

KEY NARRATIVES THIS MONTH

16th Nov 2022

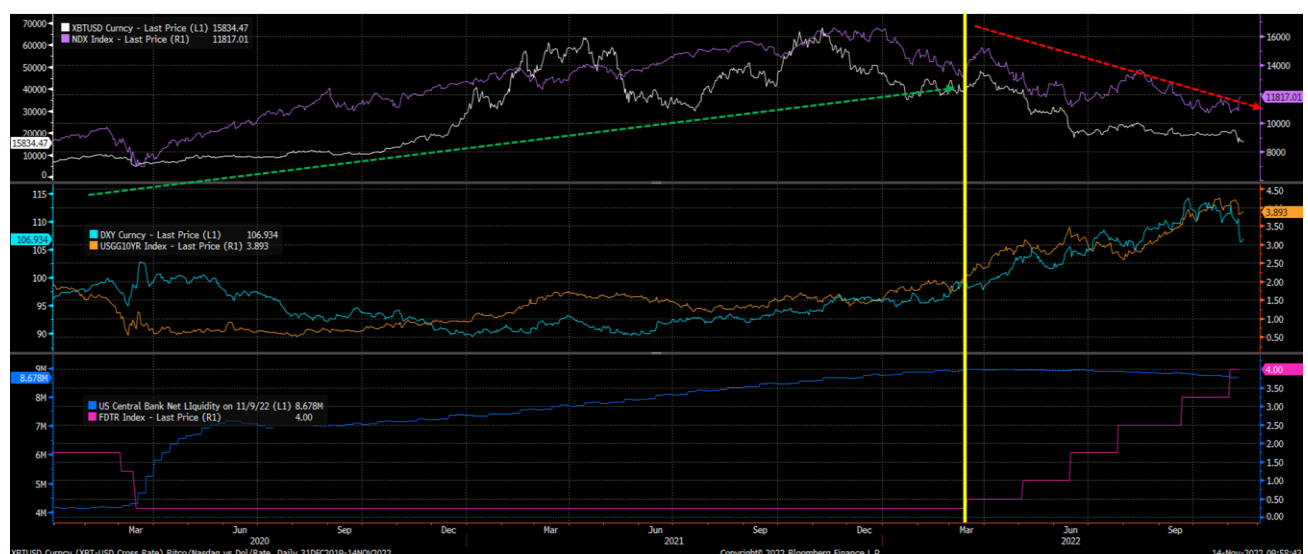
TOO EARLY TO CELEBRATE?

Global Risk assets heaved a sigh of relief as US CPI nos. presented a big surprise trending downwards to 7.7% in Oct 2022 vs 8.2% in Sept 2022 and a median estimate of 7.9%. October's US job report also indicates continued cooling in aggregate payroll gains (jobs*hours*wages). Jobs came in at 2,61,000 slightly above the median estimate of 1,93,000 but lower than the upwardly revised Sept figure of 3,15,000. The unemployment rate came in at 3.7% vs 3.5% in the previous month (Source – Bloomberg). **Lower inflation and bouts of weakness in the labor market may provide some respite in terms of the possibility of a moderation in rate hikes by FED in Dec's policy (50 bps vs 75 bps).**

Resultant Impact: Steep correction in US and global bond yields, rally in risk assets and weaker USD. The rally in S&P 500 may continue in the very near term and we may see levels of 4100 (as per the technical chart of SP500 weekly time frame). **We continue to believe even if Fed does blink and proceed with a highly unlikely pivot, a continuation of the current interest rate regime and quantitative tightening measures will keep the underlying economic growth on a tight leash and global risk assets on tenterhooks.**

LIQUIDITY KEY TO ASSET PRICES?

Since Jan 2020, risk assets like US tech and Bitcoin have seen two cycles. The disparity in performance across these two cycles is primarily on the account of central bank policy (i.e. liquidity tightening and high interest rates).



Quantitative Easing

Quantitative Tightening

Fed Fund Rate
USD Index

US 10 Year Index
Bitcoin

US Central Bank Net Liquidity

NASDAQ 100

Source - Bloomberg

Resultant Impact: - Crypto prices have seen a steep correction on account of liquidity concerns and the recent fiasco with FTX, one of the largest crypto exchanges. **We continue to monitor overall developments on this front and potential overlapping effect this can bring about to other asset classes.**

CHINA REOPENING?

In recent weeks, has been news around the Chinese government setting up a committee to phase out the Zero Covid policy and there is a perceived possibility of China reopening going into next year.

Resultant Impact: - Rally in commodities and EM equities (especially Chinese equities) and weaker USD. The technical chart below on **US Dollar Index (DXY)** showcases the steep correction from 112 handle to 106 levels and there lies a strong support at 104.8 handle.



Source - Bloomberg

IS INDIA ATTRACTIVE?

Overview of India's equity market -

Earnings Review - As of 15th Nov 2022, all the Nifty 50 companies have reported their 2QFY'23 earnings. On an aggregate basis, Sales and PAT has grown by 29% and 9% respectively (Source MOSL). The earnings are largely led by domestic cyclicals like financials, industrials, consumer discretionary (mainly autos). Commodity themes like metals, oil and gas and cement are the biggest laggards on account of lower realization and higher costs.

Moderation in majority of commodity prices in the last few months (view does not include China reopening), demand tailwinds due to festive/marriage season and rural recovery would provide boost to the top line and help to stabilize margins as we move forward towards 2HFY'23 earnings.

Valuations and Way Forward - In last month's investment note ("Domino Effect"), we highlighted that the direction of India's equity market in the near term would be dictated by its response to the festive season and Q2 earnings. With the recent up move in the Nifty 50, the index is trading at 12-month trailing PE of ~23 times, above the long-term averages.

Over the last few months, Indian equity markets have outperformed its global peers. We believe the current trajectory of the markets would be well supported primarily through continued DII and retail participation and further augmented by returning flows from FPIs.

Key Headwinds which may disrupt ongoing rally in Indian markets are highlighted below: -

- High valuations.
- Foreign flows moving to other EMs like China (as and when Zero Covid policy ends, and Chinese government/central bank start moving secularly to stimulate the economy).
- High commodity prices (especially food and energy due to EU oil embargo, price caps on oil prices, geopolitical tensions) may not allow an imminent pause or rate cuts by RBI.
- Global slowdown may impact exports (one of the key sectors which has led to GDP and credit growth in last couple of years).
- Continued K shaped recovery in consumption patterns, etc.

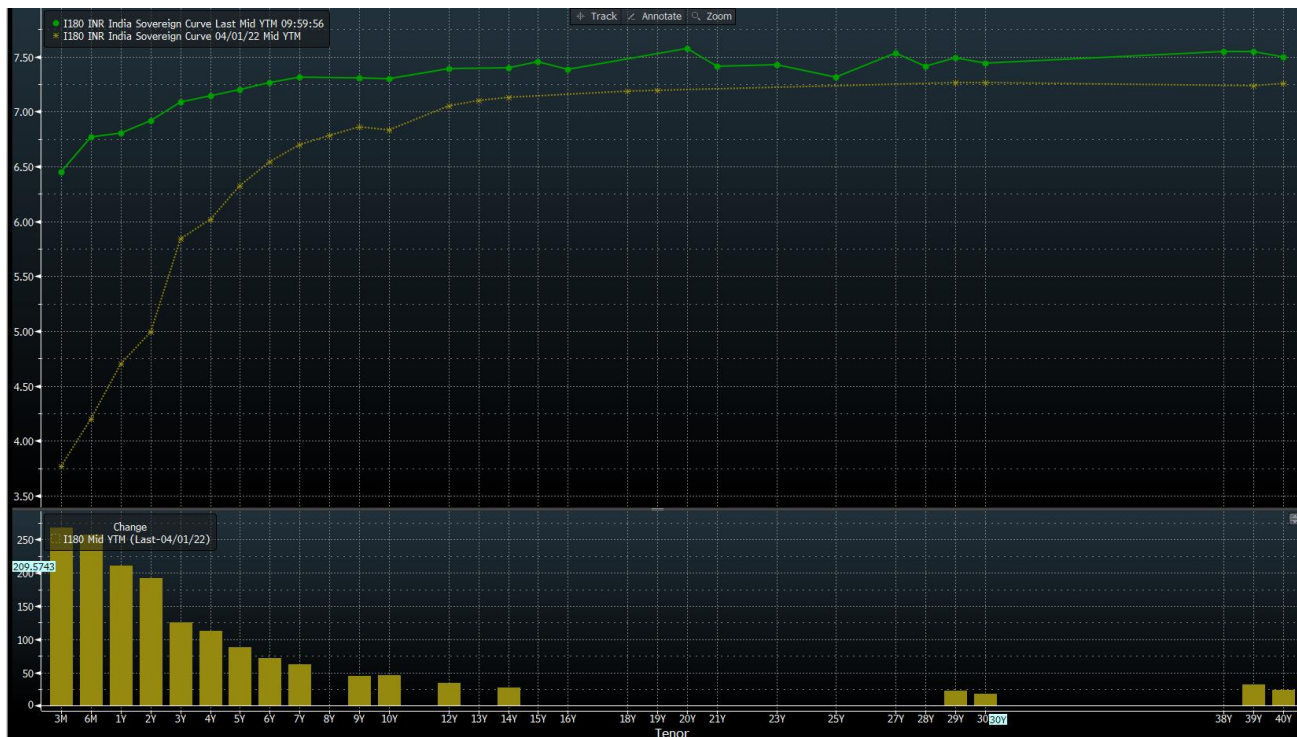
In the near term, the current market levels are not attractively poised from risk-reward point of view though we continue to recommend continued allocation with a minimum holding period of 3 to 5 years.

Overview of India's Fixed Income Market -

Indian Sovereign yields continued its uptrend in the month of October on account of hawkish FED policy, rising crude oil prices, deferment of inclusion of in Global bond index and higher domestic CPI print. However, a less than expected US CPI print earlier this month aided risk sentiments and led to a steep recovery in Indian bond yields with 10year G Sec currently trading around 7.30%, significantly lower than 7.48% as on 31st Oct.

With both CPI (6.77% in Oct'22 compared to 7.41% in September) and WPI (8.39% in Oct'22 compared to 10.7% in Sep'22) prints allowing for a policy breather, market participants would be keenly awaiting the next RBI MPC meeting which is scheduled to be held on 5th to 7th of Dec'22. **We believe, the RBI would hike rates by 25-35 bps in its Dec policy meet thereby taking the repo rate to 6.15%-6.25%. Moving into 2023, we would expect the RBI to monitor factors like growth-inflation tradeoffs, US FED fund terminal rate, energy price action and geopolitical risks before hiking/pausing/cutting rates.**

Opportunities across Yield Curve - Yields have moved higher across the curve since the start of the current fiscal year and investors are offered with very attractive rates especially on shorter end of the curve. We have been focusing on short to medium term (duration below 5 years) which offers attractive carry and have largely stayed away from building duration in given overall macro uncertainties and low risk premia.



Source – Bloomberg

INVESTMENT OUTLOOK

Continuing with our earlier assessment which we published, it is imperative to reiterate that investors are encouraged to adhere to ‘Asset Allocation’ and calibrate investment decisions by carefully monitoring the ever evolving economic and geopolitical data points. Given the way our asset allocation framework is carved out with key 4 quadrants **Asset Growth, Return Stability, Inflation Hedge and Volatility Hedge**, we have provided brief overview of overall market trajectory and outlook.

We continue to maintain higher allocations to volatility hedges through market neutral strategies. Central bank policy making and developments on geopolitical front would be the foremost reasons for higher volatility in risk assets and we expect long short fund managers to benefit from dispersion in returns across sectors.

On return stability quadrants, we continue to prefer allocations to short-term bond funds and/or roll down funds (match funds duration with the investment time horizon). As mentioned above, we believe the RBI may continue to hike rates towards 6.15%-6.25% (repo rate currently stands at 5.9%). Short term bond funds have become attractive with the upward move in yields in recent months across the 1–3 year segment. Investors who are looking for visibility of returns could invest in high

quality roll down strategies across a 3–5 year duration. Investors could also look to invest in well managed credit funds (on the AIF platform) where the focus is on capital preservation and current income.

We continue to avoid lumpsum deployments in equities – part of the asset growth quadrant and we prefer a staggered approach. For long term investors who prefer to invest more tactically, we had recommended a strategy in our July 2022 publication titled “Revalidate”, to deploy the first 1/3rd of the money earlier this year in July on account of more reasonable valuations and improved macroeconomic condition in India. We would invest the remaining two tranches (1/3rd each) only in the periods of Dec-Mar 2023 and Q2-Q3 CY23.

Funds which benefit from domestic growth led by government spending and policies and selective consumption and export opportunities could be considered as an investment opportunity. Allocation to the asset growth quadrant should be consistent with the risk profile of an investor.

Allocation to gold which is a part of inflation hedge quadrant should be maintained in one’s portfolio given its overall inverse relationship with real rates and hedge against economic uncertainties.

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