More than our fair share of pain

We believe that the concerns over the Indian equity market are being overdone

- We believe that the concerns over the Indian equity market are being overdone. We believe that the worst is over for our market.
- While the correction in our market as well as in the other equity and commodity markets across the emerging economies happened because of the fear that the US Federal Reserve (Fed) may continue to hike the Fed rate, we believe that the rate hike has already been discounted by market players.
- Consequently any pause taken by the Fed in the rate hike exercise will be a big positive for them.
- To be on the safer side, we prefer to take exposure to large-cap stocks rather than mid-cap and small-cap ones. With a good run-up in the prices of the mid-cap and small-cap stocks, the gap between the valuation of the CNX Mid-cap 200 and the Sensex has narrowed down significantly over the last two years.

Expectation of another Fed rate hike takes its toll

The heading of our last ValueLine editorial said "Strong earnings but watch for unpredictables" and the market's movements in the following month certainly were unpredictable! In our view, the two key determinants of the market direction over the next few months are going to be (1) earnings and (2) the Fed. While the earnings growth and the macro-economic data remain robust (more on that later), the changing expectations on the US interest rates have been affecting all the emerging markets. While the fall was exacerbated in India's case because of the huge build-up of leveraged positions, the other emerging markets across the world fell on the interest rate concern.

As explained in our earlier notes, volatility is higher now because we are approaching a point of inflection—earlier anyone could predict what the Fed would do since it was raising rates by 25 basis points in each meeting (as happened in the last 16 meetings) but now we have reached the point where opinion is sharply divided on whether the 29th June Fed meeting would result in a rate hike or not. The Fed itself said that it would look at the economic data of the May-June period before firming up its view. To quote the Fed: "*The Committee judges that some further policy firming may yet be needed to address inflation risks but emphasises that the extent and timing of* ***any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information***." Thus we are now in a situation where the markets are reacting wildly to each piece of data and trying to look for clues to growth, inflation and interest rates. This is best reflected in the Fed future rate for July which has swung between 30% chance and 80% chance of a rate hike in the last 20 days.

Correction overdone, India suffers more than its fair share of pain

While there is no doubt that the Indian market's behaviour in early May was unsustainable, we feel the froth has been squeezed out and the correction was overdone. Our reasons are as follows.

- We believe that the Indian equity market has had more than its share of pain compared with its peers as the BSE Sensex has corrected much more than the other such emerging market indices. India, which at its peak was outperforming the other markets, had fallen far more than most other emerging equity markets and global commodity markets by June 1, 2006.
- India's share in *foreign institutional investor (FII) outflows* among the emerging Asian markets has been much more than that of its peers.
- The concerns over the Fed rate hike now seem to be very much discounted as can be seen from the increase in the US Fed futures rate. By June 1, the Fed future was implying an 80% probability of a hike which means that the markets had almost fully factored in that there would be a rate hike.
- The recent data on US economy has been benign. Our expectation as discussed earlier remains that a slow-down in the US housing sector would cause a soft landing for US economic growth. A pause in the rate hike by the

Fed would be a positive for the emerging markets (see the chart named "Fed rate hike—a pause, sooner the better" below).

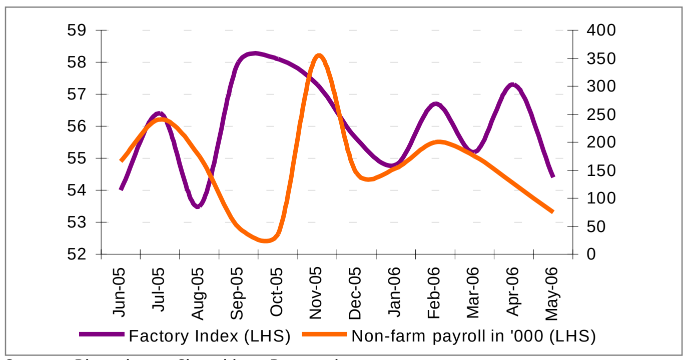
- According to our analysis, rumours of huge redemption in India-dedicated funds (from Japan and elsewhere) are untrue. The data shows that as of end of May, adjusted for the currencies and prices, the assets under management in these funds are at similar levels as at end April.
- Meanwhile, the much talked about Indian growth story remains intact with strong growth in gross domestic product as well corporate earnings.
- After the correction the market's valuation has reached attractive levels at 14.3x FY2007E earnings. On June 1, 2006, at the level of 10,071, the Sensex' valuation was virtually at the bottom of 13.8x its one-year forward earnings.
- To be on the safer side, we prefer to take exposure to large-cap stocks rather than mid-cap and small-cap stocks. With a good run-up in the prices of the mid-cap and small-cap stocks, the gap between the valuation of the CNX Mid-cap 200 and the Sensex has narrowed down considerably over the last two years.

Latest data on US economy shows benign picture

The latest data on the US economy presents a benign picture of the economy. The manufacturing growth slowed down last month and construction spending fell for the first time in almost a year, as indicated by the Factory Index released by the Institute for Supply Management (ISM), US.

Latest US economic data benign

- Residential building sales dropped 1.1% in April 2006, the biggest decrease since January 2004.
- Pending home sales slid 3.7% in April, the third straight decline.
- The non-farm sector added just 75,000 new jobs in May 2006, the lowest since November 2005.
- The ISM Manufacturing Index slowed down for May 2006.
- The number of jobless claims has also increased over March-May 2006.



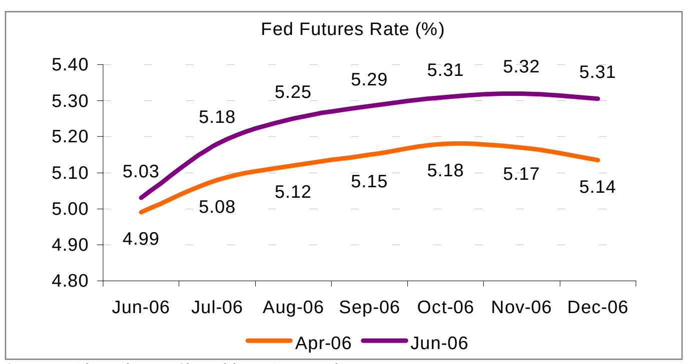
Source: Bloomberg, Sharekhan Research

...whereas the worst seems to have been discounted

We believe that at least one more hike in the Fed rate has already been fully discounted in the commodity and equity markets as is reflected in the upward shift in the Fed futures rates. In case the Fed decides to take a pause in the rate hike exercise, it will have a positive impact on the equity markets of the emerging countries.

Fed futures rate has discounted one rate hike

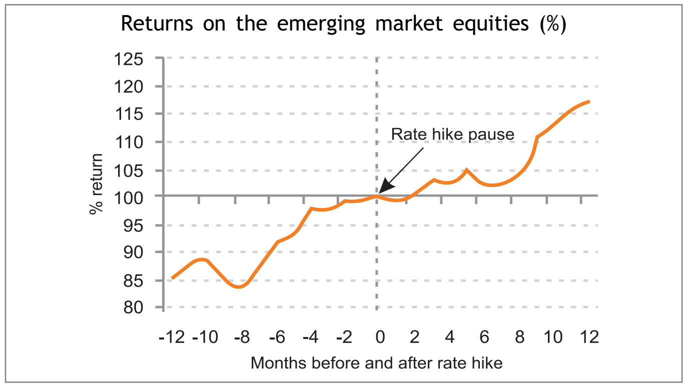
- Fed futures for August 2006 and November 2006 are quoting at yields of 5.25% and 5.32% respectively.
- The market has fully discounted one rate hike while being unsure about the second one.



Source: Bloomberg, Sharekhan Research

Fed rate hike—a pause, sooner the better

- There have been ten instances of a rate hike exercise by the Fed over the last 45 years.
- In the instances when the US Fed rate hike was not followed by recession, the emerging markets performed even better.



Source: Bloomberg, Sharekhan Research

India has had more than its fair share of pain

We believe that the concerns over India, as reflected in the steep correction in its benchmark indices, have been overdone for two reasons as mentioned below.

Correction overdone for two reasons

- The correction in the Indian benchmark indices has been much more than that in the peer indices in the other emerging markets and even more than that in the various commodities like aluminium, copper, zinc and gold.
- *India's share in the FII money outflow has also been much more than that of its peers:* Of the total net selling of US$7.4 billion of equity by the FIIs in the emerging Asian markets, nearly US$1.9 happened in India.
- Despite such huge selling, the FIIs are net buyers of US$2.2 billion of Indian equity in YTD CY2006—nearly one-fourth of net equity investments made by the FIIs in the emerging Asian markets.

Markets correct across the globe

Countrys	Index level		% change
	June 01,2006	May 10, 2006	
Hong Kong	15,912.7	17,080.6	-6.8
Korea	1,309.0	1,451.1	-9.8
Taiwan	6,959.6	7,324.7	-5.0
India	10,451.3	12,612.4	-17.1
Malaysia	930.7	966.6	-3.7
Philippines	2,304.2	2,529.5	-8.9
Indonesia	1,347.7	1,539.4	-12.5
Thailand	722.6	784.3	-7.9
Mexico	19128.63	21781.07	-12.2
Brazil	37748.3	41751.5	-9.6

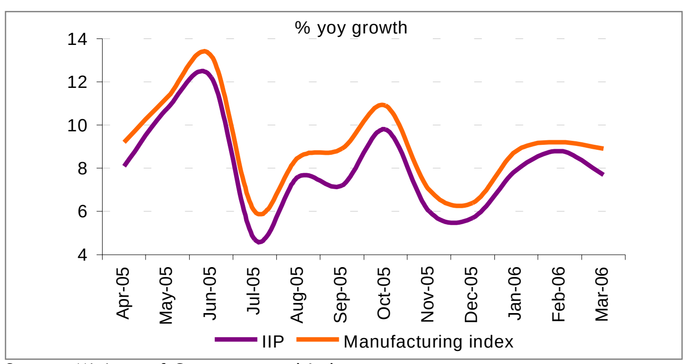
Source: Bloomberg, Sharekhan Research

Economic indicators—strong growth continues

We have frequently mentioned that the Indian economy was taking a breather during the period November-December 2005 and that we expected it to bounce back in the last quarter of FY2006. The recent economic data vindicates our view. The Index of Industrial Production has grown by 8.1% in Q4FY2006 compared with a growth of 7.1% and 6.5% in the previous two quarters. The manufacturing sector grew by 9% for the same quarter compared with a growth of 8.1% and 7.8% in the previous two quarters. We expect the growth to continue in April 2006 as is indicated by the leading indicators like electricity production and sales of motorcycles, commercial vehicles and cement dispatches.

IIP sparkles with manufacturing sector's strong growth

- Economic growth subdued during second and third quarters of FY2006 due to natural calamities.
- Growth bounced back in Q4FY2006 as anticipated by us.



Source: Ministry of Commerce and Industry

Leading indicators reflect strong growth for April 2006

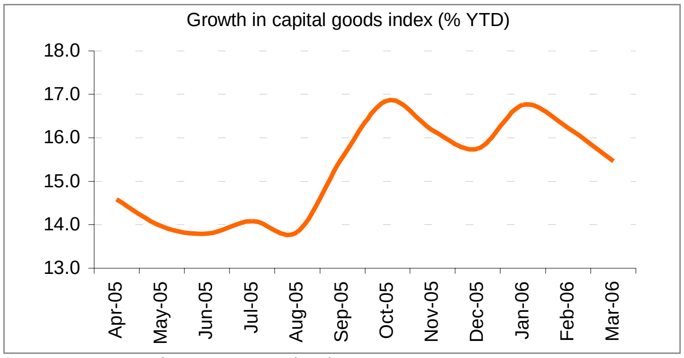
- Strong growth expected in April 2006 as is indicated by the upswing in the consumption of commercial vehicles, motorcycles, cement and production of coal and electricity.

Indicator	% growth				Trend
	Jan-06	Feb-06	Mar-06	Apr-06	
Cement	14.3	15.8	15.4	10.2	Up
Commercial vehicles	13.8	18.1	23.4	63.6	Up
Motorcycles	15.3	17.6	21.3	18.2	Up
Coal	10.5	9.3	7.2	3.4	Down
Electricity	5.8	9.0	3.2	5.6	Flat

Source: CMIE, Sharekhan Research

Underlying capex theme going strong

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



Source: Ministry of commerce and industry

Growth story remains intact—Sensex' valuation has corrected by 17%

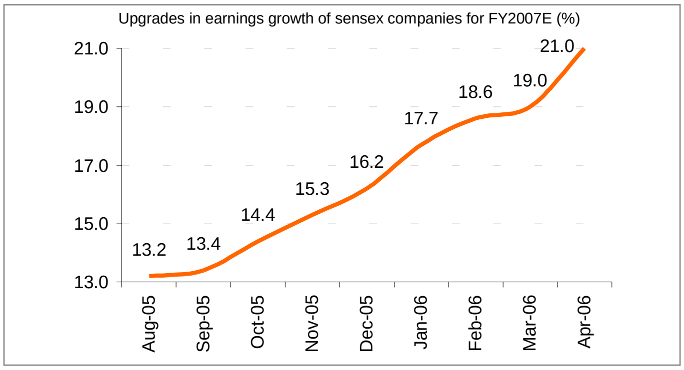
We have been mentioning that although the earnings momentum of the Sensex has slowed down a bit, yet the same appears strong when compared with that of its peers in Asia as well as in the other emerging markets like Brazil and Mexico. The growth in the earnings of the Sensex companies for FY2007E is likely to be strong at 21% while that for FY2008E is likely to be at 11.5%.

The earnings of the Sensex companies for the quarter ended March 2006 grew by 23.4% year on year (yoy) and by 21.3% quarter on quarter (qoq) compared with the expectations of an 18.9% growth yoy and a 16.8% growth qoq.

The Sensex' valuation has corrected by over 17% over the last two months (from 12,310.7 at the end of April 2006 to 10,204 in June 2006) to 14.2x its 12-month forward earnings, which is now near its ten-year average.

FY2007E EPS growth stands at 21.0%

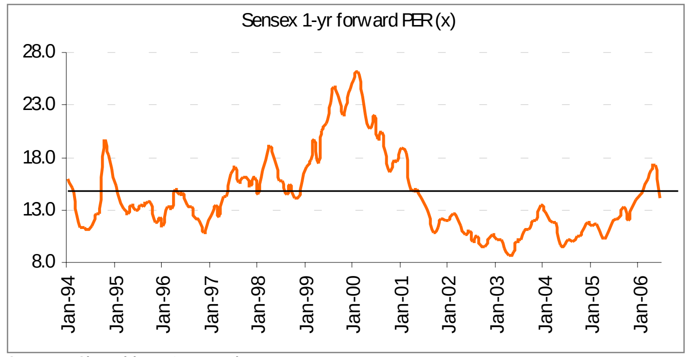
- The growth in the earnings of the companies constituting the Sensex stands at a strong 21% for FY2007E.
- The growth for FY2008E stands at 11%.



Source: Bloomberg

One-year forward PER (x)

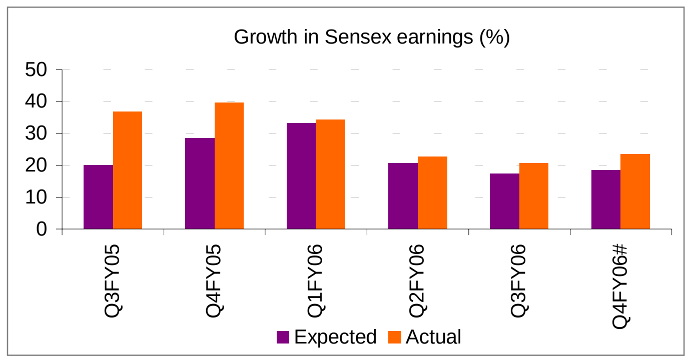
- The Sensex has usually traded between 12x and 16x its one-year forward price/earnings ratio (PER) over the last ten years.
- At 14.2x its FY2007E EPS the Sensex' valuation has corrected by over 17% from its peak.



Source: Sharekhan Research

Strong growth in Q4FY2006 earnings

- The earnings of the Sensex companies have grown by 23.4% yoy in Q4FY2006.
- The expected growth was 18.9% yoy.



for 28 companies that have declared results

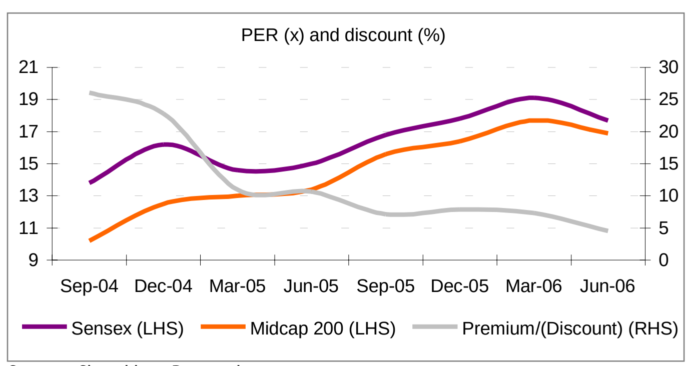
Source: Sharekhan Research

We prefer large caps over small caps for a while

To be on the safer side, we prefer to take exposure to large-cap stocks rather than the mid-cap and small-cap stocks. With a good run-up in the prices of the mid-cap and small-cap stocks, the gap between the valuation of the CNX Mid-cap 200 and the Sensex has narrowed down considerably over the last two years.

Discount in the valuations narrowing—we prefer large caps

- While the discount between the trailing twelve-month PER of the CNX Mid-cap 200 and that of the Sensex was as high as 24% in June 2004 and 10.7% in June 2005, it has almost flattened out now at the beginning of June 2006.



Source: Sharekhan Research