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Subject: Impressive returns likely for Indian equities in the next 3 years accompanied by changing and expanding product leadership

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Impressive returns likely for Indian equities in the next 3 years accompanied by changing and expanding product leadership -A mid year Indian market view July 23, 2007

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Background

My last 2 notes of Jan. 4, 2007 and post budget March 1, 2007 ended with the following recommendation:

‘For the next few years, stock market should continue to deliver good returns. Overall, still the business cycle stage is such that a heavier allocation to Indian equities is favourable and therefore the current drop (a lot of it from global cues rather than the budget) serves as a very good buying opportunity. Recommendation will be to continue to allocate a higher proportion of portfolio to stocks, though selectively and with a more careful monitoring of markets and risk factors.

NRI’s will be able to enhance their total portfolio returns by allocating a significant part of their portfolio to Indian equities.’

What happened in the first 6 months of 2007

Sensex has moved up from 13787 to 15565 while the rise in midcap stocks is even more impressive with CNX Midcap Index moving to 6268 from 5200. Even smallcaps have started moving up with BSE Smallcap Index going up to 8188 from 6862.

The economic scenario is even more robust with the latest Indian GDP figures showing a 9.4% growth. Inflation (as measured by WPI) is fairly well controlled as the recent weekly figures have fallen to a level of 4.27%- this had risen to more than 6% during the last 3 months prompting monetary, fiscal and supply side measures. Indian Rupee has appreciated significantly to Rs 40.25/USD and has impacted the results of companies depending on exports and especially Information Technology sector including Infosys, However, many corporate sectors stand to benefit from the appreciating currency.

Forecast

More robust economic growth is expected with controlled inflation. RBI in its forthcoming credit policy is expected to keep interest rates stable. 10-year treasury bonds have seen a decline in the yields from 8.3 % to 7.8%. Indian Rupee after a sharp appreciation is expected to trade in a range of Rs. 40-42 before resuming its long-term appreciation trend.

Stock market after its mid cycle correction in May 2006 has resumed its ascent in a robust manner. One factor that gives lots of confidence is that this initial rise is not broad based with very few stocks contributing to this rally. Consequently, there is tremendous undervaluation of many sectors and stocks giving rise to corresponding opportunity.

Domestic sectors including infrastructure, finance and telecom should deliver impressive returns.

Changing and expanding market leadership

In the earlier post 1992 reforms period, well established companies like Franklin Templeton and HDFC performed very well. However, the market leadership has changed with Reliance, DSP Merrill Lynch, SBI and Fidelity delivering excellent comparative returns lately.

There has been some movement of well-regarded fund managers with J.M. Mutual fund hiring Sandip Sabharwal of SBI Contra fame in Feb. 2007. Interestingly, funds like JM Basic have catapulted to top positions ever since he took over. They are now introducing JM Contra with some interesting strategies and I believe that it will perform well.

Another heartening factor has been the introduction of products in various asset classes. Some examples of new innovative products include Sundaram Global Fund, DSP Merrill Lynch World Gold Fund, HSBC capital protected equity fund and Reliance structured hybrid product.

It is therefore now possible to diversify the portfolio across asset classes, thus facilitating our objective to structure your portfolio for maximizing returns with minimal risks.

Recommendation

Very similar to our earlier notes, we recommend a heavier allocation to Indian equities although with some changes in selection of funds.

NRI's should also have a significant allocation to Indian equities with good returns getting enhanced further with long-term appreciation of Indian Rupee.

Of course, the principles of long term horizon, diversification and appropriate valuation have to be followed always while investing in stocks.

I will be sending you specific recommendations for your portfolio.

Best wishes,
Dr. Sanjiv Mehta

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