May 05, 2020

Investment Strategy

Two Sides of a Coin

"The more things change, the more they remain the same".

Do they? We have been in the eye of a storm that has been threatening to change most things that touches our lives directly as well as indirectly. We have been exploring in the context of investment strategy as advisors, custodians and 'fiduciarists'.

Global macro data is expectedly grim. Large economies are contracting. The damage of 2-3 weeks post movement restrictions in the US was severe enough to bring down its growth for the whole quarter to the negative territory. The International Labour Organization (ILO) predicted cutbacks equivalent to nearly 200 million full-time workers expected in the next three months alone. The lockdown measures are affecting almost 2.7 billion workers – four in five of the world's workforce.

PMIs across Southeast Asia slumped further below 50, the dividing line between contraction & expansion, to post their weakest readings since series began, according to data released by IHS Markit on Monday. Taiwan, Japan & South Korea dropped to lowest levels since 2009.

PMIs across the board have nosedived in April-20

Source: Bloomberg, Sanctum Wealth Management

GDP growth has moved in the negative territory

Country	Q1CY20 GDP
US	-4.8%
Eurozone	-3.3%
China	-6.8%

Perhaps it is the intense pain of it that prompted administrators to side with livelihoods in the battle of lives and livelihoods. The cure indeed can't be worse than the disease. Several countries such as USA, Australia, India are now easing restrictions. Re-opening of economies, however, it doesn't mean that a swift economic recovery is on the anvil. Even if the stock market rally almost lulls many into believing it.

There are parts of economic systems that are broken or are vastly damaged. Small businesses are at core of the problem since these comprise a large part of our economic ecosystem and also provide employment to a large part of the population. These also often have limited financial means to deal with a complete freeze in business.

In India, a recent survey done by a community platform covering 7000 business found out that 47% of them have either already run out of funds or have less than a month of runway before they exhaust their cash. 61% of the respondents said they are considering scaling down their operations to deal with the cash crunch. Loans and other forms of credit are also not flowing through easily in this segment of businesses, thereby compounding their problems. The higher the mortality rate in this segment, longer the time to recovery of the economy as people lose their spending power resulting in a set back to consumption. In our note "Muddling through the Covid19 crisis' we had highlighted that India needs more stimulus – "Go Keynesian" it said. It has been a disappointing wait since, as the stimulus package is still under works. The lack of visibility of stimulus would be hampering the ability of millions of entrepreneurs to address the disruption even as we come out of lockdown.

We will have to be mindful that there are likely to be higher long-term economic costs of any large stimulus package. We are likely borrowing from our future. Central plus state government fiscal deficit is already high and will be pushed higher due to loss of revenue in the current situation. And yet the package is crucial. Retreat from the battle to win the war, as we said the last time.

The global equity markets, in denial of the macro-economic reality whilst believing in the Powell put, continued to power ahead. The S&P 500 posted the biggest monthly gain since 1987 erasing nearly a third of the losses since the global rout started in February 2020. Indian equity markets also rallied a pretty 31% from the bottom to limit current calendar year losses to 19%. On the back of nationwide lockdown that is considered as the most restrictive globally, we had the best equity month in over a decade. We wonder whether divergence between markets and economic reality has ever been this stark.

Performance of Key Global Indices

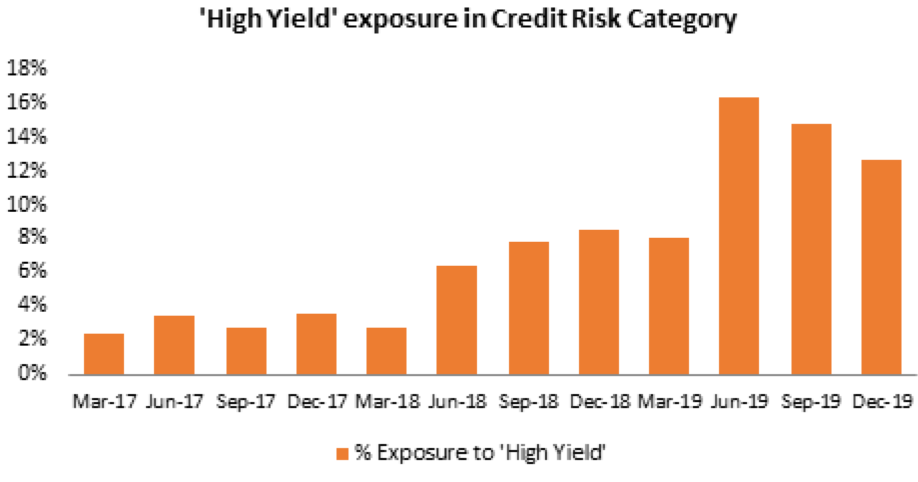
India	1 Week	1 Month	1 Year	3 Year	5 Year	% Fall from 52 week High	52 week High Date
NSE Nifty 50 Index	5.9%	14.7%	-16.1%	2.0%	3.8%	-20.7%	20-Jan-20
S&P 500 Index	4.1%	12.7%	-1.1%	6.9%	6.9%	-16.6%	19-Feb-20
NASDAQ Composite Index	4.6%	15.4%	9.8%	13.7%	12.5%	-12.5%	19-Feb-20
Shanghai Stock Exchange Compos	0.8%	4.0%	-7.1%	-3.2%	-8.4%	-8.5%	14-Jan-20
Nikkei 225	3.9%	6.7%	-9.3%	1.7%	0.7%	-18.6%	17-Jan-20
MSCI Global Index	3.9%	10.6%	-6.8%	2.4%	2.3%	-17.6%	12-Feb-20
MSCI AC Asia Pacific Index	3.8%	8.1%	-8.9%	-0.2%	-0.7%	-17.0%	20-Jan-20
MSCI Emerging Markets Index	3.7%	9.0%	-14.3%	-1.8%	-2.5%	-20.3%	20-Jan-20

Source: Bloomberg, Sanctum Wealth Management

This divergence is reflected even in the global bond markets. On the back of US Fed/Treasury provisions to buy junk bonds, US BBB rated corporate debt had its biggest monthly rally ever recorded in April. This is when risk of downgrades is especially heightened as a consequence of a stalled economy (in the 2007-09, 2000-03 and 1989-91 downturns, between 23% and 45% of investment-grade bonds were downgraded to junk). As an aside, the Fed hasn't bought a single junk bond yet. The Indian debt markets however have been going through significant pain in lower rated bonds. More on this later in the note.

Corporate performance last quarter would reflect supply-chain disruption due to China lockdown and a few weeks of domestic lockdown. The results will be no indicators of the upcoming quarters' performance. But interaction with the managements will help us get insights into business confidence and recovery expectations. We expect that all positive surprises will be rewarded by the stock markets in the near term. Once the economy opens up, however, all negative surprises could be met with meaningful corrections in the stock prices.

The Indian fixed income markets have intermittently been facing brief dislocations. While policy interventions have helped soothe the markets post each such event, the Franklin funds episode has deeper ramifications and will drag for some time. The root of the issue is, when a few years ago mutual funds started investing in lower credit quality in search for higher yields. As higher returns attracted more AUM, incremental money was allocated to higher yielding papers. Since the AUM flow was largely net positive, illiquidity risk was largely ignored.



Source: ICRA MFI Explorer, ICRA/CRISIL Bond Valuation, IDFC MF Estimates

Until the IL&FS default. Spate of defaults thereafter and polarization of flows towards strong balance sheets, caused the credit risk category to start shrinking. Risk aversion escalated as uncertainty surrounded the fate of weaker balance sheets and market activity in weaker credits seized, even as these funds continued to get redemptions. In case of Franklin funds, as high-quality papers where liquidated, portfolio became increasing illiquid, resulting in the announcement of winding up of 6 schemes. While the impact on debt funds was discussed in our note dated April 27, 2020, we want to discuss the larger impact of these events. Structured credit flow seems to be waning at a rapid pace in the economy. Only highly rated, conservatively managed corporates, banks and NBFCs are able to raise funds. The cost of money for the others is increasing and some are simply unable to access it. In fixed income markets, if liquidity crisis persists it can potentially snowball into a solvency crisis. At a wider scale this could have a far more devastating, long term impact hence immediate policy intervention is needed. This explains what the US is attempting to do by announcing intervention in the high yield and junk bond markets.

As economic trouble cascades from one pocket to the other, fiscal intervention is here to stay for an extended period. Printing of currency, unprecedented levels of debt, force majeure getting invoked in cross border trade, potential currency war as economies protect trade share and renewal of trade war rhetoric by the US against China collectively creates appetite for safe haven assets. Gold leads that trade. As demand recovers, countries could get into a currency war to make their exports attractive. This further supports the gold trade. We have been bullish on gold for a year now and continue to be significantly overweight. It also helps that our view is supported by strong technical trends too. (See Technical Trends section below)

Portfolio Actions

It was a tough month for portfolio managers as the market rebound was sudden and steep. While, the news flow across the world continued to be gloomy, market movements did not reflect the same. We had increased cash position in both our portfolios in Feb-20 to protect the capital in uncertain times caused by the spread of COVID-19. We continue to maintain high cash levels in both the portfolio as we believe the times ahead will be rough. However, the high cash position has hurt us in the short term as market up move in April was steep and we could not participate completely in the rally.

We have increased allocation to defensives like pharma, consumers and non-lending financials these companies are relatively less impacted by the disruption and have strong balance sheets and cash flows thus indicating better resilience. While, we have pruned weights in energy, lending financials

and IT as the global slowdown may impact earnings of these companies, we believe both the portfolios are well positioned to sail through in times to come.

Amidst this economic disruption there are certain pockets that could be lot less impacted and throw up investment opportunities. Our newly launched PMS strategy, Sanctum India Resilience Portfolio seeks to take advantage of such tactical opportunities in select sectors that are expected to remain resilient in these conditions. This strategy focuses on such companies in the non-cyclical, essential sectors that are less susceptible to demand disruptions. The portfolio launched last month, has delivered a 14.3% return vs 14.7% by the benchmark.

Portfolio Performance

Performance as on April 30, 2020	1 Month	3 Month	6 Month	1 Year	CAGR		
					2 Year	3 Year	Since Inc.*
Sanctum Indian Olympians	11.1%	-14.8%	-13.7%	-5.6%	0.6%	6.6%	5.4%
NSE100 Index	14.6%	-17.2%	-16.9%	-15.7%	-5.2%	1.2%	3.1%
Relative to NSE100 Index	-3.5%	2.4%	3.2%	10.1%	5.8%	5.4%	2.3%

* Since Inception Returns are from 16-Sep-16

Sanctum Indian Titans	10.3%	-14.1%	-10.8%	-2.4%	-4.4%	2.3%	6.3%
NSE200 Index	14.7%	-18.1%	-17.2%	-16.5%	-6.9%	0.1%	4.9%
Relative to NSE200 Index	-4.4%	4.0%	6.4%	14.2%	2.5%	2.3%	1.3%

* Since Inception Returns are from 18-Nov-16

Sanctum Smart Solutions	10.6%	-6.2%	-1.6%	4.1%	-6.2%	0.7%	3.7%
NSE200 Index	14.7%	-18.1%	-17.2%	-16.5%	-6.9%	0.1%	3.0%
Relative to NSE200 Index	-4.1%	11.9%	15.6%	20.6%	0.6%	0.6%	0.7%

* Since Inception Returns are from 03-Nov-16

All returns are on TWRR basis, after fees and expenses

Technical Trends

Gold

Technically Gold remains in a long-term uptrend. After touching a high of 1789 a couple of weeks ago price has been range bound and has been consolidating gains. If gold holds above the price level of 1660, it can be expected to see breakout above 1740 on upside and continue its rally towards 1900 levels. While on the downside, if gold breaks below 1660, we can expect correction towards 1580 levels.

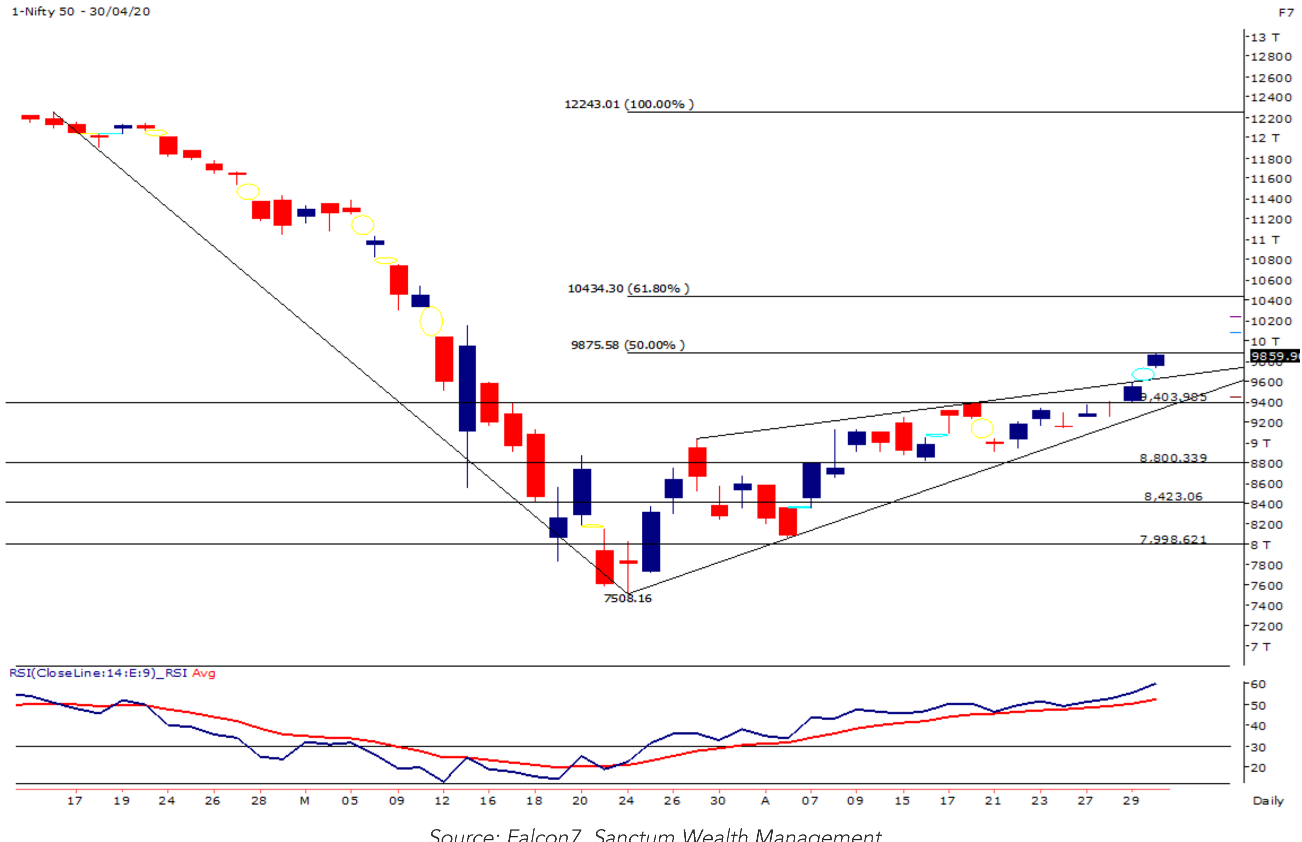
Dow Jones

Dow Jones has seen 11% rally last month retracing more than 50% of the whole decline. But the rally is showing slacking of momentum and is seeing some signs of weakness. Thus, fresh selling is likely if it starts to trade below 23,940. Decline can be expected towards 20,700 and possibly even a retest of low of 19,000 odd levels could be seen.

Nifty

After the market rout in March, Last month provided some respite to bulls as Nifty rallied almost 15% in April and 31% from the bottom. The rally has formed rising wedge pattern on daily chart which is bearish in nature. The pattern suggests decreasing momentum as market rallies higher. But last session's gap up opening breakout on upside has closed above pattern, which can happen sometimes giving false breakout on upside instead of downside. Nifty has closed at resistance level

of 9880 which is 50% retracement of the decline from mid-February high of 12247 to March of low 7511. Thus, suggesting bounce back has reached normal retracement zone. If index is unable to move higher then market may see decline back to below 9400 level which would confirm breakdown of the bearish pattern. Below 9400 levels, major supports are seen at 8900-8800 zone and then 8000 levels with intermediate support at 8420 levels. For the current uptrend to sustain, index must first hold above 9400 levels then cross 9880 resistance for rally towards 10440 levels. India VIX, a measure of volatility, has dropped from multi-year high of 86.6 to current levels of 34. Thus, after such a sharp decline, VIX can stabilize at current level and bounce back, leading to selling pressure in the market.



Source: Falcon7, Sanctum Wealth Management

Conclusion:

Equities

In March 2020, the market rout was very rapid, even before we got a chance to assess potential extent of damage the virus was wreaking on the economy. We have been experiencing lockdown for nearly 40 days now and understand that the dislocation could be deeper and prolonged than we initially thought. In the interim, as we mentioned above, markets have recovered. We think the Nifty p/e of 20x (TTM) can be deceptively expensive as growth in many sectors flattens or turns negative. Also, the technical trends of Nifty currently appear weak, syncing in well with our fundamentals led view. We are therefore moving to an **underweight position tactically**.

A question that we get asked often in such situations is why not move sell out of equities completely/largely and re-enter when the time is right. We believe, it is extremely difficult to catch the bottom of any market correction. Historically, missing just 5 best days of an up-move post a market correction has had significant impact in terms of delay in recovering losses. For example,

Nifty took 27 months to recoup all losses after Dot-com crash in 2000-01. However, if someone missed the best 5 days it would have taken 41 months to recoup losses. The impact is much sharper when we look at global financial crisis of 2008-09. The months to recoup losses increases from 25 months to 104 months (about 6.5 extra years) if someone missed the best 5 days of rally.

We decide allocations based on current facts. But could we see a significant co-ordinated stimulus package by G-20 countries? Could there be a break-through in terms of finding a cure of the virus? Could the US Fed decide to buy equities? We can never know beforehand. Could all or some of this happen in a short period time causing sentiment to change? We have just witnessed that in the worst week in the history of unemployment data US equity market had its best week. These dichotomies will always exist. Equity markets would have been an easy game were it only based on data but expectations, sentiment and liquidity play an important role.

Hence tactical calls are made within a predefined band. Exiting an asset class isn't a solution.

Debt

In our event update post the RBI policy intervention on March 27, 2020 we said that we expected liquid funds to normalize in April as the new financial year begins. Accordingly, we had recommended moving back from overnight to liquid funds in early April 2020. The stress has indeed largely dissipated since. SEBI has also now suspended marking short term securities to market and therefore liquid funds will now follow amortization. This will ensure that the price volatility in liquid funds is largely reduced.

We continue to recommend select Corporate bonds funds. These offer a relatively higher carry and have high quality portfolios. The polarization we mentioned above should help yield compression and these funds could gain from the same.

Alternate Assets:

Gold and international funds continue to be important diversification tools. Despite the rally in gold, there are fundamental factors that could help the price move up further. We recommend Gold ETFs as the holding period is flexible. Since gold fund NAVs are linked to traded prices of gold ETFs there could be larger tracking errors as discount/premium on gold ETFs fluctuate. We therefore prefer gold ETFs to Gold funds.

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