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EQUITY OUTLOOK

ATUL KUMAR – FUND MANAGER (EQUITY)

During the month of June 2011, BSE Sensex gained 2.22% as compared to its level in the previous month. The narrow index i.e. BSE 30 did better than the other broader indices such as BSE 200 and BSE 500. Continuing their last month's performance, FMCG and capital goods were among the best performing sectors. Real estate performed poorly and was the major loser followed by Oil & Gas and Metals during the month.

FIIs were net sellers to the tune of approximately USD 1.48 Billion in June 2011. Calculating from the start of the calendar year to date, FII net flows have been negative and stand at USD 382 Million. On the policy side in India, clearances were approved for some mining blocks, spreading a wave of relief among corporate and individual investors, given the delay in past few months. Recently, the oil regulatory body also got dragged into controversy for favoring a few players at the cost of national exchequer. The list of nexus between corporate houses and others parties gets bigger.

RBI released its monetary policy in the month of June 2011. As expected, the policy rate was increased by 25 basis points. In May 2011, inflation stood at 9.1% and given that it continues to be above the comfort zone of the RBI, future rate hikes are likely to occur.

The Government of India finally raised the prices of diesel and cooking fuels during the month. There was a decent price hike in diesel, LPG and kerosene which was required, in order to bring down the losses of oil PSUs in India. The Government also cut excise/custom duties for these fuels, which will add to the fiscal deficit which is likely to shoot beyond the targeted 4.6%.

India is expected to perform better than many other economies in the future, bringing forward a number of opportunities for Indian companies. While inflation, slow government policies and weak global environment are among the key risks, we remain buyers of Indian equity for the long term.

GOLD OUTLOOK
CHIRAG MEHTA - FUND MANAGER (COMMODITIES)

Gold prices saw a sharp sell off during the month of June 2011, but ended with an 11th consecutive quarterly gain. However, with the authorization of an austerity plan which involved budget cuts and asset sales to reduce the crisis in Greece, and to qualify for the bailout made by Greek lawmakers, gold prices slumped as a safe-haven appeal at the end of the month. Also, markets exited the US Federal's bond-buying program and since then, the Central Bank is yet to come up with additional monetary stimulus. Thus, with the plans of rescuing Greece from its crisis and with the end of QE2, gold was prone to a speculative sell off on lack of triggers to pull gold prices higher.

As measured by the London AM Fix, gold prices declined by -1.9% for the month. However, for the quarter ended June 2011, it's prices increased by +4.9%.

Mixed set of economic data and the ongoing sovereign debt issues in the Euro zone led to increased volatility in the dollar and hence affected gold prices as well. The gold sell off began after the Federal Reserve's Open Market Committee (FOMC) meet boosted the dollar as Federal chairman, Mr. Bernanke avoided indications of future easing measures and commented favorably for the dollar. Additionally, efforts by Greece to stave off the Euro zone's first sovereign default led to further selling. These factors along with technical selling aggravated the decline of gold prices.

The correction in prices coincides with the seasonal slack in demand. However, if the price falls further, we can expect gold purchases to emerge from traditional consumption centers despite the seasonal slowdown. Demand in India has been growing at 10% to 11% over the last year which in itself was a record year. China's demand for gold will grow by at least 20% this year and is expected to double in the next two years, said Zhang Bingnan, deputy chairman of the China Gold Association. A key reason for a correction in gold prices is the long-term fundamental change in emerging markets as wealth increases and inflation stays high.

Outlook:

There does not seem to be much change for gold in terms of fundamentals. The sovereign debt issues have not been solved but instead, the possibility of a solution has been postponed by bailing out Greece as policymakers unveil one more rescue package. While it is a positive sign that austerity measures have been demanded along with the bailout, it is yet to be seen how much of it really materializes. Also, the US has avoided quantitative easing measures this time around but it has neither increased rates nor announced any exit strategies. It also remains to be seen until how long the Federal can keep up with this muted stance.

There could be a correction in gold prices in the short term if the dollar appreciates further, and this could be an opportunity to buy gold. Gold is being seen as a currency and the macroeconomic factors still lie in favor of gold, making it stronger as a safe haven asset. The global economy is highly fragile amidst high risks, especially with the sovereign debt issues because of which investors are increasingly losing faith on paper currencies and are leaning towards gold as a security as they diversify from the paper money.

An outlook on gold by Australian Government agency, Australian Bureau of Agricultural and Resource Economics **(**ABARE**)**

Gold may climb 23 percent to average $1,500 an ounce this year, up from a March prediction of an 8 percent gain, because of concern over global budget deficits and inflationary pressures, an Australian government agency said. Prices may advance a further 3 percent in 2012 to average $1,550 an ounce, the Australian Bureau of Agricultural & Resource Economics & Sciences said in a report.

The report cites the following reasons that would buoy gold prices higher:

- Uncertainty about the ability of many developed economies to stimulate economic growth and control growing budget deficits is expected to encourage investment demand for gold as a lower risk or safe haven asset.
- Emerging inflationary pressures in some developing countries such as China and India, could also support demand.
- Investment demand for gold is likely to benefit from the perception that its value is eroded less by price inflation than are the values of other asset classes.
- Gold demand from risk-averse investors is expected to remain strong as political and social unrest continues in some parts of the world, particularly the Middle East.

DEBT OUTLOOK
ARVIND CHARI- FUND MANAGER (DEBT)

Market Round up

In a largely expected move, the RBI continued its anti-inflation stance by hiking the Repo rate by 25 bps to take it to 7.5% in June 2011. This was the 10th benchmark rate increase since January 2010 which brought a total hike of 275 bps in the normalizing and rate tightening cycle. Recent inflation numbers have shown worrisome trends with inflation remaining above 7% and headline inflation at above 9.0% for the month of May 2011. The RBI had indicated in its previous policy that they expect inflation to remain at 9% till September, but the increased speed of manufacturing inflation is a cause of concern.

The RBI's outlook towards inflation was hawkish (suggesting more rate hikes) bringing out several concerns on this price increase and its impact on future growth. The RBI firmly believes that short term growth has to be sacrificed to contain inflation. They highlight that, the slowdown in global growth and the ongoing European sovereign crisis are obstacles to global growth prospects, and believe that recent drop in global commodity prices, while welcome, is not enough to remove it off the radar as a key external risk. Given the current scenario, we believe there would be another 25-50 bps hike in benchmark rates. But we are definitely close to the end of the rate hikes as market interest rates are a lot higher due to the rigid liquidity scenario.

Market movements have been strong with investors gradually taking position in the market since they expect an imminent end of the rate hiking cycle. In the bond market as yields fall, prices rise and with everything else remaining constant, the longer it takes for the maturity of the bond, the more is the price rise for a given fall in yield. The derivative swap markets have driven the rally (fall in yields) and change in investor's sentiments, with the 5 year overnight indexed swaps (OIS) moving down from 8.3% in early May to as low as 7.65% and closing at 7.75% towards the end of the month, while 10 year government bond yields fell to 8.22% from its high of 8.48%. We also saw strong trading activities in the longer tenor corporate bond market with AAA PSU yields trading between 9.60% and 9.70% levels.

The RBI has shown signs of a slowdown in its rate tightening cycle and economic growth, giving reasons to believe that the markets interest rates are poised for a fall. A fall in interest rates in bond markets will be a positive aspect since it leads to a rise in prices of existing bonds. But market movements will be driven more by global oil prices in the near term. If we see a sharp fall in Brent Oil prices, we would see immediate movements in the markets with long term bond yields falling since oil represents the biggest macro-economic risk for India. High oil prices worsens the trade deficit as India imports more than 70% of its oil requirement; it increases the fiscal deficit as retail fuel prices are subsidized and it strengthens inflation. A situation of falling oil prices would lower the inflationary expectations and support the fiscal situation, both of which are positive for bond markets.

We expect liquidity to remain stable and thus believe 3 month CDs would trade around 8.5% levels. 1 year CDs has softened to around the 9.5% - 9.75% level. So, although we expect market interest rates to ease on the back of slower growth and lower inflation, we do not see any rate cuts by RBI as inflation is likely to remain high due to the recent fuel price hikes. We also expect deposit rates to remain at current levels as banks restructure their asset-liability mismatches. The market interest rate levels are still attractive and investors should use this opportunity to fulfill their fixed income allocations.
