Sanctum View

Aug 05, 2019

Investment Strategy

The Onerous Cost of Capital

"Wealth isn't primarily determined by investment performance, but by investment behaviour." – Nick Murray

U.S. Central Bank Policy Tapers Investor Expectations

Dovish central bank policy has been one of the key underpinnings of our outlook this year. That domino fell last week, with the Fed dashing expectations of a sustained monetary easing campaign. In all likelihood, the Fed will still cut rates further, but it's going to take pain in the markets or economy before it happens.

A Synchronous Slowdown in Domestic and Global Is Underway

We've moved from a synchronous global recovery to a synchronous global slowdown. Respected observers such as Ex-Gov Subbarao believe we are in the midst of structurally low global growth. Parts of the domestic slowdown – such as autos – are increasingly looking structural in nature. EVs are likely to add to the turmoil. Global manufacturing looks like it's heading for a recession. India trade – exports and imports – has collapsed in June, thanks to the trade war and slowing growth.

The Playbook for the Bulls Has Narrowed

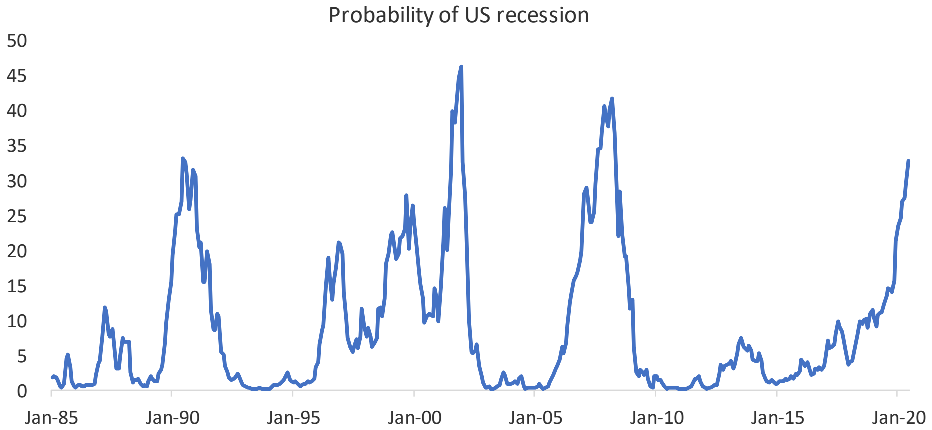
The Fed playbook for the past 10 years has been **sell-off, panic, QE, repeat**. That likely looks to remain the playbook yet again, and the key question really is whether QE will sustain markets, or are we entering an end game. The yield curve is perilously close to inverting, which suggests that the risks of a recession in the U.S. are getting higher by the day, and a slowdown lurks in the not too distant future. A Fed rate cut when stock markets are at record highs is a rarity and it is worth noting that Fed easings only avert recessions roughly half the time. Ten years into a stagnant recovery, the

Fed has staved off a depression but has otherwise failed to stimulate growth and inflation. Should the situation worsen, the U.S. risks becoming a Japanese style stagnant economy with near zero interest rates to perpetuity.

How Many More Steroid Shots Does the Fed Have Left?

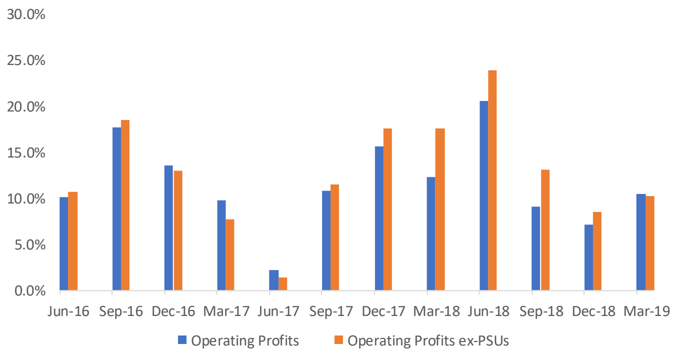
In Open, Andre Agassi's memoir, he mentions that the spine can be administered a finite number of steroid injections before the treatment loses its effectiveness, and otherwise has the potential for serious harm. We cannot help but wonder at what point will these steroid shots stop working with central bank QE policy. That overhang attains relevance today because a few key indicators are signaling a recession could be coming to the U.S.

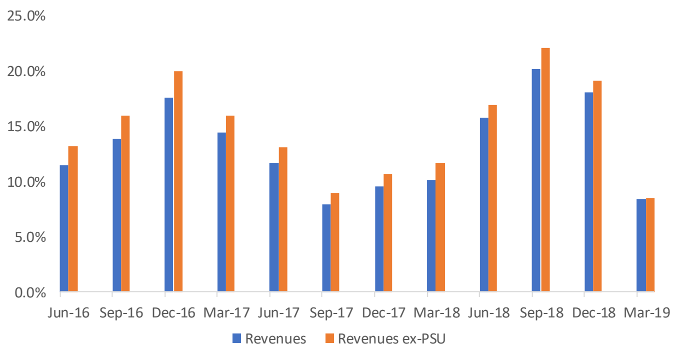
For the First Time in 10 Years, the Risk of a Recession in the U.S. Has Risen to Alarming Levels…



While Top Line Growth (Left Chart) and Operating Profits for the Domestic Market Have Been Healthy…

…PAT Growth Has Disappointed, and It's Due to the High Cost of Capital and High Taxes





Earnings Growth Has Slowed to Anemic -5.2% for the Nifty 50 and 7.1% for the Broader Market…
…No Matter How You Cut It, Earnings Growth Has Not Delivered at the Index Level…

	Sales YoY		Operating Profit YOY		Net Profit YOY		Operating Margin		Net Margin	
	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500
Consumer Discretionary	-8.3%	-4.0%	-17.0%	-5.5%	NA	-70.0%	10.4%	11.3%	-0.2%	0.9%
Consumer Staples	6.1%	12.9%	17.1%	22.3%	9.9%	16.6%	28.1%	19.2%	17.5%	11.4%
Energy	10.9%	10.8%	-6.7%	-8.1%	-16.4%	-18.5%	10.3%	9.9%	4.3%	4.0%
Financials	25.0%	21.0%	23.5%	17.7%	35.0%	81.1%	39.1%	33.1%	14.1%	9.4%
Health Care	3.1%	12.6%	43.0%	31.4%	42.1%	26.9%	31.1%	33.4%	18.0%	13.3%
Industrials	9.7%	6.4%	24.6%	34.5%	28.9%	27.1%	19.5%	17.7%	5.3%	5.7%
Information Technology	10.2%	10.7%	12.2%	11.5%	9.3%	7.8%	27.6%	26.5%	18.3%	17.3%
Materials	6.3%	3.9%	-12.7%	-3.5%	-33.9%	-12.7%	22.3%	23.3%	6.1%	8.7%
Real Estate	NA	7.4%	NA	3.3%	NA	-32.4%	NA	36.2%	NA	10.0%
Communication Services	5.2%	17.9%	23.7%	51.6%	-98.5%	NA	44.2%	37.9%	0.1%	-8.7%
Utilities	NA	14.3%	NA	31.5%	NA	NA	NA	25.9%	NA	4.6%
Index	8.9%	10.2%	6.2%	11.3%	-5.2%	7.1%	19.2%	20.4%	7.0%	6.5%

Domestic
The Fragility of Investor Confidence

The destruction of sentiment appears to be fairly complete. In each of the slowdowns in 2018, 2016, 2015, there was an underlying hope, a prevailing sense and expectation, that things would get better. Hope has been replaced by consensus pessimism, disappointment and despair.

This Quarter's Earnings Results Look Particularly Dismal

The CNX 500 has delivered a respectable 11.3% in operating profit growth, and an equally respectable 10.2% in sales growth. With normal operating leverage one would expect at least 12% earnings growth. A high cost structure, and **lack of easy availability of credit is killing the bottom line**. High taxes are further impeding profitability.

A Substantial Cut in Interest Rates is Needed

Domestically too, the playbook for the bulls has narrowed to monetary policy. One would hope for a minimum 50 bps cut or alternative relief via policy measures to support the market. The central bank must address the issue that borrowing rates are too high in India and must be reduced with **borrowing rates averaging 9-14% the past few years, interest rates are just too high. In order for profits to recover, rates need to come down**.

Outlook
Equities
Key Indicators Are Signalling Caution in the U.S.

While the U.S. unemployment rate continues to inch lower, historically a sign of a peaking economy, disposable personal income is still rising at a fairly healthy clip of 4.1%. However, a fair number of **key indicators are starting to flash warning signs**.

We've Given Back the Modi Rally

Clearly some will feel remorse about missing out on Nifty 12,000. However, that was really a euphoric rally built on Modi's victory and the market has since taken it back. The more important question today, revolves around forward strategy.

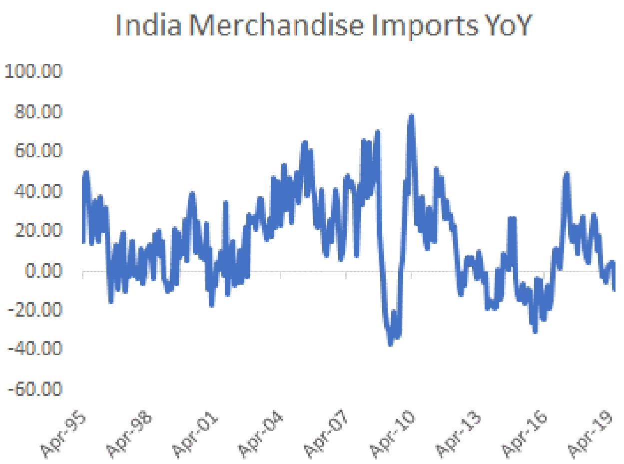
Valuations Remain Expensive

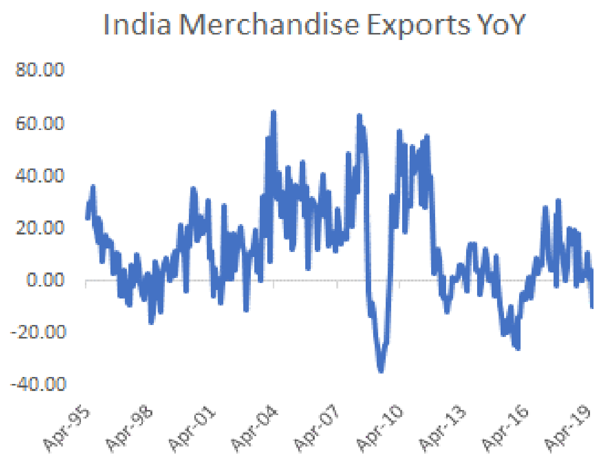
The broader market is in a bear market. Small and mid cap companies have been pummelled for 18 months, but we would still be unable to say that valuations appear compelling. **Our bottom up computation puts the larger CNX 500 valuation at 25.6 times trailing earnings.** Forward earnings will need to be ratcheted down yet again in the fourth quarter.

Technicals Are Deeply Oversold

In the short term, technicals are extremely oversold and while there is no evidence of a bottom, key support held on Friday. **There are those that are itching to time the bottom and buy the market. Shorter term, they can look like heroes.** Such eagerness gives us pause, because the longer-term outlook remains fairly uncertain, and hope isn't always a wise strategy. We'd prefer to wait for a buy signal on our data.

Import Export Data Highlight the Severity of the Current Slowdown…





Continue to Prefer a Pragmatic and Patient Approach Right Now

Given our view of the macro risks, we believe adding exposure or shifting to defensive strategies - long short strategies, income strategies, capital protected strategies – makes sense in the current environment. **At some point, in coming days / weeks, our next signal will be a buy signal on equities.** Alongside, we'd also like to witness a philosophical shift to pro-growth, pro investment policies at the Fin Min to gain further comfort.

Continue to Prefer Large Caps

From a cap perspective, mid and small continue to get hammered. The recent calls we are witnessing to buy mid and small have been loud, and wrong. Mid and small have underperformed even in the past month. There is no particular necessity to catch that falling knife early. **We remain comfortable with quality large caps.** The biggest mistake investors make at these times is to shed quality companies.

We end by pointing out that **investment behaviour is likely to be far more critical than investment performance in coming days.** This is an important time to **review asset allocation, ensure alignment with risk appetite,** and **build a portfolio of non-correlated investment streams that position portfolios for multiple outcomes.**

Small and Mid Caps Continue to Underperform Large Caps Across Time Frames

India	1 Week	1 Month	3 Month	6 Month	YTD	1 Year	2 Year	3 Year	5 Year	From 23-Mar-18	From 29-Jan-18
S&P BSE SENSEX Index	-2.0%	-6.8%	-4.8%	1.8%	2.9%	-0.1%	6.9%	9.9%	7.8%	13.9%	2.3%
NSE Nifty 50 Index	-2.5%	-7.7%	-6.2%	1.0%	1.2%	-2.2%	4.4%	8.4%	7.7%	10.0%	-1.2%
NIFTY Midcap 100	-2.8%	-11.5%	-10.0%	-7.5%	-12.1%	-17.0%	-7.9%	2.1%	7.9%	-15.0%	-26.2%
NIFTY Smallcap 100	-4.7%	-12.7%	-15.9%	-11.4%	-15.7%	-27.3%	-16.2%	-3.5%	1.8%	-29.2%	-40.1%

Fixed Income

In line with our macro views, our key **preferences remain high quality AAA bonds, absolute yield strategies, with diversified exposure to low to moderate duration and yield compression. The clamor is also rising for the RBI to cut rates, so duration is likely to continue to perform.** In a world with $14 trillion in negative yielding bonds, a top ten economy with a stable currency, low inflation and stable fiscal situation can see a further decline in rates.

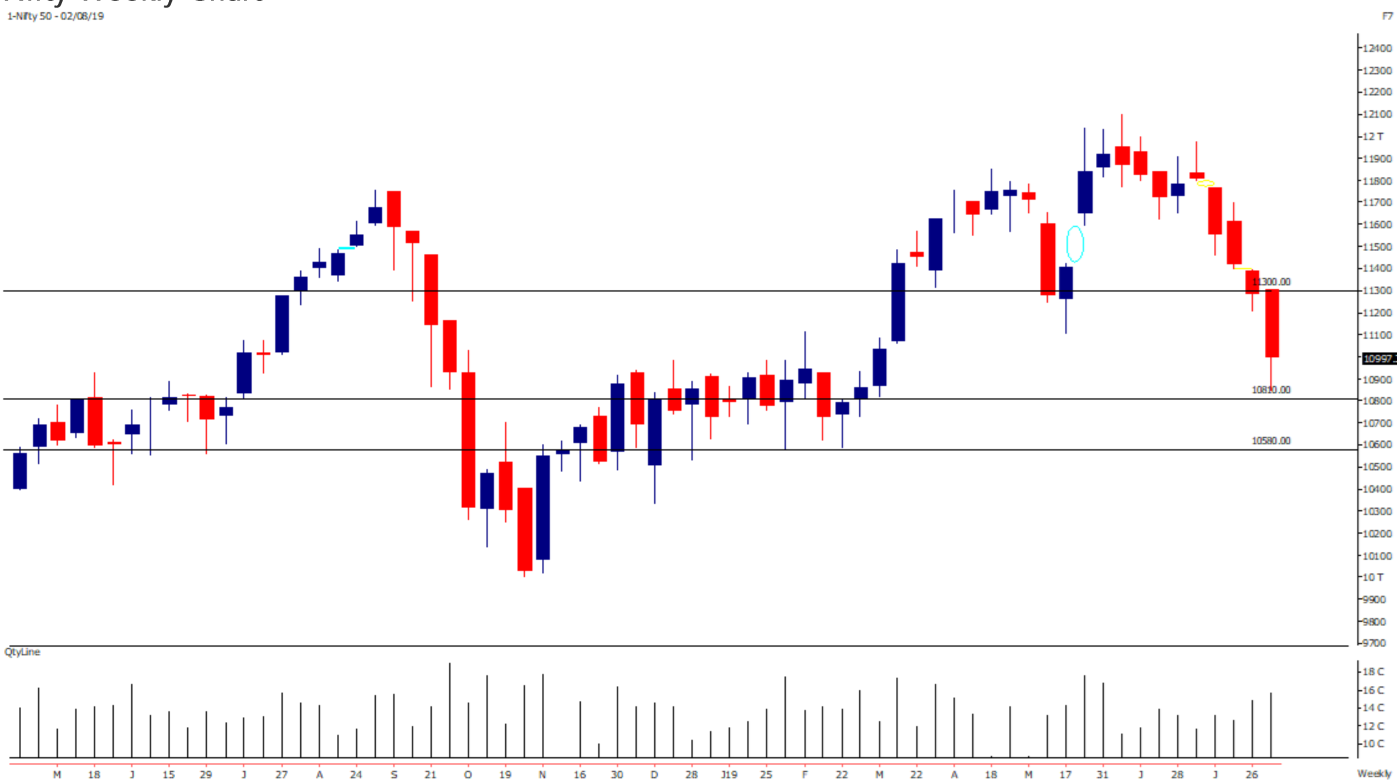
Beyond the AAA highest quality paper, it's clear that there is a funding and liquidity crunch, and it remains fairly challenging to get access to capital. Rates for lower quality credit are likely to stay elevated, and the spread compression game further out the curve will take longer to play out.

Should the slowdown accelerate, lower quality corporate bonds have risk to the downside, and we'd avoid lower rated credit duration exposure. Conservative investors should stick to the short end of the curve and play for absolute high quality yield.

Technical Outlook

Fourth consecutive week of decline with the Nifty logging second biggest weekly fall of 2019, down by 2.54%. The bounce back on Friday failed to sustain above psychological level of 11,000 and Nifty settled at 10,997. Broader market indices BSE Midcap and Small lost 2.23% and 4.32% respectively on weekly basis. For the week Nifty has formed long body bearish candle with lower shadow; while on daily chart it has formed High wave kind of candle with both upper and lower shadow indicating volatility. On Friday market witnessed short covering from low of 10,849 but failed to sustain at higher levels. Immediate hurdle for market is at 11,150 where 200 day moving average is seen. Crossing above 11,150, index can see bounce back towards 11,300-11,350 zone. On the downside immediate support is at 10,810 where 61.8% Fibonacci retracement of the entire rise from 10,005 to 12,103 comes. Breaking below 10,810 further decline can be seen towards 11,580. In Nifty options maximum open interest for Put is seen at strike price 11,000 followed by 10,800; while for Call maximum open interest is seen at 11,500 followed by 11,700. Writing was seen in 10,900 Put and 11,000 Call. The range for Nifty has shifted lower to 10,800 and 11,300 levels. India VIX measure of volatility saw spike of 25% last week to close at 15.19 level. VIX has seen bounce back from 20-month lows and may rise further towards 17 levels which keep the market volatile.

Nifty Weekly Chart



Source: Falcon7

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