace of recovery and global activity far below pre-crisis levels have triggered the fear of a possible double dip. Investors fear that the current recovery is more of a stimulus led rebound and may not last for long.

Exhibit 28: Recovery in GDP growth (%)



Source: Bloomberg, ICICIdirect.com Research

Exhibit 29: Improving IIP numbers (%)



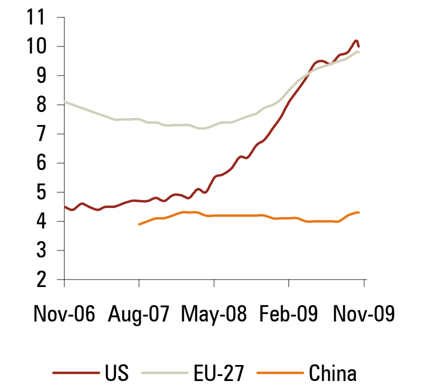
Source: Bloomberg, ICICIdirect.com Research

…but risk of a double dip overhangs

High unemployment rates and widening fiscal deficit in developed economies remain an overhang to the global economic recovery and create doubts about a global double dip

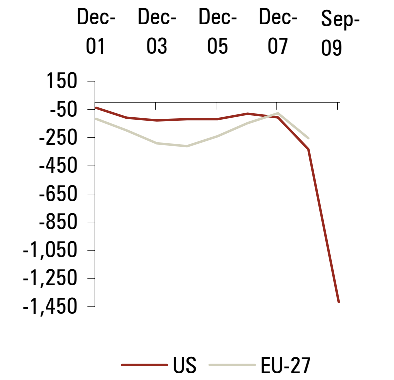
A double-dip recession occurs when, after a period of growth and recovery, the economy slides back into a recession again. Many times, the second recession is caused by consumers not spending as much due to layoffs and tightening of budgets, thus causing a contraction in demand. The cycle of more job losses then continues and spirals into the second recession.

Exhibit 30: Unemployment rate (%)



Source: Bloomberg, ICICIdirect.com Research

Exhibit 31: Fiscal deficit (US$ billion)



Source: Bloomberg, ICICIdirect.com Research

The last double dip happened nearly three decades ago, with the global economy coming out of a minor recession in early 1980 only to be followed by a far more pronounced downturn that lasted from the middle of 1981 throughout the end of 1982.

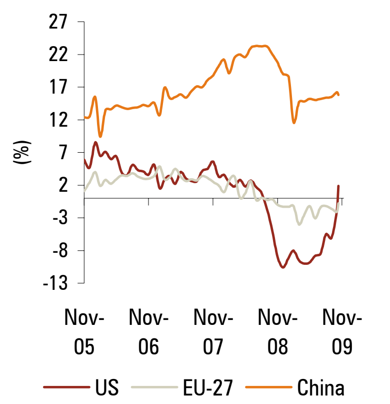
The key question is whether a renewed recession is in the offing over the next few years as monetary and fiscal policies lose impetus and private demand fails to gain momentum.

Double dip – possible but not probable…

This time though the risk of a possible double dip remains, it does not seem probable. Global activity has started to pick up on the back of a rebound in manufacturing activity and an upturn in the inventory cycle. There are signs of gradually stabilising retail sales, rising consumer confidence, improving global PMI and firming housing markets. As overall prospects have improved, commodity prices have also staged a comeback from the lows reached earlier this year. Also, world trade has started to pick up.

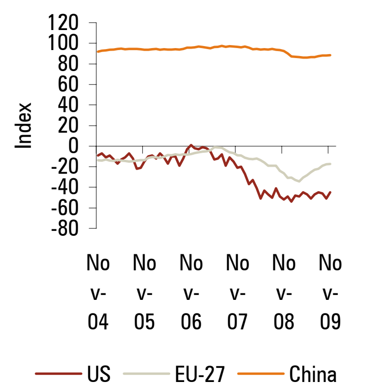
Rising retail sales, improving consumer sentiment and better coordination among the world's central banks on exit strategy leave a very low probability of double dip

Exhibit 32: Retail sales (YoY % chg)



Source: Bloomberg, ICICIdirect.com Research

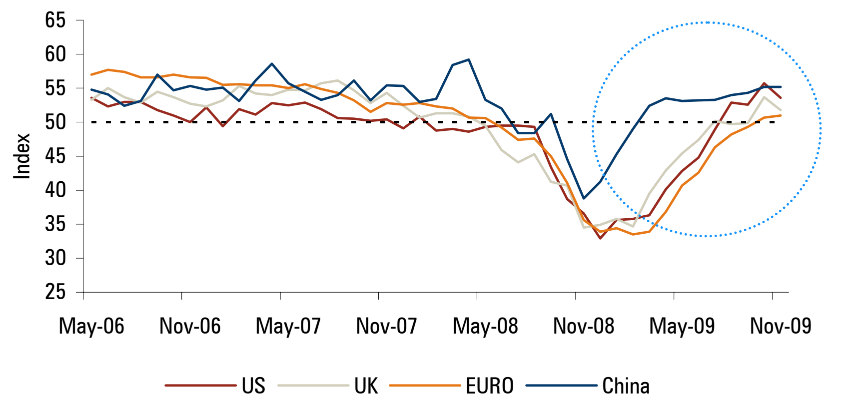
Exhibit 33: Consumer confidence index



Source: Bloomberg, ICICIdirect.com Research

The Global PMI has bounced back from its earlier lows by showing continuous MoM improvement. It is currently sustaining well above the symbolic 50.0 boom-or-bust line, indicating a return to expansion in overall manufacturing activity

Exhibit 34: Global PMI - back on track



Source: Reuters, ICICIdirect.com Research

The PMI index in major economies has bounced back from its earlier lows and is sustaining well above the symbolic 50 mark. Even employment has started to grow in 11 major economies, which include India, Japan, Canada, Singapore, Brazil, Russia, Sweden and Taiwan. The US economy, which was sitting on the sidelines until recently, has also started to participate in the global recovery process.

Global financial system — well capitalised

The collapse of housing bubble, which peaked in the US in 2006, caused the values of securities tied to real estate pricing to plummet, thereafter damaging financial institutions globally. Questions regarding bank solvency, declines in credit availability and damaged investor confidence had an impact on the global stock markets, where securities suffered huge losses during late 2008 and early 2009. In the US alone, 25 banks failed and were taken over by the government in 2008.

Since then massive policy action has been taken to reduce systemic and liquidity risks. Central banks reacted quickly with exceptionally large interest rate cuts as well as unconventional measures to inject liquidity and sustain credit. Governments launched major fiscal stimulus programmes, while assessing their banks with stress tests and supporting them with guarantees and capital injections. Consequently, the IMF has also reduced its estimates for potential global write downs by $600 billion from about $4 trillion to $3.4 trillion. Nevertheless, the depth of economic downturn and tentative recovery is weighing on the performance of major asset classes.

In this scenario, adequacy of capital gains is of paramount importance. Although the expected write-down in global banks would outweigh the revenue forecast in the next few quarters, the global financial system is well capitalised to weather this storm.

The stress test done by US regulators shows that capital ratios exceed the 6% Tier 1 capital-to-risk-weighted assets ratio in aggregate. This is owing to increased earnings and successful private capital raising efforts, as well as government capital injections. Banks in all regions have achieved a degree of stability in their capital positions. US banks have raised $104 billion of capital in the first half of 2009, taking their Tier 1 capital to around 11.5% of risk weighted asset (RWA).

On a system-wide basis, banks exceed minimum capital levels but would benefit from additional tangible capital to better absorb impending losses and revive lending. Bank capital has stabilised but will have to be rebuilt further to support the recovery

Exhibit 35: Global financial system — well capitalised

(USD Bn)	US	Euro	UK	Other EU
Estimated Capital Positions at Q2CY09				
Total reported writedowns to at Q2CY09	610	350	260	80
Total capital raised to Q2CY09	500	220	160	50
Tier 1/RWA capital ratios, in percent at Q2CY09 (change from CY08)	11.5 (+1.1)	8.5 (+1.2)	10.4 (+1.2)	8.9 (+1.6)
Expected earnings and writedowns				
Expected writedowns Q3CY09 - Q4CY10 (1)	420	470	140	120
Exp. net retained earnings Q3CY09 - Q4CY10 (2)	310	360	110	60
Net drain on equity (3) = (1)–(2)	110	110	30	60
Capital Needs (to reach target ratio)				
6 percent Tier 1/RWA3	0	0	0	0
8 percent Tier 1/RWA	0	150	0	30
10 percent Tier 1/RWA	90	380	0	60

Source: IMF, ICICIdirect.com Research

On a system-wide basis, banks exceed minimum capital levels but would benefit from additional tangible capital to better absorb impending losses and revive lending. Bank capital has stabilised but will have to be rebuild further to support the recovery.

We do not expect a ripple effect from the Dubai crisis to be felt globally and consider it a one-off failure of a business model that would ultimately have little impact on the global economy

Dubai scare – Failure of business model

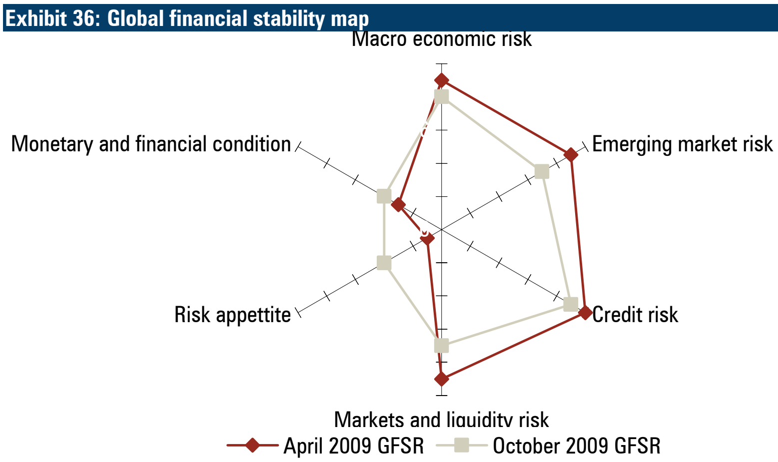
The Dubai crisis, which emanated in late November after the announcement of a delay on payment of US$26 billion debt by Emirate's major investment vehicle, Dubai World, has clearly outlined the failure of a business model. The vision of building Dubai into a regional hub for commerce and tourism relied heavy on borrowing by its ruling family.

The high borrowing through the last few decades resulted in extraordinary real estate activities in Dubai that ultimately suffered a slowdown due to the economic downturn in global markets and led to the present debt repayment crisis. Dubai had spent heavily on real estate on easy and cheap credit availability. However, since many other economies do not follow a similar model, the present crisis will turn out to be a very minor affair for the world economy and financial markets on the whole in the long run.

Global financial stability improves significantly in the past six months…

Factors underlying the global financial performance have shown significant improvement according to the Global Financial Stability Report (GFSR) by IMF.

Exhibit 36: Global financial stability map



Source: IMF, ICICIdirect.com Research

Macroeconomic risks have receded as the economic downturn is showing signs of reaching its trough. Emerging market risks have eased overall as official initiatives have reduced tail risks, portfolio inflows have resumed and the return of risk appetite has supported emerging market assets. Credit risk has retreated from historic highs though overall risks remain elevated. Bank stability risks have also receded, reflecting government support of balance sheets and as securities write downs by financials have begun to taper and capital cushions have increased. Market and liquidity risks have fallen as inter-bank markets and some channels of private wholesale funding markets have reopened. Also, market volatility has declined as worries of systemic collapse and economic free fall have abated.

Monetary and financial conditions have eased, as policy rates have remained low and financial assets have rallied. Risk appetite has risen three notches from depressed levels at the time of the April 2009 GFSR.

Sustained economic activity to continue…

IMF has revised upward its baseline forecast for global growth with developed economies expected to register positive growth in 2010 and emerging economies projected to rebound significantly. Prospects for global trade have improved and fears of widespread deflation have receded.

Although the recovery is expected to be slow, as financial systems remain impaired, support from public policies will gradually have to be withdrawn and households in economies that suffered asset price busts will continue to rebuild savings while struggling with high unemployment. We expect central banks across the world to be able to cautiously steer through the precarious course of exit strategy and maintain a balance between supportive macroeconomic policies and rising public debt levels through synchronised measures.

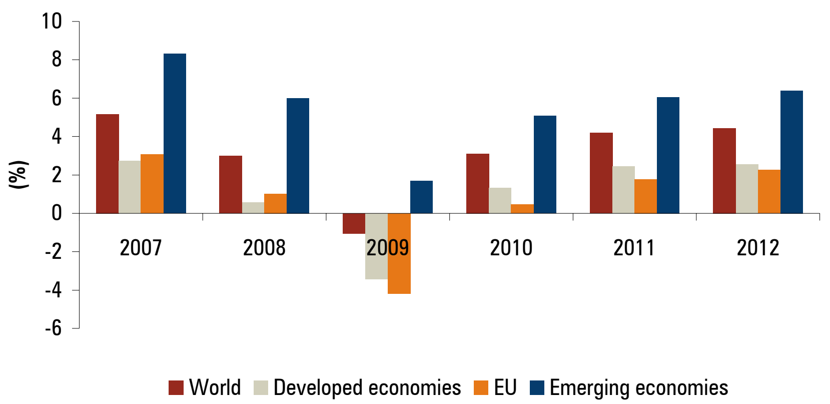
Upward revision in GDP estimates by IMF indicates a stable global growth environment in 2010E led by emerging economies

Exhibit 37: World economic outlook projections (% Change)

			Projection		Δ from July' 09 projection	
	2007	2008	2009	2010	2009	2010
World output	**5.2**	**3.0**	**-1.1**	**3.1**	**0.3**	**0.6**
Developed economies	2.7	0.6	-3.4	1.3	0.4	0.7
United States	2.1	0.4	-2.7	1.5	-0.1	0.7
Euro area	2.7	0.7	-4.2	0.3	0.6	0.6
Japan	2.3	-0.7	-5.4	1.7	0.6	0.0
United Kingdom	2.6	0.7	-4.4	0.9	-0.2	0.7
Emerging economies	8.3	6.0	1.7	5.1	0.2	0.4
China	13.0	9.0	8.5	9.0	1.0	0.5
India	9.4	7.3	5.4	6.4	0.0	-0.1
ASEAN–53	6.3	4.8	0.7	4.0	1.0	0.3
Brazil	5.7	5.1	-0.7	3.5	0.6	1.0
World trade volume	**7.3**	**3.0**	**-11.9**	**2.5**	**0.3**	**1.5**
Imports						
Developed economies	4.7	0.5	-13.7	1.2	-0.1	0.6
Emerging economies	13.8	9.4	-9.5	4.6	0.1	3.8
Exports						
Developed economies	6.3	1.9	-13.6	2.0	1.4	0.7
Emerging economies	9.8	4.6	-7.2	3.6	-0.7	2.2

Source: IMF, ICICIdirect.com Research

Exhibit 38: IMF GDP growth estimates



Source: IMF, ICICIdirect.com Research

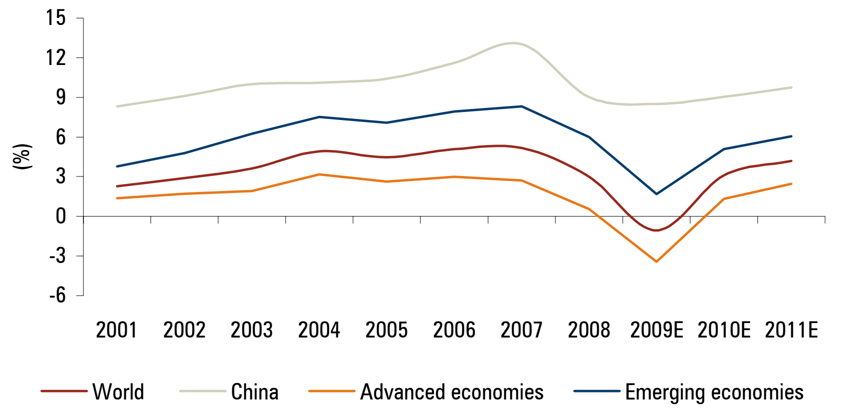
Concerns about the dragon – real growth or bubble?

China bouncing back to its supernormal growth path

China has been growing at a phenomenal average rate of over 10% in the last decade, led by strong capacity addition and robust domestic demand. This has led to the country controlling a significant share of world production and consumption, across base metals and other commodities. China is the world's fastest growing economy, has a significant dollar denominated surplus and plays an important role in the global economic canvas. After suffering a slight slowdown with a decade low growth of 6.1% in Q1CY09, China's economy has bounced back to its supernormal growth path and is expected to grow at 9.0% while the world is expected to grow at 3.1% in 2010.

China has bounced back to its supernormal growth path on the back of the stimulus package and credit boom

Exhibit 39: GDP growth (%) – China vis-à-vis rest of the world

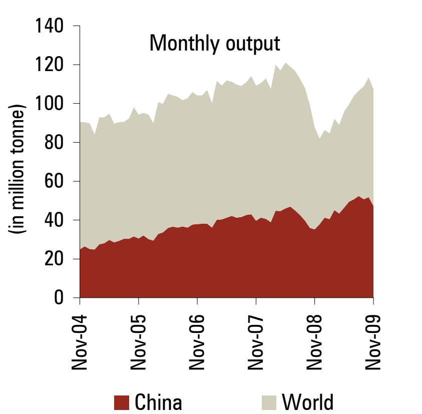


Source: IMF, ICICIdirect.com Research

China's strong credit growth has led to a surge in fixed assets investment and further build-up of capacities to meet domestic and overseas demand. This has led to a situation where China controls more than one-third of total production and consumption across various commodities, especially metals.

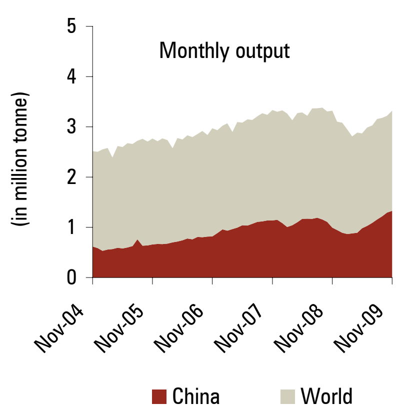
China controls ~48% of world steel production and ~35% of world aluminium production, up from ~34% and ~27%, respectively, a couple of years ago

Exhibit 40: China's share in world steel output



Source: Bloomberg, ICICIdirect.com Research

Exhibit 41: China share in total alum output



Source: Bloomberg, ICICIdirect.com Research

Is the Chinese economy running on steroids?

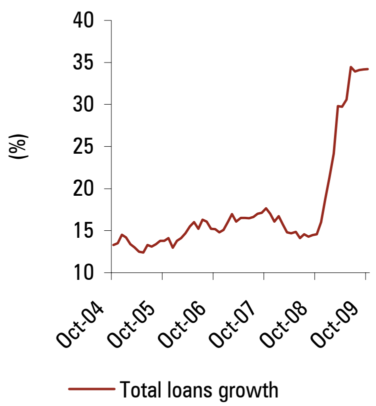
Concerns have cropped up regarding the formation of a possible investment bubble in China on the back of a US$586-billion fiscal stimulus and US$1.3 trillion credit boom

However, there are now serious fears that the robust growth in the Chinese economy has mainly been led by fiscal stimulus feed and may not be sustainable in the long run. Concerns have cropped up regarding the formation of a possible investment bubble in China on the back of a US$586-billion fiscal stimulus and US$1.3-trillion credit boom, which on bursting would have an adverse impact on the world economy and can single-handedly push the global activity into recession again.

Credit growth and fixed asset investments have shot up smartly and reached unprecedented levels leading to strong economic activity

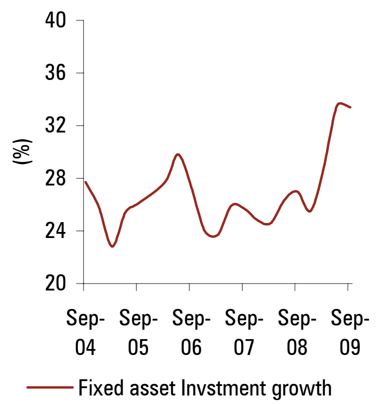
China's GDP has rebounded sharply from its decade low growth of 6.1% recorded in the first quarter of 2009 on the back of infrastructure and consumer spending. Fixed asset investment has soared and capacities across steel, aluminium, cement, chemical, refining and wind power industries have increased to very high levels.

Exhibit 42: Credit growth in China (YoY % chg)



Source: Bloomberg, ICICIdirect.com Research

Exhibit 43: Fixed asset investment growth (%)



Source: Bloomberg, ICICIdirect.com Research

Major risks to world economy from China

Overcapacity and currency undervaluation in China remains among the major risks to the world economy

The growth in China has had its share of concerns. The ripples of a possible investment bubble bursting in China would be felt the world over. Major concerns, which would pose a serious threat to the world economy include:

- Increased credit off-take would trigger the risk of a surge in NPA within China. As short-term credits fall due, they will have to be refinanced and much of this refinancing may have to be done by taking out longer-term loans, raising the banks' non-performing loan ratios and threatening the long-term stability of the financial system
- Worsening overcapacity in China would lead to growing trade tensions once exports from China rise further. This could be in the form of potential dumping of goods, adversely impacting industries in other countries and increasing unemployment worldwide
- By holding the Yuan at the artificially low level of 6.83 to a dollar and making Chinese exports cheaper in the process, it is widely perceived that China is in a way dumping unemployment abroad. This is bound to create repercussions across the world.

While the internal strength of the Chinese economy may augment domestic consumption to match the created capacity and help avoid a global slowdown, the huge credit boom may lead to an eventual surge in NPA and threaten the stability of the financial system. Whether China is experiencing real growth or it is formation of an investment bubble remains to be seen.

Predicament of domestic investors

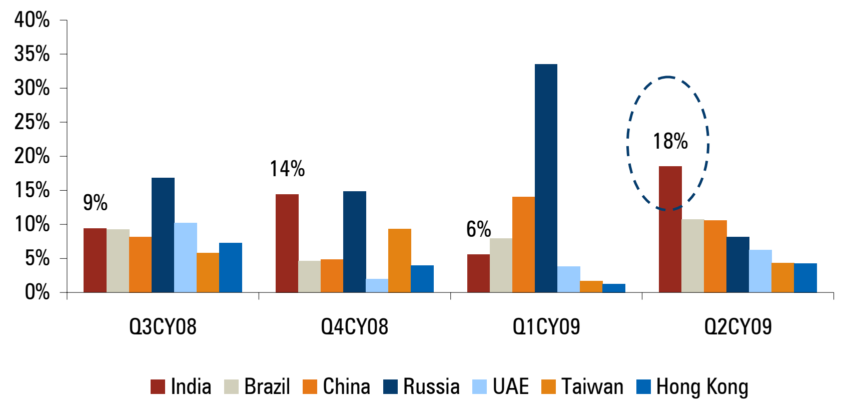
Besides global factors, investors are also confronted with a host of domestic dilemmas. We had one of the best yearly returns globally with the Sensex delivering a return of 79% aided by IT and metal sectors outshining others. The Indian markets were blessed with ample liquidity with FIIs lapping up stocks across sectors. This, in turn, has left little on the table for investors. This has made them sceptical about a host of factors such as valuation, role of government, inflation and rate hike worries and which stocks or sectors to look at for 2010.

Sustainable liquidity on strong investor confidence

The strong performance of the Indian stock market since March 2009 was primarily driven by liquidity from improved investor confidence in the Indian growth story. This liquidity has come from broad-based participation of domestic and foreign institutional investors. Inflows are expected to remain strong as India has been revising its GDP growth rate upwards for the last two quarters and is now expected to grow at greater than 7% in FY10. With this, India continues to be the second fastest growing economy after China adding to investor confidence.

India emerged as the No.1 investment destination attracting 18% share of the total fund flow to emerging markets

Exhibit 44: Share of inflow to emerging markets

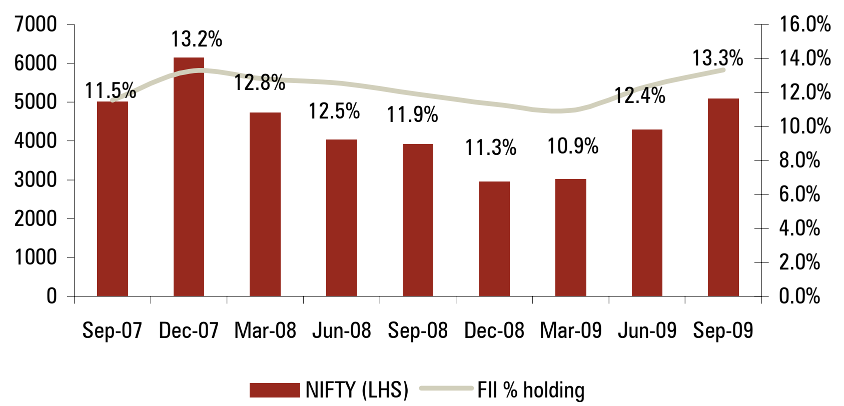


Source: Bloomberg, ICICIdirect.com Research

The global liquidity crisis led to a huge sell-off in India in Q1CY09, resulting in a decline in its share of inflows from 14% in Q4CY08 to 6% in Q1CY09. However, in Q2CY09, India's share of inflows has risen to 18%, higher than pre-Q4CY08 levels.

FII holding in Nifty companies crossed the 13% mark, even higher than the peak level of Dec 07

Exhibit 45: FII holding in Nifty stocks



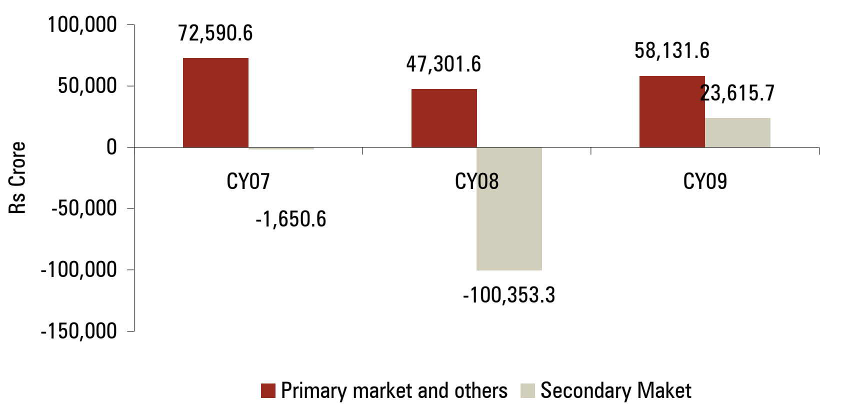
Source: Bloomberg, ICICIdirect.com Research

FII holding in Nifty stocks touched the peak of 13.2% in December 2007. It has dropped to 10.9% in March 2009 as they liquidated their holdings in Indian companies on account of the global financial crisis. However, since March 2009 the trend has reversed and their holding pattern in Indian companies in September 2009 stood at 13.3%, a shade higher than the pre-crisis level.

In CY09, FIIs cumulatively invested Rs.81747 crores in Indian equity market. However, 71.1% of the total investments from FII came through primary markets and other sources while 28.9% of the FII inflows were through secondary market investments. It is noteworthy that primary markets have been preferred by FIIs over secondary markets in India over the last 3 years. Investments through primary markets raise the equity capital consequently increasing their responsibility to deliver better profits. However, if the companies fail to deliver the requisite performance, flight of capital is inevitable resulting in a negative pressure on the stock.

71.1% of FII inflows in CY09 were routed through primary markets while the share of secondary markets was a meager 28.9%

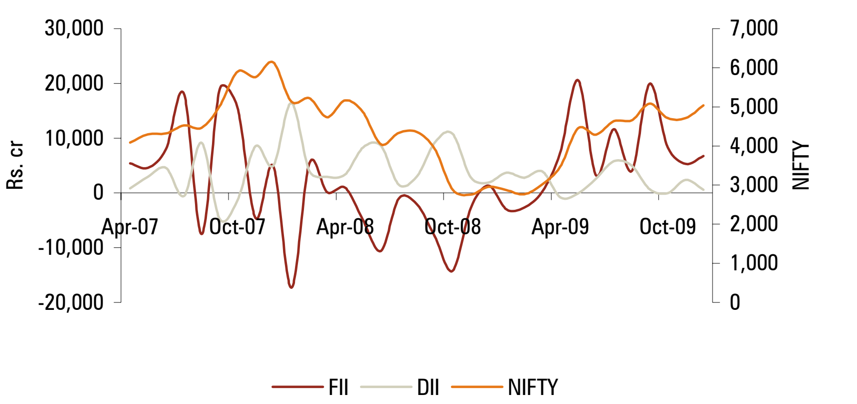
Exhibit 46: Sources of FII inflow



Source: Bloomberg, SEBI, ICICIdirect.com Research

Strong FII flows led to a rally in equity markets and DII flows provided a cushion at lower index levels

Exhibit 47: Comparative flow of funds through DIIs and FIIs



Source: Bloomberg, ICICIdirect.com Research

As depicted in the above graph, the rally in the Indian stock market has been driven by FII inflows. The total investment of FIIs in CY09 was to the tune of Rs 81747 crore while that of DIIs was Rs 26604 crore in the same period. The investment from DIIs, though relatively small (32.5% of the investment by FIIs), has been a major cushion at the time of sell-off by FIIs.

Liquidity "INSURANCE"

LIC invested Rs 35,000 crore in FY09 and Rs 40,000 crore in April-July 2009 in equities

In CY09, insurance companies were major investors in Indian equity market. Life insurance has been a major contributor to the premium collections while the share of non-life is very insignificant. Life insurance premium has grown at a CAGR of 27% over the past five years i.e. FY04-FY09. In FY09, life insurance companies collected a sum of Rs 2,16,200 crore of which approximately 25% was invested in equity markets. LIC, the market leader in the life insurance sector with a share of 71.7%, has been gradually increasing its exposure in equities from 16% in FY06 to 27% in FY08. Even during the equity market turmoil in FY09, LIC invested 22% of its premium collections in equities. On a conservative basis, if we assume that the insurance premium collection would grow at 15% in FY10 and 20% in FY11E and 15% of the premium collected in each year would be invested in equities, we can expect a flow of Rs 44,800 crore from insurance companies in FY11.

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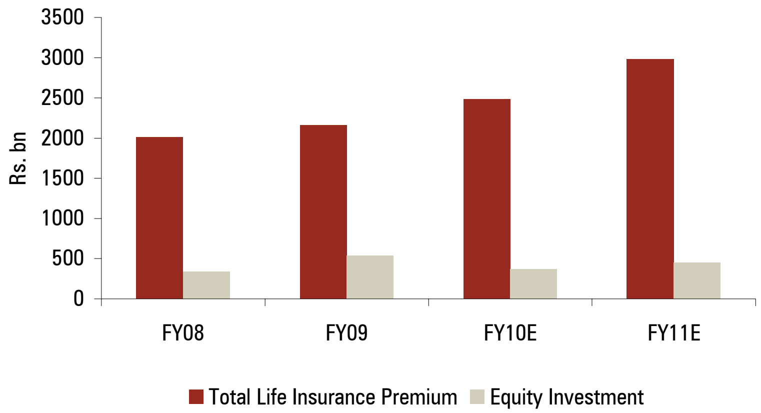
Exhibit 48: Total life insurance premium & investments in equity markets

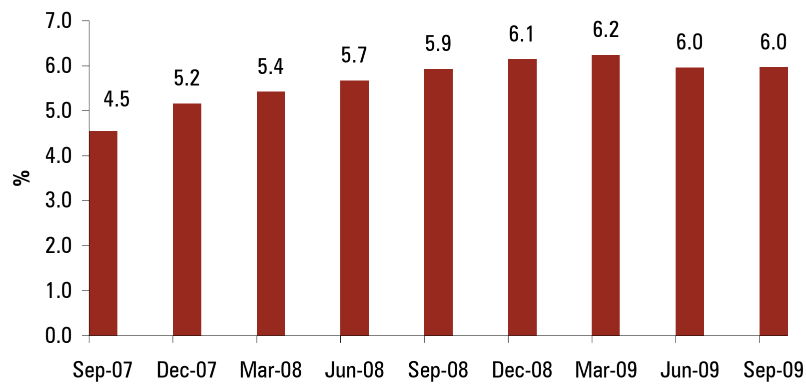


Source: Industry, ICICIdirect.com Research

With the expected increase in premium collection due to increased awareness among people on risk coverage and investment in ULIPs, we believe exposure to equities will continue to rise at a gradual pace. This is evident from the exhibit below wherein insurance companies' holding in Nifty stocks has risen from 4.5% in Q3FY08 to 6% in Q2FY10.

Insurance companies have steadily increased their holdings in Nifty stocks

Exhibit 49: Insurance companies holding in Nifty stocks



Source: Bloomberg, ICICIdirect.com Research

With the rising awareness of risk coverage, the share of insurance in the total financial savings is on the rise. The share of insurance as a percentage of household savings has increased from 17.7% in FY07 to 20.1% in FY09, while that of the mutual funds has declined to -1.4% over the same period. As almost one-fifth of the total insurance premium collection is deployed in equity markets, the rise in insurance as a percentage of household savings is a positive for the liquidity scenario of the country.

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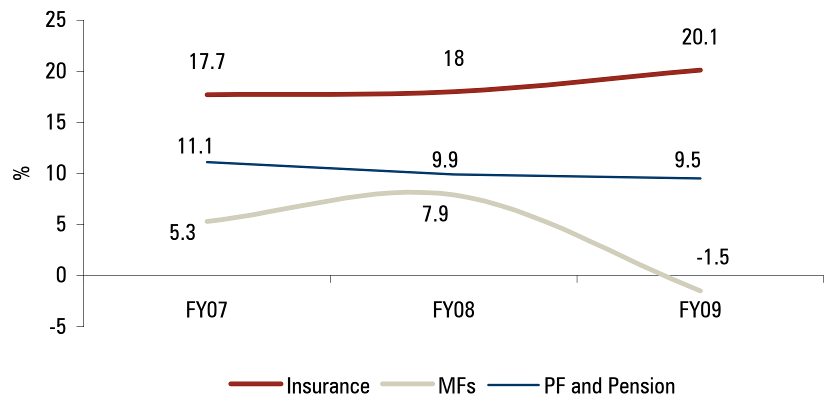
Exhibit 50: Avenues of financial savings



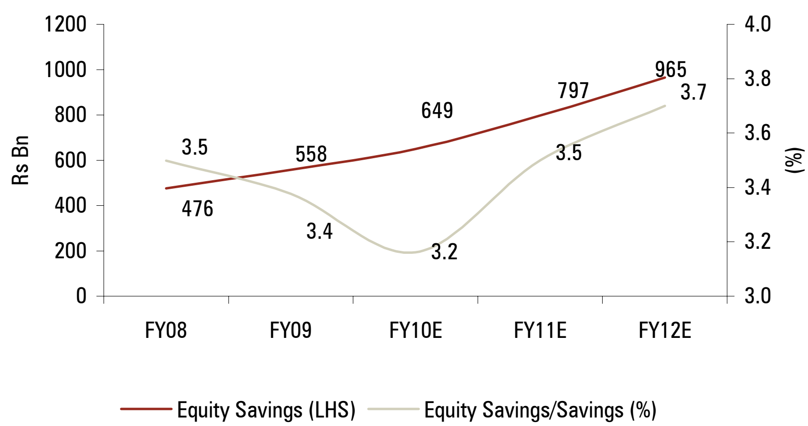
Source: RBI, ICICIdirect.com Research

Increasing saving rate – to aid liquidity

The savings rate as a percentage of GDP stood at 33.5% in FY09 and is expected to reach 36% in FY12E. However, the allocation of savings to equity investments has been very low at 3.4% in FY09. With diversification in asset class, we believe the allocation to direct equity investments would rise, leading to additional Rs 41,000 crore inflows in equity markets through domestic household savings over the next three years.

Channelling of domestic savings in direct equities will provide additional Rs 41,000 crore over the next three years

Exhibit 51: Domestic savings as % of GDP



Source: Bloomberg, ICICIdirect.com Research

Worries on government performance

Year 2010 would be a politically stable year as only one state (Bihar) would go for elections

We believe the government would be in a comfortable position to implement infrastructure projects as raising funds through disinvestment and other reforms would not be a major concern. Year 2010 would be a politically stable year as only one state (Bihar) would go for elections, which alleviates concerns over political interference in the reforms process.

Infrastructure spending to continue

In order to accelerate the GDP growth rate, the government has laid emphasis on investment in infrastructure areas such as electricity, roads & railway, water supply & sanitation and irrigation. With the increased infrastructure spending, the share of infrastructure spending to GDP is expected to increase to 9% in 2011-12 from 5% in 2007-08. Government would be the major contributor to infrastructure spending, which was ~80% in the Tenth Five Year. Efforts are also being made to make infrastructure investment more attractive to private players. In the Eleventh Five Year Plan, the government is targeting private players' contribution to reach ~30%. This is likely to partially offset the burden on the government from increased infrastructure spending.

Share of infrastructure spending to GDP is expected to increase to 9.0% in 2011-12

Exhibit 52: Five Year Plan target in infrastructure (top down approach)

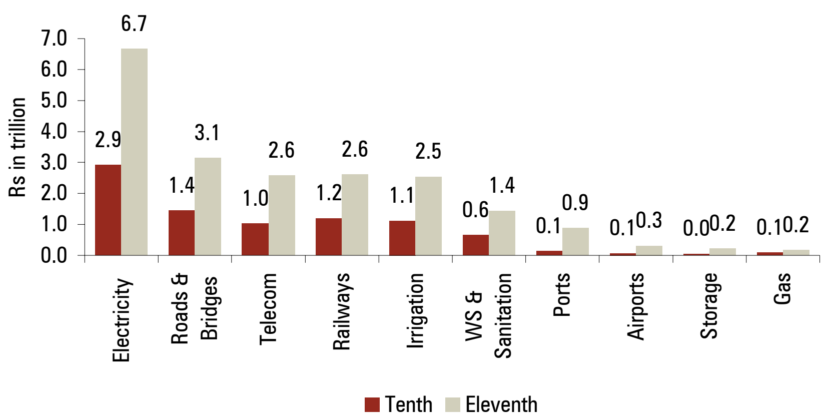
		Eleventh Plan				
	FY07	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**
GDP (Rs trn)	41.5	45.2	48.0	51.3	55.5	60.4
GDP growth rate %		9.1%	6.1%	7.0%	8.0%	9.0%
GCF in Infrastructure as % of GDP	5.0	5.8	6.5	7.3	8.0	9.0
GCF in Infrastructure (Rs bn)	2.1	2.6	3.1	3.7	4.4	5.4
Eleventh plan total GCF in Infra (Rs trn)		**19.3**				

Source: Planning Commission, ICICIdirect.com Research

Note: We have revised GDP growth rate assumption and kept GCF in infra % of GDP constant. Based on these assumptions, the revised target for infrastructure spending works out to be Rs 19.3 trillion as compared to Rs 20.1 trillion target considered in the plan document

The electricity and road vertical will witness a rise in spending in the Eleventh Plan

Exhibit 53: Segment wise break-up of infrastructure spending



Source: Planning Commission, ICICIdirect.com Research

Disinvestment to provide cushion

With the UPA now in full command at the centre, the disinvestment drive is hotting up. The government has already raised close to Rs 4,250 crore through the disinvestment drive and is expected to raise around Rs 25,500 crore through this route in FY10E.

The government's aggressive stance towards the investment process will fetch ~Rs 29,000 crore in FY10E

Exhibit 54: Disinvestment agenda for FY10E

Disinvestment already done during FY10			
Name	Govt Holding (%)	Stake (%)	Amount (Rs Cr)
NHPC		5	2,000
Oil India		10	2,250
Total			**4,250**
Proposed Disinvestment during FY10 through the follow on offers			
Name	Govt Holding (%)	Stake (%)	Amount (Rs Cr)
NTPC	89.5	5	9,500
REC		5	1,000
NMDC	98.4	8	13,500
Total			**24,000**
Proposed Disinvestment during FY10 through the initial offering			
Name	Govt Holding (%)	Stake (%)	Amount (Rs Cr)
SJVNL	100.0	10	1500-1750
Total			**1500-1750**

Source: Companies, Ministry of Finance, ICICIdirect.com Research

The line up of disinvestment for the next year is more aggressive with major companies in the energy and telecom arena lined up for disinvestment. We believe it will be a little premature to comment on the exact issue size of unlisted players in the next fiscal. However, it will exceed Rs 50,000 crore according to initial estimates.

Exhibit 55: Disinvestment agenda for FY11E

Proposed Disinvestment during FY11 through the follow on offers			
Name	Govt Holding (%)	Stake (%)	Amount (Rs Cr)
MMTC	9.3	9	16,000
Neyveli Lignite	93.6	5	1,200
Power Grid	86.5	5	2,300
SAIL		5	4,450
Power Finance		5	1,450
Total			**25,400**
Proposed Disinvestment during FY11 through the initial offering			
Name	Govt Holding (%)	Stake (%)	Amount (Rs Cr)
BSNL	100.0	10	NA
Coal India	100.0	10	NA
Manganese Ore	100.0	10	NA
Kudremukh Ore	100.0	10	NA

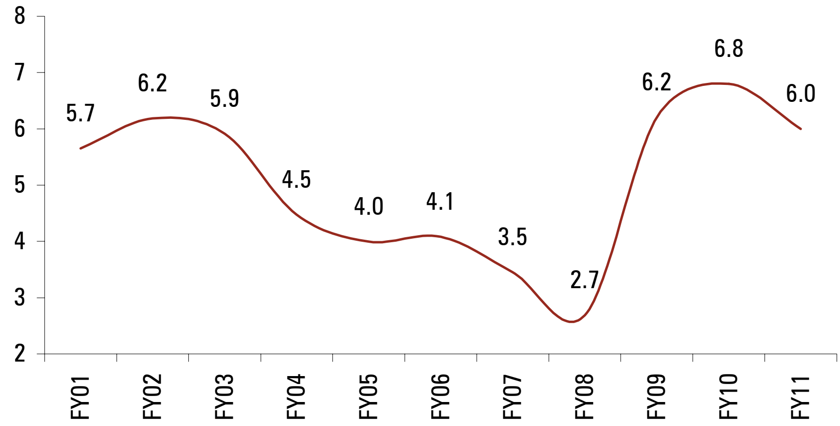
Source: Companies, Ministry of Finance, ICICIdirect.com Research

Pruning of fiscal deficit – likely to be pushed to next year

The government's budget estimates for the fiscal deficit stand at 6.8% for FY10. The stimulus package of $9 billion in FY10 and other measures for economic recovery have pushed the fiscal deficit from 2.7% in FY08 to 6.8% in FY10E. We expect a 3-5% dip in tax collection against Budget estimates. Simultaneously, a delay in auction for 3G licenses would defer the receipts of ~Rs 30,000 crore to the next fiscal. However, the government's aggression on disinvestment would fetch ~Rs 29,750 crore in FY10E. We believe the government may not to be able to meet its fiscal deficit target in the current year but the continued disinvestment process and expected higher tax collection in FY11 would help in bringing down fiscal deficit to 6% in FY11.

Fiscal deficit to get pruned to 6% in FY11

Exhibit 56: Fiscal deficit (as % to GDP)



Source: RBI, ICICIdirect.com Research

Stimulus – Limited withdrawal, too little to impact

With the economy stabilising due to improvement in domestic demand across all industries, the government is likely to withdraw the stimulus packages, which were announced in three phases during December 2008-February 2009. We believe the withdrawal of the stimulus packages, worth ~$9 billion, would not have any major impact on the economy as the size of the package accounts for only ~0.7% of GDP. The government had announced the following packages:

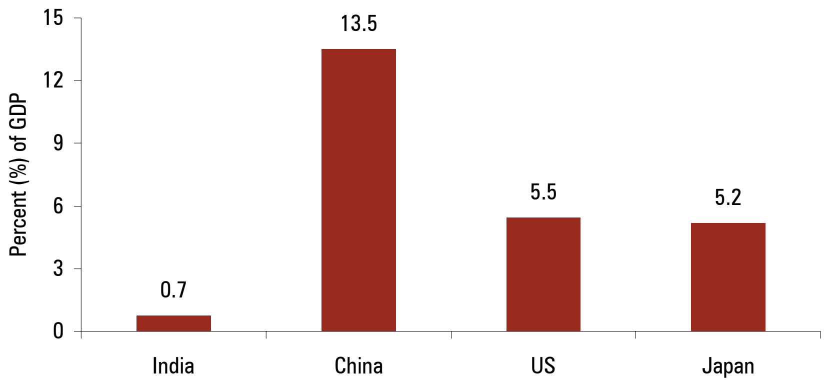
Exhibit 57: Stimulus packages announced during Dec 08 to Feb 09

Rate cuts by RBI in three phases	400 bps cut in CRR 275 bps cut in Reverse repo rate 425 bps cut in Repo rate
Excise duty, Service duty and other duty cuts	4% cut in ad valorem cenvat rate for all products other than petroleum 2% Excise duty cut on goods attracting 10% excise duty Cut in service tax from 12% to 10% 2% Excise duty cut on bulk cement customs exemption on naptha imports CVD & Special CVD imposed to cement, TMT bars and structurals Rs 1100 cr additional fund provided to ensure full refund of terminal excise duty/CST
Refinance facility	Refinance facility of Rs 4000 cr for NHB Refinance facility of Rs 7000 cr for SIDBI
Infrastructure spending	IIFCL raised Rs 10000 crore through tax free bonds
Credit facility to NBFC	SPV to provide liquidity to NBFC with Potential size - Rs 25000 cr
Easing ECB norms and FIIs investment	Ceiling on interest rate removed FIIs investment limit in rupee denominated corporate bonds increased from $6bn to $15bn
Others	Additional Rs 350 cr for export incentive scheme Additional allocation of Rs 1400 cr to clear entire backlog in TUF scheme Govt back up guarantee to ECGC to the extent of Rs 350 cr

Source: Ministry of Finance, ICICIdirect.com Research

Implementation of GST across goods and services is expected to provide gains to India's GDP within a range of 0.9-1.7%

Exhibit 58: Stimulus package as a % of GDP



Source: Ministry of Finance, ICICIdirect.com Research

Other policy measures – GST roadmap/bank consolidation

The government is proposing tax reforms for indirect taxes to simplify the existing tax structure. We believe the new tax reform (common GST) is a step forward for long-term growth.

GST roadmap

The Indian government is likely to roll out a pan-India common GST framework wef April 2010 to simplify the indirect tax system for goods and services consumed. GST will be a destination based tax on consumption of goods and services, which will subsume all multilayered indirect taxes (levies on goods and services; excise duty, VAT and service tax) into one basket. This framework will also allow full credit for taxes paid on inputs in the supply chain. GST will be rolled out in dual form; central GST and state GST. GST is expected to be in the range of 14-16%.

Central government levies

- Customs duty on imported goods
- Excise duty (CENVAT) on manufactured products
- Service tax
- Central sales tax on inter state trade of goods

State government levies

- VAT/sales tax on intra-state sales of goods
- State excise on alcohol
- Luxury tax, entertainment tax

With a single GST rate applicable to goods and services across sectors, it would be positive only for those sectors that have existing effective indirect tax rate (including excise duty/service tax, VAT and CST) higher than 14%.

The Thirteenth Finance Commission study on GST shows that the implementation of GST across goods and services is expected to provide gains to India's GDP somewhere within a range of 0.9-1.7%. The corresponding change in absolute values of GDP over FY09 is expected to be between Rs 42,789 crore and Rs 83,899 crore, respectively.

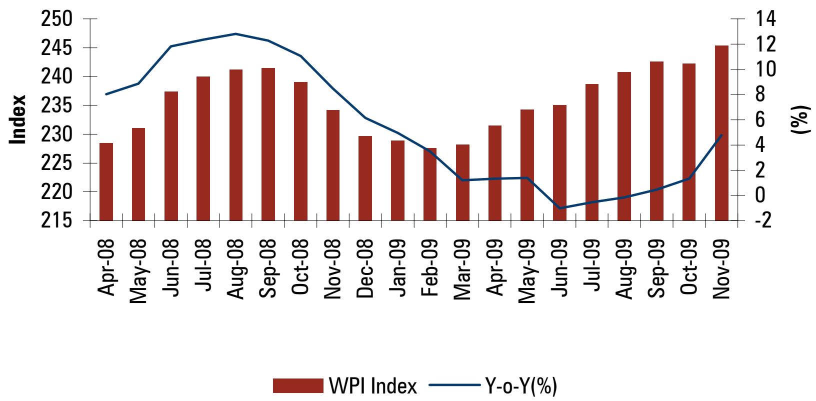
Would inflation choke growth?

Inflation is a risk but would not derail growth

High inflation in H1CY10 would not derail growth as supply concerns of major commodities would be overcome by H2CY10. We expect the Wholesale Price Index (WPI) to climb up to 7-8% by March 2010 due to rising food prices and lower base effect. Commodity prices would not witness a significant rise in 2010 on the back of increasing capacities. Also, high crude price volatility would be restricted due to lower demand from developed countries resulting in inflation stabilising at 6% in H2CY10. However, we believe inflation in India would be relatively high compared to other emerging economies due to high contribution from services. Nevertheless, moderately higher inflation in a services driven economy is evident as it results in more purchasing power for individuals and would not derail growth.

The drop in crude oil price has resulted in lower WPI during the beginning of CY09

Exhibit 59: WPI Index and YoY growth (%)

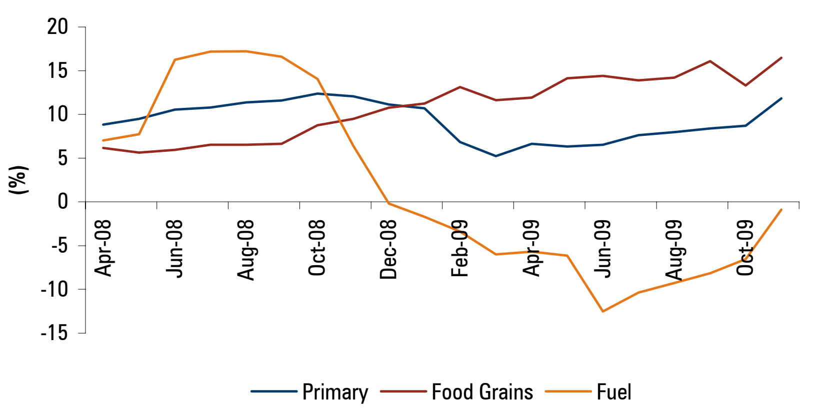


Source: CSO, ICICIdirect.com Research

We believe high inflation could create certain jitters in the first half of CY10 but stable commodity and crude prices would alleviate concerns in H2CY10. Given the receding of supply concerns, food inflation is also expected to decline to acceptable levels on expectations of decent monsoon.

High inflation could create certain jitters in the first half of 2010 but stable commodity and crude prices would alleviate concerns in H2CY10

Exhibit 60: WPI components (%)



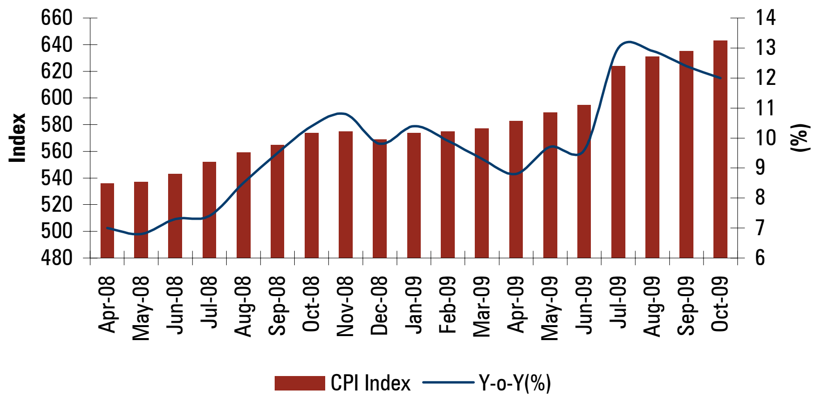
Source: CSO, ICICIdirect.com Research

Food inflation – more of a supply issue

Consumer price inflation increased to 12% in October due to 14% rise in food inflation. Food inflation (consumer price inflation of commodities consumed by agricultural and rural labourers) increased to 19.1% in November 2009. The steep rise in CPI was due to the high weightage of the food index in CPI (~47%).

High weightage of food resulted in rise in inflation to 19.1% in November

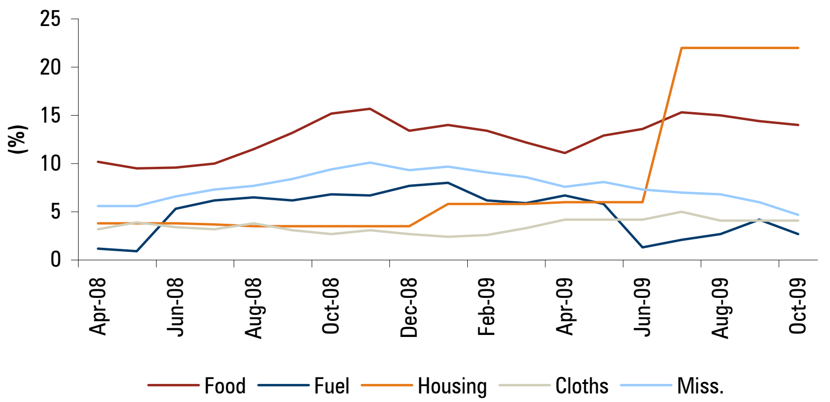
Exhibit 61: CPI Index and YoY growth (%)



Source: CSO, ICICIdirect.com Research

The steep increase in CPI has been primarily led by food articles

Exhibit 62: CPI Components YoY growth (%)



Source: CSO, ICICIdirect.com Research

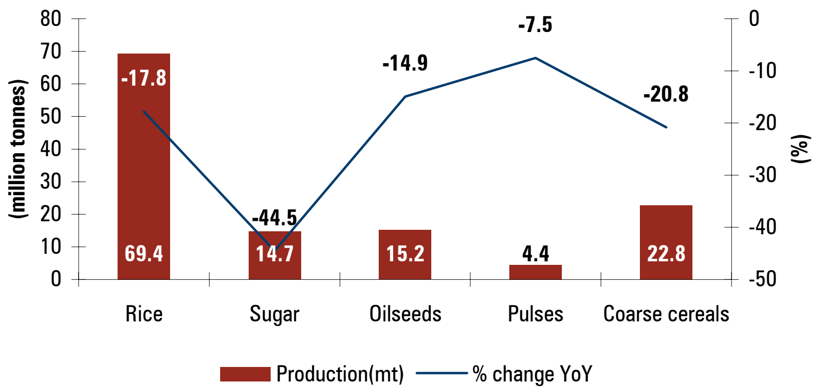
Decent monsoon can alleviate concerns

We expect the consumer price index to remain high for another three to four months as food prices (rice, sugar, food grains) would remain firm. However, it is likely to come down in H2CY10 due to the high base effect and increase in production of essential commodities in 2010-11 on expectation of better monsoons in 2010.

We also believe high CPI in the first half of 2010 would not affect growth as the steep rise in inflation is due supply side concerns, which ultimately would be overcome by normal monsoons and rise in production of essential commodities in the second half of 2010. High weightage of food in CPI would drag down inflation in H2CY10.

Exhibit 63: Decline in production has aggravated food inflation

Supply concerns due to poor monsoons have contributed to food inflation



Source: Industry, ICICIdirect.com Research

Rate hikes imminent but seen only in early FY11

Monetary policy cannot combat food inflation…

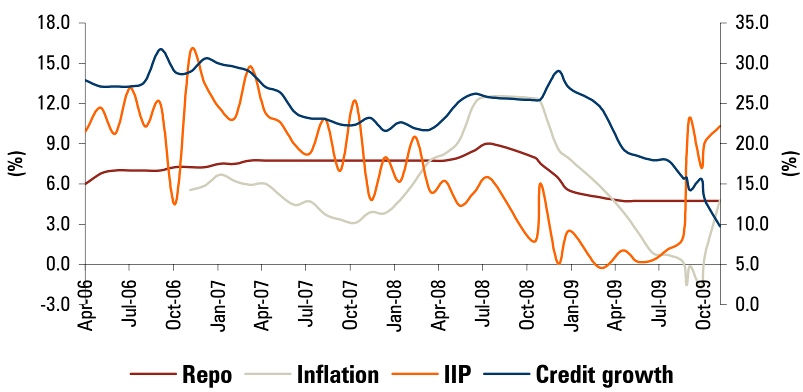
In recent history, the rate hikes were the outcome of high inflation driven by the demand side and excess money supply (M3) at 21%. However, currently money supply (M3) has fallen below 18%. Credit growth, after touching single digits, has just managed to reach 10.5% as on December 4 2009. Bankers are still high on liquidity depositing Rs 8000 crore to Rs 10000 crore under the liquidity adjustment facility (LAF) window with RBI.

We believe rates will be raised from the first quarter of FY11 onwards with overall 100-150 bps hike for the entire year.

With full year inflation expected to reach 6%, boosted by CPI food inflation touching 19%, we believe near term rate hikes in the repo and reverse repo would not help. However, post credit offtake with pick-up in absolute disbursements to the corporate sector and persistently high IIP growth of around 8-9% depicting real recovery, we see repo rate hikes starting. We believe rates will be raised from the first quarter of FY11 onwards with overall 100-150 bps hike for the entire year.

Although inflation is a concern, low credit offtake limits chances of immediate hike in interest rates

Exhibit 64: Historic low credit offtake to push rate hike next year



Source: Reuters, ICICIdirect.com Research

We expect CRR hikes will soon start to drain liquidity that could be announced prior to the monetary policy in January 2010. The government borrowing programme has eased out now as it has already borrowed Rs 3,24,500 crore out of the total required borrowings of Rs 3,98,000 crore. Hence, the balance Rs 73,500 crore in the last quarter would not put extra pressure on yields.

The expectations of higher inflation and CRR plus repo rate hikes led to the recent rise in G-Sec yields but the current range of 7.7-7.8% on the higher side is not expected to be broken.

Rate hikes to follow but unlikely to hamper growth

We believe rate hikes are imminent in a growing economy and though the RBI is concerned over inflationary pressures, we believe monetary policy will ensure a balance between growth and price stability. The GDP growth of the economy is not expected to get hurt by rate tightening measures.

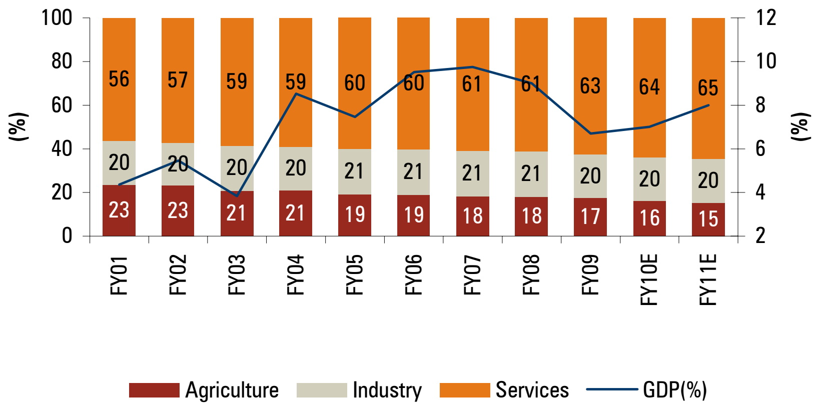
GDP growth – well balanced

With the economy recording a growth rate of 7.9% in the second quarter (July-October '09), it is expected that GDP would grow at 7.0% in FY10E and ~8% in FY11E.

The agricultural component of GDP came down from 25% in FY00 to 17.5% in FY09 while the services component increased to 62.6% in FY09 from 55.4% in FY00. We believe the next level of GDP growth would be mainly attributed to industrial growth that would be driven by capex from India Inc.

India has maintained a healthy GDP growth rate over the past few years. The FY09 performance was impacted due to the global meltdown

Exhibit 65: Component of GDP (%)

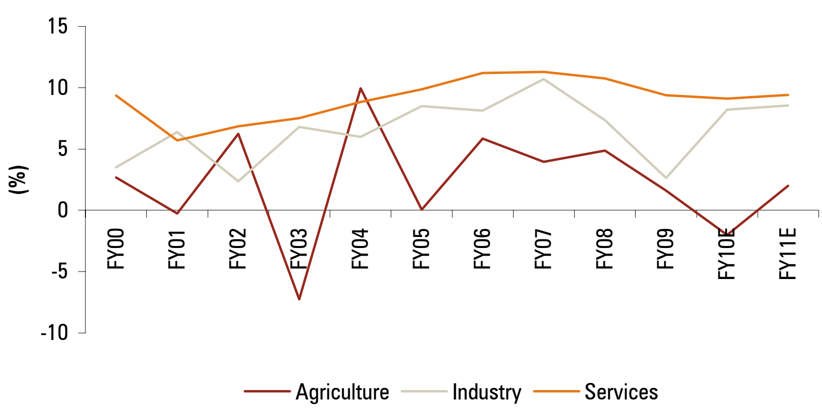


Source: RBI, ICICIdirect.com Research

During the last 10 years, GDP growth was primarily driven by services, which is growing at more than 8% from FY04. Simultaneously, the industrial component of GDP has grown at more than 6% from FY03 to FY08. In FY09, the Indian GDP grew by 6.7%, which was contributed by 9.4% growth in services. High contribution from services has resulted in high GDP growth in 2009 despite one of the worst recessions in the developed world. We believe services would continue to grow at more than 8% in FY11. Moreover, industrial growth would be primarily driven by capex from Indian industries, which would pave the way for ~8% GDP growth in FY11.

The high GDP growth has been possible due to increasing contribution of the services segment

Exhibit 66: Component wise GDP growth (%)

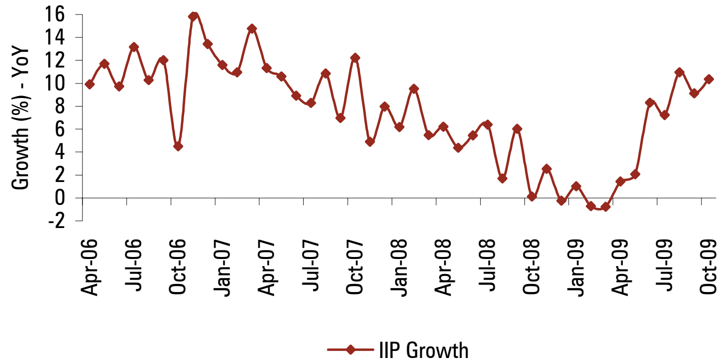


Source: RBI, ICICIdirect.com Research

Industrial production – Recovery getting broad based

In the entire recovery trail, industrial production has been the shining star. The industrial production numbers have witnessed growth in excess of 7% since June 2009.

Exhibit 67: Industrial production numbers have started trending higher



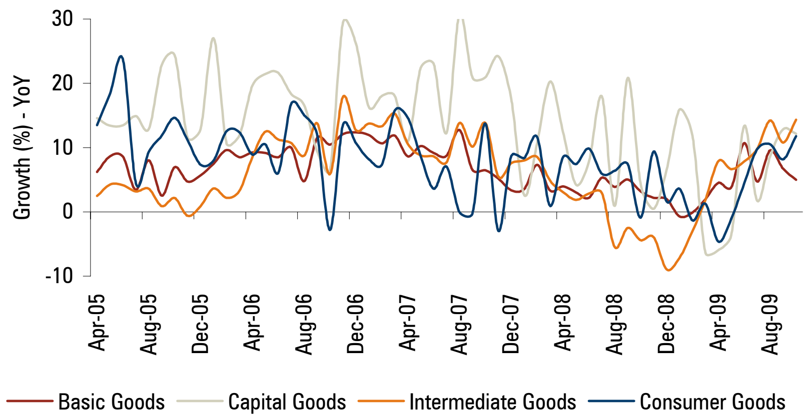
Source: CSO, ICICIdirect.com Research

Momentum visible in several IIP components

The turnaround has been led by broader participation from several sectors led by a significant growth in consumption demand. The consumer goods segment has grown by ~10% over the past four months. Part of the good news is due to auto sales, which are rising at the fastest pace in five years.

Capital goods, intermediate goods & consumer goods have started gaining positive momentum

Exhibit 68: Broad based recovery of several use based components



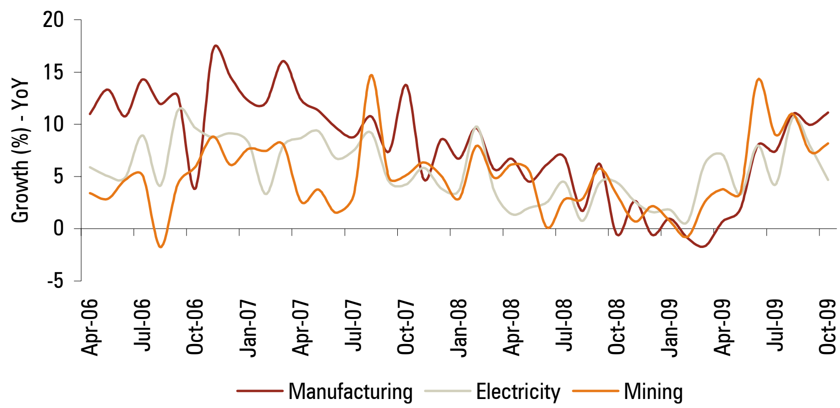
Source: CSO, ICICIdirect.com Research

Revival signs looking brighter

Industrial growth has also started showing signs of a pickup in momentum. Manufacturing, which commands a lion's share of 80% in the overall IIP, has shown a healthy growth of 11% in October 2010. Electricity has been able to achieve a growth in excess of 4% over the past four months even after a subdued performance from hydro-based generators. Generation by gas-based plants has seen significant improvement led by increased availability of fuel. The mining sector has also started gaining momentum over the last four months led by growth in exploration activity on the hydrocarbon front.

Manufacturing and mining have been key sectoral drivers of IIP growth

Exhibit 69: Industrial production – Sectoral growth outlook



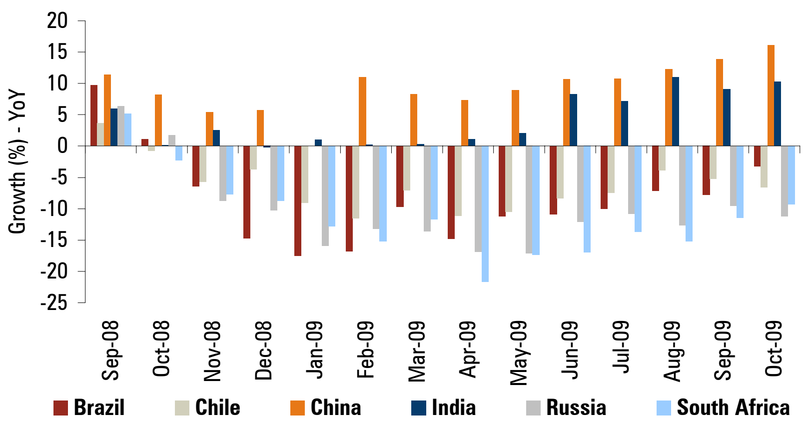
Source: CSO, ICICIdirect.com Research

India faring better than many emerging economies

In light of the fact that the other emerging economies are still to post positive IIP growth, India is exhibiting relative strength compared to other emerging economies. India is next only to China with respect to the growth momentum in the industrial production numbers.

Low dependence on external demand has resulted in relative outperformance of India compared to peers

Exhibit 70: Relative strength compared to other emerging countries



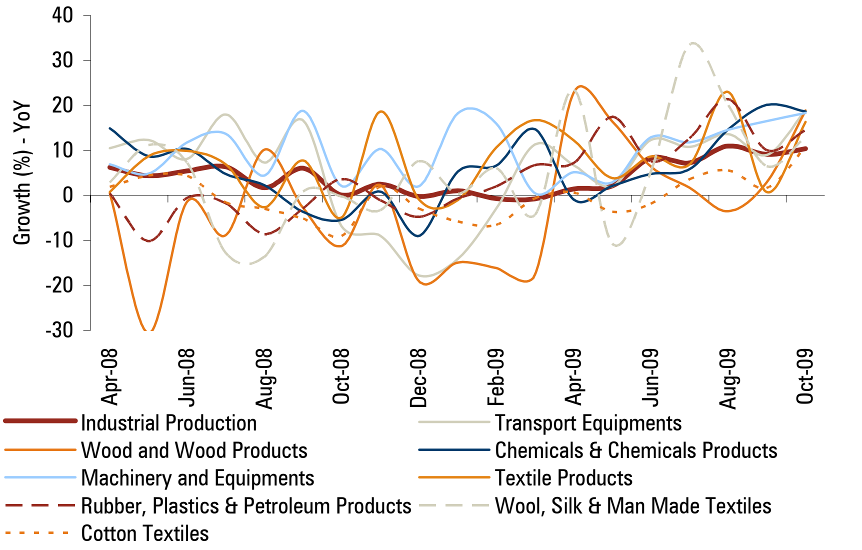
Source: Bloomberg, CSO, ICICIdirect.com Research

Broader participation within IIP signifying sustained recovery

The underlying participation from eight sub segments within the manufacturing index has improved. They have started to outperform the overall growth numbers of the industrial production in the latest October 2009 release. Healthy participation from various sectors strengthens the viewpoint of a sustainable recovery.

Broader participation from several segments of the manufacturing index signifies a long-term sustainable recovery

Exhibit 71: 8 Sub segments have outperformed overall industrial production growth in Oct 09



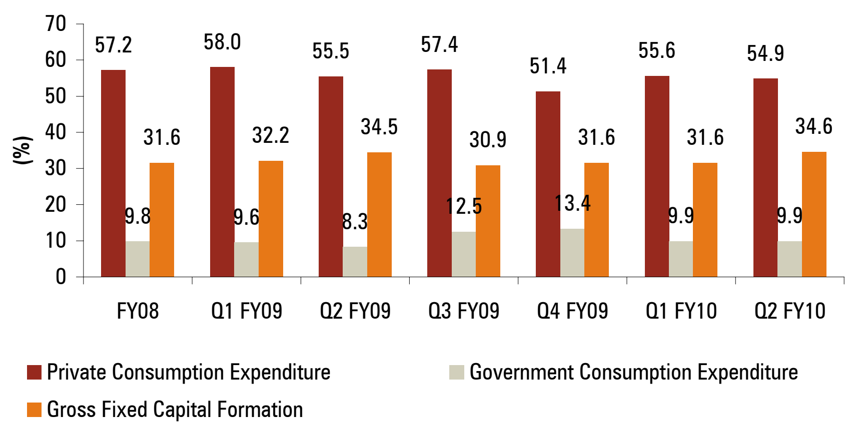
Source: Bloomberg, CSO, ICICIdirect.com Research

Component of real demand — well oiled

The relative resilience of the Indian economy in the face of the severe global recession had been largely ascribed to the greater role played by domestic demand as opposed to external demand. The domestic consumption expenditure constituted ~66.5% of the GDP in FY09. The total final consumption expenditure has seen an improvement of 8.4% YoY, from Rs ~5.4 lakh crore in Q2FY09 to Rs ~5.9 lakh crore in Q2FY10. The private final consumption expenditure, which constitutes ~ 55% of GDP, grew by 5.6% in Q2FY10, the highest in the last six quarters. During 2009-10, the growth was driven by $9 billion of stimulus by the government, which was primarily spent during the fourth quarter of FY09 and first half of FY10. We believe FY11 would see a shift from government spending to private spending, which would drive growth in FY11 and FY12.

Private sector has taken a lead in the India consumption story

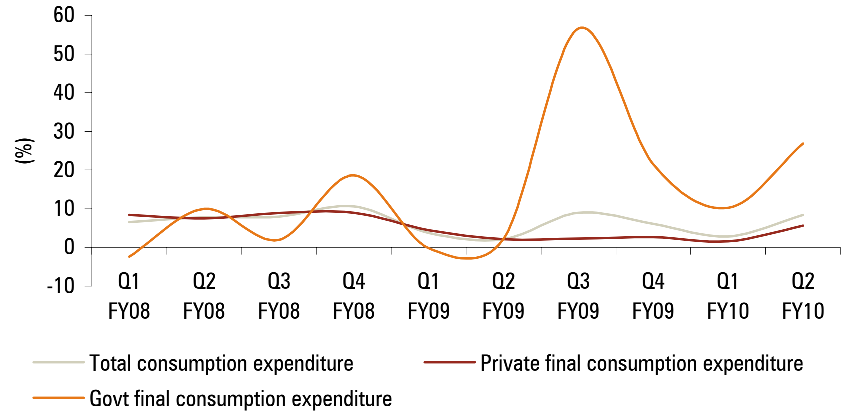
Exhibit 72: Share as a percentage of GDP



Source: CSO, ICICIdirect.com Research

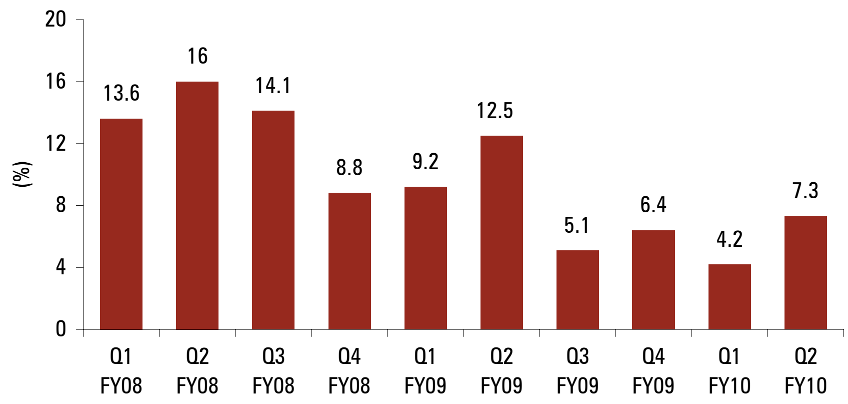
Government consumption has shown a growth rate of 26.9% in Q2FY10. It had increased to 12.5% of GDP in Q3FY09 but has declined to 9.9% in Q2FY10 as private consumption has picked up in the last two quarters.

Exhibit 73: Growth rates of private and government final consumption expenditure (YoY)



Source: CSO, ICICIdirect.com Research

Exhibit 74: Growth in gross fixed capital formation (YoY)



Source: CSO, ICICIdirect.com Research

The gross fixed capital formation reported a growth of 7.3% in Q2FY10, the highest in the last four quarters. This reflects an improvement in the investment climate for the Indian economy.

The gross fixed capital formation reported a growth of 7.3% in Q2FY10, the highest in the last four quarters. This reflects an improvement in the investment climate for the Indian economy.

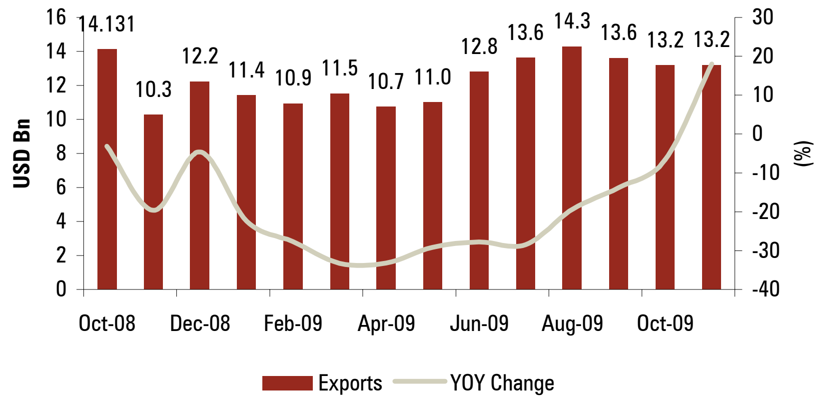
We believe a strong recovery in industrial production and continuous growth of services would result in ~7% and 8% GDP growth in FY10 and FY11, respectively. However, higher inflation could create some jitters in the first quarter of 2010. Still, these concerns would be overdone by the second half of 2010. We also believe rate hikes in repo and reverse repo would not affect growth as large government spending would continue supporting growth, which ultimately would be replaced by private consumption.

Exports on the way to recovery

With the onset of the global financial crises, world trade was impacted. This also took a toll on India's exports. Exports from India have been declining YoY for the past 12 months beginning October 2008, which has been arrested in November 2009.

The poor performance of exports over the past year has been arrested with positive growth recorded in November

Exhibit 75: Improving monthly export trend

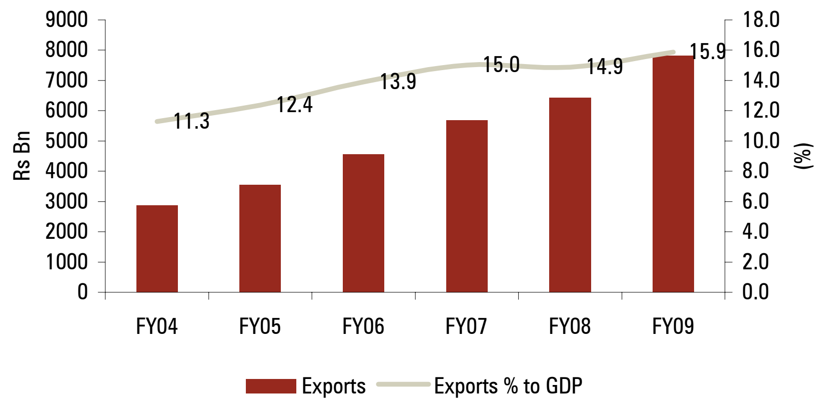


Source: Bloomberg, ICICIdirect.com Research

One of the key reasons for India's relative strength during the global crises compared to larger Asian peers was its low dependence on exports. The country's export percentage to GDP was 16%, which makes its growth highly domestic driven.

India's export as contribution to GDP was 16% in FY09

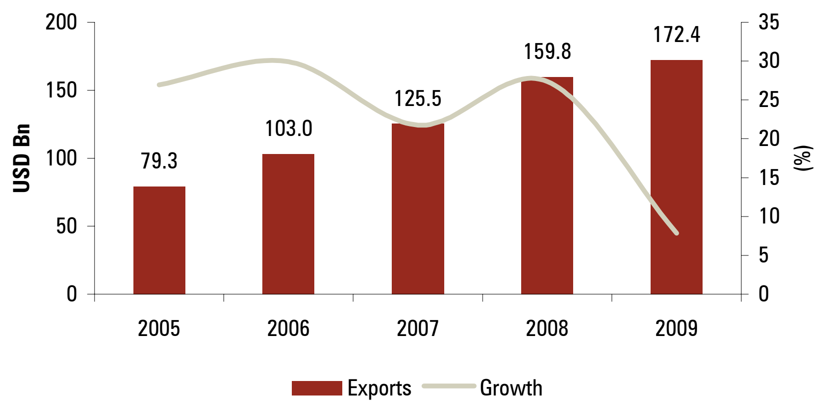
Exhibit 76: Exports contribution to GDP



Source: Bloomberg, ICICIdirect.com Research

Barring the poor performance in FY09, exports have grown over 25% over 2005-08. The government expects exports growth to rebound to 15% in FY11

Exhibit 77: Export growth over the years



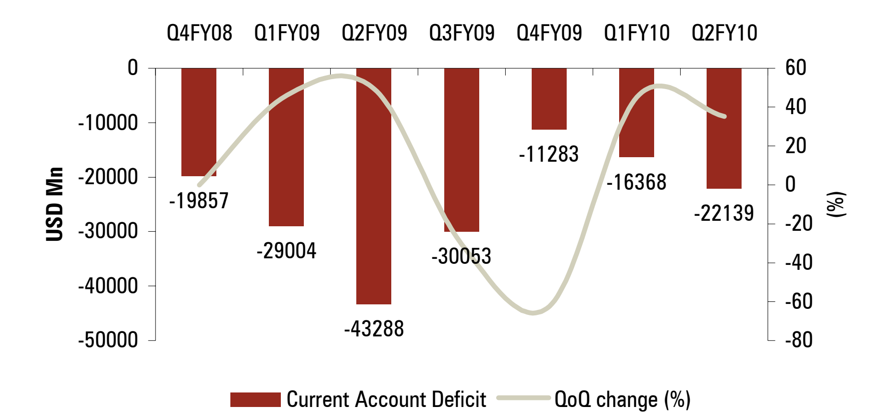
Source: Bloomberg, ICICIdirect.com Research

The slowdown in world trade has had a positive impact on India's current account deficit position

The productive population (15-64 years) is expected to expand from 63% of total population in 2006 to 65% in 2011 and further to 68% in 2026

Excluding the performance in 2009, Indian exports have risen over 25% annually over 2005 to 2008. With the financial meltdown behind us, we believe exports could pick up, going ahead, with the world economy showing early signs of revival. FY10 exports would be impacted due to the poor performance until October 2009. However, the government expects exports to rebound in FY11 and increase by 15% YoY, which could provide a fillip to growth beyond Q1CY10.

Exhibit 78: Current account deficit



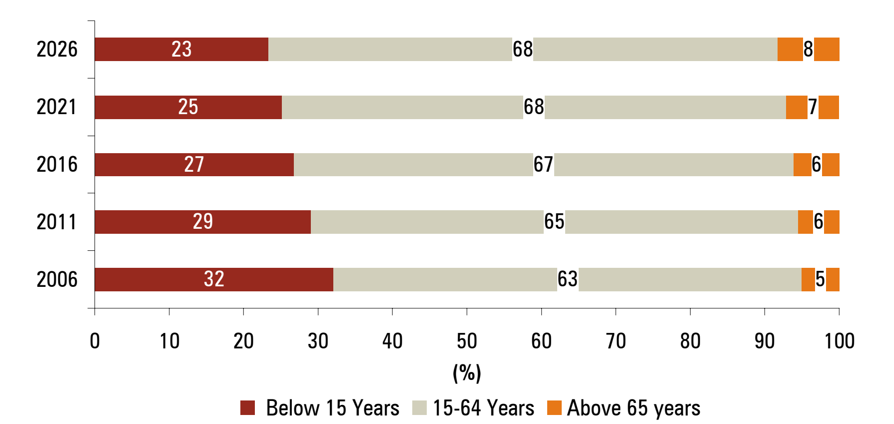
Source: Bloomberg, ICICIdirect.com Research

One of the key positives to emerge out of the slowdown in world trade along with reduction in crude prices was improvement in India's current account deficit position. Although the deficit has increased over the past two quarters the same has seen a fall of 49% on a YoY basis (Q2FY10).

Demographics to support domestic consumption and savings

India's demographics set it apart from other emerging countries. The increasingly productive population would lead to an increase in per capita income. This, in turn, would lead to higher savings and consumption.

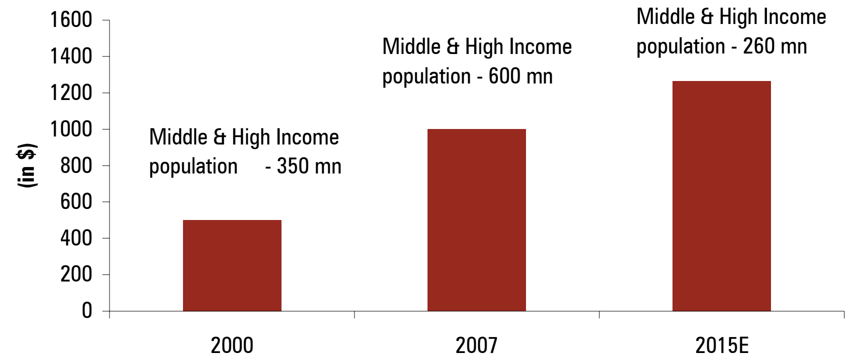
Exhibit 79: Increase in productive population (%)



Source RBI, ICICIdirect.com Research

Increase in per capita income along with growing middle and high income population would boost savings

Exhibit 80: Per capita rise to further boost savings and consumption

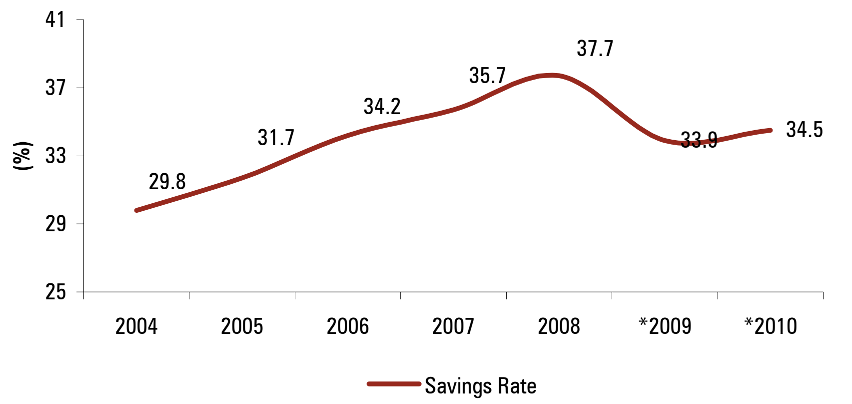


Source: NCAER, ICICIdirect.com Research

NCAER expects the middle class to make up 44% of the population by FY10, which would further drive the household savings rate.

India has seen secular growth in saving rate

Exhibit 81: Savings rate



Source: Bloomberg, ICICIdirect.com Research

The household savings rate has also increased from 22.8% in FY05 to 24.3% in FY09.

The demographic shift of the Indian population concurs well with the GDP growth, which has seen services contribution increase from 55.4% in FY00 to over 62.6% in FY09 and reduction in contribution from the agriculture sector from 25% to 17.5% over the same period.

On the other hand, the high savings rate would aid in capital formation. This, in turn, would help in the future growth of the economy.

Our take on 2010

Year 2010 could turn out to be different from 2009 wherein we would start discounting the strength of the recovery as against discounting recession

Year 2010 could turn out to be different from 2009 wherein we would start discounting the strength of the recovery as against discounting recession, which has been the case till now. Year 2009 saw all asset classes (i.e. equity, gold and other commodities, etc.) performing well on the back of dollar carry trade wherein investors shifted funds out of the greenback and chased growth-linked asset classes. Although it is unlikely that this trend would completely reverse soon, at the same time, it is hard to think the market will just keep rising as in 2009. Hence, we expect some rationing of liquidity to happen as a few economies will need to move sooner than others to rein in their budget deficits. Keeping this in mind, the investor would need to formulate a strategy that allows divergence across asset classes based on merits of an asset class rather than a basket of asset classes.

India has come out well from the global crisis and would now be taken more seriously than just a risky asset class.

We believe emerging markets like India have come out well from the global crisis and would now be taken more seriously than just a risky asset class. Keeping this in mind, we believe the Indian equity market would continue to outperform though there would be a moderation in expectation due to the high base effect.

On sectors, we would avoid sectors that are integrated to global trade and command rich valuations. Metal is one of the best performing sectors but global output getting polarised towards China makes us uncomfortable. Though expensive, IT is neutral for us as it would be the beneficiary of a global economic recovery. We are also sceptical on the shipping sector on fears of capacity addition and fortunes tied to the Chinese economy though they are very attractive from a valuation perspective. High beta and capital sensitive sectors like real estate also look uncomfortable and could face the brunt in case of sector rotation and shrinkage of global liquidity.

We believe domestic and defensive plays like Pharma, FMCG, PSUs and banks would be back on the investor's menu

We believe domestic and defensive plays like pharma, FMCG, PSUs and banks would be back on the investor's menu on the back of domestic led growth and benefits of sector rotations coming in. We also like media and hotels where earnings are yet to catch up with the recovery and valuations have some headroom left.

Besides IT we are neutral on sectors like telecom and oil & gas where the outlook is hazy though valuations are compelling. Oil & gas could prove to be a wild card if the positive regulatory noises start getting louder. Auto is neutral for us on the back of rich valuations despite an impressive outlook

We believe 2010 would turn out to be a stock picker's delight wherein midcaps would outperform large caps. Midcaps are still trading at around 30% discount to large caps

We believe 2010 would turn out to be a stock picker's delight wherein midcaps would outperform large caps as they have a lot of ground to catch up in terms of earnings and valuation multiples. Midcaps are still trading at around 30% discount to large caps while small cap's exposure should be based on risk appetite and fundamentals attached to the company.
Gold should only be a smaller portion of the overall portfolio as it provides a good balance to the portfolio during economic uncertainty. However, over a longer time period higher allocation may dent the overall portfolio return.

Therefore, prudent asset allocation between large caps and midcaps along with some exposure to gold may provide optimal portfolio balance.

We believe 2010 would offer investors a decent investment opportunity though not of the same magnitude

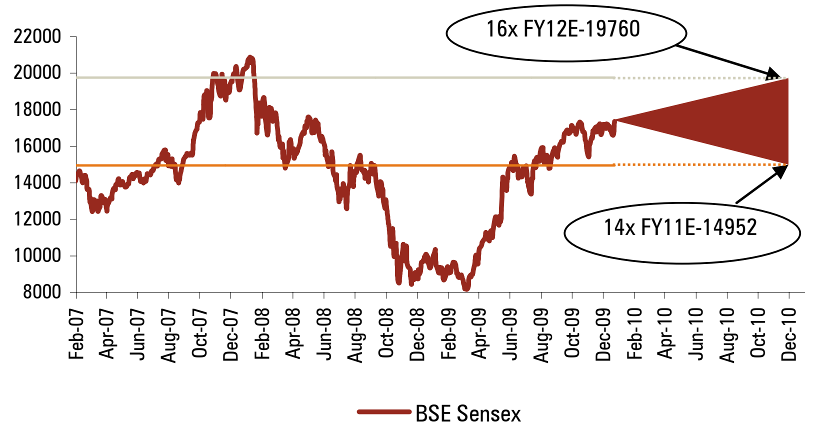
We believe the market would deliver returns to the tune of 10-15% from current levels in line with earnings growth

Would markets rally from hereon?

Year 2009, with a return of 79% coupled with rich market multiples of 17x FY10E EPS of 1048, is by no means an encouraging sign for an investor who had been waiting on the sidelines to jump into the market. A significant contributor to the market's outperformance was attributed to foreign inflows and relative resilience of the Indian economy on a global canvas.

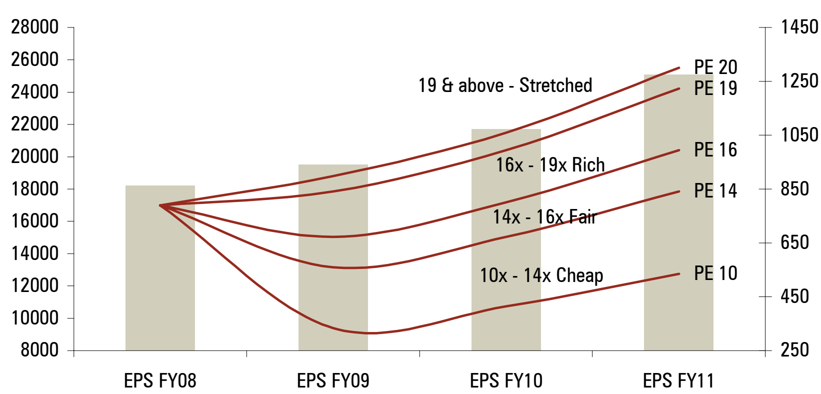
Year 2010 would definitely be different wherein an investor needs to undertake thorough homework before placing investment bets. We believe 2010 would offer investors a decent investment opportunity though not of the same magnitude and within the same segment as witnessed in 2009. India, according to us, would continue to be there on the global investor's menu on the back of inherent economic strength compared to its global peers. However, at the same time, we expect the driver of this uptrend to change. Consequently, investors also need to align their portfolios. We believe the market would deliver returns to the tune of 10-15% from current levels in line with earnings growth as markets have recouped most of the losses due to the financial crisis. We expect India to get its fair share of fund inflows in 2010 coupled with cushions from domestic institutions, which along with a strong macro ecosystem would lead to relative outperformance within emerging as well as developed counterparts.

Exhibit 82: BSE Sensex - expected December 2010 level



Source: Bloomberg, ICICIdirect.com Research

Exhibit 83: Valuation matrix



Source: Bloomberg, ICICIdirect.com Research

Valuations – rich but not uncomfortable

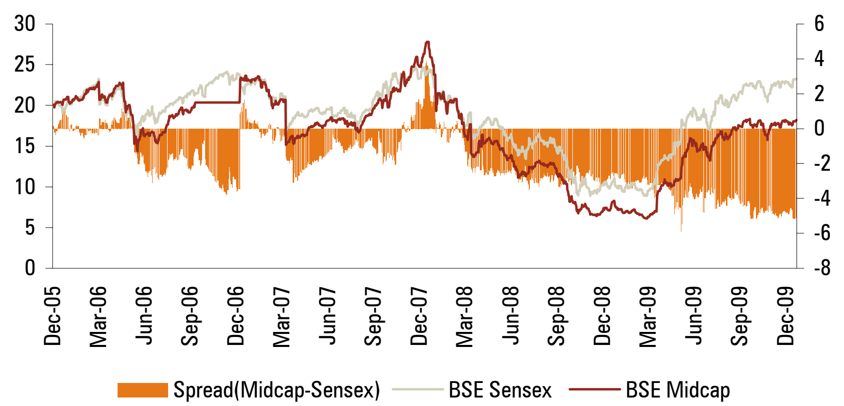
Indian markets in March 2009 were at a three-year low of 8160 and were trading at lower than 10x their trailing P/E multiples, which was last seen in March 2003, a discount of more than 40% to its long-term average of 16-17x. Markets at 17400 levels are valued at 16.3x FY11E Sensex EPS of Rs 1068.

We estimate the Sensex fair value at 19760 (16x FY12 EPS of Rs 1235, 14% upside). Valuation spread between large caps and midcaps to narrow down as it has widened (23x large Caps- 18x midcaps)

We expect the Sensex to be in line with EPS growth of 14.0% in FY11E and 15% in FY12E to Rs 1068 and Rs 1235, respectively. Accordingly, we estimate the Sensex fair value at 19760 (16x FY12 EPS of Rs 1235, 14% upside). In the event of impairment in the global or domestic outlook, wherein valuation multiples contract and earnings outlook is ignored, we expect the Sensex to trade at 14952 (14x FY11 EPS of Rs 1068). We expect the valuation spread between large caps and midcaps to narrow down as it has widened (23x large Caps- 18x midcaps). This would provide good cherry picking opportunities for an investor in 2010.

We suggest cherry picking in the midcap segment, which offers more value relative to the Sensex companies

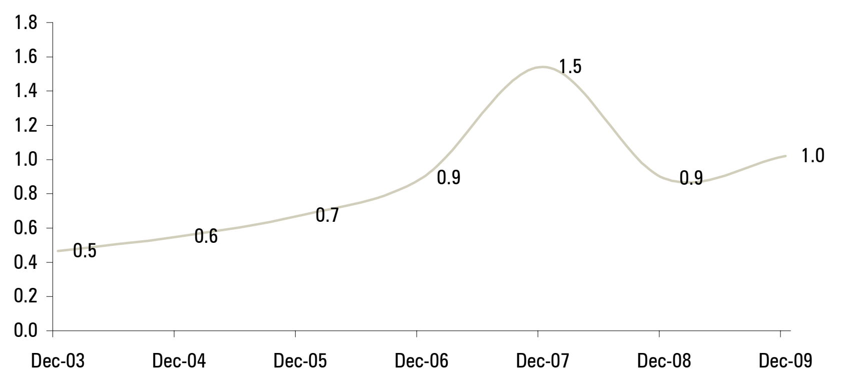
Exhibit 84: P/E ratio – Sensex V/s Midcap Index



Source: Bloomberg,, ICICIdirect.com Research

Market cap to GDP at 1.05x on a higher band of the historical average but not higher as compared to global peers

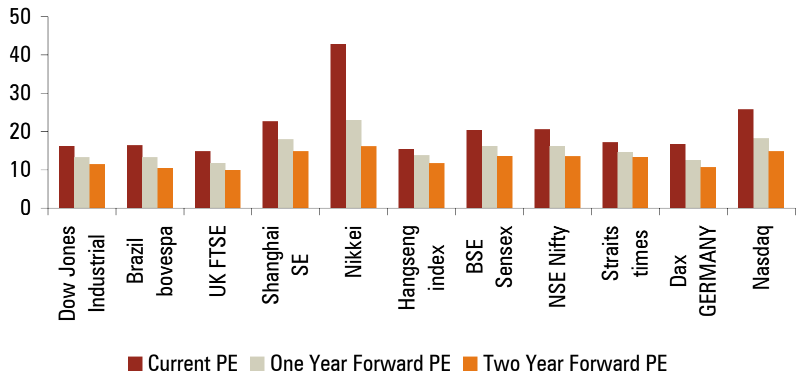
Exhibit 85: Market cap to GDP



Source: Bloomberg, ICICIdirect.com Research

On a P/E basis, India is commanding rich multiples, but higher earnings growth along with visibility of earnings may continue to support higher valuations

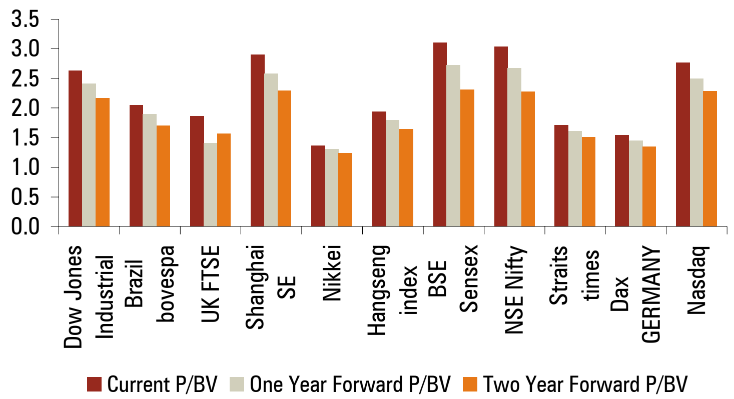
Exhibit 86: Global comparison



Source: Bloomberg, ICICIdirect.com Research

Price to book valuation multiple also suggests valuation at the higher band

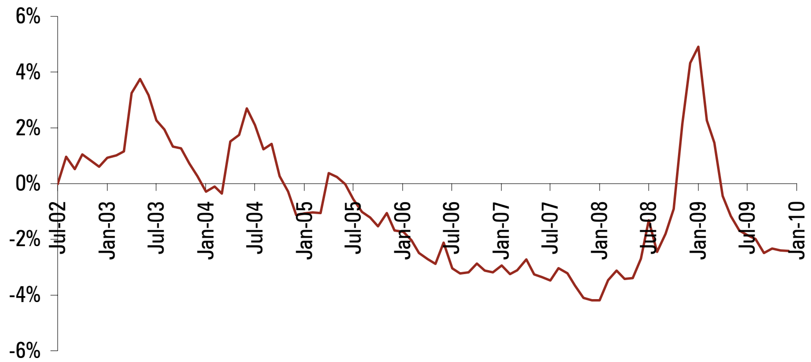
Exhibit 87: Price to book



Source: Bloomberg, ICICIdirect.com Research

The earnings yield gap at -2.41 is at low levels indicating higher equity valuation in anticipation of higher earnings growth. The same may continue as had happened from 2006-2008 when earnings upgrade supported valuations

Exhibit 88: Sensex vs. G-Sec yield



Source: Bloomberg,, ICICIdirect.com Research

Sectoral Outlook

The markets have been very volatile in the last year. Some of the top performing sectors are no longer the favourites, while others are starting to pick up and might be the best bet for 2010.

Automobile and auto ancillaries — Neutral

Top pick:
Bajaj Auto

New launches, easy finance and lower interest rates would keep vehicle demand buoyant in the near term. The excellent performance in November is fuelling a positive outlook for the sector. The likely rise in excise duty and Street expectation of a rise in interest rates, hereafter, would result into a preponing of buying. This would further support robust sales. Rising steel and rubber prices would pressurise EBITDA margins and eventually cost pressure would be passed on by rising prices. Tata Motors and Ashok Leyland have increased commercial vehicle (CV) prices in October and a price hike on passenger cars is very much on the cards. The two wheeler market is looking buoyant. This is on account of new launches and tax benefit enjoyed by them for their facilities in Uttarakhand and Hardwar plants that would cushion the impact of rising raw material prices. Rising industrial production would support CV demand.

Banking — Positive

Top picks:
OBC, UBI, HDFC Bank, IDFC

Last year, the profits of Indian banks have been impacted by strong movement on either side in G-Secs ranging between 5% and 8%. However, core credit growth failed to pick up falling from 18% levels initially to 10.5% now. We believe the coming year will see a faster up tick in credit offtake with FY10 closing with 15-16% YoY growth. FY11E credit growth should be in the 20-22% range. Along with the rising interest rate scenario this will lead to strong NII growth and asset based plus third-party fee income growing over 20% too. We believe larger CRR hikes of over 150 bps will again start having a material impact on NIMs. Therefore, we anticipate that for the first quarter of CY10 banks, particularly large PSU banks, should underperform due to rate hike pressures. However, later with growth on-track the overall banking sector should give better than index returns.

Cement — Negative

Top picks:
Orient Paper, JK Lakshmi Cement

With ~24 MTPA of capacity addition across all regions in YTD 09, all-India average cement prices have declined by ~11% during the same period. In the southern region, cement prices have corrected over 40% in YTD 09 on account of ~35% of capacity being addition in the southern region. Moreover, with more capacity additions expected, ~65 MTPA during FY09-11 across all regions, we believe it will pull down the capacity utilisation rates and put further pressure on pricing. We expect the all-India utilisation rate to drop to ~78% in FY11E from the YTD FY10 rate of 85%. We prefer northern and central region players on account of better pricing outlook compared to other regions. These regions have been enjoying firm pricing on the back of continuous strong consumption growth, driven by infrastructure spending by the government and demand from rural and semi-urban housing. On the cost front, we expect cost pressure for companies to be visible by the end of FY10.

Construction Positive

After seeing a stable government in place post elections and infrastructure being the focus area for the government, order inflow for construction companies is expected to remain healthy in the next year. For instance, in the road segment alone, National Highway Authority of India (NHAI) is looking to award ~12600 km road projects aggregating ~Rs 96,000 crore over the next year. Additionally, softening commodity prices such as steel and cement (being far below peak level) support the stable EBITDA margin for construction companies in the next year. Based on these factors, we expect midcap construction company's net profit to grow 20-35% in FY11.

FMCG Positive

Top picks:
Dabur India, ITC

Buoyed by firm rural demand led by government spending the FMCG sector would continue to register robust volume growth. However, rising input costs would induce margin pressure in the near term. Hence, we maintain a positive view on the sector in spite of its sustained growth momentum. With continued inflationary pressures showing no signs of abating in the near term, FMCG companies are under pressure to raise prices or reduce quantities in order to offset the rise in prices of key inputs. Although companies will engage in grammage reductions in order to maintain price points any considerable rise in raw material prices will adversely affect volumes and margins.

Hospital Positive

Top picks:
Apollo Hospital

The hospital sector in India is rated favourable, in the face of high and stable demand growth, limited supply of beds and strong entry barriers (due to the high capital intensity). This growth will be propelled by several factors like change in demographics, improvement in health awareness and rising incomes, change in disease profiles, rising penetration of health insurance, increasing opportunities from medical tourism, etc. India, at present, has about 0.9 hospital beds per 1000 population as against the global a benchmark of 3-3.5 beds per 1,000 population indicating a huge shortage of healthcare infrastructure in India. To meet the projected demand and to maintain the ratio of beds to potential demand, India will need around Rs 1,65,400 crore in investment over the next decade. Hence, our view on the hospital sector continues to remain positive for 2010.

Hotel Positive

Top picks:
Indian Hotels, Royal Orchid Hotels

Improving GDP outlook, rise in confidence in the country's economic prospects and the "Incredible India" campaign have improved the outlook for the Indian hotel Industry, which is also lagging far behind Asian peers like China and Singapore in terms of room availability. This positive outlook would increase tourist arrivals in the country and the hotel industry is expected to be the major beneficiary. Even domestic tourism is gaining momentum. According to the latest WTTC report, India is second after China in terms of future travel & tourism (T&T) demand growth, which is expected to grow by 8.2% annually over the next 10 years. Hence, our view on the hotel sector remains positive for 2010.

Information Technology — Neutral

Top picks:
Patni Computers, TCS

CY09 saw the IT sector outperform the BSE Sensex (129% return vs. 79%) on the back of the revival of the global economy especially the American economy (the primary market for Indian IT exports). The fortunes of IT companies have seen huge improvements from Q4FY09 to Q2FY10. During the said period companies not only witnessed improving sales growth but also expansion in margins, which came in as a positive surprise. Consolidation in the BFSI segment and vendor rationalisation exercise undertaken by global firms led to demand growth for large Indian IT firms. Increase in hiring targets along with wage hikes announced by companies gave a clear signal for improved growth, going ahead. This led to a re-rating of IT stocks resulting in peak valuations for IT majors. Given the uncertain currency movement we believe forex volatility will pose one of the biggest risks to IT firms. Going forward, stock performance would be determined by earnings upgrades rather than valuation upgrades. Hence, we rate the sector as Neutral.

Logistics — Positive

Top picks:
Container Corporation of India

After 12 consecutive months of negative growth, exports have registered a 3% growth in October 2009. Container volumes for November grew 15.2% YoY and 1.5% MoM. Volumes at the 12 major Indian ports have also shown positive YoY growth for the last four successive months, with November 2009 volumes the highest since March 2008, reflecting recovery in Exim and domestic demand. We see an improvement in transportation infrastructure and GST reforms supporting growth for the sector. Viewing the stability in port volumes we believe the recently built growth trajectory will continue in the coming year. We expect growth in container volumes to remain high over the next six months (helped by the base effect), providing an improved utilisation and pricing environment for rail container haulage companies Container Corporation and Gateway Distriparks.

Media — Positive

Top picks:
UTV Software, Deccan Chronicle

Weighed down by high cost inventory and low advertisement growth in most of CY09, the print media sector is expected to rebound in CY10, aided by stabilising newsprint prices and higher advertisement revenue growth. In the broadcasting space, advertisement revenue has started to pick up and would help companies to post relatively better growth in CY10 compared to CY09. Also, print and broadcasting companies are expected to focus on augmenting subscription revenue. Regional players are expected to continue their outperformance vis-à-vis the national counterparts. Multiplex companies would fare better in CY10, with a robust movie pipeline, IPL coming to theatres and rising occupancy levels.

Metals and Mining — Negative

Top picks:
Visa Steel

The metals sector is unlikely to repeat its tremendous CY09 performance on concerns over rich valuations and output getting polarised towards China. We expect India's demand growth for most base metals and steel to be in double digits in CY10 and CY11 on the back of robust infrastructure spending, though margins could remain under pressure due to expected upward revision of 10-30% in contract prices for CY10 of major raw materials. We expect product prices across base metals and steel to remain firm on the back of robust input prices and sustained demand recovery globally. However, any demand erosion in China would create price volatility due to possible fears of overcapacity. With most stocks in the metals & mining space trading at rich forward valuations, upside potential seems to be limited as earnings upgrades remain doubtful due to possible margin compression. We remain neutral on the sector as a whole.

Oil and Gas — Neutral

Top picks:
Shiv-Vani Oil, ONGC

The oil & gas sector reported a lacklustre performance last year on account of recession in major global economies. The performance has now improved from the lows seen in H2FY09. However, it continues to remain below the previous highs. Refining margins are expected to remain under pressure at the current levels in the coming year on account of new capacities being added in the Middle East and Asian countries. However, regulatory reforms on petroleum products pricing may lead to a re-rating of oil marketing companies (OMCs). The revival in the global economy and increase in crude oil prices will result in an improved performance of oil exploration and production companies. Gas utilities are also expected to show good earnings growth on the back of increased domestic gas supply volumes from Reliance and Petronet LNG.

Pharmaceuticals — Positive

Top picks:
Ipca Laboratories, Glenmark Pharma, Lupin, Dishman Pharma

Higher competition in regulated markets and increased patent expiries have led MNC pharma to look towards emerging markets like India. The reason for the shift is attractiveness of the Indian market, which is branded in nature. The Indian market will likely log immense growth on improvement in affordability, contagious diseases spreading fast due to dense population and climatic condition, varied diseases and rise in health insurance coverage. Patent expiries also throw open a large market. Indian pharma has emerged as a significant player in the global generics space with highest number of USFDA approved plant in India after US. With Indian companies getting the USFDA nod for product launches, there is improved visibility on timelines of generic launches under exclusivity of blockbusters such as Nexium (~US$6 billion), Lipitor (~US$13 billion), Flomax (~US$2 billion), etc. A recovery in the global economy, pressure on research productivity, intense competition and fast patent expiries will carve new business opportunities for Indian CRAMS players due to its low cost structure.

Power — Positive

Top picks:
GVK Power and Infra, NHPC

Demand outlook for the power sector continues to remain robust. After witnessing a demand CAGR of 6.7% from FY04-FY09, demand has grown over the past eight months to 7.4% till November 2009. Till November 2009, India has achieved only ~30% of the (78,700 MW) targeted capacity addition in the Eleventh Five Year Plan. We believe the supply situation has witnessed an improvement due to the increased availability of gas. On the other hand, a weak monsoon has contributed to supply woes. We expect a capacity addition of 15,000 MW over the coming 15 months and a better monsoon situation to improve the supply scenario further. Average rates of merchant power are expected to stabilise between Rs 4-6 during the coming year based on the demand-supply situation. We remain upbeat on the sector and although fresh issuances in the power sector have received a tepid response, we believe better pricing of prospective issues will attract significant interest and secondary markets will continue to bolster growth within the sector.

Real Estate — Neutral

Top picks:
Indiabulls Real Estate, Mahinda Life Space.

After seeing the challenging year in CY08, the real estate players showed the sign of improvement in CY09 on account of the recovery witnessed in the residential segment, benign interest rate scenario & improvement in the solvency ratio through QIP issue (raised ~Rs14000 crore since April,2009) due to increased liquidity in the system. Going forward, post de-leveraging balance sheet exercise in CY09, we believe the focus of the real estate developers would now again shift on the growth trajectory through execution and completion of the projects. Furthermore, the street could also see Net Asset Value upgrades of the real estate players on account of anticipated recovery in commercial space following the improvement in the corporate earnings. Nonetheless, the performance of the real estate sector, being capital intensive in nature, could see hindrance in CY10 on account of rising inflation and tightening monetary policies.

Retail — Positive

Top picks:
Pantaloon Retail

With the improving growth rate of the Indian economy, the retail sector is well poised to leverage on the favourable demographic profile of the country. The organised retail sector is expected to grow at a CAGR of 25% over 2008-2018 with penetration levels rising to 22.5% by 2018 from the current 4.4%. During the last year of slowdown, value retail performed better than lifestyle retail as consumers shifted their focus on necessities with good bargain. This year though value retail would be the fastest growing vertical, lifestyle is also expected to gain traction. After consolidation in 2009, retailers are now on an expansion mode with capex worth more than Rs 1000 crore lined up this year. We prefer retailers with a balanced mix of both verticals along with strong backend support like supply chain and technology.

Shipping — Negative

Top picks:
Aban Offshore, Bharati Shipyard, GE Shipping

Dry bulk freight rates are expected to remain range bound for a major part of 2010. Freight rate movements would remain dependent on demand for iron ore and coal by China but new build vessels joining the fleet would cap any rise in freight rates. Tanker rates would firm up further, especially for Aframax tankers, due to rise in heating oil shipments in winter months. However, significant upside trigger for tanker rates can be expected only if Opec increases its production in FY10. Product tanker rates are expected to gradually recover as US inventory levels of gasoline and refined petroleum products come down while LPG rates are expected to be stable for 2010. Oil exploration & drilling activities are expected to increase with rise in exploratory spending as crude oil prices have consistently stayed above $60/barrel. Thus, the offshore vessel utilisation levels & rates are expected to improve resulting in better outlook for offshore companies. We believe these would be the best performers among shipping companies in 2010.

Sugar — Positive

Top picks:
Renuka Sugar, Dhampur Sugar, Balrampur Chini

Although sugar production is expected to be higher this year at 16.0 million tonnes (MT) as compared with 14.7 MT last year, we continue to remain positive on the sector as India still needs to import around 3-4 MT in order to meet consumption demand in 2010. Concurrently, excessive rainfall spawned by the El Nino effect will lead to lower-than-anticipated production of sugar in Brazil at 34.6 MT. This has propelled a substantial rise in global and domestic sugar prices to US$680 per tonne and Rs 33.0 per kg, respectively. With consumption continuing to remain robust, we expect sugar prices to maintain their upward trend in the near term (six to eight months) and the industry to reap windfall profits.

Tea — Positive

Top picks:
McLeod Russel, Jayshree Tea

The robust demand for tea, sluggish domestic production and a simultaneous rise in tea prices has significantly altered the fundamentals of the tea industry. The precipitous decline in tea auction prices during the 2001-2005 period had adversely affected tea plantation activity in India. This led to a progressive decline in carry-over stocks and induced a mismatch between tea production and supply. Given the lengthy gestation period of a tea plant and negligible area additions under tea during 2000-07, we expect production to stagnate, going forward. Apart from this, unfavourable weather conditions hampering the production of tea in major tea exporting countries (Kenya and Sri Lanka) and global demand for tea steadily growing have led to global tea auction prices witnessing a noteworthy rise. Subsequently, we believe higher margins aided by remunerative tea prices will enhance profitability.

Telecom — Neutral

Top picks:
Bharti Airtel

The telecom industry is in a state of over capacity, wherein tariffs have fallen to unacceptably low levels. The price war is expected to intensify in the coming quarters as new players launch services. The industry would remain under pressure, with dwindling key performance indicators, slow revenue growth and declining profitability. However, in the second half of CY10, we expect to see some consolidation in the industry followed by tariffs returning to sustainable levels. Overall, the industry is expected to post flattish revenue growth in the next fiscal. We recommend a selective play with preference for companies with a pan-India presence, strong balance sheet and operational excellence to weather the current storm.

Textiles — Neutral

Top picks:
Alok Industries, Raymond

With world GDP expected to increase by 2.3% in 2010, the demand for discretionary products like clothing is also expected to gain traction. The performance of Indian textiles exports is improving. It grew at 8% in November, albeit due to lower base of last year. Vendor consolidation has been a major activity for retailers worldwide this year. This can be seen from the US textile and clothing imports data wherein China (despite large base) managed to improve its share in total imports by 4.2% to 39.2% in January –October 2009. We expect the demand in the US to revive further due to the improving economic scenario and positive flow of data from the nation. We prefer companies with integrated operations from spinning to garment manufacturing/retailing and having large capacities as they will be in a better position to ride the raw material and demand volatility.

Top Picks for 2010

The following stocks are ICICIdirect top picks. These, we believe would outperform the broader market, which is expected to generate a return of 15% in 2010.

1. Bajaj Auto

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
BAAUTO	1762	24595

The company's plan to exit from the low volume, low margin scooter business and focus on high value, high margin Pulsar/Discover portfolio will enrich EBITDA margins and bottom line.

2. Bharti Airtel

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
BHATE	329	121844

Bharti Airtel is one of the lowest cost producers of a minute in the world. With the highest share in the subscriber and revenue market, positive free cash flow, strong balance sheet and well diversified business, the company is best positioned among its peers to face the challenges the sector is facing.

3. Deccan Chronicle

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
DECCHR	164	4145

Deccan Chronicle has a diversified portfolio with a presence in print, retail and sports. It is the largest read newspaper in Southern India. Its sporting venture has also contributed positively to the bottomline. The company would further consolidate its position in newly launched markets in the print segment. Being the winner last season, it is expected to generate higher sponsorship revenue in IPL season 3.

4. Dish TV

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
DISHTV	43	3913

Dish TV is the market leader in the DTH industry with a total subscriber base of 6.3 million and market share of ~37%. It has been adding the highest subscribers in the industry and has also turned EBITDA positive in Q4FY09. With recent cost control measures and sustained subscriber growth the company is expected to outperform in the year ahead.

5. GVK Power

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
GVKPOW	47	7509

GVK Power & Infra has started gaining momentum in all operational verticals (power, airports and road). GVK has witnessed a 4.5 fold growth in the overall topline led by commissioning of two plants over the last financial year. The aviation segment is continuing to witness heightened activity along with volume growth in the road segment, which will drive the operational performance.

6. IDFC

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
IDFC	154	20322

We expect IDFC to grow its balance sheet by 15-17%. PAT is pegged to grow at 19% CAGR to Rs 1103.8 crore over FY09-FY11E. We expect the loan book to grow at 18% CAGR over FY09-FY11E as the infrastructure space needs huge funding and IDFC has the leverage and CAR to capture the growth. As leverage increases, we expect ROEs to pick up and reach 15-16% over FY09-FY11E.

7. Indian Hotels

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
INDHOT	102	6974

With an improvement in occupancy levels backed by revival in the economy, we expect occupancy levels to rise from 57% in 2009 to 64% in 2010E. IHCL being the largest player in the industry is well poised to benefit from this through its geographical spread and long-term expansion strategy. Hence, we continue to remain positive on the company.

8. Ipca Laboratories

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
IPCLAB	1049	2575

Ipca's recent long-term export supply contract for two APIs is expected to contribute substantially during FY10. With traction in ANDA filing for the USFDA, the Ipca management has revised FY10E US revenue guidance to Rs 55 crore from Rs 45 crore. We expect Ipca to grow at a CAGR of ~16% on topline and ~51% on bottomline through FY11E.

9. Jayshree Tea

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
JAYTEA	336	378

Jayshree Tea with over 21 tea estates across North and South India has been able to increase its volume from 18.2 million kg in FY08 to 21.5 million kg in FY09, post the acquisition of Jayantika Tea in 2008. With tea prices expected to remain firm due to demand-supply mismatch, the company would witness a significant rise in tea price realisations, thereby augmenting EBITDA margins.

10. Lupin

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
LUPIN	1490	13020

Extensive US business, strong foothold in the growing domestic market, thriving Japanese business and strong API business are key pillars of Lupin's business model. We believe, after the recent acquisition of Antara, Lupin's US branded business would reach ~US$125 million in FY10E. We expect Lupin to grow at a CAGR of ~23% on topline to Rs 7062 crore and ~24% on net profit to Rs 1003 crore over FY09-12E.

11. NHPC

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
NHPC	34	42068

NHPC, the largest hydropower generator in India, has an operational capacity of 5,175 MW as of June 2009. Another 4,292 MW of capacity is under construction. The plants are scheduled to become operational by 2013. Implementation of the new tariff policy along with the expansion potential will drive the long-term performance. Untapped hydropower potential in India stands at ~110 GW.

12. Patni Computers

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
PATCOM	485	6104

We believe the stock is worth investing in because the company has recently gone through a metamorphosis from a family run business to a professionally managed company. This has resulted in significant broad-based improvement in operational parameters like utilisation, revenue mix and margin performance. We expect the company's revenue to grow at

11.6% CAGR over next three years. Cash worth US$379 million on books would limit the downside and also aid in inorganic growth.

13. Shree Renuka Sugar

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
RENSUG	222	6924

Shree Renuka Sugars (SRSL) is well poised to benefit from firm sugar prices. Given the rise in sugar prices, the company's foray into Brazil and the large quantity of raw sugar imported, we expect SRSL to witness a significant rise in volumes and realisations. This, in turn, would boost earnings for the company in SY10.

14. Union Bank

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
UNIBAN	264	13524

The bank is still available at 1.1x FY11E ABV of Rs 230 with consistent ROEs of 18-20%. The PAT is expected to grow at 16% CAGR over FY09-11E to Rs 2308 crore. We believe the bank has a strong management and clean asset books of 0.3% NNPA (high NPA provisions) provides reasonable cushion during economic downturns.

15. UTV Software

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
UTVSOF	484	1657

UTV Software is expected to outperform its peers in FY10, primarily on the back of the launch of its three new indigenously developed console games (IP). This would provide a boost to the otherwise ordinary revenue growth. Contribution to total revenue from the interactive segment is expected to increase from 25% currently to ~36%. The company is expected to post a CAGR (FY09-11E) revenue growth of 45.3%.

16. Visa Steel

Idirect Code	CMP (Rs)	Market Cap (Rs cr)
VISST	39	392

Visa Steel is all set to see a structural shift with its 0.5 MT bar and wire rod facility coming on stream in Q4FY11E. This will enable the company to cater to the value-added steel product segment. Along with this, strong outlook for met coke and captive power make it a value play for 2010.

Annexure

Central government – Budget estimates for FY09-10

Exhibit 89: Central government - budget estimates for FY09-10

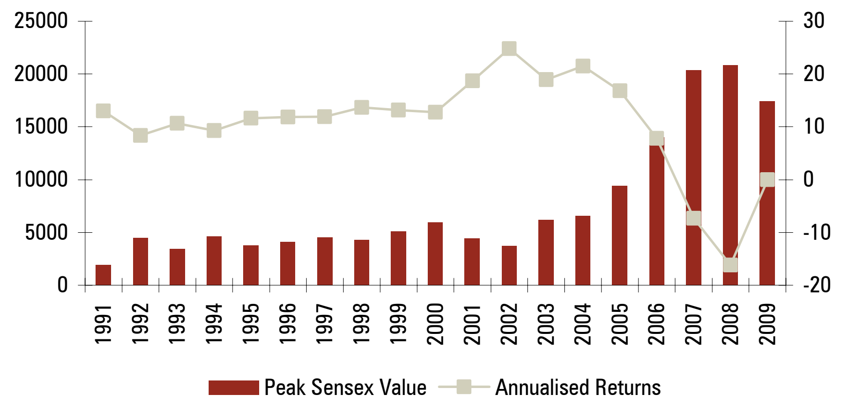
	Budget Estimate 2009-10	Actual April-September 2008-09	Actual April-September 2009-10
Revenue Receipt	**614497**	**244898**	**244471**
Gross tax revenue	641079	280141	258880
Tax (Net to centre)	474218	202247	185669
Non-tax	140279	42651	58802
Capital Receipt	**406341**	**104183**	**204377**
Recovery of loans	4225	1486	2302
Other receipts	1120	43	4300
Borrowings and other liability	400996	102654	197775
Total receipts	**1020838**	**349081**	**448848**
Non plan expenditure	**695689**	**240629**	**322070**
revenue acount	**618834**	229484	301291
Interest Payment	225511	86061	86669
major subsidies	105579	54916	66013
pension	34980	12247	21271
capital account	**76855**	**11145**	**20779**
Plan expenditure	**325149**	**108452**	**110024**
Revenue account	278398	93727	108163
Capital account	46751	14725	1861
Total expenditure	**1020838**	**349081**	**448848**
revenue expenditure	897232	323211	409454
capital expenditure	123606	25870	39394
Revenue Deficit	**282735**	**78313**	**164983**
Fiscal Deficit	**400996**	**102654**	**197775**
Primary Deficit	**175485**	**16593**	**111106**

Source: Ministry of Finance, ICICIdirect.com Research

Testimony for staying invested in equities…

The following chart reflects the annualised return as on December 31 2009 on investment made at peak level during that calendar year. Returns over the three-year period are more than 10% annualised even if investment is made at the peak levels during any calendar year. This testifies that longer term investment in equities at any levels reap rich gains.

Exhibit 90: Sensex annualised returns at peak level



Source: Bloomberg, ICICIdirect.com Research

The decade that was

Emerging markets like India in the last decade have been able to carve a niche for themselves in the global investing arena while the scenario is sombre for the developed counterparts. India have been rewarded and regarded well for standing tall in testing times of global meltdown and other major crisis, which had eclipsed the developed world. India was one of the shining stars in the global equity canvas as it delivered an annualised return of 12.8% in the last decade compared to 7.6% for the MSCI emerging market index and -2.9% for MSCI US index. However, the journey towards the same has had its share of impediments in the form of a market scam, credit boom & bust and terrorism hogging the minds of investors.

Exhibit 91: BSE Sensex over the last decade…

Source: BSE, ICICIdirect.com Research

2009 flashback

While 2008 saw the dreams of an average equity investor worldwide getting jeopardised, 2009 has brought back smiles. Our 2009 strategy report said, "In technical analysis, both time and price forecasts must be achieved. Accordingly, in 2008, we have already achieved price wise correction to the tune of 64%. However, time wise correction should get over by February-March 2009. By then it would have consumed 13-14 months."

The Sensex eventually bottomed out in March 2009 amid extreme pessimism and started an upward leg, which saw the 2008 fall getting retraced by as much as 80% to the levels last seen in May 2008. The question that now remains is where are the markets headed? We discuss below some technical studies, which may help us in formulating our 2010strategy.

Eight year time cycle

The Sensex has been following a classic eight year cycle since 1984. As shown on the chart below, 1984 was the beginning of the eight-year long Bull Run till 1992. The next important turning points occurred exactly eight years thereafter, in 1992 and 2000. Both these turning points coincided with the two biggest stock market scams we had and, consequently, the leaders of the rally during these turning points had an extremely difficult time later. For example, ACC, the leading stock of the 1992 bull market, remained below its highs till the end of 2004. Similarly, the IT stocks, which were leaders of the 2000 rally, lost as much as 90% of their top valuations by 2003. Most are below their top levels even today (barring Infosys). The bear market of 2008 saw the BSE Realty index losing over 90% of its top valuations and so far the index has recovered only 28% of the losses, thereby clearly indicating huge under performance compared to the broader markets.

An important and striking fact about this eight year cycle is the similarity of both time and price wise correction, which has happened. In the previous eight-year cycle top during 1992-93, the Sensex lost 56% from 4546 to 1980. In the next cycle top, the cut was almost 58% from 6150 in 2000 to 2594 in 2001. Time wise, the 1992 cycle completed the bear phase in 12-16 months, while the 2000 cycle took 19 months to hit the low, which was then followed by 19 months of base formation before the bull phase resumed again. Remember, in technical analysis, both time and price forecasts must be achieved. Accordingly, in 2008, we saw the price lows being achieved during October 2008 whereas time wise correction got over during March 2009 in approximately 13 months.

Exhibit 92: Price wise time correction

Period	Peak levels	Bottom levels	Correction	
			Price wise (%)	Time wise
1992-93	4546	1980	56	12-16 mth
2000-01	6150	2594	58	19 mth
2008-09	21266	7697	64	Feb-Mar 09 (13-14 mth)

Source: BSE, ICICIdirect.com Research

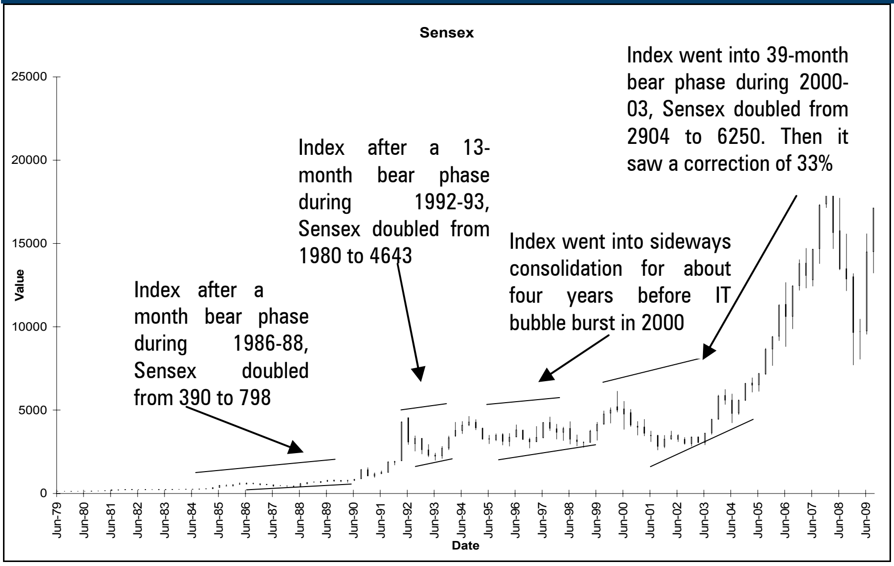
Exhibit 93: Eight year cycle

Source: BSE, ICICIdirect.com Research

Larger consolidation likely to continue in 2010

The current rally in the markets is considered an upward leg of the larger consolidation pattern. The Sensex usually corrects after doubling from important bottoms. Ratio of 200% can be seen even for all the first rallies coming out of previous bear phases (Refer chart below).

Exhibit 94: Consolidation



Source: BSE, ICICIdirect.com Research

- After a 24-month bear phase during 1986-88, the Sensex doubled from 390 to 798 and went into sideways consolidation for about a year before moving further up
- After a 13-month bear phase during 1992-93, the Sensex doubled from 1980 to 4643 and went into sideways consolidation for about four years before the IT bubble happened in 2000
- After a 39-month bear phase during 2000-03, the Sensex doubled from 2904 to 6250 and saw a quick 33% cut before resuming the bull phase further

Taking cues from historical evidences, our preferred scenario remains that the Sensex may consolidate in the range of 19000–13500 levels for 2010.

Technical Outlook for 2010

For 2010, we expect the Sensex to oscillate in the range of 19000 on the higher side and 14800 on the lower side. Also, we do not expect the market to surpass the previous high of 21206 as it is likely to remain within a larger consolidation pattern according to the eight year cycle and not part of the next Bull Run, which we would expect to resume in 2011.

The current bullish structure would be negated only if the Sensex breaks below 14,800 levels, which is the 61.8% retracement of the rally, post election results till October 2009 highs of 17,493. Hence, we consider 14800 to be the major trend decider for the markets, going forward. In the event of 14800 levels being broken, we do not expect the markets to breach the support of 12300, the levels prior to the results of General Election 2009. The levels of 12300 are also the 50% retracement of the entire rally post March 2009 lows.

Exhibit 95: Support and resistance levels

Source: BSE, ICICIdirect.com Research

Expectation vs. Achievement

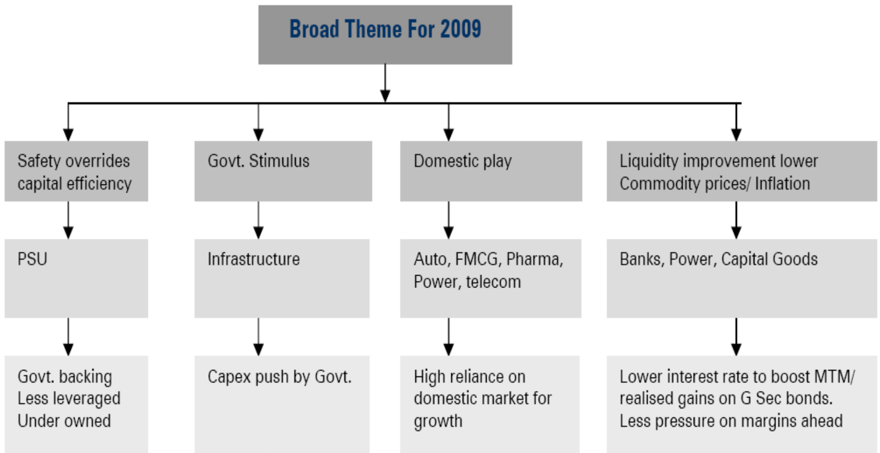
In our last year end strategy report Titled: **"2008: Wealth Erosion: Too fast too furious"** (dated: December 29, 2009) the broader indices were ruling at 9000 levels. At that point in time we were of the view that markets were hugely oversold on the back of mayhem in the international financial crisis, thus creating an enormous entry point into the Indian equities. So, taking into account the following was our predictions that we had come out with for the year 2009.

Exhibit 96: Expectation vs .achievement

	2009 E	2009 A	Returns (%)
Sensex levels			
Fundamentals based	12000-14000	17420	79%
Technical based	14450-15300	17420	79%

Source: BSE, ICICIdirect.com Research

On the sectoral front following were the themes that we were betting on:



Following was the returns of sectors that we had betted on:

Exhibit 97: Index returns

Sectors	Index tracked	YTD Returns (%)
PSU	BSE PSU	85.0
Automobiles	BSE AUTO	194.6
Power	BSE POWER	75.9
Pharma	BSE Pharma	78.4
FMCG	BSE FMCG	42.1
Banks	BSE Banks	104.3
Capital Goods	BSE Capital Goods	123.2

Source: BSE, ICICIdirect.com Research

For detailed report click here

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