



Sanctum view

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Investment Strategy

10 Things That Have Changed for Investors in 2019

"The biggest mistake investors make is to believe that what happened in the recent past is likely to persist." – Ray Dalio, Bridgewater

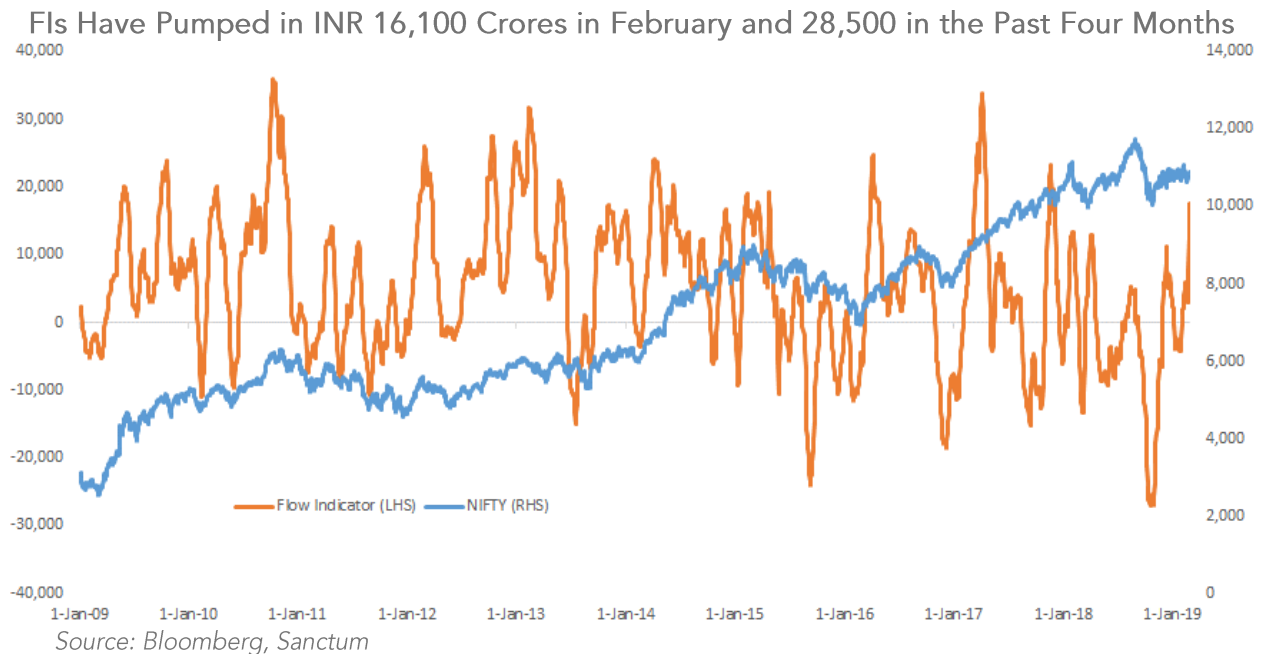
An event such as the India Pakistan escalation illustrates the highly unpredictable nature of politics, markets and the global economy. Anticipating the future decisions and actions of hundreds of key players globally down to a single accurate forecast, consistently, is a difficult task fraught with a high likelihood of error. Demonetisation, the SEBI reclassification, IL&FS are just some of the recent unforeseen events that led to high volatility and dispersion in outcomes in recent history.

Similarly, the notion of basing investment decisions on expectations of a particular outcome is similarly challenging. Things rarely evolve as one reasonably expects. It is also human nature to expect a continuation of the recent past, which rarely occurs. The fact is that forecasts aren't worth very much, because nothing is certain.

Rather, we would submit that the job of forecasting is better reduced to the job of identifying shifts in the market narrative *as they're occurring* and shifting financial exposures and implementing strategies to take advantage of the opportunities best suited for the evolving environment. We list ten of these shifts below:

I. FI Flows into India Are Rising Again (Positive)

FIs were net buyers to the tune of INR 16,100 crore in February. In comparison, FIs sold a net INR 21,000 crore during April '18 to Feb '19. Over the last four months, FIs have pumped in INR 28,500 crores. It is too early to state that FIs flows will sustain through the rest of the year; however, the data clearly suggests that FIs have been supporting the markets of late, which is encouraging news for investors.



Emerging markets received \$25.6 billion of foreign fund flows in February, of which \$2.9 billion has come to India, signalling that sentiment for the region is possibly turning, and India *will* garner a fair share of FI inflows.

II. Key Global Headwinds in 2018 Are Shifting to Neutral (Positive)

Key global headwinds in 2018 – the U.S. China trade wars and Fed Chairman Powell's ill-conceived and aggressive rate hikes and balance sheet contraction – appear to be dissipating, and shifting to neutral. The Fed has been forced by markets to pull back on its interest rate hikes, and President Trump appears ready to finalize a trade deal with China. Both are significant changes in early 2019 that bode well.

III. Crude Oil Appears Ready to Move Higher on Peaking U.S. Shale Production (Negative)

With the peaking of rig counts in the U.S., U.S. shale production could be peaking in the near term. That's offset by slowing global demand, but aggressive supply cuts by OPEC suggest that oil producers want, or need, higher prices. President Trump remains a decisive force in favor of lower crude, so we'd expect the rise, if any, to be gradual. Further increases in crude will yet again begin to act as a drag on Indian markets.

IV. India Pakistan Tensions Have Shifted the Election Narrative in Favor of the Incumbent Party (Positive)

The next few weeks leading to the election are likely to be dominated by rhetoric on the escalating tension between India and Pakistan, and this favors the incumbent party. Markets, as usual, prefer predictability and fear the unknown, and have responded to the shifting narrative by demonstrating

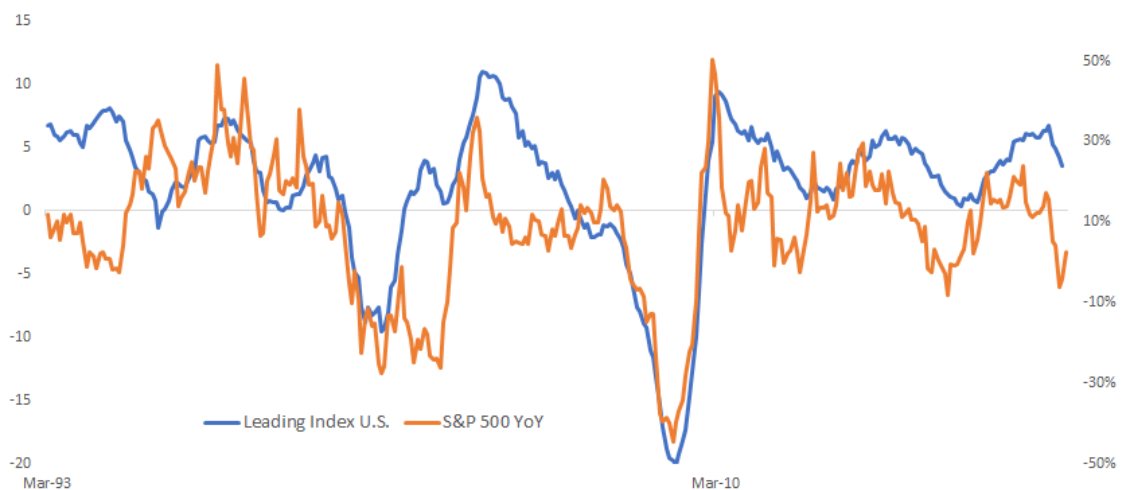
resilience of late. Should the BJP win the election, overseas institutional capital is likely to flow back into India.

V. Economic Data Remains Healthy Enough for the U.S., While Domestic Data on Credit & Manufacturing Looks Strong (Positive)

Despite worries about a global slowdown, we see no clear indications that the U.S. is heading into a contraction. Housing has slowed, primarily due to rising mortgage rates. Leading indicators have turned lower but still in growth mode, +3.5% YoY.

The US Services PMI rose to 56.2 in February 2019 from 54.2 in the previous month, well above expectations of 54.3. The latest reading points to strong services sector performance, and robust business and consumer spending. However, euro zone activity has slowed and China's manufacturing also contracted for a third straight month, a result of trade war fears and collapsing financial markets.

The U.S. Leading Indicator Has Begun Moving Lower, But Remains in Growth Mode, +3.3% YoY...



Source: Bloomberg, Sanctum

VI. A Pro Growth, Communicative and Aligned RBI (Positive)

In a change from the prior regime, the RBI is clearly aligned with government policy and growth initiatives. We believe the benefits of an aligned policy mandate more than offset the risks, particularly in light of a government that has brought about structurally low inflation and demonstrated fiscal discipline. The RBI will play a key role in ensuring liquidity in the system and working in concert with the government suggests an integrated response, which will probably be more effective in addressing domestic credit concerns.

VII. Earnings Growth (adjusted) is Strong, But Valuations Still Remain Expensive (Mild Positive)

While the macro picture suggests robust earnings, identifying attractively valued investments remains a challenge. Stocks are still expensive. Earnings growth has been impressive, particularly in IT, private banks, corporate banks and staples, and earnings will drive the markets, and stocks, higher.

VIII. Stress Remains in NBFC, Developer and Housing Finance and Low Rated Papers (Negative)

Unlike most credit crisis, this crisis is unique in that large banks and large NBFCs are in relatively healthy shape. The stress is concentrated in the tertiary lenders, unorganized and smaller players.

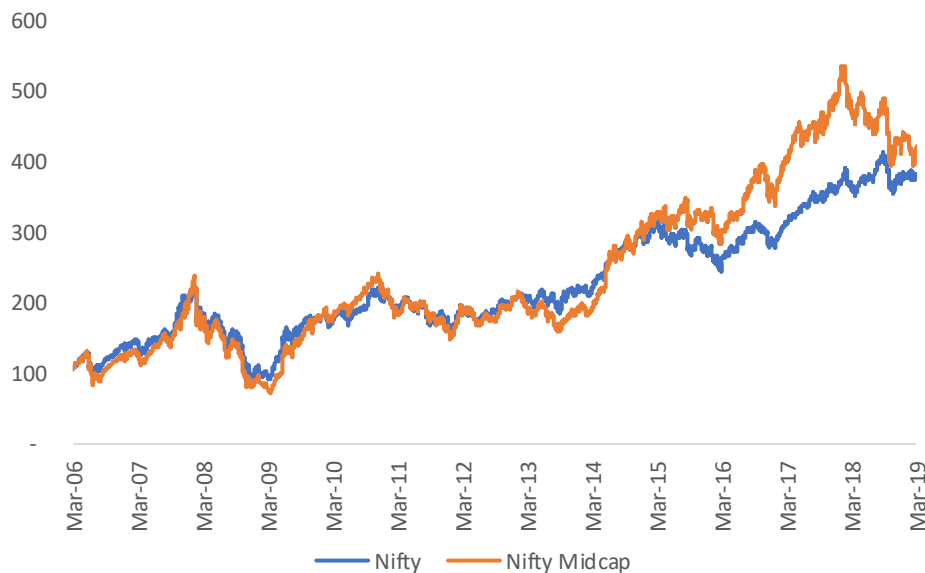
This does not look like a systemic problem and it will need to be managed; for now, the government has ringfenced the situation in the short term via the INR 46,000 crore PSU bank capital infusion.

IX. Valuations Have Come Down to Reasonably Valued (Positive)

The chart below highlights the relative performance of mid caps versus large caps. Mid caps underperformed large caps during the period 2006 to 2014 versus large caps. Mid cap outperformance accelerated in 2016 and 2017. Since 2018 to now, mid cap performance has reverted back in line with large caps, as mid caps have surrendered their outperformance to large caps, at the index level.

Valuations for mid caps have dropped to in line with large caps. However, bottom up efforts to identify attractively valued mid and small caps continues to turn up only limited alternatives.

Mid Cap Outperformance Versus Large Caps During 2016 and 2017 Has Been Wiped Out... ...Mid Caps Currently Have Performed in Line with Large Caps Since 2006



Source: Bloomberg, Sanctum

X. Sentiment Displaying Aversion, Skepticism and Pessimism (Positive)

Aversion to small and mid caps, skepticism on investments, fear of loss and pessimism are classic investor behaviors, usually found around troughs. We're witnessing some version of that these days. In contrast, FIs appear to be acting in a contrary manner and putting money into domestic equities.

Outlook

Equity – Cycles Rhyme, but Rarely Repeat

In 2013, the Nifty 50 remained in a holding pattern from November '13 to February '14, awaiting election clarity, as it is likely doing today. Clarity on elections emerged around mid February 2014, and markets took off. This time around, clarity appears to be emerging. Markets were emerging from a vicious INR depreciation and sell off in 2013, as they are today. Cycles rhyme, but never repeat.

The key difference is that valuations are more expensive today than 2013, but arguably offset by a healthier demand environment, a more productive economy and much lower inflation. From a cycle perspective, we look to be exiting a cyclical bottom made in October '18. Most sectors of the market are working out their woes, such as corporate banks, materials, pharma, telecom and IT.

Key issues plaguing the markets are resolving themselves favorably, such as the Fed, the U.S. trade war, and domestic elections. The macro winds continue to shift favorably for equities and bode well for future returns.

Our strategy remains centered around owning quality growth. For risk averse equity investors, or investors scarred by small and mid cap volatility, a large cap portfolio concentrated in reasonably priced quality growth will withstand volatility and deliver fine returns. For most investors, we would allocate to mid and small caps in the context of a balanced portfolio allocation, anchored around two thirds to large caps and up to one third to mid and small caps.

Fixed Income – Yet Another Bailout for PSUs

The risks appear to have abated somewhat in recent days, but stresses remain in lower quality paper, much of which is not liquid and therefore, not being priced in mutual fund portfolios. We'd expect yields on risky debt to re-price higher as some form of liquidity returns to the markets.

Unlike prior episodes, the larger private banks and larger NBFCs have generally healthy balance sheets and have largely skirted the issues plaguing the smaller players. The stress exists in the second, third tier. Sectorally, the stress is concentrated in exposure to the real estate sector, developer loans and housing finance companies in particular.

While bond market yields have remained generally sanguine about the issues plaguing the credit sector, security of principal and capital loss remain our paramount focus, so we continue to prefer liquid, ultra short, low duration, higher quality assets in the shorter term until risks clarify, which will most likely occur post elections.

Technical Outlook

After three days of consecutive correction, the index gained 0.66% to close at 10,864 on Friday driven by a de-escalation of tensions between India & Pakistan and positive global cues. For the week, the index gained 0.67% while the broader market BSE Midcap and Smallcap gained 2.4% and 3.4%, respectively, significantly outperforming the benchmark.

Market breadth on the NSE was positive with 4 stocks advancing for every decliner on Friday. Broadly, the market continues to trade in the range of 11,100 and 10,550. The Nifty has seen a bounce back from the lower end of the range and for the last one week it has been trading between 10,750 and 10,900; except for a mid-week spurt when it touched high 10,940.

Immediate resistance is at 10,890-10,940 levels, crossing above this Nifty can rally towards 10,990 initially and 11,117 subsequently. Confirmation of breakout will come once index starts to trade above 11,117 on a sustainable basis. On the downside, if Nifty breaks 10,730, expect Nifty to test lower end of the range i.e. 10,585-10,550 zone.

In Nifty options, maximum open interest for Puts is seen at strike price 10,700 followed by 10,600; while for Calls it is seen at strike price 11,000 followed by 11,500. Call writing was seen in 11,000, 11,400 and 11,500 along with Put writing at 10,900, 10,800 and 10,700. Thus, suggesting supports are shifting higher, but market is expected to face resistance at 11,000. Though India VIX saw a decline of 11% on Friday, for the week it has risen by 5.3% to close at 16.28. VIX cooling off in latter part of the week is positive, but it needs to decline below 15 for market to move higher. Rise in volatility will continue to keep the market in the broader range.



Source: Falcon7

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