

Equity Markets : Current Environment and Outlook

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January 2011

Current Environment

- Global Equity markets remained bullish in January, with the MSCI World Index rising by 2.19%.
- Emerging markets underperformed Developed markets for the fourth month in a row.
- Indian markets sharply underperformed the global trend, falling by 10.64% in the month of January.
- Commodity prices mirrored the global trend in equities, with the benchmark CRB Reuters Jefferies total return index rising by 2.8%.
- Consumer Durables was the best performing sector followed by IT. Capital Goods, Auto and Realty sectors delivered the worst return for the month.
- FII outflows were at Rs.48bn in January 2011, while DIIs recorded inflows of Rs.52bn. MF remained net buyers to the tune of Rs.6bn.
- Trading Activity has continued abating in January, with cash trading volumes (US \$mn) falling MoM by 11% and the average open interest declining by 6%MoM.

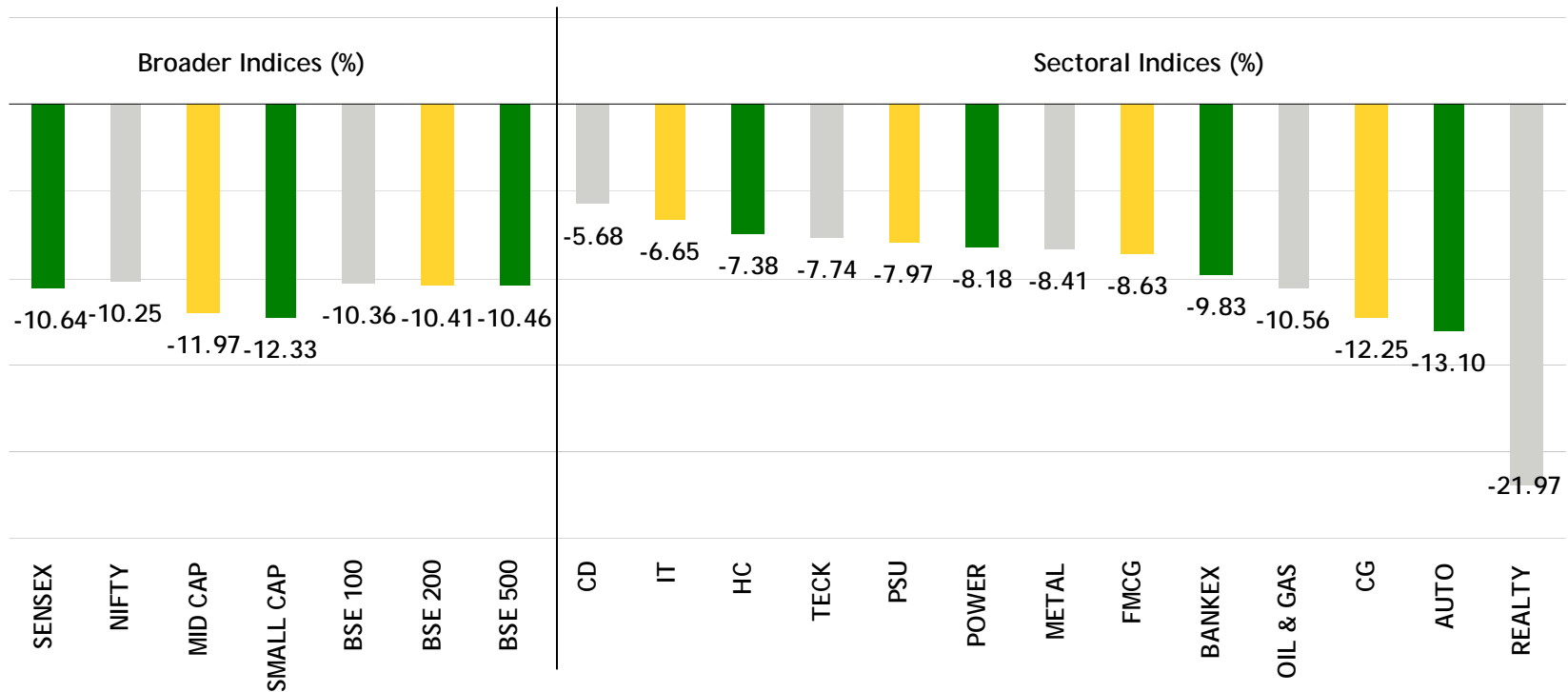
Global Equities

Index	Country	Closing Price*	1 Month Return (%)	YTD Return (%)	Category
SSE Composite Index	China	2790.69	-0.62%	-0.62%	EM - Asia
BSE Sensex	India	18327.76	-10.64%	-10.64%	EM - Asia
Kospi	South Korea	2069.73	0.91%	0.91%	EM - Asia
Taiwan Weighted	Taiwan	9145.35	1.93%	1.93%	EM - Asia
Thailand SET 50 Index	Thailand	668.58	-7.17%	-7.17%	EM - Asia
Jakarta Composite Index	Indonesia	3409.17	-7.95%	-7.95%	EM - Asia
KLSE	Malaysia	1519.94	0.07%	0.07%	EM - Asia
Ibovespa Sao Paulo Index	Brazil	66574.88	-3.94%	-3.94%	EM
Mexico IPC	Mexico	36982.24	-4.07%	-4.07%	EM
Russian RTS Index	Russia	1870.31	5.52%	5.52%	EM
Philippine PSEi	Philippines	3881.47	-7.61%	-7.61%	EM
Merval Buenos Aires Index	Argentina	3593.13	1.97%	1.97%	EM
HangSeng	Hong Kong	23447.34	1.79%	1.79%	Developed - Asia
Nikkei	Japan	10237.92	0.09%	0.09%	Developed - Asia
Strait Times	Singapore	3179.72	-0.32%	-0.32%	Developed - Asia
Dow Jones	USA	11891.93	2.72%	2.72%	Developed
CAC 40 Index	France	4005.50	5.28%	5.28%	Developed
All Ordinaries Index	Australia	4850.00	0.06%	0.06%	Developed
DAX Index	Germany	7077.48	2.36%	2.36%	Developed
Swiss Market Index	Switzerland	6479.15	0.67%	0.67%	Developed
FTSE 100	UK	5862.94	-0.63%	-0.63%	Developed
MSCI World Index	--	1308.08	2.19%	2.19%	--

* as on 31st January 2011. Source : Bloomberg
EM – emerging markets, Developed – developed markets.



India : Sector performances



- Sensex fell by 10.64% over the previous month.
- MidCaps underperformed LargeCaps with a 11.97% loss for the MidCap index.
- Consumer Durables was the best performing sector followed by IT.
- Capital Goods, Auto and Realty sectors delivered the worst return for the month.

*Source: BSE,NSE. one month performance as on 31st January 11.

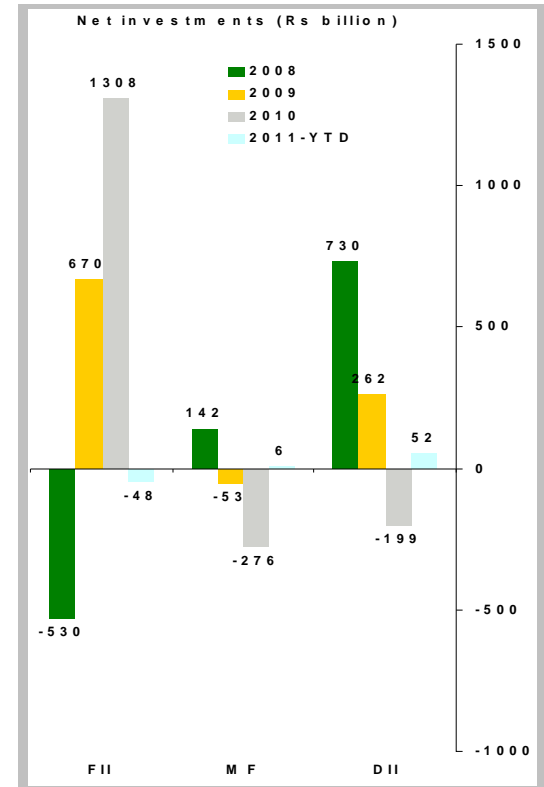
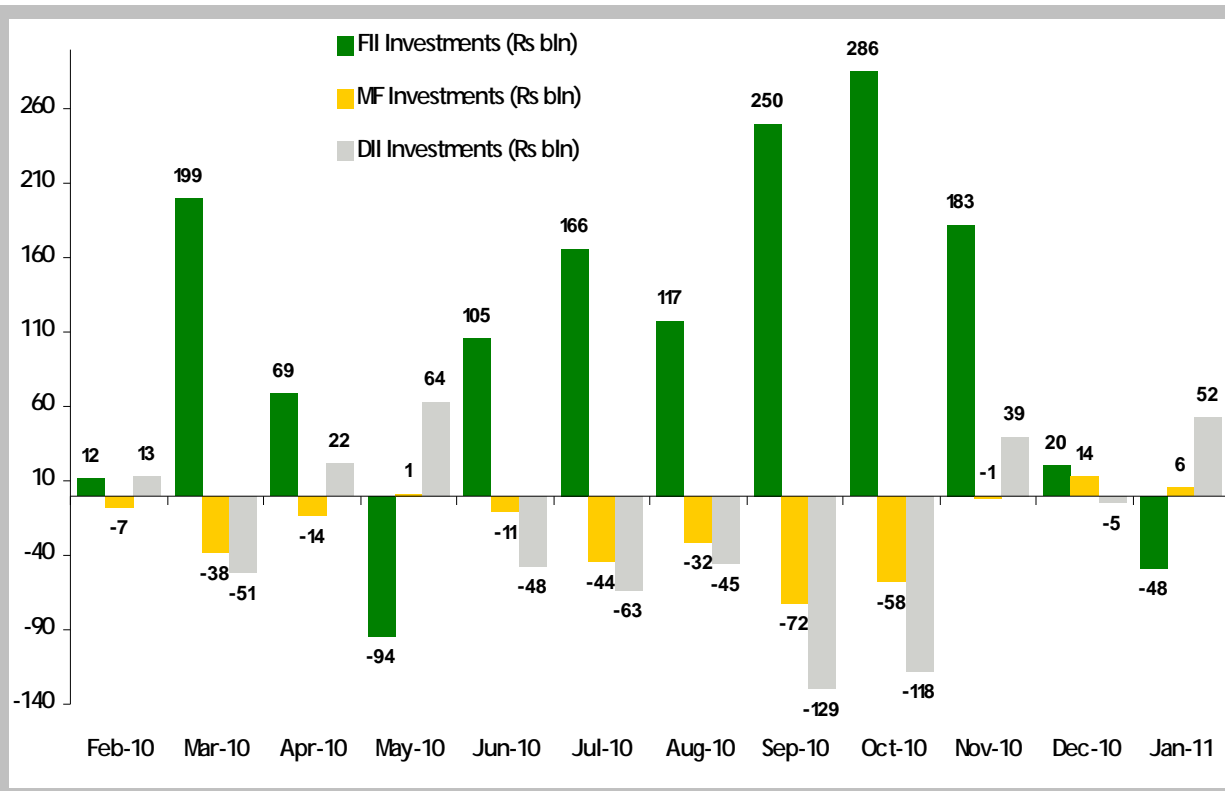
Top Gainers / Losers - Nifty

Top Gainers for the month			
Gainers	52 week H/L	Last Price#	% Gain*
HCL Technologies	517.15 / 317.55	490.75	7.56%
Siemens	884.6 / 611.25	853.95	4.08%
TCS	1220 / 685.25	1159.5	-0.53%
Sesa Goa	495 / 285	326.1	-0.75%
Cairn India	368.05 / 248.1	328.55	-1.26%
Top Losers for the month			
Losers	52 week H/L	Last Price#	% Loss*
DLF	397.5 / 214.35	223.9	-23.31%
Reliance Capital	882.3 / 517.5	523.7	-21.64%
JP Associates	162.9 / 82.5	83.15	-21.45%
I D F C	218.25 / 141.1	147.25	-19.36%
Bajaj Auto	1665 / 813.45	1245.95	-19.15%

closing price as on 31st January 2011.* one month performance as on 31st January 2011.
Source: Capitaline

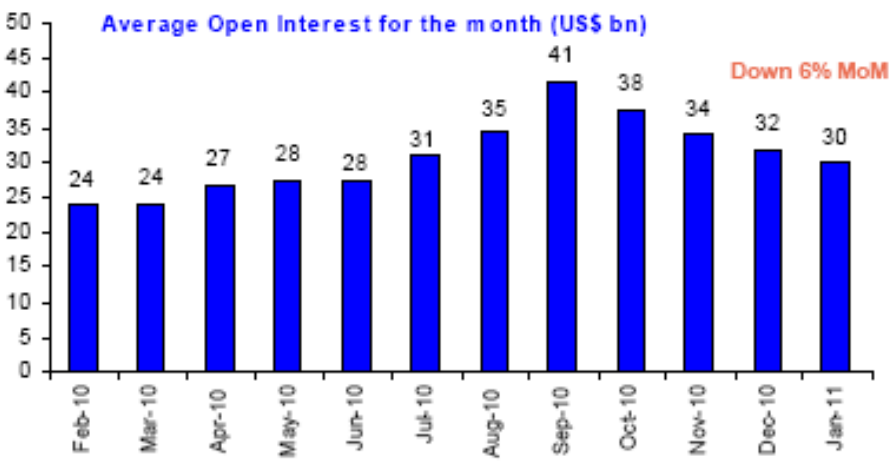
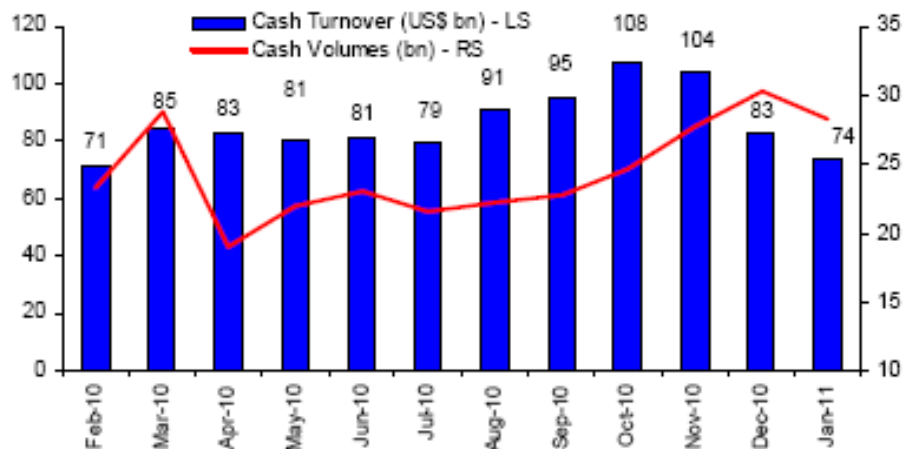


FII & DII Inflows



- FII outflows were at Rs.48bn in January 2011. After a Rs.1308bn inflow in CY10 and Rs.670bn inflow in CY09.
- DIIs recorded inflows of Rs.52bn. MF remained net buyers to the tune of Rs.6bn.

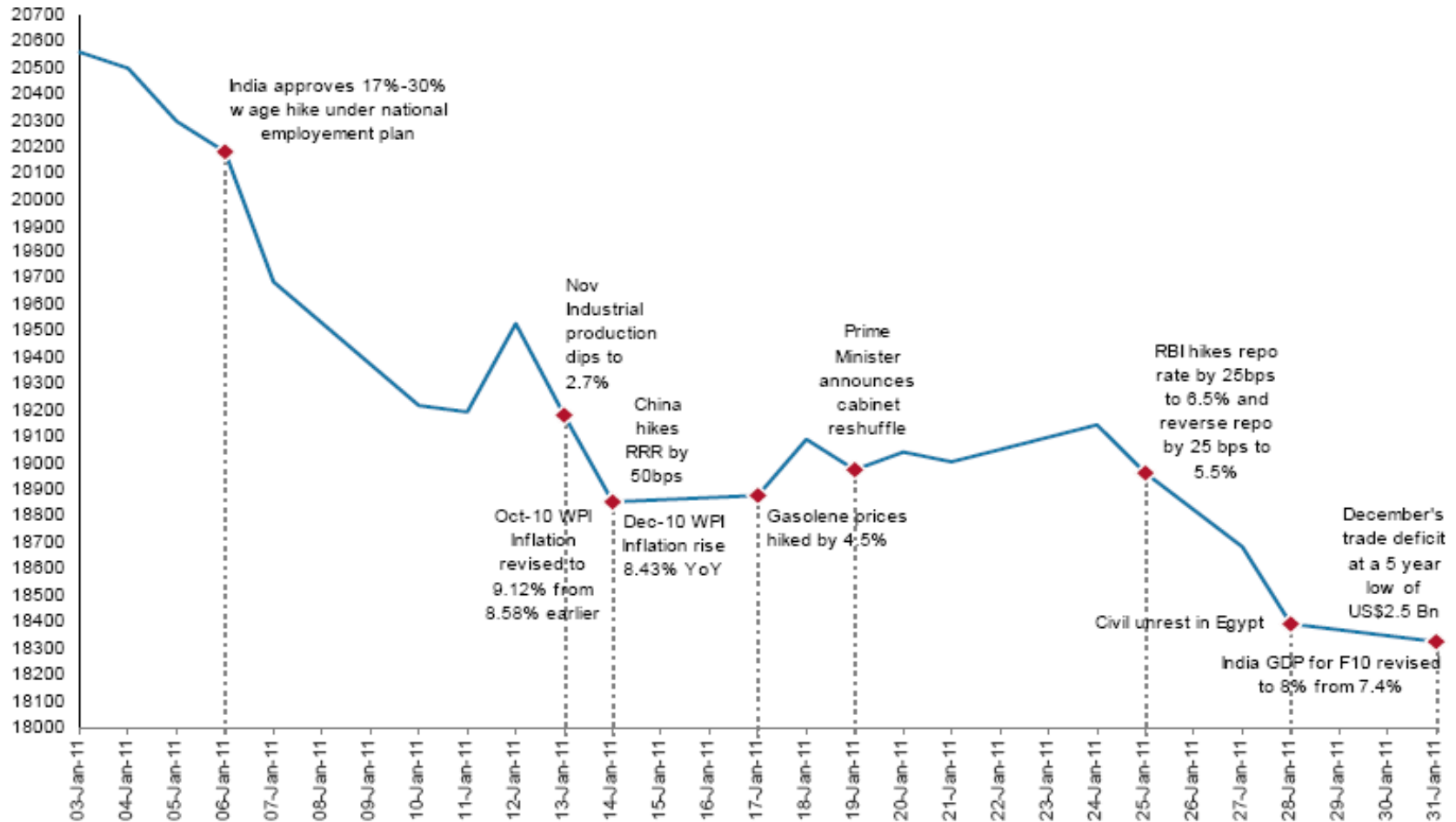
Market Activity



- In January 2011, cash trading turnover (US \$bn) decreased MoM by 11%.
- At the end of January 2011, average open interest decreased by 6% MoM. This is the fourth month of consecutive declines after six continuous months of rise.



January 2010 events timeline



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

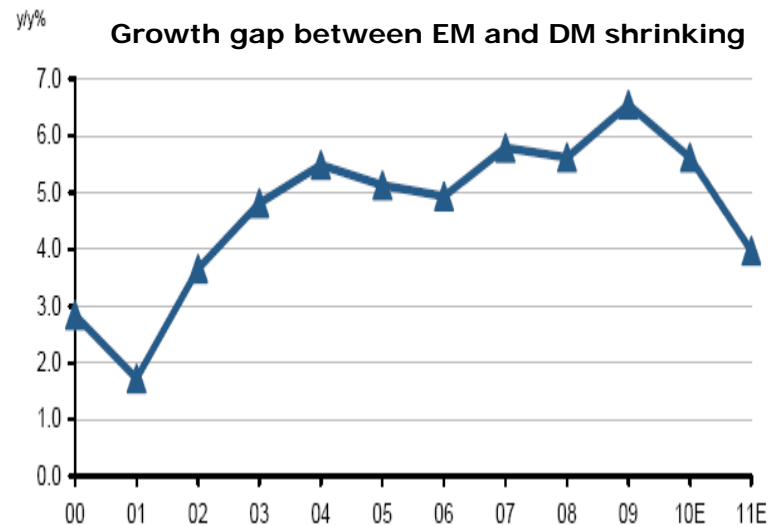
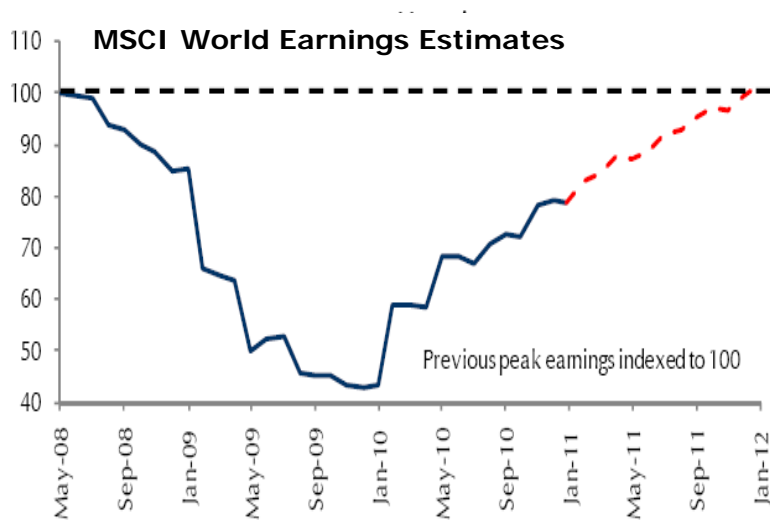


Religare MF: Equity Market Outlook and Opportunities

Equity Market Outlook

- Global growth continues to recover with the IMF raising its forecast for global economic growth in CY2011 from 4.2% (Oct'2010 expectations) to 4.4%. The hike in forecast is due to better than expected performance of US economy.
- However, it has also resulted in reduction in the growth gap between Emerging Markets (EM) and Developed Markets (DM).
- India's key worry continues to remain higher than normal inflation which is due to a combination of domestic and global factors.
- Fiscal Deficit trends remain healthy, with the April-Dec 2010 deficit coming down 45% YoY, and at 45% of the budget estimate on the back of 3G and BWA license fee receipts and continued buoyancy in tax collections.
- So far, almost half the Sensex companies have reported the earnings, which are in line with estimates.
- Expected earnings for Sensex for FY12 has undergone just a 1% cut so far, but the risk of further cuts has increased.
- India's valuations have corrected materially both on an absolute and relative basis. Thus India's PE premium to MSCI Emerging markets has corrected from its peak of about 70% in November, and it is now at around 50% premium to MSCI EM PE currently.
- Even on trailing earnings, Sensex is currently trading at 20.6x which is just a 10% premium to its historical average on trailing earnings basis, compared to 30% premium in November 2010.

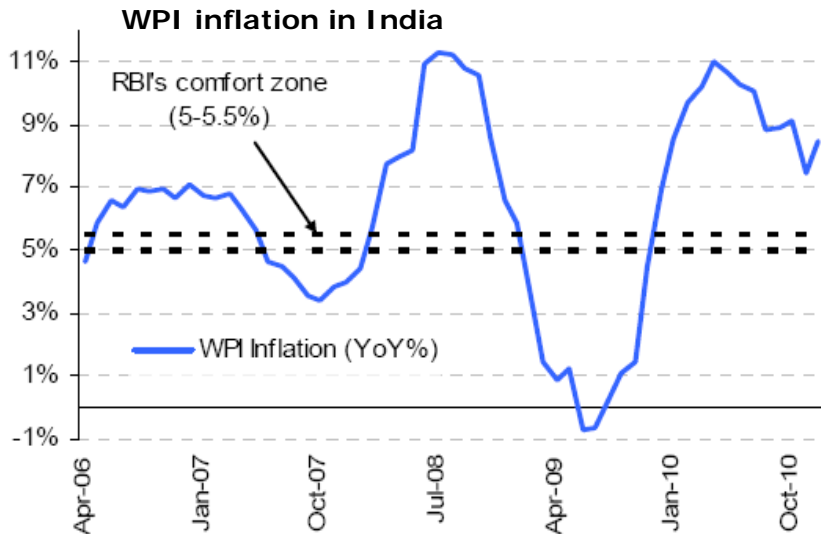
Global Growth Continues to Recover



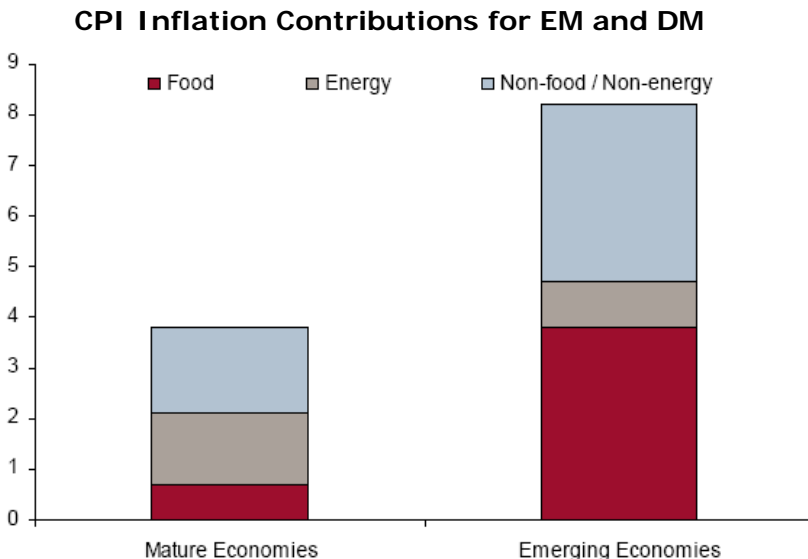
- The International Monetary Fund (IMF) raised its forecast for global economic growth in CY2011 from 4.2% (Oct'2010 expectations) to 4.4%. The hike in forecast is due to better than expected performance of US economy.
- Global growth continues to recover, with the MSCI World Earnings now expected to reach the previous peak by the end of CY11.
- However, it has also resulted in reduction in the growth gap between Emerging Markets (EM) and Developed Markets (DM).
- The result of this reduction in growth gap has resulted in global investors portfolio reallocation from EM to DM.



Inflation: Moderating, But Remains At An Elevated Level



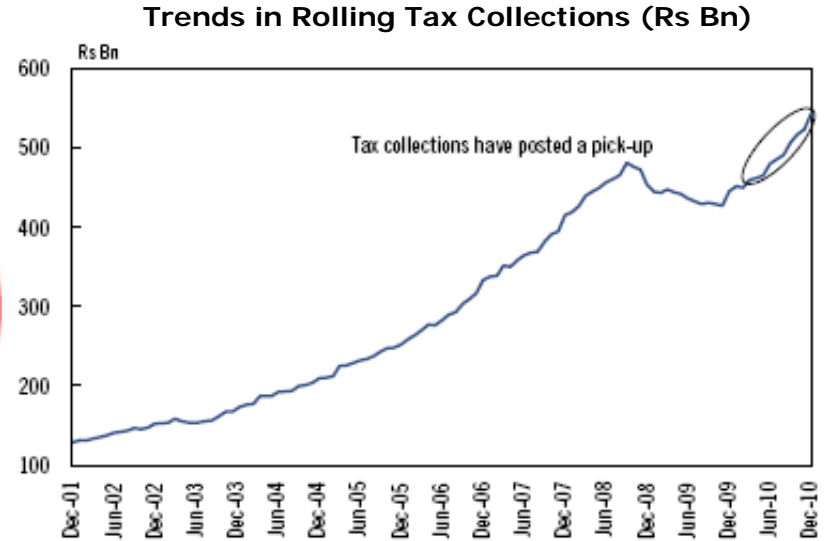
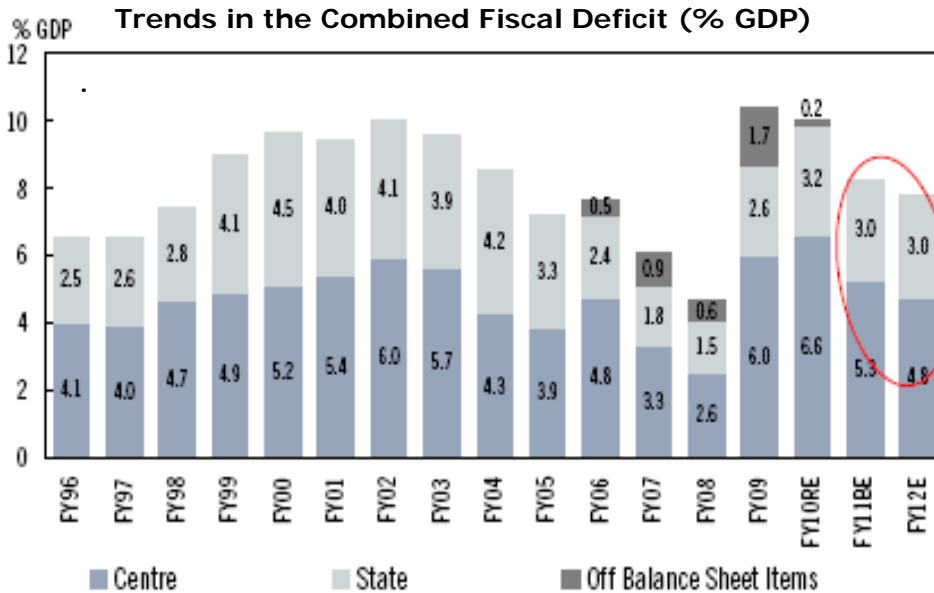
- India's key worry continues to remain higher than normal inflation which is due to a combination of domestic and global factors.
- Some of the key domestic factors causing the high inflation include 1) Demographic and income changes resulting in improved food consumption; 2) Sluggish production due to stagnating yields; and 3) NREGA, which has resulted in higher rural incomes and greater demand; 4) Unseasonal rains, resulting in loss of crops.



- However inflationary pressures are being seen across most developing nations due to rise in prices of some of the global commodities.
- Thus, necessities like food are the predominant contributors of inflation in developing markets like India and China compared to developed markets like USA, where the primary contributor of price rise is Energy.



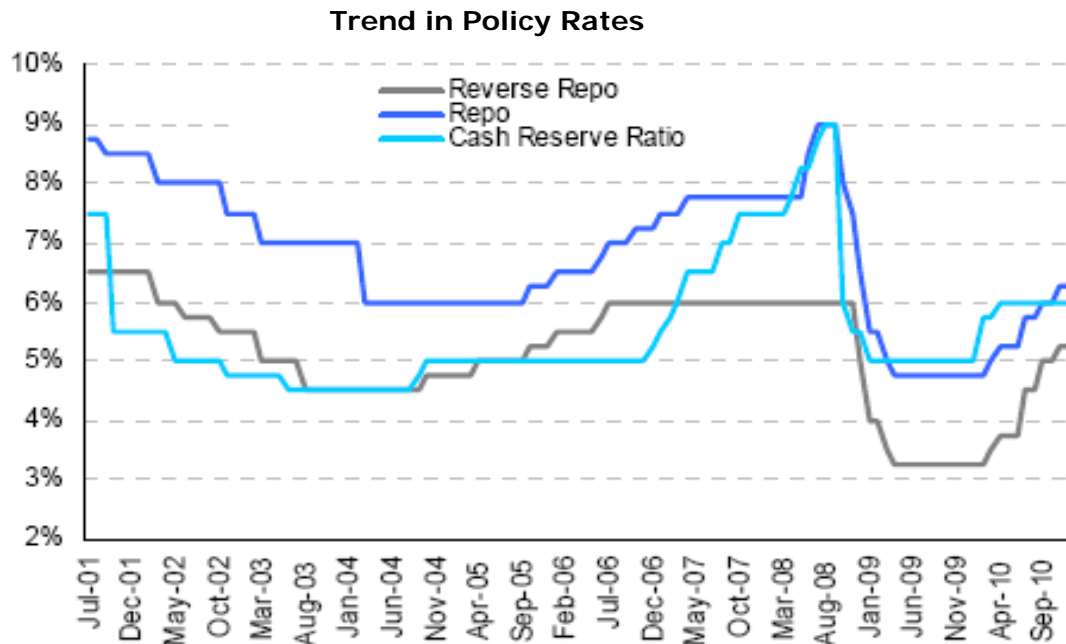
Fiscal Situation Improving on Rising Tax Revenues



- Fiscal Deficit trends remain healthy, with the April-Dec 2010 deficit coming in at Rs1.7trn, down 45% YoY, and at 45% of the budget estimate of Rs3,814bn.
- The improvement this year is due to 1) 3G and BWA license fee receipts, 2) continued buoyancy in tax collections – up 27% v/s budget estimate of 18% and 3) slower growth in expenditure
- The government is looking at a further reduction in the deficit to 4.8% in FY12 and 4.2% in FY13.
- The overshoot on food, fuel and fertilizer subsidies and the increase in entitlement outlays such as NREGA could limit the extent of reduction in the fiscal deficit.



RBI Turns Hawkish



- In the third quarter monetary policy review, the Reserve Bank of India (RBI) hiked repo rate by 25 bps to 6.5% and reverse repo rate by 25 bps to 5.5%.
- Also the RBI raised its headline inflation forecast to 7% for March 2011 from earlier 5.5%.
- In its policy statement, RBI indicated its stance as being to “contain the spill-over of high food and fuel inflation into generalised inflation and anchor inflationary expectations, while being prepared to respond to any further build-up of inflationary pressures”.
- We feel this statement paves the way for further action of 50 to 75bps during the current year



Earnings Season So Far: In-line With Expectations

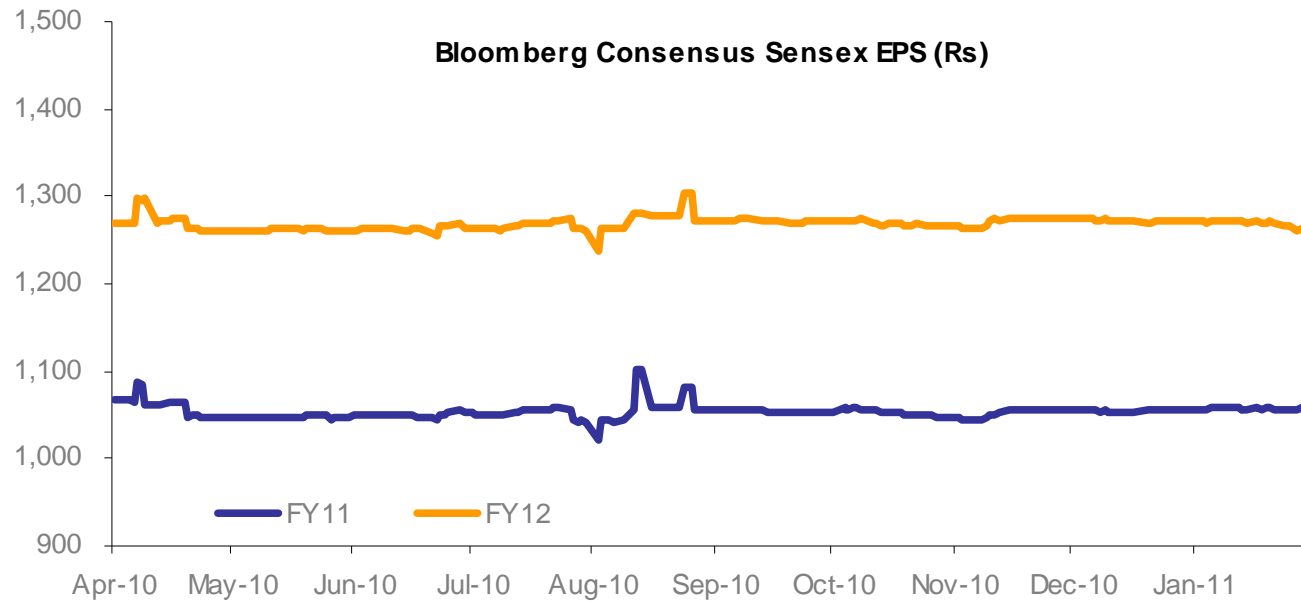
Sensex and Citigroup Universe 3QFY11 Results (Growth in percent YoY)

Aggregate	Sales		EBITDA		PAT		Act. Vs. Est.
	Expected	Actual	Expected	Actual	Expected	Actual	
Sensex (14/30)	15.2%	16.1%	20.2%	21.4%	21.6%	21.6%	⇌
Sensex ex-Energy (13/30)	21.5%	25.4%	18.5%	21.3%	19.5%	19.8%	⇌
Citi Universe	17.1%	19.2%	14.8%	16.3%	17.2%	17.3%	⇌
Citi Univ Ex-Energy	21.3%	24.9%	12.6%	15.0%	15.0%	15.3%	⇌
Citi Univ ex-Fin	15.9%	17.6%	11.6%	11.1%	16.1%	16.1%	⇌
Citi Univ ex-Comd.	23.4%	26.3%	17.6%	19.7%	18.3%	18.6%	⇌

- So far, almost half the Sensex companies have reported the earnings, which are in line with estimates (Citigroup Research Estimates used as a proxy for market expectations).
- The expected earnings for Sensex for FY12 has undergone just a 1% cut
- But 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

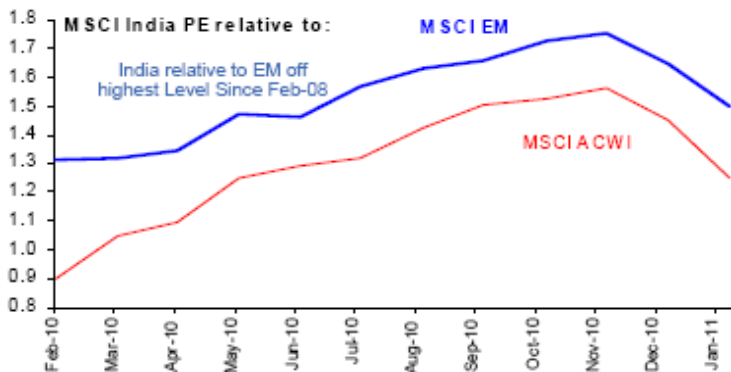
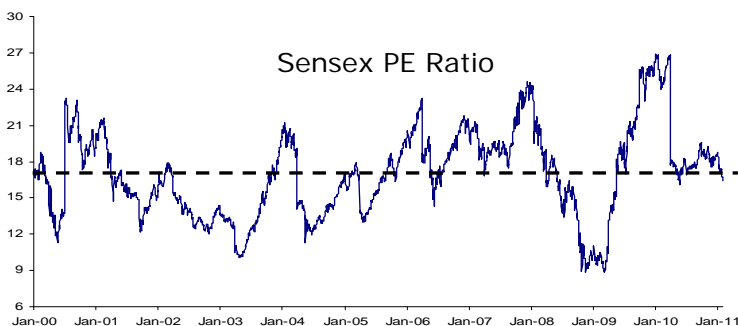
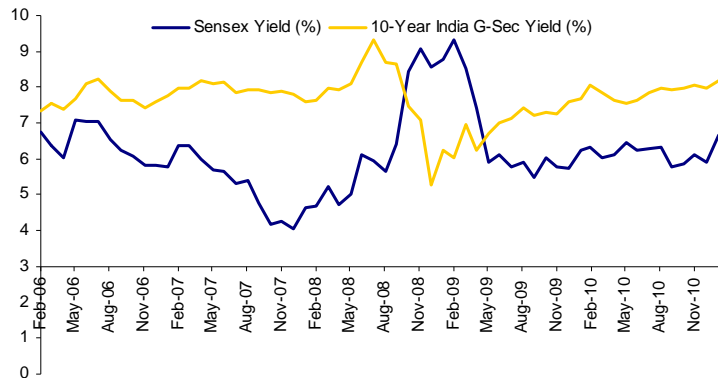


Earnings Forecasts- marginal cut



- Consensus earnings expectations for Sensex companies for FY11 have remained unchanged , while FY12E earnings have been cut by 0.7%, during the month.
- Consensus expects a a 29% growth in FY11 Sensex EPS over FY10 and a 19% growth in FY12E Sensex EPS over FY11E.

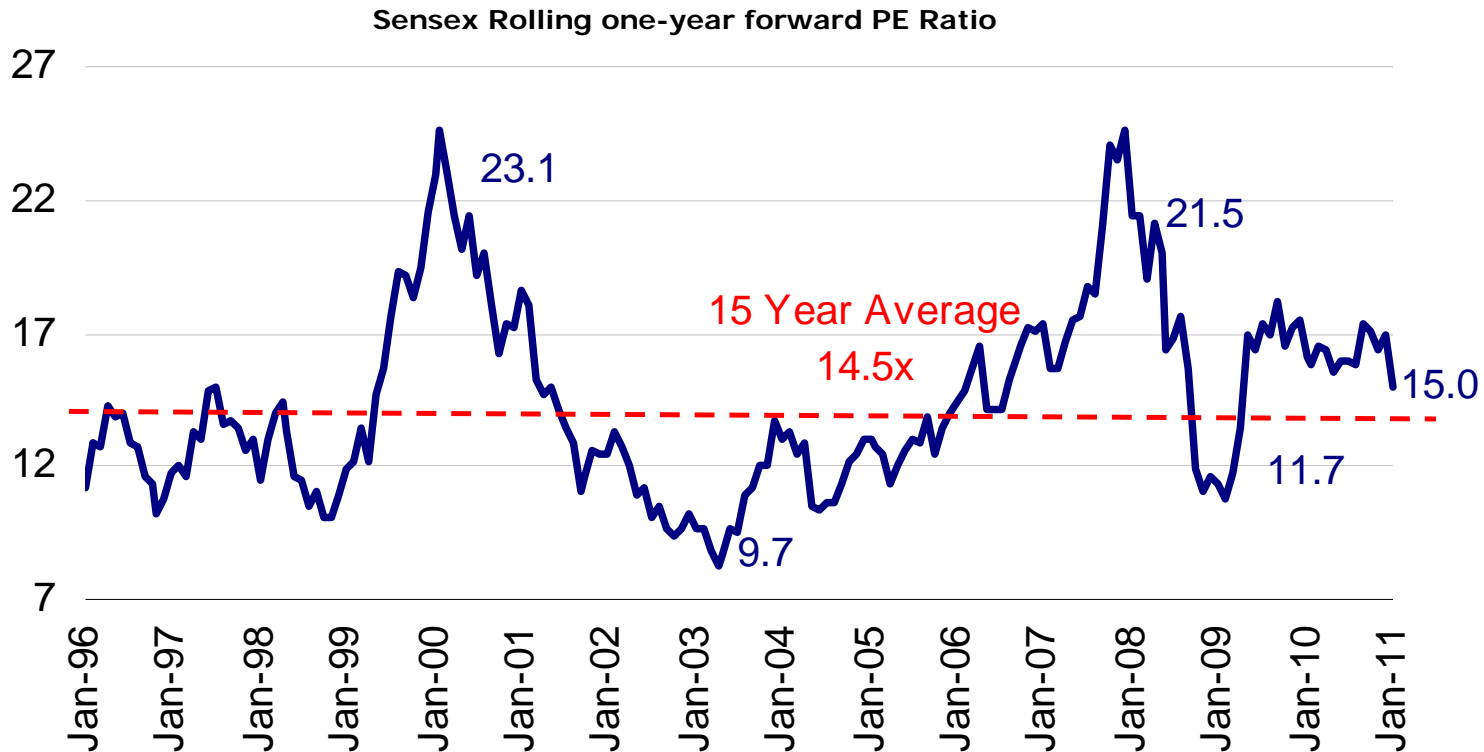
Valuations - Corrected Materially



- The gap between Sensex earnings yield and bond yield has narrowed substantially by 57 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.



Valuations - Corrected Materially



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



Looking Ahead...

- India has been one of the largest recipient of foreign flows in emerging markets in CY2010 has seen some reversal in January 2011.
- Key headwinds facing India include tightness in domestic liquidity and hardening in commodity prices, which though transient, have ended the 'sweetest spot' scenario that prevailed for most of 2010.
- In CY2011, India face 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 75basis points of rate action this year.
- The budget will be keenly watched for further fiscal consolidation as the need now is to dampen excess demand and also reduce the government's borrowing program.
- The structural India growth story remains unchanged and feel the current outperformance and preference for developing markets is only a tactical change.
- With the recent sell off the Sensex has dropped to 15x forward 12-month earnings. It is now at the lower end of the forward p/e range (15-17.5) since mid 2009 and just 3-4% higher than the 15 year average forward 12-month p/e multiple of 14.5.
- 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. We think the market is now reasonably valued and while one cannot rule out further weakness, we think investors should now focus on using further dips if any as buying opportunity.

Investment view

Short term

- GDP growth likely to be about 8.5% in FY11.
- With the first half of the year in the bag earnings appear to be on track for the forecast 29% earnings growth.
- Valuations have materially corrected and are now in the comfort zone

Long term

- India will double in size, adding \$1trillion to GDP over the next 5-7 years.
- Over the same period, earnings should match nominal GDP growth @12-14% p.a.
- With valuations close to near term averages investors can benefit from an upward re-rating of valuations in the future.

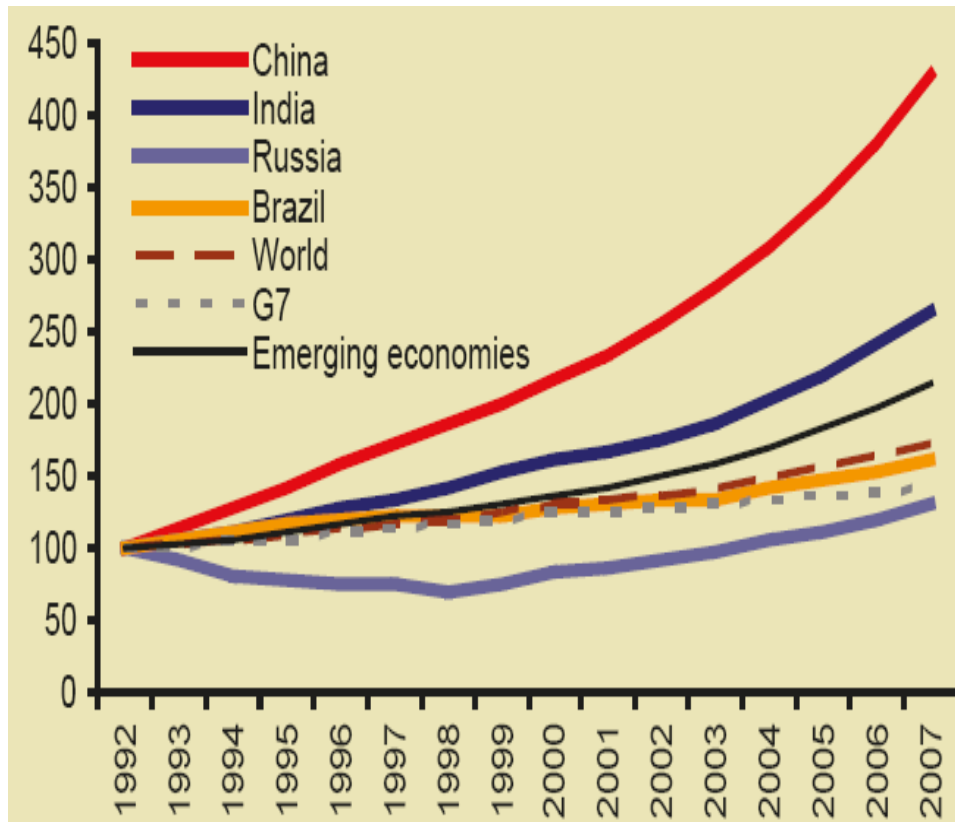
Strategy for investors

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

The Long Term Case For Indian Equities

India - Growth On The Fast Track

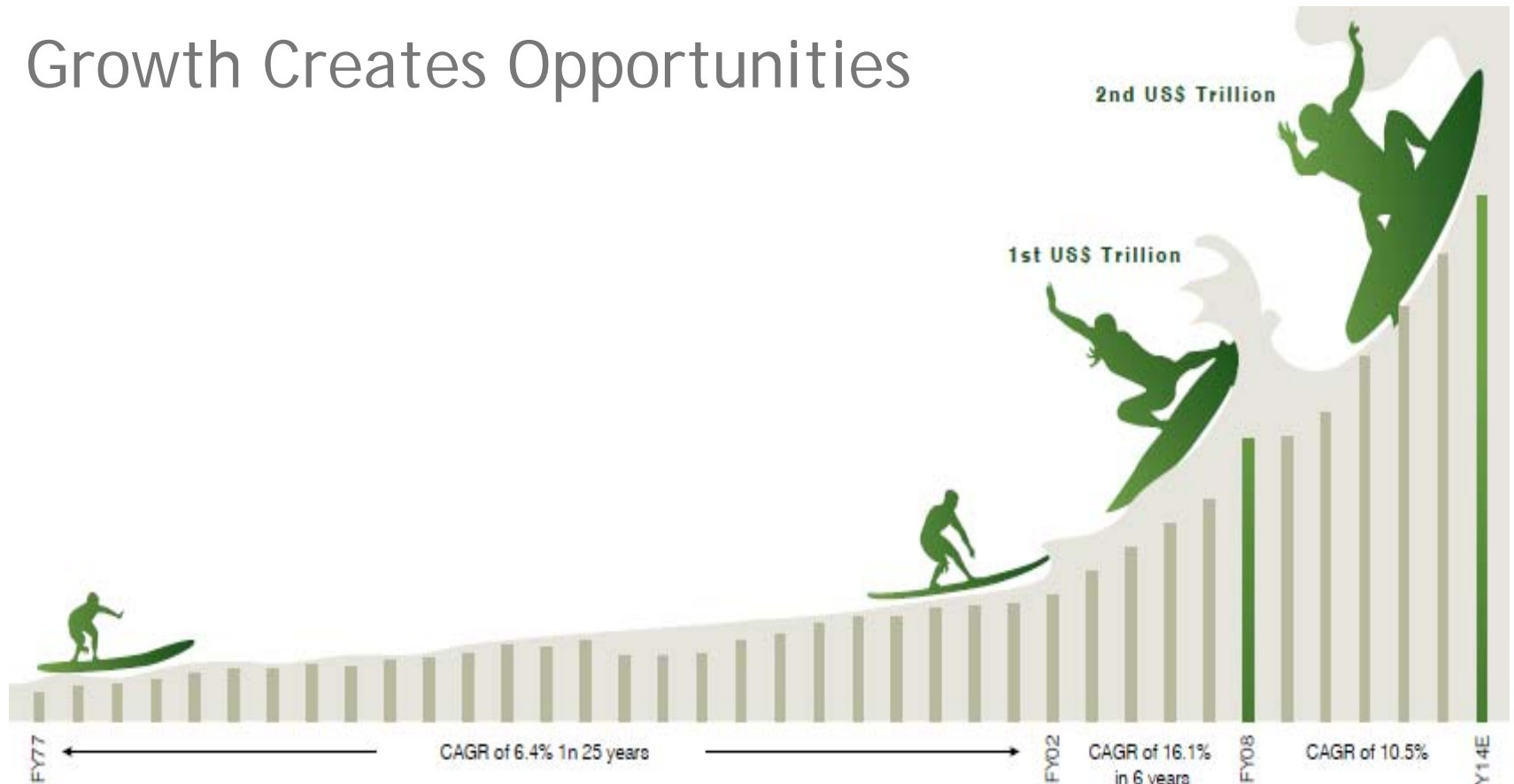
GDP growth rebased to 1992



Source: IMF, IIFL Research

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

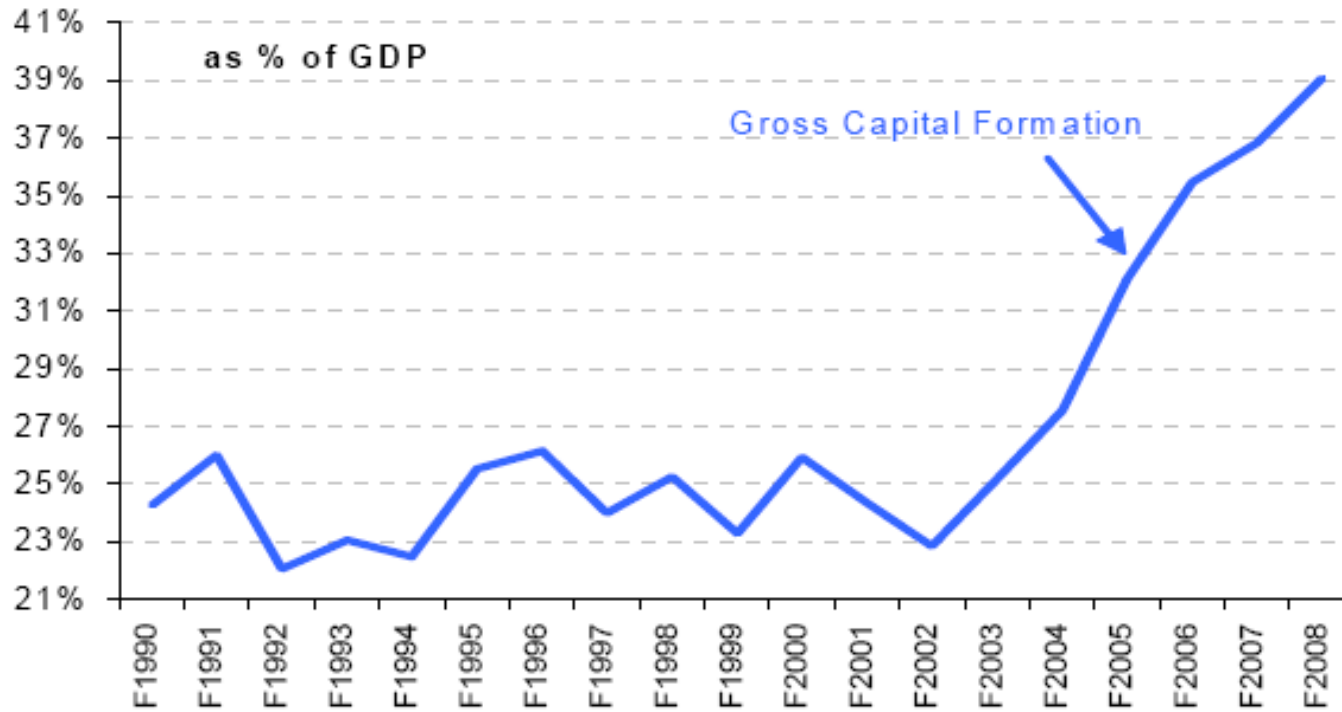
Growth Creates Opportunities



- 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

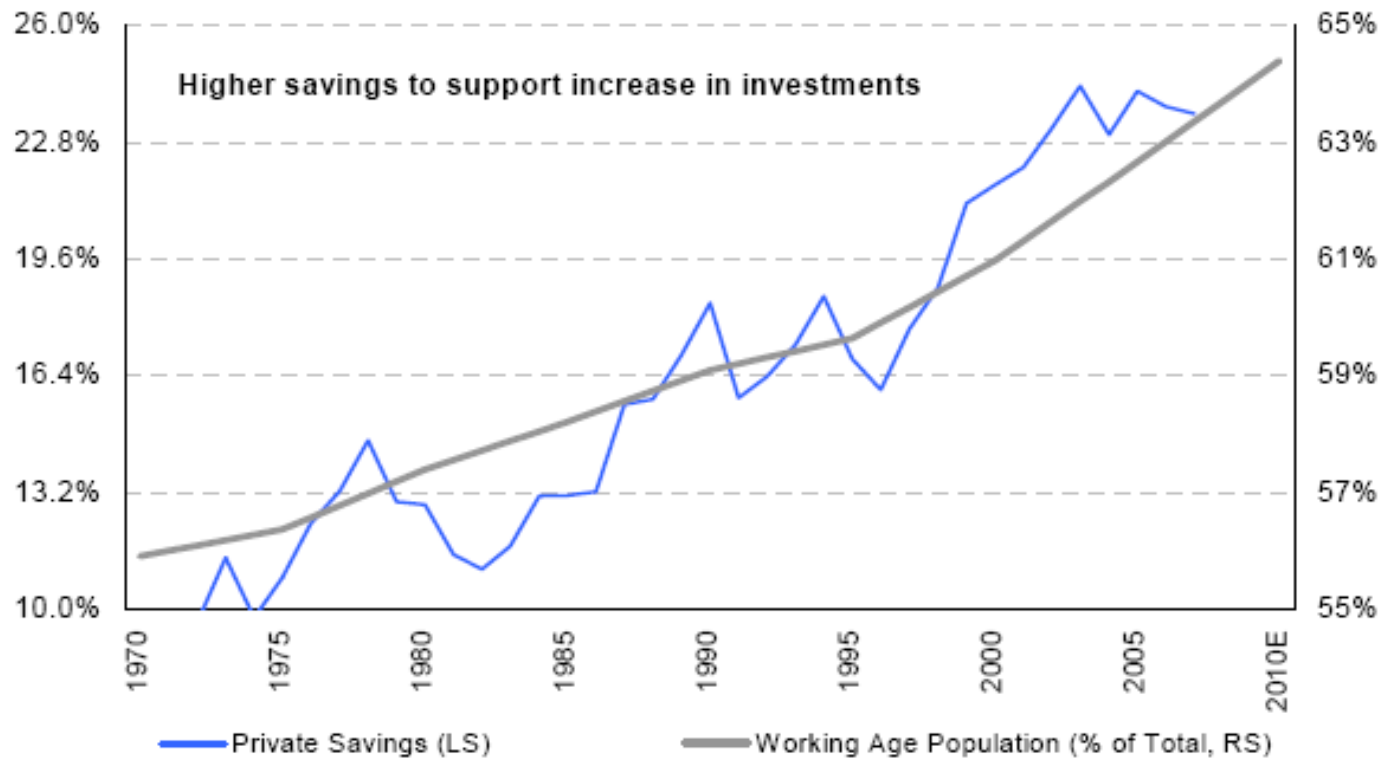


Growth Is Being Led By A Rise In Capital Formation...



Source: CSO, Morgan Stanley Research

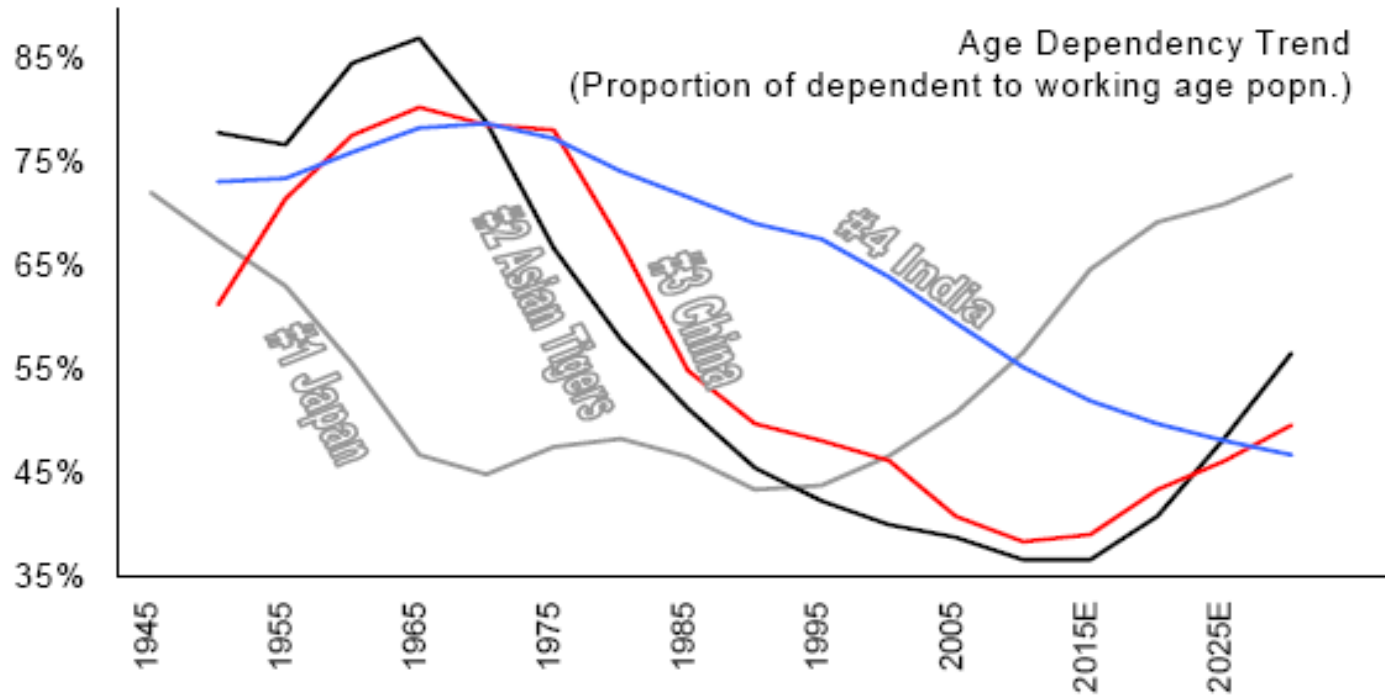
...Which Is Supported By A High Savings Rate



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



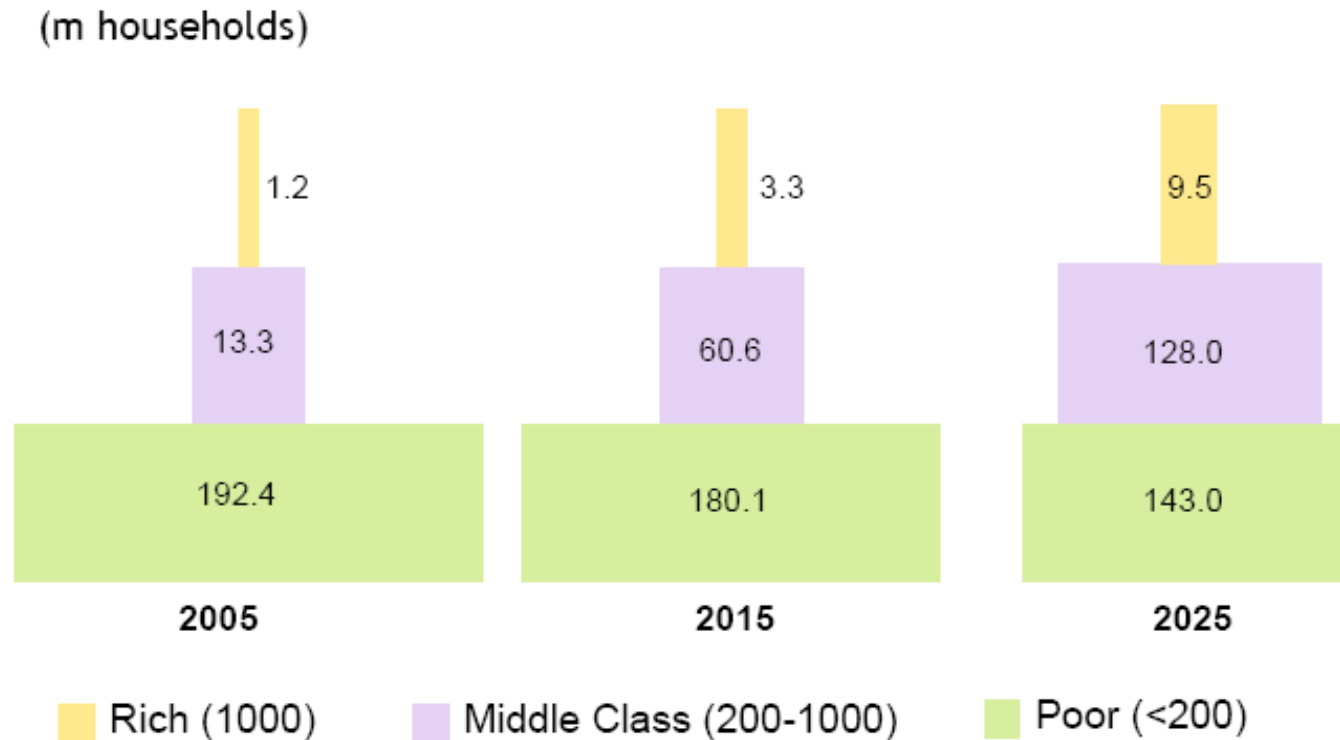
India Is Poised To Reap Rich Demographic Dividend In Years To Come



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

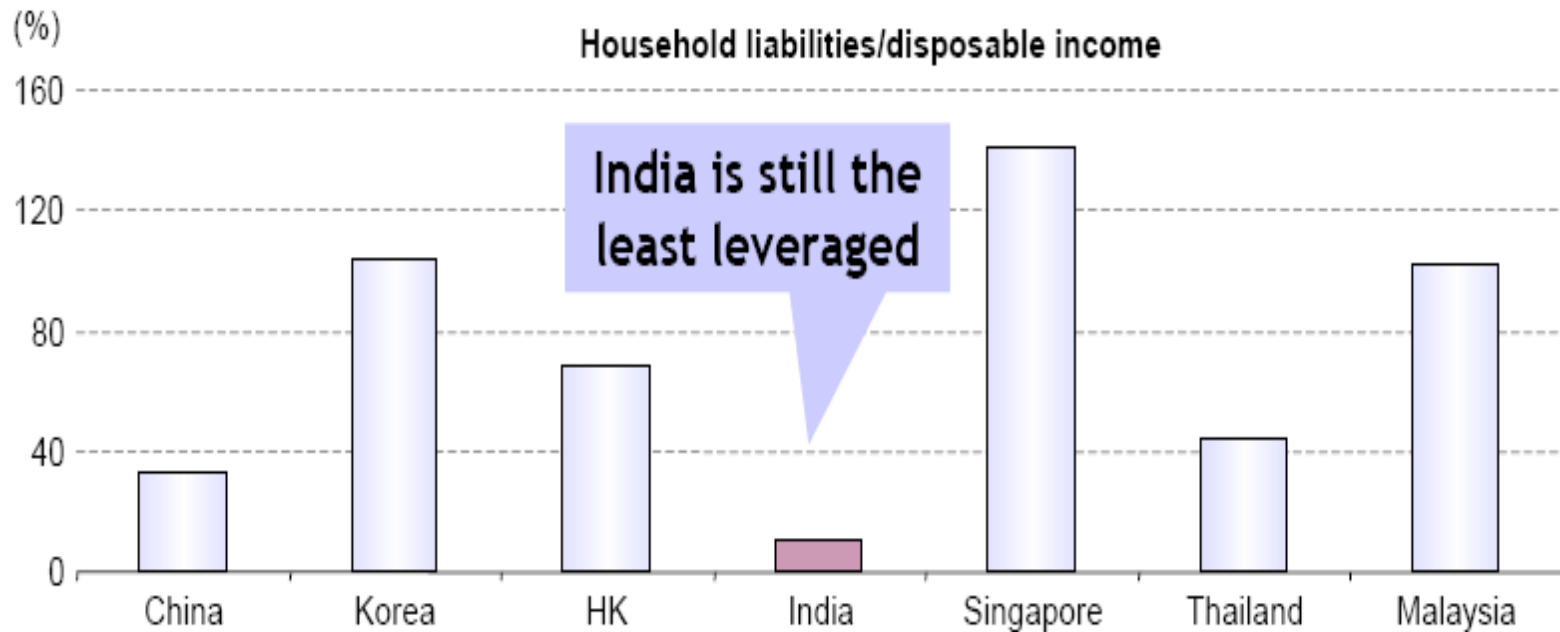


Income Imbalance To Correct Leading To Rise In Consumption



Source: IDFC SSKI

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



Source: IDFC SSKI

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