Dear Investor,

The year FY23 ended on a somber note for Equity markets with both Sensex and Nifty ending almost flat, albeit after two back-to-back years of solid returns. From a long-term standpoint, over the last five-and ten-year horizon, the Nifty50 yielded healthy double-digit returns of 11.4% and 11.8% CAGR in INR terms, respectively. The ten-year market performance data through FY14-23 clearly reinforces the futility of timing the markets and rather staying invested to reap the benefit of compounding over a long-term horizon. Going forward, while the markets over the near-to-medium term are unnerved by macro concerns and heightened uncertainties across the globe, investors will do well by staying invested. Uncertainties refuse to go away, with the month of March seeing failure of regional banks in US, taking over Credit Suisse by UBS.

Are Global Markets oblivious to the pains in the banking sector?

Surprisingly for many, March was a positive return month for global equities. This was in spite of few regional banks failing in the US (Silicon Valley Bank and Signature Bank; additionally, Silvergate Bank is also going through a liquidation process) and the second largest bank in Switzerland, Credit Suisse, having to be rescued (now taken over by its larger rival UBS, after government involvement). While the timely intervention by the US Federal Reserve stemmed any negative consequences on the larger economy from the banking sector issues, the markets were likely enthused by the possibility of the Fed rate hiking cycle coming to an end and in fact are now pricing-in the possibility of cuts in 2023 (though the Fed has clearly ruled it out).

The markets at the moment seem to be weighing two broad aspects currently as far as the US Fed is concerned-

The first, that the Inflation fight is not over:

- Inflation in the US at ~6% is far higher than the stated target levels of 2%
- While the 2% target is likely not achievable in the visible horizon, the Fed is trapped in its own narrative and might not want to be seen to give-in on its fight against inflation.
- Hence, at least one more of the lower quantum hike of 25 bps might be required (the Fed however has indicated in its last meeting that it can hike more than what the dot plot indicates if the conditions warrant).
- The second, that the regulatory regime has to be benign:
- The US Fed will have to take cognizance of the negative fallouts of the large quantum of hikes (450 bps since the hiking cycle began about a year ago) already taken, which manifested itself in the recent regional banking crisis.
- Also, recent events have already tightened credit conditions further, a fact that the Fed itself has noted in its recent meeting.
- Furthermore, regulators and governments may intervene to resolve any crisis and take all necessary measures to mitigate the impacts of accidents, if any.

The second aspect is clearly the more dominant one now and that is what the market is betting on. This along with a downward inflation trajectory in the US (inflation has consistently fallen from the peak of 9.1% in June-2022 to 6.4% in January-2023 and 6% in February-2023) and weak economic sentiments (recessionary fears in the US) is keeping market feelings buoyant on benign global liquidity. Although inflation is likely to remain higher than comfort levels (the Fed’s assessment of inflation has not changed and it has said that inflation remains ‘too high’; high inflation is driven by the services sector, which would reduce only with softening of demand or weak labor market conditions), the markets are believing that ultimately the regulatory regime will be fine to go along with a less-worse problem.

Before the Silicon Valley Bank crisis, the markets were pricing in a peak Fed Funds rate of 5.6%, and this has now come down to 5.1%. Before the crisis, the Fed was reportedly thinking about a 50-bps hike, while it delivered a hike of 25 bps in March, post the crisis. Before the crisis, it was thought that there might be an uptick in the dot plot as well for 2023, while the dot plot has remained flat.

In addition to the likely peaking of the cost of capital, the markets are also cheering the likely increase in liquidity. The liquidity support provided by the US Fed to the banking sector led to an enlargement of its balance sheet and reversed about one-third of the Quantitative Tightening (QT) that it had done so far. So, while the US Fed continues with its QT program of reducing its bond holdings by up to USD 95 billion a month, its effectiveness has basically been put on hold for a few months.

Further, the markets have also taken a lot of comfort with the speed and timeliness of actions taken by the various governments and regulators, that have worked in tandem, to ensure that there is no damage to the overall financial system. Whether it be protecting all the deposit holders of the failed banks, or in engineering a quick takeover of a large entity like Credit Suisse, or in assuring to provide sufficient liquidity to the entire banking system if and when required. The markets now have the faith that if there are any more incidents, the authorities are competent and agile to localize and manage the same.

On the domestic front, 3QFY23 Current Account Deficit (CAD) eased to US$18.2 bn (2.2% of GDP from 3.7% of GDP in 2QFY23), led by improvements in goods trade deficit and net service exports. Goods trade deficit narrowed to US$72.7 bn (2QFY23: US$78.3 bn), amid a sharper fall in imports compared to exports due to fading of pent-up demand and lower crude oil prices. Services exports continued to trend higher, led by software services and professional and management consulting. Net invisible inflows increased to a record quarterly high of US$54 bn. Additionally, 2QFY23 CAD was revised down to US$30.9 bn (3.7% of GDP) from US$36.4 bn (4.4% of GDP) due to lower imports (US$190 bn compared with US$196 bn earlier). 9MFY23 CAD/GDP was at 2.7% (9MFY22: -1.1%). 4QFY23 current account can turn positive.

Current account pressures have been easing since October 2022, driven by:

- Sharp moderation in commodity prices, especially crude oil prices.
- Fading festive demand, leading to lower core imports.
- Continued improvement in services trade surplus.

Furthermore, in FY2024, weaker global demand to weigh on exports, whereas lower global commodity prices will aid a lower import bill. Services trade surplus should remain steady unless the Developed Markets see a sharp recession or financial sector stress. Accordingly, we believe CAD/GDP for FY2024 can remain steady at between 1.5% and 2.0% (vs 1.8% in FY23). This may take away some pressure from the currency.

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Valuations and Flows

In March, after flattish Foreign Institutional Investors (FII) flows in the previous month, Indian markets saw FIIs net buying to the extent of USD 1.4 bn. Higher allocations could have been driven by relative attractiveness of Indian markets post recent underperformance as well as re-balancing of portfolios post net selling for the previous three months. Domestic Institutional Investors (DII) invested a net of USD 1.3 bn in the month of March, led by strong retail participation with USD 1.7 bn worth of SIP inflows.

The Nifty's 12-month forward PE ratio at ~17.6x is now at about 10-year historical averages. This is with an earnings growth outlook of low to mid-teens over the next couple of years. Recent improvements in the country's external balances, weakness in commodity prices and correction in crude, augur well for the domestic macros. This in turn are likely to support margins (likely to have bottomed out in the previous quarter) led earnings growth.

The long-term earnings growth trajectory for our investible universe remains significantly higher and robust. Our focus remains only on companies with high-quality businesses and superior Returns on Capital. As the economy continues to gain strength over the years, we expect the same to be reflected in our portfolios.

Happy investing.

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Mr. Sumit Jain
Deputy CIO, ASK Investment Managers Ltd

ASK Investment Managers

Investment Approach Update

Global markets continued to remain volatile driven by adverse news flow on bank failures in US (Silicon Valley Bank and Signature Bank) and troubles at Credit Suisse coupled with stickiness in inflation which led to the Federal Reserve continuing to tighten interest rates. On the domestic front too, inflation continues to remain over the comfort zone of the RBI.

On the portfolio performance front, the benchmark ended lower by ~0.1% with our portfolio underperforming the benchmark. The key outperformers during the month were ICICI Bank, HDFC Life Insurance Company, Cholamandalam Investment and Finance, and HDFC Bank while the key underperformers during the month were Bajaj Finance, Bajaj Finserv AU Small Finance Bank and SBI Life Insurance and Navin Fluorine Limited.

FY2023 has ended on a tepid note with the benchmark index ending higher by 5.7% with our portfolio underperforming the benchmark. The underperformance is despite a very strong financial performance with 9MFY23 profit growing by +30% YoY driven by improvement in loan growth, Net Interest Margin (NIM) expansion and easing asset quality concerns. Hence, we believe that the underperformance is result of rise in cost of equity as interest rates worldwide have inched up dramatically over the fiscal which seems to have translated into contraction in valuation multiples of quality companies.

Going forward all eyes will be on the ensuing Q4FY23 result season wherein we expect continued healthy loan growth and further NIM expansion to drive healthy NII growth. This along with further easing in provisions should drive strong bottom-line growth. As we look forward to FY24, the expectation is that the bottom-line growth will begin to converge with loan growth as 1) NIM expansion is likely to peak out and 2) favourable base effect of provisions is largely behind us.

Over the medium to long term, we believe that various regulatory/fiscal initiatives taken in the past few years coupled with structural transition in the manufacturing sector (favourable policy environment coupled with opportunities from shift in global supply chain) will translate into acceleration in GDP growth. This in turn should create growth opportunities for financial services companies.

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