The good news has been priced in

While we believe that most of the good news has already been factored in, the negative surprises on the Fed front could weaken the market

Recent run-up in Sensex has factored in most of the good news

We have been saying that the better-than-expected earnings of the corporates and a pause by the Federal Reserve (Fed) in hiking interest rates would be the key drivers of the Sensex in the short term (see our market outlook reports dated June 3, 2006 and August 2, 2006).

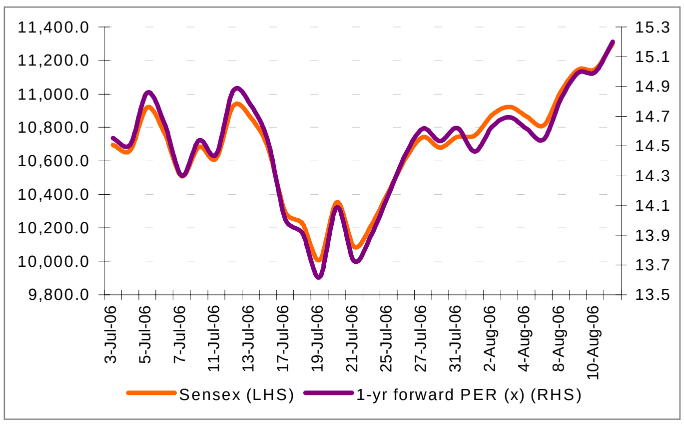
While both the factors have played out in favour of the markets, we believe that the same have already been priced in the valuations. The earnings of the corporates and the economic growth numbers (tax collections, IIP etc) remain buoyant and high cash levels of over Rs12,000 crore with the domestic mutual funds should also support the market. However, we do not see too much upside from here.

Our 12-month target of the Sensex at 12,000 would give a return of only 6% from here on and this indicates that the market is now close to being fully valued.

- The Indian market's valuations at 15.2x one-year forward earnings are near the upper end of the band (12x-16x).
- Global markets (as shown by the Fed rate futures) are too complacent and are pricing in a very low probability of another rate hike setting themselves up for some surprises.
- History shows that the emerging markets normally do not go up much in the first few months after the Fed stops hiking interest rates, but wait for the Fed to start cutting interest rates before going up. The markets do well ONLY if the Fed pause is NOT followed by a recession, which happens about 50% of the time.
- The revaluation of Chinese Yuan could provide a positive trigger to the market in the short term.

Good news priced in—valuation again towards the higher end of the band

- The Sensex has moved up by around 570 points since June 2006 and by 270 points since August 08, 2006.
- The Sensex valuations at 15.2x (level = 11,300) are near the upper end of the band.
- The revaluation of Chinese Yuan could provide a positive trigger to the market in the short term.



Source: Sharekhan research

Markets react positively to a CUT not a PAUSE

We have often been mentioning in the past that when the Fed stops hiking interest rates, it would be positive for the equity markets. However, it is important to note two things.

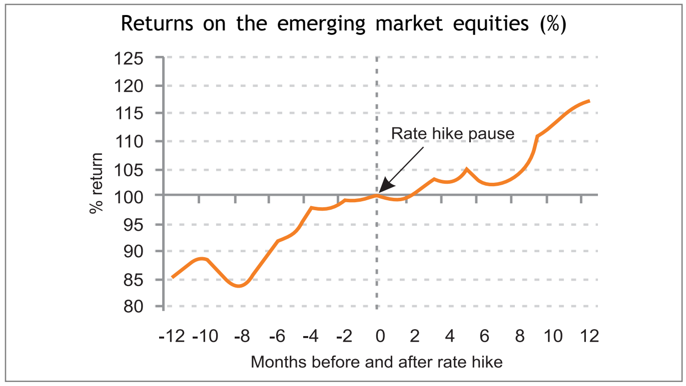
(1) The upmove happens only if there is a soft-landing ie the USA does not go into a recession.

(2) In the first few months following a pause, the markets go up only slightly and the major move happens after about 6 months after the pause when the Fed actually begins to cut rates. Until then, the markets remain unsure about the future direction and react significantly only when the Fed signals the future direction with a rate cut as shown in the chart below.

The most recent example of a pause by the Fed and a soft-landing was in 1995 (note that the 2000 pause by the Fed was during a recession so we have not taken that example). In that year, the Asian markets ex-Japan went up by 14% in the 12 months following the pause by the Fed, but in the first 3 months the markets barely moved up by 3.8%. If 2006 turns out to be similar to 1995 then the upmove of the first 3 months is largely done while the volatility and the risk of things not panning out still remain.

Emerging markets give healthy returns over a 12-month period after a stop

- For a couple of months after the pause the equity markets are likely to remain confused about whether the Fed has taken a pause or has stopped the interest rate hikes completely.
- As the confusion gets cleared over the next few months and the Fed starts cutting the interest rates, the markets should give better returns.



Source: Bloomberg, Sharekhan Research

Initial upmove has already happened

- The markets have already given an initial reaction to the pause, moving up by approximately 1-2.5% over the last seven trading days.
- Further upmove will come only once it becomes clear whether the Fed had just taken a break or its rate hike exercise has been completed.

	Returns over last seven trading days (%)	Returns YTD (%)
Hong Kong	1.1	15.4
Korea	0.7	-7.4
Taiwan	1.7	-0.3
India	2.5	17.5
Malaysia	1.0	5.5
Philippines	0.8	11.0
Indonesia	-0.7	18.4
Thailand	0.6	-2.5

Source: Bloomberg, Sharekhan research

Markets too complacent about no further hikes

The US Federal Reserve (Fed) took a pause after its two-year series of interest rate hikes at its meeting on August 08, 2006. As we had anticipated the markets cheered the same and the BSE Sensex rallied by 154 points.

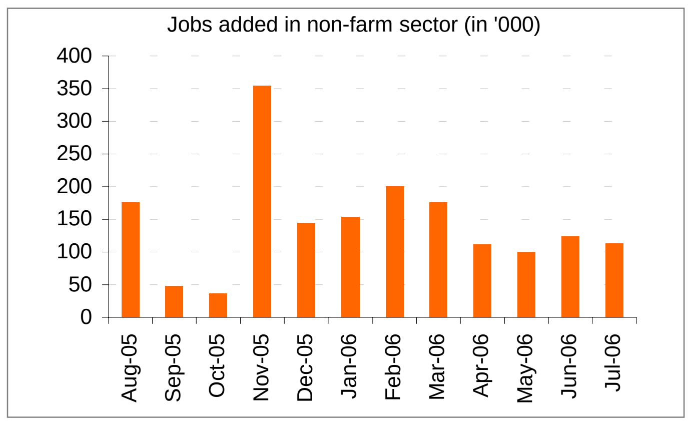
The scenario on the US economy front remains ambiguous. While economic indicators exhibit a mixed trend (some such as gross domestic product [GDP] growth, job growth and housing are negative, others such as retail sales and manufacturing show resilience), the taming of the inflation remains an important task.

The inflation in the US economy continues to remain high and well above the 1-2% comfort level of the Fed. The underlying assumption here is that the gradual cooling down of the housing market followed by a slowdown in the economy will help cool off the inflation. Historical experiences suggest that it normally takes 6-9 months before the weakness in the housing market starts to cool inflation. In this 6-9 month period if the incoming data on the growth or inflation rates are to the contrary, the Fed may have to pull away from the break in the interest rate increases and resume the rate hike exercise.

Meanwhile, as shown by the Fed futures, the markets are complacent that there is unlikely to be another rate hike. Any negative surprise on the growth or inflation rates could thus create a lot of volatility in the markets.

Job growth weaker than expected

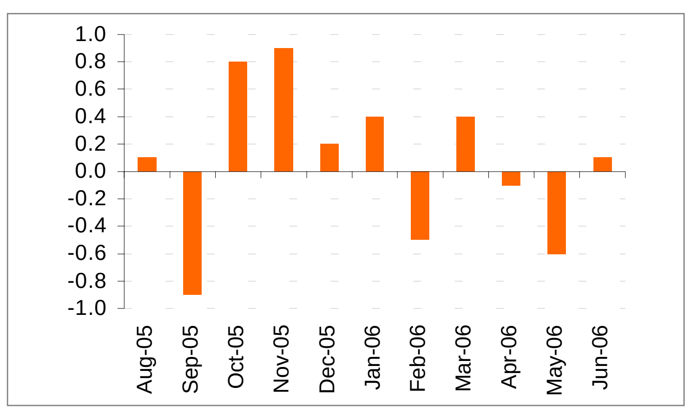
- The number of jobs added in the non-farm sector was weaker for the fourth consecutive month.
- The US economy added 113,000 new jobs in July 2006 compared with a consensus forecast of an addition of 145,000 new jobs.



Source: Bureau of labour statistics, US

Leading indicators show an up tick but remain sluggish

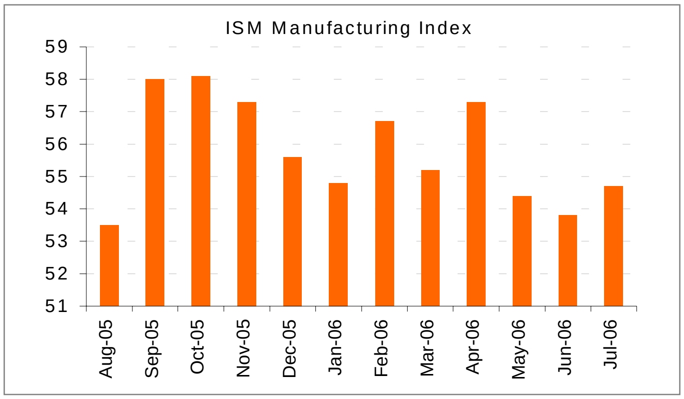
- The leading indicator index shows a slight up tick for June 2006.
- However, it still remains sluggish suggesting that the cooling off of the US economy may continue.



Source: Conference Board

Manufacturing sector shows surprising growth

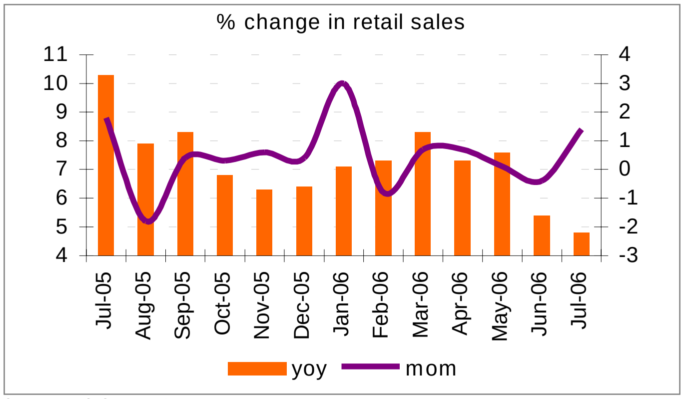
- The growth in the manufacturing sector accelerated surprisingly.
- The ISM manufacturing index inched up to 54.7 in July 2006 from 53.6 in June 2006.



Source: Institute of Supply Management

Retail sales rebound after a sharp dip

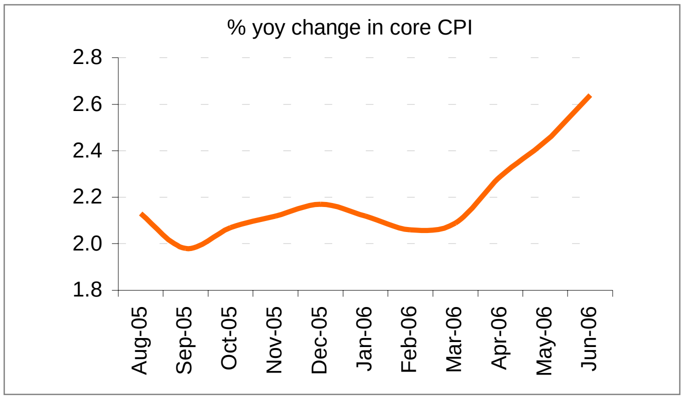
- The retail sales fell by 0.4% month on month (mom) for June 2006.
- The decline was the first after February 2006.
- However, the same rebounded in July 2006 with a growth of 1.4% mom.
- However, on a year-on-year basis the growth was the slowest over the last 12 months.



Source: US Census Bureau

Inflation continues to be a pain

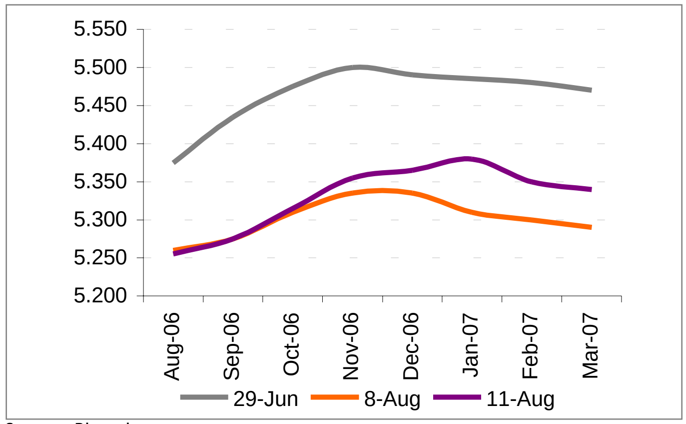
- The inflation continues to be a pain for the US Federal Reserve.
- The consumer price index grew by 4.3% for June 2006.
- The core CPI (CPI excluding food and energy) grew by 2.6%, the highest in the last four and half years.
- The gradual cooling of the economy coupled with the slowdown in housing may help to cool down the core CPI and consequently the CPI.



Source: Bureau of labour statistics

Fed Futures imply 26% probability for a rate hike

- The Fed futures are quoting at 5.31% for October 2006 maturity implying that there is a 26% probability for a rate hike in the next Fed meeting scheduled on September 20, 2006.
- Any negative surprise on the growth or inflation rates could thus create a lot of volatility in the markets.



Source: Bloomberg

Yuan revaluation—could be a positive trigger

Of lately the talks of the revaluation of the Chinese Yuan have been gathering momentum. The Chinese policy makers have been trying to cool down the economic growth, which has averaged at around 10% over the last three years, fearing that the ongoing investment boom may ignite inflation in the economy. The strong inflow of foreign exchange backed by a huge trade surplus has led to the investment boom in China. The People's Bank of China has been trying hard in its own way to soft land the economy as it raised the key policy rate in April 2006 and also raised the reserve requirement by the Chinese banks to reduce the money supply in the economy.

Also, the revaluation of the yuan will not be the only way out for China if it wants to soft land its economy. It may have to resort to further hikes in the interest rates if it wants to target the huge loan growth.

The cooling of the Chinese economy coupled with their exports getting dearer would be positive for the other Asian economies in the same region including India, as it will boost the exports and at the same time increase the flow of foreign money into these economies.