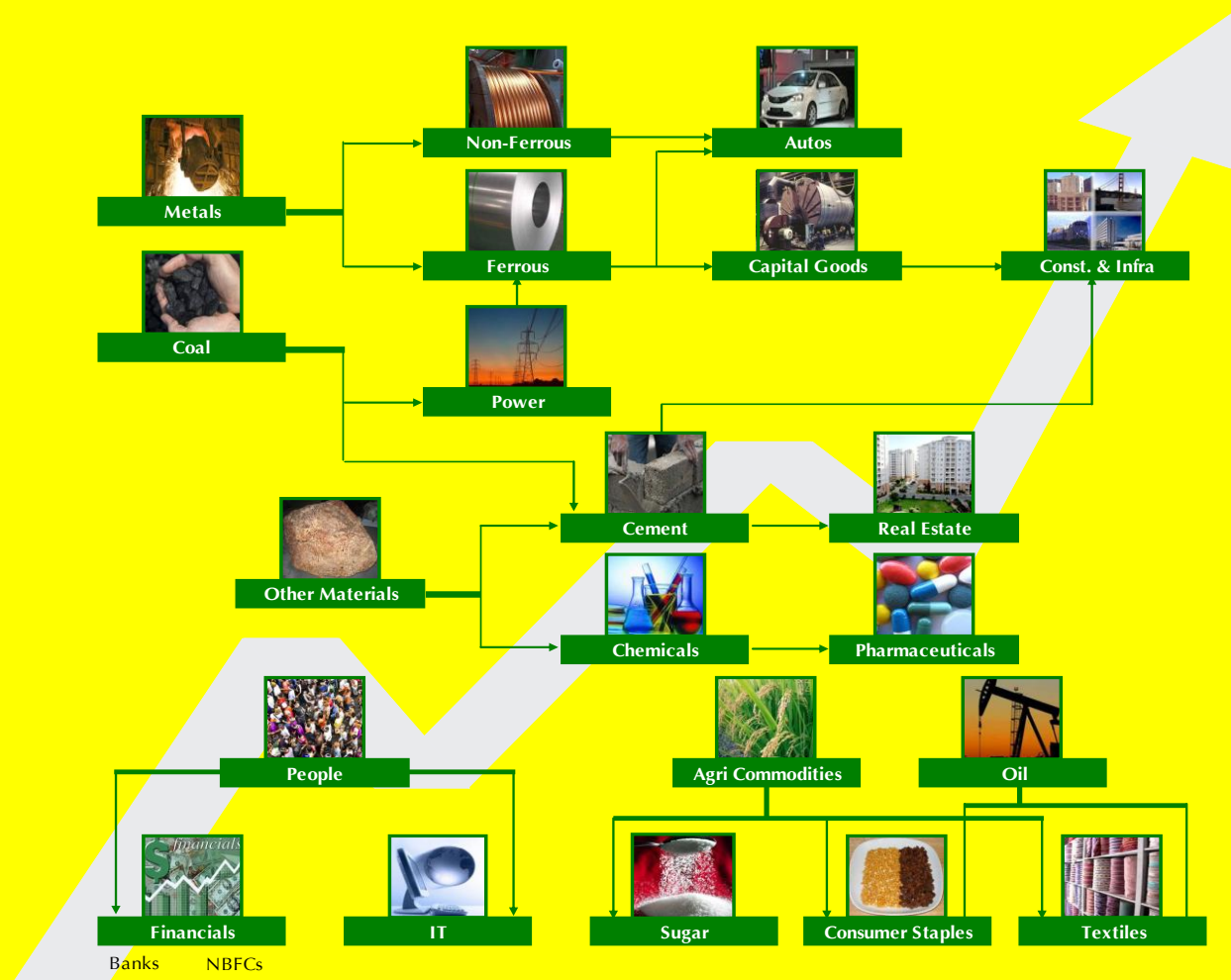


Stratezine

India Strategy

March 2011





Slippery Ride Ahead

- ❖ **India has underperformed regional and global emerging markets on concerns over inflation, fiscal deficit and governance deficit.**
- ❖ **February saw India correct along with other markets on rising turmoil in the Middle East and US\$ 100+ crude.**
- ❖ **Domestic demand however remains buoyant and somewhat price-resistant.**
- ❖ **Markets corrected on strong capital outflows—primarily ETF-based—but long-term fundamental money has stayed put.**
- ❖ **Q1 has always been weak historically—we expect a strong H2.**
- ❖ **Our portfolio strategy for 2011 is skewed towards sectors levered to domestic consumption:**
 - ❖ **OW : Autos, Banking, Telecom, Real Estate**
 - ❖ **UW: NBFCs, Utilities, Metals, Pharmaceuticals**
 - ❖ **MW: IT Services, Capital Goods, Cement, Infra/Construction, FMCG, Energy**



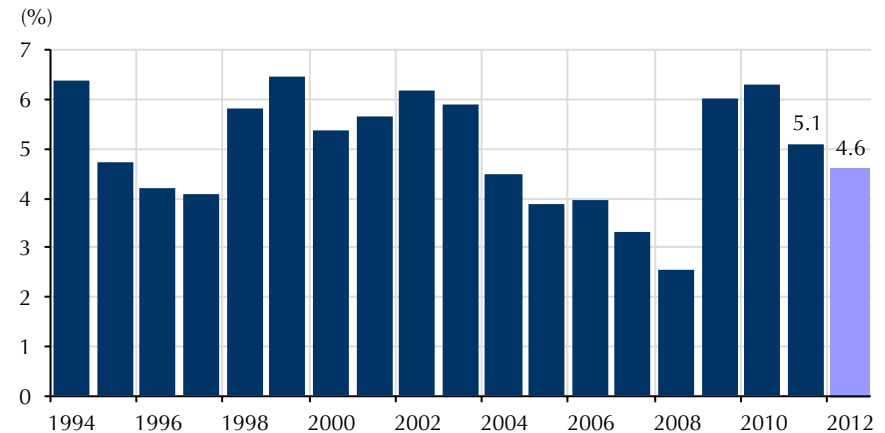
❖ India has underperformed on concerns over inflation, fiscal deficit and governance deficit

Market underperformance has been substantial in the last few months (-13% YTD) over stubborn inflation, rising crude prices, the consequent fiscal burden, and policy paralysis at the centre. While the Union Budget 2011–12 was growth oriented, the fiscal arithmetic (4.6% for FY12) appears untenable given understated subsidies and aggressive revenue growth projections.

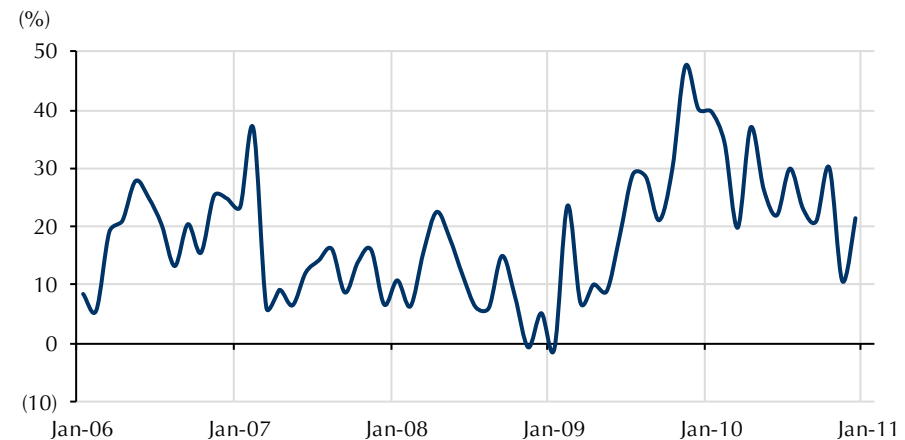
❖ But domestic demand still holding strong

Domestic indicators such as auto sales, and freight traffic continue to point to a robust broad economy. Business sentiment surveys also point to strong demand growth and the ability of businesses to pass on raw material price hikes in a buoyant environment. Higher cost of credit and raw material and wage inflation might weaken business sentiment in the coming months, but in a growth-scarce world, we believe that the Indian domestic consumption theme will continue to play along.

Fiscal deficit as a % of GDP



Passenger cars sales growth (% YoY)

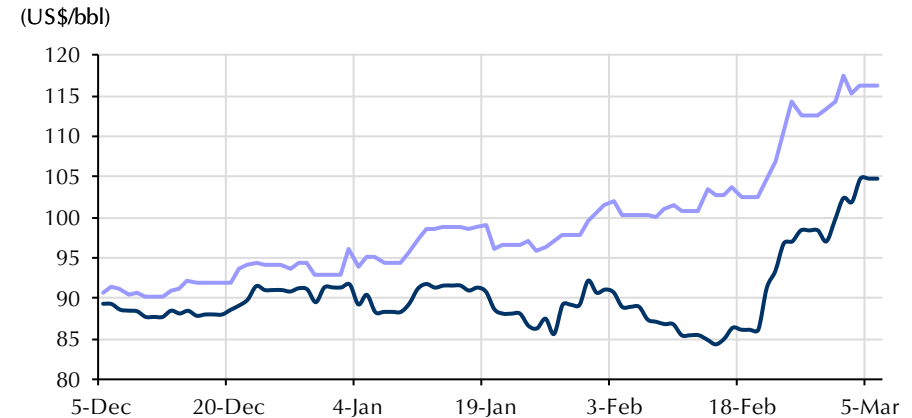




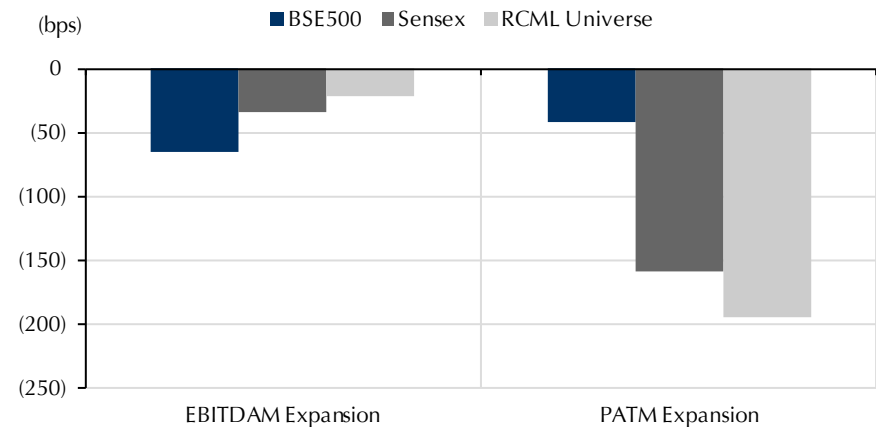
❖ Runaway rally in crude—a big risk

Recent news-flow on a lower fiscal deficit for FY11 (5.1% vs. the budgeted 5.5% on buoyant revenues and higher GDP base), and a rise in government project approvals have been overshadowed by higher oil prices. India's dependence on crude renders it susceptible to the twin-deficit problem, with current and fiscal balances both coming under pressure. Near-term Middle East uncertainty apart, we believe global demand-supply dynamics on oil remain favourable towards sub-US\$100 crude prices.

Crude (Brent, WTI) prices have rallied since December



Margin pressures evident in Q3FY11 results

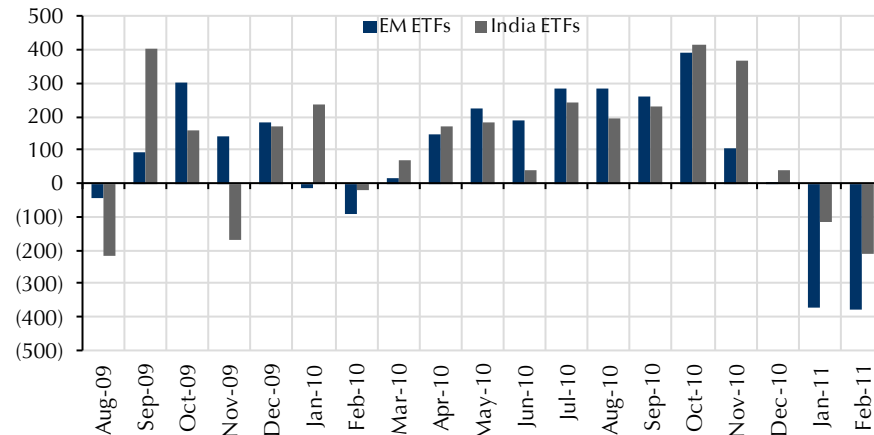




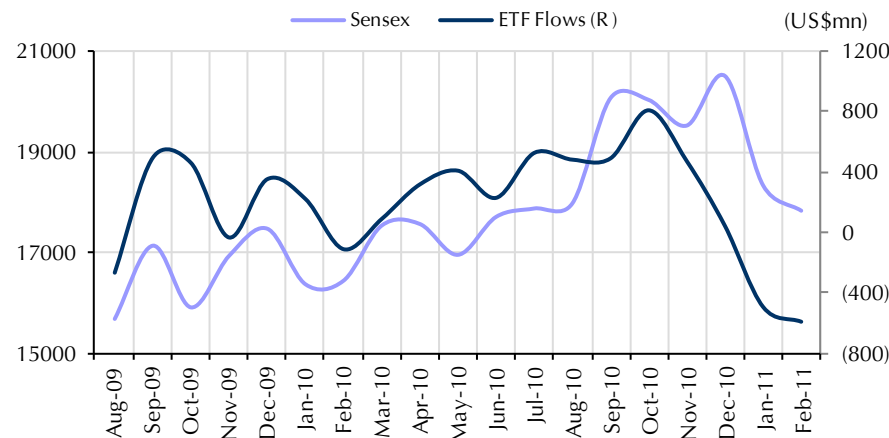
❖ Markets corrected on strong capital outflows—primarily ETF-based

- Portfolio capital outflows this year have been largely on account of ETFs (exchange-traded funds), with ~50% (US\$ 1.08bn) of outflows over Jan-Feb '11 (US\$ 2.2bn) compared to ~10% (US\$ 1.3bn) of inflows into India equities over Sep-Oct '10.
- Our analysis indicates that the majority of outflows from India are from regional funds tracking the MSCI EM, or the MSCI AxJ universes rather than from India-specific ETFs. In addition, contrary to traditional long-only FII money, ETFs essentially track performance instead of fundamentals.
- DMFs (domestic mutual funds) have seen redemptions to the tune of US\$ 3bn in CY10. Markets have shown a strong negative reaction (down ~13% YTD) on the back of relatively small capital outflows of ~US\$ 2.1bn to date compared to capital inflows of US\$ 29bn and returns of ~14% in CY10.
- While DMFs have been net buyers since the start of the year, the lack of strong incremental inflows into these funds and in insurance schemes coupled with regulatory headwinds mean that the call on Indian markets is essentially a call on capital flows.

ETF net inflows into India



ETF flows follow Sensex performance





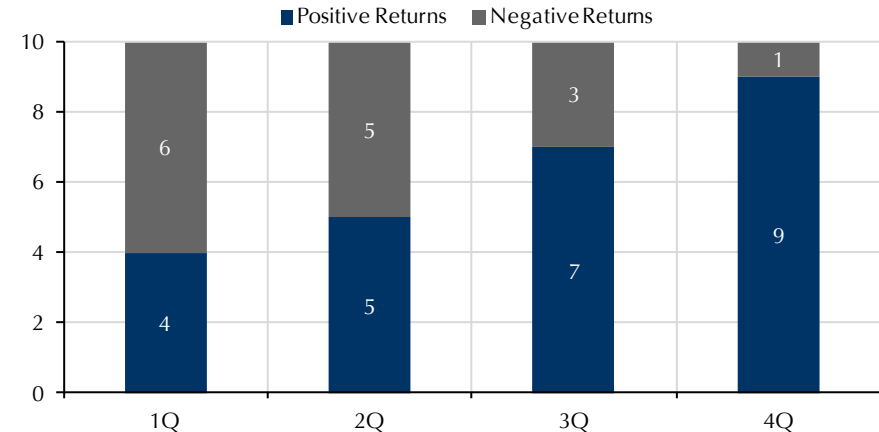
❖ And Q1 has always been weak historically—we expect a strong H2

- The first half of the year, H1 (and especially Q1) has generally been the weakest period in the calendar year for Indian markets, with a negative performance in 6 of the last 10 years. Performance then tends to improve through the year, with just one instance of negative fourth-quarter returns for the Sensex (Q4CY08). Returns in the second half of the year are thus typically better.
- Further, the political stand-off, a consequent setback to the reform agenda and a populist government stance before state elections have not helped in the potential growth of the economy till now, but these headwinds are only expected to abate from here on.

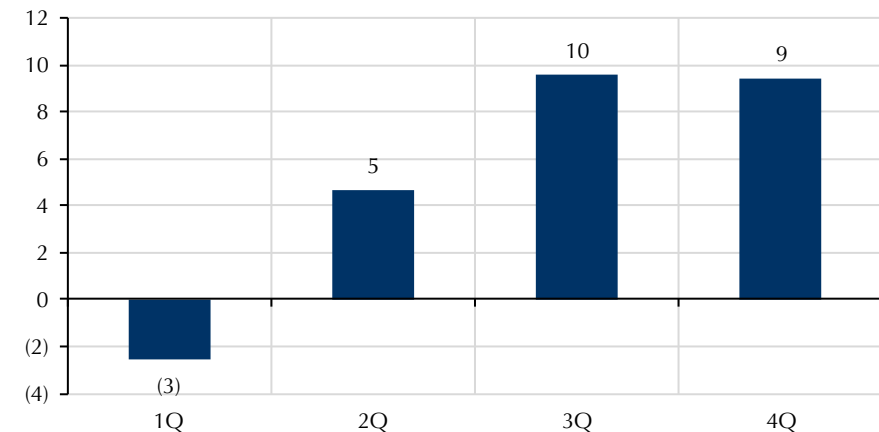
❖ Portfolio strategy

- We remain bullish on India fundamentals and our portfolio strategy is leveraged to domestic consumption through Autos, FMCG, Telecom and a slow pick-up in the investment cycle through Financials.
- **Overweight:** Autos, Banking, Telecom, Real Estate
- **Underweight:** NBFCs, Utilities
- **Neutral:** IT Services, Metals, Capital Goods, Pharmaceuticals, FMCG

Sensex quarterly results for last ten years



Sensex average quarterly results for last ten years





Business Activity & Sentiment Indicators

- ❖ While markets corrected on macro concerns such as stubborn inflation, a hawkish RBI and the high fiscal deficit, business activity indicators continued to point to robust economic activity.
- ❖ Higher cost of credit, raw material and wage inflation may mean that the business sentiment could weaken a bit in the coming months, but in a growth-scarce world, we believe that the Indian domestic consumption theme will continue to play along.
- ❖ Our optimism is based on our view of continued private consumption, a gradual pick-up in investment through the year, and the ability of companies to pass on price hikes to consumers due to increasing disposable incomes.
- ❖ Business sentiment indicators point northwards with optimism seen on almost all fronts in the D&B Business Sentiment Survey.
- ❖ The OECD India Composite Leading Indicator showed weak numbers primarily on account of a lower single-digit IIP print.



Business Activity – No cause for concern

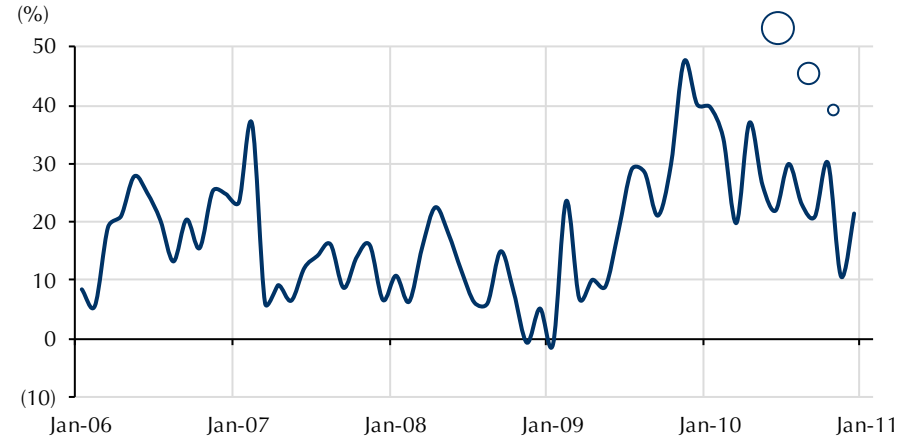
2-wheeler sales continue to grow in the mid-20s despite a higher base of last year

Passenger cars too are growing at 20% despite increasing prices, fuel and credit costs

2-Wheeler sales growth



Passenger car sales growth



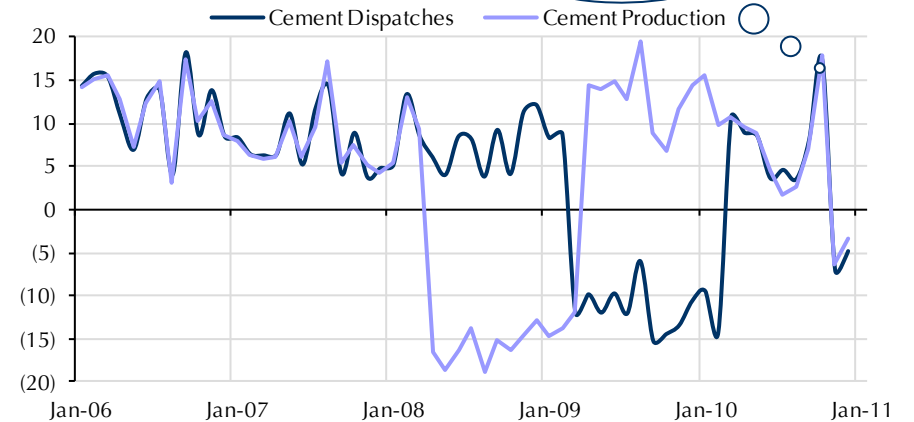
CV sales growth

CV sales too display the same buoyancy



Cement dispatch growth

Cement dispatches and production have been increasing after an extended monsoon season suppressed demand last year

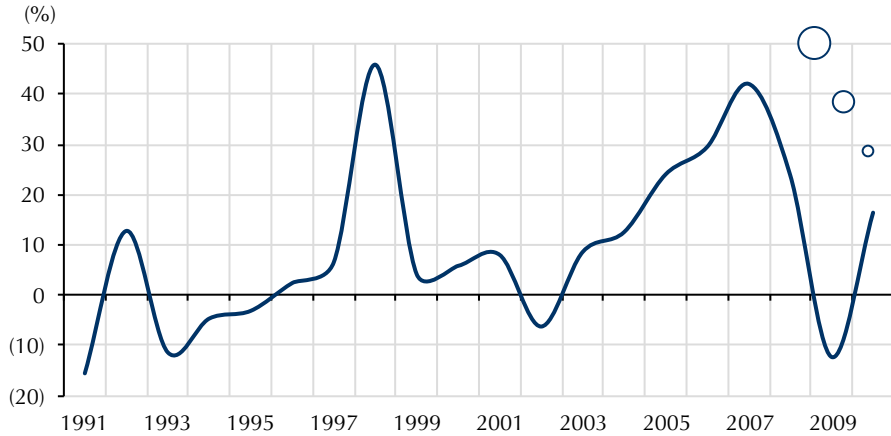




Business Activity – No cause for concern

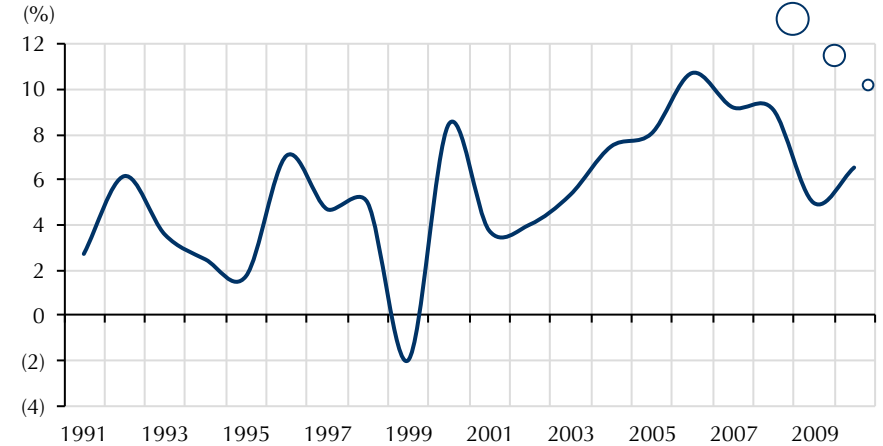
Aviation industry saw higher domestic passenger growth on rising business optimism

Aviation—Domestic passenger growth



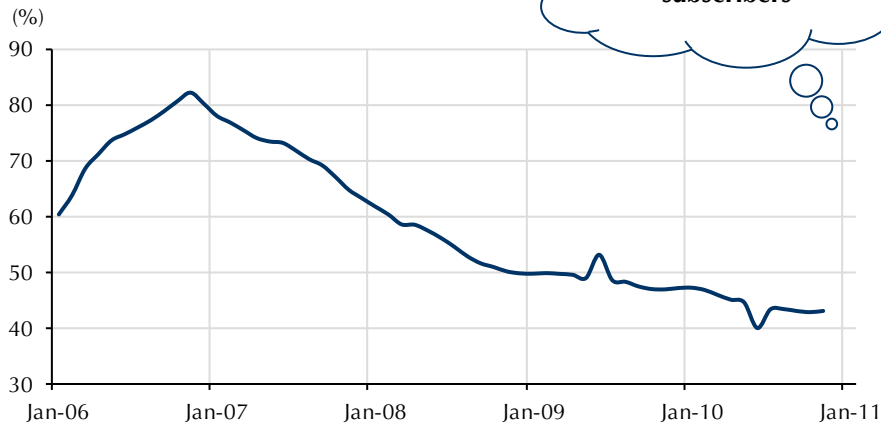
Railway freight traffic too has increased despite a ban on iron ore exports from Karnataka

Railways—Freight traffic

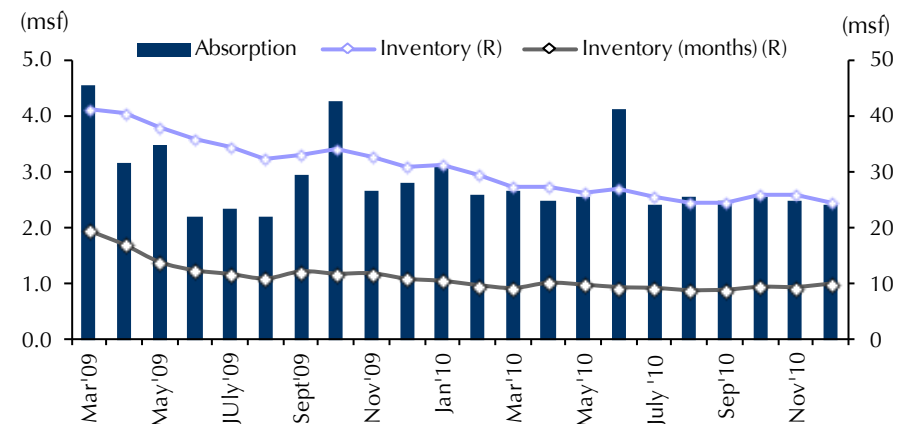


Mobile subscriber additions

Telecom companies continue to add subscribers



Residential real estate





Business Optimism – Bullish as always

D&B Business Optimism Index—Composite



Despite macro headwinds, business optimism remains robust on the back of strong demand

D&B Business Optimism Index—New Orders



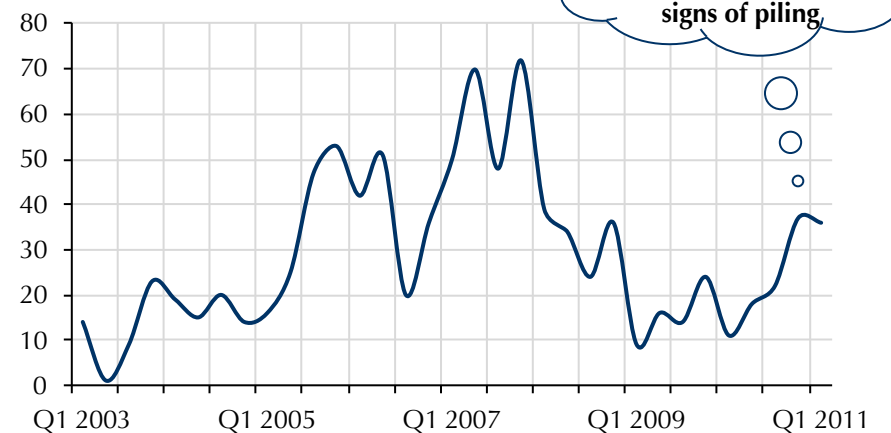
Outlook on new orders has been improving, indicating that demand expectation is still robust

D&B Business Optimism Index—Selling Prices



Strong demand translates into a positive outlook for realisations

D&B Business Optimism Index—Inventory



Inventory levels however show some moderate signs of piling



D&B Business Optimism Index—Employees

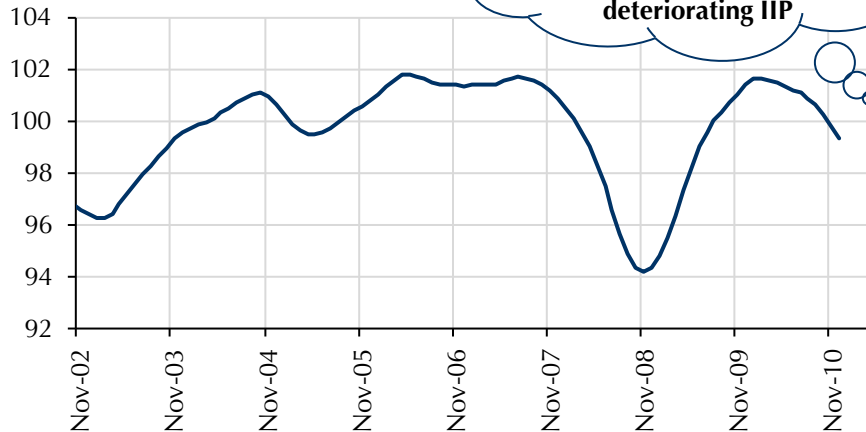


D&B Business Optimism Index—Volume of Sales



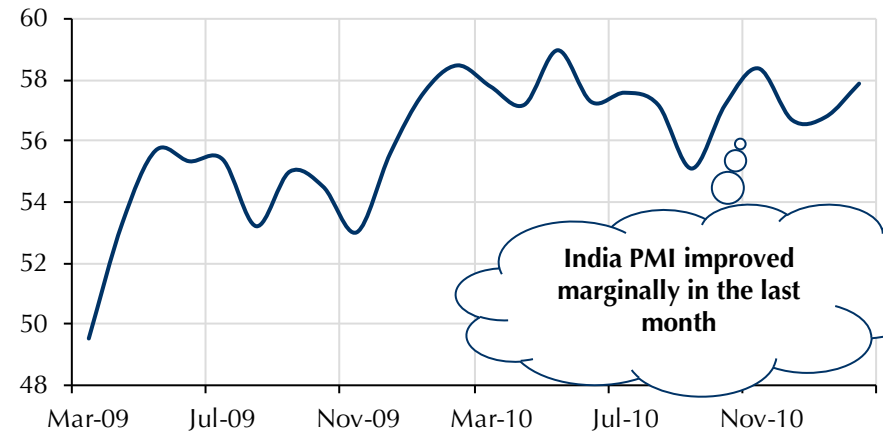
Sales volume expectations are turning increasingly bullish

OECD CLI—India (Amplitude Adjusted)



OECD CLI however pointed towards deteriorating conditions primarily on account of deteriorating IIP

HSBC Markit India PMI



India PMI improved marginally in the last month



Economy – Real

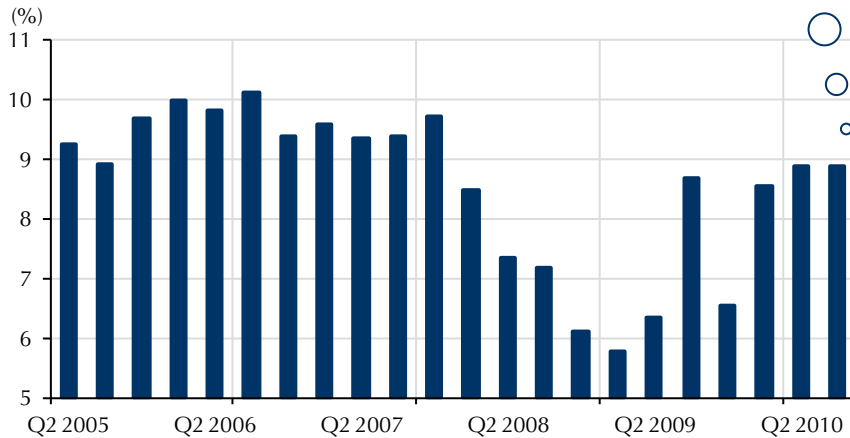
- ❖ **India's real economy has shown remarkable resilience with GDP growth of 8.2% in the most recent quarterly GDP growth reading (Q3).**
- ❖ **In the recent Union Budget, the government has projected GDP growth of 8.6% in FY11 and 9% in FY12.**
- ❖ **Thanks to seven rounds of policy rate hikes, IIP has been tumbling for some time now.**
- ❖ **The Capital goods segment of the IIP has been chunky and volatile.**
- ❖ **We believe that as inflation moderates and the rate-hike cycle peaks, the capex cycle will begin to unfold in the second half of the year.**



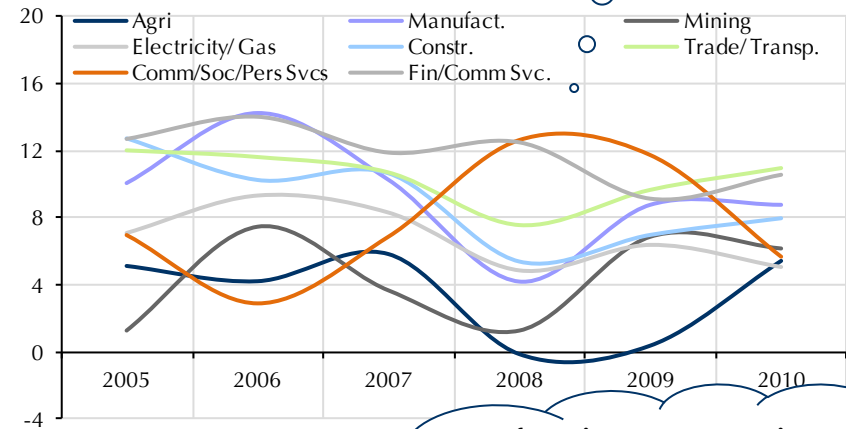
While core inflation has been moderate, primary article inflation has been stubborn in India

Strong agri growth seen on the back of a good monsoon season

India quarterly GDP growth

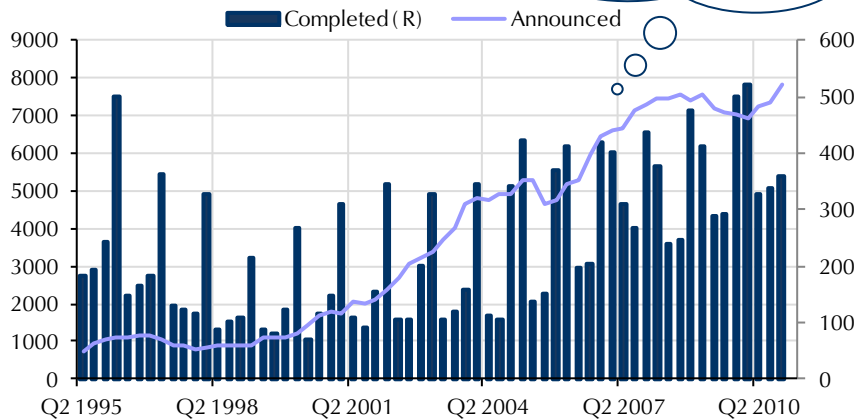


India annual GDP growth



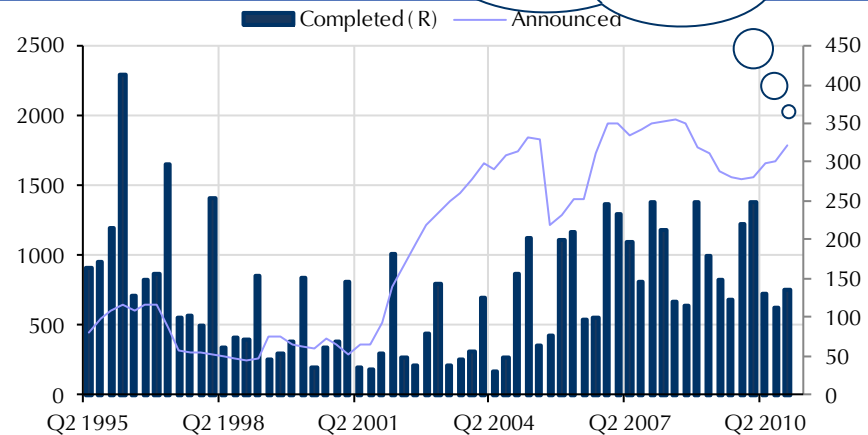
Non-financial capex projects

While execution clearly need improvement, overall capex announcements have picked up



Manufacturing—Capex projects

Manufacturing capex execution has however slowed down in the wake of uncertainty arising from high inflation and rising credit costs

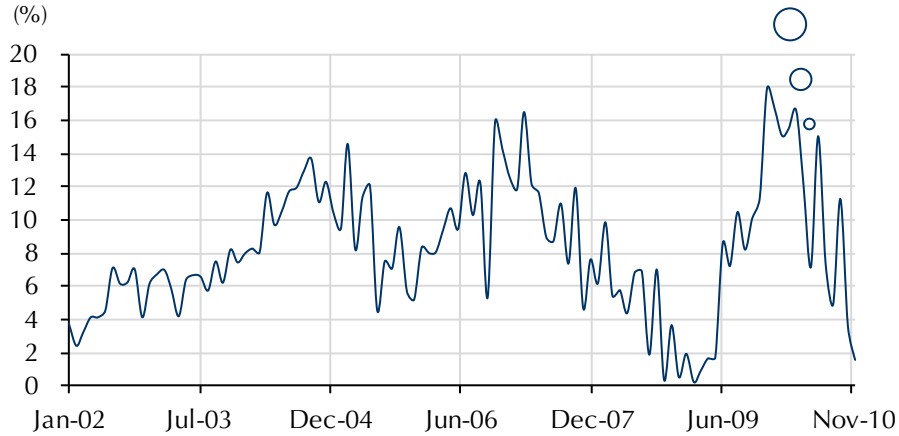




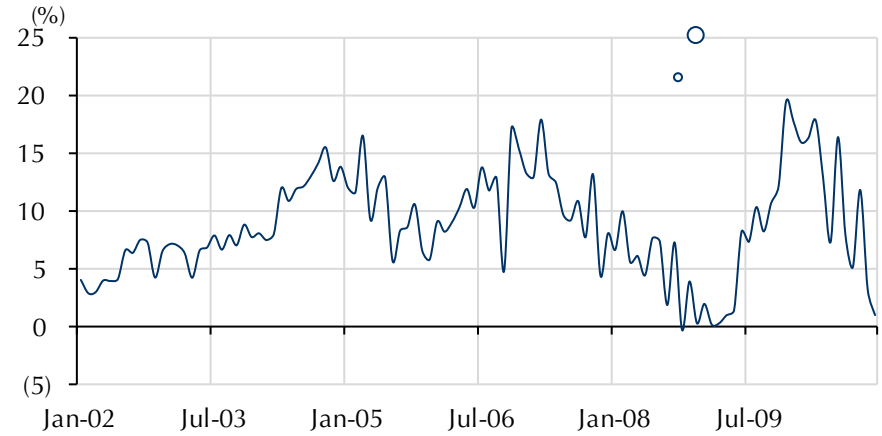
Industrial production clearly slowing down on tightening by the RBI

Mining and quarrying has slackened

Index of Industrial Production (%YoY)

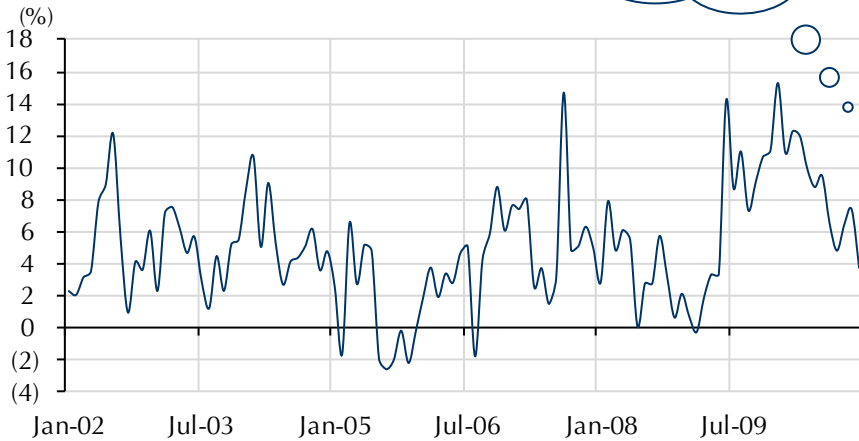


IIP—Mining & Quarrying (%YoY)



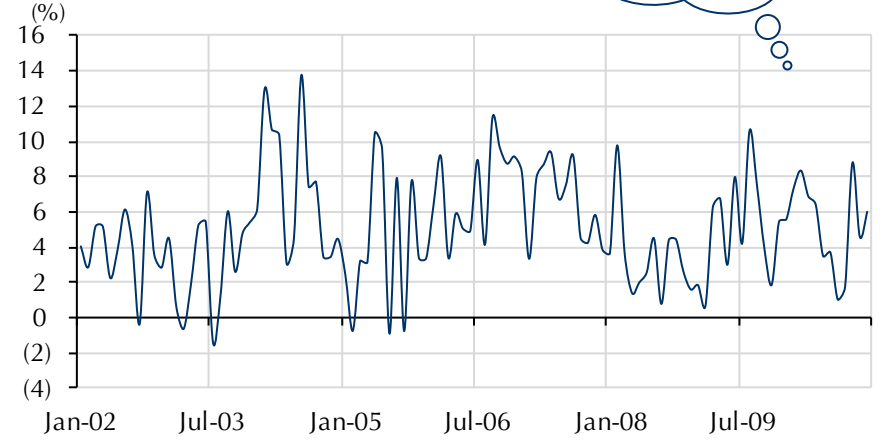
IIP—Manufacturing (%YoY)

Manufacturing IIP has moderated on a high base...



IIP—Electricity (%YoY)

...and so has electricity

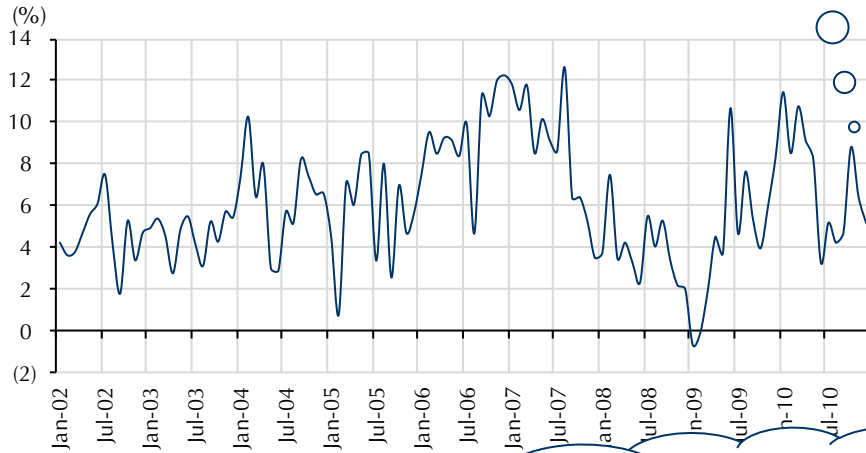




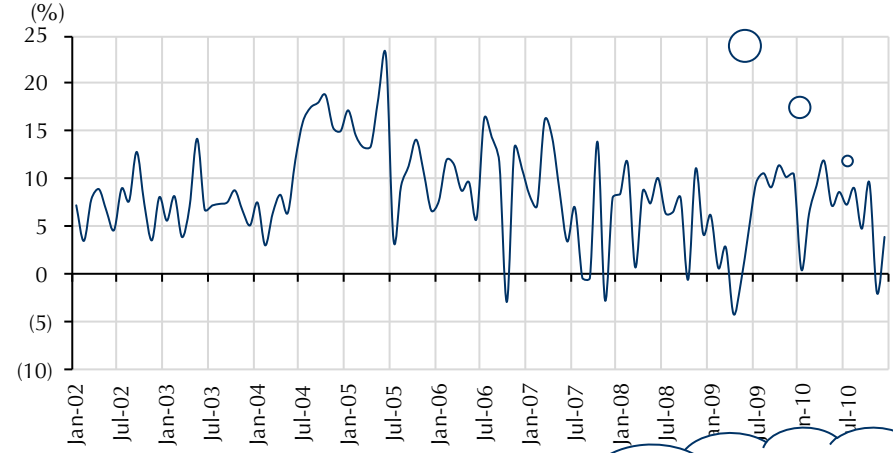
IIP for basic goods has run out of steam

Capital Goods index in the IIP tends to be very volatile and clocked sub-3% growth in last month's reading

IIP—Basic Goods (% YoY)



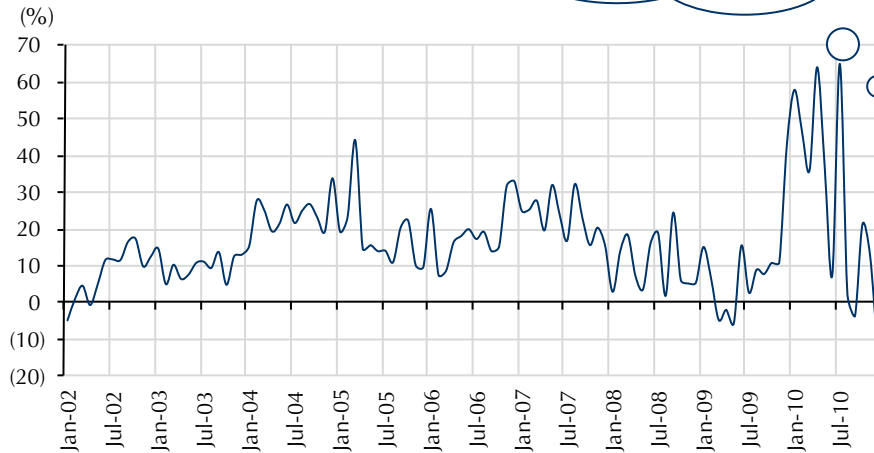
IIP—Capital Goods (% YoY)



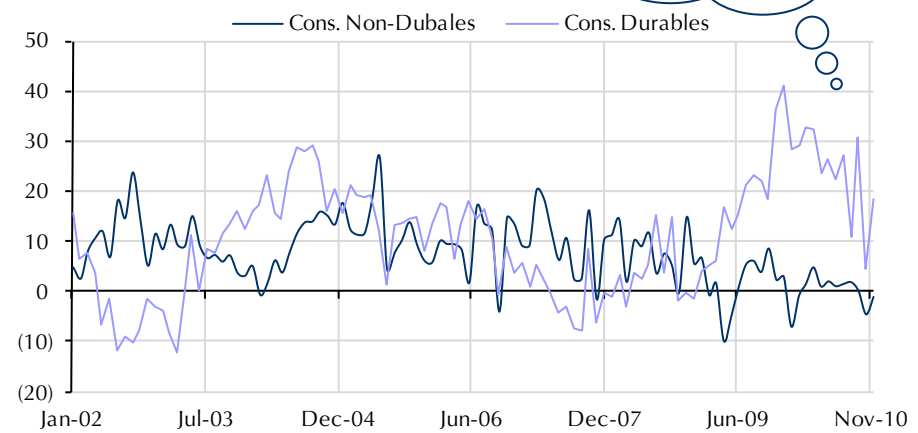
Intermediate goods have been holding strong but showed weakness of late

Durables and non-durables have also been on the decline

IIP - Intermediate Goods (% YoY)



IIP—Consumer Durables/Non-durables (% YoY)





Economy – Monetary

- ❖ **Primary inflation remains sticky in India and in other emerging markets.**
- ❖ **RBI is expected to hike policy rates by another 75bps this fiscal in order to contain inflation.**
- ❖ **The short-end of the yield curve has spiked thanks to tight liquidity conditions.**
- ❖ **Liquidity seem to be improving, however, with lower borrowing at the repo window.**
- ❖ **In the meanwhile, credit in the overseas markets remains cheap owing to accommodative monetary policies by central banks in developed economies.**

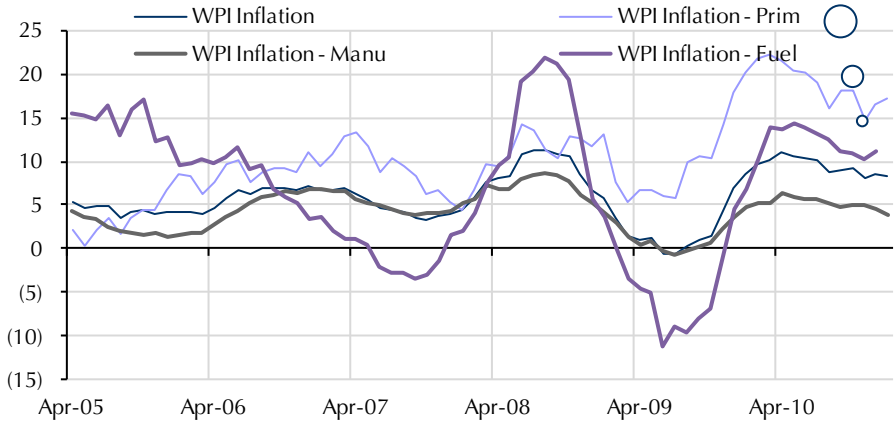


Inflation – Stubborn but peaking out

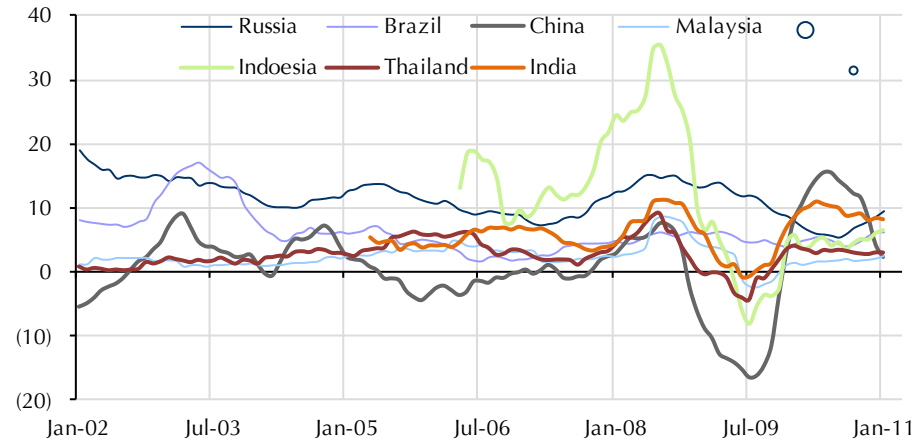
While core inflation has been moderate, primary article inflation has been stubborn in India...

...and across most other emerging markets

WPI Inflation—Primary inflation still stubborn

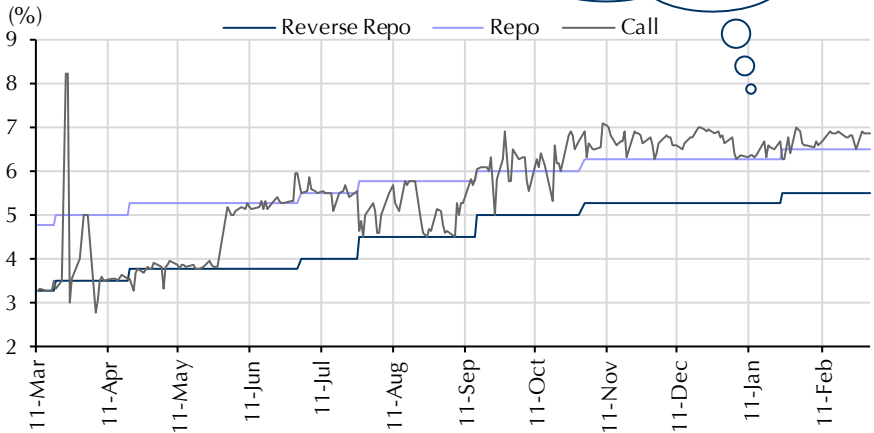


Inflation is a big concern across emerging markets



Policy rates in India—Tightening continues

Hawkish RBI favouring inflation control more than growth?



3M Libor

Globally cost of credit continues to remain inexpensive

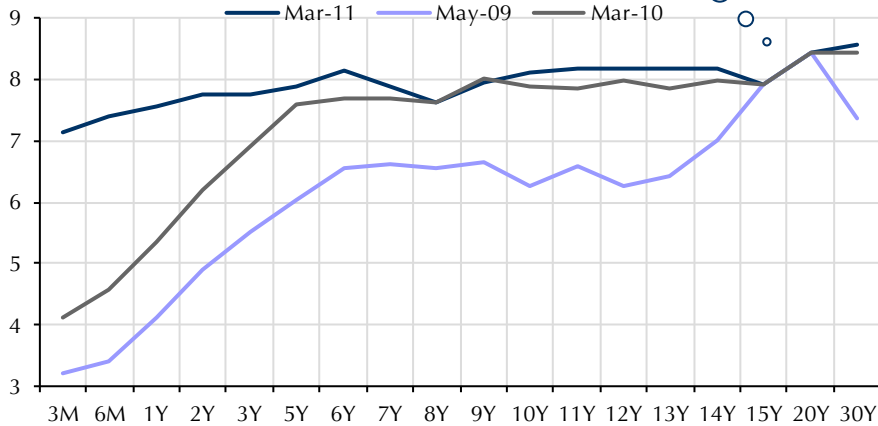




Yields inched higher but easing post budget

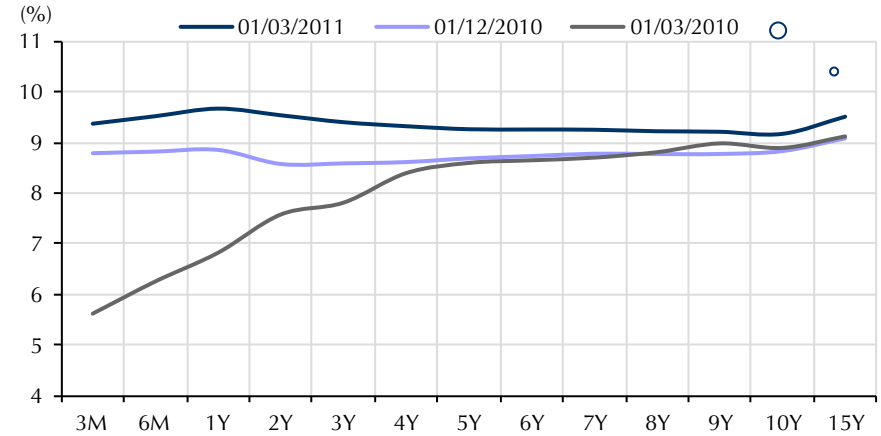
Scarce liquidity has pushed up shorter end of the yield curve

Sovereign yield curve



Corporate yield curve shows a kink at 1-year maturity, indicating liquidity deficit

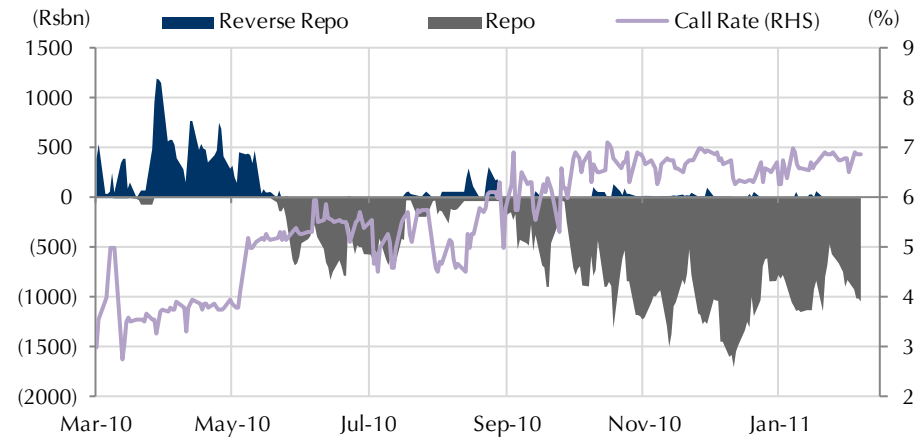
AAA Corporate yield curve



Excess liquidity



Borrowing at LAF corridor



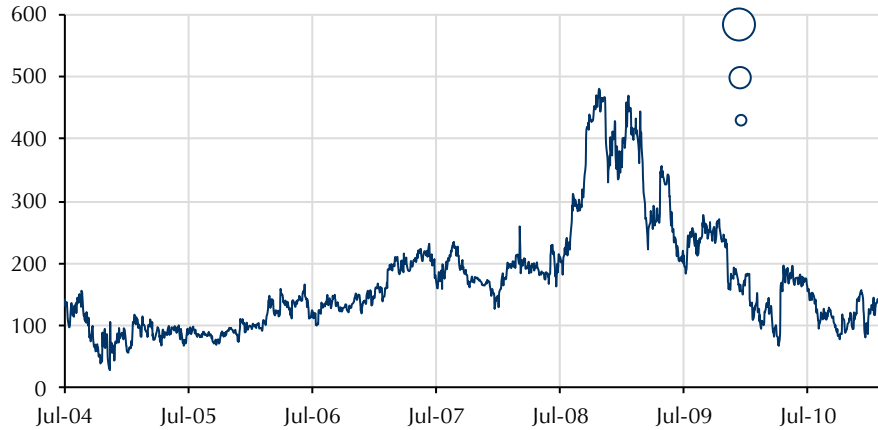


Robust credit growth amidst low liquidity

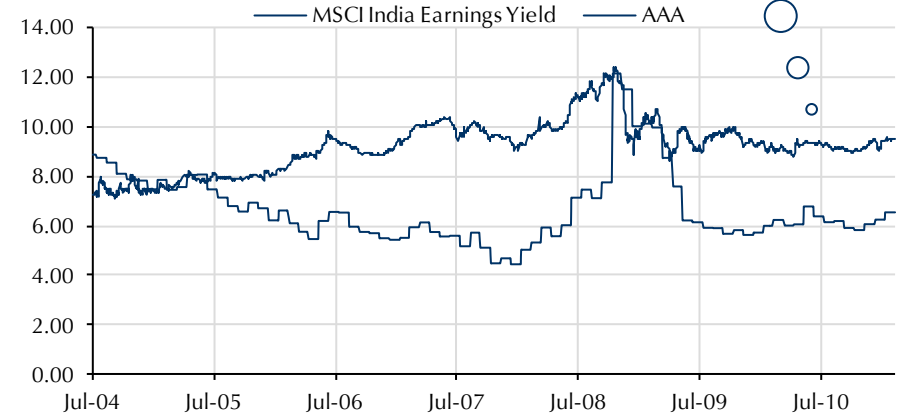
Large government borrowing and low systemic liquidity crowding out private sector?

Equities still not attractive based on earnings yield

AAA spread over sovereign yields



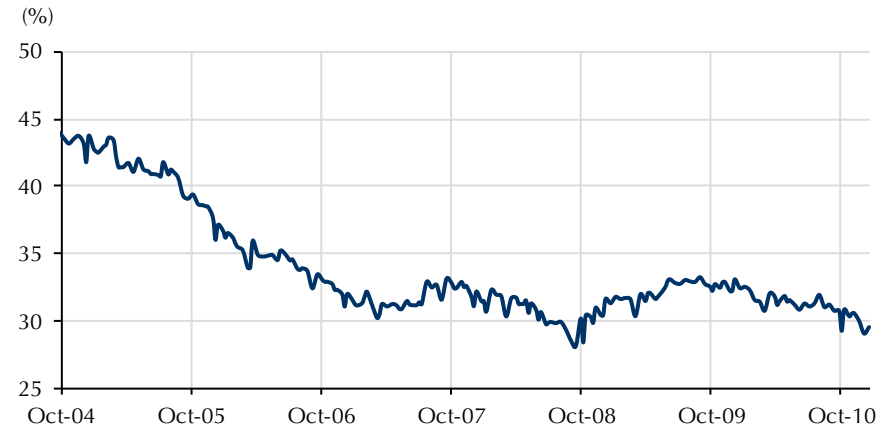
10Yr AAA and MSCI India earnings yield



Credit-Deposit ratio (%)



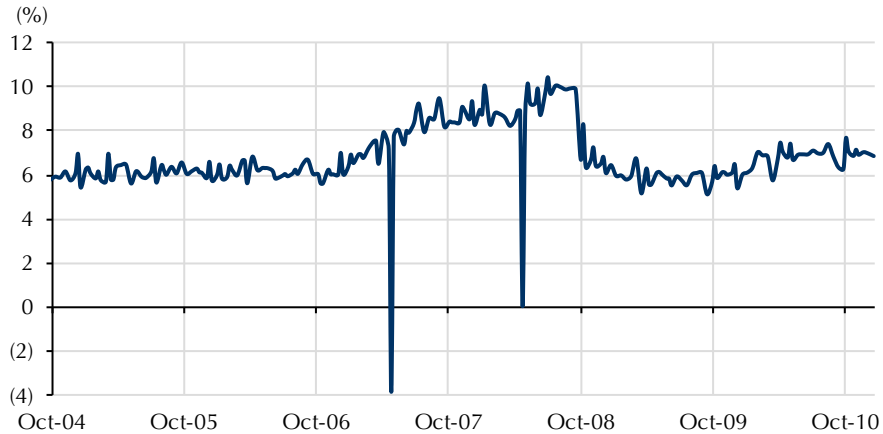
Investment-Deposit ratio (%)



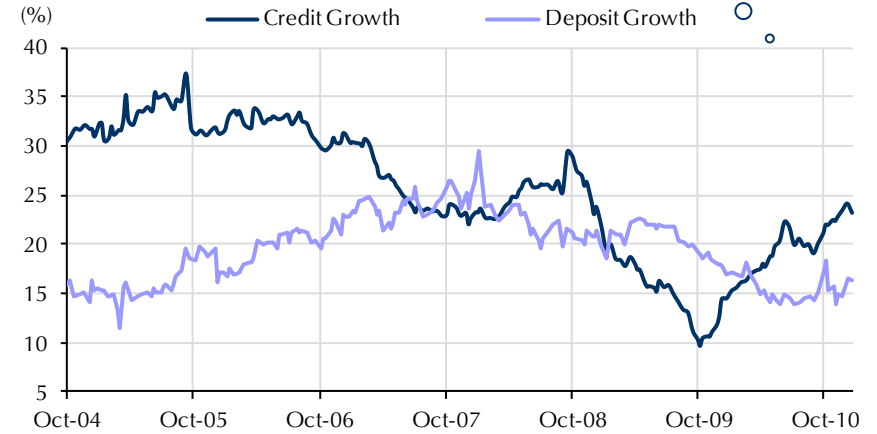


Credit growth continues to outstrip deposit growth

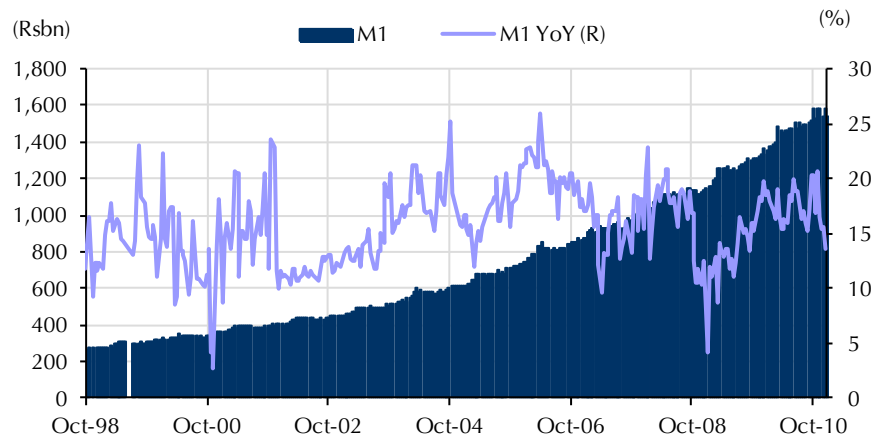
Cash-Deposit ratio (%)



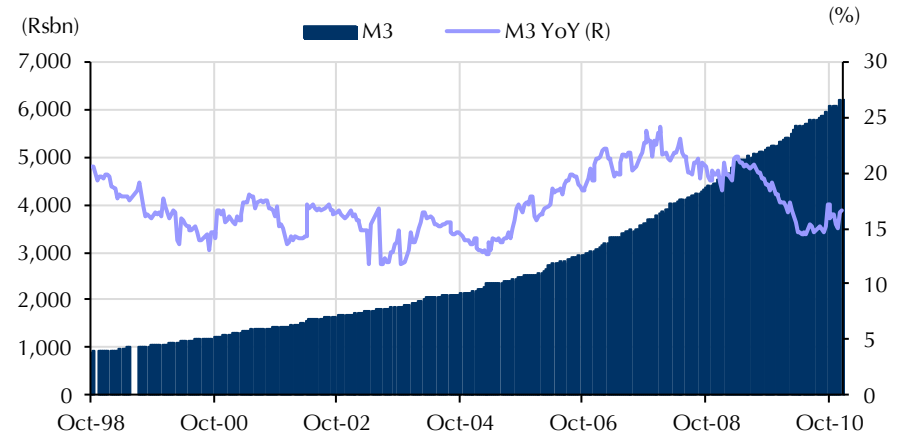
Credit/ Deposit growth (%)



India narrow money (M1)



India broad money (M3)





Economy – Fiscal

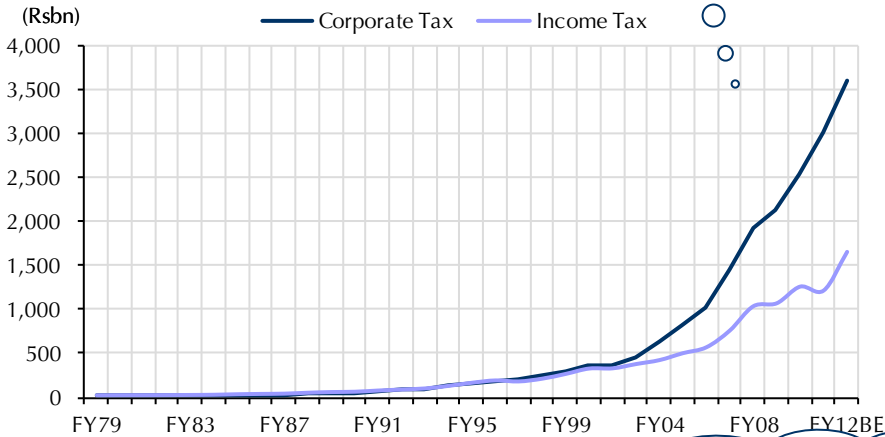
- ❖ **RBI had hinted that a fiscal response to contain inflation along with a tight monetary policy is essential.**
- ❖ **The Union Budget has delivered on this front (at least in intent and numbers) with no tax increases by accounting for a buoyant economy and subsequent tax collections.**
- ❖ **The Budget has projected fiscal deficit for FY11 at 5.1% and for FY12 at 4.6%.**
- ❖ **While we believe that the print number is understated on account of lower provisioning for subsidies, the number may be revised higher during the course of the year.**
- ❖ **The Budget has projected net market borrowings for FY12 at Rs 3.43trn—less than market expectations, a positive that has pushed down yields.**



Credit outside India continues to be inexpensive

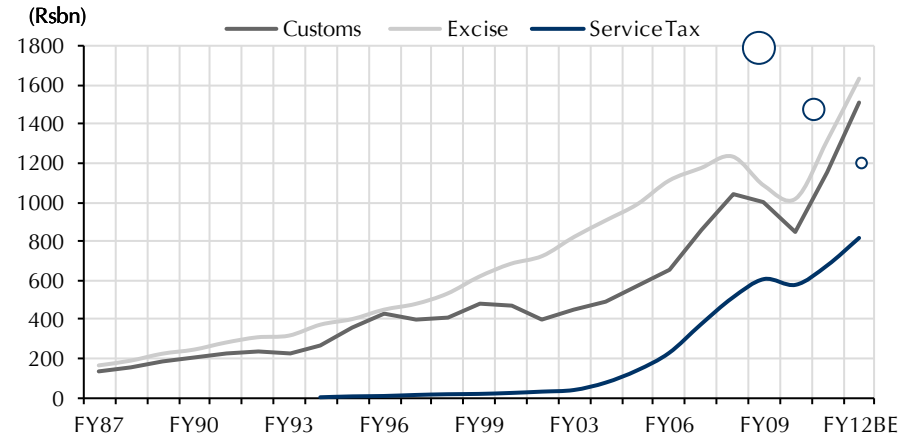
Direct tax collections have been buoyant...

Direct tax collections



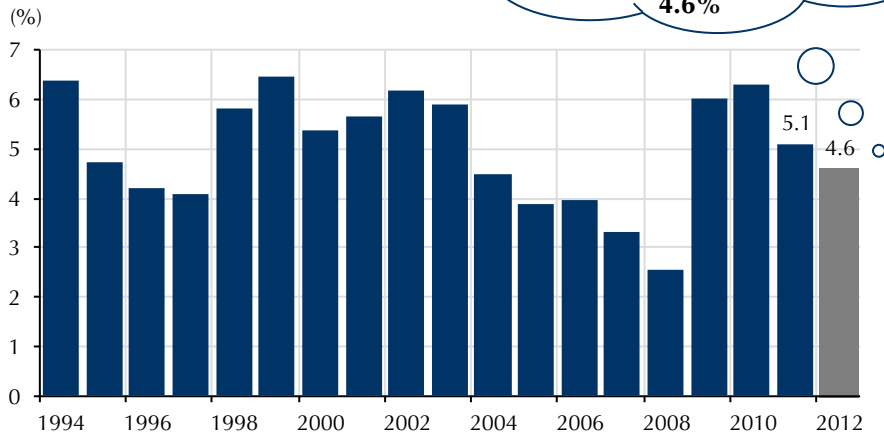
...and indirect tax collections as well despite no roll-back in customs duties

Indirect tax collections



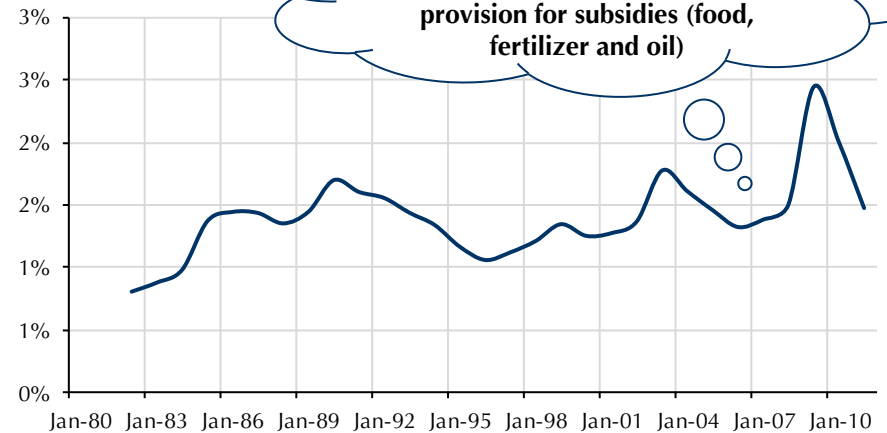
Budget has projected FY11 fiscal deficit at 5.1% vs. 5.5% earlier and put FY12 fiscal deficit projection at 4.6%

Fiscal deficit as a % of GDP



Subsidies as a % of GDP

However, we believe that the print number may be revised higher later as it looks understated on lower provision for subsidies (food, fertilizer and oil)





Economy – External

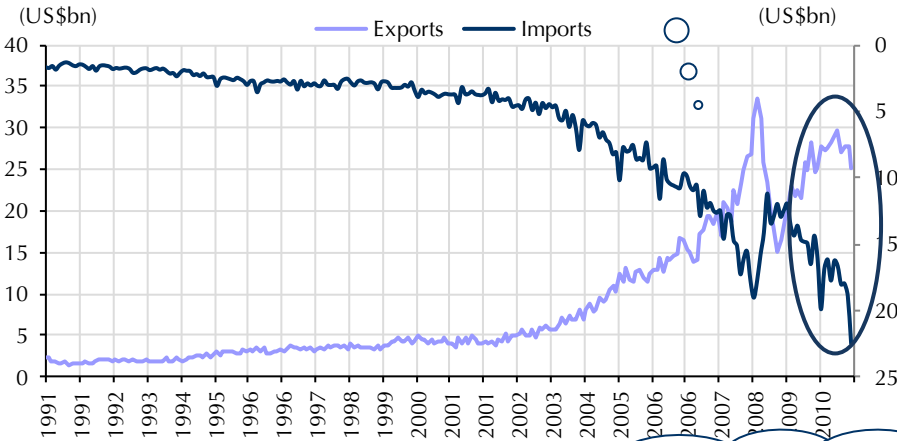
- ❖ **Recent data suggest that India's trade deficit is set to narrow with export growth outpacing import growth.**
- ❖ **Recovery in the developed world and consequent demand would further support a pick-up in exports.**
- ❖ **Despite an avalanche of capital flows last year, forex reserves have not ballooned, indicating that the RBI has move to a more flexible currency management system.**
- ❖ **This means that the rupee will remain sensitive to capital flows in and out of the country.**
- ❖ **Crude oil remains the key risk on account of India's dependence on imported oil.**



India's trade deficit narrowing

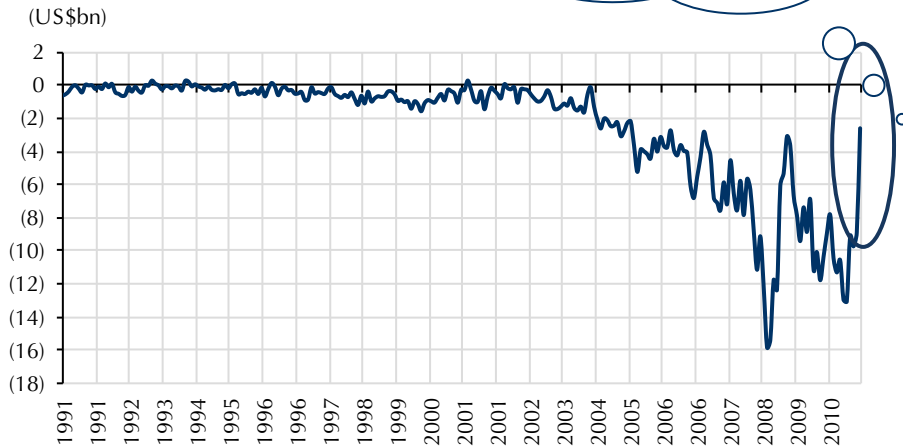
India's trade with the world, though still below levels seen in 2008, is slowly recovering

India trade balance



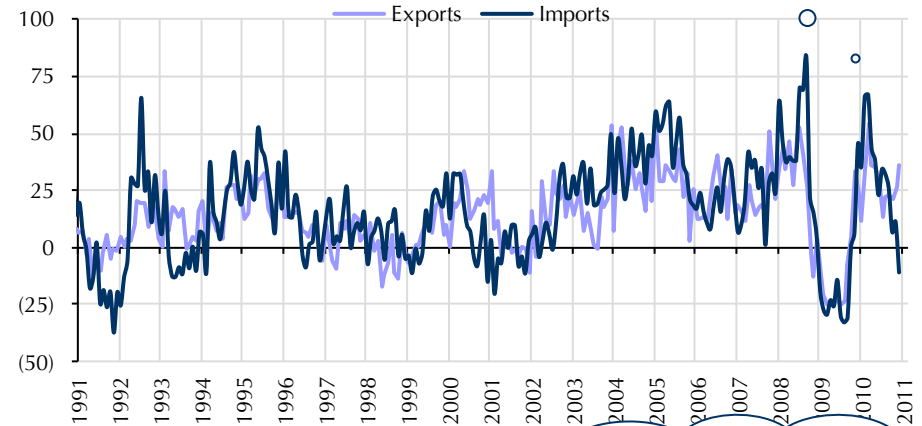
Trade deficit set to narrow down if recent trend is anything to go by

India's trade deficit



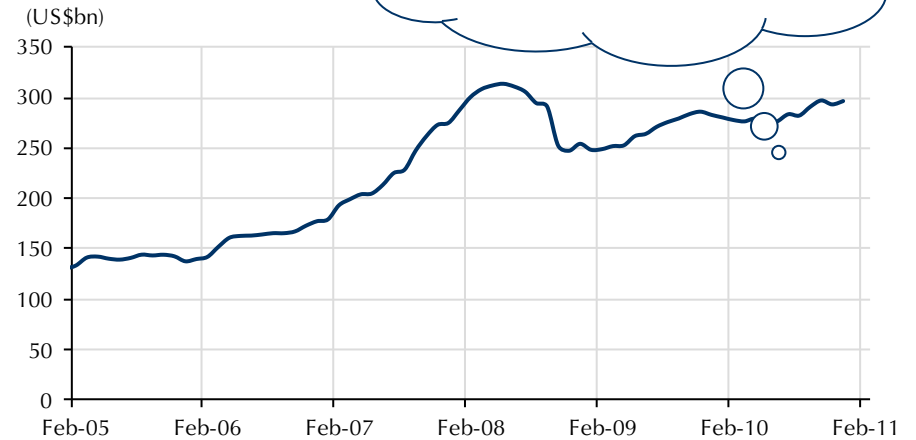
Export growth has outpaced import growth in the recent months

India import and export growth



Forex reserves steady despite large capital inflows in CY10, largely on account of a large current account deficit

India forex reserves





Economy – Political

- ❖ **Elections in five states have been announced for the months of April and May.**
- ❖ **While the government is on the defensive in the wake of the recent spate of scams and pinching inflation, we think that with moderating inflation and elections out of the way, things are slated to improve in the second half of the year.**
- ❖ **A key risk to the global recovery continues to be the political situation in Africa / Middle East and a sustained escalation in crude oil prices which may result in demand destruction in a particularly unripe global recovery.**
- ❖ **Demand elasticity could further be magnified by the fact that a chunk of the demand for crude and other commodities is coming from emerging markets instead of developed markets.**

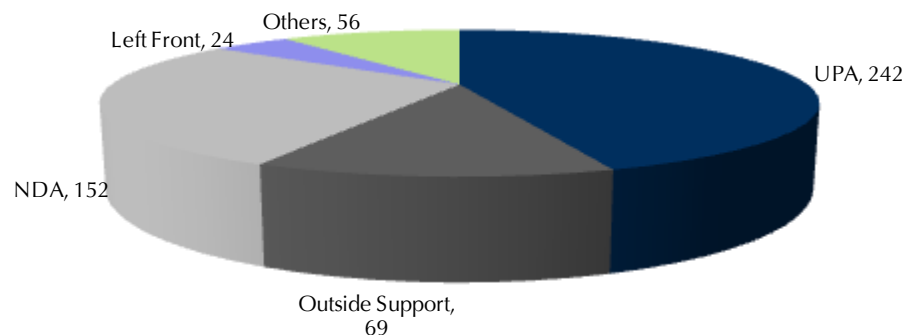


Economy – Policy

- ❖ **Government seems to have failed to deliver on its promised reform agenda but matters may improve from hereon.**
- ❖ **The Budget gave lip-service to reforms but did not deliver any concrete action.**
- ❖ **GST implementation is pushed back and consensus over GST between states and the centre is still a matter of concern.**
- ❖ **With high crude oil prices and rising inflation, further fuel price deregulation looks unlikely soon.**
- ❖ **The impending food security bill would add to the subsidy burden if implemented and depending on what form (NAC or EAC).**
- ❖ **Government has time and again shown its inclination to allow FDI in retail but the actual timeline still remains uncertain.**



Composition of Indian Parliament



UPA—2 Seats in Parliament

Congress	207
Trinamool Congress	19
NCP	9
National Conference	3
Muslim League	2
Jharkhand Vikas Morcha	1
VCK	1
UPA	242
SP	23
BSP	21
DMK	18
RJD	4
JD (Secular)	3
Total Outside Support	69

U-turn on Reforms?

Reform	Date	Status
Gas Price Revision	May-10	Government increased the APM prices of subsidized gas by \$2.5 per mmBtu to \$4.2 per mmBtu
Fuel Price Deregulation	Jun-10	Petrol prices deregulated completely. Diesel to follow suit. Being politically sensitive, Kerosene and LPG price deregulation will take some time.
Public Shareholding	Jun-10	The government made it mandatory for listed companies to maintain a public shareholding of at least 25% and gave a timelines of five years for companies to comply. Later, in a u-turn, the PSUs were exempted from this rule.
Takeover Regulation Advisory Committee	Jul-10	The proposed changes suggest a mandatory 100% open offer, increased trigger threshold ownership of 25% for open offer, etc. and is widely believed to make takeovers tougher for corporates if implemented
Foreign Investment Guidelines	Paper put up for discussion in Jul-10 Tabled in parliament	Expected to do away with inconsistent foreign investment policy of India
DTC	in Aug-10	Expected to be implemented from April 2011
GST	-	Comign at a consensus is proving to be a task for the centre. The actual implementation may be delayed.

Election calendar

State	Last Election	Seats	Incumbent	Election Date
West Bengal	May-06	294	DMK+	Starting 18-Apr
Tamilnadu	May-06	234	Left Front	13-Apr
Assam	May-06	126	Congress+	4-Apr and 13 Apr
Kerala	May-06	140	Congress	13-Apr
Pondicherry	May-06	30	Left Front	13-Apr



Fund Flows

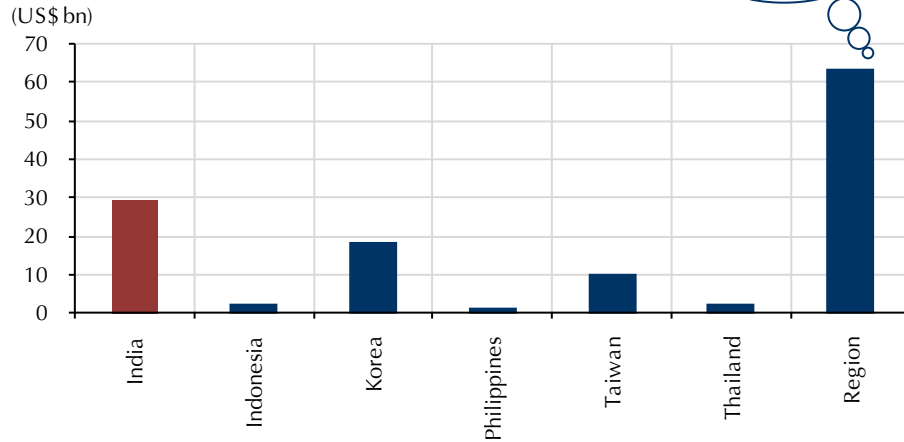
- ❖ **2010 was essentially driven by FIIs with US\$ 29bn invested (net) in India.**
- ❖ **DMFs are reeling under redemption pressures, taking US\$ 6bn off the table in 2010.**
- ❖ **The recent fall in the markets was primarily on account of the lack of DII support as FIIs rebalance out of India in other DMs/EMs.**
- ❖ **DMF net inflows turned marginally positive in December '10.**
- ❖ **Money market funds saw record inflows in January '10.**
- ❖ **Insurance FYPs are also seen picking up.**
- ❖ **Can domestic institutional investors support the markets in an FII exodus? Not so far...**



Call on markets is essentially a call on portfolio flows

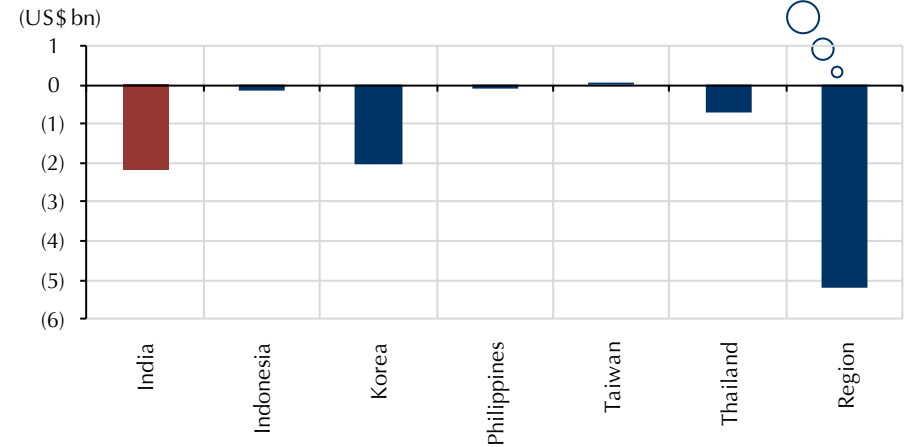
India got a disproportionate share of regional portfolio inflows in 2010

India's share of regional FII flows - 2010



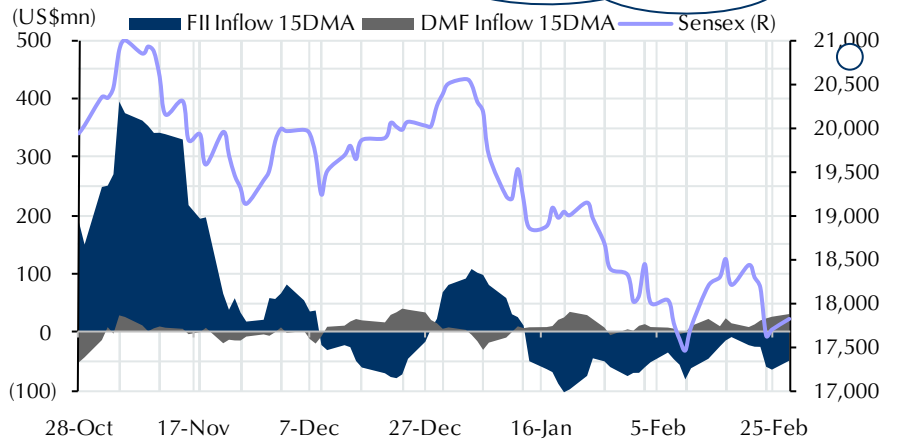
India has seen outflows of US\$ 2.2bn since the start of the year

India's share of regional FII flows - 2011

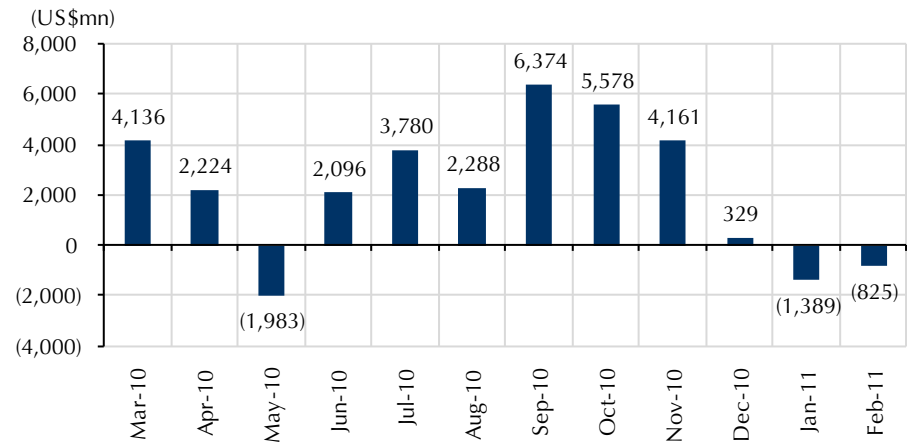


Flood of portfolio flows last year has now dried up dragging the Sensex downwards

FII, DMF Inflows and Sensex



Monthly FII net flows

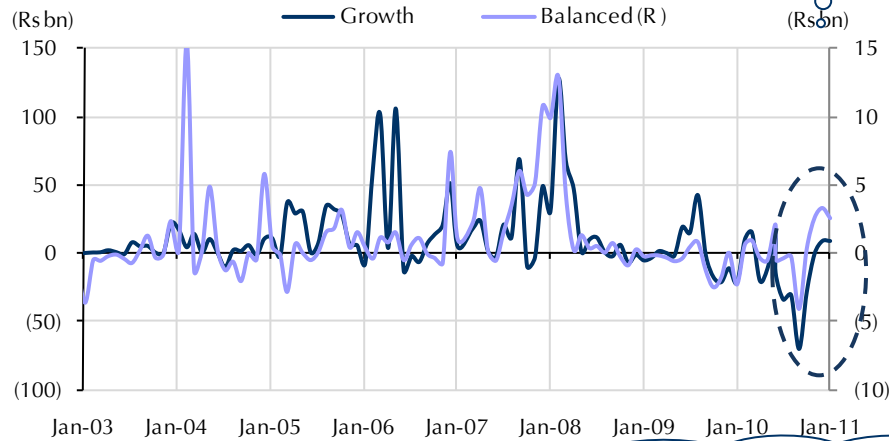




Call on markets is essentially a call on portfolio flows

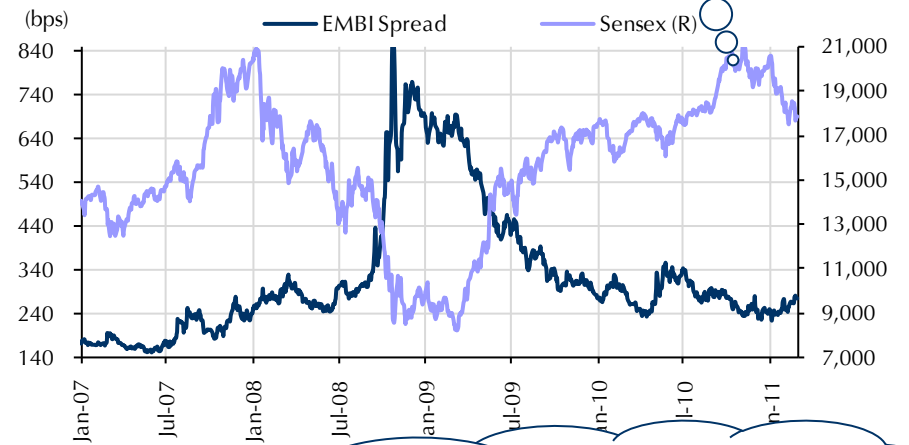
Equity funds have seen some net inflows after a long time

Net inflow into growth and balanced mutual fund schemes



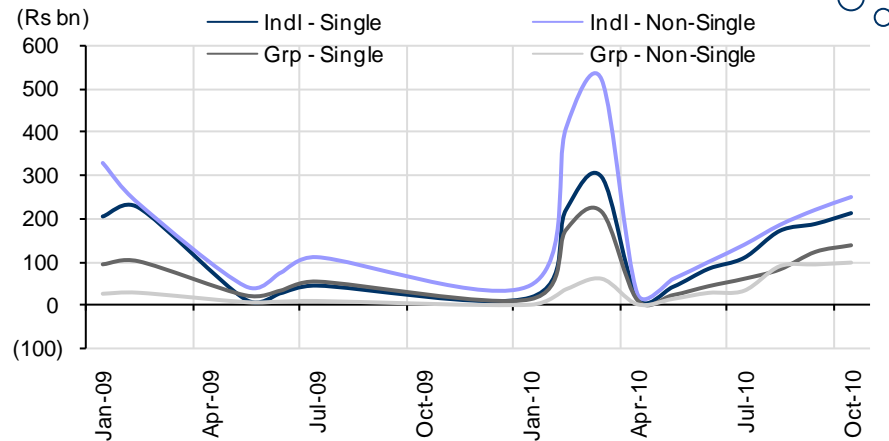
EMBI spreads have been going down since the GFC, highlighting increased risk appetite

EMBI spreads continue to go down



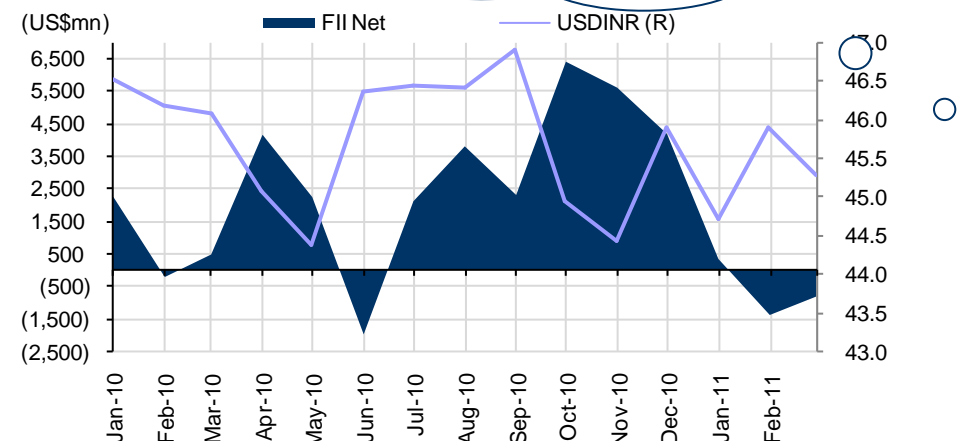
Insurance premiums indicate some possible inflows into the market through the insurance channel

Insurance premium picking up



While Sep-Nov'10 saw large capital inflows and a strengthened INR, the currency has been depreciating ever since

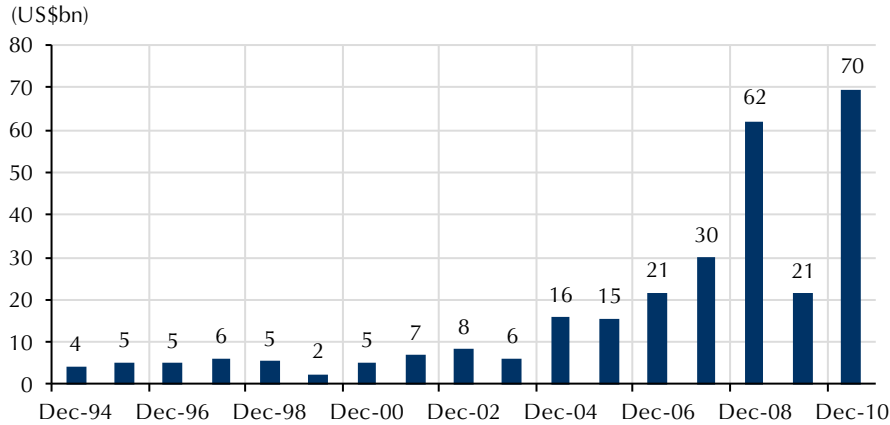
FII flows and USD/INR



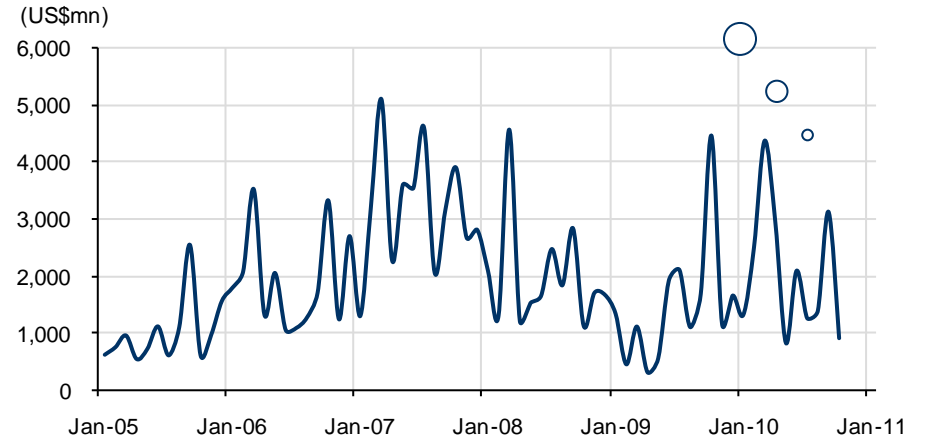


ECBs and FCCBs continue to be favoured on account of lower cost of borrowing outside India

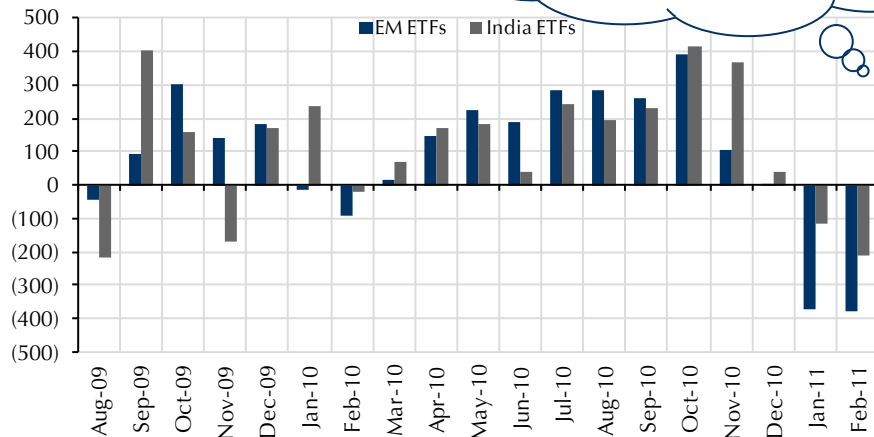
Annual FDI Inflows



ECB/FCCB Flows

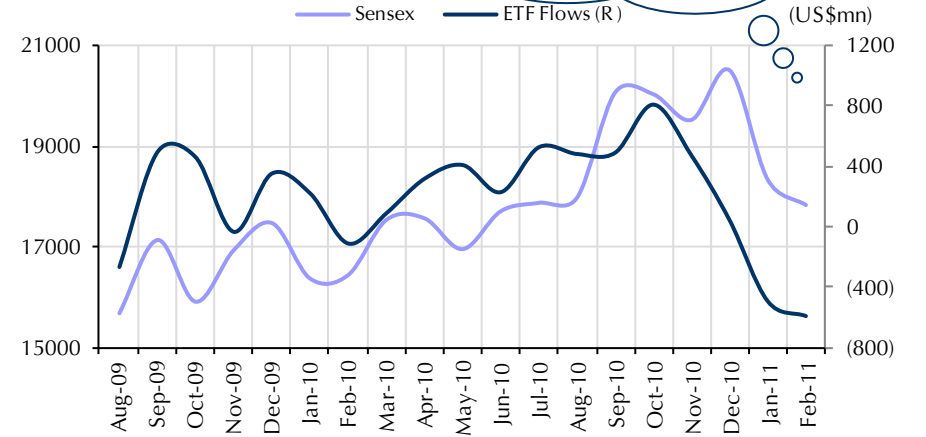


ETF net inflows into India



Of US\$2.2bn net outflow this year, ETFs accounted for ~50% EM ETFs saw higher outflows than India based ETFs

ETF flows and Sensex



Historically ETFs have been seen tracing performance rather than fundamentals



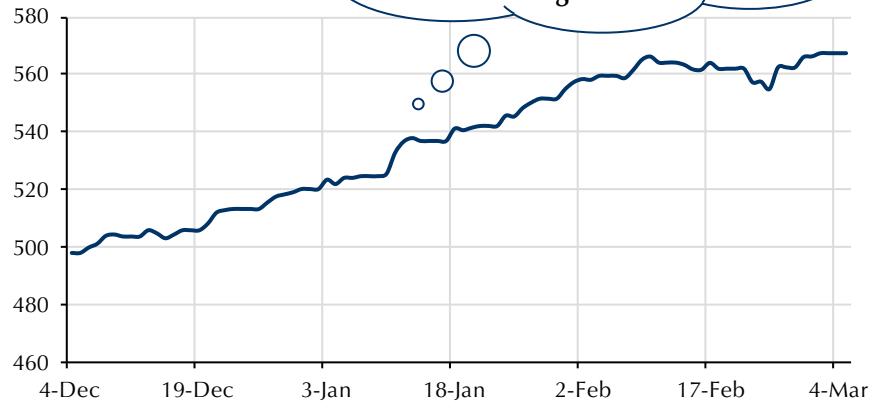
Commodities

- ❖ **Global commodities have rallied since the start of the year, continuing their good run from last year.**
- ❖ **Supply bottlenecks and increasing demand from emerging markets have meant strengthening soft commodity prices over the last year. The issue seems more structural than transient and high soft commodity inflation is here to stay globally.**
- ❖ **Oil has surged thanks to uncertainties in Egypt and now Libya.**
- ❖ **The recent correction in metals stems from concerns over global recovery in the wake of high energy prices after a run-up throughout the last six months.**
- ❖ **After a sustained outperformance last year, commodities are expected to stabilise, especially in the context of a slowing China and a weak global recovery.**



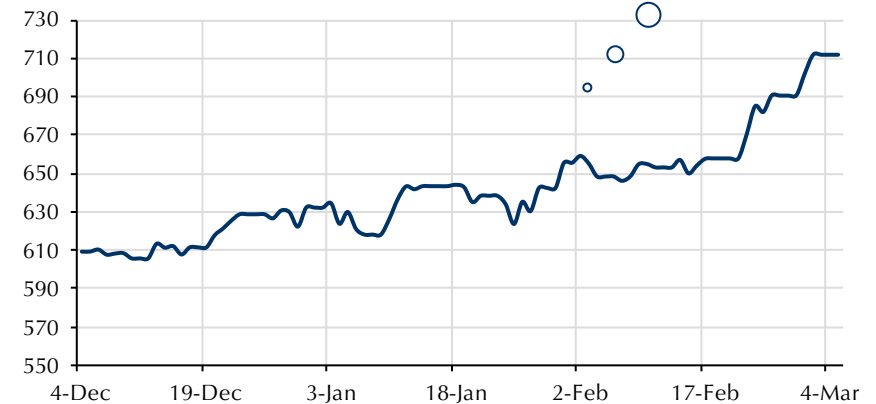
CRB Index

Ample liquidity and expectations of better than expected recovery have been driving commodities higher



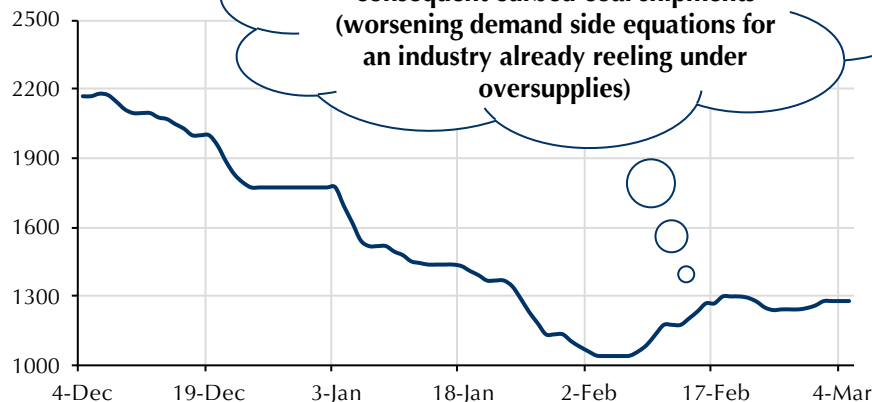
GSCI TR Index

As is indicated by GSCI TR Index



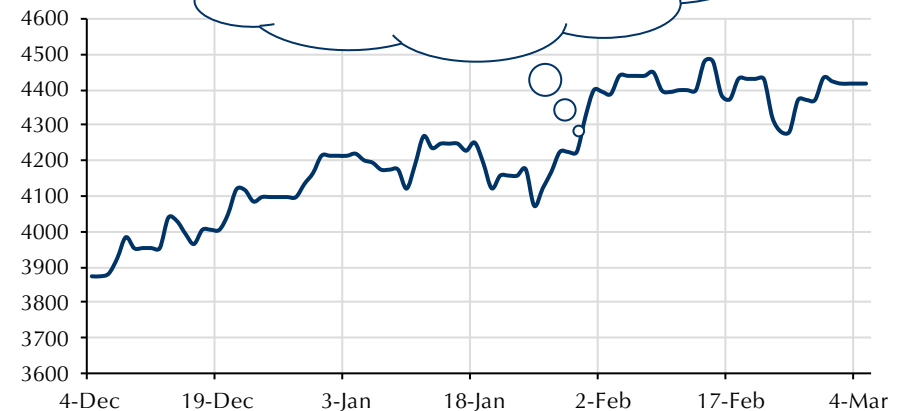
Baltic Dry Index

Baltic Dry has seen a free fall on account of floods in Australia and consequent curbed coal shipments (worsening demand side equations for an industry already reeling under oversupplies)



LME Index

Metals have been one of the best performing asset sub-class in commodities

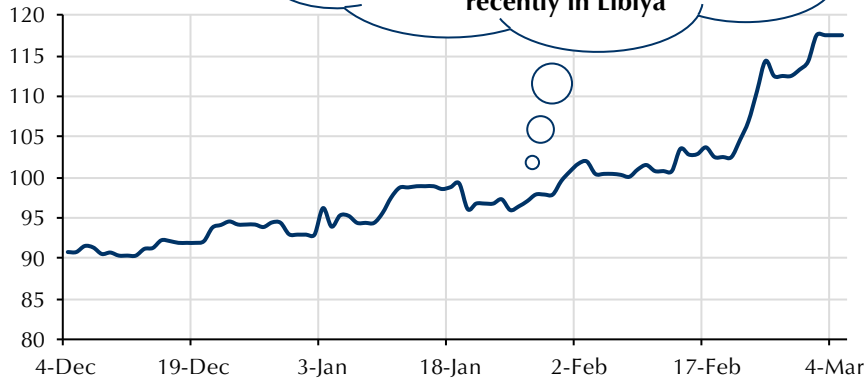




Energy – Crude threatens to dampen global recovery

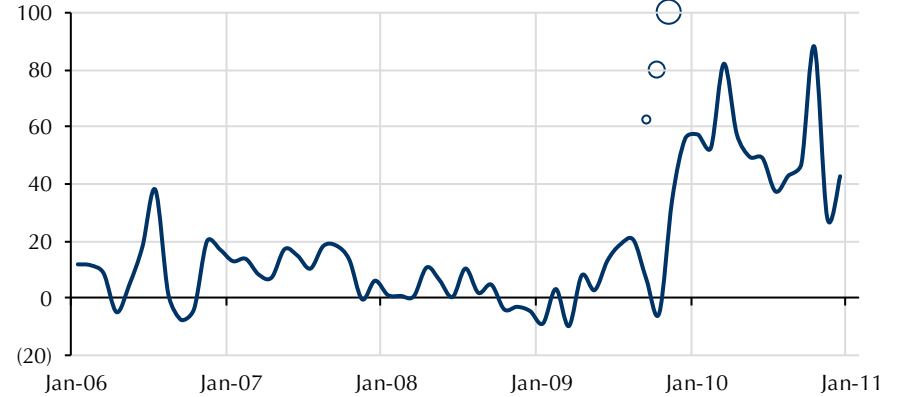
Brent Crude

(US\$/bbl)



Brent has been on the rise initially on spurt in demand due to adverse weather conditions and then unrest in Egypt and more recently in Libiya

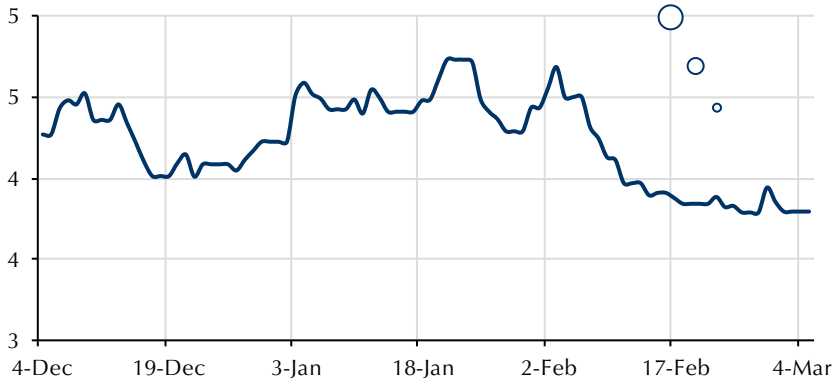
Dubai crude cracking margins



Cracking margins recovered sharply in the last month

Natural Gas

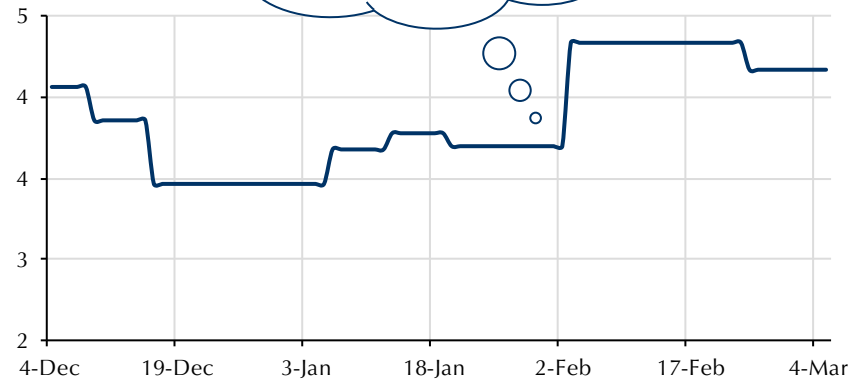
(US\$/mmbtu)



Natural gas prices have also been on the rise

Biodiesel

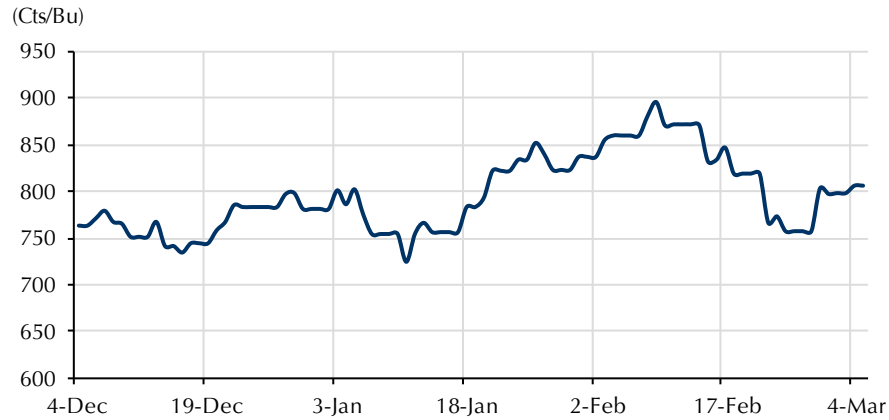
(US\$/Gallon)



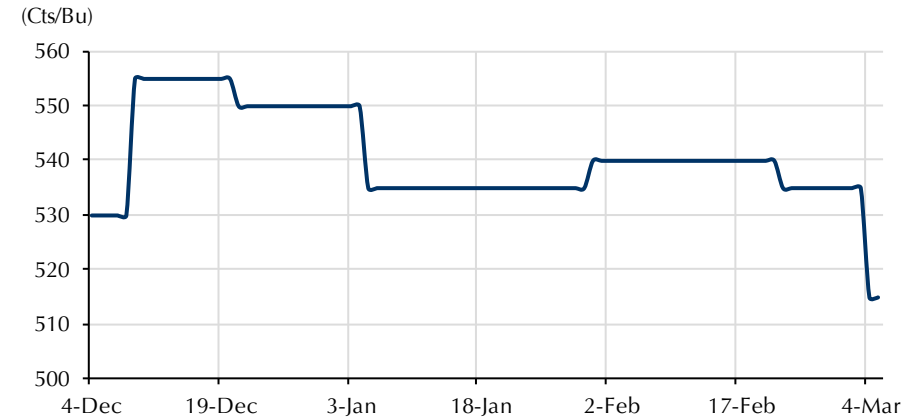
Higher crude may translate into higher demand for biodiesel in the future



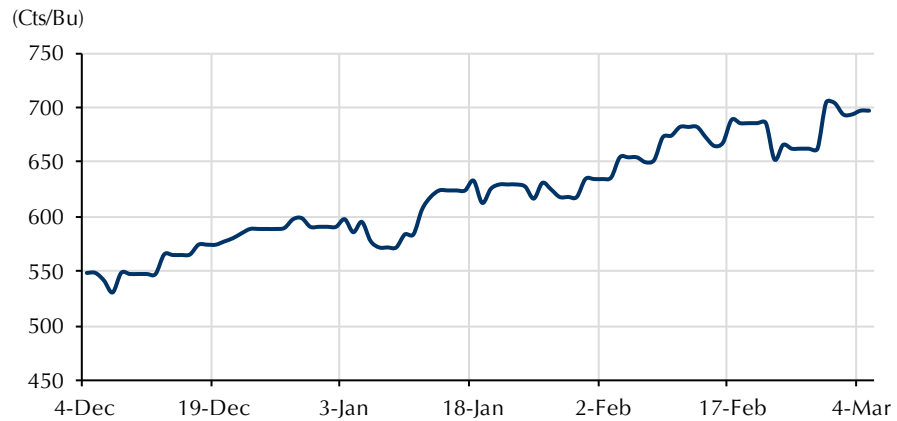
Wheat



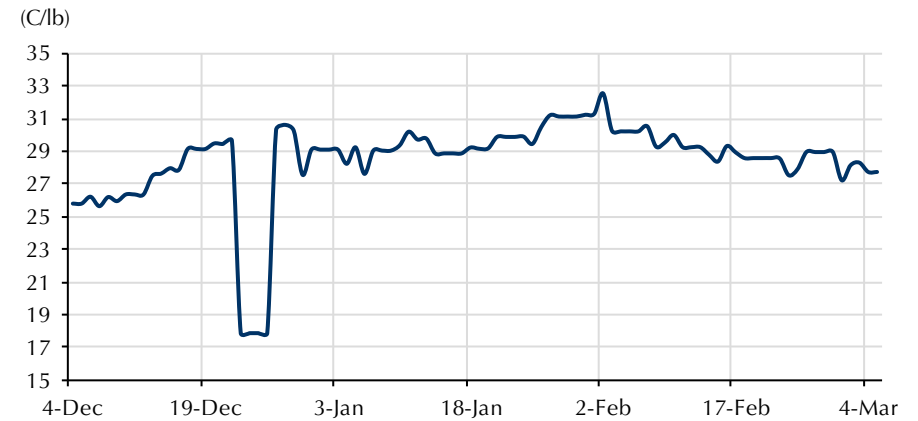
Rice



Corn

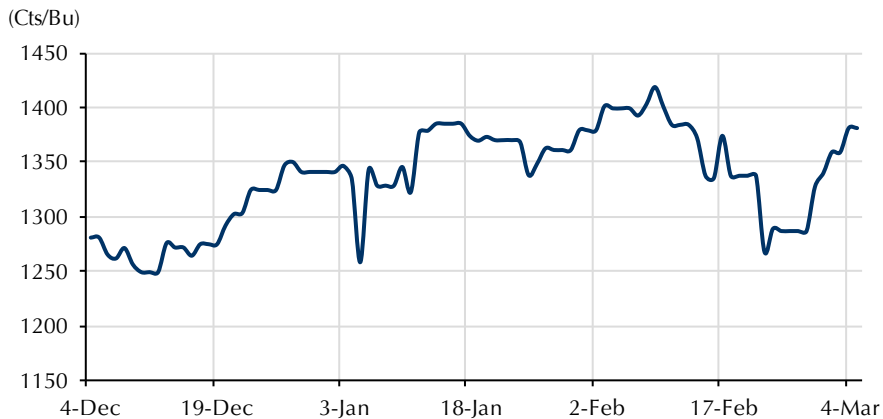


Sugarcane





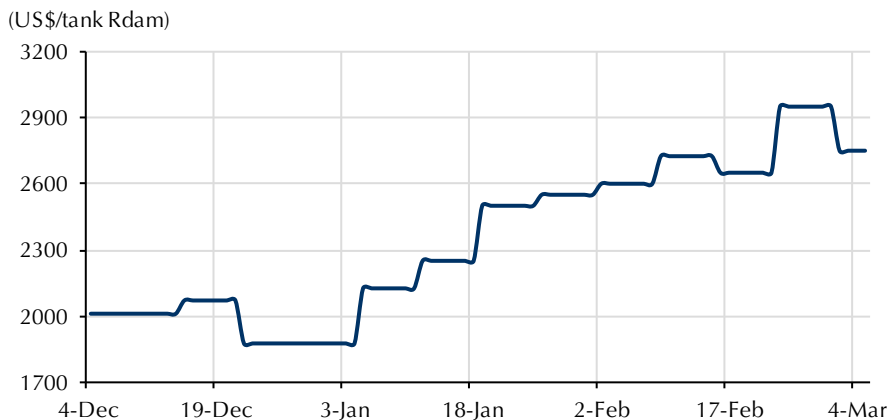
Soya bean



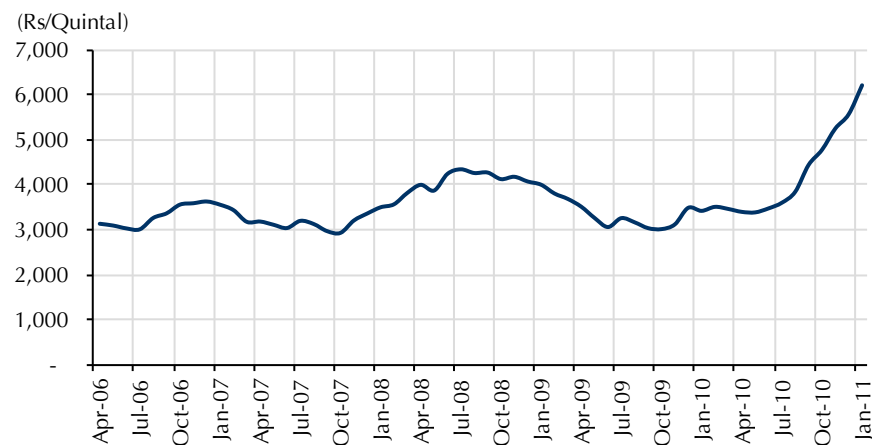
Palm oil



Castor oil



Copra

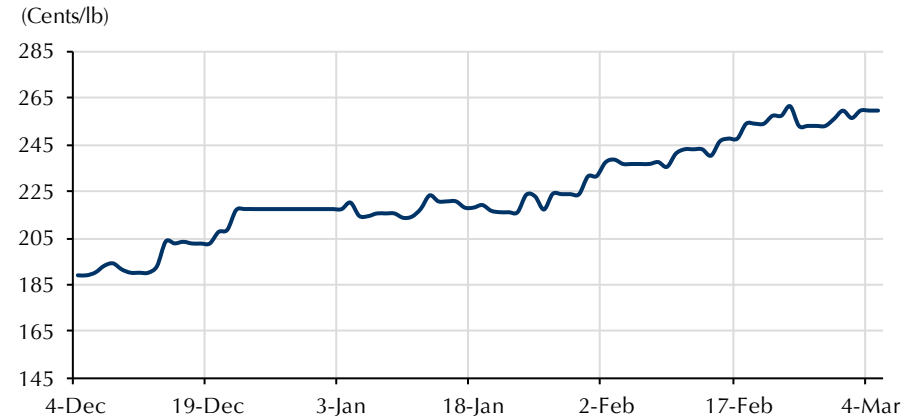




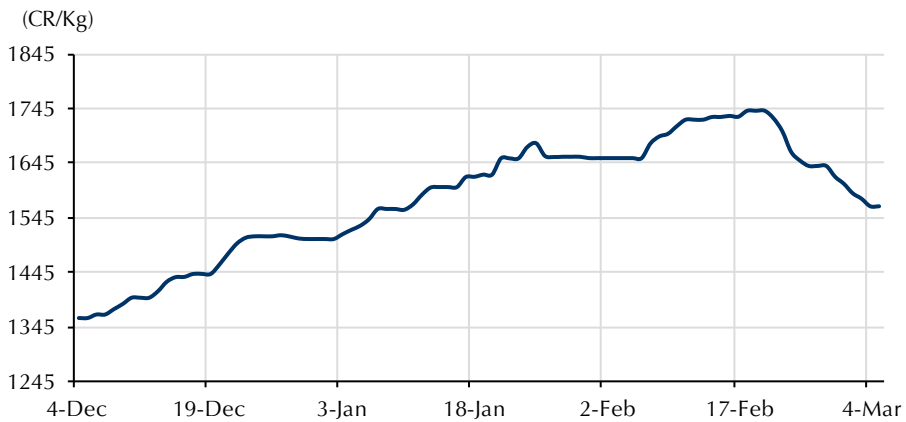
Tea



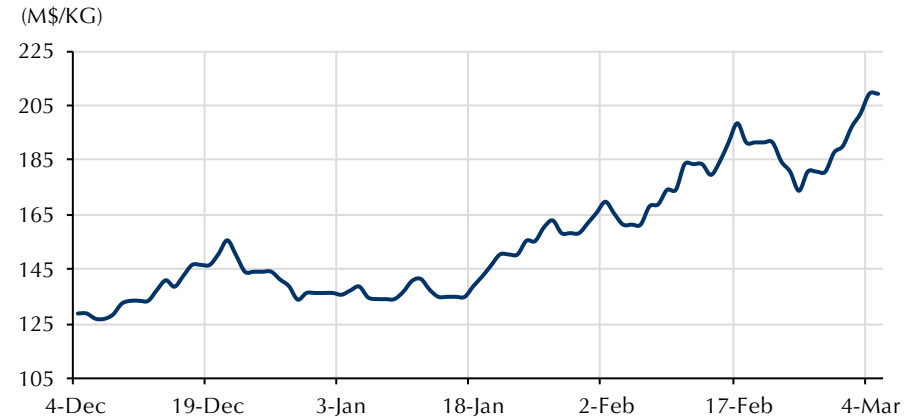
Coffee



Rubber



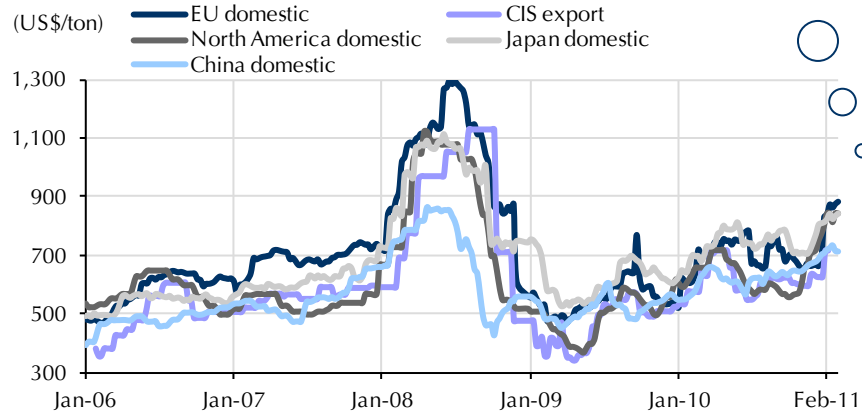
Cotton





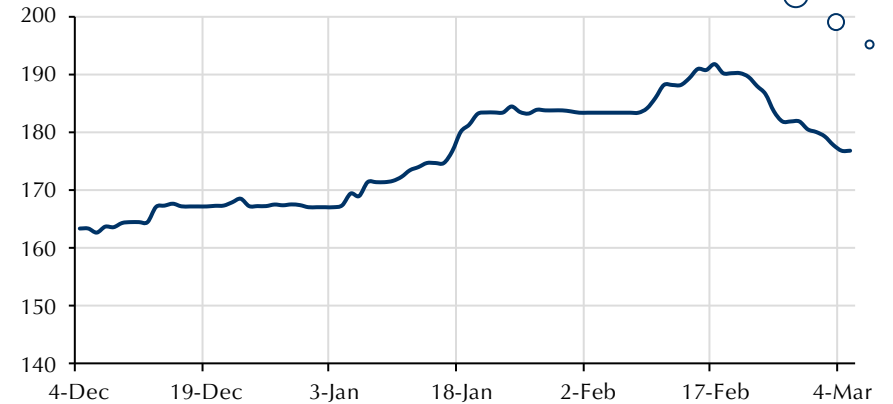
Expect further uptick in steel prices if strong global recovery continues to strengthen demand in the backdrop of a cost push from higher raw material prices

CRU Global Steel Price Index

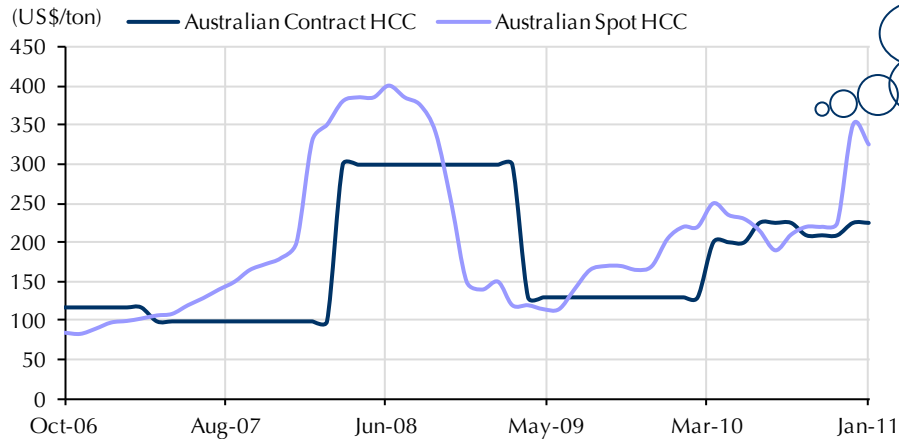


Metal Bulletin iron ore index

Iron ore has also been on a steady rise



Coal



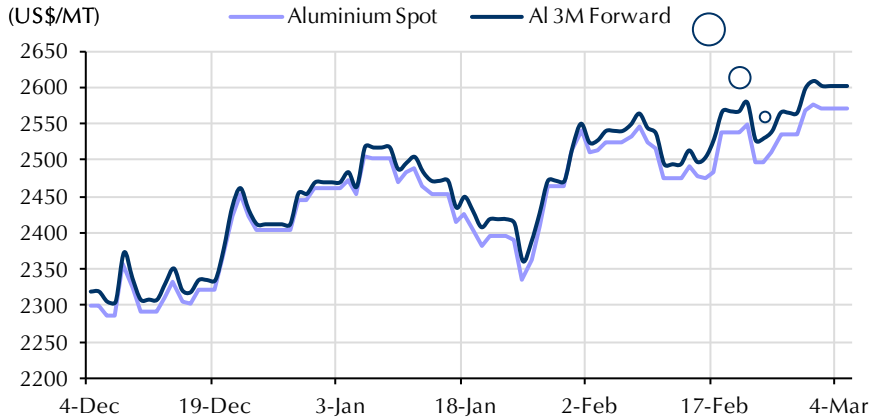
Coking coal is on the rise after recent floods in Australia have disrupted some major supplies



Base Metals

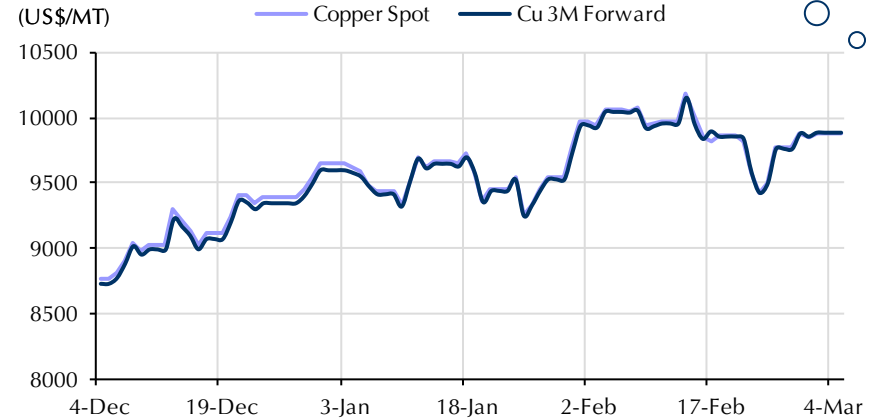
Recovery in the developed markets and ample liquidity on account of loose monetary policy in the west has augured well for base metals like Aluminum

Aluminum



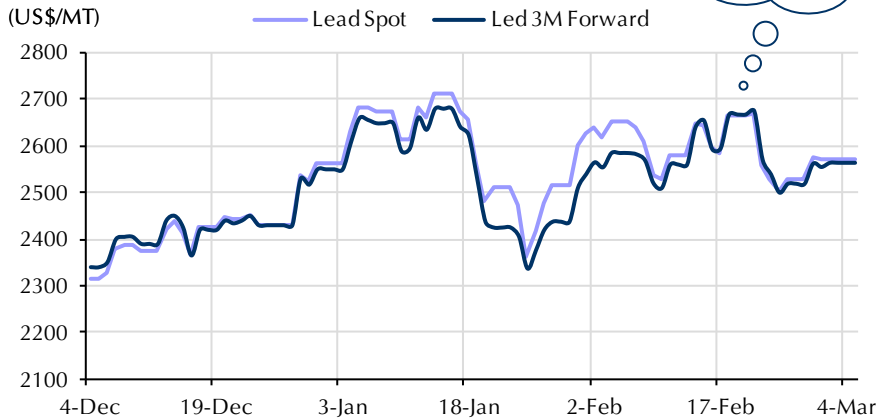
Copper was one of the best performing base metals in the last twelve months

Copper



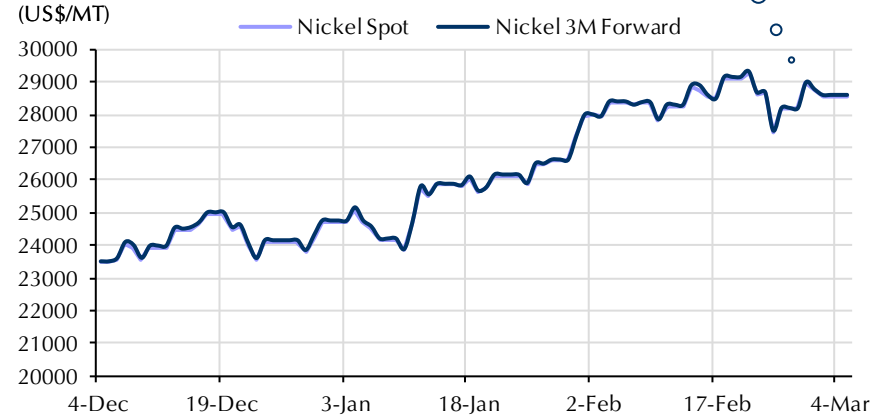
Ditto for Lead

Lead



... and Nickel

Nickel

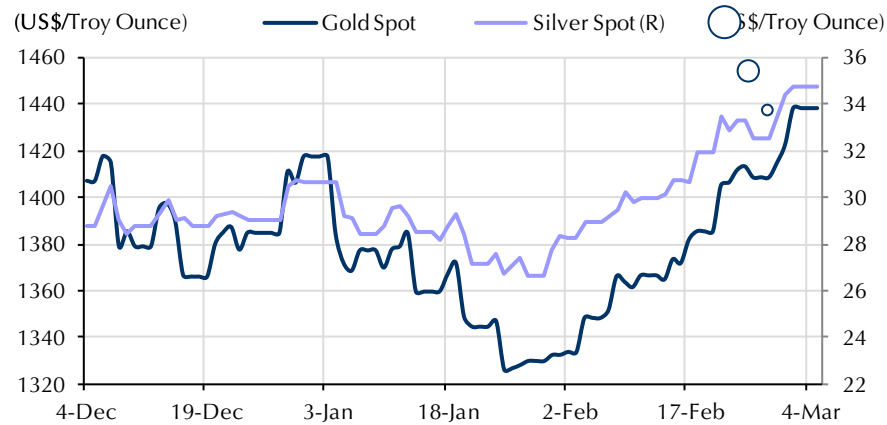




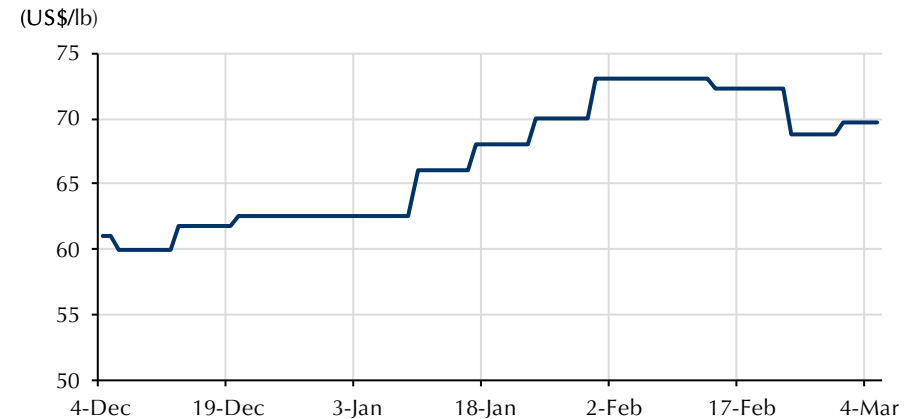
Precious Metals – Flight to safety helps them gain further

Gold, Silver have gained further on renewed concerns in Africa/Middle East and consequent uncertainty about oil prices

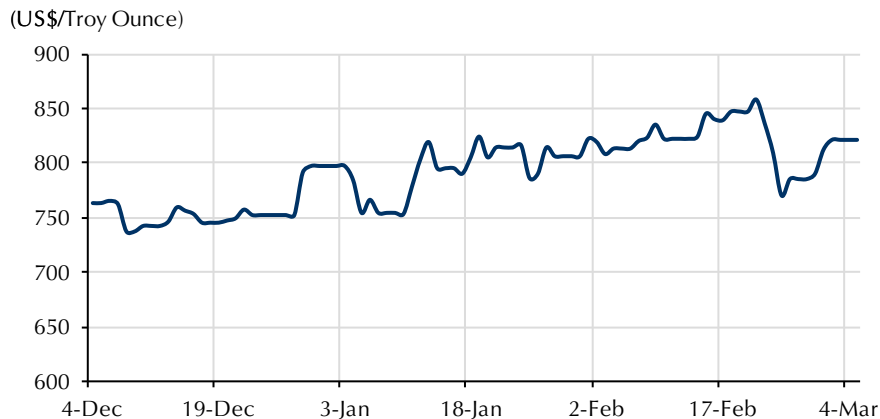
Gold/Silver



Platinum



Palladium





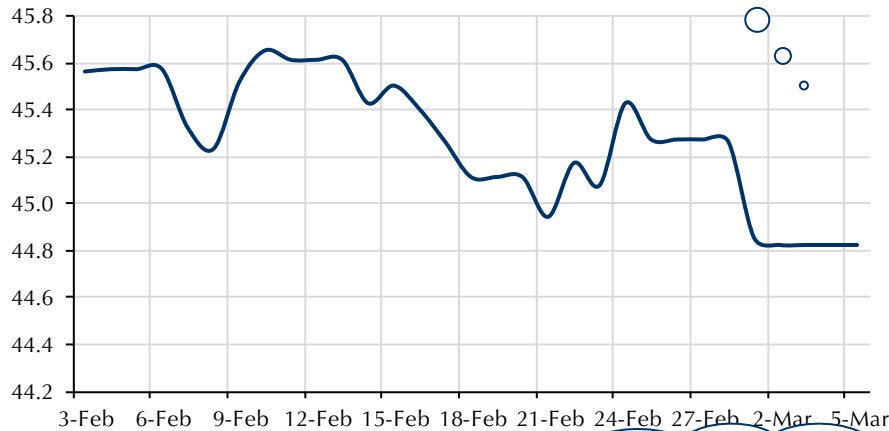
Currencies

- ❖ **The rupee has gained 2% versus the dollar in the last month on account of the dollar's general weakness against all currencies.**
- ❖ **INR six-currency REER/NEER indicates a slight appreciation of the rupee versus a trade weighted basket of currencies.**
- ❖ **The recent Budget announcements of a higher investment limit for FIIIs in infrastructure bonds (from US\$ 5bn to US\$ 25bn) and a divestment target of Rs 400bn for FY12 can help the rupee appreciate against a weakening dollar from here on, in the absence of any shocks in the global markets.**



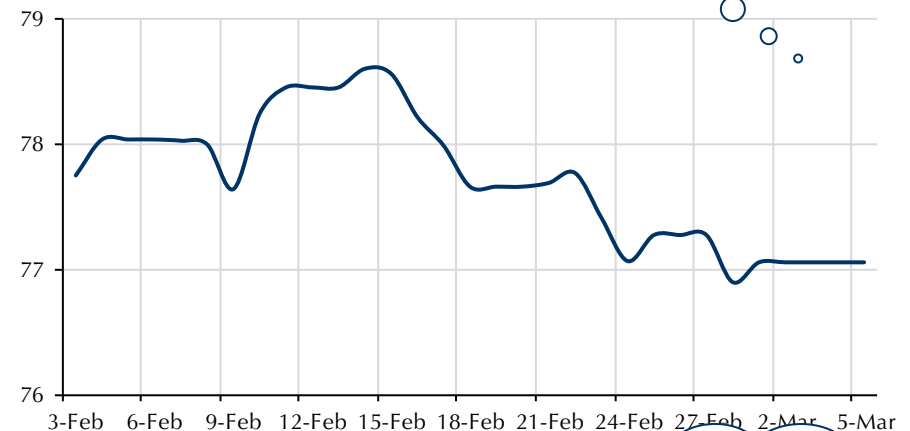
USDINR

Dollar has depreciated in the last month vs. INR after appreciating since the start of the year.



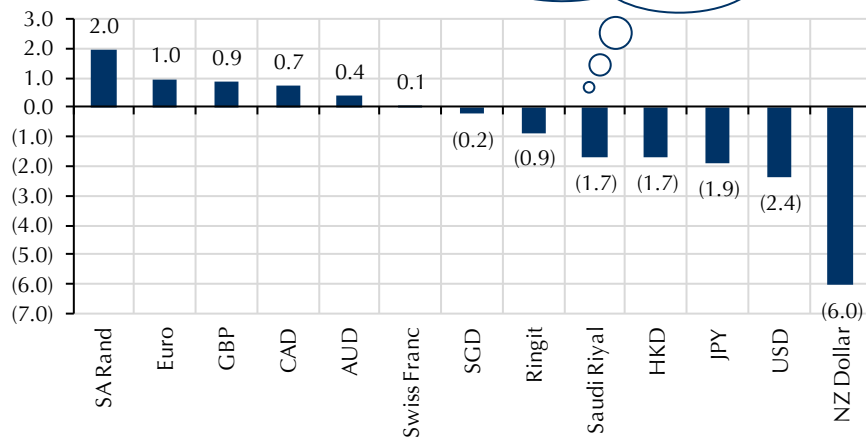
Dollar Index

The dollar index shows that US\$ has depreciated against major currencies



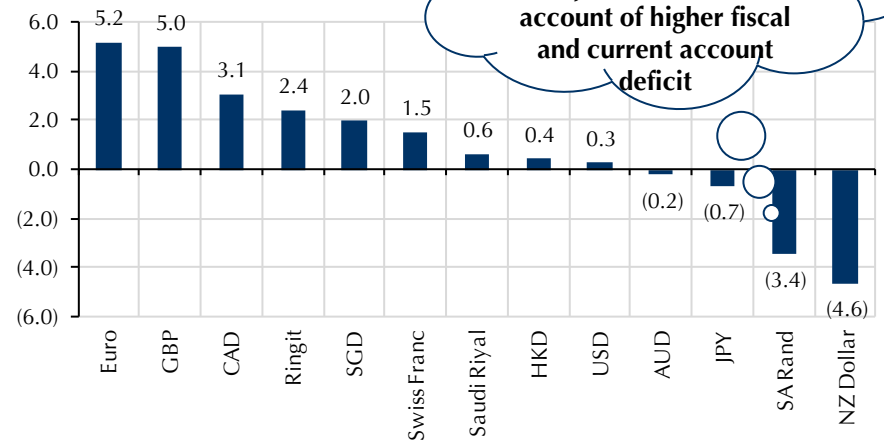
INR vs. Major currencies (1M)

INR has appreciated against most of the currencies in the last month



INR vs. Major currencies (YTD %)

Since the start of the year, INR has depreciated against major currencies on account of higher fiscal and current account deficit

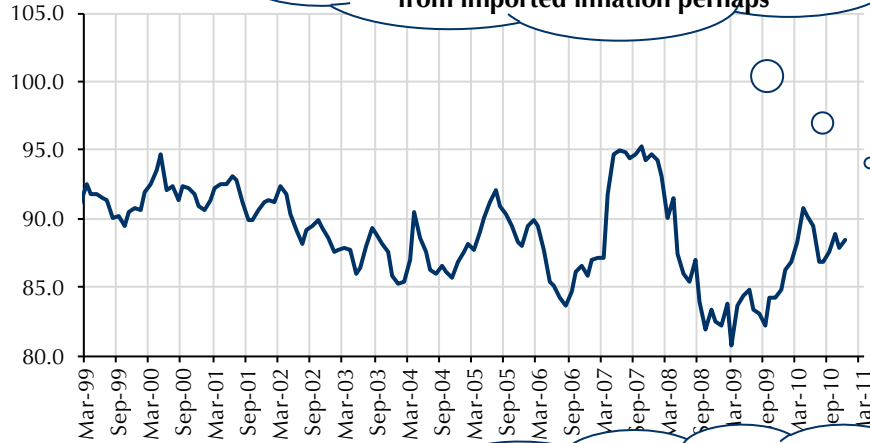




Rupee – Gained some vs. Dollar

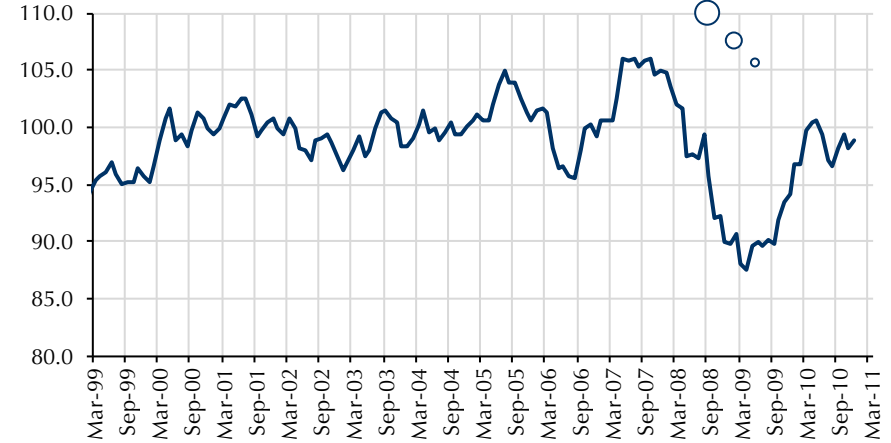
Nominal effective exchange rate shows that rupee has gained value in nominal terms—a little respite from imported inflation perhaps

India NEER



And in real terms as well

India NEER



Implied volatility for USDINR has been on a downward trajectory

USDINR 1M implied volatility





Earnings

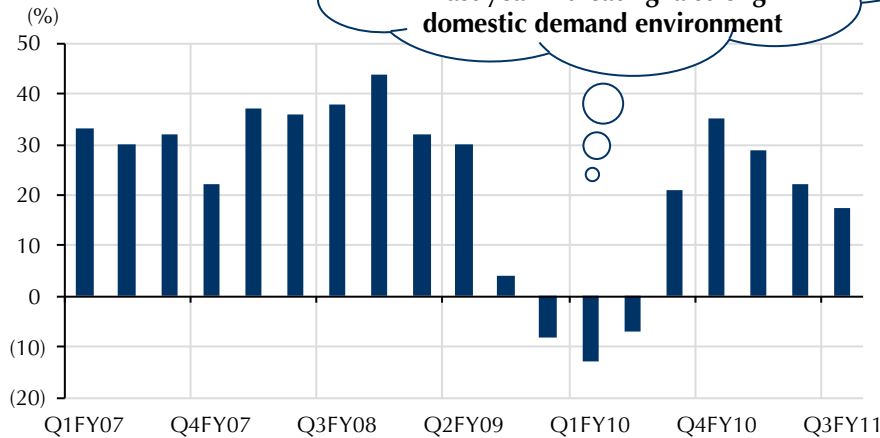
- ❖ **The Q3FY11 earnings season was characterised by strong topline growth (partly helped by inflation) and deteriorating margins across a majority of the sectors.**
- ❖ **The Sensex is on track to clock earnings growth of 20%+ in FY11.**
- ❖ **However, higher commodity prices and soaring crude may mean further margin pressure in the coming quarters.**
- ❖ **While a higher share of commodity-driven earnings in the Sensex will ensure that index earnings hold up in the event of a commodity rally (as margin contraction is compensated by higher profits from commodity-driven sectors), a higher share of cyclical earnings will also mean a P/E de-rating.**



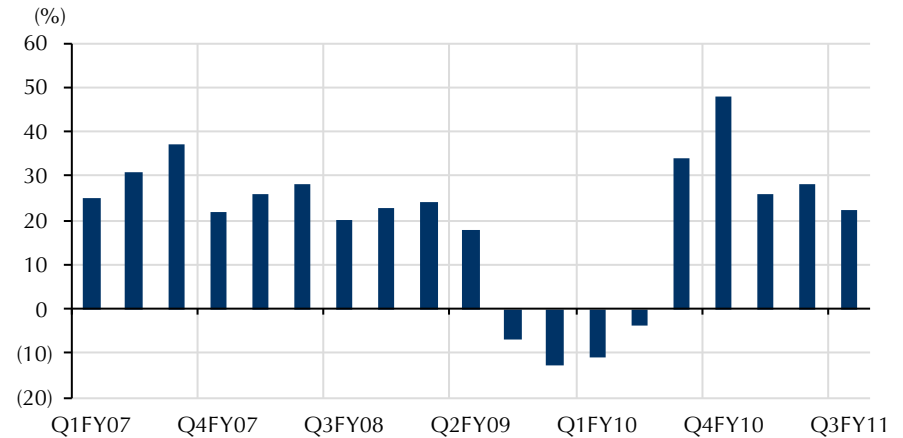
Earnings – 20% or thereabouts in FY11 and FY12

Sensex revenue growth

Q3FY11 saw Sensex companies post a revenue growth of ~17% indicating despite a high base of last year indicating a strong domestic demand environment

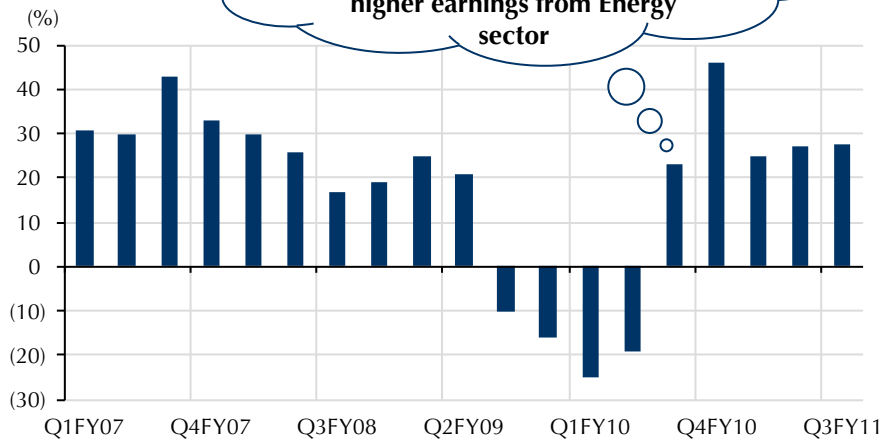


Sensex EBITDA growth



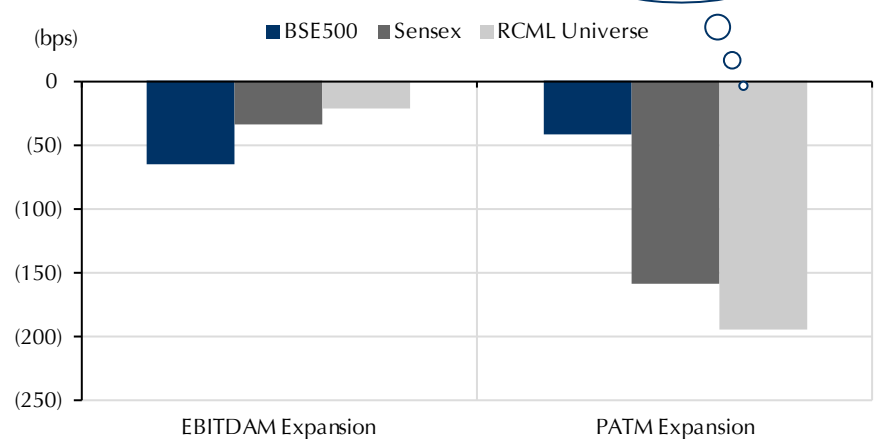
Sensex PAT growth

Profits for Sensex companies continued to soar with 27% YoY growth in Q3FY11—helped by higher earnings from Energy sector



Margin expansion/contraction

Despite high growth markets are specifically concerned about margin contraction



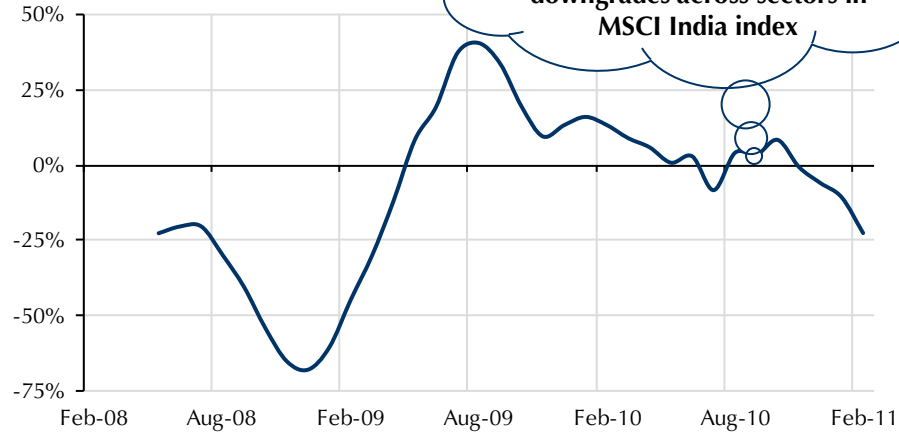


Earnings Revision Indicators

- ❖ Earnings Revision Indicators for MSCI India and broader IBES Index both are pointing downwards indicating more downgrades than upgrades by analysts
- ❖ While topline growth has been robust in the Q3FY11 earnings season, margin pressure has seen recommendation downgrades across sectors in MSCI India index
- ❖ MSCI India EPS, however, has fallen a little, thanks to higher commodity exposure of the Index

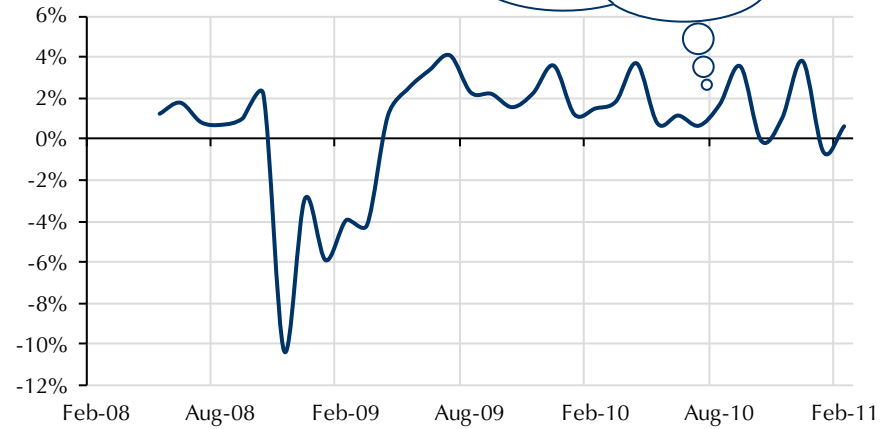


MSCI India Earnings Revision Index



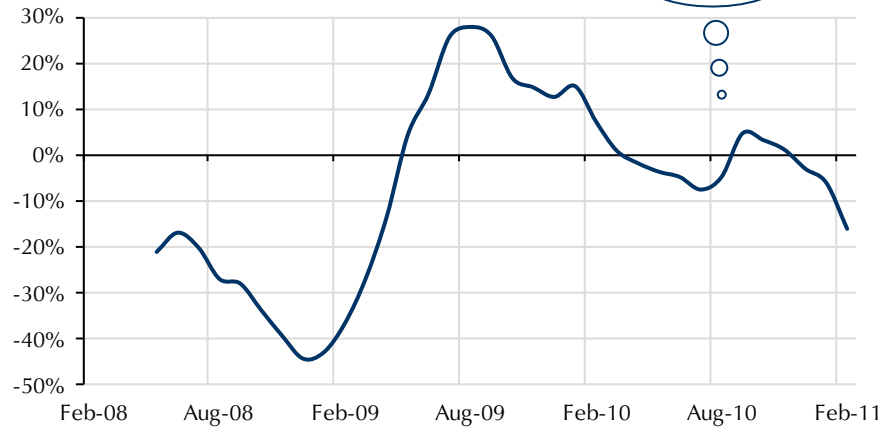
Margin pressures in this earnings season and consequent de-rating of stocks has seen recommendation downgrades across sectors in MSCI India index

MSCI India NTM EPS change



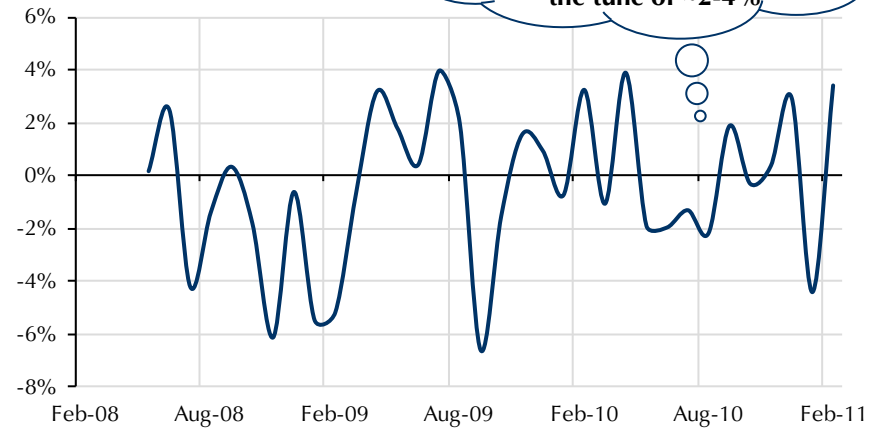
MSCI India EPS has fallen a little thanks to higher commodity exposure of the Index

IBES India Earnings Revision Index



And in the broader ~700 stock IBES India index

IBES India NTM EPS change

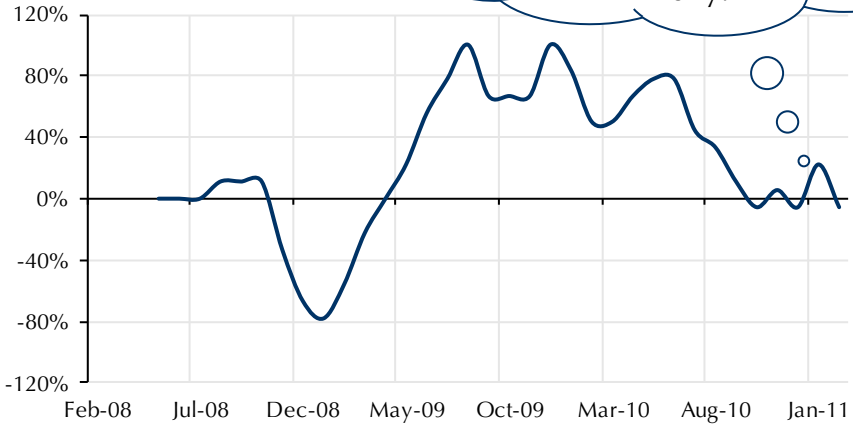


But the broader IBES India index has already seen EPS downgrades to the tune of ~2-4%



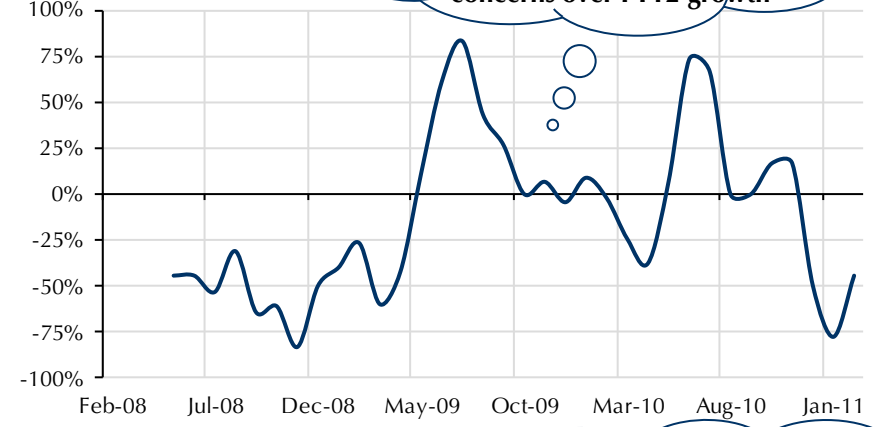
MSCI India Autos ERI

Autos haven't seen many downgrades despite run up in commodities. Do we need to worry?

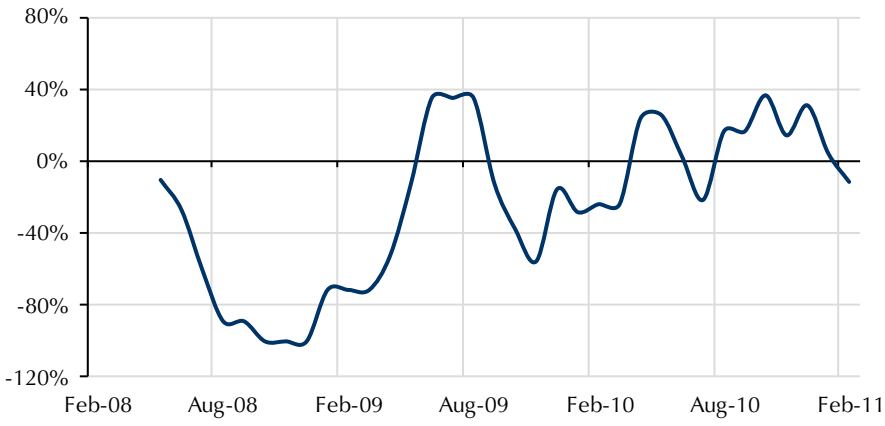


MSCI India Banks ERI

Banks have been the biggest losers on account of hawkish RBI stance and consequent concerns over FY12 growth

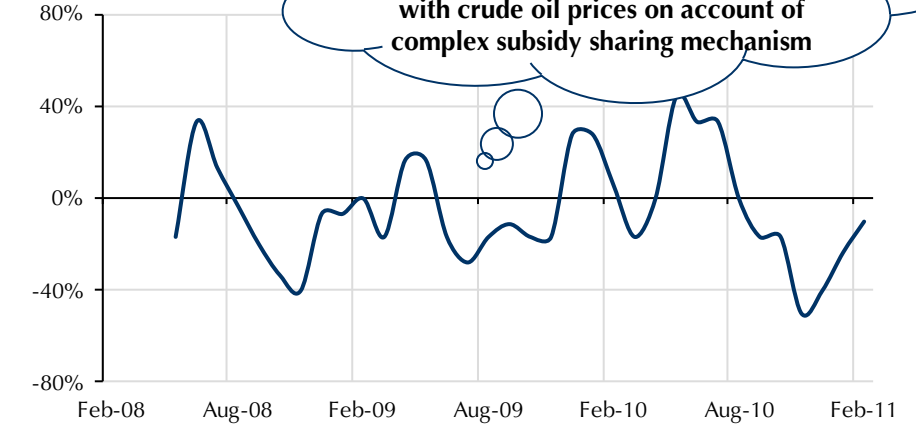


MSCI India Capital Goods ERI



MSCI India Energy ERI

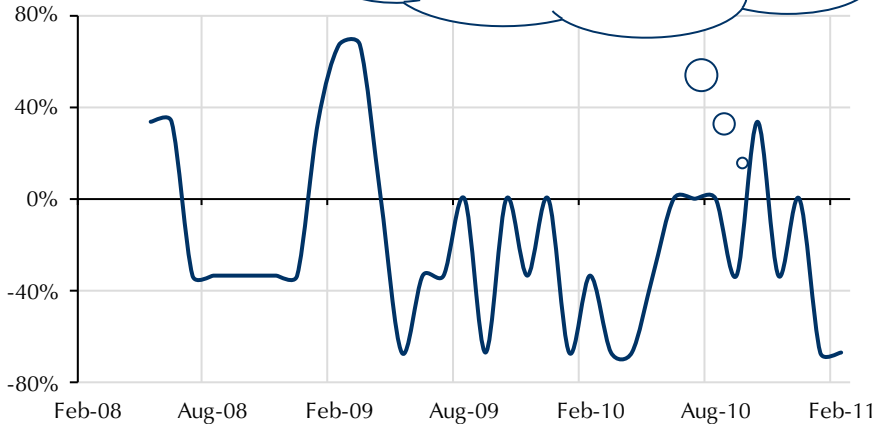
While globally, rising crude oil prices translate into earnings upgrades for energy companies, India's energy sector has a complicated relationship with crude oil prices on account of complex subsidy sharing mechanism





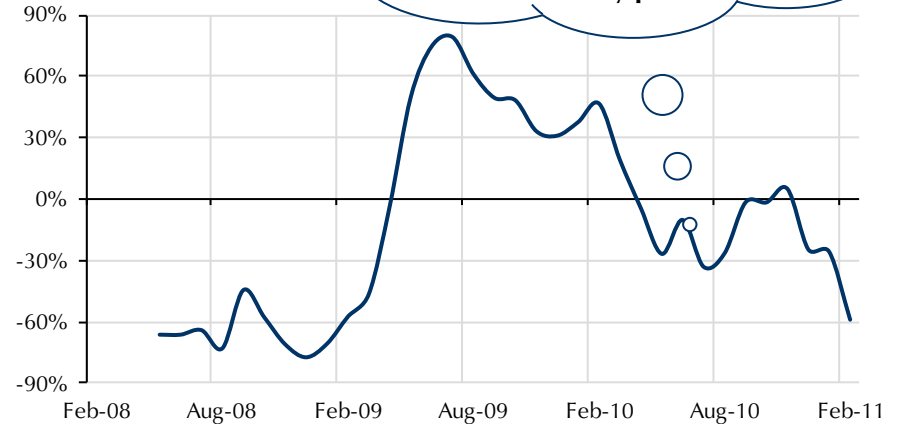
MSCI India FMCG ERI

FMCG companies have seen earnings downgrades on the back of rising raw material prices



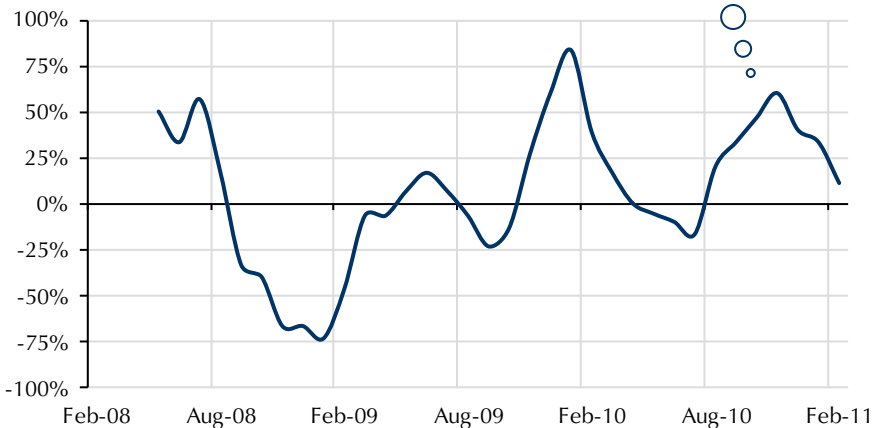
MSCI India Materials ERI

Rising raw material costs/ overcapacities have put pressure on Cement whereas Metals may be a big beneficiary of sustained high commodity prices



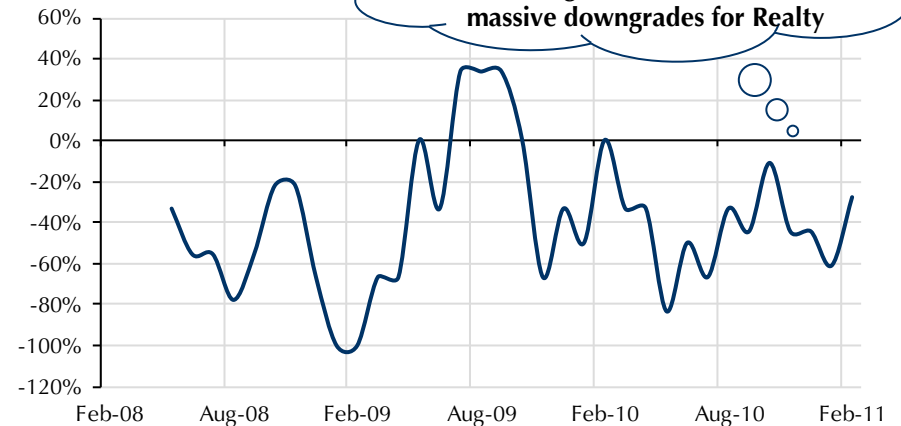
MSCI India Pharmaceuticals ERI

CRAMs' woes continue weighing down on the pharma sector in general



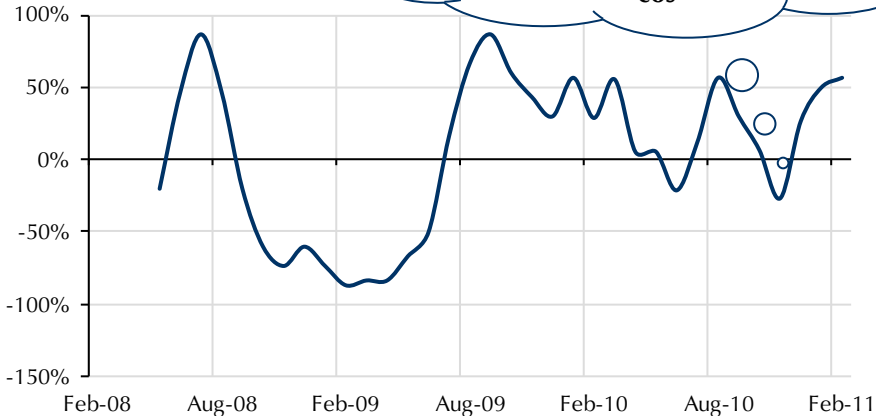
MSCI India Real Estate ERI

Hawkish RBI, rising credit costs and oversupply in some pockets have together translated into massive downgrades for Realty



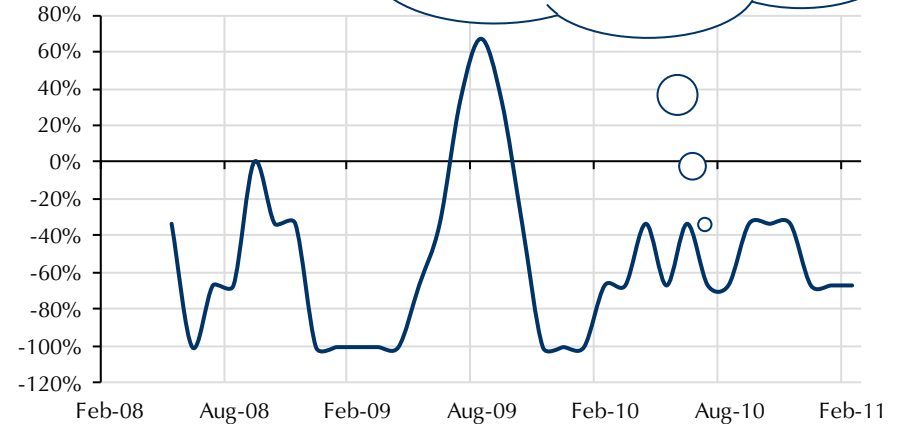


MSCI India IT Services ERI



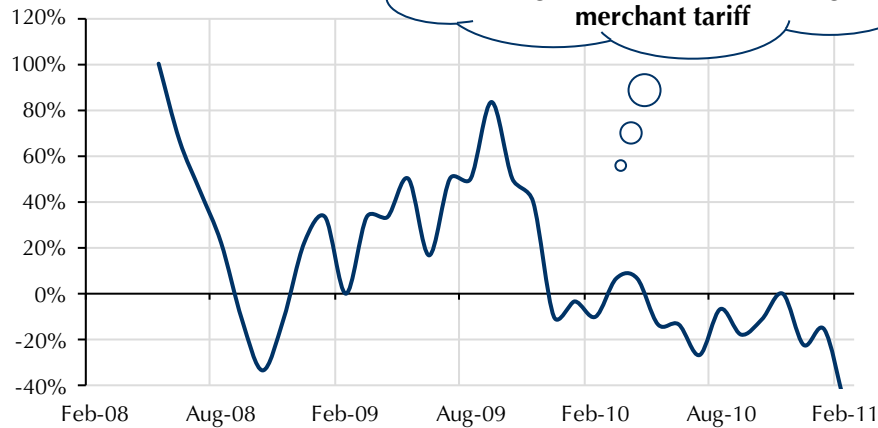
On the back of optimism on account of global recovery, analysts have been upgrading IT cos

MSCI India Telecom ERI



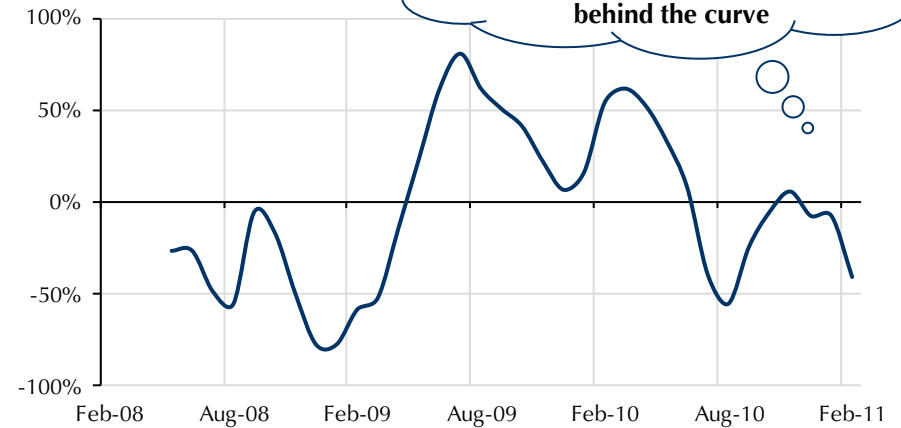
Policy and regulatory headwinds have translated into sustained earnings downgrades for Telecom sector

MSCI India Utilities ERI



Utilities have also seen downgrades on the back of rising raw materials and falling merchant tariff

MSCI India Metals & Mining ERI

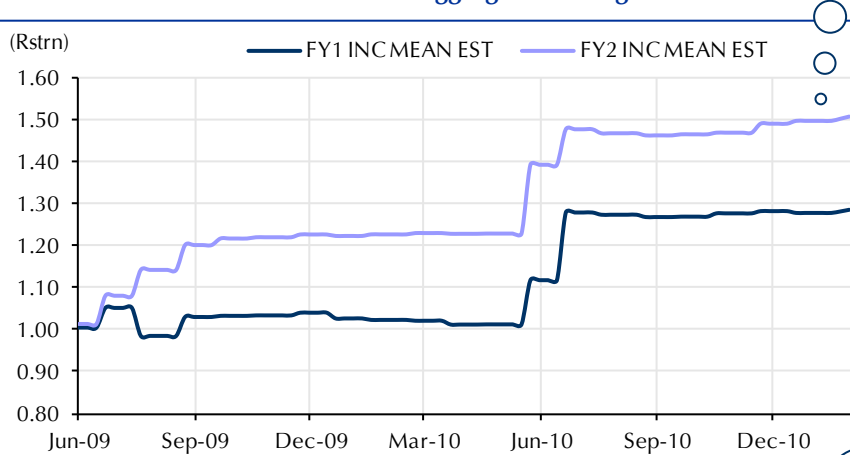


Metals can provide a big alpha on firming global commodity prices and analysts seem to be behind the curve

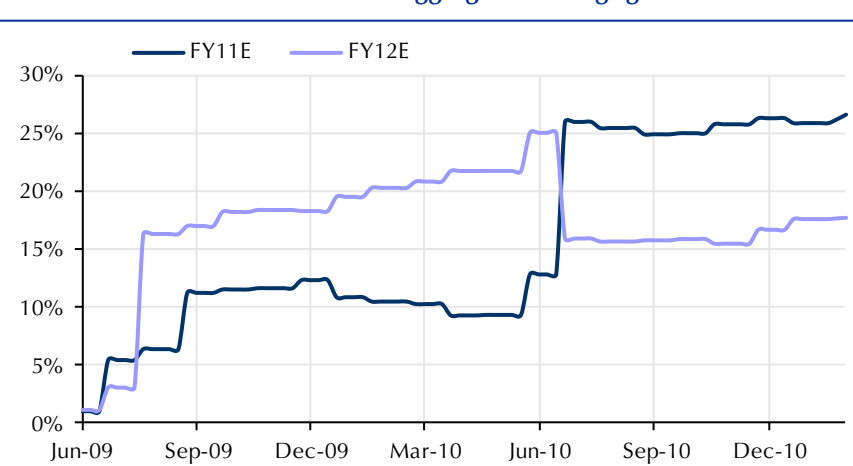


While there have not been any upgrades, there have been no major downgrades either for Sensex FY11 and FY12 earnings estimates

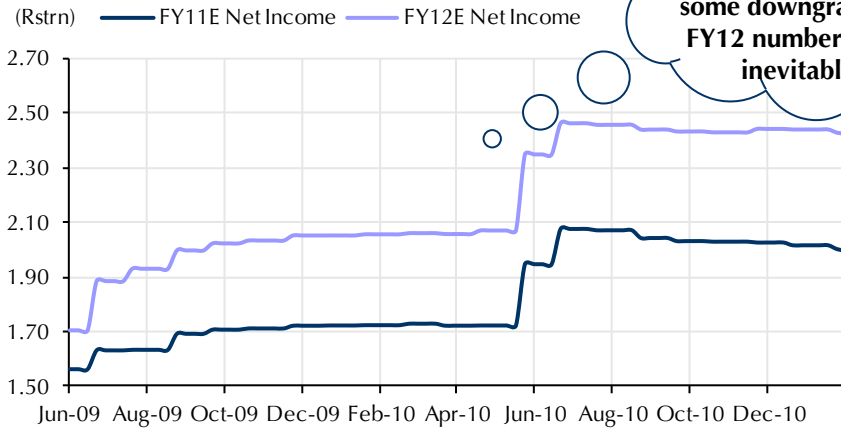
Sensex FY11E and FY12E consensus aggregate earnings



Sensex FY11E and FY12E consensus aggregate earnings growth

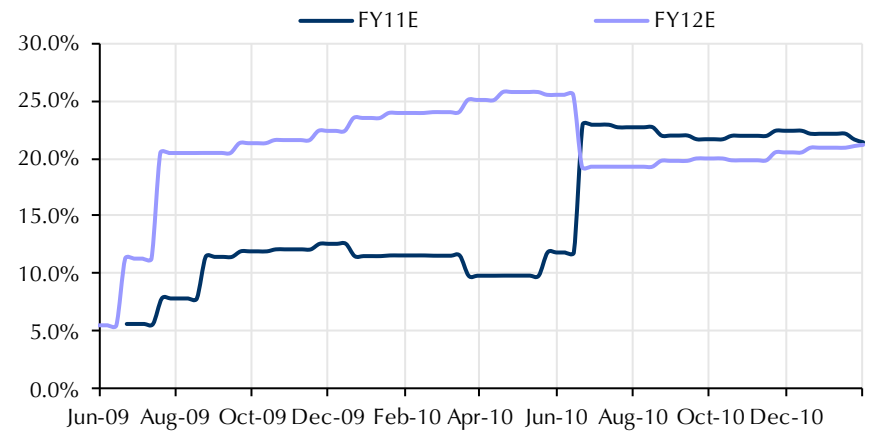


Nifty FY11E and FY12E consensus aggregate earnings



Commodity price inflation and consequent margin pressures mean some downgrades in FY12 numbers look inevitable

Nifty FY11E and FY12E consensus aggregate earnings growth





Valuations

- ❖ **MSCI India is now trading at ~14.1x versus the long-term average of ~15.1x.**
- ❖ **Whereas higher commodity prices are expected to translate into lower margins for Sensex companies, a high share of commodity earnings in the Sensex basket would mean that the overall EPS number will hold up.**
- ❖ **Higher share of cyclical commodities in incremental earnings may mean a slight P/E de-rating.**
- ❖ **On account of the recent correction, some value can be seen in large-caps.**
- ❖ **We believe that in the event of a downward movement in crude price as the Libya issue settles down, the market may see some value buying in select large-caps.**
- ❖ **Midcaps are likely to start performing again after the rally in large-caps.**



Valuations – Slight discount to long-term average

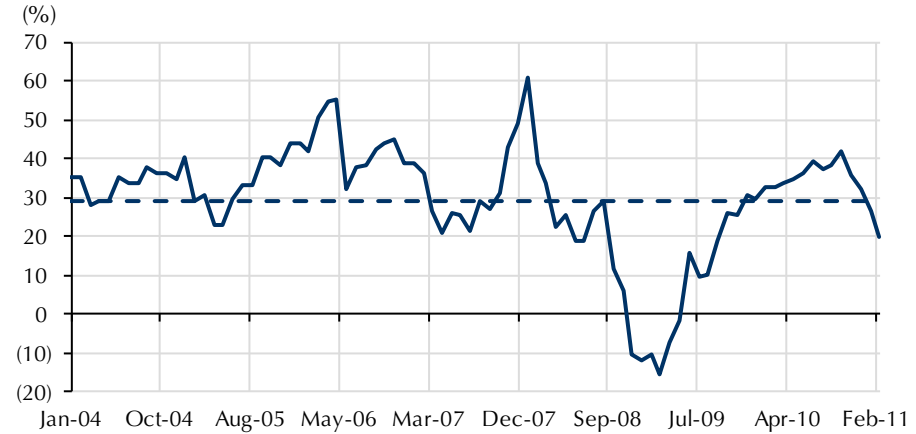
MSCI India is trading at NTM PE of 14.1 vs. LTA of 15.1—fairly attractive

MSCI India NTM PE



The premium to MSCI EM Asia has also been on the fall

MSCI India NTM PE premium to MSCI EM Asia



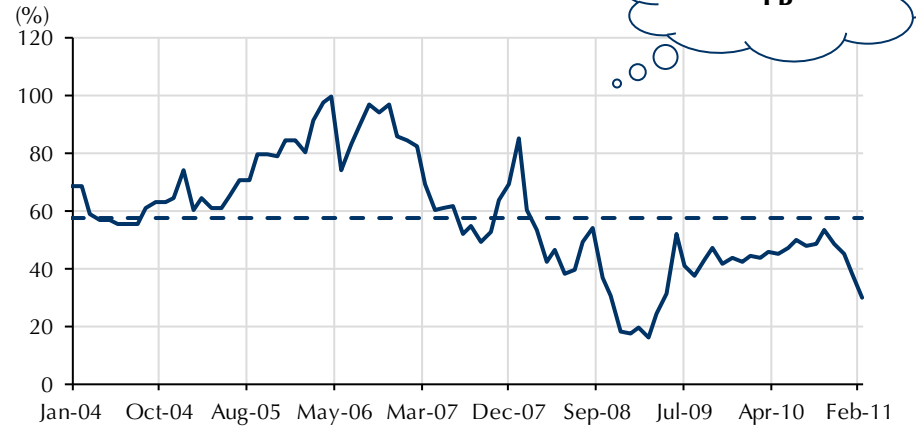
MSCI India NTM PB

MSCI India now trading at a PB multiple of 2.4 vs. LTA of 2.8



MSCI India NTM PB premium to MSCI EM Asia

And ditto for PB





Valuations – Slight discount to long-term average

We believe that the RoEs for Indian markets have bottomed out (weighed down by banks— capital raising, Telecom) and are on their way up from here

MSCI India NTM RoE



India has seen its RoE premium deteriorate in the recent past

MSCI India NTM RoE premium to MSCI EM Asia



Sensex now trades at sub-15x NTM PE

Sensex NTM PE Band chart



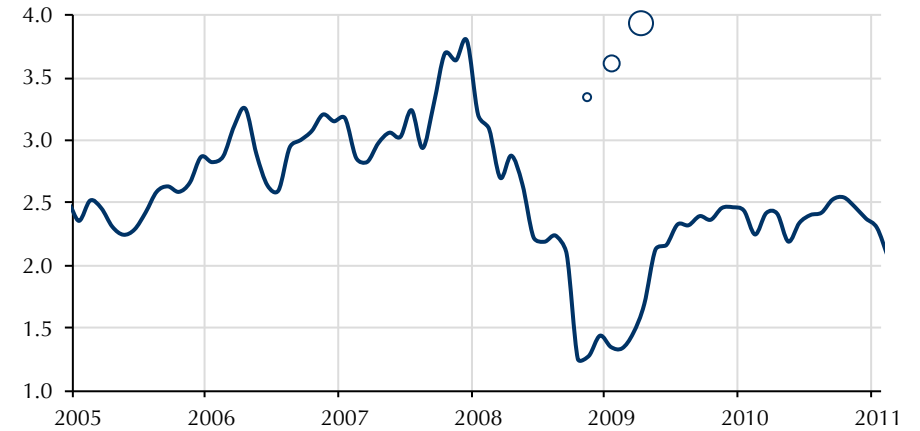


Valuations – Slight discount to long-term average

IBES India NTM PE

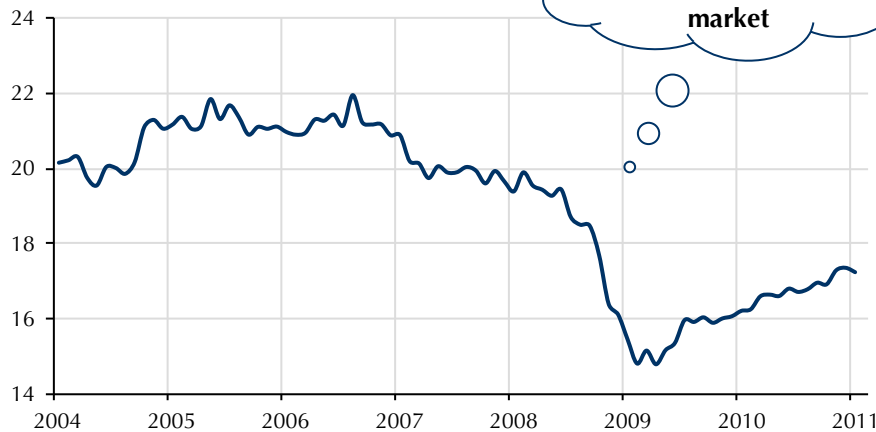


IBES India NTM PB



IBES India is trading near long-term averages

IBES India NTM RoE (%)



RoEs seem to have bottomed out even for the broader market



PE(x)	ACWI	World	Emerging Asia	India	China	Brazil	Russia	US	UK	Indonesia	Taiwan	Korea
MSCI	13.9	12.6	11.4	14.6	11.0	10.0	6.6	13.3	10.3	12.8	11.4	9.7
Consumer Discretionary	14.3	14.2	10.9	12.9	13.1	9.5	nm	15.0	13.0	13.3	15.9	9.2
Consumer Staples	11.8	14.1	15.1	22.5	14.3	17.8	25.6	14.0	12.6	15.4	14.7	12.6
Energy	11.2	12.6	10.8	12.0	10.3	11.4	5.7	13.5	9.3	11.4	11.2	9.7
Financials	11.5	11.3	10.8	15.7	9.5	10.1	8.0	12.2	10.7	12.7	10.9	8.8
Healthcare	13.5	11.5	19.6	19.5	23.3	19.3	nm	11.6	9.3	18.0	nm	16.0
Industrials	13.2	13.7	11.0	13.3	11.1	19.1	nm	14.8	12.1	15.0	6.8	9.7
IT	11.4	13.4	12.2	20.7	20.0	12.4	nm	13.1	25.7	12.6	nm	10.3
Materials	11.8	11.8	11.0	9.7	12.3	7.7	9.2	13.3	8.3	11.7	11.6	9.5
Telecom	12.7	12.1	11.4	12.4	11.4	7.2	8.7	16.6	10.4	nm	11.1	7.3
Utilities	11.0	12.9	13.2	14.7	11.7	8.8	12.5	12.9	11.9	11.5	10.6	16.4
Automobiles	10.4	11.3	9.5	12.5	10.4	nm	nm	9.9	nm	13.3	nm	8.3
Banks	19.0	10.6	10.1	16.8	8.4	9.6	8.0	12.6	10.5	12.7	10.9	7.7
Real Estate	13.2	21.0	8.9	10.5	8.2	18.1	nm	34.9	20.1	nm	nm	nm
Capital Goods	10.8	13.4	11.2	13.3	10.8	17.6	nm	14.6	11.3	15.0	nm	9.8
Div Financials	11.3	10.7	12.6	12.6	14.3	13.9	nm	10.3	10.0	nm	nm	11.5
Oil & Gas	10.1	12.0	10.7	12.0	10.3	11.4	5.7	12.6	9.3	11.4	11.2	9.7
Metals & mining	13.6	10.5	9.9	9.1	12.7	7.5	9.2	10.5	8.2	12.2	nm	8.5

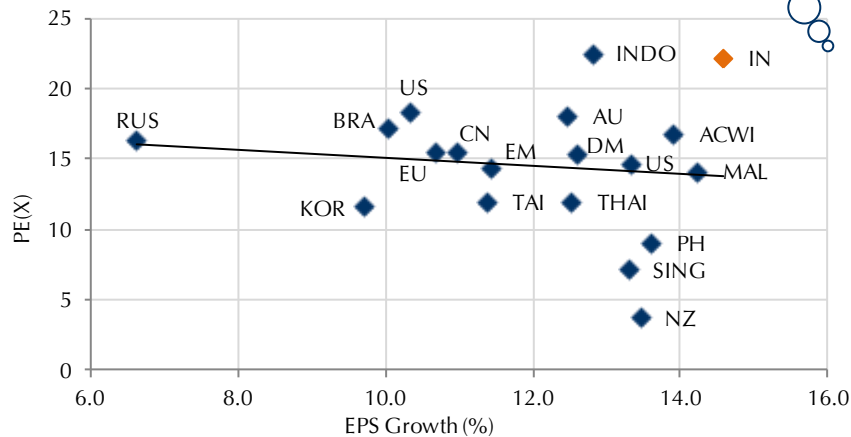
India continues to be the most expensive major market on account of its superior growth and return profile but has come off the earlier highs after the recent correction



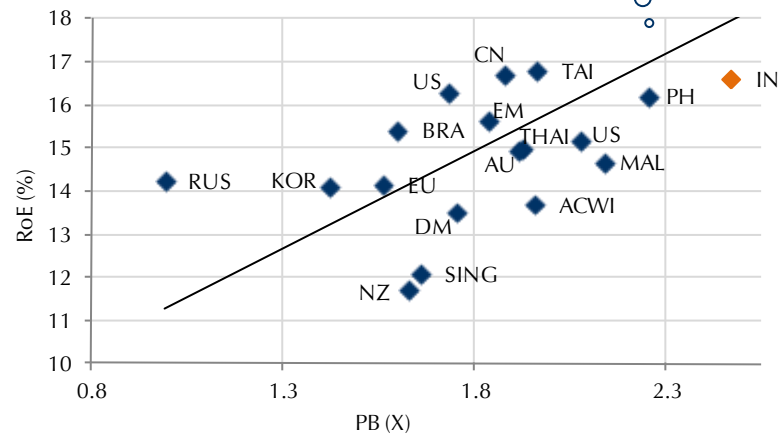
India looks slightly overvalued on PE vs. EPS growth basis

And on PB vs. RoE basis

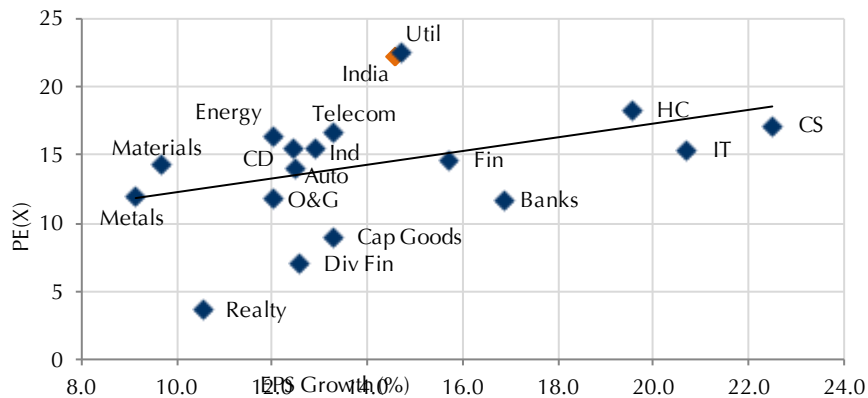
MSCI Country Indices PE vs. EPS Growth



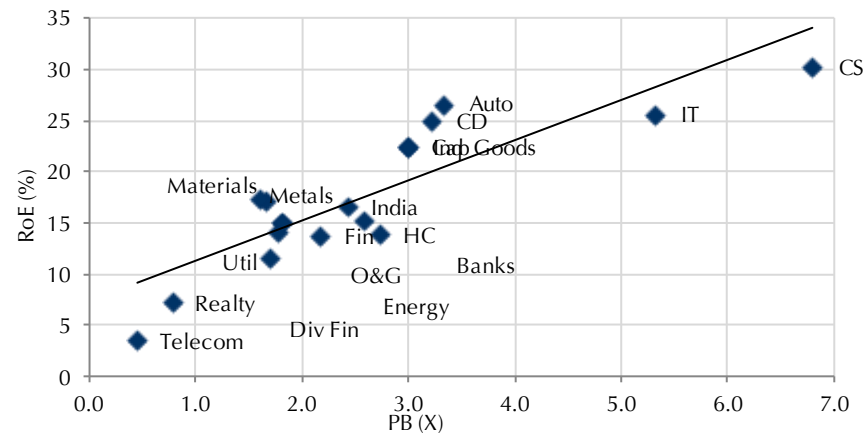
MSCI Country Indices PB vs. RoE



India MSCI Sectors PE vs. EPS growth



India MSCI Sectors PB vs. RoE





Market Performance

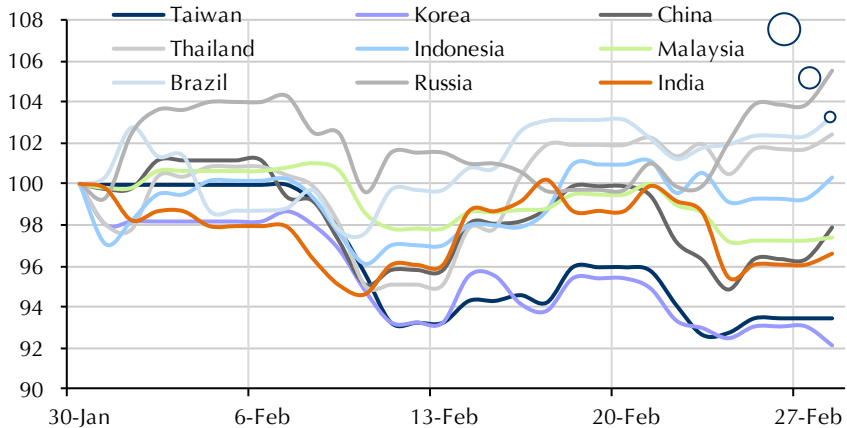
- ❖ **DMs over EMs – the consensus trade since the start of the year – is now on the wane in the wake of the oil scare.**
- ❖ **India continues to be the biggest underperformer in the emerging market space with a YTD shave-off of 13%.**
- ❖ **While the last few weeks saw a global correction on account of the oil scare, emerging markets seem to have decoupled from each other as indicated by falling correlations.**
- ❖ **The correction in India was broad-based but large-caps seem to have held up relatively well.**
- ❖ **Sector-wise, while every sector other than Oil & Gas has yielded negative returns, Real Estate, Pharmaceuticals and Construction were under pressure in particular.**



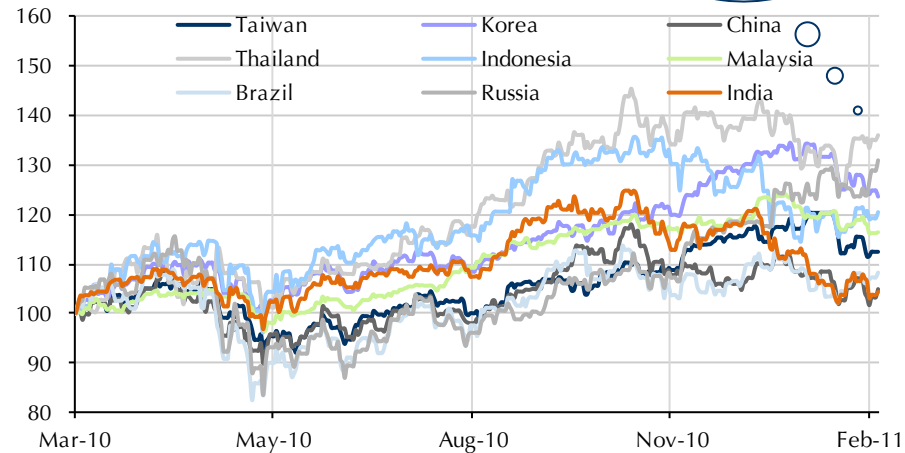
Market Performance – Yet another month belongs to the bears

Big divergence can be seen even amongst EMs on account of different drivers (growth, commodities) and concerns (inflation)

Key Emerging Markets (1M %)

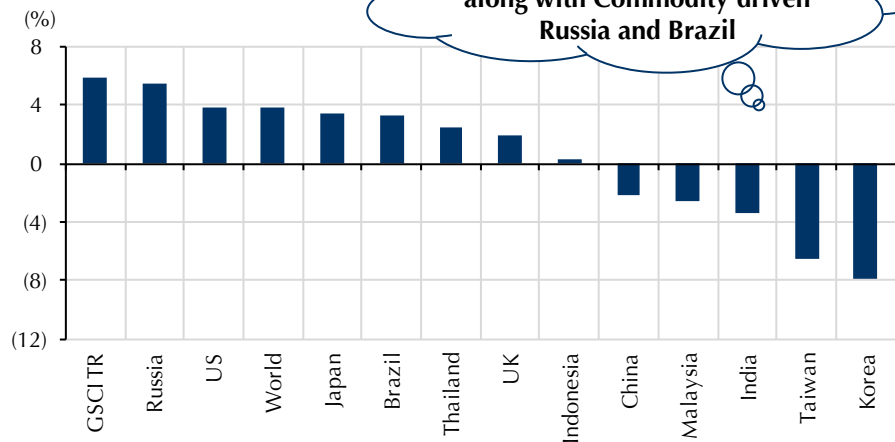


Key Emerging Markets (12M %)



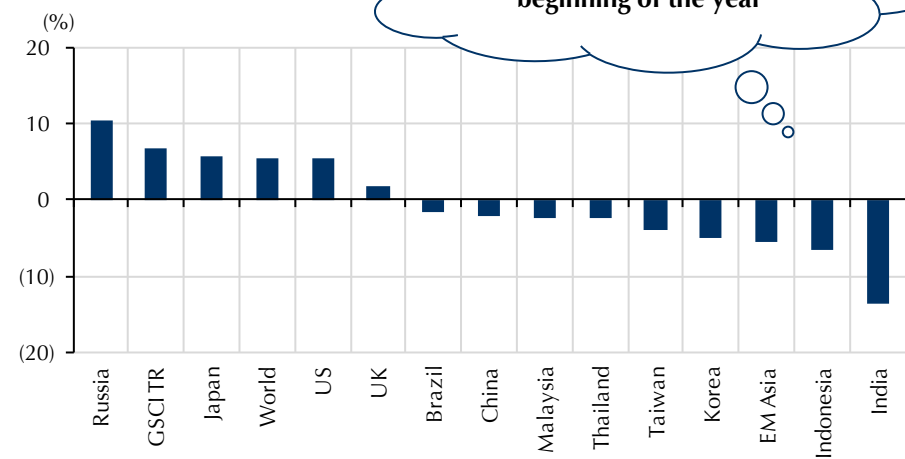
India has given up all of its outperformance of last year

Key Global Indices (1M %)



Developed world outperformed last month along with Commodity driven Russia and Brazil

Key Global Indices (YTD %)



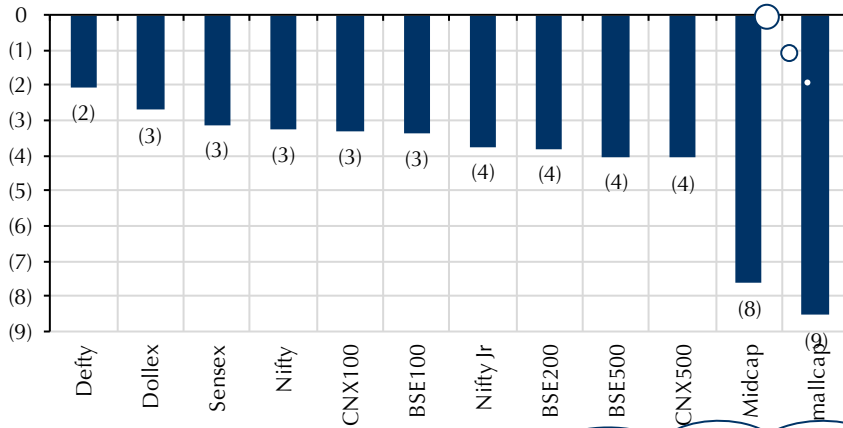
India is highest underperformer since the beginning of the year



Market Performance – Yet another month belongs to the bears

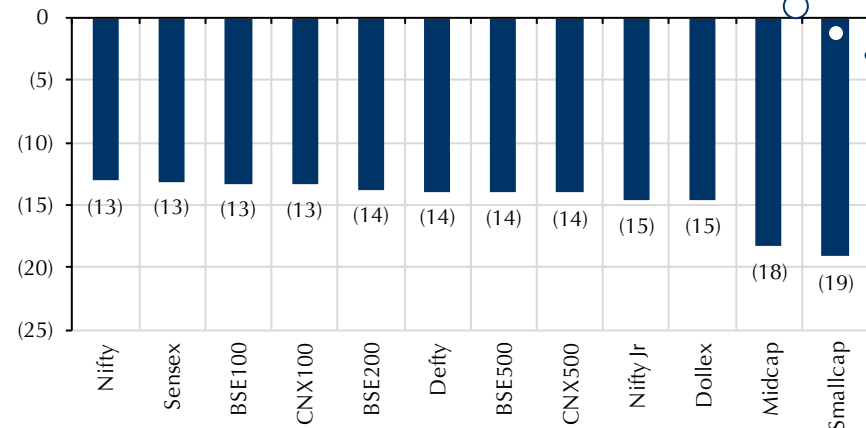
Key domestic indices (1M %)

After last month's correction, large-caps seem to be holding relatively well



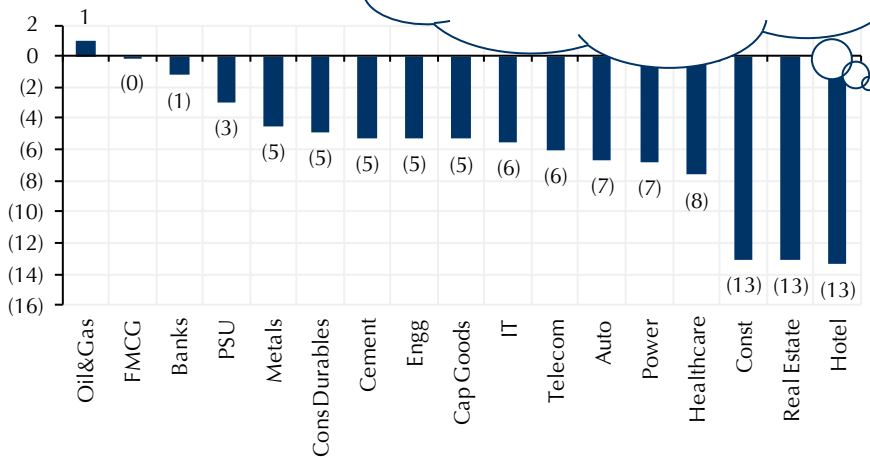
Key domestic indices (YTD %)

Small and Mid-caps have corrected more compared to large-caps



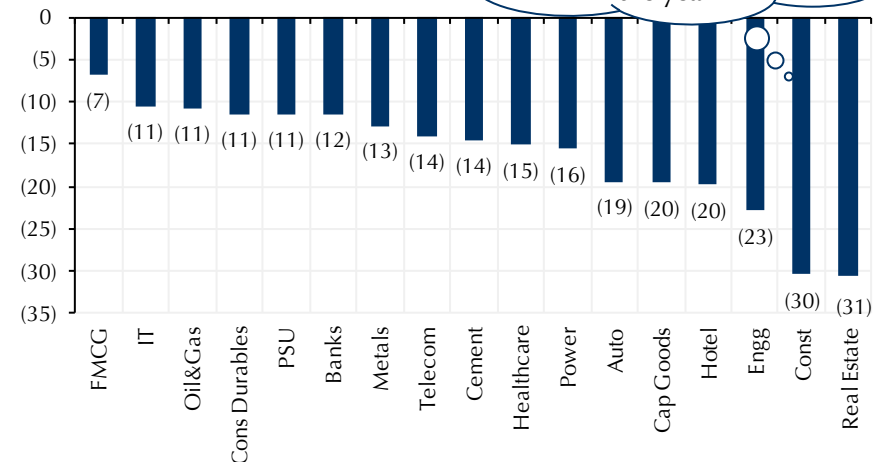
India sector indices (1M %)

Hotels, Real Estate and Construction sectors underperformed in an across the board correction



India sector indices (YTD %)

Rate sensitives have been correcting since the start of the year





Sr. No.	Top Gainers					
	Name	Ticker	Sector	CMP	1M (%)	1Y (%)
1	Welspun Corp Ltd	WLCO IN Equity	Metals & Mining	192	29.4	(19.5)
2	Housing Development & Infrastructure Ltd	HDIL IN Equity	Real Estate	158	26.5	(47.6)
3	Jain Irrigation Systems Ltd	J1 IN Equity	Agro & Fert	191	21.6	15.1
4	Hindustan Copper Ltd	HCP IN Equity	Metals & Mining	307	19.4	(41.8)
5	Shriram Transport Finance Co Ltd	SHTF IN Equity	Diversified Financials	762	12.9	67.0
6	Nestle India Ltd	NEST IN Equity	Food Beverage & Tobacco	3595	10.8	38.8
7	LIC Housing Finance Ltd	LICHF IN Equity	Diversified Financials	195	10.7	31.2
8	Syndicate Bank	SNDB IN Equity	PSU Banks	116	9.6	42.6
9	Kotak Mahindra Bank Ltd	KMB IN Equity	Private Banks	412	9.6	11.1
10	Adani Enterprises Ltd	ADE IN Equity	Conglomerate	618.95	9.4	27.4

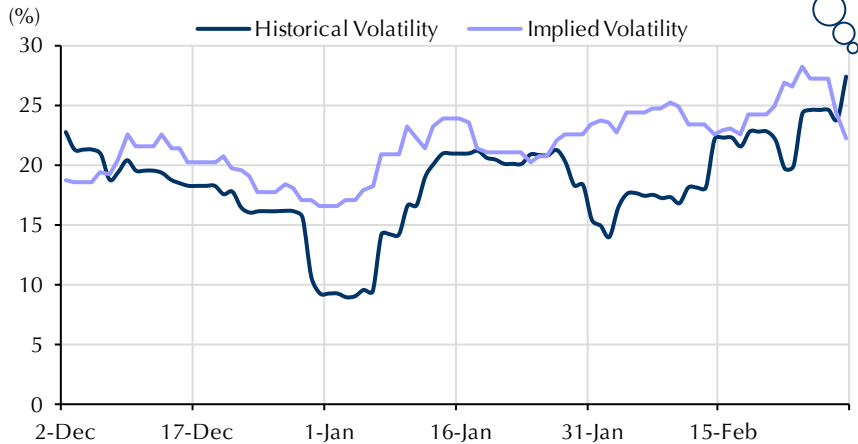
Sr. No.	Top Losers					
	Name	Ticker	Sector	CMP	1M (%)	1Y (%)
1	Punj Lloyd Ltd	PUNJ IN Equity	Infra-Construction	61	(32.3)	(64.9)
2	Mphasis Ltd	MPHL IN Equity	IT Services	449	(32.0)	(31.9)
3	Reliance Communications Ltd	RCOM IN Equity	Telecom	85	(27.9)	(45.5)
4	Aurobindo Pharma Ltd	ARBP IN Equity	Pharma & Biotech	174	(26.2)	(4.1)
5	Anant Raj Industries Ltd	ARCP IN Equity	Real Estate	76	(24.5)	(37.8)
6	Essar Shipping Ports & Logistics Ltd	ESRS IN Equity	Shipping	74	(23.9)	11.2
7	Gujarat NRE Coke Ltd	GNC IN Equity	Metals & Mining	43	(23.8)	(33.8)
8	BEML Ltd	BEML IN Equity	Capital Goods	638	(22.8)	(36.2)
9	Lanco Infratech Ltd	LANCI IN Equity	Infra-Construction	38	(22.3)	(17.0)
10	Unitech Ltd	UT IN Equity	Real Estate	34	(20.3)	(52.2)



Lower implied volatility hints at lack of action next month

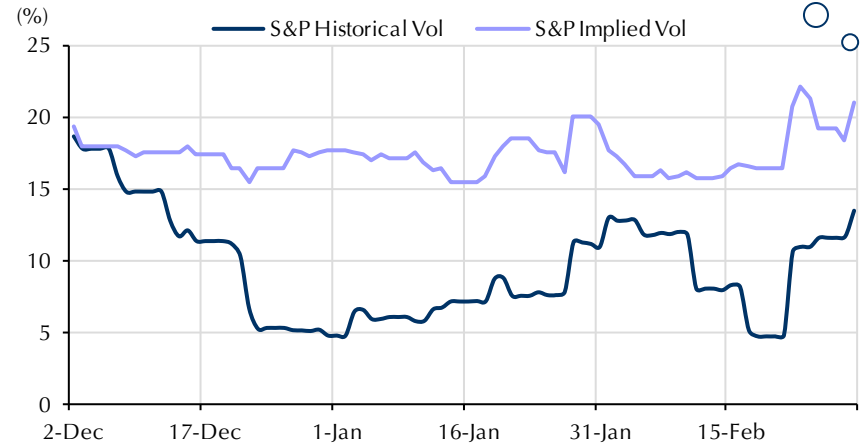
Implied volatility indicates that the street is %expecting relatively stable markets ahead

Nifty historical and implied volatility



Volatility in the US is on the rise

S&P500 historical and implied volatility

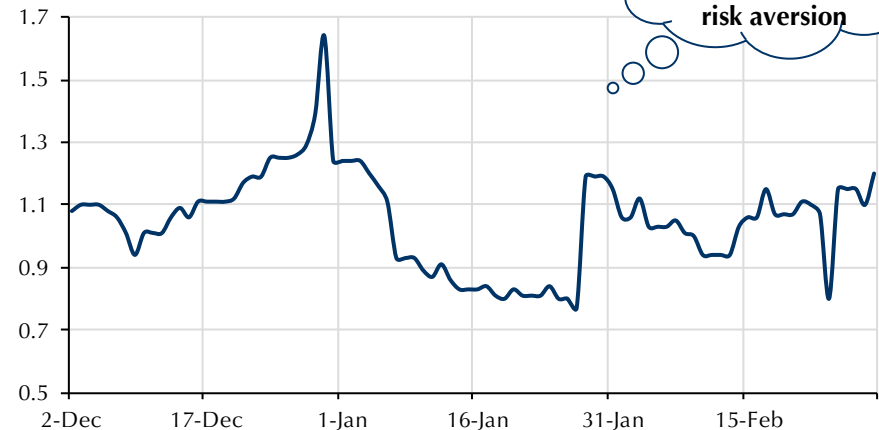


BSE500 Advance-Decline Ratio



Shows improved sentiments despite oil scare

Index Put Call Ratio

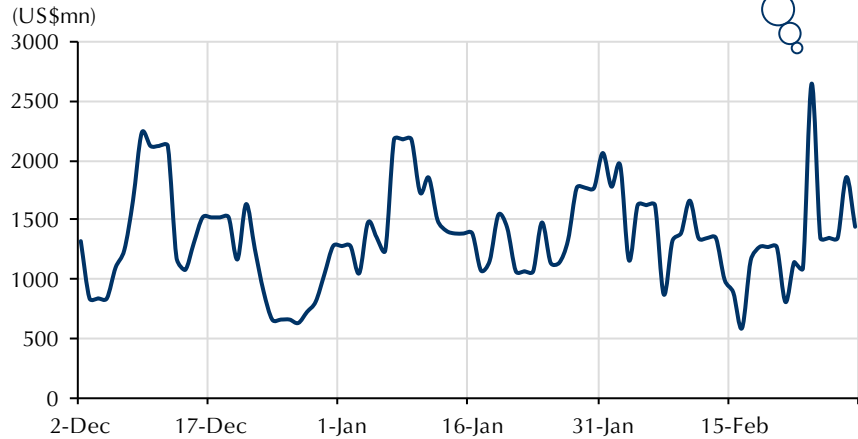


No major build up in the PCR indicates lesser risk aversion

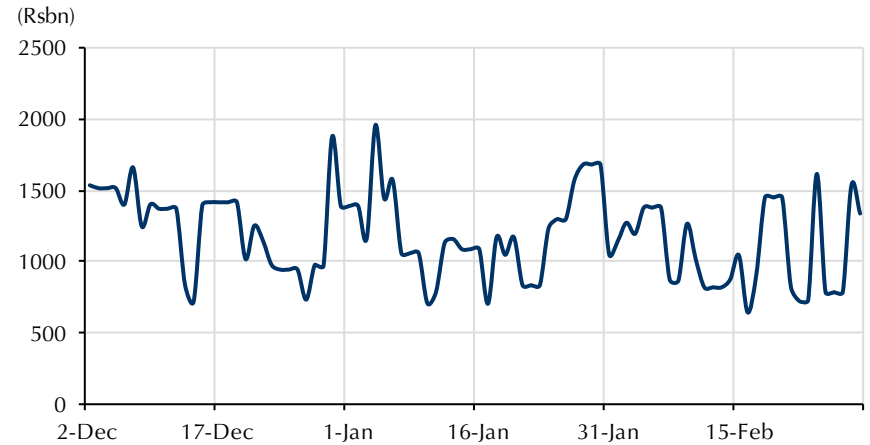


Cash participation in the markets has been on the rise

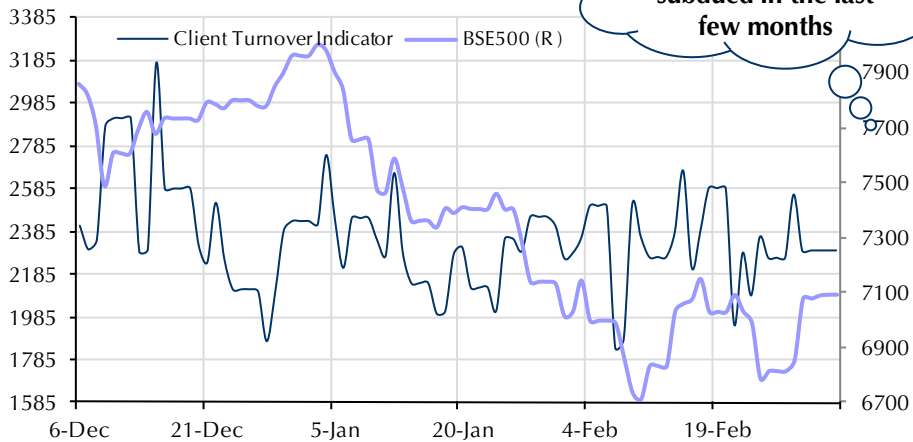
India Cash Turnover



India F&O Turnover

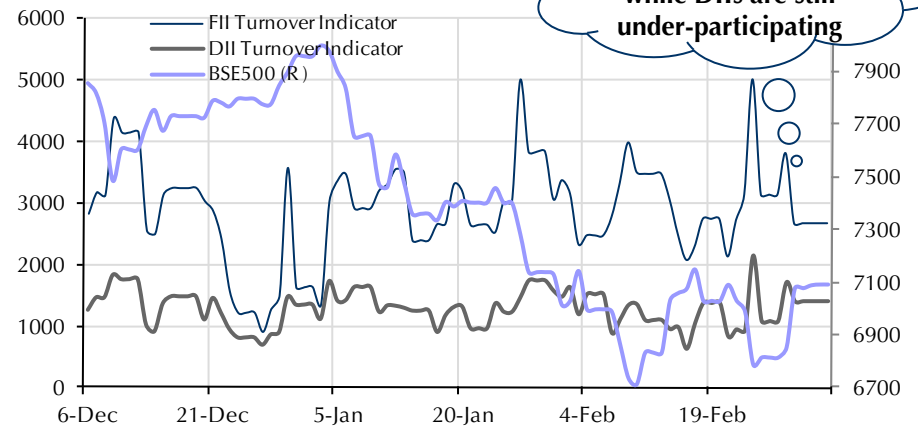


Retail participation Indicator



Retail trading activity has been subdued in the last few months

Institutional investor participation indicator



FII activity has increased slightly while DIIs are still under-participating



Model Portfolio

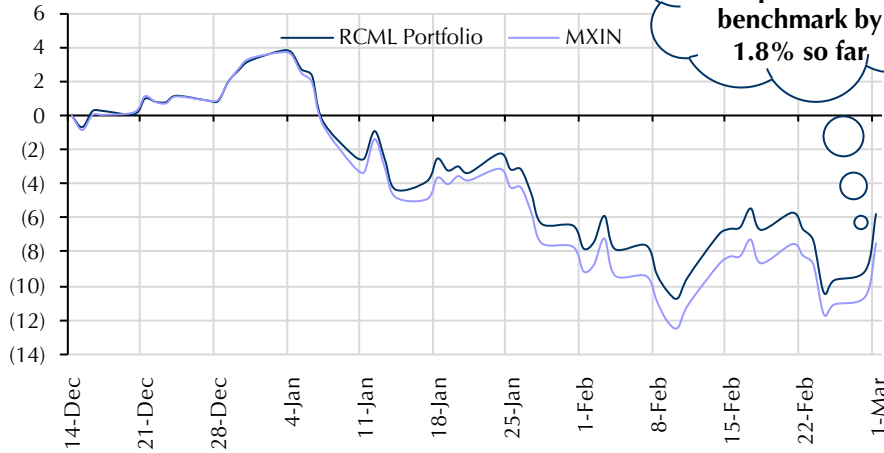
- ❖ **We are leveraged to domestic consumption through Autos, FMCG and Telecom and a slow pick-up in the investment cycle through Financials.**
- ❖ **Overweight: Autos, Banking, Telecom, Real Estate**
- ❖ **Underweight: NBFCs, Utilities, Metals, Pharmaceuticals**
- ❖ **Neutral: IT Services, Capital Goods, Cement, Infra/Construction, FMCG, Energy**



Name	MktCap US\$m	Weight (%)	RCML Target	Upside/dow nside	Rating	1W	MTD	YTD	1YR
Mahindra & Mahindra Ltd	9,170	2.00	810	20.9	BUY	4.4	(1.0)	(1.0)	38.0
Maruti Suzuki India Ltd	8,180	4.50	1,550	22.0	BUY	(1.7)	(12.2)	(12.2)	(13.1)
Tata Motors Ltd	15,402	2.00	1,500	28.6	BUY	0.7	(9.2)	(9.2)	55.0
Axis Bank Ltd	11,759	7.00	1,800	40.0	BUY	(0.7)	3.1	(7.0)	12.8
HDFC Bank Ltd	22,961	6.00	2,390	7.9	HOLD	1.3	(10.7)	(10.7)	25.6
State Bank of India	36,650	7.00	3,500	35.2	BUY	3.2	(7.6)	(7.6)	26.2
Housing Development Finance Corp	21,833	5.00	750	12.2	HOLD	(1.9)	(10.6)	(10.6)	36.9
LIC Housing Finance Ltd	2,121	1.00	250	24.8	BUY	28.3	(0.7)	(0.7)	23.5
DLF Ltd	8,670	3.00	330	44.0	BUY	0.5	(13.8)	(13.8)	(28.3)
Bharat Heavy Electricals Ltd	22,311	1.50	2,400	17.4	HOLD	1.0	(5.0)	(5.0)	(6.4)
Thermax Ltd	1,594	1.50	875	45.8	BUY	(4.7)	(19.5)	(19.5)	6.0
Larsen & Toubro Ltd	21,081	4.40	2,250	44.9	BUY	(1.8)	(16.7)	(16.7)	12.9
Ambuja Cements Ltd	4,403	1.50	155	20.1	BUY	0.6	(11.6)	(11.6)	22.3
Jindal Steel & Power Ltd	13,820	2.00	700	5.5	HOLD	4.4	(1.7)	(1.7)	3.9
Tata Steel Ltd	12,757	3.00	760	27.4	BUY	0.6	(7.5)	(7.5)	2.4
Sterlite Industries India Ltd	12,381	2.00	240	45.2	BUY	4.5	(5.0)	(5.0)	(12.8)
Bharat Petroleum Corp Ltd	4,381	3.00	755	38.9	HOLD	0.9	(10.3)	(10.3)	5.3
Reliance Industries Ltd	71,867	9.80	1,200	21.9	BUY	(1.1)	(6.8)	(6.8)	(5.8)
Hindustan Petroleum Corp Ltd	2,377	3.00	535	69.9	BUY	2.4	(6.3)	(6.3)	6.8
Hindustan Unilever Ltd	13,455	3.00	315	13.9	BUY	(1.1)	(4.7)	(4.7)	18.3
ITC Ltd	29,396	2.00	210	23.0	BUY	(1.8)	(3.3)	(3.3)	40.5
Wipro Ltd	24,839	5.00	475	4.6	HOLD	(2.3)	(7.2)	(7.2)	9.5
Infosys Technologies Ltd	39,538	9.80	3,200	3.6	HOLD	(0.8)	(5.8)	(5.8)	28.3
Tata Consultancy Services Ltd	48,358	4.00	1,150	3.8	HOLD	6.5	3.9	3.9	63.9
Dr Reddy's Laboratories Ltd	5,981	3.00	2,030	28.0	BUY	0.7	(0.7)	(0.7)	47.7
Bharti Airtel Ltd	27,930	4.00	400	21.2	BUY	(3.6)	(6.3)	(6.3)	4.6



RCML Model Portfolio vs. MSCI India



RCML Model portfolio has outperformed benchmark by 1.8% so far

RCML Portfolio Key Tracking Indicators

Tracking Indicators	Total	Bull	Bear
Alpha	0.03	-0.02	0.07
Beta	0.98	1.01	1
Correlation	0.99	0.98	0.97
Mean Excess Return	13.24	-3.57	30.77
Information Ratio	3.56	-1.07	7.81
Jensen Alpha	7.04	-123.51	0.73
R-Squared	0.98	0.96	0.95
Sortino Ratio Vs Index	0.51	-0.28	1.55
Tracking Error	3.72	3.34	3.94



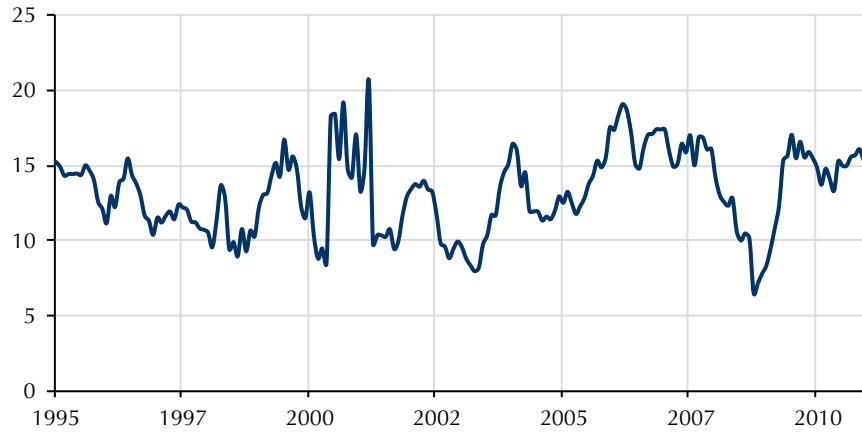
MSCI India Sector Valuations



Name	PE			EPS			EPS Growth		NTM PE	NTM PB	RoE (%)	1M Ret (%)	3M Ret (%)	YTD Ret (%)
	FY10A	FY11E	FY12E	FY10A	FY11E	FY12E	FY11E	FY12E						
MSCI India	17.6	14.4	12.2	40.9	50.0	59.2	22.2	18.3	14.6	2.4	16.6	1.0	-7.0	-9.2
Consumer Discretionary	14.5	12.8	11.3	29.1	33.1	37.5	13.9	13.2	12.9	3.2	25.0	-5.2	-19.7	-17.7
Consumer Staples	26.5	22.2	19.0	9.8	11.7	13.6	19.4	16.5	22.5	6.8	30.2	-0.2	-8.9	-9.1
Energy	14.0	11.8	10.3	88.4	104.4	119.9	18.1	14.9	12.0	1.8	15.1	5.6	-2.3	-6.7
Financials	19.1	15.4	12.8	230.0	284.1	342.7	23.5	20.7	15.7	2.2	13.8	2.4	-12.3	-9.1
Healthcare	24.5	19.3	16.6	31.6	40.0	46.8	26.6	16.8	19.5	2.7	13.9	-4.1	-11.1	-12.2
Industrials	17.1	13.0	11.0	77.8	102.0	120.4	31.2	18.0	13.3	3.0	22.5	2.3	-10.2	-10.7
IT	25.1	20.6	17.1	29.9	36.6	44.1	22.2	20.5	20.7	5.3	25.7	1.1	4.2	-5.7
Materials	11.8	9.5	8.0	74.7	92.9	109.9	24.4	18.3	9.7	1.7	17.2	-0.9	-1.7	-8.7
Telecom	12.2	12.4	8.0	2.6	2.6	4.0	-2.1	55.7	12.4	0.4	3.6	-19.8	-27.9	-31.8
Utilities	16.9	14.5	12.3	36.7	42.7	50.5	16.3	18.3	14.7	1.7	11.5	-4.6	-12.2	-13.6
Automobiles	14.1	12.4	10.9	74.7	85.0	96.0	13.7	13.0	12.5	3.3	26.7	-6.3	-19.9	-17.9
Banks	20.4	16.6	13.8	72.4	88.8	106.8	22.7	20.3	16.8	2.6	15.3	3.2	-8.5	-6.2
Real Estate	14.1	10.3	8.3	2.3	3.1	3.9	37.1	24.0	10.5	0.8	7.3	-2.3	-30.8	-26.1
Capital Goods	17.1	13.0	11.0	95.1	124.7	147.2	31.2	18.0	13.3	3.0	22.5	2.3	-10.2	-10.7
Div Financials	14.8	12.4	10.3	12.7	15.2	18.3	19.7	20.6	12.6	1.8	14.1	-0.3	-24.8	-17.9
Oil & Gas	14.0	11.8	10.3	88.4	104.4	119.9	18.1	14.9	12.0	1.8	15.1	5.6	-2.3	-6.7
Metals & mining	11.3	9.0	7.6	69.4	87.6	103.7	26.2	18.4	9.1	1.6	17.5	-1.2	0.8	-8.2
Software	25.1	20.6	17.1	35.8	43.8	52.8	22.2	20.5	20.7	5.3	25.7	1.1	4.2	-5.7



Consumer Discretionary NTM PE



Consumer Discretionary NTM PB



Consumer Discretionary NTM RoE



Consumer Discretionary NTM PE to MSCI India NTM PE

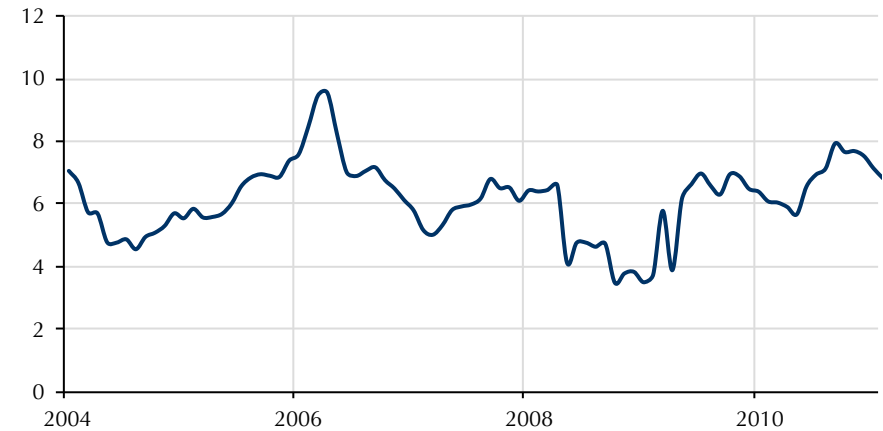




Consumer Staples NTM PE



Consumer Staples NTM PB



Consumer Staples NTM RoE



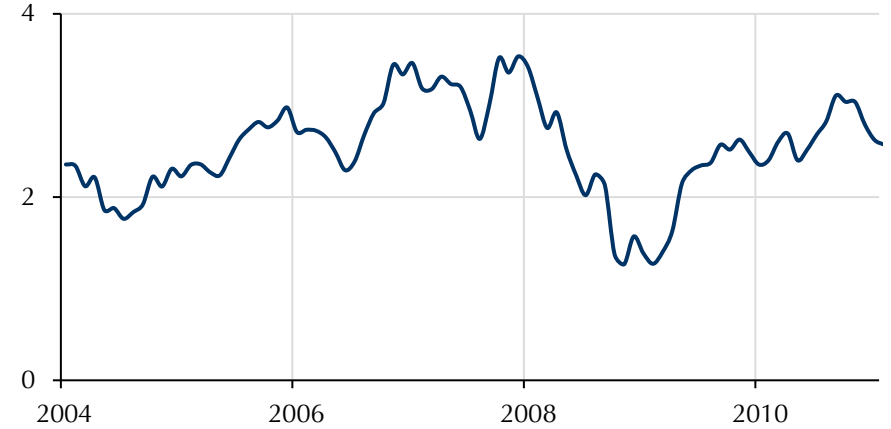
Consumer Staples NTM PE premium to MSCI India NTM PE



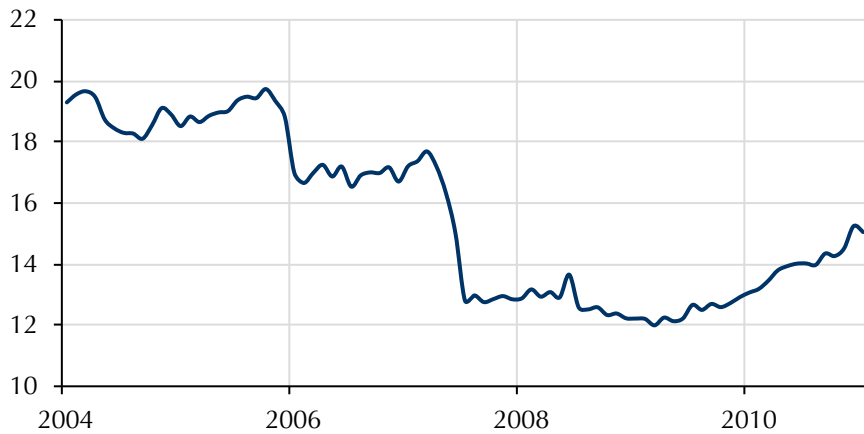
Banks NTM PE



Banks NTM PB



Banks NTM RoE



Banks NTM PE premium to MSCI India NTM PE



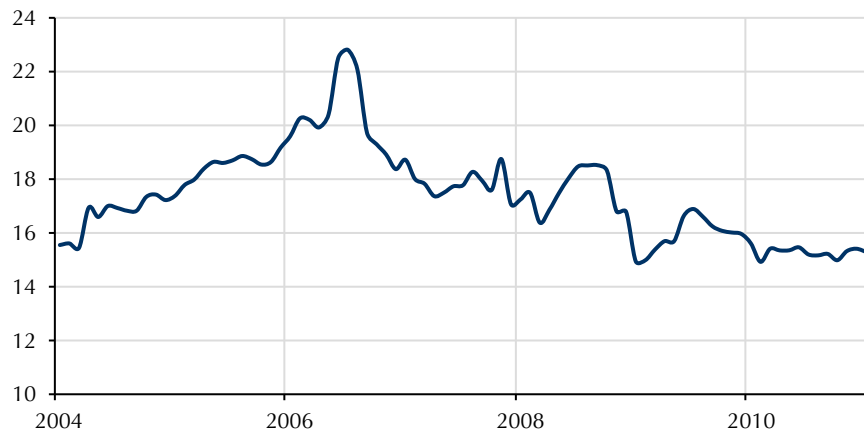
Energy NTM PE



Energy NTM PB



Energy NTM RoE



Energy NTM PE premium to MSCI India NTM PE

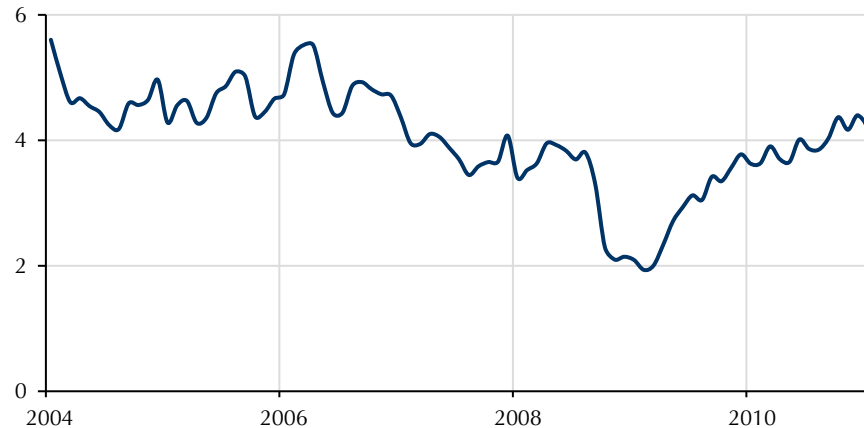




Healthcare NTM PE



Healthcare NTM PB



Healthcare NTM RoE



Healthcare NTM PE premium to MSCI India NTM PE





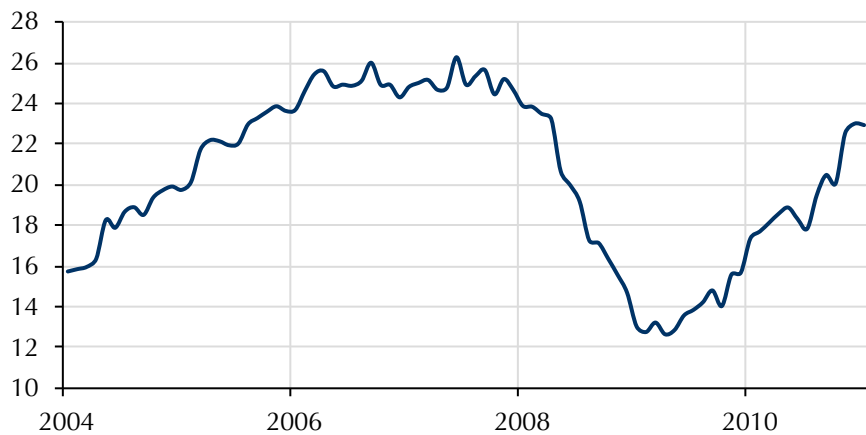
Industrials NTM PE



Industrials NTM PB



Industrials NTM RoE



Industrials NTM PE premium to MSCI India NTM PE



IT NTM PE



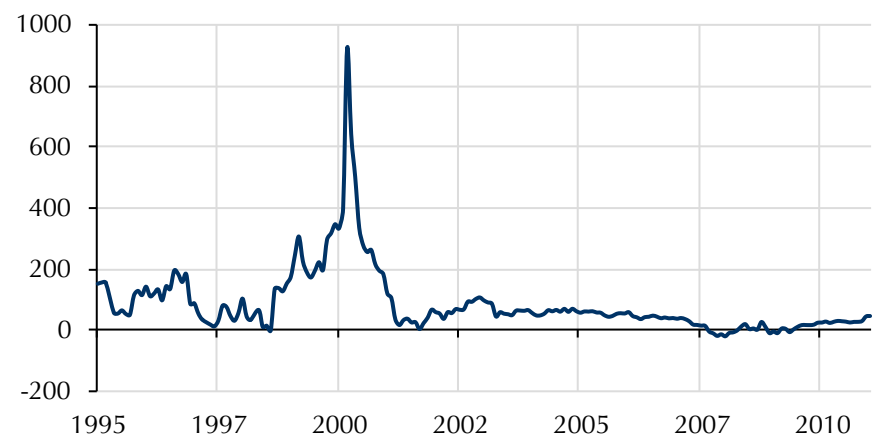
IT NTM PB



IT NTM RoE



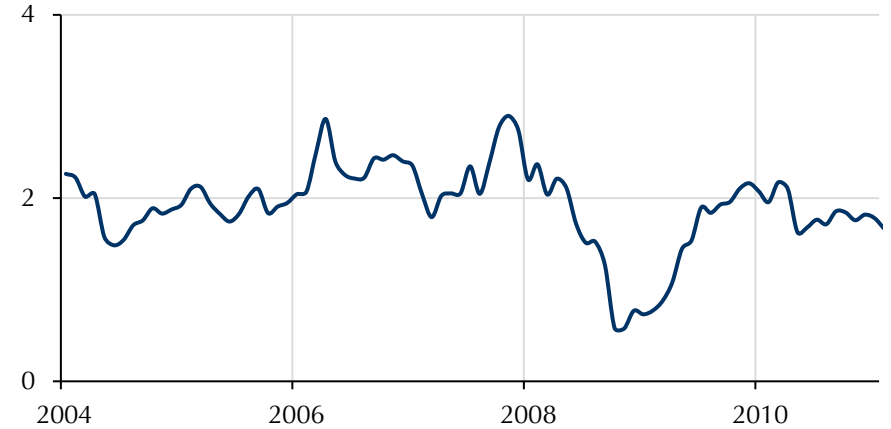
IT NTM PE premium to MSCI India NTM PE



Materials NTM PE



Materials NTM PB



Materials NTM RoE



Materials NTM PE premium to MSCI India NTM PE

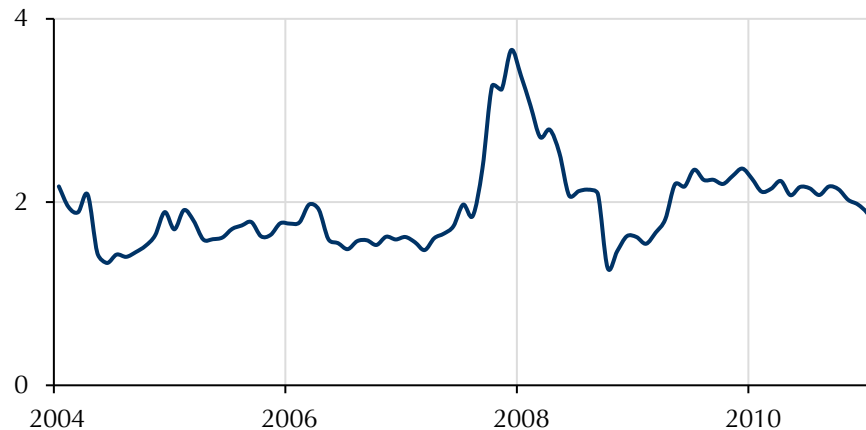




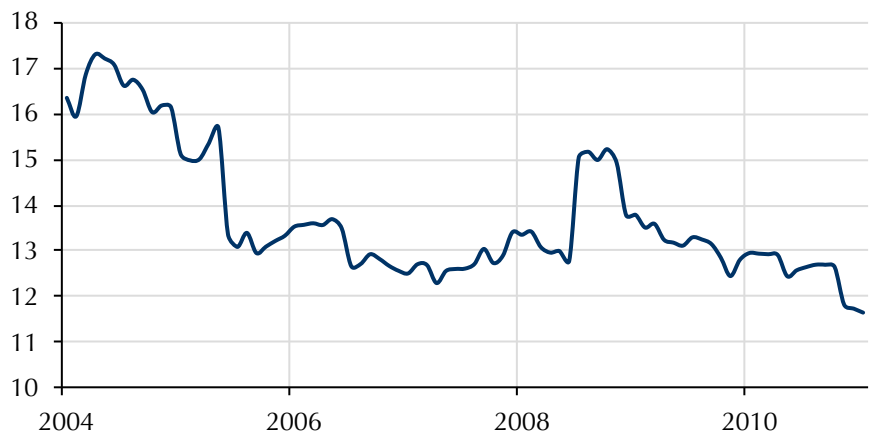
Utilities NTM PE



Utilities NTM PB



Utilities NTM RoE



Utilities NTM PE premium to MSCI India NTM PE



Telecom NTM PE



Telecom NTM PB



Telecom NTM RoE



Telecom NTM PE premium to MSCI India NTM PE

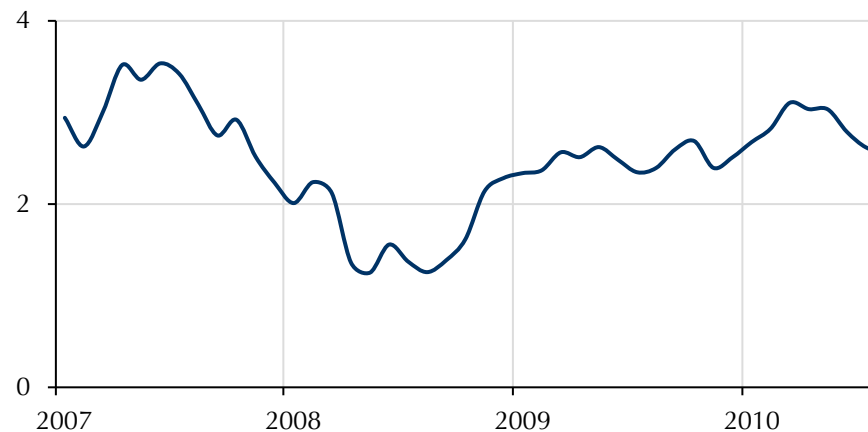




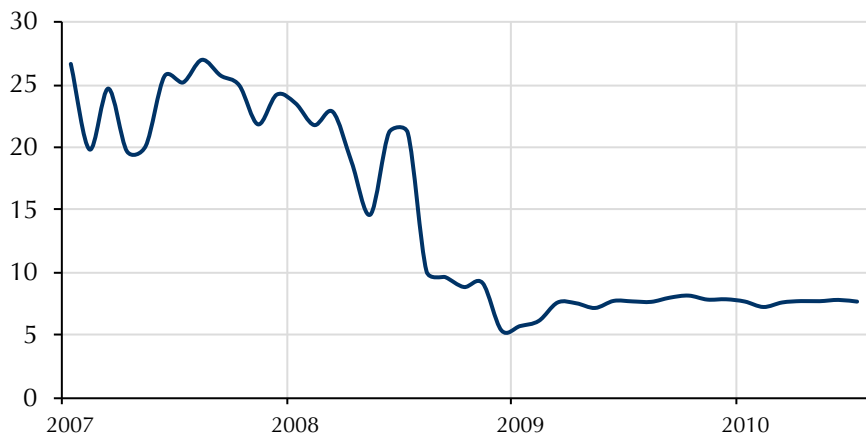
Real Estate NTM PE



Real Estate NTM PB



Real Estate NTM RoE



Real Estate NTM PE premium to MSCI India NTM PE





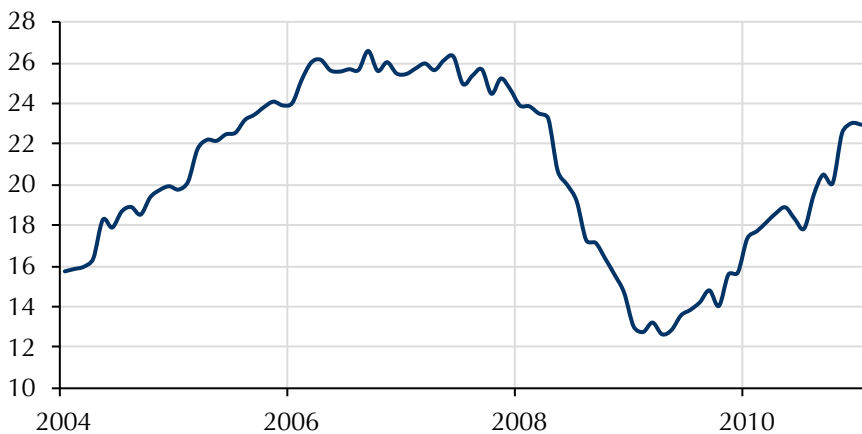
Capital Goods NTM PE



Capital Goods NTM PB



Capital Goods NTM RoE



Capital Goods NTM PE premium to MSCI India NTM PE





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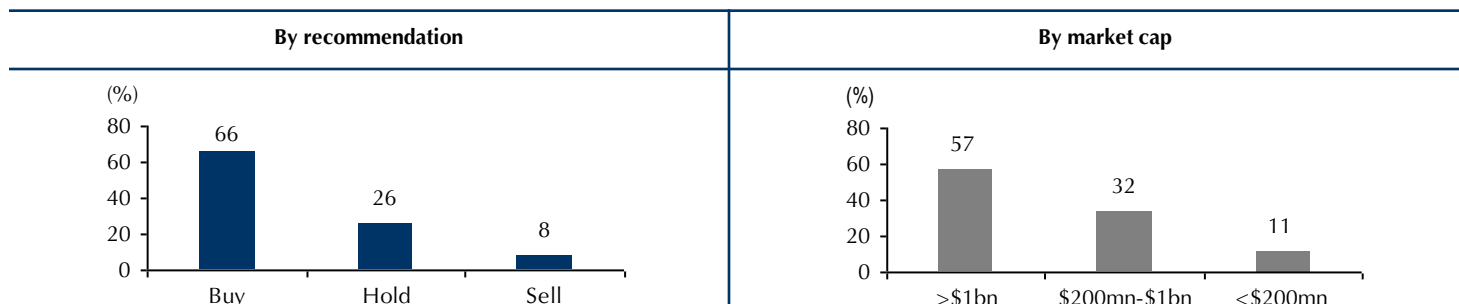
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Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and -5%
Sell	Less than -5%

Recommendation structure changed with effect from March 1, 2009

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