Market Overview and Strategy

22nd August, 2011

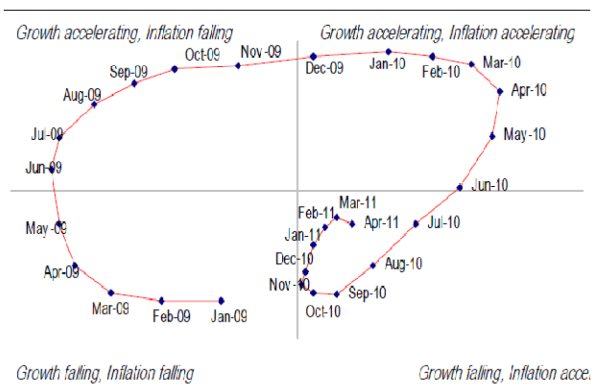
Performance of Major Indices as of 19th August 2011

SENSEX	16141.67	-2361.63	12.76%
NIFTY	4845.65	-801.48	14.19%
DOW JONES	10817.65	-1596.65	12.86%
NASDAQ	2341.84	-431.16	15.54%
HANG SENG	19399.92	-2661.28	12.06%
FTSE 100	5040.76	-904.94	15.22%

Performance of Other Assets as of 19th August 2011

Gold ($/ounce)	1851.71	348.91	23.21%
Crude Oil WTI ($/BBL)	80.26	-15.16	15.88%
10-Yr G-Sec (%)	8.28	-	0.05%

Chart 7: Business cycle phases based on inflation and growth (IP)



Interplay between inflation and growth indicates that currently we are in falling growth and high inflation period, but we expect inflation to cool off over the 6-8 months.

Equity Market-Overview

The Indian bourses along with other major indices of the world had a serious setback after premium credit rating agency Standard and Poor downgraded USA's credit rating from the highest level AAA grade which it has been enjoying since 1917 to one notch below i.e. AA+. SENSEX and NIFTY as of 19th August were down by 12.76% and 14.19% since the beginning of July. The major events that were unfolded during this time period are:

Second Bailout for Greece

European leaders agreed for a new Euro109 bn bail out for Greece under which private bondholders were called on to participate for the first time, contributing a target of a further Euro37 bn. It was also decided that all the three bail out countries i.e. Ireland, Portugal and Greece will have a haircut to about 3.5% and will not have to repay the loans for up to 30 years.

RBI Continued Its Hawkish Stance

RBI continued to maintain its anti inflationary stance when it raised its key policy rates by sharper-than-expected 50 bps at a policy review on 26th July 2011 to tame inflation. It raised concerns that higher interest will pinch corporate profit growth.

S&P Downgrades USA's Credit Ratings

For the first time since 1917, the credit rating agency S&P downgraded the esteemed AAA rating of USA to one notch below i.e. AA+, spreading jitters across global markets. The move came just days after a gridlocked Congress finally agreed to spending cuts that would reduce the debt by more than $ 2 trillion.

S&P said that in addition to the downgrade, it is issuing a negative outlook, indicating that there may be a chance that it will lower the rating further within the next two years. It said such a downgrade, to AA, would occur if the agency sees a) smaller reductions in spending than Congress and the administration have agreed to make, b) higher interest rates or c) new fiscal pressures during this period.

Debt Market-Overview

Domestic interest rates are near peak, debt investments should move up the maturity curve, for capital gains over the next 12 months.

The US downgrade also affected the Indian debt market as the 10 year G Sec yields came down to 8.28% from 8.33% seen during July beginning. However, the yields were volatile in the recent past, as they also rose to 8.45% after the Reserve bank of India raised its key rates to 50 bps to tame inflation. Rates over the medium term could remain high, considering significant uncertainty in the domestic and global front. However, we believe that we are at the end of the current tightening cycle and rates are close to their peak, notwithstanding, another 25bps rate hike in September. Debt investors should start looking to play the yield curve and look to invest in higher maturities going forward. .

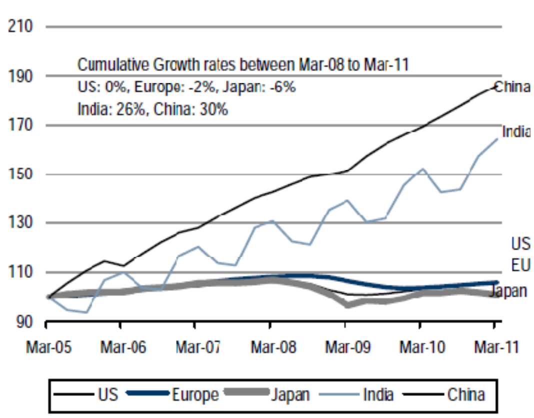
Commodity Market-Overview

The recent performance of Gold asserted its hegemony over other asset classes as a safest haven to invest in. Gold has rallied in the last 2 week, driven by worries over Euro zone and US debt along with the growth concerns around the globe. Gold reached an all time high of close to US1851$/ounce as of August 19th.

Crude oil (WTI) dropped 16% to end at $ 80.26 as of 19th August 2011. The market, after the US downgrade was spooked by fears that oil demand would crash if global economy slows down. Lower crude oil and other base metals on account of recessionary fears bode well for the Indian economy, as it will ease inflationary pressures.

With growth concerns dominating the near term outlook, and uncertainty and inflationary pressures likely to persist, we expect gold to remain at the current levels. However, we would add that fresh entry into gold at these levels should be made with utmost caution.

Developed Economies Barely Growing Despite Stimulus



Equity Market Outlook

We consider the current turmoil in the market as a good buying opportunity for a long term investment. We expect the developed world to struggle with their burgeoning debt problems for a very long period which is expected to dent their GDP growth rate for a long period to come. In fact, as seen in the graph the loose monetary policy and stimulus has not helped in stimulating growth in the developed world, but India and China have seen robust growth during the same period. And we expect this outperformance of emerging economies will continue going forward as well. Considering this, we are positive on the emerging markets especially India whose growth story is more driven by domestic consumption and relatively healthier finances.

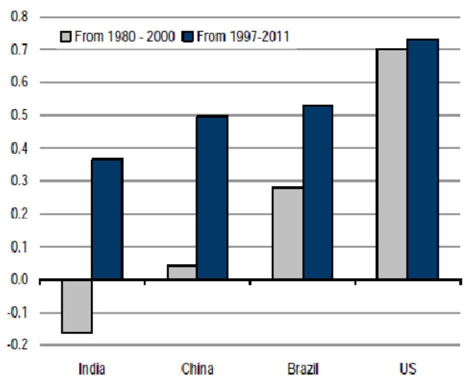
We have tried to analyze a few factors about Indian economy which is the cornerstone of our bullish view:

Debt to GDP Ratio

The biggest nemesis for the developed world, the debt to GDP ratio, which is expected to compel the developed world to compromise with their living standards for years to come has comparatively much lesser impact in the emerging markets.

China and India seems much more comfortable on this front as officially China's debt to GDP is reported at 17%, but experts believe it could be in the range of 77%, while India reports a debt to GDP ratio of 66%. These compare against 100+ Debt/GDP ratios for most developed economies.

India has Lowest Correlation with Global Economy



Lower Dependency on Exports

As compared to other emerging markets, Indian economy is less dependent on exports, especially when compared to China. Net exports as a percentage of GDP in India is just 22% compared to almost 40% in China. In addition, it is felt that structurally, the Indian economy is relatively better placed, on account of lower percentage of investment into fixed assets at 30% of GDP as compared to 50% of China. As seen in the graph India has the lowest co-relation with global economy as compared to other major economies.

A high investment in fixed asset financed by liberal bank lending creates excessive overcapacity in the economy, which perpetuate a relatively hard landing of the economy in case the economy slows, as is feared for China. We believe India on the other hand faces a problem of shortages in capacity across various sectors.

Global Commodity Prices are Falling

Household Consumption as a Percentage of GDP

We believe household consumption to be the predominant factor that would keep the growth story of India intact. The household consumption as a percentage of GDP in India is 58%, it is one of the lowest in China with a meager 35%. However, high interest rates and inflation could affect the consumption, impacting growth to a certain extent.

Falling Commodity Prices

A low growth and recessionary fears spread across the globe, demand projection for commodities are expected to come down, which will lead to a softening of commodity prices. Since India imports close to 30-35% of GDP, lower commodity prices would help abate inflationary pressures on the economy. Similarly, corporate earnings which have been hurt by rising commodity prices will also benefit as softer commodity prices will help shore up margins which are currently close to decade lows. Lower inflation will lead to lower interest rates, and benign rate environment coupled with improving corporate profitability is positive for the equity markets.

Valuation Perspective

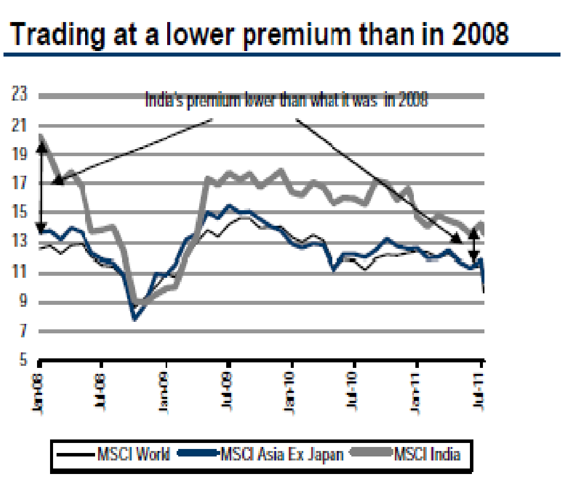
Performance of Global Markets

EQUITY MARKETS IN 2011

	FRIDAY	1 WEEK	SINCE JANUARY 1, 2011
China [Shcomp]	-0.98	-2.27	-9.75
Hong Kong [HSI]	-3.08	-1.12	-15.78
India [Sensex]	-1.99	-4.14	-21.30
Japan [Nikkei]	-2.51	-2.73	-14.76
Korea [Kospi]	-6.22	-2.70	-14.93
Taiwan [TWSE]	-3.57	-3.85	-18.16
Germany [DAX]*	-2.19	-9.51	-21.50
UK [FTSE]*	-1.01	-5.98	-15.22
US [Nasdaq]*	0.45	-5.07	-10.26

Comparison of the current situation with that of 2008 is imperative. When compared to 2008, the Indian economy has outperformed the developed economies considerably, and it is estimated that the nominal GDP is higher by 56% as compared to 2008 levels. On the flip side the Indian markets have considerably underperformed global markets during the calendar year. Indian markets are down 21.3% YTD, the second worst performing major market. Traditionally, India has always traded a relative premium to other markets, but the recent underperformance has narrowed the relative premium to its lowest in the last two years.

Relative Premium has Come Down



We expect corporate profitability in India to be lower than expected on account of global uncertainty, but it is still expected to around 12-15% for FY 12E and FY13E. At the current levels the Indian markets are trading at a PE of 14x FY12E and 13xFY13 EPS, which is close to its all-time lows.

We believe that the current valuation, price in slower growth scenarios for India and hence does not show major downside from these levels. With reasonable valuation and growth India could be outlier in the global context and could attract flows. We recommend clients to increase allocation to Indian equities as we expect the markets to outperform all other asset classes over the next 2-3 years.

Risks to Our View

Inflation Concern

Although headline inflation eased to its 8-month low at 9.22% in July from 9.44% in previous month, the prices of both edibles and manufactured products continued to rule at higher levels. Food inflation rose by 8.19% in July, lower than 8.38% recorded in June. Inflation in the manufactured products group rose by 7.49% in July, up from the 7.43% in June. We expect that RBI may continue monetary tightening in the coming months until inflation is reign in, despite increasing uncertainty over a global slowdown.

Another round of Quantitative Easing may buoy commodity prices

There is a good probability that the Federal Reserve may print more money in order to boost economic activities in USA, if the unemployment rate remains significant. QE3 will surge the prices of commodities which will again dent the margins of India Inc.

Global Contagion

There is a fear in market that a few major European countries like Italy and France may default on their debt or be downgraded. With most major European and Global banks having high exposure to these countries, these events could create a catastrophe. The repercussions would be felt at India Inc. especially those sectors which have significant interest in European markets.

Slowing growth outlook and recessionary fears in the US and Europe will impact Indian exporters and number of Indian companies with exposure to these markets. This will impact corporate earnings and risk appetite significantly.

Political Uncertainty

The recent protests in India against corruption, has crippled an already cornered government further. This will add to the policy paralysis the government is suffering from in the recent past and stall crucial reforms like GTC, DTC, FDI norms etc.

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