2013: The World Has Not Come To An End…Now What?

'2012: The World Is Not Coming To An End…' was predicted by us on January 2, 2012 in our strategy note carrying this title. Of course, at the outset, we must confess that the Mayan Calendar was not on our minds. However, on this first trading day of 2012, what was on our minds and what we fairly understood was that at ~11x FY2014E earnings, the Indian stockmarket had little downside and the risk-reward was in favour of medium-to-long-term investors. *(Please do refer RSec Research performance on page No. 8)*

It is in this context that we were optimistic about Indian equities, leading to our conclusion, *"Well it is certainly not the end of bad news; however, we believe that the efforts at overcoming the bad news will increase, which will be taken positively by the market. And considering that the markets have a tendency to react, to trend reversals in anticipation of one materializing, at least 4-6 months in advance (remember markets are forward looking), 2012 is expected to be a year of positive returns for Indian equities."*

The Sensex has surged a noticeable 26% in 2012! Again, we are not entirely surprised because (temporarily leaving aside the fundamental valuation aspect) we had noted in our strategy note, *"What also goes in favour of investing at the current juncture is the fact that while the Sensex has lost 8 times on a calendar year basis in the past 33 years (excluding 2011), the "average returns" in the immediate following year has been over 20%!"* **In hindsight, the trend probability has stood true.**

Thus, while we have survived to celebrate the dawn of 2013 as the world did not come to an end (for equity investors also), now what? Will 2013 be a good year again for Indian equities?

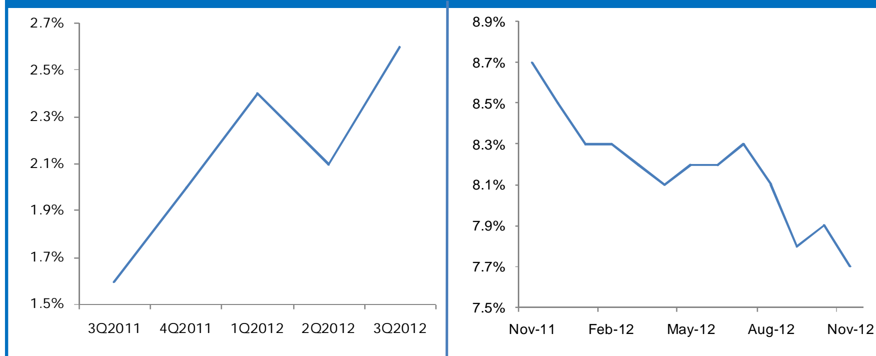
We again look at a set of Q&A (definitely not exhaustive) where we try to throw some light on a few of the many issues that are important from an equity investors' investment point of view.

Head – Research: Hitesh Agrawal
hitesh.agrawal@rcap.co.in

Has there been any improvement in the global macro-economic environment over the past 1 year?

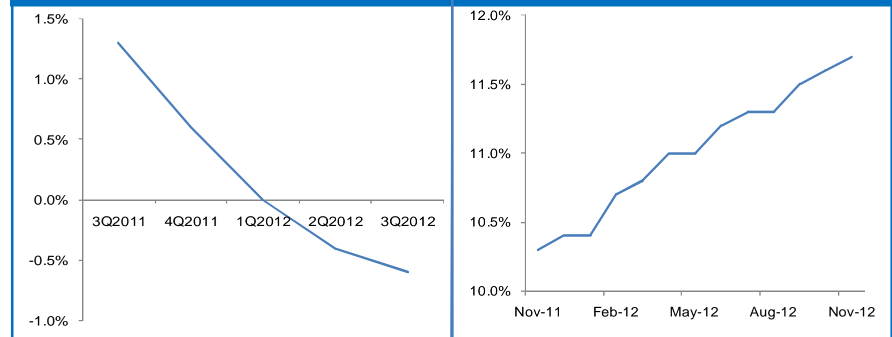
The answer to the above is Yes and No, as it pertains to two major regions that dictate trade and capital flows across the globe. Thus, while there have been signs of stability and mild improvement in the health of the US economy, as has also been acknowledged by the US Federal Reserve, as well as revealed periodically by various data points (higher jobs creation, lower unemployment rate, encouraging housing data, improving GDP growth); the Eurozone continues to face the slowdown heat (recessionary-to-negligible GDP growth, rising unemployment rate, very high debt-to-GDP and deficits).

Exhibit 1: US GDP growth (LHS) & Unemployment rate



Considering this, it is not difficult to conclude that the world is not out of the woods as yet, chiefly owing to the possibility of a contagion effect of events in one region on another like that of a nation exiting from the Eurozone, further country ratings downgrades, failed implementation of austerity measures leading to lower than expected reduction in deficits, etc. Further, the one big immediate challenge is the US$600bn US fiscal cliff issue, which has overshadowed all other economic challenges for the time being.

Exhibit 2: EU-17 GDP growth (LHS) & Unemployment rate



Despite the murky global/domestic economic environment/outlook, equities managed a splendid performance across most markets?

True. If we consider the year to date returns of the stockmarket indices across regions, most of them in no way depict the current economic scenario of these economies. Thus, while the 5-15% rise in US indices in 2012 has come about despite only a tepid economic recovery, the 5-30% gains across the Eurozone markets have been witnessed despite deteriorating economic conditions of the region as a whole. Similarly, the 5-30% surge witnessed across the Asian pack too cannot be traced to actual concrete improvement in economic data points as of now. However, these gains are a reflection of the bottoming out of the economies at this point of time and the expectations of the sustenance of the same well into 2013. Thus, this trend does not worry us as this is typical stockmarket behaviour as it tries to make a qualified guess (and factor in) the economic scenario that is likely to unfold in the coming quarters.

Exhibit 3: Global indices in 2012; India outperforms

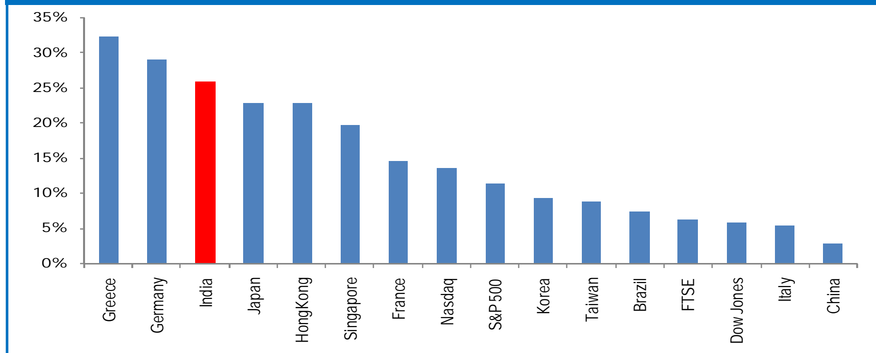
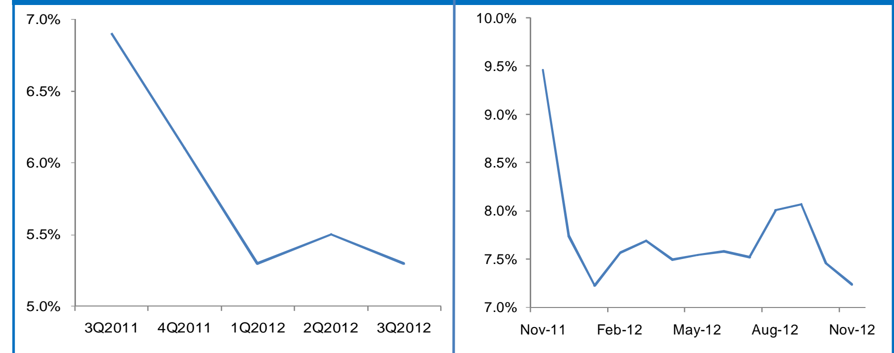


Exhibit 4: India GDP growth (LHS) & Inflation rate



So, is the Indian economy expected to recover in 2013 from the near-5% growth rates?

While the global challenges are far too many even at the current juncture and the resolution of those will take a lot more time, the domestic macro-economic environment in the meanwhile also deteriorated during 2012 against expectations. Our premise of some stability/recovery in the domestic GDP in 2012 was based on a lower inflation trajectory leading to reversal of interest rate cycle. However, admittedly, none of it materialized last year, chiefly because of sustained high inflation. Consequently, the health of the domestic economy worsened and with little support coming from the government corridors in terms of policy action and/or reforms initiatives, the Indian GDP printed a 5.3% growth rate for the 1st and 3rd quarters of 2012 (almost decade lows). However, the final quarter of 2012 did see the government come out of its long comatose with appreciable actions, the impact of which will be seen in the coming quarters.

At the risk of sounding repetitive, it must be noted that India is not in a structural downturn and is passing through a cyclical down phase only. Thus, while the domestic economic growth trajectory may not have charted out as per the market liking in 2012, there are signs that the Indian economy will finally see its head above the 6% growth mark in 2013.

To begin with, the government has initiated the reforms process in the last quarter of 2012, which has sent the right signals to the global investor community about India's intentions of attracting capital to support and spur domestic growth. Further, conscious of its fiscal challenges, the government has resorted to non-populist measures pertaining to diesel pricing and subsidized LPG usage. Disinvestments have also been kick-started to manage the fiscal gap. And, going by the indications from the government, more reform measures and fiscal managing steps are on the anvil, which may have short-term repercussions but the medium-to-long-term impact on the Indian economy will be highly positive.

Exhibit 5: Government 'inaction' turns to Government 'in action'

- 51% FDI in Multi-brand Retail
- 49% FDI in Aviation
- 49% FDI in Insurance
- 26% FDI in Pension
- FDI in broadcasting services sector raised from 49% to 74%
- Withholding tax reduced from 20% to 5% on interest income for foreign investors
- State Electricity Board (SEB) restructuring
- Diesel price hike by Rs5/litre
- Subsidized LPG usage capped at 6/year
- Disinvestment back on track
- Direct cash-transfer scheme approved
- The Banking Laws (Amendment) Bill, 2011 passed by Parliament
- The Companies Bill, 2011 passed by Parliament
- Cabinet Committee on Investment (CCI) approved to accelerate investment projects approvals

Will the RBIs monetary policy lend support to domestic economic recovery in 2013?

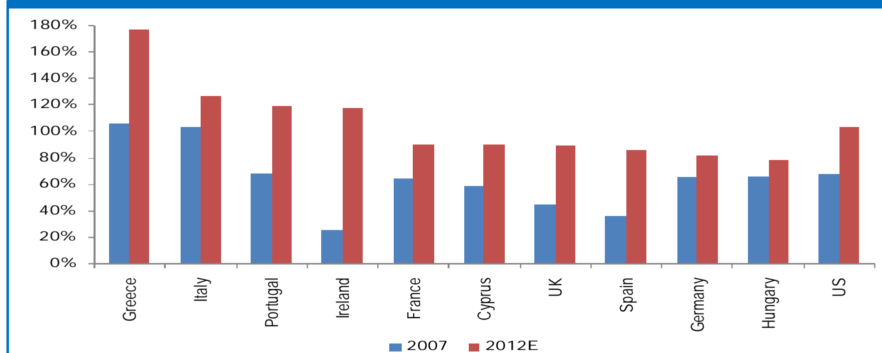
The RBI in its December 2012 Monetary Policy seemingly presented a case again for a repo rate cut soon. Going by the excerpts from the policy press release, with faster than anticipated pace of moderation in wholesale price inflation and acknowledgement of the fact that the monetary policy has to increasingly shift focus and respond to threats to growth from this point onwards (with the risk to inflation caveat), the probability of a repo rate cut remains high.

Notably, while the RBI had made an attempt in April 2012 (along expected lines) at cutting interest rates, sustained high inflation coupled with government inaction to mend economic situation restricted it from taking any further action. Nonetheless, going into 2013, with relatively tempered expectations of a sharp reversal in inflation and consequently interest rates, we believe that the RBI will come to the rescue of the economy, as inflation is also expected to veer towards the 6% mark in 2013. This will comfort the RBI to lower interest rates, which could be to the tune of 100-125bps depending upon the cool-off in inflation trajectory.

What global/local indicators must be watched out for in 2013 that will dictate Indian stockmarket trend?

As expected, the world last year witnessed continued support from the US Fed, the ECB, the IMF and the European governments in the form of various liquidity infusion programs like LTRO2, Outright Monetary Transactions (OMT), European Stability Mechanism (ESM), etc. Further, strict austerity plans were negotiated with countries like Greece, which have very high budget deficit and high debt-to-GDP ratio. It is precisely these fronts that the action is expected to remain centered around even in 2013. Thus, a close watch on how the austerity implementations and the consequent reduction in debt-to-GDP of most of the EU-27 countries pans out will be critical for stability in the Eurozone. Further, the Parliamentary elections in Italy and Germany in 2013 will also be on investors' radar.

Exhibit 6: Eurozone debt-to-GDP alarming; US no different



Apart from the Eurozone, the other grey area is the US. While the US economic recovery continues to remain fragile, the US fiscal cliff issue is the next big challenge, which if not resolved in an optimum fashion, will torpedo any hopes of further strengthening of the US economy and could rather push it into a mild recession in 2013 and affect global growth.

In the case of India, the Government springing into action during 4QCY2012 has raised lot of hopes amongst market participants that the reforms ball is finally rolling and will continue to achieve new landmarks along the way. Further, with 2014 being the general election year, the UPA-2 would aim at rechristening the coalition ruling party to UPA-3 by scoring a victory for which the efforts are expected to begin from the Budget this year itself. In this context, government largesse towards social schemes and its consequent impact on government finances and domestic currency will be under lens.

Apart from this, the RBI is expected to hog considerable limelight in 2013 for the frequency and magnitude of interest rate cuts that could come through over the next 12 months. Further, business commentary by the captains of the Indian industry during earnings seasons (especially in 1HCY2013) will attract particular attention as it would corroborate/contradict the consumption/investment uptick that is expected in the Indian economy, which in turn will have an impact on stock prices.

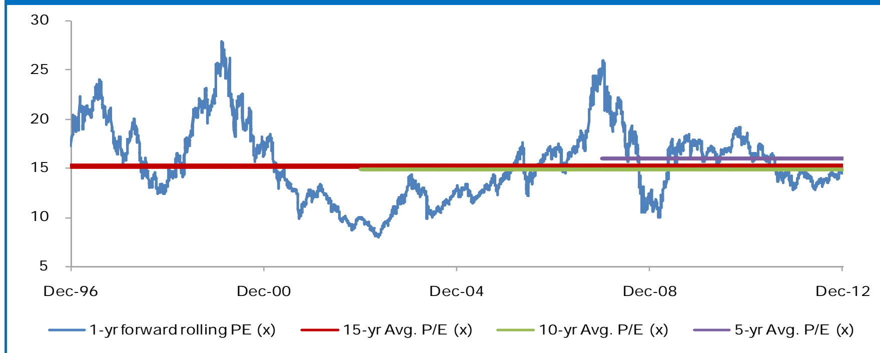
What should be the investment strategy for equity investors in 2013?

Framing a strategy when the market has already surged 26% is always a challenging proposition, especially when one is trying to gauge the outcome for the next 1-year rather than over the next 3-5 years. This is because investor sentiments can fluctuate wildly over shorter time periods but over longer time periods, understanding and stability in thought processes overshadows hasty decision making.

Nonetheless, considering that the Indian economy is expected to soon be on the recovery path, which will also lend support to India Inc. earnings growth trajectory (aptly supported by falling interest rates), Sensex valuation at ~12x FY2015E EPS does not seem demanding. Liquidity, especially global, is unlikely to dry up anytime soon considering the concerted efforts of global central banks at cushioning their faltering economies will continue if need be.

Thus, even at the current juncture, it is advisable to invest/remain invested in Indian equities. However, since the market has ended 2012 near its highs, some caution would be prudent during 1QCY2013, especially in sectors which have almost outpaced their justifiable valuation zone.

Exhibit 7: Sensex: Still time to accumulate value



What are the levels that must be borne in mind for 2013?

Fundamentally, we believe that over the next 12-months, the Sensex could witness a range of 17,500 – 23,500. Anything outside this range must be supported by commensurate improvement/deterioration in economic and earnings parameters for it to be sustained.

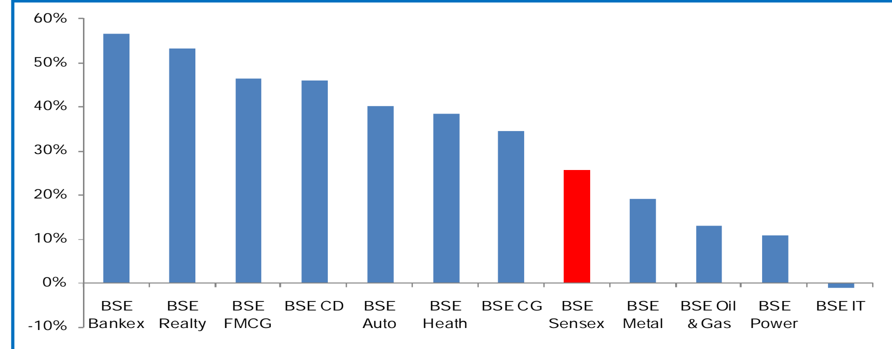
However, it is also pertinent to try and gauge the answer to the question from the technical analysis point of view. Just to bring forth our technical commentary excerpt from our New Year report last year, *"…the probability of Nifty (at 4,624) drifting lower to the 4,000-4,200 zone is likely (which never happened), where we see a high probability of the market bottoming out. However, it must be noted that this does not take into consideration any 'significant' positive announcement coming through in the interim at the global/domestic level, which has the power to reverse the trend…a Nifty close above 4,850 could ensure a trend reversal for the Indian market for the medium-term* (this happened on January 10, 2012)."

Now, for 2013, while the bullish set-up for the Nifty is already in place, stiff resistance will be observed around 6,000 and fresh momentum is expected to get triggered only above 6,300, which could take the Nifty past the 7,000 mark. In the interim, we do not rule out a dip to 5,500, which we believe will be healthy for market strength and progression.

Which are the sectors one should look forward to in 2013?

Our sectoral calls for 2012 panned out largely as per our expectations with 4 out of the 5 sectors recommended outperforming the Sensex returns (26%). Thus, while Banking (up 57%) was our top sectoral call, Automobiles (40%), Pharma (39%), FMCG (47%) and IT (-1%, the underperformer) followed.

Exhibit 8: Sectors in focus in 2012



Now, with 2013 in sight, and with such strong gains already behind us, we cannot once again say, *" At the current juncture, there is value across sectors and an investor can be really spoilt for choice."* Nonetheless, with valuations still within the comfort zone, we believe there are sectors that still offer reasonable upside over the coming quarters.

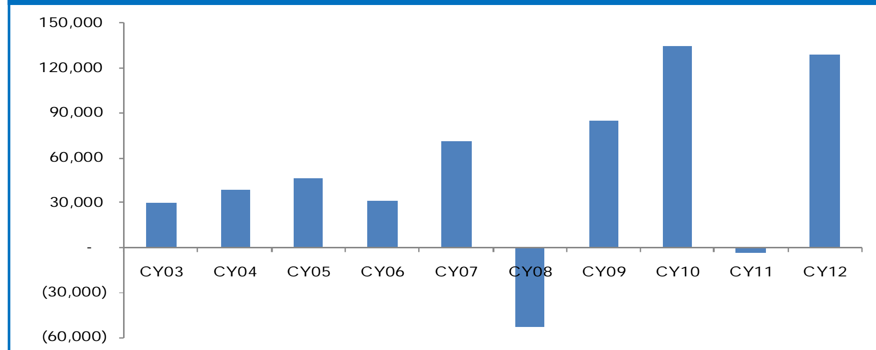
Thus, considering that the reversal of domestic interest rates cycle has been postponed to 2013, we continue to believe that interest-rate sensitive sectors like Automobiles and Banking will be on investors' radar. While we acknowledge the anticipatory gains already built into the current valuations of stocks belonging to these sectors, we still believe that the domestic consumption story, which can get additional support from a fall in interest rates, lower inflation and consequently higher disposable income, will support the growth and valuations of companies in these sectors.

Further, since we are hopeful that the deterioration in global economic parameters will subside in 2013, it should lend some support to global demand for commodities. Sustainability and/or growth of the US economy and China and Japan's efforts at reviving their economies under new leaderships could support sentiments towards commodities. Thus, the Metals & Mining sector can throw up some good investment opportunities. However, considering the high beta of the sector, the relative risks/returns associated with the sector are also high.

Also, we continue to favour investments in the Pharma sector in view of the pipeline strength and a number of drugs facing patent expiry. With USFDA related manufacturing issues of various Indian pharma companies being resolved, coupled with increased capacity utilization and higher sales in emerging markets, Indian pharma companies are expected to deliver strong performance in 2013.

Another sector which we believe could be a hopeful beneficiary (2HCY2013 onwards) of some stability in the domestic economy supported by the improvement in domestic consumption will be the Capital Goods sector.

Exhibit 9: FIIs love India…



Will 2013 be a repeat of 2012?

We believe that Indian equities will continue to attract investor attention even in 2013 as domestic economic/corporate indicators slowly and steadily start to fall in place to justify further gains. However, while 2012 may have been the second-best year (2010 was best) for FII inflows into India, since their entry into Indian capital market in 1992, with investments of over Rs1.3 lakh crore (US$24bn), 2013 may see competition for the FII pie from China in the emerging markets pack and from IPOs/FPOs/OFS within the country. Nevertheless, a 15-20% return still seems on the cards.

Happy New Year 2013!

Happy Investing!

Annexure

Key Outperforming recommendations in 2012

Company	Reco. Price	Last Target Price/CMP	Return
Cera Sanitaryware	182	395	117%
Balkrishna Inds.^	147	294	100%
Hexaware Tech.**^	73	139	90%
J&K Bank	821	1,433	75%
Yes Bank	278	440	58%
IPCA Labs.*^	328	519	58%
HCL Tech	407	638	57%
IndusInd Bank^	271	417	54%
Divi's Lab*	800	1,195	49%
ING Vysya Bank^	355	529	49%
Federal Bank	390	536	37%
Mindtree	411	558	36%
Cadila Health^	720	952	32%
Sun TV	251	329	31%
Eicher Motors	1,993	2,586	30%
HDFC Bank	490	632	29%
Emami Ltd.	398	513	29%
Maruti Suzuki^	1,161	1,490	28%
Satyam Comp.	76	97	28%

Note: Recommendations since October 2011 including upgrades
** Initiated in August 2011 ; ** Initiated in September 2011 ; ^ Calls still open*

Key Underperforming recommendations in 2012

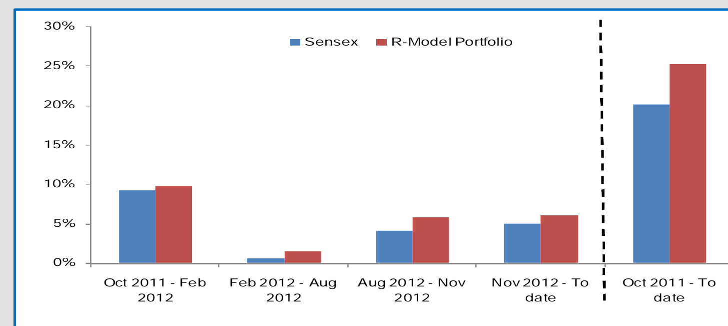
Company	Reco. Price	CMP	Return
Opto Circuits	144	107	-26%
Polaris Software	142	114	-20%
Vivimed Labs	406	341	-16%
Indian Bank	215	199	-7%
Jyoti Structures	47	45	-4%
Allahabad Bank	170	170	0%

Note: Recommendations since September 2011

R-Model Portfolio

Sector	Company	CMP*	Sensex Weightage (%)*	RSec Weightage (%)
Automobiles	Tata Motors	261	3.1	5.0
	Maruti	1,494	1.4	3.0
	Eicher Motor	2,425	-	2.0
Banking & Finance	HDFC	778	7.6	8.0
	HDFC Bank	670	8.1	8.0
	SBI	2,090	3.6	6.0
	Yes Bank	419	-	2.0
	IndusInd Bank	374	-	2.0
Capital Goods	Larsen & Toubro	1,587	5.6	6.0
FMCG	ITC	286	10.0	10.0
	Britannia Inds.	483	-	2.0
	Nestle	4,589	-	2.0
Metals & Mining	Hindalco	108	0.9	2.0
	Coal India	358	1.4	2.5
Oil & Gas	Reliance Inds.	773	8.8	9.0
	ONGC	251	3.4	4.0
Pharmaceuticals	Dr. Reddy's	1,738	1.4	2.5
	Glenmark Pharma	445	-	2.5
	IPCA	445	-	2.5
	Dishman Pharma	113	-	2.0
IT Services	Infosys Tech.	2,376	7.4	8.0
	TCS	1,288	4.8	5.0
	Wipro	366	1.4	2.0
	CMC	1,100	-	2.0

*Source: RSec Research; * BSE Data as on November 23, 2012*



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