Prabhudas Lilladher

INDIA
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Global Prism

India Underweight Maintained

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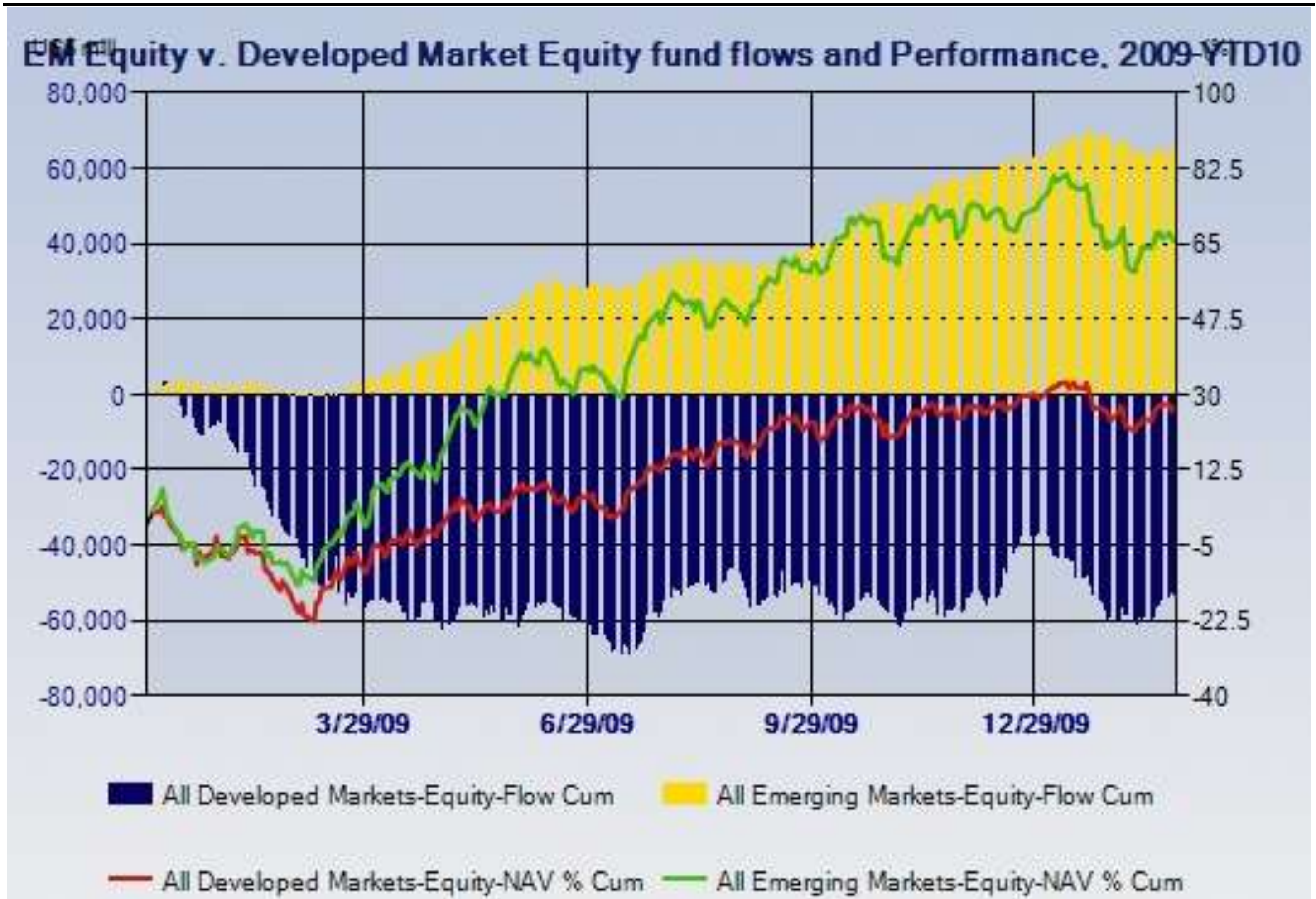
India Underweight Maintained

In March 2010, Indian equities outperformed their emerging market peers by 120 basis points (bps). This brings the year-to-date outperformance of Indian equity market versus the MSCI EMF index to 270bps. At a global level, we maintain our recommended ***Underweight*** stance towards the Indian equity markets owing to: 1) valuations, as Indian equities trade close to 17x12 month forward earnings, 2) a large premium to the historical average relative valuation premium levels of Indian equities and 3) positioning, as dedicated global emerging market institutional investors are ***Overweight*** on Indian equities and local Indian investor sentiment metrics remain optimistic.

In March 2010, emerging market equities, as represented by the MSCI EMF emerging markets index, outperformed world equities, as represented by the MSCI AC World Index, by 157bps. Specifically, in March, the MSCI AC World Index rose 6.43% versus an 8% rise for the MSCI EMF index. Within the emerging markets space, total return leadership was held by the EMEA region, rising 10%, followed by the Asia Pacific ex-Japan group, which rallied 7.3% and Latin America, as the laggard region performance wise, with the regional stocks rising 6.9%. EMEA region's return leadership during March was accompanied by a sharp acceleration in investor inflows. Finally, among the so-called BRIC group, India and Russia outperformed the MSCI EMF index, while Brazil and China underperformed.

Emerging markets' solid outperformance of developed market peers during March was accompanied by a sustained acceleration of investor flows not only into emerging market equity mutual funds (Figure 1, with eight consecutive weeks of inflows and recently most notably into the EMEA region) but even more impressively into emerging market bond funds. As a result, emerging market bond spreads have compressed to the lowest levels since December 2007 (Figure 2). From a relative valuation perspective, emerging market equities have become significantly cheap to emerging market bonds. Another dynamic lending further support to emerging market equities that stems from the M&A sector. Specifically, not only have monthly M&A volumes been on a rising trend since the beginning of 2009 but even more impressively, the share of emerging market countries (as a target in global M&A transactions) has been tabulated by analysts at JPMorgan at close to 30% currently, from levels close to 10% in 2007! Such dynamics enhance the scarcity value of emerging market equity instruments.

Figure 1: Investor flows continue to favor emerging market funds, though at a declining rate



Source: EPFR Global

Over the first quarter of 2010, emerging market equities have slightly underperformed their developed market peers (by around 60bps). Arguably, some of the principal factors adversely affecting emerging markets' relative return performance during the period include the Chinese monetary policy tightening measures adopted early in the year, mounting sovereign credit concerns fuelled by Greece's debt crisis and global market concerns over the impact on liquidity conditions sensitive markets, such as emerging markets, emanating from the end of quantitative easing (QE) measures in the US.

Against the backdrop delineated above, we continue to embrace the thesis that emerging markets are likely to retake their global return leadership role sometime in the second quarter as (1) tightening measures across most of the world's largest emerging market countries are significantly priced into the money market curves, (2) the end of QE phase in the US has not resulted in any meaningful upward pressure on credit spreads and (3) the April 11th announcement by the EU of an assistance package for Greece was materially larger-than-expected and subject to softer economic terms than previously rumored in the market, thereby likely to result in to lower pressures on risk premia for the balance of the year. To the latter mentioned factors, one must also include the favorable risk premium implications stemming from the broader nature of the ongoing economic recovery, as discussed in the following global markets section.

Figure 2: Emerging market bond spreads compress to levels last seen in December 2007(in bps)

GRAB Index GP
At 18:27 Op 254.14 Hi 254.14 Lo 254.14
JPEIGLSP INDEX Advanced Hide GP - Line Chart Page 1/26
Range 01/03/06 - 04/13/10 Upper Mid Line Mov. Avgs Currency USD
Period Daily Lower None Mov. Avg 15 Events
Mid Line 254.14
High on 10/24/08 890.90
Average 316.09
Low on 06/01/07 151.09
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2010 Bloomberg Finance L.P.
SN 189000 H249-570-0 13-Apr-10 21:26:23

Source: Bloomberg

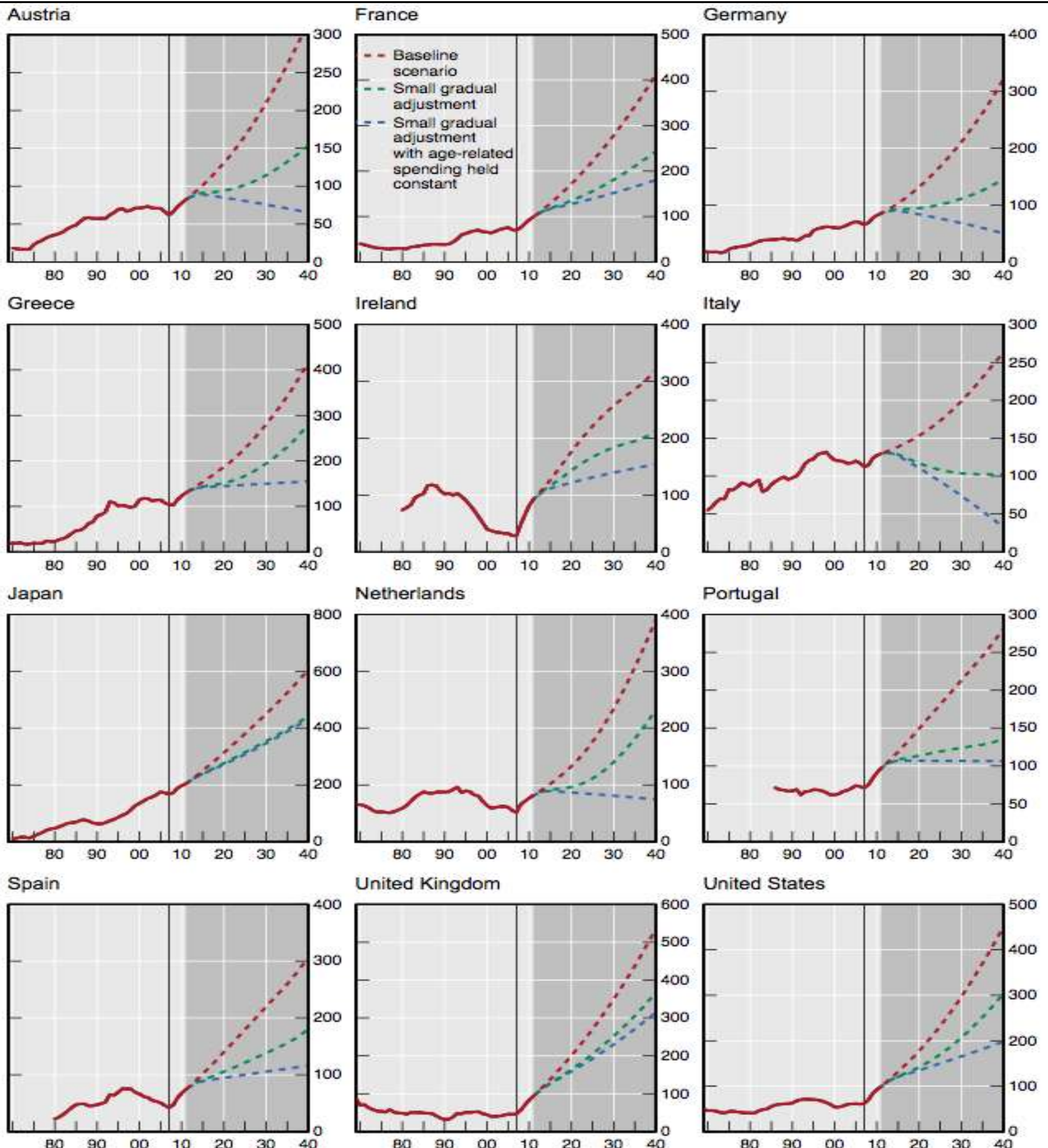
Cyclical forces come to the rescue not a moment too soon, as Greece's debt crisis highlights the market's sovereign credit concerns

In April 2010, for the first time since 2008, the global economic calendar signaled an almost universal improvement in economic momentum across various geographies comprising the world economy. Such an improvement is most welcome as it comes not a moment too soon as evidenced by the dramatic deterioration experienced by the Greek financial markets in the week ending April 9, 2010, triggered by news of accelerated capital flight out of the country, threatening a metamorphosis from a debt into a full-fledged macro crisis in that country. Arguably, risk market's, especially equities', best hope for a preservation of the price gains attained since March 2009 is centered on a rotation of economic growth away from the public sector-sponsored approach governing economic activity since the end of 2008 to one anchored on private sector consumption and investment spending.

Sudden deterioration of Greece's crisis to a full-fledged macro-crisis evidencing capital flight, serves as a powerful reminder of the fundamental challenges facing the economic and market outlooks

A sudden and sharp nature of the rising financing costs faced by the Greek government, within a few days prior to April 9, 2010, highlights global market's limited tolerance for sustained deteriorations in government's creditworthiness. Since the onset of the financial crisis, as is well known by most market observers, governments worldwide led by US, UK and China have sustained the ongoing economic recovery through direct intervention measures, including subsidies, exceedingly low interest rates and massive debt creation. As a result, across most developed countries, public debt ratios have escalated to levels deemed unsustainable on a medium-to-long term basis (Figure 3).

Figure 3: Public Debt-to-GDP Levels in OECD entering ranges of unsustainability



Source: The future of public debt: prospects and implications, Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, Bank for International Settlements, March 2010, BIS Working Papers, No 300

Elevated public debt levels implying the current juncture in market history may be summarized as “the era of investing dangerously…”

A recent Bank for International Settlements study, authored by Stephen Cecchetti et al, quantifies the trajectory of debt dynamics unfolding for a range of OECD countries over the coming years. Starting at already elevated initial levels of close to 100 percent of GDP, at best current public debt ratios virtually guarantee a below trend intermediate and long-term economic growth outlook for the developed world. At worst, selected countries may confront systemic or quasi-systemic macro crises involving weakening currencies, inverted yield curves, asset deflation and sudden economic contractions. From our perspective, the main question is not ‘IF’ but rather ‘WHEN’. Unfortunately, the task of pinning down the timing of such crises episodes is rather elusive owing to the presence of multiple factors potentially retarding the onset of such crisis, including inter alia the application of large external subsidies, bail-out funds (such as the one announced on April 11, 2010 by the EU/IMF in support of Greece).

With the above caveats as for the timing of such confidence crises, likely to foster sudden sharp erosions of asset values from investors large and small, what is an investor to do? From our perspective, the answer is clear. History teaches us that deflationary dynamics characterize crises fuelled by deflating asset bubbles. In that light, it is clear that a barbell approach to portfolio construction requires overweight allocations to cash and high quality/cheap valuation sectors both in the cyclical and defensive areas of the market.

April economic releases, especially out of US, Japan and UK, point to increased likelihood of sustainable, private-sector led expansion into the year’s second half

Recent economic releases out of several of the world’s main economic geographies point to a broadening and deepening economic recovery. Not only has the expansion sustained itself in sectors, we have long identified as robust, especially manufacturing, but also to domestic demand areas, including consumption and investment spending in some of the world’s laggard growth areas, such as US and Japan. For example, in the US, the recently released March employment report evidences the consolidation of private sector employment creation, albeit at a rather small pace. The March employment growth pace was also reinforced by an even stronger recovery signaled by the household survey. Moreover, on the employer’s side, recently released business confidence surveys, such as the ISM, not only have sustained the recent rebounds experienced in February and March 2010 but have also extended to the service-based sectors.

Across the pond, over in Asia, the latest string of economic releases out of laggard Japan have also surprised, including the latest quarterly business confidence survey (Tankan). Data releases out of the emerging market regions, including Latin America and Emerging Asia, remain strong, including recent export orders data out of Taiwan and Korea.

Sustained strength out of North Asia markets, especially Taiwan and Korea, is highly significant as this reflects ongoing demand strength by developed markets in the US and Europe. The latter is consistent with growing levels of US household confidence as evidenced in declining personal savings rate levels and the recovering labor market.

Taiwan, similar to Korea's case, is undergoing continued strength in demand for its export goods. Similar indications of strengthening economic conditions out of Asia include India and Indonesia. Likewise, in the Americas, the Brazilian and Mexican economies continue to display signs of strength.

A distinct difference in the nature of the undergoing economic expansion in developed and developing countries is the two blocs' different stance on the utilization of economic resources. Emerging market economies are hovering at close to full capacity utilization, in contrast to developed countries for which measures of slack still point to elevated levels. As such, underlying inflation pressures are measurably stronger for emerging market regions versus the developed country counterparts. These considerations imply that Central banks in the emerging markets have been on a rate hiking mode these past several weeks, a dynamic likely to sustain itself over the coming months. Such interest rate policy stance stands in stark contrast to that of developed regions for which Central banks are likely to remain on hold for the balance of the year.

Unprecedented nature of 2007-09 crisis, combined with the unprecedented debt accumulation that is still being unwound advice in favor of a value-oriented approach

While the long overdue arrival of the cyclical upswing is most welcome, the investment implications of such development should not be viewed through the prism of the post World War-II post-recession period template. Such cautious stance is warranted as it is predicated based on the unprecedented nature of the deleveraging dynamics currently unfolding in the US and Europe. Such process finds no precedent in the post-1930s Depression period. One of the implications springing from such an observation is the likely higher probability of a macroeconomic relapse in the ensuing quarters owing to the higher fragility of the US and European economies. Such relapses could unfold due to either an exogenous shock (e.g. geopolitical

development in the Middle East triggering a sharp escalation in energy prices) or the concatenation of policy mistakes by Central banks (e.g. premature interest rate hikes) or finance ministries (tax hikes).

Owing to the above, we continue to structure our managed investment portfolio's emphasizing value, both through macro (currency) and micro (traditional stock and bond valuation) lenses. In that regard, we continue to favor the US dollar versus the Euro, despite our view that at 1.35 the Euro could likely consolidate or even strengthen modestly to the 1.38/1.39 period in the weeks ahead. In addition, we continue to favor BBB/A rated corporate bonds, especially in the higher liquidity US market, over equities. Within equities, we favor North Asian emerging market equities, selected Japanese stocks and high quality/high dividend paying US equities over their UK and Eurozone brethren. Within the commodities space, we continue to favor agriculture commodities over precious metals, especially on a long-term strategic perspective. Within the commodities space, we highlight the rather elevated levels at which gold price is trading vis-à-vis traditional value comparators tied to real interest rates which have surged in the past several weeks, historically a bearish backdrop for gold prices. We attribute the recent gold price strength predominantly to the mounting concerns tied to the Greece sovereign credit crisis.

Finally, as for the Greece sovereign debt crisis, we are inclined to take the April 11th announcement by the Euro area countries as the final resolution to the market's concerns on the likelihood of a Greek sovereign debt restructuring scenario in 2010. More generally, in our view, the details of the April 11th announcement are likely to prove rather significant to the market and macro outlooks in the quarters and years ahead. More specifically, we believe that Euro currency's store of value has been impaired as a result of the overly generous and universal participation approach taken on by Europe. First, the size of the package (45bn Euros) is materially larger than the amount rumored in the markets ahead of the final announcement. Second, the terms accompanying the disbursement of funds are to be of the concessional (below market) variety which goes against the disciplining approach endorsed by the likes of Germany. Consequently, we are led to infer that Germany was forced to budge by the rest of Europe when confronting a fiscally imprudent member, such as is the case of Greece. Third, the funds to be provided by the EU are to proceed from all member countries in a proportionate basis to the country's share of ECB capital.

In conclusion, the final approach taken on by Europe vis-à-vis Greece sets a dangerous precedent for futures crisis countries, such as Spain, Portugal and Italy, whose economic sizes are many multiples of Greece's (six times larger in the case of Spain). Markets are certain to infer that European policymakers' tolerance for pain in fiscal adjustments is rather low. Consequently, asset prices for the Eurozone are virtually guaranteed to reflect the lower store of value conferred by Europe to its currency, the Euro. This is most likely to be true vis-à-vis currency values of sound emerging market countries as well as real assets.

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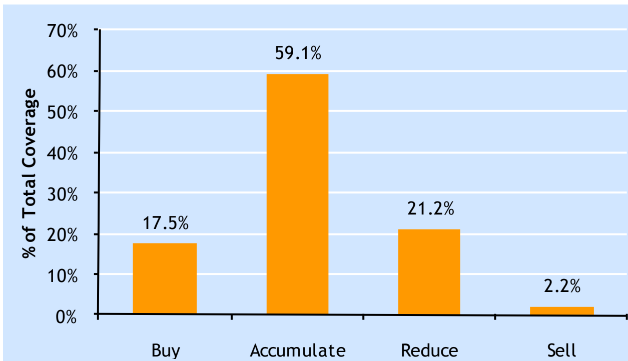

PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly

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