India Alternative Research

hEDGE

The alternative insights monthly

February 2008

February view: Pain may not be over; liquidity to be the key driver for market

- Metals: Rising steel prices, falling copper inventories
- Power: Fundamentals intact
- Cement: Price hikes likely to bring buoyancy
- Auto: Softening interest rate regime likely
- IT: Buy at beaten down valuations

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Januray Retrospect

India vs. Global Markets

Under perform	In line	Out perform
■		

Fund Flows

- FII ↓
- MF ↑

January - Sectoral performance

- Outperformers –Banking and FMCG
- Underperformers – Metal and IT

February – Sectors to watch

- Outperformers
  - Banking
  - Metals & Mining
  - IT
- Underperformers
  - Pharma

Decoupling still a distance away; Indian markets follow global cues

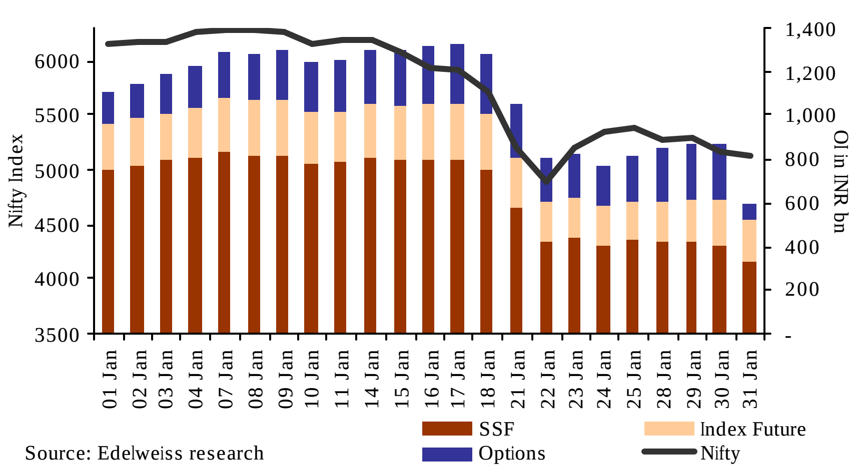
Indian markets started 2008 on a positive note with the euphoria of December continuing in full swing. In the first week of January, the Nifty traded well above the previous resistance of 6000 mark and BSE mid and small cap indices continued to roar louder. Some amount of profit booking was witnessed in mid and small caps on the back of the mega IPO of Reliance Power which was expected to mop up INR 120 bn.

It was the US unemployment data released on January 8 that brought in further negative sentiments in the over heated subprime burnt market. The unemployment rate in the US climbed up to a two-year high of 5%, making it clear that recession is a reality rather than a forecast now. The Fed cutting the interest rate by 75bps and following it up by another 50bps cut in the same month put a stamp of authority on recession fears. The sell off which started in global indices soon engulfed the Indian market as well.

Expected comes unexpectedly

Major Indian indices—Nifty and Sensex—hit lower circuit levels twice during January (21 and 22) on the back of cascading effect of global sell off and then with the forced unwinding of long future positions that hit margin calls. Indian F&O markets, which had entered into an over leveraged zone with the OI at an all-time high level of INR 1.32 trillion (Futures & Options on January 17), indicated significant worry over the sustainability of leverage positions. Even the distribution of Single Stock Futures (SSF) OI versus Index OI went to an extreme ratio of 76:24, indicating more speculative SSF positions being entered into by market participants.

Chart I: Market wide OI versus Nifty index



Source: Edelweiss research

January: Retrospective…

Forced unwinding of long future positions resulted in deep discount

Markets corrected around 22% on closing basis (intraday fall 29%) from January 8-22 (11 trading sessions). The volatility in the market broke all its previous records with implied volatility in Nifty options touching 65-70% levels on the back of sharp movement in the Index. Huge amount of long positions in single stock futures (SSF) witnessed unwinding on the back of either profit booking or forceful closure of long positions as the market corrected sharply.

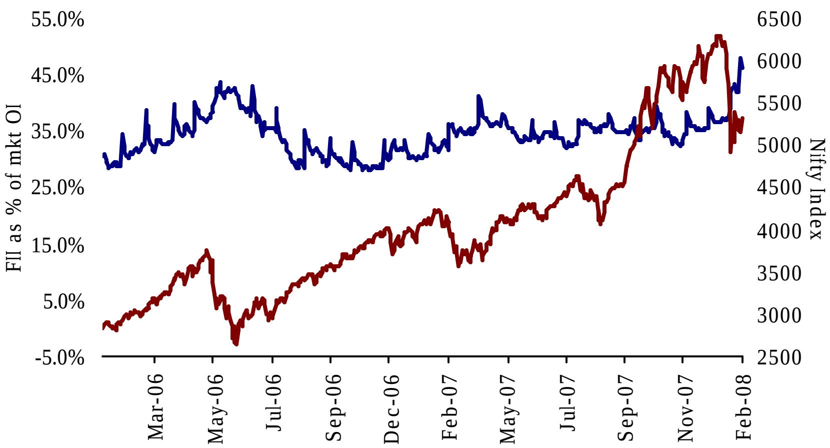
Market wide future OI in shares has fallen by nearly 51% since January 8 against Nifty OI in shares reducing by just 3%. The forced selloff in SSF resulted in the futures to trade at a significant discount to the underlying cash The discount in few counters was as huge as 15% in Indian Bank, Matrix Lab, and Laxmi Mach (intraday on January 22). On an average, 2-3% discount was seen in most stocks. The discount in SSF resulted in unwinding of cash futures arbitrage positions.

Market wide OI (F&O) on the last day of January stood at INR 597 bn (2,570,434 contracts) which is 55% lesser than the peak F&O OI of INR 1,322 bn on January 17. Since OI was at a lower base, the market wide positions that got rolled also appeared to be strong. As most of the weak hands were out on the back of the forced unwinding, the market wide rollover on the expiry day standing at 79% was no wonder. The average rollover cost in SSF fell to 60-65bps (average of positives) towards the expiry, clearly indicating the lack of aggression by long rollers.

On the other hand, Nifty positions found aggressive rolls with 73% of the positions getting rolled into the next month. The roll cost (cost to the short roller) expanded towards the last day of the expiry to around 75-80bps on the back of aggressive short positions being rolled in Nifty.

Post correction, most of the weak domestic hands were out, resulting into the FII open interest as a percentage of market wide OI moving up from an average of 35% to nearly 50% currently.

Chart II: FII OI as a percentage of market wide OI



Source: Edelweiss research

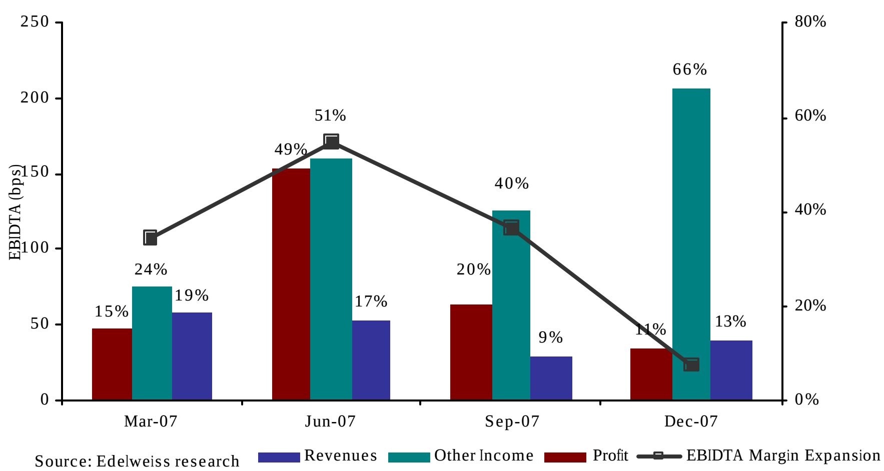
January: Retrospective…

Corporate India: A Q3FY08 snapshot

Corporate India has come up with yet another quarter of robust results with most numbers either being in line with expectations or beating estimates. However, as expected, the numbers were weaker than the year before. A look at the results announced for CNX 500 companies shows that Q3 FY08 has shown a Y-o-Y increase of 13% in revenues and 11% growth in net profit. The chart below depicts the weakness in these numbers when we look at the Y-o-Y growth figures for earlier quarters where net profit growth was much higher at 20% and 49%, respectively. A key metric that stands out is the EBITDA margin expansion which has come down steeply to 23bps from attractive levels of 170bps in Q1FY08 and 115 bps in Q2 FY08.

Another stand out number which indicates weakness in quality of earnings is the other income, which has risen unusually by 66% Y-o-Y. An adjustment for this bloated number will lead to valuations of a few companies tilting towards the expensive side. Among sectors, tier 1 companies in the banking and financial services space have shown impressive Q-o-Q and Y-o-Y growth, while some companies like BHEL, Siemens, and Suzlon have failed to impress. As reflected by their stock market performance, IT, healthcare, and auto majors were under performers from a corporate earnings perspective as well.

Chart IV: Earnings review



Source: Edelweiss research

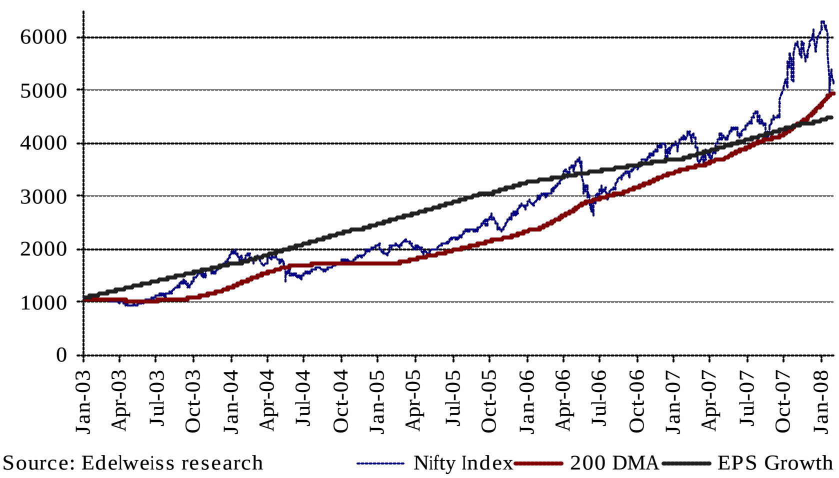
February: What lies ahead…

Market takes support at 200 DMA, but still above earnings growth

Though the Indian market has a strong fundamental story attached to it in the long run, the rally that took place before the January crash certainly questioned valuations. An in-house study conducted on the earnings growth of Nifty index versus its price growth clearly indicates that when ever the market has exceeded earnings growth, the euphoria has been brought down by a correction in the market. Indian markets surely deserve some premium over the earnings growth, but not at the scale that was witnessed till December 2007.

The Chart below clearly depicts the importance of 200 DMA acting as critical support levels for the market. Nifty took a technical support at its 200 DMA and reverted. On the other hand, earnings growth is currently below 200 DMA. If one goes by the earnings growth trend it is the 4505 level that Nifty could test theoretically. But liquidity surely would be the key driver for the market.

Chart III: Market growth versus earnings growth



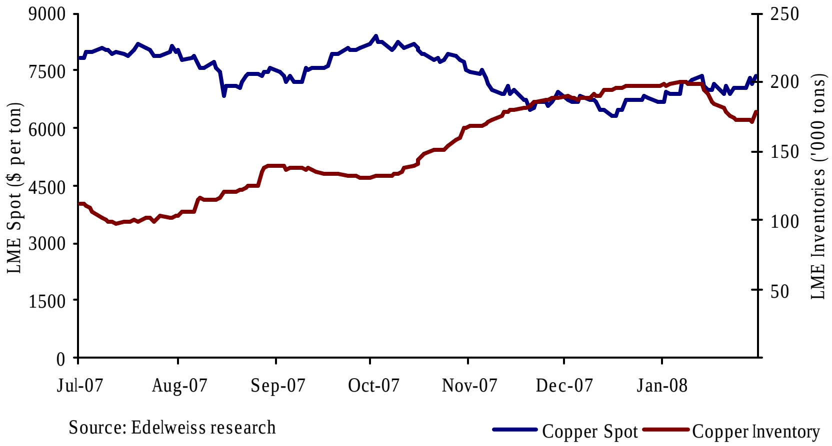
Source: Edelweiss research

February: What lies ahead…

Metals: Rising steel prices, declining copper inventories

Rise in input prices and hike in global steel prices have prompted steel majors Tata Steel and SAIL to raise prices of their products by INR 1,500-2,500 per tonne. Other players have also increased the prices of their products. On the base metals front, snowstorms in China and power cuts in South Africa imply rising copper prices or reduced output at a time of dwindling inventories. Copper inventories are expected to continue the decline phase and would provide a platform for price gains. Similarly, aluminum prices have run up in the past two weeks.

Chart V: LME copper inventory versus spot price



Source: Edelweiss research

Power: Fundamentals intact

The heavy erosion in market cap of top power companies in the recent sell off had more to do with global uncertainties, as fundamentals of the Indian economy and power sector remain intact. Valuations in the power sector expanded in the past six months on the back of improved visibility. For India to maintain its trajectory of high growth, we believe investment in the power sector (generation, transmission, and distribution) is inevitable and this precisely is the basis of our conviction on the sector's growth. Moreover, the upcoming listing of Reliance Power is likely to cause an upward re-rating of the power sector as a whole. Post the correction, we believe buying opportunities exist across verticals for long-term investors. This is the time for investors to cherry pick stocks in the sector, which have declined significantly compared to market indices. Our top picks in the power sector are BHEL, GIPCL, Jyoti Structures, Larsen & Toubro, McNally Bharat, and Transformers and Rectifiers India.

Cement: Price hikes to bring buoyancy

In response to the concern over the impact of high cement prices by the state government, cement companies in Tamil Nadu have collectively offered to supply 100,000 tonnes of cement per month in the state (~9% of average monthly consumption) at a fixed price of INR 200/bag for the weaker sections. This move should not be construed as a case of cap on cement prices as the bulk of the remaining quantum of cement will be sold at market determined prices. Out of the planned price hike, only prices in the South have been hiked in the past month and February should see further hikes in key markets of Gujarat and Maharashtra. Along with a tight demand-supply situation in Q4FY08E and Q1FY09E, the market is expected to be buoyant in the next six-seven months and further healthy price hikes can be expected. Any sharp correction in stock prices, owing to sentimental negative impact of government intervention, should be viewed as a buying opportunity in case of southern cement stocks.

February: What lies ahead…

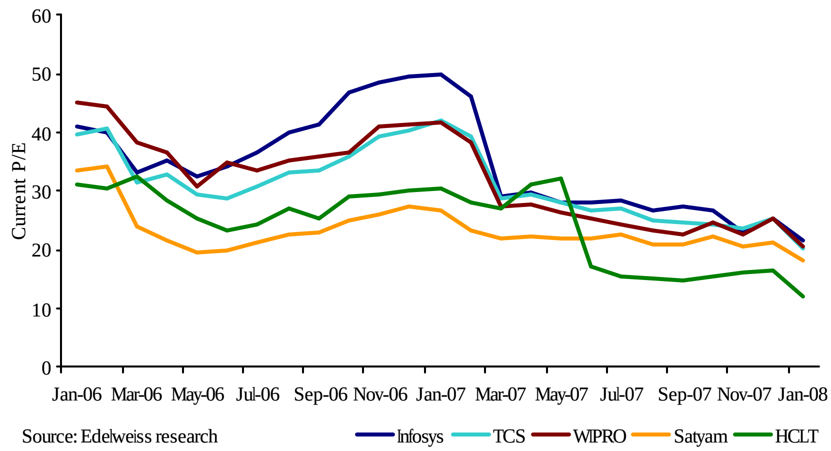
Auto: Softening interest rate regime coming up

The auto sector has been an underperformer for some time with rising steel prices and unchanged interest rates proving to be additional dampeners to falling sales numbers. But, this trend is likely to reverse with a few frontline banks hinting at reduction in lending rates. While the Reserve Bank of India (RBI) has not cut interest rates, it has indicated a softening rate stance going forward. This should see beaten down counters like Tata Motors and M&M gaining momentum in the near term.

IT: Buy at beaten down valuations

December 2007 results of tier 1 IT companies have been in line with expectations, with Satyam leading the pack. Companies which reported slightly weaker-than-expected sequential revenue growth in the quarter have offset this with better-than-expected margin performance (Infosys) and vice-versa. This is commendable in a quarter wherein the INR appreciated 12% Y-o-Y against the USD. In the light of this positive information flow, we believe the price-value gap in large cap IT counters has further widened given the recent battering of stocks. Given that there has been little that has been noticeably negative or discouraging from results and also since stock prices have weakened subsequently, valuations should provide the ultimate buffer above all the other factors. We see significant value in TCS, Satyam, HCLT, and Infosys, the near term uncertainty notwithstanding.

Chart VI: P/E valuations of tier I IT firms



Source: Edelweiss research

Technical View

Nifty: Positive

Short-term: Neutral

Intermediate-term: Positive

January saw deep correction in markets as they corrected by nearly 30% during the month from the top. The Nifty made a bottom of 4448 during the month, which saw volumes gradually drying up towards the latter half. The Nifty, though, never closed below the 200 DMA on daily charts. The index also formed an engulfing bullish candlestick pattern right at the bottom of the fall and thus the importance of 200 DMA support increases all the more (approximately at 4900 levels). The Nifty from hereon is expected to be volatile in the near term, but is expected to continue with its up wards move in the days to come. 5100, 5095, and 4930 are the important support levels for the index; whereas 5400, 5495, and 5550 are the nearest important resistance levels.

R Com: Positive

Short-term: Positive

Intermediate-term: Positive

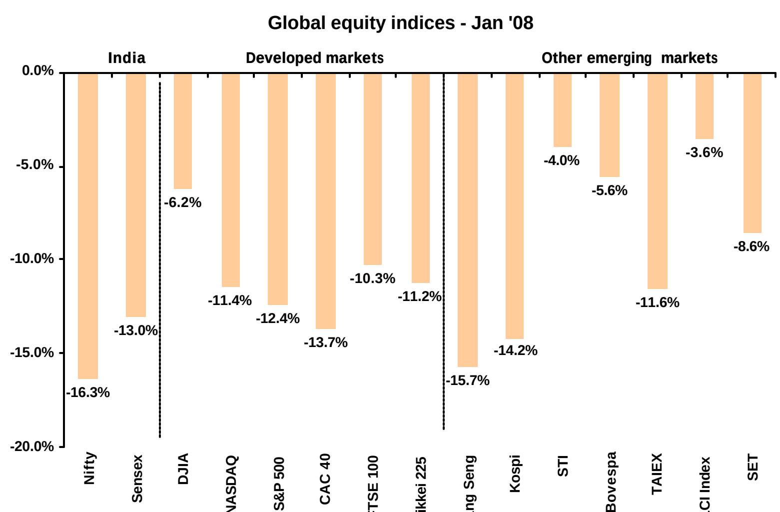
Reliance Communication (R Com) has broken out of a double bottom formation accompanied by healthy volumes. The scrip gave a breakout at near INR 675 levels, which incidentally has been a good support/resistance level for the scrip. The scrip has also completed bullish crossover recently on the MACD, whereas RSI in the very short term is showing signs of strength. The scrip is expected to see good demand from here on and looks good for a short-intermediate term target of INR 750. Buying is advisable with a stop loss of INR 630 on closing basis.

Global context

Global markets reel under sub prime woes. Nifty registers a dip of 16.31% (1001 points) and Sensex follows suit with M-o-M decline of 13% (2638 points)

Global markets once again felt the heat on the back of deteriorating economic conditions in the US; Indian indices too follow ed suit

- January witnessed massive sell offs across the globe as fear of a possible recession in the US began to rear its head.
- A host of factors affecting the US, like credit meltdown, sub prime crisis, massive write down of losses by major financial institutions , and recessionary fears triggered a round of massive sell offs across the globe.
- The broader indices ended the month in the red, with the Nifty losing 1001 points and the Sensex 2638 points M-o-M.
- As anticipated, the month witnessed yet another round of cut in key rates by the Federal Reserve; it currently stands at 3%. The key rates were slashed twice during the course of the month. The cut, which has been the fifth since September and second in January, mainly intends to accelerate the pace of economic growth in a country crippled by deteriorating credit growth and an eventual recession.
- Emerging markets meekly surrendered to the ongoing economic crisis in the West as all of them ended the month in the red. Major losers were Hang Seng , down 15.70% ; Kospi, down 14%; and TAIEX, down 11.6%.
- Developed markets were no different as most of the major indices ended the month in the red. The pack of losers was led by CAC 40 (-13.70%) closely followed by S&P 500 (-12.40%), and NASDAQ (-11.40%).



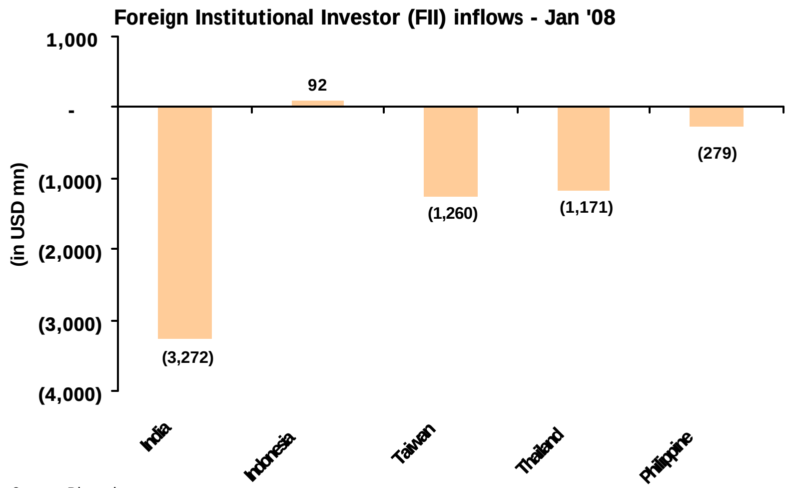
Source: Bloomberg

Global FII flows

Emerging markets witness FII sell offs on the back of weak global cues

FIIs seemed keen on liquidating their positions in most emerging markets

- The weak global cues got the better of the positive sentiments prevailing in the first half of the month.
- One has to take into account the fact that Indian markets hit their all-time high in January 2008 and with sound liquidity, conditions seemed to be under control. The month also saw liquidity being sucked out by mega IPOs like Reliance Power and Future Capital Holdings hitting the market. Dark clouds began to hover on the horizon once the news of massive write-downs by financial majors and possibility of an economic recession in the US resurfaced. As markets around the globe tumbled, the liquidity-striven Indian market too followed its global counterparts and pared most of its gains. The impact was tremendous as broader Indian indices hit the circuit for two consecutive days.
- Indian markets witnessed negative flows for the third month in a row.
- FIIs displayed mixed sentiments in the derivatives segment of the Indian market. A good deal of buying was witnessed in derivatives, especially during the latter half of the month. However, the cash segment saw good deal of selling by FIIs. Major chunk of the outflows took place between January 16 and 18. The net outflow (cash + derivatives) from Indian markets for January 2008 was USD 3,272 mn.
- In January, FIIs stood net buyers of USD 998 mn in the derivatives segment and net sellers of USD 4,270 mn in the cash segment.
- Over the past three months, FIIs have sold USD 9,211 mn (derivatives net seller of USD 5,015 mn + cash net seller of USD 4,196 mn) in Indian markets.
- Emerging markets had no respite in terms of FII outflows. All the emerging markets, barring Indonesia, witnessed negative flows. Indonesia more or less has remained insulated to global FII flow trends as it continues to witness positive FII flows for the 19^{th} month in a row. Indian markets led the race closely followed by Taiwan in terms of FII outflows in January.



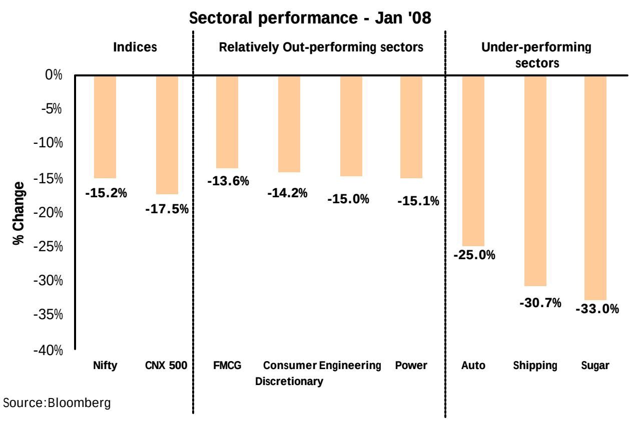
Source:Bloomberg

On the domestic front

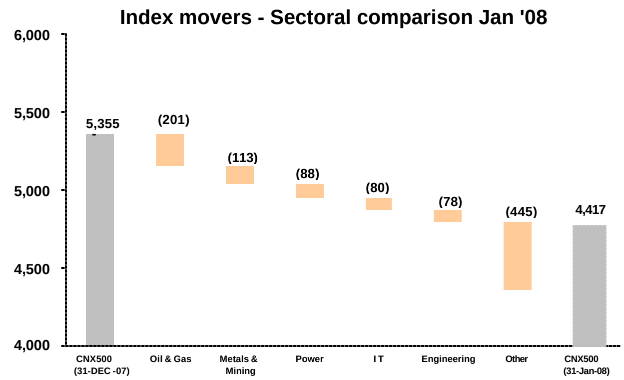
Sectors post negative gains in line with the broader sentiments. CNX 500 dips 19% M-o-M

Though sectoral indices end the month in the red, banking and FMCG were relative outperformers

- The impact of global sell off was clearly evident as all the sectors pared off their monthly gains.
- Though it was difficult to pick out sectors in the green, banking and FMCG were relative outperformers. Banking hogged the limelight as talks of a rate cut were seen doing the rounds before RBI's annual credit policy review. However, the apex authority kept key rates unchanged.
- Major laggards were IT and metals.



Source:Bloomberg



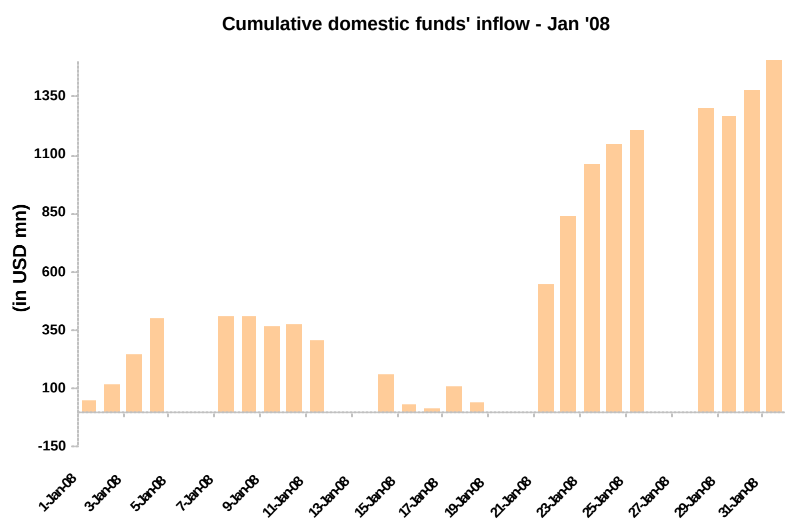
Source: Edelweiss Research

Domestic funds contradict the broader sentiments, indulge in value buying

Domestic funds turn net buyers.

- Domestic funds emerged to be net buyers in January of USD 1,919.20 mn.
- It is interesting to note the fact that in the past few months domestic funds have perceived every dip as an opportunity to buy into Indian equities. For the past three months, domestic funds have been buyers of USD 3,260 mn.
- Taking a closer look, domestic funds have contradicted FII trends in the past six months.

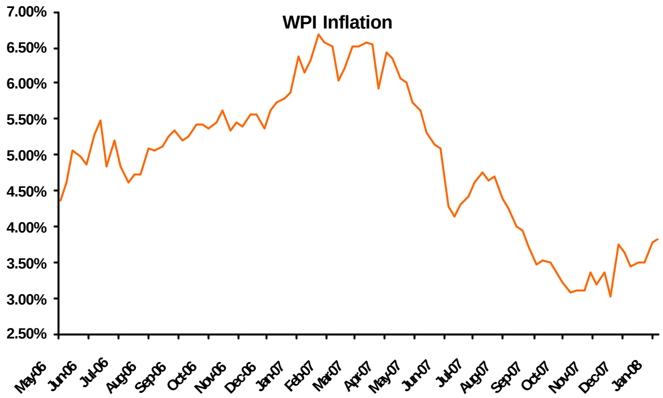
Till Jan '08	Domestic Flows (fig in USD Mn)
CY-00	(135.40)
CY-01	(1,050.00)
CY-02	(630.70)
CY-03	179.30
CY-04	(203.90)
CY-05	2,998.20
CY-06	3,555.90
CY-07	1,553.60
CY-08	1,919.20



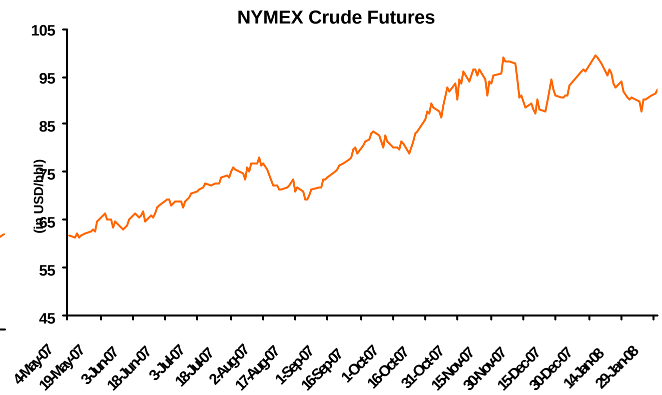
Source: Securities Exchange Board of India (SEBI)

Macro environment: India

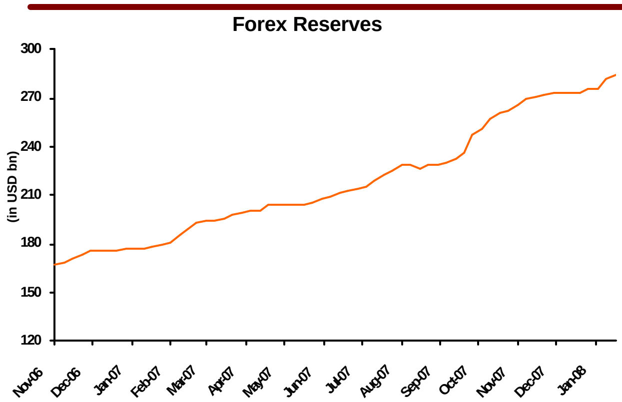
Inflation rises marginally to 3.80%



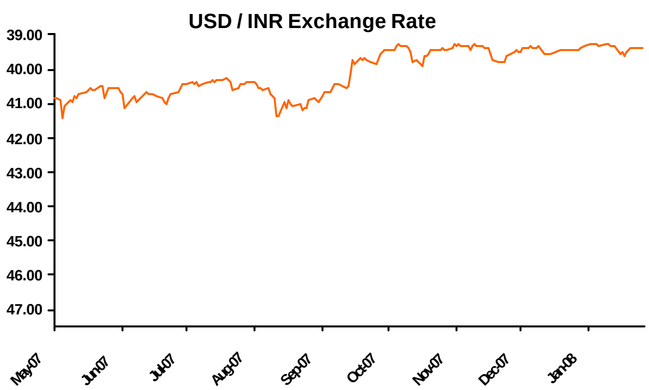
Crude firm at USD 93/barrel



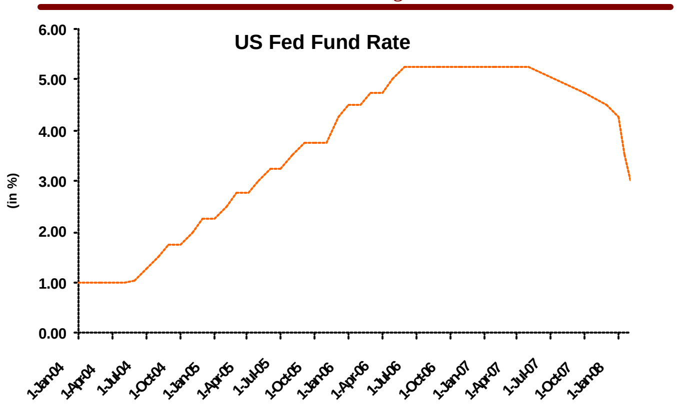
Steady accretion to reserves continues; currently at USD 285 bn



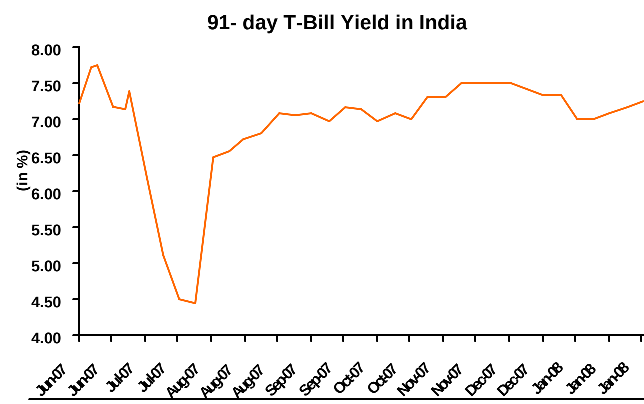
Rupee stays firm at 39 levels



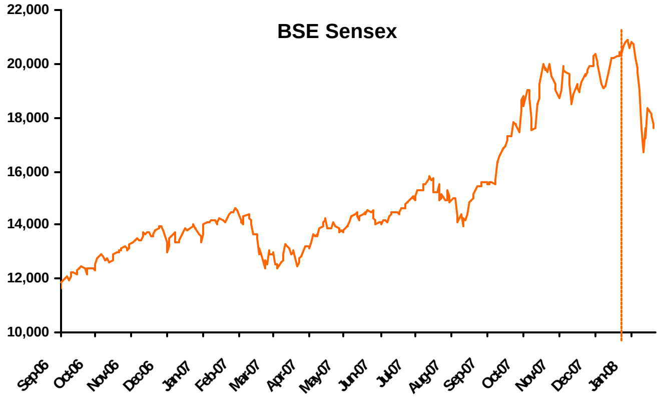
Fed rate down to 3.00% on back of growth concerns



Indian short-term yields stabilize around 7.30% levels



Sensex losses 2638 points M-o-M



Metal prices display mixed trends

Commodities		Price	1Mth % Chg	3Mth % Chg	1 Year % Chg
Steel	USD/ton	560	7.69	7.69	7.69
Tin	USD/ton	16,450	0.30	0.77	35.39
Zinc	USD/ton	2,210	(8.49)	(24.11)	(40.27)
Copper	USD/ton	6,870	1.10	(11.87)	21.38
Aluminium	USD/ton	2,310	-	2.67	2.67
Nickel	USD/ton	26,905	(0.17)	(15.26)	(28.82)
Lead	USD/ton	2,505	(5.47)	(30.22)	49.73
Gold	USD/T.Oz.	892	10.04	18.09	38.35
Silver	USD/T.Oz.	16.05	11.31	19.51	20.95

Source: Bloomberg

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Date	Special Reports
08-Jun-07	Master Moves; Opportunities from open offer, buyback, de-listing
11-Nov-07	Earning Strength Comparison
04-Jan-08	Enhanced Nifty: Nifty with an edge
11-Nov-07	Edelweiss Value Scanner; Adding Value to investments
29-Jan-08	IPO Matrix 2008- A snapshot

Date	Monthly Reports
15-Jan-08	Edelweiss Fund Insight - EFI
28- Jan-08	Rollover Analysis
04-Jan-08	RSC: Relative Strength Comparison
05-Jan-08	hEDGE: The alternative insights monthly