INDIA
Macro Strategy

India Equity Strategy

Staying defensive despite a good budget

Dr. Carlos Asilis (CarlosAsilis@PLIndia.com)
+1 (305) 333-0012

Darshan Bhatt, ACA, CFA (DarshanBhatt@PLIndia.com)
+1 (201) 633-3601

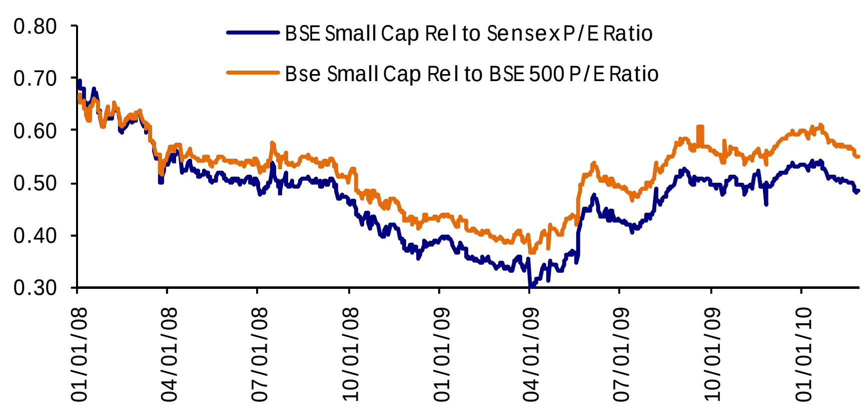
India Equity Strategy

Against the global macro and market backdrop delineated below, our India equity strategy recommendations, both at the sector and recommended cash levels, remain unchanged for the forthcoming month, as shown in *Table 1*. In order to purely rebalance the portfolio in response to changes in weights due to market movement, we are adding 0.30% to FMCG, 0.20% to Technology and reducing 0.40% from Telecom and 0.1% from Real Estate.

Our recommended sector allocation has outperformed the BSE 500 by 0.36% since January 22, 2010. Our recommended stock portfolio has outperformed the Sensex by 9.38% since initiation on September 3, 2009.

We believe Indian market participants' continued resilience in embracing the thesis of 'full decoupling' between the Indian and the Global macro outlook, at a time of burgeoning budget deficits globally and escalating credit concerns is most clearly reflected in the narrowing of valuation premium between small and large cap names (illustrated in *Figure 1*). Market cycle history has shown such valuation differentials to be justified only in macro environments characterized by low financial and overall macro volatility in addition to low liquidity premium. According to our global macro investment thesis, discussed at length in sections below, the current macro outlook does not meet such characteristics. As a result, we recommend clients to take a cautious stance towards smaller cap names and be overweight in higher quality large cap names.

Fig1: Narrowing valuation differentials between large caps and small caps



Source: Bloomberg and PL Research

As far as the market implications from the recently submitted National budget are concerned, the market's positive knee-jerk response was understandable on account of the government's commitment to lower annual budget deficit from the current 6.9% of GDP to 5.5% of GDP in the fiscal year starting on April 1, 2010. The extent to which the government is able to consolidate an improvement in India's fiscal fundamentals, where public debt ratio currently stands at around 82% of GDP, intermediate and long-term inflation premium built into bond yields are likely to come down. The Government's deficit reduction target is dependent on the divestment of stakes in PSUs, which will be governed by the prevailing market conditions. In any case, we continue to expect RBI to raise rates in the coming months as the headline inflation momentum is likely to sustain itself in the coming months, owing to year-ago effects. More importantly, Indian equity market valuations, relative to global emerging market peers, continue to remain unattractive. As such, we expect Indian equities to trade in line, at best, versus emerging market peers over the coming months, and more likely to underperform modestly.

Emerging Markets

In our view, the declines in risk assets since the beginning of the year are fuelled by a spike in risk premium triggered by (1) mounting sovereign credit concerns, more notably out of Greece, (2) a continued US dollar rally that has extended into the month of January and the earlier part of February, and (3) equities' overbought condition with the turn of 2009 calendar year.

Our medium and long-term investment outlook towards emerging markets remains exceedingly constructive owing to emerging market countries' strong balance sheets, underleveraged household sector, competitive currencies, and ample room for financial deepening dynamics to take hold. Moreover, the emerging markets' growing share of world growth and world GDP, versus a mere 5 or 10 years ago comparison levels, has mitigated the macroeconomic contagion risks stemming from adverse economic growth and financial sector shocks emanating from the developed world.

The beginning of the year has been unkind to global emerging market equities, with the group slightly underperforming its global peers. Specifically, the MSCI EMF index underperformed its world peers, as represented by the MSCI AC World Index, by a mere 2.3 %, a fractional percentage amount considering emerging markets' outsized excess return performance of 43.6% for the 2009 calendar year. Latin America underperformed the emerging markets index, fuelled by the sharp correction of commodity prices (Latin America markets, especially Brazil, Peru, Chile and Argentina are highly dependent on commodity prices). Conversely, EMEA (emerging Europe, Middle East and Africa) recorded the strongest regional performance, supported by the Israeli market's heavy regional index weighting and its low beta characteristics as well as the Russian and South African market's outperformance.

That Russia outperformed their emerging market peers during a period of strong US dollar and weak commodity price performance is unusual, given its markets' heavy dependence on the natural resource sector. We attribute such 'decoupling' to both valuation and technical considerations, as institutional market participants' allocations to Russia was a lot lighter in early January than for other large natural resource dependent markets, most notably Brazil.

Going forward, we recommend an increased allocation to the Brazilian market and also to Mexico owing to increasingly attractive relative valuations. We believe the Mexican peso remains one of the cheapest emerging market currencies worldwide, while Brazil, notwithstanding its vulnerability to a further decline in world commodity prices in the coming months (our baseline case), is now a more compelling investment owing to (1) a more favourable technical backdrop (institutional investors have shed significantly their large overweight allocations to Brazil, in place at the turn of the year) and (2) also attractive valuations.

In emerging Asia, we have maintained our longstanding overweight regional allocation. We continue to favour such overweight regional exposure owing to the region's (1) attractive relative valuations versus emerging market peers, (2) exceedingly strong sovereign, corporate and household balance sheets, not only at a global but also at an emerging markets level (such characteristic is particularly important from our perspective owing to the continued escalation of sovereign credit concerns out of Greece, Portugal and Spain), and (3) highly visible medium and long-term economic, and thereby earnings, growth outlook. Within the emerging Asia portfolio, we recommend raising exposure to the Chinese market from a large underweight to a neutral weighting, following the market's sharp relative underperformance which has made Chinese equities attractive. We have funded the purchase of Chinese equities via a sharp reduction in our large recommended overweight allocation to Taiwan, which has served us very well for several months, as well as Korean equities, though by a much lesser degree.

Finally, from a portfolio perspective, we recommend lowering exposure to Malaysian and Thai equities, largely to fund an increase in cash allocations from around 4 % at the beginning of January to 14 %.

Going forward, we expect emerging Asia to outperform, followed by EMEA and Latin America, in that order. We expect to maintain an overweight cash allocation over the short-term pending either the return of greater price concessions from the market, in the way of lower valuations, or a clearer resolution of sovereign credit concerns and the playing out of scheduled withdrawal of Central bank liquidity on the part of G4 Central banks in the coming weeks. From a positioning perspective, we are comforted with the emerging markets' far healthier backdrop as the recent correction period has pushed some of the 'weaker hands' out of the market, as witnessed by the large weekly outflows recorded by emerging market funds during the month of January.

Global Markets

During the 2010 Year-to-date period, global equities, as represented by the MSCI AC World Index, fell sharply, recording a 3.32 % decline. The decline was even sharper for global emerging market equities which fell 5.41% during the period.

The sharp sell-off recorded by major risk assets, during the period was largely the result of the deterioration in the three global macro factors outlined in our prior commentary. Specifically, the period witnessed:

(1) A further sharp appreciation of the US dollar, especially versus the Euro

(2) A continued deterioration of Greece credit concerns, and

(3) A second upward adjustment of reserve requirements, representing further credit contraction, by the People's Bank of China (China's Central bank).

In line with our expectations, the US dollar has sustained the revaluation path versus the Euro that began in early December 2009. Specifically, the Euro has declined almost 11 % versus the US dollar between early December 2009 and February 2010. Quite impressively, within a short 3 months, the US dollar has regained approximately 62 % of the lost ground with the Euro that unfolded over a period of nine months (March-November 2009).

We expect the US dollar to strengthen further versus the Euro over the coming months owing to (1) the continued downside risks to economic growth afflicting the Eurozone region, (2) the still unresolved nature of the sovereign credit concerns hovering over Greece, Spain, Portugal and Italy – further discussed below, and (3) the modest, yet steady, withdrawal of excess liquidity from global money markets on the part of the Fed, Bank of England and European Central Bank, over the coming months.

Notwithstanding our continued bullish outlook toward the US dollar, we are conscious of the potential for a short-term consolidation and possibly weakening of the US dollar owing to technical considerations, including a short-term oversold positioning in the Euro on the part of FX futures traders as well as the likelihood of market-friendly policy announcements by European institutions, vis-à-vis assistance measures toward Greece, over the coming weeks (by the middle of March). From a strategic perspective, we would meet such short-term bounces in the Euro as opportunities to further lower exposure to that currency.

Global financial market concerns over Greece are well-founded, in our view. These concerns reflect the market's skepticism towards the Greek political establishment's ability to reverse, over a prudential horizon, the public sector's longstanding track record of fiscal profligacy. Such state of affairs is reflected in the country's net public debt ratio level in excess of 100 % of GDP and annual budget deficits in excess of 8 % of GDP. The latter factors, combined with Greece's exceedingly unfavorable prospects in generating economic growth rates in excess of 2 % over the next five years (owing to the Greek economy's lack of competitiveness, in part the result of an overvalued currency and an inflexible labor market), lead to valid concerns over Greece's long-run solvency. That the market's concerns have escalated to such elevated levels is understood partly as a result of the fast approaching dates by when upwards of 20 billion euros of public debt are scheduled to be refinanced (March and April) and also by broader concerns over the European banking system's disposition in financing high risk destinations.

It is quite clear that over the short term the evolution of the Greek saga is likely to be defined by actions taken by government officials in Berlin, Paris and Brussels. In our view, deteriorating popular support in Germany and France towards multilateral or bilateral assistance of Greece imply that any short-term assistance effort is likely to be a short-term as opposed to a comprehensive solution to Greece's fiscal solvency challenges. In that regard, we believe that the backdrop facing the Euro and the broader financial conditions in the Eurozone are likely to remain challenged over the balance of the year. Consequently, we believe that the recent bout of hope for a durable short term resolution of Greece's challenges, as evidenced in the recent decline in CDS spreads, is bound to be ephemeral.

The broader implications of the ongoing Greek sovereign credit crisis are far reaching. First, the Greek crisis is taken by market participants as a 'dry-run' of what may be a far more consequential crisis tied to concerns over Spain's and Italy's medium- and long-term debt sustainability challenges. In that regard, to the extent that financial market concerns towards Greece and Portugal linger over the coming weeks and months, to the same extent will financial conditions in the Eurozone remain under pressure. That such dynamics are real is best evidenced by the sizable German and French bank exposures to Greece and Spain, for example. Specifically, according to third quarter 2009 data from the Bank for International Settlements, combined German and French bank exposures to Spain amount to 425 billion US dollars. Similar combined exposure to Italy and Greece by French and German banks amount to 700 billion US dollars and 122 billion US dollars, respectively.

At the market level, we maintain a defensive stance owing to the following considerations: (1) our continued thesis of market analysts' overly optimistic earnings expectations for the balance of 2010; (2) the lagged, yet sustained, effects on risk assets from a deceleration in the rate of growth of global liquidity conditions as G4 central bank slowly but surely withdraw excess liquidity from money markets – the latest Fed discount rate increase is but a signal of the unfolding of such dynamics; (3) the downside economic and earnings risks associated with continued concerns in sovereign credit markets, a la Greece, Spain, Portugal and Italy, in the months to come.

We view the recent recovery of risk markets that started on February 8th as largely a reflection of a technical bounce from a short-term oversold condition. First, this is evident in the traded volume patterns that have accompanied recent sell-off and recovery phases. Specifically, the market's sell-off in January came on heavy volume though the recent recovery phase has come on low volume

Second, the rally has failed to reverse more than 60 % of the January losses despite a sizable decline in implied volatility and investor positioning to levels similar to those of early January.

We remain overweight on the US dollar, US high grade bonds, agriculture commodities and emerging Asia equities. Correspondingly, we maintain an underweight allocation to global equities, cyclical commodities, European and UK equities. At current levels, we are likely to build long positions in high quality / high dividend paying energy stocks following the recent sharp correction period.

Table 1: Sector Allocation - India Equity Market Performance

Sector	Last Change + / -	On	Recommended + / -	Weight (%)	Market Weight (%)	Market Cap (FF adj) (Rs Crs.)	Cap (FF adj) (US$ bn)	Index Level	52-Week High	52-Week Low	Return 1 Week	Return 1M	Return 3M	Return YTD
Autos			-	4.5%	5.2%	112,859	24.5	6,880	7,669	2,495	-0.9%	-7.1%	-2.5%	-7.5%
Capital Goods			+	9.5%	8.2%	179,581	39.0	13,165	14,448	5,394	1.4%	-1.2%	-2.0%	-6.7%
Consumer Durables			+	1.0%	0.4%	8,977	1.9	4,010	4,189	1,429	0.9%	3.5%	13.7%	5.9%
FMCG			=	6.1%	6.1%	133,841	29.1	2,749	2,940	1,782	0.6%	-0.8%	-4.8%	-1.5%
Health care			+	5.0%	4.1%	90,762	19.7	4,861	5,201	2,491	1.4%	0.1%	2.1%	-3.1%
Technology			+	10.6%	10.0%	218,897	47.5	5,159	5,443	1,988	2.5%	-0.6%	6.3%	-0.5%
Metals			-	5.0%	7.2%	157,814	34.3	16,029	18,560	4,407	2.3%	-7.4%	-1.2%	-7.9%
Oil & Gas			+	11.9%	11.2%	246,188	53.5	9,593	10,896	5,526	-1.3%	-4.8%	-7.4%	-8.4%
Power			-	4.0%	4.6%	100,905	21.9	2,957	3,293	1,581	-0.6%	-4.4%	-1.7%	-7.3%
Realty			-	1.4%	1.5%	33,556	7.3	3,163	4,846	1,298	-6.1%	-15.8%	-17.3%	-18.0%
Banks			-	11.5%	14.2%	310,414	67.4	9,601	10,699	3,599	2.8%	-2.1%	-6.6%	-4.3%
Cement			+	2.7%	2.6%	57,689	12.5							
Telecom Services			=	4.2%	4.2%	92,949	20.2							
Others (Unclassified)			-	18.6%	20.3%	443,959	96.4							
BSE 500				96.0%	100.0%	2,188,392	475.3	6,452	7,070	2,961	0.4%	-4.1%	-3.0%	-5.7%
Sensex						1,141,680	247.9	16,286	17,790	8,047	1.5%	-3.4%	-4.9%	-6.7%
Nifty						1,241,162	269.6	4,870	5,311	2,539	1.4%	-3.3%	-4.3%	-6.4%

Source: PL Research

Pricing data as of February 23, 2010

Table 2: Sector Allocation - India Equity Market Valuations

Sector	Consensus EPS Growth (%)		PL EPS Growth* (%)		PL P/E* (x)		EV /EBITDA (x)		Dividend Yield (%)	P/BV (x)	Net Debt to Equity
	FY10	FY11	FY10	FY11	FY10	FY11	FY10	FY11			
Autos	302.2	35.8	254.0	17.6	17.0	14.5	10.4	8.5	0.89	4.1	120.4%
Capital Goods	13.5	32.2	10.0	33.7	27.2	20.9	16.1	12.6	0.69	5.2	65.7%
Consumer Durables	24.1	25.8	56.0	26.7	25.4	28.7	13.1	10.6	0.82	1.7	121.0%
FMCG	18.4	17.3	26.4	17.4	25.2	21.5	16.4	14.1	1.90	8.4	44.6%
Health care	93.8	32.5	125.3	33.9	20.3	15.1	15.8	13.0	0.72	4.6	66.3%
Technology	12.0	15.0	12.6	15.1	21.5	19.2	15.8	13.9	0.84	7.0	-0.1%
Metals	-8.5	48.2	-1.1	58.2	20.6	14.8	10.2	7.4	0.77	3.3	83.8%
Oil & Gas	23.9	22.2	29.7	23.5	13.8	11.2	8.8	7.3	1.36	2.2	59.3%
Power	18.1	21.1	27.4	12.2	23.7	21.2	16.4	12.4	1.09	2.6	79.4%
Realty	-35.0	27.7	-30.3	57.9	17.7	11.2	16.3	12.3	0.45	1.7	69.5%
Banks	7.9	17.4	13.6	24.3	11.8	10.1	14.4	11.3	1.38	1.9	102.0%
Cement	33.9	-7.7	40.9	-20.3	9.9	13.4	6.1	6.4	1.88	2.3	59.1%
Telecom Services	-15.3	(6.9)	-12.6	-17.1	13.6	16.4	8.3	7.7	0.41	1.7	68.2%
Others (Unclassified)	28.3	25.3	50.7	26.7	19.2	17.6	8.2	6.5	0.90	3.0	148.9%
BSE 500	**15.7**	**22.5**	**25.1**	**23.4**	**17.6**	**15.1**	**10.8**	**8.8**	**1.02**	**2.9**	**90.2%**
Sensex	**2.7**	**21.5**	**8.7**	**20.3**	**17.1**	**14.2**	**11.8**	**9.7**	**1.22**	**3.0**	**80.9%**
Nifty	**2.7**	**24.6**	**8.3**	**24.1**	**17.6**	**14.2**	**12.2**	**9.8**	**1.19**	**2.8**	**79.2%**

Source: PL Research

**Consensus numbers are used for stocks that are not under PL coverage*

Pricing data as of February 23, 2010

Prabhudas Lilladher Pvt. Ltd.
3rd Floor, Sadhana House, 570, P. B. Marg, Worli, Mumbai-400 018, India
Tel: (91 22) 6632 2222 Fax: (91 22) 6632 2209

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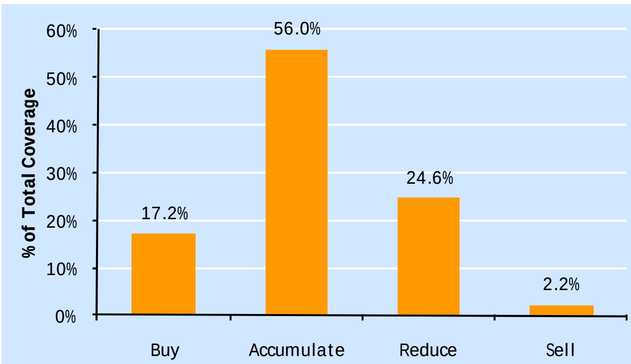

PL's Recommendation Nomenclature

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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