INDIA STRATEGY

Weaker hands exit

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Significant volatility in the markets witnessed over the last week was driven by unwinding of leverage positions in the system, which was in turn triggered by weakness in global markets. While near term outlook points to continued volatility, India's unchanged strong fundamentals mean any market weakness is an opportunity for the long term investor to enter select stocks at attractive valuations.

Turbulence over the last 7 trading sessions – F&O market unwinding

Large open positions on the long side have been building up in the derivatives markets since November 2005. The futures open interest (OI), which offers substantial leverage, had risen to INR 410 bn from INR 200 bn in November 2005, with significant participation from non institutional investors. However, the 463 point fall in the Sensex on May 15 driven by global factors, triggered large margin calls. Inability to meet margin calls led to forced closure of futures positions, causing a further fall in the market and creating a vicious cycle.

Growing global risk aversion triggered the initial fall in emerging markets

Fears about higher global interest rates and economic outlook fueled the concerns on flight of capital to safer markets thereby resulting in initial breakdown of all emerging markets. Also fear of a slowdown in US consumption due to rise in oil prices, bursting of the real estate bubble and higher inflation dented global market sentiments. The selling in commodities by hedge funds, as also signs of the global carry trade unwinding added to the negative sentiments.

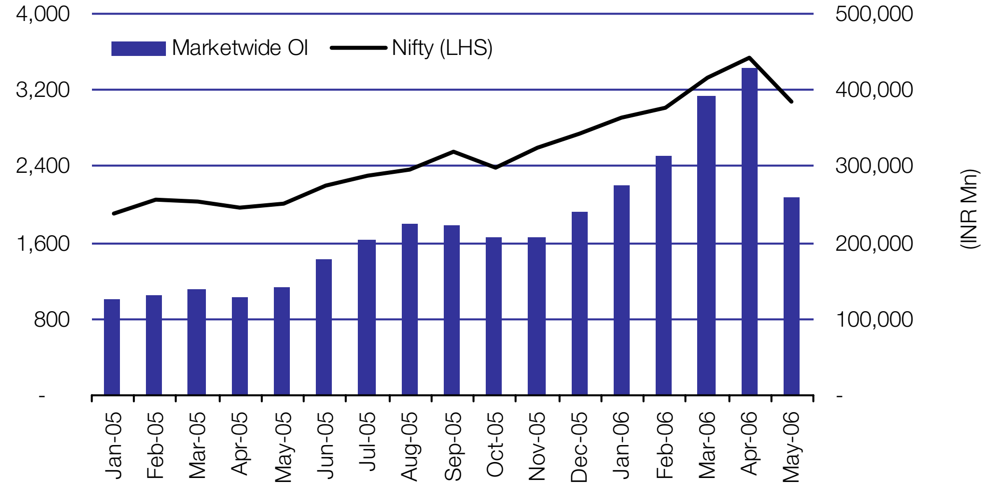
In India, markets have been soft due to perception of a few government announcements – cap on cement prices to control inflation, a draft IT circular appearing to seek taxation of FIIs (since clarified), etc.

OI levels are still high – more volatility likely

Over 38% of the market wide positions have got squared off over the last 4 trading sessions due to the selling triggered by the margin shortfall and some profit booking. Market wide OI has reduced by INR 150 bn in the last 4 trading sessions and is at the same level seen in December 2005 (see chart).

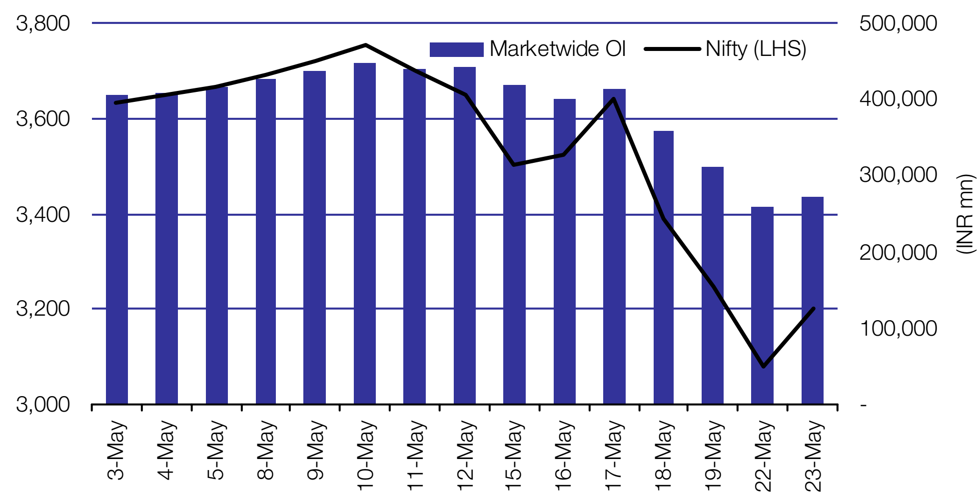
The absolute amount of OI still remains high and given the market scenario, the rollover of futures positions will be the most crucial trigger for the markets this week. Only 34% of the positions have got rolled to June compared to an average of 48% positions getting rolled up to 2 days before expiry and this remains a cause of concern. However, it is also likely that futures positions will get squared off and cash positions reinitiated if premiums reduce. Market wide rolls are taking place at an average cost of 45 bps (90-100 bps in the last few expiries).

Chart 1: Marketwide open interest (MoM)



Source: Edelweiss research

Chart 2: Marketwide open interest (Daily)

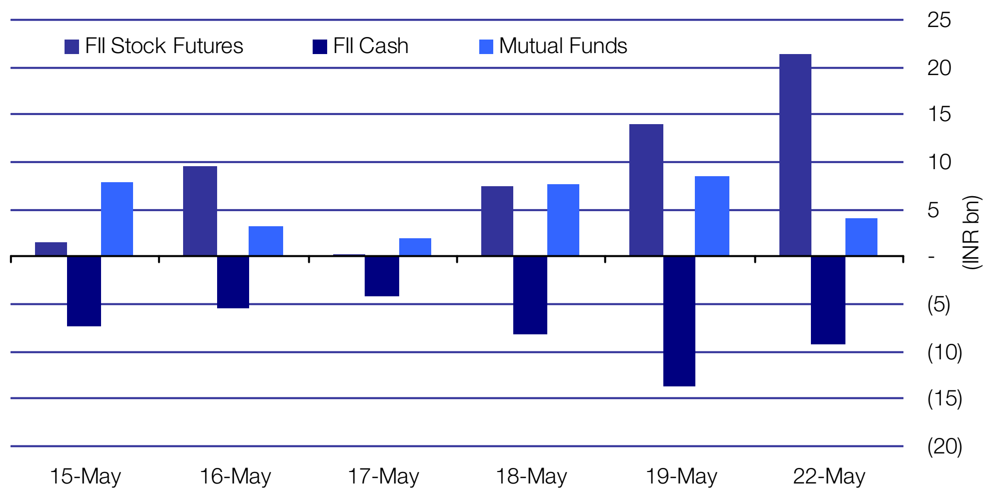


Source: Edelweiss research

* FIIs continue to hold their long positions; buy aggressively in stock futures

Contrary to the belief of most people in the market, FIIs have been buyers over the last few trading sessions. While FII cash volumes indicate selling, taken together with volumes in stock futures, they imply squaring up of the substantial long cash-short futures positions that had been built up when the market was trading at a premium (see chart below). Mutual funds too have been buying on every dip and have purchased stock worth INR 33.4 bn in the last 6 trading sessions.

Chart 3: Institutional volumes



Source: Edelweiss research

Commodities – outlook still positive

Over the course of last 1 week i.e. 12– 19 May, LME prices of aluminium, copper and zinc have corrected by 12%, 8% and 14% respectively. It is difficult to pinpoint the exact reasons for this correction, but one thing which is for sure is that the fundamentals have not changed over the past 10 days. Sustained above-trend demand growth, supply side's failure to keep pace with demand, and low inventory levels remain the order of the day. Hence, the recent bout of selling seems more to be of the order of a technical sell off on account of possibly a competing asset class becoming more attractive.

We believe that the concerns over sustainability of the cycle are overdone. While we have earlier maintained that such high prices for base metals are not sustainable, at the same time there has been a structural shift in the cost structure, which warrants a high price regime for some time to justify the new investments for incremental supplies.

India fundamentals remains attractive – buy selectively

India's long-term growth drivers remain in place – a young demographic driving global services and manufacturing outsourcing and robust domestic consumption together with acceleration in infrastructure creation. While near term outlook is likely to be murky and driven by global factors, the macro story is intact and should reflect in equity performance in the medium to long term.

The Sensex trades at almost 17x FY07E, which is still at a premium to most emerging markets. However, the correction in the markets has provided an opportunity to enter select stocks at attractive levels. Our top picks across large caps and mid caps are listed in the table below.

Selective buying opportunities

Large cap picks

Company	Sector	Market Cap	Price (May 23)	52 week high	% change since high	FY07E PEx
Nifty			**3,199.4**	**3,774.2**	**(15.2)**	**17.2**
CNX Midcap			**4,435.7**	**5,349.4**	**(17.1)**	**19.7**
Hindustan Zinc	Metals	274,815	650.4	1,119.0	(41.9)	10.6
Suzlon Energy	Infra-power equipment	298,914	1,039.7	1,429.0	(27.2)	22.2
Syndicate Bank	Banking	36,719	77.8	105.0	(25.9)	5.1
Union Bank of India	Banking	48,957	106.4	143.0	(25.6)	5.0
Satyam Computer Services	IT	219,974	689.0	918.4	(25.0)	17.1
Hindalco Industries	Metals	188,401	191.0	251.3	(24.0)	8.3
Tata Motors	Auto	282,564	781.1	997.8	(21.7)	15.8
Aurobindo Pharma	Pharma	29,853	588.0	747.0	(21.3)	14.7
Larsen & Toubro	Equipment & capital goods	300,644	2,314.0	2,909.0	(20.5)	23.1
Bharat Heavy Electricals	Infra-power equipment	489,275	1,999.0	2,500.0	(20.0)	23.3

Mid-cap picks

Company	Sector	Market Cap	Price (May 23)	52 week high	% change since high	FY07E PE x
Nifty			**3,199.4**	**3,774.2**	**(15.2)**	**17.2**
CNX Midcap			**4,435.7**	**5,349.4**	**(17.1)**	**19.7**
Orchid Chem. & Pharma.	Pharma	11,417	223.0	400.0	(44.2)	9.2
Shree Renuka Sugars	Sugar	21,288	1,064.4	1,667.0	(36.1)	11.9
Simplex Infrastructures	Construction	16,630	1,933.7	2,725.0	(29.0)	17.6
Bombay Rayon Fashions	Textiles	6,263	190.0	258.6	(26.5)	18.3
Deepak Fert. & Petro. Corp	Chemicals & Fert	7,886	89.4	120.0	(25.5)	7.8
Dishman Pharma. & Chem.	Pharma	13,528	197.0	262.0	(24.8)	14.9
Alok Industries	Textiles	10,031	74.9	99.4	(24.7)	5.7
Sanghvi Movers	Equipment & capital goods	5,167	698.2	913.0	(23.5)	10.0
PSL	Oil&Gas	6,949	239.0	312.0	(23.4)	11.5
BL Kashyap & Sons	Urban infra	6,006	1,238.8	1,594.9	(22.3)	17.1

@ year ending September

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period