May 27, 2019

Investment Strategy

The Fourth Wave

"The 2019 Election has worked to tear down walls, and heralds the dawn of a new age"– Narendra Modi

The people have spoken and a massive pro incumbent wave has entrusted the nation's stewardship to P.M. Modi for five more years. This week, we widen our lens to focus on macro challenges and opportunities, and implications for investment strategy.

A Slowing Global Economy, Protectionism, Tech for Labor Substitution Present Challenges

Most of us have forgotten the Fragile Five economy label that the Modi government inherited. Many of us have also forgotten the double digit rates of food inflation and massive non-performing loans in the banking system.

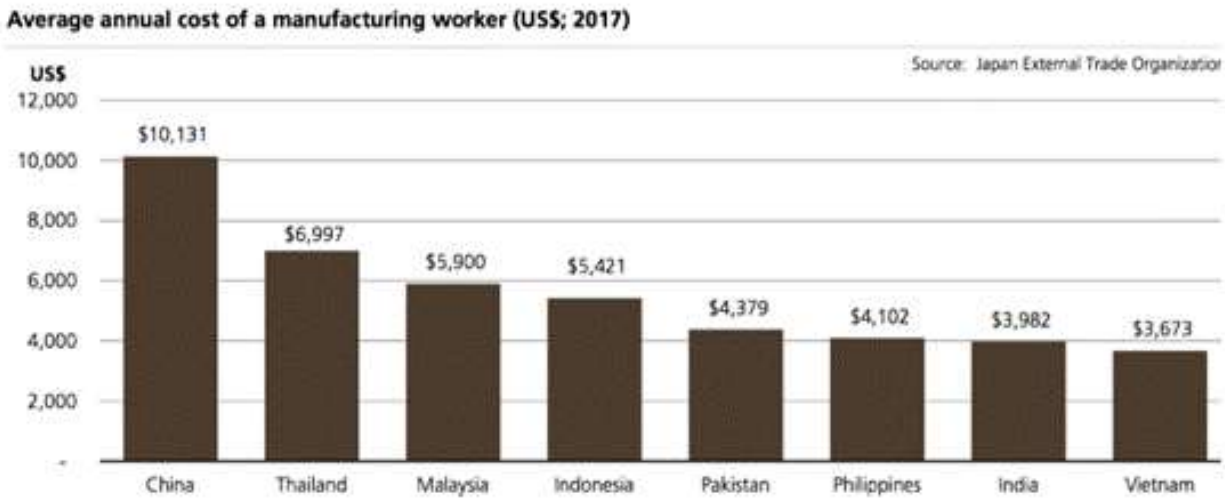
But the global economy also looks quite different from the way it did five years ago. The U.S. is re-writing the rules on global trade and increasingly protectionist. Slowing advanced economies, rising populist angst, rapid tech for labour substitution, software automation, and slow job creation are amongst the key challenges facing the Modi government.

Within this backdrop, access to commerce is a strategic imperative, and every country wants access to India's growing market. This is **India's potent point of leverage**.

The Way Forward: 3 Key Themes to Catapult India to a $5 Trillion Economy

In our view, three key themes hold the promise and potential to catapult India's economy and achieving its goal of being a $5 trillion economy by 2025.

India Offers Cost Advantages and a Large Domestic Market as a Manufacturing Hub



Theme I: The Fourth Wave

The first wave of manufacturing saw production shift from the U.S. to Japan. Wave two saw production shift from Japan to South East Asia, and birthed the Asian Tigers. Wave three saw China step forward and become the manufacturer for the world. We are at the threshold of the fourth wave, and the opportunity beckons India.

India is a Great Option for Global Supply Chain Risk Mitigation

China is increasingly likely to be viewed as a risky – and increasingly expensive - choice for global supply chains. Separately, China is looking to reduce its dependence on the U.S. China has a substantial labor cost premium versus India, and environmental regulations are a third factor. This is a multi year, step up opportunity for which India appears to be well positioned.

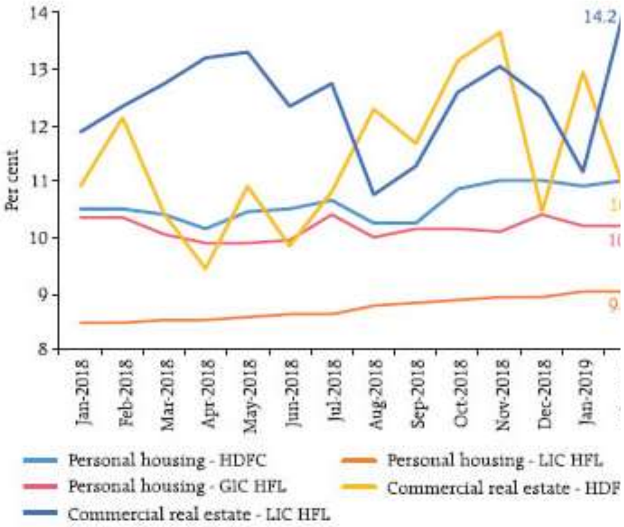
This opportunity opens for other Asian low cost economies as well, the likes of Vietnam, Indonesia, Thailand and Malaysia. However, India has a better ranking in the global manufacturing competitiveness index and offers manufacturers a large domestic market opportunity.

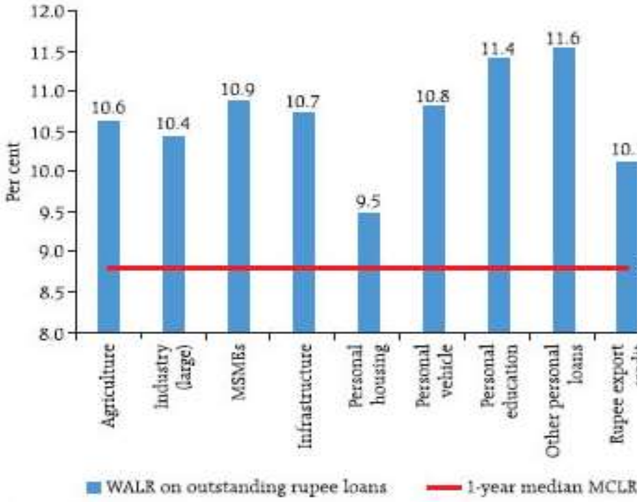
What India must address are infrastructure and legal, regulatory bottlenecks. Reforms on land acquisition and labor laws, licenses are crucial and are likely to further accelerate with the government now expecting a majority in the Rajya Sabha by late 2020.

Theme II: Lower Interest Rates & Ensure Transmission to Unleash Economic Activity

The tried and tested, classic monetary policy response to slowing growth is lower interest rates. India has run a persistently high real rate for years, and with the new regime well versed in keeping inflation low, the RBI should look to reduce rates aggressively over the coming weeks, telegraphing their intent to do so. Average real lending rates have virtually doubled since 2014 on high RBI real policy rates and tight liquidity.

Lending Rates of 10%-14% Would Be Considered Usurious in Developed Markets…
…Lowering Rates to Creditworthy Borrowers Can Unleash a Wave of Economic Benefits





Source: RBI, Sanctum Wealth

Simultaneously, the RBI should undertake measures that ensure transmission of lower rates to borrowers. This would unleash a wave of credit in the economy, spur refinancings, spur real estate purchases, lead to higher profits for companies, attract foreign flows, increase purchasing power and attract private investment. Senior citizens FDs would need to be protected or grandfathered.

The BJP manifesto has mentioned stepping up investment by reducing the cost of capital. Therefore, a low cost of capital, low inflation environment will bring in a flood of capital. Second, the RBI must continue to inject US$2-3bn of durable liquidity a month to pull the money market to surplus liquidity.

Jalan Committee Report to Provide for PSU Bank Recapitalization

The Jalan committee report is the next trigger in the government's intent to recapitalize PSU banks with excess RBI capital of US$15-40bn possibly released by the Jalan report. The government will likely utilize funds to recapitalize PSU banks. This should be liquidity neutral and fiscal deficit neutral.

III. Housing for All

A staggering 500 million people are expected to migrate from rural India to a city over the next decade. There is an urgent need for affordable housing. Nothing makes an economy hum like a vibrant housing sector. Money spent on real estate has critical sustainable multiplier effects, and real estate is a key component of a healthy growing economy.

Fresh thinking is necessary that brings affordable housing to a reality. Lower interest rates are an obvious starting point. Real estate is a magnate for job creation, and provides sustainable multiplier benefits. Housing has a great multiplier effect on the economy creating demand for cement, construction, credit, and building materials and most importantly, creates jobs.

The BJP has implemented landmark reforms in real estate through DeMo, RERA and GST. Simultaneously, the government pushed the sector for affordable housing through its PMAY - Housing for All initiative. The government's progress has been commendable with nearly 5 million houses completed under the rural PMAY scheme during FY19 vs. 2.7million houses completed in FY18.

More reforms and protections are likely to be needed. The government would do well to consider public private partnerships in developing model cities rather than attempting to morph existing cities with challenged infrastructure into smart cities. These are massive job creation opportunities. Overall, the sector is more transparent than ever and organized players are grabbing market share.

Outlook

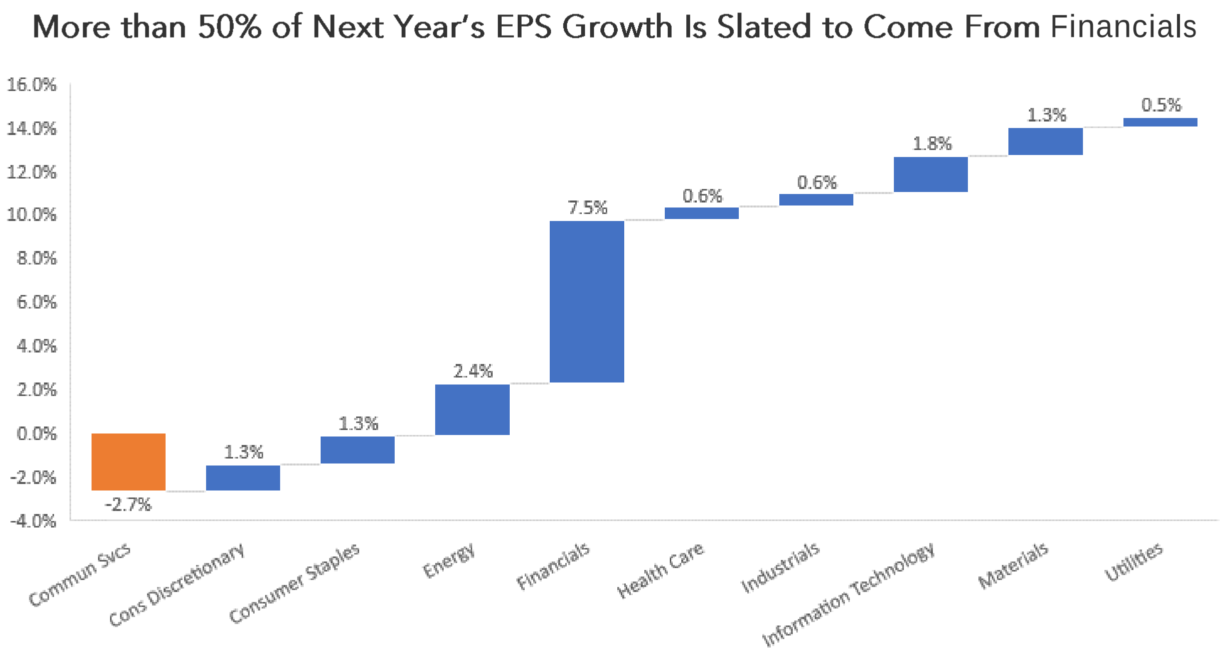
Equities

Earnings Are Skewed by Large Swings in PSUs

With large swings in earnings in the PSU pack - State Bank of India swung to a profit from a large loss – it is difficult to make definitive conclusions about earnings. Outside of financials, stress is clearly evident in Consumer Discretionary. Information Technology continues to execute across top and bottom lines.

Financials Ex PSU, Information Technology are Standout Performers…
Index Level Earnings Are Skewed by Large One-off Swings

	Sales YoY		Operating Profit YOY		Net Profit YOY		Operating Margin		Net Margin	
	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500
Consumer Discretionary	-1.9%	1.7%	-16.1%	-7.9%	-21.7%	-7.6%	12.9%	14.0%	5.2%	6.4%
Consumer Staples	10.9%	12.2%	13.8%	15.9%	16.8%	29.1%	33.5%	22.9%	21.9%	15.4%
Energy	11.8%	10.2%	14.8%	18.0%	10.4%	15.5%	11.0%	10.1%	5.1%	4.7%
Financials	11.3%	10.5%	8.9%	13.4%	146.8%	NA	38.7%	36.1%	9.0%	0.5%
Health Care	15.5%	14.1%	62.5%	31.0%	55.7%	-54.9%	24.4%	26.4%	10.3%	10.1%
Industrials	10.5%	12.7%	10.6%	11.9%	7.9%	7.9%	18.2%	17.4%	7.6%	8.5%
Information Technology	16.8%	15.8%	14.6%	15.1%	15.9%	16.3%	26.8%	23.7%	18.5%	16.1%
Materials	10.2%	11.8%	4.1%	4.3%	129.3%	21.3%	21.4%	20.3%	7.2%	7.4%
Real Estate	NA	30.3%	NA	-35.2%	NA	-56.9%	NA	29.0%	NA	12.6%
Communication Services	5.7%	26.2%	-5.8%	0.1%	NA	NA	35.6%	27.5%	-5.9%	-10.3%
Utilities	NA	3.5%	NA	13.7%	NA	12.0%	NA	23.8%	NA	5.2%
Index	9.8%	10.5%	7.5%	10.2%	24.8%	32.0%	20.4%	20.2%	7.7%	5.7%



Source: Bloomberg, Sanctum Wealth

Rural Demand Recovery Is Likely

Key reasons driving our expectations of a rural demand recovery are an easing liquidity situation, improving consumer confidence with an NDA victory, expectations of a normal monsoon, increased government focus on rural recovery in the July budget, direct income support for farmers, and meaningful structural reforms to double farmer incomes by 2022.

The Urban Consumer Story Remains Generally Intact

We believe the urban consumption story hit a pre-election uncertainty lull. Income levels remain healthy for the urban consumer. The quarter leading into the election saw activity ground to a standstill. Worries related to the IL&FS and stressed NBFCs added to the consumer's decision to hold back on consumption. We think consumer confidence is likely to return particularly if the RBI delivers meaningful rate cuts with transmission, or the government delivers a tax cut.

Financialisation Trends Will Continue

Global and domestic financial flows have already begun to find their way into Indian markets. Domestic financialization trends are in their infancy and these trends will continue their upward march. FDI investments in India as corporations look to de-risk global supply chains.

The Challenges Today Appear Manageable

While many are concerned about the systemic risks in the credit system, the risks are not systemic; rather, the risks are the result of pro-cyclical greed and extending business leverage beyond normal and prudent levels. Such businesses will be re-structured via the bankruptcy reform, sold off piece-meal, or receive private capital infusion. Separately, a couple of PSU banks could be privatized, which would unleash far greater value creation than trying to nurse sick franchises to profitability.

Implications of A New India Vote

A New India rejected the false promises of the past and has tied its fortunes to the P.M.'s message of dignity of labor, progress and growth. This has meaningful implications for strategy, allowing the government to freely pursue a growth driven agenda.

Equity Market View

Regular readers would recall that we've had a positive view on markets since last October and January this year. Here we are, with the Nifty near all time highs. The Modi rally began in Feb 2014 when markets discounted a BJP victory. The ensuing 5 years saw the index climb to 11,844, delivering roughly a 100% return. We believe the challenges facing the BJP today are far more manageable than 2014, but that's offset by higher valuations. On valuations, we'll mention that should the government manage to get the PSU pack turn the corner, the acceleration to earnings could be dramatic. **This past week's events reinforce** a positive view on markets longer term. We prefer regular deployment plans, particularly when combined with a three year plus outlook.

Given the large amount of groundwork already in place, we expect the next five years to surprise to the upside on earnings, once remaining PSU bank issues are resolved.

A Steady News Flow of Reforms, Rate Cuts and Initiatives Will Sustain Markets

The news flow is likely to remain positive in coming weeks. Sentiment has turned positive in the near term. In the longer term, markets got what they wanted, five more years.

Cap Preference… Large Two Thirds, Mid Small One Third

Many are now calling for midcaps to outperform large caps and this as the appropriate time to get into mid caps. We hope they are right. Small caps bounced 6.7% and mid caps bounced 4.9% this past week. We would like to witness further confirmation, and regardless, prefer to own a diversified portfolio, anchored by large caps at roughly two thirds and the balance in mid and small. The balance of earnings delivery continues to come from large caps.

Sector Preference… Financials, IT, Consumption, Specialty Chem…and Looking at Pharma

Sectorally, we are over-weight Financials, Information Technology, Consumer, Specialty Chemicals, and would be looking at Infra, Materials, Pharma as trends unfold.

Hedging

We chose to not hedge, despite getting a technical signal to do so, and that has worked out. Tyche – the Greek goddess of chance, fate, fortune – has been benevolent.

PMS Strategy Performance Update

Using publicly disseminated data on PMS performance, as of April 30th, the Sanctum Olympians large cap fund ranks #3 out of 72 funds across categories in the past one year. The Sanctum Titans Multicap fund ranks #8 out of 72 funds, across categories in the past one year.

Best Performing Sectors Since 2014 Election Outcome (May 16, 2014)

Index	Total Returns since May 16, 2014					Rank				
	1 MONTH	3 MONTHS	6 MONTHS	1 YEAR	5 YEARS*	1 MONTH	3 MONTHS	6 MONTHS	1 YEAR	5 YEARS
Nifty Pharma	4.2	23.2	46.3	60.7	2.7	16	1	1	1	17
Nifty MNC	12.1	20.1	33.9	48.2	15.3	5	2	3	2	3
Nifty Auto	6.8	17.5	34.0	38.2	5.8	10	3	2	3	12
NIFTY Private Bank	0.8	3.2	22.4	32.2	16.8	19	17	7	4	1
Nifty IT	6.0	16.7	29.8	25.6	14.1	11	5	4	5	5
Nifty Financial Services	3.8	7.3	19.9	24.6	16.0	17	11	9	6	2
Nifty India Consumption	5.9	10.4	22.7	24.0	11.2	12	7	6	7	9
Nifty Bank	2.2	2.6	19.5	23.6	15.1	18	18	10	8	4
Nifty Services Sector	4.6	10.0	22.3	22.7	14.0	15	8	8	9	6
Nifty 50	5.1	9.2	17.9	16.4	10.9	14	9	11	10	10
Nifty FMCG	0.2	6.0	12.7	12.0	11.7	20	14	12	11	8
Nifty Media	8.7	3.5	26.3	11.3	3.2	8	16	5	12	16
Nifty Infrastructure	12.2	6.5	11.5	7.6	2.1	4	12	14	13	18
Nifty PSE	11.1	6.4	11.5	5.5	4.1	6	13	13	14	14
Nifty PSU Bank	7.5	-1.6	11.4	4.0	-2.7	9	20	15	15	20
Nifty Commodities	12.8	8.6	7.4	2.3	9.4	3	10	17	16	11
Nifty CPSE	10.8	5.1	8.9	1.6	1.0	7	15	16	17	19
Nifty Realty	24.4	12.0	5.4	-2.8	4.6	1	6	18	18	13
Nifty Metal	18.7	16.8	4.1	-10.1	4.0	2	4	19	19	15
Nifty Energy	5.4	0.0	-0.5	-11.2	12.4	13	19	20	20	7

** 5 year returns are on CAGR basis*
Source: Bloomberg, Sanctum Wealth

Fixed Income

Interest Rates Should be Headed Lower

Indian government bonds yields fell a second week, with the benchmark yield falling the most in five months. The benchmark ten year bond ended the week yielding 7.23%. The benchmark bond yield fell 14 basis points this week, its biggest weekly fall since Dec. 21st.

With an ailing rural sector, low inflation, stable crude, stable exchange rates, neutral Fed policy, a slowing domestic and global economy, and a government anxious to demonstrate progress on growth, we expect interest rate cuts in the June meeting and beyond. We also hope the Modi government will unleash the massive power of interest rates for energizing growth via monetary policy transmission.

New Norms for NBFCs Strengthen Regulatory Oversight

The requirement for NBFCs to maintain high-quality liquidity reserves brings them closer to banks in terms of regulations. Banks have to maintain part of their deposits in cash reserves with RBI and in government bonds under the statutory liquidity ratio requirement.

Infra Spending Via RBI Surplus

India's new government is likely to consider partial funding of infrastructure development projects via accessing the accumulated surplus of Reserve Bank of India. That will alleviate pressure on the fiscal deficit.

Fund Positioning

Banking and PSU funds look to be attractive alternatives, yielding 8.4 to 8.8% over the past year. We'd avoid credit risk until an Asset Quality Review has been conducted or until clarity and reliable mark to market on papers is achieved.

Long duration is the best performing sub category within fixed income year to date. Looking ahead, duration remains a play that appears to have legs. A small allocation to long duration in a diversified portfolio remains a prudent decision.

Credit risk funds bring up the bottom of the pack. It remains fairly clear that there remains a fair amount of risk still embedded in credit risk and low rated paper. There are likely additional negative surprises that have not yet been unearthed in many of these schemes.

Technical Outlook

Event led volatile week saw the Nifty opening with a gap and followed through to touch new all-time high of 12041.15 on the Election Result day. For the week the Nifty gained 3.83% to close at 11,844. Broader market indices outperformed the benchmark indices with BSE Midcap and Smallcap up by 4.45% and 5.85% respectively. Now, last week's rising gap area of 11,591 and 11,426 levels will act as support for the market. On the upside 12,000 will act as resistance for the market and crossing above it can rally towards 12,300 levels. In the near term market is likely to consolidate between 11,600 and 12,000 odd levels. In Nifty options, maximum open interest for Put options stands at 11,000 followed by 11,500 and 11,700. Also 11,700 witnessed significant amount of writing suggesting 11,700 as immediate support for the market heading into May expiry. In Call maximum open interest stands at 12,500 followed by 12,000; indicating 12,000 is going to act as resistance for the market. India VIX has dropped from 28-29 levels seen prior to Election Results to 16.47 on Friday with event out of the way. Further decline towards 15-14 levels can be expect going ahead which will also be supportive for the market.

Nifty Weekly Chart

Source: Falcon7

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