

Equity Markets : Current Environment and Outlook

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July 2010

Current Environment

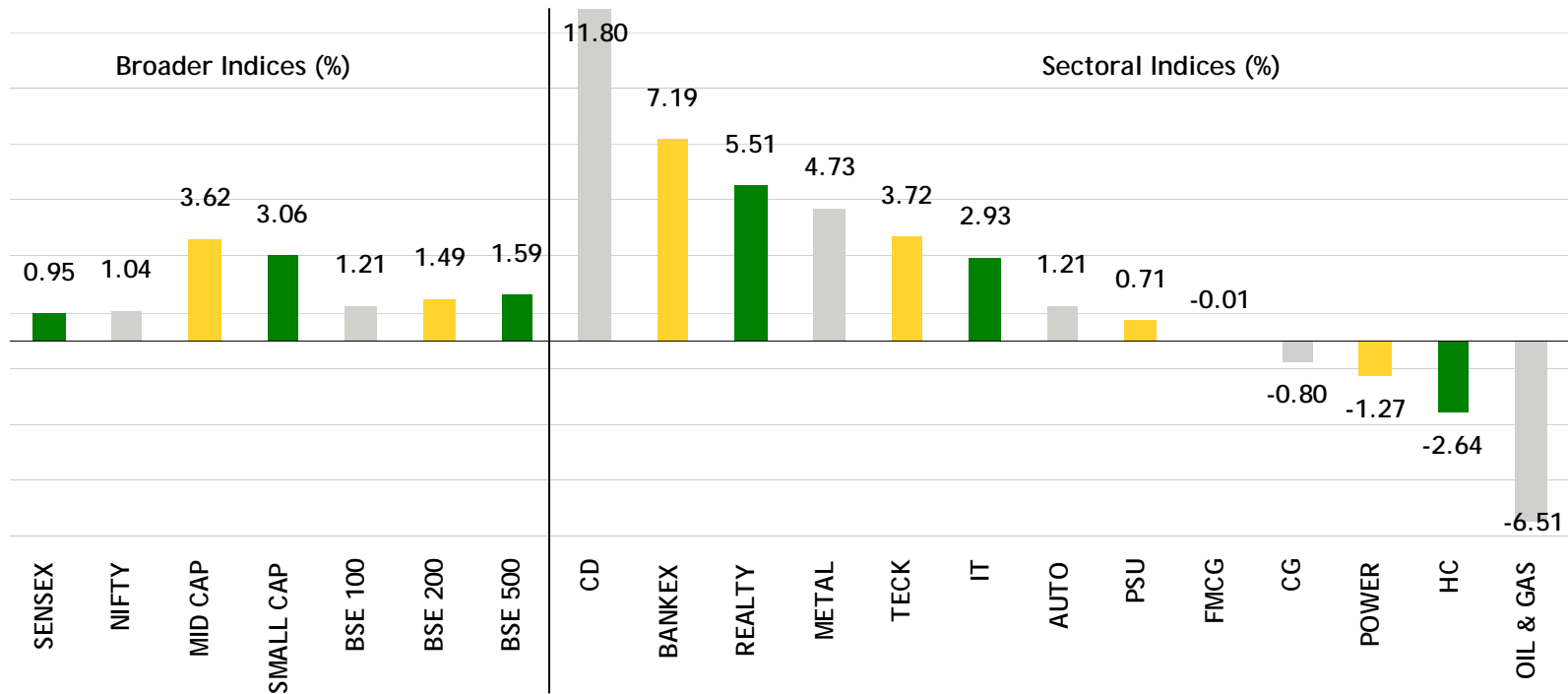
- Global Equity markets rose sharply in July after two consecutive months of decline, with the MSCI World Index rising by 8.02%.
- Indian markets sharply underperformed the global trend (after two months of outperformance), rising by just 0.95% in the month of July.
- Commodity prices reflected the global trend in equities, with the benchmark CRB Reuters Jefferies total return index rising by 8.8%.
- Consumer Durables was the best performing sector followed by the Banking. Oil & Gas and Healthcare sectors delivered the worst return for the month.
- FII inflows were at Rs.166bn in July 2010, while DIIs recorded outflows of Rs.63bn. MF remained net sellers to the tune of Rs.44bn.
- Trading Activity remained at elevated levels in July, with cash trading volumes (number of shares) rising by 2% MoM and the average open interest rising by 11% MoM to its highest level since Jan-08.

Global Equities

Index	Country	Closing Price*	1 Month Return (%)	YTD Return (%)	Category
SSE Composite Index	China	2637.50	9.97%	-19.52%	EM - Asia
BSE Sensex	India	17868.29	0.95%	2.31%	EM - Asia
Kospi	South Korea	1759.33	3.59%	4.55%	EM - Asia
Taiwan Weighted	Taiwan	7760.63	5.88%	-5.22%	EM - Asia
Thailand SET 50 Index	Thailand	583.83	6.64%	12.13%	EM - Asia
Jakarta Composite Index	Indonesia	3069.28	5.34%	21.11%	EM - Asia
KLSE	Malaysia	1360.92	3.57%	6.92%	EM - Asia
Ibovespa Sao Paulo Index	Brazil	67515.40	10.80%	-1.56%	EM
Mexico IPC	Mexico	32308.74	3.70%	0.59%	EM
Russian RTS Index	Russia	1479.73	10.48%	2.43%	EM
Philippine PSEi	Philippines	3426.95	1.61%	12.26%	EM
Merval Buenos Aires Index	Argentina	2394.16	9.57%	3.16%	EM
HangSeng	Hong Kong	21029.81	4.48%	-3.85%	Developed - Asia
Nikkei	Japan	9537.30	1.65%	-9.57%	Developed - Asia
Strait Times	Singapore	2987.70	5.37%	3.11%	Developed - Asia
Dow Jones	USA	10465.94	7.08%	0.36%	Developed
CAC 40 Index	France	3643.14	5.82%	-7.45%	Developed
All Ordinaries Index	Australia	4507.40	4.22%	-7.69%	Developed
DAX Index	Germany	6147.97	3.06%	1.65%	Developed
Swiss Market Index	Switzerland	6200.78	1.19%	-5.27%	Developed
FTSE 100	UK	5258.02	6.94%	-2.86%	Developed
MSCI World Index	--	1124.83	8.02%	-3.73%	--

* as on 30th July 10. Source : Bloomberg
EM – emerging markets, Developed – developed markets.

India : Sector performances



- Sensex rose by 0.95% over the previous month. MidCaps outperformed LargeCaps with a 3.62% gain for the MidCap index.
- Consumer Durables was the best performing sector followed by the Banking sector.
- Oil & Gas and Healthcare sectors delivered the worst return for the month.



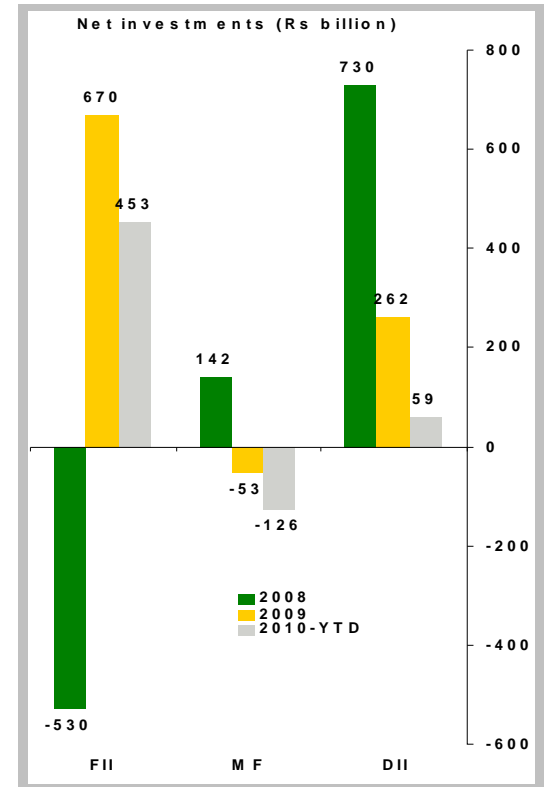
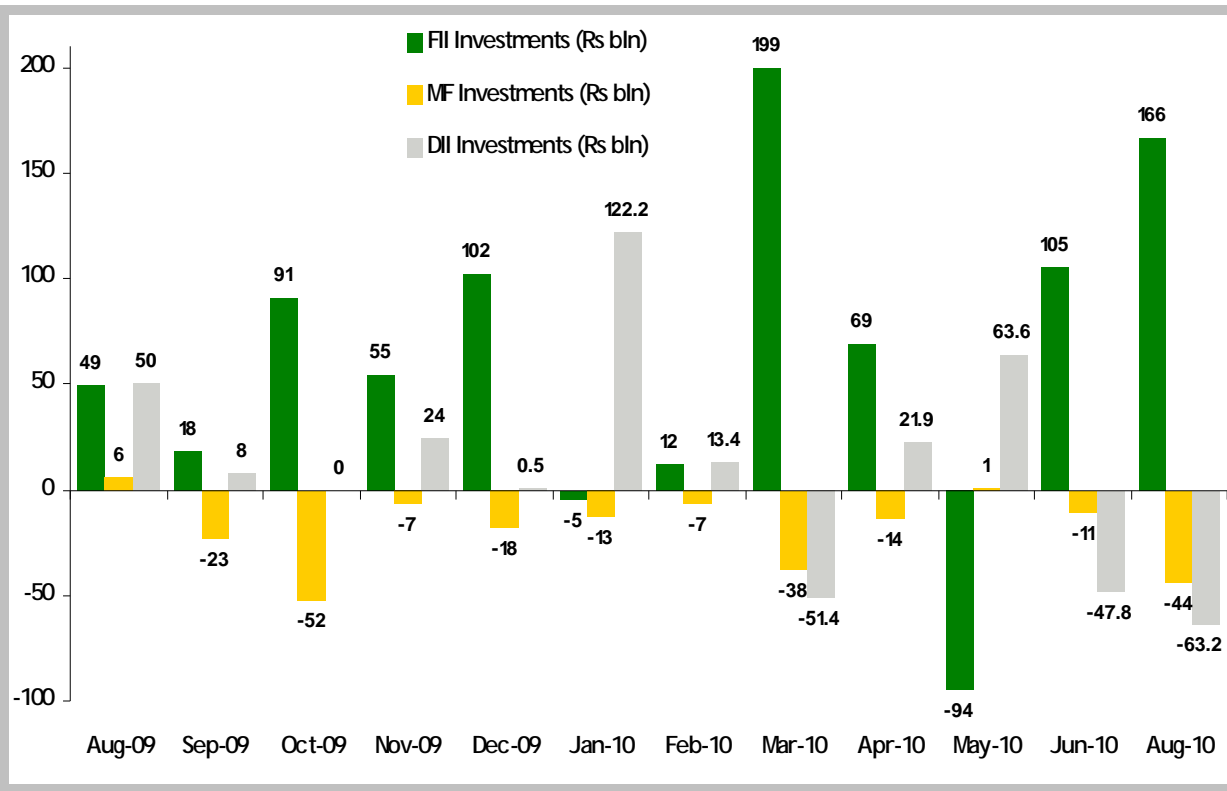
*Source: BSE,NSE. one month performance as on 30th July 10.

Top Gainers / Losers - Nifty

Top Gainers for the month			
Gainers	52 week H/L	Last Price#	% Gain*
Idea Cellular	84.8 / 47.8	70.6	18.96
Bharti Airtel	485 / 252	306.8	16.74
TCS	859.8 / 494	839.8	11.82
Hindalco Inds.	193 / 95.25	160.35	10.97
HDFC Bank	2144.9 / 1355	2126.9	10.83
Top Losers for the month			
Losers	52 week H/L	Last Price#	% Loss*
Maruti Suzuki	1737.3 / 1126.85	1198.6	-15.81
Hero Honda Motor	2094 / 1344	1814.85	-11.41
Rel. Comm.	321 / 131.5	178.7	-9.88
JP Associates	179.97 / 108	118.1	-8.13
Reliance Infra.	1404.5 / 950.1	1108.6	-7.69

closing price as on 30th June 2010.* one month performance as on 30th June 2010.
Source: Capitaline

FII & DII Inflows

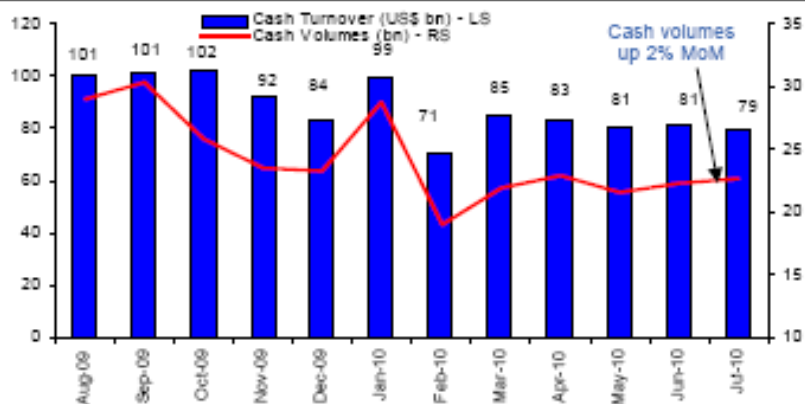


- FII inflows were at Rs.166bn in July 2010. FII inflows have remained positive on a YTD basis at Rs.453bn for CY10 after a Rs.670bn inflow in CY09.
- DII recorded outflows of Rs.63bn. MF remained net sellers to the tune of Rs.44bn.

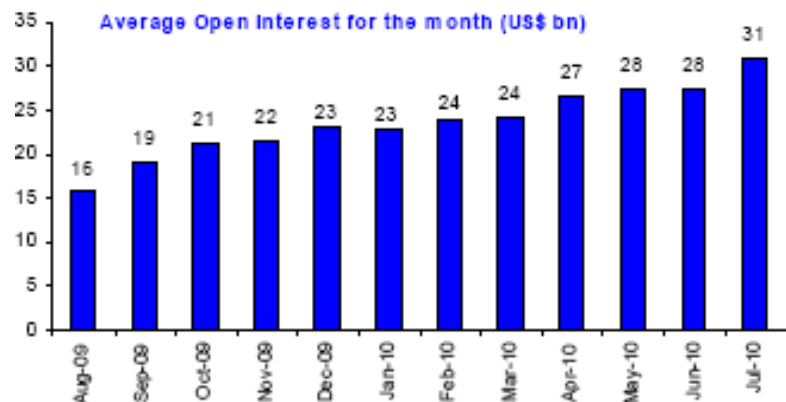


Market Activity

Cash Trading: Turnover and Volumes



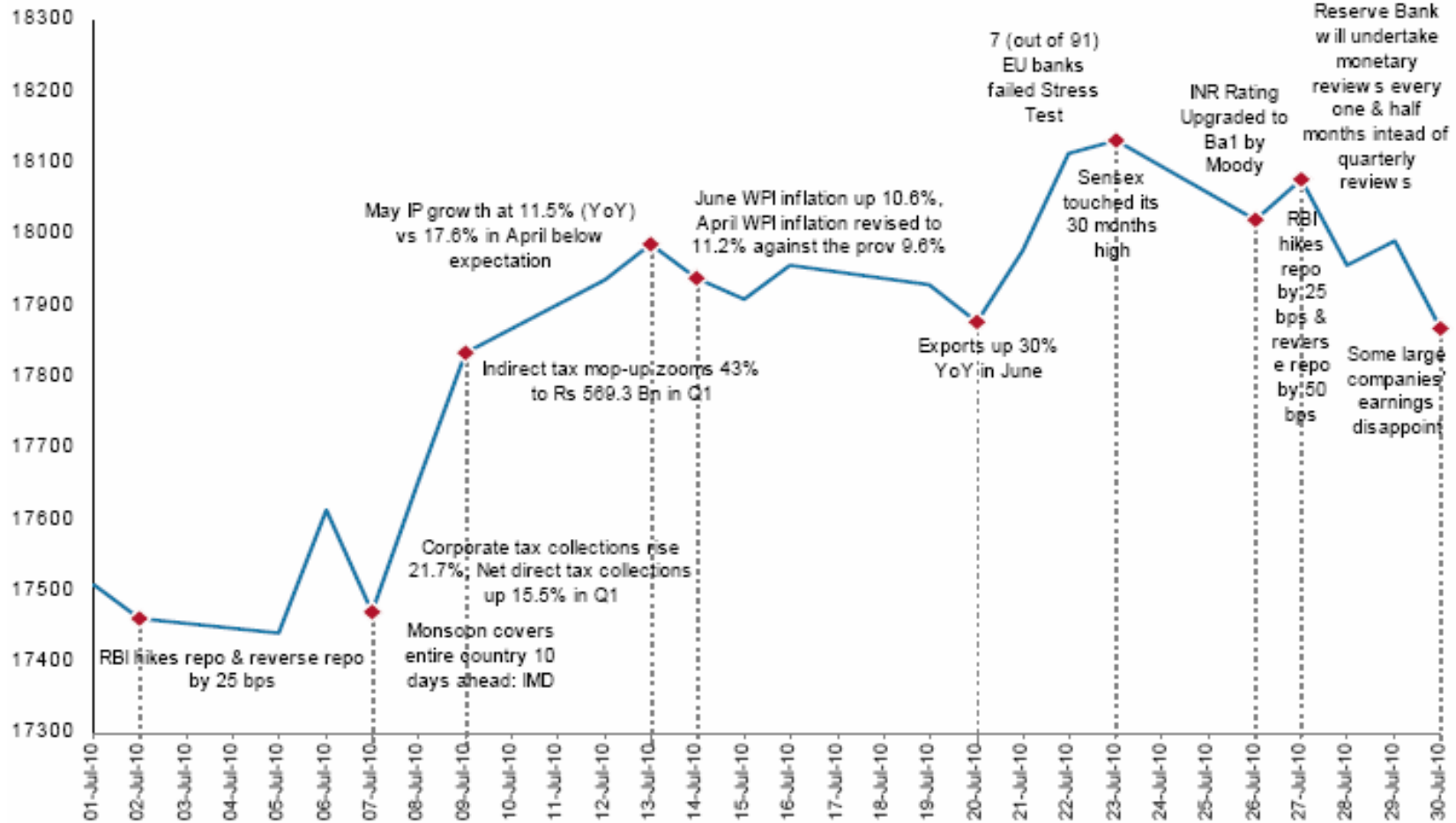
- In July, cash trading volumes (number of shares) increased by 2% MoM.



- At the end of July, average open interest increased 11% MoM to its highest level since Jan-08.



July 2010 events timeline



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



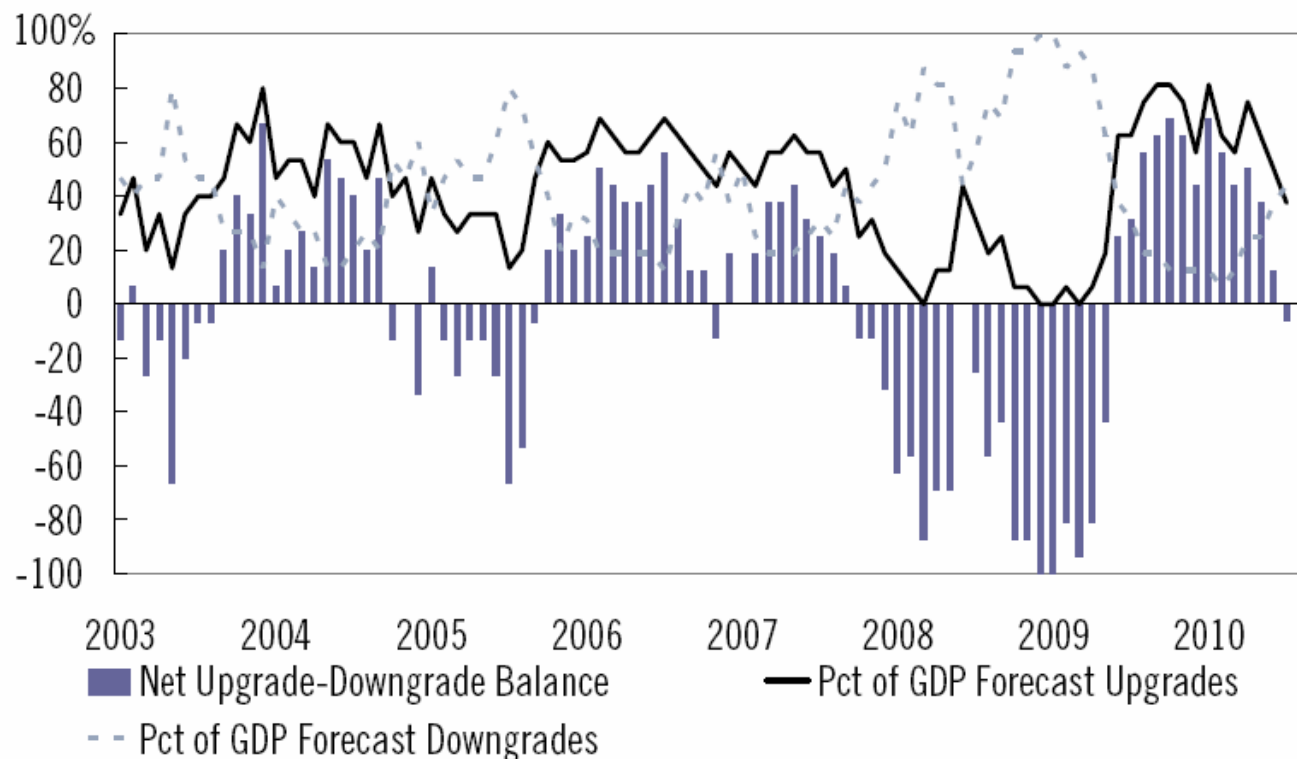
Religare MF: Equity Market Outlook and Opportunities

Equity Market Outlook

- Global macro is throwing in a contrasting picture, with expectations of global growth being reduced, while that of India being raised.
- Most economists are expecting India's GDP to grow at 8-9% rate in FY11E, highlighting the growth gap with Rest of World, which is expected to grow in the range of 3-4%.
- India's fiscal situation continues to improve, with the headline deficit likely to come in lower than the budgeted 5.5% of GDP for FY11.
- The rainfall situation seems to have normalized, with the cumulative rainfall currently being at ~2% below its LPA, which is better than being at ~16% below LPA a month back.
- Higher Inflation continues to remain a key risk, with latest reading of WPI accelerating to 10.6% YoY, after touching a low of -1% YoY a year back.
- The current account deficit is now close to 3% of GDP and any further widening could put the current account deficit at vulnerable levels, resulting in a depreciation in INR.
- The Q1FY11 earnings season has been so far disappointing, with reported profit growth of 3% vs estimates of 7%.
- Post the disappointing Q1FY11 results, analysts have downgraded the Consensus earnings expectations for FY11 & FY12 by 1.7% and 1.4% respectively during the month.

Global GDP Growth - Expectations Being Revised Downward

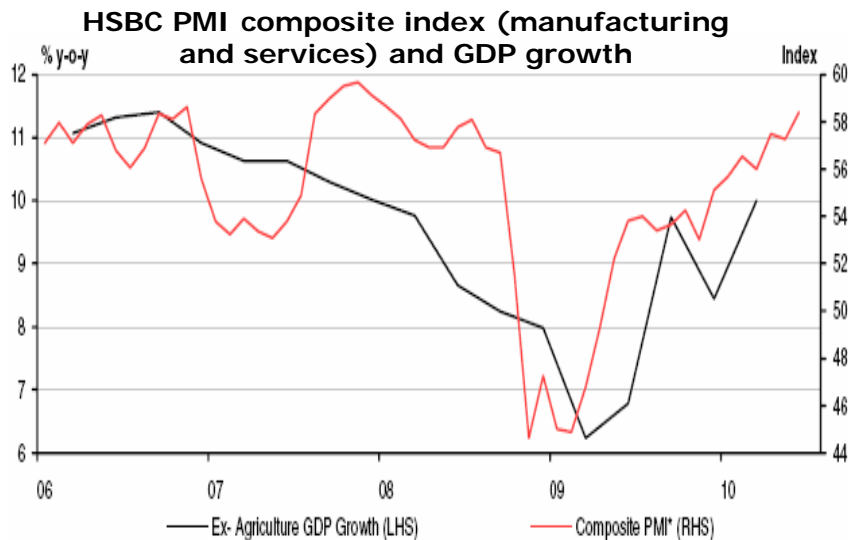
Global GDP Percent Growth Forecast Upgrades and Downgrades, 3-Month Total, 2003-10



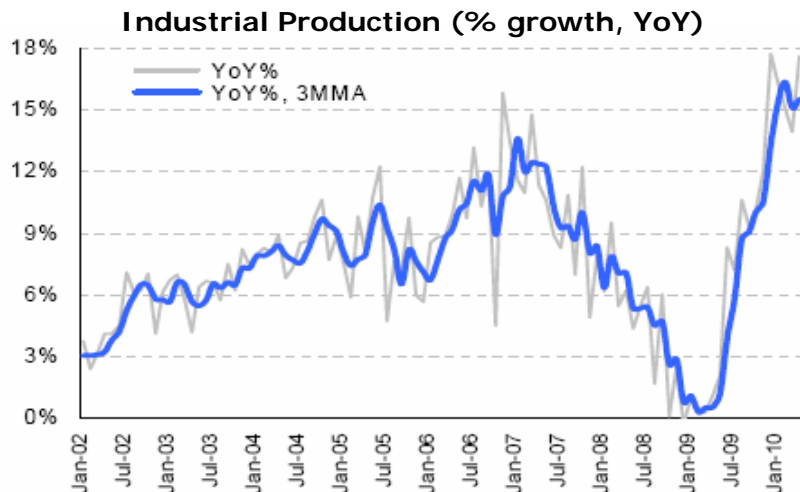
- For the first time since early 2009, there have been more forecast downgrades than upgrades in the last three months.
- This has been led by downward revisions in GDP growth forecasts for US, Japan, China and Euro Area.
- Thus, analysts are expecting slower global growth in the near future.



India's Growth Shows No Signs Of Abating

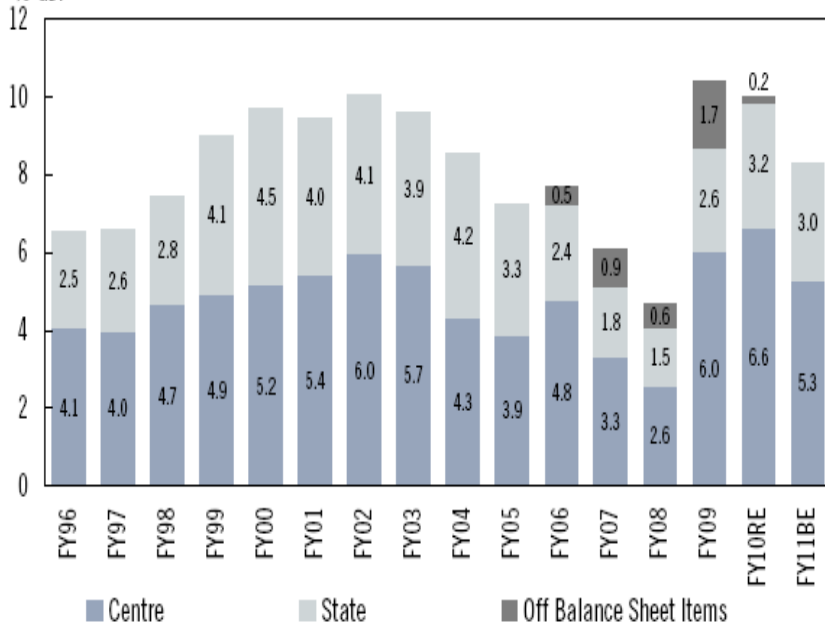


- The HSBC composite PMI (a lead indicator of economic activity) is still pointing to 9-11% year-on-year GDP growth.
- Most economists are expecting India's GDP to grow at 8-9% rate in FY11E, highlighting the growth gap with Rest of World, which is expected to grow in the range of 3-4%.
- Industrial production, which is the best proxy to measure the monthly trend in overall growth environment, has grown by 17.6% seasonally adjusted over the last 12 months.
- The sharp pace of recovery reflects the strength of India's domestic demand oriented model.

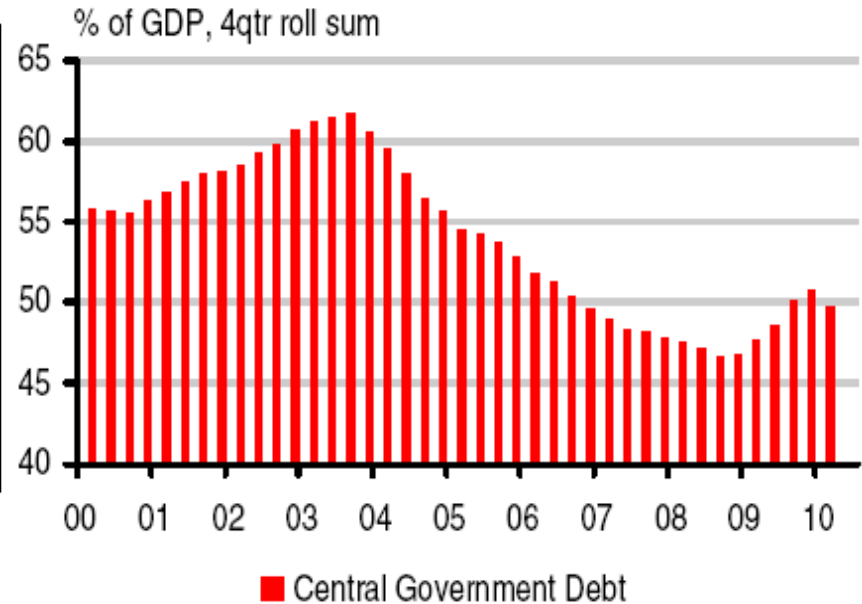


Fiscal Situation Improves Materially

Trends in the Combined Fiscal Deficit (% GDP)



Central government debt (% of GDP)

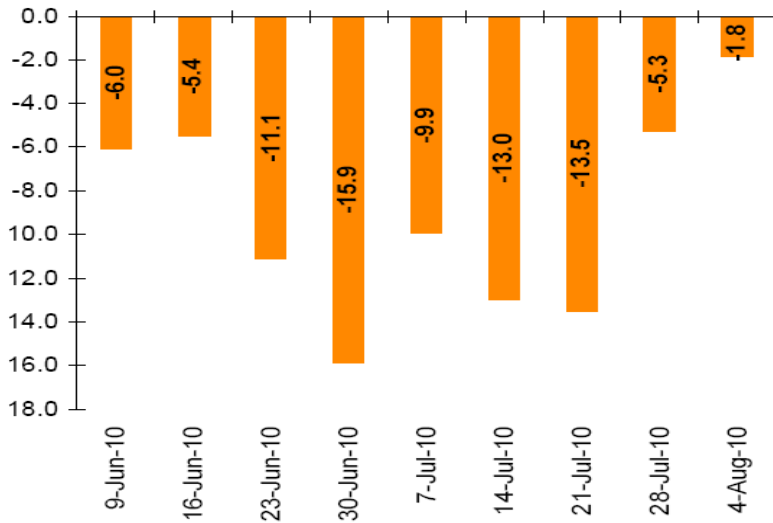


- The fiscal situation, which has already benefited from higher telecom revenues, has got brighter with (i) The government's fuel price measures; (ii) Buoyancy in tax collections (iii) Upgrade in local currency outlook; and (iv) Recently released road-map on GST.
- The headline deficit is likely to come in lower than the budgeted 5.5% of GDP for FY11.
- Central Government debt as a % of GDP also seems to have stabilized at levels far lower than that in FY04.

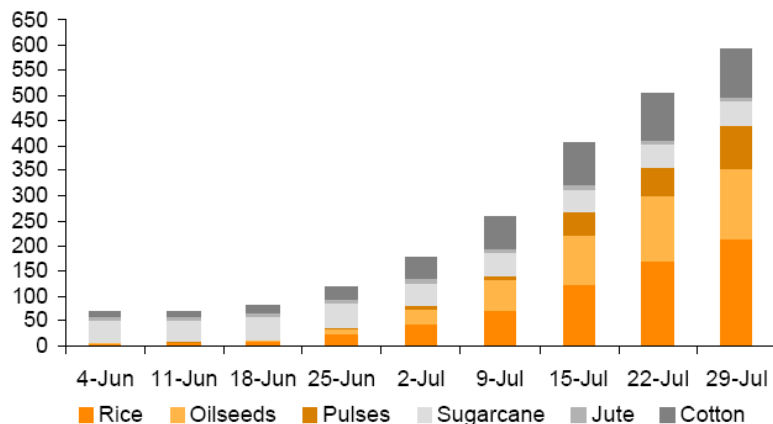


Rainfall Now Showing Signs Of Normalcy

Monsoon - % of Long Period Average (LPA)



Major crops – Cropped area (2010)

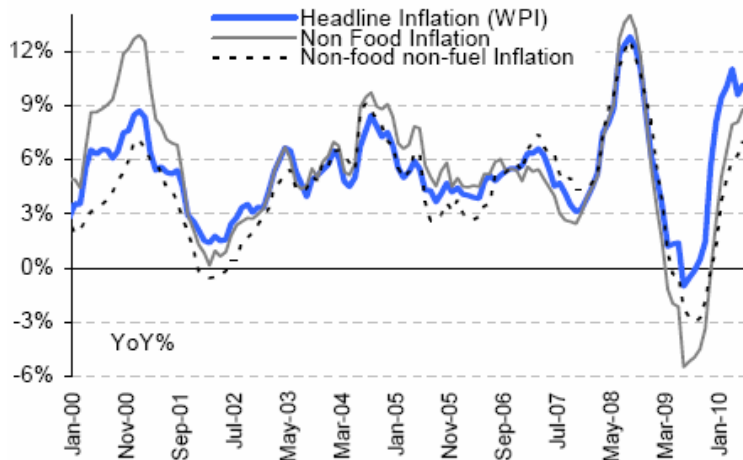


- The advancement of the southwest monsoon has seen sustained momentum from last week, and is now closer to the crucial Long Period Average (LPA) levels.
- The cumulative rainfall for the week ended 04 August, 2010 stood at ~2% below its LPA.
- The number of divisions experiencing excess/normal rainfall increased to 31 from 28 of last week, while those experiencing scanty rainfall dropped to 5 from 8 of last week.
- Cropped area under rice and cereals are increasing in a steady manner. Area sown for all the major crops, excepting oilseeds is ~10-15% higher than the same period last year.
- Normal rainfalls can thus lead to softening of food prices.

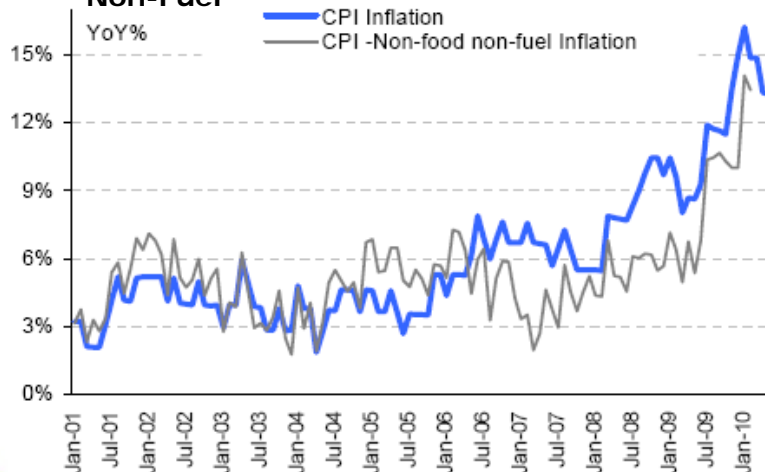


Inflation - A Potential Party Pooper

Inflation (WPI): Headline, Non-Food and Non-Food Non-Fuel



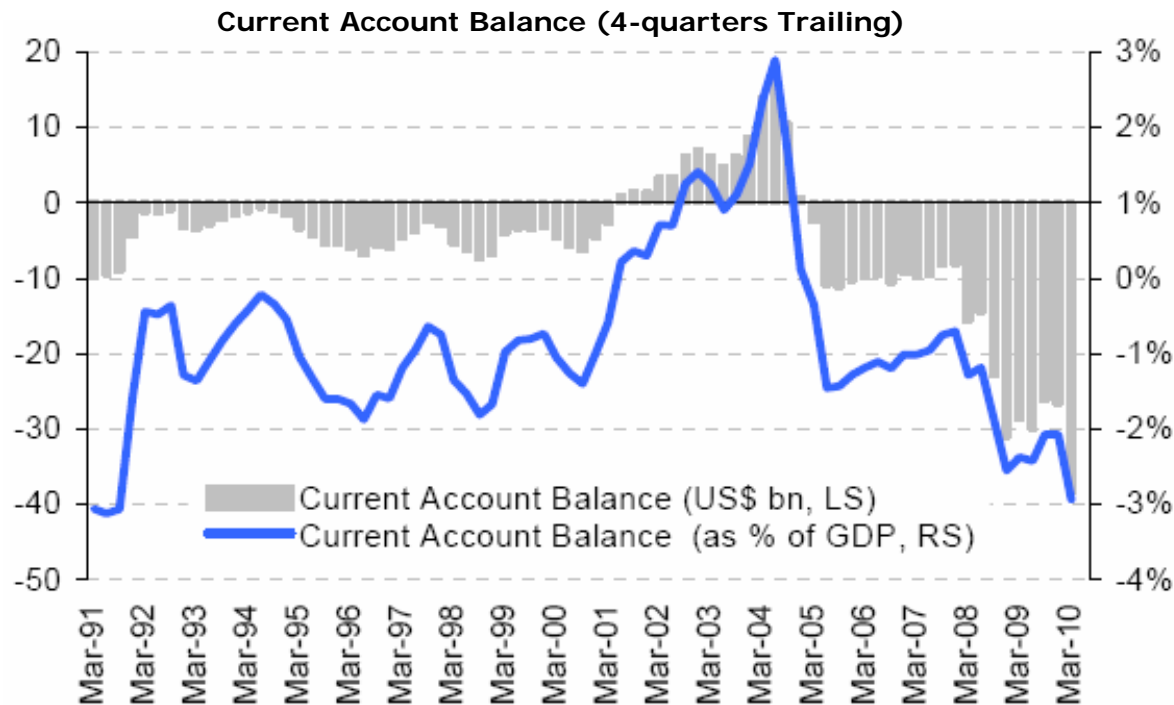
Inflation (CPI): Headline and Non-Food Non-Fuel



- The headline Wholesale Price Index (WPI) accelerated to 10.6% YoY in June 2010, after touching a low of -1% YoY in June 2009.
- While food inflation remains high, the non-food WPI inflation has also started picking up sharply, reflecting the rise in global commodity ex-mineral oil and fuel prices. According to RBI, the inflation is now being generalized in non-food areas as well.
- Similarly, higher food prices have kept CPI-Industrial Workers (CPI-IW) in the 8-16% range over the last 21 months.
- Though food inflation is expected to moderate over the coming months, non-food inflation is likely to remain high.
- High inflation can lead to higher interest rates, which can ultimately result in a deceleration of economic growth.

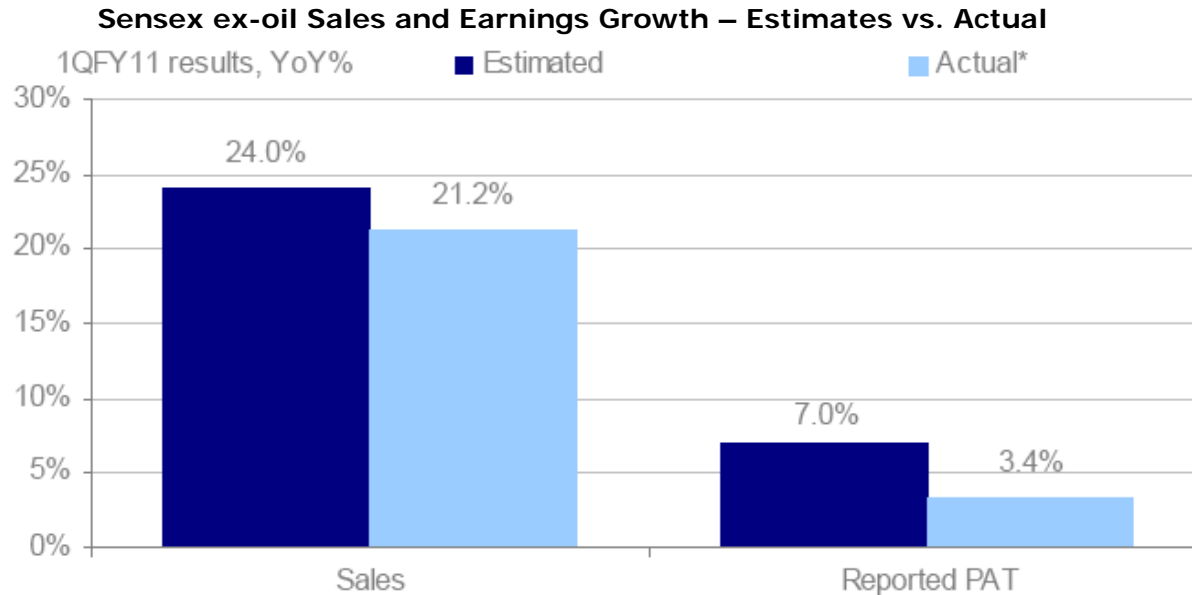


Current Account Deficit - Potential Fuel For Inflation Fire



- The current account deficit is now close to 3% of GDP as of F2010. Any further widening in the trade deficit could put the current account deficit at vulnerable levels.
- If the current account deficit widens to 3.5-4.5% of GDP, risk of currency weakness will increase significantly. Any decline in capital inflows or sharp rise in oil above US\$100/bbl will cause exchange rate depreciation – only adding to inflation pressure.

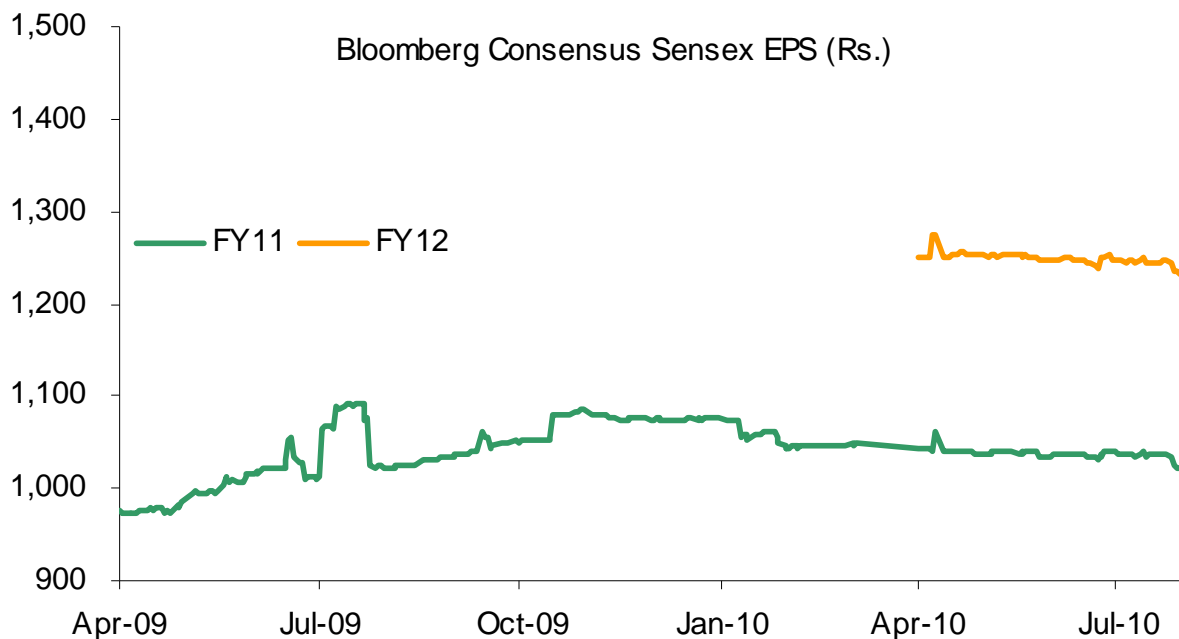
Earnings Preview - June 2010E earnings expected to grow strongly



- Most companies have reported their 1QFY11 results, and overall, the results have been below market expectations, with reported profit growth of 3% vs estimates of 7%.
- Earnings for Autos, Capital Goods, Cement, Energy, Real Estate and Utilities came in below estimates, while earnings for Financials, IT Services, Media and Pharma came in above estimates.
- The misses in domestic cyclical sectors such as Autos and Capital Goods reflect competitive or supply-side (execution) issues rather than a slackening of demand.

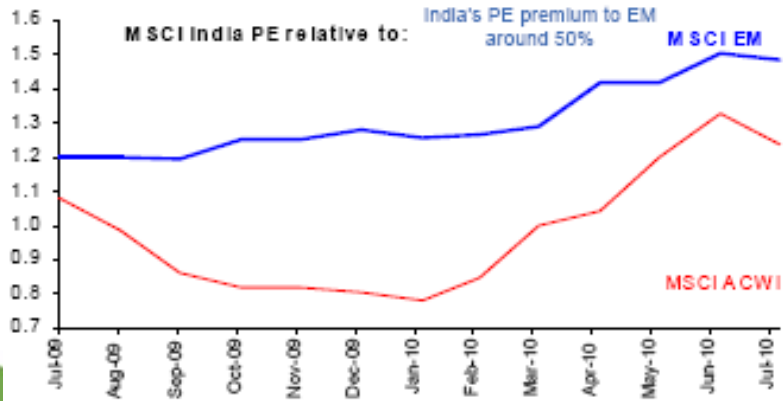
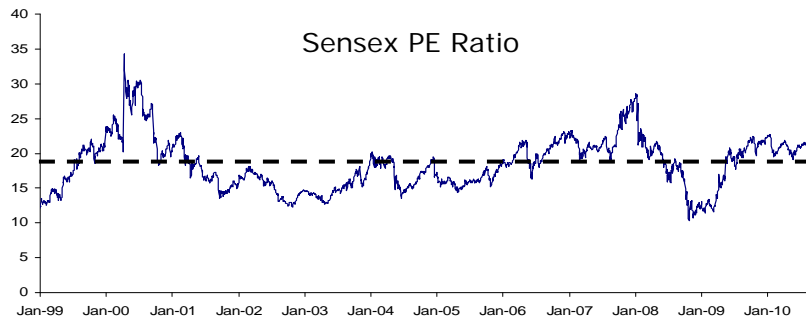
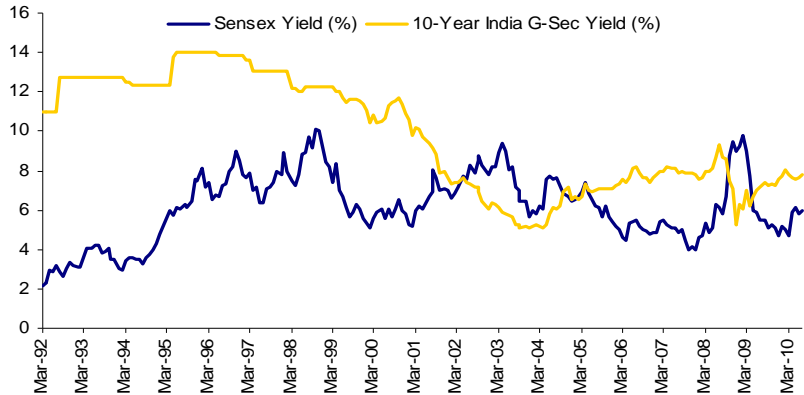


Earnings - No Material Changes In Expectation



- Post the disappointing Q1FY11 results, analysts have downgraded the Consensus earnings expectations for FY11 & FY12 by 1.7% and 1.4% respectively during the month.
- Consensus expects a 24% growth in FY11 Sensex EPS over FY10 and a 21% growth in FY12E Sensex EPS over FY11E.

Valuations



- The gap between Sensex earnings yield and bond yield has increased by 10 basis points over the previous month. The Sensex yield has fallen while the bond yields have risen in the month.
- Sensex is currently trading at 21.5x its trailing earnings. The gap between the current multiple and historical 10-year average trailing PE of 18.5x has remained almost the same in the month.
- India's PE premium to MSCI Emerging markets remains at elevated levels, and it is now at around 50% premium to MSCI EM PE currently.



Looking Ahead...

- The outlook for global growth has weakened materially with most economists cutting global GDP growth forecasts. The cuts are mainly led by downward revision in growth expectations in US, Europe, China and Japan.
- On the other hand, the macro environment in India remains strong as indicated by the latest GDP growth data and as also Industrial growth, credit growth and other lead indicators. RBI has hiked India's GDP growth expectations for FY11 to 8.5%, an increase of 50 bps from its earlier forecast.
- Markets focus shall remain on the governments resolve to drive the reforms process further. The next monitorables can be the implementation of the GST, continued thrust on divestment process and visible intent to lower the fiscal deficit.
- RBI, in the latest monetary policy meeting, has hiked repo by 25 bps and reverse repo by 50 bps signaling its intent to anchor inflationary expectations and intent to cool the economy. We have revised our expectation to a further 75bps of policy hikes from the RBI during the current fiscal.
- While India's beta relative to the rest of the world has come down the correlation between global equity markets remains high – this is a source of both upside as well as a downside risk for our markets.
- However, India's valuation premium to other emerging markets has expanded in recent months.
- Our focus remains on stock picking and sector allocation for generating alpha.

Investment view

Short term

- GDP growth likely to be slightly above 8% in FY11.
- The current consensus forecasts a healthy 24% growth in FY11, but we would be cautious about visibility of this estimate as a significant contribution comes from global cyclicals.
- Valuations are near the top end of the comfort zone; but supported by the prospect for continued earnings growth
- However, without significant earnings upgrades further re-rating is unlikely.

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. but will be back ended.

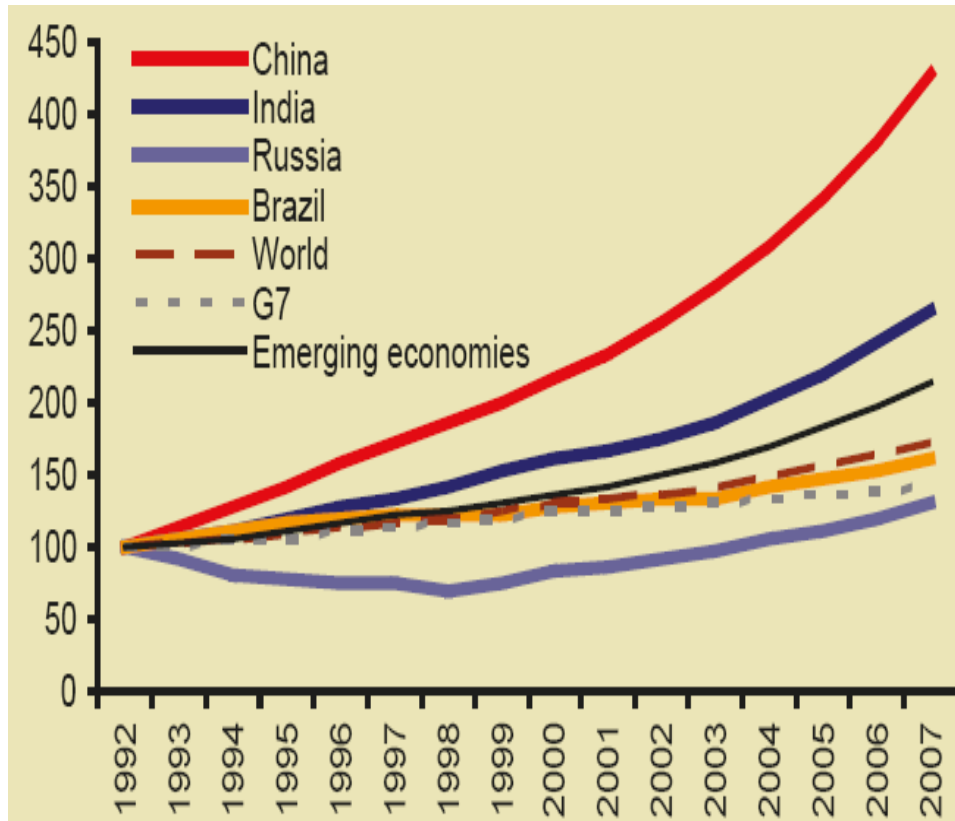
Strategy for investors

- The valuations are above historical averages but have eased off from their highs late last year.
- Global correlations remain a source of risk but further drops closer to historical averages can be used as buying opportunities.
- Long term investors can continue with SIP.

The Long Term Case For Indian Equities

India - Growth On The Fast Track

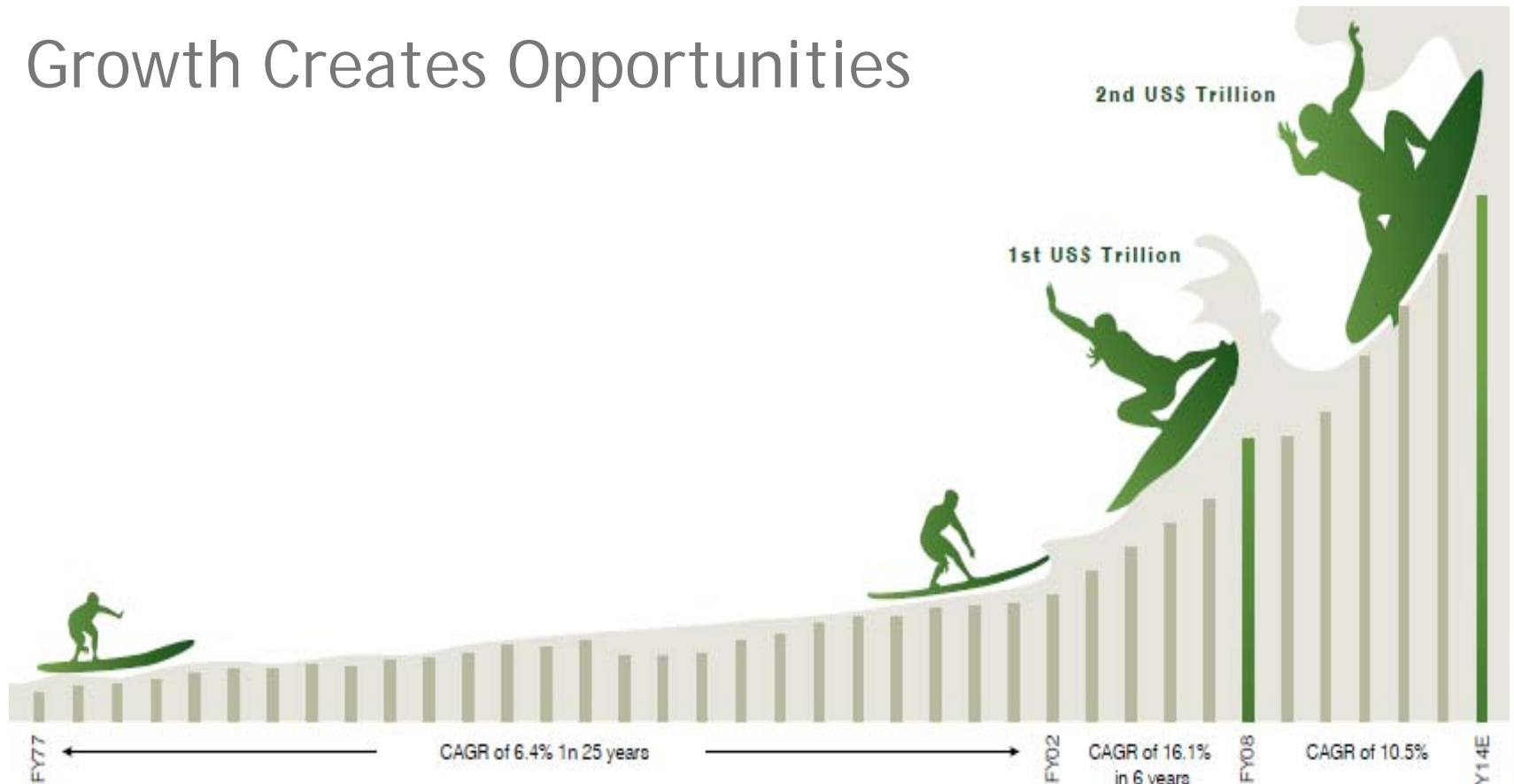
GDP growth rebased to 1992



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

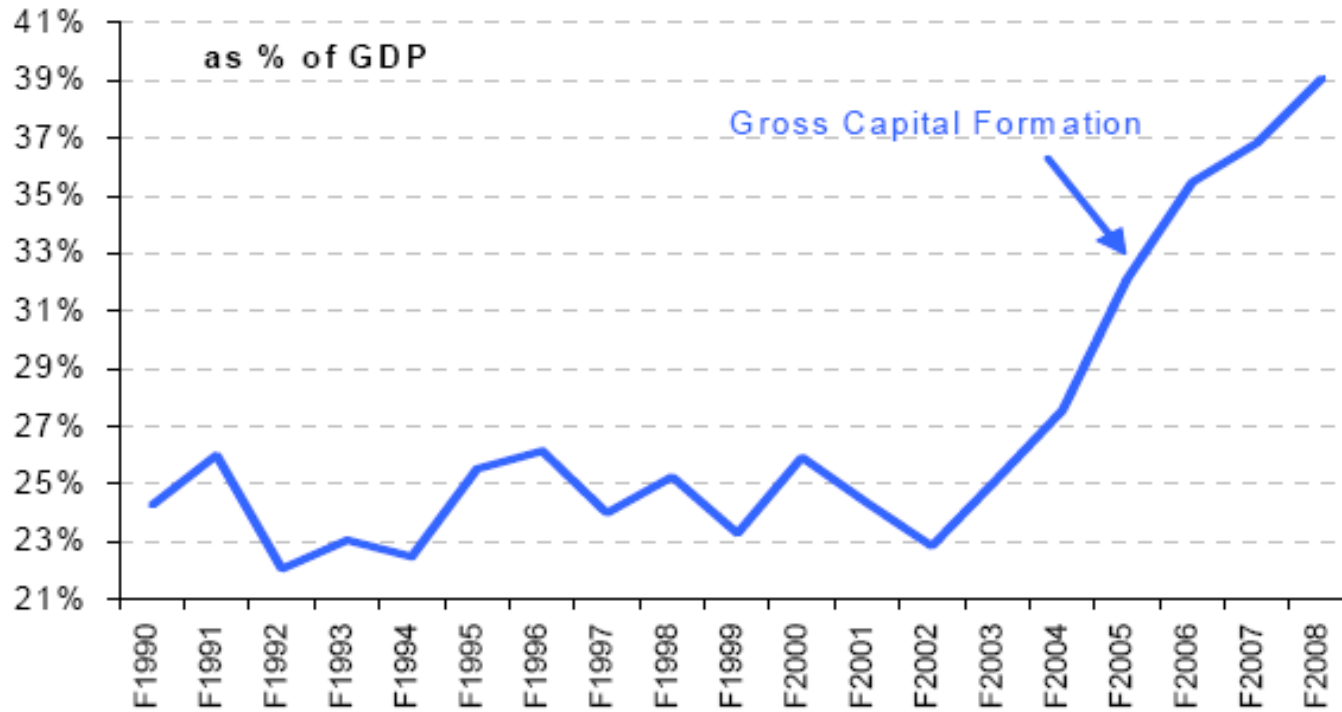
Growth Creates Opportunities



- 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



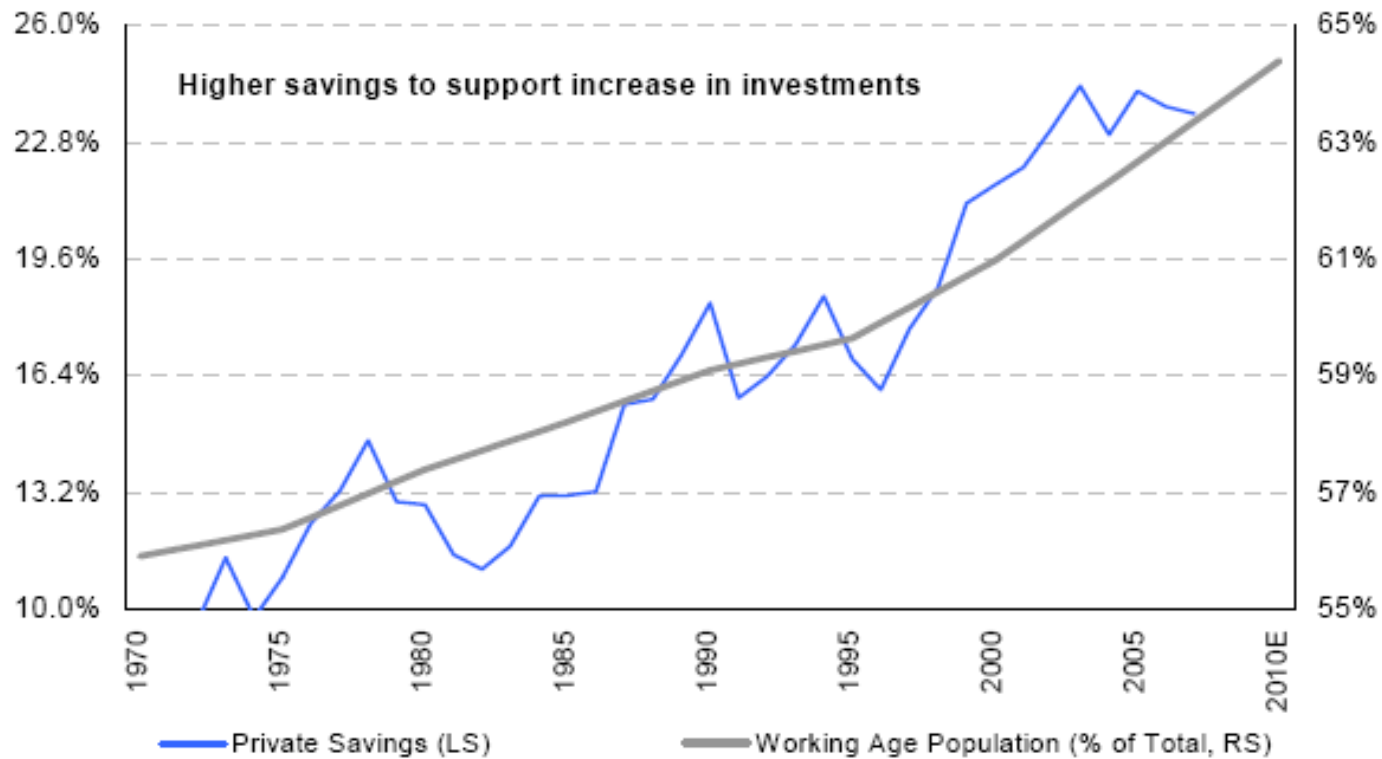
Growth Is Being Led By A Rise In Capital Formation...



Source: CSO, Morgan Stanley Research



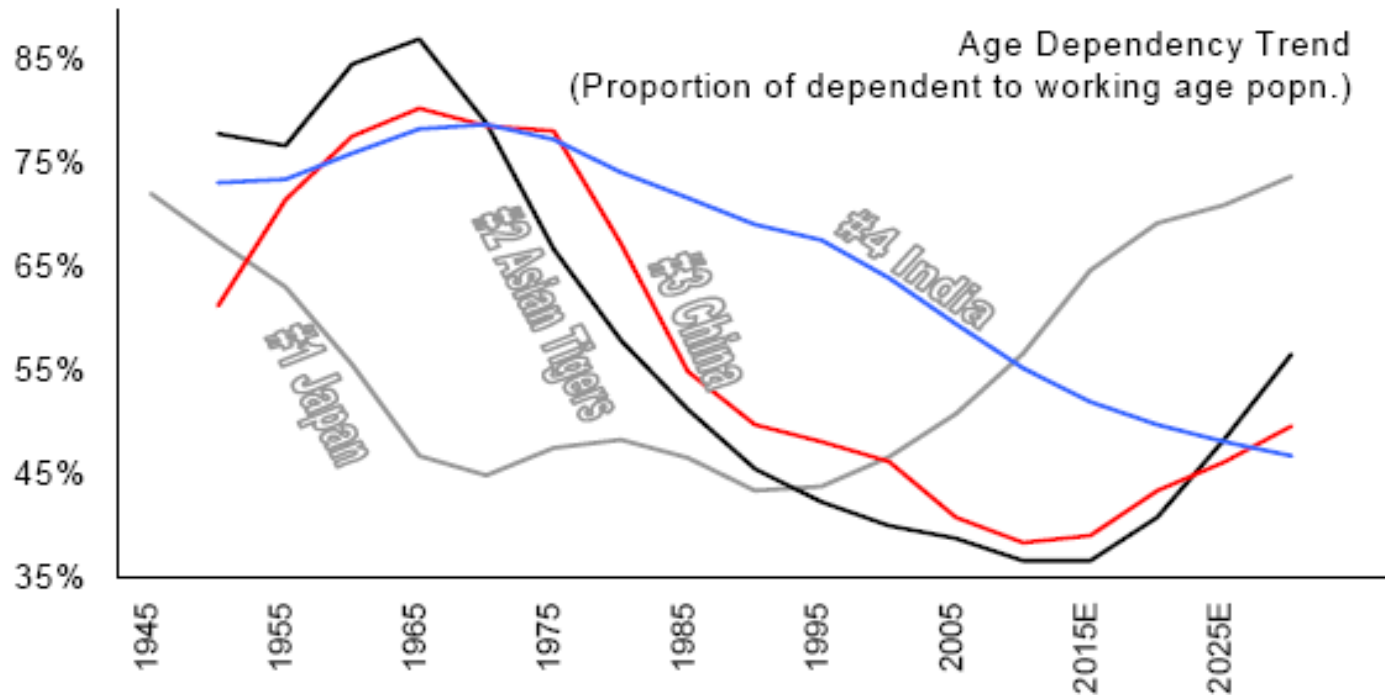
...Which Is Supported By A High Savings Rate



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



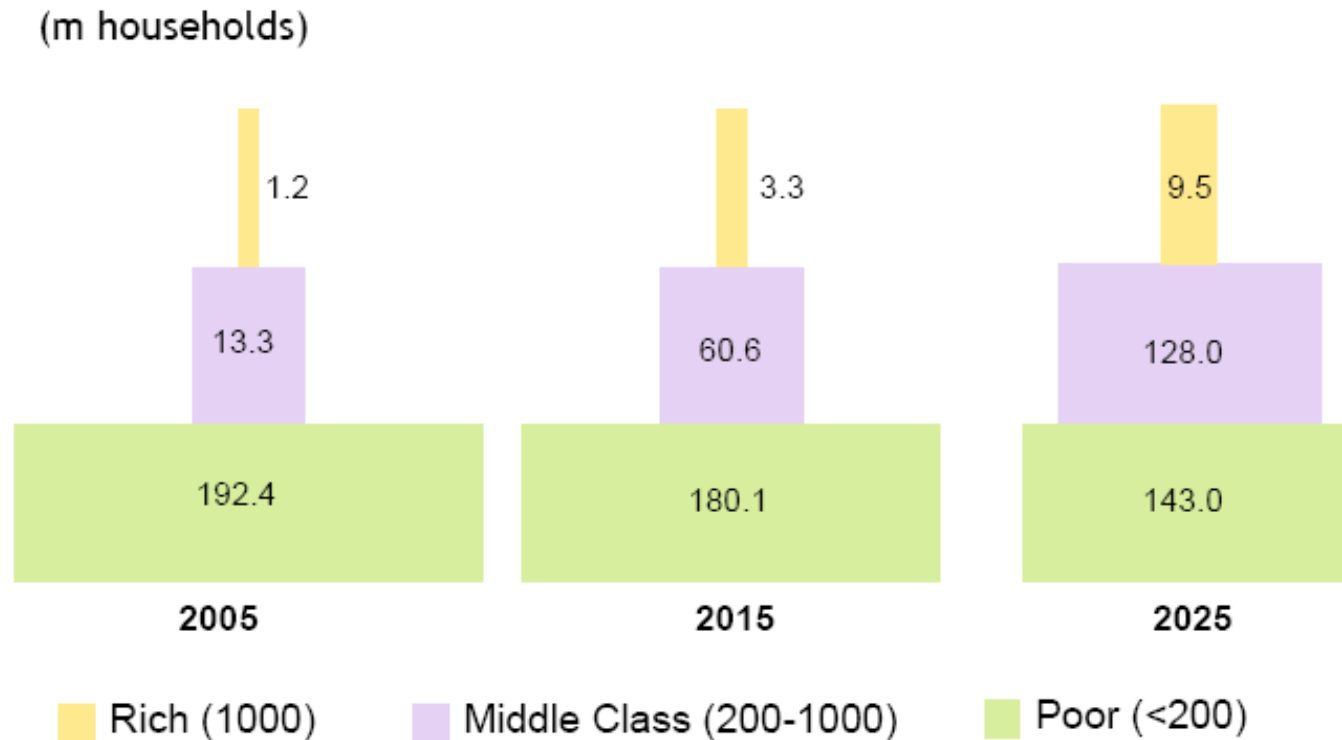
India Is Poised To Reap Rich Demographic Dividend In Years To Come



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

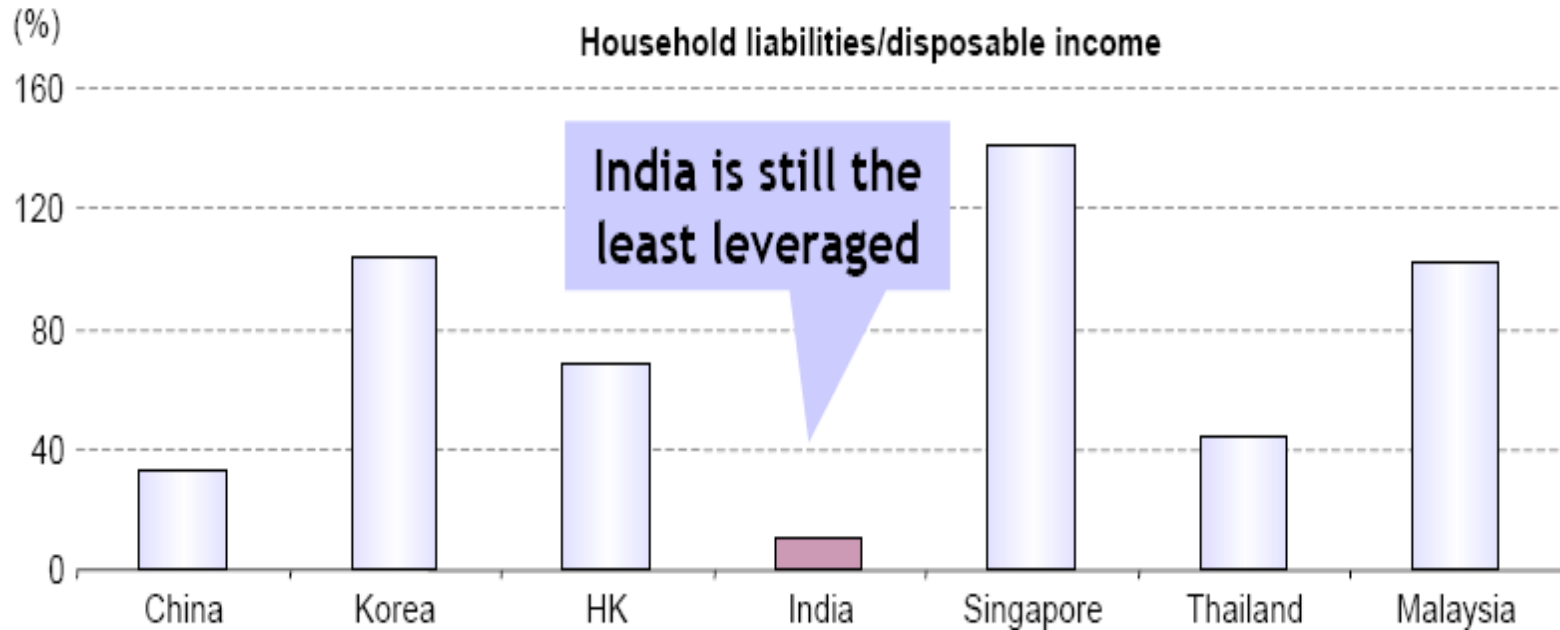


Income Imbalance To Correct Leading To Rise In Consumption



Source: IDFC SSKI

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



Source: IDFC SSKI

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