

Equity Markets : Current Environment and Outlook

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Current Environment

- Global Equity markets remained almost flat in December, with the MSCI World Index falling by 0.17%.
- Indian markets under performed their global peers, falling by 4.15%.
- Commodity prices also remained flat on a MoM basis mirroring the trend in equities, as indicated by the benchmark CRB Reuters Jefferies total return index.
- In India IT and FMCG were the best performing sectors, while Realty and Metals sectors delivered the worst return for the month
- Institutional activity remained subdued in December. FII inflows during the month were at Rs.1bn. MF were buyers at Rs.6bn, while DII were net buyers of Rs.9bn during the month.
- Trading Activity faltered up in November, with the cash trading turnover (US \$bn) declining by 12% MoM and the average open interest falling by 4% on a MoM basis.

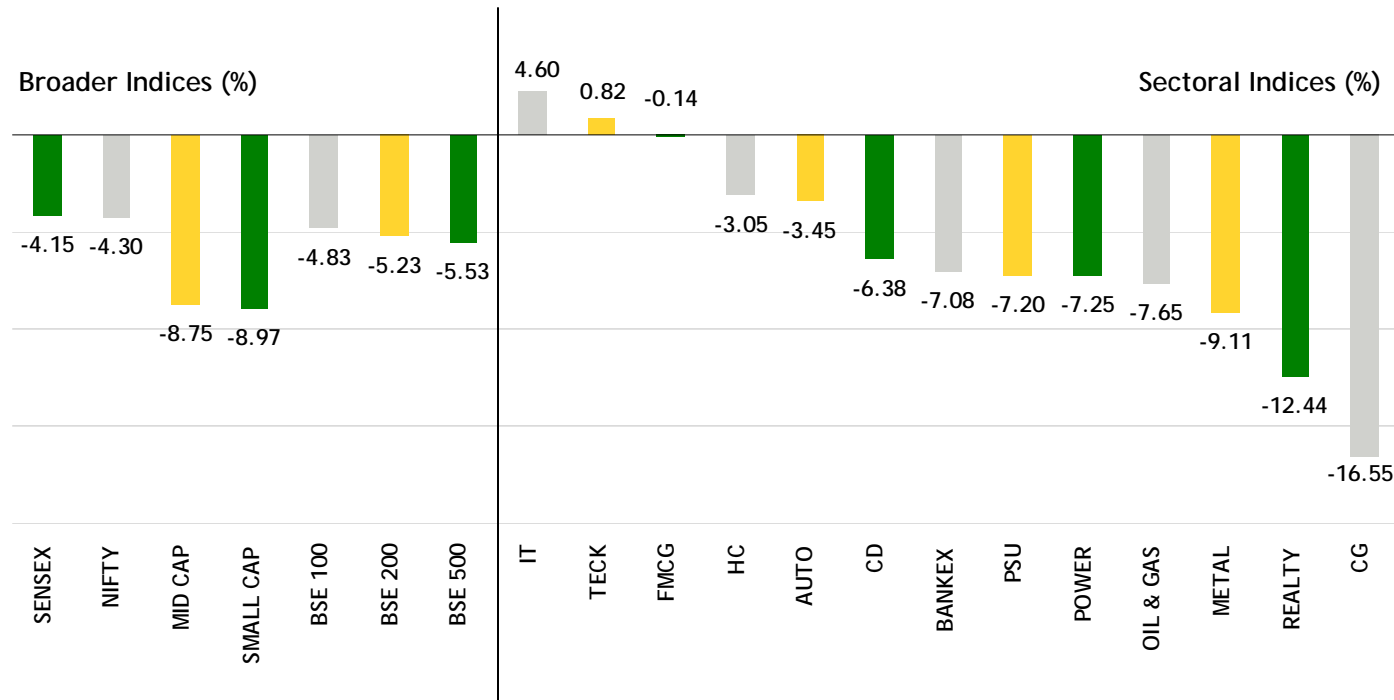
Global Equities

Index	Country	Closing Price*	1 Month Return (%)	YTD Return (%)	Category
SSE Composite Index	China	2199.42	-5.74%	-21.68%	EM - Asia
BSE Sensex	India	15454.92	-4.15%	-24.64%	EM - Asia
Kospi	South Korea	1825.74	-1.18%	-10.98%	EM - Asia
Taiwan Weighted	Taiwan	7072.08	2.43%	-21.18%	EM - Asia
Thailand SET 50 Index	Thailand	718.40	3.02%	-0.25%	EM - Asia
Jakarta Composite Index	Indonesia	3821.99	2.88%	3.20%	EM - Asia
KLSE	Malaysia	1530.73	3.98%	0.78%	EM - Asia
Ibovespa Sao Paulo Index	Brazil	56754.08	-0.21%	-18.11%	EM
Mexico IPC	Mexico	37077.52	0.67%	-3.82%	EM
Russian RTS Index	Russia	1381.87	-10.32%	-22.04%	EM
Philippine PSEi	Philippines	4371.96	1.90%	4.07%	EM
Merval Buenos Aires Index	Argentina	2462.63	-3.91%	-30.11%	EM
HangSeng	Hong Kong	18434.39	2.47%	-19.97%	Developed - Asia
Nikkei	Japan	8455.35	0.25%	-17.34%	Developed - Asia
Strait Times	Singapore	2646.35	-2.08%	-17.04%	Developed - Asia
Dow Jones	USA	12217.56	1.43%	5.53%	Developed
CAC 40 Index	France	3159.81	0.16%	-16.95%	Developed
All Ordinaries Index	Australia	4111.00	-1.76%	-15.18%	Developed
DAX Index	Germany	5898.35	-3.13%	-14.69%	Developed
Swiss Market Index	Switzerland	5936.23	5.02%	-7.77%	Developed
FTSE 100	UK	5572.28	1.21%	-5.55%	Developed
MSCI World Index	--	1182.60	-0.17%	-7.61%	--

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



India : Sector performances



- Sensex fell by 4.15% over the previous month.
- MidCaps underperformed LargeCaps with 8.75% loss in the MidCap index.
- IT and FMCG were the best performing sectors.
- Realty, Metals and Consumer Goods sectors delivered the worst return for the month.



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

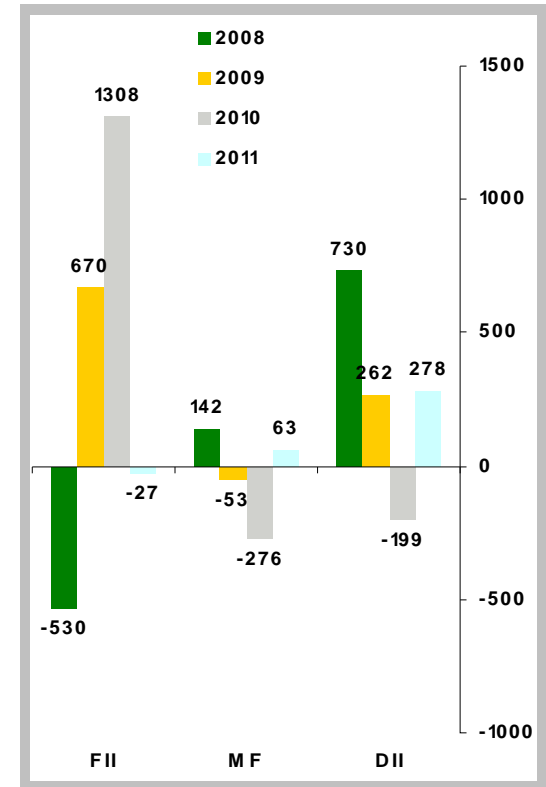
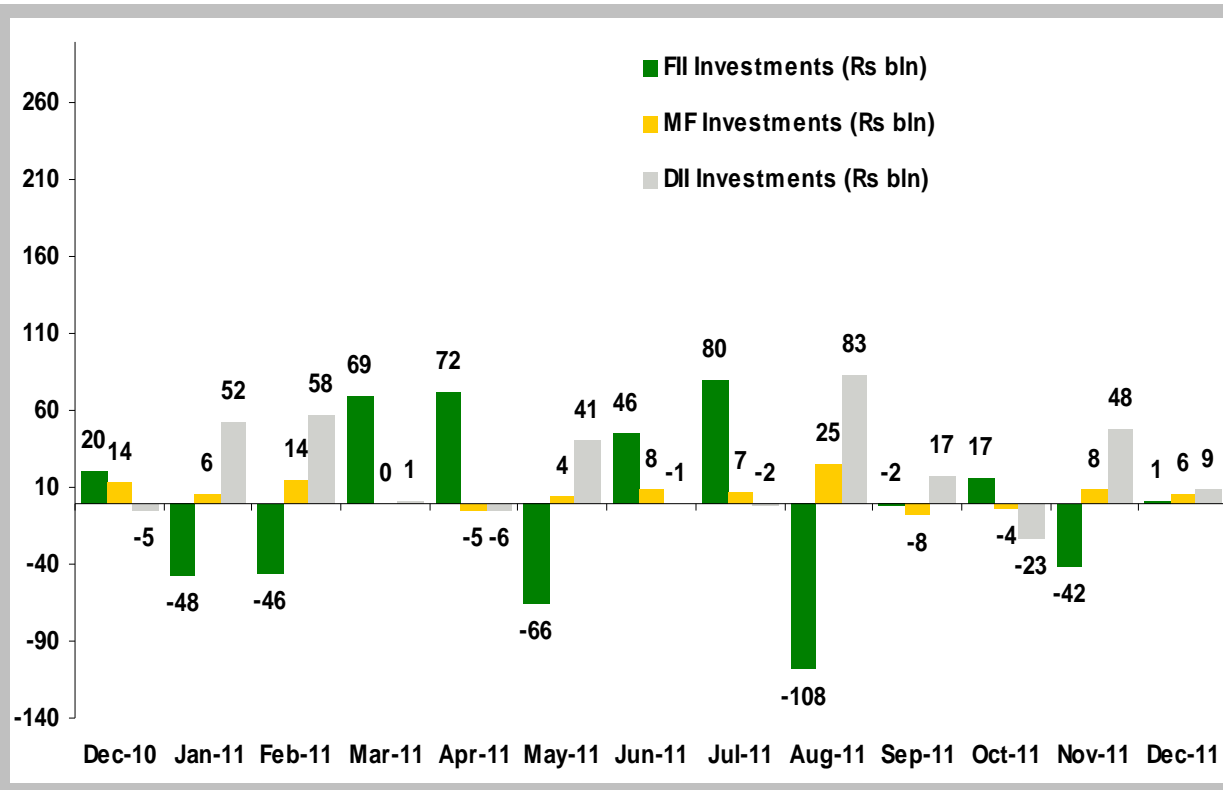
Top Gainers / Losers - Nifty

Top Gainers for the month			
Gainers	52 week H/L	Last Price#	% Gain*
Grasim Inds	2626.35 / 1981.9	2488.75	6.30%
Infosys	3499 / 2161.5	2767.65	6.17%
Wipro	496.8 / 310.5	398.7	5.70%
Ambuja Cem.	165.45 / 111.6	155.35	4.61%
Cairn India	372.35 / 249.3	314.25	4.25%
Top Losers for the month			
Losers	52 week H/L	Last Price#	% Loss*
JP Associates	110.7 / 51.15	52.4	-15.62%
I D F C	185.65 / 90.9	91.65	-15.69%
Reliance Infra.	895 / 335.65	340.8	-15.72%
Reliance Power	162.2 / 68.5	70.95	-16.97%
Larsen & Toubro	2003 / 969.15	994.65	-21.81%

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



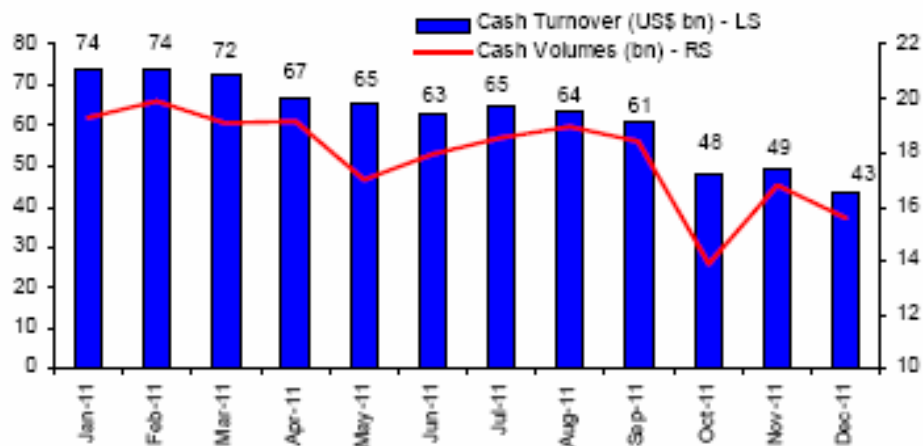
FII & DII Inflows



- Institutional activity remained subdued in December.
- FII inflows during the month were at Rs.1bn. FII outflows were at Rs.27bn for CY11 after a Rs.1308bn inflow in CY10 and Rs.670bn inflow in CY09.
- MF's were buyers at Rs.6bn, while DII's were net buyers of Rs.9bn during the month.



Market Activity



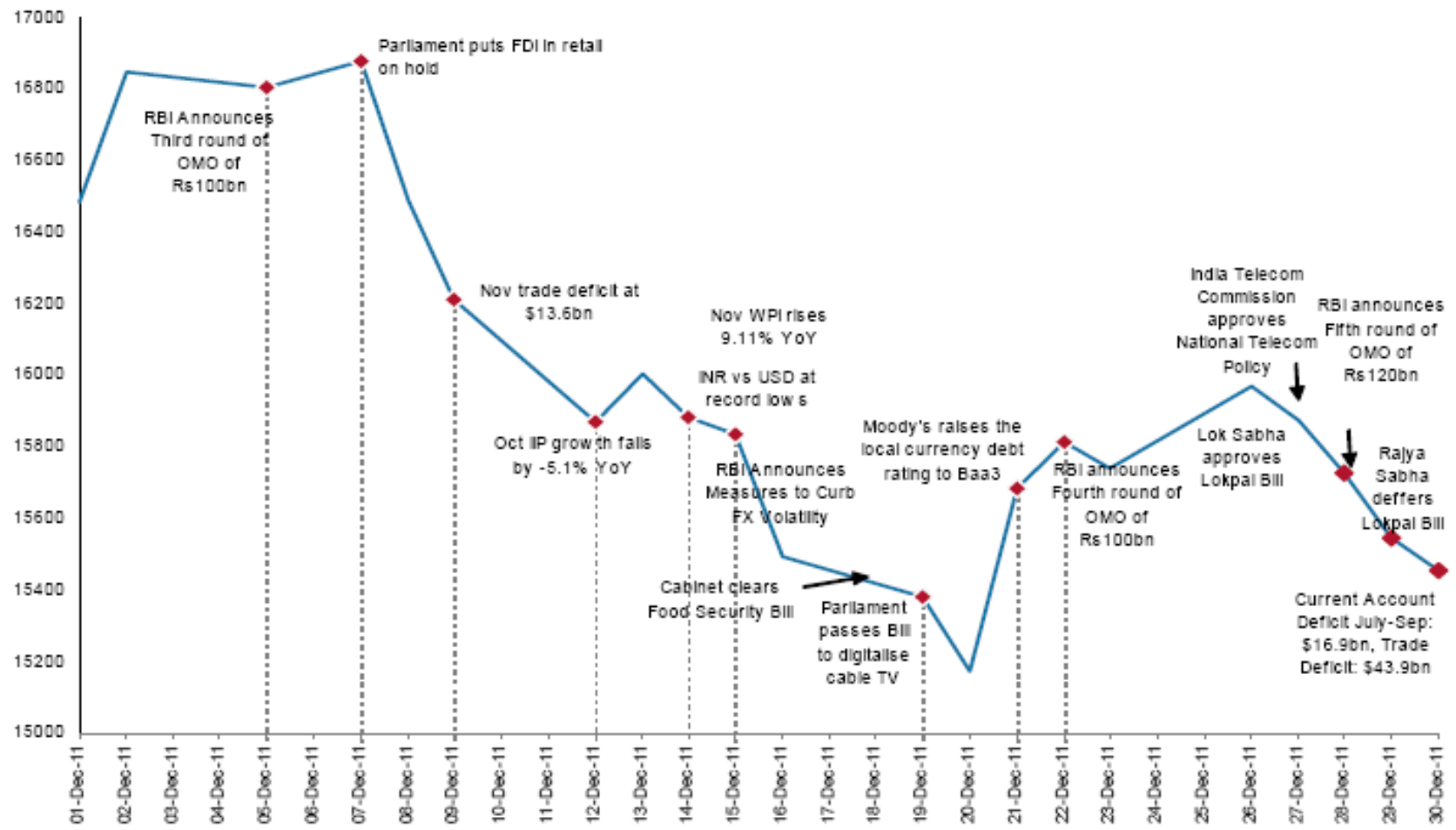
- In December 2011, cash trading turnover (US \$bn) decreased sharply by 12% MoM.



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



December 2011 events timeline



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

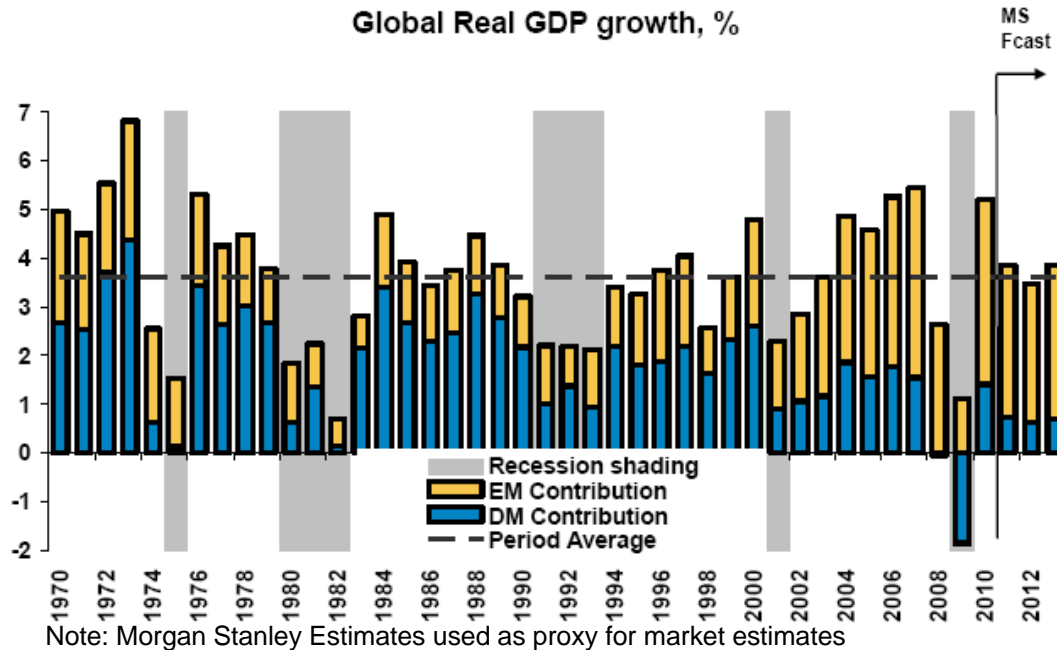


Religare MF: Equity Market Outlook and Opportunities

Equity Market Outlook

- Global GDP growth estimates have remained soft with growth estimated at 3.5% in CY12.
- The key contributors to recent cuts have been the Eurozone and UK; this is partially offsetted by an uptick in US GDP growth.
- Market expects GDP in India to grow between 6.5%-7% in FY12 and FY13, which is a significant deceleration from 8.0% – 8.5% clocked in FY10 and FY11.
- The slowdown has been led a sharp downtick in investment demand and tight monetary conditions as well as a governance deficit.
- New projects announcements continue to decelerate, with both government and private sector orders drying up resulting in orders under-execution slowing down.
- On the positive side, Inflation is showing signs of moderation, mainly on account of sharp fall in agro inflation and softening of domestic demand.
- However, the Fiscal challenges remain with the Fiscal Deficit expected to breach 5.5% level in FY12 (as against 4.6% guidance).
- Corporate earnings in December quarter are expected to be slightly better than September quarter. However, the overall earnings expectations for FY12 remains unchanged.
- Valuations have turned attractive, with equities yield now within close distance of the long term bond yield and Sensex valuations are at more than 15% discount to longer term averages on both trailing as well as forward basis.

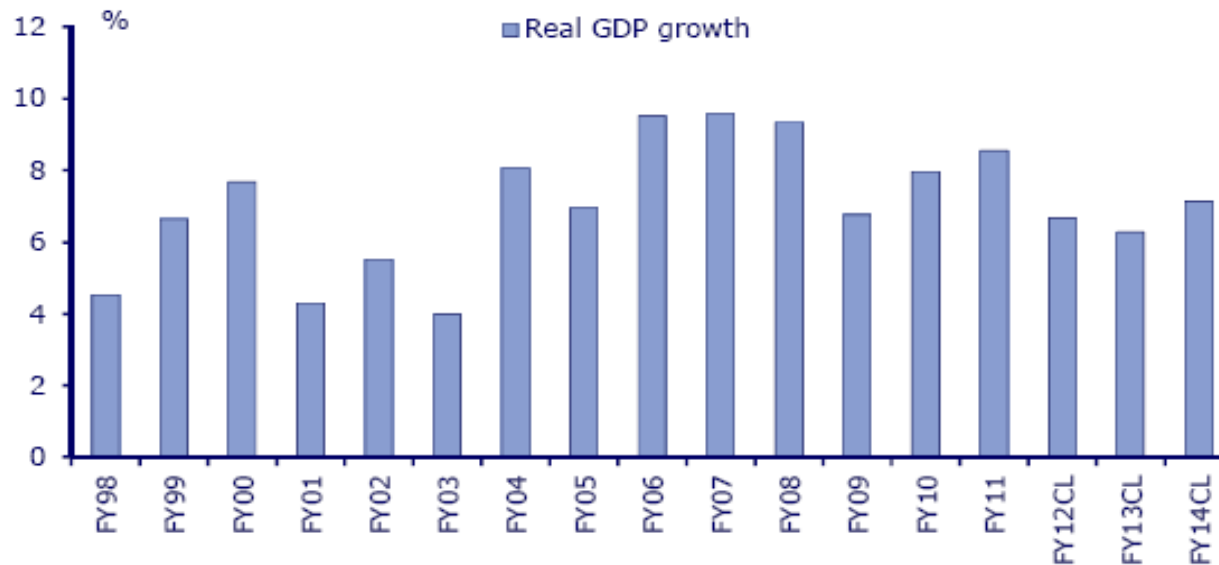
Global Growth - EU pulls down, US holds on



- Global GDP growth estimates have remained soft with growth estimated at 3.5% in CY12.
- The key contributor for the slowdown is the cuts in Eurozone and UK economic growth estimates. Euro Zone Area is expected to de-grow versus a nominal growth forecast earlier.
- Even the growth in emerging markets has been cut from 6.1% earlier to 5.7% currently.
- However, in stark contrast, the USA economic growth estimates have been revised upward from 2.1% growth to 2.2% growth forecast in 2012. This is also corroborated by recent improvement in US economic data like improvement in retail sales, decline in unemployment, etc.



India's Economy is slowing down

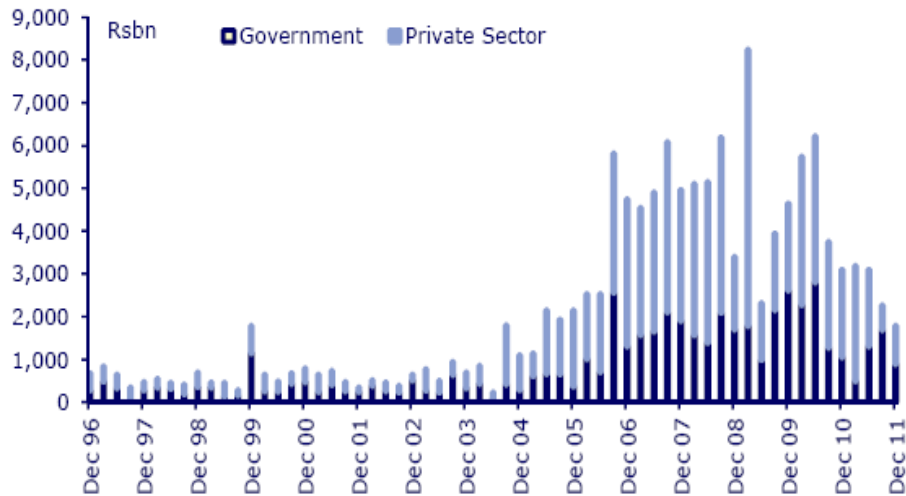


- Market expects GDP to grow between 6.5%-7% in FY12 and FY13, which is a significant deceleration from 8.0% – 8.5% clocked between FY10-FY11.
- The slowdown has been led a sharp downtick in investment demand and tight monetary conditions as well as a governance deficit.
- The virtuous cycle of higher project approvals leading to higher investment, which in turn raises economic growth, stalled in 2011 owing to a combination of factors that are an offshoot of political inaction, corruption scandals and the hit to business confidence.
- We expect the state elections to be an important event in the political environment in the near term

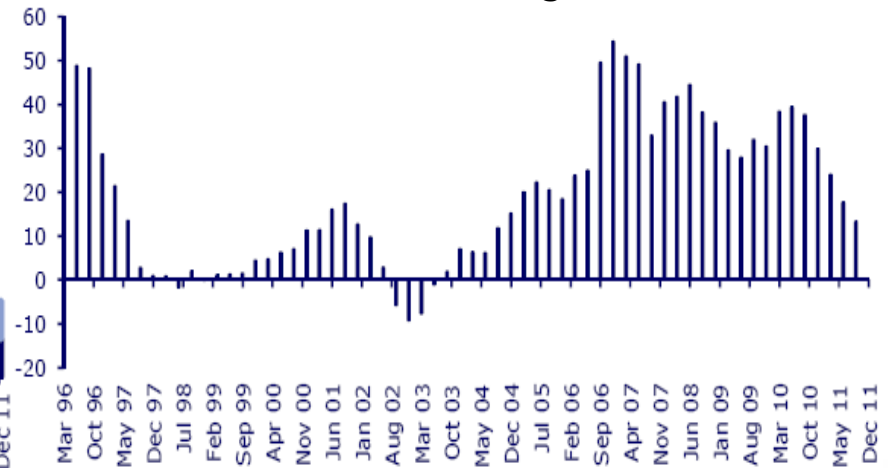


Investment Demand Has Not Yet Picked Up

New projects announcement



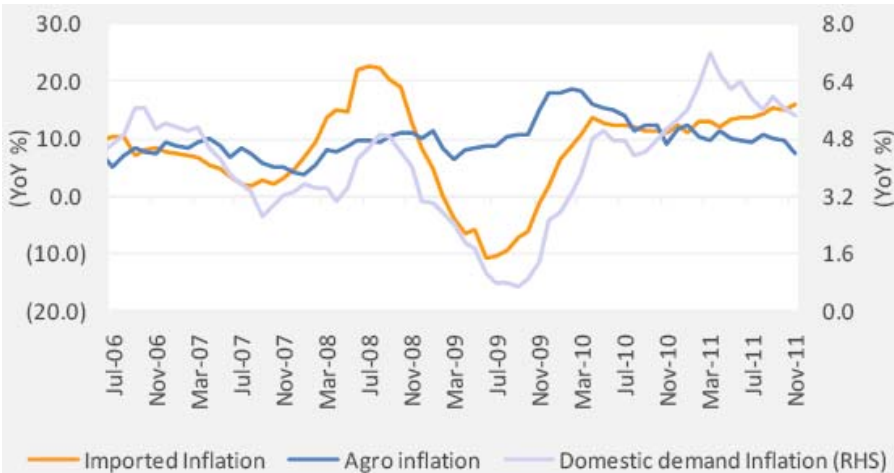
Incremental projects under implementation (YoY change)



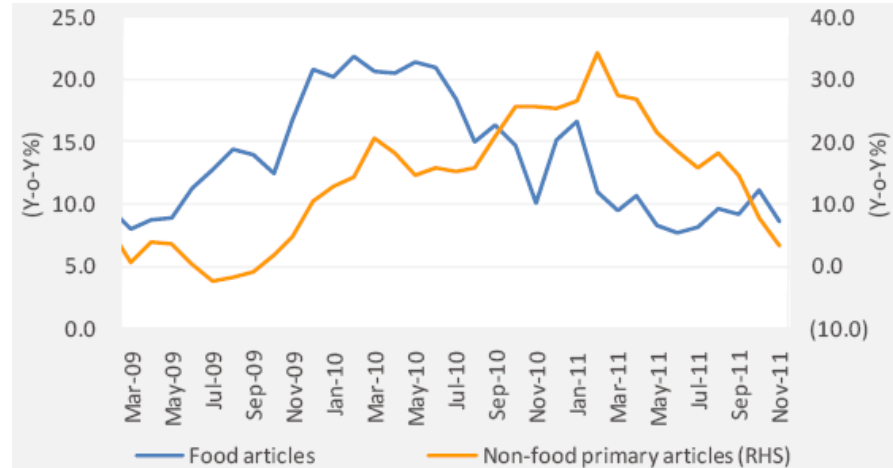
- New projects announcements continue to decelerate, with both government and private sector orders drying up.
- Also the incremental projects under implementation have started to show a meaningful decline. Increased execution of old orders, without receiving new orders results in decline in incremental projects under implantation.

Inflation - Started to Moderate

Inflation – Domestic vs Imported

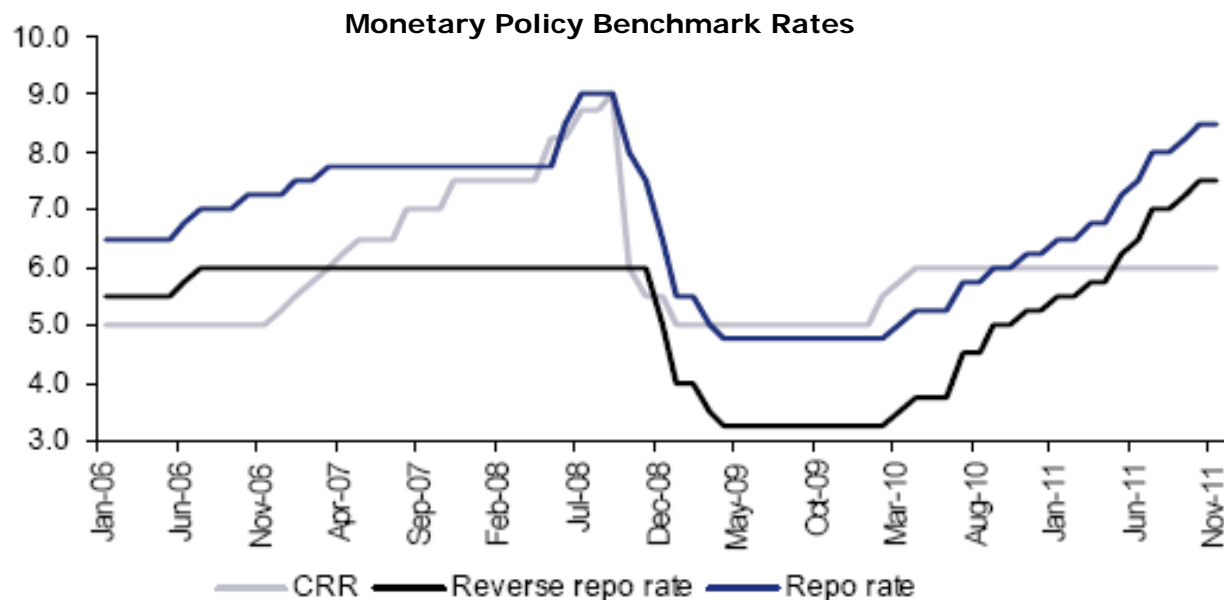


Inflation – Food vs Non-Food Primary



- Inflation is showing signs of moderation, mainly on account of sharp fall in food inflation.
- The moderation is led by agro inflation and a softening in domestic demand.
- However, there is likely to be upside pressure on inflation from the weak rupee and also fuel prices.
- But the recent weakening in food prices increases the probability of inflation falling below RBI's forecast of 7% in March, which should provide the central bank with some comfort.

Monetary Policy - Pause with hints of reversal

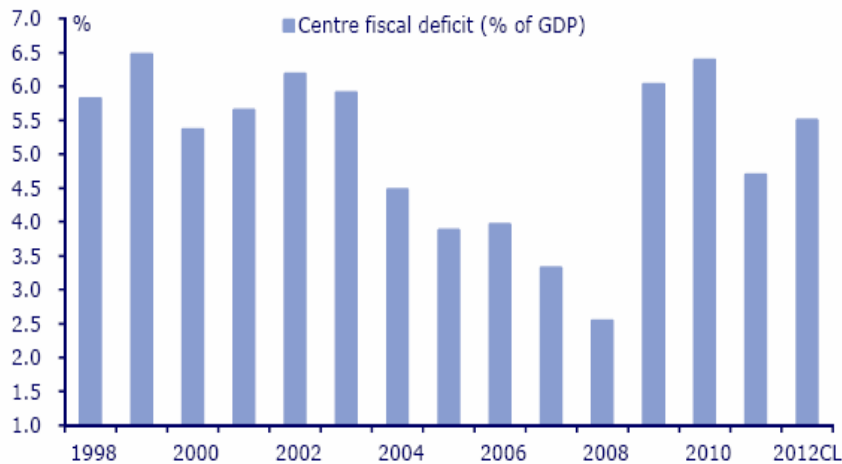


- RBI kept its key policy rates unchanged in line with consensus expectations – CRR at 6.0% and Repo rate at 8.5%.
- Credit policy stance was dovish with RBI indicating that monetary policy from this point would most likely lead to a reversal of the tightening cycle as growth downshifts.
- We expect RBI to start focusing on growth over inflation in CY12, but we do not expect the RBI to act in a rush and in any case a series of rapid fire cuts ala 2008-09 is unlikely

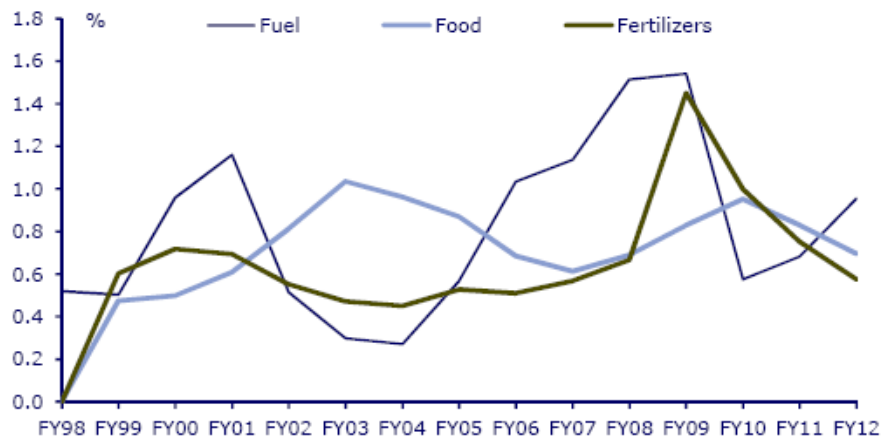


Fiscal Deficit - Reforms Needed Urgently

Central government's fiscal deficit as a % of GDP



Trend in government's major subsidy burden as % of GDP



- Fiscal balances for the government have deteriorated in FY12, with the 4.6% guidance for FY12, expected to be missed by a wide margin.
- We estimate the fiscal deficit at greater than 5.6% for FY12, with downside risks as tax collections have started to waver in a slowing economy, while subsidies have increased.
- The government is exploring various stop-gap options to shore-up its revenues by resorting to options like buy-backs by cash rich PSU's, divestment of SUUTI assets, etc. While these may lessen the short term pain, the longer term solution is to control the revenue expenses.



December 2011 Earnings Preview - Sequential Improvement Seen

December 2011 earnings growth forecasts

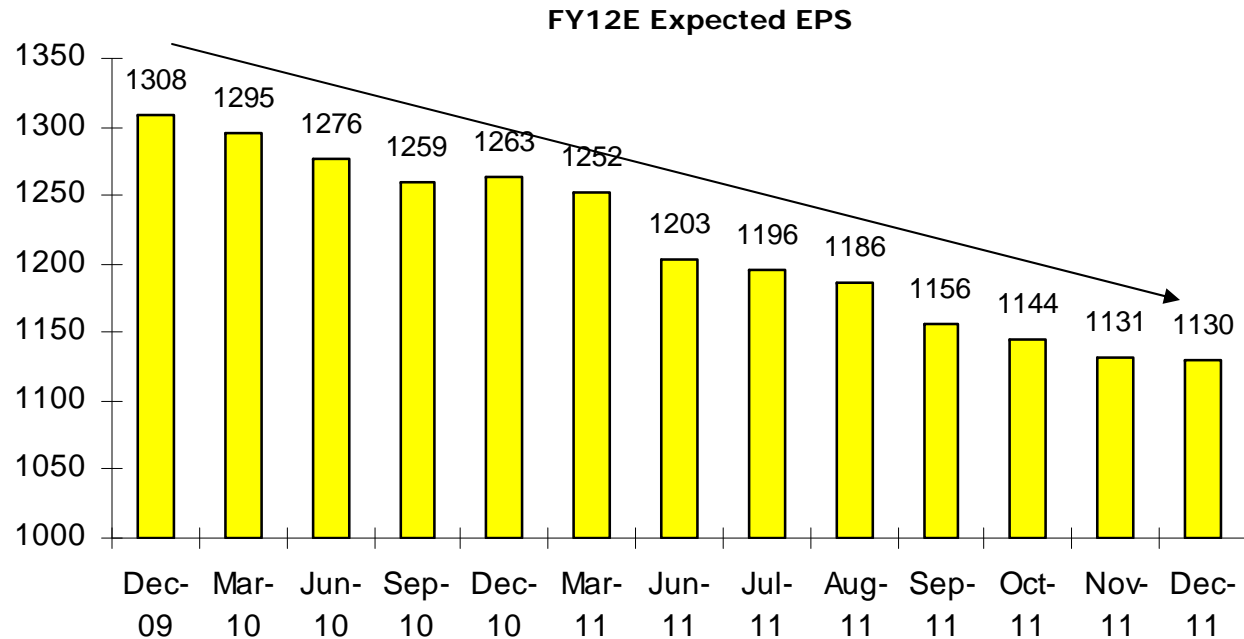
YoY Change for QE Dec-11E	Revenues	EBITDA	Net Profit	Growth in Net Profit QE Jun-11	Growth in Net Profit QE Sep-11
BSE Sensex	20%	2%	1%	9%	15%
BSE Sensex (ex-Oil PSU)	23%	10%	10%	9%	8%

Note: Morgan Stanley Estimates used as proxy for market estimates

- The earnings expectations for Q3FY12 for Sensex (ex Oil PSU) companies has been toned down; Expect mere 10% yoy growth in Net profit despite a healthy 23% yoy growth in Sales.
- Revenue growth momentum appears healthy, but it is price led (inflationary pressure); volume growth remains tepid.
- Note the earnings growth (ex Oil PSU) is expected to pick up marginally on a sequential basis from 8% net profit growth in September 2011 to 10% in December 2011.



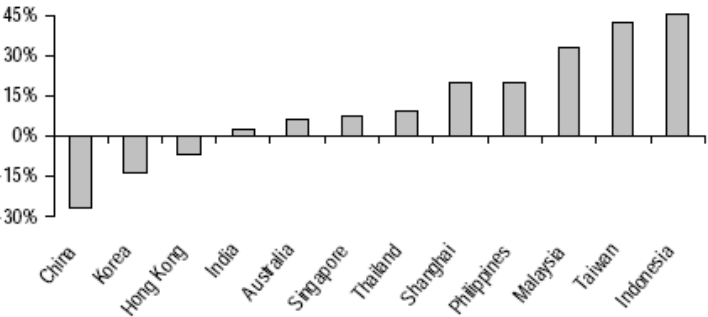
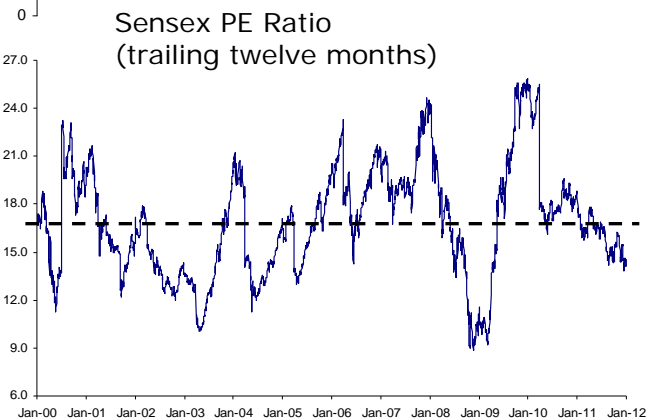
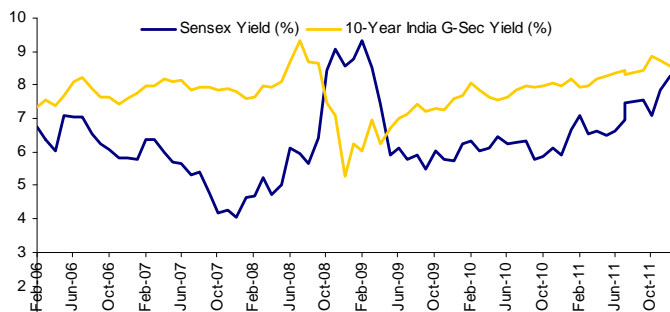
Earnings Forecasts - Cut by 11% in One Year



- The FY12 earnings estimates have remained unchanged in December 2011. The cut in FY12 EPS since last year is now to the tune of 11%.
- Market estimates of FY 13 growth in the range of 15-18% are at risk and we expect downgrades.



Valuations - Corrected Materially



- The gap between Sensex earnings yield and bond yield has narrowed by 28 basis points over the previous month as Sensex yield rose while the bond yield fell.
- Sensex is currently trading at 14.1x its trailing earnings. It is now 16% lower than its historical 11-year average trailing PE of 16.9x.
- On a 1-yr forward basis, Sensex is trading at 12.1x which is about 17% below its 15 year average PE.
- India's price to book value (adjusted for RoE) is fourth lowest relative to its Asian peers (ex Japan). Thus, India becomes attractive on both on asset values as well earnings value.



Looking Ahead...

- 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.
- The global growth environment is tepid, while data from the US has improved Europe is expected to suffer reversal this year. Emerging economies are slowing due to the monetary tightening in 2011 but during the course of this year the monetary cycle is likely to reverse in several emerging economies.
- In India, there is an increasing expectation in the market that the RBI will ease in the near future. The RBI's stance appears to have softened of late and we expect the central bank to now focus more on growth concerns over inflation.
- Rate cuts are positive for the investment cycle but the cuts alone cannot revive the investment cycle. Policy action is more crucial for reviving the investment cycle.
- The worst case is that the 'Governance' issue might drag on till the next general elections, currently scheduled for 2014. The best case is that after the state elections next month the government will have the elbow room on policy. We have our fingers crossed but expectations are low.
- The fiscal deficit and government borrowing program has considerably overshoot the government targets. However, rates at the long end have stabilized as the central bank has injected liquidity into the market. This remains a key monitorable.
- The Sensex is currently trading at 14.1x, which is 17% 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 6.5% - 7% in FY12 and FY13.
- Earnings estimates have been cut for FY12 as we have long expected but the implied growth rate for FY13 is still 15-18% and we expect downgrades to this number.
- 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% p.a. 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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