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Morgan Stanley Dean Witter Asia Limited+

Ridham Desai
Ridham.Desai@morganstanley.com
+91 22 2209 7790

JM Morgan Stanley Securities Private Limited+

Sheela Rathi
Sheela.Rathi@morganstanley.com
+91 22 2209 7730

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India Strategy

More Snakes Than Ladders

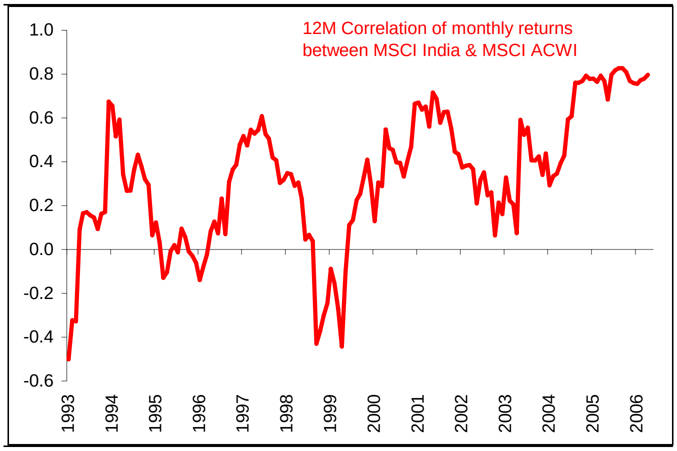
Conclusion: As the market tries to forge ahead, we think it is more likely to encounter snakes that gulp it down to lower levels than arrows or ladders that propel it to higher levels. There are three reasons for our view. The first is that, anecdotally, investors seem complacent about the recent fall, having been burnt by their experience last year when they were caught being too bearish post the May 2006 fall. Second, the market faces several headwinds in the form of a weaker domestic demand outlook (heralded by higher interest rates), a relatively less docile political environment at home and uncertain prospects for global risk appetite. Last, neither fundamentals nor market technicals suggest that we are done with the correction.

What's New: Recent flows suggest that investors are not as bearish as they were in the weeks after the May 2006 correction. However, unlike in the aftermath of May 2006, investors have to deal with the prospects of slowing domestic growth – the only way India can fix its inflation problem in the coming months. This is juxtaposed with a less favorable political environment with the forthcoming elections (19 in all over the next 24 months) creating possibilities of a backlash on reforms, though probably not an upheaval in the government. The market is trading at valuations that do not suggest positive returns, while fundamentals are looking less robust than before. India's high and rising beta indicates heavy dependence on global factors for its immediate performance and global factors appear less predictable than before. This situation is hard for a mixed bag of technical indicators to neutralize.

Implications: Fundamentally, the fair value for the BSE Sensex is around 11,500 on our residual income model, but we see little to prevent it from trading below fair value (especially given that it has traded above fair value for months). From a portfolio perspective, we are anchored in a relatively defensive portfolio, which is underweight consumer cyclicals and rate sensitives. In a tactical move, we are increasing the cash balance in our model portfolio, while trimming our position in the software services sector.

Exhibit 1

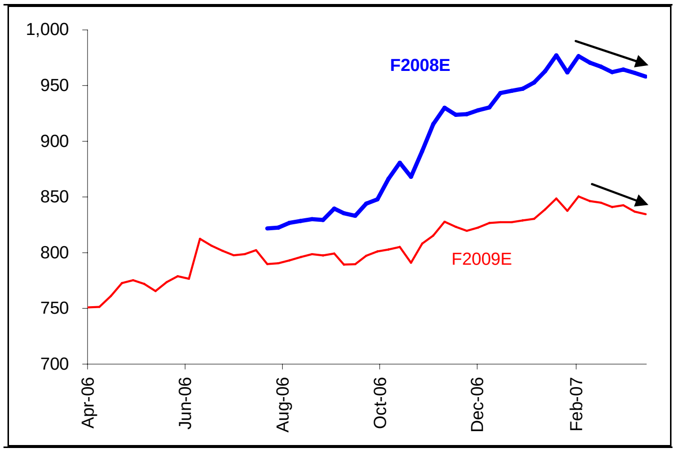
India: Highly Correlated to the World



Source: FactSet, MSCI, Morgan Stanley Research

Exhibit 4

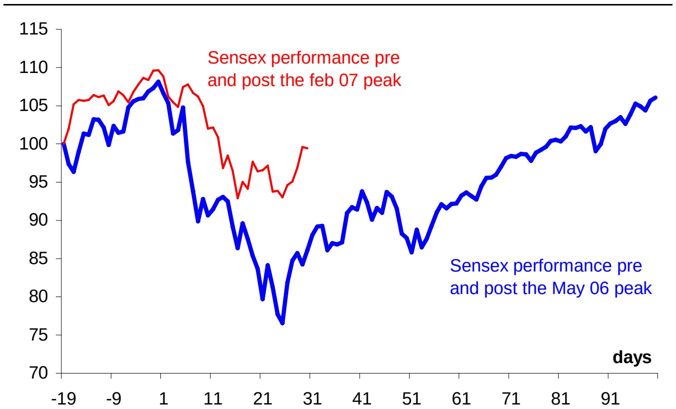
Sensex: Consensus EPS Lowered Since February



Source: FactSet, IBES, Morgan Stanley Research

Exhibit 2

Sensex: Correction Not As Deep This Time



Source: Bloomberg, Morgan Stanley Research

Exhibit 5

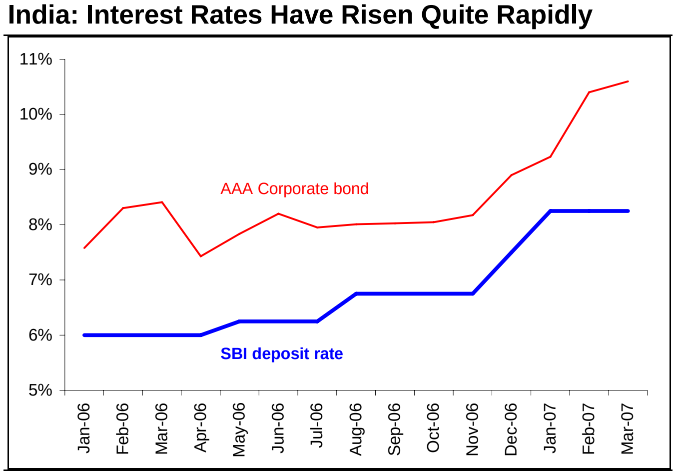
Sensex: Earnings Revisions at the Sector Level

NP08	Current Value	1 months back	3 months back	6 months back
Market	15.1%	15.4%	15.2%	12.8%
Market ex energy	20.3%	20.5%	19.9%	17.1%
Cons. Discretionary	22.4%	23.1%	22.7%	22.7%
Cons. Staples	19.1%	19.9%	21.8%	19.2%
Energy	2.2%	3.0%	3.6%	2.5%
Financials	23.6%	23.3%	24.4%	22.3%
Healthcare	11.7%	12.8%	18.2%	18.9%
Industrials	23.8%	25.0%	23.5%	21.5%
Material	0.5%	0.0%	-2.8%	-6.1%
Tech	30.1%	29.7%	27.7%	24.7%
Telecom	44.0%	45.2%	41.9%	34.4%
Utilities	11.3%	11.0%	11.4%	9.9%

Source: FactSet, IBES, Morgan Stanley Research

Exhibit 3

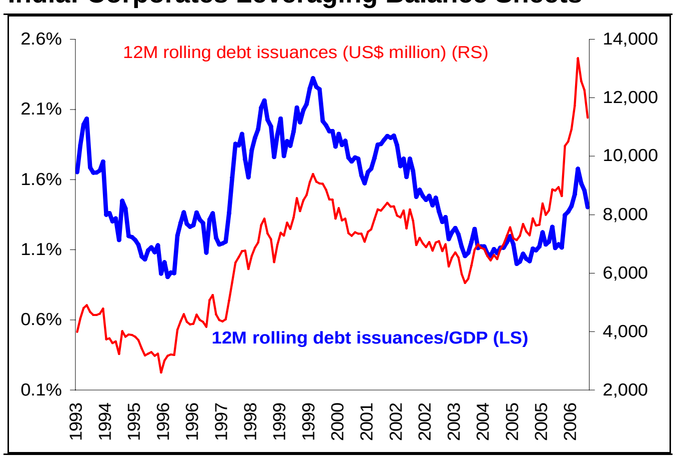
India: Interest Rates Have Risen Quite Rapidly



Source: Bloomberg, SBI, Morgan Stanley Research

Exhibit 6

India: Corporates Leveraging Balance Sheets



Source: CMIE, Morgan Stanley Research

The Gulping Snakes
As the market tries to forge ahead, we think it is more likely to encounter snakes that gulp it down to lower levels than arrows or ladders that propel it to higher levels. There are three reasons for our view. The first is that, anecdotally, investors seem complacent about the recent fall, having been burnt by their experience last year when they were caught being too bearish post the May 2006 fall. Second, the market faces several headwinds in the form of a weaker domestic demand outlook (heralded by higher interest rates), a relatively less docile political environment at home and uncertain prospects for global risk appetite. The fact is that Indian equity returns continue to be highly correlated with the world and hence heavily dependent on global outcomes (Exhibit 1). The global scenario seems mired by sub-prime concerns in the US, a possible slowdown in China and inflation and growth issues in the US. In such circumstances, we think that global risk appetite may not be as strong as it was in 2006. Last, neither fundamentals nor market technicals suggest that we are done with the correction.

Investors Have Come Back
Investors seem to have learnt from their May 2006 experience by not selling down heavily into the February fall (Exhibit 2). In fact, in recent days and weeks, overseas investors seemed to have covered shorts and also bought stock in the cash market. In the six weeks post the market high in May 2006 (which is where we are currently with respect to the Sensex high hit on February 8, 2007), FIIs had purchased a net of US$200 million through the cash and futures market with net selling of US$2.1 billion in the cash market. This time around, the six weeks post the February 8 high have witnessed net buying of over US$2 billion, including net buying of US$950 million in the cash market.

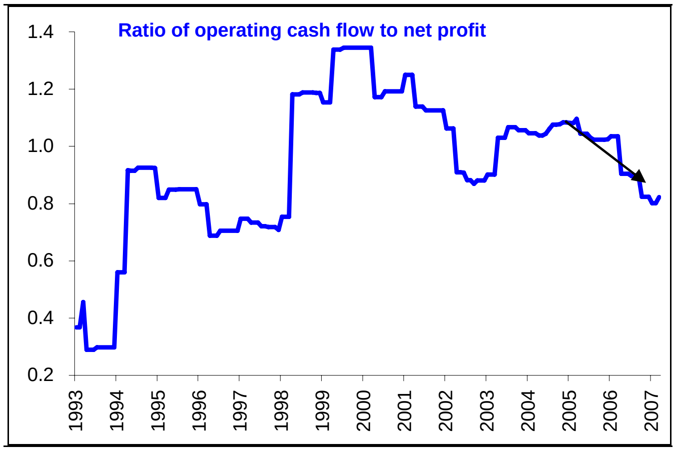
We think this reflects some complacency on the part of investors, especially given how different the macro conditions are today compared with May 2006. Hence, we believe the market has not discounted the possible slowdown in growth that we think is only way India can resolve its inflation problem. In our view, the inflation problem is one of excess demand over supply and, with supply unlikely to be created quickly, demand needs to slow. The rise in rates over recent months should produce a lagged effect on India's leveraged consumption-driven growth cycle. While bank deposit rates have risen 150 bps over the past four months, AAA corporate borrowing rates are up by close to 250 bps (Exhibit 3). We expect GDP growth to slow from 9.2% in F2007 to 7.5% in F2008.

The market also has to deal with a deteriorating political environment. No doubt, politics have not contributed to the economy's performance or, for that matter, the market's performance over the past three years. However, we think that 2007 could be an inflexion point. We have already seen some signs of negative political intervention post the state elections in February. Uttar Pradesh, India's largest state, goes to the polls in the next two months. We still see little risk to the government – the BJP and its allies do not appear to have enough support to be a serious threat, while the third front (ex Congress and the BJP) does not have the strength to form a government. The BJP and its core allies plus Congress have close to 300 seats in the 543-seat parliament, leaving the third front with limited options. However, the policy environment could be at risk if the parties in power at the centre suffer from electoral reversals. We must also note that there are 19 state elections (including Uttar Pradesh) coming up over the next 24 months in the run-up to the next central elections in 2009. As such, this does not imply a conducive background for positive policy action.

Valuations and Earnings Are Doing OK … But Only Just
Obviously, earnings are in good shape. The economy is still operating at full speed. In all probability, the forthcoming earnings season will be good. However, expectations are also high, which lends itself to negative surprises. It is noteworthy that, for the first time in several months, the sell side consensus has been lowering estimates. We have seen, a small downward draft in the estimates for the BSE Sensex constituents (Exhibit 4). F2008 EPS and F2009 estimates have been cut by 2% each since their peaks on February 8, 2007. The four sectors where forecast earnings growth has risen over the past month are: financials, technology, utilities and materials (Exhibit 5). We think earnings will turn distinctly weaker in the latter part of 2007 if the economy slows down as we are forecasting.

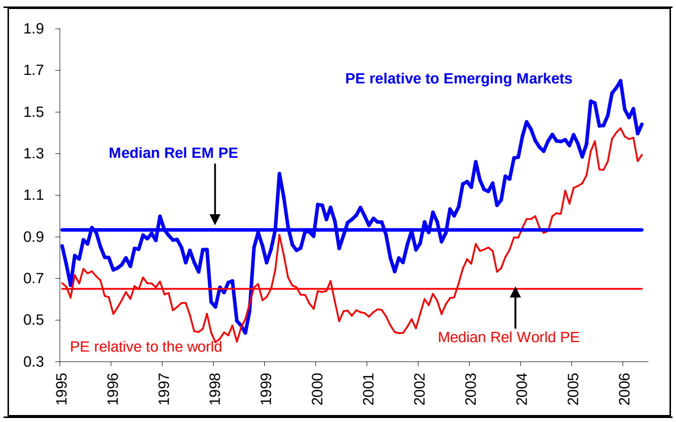
At the same time, ROE is also likely to come under pressure. The fact is that corporate India has upped the ante on adding assets to its balance sheet. This will have negative implications for asset turnover, especially if revenue growth slows. Corporate India is trying hard to shore up ROE by leveraging the balance sheet – the only viable option in the coming 12 months (Exhibit 6, and see *A New ROE Wave* dated February 14, 2007). The other issue for investors to deal with is the slippage that we are witnessing in earnings quality. Thus the share of operating cash flow in net profit is at an eight-year low, suggesting that book entries may be shoring up reported earnings (Exhibit 7, and see *Who Cares for Cash?*, dated January 2, 2007)

Exhibit 7
Corporate India: Earnings Quality Suffering



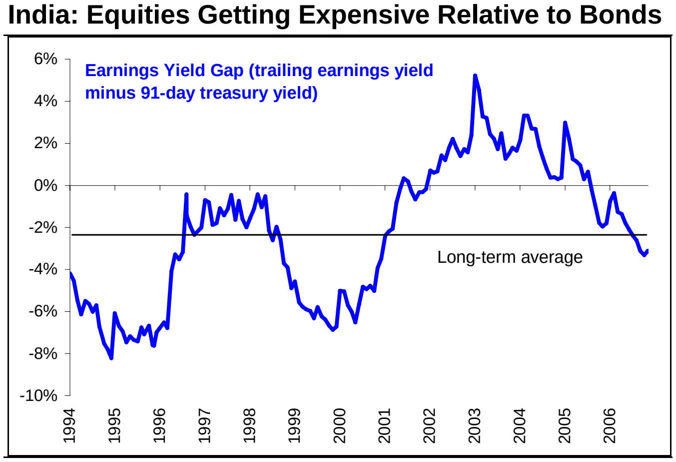
Source: Company data, Morgan Stanley Research

Exhibit 8
India: Relative Valuations Still Rich



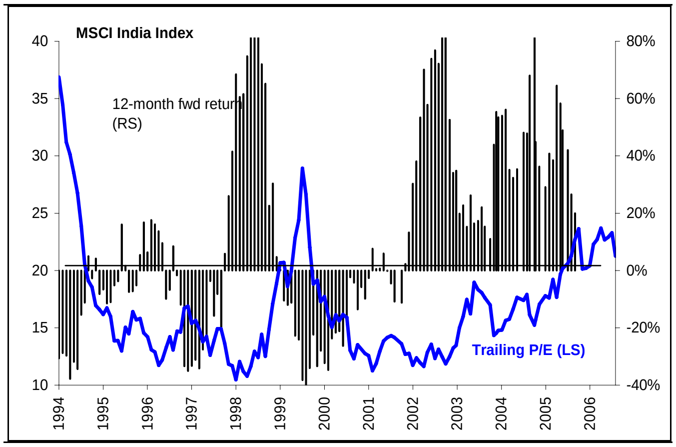
Source: FactSet, MSCI, Morgan Stanley Research

Exhibit 9
India: Equities Getting Expensive Relative to Bonds



Source: Bloomberg, company data, Morgan Stanley Research

Exhibit 10
India: Absolute Valuations Implying Negative Returns



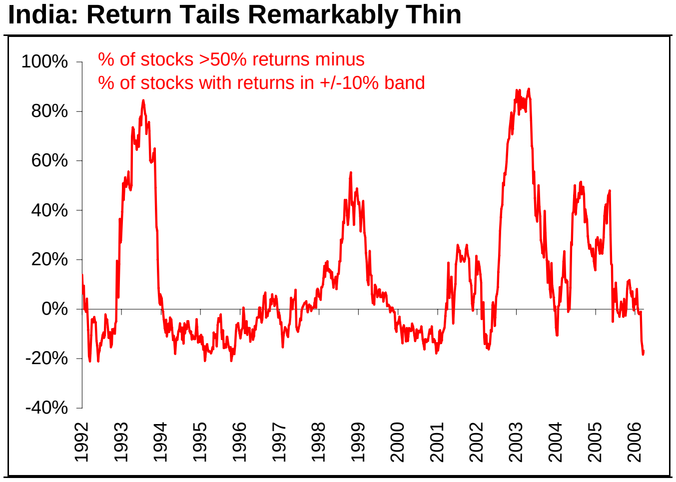
Source: FactSet, MSCI, Morgan Stanley Research

Exhibit 11
India: Most Sectors Looking Richly Valued

	MSCI India		Asia Pac		Emerging Markets	
March 27, 2007	P/E	Curr / Avg	Rel P/E	Curr / Avg	Rel P/E	Curr / Avg
Consumer Discretionary	19.5	105%	1.2	114%	1.3	109%
Consumer Staples	22.7	72%	1.1	75%	1.1	68%
Energy	14.9	140%	1.4	168%	1.6	166%
Financials	25.2	217%	1.5	217%	1.6	218%
Health Care	28.5	93%	0.7	80%	1.3	118%
Industrials	24.8	160%	1.4	170%	1.4	166%
Technology	31.6	66%	1.9	99%	2.0	103%
Materials	11.2	93%	0.9	119%	0.8	92%
Telecoms	12.7	121%	0.8	140%	0.8	122%
Utilities	12.2	124%	0.9	132%	0.7	97%

Source: FactSet, MSCI, Morgan Stanley Research

Exhibit 12
India: Return Tails Remarkably Thin



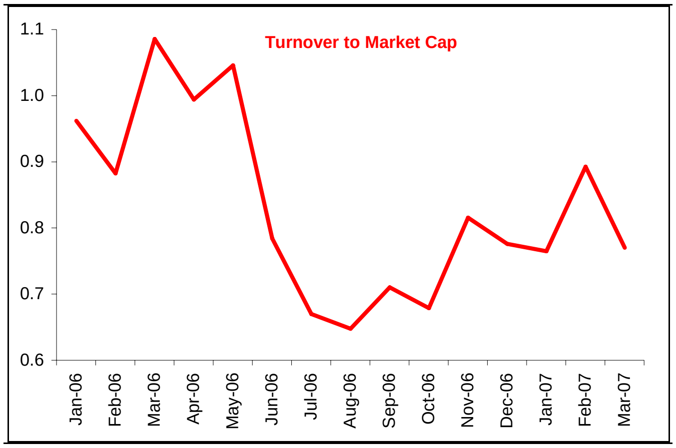
Source: Bloomberg, Morgan Stanley Research

The market trades at 16x F2008 earnings (based on the BSE Sensex, using consensus estimate). This does not appear terribly expensive, but has to be put into context with where earnings estimates could go over the coming months. The distinct difference from where we have been over the past three years is that earnings estimates may not necessarily rise in the coming months. On a relative basis, India remains richly valued, at premiums of 29% and 40% over the world and emerging market P/E multiples on a one-year forward basis (Exhibit 8). Relative to interest rates, valuations are now more expensive than they have been in six years (Exhibit 9). The trailing multiple on the MSCI India index suggests that we may have to deal with negative returns in the coming 12 months. At just over 22x earnings, historical patterns would suggest that there is a 75% chance that index delivers a negative return in the coming 12 months (Exhibit 10). As we have noted recently, most Indian sectors are trading at a premium to history when compared with emerging markets. The exceptions are consumer staples, utilities and materials (Exhibit 11).

Market Technicals: A Mixed Bag Providing Little Solace
Market technicals remain a mixed bag. To start with, breadth has been very feeble. Of all the stocks that have traded over the past one year, 66% have delivered negative returns. The median 12-month trailing return on all the stocks that have traded is -18.5%, whereas the BSE Sensex is up 15% over the same period. Return tails are remarkably thin and now in ‘buy’ territory (Exhibit 12). Unsurprisingly, trading volumes are drifting lower (Exhibit 13). All this would suggest that the market is far from exuberant. However, the Nifty put-call ratio is also off its highs, indicating that the market has fewer ‘shorts’ than a month ago (Exhibit 14). The trailing six-month return is strong and this has historically indicated forthcoming weakness (Exhibit 15). The bottom line is that market dynamics are probably neutral and not indicating an oversold market. We think this could mean more downside than upside, given other factors at work.

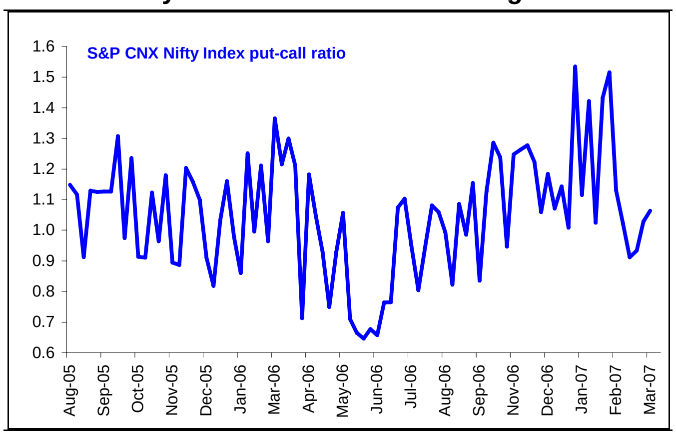
Model Portfolio Change
Expectations have been building up in tech stocks. True, earnings are likely to be strong, but the key is how good the guidance will be. In the context of a slightly less predictable growth environment in the US and immediate currency concerns, coupled with the ownership issues, we think tactically it may be better to trade out of technology for the time being. We are reducing our position in Infosys by 200 bps, which effectively lowers our technology position to neutral versus the MSCI benchmark. Our analyst, Anantha Narayan, continues to rate the stock Overweight. Once again, given our view on the market, we move this to cash.

Exhibit 13
Sensex: Trading Volumes Fell in the Correction



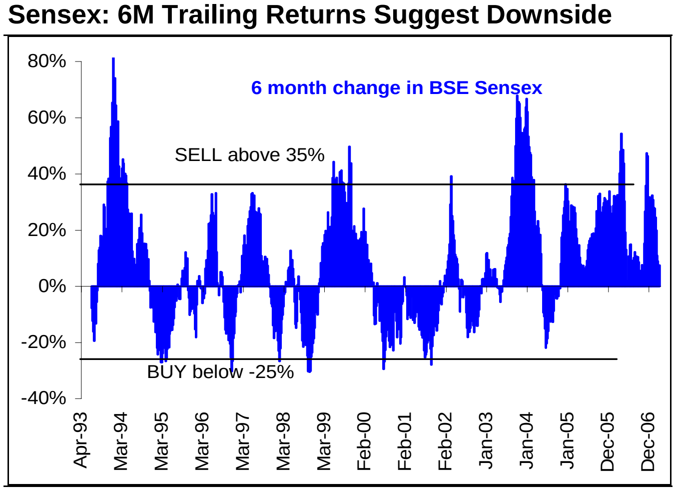
Source: BSE, NSE, Morgan Stanley Research

Exhibit 14
Sensex: Nifty Put-Call Ratio Is Off Its Highs



Source: ASA, Morgan Stanley Research

Exhibit 15
Sensex: 6M Trailing Returns Suggest Downside



Source: Bloomberg, Morgan Stanley Research

Model Portfolio

Company	Reuters Ticker	MSCI Weight (%)	Portfolio Weight (%)	Over/Under - Weight (bps)	Price (Rs) 28/3/07	Mkt Cap US$mn	Avg 3M T/O US$mn	Analyst Rating	YTD Perf. (%)
Consumer Discretionary		**7.0**	**0.0**	**-696**					
Consumer Staples		**6.0**	**9.6**	**355**					
Hindustan Lever Ltd	HLL.BO	2.1	5.6	350	197.8	10,018	20.1	Overweight	-8.7
Marico Industries	MRCO.BO	NA	2.0	200	58.7	783	0.7	Overweight	8.7
Dabur India	DABU.BO	NA	2.0	200	90.7	1,795	3.6	Overweight	-7.4
Energy		**16.9**	**23.1**	**622**					
Oil & Natural Gas Corp.	ONGC.BO	3.1	6.1	300	866.3	42,645	29.5	Overweight	-0.4
Reliance Industries Ltd.	RELI.BO	13.1	15.1	200	1,348.7	43,243	104.1	Overweight	6.2
Hindustan Petroleum	HPCL.BO	0.3	1.9	160	254.8	1,987	4.5	Underweight	-8.5
Financials		**20.8**	**12.5**	**-823**					
HDFC Bank Ltd.	HDBK.BO	3.1	3.1	0	955.5	6,886	16.7	Equal-Weight	-10.7
ICICI Bank	ICBK.BO	8.0	7.5	-50	857.6	17,563	36.1	Equal-Weight	-3.7
Union Bank of India	UNBK.BO	NA	2.0	200	98.8	1,148	2.4	Overweight	-19.5
Healthcare		**4.9**	**5.9**	**101**					
Lupin	LUPN.BO	NA	1.3	125	582.4	1,120	2.1	Overweight	-4.9
Sun Pharma	SUN.BO	0.7	4.7	400	996.8	4,752	6.5	Overweight	1.8
Industrials		**9.1**	**0.0**	**-915**					
Materials		**6.4**	**1.5**	**-489**					
Steel Authority of India	SAIL.BO	NA	1.5	150	110.0	10,452	35.1	Overweight	23.3
Technology		**21.5**	**21.5**	**5**					
Infosys Technologies Ltd.	INFY.BO	14.2	15.2	100	1,992.3	25,035	74.2	Overweight	-11.1
Patni Computer Systems	PTNI.BO	NA	1.0	100	372.8	1,182	3.4	Overweight	-10.8
Tata Consultancy Services	TCS.BO	2.3	5.3	300	1,201.0	27,050	38.8	Overweight	-1.4
Telecoms		**4.9**	**6.2**	**129**					
Reliance Communications Ltd.	RLCM.BO	4.2	6.2	200	418.5	19,691	88.7	Overweight-V	-11.2
Utilities		**2.5**	**3.9**	**142**					
Reliance Energy	RLEN.BO	0.8	1.8	100	482.4	2,357	9.5	NA	-7.2
GAIL India	GAIL.BO	1.1	2.1	100	267.3	5,201	5.4	Underweight	2.2
Cash		**0.0**	**15.7**	**1,568**					

NA = Not applicable/available Source: Bloomberg, Morgan Stanley Research

Market Focus

	Current	1-W	YTD
BSE Sensex	12,884.34	-0.48	-6.55
MSCI India *	533.03	1.21	-4.95

* Local currency, As of March 26, 2007. Source: Bloomberg, Morgan Stanley Research

Model Portfolio Changes

	From%	To %
Infosys	17.2	15.2
Cash	13.7	15.7

Source: Morgan Stanley Research

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(as of February 28, 2007)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**834**	**38%**	**288**	**42%**	**35%**
Equal-weight/Hold	**1003**	**45%**	**308**	**45%**	**31%**
Underweight/Sell	**370**	**17%**	**91**	**13%**	**25%**
Total	**2,207**		**687**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

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More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

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Morgan Stanley
JM MORGAN STANLEY

MORGAN STANLEY RESEARCH

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200