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Déjà Vu? 2003 All Over Again

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Déjà Vu? 2003 All Over Again!

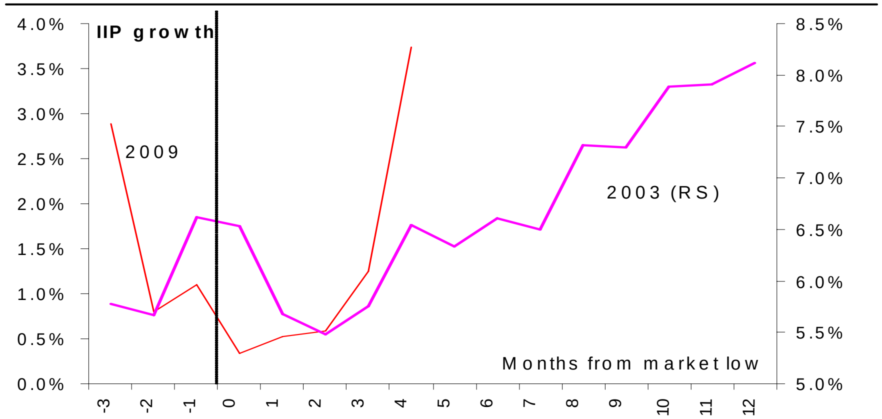
- **The 2003 story**: The market's behavior since its bottom in March 2009 is reminiscent of how it behaved post its bottom in April 2003. Back in 2003, the economy was coming out of a growth slowdown led by both global and local factors (drought). Valuations had hit a low point of the cycle and the markets rallied hard on the back of liquidity. Central banks around the world, including India, had put substantially liquidity in the markets to revive growth. This liquidity drove asset markets higher. Very quickly, valuations rose 50% from the lows and the market started to appear expensive. However, a growth recovery meant that earnings revisions were strong. Thus, despite rich valuations, the market sustained its performance in 2004 and beyond.

- **2009 reminiscent of 2003**: We see a similar pattern this time around. Valuations hit a cycle low point in March 2009. Liquidity was sloshing in the system consequent to fiscal and monetary stimulus post the financial crisis of 2008. Stocks have surged with the narrow indices rising 85% from the low. Valuations have also risen 65% from the low point. Earnings revisions have also heaved as the growth outlook has improved. Investors have become concerned that the market is pricing in all the growth that is coming over the next 12 months, and that authorities will retract some of the stimulus from the system. The fears of a drought-led slowdown in growth has not helped. These factors are causing stocks to be extremely volatile. However, an outcome similar to 2003 should not be ruled out, i.e., the market could close 2009 on a strong note. Indeed, if at all, liquidity (both flows and economic measures) appears to be more forceful than in 2003, even though valuations are higher. The jury is still out on the vigor of the growth recovery and, in part, that will determine how much pace this market recovery gathers beyond 2009.

- **Heightened volatility calls for "buy on dips and hold" strategy**: As we pointed out last week (see *Market Uptrend Intact*, August 13), we reckon that earnings momentum will continue to stay positive (the lack of rainfall will have a lesser-than-expected impact on the industrial economy), liquidity continues to be strong and even though various technical and sentiment indicators are moving in opposite directions, the market is likely to make positive progress in the months ahead. Key catalysts could be reforms and infrastructure spending, although investors should be prepared for heightened volatility, which could make trading a less-rewarding strategy compared to "buy on dips and hold". The experience of 2003 suggests that cyclical sectors and the broad market will likely continue to beat defensive sectors and the narrow market, respectively.

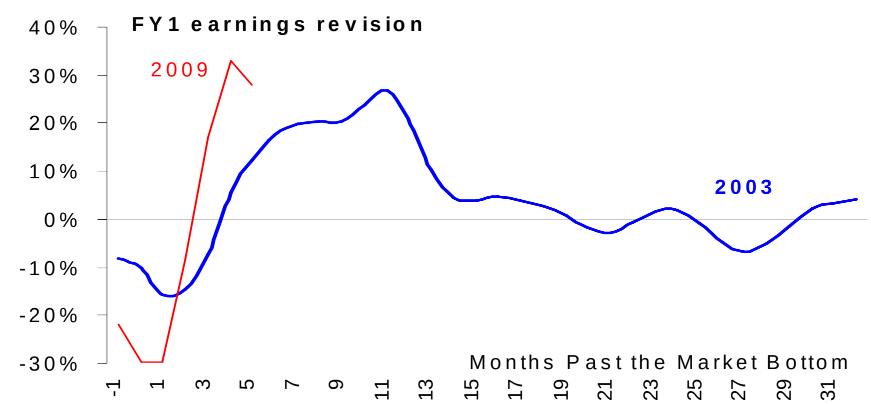
2003 vs. 2009: Fundamentals Tracking a Similar Path

Industrial Growth Lagged the Market Bottom but Picked Pace in 2003 & Likely to Repeat Pattern in 2009

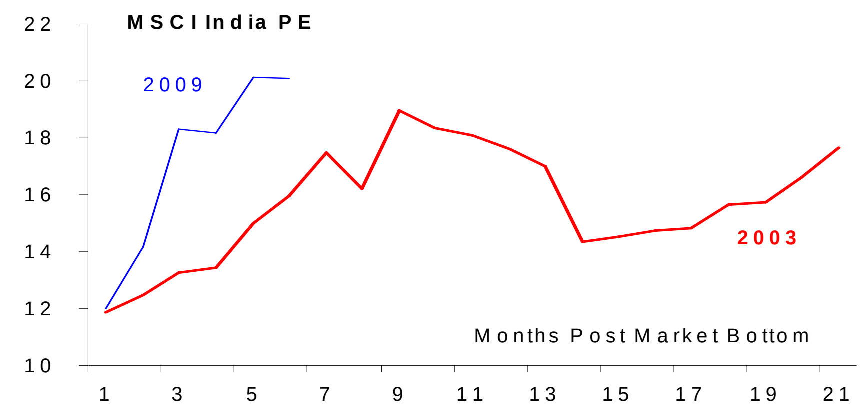


- While industrial growth trailed the market bottom in 2003, the subsequent recovery was sharp. We are expecting a similar growth path in 2009 and 2010 (notwithstanding the drought). Earnings revisions followed the growth recovery and, if 2003 is an indicator, we believe investors should expect further upward revision in earnings. Valuations in 2009 seem to be ahead of 2003 even though the starting point was the same in both years.

Earnings Revisions: 2009 Tracking 2003, More Upward Revisions Possible



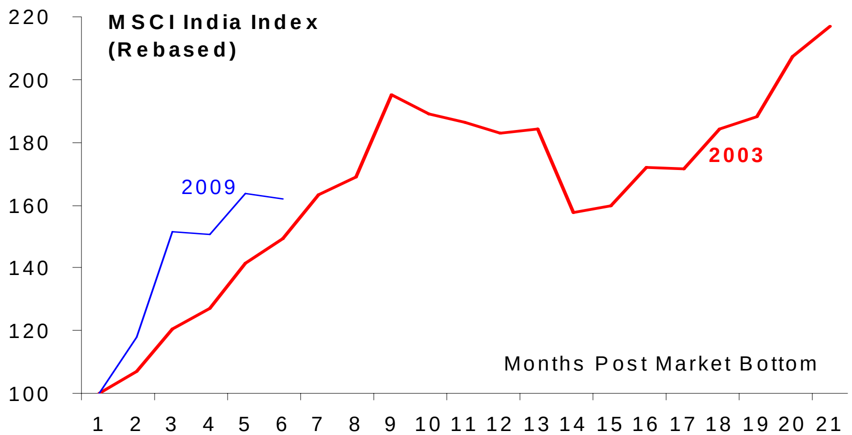
Valuations: Starting Point the Same in 2003 and 2009



Source: FactSet, MSCI, Bloomberg, CSO, Morgan Stanley Research

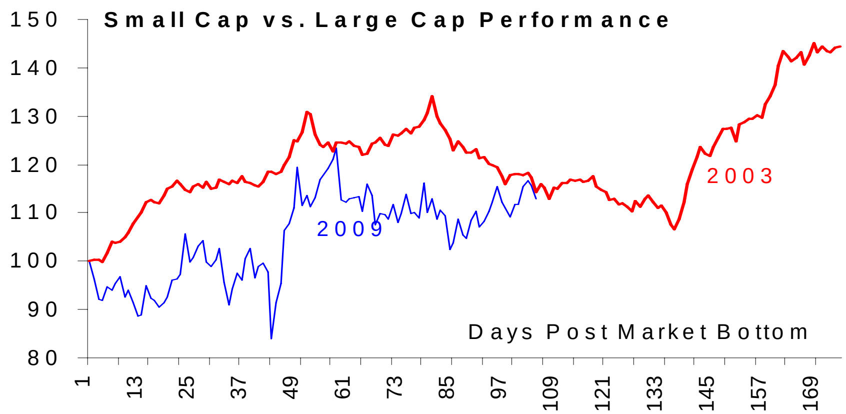
Market Performance 2009 = 2003

2003 vs. 2009: Market Performance Not Very Different



- The market performance in 2009 seems to be tracking what we experienced in 2003. The broad market likewise is outperforming the narrow market, as it did in 2003. Even at the sector level, broadly speaking, the patterns are being repeated with cyclicals outperforming defensives. If we use 2003 as a guide, sector performance is likely to continue to favor cyclicals over defensives over the coming months.

Broad Market Outperforms Narrow Market



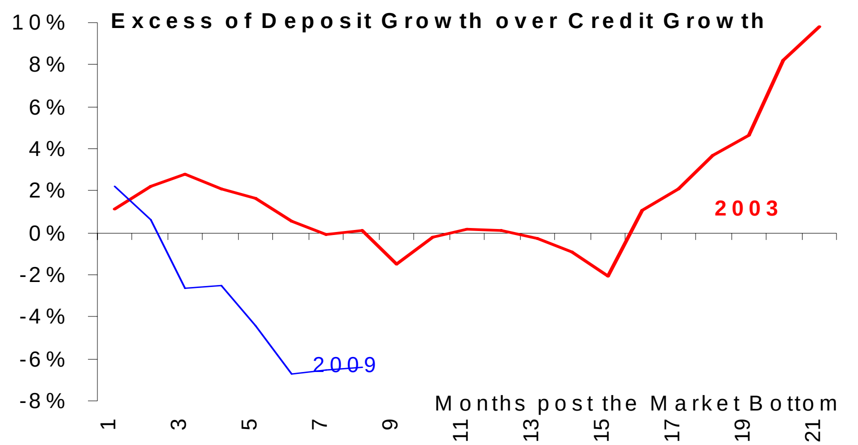
2003 vs. 2009: Similarities in Sector Performance

First 5½ Months From Market Bottom	Performance in 2003		Performance in 2009	
Consumer Discretionary	56%	1	83%	4
Consumer Staples	25%	10	11%	10
Energy	46%	4	56%	6
Financials	42%	7	94%	3
Health Care	45%	5	50%	7
Industrials	53%	3	103%	2
Information Technology	39%	8	77%	5
Materials	56%	2	132%	1
Telecommunications Services	43%	6	50%	8
Utilities	37%	9	48%	9

Source: FactSet, MSCI, Bloomberg, Morgan Stanley Research

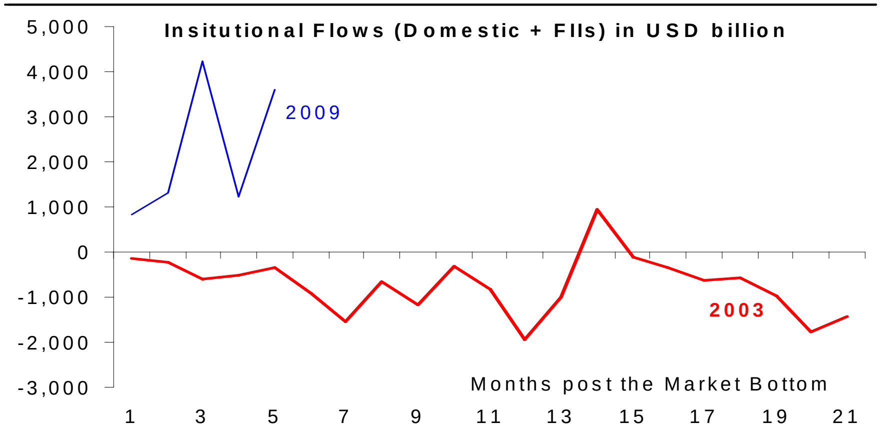
Liquidity, the Market's Lifeline, Seems Stronger in 2009

Commercial Banks Appear to Be More Liquid in 2009

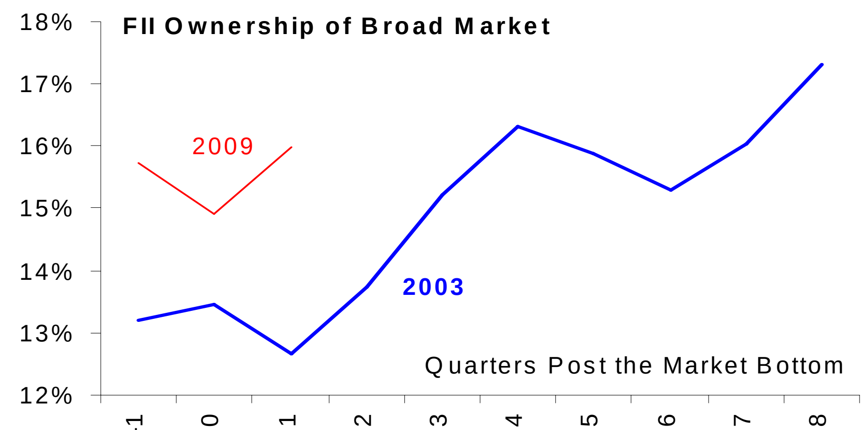


- The bull market of 2003 started with a low point in valuations backed by powerful liquidity conditions. Ultimately growth recovered and the bull market gathered significant pace. The market recovery in 2009 has also started with a low point in valuations and forceful liquidity. Indeed, liquidity metrics appear to be stronger in 2009 (not surprising given the response from authorities to the financial crisis in 2008). The jury is still out on the vigor of the growth recovery and, in part, that will determine how much pace this market recovery gathers beyond 2009.

Institutional Flows Appear Stronger in 2009



FII Ownership is Starting at Higher Point in 2009



Source: FactSet, MSCI, Bloomberg, RBI, SEBI, BSE, NSE, AMFI , ASA, Morgan Stanley Research

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