market outlook

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Range-bound

We prefer the domestic-demand driven sectors like cement, capital goods, FMCG and pharma

March of 2006 will be a historical month for the BSE Sensex. For the second time in its history, the Sensex overtook the Dow Jones Industrial Average (commonly known as DJIA) when it closed at 11,183.48 on March 29, 2006. Its ride was backed by strong inflows from the foreign institutional investors (FIIs) who pumped in $1.4 billion in the month. The domestic mutual funds too bought stocks worth Rs4,482 crore. The fundamental story just got better during the month with the consensus estimates for the earnings growth of the Sensex companies upgraded to 18.6% (17.7%) and 11.6% (9.8%) for FY2007 and FY2008 respectively. The Sensex is currently trading at 16.7x its FY2007E earnings per share (EPS), and 14.9x its FY2008E EPS. We believe that the Sensex valuations are no longer cheap but they don't seem too stretched either.

While we believe that the upside from here will be driven by the earnings reported by the corporates for the quarter ending March 2006, the downside will be capped by the high cash levels with the domestic mutual funds.

On the economy's front, the scene got better with the Index of Industrial Production showing some improvement. In January it ended with a higher growth of 8.3% compared with a 5.3% growth in the quarter ended December 2005 as we had anticipated. The corporate tax revenues for the year till March 15, 2005 have shown a growth of 18.2% over the same period last year which indicates that India Inc is still in the pink of health.

However, liquidity remains a concern as the interest rates are tightening. We mentioned about the same in our note *"Potential threat from rising interest rates"* dated March 23, 2006. The key event to watch out in this context is the annual monetary policy statement of the Reserve Bank of India (RBI) slated to be announced on April 18, 2006.

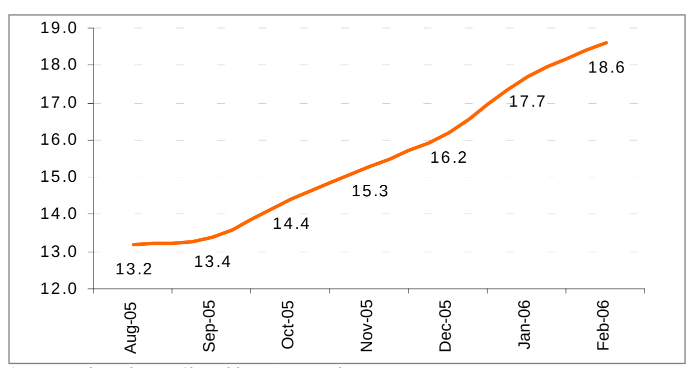
Our preferred sectors are cement, capital goods, fast moving consumer goods and pharmaceuticals.

Sensex' valuations—no longer cheap but not too stretched either

Though the Sensex' valuation is on the higher side of its ten-year average of 12-month forward PER, but the same is still reasonable. At 11,747 the Sensex is trading at 16.7x its FY2007E EPS. Although the earnings momentum of the Sensex has slowed down a bit, yet the same appears strong when compared with its peers in Asia as well as in the other emerging markets like Brazil and Mexico. India's earnings growth is expected to be the highest amongst the peers whereas its valuation is more or less in line with theirs.

FY2007E EPS growth stands at 18.6%

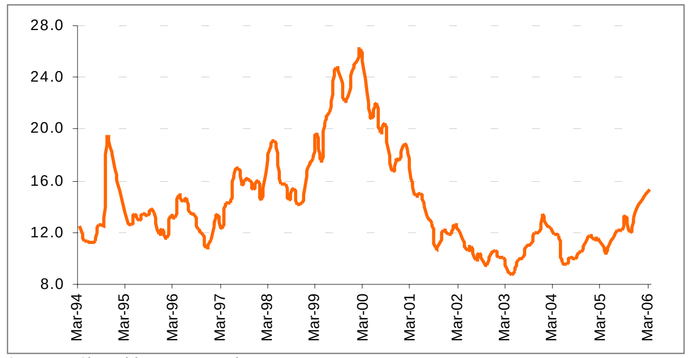
- The growth in earnings of the companies constituting Sensex stands at 25.5% for FY2006
- The growth for FY2007E stands at strong 18.6%



Source: Bloomberg, Sharekhan Research

Sensex trading at its ten-year average 12-month forward PER (x)

- Sensex has usually traded between 12x and 16x one-year forward PER over last ten years
- At 16.7x its FY2007E EPS the Sensex' valuations are no longer cheap but not too stretched either
- Gradual upgrades in FY2008E EPS to drive Sensex further.



Source: Sharekhan research

Liquidity—likely to remain strong, however tightening interest rates could be a threat

In the first three months of CY2006 India has seen a handsome inflow of foreign funds. The investments by foreign institutional investors (FIIs) in the equity markets in Q1CY2006 are already up by 60% over that in Q4CY2005. The mutual funds have just turned net buyers after three months.

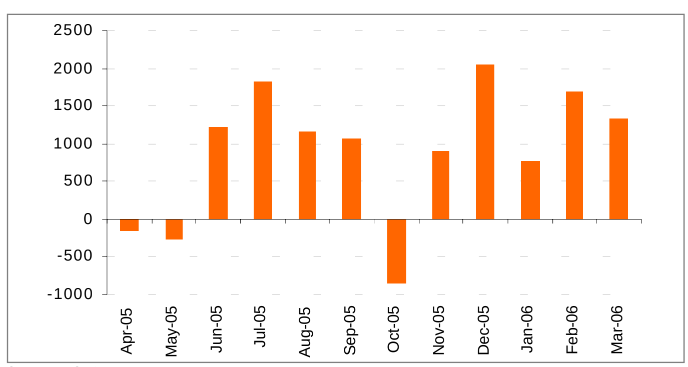
As we had mentioned earlier, the domestic money now seems ready to participate in the market. The subscription to the equity-based mutual funds has been at historic levels for February and March 2006, crossing Rs7,000 crore in each month. With the mutual funds sitting on piles of cash garnered from the new fund offerings, the money should enter the market in the coming months.

However, the domestic liquidity remains a concern. The unforeseen growth in the credit offtake for capital expenditure and with no room for improvement in the credit/deposit ratios, the banks are finding it hard to mop up funds. The long-term and short-term interest rates have both hardened. The RBI has already stepped in to ease the situation by increasing the interest rate on the non-resident Indian deposits. The forthcoming "Annual Monetary Policy" statement scheduled to be announced on April 18, 2006 will be a key event to watch out for. To ease the liquidity situation the RBI may take further steps like reduce the cash reserve ratio (CRR) etc.

The series of interest rate hikes in the USA seems to be nearing its end. The US Federal Reserve raised the interest rate for the sixteenth time in a row on March 28, 2006. We expect one more hike in the next meeting scheduled on May 12, 2006 which should mark the end of the exercise if the recent data on US economy is anything to go by. Recent data suggests that the housing-led consumption growth story is about to slow down which also affirms the view that the interest rate hikes would end sometime soon.

FII inflows remains strong for Q1CY2006

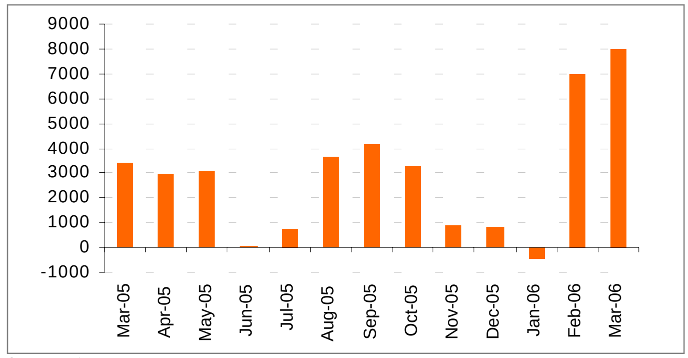
- FIIs have poured in $3.8 billion over first three months of CY2006
- 60% more than that in Q4CY2005 ($2.1 billion)
- Any change in the FII norms after state elections (see "Events to watch..." in the last section) would boost the flows further



Source: SEBI

Pick-up in domestic investments—MF mobilisation at record high

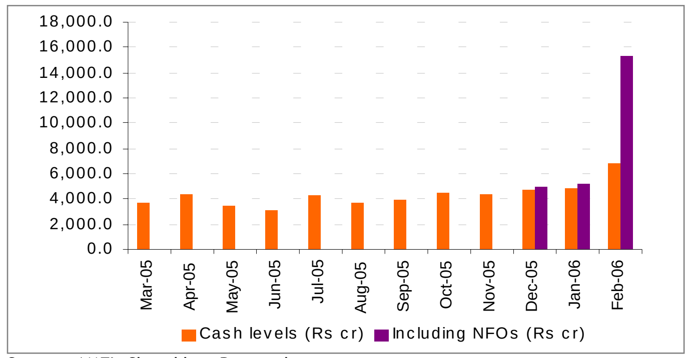
- The inflows for February and March 2006 vindicate our view that domestic investor will participate in a bigger way
- The low penetration among retail investors and absence of other lucrative investment avenues to help strengthen domestic flows



Source: AMFI

MFs sitting on a pile of cash

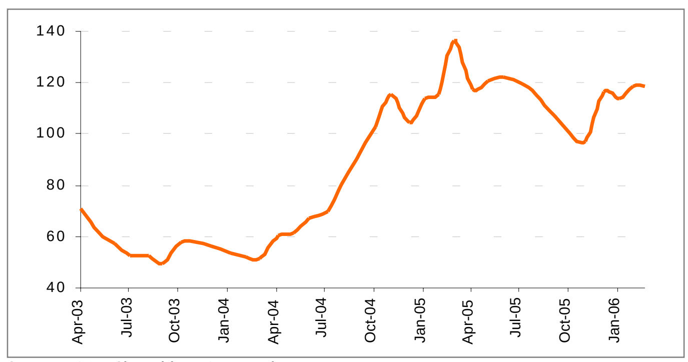
- Domestic liquidity for equity markets remains buoyant
- MFs sitting on Rs15,000 crore of cash which should be invested in the market over next couple of months
- During March 2006 MFs bought equities worth Rs4,482 crore
- The high cash levels of domestic levels to limit downside to the market



Source: AMFI, Sharekhan Research

However interest rates need to be watched closely

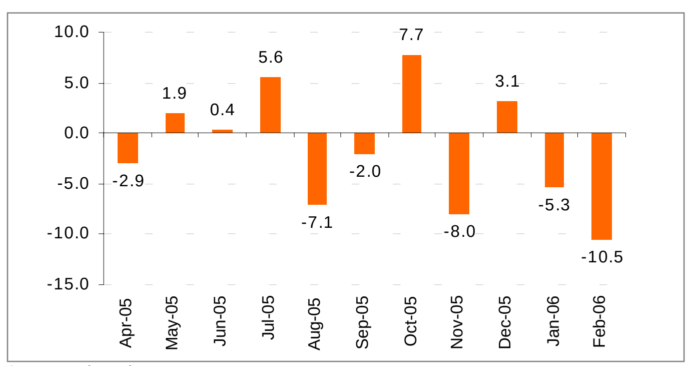
- The domestic liquidity is tightening with the incremental credit/deposit ratio running at all-time high
- The interest rates have hardened by 50 basis points over the last six months as the ten-year G-sec bond yield stands at 7.55%
- Key event to watch—RBI's annual monetary policy statement on April 18, 2006



Source: RBI, Sharekhan Research

US economy shows signs of slowing down

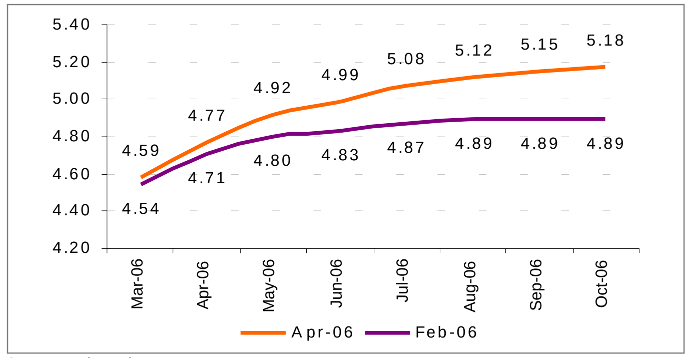
- The new homes sales data shows a declining trend over the last two months
- The housing boom-led consumption story may be slowing down
- Inflation may remain under control



Source: Bloomberg

Fed rate hike may stop at 5.0-5.2%

- As per consensus estimate the US rate hikes would stop at around 5.0-5.2%
- The end of the rate hike regime could lead to appreciation of the rupee against the dollar
- A big positive for domestic demand-driven sectors like two-wheelers, FMCG



Source: Bloomberg

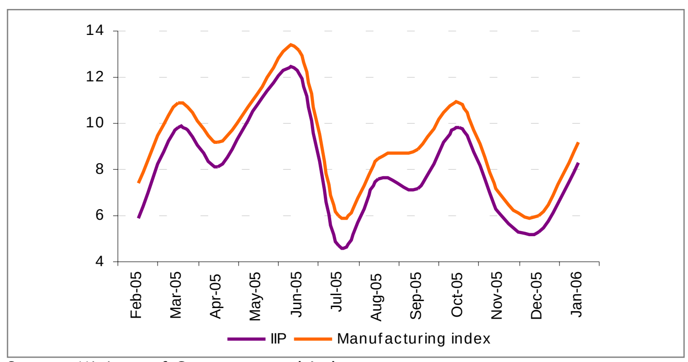
Economic growth recover after brief pause

We have frequently mentioned in the past that the Indian economy was taking a breather during the period November-December 2005 and that it would bounce back in the last quarter of FY2006. The recent economic data vindicates our view. The Index of Industrial Production (IIP) grew by 8.3% for January 2006 with the manufacturing sector reporting a strong 9.2% growth. The capital expenditure cycle continued unabated with the Index of Capital Goods growing by 26.3%.

We expect the growth to continue in February 2006 as is indicated by the leading indicators like coal and electricity production and sales of motorcycles, commercial vehicles and cement dispatches.

Manufacturing sector regains sparkle

- Economic growth subdued during Nov-Dec 2005 because of floods in southern region
- Growth bounced back in January 2006 as anticipated by us
- The IIP and the manufacturing sector grew by 8.3% and 9.2% respectively in January 2006



Source: Ministry of Commerce and Industry

Strong growth to continue through year-end

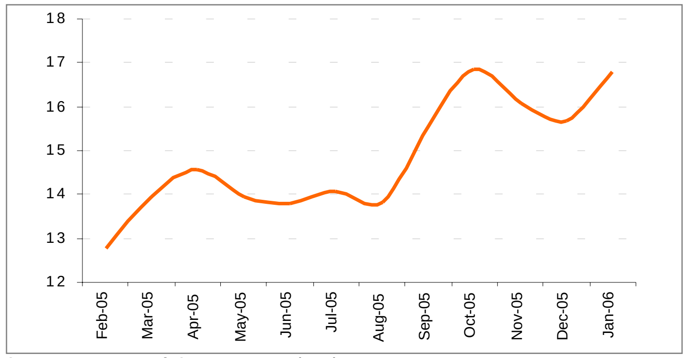
- Strong growth expected in February 2006 as is indicated by the upswing in the consumption of commercial vehicles, motorcycles, cement, and the production of coal and electricity
- All the leading indicators showing high single-digit or double-digit growth

Indicator	% growth		Trend
	Nov-Dec 2005-06	Jan-Feb 2005-06	
Cement	9.8	15.1	
Commercial vehicles	2	16	
Motorcycles	3.6	16.5	
Coal	6.9	8.8	
Electricity	2.8	7.4	

Source: Ministry of Commerce and Industry, CMIE, Sharekhan Research

Underlying investment theme going strong

- The underlying investment expenditure theme remains strong
- The Index of Capital Goods grew by a strong 26.3% for January 2006
- Broad-based growth with industries like boilers, textiles machinery, industrial machinery posting strong gains



Source: Ministry of Commerce and industry

Events to watch over next couple of months

Forthcoming elections to decide pace of reforms

Of the five states having assembly elections this year, all except Tamil Nadu are currently being ruled by the allies of the United Progressive Alliance (UPA) government. After the assembly elections, the reforms may pick up pace as the UPA allies would be more willing to implement the same if the poll results are favourable.

State	Election due
Kerala	April-May 2006
Pondicherry	May 2006
Tamil Nadu	May 2006
West Bengal	April-May 2006
Assam	April 2006

Result season starts from April

The March quarter results of the companies will start coming in from April. The earnings of the 30 companies constituting the Sensex are expected to grow by 22.4% for the quarter.

Where to expect growth

Company	Q4FY2006 Implied profit	Q4FY2005 actual profit	% yoy growth
Bharti Televentures	704.6	436.8	61.3
BHEL	757.8	584.6	29.6
Grasim Industries	374.7	287.2	30.5
HDFC Bank	308.0	202.4	52.2
Infosys Technologies	718.8	523.9	37.2
ITC	506.7	417.4	21.4
L&T	495.1	333.7	48.4
Maruti Udyog	323.0	259.5	24.5
Tata Motors	535.9	397.2	34.9
Wipro	620.3	421.4	47.2

Source: Bloomberg, Sharekhan Research

Annual monetary policy statement 2006-07

The RBI is slated to announce its annual monetary policy on April 18, 2006. While liquidity remains a concern as mentioned above, the banking sector is expecting a slew of measures from the RBI to ease up the situation. In the forthcoming policy the RBI may reduce the CRR by 25 basis points or by 50 basis points in two stages.

Monsoon to be normal in CY2006

The monsoon is forecast to be normal in CY2006 due to the favourable wet weather patterns generated by the La Nina event developed in the Pacific region. La Nina is characterised by a cool surface temperature in the Pacific Ocean that results in storm surges and strong winds. La Nina has a positive impact on the south-west monsoon in India that takes place during June-September 2005.

Year	Monsoon (% of normal)
1975	95
1988	119
1999	96

Revision of MSCI index in May 2006

The Morgan Stanley Capital International Inc. (MSCI) is slated to announce the next quarterly revision in its indices for various markets across the world including India in mid-May. MSCI is the leading provider of equity, fixed income and hedge fund indices that are widely followed by fund managers and institutions across the world. The expected upward revision in India' weightage in the MSCI Asia Index will affect the FII inflows positively (see our note on previous year's revision "*Reshuffle in MSCI India*" dated May 09, 2005).