Market Review

DWS INVESTMENTS
Deutsche Bank Group

Details as on July 30, 2010

Equity Market

The market that was...

It was a relatively quiet month for the Indian equity markets. The NSE 50 went up by 1% during the month which happened to be a results season month. After outperforming global and emerging markets for two consecutive months, the Indian equity market trailed other equity markets. However, Small and Midcaps continued to outperform with the BSE Midcap and the BSE Smallcap indices going up by 4.1% and 3.5% respectively. After a long period of cautious sentiments, there was a strong bounce back in developed markets. This in turn led to strong inflows into emerging markets with FIIs investing a significant USD 3.5 Bn during the month. Financials and materials were the outperforming sectors while utilities, healthcare and energy were the underperforming sectors. The results season for the June quarter was average with no major earnings upgrades. Margin pressures across many sectors led to disappointments in quite a number of stocks. The monsoon rainfall advanced all over India and is likely to be adequate which should be a positive for the markets.

Fund Manager's view*

With adequate rainfall in most parts of the country, the risk of continued food led inflation is receding. Apart from this, a better kharif crop as compared to last year will be good for the rural economy. The equity market is seeing abundant inflows from global investors, both in periods of uncertainty and in periods of gains like in the month of July. Economic momentum is steadily picking up in the manufacturing and services sectors. The market however, appears to be stubbornly stuck in a slightly upward moving range. One reason could be that many investors find valuations on the higher side. Valuations of the Sensex at 16.5X FY11 are not cheap but they are reasonable for long term investors. This is because the Indian markets are likely to show double digit earnings growth on a multi-year basis. Even then, the remainder of the year 2010 is likely to be spent in a range with more focus on stock specific activity. If earnings season for the September quarter leads to earnings upgrades markets might move on to a higher level. In any case, as markets start factoring FY12 earnings at the start of the next calendar year, we might see much better performance from equities. As all of this is very difficult to time, we advise investors to get into the markets in a disciplined manner from now on.

Debt Market

Fixed Income Market

	Dec-09	Jun-10	Jul-10	YTD Change
10 yr GOI yield	7.59%	7.55%	7.82%	0.23%
1 yr CD	5.80%	6.85%	7.50%	1.70%
Overnight rate (NSE MIBOR)	3.59%	5.73%	5.83%	2.24%
WPI (New Monthly)	4.78%	10.16%	10.55%	5.77%
INR/USD	46.525	46.45	46.4075	-11.75%
Excess Liquidity (crore)	43,570	-78630	1,775	-41795
5 Yr AAA spread	100	85	91	-9
US 10 Yr yield	3.84%	2.92%	2.91%	-0.93%

Source: RBI WSS & Bloomberg

Strong economic growth momentum coupled with rising concerns that inflationary pressures were becoming more "generalized", prompted RBI to hike key policy rates twice in this month. RBI raised the reverse repo and repo rate by 25 bps on 2nd July 2010, followed by a further hike of 50 bps in reverse repo and 25 bps in repo in the policy meeting on 27th July 2010. The reverse repo now stands at 4.5%, while the repo rate is at 5.75%. Since January 2010, RBI has raised the reverse repo by 125bps, repo by 100 bps and the CRR by 100 bps, in a calibrated manner, as it tries to manage growth and inflation.

The policy document was primarily focused on inflation, with RBI noting that inflation scenario has become worrisome. The source of RBI concerns seem to be that even as primary articles inflation continues to be in double digits, non-food inflation (WPI excluding food products and food articles), which was near zero in November 2009, rose sharply to 10.6% in June 2010, indicating that inflation pressures have percolated to the broader economy and were becoming demand driven. WPI inflation printed 10.55% for June 2010. The central bank raised the baseline projection for WPI inflation from March 2011 to 6% from 5.5%. RBI also introduced, for the first time, a Mid-Quarter review of Monetary Policy. This is aimed at communicating RBI's assessment of the economic conditions more frequently and also to take away the surprise element out of the off-cycle actions.

Liquidity, which had been tight since end May 2010, eased by end of July and is now relatively benign. Short term money market rates, which had gone up by 50-60 bps, eased a little as liquidity flowed back into the system on large bond maturities, and government spending at the end of the month. Going forward, liquidity is expected to be bi-directional i.e. moving between deficit and surplus, instead of being unidirectional, as was the case in the recent past. Bond markets reacted adversely to policy moves, especially on the more than expected rise in reverse repo rate. Further, the introduction of the mid-quarter policy review also dented sentiments. The 10Y benchmark bond, which was trading between 7.55% - 7.65%, went up to 7.82%, as markets feared increased frequency of rate hikes.

The foreign exchange reserves went up as buoyant equity markets continued to attract foreign investors. The USD/INR was stable and quoted at Rs.46.4075/US$. The foreign exchange reserves were US$ 282.93 billion as on July 23, 2010, as compared to US$ 275.97 billion as on June 18, 2010.

Global Backdrop

Developed economies continued to give mixed signals. US macro data, especially housing, continues to be weak. US GDP annualized growth slowed to 2.4% in the second quarter of CY2010 against 3.7% in the first quarter. FED (Federal Reserve) rhetoric remains dovish, and the FED Chairman highlighted an "uncertain outlook" and "subdued inflation" for the US economy in his bi-annual testimony. Euro-zone core economic numbers are stronger, confirming on-going recovery, while UK Q2 GDP at +1.1%, showed the strongest growth rate in last nine years. Stress tests conducted on 91 European banks, to check banks' ability to survive future economic shocks, resulted in 7 banks failing the same, pointing towards still lingering weakness in the EU banking system.

Outlook

While the IIP moderated to 11.5% YoY in May 2010 against a scorching pace of 16.5% YoY delivered in April 2010, inflation concerns continued to remain on the forefront. With food inflation continuing to show some moderation in the weekly readings, it is expected that the overall WPI inflation should start to fall post July 2010. WPI inflation is expected to be in single digits by 3QFY2011. Bond markets, which had been shaken by RBI's hawkish policy, seem to have now stabilized. Liquidity is also come back to the system, allaying fears of long drawn liquidity shortage. Markets will continue to watch key macro numbers like IIP and inflation to gauge further actions from the RBI. We expect markets to recover with bond yields likely to soften in the near term. We will dynamically manage the portfolios to take advantage of the yield movements. We will dynamically manage the portfolios to take advantage of the yield movements.

Portfolio Actions

During the month, we have generally increased the portfolio maturity.

Impact of New Mark-to-Market Guidelines

The new guideline on mark-to-market, wherein all instruments above 91 days are to be valued on a daily basis, was operationalised from 2nd August. Prior to this guideline, only instruments above 182 days were being valued, while money market instruments like Certificate of Deposits (CDs) and Commercial papers (CPs) were out of the valuation ambit. As expected, the impact was marginal on the very short term debt funds, as our funds were well positioned for the change.

*The views of the Fund Manager should not be construed as an advice and investors must make their own investment decisions regarding suitability of the funds based on their specific investment objectives and financial positions and using such independent advisors as they believe necessary.