Equity Markets :
Current Environment and Outlook

Vetri Subramaniam, Head of Equity Funds

February 2011

Current Environment

- Global Equity markets remained bullish in February, with the MSCI World Index rising by 3.33%.
- Emerging markets underperformed Developed markets for the fourth month in a row.
- Indian markets sharply underperformed the global trend, falling by 2.75% in the month of February.
- Commodity prices mirrored the global trend in equities, with the benchmark CRB Reuters Jefferies total return index rising by 3.8%.
- FMCG was the best performing sector followed by Oil & Gas. Realty and Capital Goods sectors delivered the worst return for the month.
- FII outflows continued for the second consecutive month and were at Rs.46bn in January 2011. DIIs however recorded inflows of Rs.58bn and MF remained net buyers to the tune of Rs.14bn.
- Trading Activity remained subdued in February, with both the cash trading volumes (US $mn) and the average open interest remaining flat MoM.

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Global Equities

Index	Country	Closing Price*	1 Month Return (%)	YTD Return (%)	Category
SSE Composite Index	China	2905.05	4.10%	3.45%	EM - Asia
BSE Sensex	India	17823.40	-2.75%	-13.10%	EM - Asia
Kospi	South Korea	1939.30	-6.30%	-5.45%	EM - Asia
Taiwan Weighted	Taiwan	8599.65	-5.97%	-4.16%	EM - Asia
Thailand SET 50 Index	Thailand	690.89	3.34%	-4.07%	EM - Asia
Jakarta Composite Index	Indonesia	3470.35	1.79%	-6.30%	EM - Asia
KLSE	Malaysia	1491.25	-1.89%	-1.82%	EM - Asia
Ibovespa Sao Paulo Index	Brazil	67383.22	1.21%	-2.77%	EM
Mexico IPC	Mexico	37019.70	0.10%	-3.97%	EM
Russian RTS Index	Russia	1969.91	5.33%	11.14%	EM
Philippine PSEi	Philippines	3766.73	-2.96%	-10.34%	EM
Merval Buenos Aires Index	Argentina	3455.65	-3.83%	-1.93%	EM
HangSeng	Hong Kong	23338.02	-0.47%	1.31%	Developed - Asia
Nikkei	Japan	10624.09	3.77%	3.86%	Developed - Asia
Strait Times	Singapore	3010.51	-5.32%	-5.63%	Developed - Asia
Dow Jones	USA	12226.34	2.81%	5.60%	Developed
CAC 40 Index	France	4110.35	2.62%	8.03%	Developed
All Ordinaries Index	Australia	4922.60	1.50%	1.56%	Developed
DAX Index	Germany	7272.32	2.75%	5.18%	Developed
Swiss Market Index	Switzerland	6610.44	2.03%	2.71%	Developed
FTSE 100	UK	5994.01	2.24%	1.59%	Developed
MSCI World Index	--	1351.65	3.33%	5.59%	--

* as on 28th February. Source : Bloomberg
EM – emerging markets, Developed – developed markets.

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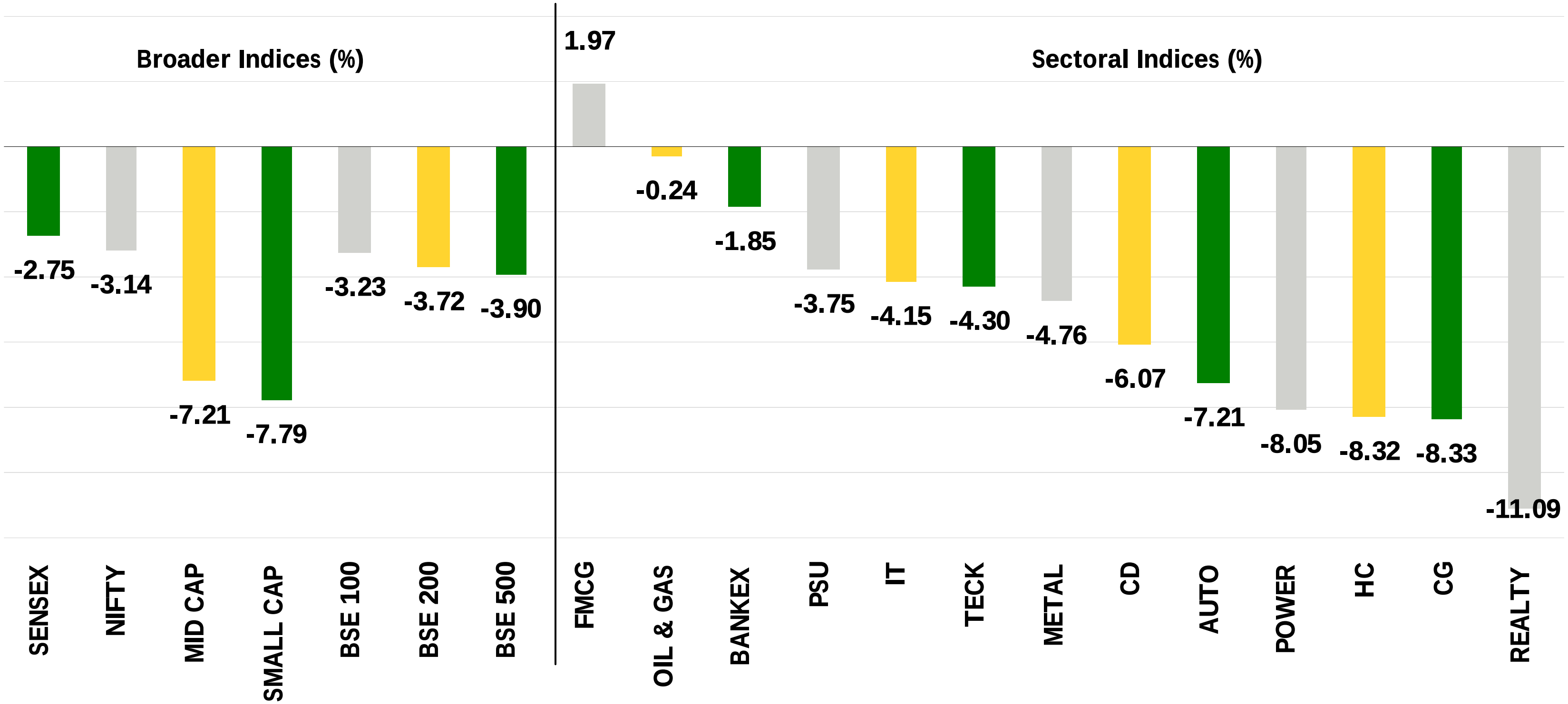
India : Sector performances



- Sensex fell by 2.75% over the previous month.
- MidCaps underperformed LargeCaps with a 7.21% loss for the MidCap index.
- FMCG was the best performing sector followed by Oil & Gas.
- Realty and Capital Goods sectors delivered the worst return for the month.

*Source: BSE,NSE. one month performance as on 28th February 11.

Top Gainers / Losers - Nifty

Top Gainers for the month			
Gainers	52 week H/L	Last Price#	% Gain*
Kotak Mah. Bank	526.55 / 333	405.05	7.56%
Reliance Inds.	1149.7 / 885.1	964.25	4.08%
Hind. Unilever	329.9 / 218	282	-0.53%
ITC	181.8 / 117.5	169	-0.75%
Bharti Airtel	376.95 / 252	331.3	-1.26%
Top Losers for the month			
Losers	**52 week H/L**	**Last Price#**	**% Loss***
Rel. Comm.	207.8 / 85	85.75	-23.31%
Ranbaxy Labs.	624.2 / 403.15	434.65	-21.64%
Sesa Goa	495 / 258	261.2	-21.45%
Reliance Power	192.8 / 106	110.35	-19.36%
Reliance Infra.	1224 / 492.05	609.8	-19.15%

closing price as on 28th February 2011.* one month performance as on 28th February 2011.
Source: Capitaline

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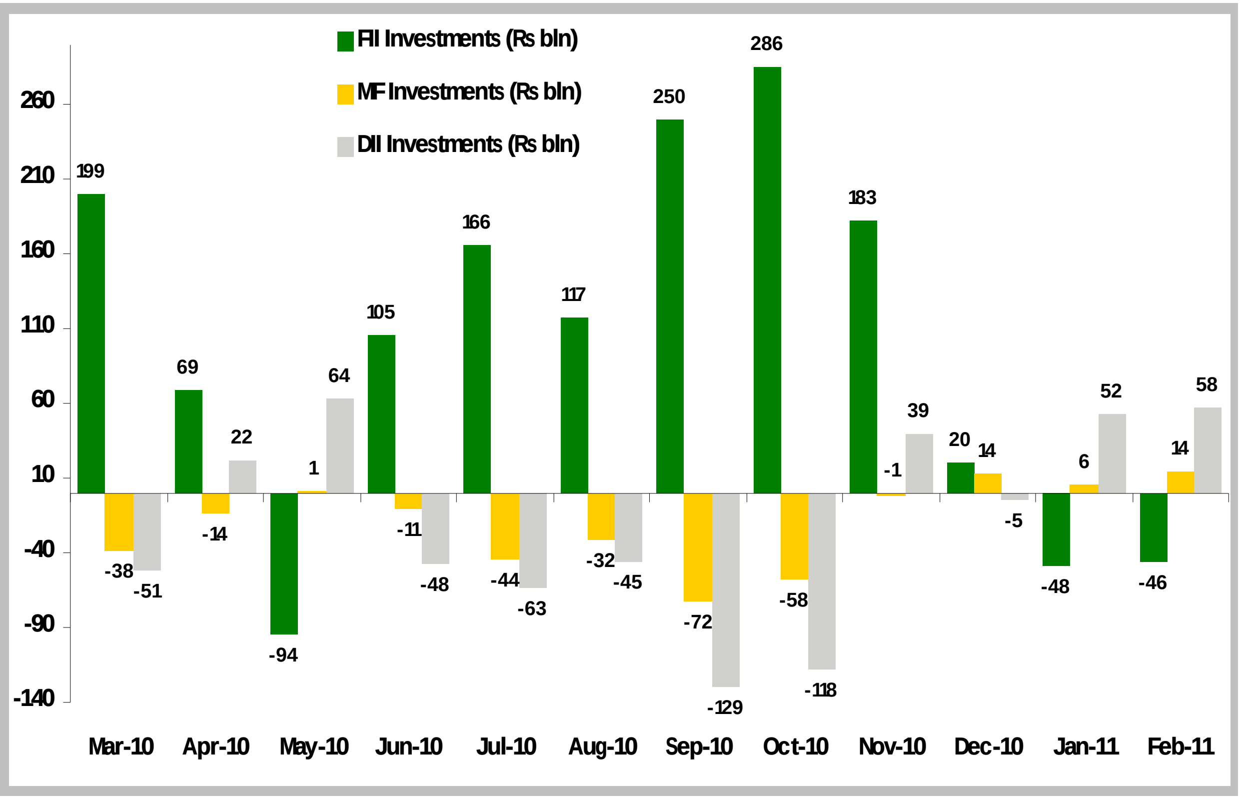
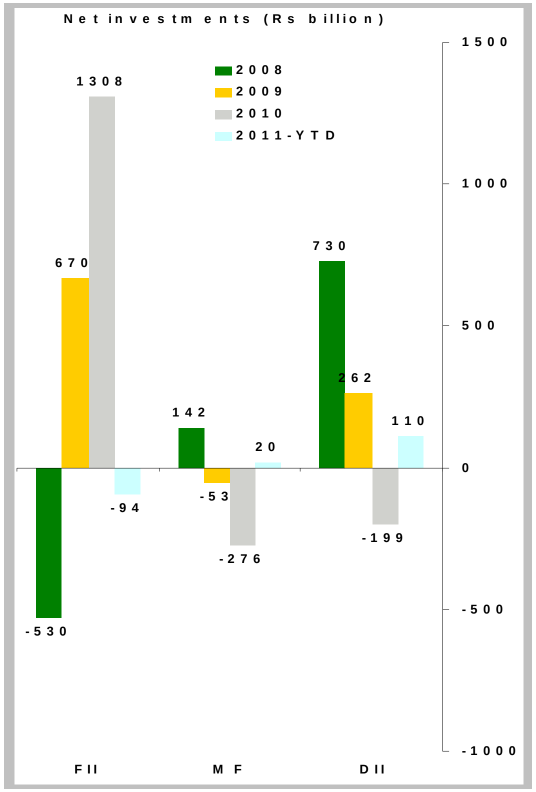
FII & DII Inflows





- FII outflows continued for the second consecutive month and were at Rs.46bn in January 2011. FII outflows were at Rs.94bn for CY11 after a Rs.1308bn inflow in CY10 and Rs.670bn inflow in CY09.

- DIIs recorded inflows of Rs.58bn. MF remained net buyers to the tune of Rs.14bn.

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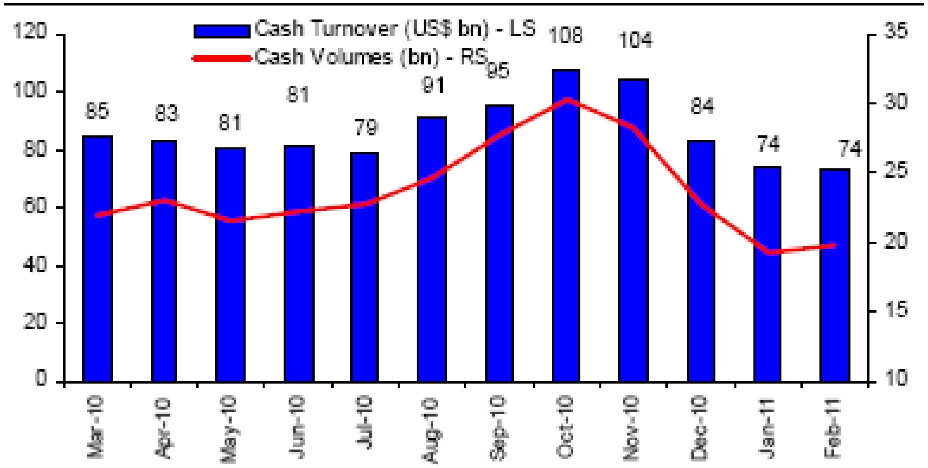
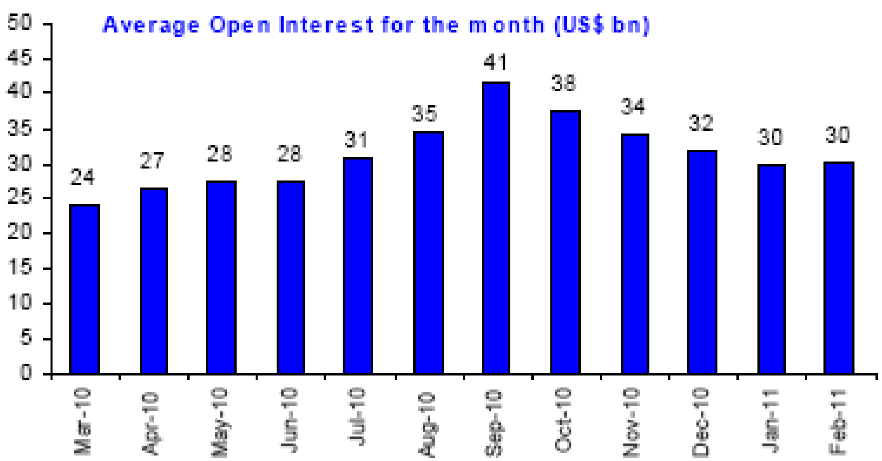
FII - Foreign Institutional Investors, DII - Domestic Institutional Investors (Includes Bank, DFIs, Insurance and MF)
Source: SEBI, BSE

Market Activity



- In February 2011, cash trading turnover (US $bn) remained flat MoM.



- At the end of February 2011, average open interest also remained flat MoM.

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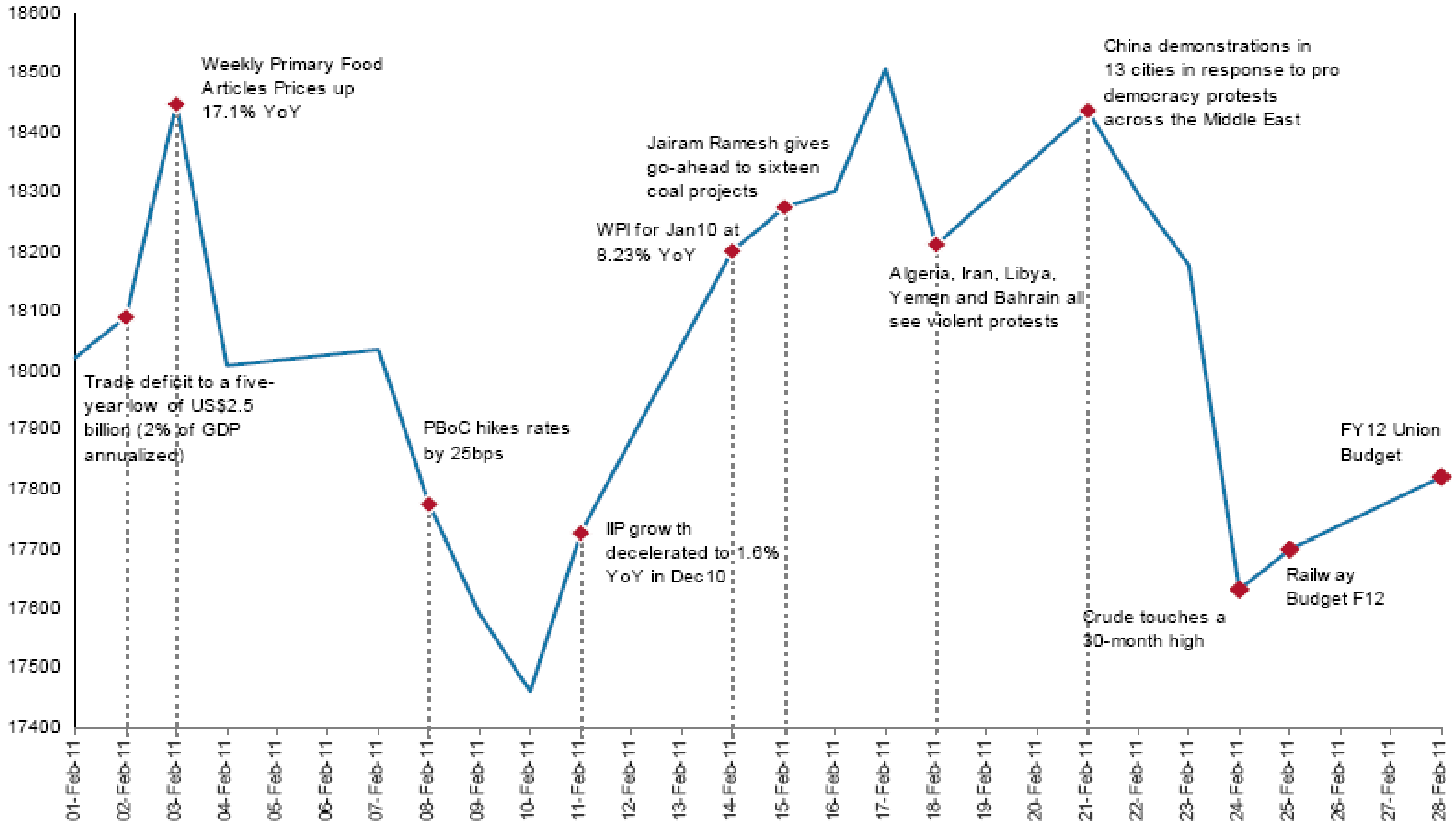
Sources: Bloomberg, Morgan Stanley

February 2011 events timeline



Source: Bloomberg, Economic Times, Business Standard, Morgan Stanley Research

Religare MF: Equity Market Outlook and Opportunities

Equity Market Outlook

- The ‘Jasmine Revolution’ in Tunisia a few months ago which led to the collapse of the government is spreading to nearby Arab nations, resulting in fall in the autocratic regime in Egypt and current rebellion in Libya.

- The immediate impact of such a political unrest is a threat to global oil supplies and resultant spike in crude-oil prices (21% spike already seen in less than a month!). This brings into the spotlight India’s dependence on oil imports and the large current account deficit (est 3.3% in FY11)

- On the domestic front, India’s 3QFY11 GDP growth at 8.2% came below expectations, though still remained above the 8% mark. However the good news is that private consumption has replaced the more volatile Government expenditure, as the key economic growth driver.

- While the Inflation has cooled recently, it remains above the central Bank’s comfort level and the higher oil prices are not reflected in inflation measures as fuel prices have not been revised.

- The current tactical theme of shifting of fund allocations from Emerging Markets (EM) to Developed Markets (DM) does not help India’s cause.

- The Union Budget 2011-12 was presented with a pro-growth approach focusing on fiscal consolidation by expenditure control.

- In 3QFY11, Sensex companies have reported the earnings, which are in line with estimates. However, there is clear evidence of margin pressure in several industries and the full impact of higher inflation and interest places earnings estimates at risk.

- Consensus earnings expectations for Sensex companies for FY11 and FY12 are largely unchanged since the start of the earnings season in January.

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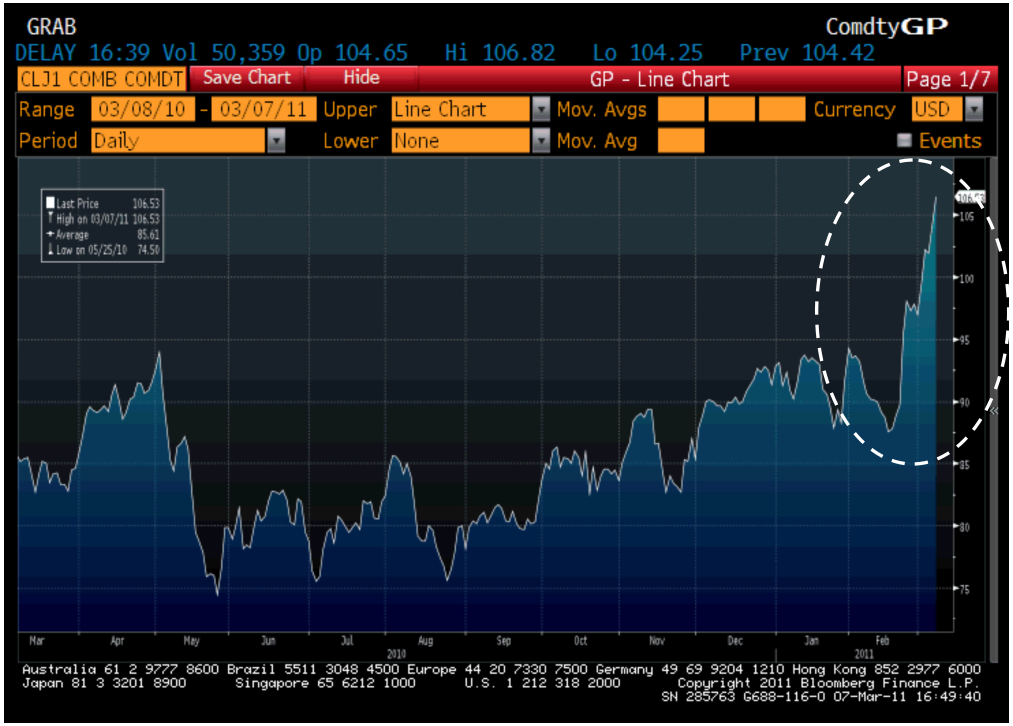
Global – Geopolitical Risks To The Fore

WTI Crude Oil Prices – One Year



- 'Jasmine Revolution' in Tunisia a few months ago which led to the collapse of the government is spreading.
- It has already resulted in a chain effect, resulting in fall in the autocratic regime in Egypt and current rebellion in Libya.
- The current political turmoil in the Middle-East and North America (MENA) region is expected to spread to similar countries in the Arab world.
- The immediate impact of such a political unrest is a threat to global oil supplies and resultant spike in crude-oil prices (21% spike already seen in less than a month!).

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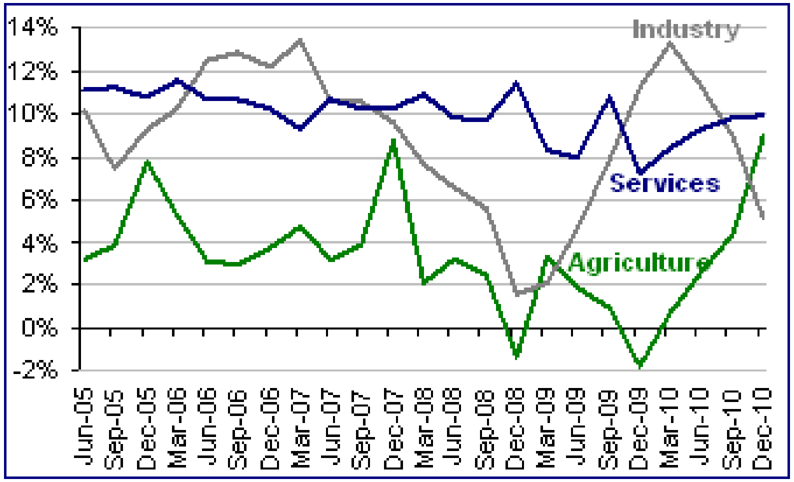
Source: Bloomberg

India Q3FY11 GDP Growth Slows, But Still Above 8% Mark

GDP growth by sector



- While India's 3QFY11 GDP growth at 8.2% (consensus 8.6%) came below expectations, it still remained above the 8% mark.
- The key driver of negative surprise was a cyclical slowdown in industry, partially offset by a positive surprise in agricultural growth.
- One more positive takeaway from the numbers was that the more stable component of private consumption has replaced the more volatile component, viz., Government expenditure, as the key economic growth driver.

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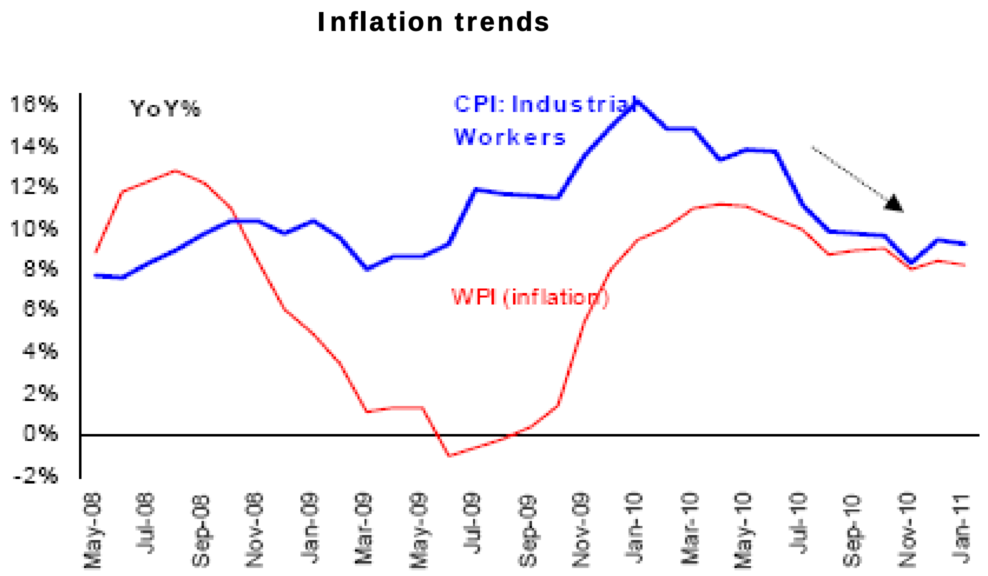
Source: CSO, MOSL Research

Inflation decelerates, but…



- Inflation, both the CPI and WPI, seems to have cooled recently.
- While the food inflation decline is sustainable, the crude and crude-derivative basket is not.
- Thus, one of the key concerns is that inflation from Crude Oil is understated on two fronts;
  - a) retail fuel prices are currently subsidized and running significantly below current international prices and
  - b) transmission of higher prices of crude-linked derivatives used as raw materials in general consumer products takes at least one-two quarters.

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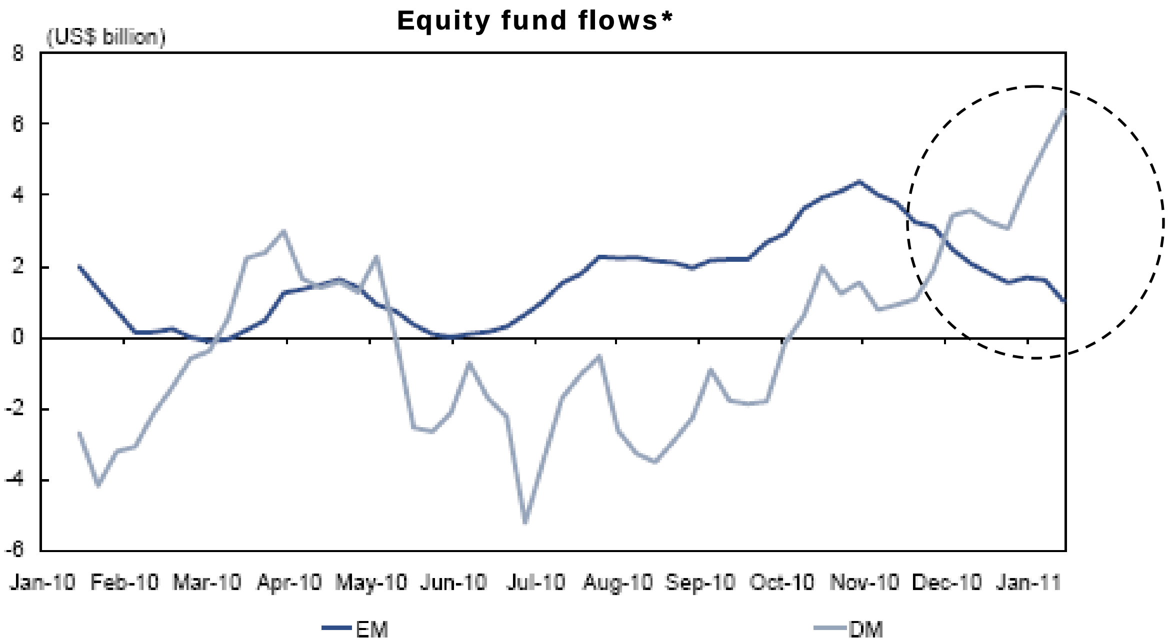
Source: CEIC, RBI, Morgan Stanley Research, BIS, Credit Suisse

Fund Flows: Headwinds Currently, May Not Sustain



- One of the key tactical fund flow themes recently has been shifting of fund allocations from Emerging Markets (EM) to Developed Markets (DM).
- Key Reasons for the same include i) inflation in EM; ii) a fall in the GDP growth differential between EM and DM; and iii) the possibility of a sooner-than-expected rise in US interest rates.
- We feel that the current fund flows are only tactical in nature, and given the longer term superior fundamentals of EM's like India, the same should revert back in the long term.

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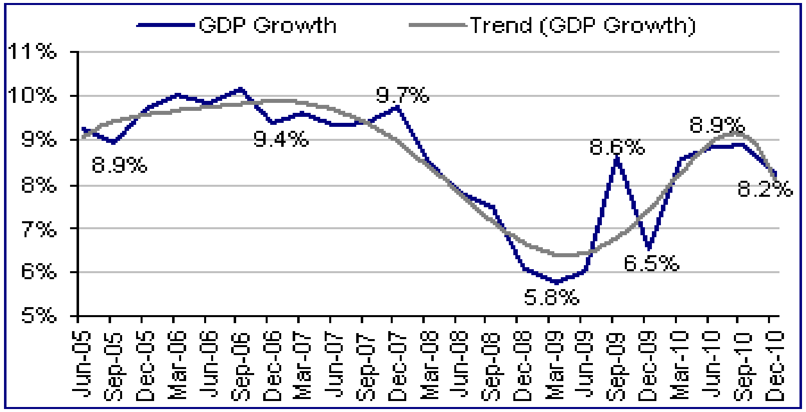
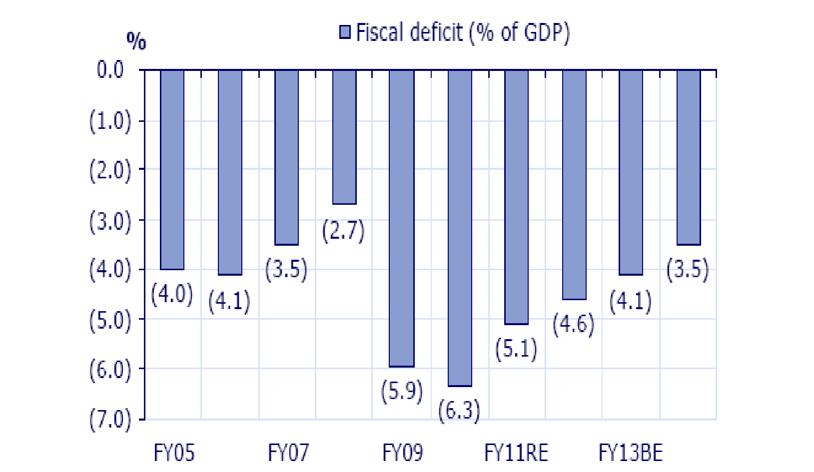
Source: EPFR; CIRA, Note: *8-week rolling moving average

Budget – Government plays safe in an uncertain environment

India growth –strong but moderating



Reiterates commitment to fiscal consolidation



Source: CLSA Asia-Pacific Markets

- In an uncertain global environment the government chose a pro-growth approach in the budget with minimal changes.
- The government has budgeted the lowest ever increase in total expenditure @3.4% in FY12. No populism here
- Fiscal deficit consolidation remains on track; however the target of 4.6% is ambitious and the government may slip by 0.5%.
- Oil & fertilizer subsidy are key variables
- Tax revenue growth estimate at 18% is very reasonable in light of recent trends
- The big changes in tax regime - GST and DTC will debut in 2012 as expected
- Move to direct cash subsidy for Kerosene in 2012 is a step in the right direction
- Infrastructure funding needs being addressed through greater flexibility in raising equity and debt from foreigners

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Source: CEIC, RBI, Morgan Stanley Research, BIS, Credit Suisse

Earnings Season: In-line With Expectations

Sensex and Citigroup Universe 3QFY11 Results (Growth in percent YoY)

	Sales		EBITDA		PAT		
Aggregate	Expected	Actual	Expected	Actual	Expected	Actual	Act. Vs. Est.
Sensex	16.8%	18.6%	19.6%	20.1%	25.6%	27.2%	⇔
Sensex ex-Oil (29/30)	16.4%	18.4%	18.2%	19.5%	18.1%	16.5%	⇔
Sensex ex-fin	16.4%	17.9%	18.8%	18.5%	26.5%	27.9%	⇔
Citi Universe	14.4%	18.9%	22.4%	24.0%	25.6%	27.2%	⇔
Citi Univ Ex-Energy	19.0%	21.2%	17.5%	18.2%	17.1%	14.6%	⇔
Citi Univ ex-Fin	13.6%	18.0%	21.6%	22.6%	26.0%	28.4%	⇔
Citi Universe ex-Metals	15.4%	19.5%	26.3%	27.6%	27.0%	29.0%	⇔
Citi Univ ex-Commodities	22.2%	23.0%	21.8%	21.8%	17.5%	14.9%	⇔

- In 3QFY11, Sensex companies have reported the earnings, which are in line with estimates (Citigroup Research Estimates used as a proxy for market expectations).
- There is clear evidence of margin pressure in several industries as raw material prices and interest rates rise
- The attempt by companies to offset this pressure by passing through increases to the consumer could negatively impact customer demand

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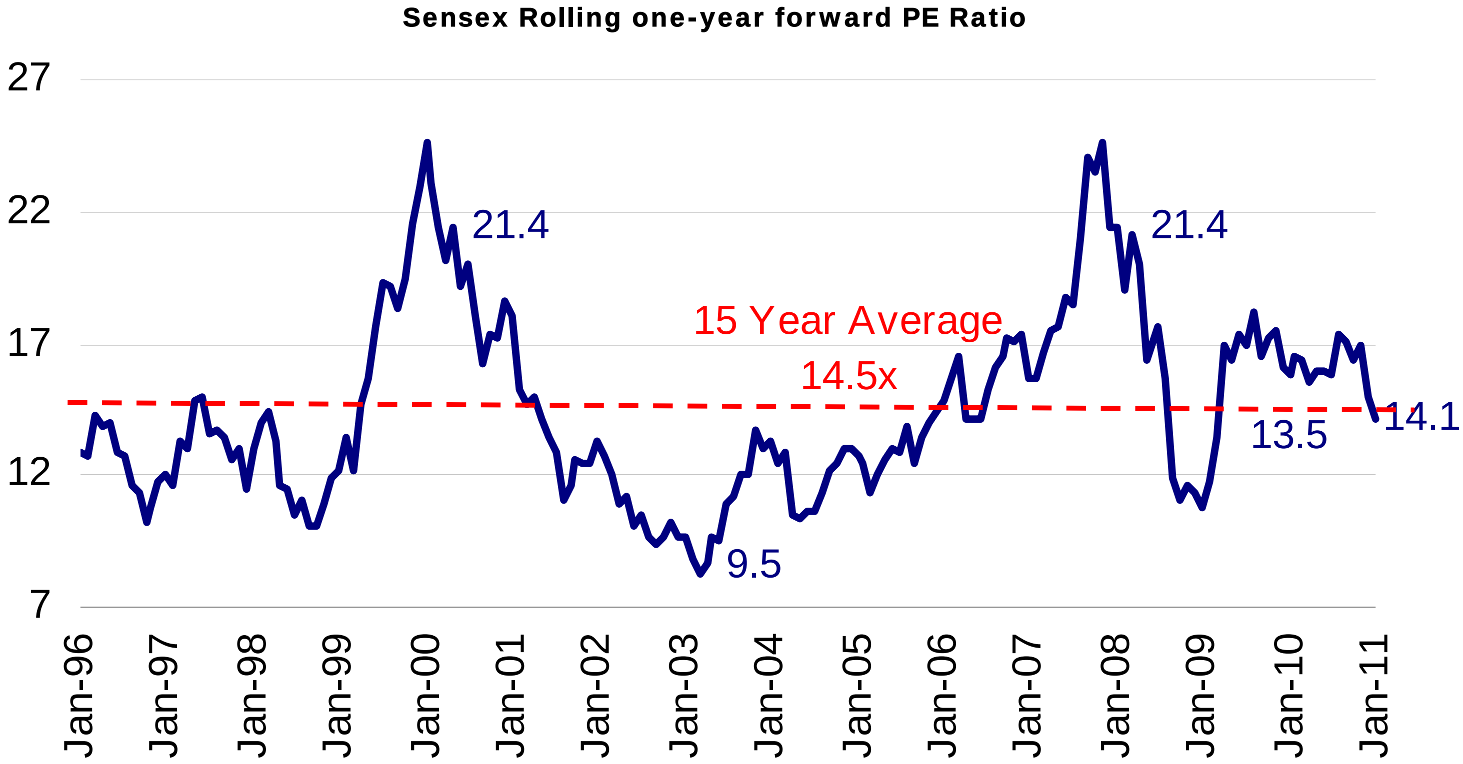
Source: Company data, CIRA estimates

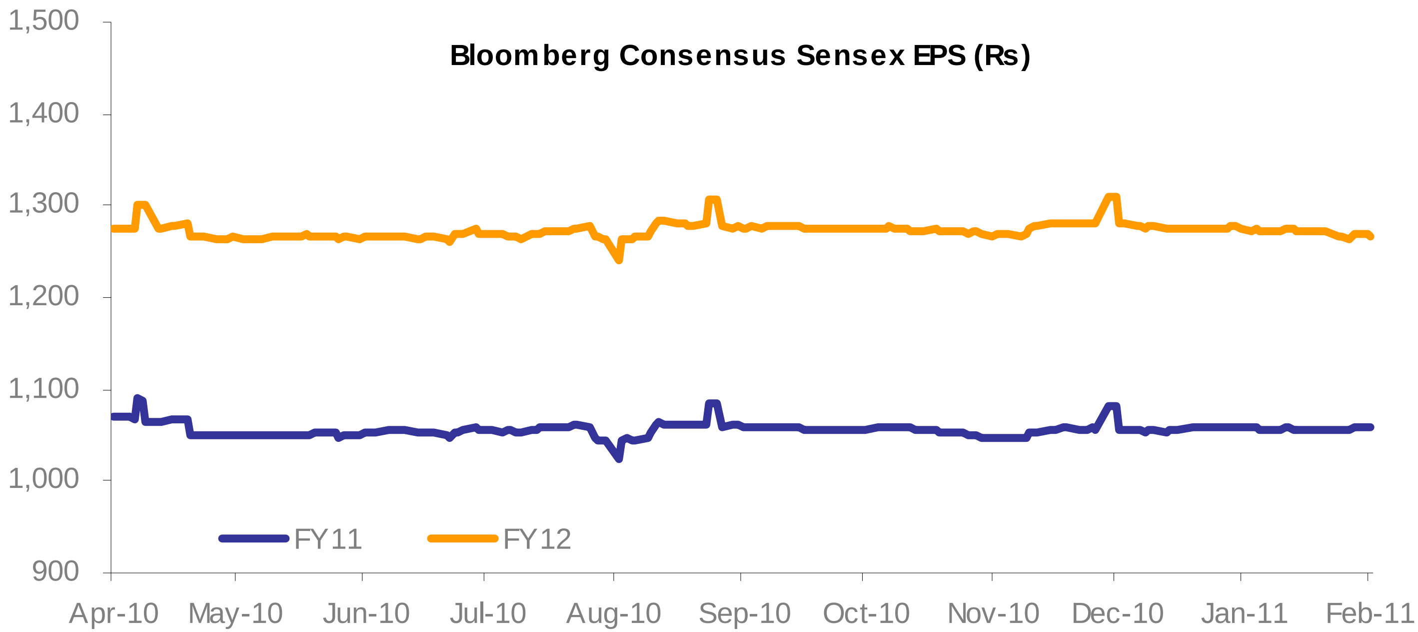
Valuations – Corrected Materially



- Sensex is now below its 15-year average one-year rolling forward PE ratio. The valuations are now clearly in the comfort zone.

Source: MOSL Research

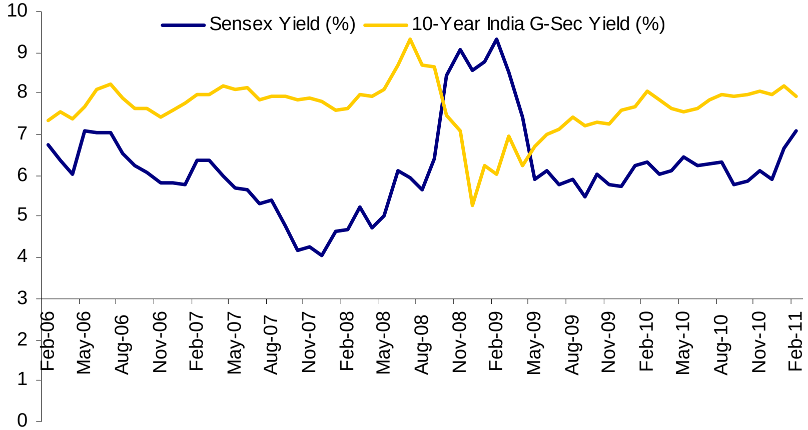
Earnings Forecasts–unchanged over the earnings season

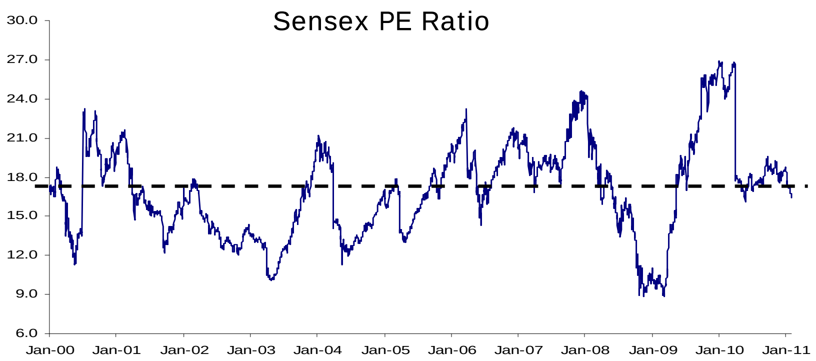


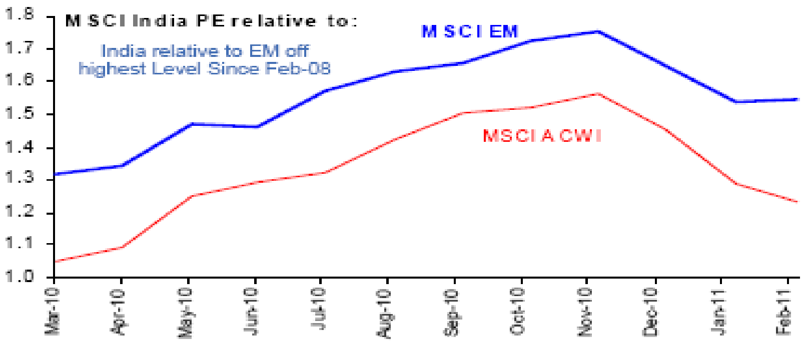
- Consensus earnings expectations for Sensex companies for FY11 and FY 12 are largely unchanged since the start of the earnings season in January.
- Consensus expects a 29% growth in FY11 Sensex EPS over FY10 and a 19% growth in FY12E Sensex EPS over FY11E.
- We see cuts to FY12 earnings estimates after the March reporting season and our back of the envelope calculation suggests FY12 earnings growth at 15% vs. consensus at 19%.

Sources: *Bloomberg*

Valuations – Corrected Materially







- The gap between Sensex earnings yield and bond yield has narrowed substantially by further 64 basis points over the previous month due to the material correction in Sensex earnings yield.
- Sensex is currently trading at 16.4x its trailing earnings. It is now 3% lower than its historical 10-year average trailing PE of 17x.
- India's PE premium to MSCI Emerging markets has corrected materially from its peak, and it is now at around 50% premium to MSCI EM PE currently.

Source: NSE, MOSL Research, FactSet, MSCI, Morgan Stanley Research

Looking Ahead...

- Key headwinds facing India include tightness in domestic liquidity and hardening in commodity prices, which though transient, have ended the 'sweet spot' scenario that prevailed for most of 2010.

- Governance issues in companies and the government have been in the limelight in recent months; this has certainly caused sentiment among investors and business to deteriorate and slowed the pace of decision making.

- In CY2011, India faces similar risks (as most emerging markets) in the form of higher inflation and the impact of a global rally in commodity prices.

- In its third quarter monetary policy review, the RBI increased the repo rate (at which banks borrow from the RBI) and the reverse-repo rate (at which banks park money with the RBI) by 25bps each.

- We expect rate hikes to continue and expect further 50 to 75 basis points of rate action this year.

- The budget moved forward in the direction of fiscal consolidation (est 4.6%) but the subsidy risk could add 0.5% to the deficit. However deficit is much lower than the true 8% gap recorded in 2009.

- The structural India growth story remains unchanged and feel the current outperformance and preference for developing markets is only tactical in nature.

- With the recent sell off the Sensex has dropped to 14.1x forward 12-month earnings. It is now at the lowest level post election 2009 and below the 15 year average forward 12-month p/e multiple of 14.5x.

- We feel this provides an opportunity for medium term investors, whereby they can benefit not just from earnings growth but also from p/e multiple expansion in the future.

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Investment view

Short term

- GDP growth likely to moderate to about 8-8.5% in FY11.
- Markets are factoring in a 19% growth in earnings in FY12, which may be a stretch in the current inflationary environment.
- However, valuations have materially corrected and are now in the comfort zone, with risk-reward attractive.

Long term

- India is capable of sustaining nominal growth rates (12-14%) that will lead to the economy doubling in size over the next 5-6 years.
- This should enable corporate earnings growth to grow at about 15%pa over the same period
- With valuations close to near term averages investors can benefit from an upward re-rating of valuations in the future.

Strategy for investors

- The case for increasing equity allocation is now favorable as valuations are near long term averages.
- Long term investors should continue with SIP.

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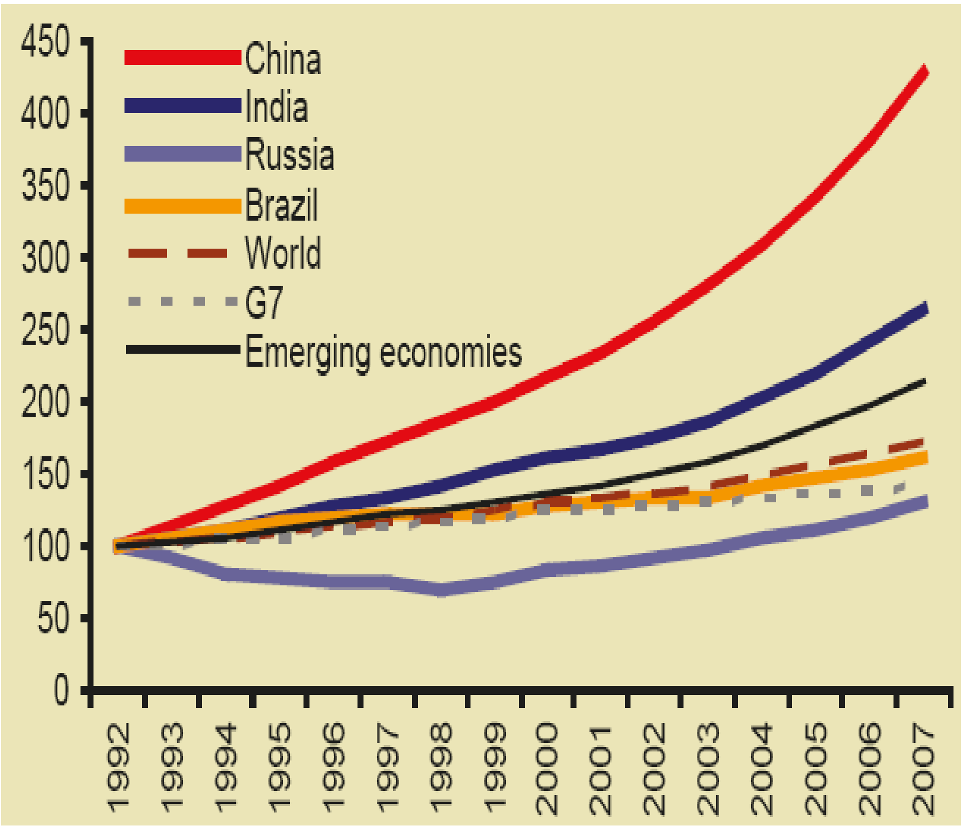
The Long Term Case For Indian Equities

India – Growth On The Fast Track

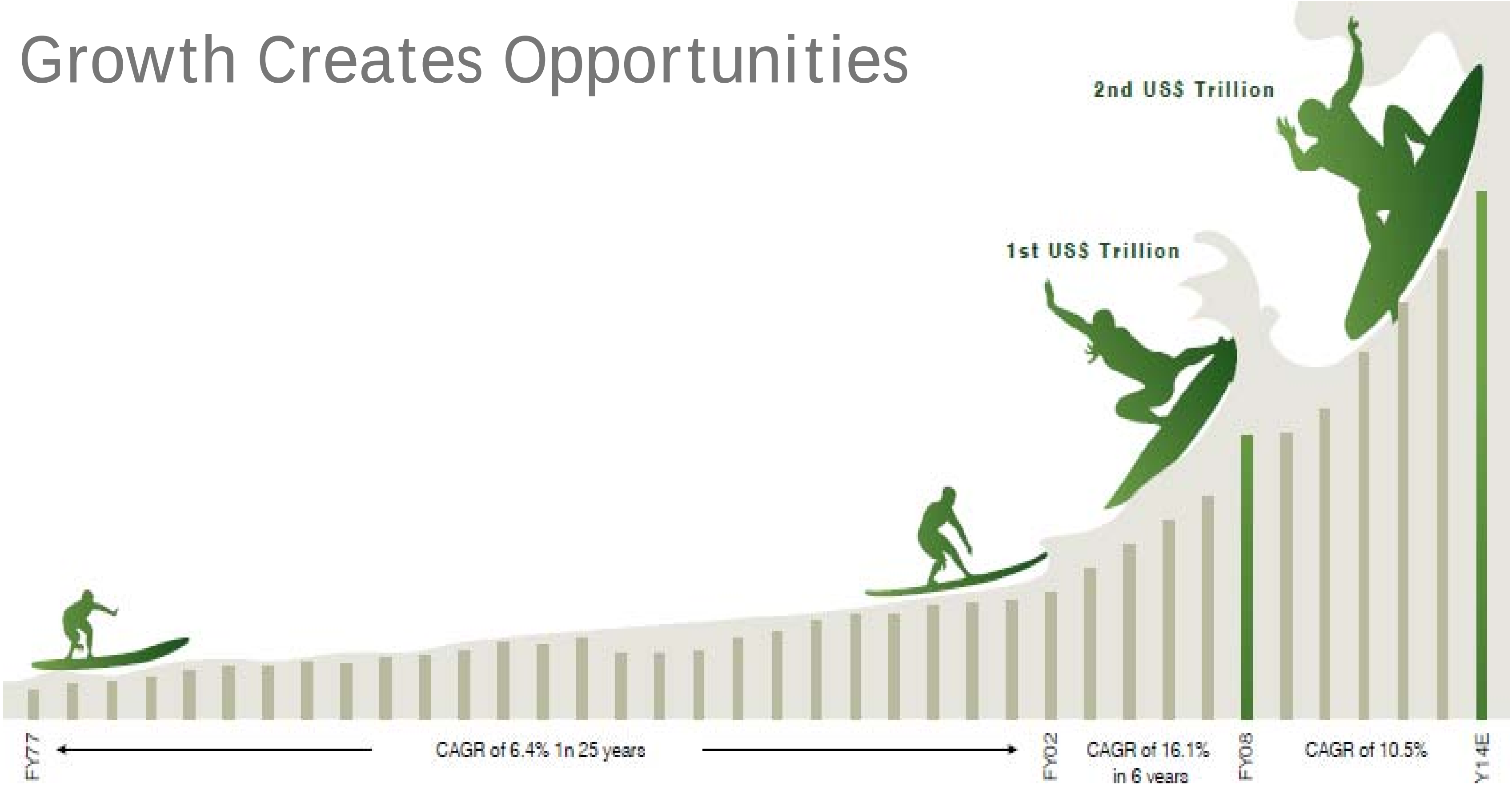
GDP growth rebased to 1992



Source: IMF, IIFL Research

- India's economy has been the among the fastest growing economies in the world driven by:
  - Increase in savings rate
  - Rising capital formation
  - Better demographics and
  - Rising consumption

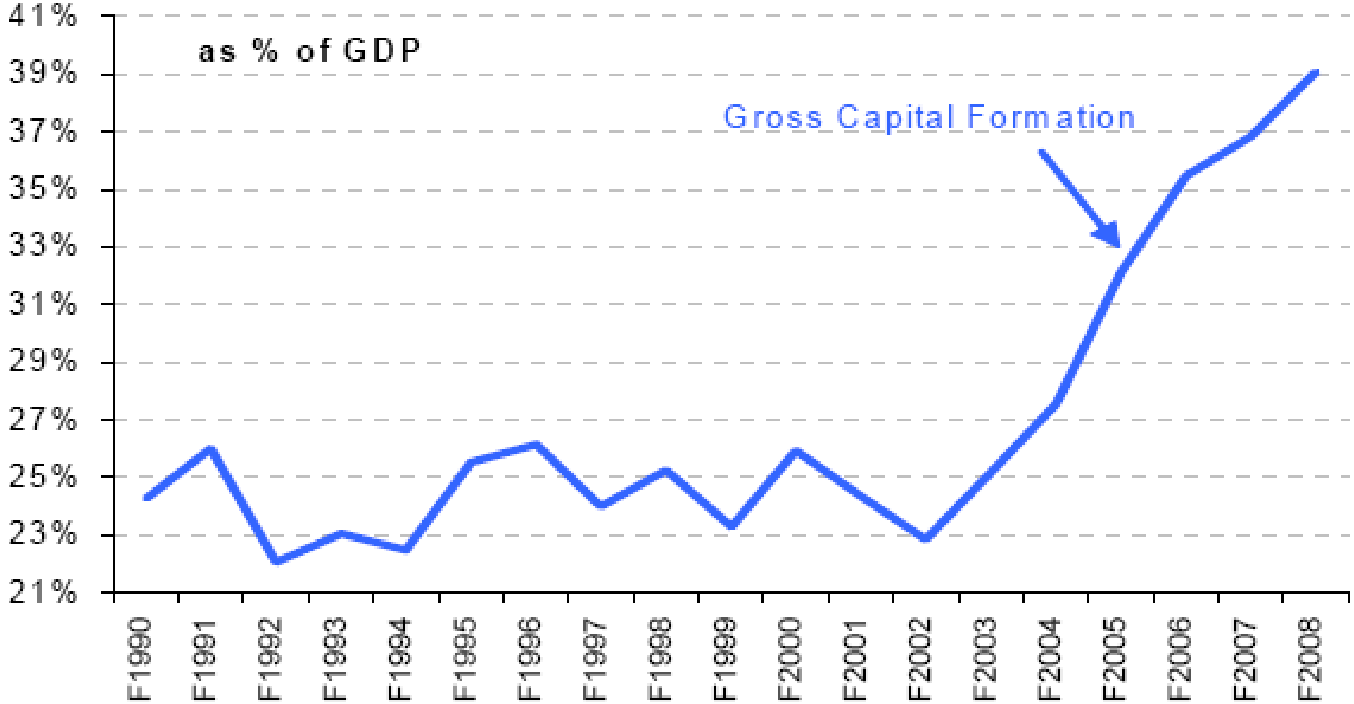
Growth Creates Opportunities



- India became a Trillion Dollar Economy (12th largest country by GDP in FY2008)
- The economy is expected to add another Trillion Dollars to annual output in 6 Years i.e. 2014
- That is likely to make India the 8'th largest economy in the world.
- This is a structural transformation driven by increasing investments, growing consumption and a young workforce
- For equity investors : an attractive investment opportunity

Source: Motilal Oswal Securities Ltd.

Growth Is Being Led By A Rise In Capital Formation…



Source: CSO, Morgan Stanley Research

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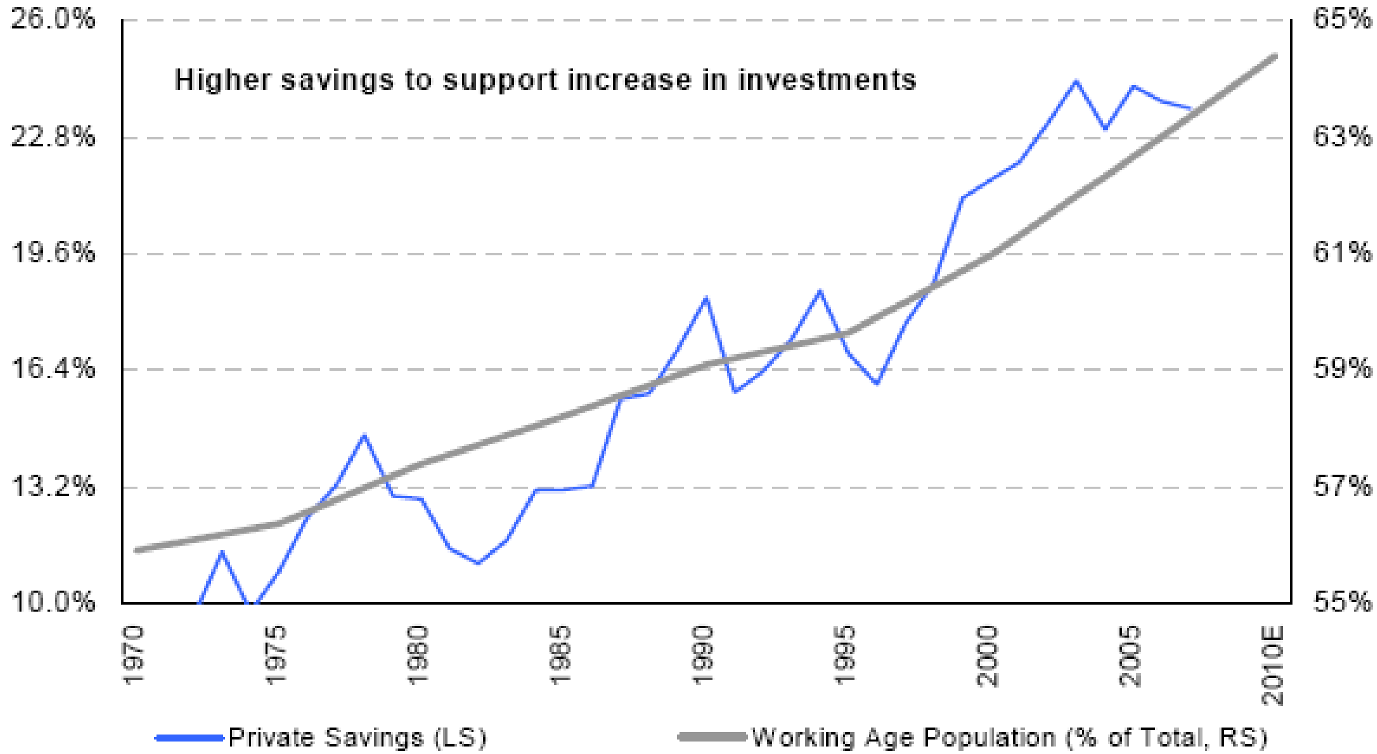
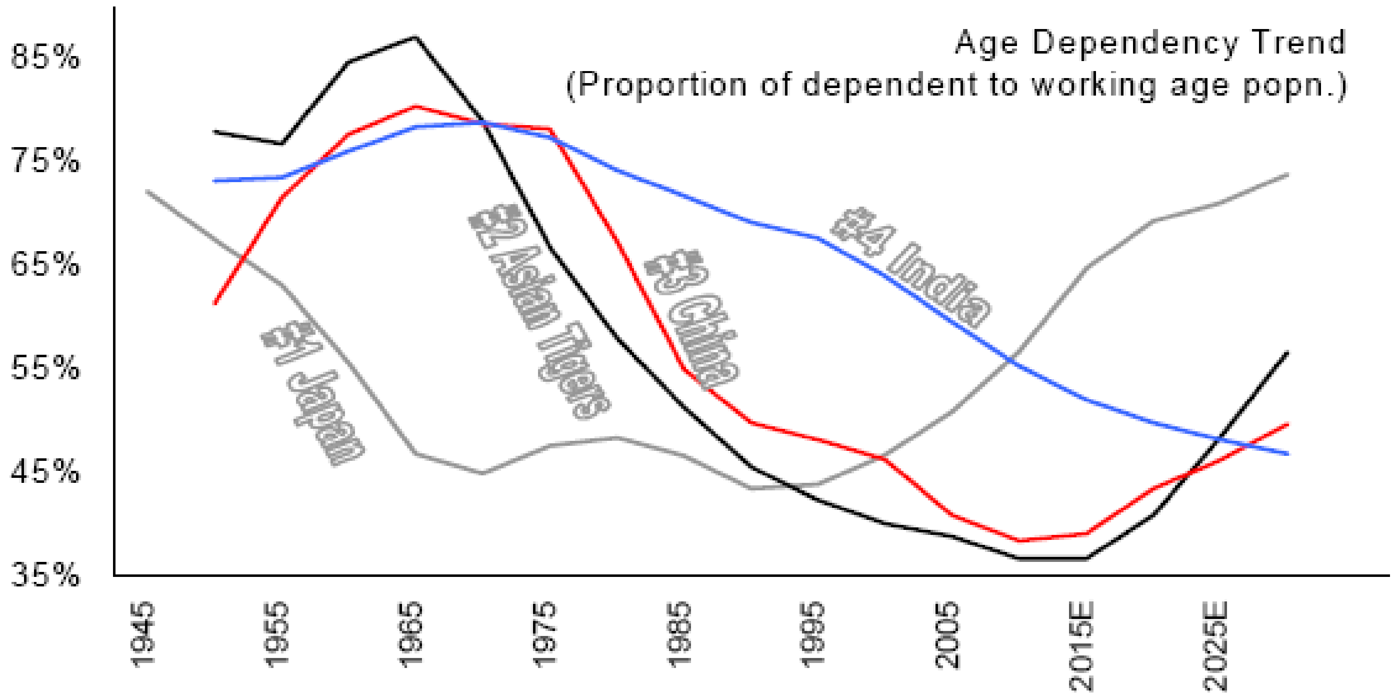
...Which Is Supported By A High Savings Rate



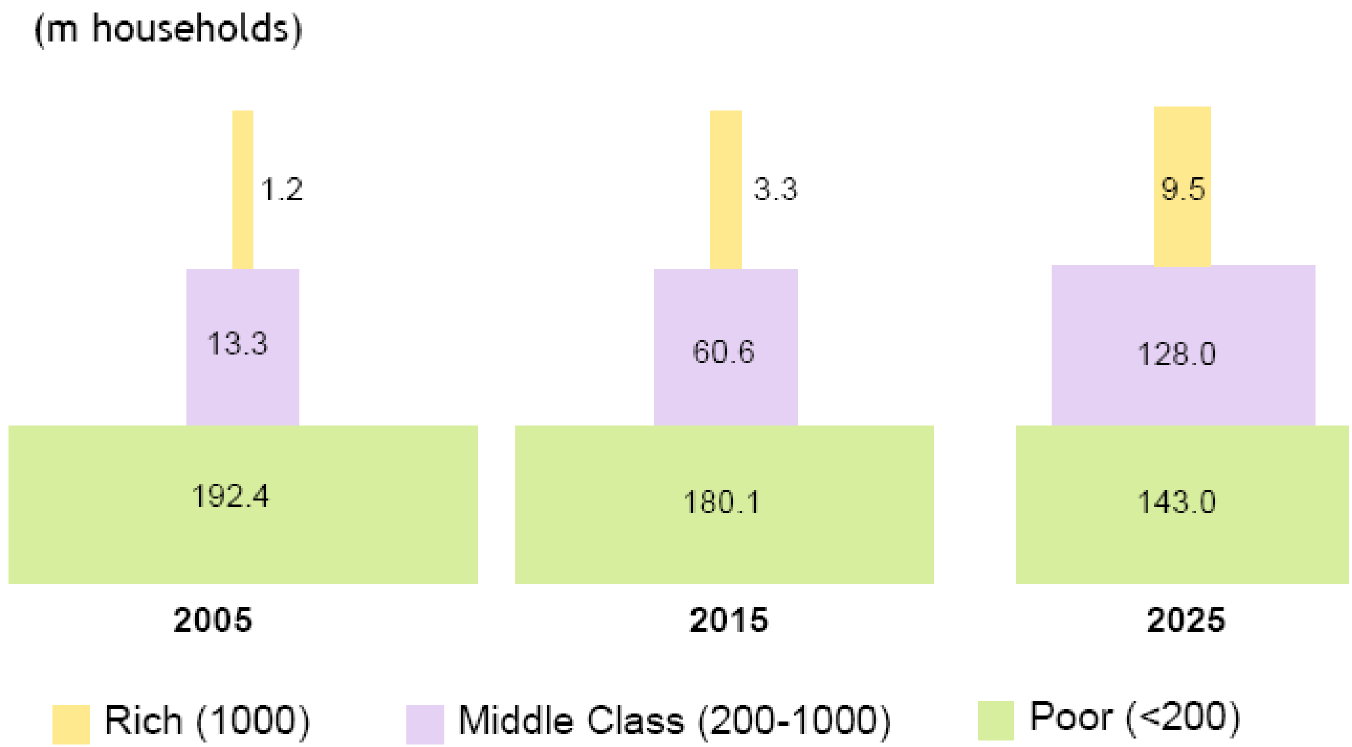
Source: CSO, UN, Morgan Stanley Research E= United Nations Research estimates

India Is Poised To Reap Rich Demographic Dividend In Years To Come



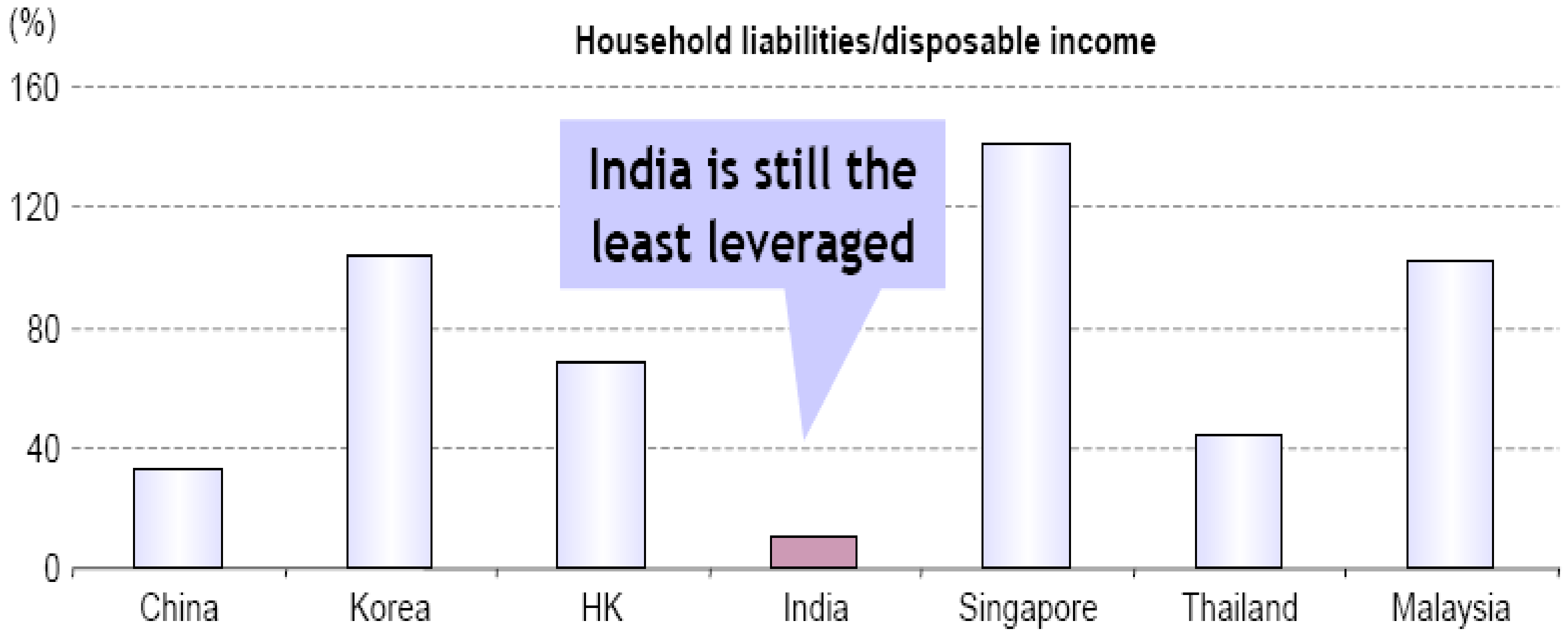
E= United Nations Research estimates Source: UN, Morgan Stanley Research

Income Imbalance To Correct Leading To Rise In Consumption



Source: IDFC SSKI

Indian Consumer Is Conservative; Consumption Largely Driven By Income Growth And Not Leverage



Source: IDFC SSKI

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