Sanctum View

October 6, 2021

Investment Strategy

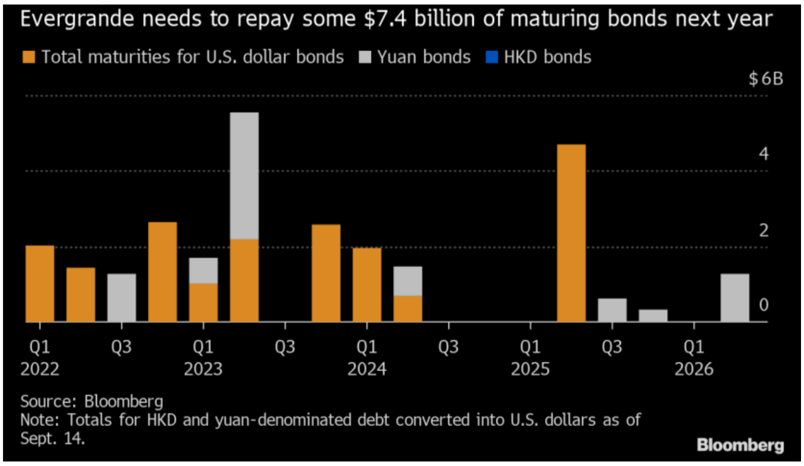
No Tantrum Just Taper

The first half of this fiscal year is now behind us. Indian equities are up about 20% over the last 6 months, despite the second wave. Economic activity has rebounded sharply, the same is reflected in resilient earnings as well. Market participants, including us, will be watching the trajectory of both the macro data and earnings as, given the elevated valuations, an earnings disappointment would not be overlooked by the market.

Performance of Key Equity Indices as of 30th Sept 2021	1 Month	6 Months	1 Year	3 Year	5 Year
NSE Nifty 50 Index	2.8%	19.9%	56.6%	17.2%	15.4%
S&P 500 INDEX	-4.8%	8.4%	28.1%	13.9%	14.7%
NASDAQ Composite Index	-5.3%	12.2%	29.4%	21.5%	22.2%
Shanghai Composite Index	0.7%	3.7%	10.9%	8.1%	3.5%
Nikkei 225	4.9%	0.9%	27.0%	6.9%	12.4%
MSCI Global Index	-4.3%	5.0%	25.5%	10.6%	11.1%
MSCI AC Asia Pacific Index	-2.3%	-3.1%	16.0%	6.1%	7.1%
MSCI Emerging Markets Index	-4.2%	-4.8%	15.8%	6.1%	6.8%

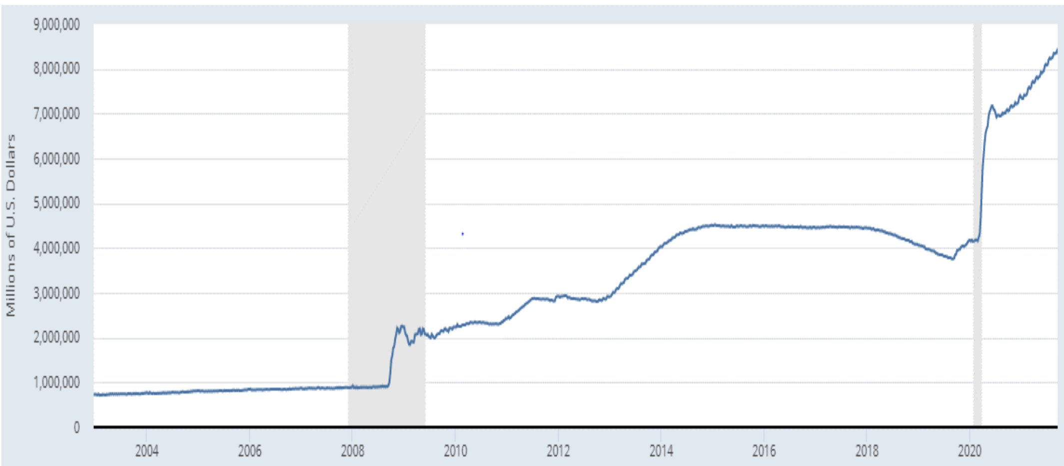
* Source: Bloomberg, Sanctum Wealth Management
The above returns are local currency price returns

An event that the market has been watching closely is the Evergrande debt crisis. China's largest property developer, Evergrande failed to pay the interest payment due on two of its dollar-denominated bonds last month. According to reports total debt outstanding for the company is more than USD 300bn+ (about 2% of China's GDP). Currently, Evergrande has 30 days grace period to pay the coupons. Also, it met a domestic debt interest payment deadline and repaid part of a wealth management product due to investors. The Chinese government is clear in its messaging. They are willing to let the equity and bondholders take a hit, but they will protect homebuyers. This is important given that some estimates show 80%-90% of Chinese household wealth is in real estate. But then Evergrande is one of the many enterprises that are increasingly getting weighed down by debt burden. Is the common lack of fiscal prudence, making way from a Lehmann moment in China is a question asked by many. For now, Evergrande doesn't seem to be triggering a contagion, but the space needs to be watched.



On the other side of the world, the Fed signalled that it could start tapering its bond purchase program by late 2021 and possibly start increasing rates by late 2022. Additionally, from the Fed's language, it appears that more members are taking note of inflation. The bond markets reacted to the change in stance with the US 10-year yield rising by 10bps following the statement. The ECB and the Bank of England have also indicated tapering later this year. The equity markets shrugged off the tapering announcement as a sign of confidence shown by central bankers in economic strength. The world is divided even more on whether the inflation is transitory or not, but if it turns out to be stickier (which we think it is) central banks could be pushed to rein in liquidity much quicker than market expectation and could have ripple effects on the markets.

Fed balance sheet will continue to expand but at a slower pace during tapering



Source: The FRED

Oil is back over USD 75 and cyclone Shaheen related disruptions threaten to send prices higher. The recent power shortage faced by China and the growing shortage of natural gas in Europe may not be as quickly resolved. Over the last few years, mining and excavation of fossil fuels have been on the decline. With the demand recovery post Covid, demand is outstripping supply despite the "greening" of the world. Additionally, the move towards renewable is likely to lead to significant demand growth for metals such as copper, cobalt and uranium over the long term in our view. Our conviction in this view is reflected in our holding of mining funds in our discretionary, international strategy.

Quarterly Asset Pair Review

The Sanctum Investment Committee met last month to deliberate our proprietary asset pair model which helps determine favourable assets for investments based on macroeconomic data and trends. In our model, the score for each asset pair is determined based on multiple parameters. The score for each parameter is in turn are based on multiple factors.

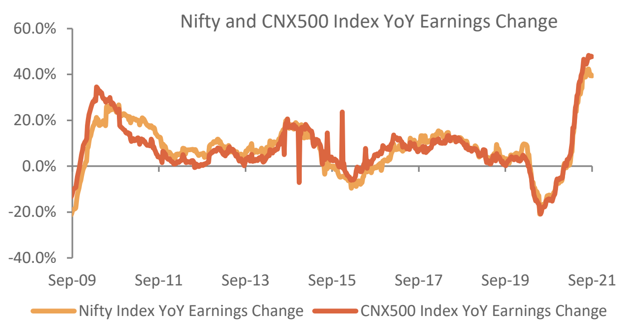
Most asset pair scores did not change materially this time. Hence, we aren't making any changes to our model portfolios. We continue to be overweight equities vs bonds and within equities we prefer midcaps. For the fixed income part of the portfolio, a barbell strategy remains a preferred choice. As we have highlighted earlier, inflation is a key risk we are watching. Hence, despite a marginal decline in the score for gold, we remain neutral gold in our model portfolios.

Equities Vs. Bonds

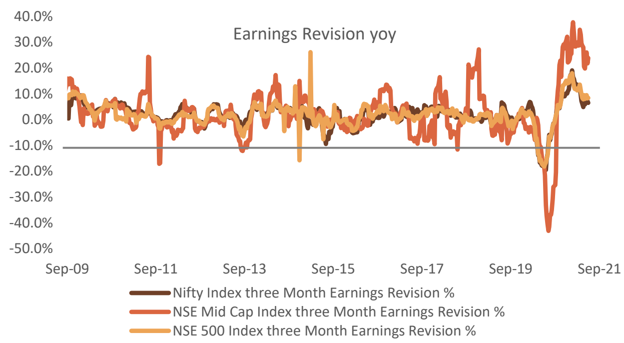
Valuations expensive; earnings, flows and liquidity favour equities

Indian corporates are currently in good health. Balance sheets are strong, some cost-cutting measures implemented during Covid have sustained and operating leverage is playing out with demand recovery. This is reflected yet again in resilient Q1FY22 earnings. While revenue and profit growth declined quarter on quarter; earnings results were largely in line with expectation. Earnings growth forecasts for the full year have largely been sustained.

1 yr forward EPS estimates on a positive trend



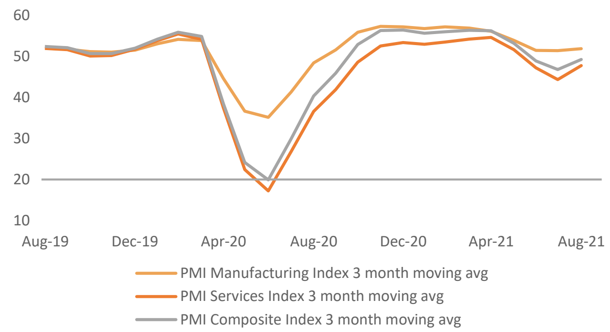
Earnings revision still in positive territory



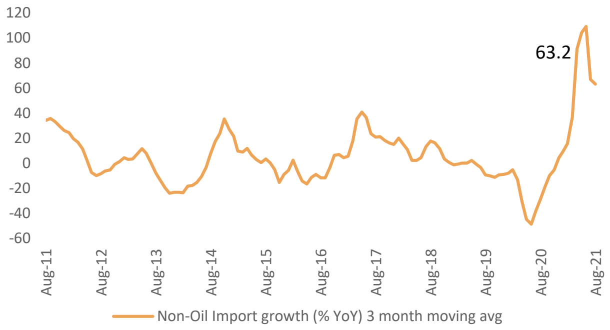
Source: Bloomberg, Sanctum Wealth

As expected, macroeconomic data bounced back after a decline in the quarter ended June 2021. However, if we look on a 2-year CAGR basis (given the low base effect) the data is mixed. PMIs are back in the expansion zone. Non-oil import growth has witnessed a strong rebound and has delivered 7.7% compounded annual growth over 2 years. Similarly, IIP and core industry growth has also bounced back. However, core industry growth over the 2-year period is lower than in 2019.

PMIs remain in the expansion zone



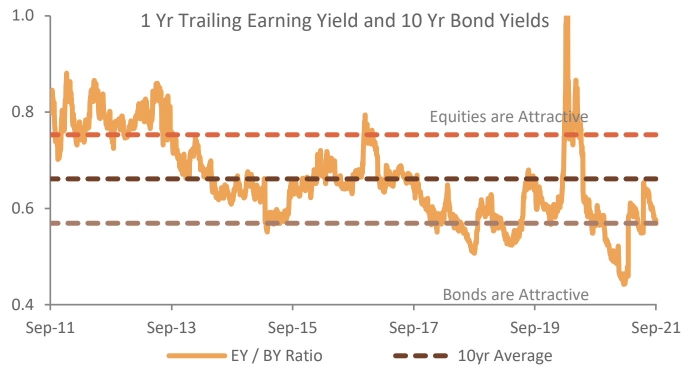
Non-Oil Imports (2yr CAGR: 7.7%) witnessed a sharp rebound



Source: Bloomberg, Sanctum Wealth

As highlighted above global central banks have indicated tapering in the coming months. But the pace is expected to be gradual, hence liquidity is likely to remain supportive equities for now. Flows have been supportive of equities with both foreign and domestic investors being net buyers so far this year. Technical indicators are also supportive of equities with markets touching new all-time highs regularly. However, this has led to valuations becoming even more expensive despite the rise in EPS numbers.

Equity valuations expensive relative to bond yields



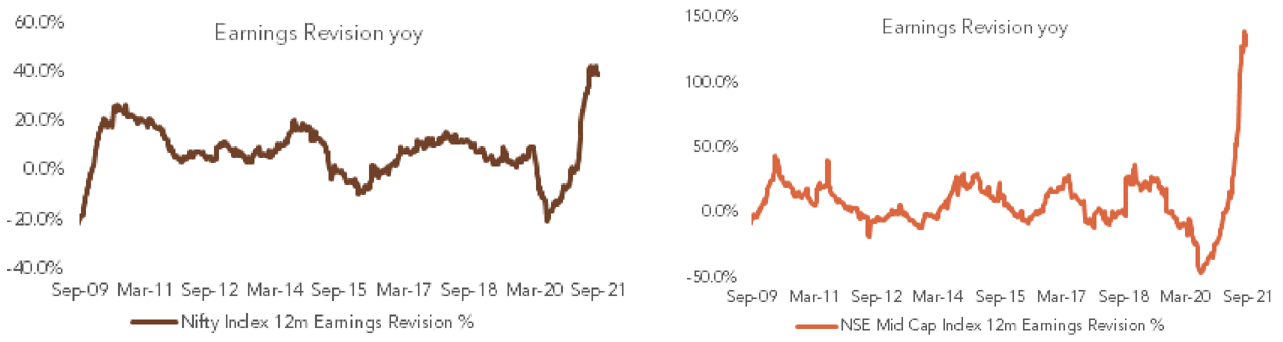
Overall, we believe, despite expensive valuations equities could remain supported given resilient earnings, supportive liquidity, and positive inflows. However, sustainability of earnings is critical given the valuations.

Large Cap Vs. Midcap

Earnings momentum stronger for midcaps

The earnings momentum has been sharper for midcaps, this has resulted in larger EPS upgrades for midcaps relative to large caps. Over the next 3 years, analysts expect higher earnings growth for midcaps relative to large caps. Midcaps are supported by the broader economic recovery. Also, since the unorganised sector was most impacted due to covid, midcaps will benefit from a shift to organised from unorganised.

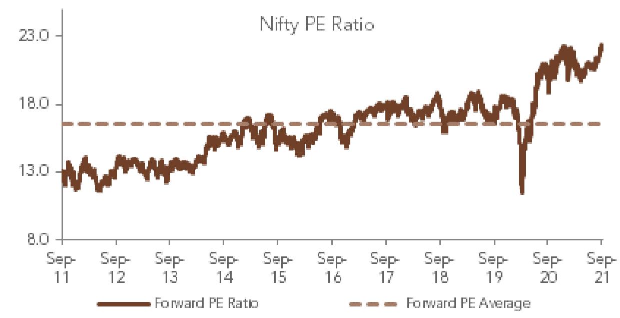
Midcaps have seen larger EPS upgrades than large caps



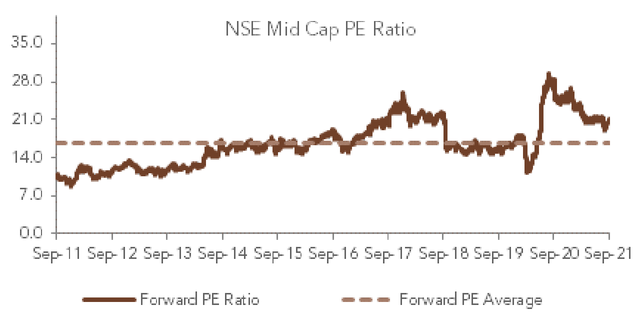
Source: Bloomberg, Sanctum Wealth

In terms of valuation, both large and midcaps are trading at a premium to historic averages. While Nifty is at a 35% premium to historic averages, midcaps are trading at a 25% premium to historic averages. Technical indicators are also mixed with RSI in favour of large caps and mid to large cap ratio in favour of midcaps.

Large caps are expensive



Midcaps equally expensive



Source: Bloomberg, Sanctum Wealth

In our model portfolios, we have been overweight midcaps for more than 6 months now. This has played out well for us. The midcap index has outperformed the large cap index by about 6-7% during this period.

Several investors missed out on the initial rebound after the crash of March 20 and invested back in equities in a staggered manner. The new highs in equity markets have aided confidence and we see larger chunks being committed to equities now. We are ourselves constructive on equities but we would implore investors to commit capital only if they can stomach volatility. Both sentiment and liquidity can pivot away from equities rather quickly and oscillating behaviour can make temporary losses permanent.

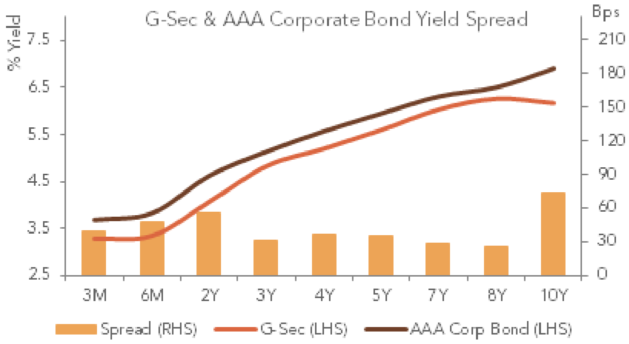
Fixed Income

Corporate Bonds Vs. Government Securities

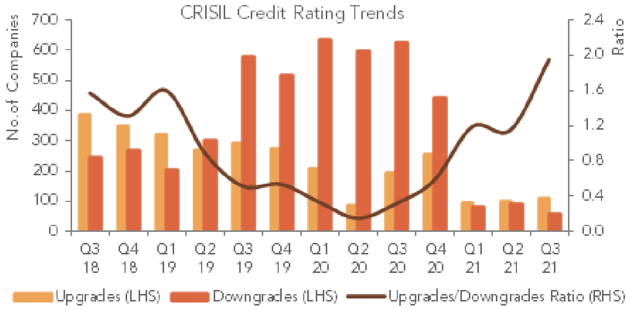
Neutral

Not much has changed for this asset pair. Credit spreads have remained low across the curve, barring some pick up in short-term spreads. Elevated government borrowing continues to be a key risk for government bonds. The credit environment, as indicated by the upgrade to downgrade ratio has improved further. Overall, we remain neutral for this asset pair.

Very little corporate spreads across the curve

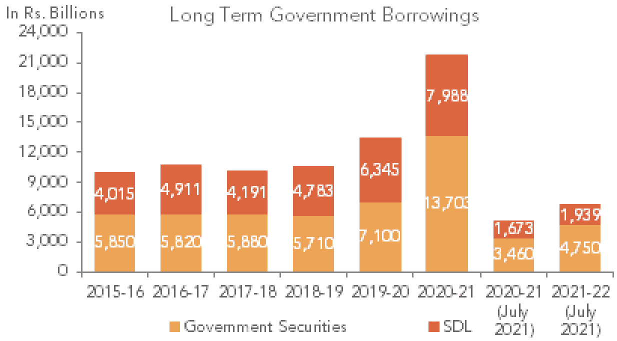


Credit environment improved further



Source: Bloomberg, Sanctum Wealth

Government borrowing biggest risk to government bonds



Source: Bloomberg, Sanctum Wealth

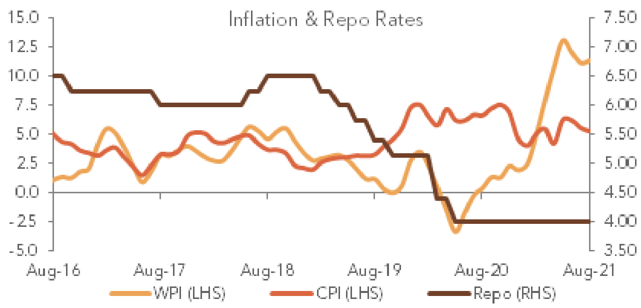
Short-term Vs. Long-term bonds

A barbell strategy

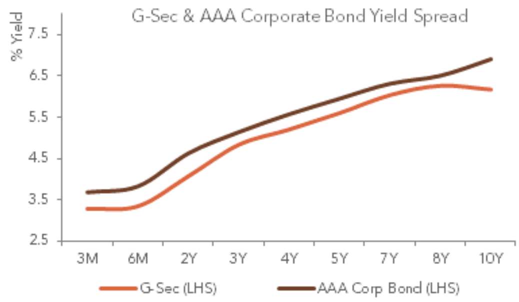
The yield curve has flattened slightly, especially the g-sec yield curve. This has resulted in short-term spreads rising slightly. However, the curve is still steep, hence there is significant yield pickup for taking higher duration.

On the other hand, elevated inflation and the imminent tapering of liquidity by global central banks are key risks to a duration call. Hence, in current times of low yield investors need to balance between safety by keeping the bulk of the fixed income assets in short term bonds and yield by looking at alternative sources to enhance yield.

Elevated inflation is a concern



Term spreads are attractive



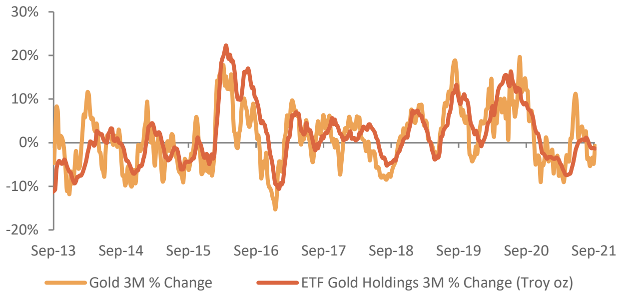
Source: Bloomberg, Sanctum Wealth

Gold Vs. Cash

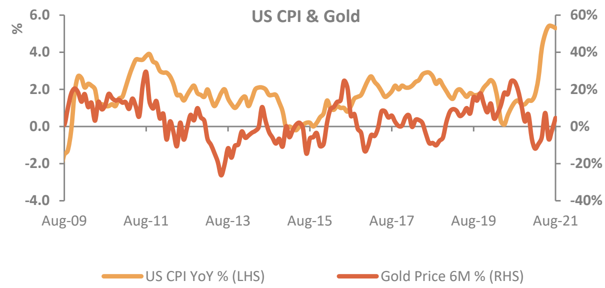
Marginally negative gold, but remains an inflation hedge

Gold scores declined this time with a fall in ETF holdings of gold, lower equity volatility, and some sign of dollar strength. However, we have highlighted multiples times before that inflation is a key risk we are watching. Gold tends to act as an inflation hedge. Hence, we remain neutral on gold in our wealth profiles.

ETF holding of gold has declined



Gold typically acts as an inflation hedge



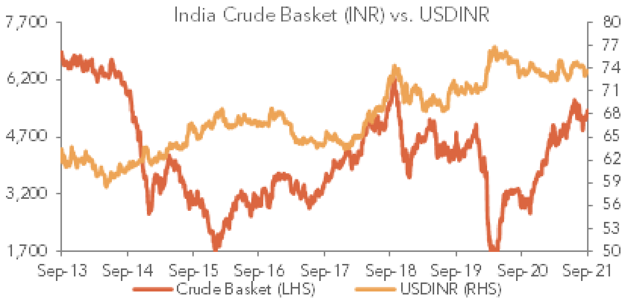
Source: Bloomberg, Sanctum Wealth

USD Vs. INR

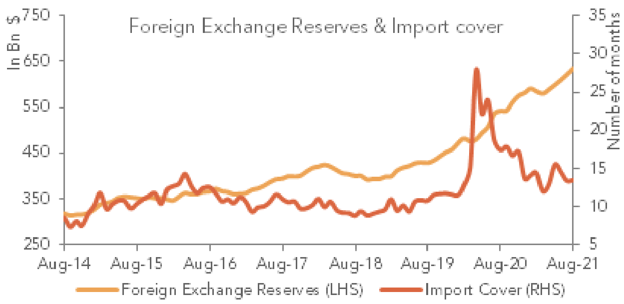
Neutral

Rising crude oil and other commodity prices have been negative for the INR. Recent USD strength has also added to pressures on the INR. On the other hand, strong FDI and FII flows (both in equity and debt) have supported the INR. Additionally, the RBI has been consistently adding to its FX reserves. This should allow the RBI to intervene in case there is significant volatility in the INR. Technicals also suggest a range-bound INR in the near term.

Rebound in crude prices a concern for the INR



FX Reserves continue to rise



Source: Bloomberg, Sanctum Wealth

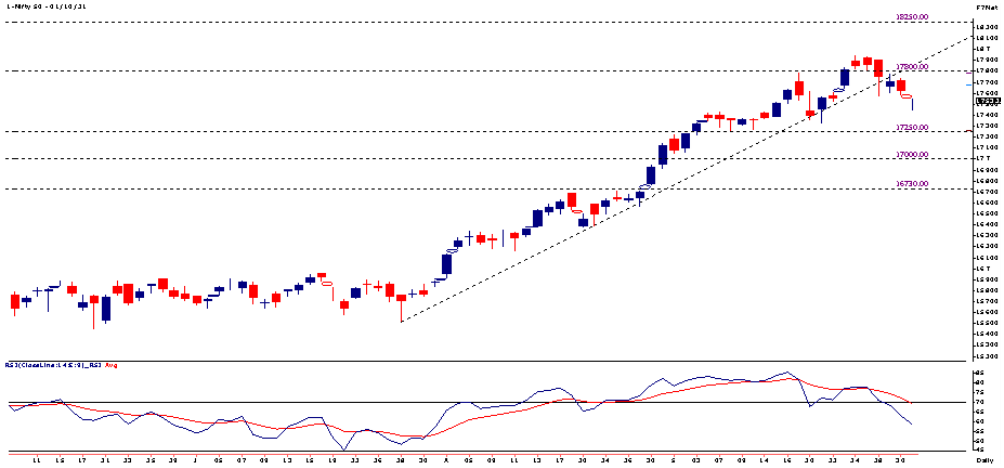
Summary of Our Asset Model

Asset Class Pairs	Scale											View
	-5	-4	-3	-2	-1	0	1	2	3	4	5	
Equity Vs. Bonds								X	←			Positive – Equity
Large Cap vs. Mid Cap					X←							Marginally Positive Midcaps
Corp Bonds Vs. G-Secs						X						Neutral
Short-Term Vs. Long-Term							X	←				Marginally positive- Short Term

USD Vs INR						X						Neutral
Gold Vs. Cash						X	←					Marginally Negative Gold

Technical Commentary

After hitting the all-time high of 17,948, the Nifty index corrected last week. In the adjacent daily chart, we can see that last week the Nifty broke below the rising support trend line from the late July low of 15513 and is now trading below it. But Index is yet to break the previous swing low and thus the higher top and higher bottom structure is being maintained. On 1st October we saw buying at lower levels, however, for the index to resume its upward move, it needs to cross 17,800. A break above this could suggest a move towards 18,250 levels.



Source: Falcon7

The Bank Nifty is facing resistance at 38,100 levels and hasn't been able to sustain above it. If the index holds 38,100 a rally towards 39,150 could be expected. Similarly, the BSE Midcap index is facing resistance at 25,450-25,650 levels, a break above 25,650 could suggest a move towards 27,000. BSE Smallcap between 3,674 and its all-time high of 3,867. For the index to resume an upward trend a break above 3,867 is needed.

Indices	Next Resistance Level	Key Resistance Level	Current Market Price	Initial Support Level
Nifty Index	18,250	17,800	*17,532*	17,450
BSE Midcap Index	27,000	25,650	*25,224*	24,800
BSE Small Cap 250 Index	4,055	3,867	*3,850*	3,674
Nifty Bank Index	39,150	38,000	*37,225*	36,500
Nasdaq 100 Index	15,260	15,000	*14,792*	14,450
USD Gold	1,840	1,810	*1,761*	1,710

* Current Market Price as of 3rd October 2021

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