December 7, 2022

Investment Strategy

- **Global equities rally on the back of likely slower Fed rate hikes but terminal rates likely to be higher than anticipated earlier**
- **PMI data across geographies in contraction zone. India amongst the few exceptions**
- **Despite incremental improvement in data, Eurozone worries are far from over.**
- **Large scale protests in China against the zero covid strategy, equity markets rebound in November after a sharp fall.**
- **India still a bright spot, however, valuations expensive.**

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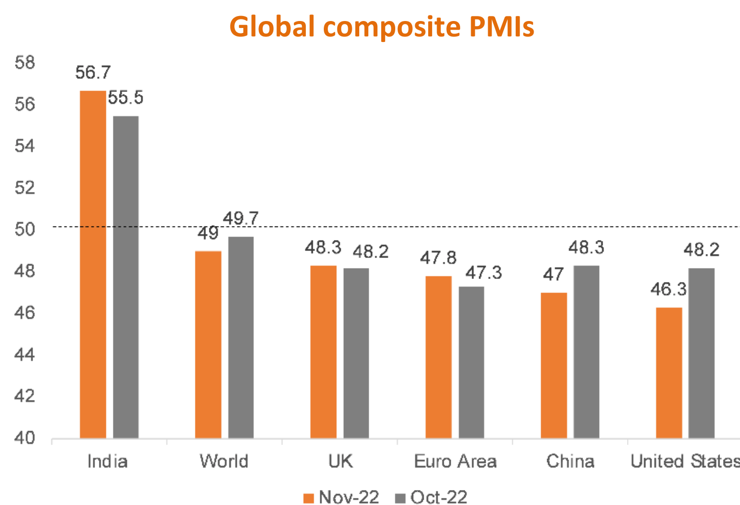
A bear market rally

Since September 2022 lows, global equities have rallied close to 10% across geographies on the back of a likely slowdown in the pace of Fed rate hikes and lower US inflation data in October. As per the minutes of the November Fed meeting FOMC members believed that it would be appropriate to slow down the pace of rate hikes soon. The minutes also highlighted that the Fed now sees the terminal rate at 5% vs 4.6% in September, given the elevated inflation and ongoing tight labour markets.

Performance data as of 30th Nov 2022	1 Month	2 Month (Since Sept Lows)	YTD
NSE Nifty 50 Index	4.1%	9.7%	8.1%
S&P 500 INDEX	5.4%	13.8%	-14.4%
NASDAQ Composite Index	4.4%	8.4%	-26.7%
MCSI China	28.3%	7.2%	-25.9%
Nikkei 225	1.4%	7.8%	-2.9%
MSCI ACWI Index	7.6%	14.0%	-16.4%
MSCI AC Asia Pacific Index	14.8%	12.6%	-19.0%
MSCI Emerging Markets Index	14.6%	11.0%	-21.1%
Gold/US DOLLAR	8.3%	6.5%	-3.3%

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

Composite PMIs for both China and the US weakened further in November 2022, while the Eurozone PMI saw an improvement, yet it remained in the contraction zone. Only a few countries are reporting PMIs greater than 50 (expansion), and India is one of them. More on this later.



Source: Tradingeconomics.com

The US jobs data for November 2022 showed that the labour market remains strong, sparking inflation worries. However, despite inflation concerns, US retail sales have been resilient. A closer look highlights that these purchases are being funded by credit cards. US consumers are burning through their savings and are borrowing more to fund purchases. With credit card delinquencies for subprime customers beginning to deteriorate, a fall in savings, and a rise in borrowing and its costs, point toward weak consumption in the US in 2023. Early signs of weaker consumption impacting earnings were visible in the corporate earnings of the last quarter. A continued slowdown is expected to weaken corporate earnings further and by extension put pressure on US equities.

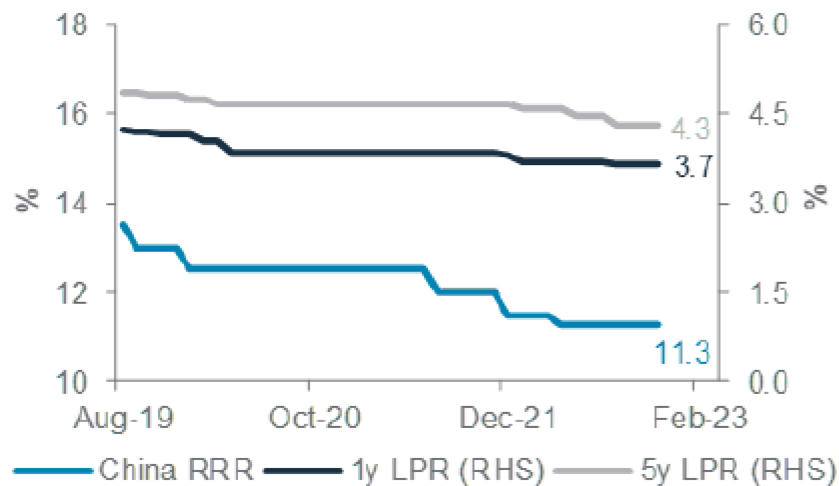
Total outstanding credit card balances
(in billions, seasonally adjusted)

Source: New York Fed Consumer Credit Panel/Equifax

The recession possibility is highest in Europe with still very high inflation, given natural gas supply disruptions, and tight monetary policy. However, incremental data seems to be improving on the margin. Both PMI, as well as consumer confidence, were better than expected, though still very depressed. Energy prices have come down and supply chain disruptions have eased to some extent. Overall, while troubles for Europe are very far from being over, things are starting to improve.

After months of lockdown due to China's "Zero Covid" strategy, angst amongst people reached a boiling point culminating in one of the largest demonstrations against the ruling Communist Party in decades. In reaction to this, the government eased some of the restrictions. To support the economy, the Chinese central bank (PBoC) is amongst the very few global central banks that are easing monetary policy. After falling by more than 25% in September and October, MSCI China recovered most of those losses last month. Even after the rally, year to date, MSCI China is down by close to 26% in local currency. Chinese equities are trading at near all-time low valuations. Hence, cheap valuations and the easing of covid restrictions could lead to a near-term bounce in Chinese equities.

China's bank reserve requirement ratio (RRR)



Source: Standard Chartered Bank
LPR (Loan prime rates)

Quarterly Asset Pair Review

Looking at data in a structured way allows an investor to cut through the noise and focus on what really matters. Through our asset pair model, the Sanctum Investment Committee deliberates on various data points to arrive at tactical asset allocation views. This time around, scores are neutral across all pairs. This underlines the point that investors need to put in more effort to find tactical opportunities in current markets.

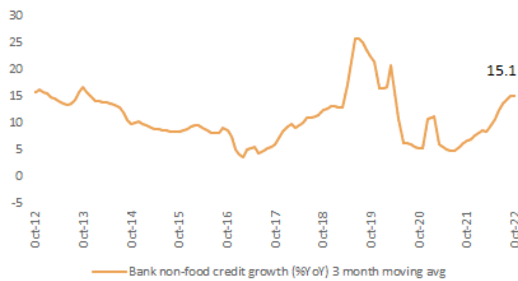
Equity vs. Bonds

Macro data strong, valuations a concern

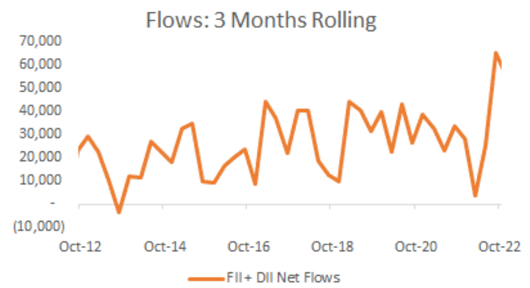
India's better growth prospects relative to the world have been a primary factor for Indian equities being able to side-step the global equity market correction. India continues to deliver strong macro data. The GDP growth for Q2 FY2023 (quarter ended Sept 2022) was recorded at 6.3%, in line with expectations. Composite PMIs in November 2022 came in at 56.7, non-food credit growth picked up further and non-oil import growth remained strong. While on a sequential basis we have seen some softening, we don't see any signs of concern yet.

Year to date FII have been net sellers, but DIIs have been able to step in and compensate for FII outflows. In November, DIIs took a breather with marginal outflows, while FIIs turned net buyers. Technical momentum is also in favour of equities with Nifty touching new all-time highs and breaking key resistance levels.

Non-food credit growth is strong



FIIs also turned net buyers

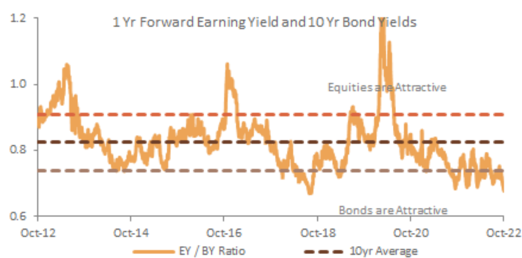


Source: Bloomberg, Sanctum Wealth

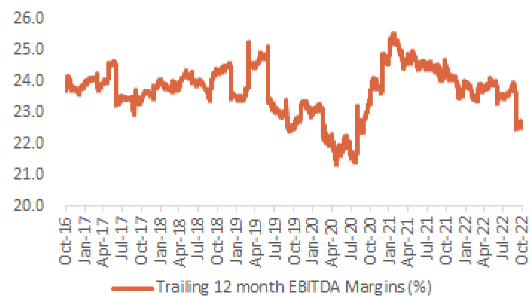
Corporate earnings for the quarter ended September 2022 recently concluded. Amid rising costs, analysts had anticipated pressures on margins and thus flattish earnings growth for Nifty. EBITDA margins declined in Q2 FY23 and Nifty ended up delivering a slight decline in earnings compared to flattish expectations. This is after multiple quarters of positive earnings surprises and strong earnings growth. We expect margin pressures to decline going forward.

While domestic fundamentals have been strong, expensive valuations have been a sore thumb for Indian equities. With earnings disappointment, this gets exacerbated. India is expensive relative to the rest of the world, its own history, and relative to bonds (especially since bond yields have moved up).

Equity valuations expensive



EBITDA margins declined last quarter



Source: Bloomberg, Sanctum Wealth

If earnings disappointment continues in the coming quarters, it could be a trigger for equity market volatility. Additionally, since Indian equities have hardly corrected while global equities have fallen significantly, whenever we see global risk-on sentiments, India could underperform the rest of the world.

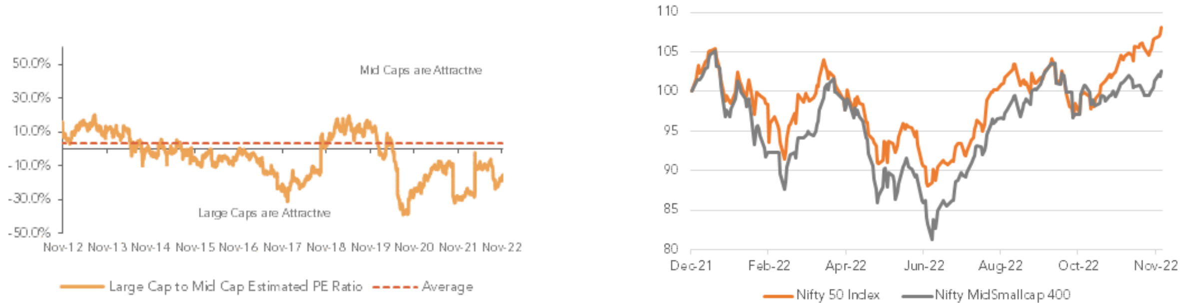
Largecap vs. Midcaps

Midcap still expensive, despite correction but technical momentum changing

This year, mid and small-cap have underperformed large-caps. In the first half of this year, mid and small-caps fell a lot more than large caps, since then they have rebounded but still lag

large-caps. Earnings momentum for midcaps has been muted relative to large-caps, which explains the higher midcap P/E despite a flattish return this year. However, technical momentum has started favouring midcaps given the deviation in the performance year to date.

Mid-cap forward PE expensive vs large-caps **Mid and small-caps have lagged large caps**



Source: Bloomberg, Sanctum Wealth

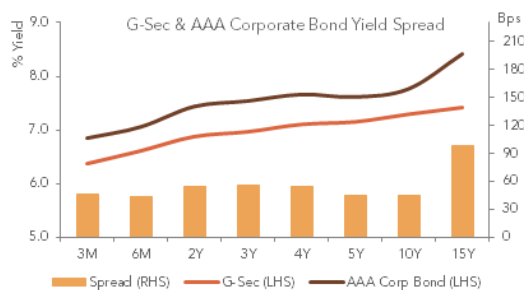
As highlighted, we believe the divergence between mid and large-cap equities may not be significant going forward to tilt the portfolio to either side. Remaining closer to strategic weights within equities and choosing good multi-cap managers, that could pick stocks across the spectrum, maybe more prudent.

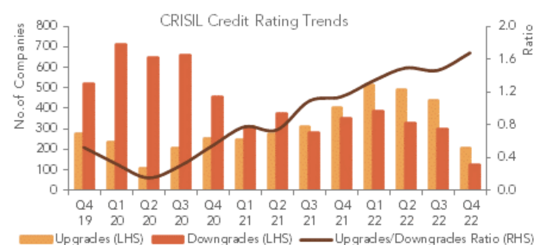
Fixed Income

Corporate spreads still narrow and flat curve is yield

Across the yield curve, the spread between corporate bonds and government bonds (credit spreads) is close to 40-50bps compared to long-term averages of about 80bps. This indicates that investors are not getting adequately compensated for taking the additional risk. As the spreads normalise investors holding corporate bonds could see some market-to-market impact. Hence, we continue to prefer government bonds over corporate bonds.

Credit spreads across the curve are narrow **Credit environment is favourable**



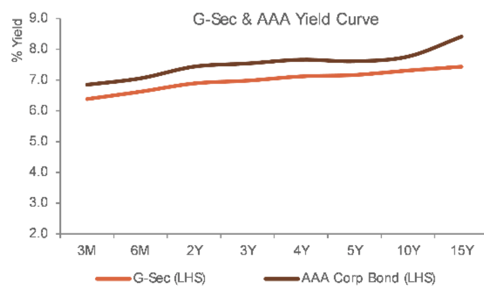


Source: Bloomberg, Sanctum Wealth

However, the credit environment remains favourable as upgrades continue to outpace downgrades. Hence, select opportunities in the AA/A rated papers may arise from time to time which investors could capitalise on. We still believe that select structured credit opportunities could allow investors to capture higher returns with some amount of higher risk even though the spread between high-rated papers and structured credit has narrowed a bit.

The yield curve is also flat, the difference between a 1yr and a 10yr G-sec is now less than 50bps vs an average of about 80bps. There is still some yield pick-up if investors move from a 6-month duration to 3-4 years but hardly post that. While we believe we are closer to peak bond yield levels, higher duration adds to the volatility. Unless the investment horizon matches the investment duration, we suggest investors avoid adding too much duration at this juncture. As soon as there is a sign of the rate cycle reversing, duration may be a good tactical opportunity. We don't think the time has come yet.

Yield curve is very flat



1yr and 10yr G-sec spread less than 50bps

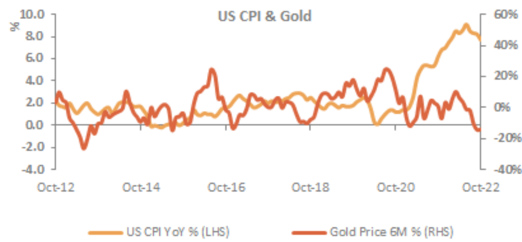
Source: Bloomberg, Sanctum Wealth

Gold vs. Cash

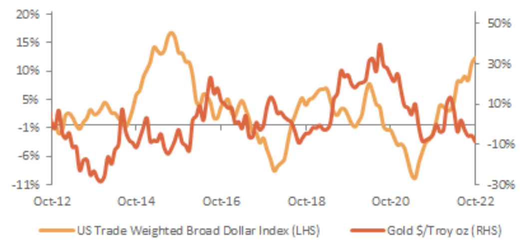
We have remained overweight gold through most of the year, primarily because of geopolitical risks and inflation even as some of the other factors like USD strength have not been supportive. For Indian investors, INR weakness has helped INR gold which has delivered positive returns year to date.

While the dollar has given away some strength, a strong USD continues to be an overhang. However, US inflation remains elevated despite some moderation. Equity market volatility also remains supportive of gold. Additionally, technical indicators for INR gold have broken key levels, suggesting a move upward. Hence, we continue to remain overweight gold.

US inflation still elevated



USD strength has weighed on gold prices so far



Source: Bloomberg, Sanctum Wealth

Conclusion

In conclusion, the asset pair model suggests sticking to strategic asset allocation weights across asset pairs. As we approach the end of the year, it may be prudent to review the current allocation against strategic weights. It has been a tough year so far, the next few months could continue to be challenging, hence getting the strategic weights correct is very important. Additionally, markets keep throwing tactical opportunities time and again, investors should utilize them wisely as and when available.

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