

September 08, 2022

Investment Strategy

The inflation talk

After relentless selling during the first half of this year, markets rallied hard in July as the Fed remarks were interpreted as more dovish than expected. The bond markets were pricing in a Fed rate cut by as early as February 2023, and equity markets too rejoiced at the prospect; with the S&P 500 up nearly 18% from June's bottom, safe-haven buying of the US Dollar paused. As August rolled in, all eyes were at the Jackson Hole event for further guidance from the Fed. In a crisp 8-minute speech at the event, Fed chair Powell mentioned inflation over 45 times, leaving no ambiguity about their focus on inflation, thus dampening the markets' optimism.

Price change as of 31 Aug 2022	1 Month	CYTD 2022	1 Year
NSE Nifty 50 Index	3.5%	2.3%	3.7%
MSCI Emerging Markets Index	0.0%	-19.3%	-24.0%
S&P 500 Index	-4.2%	-17.0%	-12.6%
NASDAQ Composite Index	-4.6%	-24.5%	-22.6%
Brent Crude	-5.7%	29.5%	43.3%
Gold/US Dollar	-3.1%	-6.5%	-5.7%
Dollar Index Spot	2.6%	13.6%	17.4%

Source: Bloomberg, Sanctum Wealth
The above data is in local currency and represents price change and not total returns

The incoming macro data from across the globe is softer. Of 30 PMIs measured by S&P Global PMIs, only ten have stayed positive. India numbers, however, continue to exhibit strength but more on this later.

Muted global PMI data



Source: S&P Global, JPMorgan

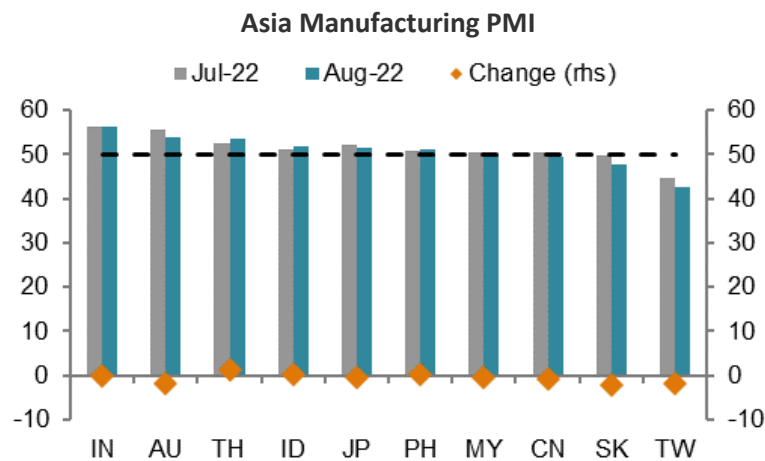
The Europe energy crisis has deepened with Russia shutting off the Nordstream 1 gas pipeline and German politicians fearing civil unrest. We believe that the price cap on Russian energy imports is likely to be ineffective, at best.

China's economic woes continue as the government persists with the zero covid policy. According to Caixin, 33 Chinese cities, including Chengdu, Tianjin and six provincial capitals, are now under partial or complete lockdowns, affecting more than 65 million residents. China's real estate slump, which is at the heart of its current economic woes, is not showing any signs of recovery. Housing property accounts for 71.4% of the family wealth in urban areas, according to the China Household Wealth Survey Report 2019. More than 30

Chinese real estate companies have already defaulted on their international debt this year and the top-ranked developer just declared a 96% drop in its half-yearly profit.

US growth is also slowing down, although some of the data especially unemployment data continues to be strong (although some of it is marginally weaker than expectations). Housing has been an enormous wealth creator for US households, and there are signs of softening in the sector. New home supply is at the highest since 2009, while mortgage demand is at the lowest since 2000. Median prices have started decreasing, adversely impacting the wealth effect, which is a significant demand catalyst.

Amidst all of this gloom and doom, some of the Asian economies continue to be holding up. A lot of these economies are benefitting from China+1 and import substitution policies. With Europe's energy crisis deepening, several of these economies could also be beneficiaries of manufacturing reshoring.



Source: Natixis, Bloomberg

Quarterly Asset Pair Review

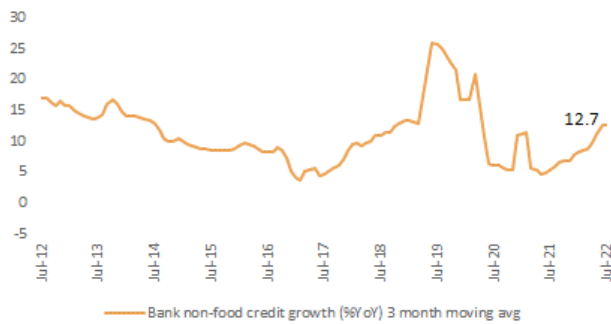
It's that time of the year when the Sanctum Investment Committee meets to deliberate on our proprietary asset pair model, which helps formulate our tactical asset allocation views. Most pairs saw marginal changes, and we aren't making any tactical changes to our model portfolios. The only pair that saw a noteworthy change in score was the Corporate Bond vs G-Sec pair, which moved in favour of G-Sec.

Equity vs. Bonds

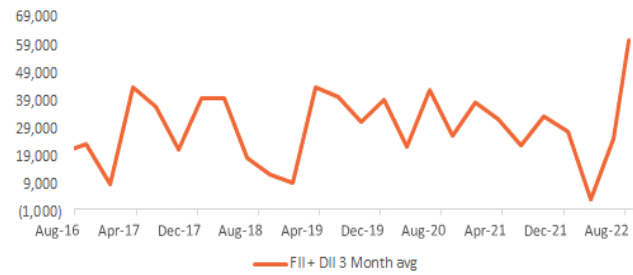
Negative on valuations, while macro and flows supportive

Even as the global macroeconomic data is coming in soft, India is relatively better placed. Data from India remains robust with IIP, credit growth and PMI indicating sustained growth momentum. India's GDP growth for Q1 FY2023 (quarter ended June 2022) came in at 13.5%. While this was lower than the RBI estimate of 16.2%, with double-digit GDP growth, India remains the fastest-growing major economy, resulting in Indian equities outperforming global markets despite FII selling since Mid-2021. FII selling moderated in July, and they have turned net buyers in August, while DIIs continue to pump in money.

Non-food credit growth has picked up



Net equity flows have turned positive

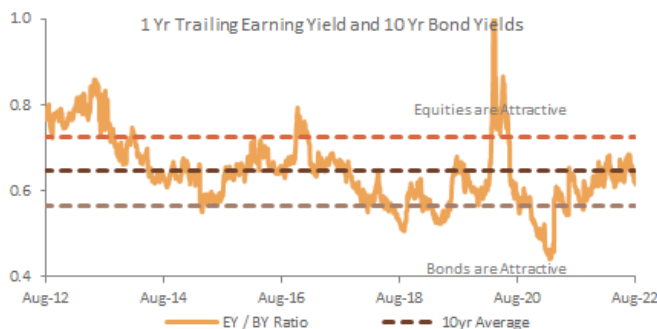


Source: Bloomberg, Sanctum Wealth

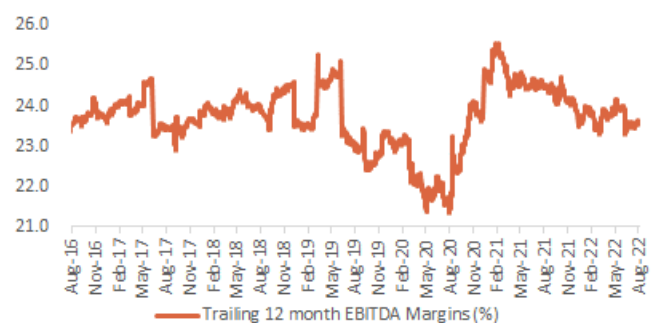
Indian corporate earnings saw sharp growth last year, primarily supported by a favourable base. The earnings momentum slowed in FY22 as the base effect moderated and margin pressures increased. In Q1FY23, we saw signs of EBITDA margin pressures easing to some extent. Overall, earnings have primarily been in line with expectations.

Post the correction we saw in the first half of this year, valuations of equities had improved. However, with a sharp rally in July, valuations have increased and turned unfavourable.

Equity valuations have turned adverse



EBITDA margin pressures seem to have eased



Source: Bloomberg, Sanctum Wealth

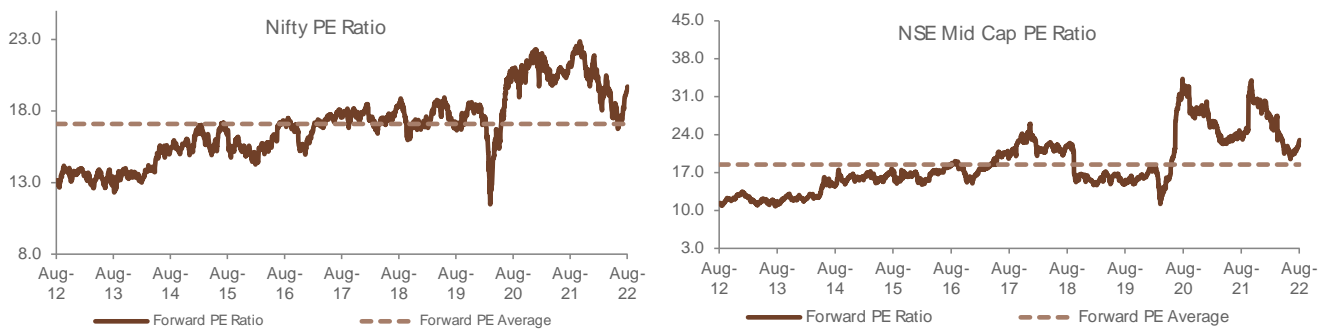
Given the valuations, despite the positive macro trends and improved equity flows, overall scores for equities have remained close to neutral. We had indicated that we would like to add 0.5% weight every three months to equities in our July investment commentary note. We added the first tranche in July, but given the sharp run-up, we have paused since then. We will closely track US inflation numbers for August and the Fed policy later this month. We may add equities if the market provides an opportunity due to these events.

Largecap vs. Midcaps

Corporate earnings and technical momentum in favour of large caps

Midcaps significantly outperformed large caps in 2021. The correction has also been steep for midcaps. Currently in terms of valuations both large caps and midcaps are trading slightly above the historical average; hence, there is very little to choose.

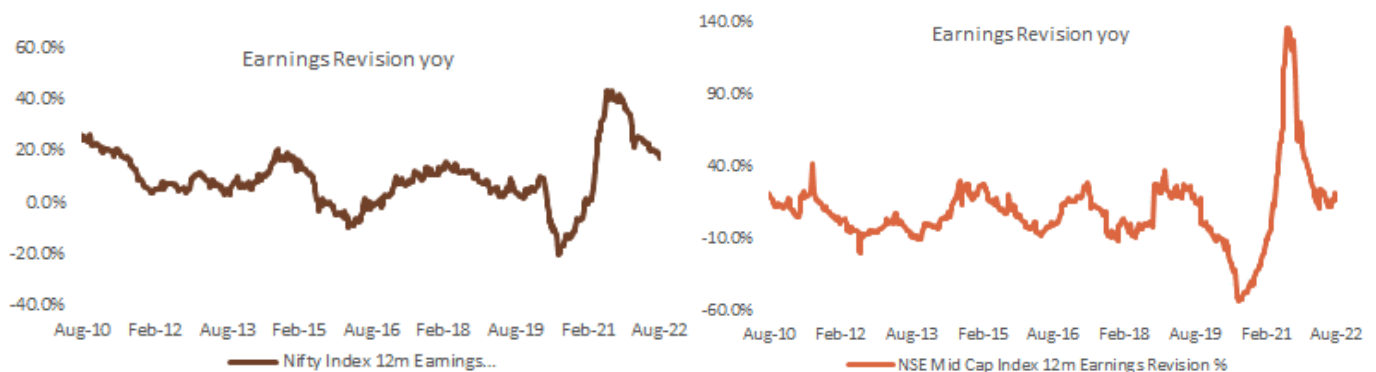
Valuations similar for both large caps and midcaps



Source: Bloomberg, Sanctum Wealth

Corporate earnings momentum suggests that large caps are better placed. The 12-month earnings revision for Nifty is still more than 20% which is higher compared to midcaps. Technical momentum is also in favour of large caps; hence, the overall scores favour large caps.

Earnings revisions have seen normalisation, yet Nifty earnings revision is still above 20%



Source: Bloomberg, Sanctum Wealth

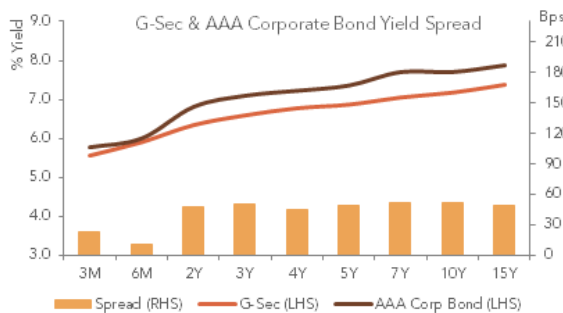
We think, unlike in 2020 and 2021, this year, investors might not be able to make substantially higher returns by just getting the market cap allocation right. This year might be a stock-pickers market, and hence multi-cap funds with the ability to choose the best available stocks across the market cap segment may be better placed.

Corporate Bonds vs Government Bonds

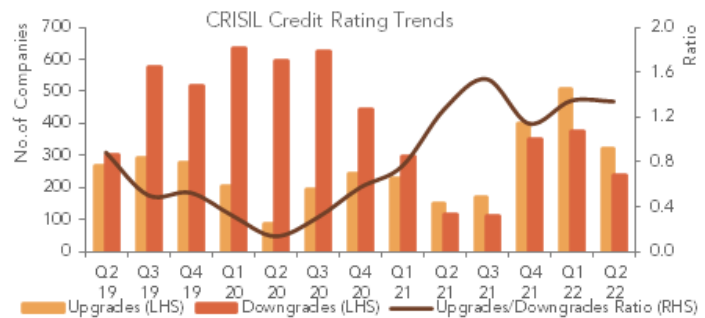
Positive G-Sec

As we have seen through most of this year, corporate spreads remain very low. The 3-year AAA corporate bond to G-Sec spread is close to 50bps, while the 10-year average is closer to 80bps. As seen below, across the yield curve credit spreads are close to 50bps vs a historical average of 80bps, indicating that investors are not compensated adequately for taking the credit risk of AAA bonds vs G-Secs. However, the credit environment generally is favourable, with higher upgrades than downgrades.

Credit spreads across the curve are narrow



Credit environment is favourable



Source: Bloomberg, Sanctum Wealth

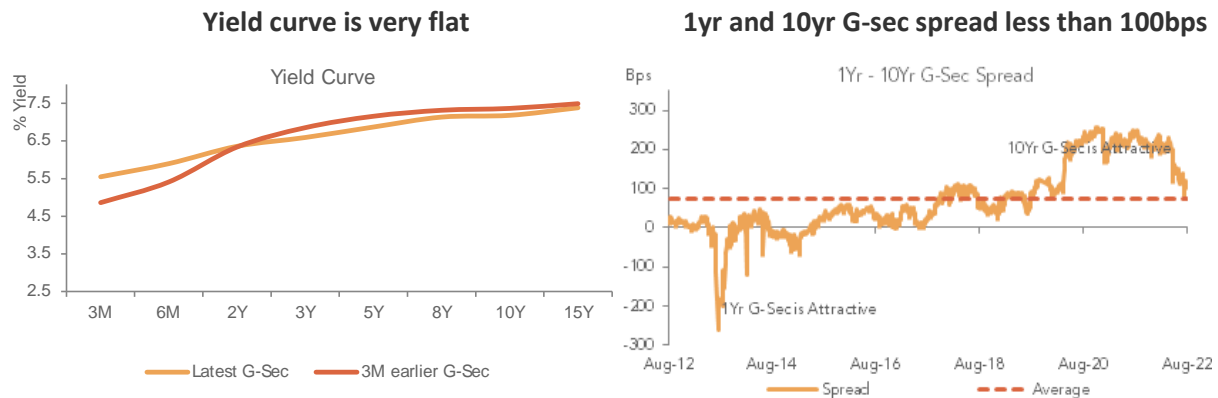
While highly quality bonds (AA and above rated) are trading with a narrow spread relative to G-Sec, A and below rated bonds are adequately priced. We believe this exposure is best taken via specialised credit AIFs that carefully select companies in this segment after thorough due diligence.

Short Term vs Long Term Bonds

Neutral

The yield curve has flattened significantly over the last few months as short-term rates have moved higher. Hence, while there is some yield pickup if one moves from a 3-month bond to 4-6 years maturity, there is hardly 5bps for taking an additional 1-year maturity post that.

With the yield curve flattening we suggest investors ladder their portfolios i.e., have exposure across the yield curve by investing in different maturities. However, since the incremental yield beyond six years falls drastically, investors should restrict their duration to less than six years.

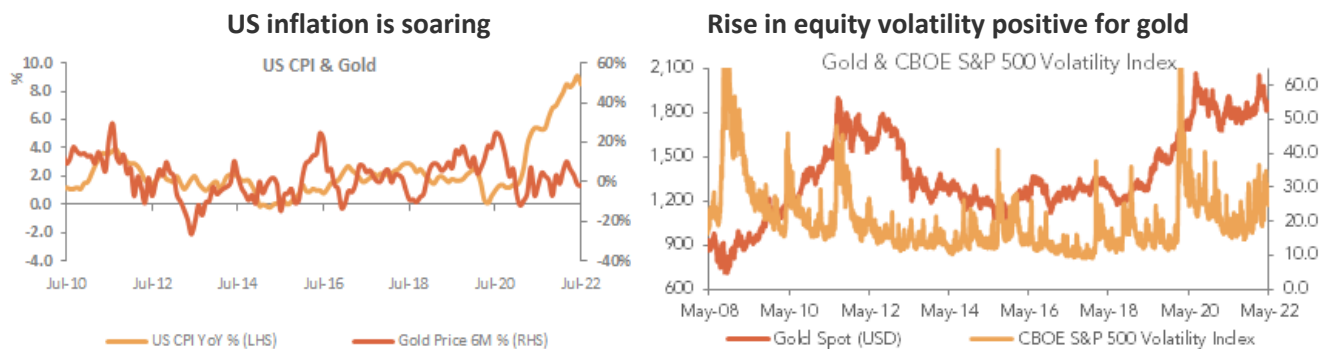


Source: Bloomberg, Sanctum Wealth

Gold vs. Cash

Neutral

Throughout this year, USD strength has impacted gold prices adversely. However, the depreciation of INR has supported gold prices in INR terms. We have been overweight gold in our model portfolio since the Russia-Ukraine crisis broke out, and this cushioned the portfolio, especially when equity markets were declining. We expect equity market volatility to continue going forward. Additionally, US inflation is also soaring. Hence, we continue to remain overweight gold.



Source: Bloomberg, Sanctum Wealth

Fixed Income Mutual Fund Review

As part of our regular process, we carry out a semi-annual review of debt mutual funds, where we thoroughly assess the entire debt MF universe to identify categories and funds to recommend to our clients. We carried out this exercise last month. Since the fixed income views have changed drastically given the rate cycle, our recommendations have also changed accordingly. We summarise key highlights below.

Since the Franklin fiasco, debt mutual funds portfolios have become relatively clean and thus, across categories, we see limited credit quality issues. Additionally, as highlighted above the yield curve is flat;

hence, across categories, the gross YTM (yield to maturity- an indicator of returns to be made if held till maturity) is between 5-7.5%. Hence, expense ratios have become a major deciding factor. We observed that categories like medium duration, medium to long duration, credit risk, and dynamic funds have close to 7.5% gross YTM but have more than 1.5% expense ratios, reducing net YTM (YTM after expense) to less than 6%. As seen below this is less than short duration and corporate bond funds in most cases. Hence, we suggest that investors avoid exposure to categories that have higher expense ratios.

We recommend allocation across the categories highlighted in green which offer decent net YTM. As discussed earlier in the note, we recommend laddering; hence some exposure across these categories makes sense.

Data of Median Fund across category	Average Maturity (Years)	Modified Duration (Years)	Gross YTM (%)	Expense Ratio	Net YTM (%)
Overnight Funds	1 Day	1 Day	5.05	0.18	4.86
Liquid Funds	0.10	0.10	5.66	0.27	5.42
Ultra-Short Term Fund	0.39	0.37	6.12	0.84	5.35
Low Duration Fund	0.89	0.66	6.26	0.64	5.64
Money Market Funds	0.39	0.39	6.11	0.39	5.74
Short Duration	1.81	1.58	6.72	1.02	5.77
Medium Term Funds	3.61	2.47	7.58	1.43	6.11
Medium to long Duration Funds	6.82	3.92	7.18	1.69	5.41
Dynamic Bond Funds	3.84	2.38	6.76	1.47	5.38
Corporate Bond Funds*	2.34	1.49	6.84	0.61	6.17
Credit Risk	2.56	1.70	7.83	1.62	6.07
Banking & PSU Funds	2.26	1.58	6.61	0.71	5.85
Gilt	5.15	3.18	6.99	1.10	5.62
Target Maturity*	4.48	3.62	7.23	0.30	6.90

Source: ACEMF, Sanctum Wealth

Data as of 31st July 2022

Categories highlighted in green are recommended for new subscriptions

*Select corporate bonds with lower duration are recommended and select target maturity funds with exposure to G-Sec or SDLs

We recommend all funds across overnight and liquid fund categories

We highlighted above how corporate spreads are low relative to historic levels, and target maturity funds with exposure to AAA corporate offer only marginally higher YTM for the additional risk. Also, the normalisation of corporate spreads and the illiquidity of the corporate bond market could lead to lower realised returns than indicated YTM amid higher impact costs. Hence, amongst the various target maturity funds, we recommend funds that invest in G-Sec or SDLs only.

Sanctum Wealth

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