

After two months of correction, the Indian markets bounced back smartly in March 2011 to end the month with robust gains. The BSE Sensex & Nifty surged 9.1% & 9.4% respectively in the month. The markets started off the month on a positive note on the back of positive announcements from the Union Budget, expansion in the manufacturing sector and in line GDP growth in Q3FY11, but witnessed correction in the middle of the month, on the back of tension in Middle East and North Africa region and a major earthquake in Japan. However, the indices bounced back smartly in the fourth & fifth week on the back of positive comments from Warren Buffet on the Indian economy, easing food inflation & the decline in India's trade deficit during April-Feb 2011.

The world markets ended the month of March 2011 on a mixed note with India, Indonesia & Singapore being the top three gainers, which rose 9.1% (Sensex), 6% & 3.2% respectively. However, Japan, Germany & UK under performed, falling by 8.2%, 3.2% & 1.4% respectively. The Japanese market fell sharply during the month on the back of a massive earthquake, tsunami over there, killing thousands of people.

In India, Mutual funds were net buyers for fourth consecutive month to the tune of Rs. 28 cr during the month of March 2011 after being net buyers of Rs. 1,426 cr in Feb 2011. FIIs were reported as net buyers to the tune of Rs. 6,731 cr in cash markets in March 2011 (Data available till March 30) after being net sellers of Rs. 5313 cr in Feb 2011 (excl. data for Feb 15). FIIs were net buyers in 14 out of 21 trading sessions in the month (till March 30). In CY11, FIIs have sold stocks worth Rs. 5066 cr (net).

Indian G-Sec bond yields closed the month at 7.98%, which is a drop of 3 bps for the month ended March 2011. Bond yields exhibited mixed movements through the month of March 2011. On 17th March 2011 the RBI announced its monetary policy. It raised the interest rates by an expected quarter percentage point, and flagged inflation as a big concern spurring expectations for more tightening measures. The Reserve Bank of India (RBI) warned of both inflationary pressures and emerging risks to growth, after raising its short-term rates for the eighth time in the past 12 months. The central bank raised its forecast for headline inflation at the end of March to 8 percent, from its earlier 7 percent, and indicated it was likely to stay with its anti-inflationary stance.

We expect the global economy to be modestly impacted by the disaster in Japan, even though Japan represents about an 8.7% share of global GDP & comprises the world's third largest economy. For many years, the Japanese economy has been struggling & was not considered a source of significant global growth. Major economic impacts to Japan will be disruptions to the supply chain within industries like automobiles & electronics. With excess capacity in other parts of the world, this should quickly pass. Morgan Stanley MUFG Securities Co has said that the March 11 disaster may cause Japan's GDP to shrink by as much 12% on an annualised basis in Q2CY11. As per the World Bank report, the real GDP growth of Japan will be negatively affected through mid-2011, but will pick up in the subsequent quarters when the reconstruction efforts, which may last five years, gain momentum. If nuclear meltdown occurs in future over there (which is quite possible), then the human, environmental and economic toll could rise significantly, causing a larger challenge to the global economy. While some industries & economies could be severely impacted, some might benefit from the devastation in the short to medium term.

Euro zone countries continue to be in turmoil. This is one wild card that could upset the appletart, especially if some new country falls into debt crisis situation.

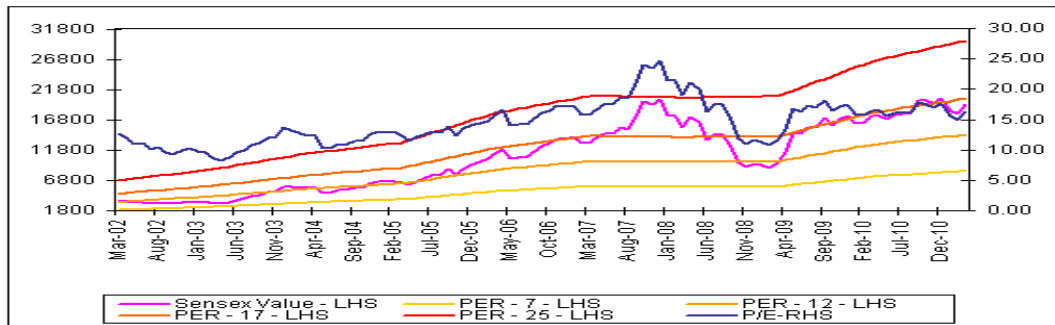
There are some growth worries in Asia arising from rising global oil prices on the back of Middle east & Japan concerns and potential trade disruption. However, this looks a bit overblown. While high-energy prices could benefit certain countries that are net oil exporters like Malaysia & Indonesia, countries that are large net oil importers like India, Korea & China could be affected significantly. However, the use of fiscal measures, including energy subsidies/taxes/refining margins, and currency appreciation could mitigate the impact from higher input costs. Korea, India & China could benefit from potential trade gains with the Middle East. Inflation should still be the bigger concern of Asian central banks. Inflation has mostly surprised on the upside, prompting upward revisions to the forecasts, & core inflation momentum has been rising broadly across the region.

For India, the two crucial spots are current account and fiscal deficits. In both these places, India runs a large deficit. Oil prices impacts both these numbers. While a rebound in exports has led to some improvement in the current account position (India's trade deficit during April 10 - Feb 11 declined to \$97.06 bn from \$100.24 bn in the same period previous fiscal), higher oil prices are simply not good for the Indian markets. High inflation could compel RBI to go for more interest rate hikes, thus hampering

India's growth story. At its recent policy, the RBI has also highlighted upside risks to inflation and raised its March-11 WPI estimate from 7% to 8%. We feel that if the inflation continues to remain high, RBI could go in for another 50-75 bps hike in the interest rates.

While real GDP growth may slow to around 8.5% Y-o-Y in FY12 as the economy fights with high interest rate, high commodity prices and political uncertainty, we feel that the fears in the market are exaggerated as India's consumption story remains buoyant. As in 2010, the market for skilled labour remains buoyant led by the service sector. US tech spending, supported by higher corporate free cash flow and the need to reduce cost pressure, would remain strong, spurring additional hiring by the IT and ITeS sectors. We believe a skilled labour shortage (reinforced by slowing population growth rate- as per the latest census), coupled with the aggressive hiring plans by IT and ITeS, could exert significant upward pressure on salaries across other sectors. This augurs well for urban-consumption demand. Rural consumption shall likely remain supported by higher support prices for agricultural products and higher government redistributive expenditure. We feel that consumption could be a major growth driver for the economy going forward.

The net profit of the Nifty companies has grown at more than 20% in the trailing 12-month period for each of the past four quarters. Considering the uncertainty on the macroeconomic front, the companies should be able to grow profits at a conservative rate of 13-14% in FY12. On that basis the Nifty trades at a 1-year forward PE of 16.2 (on an estimated EPS of ~Rs. 1200 for FY12), which is neither very cheap nor



expensive. However, the valuation is slightly higher than the long-term average PE (8-10 year average PE), which stands at ~15x

While the Indian Government continues to remain optimistic about India's growth story going forward, we feel that factors like increasing oil prices, political issues & increasing co-relation of market earnings growth to the global factors need to be closely monitored. That can actually put the premium valuations of the Indian markets vis-à-vis other emerging markets under pressure. Around 55-56% of earnings of the Indian market are currently co-related to global factors. These earnings either come from global commodities or from international subsidiaries of Indian corporates. As the co-relation of India's earnings to global growth increases, the chances of India enjoying substantially higher premium to its peers also reduces.

While Indian markets continue to be more FII driven, retail participation is equally important. Substantial PE expansion seems difficult unless there are more earnings upgrades. It took nearly \$29 bn in investor flows in CY10 to cause the market to rise steadily until Nov 2010 but relatively tiny outflows have caused sharp reversals. For markets to surpass the all time high, the retail participation (directly or through mutual funds) is also important. After registering a sharp rally in March 2011, the markets are likely to consolidate in the month of April before taking any further direction. The Sensex could trade in a range of 19000-20000. Along with the oil prices, inflation & corporate results, state elections in April & May 2011 would also be keenly watched by the market participants & would test the Government's pragmatic or populist approach to policy issues in this period.

Over the long term, India's growth rates could remain attractive than most other emerging & developed economies. Hence India remains a long-term buy on sharp dips.