NextGen India Investments

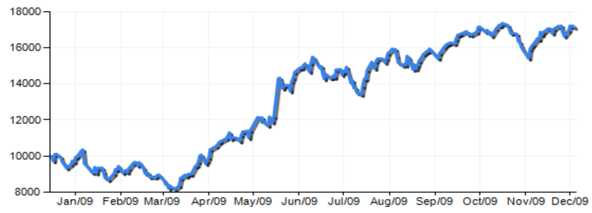
Market Outlook
Neutral (N)

Equity Strategy

16 December 2009

BSE Sensex	16,912
BSE 100	5,042
Sensex 52 weeks range	17,493/ 8,047

Sensex (1 year trend)



BSE Sensex Performance (%)	1m	3m	12m
Absolute	-0.8	1.4	74.1

Key Indicators	Sensex	BSE-100
PE	21.6	21.7
P/BV	4.1	4.1
Div. Yield (%)	1.1	1.0

Energy and Precious Metal	
Crude Oil Futures (US$/bbl)	72.9
Gold 100 OZ FUTR (US$/t oz.)	1,142.0

Forex and Money Market	
India GSec Yield (10 Year %)	7.6
US$/INR	46.7

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India Equity Strategy: 2010

Domestic fundamentals to improve; cautious due to rich valuations

Equities: Neutral Outlook

At current level of 16,912, the view on BSE Sensex is neutral with cautious outlook. In the first quarter, Sensex is expected to stay range bound between 14,500 and 18,500. In this year of consolidation domestic fundamentals would improve and establish base for long term upturn.

High valuations: Black clouds looming

We expect operating margins to contract despite momentum in revenues. Monetary tightening and supply of new paper would cause an intermediate term correction

Positioning for 2010: Key themes

We view current disinvestment as similar to privatization Disinvestment has potential to change long term investing landscape. We are overweight on water management, carbon trading, public private partnership in education, and defence procurement offset plays. Intermediate correction should be used to create long term positions in alcoholic beverages, hotels, cement, logistics and construction equipment companies.

Long term bull market in US treasury bonds is over

We believe that 28 years old bull market in US treasury bonds ended in December 2008. We expect this reversal to have long term impact on asset markets. Money printing would lead to inflation and rising interest rates in the US. Real assets would outperform financial assets.

Gold to continue shining

As expected in our India Market Outlook: 2009 (January 19, 2009), gold and crude oil have delivered a return of 36% and 90% respectively. We expect that inflationary outlook, fragile global financial system and worsening geopolitics would continue to support higher gold prices. At current prices we are positive on gold while neutral on crude oil.

BSE Sensex to trade between 12,000 and 21,000 in 2010

Market outlook: Neutral

At the current BSE Sensex level of 16,912 we are neutral with cautious outlook. As a deep value investor, we believe that except for a few bottom up ideas, current valuations do not support long term investments. In the first quarter of 2010, Sensex is expected to stay range bound between 14,500 and 18,500; for the calendar year 2010 it is likely to trade between 12,000 and 21,000. We expect domestic fundamentals to improve and reform process to gather momentum. It would be a year of consolidation when long term fundamentals improve and equity valuations may mildly soften or stay stable therefore building a solid base for the long term upturn.

Higher input costs may adversely impact corporate margins

Corporate margins: An invisible challenge

Indian market is currently trading at PE multiple of 21.6 (trailing 12 months), this is historically a higher PE band. While we are convinced that momentum in revenues would continue in the first 2 quarters, we are circumspect about operating margins. Prices of real assets including coal, ferrous and non ferrous metals, and agricultural commodities may increase in 2010. Indian consumers and economy have limited ability to absorb cost push inflation. Such higher cost of inputs may cause erosion in margins, and fall in return on capital employed thus leading to contraction in equity multiples.

Exhibit 1
Navigating future challenges

- Contraction of operating margins
- Rising decibels on monetary exit
- Fund raising at high valuations
- Cheaper overseas markets
- Withdrawal of fiscal stimulus

Monetary exit to lead intermediate correction

Monetary exit to gain momentum

Equity valuations have negative correlation with interest rates. Between January and March 2010, we expect RBI to mildly tighten monetary policy. High fiscal deficit, improved credit off take and central bank's preference to curb any asset bubble or inflationary pressure would lead to increase in interest rates in the economy. While such increase in interest rates would not reverse long term structural bull market in India, it will cause intermediate correction.

Primary market activities slowing turning into irrational exuberance

Increased fund raising to elevate risks

Post May 2009, fund raising activities from primary market have increased. We expect this trend to continue in 2010. While listing of new public sector undertaking would be fundamentally positive, it may temporarily affect liquidity in secondary market. Current trend to price initial public offers at rich valuations would adversely impact investor sentiments and lead to correction in equity prices.

India is more expensive than some other Asian markets

Cheaper overseas market to make FII flows trickier

Emerging markets such as Taiwan, Korea, Thailand, and Singapore offer higher dividend yield than bond yields. Equity valuations in these markets are more reasonable than in Indian market. In case of short term correction FII's may chose to stay invested in these markets over Indian market. However such correction should be used to create long term positions as large domestic demand, favorable demographics, potential for outsourcing, under ownership of equities by Indian households, and reform process would continue to keep Indian fundamental story intact.

Roll back of fiscal stimulus and implementation of direct tax code may lead to short term correction

Fiscal stimulus to fade in 2010

During 2010, government may roll back the fiscal stimulus. Though we expect such roll back to happen only after observing reliable signs of revival in export demand, it may cause temporary correction in the stock prices of export related sectors. Export sensitive sectors such as diamond jewellery, tanneries, and export oriented auto ancillary companies have underperformed in the last 6 months. There have been lack of earning visibility due to adverse export demand; however signs of sustainable revival of international economy may lead to uptrend in valuations of these sectors.

In case government decides to implement new direct tax code in 2010, that would lead to temporary sell off in equities.

Themes to play

Due to structural reasons, we are positive on long term potential of water management, companies related to defence procurement offset policy, carbon trading, logistics, public private partnership (PPP) plays in education, alcoholic breweries, construction equipment and listing of new PSU's by way of disinvestment. Correction in the broad market should be used to create long term positions in the stocks belonging to these themes.

Disinvestment: A key fundamental trigger

Disinvestment to change investing landscape

Exhibit 2
Riding the macro themes

- Disinvestment
- Carbon trading
- Defence procurement offset policy
- Public private partnership in education
- FDI and sector specific reforms

Demonstrating its commitment for reform oriented policies and to bridge the budgetary deficit, government has increased momentum of disinvestment. For emerging economies reforms play an important role in expansion of PE multiples and contraction of treasury bond yield differential with developed markets. Such reforms increase sustainability of long term economic growth, generate employment, enhance productivity in the economy and improve capital output indicators.

In our view, disinvestment program would be a key long term fundamental driver. In the short run it would contain fiscal deficit; in the long run it would increase size and depth of Indian equity markets. This disinvestment program would have similar economic impact of the privatization program initiated by the UK's former Prime Minister Margaret Thatcher in 1980's that led to substantial foreign funds inflow and rerating of many PSU's owned by the government of the UK. While in 2010, we don't expect Indian government to decrease it's shareholding below 51%, the disinvestment program would improve governance structure, increase capital efficiency indicators and provide investors the opportunity to participate in the growth of attractive businesses. Having said so, we are cautious on pricing; post listing investors may chose to patiently wait for price corrections in secondary market before taking long term position in selected PSU's.

Exhibit 3 Positioning for 2010		
Overweight*	**Neutral**	**Underweight**
▪ Water management ▪ Hotels ▪ Cement ▪ Alcoholic beverages ▪ Logistics & warehousing ▪ Agriculture ▪ Construction equipment ▪ Railway signaling * Overweight on conservatively priced bottom up ideas	▪ Textile ▪ Paper ▪ FMCG ▪ Consumer durables ▪ Media ▪ Real estate ▪ Infrastructure ▪ Insurance ▪ Pharmaceuticals	▪ Telecom ▪ Petro Chemicals ▪ Aviation

Hospitality: Trading below replacement cost

Hotel stocks to turnaround soon

Hotels present a long term investment opportunity since most of them are trading at valuations below their replacement cost. Initial indicators of turnaround in occupancy levels and average room rates are favorable for the sector. Commonwealth games in the second half of 2010 present attractive opportunity for North India based hotel companies. After 15-20% correction from current stock prices of hotel companies, fresh positions can be created selectively.

Cement: Stock prices to bottom out in 2010

Cement to provide opportunity to selectively value pick

In our view, 2010 would provide opportunity to create long term position in cement stocks. For cement companies results for December 2009 quarter would be subdued due to pricing pressure and lag effect of adverse monsoon. Potential increase in coal and transportation cost would further cause margin erosion. Though the sector has been underperforming due to fear of new capacity additions, we are convinced about long term potential. Emphasis on infrastructure creation would be a key trigger. We don't rule out the possibility of sharp correction in the stock prices of cement companies, and in some cases it may drive valuations of some companies at distressed levels. We will be using these distressed valuations as a long term investment opportunity.

Reform and rationalization to change landscape

Overweight on alcoholic beverages and agriculture after price correction

We expect agricultural reforms to gain momentum in 2010. Stocks of companies operating in irrigation, agriculture supply chain, agro chemicals, and warehousing may be considered at reasonable valuations. Steps towards implementation of GST would be positive for the economy. In the long run, it may rerate logistics companies. Creation of dedicated freight corridor would be favorable for companies related to warehousing, railway signaling and transmission.

Demographic factors and low penetration levels present long term potential for Alcoholic breweries; however rationalization in indirect tax structure is needed to improve profitability. Any indication to reform government policies may lead to rerating. We continue to be overweight in the sector due to attractive EV/Sales indicators and prospects of long term increase in consumption.

Textile and Paper: Spare capacity makes it hard to generate inflation

Though in the last one month textile and paper stocks have outperformed due to indications of revival in overseas demand; we continue to be neutral due to overcapacity at global level. Only a sharp dip in frontline stocks would make the valuations attractive.

Growth sound, but margins under pressure

Margin concerns would reemerge; FDI limit relaxation to provide growth impetus

Though infrastructure, consumer durables and fast moving consumer goods companies may record good revenue growth; higher input costs may lead to contraction in margins. We are cautious on real estate as we believe there is still oversupply. Rise in interest rates may further impact demand prospects. However we are convinced about structural potential of real estate and would use any price correction to selectively bottom pick. We expect increase in FDI limit for insurance and would be positive on selected companies in the sector at reasonable valuations. We continue to be neutral on radio business despite expectation of increase in FDI limit since there are concerns about limited market size, high license fee and intense competition. We continue to remain underweight in telecom due to increased competitive pressure.

Though during the first quarter due to oversold position in greenback, US$ would strengthen against rupee, in the long run we expect US$ to weaken. At the same time any sign of recovery in US economy would be positive for IT. Bottom up approach should be used while creating position in mid cap IT stocks.

Technical indicators: Tired, a question of supply and demand

Correction to 12,000 would strengthen the long term technical position

On upper side, the immediate resistance for the Sensex is 17,500. In case of Sensex convincingly crossing this level, midcaps would rise more than the frontline stocks. On downside, there is intermediate term support at 15,500 and then at 14,500. During the first quarter of 2010, we expect the Sensex to stay in the range of 14,500 and 18,500. In case of extremely negative news flow, Sensex may create a panic bottom at 12,000. In our view correction to 12,000 would be technically positive as the Sensex will fill the gap of 1300 points it made post election results on May 19, 2009. In that case, stock ownership would move to stronger hands that would be positive for the long term strength of the markets.

Fading returns on FII inflows

Substantial FII inflows fail to cheer markets

Exhibit 4
Market needs to consolidate before moving up

- Fading returns on FII inflows
- 1300 points gap in Sensex to be filled
- Dollar carry trade to continue

Though new high/low indicator is favorable, we believe a correction is needed to keep the long term uptrend intact. The ratio of buy/sell analyst calls is heavily tilted in favor of buy calls therefore indicating short term tiredness for the market. Since June 2009, there has been trend of reducing rate of marginal return on FII inflows. The rally from Sensex level 8,000 in March 2009 to 15,000 in May 2009 saw an FII inflow of about US$ 5.5 billion. However from June to November 2009, there has been inflow of over US$ 14 billion yet the Sensex increased only by 15% to 17,000. Since the last 2 months, despite over US$ 2 billion FII inflow the market is at the same levels. Though there has been rise in the price of midcaps, we believe that current valuations largely don't support long term investments. In case of sharp pullback, we don't expect support from domestic institutions due to rich valuations.

Dollar carry trade may continue in the first quarter

There has been global trend of inverse relationship of the dollar index with equity prices. Sensex has also been following the trend. In the short run, we believe that dollar is oversold. Any pullback in the greenback may cause correction in emerging market equities including in Indian equities.

Liquidity: Problems of plenty

Secular long term trend of money inflow to India would continue

In our Equity market outlook for 2009, we mentioned that liquidity surge by central banks often leads to disproportionate rise in the value of unrelated asset class. During 2009, money printing by the US Fed led to substantial FII inflows to emerging markets including to India. Higher deficit in developed markets such as the US and the UK would continue to drive long term investments in India. Such fund inflow would keep Indian rupee buoyant against US$ and would prevent interest rates to rise above a threshold level. However there would be intermittent corrections in Indian equity prices. Such corrections may be driven by increase in the value of greenback, signs of recovery in US economy, increase in benchmark bank rate by the US Federal Reserve. In case US economy cracks that would lead to significant FII outflows from emerging markets; in that case Sensex may test 12,000.

Long term bull market in the US treasury bonds is over

Reversal in the long term bull market for the US treasury bonds

There have been debates over inflationary or deflationary outlook for the US economy. We are in the inflationary camp since we believe that substantial money printing by the US Fed and US government's inability to control fiscal deficit would lead to inflation. To control inflationary pressure the US central bank would increase its benchmark bank rate. That makes us bearish on the US treasury bonds. Bull market in the US treasury bonds started in October 1981. In our view this 28 year bull market has ended in December 2008 and now we expect expect that US treasury bonds would underperform for the next few years. This reversal will have long term impact on asset prices as it will impact liquidity, risk appetite towards equities, long term lending rates, and deficit situation in the US.

Exhibit 5
10 year US treasury bond yield : Year 1970 to 2009

Source: US Federal reserve (www.federalreserve.gov)

Post 2006, risk aversion for the US corporate bonds has increased. In year 2006-07, the spread between A rated US corporate bond yield and 10 years US treasury bond touched ten year low of 120 basis points; this spread has now widened to over 400 basis points thereby indicating increased risk aversion from the US corporate bonds. We believe that this trend is a significant indicator as it raises questions on the recovery of the US economy. In line with this trend, we continue to believe that recent surge in the US equity markets is liquidity led. There have been concerns about sovereign rating of the US and the UK, though we expect the distressed situation to continue in 2010, we don't have any view on the rating migration as occurrence of such event would entail a systematic risk.

Global economy: Patchy road ahead

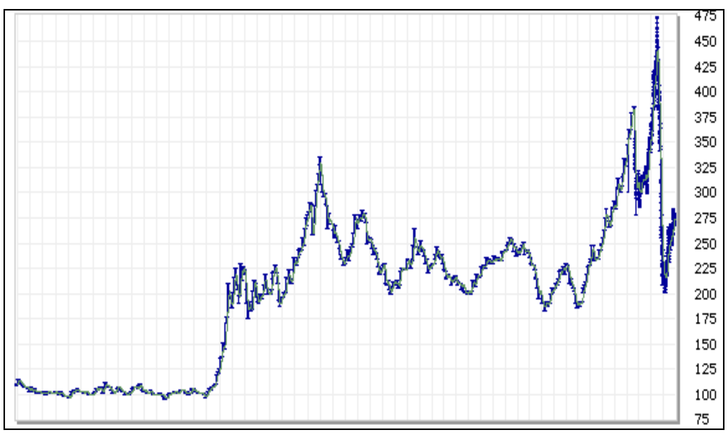
Global uncertainty to increase equity risk premium for emerging markets

Governments in other countries have also been facing recessionary pressure. Dubai, Greece, Iceland and Ireland have already witnessed rating downgrades. In our view this trend may continue in 2010 and more countries including Spain, Argentina, and Ukraine may join the list. We also expect that currency markets would continue to be volatile. Recently Vietnam devalued its currency and Brazil put special tax in currency markets. We see similar steps by other countries to prevent their currencies. Due to these uncertainties we expect escalation in risk premium for emerging market equities. Formation of new government in Japan creates uncertainty about government policies. We would continue to watch political developments in Japan and direction in government policies to determine their impact on equity prices. We also continue observing other emerging markets such as Cambodia, Laos, and Mongolia as we believe that these economies may enter into a growth phase and attract FII inflows.

A paradigm shift towards real assets

Real assets to continue outperforming over financial assets

Exhibit 6
Reuters CRB Index : Year 1958 to 2009



Source: Chicago Board of Trade

Uncertainty in global economy is expected to be in favor of real assets. In case there is recovery in international economy then due to increased demand there would be uptrend in commodity prices. If global economy does not recover and inflationary pressure increases in that case too commodity prices would increase against currencies. We hold long term overweight view for agricultural commodities including Wheat, Sugar and Rice. We are also overweight on Coal, Chromium, Natural gas, Uranium and Manganese since China lacks these resources and we expect them to build reserves. Lithium market to stay volatile during 2010 due to news flow regarding new discoveries. Technically as long as Reuters CRB index holds its long term support levels at 197 and 180, bull run in commodities would continue. Supply side constraints, fall in prices in real terms over the last 25 years, trend of increasing consumption levels due to rising population and uncertainty in the financial sector are the main reasons for our bullishness for commodities.

Crude oil: Hold

Continue to hold crude oil positions

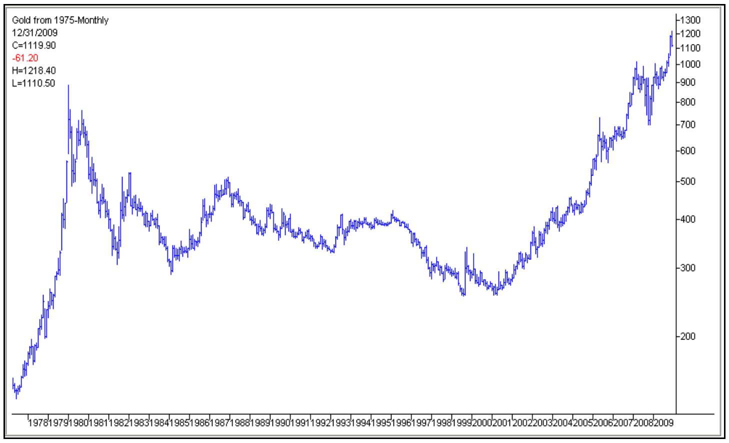
Crude oil is trading 90% above our overweight call of US$ 38.4 per barrel in January 2009; at current prices our view is neutral. However any sharp correction should be used to make long term position in energy futures. In India, crude oil can be traded through crude oil futures in commodity exchanges. For overseas investors, NYSE listed "USO":http://www.unitedstatesoilfund.com, provides opportunity to directly take exposure in crude.

Gold to continue shining

Economic and geopolitical factors to continue supporting higher gold prices

Gold has delivered a return of 36% from our call at US$ 840.4 in January 2009. As expected gold prices crossed its 30 years range and closed above a key resistance level at US$ 1030 per ounce. Fundamentally we continue to like gold as an insurance against inflation. Uncertainty in financial markets would keep the demand buoyant and gold would continue to replace dollar in central banks' reserve. Since supply of gold is limited higher demand would continue to drive prices upward. IMF has emerged as a major seller of gold to central banks and we expect gold prices to stay range bound till this selling continues. Once the selling is over gold may enter into the next stage of bull market. In India and in overseas markets, exposure in gold can be taken through exchange traded funds (ETF).

Exhibit 7
Gold prices US$ per ounce: Year 1978 to 2009



Source: World Gold Council

In our view, higher commodity prices lead to geopolitical tensions and wars. Such developments would be conducive for further uptrend in gold prices. Despite these factors, we believe that the upturn in gold prices is rather quick and a sharp correction till US$ 1030 per ounce is not ruled out. In case gold breaks the support of US$ 1030 per ounce, it may settle at US$ 800-US$ 900 price range and stay range bound for long. That situation would be accompanied by improved prospects of global recovery and fall in risk aversion from financial assets. In case gold falls below US$ 700 per ounce (May 2008 low), we may need to revisit our hypothesis of investing in gold.

APPENDIX I

Disclosure Section

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Equity rating key for long-term investment opportunities

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