Equity Strategy

Investment Strategy | India
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Volatile-yes; weak-no

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Markets to remain volatile

The highly uncertain external environment and risk aversion amongst global fund managers may keep Indian markets volatile for next few months. After big sell-offs in 2004, 2005 and 2006, it took five to seven months for Emerging Market equities to regain old highs.

We might have hit the nadir

We knew it for long that sub-prime loss will be booked on P&L, US economy is slowing down, food inflation is rising, global growth is slowing down a tad, higher inflation is forcing central bankers in most growing economies to tighten monetary policy stance and valuations are unsustainably high in some emerging markets. We just waited too long to accept this.

And since now we have accepted it, the trough may be in sight. The markets may not run away but these are certainly not ‘weak’. Consolidation at the present or a little lower level would strengthen the market significantly.

Indian economy still resilient

The stress test on Indian economic fundamentals suggests that if the US were to go into a profound recession and the world does follow her in the deep pit, India may still grow 6.5%, a decent number as compared to 4% growth seen in previous global shocks of FY98 and FY01.

While most analysts prefer to term this phenomenon as ‘decoupling’ from US, the more appropriate description might be ‘globalization’ of economy, where the interdependence is diversified enough to be impacted by US and/or Japan alone.

…though earnings may not be

While the Indian economy is quite resilient to a global slow down, the corporate earnings are vulnerable. About 40% of the contributors to Sensex EPS would be hurt by a global slow-down. In past few quarters we have seen the profit growth slowing leading to lower RoEs.

Strategy

- Take a business perspective
- Do not be a contrarian
- Market cycle approach may not be profitable
- Look at strengths not apprehensions

Table 1: % return on assets

		Returns		
	Current	1 month	3 month	YTD
BSE SENSEX	18048.05	-5.1%	-8.4%	-11.0%
CNX NIFTY	5276.9	-7.5%	-10.7%	-14.0%
NCDEX AGRI INDEX	1599.47	1.9%	9.4%	6.8%
GOI 10 Year Bond Yield	7.608	-1.8%	-3.5%	-2.4%
GOI 365 Days T-Bill Yield	7.55	3.1%	-1.4%	-0.5%
GOI 91 days T-Bill Yield	7.24	3.3%	-2.6%	-0.5%
INR vs. US$	39.7575	1.2%	1.1%	0.9%
Brent Crude Oil Spot	95.47	6.8%	3.5%	1.7%
GOLD SPOT $/OZ	904.16	2.4%	15.0%	8.4%
WPI YoY	4.07			

Source: Bloomberg, price data as on 18 February 2008

Refer to important disclosures on page 27 to 28. Analyst Certification on page 26.

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Decoupling, sub-prime, recession, valuations…

Two weeks into the New Year, the world markets suddenly woke up to this multitude of problems! As if some sleeping volcano has erupted unexpectedly. As if we did never expect any sub-prime losses to be booked on P&L, US economy to slow down, food inflation to rise, or global growth to slow down a tad. We suddenly accepted, which we had known long before, that valuations are unsustainably high in some emerging markets and therefore many fund managers might chose to book out of these markets due to growing sense of risk aversion.

Reams after reams have been written about whether to call it a recession in US or it's just a slow down; whether the US recession would also lead the world into recession or the US is no longer the growth engine for the world; whether equities in emerging markets would continue to outperform their peers in developed markets, and whether tight monetary policy stance of most central bankers outside US due to high inflation threat will impact the global liquidity and further promote risk aversion thus impairing the flows to emerging markets, etc.

Lost in the maze of jargon, investors are jittery

While financial analysts debate the semantic merits of the terms like value & valuation; coupling, decoupling, recoupling & rebalancing, deflation & stagflation, recession & slow down, investors seems to be getting lost in the maze of this jargon. The bearish media tone primarily emanating from the US credit crunch appears swaying the sentiments to the brink.

Negative sentiment is reflected by retail and institutions alike. The American Association of Individual Investors survey showed that 59% of investors were bearish, the most since October 1990. And Merrill Lynch's latest Global Fund Managers Survey outlined one of the most bearish expectations on global growth and profits ever.

…while strategists debate on the suitable strategy

What to do?

- Conservative mix of EM & developed markets; or
- Long BRIC resources; or
- Long non-BRIC domestic consumption; or
- Long Middle East; or
- Long Asian currencies

An intense debate is going on about the preferred investment strategy in this scenario. While the current momentum may support the emerging markets in near term, some prefer more conservative mix of emerging and developed markets towards 2009.

The economic prospects of Asia in general remain promising. In particular, the stress test on Indian economic fundamentals suggests that if the US were to go into a profound recession and the world does follow her in the deep pit, India may still grow 6.5%, a decent number as compared to 4% growth seen in previous global shocks of FY98 and FY01. *(Bloody but unbowed: Stress testing US risk, 28 January 2008, Indranil Sen Gupta, ML India Economist)*.

"Normal" mix of developed and emerging markets warranted

Normalize overweight on EM equities

ML Chief Investment Strategist Richard Bernstein feels *(5 Reasons to favor developed markets, 14 January 2008)* that in the present circumstances a constructive rebalancing of equity portfolios toward more "normal" allocations is warranted. In his view the developed markets seem to offer better valuation, better economic momentum and more attractive sentiment toward 2009, against the combination of very positive sentiment, an increasing cost of capital, expensive valuations, and deteriorating earnings fundamentals in emerging markets. Though not advising an indiscriminate selling in EM, Richard suggests a “constructive rebalancing” of portfolios by increasing the weight of developed markets, which is not necessarily US.

Near term momentum might continue in emerging markets

Volatile but positive year for EM equities

ML Chief Emerging Market Strategist Michael Hartnett though remains bullish on the EM equities. He looks for another year of volatile but positive returns of around 15–20% in EM equities *(2008: EM Year Ahead, 03 December 2008)*.

His argument — “The equity bull market began at a time of deflation, fear and inexpensive stocks. It will end at a time of inflation, greed and expensive stocks. We’re not there yet. Equity leadership is likely to remain with the BRIC markets, resources, industrials (infrastructure) and financials (consumer). Relative value supports resource stocks in BRIC markets and domestic demand plays in non-BRIC markets.” Therefore the overarching investment themes for 2008 are long BRIC resources, long non-BRIC domestic demand plays, long Middle East, with a slow rotation to “US plays” (Mexico, Asia tech) and small cap by late spring.

The “growth” trade will end with a bubble burst, and money flow will reverse to value!

The risks to this view include capital controls caused by rising inflation and surging capital inflows that contribute to the end of the USD bear market. Another risk could come from Europe and Japan joining the US in recession, raising the likelihood of a bear market in commodities. Further along, at some point – the “scarce growth” trade will end with a bubble or a dramatic swing back to “value”.

Asia supports the world growth, but what “if”

Asia hitting the growth limits would be a bigger threat to global growth than US recession.

The Asian upturn is five years old, and the big macro question for 2008 is whether the region has reached its limits to growth – inflation, the availability of oil and other raw materials, and the sustainability of Asia’s dollar-centered FX regimes. Although the fundamentals do not suggest that these limits will be hit in 2008, the risks may rise as the upturn matures. And hitting a growth limit would matter not only to Asia, but also to the global economy and its financial markets.

Put another way, as resource constraints approach, prices of goods and assets could behave in a “non-linear” manner. ML Economist T. J. Bond expects Asian inflation to rise as commodities, currencies and asset prices appreciate. However, the risk is if Asia grows as strongly and the Fed cuts as aggressively as T. J. expects, we might see a bubble building up.

Shifting some money to Asian currencies may be a good idea.

Therefore, though macro backdrop remains positive for Asian stocks and currencies the looming presence of limits to growth, rising economic volatility calls for careful risk management and diversification. T. J. therefore prefers shifting some money from stocks to cash (Asian FX) as the world’s fastest-growing region approaches its limits.

Will it be a repeat of 2003?

A repeat of 2003 would make Asian markets outperform again.

ML Chief Asia Strategist Mark Matthews believes that though it has not been an auspicious start for equity market, this year will follow the pattern of 2003. In 2003 despite falling 1% in January, the MSCI Asia index eventually outperformed the global markets and gave 27% yoy return.

The key risk is that China’s corporate sector is facing strong headwinds of a tight domestic monetary policy and a likely deterioration in the export environment. Things may change later during 2008 if we see inflation under control in China and/or the global sub-prime crisis come to an end.

Despite a robust macro outlook, Indian markets may not be completely insulated from global turmoil, and earnings are conspicuously slowing down.

India offers a safe heaven in uncertain times

Talking in particular about Indian economy, it is less exposed to the external macro risks facing China. It is certainly nowhere near testing its growth limits in the near term. India exports of goods and services account for about a fifth of GDP, compared with 40% for China. India has the lowest share of exports-to-GDP in the region and private consumption is 18% of GDP, greater than China's. There is no sign of it crash landing. It is though expected to soft land in to a healthy 8% plus real GDP growth region in 2008 and 2009, against over 9% real GDP growth in 2007.

…though earnings may not be as defensive as economy

Earnings in India are vulnerable to a global slow-down. About 40% of the contributors to Sensex EPS would be hurt by a global slow-down. However this would be compensated to some extent by gainers from lower commodity prices.

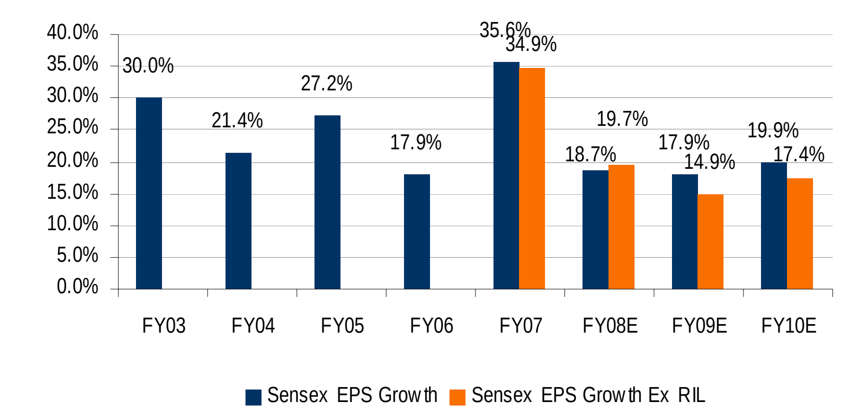
The key point to note here is that while the economy is relatively well insulated from the global economy, earnings are not as defensive. ML India Chief Strategist Jyoti Jaipuria believes that earnings will slow from 36% in FY07 to 16% in FY08 and below the 26% or more average of the past four years. That's because more than 40% of the contributors to the Sensex EPS would be negatively hit by a slowing global economy. We have in fact seen this trend over past few quarters.

The other factor that hurts earnings is that the user industry is not as sensitive to falling commodity prices as the primary producer of commodity, e.g., a 5% fall in steel price will lead to a 10% drop in SAIL's earnings but only a 5% gain in Maruti's earnings.

…and earnings, RoEs may slow further

ML India Research team expects earnings to slow in FY09. This is reflected in sales growth slowing to the 15% range from the near 25% over past few years. Moreover, with companies now operating at peak utilizations and in a capex mode, the operating leverage is very low. This may also lead to lower RoEs as asset turns slow.

Chart 1: Earnings to moderate



Source: Merrill Lynch Estimates

Post correction valuations are more reasonable

Post major correction in recent weeks, valuations look more reasonable. Though it may still not be termed as 'cheap', these are just above their long term average.

Investment Strategy & Themes

Strategy

Take a business perspective

Investors shall take the traditional approach to the investing in equities, i.e., identifying good businesses and investing in the leaders. They should stay invested so far these businesses are doing better than other ones. The businesses which are not doing well shall be scaled / closed down.

Take traditional value based approach

In the environment of uncertainty, caution and slowing momentum, the aggressive and innovative investment rationale may not hold good. We recommend focusing on the conservative core business value approach to investing against the aggressive sum-of-parts or embedded value approach.

We may however distinguish between embedded value and incubated businesses. For example, in valuing the core business of a company incubated businesses which are now profitable and can be run as independent profitable enterprises may be considered while assets like plot of land or a captive power plant which cannot be run as an independent profitable venture may be ignored.

Look for strong visible growth; avoid 'value trap'

Since the overall macro outlook for India is still positive, one should continue to invest in strong visible growth businesses like energy, financials, capital goods and consumers. The 'value trap' should be avoided.

Not a time to be contrarian

Most of the time following the collective wisdom of market is better strategy than being contrarian. A contrarian strategy might be useful only in a bubble like situations when the herd mentality overpowers the wisdom. We are perhaps still some distance away from such a situation.

Market cycle approach may not work

High volatility due to uncertainty in the external environment and slowing growth momentum may persist.

The market cycle approach of investing may not work in the environment of high volatility and uncertainty in the external environment. Investors should therefore ride the business cycle and not the market cycle. Calculating your NAV on daily basis would only give you sleepless nights.

Look at strengths not apprehensions

The ongoing market correction and the negative news flow, largely flowing out of US, might lure investors to move to 'safer' assets like bonds and 'defensive' stocks. The move may prove to be right for few months. But more chances are that they miss on the larger picture.

Remember in past three year it has not been the 'value' that has outperformed. It has been telecoms, materials, property and banks – reflation and growth. Nothing has happened in India to suggest any change at the ground. Demand and need for better infrastructure is still rising and availability of resources to fund this need is rising even faster. The middle class is burgeoning and the consumption is actually increasing albeit not as fast as the income.

Investors should therefore concentrate on the intrinsic strengths of Indian economy rather than apprehensions like prolonged US recession leading the world into a deep recession, considerable economic slowdown in India, and political uncertainty.

Theme

Large cap

Large cap stocks with growth oriented business, good liquidity, established track record and high visibility are preferred investment ideas. There are many large cap stocks which have under performed the market in 2007, notably from IT space. We would not suggest investors moving into these stocks with a defensive or contrarian strategy. One should look for strong growth stories with high visibility, which might be in any sector including IT.

Banking

Banking stocks have surprised both on earnings growth and margin front in recent quarters. The same trend may continue in the coming quarter also. The next phase of financial sector reforms expected in 2009 may also drive the demand for banking stocks.

Rural Development

- Rural connectivity: Telecommunication, roads, supply chain management
- Rural productivity: Irrigation, electrification, fertilizers, high yielding seeds, value addition (e.g., food processing), quality of life (e.g., education, sanitation and drinking water), and basic health services
- Rural financing: Micro financing and consumer financing

Energy Security

Energy security essentially means the continuous availability of energy in varied forms in sufficient quantities at reasonable price. Renewable sources of energy, R&D for higher energy efficiency and productivity, natural gas commercialization, material handling equipment and services, acquisition of foreign energy assets, low carbon emission, nuclear energy are some preferred investment ideas.

Caveat

- Despite a major correction the valuations in certain sectors and stocks are still stretched. These valuations may not have factored in the slowing growth trend. We are therefore cautious that considerable slow down in the corporate profit growth may continue to impact stock prices significantly in the immediate term.
- Slowdown in FII flows post recent regulatory changes with respect to investment through PN route, global reaction to significant slowdown in US may continue to impact the market momentum.

The current phase of volatility may continue for some more time.

- The current phase of high volatility and uncertainty could last for some time in the near term. Any strategic investment should be planned keeping this in mind.

Be on lookout for those ‘Red Sales’ trading sessions.

- In past political events have affected the Indian stocks markets negatively in the short term. With some major states going for election later this year, and various political parties being already in election mode for the next year general election, we might see some more wild swings in the market. It would be a good idea to be on look out for those ‘Red Sale’ days when you get everything at a deep discount.

Actionable themes and investment ideas

Table 2: Actionable themes and investment ideas

Themes: Large cap, Energy, Banking, Rural Development	
Investment Idea	Rationale
HDFC (HGDFF, C-1-7, Rs2902)	HDFC is the largest mortgage financer in India. Besides mortgage financing, the company has, through its various subsidiaries, successfully incubated other businesses including banking (HDFC Bank), Life and Non-life insurance (HDFC Std Life and HDFC Chubb), asset management (HDFC MF) and BPO (Intelenet). HDFC has maintained one of the best asset quality with high ROE in the industry.
BOI (XDIIF, C-1-7, Rs373)	BOI is one of the top performing banks in India, with a balance sheet size of Rs950bn and a network of 2,600 branches, mainly in western and eastern India. In recent years BOI has successfully taken significant initiatives to improve its asset quality and drive business growth.
BHEL (BHHEF, C-1-7, Rs2207)	India's dominant producer of power & industrial machinery. Sets produced by BHEL account for 65% (77GW) of India's installed power capacity (118GW) and generate 73% of India's power. A major potential gainer from Indo-US civil nuclear deal. The company is entering the super critical plant arena and would need to import huge quantum of technology and equipment. Favorite large cap high growth stock.
L&T (LTOUF, C-1-7, Rs3508)	L&T is India's largest E&C co. offering exposure to an entire capex cycle, including power and oil & gas. With improved visibility of new order pipeline & shift in sales in favor of higher margin oil & gas and manufacturing sales, L&T remains one of the favorite large cap stocks in infrastructure development space. It also has huge incubated value.
Reliance Industries (XRELF, B-1-7, Rs2553)	The largest private sector oil & gas company, with interest in retail, life science, petrochem and textile. Commencement of Commercial production of natural gas from 1QFY09 would make it a major player in clean fuel segment. India's largest private company, with huge incubated value.
ONGC (ONGCF, C-1-7, Rs1021)	ONGC is India's largest upstream oil company. Its operations are dominated by production and exploration, both onshore and offshore. Its overseas exploration activities in Africa, Eastern Europe, the Middle East, Latin America and Southeast Asia are handled by its 100%-owned subsidiary, ONGC Videsh. ONGC also has a refining subsidiary, MRPL, with a 9.7mmtpa refinery in Mangalore, India.
Aditya Birla Nuvo (ADYAF, C-1-7, Rs1764)	ABNL is a conglomerate with exposure to 10 diverse businesses, including high growth telecom and financial services businesses. Other key businesses include carbon black, garment-retailing, BPO services, rayon, fertilizers, textiles, insulators, and financial services.
Axis Bank (UTBKF, C-1-7, Rs1051)	ICICI is India's leading financial institution with a strong retail franchise and large corporate banking activities. It has a multi-channel distribution network, complete product range and a strong brand. Leader in financial services with large incubated value.
M&M (MAHHF, C-1-7, Rs645)	Mahindra & Mahindra (M&M) is one of the leading automobile and farm equipment manufacturers in India. The company has successfully incubated businesses in areas of hospitality, trade & financial services, auto components, IT, telecom and infrastructure development. One of the most visible Indian companies globally.
ITC (ITCTF, C-2-7, Rs210)	ITC is India's leading company with (1) extensive distribution, (2) strong brands across price segments, and (3) a healthy balance sheet. It is largest cigarette company with about 70%+ volume share and 85%+ value share. Cigarettes account for 59% of turnover and 89% of EBIT. The company has substantial interest in hotel, paper and agri commodities businesses. It also has presence in other businesses such as consumer products, apparel and retailing.
Indian Oil Corp (IOCOF, C-2-7, Rs561)	IOC is India's largest oil refining & marketing company. Its seven refineries have a total capacity of 827,000bpd. It also owns 52% IN CPCL refinery (210,000bpd) and 74.5% in BRPL refinery (47,000bpd). Though the profitability of the company is impacted to a great extent by government policies on pricing of petroleum products, the large infrastructure, strong brand and probability of higher profits in case international crude prices fall as predicted by ML commodity team, and reasonable valuation, makes a good investment case for medium to long term.
Cairn India (XCANF, B-1-7, Rs219)	Cairn India is a major player in India's fast growing E&P sector. It has assets comprising 2 production, 1 development and 10 exploration blocks. Its main asset is RJ-ON-90/1, which includes the largest on land oil discovery in India in 22 years. RJ-ON-90/1 production is expected to come on stream in 2009.
Ranbaxy (XIZZF, C-1-7, Rs397)	Ranbaxy is India's largest pharmaceutical company (by revenue). It sells products in more than 125 countries, has an expanding international portfolio of affiliates, JVs & alliances, ground operations in 49 countries and mfg operations in 9 countries. The US and Europe contribute more than 45% of revenues with the rest mainly from BRICS markets. It has targeted revenues of US$5bn by 2 012. Could be a major beneficiary of expansion of basic health services in rural areas. Visible global footprints.

Source: ML Research, Prices as on 18 February 2008

Renaissance economies—is a larger picture emerging?

"We all are in the gutter, but some of us are looking at the stars." – Oscar Wilde

Not bothering about the semantic relevance of the terms like coupling, decoupling, recoupling, rebalancing, 'slow growth' or 'slow down', inflation, deflation or stagflation, we may want to visualize a larger picture, which is:

US is still relevant

The share of US GDP and imports has contracted in relative terms over past couple of years but it is still the largest consumer in world. It would be inappropriate to conclude that the world will remain the same if US consumption slows down significantly.

"Happiness is not an individual matter."

The Asian lions China and India, with combined consumption equal to about one sixth of US consumption, are still far away from the position where they can hold the global economy irrespective of US. The commodity price fueled growth of Middle East and Latin America is also contributed to a large extent by US consumers, who guzzle a major share of most commodities.

Globalization vs. decoupling

The world as a whole has shown resilience to US slow down in past few quarters. The trend is more pronounced in Asia. In particular India and China have shown greater strength in these troublesome times.

While most analysts prefer to term this phenomenon as 'decoupling' of Asian economies, the more appropriate description might be 'globalization' of Asian economies, where the interdependence is diversified enough to be impacted by US and/or Japan alone.

However, as the global markets catch the cold, jitters will be felt throughout. The current trend of high volatility may get rather prolonged. The markets with larger participation of global investors will face more volatility as these investors tactically change their geographical asset allocation.

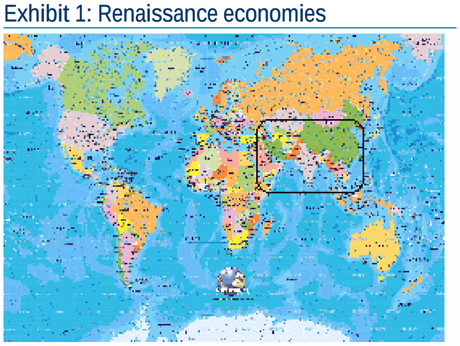
A larger picture may be emerging

The more we dislike something the more we get closer to that.

While struggling to get out from the maze of jargon, we invariably end up adding to the complicity. But that's ok.

We have long studied global markets divided into two silos, viz., developed markets and emerging markets. Within emerging markets many sub-segment have emerged over a period of time—the most prominent being BRIC (Brazil, Russia, India and China) and GCC (Gulf Cooperation Council). Recently frontier markets, i.e., the lowest end of emerging markets, have emerged as a new sub-set for analysis.

Exhibit 1: Renaissance economies



Source: Merrill Lynch

However, if we look at the world map and find the most happening economies, we find many of these economies are geographically located in or around the areas where four major ancient civilizations developed, i.e., Mesopotamian or Fertile Crescent (5300 BC), Indus Valley civilization (3500 BC), Chinese civilization (2200 BC) and Nile River or Egyptian civilization (3200 BC).

Though economists may disagree with this, many historians believe that these economies, particularly India and China, dominated the world trade till two centuries ago. These economies lost their place in the course of spread of British Empire, industrial revolution and two world wars.

A greater in-depth examination of growth pattern of these economies in past ten years might suggest that some sort of economic renaissance is taking place, whereby the resources are flowing back to these older civilizations.

While everyone had been following the India and China story, the following examples also point towards this larger picture:

For more details and important disclosures please refer to Guanxi, 14 January 2008

(a) Pakistan's is doing well despite everything

In the past year, Pakistan has had:

1. Several dozen suicide bombings,
2. A court crisis with the Chief Justice,
3. The prime minister changed to a caretaker,
4. The assassination of Benazir Bhutto,
5. Ongoing issues with Al Qaeda,
6. An oil price at USD100, not a good thing for any net oil importer.

And yet, its stock market won't go down. In fact, it rose 40% last year, in dollar terms.

Despite the politics, foreign investors still want a piece of Pakistan

Something must be going on, more powerful than all that violence and unrest, something perhaps best evinced by the fact that in the past few months:

1. Nomura announced it would team up with an Omani bank to buy Saudi Pak Bank for USD160mn.
2. Barclay's Bank received a banking license in Pakistan and will open up 10 branches with USD100mn.
3. International Petroleum Investment, a UAE company, announced it would build a USSD5bn refinery.
4. Hutchison Port Holdings announced it will build a USD1bn deep water container port.
5. Singapore's Temasek, through NIB Bank, is buying PICIC.
6. Philip Morris is building a new plant, and China Mobile is hiring thousands of people, as it doubles its base stations in the country … in fact, this list could go on, and on.

For more details and important disclosures please refer to 2008: The global macro year ahead, 28 November 2007

(b) GCC: Spending, not wasting

Gulf Cooperation Council (GCC) countries have enjoyed an oil bonanza many times in past 5 decades. However, it is only over the last five years this region has staged a strong economic revival. The massive accumulation of current account surpluses is helping the GCC build up international reserves, reduce indebtedness, finance structural change and invest in social and economic projects.

Having learned from their past mistakes, GCC countries have saved some 80% of the oil windfall, almost triple the amount they saved in past oil booms. Going forward, fiscal spending is expected to gain pace to finance mega investment projects. Domestic absorption is also on the rise, feeding into higher import growth. Based on flat oil prices in 2008-09, the region's GDP is expected to grow around 6% on average in 2008-09.

Growth is becoming less of an oil story

GCC countries grew at a 7.3% real average rate since 2002 and this high growth is becoming less dependent on the oil sector. While the contribution of the non-hydrocarbon sector to GDP growth was 49% back in 2003, it increased to 85% in 2006. As governments introduce market liberalisation measures, privatization and tax reforms to improve the investment environment, this trend is likely to become more pronounced as FDI inflows multiply.

A significant fiscal stimulus

Contrary to previous oil booms, governments in GCC countries have been quite prudent on spending. The breakeven oil price for budget expenditures is approximately $40/bbl. Fiscal spending is likely to gain pace as mega investment projects are launched across the region. Together with increased private sector confidence, investment projects to be implemented in the next five years are estimated to be worth US$800bn.

Re-pegging and/or revaluation of the currencies

GCC countries have built up a cumulative current account surplus of some US$710bn over the past five years. Capital inflows have gained pace, and the region is awash with cash. Big investment projects kick start one after another. Some supply side bottlenecks seem inevitable in the short term (e.g., in the housing sector in the UAE and Qatar). With domestic demand heating up, pegs to the sliding US$ is feeding in some imported inflation and fuelling domestic liquidity. Inflation is likely to stay on an increasing trend in the short-term. In a region of constrained policy choices, strengthening currencies will be a policy tool which we expect to be used in the fight against inflation. Our global currencies strategy team expects re-pegging and/or revaluation of the currencies.

India Wrap

Economic overview

Worst possible scenario: 6.5% growth, if all falls down

For more details and important disclosures refer to *"Bloody but unbowed: Stress testing US risk"* dated 28 January 2008

ML economist Indranil Sen Gupta believes India's domestic demand story will stand up to a US-led global shock, but only just. Real GDP will likely still grow 6.5% even if the US drags the world into recession, killing off export – merchandise and services – demand. Contagion from global shocks pulled growth down to 4% in FY98 and FY01.

This simulation is by no means the Merrill Lynch expectation. ML economics team still forecasts the world to decouple from an US recession to grow 4.6%, healthy but lower than 07's 5.2%. In this relatively benign case, India will likely soft land to 8%+ growth.

Table 3: India likely soft landing

Variable	FY07	FY08E	FY09E
Macroeconomic parameters (%)			
Real GDP growth rate	9.6	8.6	8.2
Agriculture	3.8	2.6	3.0
Industry	10.6	9.0	7.6
Services	11.2	10.2	9.9
M3 growth rate	21.3	20.0	18.0
Commercial credit	26.3	22.5	21.5
WPI inflation rate	5.9	4.5	5.1
Center's fiscal deficit (% of GDP)	(3.7)	(3.2)	(3.0)
Current account balance (% of GDP)	(1.0)	(1.2)	(1.5)
Forex reserves (US$bn)	199.2	284.0	325.7
RBI's LAF reverse repo rate (%)	6.0	6.0	5.5
10-year Govt yields (%)	8.00	7.80	7.70
Prime lending rate of PSU banks (%)	12.25-12.75	12.75-13.25	12.25-12.75
US$/INR	43.5	38.0	39.0

Source: Government of India, RBI, Merrill Lynch estimates.

Domestic demand still a powerful buffer

Indranil believes that India will likely do better than peers, China apart. This is, after all, as ML Asia economist Arthur Woo calculates, one of Asia-Pacific's most powerful domestic demand stories.

Can exports really collapse?

Non-oil exports did contract by 4.4% in FY99 and 2.3% in FY02, decimated by the Asian crisis the first time and the US the second.

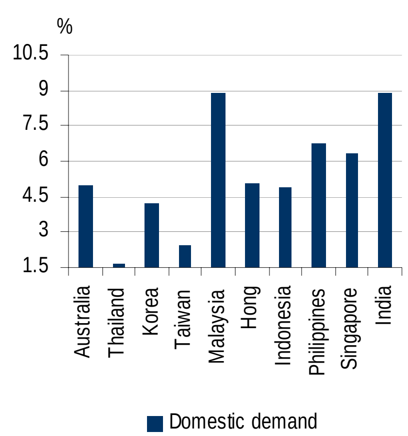
How do exports affect growth?

We estimate that Rs100 of exports impacts national income by Rs120, accounting for the cascading effect as well. However, since the overall share of non-oil exports is limited to 16.5% of GDP (including services exports of 4.5% of GDP), even factoring in the second round impact, exports influence just about 20% of GDP.

What's changed? Decoupling, reasonable rates, SLR

ML economics team expects healthy 5.5% non-US global growth. Besides, US share in Indian exports have declined to 15% from 20.9% in FY01. 40% of export markets - developing Asia and OPEC - will likely remain robust.

Chart 2: India's robust domestic demand



Source: CEIC, Merrill Lynch estimates.

Second, neutral real rates, at 7.75%, around our estimated 8% potential real GDP growth, are a buffer. Credit costs were earlier crippling: real rates, at 8.5+%, by far exceeded the then 6% trend growth in FY99.

Third, the RBI's new-found power to cut SLR now allows it to fund growth free of foreign capital. If risk repricing dries up flows, the RBI can run down its US$282bn forex reserves to fund even a higher current account deficit. The resultant Rupee gap can be filled up by open market operations. Bank access to the RBI's repo window can now easily be enlarged by cutting SLR (1% cut releases US$10bn).

In stark contrast, the RBI had to raise forex reserves by issuing Resurgent India Bonds and India Millennium Deposits in FY99 and FY01.

Finally, a bit of luck, perhaps, with the monsoon. A poor crop accentuated earlier downturns. We estimate that an unfortunate repeat will still hold growth at 5.5%.

Trade deficit up: Rupee hits exports, growth spurs imports

The trade deficit surged to US$58bn in April-December 2007 from US$43bn last year. Exports decelerated – 21.7% during April-December 2007 from 23.9% in FY07 - weighed down by a strong Rupee and base effects. In Rupee terms, exports grew a mere 7.7%. India's non-oil imports picked up to 33% during April-December 2007, on the back of strong growth.

Disaggregated trade data suggest that a stronger Rupee is hitting the export-oriented labor intensive textile industry. Textiles exports declined by 0.9% in April-August 2007 in sharp contrast to 13% growth last year. Petroleum product exports thankfully act as a buffer at a time of rising crude prices.

Table 4: Trade deficit widening, as exports slow down, imports remain robust
India's merchandise trade (US$bn)

Item	FY05	FY06	FY07	Apr-Dec 06	Apr-Dec 07	FY 08E	FY09E
Exports	80.5	100.6	124.6	91.2	111.0	152.0	182.0
% growth					21.7		
Imports	109.2	140.2	181.3	134.1	168.9	231.0	277.0
% growth					26.0		
Oil	29.8	43.8	57.3	44.2	49.3	72.5	85.8
% growth					11.5		
Non-Oil	79.4	96.4	124.0	89.9	119.6	158.5	191.2
% growth					33.0		
Trade Balance	-28.7	-39.6	-56.7	-42.9	-57.9	-79.0	-95.0

Source : DGCI&S. Excludes non-DGCI&S - essentially defence - imports.

Gross fiscal deficit lower on robust taxes

There is better news from the fiscal front, buoyed by robust tax collections at a time of strong growth. The Center's gross fiscal deficit declined to 51.4% of budget estimates during April-December 2007 from 63.8% last year.

Table 5: A fisc on track

		% of budget estimates	
	FY08BE (Rs.bn)	FY08 (-Dec)	FY07 (-Dec)
1.Revenue receipts	4864	73.1	69.6
Tax revenue	4039	73.3	71.0
Non-tax revenue	826	72.3	63.9
2. Non-debt capital receipts	432	95.1	67.2
Recovery of loans	15	220.3	99.4
Other receipts	417	90.6	0.0
3. Total receipts (1+2)	5296	74.9	69.6
4. Non-plan expenditure	4754	70.9	69.6
4.1 On revenue account	3835	73.0	73.7
4.1.1of which: Interest payments	1590	70.3	66.3
On capital account	919	62.1	39.3
of which: loans disbursed	8	106.9	51.3
5. Plan expenditure	2051	66.9	64.6
5.1 On revenue account	1744	65.8	65.3
On capital account	307	72.7	60.8
of which: loans disbursed	67	98.2	79.0
6. Total expenditure	6805	69.7	68.0
7. Gross fiscal deficit (6-3)	1509	51.4	63.8
8. Revenue deficit (4.1+5.1-1)	715	54.9	78.8
9. Primary deficit (7-4.1.1)	-81	424.8	25.0

Source: GoI

Market overview

- In one of its worst performance in recent months, the benchmark Sensex lost 13% during the month of January. The volatility was very high. The Sensex touched an all time high level of 21206 and four month low of 15332 before ending the month at 17648, down 13% m-o-m. Volatility was even higher in midcap and small cap arena. Consumer staples and banking sectors outperformed the benchmark, while metals, oil & gas, consumer durables, healthcare and capital goods were notable underperformers.

Table 6: Market performance during January 2008

Index	Jan Close	Jan Return	YTD Return
Sensex	17648.71	-13.00%	-13.00%
BSE 100	9440.94	-15.36%	-15.36%
BSE 200	2230.39	-16.04%	-16.04%
BSE 500	7160.03	-16.67%	-16.67%
BSE Midcap	7766.62	-20.66%	-20.66%
BSE Small Cap	10124.42	-24.15%	-24.15%
BSE IT	3710.11	-18.09%	-18.09%
BSE FMCG	2167.34	-6.58%	-6.58%
BSE Health Care	3603.52	-18.45%	-18.45%
BSE Cap Goods	16387.7	-17.05%	-17.05%
BSE Cons Dur.	5103.86	-26.63%	-26.63%
BSE BANKEX	10713.91	-6.17%	-6.17%
BSE AUTO	4832.48	-14.73%	-14.73%
BSE Metal	15312.92	-23.51%	-23.51%
BSE OIL & Gas	10705.2	-19.52%	-19.52%

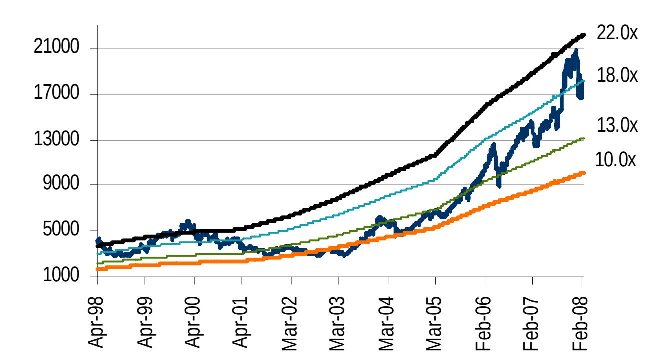
Source: Bloomberg, All data as on 31 January 2008

Table 7: Wtd. BSE Sensex Valuation

Sensex @ 18115.25	FY06	FY07A	FY08E	FY09E	FY10E
PE	37.2	25.1	21.1	17.9	15.0
EPS Growth	17.9%	35.6%	18.6%	17.8%	19.3%
P/Cash Eps	29.10	22.28	16.52	14.09	11.85
CEPS Growth	14.8%	26.2%	18.2%	17.2%	18.9%
P/BV	8.3	5.7	4.2	3.6	3.0
RoE	24.2%	25.0%	23.3%	21.7%	21.9%
Cor Gearing	14.3%	12.5%	25.9%	17.2%	6.9%
Dividend Yield	0.7%	0.9%	1.1%	1.2%	1.3%
EV/EBIDTA	12.64	14.98	12.57	10.62	8.87

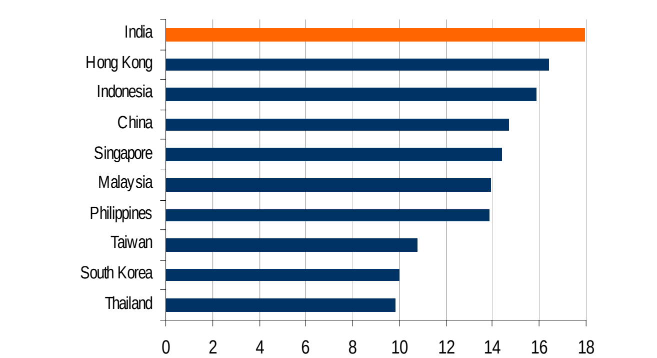
Source: ML Research Estimates, All data as on 17 February 2008

Chart 3: 1 Year forward PE



Source: ML Research

Chart 4: PE Regional (x) CY08



Source: ML Research

India asset allocation

The following asset allocation model suggests guidelines for target allocation of financial assets by non-institutional clients investing in Indian financial assets. The allocations are derived from the performance of a set of 10 lead indicators discussed in IST Report of January 2008. Based on performance of these indicators we have worked out three investment scenarios.

Presently, we are in Scenario A. The allocations would change as we move from one scenario to the other.

Client profiles

1. Aggressive
2. Moderately Aggressive
3. Moderate
4. Moderately Conservative
5. Conservative

Allocation cases

Table 8: Allocation cases

Client Profile / Investment Scenario	A	B	C
1. Aggressive	A-1	B-1	C-1
2. Moderately Aggressive	A-2	B-2	C-2
3. Moderate	A-3	B-3	C-3
4. Moderately Conservative	A-4	B-4	C-4
5. Conservative	A-5	B-5	C-5

Source: ML Research

Asset allocation for current investment scenario

Table 9: Financial assets allocation (with alternative investments)

Scenario A (% allocation)

Asset category / Allocation case	A-1	A-2	A-3	A-4	A-5
Wealth Creation (Equity)	70	65	60	55	50
Direct Equity	52	42	33	25	17
Strategic	34	27	23	20	14
Tactical	18	15	10	5	3
Managed Assets(MF and PMS)	18	23	27	30	33
Wealth Preservation (Debt & Cash)	20	25	30	40	45
Alternative Investments	10	10	10	5	5

Source: ML Research

Table 10: Financial assets allocation (without alternative investments)

Scenario A (% allocation)

Asset category / Allocation case	A-1	A-2	A-3	A-4	A-5
Wealth Creation (Equity)	75	70	65	55	50
Direct Equity	56	46	36	25	17
Strategic	36	30	25	20	14
Tactical	20	16	11	5	3
Managed Assets(MF and PMS)	19	24	29	30	33
Wealth Preservation (Debt & Cash)	25	30	35	45	50

Source: ML Research

Commodities outlook

The global energy markets are turning tight as a tick

For more details and important disclosures please refer to "Oil remains the energy source of last resort", 15 February 2008

The global energy markets have tightened tremendously in the last few weeks on the back of growing power bottlenecks in places like Japan, China, South Africa, Chile or Vietnam. European and South African coal prices have hit record highs, and spot LNG prices skyrocketed. Energy markets could tighten further in the near-term on the back of supply disruptions, cold weather and growing EM liquidity. Thus, ML commodity team believes that the short-term risks to WTI oil prices are firmly skewed to the upside, and a spike above $100/bbl is possible.

WTI oil prices could spike above US$100/bbl mark.

Distillate tightness is spilling into European gasoil cracks

More recently, the gasoil or heating oil markets have also started to tighten, driving up European gasoil prices—the global benchmark in the distillate market. Showing remarkably low sensitivity to prices, European distillate demand has held up well at around 3% in the last 3 months despite the warm winter in Europe.

For many consumers, there is no choice but oil

Ultimately, the oil market remains the "lender of last resort" whenever the world faces an energy emergency. In effect, oil remains the most flexible source of energy on the planet, as it can be widely used across a number of economic sectors including transportation, industry and power generation. Whenever there are bottlenecks in coal or natural gas production, the weather turns cold, or demand is just running too fast, the world resorts to oil.

Coal prices to remain supported over the next 6 months

For more details and important disclosures please refer to "Energy appetite in emerging markets to support coal prices", 11 January 2008

International coal prices have been one of the star performers in the energy complex, surging by almost 150% in 2007. A combination of record dry freight rates, supply bottlenecks and soaring coal-fired power generation in emerging markets, along with various nuclear problems in Japan and Europe, have helped the coal market perform strongly. ML commodities team feels global coal prices could rise to new highs as the fundamental support is still strong. However, the pace will likely slow as nuclear power plant outages are easing and the US is increasing exports.

…bottlenecks are not going away and coal is still cheap

Going forward, significant bottlenecks in the dry freight and rail markets, particularly in Australia and Russia, and strong demand for coal in the Pacific will provide the strongest leg of support to coal prices. Despite the latest price spike, the spread between coal and hydrocarbon prices remains very wide, even when factoring in efficiency-losses and the cost of CO2 in Europe. Also, soaring Asian spot LNG prices continue to make coal an increasingly attractive alternative

Metals: long precious metal; short base metals

For more details and important disclosures please refer to "Metals stuck between a rock and a hard place", 15 January 2008

ML commodity team suggest as a key sector strategy to remain long precious metals, short base metals. A weak USD, rising inflation and rising geopolitical risks have all contributed to a surge in investor demand for gold and silver, pushing prices to record levels.

Inflation vs growth: the key to metal demand in 2008

Concerns about an economic slowdown are driving down interest rates in the developed world, a movement that has created a flurry of liquidity in emerging markets, supporting demand for metals. In contrast, faced with robust growth and growing imbalances, many EM countries are hiking interest rates to contain inflation (and to slow down metal demand growth). Thus, the prospects for global industrial metal demand in 2008, and ultimately prices, likely will depend on the outcome of the battle between EM inflation and developed market growth.

Robust demand & supply constraints should support prices…

In the end, we believe that while EM inflation is a growing problem, interest rate hikes in China and elsewhere will only modestly reduce the EM growth momentum in the short-run. In addition, rising costs across the industry should contain any rampant growth in supply. As a result, ML commodity team believes metal prices will be well supported at current levels.

…despite a weak US economy

ML commodity team's base case scenario is that metal demand growth globally will remain firm, despite the ongoing US economic slowdown. In 2007, the contribution of OECD economies to global metal demand growth has been negative. By contrast, strong demand growth has taken place in China, India, Brazil and Russia. So long as growth in these regions remains supported by undervalued exchange rates and major energy subsidies, demand for aluminium, copper and nickel should continue to expand.

Selective strategies are still required in base metals…

Overall, ML commodity team is positive on the metals and thus has made only minor changes to price forecasts; aside from lead (down 25% in 2008) and gold (up 18%). Nickel remains our pick of the base metals; as strong demand from a stainless steel restock and high costs push prices back above $35,000/t. There appears plenty of upside to zinc prices, with loss-making smelters expected to keep supply constrained. Aluminium, the most energy intensive metal should see prices underpinned by high oil and coal prices. Copper and lead look vulnerable to further weakness and are now our least preferred metals

Severe Chinese winter to impact commodities

The recent snowstorms in China have probably been the harshest in 50 years, creating major disruptions across the country. Electricity shortages have been reported in 13 provincial regions, and up to 6% of total electricity generation capacity has been shut down. The electricity plant closures have mainly come from a reported daily input gap of 333,000 tons of coal, or 14% of consumption, leaving stocks at very low levels.

The impact on the commodity markets could be substantial

The emergency credit expansion together with the food and energy shortages in China, coupled with aggressive monetary easing in the United States, will mean that too many dollars are chasing too few commodities in the global economy, despite the inflationary risks. ML commodity team feels China will have tremendous short-term pressure to deliver food and shelter to millions. Food and energy shortages across China coupled with looser global monetary policy could send some commodity prices much higher over the next three months.

Coal, agriculture and to some extent oil prices could profit

While the electricity shortages have already resulted in a rally in coal prices, oil prices have yet to react. In part, China has become a lot more oil efficient in recent years, managing to produce the same amount of output with significantly less oil. Still, oil remains the most flexible source of energy and shortages often result in a substantial increase in oil use. Possibly, imports of fuel oil could start rebounding strongly this quarter. On top of the ongoing energy disruptions, snow has ruined 735,000 hectares of crops. ML commodity team expects further upside pressure on oilseeds as they are likely hurt the most by the damage of snowfall.

Global markets
U.S. economic forecast
Not your father's recession

The popping of the real estate and credit bubbles, the downturn in equities, and the credit crunch make this recession unlike those in the recent past.

We think that investors should not be under any illusions that this slowdown will be a "plain vanilla" one. Earlier recessions were induced by excessive manufacturing inventories (the 1950s and 1960s); inflationary spirals that required heavy doses of interest rate hikes (the 1970s and early 1980s); a wartime shock recession in the early 1990s that was aggravated by a regional commercial and residential sector downturn; and a capex/dot-com induced recession in 2001 that was exacerbated by the terrorist attacks.

The current recession is a different animal altogether

ML North American Economist David Rosenberg, views reproduced from "*The RIC Report*", 12 February 2008.

This time around, the recession was caused by the popping of real estate and credit bubbles that affected more than half of the household sector's balance sheet. A classic cyclical bear market is unfolding in equities during the deepest and broadest real estate deflation in the post-WWII era. And alongside that negative wealth shock, there has been a retrenchment in credit availability as default rates and banking-sector losses mount during the credit crunch.

Forecast update

Against that backdrop, here is a quick look at what we think lies ahead for the U.S. economy.

Interest rates. The Federal Reserve appears to be pulling out all the stops to minimize recession risks and underpin the financial system. With that in mind, we expect the funds rate to decline to 1% during the next year as the Fed does what it usually does – unwind the entire tightening cycle that led to a recession. The extent to which such a decline in rates will help the economy depends on how deep and prolonged the residential real estate contraction and the credit availability contraction will be in the post-bubble de-leveraging period.

GDP. GDP is expected to average 0.8% in 2008 and only pick up to 1.0% in 2009, in spite of $150 billion in fiscal stimulus and aggressive monetary easing. As we saw in prior post-bubble de-leveraging episodes, the healing process takes time as bad debts are extinguished and balance sheets repaired.

Home prices. Home prices are expected to decline by 15% in 2008 and by a further 10% in 2009, with more depreciation likely beyond the forecast period. The inventory situation has become intractable and home prices are still far above historical norms when benchmarked against other measures such as rent or GDP. Housing starts will probably slide another 30% from current levels to 700,000 by the end of 2008, an historic low.

Earnings. We expect S&P 500 operating earnings to be $80.00 this year, down from $87.30 in 2007, and $80.50 in 2009. The annual figures, however, mask a 20% peak-to-trough decline, which is typical for recessionary backdrops. We expect more write-downs to result in a 15% decline in reported earnings this year. Our forecast takes into account the hit to the consumer balance sheet and equity cost-of-capital considerations from a "normal" 25% cyclical bear market in stocks.

Employment. We expect job losses to amount to roughly 2.5 million, close to what occurred in the last recession. That, in turn, is expected to push the unemployment rate up, to 5.8% by the end of 2008 and 6% by early 2009.

Consumer sector. Rising unemployment, $6 trillion in lost housing wealth, slumping equity valuations, and a lack of participation from the baby boomers for the first time in three decades likely will result in the worst consumer recession since 1980. We see the year-to-year rate of real personal consumption spending dropping to -1.3% by the second quarter of 2008, led by double-digit declines in consumer durables.

Business sector. Business investment spending, by comparison, should hold up comparatively well, although we do think that capex will start to contract in the second half of 2008. While companies may still be focused on strategic productivity-enhancing spending, such as software, capex in general tends to follow the profits cycle very closely.

Foreign trade. The foreign trade sector should continue to support top-line growth, adding about one percentage point to both 2008 and 2009, but increasingly this would come from weaker imports rather than stronger exports. The last time net exports contributed this much was in 1991. Decoupling, if it is still a valid theory, did not save the US economy then, and we think it will not do so now.

Inflation. We think that as long as food and energy manage to even stabilize, the output gap widens, the rent and owners' equivalent rent (OER) components of the CPI decelerate sharply, inflation will move back below 2% by year-end (core 1.7%). We remain bullish on bonds, and see the yield curve continuing to steepen, and we believe that the 10-year Treasury note yield will be as low as 2.7% by the time the cycle is over.

Table 11: Forecast summary

	2007.4	2008.1F	2008.2F	2008.3F	2008.4F	2007F	2008F	2009F
Real GDP (% SAAR)	0.5	-0.4	-0.5	-0.1	0.1	2.2	0.7	1.0
Consumer Spending (% SAAR)	2.0	-0.3	-1.3	-0.6	-1.0	2.9	0.4	0.4
Residential Investment (% SAAR)	-24.6	-26.3	-27.6	-24.2	-22.9	-16.9	-24.1	-11.6
Unemployment Rate (%)	4.8	5.3	5.4	5.6	5.8	4.6	5.5	6.0
Personal Savings Rate (%)	0.2	0.2	0.7	2.0	2.1	0.5	1.3	2.6
Current Account (Bil $)	-198.6	-196.3	-187.1	-176.4	-165.5	-763.0	-725.2	-572.0
Operating Corp. Profits After Tax (% YoY)	3.0	-4.1	-14.0	-16.7	-15.1	2.6	-12.6	0.2
CPI, Consumer Prices (% YoY)	4.0	3.9	2.9	2.8	2.1	2.9	2.9	1.1
CPI ex Food & Energy (% YoY)	2.3	2.4	2.3	2.1	1.7	2.3	2.1	1.4

Shaded regions denote forecast.
Source: Merrill Lynch

Global Performance Matrix

The Global Performance Matrix provides a quick, comprehensive way to compare how 15 major market sectors and groups performed during the past month in 25 equity markets around the world. The returns, which are in U.S. dollar terms, are price returns weighted by market capitalization. Sectors that outperformed the MSCI All Country World Index by at least 4% during January are shaded dark blue; sectors that underperformed the world by at least 4% are shaded light blue. The world index's performance for the month was -8.3%.

Global sector performance for January 2008

US and Japan had the broadest positive sector performance while Telecom has the broadest positive country performance

Table 12: Global sector performance for January 2008

	Auto/Dur/Services	Banks	Cons. Staples	Div Financials	Energy	Health Care	Industrials	Insurance	Materials	Media	Retailing	Software	Tech Hardware	Telecom	Utilities	Country
Canada	n/a	-3.2%	-7.8%	-15.6%	-10.4%	-13.0%	-3.2%	-11.1%	-6.4%	n/a	-13.0%	n/a	n/a	-14.8%	-2.3%	-6.5%
USA	-3.8%	4.6%	-5.0%	-0.9%	-11.0%	-4.8%	-5.2%	-5.7%	-4.1%	-6.2%	2.3%	-10.9%	-13.6%	-9.8%	-7.2%	-6.2%
Belgium	n/a	-8.6%	-3.0%	-13.6%	3.7%	-5.5%	-10.2%	n/a	-10.5%	n/a	-1.6%	n/a	-7.8%	-0.8%	n/a	-10.0%
Finland	-12.5%	n/a	-8.3%	n/a	-10.4%	-4.8%	-10.8%	n/a	-6.2%	n/a	n/a	-18.0%	-7.0%	-8.3%	-11.3%	-7.7%
France	-15.3%	-11.7%	-11.6%	-1.1%	-13.7%	-12.4%	-13.4%	-14.1%	-10.4%	-11.2%	-13.6%	-10.2%	-13.2%	-3.8%	-12.1%	-12.1%
Germany	-13.8%	-21.8%	-5.9%	-13.1%	n/a	-5.8%	-17.8%	-15.2%	-10.3%	-2.0%	-19.7%	-8.2%	-15.7%	-7.4%	-13.7%	-14.0%
Italy	-9.8%	-11.3%	n/a	-12.4%	-12.9%	n/a	-10.4%	-7.4%	-7.9%	-13.0%	n/a	n/a	n/a	-3.0%	-5.8%	-9.7%
Netherlands	n/a	n/a	-11.8%	-15.1%	-11.1%	n/a	-8.5%	-16.6%	-9.6%	-18.4%	n/a	n/a	-15.5%	-1.3%	n/a	-11.8%
Norway	n/a	-16.3%	n/a	n/a	-18.8%	n/a	-41.4%	-24.1%	-10.0%	-31.1%	n/a	n/a	-19.4%	-15.6%	n/a	-21.1%
Spain	n/a	-16.7%	2.5%	n/a	-11.4%	-21.1%	-14.2%	-8.5%	-5.0%	-9.8%	-19.3%	-6.0%	n/a	-10.9%	-2.3%	-12.3%
Sweden	-9.6%	-15.7%	-10.2%	-6.3%	-6.5%	-11.2%	-13.7%	n/a	-11.8%	-13.4%	-12.5%	n/a	-4.9%	-6.1%	n/a	-11.7%
Switzerland	-16.2%	n/a	-3.0%	-10.4%	n/a	-2.9%	-10.4%	-1.1%	-3.7%	n/a	n/a	n/a	-15.4%	1.2%	n/a	-5.6%
UK	-7.8%	-9.8%	-10.4%	0.7%	-12.8%	-6.2%	-8.1%	-10.0%	-4.9%	-10.4%	-12.4%	-5.9%	-8.1%	-6.8%	-7.2%	-9.0%
Australia	-8.5%	-9.0%	-10.5%	-13.9%	-11.6%	-1.9%	-8.0%	-13.4%	-5.3%	-10.7%	-16.1%	-18.5%	n/a	-6.0%	-8.3%	-9.2%
Hong Kong	-11.4%	-9.5%	n/a	-10.6%	n/a	n/a	-10.2%	n/a	n/a	-9.7%	-15.1%	n/a	-26.1%	-5.6%	1.1%	-11.6%
Japan	-4.9%	0.5%	-5.6%	0.7%	-13.7%	1.4%	-4.5%	6.5%	-7.9%	-2.5%	-7.4%	-13.8%	-10.0%	-6.5%	2.0%	-4.6%
Singapore	n/a	-11.7%	n/a	-14.6%	n/a	-8.4%	-15.0%	n/a	n/a	-1.6%	-9.2%	n/a	-19.1%	-7.3%	n/a	-12.6%
China	-16.2%	-17.8%	-13.1%	-29.2%	-20.9%	n/a	-19.2%	-32.4%	-30.5%	n/a	-17.9%	-6.9%	-20.6%	-14.8%	-26.1%	-21.6%
India	-13.2%	-3.3%	-6.9%	n/a	-17.1%	-14.7%	-16.6%	n/a	-21.4%	-18.5%	n/a	-18.2%	n/a	-22.1%	-18.3%	-14.3%
Korea	-7.1%	-8.8%	-9.1%	-29.7%	-31.0%	-10.0%	-27.8%	-26.1%	-14.7%	-18.8%	-21.6%	-12.5%	2.8%	-8.7%	-1.6%	-14.2%
Taiwan	-13.3%	5.1%	-4.7%	11.4%	n/a	n/a	-2.4%	10.7%	-12.9%	n/a	n/a	n/a	-14.3%	3.4%	n/a	-10.5%
Brazil	-6.2%	-9.5%	-1.1%	n/a	-8.2%	-17.1%	-12.8%	n/a	-6.4%	n/a	-14.5%	n/a	n/a	11.5%	-6.7%	-8.5%
Mexico	6.5%	-0.1%	0.8%	n/a	n/a	n/a	-0.3%	n/a	1.9%	-6.2%	n/a	n/a	n/a	-2.3%	n/a	-1.3%
Russia	n/a	-14.7%	n/a	n/a	-18.7%	n/a	n/a	n/a	-7.5%	n/a	n/a	n/a	n/a	-16.8%	-19.9%	-16.1%
South Africa	-23.4%	-20.0%	-21.4%	-20.7%	-4.6%	-23.1%	-24.9%	-23.1%	-3.4%	-22.9%	-26.0%	n/a	-21.6%	-14.2%	n/a	-13.2%
Global Sector	-7.8%	-8.8%	-6.7%	-7.3%	-13.2%	-4.8%	-9.8%	-9.2%	-7.6%	-8.6%	-5.2%	-11.6%	-11.8%	-8.8%	-8.6%	-8.3%

Source: ML RIC Report

Price returns in U.S. dollars, weighted by market capitalization. MSCI World Index return for January was -8.3%. . n/a – Not available or applicable. As of month end January 2008. Auto/Dur/Services: dur is durables, services comprises hotels, restaurants, leisure, and diversified consumer services.

Source: Merrill Lynch Global Quantitative Strategy.

Asset allocations for global investors

The Global Asset Allocation Models show target asset allocation guidelines as well as ranges. The midpoint of the ranges is the long-term neutral benchmark allocation for a particular investor profile.

Table 13: Global asset allocation guidelines with alternative investments*

	Allocation Ranges				
	Conservative	Moderately Conservative	Moderate	Moderately Aggressive	Aggressive
Equities	25%	35%	45%	55%	65%
Equity Range	10-30	20-40	30-50	40-60	50-70
Fixed Income	50	45	35	25	10
Fixed Income Range	45-65	40-60	30-50	20-40	5-25
Cash	20	15	5	0	0
Cash Range	10-30	5-25	0-20	0-10	0-10
Alternative Investments	5	5	15	20	25
AI Range	0-10	0-10	0-20	5-25	10-30

Source: RIC.

*These percentage allocation recommendations are for the global investor in the major base currency regions including the US$, Euro, Yen, and Sterling.

Table 14: Global asset allocation guidelines without alternative investments*

	Rounded Allocation Ranges				
	Conservative	Moderately Conservative	Moderate	Moderately Aggressive	Aggressive
Equities	25%	40%	55%	65%	80%
Equity Range	10-30	25-45	40-60	50-70	65-85
Fixed Income	55	45	35	30	15
Fixed Income Range	50-70	40-60	30-50	25-45	10-30
Cash	20	15	10	5	5
Cash Range	10-30	5-25	0-20	0-10	0-10

Source: RIC.

*These percentage allocation recommendations are for the global investor in the major base currency regions including the US$, Euro, Yen, and Sterling.

Emerging markets

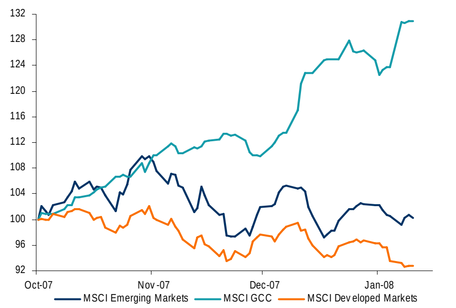
Frontier market outperformance continues

Frontier markets are strongly outperforming. Since Sept 30th Gulf markets are up 31% versus flat returns in Emerging markets and 8% losses in Developed equity markets. Frontier markets have proved to be uncorrelated with both EM and DM equities.

As the emerging market universe matures, investors are looking for opportunities in previously untapped markets outside the EM mainstream. Hence the rising interest in frontier markets or the emerging *emerging* markets. The MSCI Frontier Market index should provide investors with a good framework to structure the theme within EM.

We believe the Frontier theme will continue to gain traction in 2008 thanks to its perceived lack of correlation with both emerging and developed equity markets. The other key positive is the enormous growth potential of Frontier economies in the Middle East, Africa and Asia, particularly Vietnam. The key risks continue to be a lack of liquidity, transparency and a dependency on commodity export revenue in many Frontier economies.

Chart 5: Frontier markets outperforming Emerging & Developed markets, US$ returns*



Source: Bloomberg. * Index 10/1/07=100

Table 15: Monthly Return Correlations vs. the S&P 500

S&P Frontier Markets Index	32%
Emerging Markets MSCI Small Cap Index	63%
MSCI Emerging Markets Index	73%
US Small Cap index	76%
MSCI EAFE index	82%
NASDAQ	85%

Source: Bloomberg. Data from 3/31/00 to 11/30/07

Favorite Markets remain in the Gulf

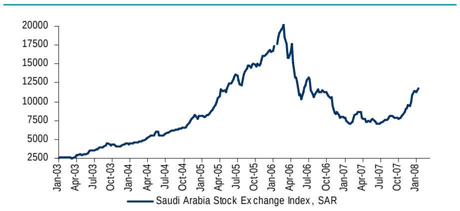
Our top frontier recommendation continues to be the Middle East Gulf markets. It is consensus, but it's hard to argue against massive oil surpluses, excess liquidity, easy fiscal and monetary policies and inexpensive stocks. Likely FX appreciation and the promise of a safe haven from global equities provide the icing on the cake.

We estimate GCC current account surpluses will total $750mln per day in '08. We believe that liquidity, together with increasing inflows from international funds, means the dramatic re-rating of Gulf markets is set to continue. Domestic investors have been heartened by the perceived reduction in regional political risk. The future opening of the Saudi Arabian market to international investors as well as the Saudi market's future inclusion in the Frontier index is a final incentive. A second asset price bubble in the region is not beyond the realms of possibility.

We always like emerging markets with low PE's and economies shielded from negative external shocks (i.e. with big current account surpluses). Chart 5 shows the relative valuation of MSCI Frontier Markets and the MSCI Emerging Markets index in terms of 12 month trailing PE and the current account position.

Markets such as Kuwait, Qatar and the UAE thus still look very good in relative value. Stock pickers should focus on stocks still well-below their ownership limits as well as names exposed to the regional infrastructure and consumer themes.

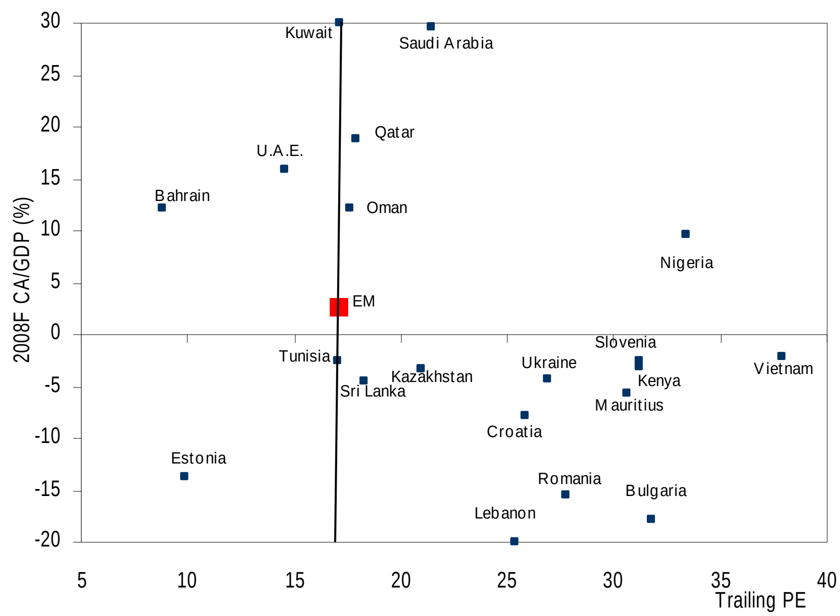
Chart 6: Saudi Arabia Performance



Source: Bloomberg

Global EM Equity Strategist Michael Hartnett view reproduced from "GEM Strategy", 15 January 2008.

Chart 7: Frontier Valuation Matrix= Low PE+ High CA/GDP= Attractive markets



Source: EIU and Merrill Lynch based on MSCI. Data as of January 7th 2008. Note: Kuwait CA/GDP 50%, but adjusted for editorial reasons.

Table 16: ML Accessibility to Frontier

	Long Access	Structured Products
Middle East		
Kuwait	Yes	No
U.A.E.	Yes	Yes
Qatar	Yes	Yes
Oman	Yes	Yes
Bahrain	Yes	Yes
Lebanon	Yes	Yes
Frontier Europe		
Slovenia	Yes	Yes
Kazakhstan	ADRs only	No
Croatia	Yes	Yes
Romania	Yes	Yes
Ukraine	No	No
Bulgaria	No	No
Estonia	Yes	yes
Africa		
Nigeria	Yes	Yes
Kenya	No	No
Mauritius	No	No
Tunisia	Yes	Yes
Asia		
Vietnam	No	Yes
Sri Lanka	Yes	No

Source: Merrill Lynch

How to Invest in Frontier Markets

International investor opportunities are somewhat limited in Frontier Markets due to high foreign ownership restrictions and low liquidity. Structured products, custom indices and ADRs, GDRs are convenient ways to attain exposure in these markets.

Merrill Lynch has designed several custom-made indices to facilitate institutional investor's access to these markets:

- **ML Dubai Investable Index** (MEIMDUBA) provides efficient exposure to large and liquid stocks listed on the Dubai Stock Exchange that are tradable by foreign investors.
- **Gulf Baskets are designed to provide investor access to different sectors of the Gulf equity market:** GCC Sharia compliant basket (MEIMGCSD); Abu Dhabi Basket (MLEMABUD); Oman Basket (MLEMOMAN); Kuwait Basket (MLEMKUWA).
- **ML Africa Lions Index** (MLEIAFLD (US$) & MLEIAFLE (EUR)) comprises stocks with exposure to the Africa theme.
- **Nigeria Basket (MLEMNIGE).** Consists of 12 of the most liquid stocks traded on the Nigerian Stock Exchange. Weighting is based on the relative liquidity of the stocks. The basket is split between banks (86.19%) and industrials (13.81%).
- **ML Vietnam Basket (MLEMVIET)**. This basket is designed to provide investors with exposure to Vietnam.

Table 17: EM price returns, %

	Jan-08	2007
EM countries/regions		
MSCI EMERGING MARKETS	-12.6	36.5
Morocco	13.4	44.0
Jordan	1.9	20.9
Malaysia	-1.1	41.5
Mexico	-1.3	9.3
Indonesia	-2.0	50.8
Chile	-2.0	20.8
Egypt	-2.8	54.8
Israel	-4.3	35.8
Peru	-4.5	86.0
LatAm	-6.4	46.9
Thailand	-6.7	40.9
Argentina	-7.8	-5.4
Philippines	-7.9	38.0
Brazil	-8.5	75.3
Taiwan	-10.5	5.4
Czech Rep	-10.8	51.7
Hungary	-12.2	13.4
South Africa	-13.2	14.7
EMEA	-13.6	25.8
Poland	-13.9	22.7
South Korea	-14.2	30.0
India	-14.3	71.2
Asia	-14.5	38.3
Russia	-16.1	22.9
China	-21.6	63.1
Turkey	-23.6	70.0
EM sectors		
Consumer Staples	-6.4	24.1
Health Care	-6.8	28.8
Telecoms	-9.4	50.4
Materials	-10.5	58.4
Consumer Discretionary	-11.0	16.2
IT	-11.0	-0.1
Utilities	-11.9	34.4
Financials	-14.2	28.9
Energy	-14.7	51.9
Industrials	-18.3	66.6

Data as of 31 Jan 08. Returns in US$. Source: Factset

Emerging market performance

Emerging markets fall 12.6% in Jan…

Emerging markets witnessed the largest monthly fall since Sep 2001. Almost every EM market fell in January. Losers this month were the largest EM markets – Turkey (-24%), China (-22%), Russia (-16%), India (-14%) and Korea (-14%).

All EM sectors were down in January, with industrials (-18%), energy (-15%) and financials (-14%) the worst performers.

EM Asia down 14.5% in Jan…

…the third successive monthly fall and the worst performance since Sep 2001. The Asia index was dragged down by China, India and Korea, all posting double-digit losses. Asian industrials (-18%) and energy (-15%) were the worst hit sectors.

China worst performer

- Chinese equities performed the worst among Asian emerging markets in January. The **MSCI China** Index fell -21.6%, underperforming the benchmark **MSCI EM Asia** Index, which declined -14.5% in January. The worst performing sector was materials (-31.1%).
- The **MSCI India** Index fell -14.3%, marginally outperforming the **MSCI EM Asia** benchmark index, which declined -14.5% in January. The worst performing sectors were telecoms and materials.

EM EMEA down 13.6% in Jan…

…the largest one-month fall since May 2006. The largest EMEA markets were the worst performers this month, with Turkey, Russia and South Africa worst affected. The smaller EMEA markets of Morocco (+13.4%) and Jordan (+1.9%) were the only EM markets posting gains in January. EMEA sector losers were consumer discretionary and consumer staples.

- The MSCI Russia Index declined -16.1% in January, underperforming the MSCI EM EMEA Index, which declined -13.6% during the same period. The best performing sector was consumer discretionary, while the worst performing was utilities.

LatAm down 6.4% in Jan…

…the worst monthly performance since May 2006. Biggest losers were Brazil and Argentina. Mexico outperformed the regional index, buoyed by the materials sector. LatAm financials were badly hit. LatAm telcos were the only regional sector recording a gain in January.

- Brazilian equities performed the worst among emerging markets of Latin America in January. The **MSCI Brazil** Index declined -8.5%, underperforming the **MSCI Emerging Markets Latin America** Index, which declined -6.4% in the same period. The best performing sector was telecoms, while the worst performing sector was financials.

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