STRATEGY

Bulls to hibernate

January 3, 2011

- ## Global economic recovery to gather pace in 2011....

  We have grown more confident of the economic recovery in western economies in 2011. The Fed's QE2 has reduced the downside risks, while extension of tax benefits has improved US' growth prospects, auguring well for rest of the world. In Europe, we expect real economy to gain traction, but intra-regional divergences will persist. In the emerging markets (EMs), recovery seems complete with output gaps closed. 2011 will see growth consolidating, with the private sector replacing public as the driver of the economy.

- ## ...but the horizon is still cloudy

  Few risks continue to linger: (1) Possible worsening of European sovereign crisis, triggering global risk aversion; (2) ultra-loose monetary stance by major central banks (putting upward pressure on domestic inflation and EM currencies), leading to restrictions on capital and trade accounts by EMs; (3) Chinese policymakers are walking a tightrope in terms of simultaneously tackling rising inflation, imbalance in the economy, moderating economic growth and cooling off property market. Getting the policy mix just right will be a tall order.

- ## India's economic expansion brisk and balanced...

  After bottoming out in March 2009, India's GDP growth is regaining its pre-crisis trajectory. In FY12, we expect private consumption to lead the economic momentum, supported by buoyant rural and urban incomes. Also, investment activity is likely to pick up gradually through the year. However, government support to the economy may wane, going forward, while agri-growth will normalise after a sharp turn-around. Widening current account deficit will be an added drag on the GDP growth. We expect real GDP to grow ~8.3% in FY12 against the projected ~8.6% in FY11.

- ## ...yet concerns are more than ever

  Indian macroeconomic scenario is marked by few risks/challenges: (1) Widening of the current account deficit and shifting nature of funding of the deficit towards non-FDI flows; (2) rising global commodity and crude oil prices, adversely affecting inflation, current account deficit and the Centre's fiscal position; (3) rising cost pressures (raw material and interest rates), posing a risk of earnings downgrades as we progress into 2011; and (4) recent instances of lapses in corporate governance have negatively impacted India's image as an investment destination.

- ## Overweight on sectors with global interface, cautious on rate-sensitive cyclicals

  We favour a defensive bias within the portfolio. We recommend focusing on low capital intensive industries with secular growth rates and industries with global interfaces, while avoiding rate sensitive cyclicals and financials. In this context, we are moving energy, metals, utilities and healthcare from equal-weight to over-weight. We are downgrading BFSI from equal-weight to under-weight and are moving both industrials and real estate from over-weight to under-weight. We remain bullish on IT and maintain our over-weight stance on the sector. We continue to remain bearish on cement and telecom.

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Global economic recovery to gather pace in 2011

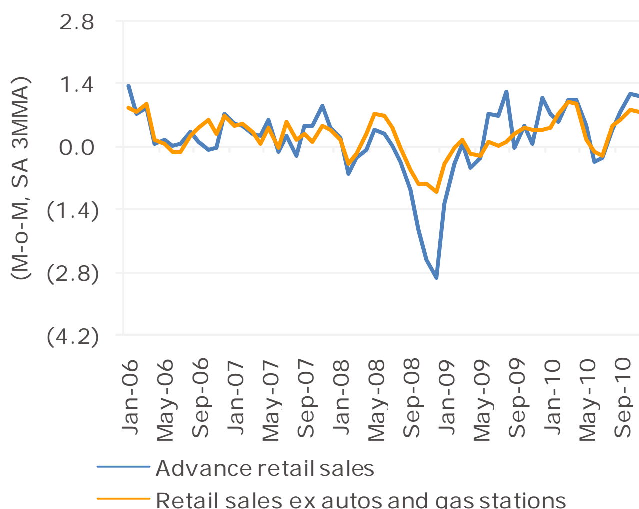
US: Growth prospects better

Retail sales, ISM manufacturing and jobless claims data point towards improving US growth

The US economy expanded 2.6% Q-o-Q (annualised) in Q3CY10, up from 1.6% in the previous quarter, but lower than 3.7% in Q1CY10. Improvement in private consumption and rise in inventories contributed strongly to the GDP growth in Q3. Fed's fresh round of quantitative easing (QE2, involving purchase of US Treasuries up to USD 600 bn) has reduced the downside risks to the economy. Further, the extension of tax cuts (which were due to expire in January 2011, and therefore could have been a huge drag on the economic recovery), along with reduction in payroll taxes, have improved the economy's outlook for 2011.

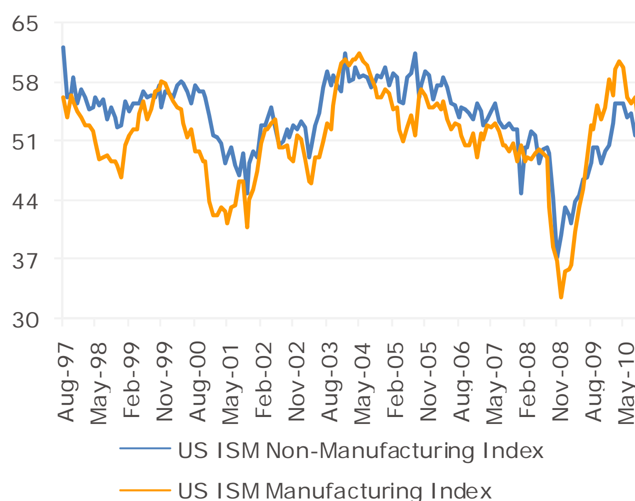
High frequency economic data show that retail sales have picked up in the recent months after a period of weakness in Q2CY10. The ISM manufacturing and non-manufacturing indices are firmly in expansion zone (above 50), indicating optimism for businesses. There has also been improvement in weekly jobless claims data, suggesting that the pace of firing by the businesses has slowed down; the pace of adding payrolls, however, remains sluggish, as reflected in the elevated unemployment rate. Meanwhile, nonfinancial businesses are showing impressive productivity gains, balance sheets remain robust, and financial market conditions are supportive, which means businesses are prepared to expand capacity as soon as excesses in the system are removed.

Chart 1: US consumer spending showing traction



Source: Bloomberg, Edelweiss research

Chart 2: Industrial activity strong too



Source: Bloomberg, Edelweiss research

Weak housing market, crude oil prices, and European concerns are risks to US recovery

However, it may be acknowledged that the recovery is still largely policy driven, as evident from the fact that fiscal and monetary stimulus has been renewed in recent months. This is largely due to the fact that the private financial corporates and households continue to pay back debt even at exceptionally low interest rates in an attempt to improve their balance sheets; secondly, the unemployment rate remains elevated at ~10%. In addition, the US housing market trends are still sluggish.

Overall, we believe that recovery is underway and extension of tax benefits will boost it further. Accordingly, growth forecasts for the US GDP growth in 2011 have been revised higher by 50-70bps, such that the economy is now expected to grow ~3% in CY11. Further, the ongoing economic recovery would pre-empt the need for another round of QE, although Fed is likely to remain ultra-accommodative until the unemployment rate begins to fall persistently. Risks to the outlook arise from: (1) the possibility of sharp

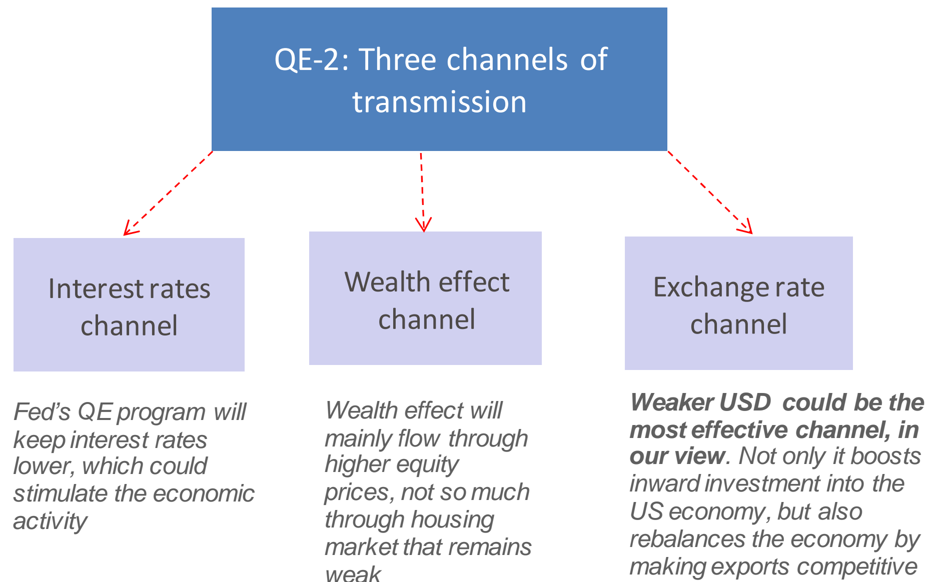
strengthening in the USD if the European sovereign contagion spreads; (2) crude prices are on continued uptrend; and (3) there is likelihood of another leg down in the US housing market, especially since mortgage rates have climbed sharply higher. It is against this backdrop, that while recovery is underway, the Fed continues to commit itself to ultra-accommodative monetary stance through its QE operations. But the effectiveness of QE-2 may be varied. We analyse various channels of transmission of Fed's QE.

Fed's QE2: How effective?

USD strengthened despite QE2 reflecting European concerns and recovering US economy

The Fed's Treasury purchase program impacts the real economy through three possible channels: (1) The interest rate channel that works by lowering borrowing costs in the economy; (2) wealth effect that impacts by raising the value of asset prices, thus stimulating spending; and (3) enhancing the export competitiveness of the economy through a weaker USD.

Fig. 1: Fed's QE and the real economy



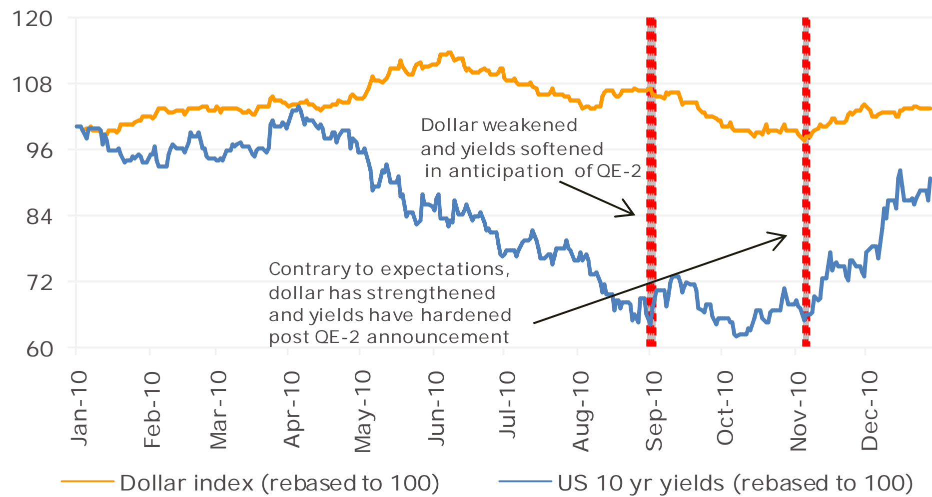
Source: Edelweiss research

Hardening in yields despite QE2 possibly also reflects improved growth prospects

After the Fed first hinted at QE2 in August 2010, the yields started falling and USD started weakening, which was largely expected. However, the weakening trend in USD reversed when QE2 was actually announced in early November, largely because Fed's QE announcement was clouded by fresh uncertainty in Europe. In other words, European problems overshadowed Fed's QE2. Further, the sharp rise in the US bond yields could be reflecting improving growth prospects of the economy, although associated rise in home mortgage rates could hurt sentiments in the US housing market.

In 2011, these two competing forces – Fed's QE2 and European sovereign problems, would continue to weigh on EUR/USD rate in opposite direction and would largely shape the global risk appetite. If the European problems remain contained, Fed's QE2 will continue to put weakening pressure on USD, while keeping the risk appetite healthy. However, if European problems flare up, global risk appetite could be hurt and USD may strengthen, despite Fed's QE program.

Chart 3: Interest rate and currency movement contrary to Fed's objective



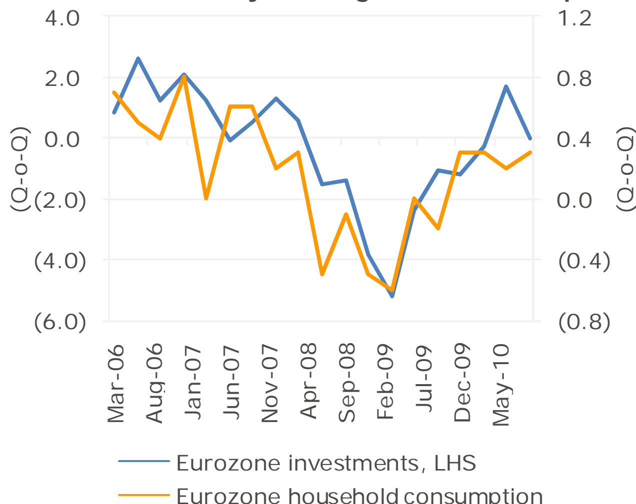
Source: Bloomberg, Edelweiss research

Europe: Core strong, periphery weak

European recovery will continue, although at an uneven pace

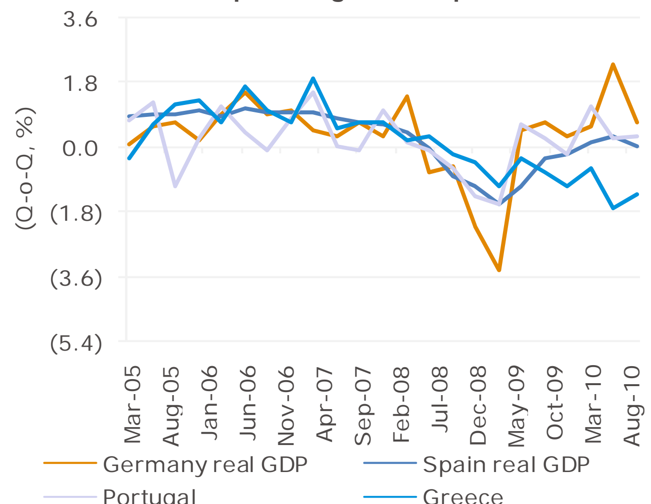
The European recovery is continuing, though at a much slower and uneven pace compared to the US. Household consumption has picked up in recent quarters, but remains at depressed levels on account of high unemployment levels, sluggish credit growth and generally uncertain financial markets environment. Meanwhile, investment activity rebounded sharply on the back of inventory re-stocking, but the trend is now petering out in many of the economies. In Q3CY10, growth in Euro zone slowed down to 0.4% Q-o-Q against 1% in the previous quarter and the trend is quite divergent within the region. Germany expanded 0.7% in Q3CY10, Spain was flat, Greece continued contracting, while Portugal and Italy slowed down. These divergences are due to the fact that German economy has remained highly competitive and largely free of excesses of a housing sector boom (unlike Spain and Ireland) or a consumption boom (like Greece) in the past 5-7 years. On the contrary, the periphery remains trapped in lack of competitiveness, high level of indebtedness and unemployment and ongoing fiscal retrenchment. This enabled the German economy to recover much faster against the periphery.

Chart 4: Real economy showing traction in Europe



Source: Bloomberg, Edelweiss research

Chart 5: Intra-Europe divergences to persist



Source: Bloomberg, Edelweiss research

Going ahead, economic momentum may continue at a gradual pace, but divergences in growth are likely to persist. In the absence exchange rate flexibility, the periphery can become competitive only through downward adjustment in nominal wages, which will be a prolonged and painful process and will keep the economic momentum among peripheral economies suppressed. Further, while healthy external demand environment in the EM and US would be supportive of European recovery (particularly that of Germany), unfavourable movements on the exchange rate front could hurt growth prospects. For example, if in response to Fed's QE2, USD embarks on a weakening trend, there would be upward pressure on all major currencies. However, in the face of upward pressure on exchange rates, Asian economies are likely to intervene in the forex market to curb currency appreciation. In such a scenario, the burden of USD weakening will fall on EUR, thereby hurting the European exports. Finally, if the European sovereign debt problems worsen, it would negatively impact the business and financial market sentiments, thereby threatening the economic recovery.

Strong EM momentum and improving US growth prospects to support European recovery

Overall, we believe that the real economy in Euro zone is showing some traction and the improving US growth prospects and strong EM economic momentum would further support the European recovery. Yet, the pace of expansion is likely to be moderate and intra-regional divergences are likely to persist. Overall, risks to the outlook are evenly balanced.

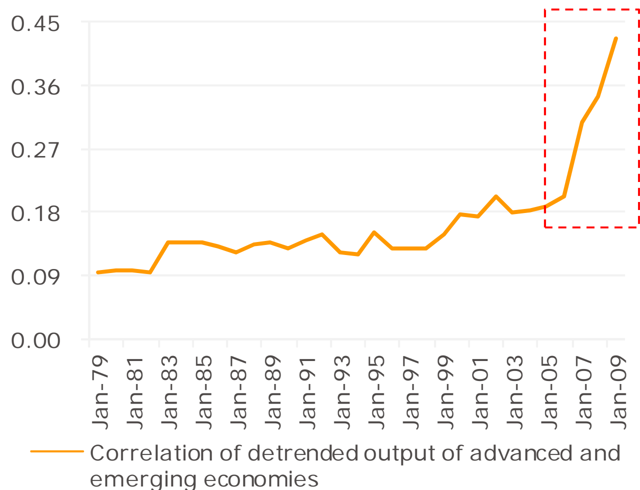
Emerging economies: Growth robust, but inflation a concern

The EM economies have shown impressive resilience during the global financial crisis and growth turnaround has been the sharpest in Asia and Latin America. India and China led the momentum in Asia, while Brazil supported the pace of expansion in Latin America. The manufacturing sector in these economies has seen brisk recovery on the back of policy stimulus, inventory re-stocking and recovery in global trade. Largely supportive financial markets further aided the economic recovery. More recent trends suggest that investments and private consumption trends are picking up in EMs, indicating sustained momentum in the private sector as policy stimulus fades. The pickup in private consumption is very healthy for the Asian economies, although at this stage it is not fully established whether the rise in private consumption in Asia is structural or cyclical in nature.

EM recovery has been led by policy stimulus, inventory re-stocking, and recovery in global trade

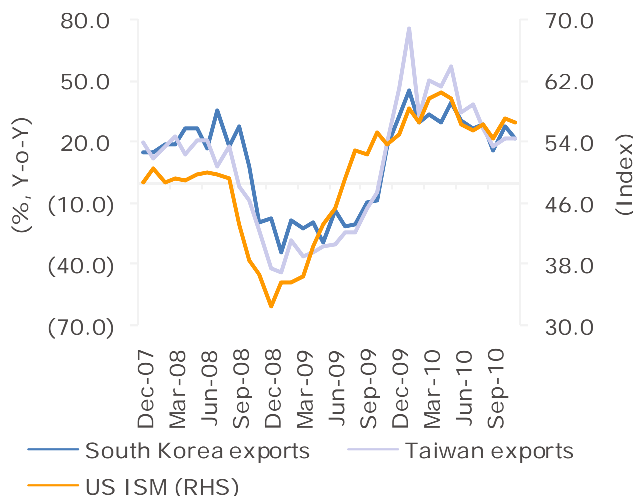
Meanwhile, improving growth prospects of the US economy would further support the Asian growth prospects, given the inter-linkages. The IMF has established that the correlation between the output of emerging economies and western economies has increased very significantly over the past decade; also, EMs' resilience to fight external shocks has improved meaningfully.

Chart 6: Increasing integration of global economy



Source: IMF, Edelweiss research

Chart 7: Improved US growth prospects good for Asia



Source: Bloomberg, Edelweiss research

Within Asia, India and China are showing very strong momentum and healthy trends in PMI indices, while other export-oriented economies such as Korea, Taiwan and Singapore which have seen a phase of softening in their PMI indices are showing improving trends of late.

Rising crude oil prices and excess liquidity will make EM policy environment challenging

Overall, EMs as a whole are expected to grow 6.4% (7.1% in 2010 expected), while Asia is expected to grow 8.4% in 2011 (against 9.4% projected in 2010), as per IMF. Key challenges for the Asian policymakers in 2011 would be inflation, which is inching higher in most of the economies and more recently in China. These inflationary pressures are a mix of both global factors as well as domestic demand pressures. On the global side, rise in commodity prices, including that of crude oil, are fueling domestic inflation in Asia and domestically; this is building up capacity constraints, as demand expands are also putting upward pressure on prices. If these pressures continue to mount, Asian policymakers may have to resort to aggressive tightening (such as the one happening in China), which might come at the cost of growth.

- Bu the horizon is still cloudy

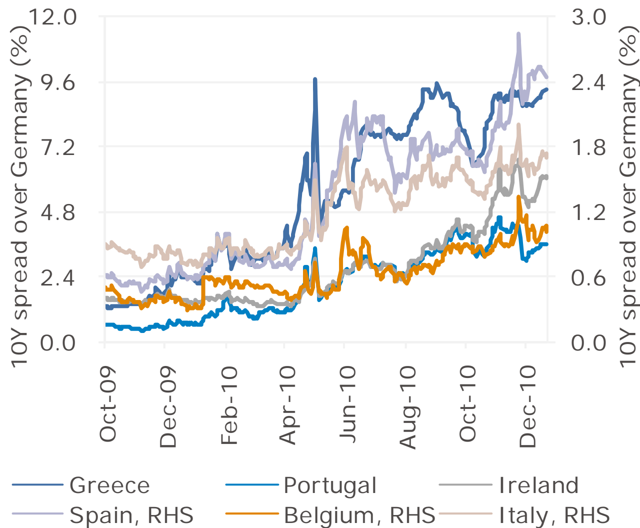
There are certain lingering risks in the global economy which could hurt the ongoing recovery and induce fresh instability in financial markets.

Sovereign and banking risks intertwined in Europe

In Europe, peripheral sovereigns and banks are vulnerable to ratings downgrades

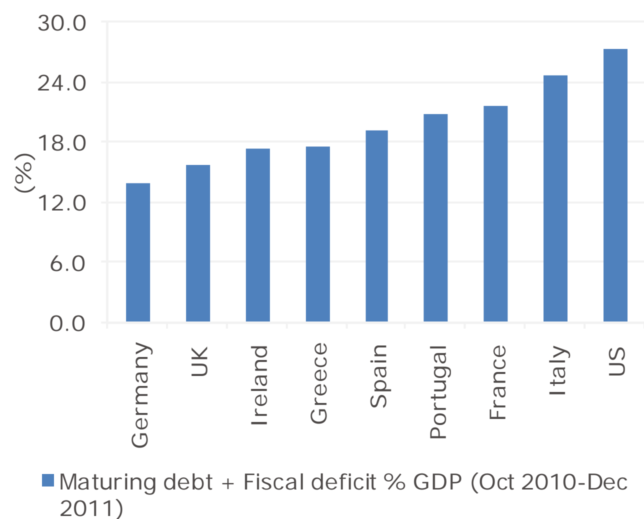
The potential source of instability arises from Europe where peripheral countries are witnessing painful dynamics of high and mounting indebtedness, rising interest rates, sluggish economic growth and lack of competitiveness. They are, therefore, under the constant threat of ratings downgrade. Accordingly, the bond spreads for Ireland, Portugal, Spain and Italy continue to widen. Further, the European banking sector is holding a large amount of sovereign debt of these peripheral countries and, hence, is running the risk of possible downgrades and hair-cuts. In other words, the sovereign and banking sector risks are highly intertwined in Europe. In addition, the borrowing requirements of these countries in the coming year remain high. So far, Greece and Ireland have been bailed out by EU and IMF, but the European authorities have not been able to ring-fence the problem. If anything, these countries continue to exhibit lack of policy coordination. Accordingly, the risk of contagion to other countries, particularly Spain remains high. Any unfavourable development in Europe could lead to sharp rise in global risk aversion, strengthening of USD, thereby triggering capital outflows from risky assets including equities and commodities.

Chart 8: Is European contagion spreading?



Source: Bloomberg, Edelweiss research

Chart 9: Large borrowing needs of European nations



Source: BIS, Edelweiss research

Ultra-loose monetary policy in western economies poses challenges for EMs

EMs will have to manage rising inflation, appreciating currencies, and excess liquidity

While the economic growth in the emerging economies, particularly Asia and Latin America, remains robust, the policy environment is not free of challenges. The key challenge for the EM policymakers in 2011 is the ultra-loose monetary policy adopted by Fed, ECB, BoE, and BoJ and the associated flow of cheap liquidity into the emerging economies. This abundant liquidity is manifesting in the following forms:

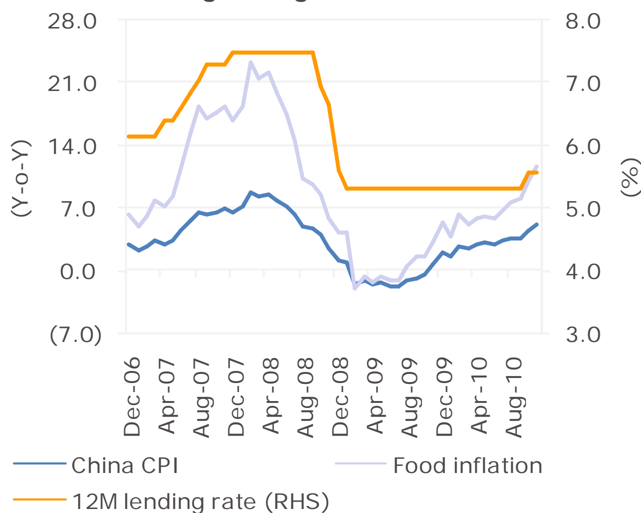
- Upward pressure on global commodities (including crude oil prices), leading to higher domestic inflation in EMs. This could lead to aggressive policy tightening by EM policymakers.
- Rising pressure on EM currencies, leading to deterioration in trade competitiveness of these economies, especially since Chinese authorities are reluctant to allow any meaningful appreciation in RMB.
- Upward pressure on domestic asset prices such as equities and real estate, which if continue, could prove to be destabilising.

In the wake of these challenges, EM policymakers will be forced to take measures such as aggressive intervention in currency market, imposing capital controls in one form or the other or even imposing trade restrictions. Such developments would be negative for financial market sentiments and economic growth.

China's balancing act in macroeconomic management

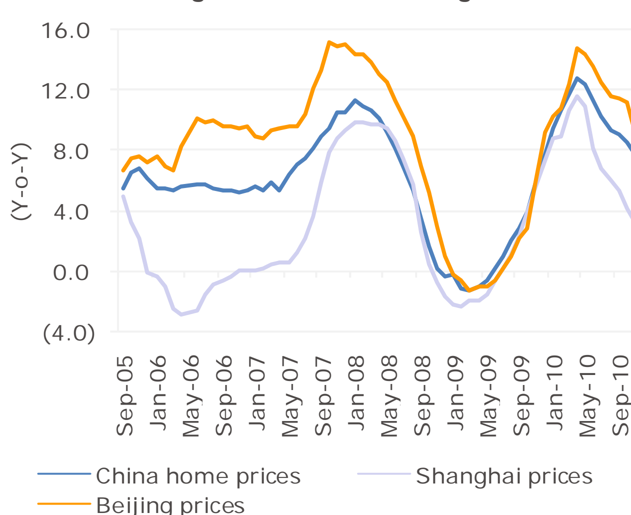
The Chinese economy has seen a very impressive rebound since March 2009, reaching a growth rate ~12% in March 2010 from 6.5% in March 2009. The rebound has been led by aggressive domestic policy stimulus and sharp rebound in global trade. However, while massive policy-led lending by the banks has surely helped the economic growth, there are the following new challenges on the horizon:

Chart 10: More tightening on the cards



Source: Bloomberg, Edelweiss research

Chart 11: Cooling off in China's housing market



Source: Bloomberg, Edelweiss research

- Inflation has risen quite sharply in recent months. It is currently largely driven by food inflation, but could become more generalised eventually given excess liquidity conditions. This means that policymakers have to tighten monetary conditions further.

China facing multiple challenges of excess liquidity, rising inflation, and rebalancing economy

- Meanwhile, ultra-loose monetary policy by Fed and rising interest rates in China suggest that China will have to deal with speculative capital flows into the economy, which could prove to be destabilising.

- Further, China needs to re-balance its economy structurally toward domestic consumption as growth in western economies is likely to be below trend for some time. In this regard, Chinese authorities would be under pressure to allow greater flexibility in RMB.

Clearly, Chinese policymakers have to play a fine balancing act in terms of managing multiple challenges of moderating economic growth, rising inflation and a cooling off property market. Any over-tightening by policymakers could lead to sharper-than-expected slowdown in the economy, while slower-than-required response could lead to inflation becoming generalised in the economy. Since China remains the major driver of the EM economic momentum, any unfavourable event in the country could hurt global business and market sentiments.

India: Economic expansion brisk and balanced

We forecast GDP growth to be ~8.6% in FY11 and ~8.3% in FY12

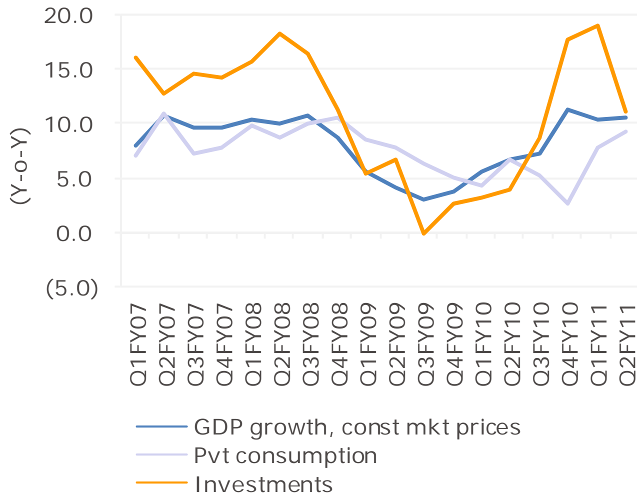
Indian economic growth has regained its pre-crisis trajectory

After bottoming out in March 2009, the economic expansion has been very robust. Sequential seasonally adjusted data suggest that the economy has now regained its pre-crisis growth trajectory. With the release of Q2FY11 GDP numbers (real GDP growth at 8.9% Y-o-Y), it is established that growth is brisk and balanced. All the three sectors - services, industry and agriculture - are showing strong output growth. On the demand side as well, private consumption and investments have picked up strongly.

In April-October FY11, the industry has grown at a robust ~10.5% against the same period last year. The upswing in the industrial production growth so far has been the result of inventory re-stocking (as demand recovered), very favourable base effect (as activity was very weak last year), recovery in India's exports (in line with recovery in global trade), benign interest rate environment and recovery in business sentiments.

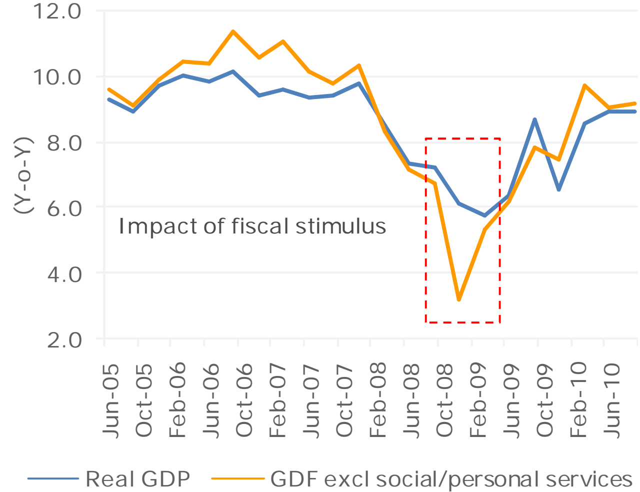
Within industry, manufacturing has led the momentum, with strongest pace of expansion observed in metal products, machinery equipment and transport equipment. However, the momentum in industrial activity is moderating for some time now, as observed in sequential seasonally adjusted data.

Chart 12: Pvt. consumption reaching pre-crisis trajectory



Source: CMIE, Edelweiss research

Chart 13: Govt. support to fade in coming year



Source: CMIE, Edelweiss research

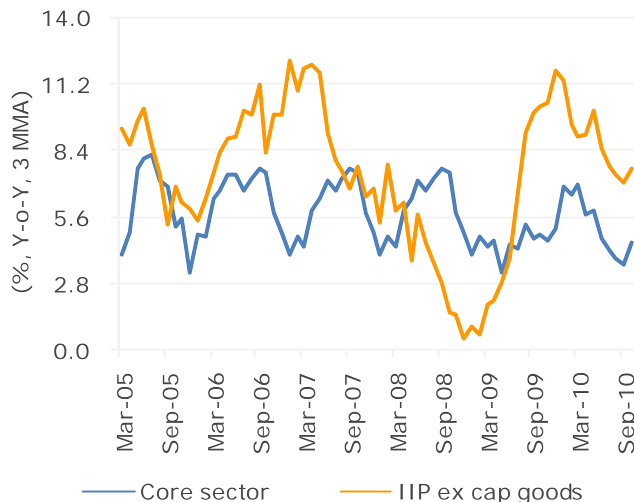
In FY12E, we expect industry to grow ~8.4% and ~8.8% in FY11E

Going ahead, growth in industrial activity will moderate, but will stay healthy. While PMI numbers remain quite robust, the rest of FY11 is likely to see softer IIP numbers on the back of unfavourable base effect. As we move into FY12, the healthy momentum is expected to continue, with growth averaging ~8.4% in FY12. While lagged impact of monetary tightening and not so robust exports growth will weigh on industrial activity, healthy private consumption momentum and building capacity constraints will support the momentum.

However, government support to the economy is likely to wane

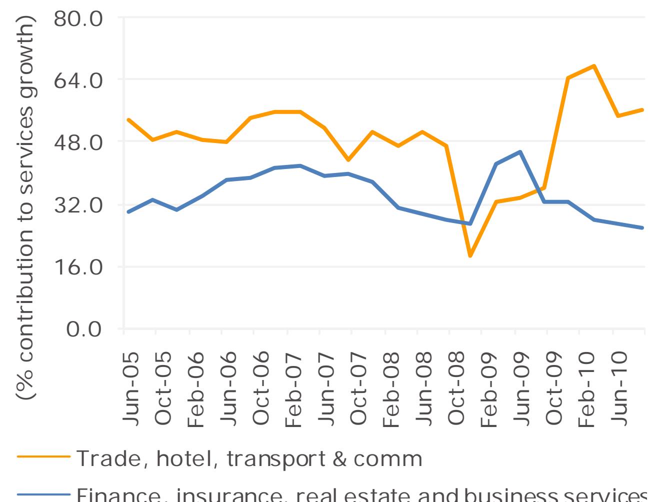
Services too have shown very strong momentum, growing at a solid 9.8% Y-o-Y in Q2FY11, over and above 10.5% Y-o-Y registered in the same quarter last year. Indeed, over the past three quarters, the contribution of services to GDP growth has been rising, while that of the industry has been declining. Most importantly, the current phase of recovery in services has been characterised by falling contribution of the financial and business services segment (finance, real estate, business and insurance) sector and rising contribution from trade, hotel and transport services. Pick up in private consumption and recovery in global trade supported this trend. Meanwhile, the contribution from social and personal services to the GDP growth in the recent phase of recovery has also been high.

Chart 14: Moderation in IIP



Source: Bloomberg, Edelweiss research

Chart 15: Trade has driven the services momentum



Source: CMIE, Edelweiss research

Going ahead, some of the lead indicators for services sector such as commercial vehicles production, cargo handled at major ports, passenger traffic at airports are generally showing healthy growth, which augurs well for the services sector. We expect contribution of finance and business services segment to increase while that of 'social and personal services' segment to reduce, in line with reduced support from government spending. Overall, service sector is likely to grow ~9.5% Y-o-Y in FY11 and 9.3-9.4% in FY12.

Agri growth is expected to normalise in FY12 after strong rebound in FY11

Agriculture is seeing a sharp rebound on the back of better monsoon and favourable base effect (due to drought-led decline in output last year). The total Kharif cereal production in FY11 was better than FY10, but lower than FY09 and FY08, although trends were relatively better in case of pulses and sugarcane. Accordingly, agriculture expanded 4.4% Y-o-Y in Q2FY11 and is likely to be stronger in the next two quarters of FY11, such that, for FY11, agri-GDP could clock growth higher than 5%. However, agriculture growth is expected to normalize towards 3% in FY12, assuming normal monsoon in FY12.

We expect real GDP to grow ~8.3% in FY12E after growing ~8.6% in FY11E

Against this backdrop, we expect Indian economy to grow at ~8.6% Y-o-Y in FY11 and ~8.3% in FY12. Private consumption momentum is expected to continue on the back of resilience in rural economy and rising wages. However, reducing government spending and widening current account deficit would weigh on growth prospects. Agri-contribution would also normalise after a sharp upturn.

- Yet concerns are more than ever

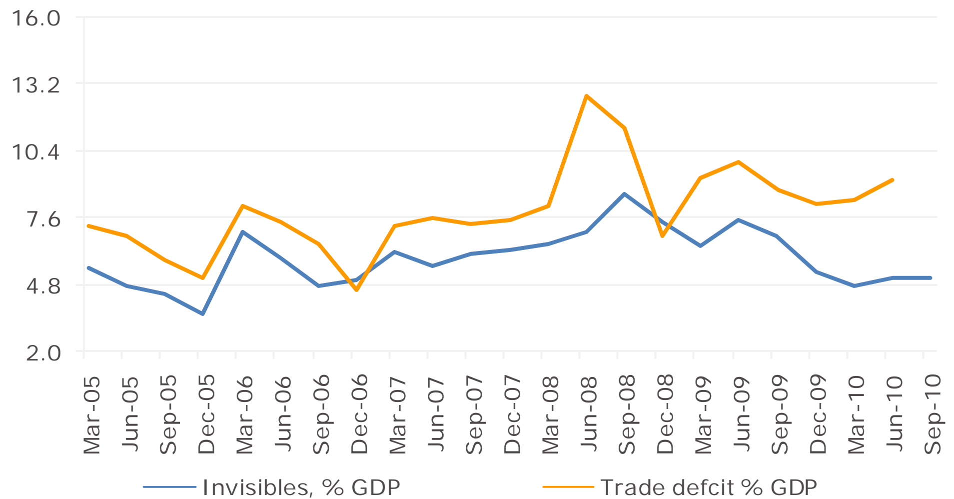
Widening current account deficit and nature of financing cause concern

India's current account deficit has been on a widening trend, reaching ~4% of GDP in Q2FY11 (highest since September 2008), up from 3.2% in the previous quarter. This widening of deficit remains a worry as the RBI governor also acknowledged stating, "a sustained current account deficit beyond 3% year after year will be difficult to manage by flows that are not of a stable nature". The following trends stand out:

- Within current account, the growth in exports and imports has recovered strongly in line with trade trends globally, although recent quarter suggests deterioration in exports. Invisibles on the other hand have lagged recovery in merchandise trade with invisibles surplus falling from 6.9% of GDP in Sept 2009 to 5.1% in Sept 2010.

Accordingly, the invisibles (such as software services) surplus financed only ~55% of the trade deficit in Q2FY11 against 70% in Q2FY10.

Chart 16: Trade-deficit has been stable (as % GDP); invisibles have declined

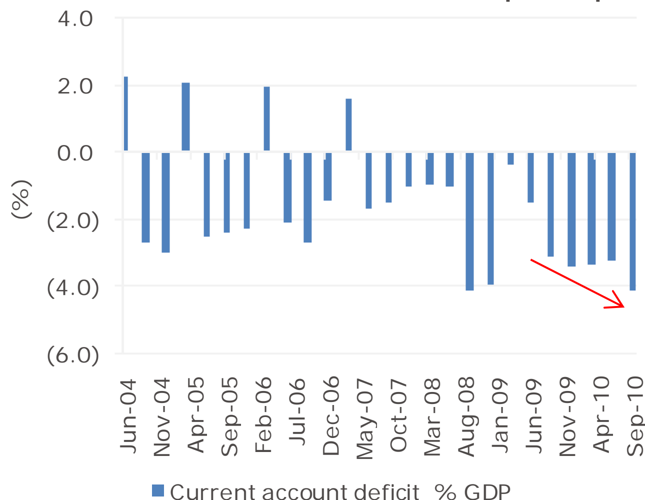


Source: CMIE, Edelweiss research

India's current account deficit has reached ~4% of GDP, an extremely high level

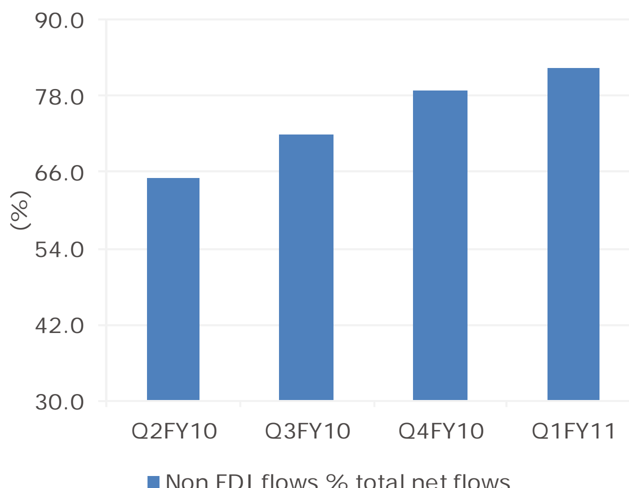
- Going ahead, improving US growth prospects augur well for Indian exports but imports would continue to remain strong too. Importantly, movement in crude oil prices would significantly influence India's trade balance in the coming months given the fact that crude oil imports constitute nearly 30% of India's total merchandise imports.
- In addition, movements in INR would also be crucial in shaping trade position of India. While widening current account deficit should put weakening pressure on the exchange rate, the persistent and rising capital inflows will prevent any significant fall in the currency. On real basis, domestic inflation trends (or cost pressures) would also influence India's trade competitiveness growth in exports.
- Invisibles, which have been a bit of a laggard so far, are likely to gather pace in the coming quarters as sequential trend in software exports suggests.
- Overall, we expect current account deficit to remain elevated, but reduce from current levels of over 4% of GDP.

Chart 17: Current account has widened in past 5 quarters



Source: CMIE, Edelweiss research

Chart 18: Share of non-FDI flows on the rise



Source: CMIE, Edelweiss research

Importantly, it is not just the size of the current account which deserves monitoring. The nature of the capital flows funding the deficit is also important for stable balance of payments trends.

Nature of capital flows is increasingly skewed towards non-FDI flows, which is worrying

- The non-FDI flows have increased from ~65% of the total net capital inflows in Q2FY10 to ~85% in Q2FY11.
- Further, within non-FDI inflows, the external commercial borrowings, short-term trade credit and FII inflows have been rising while net FDI inflows have been declining as % of GDP.

The fact that current account deficit is increasingly getting funded by non-FDI short-term flows is a concern, given the fact that global financial market environment remains relatively uncertain given the lingering sovereign debt problems in Europe.

Upside risks to inflation have mounted

Inflation (based on WPI) climbed quite sharply early in this recovery cycle, reflecting a combination of base effect, high food prices and rising global commodity prices. The Y-o-Y inflation peaked in April 2010 at ~11% and started softening thereafter to 7.5% in November.

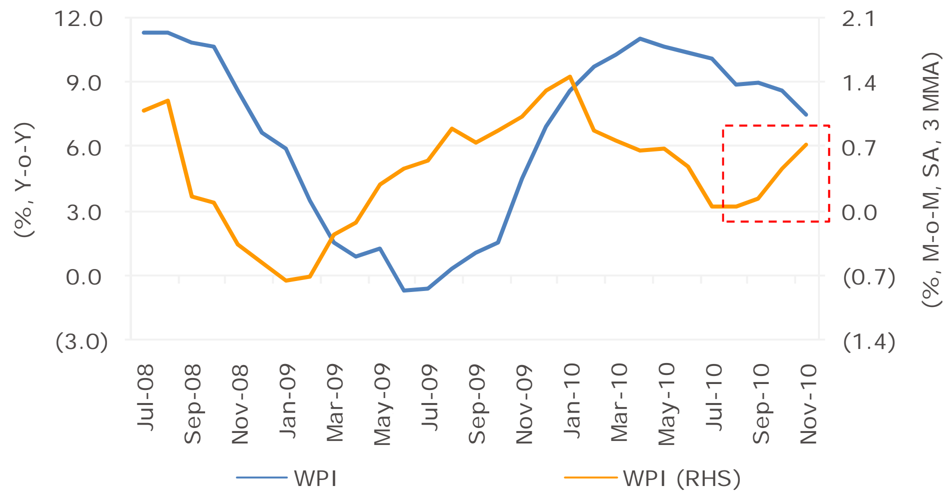
The RBI is likely to revise its inflation projection upwards from 5.0-5.5% for March 2011

To get better insights into the drivers of inflation in India, we have re-arranged the WPI into three baskets: (a) Agro-inflation (wt: ~30%); (b) imported industrial inflation (wt: ~27%); and (c) non-food domestic demand driven inflation (wt: 43%). We find that in the current inflation of 7.5%, agro inflation is contributing ~290bps, imported inflation ~280bps, while domestic demand inflation is contributing ~180bps. In other words, global commodity prices and food inflation constitute major portion of the domestic inflation, although all these components are now softening.

Yet, it must be acknowledged that inflation has been slow-to-moderate and upside risks to inflation trajectory have increased in the recent months, as explained below:

- Seasonally adjusted sequential trends in WPI suggest that momentum in inflation (which was softening since early this year) has started increasing since September 2010. This is reflected in the manufacturing category as well. Accordingly, if this sequential trend persists, it would start getting reflected in the headline Y-o-Y inflation eventually.

Chart 19: M-o-M SA trend shows rise in price pressures

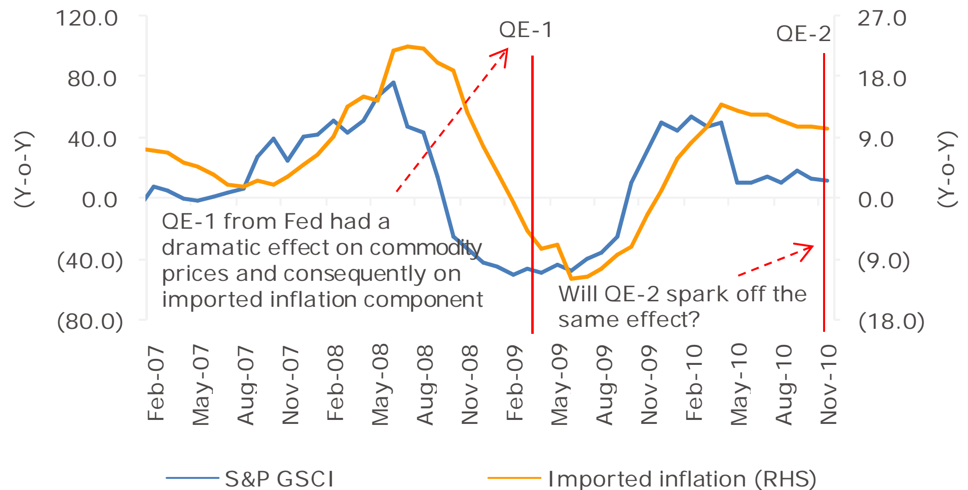


Source: CMIE, Edelweiss research

Rising global commodities and domestic demand pressures pose upside risks to domestic inflation

- Non-food manufacturing inflation (proxy for core inflation in India) has also inched higher in the latest month, although the trend is yet to be established.
- Global commodity and crude oil prices are facing upward pressure. Since beginning October 2010, crude oil prices have climbed more than 12% and Goldman Sachs Industrial Metals index has climbed more than 9%.

Chart 20: Global commodity/energy prices influence domestic inflation outlook



Source: CMIE, Edelweiss research

Inflation is likely to remain above RBI's comfort zone in the coming months, averaging 7.0-7.5% in FY12E

- Some stickiness has been observed in some protein rich food items such as milk, meat, and fish due to structural factors such as changing consumption patterns with rising income levels. Since supply would be slow to catch up, inflation is likely to inch higher in these commodities.
- Finally, demand side pressures are also building up, as reflected in our re-arranged WPI basket, where we find that the contribution of domestic demand component has risen in the past three months.

In light of these factors, we believe that while inflation could still reach ~6.5% by March 2011, it may not continue to soften further. In FY11, inflation is likely to average ~8.5% while in FY12, we expect inflation to stay higher than RBI's comfort zone, averaging ~7.0-7.5% in FY12.

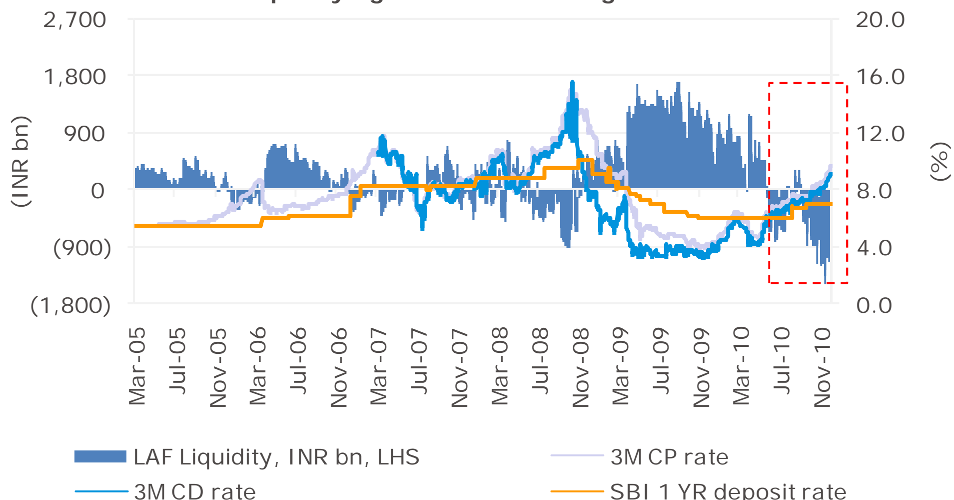
Monetary policy to remain hawkish in 2011

RBI started normalising the policy rates from low levels starting February 2010 as the economy began to recover and inflation inched higher. In this recovery cycle, the central bank has hiked repo rate by 150bps, reverse repo by 200bps and CRR by 100bps. With these rate hikes, the process of normalisation seems largely over as the rates are closer to neutral zone.

Having developed comfort on growth, RBI's focus has been liquidity and inflation in recent months

However, in the recent months domestic liquidity conditions have tightened quite significantly, such that average daily liquidity injection at RBI's LAF window amounted to ~INR 700 bn during October-December 2010. Accordingly, the short-term market interest rates rose sharply (3M CP rate hardened ~200bps between September and December 2010) and bank deposit and lending rates moved higher.

Chart 21: Persistent liquidity tightness could hurt growth



Source: Bloomberg, Edelweiss research

This tightness in liquidity has been contributed by both structural as well as frictional factors. Among structural factors, faster growth in credit compared with deposits (credit growth is hovering ~23%, while deposit growth is ~14-15%) led to the tightness in liquidity. Generally, higher growth in currency in circulation because of higher inflation and low real deposit rates has also led to erosion in liquidity. Among the frictional factors, the considerable build up in government cash balances with RBI due to higher-than-expected receipts from 3G/BWA auctions led to the tightness in domestic liquidity conditions. Moreover, there were periods when the government borrowing program continued despite build up in cash balance of the government, thereby accentuating the liquidity deficit conditions.

Liquidity conditions to ease only gradually; deposit growth remains the key

Against this backdrop, the December policy review by RBI was largely about liquidity management (announcing OMOs of INR 480 bn and an SLR cut of 1%). Going ahead into 2011, liquidity conditions are expected to improve although gradually. While government spending would increase toward the end of the current fiscal, what is equally important is the improvement in deposit growth rate, especially when the credit demand is generally buoyant in Q4 of the fiscal year. With banks raising deposit rates, deposit growth is likely to pick up, thereby reducing the pressure on liquidity, although it is not yet clear how fast the liquidity will return to normalcy because credit growth is firming up as well.

Chart 22: Currency demand remains above trend, causing liquidity erosion

Source: CMIE, Edelweiss research

On the inflation front, upside pressure is clearly being felt on account of rising global commodity prices and domestic demand pressures. While inflation is likely to soften to ~6.5% by March 2011, it may not sustain at those levels (see previous section). Therefore, we expect RBI to revise its inflation forecast for March 2011 upwards in its January policy meeting to 6.0-6.5% from 5-5.5% currently. Further, inflation is likely to remain above RBI's comfort zone in 2011, averaging ~7.0-7.5% during FY12. Accordingly, we expect RBI to maintain its hawkish policy stance in the coming year, delivering at least 50bps hike in 2011.

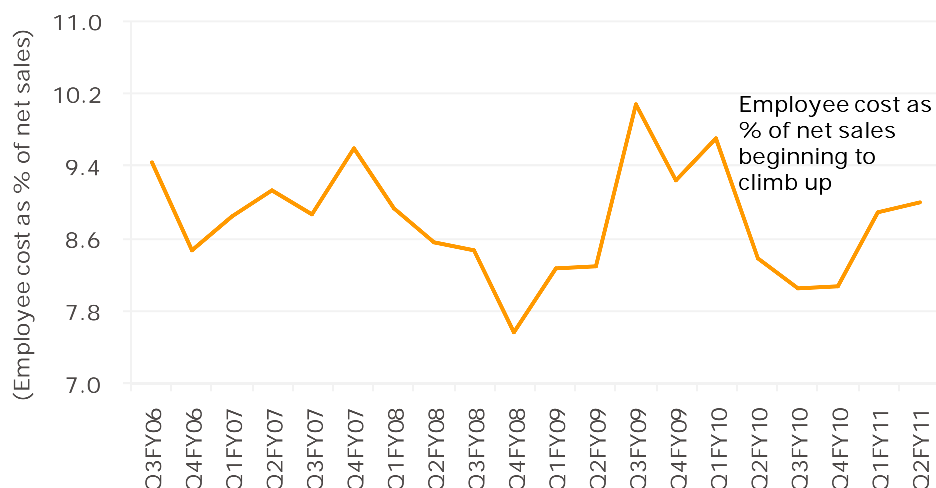
Downside risks to earnings increasing

Downside risks to earnings increasing due to a combination of rising costs and increasing macro-headwinds

The macro-economic backdrop for earnings has turned a bit challenging of late. Although top line growth is expected to be robust, elevated cost pressures (because of higher wages), tight liquidity conditions, higher commodity prices and rising interest rates could keep margins muted and, hence, negatively impact corporate earnings.

Wage pressure has already been a concern for India Inc. for a major part of CY10. The employee cost to sales ratio has been steadily trending upwards over the past two-three quarters. Wages, as percentage of net sales for the Sensex universe, account for ~9.0% of total sales (as of Q2FY11). This is below its peak of 10% recorded in Q3FY09, but the steady upward trajectory in terms rising wages worries us. On a broader market level, for BSE 500 companies, we have seen a sharp jump in wages and salary costs over the past three quarters. Meanwhile, headwinds from rising interest rates and commodity prices are only expected to intensify from here; tightening liquidity conditions could also add some pressure.

Chart 23: Employee cost as % of sales starting to rise again



Source: Prowess, Bloomberg, Edelweiss research

Note: The data is for Sensex constituents, net sales for banks is operating income

Rising interest costs could also have negative effect on Sensex earnings

Interest costs are expected to head north from the current level as RBI may be forced to consider further tightening measures to tackle rising inflation and/or inflationary expectations. We estimate that tighter liquidity conditions and lagged effect of previous rate hikes could push up the borrowing costs by as much as 100bps over FY12E. All other things remaining constant, our calculations show that a 100bps increase in borrowing costs could negatively affect Sensex earnings (ex financials) for FY12E by ~1.9%. Further a 125 bps increase in borrowing costs could push down earnings by ~2.4% bps while a 7% increase in wage bill (over and above the wage increase estimated by our analysts) could depress FY12E earnings by 4.6%.

Table 1: Effect of rising interest and employee cost on Sensex earnings (FY12E)

% increase in interest cost	% effect on Sensex earnings	% increase in employee cost	% effect on Sensex earnings
0.50	(0.94)	3.00	(1.98)
0.75	(1.42)	5.00	(3.29)
1.00	(1.89)	7.00	(4.61)
1.25	(2.36)	9.00	(5.93)
1.50	(2.83)	11.00	(7.24)
1.75	(3.30)	13.00	(8.56)
2.00	(3.78)	15.00	(9.88)

Source: Edelweiss research

Note: data for effect because of rising interest cost for Sensex ex financials universe, data for effect of increase in employee costs for Sensex universe

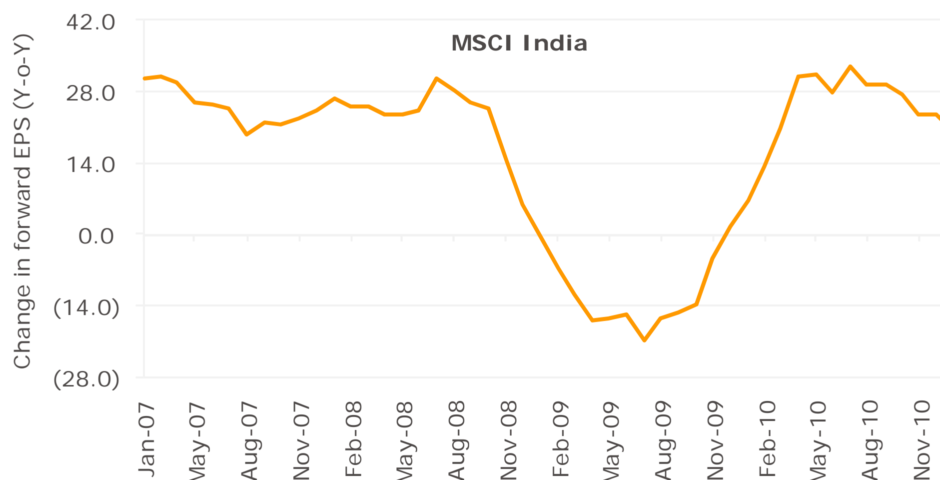
Further, rising raw material costs could also act as significant headwind for earnings growth in FY12E. As prices of raw materials rise, margins could come under pressure as companies would find it difficult to pass on the hikes to consumers because of increasing competition. This is particularly true in case of sectors such as autos, where cost pass through will become increasingly difficult.

Most upsides already into valuations; earnings downgrades increases chances of de-rating

We believe that increasing headwinds to earnings is being reflected in earnings revisions cycle for Sensex as well. There have been no significant revisions to FY11E earnings since April 2011 and earnings upgrades have virtually hit a roadblock. FY12E earnings estimates too have remained largely unchanged since the beginning of CY10. It is,

therefore, no surprise that the earnings momentum for MSCI India, as measured by Y-o-Y change in forward EPS, has been tapering off since hitting its high April 2010. This clearly indicates that the revisions cycle hangs in balance with most upsides already been captured into current estimates. If cost pressures continue, we could very well see downgrades in earnings estimates, leading to a cycle of de-rating of Indian equities.

Chart 24: Momentum in EPS has slowed down



Source: Bloomberg, Edelweiss research,

Note: Forward EPS calculated as Blended forward 12 month EPS from Bloomberg

Other issues in Indian economy

Over the past few months, corruption charges against the government officials in relation to 2G telecom auctions and Common Wealth Games has dealt a serious blow to the image of the government. The functioning of the Parliament has been disrupted by the opposition and the ruling coalition, is clearly on the defensive. Against this backdrop, the reform process has taken a backseat. Further, tightening of environmental regulations in the recent past and lingering issues with regards to land acquisition has only hurt the business sentiments in the country.

Recent lapses in corporate governance have hurt India's image as investment destination

Meanwhile, issues with regards to corporate governance have come to the fore at the same time. Officials at the commercial banks are alleged to have been involved in unfair lending practices. This has generally made banks overly cautious in their project approvals.

All these issues combined, have hurt India's image as an investment destination. India needs a series of political reforms, and the starting point could be the reforms with regards to election funding and independence of central investigative agencies.

Yet, not all is gloomy in Indian politics. The results of the Assembly Elections in Bihar show a ray of hope. In a state where caste and religion based politics dominated for decades together, the re-election of progressive incumbent Mr. Nitish Kumar goes on to suggest that people have voted for governance and growth. Bihar has grown from average 4.5% annual rate during 2000-04 to an impressive 12.4% annual rate during 2004-09. Apparently, this carries a message for incumbents in other states as well who are looking to get re-elected. This trend of incumbents getting re-elected based on performance rather than caste loyalties, augurs well for Indian politics and economy in the coming years.

FII flows: Will the party continue?

FII flows strongly correlated with market returns

FII flows have been key in driving the performance of Indian equity markets. As can be interpreted from the table below, since CY05-10, positive FII flows have been generally correlated with a positive return for the markets. The only year when net FII flows turned negative was CY08; then, the Sensex performance dipped ~52%.

To gain a more holistic perspective, we analysed the trend of net inflows from all institutional sources (domestic as well as foreign) into the secondary markets. To calculate the net inflows into the secondary markets, we adjusted the total net inflows from all institutional sources against all IPO/FPO issuances for the year. Our analysis suggests that for most of the years, except CY08, net flows into the secondary markets have been positive. However, certain trends make us a bit concerned about the level of support which net institutional flows will probably render to the secondary markets in CY11E.

Table 2: Details of fund flows into Indian markets

	(USD bn) FII Inflows	Mutual funds	Insurance/Banks	IPO & additional offerings	Net inflows into secondary markets	Sensex returns (%)
CY00	1.38	(0.2)				(20.6)
CY01	2.73	(1.1)				(17.9)
CY02	0.74	(0.6)				3.5
CY03	6.63	0.1				72.9
CY04	8.47	(0.3)				13.1
CY05	10.8	3.0		6.0	7.8	42.3
CY06	7.9	3.4		8.0	3.3	46.7
CY07	17.4	1.7	4.2	18.8	4.4	47.1
CY08	(13.3)	3.3	13.3	6.2	(2.9)	(52.4)
CY09	18.2	(1.2)	6.5	13.6	9.9	81.0
CY10	29.3	(6.0)	1.3	22.5	2.1	17.0
CY11E	15-20	At best flat		15 (H1CY11)	1.0-2.0	?

Source: Bloomberg, Edelweiss research

Another year of tepid participation from domestic institutional players could adversely affect markets

For one, domestic participation has been very tepid over the past two years; in fact, the net domestic flows have been in the negative zone for CY10. Going into CY11 also, we do not see much traction in domestic flows and expect them to remain, at best, neutral. Meanwhile, our estimates suggest the total new paper issuance in H1CY11 could be as high as USD 15 bn. While FII participation is expected to be robust, net inflows will certainly not be as strong as ~USD 30 bn seen during CY10. In this context, we expect a strong, yet relatively moderate net FII inflow of USD 15-20 bn for CY11, which leaves very little net money for investment into the secondary markets. Further, with very tepid participation from domestic players, absorption of paper from primary markets may also become a challenge.

Some of the larger equity IPO/FPO issues which have been approved by SEBI and could hit the markets in H1CY11 include Indian Oil, Steel Authority of India, ONGC, Jindal Power, Sterlite Energy, HCL, ONGC Petro Additions, GSPC, Lodha Developers and L&T Finance.

Strong pipeline of issuances could keep flows to secondary markets tempered

Table 3: Probable IPO/FPO issues which could hit the markets in H1CY11

Name of company	Estimated issue size (INR bn)
IOC	190
SAIL	160
ONGC	100
Jindal Power	72
Sterlite Energy	51
HCL	40
ONGC Petro-Additions	35
GSPC	31
Lodha Developers	28
L&T Finance	15

Source: Edelweiss research

Note: This is from the list of companies which have received SEBI approval

Valuations remain on the higher side

Valuations have remained a concern given that Indian equity markets have rallied more than 150% since its lows in March 2009 and by a further ~17% in CY10. India is currently trading at a premium to most of its peers. The premium which India commands to EMs on the forward P/E is 1.46x, which is above its long-term average of 1.38x. On P/B as well, India is trading at a premium of 1.63x over MSCI EM, although it is a shade below its long-term average of 1.7x.

India's relative advantage on RoE is gradually fading

Historically too, India has enjoyed a premium over other EMs. This has partly been contributed by structural factors such as high RoE of India against other EMs. However, this advantage gradually seems to be fading away at the moment. Some of the factors contributing to the declining spread between the RoEs of India and EM universe have been rising competitive intensity (leading to shrinking margins), lower threshold of required returns (as capital became cheaper and accessible) and shifting priority towards attaining scale. We have explored these themes in detail in our Third Dimension piece titled; "*Should India enjoy a valuation premium over peers?*" (dated July 6, 2010). If this trend of narrowing of return ratios continues, then we may well see an erosion of the valuation premium which India commands over EMs.

Chart 25: India's valuations at premium to EMs

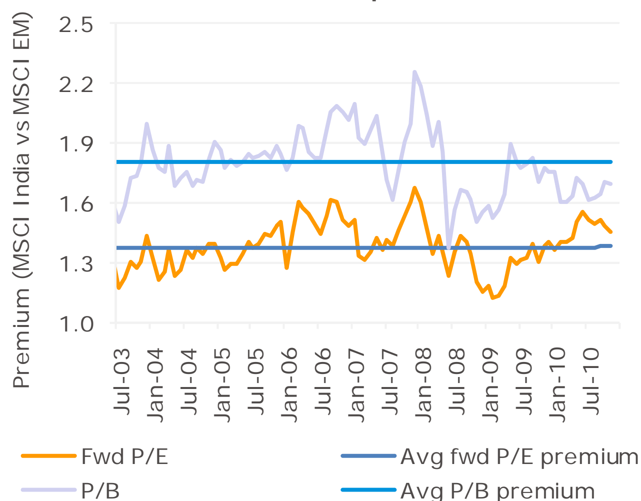
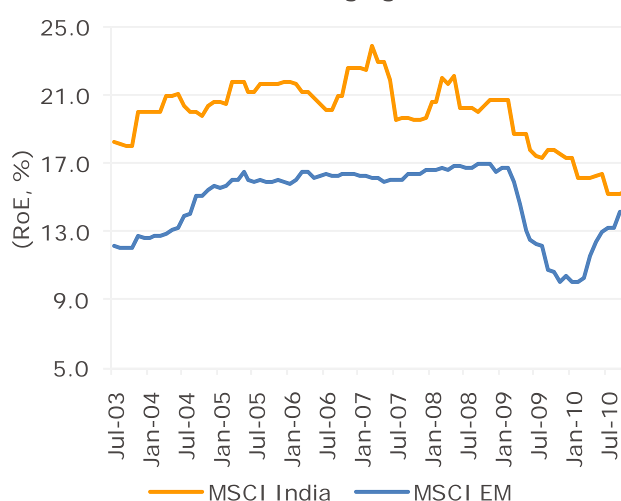


Chart 26: RoE trends converging



Source: Bloomberg, Edelweiss research

India's earnings growth profile stronger, but risk of downgrades increasing

While valuations are a concern, India's earnings growth profile offers some comfort; it is estimated at ~22% for FY12/CY11 against ~16% expected for the EM universe. Although growth appears robust, the macro headwinds may drag down the actual earnings growth rate for FY12 to 18-20%. For developed markets, earnings growth for CY11 is expected to be a shade lower at 14-15%, which is again below India's. To carry out a benchmarking exercise, we also analysed the PEG (price to earnings growth ratio) for FY12/CY11 for the peer group. India's PEG ratio stands at 0.7x, which is broadly in line with EM peers.

Table 4: Earnings growth profile of India relatively strong

	Earnings growth (%)	P/E	PEGY
	FY1E	FY1E	FY1E
Mexico	27.9	15.6	0.6
Indonesia	22.3	14.1	0.6
India	22.2	15.9	0.7
Brazil	18.8	10.4	0.6
China	16.4	11.7	0.7
Russia	15.3	7.1	0.5
Korea	12.5	10.3	0.8
Emerging markets	**16.6**	**11.5**	**0.7**
UK	15.7	10.3	0.7
US	14.4	13.0	0.9
Australia	12.1	12.2	1.0
Germany	10.4	10.8	1.0
Developed markets	**14.2**	**12.4**	**0.9**

Source: Bloomberg, Edelweiss research

Note: FY1 indicates either CY11 or FY12

- Overweight on sectors with global interface; cautious on rate sensitive cyclicals

The key themes to focus in this context are:

- Focus on low capital-intensive industries with more secular growth story, given cost of capital and input costs are going up; so increasing exposure in consumption, pharma and utilities
- Global recovery and QE2 support to benefit sectors, which have global interfaces; overweight on sectors such as IT, metals and energy
- Avoid sectors that are likely to face cost pressures in a rising interest rate and commodity scenario like BFSI, real estate and autos

Over weight on energy, metals, IT, consumption sectors, utilities, and healthcare

The key is to buy sectors that are low on capital intensiveness, but where secular growth story remains intact. As interest rates rise, companies/sectors with higher capital requirements may find it difficult to expand, thereby clearly handing over the edge to companies with lower capital requirements. The sectors which we like within this space are **consumption, pharma, utilities and media**. With the overall economy improving and better media spends, we expect robust ad revenue growth for TV and print media companies. Broadcasting and DTH companies are also expected to benefit from increasing digitisation and rapid increase in DTH subscriber numbers.

As we have highlighted earlier, global recovery is expected to gather pace as we move into CY11. We like sectors that will benefit from the likely combination of global growth and easy monetary conditions, such as **energy and metals**. As global recovery becomes stronger, the need for metals and energy will rebound the world over. Further, we

continue to like **tech,** given its strong linkages with improving corporate spending in the US and elsewhere in developed world and rising momentum in its top-line growth.

Under weight on BFSI, real estate, autos, cement, and telecom

Some sectors, however, are increasingly facing cost pressures in a rising interest rate, rising commodity cost and rising resource cost scenario. We are, thus, underweight on **real estate** (which is expected to face dual headwinds of resource crunch, rising resource costs and higher interest rates), **BFSI** (lower margins and higher pension liabilities) and **autos** (rising raw material prices may put margins under pressure as auto manufacturers would find it difficult to pass on cost increases because of increasing competition).

Accordingly, our sector picks are geared towards the consumption story continuing in India (overweight consumption) and gradual recovery in global growth (overweight global cyclicals such as IT, energy and metals). We avoid sectors with rising cost pressures, such as BFSI, autos and real estate. On significant changes from our previous strategy update published in October titled, *Ride the Tiger*, we have moved BFSI from equal weight to underweight, real estate from over weight to under weight, while upgrading metals and energy from equal weight to over weight. We are also upgrading healthcare and utilities from neutral to over weight while moving industrials from over weight to under weight.

Metals: Play on global recovery; overweight from neutral

We believe the sector will outperform, given a background of a steady global recovery. Metals have underperformed the broader indices over the past year or so and we believe it is an opportune time to go overweight on metals as the current cycle transitions gradually into a mid-cycle phase.

Global growth to be supportive of uptick in demand for metals

The recovery in global economy, in our view, will be supportive of higher metals prices in the near term. Global PMI indices, which had softened a bit in H1CY10, have shown some revival of late. This momentum is expected to sustain in CY11 as economic recovery gathers pace in the developed world as well and real demand picks up. This uptick in demand will feed into higher metal prices as well.

Our metals team estimates that given the continuous global recovery, demand for aluminum has increased more than anticipated. Auto, consumer goods have shown impressive and sustainable growth. The expected demand growth in aluminum is expected to be 15% in CY10 and 13% in CY11. Though incremental supply is coming in, mostly from China and rest of Asia, we expect global market to be in a deficit in CY11 due to strong demand momentum prevailing in CY10 and CY11.

Table 5: Global aluminum demand-supply model

(mt)	CY08A	CY09A	CY10E	CY11E	CY12E	CY13E
Production	39.6	37.0	40.9	45.4	49.9	51.9
% change	*3.9*	*(6.6)*	*10.6*	*11.0*	*9.9*	*4.0*
Consumption	38.2	35.2	40.5	45.8	49.4	52.4
% change	*0.3*	*(7.8)*	*15.0*	*13.0*	*8.0*	*6.0*
Surplus/(Deficit)	1.4	1.7	0.4	(0.4)	0.5	(0.5)
Aluminium price (USD/tonne)	2,571	1,645	2,250	2,550	2,700	2,700

Source: IAI, LME, Nymex, SHFE, Bloomberg, Edelweiss research

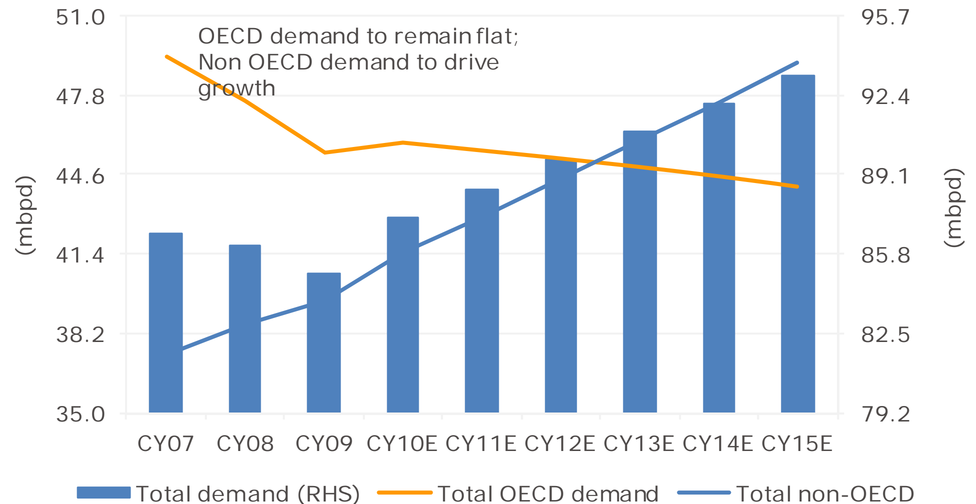
Oil & gas: Higher crude prices to benefit players; overweight from neutral

We are bullish on the oil & gas sector, as: (1) Crude prices are expected to remain high in CY11 and CY12 on the back of continued demand growth, leading to spare capacity dipping below 5% of total global demand CY12 onwards; (2) refining margins are likely to continue to improve gradually; and (3) petrochemical cycle is expected to improve.

Rising demand from non-OECD countries and slower increase in crude supplies, will keep crude oil prices elevated

According to International Energy Agency's (IEA) estimates, global crude demand is expected to expand to 87.3 mbpd, much above the earlier peak of 86.7 mbpd (CY07), on the back of faster-than-expected global recovery. Going forward, overall crude demand is expected to rise at 1.3% CAGR (CY10-15E) or average 1.2 mbpd per year. While incremental demand from OECD countries will remain sluggish, non-OECD countries are expected to clock much higher growth rates. Non-OECD crude demand (growth of 3.5% CAGR through CY10-15E or 7.68 mbpd) will contribute to global demand growth and offset the overall demand decline in OECD economies. Within EMs, we have seen emergence of specific themes that support rising demand for crude. Overall, crude and natural gas capacity are expected to increase only marginally by 0.5 mpbd per year Slower increase in crude and liquid supplies over CY10-12 (0.5 mbpd/year) compared with demand increase (1.2 mbpd/year) will lead to increased dependence on OPEC crude. Meanwhile, OPEC spare capacity is likely to decline CY11 onwards, to less than 5% of total crude demand in CY12E. As the spare capacity heads towards 5% of global demand, crude prices are expected to increasingly turn volatile. This volatility may keep oil prices elevated.

Chart 27: Non-OECD to drive crude demand



Source: IEA, Edelweiss research

Rising operating rates of refiners is a key positive for margins; FY12E GRMs seen close to USD 10.5/bbl

Meanwhile, increased demand of crude is expected to lead to higher demand of refined products. Rising crude prices also benefits complex refiners like Reliance as the company is able to garner larger discounts for its purchase of crude. Reliance remains one of our key sector overweights, given its high sensitivity to rising crude prices. In the near term, GRMs should trend upwards due to impact of severe winter in Europe and North America. Our oil & gas team is of the opinion that rising operating rates of refiners is a key positive for margins and FY12 GRM should be close to USD 10.5/bbl.

Petrochemicals and polyester are also expected to exhibit improved margins. Our oil & gas team opines that the ethylene cracker margins are set to bottom in Q1CY11 as the scale-up of crackers in the Middle East completes. Also, higher cotton prices and increased textile domestic consumption in China has led to increase in polyester prices, which, in turn, has pushed polyester margins to the highest in the past 20 years.

BFSI: Turning underweight on macro concerns

We believe the emerging headwinds in the economy are going to put pressure on the banking sector. Given strong outperformance over the past year, pressure on liquidity, higher pension costs and sticky inflation leading to higher interest costs could act as headwinds for the sector. We are downgrading the sector from neutral to under-weight.

BFSI has outperformed the benchmark Sensex by a massive 15% for CY10. Further, a large part of this outperformance has come between June and October. Since hitting its highs in November, the sector has undergone a sharp correction by ~11% compared with the Sensex that has corrected by just ~2%. In the near term, as macro-headwinds intensify, we expect underperformance from the banking sector.

Increasing macro-headwinds to act as a challenge to banks' outperformance over Sensex

Chart 28: Large relative outperformance of banks in CY10

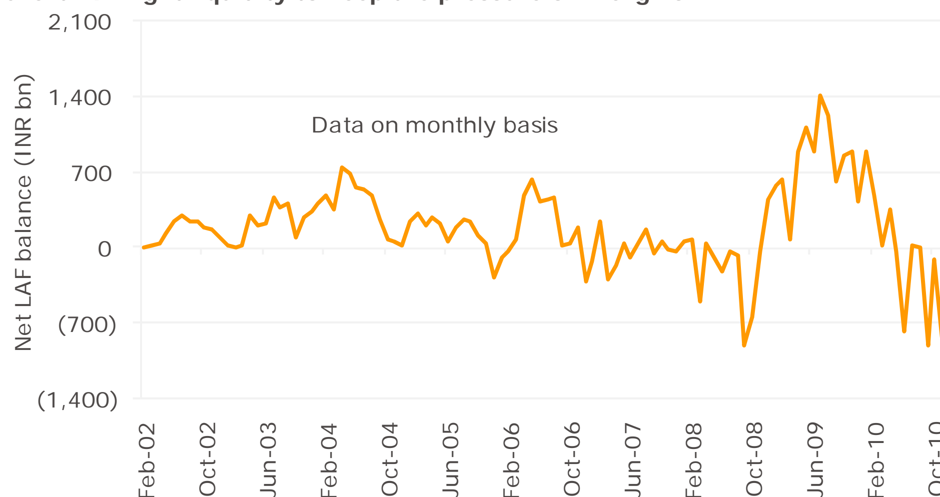
Source: Bloomberg

In an environment of tight liquidity and slow deposit mobilisation, cost pressure will be prevalent

After two quarters of consecutive surprise on margins across banks, we believe margins have peaked, albeit at a higher level. Going forward, given the environment of tight liquidity and slow deposit mobilisation, we believe cost pressures will be more prevalent and the impact will be disproportionate across banks with relatively weaker franchises getting impacted more. Rising loan to deposit ratio (LDR), a key contributor to margin improvement, has peaked. A pick up in credit demand suggests presence of pricing power. However, we believe it is unlikely to be passed on completely, leading to margin compression.

We believe headwinds on commodity prices, coupled with out-of-turn rainfalls, have the potential to keep inflation above the RBI target of 5.5% by FY11. Considering the modest IIP readings over the past couple of months gyrating to some extent to the central bank tightening move, puts RBI in a spot to react (tighten further) to rein in inflation at the cost of further hurting growth. We believe this will be adverse for the banking system given the capacity to pass on rising regulatory cost. Also, a sticky inflation could keep bond yields elevated.

Chart 29: Tight liquidity to keep the pressure on margins



Source: Bloomberg

Pension option liabilities could also act as headwinds

So far, it has been a one-way street for PSU banks, in case of operating leverage. The market is concerned that the second pension option liabilities and gratuity cost will break the journey. Extrapolating the impact on Union Bank to other PSU banks suggests that higher-than-expected cost pressure could emerge in the near term. However, if banks are allowed to amortise the cost over a span of five years, we believe the impact could be restricted.

Real Estate: Funding constraints, resource availability, tepid volumes; reduced weightage

Funding constraints, rising costs, and tepid volumes could act as headwinds to real estate sector

We are downgrading real estate sector from overweight to underweight on the back of increasing concerns. Volumes in real estate are likely to remain tepid in key markets such as Mumbai and NCR. There is little probability of further price increases in near term, while some regions such as Mumbai and NCR could actually witness some price correction. In our view, funding constraints will continue to impact this sector. Consequently, this will result in increasing cost of debt. Our real estate team estimates that for DLF, for example, cost of incremental debt will increase by ~1.0-1.5%. Elevated cost pressures could also act as a drag on this sector. Manpower costs have risen by ~1.5-1.7x in the past three months. This has resulted in increase in construction costs by ~7-8%. Higher labour costs/wage pressures will also mean higher overheads, impacting profitability and valuations. Given these factors, we are completely exiting the real estate sector.

Industrials: Execution challenges and valuations a concern; turning under-weight

Execution challenges and valuations a concern in industrials' sector

We are downgrading industrials from over-weight to under-weight on back on concerns regarding execution and valuations.

Execution challenges could act as a headwind for the sector. Despite a healthy book to bill, the sector is still not completely out of the woods with respect to overall execution issues given various aspects like environmental clearances, financial closures particularly in infra and power projects etc, which we see as potential risks. The sector has seen a strong recovery in new orders in last 3-4 quarters led by power, oil and gas, mining and construction etc, most of which we feel is in the price. We feel the sector looks slightly over-valued on a medium term perspective with not enough clarity with respect to sustainability of superior earnings and new order growth which we have seen in last 3-4 quarters in front-line cap goods stocks.

Top picks

In this selection of specific stocks, we have focused on names which have proven execution skills and are leaders or emerging leaders in their respective segments. Accordingly, our selection is based on bottom up approach and focus on quality.

Table 6: Top picks

Company	Current market cap	CMP	P/E		P/B		ROE		Div yield
	USD bn	INR	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY12E
Large-caps									
RIL	77.3	1,056	16.1	13.6	2.2	2.0	14.5	15.3	0.8
TCS	50.7	1,158	27.1	23.9	8.3	6.6	34.6	30.7	0.9
Tata Steel	14.2	704	9.3	8.0	2.3	1.8	26.3	24.3	2.4
Axis Bank	12.2	1,334	16.5	12.9	3.0	2.5	19.0	20.7	1.1
Hindalco	10.5	246	15.4	11.5	1.9	1.7	13.3	15.6	0.4
M&M	10.5	788	20.2	17.9	4.4	3.7	25.3	22.5	0.9
PFC	7.9	307	13.7	11.3	2.3	2.0	18.0	18.9	1.5
HCL Tech	6.9	454	19.1	14.8	3.6	3.1	21.6	23.2	0.9
GMR Infra	4.1	47	NM	50.7	2.2	2.1	NM	4.2	0.0
Dabur	3.9	101	28.8	22.9	12.7	9.7	49.9	48.2	1.7
Mid-caps									
Pantaloon	1.8	374	25.6	18.6	2.2	2.0	9.0	11.2	0.1
United Phosphorus	1.7	169	11.8	9.0	1.9	1.7	17.9	18.5	1.1
Dish TV India	1.7	72	NM	190.2	40.6	33.4	NM	19.3	NM
Federal Bank	1.5	404	10.8	8.7	1.4	1.2	12.9	14.5	1.7
Shree Renuka Sugars	1.5	98	13.7	9.7	2.4	2.0	19.0	22.4	1.0
Jindal Saw	1.2	189	10.3	9.2	1.2	1.1	13.5	12.5	0.8
KEC International	0.6	106	11.7	8.9	2.5	2.0	26.7	25.3	1.2
Escorts	0.4	184	11.9	9.5	1.0	0.9	8.8	10.1	0.9
VIP Industries	0.4	678	18.3	13.3	8.4	6.0	53.5	52.3	1.5
Hexaware	0.4	128	19.7	12.2	1.9	1.8	8.3	15.8	1.2

Source: Edelweiss research

Model portfolio

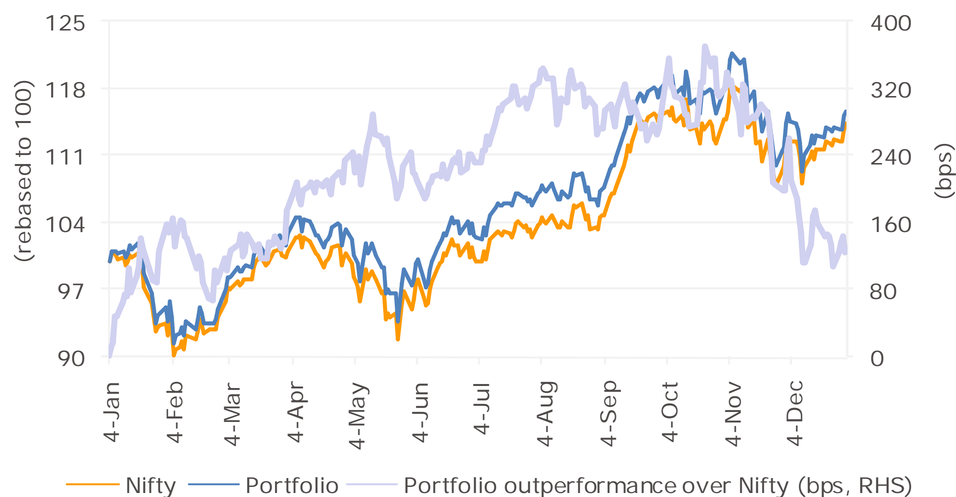
Given below is the model portfolio. On the major changes since October, as discussed, we have moved metals, energy, healthcare and utilities from equal weight to overweight, BFSI from equal weight to underweight and real estate and industrials from overweight to underweight.

Stocks	Mkt cap (USD	Price (INR)	Portfolio wt (%)	Nifty wt (%)	Rel wt bps	P/E FY11E	P/E FY12E	P/B FY11E	P/B FY12E	RoE FY11E	RoE FY12E	Div Yld FY12E
Energy			**17.2**	**14.7**	**250**							
Reliance Industries	77.3	1,056	11.0	9.8	120	16.1	13.6	2.2	2.0	14.5	15.3	0.8
ONGC	61.8	1,293	2.4	2.4	0	10.5	9.7	2.4	2.1	24.5	23.2	3.8
Cairn India	14.3	336	1.8	0.8	100	12.3	7.7	1.7	1.4	14.3	19.4	0.0
Jindal Saw	1.2	189	1.0	0.0	100	10.3	9.2	1.2	1.1	13.5	12.5	0.8
Indraprastha Gas	1.1	350	1.0	0.0	100	19.9	17.7	5.0	4.2	27.1	25.6	1.8
Information Technology			**16.8**	**14.4**	**240**							
TCS	50.7	1,158	4.3	3.3	100	27.1	23.9	8.3	6.6	34.6	30.7	0.9
Infosys Technologies	44.4	3,458	9.8	9.1	70	28.4	24.2	7.0	5.8	27.2	26.3	1.0
HCL Technologies	6.9	454	1.7	0.6	110	19.1	14.8	3.6	3.1	21.6	23.2	0.9
Hexaware Tech.	0.4	128	1.0	0.0	100	19.7	12.2	1.9	1.8	8.3	15.8	1.2
Metals & Materials			**10.8**	**8.5**	**230**							
Tata Steel	14.2	704	3.6	2.3	130	9.3	8.0	2.3	1.8	26.3	24.3	2.4
Hindalco Industries	10.5	246	3.8	1.7	210	15.4	11.5	1.9	1.7	13.3	15.6	0.4
JSW Steel	5.9	1,191	1.1	0.0	110	16.6	9.3	1.7	1.5	13.9	17.1	0.8
Bhushan Steel	2.3	491	1.1	0.0	110	11.2	8.8	2.1	1.7	21.2	21.8	0.2
United Phosphorus	1.7	169	1.1	0.0	110	11.8	9.0	1.9	1.7	17.9	18.5	1.1
Consumer Goods			**8.9**	**6.9**	**200**							
ITC	30.1	175	5.1	5.1	0	26.7	22.7	7.8	6.7	31.6	31.7	1.9
Hindustan Unilever	15.3	313	1.8	1.8	0	30.5	26.4	21.7	16.8	77.8	71.9	2.1
Sun TV Network	4.8	540	0.4	0.0	40	30.4	26.1	8.9	7.2	32.8	30.5	1.0
Dabur India	3.9	101	0.4	0.0	40	28.8	22.9	12.7	9.7	49.9	48.2	1.7
Dish TV India	1.7	72	0.4	0.0	40	NM	190.2	40.6	33.4	NM	19.3	NM
Shree Renuka Sugars	1.5	98	0.4	0.0	40	13.7	9.7	2.4	2.0	19.0	22.4	1.0
VIP Industries	0.4	678	0.4	0.0	40	18.3	13.3	8.4	6.0	53.5	52.3	1.5
Utilities			**6.9**	**4.5**	**240**							
NTPC	36.6	198	1.7	1.4	30	19.2	16.9	2.4	2.2	13.1	13.8	2.1
Tata Power	7.3	1,375	1.7	1.2	50	15.6	11.8	2.5	2.2	15.8	18.4	1.6
Reliance Infra.	4.7	862	1.4	0.6	80	19.2	13.1	1.5	1.4	8.4	11.2	1.0
GMR Infrastructure	4.1	47	1.0	0.0	100	NM	50.7	2.2	2.1	NM	4.2	0.0
Lanco Infratech	3.5	66	1.0	0.0	100	24.9	15.9	4.0	3.1	11.4	22.3	0.0
Health Care			**5.2**	**3.7**	**150**							
Lupin	4.9	487	2.4	0.0	240	24.1	19.6	6.7	5.4	29.4	28.9	1.1
Aurobindo Pharma	1.7	1,331	1.4	0.0	140	16.0	13.6	3.2	2.8	25.3	24.3	0.4
Torrent Pharma	1.1	579	1.4	0.0	140	16.5	13.0	4.6	3.6	31.2	30.9	1.3
BFSI			**21.2**	**25.9**	**(470)**							
State Bank of India	40.1	2,822	2.2	3.9	(170)	12.3	10.1	2.3	1.7	16.6	17.5	1.4
ICICI Bank	29.4	1,145	7.2	7.2	0	25.2	19.8	2.5	2.3	9.8	11.6	1.3
HDFC Bank	24.8	2,391	4.5	4.5	0	27.8	21.1	4.5	3.9	17.1	19.6	0.8
HDFC	23.8	728	4.4	5.2	(80)	31.0	25.7	7.8	5.4	20.8	20.7	1.2
Axis Bank	12.2	1,334	1.9	1.9	0	16.5	12.9	3.0	2.5	19.0	20.7	1.1
Power Finance Corp	7.9	307	0.5	0.0	50	13.7	11.3	2.3	2.0	18.0	18.9	1.5
Federal Bank	1.5	404	0.5	0.0	50	10.8	8.7	1.4	1.2	12.9	14.5	1.7
Autos			**4.3**	**7.5**	**(320)**							
Tata Motors	17.4	1,308	2.4	2.4	0	10.4	8.8	4.2	2.9	24.9	27.2	0.8
Mahindra & Mahindra	10.5	788	1.9	1.9	0	20.2	17.9	4.4	3.7	25.3	22.5	0.9
Telecommunication Services			**0.8**	**2.9**	**(210)**							
Bharti Airtel	30.5	359	0.8	2.4	(160)	19.1	14.8	2.8	2.2	15.7	16.3	0.0
Industrials			**7.9**	**9.4**	**(150)**							
Larsen & Toubro	26.9	1,981	5.8	5.8	0	29.1	23.6	5.0	4.3	18.4	19.5	0.6
BHEL	25.7	2,344	1.6	2.0	(40)	20.9	16.8	5.7	4.5	30.5	29.9	1.0
KEC International	0.6	106	0.5	0.0	50	11.7	8.9	2.5	2.0	26.7	25.3	1.2
Cement			**0.0**	**1.2**	**(120)**							
Real Estate			**0.0**	**0.6**	**(60)**							
Model Portfolio	**659**		**100**	**100**	**0**	**18.9**	**15.1**	**3.3**	**2.8**	**17.6**	**18.6**	

Performance of model portfolio

Given below is the performance of our model portfolio. It has outperformed the benchmark index (Nifty) by ~130 bps during CY10.

Chart 30: Performance of model portfolio



Source: Edelweiss research

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