Sanctum View

July 22, 2019

Investment Strategy

Searching for a Bottom

"Wealth isn't primarily determined by investment performance, but by investment behavior." – Nick Murray

It was a difficult week in the markets last week, broadly brought about by FI selling, a disappointing budget, a change in sentiment, and generally dismal earnings. Markets could likely continue to be under pressure in the near term as we move through a challenging earnings season.

Where are we in the Business Cycle?

Short Rates are Falling

Short rates are declining, driven lower by a slowing economy, monetary and fiscal policy. While much action has been focused on the long bond, short rates have fallen from 7.65% to 5.86% over the past year, a meaningful drop of 179 bps. The action in short rates is indicative of a slowing economy.

Inflation Remains in the RBI's Glide Path

Inflation continues to remain generally low, and within the RBI's glide path. Given a below expectations monsoon to date, some pressure is likely to emerge in food prices but likely to be offset by slowing demand in other inflation contributors.

The Global Commodity Cycle Has Rolled Over

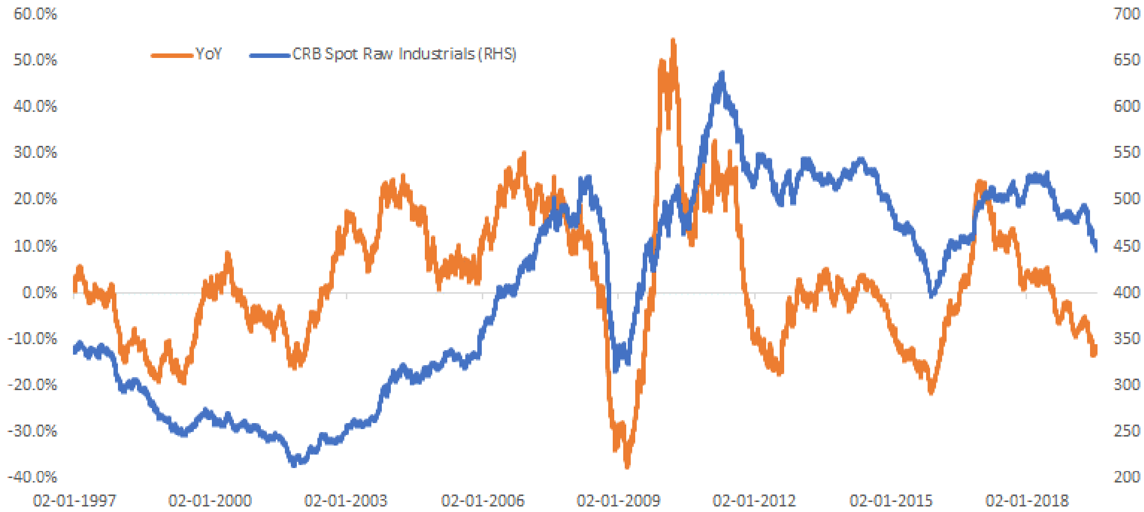
Global commodities were in a bull market from 1998 to 2007, and finally peaked in 2011, driven by China's expansive buildout. Since 2010, commodities remain in a lacklustre downtrend, highlighting the weak global economic conditions and weak demand for raw materials. Commodities rallied recently on the back of positive news flow in the U.S. and China, but have convincingly rolled over late last year.

The Yield Curve is Flattening, and Short & Long Rates are Falling in Tandem

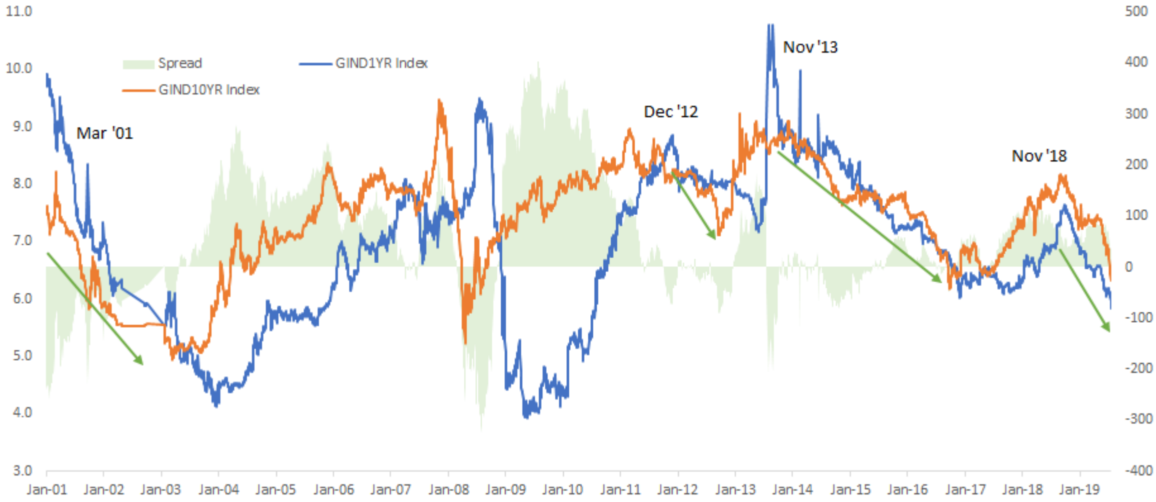
Short and long rates declining in tandem is a fairly rare event in Indian markets, and we've only had two instances previously, in 2001-02, and 2013. In both instances, the sharp decline in rates led to a bottoming in the economy, created the underpinning for an eventual recovery, and subsequent strong performance for equities. Incidentally, short rates are also at their lowest in at least 8 years.

Unlike Prior Major Market Peaks in 2007, 2010, Short Rates Have Been Falling Dramatically…

The Commodity Cycle Has Rolled Over and Global Demand Remains Weak…



Short & Long Rates Declining in Tandem Eventually Led to Strong Growth Periods …



Source: Bloomberg, Sanctum Wealth

Meanwhile, Core Industry Growth Looks to Have Troughed and Recovering, Ditto Capital Goods

Core industry growth has a fairly long lived history, spanning two decades, and fits well with the business cycle. This indicator appears to have troughed last year, and appears to be attempting a recovery. Ditto IIP Capital Goods production, which also appears to have troughed and recovering.

Services PMI in a Steady Downtrend, Non Durable Goods Steady & Bank Credit is Growing

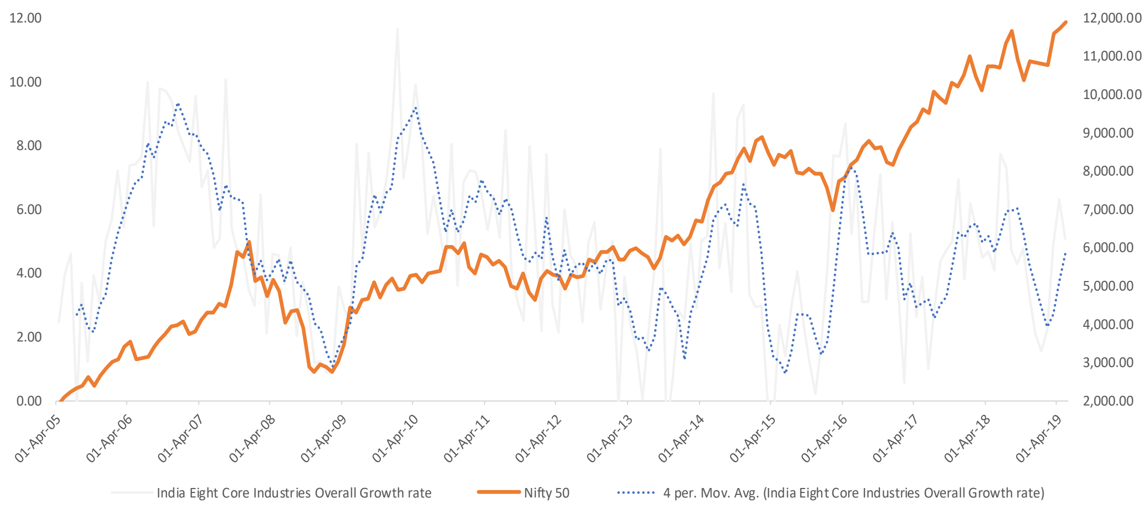
On the other hand, Services PMI has been in a consistent, steady downtrend, while manufacturing PMI remains in growth mode above 50. Meanwhile, non-food bank credit is growing 12.0% yoy, alongside robust deposit growth of 10.32%. Advances continue to grow sharply; however, transmission is yet to occur.

Global

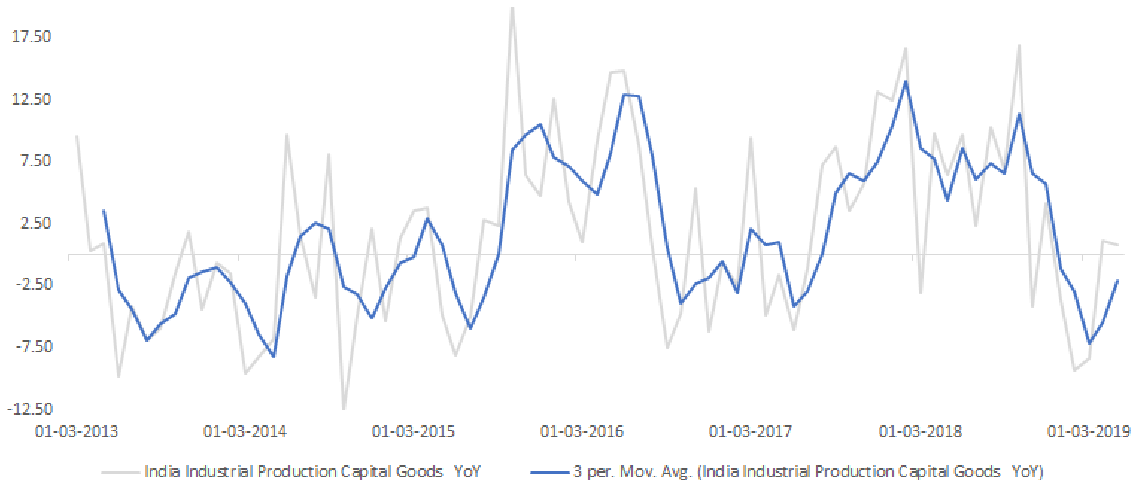
Forward 1 Year S&P 500 Returns from the First Fed Rate Cut Are Consistently Attractive Since 1970

We are looking at a July rate cut by the Fed. Fed rate cut regimes have led to positive equity market outcomes. We plot the forward one year return for the S&P 500 versus the Fed Funds rate, and find that from the time of the first rate cut, S&P 500 returns have improved markedly almost immediately.

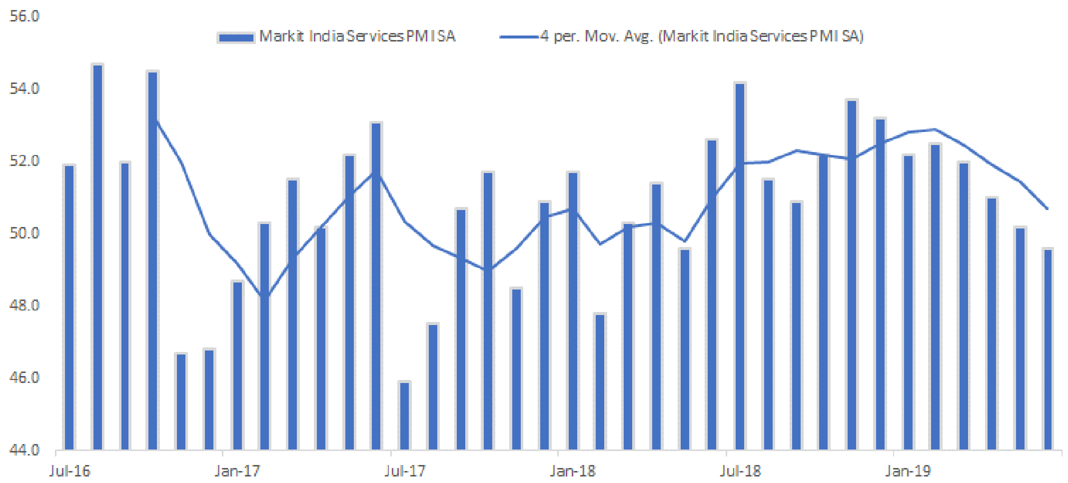
Core Industry Growth Appears to Have Troughed and Staging a Recovery …



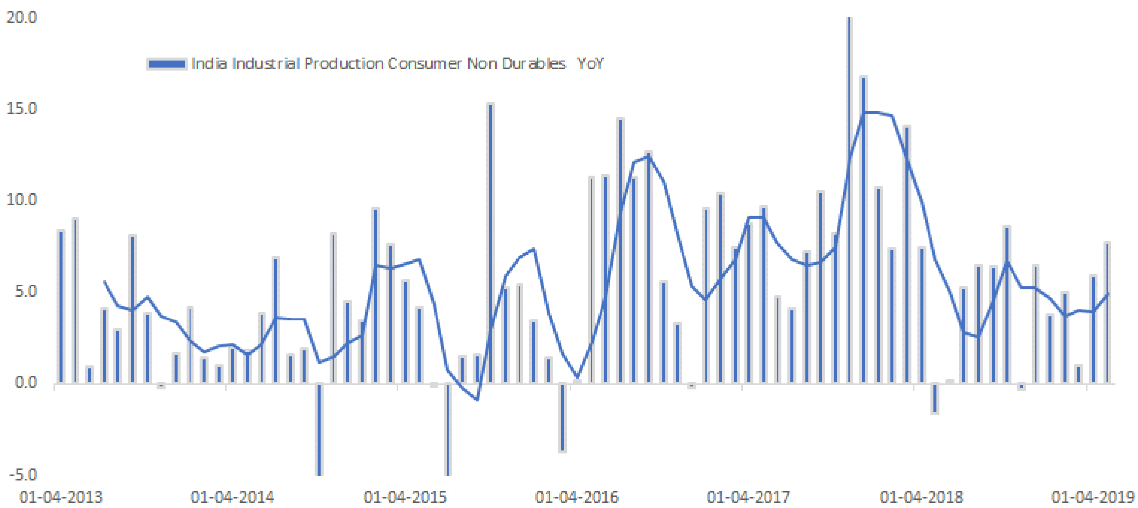
Capital Goods Production Appears to Have Troughed…



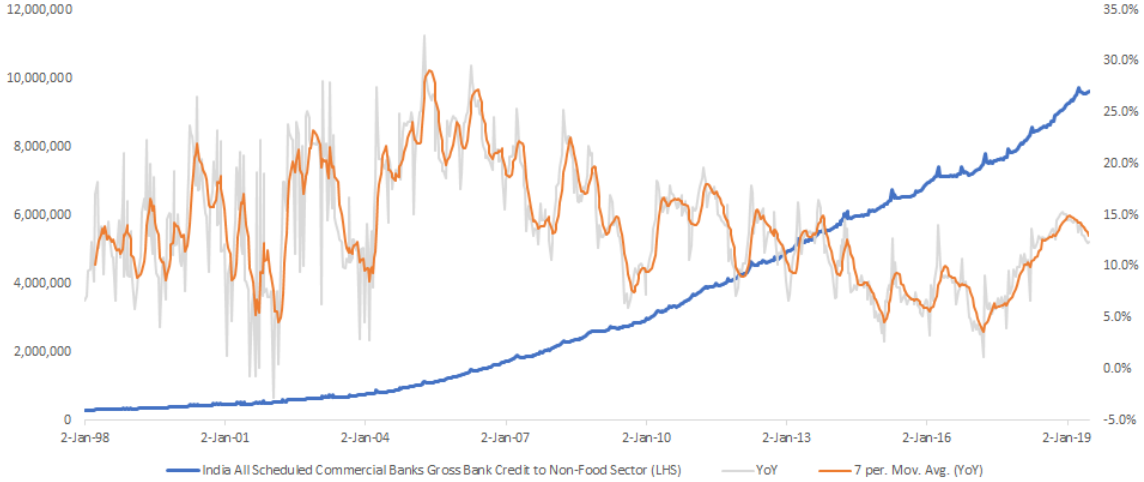
The Services Sector is in a Steady Downtrend, Barely Below Neutral at 49…



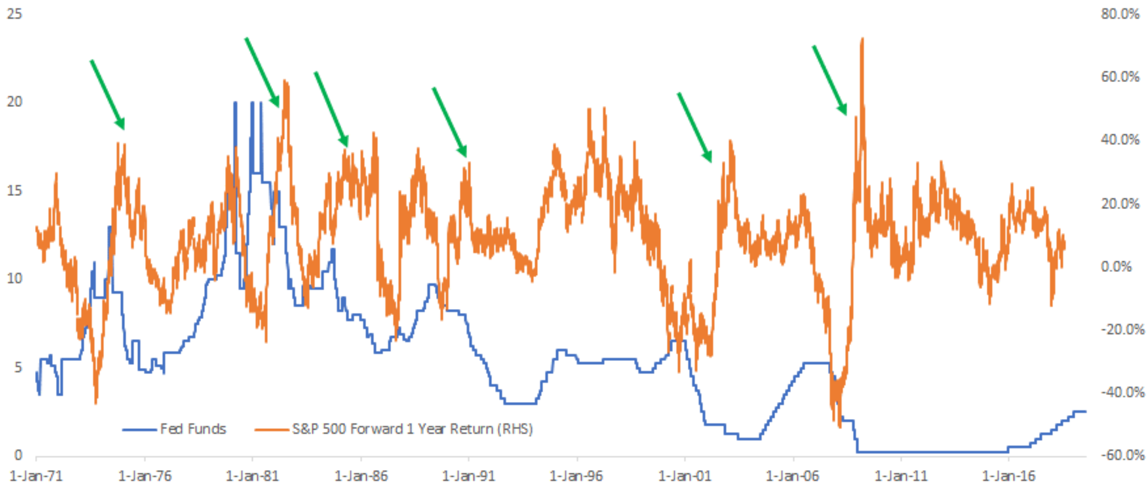
While Production of Consumer Non Durable Goods Is Stable…



And Commercial Banks Non-Food Credit Growth (+12%) Remains in an Uptrend…



Forward 1 Year Returns from the 1st Fed Ease Have Been Consistently Healthy Since 1970…



Source: Bloomberg, Sanctum Wealth

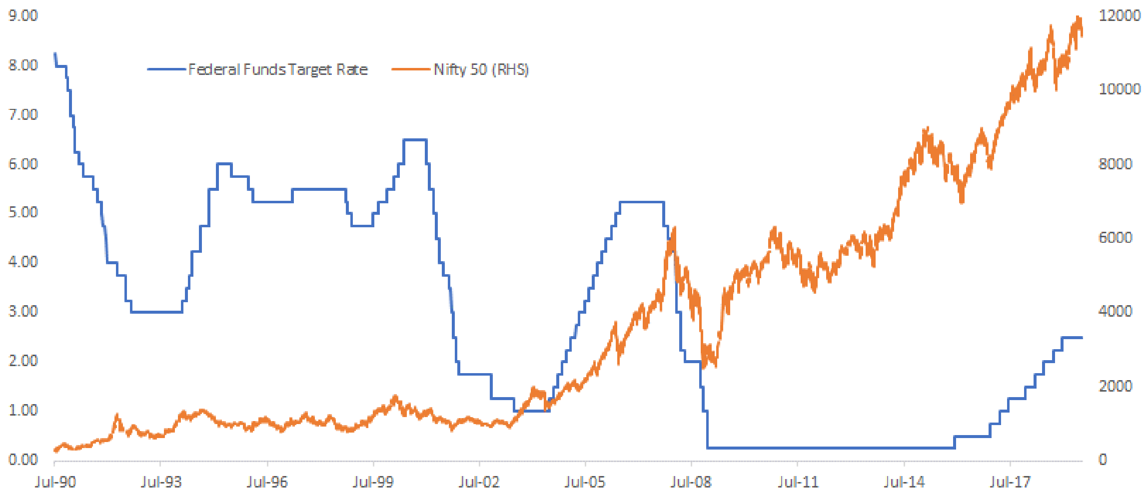
Nifty Returns Positive in 1990, Strongly Negative in 2001 and 2008, But…

Incidentally, Nifty 50 returns were positive during the 1990 Fed rate cut cycle, but 2008 and 2000 were dismal periods. However, those were massive bubbles economies. Generally, EMs would be expected to benefit when the Fed lowers the cost of borrowing.

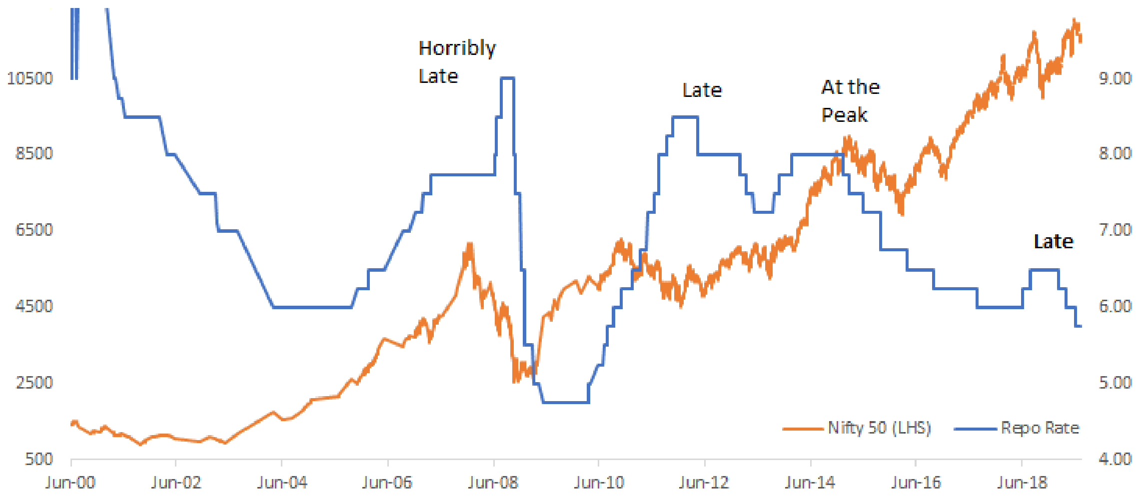
RBI Rate Cuts to Flow Through Later This Calendar Year

The 2015 RBI was the only instance where the RBI cut rates prior to the market peak. Had the RBI lowered rates last year, we could likely have ameliorated the dismal economic performance today. Instead, the RBI was raising rates in May and August 2018. With the first rate cut in Feb 2019, much too late frankly, this RBI has moved aggressively, and the first benefits can be expected to trickle down near the end of the calendar year.

Nifty Returns in 2001 and 2008 Were Negative…



The RBI Has Begun a Meaningful Rate Cutting Cycle…
…And Nifty 50 Returns from Easing Cycles Have Also Been Healthy



Source: Bloomberg, Sanctum Wealth

Outlook
Equities
The Economic Data Suggest an Economy Searching for a Bottom

Based on the data, the economy is skirting the bottom of the business cycle. While there are signs of a marked slowdown in activity, we should recall much of it was related to the election uncertainty. Unfortunately, the budget has added to the market's woes, and led to an environment of disappointment, consternation and pessimism.

Still, key parts of the economy are attempting to stage a recovery. We've already come through a fairly painful 2018 credit crisis and a bear market in stocks, and the forces of recovery – declining interest rates, rising credit, rising liquidity, rising savings and hopefully investment or subsidies – are at work.

Earnings Could be the Worst in 2-3 Years

The data we've seen to date suggest that this quarter's earnings are likely to be the worst in 2-3 years, and are likely to mark the trough quarter in earnings.

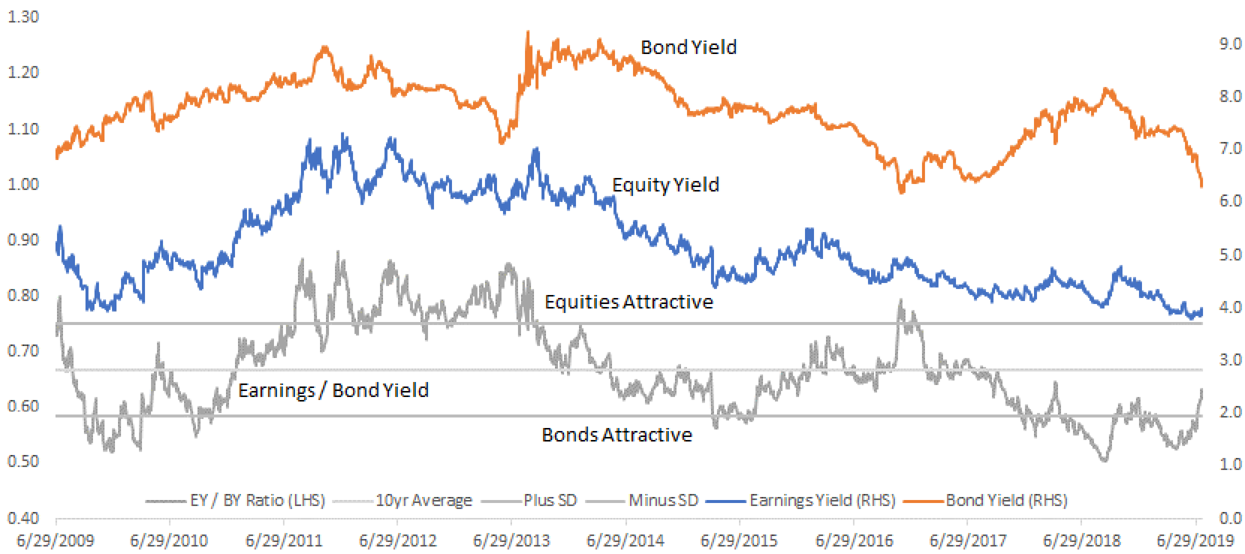
Relative Yield Model Back to Neutral

Our relative equity-bond yield model is headed back to neutral and indicates clearly that the next move is likely to be a bullish call on equities. This can be achieved three ways – a roughly 50 bps decline in yields, improving earnings, or a sell-off in equities. Incidentally, the bottom up computed earnings yield is now 6.6%, versus 6.3% in gilts, suggesting equities are offering a higher yield vs gilts.

The Broader Market is in a Bear Market, but It's Not Reflected in the Nifty 50

Small caps have delivered a negative three year return to date and are down 35.5% from the Jan '18 peak. Mid caps have delivered a negative two year return, down 22.8% from the Jan '18 peak. **For 98% of stocks, we're in a bear market.**

Our Signal is Moving to Neutral, but the FY20 Nifty Earnings Yield (Bottom Up) is 6.6%...
...Compared with a Bond Yield of 6.3%...
...Equities Are Now More Attractive Than Bonds from a Yield Perspective



Since the Market Peak in Jan 2018, Small Caps are Down 35.5%, Mid Caps Down 22.8%…
…That Clearly Qualifies as a Bear Market

India	1 Month	3 Month	6 Month	YTD	1 Year	2 Year	3 Year	5 Year	From 29-Jan-18
S&P BSE SENSEX Index	-2.0%	-2.1%	5.4%	6.3%	5.5%	9.5%	11.3%	8.4%	5.7%
NSE Nifty 50 Index	-2.3%	-2.8%	4.7%	5.1%	4.2%	7.4%	10.2%	8.3%	2.6%
NIFTY Midcap 100	-4.2%	-9.1%	-6.2%	-8.1%	-8.1%	-5.4%	4.9%	8.4%	-22.8%
NIFTY Smallcap 100	-3.5%	-12.3%	-8.1%	-9.2%	-16.1%	-12.7%	-0.3%	2.3%	-35.5%

Source: Bloomberg, Sanctum Wealth

Near Term Volatility, Medium Term Opportunity Ahead

One can make a case that a large part of the pain would appear to be behind us. The worst of the credit crisis appears to be behind us. We believe **weak hands are being shaken** out of the market, and blood is starting to spill. At some **point, between now and the late Fall, we'd look to be buyers.** Our technical models are close to oversold bottom levels, but we're not there yet.

Tactical Protection Strategies

For those **investors feeling unease** about short term losses, **tactical protection should be considered if the selling continues.** It's a small price for peace of mind. We prefer low cost derivative strategies and cash. On the other hand, an **asset allocation change to under-weight equities comes fraught with timing risk**.

Asset Allocation - Timing, Transaction and Tax Risks

We endeavour to time a turn in the cycle. We **put out warnings in late 2017 and Jan 2018** (see here, here, here) to that effect. Today, with our view of an improving economy later this year, **our endeavours are focused on positioning for the eventual bottom**. The risks associated with exiting or reducing equity exposure are tangible. Should one mistime either the exit or re-entry, the damage to portfolio returns can be significant. Timing strategies are further complicated by the hurdle of overcoming tax rates, transaction costs and selection risk.

Portfolio Strategy

From our perspective, there are two likely scenarios. One, the sell-off is going to extend to large caps selling at lofty valuations. Alternatively, large will continue to thrive. Looking at the top wealth creators over the past three years, you could have owned quality large cap names, or owned DCM Shriram, Himadri, HEG, Graphite, Indiabulls Ventures and such (see table below). We continue to favour leadership stocks with competitive advantages and advise using times such as these to accumulate positions. While Warren Buffett talks about shopping for groceries, his money finds its way into Apple, Google and Goldman Sachs.

10%+ Corrections in the Nifty 50 Since 2010…

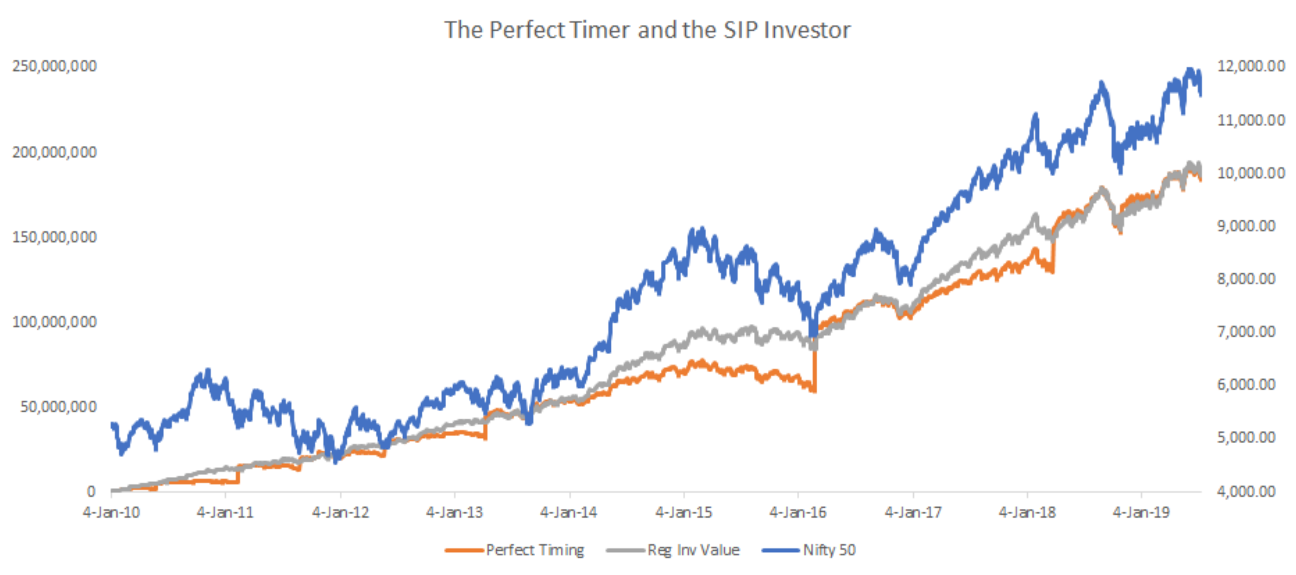
Peak	Peak	Trough	Trough	Correction
05-Nov-10	6,312	20-Dec-11	4,544	-28.0%
17-May-13	6,187	28-Aug-13	5,285	-14.6%
03-Mar-15	8,996	29-Feb-16	6,987	-22.3%
08-Sep-16	8,953	26-Dec-16	7,908	-11.7%
29-Jan-18	11,130	23-Mar-18	9,998	-10.2%
28-Aug-18	11,739	26-Oct-18	10,030	-14.6%
03-Jul-19	11,917	?	?	?

Highest CAGR Returns Over 3 Years in the NSE 500

NSE500 Index	Sector	1 Month	3 Month	QTD	YTD	1 Year	2 Year	3 Year
Indiabulls Ventures Ltd	Financials	9.3%	-11.1%	0.7%	-28.6%	-44.5%	24.3%	108.6%
Procter & Gamble Health Ltd	Health Care	18.9%	37.2%	14.4%	68.6%	132.3%	112.1%	96.6%
Adani Transmission Ltd	Utilities	-0.5%	-6.2%	-6.2%	6.0%	41.0%	29.8%	79.1%
HEG Ltd	Industrials	-23.6%	-50.0%	-31.4%	-72.8%	-75.1%	58.6%	76.8%
Indiabulls Integrated Services	Industrials	-23.3%	-56.2%	-22.8%	-61.0%	-65.5%	100.1%	75.0%
V-Mart Retail Ltd	Consumer Discretionary	-10.4%	-23.8%	-8.8%	-22.3%	-14.7%	33.4%	61.9%
Vinati Organics Ltd	Materials	-1.8%	17.1%	-2.7%	25.2%	117.7%	43.3%	59.6%
Graphite India Ltd	Industrials	-32.0%	-39.3%	-18.2%	-63.8%	-72.6%	33.4%	57.5%
Bajaj Finance Ltd	Financials	-5.7%	10.2%	-9.7%	25.6%	31.9%	47.1%	57.0%
KEI Industries Ltd	Industrials	7.0%	11.6%	-1.8%	31.2%	12.4%	40.4%	56.8%
Minda Industries Ltd	Consumer Discretionary	-8.5%	-25.9%	-9.7%	-11.1%	-26.3%	12.6%	55.1%
Future Lifestyle Fashions Ltd	Consumer Discretionary	2.4%	-6.3%	-4.3%	6.9%	17.4%	19.5%	53.6%
Sunteck Realty Ltd	Real Estate	-0.5%	-10.1%	1.2%	27.4%	12.2%	35.4%	50.8%
Phillips Carbon Black Ltd	Materials	0.9%	-30.9%	-1.0%	-44.4%	-43.0%	0.5%	49.7%
VIP Industries Ltd	Consumer Discretionary	-12.7%	-15.1%	-10.0%	-22.4%	-2.4%	50.9%	48.8%
Radico Khaitan Ltd	Consumer Staples	6.9%	-13.8%	-8.9%	-28.2%	-19.2%	47.7%	47.8%
Venky's India Ltd	Consumer Staples	-16.0%	-33.6%	-14.1%	-40.5%	-23.5%	-16.0%	47.4%
Deepak Nitrite Ltd	Materials	9.8%	13.4%	4.3%	36.9%	37.1%	36.5%	45.3%
Bajaj Finserv Ltd	Financials	-8.4%	-0.1%	-11.2%	16.8%	20.2%	28.8%	44.7%
NIIT Technologies Ltd	Information Technology	3.3%	2.5%	0.1%	17.2%	22.1%	59.4%	44.6%
Maharashtra Scooters Ltd	Consumer Discretionary	-9.1%	4.1%	-12.7%	26.6%	40.8%	42.4%	43.4%
TeamLease Services Ltd	Industrials	-0.9%	-0.8%	0.0%	2.9%	9.8%	43.3%	42.4%
ITI Ltd	Information Technology	-0.7%	-13.6%	-7.4%	-10.2%	5.1%	-7.5%	41.6%
Indraprastha Gas Ltd	Utilities	-3.7%	-1.3%	2.6%	20.8%	17.6%	20.0%	39.5%
Titan Co Ltd	Consumer Discretionary	-14.4%	-3.1%	-18.3%	17.2%	25.4%	43.7%	38.6%
Info Edge India Ltd	Communication Services	6.9%	12.9%	-4.3%	49.3%	65.7%	44.9%	38.1%
Godrej Properties Ltd	Real Estate	2.2%	3.9%	-5.1%	45.7%	42.8%	36.5%	38.0%
Rain Industries Ltd	Materials	-8.9%	-30.2%	-13.2%	-34.9%	-48.9%	-17.1%	37.4%
Astral Poly Technik Ltd	Industrials	-0.2%	2.5%	-3.6%	13.4%	21.8%	40.8%	37.3%
Chambal Fertilizers and Chemic	Materials	-7.4%	-2.5%	-7.5%	9.3%	15.8%	13.5%	37.3%
DCM Shriram Ltd	Materials	1.2%	26.5%	-10.4%	48.9%	43.8%	23.1%	36.2%
Himadri Speciality Chemical Lt	Materials	-17.4%	-24.4%	-16.6%	-33.3%	-25.9%	6.6%	36.1%
Trent Ltd	Consumer Discretionary	6.1%	22.3%	-0.2%	21.5%	33.9%	31.7%	36.0%
Reliance Industries Ltd	Energy	-2.2%	-9.9%	-0.3%	11.4%	13.0%	28.0%	35.5%

Source: Bloomberg, Sanctum Wealth

Regular Investments Vs Market Timing With Perfect Insight – Which Is Better?



Source: Bloomberg, Sanctum Wealth

There is a fair amount of interest amongst many investors to **time the bottom**. We conducted a comparative analysis: one investor contributes 10 lakhs monthly to an SIP and another with perfect insight only invests at absolute market bottoms.

As the chart above demonstrates, **the Perfect Timer suffers consistent bouts of under-performance**, and it is only the large allocation in Dec 2015 that allows him to catch up with the regular investor. We sceptically wonder how many investors would be buyers at the bottom in Dec 2015 when the markets were in chaos, and fear was rampant.

The upshot – adopting **a market timing is fraught with the risk of underperformance, and we prefer Sir John Templeton's advice: "the best time to invest, is when you have the money" and regularly.**

Fixed Income

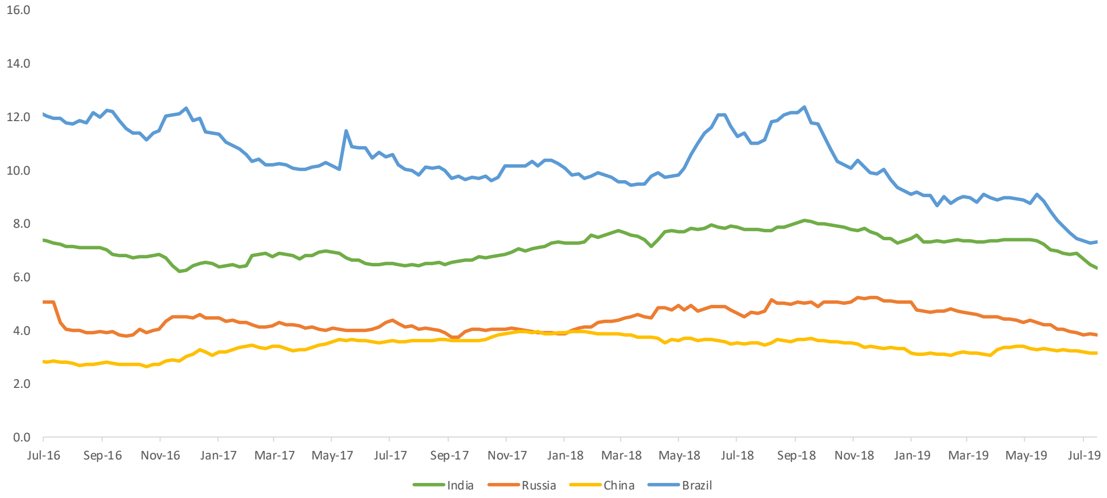
Duration Strategies Have Delivered Natural Hedges to Portfolios

Duration strategies in diversified portfolios have buttressed losses in the equity portfolio this year. Diversification and fixed income are doing their job. Looking ahead, though, much of the juice – a 115 bps drop in g-sec yields since April – is already in the bag. Rates now appear priced for perfection and **we'd be a bit wary about adding duration exposure at these levels.**

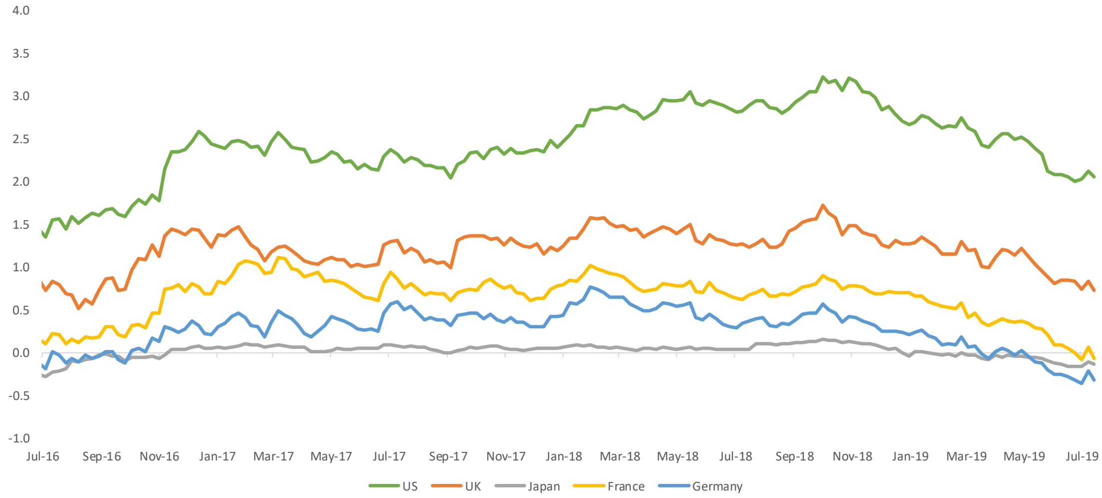
Spread Compression Gradually Unfolding

The AAA vs A spread has declined by roughly 50 bps from above 200 bps to around 150 bps in recent weeks. We're witnessing gradually receding credit rate risk. The absolute decline in rates is another positive.

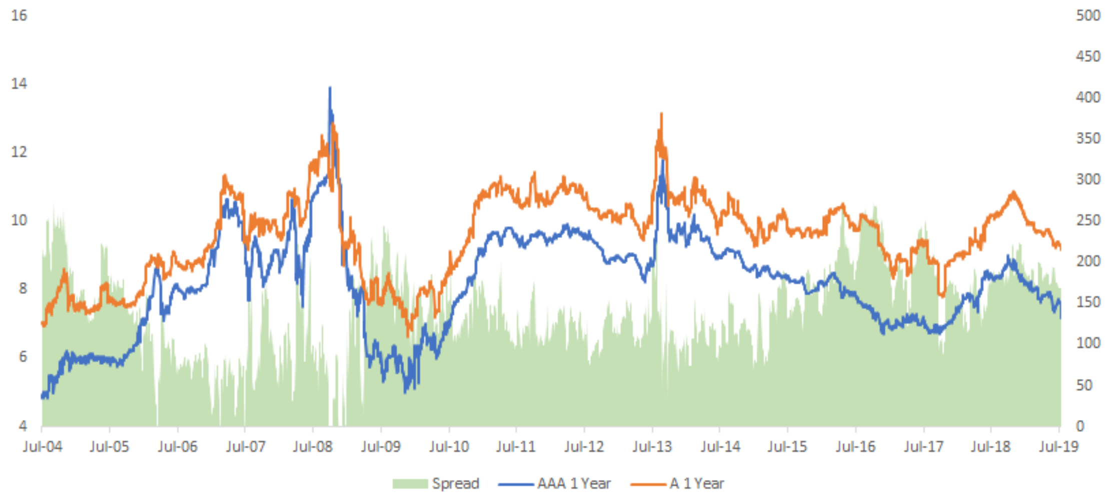
Sovereign 10 Year Bond Yields (Emerging Markets)



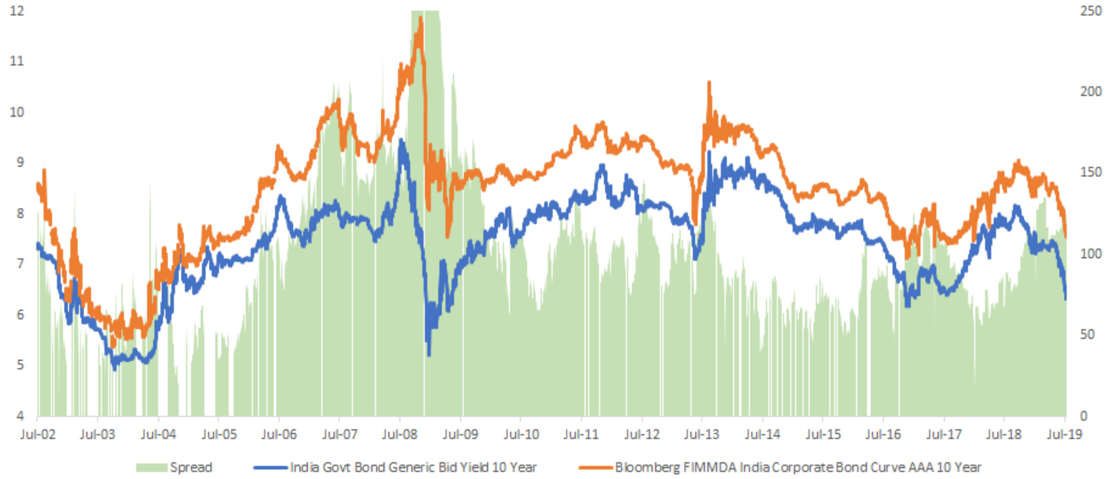
Sovereign 10 Year Bond Yields (Developed Markets)



The AAA vs A Spread is Compressing Gradually Since Oct 2018…
…Nor is A Paper Showing Particular Stress Relative to 2016-17



Spreads Peaked in March 2019 at 135 bps…
…There Has Been Limited Compression to Date, Currently at 125 bps



Strategy

In line with our macro views, **our key preferences remain high absolute yield strategies, with the possibility of moderate yield compression**. As the recovery unfolds, and liquidity improves, one could consider a move further down the curve and consider exposure to high yield opportunities.

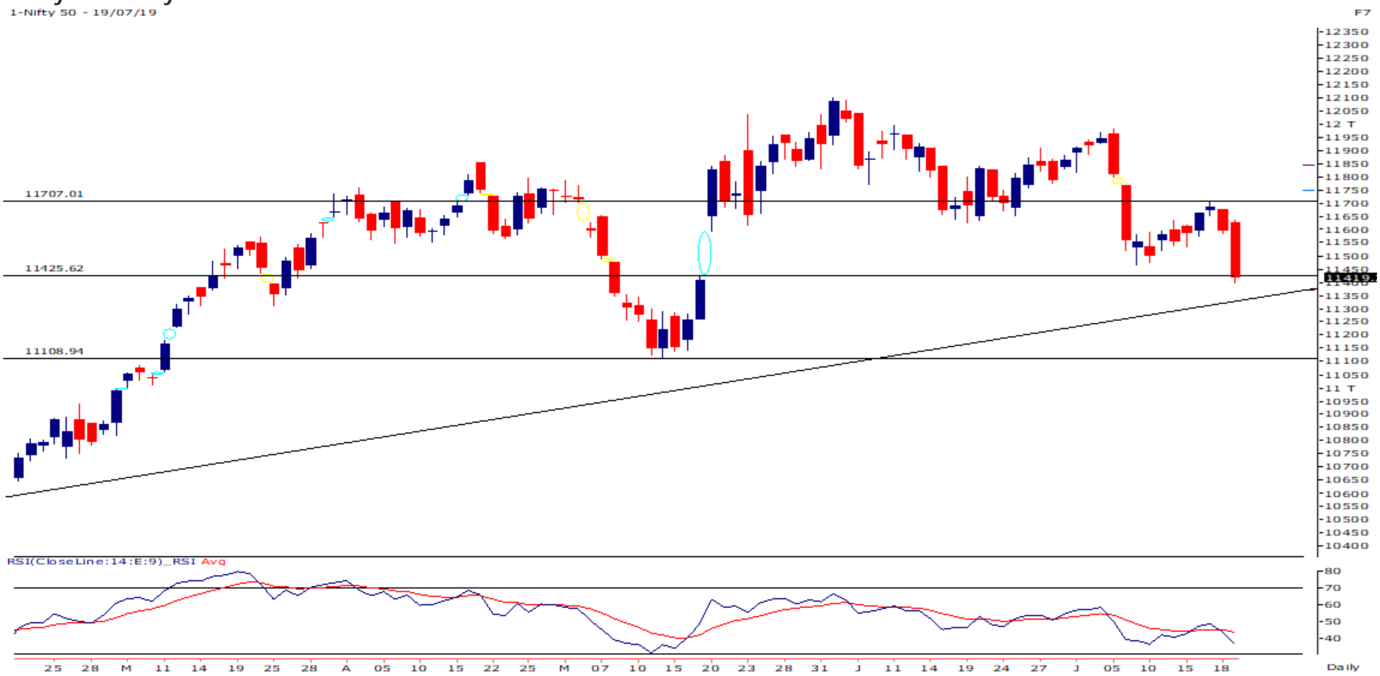
Time to Lock in High Long Term Yields

We can't help but wonder if this isn't an opportune time to lock in long term yields. Separately, we'd be looking to allocate to PSU and Banking Bonds, select MLDs, AAA Corporate bonds with spread compression kickers.

Technical Outlook

After steady start to the week, latter part especially on Friday market witnessed sharp decline. The Nifty ended the week at 11,419 declining 1.2%. Broader market indices underperformed benchmark with BSE Midcap and Smallcap losing 3.3% and 3.4% respectively for the week. After brief bounce back from 11,461 to 10,707, Nifty has resumed the downtrend. It has now filled rising gap of 20th May and closed just below. Thus, next support is seen at 11340 where rising support trend line connecting lows of 10,005 and 10,586 is seen on weekly chart. Breaking below this next support zone is seen at 11,100-11,050 levels. On the upside 11,707 needs to be crossed on sustainable basis for the strength to be seen. While intermediate resistance is seen at 11,525-11,560 zone. In Nifty options, maximum open interest for Put is seen at strike price 11,300 followed by 11,400 while for Call it is seen at 11,600 followed 11,700. Significant Call writing was witnessed in 11,500 and 11,600. Thus suggesting 11,600 as resistance on upside and trading range shifting lower to 11,300 to 11,600. India VIX jumped by 6.5% on Friday to close at 12.52 level. VIX has seen bounce back from 19 month low and further rise would lead to volatility in the market.

Nifty Weekly Chart



Source: Falcon7

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