



## Sanctum view

March 15, 2021

### Investment Strategy

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#### De-escalation or More Uncertainty

Many around the world are probably heaving a sigh of relief, as a de-escalation between Russia-Ukraine seems to be in sight. Perhaps, it's only wishful thinking for no one knows Putin's intent or endgame. Nonetheless, global sympathy lies with Ukraine and a barrage of sanctions have been announced against Russia. However, sanctions hurt both parties, the imposer and the imposed. Before further analysis a few facts about Russia:

Russia is the world's third-largest oil producer behind the United States and Saudi Arabia, the world's largest exporter of oil to global markets and the second-largest crude oil exporter behind Saudi Arabia<sup>1</sup>. Russia also makes up close to 45% of natural gas imports to Europe<sup>1</sup>.

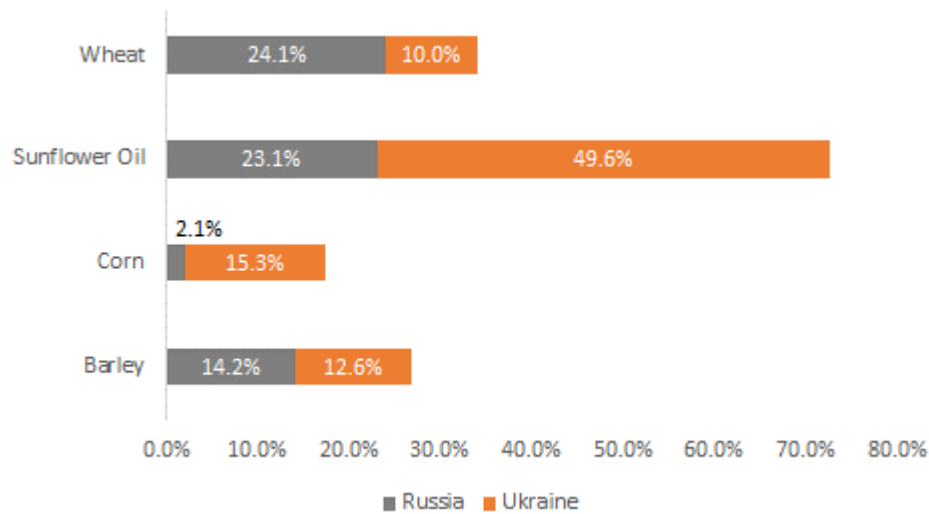
Russia and Belarus combined account for nearly a third of global Potash exports. Potash is an important ingredient in Fertilisers.

Russia and Ukraine's exports account for about 12% of total calories traded in the world, and the two countries are among the top five global exporters for many important cereals and oilseeds, including wheat, barley, and corn.

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<sup>1</sup> Source:IEA (2022), Russian supplies to global energy markets, IEA, Paris <https://www.iea.org/reports/russian-supplies-to-global-energy-markets>

Share of Russia and Ukraine in Key Agri Commodities



Source: International Food Policy Research Institute

Ukraine is the largest producer of Neon Gas and Russia of Palladium. These are used in semiconductors and automotives.

Since the invasion, commodity prices have been moving up at a rapid clip. Further, the sanctions on Russia and the destruction of infrastructure in Ukraine will add pressure to an already stressed global supply chain and the world will have to contend with higher inflation for longer.

China continues to be in deleveraging cycle and the growth target for 2022 set at 5.5% is the lowest in decades. Yet, it appears ambitious relative to the consensus target of 5.1%. China also appears to have been preparing for higher inflation and currently holds 84% of the world’s copper reserve, 70% of its corn, and 51% of its wheat.

The war and the sanctions will of course debilitate both China and Ukraine. But Europe will also be hit the hard. Global food security could emerge as a key issue over the next 2-3 years.

The IMF had already warned in October 2021 that the global recovery momentum was weakening on account of slower supply response to demand, and inflation. These issues are further exacerbated as discussed above and the US bond markets are already pricing in lower growth. This puts central bankers in an unenviable position. Economic tools to manoeuvre an economy out of stagflation (stagnating growth and higher inflation) are very limited. This is already reflected in the global risk-off.

Sanctions on a central bank and freezing of assets is unprecedented, this could lead to long term repercussion on how various nations around the world see FX reserve going forward.

Performance as of 8 <sup>th</sup> March 2022	Since 24 <sup>th</sup> Feb 2022	1 Month	3 Month	6 Month	1 Year	3 Year
Nifty 50 Index	-1.4%	-7.3%	-8.3%	-7.7%	7.1%	13.2%
S&P 500 INDEX	-2.8%	-7.8%	-11.3%	-7.6%	9.1%	15.0%
NASDAQ Composite Index	-5.0%	-9.9%	-18.9%	-16.3%	1.5%	20.0%
MSCI Europe Index						
MSCI Global Index	-3.9%	-9.2%	-12.4%	-11.8%	0.2%	9.8%
MSCI Emerging Markets Index	-5.1%	-10.1%	-11.7%	-16.6%	-16.2%	2.1%
Gold/US DOLLAR	7.7%	12.3%	15.0%	14.6%	21.8%	16.5%

Source: Bloomberg, Sanctum Wealth

The above returns are local currency price returns, returns for MSCI indices are USD returns.

Bond Yield as of 8 <sup>th</sup> March 2022	Current Yield	1 Month Ago	Change in bps
US 10 Year Bond Yield	1.85%	1.96%	-12
US 2 Year Bond Yield	1.60%	1.34%	-26

Source: Bloomberg, Sanctum Wealth

## Impact on India

Reliance on oil imports has been India's Achilles heel. The Union budget for FY23 had assumed oil prices around USD 75 and as we write this, oil is already at USD 130. This throws calculations awry. While the geopolitical premium in the oil price will settle down as de-escalation is within sight, the prices will remain elevated as supply contracts get redistributed.

In the past, similar sanctions were imposed on Iran. We had then obtained a waiver on Iranian oil sanctions and imported oil from them at discounts, mitigating some of the price escalations. These were scaled down only in 2019 after pressure from then US President Trump.

Russia continues to be of strategic importance to us and we have abstained from voting in the various UN meetings. We have also not imposed any sanctions. This could give us a window to continue buying oil from Russia and cushion some of the price escalations.

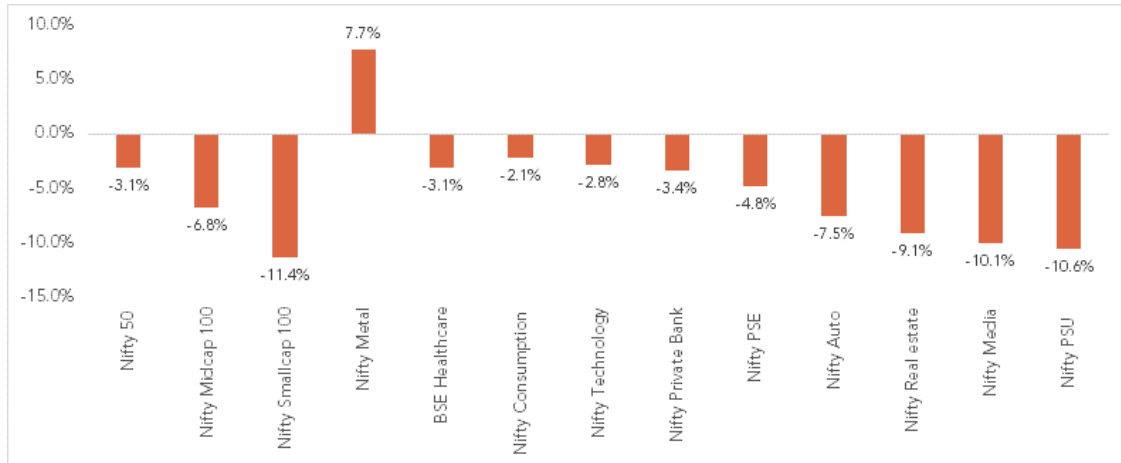
India is the second-largest producer of wheat and consumes only 2.4% of the global corn production. This also helps mitigate some of the food inflation pressures. India is also the world's largest producer of crude steel, with sanctions on Russia, the demand for steel produced in India has surged.

This however doesn't mean we are insulated. It means that potentially we could be less impacted than some of the other parts of the world.

As an aside, the Dragonbear (China-Russia strategic alliance) could pose challenges/difficulties to the present world order and on the counter raises India's strategic importance to the West.

## Equities

The global risk-off has hurt Indian equities as well. Except for Metals stocks that gained in February 22, selling has been broad-based:



Source: Bloomberg, Sanctum Wealth

Over 40% of BSE 500 stocks have declined more than 10% in Feb 22 alone. From the market peak of October 18th 2021, stock prices of 191 of BSE 500 companies have corrected over 20%. With all the troubling macro developments and the market correction, we went back to the drawing board to assess the impact on our key themes of 2022.

- **Manufacturing** – Diversification of supply chains away from China post the pandemic was one of the key factors supporting manufacturing. The recent crisis which has impacted supply chains of a few commodities is only likely to accelerate this process in favour of countries like India which are relatively large and politically stable economies.

The other factor supporting manufacturing is the Indian government’s push for manufacturing self-sufficiency via the AatmaNirbhar Bharat, Make in India and PLI schemes. Additionally, the Union budget of 2022 re-iterated the government’s focus on capex and infrastructure build-out. We don’t think this gets derailed by the recent crisis but there could be a delay in the new capex announcement or slight deferment in execution till the geopolitical issue deescalates.

- **Formalisation**– As highlighted earlier inflationary pressures to get accentuated by the crisis. This would increase raw material costs for a lot of companies. We believe the larger and stronger player in each industry would be able to absorb and, in some cases, pass on these costs to the end consumers and see lower margin compression. The smaller and marginal players would find it difficult to manage margin decline pressures thus further accelerating market share gains for the organised sector.
- **Housing** – After eight straight years of downturn, the sector started showing signs of revival in 2021. Time correction of housing prices over the last decade, wage growth, lower interest rates and favourable demographics point towards a confluence of factors that could support a multi-year housing cycle. The government continues to prioritize the affordable housing segment with additional Rs 48000 Crs under the Pradhan Mantri Awas Yojana for construction of 80 lakh new affordable homes.

While the multi-year cycle has just begun, in the near-term building materials and real estate companies will see some price escalation in their input costs depending upon their product mix.

We have had concerns about inflation for a few months now and hence were holding 10% weight of Gold in our model portfolios. Even as the FII selling intensified in January and early part of February we were clear, we did not want to underweight equities since we were constructive for the longer term. For a brief period, the

reaction of the West was perceived as lukewarm, and markets recovered most of the initial losses. We used that opportunity to equal-weight equities and add to gold. With markets selling off, several pockets of opportunity are beginning to appear.

## Conclusion

**Equities:** Nifty valuations have moderated to 19x FY 23 earnings and are closer to the 10-year average p/e. However, some downward earnings revision is expected and hence the forward PE will get revised accordingly. As highlighted above we are neutral equities in our model portfolios. Additionally, given our expectations of volatility over the next couple of quarters, we recommend staggering the investments. We will evaluate the contagion effect of dislocation arising out of the sanctions and review the stance on equities, if required.

**Fixed Income:** We have been recommending investors to build a portfolio that combined mark-to-market and non mark-to-market instruments. We have consistently maintained a barbel approach for the past several months.

**Gold:** We continue to be constructive on gold even if the ongoing war de-escalates. The threat of sustained elevated inflation is real, and gold could help buffer portfolios.

Our tactical asset allocation calls as reflected in our model portfolio have delivered consistent, superior risk adjusted returns. In a tough environment, even the conservative risk profile (Wealth Shield) has delivered a 250bps outperformance over the last year.

February 28, 2022	1 Month	3 Month	6 Month	1 Year	3 Year	5 Year
Wealth Shield	0.8%	1.9%	3.9%	10.1%	10.7%	9.6%
Benchmark	0.2%	0.6%	1.7%	7.5%	9.5%	8.2%
Outperformance	0.6%	1.3%	2.2%	2.6%	1.2%	1.4%

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