

Equity Markets : Current Environment and Outlook

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Current Environment

- Global Equity markets bounced back in October, with the MSCI World Index rising by 10.26%.
- Indian markets under performed their global peers, rising by 7.6%.
- Commodity prices reflected the strong trend in global equities, rising by 6.2% on a MoM basis, as indicated by the benchmark CRB Reuters Jefferies total return index.
- In India Auto, IT and Realty were the best performing sectors, while Consumer Durables, Capital Goods sectors and PSU Index delivered the worst return for the month.
- FII inflows during the month were at Rs.17bn. MF were sellers at Rs.3bn, while DII were net sellers of Rs.23bn during the month.
- Trading Activity remained subdued in October, with the cash trading turnover (US \$bn) declining by 21% MoM and the average open interest declining by 11% on a MoM basis.

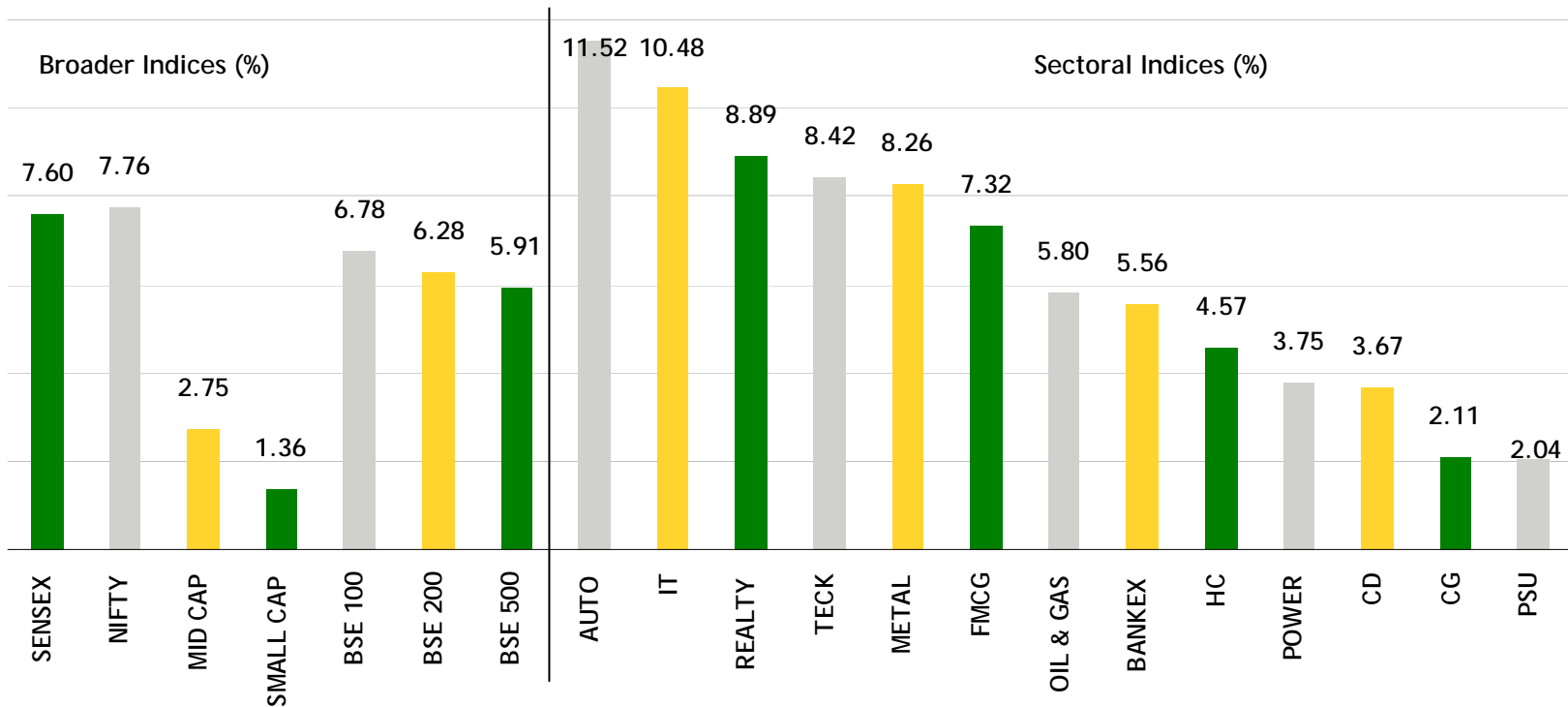
Global Equities

Index	Country	Closing Price*	1 Month Return (%)	YTD Return (%)	Category
SSE Composite Index	China	2468.25	4.62%	-12.10%	EM - Asia
BSE Sensex	India	17705.01	7.60%	-13.67%	EM - Asia
Kospi	South Korea	1909.03	7.88%	-6.92%	EM - Asia
Taiwan Weighted	Taiwan	7587.69	5.01%	-15.43%	EM - Asia
Thailand SET 50 Index	Thailand	691.97	8.75%	-3.92%	EM - Asia
Jakarta Composite Index	Indonesia	3790.85	6.81%	2.36%	EM - Asia
KLSE	Malaysia	1491.89	7.55%	-1.78%	EM - Asia
Ibovespa Sao Paulo Index	Brazil	58338.39	11.49%	-15.82%	EM
Mexico IPC	Mexico	36159.99	7.93%	-6.20%	EM
Russian RTS Index	Russia	1563.28	16.57%	-11.81%	EM
Philippine PSEi	Philippines	4333.72	8.35%	3.16%	EM
Merval Buenos Aires Index	Argentina	2905.54	17.94%	-17.54%	EM
HangSeng	Hong Kong	19864.87	12.92%	-13.76%	Developed - Asia
Nikkei	Japan	8988.39	3.31%	-12.13%	Developed - Asia
Strait Times	Singapore	2855.77	6.75%	-10.48%	Developed - Asia
Dow Jones	USA	11955.01	9.54%	3.26%	Developed
CAC 40 Index	France	3242.84	8.75%	-14.77%	Developed
All Ordinaries Index	Australia	4360.50	7.13%	-10.04%	Developed
DAX Index	Germany	6141.34	11.62%	-11.18%	Developed
Swiss Market Index	Switzerland	5731.27	3.61%	-10.95%	Developed
FTSE 100	UK	5544.22	8.11%	-6.03%	Developed
MSCI World Index	--	1217.30	10.26%	-4.90%	--

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



India : Sector performances



- Sensex rose by 7.6% over the previous month.
- MidCaps underperformed LargeCaps with 2.75% gain in the MidCap index.
- IT and Realty were the best performing sectors.
- Consumer Durables, Capital Goods sectors and PSU Index delivered the worst return for the month.



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

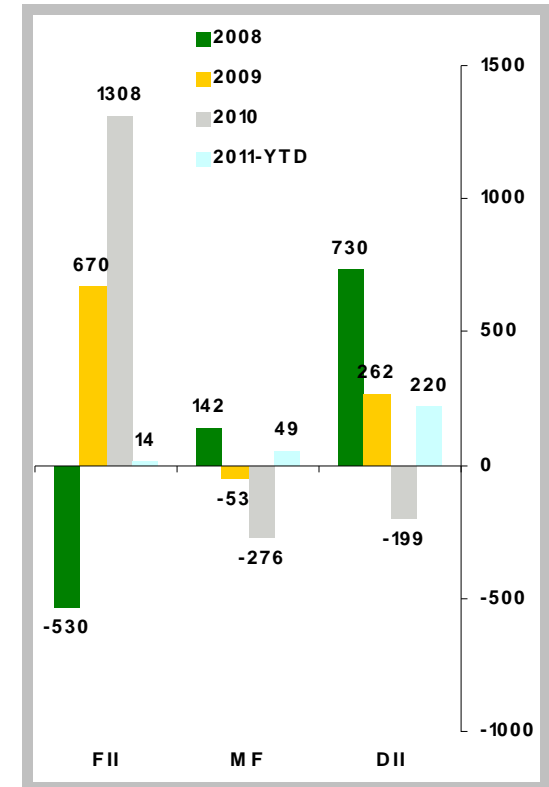
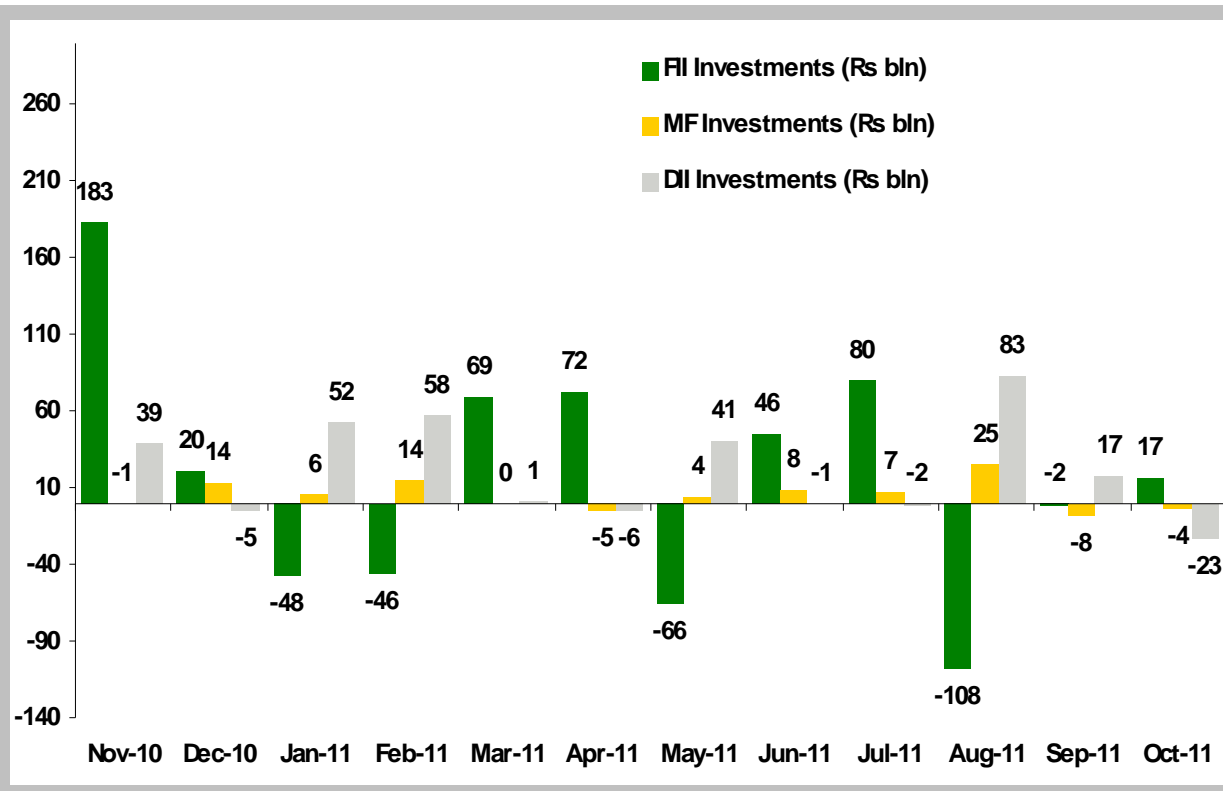
Top Gainers / Losers - Nifty

Top Gainers for the month			
Gainers	52 week H/L	Last Price#	% Gain*
Tata Motors	276.4 / 137.55	198.45	27.17%
Reliance Power	192.8 / 75.1	95.5	24.43%
Reliance Infra.	1075 / 365.35	464.3	24.33%
I D F C	218.25 / 103.25	132.5	19.58%
Tata Steel	737 / 390.3	482.8	16.24%
Top Losers for the month			
Losers	52 week H/L	Last Price#	% Loss*
B P C L	796.9 / 529.35	622.6	-3.89%
B H E L	510.8 / 309.45	317.8	-3.09%
Ranbaxy Labs.	624.2 / 414	502.05	-2.30%
Coal India	422.35 / 289	332	-0.36%
St Bk of India	3515 / 1710	1906.3	-0.25%

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



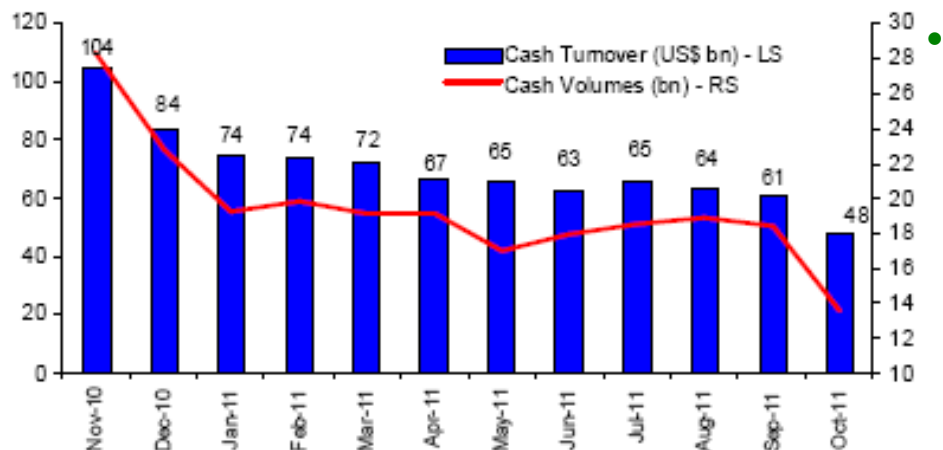
FII & DII Inflows



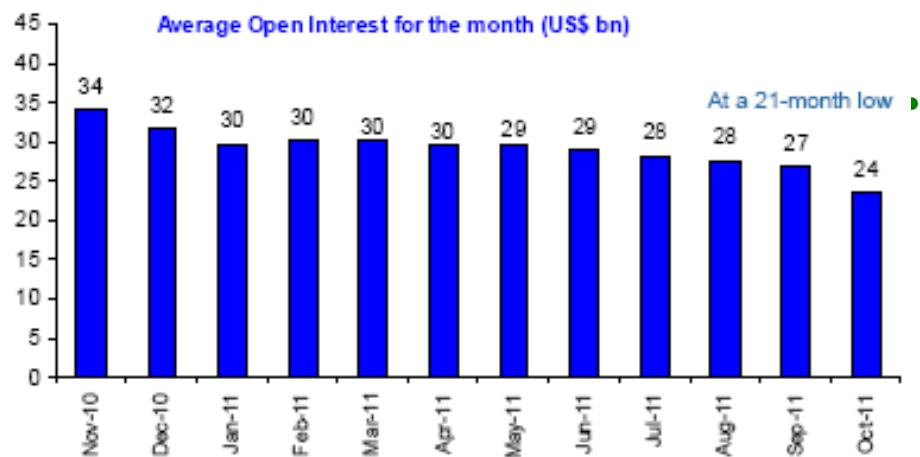
- FII inflows during the month were at Rs.17bn. FII inflows were at Rs.14bn for CY11 after a Rs.1308bn inflow in CY10 and Rs.670bn inflow in CY09.
- MF were sellers at Rs.3bn, while DII were net sellers of Rs.23bn during the month.



Market Activity



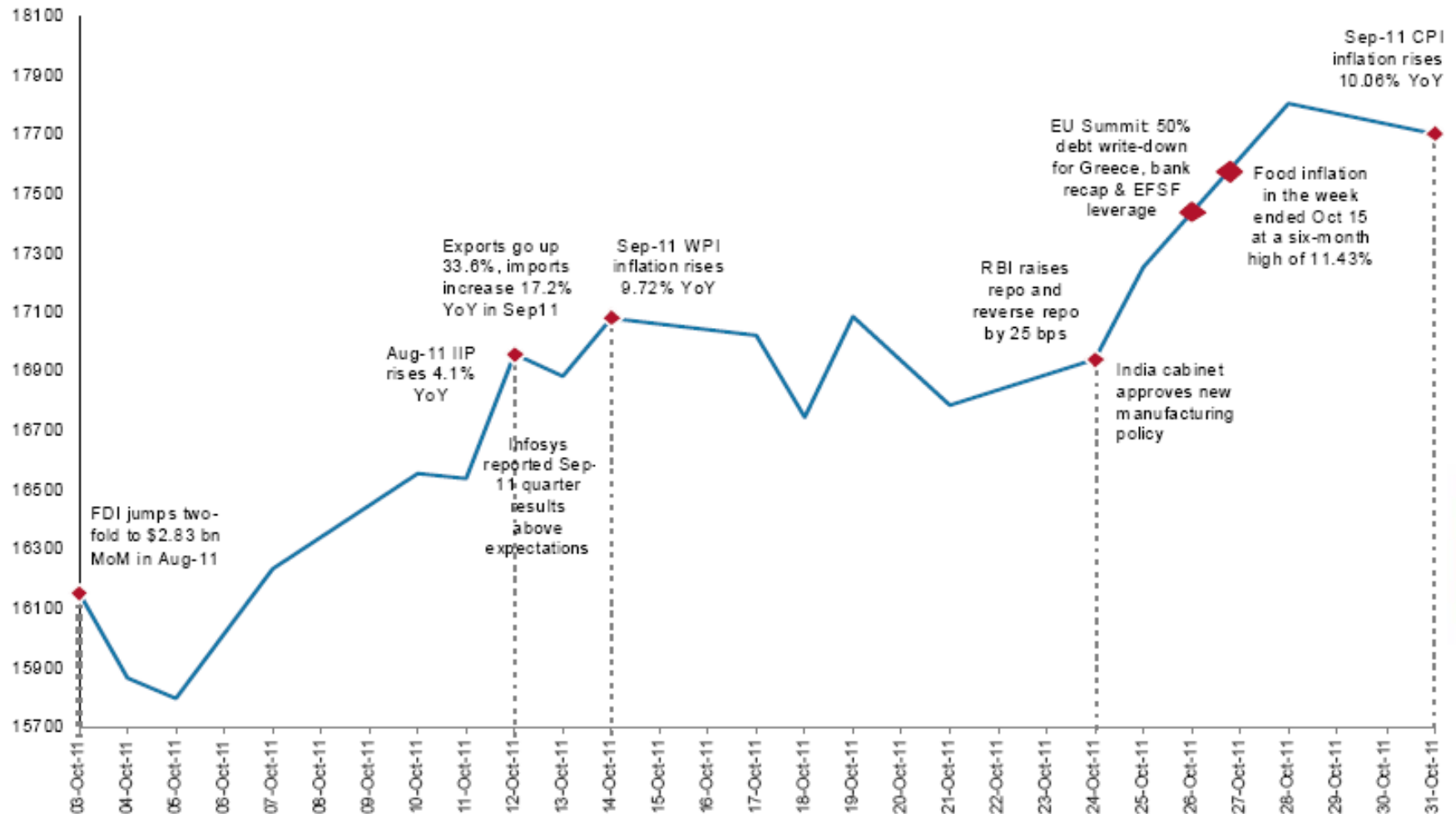
In October 2011, cash trading turnover (US \$bn) declined sharply by 21% MoM.



At the end of October 2011, average open interest declined 11% on a MoM basis.



October 2011 events timeline



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



Religare MF: Equity Market Outlook and Opportunities

Equity Market Outlook

- Eurozone, the largest contributor to global GDP is expected to sharply slowdown in the near term. The Eurozone PMIs are forecasting a 0.5% decline in region's GDP.
- Nearly one-third of European GDP—the periphery nations of Greece, Portugal as well as Italy and Spain —are expected to witness recession post the recent sovereign debt crisis.
- In India, most surveys to judge the business confidence are currently negative, signaling lack of confidence of demand growth and constraints in adding supply.
- The Indian Rupee (INR) has depreciated sharply in in the previous quarter, with the spot INR declining by 11% in the last three months.
- While this has increased competitiveness of exports, it has also swelled India's subsidy bill on imports like Oil and has resulted in increased cost of raw materials. This might offset the anticipated easing in inflation.
- Aggregate reported earnings (ex-energy) have been 3 percent points behind analysts' expectations, up 12% YoY. Even as revenue growth remains strong at 20% YoY, margins compressed in six out of the ten sectors.
- While the current year (FY12) estimates have been cut by 1.3% in October 2011, the market continues to expect a robust 19% growth in earnings in FY13. We feel the FY13 estimates can come under pressure and expect an earnings growth of around 15%.

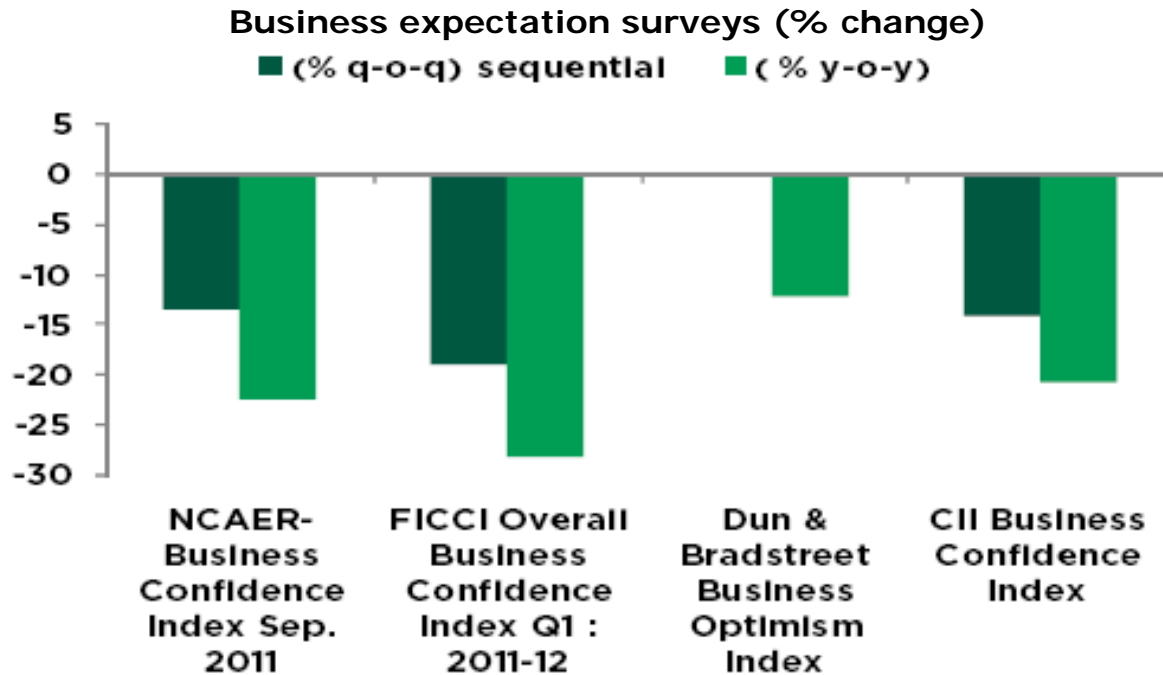
Europe: The Epicenter Of Global Macro Storm - Looking Beyond Greece



- Eurozone, the largest contributor to global GDP is expected to sharply slowdown in the near term. The Eurozone PMIs are forecasting a 0.5% decline in region's GDP.
- Forced fiscal tightening is looming which looks to shave a meaningful portion of Eurozone GDP growth;
- The banks are also expected to de-leverage to comply to increased capital adequacy requirements.
- Nearly one-third of European GDP—the periphery nations of Greece and Portugal as well as Italy and Spain—are expected to witness recession post the recent sovereign debt crisis. The increase in cost of capital for most countries in the periphery is also expected to put brakes on consumption and investment demand in such countries.



India Business Confidence Continues to Remain Weak



- Most surveys to judge the business confidence are currently negative, signaling lack of confidence of demand growth.
- The poor business confidence is also led by current policy and decision making logjam in the government, which has made it difficult to execute projects on time.

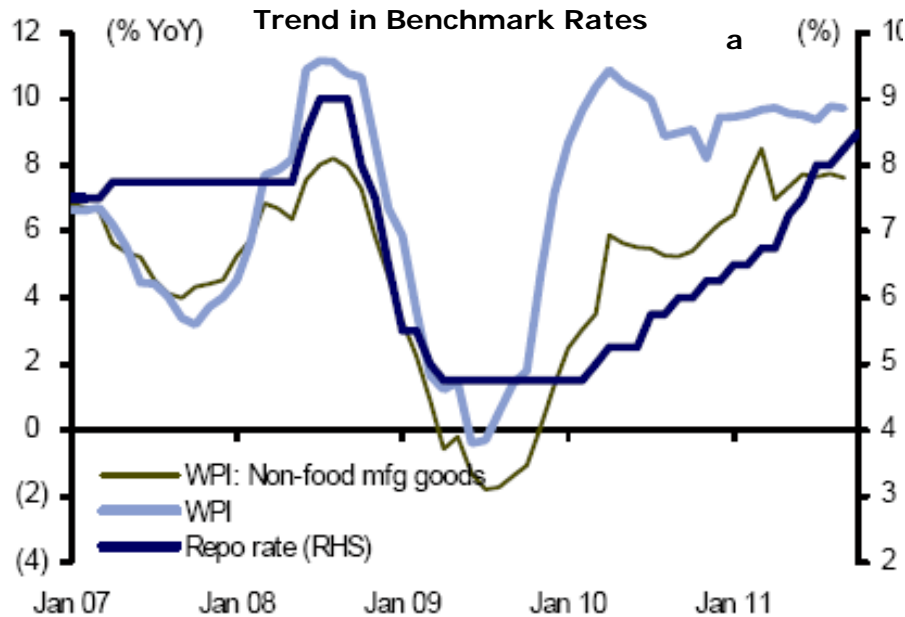
Currency Movement - Boon or Bane!



- The Indian Rupee (INR) has depreciated very sharply in the previous quarter, with the spot INR declining by 11% in the last three months.
- This has led to increased competitiveness of export linked industries like Information Technology and Textiles.
- However, on the flip side, it has increased India's fiscal deficit (increased Oil bill), increased cost of funds for corporates raising funds via ECB and raises the risk of higher inflation.



RBI Hikes Rate but Signals End of Tightening Cycle



- The Reserve Bank of India (RBI) in its 2Q review of monetary policy for FY12, hiked the repo rate and reverse repo rate by 25bp each to 8.5% and 7.5%, respectively.
- The RBI has highlighted the increased concerns about the growth outlook and hence lowered its FY12 GDP growth forecast to 7.6% from 8% earlier.
- RBI noted that there is a very low probability of a rate action in the mid-quarter review of monetary policy in December provided that inflation outcomes are as per the expected trajectory, which would give room to balance growth concerns, signaling for an end to tightening cycle.



September 2011 Earnings Season So Far - Worse Than Expected

September 2011 PAT growth forecasts and actuals

YoY Earnings growth	Q3F11	Q4F11	Q1F12	Q2F12E	Q2F12E*	Q2F12A
MS coverage	25%	10%	11%	-12%	-13%	-18%
MS coverage Ex-Energy	15%	12%	3%	3%	14%	12%
Broad Market	25%	14%	15%	-	-	-12%
Broad Market Ex-Energy	17%	14%	12%	-	-	7%
BSE Sensex	26%	4%	9%	3%	19%	15%

E = MS Analyst Estimate for MS coverage universe

E* = MS Analyst estimate for 63 companies that have reported thus far

A = Actual earnings for the quarter for 63 companies that have reported thus far

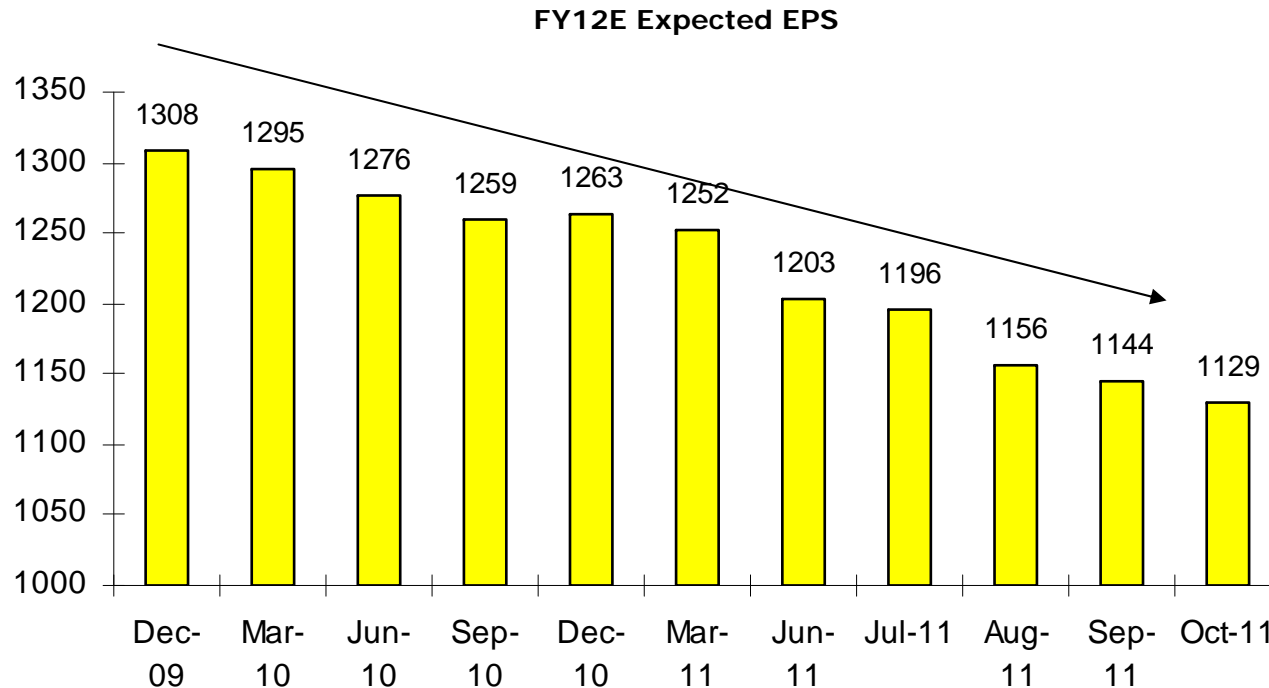
Please note Sensex estimate for quarter does not include Coal India.

Note: Morgan Stanley Estimates used as proxy for market estimates

- Aggregate reported earnings (ex-energy) have been 3 percent points behind analysts' expectations, up 12% YoY. Even as revenue growth remains strong at 20% YoY, margins compressed in six out of the ten sectors.
- So far, 1193 companies in the broad market have reported. Ex-energy, revenue and earnings are up 19% and 7% YoY, respectively. The EBITDA margins (ex- energy) are down 106bps YoY.



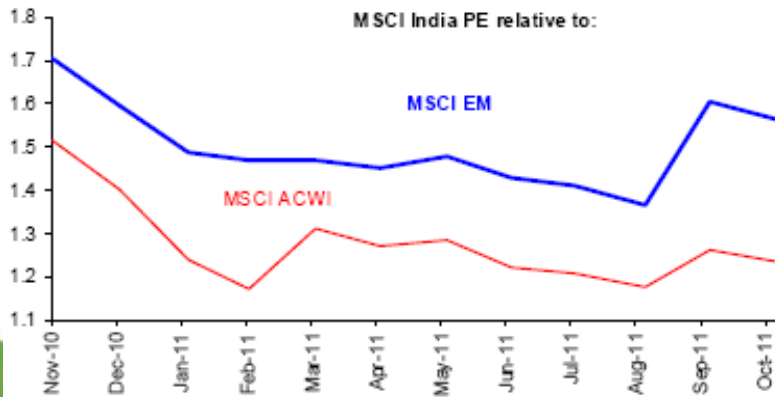
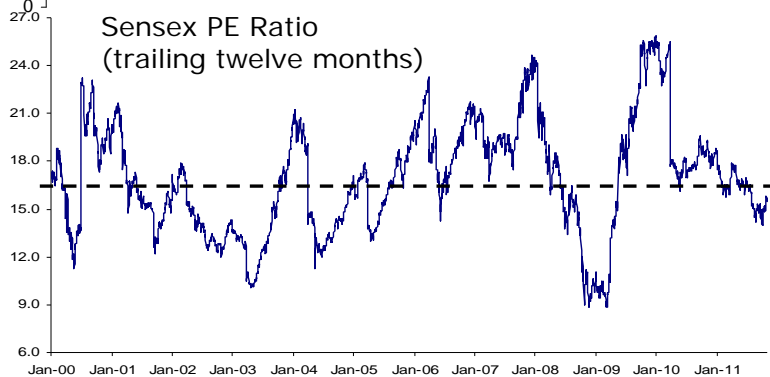
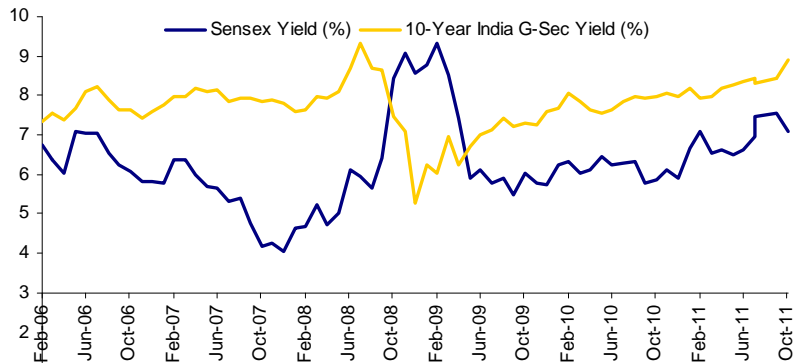
Earnings Forecasts - Still Falling



- Due to a mix of both negative macro outlook and disappointing earnings performance so far for September 2011 quarter, FY12 earnings estimates have been cut by 1.3% in October 2011.
- However, FY13 earnings are still expected to grow by 19%, which we feel can also come under pressure (we expect a 15% growth) if the current macro headwinds persist.



Valuations - Corrected Materially



- The gap between Sensex earnings yield and bond yield has widened by 89 basis points over the previous month as Sensex yield fell while the bond yield increased.
- Sensex is currently trading at 15.4x its trailing earnings. It is now 9% lower than its historical 11-year average trailing PE of 16.9x.
- On a 1-yr forward basis, Sensex is trading at 14.1x, which is about 3% below its 15 year average PE.
- India's PE premium to MSCI Emerging markets has slightly contracted over the previous month, and is now at about 60% premium to MSCI EM PE currently.



Looking Ahead...

- The global environment is adverse with a slowdown looming in developed economies and emerging markets experiencing a policy induced slowdown in growth rates.
- The conflagration in sovereign debt issues in Europe is a key risk to financial markets across the globe due to the rising possibility of a disorderly outcome which causes financial markets to freeze up.
- Recent market gyrations to Greece flip-flop on call for referendum on EU Package (which carries increased austerity measures as pre-condition) is an indication of the importance of the current sovereign debt crisis to the markets.
- The Reserve Bank of India in its mid-quarter review of monetary policy hiked the repo rate and reverse repo rate by 25bps to 8.5% and 7.5% respectively.
- The RBI has also signaled that there is a very low probability of a rate action in the mid-quarter review of monetary policy in December provided that inflation outcomes are as per the expected trajectory.
- A key negative during the last couple of months was the increase in government borrowing program resulting in a hardening of the 10 year yield to 8.9%. We worry that this would have a negative impact on the investment climate and it also pressurizes equity valuations.
- The Sensex is currently trading at 15.4x, which is 13% lower than its historical 11-year average trailing PE of 16.9x. Given the risk to earnings forecasts the trailing valuations provide a better benchmark and this number certainly provides comfort.
- We recognize the adverse macro economic challenges but prefer to focus on the ability of companies to withstand such pressures and emerge stronger when a cyclical upturn presents itself. Where valuations are supportive and bottom up credentials are healthy we would rather be constructive than be risk averse on macro considerations.

Investment view

Short term

- GDP growth likely to moderate to about 7- 7.5% in FY12.
- Earnings estimates have been cut for FY12 as we have long expected but the implied growth rate for FY13 is still 19% 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 below average on trailing and forward basis investors can benefit from an upward re-rating of valuations in the future.

Strategy for investors

- The lesson from history is that valuations at entry are the crucial determinant of future returns and not the news flow.
- We recommend that investors should adopt a constructive approach towards equities given the comfort provided by valuations.

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