Sanctum View

June 15, 2022

Investment Strategy

RBI Policy and Asset Pair Commentary

Over the last week, the Monetary Policy Committee met and decided to raise policy rates by 50 bps to 4.9%, which was largely in line with the market and our expectations. The RBI acknowledged higher inflation by hiking inflation forecasts by 100 bps but kept growth forecasts unchanged, probably waiting for more data on the likely slowdown ahead. While the market is pricing steep rate hikes in the future, we think the RBI may pause much ahead of the terminal rate currently priced in by the market.

Last week the Sanctum Investment Committee also met to deliberate on our proprietary asset pair model which allows us to cut through the noise and focus on data. We use this model to then formulate our tactical asset allocation views. Overall, the asset pair model has a marginally improved score on equities, favours large-cap vs mid-cap and suggests the dollar is likely to strengthen further vs. the INR. The asset pair model is neutral on other asset pairs.

RBI Monetary Policy

After a surprise inter-meeting policy action in May 2022, the bond yields had hardened sharply fearing very steep rate hikes and liquidity tightening by the RBI. A 50 bps point rate hike was largely priced in. No cash reverse ratio (CRR) hike and the multi-year normalisation of extraordinary liquidity, created during the pandemic, calmed market nerves. Please find below key highlights from the policy meetings.

Inflation Forecasts

The RBI raised the inflation forecast for FY 2023 by 100 bps to 6.7% from 5.7% earlier, with a 75 bps increase in inflation projection attributed to food inflation. While this is a steep hike, this is more of an acknowledgement of visible inflationary pressures. The RBI forecasts inflation to fall below 6% by Q4 FY 2023.

The RBI highlighted that expectation of a normal monsoon, recent government measures including cutting excise duty on petrol and diesel, and moderation of global industrial metal prices are positive developments on the inflation front. However, the RBI did acknowledge upside risks to inflation from elevated commodity prices, electricity tariff revisions, supply chain bottlenecks, the pass-through impact of input costs and elevated crude oil prices.

Growth Forecasts

The RBI did not revise its growth forecast for FY 2023 and held it at 7.2%. It pointed to strong PMI numbers, rail/air traffic, GST collections and credit growth among others to suggest strong domestic economic activity. It assessed that urban demand is recovering and rural demand is gradually improving. Contact intensive sectors like trade, hotels and transport have recovered in Q4 FY 2022, which is expected to sustain urban consumption.

However, the RBI did recognise risks like geopolitical tensions, elevated commodity prices, rising input costs, tightening global financial conditions, and global economic slowdown as risks to growth forecasts.

As highlighted in our June note, we believe the FY 2023 growth number could fall short of the RBI expectation given the global economic environment. However, we believe India is better placed than the rest of the world and will remain one of the world’s fastest growing major economies this year as well.

Liquidity

As a relief to the market, the RBI indicated that it would normalise the extraordinary liquidity pumped during the pandemic over a multi-year time period rather than rushing. It is important to note that India did not have to pump as much liquidity as some of the other central banks across the globe and hence the normalisation is that much lesser.

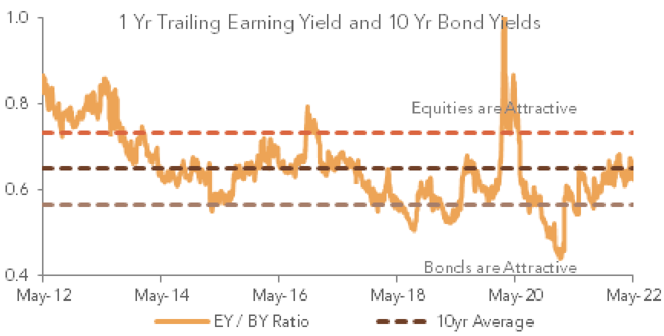
Quarterly Asset Pair Review

Equity vs. Bonds

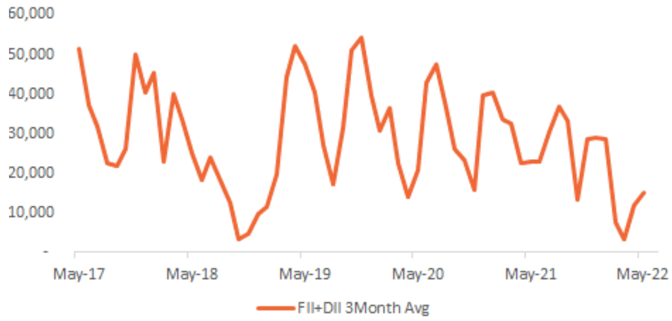
Valuations have moderated, earnings resilient

With the correction witnessed over the last few months valuations are now closer to historic averages on most parameters. Additionally, macroeconomic indicators have remained resilient, despite global slowdown worries. While global tightening financial condition is the biggest worry, we have seen FII outflows abate, and domestic flows remain strong. Finally, corporate earnings indicate margin pressures but are broadly in line with expectations. Balancing the economic environment and sentiment, the model continues to suggest a neutral view on equities. Our equity weight in model portfolios, therefore, remains unchanged at neutral.

Equity valuations have improved

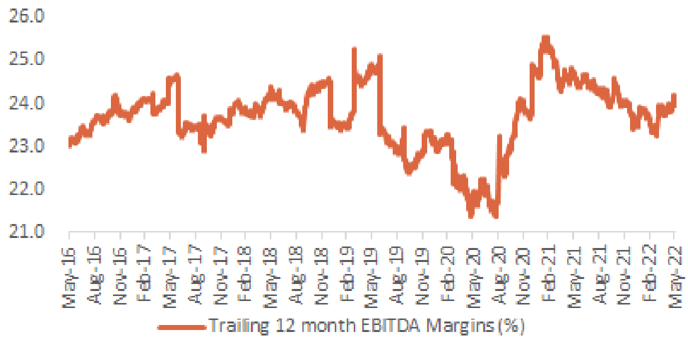


Net equity outflows have moderated



Nifty has retested March lows, but holding above

EBITDA margins have contracted as expected



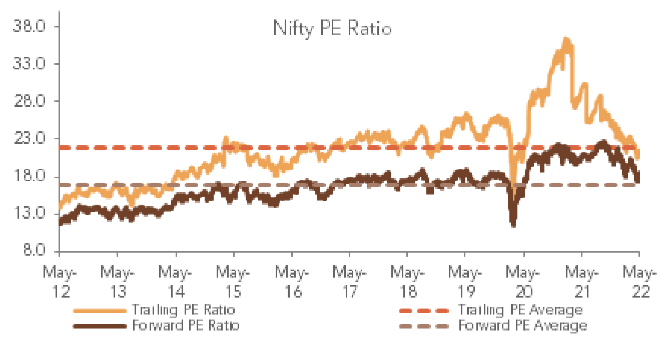
Source: Bloomberg, Sanctum Wealth

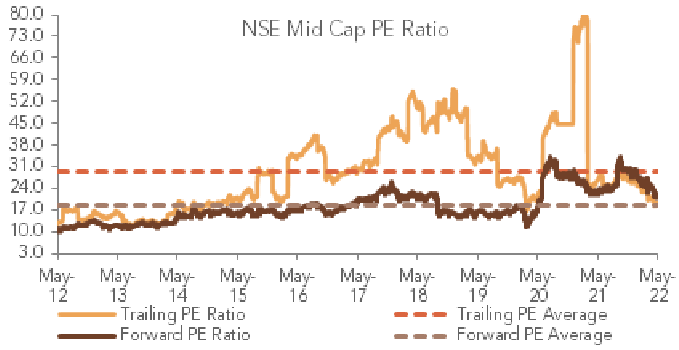
Largecap vs. Midcaps

Corporate earnings revisions in favour of largecaps

Valuations have corrected for both large and mid-caps. However, analysts expect higher earnings momentum for large caps. Financials and automobile companies are likely to contribute significantly to earnings growth in the coming quarters. Since financials and auto make a part of the large-cap indices, earnings growth for large-caps are expected to be higher. Technical momentum is also in favour of large caps. Overall, scores are in favour of large cap. Having said that, as mentioned in our commentary last week, the index masks the actual correction in the midcaps. We believe there are many pockets of opportunities in quality mid-sized companies at inexpensive valuations and hence, we are choosing to maintain our exposure to midcaps. This might cause some amount of short-term performance pressure, but we believe reward potential favours this risk.

Valuations have moderated for both large and midcaps



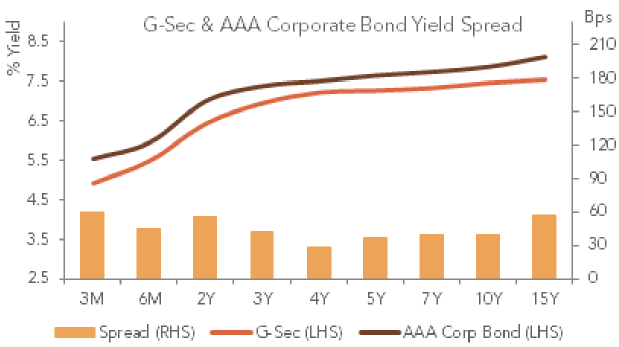


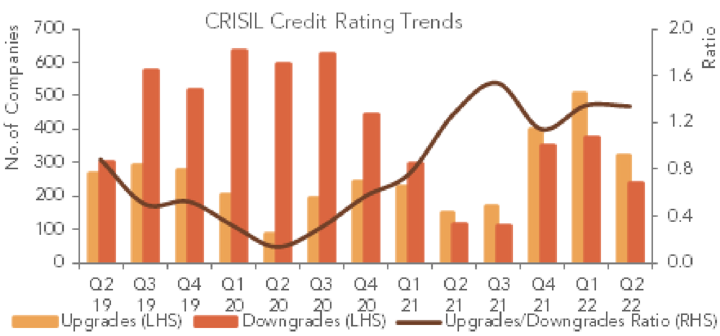
Source: Bloomberg, Sanctum Wealth

Corporate Bonds vs. Government Bonds

Neutral

Corporate spreads are close to an all-time low with 3-4 years spread between G-Sec and AAA less than 30 bps vs historic averages of about 75-80 bps. There is hardly any spread for the additional risks. However, the credit environment is favourable with upgrades outnumbering downgrades and credit growth picking up. While elevated government borrowing is a risk for government bonds given the low credit spreads we prefer government bonds over corporate bonds, especially in the belly of the curve.





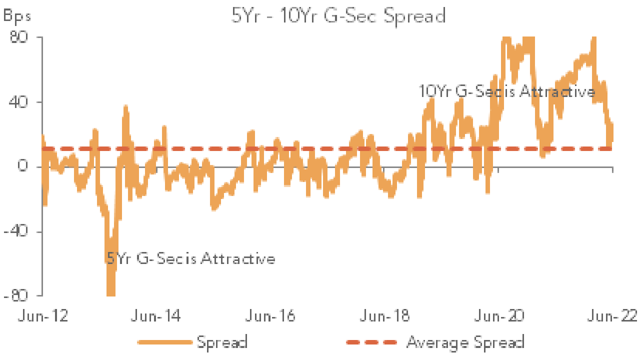
Source: Bloomberg, Sanctum Wealth

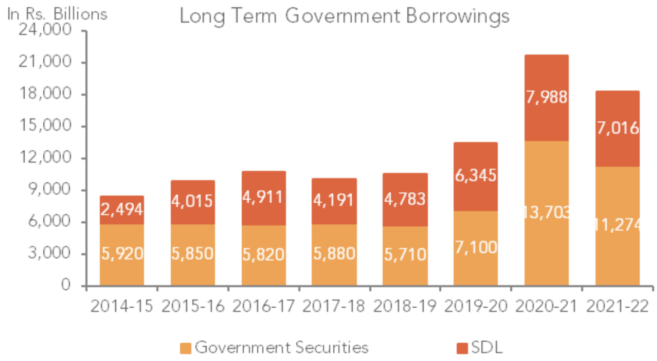
Short Term vs. Long Term Bonds

Neutral

The yield curve is steep till the middle of the curve and flattens beyond 6 years. Hence, one is not getting compensated enough for the additional risk by investing beyond that portion of the curve. Additionally, government borrowing is likely to be towards the longer end which should add to further pressure.

Less than 20 bps spread between 10 yr and 5 yr bonds Government borrowing a risk for LT bond





Source: Bloomberg, Sanctum Wealth

Conclusion- Fixed Income

As covered above, the RBI policy was largely in line with expectations. Bonds yield did not move much after the policy action reiterating that the rate hike was priced in. The overnight index swaps (OIS) curve is pricing in a terminal repo of more than 6.5%+. We think the RBI may pause much before this as growth pressures could start dominating rather than inflation, unlike the current times. This suggests corrections in the short-term rates are largely priced in. However, some volatility, especially at the long end of the curve is expected in the near-term.

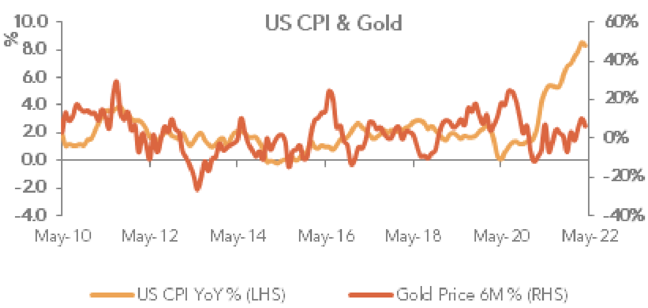
For most of the past year, we have been recommending investors to barbell portfolios. With our view that a large part of the correction in bond prices is behind us, we recommend investors to build a portfolio that is spread across low duration funds, roll down funds with current maturities ranging from 5-6 years, select credit-oriented AIFs and select direct bonds (for holding to maturity).

Gold vs. Cash

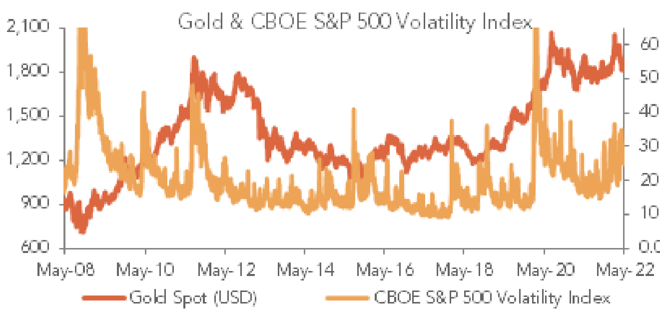
Neutral

USD strength has been negative for Gold. However, US inflation and capital market volatility could make a case for gold exposure. Additionally, INR weakness could add to returns in INR gold. Gold acted as a cushion when both equity and bond markets saw volatility. As highlighted in our earlier commentaries, we expect volatility in equity, and bond markets as well as geopolitical uncertainty could continue. Hence, we remain overweight in gold.

US inflation is soaring



Rise in equity volatility positive for gold



Source: Bloomberg, Sanctum Wealth

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