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India Strategy

Time to Lighten Up on Mid- and Small-caps

Conclusion: In mid-November, the market as measured by the leading indices appeared euphoric, but a deeper analysis revealed a lack of breadth, which was a good reason to believe that the broader market could outperform the narrow indices. As has been the case with several market variables in recent months, the pace of change has been swift. The market's breath has climbed to an all-time high, valuation dispersion has come off highs, mid- and small-cap valuation has gone to new levels, and broad market returns have comfortably beaten the BSE Sensex over the past six weeks. We think all this suggests that investors should now get selective about mid-caps, be ready for greater volatility in the broader market, and prepare for a shift of performance back into the large-caps. Our favorite large-cap stocks with a 12-month view are Sun Pharma, Jaiprakash, Sobha, and Infosys.

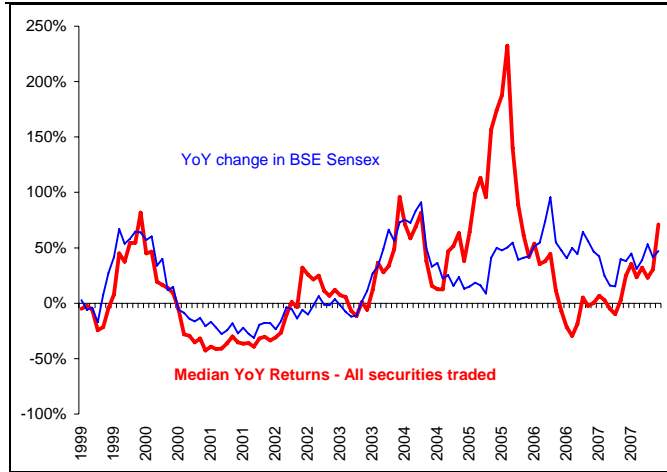
What's New: In November, the broad market had risen only 20% year-on-year, whereas the BSE Sensex was up 47% (please see our note entitled "Recipe for Volatility," November 21, 2007). This disconnect between the narrow and broad markets seemed to suggest a sharp rally in the broader market. In the month of December alone, the BSE Mid-cap and small-cap indices rose 14% and 27%, respectively, versus 5% for the BSE Sensex, taking the market's breadth to a new high. The trailing 30-day moving average of the advance/decline ratio exceeds 2 – a level not seen since 1991. The broad market is now up 71% yoy, whereas the Sensex is up 47%. Valuation dispersion has receded from its all-time high underpinning the broad market rally – the valuation level is more broad-based than it was a couple of months ago. The absolute valuation indicates the same. The P/B for the BSE Mid-cap index is now at a premium to the BSE Sensex, whereas the multiple of the BSE Small-cap index is at its smallest discount ever.

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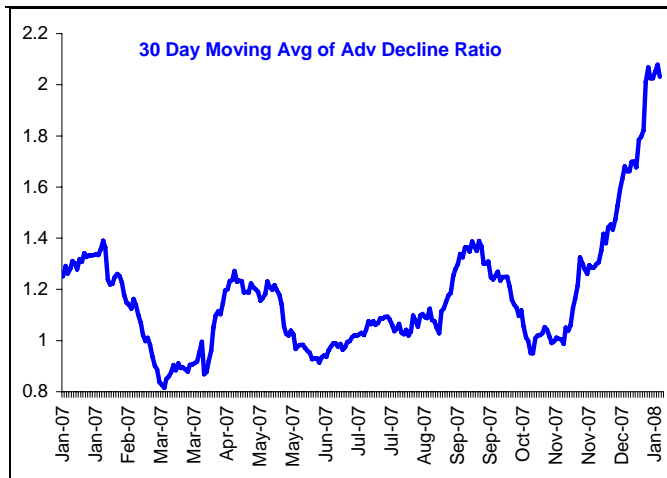
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Exhibit 1
Broad Market Returns Surge to Dangerous Level



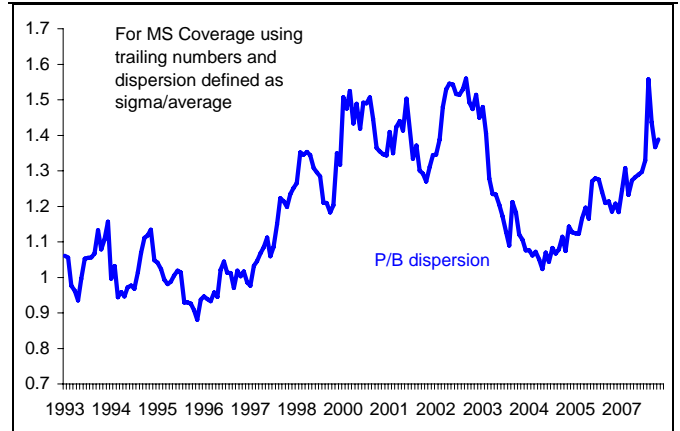
Source: Capitaline, Morgan Stanley Research

Exhibit 2
Market Breadth Zooms



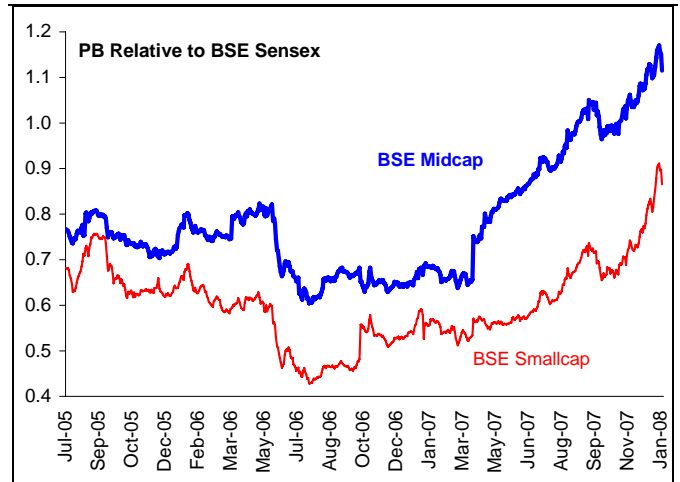
Source: ASA, Morgan Stanley Research

Exhibit 3
Valuation Story Becomes More Broad-based



Source: Company data, Morgan Stanley Research

Exhibit 4
Broader Market Trading at Almost Same Multiple as Mega-caps



Source: BSE, Morgan Stanley Research

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(as of December 31, 2007)

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