# hEDGE

*The alternative insights monthly*

**May 2007**

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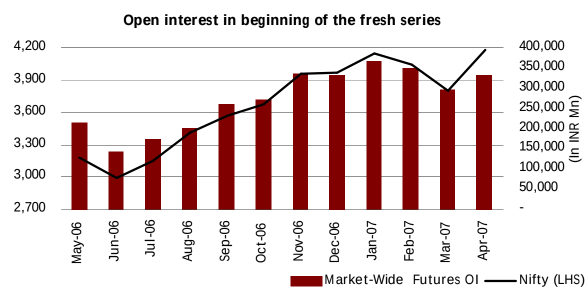
## May view: Risk reward favor shorts

- IT: Strong INR/USD to keep investors away.
- Banking: Concerns on asset quality and equity dilution to weigh on scrips.

## April retrospective:

- **Robust rollovers to May series in stock futures**

  Strong results by most heavy weights, along with RBI's decision to keep key policy rates unchanged resulted in strong rollovers to the May series across the board. 83% of total open positions got rolled to May series against 80% in March expiry. The total market wide rolled open interest of INR 332 bn is 12% higher than that rolled in the previous expiry. Average rollover cost (average of positives) showed significant strength in the whole of the expiry week and jumped to 100bps on the last day of expiry. The future position, which began on a very light note post March expiry, is again loaded with huge long side positions. Disappointment on any front, domestic or global, could initiate the process of long unwinding.

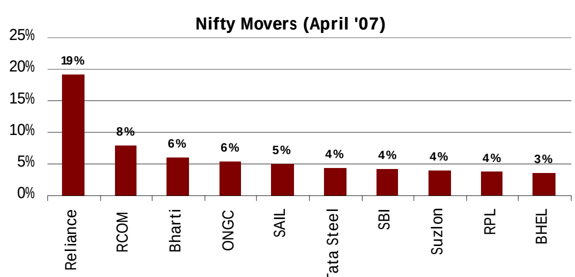



- **FII's continue to plough money into India; MF's buy after remaining short for 3 months**

  FII's were net buyers in the Indian market for second month in a row. Unlike in March 2007, this time, major portion of buying came in the cash market. FII's were net buyers of USD 1.53 bn in April after buying USD 1.74 bn in March. They bought USD 1.26 bn in cash and another USD 0.27 bn in futures. FII's flows revived in all other emerging markets too with Taiwan leading the pack (net inflow of USD 2.36 bn against net sell of USD 3 bn in March). Mutual funds changed their bearish stance and bought USD 238 mn in April after remaining net sellers of USD 740 mn in the previous three months.

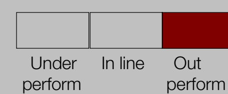
- **Rally in April concentrated; 14% stocks contribute to more than 50% of movement**

  Telecom, metals, and oil & gas stocks were the flavor of the month. Reliance, RCOM, Bharti, ONGC, SAIL, and Tata Steel contributed to 48%of the rally in Nifty. IT remained a laggard with the four heavy weights (Infy, TCS, Wipro, and Satyam) contributing only 4%.




### April Retrospect

**India vs. Global Markets**




**Fund Flows**

- FII ↑
- MF ↑

**Sectoral performance**

- Outperformers – Metals, Shipping, Media and Engineering
- Underperformers – Sugar and Cements

**May – Sectors to watch**

- Outperformers
  - Telecom
- Underperformers
  - IT
  - Banking
  - Sugar

# May: What lies ahead…

## May view: Risk reward favor shorts

### Good results and unchanged RBI policy fuel short covering in market; follow on buying unlikely in absence of any positive triggers

The rally in markets over the past month has taken many by surprise. Markets have recovered by over 12% from the bottom touched on April 2, 2007, and are trading almost close to the all time high level. Short covering by institutions along with strong global markets have been major drivers fuelling this rally.

With almost all the index heavy weights having declared their results, there is no event that could provide a fillip to the market from here. Markets have already rallied quite strongly on the back of good results and unchanged RBI policy and we do not see any positives coming in the near future. On the contrary, inflation continues to remain a concern for the government and the number becomes more important ahead of UP elections on May 11. Also, the impact of higher interest rates could start reflecting in the next quarter results.

Markets had started showing initial signs of weakness post RIL and Bharti Airtel's results, signifying that the recent rally had already factored too much of positive numbers. Indian markets have historically traded in the range 17x-19x on the higher side (which is where we currently are) and we believe that current valuations are already factoring in too many expectations. The F&O series had started the month on a very light note, but subsequently aggressive long positions started building up across the board. Any negative news flow could drag the markets into the vicious cycle of long unwinding.


On the whole, we believe that the risk-reward ratio favors remaining short in the market. In the absence of any domestic triggers (besides interest rates), global news flows will be an important factor determining further direction.

### IT - Strong INR/USD to keep investors away

With a view to fight inflation, RBI has kept away from forex markets and allowed the rupee to appreciate. As a result, the rupee rose to its highest in almost nine years against the dollar. The concern on rupee appreciation has kept the investors away from the sector till the time they get some clarity on further currency movements. Margins for the next quarter are also expected to remain under pressure as the beginning of new financial year will result in salary hikes of 12-15% for offshore employees and 3-5% for onsite employees.

Although we believe that business across tier I vendors will continue to remain strong and there will be no major impact of any slow down in the US, investors are concerned over the appreciating rupee. With inflation numbers failing to come down to RBI's comfort level, the central bank's intervention in the forex market is not expected. This, along with fears of margin erosion will prevent fresh buying into IT stocks in the near term.

### Banking - Concerns on lower growth, asset quality, and equity dilution to weigh on investors' expectations

RBI finalized capital adequacy guidelines (implementation of Basel II) on April 27 with some modification. It prescribes minimum 6% (earlier 4.5%) tier I capital within overall 9% capital adequacy ratio (CAR), which will result in lower RoE. Overall, these guidelines will increase tier I capital requirements as it proposes higher risk weights and also adds risk weights to new exposure categories. This will increase equity capital requirements for the same amount of earnings assets, resulting in lower RoEs. Risk weight on residential mortgages (loans of INR 2 mn or higher) where loan-to-value ratio is higher than 75% has been increased to 100% (earlier 75%). Also, RBI has increased risk weights on all unrated loans to corporates to 150% (from 100% earlier) on loans above INR 500 mn from April 1, 2008, onwards and loans above INR 100 mn from April 1, 2009 onwards.

Equity dilution has kickstarted with ICICI Bank coming up with mega capital raising plan of INR 200 bn through an equity offering in India and abroad (ADS). However, PSU banks with close to 51% government holding will not be able to dilute equity and so may face growth constraints. We believe concerns on lower growth, asset quality, and equity dilution are likely to weigh on investors' expectations. We remain neutral on the sector.

### Sugar: Little respite

Sugar stocks have been languishing for quite some time now. We believe their underperformance will continue in the near term, largely on the back of:

1. Large capacity expansion and cane availability is likely to lead to record sugar production of ~26 MMT in SS07E vis-à-vis demand of 20 MMT.
2. Closing inventory is at 180 days (~ 10 MMT).
3. Sugar mills will incur losses, as current sugar prices are lower than cane procurement costs.
4. Only integrated sugar mills will survive in the downturn with co-products (ethanol and cogeneration) cushioning the falling margins.
5. Export non remunerative with bumper production expected in Brazil.
6. Balance sheet to be severely impacted with high inventory carriage and high debt/equity ratio.

# Technical View


## Nifty: Volatile

*Short term: Volatile*

*Intermediate term: Caution*

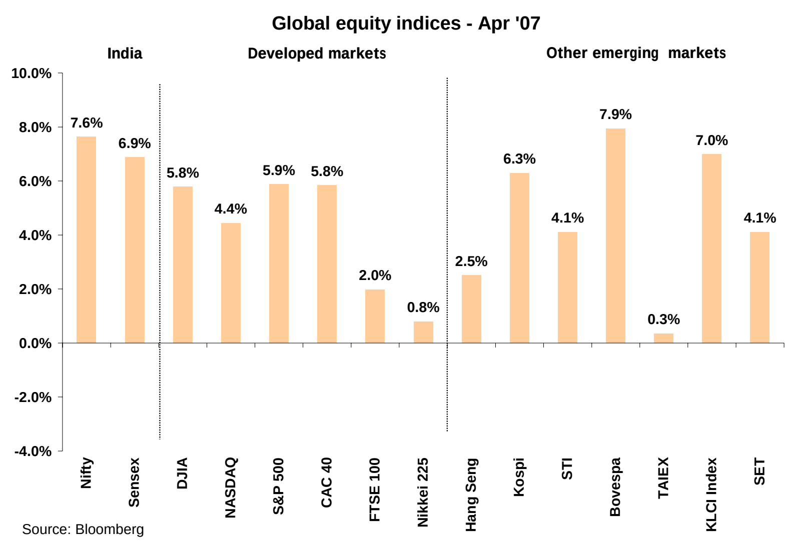
The Nifty has a strong resistance at the 4178 level and a close above that level will trigger a continuation in the bullishness up to the 4245 level. Similarly, a daily close below 4028 will trigger an intermediate bearishness with 3901 as the intermediate support. We expect this month to be volatile as momentum in the market is still bullish, although there is a clear divergence with the momentum oscillators. These could be the last couple of months of the existing bullishness and it makes more sense to be a trader than an investor in this phase.

# Global context

Indian markets ended April 2007 on a positive note with Nifty gaining 7.5% (285 points) and Sensex up 7.2% (929 points)

**Indian equity markets were a bit circumspect to begin with on account of concerns pertaining to rising inflation and global factors, but ended the month on a positive note**

- The major Indian benchmark indices ended in green for April 2007. The rise was significant considering the fact that markets were in dearth of clues at the beginning of the month.
- After ending March on a positive note following the February carnage, markets were on tenterhooks to start off with. Moreover, the concern of rising inflation coupled with excess liquidity added fuel to fire. RBI hiked the repo rate by 25bps to 7.75% and the CRR was raised by 50bps in two tranches of 25 bps each applicable on April 14 and 28. This hike triggered panic selling. However, markets bounced back on the back of good corporate results and robust buying in the cash segment.
- Nifty closed the month gaining 285.4 points (up 7.6%) followed by the Sensex, which nearly gained 928.9 points (6.9%).
- Global equity indices were buoyant with a few registering new highs in April.
- Emerging markets across the globe ended the month in the green, with Bovespa gaining 7.9%, followed by KLCI Index (7%), and Kospi (6.31%).
- Among the developed markets, S&P and DJIA led the race with each registering a M-o-M rise of 5.90% and 5.80%, respectively.



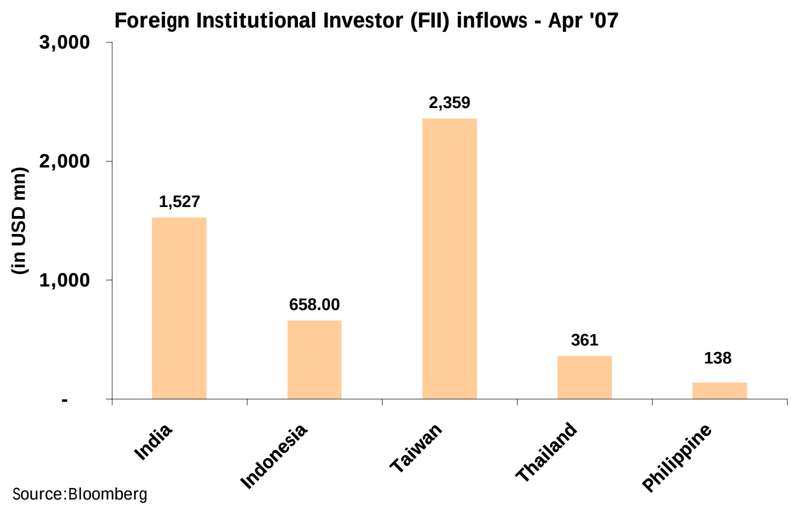
Source: Bloomberg

# Global FII flows

The momentum in Indian equity market continued as markets witnessed positive FII flow for the second month in a row. FII's were net buyers of USD 270 mn in April 2007.

FII show positive flows for the month in Indian markets. Among the emerging markets Taiwan attracts the maximum chunk of FII inflows

- As opposed to the previous month where majority of FII buying happened in the derivative segment, April saw robust FII's buying in the cash segment.
- FII's stood net buyers in April 2007 of USD 270 mn in the derivatives segment, followed by a net purchase of USD 1,257 mn in the cash segment.
- Over the past three months, FII have bought USD 2,471 mn (derivatives net buyer of USD 422 mn + cash net buyer of USD 2,049 mn).
- Among emerging markets, Taiwan bounced back, managing to draw FII inflows of USD 2..36 bn in contrast to an outflow of USD 3.07 bn in March 2007.
- Other emerging markets too witnessed marginal, but positive flows.



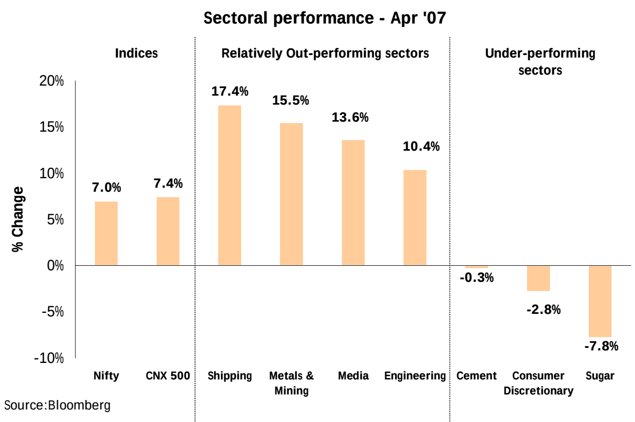
Source:Bloomberg

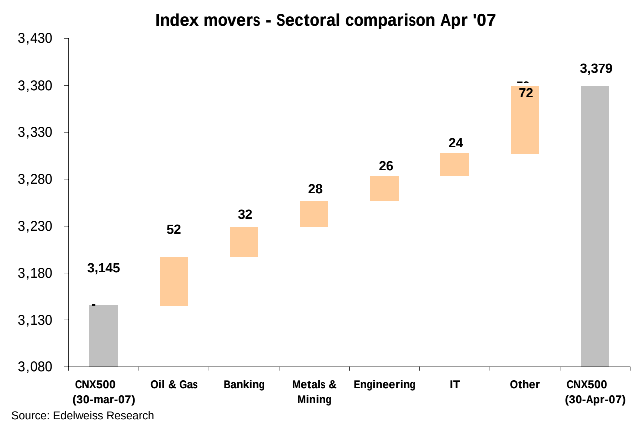
# On the domestic front

## Shipping, metals & mining register substantial gains; sugar heads southwards

Large part of rise in CNX500 index was contributed by oil & gas stocks

- Shipping and metals & mining rallied on account of good amount of investor interest. The sectors delivered handsome M-o-M returns of 17.4% and 15.5%, respectively. Metals rallied on account of increase in demand for both ferrous and non-ferrous metals, coupled with limited production control. The sugar sector, which was the frontrunner in the previous month, was at the losing end this time. The sector's market cap was down by 7.8% in the month.
- CNX500 Index was up by more than 7.43% (234 points) with oil & gas contributing 52 points and banking contributing 32 points to the rally.



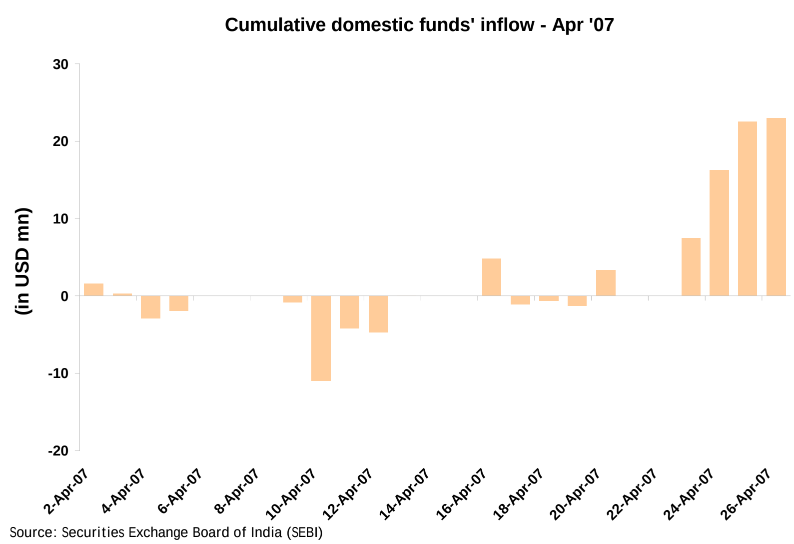




## Domestic funds net buyers for the first time in four months

Domestic funds net buyers in April 2007 of USD 220 mn

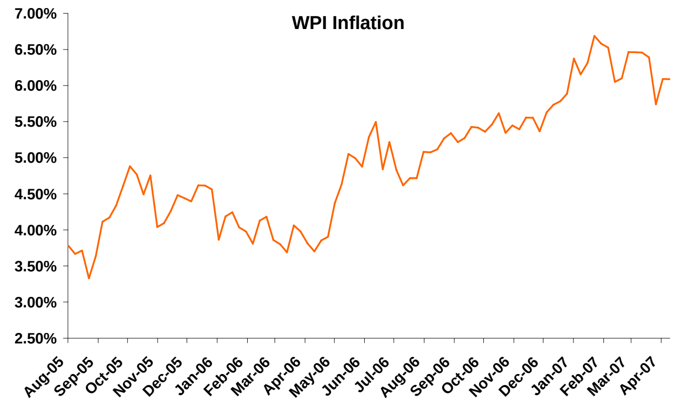
- Domestic funds were net buyers for the first time in the past four months. They bought USD 220 mn in April 2007.
- Domestic funds have sold nearly USD 520 mn in CY07 with major chunk getting pulled out in March.

| Till Apr '07 | Domestic Flows (fig in USD Mn) |
|---|---|
| CY-00 | (135.40) |
| CY-01 | (1,050.00) |
| CY-02 | (630.70) |
| CY-03 | 179.30 |
| CY-04 | (203.90) |
| CY-05 | 2,998.20 |
| CY-06 | 3,555.90 |
| CY-07 | (519.70) |

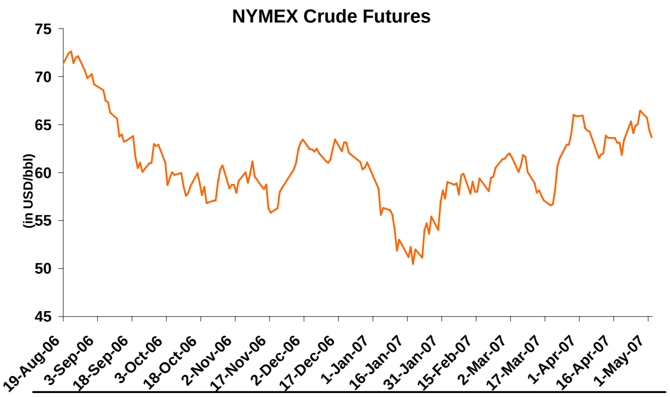


# Macro environment: India

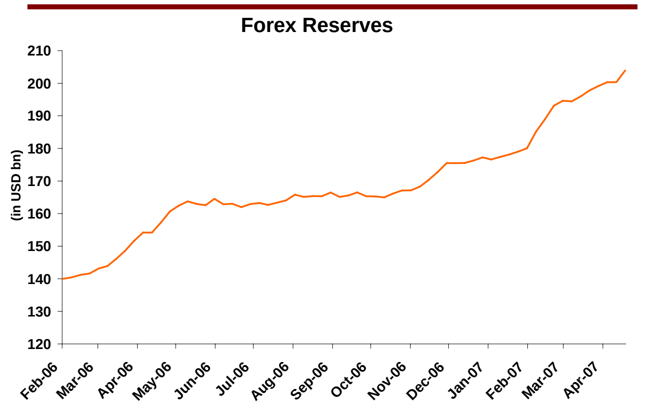
## Inflation stays at 6.09% for April



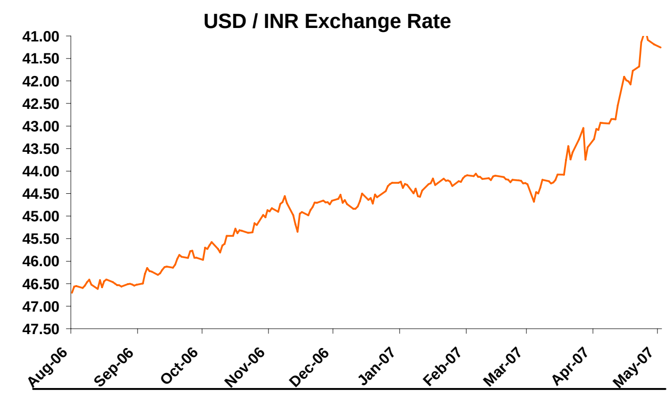

## Crude remains firm at USD 63.68



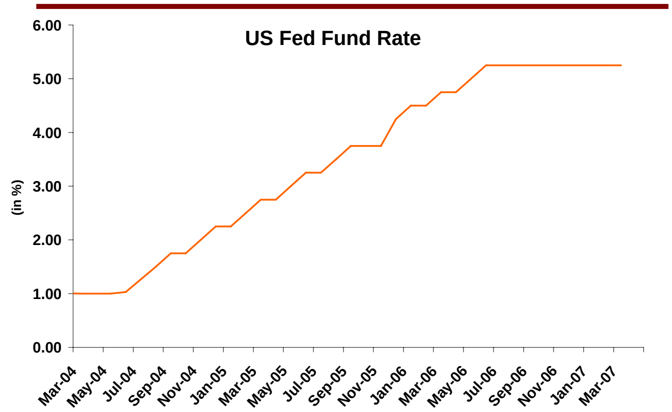

## Steady accretion to reserves continues, currently at USD 203.88 bn



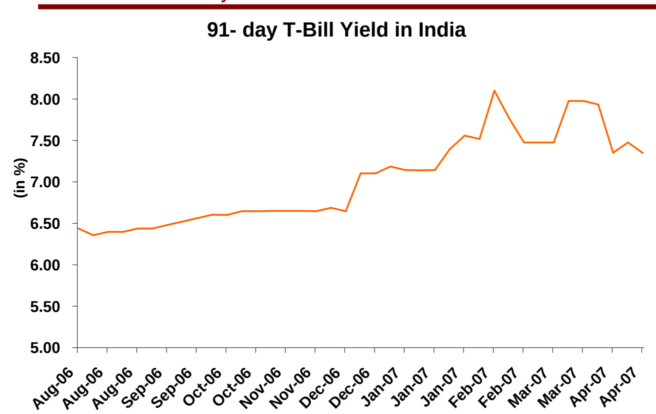

## Rupee at a nine-year high, ends at 41.19 on 30 April 30, 2007



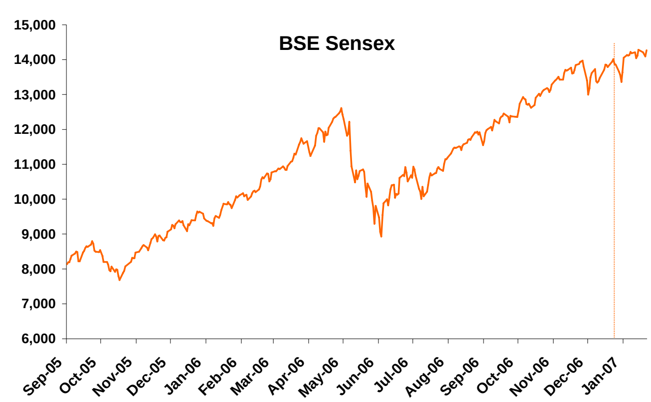

## Fed rate unchanged at 5.25%




## Indian short-term yields hovers around 7.35-7.50%




## Sensex gains 928.9 points in April




## Metal prices surge

| Commodities | | Price | 1Mth % Chg | 3Mth % Chg | 1 Year % Chg |
|---|---|---|---|---|---|
| Steel | USD/ton | 615 | (0.81) | 18.27 | 17.14 |
| Tin | USD/ton | 14,150 | 2.95 | 20.94 | 49.74 |
| Zinc | USD/ton | 3,865 | 22.70 | 25.49 | 18.92 |
| Copper | USD/ton | 7,955 | 14.13 | 48.83 | 11.57 |
| Aluminium | USD/ton | 2,245 | 1.13 | 0.67 | (13.49) |
| Nickel | USD/ton | 48,800 | 7.02 | 30.48 | 156.84 |
| Lead | USD/ton | 2,050 | 6.49 | 25.77 | 70.12 |
| Gold | USD/T.Oz. | 676 | 1.81 | 4.34 | 1.34 |
| Silver | USD/T.Oz. | 13.35 | (0.41) | (0.30) | (3.37) |

Source: Bloomberg

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| Vikas Khemani – 2286 4206 | Head, Institutional Equities |

| INDIA RESEARCH | | | SECTOR |
|---|---|---|---|
| Shriram Iyer | - | 2286 4256 | Head – Research |
| Gautam Roy | - | 2286 4305 | Airlines, Textile |
| Ashutosh Goel | - | 2286 4287 | Automobiles, Auto Components |
| Vishal Goyal, CFA | - | 2286 4370 | Banking & Finance |
| Revathi Myneni | - | 2286 4413 | Cement |
| Sumeet Budhraja | - | 2286 4430 | FMCG |
| Harish Sharma | - | 2286 4307 | Infrastructure, Auto Components, Mid Caps |
| Priyanko Panja | - | 2286 4300 | Infrastructure, Engineering, Telecom |
| Hitesh Zaveri | - | 2286 4424 | Information Technology |
| Parul Inamdar | - | 2286 4355 | Information Technology |
| Priyank Singhal | - | 2286 4302 | Media, Retail |
| Prakash Kapadia | - | 4097 9843 | Mid Caps |
| Niraj Mansingka | - | 2286 4304 | Oil & Gas, Petrochemicals |
| Nimish Mehta | - | 2286 4295 | Pharmaceuticals, Agrochemicals |
| Manika Premsingh | - | 4019 4847 | Economist |
| Sunil Jain | - | 2286 4308 | Alternative & Quantitative |
| Yogesh Radke | - | 2286 4328 | Alternative & Quantitative |

| INSTITUTIONAL SALES | | |
|---|---|---|
| Nischal Maheshwari | - | 2286 4205 |
| Rajesh Makharia | - | 2286 4202 |
| Shabnam Kapur | - | 2286 4394 |
| Balakumar V | - | (044) 4263 8283 |
| Ashish Agrawal | - | 2286 4301 |
| Nikhil Garg | - | 2286 4282 |
| Swati Khemani | - | 2286 4266 |
| Neha Shahra | - | 2286 4276 |
| Priya Ramchandran | - | 2286 4389 |
| Anubhav Kanodia | - | 2286 4361 |
| Tushar Mahajan | - | 2286 4439 |
| Harsh Biyani | - | 2286 4419 |
| Nirmal Ajmera | - | 2286 4258 |
| Ankit Doshi | - | 2286 4671 |
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## RATING INTERPRETATION

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