NextGen India Investments

India Equity Market Outlook: 2009

Gold and Oil to outperform all asset classes

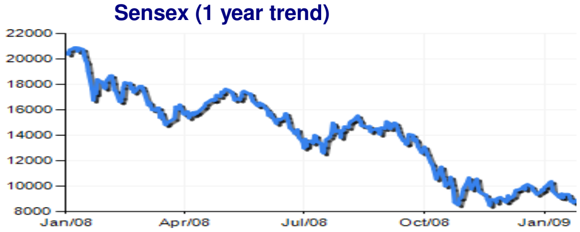
Equity Strategy

Market Outlook
Neutral (N)

19 January 2009

BSE Sensex	9,342
BSE 100	4,760
Sensex 52 weeks range	20,079/ 7,697

Sensex (1 year trend)



BSE Sensex Performance (%)	1m	3m	12m
Absolute	-6.3	-11.7	-53.0

Key Indicators	Sensex	BSE-100
PE	12.2	13.9
P/BV	2.5	2.4
Div. Yield (%)	1.9	1.8

Energy and Precious Metal	
Crude Oil Futures (USD/bbl)	38.4
Gold 100 OZ FUTR (USD/t oz.)	840.4

Forex and Money Market	
India GSec Yield (10 Year %)	4.6
USD/INR	48.3

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All prices are closing prices for January 16, 2009. Data is sourced from Bombay Stock Exchange (BSE), Bloomberg and the subject company. This report should be considered only a single factor in making investment decisions.

Equities: Neutral Outlook

At current level of 9300, the view on BSE Sensex is neutral. The global downturn started with financial sector and now real economy is getting impacted. Equity price movement has become more events driven therefore uncertain. The economic upturn between 2003 and 2008 seems to be driven by excess liquidity; now in the absence of the liquidity boom, emerging markets are expected to grow at long term trend growth. Once global equity markets find bottom, due to favorable growth differential India would continue to remain favorable for foreign capital inflows.

Impact of expansionary monetary policies on Asset prices

Historical evidence indicates that central banks' response to economic crisis has been the use of expansionary monetary policies. It often leads to disproportionate increase in the value of unrelated assets, it is to be seen which asset class gets upturn in prices.

Crude oil offers favorable risk reward

Non-discretionary nature of demand and limited sources of supply favors long term investors to invest in crude. Current price at US$ 38.4/bbl offers favorable risk reward for crude.

Gold may break long term range on upside

Though the reason for this crisis is excess liquidity, the intended response by central banks is creation of further liquidity by easing monetary policy. This raises question about success of central banks' policies in solving the problem. It also makes financial assets and financial system vulnerable. During such uncertain times, Gold has proved as an insurance against inflation. Current lack of confidence in financial assets may lead to long term upturn in gold prices.

Market outlook: Neutral

Global downturn has started impacting real economy

At current level of 9300, the view on BSE Sensex is neutral. The global downturn started with financial sector and now real economy is getting impacted. Equity price movement has become more events driven therefore uncertain.

One view on the economic upturn between 2003 and 2008 is that it was driven by global liquidity, that made the capital cheap, caused surge in US led demand and artificial jump in growth rate. For emerging markets also, the upturn was driven more by liquidity than by demography and acceleration in reforms (as was thought earlier). Now in the absence of the liquidity boom, emerging markets are expected to grow at their long term trend growth.

Having said that, once global equity markets find bottom, global investors would evaluate different markets based on inherent potential; the differential between GDP growth rate of India and developed economies (mainly US) is expected to remain in favor of India and may drive capital inflow. However the bottom forming process is still at least 6 months away.

Emerging markets have been outperforming developed markets

Emerging market equities have already been outperforming equity from developed countries in this downturn. India/ China/ Brazil are quoting at 3 years low, against 5 years low for Dow, 6 years low for FTSE and Multiyear low for Nikkei. India and China are expected to continue outperformance in the long run due to higher proportion of domestic demand and relatively stable currencies than other emerging markets (like Brazil/ Russia). Short term concerns emanating from corporate governance issues such as Satyam may have adverse impact. In case regulator tightens the rules more stringently than warranted, it may keep valuations suppressed for relatively longer time. Some other concerns for Indian markets are absence of reforms since 2003, decline in the quality of governance and escalated equity risk premium due to adverse geo-political situation. However fall in energy prices would help restoring external trade balance therefore would lead to reduction in inflation and reduction of interest rates in the economy.

Market may take time to start new bull run

BSE Sensex held it's bottom despite adverse events

BSE Sensex held its bottom of 7800 (October 2008) despite adverse events such as Mumbai attacks and recent Satyam issue. It apparently represents appetite for Indian equities at lower levels. However upside is getting capped. Volatility continues to be high, which indicates time-wise bottom is still away. At the market bottom, it is needed that participants loose interest in the market, volatility reduces and volumes fall. Time wise, we are still away from this situation.

Market downturn to create numerous value traps

Also, a common tendency of investors during such times is to get involved in bargain hunting/value buying; however in Indian situation often such downturns create numerous value traps; empirical evidence from previous Indian equity cycles is that the sector that led the upturn in bull phase generally doesn't lead the bull run in next phase. Going by the same analogy, infrastructure and capital goods may create value traps for investors. At the same time, such sectors may create opportunity for short term traders due to confusion regarding price rediscovery of stocks from such beaten down sectors.

Creation of panic bottom is not ruled out

Ironically, in the last decade, Indian and US market created panic bottom at the reversal stage. This panic was either caused by terrorist attacks or big scam. Such events presented opportunities for long term investors to pick stocks. Though so far, Indian markets have held its ground despite adverse events, the possibility of panic bottom creation in response to future scam/terrorist attacks is not ruled out. Such occurrence of creation of panic bottom may indicate trend reversal.

Impact of expansionary monetary policy on asset prices

Central banks' expansionary monetary policies to lead new bubble

During previous crisis such as Russian and South East Asian currency crisis, central banks reduced interest rates; it has been observed such monetary easing leads to disproportionate increase in the value of unrelated assets such as technology stocks during year 2000 after monetary easing of South East Asian crisis. Then technology stocks corrected and interest rates were cut, that led to bubble in housing markets/ real estate. And in 2008, when housing problem intensified the bubble shifted to crude oil and drove the prices to $145 a barrel. Now again the response of central banks is easing of monetary policies, it is to be seen which asset class gets upturn in prices.

Crude oil offers favorable risk reward

Crude prices favor long term investment

Though crude oil prices are at historical lows, non-discretionary nature of demand and limited sources of supply favors long term investors to invest in crude. It is expected that crude production may peak during Mid-2009 causing further intermediate term decline in prices. Having said so, staggered purchase between $20 and $35 a barrel with over 3 years perspective may have favorable risk/return profile. In India, energy futures have short maturity causing escalated transaction costs associated with frequent rollovers. Alternative is, exposure through oil exploration stocks though the correlation of their stock price movement with crude price movement is relatively less. For US based investors, NYSE listed “USO": http://www.unitedstatesoilfund.com, provides better opportunity to directly take exposure in crude.

Gold may break long term range on upside

Success of central banks' policies questionable; uncertainty to favor gold prices

Though the reason for this crisis is excess liquidity, the intended response by central banks is creation of further liquidity by easing monetary policy. This raises question about success of central banks' policies in solving the problem. It also makes financial assets and financial system vulnerable. During such uncertain times, Gold has proved as an insurance against inflation. Current lack of confidence in financial assets may lead to upturn in gold prices. At current gold prices of US$ 840 per ounce, Dow/Gold ratio is around 10, which though can't be considered high, still represents premium for Dow in such uncertain times. During 1930's, the ratio was close to 2; whereas during 1979 the ratio was 1 (Implying with one ounce of gold, one could have bought 1 ETF of Dow). Any upturn in gold prices coupled with downturn in Dow towards maintaining the parity may be in favor of investing in gold. It is to be noted that it would represent long term breakout for gold, therefore needs to be accompanied by strong buying by long term gold investors. It would be similar to breakout of Dow from 500-1000 range (in years between 1968 and 1982) and reaching current levels of 8000, breakout of crude oil from $10 to $40 per barrel range (between years 1979 and 2003) and later reaching $145 a barrel, breakout of BSE Sensex from 2800-4500 range (between 1992 and 2002) and then reaching 21,000. Since gold has been trading in a range of $300-$1000 since 1979, any breakout from $1000/ ounce may indicate long term trend reversal.

APPENDIX I

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Equity rating key for long-term investment opportunities

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Neutral (N) – The stock's total return is expected to be in line with the total return of the MSCI India Total Return Index, on a risk adjusted basis over the next 12-24 months
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Not-Rated (NR) – Currently we do not have adequate conviction about the stock's total return relative to the MSCI India Total Return Index, on a risk adjusted basis over the next 12-24 months
Unless otherwise specified, the time frame for price targets included in NextGen India Investments Research is 12 to 24 months.

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