Equities

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India Equity Strategy

Rally Reality – 30% in 33 days

- **30% in 33 days! Seen it before?** — Actually Yes. This rally – 33 trading days so far, and currency adjusted - only makes the middle of the 5 big rallies in the last decade. It is however clearly a very impressive rally: leader in local currency (+20%) and currency adjusted terms (+30%) amongst large EM/DM markets, India's strongest USD rally vs. EMs, and more broad-based (i.e. mid/cap and Small cap participation) than the index's performance would suggest. All this is good (and past), so we look closer at the reality of this rally, and (more importantly) question how real it is.
- **The Reality of this Rally** — How does this rally stack up against the previous 5 rallies? It is a) more broad-based (relative mid-cap/small cap performance is second best) b) starting from a relatively higher valuation (1yr fwd PE: 12.6x – second highest; range:9x-16.5x) c) Outperformance is led by the usual sector suspects (Materials: 16%, Industrials:10%, Financials: 8% and as always d) has been led by strong foreign Inflows, though this time there has been aggressive domestic selling (almost 50% of foreign buying). Not enough to say its 'different this time', but there are differences.
- **Real? Will it Rally on?** — India's had a few false starts - (11/21 15%+ rallies have petered out. But the four that have lasted 100 days have generated a 48% median local currency return (55% averages) and volumes have gone up sharply (86%). So far, the domestics haven't even participated; equities worldwide continue to rally , and Citi's Global and EM strategist expect the equity rally to go on:+11% for global equities, +15-20% for EM, from here. Will India continue to lead the rally, or at least rally along?
- **Fundamentally, we believe India's fair value is now near** — The Indian market, at 18,154 on the Sensex is almost at our fundamental December 2012 target of 18,400. We are holding our target. We would continue to position our portfolio relatively aggressively and for risk (and stay away from defensives): see overshoot risks on the upside rather than the downside. But we believe the markets' move now prices in a quickly recovering economy/corporate sector; this will likely take time (3/4QFY13), and the market will likely wait for most 2012 for the economy to catch up.

- Equities

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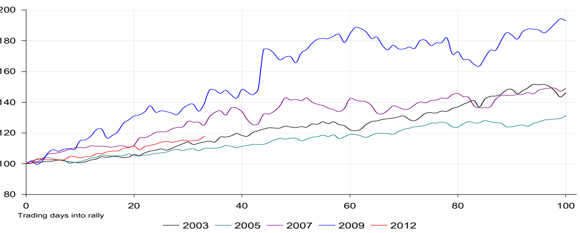
Figure 1. Sensex Rallies



Source: Bloomberg

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

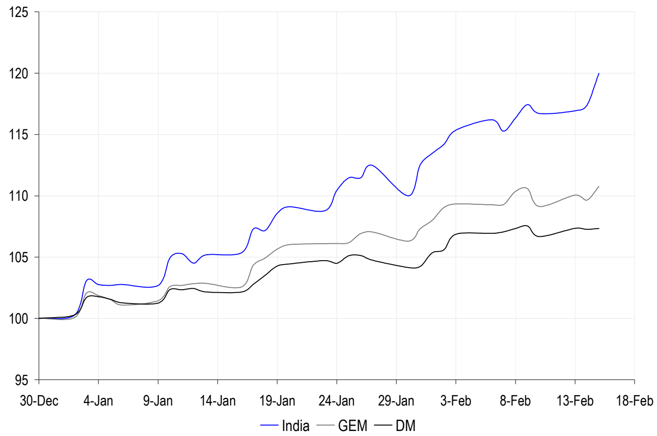
Rally Reality

30% in 33 days

India has led the big markets, by quite a margin

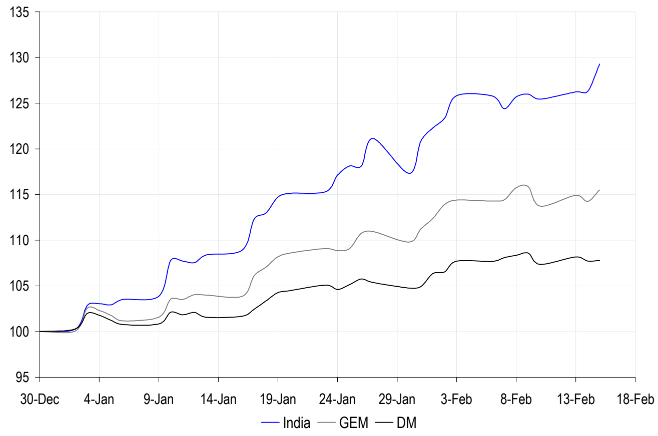
India has led the global equity market rally: up 30% in 33 days in USD terms, 20% in local currency terms, and tracked closely only by Brazil amongst the relatively large EM's. It's in part a bounce-back from a very poor 2011 (-38% in USD), but it is nonetheless a very strong bounce-back.

Figure 2. 2012 YTD Equity Market Performance (Local Currency)



Source: MSCI, Datastream

Figure 3. 2012 YTD Equity Market Performance (USD)

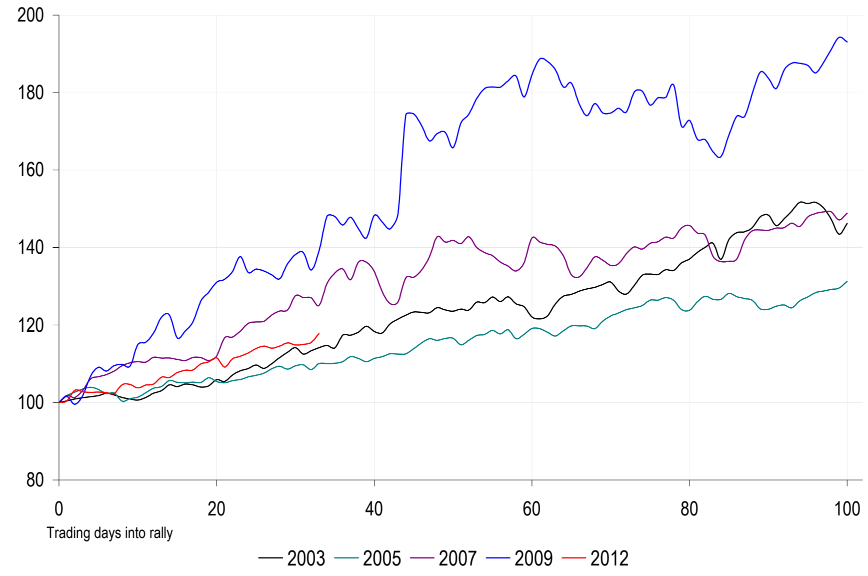


Source: MSCI, Datastream

It's an impressive rally, but only in the middle of the pack of 5 strong rallies in the last decade

So is this big rally India's best and shiniest over the last decade? Actually no. It is one of five (which went all the 100-day way), and even amongst these rallies, it only lies in the middle of the pack, at an equivalent stage. The 2009 rally takes the lead – by a wide margin, and the 2005 rally (after a fall post a change in Government) also leads in early performance, compared with Jan / Feb 2012.

Figure 4. Sensex Rallies

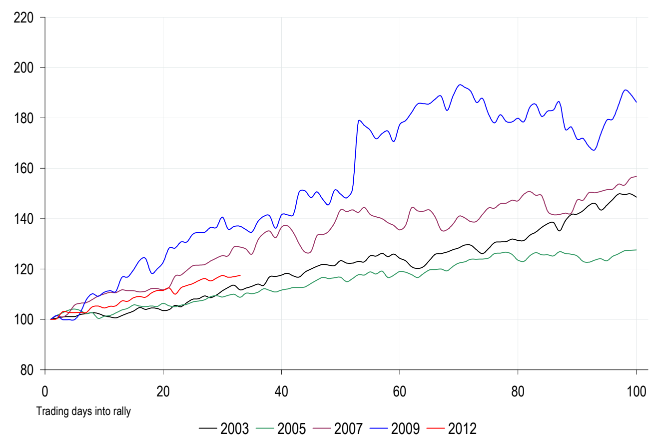


Source: Bloomberg

It's a stronger rally in USD terms…..but still not its best

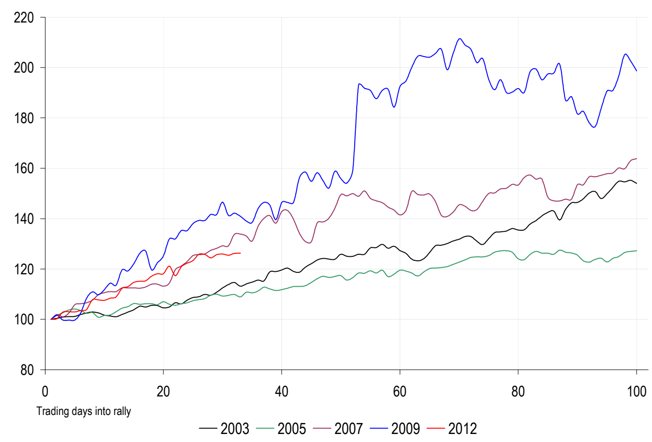
This is a relatively stronger rally in USD terms, compared with the previous market runs – but here too, it is only the third best rally of the five that sustained and have lasted the 100 trading days. Clearly, India's equity markets are highly and positively correlated with the currency, albeit a little more closely correlated this time.

Figure 5. MSCI India Rallies (INR)



Source: MSCI, Datastream

Figure 6. MSCI India Rallies (USD)



Source: MSCI, Datastream

India led EM's in 2009 and lagged them in 2003 (the two big EM rallies)….in USD terms, it is ahead this time

India's performance relative to EM's (in local currency) has tended to be more middle of the road in the early part of the rally (local currency): with India Underperforming EM's in the 2003 rally, and outperforming in the 2009 rallies (the two big EM rallies – the other two were a little more India-centric. Its USD based performance this time though is stronger than any of the other rallies in the early part; and that India went on to out-perform at the 100 day mark of these rallies suggests a very strong start.

India's starting valuations are at the higher end of previous rallies...

Will this outperformance continue? We believe the jury is still out. In 2003, India was sitting on very low valuations and high operating leverage at the start of rally. And in 2009, valuations were a lot lower and while India did face a financing crisis economic momentum was only mildly interrupted by the slow down. This time, while the market's start has been strong in absolute and relative terms; starting valuations are less compelling, and its economic outlook more tepid.

Figure 7. MSCI India rel. to MSCI GEMs in rallies (local currency)

Source: MSCI, Datastream

Figure 8. . MSCI India rel. to MSCI GEMs in rallies (USD)

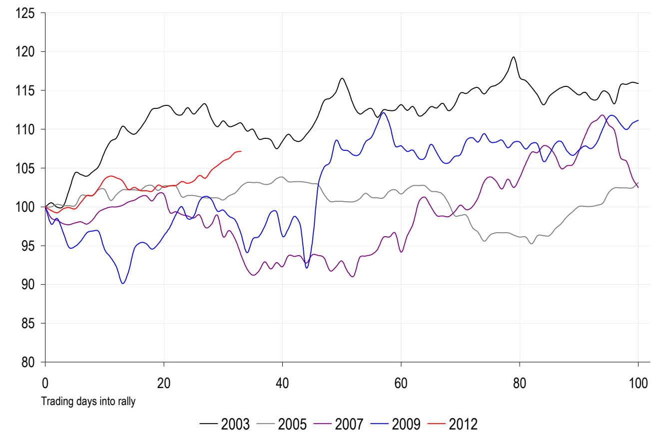
Source: MSCI, Datastream

....small and mid-caps are doing better than in 4/5 previous rallies

This is a broad market rally

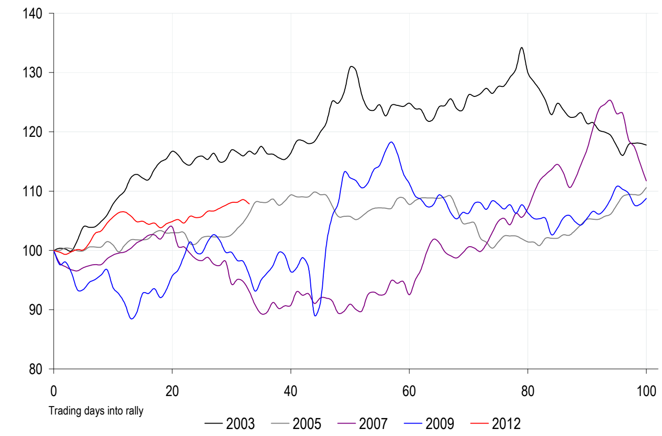
This rally so far; is the second broadest of the five big ones that we consider; with the Mid and Small Caps recoding the second strongest performance relative to the narrower Sensex. While both lag the breadth of the 2003 rally, it is a broader rally relative to the 2009 one – which as rallies go, was clearly the sharpest and straightest of them all. The rallies of the past do also suggest a bit of surge in the mid/small caps closer to the mid point of the 100 day period: will it come this time, given that their moves has been more trend-line than in previous cases?

Figure 9. BSE Mid-Cap rel. to Sensex in rallies



Source: Bloomberg

Figure 10. BSE Small-Cap rel. to Sensex in rallies



Source: Bloomberg

Rally leaders are not very different ….materials, industrials and financials

Leaders and laggards are pretty traditional

Are the leaders and laggards very different this time? Not really: it's the rate sensitives – Materials / Industrials/ Financials that drove the market. And it's the traditional defensives – Consumers, IT and healthcare that make up the rear. We believe if the rally is to continue, then it will largely be these sectors that will lead, although materials will potentially be a little less predictable given the increasingly varied global driver. We also expect Consumer discretionary to potentially outperform going forward given their relative rate sensitivity and make more of a mark compared to the material sector.

Figure 11. Sector Leaders and Laggards in rallies (returns relative to MSCI India)

	Leaders			Laggards		
2003	Industrials (16%)	Cons. Discretionary (13%)	Materials (12%)	Cons.Staples (-17%)	IT (-4%)	Utilities (-2%)
2005	Cons. Discretionary (8%)	Cons. Staples (6%)	Energy (3%)	Materials (-8%)	Healthcare (-4%)	Utilities (-4%)
2007	Utilities (101%)	Financials (22%)	Energy (17%)	IT (-59%)	Healthcare (-35%)	Cons. Discretionary (-35%)
2009	Materials (46%)	Financials (42%)	Industrials (33%)	Cons. Staples (-61%)	Healthcare (-34%)	Utilities (-29%)
2012	Materials (16%)	Industrial (10%)	Financials (8%)	Cons. Staples (-17%)	IT (-14%)	Healthcare (-12%)

Source: MSCI, Datastream

Previous rallies – over 100 days…have gone a lot higher than the current one

Its not a particularly low valuation rally

Starting low, and so can go higher? No. India has not started this rally at a relative low: its starting valuations are at the higher end of previous 'start of rally' levels. It is also distinctly higher than the big 2003/2009 rallies. This does suggest that the headroom is potentially less than in previous rallies: though the 100 day gains for most of the rallies suggest there is meaningful headroom for the rally to generate more market gain. But typically, the lower you start, the higher you have to go: India though currently remains well off the 100 day valuation levels previous rallies have reached. 67 days to go.

Figure 12. Change in valuation (1-Yr Fwd Consensus P/E)100 Days into rallies

	Sensex Returns	Starting P/E	Ending P/E	% Change in multiple
2003	46%	8.96	12.09	35%
2005	31%	11.57	15.11	31%
2007	49%	16.52	21.79	32%
2009	93%	9.75	17.24	77%
2012	18%	12.62	14.53	15%

Source: Factset

Its foreigners who are driving this rally too…..but almost for the first time, domestics have been selling into the rally

It is foreign money

Who is driving this rally? Not surprisingly, it is foreign money that is dominating the market and the flows this time are second only to 2007, and meaningfully more than the 2003 and 2009 Equity rallies (starting valuations though are higher). What is however different this time is that DII flows have actually been negative – over 50% of foreign inflows, and clearly moderating 'what could have been' if domestic's had participated like in the past. Will domestic selling continue – and thereby stall the rally? Or could it reverse (as most domestics are believed to have underperformed the market, and have increasingly got hurt as the market has gone higher): and the second leg of domestic buying drives the market higher? The jury is out on this – but this could potentially moderate the dependence on foreign flows to sustain the rally.

Figure 13. Rallies and flows

	33 Days into Rally				100 Days into Rally			
	Flows			Sensex	Flows			Sensex
	FII	DMF	DII	return	FII	DMF	DII	Return
2003	483	15		14%	2,291	(53)		46%
2005	(117)	912		10%	4,454	1,568		31%
2007	7,469	30	(963)	25%	10,899	1,556	3,306	49%
2009	1,686	417	435	39%	9,201	1,475	2,219	93%
2012	4,062	(596)	(2,299)	18%				

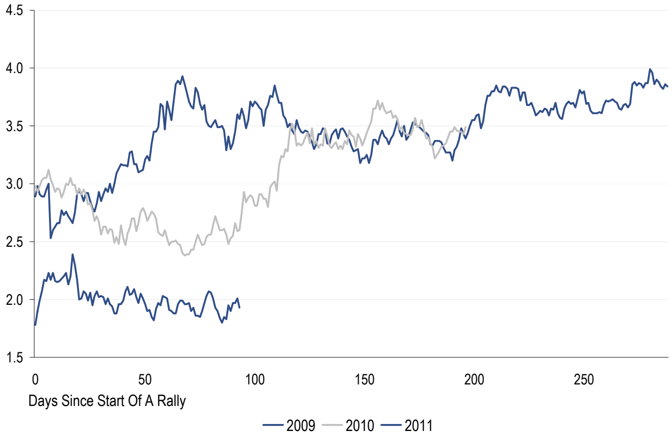
Source: SEBI, Bloomberg

What have Interest rates got to do with it…little so far, but matters globally, so let's keep a watch

'What if' rates start rising?

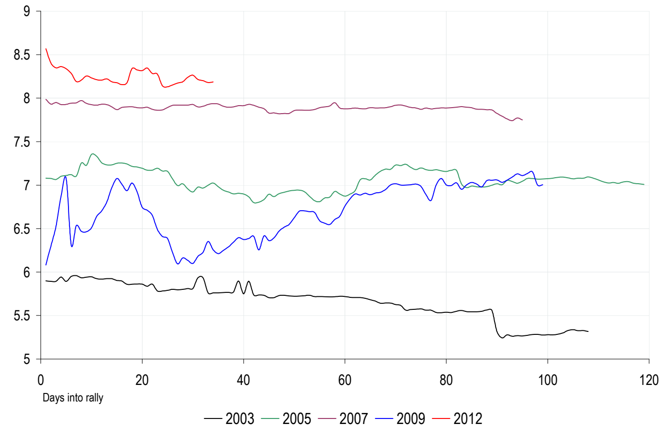
Our Global Equity Strategist has highlighted that Global equity rallies have historically got a little nipped as interest rates have started to rise. This is not the case this time, rates remain relatively stable, and they expect the rally to continue (a further +11% from here, for the MSCI world). In India's case, we do not find a concomitant rise in rates during the 5 rallies we analyzed. With the RBI adopting a decidedly dovish stance on interest rates, we do not see rates as a potential impediment to the current rally.

Figure 14. US 10 Yr Govt. Bond Yield during rallies



Source: Datastream

Figure 15. India 10 Yr Govt. Bond Yield during rallies



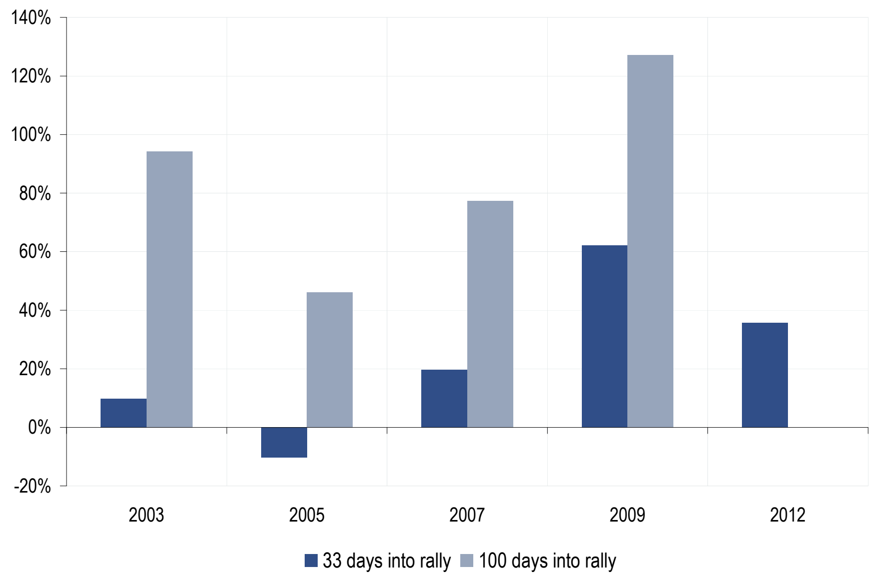
Source: Bloomberg

Volumes usually go up a long way in such market moves…similar this time, but potentially a long way to go

It always is a volume story

What do volumes tell us? That the market is trading much more aggressively, that market volume expansion is in line with previous strong rallies, and if it were to sustain, it will be good for our business. That it remains largely foreign inflow driven - with relatively little evidence of retail participation at this stage - suggests that it has yet to take on the breadth of previous rallies. If it gets there, then there is enough evidence to suggest the rally could go on for a while. If not, then the dependence on only foreign money will continue (which could potentially be challenging, given India's significant outperformance).

Figure 16. Change in India turnover (30 day ma) during rallies*



Source: Bloomberg

* Change is measured relative to turnover 1 week prior to rally beginning

Figure 17. India Turnover (USD Mn)

	1 Week Ago	33-days	100-days	chg (33-days into rally)	chg (100-days into rally)
2003	728	800	1,414	10%	94%
2005	1,593	1,427	2,326	-10%	46%
2007	4,206	5,036	7,454	20%	77%
2009	2,258	3,660	5,130	62%	127%
2012	2,356	3,198		36%	

Source: Bloomberg

Fair Value and Model Portfolio

The call has worked so far….time to swim along, or get swamped

We like this Rally, particularly given our Dec 2011 (2012 Outlook: Structural Pain In, Cyclical Gain Not) call that the Indian market offers upfront upsides – and a December 2012 Sensex target of 18,400. But such sharp, liquidity backed and 'going with the flow' kind of investor and inflow momentum can be a scary thing. It is hard to get off the rising wave, and stand up against it; in some measure because you can get swamped by it, and in part because – as a lot of the data in this note suggests -- such rallies can go on a long way.

Stay with the fundamental view….the market should be at 18,400 at Dec 12…the market has moved, time for the economy/corporate sector to catch up…

We do however choose to run some risk and at the market level, stick with what we believe is fair value for the Indian market. Which remains 18,400 for Dec2012, based on a March 13 PE multiple of 14X, a slight discount to the markets long term multiple of 15.5-16X. We recognize the market mood has changed, there is more capital that is available (and that is critical for a market / economy like India), and there is probably a little less caution with the corporate sector than two months ago. But not enough has changed on the ground in the broader economy, or the corporate sector. We argue that while the macro and the market have moved favorably – the economy/corporate sector have to play catch up, and deliver in earnings, investment, expansion and risk appetite.

… and that could take more time than the markets current mood suggests

In our view, that will take some time – the market will expect it to start showing up almost immediately, and our own sense is that this is still 2/3 quarters away (India is now a big economy: once it starts slowing – as is the case, will take more than a some policy and market action to reverse this slackening momentum in a hurry). Our sense is that the markets' bounce will moderate as real changes take time to come through. And the market will stay around fair value till some of this starts coming.

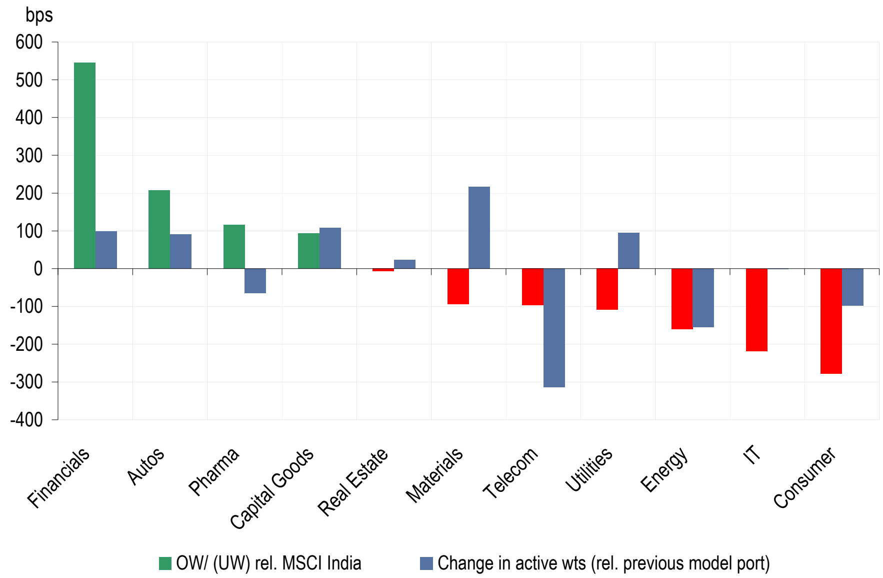
Overshoot risks on the upside…..

Are the risks on the upside or the downside? Rallies can go on and on, but big moves often retrace sharply. Our view is that the overshoot risks lie on the upside rather than the downside: the market had got oversold, the economy had not slowed as much as was made out to be the case, there is a real monetary peaking that is happening (along with inflation falling), and there was just too much caution on the Governments inaction – some of which is being unwound now. This mix, to us suggests, barring any meaningful global event, that market risks lie on the upside rather than the downside. And fair value rests a little above where we currently sit – which is where the market should revert to in the event of an overshoot.

Keep the portfolio and stocks aggressive….cut Telecom to UW, Financials remain the biggest bet..

So what do we do with our portfolio: keep it aggressive, biased towards interest rates cyclicals, and stay away from the defensives. We make modest changes in our portfolio, cut our Telecom OW to an UW, moderate our UW on materials, and slightly raise our weighting in the capital goods sector. Financials continue to remain our biggest OW, followed by automobiles. We also introduce more stocks – add on more risk, though we refrain from going too far down the quality spectrum. India is now supposed to be technically in a bull market (20% gains from its low): just the time not to throw caution (or quality) to the winds.

Figure 18. Model Portfolio Sector UWs/ UWs



Source: Citi Investment Research and Analysis

Figure 19. Citi India Model Portfolio

	Price 16-Feb-12 (Rs)	YTD Perf. (%)	RIC	Rating	MSCI Wt (%)	Portfolio Wt (%)	OW/ UW/Rel. MSCI (bps)	FY13 PE (x)	FY13 EPS Growth (%)	FY13 PB (x)	FY13 ROE (%)
Automobiles and Components					7.43	9.5	207				
M&M	725.5	6.2%	MAHM.BO	2		2.5	O/W	16	4.0%	3.0	20.8%
Maruti	1357.2	47.5%	MRTI.BO	1		3.0	O/W	23	36.2%	2.4	11.0%
Tata Motors	275.9	54.7%	TAMO.BO	1		4.0	O/W	7	22.8%	2.1	37.9%
Banks & Diversified Financials					25.55	31.0	545				
AXIS Bank	1222.7	51.6%	AXBK.BO	1		5.0	O/W	11	14.4%	1.9	19.2%
IDFC	146.0	59.1%	IDFC.BO	1		1.5	O/W	12	11.8%	1.6	13.7%
HDFC Bank	526.2	23.2%	HDBK.BO	2		5.2	U/W	19	28.5%	3.4	19.4%
ICICI Bank	968.9	41.5%	ICBK.BO	1		6.0	O/W	15	21.0%	1.7	12.4%
State Bank of India	2349.1	45.0%	SBI.BO	1		3.5	O/W	10	30.2%	1.7	18.1%
Yes Bank	366.4	53.5%	YESB.BO	1		1.0	O/W	11	23.5%	2.2	23.3%
Kotak Mahindra	573.8	32.7%	KTKM.BO	2		1.0	U/W	19	23.8%	2.8	16.2%
MMFSL	707.2	16.7%	MMFS.BO	1		1.0	O/W	10	22.2%	2.0	22.5%
Bank of Baroda	863.3	30.6%	BOB.BO	2		0.7	O/W	6	18.2%	1.1	20.9%
Industrials & Capital Goods					6.06	7.0	94				
Larsen & Toubro	1447.1	45.4%	LART.BO	1		4.0	O/W	19	7.8%	3.1	17.2%
Adani Port & SEZ	147.7	22.5%	APSE.BO	1		1.0	O/W	15	44.2%	4.3	32.4%
Cummins	469.5	34.5%	CUMM.BO	1		1.0	O/W	20	18.7%	5.8	30.2%
IRB Infra	201.5	55.0%	IRBI.BO	1		1.0	O/W	11	14.8%	1.9	18.4%
Energy					11.10	9.5	-160				
Reliance Industries	812.2	17.2%	RELI.BO	1		7.0	U/W	13	2.9%	1.4	11.9%
Cairn	390.7	24.6%	CAIL.BO	1		2.5	O/W	7	35.5%	1.3	20.5%
Consumer					8.78	6.0	-278				
ITC	203.9	1.3%	ITC.BO	1		3.0	U/W	22	17.8%	8.9	41.8%
United Spirits	676.5	37.7%	UNSP.BO	1		3.0	O/W	19	28.1%	1.7	9.6%
Materials					10.93	10.0	-93				
Coal India	321.0	6.7%	COAL.BO	1		1.0	U/W	14	2.1%	3.6	29.9%
Hindalco	154.7	33.6%	HALC.BO	1		3.0	O/W	11	0.6%	0.9	8.3%
Jindal Steel & Power	640.0	41.2%	JNSP.BO	1		2.0	O/W	12	25.1%	2.6	25.2%
Grasim	2836.4	13.1%	GRAS.BO	1		1.0	O/W	11	-1.5%	1.4	13.6%
JSW Steel	859.7	69.5%	JSTL.BO	1		3.0	O/W	10	111.9%	1.0	11.1%
Pharmaceuticals, Biotechnology, Agrochem					4.84	6.0	116				
Ranbaxy	449.2	10.8%	RANB.BO	1H		2.0	O/W	17	42.1%	1.7	21.0%
Dr Reddy	1620.4	2.7%	REDY.BO	1		2.5	O/W	16	36.6%	3.6	26.8%
Lupin	489.0	9.3%	LUPN.BO	1		1.5	O/W	17	31.5%	4.3	27.8%
Software & Services					16.68	14.5	-218				
Infosys Technologies	2903.4	5.0%	INFY.BO	2		7.0	U/W	17	14.4%	4.3	27.6%
Tata Consultancy Services	1226.0	5.6%	TCS.BO	2		2.5	U/W	18	20.1%	5.5	34.0%
Wipro	438.6	10.0%	WIPR.BO	1		2.5	O/W	16	21.5%	3.2	22.3%
HCL Technologies	474.6	22.2%	HCLT.BO	1		2.5	O/W	13	23.3%	2.8	24.2%
Telecom Services					2.47	1.5	-97				
Bharti Airtel	350.3	2.1%	BRTI.BO	1		1.5	M/W	17	67.1%	2.3	14.4%
Utilities					5.09	4.0	-109				
Tata Power	113.4	29.9%	TTPW.BO	2		2.0	O/W	27	3.7%	2.2	8.3%
Power Grid Corp	110.6	10.7%	PGRD.BO	1		2.0	O/W	14	16.8%	2.0	14.4%
Real Estate					1.07	1.0	-7				
DLF	249.5	36.3%	DLF.BO	1		0.5	U/W	23	38.3%	1.6	7.1%
Phoenix	210.9	27.6%	PHOE.BO	1		0.5	O/W	21	21.5%	1.6	8.0%
Total					**100.0**	**100.0**					

Source: Citi Investment Research and Analysis

*Weights may not add up to 100 due to regulatory restrictions

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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