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India Strategy

Chart Focus: Respecting the Range

Key Debate: The Nifty has been highly respectful of the 5,300-6,300 range despite the slew of bad news. Given our recent upgrade of the EM view for 2H11, does this change the situation for India?

Our View: The market has underperformed EM since October 2010 by a significant 17%, reflecting the string of bad news in the form of alleged corruption cases, high inflation, rising rates, lack of policy initiatives, a prospective slowdown in growth, and a difficult global environment. While the market remains in the range for the near term, the case for a stronger 4Q11 and beyond is building. For now, we remain focused on stock picking given correlations across stocks (Exhibit 1). Essentially, the market has suffered more of a time correction in contrast to a price correction.

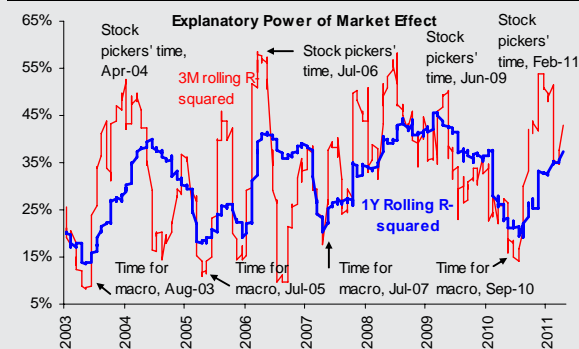
What's Next: 1) Our composite valuation indicator remains in neutral territory at best (Exhibit 2). India's relative valuations are still not attractive, and are a key reason why Jonathan Garner is underweight India.

2) Earnings revisions seem to be forming a trough (Exhibit 3). The earnings season will likely produce a significant amount of dispersion, but our focus is on where gross margins head. Gross margins are at decade lows and companies may start exhibiting pricing power lending upside risk to earnings in the coming quarters. Our proprietary earnings growth leading indicator (Exhibit 4) suggests that broad market earnings growth may accelerate moderately over the coming quarters.

3) Our proprietary sentiment indicator (Exhibit 5) is firmly entrenched in buy territory and is in sync with Jonathan's view of a rally. Our proprietary market timing indicator (Exhibit 6), which combines sentiment, valuations, and earnings, is also in buy territory.

Exhibit 1

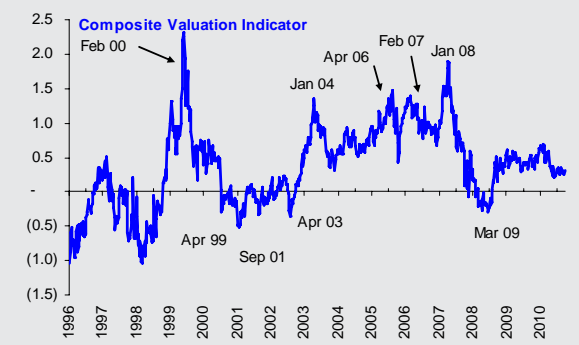
Market Effect Off Highs



Source: Bloomberg, Morgan Stanley Research

Exhibit 2

Composite Valuation Indicator: Neutral Zone



Source: Bloomberg, ASA, FactSet, MSCI, Morgan Stanley Research

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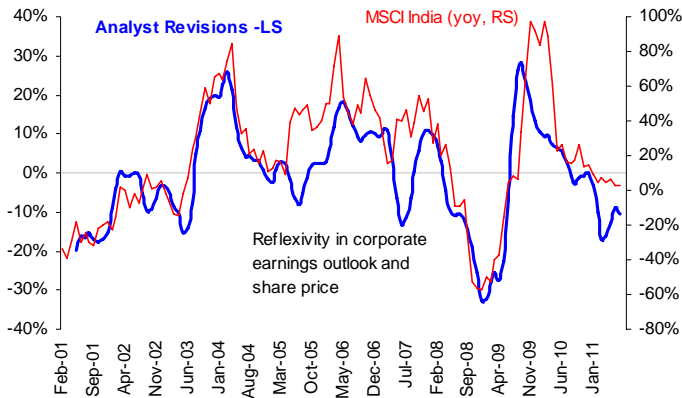
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4) Our modified earnings yield gap model (Exhibit 7) underpins our view that the market is setting itself up for significantly better returns as we head toward 4Q11 and beyond. See Exhibit 8 for key market indicators.

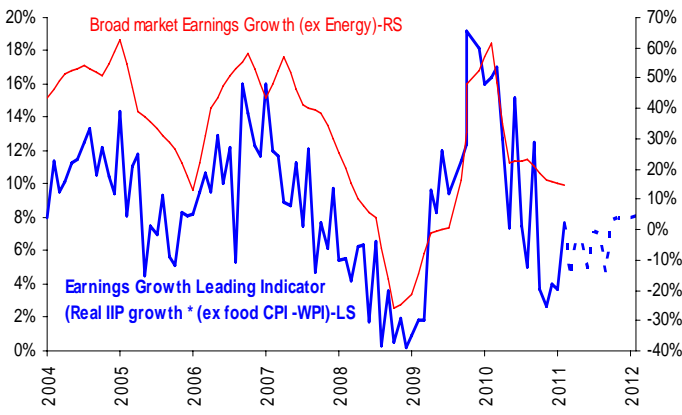
Conclusion: First, we continue to favor mid-caps over large caps. Second, we think domestic cyclicals look more attractive than before and, consequently, at the margin, we are buyers of industrials and consumer discretionary. Our favorite stocks include Larsen, Adani Enterprises, Mahindra & Mahindra and Infosys, among others.

Exhibit 3
Earnings Revisions Breadth Off Lows



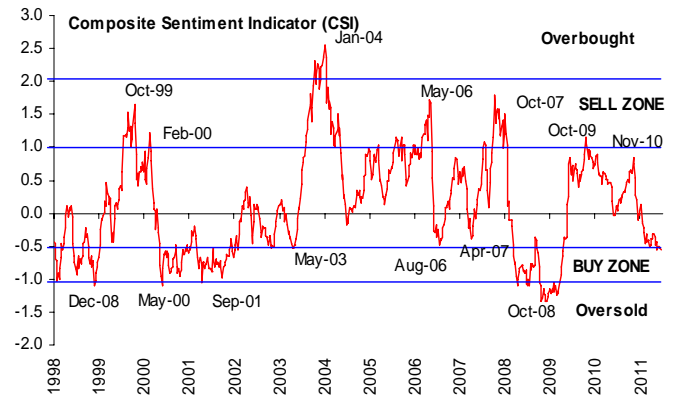
Source: FactSet, MSCI, Morgan Stanley Research

Exhibit 4
Broad Market Earnings Growth May Have Troughed



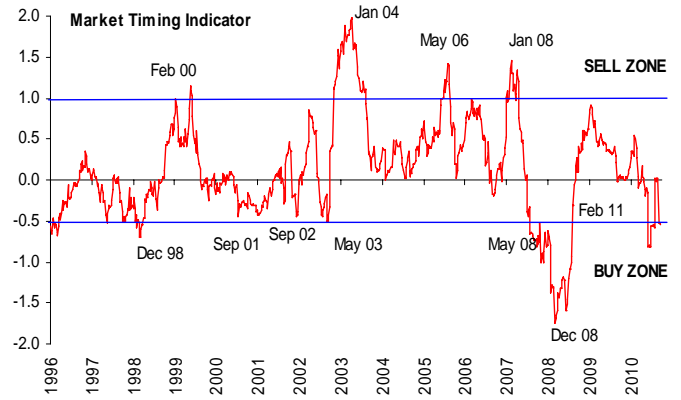
Source: Bloomberg, Morgan Stanley Research

Exhibit 5
Proprietary Composite Sentiment Indicator: Remains Weak



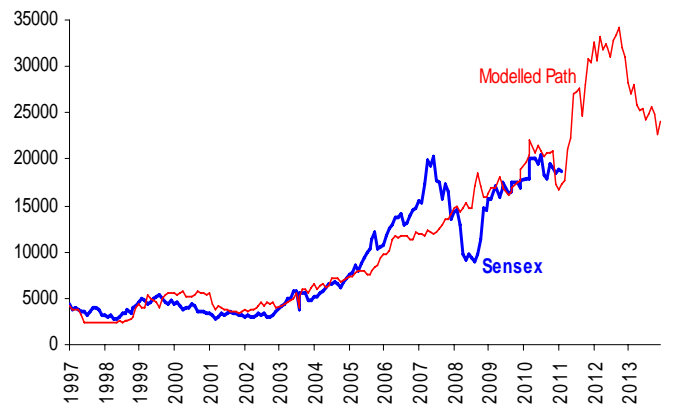
Source: Bloomberg, ASA, FactSet, MSCI, Morgan Stanley Research

Exhibit 6
Market Timing Indicator: In Buy Zone



Source: Bloomberg, ASA, FactSet, MSCI, Morgan Stanley Research

Exhibit 7
BSE Sensex vs. Modeled Sensex Path



Source: Bloomberg, Morgan Stanley Research

Exhibit 8

Summary of Key Market Indicators

Key Indicators	View
MACRO	
Industrial Growth	Industrial growth continues to slow, risk is that it falls further due to inflation/global growth issues
Current account deficit	Appears to be declining but crude oil is risk
Inflation	Remains sticky though the headline number could decline - risk is oil and other global commodities prices
Fiscal Deficit	Budgeted to decline but assumptions may turn out to be optimistic. Yet deficit is off its recent high point
Credit Deposit Ratio	Declining at the margin
Monetary policy	75bp rate hike likely
Government action	Not strong enough but improving at the margin: Retail FDI, Land acquisition bill, Urea price decontrol, Environmental clearances
Politics	Alleged corruption scandals may be slowing down policy actions
Monsoons	Unknown but forecasts call for "Below Normal" monsoons
Global risk appetite	Fragile - MENA risk, DM growth
VALUATIONS	
Absolute valuations	Attractive - ERP over 6% - consistent with strong returns
Relative valuations	Approaching long term averages
Valuations relative to bonds	Finely balanced, equities hold the edge on growth optionality
Composite Valuations	Broad market valuations look attractive
CORPORATE FUNDAMENTALS	
Earnings growth	Pricing power low, our proprietary leading indicator suggests moderate acceleration in broad market earnings growth
Earnings revisions	Revisions off lows
Capex	Remains tepid, at risk due to sharp change in Central Bank tone and action
ROE	Off the low point - key debate is whether ROE is on a structural decline
MARKET DYNAMICS	
Liquidity	Remains tight but may have troughed
Breadth	Weak
Momentum	Weak - again good for future returns
Hedging	Put-call ratio off highs, markets still appear hedged for downside risks
Flows	Mixed bag - Corproates, retail buying, FIIs may not have capitulated
Ownership	High for FIIs relative to history, though slightly off the peak in December
Performance	India has underperformed since Oct-10 though performance has been more volatile since the end of January
Stock Pledging	Off highs
Style	Market focused on low beta, high quality (low capex, high FCF and ROE)

Source: Morgan Stanley Research

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(as of June 30, 2011)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1138	41%	470	49%	41%
Equal-weight/Hold	1143	41%	365	38%	32%
Not-Rated/Hold	117	4%	19	2%	16%
Underweight/Sell	389	14%	96	10%	25%
Total	2,787		950		

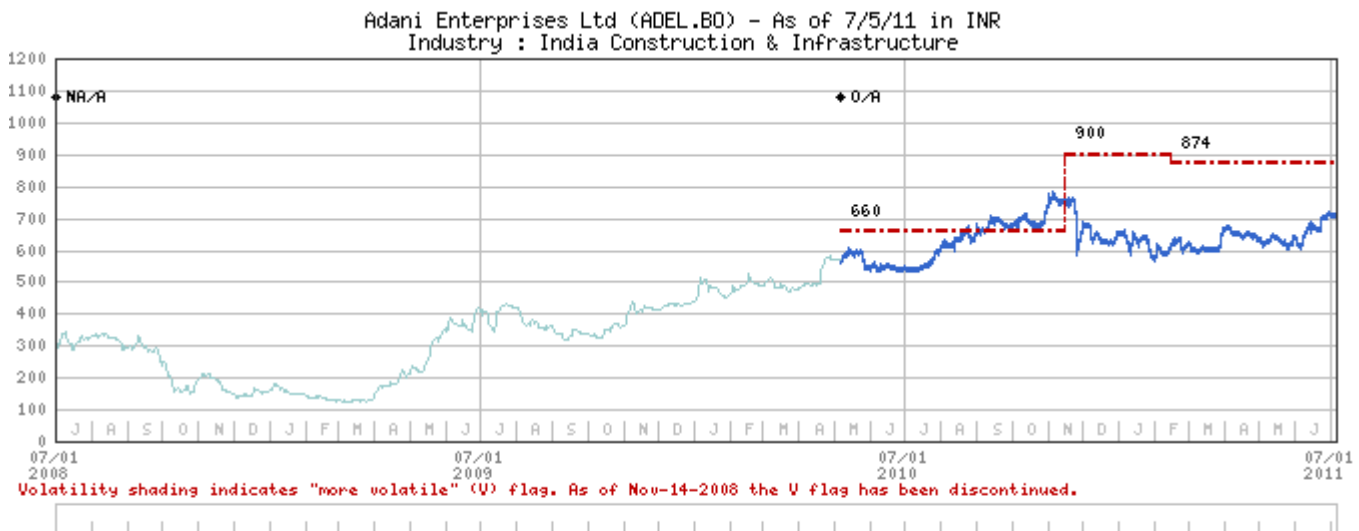
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Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.
 Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

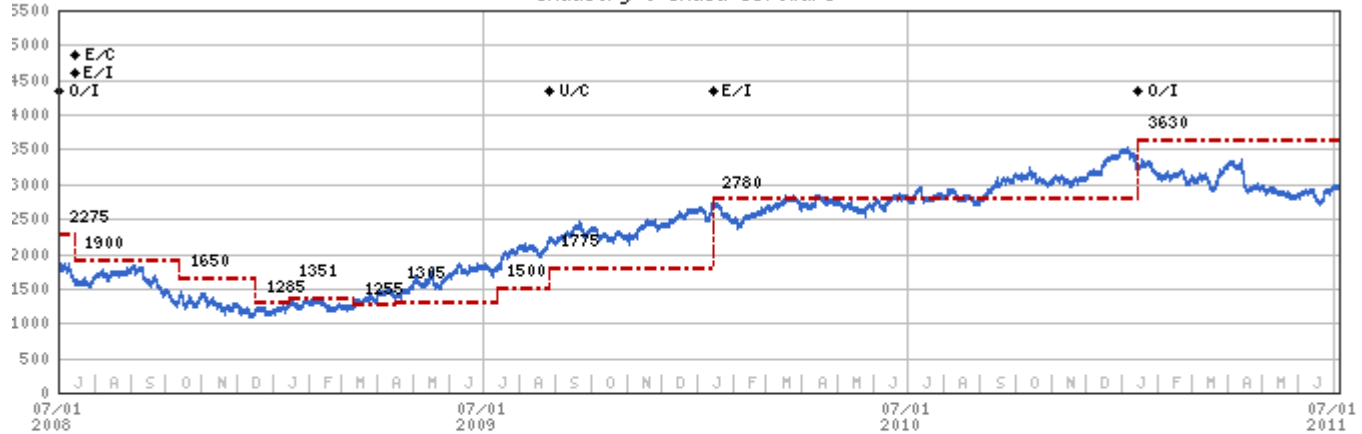
Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
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 Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.



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 Stock Price (Not Covered by Current Analyst) --- Stock Price (Covered by Current Analyst) ---
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (V) No Rating Available (NA)
 Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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Infosys Technologies (INFY.BO) - As of 7/5/11 in INR
Industry : India Software



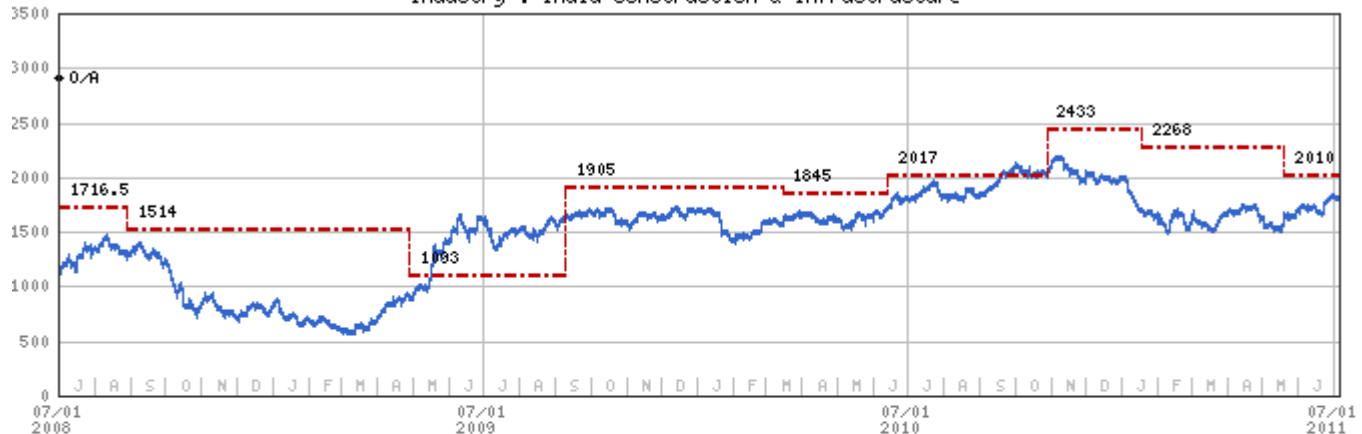
Volatility shading indicates "more volatile" (U) flag. As of Nov-14-2008 the U flag has been discontinued.

Stock Rating History: 7/1/08 : 0/I; 7/14/08 : E/I; 7/15/08 : E/C; 8/27/09 : U/C; 1/14/10 : E/I; 1/14/11 : 0/I

Price Target History: 6/10/08 : 2275; 7/14/08 : 1900; 10/13/08 : 1650; 12/17/08 : 1285; 1/14/09 : 1351; 3/11/09 : 1255; 4/16/09 : 1305; 7/12/09 : 1500; 8/27/09 : 1775; 1/14/10 : 2780; 1/14/11 : 3630

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Larsen & Toubro (LART.BO) - As of 7/5/11 in INR
Industry : India Construction & Infrastructure



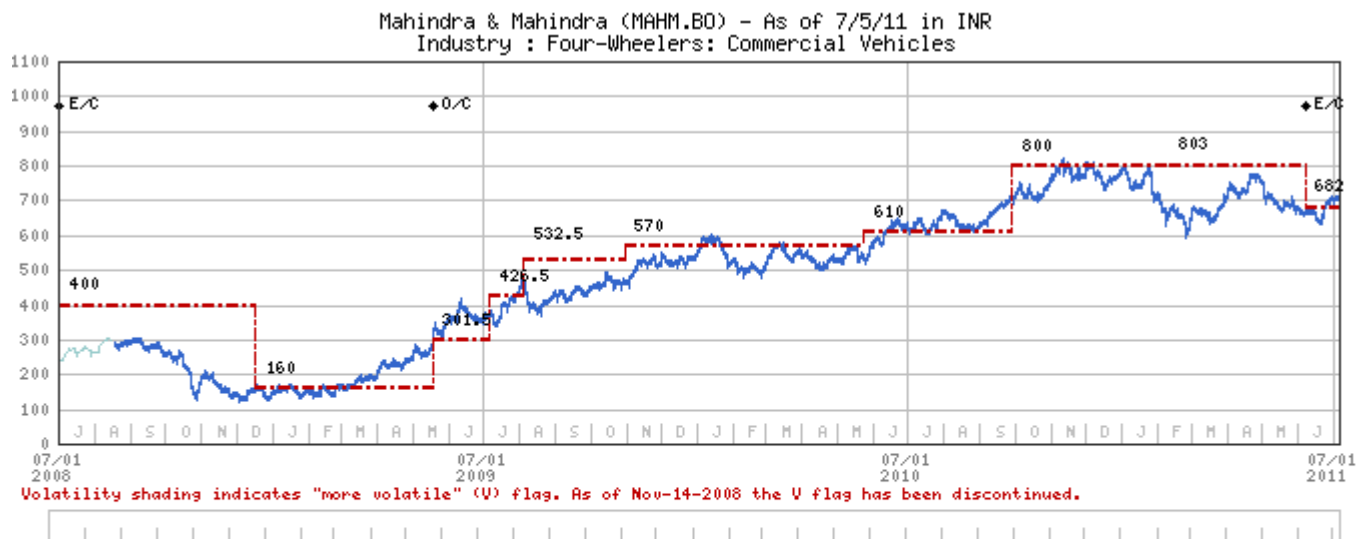
Volatility shading indicates "more volatile" (U) flag. As of Nov-14-2008 the V flag has been discontinued.

Stock Rating History: 7/1/08 : 0/A

Price Target History: 3/10/08 : 1716.5; 8/29/08 : 1514; 4/28/09 : 1093; 9/10/09 : 1905; 3/15/10 : 1845; 6/14/10 : 2017; 10/28/10 : 2433; 1/18/11 : 2268; 5/20/11 : 2010

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Stock Rating History: 7/1/08 : E/C; 5/18/09 : O/C; 6/7/11 : E/C

Price Target History: 2/4/08 : 400; 12/17/08 : 160; 5/18/09 : 301.5; 7/6/09 : 426.5; 8/4/09 : 532.5; 10/30/09 : 570; 5/24/10 : 610; 9/28/10 : 800; 2/10/11 : 803; 6/7/11 : 682

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target --- No Price Target Assigned (NA)
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