Equity Markets :

Current Environment and Outlook

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September 2011

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Current Environment

- Global Equity markets continued to remain weak in September, with the MSCI World Index falling by 8.85%.
- Indian markets significantly out performed their global peers, falling by 1.34%.
- Commodity prices reflected the weak trend in global equities, declining by 13% on a MoM basis, as indicated by the benchmark CRB Reuters Jefferies total return index.
- In India IT and Oil & Gas were the best performing sectors, while Capital Goods and Metal sectors delivered the worst return for the month
- FII outflows during the month were at Rs.2bn. MF's were net sellers at Rs.8bn, while DII's were net buyers of Rs.17bn during the month.
- Trading Activity remained subdued in September, with the cash trading turnover (US $bn) declining by 5% MoM and the average open interest declining by 4% on a MoM basis.

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Global Equities

Index	Country	Closing Price*	1 Month Return (%)	YTD Return (%)	Category
SSE Composite Index	China	2359.22	-8.11%	-15.98%	EM - Asia
BSE Sensex	India	16453.76	-1.34%	-19.77%	EM - Asia
Kospi	South Korea	1769.65	-5.88%	-13.72%	EM - Asia
Taiwan Weighted	Taiwan	7225.38	-6.67%	-19.47%	EM - Asia
Thailand SET 50 Index	Thailand	636.30	-14.83%	-11.65%	EM - Asia
Jakarta Composite Index	Indonesia	3549.03	-8.20%	-4.17%	EM - Asia
KLSE	Malaysia	1387.13	-4.16%	-8.68%	EM - Asia
Ibovespa Sao Paulo Index	Brazil	52324.42	-7.38%	-24.50%	EM
Mexico IPC	Mexico	33503.28	-6.21%	-13.09%	EM
Russian RTS Index	Russia	1341.09	-21.22%	-24.34%	EM
Philippine PSEi	Philippines	3999.65	-8.02%	-4.80%	EM
Merval Buenos Aires Index	Argentina	2463.63	-16.90%	-30.08%	EM
HangSeng	Hong Kong	17592.41	-14.33%	-23.63%	Developed - Asia
Nikkei	Japan	8700.29	-2.85%	-14.94%	Developed - Asia
Strait Times	Singapore	2675.16	-7.28%	-16.14%	Developed - Asia
Dow Jones	USA	10913.38	-6.03%	-5.74%	Developed
CAC 40 Index	France	2981.96	-8.44%	-21.63%	Developed
All Ordinaries Index	Australia	4070.10	-6.86%	-16.03%	Developed
DAX Index	Germany	5502.02	-4.89%	-20.42%	Developed
Swiss Market Index	Switzerland	5531.74	0.06%	-14.05%	Developed
FTSE 100	UK	5128.48	-4.93%	-13.08%	Developed
MSCI World Index	--	1104.07	-8.85%	-13.75%	--

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

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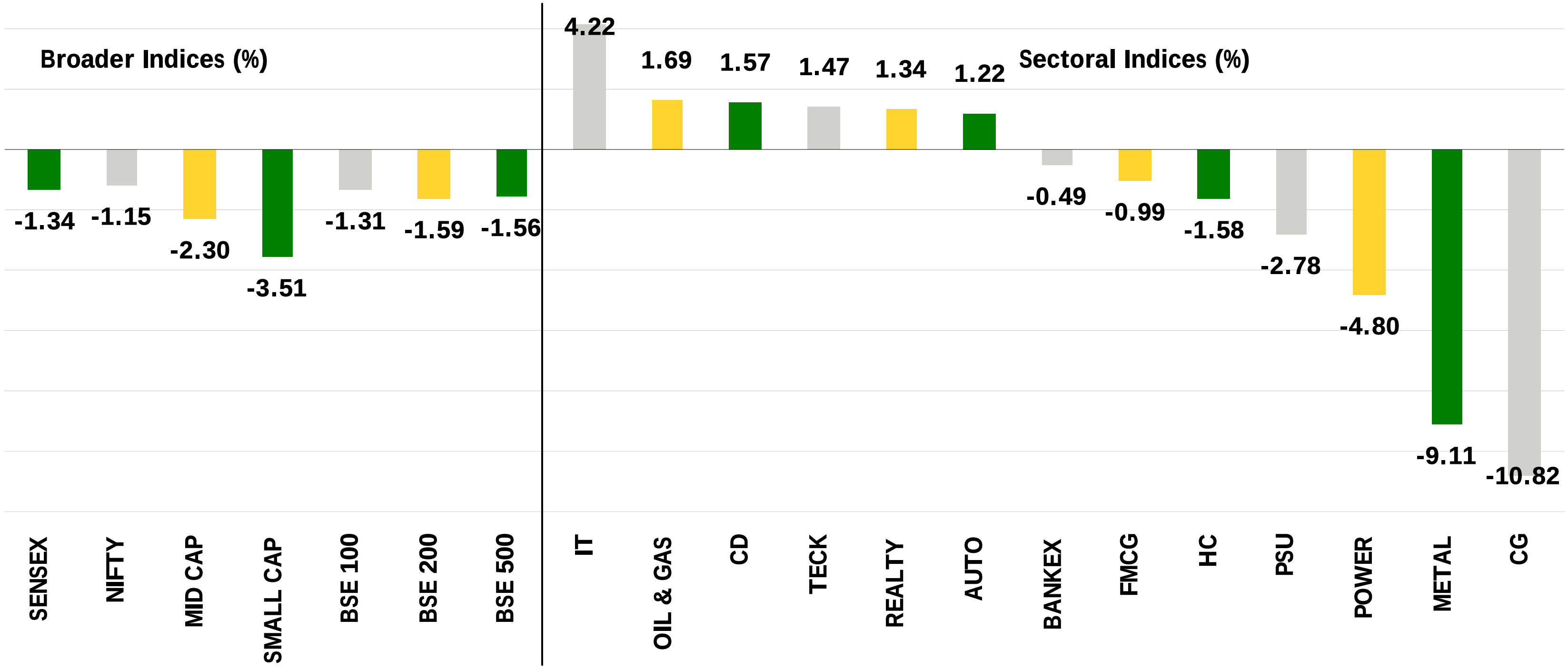
India : Sector performances



- Sensex fell by 1.34% over the previous month.
- MidCaps underperformed LargeCaps with 2.3% fall in the MidCap index.
- IT and Oil & Gas were the best performing sectors.
- Capital Goods and Metal sectors delivered the worst return for the month

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

Top Gainers / Losers - Nifty

Top Gainers for the month			
Gainers	52 week H/L	Last Price#	% Gain*
JP Associates	140.85 / 54.2	72.75	18.58%
Ambuja Cem.	166.8 / 111.6	148.9	11.91%
DLF	397.5 / 173.25	218.9	11.26%
ACC	1144 / 917.6	1098.55	9.55%
M & M	826.7 / 585	804.75	9.02%
Top Losers for the month			
Losers	52 week H/L	Last Price#	% Loss*
Reliance Capital	882.3 / 309.7	315.15	-17.97%
Larsen & Toubro	2212.7 / 1302.65	1357.6	-15.62%
Reliance Infra.	1135 / 365.35	373.45	-14.42%
Sesa Goa	383.65 / 189.35	200.55	-14.31%
Hindalco Inds.	252.85 / 123.2	131.45	-12.72%

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

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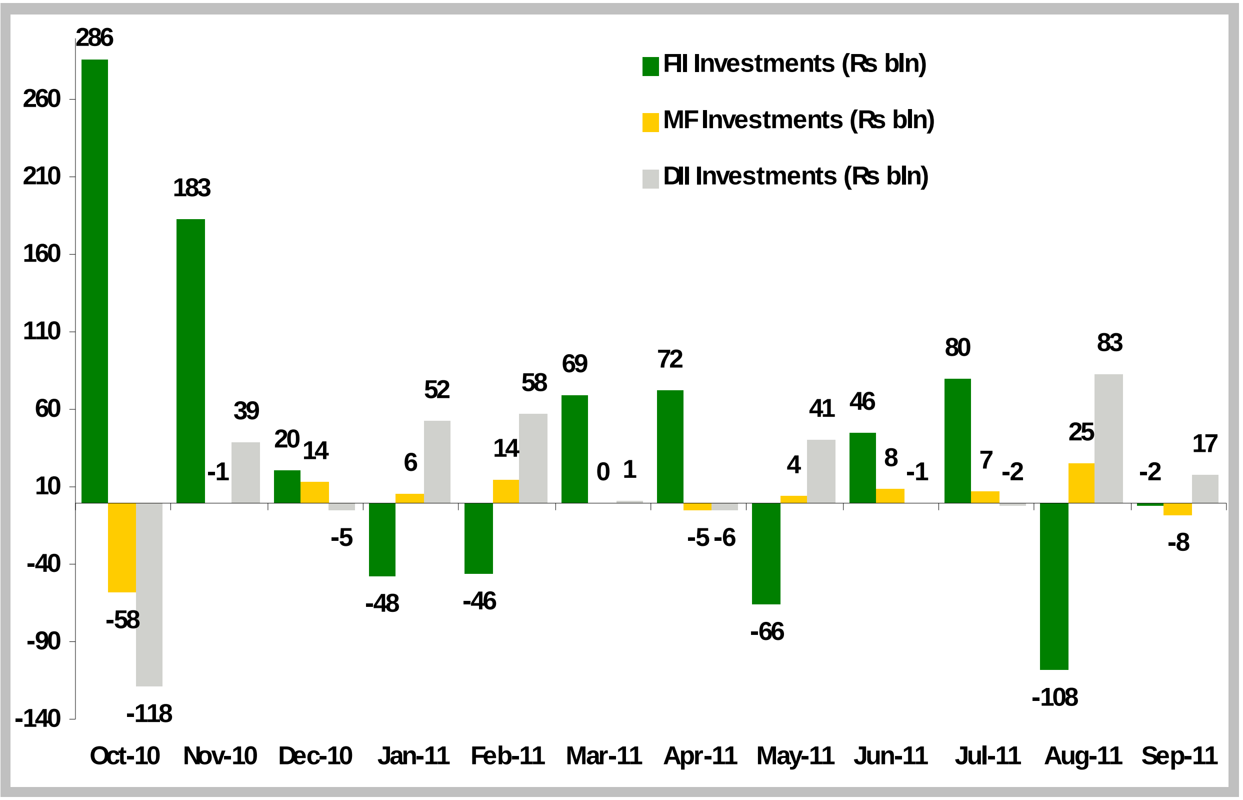
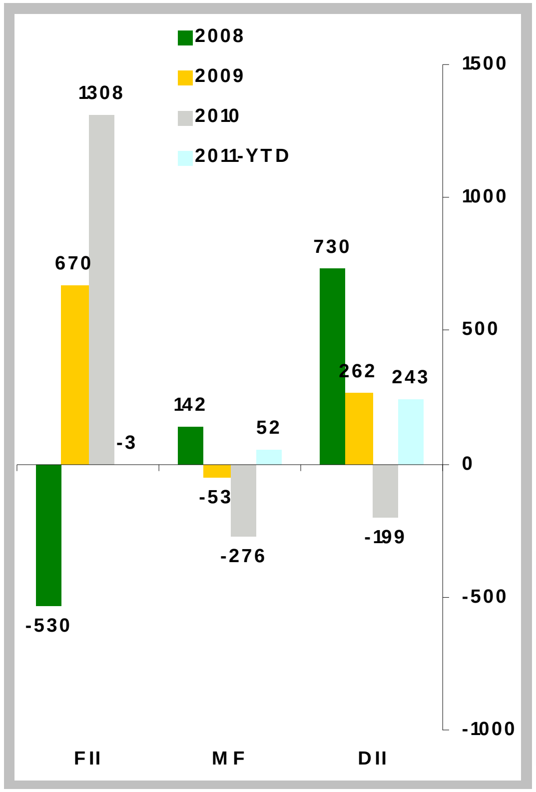
FII & DII Inflows





- FII outflows during the month were at Rs.2bn. FII outflows were at Rs.3bn for CY11 after a Rs.1308bn inflow in CY10 and Rs.670bn inflow in CY09.
- MF's were sellers at Rs.8bn, while DII's were net buyers of Rs.17bn during the month.

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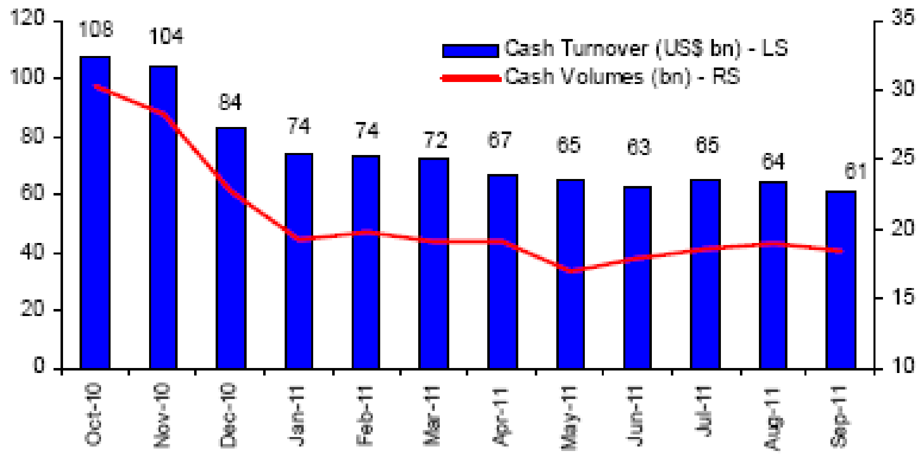
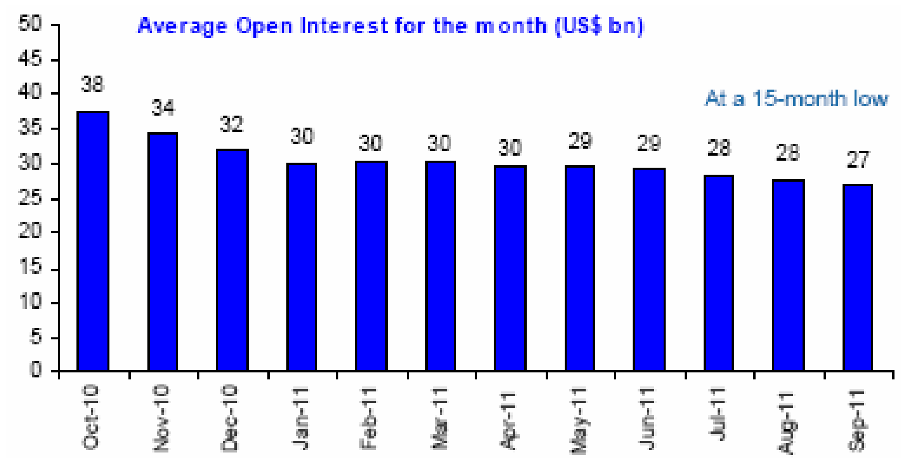
FII - Foreign Institutional Investors, DII - Domestic Institutional Investors (Includes Bank, DFIs, Insurance and MF)
Source: SEBI, BSE

Market Activity



- In September 2011, cash trading, turnover (US $bn) declined by 5% MoM.



- At the end of September 2011, average open interest declined 4% on a MoM basis.

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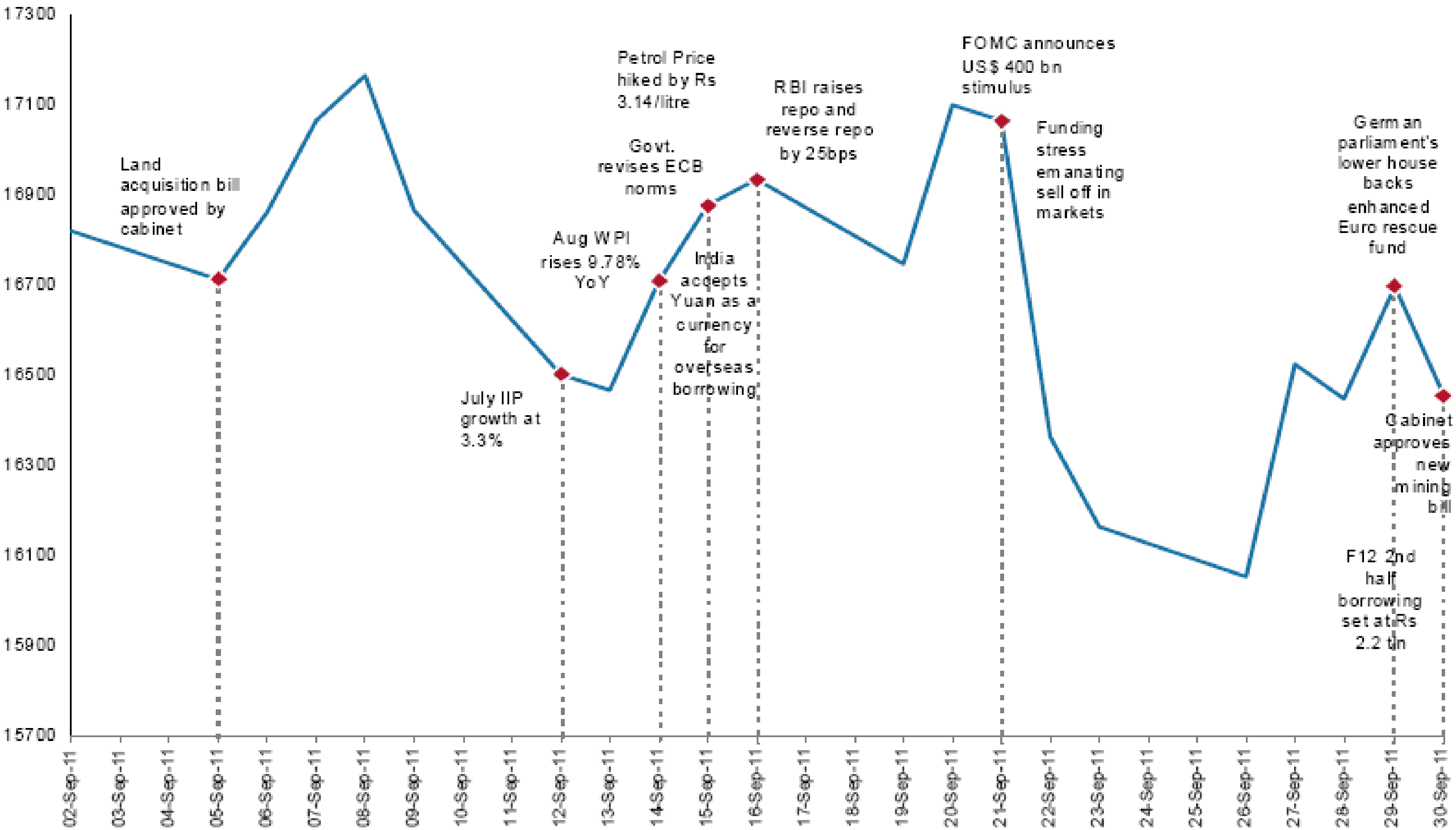
Sources: Bloomberg, Morgan Stanley

September 2011 events timeline



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

Religare MF: Equity Market Outlook and Opportunities

Equity Market Outlook

- IMF in its latest World Economic Outlook forecasts Global GDP growth to slowdown at 4% in 2012, lower than the 5% growth achieved in 2010 period.
- It further expects activity in emerging and developing economies to decelerate in the face of capacity constraints and tightening policies.
- Back home in India, Manufacturing PMI has declined for the fifth successive month to its lowest level in 30 months, and is now barely in expansionary territory at 50.4. Services PMI has also contracted from 53.8 in August 2011 to 49.8 in September 2011.
- We feel that the economic slowdown is now more broad-based and is a result of the monetary tightening measures of RBI and the policy related slowdown in investments; as well as the deterioration in global economic outlook.
- However, RBI in its recent policy statement mentions that though many indicators point to moderating growth, but both headline and non-food manufactured products inflation remained at uncomfortably high levels. Thus, the central bank continues to remain hawkish.
- Sept'2011 quarter net profit is estimated to grow at 10% and is expected to be the third in the series of the lowest four consecutive quarters of Sensex PAT growth excluding the global crisis period.
- Due to a mix of both negative macro outlook and disappointing earnings performance in June 2011, FY12 earnings, estimates have been cut by 5% since June 2011. However, FY13 earnings are still expected to grow by 17%, which we feel can also come under pressure if the current macro headwinds persist.

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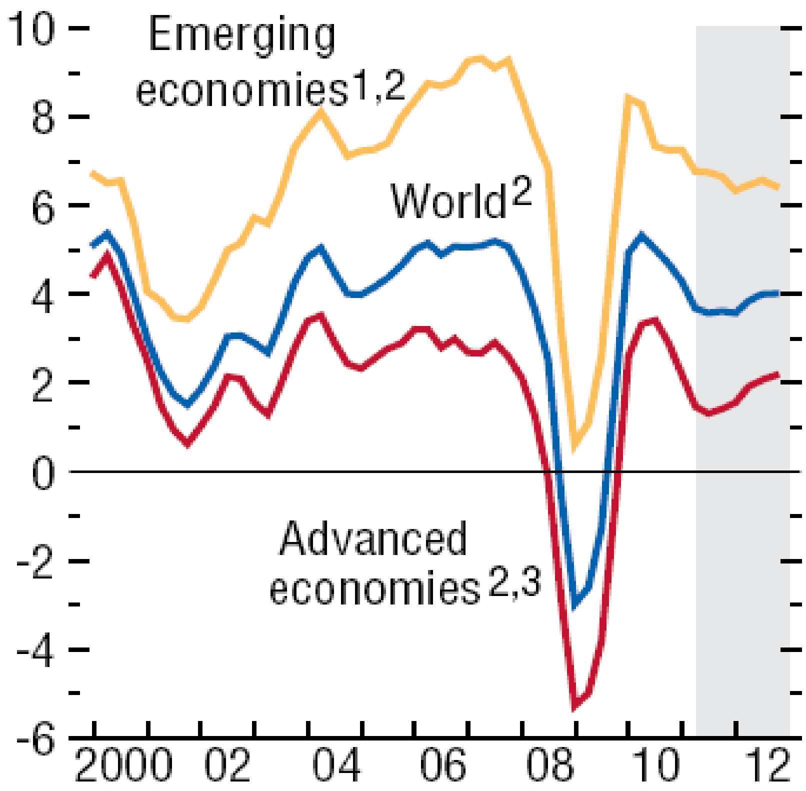
Global Economic Outlook Weakens

World Economic Outlook – IMF Forecasts



- IMF forecasts Global GDP growth at 4% in 2012, lower than the 5% growth achieved in 2010 period.
- Activity in emerging and developing economies is expected to decelerate in the face of capacity constraints and tightening policies.
- However, Global growth is forecasted to regain some momentum during the second half of 2011.
- Advanced economies are projected to grow at about 1.5% in 2011 and 2% in 2012.
- Emerging economies (including India and China are expected to grow in 6.5% - 7.5% range in 2011 and 2012.
- Growth is expected to remain very elevated in emerging Asia, notably in China and India, followed by sub-Saharan Africa.

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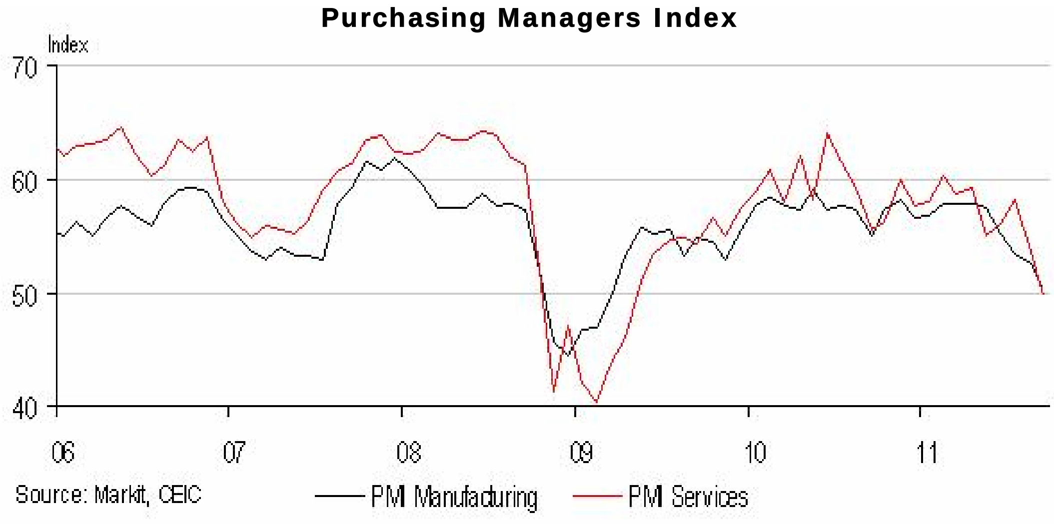
Source: IMF

Indian Economy slows

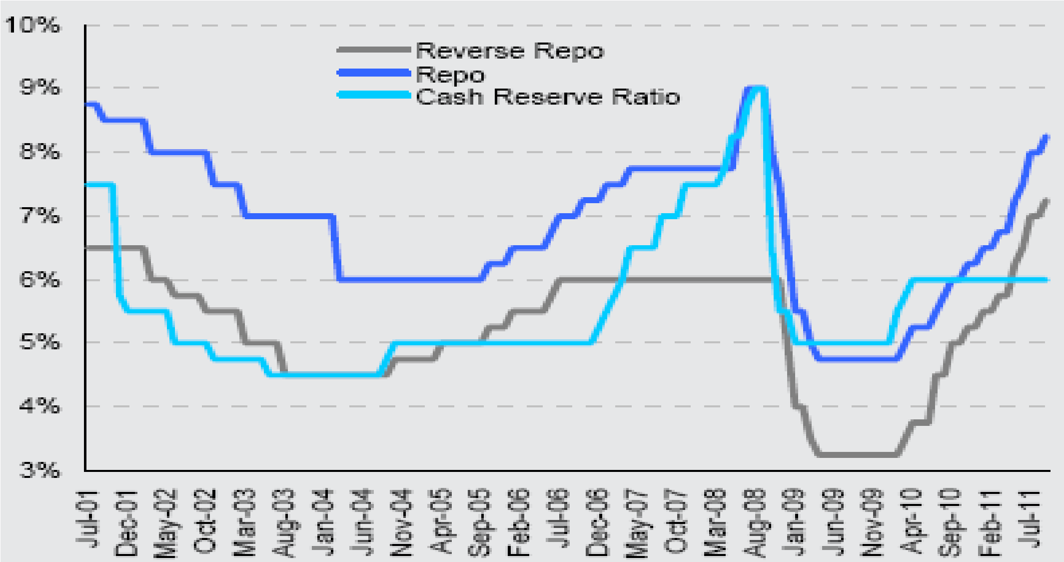


- Manufacturing PMI falls for a fifth successive month to its lowest level in 30 months, and is now barely in expansionary territory at 50.4.
- Services PMI has also contracted from 53.8 in August 2011 to 49.8 in September 2011.
- We feel that the economic slowdown is now more broad-based and is a result of the monetary tightening measures of RBI and the policy related slowdown in investments; as well as the deterioration in global economic outlook.

Source: Markit, CEIC

RBI Continues To Remain Hawkish, Inflation The Key Monitorable

Trend in Benchmark Rates



- The Reserve Bank of India (RBI) in its mid-quarter review of monetary policy hiked the repo rate and reverse repo rate by 25bps to 8.25% and 7.25% respectively.
- The policy statement mentions that though many indicators point to moderating growth, both headline and non-food manufactured products inflation remained at uncomfortably high levels.
- It also highlighted weak global macro environment and signs of potential deceleration in domestic growth.
- The statement highlighted the need to continue to persist with the current anti-inflationary stance.

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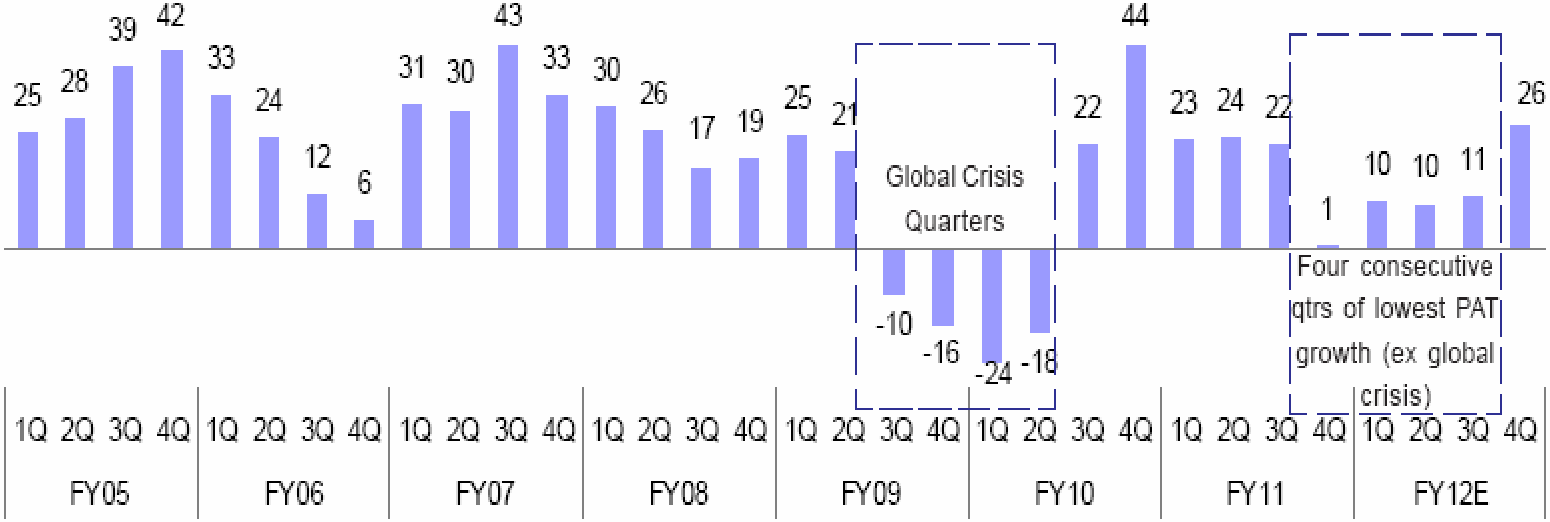
Source: CEIC, Morgan Stanley Research

September 2011 Earnings Season Preview – Speed Breakers Ahead

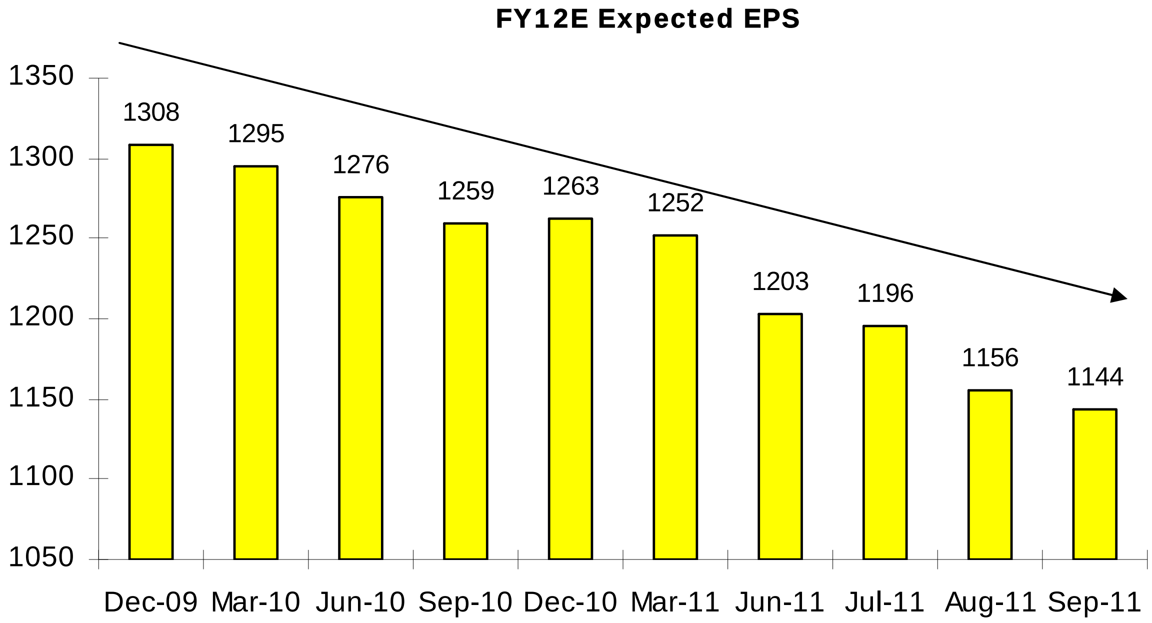
Sensex PAT growth forecasts



- 2QFY12 estimated PAT growth at 10% is expected to be the third in the series of the lowest four consecutive quarters of Sensex PAT growth excluding the global crisis period.
- Cement, Consumer Goods, Technology, Oil & Gas and Telecom Sectors are expected to report above average earnings growth.
- Infrastructure, Financials and Capital Goods sectors are expected to report below average earnings growth.

Source: MOSL Research

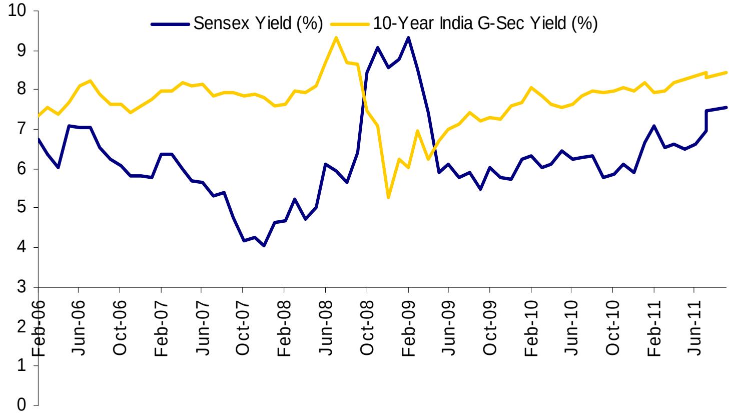
Earnings Forecasts – still falling

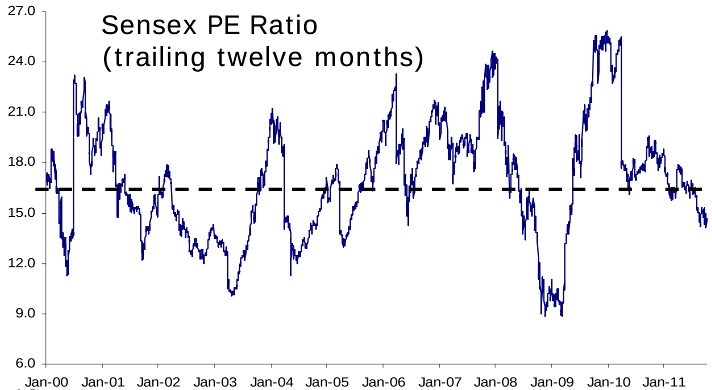


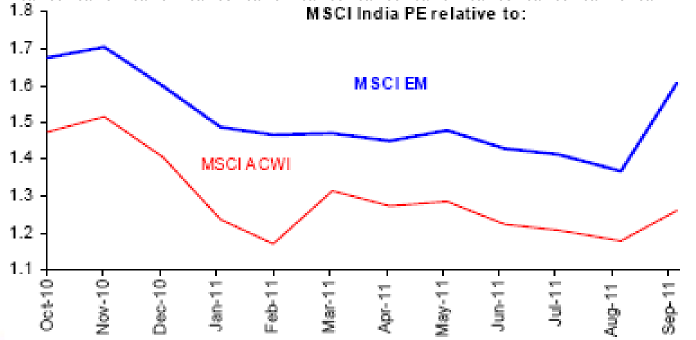
- Due to a mix of both negative macro outlook and disappointing earnings performance in June 2011, FY12 earnings estimates have been cut by 5% since June 2011.
- However, FY13 earnings, are still expected to grow by 17%, which we feel can also come under pressure if the current macro headwinds persist.

Sources: MOSL Research

Valuations – Corrected Materially







- The gap between Sensex earnings yield and bond yield has widened by 5 basis points over the previous month as both Sensex as well as bond yield increased.
- Sensex is currently trading at 14.7x its trailing earnings. It is now 13% lower than its historical 11-year average trailing PE of 17x.
- On a 1-yr forward basis, Sensex is trading at 13.3x, which is about 9% below its 15 year average PE.
- India's PE premium to MSCI Emerging markets has widened over the previous month, and is now about 60% premium to MSCI EM PE currently.

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

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.
- Moody's has already downgraded Italy ratings by 3 notches and has downgraded nearly a dozen banks in Portugal and UK each, highlighting the impact of the sovereign debt crises.
- The Reserve Bank of India in its mid-quarter review of monetary policy hiked the repo rate and reverse repo rate by 25bps to 8.25% and 7.25% respectively.
- The odds are now evenly balanced that the RBI might push through another hike this month even as the economy is showing multiple signs of a slowdown, due to its concern over inflation.
- A key negative during the last month was the increase in the Government borrowing program. While we have been worried about this possibility, the markets were surprised and 10 year yield has hardened to 8.65%. We worry that this would have a negative impact on the investment climate, and this also pressurizes equity valuations.
- The Sensex is currently trading at 14.7x, 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 see several opportunities for stock picking across sectors 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 7.5% to 8% in FY12.
- Earnings estimates have been cut for FY12 as we have long expected but the implied growth rate is still 17% 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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