Quarterly Investment Policy Committee (IPC)
Oct-20 :
The great expectations rally!

Oct 20, 2020

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Research, ASKWA
Quarterly Investment Policy Committee (IPC) – Neutral Equity; Overweight Fixed Income; Underweight Alternatives

A. Economy: Recovery apace but medium term weakness
   1. ACAI shows pace of recovery quickened in Sep-20
   2. Govt. and corporate on weaker footing
   3. Chinks in the growth story
   4. Back to basics growth strategy: Reform scorecard
   5. Current pursuit: Building a globally competitive manufacturing sector
   6. Geopolitical imperative of China import substitution

B. Neutral on equity
   1. Equity market has recovered but the pace of recovery slowed
   2. Sector performance has diverged further
   3. Volatility is staying high
   4. Valuations are at all time peak
   5. Earnings recovery on high hopes
   6. Flows have been fluctuating and don’t show any spike
   7. US election – what is there for us
   8. The risk of second wave before vaccine availability

C. Overweight on Fixed Income
   1. Yield curve brought down to Jul-20 levels
   2. RBI takes care of remaining concerns of bond market

E. Underweight Alternatives
   1. The relationship of gold with other financial variables weakened somewhat
   2. INR may not propel similar type of toppings on Dollar return
1. The pace of recovery has quickened in Sep-20. But the medium term growth prospect has weakened on account of falling saving and investment and weak financial position of the Government and the corporates constraining their ability to act as growth drivers.

2. Meanwhile the momentum of recovery in the equity market has slowed down and there has been some sector rotation. Volatility and valuations remain high while earnings expectations hasn’t materialized for long. Flows remain volatile and much less than expected. Meanwhile Covid-19 cases have surged again in Europe/US and have crossed 7.5m in India. We stay neutral on equity but have turned overweight on financials due to higher margin of safety.

3. On the fixed income side Government borrowing stay within limits anticipated earlier. A slew of measures by RBI has eased the benchmark rates and kept various spreads rangebound. As the inflation and liquidity pressures ease in the second half, we expect pressure to ease further. Hence we stay overweight on fixed income with a bias for duration play at the mid segment in Gsec and AAA space.

4. In the alternative space, the relationship of gold with usual financial variables have weakened somewhat. Due to India’s current strategy for import substitution and capital flow prospect, INR outlook has changed and unlikely to provide similar topping on dollar returns. We have turned underweight on gold. We stay underweight on absolute return strategies and neutral on REIT.
Acai shows pace of recovery quickened in Sep-20

Many a indicators have started turning up

ASCI Composite Activity Index (ACAI) recovery gathering pace

- ACAI shows indication of economy bottoming out in Apr-2020 and after relatively sharp recovery in May-20 and Jun-20. While it slowed down somewhat during Jul-20 and Aug-20, early indication point to recovery gaining pace in Sep-20.
- Electricity demand showed YoY growth. Rail freight grew sharply. Import of telecom instruments too revived. On the financial sector, double digit deposits growth was preserved while first year premium of life insurance companies spiked. Exports, trade balance and foreign investment flows too were buoyant.
- However, residential real estate, bank credit growth, corporate ratings, central government tax and expenditures were areas yet to show any traction at present.

Note: The ASCI Composite Activity Indicator (ACAI) is a comprehensive tracker of the economy with a data dashboard of 36 key indicators of the economy covering nearly all aspects of the non-agricultural economy including energy, manufacturing, investments, real estate, infrastructure, foreign trade & investments, transports, financial services, and measures of corporate and government financial health and household well being. The number of variables that are at (yellow), above (green) or below (red) their historical average for the period, provides a good guide to the state of the economy. The aggregate of the 36 indicators into a single index - ACAI incorporates the extent of variation in the variables apart from their direction of change. ACAI is meant to serve as a more recent (nowcasted) and alternative measure of economic activities to be available before the GDP data is released for the quarter.

Sources – CMIE, RBI, Govt, Bloomberg, ASKWA Research.
However, Govt. and corporate on weaker footing

**One of the weakest fiscal effort**
- Increase in 2020 Fiscal Deficit
- General Govt. deficit (2020)

**Corporate sector focused on deleveraging**
- D/E
- Interest coverage (RHS)

**Despite manageable debt level**
- Increase in 2020 Public Debt
- Public Debt (2020)

**Amidst rising NPAs**
- Gross NPAs

Sources – CMIE, IMF, ASKWA Research
Chinks in the growth story

Real sector growth stagnated at 5%

Slow structural transformation

The phenomenon of Jobless growth

Global trade prospects weak

Sources – CMIE, WTO, ASKWA Research
## Back to basics growth strategy: Reform scorecard – Pt 1

<table>
<thead>
<tr>
<th>Reform</th>
<th>Assessment</th>
<th>Performance</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Indirect tax : GST</td>
<td>Largely accomplished but needs fine tuning and adherence to rule based approach</td>
<td><img src="green.png" alt="Green" /></td>
<td>5</td>
</tr>
<tr>
<td>2. Direct tax : DTC</td>
<td>Direct Tax Code effectively implemented for the corporate sector, tax rate lowered</td>
<td><img src="green.png" alt="Green" /></td>
<td>5</td>
</tr>
<tr>
<td>3. Doing Business</td>
<td>Progress in certain aspect marred by its lack in other areas, crucially dependent on States</td>
<td><img src="yellow.png" alt="Yellow" /></td>
<td>3</td>
</tr>
<tr>
<td>4. FDI</td>
<td>Largely liberalised for most sectors with some strategic limits</td>
<td><img src="green.png" alt="Green" /></td>
<td>5</td>
</tr>
<tr>
<td>5. Subsidies</td>
<td>Petroleum subsidy nearly eliminated; now taxed heavily</td>
<td><img src="green.png" alt="Green" /></td>
<td>5</td>
</tr>
<tr>
<td>6. Bankruptcy law</td>
<td>IBC/NCLT is the most successful way of handling corporate stress. Capacity needs to be enhanced.</td>
<td><img src="green.png" alt="Green" /></td>
<td>5</td>
</tr>
<tr>
<td>7. Bankruptcy for financial firm</td>
<td>Law passed, implementation awaited</td>
<td><img src="yellow.png" alt="Yellow" /></td>
<td>3</td>
</tr>
<tr>
<td>8. NPA resolution</td>
<td>NPAs have remained high amidst high real interest and slowing economy</td>
<td><img src="red.png" alt="Red" /></td>
<td>1</td>
</tr>
<tr>
<td>9. Privatisation</td>
<td>While better than previous attempts, the disinvestment proceeds fallen short of target. Overdependence on share sale in lots than privatisation.</td>
<td><img src="yellow.png" alt="Yellow" /></td>
<td>3</td>
</tr>
<tr>
<td>10. RERA</td>
<td>Helped the real estate sector transformation to an organised one</td>
<td><img src="green.png" alt="Green" /></td>
<td>5</td>
</tr>
</tbody>
</table>

*Sources Media, CMIE, Bloomberg, ASKWA Research*
### Back to basics growth strategy: Reform scorecard – Pt 2

<table>
<thead>
<tr>
<th>Reform</th>
<th>Assessment</th>
<th>Performance</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>11. Land availability</td>
<td>Significant progress in digitising record, creation of land bank despite challenges from State governments</td>
<td>🟠</td>
<td>5</td>
</tr>
<tr>
<td>12. Labour reform</td>
<td>Code simplified, laws enacted despite significant challenges</td>
<td>🟠</td>
<td>5</td>
</tr>
<tr>
<td>13. Agricultural reform</td>
<td>Laws to liberalise agricultural market enacted despite significant challenges; food inflation lowered substantially</td>
<td>🟠</td>
<td>5</td>
</tr>
<tr>
<td>14. Mining</td>
<td>No major success post the initial auctions, Private sector mining permitted</td>
<td>🟥</td>
<td>1</td>
</tr>
<tr>
<td>15. Priority sector lending</td>
<td>Norms relaxed</td>
<td>🟠</td>
<td>3</td>
</tr>
<tr>
<td>16. Power sector reform</td>
<td>UDAY scheme met with some initial success but some fundamental issue of Discom viability have stayed.</td>
<td>🟠</td>
<td>3</td>
</tr>
<tr>
<td>17. NBFCs and Cooperative banks</td>
<td>Weaknesses persist while financial market stability has been ensured</td>
<td>🟥</td>
<td>1</td>
</tr>
<tr>
<td>18. Filling up Judicial vacancies</td>
<td>Tardy progress</td>
<td>🟥</td>
<td>1</td>
</tr>
<tr>
<td>19. Digitising judiciary</td>
<td>Tardy progress</td>
<td>🟥</td>
<td>1</td>
</tr>
<tr>
<td>20. Transfer pricing</td>
<td>Work in progress</td>
<td>🟥</td>
<td>1</td>
</tr>
</tbody>
</table>

**Total** 26

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Sources: Media, CMIE, Bloomberg, ASKWA Research
Current pursuit: Building a globally competitive manufacturing sector

<table>
<thead>
<tr>
<th>Enablers</th>
<th>Competitiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Correcting inverted duty structure</td>
<td>R&amp;D and skill development (TAFP and TADP programmes), M&amp;A to promote tech acquisition</td>
</tr>
<tr>
<td>Public procurment (20-30% of GDP), move to EU norm of &quot;price quality ratio), Favour MSME</td>
<td></td>
</tr>
<tr>
<td>Efficient customs and procedures</td>
<td>Industrial cluster development</td>
</tr>
<tr>
<td>Reliable standards and certification</td>
<td>WTO compliant incentives (capital, R&amp;D subsidy) vs. sector specific e.g., EHTP, EOU, SEZ, EPCG</td>
</tr>
<tr>
<td>Doing business, enforcement of contract, judicial process, state reforms</td>
<td>Improve global mfg competitiveness rank to 5th from 11th on 2016</td>
</tr>
<tr>
<td></td>
<td>Graduation/sunset clause and trigger mechanism to FTAs</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Then</th>
<th>Now</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very restrictive FDI regime</td>
<td>Soliciting FDI with near full liberalisation</td>
</tr>
<tr>
<td>Inward looking – producing mainly for domestic market</td>
<td>Producing for domestic market and crucially exports</td>
</tr>
<tr>
<td>Global trade regime was very restrictive, and countries could follow their own policy</td>
<td>WTO regime places restriction to the extent to which countries can follow trade-restrictive policies</td>
</tr>
<tr>
<td>Reliance on State monopolies to deliver on crucial sectors</td>
<td>Far higher reliance on private sector to deliver</td>
</tr>
<tr>
<td>Had choice to be more open</td>
<td>Trade-war limited possibilities of export-led growth</td>
</tr>
<tr>
<td>Markets worked under a lot of restrictions.</td>
<td>Factor market largely unlocked with latest series of changes.</td>
</tr>
</tbody>
</table>

Sources: Media, Exim Bank, ASKWA Research
Geopolitical imperative of China import substitution

Note: Word cloud map from news headlines from Google search on “India China” extracted on October 2, 2020
Equity market has recovered but the pace of recovery slowed

Sources: CMIE, Bloomberg, ASKWA Research
Sector performance has diverged further

Sources: CMIE, Bloomberg, ASKWA Research
Volatility is staying high

Source: Bloomberg, ASKWA Research
Valuations are at all time peak

Sources – CMIE, Bloomberg, ASKWA Research
Earnings recovery on high hopes

Sources – Bloomberg, ASKWA Research
Flows have been fluctuating and don’t show any spike

FIIs flows have been volatile with debt sell off

Even FIIs equity flows are not outsized by historical standards

MFs have been selling in equities

Flows by other institutions are also not high

Sources – CMIE, Bloomberg, ASKWA Research
US election – what is there for us

Democrats’ have fared better for the market but there could be more factors at play

Evidence is mixed for Indian markets highlighting dominance of other factors

<table>
<thead>
<tr>
<th>Appointment</th>
<th>President</th>
<th>Party</th>
<th>Sensex</th>
<th>S&amp;P 500</th>
<th>Sensex</th>
<th>S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>20-Jan-81</td>
<td>Ronald Reagan</td>
<td>Republican</td>
<td>147</td>
<td>132</td>
<td>19.9</td>
<td>10.2</td>
</tr>
<tr>
<td>20-Jan-89</td>
<td>George H. W. Bush</td>
<td>Republican</td>
<td>632</td>
<td>287</td>
<td>41.5</td>
<td>10.9</td>
</tr>
<tr>
<td>20-Jan-93</td>
<td>Bill Clinton</td>
<td>Democratic</td>
<td>2532</td>
<td>433</td>
<td>6.5</td>
<td>15.2</td>
</tr>
<tr>
<td>20-Jan-01</td>
<td>George W. Bush</td>
<td>Republican</td>
<td>4194</td>
<td>1343</td>
<td>10.2</td>
<td>-6.2</td>
</tr>
<tr>
<td>20-Jan-09</td>
<td>Barack Obama</td>
<td>Democratic</td>
<td>9101</td>
<td>805</td>
<td>14.6</td>
<td>13.8</td>
</tr>
<tr>
<td>20-Jan-17</td>
<td>Donald Trump</td>
<td>Republican</td>
<td>27035</td>
<td>2271</td>
<td>10.6</td>
<td>11.2</td>
</tr>
<tr>
<td>10-Oct-20</td>
<td></td>
<td></td>
<td>40509</td>
<td>3477</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Macrotrends, Bloomberg, ASKWA Research
The risk of second wave before the vaccine availability

Sources – Worldometer, ASKWA Research
Fixed Income: Yield curve brought down to Jul-20 levels

Yield curve softened between Apr-20 to Jul-20

Current yield curve brought down to that level again

No surprise on the borrowing programme

Scope of drop in yield in mid-maturity

<table>
<thead>
<tr>
<th>Amount of borrowing (INR tn)</th>
<th>Centre</th>
<th>States</th>
<th>Total net borrowing</th>
<th>Total gross borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY20</td>
<td>4.7</td>
<td>9.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FY21 E</td>
<td>4.9</td>
<td>8.0</td>
<td>17.5</td>
<td>21.4</td>
</tr>
</tbody>
</table>

| Sources – CMIE, Bloomberg, Media, ASKWA Research |
1. Assurance of accommodative stance for extended period
2. Explicitly mentioning that the inflation hump would be looked through
3. On Tap TLTRO of INR 1tn to be reviewed later
4. OMOs in SDLs
5. Strong moral suasion
6. Increased limit of HTM in SLR
7. Increased size of OMO auctions
8. Conduct of OMOs to stabilize yield than to infuse further liquidity
9. Secondary market sizable OMO operations
10. Bias to mid-duration for auctions bringing yields down in that segment
11. Signaling through auction devolvement
12. Tightening transmission to ensure that rate cuts are fully reflected across market segments over a period of time

Sources RBI, Media, CMIE, ASKWA Research
Gold: The relationship of gold with other financial variables weakened somewhat.

- **Gold cycles are long and contains a bet on INR**
  - Gold (USD) vs. US 10-yr yield (Correl: -89%)
  - Gold (INR) vs. USD (Correl: -46%)
  - Gold (USD) vs. SPX Index (Correl: 59%)
  - Gold (INR) vs. SPX Index (Correl: 3% since 2012)

**Sources** - Bloomberg, CMIE, ASKWA Research
INR may not propel similar type of toppings on Dollar return

Large Rupee depreciation happened during CAD drop

Targeted reduction in trade deficit

No need to depreciate the currency with current REER/NEER

Sources – Bloomberg, CMIE, ASKWA Research
Strategy: Neutral Equity; Overweight Financials

**Equity:**

1) There has been some weakening of the medium term drivers of growth in India including a drop in saving and investment ratios and stagnation of the real sector. Fiscal constraint has led to one of the restrained Covid-19 response from the government while private sector is yet to emerge from its cycle of deleveraging.

2) The policy to revive manufacturing through a combination of Make in India initiative along with import substitution attempts to add new levers to growth. A slew of reforms undertaken provides the backdrop. The geopolitical tension with China makes such a growth strategy an imperative while in the near term it is a risk to the equity market.

3) Equity market recovery momentum has weakened somewhat and there has been some trend change in sectoral performance in the last quarter.

4) Both volatility and valuation has remained high in equity market in the post recovery phase. Earnings growth has been at low single digit for last six years although expectation for a sharp recovery stays afloat. Flows too has been volatility without clear upsurge.

5) US elections is likely to create some near term volatility in the market. A surge in Covid-19 cases abroad is another source of uncertainty for the equity market.

In view of the accumulated risks in the market we would stay neutral on the market. However, in view of the higher margin of safety in the financial sector amidst recent corrections and signs of recovery, we are overweight on the space.

Sources – ASKWA Research.
**Fixed Income market:**

1) The revised FY21 borrowing by Centre and the States now stands at near INR 22 tn vs. 11.5 tn of FY20. However, there hasn’t been hike since the previous estimates and includes increased borrowing by the Centre for GST compensation.

2) Higher capital flows coupled with continued OMOs from RBI have ensured high deposits growth for the banks unmatched by credit growth which remains muted. This would keep SLR demand high from banks.

3) RBI has undertaken a slew of measures to stabilize the yields effectively making sure that the benchmark 10yr yield moves below the upper band of 6%.

4) RBI has also conducted the borrowing programme across maturity basket in such a way that it does not generate any undue stress at any particular market segment. The OMO in SDL is another measure to have a salutary impact on the yield spreads.

Given the strong bias of RBI to see rates lower and inflation risks eventually tapering off, we stay with our 10yr benchmark Gsec forward guidance at 5.00% to 6.50% and maintain our **overweight stance on fixed income**. As before, the strategy should be geared towards high quality Gsec and AAA in the 3-5 year maturity bucket, and locking in yields across highest rated instruments at the short end of the curve. We stay underweight on credit given the impact of crisis on credit environment.

**Cash:**
We stay underweight on cash to accommodate for stance for other asset classes.

Sources – ASKWA Research.
Gold:
1) Gold is typically negatively correlated with other financial assets viz., including USD, S&P and bond yield. The equity market has recovered the lost ground to new heights and the peak of volatility is also behind us.
2) Thus in recent times there has been some weakening of these relationships.
3) As the lower bound on US interest rate has neared and US equities have run up too the relative attractiveness of gold has dimmed. USD has weakened and the prospect of US economy and market do not point to secular downtrend of USD.
4) INR outlook too is altered now as there has been concerted attempt to reduce trade gap through import substitution strategy and overall trade also slowed down resulting in current account surplus for two consecutive quarters. Besides there is no urgency now to follow a depreciation policy with REER/NEER valuation been rangebound.

In view of weakening of the relationship between gold and other financial variables and relative higher valuation we have turned underweight on gold.

Absolute return:
With the period of extreme volatility ahead us and increased tax incidence, we remain underweight on Absolute returns strategies.

REIT:
With the overhang of issues due to Covid-19 uncertainties we stay neutral on REIT.

Sources – ASKWA Research.
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