



April 30, 2019

Investment Strategy

Global and Domestic Cross Currents

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go." – Benjamin Graham

Rate Cuts Have Led to a Steepening of the Domestic Yield Curve...

Rate cuts by the RBI have led to a widening of spreads between the long and short end of the curve. In contrast to early 2018, when spreads widened due to a rise in risk, and rates, the recent spread has been driven by a decline in short term rates. Declining short rates are a positive, the impacts of which will filter through the economy in H2 CY19. They're also indicative of a stabilisation in general credit conditions.

Our Base Case Remains A Mandate for Growth...

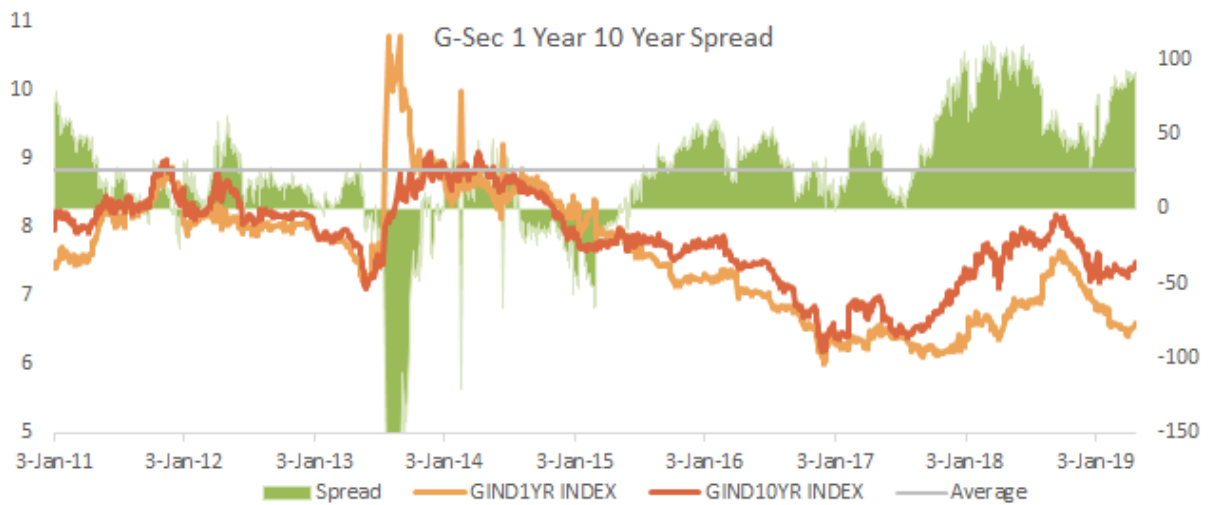
Our base case expectation of a majority government being formed by the incumbent party continues to look plausible. With the slack witnessed in the current quarter, we expect a pro-growth central bank to deliver additional rate cuts if necessary, with global deflationary trends and global demand slowdown likely keeping a lid on inflation.

The Flow of Foreign Capital Is Driving Markets Higher...

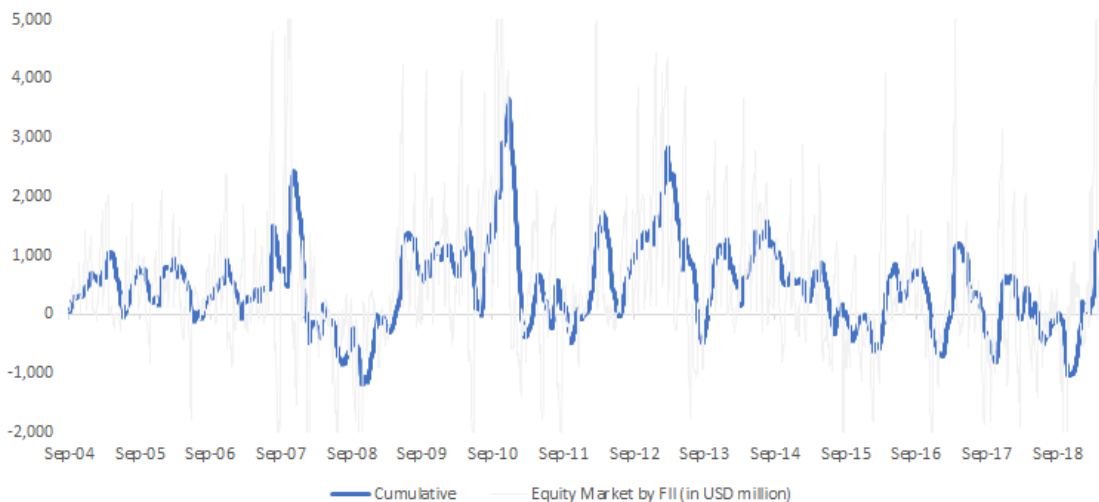
“With the market hitting all-time highs, one would think that investors would finally get off the skeptical fence they have been sitting on since October and put their capital into the market.”

Interestingly, that’s a comment about the U.S. market, but one that applies equally to India. The rally in global markets – and India - remains a flow driven rally, with strong flows driven by FI investors fairly confident that the Fed will reverse course and unleash more QE in due course.

RBI Rate Cuts Have Steepened the Yield Curve and Bode Well for Recovery Later This Year



But Right Now, It’s an FI Flow Driven Market...



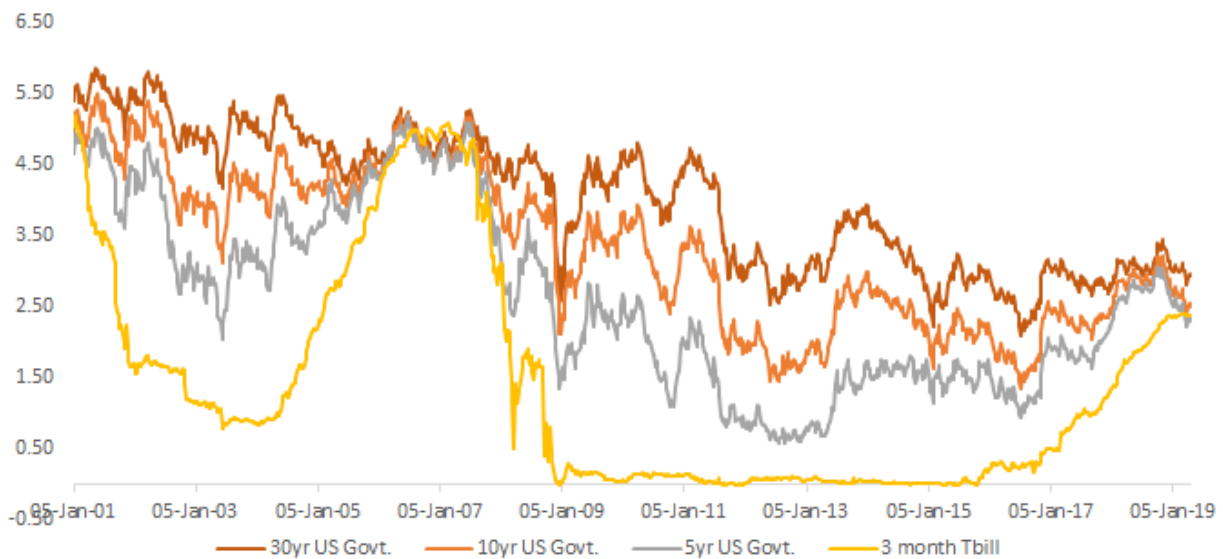
Indian and U.S. Equities Are at or Near New All Time Highs in Recent Days...

Americas	1 Month	3 Month	6 Month	YTD	1 Year	2 Year	3 Year	From 23-Mar-18	From 29-Jan-18
NSE Nifty 50 Index	2.4%	9.0%	17.2%	8.2%	10.7%	12.1%	13.9%	17.6%	5.6%
Dow Jones Industrial Average	3.1%	7.0%	7.2%	13.4%	8.8%	12.3%	13.7%	12.4%	0.1%
NASDAQ Composite Index	5.6%	13.3%	13.3%	22.4%	14.0%	16.1%	18.4%	16.1%	8.7%
S&P 500 Index	3.8%	9.8%	10.1%	16.7%	9.7%	10.7%	11.8%	13.1%	2.5%

Demonstrating the Strong Correlation between the Two Markets Since 2012...



Similar to G-Secs, Long End U.S. Yields Have Rolled Over in Recent Days... ...Messaging Slowing Global Growth and Expectations of More Stimulus



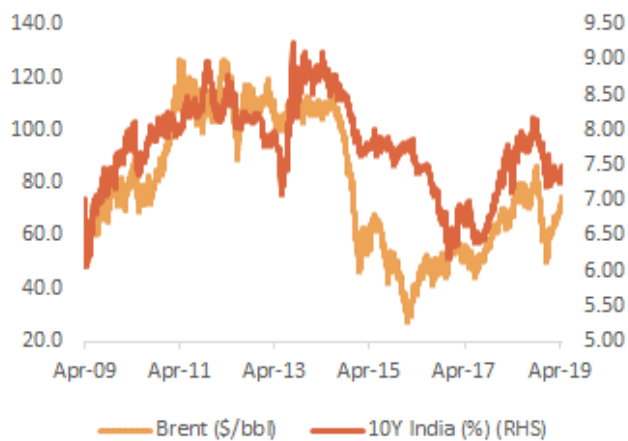
Long End U.S. Yields Have Rolled Over...

10 year and 30 year U.S. bond yields have rolled over in recent days. Falling yields are signaling slowing global growth. Markets have chosen to cheer the data alongside expectations of a pliable Fed. The Fed meeting this week will shed light on central bank thinking and positioning, and we wouldn't be surprised if the central bank takes a calibrated marginally hawkish tone to manage market euphoria via commentary.

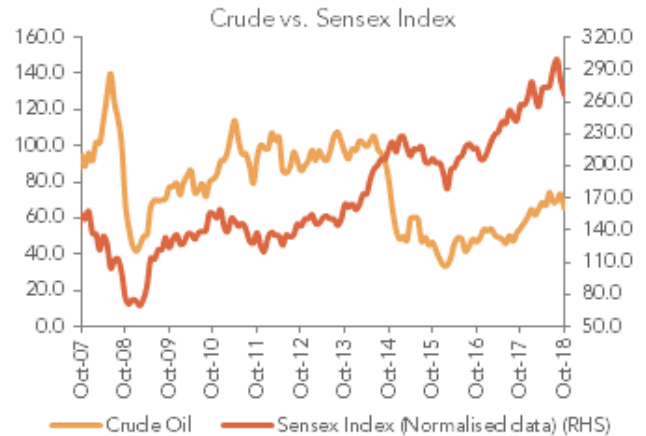
Good News...Crude Prices have Dropped 3.5%

In what is decidedly good news, the soap opera that is the global crude oil market witnessed a welcome 3% drop last Friday, and dropped a further 0.5% today to \$71.75, far more comfortable than the \$75 levels that were threatening to be pierced last week. It appears there remains enough supply to offset a drop in Iranian crude output, and global demand is likely weakening, as witnessed in global crude oil inventory data.

Brent Crude Has Led 10 Year Yields Lower...



...And Helped Markets Head Higher

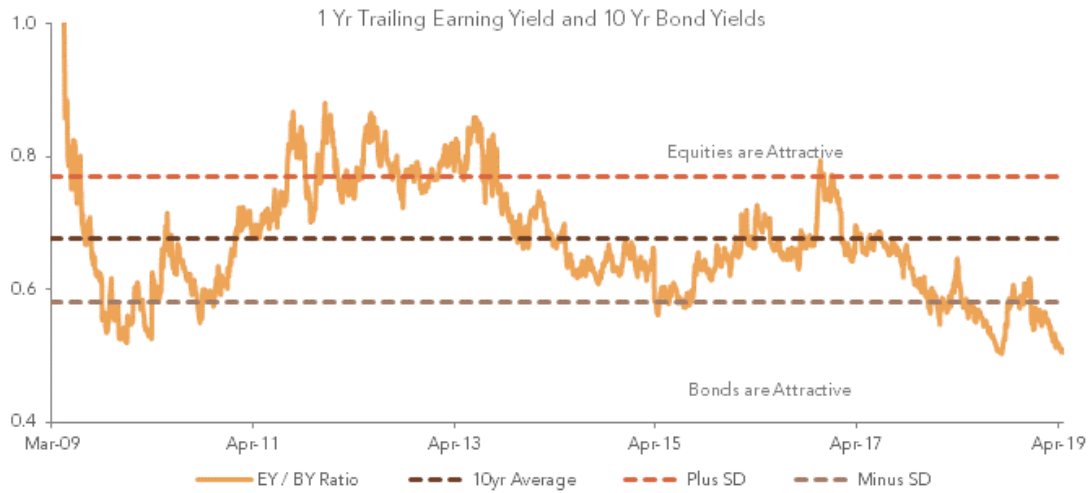


Valuations Remain a Conundrum: the Fed Model Strongly Favors Bonds over Equities

Moving to domestic valuations, the earnings yield to bond yield ratio has reached levels last witnessed in the summer of 2018. This indicator has had a fairly decent track record. It's signaling an attractive environment for bonds, less so for equities.

We would note that the indicator is based on Nifty earnings yield, so the data is somewhat skewed towards large caps, and does not reflect the damage inflicted on mid and small caps.

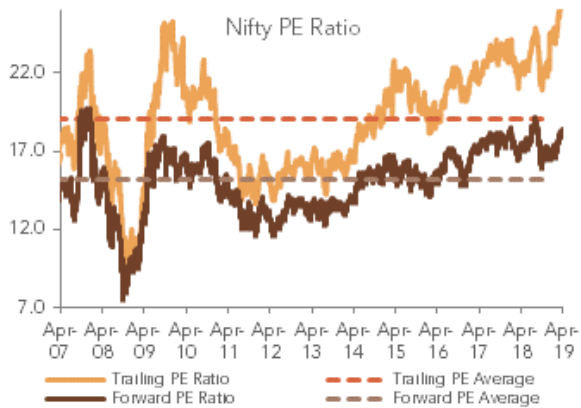
The Earnings / Bond Yield Indicator is at Extreme Levels, Favoring Bonds...



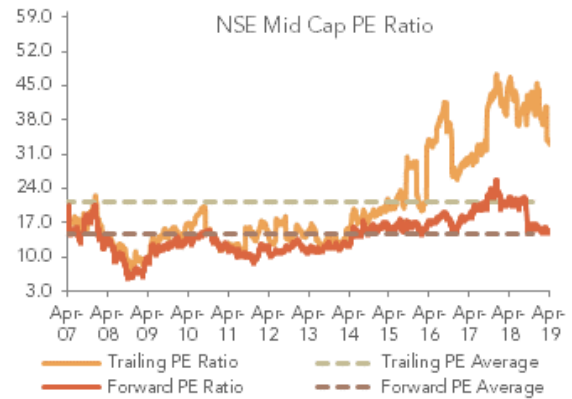
Valuations Have Stayed Above 20 P/E for Almost All of the Modi Tenure

Like the proverbial sword of Damocles, valuations hang over investor’s heads. A look at the chart below suggests valuations have reached extreme levels. But the counter point is that valuations rose above 20 levels in 2014, and have stayed above 22 levels for much of the past four years. Clearly, there’s more than meets the eye.

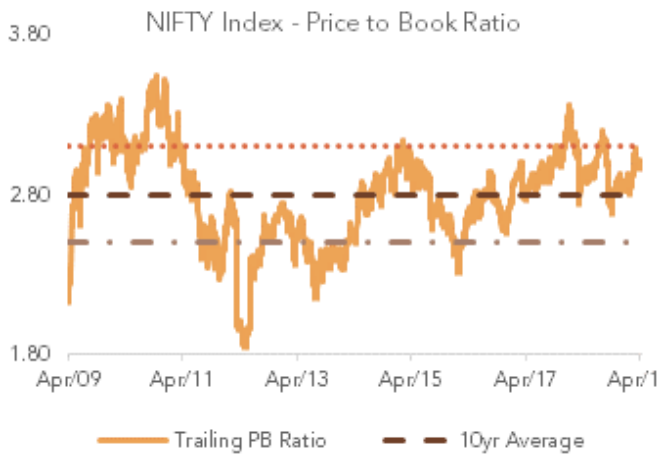
Trailing PEs at Extremes for Nifty 50...



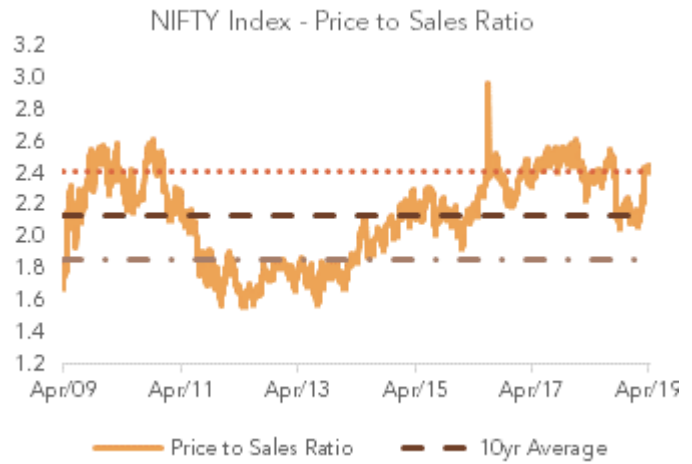
...Trailing PEs Have Fallen for Mid-Caps



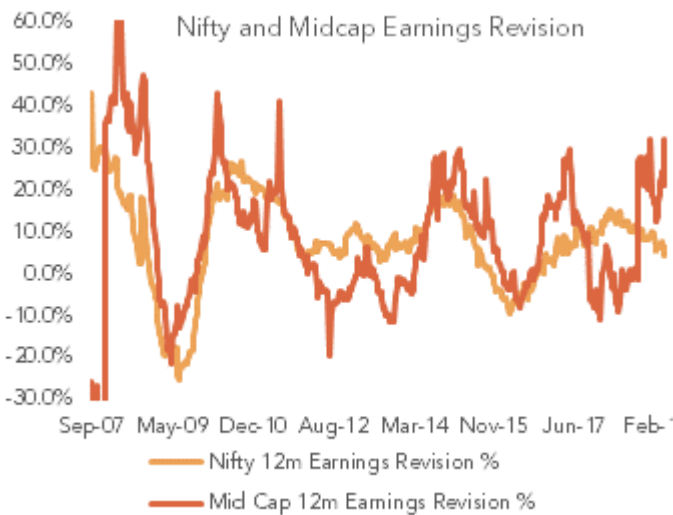
Price to Book Is Moderately Expensive...



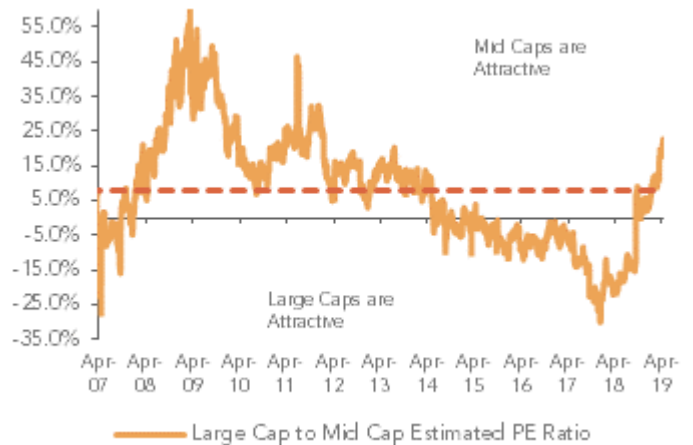
...While Price to Sales Have Stayed High



Nifty Midcap Revisions Have Risen...



Compressing Forward PEs Have Moved Mid-Caps to Attractive Relative Valuations



Valuation Conundrums...

Further, as we look at our portfolios, both our large cap and multi cap portfolios have a PEG ratio that's comfortably placed around 1.2 times, certainly not indicative of valuation excess.

We've shared a scatter diagram in previous weeks that perfectly correlates high valuations with low inflation and positive real yields. Valuations also deserve a premium assigned to being the fastest growing large, open, domestic focused consumption economy. Further, there are few viable alternatives that have delivered 15-16% CAGR returns in the past few years.

So Is This Market Behavior Rational | Irrational?

The rational investor that believed central bank actions would have major repercussions, has been wrong for a decade now. The equally rational investor that recognized that the central bank is the most powerful participant in the global market, and will drive asset prices higher, has been right.

Outlook

Equities

Global Flows and the Fed Put are Driving Equities

We remain a market driven by global flows. It's clear that the Fed capitulated last year, and Fed stimulus is likely to be back at some point later this year. That's the dominant force driving markets.

Global Uncertainties Remain with Hopes Pinned on the Fed

Will the Fed engineer a soft landing? Or will the U.S. head into a recession. There is a fair amount of hand-wringing going on in the U.S. these days. Initial claims for unemployment rose by the most that we have seen in 19 months, jumping 37,000 to 230,000 s.a., the largest increase since September 2017. Real estate sales have slowed, even in perennially hot markets such as New York city.

Credit Stress in Domestic Balance Sheets a Key Monitorable

The domestic credit crisis refuses to pass. While things have improved from the panic levels of Oct 18, a slow motion deterioration in credit quality continues to persist, and will bear monitoring.

Our Base Case Remains a Flow Driven Market

We've had a fairly positive view for the past few months. Going forward, our base case remains that a majority government will drive further upside. Post-election, **relief, optimism and confidence could drive markets higher**, given the fair amount of domestic capital is on the sidelines. However, the market will need to contend with rising stress on financial balance sheets. Should our base case scenario not come forth, markets will sell off but in time, re-rationalize.

Fixed Income

G-Secs Have Pushed Lower by Declining Repo Rates and Stabilizing Credit Markets

10 Year G-Secs yields have come down in recent weeks from a peak in October 2018, driven lower by a decline in the repo rate and stabilizing credit markets. Crude has been a headwind, but here too, there has been some relief in the past week.

Corporates Not Reflecting G-Sec Trends Except at the Short End

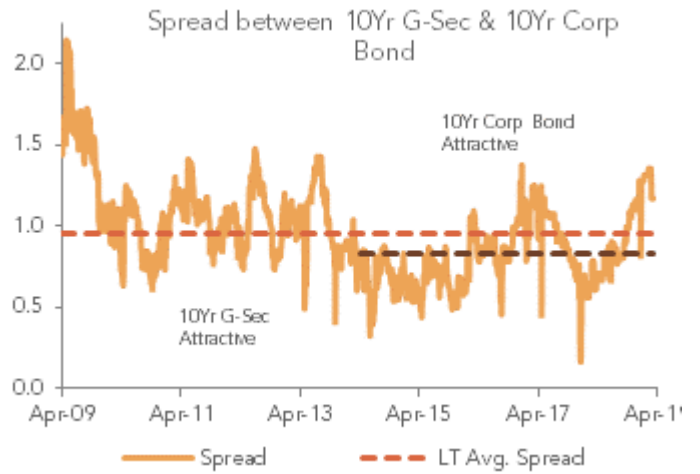
While both corporate bonds and government bonds have witnessed an improvement in short rates, reflecting a gradual stabilization of credit markets, only G-secs have rallied on the long end, leading to spread widening at the long end.

The risk premium for corporates remains elevated relative to g-secs, near historical extremes. Alongside yield action, credit growth has slowed to 13.24% after making highs earlier this year at 15%~ levels. Slowing data point to a greater likelihood of rate cuts in the latter half of the year. Deposit growth meanwhile has picked up, up 10.03% yoy.

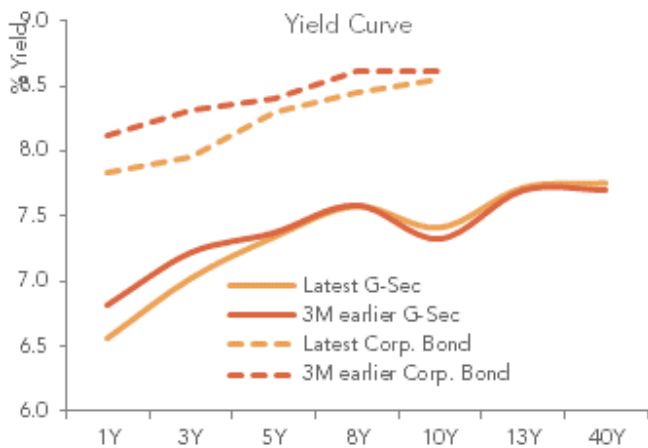
Repo Rate - 10 Year Spreads Have Narrowed



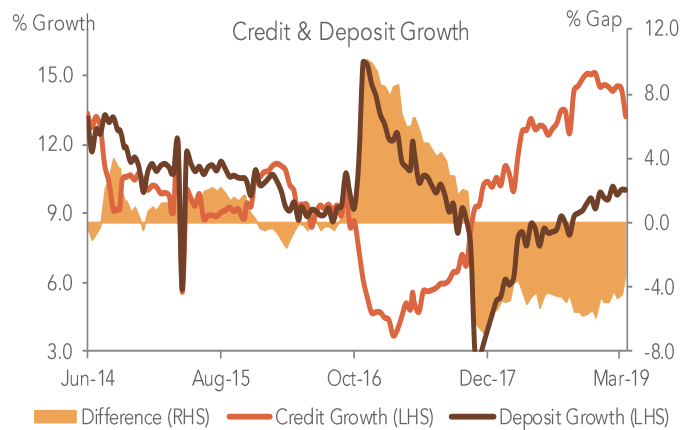
While G-Sec Corp 10 Year Spreads Have Widened



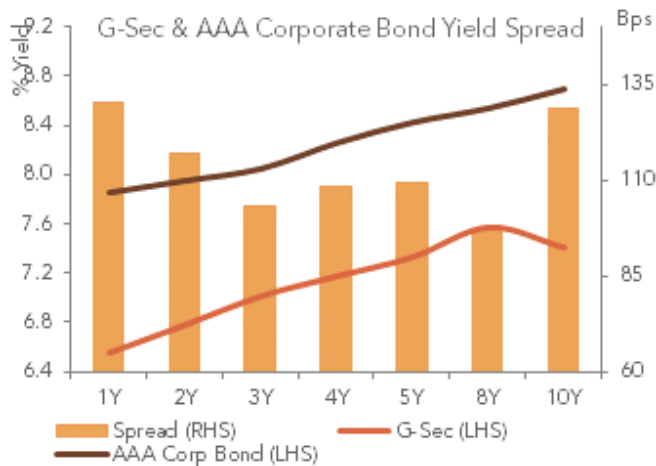
A Lowering of Yields on the Short End..



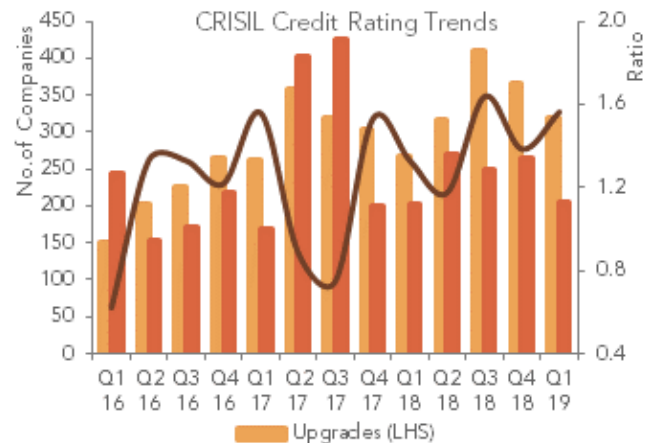
...While Credit Growth Has Decelerated



Spreads Widest at 1 Year & 10 Year...Compressed in the Middle



While Credit Rating Trends Are On an Uptick (FIX LEGEND)



Housing Finance, Developer Leverage and NBFC Funding Worries Remain

Declining short rates are indicative of a gradual improvement and thawing in credit markets, while the steady risk premium of corporates suggests that investors expect to be compensated for longer duration risk.

Despite the general improvement, stress remains in housing finance, developer funding and related lending parts of the market, which we expect will gain greater attention post elections.

Positioning

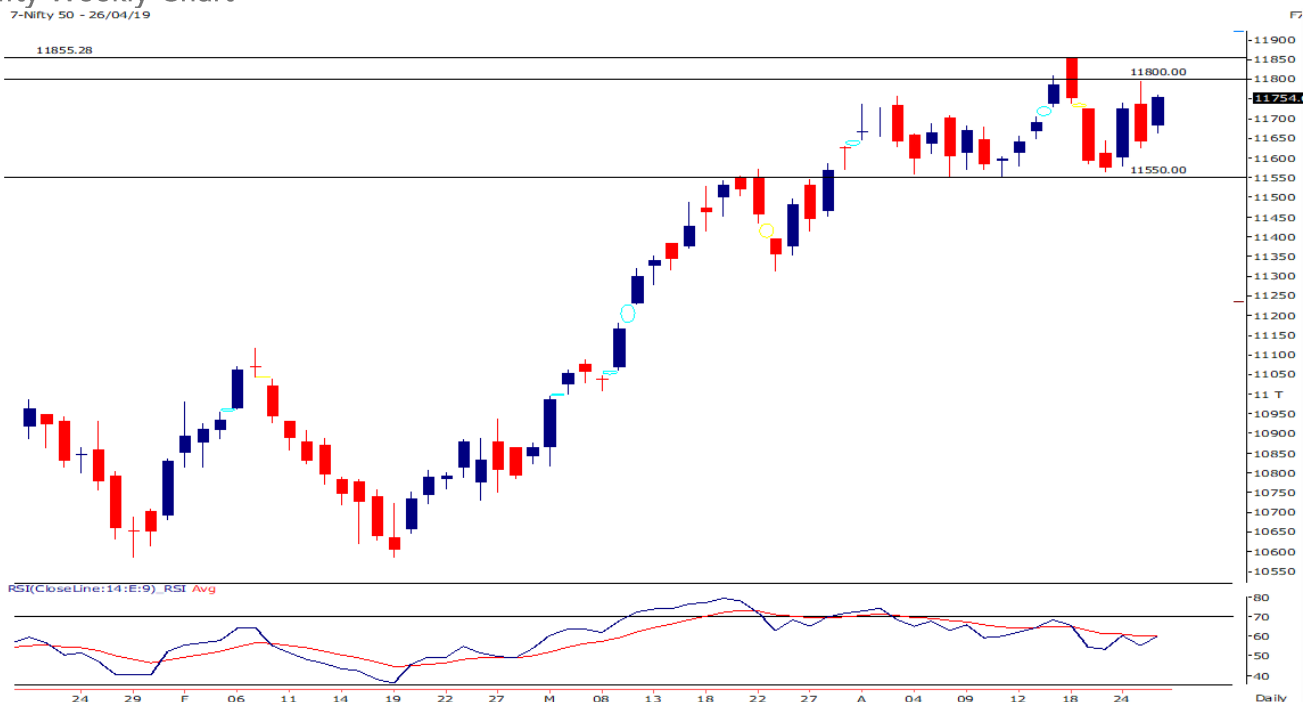
Until election clarity emerges, the safer path for fresh capital is to wait it out on the side-lines. Our preference remains tilted towards a diversified portfolio of short-term bond funds, high quality corporate bond funds, and given an expectation of further rate cuts by the RBI, a weightage to moderate duration.

Technical Outlook

On Friday, rally in last hour of trade saw the Nifty closing in green at 11,754.65 up by 0.97%, but on weekly basis it was unchanged. Though Nifty witnessed breakout above previous high of 11,760 and touched new all-time high of 11,856; market is largely sideways in the range of 250 points since last four weeks. Index hasn't broken its previous swing low of 11,550 thus, maintaining sequence of higher highs and high lows. Hence 11,550 becomes pivotal support level for the market. However, breaking below 11,550, market will see break in current uptrend and profit booking will emerge in the market initially towards 11,350-11,310 levels. On the upside 11,800-11,860 will act as resistance zone for the market. If Nifty crosses 11,860 on sustainable basis, it can rally initially towards 12,000 and then 12,200. India VIX has declined in last three sessions from high of 24.64 to 21.72. Cooling off in VIX has supported market in bouncing back from lower end of the range. Expect VIX to remain at elevated levels and any sharp rise in VIX will cap market upside.

Nifty Weekly Chart

7-Nifty 50 - 26/04/19



Source: Falcon7

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