market outlook

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Booming economy keeps sentiments upbeat

The improved performance of the government could act as a catalyst for a rally in the stock market

Key points

- We feel the government's improved performance so far in this fiscal has been partially overlooked by the market and the same could act as a catalyst for a rally in the stock market during the run-up to the Union Budget 2008.
- In our last Market Outlook report dated October 06, 2006, we had stated that we expected an upgrade in the Sensex' earnings estimates going forward and we have witnessed an 11.4% earnings upgrade for FY2007E, in line with our expectations of a 10-15% earnings revision.
- The domestic scenario remains upbeat: On a year-on-year (y-o-y) basis, the gross domestic product (GDP) has grown by 9.1% and the Index of Industrial Production (IIP) has risen by 10.9% in H1FY2007 with a strong growth of 12.1% in the manufacturing sector.
- In Q3FY2007, no major surprises are expected on the earnings front. However since the *Diwali* festival fell in October in FY2007 and in November in FY2006, some purchases could have already got reflected in the higher Q2FY2007 numbers, especially for the automobile sector. Hence the y-o-y growth in the profits could be slightly muted for Q3FY2007 compared with that in Q2FY2007.
- US housing data continues to be weak; however the third quarter GDP numbers were better than expected. The huge inventory build-up is the main concern, which is feared to limit growth in the last quarter. The market is expecting the US Federal Reserve (Fed) to start cutting rates from March 2007 onwards.
- Normally, December is the year-ending month for most foreign investors, who prefer to allocate fresh funds from January onwards. However there has been a change in this pattern since FY2004 and we expect the foreign institutional investors (FIIs) to actively participate in the stock market during the run-up to the next year's budget. A study of the trend of FII activity in the Indian stock market over the past two fiscals reveals that 51% of the net investments for FY2005 and 50% of that for FY2006 were made between November and February.
- We continue to prefer domestic demand-driven stories like automobiles, banking, capital goods and cement.

Government's improved performance could act as a catalyst

Tax collections remain buoyant: For the first seven months of FY2007, the gross tax collections were up 29.8% year on year (yoy). The Others category (comprising service tax, securities transaction tax, banking cash transaction tax, fringe benefit tax) saw a growth of 58.4% while corporate tax collections surged by 47.5%. Since the bulk of the direct tax revenues are collected in the second half of any financial year, we feel the government could surpass its tax collection target for FY2007.

Implied growth in total receipts likely to be surpassed: Further analysis of the government's accounts for the first seven months of FY2007 shows that the total receipts are 48.7% of the FY2007 budget estimate compared with 44.1% of the FY2006 budget estimate. The net tax collection as a percentage of the FY2007 budget estimate stood at 47.6% compared with 42.5% in FY2006. Going forward, based on the FY2007 budget estimate and the year-to-date reported numbers, the implied y-o-y growth rate for the total

Government accounts (Rs crore)

Particulars	YTD FY07	% yoy chg	YTD FY07 as % of FY07BE	YTD FY06 as % of FY06	Nov-Mar FY07 implied	% yoy chg
Tax (net)	155660	33.8	47.6	42.5	171545	11.6
Total receipt	202169	26.1	48.7	44.1	213136	8.0
Total expenditure	289269	14.6	51.3	49.1	274722	9.2
Fiscal surplus/(deficit)	(87100)	-5.4	58.6	60.9	(61586)	13.5

Source: Controller General of Accounts

receipts as well as the net tax collections stands at 8.0% and 11.6% respectively for the remaining five months. These targets appear very realistic and achievable.

Fiscal deficit numbers are broadly in line with estimates: On the year-to-date expenditure front, the total expenditure stood at 51.3% of the FY2007 budget estimate compared with 49.1% of the FY2006 number. The change has been marginal, as a lower planned capital expenditure (down 24.4% yoy) has offset the higher interest expenditure (up 17.2% yoy) on the non-planned side. The centre's April-to-October gross fiscal deficit stood at 58.6% of the budget estimate, broadly in line with 60.9% recorded last year.

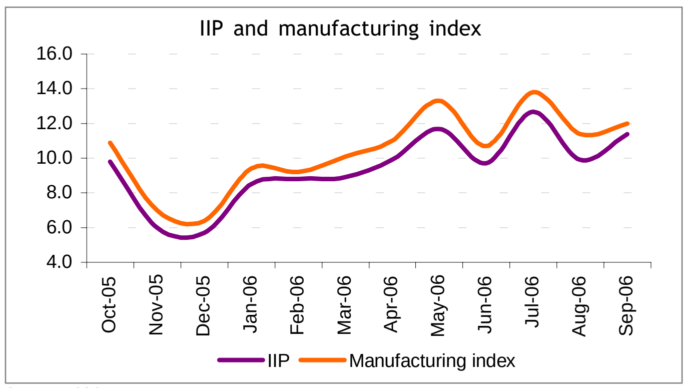
Fiscal deficit target likely to be reined in at 3.8%: With the government sticking to its borrowing plan of Rs152,000 crore for FY2007 and the GDP growing by a robust 9.1% in H1FY2007, we feel the fiscal deficit target could be reined in at 3.8% of the GDP. If it achieves its budget estimates, the government would definitely receive high praise from the investor community and the stock market could reflect this positive sentiment by rallying in the run-up to the Union Budget in February next year.

Indian economic scenario remains upbeat

In H1FY2007, on a y-o-y basis the GDP grew by 9.1% and the IIP was up 10.9% with a 12.1% growth in the manufacturing sector. Thus the domestic scenario remains optimistic. Credit growth remains at 28% yoy and most of the leading indicators continue to point upwards. However, the Capital Goods Index grew by only 2.2%, largely influenced by a higher base as the index had grown by 22.8% in September 2005. On a month-on-month basis, the growth in the index was strong at 9.3%; even in the (financial) year till date, the index has recorded a growth of 15.2% on a higher base of a 15.6% growth reported in FY2006.

Manufacturing sector continues to report strong growth

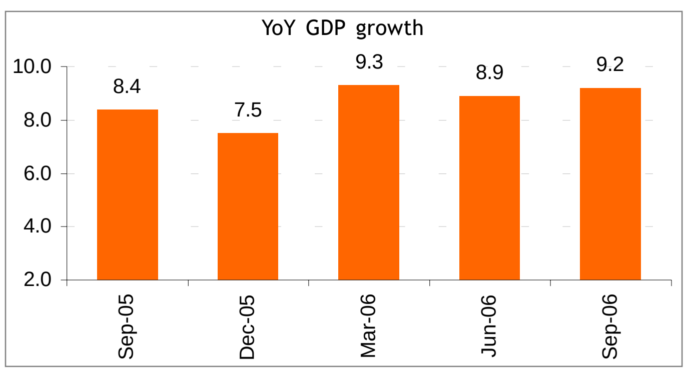
- The IIP for September 2006 grew by a strong 11.4% yoy.
- The manufacturing sector maintained its double-digit growth rate at 12.0% yoy.
- However, the Capital Goods Index grew by only 2.2%, largely influenced by a higher base, as the index had grown by 22.8% in September 2005.



Source: CSO

Robust GDP growth of over 9% for H1FY2007

- In Q2FY2007 India's GDP grew by 9.2% yoy, slightly above the expectation of an 8.9% growth. In H1FY2007 the GDP growth stood at 9.1%.
- The growth was achieved on the back of a 10.3% y-o-y rise in the industrial sector and a 10.9% y-o-y growth in the service sector.
- However, the agriculture sector grew by only 1.7% during this period due to a decline in the production of some major crops.



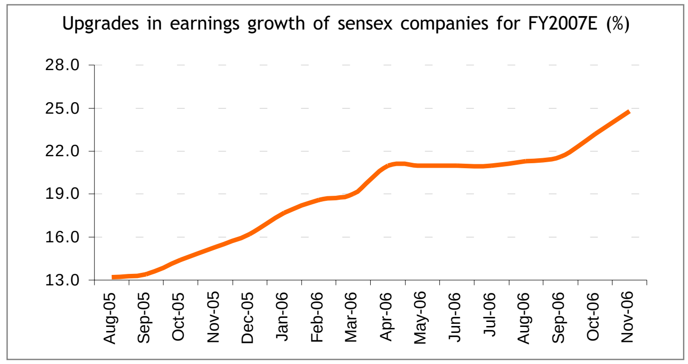
Source: MOSPI

Sensex' earnings estimate upgraded after Q2FY2007 results

The estimated growth in Sensex' earnings in FY2007 has been revised upwards to 24.8% from 21% as of September 2006. That's an 11.4% earnings upgrade for FY2007E and is in line with our expectations of a 10-15% earnings revision. However the Sensex has gone up by nearly 12% in the meantime and its valuations are at the higher end: The index is trading at 16.6x its one-year forward earnings. We feel India's valuations would continue to remain high, as the earnings growth remains intact and government policy changes are on track.

Sensex' earnings expected to grow by 24.8% yoy

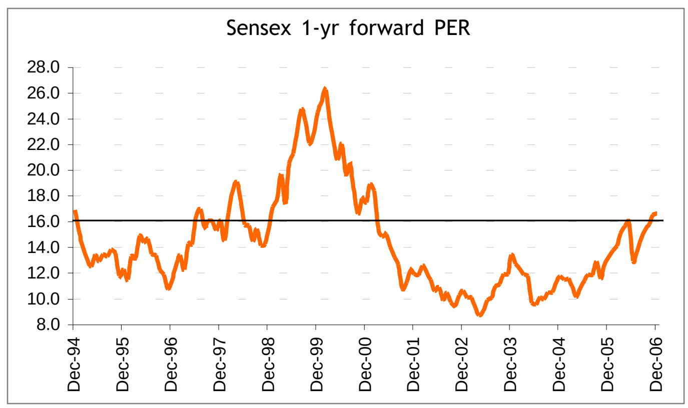
- The estimated growth in Sensex' earnings in FY2007 has been revised upwards to 24.8% from 21% as of September 2006.
- We have not seen any major downgrades in FY2007 earnings estimates after the Q2FY2007 corporate results.



Source: BSE, Bloomberg, Sharekhan research

Sensex trading at the higher end of its one-year forward PE band

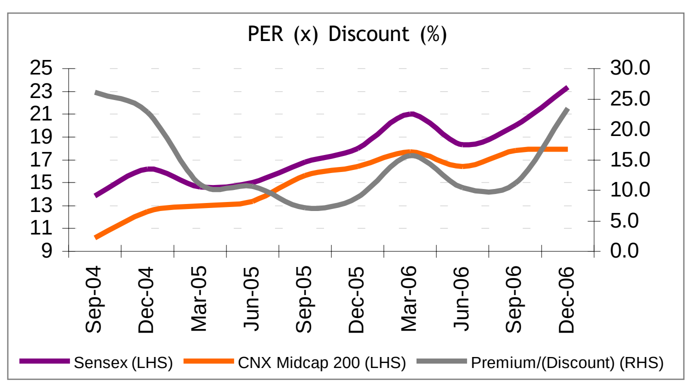
- The Sensex has usually traded between 12x and 16x one-year forward price/earnings (PE) over last ten years.
- Sensex continues to trade at 16.6x its one-year forward earnings (Sensex = 13972)
- We have seen an 11.4% earnings upgrade for FY2007 after the Q2FY2007 corporate results.



Source: BSE, Bloomberg, Sharekhan research

Discount between large-caps and mid-caps has increased sharply

- The Sensex has gone up by nearly 12% since the release of our last Market Outlook report on October 06, 2006.
- The CNX Midcap Index has gone up by only 7.8% over the same period.
- This has widened the valuation gap between the two indices to 23.5% as on December 04, 2006 on a trailing twelve-month basis compared with 11.1% in September 2006.



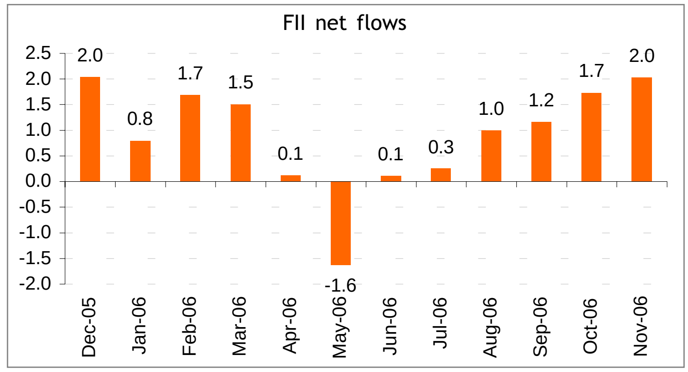
Source: BSE, NSE, Sharekhan research

FIIs continue to drive the domestic market

The Sensex and Nifty have scaled their all-time high levels of 14000 and 4000 respectively on the back of strong and continued inflow of funds from the FIIs into our markets. Even though the domestic fund houses have preferred to wait on the sidelines all this while, with the new fund offerings (NFOs) raising Rs1,800 crore in September and October, December could see higher participation from the domestic mutual funds.

FII buying remains unabated following strong Q2FY2007 numbers

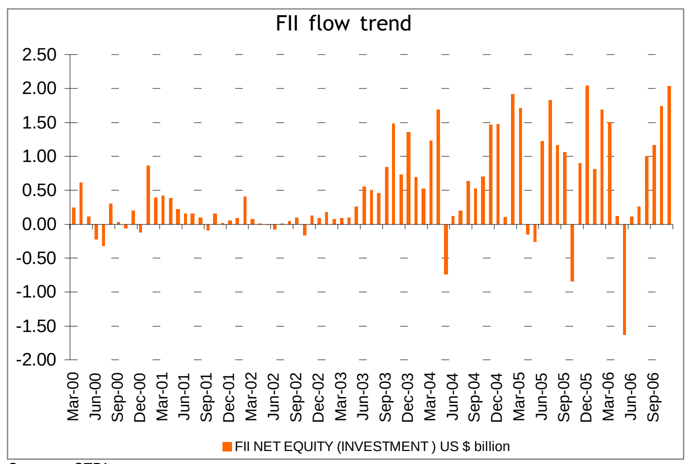
- The FIIs have invested $8.8 billion (net) in Indian equities in CY2006 so far.
- FII investments have shown a steady growth after the sharp sell-off witnessed in May 2006.
- Better-than-expected Q2FY2007 numbers leading to an upward revision in the earnings estimates of Indian companies coupled with strong industrial and economic data have once again attracted significant FII interest.



Source: SEBI

Pattern of FII flows have changed

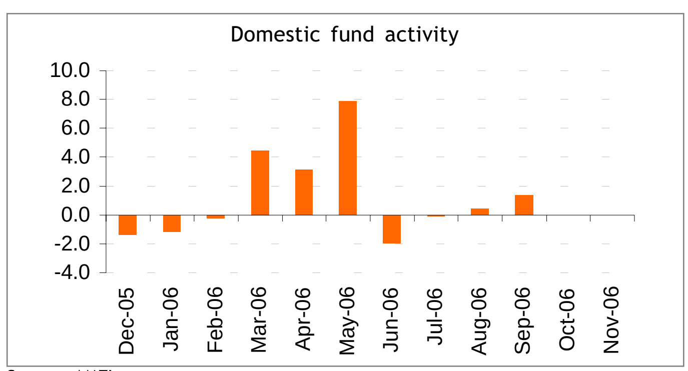
- If we look at the FII investment data from FY2000 to FY2003, the months of November and December don't see much activity, as it's the end of the year and holiday season for most foreign investors.
- However, things have changed since FY2004 and we have seen robust FII flows into our domestic market even in this period. We expect this trend to continue.



Source: SEBI

Domestic fund activities remain subdued

- Domestic funds have turned net sellers by a small margin in the market for the last two months (October and November 2006).
- However net equity investments made by them year to date remain at Rs10,693 crore compared with Rs14,302 crore in FY2006.
- As in October 2006, the cash levels of mutual funds as a percentage of the asset under management (without NFO money) stood at 6.2% (Rs6,689 crore); the same including the NFO collections stood at 7.4% (Rs8,155 crore).



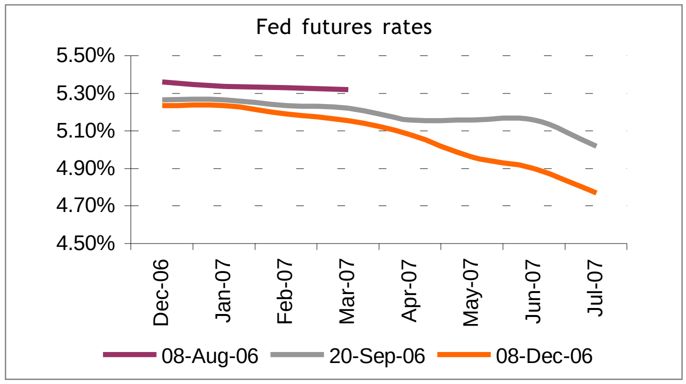
Source: AMFI

Housing slump affecting US economic growth

The US economy expanded at a revised 2.2% annual rate from July through September 2006,faster than forecast, reflecting an increase in inventories that may limit growth in the fourth quarter. Housing shaved around 1.1% from the economic growth last quarter. The core Consumer Price Index (CPI) excluding food and energy rose by 2.7% yoy as on October 2006, which is considered to be high. Policy makers are expecting the slowdown in the economy to reduce inflation. The pace of economic growth witnessed in the USA for the past few years is expected to slow down as the housing market indicators point to a slump and manufacturers are expected to cut production to reduce stockpiles. The market expects the Fed to start cutting rates as early as March 2007.

Markets expecting a rate cut next year

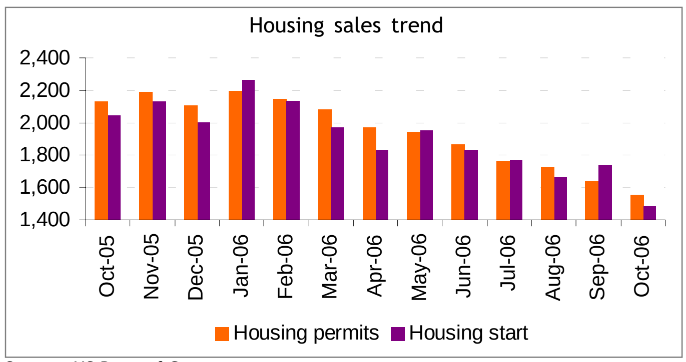
- Markets are expecting a rate cut between March and May 2007. The Fed futures maturing in April 2007 and May 2007 are trading at 5.08% and 4.96% respectively.



Source: Bloomberg

New housing permits continue to slow down (in thousands)

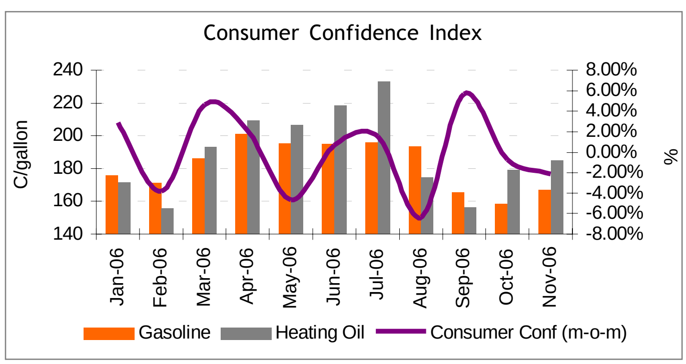
- New housing permits and new housing starts continue to report a slowdown.
- The housing starts reported a sudden spurt in September 2006, but October numbers confirm the declining trend has continued, reflecting mostly the impact of a huge inventory of unsold homes.



Source: US Dept of Commerce

Consumer Confidence Index declines from its September high

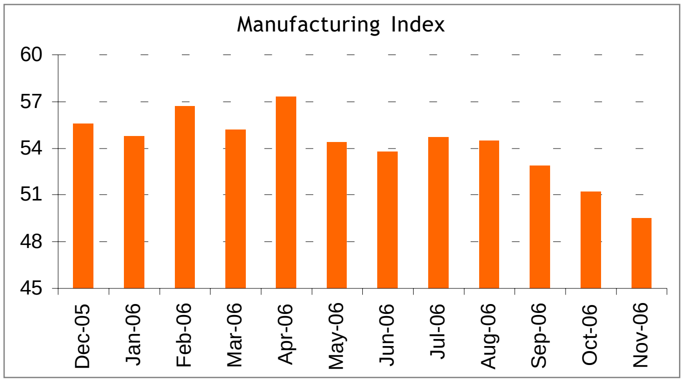
- The US Consumer Confidence Index has declined by 2.1% month on month.
- Retail sales for October 2006 dropped by 0.4% after remaining stable over the last two months.
- The decline in consumer confidence is perhaps because the housing market is witnessing a slump, the unemployment rate is creeping higher and job growth remains lower than last year's average.



Source: Conference Board, Nymex, Bloomberg

ISM Manufacturing Index continues to decline

- Growth in the manufacturing sector remained stable till August 2006 after which we have witnessed a gradual decline, as indicated by the ISM Manufacturing Index.
- The ISM Manufacturing Index has come down below 50 for the first time in 12 months. In November 2006 the index stood at 49.5.



Source: Institute of Supply Management