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March 17, 2008

## India Strategy

### Brace for a Bear Market Rally

**Quick Comment:** No doubt, Indian equities continue to face challenges. Consider the following:

- a) India's current account deficit exposes it to slowing capital flows;
- b) India's high-beta characteristic will keep causing pain in a global financial market sell-off;
- c) Slowing growth creates earnings risk, which is magnified by potential balance sheet losses and peak EBITDA margins;
- e) Domestic inflation creates a monetary policy conundrum with its attendant liquidity and growth risks;
- f) Our fundamental indicator puts fundamentals at a five-year low (Exhibit 1);
- g) Market valuations are still rich on a relative basis (India's forward P/E is the second highest in EM);
- h) Politics may not help;
- i) The market is still up 6% since its August 2007 low, whereas several markets are below that level.

However, at the same time, the market has suffered a major loss of confidence. Consequently, our proprietary sentiment indicator, which combines 15 market metrics, is at its lowest point since March 2007 (Exhibit 2). Some market metrics have reached buy zones, with the most notable being the ever reliable value-at-risk (Exhibit 3). Technically, the market is sitting on an important support level (Exhibit 4). Valuations are still rich but have reached the low end of the three-year trading range from where the market has tended to rally (Exhibit 5). The market is no longer outperforming emerging markets since August low – it was outperforming by 30% at the start of 2008. No doubt, valuations could trend lower, given the change

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March 17, 2008  
India Strategy

in market conditions, but with sentiment approaching fear, a trading rally is quite possible. Tactically speaking, we think such a rally should be sold rather than bought, especially if we have entered a bear market, as it seems at this point. As usual, the high-beta sectors of financials and industrials may lead the rally, though from a strategic perspective we stay underweight these sectors.

Exhibit 1  
**Fundamentals: Not in Good Shape**

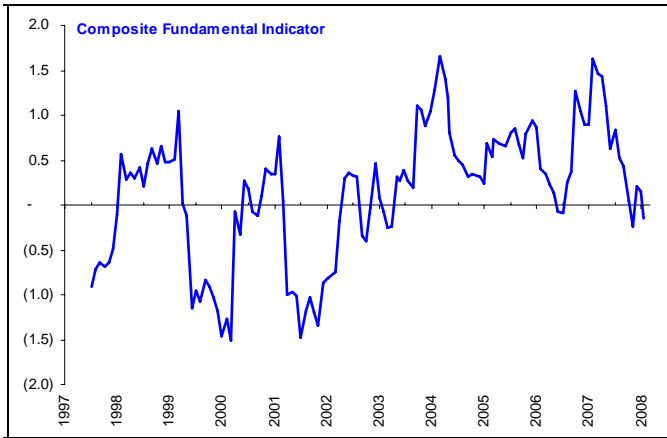
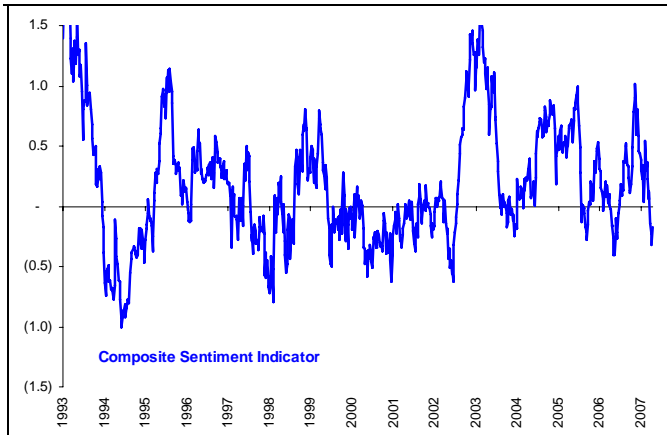


Exhibit 2  
**Sentiment Purged**



Sources for all Exhibits: SEBI, BSE, NSE, AMFI, Bloomberg, ASA, FactSet, MSCI, Morgan Stanley Research

Exhibit 3  
**VaR in Buy Zone**

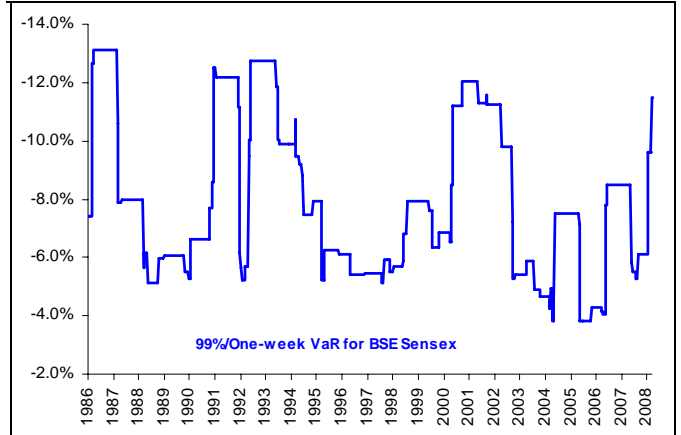
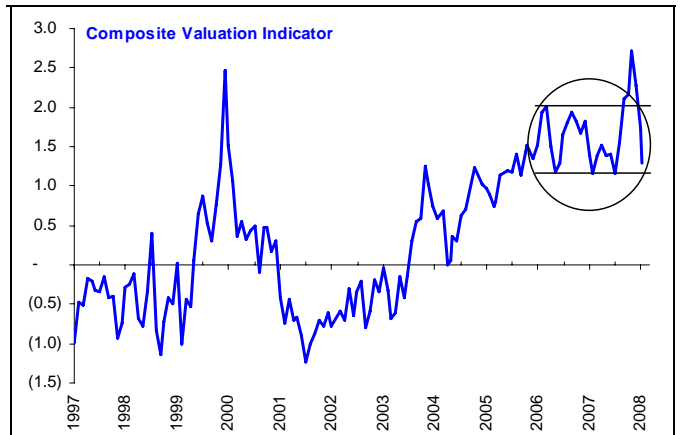


Exhibit 4  
**Market Sitting on Critical Support Levels**



Exhibit 5  
**Valuations Approaching Low End of Three-Year Trading Range**





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| Stock Rating Category    | Coverage Universe |            | Investment Banking Clients (IBC) |            |                      |
|--------------------------|-------------------|------------|----------------------------------|------------|----------------------|
|                          | Count             | % of Total | Count                            | Total IBC  | % of Rating Category |
| <b>Overweight/Buy</b>    | <b>1039</b>       | <b>44%</b> | <b>322</b>                       | <b>45%</b> | <b>31%</b>           |
| <b>Equal-weight/Hold</b> | <b>974</b>        | <b>41%</b> | <b>300</b>                       | <b>42%</b> | <b>31%</b>           |
| <b>Underweight/Sell</b>  | <b>356</b>        | <b>15%</b> | <b>100</b>                       | <b>14%</b> | <b>28%</b>           |
| <b>Total</b>             | <b>2,369</b>      |            | <b>722</b>                       |            |                      |

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March 17, 2008  
India Strategy

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March 17, 2008

India Strategy

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