Equity Markets :

Current Environment and Outlook

Vetri Subramaniam, Chief Investment Officer

June 2011

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Current Environment

- Global Equity markets remained weak in June, with the MSCI World Index falling by 1.73%.
- Indian markets outperformed the global markets, rising by 1.85% in the month of June.
- Commodity price indices continued their bearish run, with the benchmark CRB Reuters Jefferies total return index falling by 2.7%.
- Capital Goods and FMCG were the best performing sectors, while Oil & Gas and Realty sectors delivered the worst return for the month
- FII inflows during the month were at Rs.46bn. MFs recorded inflows of Rs.8bn, while DIIs were net sellers at Rs.1bn during the month.
- Trading Activity remained subdued in June, with the cash trading turnover (US $bn) declining by 3% MoM and the average open interest remained flat on a MoM basis.

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Global Equities

Index	Country	Closing Price*	1 Month Return (%)	YTD Return (%)	Category
SSE Composite Index	China	2762.08	0.68%	-1.64%	EM - Asia
BSE Sensex	India	18845.87	1.85%	-8.11%	EM - Asia
Kospi	South Korea	2100.69	-1.95%	2.42%	EM - Asia
Taiwan Weighted	Taiwan	8652.59	-3.74%	-3.57%	EM - Asia
Thailand SET 50 Index	Thailand	729.78	-3.22%	1.33%	EM - Asia
Jakarta Composite Index	Indonesia	3888.57	1.34%	5.00%	EM - Asia
KLSE	Malaysia	1579.07	1.33%	3.96%	EM - Asia
Ibovespa Sao Paulo Index	Brazil	62403.64	-3.43%	-9.96%	EM
Mexico IPC	Mexico	36558.07	2.02%	-5.17%	EM
Russian RTS Index	Russia	1906.71	0.96%	7.57%	EM
Philippine PSEi	Philippines	4291.21	1.10%	2.14%	EM
Merval Buenos Aires Index	Argentina	3360.64	3.38%	-4.62%	EM
HangSeng	Hong Kong	22398.10	-5.43%	-2.77%	Developed - Asia
Nikkei	Japan	9816.09	1.26%	-4.04%	Developed - Asia
Strait Times	Singapore	3120.44	-1.25%	-2.18%	Developed - Asia
Dow Jones	USA	12414.34	-1.24%	7.23%	Developed
CAC 40 Index	France	3982.21	-0.62%	4.66%	Developed
All Ordinaries Index	Australia	4659.80	-2.70%	-3.86%	Developed
DAX Index	Germany	7376.24	1.13%	6.68%	Developed
Swiss Market Index	Switzerland	6187.07	-5.61%	-3.87%	Developed
FTSE 100	UK	5945.71	-0.74%	0.78%	Developed
MSCI World Index	--	1331.18	-1.73%	3.99%	--

* as on 30th June 2011. Source : Bloomberg
EM – emerging markets, Developed – developed markets.

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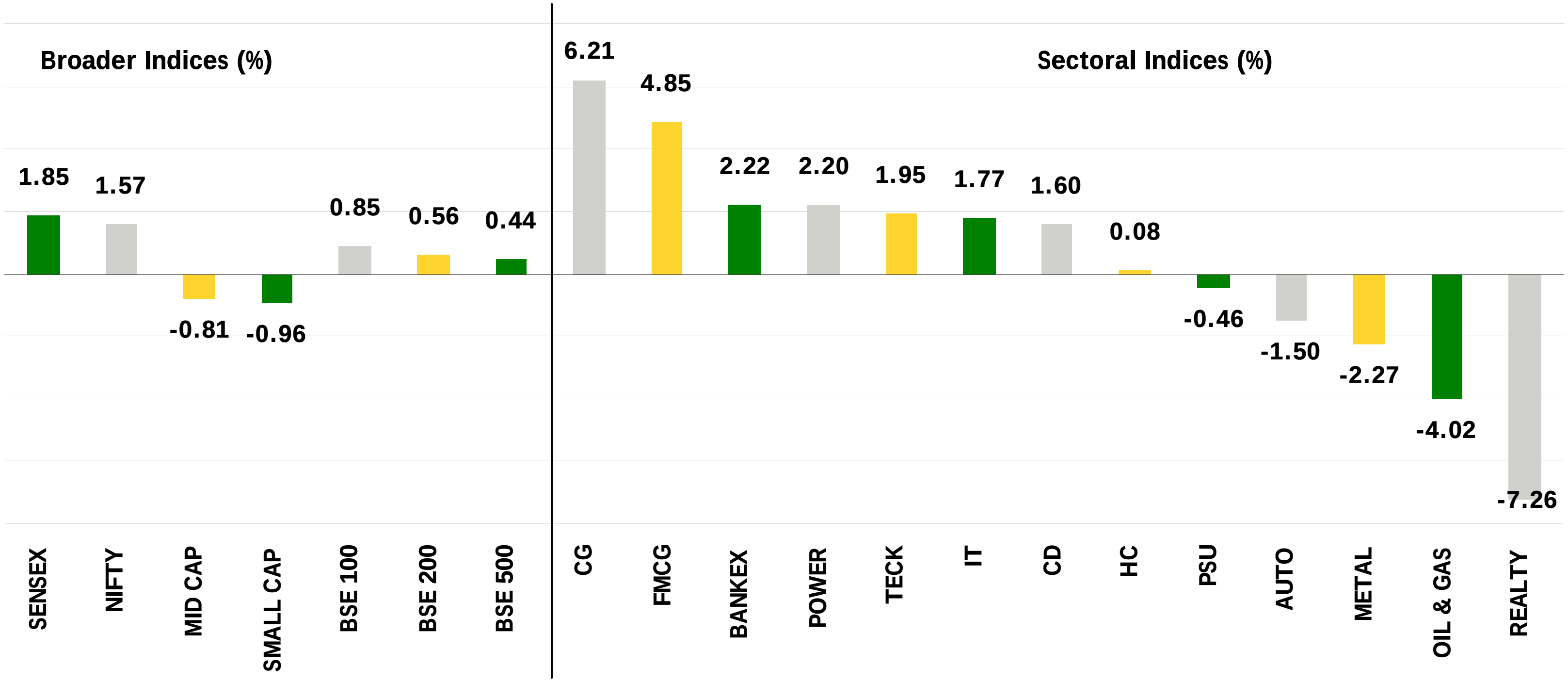
India : Sector performances



- Sensex rose by 1.85% over the previous month.
- MidCaps underperformed LargeCaps with a 0.81% loss for the MidCap index.
- Capital Goods and FMCG were the best performing sectors.
- Oil & Gas and Realty sectors delivered the worst return for the month

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*Source: BSE,NSE. one month performance as on 30th June 11.

Top Gainers / Losers - Nifty

Top Gainers for the month			
Gainers	52 week H/L	Last Price#	% Gain*
Reliance Capital	882.3 / 388.4	578.45	15.38%
Hind. Unilever	348 / 249.6	343.65	12.84%
NTPC	222.3 / 165.15	186.9	11.08%
Larsen & Toubro	2212.7 / 1461	1823.75	11.05%
Kotak Mah. Bank	526.55 / 333	479.35	8.59%
Top Losers for the month			
Losers	52 week H/L	Last Price#	% Loss*
DLF	397.5 / 206.1	210.45	-11.93%
Tata Motors	1382 / 748.4	994.2	-9.23%
Grasim Inds	2626.35 / 1755	2095.85	-8.98%
Hindalco Inds.	252.85 / 140.75	180.55	-8.51%
Cairn India	372.35 / 283.25	311.75	-8.01%

closing price as on 30th June 2011.* one month performance as on 30th June 2011.
Source: Capitaline

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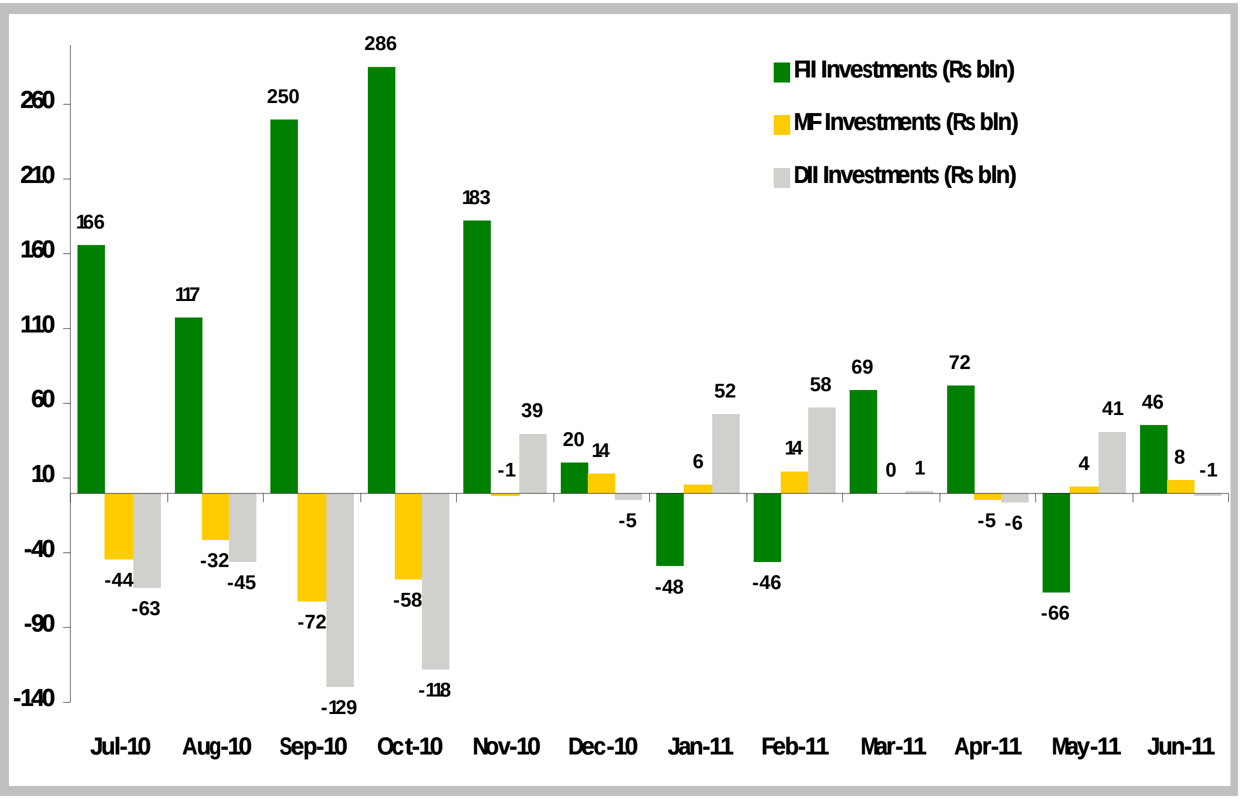
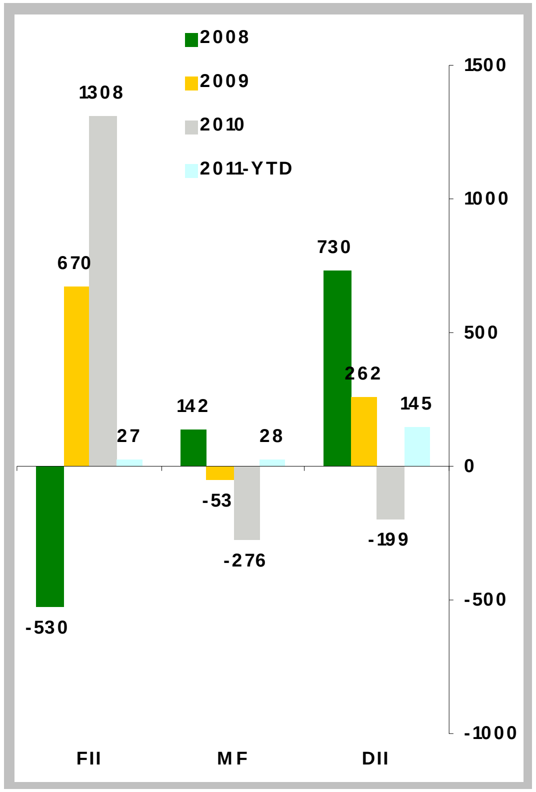
FII & DII Inflows





- FII inflows during the month were at Rs.46bn. FII inflows were at Rs.27bn for CY11 after a Rs.1308bn inflow in CY10 and Rs.670bn inflow in CY09.
- MFs recorded inflows of Rs.8bn. DIIs were net sellers at Rs.1bn during the month.

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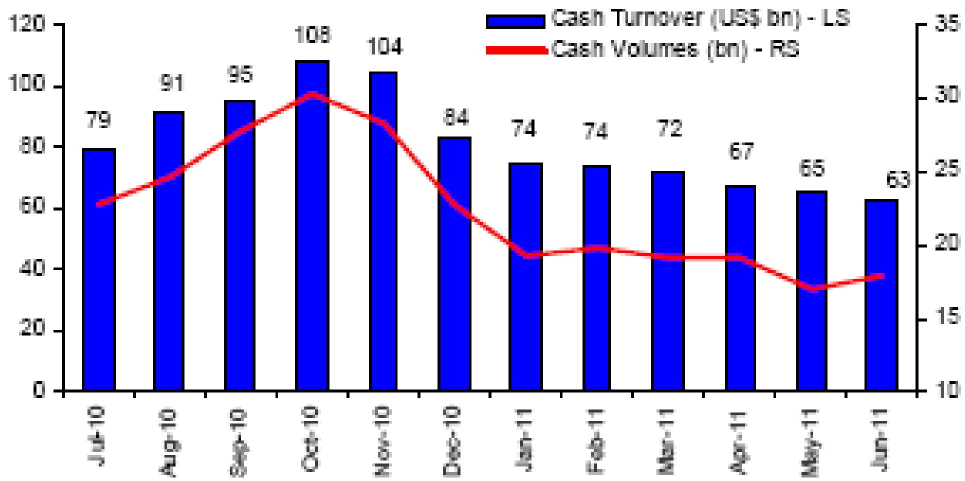
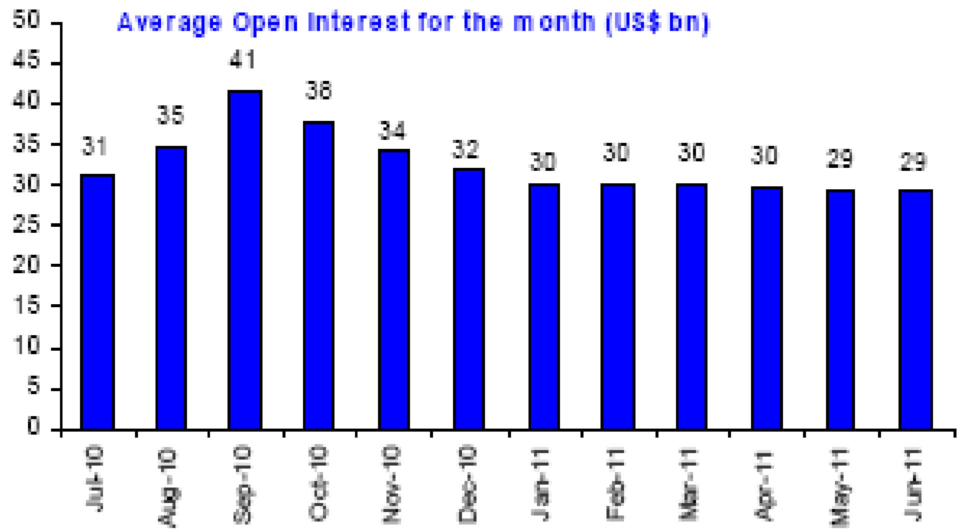
FII - Foreign Institutional Investors, DII - Domestic Institutional Investors (Includes Bank, DFIs, Insurance and MF)
Source: SEBI, BSE

Market Activity



In June 2011, cash trading turnover (US $bn) declined marginally by 3% MoM.



At the end of June 2011, average open interest remained flat MoM.

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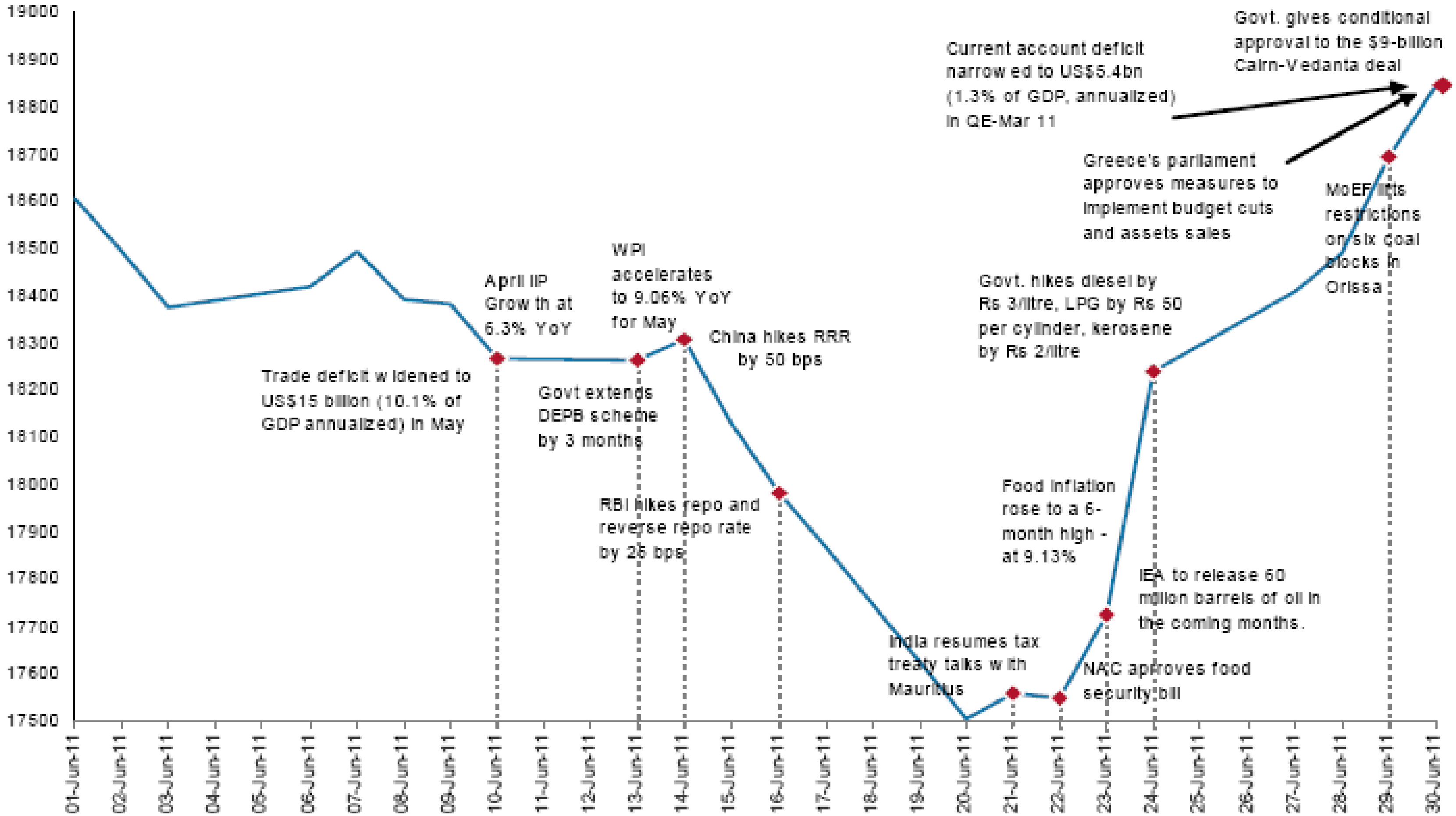
Sources: Bloomberg, Morgan Stanley

June 2011 events timeline



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

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Religare MF: Equity Market Outlook and Opportunities

Equity Market Outlook

- Global markets have rallied recently in response to apparent resolution to Greek crisis, however all solutions continue to address the issue as a liquidity problem rather than as the solvency problem that it truly is.
- The US quantitative easing programme (QE2) has officially ended on June 30, 2011. Markets will watch keenly for any impact it has on yields.
- On domestic side, India’s GDP growth is decelerating led by decline in investment demand. This is largely triggered by policy bottlenecks and a sharp increase in cost of capital (led by RBI moves).
- A revival in the investment cycle is key to sustaining growth momentum and relieving supply side bottlenecks. The hope is that the government addresses these bottlenecks soon.
- Monsoon remains above normal and this raises hopes of a benign outlook on food prices.
- The government announced a hike in fuel prices after much delay and also cut indirect taxes on oils to reduce the under recoveries. This is a welcome step but we still await a transparent framework for subsidy sharing.
- Q1FY12E PAT growth is expected at 10%, which may be the worst quarterly performance since Q2FY10. The poor performance is expected to be driven by the double-impact of an 18-month rate hike cycle and rising input costs on the profit margins.
- Analyst estimates for FY12 have been cut by about 3-4% in recent months and markets will watch for out for further risks to earnings. However we would now be more concerned about revenue weakness than margin led cuts to earnings.

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European Sovereign Debt Problems Postponed

Greece 10-yr Treasury Credit Default Swap (CDS)

- One of the key issues worrying the global credit and equity markets has been a default by Greece. One year after the first bailout Greece is in trouble again.
- A temporary solution appears to have been reached but the issue is not just one of liquidity but of solvency.
- The worry is that the issue has merely been kicked down the road. Meanwhile the risk of contagion is high with Portugal also suffering a downgrade and Ireland being next in line.

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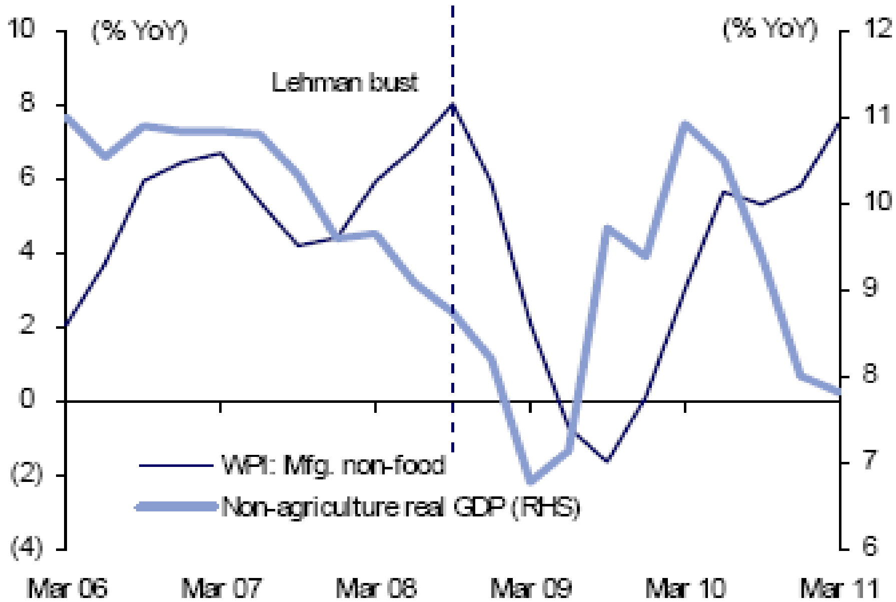
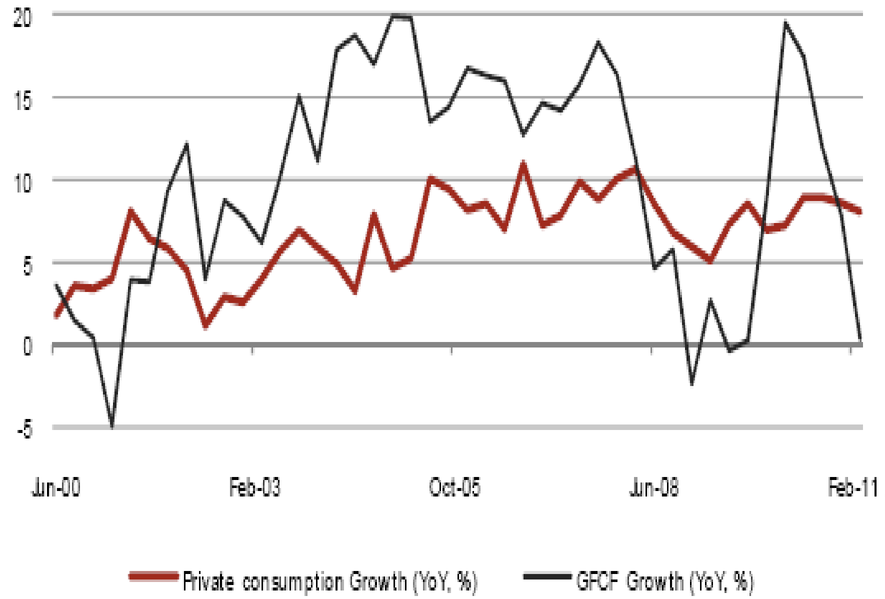
Source: Bloomberg,

GDP slowdown led by fall in investment demand

GDP growth and Inflation (% chg, YoY)



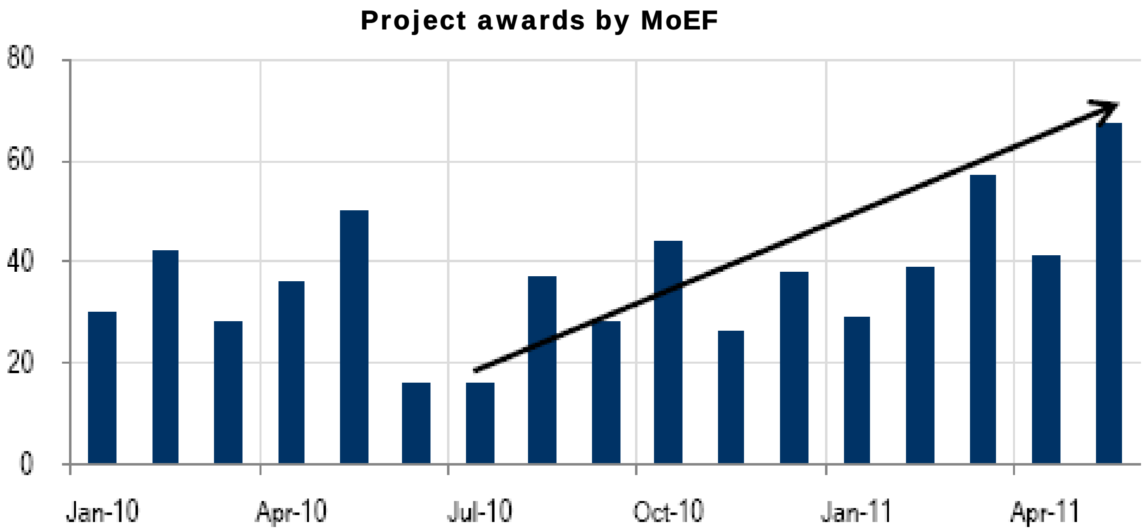
GDP growth composition



- The real GDP growth has decelerated sharply and the Q4FY11 exit growth was the lowest for FY11.
- However, on the other side, the non-food inflation continued to ramp up on the back of a steady consumption demand.
- We feel the revival in investment demand is critical for a revival in GDP growth.

Source: CEIC, CLSA Asia-Pacific Markets, CMIE, Jefferies

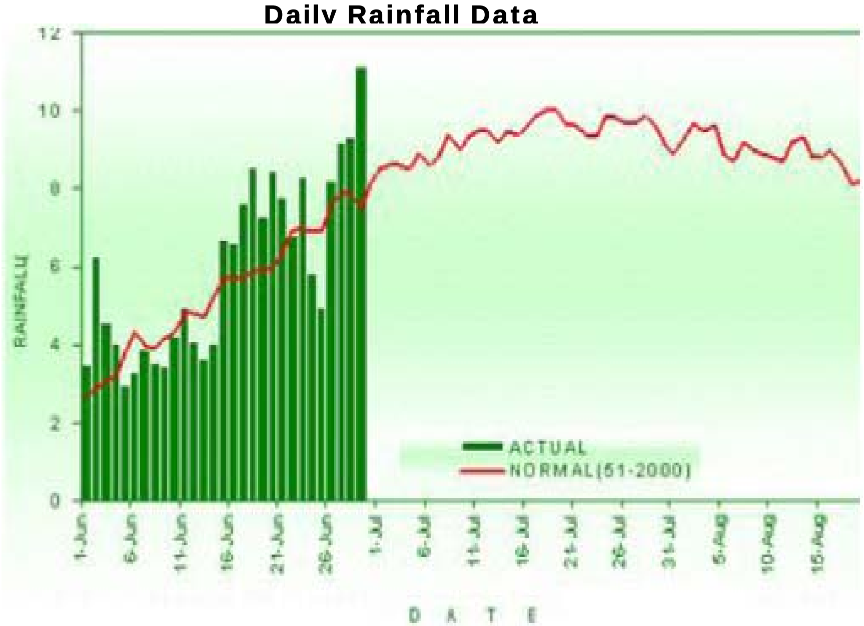
Policy making appears to be gaining traction

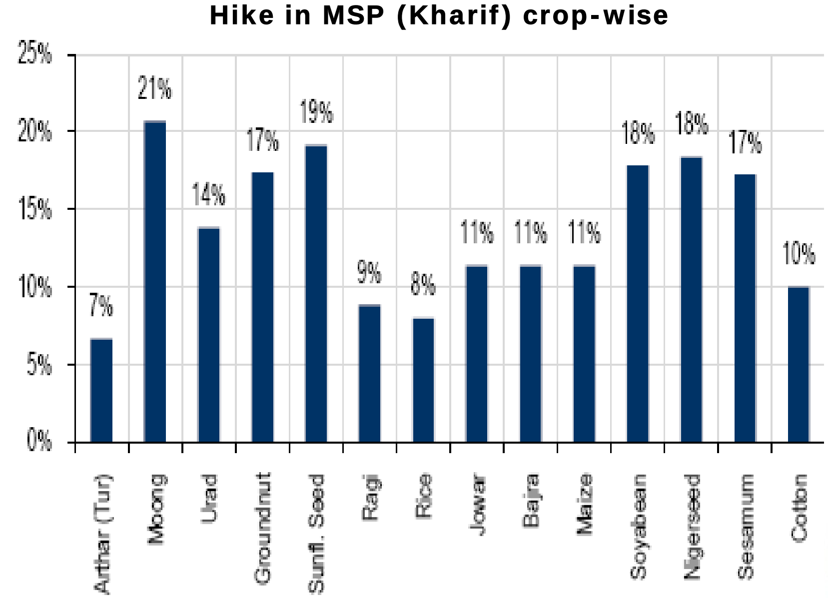


- Government appears to be cognizant of the decline in investments leading to a sharp economic slowdown.
- Hence recent activity suggests governments willingness to re-ignite investment demand.
- Thus MoEF has rapidly approved projects in recent months. Even the mega Cairn-Vedanta deal has been cleared.
- Post the Cabinet reshuffle, projects worth Rs.110bn have been awarded by NHAI. The total investment in the national highways sector in 2011-12 is expected at about Rs.730bn with award of 9000Km of highways.

Source: MoEF, RCML Research

Normal Monsoons, MSP Hike May Ensure Farm Economy Growth





- Overall rainfall thus far is 11% above normal and the monsoon has reached the northern parts as per the normal timeline.
- While is early days yet to take a call on the monsoon; important factors are the spatial distribution and the timing of the rainfall; we note that normal rainfall so far has led to an increase in sown area for different crops. This is expected to help boost farm output further.
- Government has recently announced an increase in MSP for various crops in the range of 6-20%, which should help increase farm income by about Rs.304bn (based on previous year's production levels).
- All the above can help in lowering food inflation, while increasing consumption expenditure.

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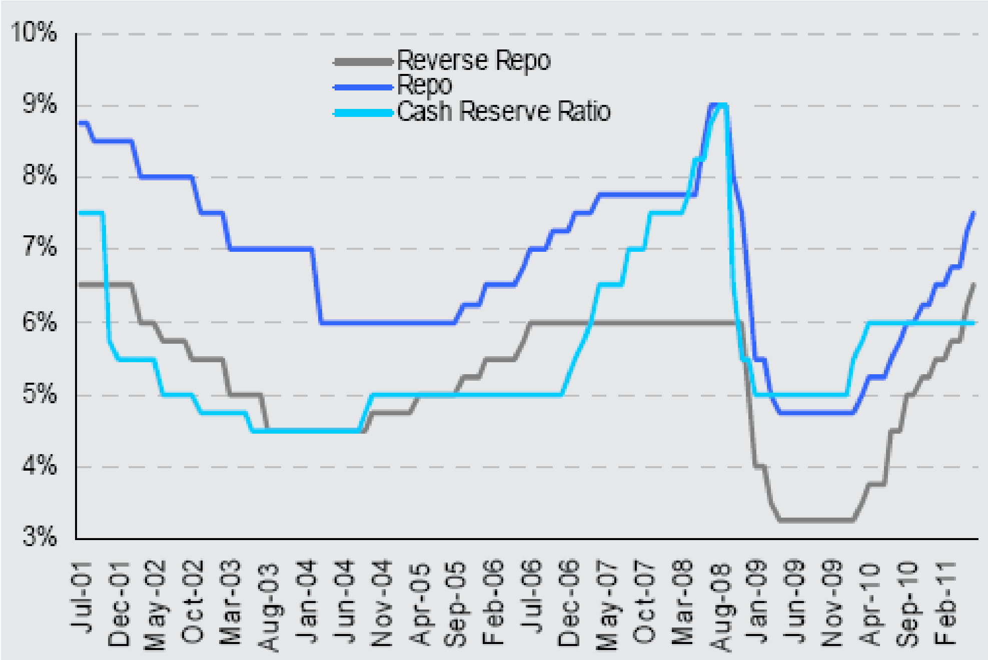
Source: IMD, RCML Research

Monetary Policy – Hawkish Stance Continues

Trend in Policy Rates



- The Reserve Bank of India (RBI) in its mid-quarter review of monetary policy hiked the benchmark rates by 25 basis points. Thus repo rate increased to 7.5% and the reverse repo rate to 6.5%.
- The policy statement mentioned that "inflation persists at uncomfortable levels. In April 2011, WPI headline inflation was 8.7% and rose to 9.1% in May 2011".
- The statement mentioned, "the monetary policy stance remains firmly anti-inflationary". It also adds that RBI is "recognizing that, in the current circumstances, some short-run deceleration in growth may be unavoidable in bringing inflation under control". Thus RBI is ready to choose inflation management over growth

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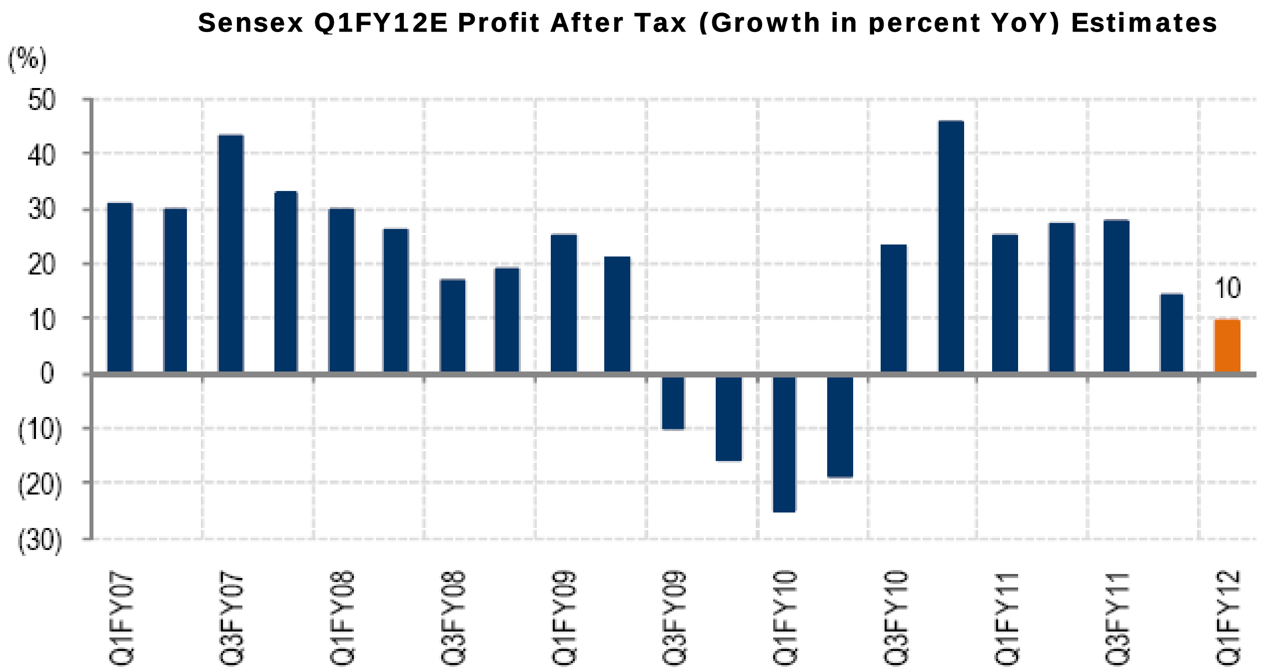
Source: RBI, CEIC, Morgan Stanley Research

Earnings Season – Q1FY12E Preview



Note: Religare Securities estimates used as proxy for market estimates

- Q1FY12E PAT growth is expected at 10%, which may be the worst quarterly performance since Q2FY10.
- Even as top-line remains somewhat resilient at 26%, we expect margins to feel the double-impact of an 18-month rate hike cycle and rising input costs (-250bps at EBITDA, and -170bps at PAT).
- Profit growth would be led by sectors like Energy, IT, Power and FMCG, while Realty, Telecom, Pharma and Banks would remain laggards.

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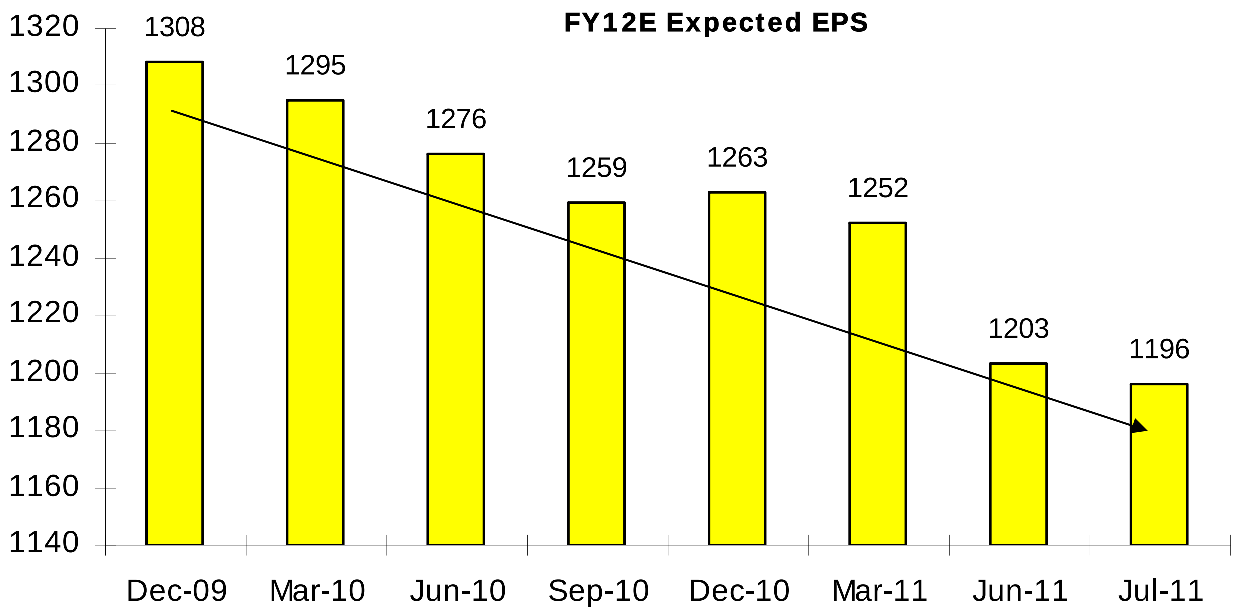
Source: RCML Research

Earnings Forecasts – Sharp Downgrades In Estimates



- The Q4FY11 earnings season led to a sharp round of earnings downgrades for FY12, due to both base effect (actual reported FY11 EPS being materially lower than expected) as well as weaker outlook.
- This is in line with our long held view that FY12 estimates would need to be revised down. However with the estimates implying nearly 18% growth in FY12 we worry that the bar may need to be lowered again.

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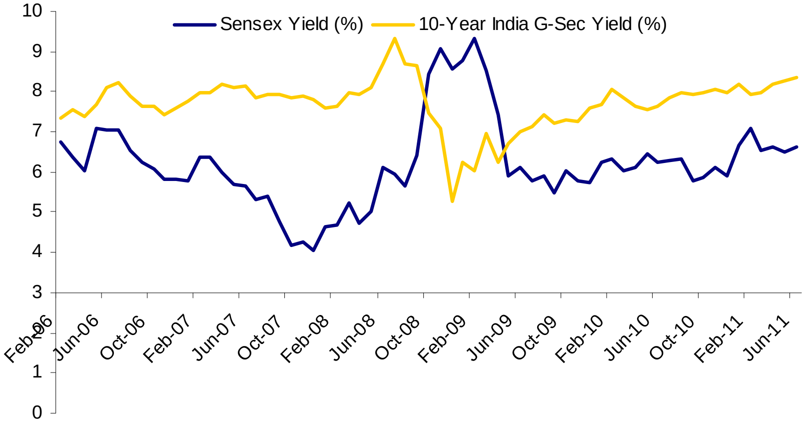
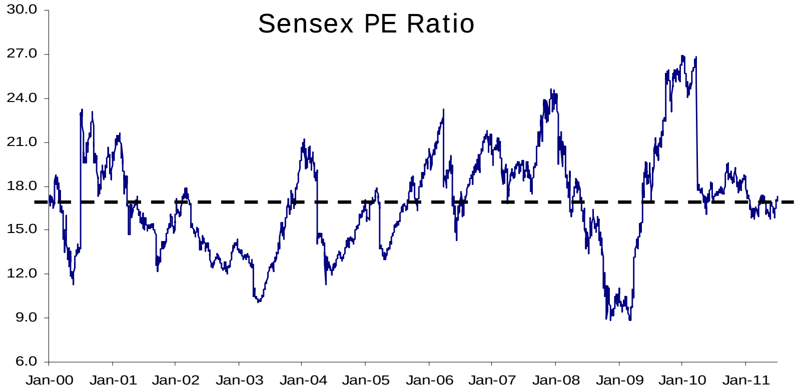
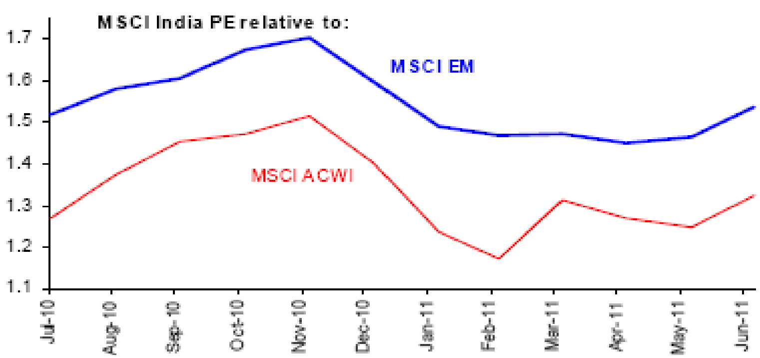
Sources: *Motilal Oswal Research*

Valuations – Corrected Materially







- The gap between Sensex earnings yield and bond yield has reduced by 5 basis points over the previous month largely due to increase in Sensex yield.
- Sensex is currently trading at 17.3x its trailing earnings. It is now 2% higher than its historical 11-year average trailing PE of 17x.
- On a 1-yr forward basis, Sensex is trading at 15.1x, which is about 4% above the 15 year average PE.
- India's PE premium to MSCI Emerging markets has slightly widened over the recent months, 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 hardening commodity prices resulting into inflation, which threatens to soften demand and squeeze corporate margins (some evidence of which was seen in Q4FY11 numbers). However we are comforted to some extent by the recent softening of food inflation.
- RBI has in its recent policy review hiked the benchmark rates by another 25 basis points. Since the RBI began tightening in early 2010 it has effectively raised policy rates by a total of 425bp.
- We expect a further 50bp of rate action but that should bring this round of tightening to an end in our opinion.
- RBI actions signals that it is ready to sacrifice some near-term growth for stronger sustainable medium-term growth in a lower inflation setting. The RBI's forecast for GDP growth for 2011-12 is around 8.0%, down from an estimated 8.6% in 2010-11. The official WPI inflation guidance (not target) for March 2012 is pegged at 6.0% YoY,
- The government is also taking the right steps by hiking the domestic fuel prices, as it shall lead to cooling of the economic growth while at the same time curtailing fiscal deficit.
- Despite economic slowdown, India remains one of the fastest growing economies in the world. The current valuations are near long term averages. Thus while there are near-term headwinds for earnings, the longer term trend remains positive for both earnings as well as PE multiple re-rating.
- Valuations are now in the comfort zone with markets trading near long term average multiples.
- We see more opportunities for stock picking as dispersion in company performance within sectors is quite high. Given the hazy macro outlook the focus on generating Alpha is now led largely by stock selection.

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Investment view

Short term

- GDP growth likely to moderate to about 8% in FY12.
- Earnings estimates have been cut for FY12 as we have long expected but the implied growth rate is still 20% and that could prove to be a high bar.
- However, valuations have 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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